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A CONTEMPORARY CONCEPT OF MONETARY SOVEREIGNTY

Claus D. Zimmermann

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A Contemporary Concept of Monetary Sovereignty

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A Contemporary Concept of Monetary Sovereignty

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To my beloved wife Marine

General Editors' Preface

One of the central paradoxes laid bare by the financial storms of the past decade is the fact that many States are seeking to strengthen their capacity for economic self-determination by pooling their powers in some form of economic or monetary cooperation. Like most paradoxes, this one underlines the lack of focused thinking on the core concepts. The collision of the shibboleth of 'sovereignty' with the arcana of the international monetary system unleashes powerful forces of confusion and obscurity.

Claus Zimmermann has undertaken a brave and pioneering attempt to bring clarity and order to this subject, at once one of the most pervasive and least understood areas of international law. His development of the idea of cooperative sovereignty clears the ground for a debate on the proper role of international law in relation to national economies. While his focus and his analytical framework are those of the international lawyer, his analysis should be of interest to all who try to articulate the precise nature of the problems facing the international economy and the range of institutional responses to those problems.

AVL

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Foreword

In recent years we have witnessed seismic changes in the international monetary system. Financial innovation, globalization, regional integration, monetary union in Europe, dematerialization of money and securities, and cross border expansion of financial institutions are amongst some of the forces and developments that have profoundly altered our traditional understanding of money and finance. Monetary law is not only complex to understand and to analyze; it remains subject to constant change. The different jurisdictional domains–the national, the supranational, and the international–intersect with each other at different levels. The study of monetary law is in effect the study of a moving target. And yet a few concepts provide the tools and the intellectual foundations to understand and interpret this evolution. Key amongst those is the concept of monetary sovereignty.

In the opening words of the first chapter, Claus Zimmermann argues that few international law concepts have been subject to as little critical scrutiny over the past few decades as that of monetary sovereignty, in stark contrast with the renewed interest that the political science, legal philosophy, and legal literatures have shown in different aspects of broader concepts of sovereignty. Zimmermann masterfully redresses such deficiency in this book, which originated in a PhD thesis in Oxford that I was privileged to examine.

A Contemporary Concept of Monetary Sovereignty is destined to become a classic in international economic law. Claus Zimmermann in this volume provides a much needed, comprehensive, timely, and economically-sophisticated overview of monetary sovereignty. The book represents a significant contribution to the theoretical literature on monetary law, which is a growing field that appeals to both banking and financial law scholars and to the international economic law fraternity.

Claus Zimmermann views monetary sovereignty in two ways; on the one hand, from the perspective of the supreme and irreducible authority of independent states and, on the other hand, from the perspective of the various sovereign powers (or attributes) that can be exercised by different levels of governance (notion of 'cooperative sovereignty'). The dual nature of sovereignty as both a 'positive' and a 'normative' concept lead him to contend that monetary sovereignty cannot become eroded under the impact of legal and economic constraints. Drawing upon his understanding of monetary sovereignty as a dynamic concept, he suggests that, in a monetary union like the EMU, what has been transferred from the national to the supranational level, is the exercise of some sovereign powers or 'state competences', but not 'monetary sovereignty' per se.

In order to fully understand contemporary developments in monetary matters, he suggests we need to 'resist the temptation of oversimplifying the relevant issues by trying to squeeze them into existing legal categories'. And this provides a template to address new issues and challenges.

In response to the question as to whether, absent an express treaty rule authorizing a unilateral withdrawal, a member state of a supranational organization may nevertheless assert its sovereignty by withdrawing from the organization, Claus Zimmermann suggests that any member state (Greece, for example) may always decide to breach the rules of the monetary union and leave and also that, in line with the ruling by the German constitutional court in the Maastricht case, each member state of a monetary union in its capacity as one of the 'masters of the treaty' may recover the conferred powers by simply leaving the union.

The International Monetary Fund, being at the centre of the international monetary system, features prominently in the book, in particular in Chapter 3. Claus Zimmermann advocates binding and enforceable rules on current account imbalances, with equal efforts from surplus and deficit countries. Since such imbalances are at the root of financial crises, they cannot be ignored. This, however, remains the source of much controversy, as it was at the time in which Harry Dexter White and John Maynard Keynes put together the proposals that eventually led to the birth of the Bretton Woods institutions. Though history is written by victors and by creditors, no doubt greater attention should be given to the needs– and the social impact of adjustment efforts–of debtor countries.

The book is beautifully written and well structured. Claus Zimmermann is not only an expert in monetary law; he shows proficiency in other areas of law (international trade law, international investment law), and in other neighboring fields (in particular economics). Indeed, in order to make sense of this evolving, multi-layered monetary system, an observer now needs many inter-related skills. These include a knowledge of the historical and political pressures that have shaped, and continue to shape, current institutions; of the economic factors that help to determine how, and why, the various systems and institutions function as they do; and of the legal processes, both formal and informal, that fix the rules of the game. Claus Zimmermann masters all these skills in this book, which will soon establish itself as an essential reference for students and experts in this area.

As the author himself points out in his conclusions, many of the findings are not narrowly limited to the exercise of sovereign powers in monetary and financial matters but are more broadly applicable to the concept of sovereignty in general and inform our understanding of what it means for a state to be sovereign under contemporary economic constraints and evolving economic circumstances.

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London
5 September 2013

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This study is a revised version of the doctoral dissertation that I defended at the University of Oxford in December 2011. In the often enjoyable, yet also lengthy and at times difficult, process of completing my DPhil thesis and the manuscript for this monograph, I have incurred many debts. Above all, I owe special thanks to my wife Marine. Without her love, unfailing support and encouragement as well as, last but not least, her infinite patience, this study would not have been produced. I am equally indebted to my dear parents.

While at Oxford, I was extremely fortunate to being able to work with two wonderful doctoral supervisors, Professor Dan Sarooshi from the University of Oxford and Professor Jean-Marc Sorel from the University Paris 1 'Panthéon-Sorbonne'. I am extremely grateful for their intellectual guidance and constant inspiration as well as for their support and personal friendship. I also owe great thanks, for a variety of reasons, to Professor Vaughan Lowe, QC, and Professor Rosa Lastra both of whom I truly admire. Their feedback on my work has greatly helped me in the process of turning my doctoral dissertation into the present monograph. I am delighted that Professor Lastra as one of the outstanding authorities on monetary and financial law in the English-speaking world kindly accepted to contribute the foreword to the present book.

My work on this monograph, in particular on its Chapter 3 on the phenomenon of exchange rate misalignment, has greatly benefited from my internships with the legal department of the International Monetary Fund (IMF) and the Appellate Body Secretariat of the World Trade Organization (WTO). My time as a visiting scholar at Harvard's Department of Government and at Stanford Law School has been equally precious for the gradual evolution of my thoughts on what is indeed a complex topic. In this context, I wish to single out and acknowledge, in alphabetical order, the essential contribution that has been made in one way or the other by Professor Jeffry Frieden, IMF General Counsel Sean Hagan, Kyung Kwak, Ross Leckow, Vilaysoun Loungnarath, Professor A. Mitchell Polinsky, Amy Porges, Deborah Siegel, Professor Beth Simmons, and Professor Alan Sykes.

For my DPhil thesis that eventually became this book, I would like to acknowledge generous financial support from the Arts and Humanities Research Council in the UK as well as from the ERP Fellowship Programme of the Studienstiftung des deutschen Volkes which sponsored my research at Stanford and Harvard.

There is no doubt that this monograph would have been published with great delay without the great comprehension and support of this project by my current employer, the international trade and dispute settlement practice of Sidley Austin LLP in Geneva. A very warm 'thank you' to Partners Scott Andersen, Todd Friedbacher and Nicolas Lockhart.

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The final manuscript for this monograph was completed on 1 July 2013; every effort was made for it to be fully up to date as of that day; but for a few exceptions, subsequent developments could not be considered.

I conducted the research for this monograph exclusively in my personal capacity. Therefore, the content expresses my personal views only and does not represent the views of Sidley Austin LLP, of any of the firm's clients, or of any of my colleagues at the firm.

CDZ

Geneva
3 September 2013

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List of Abbreviations

ADA	Anti-Dumping Agreement
AJIL	American Journal of International Law
ALBA	Alianza Bolivariana para los Pueblos de Nuestra América (Bolivarian Alliance for the Americas)
ASCM	Agreement on Subsidies and Countervailing Measures
ASEAN	Association of Southeast Asian Nations
ASIL	American Society of International Law
BCAS	Bank of Central African States
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BITs	bilateral investment treaties
BoP	balance of payments
BRICS	Brazil, Russia, India, China and South Africa
BSD	Bilateral Surveillance Decision
BVerfG	Bundesverfassungsgericht
BVerfGE	Entscheidung (i.e. ruling) of the Bundesverfassungsgericht
CACEU	Central African Customs and Economic Union
CAEMU	Central Africa Economic and Monetary Union
CAMU	Central African Monetary Union
CBWAS	Central Bank of West African States
CFA	Communauté Financière Africaine (during the colonial era: Colonies Françaises d'Afrique)
CFF	Compensatory Financing Facility
CGFS	Committee on the Global Financial System
CHATS	Clearing House Automated Transfer System
CHF	Swiss franc
Commerce	United States Department of Commerce
CPSS	Committee on Payments and Settlements Systems
CRS	Congressional Research Service
CUP	Cambridge University Press
DEM	deutsche mark
DG	European Commission Directorate-General
DG ECFIN	Directorate General for Economic and Financial Affairs
DSB	Dispute Settlement Body
DSU	Understanding on Rules and Procedures Governing the Settlement of Disputes
EBA	European Banking Authority
EBLR	European Business Law Review
EC	European Communities
ECB	European Central Bank
ECCB	Eastern Caribbean Central Bank
ECCU	Eastern Caribbean Currency Union
ECF	Extended Credit Facility

ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
ECOWAS	Economic Community of West African States
ECU	European Currency Unit
EFAR	European Foreign Affairs Review
EFF	Extended Fund Facility
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EIOPA	European Insurance and Occupational Pensions Authority
EJIL	European Journal of International Law
EMS	European Monetary System
EMU	European Economic and Monetary Union
ERM	European Exchange Rate Mechanism
ERPL/REDP	European Review of Public Law/Revue Européenne de Droit Public
ESCB	European System of Central Banks
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETD	exchange-traded derivatives
EU	European Union
EUR	Euro
EWE	Early Warning Exercise
FATF	Financial Action Task Force
FCL	Flexible Credit Line
Fed	United States Federal Reserve
FSA	Financial Sector Assessment
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSSA	Financial System Stability Assessment
FTA	Free Trade Agreement
G-20	Group of Twenty
GAFTA	Greater Arab Free Trade Area
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GBP	pound sterling
GCC	Gulf Cooperation Council
GDP	gross domestic product
GFSR	Global Financial Stability Report
GNI	gross national income
GRA	General Resources Account
HUP	Harvard University Press
IAASB	International Auditing and Assurance Standards Board
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IBRD	International Bank for Reconstruction and Development
ICSID	International Centre for Settlement of Investment Disputes

IDA	International Development Association
IEL	international economic law
IEO	Independent Evaluation Office
IFA	international financial architecture
IFC	International Finance Corporation
IFIs	international financial institutions
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IML	international monetary law
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
ISD	Integrated Surveillance Decision
ITO	International Trade Organization
JIBFL	Journal of International Banking and Financial Law
JIEL	Journal of International Economic Law
JILP	Journal of International Law and Policy
JPY	Japanese Yen
JWT	Journal of World Trade
LGDJ	(A French publishing house based in Paris)
LIBOR	London Interbank Offered Rate
LIFFE	London International Financial Futures and Options Exchange
M0–M4	(categories of monetary aggregates)
MAI	Multilateral Agreement on Investment
MAP	Mutual Assessment Process (G-20)
MEPs	Members of the European Parliament
MIGA	Multilateral Investment Guarantee Agency
MIT	Massachusetts Institute of Technology
MMF	Money Market Fund
MOCOMILA	Committee on International Monetary Law of the International Law Association
MONA	Monitoring of Fund Arrangements
MTO	medium-term budgetary objective
NAFTA	North American Free Trade Agreement
NBER	National Bureau of Economic Research
OECD	Organisation for Economic Co-operation and Development
OECS	Organisation of Eastern Caribbean States
OEEC	Organisation for European Economic Co-operation
OJ	Official Journal
OMT	Outright Monetary Transactions
OTC	over-the-counter
OUP	Oxford University Press
PCIJ	Permanent Court of International Justice
PCL	Precautionary Credit Line
PIN	Public Information Notice
PLL	Precautionary and Liquidity Line
PUP	Princeton University Press
QE2	second round of quantitative easing
QPCs	quantitative performance criteria

General Introduction

So much of barbarism . . . still remains in the transactions of the most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbors, a peculiar currency of their own.

John Stuart Mill (1806–1873), *Principles of Political Economy*[1]

Few international law concepts have been subject to as little critical scrutiny over the past few decades as that of monetary sovereignty. This stands in contrast with the renewed interest that the political science, legal philosophy, and legal literatures (often in pursuance of an interdisciplinary approach) have shown in different aspects of broader concepts of sovereignty over the past two decades.[2] Interestingly, the concept of monetary sovereignty has never been expressly recognized by the international community, neither in the Articles of Agreement of the International Monetary Fund (IMF or Fund) (IMF Agreement or Fund's Articles),[3] nor in any other key instrument of international law.[4] It is a judgment of the former Permanent Court of International Justice (PCIJ) that is commonly cited as the first official

[1] John Stuart Mill, *Principles of Political Economy, Vol. II* (Charles C Little & James Brown Publishers, Boston 1848) 155.

[2] This vast body of literature includes, notably, Tanja E Aalberts, 'The Future of Sovereignty in Multilevel Governance Europe—A Constructivist Reading' (2004) 42 *Journal of Common Market Studies* 23; Samantha Besson, 'Sovereignty in Conflict' (2004) 8(15) *European Integration online Papers* <http://eiop.or.at/eiop/pdf/2004-015.pdf> accessed 1 July 2013; Abram Chayes and Antonia Handler Chayes, *The New Sovereignty: Compliance with International Regulatory Agreements* (Harvard University Press (HUP), Cambridge MA 1995); Oona A Hathaway, 'International Delegation and State Sovereignty' (2008) 71 *Law and Contemporary Problems* 115; John Jackson, 'Sovereignty Modern: A New Approach to an Outdated Concept' (2003) 97 AJIL 782; John Jackson, *Sovereignty, the WTO, and Changing Fundamentals of International Law* (Cambridge University Press (CUP), Cambridge 2006); Hent Kalmo and Quentin Skinner (eds), *Sovereignty in Fragments: The Past, Present and Future of a Contested Concept* (CUP, Cambridge 2010); Stephen D Krasner, 'Sovereignty: An Institutional Perspective' (1988) 21 *Comparative Political Studies* 66; Stephen D Krasner, *Sovereignty: Organized Hypocrisy* (Princeton University Press (PUP), Princeton NJ 1999); David Lake, 'Delegating Divisible Sovereignty: Sweeping a Conceptual Minefield' (2007) 2 *The Review of International Organizations* 219; David Lake, 'The New Sovereignty in International Relations' (2003) 5 *International Studies Review* 303; Neil MacCormick, *Questioning Sovereignty* (Oxford University Press (OUP), Oxford 1999); Kal Raustiala, 'Rethinking the Sovereignty Debate in International Economic Law' (2003) 6 JIEL 841; W Michael Reisman, 'Sovereignty and Human Rights in Contemporary International Law' (1990) 84 AJIL 866; Catherine Richmond, 'Preserving the Identity Crisis: Autonomy, System and Sovereignty in European Law' (1997) 16 *Law and Philosophy* 377; Dan Sarooshi, *International Organizations and their Exercise of Sovereign Powers* (OUP, Oxford 2005); Dan Sarooshi, 'The Essentially Contested Nature of the Concept of Sovereignty: Implications for the Exercise by International Organizations of Delegated Powers of Government' (2004) 25 *Michigan Journal of International Law* 1107; Anne-Marie Slaughter, *A New World Order* (PUP, Princeton NJ 2004); Wenhua Shan, Penelope Simons, and Dalvinder Singh (eds), *Redefining Sovereignty in International Economic Law* (Hart Publishing, Oxford 2008); and Georg Sørensen, 'Sovereignty: Change and Continuity in a Fundamental Institution' (1999) XLVII *Political Studies* 590.

recognition of the principle of monetary sovereignty in modern international law. As famously stated by the PCIJ in 1929 in the *Serbian Loans Case*, 'it is indeed a generally accepted principle that a state is entitled to regulate its own currency'.[5] It is on this basis that the state's sovereignty over its own currency, and, by implication, over both the internal and external aspects of its monetary and financial systems, has traditionally been recognized by public international law.[6] In the words of FA Mann:

> [T]o the power granted by municipal law there corresponds an international right, to the exercise of which other States cannot, as a rule, object . . . It must . . . follow that, subject to such exceptions as customary international law or treaties have grafted upon this rule, the municipal legislator is free to define the currency of his country, to decide whether or not it should be pegged to another currency, to determine the means by which monetary and exchange rate policies are to be defined and implemented, to devalue or revalue the currency, to allow or prohibit the use of foreign currencies within its borders, to impose exchange controls, or to take other measures affecting monetary relations.[7]

Contrary to much of the existing literature this monograph takes fully into account the dual nature of the concept of sovereignty which can be validly approached in two ways: directly, by focusing on the supreme and irreducible authority of independent states and indirectly, by looking at the various sovereign powers that originally all derive from the same source, namely the capacity of independent statehood.[8] When looked at through the prism of its constituent regulatory powers, which may indeed be subject to various factual and legal constraints, sovereignty is a *positive* concept allowing a 'judgment about the actual capacity of states and/or their governments to affect or determine outcomes'.[9] By contrast, when approached as the supreme and irreducible authority of independent states, the concept of sovereignty is built on constantly evolving sovereign *values*, and is hence a *normative* concept. However, as perfectly analysed by Robert Howse, '[t]he way in which sovereignty continues to structure and restructure global order cannot be properly appreciated or explained through attempts to simplify the idea into a purely normative or purely positive concept'.[10]

[3] Articles of Agreement of the International Monetary Fund, 22 July 1944, 60 Stat 1401, 2 UNTS 39, as last amended effective 3 March 2011, <http://www.imf.org/external/pubs/ft/aa/index.htm>. The IMF Agreement is the constituent treaty of the IMF. Having been adopted on 22 July 1944, at the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire, it entered into force on 27 December 1945.

[4] Geneviève Burdeau, 'L'exercice des Compétences Monétaires par les Etats' (1988) 212 *Recueil des Cours de l'Académie de Droit International (Recueil des Cours)* 211, 236–7.

[5] *Case Concerning the Payment of Various Serbian Loans Issued in France (France v Serbia)*, Judgment of 12 July 1929, PCIJ Rep Series A Nos 20–21, 44.

[6] See, for example, Burdeau (n 4) 236; Dominique Carreau, *Souveraineté et Coopération Monétaire Internationale* (Cujas, Paris 1971) 52–4; Rosa M Lastra, *Legal Foundations of International Monetary Stability* (OUP, Oxford 2006) 16–17; Charles Proctor, *Mann on the Legal Aspect of Money* (7th edn OUP, Oxford 2012) 526; and Milan R Shuster, *The Public International Law of Money* (OUP, Oxford 1973) 9.

[7] Proctor (n 6) 526–7, footnotes omitted.

[8] For detailed developments on the dual nature of sovereignty and for references to related literature, see Chapter 1, Section II.A, of this monograph.

[9] Robert Howse, 'Sovereignty, Lost and Found' in Shan, Simons, and Singh (eds) (n 2) 61, 75.

In the light of the above, this monograph aims to meet the challenge of approaching the concept of monetary sovereignty in a truly holistic manner, thereby achieving a better understanding of the contemporary exercise of sovereign powers in the realm of money (as understood in a wider sense) and of the constantly evolving driving forces behind the evolution of international law in this crucial field at the intersection of law, economics, and politics.

An authoritative, or commonly accepted, list of sovereign powers delimiting the conceptual scope of monetary sovereignty does not exist at present.[11] The right to create money via the issuance of currency and the right to conduct independent exchange rate and monetary policies emerges as the lowest common denominator from the existing literature. However, under the impact of economic globalization and the ever-increasing integration of financial markets worldwide a more comprehensive approach appears warranted. Hence, this monograph is based on the understanding that the following regulatory powers (each of them being subject to various legal and economic constraints), fall within the conceptual scope of monetary sovereignty:

(i) The right to create money via the issuance of currency, ie of coins and banknotes that are legal tender[12] within the territory of the issuing state: the classical *ius cudendae monetae*.[13]

(ii) The right to conduct a monetary policy, ie to use interest rates and reserve requirements in order to control the money supply (or stock of money). The regulation of the banking system (and therewith of the availability and cost of credit) and of the payments system (clearing and settlement) are increasingly important, additional, tools for controlling the money supply in a modern economy.

(iii) The right to conduct an exchange rate policy, ie to determine the exchange rate regime and to control the exchange rate.

(iv) The right to decide upon the appropriate amount of current and capital account convertibility via the imposition of exchange controls, thereby controlling the use that can be made of the state's currency outside its territory.

[10] Howse (n 9) 61, 75.

[11] For three different views, by three eminent authors, on which regulatory powers ought to be considered truly sovereign powers in the realm of money, see Lastra (n 6) 22–3; Proctor (n 6) 526–7; and François Gianviti, 'Current Legal Aspects of Monetary Sovereignty' in *Current Developments in Monetary and Financial Law, Volume 4* (IMF Legal Department, Washington DC 2005) 3, 4.

[12] Legal or forced tender is anything which, when offered in payment, extinguishes a certain debt. Domestic currency is the most common form of legal tender thereby demonstrating the originally territorial dimension of monetary sovereignty. Outside its territory of issuance, a currency usually loses its characteristic of legal tender and is reduced to a simple commodity. Individuals may still choose to accept foreign money as payment but they are not obliged to do so, unless their home state has decided to grant legal tender status to a specific foreign currency, like in contemporary scenarios of dollarization. There seems to be no basis in contemporary international law on which a state could object to the use of its currency abroad (see Lastra (n 6) 20).

[13] Latin for 'the right to coin money'.

(v) The organization of financial regulation and supervision.[14] The overarching policy objectives in this context are usually to maintain the integrity of the financial system and to foster financial stability.[15]

Fiscal policy (with its two main tools being government spending and taxation) is the other main type of economic policy besides monetary policy. On the one hand it would go too far to claim that the regulatory scope of monetary sovereignty embraces fiscal policy, since this would entirely blur the profile of monetary sovereignty as a concept distinct from broader domestic sovereignty. On the other hand, however, one cannot entirely ignore the fact that bad fiscal policy can endanger monetary and financial stability, as has been demonstrated by several economic crises in the past and present. The fact that structural IMF conditionality has been frequently used to impose severe restraints on, among other things, a debtor state's fiscal rigour, is a powerful demonstration of both the latter's impact on monetary and financial stability and of the major incursions made into domestic sovereignty for the sake of monetary and financial stability.[16] Other examples of this intrinsic link can be found in the context of the European Union's (EU) Stability and Growth Pact (SGP) and, most recently, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, whose fiscal arm is more commonly referred to as the European Fiscal Compact.[17] Overall, it is therefore impossible to exclude fiscal policy entirely from a holistic analysis of monetary sovereignty and its contemporary exercise as undertaken in this monograph.

The contemporary legal and economic constraints on the exercise of the various sovereign powers in the realm of money have already been thoroughly analysed, under various aspects, in the legal, economics, and political science literatures.[18] Most authors, however, appear to approach monetary sovereignty as a purely *positive*, and *static*, concept, ie as nothing more than an immutable catalogue of state competences whose prescriptive implications, if it ever possessed any, have been emptied of any relevance over time. The existing literature convincingly

[14] For insightful developments on the conceptually important distinction between financial regulation (referring to any sort of rule-making applicable to financial actors) and supervision (relating to monitoring and enforcement), see Lastra (n 6) 84–90.

[15] For detailed definitions and discussions of the concepts of monetary and financial stability and of financial integrity, see Chapter 1, Section III.A, of this monograph.

[16] For a detailed analysis of IMF conditionality, ie the conditions underlying financial assistance by the IMF, and of related issues, see Chapter 2, Section II, of this monograph.

[17] For a detailed analysis of the origins and the 2010–2011 rewriting of the SGP and an assessment of the European Fiscal Compact, see Chapter 4, Section II, of this monograph.

[18] In this vast, often interdisciplinary, body of literature, see, eg, J Lawrence Broz and Jeffrey A Frieden, 'The Political Economy of Exchange Rates' in Barry R Weingast and Donald A Wittman (eds), *Oxford Handbook of Political Economy* (OUP, Oxford 2006) 587; Carreau (n 6); Dominique Carreau and Patrick Juillard, *Droit international économique* (3rd edn Dalloz, Paris 2007) 559–706; Dominique Carreau, 'Le système monétaire international privé (UEM et euromarchés)' (1998) 274 *Recueil des Cours* 309; Benjamin J Cohen, 'The International Monetary System: Diffusion and Ambiguity' (2008) 84 *International Affairs* 455; W Max Corden, *Too Sensational: On the Choice of Exchange Rate Regimes* (MIT Press, Cambridge MA 2004); Barry Eichengreen, *International Monetary Arrangements for the 21st Century* (Brookings, Washington DC 1994); Jeffry A Frieden, 'Globalization

analyses the fact that economic globalization and the increasing integration of financial markets have rendered several formal state competences in monetary and financial matters essentially hollow, but omits to question critically whether the underlying concept of monetary sovereignty itself has evolved over time and what this might imply. Hence, it is hardly surprising that large parts of the literature conclude that monetary sovereignty has become increasingly eroded,[19] that it can only be accepted as 'a figure of speech',[20] and, even stronger, that it should be regarded as no more than a myth.[21]

The approach adopted in this monograph is different. Chapter 1 undertakes a thorough review of the concept of monetary sovereignty itself, taking fully into account the concept's dual nature as noted above. It will emerge from this opening chapter that monetary sovereignty, far from being outdated, is still highly relevant as a *dynamic* and not only *positive*, but also *normative*, legal concept that has major implications on how contemporary sovereign powers in the realm of money should be exercised.

Intrinsically linked to the conceptual evolution of monetary sovereignty is the changing nature of international monetary law (IML). Chapter 2 of this monograph therefore considers an ongoing phenomenon: the increasing hybridization of IML. That process of hybridization that results from constant changes in the formal and material sources of this increasingly complex body of law, from the unsuitability of the rigid categories of 'hard' and 'soft' law for appropriately characterizing all recent normative evolutions in this field, and from the rise in importance of private and transnational monetary law as intrinsic elements of contemporary IML.

The other three chapters of this monograph examine how the findings of the two opening chapters inform the analysis of contemporary regulatory challenges in the realm of money (as understood in a wider sense).

Chapter 3, which examines the complex phenomenon of exchange rate misalignment under both international monetary and trade law in their historic context, aims to contribute to a better understanding of the following two-fold question. To what extent can a contested practice such as the maintenance of an undervalued real exchange rate be dealt with effectively under existing international

and Exchange Rate Policy' in Ernesto Zedillo (ed), *The Future of Globalization* (Routledge, New York 2007) 344; Gianviti (n 11); Lastra (n 6); Andreas F Lowenfeld, *International Economic Law* (2nd edn OUP, Oxford 2008) 593–851; Robert A Mundell, 'Money and the Sovereignty of the State' (1997, Paper for the International Economic Association Conference in Trento) <http://www-ceel.economia.unitn.it/events/monetary/mundell14.pdf> accessed 1 July 2013; Proctor (n 6); Jean-Marc Sorel, 'Les Etats face aux marchés financiers' in Charles Leben, Eric Loquin, and Mahmoud Salem (eds), *Souveraineté étatique et marchés internationaux à la fin du 20ème siècle: Mélanges en l'honneur de Philippe Kahn* (Litec, Paris 2000) 507; Benn Steil and Manuel Hinds, *Money, Markets, and Sovereignty* (Yale University Press (YUP), New Haven CT 2009); Annamaria Viterbo, *International Economic Law and Monetary Measures: Limitations to States' Sovereignty and Dispute Settlement* (Edward Elgar Publishing, Cheltenham 2012).

19 See, eg, Lastra (n 6) 26–32 and Tullio Treves, 'Monetary Sovereignty Today' in Mario Giovanoli (ed), *International Monetary Law: Issues for the New Millennium* (OUP, Oxford 2000) 111.

20 Treves (n 19).

21 Dominique Carreau, 'La souveraineté monétaire de l'Etat à la fin du XXe siècle: mythe ou réalité?' in Leben, Loquin, and Salem (eds) (n 18) 491.

law? Intrinsically related, which key aspects of the IMF's legal framework would require reform in order to successfully tackle contemporary challenges to the stability of the international monetary system, such as notably global current account imbalances?

Chapter 4 focuses on the increasing regionalization of monetary sovereignty that results from the creation of various economic and monetary unions around the globe. Vast transfers of state competences to the organs of a monetary union imply, by definition, that the participating states renounce, at least temporarily, the independent exercise of these competences. It will be argued in this chapter that, to the extent that agreeing to such transfers is what provides a state's population with a maximum of monetary and financial stability under contemporary economic constraints, it appears appropriate to analyse the underlying transfers of sovereign powers not as a surrender of monetary sovereignty, but as an effective exercise of the latter. In this context, the analysis undertaken in this chapter will be strongly informed by the current trials and tribulations of the European Economic and Monetary Union (EMU) and the ongoing sovereign debt crisis of an increasing number of its member states.

Chapter 5, finally, looks into the main implications of the contemporary concept of monetary sovereignty as proposed by this monograph for the ongoing reorganization of the international financial architecture (IFA) in the wake of the greatest economic and financial crisis since the Great Depression of the 1930s.

1

A Revision of the Concept of Monetary Sovereignty[1]

Introduction

In political and legal discourse, the essence of the concept of sovereignty continues to be defined as the supreme and independent control by states of their internal affairs, subject only to the recognized limitations imposed by international law.[2] As famously phrased by Max Huber in his award in the *Island of Palmas Case*: 'Sovereignty in the relations between States signifies independence. Independence in regard to a portion of the globe is the right to exercise therein, to the exclusion of any other State, the functions of a State'.[3] As elaborated in the general introduction to this monograph, in the realm of contemporary monetary and financial affairs it appears appropriate to define these 'functions of a State', ie its sovereign powers, as covering the formal state competences to create money via the issuance of currency and via the regulation of credit, to conduct monetary and exchange rate policies, to determine the appropriate amount of current and capital account convertibility, and to organize financial regulation and supervision.

As noted earlier, large parts of the existing literature analyse monetary sovereignty as a purely *positive* concept, ie as nothing more than a static catalogue of formal state competences in monetary and financial matters.[4] Approaching the concept of monetary sovereignty that way invites the undertaking of judgments over the degree to which a given state, the members of a monetary union, or the international community as a whole, should be considered as having preserved or as having lost their respective monetary sovereignty under the impact of various economic and legal constraints on the exercise of the sovereign powers in the

[1] A condensed version of this opening chapter, including also elements of Chapter 4, Section III.C, of this monograph has recently been published as an article: see Claus D Zimmermann, 'The Concept of Monetary Sovereignty Revisited' (2013) 24(3) EJIL 797.

[2] See, eg, Elizabeth A Martin and Jonathan Law (eds), *Oxford Dictionary of Law* (6th edn OUP, Oxford 2006).

[3] *Island of Palmas Case (Netherlands v USA)* (1928), 2 UNRIAA 829. For a thought-provoking analysis of the terms used by Huber in the phrase quoted above, discussing what sovereignty *signifies* and what independence *is*, see Vaughan Lowe, 'Sovereignty and International Economic Law' in Wenhua Shan, Penelope Simons, and Dalvinder Singh (eds), *Redefining Sovereignty in International Economic Law* (Hart Publishing, Oxford 2008) 77.

[4] See the various references provided in the general introduction to this monograph, notably in nn 19–21.

realm of money. Indeed, as has been rightly observed by John Jackson, 'most (but not all) of the time that "sovereignty" is used in current policy debates, it actually refers to questions about the allocation of power; normally "government decision-making power"'.[5]

The approach adopted herein is different. Certainly, nowadays most states are subject to various legal constraints on the exercise of their sovereign powers in the realm of money, notably to those legal constraints that arise from their membership of the IMF or, on a regional level, of a monetary union. In addition, and probably much more importantly, there is no doubt that factual constraints brought about by economic globalization and the increasing integration of financial markets worldwide have rendered several formal state competences in monetary and financial matters essentially hollow. But does this undeniable erosion of the formerly exclusive character of certain state competences imply, as is being claimed in much of the existing literature, that monetary sovereignty as a legal concept is no longer more than a figure of speech?

Attempting to fill an important gap in the literature, this opening chapter examines whether the concept of monetary sovereignty itself, as a concept having not only *positive* but also increasingly important *normative* components, is subject to evolution and is still of any actual relevance. It will be argued in this chapter, and indeed throughout this monograph, that monetary sovereignty is still more than a mere rhetorical framework for debates on specific rights and duties of states.[6] Monetary sovereignty is still relevant today as a legal concept for evaluating the contemporary exercise of sovereign powers in the realm of money and for improving our understanding of the driving forces behind the evolution of the law in this important field. Subsequent chapters of this monograph will test and substantiate this view, putting it critically into perspective.

After a review of the conceptual foundations and underlying legal theories of money and monetary sovereignty (Part I), this opening chapter assesses the conceptual evolution of monetary sovereignty under the impact of contemporary constraints on its exercise (Part II). Finally, the chapter looks into the conceptual implications of the proposed new understanding of monetary sovereignty for the evaluation of the exercise of sovereign powers in the realm of money (Part III).

I. Money and Monetary Sovereignty in International Law: Conceptual Foundations and Underlying Legal Theories

This first part provides a succinct overview of the historical and doctrinal origins of the concept of monetary sovereignty (Section A) before examining the legal theories of money and their respective relevance today (Section B).

[5] John Jackson, 'Sovereignty Modern: A New Approach to an Outdated Concept' (2003) 97 AJIL 782, 790.

[6] For detail on the view that debates over sovereignty constitute a mere vehicle for more specific, and truly legal, debates over rights and duties of states, see Lowe (n 3) 84. For comments on Lowe's position, see the conclusion to this opening chapter below.

A. Ex post facto ius oritur:[7] *classical monetary sovereignty in context*

Providing a detailed overview of the historical and doctrinal origins of the concept of monetary sovereignty would go well beyond the scope of this study.[8] For the conceptual review undertaken in this chapter it is important, however, to look into one specific characteristic of the concept of monetary sovereignty; one that it shares with many other legal and political concepts. Originally, it was not political reality that was shaped and determined by an abstract concept of monetary sovereignty as developed by outstanding philosophers or jurists. Instead, historical and political developments established certain facts in the first place and the related concept was developed only at a later stage, in an attempt to analyse reality as part of a legally coherent framework, thereby strengthening the monarch's power base: *ex post facto ius oritur*...

The writings of Jean Bodin (1529–1596) in *Les Six Livres de la République* (1576) are the first systematic expression of the principle of sovereignty as the key foundation for the exercise of state power.[9] Bodin's concept of sovereignty is of particular interest for the present chapter as it explicitly incorporated the royal prerogative to coin money.[10] Bodin is likely to have been influenced by a much less famous contemporary, François Grimaudet (1520–1580).[11] Both Bodin and Grimaudet came from the French city of Angers. In 1560, Grimaudet had given an important speech in which he proclaimed that 'the welfare of the State demanded the subjection of the ecclesiastical to the civil power, in whose hands all the functions of society were legally invested'.[12] In his major treatise *The Law of Payment* (1579) Grimaudet insisted that 'the value of money depends on the State; that is to say, in a monarchy, upon the prince, and in an oligarchy, upon the State, which alone has the right to coin money, or to have it coined and to stamp a valuation upon it'.[13] Bodin and Grimaudet had an important precursor in

[7] Latin for 'law arises out of fact'.

[8] For detailed presentations of the historical and doctrinal origins of monetary sovereignty and its relationship to the broader concept of sovereignty, see, eg, Dominique Carreau, *Souveraineté et Coopération Monétaire Internationale* (Cujas, Paris 1971) 35–41 and Rosa M Lastra, *Legal Foundations of International Monetary Stability* (OUP, Oxford 2006) 3–21.

[9] See, eg, Carreau (n 8) 37–8, Lastra (n 8) 6–7.

[10] Jean Bodin, *Les Six Livres de la République* (1576) I, chapter 11, 213 (quoted in Arthur Nussbaum, *Money in the Law—National and International* (The Foundation Press, New York 1950) 34).

[11] See Robert Mundell, 'Money and the Sovereignty of the State' (1997, Paper for the International Economic Association Conference in Trento) 14 <http://www-ceel.economia.unitn.it/events/monetary/mundell14.pdf> accessed 1 July 2013.

[12] François Grimaudet, *Remonstrances aux Etats d'Angers* (1560) (originally delivered in French as speech in the Provincial Assembly of Angers on 14 October 1560) (quoted in William Maude (trs), *The Fluctuations of Gold (by Alexander von Humboldt)—The Law of Payment (by François Grimaudet)*, Burt Franklin: Research and Source Works Series 722 (ed) (Lenox Hill Publishers, New York 1900, reprinted 1971) part 2 on *The Law of Payment* iv).

[13] François Grimaudet, *The Law of Payment* in Maude (trs) (n 12) part 2 on *The Law of Payment* 11.

Charles Dumoulin (1500–1566), also known as Molinaeus, who is commonly regarded as having laid the basis for the modern principle of nominalism[14] in his treatise *Tractatus commerciorum et usurarum* (1546).[15] Writers like Charles Loyseau (1566–1627) and Cardin Le Bret (1558–1655) lent further conceptual support to the absolutist monarchs' unfettered right to change the value of the coins they issued.[16]

It is important to stress that the exclusive competence of the sovereign to issue money had *de facto* already existed well before the above-mentioned writers elaborated a consistent conceptual underpinning for it, thereby providing a widely accepted justification for monetary sovereignty as held by the absolutist monarchs of the time.[17] *De facto*, the French kings had claimed a full monetary prerogative as early as in the thirteenth and fourteenth centuries, going well beyond the traditional right to coin money (*ius cudendae monetae*). Based on their claim that the money fully belonged to the king as his *ius et proprietas*,[18] the absolutist monarchs of the time insisted on their right to change the value of the money as they deemed fit.[19]

Early on, however, other jurists, in particular from outside then absolutist France, called into question the monarch's unfettered monetary sovereignty. The Spanish Jesuit Juan de Mariana (1536–1624), for instance, denied the monarch the right to reduce arbitrarily the weight of coins arguing that any such alteration of the monetary substance unduly deprived the monarch's subjects of their very own fortune. Samuel von Pufendorf (1632–1694) further insisted that the value of a coin should be changed only in case of great need or danger and only in as much as was absolutely necessary and that, ultimately, the monarch was obliged to re-establish the original state of affairs.[20] Last but not least, Emmerich de Vattel (1714–1767), in his famous treatise *Le Droit des Gens*, equally accepted the idea that monetary sovereignty implies not only rights but also duties for the monarch.[21]

When it comes to assessing the importance of the writings by this last group of authors for the overall concept of monetary sovereignty, the literature is divided. François Gény asserts that it was a broadly acknowledged principle in the legal philosophy of the eighteenth century that states are subject, in their exercise of monetary sovereignty, to certain superior rules depending on overarching ideas of justice and general welfare.[22] Dominique Carreau has criticized this as a hazardous

[14] The principle of nominalism is commonly defined as follows:

> A debt expressed in the currency of another country involves an obligation to pay the nominal amount of the debt in whatever is the legal tender at the time of payment according to the law of the country in whose currency the debt is expressed (*lex monetae*), irrespective of any fluctuations which may have occurred in the value of that currency in terms of sterling or any other currency, of gold, or of any commodities between the time when the debt was incurred and the time of payment.
> (Albert V Dicey and John HC Morris, *Dicey and Morris on the Conflict of Laws* (edited by Lawrence Collins et al) (13th edn Sweet & Maxwell, London 2001) Rule 206).

[15] See Carreau (n 8) 38 and Nussbaum (n 10) 177.

[16] For detail, see Carreau (n 8) 38.

[17] Carreau (n 8) 39.

[18] Latin for 'right and property'.

[19] Carreau (n 8) 36.

[20] Carreau (n 8) 39–40.

[21] See François Gény, *Quelques observations sur le rôle et les pouvoirs de l'Etat en matière de monnaie et de papier-monnaie* (Mélanges Hauriou, Paris 1929) 406.

[22] Gény (n 21) 406.

conclusion. He argues that the doctrinal work of the previously cited French writers and, even before that, consistent state practice, have made monetary sovereignty, as one of the key attributes of general state sovereignty, the central foundation of the modern state.[23] Overall, it would appear that the positions of both authors do not entirely exclude each other. Both should be read as providing valuable lessons for any contemporary analysis of the conceptual evolution of monetary sovereignty such as the present one.

It is indeed very important to keep in mind, as elaborated by Carreau, that the concept of monetary sovereignty was originally elaborated by loyal legal writers, in an attempt to integrate the already well-established exercise of internal monetary sovereignty by absolutist monarchs into a coherent legal framework. However, whereas monetary sovereignty as an essential attribute of general state sovereignty may always have been particularly important to states in the modern era, the concept itself has never expressed a sacrosanct, constitutional, privilege of the sovereign. The concept was originally developed to provide justification *ex post* to the exercise of state power in the monetary realm in a narrow sense, at a time when the central power in most states was still very weak.

As will be analysed in Parts II and III of this chapter, it is difficult to see why the concept of monetary sovereignty should not have significantly evolved since then, in order to continue to integrate the exercise of state competences in the realm of money into a coherent legal framework shaped by evolving contemporary constraints. Gény's observation concerning the majority position in the legal philosophy literature of the eighteenth century is of particular interest in this regard. As rightly observed by Carreau, the idea that monetary sovereignty entails both rights and obligations for states has not (yet) become part of the majority position in international law. However, the fact that as early as in the seventeenth century, when the concept of monetary sovereignty was as yet in a nascent state, legal writers seriously contemplated monetary sovereignty as a both positive and normative concept constraining state power and not only as fettering an unbounded exercise thereof, indicates that it is necessary to embark on a more detailed scrutiny of the concept.

Before embarking on this chapter's central analysis of the extent to which the concept of monetary sovereignty has evolved under contemporary constraints on its exercise, a brief look needs to be taken at whether the legal understanding of what constitutes money is itself subject to change.

B. The legal theories of money and their respective relevance today

The basic concept of what amounts to 'money' has traditionally been significantly larger in economics than in law. For economists, money is everything that is generally

[23] Carreau (n 8) 40–1.

[24] For detail on the economic concept of money, see, eg, Frederic S Mishkin, *The Economics of Money, Banking, and Financial Markets* (Business School 2nd edn Addison Wesley, Boston 2009); John Smithin (ed), *What is Money?* (Routledge, London 2000); and James Tobin, 'money' in Steven N Durlauf and Lawrence E Blume (eds), *The New Palgrave Dictionary of Economics* (2nd edn Palgrave

accepted as payment for goods and services and as repayment of debts.[24] The four essential functions ascribed to money by economists are: money as a unit of account, money as a means of payment, money as a means of exchange, and money as a store of value. In economic terms, the money stock or money supply designates the total amount of money available in an economy at a given time. However, there is no single accepted economic definition of which assets are included under the general term 'money'.[25] That is why, for the purpose of conducting monetary policy, the money supply is usually broken down into more or less narrowly defined monetary aggregates, the main ones of which are M0, M1, M2, and M3 (with M0 (notes and coins) being the narrowest aggregate and M3 (extending to various types of deposits like savings and demand deposits) being the largest).[26]

By contrast, three different *legal* theories exist for what constitutes money. According to the still largely dominant State theory of money, which was developed to a large extent by FA Mann, only that which is recognized as money under the law of the issuing jurisdiction has the legal quality of money.[27] It is not only the state's monopoly in issuing notes and coins, but in a larger sense the state's predominant

Macmillan, 2008), online edn <http://www.dictionaryofeconomics.com/article?id=pde2008_M000217> accessed 1 July 2013.

[25] John Black, eg, describes this dilemma as follows:

> [W]hile notes and coins are legal tender [ie forms of money that creditors are obliged, by law, to accept in settlement of a debt] and must be included in any definition [of money supply], and bank deposits repayable on demand are unlikely to be excluded, there are various types of deposit in non-bank financial intermediaries such as building societies, and various forms of highly liquid security, which can be included or excluded in various ways. Even unused postage stamps and uncashed postal orders could be used as money, though they are not included in any current definition.
> (John Black, *Oxford Dictionary of Economics* (2nd edn OUP, Oxford 2003) 266, 305–6).

[26] Most major central banks no longer rely on official M0 aggregates, although they continue to publish the amount of notes and coins in circulation. The European Central Bank (ECB), eg, relies on the following three monetary aggregates: Narrow Money M1 (defined as the sum of currency in circulation and overnight deposits), Intermediate Money M2 (M1 plus deposits with an agreed maturity of up to two years and deposits redeemable at a period of notice of up to three months) and Broad Money M3 (M2 plus repurchase agreements and money market fund shares/units and debt securities of up to two years) (<http://www.ecb.int/stats/money/aggregates/aggr/html/hist.en.html>). The United States (US) Federal Reserve System (Fed), having discontinued publication of the M3 monetary aggregate on 23 March 2006, publishes weekly figures for M1 and M2 (<http://www.federalreserve.gov/releases/h6>). Finally, in the United Kingdom (UK), the Bank of England, following implementation of the May 2006 Money Market Reform (<http://www.bankofengland.co.uk/mfsd/iadb/notesiadb/M0.htm>) publishes figures for notes and coins and reserve balances as well as a broad money aggregate M4 (<http://www.bankofengland.co.uk/mfsd/iadb/notesiadb/M4.htm>) that measures the money supply in the UK. In addition, the Bank of England publishes a UK estimate of the important monetary aggregate M3 as defined by the ECB (<http://www.bankofengland.co.uk/mfsd/iadb/notesIADB/m3.htm>) (all accessed 1 July 2013).

[27] According to FA Mann, the quality of money is to be attributed to all chattels that are:

> (a) issued under the authority of the law in force within the State of issue;
> (b) under the terms of that law, denominated by reference to a unit of account; and
> (c) under the terms of that law, are to serve as the universal means of exchange in the State of issue.
> (Charles Proctor, *Mann on the Legal Aspect of Money* (7th edn OUP, Oxford 2012) 15 (citing FA Mann, *The Legal Aspect of Money* (5th edn OUP, Oxford 1991, first published in 1938) 8)).

role in establishing a monetary system that the State theory of money is built upon.[28] Mann's thoughts on the subject appear to have been informed by the writings of the German economist Georg Friedrich Knapp who, as early as in 1905, wrote that only chattels issued by the legal authority of the state could acquire the character of 'money', and that the value to be attributed to them is fixed by law, rather than by reference to the materials employed in the process of production.[29]

The State theory of money has traditionally been analysed as a corollary of the sovereign power over currency, and its global acceptance has even led to it being indirectly recognized in several modern constitutions, like for example Article 1, section 8, paragraphs 5 and 6 of the US Constitution and Article 73(4) of the German *Grundgesetz* (in both cases by vesting the exclusive legislative authority in monetary matters in the federal state).[30] However, the State theory of money has the widely acknowledged downside that, under this theory, only a tiny percentage of the actual money stock in a modern economy qualifies as money in a strictly legal sense. Scriptural and electronic money as the largely dominant payment instruments nowadays do not constitute money according to the State theory of money. Scriptural money, and therewith the huge bulk of all bank deposits, does not amount to *money* but to *credit* according to the State theory of money which regards electronic money merely as a specific technique for using scriptural money.[31]

In order to overcome this widening gap between economic reality and the legal concept of money, very early on a so-called Societary theory of money has appeared in the legal literature with Friedrich Carl von Savigny (1779–1861) in the nineteenth century and Arthur Nussbaum (1877–1964) in the middle of the twentieth century being its first outstanding proponents.[32] According to this theory, it is not a formal decision by the state, but the attitude taken by society—as expressed in the practices of commercial life—which is relevant in deciding what counts as money. In his famous treatise *Money in the Law—National and International*, Nussbaum argued convincingly as follows:

> [I]n the phenomenon of money the attitude of society, as distinguished from state, is paramount . . . [A]s a matter of legal theory . . . the Societary process which gives life to money is not exactly a process of 'customary law'. It does not engender new canons of law. Similarly, as in the emergence of new types of negotiable instruments the process only widens the range of things to which a pre-existing body of rules – in this case of rules of monetary conduct – may be applied. By no means does the [S]ocietary theory of money deny the fact that normally the modern state exercises full power over the currency. But legal

[28] On this point, see also Proctor (n 27) 15.

[29] Proctor (n 27) 16 (referring to Georg Friedrich Knapp, *Staatliche Theorie des Geldes* (4th edn Duncker & Humblot, Munich 1923), translated by Lucas and Bonar, *State Theory of Money* (abridged edn Macmillan, London 1924)).

[30] For these and additional references to modern constitutions indirectly recognizing the State theory of money, see Lastra (n 8) 18, fn 52.

[31] For detail, see Geneviève Burdeau, 'L'exercice des Compétences Monétaires par les Etats' (1988) 212 *Recueil des Cours* 211, 234–6.

[32] On this point, see Dominique Carreau, 'Le système monétaire international privé (UEM et euromarchés)' (1998) 274 *Recueil des Cours* 367.

theory has to take care also (and in a sense primarily) of abnormal and controversial situations. This test the State [t]heory of money cannot stand.[33]

Nussbaum's analysis still seems perfectly valid and, if anything, appears to have gained in power over the past decades. The State theory of money certainly provides a perfectly coherent definition of what constitutes money in a strictly formal sense. Its increasing inability, however, to properly recognize as money in the legal sense, most monetary aggregates that form the monetary stock in a modern economy and which are the objects of monetary policy, clearly indicates that the State theory of money has to a large extent become outdated.

It should be noted, however, that abandoning the rigid corset of the State theory of money and harmonizing the legal concept of money with economic reality would not entail any immediate practical consequences. Scriptural money may not qualify as 'money' under the still dominant State theory of money. However, as 'credit' it is already now well integrated into a sophisticated legal framework devised by states. Similarly, timeless yet increasingly widespread phenomena such as local or regional currencies[34] as well as virtual or digital currencies[35] may not amount to

[33] Nussbaum (n 10) 8, footnotes omitted.

[34] Local or regional currencies, often also referred to as community currencies, are currencies that are not legal tender and are intended to be used in parallel to the respective national currency and which trade only in a rather limited geographical area and usually not across borders. At present, close to 3,000 different local or regional currencies are known to exist worldwide, many of them operating as scrips or vouchers that can be exchanged into national currency. From an economic perspective, local or regional currencies tend to circulate more quickly than regular currency since they usually operate on the basis of a demurrage-charge, ie their nominal value decreases over time making it attractive to spend the money instead of holding on to it. The underlying idea of contemporary local or regional currencies is to foster local and regional identities and to encourage people to buy locally. Well known current examples include the Brixton Pound and the Stroud Pound in the UK as well as the Chiemgauer in Germany. To find what were arguably more interesting examples of local or regional currencies one has to go back in history to free economy experiments that were undertaken in Germany and Austria by members of the so-called Physiocratic League, founded by Silvio Gesell, during the Great Depression. Thus, a privately organized currency agency issued a demurrage-charged currency, the Wära, which circulated in parallel to the Reichsmark. Among the most notable experiments thus undertaken figures the Wära experiment of Schwanenkirchen (a village that is now part of Hengersberg in Lower Bavaria where this author grew up). Initiated in 1929 by the new owner of the originally bankrupt coal mine in Schwanenkirchen, who now paid salaries in a mix of Wära (two-thirds) and Reichsmark (one-third), the fact that each Wära banknote lost one per cent of its nominal value each month played a crucial role in then deflation-struck Germany in encouraging the local population to actually spend their wages; Wära banknotes were widely accepted by local businesses. On 30 October 1931, the finance ministry of the German Reich forbade the Schwanenkirchen Wära experiment, which until then had led to modest economic prosperity in the area against all national and global trends. For a more detailed account of the Schwanenkirchen Wära experiment, see Franz Fischer, 'WÄRA: Das Schwundgeld von Schwanenkirchen', <http://www.hengersberg.de/geschichte/waera.html> accessed 1 July 2013.

[35] The term virtual or digital currencies refers to various forms of electronic money issued not by government-endorsed central banks but by private entities. Virtual or digital currencies serve as an alternative currency among their users. Many of them have so far been rather short-lived and have not seen widespread usage. The first notable such currency was the so-called e-gold, which was established in 1996 but is no longer active. Interestingly, e-gold was based on a bimetallist standard, ie a promise that each of its units could be exchanged into a set amount of gold or silver bullion. A more recent, and still active, digital currency that has attracted much attention is bitcoin. Established in 2009 as an online commodity, based on an open-source, peer-to-peer encryption protocol which enables its users to 'mine' new bitcoins by adding unique programming codes to a decentralized log. As of early April 2013, about 5,000 merchants worldwide accepted bitcoin-denominated transactions. For more

'money' under the State theory of money. However, even without enjoying the capacity of being legal tender, and depending on their precise design, these innovative types of money can be coherently analysed as being either simple commodities, scrips, or vouchers. In other words, adhering to the State theory of money may seem increasingly out of touch with economic reality, but it does not create a legal grey area. At least arguably, however, broadening the legal concept of money and adapting it to the evolving usages of commercial life as suggested by the Societary theory of money is about more than changing names. As noted above, the State theory of money is deeply enshrined in the classical concept of monetary sovereignty. If one admits, as will be argued below, that monetary sovereignty is not a static concept but that it continues to evolve, then sticking to the State theory of money, despite its loss of touch with economic reality, might put the consistency of the concept of monetary sovereignty itself at risk.

Finally, a few words need to be said with respect to a 'third' theory of money, the so-called Institutional theory of money, which has more recently been introduced into the legal literature by Antonio Sáinz de Vicuña, the current general counsel of the European Central Bank (ECB).[36] The Institutional theory of money is based on the presupposition that the concept of legal tender underpinning the State theory of money has become outdated as a consequence of the overwhelming use of scriptural money in today's economy.[37] As elaborated by Sáinz de Vicuña:

> the concept of money, in a situation of global markets and modern communication technologies, is now inseparable from the institutional set-up of the central banks (that is, their independence, mandate, and *instrumentaria*) and from the normative framework under which central banks, credit institutions, financial infrastructures (for example, payments systems), and markets operate, which ensures the stability and the functionality of money. The value of money no longer depends on the will of the individual sovereigns.[38]

However, as a 'third' legal theory of money, the Institutional theory of money does not appear to be substantially different from the Societary theory of money as refined by Nussbaum. As noted above, the Societary theory of money perfectly recognizes that the definition of the monetary system remains the prerogative of the

detailed information on the design and operation of bitcoin, see its official website: <http://bitcoin.org/en> accessed 1 July 2013. The price of a single bitcoin suddenly rose in early April 2013, peaking at 266 US dollars (USD) on 10 April 2013. However, only three days later its value had dramatically slumped to USD 54, showing that their overall little volume exposes bitcoins to significant speculative risk. See, eg, Stephen Foley, 'Bitcoin fans put brave face on price fall' *Financial Times* (12 April 2013) <http://www.ft.com/cms/s/0/4118322c-a389-11e2-ac00-00144feabdc0.html> accessed 1 July 2013.

[36] This Institutional theory of money was first proposed by Sáinz de Vicuña in a paper entitled 'The Concept of Money in the XXIst Century' presented at a meeting of the Committee on International Monetary Law of the International Law Association (MOCOMILA) in Tokyo on 1 April 2004. A brief discussion of that paper and the Institutional theory of money outlined therein can be found in Lastra (n 8) 21, n 34. Sáinz de Vicuña has more recently provided an updated analysis of his Institutional theory of money in Antonio Sáinz de Vicuña, 'An Institutional Theory of Money' in Mario Giovanoli and Diego Devos (eds), *International Monetary and Financial Law: The Global Crisis* (OUP, Oxford 2010) 517. For a nuanced discussion of that article, see Proctor (n 27) 25–30.

[37] For detail, see Sáinz de Vicuña, 'An Institutional Theory of Money' (n 36) 521–3.

[38] Sáinz de Vicuña, 'An Institutional Theory of Money' (n 36) 519.

state, and does not take a merely functional approach, contrary to what some authors have claimed.[39] The fact that the legal literature has not proceeded to a further elaboration of the Institutional theory of money supports the view that it should not be regarded as an independent 'third' legal theory of money, separate from the Societary theory of money. It still remains that Sáinz de Vicuña's Institutional theory of money constitutes a valuable reminder not only of the shortcomings of the State theory of money but also of the crucial importance of the institutional and normative framework in which modern monetary policy is being conducted.

Having completed this review of the foundations of the concepts of money and monetary sovereignty, this chapter now turns its attention to the conceptual evolution of monetary sovereignty under the impact of contemporary constraints on its exercise.

II. The Conceptual Evolution of Monetary Sovereignty Under the Impact of Contemporary Constraints on its Exercise

After analysing whether monetary sovereignty has become factually eroded or whether it has conceptually evolved in light of the dual nature of sovereignty as a both positive and normative concept (Section A), this second part explains that, in order to fully expose the concept's underlying nature, monetary sovereignty may be best understood as what has been called an 'essentially contested concept' in the philosophy of language (Section B).

A. Factual erosion of monetary sovereignty or conceptual evolution in light of the dual nature of sovereignty?

The contemporary exercise of the various sovereign powers in the realm of money[40] is subject to both legal and economic constraints. The constraints on the exercise of monetary sovereignty that arise from customary international law[41] and international treaties (most notably the IMF Agreement with its Articles IV[42] and VIII[43]) have

[39] See, eg, Proctor (n 27) 24.

[40] As noted earlier, a commonly accepted definition, broad or narrow, of the sovereign powers in the realm of money does not exist. See the detailed list of regulatory powers presented in the general introduction to this monograph for the broad approach adopted in the present study.

[41] For a succinct presentation of relevant constraints arising from customary international law, see Proctor (n 27) 526–48.

[42] IMF Article IV:1 contains a code of conduct for IMF members. Most notably, IMF Article IV:1(iii) obliges IMF members to avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members. For a thorough assessment of the IMF's code of conduct in IMF Article IV:1 in light of contemporary challenges to systemic stability, providing a detailed analysis of the complex phenomenon of exchange rate misalignment under international monetary and trade law, see Chapter 3 of this monograph.

[43] IMF Article VIII sets forth various general obligations of IMF members. In particular, according to Article VIII:2(a), no IMF member shall impose restrictions on the making of payments and transfers for current international transactions without approval of the Fund. For related developments, see Chapter 2, Section I.A, of this monograph.

been rightly analysed in the literature as constituting only relatively minor constraints for states compared to the factual economic constraints that have arisen from economic globalization and the increasing integration of financial markets.[44] On the purely legal side there are even examples, notably the Second Amendment of the Fund's Articles in 1978, preceded by the *de facto* breakdown of the IMF's par-value system in 1971, where states can be regarded as having recovered a large margin of discretion with respect to the exercise of at least one sovereign power in the realm of money, namely the conduct of exchange rate policies.[45] On the regional level, states that enter into a monetary union thereby consent to major constraints on how they may exercise various sovereign powers in the realm of money. Some of these powers are usually even transferred to the organs of the union altogether.[46]

In addition to legal constraints like the ones addressed above, the factual constraints on the exercise of monetary sovereignty have been thoroughly analysed in the existing literature. The latter is right to point to the increasingly dominant role of global financial markets and to argue that many formal state competences in monetary and financial matters give an impression of regulatory flexibility that states do *de facto* no longer enjoy. The following examples perfectly illustrate this state of affairs. To begin with, Article VI:3 of the IMF Agreement certainly leaves IMF members entirely free to impose capital controls as long as they are not exercised in a manner that will restrict payments for current transactions. However, once a state has liberalized its capital account, the economic cost of reversing this move and reintroducing capital controls in the future is likely to prove prohibitive.[47] The loss of factual state control is even more impressive with regard to money creation.[48] Notes and coins, ie the currency in circulation, account for no more than approximately 10 per cent of the money supply in developed countries,[49] with various forms of scriptural money, notably eurocurrencies[50] and

[44] Lastra (n 8) 26–32.

[45] The Second Amendment of the Fund's Articles entered into force on 1 April 1978, adjusting the law to economic reality, thereby confirming once again: *ex post facto ius oritur*... For a detailed analysis of the international legal framework for the conduct of exchange rate policies, see Chapter 3 of this monograph.

[46] For a detailed analysis of the regionalization of monetary sovereignty in various parts of the world, see Chapter 4 of this monograph. Section III.C of that chapter provides a detailed answer to the fundamental question of whether the increasing regionalization of monetary sovereignty amounts to an erosion of monetary sovereignty or, on the contrary, to an effective exercise of the latter.

[47] Carreau rightly makes this observation regarding the liberalization of the capital and current accounts. See Dominique Carreau, 'La souveraineté monétaire de l'Etat à la fin du XXe siècle: mythe ou réalité?' in Charles Leben, Eric Loquin, and Mahmoud Salem (eds), *Souveraineté étatique et marchés internationaux à la fin du 20ème siècle: Mélanges en l'honneur de Philippe Kahn* (Litec, Paris 2000) 491, 499.

[48] Again, the existing literature has provided highly insightful analyses of the related legal issues that lie beyond the scope of this chapter. See notably Carreau (n 32) and Jean-Marc Sorel, 'Les Etats face aux marchés financiers' in Leben, Loquin, and Salem (eds) (n 47) 507.

[49] In the eurozone, eg, notes and coins in circulation as of May 2013 accounted for merely 8.9 per cent of the total monetary stock M3 (own calculation based on figures published by the ECB, available at <http://sdw.ecb.europa.eu/reports.do?node=100000141> accessed 1 July 2013).

[50] The term 'eurocurrencies' is used consistently throughout this monograph to designate what had originally become known as 'eurodollars'. Eurocurrencies are deposits of a specific currency outside the territory of the issuing state. A neutral designation such as 'xenocurrencies' (from the Greek 'xeno' for

rapidly spreading innovative financial instruments (notably credit derivatives), having played an increasingly important role (mainly, but not exclusively, for professional market players) since the onset of economic globalization in the 1960s.[51]

However, the undeniable fact that states are subject to a great number of consensual limitations and to increasingly powerful factual constraints in their exercise of what were formerly exclusive state competences in the realm of money, does not imply that the states concerned have given away their monetary sovereignty as such. As briefly noted in the general introduction to this monograph, it is crucial not to overlook the fact that the concept of sovereignty can be validly approached in two ways: directly, by focusing on the supreme and irreducible authority of independent states, and indirectly, by looking at the various sovereign powers that originally all derive from the same source, namely the capacity of independent statehood. As analysed in a timeless manner a century ago by Carré de Malberg, whereas sovereignty as the supreme authority of independent states is irreducible, sovereignty, if looked at through the prism of the powers originally vested in sovereign states, can be shared.[52] This same differentiated view of sovereignty is reflected in the position adopted by the PCIJ in the first case that came before it, the *Case of the SS 'Wimbledon'* of 1923:

> The Court declines to see in the conclusion of any Treaty by which a State undertakes to perform or refrain from performing a particular act an abandonment of its sovereignty. No doubt any convention creating an obligation of this kind places a restriction upon the exercise of the sovereign rights of the State, in the sense that it requires them to be exercised in a certain way. But the right of entering into international engagements is an attribute of State sovereignty.[53]

foreign) might have been preferable, but the prefix 'euro' is now firmly established in financial practice and the related literature. In summary, the phenomenon of eurocurrencies deprives the issuing state of some factual control over money creation since this phenomenon limits the state's capacity to control credit as an important aspect of money supply. For detail on the legal nature of eurocurrencies, their historical background, and related phenomena, see the analysis provided in Chapter 2, Part III, of this monograph.

[51] As explained in Section I.B above, whereas for economists scriptural money (under its multiple appearances) is the main part of the monetary stock in a given economy, legal theory has found it much more difficult to face reality and to admit that the state has factually lost control over essential parts of money creation. According to the mainstream State theory of money scriptural money does not amount to money, but it does so according to the Societary theory of money adhered to in this study.

[52] As formulated by Carré de Malberg in the French original:

> [D]ans son sens originaire, la souveraineté désigne le caractère suprême de la puissance étatique. Dans une seconde acception, elle désigne l'ensemble des pouvoirs compris dans la puissance d'Etat. La souveraineté, en tant que puissance suprême, demeure l'apanage de l'Etat; la souveraineté, en tant que l'ensemble des pouvoirs compris dans la puissance de l'Etat, peut en revanche être partagée.
> (Raymond Carré de Malberg, *Contribution à la théorie de l'Etat* (Sirey, Paris 1920) 79).

[53] *Case of the SS 'Wimbledon' (United Kingdom, France, Italy, Japan v Germany)*, Judgment of 17 August 1923, PCIJ Rep Series A No 1, 25.

In light of the almost exclusive focus of the existing literature on analysing the factual and legal constraints on the exercise of the various sovereign powers in the realm of money, ie on monetary sovereignty as a positive concept,[54] it is not very surprising that most authors have concluded that monetary sovereignty has become gradually eroded and outdated. However, approaching monetary sovereignty as a purely positive concept captures at best half the picture. With respect to sovereignty in general this dilemma has been perfectly described by Robert Howse as follows:

> In understanding the significance of globalisation . . . for sovereignty we must always bear in mind the fundamentally dual . . . nature of the concept—that it remains both a statement of a normative ideal . . . and a judgment about the actual capacity of states and/or their governments to affect or determine outcomes . . . The way in which sovereignty continues to structure and restructure global order cannot be properly appreciated or explained through attempts to simplify the idea into a purely normative or purely positive concept. The formalism with which many international lawyers continue to treat sovereignty is perhaps a way of trying to avoid this difficulty but at the cost of not being true to the phenomena, and in many respects . . . distorting them.[55]

As will be argued throughout this chapter and, indeed, this monograph, monetary sovereignty, due to its dual nature as a concept with both positive and normative components, is not a rigid or static concept but adapts constantly to a changing economic environment, with its normative components providing valuable regulatory guidance to those exercising sovereign powers and serving as a legitimacy benchmark for the contemporary exercise of sovereign powers in the realm of money and finance. However, prior to looking at these and other conceptual implications of a contemporary understanding of the concept of monetary sovereignty, the following section will approach it as an essentially contested concept in order to fully expose the concept's underlying nature.

B. Contemporary monetary sovereignty as an essentially contested concept

Monetary sovereignty might be best understood as what has been termed an 'essentially contested concept' in the philosophy of language.[56] Samantha Besson appears to have been the first to analyse sovereignty as an 'essentially contested

[54] For a notable exception, taking into account the dual nature of the concept of monetary sovereignty as a both positive and normative concept, see Francesco Martucci, 'De l'Union Economique et Monétaire à l'Ordre de la Politique Economique et Monétaire' (2009) 21(3) *European Review of Public Law* 1097.

[55] Robert Howse, 'Sovereignty, Lost and Found' in Shan, Simons, and Singh (eds) (n 3) 61, 75.

[56] Walter Gallie was the first to develop the idea of essentially contested concepts in Walter B Gallie, 'Essentially Contested Concepts' (1956) LVI *Proceedings of the Aristotelian Society* 167. Several authors further developed and applied the concept, notably John N Gray, 'On the Contestability of Social and Political Concepts' (1977) 5(3) *Political Theory* 331 and Jeremy Waldron, 'Is the Rule of Law an Essentially Contested Concept (in Florida)?' (2002) 21(2) *Law and Philosophy* 137. Whereas Gallie, in his original promulgation of the idea, speaks about essentially 'contested' (and not 'contestable') concepts, subsequent studies (see notably Besson (n 57) below) have used both terms synonymously.

concept'[57] and Dan Sarooshi further added to this analysis.[58] In the words of Besson:

[An essentially contested concept] is a *concept that not only expresses a normative standard and whose conceptions differ from one person to the other, but whose correct application is to create disagreement over its correct application or, in other words, over what the concept is itself*... [T]he recognition of the essentially contestable nature of a concept is an *analytical* statement. It implies the possibility of conceiving a concept as normative, that is to say as encompassing a contestable value.[59]

Due to the intrinsic relationship between the concepts of general state sovereignty and monetary sovereignty as described earlier in this chapter,[60] many of Besson's findings with respect to sovereignty in general can be directly applied to the present analysis of the concept of monetary sovereignty. In particular, it appears valid to say with Besson that monetary sovereignty, in the same way as sovereignty,

[i]s not a merely prescriptive political concept that insists on constraining political and legal reality according to an abstract standard. Nor is it a purely descriptive political concept that refers to an independent and objective reality... [Monetary] [s]overeignty should be entitled to remain the same concept and hence [provide] a conceptual framework in which debate can take place, while also fluctuating at the same time through changes of paradigms and of conceptions; the essential contestability of [monetary] sovereignty 'can account for both change and for continuity in change'. Instead of understanding [monetary] sovereignty as a mere fact or as a purely normative standard, the concept's essential contestability makes it possible to account for its institutional and discursive resilience while also respecting its normative input.[61]

The above view is perfectly in line with the analytical stance taken in this chapter and as applied throughout this monograph: monetary sovereignty is not a static and purely positive concept that over time has moved away from the political reality it once described and whose prescriptive elements have become hollow. Contemporary monetary sovereignty certainly stands in conceptual continuity with the doctrinal and historical origins of classical monetary sovereignty, but the concept's

[57] Samantha Besson, 'Sovereignty in Conflict' (2004) 8(15) *European Integration online Papers*, <http://eiop.or.at/eiop/pdf/2004-015.pdf> accessed 1 July 2013, 7–16. Whereas Besson, in her analysis of sovereignty, appears to have been the first author to explicitly rely on the framework of 'essentially contested concepts' as developed by Gallie, other authors had previously pointed to the nature of sovereignty as an increasingly contested concept, arguing rightly that sovereignty was characterized by both changing and stable elements and that the appropriate debate was not one of continuity versus change. See, notably, Georg Sørensen, 'Sovereignty: Change and Continuity in a Fundamental Institution' (1999) XLVII *Political Studies* 590, 604.

[58] Dan Sarooshi, 'The Essentially Contested Nature of the Concept of Sovereignty: Implications for the Exercise by International Organizations of Delegated Powers of Government' (2004) 25 *Michigan Journal of International Law* 1107, 1108–20; Dan Sarooshi, *International Organizations and their Exercise of Sovereign Powers* (OUP, Oxford 2005) 3–11.

[59] Besson (n 57) 6–7, original emphasis.

[60] See Section I.A of this chapter.

[61] Besson (n 57) 5 (quoting, in relevant part, Tanja E Aalberts, 'The Future of Sovereignty in Multilevel Governance Europe—A Constructivist Reading' (2004) 42 *Journal of Common Market Studies* 23, 39).

nature is essentially dynamic. Both its positive and normative components are subject to constant evolution, thereby enabling the concept to adjust to the changing economic environment brought about by increasing globalization and financial integration.

In order to amount to an essentially contested concept, a concept must be (i) intrinsically complex (ie it must encompass different dimensions of meanings), (ii) a-criterial (ie it must lack immutable minimal criteria of correct application), and (iii) normative (ie it must express and incorporate one or several values).[62] The first two criteria are obviously fulfilled with respect to monetary sovereignty. The concept itself opposes different dimensions of meanings such as external and internal monetary sovereignty or the exercise of essential parts of monetary sovereignty by international organizations or by the community organs of a monetary union to name just the two outstanding examples.[63] That there is no commonly agreed upon set of minimal criteria of correct application of monetary sovereignty should equally have become obvious over the course of this chapter. In any event, it is essential to keep in mind that:

> [c]oncept determination amounts to more than a mere description of the concept's core criteria… [T]he determination of the concept of [monetary] sovereignty cannot be distinguished from the values it entails and from the normative discussion that generally prevails around it.[64]

It is interesting to note at this stage, as has rightly been pointed out by Vaughan Lowe, that up to the nineteenth century 'it remained common practice in treaties of cessation to refer to transfers of *"tous les droits de souveraineté"*, as if sovereignty really were the bundle of separate public rights that it had been considered to be in feudal times'.[65] However, as explained in the preceding section of this chapter,

[62] Besson (n 57) 7. It should be noted that the characteristics of essentially contested concepts have been expressed in various ways in the literature. Besson's convincing focus on three key characteristics is a reformulation of the approach taken in William E Connolly, *The Terms of Political Discourse* (3rd edn Blackwell, Oxford 1993) 10–12. In his original account of essentially contested concepts, Gallie had relied upon five conditions for expressing the same key ideas (see Gallie (n 56) 171–2). See also Gray (n 56) 332 for an early (1977) summary presentation of Gallie's ideas as three characteristics.

[63] For a detailed analysis of the regionalization of monetary sovereignty, see Chapter 4 of this monograph.

[64] Besson (n 57) 7. In her argument, Besson convincingly relies on Hans Kelsen's analysis of the *bellum justum* theory as advanced in 1942, in the early days of contemporary international law. As put by Kelsen:

> The technical inadequacies of general international law do indeed to a certain extent justify the interpretation of the opponents of the *bellum justum* theory… It is one of the peculiarities of the material which forms the object of the social sciences to be sometimes liable to a double interpretation. Hence, objective science is not able to decide for or against one or the other. It is not a scientific, but a political decision which gives preference to the *bellum justum* theory. This preference is justified by the fact that only this interpretation conceives of the international order as law.
> (Hans Kelsen, Law and Peace in International Relations: The Oliver Wendell Holmes Lectures (HUP, Cambridge MA 1942) 54).

[65] Lowe (n 3) 81 (referring to the seminal study undertaken by JHW Verzijl (JHW Verzijl, *International Law in Historical Perspective: General Subjects, vol. 1* (Kluwer Law International, Alphen aan den Rijn 1968) 259)).

although a thorough understanding of the various legal and factual constraints on the contemporary exercise of the sovereign powers in the realm of money is important, monetary sovereignty is clearly no longer limited to the concept's positive components. Under a contemporary understanding of international law it would be inconsistent to contest that monetary sovereignty entails constantly evolving values. Nevertheless, acknowledging the normative nature of essential constituent elements of monetary sovereignty does not mean that the entire concept is normative,[66] nor even that the entire concept is *purely* normative. As noted earlier, any characterization of monetary sovereignty as a purely positive or purely normative concept would amount to an inappropriate oversimplification. Importantly, in order for monetary sovereignty to amount to an essentially contested concept, it is not necessary (besides fulfilment of the other two characteristics) for the entire concept to be normative. It is enough that the concept expresses and incorporates *also* one or several values that are themselves, by their very nature, subject to constant evolution and contestation.

As for more general notions of sovereignty, the crucial question whether or not monetary sovereignty incorporates specific values that can adapt over time hinges upon the fundamental task of determining the *locus* of monetary sovereignty, ie of determining the true holder(s) of monetary sovereignty. Are the sovereign powers in the realm of money original powers of national governments, which national rulers may exercise at their full discretion, or are they rather the people's powers with the government (or international organizations upon further conferrals of powers[67]) being merely entrusted with their execution? The answer to this question is so obvious that it is not necessary to address it in great detail. Back then when the concept of monetary sovereignty first appeared in order to support the exercise of the royal prerogative to coin money as exercised by absolutist monarchs, the *locus* of both sovereignty and the power to exercise it may still have been identical. Times have obviously changed.

The contemporary mainstream view of states being instruments at the service of their peoples as true holders of sovereignty[68] may be regarded as a corollary of the fundamental idea of popular sovereignty or sovereignty of the people. Similarly, and closely related to the notion of popular sovereignty, the idea of social contract

[66] Lowe has made this major point with respect to the concept of sovereignty in general (Lowe (n 3) 83).

[67] For a thorough study of the various types of conferrals of sovereign powers by states to international organizations (agency relationships, delegations, and transfers), see Sarooshi, *International Organizations* (n 58).

[68] As reflected upon by Kofi Annan, then Secretary-General of the United Nations (UN), at the turn of the last century:

> We need to adapt our international system better to a world with new actors, new responsibilities, and new possibilities for peace and progress. State sovereignty, in its most basic sense, is being redefined—not least by the forces of globalisation and international cooperation. States are now widely understood to be instruments at the service of their peoples, and not vice versa.
>
> (Kofi Annan, 'Two concepts of sovereignty', *The Economist* (online edn, 16 September 1999) <http://www.economist.com/node/324795> accessed 1 July 2013).

as developed in the writings of Thomas Hobbes (1588–1679), John Locke (1632–1703), and Jean-Jacques Rousseau (1712–1778) is still relevant today and serves as a strong argument for considering monetary sovereignty as incorporating evolving values.

According to the social contract school, individuals give up some rights in return for protection by those entrusted with the power to rule. Applied to the monetary realm at a time of economic globalization and ever-increasing financial integration this would mean that peoples all over the world, as true sovereigns, may validly be regarded as having entrusted those in power with the exercise of the relevant competences in monetary and financial matters out of recognition that certain policy objectives can only be achieved if the exercise of certain powers is centralized. This is a clear expression of the complex dual nature of monetary sovereignty as a dynamic concept with both positive and normative components. Although national governments, or anybody else exercising sovereign powers upon conferral of these powers, might not always be bound by a formal and explicit catalogue of objectives that must be achieved or of specific values that must be observed, they can certainly not be regarded as being entirely free to conduct whatever policy they deem fit. Those in power are responsible before the true sovereign, ie their people, for working diligently towards the achievement of the objectives which the contemporary social contract in the monetary field rests upon. As noted earlier, these objectives, the normative components of monetary sovereignty, are not static in nature but adapt over time to changing economic and political circumstances.[69]

Abandoning the still dominant, yet outdated, classical approach of the concept of monetary sovereignty thus appears to be perfectly in line with the widespread, broader, acknowledgment in contemporary international law that the notion of sovereign statehood itself is changing under the impact of the evolving core values enshrined in the concept of sovereignty. As analysed by Daniel Thürer:

> Considering the evolution and integration of the international legal order, sovereignty cannot just mean the final, superior decision-making power ('Höchstmächtigkeit' or 'letzte Entscheidungsgewalt') under international law. It also implies . . . the idea that a state is a political community which is invested with the effective power to grant, to realize and to implement certain basic values inherent in the principle of the 'rule of law' understood in a substantive sense . . . [D]ue to its purpose and because of its very nature state sovereignty represents a *value-laden* notion. It does in fact, as a concept of present-day international law

[69] This analysis is in line with what Michel Virally, more than 35 years ago, analysed as follows:

> [C]omme tous les concepts juridiques également, [le concept de souveraineté] a une valeur opératoire. Par les valeurs qu'il exprime, par la logique interne qui lui est propre, il présente un dynamisme dont l'orientation effective dépend du système juridique dans lequel il est utilisé. Le débat d'idées sur la souveraineté n'est donc pas sans importance, même s'il a été exagéré, et la doctrine, à l'opposé de ce qu'enseigne un certain positivisme, n'est pas innocente.

(Michel Virally, 'Une pierre d'angle qui résiste au temps: avatars et pérennité de l'idée de souveraineté' in R Blackhurst and others (eds), *Les relations internationales dans un monde en mutation* (Sijthoff, Geneva 1977) 179–80).

imply the *capacity to realize human rights and other basic values recognized by the international community*.[70]

Overall, it clearly emerges that in order to fully understand the continuing relevance of the concept of monetary sovereignty under the impact of contemporary factual and legal constraints it is necessary to take a closer look at the evolving values that are expressed by, and incorporated in, monetary sovereignty as a contemporary concept and to assess the implications of the conceptual revision undertaken in this chapter. This takes us directly into the final part of this opening chapter.

III. Conceptual Implications for the Evaluation of the Exercise of Sovereign Powers in the Realm of Money

This final part takes a close look at the normative components of the concept of monetary sovereignty which provide regulatory guidance and serve as a legitimacy benchmark for the contemporary exercise of monetary sovereignty (Section A) before analysing the concept of contemporary monetary sovereignty as a special form of cooperative sovereignty (Section B).

A. The normative components of contemporary monetary sovereignty as regulatory guidance and a legitimacy benchmark

The constituent values of contemporary monetary sovereignty are diverse and it appears impossible to come up with an exhaustive and incontestable list. However, as pointed out by Sarooshi with respect to general state sovereignty, the fact that such a list will be 'continually subject to contestation and change' is perfectly in line with the idea of an essentially contested concept.[71] As explained below and substantiated throughout this monograph, the concept of monetary sovereignty certainly incorporates and expresses both more general values like democracy, equality, accountability, and legitimacy, and more specific ones like economic development, the maximization of global welfare, the maintenance of financial integrity, as well as the promotion of financial and monetary stability. At a time of ever-increasing economic globalization and financial integration and in light of the damaging, yet insightful, experience of the Global Financial Crisis of 2007–2009 and the severe recession triggered by it in large parts of the world,[72] it seems

[70] Daniel Thürer, 'The Emergence of Non-Governmental Organizations and Transnational Enterprises in International Law and the Changing Role of the State' in Rainer Hofmann (ed), *Non-State Actors as New Subjects of International Law* (Duncker & Humblot, Berlin 1999) 38–9, original emphasis, footnotes omitted. See also Jörg P Müller, 'Wandel des Souveränitätsbegriffs im Lichte der Grundrechte—dargestellt am Beispiel von Entwicklungen des internationalen Menschenrechtsschutzes auf die schweizerische Rechtsordnung' in Stephan Breitenmoser, Bernhard Ehrenzeller, and René Rhinow (eds), *Fragen des internationalen und nationalen Menschenrechtsschutzes* (Helbing & Lichtenhahn, Basel 1997) 45, 61–2.

[71] Sarooshi, *International Organizations* (n 58) 9.

[72] The term Global Financial Crisis has firmly established itself in public discussions to designate the worst financial and economic crisis since the Great Depression of the 1930s. While the term Great

appropriate to regard the last three values, ie the promotion of monetary and financial stability as well as the maintenance of financial integrity, as increasingly important key values of contemporary monetary sovereignty.

How are these values defined and what role do they play in practice?

Monetary stability.[73] Achieving monetary stability is usually the central target of monetary and, more specifically, interest rate, policies as conducted by central banks. It is important to keep in mind in this context that there is both an *internal* and an *external* dimension to monetary stability. It emerges from a detailed study of central bank objectives undertaken by François Gianviti, a former general counsel of the IMF, that in most central banking laws worldwide, monetary stability is defined as the stability of domestic prices.[74] As explained in detail by Gianviti, this is due to the economic reality that *external* price stability (in terms of the exchange rate with a given major currency) and *domestic* price stability are in fact two distinct objectives, incompatible with each other in the long run.[75] For example, a central bank that increases the monetary base in order to prevent its currency from appreciating in line with economic fundamentals, thereby aiming to maintain an unrealistic currency peg, will in the long run fuel inflation, thus endangering domestic price stability.[76]

Gianviti's survey further shows that what precisely is to be understood by domestic price stability is often not explicitly defined unless the country concerned is one of those with a specific procedure in place for the formulation of an explicit inflation target or some other form of quantified price objective.[77] In countries lacking a formal definition of the objective of domestic price stability, the understanding of that objective is subject to the central bank's case-by-case interpretation and, to the extent that the central bank is not entirely independent,[78] to the approval and review by the government.[79] However, Gianviti's survey identifies a

Recession (as compared to the Great Depression) has equally been used in the literature to characterize the state of the world economy in 2007–2009, it fails to account for the fact that throughout this entire period the gross domestic product (GDP) of large parts of the world, mostly African and Asian states, continued to grow, albeit at diminished rates. The ongoing sovereign debt crisis in several advanced European economies, though intrinsically linked to the Global Financial Crisis, may be considered a separate event. For an analysis of the reorganization of the international financial architecture in the wake of the Global Financial Crisis, see Chapter 5 of this monograph.

[73] The definitions of monetary and financial stability presented in the following paragraphs are a condensed version of the more detailed analysis of central bank objectives undertaken as part of the following book contribution: Claus D Zimmermann, 'Global Benchmark Interest Rates: Conflicting Objectives and Increasing Hybridization' in Thomas Cottier, Rosa M Lastra, Lucia Satragno, and Christian Tietje (eds), *The Rule of Law in Monetary Affairs* (CUP, Cambridge forthcoming 2014).

[74] François Gianviti, 'The Objectives of Central Banks' in Giovanoli and Devos (eds) (n 36) 449. For a detailed definition and nuanced discussion of monetary stability as key central bank objective, see Lastra (n 8) 34–9.

[75] Gianviti (n 74) 473.

[76] For detail on the economic mechanisms and policy rationale underlying exchange rate misalignment, see Chapter 3, Section I.C, of this monograph.

[77] Gianviti (n 74) 468.

[78] For an insightful analysis of the theory and practice of central banks independence, see Lastra (n 8) 41–61.

[79] Gianviti (n 74) 468–9.

global trend towards the adoption of quantified price objectives as opposed to allowing central banks to conduct monetary policy without publicly announcing specific objectives.[80]

Gianviti's study indicates that there now seems to be a common understanding on what to understand by the objective of domestic price stability. Thus, while domestic prices are those of domestic goods and services, asset prices are not usually covered by the term. As regards 'stability', there now appears to be broad consensus that while a total absence of inflation would discourage investment and thus stifle economic growth, an annual price increase of 2 per cent would still be consistent with the objective of domestic price stability.[81]

Thus, some countries have adopted inflation ceilings whereas others consider the setting of inflation targets to be the preferable approach. An inflation target may take the form of a 'point inflation target', ie a specific percentage increase of consumer prices, such as the Bank of England's inflation target of 2 per cent, or of a 'target inflation range' which seems to be the more common approach and which is adhered to, for example, in Canada and Sweden.[82] An interesting example in that context is the approach taken by the Governing Council of the ECB as it has shifted from an outright inflation ceiling of 2 per cent to a hybrid definition of price stability that might appropriately be qualified as a 'targeted inflation ceiling'. Thus, the Governing Council of the ECB has clarified that, in pursuing domestic price stability as the ECB's primary policy objective, it seeks to keep inflation below, but close to, 2 per cent over the medium term.

This leads us directly to what is arguably the contemporary key difference between the interest rate policies pursued by different central banks. While the formal adoption of an inflation target (or target range) amounts to an implicit acknowledgement that the central bank wishes to contribute, via the way it conducts monetary policy, to economic growth and employment, some central banks, notably the Fed, also aim to achieve a desired level of growth in real activity as part of their monetary policy.[83] Thus, in early December 2012, the Fed went as far as to as explicitly specify that its objective was to push the US unemployment rate below 6.5 per cent and that it would therefore leave interest rates at close to zero provided its inflation expectations did not rise beyond 2.5 per cent.[84]

Pursuing a dual objective of both price stability and economic growth/full employment becomes problematic when both objectives enjoy equal priority. Under such a scenario, pursuing an objective of promoting growth in real activity may prove incompatible with the objective of controlling inflation. This is due to

[80] Gianviti (n 74) 472. [81] Gianviti (n 74) 470.

[82] Gianviti (n 74) 471.

[83] These different approaches explain to a large extent existing discrepancies in the interest rate policies conducted on both sides of the Atlantic. Maybe more importantly, however, they help to understand the continuous struggle between the two largest economies in the EU, Germany and France (whose *Banque de France* formerly played a major role in stimulating the real economy), regarding the right approach to be pursued by the ECB.

[84] Robin Harding and James Politi, 'Fed links interest rates to US unemployment', *Financial Times* (13 December 2012) <http://www.ft.com/intl/cms/s/0/3713f096-447e-11e2-8fd7-00144feabdc0.html> accessed 1 July 2013.

the fact that whereas price stability as sole or primary monetary policy objective makes action by the central bank predictable and reliable a dual objective undermines the central bank's commitment to price stability. This may happen if the population gains the impression that, faced with the dilemma of choosing between an economic downturn and higher inflation, the central bank will attach higher importance to its objective of full employment.[85]

The Fed's and the ECB's different responses to the onset of the Global Financial Crisis in 2007 and 2008 are highly insightful in this context. The Fed reacted with a series of interest rate cuts aimed at saving employment while the ECB kept interest rates unchanged for much longer in order not to endanger domestic price stability. This example illustrates that the current lack of harmonization in the way interest rates policies are being conducted in the pursuit of different monetary policy objectives by central banks may lead to major differences in how similar economic problems are tackled across different countries.

Financial stability. Many different definitions have been advanced in the economics literature for financial stability, the other key objective pursued by most central banks worldwide even though, strictly speaking, financial stability is not an objective of monetary or interest rate policies. Usually, financial stability is defined in an indirect manner as the absence of financial instability. A broad and systemic approach defines financial instability as the prevalence of a financial system that is unable to ensure, in a lasting way and without major disruptions, an efficient allocation of savings to investment opportunities.[86] Financial regulation on minimum capital ratios for banks is the main, but not exclusive, tool for avoiding financial instability (in particular in order to reduce systemic risk, ie multiple bank failures as a result of contagion). Although there is no common position in the economics literature on the precise interdependence of monetary stability and financial stability, it seems broadly admitted that both phenomena are intrinsically linked and reinforce each other, which seems equally true for the two instability scenarios.[87] Thus, as pointed out by Gianviti, while in most cases, securing financial stability will be supportive of achieving monetary stability, a central bank may face a conflict of objectives in the conduct of its monetary and interest rate policies once it becomes engulfed in a financial crisis.[88] Gianviti cites the example of a major financial crisis in which the central bank, in order to safeguard a financial system on the verge of collapsing, decides to bail out numerous systemically important financial institutions, partly without collateral, on top of lowering its interest rates and injecting short-term liquidity into the banking system; in addition, the central bank may even be exposed to significant public pressure to purchase large amounts of government bonds to finance budget deficits arising

[85] See Gianviti (n 74) 473.

[86] Definition by the former Chief Economist and Member of the Board of the ECB Otmar Issing: Otmar Issing, 'Monetary and Financial Stability: Is there a Trade-off?' (2003) Paper presented at the ECB Conference on 'Monetary Stability, Financial Stability and the Business Cycle' held at the Bank for International Settlements (BIS), Basel (28–29 March 2003) <http://www.ecb.int/press/key/date/2003/html/sp030329.en.html> accessed 1 July 2013.

[87] See n 86.

[88] Gianviti (n 74) 481.

from countercyclical measures taken to mitigate the crisis.[89] In the long run, the thus injected amounts of central bank money, all injected in the name of financial stability, may endanger monetary stability in the sense of domestic price stability.

Based on the above, it would be wrong to conclude that central banks should not aim to safeguard financial stability in addition to pursuing their monetary policy objective(s), in particular as both monetary and financial stability will in most cases reinforce each other. However, while a sovereign state is free to determine in the statutes of its central bank that the objective of monetary stability takes priority over that of financial stability, such an order of priority would effectively have to be abandoned in the case of a severe crisis. Although, strictly speaking, financial stability is not an objective of monetary and interest rate policies, the central bank of a modern economy has little choice but to pursue simultaneously both monetary and financial stability. This seems true despite the above-mentioned potential for conflict between these two objectives. This clearly distinguishes the pair financial/monetary stability from the wholly separate choice as to whether or not to pursue an economic growth objective as part of monetary policy on top of the objective of price stability.

Financial integrity. Finally, financial integrity can be defined as the absence of money laundering, insider trading, and illegal capital flows and is commonly regarded as contributing not only to increased global security but also increased monetary and financial stability.[90]

The normative components of an essentially contested concept fulfil a dual conceptual function. On the one hand they provide important practical policy guidance to those exercising sovereign powers. On the other hand they constitute a benchmark 'according to which political situations should be evaluated'.[91] Sarooshi has taken this argument one step further noting very convincingly that:

> The incorporation of these values as an integral part of the concept of sovereignty allows the argument to be made that the exercise of public powers of government can only be considered an exercise of sovereign powers when this is in accord with sovereign values, otherwise the exercise of public powers is something entirely distinct from the exercise of sovereign powers and can even be considered as a violation of sovereignty.[92]

The above statement might be puzzling at first sight, but is perfectly coherent if one admits that monetary sovereignty is not a purely positive concept, ie a descriptive catalogue of regulatory powers in the realm of money and finance, but that it incorporates also constantly evolving values that constitute a benchmark for the legitimacy of both regulatory action and inaction. Based on the well-established view in contemporary international law that peoples are the ultimate holders of sovereignty and not those in power,[93] any policy or regulatory action that consistently disregards the constituent values of monetary sovereignty would have

[89] Gianviti (n 74) 481.

[90] Whereas financial stability and financial integrity are closely linked concepts, financial integrity is obviously not the only contributing factor to financial stability.

[91] Besson (n 57) 7.

[92] Sarooshi, *International Organizations* (n 58) 11.

[93] See the analysis provided towards the end of Section II.B above.

to be considered a violation of that same monetary sovereignty. In the words of Michael Reisman:

> In modern international law, sovereignty can be violated as effectively and ruthlessly by an indigenous as by an outside force, in much the same way that the wealth and natural resources of a country can be spoliated as thoroughly and efficiently by a native as by a foreigner.[94]

Reisman's observations regarding the locus of sovereignty and its violation by domestic actors, although made in the context of human rights violations by domestic actors and not at all with respect to monetary sovereignty, appear to be generally applicable across the whole body of contemporary international law. Admitting that the maintenance of the integrity of the financial system and the promotion of global financial and monetary stability figure among the values incorporated in a contemporary concept of monetary sovereignty thus has major implications for assessing what constitutes a proper exercise of monetary sovereignty. Under this new perspective, those exercising sovereign powers in the realm of money would have to do so in a way that promotes global monetary and financial stability and that ensures the integrity of the financial system. If a state were continuously to fail to orient its policies towards the promotion of these values, that state would effectively be violating the monetary sovereignty of its own people, thereby ultimately eroding the legitimacy of its very own governmental actions. Due to the fact that states are not unitary actors the same reasoning would apply to any entity exercising relevant sovereign powers following conferrals of powers within a given state (eg conferrals to national ministries or specialized agencies or to an independent central bank) or on the international level (eg conferrals to the IMF or to the organs of a monetary union).[95]

Contrasted with the classical understanding of monetary sovereignty as a purely positive concept, implying independence from external interference in the management of a state's monetary and financial affairs, this constitutes a huge paradigm shift. Under the contemporary understanding of monetary sovereignty as analysed in this chapter, it incorporates and expresses values, such as, notably, the maintenance of financial integrity and the promotion of monetary and financial stability, of accountability and transparency. These values form a bundle of interrelated normative goals the precise contents of which constantly adjust to changes in the economic framework.

A detailed analysis of how and to what extent the constituent values of contemporary monetary sovereignty actually fulfil their above-mentioned dual function (ie to provide policy guidance and to serve as a legitimacy benchmark) cannot be achieved in an abstract manner as part of this opening chapter. However, such an assessment will be part of the substantial analysis of the contemporary exercise of

[94] W Michael Reisman, 'Sovereignty and Human Rights in Contemporary International Law' (1990) 84 AJIL 866, 872.

[95] For a detailed analysis of various related legal challenges, see the following chapters of this monograph.

key sovereign powers in the realm of money undertaken in the remaining chapters of this monograph.

In order to avoid the slightest misunderstanding it seems important to underline that the constituent values of monetary sovereignty as an essentially contested concept are obviously not normative in the sense that they establish firmly binding legal rules the non-observance of which constitutes *ipso facto* a breach of law, potentially even entailing international legal responsibility for the state concerned. They are normative in the sense that those exercising sovereign powers in the realm of money (notably national governments, central banks, and international institutions like the IMF or hybrid bodies like the Financial Stability Board (FSB)[96]) cannot afford to persistently ignore these values if they do not want to provoke the erosion of the effectiveness, the authority and, ultimately, the legitimacy of their decisions and actions in the long run. It is precisely this impact on policy design, and on the related evolution of the law in the realm of money and finance, that is the main expression of the normative nature of essential components of the contemporary concept of monetary sovereignty as analysed by this study. The practical relevance of these fundamental dynamics will be examined in the following chapters.

The extent to which different societies have different ideas about the core values incorporated in, and expressed by, contemporary monetary sovereignty and, in particular, the extent to which they have differing convictions on how to achieve these normative goals, remains of course a constant problem.[97] Whereas ensuring the integrity of the financial system, ie avoiding illegal abuse of the financial system, can no doubt be regarded as a value that is shared worldwide, based on its intrinsic link to the rule of law, maintaining monetary stability and promoting global financial stability might be more problematic normative objectives. However, although those exercising sovereign powers in monetary and financial matters may indeed have differing ideas and economic beliefs about how to best achieve monetary and financial stability,[98] there seems to be broad agreement that certain policies are clearly counterproductive, like for example imposing insufficient minimum capital ratios for banks. In addition, most states probably agree that the exercise of sovereign powers in monetary and financial matters should be such as not to put global monetary and financial stability at risk. The earlier mentioned Article IV of the IMF Agreement can certainly be read in support of this view, in

[96] For detail on the FSB and its role in the reorganized international financial architecture, see Chapter 5, Section II, of this monograph.

[97] Sarooshi has made this point with respect to the exercise of sovereign powers by international organizations. See Sarooshi, *International Organizations* (n 58) 10.

[98] The differing objectives pursued by central banks in their conduct of monetary policy illustrate this lack of consensus. See the definition of monetary stability provided towards the beginning of the present section. That such a consensus does not exist has further been amply demonstrated, inter alia, by the failure of the so-called 'Washington Consensus', rendered infamous in the context of too rigidly applied IMF and World Bank conditionality. For detail on IMF conditionality and the Washington Consensus, see Chapter 2, Section II.A, of this monograph.

particular in light of the almost universal membership of the IMF with currently 188 members.[99] It states in relevant part:

> Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members.

At a time when national economies are ever more interdependent and when financial markets are integrated as never before, the responsible exercise of sovereign powers in the realm of money and finance increasingly requires close cooperation among states. This takes us directly into the final section of this opening chapter. Under the contemporary concept of monetary sovereignty, as examined in this monograph, such cooperation under evolving economic constraints does not amount to ringing the death knell for the concept of monetary sovereignty. Instead, it may be more appropriate to regard such a joint exercise of monetary sovereignty as reflecting a special form of cooperative sovereignty. As noted earlier, the succinct revision of the concept of monetary sovereignty undertaken in this opening chapter sketches out the general conceptual framework. Specific substantial questions, most notably the question whether the increasing regionalization of monetary sovereignty in the context of economic and monetary unions constitutes the surrender of monetary sovereignty or an effective exercise of the latter, will be analysed in subsequent chapters.[100]

B. *Regulating an increasingly interdependent global economy: contemporary monetary sovereignty as cooperative sovereignty*

As noted above, in the light of the increasing integration of financial markets and the interdependence of 'national' economies, the effective promotion of global monetary and financial stability requires cooperation among those exercising sovereign powers in the realm of money and finance. Again, Besson's findings with respect to general state sovereignty are applicable to the more specific case of monetary sovereignty:

> [G]radually the exercise of [monetary] sovereignty has turned from an individual exercise into a cooperative enterprise . . . This form of sovereignty *triggers duties of cooperation* on the part of the entities which cannot ensure the protection of all the values they should protect, as much as on the part of the entities which can help the former to protect those values they

[99] See IMF, 'Republic of South Sudan becomes the IMF's 188th member', Press Release No 12/140 (18 April 2012) <http://www.imf.org/external/np/sec/pr/2012/pr12140.htm> accessed 1 July 2013.

[100] See, most notably, Chapter 4 of this monograph which will examine, inter alia, how the idea of cooperative sovereignty plays out in light of the myriad of trials and tribulations faced by the eurozone in the context of the ongoing sovereign debt crisis faced by an increasing number of its member states.

share. They should all be seen as working towards the same end: the realization of their shared sovereign values and principles.[101]

The contemporary concept of monetary sovereignty as analysed in this chapter does not call for the introduction of binding international law as part of a globally harmonized legal framework for the exercise of all formerly exclusive state competences in the realm of money (understood in a wider sense). As explained below, the above-mentioned duty to cooperate in the promotion of the constituent values of contemporary monetary sovereignty, notably the promotion of global monetary and financial stability, is being strictly framed by the principle of subsidiarity, the observance of which has been convincingly analysed in the literature as being an integral part of the correct application of the concept of sovereignty itself.[102] As further elaborated by Besson, '[a]s a concept of power distribution . . . the principle of subsidiarity implies a *test of efficiency* in power allocation. In each case, the sovereign authority will be that authority which can realize the objective in the most efficient way'.[103]

Hence, in conformity with the principle of subsidiarity, transferring certain sovereign powers to higher levels of governance increasingly distant from the people as the true holder of sovereignty would be an appropriate choice only to the extent that lower levels of governance cannot effectively promote the values incorporated in contemporary monetary sovereignty as analysed in this chapter. If properly applied to this contemporary concept of monetary sovereignty as essentially cooperative sovereignty, respecting the principle of subsidiarity would thus help to ensure that the regulatory decisions that are part of the exercise of monetary sovereignty are taken no further away than necessary from the people to whom those in power are ultimately responsible. It should be added that, in practice, this type of responsibility does not always imply that those exercising sovereign powers in the realm of money and finance can be held effectively accountable, by the people as the true sovereign, for the quality of their respective decisions. Whereas this is obviously the case with respect to decisions taken by international organizations, the independence of central banks raises similar concerns on the national level. Hence the increasing importance of transparency and accountability in the exercise of contemporary monetary sovereignty as noted below. Depending on the nature of the precise task at issue and the existing economic circumstances, the appropriate level of governance for the exercise of a given sovereign power in the realm of money and finance could be a multilateral international organization like

[101] Besson (n 57) 13, emphasis added. See also Daniel Thürer, 'Modernes Völkerrecht: Ein System im Wandel und Wachstum—Gerechtigkeitsgedanke als Kraft der Veränderungen?' (2000) *Zeitschrift für ausländisches öffentliches Recht und Völkerrecht* 557, 592 and Catherine Richmond, 'Preserving the Identity Crisis: Autonomy, System and Sovereignty in European Law' (1997) 16 *Law and Philosophy* 377, 415–17.

[102] Besson (n 57) 13. For a related argument, see Neil MacCormick, *Questioning Sovereignty* (OUP, Oxford 1999) 135.

[103] Besson (n 57) 12, original emphasis. On the complementarity between the principle of subsidiarity and sovereignty, see also Jörg P Müller, *Der politische Mensch—Menschliche Politik* (Helbing & Lichtenhahn, Basel 1999) 171. See also Jackson (n 5) 792–4.

the IMF, an economic and monetary union or one of its organs on the regional level, a yet to be created institution, or merely the nation state or any of its sub-entities.[104]

As far as its role in the broader conceptual framework set out in this chapter is concerned, subsidiarity as an important framing element of cooperative monetary sovereignty ensures that the conceptual continuity between contemporary monetary sovereignty and classical monetary sovereignty, as well as the conceptual link between monetary sovereignty and general domestic sovereignty, is preserved. As elaborated in this chapter, the concept of monetary sovereignty has significantly evolved over time and will continue to do so in the future under evolving economic and political circumstances. However, the continued relevance of the concept's origins places the state as the supreme monetary authority in the very centre. This is consistent not only with the still dominant State theory of money, but also with the Societary theory of money as refined and understood by Nussbaum and as adhered to in this study.[105] As noted earlier, in order to be able effectively to promote their shared sovereign values in the realm of money (as understood in a wider sense), states are increasingly compelled by contemporary economic constraints to cooperate in the exercise of what were formerly exclusive, 'national', state competences. As will be analysed in detail in the following chapters of this monograph, this joint exercise of monetary sovereignty leads to the gain of a joint margin of manoeuvre for the participating states; a margin of manoeuvre that the same states would have lost under the impact of contemporary constraints had they insisted on continuing to exercise their sovereign powers individually. As explained above, the principle of subsidiarity helps to ensure that states renounce an isolated exercise of sovereign powers in the realm of money and finance only to the extent necessary for the effective promotion of the constituent values of contemporary monetary sovereignty.

Finally, with international cooperation in monetary and financial matters becoming more and more an economic necessity, it is important that the exercise of contemporary monetary sovereignty as cooperative sovereignty satisfies high standards of transparency and accountability. This seems particularly crucial in so far as such international cooperation involves conferrals of sovereign powers to international organizations or to the organs of a monetary union, due both to the increasing complexity that results from the related increase of the number of players involved and to the fact that such conferrals move the locus of decision-making further away from national peoples as the true holders of sovereignty.[106]

However, as has been convincingly pointed out by Robert Keohane and Joseph Nye, 'accountability is sometimes treated as a good per se, but it is an instrumental

[104] For a detailed analysis of several related legal challenges arising in the context of the increasing regionalization of monetary sovereignty, see Chapter 4 of this monograph.

[105] For detail on the various legal theories of money, see Section I.B of the present chapter.

[106] It goes without saying that for states acting individually, mechanisms ensuring transparency and accountability have become increasingly important issues, too, since states are far from being unitary actors: different agencies and ministries exercise relevant elements of the regulatory powers in monetary and financial matters.

value, subject to being subordinated as well as traded off against other values'.[107] The political choice, increasingly widespread in developed economies, of raising the effectiveness of monetary policy through granting central banks formal independence, thereby isolating them from direct political influence,[108] is a clear reflection of precisely this trade-off.[109] Central bank independence, coming at the price of reduced accountability in a conventional sense, serves to isolate the conduct of monetary policy from political pressure driven by short-term interests, thereby increasing the effectiveness with which central banks can promote long-term goals such as monetary and financial stability as two of the key values of contemporary monetary sovereignty, as analysed in this chapter.

Indeed, as rightly pointed out by Kal Raustiala, if the legitimacy of an economic institution or body is at least to some degree grounded in the effectiveness with which it works successfully towards the promotion of sovereign values, a given institution may be regarded as gaining at least some degree of legitimacy, *ceteris paribus*, from the simple fact that its decisions and actions are instrumentally useful, even though it lacks traditional mechanisms of accountability.[110] The fundamental question of whether international institutions lacking a formal multilateral mandate and traditional mechanisms of accountability, such as, notably, the G-20 and the FSB, may gain at least some legitimacy through working effectively towards the promotion of commonly shared values will be addressed in due detail towards the end of this monograph.[111]

On a final note, it is interesting to observe that the growing focus on the issues of transparency and accountability in the contemporary exercise of sovereign powers in the realm of money and finance is closely related to phenomena analysed by a rather young scholarly field: global administrative law. Research in the field of global administrative law has been initiated by Benedict Kingsbury and others in response to a perceived 'democracy deficit' in international law-making.[112] In the context of the myriad of global regulatory initiatives launched by all sorts of ad-hoc committees and informal gatherings of policymakers in order to restructure the international financial architecture in the wake of the Global Financial Crisis this concern is certainly more acute than ever.[113]

[107] Robert O Keohane and Joseph S Nye Jr, 'Democracy, Accountability, and Global Governance' (2001) Harvard University John F Kennedy School of Government, Politics Research Group Working Papers on International Relations No 01–4, 5 (quoted and commented on in Kal Raustiala, 'Rethinking the Sovereignty Debate in International Economic Law' (2003) 6 JIEL 841, 62).

[108] On the economic rationale for central bank independence, see, for example, Stanley Fischer, 'Central-Bank Independence Revisited' (1995) 85(2) *The American Economic Review* 201; as well as the various references listed therein.

[109] Raustiala (n 107) 862.

[110] Raustiala (n 107) 862.

[111] See, notably, the detailed analysis provided in Chapter 5, Sections I and II, of this monograph.

[112] See, eg, Michael S Barr and Geoffrey P Miller, 'Global Administrative Law: the View from Basel' (2006) 17 EJIL 15, 16.

[113] For related substantial comments, see, notably, the analysis provided in Chapter 3, Section III, as well as in Chapter 5 of this monograph.

Global administrative law can be defined as covering:

> the structures, procedures and normative standards for regulatory decision-making . . . that are applicable to formal intergovernmental regulatory bodies; to informal intergovernmental regulatory networks, to regulatory decisions of national governments where these are part of or constrained by an international intergovernmental regime; and to hybrid public-private or private transnational bodies.[114]

Analysing the techniques by which different states and monetary unions, the IMF, the G-20, the FSB and various international financial standard-setting bodies ensure that their decisions and proceedings are sufficiently transparent lies far beyond the scope of this chapter. The same is true for examining how the various international institutions and bodies in the field, many of a temporary and ad-hoc nature, remain accountable to the public and how they address existing legitimacy concerns arising from a perceived democracy-deficit and insufficiencies of their respective mandates. Wherever relevant, the following chapters of this monograph will address these issues in more detail.

Conclusion

Under its contemporary definition as elaborated in this chapter, the concept of monetary sovereignty can no longer be used by states (or by any other entity exercising sovereign powers in monetary and financial matters upon conferral) as an excuse for not effectively promoting the sovereign values in the realm of money and finance such as, notably, the promotion of global monetary and financial stability and the maintenance of financial integrity.

Based on the inherently dual nature of sovereignty as a dynamic concept with not only positive but also constantly evolving normative components, the concept of monetary sovereignty cannot, by its very nature, become eroded under the impact of various economic and legal constraints. However, there is no denying that such contemporary constraints play a major role in defining which steps need to be taken in order to promote global monetary and financial stability and the other core values incorporated in, and expressed by, contemporary monetary sovereignty. As analysed in this chapter, the concept of monetary sovereignty is able to adapt to a constantly changing economic environment, and thereby in turn helps to define what constitutes a responsible exercise of the sovereign powers in the realm of money (as understood in a wider sense).

There is indeed little doubt that most, if not all, daily questions relating to specific rights and obligations of states, international organizations, and private persons can be asked and resolved effectively without having recourse to the

[114] Barr and Miller (n 112) 16 (in reference to Benedict Kingsbury, Nico Krisch, and Richard B Stuart, 'The Emergence of Global Administrative Law' (2005) 68 *Law and Contemporary Problems* 15).

concept of monetary sovereignty.[115] The conceptual revision and fundamental update provided in this chapter and substantiated throughout the subsequent chapters of this monograph do not change this realistic observation. This study does not deny that reflections on the underlying nature of the concept of monetary sovereignty serve above all as a stimulating framework of enquiry and also as a convenient vehicle for debates on specific rights and obligations relating to the contemporary exercise of the formally exclusively national sovereign powers in the realm of money and finance. Many of the insights thus obtained, and this is certainly also true for the subsequent chapters of this monograph, could indeed have been obtained without making the slightest reference to the concept of monetary sovereignty.

Yet it would be a mistake to believe that the above observations turn the concept of monetary sovereignty and its evolution as analysed herein into a subject that lawyers have no need ever to deal with.[116] To the extent that we are interested not only in what the law is today, but also to gain a better understanding of the driving and shaping forces behind the evolution of international law in the realm of money, monetary sovereignty remains arguably a timeless concept at the intersection of law, economics, and politics. Let us therefore embark on the next chapter, which analyses the evolving nature of international monetary law by looking into the increasing hybridization of this increasingly complex body of law.

[115] Lowe was right to make this fundamental point with respect to the concept of sovereignty in general. See Lowe (n 3) 84.

[116] For this slightly provocative, and herein refuted, view, as expressed by Lowe with respect to debates over sovereignty in general, see Lowe (n 3) 84.

2

The Increasing Hybridization of International Monetary Law

Introduction

It is widely acknowledged today that the contemporary scope of international law goes well beyond that which the PCIJ once famously described as 'the body of binding norms freely entered into between sovereign States'.[1] This appears to be particularly true for the field of IML which is undergoing a major transformation whose main implications are: (i) the declining role of states as primary authors of legal norms, (ii) the decreasing extent to which the truly relevant norms in the field are made up of 'hard' law, ie of formally binding law backed up by effective sanctions, and (iii) the increasing replacement of the once clear-cut body of public IML by rules emerging from all three traditional pillars of international economic law (IEL) as supplemented by an increasingly important body of transnational[2] monetary law (TML).[3]

Hence, the ongoing hybridization of contemporary IML as analysed in this chapter covers a very broad phenomenon resulting from constant changes in the formal and material sources of this body of law, from the increasing unsuitability of the rigid categories of 'hard' and 'soft' law for appropriately characterizing all recent normative evolutions in this important sub-discipline of IEL as well as from the rise in importance of TML, not as a separate, but as an intrinsic element of contemporary IML.

In practical terms, the hybridization of IML becomes manifest mainly, but not exclusively, as follows. Firstly, the IMF Agreement is to an increasing extent no longer the sole formal source of public IML due to the fact that a contemporary key component of IML *lato sensu*—the body of rules on trade in financial services—is embedded in the WTO legal framework. In addition, bilateral investment treaties and related arbitration awards have evolved into significant material sources of

[1] *The Case of the SS 'Lotus'*, Judgment of 7 September 1927, PCIJ Rep Ser A No 10, 18.

[2] Transnational law is commonly defined as the body of rules—national, international, public, or private—that regulates actions across national borders by all sorts of actors, ie not only states and their official organs but also international organizations, businesses, as well as other public or private persons.

[3] For an insightful analysis of the gradual transformation of the first two of the above-listed constituent elements of international law and the related hybridization of international environmental law, see Veerle Heyvaert, 'Levelling Down, Levelling Up, and Governing Across: Three Responses to Hybridization in International Law' (2009) 20 EJIL 647.

IML. Secondly, the role of states as primary authors of legal norms in the monetary field is being increasingly challenged by what may be termed institutional policy-making via the normative effects of the conditionality of IMF and World Bank lending as well as of the IMF's surveillance and technical assistance activities. Thirdly, the private sector is gaining not only more and more economic leverage in the realm of money and finance, but it is also participating, at least to some extent, in determining the rules of the game for international financial transactions as part of what has become discussed in the literature as the monetary and financial dimensions of the *lex mercatoria*.

This chapter proceeds as follows. After an examination of the diversification of the legal regime for international current and capital transactions across the three traditional pillars of IEL (Part I), the evolving normative effects of the conditionality of IMF and World Bank conditionality and the impact of the IMF's surveillance and technical assistance activities (Part II) will be analysed. Finally, this chapter looks into relevant aspects of the rise in importance of TML and its implications (Part III).

I. The Diversification of the Legal Regime for International Current and Capital Transactions Across the Three Pillars of International Economic Law

This first part begins with an assessment of relevant aspects of the IMF rules on capital controls and restrictions of current payments, which are situated truly at the intersection of international trade, investments, and the related flows of capital and payments (Section A). Subsequently, the emergence of a powerful legal framework across the whole of IEL promoting the liberalization of international transfers of funds and the underlying economic incentives will be analysed. (Section B).[4] Finally, this first part examines the extent to which IEL is moving towards a coherent regime for balance-of-payments derogations (Section C).

A. The intersection of international trade, investments, and the related flows of capital and payments

At the end of World War Two, one of the most important challenges in the process of fostering global economic recovery was to restore international trade, which at the time was essentially trade in goods, thereby restoring peaceful interactions between former allies and enemies alike.[5] As was well recognized by the architects of the Bretton Woods system, one cannot effectively liberalize international trade if

[4] An extended version of the analysis included in Sections I.A and I.B of this chapter has been published as an article: see Claus D Zimmermann, 'The Promotion of Transfer-of-Funds Liberalisation across International Economic Law' (2011) 12(5) *Journal of World Investment and Trade* 725.

[5] See Cynthia Lichtenstein, 'International Jurisdiction Over International Capital Flows and the Role of the IMF: plus ça change . . . ' in Mario Giovanoli (ed), *International Monetary Law—Issues for the New Millennium* (OUP, Oxford 2000) 61, 65.

the liberalization of the corresponding payments does not keep pace. This intrinsic unity and the experience of the past[6] would logically have advocated the creation of a one-stop shop, in other words, to entrust a single international organization with the various challenges arising from the linkages between trade and money.[7] Yet under the constraints of political feasibility a different approach was chosen: while the IMF was put in charge of overseeing the international monetary system, the liberalization of international trade was given to the International Trade Organization (ITO) (with only the General Agreement on Tariffs and Trade (GATT) entering into force on a provisional basis) and, more recently,[8] to the World Trade Organization (WTO).

Under IMF Article VIII:2(a), the main multilateral provision for freeing the means of payments for international trade, IMF members are prohibited from imposing restrictions on the making of payments and transfers for current international transactions without approval of the Fund.[9] In this context, it is important to point out, as explained by Deborah Siegel, that:

> The 'making' of payments and transfers refers to *outflows*, such as payments for imports of goods and services. [Article VIII:2(a)] does not apply to receipts from exports (although these are also current international transactions). For example, it does not require a member to seek approval for a rule mandating that *receipts* of foreign exchange must be repatriated and sold in the banking system for local currency within a specified time period.[10]

In order to provide guidance on the correct application of this important rule in IMF Article VIII:2(a), the IMF has defined what constitutes an exchange restriction. This definition, set forth in a 1960 decision by the IMF Executive Board, relies entirely on a technical criterion asking 'whether [a measure] involves a direct governmental limitation on the availability or use of exchange as such'.[11] The underlying purpose or the economic effects of a measure are thus entirely irrelevant for deciding whether an exchange measure amounts to an exchange restriction under the Fund's Articles.[12] It follows that, unless a restriction on the making of payments and transfers for current international transactions has been approved by the Fund under Article VIII:2(a) or is being maintained under the transitional

[6] The commercial wars between the two world wars, eg, were not only fought via the imposition of exorbitant tariffs but also relied heavily upon competitive currency devaluations and the use of capital and exchange controls.

[7] See Dominique Carreau and Patrick Juillard, *Droit international économique* (3rd edn Dalloz, Paris 2007) 358–60.

[8] After conclusion of the Uruguay Round and entry into force on 1 January 1995 of the Marrakesh Agreement Establishing the World Trade Organization, signed on 15 April 1994. <http://docsonline.wto.org> accessed 1 July 2013.

[9] For a detailed analysis of the terms of the provisions contained in Articles VIII and XIV of the IMF Agreement, see Deborah Siegel, 'Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreement' (2002) 96 AJIL 561, 584–90.

[10] Siegel (n 9) 586, original emphasis.

[11] IMF, Decision No 1034-(60/27) (1 June 1960), IMF, *Selected Decisions and Selected Documents of the International Monetary Fund* [*Selected Decisions*] (36th issue, Washington DC, 31 December 2011) 590, 591, available at <http://www.imf.org/external/pubs/ft/sd/index.asp?decision=1034-(60/27)> accessed 1 July 2013.

[12] For detail on this point, see Siegel (n 9) 586.

provisions of Article XIV of the IMF Agreement, it constitutes a breach of the Fund's Articles.

Only 20 out of currently 188 IMF member states continue to avail themselves of the transitional arrangements provided for in IMF Article XIV.[13] According to Article XIV:1, the members of the IMF have to assume the obligations under Article VIII:2–4[14] only once they have notified the Fund of their preparedness to do so. An IMF member that relies on the transitional arrangements of Article XIV may also 'maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on the date on which it became a member'.[15] The restrictions maintained under IMF Article XIV:2 are monitored by the Fund, and IMF members are expected to accept the obligations under Article VIII:2–4 as soon as the state of their respective economic and financial systems allows it. As a result, the proportion of IMF members relying on the transitional arrangements has been steadily declining over the years.

While the IMF uses the term 'capital and financial account' to designate what most economists around the world would simply call 'capital account' (recording the international net exchanges of assets and liabilities),[16] the IMF's definition of payments for 'current international transactions' is in line with the mainstream economic definition of the 'current account' as part of national accounting. According to IMF Article XXX(d):

Payments for current transactions means payments which are not for the purpose of transferring capital, and includes, without limitation:

(1) all payments due in connection with foreign trade, other 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) payments of moderate amount for amortization of loans or for depreciation of direct investments; and
(4) moderate remittances for family living expenses . . .

[13] Figures as of 1 July 2013. See IMF, 'IMF Members' Quotas and Voting Power, and IMF Board of Governors' <http://www.imf.org/external/np/sec/memdir/members.htm> accessed 1 July 2013.

[14] Besides the already mentioned obligation to avoid restrictions on the making of payments and transfers for current international transactions in IMF Article VIII:2(a), these provisions require avoiding discriminatory currency practices, like the maintenance of multiple currencies (Article VIII:3), and ensuring the convertibility of foreign-held balances of one's own currency (Article VIII:4).

[15] IMF Article XIV:2.

[16] Confusion sometimes arises from the fact that the IMF does also make use of the term 'capital account', yet for a different purpose. As used by the IMF, the latter term designates only a small proportion of the 'capital and financial account' and is thus defined much more narrowly than the 'capital account' as used in most economic textbooks. The analysis provided in this chapter remains unaffected by these different definitions of the term 'capital account'. All capital controls in the sense of IMF Article VI are those that affect transactions accounted for in the broad 'capital and financial account' and not only the narrow 'capital account' as used by the IMF. The OECD and the UN System of National Accounts (SNA) follow the IMF approach.

As recalled by Sir Joseph Gold, IMF general counsel from 1960 to 1979, at the time when the Fund came into being the second and third of the above categories would normally have been classified by economists as 'capital'. They were nevertheless included in the IMF's definition of payments for current international transactions, according to Gold, 'in order to encourage capital transfers for productive purposes'.[17] Since then, it has become common practice to treat the items listed under (2) and (3) above as 'factor income' derived from invested capital, and hence as integral parts of the 'current account' and not the 'capital account'. Transactions included in the latter do not give rise to income, but represent changes in the form in which assets are held.

In light of the above, any IMF member, unless it is one of the remaining 20 members that still avail themselves of the above-mentioned transitional arrangements of IMF Article XIV, and provided that, as explained by Lichtenstein, it has authorized 'the entry of an investment, whether in the form of debt or equity capital . . . may not, without the approval of the IMF place [restrictions] on the outflows—and convertibility—of interest and amortization on the debt and net income from the equity investment'.[18]

With respect to international flows of capital that are not covered by the IMF's definition of current international transactions, IMF members remain formally entitled, under IMF Article VI:3, to 'exercise such controls as are necessary to regulate international capital movements'. Interestingly, even though the composition and volume of international capital flows has fundamentally changed since the Fund's Articles were drafted in July 1944, the fundamental rule in IMF Article VI:3 has never been amended. Indeed, both intellectual fathers of the Bretton Woods system, John Maynard Keynes and Harry Dexter White,[19] were outspoken proponents of capital controls. The position of both men, widely shared at the time, reflected their experience with the destabilizing effects that short-term capital flows had had on the fragile world economy in the late 1920s and 1930s.[20]

In practice, however, and despite this early opposition to outright capital account liberalization which is still reflected in the Fund's Articles today, the IMF has urged its members for a long time, via technical assistance and as part of the conditionality attached to its various lending facilities, to remove capital controls. This approach was grounded in the widespread belief that liberalizing international capital flows was just as beneficial as freeing trade flows and the related payments. Even an amendment of the IMF Agreement, intended to give the IMF jurisdiction over capital controls, was seriously contemplated. However, in the aftermath of

[17] Joseph Gold, *International Capital Movements under the Law of the International Monetary Fund*, IMF Pamphlet Series No 21 (IMF, Washington DC 1977) 20.

[18] Lichtenstein (n 5) 66.

[19] For a succinct analysis of the Keynes and White Plans drafted and negotiated over the course of several years in preparation of the Bretton Woods Conference and for insightful commentary on the Bretton Woods Conference itself, see Rosa M Lastra, 'The International Monetary Fund in Historical Perspective' (2000) 3 JIEL 507 as well as Rosa M Lastra, *Legal Foundations of International Monetary Stability* (OUP, Oxford 2006) 351–5 and the various useful references contained in these studies.

[20] See Lastra, *Legal Foundations* (n 19) 396.

the East Asian financial crisis of 1997 these reform efforts ebbed as it was then recognized that capital controls could be an economically sound policy tool under certain circumstances.[21]

Indeed, over the course of the past 15 years, in particular since the Global Financial Crisis of 2007–2009, the IMF gradually attenuated the degree to which it pushes its members towards liberalization of the capital account. Thus, in the context of its 2008 stand-by arrangement with Iceland, for example, the Fund clearly acknowledged the stabilizing effect of such controls given the threat and scale of potential capital flight, ie uncontrolled capital *outflows*, from Iceland.[22] A 2010 IMF staff position note by IMF economists further confirmed that the IMF has also switched to a much more nuanced approach with respect to potentially destabilizing capital *inflows*.[23] Over the course of 2010–2012, the IMF embarked on several additional studies intended to review the Fund's approach to capital controls.[24]

This process of rethinking culminated on 3 December 2012 when the Fund issued an official synthesis of its various internal studies on capital controls.[25] The Fund's Executive Board formally endorsed the synthesis as the IMF's new institutional view on capital flows.[26] The IMF itself has summarized the key features of its new institutional view, which is said to reflect a broad consensus among the IMF's member states, as follows:

- Capital flows can have substantial benefits for countries. At the same time, they also carry risks, even for countries that have long been open and drawn benefits from them.
- Capital flow liberalization is generally more beneficial and less risky if countries have reached certain levels or 'thresholds' of financial and institutional development.

[21] For an insightful analysis of both the IMF's legal framework on capital and exchange controls in its historic context and of the efforts undertaken in the 1990s towards giving the IMF jurisdiction over capital controls, see Lichtenstein (n 5) 61–80.

[22] IMF, 'IMF Completes First Review Under Stand-By Arrangement with Iceland, and Approves US$167.5 Million Disbursement', Press Release No 09/375 (28 October 2009) <http://www.imf.org/external/np/sec/pr/2009/pr09375.htm> accessed 1 July 2013.

[23] Jonathan D Ostry, Atish R Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S Qureshi, and Dennis BS Reinhardt, *Capital Inflows: The Role of Controls*, SPN/10/04 (IMF, 19 February 2010) <http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf> accessed 1 July 2013. See also Bob Davis, 'IMF Suggests Capital Controls for Emerging Markets', *The Wall Street Journal* (online edition, 19 February 2010) <http://online.wsj.com/article/SB10001424052748704269004575073610075698010.html> accessed 1 July 2013.

[24] At the same time, numerous external commentators, aware of the fact that the tide was shifting towards an explicit acknowledgement by the IMF of the usefulness of capital controls, published related policy briefs. See, eg, Kevin P Gallagher, 'Regulating Global Capital Flows for Development' (7 April 2012) G-24 Policy Brief No 76, <http://www.g24.org/Publications/PolicyBriefs/PB76_Regulating%20Global%20Capital%20Flows.pdf> accessed 1 July 2013.

[25] IMF, 'The Liberalization and Management of Capital Flows—An Institutional View' (14 November 2012) <http://www.imf.org/external/np/pp/eng/2012/111412.pdf> accessed 1 July 2013.

[26] IMF, 'IMF Executive Board Discusses The Liberalization and Management of Capital Flows—An Institutional View', PIN No 12/137 (3 December 2012) <http://www.imf.org/external/np/sec/pn/2012/pn12137.htm> accessed 1 July 2013.

- Liberalization needs to be well planned, timed, and sequenced in order to ensure that its benefits outweigh the costs.
- Countries with extensive and long-standing measures to limit capital flows are likely to benefit from further liberalization in an orderly manner. There is, however, no presumption that full liberalization is an appropriate goal for all countries at all times.
- Rapid capital inflow surges or disruptive outflows can create policy challenges. Appropriate policy responses involve both countries that are recipients of capital flows and those from which flows originate.
- For countries that have to manage the risks associated with inflow surges or disruptive outflows, a key role needs to be played by macroeconomic policies, as well as by sound financial supervision and regulation, and strong institutions. In certain circumstances, capital flow management measures can be useful. They should not, however, substitute for warranted macroeconomic adjustment.
- Policymakers in all countries, including countries that generate large capital flows, should take into account how their policies may affect global economic and financial stability. Cross-border coordination of policies would help to mitigate the riskiness of capital flows.[27]

Overall, the Fund's new institutional view on capital flows appears balanced and nuanced. It explicitly recognizes the potentially destabilizing effects that excessive capital inflows and uncontrolled capital outflows may have on the economy of a member state depending on the precise economic circumstances and the state of development of that member state's financial system and institutional framework. Most importantly, the Fund explicitly notes that full liberalization of the capital account may not be an appropriate goal for all countries at all times and that under certain circumstances, the use of capital controls may be a useful temporary tool awaiting warranted macroeconomic adjustment. In the wake of the Global Financial Crisis during which notably the example of Iceland clearly demonstrated the stabilizing effect that capital controls as a temporary tool may have to avoid a disastrous, uncontrolled outflow of capital,[28] the essence of the Fund's new institutional view on capital flows does not come as a big surprise.[29] It cannot be stressed often enough, however, that for the IMF, which over many years had been

[27] IMF, 'IMF Adopts Institutional View on Capital Flows', *IMF Survey Online* (3 December 2012) <http://www.imf.org/external/pubs/ft/survey/so/2012/POL120312A.htm> accessed 1 July 2013.

[28] At the end of March 2013, Cyprus became the first member of the eurozone to apply capital controls precisely in order to avoid such uncontrolled capital outflows from its oversized banking sector. Members of a monetary union face an additional set of challenges when resorting to capital controls as a temporary tool. For a detailed discussion of this and related issues, see Chapter 4, Section III, of this monograph.

[29] Only a few weeks before publishing its news institutional view on capital flows, the Fund's Executive Board had explicitly cautioned Iceland against premature and disorderly capital account liberalization. See IMF, 'IMF Executive Board Concludes Second Post-Program Monitoring Discussion with Iceland', PIN No 12/129 (19 November 2012) <http://www.imf.org/external/np/sec/pn/2012/pn12129.htm> accessed 1 July 2013.

a fierce and inflexible proponent of a complete liberalization of global capital flows, the explicit acknowledgement that a more nuanced approach is indeed warranted, is still a historic moment.

Viewed from the angle of the contemporary concept of monetary sovereignty as proposed by the present study, the Fund's new institutional view on capital flows may serve as an interesting illustration of how the principle of subsidiarity frames the contemporary exercise of specific sovereign powers in the realm of money. The Fund has eventually given up its quest for shifting the jurisdiction over capital controls to the multilateral level in light of overwhelming economic evidence showing that outright liberalization of the capital account should not be a one-size-fits-all remedy. This is indeed a powerful example where monetary and financial stability as constituent values of contemporary monetary sovereignty can be realized in the most effective and efficient manner by a lower level of governance, namely the nation state, and that additional conferrals of sovereign powers to the multilateral level would have been counterproductive as regards this specific matter. It is fascinating to see that although the volume and composition of international capital flows has changed dramatically since the 1940s, the Fund's new institutional view ultimately confirms the very cautious approach by Keynes and White to outright capital account liberalization as timelessly appropriate.

Coming back to the Fund's legal framework for payments and transfers for current international transactions, the fact that the IMF relies on a purely technical criterion for defining what constitutes an exchange restriction in the sense of IMF Articles VIII and XIV has been rightly criticized as favouring 'forum shopping' between the Fund and the WTO (formerly the GATT). As pointed out in convincing terms by Frieder Roessler:

> It seems unjustified that the internal administrative organization of foreign trade should determine whether a country is subject to the Fund's or the [WTO]'s jurisdiction. In the case of countries that are administratively equipped to control their foreign trade both through their banking system and their customs authorities there is the danger that the techniques of trade control are manipulated to make applicable the rules of the organization providing the more favourable treatment.[30]

It still remains, however, that the IMF's technical approach has the advantage of allowing a clear-cut determination of whether a measure falls within IMF or WTO jurisdiction, thereby providing IMF members with valuable legal security regarding the applicable legal framework. This is very important for a correct application of IMF Article VIII:2(b) which stipulates that '[e]xchange 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 [the IMF Agreement] shall be unenforceable in the territories of any member'. Hence, whether or not the exchange restrictions maintained by an IMF member are consistent with IMF rules as elaborated above can have major implications for the validity of private contracts

[30] Frieder Roessler, 'Selected Balance-of-Payments Adjustment Measures Affecting Trade: The Roles of the GATT and the IMF' (1975) 9 *Journal of World Trade* 622, 640–3.

before domestic courts.[31] On balance, this might justify why the IMF relies on an inflexible technical criterion for determining what constitutes an exchange restriction for the purposes of the IMF Agreement, thereby deliberately ignoring the fact that trade restrictions can also significantly affect international payments.

Overall, the Fund's legal framework on capital and exchange controls is situated truly at the intersection of international trade, investments, and the related flows of payments and capital. In light of the fact that the capital and current accounts are the two main components of every country's balance-of payments this is hardly surprising. It is difficult to see how economic globalization could not have led to the increasing hybridization of IML and the emergence across the whole body of IEL of strong economic incentives and legal rules promoting the liberalization of international transfers of funds that the following section will examine.

B. The emergence of an overarching framework promoting the liberalization and protection of international transfers of funds

After a few comments on the codes on capital liberalization issued by the Organisation for Economic Co-operation and Development (OECD) and the economic pressure towards liberalization of the capital account arising from the eurocurrency markets (Subsection 1), this section shows that the transfer-of-funds provisions in bilateral investment treaties (BITs) constitute an increasingly important material source of IML (Subsection 2). Finally, this section will turn its attention to the increasingly important role played by the WTO framework on trade in services and trade in financial services as an essential component of IML (Subsection 3).

1. The OECD codes on capital liberalization and the economic pressure arising from the eurocurrency markets

According to Article 2(d) of the OECD Convention,[32] OECD members are required to 'pursue their efforts to reduce or abolish obstacles to the exchange of

[31] Examining the many issues arising from IMF Article VIII:2(b) lies beyond the scope and purpose of this chapter. For detailed analyses see, notably, François Gianviti, 'Réflexions sur l'article VIII, section 2(b) des Statuts du Fonds Monétaire International' (1973) 62 *Revue Critique de Droit International Privé* 471–87, 629–61; and Joseph Gold, *The Fund Agreement in the Courts* Volumes 1–4 (IMF, Washington DC 1962, 1982, 1986 and 1989). See also François Gianviti, 'Le blocage des avoirs officiels iraniens par les Etats-Unis (executive order du 14 novembre 1979)' (1980) *Revue Critique de Droit International Privé* 279; and Geneviève Burdeau, 'Le gel d'avoirs étrangers' (1997) 1 *Journal du Droit International* 5.

[32] Convention on the Organisation for Economic Co-operation and Development (adopted 14 December 1960, entered into force 30 September 1961) <http://www.oecd.org/document/7/0,2340,en_2649_201185_1915847_119672_1_1_1,00.html> accessed 1 July 2013.

The OECD's forerunner was the Organisation for European Economic Co-operation (OEEC), which was created in 1947 to administer reconstruction aid under the Marshall Plan, and was reconstituted as the OECD in 1961. The OECD currently has 34 members, with Estonia being the latest country to have become a member of the organization on 9 December 2010. Most OECD members are high-income countries, but the OECD also maintains cooperative relations, thus sharing its expertise, with more than 70 developing and emerging market economies in addition to its official members. The OECD's governing body is the OECD Council; formal decisions by the OECD goods and services and current payments and maintain and extend the liberalisation of capital movements'. In order to implement this obligation, the OECD Council adopted two decisions in 1961: the OECD Code of Liberalisation of Capital Movements (Capital Movements Code) and the OECD Code of Liberalisation of Current Invisible Operations (Current Invisibles Code) (referred to together as the OECD codes on capital liberalization[33]). These codes contain provisions with respect to the international transfer of funds that are significantly larger in scope not only than the rules under the IMF Agreement, but also than the relevant provisions in many BITs.

It is important to note that even though they are legally binding only for OECD member states, decisions by the OECD Council like the two codes on capital liberalization are highly influential due to the fact that the economies of the OECD's 34 members account for a big proportion of global GDP and of international trade flows.[34] In addition, Article 1(d) of both OECD codes on capital liberalization provides that '[m]embers shall endeavour to extend the measures of liberalisation to all members of the [IMF]'. In line with this objective, the OECD Council adopted a landmark decision on 28 June 2012, delegating full decision-making powers on the OECD codes on capital liberalization to the OECD's Investment Committee and inviting non-members to join the codes with the same rights and obligations than OECD member states.[35]

Overall, the OECD codes on capital liberalization are a powerful illustration of the diversification of the legal regime for capital and exchange controls across the entire body of IEL and of the extent to which states are prepared to sign up to far-reaching commitments in addition to their obligations under the IMF Agreement.

The essential characteristics of the OECD codes on capital liberalization can be summarized succinctly as follows. Firstly, the degree to which OECD member states have made progress towards the achievement of the common goal of liberalization of international capital movements is not the same for every member, since the OECD codes on capital liberalization follow a 'top-down' approach. If an OECD member has lodged a reservation about a specific item of one of the codes, it is not expected to fully liberalize it immediately.[36] Progress towards liberalization under the OECD codes is achieved through unilateral liberalization and peer pressure.[37] Secondly, taken together, the OECD codes (unlike the IMF Agreement, but like most

Council are taken by consensus and are legally binding on all OECD members. However, decisions by the OECD Council are not international agreements in the sense of public international law.

33 Both codes as well as the OECD's official User's Guide for both codes are available at <http://www.oecd.org/daf/investment/codes> accessed 1 July 2013.

34 It still remains, however, that major developing countries, notably China, India, and Brazil, do not figure among the OECD's member states and are thus not bound by the organization's rules on capital liberalization. Russia is not a member either.

35 OECD, 'OECD Codes of Liberalisation: New Governance Arrangements', OECD Info Sheet (July 2012) <http://www.oecd.org/daf/inv/investment-policy/Codesinfosheet2012bis.pdf> accessed 1 July 2013.

36 For detail, see OECD, *OECD Codes of Liberalisation: User's Guide* (OECD, Paris 2007) 12–15 <http://www.oecd.org/daf/investment/codes> accessed 1 July 2013.

37 The approach under the OECD codes on capital liberalization is thus distinct from the 'bottom-up' approach under the WTO's General Agreement on Trade in Services (GATS) (n 61 below) (see OECD, *OECD Codes of Liberalisation: User's Guide* (n 36) 15). See the analysis in Subsection I.B.3 below.

BITs) cover all proceeds of inward investment. Thirdly, unlike many BITs, as will be examined in more detail in the following subsection, the OECD codes on capital liberalization serve not only to protect existing investment, but also to liberalize the admission of new investment. Fourthly and finally, the scope of the liberalization of international transfers of funds that has been accepted by OECD members is significantly larger than the relevant legal regime arising from both the IMF Agreement and most BITs. This is due to the fact that the OECD's Capital Movements Code protects both inward and outward transfers made in connection with investments, and this by both residents and non-residents.[38]

At present, the only OECD member state to maintain capital controls is Iceland, which, as previously noted, introduced such controls in November 2008 in order to prevent capital flight during its severe financial crisis.[39] Obviously, the far-reaching provisions on the transfer of investment-related funds contained in the OECD codes on capital liberalization and in most BITs are not the sole reason why so many states around the world have indeed renounced the maintenance of capital controls unless confronted with a severe balance-of-payments crisis like the one experienced only recently by Iceland. The fact that many states have readily accepted binding commitments to liberalize international transfers of funds well beyond their obligations under the applicable multilateral treaty, the IMF Agreement, is above all an impressive illustration of the presence of strong economic incentives towards gradual liberalization of international capital flows. This seems true despite the recent acknowledgment by the IMF that capital controls may indeed be a useful temporary tool to prevent uncontrolled outflows of capital during a financial crisis and that, depending on the state of development of their respective financial sectors and related institutional frameworks, not all countries will equally benefit from outright capital liberalization.[40]

This being said, the willingness of investment host countries to grant increased investor protection in order to reduce the risk premium required by foreign investors (thus shrinking the cost of foreign capital) is not the only, and certainly by far not the most powerful, expression of the existing economic incentives towards capital account liberalization. It is in the context of eurocurrency markets that the economic incentives to liberalize the flow of capital and payments have demonstrated their force in the most sweeping way.[41] A currency that is not freely

[38] For a detailed overview of the essential features of both codes, see United Nations Conference on Trade and Development (UNCTAD), *Transfer of Funds*, UNCTAD/ITE/IIT/20 (UNCTAD, New York and Geneva 2000) 18–23, and, in particular, OECD, *OECD Codes of Liberalisation: User's Guide* (n 36).

[39] The OECD codes on capital liberalization, like the GATT and the GATS (n 61 below), include balance-of-payments derogations allowing for deviations from the obligation to liberalize the transfer of funds, if such a course of action is necessary in light of the economic and financial circumstances. Among BITs, some do provide for similar balance-of-payments exceptions, but by far not all (see UNCTAD (n 38) 2, 36–8). For detail on the issue of balance-of-payments derogations, see Section I.C of this chapter.

[40] See the analysis of the IMF's new institutional view on capital flows provided in Section I.A of this chapter.

[41] As noted already in Chapter 1, n 50, of this monograph, eurocurrencies are deposits of a currency outside the territory of the state that issued that currency. For detail on the historic and economic background of eurocurrencies and on their legal nature, see Section III.A of this chapter below.

convertible could never rise to the status of a eurocurrency on global financial markets.[42] Strictly legally speaking, establishing this free convertibility has always been, and continues to be, a sovereign choice in light of the earlier discussed IMF Article VI:3. However, any state that renounces the freeing of the capital account deprives itself (and anybody else using its currency) of full access to international capital markets. It is thus not surprising that all major currencies have been made freely convertible as soon as domestic economic and financial conditions permitted and that the states concerned have been particularly cautious not to overregulate the eurocurrency markets in order to ensure that their respective currencies were heavily used on international financial markets.[43]

The eurocurrency markets may thus be regarded as a perfect illustration of the extent to which a formal state competence, ie the right to impose capital controls as set forth in IMF Article VI:3, can be rendered essentially hollow by contrary economic incentives.[44] This *de facto* normative force of the economic incentives that shape domestic policy decisions regarding the international transfer of funds appears to be one of the key aspects of the increasing hybridization of IML. This being said, this section now turns to analysing the extent to which transfer-of-funds provisions in BITs constitute an increasingly important material source of IML.

2. Transfer-of-funds provisions in bilateral investment treaties as an increasingly important material source of international monetary law

As elaborated in Section I.A above, the prohibition under IMF Article VIII:2(a) to impose restrictions on payments and transfers for current international transactions without approval by the Fund does protect the free outward transfer of income derived from investments made in the territories of those IMF members that no longer avail themselves of the transitional provisions of IMF Article XIV. Other transfers of funds, however, like the transfer of the proceeds of liquidation of a foreign investment, are not protected under IMF Article VIII:2(a), since they count as capital transfers. Considering that IMF members are free, at least formally, to

[42] On this point, see Dominique Carreau, 'Le système monétaire international privé (UEM et euromarchés)' (1998) 274 *Recueil des Cours* 309, 376.

[43] See, eg, Jean-Marc Sorel, 'Les Etats face aux marchés financiers' in Charles Leben, Eric Loquin and Mahmoud Salem (eds), *Souveraineté étatique et marchés internationaux à la fin du 20ème siècle: Mélanges en l'honneur de Philippe Kahn* (Litec, Paris 2000) 517–25, and Carreau (n 42) 375–7.

[44] Dominique Carreau has expressed this major point in such penetrative terms that it appears appropriate to quote him in the French original:

> Il apparaît ainsi que pour l'Etat dont la monnaie nationale est devenue une eurodevise—et bien entendu pour peu que celle-ci soit largement utilisée sur les euromarchés—sa compétence se soit épuisée en décidant la convertibilité totale. Le retour à un régime d'*inconvertibilité*, bien que théoriquement possible en droit, est rendu pratiquement impossible en raison des contraintes posées par les euromarchés. En bref, et pour conclure, si les euromarchés supposent la convertibilité totale des monnaies, ils en imposent aussi le maintien. L'Etat émetteur, là encore, devient en quelque sorte le prisonnier de sa monnaie nationale de par l'usage international qui en est fait par ses détenteurs.
> (Carreau (n 42) 377, original emphasis).

introduce capital controls under IMF Article VI:3, it is understandable that from the viewpoint of foreign investors the IMF Agreement provides only incomplete protection.

Investor protection does not figure among the explicit purposes of the IMF contrary to the expansion and the balanced growth of international trade.[45] However, since the IMF legal framework does protect certain investment-related transfers, its failure to cover others might have spurred the development of provisions in international investment agreements relating to the international transfer of funds. In the following, this subsection examines the varying scope of transfer-of-funds provisions in BITs (a) before focusing on the extent to which such clauses provide investor protection with respect to the type of currency in which transfers can be made and with respect to the applicable exchange rate (b).

a. The varying scopes of transfer-of-funds provisions in bilateral investment treaties

In the absence of a multilateral investment treaty,[46] the network of international investment agreements is essentially bilateral and regional in nature. Since the first BIT was signed in 1959 between then West Germany and Pakistan, their number has been constantly growing to reach 2,833 by the end of 2011.[47] Most BITs contain detailed provisions guaranteeing investors the right to transfer funds related to an investment. These provisions do indeed provide investors with a significantly higher level of investor protection than that which they might derive from the multilateral rules on capital and exchange controls under the IMF Agreement. Whereas specific transfer provisions in BITs differ in relying either on illustrative or exhaustive lists, all relevant flows of capital and payments relating to a foreign investment are usually covered. In the BITs concluded since 1995, detailed, yet non-exhaustive, lists appear to have been used most frequently,[48] thereby providing a maximum of assurance to investors that they will be able to transfer all sorts of funds related to their investment.

An increasing number of BITs now contain transfer provisions covering both inward and outward transfers of funds linked to inward investments.[49] As previously noted, BITs do not usually cover outward investments made by residents of the host country, which is an important difference from the OECD codes on

[45] As stated in IMF Article I(ii). This is only one purpose among others. For a self-explanatory list of the IMF's other purposes, see the remainder of IMF Article I, and also the chapeau of IMF Article IV:1.

[46] The most recent attempt to establish a multilateral investment framework still remains the abandoned Multilateral Agreement on Investment (MAI), negotiated unsuccessfully between OECD members from 1995 to 1998. For consolidated draft texts of the MAI, see <http://www.oecd.org/daf/mai> accessed 1 July 2013.

[47] According to UNCTAD, in addition to these 2,833 BITs, 331 'other' international investment agreements existed by the end of 2011, including, most notably, free trade agreements (FTAs) with investment provisions, economic partnership agreements, and regional agreements. UNCTAD, *World Investment Report 2012: Towards a New Generation of Investment Policies* (UNCTAD, New York and Geneva 2012) xx, available at <http://www.unctad-docs.org/files/UNCTAD-WIR2012-Full-en.pdf> accessed 1 July 2013.

[48] According to a detailed survey undertaken by UNCTAD. See UNCTAD, *Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking* (UNCTAD, New York and Geneva 2007) 58.

[49] UNCTAD (n 48) 57.

capital liberalization which, as noted above, aim to liberalize both inward and outward investments, by both residents and non-residents. However, due to the fact that they usually liberalize both inward and outward transfers linked to inward investments, the scope of transfer-of-funds provisions in BITs is still significantly larger than the prohibition, under IMF Article VIII:2(a), of restricting the making of payments and transfers for current international transactions which, in any event, covers only *outflows*. The picture across BITs is not uniform,[50] though, and it is crucial to distinguish between two types of inward transfers and their respective treatment in transfer provisions:

> The first type [of inward transfers] [concerns] those that are made for purposes of making a new investment; the second type [concerns] . . . those that are made to develop or maintain an existing investment (e.g. increased capitalization of a foreign affiliate). Almost all foreign investment agreements cover the latter type, on the basis that the right of an investor to provide additional infusions of capital into an existing investment is an important attribute of investment protection. However, only those agreements that require the host country to admit new investments include the first type of transfers in the transfer provisions. Most [BITs] do not include such admission obligations.[51]

Furthermore, the outward transfer of payments that the host country has to authorize in order to comply with other investor protection clauses, notably the payment of compensation in the event of expropriation, is equally protected under most BITs.[52] If the outward transfer of such payments were not ensured, the respective investor protection clauses would be of little value to investors. Neither from the IMF Agreement nor the OECD codes on capital liberalization can investors derive protection for this type of transfer, but obviously these two legal frameworks do not contain the respective investor protection clauses in the first place.

The remainder of this subsection will provide a short overview of the different standards of protection that transfer-of-funds provisions provide to foreign investors with respect to the type of currency that can be used for such transfers and the applicable exchange rate.

b. Different standards of investor protection with respect to the type of currency and the applicable exchange rate

For host countries with scarce foreign exchange reserves it is of crucial importance whether a transfer-of-funds provision grants discretion as to the choice of the currency in which transfer obligations have to be honoured. On this issue, recently concluded BITs show quite a mixed picture. A first category of transfer-of-funds provisions provides that transfers be effected in any freely convertible currency, thus leaving the host country with broad discretion as to the currency in which the transfer of funds is to be undertaken.[53] A second category requires that transfers be

[50] For an overview of the different types of transfer provisions that have been used in BITs concluded since 1995, see UNCTAD (n 48) 57–8.

[51] UNCTAD (n 38) 32.

[52] UNCTAD (n 38) 32.

[53] For relevant examples, see UNCTAD (n 48) 59.

permitted either in the currency in which the investment was originally made or in any convertible currency agreed by the parties.[54] This approach is narrower than the first one but still leaves the host country with some discretion for determining, through negotiations with the investor, a transfer currency that suits both sides. The alternative of allowing the transfer in the currency in which the investment was made can be of particular interest to the host country if the original investment has been made in its domestic currency, since such a transfer would not affect the host country's foreign exchange reserves. Finally, a third category limits the discretion of the host country by obliging it to authorize transfers in any freely usable currency. BITs usually use the term 'freely usable currency' in line with IMF Article XXX(f), which provides that '[a] freely usable currency means a member's currency that the Fund determines (i) is, in fact, widely used to make payments for international transactions, and (ii) is widely traded in the principal exchange markets'. At present, the USD, the euro (EUR), Japanese yen (JPY), and pound sterling (GBP) are freely usable currencies as determined by the IMF. These currencies are also the ones that form the basket of weighted currencies used for determining the value of the IMF's Special Drawing Rights (SDRs).[55]

In addition to the type of currency in which a transfer can be made, it may make a big difference for the investor whether he has to rely on an official exchange rate as set by the authorities of the host country (as a result of which the exchange rate might be severely under- or overvalued) or on the market exchange rate, or, in the absence of such a rate, on some sort of economic equilibrium exchange rate as determined on the basis of jointly agreed criteria. Again, the picture arising from recently concluded BITs is quite mixed. Whereas the transfer provisions in some BITs do not address the exchange rate issue at all, others do not specify whether the applicable exchange rate shall be the official exchange rate or a market-based rate but merely refer the issue to the exchange regulations as devised by the host country.[56] As a result, the degree of investor protection provided by such transfer provisions has to be regarded as quite weak. By contrast, other BITs determine that the market exchange rate of the day of the transfer shall be applicable,[57] with some BITs even spelling out alternative techniques for determining the rate of exchange at which transfers of funds are to be effected in case a market exchange rate does not exist.[58]

[54] See UNCTAD (n 48) 59.

[55] On the IMF's SDRs, see Subsection II.A.1 of this chapter.

[56] For the precise wording of related provisions included in recent BITs, see UNCTAD (n 48) 60.

[57] For relevant examples, see UNCTAD (n 48) 61.

[58] Eg Article 6 of the 2000 BIT between Brunei Darussalam and China states in relevant part:

> 2.... Transfers shall be made at the market rate of exchange of the Contracting Party accepting the investment on the date of transfer. In the event that the market rate of exchange does not exist, the rate of exchange shall correspond to the cross rate obtained from those rates which would be applied by the International Monetary Fund on the date of payments for conversions of the currencies concerned into Special Drawing Rights.
> (Agreement Between the Government of the People's Republic of China and the Government of His Majesty the Sultan and Yang Di-Pertuan of Brunei Darussalam Concerning the Encouragement and Reciprocal Protection of Investment (17 November 2000) (<http://www.unctad.org/sections/dite/iia/docs/bits/china_brunei.pdf> accessed 1 July 2013)).

Overall, this brief review of the main characteristics of transfer-of-funds provisions contained in BITs reveals that states have accepted the need to restrain bilaterally the regulatory discretion in respect of capital controls and the control of all types of inflows[59] of funds that they enjoy formally under the IMF Agreement. Hence, to the extent that the high level of investor protection provided by BITs is upheld by arbitration and effectively enforced,[60] BITs would have to be regarded as a significant material source of contemporary IML with respect to the international transfer of funds.

The analysis of the promotion of transfer-of-funds liberalization across the three traditional pillars of IEL provided in this section would be incomplete without taking into account the increasingly important role played by the WTO framework on trade in services in general, and trade in financial services in particular.

3. The WTO framework for trade in services as an essential part of contemporary international monetary law

The General Agreement on Trade in Services (GATS)[61] is a framework agreement, which implies that the extent to which WTO members are committed to liberalize a specific service industry is the result of individual negotiations. Schedules negotiated with each member and containing the specific commitments undertaken by that member are attached to the common provisions of the GATS and form an integral part of it.[62] In these schedules, WTO members make commitments according to four 'modes of delivery': cross-border supply of services (mode 1); consumption abroad (mode 2); foreign commercial presence (mode 3); and movement of natural persons (mode 4).

To the extent that a WTO member makes commitments regarding a specific type of service under modes 1 and 3, the GATS strongly promotes foreign investments, as any related transfers of funds are protected. This is ensured by Article XI of the GATS which provides that WTO members shall not impose restrictions on international transfers and payments for current transactions (Article XI:1) or on any capital transactions inconsistently with the specific commitments

See also UNCTAD (n 48) 61.

[59] As pointed out in Section I.A of this chapter, the prohibition under IMF Article VIII:2(a) to impose restrictions on the making of payments and transfers for current international transactions applies only to *outflows*.

[60] For an interesting study of recent BIT jurisprudence related to transfer-of-funds provisions, see Rudolf Dolzer, 'Transfer of Funds: Investment Rules and their Relationship to other International Agreements' in Mario Giovanoli and Diego Devos (eds), *International Monetary and Financial Law: The Global Crisis* (OUP, Oxford 2010) 533, 534.

[61] General Agreement on Trade in Services (15 April 1994) in WTO Secretariat, *The Results of the Uruguay Round of Multilateral Trade Negotiations, The Legal Texts* [hereinafter: *Legal Texts*] (WTO and CUP, Cambridge and Geneva 1999) 284. The WTO *Legal Texts* are also available at <http://www.wto.org/english/docs_e/legal_e/legal_e.htm> accessed 1 July 2013.

[62] The underlying idea being, according to the preamble of the GATS, to achieve progressively higher levels of liberalization of trade in services through successive rounds of multilateral negotiations. As noted above (n 37), the GATS' 'bottom-up' approach contrasts with the 'top-down' approach to liberalization under the OECD codes on capital liberalization.

made by that member (Article XI:2).[63] If a member has made commitments in the domain of financial services, this rule would serve, for example:

> to liberalize both the interest and principal portion of loan repayments made by a consumer to a foreign bank. Moreover, both inward and outward transfers relating to the service committed are covered where the cross-border movement of capital is an essential part of the service itself. Thus, a member must permit the non-resident bank to disburse the amount it has agreed to lend to a local consumer; the consumer must also be free to transfer the amounts it wishes to deposit with a non-resident bank.[64]

It is indeed in the vast and constantly evolving domain of financial services that the hybridization of IML, with its diversification across the three traditional pillars of IEL, is particularly visible. The first attempt to provide a multilateral legal framework for what constitutes the heart of the global economy was not undertaken under the auspices of the IMF, the World Bank, or the OECD, but at the WTO.[65] Long and complex negotiations[66] led to the conclusion, on 3 December 1997, of the Fifth Protocol to the General Agreement on Trade in Services.[67] This Protocol (including the schedules of specific commitments and the lists of exemptions from GATS Article II for each member attached to it) constitutes a multilateral agreement among 70 WTO members to open their financial services sectors. It entered into force on 1 March 1999 and, at the time of its conclusion, covered more than 95 per cent of the global trade in banking, insurance, securities, and financial information.[68] The value of the financial services sectors that have thus been opened to international competition has been estimated to amount to approximately USD 140,000 billion.[69] Since then, major efforts have been undertaken to further liberalize trade in financial services, notably since the incorporation of financial services negotiations into the Doha Development Agenda in November 2001. Whether WTO members will ultimately reach agreement on a further liberalization of trade in financial services (thereby further increasing the extent to which the international legal regime promoting the liberalization of transfers of funds arises jointly from the realms of international trade, investments, and money) remains to be seen.[70]

Finally, in light of the strong incentives under the WTO framework for trade in services and trade in financial services to further liberalize international transfers of

[63] GATS Article XII provides for the exceptional possibility to impose balance-of-payments restrictions and thereby to temporarily deviate from the general rule contained in Article XI. For detail on the issue of balance-of-payments derogations, see Section I.C of this chapter.

[64] UNCTAD (n 38) 25.

[65] On this point, see Sorel (n 43) 532.

[66] For an insightful account of these negotiations, see Carreau and Juillard (n 7) 334–7.

[67] Fifth Protocol to the General Agreement on Trade in Services (3 December 1997) S/L/45 <http://docsonline.wto.org> accessed 1 July 2013.

[68] WTO, 'Successful conclusion of the WTO's financial services negotiations', PRESS/86 (WTO, 15 December 1997) <http://www.wto.org/english/news_e/pres97_e/pr86_e.htm> accessed 1 July 2013.

[69] Carreau and Juillard (n 7) 337.

[70] For detailed information on the progress (or lack thereof . . .) with current WTO negotiations on financial services, see <http://www.wto.org/english/tratop_e/serv_e/finance_e/finance_e.htm> accessed 1 July 2013.

funds, one point needs to be stressed. As stated in Article 2(a) of the Annex on Financial Services to the GATS, notwithstanding any provisions of the GATS (including any legal instrument attached to it) WTO members 'shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system'. This provision, also known as 'the prudential carve-out', leaves no doubt that WTO members have always been aware of the necessity for prudential regulation—despite the economic benefits that the liberalization of financial services can bring about.

In that context, one of the biggest present and future challenges will be to provide the type and degree of objectively necessary prudential regulation without misusing the prudential carve-out for protectionist purposes. In other words, the challenge consists in finding a balanced solution to the undeniable tension that exists between the objective to foster financial stability via strengthened financial regulation and supervision and the demand by financial markets for increased financial liberalization.[71] Thus, the aftermath of the worst global financial and economic crisis since the Great Depression seems to be an appropriate moment for WTO members to reflect on their individual and joint responsibility for the integrity and stability of the global financial system as constituent values of the contemporary concept of monetary sovereignty as analysed in this monograph.

As noted earlier, almost all international agreements that limit the use of capital and exchange controls contain rules on temporary derogations that states can rely on in the event of a balance-of-payments crisis. This takes us into the next section.

C. Balance-of-payments derogations: towards a coherent regime across international economic law?[72]

The final section of this first part proceeds as follows. After looking at institutional and procedural aspects of IMF–WTO interaction and at the scope of the GATT Article XV:2 requirement that the WTO consult with the IMF on selected matters, including balances of payments (Subsection 1), the legal value and role of the findings issued by the IMF upon such consultations will be analysed (Subsection 2). Finally, this section will assess the extent to which IMF–WTO interaction on balance-of-payments derogations serves as a model across IEL (Subsection 3).

[71] For a stimulating analysis addressing precisely this challenge, see Panagiotis Delimatsis and Pierre Sauvé, 'Financial Services Trade After the Crisis' in Thomas Cottier, John H Jackson, and Rosa M Lastra (eds), *International Law in Financial Regulation and Monetary Affairs* (OUP, Oxford 2012) 288.

[72] An extended version of the analysis contained in this Section I.C has been included in Claus D Zimmermann, 'IMF-WTO Interaction: Institutional, Jurisdictional and Procedural Aspects' in Ole Kristian Fauchald and André Nollkaemper (eds), *Unity or Fragmentation of International Law: The Role of International and National Tribunals* (Hart Publishing, Oxford 2012) 57.

1. Institutional and procedural aspects of IMF–WTO interaction: the scope of the consultation requirement in GATT Article XV:2

Most of the rules that address the relationship between the IMF and the WTO do so only in a quite general manner. For instance, Article III:5 of the Marrakesh Agreement Establishing the World Trade Organization (WTO Agreement)[73] provides: '[w]ith a view to achieving greater coherence in global economic policy-making, the WTO shall cooperate, as appropriate, with the [IMF] and with the International Bank for Reconstruction and Development [ie the World Bank] and its affiliated agencies'. In a similar manner, paragraph 5 of the Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking (Declaration on Coherence in Economic Policy-making)[74] states in relevant part:

> The interlinkages between different aspects of economic policy require that the international institutions with responsibilities in each of these areas follow consistent and mutually supportive policies. The World Trade Organization should therefore pursue and develop cooperation with the international organizations responsible for monetary and financial matters, while respecting the mandate, the confidentiality requirements and the necessary autonomy in decision-making procedures of each institution, and avoiding the imposition on governments of cross-conditionality or additional conditions.

The IMF Agreement contains similarly general statements. IMF Article X states, inter alia, that '[t]he Fund shall cooperate with public international organizations having specialized responsibilities in related fields'. The IMF Agreement lacks any more specific cooperation provisions with respect to the former GATT or even the WTO.[75] In 1996, in an attempt to formalize their cooperation, the WTO and the IMF signed the Agreement Between the International Monetary Fund and the World Trade Organization (IMF–WTO Cooperation Agreement).[76] This agreement is based on the authority and mandate to cooperate, as spelt out in the previously mentioned parts of the respective treaties. It contains various provisions on document exchange, consultations between the WTO Secretariat and the Fund's staff, attendance at each other's meetings, and deals with other routine bureaucratic matters thought to facilitate cooperation between the two organizations at various levels.[77]

[73] Marrakesh Agreement Establishing the World Trade Organization (15 April 1994) in WTO Secretariat, *Legal Texts* (n 61) 4.

[74] Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking (15 April 1994) in WTO Secretariat, *Legal Texts* (n 61) 386.

[75] For detail on this point and for a very informative historic overview, see Dukgeun Ahn, 'Linkages Between International Financial and Trade Institutions: IMF, World Bank and WTO' (2000) 34 *Journal of World Trade* 1.

[76] Agreement between the International Monetary Fund and the World Trade Organization, adopted by WTO General Council Decision WT/L/194 (18 November 1996) as well as by IMF Executive Board Decision No 11381-(96/105) (25 November 1996). For the IMF–WTO Cooperation Agreement and both Decisions, see IMF, *Selected Decisions* (n 11) 858.

[77] See Siegel (n 9) 568.

The key provision for IMF–WTO interaction, in particular with a view to avoiding inconsistent rights and obligations for members common to both organizations, is Article XV of the GATT 1994.[78] GATT Article XV:2 provides in relevant part: 'In all cases in which the [WTO][79] [is] called upon to consider or deal with problems concerning monetary reserves, balances of payments or foreign exchange arrangements, [it] *shall consult fully* with the [IMF]'.[80]

Whether WTO dispute settlement panels or the WTO Appellate Body are required to consult with the IMF as opposed to having merely the option to do so when considering a measure falling within the scope of GATT Article XV:2 is not entirely clear. This is due to the fact that Article XV:2 broadly obliges *the WTO* to fully consult with the IMF on the matters listed, without further specification whether or not this obligation extends to dispute settlement proceedings.

In particular with respect to one of the subject matters listed in GATT Article XV:2—balances of payments—the precise meaning of the WTO agreements remains ambiguous and lends support to interpreting the WTO's obligation to 'consult fully with the IMF' as merely extending to the consultations carried out by the competent WTO body, the Committee on Balance-of-Payments Restrictions, according to GATT Articles XII and XVIII,[81] the Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994,[82] the Declaration on Trade Measures Taken for Balance-of-Payments Purposes, adopted on 28 November 1979,[83] as well as the relevant consultation procedures.[84]

[78] General Agreement on Tariffs and Trade 1994 (15 April 1994) in WTO Secretariat, *Legal Texts* (n 61) 17. For the sake of improved readability, the remainder of this chapter, when quoting specific provisions in the GATT 1994, mostly refers to the GATT 1994 as 'GATT'. This does not give rise to ambiguity since the rules that were contained in the GATT 1947 have been incorporated by reference into the GATT 1994 according to paragraph 1(a) of the introductory text of the GATT 1994. All GATT Articles that were originally contained in the GATT 1947 can be recognized by their Roman numerals (I, II, III, . . .).

[79] This quotation of GATT Article XV has been adapted according to Article 2(a) of the introductory text of the GATT 1994, stipulating that all references to 'contracting party' in the incorporated provisions of the GATT 1947 shall be deemed to read 'Member'. In addition, the quoted parts of GATT Article XV are among those provisions for which, according to Article 2(b) of the introductory text of the GATT 1994, references to the CONTRACTING PARTIES acting jointly shall be deemed to be references to the WTO. These changes have been included without further express notice into any relevant quotes in the remainder of this monograph.

[80] Emphasis added.

[81] Any WTO member applying new balance-of-payments restrictions or substantially intensifying existing ones is obliged to consult with the WTO Committee on Balance-of-Payments Restrictions (according to GATT Articles XII:4(a) and XVIII:12(a)). Any member maintaining such restrictions is required to consult with the Committee annually (Article XII:4(b)) or biennially (Article XVIII:12(b)). A third type of consultations may be initiated on the basis of a complaint by a member adversely affected by restrictions maintained by another, if these restrictions are inconsistent with the relevant legal provisions (Articles XII:4(d) and XVIII:12(d)).

[82] Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994 (15 April 1994) in WTO Secretariat, *Legal Texts* (n 61) 22.

[83] Declaration on Trade Measures Taken for Balance-of-Payments Purposes (28 November 1979) BISD 26S/205–209.

[84] The so-called 'full consultation procedures' (BISD 18S/48–53) and 'simplified consultation procedures' (BISD 20S/47–49).

Such a reading of GATT Article XV is supported by the GATS provision dealing with balance-of-payments restrictions in the context of trade in services, GATS Article XII. After stating, in Article XII:5(a), the obligation for WTO members making use of balance-of-payments restrictions to consult with *the Committee on Balance-of-Payments Restrictions*, paragraph 5(e) of the same Article further specifies, in language extremely close to GATT Article XV:2:

> *In such consultations*, all findings of statistical and other facts presented by the International Monetary Fund relating to foreign exchange, monetary reserves and balance-of-payments, shall be accepted and conclusions shall be based on the assessment by the Fund of the balance-of-payments and the external financial situation of the consulting Member.[85]

Unfortunately, the ambiguity created by the corresponding GATT and GATS provisions is not limited to scenarios of balance-of-payments-restrictions, but concerns also all other subject matters addressed in GATT Article XV, ie also those for which the Fund does not merely provide a technical service to the WTO, as is the case for trade restrictions to safeguard the balance of payments, but for which conflicting rights and duties of members common to both organizations might arise. So far, WTO dispute settlement has not contributed to clarifying this ambiguity—despite the fact that the consultation requirement under GATT Article XV:2 has already been covered by panel proceedings three times.

The first relevant dispute, *Argentina—Textiles and Apparel*, involved, among other measures, an import surcharge which was claimed to violate GATT Article VIII:1(a) but which Argentina argued was part of the commitments it had undertaken in the context of its IMF adjustment programme and should therefore not lead to a finding of breach under WTO rules. However, the Appellate Body found that Argentina had not demonstrated an 'irreconcilable conflict between the provisions of its "Memorandum of Understanding" with the IMF and the provisions of Article VIII of the GATT 1994' and thus upheld 'the Panel's implicit finding that Argentina failed to demonstrate that it had a legally binding commitment to the IMF that would somehow supersede Argentina's obligations under Article VIII of the GATT 1994'.[86] Hence, the issue of a potential exemption for Argentina from its obligations under GATT Article VIII did not have to be resolved in this dispute as there were no conflicting obligations in the first place.

Regarding the consultation requirement under GATT Article XV:2, Argentina had argued on appeal that the Panel had failed to make 'an objective assessment of the matter', as required by Article 11 of the Dispute Settlement Understanding (DSU),[87] 'by not acceding to the request of the parties to seek information from, and consult with, the IMF so as to obtain its opinion on specific aspects of the

[85] GATS Article XII:5(e), emphasis added.

[86] WTO Appellate Body Report, *Argentina—Measures Affecting Imports of Footwear, Textiles, Apparel and other Items (Argentina—Textiles and Apparel)*, WT/DS56/AB/R and WT/DS56/AB/R/Corr.1, adopted 22 April 1998, para 69.

[87] Understanding on Rules and Procedures Governing the Settlement of Disputes [hereinafter DSU] (15 April 1994) in WTO Secretariat, *Legal Texts* (n 61) 354.

matter concerning the statistical tax'.[88] The Appellate Body upheld the Panel's finding and recalled that there is a requirement for the WTO to consult on the matters specified in GATT Article XV:2, but that measures included in an economic adjustment programme sponsored by the IMF are not among them.[89] It noted, however, that 'it might perhaps have been useful for the Panel to have consulted with the IMF on the legal character of the relationship or arrangement between Argentina and the IMF in this case',[90] which it could have done based on the discretionary authority of dispute settlement panels, under DSU Article 13, to seek information and technical advice. Unfortunately, all this did not contribute to a clarification of the consultation requirement in GATT Article XV:2.

The next dispute, *India—Quantitative Restrictions*, concerned quantitative restrictions imposed by India due to alleged balance-of-payments difficulties. Regarding the issue of whether the consultation requirement under GATT Article XV:2 extends to panel proceedings the panel stated that it did not find it necessary, for the purposes of this dispute, to decide the issue.[91] Instead, the Panel consulted the IMF 'as a recognized body with extensive expertise in [balance-of-payments] matters',[92] based on its discretionary authority under DSU Article 13. The issue was not appealed.[93]

Although the Panel did consult with the IMF regarding India's balance-of-payments situation the Panel's related legal reasoning needs to be criticized. In conformity with the logic followed by the Panel in *India—Quantitative Restrictions*, ie consultation merely on the basis of the discretionary authority under DSU Article 13, in the future a panel might choose not to consult the Fund at all or, which would conflict with GATT Article XV:2, to consult the IMF but without accepting its findings.[94]

In a more recent dispute, however, *Dominican Republic—Import and Sale of Cigarettes*, the Panel resisted the temptation to consult the IMF merely under DSU Article 13.[95] The Panel in this dispute was the first to consult with the IMF on the basis of GATT Article XV:2. It explained its move as follows:

> The Panel *considered* during the proceedings *that it needed to seek more information* on the precise legal nature and status of the foreign exchange fee measure in the stand-by

[88] WTO Appellate Body Report, *Argentina—Textiles and Apparel* (n 86) para 82.
[89] WTO Appellate Body Report, *Argentina—Textiles and Apparel* (n 86) para 84.
[90] WTO Appellate Body Report, *Argentina—Textiles and Apparel* (n 86) para 86.
[91] WTO Panel Report, *India—Quantitative Restrictions on Imports of Agricultural Textile and Industrial Products (India—Quantitative Restrictions)*, WT/DS90/R, adopted 22 September 1999, upheld by Appellate Body Report, WT/DS90/AB/R. Panel Report, para 5.13.
[92] WTO Panel Report, *India—Quantitative Restrictions* (n 91) para 5.12.
[93] WTO Appellate Body Report, *India—Quantitative Restrictions* (n 91) para 152.
[94] Siegel (n 9) 581.
[95] The Panel found that the imposition by the Dominican Republic of a foreign exchange fee on imports of cigarettes was not justifiable as an exchange restriction within the meaning of GATT Article XV:9(a), but that it constituted 'another charge or duty' inconsistent with GATT Article II:1(b). For a discussion of relevant aspects of this dispute, see, eg, Annamaria Viterbo, 'Dispute Settlement of Exchange Measures Affecting Trade and Investments: The Overlapping Jurisdictions of the IMF, WTO and the ICSID', SIEL Online Proceedings Working Paper No 34/08, at 14 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1154673> accessed 1 July 2013.

arrangement between the IMF and the Dominican Republic. Secondly, since the Dominican Republic argues that the fee is an exchange restriction and it is imposed in accordance with the Articles of Agreement of the IMF, the Panel *considered that it needed to consult with the IMF based on paragraph 2 of Article XV to verify such an argument for a determination by the Panel* on whether the measure is justified under [GATT] Article XV:9(a).[96]

Yet, what would the Panel have done had it *considered* that it did not need more information on the precise legal nature of the foreign exchange fee at issue? Would it then still have *considered* that it needed to consult with the IMF? It seems that although the Panel formally opted to consult the IMF on the basis of GATT Article XV:2, it did so without taking the view that it was obliged to do so. In other words, although the Panel formally consulted under Article XV:2, it appears to have reasoned as if it were acting on the basis of its discretionary authority under DSU Article 13.

Overall, all three of these disputes, in particular *India—Quantitative Restrictions* and *Dominican Republic—Import and Sale of Cigarettes*, should be regarded as having underlined the urgent need for a concerted clarification, by the WTO and the IMF, of whether or not the consultation requirement in GATT Article XV:2 and the analogous requirement in GATS Article XII extend to dispute settlement proceedings. It would be important that a clear line be drawn between such consultations and a panel's discretionary right under DSU Article 13 to seek information and technical advice from outside sources. As has been argued convincingly by the US in *India—Quantitative Restrictions*, accepting an interpretation of GATT Article XV:2 leaving panels less constrained by the rules of the GATT 1994 than other WTO bodies (notably the Committee on Balance-of-Payments Restrictions) would introduce inconsistency between panels and the rest of the WTO.[97]

Once the IMF has been consulted by the WTO under GATT Article XV:2 or under GATS Article XII the question as to the precise legal nature of the IMF's responses arises.

2. The legal value and role of the findings issued by the IMF upon consultation by the WTO under GATT Article XV:2

Even assuming that the WTO's obligation under GATT Article XV:2 to consult with the IMF in exchange matters extends to dispute settlement proceedings, this requirement does not imply that the WTO has to hand over its complete decisional power to the Fund in respect of the issues covered by such consultations.[98] As set forth, in relevant part, in GATT Article XV:2:

In such consultations, the [WTO] *shall accept all findings of statistical nature and other facts presented by the Fund* relating to foreign exchange, monetary reserves and balances of

[96] WTO Panel Report, *Dominican Republic—Measures Affecting the Importation and Internal Sale of Cigarettes (Dominican Republic—Import and Sale of Cigarettes)*, WT/DS302/R, adopted 19 May 2005, modified by Appellate Body Report, WT/DS302/AB/R. Panel Report, para 7.139, emphasis added.
[97] WTO Panel Report, *India—Quantitative Restrictions* (n 91) para 3.309.
[98] See Siegel (n 9) 570.

payments, and *shall accept the determinations of the Fund as to whether action by a [Member] in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund*... The [WTO] ... shall accept the determination of the Fund as to what constitutes a serious decline in the [Member's] monetary reserves, a very low level of its monetary reserves, and as to the financial aspects of other matters covered in consultation in such cases.[99]

In light of the above, the determinations made by the Fund in response to a consultation are to be treated by the WTO as either a factual or a legal finding depending on the context in which the IMF has been consulted.[100] The WTO needs factual information, like, for example, the level of a state's foreign exchange reserves, in order to correctly apply the balance-of-payments exception set forth in GATT Article XII. Here, the IMF is consulted for its specific expertise acquired through the regular statistical work it undertakes. The Fund's task in this scenario is not to rule whether the balance-of-payments exception of Article XII applies, but to provide the factual basis for the legal assessment undertaken independently by the competent WTO panel.[101]

By contrast, a determination by the Fund on whether a specific action in exchange matters is consistent with the IMF Agreement has to be regarded as a legal finding. Other WTO rules, aiming at avoiding inconsistent conflicting rights and obligations for members common to both organizations, depend upon such case-by-case determinations by the Fund.[102] The best-known of these provisions is GATT Article XV:9.[103] For the realm of trade in services an essentially equivalent provision can be found in GATS Article XI:2. GATT Article XV:9 states in relevant part:

Nothing in this Agreement shall preclude:

(a) the use by a [Member] of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund or with that [Member's] special exchange agreement with the [WTO][.] ...

Unfortunately, the case law on the issue raises the question of whether the distinction between the Fund's factual determinations (which will flow into a panel's independent legal assessment) and the Fund's legal findings on the consistency of a contested exchange measure with the Fund's Articles (from which, according to GATT Article XV:2, the WTO cannot depart) has been fully understood. Only two panel reports, both from disputes discussed in the preceding subsection, *India—Quantitative Restrictions* and *Dominican Republic—Import and Sale of Cigarettes* are relevant in this context.

The Panel in *India—Quantitative Restrictions*, by circumventing GATT Article XV:2 and consulting the IMF on the basis of DSU Article 13 as noted earlier, not only eluded the question of whether the requirement to consult the IMF extends to

[99] Emphasis added. [100] Siegel (n 9) 571.
[101] Siegel (n 9) 571, 582–3. [102] Siegel (n 9) 571.
[103] For a detailed analysis of the exception enshrined in GATT Article XV:9(a), see Chapter 3, Subsection II.C.2, of this monograph.

WTO panels, but also the question of whether a panel would have to regard as dispositive the determinations made by the IMF.[104] In contrast, as discussed above, the Panel in *Dominican Republic—Import and Sales of Cigarettes*, did at least formally consult the IMF on the basis of GATT Article XV:2. However, the relevant passage in the Panel Report, though not affecting the overall correct findings in this dispute, points to a wrong understanding of the legal value of the determinations made by the Fund:

> The Panel *fully agrees with the opinion of the IMF . . . [C]onsidering the opinion expressed by the IMF*, the Panel finds that the foreign exchange fee measure as it is currently applied by the Dominican Republic does not constitute an 'exchange restriction' within the meaning of Article XV:9(a) of the GATT 1994.[105]

As alluded to previously, although formally consulting the IMF under GATT Article XV:2, the Panel in *Dominican Republic—Import and Sales of Cigarettes* appears to have attached to the IMF's findings no greater legal value than to the type of information that panels may obtain based on their discretionary right to seek information under DSU Article 13. This stands in implicit contrast to the language of GATT Article XV:2 ('shall accept the determination of the Fund . . . '). Unfortunately, this issue was not appealed.

Overall, despite the remaining ambiguities, the WTO rules on balance-of-payments derogations reflect the importance of the issues situated at the intersection of international trade and monetary law. As noted earlier, restricting trade flows necessarily also restricts the related flows of payments and capital. The WTO provisions on balance-of-payments derogations may thus be considered as being intrinsically linked to the rules on capital and exchange controls contained in the IMF Agreement, with the relevant parts of both legal frameworks appearing increasingly as a single body of law, which might be regarded as yet another expression of the hybridization of contemporary IML.

3. Balance-of-payments derogations across international economic law and the IMF's imperfect lead role

The picture in the field of international investments is somewhat different. Although most BITs contain provisions protecting the transfer of funds as analysed earlier in this chapter,[106] only a very small proportion specifically allows for temporary balance-of payments derogations. Of the regional agreements on investment in force, only the North American Free Trade Agreement (NAFTA),[107] which entered into force on 1 January 1994, contains such a provision.[108]

104 WTO Panel Report, *India—Quantitative Restrictions* (n 91) paras 5.12–5.13.

105 WTO Panel Report, *Dominican Republic—Import and Sale of Cigarettes* (n 96) para 7.145, emphasis added.

106 See Subsection I.B.2 above.

107 North American Free Trade Agreement (adopted 17 December 1992, entered into force 1 January 1994) 32 ILM 289, 605 (1993) <http://www.nafta-sec-alena.org/en/view.aspx?conID=590> accessed 1 July 2013.

108 See UNCTAD (n 38) 36–7.

However, neither the NAFTA nor the few BITs that contain balance-of-payments exceptions give the IMF the same predominant role as it enjoys under the relevant WTO rules.[109] In that respect, BITs allowing for balance-of-payments derogations and NAFTA Article 2104 are limited to stating that any measures taken as part of a temporary restriction of the free transfer of funds need to be consistent with the relevant provisions in IMF Articles VI and VIII. Binding obligations to consult with the Fund and to accept its findings, notably with respect to the important legal determination of whether a specific exchange restriction is consistent with the IMF Agreement, are searched for in vain in these agreements.

NAFTA Article 2104.7 provides that in consultations among parties relating to restrictions on cross-border trade in financial services, the parties 'shall accept all findings of statistical and other facts presented by the IMF relating to foreign exchange, monetary reserves and balance of payments, and shall base their conclusions on the [IMF's] assessment'. This corresponds to the category of factual determinations as analysed above with respect to GATT Article XV:2, for which the IMF is consulted for its technical expertise. Both the NAFTA and BITs thus leave the question open as to who, in a potential dispute, would determine whether restrictions imposed in order to safeguard the balance-of-payments are consistent with the Fund's Articles. The IMF Agreement is thus not granted the same jurisdictional priority as in the IMF–WTO relationship.

An interesting exception to this pattern can be found in the unsuccessful negotiations on the MAI, held at the OECD between 1995 and 1998. The draft consolidated treaty text for the MAI,[110] ultimately unsuccessful for a whole set of other reasons,[111] contained a temporary safeguard provision for balance-of-payments crises which, like the relevant GATT and GATS provisions analysed above, would have taken the IMF's jurisdiction explicitly into account. The draft consolidated text of the MAI read in relevant part:

TEMPORARY SAFEGUARD

1. A Contracting Party may adopt or maintain measures inconsistent with its obligations . . .
   (a) in the event of serious balance-of-payments and external financial difficulties or threat thereof; or
   (b) where, in exceptional circumstances, movements of capital cause, or threaten to cause, serious difficulties for macroeconomic management, in particular monetary and exchange rate policies.

[109] See the detailed analysis in the preceding subsection.

[110] See n 46 above.

[111] For an insightful analysis of the MAI's failure and its implications, see, eg, Peter T Muchlinski, 'The Rise and Fall of the Multilateral Agreement on Investment: Where Now' (2000) 34 *The International Lawyer* 1033.

2. Measures referred to in paragraph 1:
   (a) shall be consistent with the [IMF Agreement];
   . . .
   (c) shall be temporary and shall be eliminated as soon as conditions permit.
   . . .
5. With regard to measures referred to in paragraph 1 . . .
   . . .
   (b) The Parties Group shall request an assessment by the [IMF] of the Conditions mentioned under paragraph 1 and of the consistency of any measures with paragraph 2. Any such assessment shall be accepted by the Parties Group.
   . . .

Additional Article:

If a dispute arises under this Article . . . a Dispute Settlement Panel shall request an assessment by the [IMF] of the consistency of the measures with its Articles of Agreement, of the conditions mentioned under paragraph 1 and of the consistency of any measures as applied with paragraph 2. Any such assessment by the [IMF] shall be accepted by the Panel.

Hence, had this text entered into force, the IMF would have been granted the same jurisdictional deference under the MAI (regarding both legal findings of consistency of contested measures with the Fund's Articles and factual determinations in the Fund's area of expertise) as in the IMF–WTO relationship.[112]

Despite the MAI's failure, new attempts may be undertaken by the international community in the not too distant future to establish a coherent set of multilateral rules on foreign investment, including maybe even the creation of a specialized international organization. It remains to be seen to what extent the drafters of such a future treaty will adhere to the draft MAI's approach for balance-of-payments derogations with the major role given to IMF jurisdiction as described above. To this author, following the same approach appears desirable, since it would result in a consistent legal treatment of balance-of-payments derogations across the realms of trade, investment, and money.

The diversification of the legal regime for international current and capital transactions across the three traditional pillars of IEL is only one aspect of the increasing hybridization of contemporary IML. The following section will analyse a second major aspect of this hybridization: the role of states as primary authors of legal norms in the monetary field is being increasingly challenged by what can be termed institutional policymaking through the conditionality of IMF and World Bank lending as well as through IMF surveillance and technical assistance.

[112] For comments on this and other balance-of-payments exceptions, see Sean Hagan, 'Transfer of Funds' (2000) UNCTAD Series on issues in international investment agreements UNCTAD/ITE/IIT/20, 52 <http://unctad.org/en/docs/psiteiitd20.en.pdf> accessed 1 July 2013.

II. The Evolving Normative Effects of IMF and World Bank Conditionality and the Impact of IMF Surveillance and Technical Assistance

After analysing past and current paradigm changes in the conditionality of IMF and World Bank lending (Section A), this second part will look at the shaping of domestic policies that occurs through IMF surveillance and technical assistance (Section B).

A. The reshuffle of the conditionality of IMF and World Bank lending: past and current paradigm changes

After examining relevant procedural aspects of the IMF's and the World Bank's lending operations and of the legal nature of their conditionalities (Subsection 1), this section analyses the role of implementation techniques as key vectors of conditionality (Subsection 2), prior to putting into perspective the rise and fall over the past years of structural conditionality (Subsection 3).

1. Procedural aspects of IMF and World Bank lending and the legal nature of their respective conditionalities

Most financial transactions between the IMF and its member states take place through the IMF's General Department, which consists mainly of the General Resources Account (GRA) and the Special Disbursement Account (SDA). Tranche purchases as regulated by IMF Article V:3(b) remain the basic mechanism of any financial assistance provided by the IMF. Upon entering the IMF, each member state subscribes to a certain capital quota of which 25 per cent is to be contributed in a freely usable currency as accepted by the IMF or in SDRs.[113] The remaining 75 per cent may be paid in the member's national currency. These quotas are used in order to determine the amount of voting rights held by each IMF member, and to calculate the maximum amount of financial assistance available to it.

[113] SDRs were created in 1969 in order to support the post-war system of fixed exchange rates. They constitute potential claims on the freely usable currencies of IMF member states. They are defined in terms of a basket of major currencies used in international trade and finance. Since 1 January 2011, the currencies in the basket are the following: USD (41.9 per cent), EUR (37.4 per cent), GBP (11.3 per cent), and JPY (9.4 per cent). The next review of the basket composition as well as of the weights of the included currencies is scheduled to take place by 2015. Having never had much economic relevance, SDRs have recently been subject to renewed interest by the international community out of desire to supplement global reserve assets during the Global Financial Crisis. Hence, IMF members decided to proceed to a major third general allocation of SDRs (in effect since 28 August 2009) for an amount of SDR 161.2 billion (a huge amount compared to the first two general allocations of SDR (SDR 9.3 billion in 1970–72 and SDR 12.1 billion in 1979–81)). In addition, in order to ensure that all IMF members could participate in the SDR system, a special one-time allocation of SDR 21.5 billion became effective through the Fourth Amendment of the IMF Agreement on 10 August 2009 and was implemented on 9 September 2009. For detailed information on the Fund's SDRs, see IMF, 'Special Drawing Rights (SDRs)' (Factsheet) (29 March 2013) <http://www.imf.org/external/np/exr/facts/sdr.htm> accessed 1 July 2013.

The conditions for access to Fund resources are distinctly different for reserve and credit tranche purchases. According to IMF Article XXX(c), a reserve tranche purchase designates 'a purchase by a member of special drawing rights or the currency of another member in exchange of its own currency which does not cause the Fund's holdings of the member's currency in the GRA to exceed its quota'. Strictly speaking, purchases within the reserve tranche thus do not constitute financial 'assistance' since the IMF member concerned merely draws from reserves it has itself paid in earlier. As a consequence, reserve tranche purchases are always unconditional, unlike credit tranche purchases that are subject to IMF conditionality, ie to the respect of certain economic policies that the Fund expects a member to follow in order for it to be able to use the Fund's general resources beyond its own reserve tranche.[114]

Making a credit tranche purchase enables IMF members to exchange their respective domestic currencies, most of which are of little use on international markets, against SDRs or freely usable foreign exchange, without having provided that foreign exchange to the IMF in the first place. A purchase in the first credit tranche brings the IMF's holdings of the drawing member state's currency to a level beyond the member's quota, but without going beyond 125 per cent of it. A purchase in the second credit tranche will be comprised between 125 and 150 per cent; the third and fourth credit tranches have 175 and 200 per cent as limits. This means that without the Fund's various special lending facilities,[115] IMF members would be barred from making purchases from the Fund beyond 200 per cent of their respective quotas.[116] The extensive use of these special lending facilities explains why IMF members have on numerous occasions been granted access to Fund resources well beyond the theoretical limits determined under the Fund's Articles. Notable examples include Brazil (752 per cent of its quota) and Turkey (1,330 per cent) in 2002, Argentina (424 per cent) in 2003,[117] and, more recently, Iceland (1,190 per cent) in 2008,[118] Greece (more than 3,200 per cent) in May 2010,[119] Portugal (more than 2,300 per cent) in May 2011,[120] and again Greece (more than 2,150 per cent) in March 2012.[121]

[114] See, eg, Joseph Gold, *Conditionality*, IMF Pamphlet Series No 31 (IMF, Washington DC 1979) 1; Ross Leckow, 'Conditionality in the International Monetary Fund' in *Current Developments in Monetary and Financial Law*, Vol 3 (IMF, Washington DC 2005) 53; Rosa M Lastra, *Legal Foundations* (n 19) 412.

[115] See the analysis in Subsection II.A.3 below.

[116] However, if an IMF member's currency has been purchased by other members, its drawing rights increase accordingly.

[117] Patrick Lenain, *Le FMI* (La Découverte, collection 'Repères', Paris 2004) 99.

[118] IMF, 'IMF Completes First Review Under Stand-By Arrangement with Iceland, and Approves US$167.5 Million Disbursement' (n 22).

[119] IMF, 'IMF Executive Board Approves €30 Billion Stand-By Arrangement for Greece', Press Release No 10/187 (9 May 2010) <http://www.imf.org/external/np/sec/pr/2010/pr10187.htm> accessed 1 July 2013.

[120] IMF, 'IMF Executive Board Approves an €26 Billion Extended Arrangement for Portugal', Press Release No 11/190 (20 May 2011) <http://www.imf.org/external/np/sec/pr/2011/pr11190.htm> accessed 1 July 2013.

[121] IMF, 'IMF Executive Board Approves €28 Billion Arrangement under Extended Fund Facility for Greece', Press Release No 12/85 (15 March 2012) <http://www.imf.org/external/np/sec/pr/2012/pr1285.htm> accessed 1 July 2013.

In the first credit tranche, the IMF normally contents itself with general assurances. Usually this takes the form of a letter of intent specifying the economic policies that the member state concerned intends to follow. In higher credit tranches, as will be explained below, the respect of conditionality is usually ensured via an original tool: stand-by arrangements. According to IMF Article XXX(b), stand-by arrangement 'means a decision of the Fund by which a member is assured that it will be able to make purchases from the [GRA] in accordance with the terms of the decision during a specified period and up to a specified amount'. A stand-by arrangement basically consists of a credit line whose modalities have been discussed between the Fund and the member state concerned. It authorizes the member state to draw a particular amount of Fund resources over a limited amount of time. Usually this involves two documents. One of them regularly lists a number of standard clauses indicating the objective, the duration, the precise amount of Fund resources involved as well as various conditions upon which the access to Fund resources is contingent. The other document is the letter of intent, usually signed by either the governor of the central bank or the ministry of finance, specifying (often in an annexed 'memorandum of economic and financial policies') the financial and economic policy that the IMF members seeking assistance intends to pursue. In addition, the IMF often makes the conclusion of a stand-by arrangement conditional on the implementation of economic stability programmes.

By contrast, financial assistance by the World Bank has always had a more project-specific character, intended to finance specific development projects. The World Bank's Investment Loans, as its main lending instrument, serve precisely this role; they offer long-term financing, mostly for infrastructure projects.[122] Over the last two decades, they have represented about 75 to 80 per cent of all World Bank loans.[123] Investment loans are available to member states, which are eligible to borrow from the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) as long as they are not in arrears with the World Bank Group.[124] World Bank loan contracts are registered as international treaties with the UN Secretariat pursuant to Article 102 of the UN Charter.[125] However, not all states appear to respect the standard process for the conclusion of international treaties when faced with a World

[122] The large majority of investment loans are 'specific investment loans', but the World Bank also proposes so-called 'sector investment and maintenance loans', 'adaptable program loans', 'learning and innovation loans', 'technical assistance loans', 'financial intermediary loans' and 'emergency recovery loans'. For the purposes of this chapter it is sufficient to underline that all these loans are investment loans and function basically in the same way. Since the 1980s, the World Bank has developed a second group of loans, the 'structural adjustment loans', which constitute about 20 to 25 per cent of its loans.

[123] For detailed information, see World Bank, *A Guide to the World Bank* (World Bank, Washington DC 2007).

[124] Besides the IBRD and the IDA, the World Bank Group is comprised of three additional institutions: the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the International Centre for Settlement of Investment Disputes (ICSID). Strictly speaking, the term World Bank only refers to the IBRD and the IDA taken together.

[125] Jean-Marc Sorel, 'La puissance normative des measures de suivi au sein du FMI et de la Banque Mondiale' in Hélène Ruiz Fabri, Linos-Alexander Sicilianos, and Jean-Marc Sorel (eds), *L'effectivité des organisations internationales: Mécanismes de suivi et de contrôle* (Pedone, Athens-Paris 2000) 204.

Bank loan contract and the Bank itself appears to content itself with quite general assurances given by the borrowing country that it considers the loan contract as binding. Jean-Marc Sorel has therefore argued convincingly that the manner in which both the World Bank and its members deal with this type of contract makes it necessary to analyse the legal nature of every single World Bank loan on a case-by-case basis.[126]

On the Fund's side, the IMF itself has always been extremely reluctant to consider itself as being legally bound by a stand-by arrangement. According to Joseph Gold, 'if a party lacks *animus contrahendi* and makes its attitude clear to the other party, it is not possible to hold that an agreement has been entered into'.[127] The IMF's Guidelines on Conditionality as revised in 2002 equally recall without ambiguity: 'Fund arrangements are not international agreements'.[128] The Fund's view has also found strong support in the literature. For Alain Pellet, a former president of the International Law Commission, for example, stand-by arrangements are unilateral decisions that create the one-sided obligation for the IMF to grant the member state in question access to its finances as long as the latter conforms to the relevant conditionality.[129] According to Pellet, and this corresponds to the Fund's official position, the non-respect by an IMF member of these conditions does not give rise to legal responsibility. The only consequence is a suspension of the access to IMF resources. This line of thought has been further refined by Sorel who convincingly analyses the constituent elements of stand-by arrangements[130] as parallel unilateral acts that converge in their finality.[131]

The opposite position has been defended by Dominique Carreau: he argues that stand-by arrangements should be viewed as international agreements whose terms create rights and obligations for the Fund and the member state concerned.[132] Carreau considers the letter of intent as the counterpart of the access to IMF resources. His central claim is that the disguised consensual character of the acts involved and their hidden reciprocity cannot modify the true legal nature of the underlying legal instrument. The legal acts undertaken by the parties of a stand-by arrangement may be unilateral on the surface, but are essentially bilateral in nature.[133]

[126] Sorel (n 125) 204.

[127] Joseph Gold, *The Legal Character of the Fund's Stand-By Arrangements and Why It Matters*, IMF Pamphlet Series No 35 (IMF, Washington DC 1980) 12.

[128] IMF, 'Guidelines on Conditionality', approved by the IMF Executive Board on 25 September 2002 replacing an older version dated 2 March 1979 <http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm> accessed 1 July 2013.

[129] Alain Pellet, 'Le financement dans le cadre du Fonds monétaire international' in Patrick Daillier, Géraud de la Pradelle, and Habib Ghérari (eds), *Droit de l'économie internationale* (Pedone, Paris 2004) 224, 227.

[130] As explained above, one of these documents usually lists a number of standard clauses that indicate the objective, the duration, the amount of Fund resources involved as well as the conditions upon which the access to Fund resources is contingent. The other document is the letter of intent delivered by the member seeking financial assistance.

[131] Sorel (n 125) 203.

[132] Carreau and Juillard (n 7) 618.

[133] See Sorel (n 125) 203.

It is difficult to see, however, how Carreau's position could possibly be reconciled with the law of treaties, since at least one of the parties, the IMF, has reaffirmed persistently that is does not wish to enter into a binding agreement when concluding a stand-by arrangement. Nor do IMF members appear to apply to their letters of intent the constitutional mechanisms usually applicable to the ratification of international treaties. In light of the above, Carreau's claim that stand-by arrangements are international agreements appears therefore to be unsustainable.[134]

One cannot overlook, however, that under the major economic constraints faced by countries which are in desperate need of hard currency, conditionality can *de facto* have a significant normative impact via the economic incentives and implementation techniques involved. The following subsection will therefore take a closer look at the techniques through which the conditionality of sovereign lending is implemented.

2. Implementation techniques as the key vectors of conditionality

The majority of IMF loans are disbursed according to a timetable agreed between the IMF and the authorities of the member state concerned. This enables the Fund to verify whether the state concerned continuously honours the commitments made in its letter of intent. This practice has become known as the 'phasing out' technique, meaning that 'successive tranches of financing are delivered only if key objectives remain attainable'.[135] Thus, the threat of programme suspension functions as the sword of Damocles for any IMF member in desperate need of continued financial assistance from the Fund. In most instances, this powerful economic constraint will be a sufficient incentive for IMF members to implement the promised measures, even against potentially severe domestic resistance.

In order to monitor the respect of conditionality, the IMF essentially relies on the following target instruments.[136] Firstly, *prior actions* are measures that an IMF member agrees to take even before the IMF's Executive Board approves a financial assistance programme. The elimination of exchange controls or adjustments of the exchange rate to a sustainable level are examples of what prior actions could look like. Secondly, *quantitative performance criteria* (QPCs), ie specific and measurable conditions that have to be met in order for an agreed amount to be disbursed, often supplemented by so-called *indicative targets*, usually cover macroeconomic policy variables that are, at least in theory and according to the Fund, 'under the control of the authorities': fiscal balances or external borrowing, international reserves as well as monetary and credit aggregates. Thirdly, *structural benchmarks*, ie measures that

[134] It should be added that Carreau's analysis of stand-by arrangements as international agreements is part of a short paragraph on IMF conditionality in a legal textbook on IEL (Carreau and Juillard (n 7)). Carreau does not appear to have published a detailed legal analysis on this precise issue substantiating his claim.

[135] Lastra, *Legal Foundations* (n 19) 416. See also Rosa M Lastra, 'IMF Conditionality' (2002) 4 *Journal of International Banking Regulation* 167, 171.

[136] This paragraph is built on the information provided in IMF, 'IMF Conditionality' (Factsheet) (2 April 2013) <http://www.imf.org/external/np/exr/facts/conditio.htm> accessed 1 July 2013.

cannot be monitored objectively by QPCs as they are often non-quantifiable, but which are nevertheless considered to be important. Examples include the build-up of social safety nets or the improvement of financial sector operations.

It is in the context of official *programme reviews* that the IMF monitors whether the agreed conditionality targets have been met. The IMF's Executive Board thus possesses an efficient framework for assessing a member's progress towards meeting the programme's objectives, with the possibility of reacting to changing circumstances. All these techniques are intrinsically linked and IMF members engaged in an IMF-supported programme usually have little leeway to deviate from their commitments. Although the IMF has recently reoriented conditionality away from an excessive focus on structural reforms,[137] the monitoring tools and implementation techniques just described remain essentially the same.

The monitoring of World Bank loans is achieved via very similar techniques. In most of their programmes, both institutions rely on phased-out disbursements, monitor closely the progress with respect to programme implementation via a whole set of intermediary goals and indicators, and require frequent, detailed reporting from borrowing members throughout the loan's lifetime. Both institutions dispose of elaborate monitoring mechanisms in order to increase the likelihood that loans will be paid back. It cannot be stressed often enough that the strength, and indeed the normative force, of these mechanisms relies exclusively on economic constraints, most importantly the threat that future disbursement will be delayed or that the entire loan will be cancelled. It is not out of fear of being held legally responsible that a borrowing member will do its best to comply with the conditionality attached to the assistance programme, but in order to ensure that the hard currency it is in desperate need of keeps flowing. States have little leeway in these mechanisms; effective sanctions arise from non-legal vectors, thereby contributing to the emergence of a normative power for IMF and World Bank conditionality that goes well beyond the constraining impact of their basic monitoring mechanisms.[138]

The following subsection will add to this analysis by providing a brief overview of the extent to which the key features of conditionality have evolved over time; a phenomenon which has strongly affected the degree to which conditionality infringes upon the regulatory freedom of borrowing members.

3. Contemporary monetary sovereignty and the rise and fall of structural conditionality

The IMF's basic financing mechanism was first subject to criticism by developing states back in the early 1960s. The classical tranche purchases were criticized as being both too limited in quantity and as being not sufficiently adapted to the specific needs of developing countries. In reaction to this criticism, the IMF started to set up several special lending instruments which still served the traditional purpose of macroeconomic support and whose conditionality was not very demanding. It is

[137] For detail, see Subsection II.A.3 of this chapter.

[138] Sorel (n 125) 209.

only in a second step that the IMF started to create lending instruments that relied on a strong structural conditionality.[139]

The first of these special policies, of which this chapter will only mention the most important ones, was the so-called Compensatory Financing Facility (CFF). It was established in 1963 to assist member states facing either a sudden shortfall in export earnings or an increase in the cost of cereal imports. Various other specific mechanisms followed, notably two facilities created in 1974 and 1975 to help member states with short-term balance-of-payments crises resulting from the First Oil Crisis. In 1974, the so-called Extended Fund Facility (EFF) was created in order to help countries address long-term balance-of-payments requiring fundamental economic reform.[140] Although the term 'structural adjustment' made its official appearance only in 1986 with the creation of the Structural Adjustment Facility (SAF), it appears that the EFF, with its strict conditionality, was the first special policy addressing structural needs.[141] It was in the late 1980s and throughout the 1990s that the IMF relied most heavily on structural conditionality, which coincided with the IMF's increasing involvement in low-income countries and transition economies.

In recent years both the IMF and the World Bank have become more flexible with respect to structural reforms. In 2002, following an internal review of the modalities of the conditionality attached to its programmes, the IMF revised its Guidelines on Conditionality.[142] Over the following years, the Fund aimed to further streamline its conditionality, aiming to avoid an excessive use of structural conditions as well as unnecessary cross-conditionality with World Bank lending, and to increase country-ownership of lending arrangements.[143] Similar efforts have been undertaken at the World Bank.

In 2007, however, an assessment of structural conditionality in IMF-supported programmes, undertaken by the IMF's Independent Evaluation Office (IEO), found that the number of structural conditions was still too high and that frequently conditions were used that were not critical for the achievement of programme goals.[144] In reaction to the IEO's assessment, the IMF strengthened its

[139] In order to create these new lending instruments, the IMF initially relied upon the theory of implicit competences. It is only with the Second Amendment of the Fund's Articles, which entered into force on 1 April 1978, that the IMF was explicitly given the power, pursuant to IMF Articles V:2(b) and V:3(a), to create specific policies as long as the latter are consistent with the Fund's purposes.

[140] Whereas stand-by arrangements had typically only been, and still are, 12–24 months in length with repayment being expected within 2–4 years, arrangements under the EFF were oriented towards the long term, running usually for 3 years with repayment being expected after 5–7 years.

[141] For detail on the diversification of the IMF's lending facilities, see, eg, Pellet (n 129) 229.

[142] IMF, 'Guidelines on Conditionality' (n 128); for related background material, notably on the periodic review of the Fund's Guidelines on Conditionality, see <http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm> accessed 1 July 2013.

[143] In addition, in a major effort to increase transparency, all conditionality-related aspects of most assistance programmes since 2002 have been made publicly available through the Fund's database for the Monitoring of Fund Arrangements (MONA) <http://www.imf.org/external/np/pdr/mona/index.aspx> accessed 1 July 2013.

[144] For the full report, see IEO, 'Structural Conditionality in IMF-Supported Programs' <http://www.ieo-imf.org/ieo/files/completedevaluations/01032008SC_main_report.pdf> accessed 1 July 2013.

efforts to modernize its conditionality framework and, in March 2009, proceeded to a major overhaul of its *non-concessional*[145] lending facilities and related conditionality.[146] Parallel reforms of the Fund's *concessional*[147] lending facilities took effect in January 2010 and were further refined in April 2013.

To begin with the IMF's non-concessional lending facilities, under the recently created Flexible Credit Line (FCL) the Fund now relies, for the first time in its history, more on rigorous pre-qualification criteria (so-called *ex-ante* conditionality) rather than on conventional *ex-post* conditionality.[148] It has also discontinued the use of structural performance criteria in all of its lending facilities, including those for low-income countries. Certain little-used facilities, among them the above-mentioned CFF, have been abolished altogether.[149] In its Operational Guidance to IMF Staff on the 2002 Conditionality Guidelines,[150] as revised in January 2010, the Fund underlines the need to rely more on *ex-ante* conditionality in programmes under the above-mentioned FCL and the Precautionary Credit Line (PCL) created in 2010 and again replaced in 2011 by the Precautionary and Liquidity Line (PLL).[151] When discussing the 2011 Review of Conditionality in September 2012, the Fund's Executive Board concluded, inter alia, that the existing Guidelines on Conditionality were still broadly appropriate but that conditionality would have to be kept focused and that transparency and programme ownership would have to be improved.[152]

As regards the Fund's non-concessional lending facilities, the Fund has established a so-called Poverty Reduction and Growth Trust (PRGT) in order to make its financial support more flexible and tailored to diverse country needs. As refined in April 2013, the PRGT consists of three lending windows:[153] the Extended

145 The IMF's non-concessional lending facilities are all subject to the so-called 'rate of charge', ie the Fund's market-related interest rate, with large loans carrying a surcharge.

146 IMF, 'IMF Overhauls Nonconcessional Lending Facilities and Conditionality', PIN No 09/40 (3 April 2009) <http://www.imf.org/external/np/sec/pn/2009/pn0940.htm> accessed 1 July 2013.

147 The IMF's concessional lending facilities are interest-rate free after which interest rates of between 0 and 0.75 per cent are expected to be charged for the various facilities. See IMF, 'IMF Support for Low-Income Countries' (Factsheet) (12 April 2013) <http://www.imf.org/external/np/exr/facts/poor.htm> accessed 1 July 2013.

148 On the FCL, see IMF, 'The IMF's Flexible Credit Line (FCL)' (Factsheet) (3 April 2012) <http://www.imf.org/external/np/exr/facts/fcl.htm> accessed 1 July 2013.

149 For detailed information on the March 2009 reforms of the IMF's lending facilities and of conditionality, see IMF, *Annual Report 2009: Fighting the Global Crisis* (IMF, Washington DC 2009) 25–32. See also Sean Hagan, 'Reforming the IMF' in Giovanoli and Devos (eds) (n 60) 40.

150 IMF, 'Operational Guidance to IMF Staff on the 2002 Conditionality Guidelines: Revised' (25 January 2010) <http://www.imf.org/external/np/pp/eng/2010/012510a.pdf> accessed 1 July 2013.

151 The PCL and its immediate successor, the PLL, were designed for countries with sound economic fundamentals but with a few remaining vulnerabilities that preclude them from relying on the FCL. PLL arrangements, running for either 6 months or 1–2 years, include both *ex-ante* and (relatively light) *ex-post* conditionality, with prior actions and performance criteria being used only when considered critical for the programmes success. See IMF, 'The IMF's Precautionary and Liquidity Line (PLL)' (Factsheet) (3 April 2013) <http://www.imf.org/external/np/exr/facts/pll.htm> accessed 1 July 2013. See also IMF (n 136).

152 See IMF, 'IMF Executive Board Concludes Discussion of 2011 Review of Conditionality', PIN No 12/109 (17 September 2012) <http://www.imf.org/external/np/sec/pn/2012/pn12109.htm> accessed 1 July 2013.

153 See IMF (n 147).

Credit Facility (ECF),[154] the Standby Credit Facility (SCF),[155] and the Rapid Credit Facility (RCF).[156] All three facilities offer significantly higher access to financing than before and are based on more flexible, streamlined conditionality. While the RCF serves to address needs for short-term and emergency support, the ECF seeks to address medium-term balance-of-payments needs. The SCF is designed to assist middle-income countries that are not facing protracted balance-of-payments needs and may also be used on a purely precautionary basis to provide assurance to financial markets and policymakers.[157]

Without entering into a detailed assessment of the various reforms of the IMF's lending facilities and their related conditionality undertaken since 2009, two points need to be stressed. Firstly, even after the latest set of reforms, there is no doubt that conditionality remains the Fund's most powerful tool for influencing and constraining the governments of its members in the conduct of their domestic policies on a wide range of issues, including, most notably, the exercise of the sovereign powers in the realm of money and finance as defined in the introduction to this monograph. Secondly, the reform objectives pursued by the IMF since it first started to thoroughly review the conditionality linked to its lending facilities demonstrate that the IMF has well understood that, to the extent that it infringes upon domestic policy decisions, it, too, needs to be perceived by the public as promoting the constituent values of the concept of contemporary monetary sovereignty as analysed in the first chapter of this study. Even more importantly, when promoting monetary and financial stability and financial integrity, the IMF can no longer just forcefully impose whatever measure it deems appropriate. These days the IMF has little choice but to put a stronger focus on the promotion of transparency, accountability, and subsidiarity in the context of programme design in order to avoid a dramatic erosion of its own legitimacy as crisis-lender and as guardian of the stability of the international monetary system.

Conditionality is not the only means, though, by which the IMF can influence domestic policy design. For the full picture it is necessary to take at least a brief look at the other two pillars of the IMF's toolkit: IMF surveillance and technical assistance.

B. *The shaping of domestic policies through IMF surveillance and technical assistance put into perspective*

IMF Article IV:3(a) provides the basis for the IMF's multilateral and bilateral surveillance activities. According to this provision, '[t]he Fund shall oversee the international monetary system in order to ensure its effective operation' (this is the

[154] For detail on the ECF, see IMF, 'IMF Extended Credit Facility' (Factsheet) (11 April 2013) <http://www.imf.org/external/np/exr/facts/ecf.htm> accessed 1 July 2013.

[155] For detail on the SCF, see IMF, 'IMF Standby Credit Facility' (Factsheet) (11 April 2013) <http://www.imf.org/external/np/exr/facts/scf.htm> accessed 1 July 2013.

[156] For detail on the RCF, see IMF, 'IMF Rapid Credit Facility' (Factsheet) (11 April 2013) <http://www.imf.org/external/np/exr/facts/rcf.htm> accessed 1 July 2013.

[157] See IMF (n 147).

multilateral element) and 'shall oversee the compliance of each member with its obligations under [IMF Article IV:1]' (and this the bilateral element). IMF Article IV:3(b) further provides that, 'in order to fulfil its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies'. It is on this basis that the IMF set up, in 1977, its bilateral surveillance mechanism, which, in 2007 and 2012, underwent a significant overhaul aimed at increasing the effectiveness of the Fund's surveillance activities in the interest of international monetary stability.[158] In light of the main theme of the present chapter, this section addresses merely some key procedural and institutional aspects of the Fund's surveillance activities. The substantive changes that were introduced by the IMF in its 2007 and 2012 reforms of its surveillance mechanism are covered by the detailed analysis provided in the next chapter of this monograph.[159]

The two main elements of the Fund's multilateral surveillance activities are two semi-annual publications, the World Economic Outlook (WEO) and the Global Financial Stability Report (GFSR).[160] In addition, the IMF publishes Regional Economic Outlook Reports.[161] These reports are widely recognized as important tools for highlighting imbalances and vulnerabilities threatening the world economy and global financial markets and are a valuable means for the IMF to make its views known to the international financial community and policymakers. In addition, with its 2012 surveillance reform, the Fund laid out for the first time an explicit framework for potential multilateral consultations and, in order to improve the Fund's capacity to conduct effective spillover analyses, for the first time integrated bilateral and multilateral surveillance by making Article IV consultations also a vehicle for multilateral surveillance.[162]

In the exercise of its surveillance mandate, the IMF keeps its members' economies under regular, approximately yearly, monitoring.[163] As part of what is known as Article IV consultations, which it undertakes on a rotating basis with every member, the IMF sends delegations to its members' capitals to assess whether there are risks to domestic and external stability that require policy adjustments. As part of its mission, the IMF's delegation usually meets not only with government and central bank representatives, but also with other stakeholders, such as business

[158] IMF, 'IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies', PIN No 07/69 (21 June 2007) <http://www.imf.org/external/np/sec/pn/2007/pn0769.htm> accessed 1 July 2013.

[159] See Chapter 3, Sections I.B and I.C, of this monograph.

[160] For the latest editions of the WEO and the GFSR, see the Fund's website at <http://www.imf.org/external/ns/cs.aspx?id=29> (for the WEO) and at <http://www.imf.org/external/pubs/ft/gfsr/index.htm> (for the GFSR) accessed 1 July 2013.

[161] For the latest Regional Economic Outlook Reports, see the Fund's website at <http://www.imf.org/external/pubs/ft/reo/reorepts.aspx> accessed 1 July 2013.

[162] IMF, 'Integrated Surveillance Decision' (Factsheet) (15 March 2013) <http://www.imf.org/external/np/exr/facts/isd.htm> accessed 1 July 2013.

[163] This paragraph is a summary of a more detailed description of the surveillance mechanism provided in IMF, 'IMF Surveillance' (Factsheet) (30 March 2013) <http://www.imf.org/external/np/exr/facts/surv.htm> accessed 1 July 2013.

representatives, parliamentarians, labour unions, and civil society, in order to gain as much insight as possible into the political environment and the specific economic circumstances of the member state concerned as well as the specific background of any relevant domestic policies. Subsequently, the Fund's Executive Board discusses the delegation's report and the Board's views are transmitted to the authorities of the member concerned. Over recent years, bilateral surveillance has become more transparent. Almost all IMF members now agree to the publication of a so-called Public Information Notice (PIN) summarizing the key aspects of the assessment undertaken by IMF staff and the views of the Executive Board expressed in reaction to the staff report.[164]

It is important to note that whereas the IMF can exert influence on the design of domestic policies via conditionality only with regard to the limited circle of members that approach the Fund for financial assistance, Article IV consultations as a key element of now both bilateral and multilateral surveillance are conducted with every single member, including those of its members that are unlikely to ever have to rely on financial assistance by the Fund. It is precisely due to the fact that all IMF members, even the biggest and most powerful ones are subject to IMF surveillance that places surveillance at the core of the Fund's tool set which also implies a huge degree of responsibility for the Fund when conducting surveillance in order to safeguard the stability of the international monetary system. As perfectly analysed by the late Manuel Guitián, a former director of the Fund's Monetary and Exchange Affairs Department:

> [T]he IMF is primarily a surveillance institution. All other institutional functions and responsibilities derive their legitimacy from surveillance, which gives the IMF its uniqueness among international agencies. The essential unity of the institution's responsibilities lies in the relationship between surveillance and conditionality. Their respective effectiveness and mutually reinforcing nature are indispensable for the IMF to be able to fulfill its mandate. Conditionality not only presupposes but also contributes to the effectiveness of surveillance. As in many other areas of economics, surveillance and conditionality exhibit the characteristics of a razor's edge-type of relationship. Surveillance, when well conducted at the systemic and individual country levels, tends to avert the emergence of balance of payments needs; as such, it helps contain the frequency of the need for conditionality. Yet balance of payments needs will arise even under the best of circumstances. Conditionality, well implemented, will then help to keep potential balance of payments problems from actually materializing or to prevent actual balance of payments needs from becoming entrenched. Thus, appropriate surveillance provides the setting for efficient conditionality, and conditionality strengthens surveillance by adding to the instruments available to support observance of the code of conduct.[165]

The third element of the IMF's toolkit, technical assistance, is intrinsically linked to its two main pillars, ie conditionality and surveillance, and contributes significantly

[164] PINs of recent years, including those on Article IV consultations are available on the IMF's website at <http://www.imf.org/external/news/default.aspx?pn> accessed 1 July 2013.

[165] Manuel Guitián, *The Unique Nature of the Responsibilities of the International Monetary Fund*, IMF Pamphlet Series No 46 (IMF, Washington DC 1992) 44–5.

to their effectiveness.[166] The IMF provides technical assistance in its areas of expertise, notably macroeconomic policy, the exchange rate system, financial sector stability, expenditure management, tax policy, and revenue administration.[167]

There is little doubt that, in practice, technical assistance is a very useful tool and that it is as such much appreciated by those IMF members that rely on it. It appears obvious, however, that at a time when successful economic policymaking requires a thorough understanding of increasingly complex mechanisms (a type of know-how that is often not sufficiently available in small developing countries), poor IMF members will often have little choice but to rely heavily on the IMF for technical assistance. Under such circumstances, the technical assistance and advice given by the Fund can be expected to have a major impact on the design of domestic policies in the countries concerned. The commonly accepted fact that, in economics, convincing arguments can often be made for diametrically opposed policy approaches underscores the major responsibility that has to be assumed by the Fund in providing technical assistance. As evidenced by the failure of the Washington Consensus,[168] it is far from certain that in opting for one specific direction, the IMF will always make the best choice.

Under the contemporary concept of monetary sovereignty as analysed in this monograph, a responsible exercise of technical assistance by the Fund would therefore be one that ensures that IMF members are not pushed blindly into adopting a certain mainstream position, adhered to by the Fund, if reasonable alternatives exist. In other words, technical assistance should merely aim to enable

[166] For more detailed information on the IMF's technical assistance activities, see IMF, 'Technical Assistance' (Factsheet) (15 April 2013) <http://www.imf.org/external/np/exr/facts/tech.htm> accessed 1 July 2013, as well as the various links to background material provided therein.

[167] About two-thirds of IMF technical assistance, which accounts for about one quarter of the IMF's operational budget, goes to low and lower-middle income countries. (IMF (n 166)).

[168] The term 'Washington Consensus' was originally coined in 1989 by John Williamson in reference to the common set of policy reform recommendations that were usually given by the IMF, the World Bank, and the US Treasury Department, all three based in Washington DC, in the context of the Latin American financial and economic crises of the 1980s. In a nutshell, this 'standard reform package' covered fiscal discipline, elimination of subsidies, tax reform to broaden the tax base, market-based interest rates, competitive exchange rates, privatizations, deregulation, trade liberalization, broad acceptance of inward foreign direct investment, and protection of property rights. See John Williamson, *The Progress of Policy Reform in Latin America* (Institute for International Economics, Washington DC 1990) 9–34; See also John Williamson, 'What Washington Means By Policy Reform', available at <http://www.iie.com/publications/papers/paper.cfm?researchid=486> accessed 1 July 2013. Over the years, the Washington Consensus and the institutions prescribing it became the subject of increasingly fierce criticism. In this context, the key criticism against the IMF and the World Bank was that the conditionality of their respective lending activities followed an inappropriate one-size-fits-all approach focused on radical privatization and financial liberalization without paying regard to the devastating social cost of excessively rapid and unbalanced adjustment. The Russian financial crisis of 1998 and the Argentine economic crisis of 1999–2002 and the partly harmful policy advice given by the IMF in this context are usually considered as marking the failure of the Washington Consensus. For a highly insightful account (by a former chief economist of the World Bank and Nobel Prize in economics) of the dubious role played by the IMF and the World Bank in these crises, see Joseph E Stiglitz, *Globalization and its Discontents* (WW Norton & Company, New York 2003). Following theses crises, and faced with a severe legitimacy crisis and severe protests from civil society, the IMF and the World Bank had little choice but to embark on a self-critical review of their respective conditionalities as analysed in detail earlier in this section.

IMF members to make informed, but independent, policy choices. According to this theoretical ideal, any direct impact of technical assistance on the design of domestic policies should be avoided. Having reached the end of this second part, the analysis provided in this chapter would be incomplete without providing an assessment of another key aspect of the ongoing hybridization of IML: the rise of TML.

III. The Rise in Importance of Transnational Monetary Law and its Implications

This last part opens with a succinct overview of the key characteristics of eurocurrencies as private and transnational money (Section A) prior to looking into the irresistible emergence of a private and transnational monetary and financial system on a global scale (Section B) and assessing the extent to which we are witnessing the evolution of a monetary and financial *lex mercatoria* (Section C).

A. Eurocurrencies as private and transnational money

As noted earlier,[169] eurocurrencies are deposits denominated in a specific currency that are made with a financial institution, of whatever nationality, situated outside the territory of the issuing state. The eurocurrency market first emerged in the 1960s when significant amounts of USD accumulated outside the US as a result of frequent balance-of-payments deficits of that country. Several aspects of domestic US regulation at the time created strong incentives for those holding USD abroad not to reintroduce them into the US, but to both deposit and reinvest them overseas. Firstly, the US prohibition of interest payments on current accounts and the limits on rates payable on time deposits made USD deposits outside the regulatory framework of the US more attractive, since banks in other countries, notably in Europe, readily paid such interests. Secondly, overseas branches of US banks were very interested in attracting eurodollar deposits, because reserve requirements were imposed only on USD liabilities of banks within US territory; liabilities of overseas branches were not taken into account. In the same vein, federal insurance premiums for US banks were calculated exclusively on the basis of their domestic USD liabilities. Thirdly, the interest equalization tax enacted by the US in 1964 had the effect of taxing the export of capital, rendering it more expensive to use the US financial markets to finance operations outside US territory. In summary, eurocurrency markets originally developed as eurodollar markets in order to allow USD transactions, mainly between large financial institutions, outside the economically less attractive regulatory framework of the US as the issuing state of the world's leading currency, the USD.[170] Later, the

[169] See Subsection I.B.1 above.

[170] See Charles Proctor, *Mann on the Legal Aspect of Money* (7th edn OUP, Oxford 2012) 58–63. The complex historic background of the eurocurrency markets has been thoroughly analysed by the existing literature, which explains why, for the purposes of this chapter, a very brief historical overview

phenomenon broadened in scope and eurocurrency markets emerged for other global currencies, notably the deutsche mark (DEM), JPY, GBP, Swiss Franc (CHF) and, more recently, EUR.

Originally, eurocurrency markets were limited to their two fundamental components: eurocurrency deposits and eurocurrency loans, the latter being essentially the use by the recipient financial institution of the eurocurrency deposits as a means of funding for customers not wishing to rely on the capital markets in the issuing state. The multiplier effect arising from the lending activities of financial institutions and the related rise in the money supply have traditionally been more pronounced with respect to eurocurrencies due to the fact that, as noted above with respect to the US regulatory framework, the domestic reserve requirements do not usually apply to deposits made outside the territory of the issuing state. The operation of the banking system thus created, and continues to create, eurocurrencies at a significantly higher pace than that which can be observed for lending operations within the territory of the issuing state with respect to domestic currency, for which states retain at least some control over the evolution of the money supply via reserve requirements.[171]

Intrinsically related, the large amounts of eurocurrency deposits also triggered the evolution of the market for eurobonds,[172] ie bonds issued in a eurocurrency. The great success of the eurobond market stems from the fact that eurobonds are issued in bearer form, with interest payments being free of withholding taxes. This makes them very attractive to investors wishing to remain anonymous or to avoid taxes. Eurobonds may be of various maturities subject to agreement between the financial institutions involved, and at fixed interest rates, or at floating rates linked to a benchmark rate such as the London Interbank Offered Rate (LIBOR).[173]

has to suffice. For much more detailed information, see Carreau and Juillard (n 7) 637–45 and Carreau (n 42) 350–79. For an interesting discussion in an economic history approach of the reasons for the original growth of the eurodollar market in London, see Catherine R Schenk, 'The Origins of the Eurodollar market in London: 1955–63' (1998) 35 *Explorations in Economic History* 221.

[171] The eurocurrency market has reached dimensions that no one would have imagined when that market first emerged several decades ago. By the end of 2009, loans granted and deposits placed in the five major eurocurrencies (USD, EUR, JPY, GBP, and CHF) amounted to the equivalent of approximately USD 13,500 billion. Deposits received and borrowing in these same five major eurocurrencies amounted to the equivalent of approximately USD 15,500 billion, with USD accounting each time for approximately 60 per cent (source: unpublished BIS international locational banking statistics by residence. Communicated by Mr Swapan-Kumar Pradhan (personal email correspondence 4 June 2010, on file with author)). The size of these numbers appears even more impressive when compared to the total foreign exchange holdings held by the world at the same time. According to IMF statistics, these holdings amounted to the equivalent of just over USD 8,000 billion by the end of 2009 (<http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf> accessed 1 July 2013).

[172] By the end of 2006, the eurobond market had already reached a total volume of more than USD 4,000 billion (Carreau and Juillard (n 7) 643), which is several times the total current lending capacity of the IMF. The amount the IMF has readily available for new (non-concessional) lending is indicated by its one-year forward commitment capacity, which, in April 2013, stood at USD 399.4 billion (<http://www.imf.org/external/np/tre/liquid/2013/0413.htm> accessed 1 July 2013).

[173] The LIBOR is a daily reference rate, which, in a nutshell, is calculated on the basis of the average of hypothetical interest rates that leading banks operating in the City of London estimate they would be charged by their peers if borrowing unsecured funds from each other short-term. For detail on how the LIBOR and similar reference rates are calculated, and an analysis of the 2012 LIBOR manipulation

The legal nature of eurocurrencies is of particular interest for the purposes of this chapter as it can be regarded as an additional, powerful expression of the ongoing hybridization of IML.[174] What renders the legal regime of eurocurrencies complex and unique is the fact that any financial transaction relying on eurocurrencies will be subject concurrently to two national legal regimes: the law governing the underlying contract, the *lex contractus*, and the law of the state whose currency is relied upon as eurocurrency, the *lex monetae*. If one takes further into account that it is ultimately the operation of the private banking system outside the territory of the issuing state that effectively creates eurocurrencies via the multiplier effect of lending operations as mentioned above, Carreau's analysis of eurocurrencies as 'private and transnational money' appears very convincing.[175] According to this logic, two distinct types of money can be identified for every currency that has risen to the status of a eurocurrency on international capital markets. The underlying support currency, whose supply is at least to some extent still subject to the control of the issuing state, would appear as 'public and national money'.[176] By contrast, the related eurocurrency has been convincingly analysed by Carreau as 'derivative', as 'private and transnational money', created by the private sector overseas, but subject, at least in theory, not only to the *lex contractus*, but also to the *lex monetae*.

The link between a eurocurrency and its underlying support currency consists precisely in the submission of eurocurrencies to their respective *lex monetae*. All other, seemingly more obvious, links, notably the dependence of a eurocurrency on fluctuations of the value of the underlying support currency, may be perfectly controlled by individual contractual arrangements on the eurocurrency market, like value clauses.[177] To the extent that eurocurrency transactions have to rely on clearing and settlement mechanisms in the territory of the state issuing the

scandal and the regulatory response thereto, see Claus D Zimmermann, 'Global Benchmark Interest Rates: Conflicting Objectives and Increasing Hybridization' in Thomas Cottier, Rosa M Lastra, Lucia Satragno, and Christian Tietje (eds), *The Rule of Law in Monetary Affairs* (CUP, Cambridge forthcoming 2014).

[174] The legal nature of eurocurrencies has been thoroughly analysed in the existing literature, which explains why this section points out merely some key issues. For detailed developments, see notably Carreau (n 42) 350–79. Additional, timeless sources of insight are Joseph Dach, 'Legal Nature of the Euro-Dollar' (1964) 13 *American Journal of Comparative Law* 30; and Robert C Effros, 'The Whys and Wherefores of Eurodollars' (1968) 23 *The Business Lawyer* 629.

[175] Dominique Carreau, 'La souveraineté monétaire de l'Etat à la fin du XXe siècle: mythe ou réalité?' in Leben, Loquin, and Salem (eds) (n 43) 491, 504: 'En bref, il apparaît bien aujourd'hui que les eurodevises sont de véritables monnaies scripturales conventionnelles privées à usage transnational'.

[176] Strictly speaking, this analysis appears only convincing if one adheres to the Societary theory of money as analysed in Chapter 1, Section I.B, of this monograph or at least to the revised State theory of money proposed by Proctor, according to which the legislature determines what constitutes 'money' by defining the unit of account for the domestic medium of exchange (Proctor (n 170) 40–3). According to the traditional State theory of money, a huge proportion of this 'public and national money' as described by Carreau—the scriptural money created by domestic lending activities—would not amount to money in the legal sense, but to credit.

[177] For relevant detail on the use of such contractual arrangements, see Section III.C below.

underlying support currency,[178] regulatory control by the state concerned, and thus the assertion of the *lex monetae*, indeed becomes technically possible.[179]

However, although in practice a huge proportion of eurocurrency transactions will indeed rely on clearing and settlement mechanisms subject to the *lex monetae*, this step is no longer indispensable. Depending on the circumstances, clearing could take place directly, within the same overseas bank, or rely upon a clearing and settlement mechanism outside the territory of the state issuing the support currency.[180] An interesting example for such an institutionalized clearing mechanism would be the Clearing House Automated Transfer System (CHATS), a real time gross settlement system for the transfer of funds, including USD, situated in Hong Kong.[181]

Having explained why the hybridization of IML finds one of its most powerful expressions in the contemporary phenomenon of eurocurrencies, as private and transnational money, the next section will look into an intrinsically related issue, namely the emergence of what appears to be a truly transnational monetary and financial system.

B. *The irresistible emergence of a truly transnational monetary and financial system*

Triggered by the impressive evolution of eurocurrency and eurobond markets and fuelled by the spreading of derivatives as new financial instruments, a private monetary and financial system has emerged alongside the traditional public and intergovernmental monetary system. With both systems having become more and more intertwined and interdependent, the global monetary system appears to have become an outstanding example of a legal framework that has become truly transnational in nature, exceeding the traditional, and increasingly somewhat artificial, boundaries between public and private law as well as between domestic and international law.[182]

[178] For most eurodollar transactions, ie transactions with USD as eurocurrency, the parties would thus rely on the American Clearing House Interbank Payments System (CHIPS), implying reverse bank postings in both the overseas eurodollar banks and their respective US correspondent banks. For an illustrating description of the financial operations involved, see Carreau and Juillard (n 7) 649–50.

[179] On this point, see Carreau (n 175) 504.

[180] See Carreau (n 42) 362–3. It is somewhat puzzling that elsewhere Carreau supports the view that eurocurrency transactions will in any event have to rely on clearing and settlement mechanisms in the territory of the state issuing the underlying support currency, and that eurocurrency transactions can thus not escape the *lex monetae* (Carreau and Juillard (n 7) 654). The more nuanced view supported in this chapter appears to be the only appropriate one, for the reasons that have been given by Carreau himself (Carreau (n 42) 362–3) and that reflect the economic reality of contemporary eurocurrency transactions.

[181] CHATS is operated by Hong Kong Interbank Clearing Limited, a private company jointly owned by the Hong Kong Monetary Authority and the Hong Kong Association of Banks. Transactions in USD, EUR, and in Hong Kong dollars may be settled using CHATS (<http://www.gov.hk/en/about/abouthk/factsheets/docs/financial_services.pdf> accessed 1 July 2013).

[182] This section is limited to a succinct overview of selected key features of this fascinating, yet complex, evolution.

During the first years of their existence, the eurocurrency markets were a source of financing designed exclusively by and for the private sector (mainly professional market players in the form of multinational companies).[183] From the mid-1970s onward, however, states and their public companies have become increasingly important participants on both the lending and borrowing sides of the eurocurrency markets. This development was triggered by the two oil crises of 1973–4 and 1979–80 as a result of which oil-producing countries, mainly from the Middle East, were looking for investment opportunities (overseas, but outside the US) for their huge USD excess revenues,[184] which led to a strong increase in eurodollar deposits.[185] As a result, eurocurrency markets emerged as the principal source of external financing for many states around the world, with an overall lending capacity which, even over three decades ago, far exceeded that of the IMF.

Over the years, the originally separated markets for the lending and borrowing of eurocurrencies short-term (under the form of eurocurrency deposits and loans) and long-term (under the form of eurobonds) have become more and more intertwined under the impact of financial innovation[186] and the use of derivatives.[187] This led to the creation of a dense network of hardly visible links between these formally distinct components of the global market for capital, resulting in their horizontal

[183] Carreau and Juillard (n 7) 564.

[184] The huge amounts of USD earned by oil-producing countries through the sale of petroleum became famous at the time as 'petrodollars'.

[185] The term 'petrodollar recycling' describes this reliance, by oil-producing countries, on investment opportunities abroad, for the placement of their large surpluses of petrodollars.

[186] In the words of John Black, the key characteristics of derivatives can be defined succinctly as follows:

> A tradable security whose value is derived from the actual or expected price of some underlying asset, which may be a commodity, a security or a currency. Derivatives include futures contracts, futures on stock market indices, options and swaps. Derivatives can be used as a hedge, to reduce risk, or for speculation. A derivatives market is a market such as the London International Financial Futures and Options Exchange (LIFFE) on which derivatives can be traded.
>
> (John Black, *Oxford Dictionary of Economics* (2nd edn OUP, Oxford 2003) 118).

[187] As briefly noted above, there are three main categories of derivatives: swaps, options, and futures (also called forwards). Swaps are contracts by which the parties involved exchange some benefits of one party's financial instrument against some benefits of the other party's financial instrument. Options are contracts that give the owner the right, but not the obligation, to buy (in the case of a call option) or sell (in the case of a put option) an asset. Futures, finally, are contracts on buying or selling an asset on or before a future date at a price specified already today. By combining selected elements of these three basic types of derivatives and by additional contractual arrangements it is possible to create more complex derivatives, which illustrates the potential of financial innovation. Broadly speaking, two groups of derivative contracts can be distinguished. Firstly, over-the-counter (OTC) derivatives are privately traded and negotiated directly between two parties without relying on an official intermediary. The OTC derivatives market is largely unregulated regarding the disclosure of information and is the largest market for derivatives. According to the BIS, the notional amounts outstanding of OTC derivatives amounted to the equivalent of about USD 640,000 billion (with a gross-market value, ie the theoretical cost for replacing all existing contracts of just under USD 25,400 billion) by June 2012 (<http://www.bis.org/statistics/otcder/dt1920a.pdf> accessed 1 July 2013). Secondly, exchange-traded derivatives (ETD) are traded on specialized derivatives exchanges (such as Eurex and the Korea Exchange), but not directly between the parties.

integration.[188] In addition, the traditional key role of banks in financial intermediation has been shuffled by the emergence, beginning in the 1980s, of securitization,[189] as a result of which an increasing proportion of borrowing operations by professional market players has been undertaken via the issuance of securities. Classical bank loans, including eurocurrency loans, have thus been replaced, at least to some extent, by new financial techniques.

The interdependence of the public and private, the domestic and international, monetary regimes has significantly increased over time. Informal cooperation across systems on sovereign debt restructuring can be regarded as an expression of this interdependence and of the ensuing necessity for at least some co-management of the global monetary system.[190] However, it is the various subsystems' shared responsibility for global monetary and financial stability that is the clearest demonstration of the fact that the global monetary and financial system has become truly transnational in nature. As illustrated by the Global Financial Crisis, this responsibility rests on the shoulders of both the public and private, the domestic and international, monetary regimes. Ever-increasing financial integration among national economies and among the public and private sectors, and the tremendous global dependency on functioning private capital markets has led to a situation where the stability of the system as a whole can be put at risk by economic or regulatory failure in one of the previously separate elements, public or private, domestic or international.

Due to their essentially contractual nature, eurocurrency markets would appear to be fertile ground for the emergence of a contemporary monetary and financial *lex mercatoria*. The final section of this chapter will briefly examine whether such a development can actually be observed.

C. *Towards a monetary and financial* lex mercatoria*?*

Literally meaning 'merchant law', the medieval *lex mercatoria* was a body of trading principles that evolved as a system of custom and best practice, common to merchants and traders in Europe, emphasizing contractual freedom and enabling quick dispute resolution by merchant courts along the main trade routes. A key characteristic of the system was that local authorities opted to interfere as little as possible, thus leaving merchants with a significant amount of contractual freedom, which led to increased levels of trade and, as a result, increased tax revenues.[191] One

[188] Carreau and Juillard (n 7) 644.

[189] In broad terms, securitization can be defined as '[t]he process by which a company packages its illiquid assets as a security. For example, when a company makes an initial public offering, it effectively packages the company's ownership into a certain number of stock certificates. Securities are backed by an asset, such as equity, or debt, such as a portion of a mortgage'. (Farlex Financial Dictionary 2012 <http://financial-dictionary.thefreedictionary.com/securitization> accessed 1 July 2013).

[190] For detail on this point, see Carreau and Juillard (n 7) 565.

[191] See, including a detailed overview of the historical development of international commercial law, Len S Sealy and Richard JA Hooley, *Commercial Law: Text, Cases, and Materials* (4th edn OUP, Oxford 2008) 14–20.

reason why the medieval *lex mercatoria* has attracted so much attention is that many of its uncodified customs and usages ended up becoming formal law.[192]

Following the publication, in 1964, of an influential article by Berthold Goldman,[193] the private international law and international commercial law literatures have deployed significant efforts to identify the emergence of a contemporary *lex mercatoria*.[194] For the purposes of this chapter it is not necessary to embark on a discussion of the doctrinal controversies surrounding the concept of *lex mercatoria*. However, there is one question related to the idea of *lex mercatoria* that needs to be addressed in a study of the hybridization of IML: to what extent have the participants in the eurocurrency and eurobond markets, via their seemingly endless inventiveness in respect of new financial products and their strong reliance on commercial usages and contractual clauses,[195] brought about the creation of new substantive rules of law? Since this question has already been analysed very well elsewhere,[196] it seems appropriate to limit the following paragraphs to four succinct comments.

Firstly, whereas eurocurrencies can indeed be analysed as scriptural and contractual, private and transnational, money, and whereas the creativity of participants in the eurocurrency and eurobond markets with respect to the design of new financial products indeed appears unparalleled in the history of finance,[197] it is essential not to overlook the fact that domestic legal systems continue to play a key role in this rapidly evolving field. Despite the fact that they are essentially created by the overseas banking sector—with increasingly limited possibilities for the state issuing the underlying support currency to intervene[198]—eurocurrencies continue to be defined by reference to units of account devised by states. Those operating in eurocurrency markets can obviously rely on various contractual arrangements, like value clauses and reference currencies, in order to limit the economic uncertainty of their transaction. The fact, however, that eurocurrencies rely on domestic units of account as anchor points, is indeed a powerful illustration of the transnational character of eurocurrencies.

192 See Lastra, *Legal Foundations* (n 19) 472.

193 Berthold Goldman, 'Frontières du Droit et Lex Mercatoria' (1964) 9 *Archives de Philosophie du Droit* 177.

194 For an insightful overview, see, eg, Emmanuel Gaillard, 'Trente ans de *Lex Mercatoria*—Pour une application sélective de la méthode des principes généraux du droit' (1995) 122 *Journal du Droit International* 5.

195 For an insightful related analysis, see Charles Proctor, 'Indexation and Value Clauses' in Giovanoli and Devos (eds) (n 60) 575.

196 See, notably, Carreau (n 42) 379–83. For insightful remarks on a related, yet differently focused, issue, namely the emergence of a *lex financiera* through financial soft law standards and their gradual formalization and transformation into hard law backed up by effective sanctions, see Rosa M Lastra, 'The Quest for International Financial Regulation', Inaugural Lecture (23 March 2011) <http://www.law.qmul.ac.uk/docs/podcasts/50504.pdf> accessed 1 July 2013. For a discussion of Lastra's insightful remarks on whether we need a World Financial Authority (WFA), see Chapter 5 of this monograph.

197 On both issues, see the two preceding sections.

198 As noted in Section III.A above, the extent to which a eurocurrency will be subject to the *lex monetae* depends on the degree to which international transfers denominated in a specific currency have to rely on clearing and settlement mechanisms located in the territory of, and are thus subject to the regulation of, the issuing state.

Secondly, and in the same vein, the contribution of those operating in the eurocurrency and eurobond markets with respect to the development of new financial products appears to a large extent to have been limited to applying, on a global scale, techniques that had been previously developed for, and applied to, domestic transactions.[199] Almost inevitably, this broadened the scope of financial instruments available for global financial transactions, since not all techniques had previously been available everywhere, sometimes because of legal obstacles, as was long the case for futures in Germany.[200] It is important to note, however, that this harmonization of the legal techniques applied in the eurocurrency and eurobond markets would not have occurred without the large margin for manoeuvre that was effectively and deliberately given to the markets by domestic regulators. Whereas this lenient approach of regulators towards eurocurrency and eurobond markets can be explained by the desire of states to attract international capital flows,[201] it should not be overlooked that it is still domestic regulators and not markets that continue to have the last word on whether a specific financial technique or instrument can be lawfully used in a given domestic market.

Thirdly, it is crucial to note that despite the great variety of standard contractual clauses relied upon in transactions in the eurocurrency and eurobond markets, all of these contracts remain subject to the domestic laws of a specific country as agreed upon by the parties. As convincingly observed by Carreau, the parties may actually welcome this submission to a domestic legal framework as a source of increased transparency and legal security for their financial operations.[202]

Fourthly, and intrinsically related, the rare disputes that arise from the transactions within the eurocurrency and eurobond markets tend to be brought before domestic courts and not before arbitration panels, which further speaks against the emergence of a monetary and financial *lex mercatoria*.[203]

Overall, the financial and monetary transactions occurring within the eurocurrency and eurobond markets appear to be profoundly transnational in nature. Evolving exclusively according to changing economic incentives, the normative impact, but obviously not the economic clout, of the private and transnational component of the global monetary and financial system might be regarded as rather limited.[204] This underscores the responsibility of domestic regulators to provide a regulatory framework that contributes to global monetary and financial stability by creating appropriate legal boundaries, and appropriately channelling economic incentives, so as to include those parts of the system that have so far remained largely unregulated.

Conclusion

The vast *tour d'horizon* of the key aspects of the increasing hybridization of IML provided in this chapter speaks for itself. National governments and central banks,

[199] Carreau (n 42) 380–1. [200] Carreau (n 42) 382.
[201] On this point, see, eg, Sorel (n 43) 521–2. [202] Carreau (n 42) 383.
[203] Carreau (n 42) 383. [204] Carreau and Juillard (n 7) 564.

as well as any other body exercising sovereign powers in the realm of money upon formal conferral of the latter, have to act in a legal environment which is getting increasingly complex and whose constituent elements transcend the traditional black-and-white categories used for describing the law as either public or private, as domestic or international, as hard or soft. Whereas important aspects of IML are certainly still firmly enshrined in the IMF Agreement, the main multilateral treaty in this field, contemporary IML has become the prototype of a hybrid body of law. The emergence of a truly transnational monetary and financial system as examined, inter alia, in this chapter, is certainly the most powerful illustration of this ongoing hybridization process.

An equally important aspect of this process is the fact that legal and economic constraints do not influence the exercise of sovereign powers in monetary and financial matters in a separate, isolated manner, but they form a bundle of interwoven constraints. For example, it is only by taking into account the *de facto* normative force of economic incentives and of subtle implementation techniques that one can grasp the true force of the conditionality of IMF and World Bank lending.

Overall, in order to fully understand, and be in a position to assess, recent normative evolutions in monetary and financial matters, one has to resist the temptation of oversimplifying the relevant issues by trying to squeeze them into existing legal categories like hard or soft law, and avoid an overly narrow focus on the seemingly purely legal aspects of a problem without taking into account the crucial role of economic constraints. The contemporary exercise of sovereign powers in monetary and financial matters takes place in an increasingly complex legal and economic environment which then also turns the promotion of the sovereign values incorporated and expressed in the contemporary concept of monetary sovereignty analysed in this monograph into an increasingly complex undertaking. With this in mind, this study now turns to examining in detail the phenomenon of exchange rate misalignment.

3

Exchange Rate Misalignment and International Law[1]

Introduction

History is replete with examples where states have interfered with foreign exchange markets in order to influence exchange rates. The trade conflicts between the two world wars, for instance, were fought not only via the imposition of tariffs, but also via competitive devaluations. Since then, straightforward competitive devaluations have become a rare phenomenon; contemporary scenarios, in which exchange rate policies are criticized for their potentially protectionist impact, tend to be much more sophisticated. In the recent past, China's exchange rate policy is the outstanding, yet not exclusive, example. In recent years policymakers worldwide have criticized China for maintaining an undervalued real exchange rate as part of its strategy of export-led growth.[2]

It is important to note from the outset that questions about exchange rate misalignment—deviations of exchange rates from their economic equilibrium

[1] A significantly extended version of this chapter (including also elements of Chapter 2 (Subsections I.C.1 and I.C.2, and Section II.B) of this monograph) has been published as an article: see Claus D Zimmermann, 'Exchange Rate Misalignment and International Law' (2011) 105(3) AJIL 423.

[2] China's official currency is the renminbi (RMB). The Yuan, which is often used as a synonym for the RMB in public discussions, is the unit of account of the RMB (one yuan, two yuan, . . .). For over a decade now, China's exchange rate policy has been subject to fierce criticism, especially by US politicians. Between 1995 and July 2005, China pegged the RMB to the USD at a rate of RMB 8.28 per USD. Over the course of the following three years, the Chinese authorities let the RMB appreciate by around 21 per cent against the USD under a managed float. From July 2008 until 19 June 2010, the RMB was again effectively pegged to the USD, this time at around RMB 6.83 per USD. On 19 June 2010, one week before the G-20 Toronto Summit, the People's Bank of China, China's central bank, announced that it would increase the exchange rate flexibility of the RMB but emphasized that it did not see the economic basis for a large-scale appreciation of the RMB under its new managed float. By 1 July 2013, the RMB had appreciated by 11.2 per cent against the USD in absolute terms and stood at around 6.14 RMB per USD. On the Chinese policy shift announced on 19 June 2010, see Claus D Zimmermann, 'Congress Continues to Attack Currency Manipulation as China Defuses G-20 Pressure For Now: the International Law Issues' (2010) 14(19) *ASIL Insights* <http://www.asil.org/insights100630.cfm> accessed 1 July 2013. On the main economic issues related to the Chinese exchange rate, see, eg, Jeffrey Frankel, 'The Renminbi Since 2005' in Simon J Evenett (ed), *The US-Sino Currency Dispute: New Insights from Economics, Politics and Law* (VoxEU.org e-book, 2010) <http://www.voxeu.org/index.php?q=node/4868> 51; Charles Wyplosz, 'Is an Undervalued Renminbi the Source of Global imbalances?', ibid 37; Wayne M Morrison and Marc Labonte, 'China's Currency Policy: An Analysis of the Economic Issues' (CRS Report for Congress) (19 December 2011, RS21625) <http://www.fas.org/sgp/crs/row/RS21625.pdf> accessed 1 July 2013.

levels[3]—and its potential causation by exchange rate manipulation undertaken for competitive purposes did not arise for the first time a few years ago. Exchange rate misalignment has been a recurrent issue in international economic relations. In the late 1960s and early 1970s, for example, Japan and West Germany, both then still in the process of rebuilding and industrializing their economies after World War Two, were criticized for maintaining the JPY and DEM, respectively, at artificially low levels in order to promote exports. Indeed, the recent calls by US politicians across the political spectrum to legislate on the issue of 'currency manipulation'[4]—attacking China's exchange rate policy more or less explicitly—bring to mind the sabre rattling that preceded the Plaza Agreement of 1985.[5]

In the recent past, ie from the second half of 2010 onwards, several major states other than China have resorted to measures intended to affect exchange rates directly or indirectly. In this context, both Japan and the US were, and still are, subject to fierce criticism. To begin with the US, having undertaken a first round of quantitative easing[6] (commonly referred to as QE1) at the peak of the Global Financial Crisis in 2008, the Fed announced on 3 November 2010 that it would buy USD 600 billion in long-term Treasury bonds over a time frame of eight months and that it would reinvest an additional USD 250–300 billion in Treasury bonds with the proceeds of its earlier investments. The intended goal of this second round of quantitative easing (QE2) was to stimulate US growth by squeezing the yield on US assets, thereby lowering the costs of domestic borrowing and stimulating domestic investment. As a side effect, capital inflows into foreign countries, and thus demand for foreign currencies, were likely to rise.[7] On 13 September 2012, the Fed announced QE3, launching a monthly USD 40 billion bond purchasing programme of mortgage backed securities,[8] with the monthly amount of bond purchases being raised to USD 85 billion three months later. Commentators from

[3] On the concept of equilibrium exchange rate see, eg, Paul R Krugman, 'Equilibrium Exchange Rates' in William H Branson, Jacob A Frenkel, and Morris Goldstein (eds), *International Policy Coordination and Exchange Rate Fluctuations* (University of Chicago Press, Chicago 1990) 159, available at <http://www.nber.org/chapters/c6948.pdf> accessed 1 July 2013.

[4] As used in public debate, the term 'currency manipulation' reflects a negative political judgement since it implicitly refers to situations in which a country seeks to achieve an artificial undervaluation of its currency to obtain an unfair competitive advantage in global trade. By contrast, the term 'exchange rate manipulation', as employed in this chapter (consistent with IMF terminology), is a technical term designating any policy measures that are targeted at, and actually affect, the exchange rate, independent of the (lawful or unlawful) purpose for which such manipulation is being undertaken.

[5] The Plaza Agreement (also called Plaza Accord) was an agreement between France, Japan, the UK, the US, and West Germany, to intervene in currency markets to bring about an appreciation of the JPY and DEM in relation to the USD. It was signed on 22 September 1985 at the Plaza Hotel in New York City, hence its name.

[6] The term 'quantitative easing' refers to the injection, by the central bank, of a predetermined quantity of money into the national economy. This is an unconventional tool of monetary policy resorted to by central banks when short-term interest rates can no longer be lowered to stimulate the economy because they are already at or close to zero, meaning that conventional monetary policy has become ineffective.

[7] See, eg, Annalyn Censky, 'QE2: Fed Pulls the Trigger', CNNMoney.com (3 November 2010) <http://money.cnn.com/2010/11/03/news/economy/fed_decision/index.htm> accessed 1 July 2013.

[8] See Fed, Press Release (24 October 2012) <http://www.federalreserve.gov/newsevents/press/monetary/20121024a.htm> accessed 1 July 2013.

both inside[9] and outside[10] the country criticized the US for pursuing a policy of weakening the USD with its repeated rounds of quantitative easing.

More recently, attention has again shifted to Japan, which, in early April 2013, announced a massive programme of quantitative easing.[11] Worth the equivalent of USD 1.4 trillion, the programme will have a monthly volume of approximately USD 70 billion and is expected to double Japan's money supply. The declared objective of this programme, which is a part of a set of measures referred to as Abenomics (named after Japan's current prime minister Shinzo Abe), is to stimulate the Japanese economy by replacing Japan's long period of deflation with a yearly inflation rate of approximately 2 per cent. Following the announcement of the new policy, the value of the JPY immediately fell by 3 per cent against the USD in Asian trading which raised concerns that the underlying goal of Japan's policy was to gain an unfair competitive advantage in global trade.[12] Some time earlier already, on 15 September 2010, following a 15-year high of the JPY against the USD, Japan had intervened on foreign exchange markets for the first time since 2004 by selling large amounts of JPY.[13]

Partly in reaction to these contested policies by the world's largest economies several developing countries took actions aimed at resisting upward pressure on their currencies. Thailand, for instance, announced a 15 per cent withholding tax for foreign investors in its bonds, and Brazil doubled a tax on foreign purchases of its domestic debt.[14]

In expressing his criticism, Brazil's finance minister Guido Mantega went as far as to declare that an 'international currency war' had broken out.[15] Over the past few years, Mantega regularly reiterated that claim and established himself as one of the leading voices of the BRICS[16] countries in criticizing the monetary policies

[9] Alan Greenspan, a former chairman (1987–2006) of the Fed, is among the best-known critics of contemporary US monetary policy. See, eg, Alan Beattie, 'Greenspan Warns over Weaker Dollar', *Financial Times* (10 November 2010) <http://www.ft.com/cms/s/0/b6e3d086-ed12-11df-9912-00144feab49a.html> accessed 1 July 2013.

[10] See, eg, John P Rathbone and Jonathan Wheatley, 'Brazil Ready to Retaliate for US Move in "Currency War"', *Financial Times* (4 November 2010) <http://www.ft.com/intl/cms/s/0/326a6d62-e83d-11df-8995-00144feab49a.html>; Ralph Atkins, 'Germany Attacks US Economic Policy', *Financial Times* (7 November 2010) <http://www.ft.com/cms/s/0/c0dca084-ea6c-11df-b28d-00144feab49a.html> all accessed 1 July 2013.

[11] Heather Stewart, 'Japan Aims to Jump-start Economy with $1.4tn of Quantitative Easing', *The Guardian* (4 April 2013) <http://www.guardian.co.uk/business/2013/apr/04/japan-quantitative-easing-70bn> accessed 1 July 2013.

[12] Stewart (n 11).

[13] See, eg, Michiyo Nakamoto, 'Japan Finance Chief Defends Yen Intervention', *Financial Times* (8 October 2010) <http://www.ft.com/cms/s/0/6a5d13ca-d292-11df-9e88-00144feabdc0.html> accessed 1 July 2013.

[14] 'How to Stop a Currency War', *The Economist* (online edn, 14 October 2010) <http://www.economist.com/node/17251850> accessed 1 July 2013.

[15] *The Economist* (n 14).

[16] BRICS (Combining the first letters of Brazil, Russia, India, China, and South Africa) is the name of an association of five emerging, fast-growing, economies. Initiated in 2006 as the BRIC, South Africa was added to the group in 2010. The combined population of the BRICS countries is approximately 3 billion. Over recent years the BRICS has attempted to position itself as an influential

conducted by developed countries, notably the US and Japan, in reaction to the Global Financial Crisis.[17] In this context, Brazil also obtained that the WTO held a two-day seminar on 27–28 March 2012 on the effects of exchange rate shifts on global trade flows.[18]

The key rules of international law with respect to the conduct of exchange rate policies are laid down in the IMF Agreement. However, it is only since the *de facto* breakdown of the Bretton Woods system of fixed exchange rates in August 1971, followed by the inescapable rewriting of the international rules of monetary conduct via the second amendment of the IMF Agreement, that freely floating currencies have become common practice for most of the world's major economies.[19] Since then, IMF member states have been authorized to opt for any form of exchange arrangement except pegging their currency to gold:[20] allowing the currency to float freely, pegging it to another currency or to a basket of currencies,

counterweight to the traditional dominance by the US and European countries in international cooperation and policymaking, most notably in the field of international economic affairs.

[17] See, eg, John P Rathbone and Jonathan Wheatley, 'Brazil's Finance Chief Attacks US Over QE3', *Financial Times* (20 September 2012) <http://www.ft.com/cms/s/0/69c0b800-032c-11e2-a484-00144feabdc0.html> accessed 1 July 2013.

[18] Organized by the WTO's Working Group on Trade, Debt and Finance upon Brazil's initiative, that seminar was devoted exclusively to the economic effects of exchange rates on global trade flows and did not address whether specific monetary or exchange rate measures could amount to a violation of the WTO agreements. The presentations given at that seminar by academics and policymakers are all available on the WTO website at <http://www.wto.org/english/news_e/news12_e/devel_27mar12_e.htm> accessed 1 July 2013.

[19] On 15 August 1971, the US under President Nixon informed the IMF that it would no longer freely buy and sell gold to settle international USD transactions. Par values and convertibility of the USD—two main features of the Bretton Woods system—thereby ceased to exist. On 19 March 1973, 'generalized floating' began as the members of the European Community introduced a joint float for their currencies against the USD. On 1 April 1978, the second amendment of the IMF Agreement entered into force, establishing the right of members to adopt exchange rate arrangements of their choice. For insightful accounts of the former system of par values and its demise leading up to the second amendment of the IMF Agreement, see, eg, Joseph Gold, 'Strengthening the Soft International Law of Exchange Arrangements' (1983) 77 AJIL 443, 445–52; and Andreas F Lowenfeld, *International Economic Law* (2nd edn OUP, Oxford 2008) 622–7.

[20] In other words, the Second Amendment of the Fund's Articles prohibited precisely the type of exchange arrangement which the Bretton Woods Agreement of 1944 was based upon and which is often referred to as 'gold exchange standard'. Due to the uneven distribution of gold after World War Two, with the US possessing about 70 per cent of it, most countries would have been prevented from returning to individual gold standards for their respective currencies. Hence, the par-value system of Bretton Woods was effectively designed as a two-tier system of convertibility: (i) the US agreed to fix the price of gold at USD 35 an ounce and (ii) all other IMF members agreed to maintain fixed exchange rates (par-values) between their respective currencies and the USD (see Rosa M Lastra, *Legal Foundations of International Monetary Stability* (OUP, Oxford 2006) 348). With the entry into force of the Second Amendment of the Fund's Articles on 1 April 1978, and *de facto* already since 15 August 1971 when the US was forced by market pressures to render the USD inconvertible (n 19), gold has been reduced to a simple reserve asset and as such continues to play an important role for many states. For a highly insightful account of the origins of the classical gold standard in the nineteenth century, its gradual evolution, operation in practice in different countries, its eventual failure during the interwar years, and the shift to the gold exchange standard of Bretton Woods, see Barry Eichengreen and Marc Flandreau (eds), *The Gold Standard in Theory and History* (2nd edn Routledge, New York 1997).

adopting the currency of another country, or participating in a currency bloc,[21] to name just the major options.[22]

In order to ensure that IMF members exercised their regained margin of manoeuvre in a manner that did not endanger the stability of the international monetary system, the negotiations leading up to the second amendment of the IMF Agreement also produced a set of rules, enshrined in IMF Article IV:1, intended to guide IMF members in the conduct of their respective exchange rate policies. This provision consists of a chapeau establishing a general obligation for each IMF member to collaborate with the IMF and other members, followed by a non-exhaustive catalogue of four specific obligations intended to give concrete meaning to the overarching obligation to collaborate. The entire provision reads as follows:

> Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:
>
> (i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;
>
> (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;
>
> (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and
>
> (iv) follow exchange policies compatible with the undertakings under [IMF Article IV:1].

The rule set forth by IMF Article IV:1(iii) has frequently led to fierce discussions on the extent to which the IMF succeeds in ensuring compliance with the key provisions of its code of conduct. The IMF has never found a single IMF member

[21] Since the second amendment in 1978, IMF Article IV:2(b) provides that:

> exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice.

[22] Overall, the IMF has identified eight different categories of exchange rate regimes: (1) exchange arrangements with no separate legal tender (ie where one state uses the currency of another), (2) currency board arrangements, (3) conventional fixed-peg arrangements, (4) pegged exchange rates with horizontal bands, (5) crawling pegs, (6) exchange rates within crawling bands, (7) managed floating with no predetermined path for the exchange rate, and (8) independently floating. For a detailed description of each category, see IMF, 'De Facto Classification of Exchange Rate Regimes and Monetary Policy Framework' (31 July 2006) <http://www.imf.org/external/np/mfd/er/2006/eng/0706.htm> accessed 1 July 2013.

to be in breach of Article IV:1(iii),[23] even though some IMF members, such as Sweden in 1982, came dangerously close to a formal finding of breach.[24] Except in the case of an abrupt, large, and overtly competitive devaluation, the process of determining whether an IMF member is manipulating its exchange rate in breach of IMF Article IV:1(iii) is not only economically complex, but also politically delicate. Article IV:1(iii) requires a showing that exchange rate manipulation has been undertaken *with the intent* to gain an unfair competitive advantage over other members or to prevent effective balance-of-payments adjustment. As will be discussed below, the requirement of intent renders the key provision of the IMF's code of conduct essentially inoperative.[25] Other, intrinsically related, contemporary challenges to the stability of the international monetary system, namely global current account imbalances and excessive foreign exchange reserve accumulation, are not at all, or only insufficiently, addressed by the IMF's code of conduct.

The analysis provided in this chapter aims to contribute to a better understanding of the following two-fold question. To what extent can a contested practice like the maintenance of an undervalued real exchange rate be dealt with effectively under existing international law? Intrinsically related, which are the key aspects on which the IMF's code of conduct would require reform in order to tackle contemporary challenges to the stability of the international monetary system, such as global current account imbalances? After assessing whether the code of conduct in IMF Article IV:1 constitutes an effective framework for securing systemic stability (Part I), this chapter assesses the extent to which trade rules might constitute an alternative for tackling an undervalued real exchange rate (Part II). Finally, the chapter looks at overarching conceptual issues and at the G-20's ongoing efforts to reduce global current account imbalances as one of the underlying key challenges to systemic stability (Part III).

I. The Code of Conduct in IMF Article IV:1—An Effective Framework for Securing Systemic Stability?

This first part begins with an analysis of the key aspects of the IMF's code of conduct (Section A) prior to looking into the 2007 reform of the IMF's bilateral

[23] Michael Mussa, 'IMF Surveillance over China's Exchange Rate Policy' (Peterson Institute of International Economics, 19 October 2007) 40 <http://www.iie.com/publications/papers/mussa1007.pdf> accessed 1 July 2013.

[24] On 8 October, then Swedish Prime Minister Olof Palme announced a 16 per cent devaluation of the Swedish krona serving to restore confidence in the krona and improve the competitiveness of the Swedish industry. Upon fierce complaints by the other Nordic countries, the IMF Executive Board met in formal session to consider Sweden's move and even held a special consultation with Sweden. While this led to no formal decision or sanction it appears to have been generally understood at the time in the international financial community that Sweden's action, which it did not rectify, was plainly inconsistent with IMF Article IV:1(iii). The Swedish move triggered Finland to equally devalue its currency. See Lowenfeld (n 19) 636. See also Charles Proctor, *Mann on the Legal Aspect of Money* (7th edn OUP, Oxford 2012) 605. I thank Rosa Lastra for reminding me of this important incident.

[25] As was amply demonstrated by the Swedish incident of 1982, described in the preceding footnote.

surveillance mechanism with its new focus on the concept of external stability (Section B). It concludes with a presentation of the key scenarios of exchange rate misalignment and their economic impact in the light of existing international law (Section C).

A. IMF Article IV:1 and the struggle for domestic regulatory autonomy

The four obligations contained in the non-exhaustive catalogue under IMF Article IV:1 as quoted in full in the introduction to this chapter differ significantly concerning their respective purpose and legal value. As analysed in a paper prepared by the IMF's Legal Department,[26] the first two obligations, set forth in Articles IV:1(i) and (ii), were introduced by the Second Amendment of the IMF Agreement, 'given the important relationship between a member's domestic policies and its exchange rate'. As signalled by their moderate language (shall endeavour/seek), 'these obligations are of a particularly "soft" nature, out of recognition that members should not have to give up a significant degree of sovereignty with respect to policies that, while they may have an international impact, are of a domestic nature'.[27] In addition, both provisions are framed in rather vague terms (eg 'orderly economic growth with reasonable price stability') that leave plenty of room for interpretative differences. As concluded by François Gianviti, IMF general counsel between 1987 and 2004, the quasi-impossibility for the IMF of establishing a breach of obligation was the side-effect, or maybe even the deliberate objective, of formulating the first two obligations in IMF Article IV:1 as vague obligations of conduct instead of precise obligations of result.[28] As put by Sir Joseph Gold, IMF general counsel from 1960 to 1979:

> Governments have [always] tended to regard the choice of domestic policies as a privilege inherent in sovereignty and a privilege that is not to be lightly limited or yielded . . . Indeed, for some members, particularly the United States, the main virtue of [IMF Article IV:1] was that it would leave as much freedom as possible for the national determination of domestic policies.[29]

The obligations under paragraphs (i) and (ii) appear to have been included in IMF Article IV:1 out of recognition that there is no such thing in an open economy as purely domestic economic and financial policies, in particular at a time of

[26] IMF, 'Article IV of the Fund's Articles of Agreement: An Overview of the Legal Framework' (28 June 2006) para 3.2 <http://www.imf.org/external/np/pp/eng/2006/062806.pdf> accessed 1 July 2013. It should be noted that, although the numerous papers prepared by the Legal Department and other Fund departments constitute an invaluable source of insight into all sorts of Fund-related aspects, they do not express the formal view of the Fund as an institution. The latter can only emerge from the Executive Board. Whereas all decisions by the Executive Board are prepared and drafted in a first step by Fund staff, it is only through vetting and approval by the Executive Board, after consideration of the views of members as expressed by the 24 executive directors, that they become a formal decision of the institution. See Deborah Siegel, 'Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreement' (2002) 96 AJIL 561, 569.

[27] IMF (n 26) para 3.2.

[28] François Gianviti, 'Stabilité et Manipulation des Taux de Change' in Jean-Marc Sorel (ed), *Le Droit International Economique à l'Aube du XXIème Siècle* (Pedone, Paris 2009) 113, 119.

[29] Joseph Gold, *Legal Effects of Fluctuating Exchange Rates* (IMF, Washington DC 1990) 16–17.

ever-increasing economic globalization and financial integration. Whereas IMF Articles IV:1(i) and (ii) thus enable the Fund to discuss more or less any aspect of a member's economic and financial policies with that member as part of Article IV consultations,[30] IMF members retain full regulatory authority over their economic and financial policies.

As further analysed by the Fund's Legal Department, unlike these two best-effort obligations with respect to domestic policies, the obligation under paragraph (iii) to avoid pursuing exchange rate policies designed to either interfere with the adjustment of the balance of payments or to gain an unfair competitive advantage over other members is 'of a "hard" nature, reflecting the international nature of [exchange rate policies]'.[31] By contrast, as far as the obligation spelt out in paragraph (iv) is concerned, it seems quite uncertain, despite it being framed as 'a "hard" obligation that is expressed in terms of achieving results',[32] whether and to what extent it creates an additional duty. According to the Fund's Legal Department, 'the legislative history reveals that, at the time of its adoption, there was some uncertainty as to its meaning'.[33] It appears convincing, though, to interpret the term 'exchange policies' in IMF Article IV:1(iv) in a way that is distinct from 'exchange rate policies'. '[S]uch an interpretation would serve to confirm that, while [IMF] members have the general right to maintain exchange controls that are consistent with their obligations under [IMF] Article VIII', they may not use such controls 'in a manner that is inconsistent with their obligations under [IMF Article IV:1]'.[34] However, in the absence of a formal interpretation by the Fund's Executive Board, and since the legislative history of the Second Amendment of the IMF Agreement does not contain any evidence that IMF Article IV:1(iv) was indeed intended to subject the use of exchange controls to the set of obligations under Article IV:1, the precise meaning and relevance of paragraph (iv) remains ambiguous.[35]

What a look into the negotiating history of the Second Amendment of the Fund's Articles does reveal, however, is that an earlier draft of IMF Article IV:1(iv), discussed by the Fund's Executive Board in December 1975, would have obliged each member to 'follow exchange policies conducive to effective balance of payments adjustment and compatible with the undertakings under [IMF Article IV:1]'.[36] By contrast, in a draft version of Article IV:1(iii) discussed back then, no reference would have been made to the purpose of avoiding effective balance of payments adjustment. Eventually, as a result of a last minute change that occurred in January 1976, IMF members eliminated the objective of effective balance of payments adjustment from IMF Article IV:1(iv). Instead, they added it to Article IV:1(iii) as a second outlawed purpose of exchange rate manipulation.[37] As analysed perfectly by Gianviti, this major change between the earlier drafts of IMF Articles IV:1(iii) and (iv) and their eventually adopted versions can be commented on succinctly as follows. A positive obligation to conduct exchange policies

[30] See Chapter 2, Section II.B, of this monograph.
[31] IMF (n 26) para 3.3. [32] IMF (n 26) para 35. [33] IMF (n 26).
[34] IMF (n 26) para 36. [35] See IMF (n 26).
[36] Gianviti (n 28) 120, n 14. [37] Gianviti (n 28) 121.

conducive to balance of payments adjustment as contained in draft IMF Article IV:1(iv) would have been significantly more demanding than the eventually adopted prohibition, in IMF Article IV:1(iii), of exchange rate manipulation in order to prevent effective balance of payments adjustment.[38] However, had the objective to achieve balance of payments adjustment not been eliminated from the final draft of IMF Article IV:1(iv), a conflict might have arisen between that explicit obligation of result and the 'soft' obligation of conduct for IMF members in Article IV:1(i) to direct their economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability.[39] According to the rule *generalia specialibus non derogant*, an obligation of result to achieve balance of payments adjustment would have taken precedence over the more general obligation of conduct regarding domestic policies. As Gianviti persuasively argues, however, such precedence would have been contrary to the negotiators' intention to obtain maximum regulatory autonomy with respect to domestic policies and to free themselves from any exchange rate related constraints.[40]

Indeed, with the eventually adopted versions of paragraphs (iii) and (iv) of IMF Article IV:1, IMF members retained much greater regulatory autonomy (not only over their economic and financial policies, but also with respect to balance of payments adjustment) than would have been the case under the initially proposed paragraphs, especially compared to the specific obligation of result set forth by the earlier version of paragraph (iv). Furthermore, as observed by Gianviti, by turning the originally proposed positive obligation to achieve balance of payments adjustment into a negative obligation under Article IV:1(iii) not to aim to prevent such adjustment as one of the outlawed purposes of currency manipulation, IMF members appear to have created an obligation which, due to the 'intent' element of that same provision, is rendered essentially inoperable.[41]

Note, however, that respect of the four obligations under IMF Articles IV:1(i)–(iv) 'does not necessarily mean that [an IMF] member will always be in compliance with the general obligation [to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates]',[42] as is being clearly signalled by the introductory words 'in particular, each member shall'. Hence, it appears appropriate to read the chapeau of IMF Article IV as containing a net residue with respect to the type of conduct that is consistent with the code of conduct set forth in IMF Article IV:1. As we shall see in the following section, the Fund has adopted a number of principles as part of its bilateral surveillance mechanism in order to provide its members with guidance on how to comply with IMF Article IV:1 as a whole and to give meaning to the chapeau obligation to cooperate and the net residue of obligation contained therein.

[38] Gianviti (n 28) 122.

[39] According to the following logic: in order to control inflation, most central banks will keep interest rates at a high level which will attract foreign capital and lead to an appreciation of the domestic currency. This, in turn, will render the export of domestic goods more expensive which will lead to a deterioration of the balance of trade and, if not compensated by a corresponding shift in the capital account, of the entire balance of payments (see Gianviti (n 28) 122).

[40] Gianviti (n 28) 122. [41] Gianviti (n 28) 123. [42] IMF (n 26) para 28.

In sum, when considered in isolation, IMF Article IV:1 is not an especially demanding legal provision. It leaves IMF members with a maximum of regulatory autonomy in determining not only their domestic economic and financial policies, but also, *de facto*, their exchange rate policies. Since the IMF's reformed bilateral surveillance mechanism represents an effort to achieve stronger controls, an examination of that mechanism will reveal the full scope of the constraints that the IMF legal framework imposes on members regarding the conduct of their respective exchange rate as well as domestic economic and financial policies.

B. *The IMF's 2007 and 2012 reforms of bilateral surveillance and the new combined focus on balance of payments stability and domestic stability*

After the breakdown of the original par-value system of Bretton Woods in the early 1970s, the role and operation of IMF surveillance necessarily had to change. As concisely put by Lastra:

> Following the abandonment of the par value regime, the Second Amendment places the function of surveillance at the centre of the Fund's operations, at the core of the international monetary system. From being a virtually self-enforcing arrangement subject to strict rules, surveillance now becomes a function in which judgment is of the essence.[43]

As already noted in the preceding chapter,[44] IMF Article IV:3(b) indeed provides that 'the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies'. It is on this basis that the IMF set up its bilateral surveillance mechanism with its 1977 Decision on Surveillance over Exchange Rate Policies[45] (1977 Surveillance Decision (SD)) which, in 2007, has undergone a first major overhaul as part of a broader 'effort to upgrade the foundations of the IMF's bilateral surveillance . . . in the interest of international monetary stability'.[46]

[43] Rosa M Lastra, 'The Role of the IMF as a Global Financial Authority' in Christoph Herrmann and Jörg P Terhechte (eds), *European Yearbook of International Economic Law 2011* (Springer, Berlin and Heidelberg 2011) 121, 127. On the view that after the breakdown of the par-value system, IMF surveillance has moved from a rules-based mechanism to being a discretion-based regime, see also Manuel Guitián, 'The IMF as a Monetary Institution: The Challenge Ahead' (1991) 31(3) *Finance & Development* 38.

[44] See Chapter 2, Section II.B.

[45] Decision No 5392-(77/63) (29 April 1977), as amended by Decision Nos 8564-(87/59) (1 April 1987), 8856-(88/64) (22 April 1988), and 10950-(95/37) (10 April 1995), repealed and replaced by Decision No 13919-(07/51) (15 June 2007). The full text of the 1977 SD as amended can be found in IMF, *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview*, App (2 July 2004) <http://www.imf.org/external/np/pdr/surv/2004/082404.pdf> accessed 1 July 2013.

[46] IMF, 'IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies', PIN No 07/69 (21 June 2007) <http://www.imf.org/external/np/sec/pn/2007/pn0769.htm> accessed 1 July 2013. For a succinct analysis of the 2007 revision of the Fund's legal framework for surveillance by the current IMF general counsel, see Sean Hagan, 'Reforming the IMF' in Mario Giovanoli and Diego Devos (eds), *International Monetary and Financial Law: The Global Crisis* (OUP, Oxford 2010) 40.

Thus, the Fund's 2007 Decision on Bilateral Surveillance[47] (2007 Bilateral Surveillance Decision (BSD)) refocused the Fund's bilateral surveillance activities on how to deal with contemporary scenarios of exchange rate under- and overvaluation. Triggered by the latest Triennial Surveillance Review held in October 2011,[48] the Fund's Executive Board adopted the 2012 Decision on Bilateral and Multilateral Surveillance[49] (2012 Integrated Surveillance Decision (ISD)) on 18 July 2012 (entered into force on 18 January 2013). According to the Fund, the 2012 ISD is 'another step toward modernizing the foundations of Fund surveillance and part of a continuous effort to ensure that surveillance remains relevant and effective amidst the changing global economic landscape'.[50]

While the 2012 ISD repealed the 2007 BSD, just as that decision had repealed the original 1977 SD, it is important to note from the outset that, as far as the operation of the Fund's bilateral surveillance mechanism is concerned, the 2012 ISD merely refines the 2007 BSD the original text of which it incorporates to a large extent. What really is innovative about the 2012 ISD is that with this decision, the Fund laid out for the first time an explicit framework for potential multilateral consultations,[51] and, in order to improve the Fund's capacity to conduct effective spillover analyses, for the first time integrated bilateral and multilateral surveillance by making Article IV consultations also a vehicle for multilateral surveillance.[52]

However, the Fund has made clear that whereas the 2012 ISD (and before it the 2007 BSD) provides valuable interpretation and guidance to IMF members with respect to the code of conduct in IMF Article IV:1, it 'does not, and cannot be construed or used to, expand or broaden the scope—or change the nature—of members' obligations under the Articles of Agreement, directly or indirectly,

[47] IMF, Decision No 13919-(07/51), 'Bilateral Surveillance over Members' Policies—2007 Decision' (15 June 2007), *Selected Decisions and Selected Documents of the International Monetary Fund* [*Selected Decisions*] (36th issue, Washington DC, 31 December 2011) 33, available at <http://www.imf.org/external/pubs/ft/sd/index.asp?decision=1034-(60/27)> accessed 1 July 2013.

[48] The various IMF staff reports, external studies, and commentaries prepared as part of the 2011 Triennial Surveillance Review as well as the report of the external advisory group are all available at <http://www.imf.org/external/np/spr/triennial/index.htm> accessed 1 July 2013.

[49] When this monograph went to press, this decision had not yet been published in the Fund's *Selected Decisions*. However, for the full text of the decision as adopted by the Executive Board, see IMF, 'IMF Executive Board Adopts New Decision on Bilateral and Multilateral Surveillance', PIN No 12/89 (30 July 2012) <http://www.imf.org/external/np/sec/pn/2012/pn1289.htm> accessed 1 July 2013. For a related policy paper prepared by the Fund's Legal and Strategy, Policy and Review Departments, containing also a redline version of the proposed 2012 ISD against the 2007 BSD, see IMF, 'Modernizing the Legal Framework for Surveillance—An Integrated Surveillance Decision', IMF Policy Paper (26 June 2012) <http://www.imf.org/external/np/pp/eng/2012/062612.pdf> accessed 1 July 2013.

[50] IMF, 'IMF Executive Board Adopts . . . ' (n 49).

[51] See IMF, 2012 ISD (n 49) paras 31–33. Such multilateral consultations could be held whenever the IMF Managing Director considers 'that an issue has arisen . . . that may significantly influence the operation of the international monetary system, and that requires collaboration among members that is not already effectively taking place in another forum in which the Fund is a party' (IMF, 2012 ISD (n 49) para 31).

[52] IMF, 2012 ISD (n 49) para 24. See also IMF, 'Integrated Surveillance Decision' (Factsheet) (15 March 2013) <http://www.imf.org/external/np/exr/facts/isd.htm> accessed 1 July 2013.

including the obligations set out in [IMF] Articles IV, VI and VIII'.[53] With the 2012 ISD, the Fund has adopted the following principles in order to guide IMF members on how to conduct exchange rate policies in compliance with IMF Article IV:1 (the first three of these principles were already part of the 1977 SD; principle D was introduced by the 2007 BSD but reformulated by the 2012 ISD; principle E is new):

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized inter alia by disruptive short-term movements in the exchange rate of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

D. A member should avoid exchange rate policies that result in balance of payments instability.

E. A member should seek to avoid domestic economic and financial policies that give rise to domestic instability.[54]

Principle A merely restates IMF Article IV:1(iii). Hence, a finding of breach would have to directly follow from a finding of non-observance of principle A. As determined in the annex to the 2012 ISD (taken over unchanged from the 2007 BSD), an IMF member would be acting inconsistently with IMF Article IV:1(iii) only 'if the Fund determined both that: (a) the member was manipulating its exchange rate or the international monetary system and (b) such manipulation was being carried out [either in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members]'.[55] The same annex further provides:

(a) 'Manipulation' of the exchange rate is only carried out through policies that are targeted at—and actually affect—the level of an exchange rate. Moreover, manipulation may cause the exchange rate to move *or may prevent such movement*.[56]
(b) A member . . . will only be considered to be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that: (A) the member is engaged in these policies for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate[57] and (B) the purpose of securing such misalignment is to increase net exports.

[53] IMF, 2012 ISD (n 49) Preamble, para 2.

[54] IMF, 2012 ISD (n 49) para 21. For a detailed analysis of the original three principles adopted as part of the Fund's 1977 Surveillance Decision, focusing on their historic and economic background, see Gold (n 19) 465–74.

[55] IMF, 2012 ISD (n 49) annex, para 2.

[56] Emphasis added.

[57] This explicit limitation to scenarios of undervaluation has likely been included out of awareness that exchange rate overvaluation does, if anything, disadvantage a country in its efforts to trade

As recognized by the Fund's Executive Board when adopting the 2007 BSD, 'exchange rate manipulation can take many different forms, including intervention in the exchange markets and the imposition of capital controls for the purpose of directly targeting the exchange rate'.[58] However, as rightly stressed by the IMF's Legal Department, 'the potential applicability of the obligation to avoid manipulation is constrained by the need to determine intent [in order to . . .]'.[59] Certainly, 'this determination . . . is made independently by the Fund and is not based exclusively on the member's representation of its motives',[60] but, as explicitly stated in the 2012 ISD (as was already in the 2007 BSD), '[a]ny representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt'.[61] Overall, showing that an IMF member manipulates its exchange rate with the intention to achieve an unfair competitive advantage remains as difficult under the 2012 ISD as before.

By contrast, non-observance of principles B, C, D, and E of the 2012 ISD would not automatically constitute a breach of obligation. Several steps would be necessary before non-respect of these principles could lead to a finding of breach of the general obligation to collaborate contained in the chapeau of IMF Article IV:1:

> First, the Fund would need to adopt a policy of general applicability that provided that observance of the conduct contemplated in the recommendation, i.e. engaging in or refraining from a particular action, is required for members to comply with the general obligation of collaboration under [IMF Article IV:1]. This decision would need to be general in application because the principle of uniformity of treatment would preclude the Fund from requiring certain conduct from one country and only recommending it [to] another in the exact same circumstances. After such a policy was introduced, members, having been placed on notice that the conduct in question is now mandatory, would also need to be given a reasonable time to engage in or refrain from such conduct. Only if a member were to fail to do so would it be open to the Fund (i.e. the Executive Board) to adopt a decision finding the member to be in breach.[62]

At the end of all these steps, the Fund's options would be quite limited. The IMF has no dispute settlement mechanism similar to that of the WTO, and according to IMF Article XXVI:2, IMF members can be punished for violations of their obligations only through a curtailment of their access to Fund resources, a suspension of their voting rights, and, ultimately, expulsion from the Fund.[63] However, whereas for small economies these options constitute powerful threats, their

internationally, and that the competitive advantages addressed by IMF Article IV:1(iii) are those arising from scenarios of undervaluation. For detail on the related economic mechanisms, see Section I.C below.

58 IMF (n 46) Chairman's Summing Up of 15 June 2007 Board Discussions, para 8.

59 IMF (n 26) para 3.3. 60 IMF (n 26) para 3.3.

61 IMF, 2012 ISD (n 49) annex, para 3.

62 IMF, 'Review of the 1977 Decision on Surveillance over Exchange Rate Policies—Further Considerations' (11 January 2007) para 50 <http://www.imf.org/external/np/pp/2007/eng/fc.pdf> accessed 1 July 2013. This explanation was given by the Fund in the context of preparatory work for the 2007 BSD. It is safe to say that this explanation applies equally to principles B, C, D, and E as contained in the 2012 ISD.

63 For a more detailed analysis of the Fund's role as law 'enforcer', see Section III.A below.

economic, though not necessarily reputational, leverage may be small for large economies that have ample access to private capital markets and do not rely on the Fund for funding.[64]

In light of this broader picture, the introduction of principle D, as reformulated by the 2012 ISD, was the key innovation brought about by the 2007 BSD. Principle D extends the scope of the IMF's bilateral surveillance mechanism to any scenario of 'balance of payments instability' that *is the result* of exchange rate policies. The motives behind a given exchange rate policy are irrelevant for the purposes of principle D; the result matters. As plainly admitted by the Fund, the 2012 ISD added a further principle E, 'to fill an important gap in the 2007 [BSD] and, to the extent consistent with the Articles, help address the perceived exchange rate bias in the legal framework for surveillance'.[65]

With these two principles D and E, the IMF provides additional guidance on what needs to be understood by the chapeau obligation 'to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates'. As determined by the 2012 ISD, in its bilateral surveillance, 'the Fund will focus on those policies of members that can significantly influence present or prospective balance of payments and domestic stability',[66] with balance of payments stability being defined as 'a balance of payments position, that does not, and is not likely to, give rise to disruptive exchange rate movements'.[67] Thus, the manner in which balance of payments stability is defined takes into account the possibility of disruptive exchange rate movements in the future, which enables the Fund to intervene with advice for appropriate policy changes without having to wait for these disruptive movements to occur. Whether IMF members will always and immediately follow the IMF's advice is a different question.

As explicitly stated by the 2012 ISD, bilateral surveillance extends not only to exchange rate policies, but also to 'monetary, fiscal, and financial sector policies (both their macroeconomic aspects and macroeconomically relevant structural aspects)' as well as to other policies 'to the extent that they significantly influence present or prospective balance of payments or domestic stability'.[68] However, as stressed by the 2012 ISD, '[i]n the conduct of their domestic economic and financial policies, members are considered by the Fund to be promoting balance of payments stability when they are promoting domestic stability',[69] in other words, when they are complying with the best-efforts obligations under IMF Articles IV:1(i) and (ii) discussed as part of the preceding section. While recognizing 'that there may be circumstances where a member's domestic instability may

[64] For related analysis, see Domenico Lombardi and Ngaire Woods, 'The Politics of Influence: An Analysis of IMF Surveillance' (2008) 15 *Review of International Political Economy* 711.

[65] IMF, 'Modernizing the Legal Framework . . . ' (n 49) para 18.

[66] IMF, 2012 ISD (n 49) para 6.

[67] IMF, 2012 ISD (n 49) para 5. Note that this definition of 'balance of payments instability' is exactly the same as that of 'external instability' under the 2007 BSD. Hence, the substance of principle D has not been changed by the rewriting brought about by the 2012 ISD.

[68] IMF, 2012 ISD (n 49) para 6.

[69] IMF, 2012 ISD (n 49) para 7.

give rise to systemic instability even in the absence of balance of payments instability',[70] the Fund has made it clear that it 'will not require a member that is complying with [IMF Articles IV:1(i) and (ii)] to change its domestic policies in the interests of balance of payments stability'.[71]

In order to identify 'balance of payments instability', the Fund looks, inter alia, for 'fundamental exchange rate misalignment'. An exchange rate is fundamentally misaligned when the underlying current account (stripped of cyclical and other temporary factors) is not in equilibrium, ie not in line with fundamentals.[72] From a finding that the exchange rate of an IMF member is fundamentally misaligned it does not automatically follow that that member is breaching IMF Article IV:1(iii). For that to happen the IMF would have to determine, as noted earlier, that the misalignment at issue does not result from an external shock and that the member concerned is conducting its exchange rate policy with the intent to prevent balance of payments adjustment or to gain an unfair competitive advantage over other members.[73] Furthermore, IMF Article IV:1(iii) can be breached, at least in theory, without there being fundamental exchange rate misalignment in the first place. This would be the case if an IMF member were found to manipulate its exchange rate in pursuance of one of the purposes outlawed under Article IV:1(iii), independent of whether such intentional manipulation leads to fundamental misalignment.

As defined by the IMF, exchange rate policies are 'intervention policies and certain other policies conducted for the purpose of influencing the balance of

[70] IMF, 2012 ISD (n 49) para 7. The 2012 ISD defines 'systemic stability' as 'a stable system of exchange rates'. See IMF, 2012 ISD (n 49) para 5.

[71] IMF, 2012 ISD (n 49) para 7.

[72] This definition is set forth in IMF, 'Review of the 1977 Decision—Proposal for a New Decision, Companion Paper' (22 May 2007) para 6 <http://www.imf.org/external/np/pp/2007/eng/nd.pdf> accessed 1 July 2013. The Fund's Executive Board formally endorsed this definition when adopting the 2007 BSD. See IMF (n 46) Chairman's Summing Up of 15 June 2007 Board Discussions, para 6.

[73] Fundamental exchange rate misalignment is only one of several economic factors that will alert the Fund. According to the 2012 ISD, '[i]n its surveillance of the observance by members of the [p]rinciples [A to E], the Fund shall consider the following developments as among those which would require thorough review and might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;
(ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;
(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or
(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;
(iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;
(v) fundamental exchange rate misalignment;
(vi) large and prolonged current account deficits or surpluses; and
(vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows'.

(IMF, 2012 ISD (n 49) para 22).

payments and hence the exchange rate'.[74] Principles A and D of the 2007 Surveillance Decision are thus 'not relevant for countries that do not intervene or take other actions aimed at affecting the level of the exchange rate',[75] ie countries with a floating exchange rate. However, a floating exchange rate could nevertheless be found to be under- or overvalued, or 'fundamentally misaligned' under the terms of the 2012 ISD. As explained by the Fund, this might happen, as a result 'of domestic policies (eg a depreciation induced by large fiscal surpluses), as a result of other countries' policies affecting the exchange rate of the country at issue, or because of market imperfections such as a bubble (which may burst in a disorderly way)'.[76] This statement shows that the IMF takes into account that most countries with floating exchange rate regimes do occasionally intervene in exchange markets or take other actions aimed at the exchange rate. As a consequence, even for official 'floaters', observance of the principles of the 2012 ISD is not excluded from becoming an issue in Article IV consultations if the member concerned takes occasional actions aimed at the exchange rate.

Finally, principles B and C are of minor importance and can be neglected for the purposes of this chapter. Principles B, C, and any additional recommendations issued by the Fund in Article IV consultations, guide IMF members on what is acceptable to the Fund in the promotion of present or prospective balance of payments and domestic stability. As explained by the Fund in preparing the 2007 BSD:

> [N]otwithstanding that the principles do not cover all policies [relevant to] the promotion of [balance of payments and domestic] stability [ie the residue of obligation contained in the chapeau of IMF Article IV], a member that follows all of the recommendations issued by the Fund would be deemed to be in compliance with its obligations under [Article IV:1]. Observance of the principles [thus constitutes] a 'safe harbor'.[77]

It remains to be seen to what extent the changes introduced with the 2007 and 2012 updates of the Fund's surveillance mechanism will contribute to achieving meaningful results with respect to the legal treatment of sophisticated scenarios where the obligation under IMF Article IV:1(iii) might have been breached. Overall, it is important to recall that even after these two reforms, surveillance remains a cooperative and consultative process. The IMF's toolset may have been sensibly refined by the 2007 BSD and the 2012 ISD, but its teeth have clearly not been strengthened. This need not be a bad thing, though. As put by Ross Leckow,

[74] IMF, 'The 2007 Surveillance Decision: Revised Operational Guidance' (22 June 2009) 12 <http://www.imf.org/external/np/pp/eng/2009/062209.pdf> accessed 1 July 2013. It is safe to say that these explanations on principles A and D of the 2007 BSD accurately reflect the Fund's position also regarding the essentially identical principles A and D of the 2012 ISD. For the current guidance note for IMF country teams for Article IV consultations, see IMF, 'Guidance Note for Surveillance under Article IV Consultations' (10 October 2012) <http://www.imf.org/external/np/pp/eng/2012/101012.pdf> accessed 1 July 2013.

[75] IMF, 'The 2007 Surveillance Decision' (n 74) 12.

[76] IMF, 'The 2007 Surveillance Decision' (n 74) 11.

[77] IMF, 'Review of the 1977 Decision on Surveillance over Exchange Rate Policies—Further Considerations' (n 62) para 48.

the IMF's deputy general counsel, '[g]iven the enormous complexity and sensitivity involved in issues of exchange rate policies, it may not always be the case that rules taking the form of hard obligations strictly enforced by an international organization are the most effective means of achieving international cooperation'.[78]

The IMF's expanded authority to step in early with policy advice aimed at avoiding balance of payments instability might turn out to be a helpful innovation with respect to good-faith scenarios of exchange rate misalignment; of special concern here are scenarios of unsustainable, increasing overvaluations that appear when developing countries adhere for too long to unrealistic exchange rate pegs. However, for any scenario where an economically and politically powerful IMF member would deliberately seek to improve its competitive position via producing and maintaining an artificial undervaluation of its exchange rate in breach of IMF Article IV:1(iii), the Fund is essentially left as powerless as before in ensuring compliance with its code of conduct due to the political sensitivity of the 'intent' element of that provision.

Overall, there is no denying that the IMF is currently left with only limited means to put an end to sophisticated scenarios of exchange rate manipulation in the sense of IMF Article IV:1(iii), in other words, to ensure the respect of a key rule of international monetary cooperation. It is therefore not very surprising that policymakers worldwide have started to look beyond the scope of the IMF and are examining whether legal redress against the export-promoting effects of an undervalued real exchange rate could be sought in a legal forum outside the IMF, notably under international and domestic trade law. However, prior to analysing the key legal issues arising from any such alternative legal action, a succinct overview of the main scenarios of exchange rate misalignment and their underlying economic mechanisms will prove helpful.

C. The main scenarios of exchange rate misalignment and their economic impact in the light of international law

In the public debate on misaligned exchange rates and 'currency manipulation', scenarios of exchange rate *undervaluation*, stemming from either a competitive devaluation or an undervalued exchange rate peg, are by far the dominant concern. This focus is due to the export-promoting effects that potentially arise from exchange rate undervaluation and is also reflected in the current state of international monetary law, as examined in the preceding sections. As discussed above, the IMF has explicitly stated that the prohibition under IMF Article IV:1(iii) applies only to exchange rate manipulation that serves 'the purpose of securing fundamental exchange rate misalignment in the form of an *undervalued exchange rate* [in order] to increase net exports'.[79] Many developing countries, however, do not maintain under-, but overvalued exchange rate pegs. It is only in the long run

[78] Ross Leckow, 'The IMF and Crisis Prevention—The Legal Framework for Surveillance' (2008) 17 *Kansas Journal of Law and Public Policy* 285, 292.

[79] IMF, 2012 ISD (n 49) annex, para 2(b). Emphasis added.

that an overvalued exchange rate peg tends to be unsustainable, forcing the country into a major devaluation,[80] as could be observed, for example, in the 1999–2002 Argentine economic crisis.

There are many reasons why a given nominal exchange rate, ie the value of one currency in terms of another, may develop a tendency to appreciate. Among the most notable factors that create demand for a currency and raise its value in terms of another currency via simple mechanisms of supply and demand are trade surpluses, high interest rates, and high rates of foreign investment. However, in combination with any form of fixed exchange rates, the most common reason for exchange rate appreciation, and, ultimately, overvaluation, is inflation. For instance, if the currency of country A is firmly pegged to that of country B, and if inflation in A outpaces that in B, the currency of A will appreciate, *ceteris paribus*, in terms of B's currency. Since the nominal exchange rate between the two currencies is prevented from moving, the resulting overvaluation will become apparent only in relative prices.

Interest group dynamics are arguably the single-most important reason why a country would maintain an overvalued exchange rate for too long. Industries relying on cheap imports will lobby to preserve an overvalued exchange rate, while exporters will, in general, call for a devaluation in order to increase their competitiveness on foreign markets. Whereas this is the pattern most commonly encountered, the exchange rate policy in favour of which exporters and importers will lobby ultimately depends on the price elasticities of demand and supply of their respective products.[81]

Over a longer period, the maintenance of an overvalued exchange rate is usually not sustainable; eventually, the country concerned will run out of foreign exchange and will be unable to pay off its foreign debt. Unable to maintain the once chosen exchange rate peg, it will have to devalue. Devaluations that are merely aimed at adjusting the exchange rate to underlying economic fundamentals following an unsustainable overvaluation are obviously quite distinct from manipulation of the exchange rate aimed at achieving an undervaluation of the real exchange rate in order to promote exports. For the purposes of applying IMF Article IV:1(iii), a devaluation aimed at eliminating an unsustainable overvaluation would still amount to a manipulation of the exchange rate but could certainly not be regarded as having been undertaken 'in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members'. In addition, a country that proceeds to a devaluation in order to rectify an existing

[80] For a detailed analysis of the unsustainability of exchange rate pegs, see Harris Dellas, PAVB Swamy, and George S Tavals, 'The Collapse of Exchange Rate Pegs' (2002) 579 *The ANNALS of the American Academy of Political and Social Science* 53.

[81] The price elasticity of demand is a measure of the sensitivity of demand to price changes. It is measured as elasticity, ie it measures the relationship as the ratio of percentage changes between the quantity demanded of a good and changes in its price. Petrol is an excellent example of a good that has inelastic characteristics in that people will pay almost anything for it. By contrast, the demand for apples is very elastic because as the price of apples increases, consumers can switch to other types of fruit. Producers of a product with a very elastic price elasticity of demand can be expected to lobby for a devaluation, whereas others producing more inelastic goods will favour a maximum of overvaluation.

overvaluation certainly improves its competitive position, but not in a manner that would have to be regarded as 'unfair' in the sense of IMF Article IV:1(iii) as elaborated convincingly by Gianviti.[82] In other words, exchange rate manipulation undertaken in order to eliminate the competitive disadvantage resulting from an existing overvaluation is perfectly consistent with IMF Article IV:1(iii).

It is crucial to stress that, in order to gain a competitive advantage in international trade, it is not sufficient to maintain a specific *nominal* exchange rate. It is the *real* exchange rate, ie the relationship between the nominal exchange rate multiplied by the respective purchasing power factor, that determines whether a nominal undervaluation will affect trade flows. Keeping inflation low—that is, taking measures preventing prices from adjusting to economic fundamentals through appreciation—is therefore necessary lest a nominal undervaluation be zeroed, or compensated for, by a corresponding increase in prices.

When faced with increased demand for its currency, a country maintaining a system of fixed exchange rates has only two choices: to abandon its currency peg in order for the nominal exchange rate to reflect the changing economic fundamentals, or to intervene on foreign exchange markets[83] in order to relieve existing excess demand for its currency through selling it.[84] If such interventions are undertaken on a large scale, over a longer period of time and in a one-sided direction to prevent the currency from appreciating, the country concerned will have to pile up huge amounts of foreign exchange.[85] And indeed, 'protracted large-scale intervention in one direction in the exchange market' is the first of seven indicators considered by the IMF in the context of bilateral surveillance as requiring thorough review and as indicating the need for discussion with the member concerned.[86]

In public discussions it is often taken for granted that devaluations or undervalued exchange rate pegs have real effects on trade equivalent to both increased import tariffs and export subsidies, ie that they act as a tariff-cum-subsidy. It is therefore frequently argued that, since both of these measures distort trade, countries facing a deterioration of their trade balance with a country that

[82] Gianviti (n 28) 129–30.

[83] When buying foreign exchange, countries usually buy foreign government bonds. Undertaken on a large scale, this can have a significant impact on keeping down the yields of such bonds and, more generally, of ensuring low interest rates in the country whose currency is subject to the purchases in question. In line with this reasoning, it is commonly argued that Chinese exchange rate policy has helped the US to sustain its massive balance of payments deficit and acts as an incentive for Americans (through keeping US interest rates artificially low) to continue spending instead of starting saving, thus reinforcing, instead of mitigating, global current account imbalances.

[84] Analogously, when confronted with excess supply of its currency, and if unwilling to devalue its exchange rate accordingly, the country would logically intervene in foreign exchange markets through buying its currency in order to soak up any excess supply. As considered above, such efforts to maintain an overvalued exchange rate usually come to an abrupt end as soon as the country runs out of foreign exchange meaning that it can no longer intervene in foreign exchange markets as needed in order to maintain its overvalued exchange rate peg.

[85] Eg recent reports suggest that the Chinese USD reserves had grown to over USD 3.3 trillion by December 2012. See Central Intelligence Agency, 'The World Factbook: Reserves of Foreign Exchange and Gold' <http://www.cia.gov/library/publications/the-world-factbook/rankorder/2188rank.html> accessed 1 July 2013.

[86] IMF, 2012 ISD (n 49) para 22. See also the analysis provided above in Section I.B.

manipulates its exchange rate should either consider taking unilateral trade remedies or filing a complaint with the WTO. However, as elaborated in detail by Robert Staiger and Alan Sykes,[87] the underlying economic mechanisms of misaligned exchange rates are fraught with complexity, rendering it almost impossible to come up with generally valid policy recommendations. For example, a sudden devaluation of the exchange rate has real effects on trade equivalent to a uniform tariff-cum-subsidy only under very specific circumstances, namely when prices in different countries are not entirely flexible,[88] and if exporters price their products in their domestic currency.[89]

However, contrary to the scenario of a sudden devaluation as examined by Staiger and Sykes, the pricing policy adopted by exporters does not matter for the scenario that the remainder of this chapter will focus on, ie the maintenance of a stable undervaluation of the real exchange rate. In this scenario—arguably of greater contemporary relevance than a competitive devaluation—the price of one currency in terms of another is the same, by definition, before and after prices for exports are set. Contrary to a sudden devaluation occurring just after export prices have been set, the decision by consumers abroad whether or not to buy the product at issue will thus not be affected, *ceteris paribus*, by the currency in which the product is priced.

Policymakers around the world understand that in order to have an enduring impact on international trade flows via the exchange rate, it is the real exchange rate that matters, and not some temporary nominal shift. The following example might be a timely illustration. The Chinese government is strictly controlling the use of foreign exchange. Both China's capital and current account are in surplus, which implies that the supply of foreign exchange in China's domestic market is increasing. However, the use of (and thus the demand for) foreign exchange is being strongly constrained by governmental regulation. In the absence of such regulation, the excess supply of foreign currency in China would, via market forces, lead to an appreciation of the RMB. Such a shift would occur as a result of market participants in China converting foreign exchange holdings (for which there are only limited authorized uses) into RMB (which are freely usable). Faced with an ever-growing foreign exchange surplus, which in fact constitutes demand for RMB, China reacted with massive capital controls and its central bank has become a persistent buyer of foreign exchange in order to absorb existing excess supply of foreign exchange.

[87] Robert Staiger and Alan O Sykes, '"Currency Manipulation" and World Trade' (2010) 9 *World Trade Review* 583.

[88] According to the economic law of one price: 'In an efficient market, all identical goods must have only one price'. However, there is a considerable amount of empirical evidence suggesting that the law of one price fails dramatically at the international level. For a review of the related literature, see Charles Engel, 'Expenditure Switching and Exchange-Rate Policy' (2002) National Bureau of Economic Research (NBER) Working Paper No 9016 <http://www.nber.org/papers/w9016> accessed 1 July 2013.

[89] Staiger and Sykes (n 87) 623.

Other than through capital controls combined with sterilization measures (ie open market interventions[90] in order to counteract the effect of exchange market interventions on a country's monetary base) countries wishing to hold inflation down can also have recourse to increased reserve requirements. As a general matter, any policy aimed at contracting the money supply will contribute to controlling inflation. Measures of outright price control are an additional, obviously less subtle (since completely visible), means of maintaining prices at an artificially low level.

Hence, one can conclude that the successful maintenance of an undervalued real exchange rate has indeed the potential to produce real effects on trade equivalent to both import tariffs and export subsidies. However, measurement uncertainties make it extremely difficult to determine to what extent a specific shift in trade flows has been caused by a change in the real exchange rate of two currencies; simple correlations tell little about actual causation. In addition, assessing if, and to what extent, an exchange rate is under- or overvalued compared to its economic equilibrium level is a tricky task for which no commonly accepted technique exists. The IMF's 2010 Article IV consultation with China provides a perfect illustration of the difficulty of coming up with a reliable assessment of the degree to which an exchange rate is under- or overvalued. The staff report for that Article IV consultation merely states that IMF staff 'believe that the renminbi remains substantially below the level that is consistent with medium-term fundamentals' without giving a quantitative estimate of the identified undervaluation.[91] Furthermore, it emerged from the assessment of the staff report by the IMF's Executive Board that, while several Directors agreed with the staff's view that the RMB was undervalued, a number of others[92] thought this assessment was wrong.[93]

Before moving on, a few comments need to be made regarding the limited relevance of international rules of investment protection for the main scenarios of exchange rate misalignment.[94] Sudden devaluations, a rare phenomenon nowadays,

[90] Ie the buying and selling of government securities by the central bank in order to control the money supply. The Fed's new round of quantitative easing, as mentioned in the introduction to this chapter, are a good illustration of what open market operations may look like in practice.

[91] IMF, 'Staff Report for the 2010 Article IV Consultation with the People's Republic of China' (9 July 2010) para 22 <http://www.imf.org/external/pubs/ft/scr/2010/cr10238.pdf> accessed 1 July 2013. For the more recent staff report of the 2012 Article IV consultation with China, see <http://www.imf.org/external/pubs/ft/scr/2012/cr12195.pdf> accessed 1 July 2013. It should be noted that in the 2012 Article IV consultation with China, the IMF delegation reached the assessment that, following appreciation in real terms, the RMB remained moderately undervalued against a broad range of currencies.

[92] Qualifiers commonly used in summings up of meetings of the Fund's Executive Board have been given a specific meaning in order to convey significant nuances in the Board's view in the absence of a formal decision. According to this established practice, the above-used qualifier 'a number of Directors', eg, refers to about six to nine Directors out of the 24 total (see IMF, 'Qualifiers Used in Summings Up of Executive Board Meetings' <http://www.imf.org/external/np/sec/misc/qualifiers.htm> accessed 1 July 2013).

[93] IMF, 'IMF Executive Board Concludes 2010 Article IV Consultation with China', PIN No 10/100 (27 July 2010) <http://www.imf.org/external/np/sec/pn/2010/pn10100.htm> accessed 1 July 2013.

[94] In any investor-state dispute, the relevant BIT will usually be the primary point of reference for a potential legal claim. However, as noted earlier (see Chapter 2, Subsection I.B.2), the sole exchange-rate-specific provisions in BITs are those protecting the transfer of funds. These provisions are usually limited to determining the type of currency in which transfers can be made and to ensuring that

are the only scenario in which foreign investors might be in a position to successfully seek legal protection under international investment law (and even then the devaluation alone, without any additional regulatory measures—like the forcible pesoification of all bank accounts denominated in USD imposed by Argentina in January 2002—might not be enough for obtaining legal redress).[95]

Under general international law not every state measure that interferes with property qualifies as expropriation. In the words of Ian Brownlie:

> state measures, prima facie a lawful exercise of powers of government, may affect foreign investments considerably without amounting to expropriation. Thus, foreign assets and their use may be subjected to taxation, trade restrictions involving licenses and quotas, or *measures of devaluation*. While special facts may alter cases, in principle such measures are not unlawful and do not constitute expropriation.[96]

Under general international law, devaluations have usually been regarded as being part of a state's 'internal' monetary sovereignty, for which the exercise of state power cannot be questioned.[97] As ruled by the PCIJ in the *Oscar Chinn Case* of 1934, expectations concerning the continuing intrinsic or external value of a currency are, like favourable business conditions and goodwill, 'transient circumstances, subject to change'.[98] According to Proctor, it emerges from well-established national case law, that 'they suffer from the congenital infirmity that they might be changed by the competent legislator. They are not property, their change is not deprivation'.[99]

However, under contemporary international law, the exercise of monetary sovereignty is limited by the standard of fair and equitable treatment, which is today explicitly enshrined in the vast majority of BITs. As summarized by Proctor:

> It is the lack of equitable treatment, or good faith, that is the real and fundamental and, at the same time, the most comprehensive cause of action of which all other aspects of State responsibility are mere illustrations.
>
> [The correct application of the standard of fair and equitable treatment] will be one of degree: while normally the State is entitled at its discretion to regulate its monetary affairs, there comes a point at which the exercise of such discretion so unreasonably or so grossly offends against the alien's right to fair and equitable treatment . . . that international law will intervene.[100]

transfers be effected at the market exchange rate prevailing on the day of the transfer (or, in the absence of such a rate, at its fairly calculated equivalent) and not at some arbitrary, discriminatory rate.

[95] It needs to be stressed that foreign investors are not harmed by the consistent maintenance of an undervalued exchange rate peg; the contrary is true. They are provided with stable economic conditions rendering it more attractive to invest in the country maintaining the peg. Since investing in a country with an undervalued real exchange rate is cheaper than it would otherwise be, one could even argue that in such a scenario foreign investors are being treated more favourably than residents of the host state.

[96] Ian Brownlie, *Public International Law* (6th edn OUP, Oxford 2003) 509, emphasis added.

[97] Proctor (n 24) 527.

[98] *The Oscar Chinn Case (Britain v Belgium)*, Judgment of 12 December 1934, PCIJ Rep Series A/B No 63, 88.

[99] Proctor (n 24) 539–40, references to relevant US case law omitted.

[100] Proctor (n 24) 543, footnotes omitted.

It is thus not very surprising, that the numerous arbitral tribunals that have been established in the aftermath of the 1999–2002 Argentine crisis, were not called to examine whether the devaluation of the Argentine peso in January 2002 amounted to an indirect expropriation, but whether the set of emergency measures imposed by Argentina, notably the tariff freeze it had imposed on public utilities, deprived foreign investors of fair and equitable treatment. Embarking in detail on the factual background of the Argentine crisis and the many legal issues addressed by the related arbitral proceedings, many of which are still pending, would go well beyond the scope of this chapter, and indeed this monograph.

In light of the export-promoting effects of an undervalued real exchange rate, it is not surprising that those looking for ways of legal action outside the IMF framework against such a contested exchange rate policy have started to examine whether legal relief could be sought under trade rules. However, whether the maintenance of an undervalued real exchange rate amounts to a violation of a specific rule contained in one of the WTO agreements is far from obvious, despite the potential of such a policy to act as a uniform tariff-cum-subsidy in a purely economic sense. The second part of this chapter aims to shed light on this and related trade law issues.

II. Trade Law as an Alternative for Tackling the Maintenance of an Undervalued Real Exchange Rate?[101]

After analysing whether the maintenance of an undervalued real exchange rate amounts to an export subsidy under WTO rules (Section A), this second part comments briefly on the main US proposals aiming to impose unilateral trade remedies against 'currency manipulation' (Section B) and assesses the potential impact of the various ambiguities arising from GATT Article XV, the key provision of the IMF–WTO relationship, on the viability of a WTO challenge of an undervalued real exchange rate (Section C).

A. The maintenance of an undervalued real exchange rate as an export subsidy under WTO rules?

After some preliminary remarks on the governmental measures at issue (Subsection 1), this section provides an overview of the treatment of subsidies under WTO law (Subsection 2) prior to assessing whether maintaining an undervalued real exchange rate fulfils the legal criteria of an export subsidy under WTO law (Subsection 3).

1. Preliminary remarks on the governmental measures at issue

Bringing a case to the WTO is not a viable option for any exchange rate shifts that have been caused by an external economic shock. As a general matter, according to DSU Article 3.3, legal relief under WTO rules can only be sought with respect to *measures taken by another member*. The question as to whether the measures taken

[101] The contents of this Part II are a condensed, yet updated, version of the analysis provided by this author in Zimmermann (n 1) 441–72.

by a central bank would have to be attributed to a WTO member arises from the fact that an increasing number of central banks have been granted formal independence, with the consequence that neither the executive nor the legislature can directly control or influence their interventions. However, it appears safe to say that central bank independence is not a valid reason why measures taken by central banks should not be regarded as 'measures taken by another Member' in the sense of DSU Article 3.3. Independent of the economic merits of opting for central bank independence, sovereign states are free to choose to what extent they wish to isolate their central banks from political pressure. If a WTO member decides to do so, it cannot hide away from its responsibility for potential violations of international legal rules that might result from any measures taken by its central bank.

A WTO member wishing to bring a case to the WTO on the maintenance, by another Member, of an undervalued real exchange rate would most likely have to complain about a whole set of measures, depending on the precise circumstances. As analysed in the brief economic overview above,[102] in order for an undervaluation to produce real effects on trade, a country would have to maintain an artificially low price level. As explained earlier, achieving this goal would require that the country concerned take specific steps. Capital controls combined with sterilization, surrender requirements for export earnings, increased reserve requirements and outright price controls are among the most notable measures that a country wishing to manipulate its exchange rate for protectionist purposes might have recourse to in order to realize a durable undervaluation of the real exchange rate. It would be crucial for the viability of a WTO dispute on the maintenance of an undervalued real exchange rate that the claimant succeed in showing that the contested undervaluation has been achieved and is being maintained by clearly identifiable measures taken by the respondent. Proving the existence, and quantifying the precise effects, of the complex measures involved in achieving and maintaining an undervalued real exchange rate would be difficult.

2. Subsidies and subsidized trade under WTO law

The WTO rules on the legal treatment of subsidies are set forth in detail in the Agreement on Subsidies and Countervailing Measures (ASCM).[103] Under existing

[102] See Section I.C of this chapter.

[103] Agreement on Subsidies and Countervailing Measures [hereinafter ASCM] (15 April 1994), WTO Agreement, Annex 1A, in WTO Secretariat, *The Results of the Uruguay Round of Multilateral Trade Negotiations, The Legal Texts* [hereinafter: *Legal Texts*] (WTO and CUP, Cambridge and Geneva 1999) 231. For background information on the history of the ASCM, see, eg, Peter van den Bossche, *The Law and Policy of the World Trade Organization—Text, Cases and Materials* (2nd edn CUP, Cambridge 2008) 559–60. Parts of GATT Articles VI and XVI also contain provisions on subsidies and countervailing duties, but, as has been ruled by the Appellate Body in *Brazil—Desiccated Coconut* (with respect to GATT Article VI), the rules on subsidies and countervailing duties contained in the GATT cannot be invoked independently from the ASCM. (WTO Appellate Body Report, *Brazil—Measures Affecting Desiccated Coconut (Brazil—Desiccated Coconut)*, WT/DS22/AB/R, adopted 20 March 1997, 18–19). In a potential conflict between GATT Articles VI, XVI and the ASCM, the rules contained in the latter would prevail as a result of the general interpretative note to Annex 1A to the WTO Agreement which determines that '[i]n the event of conflict between a provision of the General Agreement on Tariffs and Trade 1994 and a provision of another agreement in Annex 1A to

WTO law it is necessary to distinguish two categories of subsidies, each of which is subject to separate substantial and procedural rules: 'prohibited subsidies'[104] and 'actionable subsidies'.[105] Remedial action (both multilateral and unilateral) may only be taken if that same subsidy is 'specific' in the sense of ASCM Article 2. As a general matter, unilateral remedial action against any sort of subsidy, ie the imposition of so-called countervailing duties, is only WTO-consistent if the following three conditions are fulfilled: (a) there are subsidized imports, ie imports of products from producers who benefited from a specific subsidy within the meaning of the ASCM; (b) there is injury to the domestic industry of the like products within the meaning of the detailed provisions in ASCM Articles 15 and 16; and (c) there is a causal link between the subsidized imports and the injury to the domestic industry.[106]

The fact that WTO members are not limited to acting on the multilateral level when seeking legal relief against prohibited subsidies and actionable subsidies that cause injury to the domestic industry within the meaning of ASCM Articles 15 and 16 is one of the particularities of the legal treatment of subsidies under WTO law. Upon a written, argued, application by or on behalf of an industry branch, it is equally open to any WTO member to initiate a domestic investigation 'to determine the existence, degree and effect of any alleged subsidy'.[107] These domestic investigations, which can lead to the unilateral imposition of countervailing duties,[108] have to conform to detailed procedural rules set by the WTO, though.[109] Any WTO member against whom countervailing duties have been imposed may of course contest their legality before a WTO panel, thus bringing the case to the multilateral level. WTO members have the possibility of pursuing both procedures in parallel, ie to contest the same measure(s) as part of a multilateral WTO proceeding or as part of a unilateral countervailing duty investigation, but final countervailing duties (unilaterally imposed) and countermeasures (as authorized by the WTO's Dispute Settlement Body (DSB) as part of a multilateral proceeding) must not be cumulated.[110]

[the WTO Agreement], the provision of the other agreement shall prevail to the extent of the conflict'. (General interpretative note to Annex 1A (15 April 1994), in *Legal Texts* 16).

104 As defined in ASCM Article 3. The procedural rules for multilateral remedial action against a prohibited subsidy are set out in ASCM Article 4.

105 A specific subsidy in the sense of ASCM Articles 1 and 2 that is not a 'prohibited subsidy' in the sense of ASCM Article 3, may be 'actionable' if it causes any of the 'adverse effects to the interests of other Members' set forth in ASCM Article 5. The procedural rules for multilateral remedial action against an actionable subsidy are laid down in ASCM Article 7.

106 These three conditions follow from Articles 10 and 32.1 of the ASCM and GATT Article VI. For detail, see van den Bossche (n 103) 586.

107 ASCM Article 11.1.

108 As provided for in GATT Article VI:3 (and restated almost identically in footnote 36 to the ASCM), '[t]he term "countervailing duty" shall be understood to mean a special duty levied for the purpose of offsetting any bounty or subsidy bestowed, directly, or indirectly, upon the manufacture, production or export of any merchandise'. The term countervailing duty thus designates a tariff surcharge that is imposed over a longer period of time.

109 These procedural rules are set forth in ASCM Articles 10–23.

110 According to footnote 35 to the ASCM.

For an alleged export subsidy this leads to the interesting situation that the unilateral imposition of countervailing duties will only be WTO-consistent if it can be demonstrated that not only the relevant measures amount to a prohibited subsidy in the sense of the ASCM, but also that they cause injury to a domestic industry. No similar 'injury' requirement exists if the same measure is attacked multilaterally as an export subsidy in the sense of ASCM Article 3.1(a). All prohibited subsidies are prohibited per se, due to their recognized trade-distorting nature without their harmful effects having to be demonstrated on a case-by-case basis if addressed on the multilateral level. The remainder of this section considers the multilateral scenario, ie the case where a WTO member requests consultations with another member,[111] claiming that the maintenance of an undervalued real exchange rate amounts to an export subsidy in the sense of ASCM Article 3.1(a) and thus to a prohibited subsidy that should be withdrawn according to ASCM Article 4.7.[112]

The existing literature on the question of whether the maintenance of an undervalued real exchange rate constitutes an export subsidy under WTO law is composed not only of academic writing,[113] but also of several industry-sponsored, China-specific, memoranda which have been given considerable attention due to the fact that they have been written by widely respected trade law experts, such as James Bacchus, a former Chairman of the WTO Appellate Body and Ira Shapiro, a former general counsel to the United States Trade Representative (USTR).[114]

[111] According to the procedure set forth in ASCM Article 4.

[112] Section II.B of this chapter briefly examines to what extent unilateral trade remedies could be lawfully relied upon to address the same issue.

[113] See, eg, Dukgeun Ahn, 'Is the Chinese Exchange Rate Regime "WTO-legal"?' in Simon J Evenett (ed) (n 2) 139; John Magnus and Timothy C Brightbill, 'China's Currency Regime is Legitimately Challengeable as a Subsidy under ASCM rules', ibid 147; Joel P Trachtman, 'Yuan to Fight About It? The WTO Legality of China's Exchange Regime', ibid 127; Michael Waibel, 'Retaliating Against Exchange Rate Manipulation Under WTO Rules', ibid 133; Marc Benitah, 'China's Fixed Exchange Rate for the Yuan: Could the United States Challenge It in the WTO as a Subsidy?' ASIL Insight (2003) <http://www.asil.org/insigh117.cfm>; Ioana Ciobănaşu and Erik Denters, 'Manipulation of the Chinese Yuan—May WTO Members Respond?' (2008) 9(1) *Griffin's View on International and Comparative Law* 55; Christoph Herrmann, 'Don Yuan: China's "Selfish" Exchange Rate Policy and International Economic Law' in Christoph Herrmann and Jörg P Terhechte (eds), *European Yearbook of International Economic Law 2010* (Springer, Berlin and Heidelberg 2010) 31; Gary C Hufbauer, Yee Wong, and Ketki Sheth, *US-China Trade Disputes: Rising Tide, Rising Stakes* 11–28 (Policy Analyses in International Economics 78, Peterson Institute for International Economics 2006); Catharina E Koops, 'Manipulating the WTO? Challenging Undervalued Currencies Under WTO Rules', Amsterdam Center for International Law Research Paper Series (2010) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1564093> accessed 1 July 2013; Matthew R Leviton, 'Is It a Subsidy? An Evaluation of China's Currency Regime and Its Compliance with the WTO' (2006) 23 *UCLA Pacific Basin Law Journal* 243; Han Long, 'SCM Agreement Says "No" to Charges against RMB Exchange Rate as Export Subsidy' (2010) 5 *Frontiers of Law in China* 397; Bryan Mercurio and Celine Sze Ning Leung, 'Is China a "Currency Manipulator"?: The Legitimacy of China's Exchange Regime Under the Current International Legal Framework' (2009) 43 *The International Lawyer* 1257; Staiger and Sykes (n 87).

[114] See, notably, James L Bacchus and Ira Shapiro, Greenberg Traurig LLP, 'The Consistency with the WTO Obligations of the United States of H.R. 1498, the Hunter-Ryan Bill' (Memorandum to Jim Jarrett, Chairman, International Economic Affairs Policy Group, National Association of Manufacturers) (12 September 2006) (on file with author); Terence P Stewart, Amy S Dwyer, and J Daniel Stirk, Law Offices Stewart and Stewart, 'Response to Bacchus/Shapiro Analysis of WTO-Consistency of Hunter-Ryan Bill (HR 1498)' (22 September 2006) <http://faircurrency.org/pdfs/Memo_on_

It will emerge from the analysis below that the maintenance of an undervalued real exchange rate is highly unlikely to fulfil all legal requirements of an export subsidy under WTO law.[115]

3. Assessment under the WTO criteria of an export subsidy

As defined by ASCM Article 1.1, a subsidy under WTO law is deemed to exist if it can be shown that there is a 'financial contribution by a government or any public body within the territory of a Member' or if there is 'any other form of income or price support in the sense of [GATT] Article XVI' *and* if 'a benefit is thereby conferred'. In addition, according to ASCM Article 1.2, the WTO allows the recourse to multilateral and unilateral remedies only against subsidies that are 'specific' in the sense of ASCM Article 2. A plain reading of the specificity requirements in ASCM Article 2 reveals that the subsidization that allegedly arises from maintaining an undervalued real exchange rate might satisfy the 'specificity' requirement only if it amounts to a prohibited subsidy taking the form of an export subsidy, ie a subsidy 'contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance' (ASCM Article 3.1(a) in combination with Article 2.3). The beneficial effects of an undervalued real exchange rate are available across the economy without being limited to certain enterprises, industries, or producers in a certain region.[116] This subsection looks into each of these requirements: a financial contribution or any form of income or price support (a), conferral of benefit (b), and specificity (c).

a. Financial contribution or any other form of income or price support

The measures that can be expected to be employed by a country in achieving and maintaining an undervalued real exchange rate[117] do clearly not enter into any of the four categories identified in ASCM Article 1.1(a)(1)(i)–(iv). Although this view is overwhelmingly shared in the existing literature,[118] it should be added that it has been argued in some,[119] though not all,[120] industry-sponsored memoranda that

Response_to_RH_Bill.pdf>; and Wiley Rein & Fielding LLP, 'Response to the Bacchus/Shapiro Analysis of the Consistency of H.R. 1498, the Hunter-Ryan Bill, With The WTO Obligations of the United States' <http://www.faircurrency.org/legalbackground.html> (all accessed 1 July 2013).

[115] Reaching a final conclusion on this issue would require a detailed analysis of all relevant measures at stake, which cannot be achieved in an abstract analysis like the present one.

[116] See, eg, Trachtman (n 113) 130.

[117] For detail on these measures, see Subsection II.A.1 and the analysis in Section I.C of this chapter.

[118] Large parts of the existing literature on the potential legal treatment of exchange rate manipulation under WTO law, merely state in one or at best a couple of sentences that a financial contribution in the sense of the ASCM cannot be identified in the context at issue. Hufbauer, Wong, and Sheth (n 113) 21–2; Koops (n 113) 3–4; Mercurio and Leung (n 113) 1294–5; Staiger and Sykes (n 87) 31–2; and, in particular, Long (n 113) 404–7, deal with the issue in more detail, reaching either the same negative result or expressing at least great scepticism as to the existence of a 'financial contribution'.

[119] Stewart, Dwyer, and Stirk (n 114) 2–5; Wiley Rein & Fielding LLP (n 114) 3–4.

[120] Bacchus and Shapiro (n 114) 5–7 very convincingly argue that the measures involved in the Chinese currency regime do *not* amount to a 'financial contribution' in the sense of ASCM Article 1.1(a)(1).

one should consider the fact that the country maintaining an undervalued real exchange rate will exchange all export earnings at an undervalued exchange rate (thereby overpaying those exporting from its territory)[121] as either a direct transfer of funds to exporters by the government in the sense of ASCM Article 1.1(a)(1)(i) or as government revenue foregone in the sense of ASCM Article 1.1(a)(1)(ii), or as both. For the following two reasons, however, this argument is not convincing. Firstly, the 'overpaying' of exporters which occurs as part of the maintenance of an undervalued real exchange rate is undertaken by the banking sector and does not involve a direct transfer of funds from the government. Contrary to what has been argued, the fact that banks in the territory of the country maintaining the undervalued real exchange rate might be firmly obliged to exchange all export earnings at the undervalued rate does not amount to the scenario captured by ASCM Article 1.1(a)(1)(iv) where 'a government . . . entrusts or directs a private body to carry out [the financial contribution]'. Secondly, the above argument is erroneous because it confounds the concepts of financial contribution and benefit, which are distinct elements in the definition of a subsidy under WTO law.[122]

Finally, the argument that maintaining an undervalued exchange rate peg should be considered as hedging exporters against foreign exchange losses and thus as providing 'a service other than general infrastructure' in the sense of ASCM Article 1.1(a)(1)(iii) equally fails.[123] Whereas reducing the exchange rate risk faced by exporters undoubtedly confers a benefit to them, doing so does not amount to a service provided by the government in the sense of the ASCM. If one were to adhere to the opposite view, any exchange arrangement other than freely floating currencies[124] and any type of macroeconomic policy that increases economic stability and reduces the risk of erratic shifts in the exchange rate would amount to a 'governmental service'.

As already indicated, however, in order to satisfy the first analytical step under ASCM rules it is not absolutely necessary to identify a 'financial contribution by a government or any public body'. Alternatively, according to ASCM Article 1.1(a)(2), a subsidy may result from 'any form of income or price support in the sense of [GATT] Article XVI'.[125] These terms have not yet been interpreted by a WTO

[121] The logic behind this argument is that if exporters, under a surrender requirement, are obliged to convert their export receipts into domestic currency at an undervalued exchange rate, the banking sector has to give them more units of domestic currency (which, according to this rather simplistic argument, are indirectly provided by the government through the printing of money) per unit of foreign currency earned than they would have been given if the exchange rate were not undervalued.

[122] This point has been explicitly recalled in the unappealed panel report in *US—Export Restraints* (WTO Panel Report; *United States—Measures Treating Export Restraints as Subsidies (US—Export Restraints)*, WT/DS194/R & corr 1 & 2, adopted 23 August 2001, para 8.38).

[123] This unsustainable argument has been brought forward, eg, by Stewart, Dwyer, and Stirk (n 114) 6.

[124] See n 22 above for the vast array of IMF-consistent exchange arrangements.

[125] Without providing a definition of the terms 'any form of income or price support', GATT Article XVI:1 merely states in relevant part:

> If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from,

panel or the Appellate Body. However, it seems questionable whether the terms 'any form of income or price support in the sense of GATT Article XVI' may be given a meaning broad enough to encompass just anything that boosts the income of the purportedly subsidized entity.[126] As has been argued convincingly by Staiger and Sykes, these terms should receive a narrow reading limiting them to programmes geared to such matters, as in the agricultural sector, where most WTO members rely on different types of income and product-specific price support.[127]

b. Conferral of a benefit

Assuming, however, *arguendo*, that the maintenance of an undervalued real exchange rate can somehow be found to enter into ASCM Article 1.1(a), it would further have to be shown, according to ASCM Article 1.1(b), that a benefit has thereby been conferred in order for the contested measures to amount to a subsidy under the ASCM.

In the dispute *Canada—Aircraft*, the Appellate Body agreed with the Panel's findings which rejected an interpretation of benefit based on whether there was a 'net cost' to the government. The Appellate Body also confirmed the Panel's focus on the recipient of a subsidy in determining the existence of a benefit.[128] The Appellate Body further held that a determination of whether a benefit exists for the subsidy recipient implies a comparison with market conditions.[129]

In light of the above, and to the extent that this can be said in the abstract, it might indeed be possible to identify a 'conferral of benefit' satisfying the ASCM in a scenario where a WTO member maintains an undervalued real exchange rate. However, proving the existence of such a benefit, and quantifying it, would be a much more difficult task than it seems at first sight. What if exporters price their products in their domestic currency, thus by definition not directly benefiting from the favourable exchange of export earnings?[130] In any event, it would have to be demonstrated that it was the competitive advantage resulting from the undervalued real exchange rate that put producers in the territory of the WTO member maintaining the undervalued exchange rate in a position where they could export more. Furthermore, as has been pointed out rightly by Staiger and Sykes,[131] not any increase in exports leads to higher profits. An exporter will only benefit from the increased international competitiveness arising from an undervalued real exchange rate if it can both produce more in order to raise its exports and if increased sales lead to increased profits. Whether this is the case depends on the

or to reduce imports of any product into, its territory, it shall notify the CONTRACTING PARTIES in writing of the extent and nature of the subsidization...

126 See Staiger and Sykes (n 87) 610, note 52.

127 Staiger and Sykes (n 87) 610, note 52. Staiger and Sykes are the only authors among those listed above (nn 113–114) to address the question of whether the maintenance of an undervalued real exchange rate might amount to 'any form of income or price support in the sense of [GATT] Article XVI'.

128 WTO Appellate Body Report, *Canada—Measures Affecting the Export of Civilian Aircraft (Canada—Aircraft)*, WT/DS70/AB/R, adopted 20 August 1999, para 154.

129 WTO Appellate Body Report, *Canada—Aircraft* (n 128) para 157.

130 See Herrmann (n 113) 49.

131 Staiger and Sykes (n 87) 611.

characteristics of every single industry, especially existing production technologies and capacity restraints. Finally, determining whether a benefit has been conferred would also require a close look at the firm-specific production structure. Eg if imports are needed to produce the final export product, the benefit arising from an undervalued real exchange rate might be diminished or even disappear entirely.[132]

c. Specificity

Assuming, again *arguendo*, that it can be demonstrated that the measures involved in achieving and maintaining an undervalued real exchange rate constitute a subsidy in the sense of the ASCM Article 1.1, it would further have to be shown that such a subsidy is 'specific' in the sense of ASCM Article 2 in order for the imposition of multilateral or unilateral trade remedies to be in accordance with WTO law. Parts of the literature on the potential treatment of exchange rate manipulation under WTO law look exclusively at industry- and enterprise specificity in the sense of ASCM Article 2.1, which, not very surprisingly, results in these authors immediately reaching a negative conclusion on the 'specificity' criterion.[133] However, as noted earlier, whether the maintenance of an undervalued real exchange rate is 'specific' is foremost not an issue of ASCM Articles 2.1 or 2.2, but depends on whether the measures involved amount to an export subsidy in the sense of ASCM Article 3.1(a),[134] ie a subsidy that is 'contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including [the subsidies] illustrated in Annex I [to the ASCM]'.

A close look at the non-exhaustive list of 11 types of export subsidies in Annex I to the ASCM reveals that the measures involved in maintaining an undervalued real exchange rate are not covered by the practices listed therein. This point of view is unanimously shared in the existing literature.[135] However, maintaining an undervalued real exchange rate might still satisfy the legal standard set forth in ASCM Article 3.1(a), and requires therefore closer scrutiny.

Confronted with an undervalued real exchange rate, any contingency upon export performance *in law* can be directly dismissed. By contrast, a potential contingency *in fact* upon export performance needs to be examined more closely. In this respect, it is important to take into account also footnote 4 to ASCM Article 3.1(a):

> [The standard of contingency in fact] is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

[132] Koops (n 113) 4. [133] See, eg, Trachtman (n 113) 130–1.

[134] As noted earlier, export subsidies figure among the category of 'prohibited subsidies' under ASCM Article 3 all of which are deemed to be 'specific' according to ASCM Article 2.3.

[135] See, notably, Benitah (n 113); Hufbauer, Wong, and Sheth (n 113) 22–3; and Leviton (n 113) 25–7.

As held by the Appellate Body in *Canada—Aircraft*, the three substantive elements of ASCM Article 3.1(a), read together with its footnote 4, are: (i) the granting of a subsidy that is (ii) tied to (iii) actual or anticipated exportation or export earnings.[136] The recent Appellate Body report in *EC—Large Civil Aircraft* provided further valuable clarification by holding that:

> the standard for *de facto* export contingency under Article 3.1(a) and footnote 4 of the *SCM Agreement* would be met when the subsidy is granted so as to provide an incentive to the recipient to export in a way that is not simply reflective of the conditions of supply and demand in the domestic and export markets undistorted by the granting of the subsidy.[137]

It has been argued by some authors that maintaining an undervalued real exchange rate is not contingent, in fact, upon export performance due to the fact that the WTO member concerned may have opted for the contested undervaluation for a whole set of objectives, such as attracting foreign investors, controlling inflation, or avoiding erratic exchange rate movements, with export-promotion being only one of them.[138] However, this argument appears to be based on a misunderstanding of the legal standard set forth under ASCM Article 3.1(a). The government's intention is irrelevant in deciding whether a measure amounts to an export subsidy under WTO law. The existence of an export subsidy in the sense of ASCM Article 3.1(a) depends entirely on objective criteria; there is no 'intent' element, which stands in contrast, notably, to IMF Article IV:1(iii) as analysed in detail earlier in this chapter.[139]

The maintenance of an undervalued real exchange rate (for which, as noted above, we assume, *arguendo*, that it amounts to a subsidy in the sense of ASCM Article 1.1), is indeed not tied, in fact, to actual, or anticipated exportation or export earnings as required by ASCM Article 3.1(a) read together with its footnote 4. In order to be granted the subsidy arising from an undervalued real exchange rate, one does not necessarily have to export. Foreign investments into the country with the undervalued real exchange rate, its domestic tourism sector, as well as simply anybody exchanging foreign currency at the undervalued exchange rate will equally be granted the subsidy.[140] Of course it is plausible to assume that the government of the country maintaining an undervalued real exchange rate anticipated that increased exports would result from such a policy. That undervalued real exchange rate might even be part of an openly pursued strategy of export-led growth. However, as noted above, such *anticipation* alone is not enough to fulfil the legal standard of 'factual contingency' of ASCM Article 3.1(a), as has been ruled by the Appellate Body in *Canada—Aircraft*.[141]

[136] As explicitly identified by the WTO Appellate Body in *Canada—Aircraft* (n 128) paras 169–72.

[137] WTO Appellate Body Report, *European Communities and Certain Member States—Measures Affecting Trade in Large Civil Aircraft (EC—Large Civil Aircraft)*, WT/DS316/AB/R, adopted 1 June 2011, para 1045.

[138] See, notably, Leviton (n 113) 23–4; and Koops (n 113) 5–6.

[139] See Sections I.A and I.B above.

[140] See, notably, Bacchus and Shapiro (n 114) 9–10; Koops (n 113) 5–6; and Leviton (n 113) 259–63.

[141] Appellate Body Report, *Canada—Aircraft* (n 128) para 171.

A few authors have nevertheless argued that the availability of the subsidy arising from an undervalued real exchange rate to non-exporters does not dissolve the subsidy's export-contingent nature to the extent that it is being granted to exporters.[142] These authors have relied on findings by the Appellate Body in *US—FSC (Article 21.5—EC)*[143] and *US—Upland Cotton*.[144] In these disputes the Appellate Body held that the fact that a subsidy might be not export-contingent in a first set of circumstances does not affect its possible export-contingency in a different set of circumstances.

However, contingency, in fact, upon export performance was not the key issue in both *US—FSC (Article 21.5—EC)* and *US—Upland Cotton*. In these disputes, the Appellate Body was confronted with subsidies that were contingent, in law, upon export performance in one set of circumstances, but not in another. In *US—FSC (Article 21.5—EC)*, the contested measure granted a tax exemption in two scenarios: (a) where property was produced within the US and held for use outside the US; and (ii) where property was produced outside the US and held for use outside the US. The Appellate Body held that the subsidy granted in the first scenario was export-contingent, in law, irrespective of the fact that the subsidy could also be obtained in the second scenario where it was not export-contingent.[145]

By contrast, in the context of the maintenance of an undervalued real exchange rate it appears impossible to identify a separate set of circumstances for which the strict standard of contingency upon export performance as set forth in ASCM Article 3.1(a) were satisfied, ie where the granting of the subsidy were conditioned, solely or as one of several other conditions, upon export performance. As discussed above, the subsidy allegedly arising from the maintenance of an undervalued real exchange rate is available across the entire economy; it is never conditioned, either in law or in fact, upon actual or anticipated exportation. The fact that, in practice, exporters may be the ones who benefit the most from an undervalued exchange rate does not affect this conclusion.

Hence, the maintenance of an undervalued real exchange rate (assuming that it amounts to a subsidy in the sense of ASCM Article 1.1) would not be a prohibited subsidy in the sense of ASCM Article 3 and would therefore not be specific in the sense of ASCM Article 2.3. Overall, it emerges from the detailed analysis provided above that it is highly unlikely that the maintenance of an undervalued real exchange rate, despite its potential, in purely economic terms, to promote exports, could be successfully challenged as an export subsidy under existing WTO rules. The following section complements the above analysis by looking at the key aspects

[142] See, notably, Magnus and Brightbill (n 114) 148–50; Stewart, Dwyer, and Stirk (n 114) 8–9; and Wiley Rein & Fielding LLP (n 114) 5–7.

[143] WTO Appellate Body Report (DSU Article 21.5), *United States—Tax Treatment for 'Foreign Sales Corporations' (US—FSC (Article 21.5—EC))*, WT/DS108/AB/RW, adopted 29 January 2002, paras 119–20.

[144] WTO Appellate Body Report, *United States—Subsidies on Upland Cotton (US—Upland Cotton)*, WT/DS267/AB/R, adopted 21 March 2005, para 578.

[145] WTO Appellate Body Report (DSU Article 21.5), *US—FSC (Article 21.5—EC)* (n 143) para 120.

of the main past and present legislative proposals in the US for unilateral trade remedies against exchange rate manipulation.

B. The main legislative proposals in the US for unilateral trade remedies against exchange rate manipulation

US domestic law includes several provisions on exchange rates; they are contained in Title III of the US Omnibus Trade and Competitiveness Act of 1988,[146] inspired by the misalignment of the USD in the 1980s. Title III includes a specific focus on intentional exchange rate manipulation. It requires the US Treasury Department (Treasury), in consultation with the IMF, to analyse the exchange rate policies of the US's major trading partners and to issue reports each year and updates six months thereafter.[147] These reports examine whether countries are manipulating their USD exchange rates 'for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade'. If Treasury finds such manipulation, the issue should be resolved, according to US law, via negotiations, except 'where this would have a serious detrimental impact on vital national and economic and security interests'. Since 1994 no such Treasury report has formally identified an exchange rate manipulator. It is against the background of the long-standing controversy over the Chinese exchange rate that numerous bills on exchange rate manipulation have been introduced in the current and in previous sessions of Congress.

As of 1 July 2013, not a single one of these bills has been enacted. Sessions of Congress last two years; at the end of each session all proposed bills and resolutions that have not passed are cleared from the books. However, it has become common practice, in particular on this issue, to reintroduce failed bills or slightly modified versions thereof in subsequent sessions of Congress; the current 113th session of Congress (2013–2014) is no exception to this rule.

One of the leading proposals in the 111th session of Congress (2009–2010) was the Currency Exchange Rate Oversight Reform Act of 2010, introduced on 17 March 2010 by a bipartisan group of senators led by Charles Schumer (D-NY), Debbie Stabenow (D-MI), and Lindsey Graham (R-SC) (Schumer-Stabenow-Graham bill).[148] This bill would have bridged between the two main competing legislative approaches pursued in the US Senate since 2007.[149] Whereas the

[146] Omnibus Trade and Competitiveness Act of 1988, paras 3001–3006, Pub L No 100–418, 102 Stat 1107 (1988), codified at 22 USC paras 5304–5306, <http://www.treasury.gov/resource-center/international/exchange-rate-policies/Documents/authorizing-statute.pdf> accessed 1 July 2013.

[147] All Treasury reports issued so far, including the latest April 2013 report, as well as additional background materials, are available at <http://www.treasury.gov/resource-center/international/exchange-rate-policies/Pages/index.aspx> accessed 1 July 2013.

[148] S.3134, 111th Cong. (2009–2010) <http://thomas.loc.gov/cgi-bin/query/z?c111:S.3134:> accessed 1 July 2013.

[149] The first of these approaches is best represented by the Currency Exchange Rate Oversight Reform Act of 2007, S.1607, 110th Cong. (2007–2008) <http://thomas.loc.gov/cgi-bin/query/z?c110:S.1607:> accessed 1 July 2013. This Schumer-Graham bill was approved by the Senate Finance Committee, but went no further due to a jurisdictional conflict with the Senate Banking Committee.

Currency Exchange Rate Oversight Reform Act of 2010 died, an essentially identical bill, the Currency Exchange Rate Oversight Reform Act of 2011,[150] was reintroduced on 22 September 2011 in the 112th Congress, again by a bipartisan group of senators, this time led by Senator Sherrod Brown (D-OH). That bill passed the Senate on 11 October 2011 by 63 votes to 35 but died since it was never passed by the House of Representatives. On 7 June 2013, Senator Brown, again together with various bipartisan co-sponsors, reintroduced the bill with only marginal changes as the Currency Exchange Rate Oversight Reform Act of 2013 in the current 113th session of Congress.[151]

Just as its earlier versions, this bill would replace Title III of the above-mentioned US Omnibus Trade and Competitiveness Act of 1988 and would require semi-annual reports by the Treasury (i) identifying 'fundamentally misaligned currencies',[152] and (ii) designating such currencies 'for priority action' where the country that issues the currency is engaging in actions such as protracted large-scale intervention in the currency exchange market, or excessive and prolonged official or quasi-official accumulation of foreign exchange reserves. Whether the country concerned was aiming to gain an unfair competitive advantage would be irrelevant for these assessments. For currencies designated for 'priority action', the bill establishes two tracks: one would authorize Commerce to address identified fundamental misalignment through countervailing duties; the other would require that exchange rate undervaluation be taken into account when calculating the margin of dumping[153] in anti-dumping investigations. This would be required whenever a country whose currency has previously been designated for 'priority action' fails to eliminate the identified 'fundamental misalignment' of its currency. Designation for inclusion on the priority action list would also affect decisions on whether to grant a country market-economy status for anti-dumping investigations. According to the bill, Commerce, which administers the US anti-dumping laws, would have to 'ensure a fair comparison between the export price and the normal value by

This bill was reintroduced in the 111th Congress (2009–2010) on 11 June 2009, as the Currency Exchange Rate Oversight Reform Act of 2009, S.1254. The Currency Reform for Fair Trade Act of 2009, S.1027, 111th Cong. (2009–2010), introduced under the leadership of Senators Debbie Stabenow (D-MI) and Jim Bunning (R-KY) stands for the second approach <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:s.01027:> accessed 1 July 2013.

[150] S.1619, 112th Cong. (2011–2012) <http://thomas.loc.gov/cgi-bin/query/z?c112:S.1619:> accessed 1 July 2013.

[151] S.1114, 113th Cong. (2013–2014) <http://thomas.loc.gov/cgi-bin/query/z?c113:S.1114:> accessed 1 July 2013.

[152] 'Fundamental misalignment' is defined by the bill as a 'significant and sustained undervaluation of the prevailing real effective exchange rate, adjusted for cyclical and transitory factors, from its medium-term equilibrium level'.

[153] Dumping exists when the export price of a product is lower than its 'normal value' (defined as the home market price, or a price to a third country market, or the fully-loaded average production cost plus overhead and profit). GATT Article VI permits an importing country to levy anti-dumping duties on a product in addition to normal tariffs, if dumping of that product causes material injury to the producers of the like domestic product. The WTO's Anti-Dumping Agreement provides disciplines limiting anti-dumping measures (Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 [hereinafter Anti-Dumping Agreement or ADA] (15 April 1994), WTO Agreement, Annex 1A, in *Legal Texts* (n 103) 147).

adjusting the price used to establish export price or constructed export price to reflect the fundamental misalignment of the currency of the [exporting] country'. A similar requirement had already been included in earlier bills.

Yet, it is important to stress that the punitive and automatic nature of the price adjustment prescribed by the above bills undercuts any argument that they provide for a 'fair comparison . . . between the export price and the normal value' for the products concerned as required under ADA Article 2.4. As provided by ADA Article 2.4.1, whenever this price comparison requires a conversion of currencies, the exchange rate shall be 'the rate of exchange on the date of sale', which appears clearly to refer to the nominal exchange rate and not to some 'medium term equilibrium' that would very much depend on measurement uncertainties.[154] Even more important, it should be regarded as conceptually misguided to adjust dumping margins for exchange rate misalignment. Dumping is a matter of companies' product pricing decisions, which have nothing to do with the macro-level governmental measures that lead to exchange rate misalignment. If exchange rate undervaluation were to be taken into account in anti-dumping calculations, a product that is not dumped (under normal rules) will suddenly have a dumping margin, which would amount to a violation of the ADA.[155]

Whereas none of the bills mentioned so far passed the US House of Representatives (with only the pending Currency Exchange Rate Oversight Reform Act of 2013 still having the possibility to do so), the House did pass legislation on exchange rate misalignment towards the end of the 111th session of Congress (2009–2010). This bill, H.R.2378, had been introduced on 13 May 2009 under the bipartisan leadership of Congressmen Tim Ryan (D-OH-17) and Tim Murphy (R-PA-18) as the Currency Reform for Fair Trade Act (Ryan-Murphy bill).[156] It would have amended Title VII of the Tariff Act of 1930,[157] clarifying that countervailing duties may be imposed to address subsidies relating to a fundamentally undervalued currency of any foreign country. The bill was approved by the House on 29 September 2010 with an overwhelming majority of 348 to 79.

Since the Senate did not vote on it before the end of the 111th session of Congress, this Ryan-Murphy bill did not become law. However, almost identical legislation (but for a few minor technical issues) was reintroduced in the 112th session of Congress (2011–2012) in both the Senate and the House of Representatives. Thus, Congressman Sander Levin (D-MI-12), a former Chairman of, and now ranking Democrat on, the House Ways and Means Committee, introduced on 10 February 2011 the Currency Reform for Fair Trade Act (2011 Levin bill),[158] co-sponsored by over 100 Congressmen across party lines. An identical bill bearing the same name was introduced in the Senate by Senator Sherrod Brown (D-OH)

[154] See Staiger and Sykes (n 87) 615. [155] Staiger and Sykes (n 87) 615.

[156] H.R.2378, 111th Cong. (2009–2010) <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:h2378:> accessed 1 July 2013.

[157] Tariff Act of 1930, Title VII <http://ia.ita.doc.gov/regs/title7.html> accessed 1 July 2013.

[158] H.R.639, 112th Cong. (2011–2012) <http://thomas.loc.gov/cgi-bin/bdquery/z?d112:HR00639:> accessed 1 July 2013.

on 14 February 2011.[159] While neither of these two bills was enacted, on 20 March 2013 Congressman Sander Levin (D-MI-9), together with a broad bipartisan sponsorship (including, inter alia, Congressmen Tim Ryan and Tim Murphy), already reintroduced the Currency Reform for Fair Trade Act (2013 Levin bill) in the current 113th session of Congress (2013–2014).[160]

Contrary to this currently pending proposal and the former Ryan-Murphy bill, an earlier, widely noticed, bill, the Chinese Currency Act of 2005 (Hunter-Ryan bill),[161] introduced on 6 April 2005 under the leadership of Congressmen Tim Ryan (D-OH-17) and Duncan Hunter (R-CA-52), would have revised the definition of what constitutes a countervailable subsidy under Title VII of the Tariff Act of 1930 to explicitly include exchange rate manipulation, and would thus likely have violated WTO law *as such*. By contrast, the currently pending Levin bill does not predetermine (nor did the almost identical former Ryan-Murphy bill as voted by the House of Representatives in September 2010) the outcome of a potential countervailing duty investigation in the context of a contested foreign exchange rate policy. As under current law, the bill leaves the decision of whether to impose countervailing duties in a scenario of exchange rate manipulation to the discretion of Commerce, without presupposing an outcome. Consistent with the requirements under the ASCM, the bill does not alter the fact that countervailing duties may only be imposed if Commerce finds, through a careful case-by-case assessment of all relevant facts that the definition of a countervailable subsidy is satisfied under US law.

One of the key purposes of the pending Levin bill is to address the long-standing resistance of Commerce to conclude that an export subsidy exists if the subsidy is not limited exclusively to circumstances of export, ie when also non-exporters may benefit. The bill would add a new sentence to Section 771(5A)(B) of the Tariff Act of 1930 determining that:

> In the case of a subsidy relating to a fundamentally undervalued currency, the fact that the subsidy may also be provided in circumstances not involving export shall not, for that reason alone, mean that the subsidy cannot be considered contingent upon export performance.

It has been argued by the bill's main sponsor, Congressman Sander Levin,[162] that the decisions by the WTO Appellate Body in *US—Upland Cotton* and *US—FSC (Article 21.5—EC)*, both addressed earlier,[163] support the view that Commerce's

[159] S.328, 112th Cong. (2011–2012) <http://thomas.loc.gov/cgi-bin/bdquery/z?d112:SN00328:> accessed 1 July 2013.

[160] H.R.1276, 113th Cong. (2013–2014) <http://thomas.loc.gov/cgi-bin/bdquery/z?d113:HR1276:> accessed 1 July 2013.

[161] H.R.1498, 109th Cong. (2005–2006) <http://thomas.loc.gov/cgi-bin/query/z?c109:H.1498:> accessed 1 July 2013.

[162] Sander Levin, then still chairman of the House Ways and Means Committee, had proposed the earlier 2011 Levin bill as an amendment in the nature of a substitute, the final version of the earlier mentioned Ryan-Murphy bill, passed by the House of Representatives on 29 September 2010.

[163] See Subsection II.A.3.c above.

current practice is more restrictive than is required under WTO law.[164] In light of the analysis of the standard of 'contingency, in fact, upon export performance' under ASCM Article 3.1(a) provided above,[165] it appears appropriate to comment on this aspect of the pending 2013 Levin bill (as well as of the former Ryan-Murphy bill and the 2011 Levin bill) succinctly as follows.

The fact that a subsidy is not limited to circumstances involving exportation does indeed not imply, *for that reason alone*, that the underlying measure may not amount to an export subsidy in the sense of ASCM Article 3.1(a) in a separate set of circumstances. Instead, as analysed above, a decision whether a subsidy is contingent, in fact, upon export performance requires a detailed analysis of all relevant facts. The pending 2013 Levin bill may thus be considered a valuable clarification for future countervailing duty investigations under US law, without predetermining the outcome of the detailed factual analysis that would still have to be undertaken on a case-by-case basis.

Overall, however, the currently pending bill, if it were to become law, would not alter the fact that the unilateral imposition of countervailing duties against the maintenance of an undervalued real exchange rate would likely be inconsistent with WTO law. As analysed in detail in the preceding section, the measures involved in achieving and maintaining an undervalued real exchange rate do appear to satisfy neither the definition of a subsidy under ASCM Article 1.1 nor the legal standard of 'contingency, in fact, upon export performance' under ASCM Article 3.1(a).

Finally, even if the maintenance of an undervalued real exchange rate amounted to an export subsidy as defined by domestic law in accordance with the ASCM, it would further have to be demonstrated, in order for the imposition of countervailing duties to be consistent with WTO law, that the contested measures cause injury to the domestic industry of the like products within the meaning of ASCM Articles 15 and 16. In light of the economic complexity of the matter, providing a satisfactory demonstration of this 'injury' requirement would not be easy. The required standard might be met if it could be shown that the increase of imports from a country with an undervalued real exchange rate has provoked the breakdown of an entire industry branch. It would be crucial to show that this breakdown has been caused by a decline of local sales caused by increased imports and not by factors unrelated to the contested undervaluation.

The chances of successfully attacking the maintenance of an undervalued real exchange rate under trade rules, both international and domestic, seem to be further diminished by various enigmas arising from GATT Article XV, the key provision in the IMF–WTO relationship.

[164] See House of Representatives, Committee on Ways and Means, Report 111–646, (28 September 2010), available at <http://www.gpo.gov/fdsys/pkg/CRPT-111hrpt646/html/CRPT-111hrpt646.htm> accessed 1 July 2013.

[165] See Subsection II.A.3.c above.

C. *The enigmas of GATT Article XV and their impact on the viability of a WTO challenge of an undervalued real exchange rate*

GATT Article XV is fraught with major ambiguity in respect of three key aspects of the IMF–WTO relationship, which this section shall look at in turn: the scope and legal value of the requirement under GATT Article XV:2 that the WTO consult with the IMF in exchange matters (Subsection 1), the legal value of the exception under GATT Article XV:9(a) (Subsection 2), as well as the question of whether GATT Article XV:4 could be relied upon as an independent basis for a legal claim (Subsection 3).

1. The consultation requirement under GATT Article XV:2

The important question of whether WTO dispute settlement panels and the Appellate Body are firmly obliged or not to consult with the Fund under GATT Article XV:2 and the analogous provision in GATS Article XII, and what legal value has to be accorded to the findings made by the Fund in such consultations has already been analysed in detail in the preceding chapter of this monograph.[166] In the light of that analysis, the remainder of the present chapter proceeds on the assumption that if a case on the maintenance of an undervalued real exchange rate were to be brought to the WTO, the panel (and potentially the Appellate Body) hearing that case would be obliged to consult the IMF on the basis of GATT Article XV:2 as opposed to having merely the option to do so. One cannot stress often enough, however, that the question as to how precisely a WTO panel hearing a dispute on the subject matters covered by GATT Article XV:2, notably exchange rates, would have to interact with the IMF remains fraught with ambiguity that arises from the sub-optimal drafting of GATT Article XV:2, and from misleading legal reasoning by both panels and the Appellate Body in previous WTO disputes as examined in detail earlier in this monograph.[167]

2. The exception under GATT Article XV:9(a)

The second enigma of GATT Article XV arises from its paragraph 9(a) which provides in relevant part: '[n]othing in this Agreement shall preclude . . . the use by a [Member] of exchange controls or exchange restrictions in accordance with the [IMF Agreement]'. Formulated as a general exception, essentially prescribing that the IMF-consistent use of exchange controls or exchange restrictions cannot lead to a finding of breach under the GATT, GATT Article XV:9(a) might well play a decisive role in a potential WTO dispute on the maintenance of an undervalued real exchange rate.

If this reading of GATT Article XV:9(a) is correct,[168] the measures that a country would typically rely upon in order to achieve and maintain an undervaluation of the

[166] See Chapter 2, Sections I.C.1 and I.C.2.
[167] See Chapter 2, Sections I.C.1 and I.C.2.
[168] As will be explained below, the relationship between paras 4 and 9 of GATT Article XV remains somewhat ambiguous, although it seems that GATT Article XV:9(a) can be convincingly interpreted to prevail as *lex specialis* and does thus indeed constitute a general exception to the GATT.

real exchange rate, such as capital controls, surrender requirements,[169] and the channelling of payments through the banking system, could not be found to violate the GATT if they were to amount to 'exchange controls or exchange restrictions [applied consistently with the Fund's Articles]' in the sense of GATT Article XV:9(a).[170] The following paragraphs will take a closer look at the precise meaning of these terms.

As explained earlier in this monograph,[171] unless a restriction on the making of payments and transfers for current international transactions is approved by the Fund under Article VIII:2(a) or is maintained under the transitional provisions of Article XIV of the IMF Agreement, it constitutes a breach of the Fund's Articles. Such a measure would definitely not be covered by the exception under GATT Article XV:9(a).

However, as noted above, the exception under GATT Article XV:9(a) does not only embrace IMF-consistent exchange *restrictions* but also exchange *controls* that are used in accordance with the Fund's Articles. This category of IMF-consistent 'exchange controls'[172] includes all exchange measures whose use is in accordance with the Fund's Articles, but which are non-restrictive.[173] This includes essentially two groups of exchange measures.[174] Firstly, measures that play an important part in an IMF member's exchange management for statistical or other purposes like the avoidance of tax evasion or anti-money laundering efforts: for example, rules for the channelling of payments through the banking system, or document verification requirements for various transactions. Secondly, measures that do not affect the making of payments and transfers for current international transactions in the sense of IMF Article VIII:2(a), ie that do not affect the outflow of payments. A surrender requirement would be such a measure due to the fact that it only concerns inflows of payments.[175]

169 A surrender requirement mandates exporters to exchange any foreign exchange received as payment into domestic currency. This enables the authorities imposing such a requirement to absorb any excess supply of foreign currency on its domestic market and thus to avoid the appreciation of the domestic currency. See also the analysis provided in Section I.C of this chapter.

170 Whether outright price controls as a means of controlling inflation would have to be regarded as a governmental measure that is covered by GATT Article XV:9(a) seems at least questionable. In a concrete case, any decision as to whether a specific measure has to be regarded as falling under the scope of the exception of GATT Article XV:9(a) ('exchange controls or exchange restrictions') could obviously only result from a detailed analysis of both its legal and economic characteristics.

171 See Chapter 2, Section I.A.

172 The GATS contains a similar exception. However, whereas the exception under GATT Article XV:9(a) covers 'the use . . . of exchange controls or exchange restrictions in accordance with the [IMF Agreement]', the first part of GATS Article XI:2 refers to 'the use of exchange *actions* which are in conformity with the [IMF Agreement]' (emphasis added). Providing a detailed analysis of this issue would go beyond the scope of this chapter. However, it appears safe to say that, although it would have been ideal if the drafters of GATS Article XI:2 had employed the same terms as those existing in the corresponding provision under the GATT, the difference appears to be essentially one of semantics. For a thorough analysis of the exception under GATS Article XI:2, including its second part, which limits the scope of the exception with respect to certain restrictions on capital transactions, see Siegel (n 26) 596–9.

173 Siegel (n 26) 589.

174 The remainder of this paragraph is built on the excellent analysis provided by Siegel (n 26) 589–90.

175 Siegel (n 26) 586, 590.

The restrictive and non-restrictive measures that an IMF member might employ to regulate international capital movements, would amount either to an 'exchange restriction' or to an 'exchange control' measure for the purposes of GATT Article XV:9(a), although ultimately, this distinction would be irrelevant. Whereas payments and transfers for current transactions may not be restricted without the approval of the Fund (except under the transitional provisions of IMF Article XIV), IMF members have retained a vast right, according to IMF Article VI:3, to regulate international capital movements, covering both in- and outflows.[176] It is commonly accepted that this provision authorizes the regulation of international capital movements through both restrictive and non-restrictive exchange measures, both of which are covered by the term 'controls of capital transfers' as employed in the Fund's Articles.[177] Hence, the use of exchange controls and restrictions on capital in- and outflows will in most instances be perfectly consistent with the rights and obligations under the IMF Agreement and will benefit from the exception under GATT Article XV:9(a).

Overall, to the extent that the various measures relied upon in order to achieve and maintain an undervalued real exchange rate amount to exchange controls and exchange restrictions in the above sense, a formal finding, by the IMF, that their use is not in accordance with the Fund's Articles would be a prerequisite for proceeding to a finding of breach under the GATT. Importantly, if the measures involved in achieving and maintaining an undervalued real exchange rate in a concrete scenario were perfectly IMF-consistent when considered in isolation, their use could still amount to a breach of the Fund's Articles if they were the constituent elements of an IMF-inconsistent policy, notably exchange rate manipulation in the sense of IMF Article IV:1(iii). The exception contained in GATT Article XV:9(a) might thus very well have the effect of introducing the inoperable 'intent' element of IMF Article IV:1(iii) into WTO dispute settlement on matters for which there exists a jurisdictional overlap between the IMF and the WTO. As a consequence, provided that the IMF were to be consulted properly under GATT Article XV:2 by the panel hearing a potential WTO dispute on the maintenance of an undervalued real exchange rate, and provided that the panel were indeed to treat the IMF's determinations as to the IMF-consistency of the contested exchange measures as a legal finding from which it cannot deviate, the chances that the panel could reach a finding of breach appear rather slim. This seems to be true independently of the viability, under WTO law, of such a claim in terms of substance, which, as analysed earlier in this chapter,[178] appears very weak anyway.

Additional complexity arises from the fact that the exception under GATT Article XV:9(a) is introduced by the words 'Nothing in this Agreement'. There is

[176] For detail on this point, see François Gianviti, 'The IMF and the Liberalization of Capital Markets' (1997) 19 *Houston Journal of International Law* 773, 775–6.

[177] See, eg, Lastra (n 20) 396; Siegel (n 26) 590; and Cynthia Lichtenstein, 'International jurisdiction over international capital flows and the role of the IMF: plus ça change . . . ' in Mario Giovanoli (ed), *International Monetary Law—Issues for the New Millennium* (OUP, Oxford 2000) 61, 66.

[178] See Section II.A above.

no doubt that prior to the entry into force of the WTO Agreement on 1 January 1995, the words 'this Agreement' in GATT Article XV:9(a) referred exclusively to the GATT 1947, which at the time was the only multilateral agreement on trade in goods. Since the WTO came into being, however, the body of multilateral WTO rules on trade in goods emerges from 13 different agreements on trade in goods included in Annex 1A of the WTO Agreement, with the GATT 1994 being only one of them.

None of the other 12 multilateral agreements on trade in goods contains a provision similar to the one in GATT Article XV:9(a) aimed at avoiding a conflict of rights and obligations of members common to both the IMF and the WTO for areas of jurisdictional overlap. What some of the other 12 agreements do, is incorporate, by reference, parts or all of the exceptions under the GATT;[179] most of the agreements, however, are entirely silent on the issue. A crucial question has thus arisen: despite being introduced by the words 'Nothing in this Agreement', would the exception under GATT Article XV:9(a) apply to potential violations under other multilateral agreements on trade in goods contained in Annex 1A of the WTO Agreement, including those—notably the ASCM—that are silent on the question of whether any of the GATT exceptions apply to the rights and obligations under that specific agreement?

It has been suggested elsewhere that the Declaration on the Relationship of the World Trade Organization with the International Monetary Fund (Declaration on the WTO–IMF Relationship)[180] provides sufficient relief to this dilemma.[181] After noting the 'close relationship' between the Contracting Parties to the GATT 1947 and the Fund, and the provisions of the GATT 1947 governing that relationship, especially GATT Article XV, that Declaration:

> reaffirm[s] that, unless otherwise provided for in the Final Act, the relationship of the World Trade Organization with the International Monetary Fund, with regard to the areas covered by the Multilateral Trade Agreements in Annex 1A of the WTO Agreement, will be based on the provisions that have governed the relationship of the Contracting Parties of the GATT 1947 with the International Monetary Fund.

In light of the hierarchy of the sources of the WTO legal framework, it would no doubt be problematic to maintain that a simple ministerial declaration has the effect of modifying the substantial scope of the rights and obligations contained in the multilateral trade agreements in Annex 1A of the WTO Agreement. It is broadly accepted that the WTO's various ministerial decisions and declarations, though being integral parts of the WTO's Final Act, do not generate specific rights

[179] Eg Article 3 of the Agreement on Trade-Related Investment Measures provides: 'All exceptions under GATT 1994 shall apply, as appropriate, to the provisions of this Agreement' (Agreement on Trade-Related Investment Measures [hereinafter TRIMS] (15 April 1994), WTO Agreement, Annex 1A, in *Legal Texts* (n 103) 143).

[180] Declaration on the Relationship of the World Trade Organization with the International Monetary Fund [hereinafter Declaration on the WTO-IMF Relationship] (15 April 1994), in *Legal Texts* (n 103) 391. This ministerial declaration is an integral part of the Final Act embodying the results of the Uruguay Round.

[181] See Siegel (n 26) 594.

and obligations for WTO Members that could be enforced through dispute settlement.[182] This does not mean, however, that the Declaration on the WTO–IMF Relationship is legally irrelevant. The Declaration would still have to be taken into account as an important element in the interpretation, under the rules of the Vienna Convention on the Law of Treaties (VCLT),[183] of any WTO rule that concerns the WTO–IMF relationship with respect to the matters covered by the multilateral agreement on trade in goods contained in Annex 1A of the WTO Agreement—most notably, GATT Article XV:9(a).

Prior to embarking on the interpretative process under the detailed rules of the VCLT, it is crucial to recall that, according to Article II:4 of the WTO Agreement, the GATT 1994 is legally distinct from the GATT 1947. The latter ceased to exist on 31 December 1995, ie one year after the WTO came into being. Although it incorporates by reference the provisions of the GATT 1947 (according to paragraph 1(a) of the introductory text of the GATT 1994), the GATT 1994, in its entirety, entered into force as a new agreement on 1 January 1995,[184] together with all other multilateral agreements contained in Annexes 1, 2, and 3 of the WTO Agreement as integral parts of that treaty. As a consequence, interpretation of the terms of those provisions of the GATT 1994 that were previously enshrined in the GATT 1947 does not necessarily have to reach the same result, since these provisions re-entered into force as part of a new treaty, with additional elements having to be taken into account for their interpretation. Furthermore, under the WTO legal framework, the GATT 1994 constitutes the *lex generalis* on trade in goods. Both the GATT 1994 and the other multilateral agreements on trade in goods, though being enshrined in different agreements, have to be read as complementing each other.[185] It is only when a provision of the GATT 1994 stands in open conflict to a provision contained in one of the other 12 multilateral agreements on trade in goods that the latter will prevail[186]—independent of whether it constitutes the more specific provision.

In light of the above, there is little doubt that the requirement for the WTO to consult with the Fund in exchange matters as enshrined in GATT Article XV:2 applies in the same manner across all 13 multilateral agreements on trade in goods, since none of the latter contains a provision that would stand in conflict with GATT Article XV:2 as the general rule governing the WTO–IMF relationship concerning trade in goods. The Declaration on the WTO–IMF Relationship supports this interpretation. As alluded to earlier, regarding the general exception

[182] See van den Bossche (n 103) 53.

[183] Vienna Convention on the Law of Treaties [hereinafter VCLT], opened for signature 23 May 1969, 1155 UNTS 331. The VCLT entered into force on 27 January 1980, and, as of 15 April 2013, has been ratified by 113 states.

[184] With respect to the provisions contained in GATT Article XIX and those in the Agreement on Safeguards, this point has been explicitly confirmed by the Appellate Body in the dispute *Argentina—Footwear (EC)*. (WTO Appellate Body Report, *Argentina—Safeguard Measures on Imports of Footwear (Argentina—Footwear (EC))*, WT/DS121/AB/R, adopted 12 January 2000, para 81).

[185] See van den Bossche (n 103) 47–8.

[186] According to the general interpretative note to Annex 1A of the WTO Agreement quoted above (n 103).

in GATT Article XV:9(a), matters are more complicated since this exception is introduced by the words 'Nothing in this Agreement'. However, as will be elaborated below, sticking to a literal reading of these terms does not seem appropriate in light of the rules set forth in the VCLT.

As determined by VCLT Article 31.1, '[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose'. Further, according to VCLT Article 31.2(a), '[t]he context for the purposes of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes[,] any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty'. It is precisely under VCLT Article 31.2(a), ie as context, that the Declaration on the WTO–IMF Relationship comes into play, since that Declaration reaffirms, with explicit reference to GATT Article XV, that the provisions that have governed the GATT–IMF relationship should also govern the WTO–IMF relationship with respect to all 13 multilateral agreements on trade in goods contained in Annex 1A of the WTO Agreement.[187] This clearly supports the view that, for the purposes of GATT Article XV:9(a), the terms 'in this Agreement' should be read as referring to the entire body of multilateral WTO rules on trade in goods, and this despite the fact that these rules emerge from 13 different agreements. The object and purpose of the GATT with respect to GATT Article XV, namely to avoid inconsistent rights and obligations for members common to both the IMF and the WTO, further sustains such a broad reading of the terms 'in this Agreement' in GATT Article XV:9(a).

Adopting the contrary position, ie limiting the availability of the exception in GATT Article XV:9(a) exclusively to obligations under the GATT, would lead to the paradoxical situation where the consultation requirement under GATT Article XV:2, but not the related exception, would apply with respect to exchange matters dealt with, for example, under the ASCM. The obligation for the WTO, under GATT Article XV:2, to accept the determination of the Fund as to whether action by a WTO member in exchange matters is in accordance with the Fund's Articles would be rendered meaningless if an IMF-consistent exchange measure could still be found to violate a provision under any of the multilateral trade agreements that do not explicitly incorporate the exceptions enshrined in the GATT. Such an interpretation would run counter to the principle in VCLT Article 31.1 that treaties be interpreted in good faith, as well as to the principle of effective treaty interpretation requiring that a treaty be interpreted in a manner that gives effective meaning to each of its provisions.

If one now has recourse to supplementary means of interpretation according to VCLT Article 32, either to confirm the interpretation that the terms 'in this Agreement' in GATT Article XV:9(a) have to be read in a broad manner or to determine their meaning if one considers that the interpretation under VCLT Article 31 leaves their meaning ambiguous, it is of utmost importance to take into

[187] For background information on the discussions leading up to the inclusion of the Declaration on the WTO–IMF Relationship into the Final Act supporting this view, see Siegel (n 26) 594.

account the circumstances under which the GATT 1994 came into being. If the drafters of the WTO Agreement chose the intricate way of incorporating by reference the provisions of the GATT 1947 into the GATT 1994 instead of negotiating an entirely new text, they did so in order keep a lid on the many contentious issues relating to the interpretation and application of GATT provisions.[188] This weakens the view that the reference to 'in this Agreement' in GATT Article XV:9(a) should be read as reflecting the intention of the drafters of the WTO Agreement to limit the availability of this exception to GATT provisions only. Contrary to, eg, the reference to 'this Agreement' in TRIMS Article 3, the terms 'in this Agreement' in GATT Article XV:9(a) are not the deliberate result of negotiation during the Uruguay Round; they were merely carried over from the former GATT, ie from an agreement that, at its time, contained the entire set of multilateral rules on trade in goods.

Overall, a holistic interpretation under the rules of the VCLT, strongly supports the view that the exception enshrined in GATT Article XV:9(a) is applicable to all 13 multilateral agreements on trade in goods in Annex 1A of the WTO Agreement unless one of these agreements explicitly excludes this applicability, which is not the case. It still remains, that the issue has not yet been subject to WTO dispute settlement. Whether a panel would interpret the terms 'in this Agreement' as suggested above is impossible to predict. All this creates legal uncertainty for potential WTO disputes involving a jurisdictional overlap between the IMF and the WTO, as would be the case with a dispute on the maintenance of an undervalued real exchange rate.

3. Role and legal value of GATT Article XV:4—an independent basis for a WTO claim?

The third source of ambiguity in GATT Article XV is its paragraph 4 and concerns the twofold question whether this provision prevails over GATT Article XV:9(a) as *lex specialis* and could serve as an independent basis for a WTO claim.[189] GATT Article XV:4 and its *Ad* note read as follows:

> [Members] shall not, by exchange action, frustrate* the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the [IMF Agreement].
>
> *Ad Article XV:4*
>
> The word 'frustrate' is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article.

[188] Van den Bossche (n 103) 45.

[189] The existing literature on GATT Article XV:4 is rather sparse. Detailed analyses of relevant aspects of this provision can be found in Jorge Miranda, 'Currency Undervaluation as a Violation of GATT Article XV(4)' in Simon J Evenett (ed) (n 2) 115; and John H Jackson, *World Trade and the Law of GATT* 479–91 (Bobbs-Merrill, Indianapolis 1969). See also Ahn (n 113) 139–42; Bacchus and Shapiro (n 114) 11–13; Herrmann (n 113) 46–8; Hufbauer, Wong, and Sheth (n 113) 16–20; Mercurio and Leung (n 113) 1285–93; Proctor (n 24) 599–601; Charles Proctor, 'USA v China and the Revaluation of the Renminbi: Exchange Rate Pegs and International Law' (2006) 17 *European Business Law Review* 1333, 1348–9; and Siegel (n 26) 591–2.

> Thus, a contracting party which, as part of its exchange control operated in accordance with the [IMF Agreement], requires payment to be received for its exports in its own currency or in the currency of one or more members of the [IMF] will not thereby be deemed to contravene Article XI or Article XIII. Another example would be that of a contracting party which specifies on an import licence the country from which the goods may be imported, for the purpose not of introducing any additional element of discrimination in its import licensing system but of enforcing permissible exchange controls.

In order to understand this provision, one must take into account the circumstances under which it was included in the GATT. As explained by John Jackson in his seminal treatise on the GATT,[190] the drafters of the GATT, particularly the American delegates, found it important to include in the GATT some degree of protection against the use, for protectionist purposes, of par-value manipulation and of exchange controls and restrictions, ie of exchange action in a broad sense. They therefore included paragraph 4 and some other provisions in GATT Article XV. They did so despite the fact that the IMF Agreement, containing explicit provisions to prevent the abuse of monetary practices for trade purposes, had already entered into force when the GATT was drafted in 1946–47. However, not all Contracting Parties of the GATT were also members of the Fund. It is for this reason that GATT Article XV was not only drafted to coordinate the interaction between the GATT and the IMF, but also, as put by Jackson, 'to establish an independent basis for certain obligations to cover those GATT parties that were not Fund members'.[191]

In the complex legal framework of GATT Article XV, paragraph 4 appears to fulfil the following function. According to paragraph 6 of that Article, any WTO member that is not yet a member of the Fund shall join it within a time to be agreed by the WTO after consultation with the Fund. However, in case that member fails to join the Fund, or in case its Fund membership ends, it shall enter into a so-called 'special exchange arrangement' with the WTO, which would thereupon become an integral part of its WTO obligations. Paragraph 7(a) determines that such a special exchange arrangement 'shall provide to the satisfaction of the [WTO] that the objectives of [the GATT] will not be frustrated as a result of action in exchange matters' by any WTO member that is not subject to the obligations of the IMF Agreement. Paragraph 4, which is framed as an obligation applicable to all WTO members, independent of IMF membership, establishes a similar obligation, but covers also the potentially extended periods of time during which a special exchange arrangement between the WTO and a member that is not yet, or no longer, member of the Fund does not exist.[192]

In light of this special role (particularly relevant during the early years of the former GATT) fulfilled by GATT Article XV:4 in the broader WTO legal framework, it appears uncertain whether this provision could serve as an independent basis for a claim against the maintenance of an undervalued real exchange rate;

[190] Jackson (n 189) 479.
[191] Jackson (n 189) 482.
[192] Jackson provides a highly insightful account of the tedious process in the early GATT years to conclude such special exchange arrangements. See Jackson (n 189) 486–91.

even more so in a dispute between two WTO members, like China and the US, that are both also members of the IMF. In the absence of a single panel decision on the matter, the issue remains necessarily somewhat speculative, but it seems that the above-cited explanatory *Ad* Note can be read convincingly in a way that sheds light on this question.

Ad Article XV:4 explicitly states that the word 'frustrate' in GATT Article XV:4 indicates that 'infringements of the letter of any Article [of the GATT] by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article'. This means that in order for an exchange measure to be found to breach the GATT there needs to be, in the first place, a violation of the letter of a specific GATT rule.[193] As a consequence, it emerges from Article XV:4 that a WTO member, independent of whether it is a member of the Fund, cannot be found to violate a GATT provision for employing exchange measures (both IMF-consistent and inconsistent ones) that infringe upon the literal meaning of that specific GATT provision, but that do not run counter to its intent, in a way similar to the two examples given by the *Ad* note to Article XV:4. Hence, GATT Article XV:4, read together with its *Ad* note, seems to have the effect of narrowing, and not of broadening, the possibilities for seeking legal relief under the GATT against contested exchange action understood in a wide sense. This is due to the fact that, under the effect of GATT Article XV:4, no literal infringement, by exchange action, of another GATT provision will amount to a violation. It appears therefore appropriate to conclude that a legal claim against the maintenance of an undervalued real exchange rate could not be based on an alleged violation of GATT Article XV:4 alone.

Furthermore, it has not yet been clarified in the context of dispute settlement[194] whether GATT Article XV:4 would prevail as *lex specialis* over the exception under Article XV:9(a) or vice versa.[195] The reference in GATT Article XV:9(a) to 'exchange controls or exchange restrictions in accordance with the [IMF Agreement]' certainly seems to be more specific than the broad reference, in GATT Article XV:4, to 'exchange action' without further specification.[196] However, in the absence of a formal interpretation of the issue some degree of uncertainty persists. As recalled by Jackson, a special subgroup to the Ninth Session of the GATT Contracting Parties (1954–55) noted that the relationship between paragraphs 4

[193] This point of view is shared by large parts of the literature. See, eg, Hufbauer, Wong, and Sheth (n 113) 19; Koops (n 113) 10; and Trachtman (n 113) 128–9.

[194] Jackson discusses a GATT case of 1952 where the issue arose without being decided. See Jackson (n 189) 483–5.

[195] In the dispute *Dominican Republic—Import and Sale of Cigarettes*, one of the third parties, China, had expressed her hope that the Panel would provide clarification on the relationship between GATT Articles XV:4 and XV:9(a), but the Panel did not address this issue at all in its findings (WTO Panel Report, *Dominican Republic—Measures Affecting the Importation and Internal Sale of Cigarettes (Dominican Republic—Import and Sale of Cigarettes)*, WT/DS302/R, adopted 19 May 2005, modified by Appellate Body Report, WT/DS302/AB/R; see Panel Report, paras 5.56–5.58).

[196] See Siegel (n 26) 591.

and 9 of GATT Article XV was troublesome, but it decided not to lay down general principles on this problem.[197]

After the detailed trade law analysis provided in this second part, the final part of this chapter will look into a few overarching conceptual issues as well as into the issue of global current account imbalances—the underlying challenge to systemic stability as exposed by the phenomenon of exchange rate misalignment.

III. Overarching Conceptual Issues and the Underlying Challenge to Systemic Stability

This final part considers the conceptual differences between the IMF and WTO legal frameworks and their implications (Section A) before putting into perspective the G-20's ongoing efforts to reduce global current account imbalances (Section B).

A. The conceptual differences between the IMF and WTO legal frameworks and their implications

When reflecting on a potential reform of the Fund's code of conduct it is very important to take into account that the legal nature of the rights and obligations flowing from the WTO agreements on the one side, and the IMF Agreement on the other, is fundamentally different. Taking these differences and their systemic implications into account is not only helpful in respect of the legal treatment of exchange rate manipulation for competitive purposes, which obviously bridges the domains of trade and money, it also provides valuable insights of broader relevance.

It is commonly accepted that the rights and obligations created by the WTO agreements flow horizontally, ie between WTO members.[198] Therefore, whenever a WTO member breaches a specific obligation under one of the WTO agreements, its trading partners have a legal claim against the state that imposed that measure since their individual legal rights under international law have been violated. The WTO's elaborated dispute settlement procedure, providing WTO members with the possibility to seek withdrawal of contested measures, can be regarded as a logical consequence of that horizontal nature of the rights and duties created by the WTO agreements.

The situation at the IMF is distinctly different. The rights and obligations set forth in the Fund's Articles exist only as between every IMF member and the Fund as an institution, and not horizontally between IMF members.[199] This vertical flow

[197] For detail on this point, see Jackson (n 189) 485–6.

[198] In addition, there are some obligations that flow vertically between the WTO as an institution and its members, eg, the obligation for WTO members under ASCM Article 25 to notify to the WTO on a yearly basis the entire set of subsidies that fall within the scope of ASCM Article 1.1. Although these notification requirements are important, they are of minor significance compared to the major obligations under the WTO agreements that flow only between WTO members.

[199] This position has always been adhered to by the Fund itself and has been defended in large parts of the literature. See, eg, Kern Alexander, Rahul Dhumale, and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risks* (OUP, Oxford 2006) 89, 90.

of rights and obligations has major consequences. For example, the obligation for IMF members under IMF Article IV:1(iii) not to manipulate their exchange rates in order to gain an unfair competitive advantage over other members is owed by each IMF member to the Fund as an institution, but not to other members bilaterally. As a consequence, violations of the IMF Agreement do not give rise to legal claims for individual IMF members against each other. It is therefore important that there are clear-cut mechanisms to ensure that the Fund's governing body becomes aware of instances of alleged breach. According to rule K-1 of the IMF's By-Laws, Rules and Regulations,[200] the Fund's Managing Director is required to bring instances of breach of obligation to the Executive Board. In addition, any individual executive director may at any time bring a complaint to the attention of the Executive Board, or the board itself may raise the matter. In practice, however, this appears to have happened only rarely.[201]

Hence, the fact that the IMF does not possess an elaborated dispute settlement mechanism appears in a different light. As mentioned earlier,[202] the possible sanctions provided for in IMF Article XXVI:2 are limited to three: ineligibility to use the Fund's resources, suspension of voting rights, and expulsion from the Fund. As also noted, actually imposing these sanctions is an economically and politically very sensitive issue. The draconian options under IMF Article XXVI:2 are obviously not the only means at the Fund's disposal to ensure that its members comply with their obligations. As analysed in detail earlier,[203] the three pillars of the Fund's toolset—conditionality, surveillance, and technical assistance—give the Fund many subtle possibilities, combined with peer pressure, to motivate a member to change a contested policy without even having to formally prove a breach of obligation by that member.[204]

Interestingly, the above view concerning the verticality of rights and obligations flowing from the IMF Agreement is not unanimously shared. Proctor, for example, notes:

> It is true that the [Fund's] Articles provide the Fund itself with certain sanctions against the member country in default, but this does not necessarily lead to the conclusion that other member countries are deprived of the rights and remedies usually available to them following the breach of a treaty by another party [eg the right to apply proportionate countermeasures against the party in default]. It may . . . be argued that membership of an international organization involves a mutuality of rights and obligations among the member countries, which should themselves be enforceable by the members individually[,] [this right being based upon an analogy with the position of shareholders in a private company].[205]

[200] IMF, *By-Laws, Rules and Regulations*, Rule K-1 (58th edn, IMF, Washington DC 2001).
[201] Siegel (n 26) n 14. [202] See Section I.B above.
[203] See Chapter 2, Part II, of this monograph.
[204] For a brief assessment of the Fund's role as enforcer of the international law of exchange arrangements, see, eg, Robert M Barnett, 'Exchange Rate Arrangements in the International Monetary Fund: The Fund as Lawgiver, Adviser, and Enforcer' (1993) 7 *Temple International and Comparative Law Journal* 77, 89–92.
[205] Proctor (n 24) 589–90, footnotes omitted (relevant context reflected in square brackets).

The idea of such a mutuality of rights and obligations, enforceable by IMF members individually, may be appealing at first sight, but it has to be dismissed for the following reasons. Firstly, such a point of view is clearly contrary to what the IMF itself, speaking for the community of its members, has always claimed. Secondly, the lack of an IMF-internal dispute settlement mechanism supports the view that the IMF's founding members did not see the need to provide for such a mechanism, due to the fact that breaches of the IMF Agreement do not give rise to legal claims for individual members anyway. Thirdly, one could argue that the Fund as an institution—thanks to its regular dialogue with every single one of its members—possesses the best information to intervene in an appropriate manner whenever action by one of its members threatens the stability of the global monetary system. Finally, and most importantly, by becoming a member of an international organization, states renounce on their right to take unilateral sanctions for matters that are now being regulated multilaterally, unless the international organization expressly provides for the possibility of acting unilaterally, as does the WTO with respect to unilateral trade remedies. The catalogue of sanctions in IMF Article XXVI:2 is exhaustive; it does not provide IMF members with the possibility of taking unilateral countermeasures. Hence, contrary to the view advanced by Proctor above, any attempt by an IMF member to impose unilateral sanctions based on an alleged violation of the IMF Agreement would have to be regarded as an outright breach of international law.

Another major conceptual difference between the WTO legal framework and the IMF's code of conduct concerns the manner how, if at all, the motives underlying a contested policy or measure are taken into account. On the WTO's side, when deciding whether a WTO member has breached a specific WTO rule, the competent panel will only be interested in examining the objective effects of a clearly identifiable governmental measure. The intention behind the contested measure is irrelevant for this assessment. It therefore seems appropriate to regard obligations under the WTO agreements, for example the prohibition of export subsidies or the national treatment principle under GATT Article III, as international 'obligations of result'.

By contrast, as pointed out earlier in this chapter,[206] under the IMF's code of conduct in IMF Article IV:1, the 'intent' with which IMF members pursue specific policies or take specific actions plays a much greater role. The outstanding example is obviously Article IV:1(iii). As elaborated in detail above,[207] finding an IMF member in breach of this provision does not even require that that member effectively managed to prevent balance of payments adjustment or that it gained a measurable competitive advantage through exchange rate manipulation. It is the intention to engage in certain beggar-thy-neighbour policies that is prohibited, independent of the extent to which the member succeeds in achieving the unfair results it is aiming for.[208] Hence, it appears appropriate to qualify not only the 'soft' obligations regarding 'domestic' policies under IMF Article IV:1(i) and (ii) as

206 See Sections I.A and I.B above.
207 See Section I.B above.
208 Gianviti (n 28) 126.

international 'obligations of conduct' as noted earlier in this chapter,[209] but also the seemingly 'hard' obligation under IMF Article IV:1(iii), at least in its current form.

These contrasting IMF and WTO standards can be coherently commented on as follows. On the one hand, its much stronger focus on conduct enables the IMF, at least in theory, to intervene at an earlier stage than the WTO in order to safeguard systemic stability. It does not have to wait until exchange rate policies or misguided economic and financial policies of one of its members negatively affect the stability of the international monetary system before stepping in with advice on adjustments. This might indeed be regarded as crucial since, as explained above, IMF members will never have a legal claim against each other based on an alleged violation of the IMF Agreement. In order to avoid conflicts between IMF members, and to limit the temptation for each of them to have recourse to unilateral sanctions, it is vital that the IMF is able to push its members, more or less gently, in the direction of necessary policy adjustments before the contested measures harm other members or the international monetary system as a whole.[210] On the other hand, however, the fact that most obligations under the IMF's code of conduct are framed as rather soft 'obligations of conduct' expresses a much greater degree of deference in respect of domestic regulatory autonomy or, in other words (according to the classical understanding), to the sovereignty of states than is the case under the WTO Agreement.

Taking into account that the overarching focus of the code of monetary conduct in IMF Article IV:1 is to preserve the stability of the international monetary system there is little doubt that achieving this objective depends on both domestic and external policies. Economic history is replete with examples where bad domestic economic policies have led to major economic crises with contagious effects for entire regions. As emphasized by the Fund in the latest overhaul of its surveillance mechanism, in order to ensure systemic stability through promotion, by each member, of balance of payments and domestic stability, the Fund will advise its members on necessary adjustments not only of their respective exchange rate policies but also of their domestic economic and financial policies.[211] In light of the above, the fact that IMF members opted nevertheless for a soft, 'best efforts' language for IMF Article IV:1(i) and (ii) and decided to render Article IV:1(iii) essentially inoperable (due to its focus on 'intent') is indeed best explained as having been guided by the wish to interfere with core domestic affairs only to the extent that this is necessary for ensuring the stability of the international monetary system.

[209] See Section I.A above.

[210] The situation at the WTO is distinctly different: here, the focus is put on ensuring that WTO members do not engage in trade-distortive measures with respect to other members, ie in measures that put another member at a competitive disadvantage without this having any immediate impact on the stability of the economic system as a whole. In addition, WTO members know that if another member breaches a specific WTO rule they will not only have a legal claim against that country, but will also be able to rely on an efficient dispute settlement mechanism to seek legal redress. Hence, contrary to what is the case with the international monetary system, it could be argued that the WTO can afford to wait until specific measures show adverse effects before providing clarification on a contested issue via its dispute settlement mechanism.

[211] As analysed in detail in Section I.B above.

By contrast, the WTO legal framework, with its strictly result-oriented approach, does not treat policies differently depending on their more domestic or external nature. This should not surprise. The primary focus of the WTO legal framework is to achieve an increasing liberalization of international trade through regular renegotiations of mutual trade concessions. When negotiating the GATT, and later the WTO agreements, the treaty parties appear to have accepted, on a mutual basis, a stronger interference of international trade law with traditionally sovereign policy domains. In other words, states have granted each other increased market access for the price of stronger scrutiny of their domestic policies.

The conceptual characteristics distinguishing the legal framework of the IMF from that of the WTO arise above all from the fact that the two institutions were designed, from the outset, to serve distinctly different purposes. Hence, it might be appropriate to regard the apparent deficits of the Fund's code of conduct not primarily as the result of bad treaty drafting, but as the result of a fundamental choice made by the IMF's membership. Whether, several decades later, the time is ripe to seek the necessary majority[212] among IMF members for an update of IMF Article IV, in order to turn it into an effective legal provision for fostering systemic stability, appears uncertain and cannot be answered in this chapter which now turns its attention to the ongoing efforts of the international community to tackle the true underlying challenge—global current account imbalances.

B. *The G-20's ongoing efforts to reduce global current account imbalances put into perspective*

Despite the 2007 and 2012 reforms of the Fund's bilateral surveillance mechanism it seems unlikely that the eventual solution to a sophisticated scenario of exchange rate manipulation—notably, the maintenance of an undervalued real exchange rate as part of a strategy of export-led growth—will result from a formal application of the rules enshrined in the IMF Agreement. As analysed in detail above,[213] neither multilateral nor unilateral trade remedies appear to be viable options either. Instead, to the extent that its members increasingly perceive the IMF as either unable or unwilling to ensure that all of its members fully respect IMF Article IV:1 as the key provision of the Fund's code of conduct, the determination of state leaders to

[212] Contrary to the vast majority of international treaties, unanimity among IMF members is not required in order to amend most provisions contained in the Fund's Articles. Once a proposal to amend the IMF Agreement has been approved by the Fund's Board of Governors by a majority (according to IMF Article XII:5(c)) of the votes cast (the number of votes each member has depends on its quota), the Fund will, according to IMF Article XXVIII(a), 'ask all members whether they accept the proposed amendment. When three-fifths of the members, having eighty-five per cent of the total voting power have accepted the proposed amendment, the Fund shall certify the fact by a formal communication addressed to all members'. However, as stated by IMF Article XXVIII(b), acceptance by all members is required for any amendment modifying the right to withdraw from the Fund (as specified in IMF Article XXVI:1) and the provision that a member's quota shall not be changed without its consent (Article III:2(d)).

[213] See Part II of this chapter.

bypass the IMF and to resolve the issue by diplomacy and political power play can be expected to rise.

Former French President Nicolas Sarkozy, in particular, chairing both the G-8 and G-20 in 2011, pushed for a diplomatic deal that would bypass the IMF, recalling to some extent what happened at the time leading up to the Plaza Agreement in 1985. Aiming to bring China to the negotiating table over currencies during his G-20 presidency, Mr Sarkozy was reported to be planning to bring together finance ministers, central bankers, and prominent economists from G-20 members in order to discuss issues like the level of foreign exchange reserves or the possibility of a new currency or basket of currencies that could compete with the USD in international trade.[214]

It seems highly likely that if China continues to make progress on its path towards a gradual, yet substantive, revaluation of the RMB on which it embarked in June 2010 as discussed at the very beginning of this chapter,[215] all current proposals for unilateral trade remedies, currency roundtables, and the accompanying anti-China rhetoric, will fade away. However, even if an open clash between major economies such as China, the US, Japan, and Brazil were to be avoided, it would still be very important for the long-term stability of the international monetary system that the deficits of the IMF's code of conduct in IMF Article IV:1 and the persisting ambiguities arising from GATT Article XV, as analysed in this chapter, be properly addressed by the international community.

Merely rewriting IMF Article IV:1(iii), so as to outlaw any manipulation of exchange rates that has the effect of creating a competitive disadvantage for other members or to prevent effective balance of payments adjustment, would not decisively change the current problem. It seems plausible to assume that even under a thus modified rule the Fund would not proceed to a formal finding of breach immediately after having established that one of its members is manipulating its exchange rate in a way that produces one or several outlawed results. Instead, the Fund would most likely put the member concerned on notice of its assessment and grant it a reasonable period of time to rectify its policies prior to proceeding to a formal finding of breach. Although such a finding of breach would not involve any formal showing of intent to harm another member, it would be obvious to everyone that the member concerned, having refused to change its policies despite having been put on notice of their negative effects, deliberately accepted these effects. Interestingly, the IMF could proceed in precisely this manner already under the existing legal framework in order to prove 'intent' in the sense of IMF Article IV:1 (iii).[216] Hence, the legal situation under a formally 'objectified' Article IV:1(iii) would be essentially the same as today—with the same economic measurement difficulties and the same difficulty for the Fund to pronounce a finding of breach against a politically and economically powerful member.

214 David Gauthier-Villars, 'Sarkozy Seeks Lift to Image Via China', *Wall Street Journal* (online edition, 2 October 2010) <http://online.wsj.com/article/SB10001424052748704029304575526213233997540.html> accessed 1 July 2013.

215 See above n 2.

216 See Gianviti (n 28) 132.

Nor would it make sense to prohibit any type of exchange rate manipulation independent of its effects. Doing so would run counter to the fundamental choice made by IMF members with the Second Amendment of the Fund's Articles, namely to abandon the former par-value system of fixed exchange rates and to provide IMF members with greater flexibility in the conduct of their respective exchange rate policies. By definition, several of the exchange arrangements recognized by the IMF[217]—notably, the maintenance of an exchange rate peg or a managed float—require more or less frequent interventions aimed at, and actually affecting the exchange rate, ie exchange rate manipulation as defined by the Fund.

Without ignoring the tedious modalities and uncertain outcome of seeking agreement among IMF members on such a controversial issue, it might make more sense to tackle the current inoperability of Article IV:1(iii) as part of a more fundamental reform of the Fund's code of conduct. Focusing Article IV on the avoidance of excessive global current account imbalances, requiring equal efforts by both surplus and deficit countries, would constitute a major departure from the approach that is currently being pursued by the Fund. This seems true despite the inclusion, in September 2009, of the issue of global imbalances among the economic priorities of the IMF's surveillance mechanism. Thus, according to the Fund's revised surveillance priorities for 2008–2011, surveillance aims, inter alia, to 'promote a rebalancing of sources of global demand, through both macroeconomic and structural policies, so as to achieve sustained world growth while keeping global imbalances in check'.[218] The Fund's 2011 Triennial Surveillance Review, setting forth, inter alia, operational surveillance priorities for 2011–2014, also refers to 'desirable global demand rebalancing'.[219]

With its 2012 ISD, the Fund has gone as far as it can to improve the applicable legal framework without actually amending the IMF Agreement. The Fund has defined the scope of multilateral surveillance as being determined by the obligation under IMF Article IV:3(a) to oversee the international monetary system in order to ensure its effective operation. According to the Fund the international monetary system comprises (i) the rules governing foreign exchange arrangements and rates; (ii) the rules governing the making of payments and transfers for current international transactions; (iii) the rules governing the regulation of international capital

[217] For the exchange arrangements explicitly recognized by the Fund as being consistent with the IMF Agreement, see n 22 above.

[218] IMF, Decision No 14436-(09/102),'Statement of Surveillance Priorities—Revisions of Economic Priorities and Progress on Operational Priorities' (25 September 2009), in *Selected Decisions* (n 47) 48, 49 available at <http://www.imf.org/external/pubs/ft/sd/index.asp?decision=14436-(09/102)>. See also IMF, 'IMF Executive Board Revises Surveillance Priorities for 2008–2011', Press Release No 09/336 (29 September 2009) <http://www.imf.org/external/np/sec/pr/2009/pr09336.htm> (both accessed 1 July 2013).

[219] IMF, '2011 Triennial Surveillance Review—Overview Paper', Policy Paper Prepared by the Strategy, Policy and Review Department (29 August 2011) para 9 <http://www.imf.org/external/np/pp/eng/2011/082911.pdf>.

See also IMF, 'IMF Executive Board Reviews Surveillance: Making IMF Surveillance as Interconnected as the Global Economy', PIN No 11/130 (31 October 2011) <http://www.imf.org/external/np/sec/pn/2011/pn11130.htm> (both accessed 1 July 2013).

flows; and (d) the arrangements under which international reserves are held.[220] The 2012 ISD explicitly singles out persistent current account imbalances as one of several potential 'symptoms of malfunction' indicating that the international monetary system may not be operating effectively. As explained by the 2012 ISD:

> The international monetary system is considered to be operating effectively when the areas it governs do not exhibit *symptoms of malfunction such as, for example, persistent significant current account imbalances*, an unstable system of exchange rates including foreign exchange rate misalignment, volatile capital flows, the excessive build up or depletion of reserves, or imbalances arising from excessive or insufficient global liquidity. It is recognized that, typically, the international monetary system may only operate effectively in an environment of global economic and financial stability, and that its effective operation contributes to such stability. Both global economic and financial stability and the effective operation of the international monetary system may be affected by, among other factors, members' own balance of payments and domestic stability, economic and financial interconnections among members' economies and potential spillovers from members' economic and financial policies through balance of payments and other channels.[221]

Yet, as rightly stressed by Gianviti,[222] even if certain domestic economic and financial policies pursued by a country with a balance of payments deficit are at least partly responsible for its deficit,[223] these policies will not be formally called into question by the IMF as long as they are considered to promote domestic stability. This remains true even after the 2007 and 2012 revisions of the Fund's surveillance mechanism. At the same time, and this reveals the full dimension of the problem, today's international monetary system has been rightly criticized for its lack of effective discipline on surplus countries.[224] Hence, under their current shape, the Fund's code of conduct under IMF Article IV:1 and its surveillance mechanism do not even get close to the theoretical ideal of requiring equal efforts from both surplus and deficit countries in achieving a rebalancing of the global economy.[225]

[220] IMF, ISD (n 49) para 10. It should be noted in this context that the Fund has always drawn a distinction between the international *financial* system and the international *monetary* system, the latter being explicitly defined in the 2012 ISD. What this implies for the limits and the evolution of the Fund's mandate and whether such an overly technical distinction makes still sense at a time of great economic interdependence within the international monetary and financial system, will be addressed in detail in the final chapter of this monograph. See Chapter 5, Section III.

[221] IMF, ISD (n 49) para 11, emphasis added.

[222] Gianviti (n 28) 137.

[223] Gianviti mentions high interest rates as an example of such a policy by a deficit country. Imposed in order to achieve domestic stability through controlling inflation and reducing the fiscal deficit, high interest rates will attract foreign capital, thus leading to an appreciation of the domestic currency. This, in turn, will negatively affect the competitiveness of domestic products (Gianviti (n 28) 137).

[224] See, eg, C Fred Bergsten, 'We Can Fight Fire with Fire on the Renminbi', *Financial Times* (3 October 2010) <http://www.ft.com/cms/s/0/070e525c-cf1d-11df-9be2-00144feab49a.html?ftcamp=rss> accessed 1 July 2013.

[225] Interestingly, the idea of equal efforts by both surplus and deficit countries in the process of global rebalancing is not entirely absent from the Fund's Articles as they currently exist. In IMF Article IV:4, which deals with a potential future shift back to a global system of stable, but adjustable par-values, the drafters of the Second Amendment of the Fund's Articles explicitly noted that the determination of whether international economic conditions permit such a reform should be made,

However, with the launch of the G-20[226] 'Framework for Strong, Sustainable, and Balanced Growth' at the G-20 Leaders Pittsburgh Summit, held on 24–25 September 2009,[227] G-20 leaders expressly recognized, inter alia, that both current account surplus and deficit countries will have to contribute to global rebalancing:

G-20 members with sustained, significant external deficits pledge to undertake policies to support private savings and undertake fiscal consolidation while maintaining open markets and strengthening export sectors.

G-20 members with sustained, significant external surpluses pledge to strengthen domestic sources of growth. According to national circumstances this could include increasing investment, reducing financial markets distortions, boosting productivity in service sectors, improving social safety nets, and lifting constraints on demand growth.[228]

At the G-20 Leaders Toronto Summit, held on 26–27 June 2010, G-20 leaders reiterated their commitment to strong, sustainable, and balanced growth, stating explicitly, inter alia, that '[a]dvanced deficit countries should take actions to boost national savings while maintaining open markets and enhancing export competitiveness', whereas '[s]urplus economies [should] undertake reforms to reduce their reliance on external demand and focus more on domestic sources of growth'.[229] As to the issue of exchange rates, an explicit statement welcoming China's policy shift[230] was dropped from the final version of the Summit Declaration, on China's request as China insisted that its exchange rate policy was a purely domestic issue.[231] Whereas a week before the summit, the Chinese exchange rate had promised to overshadow everything else, the final Summit Declaration merely stated that emerging surplus economies 'will undertake reforms tailored to country circumstances' in order to, among other things, '[e]nhance exchange rate flexibility to reflect underlying economic fundamentals'.[232]

inter alia, with particular reference 'to arrangements under which both members in surplus and members in deficit in their balances of payments take prompt, effective, and symmetrical action to achieve adjustment, as well as to arrangements for intervention and the treatment of imbalances'. Obviously, at least in the foreseeable future, such a shift back to a global system of fixed exchange rates is entirely unrealistic.

226 For a detailed analysis of the origins, the mandate, and the main initiatives of the G-20, see Chapter 5, Part I, of this monograph.

227 This G-20 initiative has been combined with a cooperative process of mutual assessment among G-20 members in consultation with the IMF and the World Bank. For detailed information, see IMF, 'The G-20 Mutual Assessment Process (MAP)' (Factsheet) (20 March 2013) <http://www.imf.org/external/np/exr/facts/g20map.htm> accessed 1 July 2013.

228 G-20 Leaders, 'Leaders' Statement: The Pittsburgh Summit' (24–25 September 2009) [hereinafter G-20 Pittsburgh Summit Declaration], G-20 Framework for Strong, Sustainable, and Balanced Growth, para 2, available at <http://www.g20.org/documents> accessed 1 July 2013.

229 G-20 Leaders, 'The G-20 Toronto Summit Declaration' (26–27 June 2010) [hereinafter G-20 Toronto Summit Declaration], paras 11–12, available at <http://www.g20.org/documents> accessed 1 July 2013.

230 As noted in more detail in the introduction to this chapter, this shift was announced only a few days before the G-20 Toronto Summit, on 19 June 2010. See n 2 above.

231 See, eg, Brian Love and David Storey, 'G20 Drops China-Sensitive Plaudits on Yuan Reform', *Reuters* (27 June 2010) <http://www.reuters.com/article/idUSTRE65Q1AQ20100627> accessed 1 July 2013.

232 G-20 Toronto Summit Declaration (n 229) Annex I [12].

Unfortunately, the following G-20 Leaders Summit, held on 11–12 November 2010 in Seoul, raised significant doubts on whether it is at all realistic to expect that state leaders will reach a consensus, anytime soon, on a formal set of rules on current account imbalances. At that summit, G-20 leaders refused to follow a proposal, brought forward by Timothy Geithner, the US Treasury Secretary, that current-account imbalances should not exceed 4 per cent of gross domestic product. Notably Germany and China, which are both running huge current account surpluses, resisted the setting of numerical targets.[233] Instead, as part of the so-called Seoul Action Plan, G-20 leaders reiterated that efforts by both surplus and deficit countries were needed to rebalance the global economy,[234] and pledged rather vaguely to develop a set of 'economic indicators' which would have to be assessed against a set of 'indicative guidelines' in order to identify 'persistently large imbalances' requiring in-depth scrutiny by the IMF. However, G-20 leaders stressed the need to accommodate 'national or regional circumstances, including large commodity producers'.[235] On exchange rates, the debate had been overshadowed by the Fed's plans for a new round of quantitative easing referred to in the introduction above.[236] In the end, G-20 leaders merely echoed earlier pledges to 'move toward more market-determined exchange rate systems and enhance exchange rate flexibility to reflect underlying economic fundamentals and refrain from competitive devaluations'.[237]

Agreement on the above-mentioned set of 'economic indicators' was reached at a meeting of G-20 Finance Ministers and Central Bank Governors, held in Paris on 18–19 February 2011. They include (i) 'public debt and fiscal deficits; [the] private savings rate and private debt' and (ii) external imbalances 'composed of the trade balance and net investment flows and transfers, taking due consideration of exchange rate, fiscal, monetary and other policies'.[238] Any explicit reference to 'current account imbalances' was avoided in the same way as the singling out of exchange rates as a specific indicator.[239] This significantly watered down the overall value of the compromise obtained. The 'indicative guidelines' against which each of these 'economic indicators' are to be assessed were agreed at a meeting

[233] See, eg, Chris Giles, Alan Beattie, and Christian Oliver, 'G20 Shuns US on Trade and Currencies', *Financial Times* (12 November 2010) <http://www.ft.com/cms/s/0/e65d6a44-ee2e-11df-8b90-00144feab49a.html> accessed 1 July 2013.

[234] G-20 Leaders, 'The Seoul Summit Document', para 12, attached to: G-20 Leaders, 'The G20 Seoul Summit Leaders' Declaration' (11–12 November 2010) [hereinafter G-20 Seoul Summit Declaration], available at <http://www.g20.org/documents> accessed 1 July 2013.

[235] G-20 Seoul Summit Declaration (n 234) para 9.1.3.

[236] See, eg, 'The Ghost at the Feast', *The Economist* (online edn, 12 November 2010) <http://www.economist.com/blogs/newsbook/2010/11/g20> accessed 1 July 2013.

[237] G-20 Seoul Summit Document (n 234) para 6.

[238] G-20 Finance Ministers and Central Bank Governors, 'Communiqué' (18–19 February 2011), available at <http://www.g20.org/documents> accessed 1 July 2013.

[239] See Ralph Atkins and Quentin Peel, 'G20 strikes compromise on global imbalances', *Financial Times* (19 February 2011) <http://www.ft.com/cms/s/0/1a12713e-3c56-11e0-b073-00144feabdc0.html> accessed 1 July 2013.

of G-20 Finance Ministers and Central Bank Governors, held in Washington DC on 14–15 April 2011.[240]

At the subsequent two G-20 Leaders Summits as well as at various meetings of G-20 Finance Ministers and Central Bank Governors, not much progress was made on this topic. Thus, at the G-20 Leaders Cannes Summit, held on 3–4 November 2011, G-20 leaders, after plainly noting that '[g]lobal imbalances persist',[241] merely reiterated their good intentions:

> We affirm our commitment to move more rapidly toward more market-determined exchange rate systems and enhance exchange rate flexibility to reflect underlying economic fundamentals, avoid persistent exchange rate misalignments and refrain from competitive devaluation of currencies . . . Our actions will help address the challenges created by developments in global liquidity and capital flows volatility, thus facilitating further progress on exchange rate reforms and reducing excessive accumulation of reserves.[242]

At the G-20 Leaders Los Cabos Summit, held on 18–19 June 2012, G-20 leaders reiterated that they 'remain[ed] committed to reduce imbalances by strengthening deficit countries' public finances with sound and sustainable policies that take into account evolving economic conditions and, in countries with large current account surpluses, by strengthening domestic demand and moving toward greater exchange rate flexibility'.[243] Stressing the particularly soft nature of their mutual commitments on this topic, they further noted:

> We welcome progress by countries with large current account surpluses to increase domestic demand and actions by countries with large current account deficits to increase national savings. Emerging surplus economies will carry out further actions to increase domestic consumption . . . while advanced surplus economies or those with relatively weak private demand will promote domestic demand . . . Higher national savings in countries with current account deficits will contribute to a lasting reduction in global imbalances.[244]

The need to take into account the special circumstances of large commodity producers in the context of reducing global imbalances was further stressed at the first meeting of G-20 Finance Ministers and Central Bank Governors under Russia's G-20 presidency, held in Moscow on 15–16 February 2013.[245]

Overall, it seems safe to observe that binding and enforceable rules on reducing global current account imbalances are no longer on the G-20's agenda, with the issue depending more or less entirely on the goodwill of state leaders to contribute

[240] G-20 Finance Ministers and Central Bank Governors, 'Communiqué' (14–15 April 2011), available at <http://www.g20.org/documents> accessed 1 July 2013.

[241] G-20 Leaders, 'Cannes Summit Final Declaration' (4 November 2011) [hereinafter G-20 Cannes Summit Declaration], para 1, available at <http://www.g20.org/documents> accessed 1 July 2013.

[242] G-20 Cannes Summit Declaration (n 241) para 12.

[243] G-20 Leaders, 'G20 Leaders Declaration' (18–19 June 2012) [hereinafter G-20 Los Cabos Summit Declaration], para 7, available at <http://www.g20.org/documents> accessed 1 July 2013.

[244] G-20 Los Cabos Summit Declaration (n 243) para 16.

[245] G-20 Finance Ministers and Central Bank Governors, 'Communiqué' (15–16 February 2013), para 2, available at <http://www.g20.org/documents> accessed 1 July 2013.

to global systemic stability by holding their respective current account deficit or surplus at a level which they individually regard as sustainable.

Conclusion

The detailed analysis provided in this chapter has shown that the interrelated issues of exchange rate misalignment, foreign exchange accumulation, and global current account imbalances continue to be extremely sensitive for most states. The rather limited degree of effective international cooperation on the crucial contemporary challenges in this field clearly reflects that the arguably outdated, classical understanding of monetary sovereignty, still largely determines policymaking when it comes to exchange rate policies and intrinsically related issues.

Yet the stakes of reforming the Fund's code of conduct in IMF Article IV are high. The paralysis of the law that arises from the current state of IMF Article IV:1 (iii), as analysed in detail in this chapter, illustrates that the IMF's relevance as guardian of the stability of the international monetary system may otherwise quickly become eroded. This seems true despite the major reforms of the Fund's surveillance mechanism undertaken in 2007 and 2012. In order to secure durable systemic stability, it may ultimately become unavoidable for the international community to agree on binding and enforceable rules on current account imbalances, requiring equal efforts from surplus and deficit countries.

As analysed in detail earlier in this monograph,[246] and contrary to the outdated classical understanding of monetary sovereignty, by agreeing to limit their respective individual regulatory autonomy in order to promote systemic stability in the light of increasing economic and financial interdependence, thereby promoting the values incorporated in monetary sovereignty as a contemporary concept, states would have to be regarded not as abandoning their monetary sovereignty, but instead as exercising it in an effective manner.

At least for the moment, however, the unpleasant truth may be that formal and enforceable international law has reached its limits with regard to the treatment of the challenges arising from exchange rate misalignment, and, intrinsically related, current account imbalances and foreign exchange accumulation. It seems therefore much more realistic to expect that, at least in the foreseeable future, the effective treatment of these issues will continue to reside firmly in the realms of informal cooperation among states as part of multi-issue political deals, with successful international cooperation occurring only when, and to the extent that, contemporary economic constraints and circumstances demand it.

Many of the issues addressed throughout this chapter call for a closer look at an increasingly widespread phenomenon, namely the increasing regionalization of monetary sovereignty. This takes us into the next chapter.

[246] See Chapter 1, Parts II and III, of this monograph. See also the related analysis provided in the following Chapter 4, Section III.C.

4

The Increasing Regionalization of Monetary Sovereignty

Introduction

Over the course of the decades since the onset of economic globalization in the 1960s, a large number of states around the world have sought increasingly strong economic integration and have embarked on paths towards creating monetary unions, eventually adopting a common currency, and thereby renouncing their right to conduct an independent monetary policy. The European Economic and Monetary Union (EMU)[1] constitutes the outstanding example of such regional integration efforts due to its economic weight and the fact that it consists not only of a fully-fledged monetary union, but also of a customs union and a common market.[2] This chapter examines a phenomenon, which it seems appropriate to refer to as the increasing regionalization of monetary sovereignty, ie the joint exercise of monetary sovereignty in a monetary union.[3] It does so by looking into a number of

[1] Consistent with the existing literature, this chapter uses the shortcut EMU exclusively as referring to the Economic and Monetary Union of the EU and not to any other economic and monetary unions existing already or being under construction in other regions of the world.

[2] It goes without saying that even though the focus of the present chapter lies on monetary union movements, various other types and degrees of regional cooperation in monetary and financial matters exist that are not aimed at leading to the creation of a fully-fledged monetary union. An outstanding example of such other types of regional cooperation is the Chiang Mai Initiative, a multilateral currency swap arrangement among the ten members of the Association of Southeast Asian Nations (ASEAN), China (including Hong Kong), South Korea and Japan. Originally set up in 2000 as a series of bilateral arrangements to create a financial safety net in the aftermath of the East Asian financial crisis, the Chiang Mai Initiative Multilateralisation Agreement (signed 28 December 2009, effective 24 March 2010) established a self-managed reserve pooling mechanism on a unified multilateral basis. At present, that mechanism commands USD 240 billion in reserves. See, eg, Hal Hill and Jayant Menon, 'Asia's New Financial Safety Net: Is the Chiang Mai Initiative Designed Not To Be Used?' (voxeu.org article, 25 July 2012) <http://www.voxeu.org/index.php?q=node/8278> accessed 1 July 2013. The recent principal agreement among the BRICS countries to establish a multilateral development bank constitutes another interesting example of a regional cooperation in monetary matters project that, if effectively realized, could challenge the influence of the IMF and the World Bank. See, eg, Andrew England, 'Brics Agree to Create Development Bank' *Financial Times* (27 March 2013) <http://www.ft.com/cms/s/0/2bcbd6e0-96e5-11e2-a77c-00144feabdc0.html> accessed 1 July 2013.

[3] This chapter will not examine earlier, loose forms of monetary unions, such as the Scandinavian Monetary Union (established in 1873 when Denmark and Sweden (then also comprising Norway) linked their currencies with a gold standard; disbanded in 1914) and the Latin Monetary Union (established in 1865 between France, Italy, Switzerland, Belgium, and, later, Greece; based on uniform standards of fineness for silver coins the respective national currencies enjoyed the status of legal tender

selected contemporary challenges, most of which have been brought to the fore by the Global Financial Crisis and the ensuing sovereign debt crisis that continues to threaten several EU member states, most notably Greece, Ireland, Portugal, Spain, and Cyprus. The EMU serves as the principal, yet not exclusive, object of investigation for the analysis provided herein, with economic and monetary union movements in various other regions around the globe being considered as well.

As pointed out in the first chapter of this monograph, according to the classical, static, concept of monetary sovereignty as reflected in the existing literature,[4] entering into a monetary union amounts to a sacrifice of monetary sovereignty. To give just two examples, Lastra has described the advent of the EMU as 'surrender of monetary sovereignty',[5] and Treves as 'the most profound limitation to monetary sovereignty ever to be agreed by sovereign states'.[6] The analysis undertaken in this chapter, though not at all denying that participation in a monetary union may require the participants to consent to far-reaching conferrals of sovereign powers to the organs of the union, will lead to a different conclusion. For any government confronted with the choice of either seeking greater economic and monetary integration with its neighbours (in order to secure a maximum of monetary and financial stability under the evolving constraints of an ever more interdependent global economy) or of clinging on to the independent exercise of the full range of sovereign powers in the realm of money out of national prestige, entering into a monetary union may amount not to a surrender of monetary sovereignty but to its effective exercise under the special form of cooperative sovereignty.

After considering the economic rationale and key legal characteristics of the increasing regionalization of monetary sovereignty (Part I), this chapter looks into the adaptation of the EU's legal framework to the increasing impact of domestic economic and fiscal policies on regional economic stability (Part II) and analyses several overarching legal and conceptual challenges exposed by the potential sovereign default of monetary union members (Part III).

I. The Increasing Regionalization of Monetary Sovereignty: Economic Rationale and Legal Characteristics

This first part begins by looking at the sovereign decision to enter a monetary union in light of the economic constraints that have become known as the 'Inconsistent Quartet' (Section A). Subsequently, it considers the key aspects of internal and external monetary competences of eurozone and non-eurozone EU member states

throughout the union; effectively abandoned with World War One and formally dissolved in 1927). These early forms of loose regional monetary cooperation lacked any relevant institutional framework at the supranational level and never led to the introduction of a common currency. See, eg, Charles Proctor, *Mann on the Legal Aspect of Money* (7th edn OUP, Oxford 2012) 671–2.

[4] See the many references provided in the introduction to this monograph as well as in Chapter 1.

[5] Rosa M Lastra, *Legal Foundations of International Monetary Stability* (OUP, Oxford 2006) 27.

[6] Tullio Treves, 'Monetary Sovereignty Today' in Mario Giovanoli (ed), *International Monetary Law: Issues for the New Millennium* (OUP, Oxford 2000) 116.

under the existing EU treaty framework (Section B). Finally, this first part highlights key features of existing monetary unions and of plans for such unions in Africa, the Caribbean, South America, and the Gulf Region (Section C).

A. The sovereign decision to enter a monetary union in light of the constraints of the 'Inconsistent Quartet'[7]

Whenever a group of sovereign states decides to embark on the process of creating an economic and monetary union (thereby pooling the exercise of certain sovereign powers in the realm of money and accepting limitations on their respective economic and fiscal policies in order to achieve the desired degree of harmonization) their choice will be driven by various considerations. These considerations may be both economic and political in nature as illustrated by the advent of the EMU. On the one hand, economic and monetary cooperation among EU member states has always been part of broader efforts to secure peace within Europe by moving towards closer integration in various policy fields, with monetary and economic union playing an important, yet non-exclusive, role in this process. On the other hand, there is little doubt that the creation of the euro was driven by major economic constraints. It would have been impossible to accomplish the European common market (by abolishing all capital controls) and to opt for a system of fixed exchange rates under the form of a single currency, while at the same time maintaining independent national monetary policies.[8]

The related underlying economic law has become famous as the 'Triangle of Impossibility' (also known as 'Impossible/Inconsistent Trinity' or as the 'Mundell-Fleming Trilemma'[9]) and implies that in an open economy it is impossible for a country to have all three of the following at the same time: a fixed exchange rate, free capital movements, and an independent monetary policy. In the words of Paul Krugman:

> The point is that you can't have it all: [a] country must pick two out of three. It can fix its exchange rate without emasculating its central bank, but only by maintaining controls on capital flows (like China today); it can leave capital movement free but retain monetary autonomy, but only by letting the exchange rate fluctuate (like Britain or Canada); or it can choose to leave capital free and stabilize the currency, but only by abandoning any ability to adjust interest rates to fight inflation or recession (like . . . most of Europe [ie the eurozone]).[10]

[7] The 'Inconsistent Quartet' is a refined version of the economic concept that originally became known as the 'Triangle of Impossibility' or as the 'Mundell-Fleming Trilemma'. It will be explained in this section.

[8] On the general tendency, in the monetary realm, for formal state competencies to become eroded under economic constraints see, eg, Dominique Carreau, 'La souveraineté monétaire de l'Etat à la fin du XXe siècle: mythe ou réalité?' in Charles Leben, Eric Loquin, and Mahmoud Salem (eds), *Souveraineté étatique et marchés internationaux à la fin du 20ème siècle: Mélanges en l'honneur de Philippe Kahn* (Litec, Paris 2000) 502–3.

[9] Named after Robert Mundell, winner of the 1999 Nobel Prize for Economics, and Marcus Fleming who, in the 1960s, developed the underlying formal economic model.

[10] Paul Krugman, 'O Canada—A Neglected Nation Gets its Nobel' (19 October 1999) *Slate* <http://slate.com/id/36764> accessed 1 July 2013.

A slightly refined version of the 'Triangle of Impossibility' played a significant role in the political debate on further monetary integration in Europe in the 1980s. At that time, economists underlined the necessity of finding a satisfactory solution to what Tommaso Padoa-Schioppa, in a 1982 paper, had called the 'Inconsistent Quartet' of policy objectives: free trade, free capital movements, independent national monetary policies, and a system of fixed exchange rates.[11] Only three out of these four objectives can be achieved simultaneously.

The first two objectives, free trade and free capital movements, were integral parts of the broader objective to establish a European single market for which the Single European Act[12] had already set 31 December 1992 as a firm target date. Hence, at least one of the other two objectives had to go. Padoa-Schioppa and other economists recommended abandoning independent national monetary policies; complementing the single market with a single currency appeared as the only viable long-term solution.[13] This view was supported by rising concerns that in the absence of capital controls, which were soon to disappear as a consequence of the 1988 Directive on the liberalization of capital movements,[14] the fixed but adjustable exchange rates of the European Exchange Rate Mechanism (ERM), set up in 1978–79 as part of the European Monetary System (EMS),[15] would sooner or later be subject to destabilizing speculative movements.[16]

In line with the political desire of promoting ever-closer union by adopting a single European currency, momentum thus grew to embark on the path towards monetary union. A formal decision on the issue was reached among the heads of

[11] Tommaso Padoa-Schioppa, 'Capital Mobility: Why is the Treaty Not Implemented?', June 1982 address to the Second Symposium of European Banks, Milan, in Tommaso Padoa-Schioppa, *The Road to Monetary Union in Europe: The Emperor, the King and the Genies* (2nd edn OUP, Oxford 2000) 26–43.

[12] Single European Act (1986) [1986] OJ L169/1 (signed in Luxembourg and The Hague in February 1986 and entered into force 1 July 1987).

[13] See, eg, Peter Kenen, *EMU and ESCB after Maastricht* (Financial Markets Group of the London School of Economics, London 1992) 15. See, generally, Padoa-Schioppa (n 11).

[14] Directive 88/361/EEC of 24 June 1988, adopting the principle of free capital movements not only between European Communities (EC) member states but also between EC member states and third countries.

[15] After the demise of the IMF's par-value regime as the external anchor of monetary stability, the EMS was set up by a simple resolution of the European Council on 5 December 1978, with an agreement among the central banks of EC members on 13 March 1979 setting forth its operating procedures. Its two main components were the newly established European Currency Unit (ECU) and the ERM. The ECU, based on a weighted basket of the participating currencies, did not have the status of legal tender, but served as a unit of account, as a store of value (for central bank reserves), and as a means of payment between monetary authorities in the participating member states. The ERM was designed as a system of fixed but adjustable exchange rates with the central banks of the participating currencies being obliged to intervene in order to maintain their currencies within the established fluctuation margins of plus or minus 2.25 per cent. Since the advent of the euro, a revised form of the ERM, called ERM II, continues to exist as an exchange rate mechanism between the euro and the national currencies of EU member states aspiring to join the euro. Among the criteria for joining the eurozone, Article 140 of the Treaty on the Functioning of the European Union (TFEU) provides that aspiring states must have observed the normal fluctuation margins of the ERM II for at least two years without devaluating against the euro. For detailed analyses of the EMS and the ERM, see, eg, Lastra (n 5) 183–6 and Proctor (n 3) 687–94.

[16] Kenen (n 13) and Lastra (n 5) 187.

state or government with the adoption, by the European Council, of the so-called Delors Report in June 1989. Prepared by the Delors Committee,[17] the *Report on Economic and Monetary Union in the European Community*[18] recommended moving towards EMU in three stages. The first stage involved increased cooperation between the central banks of EC members, the monitoring of national economic policies, the coordination of budgetary policies, and the removal of obstacles to financial integration. The second stage included a reduction of the margins of fluctuation of the currencies in the above-mentioned ERM (set up in 1978/79 as part of the EMS), a stronger coordination of national economic policies with the European Council, and the creation of the European System of Central Banks (ESCB). Finally, in the third stage, the exchange rates between the national currencies were to be fixed and the single European currency to be introduced. At that point, the ESCB were also to become responsible for formulating and implementing the common monetary policy as well as the common exchange rate policy.[19] The European Council opted for 1 July 1990 as starting date for the first stage of EMU; the 1988 Directive on the liberalization of capital movements entered into force the same day. The amendments of the treaty framework necessary for a gradual move towards full economic and monetary union were achieved with the Treaty on European Union, the so-called Maastricht Treaty.[20]

Overall, the process leading up to the introduction of the European single currency is a perfect illustration of the extent to which economic constraints limit the margin of manoeuvre of states wishing to achieve a greater degree of regional economic and monetary integration. Determined to establish a single market, including a single market for financial services, and to promote intra-union trade by eliminating once and for all the threat of exchange rate shifts, EC member states wishing to fully participate in the EMU had no choice but to renounce independent domestic monetary policies and to accept certain limits on the conduct of their respective economic policies in general, and fiscal policies in particular. Certainly, the formal opt-outs from participating in the third stage of EMU, obtained by the UK and Denmark, and the *de facto* opt-out of Sweden (all three of which preferred to retain their respective domestic currencies and independent monetary policies by accepting flexible exchange rates with the currency of their main trading partners, the euro),[21]

[17] Named after its chairman, Jacques Delors, President of the European Commission from 1985 to 1995.

[18] Committee for the study of economic and monetary union, 'Report on Economic and Monetary Union in the European Community' (12 April 1989) <http://ec.europa.eu/economy_finance/publications/publication6161_en.pdf> accessed 1 July 2013.

[19] For detail on the Delors Report, see Lastra (n 5) 187–8. For detailed accounts of the history and progressive development of the EMU, see, eg, Proctor (n 3) 681–724 and Lastra (n 5) 173–206.

[20] Treaty on European Union (adopted 7 February 1992, entered into force 1 November 1993). In accordance with the Maastricht Treaty, the second stage of EMU began on 1 January 1994 and its third stage on 1 January 1999. Euro coins and bank notes were put into circulation on 1 January 2002. For detail on the Maastricht Treaty and the three stages of EMU, see, eg, Proctor (n 3) 698–706 and Lastra (n 5) 188–96.

[21] The UK obtained a formal opt-out clause, set forth in a protocol annexed to the Maastricht Treaty, exempting it from the requirement to join the third stage of EMU even if it were to fulfil the convergence criteria stipulated in that Treaty. Denmark's opt-out was confirmed after its people

underline that national governments could indeed have opted for a different way out of the Inconsistent Quartet, and hence for a different exercise of monetary sovereignty, to the extent that they were prepared to renounce the benefits arising from a single currency. However, at a time of ever-increasing financial integration it still seems likely, at least in a long-term perspective, that monetary and financial stability in the whole of Europe were best served by the willingness of a large number of EU members, 17 as of 1 July 2013,[22] to transfer significant parts of their sovereign powers in the realm of money to the union.[23]

The following section will now look at these transfers of sovereign powers and will provide a succinct overview of the state of affairs regarding the main internal and external monetary competences of both eurozone and non-eurozone EU member states.[24]

B. *An overview of the internal and external monetary competences of eurozone and non-eurozone EU member states*

The EU's competences with respect to monetary and exchange rate policies arise from vast transfers of sovereign powers by the members of the eurozone and from restrictions agreed to by non-eurozone member states regarding their respective exchange rate policies. By contrast, as will be shown in the second part of this chapter, the Union's competences in the field of economic policy are the result of policy restrictions accepted, to different degrees, by both eurozone and non-eurozone member states, coupled with related surveillance and enforcement powers for the Union. This section provides an overview of the main internal and external monetary competences of eurozone and non-eurozone members under the existing treaty framework. Detailed analyses of both the complex institutional framework of the EMU and the relevant distribution of competences have been provided in the existing literature.[25]

rejected the Maastricht Treaty in a first referendum held in June 1992. Sweden, by contrast, having submitted the introduction of the euro to an unsuccessful referendum, relies on a *de facto* opt-out by not complying with several of the convergence criteria, in order to, as put by Lastra, 'obtain a semi-permanent status as a derogation State' (Lastra (n 5) 191).

[22] On 1 January 2011, Estonia became the 17th EU member state to join the third stage of EMU. When this monograph went to press, Latvia was scheduled to become the 18th member of the eurozone on 1 January 2014.

[23] This chapter returns to this issue in more detail towards its end (see Section III.C and the conclusion).

[24] As will be argued towards the end of this chapter (see Section III.C and the conclusion), contrary to what has been argued in much of the existing literature (see, eg, Proctor (n 3) 807–34), it might be more appropriate to regard the transfers of significant competences in the realm of money by states entering a monetary union not as a transfer of monetary sovereignty itself, but rather as an effective exercise of monetary sovereignty under contemporary economic constraints.

[25] In a vast body of literature, see, eg, Mads Andenaes, Laurence Gormley, Christos Hadjiemmanuil, and Ian Harden (eds), *European Economic and Monetary Union: The Institutional Framework* (Kluwer Law International, London 1997); Paul Beaumont and Neil Walker (eds), *The Legal Framework of the Single European Currency* (Hart Publishing, Oxford 1999); Hugo J Hahn, 'European Union Exchange Rate Policy?' in Mario Giovanoli (ed), *International Monetary Law: Issues for the New Millennium* (OUP, Oxford 2000) 195; Christoph W Herrmann, 'Monetary Sovereignty over the Euro

The European Central Bank (ECB), the ESCB, and the Eurosystem constitute the core of the euro's institutional framework. Whereas the ECB is an international organization, and hence possesses legal personality, the ESCB, consisting of the ECB itself and the central banks of all EU member states (including those whose currency is not the euro), has neither independent nor composite legal personality.[26] The same is true for the Eurosystem, which consists of the ECB and the central banks of all member states whose currency is the euro. Following entry into force of the Lisbon Treaty on 1 December 2009,[27] the TFEU states explicitly that the Eurosystem is in charge of conducting the monetary policy of the Union.[28] The fact that the TFEU, in its Title VIII, Chapter 2 on monetary policy (TFEU Articles 127–133), continues to refer exclusively to the ESCB, provides a valuable clarification: the central banks of non-eurozone member states are excluded from most of the material rights and obligations ascribed to the ESCB.[29] The ESCB is governed by the decision-making bodies of the ECB, ie the ECB's Governing Council and its Executive Board.[30]

According to TFEU Article 127(2), the ESCB, whose main objective is to maintain price stability, is primarily responsible for defining and implementing the monetary policy of the Union, conducting foreign-exchange operations consistent with TFEU Article 219, holding and managing the official reserves of the member states,[31] and for promoting the smooth operation of payment systems. The transfers of sovereign powers by eurozone member states to the Union includes also large parts of the classical *ius cudendae monetae*: the ECB has the exclusive right to authorize the issue, through itself and the central banks of the eurozone member states, of euro banknotes within the Union.[32] Eurozone member states may issue coins subject to the approval by the ECB of the volume of the issue.[33]

In principle, the ECB enjoys full central bank independence in the fulfilment of its mandate.[34] TFEU Article 130 sets forth unambiguously that, when carrying out

and External Relations of the Euro Area: Competences, Procedures and Practice' (2002) 7 *European Foreign Affairs Review* 1; Lastra (n 5) 207–42, 275–95; Francesco Martucci, 'De l'Union Economique et Monétaire à l'Ordre de la Politique Economique et Monétaire' (2009) 21(3) *European Review of Public Law* 1097, 1097–102, 1107–12; Proctor (n 3) 725–43, 807–34; René Smits, *The European Central Bank: Institutional Aspects* (Kluwer Law International, 1997); as well as Chiara Zilioli and Martin Selmayr, *The Law of the European Central Bank* (Hart Publishing, Oxford 2001).

[26] Proctor (n 3) 730.

[27] Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community (adopted 13 December 2007, entered into force 1 December 2009).

[28] TFEU Article 282(1).

[29] The necessary clarification is set forth in Article 42 of the Statute of the ESCB and the ECB (laid down in Protocol 4 annexed to the Treaties). See Proctor (n 3) 730.

[30] TFEU Article 129. See also the detailed rule in Articles 10–12 of the Statute of the ESCB and the ECB.

[31] According to TFEU Article 127(3), this shall be without prejudice to the holding and management by the governments of member states of foreign-exchange working balances.

[32] TFEU Article 128(1).

[33] TFEU Article 128(2).

[34] For analysis related to the issue of central bank independence, see Chapter 1, Section III.B, and Chapter 3, Subsection II.A.1, of this monograph. For analysis specifically related to the ECB, see, eg, Manuel Monteagudo, 'Neutrality of Money and Central Bank Independence' in Mario Giovanoli and

their functions under the EU legal framework, neither the ECB nor any national central bank nor any member of their decision-making bodies shall seek or take instructions from Union institutions or other entities, from any government of a member state or from whomever else. The conduct of a single European monetary policy, whose design is hardly likely to be always ideal from the perspective of the individual needs of eurozone member states, is thus insulated from short-term political expedients.[35] The autonomy enjoyed by the ECB is reflected in the fact that it may make regulations and take decisions within its sphere of competence without having to consult with any other Union organs.[36] Hence, the ECB appears indeed to have become 'a new and independent source of monetary law'.[37]

However, parts of the internal monetary competences that have been transferred to the Union may be conferred by the ECB back to the participating national central banks. This is notably the case when national central banks engage in operations involving foreign reserve assets belonging to the ECB.[38] Proctor draws a convincing private law analogy and argues that in carrying out those foreign exchange operations, for which they have to follow instructions by the ECB, the participating national central banks stand in an agency relationship with the ECB.[39]

Whereas the sole responsibility for the eurozone's monetary policy resides with the ESCB, hence giving the Union exclusive competence in this field, the responsibility for the eurozone's external monetary matters is shared between the Council (*de facto* the Eurogroup),[40] the ECB, the Commission, and, to the extent that they are individually members of international financial institutions, even the member states. The relevant provisions in the EU treaty framework are TFEU Articles 138 and 219, the essence of which can be summarized as follows.[41]

Diego Devos (eds), *International Monetary and Financial Law: The Global Crisis* (OUP, Oxford 2010) 484. For an insightful examination, in the light of the Global Financial Crisis, of the rules and mechanisms ensuring that the ECB enjoys independence while remaining accountable as an institution for its actions, see Rosa M Lastra and Jean-Victor Louis, 'European Economic and Monetary Union: History, Trends, and Prospects' in Piet Eeckhout and Takis Tridimas (eds), *Yearbook of European Law 2013* (OUP, Oxford 2013) 1, 95–100.

[35] Proctor (n 3) 731–2.

[36] TFEU Article 132 and Article 34 of the Statute of the ESCB and the ECB.

[37] Proctor (n 3) 732. See also Erwin Nierop, 'A New Corpus Iuris Monetae for Europe' (2000) 15(5) *Journal of International Banking and Financial Law* 157.

[38] On the obligation for national central banks to transfer foreign exchange reserves to the ECB, see Article 30 of the Statute of the ESCB and the ECB.

[39] Proctor (n 3) 732. For the leading study on the exercise of sovereign powers by international organizations, providing a detailed typology of the various conferrals of sovereign powers by states to international organizations, including agency relationships, see Dan Sarooshi, *International Organizations and their Exercise of Sovereign Powers* (OUP, Oxford 2005).

[40] As set forth in TFEU Article 138(3), 'only members of the Council representing Member States whose currency is the euro shall take part [in the related votes]'. The Eurogroup has been formally recognized by the Treaty of Lisbon in TFEU Article 137. Arrangements for meetings of ministers of the Eurogroup, which *de facto* replaces the Council on issues concerning the single currency as noted above, are laid down in the Protocol on the Euro Group (Protocol No 14, attached to the Treaties), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2007:306:0153:0153:EN:PDF> accessed 1 July 2013.

[41] For a more detailed analysis, see Lastra (n 5) 284–8.

Firstly, on a proposal from the Commission, and after consulting the ECB, the Council shall adopt a decision establishing a common position on matters of particular interest for the EMU within the competent international financial institutions and conferences,[42] and may adopt appropriate measures to ensure unified representation within the latter.[43] Only eurozone members may take part in such Council votes for which a qualified majority in the sense of TFEU Article 238(3)(a) is required.[44]

Secondly, either on a recommendation from the ECB or on a recommendation from the Commission and after consulting the ECB, the Council may, acting unanimously, complying with the objective of price stability, and after consultation of the European Parliament, conclude formal agreements on an exchange-rate system for the euro in relation to the currencies of third states.[45] This provision has not yet had any practical relevance but would have to be observed for the eurozone to lawfully switch from its freely floating currency to any of the other exchange rate regimes that are allowed under the IMF Agreement.[46]

Thirdly, where no exchange-rate system other than a free float exists in relation to one or more currencies of third states, which is the euro's case with respect to most currencies, the Council, again either on a recommendation from the ECB or on a recommendation from the Commission and after consulting the ECB, may formulate 'general orientations' for exchange-rate policy in relation to these currencies—these general orientations being without prejudice to the ESCB's primary objective to maintain price stability.[47] Such 'general orientations' would lack binding legal force, though. Their legal value would not go beyond that of a mere recommendation.[48] As recalled by Lastra,[49] during its meeting on 12–13 December 1997, the European Council adopted a Resolution stating that the Council may adopt general orientations only 'in exceptional circumstances, for example in the case of a clear misalignment', but even then 'such general obligations should always respect the independence of the ECB and be consistent with the primary objective of the ESCB to maintain price stability'.[50] Hence, to the extent that exchange rate fluctuations do not affect price stability in the eurozone, the ECB, which is also responsible for the main operational aspects of exchange rate interventions, ie the managing of foreign exchange reserves and the conduct of foreign exchange operations as noted above,[51] would likely not intervene on the external value of the euro, even if the Council had issued general orientations.[52]

[42] TFEU Article 138(1). [43] TFEU Article 138(2).

[44] This first set of rules may be understood as a response to the dilemma that the members of the eurozone are all individually members of the IMF whereas the EU remains excluded from Fund membership under the Fund's literal interpretation of the rule, in IMF Article II.2, that only 'countries' are allowed membership. The ECB is merely granted observer status at selected meetings of the IMF Executive Board. On the role of the EU in the IMF, see Erik Denters, 'Representation of the EC in the IMF' in Giovanoli (ed) (n 25) 211. See also Proctor (n 3) 757–9 and Lastra (n 5) 291–3.

[45] TFEU Article 219(1).

[46] See Chapter 3, notably n 22, of this monograph.

[47] TFEU Article 219(2). [48] Smits (n 25) 399.

[49] Lastra (n 5) 286. [50] [1998] OJ C35/1.

[51] As set forth in TFEU Article 127(2).

[52] For detail on the issue of EU exchange rate policy, see, eg, Hahn (n 25) and Herrmann (n 25).

On a final note, it should not be overlooked that non-eurozone EU member states, while retaining full formal competences regarding their respective national monetary policies, are at least to some extent constrained in the conduct of their exchange rate policies. TFEU Article 142 requires each member state with a derogation to 'treat its exchange-rate policy as a matter of common interest', taking into account 'the experience acquired in cooperation within the framework of the exchange-rate mechanism'. Furthermore, non-eurozone member states have renounced the use of exchange controls to the same extent as eurozone member states as part of the EU's legal framework on free movement of capital and current payments.

Having completed this succinct overview of the distribution of the main competences in monetary matters between the EU and its member states, the last section of this first part will address some selected common features and differences between the EMU and monetary unions in Africa and in the Caribbean.

C. *Key features of existing monetary unions and of plans for such unions in Africa, the Caribbean, South America, and the Gulf region*

1. Existing monetary unions in Africa

On the African continent, two regional monetary unions currently exist, both predating the EMU. In addition, there are more or less advanced plans both for a third regional and a continent-wide monetary union. To begin with, the Central African Monetary Union (CAMU)[53] and the West African Monetary Union (WAMU)[54] form together the CFA franc zone, although strictly legally speaking they constitute two entirely separate monetary unions, with their respective currencies, the Central

[53] Today, the CAMU is an integral part of the Central African Economic and Monetary Union (CAEMU) that was created on 16 March 1994. The CAEMU replaced the Central African Customs and Economic Union (CACEU), which was based on a treaty dated 8 December 1964. The CAMU was originally based on two agreements on monetary cooperation, dated 22 and 23 November 1972, one among CAMU member states and one between the latter and France. The CAMU's current constituent treaty was signed on 5 July 1996 and entered into force on 23 June 1999. The 1972 cooperation agreement with France is still in force. At present, the CAEMU comprises six member states, all of which participate in the CAMU: Chad, Cameroon, the Central African Republic, Congo, Gabon, and Equatorial Guinea. Equatorial Guinea was the last member to join on 1 January 1985. For both the CAEMU's and CAMU's constituent treaties, additional legal texts such as the statutes, dated 23 September 2007, of its central bank, the Bank of Central African States (BCAS) and further detailed information, see the CAEMU's official website (<http://www.cemac.int>) as well as that of the BCAS (<http://www.beac.inthttp://www.cemac.int>) as well as that of the BCAS (<http://www.beac.int>).

[54] Today, the WAMU is an integral part of the West African Economic and Monetary Union (WAEMU) whose constituent treaty was signed on 10 January 1994, and entered into force on 1 August 1994. Like the CAMU, the WAMU is equally based on two agreements on monetary cooperation. The one between WAMU member states, originally concluded on 14 November 1973, entered into force in its current version on 1 April 2010. The monetary cooperation treaty between the WAMU and France is dated 4 December 1973. At present, the WAEMU comprises eight member states, all of which participate in the WAMU: Benin, Burkina Faso, Guinea-Bissau, the Ivory Coast, Mali, Niger, Senegal, and Togo. On 2 May 1997 Guinea-Bissau became the eighth member. For the relevant legal texts, see the WAEMU's official website (<http://www.uemoa.int>) as well as that of its central bank, the Central Bank of West African States (CBWAS) (<http://www.bceao.int>).

African CFA franc and the West African CFA franc, being two formally distinct currencies.[55] Originally established during the colonial era as 'le franc des Colonies Françaises d'Afrique (CFA)' before becoming 'le franc de la Communauté Financière Africaine (CFA)', both CFA francs continue to be guaranteed by the French treasury, which manages operational accounts for that purpose.[56] Both monetary unions are equipped with independent central banks,[57] both of which have legal personality,[58] the Bank of Central African States (BCAS) and the Central Bank of West African States (CBWAS) respectively, and are characterized by an institutional structure and governing bodies similar to that of the ECB. Both central banks have the exclusive right to issue notes and coins which constitute legal tender in the territories of the participating states.[59] In respect of the overarching objective of price stability, both central banks are in charge of defining and conducting monetary and credit policy and of promoting the smooth functioning of the payments systems.[60] The BCAS is charged with the holding and managing of the foreign exchange reserves of CAMU members whereas the CBWAS has merely the right to require the transfer of such reserves if needed.[61] In both monetary unions, member states are required to harmonize their policies in a number of areas, including the control of lending and the distribution of credit.[62]

Whereas the WAMU Treaty expressly permits the voluntary unilateral withdrawal,[63] the CAMU Treaty remains silent on the subject.[64] Hence, the situation of CAMU member states is similar to that of eurozone member states. Certainly, since entry into force of the Lisbon Treaty, the EU treaties include, for the first time, a provision authorizing member states to withdraw from the EU altogether, namely Article 50 of the Treaty on European Union (TEU).[65] However, there is still no provision authorizing the member states that have moved to stage three of

[55] Although they could in principle have different values, both CFA francs have always been at parity. Since 1 January 1999, they have both been pegged to the euro at a rate of 655.957 CFA francs per euro.

[56] See Proctor (n 3) 674.

[57] Article 4 of the CBWAS Statutes and Article 6 of the BCAS Statutes.

[58] Article 2 of the CBWAS Statutes and Article 5 of the BCAS Statutes.

[59] Article 12 of the CBWAS Statutes and Article 7 of the BCAS Statutes.

[60] Articles 8 and 9 of the CBWAS Statutes and Article 1 of the BCAS Statutes.

[61] Articles 9 and 17 of the CBWAS Statutes and Article 1 of the BCAS Statutes.

[62] Article 22 of the WAMU Treaty and Article 32 of the CAMU Treaty. For more detailed observations on the various characteristics of both the WAMU and the CAMU, see, eg, Proctor (n 3) 672–4.

[63] Article 3 of the WAMU Treaty.

[64] Note that Article 17 of the Agreement of 23 November 1972 permitted a voluntary withdrawal. The CAMU's current constituent treaty, however, in force since 1999, remains silent on the subject.

[65] Prior to the inclusion of this provision, the question of whether EU member states may unilaterally withdraw from the Union had been subject to fierce debate, not only in academic writing, but also between the highest courts of the Union and its member states. Whereas the European Court of Justice (ECJ) had consistently held that the conferrals of sovereign powers by member states to the Union (then still the EC) are irrevocable, the highly influential German constitutional court, the *Bundesverfassungsgericht*, had insisted in its Maastricht case (89 BVerfGE 155) that member states, as 'masters of the Treaties', do have the right to withdraw unilaterally. For a succinct discussion of the relevant case law and useful references, see Sarooshi (n 39) 66–9.

EMU to turn around and leave the euro while staying in the EU.[66] The controversial question of whether it ultimately matters, not only *de facto*, but also *de iure*, whether the constituent treaty of a monetary union provides for the possibility of unilateral withdrawal will be considered towards the end of this chapter.[67]

2. Plans for additional monetary unions in Africa

Plans for two other monetary unions on African soil currently exist. The West African Monetary Zone (WAMZ) comprises five states[68] within the Economic Community of West African States (ECOWAS).[69] The five WAMZ member states plan to introduce a common currency, the eco, by 2015,[70] with a projected extension of that single currency by 2020 to all 15 member states of ECOWAS.[71] The institutional structure devised by WAMZ members appears to be inspired by European monetary integration.[72] The West African Monetary Institute, set up in late 2000, has been put in charge of monitoring compliance with agreed convergence criteria, developing an exchange rate mechanism, coordinating domestic monetary policies so as to achieve price stability, and preparing the launch of a West African Central Bank.

Distinct from the above, plans for the establishment of a single currency for the majority of states in the African Union have been under discussion for quite some time. The Treaty of Abuja, signed on 3 June 1991, created the African Economic Community and called for the creation, by 2028, of an African Central Bank, which would have to administer such an African Monetary Union. For both political and economic reasons, the prospects of this ambitious project for monetary integration covering the entire African continent seem uncertain at the present stage.

3. Monetary union in the Eastern Caribbean

Another long-standing monetary union is the Eastern Caribbean Currency Union (ECCU),[73] in which eight of the nine[74] members of the Organisation of Eastern

[66] As set forth in TFEU Article 140(3), whenever a member state moves to stage three of EMU, the Council shall, under the procedures laid down in that provision, 'irrevocably fix the rate at which the euro shall be substituted for the currency of the Member State concerned'. This suggests indeed, as put by Lastra, that the drafters of the EU treaties intended EMU to be 'a trip with no return' (Lastra (n 5) 28).

[67] See the discussion in Section III.C below.

[68] These five states are the Gambia, Ghana, Guinea, Nigeria, and Sierra Leone.

[69] ECOWAS came into being on 28 May 1975 with the signing of the Treaty of Lagos (as revised on 24 July 1993). For the text of the revised ECOWAS Treaty and detailed information on ECOWAS and its institutional structure, see its official website (<http://www.ecowas.int>). Eight member states of the WAEMU are among the 15 member states of ECOWAS. Hence, any project for a single currency for all ECOWAS member states would necessarily affect the future of the WAMU CFA franc.

[70] Earlier target dates, January 2003, then July 2005, then December 2009, had to be abandoned due to insufficient macroeconomic convergence amongst the participating states.

[71] Juliana Taiwo and Dele Ogbodo, 'ECOWAS Targets 2020 for Single Currency', *allAfrica.com* (23 June 2009) <http://allafrica.com/stories/200906230222.html> accessed 1 July 2013.

[72] See Proctor (n 3) 676.

[73] The ECCU was originally established in 1965 when the British West Indies dollar of the then defunct West Indies Federation was replaced by the East Caribbean dollar.

[74] These eight members comprise two British overseas territories (Anguilla, and Montserrat) as well as six independent Caribbean states (Antigua and Barbuda, Grenada, Saint Kitts and Nevis, the

Caribbean States (OECS) participate.[75] In its current shape, the ECCU is governed by the Agreement, dated 5 July 1983, establishing the Eastern Caribbean Central Bank (ECCB).[76] The ECCB, which is governed by a Board of Directors, and is supervised by a Monetary Council comprised of one Minister appointed by each government of the participating states, is an international organization with full legal personality in its own right. Among its main tasks are the classical tasks of a central bank: it is the exclusive issuer of the East Caribbean dollar which is the sole currency to have legal tender within the union,[77] and holds the external assets of the participating states.[78] Although not explicitly in charge of defining and conducting monetary policy, it has vast implicit powers in this field, as recognized by the Revised Treaty of Basseterre on OECS Economic Union.[79] It is responsible for the establishment of interest rates and for the regulation and promotion of credit and exchange conditions.[80] Like the WAMU Treaty, the 1983 ECCB Agreement contains an explicit provision authorizing the voluntary unilateral withdrawal from the union.[81]

4. Plans for a monetary union in the Gulf region

Approaching the end of this section, it should be noted that there are more or less concrete developments towards the establishment of a monetary union in two other regions of the world, one of them being the Gulf region. Thus, the six member states of the Gulf Cooperation Council (GCC)[82] first agreed in 2001 to introduce a single currency, pegged to the USD, by 1 January 2010. Under the impact of the Global Financial Crisis and various disagreements among the members of the GCC, it now looks as if the monetary union might not be realized before 2020.[83] So far, it

Commonwealth of Dominica, Saint Lucia, as well as Saint Vincent and the Grenadines). The only member of the OECS not participating in the ECCU is the British Virgin Islands.

[75] The OECS originally came into being on 18 June 1981 with the Treaty of Basseterre. For detailed information, see its official website (<http://www.oecs.org>). The Revised Treaty of Basseterre Establishing the Organisation of Eastern Caribbean States Economic Union, signed on 18 June 2010, entered into force on 21 January 2011.

[76] The 1983 ECCB Agreement as well as detailed information on the ECCU and the ECCB's operations are available on the ECCB's official website (<http://www.eccb-centralbank.org>).

[77] Article 18 of the 1983 ECCB Agreement.

[78] Article 25 of the 1983 ECCB Agreement.

[79] Article 14 of that Treaty states: 'The monetary policy of the Economic Union shall be executed by the Monetary Council through the Eastern Caribbean Central Bank under the terms and conditions of the Eastern Caribbean Central Bank Agreement'.

[80] See Articles 4 and 34 of the 1983 ECCB Agreement.

[81] Article 52 of the 1983 ECCB Agreement, containing detailed procedural rules for such a withdrawal, concerning, inter alia, the settling of accounts between the ECCB and the member concerned. As noted earlier, see Section III.C of this chapter for further comments on this issue.

[82] The GCC, officially: the Cooperation Council for the Arab States of the Gulf, created on 25 May 1981, comprises the Persian Gulf states of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE). A GCC common market was launched on 1 January 2008. The GCC members and Yemen are also members of the Greater Arab Free Trade Area (GAFTA). For detailed information on the GCC, see the English version of its official website (<http://www.gccsg.org/eng/index.html>).

[83] Robin Wigglesworth, 'Deadline for Gulf currency union extended' *Financial Times* (24 March 2009) <http://www.ft.com/cms/s/0/3058b2f2-1898-11de-bec8-0000779fd2ac.html>; see also 'Kuwait

has been decided that the Saudi Arabian capital, Riyadh, will host the GCC central bank, which prompted the UAE to step back from the project. Oman had already withdrawn in 2007.[84] The remaining four participating states still seem to be determined to move ahead, though: on 15 December 2009 they announced the creation of a Monetary Council, which has been charged with determining further steps towards monetary union. If it were to come into existence, this monetary union in the Gulf region has the potential of becoming the world's second most important, in terms of the combined GDP of the participating states, after the EMU.

5. Plans for a monetary union within the Bolivarian Alliance for the Americas

Finally, the member states of the Bolivarian Alliance for the Americas (ALBA),[85] have also undertaken a number of first steps (in 2009 and 2010) for introducing a regional currency, the SUCRE,[86] which, as a first step, is intended to replace the US dollar in commercial exchanges between ALBA members.[87] The value of the SUCRE is calculated on the basis of a weighted basket of the national currencies of the participating states. Its central operation is a central payments clearing house handled by an Agent Bank selected by the Regional Monetary Council based in Caracas, Venezuela, which is charged with issuing and signing SUCREs into circulation. Initially, the SUCRE will exist only as a virtual currency besides the national currencies of ALBA member states,[88] a move that appears to have been inspired by the introduction of the ECU in 1979.[89] Bills and coins might be issued at a later stage.

Having reached the end of Part I of this chapter, it needs to be stressed again that a monetary union cannot function durably without there being at least a certain degree of convergence between the economies of the participating states. This explains why most monetary unions, including the ones contemplated above, are part of a broader economic integration framework. With the EMU as object of investigation, Part II of this chapter therefore now turns to analyse the ongoing

sees GCC currency union taking up to 10 years' *arabianbusiness.com* (8 December 2009) <http://www.arabianbusiness.com/kuwait-sees-gcc-currency-union-taking-up-10-years-10219.html> both accessed 1 July 2013.

[84] See n 83 above.

[85] ALBA (acronym derived from its Spanish name: Alianza Bolivariana para los Pueblos de Nuestra América) originally came into being upon the initiative of former Venezuelan president Hugo Chávez with the Cuba–Venezuela Agreement signed on 14 December 2004. As of 1 July 2013 ALBA comprises eight member states: Antigua and Barbuda, Bolivia, Cuba, Dominica, Ecuador, Nicaragua, Saint Vincent and the Grenadines, as well as Venezuela. For detail on the organization, see ALBA's official website (in Spanish only) (<http://www.alianzabolivariana.org>).

[86] Spanish acronym for: Sistema Único de Compensación Regional, ie Unified System for Regional Compensation. The denomination of the currency also seems to have been chosen to honour Antonio José de Sucre (1795–1830), Simón Bolívar's chief of staff and second president of Bolivia.

[87] For three members of ALBA, namely Antigua and Barbuda, Dominica, as well as Saint Vincent and the Grenadines, realizing this objective would lead to inconsistency with their current membership of the single currency of the ECCU (see Subsection I.C.3 above).

[88] For detailed technical information, see the official website of the SUCRE (in Spanish only) at <http://www.sucrealba.org>.

[89] See the detailed analysis provided in Section I.A of this chapter.

efforts to adapt the EU legal framework to the impact of domestic economic and fiscal policies on regional economic stability.

II. Adapting the EU Legal Framework to the Impact of Domestic Economic and Fiscal Policies on Regional Economic Stability

This second part begins by looking at the loose coordination and surveillance in the EMU of national economic and fiscal policies under the first editions of the Stability and Growth Pact (SGP) (Section A). Subsequently, it examines various reforms embarked upon by EU member states from 2010 onwards with the goal to achieve a strengthened EU framework on fiscal governance (Section B). Finally, the EMU's new legal framework for strengthened macroeconomic governance will be put into perspective (Section C).

A. Until 2011: loose coordination and surveillance of domestic policies under a constantly weakened Stability and Growth Pact

As pointed out in Part I, the members of the eurozone have transferred large parts of their sovereign powers in the realm of money to the supranational level, thus turning European integration in this area into a fully-fledged monetary union. By contrast, for many years the weakness of the economic-union component, ie the 'E' in the designation 'EMU', used to be one of the key characteristics of the EMU.[90] While this major deficiency in the EMU's legal framework has been somewhat remedied with the various reforms launched since 2010,[91] it is important to begin this analysis with a close look at the original state of affairs in which the 'economic union' took the form of a rather loose coordination of domestic economic policies with, in particular, both eurozone and non-eurozone member states retaining vast control over their respective fiscal policies.

The history of European integration has shown that it is possible to establish a single market before achieving a single currency. Proceeding the other way round appears never to have been seriously considered in Europe.[92] By contrast, there have always been differing opinions on the degree of macroeconomic convergence and coordination of domestic economic and fiscal policies needed to achieve lasting monetary union. Charles Goodhart summarizes the dispute between so-called (French) 'monetarists' and (German) 'economists' as follows:

> The monetarists believe that early moves towards monetary union will put pressure on members to converge in other economic respects; the economists hold to the German

[90] See, eg, Lastra (n 5) 200.

[91] As announced earlier, these reforms will be analysed and discussed in Sections II.B and II.C of this chapter.

[92] This stands in interesting contrast to the above-analysed monetary unions in Africa and the Eastern Caribbean where the introduction of a single currency preceded the (still ongoing) establishment of a single market.

'coronation' theory and maintain that monetary union can be securely achieved [only] as the culmination of a general process of convergence.[93]

The convergence criteria included in the Maastricht Treaty constitute a compromise between these two approaches.[94] They serve to determine whether a member state has reached a satisfactory level of economic convergence to move to stage three of EMU,[95] and whether it meets the provisions that have been included in the EU treaties to ensure that member states, once they have joined the euro, continue to conduct their domestic economic and fiscal policies in a manner that sustains monetary and financial stability in the EMU.

The primary law pillars of the existing coordination and multilateral surveillance of domestic economic and fiscal polies of EU member states are two very detailed treaty provisions: TFEU Articles 121 and 126. The key instrument for implementing the treaty provisions on budgetary discipline is the SGP. The SGP is not a formal agreement among the member states, but is made up of a bundle of secondary EU law as detailed below.[96] Until its major overhaul in late 2011,[97] SGP consisted of a Resolution of the European Council of Amsterdam of 17 June 1997[98] and the following two Regulations: Council Regulation (EC) No 1466/1997 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (Surveillance Regulation)[99] as updated by Council Regulation (EC) No 1055/2005 of 27 June 2005;[100] and Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the excessive deficit procedure (Excessive Deficit Regulation)[101] as updated by Council Regulation (EC) No 1056/2005 of 27 June 2005.[102] It fully came into force on 1 January 1999, together with stage three of EMU.

The SGP consists of a preventive and a corrective (or dissuasive) arm implementing the treaty provisions on budgetary surveillance in TFEU Article 121 and on the excessive deficit procedure in TFEU Article 126 respectively—this feature has remained unaffected by the 2011 reforms. According to TFEU Article 121(1), member states shall regard their economic policies as a matter of common concern and shall coordinate them with the Council, which, under the procedure set forth in TFEU Article 121(2), may establish broad guidelines for the economic policies

[93] Charles AE Goodhart, *The Central Bank and the Financial System* (Macmillan, London 1995) 161.

[94] On this point, see Lastra (n 5) 201.

[95] These convergence criteria, also known as 'Maastricht Criteria', are enshrined in TFEU Article 140(1). For detail, see, eg, Proctor (n 3) 706–8.

[96] The original SGP goes back to an initiative by Germany which felt that a set of strict rules was needed in order to ensure budgetary discipline of eurozone member states. At the November 1995 ECOFIN Council Theo Waigel, then German Minister of Finance, had therefore presented a proposal for a 'Stability Pact for Europe'.

[97] See Subsection II.B.1 below.

[98] Council Resolution No 97/C236/01, [1997] OJ C236/1.

[99] Council Regulation No 1466/1997, [1997] OJ L209/1.

[100] Council Regulation No 1055/2005, [2005] OJ L174/1.

[101] Council Regulation No 1467/1997, [1997] OJ L209/6.

[102] Council Regulation No 1056/2005, [2005] OJ L174/5.

of the member states. TFEU Article 121(3) empowers the Council to monitor economic developments in each member state on the basis of reports submitted by the Commission and obliges the member states to keep the Commission informed about any important measures in the field of economic policy.

As set forth by TFEU Article 121(4), if it is established that the policies of a member state are not consistent with the broad guidelines set up by the Council and risk jeopardizing the functioning of the EMU, the Commission may address a warning to the member state concerned.[103] The Council, on a recommendation from the Commission, may issue recommendations to the member state concerned and may elect to publish them. The European Parliament and the Council, acting by means of regulations in accordance with the ordinary legislative procedure, may adopt detailed rules for this multilateral surveillance procedure.[104] It is on this basis that the above-mentioned Surveillance Regulation was adopted. It required eurozone member states to submit annual 'stability programmes' and member states with a derogation to establish annual 'convergence programmes'.[105] Among the information to be submitted were the member state's medium-term budgetary objective (MTO) and the adjustment path to achieve this objective for the general government surplus/deficit and the expected path for the general government debt ratio, the main assumptions about economic developments, and an analysis of how changes in the main economic assumptions would affect the budgetary and debt position, the reference of which being 3 and 60 per cent of GDP at market prices. The 2005 amendment rendered the definition of MTOs more flexible, allowing that these 'country-specific [MTOs] . . . diverge from the requirement of close to balance or in surplus position . . . [and leaving] room for budgetary manoeuvre, considering notably the needs for public investment'.[106]

As regards the corrective arm of the SGP, its declared objective is to speed up and clarify the excessive deficit procedure as based on TFEU Article 126. According to TFEU Article 126(1) member states are under a strict obligation to avoid excessive government deficits. As set forth by TFEU Article 126(2), the Commission is in charge of monitoring the development of the budgetary situation and of the stock

[103] This option for the Commission to issue a warning is a new step in the multilateral surveillance process. It has existed only since the Lisbon Treaty came into force on 1 December 2009.

[104] TFEU Article 121(6).

[105] These stability and convergence programmes had to be established according to the rules set forth in the Surveillance Regulation and along the guidelines laid down in a code of conduct issued by the Commission as endorsed by the ECOFIN Council. See European Commission, Economic and Financial Affairs, 'Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes' (consolidated version, endorsed by the ECOFIN Council on 7 September 2010) <http://ec.europa.eu/economy_finance/sgp/pdf/coc/2009-11-19_code_of_conduct_(consolidated)_en.pdf> accessed 1 July 2013.

[106] Article 2a of Council Regulation No 1466/1997 (n 99) as amended by Council Regulation No 1055/2005 (n 100). As indicated earlier, as part of the 2011 overhaul of the SGP, that Regulation was again amended. See Subsection II.B.1 for detail. Prior to the 2011 reform of the SGP, recommendations under TFEU Article 121(4) have been issued only once. See Council Recommendation of 12 February 2001 with a view to ending the inconsistency with the broad guidelines of the economic policies in Ireland (2001/191/EC). The Council decided the same day to publish the recommendation (2001/192/EC). See Lastra (n 5) 266–7.

of government debt in the member states in light of the reference values of 3 and 60 per cent of GDP respectively.[107] The Commission is not merely required to verify whether the actual levels of the budgetary deficit and the stock of debt exceed the reference values but, in case the reference values are not respected, to judge whether the budgetary deficit 'has declined substantially and continuously and reached a level that comes close to the reference value, or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value'[108] and whether the stock of debt 'is sufficiently diminishing and approaching the reference value at a satisfactory pace'.[109]

TFEU Articles 126(3)–(13) set forth a detailed procedure aimed at rectifying any scenario where it has been established that an excessive deficit exists. Coercive measures of increasing severeness, ranging from non-financial penalties such as the requirement to publish additional information before issuing bonds and securities to cash deposits and fines, may be applied to member states that fail to take the measures deemed necessary by the Council to remedy the excessive deficit.[110] The above-mentioned Excessive Deficit Regulation, adopted under what is now TFEU Article 126(14), and the Protocol on the Excessive Deficit Procedure supplement the treaty provisions, setting forth in detail, inter alia, the system of applicable sanctions.[111]

The corrective arm of the SGP originally became discredited following the Council's failure in 2003 to properly apply the rules of the excessive deficit procedure to the two most powerful EU members, Germany and France.[112] This open disrespect of the rules of the SGP prompted the Commission to take legal action against the Council before the ECJ which ruled on 13 July 2004, in *Commission v Council*,[113] that the Council's decision to hold the excessive deficit procedures against Germany and France in abeyance and to modify the recommendations that it had previously adopted, so as to reflect what Germany and France were willing to commit to, had been unlawful.[114] Yet, instead of leading to a more rigorous enforcement of the excessive deficit procedure, the ECJ's 2004 judgment strengthened the political resistance to what was perceived by the SGP's critics as a too narrow focus on quantitative limits and a too mechanical application of the treaty rules on fiscal discipline, resulting in the first major reform of the SGP undertaken in 2005.

[107] The reference values are specified in the Protocol on the Excessive Deficit Procedure (Protocol No 12, attached to the Treaties).

[108] TFEU Article 126(2)(a).

[109] TFEU Article 126(2)(b).

[110] According to TFEU Article 139(2)(b) the coercive measures set forth in TFEU Article 126(9) and (11) do not apply to non-eurozone member states.

[111] Articles 11–16 of Council Regulation No 1467/1997 (n 101) as amended by Council Regulation No 1056/2005 (n 102). As indicated earlier, as part of the 2011 overhaul of the SGP, that Regulation was again amended. See Subsection II.B.1 for details.

[112] For detailed information on the relevant procedures regarding France and Germany respectively, see, eg, Lastra (n 5) 268–70.

[113] ECJ, Case C-27/04, 13 July 2004.

[114] For detail on this case, see, eg, Proctor (n 3) 713–14 and Lastra (n 5) 271–2.

With the 2005 revision of the Excessive Deficit Regulation the enforcement of budgetary discipline was significantly weakened. Article 2(3) of the 2005 version of the Excessive Deficit Regulation illustrates the great amount of flexibility thus introduced into the procedure:

> [T]he Commission shall give due consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value . . . [S]pecial consideration shall be given to budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe if it has a detrimental effect on the growth and fiscal burden of a Member State.[115] A balanced overall assessment shall encompass all these factors.[116]

In the years following the loosening of the SGP, non-respect of the reference values for the annual deficit and the stock of debt became commonplace. Thus, throughout the entire history of the SGP not a single one of the many excessive deficit procedures that were formally initiated has ever led to the imposition of formal sanctions. Consequently, in the light of the Global Financial Crisis and the ensuing sovereign debt crisis affecting large parts of the eurozone, EU member states came to realize that the SGP as revised in 2005 implemented the treaty rules on budgetary discipline, both with respect to surveillance and correction, only in an inadequate manner. Hence, out of recognition 'that the framework for EMU should be urgently strengthened in order to anchor macroeconomic stability and the sustainability of public finances, which are preconditions for durable output and employment growth',[117] far-reaching legislative efforts were launched in 2010, most of them having been successfully concluded in the meantime. The key objective of all these reforms was to strengthen fiscal and macroeconomic governance in the EMU without having to modify the existing treaty framework.

The following section presents these various sets of reforms, one of which consisted in rewriting the SGP once again, this time not in order to weaken but to reinforce it, as part of a broader move towards strengthened fiscal governance in the EU in general, and the EMU in particular.

B. The various reforms of the EU legal framework undertaken since 2010 in order to strengthen fiscal governance

This section begins with an assessment of the strengthened SGP as it results from relevant parts of the so-called 'Six-Pack', a major reform package that was initiated in 2010 and completed in November 2011 (Subsection 1). Subsequently, this

[115] As lucidly noted by Lastra, this appears to be a veiled reference to the costs of German reunification which were the main justification of then German Chancellor Gerhard Schröder for why the rules of the SGP should be applied in a very flexible manner. See Lastra (n 5) 265.

[116] Article 2(3) of Council Regulation No 1056/2005 (n 102).

[117] Proposal for a Council Regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, Explanatory Memorandum (29 September 2010), COM(2010) 522 final.

section examines the March 2012 Treaty on Stability, Coordination and Governance (TSCG), an intergovernmental agreement the fiscal policy provisions of which set forth a 'Fiscal Compact' that complements and reinforces the SGP for those EU member states that have ratified the TSCG (Subsection 2). Finally, this section takes a succinct look at yet another set of reforms aiming to further strengthen EU fiscal governance, final agreement on which was reached in February 2013, namely the so-called 'Two-Pack' (Subsection 3).

1. The strengthened SGP resulting from the 2011 Six-Pack

As part of 'Europe 2020',[118] the EU's new growth strategy, and in close cooperation with the European Council's Task Force on Economic Governance,[119] the European Commission presented, in September 2010, a package of six legislative proposals aimed at reinforcing economic governance in the EMU.[120] On 13 December 2011, the Six-Pack entered into force. This subsection looks into those four components of the Six-Pack that serve to strengthen both the preventive and corrective arms of the SGP introduced earlier.[121] They complement the new alignment of national budget and policy planning under the so-called 'European Semester', the first of which was launched in January 2011.[122]

[118] Europe 2020, originally proposed by the Commission in March 2010, was formally adopted by the European Council on 17 June 2010 (EUCO 13/10). As part of this 'new strategy for jobs and smart, sustainable and inclusive growth' (EUCO 13/10), the EU has set itself five ambitious objectives to be reached by the year 2020. These EU-wide targets cover the fields of employment (75 per cent of the 20–64-year-olds to be employed), research & development (R&D)/innovation (3 per cent of the EU's GDP (public and private combined) to be invested in R&D/innovation), climate change/energy (20 per cent of energy from renewables, 20 per cent increase in energy efficiency, greenhouse gas emissions 20 per cent lower than 1990 (30 per cent if a satisfactory international agreement can be achieved to follow the Kyoto Protocol)), education (reducing school drop-out rates below 10 per cent, at least 40 per cent of 30–34-year-olds completing third level education), and poverty/social exclusion (at least 20 million fewer people in or at risk of poverty and social exclusion). Member states are called upon to establish national targets in each of these areas. For detail on Europe 2020, see the Commission's website at <http://ec.europa.eu/europe2020/index_en.htm>.

[119] The Task Force on Economic Governance was set up following the European Council meeting of 25–26 March 2010. Charged with devising proposals for better budgetary discipline and an improved crisis resolution mechanism in cooperation with the European Commission, it was composed of the finance ministers of the 27 EU member states and chaired by European Council President Herman van Rompuy. It presented its final report at the European Council meeting of 28–29 October 2010. See 'Strengthening Economic Governance in the EU—Report of the Task Force to the European Council' (21 October 2010) <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf> accessed 1 July 2013.

[120] The introduction of these proposals was preceded by two Commission communications, dated 12 May 2010 (COM(2010) 250 final and IP/10/561) and 30 June 2010 (COM(2010) 367/2 and IP/10/859).

[121] See Section II.A above.

[122] On 7 September 2010, the European Council (at a meeting of the ECOFIN Council) approved a number of changes to how the SGP is implemented in order to allow for a 'European Semester' during the first half of each calendar year. Under this new monitoring cycle, the first of which began in January 2011, the economic and budgetary policies of EU member states will be monitored in parallel during the first half of each year, replacing the uncoordinated monitoring of the past, spread over the entire year. The European Semester begins in January each year with the publication by the Commission of a so-called Annual Growth Survey, to be discussed by Council formations and the European Parliament. At the Spring European Council meeting, member states will identify the main challenges facing the EU and give strategic advice. Subsequently, taking this guidance into account, EU member

The first component of the Six-Pack that serves to strengthen the SGP is a regulation under TFEU Article 121(6),[123] amending the legislative underpinning of the preventive arm of the SGP, the earlier mentioned Surveillance Regulation.[124] The key innovation in this regulation is the introduction of the concept of prudent fiscal policymaking into the EU's multilateral surveillance process. Under this concept, a prudent rate of medium-term economic growth is used as a benchmark in assessing the sustainability of government expenditure growth in each member state. The idea is to allow departures from that benchmark only to the extent that they are matched by discretionary revenue measures to avoid one-time revenue windfalls being used to raise government expenditure levels in an unsustainable manner.[125]

The second relevant component of the Six-Pack is a regulation under the second subparagraph of TFEU Article 126(14),[126] amending the legislative underpinning of the corrective arm of the SGP, the earlier-mentioned Excessive Deficit Regulation.[127] This regulation establishes an explicit benchmark—a decline of one-twentieth per year over the course of the past three years[128]—for sufficiently diminishing debt ratios out of recognition that in the past, excessive deficit procedures have focused almost exclusively on the 3 per cent of GDP threshold for the annual budgetary deficit (although the deficit and debt criteria have in principle always been on an equal footing).[129]

states present their medium-term budgetary strategies through Stability and Convergence Programmes according to the revised Code of Conduct mentioned in the preceding section (n 105), and draw up national reform programmes covering the five fields of the Europe 2020 strategy. The two documents are sent to the Commission in April based on which the Commission will issue country-specific guidance by June and July. Each July, before member states finalize their draft budgets for the following year, the European Council and the Council of ministers provides them with policy advice. The final word on the domestic budget hence continues to rest with national parliaments. See European Council, 'European Semester: a new architecture for the new EU Economic governance—Q&A', MEMO/11/14 (12 January 2011) <http://europa.eu/rapid/press-release_MEMO-11-14_en.htm> accessed 1 July 2013. The latest Annual Growth Survey, ie that for 2013 (COM(2012) 750 final), published by the Commission on 28 November 2012, is available on the Commission's website at <http://ec.europa.eu/europe2020/pdf/ags2013_en.pdf> accessed 1 July 2013.

[123] Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, [2011] OJ L306/12.

[124] Council Regulation No 1466/1997 (n 99) as first amended in 2005 by Council Regulation No 1055/2005 (n 100).

[125] See Marco Buti and Martin Larch, 'The Commission Proposals For Stronger EU Economic Governance: A Comprehensive Response to the Lessons of the Great Recession' (voxeu.org article, 14 October 2010) <http://www.voxeu.org/index.php?q=node/5672> accessed 1 July 2013.

[126] Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, [2011] OJ L306/33.

[127] Council Regulation No 1467/1997 (n 101) as first amended in 2005 by Council Regulation No 1056/2005 (n 102).

[128] See Article 2, para (1)(a), of Council Regulation No 1467/1997 (n 101) as amended by Council Regulation (EU) No 1177/2011 (n 126).

[129] The Protocol on the Excessive Deficit Procedure (n 107), which sets forth both reference values, does not single out one of them as being more important than the other.

It seems indeed that, in the light of declining average economic growth rates and the resulting insufficiency of respecting the 3 per cent deficit threshold for ensuring a declining debt ratio, the introduction of a formal benchmark for sufficiently diminishing debt ratios may be viewed as a useful innovation.[130] However, the effectiveness of the proposed benchmark seems to be reduced by the fact that all relevant factors, such as very low nominal growth rates, have to be taken into account before a member can be placed in excessive deficit. Rather unfortunately, this recalls the flexibility introduced by the 2005 rewriting of the SGP, which, as noted earlier,[131] did not enhance but rather undermines, the framework's effectiveness.

The third relevant component of the Six-Pack is a new directive under the third paragraph of TFEU Article 126(14),[132] setting forth minimum requirements for national fiscal governance (covering, notably, accounting systems, statistics, forecasting practices, fiscal rules, and budgetary procedures). Without encumbering this study with the technical details of these minimum standards, it can be observed that if fiscal policymaking is to remain completely decentralized, then it is indeed vital to ensure that the SGP's objectives are reflected in the design of national budgetary frameworks. It still remains, of course, that the harmonization of budgetary standards achieved by the above directive does no more than setting minimum standards and falls short of a more ambitious solution that would go in the direction of European fiscal union.[133]

The fourth and final component of the Six-Pack that serves to strengthen the SGP is a new regulation under the new TFEU Article 136,[134] in combination with TFEU Article 121(6),[135] backing up the above-mentioned changes of both the preventive and corrective arms of the SGP with a new set of gradual financial sanctions for eurozone member states. This regulation essentially serves to overcome one of the main deficits of the enforcement mechanism of the excessive deficit procedure as existing up until 2011. As noted in the preceding section, the possibility to impose financial sanctions against member states that persistently fail to correct an excessive deficit has never actually been relied upon. As has been convincingly argued by the Commission when proposing this regulation, one of the main reasons for the failure of the previous enforcement mechanism seemed to be that sanctions 'come into play too late in the process to represent an effective deterrent . . . not least because the financial situation of the country concerned may

[130] See, eg, Buti and Larch (n 125). [131] See Section II.A above.

[132] Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, [2011] OJ L306/41.

[133] See Section III.B of this chapter for additional comments on the issue of European fiscal union.

[134] With TFEU Article 136, the Lisbon Treaty has given the Council the power to adopt measures by qualified majority on budgetary discipline and economic policy guidelines for eurozone member states in accordance with the relevant procedures from among those referred to in TFEU Articles 121 and 126.

[135] Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area, [2011] OJ L306/1.

have deteriorated so much as to make the threat of a fine less credible at the very time when it should become real'.[136]

Under the new regulation, financial sanctions apply much earlier. Specifically, under the preventive arm of the SGP, the lodging of an interest-bearing deposit amounting to 0.2 per cent of the member state's GDP in the preceding year will be imposed whenever a member state fails to take action in response to recommendations by the Council under TFEU Article 121(4) for a significant deviation from prudent fiscal policymaking.[137] Under the corrective arm of the SGP, a member state will have to make a non-interest bearing deposit equalling 0.2 per cent of its GDP in the preceding year whenever it is formally placed in excessive deficit, 'or where the Commission has identified particularly serious non-compliance with the budgetary policy obligations laid down in the SGP'.[138] This deposit can be turned into a fine in the event of non-compliance with the initial recommendation.[139] To ensure effective enforcement, the regulation provides for a reverse voting mechanism: whenever the Commission recommends to impose fines, the decision to impose these fines will be deemed to be adopted by the Council unless it decides otherwise by a qualified majority within 10 days of the Commission's adoption thereof. Unsurprisingly, this feature had been one of the most controversially discussed aspects of the Commission's original proposal. It renders sanctions under the strengthened SGP at least semi-automatic which is a major departure from the excessively discretionary earlier regime.

Other very contested issues, such as severe non-financial sanctions, taking notably the form of a temporary suspension of voting rights for members that persistently breach the rules, once favoured by Germany and Jean-Claude Trichet, then President of the ECB,[140] did not even make it into the Commission's original proposals. Overall, there is little doubt that the four fiscal-governance components of the Six-Pack have the potential to revive and strengthen the SGP in a sensible manner. However, the adopted instruments also plainly illustrate that EU member states are willing to coordinate their domestic fiscal policies only to the extent that doing so appears absolutely necessary for preserving the single currency. The fiscal-governance components of the Six-Pack fall short of communitarizing national fiscal policies and of establishing even a modest fiscal union.

[136] Proposal for a Regulation of the European Parliament and of the Council on the effective enforcement of budgetary surveillance in the euro area (29 September 2010), COM(2010) 524 final, explanatory memorandum 5.

[137] See the detailed provisions of Article 4 of Regulation (EU) No 1173/2011 (n 135).

[138] Regulation (EU) No 1173/2011 (n 135) Article 5.1.

[139] It should be noted in this context that the amount of 0.2 per cent of a member state's GDP in the previous year corresponds to the fixed component of the final-step sanctions that existed under the excessive deficit procedure as in force until late 2011, the main difference being the moment when these sanctions came into play.

[140] See, eg, Ralph Atkins and Lionel Barber, 'Trichet calls for tougher euro rules' *Financial Times* (9 September 2010) <http://www.ft.com/cms/s/0/13730da2-bc31-11df-8c02-00144feab49a.html> accessed 1 July 2013.

2. The Treaty on Stability, Coordination and Governance

Out of awareness that national fiscal policies had to be more narrowly coordinated than prescribed by EU law, all member states of the EU, except the United Kingdom and the Czech Republic, signed an intergovernmental treaty on 2 March 2012, the TSCG. More precisely, the TSCG serves

> to strengthen the economic pillar of the economic and monetary union by adopting a set of rules intended to foster budgetary discipline through a fiscal compact [set forth in TSCG Title III], to strengthen the coordination of their economic policies and to improve the governance of the euro area, thereby supporting the achievement of the European Union's objectives for sustainable growth, employment, competitiveness and social cohesion.[141]

The TSCG entered into force on 1 January 2013 for those 16 member states having completed their respective ratification process by that date. As of 1 July 2013, 21 out of 25 signatory states, among which 15 out of 17 eurozone member states had completed ratification.[142] The TSCG and its key component, the Fiscal Compact, though not being EU law, apply in parallel to the SGP as reformed by the four fiscal-policy components of the Six-Pack analysed above, partly reiterating, partly reinforcing the provisions of the reformed SGP.[143]

Thus, the TSCG requires the Contracting Parties to implement the key rules of the revised SGP (ie to maintain the budgetary position of the general government balanced or in surplus and to respect/ensure convergence towards the Country-specific MTOs defined in the revised SGP, with a lower limit of a structural deficit of 0.5 per cent of GDP at market prices) in national law, 'through provisions of binding force and permanent character, preferably constitutional'.[144] The Contracting Parties are further obliged to establish at national level a binding correction mechanism, to be triggered automatically in the event of significant observed deviations from the applicable MTO or the adjustment path towards it.[145]

Article 7 of the TSCG is another example where the Fiscal Compact is more stringent than the revised SGP. It determines that at each stage of an excessive deficit procedure, the member states of the eurozone 'commit to supporting the proposals or recommendations submitted by the European Commission', unless a qualified majority of eurozone member states 'is opposed to the decision proposed or recommended'. Importantly, this requirement of reverse qualified majority voting applies even if not foreseen in the SGP.

The TSCG states that within five years of its entry into force, ie by 1 January 2018, the experience with its implementation shall be assessed and that, on that

141 TSCG Article 1.1.

142 For the current status of the ratification process, see <http://www.consilium.europa.eu/policies/agreements/search-the-agreements-database?command=details&id=&lang=en&aid=2012008&doclang=EN%22>.

143 See Subsection II.B.1 above.

144 TSCG Article 3.2, in conjunction with TSCG Article 3.1(a) and (b).

145 TSCG Article 3.2, in conjunction with TSCG Article 3.1(e).

basis, the necessary steps shall be taken, in accordance with the TFEU, to incorporate the substance of the TSCG into EU law.[146]

3. Further strengthened fiscal governance: the Two-Pack

Finally, the EU legal framework on fiscal governance has been complemented in 2013 by two additional regulations, based on TFEU Article 136, the so-called 'Two-Pack', intended to further strengthen economic governance and budgetary surveillance as regards members of the eurozone.[147] The Two-Pack comprises (1) a regulation on enhanced monitoring and assessment of draft budgetary plans of eurozone members, with closer monitoring for those with an ongoing excessive deficit procedure,[148] as well as (2) a regulation on enhanced surveillance of eurozone members that are experiencing or threatened with serious financial difficulties, or that request financial assistance.[149]

In a nutshell, under the Two-Pack, by 30 April each year, eurozone members will have to publish their respective medium-term fiscal plans, together with their respective policy priorities for growth and employment for the forthcoming 12 months in the context of the European Semester.[150] By 15 October, eurozone members will have to publish their respective draft budgets for the following year and will have to adopt them by 31 December.[151] The key innovation of the Two-Pack is that, by 30 November, the Commission will have to examine, and give an opinion on, the draft budget of each eurozone member state.[152] In case of a serious non-compliance with the budgetary obligations laid down in the SGP, the Commission will request that the draft budget be revised.[153] As regards the eurozone as a whole, the Commission will publish a comprehensive assessment of the budgetary outlook for the following year. The Two-Pack further reinforces the surveillance mechanisms under the revised SGP for the eurozone. Thus, it obliges eurozone members with an ongoing excessive deficit procedure to provide additional and more detailed information to the Commission on the measures taken to correct the

[146] TSCG Article 16.

[147] Council of the European Union, 'Economic governance: Council confirms agreement with EP on "two-pack"' (28 February 2013), Press Release PRESSE 78, <http://register.consilium.europa.eu/pdf/en/13/st06/st06866.en13.pdf> accessed 1 July 2013.

[148] Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, [2013] OJ L140/11.

[149] Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, [2013] OJ L140/1.

[150] Council of the European Union (n 147). For the detailed rules on the common budgetary timeline, see Regulation (EU) No 473/2013 (n 148), Article 4. On the European Semester, see n 122 above.

[151] European Commission, '"Two-Pack" completes budgetary surveillance cycle for euro area and further improves economic governance' (12 March 2013) Press Release MEMO/13/196 <http://europa.eu/rapid/press-release_MEMO-13-196_en.htm?locale=FR> accessed 1 July 2013.

[152] Regulation (EU) No 473/2013 (n 148), Article 7.

[153] European Commission (n 151). The remainder of this paragraph summarizes the information provided in the above press release by the Commission.

excessive deficit than would be required under the SGP.[154] It should also be noted that the Two-Pack integrates some elements of the Fiscal Compact into EU law, such as the requirement for eurozone member states to report *ex ante* on their national debt issuance plans with a view to better coordinate national debt issue plans across the eurozone.[155]

C. *The EU's new legal framework for strengthened macroeconomic governance*

In addition to its four components aimed at strengthening the SGP,[156] the 2011 Six-Pack also focuses on the issue of macroeconomic governance in the EU. This section therefore presents those two components of the Six-Pack that are related to the detection, prevention, and correction of macroeconomic imbalances.

Since 2008, ie since the G-20 began to put a strong focus on the issue of global current account imbalances as one of the factors causing and exacerbating the Global Financial Crisis,[157] the Commission, too, has repeatedly called for a broadening of economic surveillance in the EMU in order to detect and address macroeconomic imbalances at an early stage.[158] It therefore included two related proposals for new regulations in the legislative package presented on 29 September 2010 and entered into force on 13 December 2011. The two new regulations serve to supplement the multilateral surveillance framework under TFEU Article 121(3) and (4) with specific rules on macroeconomic imbalances, with the related procedure to be embedded in the annual multilateral surveillance cycles under the European Semester.[159] They may thus be regarded as a major extension of the current scope of the SGP.

The first component of the Six-Pack serving to strengthen macroeconomic governance is a new regulation under TFEU Article 121(6),[160] supplementing the multilateral surveillance process with a framework for identifying and addressing large macroeconomic imbalances, as well as large and persistent divergences in external competitiveness between the economies of EU member states.[161] The new

[154] Regulation (EU) No 472/2013 (n 149), Articles 3 and 4.

[155] Regulation (EU) No 473/2013 (n 148), Article 8. On the requirement for *ex-ante* coordination of debt issuance plans as enshrined in the Fiscal Compact, see TSCG Article 6.

[156] See the analysis in Subsection II.B.1 above.

[157] On the G-20's efforts to tackle the issue of global current account imbalances see the analysis provided in Chapter 3, Section III.B, of this monograph.

[158] See, notably, European Commission, Directorate-General (DG) Economic and Financial Affairs, 'EMU@10: Successes and challenges after ten years of Economic and Monetary Union' European Economy 2/2008 <http://ec.europa.eu/economy_finance/publications/publication12682_en.pdf>; as well as European Commission, DG Economic and Financial Affairs, 'Annual Report on the Euro Area 2009' European Economy 6/2009 <http://ec.europa.eu/economy_finance/publications/publication15951_en.pdf> (both accessed 1 July 2013).

[159] For detail on the European Semester, see n 122 above.

[160] Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, [2011] OJ L306/25.

[161] The new regulation, in its Article 2, defines 'imbalances' in a broad manner as 'any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to

regulation provides for a regular assessment of each member state, based on an annually updated scoreboard of economic indicators.[162] The new regulation stipulates that, upon triggering of the alert mechanism included in the regulation, the Commission shall launch an in-depth review for each member state that it considers affected by, or at risk of being affected by, imbalances.[163] If, based on this in-depth review, the Commission identifies relevant imbalances it has to inform the European Parliament, the Council, and the Eurogroup accordingly, with the results of any in-depth review having to be made public.[164] Subsequently, in less serious cases, the Council, upon recommendation by the Commission, will address recommendations to the member state concerned under the procedure in TFEU Article 121(2) mentioned earlier.[165] In more serious cases, the Council may open a so-called 'excessive imbalances procedure' and issue its recommendations according to the procedure in TFEU Article 121(4).[166] Any member state for which such an excessive imbalances procedure has been opened, is obliged to take corrective action under close monitoring by the Commission via regular progress reports by the member state concerned and optional surveillance missions by the Commission.[167] Both the progress reports by the member undergoing an excessive imbalances procedure and the Commission's assessment of the corrective action taken would be made public.[168]

The Council's recommendations for corrective action are further backed up by the Six-Pack's second component on the subject of macroeconomic imbalances, a new Regulation under TFEU Article 136, in combination with TFEU Article 121(6).[169] Under this new regulation, which applies exclusively to members of the eurozone, non-compliance with the recommendations issued by the Council leads to the imposition of an interest-bearing deposit, and repeated non-compliance to a yearly fine, both equalling 0.1 per cent of the member state's GDP in the preceding year.[170] As in the fiscal field, in order to render the imposition of fines semi-automatic, a reverse voting mechanism under qualified majority applies, not taking into account the vote of the member state concerned.[171] The regulation determines

affect, the proper functioning of the economy of a Member State or of the [EMU], or of the Union as a whole'. 'Excessive imbalances' are defined as 'severe imbalances, including imbalances that jeopardise or risk[] jeopardising the proper functioning of the [EMU]'. Hence, this definition of macroeconomic imbalances goes significantly beyond an objective, and more easily measureable, focus on current account imbalances.

[162] See the detailed provisions of Article 4 of Regulation (EU) No 1176/2011 (n 160).

[163] Regulation (EU) No 1176/2011 (n 160) Article 5.1.

[164] Regulation (EU) No 1176/2011 (n 160) Articles 5.3 and 6.1.

[165] Regulation (EU) No 1176/2011 (n 160) Article 6.1. For detail on the procedure in TFEU Article 121(2), see Section II.A above.

[166] Regulation (EU) No 1176/2011 (n 160), Article 5.2.

[167] See Regulation (EU) No 1176/2011 (n 160) Article 9.

[168] Regulation (EU) No 1176/2011 (n 160) Articles 9.2 and 10.2.

[169] Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, [2011] OJ L306/8.

[170] See the detailed provisions of Regulation (EU) No 1174/2011 (n 169) Article 3.

[171] Regulation (EU) No 1174/2011 (n 169) Article 5.1.

that any collected fines shall be assigned to the European Financial Stability Facility (EFSF) to any subsequently created stability mechanism serving to safeguard the stability of the euro area as a whole,[172] which applies to the European Stability Mechanism (ESM) as subsequently created permanent crisis resolution mechanism.[173]

Overall, these two regulations on strengthening macroeconomic governance in the EU clearly do not alter the fact that the economic-union component of the EMU continues to be a rather weak one. Mirroring the failure of G-20 members at the Seoul Summit of November 2010 and subsequent leaders summits to agree on numerical benchmarks for the reduction of current account imbalances,[174] the Commission's proposals on reducing macroeconomic imbalances and related competitiveness gaps between EU member states remain vague and overly discretionary. Under the proposed rules on excessive imbalances, the Commission might end up finding that a current account deficit of 3.5 per cent of a small member state amounts to an excessive imbalance, whereas a 5 per cent surplus of Germany's export-driven economy does not. If this were to happen in practice, the legitimacy of the EU's efforts to reduce macroeconomic imbalances would be fundamentally undermined, similarly to what happened as a consequence of the disrespect of the rules of the SGP's excessive deficit procedure with respect to Germany and France in 2003.[175] Hence, the Six-Pack's two components on macroeconomic governance might end up doing more harm than good to the EU's multilateral surveillance mechanism.

Overall, the experience of the Global Financial Crisis and the ensuing sovereign debt crisis in parts of the EMU have clearly brought EU member states to agree on the urgent need of at least some strengthening of macroeconomic governance by the EU and a closer coordination of domestic economic policies. This illustrates two things. Firstly, economic constraints are clearly the main driving force behind the regionalization of monetary sovereignty. Secondly, every transfer of sovereign powers to the supranational level and every limitation of policies for which the members of an economic and monetary union had previously retained exclusive competence, has to overcome fierce national resistance grounded in the classical, yet outdated, understanding of sovereignty as being the mere sum of exclusive domestic competences. Moving ahead, the final part of this chapter will now look into several overarching legal and conceptual challenges exposed by the potential sovereign default of monetary union members.

[172] Regulation (EU) No 1174/2011 (n 169) Article 4. It is interesting to note in this context, that the original proposal by the Commission had suggested that any collected fines be distributed, in proportion to the size of their respective GDP, to eurozone member states that are not the subject of an excessive imbalances procedure and that do not have an excessive deficit as determined under TFEU Article 126(6).

[173] For detail on the EFSF and the ESM, see Section III.A of this chapter.

[174] For a detailed account of the relevant results reached at the various G-20 summits since 2008, see Chapter 3, Section III.B, of this monograph.

[175] See Section II.A above.

III. Overarching Legal and Conceptual Challenges Exposed by the Potential Sovereign Default of Monetary Union Members

To begin with, this final part provides an analysis of the legal techniques that have been employed, and the mechanisms which have been set up, to avoid, or at least delay, the sovereign default of members of the eurozone (Section A). Subsequently, it succinctly puts into perspective the EU's choice to fight macroeconomic imbalances between member states instead of embarking on decisive steps towards closer fiscal union, thereby avoiding a new logical inconsistency (Section B). Finally, in light of the analysis provided throughout this chapter, this final part elaborates why the increasing regionalization of monetary sovereignty should not be considered as the surrender of monetary sovereignty but as its effective exercise (Section C).

A. The legal techniques and mechanisms developed to avoid or at least delay the sovereign default of members of the eurozone

This section begins with an examination of the arrangements that were devised by the European Commission, the ECB and the IMF (the three being usually referred to in this context as 'the Troika') in 2010 in order to assist Greece with its sovereign debt crisis (Subsection 1). It then presents the EU's initial crisis resolution mechanisms, ie the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) that were relied upon for the financial assistance programmes granted to Ireland (2010), Portugal (2011), and again Greece (2012) (Subsection 2). Finally, this section analyses the creation of the European Stability Mechanism (ESM) as the eurozone's permanent crisis resolution mechanism, relied upon for the first time to support Spain (2012) and Cyprus (2013) (Subsection 3).

1. The arrangements devised by the Troika in 2010 to assist Greece with its sovereign debt crisis

In Spring 2010, in the light of increasing fears on financial markets that Greece might default on parts of its sovereign debt, as expressed in tremendously rising borrowing costs for the Greek government following repeated downgrading of Greece's credit rating by the world's leading rating agencies,[176] the eurozone had to confront a challenge without precedent in its history. Letting Greece default, at least in a precipitous and disorderly manner, was not an option for the other eurozone members out of fear that doing so might lead investors to lose faith in other eurozone countries, notably in Ireland, Portugal, Spain, and Italy, which were

[176] For information on the Greek economy, see the IMF's country page for Greece, available at <http://www.imf.org/external/country/GRC/index.htm>. For background information on the origins of the Greek sovereign debt crisis, see, eg, European Commission, DG Economic and Financial Affairs, 'The Economic Adjustment Programme for Greece' European Economy, Occasional Papers 61 (May 2010) 3–8 <http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp61_en.pdf> accessed 1 July 2013.

(and, as of 1 July 2013, still are) themselves struggling to avoid a sovereign debt crisis in the aftermath of the Global Financial Crisis. Besides the challenge of gathering the necessary political and economic support from member states for an assistance programme for Greece, the EU was constrained to using legal techniques consistent with the so-called 'no bail-out clause' in TFEU Article 125(1) which states in relevant part that '[t]he Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities . . . of any Member State'.

As a consequence, it quickly emerged that the EU would not provide direct financial support to Greece, but that Greece's fellow eurozone member states would support it, as part of a joint eurozone-IMF financing package, via bilateral, non-concessional, loans centrally pooled by the European Commission. In order to render full repayment by Greece more likely these loans were to be accompanied by strict conditionality following closely the standard techniques of IMF stand-by arrangements.[177] On 2 May 2010,[178] the Troika and Greece announced their agreement on a three-year programme of economic and financial policies providing Greece with a total of EUR 110 billion.[179] Eurogroup members unanimously found that activating stability support for Greece under the agreed modalities was warranted to safeguard financial stability in the eurozone as a whole.[180] On 9 May 2010, the IMF Executive Board approved the related three-year EUR 30 billion stand-by arrangement for Greece in support of the Greek authorities' adjustment and transformation programme, with about EUR 5.5 billion being made immediately available.[181] This stand-by arrangement, amounting to more than 3,200 per cent of Greece's IMF quota, was approved under the Fund's fast-track Emergency Financing Mechanism procedures.[182] On 10 May 2010, the European Council adopted a Decision under TFEU Articles 126(9) and 136 as part of Greece's ongoing excessive deficit procedure, hence underpinning the main elements of policy conditionality as agreed between Greece and its fellow eurozone member states.[183] Further detail on specific economic policy conditionality as

[177] For a detailed analysis of IMF conditionality and the related legal instruments and techniques, see Chapter 2, Section II.A, of this monograph.

[178] For a chronological overview of the events leading up to the financial assistance programmes for Greece by both the IMF and eurozone members, see European Commission (n 176) 8–9.

[179] Of these EUR 110 billion, EUR 80 billion were to be provided bilaterally by Eurogroup members and EUR 30 billion by the IMF.

[180] See the statement by the eurozone heads of state or government, dated 7 May 2010, <http://ec.europa.eu/commission_2010-2014/president/news/speeches-statements/pdf/114295.pdf> accessed 1 July 2013.

For the relevant Eurogroup statement, see <http://www.consilium.europa.eu/uedocs/cmsUpload/100502-%20Eurogroup_statement.pdf> accessed 1 July 2013.

[181] See IMF, 'IMF Executive Board Approves €30 Billion Stand-By Arrangement for Greece', Press Release No 10/187 (9 May 2010) <http://www.imf.org/external/np/sec/pr/2010/pr10187.htm> accessed 1 July 2013.

[182] For procedural aspects of lending by the IMF, see Chapter 2, Subsection II.A.1, of this monograph.

[183] Council Decision of 10 May addressed to Greece with a view to reinforcing and deepening fiscal surveillance and giving notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation of excessive deficit (2010/320/EU), 11 June 2010, OJ L145/6.

agreed upon between Greece and the Commission on behalf of eurozone member states was included in a Memorandum of Understanding dated 3 May 2010.[184] On 18 May 2010, eurozone member states disbursed the first instalment (EUR 14.5 billion) of their pooled bilateral loans to Greece, hence resolving Greece's immediate financing needs. At the same time, the ECB, which until then had not engaged in outright bond purchases (contrary to other central banks such as the Fed), bought a vast amount of Greek government bonds after having established its Securities Markets Programme (SMP).[185] On 6 September 2012, the ECB replaced the SMP with a new bond purchasing programme, the Outright Monetary Transactions (OMT).[186] Adopted under Article 18.1 of the ESCB Statute, the OMT programme serves to safeguard an appropriate monetary policy transmission and the singleness of the ECB's monetary policy.[187] Without entering into the details of what continues to be a highly controversial debate, it should be noted that both the SMP and the OMT programme have been criticized both on economic and legal grounds as deteriorating the ECB's balance sheet, thus endangering its stability mission, as undermining the independence of the ECB and as circumventing the prohibition of monetary financing enshrined in TFEU Article 123.[188]

Providing a detailed analysis of Greece's ambitious 2010 adjustment programme as agreed with the IMF and the Commission on behalf of eurozone member states would go beyond the scope and purpose of this chapter. What needs to be stressed, however, is that the legal techniques relied upon by eurozone members in order to buttress the conditionality linked to their pooled bilateral loans to Greece follow closely the IMF's practice with stand-by arrangements:[189] the Greek Minister of Finance and the Governor of the Bank of Greece submitted a letter of intent to their relevant European counterparts,[190] attached to which was a Memorandum of Economic and Financial Policies outlining the economic and financial policies that the Greek government and the Bank of Greece, respectively, promised to implement from 2010 to 2013 in order to strengthen market confidence and Greece's fiscal and financial position. Further attachments contained the above-mentioned Memorandum of Understanding on Specific Economic Policy Conditionality and a Technical Memorandum of Understanding setting forth definitions of

[184] This Memorandum of Understanding on Specific Economic Policy Conditionality is contained in an attachment to: European Commission (n 176).

[185] Decision of the European Central Bank of 14 May 2010 establishing a securities markets programme (ECB/2010/5) (20 May 2010) OJ L124/8.

[186] See ECB, 'Technical Features of Outright Monetary Transactions' (6 September 2012) Press Release <http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html> accessed 1 July 2013.

[187] ECB (n 186). In addition, as observed by Lastra and Louis, the OMT programme serves 'to address severe distortions in government bond markets which originate from fears on the part of investors about the reversibility of the euro' (Lastra and Louis (n 34) 94).

[188] Not very surprisingly, much of this criticism came from Germany, with the President of the *Deutsche Bundesbank*, Jens Weidmann, being the only member on the ECB's Governing Council not to vote in favour of the OMT programme. For detail on both technical aspects of the SMP and the OMT programme as well as the related controversies, see Lastra and Louis (n 34) 91–4.

[189] See the related analysis in Chapter 2, Subsections II.A.1 and II.A.2, of this monograph.

[190] Namely Jean-Claude Juncker, then President of the Eurogroup, Jean-Claude Trichet, then President of the ECB, and Olli Rehn, European Commissioner for Economic and Monetary Affairs.

programme-related performance criteria and indicative targets.[191] Three of these items—Letter of Intent, Memorandum of Economic and Financial Policy, and Technical Memorandum—are indeed the standard instruments involved in every IMF stand-by arrangement.[192]

Since the main elements of policy conditionality to be observed by Greece are equally enshrined in the above-mentioned Council Decision addressed to Greece in the context of its excessive deficit procedure, we are left with the rather exceptional situation that Greece's entire three-year financial package of 2010, totalling EUR 110 billion, has essentially been backed up by three formally distinct, yet substantially almost identical, layers of conditionality.

2. The creation of institutionalized crisis resolution mechanisms in 2010–2011 and their use to support Ireland, Portugal, and again Greece

Immediately following the arrangements for the loan agreement with Greece, EU member states embarked on creating two interrelated mechanisms in order to preserve the financial stability of the EU as a whole and, in particular, that of the eurozone. To begin with, on 9 May 2010, in an extraordinary meeting of the ECOFIN Council, the European Council decided to create the European Financial Stabilisation Mechanism (EFSM),[193] based on TFEU Article 122(2)[194] and an intergovernmental agreement of eurozone member states. The EFSM, which has the authority to raise financial funds totalling up to EUR 60 billion, is an emergency funding programme reliant on funds raised on financial markets and guaranteed by the Commission using the EU budget as collateral. Access to financing from the EFSM is open to any of the EU's member states, ie also to non-eurozone members, experiencing or seriously threatened by a severe economic or financial disturbance caused by exceptional occurrences beyond its control.[195] Financial assistance from the EFSM is subject to strong conditionality and will always take the form of joint EU–IMF support. In order not to conflict with the 'no bail-out clause' in TFEU Article 125(1), 'all costs incurred by the Union in concluding and carrying out each operation' of the EFSM, which may provide only non-concessional loans, and no grants, 'have to be borne by the beneficiary Member State'.[196] The EFSM operates without prejudice to the EU facility providing medium-term financial assistance for non-eurozone member states in

[191] For the Greek authorities' letter of intent and attached memoranda, see European Commission (n 176) Annex 2—Programme Documents.

[192] For the IMF's stand-by arrangement for Greece, approved on 9 May 2010, these items as well as additional relevant materials are all available on the IMF's country page for Greece at <http://www.imf.org/external/country/GRC/index.htm>.

[193] Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism, [2010] OJ L118/1.

[194] TFEU Article 122(2) essentially authorizes the Council, on a proposal from the Commission, to grant, under certain conditions, financial assistance to a member state in difficulties or seriously threatened by severe difficulties caused by natural disasters or exceptional occurrences beyond its control.

[195] For detail on this point and on the EFSM in general, see European Council, 'The European Stabilization Mechanism' (10 May 2010) Press Release MEMO/10/173.

[196] Article 7 of Council Regulation (EU) No 407/2010 (n 193).

difficulties, or seriously threatened by difficulties, regarding their balances of payments (BoP-facility).[197]

Equally on 9 May 2010, the representatives of the governments of the eurozone committed to stand ready to provide temporary financial assistance to each other through the European Financial Stability Facility (EFSF), a special purpose vehicle which was incorporated in Luxembourg on 7 June 2010 as a *société anonyme* (limited liability company) under Luxembourg law, with the eurozone member states as shareholders. The EFSF became fully operational on 4 August 2010.[198] The EFSF can, with the support of the German Debt Management Office, issue bonds or other debt instruments in order to raise the funds needed to provide non-concessional loans to eurozone member states in financial difficulties. Such issues were initially guaranteed by eurozone member states up to a total of EUR 440 billion on a pro rata basis reflecting their shares in the ECB's paid-up capital.[199] On 21 July 2011, the eurozone leaders agreed to raise these guarantees to a total of EUR 780 billion, which increased the actual lending capacity of the EFSF to EUR 440 billion—following ratification by all 17 eurozone members these amendments became effective on 18 October 2011.[200] The IMF will participate in EFSF financing arrangements, providing at least one-third of the total package volume through its usual facilities. According to the EFSF Framework Agreement, the EFSF shall be liquidated on the earliest date after 30 June 2013 on which there are no loans outstanding and all funding instruments issued by the EFSF and any reimbursements due to guarantors have been repaid in full.[201]

The EFSM and the EFSF were called upon to provide financial support for the first time in the context of the joint EU–IMF financial assistance package for Ireland, the second eurozone member state to request and receive financial assistance in the aftermath of the Global Financial Crisis.[202] Following the official Irish request for financial assistance from the EU, made on 21 November 2010, the Troika reached agreement with the Irish authorities at staff level on 28 November 2010 for a three-year loan package of a total of EUR 85 billion. Of this amount, the

[197] The BoP-facility was set up by Council Regulation (EC) No 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments, [2002] OJ L53/1. As of 1 July 2013, the Commission has granted assistance under the BoP-facility to Latvia, Hungary, and Romania (twice, the second time on a precautionary basis). For detailed information on the BoP-facility, see <http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/index_en.htm> accessed 1 July 2013.

[198] For the EFSF Framework Agreement and its Articles of Association as well as additional valuable information on the EFSF, see its official website at <http://www.efsf.europa.eu>.

[199] For the precise guarantee commitments by the different eurozone members and for additional useful information on various operational aspects of the EFSF, see EFSF, 'European Financial Stability Facility (EFSF)' (21 January 2013) <http://www.efsf.europa.eu/attachments/faq_en.pdf> accessed 1 July 2013.

[200] EFSF (n 199) A1.

[201] According to Article 11(2) of the EFSF Framework Agreement.

[202] For detailed information on the financial assistance package for Ireland, including a detailed overview of the evolution of events, all programme-related documents, programme reviews, and official statements, see the country pages for Ireland of the IMF (<http://www.imf.org/external/country/irl/index.htm>) and the European Commission (<http://ec.europa.eu/economy_finance/eu/countries/ireland_en.htm>).

IMF, the EFSM, and the EFSF (together with three bilateral loans from three non-eurozone members (the UK, Sweden, and Denmark)) each agreed to provide EUR 22.5 billion. The remaining EUR 17.5 billion were to come from the Irish Treasury's cash buffer and from investments of the National Pension Fund Reserve.[203] The formal decisions on financial assistance for Ireland were adopted by the ECOFIN Council on 7 December 2010[204] and by the IMF Executive Board (under the IMF's Extended Fund Facility) on 16 December 2010.[205]

On 6 April 2011, Portugal became the third eurozone member state to request joint IMF–EU financial assistance,[206] and the second one after Ireland for which the European contribution is being provided through the financial support mechanisms established under the EFSM and the EFSF. The entire financing package amounts to EUR 78 billion of which the IMF provides about EUR 26 billion through a three-year loan, formally approved on 20 May 2011, under the Fund's Extended Fund Facility (amounting to 2,306 per cent of Portugal's IMF quota).[207]

In order to calm financial markets in the light of persisting sovereign debt concerns over Greece, the heads of state or government of the eurozone and the EU institutions agreed in principle already on 21 July 2011 to support a second financing programme for Greece.[208] Formal agreement on this second financing package, totalling EUR 130 billion, and its modalities was achieved only on 21 February 2012.[209] As part of this programme, the IMF provides about EUR 28 billion through a four-year loan, formally approved on 15 March 2012, under the Fund's Extended Fund Facility (amounting to 2,159 per cent of Greece's IMF quota).[210] As part of this second financial assistance programme for Greece, the

[203] See the related statement by the Eurogroup and ECOFIN Minsters, dated 28 November 2010, at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118051.pdf> accessed 1 July 2013.

[204] European Council, 'Council Implementation Decision on granting Union financial assistance to Ireland' (7 December 2010) 17211/1/10 REV 1.

[205] See IMF, 'IMF Executive Board Approves €22.5 Billion Extended Arrangement for Ireland', Press Release No. 10/496 (16 December 2010) <http://www.imf.org/external/np/sec/pr/2010/pr10496.htm> accessed 1 July 2013.

[206] See the related statement by the Eurogroup and ECOFIN Ministers, dated 8 April 2011, at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/121401.pdf>; for detailed background material on Portugal's sovereign debt crisis, see the European Commission's country page for Portugal at <http://ec.europa.eu/economy_finance/eu/countries/portugal_en.htm> (both accessed 1 July 2013).

[207] See IMF, 'IMF Executive Board Approves €26 Billion Stand-By Arrangement for Portugal', Press Release No 11/190 (20 May 2011) <http://www.imf.org/external/np/sec/pr/2011/pr11190.htm>. For Portugal's IMF country page, see <http://www.imf.org/external/country/PRT/index.htm> (both accessed 1 July 2013).

[208] For the relevant statement, dated 21 July 2011, see <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf> accessed 1 July 2013. This agreement was formalized at the eurozone summit held on 26 October 2011.

[209] For the relevant Eurogroup statement, dated 21 February 2012, see <http://www.consilium.europa.eu/media/1440478/statement_on_greece_21_february_2012.pdf> accessed 1 July 2013.

[210] See IMF, 'IMF Executive Board Approves €28 Billion Arrangement under Extended Fund Facility for Greece', Press Release No 12/85 (15 March 2012) <http://www.imf.org/external/np/sec/pr/2012/pr1285.htm> accessed 1 July 2013. Note that at the same time Greece cancelled its 2010 stand-by arrangement with the Fund; the remaining EUR 10 billion of that programme were carried over into the new arrangement.

earlier May 2010 programme was discontinued, with the eurozone contributions under that programme (EUR 24.4 billion) being taken over by the EFSF (no involvement by the EFSM this time) in addition to it financing the total February 2012 package minus the IMF contribution.[211]

While this second bail-out package for Greece, just as the first programme for Greece as well as those for Ireland and Portugal, is conditional on the gradual implementation by the Greek government of harsh austerity measures to reduce public spending, the distinctive and novel feature of this second programme for Greece is that it also included a major debt restructuring with the private holders of Greek government bonds. Thus, private bondholders were pushed into 'voluntarily' accepting a 53.5 per cent nominal write-off on their bonds as part of a bond swap to both short-term EFSF notes and newly issued Greek bonds with prolonged maturities and lower interest rates.[212] As a result of this biggest debt restructuring deal ever undertaken on a global scale, Greece's public debt was reduced by some EUR 100 billion to reach around EUR 240 billion which, according to the Eurogroup, 'should ensure that Greece's public debt ratio is brought on a downward path reaching 120.5 per cent of GDP by 2020'.[213]

It should be observed that the debt restructuring thus undertaken as part of the second Greek bail-out package did not come out of the blue. It applied in practice the earlier agreement by the members of the Eurogroup, reached at the European Council of 16–17 December 2010, on the fundamental question as to how to deal with a public debt burden that turns out to be unsustainable:

> In the unexpected event that a country would appear to be insolvent, the Member State has to negotiate a comprehensive restructuring plan with its private sector creditors, in line with IMF practices with a view to restoring debt sustainability. If debt sustainability can be reached through these measures, the ESM may provide liquidity assistance.[214]

Thus, with the 2012 restructuring of Greece's private sector debt, the members of the Eurogroup demonstrated their strong commitment to their earlier agreement that, under exceptional circumstances, eurozone member states will have to default in an orderly manner on parts of their debt. It is not surprising that, under the constraints of the 'no-bail out clause' in TFEU Article 125(1), the members of the Eurogroup decided to formally limit any such partial sovereign default to private sector debt. This being said, there can be no doubt that once a member state's public sector debt were to reach unsustainable dimensions, that member state may well be left with no alternative whatsoever to defaulting also on parts of its public

[211] For a detailed breakdown of the various components of the second programme for Greece, explaining the purpose of each programme component and its respective sources of funding and related timing for disbursement, see EFSF (n 199) 18–22.

[212] See, eg, Editorial, 'Greece's default: The wait is over', *The Economist* (online edn, 17 March 2012) <http://www.economist.com/node/21550271> accessed 1 July 2013.

[213] Statement by the Eurogroup dated 21 February 2012 (n 209).

[214] European Council, 'European Council 16–17 December 2010 Conclusions', Annex II: 'General Features of the Future Mechanism: Eurogroup Statement of 28 November 2010'. See also European Council, 'European Council 24/25 March 2011 Conclusions', Annex II Private Sector Involvement.

sector debt, independent of what the treaty framework or any related decision by the Eurogroup may say.

3. The European Stability Mechanism as a permanent crisis resolution mechanism for the eurozone

As noted earlier, both the EFSM and, in particular, the EFSF have been conceived as temporary crisis resolution mechanisms. Thus, at the European Council meeting of 28–29 October 2010, the heads of state or government agreed on the need

> to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole and invite[d] the President of the European Council to undertake consultations with the members of the European Council on a limited treaty change required to that effect, not modifying [the 'no bail-out clause' in TFEU Article 125(1)].[215]

At its meeting of 16–19 December 2010, the European Council agreed in principle on how to amend the TFEU in order to provide the member states with a sufficient legal basis for creating the ESM in consistency with the EU treaty framework. The European Council agreed that TFEU Article 122(2), the legal basis of the EFSM, should not be used for safeguarding the financial stability of the eurozone.[216] After consultation of the institutions under the simplified revision procedure set forth in TEU Article 48(6), the European Council formally adopted a decision amending the TFEU at its meeting on 24–25 March 2011, and 'call[ed] for the rapid launch of national approval procedures with a view to [the amendment's] entry into force on 1 January 2013'.[217] Since the Czech Republic—the last one of the then 27 EU member states to do so—only ratified it on 23 April 2013, the amendment entered into force only on 1 May 2013. Through the amendment, the following paragraph has been added to TFEU Article 136:

> The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.[218]

Consistent with the above provision, on 2 February 2012, the finance ministers of the 17 eurozone member states signed the Treaty Establishing the European Stability Mechanism (ESM Treaty).[219] The ESM Treaty entered into force on 27 October 2012 and began its operations after being formally inaugurated

[215] European Council, 'European Council 28–29 October 2010 Conclusions' (30 November 2010) EUCO 25/1/10 REV 1.
[216] See European Council, 'European Council 16–17 December 2010 Conclusions' (17 December 2010) EUCO 30/10.
[217] European Council, 'European Council 24/25 March 2011 Conclusions' (25 March 2011) EUCO 10/11, para 16.
[218] European Council (n 217) Annex II, Term Sheet on the ESM.
[219] An earlier version of this treaty had been signed on 11 July 2011 but several aspects of it were soon deemed insufficient, which is why it was never ratified.

on 8 October 2012.[220] While the EFSF had been established as a special purpose vehicle under Luxembourg private law,[221] the ESM is an intergovernmental organization under public international law and its offices are based in Luxembourg. Evoking the institutional structure of the IMF, the ESM is headed by a Managing Director (currently Klaus Regling), has a Board of Governors with the finance ministers of the eurozone member states as voting members and the ECB President and the European Commissioner for Economic and Monetary Affairs as observers, as well as a Board of Directors carrying out specific tasks delegated by the Board of Governors.[222] Like the IMF, the ESM is a quota-based institution, with the members' respective voting weights in the institution's governing bodies being proportional to their subscriptions to the ESM's capital.[223] The maximum lending capacity of the ESM is EUR 500 billion. With the EFSF continuing to fund the existing programmes for Portugal, Ireland, and Greece, the combined lending capacity of the EFSF/ESM is thus brought to EUR 700 billion. Of the total subscribed capital, only EUR 80 billion are in the form of paid-in capital, the remaining EUR 620 billion being committed callable capital.[224] ESM loans enjoy preferred creditor status and are junior only to IMF loans.[225] Importantly, the ESM Treaty stipulates that, as of 1 March 2013, the granting of financial assistance by the ESM will be conditional upon ratification of the Fiscal Compact by the ESM member state seeking assistance.[226]

The ESM provided financial assistance for the first time in the second half of 2012 in the context of the recapitalization programme for banks in Spain. Following a request by the Spanish authorities on 25 June 2012, the finance ministers of the Eurogroup decided on 20 July 2012 to grant Spain financial assistance, totalling up to EUR 100 billion, to recapitalize systemically important financial institutions in order to safeguard financial stability in the eurozone as a whole. Since the ESM had not yet come into being in July 2012, it was decided that the financial assistance would initially be provided by the EFSF before being transferred to the ESM. The Eurogroup decided not to recapitalize the banks directly but that the Fund for Orderly Bank Restructuring, acting as an agent of the Spanish

220 Estonia was the last of the 17 eurozone member states to ratify the ESM Treaty on 4 October 2012. However, the ESM Treaty had already entered into force a few days earlier, on 27 September 2012, upon being ratified by Germany, which brought the combined amount of the ESM's capital requirements represented by the member states having ratified the Treaty well beyond the required 90 per cent.

221 See Subsection III.A.2 above.

222 For detailed information on the institutional structure of the ESM and on the many technical aspects of the ESM's operations, see ESM, 'Frequently Asked Questions on the European Stability Mechanism (ESM)' (19 April 2013) <http://www.esm.europa.eu/pdf/FAQ%20ESM%2019042013.pdf> accessed 1 July 2013.

223 The ESM's shareholder contribution key, set forth in Annex I of the ESM Treaty, is based on the ECB's contribution key. Thus, Germany and France as the largest shareholders hold 27.146 and 20.386 per cent respectively of the total shares whereas Estonia and Malta only hold 0.186 and 0.073 per cent respectively. For the complete shareholder contribution key and related capital subscriptions, see also ESM, 'ESM Factsheet' <http://www.esm.europa.eu/pdf/ESM%20Factsheet%2030042013.pdf> accessed 1 July 2013.

224 ESM (n 222) A9.

225 ESM (n 222) A18.

226 Preamble of the ESM Treaty, Recital 5.

government would receive the funds and channel them to affected financial institutions as needed.[227] As stated by the Eurogroup ministers, '[t]he Spanish government will retain full responsibility of the financial assistance',[228] in other words, the full amount of any financial assistance granted as part of this programme will be added to Spain's sovereign debt. So far, a total of EUR 41.351 billion has been disbursed to Spain (EUR 39.468 billion on 11 December 2012 and EUR 1.865 billion on 5 February 2013).[229] The programme is accompanied by policy conditionality focusing on the financial sector.[230] At the same time, Spain will have to honour its commitments under its ongoing excessive deficit procedure and the recommendations addressed to it within the framework of the European Semester in order to tackle macroeconomic imbalances.[231] Importantly, contrary to the other eurozone member states relying on official financial assistance, the IMF is not involved in the current recapitalization programme for Spain's financial sector.[232]

Finally, the ESM got involved for the first time in a full-scale macroeconomic adjustment programme in spring 2013 in the context of financial assistance granted to Cyprus. With its oversized offshore banking industry having been severely affected by the Greek private sector debt haircut in March 2012, Cyprus was reported on 25 June to have asked for financial assistance from the EFSF or the ESM.[233] After tedious negotiations, the Troika and the Cypriot authorities reached an initial agreement on 16 March 2013. That agreement, however, created public outcry in Cyprus since, in order to raise the money needed on top of external support by the IMF and the ESM, it would have comprised a one-off levy of 6.7 per cent for deposits up to EUR 100,000 (in an outright violation of the existing Deposit Guarantee Scheme under EU law) and 9.9 per cent for higher deposits on all bank accounts in Cyprus.[234] A revised deal, sparing deposits below EUR 100,000 but involving a 15.6 per cent levy on deposits of above EUR 100,000

[227] For the relevant statement by the Eurogroup, dated 20 July 2012, see <http://www.eurozone.europa.eu/media/367880/eg_statement_spain_20_july.pdf> accessed 1 July 2013.

[228] See <http://www.eurozone.europa.eu/media/367880/eg_statement_spain_20_july.pdf> accessed 1 July 2013.

[229] Information provided on the ESM's country page for Spain at: <http://www.esm.europa.eu/about/assistance/spain/index.htm>.

[230] The European Commission's country page for Spain provides detailed background material on the Spanish economy and on the origins of its housing bubble and ensuing banking crisis that triggered Spain's sovereign debt crisis, as well as detailed explanations of the financial sector policy commitments undertaken by Spain: <http://ec.europa.eu/economy_finance/eu/countries/spain_en.htm>.

[231] See the ESM's country page for Spain (n 229).

[232] Providing a detailed analysis of the recapitalization programme for Spain's financial sector would go well beyond the scope of this chapter. For detailed background information and technical details regarding the ESM's involvement in providing financial assistance to Spain, see the detailed Q&A sheet prepared by the ESM: <http://www.esm.europa.eu/pdf/FAQ%20Spain%2011022013.pdf> accessed 1 July 2013.

[233] See, eg, James Wilson, Daniel Dombey, and Peter Spiegel, 'Cyprus requests eurozone bailout' *Financial Times* (25 June 2012) <http://www.ft.com/intl/cms/s/0/80320e0e-bed0-11e1-b24b-00144feabdc0.html> accessed 1 July 2013.

[234] See, eg, James Kanter, 'After Negotiations, Cyprus Agrees to a Euro Zone Bailout Package' *The New York Times* (16 March 2013) <http://www.nytimes.com/2013/03/17/business/global/cyprus-agrees-to-euro-zone-bailout-package.html> accessed 1 July 2013.

was still rejected by the Cypriot Parliament on 19 March 2013. Final agreement over a support package totalling EUR 10 billion (with EUR 9 billion to come from the ESM and EUR 1 billion from the IMF) was reached on 25 March 2013. The final agreement no longer involved any sort of deposit levy.[235] Instead, it was agreed that the most troubled Cypriot bank, Laiki Bank, would be taken out of business. Whereas remaining goods and assets of Laiki Bank as well as deposits smaller than EUR 100,000 would be transferred to the Bank of Cyprus, shareholder capital as well as uninsured capital over EUR 100,000 would be lost.[236] The ESM Board of Governors formally approved the stability support programme for Cyprus on 24 April 2013.[237] As for its part, the IMF Executive Board approved the deal in May 2013.[238]

Overall, it appears valid to say that, confronted with the worst crisis since the EMU came into being, eurozone member states have proven that they are determined to safeguard financial stability in the eurozone and to prevent the eurozone from breaking apart, using techniques with a striking resemblance to IMF adjustment programmes. It is interesting to recall at this point that in spring 2010 the German Minister of Finance, Wolfgang Schäuble, had launched a debate on a 'European Monetary Fund'.[239] Although the ESM as it came into being does not amount to a full regional equivalent of the IMF whose mandate is much broader, the institutional design and the technical modalities of the EMS's lending operations undoubtedly bear a striking resemblance to those of the IMF.

[235] For the related statement by the Eurogroup, dated 25 March 2013, see <http://www.eurozone.europa.eu/media/404933/EG%20EG%20Statement%20on%20CY%2025%2003%202013.pdf> accessed 1 July 2013.

[236] A detailed discussion and analysis of the difficult negotiations leading up to the final version of the financial stability support package for Cyprus and of the heated political debate, both within Cyprus and on a European level, about these negotiations and the finally agreed support package, cannot be provided as part of this chapter. For detailed information and critical commentary in this regard, see, eg, Patrick Jenkins and Daniel Schäfer, 'Cyprus deal pulls markets back from brink' *Financial Times* (26 March 2013) <http://www.ft.com/intl/cms/s/0/28f1395a-9579-11e2-a4fa-00144feabdc0.html>; and Editorial, 'The Cypriot deal: Second time unlucky', *The Economist* (online edn, 30 March 2013) <http://www.economist.com/node/21574507> (both accessed 1 July 2013).

[237] See, ESM, 'ESM Board of Governors grants stability support to Cyprus', Press Release 03/2013 (24 April 2013) <http://www.esm.europa.eu/pdf/ESM%20Press%20Release%20ESM%20Board%20of%20Governors%20grants%20stability%20support%20to%20Cyprus1.pdf> accessed 1 July 2013.

For detailed information about the Cypriot stability support programme and attached conditionality as well as for background information on the Cypriot economy and its financial sector, see the European Commission's country page for Cyprus at <http://ec.europa.eu/economy_finance/eu/countries/cyprus_en.htm>.

[238] IMF, 'IMF Executive Board Approves €1 Billion Arrangement under Extended Fund Facility for Cyprus', Press Release No 13/175 (15 May 2013) <http://www.imf.org/external/np/sec/pr/2013/pr13175.htm> accessed 1 July 2013. See, generally, the IMF's country page for Cyprus at <http://www.imf.org/external/country/CYP/index.htm>.

[239] See Quentin Peel and Scheherazade Daneshkhu, 'Eurozone eyes IMF-style Fund' *Financial Times* (7 March 2010) <http://www.ft.com/cms/s/0/c36bf126-2d41-11df-9c5b-00144feabdc0.html> accessed 1 July 2013.

B. *Fighting imbalances instead of taking decisive steps towards fiscal union: the EU's technique to avoid a new logical inconsistency*

Those arguing that the loan arrangements with Greece, and even the private sector haircut on Greece's debt imposed in the spring of 2012 have not avoided, but merely delayed, a sovereign default of that country on a significant portion of its debt owed to public creditors, are probably right that even a non-concessional loan may amount to a violation of the 'no bail-out' clause of TFEU Article 125(1). However, in light of the tremendous harm that might have resulted for the entire eurozone from the contagious effects of an unorderly default by Greece in spring 2010 when the country's first financial assistance programme was devised, the real issue seems to be something else: including a 'no bail-out clause' in the treaty framework of a monetary union—laudably intended as an incentive for sustainable national fiscal policies—cannot function as a credible threat if the members of the union are neither authorized, by the treaty, to exit the union nor allowed, by their fellow members, to default on their debt. By conceiving the ESM as a crisis resolution mechanism that explicitly foresees the potential need for an orderly default of eurozone members on at least some portion of their public debt (namely, that owed to private creditors) for the sake of long-term debt sustainability, eurozone member states have embarked on a path out of this logical inconsistency.[240]

However, with at least some degree of sovereign default now being a realistic option for eurozone members, a new logical inconsistency has arisen: the possibility of default, persistent current account imbalances, and the lack of fiscal union.[241] As with the inconsistent trinity of fixed exchange rates, free capital movements, and an independent monetary policy,[242] you can only have two out of these three at the same time. If you wish to allow default, notably in order to resolve the above-mentioned inconsistency of 'no bail-out, no exit, no default', then you have either to reduce current account imbalances or establish at least some degree of fiscal union in order to compensate for the large cross-country financial flows that necessarily result from current account imbalances.

This new logical inconsistency illustrates the urgency with which eurozone members have to move to a level of economic integration that is economically sustainable in the presence of a fully-fledged monetary union and a single market. Indeed, it appears appropriate to view the EU's recent legislative efforts to prevent and correct macroeconomic imbalances between member states, analysed earlier in this chapter,[243] as an attempt to resolve the new logical inconsistency outlined above.

[240] See Wolfgang Münchau, 'Fiscal union is crucial to the euro's survival' *Financial Times* (14 November 2010) <http://www.ft.com/cms/s/0/ceca784c-f02a-11df-88db-00144feab49a.html> accessed 1 July 2013.

[241] On this logical inconsistency, see Münchau (n 240).

[242] See Section I.A above.

[243] See Section II.C above.

The Commission's new focus on strengthened macroeconomic governance, elaborated in cooperation with the Council's Task Force on Economic Governance (assembling the Finance Ministers of all member states), clearly indicates that European leaders have made their choice between the available policy options. The idea of fiscal union, even if such union were to cover only a small percentage of the combined GDP of EU member states, continues to be an extremely sensitive issue under sovereignty aspects due to the fact that every member state wishes to retain a maximum of effective political control over its entire domestic revenue and expenditure. The ruling on the Lisbon Treaty by the German federal constitutional court, the *Bundesverfassungsgericht* (BVerfG), is a clear expression of these concerns. In that ruling, the BVerfG explicitly stated that a considerable transfer of budgetary powers to the supranational level would substantially erode, and hence violate, the constituent elements of the principle of democracy and the right to elect the members of the German Parliament, the *Deutsche Bundestag*.[244] However, the BVerfG did *not* say that any transfer of budgetary powers to the EU would violate German sovereignty. It merely ruled that overall budgetary responsibility, with sufficient political margin of manoeuvre for revenue and expenditure, had to rest with the German Parliament.[245]

Unfortunately, due to their current design as analysed earlier in this chapter,[246] the EU's new legal instruments intended to prevent and correct macroeconomic imbalances between EU member states may turn out to be rather ineffective, eroding instead the legitimacy of the EU's multilateral surveillance framework. The failure of G-20 member states to make noteworthy progress on the issue of current account imbalances renders it further likely that the existing imbalances between EU member states will not suddenly disappear.[247] However, if imbalances were to persist due to a lack of political will to tackle them decisively and with the default of eurozone members being indeed a realistic option under the regime of the ESM, establishing at least some degree of fiscal union would become a necessary condition for the survival of the single currency.[248]

As plausibly suggested by Münchau in the Financial Times, a rather small discretionary, communitarized, budget, ranging somewhere between 1 and 5 per cent of the combined GDP of EU member states might suffice in order to send an unambiguous signal to financial markets that eurozone members are firmly

[244] BVerfG, 2 BvE 2/08, 30 June 2009, paras 249–56. For the entire judgment (in German), see <http://www.bverfg.de/entscheidungen/es20090630_2bve000208.html> accessed 1 July 2013. For a detailed summary (in English), see Bundesverfassungsgericht—Federal Constitutional Court, Press Release No. 72/2009, 30 June 2009 <http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg09-072en.html> accessed 1 July 2013.

[245] BVerfG, 2 BvE 2/08, 30 June 2009, para 256. Münchau (n 240) rightly notes that the BVerfG's ruling on the Lisbon Treaty confirms that transferring budgetary powers to the EU is not only politically sensitive but that there are also fundamental legal constraints and limits to such transfers. He errs, however, when interpreting the BVerfG's ruling as forbidding any transfer of political control over fiscal policy to the EU, since the BVerfG's ruling is more nuanced as briefly explained above.

[246] See Section II.C above.

[247] See the related analysis provided in Chapter 3, Section III.B, of this monograph.

[248] As has been argued convincingly by Münchau (n 240).

determined to not let the EMU break apart.[249] Unfortunately, the myriad of recent measures intended to strengthen fiscal governance in the EU and, particularly, the eurozone—the revised SGP, the fiscal governance components of the Six-Pack, the Fiscal Compact, and the Two-Pack—while constituting useful policy coordination and improved budgetary surveillance, fall way short of moving the EMU in the direction of at least a small communitarized budget, ie a true fiscal union.

In light of the above, and to the extent that it can be demonstrated that establishing at least some degree of fiscal union is objectively necessary in order to safeguard financial stability in the eurozone as a whole and to ensure the long-term survival of the single currency, a transfer of effective budgetary powers to the EU (going well beyond the very limited ones agreed under the Two-Pack, exercised as part of the European Semester[250]) might well have to be considered perfectly constitutional by the BVerfG and other constitutional courts concerned about the gradual erosion of key sovereign powers as a consequence of a state's membership in an economic and monetary union.[251]

The proposal for launching common European sovereign bonds (Euro bonds) to be issued by a European Debt Agency, originally brought forward on 5 December 2010 by Jean-Claude Juncker, then President of the Eurogroup, and Giulio Tremonti, then Italian Finance Minister, has widely been interpreted as a first step in the direction of fiscal union.[252] This might also explain why the proposal was immediately rejected by Germany and France, both of which fear an erosion of fiscal discipline, and was not followed up at the European Council of 16–17 December 2010. Subsequently, on 23 November 2011, the Commission published a Green Paper on the feasibility of so-called Stability Bonds to stimulate a broad discussion on the technical feasibility and economic merits of introducing Euro Bonds.[253] However, with Germany as the EU's largest member remaining fiercely opposed to any sort of joint liability for nationally issued sovereign debt, the Green Paper has so far not led to any relevant legislative action. Without entering into the legal details, and even less the economic merits, of the Juncker-Tremonti

[249] See Wolfgang Münchau, 'Bond plan could end the euro crisis' *Financial Times* (9 December 2010) <http://www.ft.com/cms/s/0/54253e90-038c-11e0-9636-00144feabdc0.html> accessed 1 July 2013.

[250] See Subsection II.B.3 of this chapter. Recall that the key innovation of the Two-Pack is that, by 30 November each year, the Commission will have to examine, and give an opinion, on the draft budget of each eurozone member state, with the power to request a revision in case of a serious non-compliance with the budgetary obligations laid down in the SGP.

[251] Without a more detailed analysis than can be provided as part of this chapter, this issue remains necessarily somewhat speculative.

[252] Jean-Claude Juncker and Giulio Tremonti, 'E-bonds would end the crisis' *Financial Times* (5 December 2010) <http://www.ft.com/cms/s/0/540d41c2-009f-11e0-aa29-00144feab49a.html> accessed 1 July 2013. For analyses of the Juncker-Tremonti E-bonds proposal, see, eg, Paolo Manasse, 'My name is Bond, Euro Bond' (voxeu.org article, 16 December 2010) <http://www.voxeu.org/index.php?q=node/5936> accessed 1 July 2013 and Münchau (n 249).

[253] See European Commission, 'Green Paper on the feasibility of introducing Stability Bonds' (23 November 2011), COM(2011) 818 final, <http://ec.europa.eu/commission_2010-2014/president/news/documents/pdf/green_en.pdf> accessed 1 July 2013.

proposal and of the Commission's Green Paper on Stability Bonds,[254] it should at least be noted that such Euro Bonds would almost certainly put an end to speculative attacks against sovereign debts in the eurozone as all eurozone members would be jointly liable for such bonds.

As for now, the logical inconsistency addressed in this section remains unresolved. Merely setting up a permanent crisis mechanism allowing the orderly default of eurozone member states seems insufficient to ensure the long-term survival of the single currency. If eurozone member states cannot agree to strengthen their efforts to reduce current account imbalances beyond what seems currently to be on the negotiating table they will have no other choice than to establish at least a limited degree of fiscal union.

All this is again a powerful illustration of the fact that economic constraints are the main driving force behind the increasing regionalization of monetary sovereignty as analysed in this chapter. As we have seen, in order for an economic and monetary union to be sustainable in the long run, the economic constraints underpinning the regionalization of monetary sovereignty necessarily entail transfers of sovereign powers in domains which go well beyond the realm of money in a narrow sense, but which are intrinsically linked to it in a modern economy.

In light of the above, the final section of this chapter will now address the question whether the increasing regionalization of monetary sovereignty should be regarded as the surrender, or as an effective exercise, of monetary sovereignty.

C. *The increasing regionalization of monetary sovereignty: surrender or effective exercise of monetary sovereignty?*

As analysed in detail in this chapter, the states participating in a fully-fledged monetary union, like the EMU, have transferred large parts of their sovereign powers in the realm of money to the supranational level. Most notably, for the duration of their membership, the members of a monetary union renounce their right to create money and to conduct a monetary policy, thereby renouncing a powerful instrument, at least in a short-term perspective, for demand management.[255] To the extent that the members of a monetary union can no longer control the exercise of these powers by the union, these conferrals of powers are indeed rightly analysed as transfers and not as delegations of powers—independent of whether the participating states retain a formal right to withdraw from the monetary union. As shown by Sarooshi, a conferral of sovereign powers that is formally revocable may nevertheless have to be regarded as a transfer if the

[254] It should be noted that the idea of a common European debt instrument is not entirely new. It was first proposed by Jacques Delors in the 1980s (see Manasse (n 252)) and was more recently taken up as proposed financing instrument for pan-European infrastructure in a recent report by Mario Monti to Commission President José Barroso. See Mario Monti, 'A New Strategy for the Single Market—at the Service of Europe's Economy and Society', Report to the President of the European Commission José Manuel Barroso, 9 May 2010, <http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf> accessed 1 July 2013.

[255] See Goodhart (n 93) 164–5.

conferring states have no direct control over the supranational organization's exercise of these powers and if the organization possesses the sole right to exercise them.[256]

The exclusive powers to conduct monetary policy and to create money, conferred upon the respective central banks under the WAMU and CAMU Treaties, are a perfect illustration of this point. As noted earlier in this chapter,[257] whereas the WAMU Treaty contains an express provision permitting unilateral withdrawal, the CAMU Treaty remains silent on this subject. Under Sarooshi's criteria of control and exclusive exercise, the conferral of the above powers to the respective central banks has to be analysed in each case as a transfer and not as a delegation in one and as a transfer in the other. The same is true of the sovereign powers that have been conferred by EMU member states to the ECB. For their correct classification as a transfer it does not ultimately matter that the EU Treaties now include a provision authorizing member states to unilaterally withdraw from the EU altogether.[258] What matters is that the ECB has, and always had, the exclusive power to conduct the EMU's monetary policy; its related decisions on interest rates are not under the control of eurozone member states. As long as a member state wishes to remain in the eurozone, it has no choice whatsoever but to fully accept the ECB's independent exercise of the transferred powers.

As illustrated by the controversial debate in the EU prior to the clarifying inclusion of TEU Article 50 (authorizing the unilateral withdrawal from the Union), the question as to whether, in the absence of an express treaty rule authorizing the unilateral withdrawal, a member state of a supranational organization may nevertheless assert its sovereignty by withdrawing from the organization, thereby revoking *in toto* all conferrals of powers to that organization, is highly contested. This issue is of particular relevance for the members of a monetary union. Without embarking on this issue in detail, three brief comments appear warranted in the context of this chapter.

Firstly, a new agreement between the member states of a monetary union to either end their cooperation or to substantially modify it by signing a new treaty would in any event constitute a lawful revocation of the original conferral of powers. This would be the case even if the relevant legal framework were designed as a 'trip with no return' as in the EMU's case.[259] Strictly speaking, of course, such a revocation would not be unilateral in nature.

Secondly, to the extent that a member state is willing and able to assume the major economic consequences of leaving the monetary union,[260] it may at any moment decide to breach the rules of the monetary union and leave. If, for example, Greece were to decide to quit the eurozone and to reintroduce the drachma and to assume both the political and economic cost of that decision,

[256] For detail, see Sarooshi (n 39) 28–32, 66–9.
[257] See Section I.C above.
[258] TEU Article 50. See the related comments in Section I.C above.
[259] See, eg, Lastra (n 5) 242 and Treves (n 6) 116.
[260] For a detailed analysis of the complex consequences of both a negotiated and a unilateral withdrawal from the eurozone for affected contracts and prior monetary obligations of the withdrawing member state, see Proctor (n 3) 835–60.

there is little the EU and Greece's fellow eurozone members could do about it. The US's unilateral decision, announced on 15 August 1971, to end the convertibility of the USD to gold, thereby unilaterally rewriting the rules of international monetary conduct, is the outstanding example of such an assertion of sovereignty contrary to valid treaty obligations.[261]

Thirdly, in line with the BVerfG's famous ruling in the Maastricht case,[262] one could go as far as to argue that each member state of a monetary union, in its capacity as one of the 'masters of the treaty', may not only recover the conferred powers *de facto* by simply leaving the union, but that it retains an irreducible right as a sovereign state to withdraw from the union, thereby ultimately lawfully revoking all conferrals of sovereign powers, independent of what the relevant treaty framework may say.

The fact that participation in a monetary union is regarded by some as the surrender of monetary sovereignty and by others as its effective exercise under contemporary economic constraints seems to a large extent to be due to the dual nature of the concept of sovereignty. As noted earlier, the concept of sovereignty can be validly approached in two ways: directly, by focusing on the supreme and irreducible authority of independent states, and indirectly, by looking at the various sovereign powers that originally all derive from the same source, namely the capacity of independent statehood. As analysed in a timeless manner by Carré de Malberg, whereas sovereignty as supreme authority of independent states is irreducible, sovereignty, if looked at via the powers originally vested in sovereign states, can indeed be shared.[263]

On the one hand, this explains why one can speak, as has been done throughout this chapter, of regionalization of monetary sovereignty whenever independent states decide to pool certain sovereign powers in the realm of money by transferring them to a supranational body. On the other hand, however, to the extent that the member states of a monetary union can potentially recover their sovereign powers,[264] all they essentially do is to transfer to the supranational level, until further notice, certain state competences in the realm of money, but not their monetary sovereignty itself.[265]

Vast transfers of state competences in the realm of money to a monetary union imply, by definition, that the state concerned renounces, at least temporarily, the independent exercise of those competences. However, to the extent that agreeing to such transfers is what provides the state's population with a maximum of monetary and financial stability under contemporary economic constraints, it appears appropriate to analyse the underlying transfer of sovereign powers not as a surrender of monetary sovereignty, but as its effective exercise under contemporary economic constraints. As noted earlier, by entering into a monetary union, the participating

[261] As has been pointed out perfectly by Treves (n 6) 116.

[262] See the related comments in n 65 above.

[263] Raymond Carré de Malberg, *Contribution à la théorie de l'Etat* (Sirey, Paris 1920) 79.

[264] As noted above, withdrawal from a monetary union remains always an option, at least in theory, independent of what the treaty framework underlying the monetary union may say.

[265] Martucci (n 25) 1056–7.

states may jointly regain a margin for manoeuvre with respect to sovereign powers in the realm of money the individual, national, exercise of which had previously become more and more ineffective under the impact of economic globalization and financial integration.[266]

Hence, to the extent that the economic conditions of the participating states warrant such regional integration in the first place, the transfer of far-reaching sovereign powers to a monetary union, instead of provoking the erosion of the monetary sovereignty of the participating states, may have to be regarded as the most effective means for states to reassert such sovereignty under the special form of cooperative sovereignty.[267] This analysis seems true despite, or precisely because of, the experience of the sovereign debt crisis that currently afflicts the eurozone.

The above arguments apply to a large extent also to the phenomenon of dollarization, ie, the official or *de facto* use of a major foreign currency, such as the USD or the euro, by the inhabitants of a given country, usually one with a very small economy, as a store of value, unit of account, and/or medium of exchange within the domestic economy. Such use of the foreign currency would be in parallel to or instead of the actual domestic currency.[268] While this issue cannot be analysed in detail as part of this chapter, it is worth pointing to the key reason why a country would not only want to deprive itself of any ability to conduct independent monetary and exchange rate policies but would also accept the loss of seigniorage revenues by no longer issuing its own currency. Clearly, if a country decides to dollarize its economy officially it does so with the objective of greater fiscal discipline and thus greater macroeconomic stability, the objective of lower inflation rates and thus lower real exchange rate volatility, and the objective of a deepened financial system. All these objectives ultimately serve to foster monetary and financial stability, ie the key normative goals of the contemporary concept of monetary sovereignty as analysed in this monograph. Thus, just as for the decision to enter a monetary union, the economic circumstances for a small country with a weak economy may be such that renouncing key regulatory powers in the realm of money by dollarizing its economy is what provides its population with a maximum of monetary and financial stability under contemporary economic constraints.

[266] This point has been analysed more generally with respect to cooperation between states as undertaken through international organizations by Louis and Ronse. As put by these authors in the French original:

> [L]'exercice de compétences au sein d'institutions communes d'une organisation d'intégration ne se traduit pas en termes de 'perte' de souveraineté pour l'Etat. Adhérer à de telles organisations est le seul moyen dans un Monde globalisé de récupérer une capacité d'action qui est devenue purement formelle pour la quasi-totalité des Etats.
> (Jean-Victor Louis and Thierry Ronse, *L'ordre juridique de l'Union européenne* (LGDJ, Paris 2005) 9–10).

[267] See Martucci (n 25) 1060.

[268] Kosovo, Monaco, and Montenegro are examples of fully dollarized economies using the euro. Notable examples of countries relying exclusively on the USD are the British Virgin Islands, Ecuador, El Salvador, and Panama.

Having reached the end of this chapter on the increasing regionalization of monetary sovereignty, it appears appropriate to conclude as follows.

Conclusion

The market forces of a globalized world economy are the main driving force behind the regionalization of monetary sovereignty, which, as has been shown in this chapter, is far from being a merely European phenomenon. As part of the broader analysis undertaken in this monograph on the conceptual evolution of monetary sovereignty under contemporary constraints on monetary and financial stability, this chapter has argued that, depending on the precise circumstances, the decision to enter a monetary union may very well have to be regarded as an effective exercise of monetary sovereignty as cooperative sovereignty, and not as its surrender.

The fact that, in order to ensure the long-term sustainability of their monetary union, the participating states have no alternative to accepting limitations on the exercise of their domestic economic and fiscal policies does not contradict this view. It rather confirms it. Certainly, sovereign states enter economic and monetary unions for a variety of reasons, many of which may not be economic in nature at all. However, the worldwide trend towards such unions since the onset of globalization in the 1960s is still best explained as an attempt by the participating states to regain, jointly, a margin of manoeuvre that they were about to lose, or had already lost, individually.

The regional pooling of sovereign powers in the realm of money and in intrinsically related domains—an outstanding example of cooperative sovereignty—constantly has to overcome fierce domestic resistance originating in the outdated understanding of sovereignty as being merely the sum of exclusive state competences. The EMU's notorious difficulties in making progress towards greater fiscal and economic integration, a step that is widely considered as unavoidable in order to ensure the survival of the European single currency, are an outstanding illustration of this dilemma. The myriad of recent measures aimed at strengthening fiscal and macroeconomic governance in the EU do not change this overall picture. The world's largest economic and monetary union still has to overcome the fundamental challenge of moving either towards a limited fiscal union or of significantly reducing current account imbalances between its members. Other monetary unions worldwide will have to find sustainable solutions to this issue, too.

5

The Reorganization of the International Financial Architecture in the Wake of the Global Financial Crisis

Introduction

The concept of international financial architecture (IFA) was first cast by state leaders in the wake of the 1997 East Asian financial crisis.[1] It may usefully be defined 'as encompassing the rules, guidelines and other arrangements governing international financial relations as well as various institutions, entities and bodies through which such rules, guidelines and other arrangements are developed, monitored and enforced'.[2] Like previous crises before it, the Global Financial Crisis[3] triggered a restructuring of the IFA. As recalled by Mario Giovanoli, a former general counsel of the Bank for International Settlements (BIS) in Basle, 'financial law—whether domestic or international—has always developed as a child of crises'.[4] Thus, the Great Depression of the 1930s spawned the introduction of modern financial regulation and supervision in many states around the world.[5] The increasing integration of financial markets, the unparalleled expansion of eurocurrency markets after the demise, in the early 1970s, of the par-value system

[1] See Mario Giovanoli, 'The Reform of the International Financial Architecture After the Global Crisis' (2009) 42 NYU *Journal of International Law & Politics* (JILP) 81, 83.

[2] Andrew Crocket, 'Lessons from the Asian Crisis' in Joseph R Bisignano, William C Hunter, and George C Kaufman (eds), *Global Financial Crises: Lessons from Recent Events* (Kluwer Academic Publishers, Norwell MA 2000) 7.

[3] For concise analyses of the causes of the Global Financial Crisis, see, eg, Emilios Avgouleas, *Governance of Global Financial Markets: The Law, the Economics, the Politics* (CUP, Cambridge 2012) 89–156; Rosa M Lastra and Geoffrey Wood, 'The Crisis of 2007–09: Nature, Causes, and Reactions' in Thomas Cottier, John H Jackson, and Rosa M Lastra (eds), *International Law in Financial Regulation and Monetary Affairs* (OUP, Oxford 2010) 9. In-depth analyses of the complex causes of the Global Financial Crisis can also be found in the following two reports: Financial Crisis Enquiry Commission, *The Financial Crisis Enquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (January 2011) <http://fcic.gov/report> accessed 1 July 2013; the High-Level Group on Financial Supervision in the EU, *Report* [*Larosière Report*] (Brussels, 25 February 2009) <http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf> accessed 1 July 2013.

[4] Giovanoli (n 1) 82. See, generally, Mario Giovanoli, 'The International Financial Architecture and its Reform after the Global Crisis', in Mario Giovanoli and Diego Devos (eds), *International Monetary and Financial Law: The Global Crisis* (OUP, Oxford 2010) 3–39.

[5] On this and the following two examples in this paragraph, see Giovanoli (n 1) 82–3.

conceived at Bretton Woods, and, triggering events, the failure in 1974 within only a few months of each other of several important banks (not only Herstatt Bank in Germany, but also British-Israel Bank in Tel Aviv and London, as well as Franklin National Bank in New York and London),[6] led to the creation of the Basel Committee on Banking Supervision (BCBS),[7] one of the first of numerous bodies in charge of setting international financial standards. The 1997 East Asian financial crisis prompted the establishment of a first edition of the Group of Twenty Finance Ministers and Central Bank Governors (G-20 or Group of Twenty) and of the Financial Stability Forum (FSF),[8] the latter being an attempt to coordinate the work of the various international financial standard-setting bodies (SSBs).

The Global Financial Crisis brought about another series of major changes to the IFA. The G-20, after having lain more or less dormant for a decade, was revived as an informal political steering group intended to provide a forum for the leaders of the world's largest economies to agree on reforms intended to promote global economic and financial stability. The FSF was re-established with increased responsibilities and an extended membership as the Financial Stability Board (FSB), intended to become an essential pillar of the IFA. Finally, the IMF, as part of a broader revision of its mandate, increased its efforts, in part together with the World Bank, to undertake a broad assessment of the financial sectors of its members and of their compliance with financial standards and codes. In order to increase the IMF's legitimacy and effectiveness in fulfilling its evolving tasks, the IMF's membership has undertaken the largest overhaul of the IMF's governance structure in the organization's history.

This chapter takes a succinct look at the key aspects of these three reform avenues and assesses whether the experience of the Global Financial Crisis has prompted states to exercise their sovereign powers in respect of the promotion of global financial stability, in a manner that reflects the contemporary understanding of monetary sovereignty as elaborated by the present study. As argued in the first chapter of this monograph,[9] as a dynamic concept with important normative components monetary sovereignty has not been eroded under the impact of economic globalization and the increasing integration of financial markets but adapts constantly to a changing economic environment, thereby in turn helping to define what constitutes a responsible exercise of the sovereign powers in the realm of money (as understood in a wider sense). It will be argued in this chapter

[6] See Andreas F Lowenfeld, *International Economic Law* (2nd edn OUP, Oxford 2008) 812.

[7] The BCBS provides its members with a forum for cooperation on banking supervisory matters and has developed an intense standard-setting activity on all aspects of banking supervision. The secretariat of the BCBS is located in Basle and is hosted by the BIS from which it is legally distinct. For an excellent legal analysis of the BCBS and its long-standing work on capital adequacy standards, see Lowenfeld (n 6) 811–45. For detailed information on the BCBS and its work, including its latest set of global regulatory standards on bank capital adequacy and liquidity, also known as Basel III, originally released in December 2010 and modified in January 2013, see its official website at <http://www.bis.org/bcbs/index.htm> accessed 1 July 2013.

[8] For detailed information on both bodies, see Parts I and II of this chapter respectively and the many references provided therein.

[9] See Chapter 1, Parts II and III.

that the way in which the international community has restructured the IFA in the wake of the Global Financial Crisis indicates that the evolving values incorporated in contemporary monetary sovereignty (notably financial stability and integrity, accountability, and transparency) do indeed provide states with valuable regulatory guidance and do serve as a legitimacy benchmark for state action as posited at the beginning of this study. The reorganization of domestic financial regulatory and supervisory regimes,[10] undertaken as part of the many reform projects triggered by the Crisis,[11] lies beyond the scope of this chapter, with its much narrower focus on the restructuring of the IFA. For the same reason, this chapter does not look into the substantive work undertaken by the various international financial SSBs.

After a critical view at the G-20 as the self-appointed steering board of the IFA and its achievements so far (Part I), this closing chapter analyses the role of the FSB as the new key institution in the reorganized IFA (Part II) and examines the changing role, as part of the new IFA, of the IMF which is itself going through a fundamental evolution. (Part III).

I. The G-20: The Self-Appointed Steering Board of the Contemporary International Financial Architecture and its Achievements

This first part examines the origins, the mandate, as well as the legitimacy of the G-20 (Section A), before providing an overview of the G-20's initiatives for improving global financial stability (Section B).

A. Origins, mandate, and legitimacy of the G-20

Confronted with the challenge of restructuring the IFA in the wake of the Global Financial Crisis, in order to increase global financial stability, the leaders of the world's biggest economies chose not to pursue the vertical, institutional, path (of putting in charge either an already existing international organization such as the IMF or a new multilateral organization) but embarked on an intensified horizontal, ie intergovernmental, cooperation process instead.[12] The G-20,[13] which, since its original formation in 1999, had served as a publicly rather unnoticed forum for meetings of the finance ministers and central bank governors of the world's main economies, was chosen to lead this process. Regular G-20 meetings on the level of heads of state or governments were devised for that purpose, the first being the

[10] On the conceptual distinction between financial regulation (referring to any sort of rule-making applicable to financial actors) and supervision (relating to monitoring and enforcement), see Rosa M Lastra, *Legal Foundations of International Monetary Stability* (OUP, Oxford 2006) 84–90.

[11] For insightful analyses of the regulatory response in the UK, see, eg, Charles AE Goodhart, *The Regulatory Response to the Financial Crisis* (Edward Elgar, Cheltenham 2010); as well as Sandeep Dhama, John Taylor, and Charles Proctor, 'The Reform of Financial Regulation in the United Kingdom after the Crisis' in Giovanoli and Devos (eds) (n 4) 234. See also Ernest T Patrikis, 'Striking Changes in US Banking Supervision and Regulation' in Giovanoli and Devos (eds) (n 4) 204.

[12] See Giovanoli (n 1) 90–1.

[13] See its official website at <http://www.g20.org> accessed 1 July 2013.

G-20 Leaders Summit on Financial Markets and the World Economy, held on 15 November 2008 in Washington, DC. In 2009 and 2010, semi-annual leaders summits were held before switching to annual summits in the country holding the yearly rotating G-20 presidency.[14] G-20 finance ministers and central bank governors continue to meet separately.

State leaders preferred the G-20 to other existing summit formations, such as the G-7, G-8, or G-10, to head the worldwide reform process due to its higher degree of representativeness of the world economy,[15] and out of recognition that key emerging-market countries were not adequately included in the core of global economic discussion and governance.[16] Under its current composition,[17] the G-20 represents 90 per cent of global gross domestic product (GDP), 80 per cent of global trade (including trade between EU member states) as well as two-thirds of the world's population.[18]

Operating without a permanent secretariat or staff,[19] the G-20, which does not possess legal personality, understands itself as 'the premier forum for international cooperation on the most important issues of the global economic and financial agenda'.[20] The objectives of the G-20 are:

1. Policy coordination between its members in order to achieve global economic stability [and] sustainable growth;
2. Promoting financial regulations that reduce risks and prevent future financial crises;
3. Modernizing [the] international financial architecture.[21]

G-20 declarations, reached by consensus, do not constitute international treaties, but are a prime example of international soft law. To the extent that such G-20 declarations express the common commitment to reform existing multilateral organizations, such as the IMF, the formal decision on such a reform would still have to be made according to the rules set forth in the constituent treaty of that organization, with all members of that organization, including those that are not part of the G-20, having their formal say. With respect to commitments to

[14] These leaders summits were held in London (UK) on 2 April 2009, in Pittsburgh (US) on 24–25 September 2009, in Toronto (Canada) on 26–27 June 2010, in Seoul (South Korea) on 11–12 November 2010, in Cannes (France) on 3–4 November 2011, as well as in Los Cabos (Mexico) on 18–19 June 2012. On 5–6 September 2013, G-20 leaders will convene in St Petersburg (Russia) and, in November 2014, in Brisbane (Australia). In 2015 Turkey will chair the G-20.

[15] Giovanoli (n 1) 90, n 28.

[16] See G-20, 'What is the G-20' <http://www.g20.org/docs/about/about_G20.html> accessed 1 July 2013.

[17] The following 19 states plus the European Union (EU) are all members of the G-20: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the UK, and the US. Several of the world's 20 largest economies (Spain, the Netherlands, and Switzerland) are not members of the G-20 to ensure a regionally more balanced membership. Without possessing official membership, Spain nevertheless attended each of the past G-20 leaders summits with its own delegation as an invitee of the respective G-20 chair.

[18] See G-20 (n 16).

[19] The G-20 operates on the basis of temporary secretariats set up by the respective chair of the rotating G-20 presidency.

[20] See G-20 (n 16). [21] See G-20 (n 16).

harmonize specific domestic policies or to proceed to certain domestic reforms, notably with respect to financial regulation and supervision, the effectiveness of G-20 declarations relies entirely on peer pressure.

Despite the fact that the G-20 cannot establish binding law and despite its quite significant degree of representativeness of the global economy as noted above, it has been criticized for its arbitrary composition and for its self-appointed nature. It has been argued, notably by the former foreign minister of Norway, Jonas Gahr Støre, that if important multilateral decisions were to be made effectively in advance by the G-20, this could undermine the legitimacy of the United Nations (UN) and lead to a creeping devaluation of the competent international organizations such as the WTO and the IMF.[22]

Upon closer consideration it seems, however, that the above criticism is only partly justified, warranting three brief comments. Firstly, to the extent that the G-20 functions merely as a forum for the coordination of domestic policies and reform agendas of its members, it certainly does not need a specific multilateral mandate, for example from the UN General Assembly, for its work, and this despite the fact that any major changes of financial regulation and supervision by G-20 states such as the UK, the US, Japan, Germany, and France, which host the world's main financial hubs, are likely to produce worldwide systemic repercussions.

Secondly, to the extent that the G-20 pursues the goal of laying the groundwork for major reforms of existing international organizations such as the IMF, the G-20's lack of a formal mandate for that purpose, from the broader international community, appears indeed somewhat problematic. Given their overwhelming economic weight (and corresponding IMF quota and voting shares), any workable consensus among G-20 members to modify, for example, the Fund's Articles is likely to become a reality. The argument that any consensus among G-20 members leaves the regular decision-making and treaty-amending process of the IMF legal framework untouched amounts to legal fiction: the huge majority of IMF members (145 out of 188[23]) will have been denied any participation in the related deliberations throughout the crucial time period during which there might still have been a realistic chance for a smaller economy to influence the outcome, ie before the world's largest economies have reached consensus on a common position. Certainly, it is a frequent practice in international economic relations for major economic powers to seek to establish common positions on important matters of joint interest early on, in order to predetermine the outcome of subsequent multilateral decision-making. It does make a difference, however, whether such policy coordination occurs through informal exchanges between government officials or as part of formal summits of the heads of state or governments of an

[22] 'Norway Takes Aim at G-20: "One of the Greatest Setbacks since World War II"', Interview with Jonas Gahr Støre, foreign minister of Norway, *Spiegel Online International* (22 June 2010) <http://www.spiegel.de/international/europe/0,1518,702104,00.html> accessed 1 July 2013.

[23] These numbers already account for the fact that in addition to those EU member states that are regular members of the G-20 (Germany, France, Italy, and the UK) or at least a regular invitee (Spain), the other 23 EU member states are at least indirectly represented through the G-20 membership of the EU. Otherwise the proportion of non-represented IMF members would rise to 168 out of 188.

exclusive, self-appointed circle, which understands itself as the steering body of the global economic and financial system. Whereas the urgent need of a coordinated regulatory response to the Global Financial Crisis may have temporarily justified the lack of a formal multilateral mandate, the G-20's long-term legitimacy would be increased if it were to seek a formal mandate as a coordination body for the regulation of the global economy. This could take the form, eg, of a Resolution by the UN General Assembly, or of a joint decision by the Board of Governors of the IMF and the World Bank with their quasi-universal membership.

Thirdly, and most importantly, the fact that essentially all reforms of the IFA initiated by the G-20 pursue the objective of increasing global monetary and financial stability, and of fostering market integrity and accountability under a high degree of transparency,[24] may be viewed as balancing the G-20's lack of a multilateral mandate and of effective possibilities for civil society to participate in the G-20's decision-making process. The declared normative goals of the G-20 are to a large extent identical with the constituent values of contemporary monetary sovereignty and are as such widely shared around the globe. This may indeed be considered as mitigating, at least to some extent, the legitimacy concerns that necessarily arise from a situation where a few powerful economies effectively steer the reorganization of the global economy.[25]

The second half of this first part will provide an overview of the G-20's main initiatives aimed at strengthening global financial stability.

B. The G-20's main initiatives aimed at strengthening global financial stability

At their initial meeting in Washington DC, on 15 November 2008, G-20 leaders stressed that financial regulation is 'first and foremost the responsibility of national regulators who constitute the first line of defense against market instability', but acknowledged that increasing integration of financial markets worldwide created the need for 'intensified international cooperation among regulators' and for a 'strengthening of international standards . . . and their consistent implementation'.[26] They agreed on five principles for the reform of financial markets—strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets, reinforcing international cooperation, and reforming international financial institutions (IFIs)[27]—and committed to taking rapid action to implement these principles.[28] To that purpose, the UK, in its capacity as 2009 chair of the G-20 (in close cooperation with the chairs of 2008 (Brazil) and 2010

[24] For related analysis, see James H Freis, Jr, 'The G-20 Emphasis on Promoting Integrity in Financial Markets', in Giovanoli and Devos (eds) (n 4) 104.

[25] See Rolf H Weber, 'Multilayered Governance in International Financial Regulation and Supervision' in Cottier, Jackson, and Lastra (eds) (n 3) 151, 159–61.

[26] G-20 Leaders, 'Declaration: Summit on Financial Markets and the World Economy' (15 November 2008) [hereinafter G-20 Washington Summit Declaration], para 8, available at <http://www.g20.org/documents> accessed 1 July 2013.

[27] For detail on each of these five principles, see G-20 Washington Summit Declaration (n 26) para 9.

[28] G-20 Washington Summit Declaration (n 26) para 10.

(South Korea)) created four working groups on (1) enhancing sound regulation and strengthening transparency, (2) reinforcing international cooperation and promoting financial integrity in financial markets, (3) reforming the IMF, and (4) reforming the World Bank and other Multilateral Development Banks.[29] The G-20 Washington Summit Declaration further contained a detailed Action Plan for implementing the above-mentioned five principles, listing several dozen measures (some for immediate action to be achieved by 31 March 2009 (eg the cooperation of supervisors to establish supervisory colleges for all major cross-border financial institutions), others for medium-term action (eg the commitment by all G-20 members to participate in the IMF's Financial Sector Assessment Program (FSAP)[30] under full transparency)),[31] the fundamental principle being 'that all financial markets, products and participants (including hedge funds and other private pools of capital which may pose systemic risk) must be subject to appropriate oversight or regulation'.[32]

At the London Summit on 2 April 2009, G-20 leaders, acknowledging that major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis,[33] reiterated their commitment to strengthen the financial system and the IFIs to rebuild trust in the financial system and agreed on further detailed steps in that direction.[34] Among the most notable achievements of that summit[35] are the decisions to re-establish the FSF with a strengthened mandate and extended membership as the FSB,[36] to extend the scope of regulation and supervision to all financial institutions, instruments, and markets, including hedge funds, that are systemically important,[37] and to provide both the IMF and the multilateral development banks with a major increase in their respective financial resources.[38] G-20 leaders expressed their determination to strengthen the long-term relevance, effectiveness, and legitimacy of the IFIs, and to increase their credibility and accountability.[39] To that purpose, G-20 leaders committed, most notably, to implement the package of IMF quota and voice reforms

[29] For detailed information on these four G-20 working groups and for detailed links to reports produced by these working groups, see Giovanoli (n 1) 92–3 as well as the official website of the G-20 (n 13).

[30] For detail on the FSAP, see Subsections III.A.2 and III.A.3 of this chapter.

[31] G-20 Washington Summit Declaration (n 26), Action Plan to Implement Principles for Reform.

[32] Giovanoli (n 1) 93.

[33] G-20 Leaders, 'The Global Plan for Recovery and Reform' (2 April 2009, London) [hereinafter G-20 London Summit Declaration], para 13, available at <http://www.g20.org/documents> accessed 1 July 2013.

[34] See the detailed commitments set forth in the G-20 London Summit Declaration (n 33) paras 13–21.

[35] For a more detailed overview, see Giovanoli (n 1) 94–6.

[36] G-20 London Summit Declaration (n 33) para 15. For detail on the FSB and its predecessor, the FSF, see Part II of this chapter.

[37] G-20 London Summit Declaration (n 33) para 15.

[38] G-20 London Summit Declaration (n 33) para 17. For detailed information on this effective tripling of the IMF's lending capacity, and, generally, on the IMF's financial resources, see IMF, 'Where the IMF Gets its Money' (Factsheet) (12 April 2013) <http://www.imf.org/external/np/exr/facts/finfac.htm> accessed 1 July 2013.

[39] G-20 London Summit Declaration (n 33) para 20.

initiated in April 2008, the biggest overhaul of the IMF's governance structure in its history.[40]

Following the G-20 London Summit, the members of the G-20 focused their efforts on achieving the various medium-term actions for financial reform set forth in the Washington Action Plan as mentioned above, while the Framework for Strong, Sustainable and Balanced Growth, launched at the G-20 Pittsburgh Summit on 24–25 September 2009,[41] moved to the top spot on the G-20's priorities list.[42] Consistent with their earlier practice, G-20 members used each of the summits following the London summit for stock-taking, with the respective G-20 chairs establishing detailed, immediately-published, progress reports on the various actions taken towards strengthening the financial system.[43] In addition, the IMF, the FSB, as well as various SSBs such as the BCBS have reported regularly, and with full transparency, on their respective reform progress to G-20 leaders.[44]

At the Pittsburgh Summit on 24–25 September 2009, G-20 leaders decided that all major G-20 financial centres should have adopted the Basel II Capital Framework[45] by 2011 and should have committed 'to developing by end-2010 internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage',[46] an objective which has been achieved with the BCBS's new set of regulatory standards on bank capital adequacy and liquidity, the so-called Basel III rules.[47] They also charged their finance ministers

[40] For detail on the overhaul of the IMF's governance structure arising from the 2008 quota and voice reform, which entered into force on 3 March 2011, and from quota modifications agreed in 2010, see Section III.B below.

[41] See the analysis provided in Chapter 3, Section III.B, of this monograph.

[42] Due to the focus of this chapter on the reorganization of the IFA, this overview of the main G-20 initiatives aimed at strengthening global financial stability, covers only parts of the G-20's work.

[43] Unfortunately, when this monograph went to press, these progress reports seemed to be no longer available on the G-20's official website.

[44] All reports by the FSB, including various letters from the chair of the FSB to either G-20 leaders or to G-20 finance ministers and central bank governors, reporting on the state of progress on the various financial reforms initiated by the G-20, are available at <http://www.financialstabilityboard.org/list/fsb_publications/index.htm>. All reports by the BCBS to the G-20 can be found at <http://www.bis.org/list/bcbs/index.htm>. Note, in particular, the BCBS's regular reports monitoring implementation of the Basel III rules. See, eg, BCBS, 'Report to G20 Finance Ministers and Central Bank Governors on monitoring implementation of Basel III regulatory reform' (April 2013), <http://www.bis.org/publ/bcbs249.pdf>. The IMF maintains a webpage dedicated to the Fund's relations and activities with the G-20, providing, inter alia, links to various IMF staff notes addressed to the G-20: <http://www.imf.org/external/np/g20/index.htm> (all web addresses accessed 1 July 2013).

[45] For detailed information on the Basel II Capital Framework devised in 2004, see BCBS, 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework' (June 2004) <http://www.bis.org/publ/bcbs107.htm> accessed 1 July 2013.

[46] G-20 Leaders, 'Leaders' Statement: The Pittsburgh Summit' (24–25 September 2009) [hereinafter G-20 Pittsburgh Summit Declaration], para 13, available at <http://www.g20.org/documents> accessed 1 July 2013.

[47] The Basel III rules were agreed by the BCBS's Governors and Heads of Supervision and endorsed by G-20 leaders at their Seoul Summit held on 11–12 November 2010. In January, the BCBS revised an essential component of the Basel III rules, namely the liquidity coverage ratio (LCR). See BCBS, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (16 December 2010 with a revised version of June 2011) <http://www.bis.org/publ/bcbs189.htm>; and BCBS, 'Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools' (January 2013) <http://

and central bank governors with improving over-the-counter (OTC) derivatives markets,[48] noting that all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms and cleared through central counterparties by end-2012 at the latest, with non-centrally cleared contracts being subject to higher capital requirements.[49]

At the G-20 Toronto Summit on 26–27 June 2010, G-20 leaders reiterated the aforementioned pledges and specified that all G-20 members, and not only the major financial centres, should aim for implementation of the Basel II framework by end-2012.[50] G-20 leaders expressed their strong commitment to the BCBS's Core Principles for Effective Supervision[51] and tasked the FSB to develop recommendations on how to strengthen oversight and supervision, in response to which the FSB delivered a detailed report on recommendations for enhanced supervision, notably with respect to systemically important financial institutions (SIFIs).[52]

At the G-20 Seoul Summit on 11–12 November 2010, G-20 leaders endorsed that report, reaffirming their view that 'no firm should be too big or too complicated to fail and that [in the future] taxpayers should not bear the costs of resolution'.[53] G-20 leaders further endorsed the above-mentioned Basel III rules, and committed to implementing them, with national implementation being scheduled to start on 1 January 2013 and to be fully phased in by 1 January 2019.[54]

At the G-20 Cannes Summit on 3–4 November 2011, G-20 leaders 'agreed to further strengthen global financial safety nets in which national governments, central banks, regional financial arrangements and international financial institutions will each play a role to and according to their respective mandate'.[55] In this context, G-20 leaders called on the IMF to expeditiously finalize its proposals for the new Precautionary and Liquidity Line (PLL) and a single, non-concessional emergency facility.[56] G-20 leaders also expressed their support for a further

www.bis.org/publ/bcbs238.pdf>. For all BCBS documents related to Basel III, see <http://www.bis.org/list/basel3/index.htm> (all web addresses accessed 1 July 2013).

48 On the issue of OTC derivatives markets and on the role of derivatives in the rise in importance of transnational monetary law, see Chapter 2, Section III.B, of this monograph.

49 G-20 Pittsburgh Summit Declaration (n 46) para 13.

50 G-20 Leaders, 'The G-20 Toronto Summit Declaration' (26–27 June 2010) [hereinafter G-20 Toronto Summit Declaration] Annex II: Financial Sector Reform, para 8, available at <http://www.g20.org/documents> accessed 1 July 2013.

51 G-20 Toronto Summit Declaration (n 50) para 15. The BCBS's Core Principles for Effective Supervision figure among the FSB's Key Standards for Sound Financial Systems (see Subsection II.B.3 of this chapter). See BCBS, 'Core Principles for Effective Banking Supervision' (September 2012) <http://www.bis.org/publ/bcbs230.pdf> accessed 1 July 2013.

52 FSB, 'Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision' (2 November 2010) <http://www.financialstabilityboard.org/publications/r_101101.pdf> accessed 1 July 2013.

53 G-20 Leaders, 'The G20 Seoul Summit Leaders' Declaration (11–12 November 2010) [hereinafter G-20 Seoul Summit Declaration], Attachment: The Seoul Summit Document, para 30, available at <http://www.g20.org/documents> accessed 1 July 2013.

54 G-20 Seoul Summit Declaration (n 53) para 29.

55 G-20 Leaders, 'Cannes Summit Final Declaration' (4 November 2011) [hereinafter G-20 Cannes Summit Declaration], para 14, available at <http://www.g20.org/documents> accessed 1 July 2013.

56 G-20 Cannes Summit Declaration (n 55) para 15. As analysed earlier, the IMF has effectively put into place both facilities in the meantime. See Chapter 2, Subsection II.A.3 above.

strengthening of the IMF's surveillance mechanism,[57] which was achieved with the Fund's 2012 Decision on Bilateral and Multilateral Surveillance (2012 Integrated Surveillance Decision (ISD)).[58] G-20 leaders committed to intensify their monitoring of financial reforms and, to that purpose, endorsed the FSB's coordination framework for implementation monitoring.[59] In addition, they repeated many of their earlier pledges as regards, most notably, the implementation of the Basel III rules,[60] the necessity to reform the OTC derivatives markets,[61] and the need to discourage compensation practices that lead to excessive risk-taking.[62] G-20 leaders further reiterated their commitment to fill in gaps in the regulation and supervision of the financial sector in crucial areas such as the shadow-banking sector,[63] to address the too-big-to-fail problem and endorsed the related aspects of the FSB's policy framework, including notably a new standard for resolution regimes, more intensive and effective supervision as well as a yearly updated list of global SIFIs.[64] They also expressed their strong commitment to foster financial integrity by tackling tax havens as well as money laundering and the financing of terrorism, notably through the work undertaken by the Financial Action Task Force (FATF).[65] Finally, G-20 leaders decided to strengthen the FSB's capacity resources and governance, notably by establishing the FSB with an enduring organizational basis with legal personality and greater financial authority.[66]

At the G-20 Los Cabos Summit on 18–19 June 2012, the last G-20 leaders summit held before this book went to press, G-20 leaders took stock on the progress of the many above-mentioned reform initiatives for strengthening the IFA and confirmed many of their earlier commitments. Recognizing 'the importance of effective global and regional safety nets',[67] G-20 leaders committed, inter alia, to implement in full the IMF's 2010 Quota and Governance Reform.[68] Unfortunately, when G-20 finance ministers and central bank governors met in Moscow on 15–16 February 2013, ratification of that reform was still not

[57] G-20 Cannes Summit Declaration (n 55) paras 17–20.

[58] See IMF, 'IMF Executive Board Adopts New Decision on Bilateral and Multilateral Surveillance', PIN No 12/89 (30 July 2012) <http://www.imf.org/external/np/sec/pn/2012/pn1289.htm> accessed 1 July 2013. See the detailed analysis in Chapter 3, Section I.B, of this monograph.

[59] G-20 Cannes Summit Declaration (n 55) para 27.

[60] G-20 Cannes Summit Declaration (n 55) para 23.

[61] G-20 Cannes Summit Declaration (n 55) para 24.

[62] G-20 Cannes Summit Declaration (n 55) para 25.

[63] G-20 Cannes Summit Declaration (n 55) paras 30–4.

[64] G-20 Cannes Summit Declaration (n 55) paras 28–9.

[65] G-20 Cannes Summit Declaration (n 55) paras 35–6. For detail on the FATF and recent initiatives in the fight against money laundering and the financing of terrorism, see IMF, 'The IMF and the Fight Against Money Laundering and the Financing of Terrorism' (Factsheet) (31 March 2013) <http://www.imf.org/external/np/exr/facts/aml.htm> accessed 1 July 2013.

[66] G-20 Cannes Summit Declaration (n 55) paras 37–9. See Section II.A below for discussion of related changes in the FSB's governance framework.

[67] G-20 Leaders, 'G20 Leaders Declaration' (19 June 2012) [hereinafter G-20 Los Cabos Summit Declaration], para 32, available at <http://www.g20.org/documents> accessed 1 July 2013.

[68] G-20 Los Cabos Summit Declaration (n 67) para 33. For a detailed analysis of the 2008 and 2010 overhaul of IMF governance, see Section III.B of the present chapter.

completed.[69] Maybe most importantly, in Los Cabos G-20 leaders followed through on their earlier commitment to place the FSB on a permanent organizational footing with legal personality and greater financial autonomy by endorsing an amended charter for the FSB.[70]

Overall, four points deserve to be highlighted. Firstly, as noted earlier, the fact that all G-20 initiatives aim to promote widely shared values such as accountability, transparency, financial integrity, and financial stability might be regarded as mitigating the lack of a formal multilateral mandate for the G-20 to lead the global financial reform process.

Secondly, and intrinsically related, the fact that the G-20, lacking the capacity to impose formally binding legal rules on its members or on international institutions, promotes its reform initiatives through mere peer pressure does not appear to negatively affect the reform progress.[71] It seems plausible to assume that contemporary economic constraints operate as strong incentives for states to implement these reforms, even in the absence of any formal obligation to do so.

Thirdly, the current reform process builds on earlier achievements of the various financial SSBs such as the BCBS,[72] and it can be expected that these bodies, together with the new FSB, will play a more important role under the reorganized IFA than before. G-20 leaders have made it clear from the outset that any future financial reform and regulatory harmonization will continue to be derived from soft-law standards, with domestic regulators retaining the possibility of adjusting any implementing measures to national circumstances, which may increase the willingness of individual states to continue to participate in what is an ambitious, yet unavoidable, reform process.[73]

Fourthly and finally, it indeed appears convincing to interpret the way in which the IFA has been reorganized after the Global Financial Crisis as another impressive illustration of the fact that the former institutionalized international monetary and financial system of Bretton Woods is progressively being replaced by a multilayered regime having oversight over a complex network of globally integrated financial markets.[74]

The second part of this chapter will now look in more detail at the FSB's role in the reorganized IFA.

[69] G-20 Finance Ministers and Central Bank Governors, 'Communiqué (15–16 February 2013), para 13, available at <http://www.g20.org/documents> accessed 1 July 2013.

[70] G-20 Los Cabos Summit Declaration (n 67) para 46.

[71] Unfortunately, as analysed in Chapter 3, Section III.B, the same cannot be said in respect of the G-20's ailing efforts to tackle global current account imbalances.

[72] Giovanoli (n 1) 96.

[73] For highly insightful studies on the crucial question why the realm of international finance is still essentially dominated by soft law, see Chris Brummer, 'Why Soft Law Dominates International Finance—and not Trade', in Cottier, Jackson, and Lastra (eds) (n 3) 95; and Chris Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (CUP, New York 2011).

[74] Giovanoli (n 1) 96.

II. The Financial Stability Board: The New Key Institution in the Reorganized International Financial Architecture?

After assessing the replacement, in April 2009, of the former FSF by the FSB, the institutional footing of which was further strengthened in 2012 (Section A), this second part puts the relationship between the FSB and the IMF into perspective (Section B).

A. The shift from the FSF to the FSB: greater inclusiveness, a broadened mandate, and evolving challenges

Following the recommendations of a study chaired by Hans Tietmeyer, then President of the *Deutsche Bundesbank,* on how to improve cooperation and coordination among the various national and international supervisory authorities and the IFIs so as to promote the stability of the international financial system, the FSF was brought into being by the G-7 finance ministers and central bank governors at their Bonn meeting in February 1999. It was first convened in Washington DC, in April 1999.[75] As originally established, the FSF brought together: its Chairman,[76] 26 representatives of national authorities from 11 states (four from the US and three from each of the other G-7 countries (usually from the Treasury, the central bank, and the main supervisory body) plus one representative each from Australia, Hong Kong, the Netherlands, and Singapore), plus also one representative from the European Central Bank (ECB), and six representatives from the IFIs, as well as nine representatives from international regulatory and supervisory groupings or committees of central banking experts.[77] In 2007, Switzerland joined the FSF as an additional 12th member state (one representative). The main mission of the FSF was to coordinate the work of the various international financial SSBs that have emerged around the globe since the BCBS came into being in 1974.[78] Among the most notable tasks of the FSF, not a standard-setter itself,[79] was the compilation of a comprehensive Compendium of Standards to provide a 'common reference work for the various standards and codes of good practice [several dozens altogether] that are internationally accepted as

[75] See FSB, 'About the FSB', History <http://www.financialstabilityboard.org/about/history.htm> accessed 1 July April 2013. For an insightful analysis of the FSF and its work, see Régis Bismuth, 'Le système international de prévention des crises financières: Réflexions autour de la structure en réseau du Forum de stabilité financière' (2007) 134 *Journal du Droit International* 57.

[76] Chairpersons of the FSF/FSB serve in a personal capacity. The current Chairman (since 4 November 2011) of the FSB is Mark Carney, a former Governor of the Bank of Canada and current Governor of the Bank of England (since 1 July 2013). His predecessor was Mario Draghi, the current President of the ECB and former Governor of the Bank of Italy.

[77] For detail on the composition of the former FSF as well as on its original tasks, see Mario Giovanoli, 'A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting' in Mario Giovanoli (ed), *International Monetary Law: Issues for the New Millennium* (OUP, Oxford 2000) 25–6.

[78] Giovanoli (n 1) 109–10.

[79] By contrast, as will be explained further down in this same section, the FSF's successor, the FSB, has itself been charged with a limited standard-setter function.

relevant to sound, stable and properly functioning financial systems'.[80] Its restrictive membership had always been one of the major criticisms faced by the FSF, and this arguably limited the international 'ownership' of its work and its legitimacy for promoting international financial standards.[81]

At the G-20 Washington Summit in November 2008 G-20 leaders called for a significant extension of the FSF's membership, notably to emerging economies. Soon thereafter, on 11–12 March 2009, the FSF invited Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, Spain, Turkey, and the European Commission to join the FSF.[82] As noted earlier, at the G-20 London Summit of April 2009, the expanded FSF was re-established as the FSB. The great variety, and varying legal personality, of the actors participating in the FSB is arguably without precedent in international economic cooperation: the FSB comprises the delegations of 24 states (the number of national authorities represented varies between one and three), four IFIs (BIS, IMF, World Bank, and OECD), six international standard-setting, regulatory, and supervisory bodies,[83] plus the ECB and the European Commission.[84] In light of the FSB's objectives,[85] its membership is to be periodically reviewed by the Plenary,[86] which is the sole decision-making body of the FSB for all matters governed by its Charter.[87] Thus, in comparison to its predecessor, the FSF, the composition of the FSB is characterized by much greater inclusiveness. Consequently, this may lead to greater legitimacy and potentially much greater effectiveness for the FSB in promoting global financial stability.

While it will continue to fulfil the tasks that were essentially already part of the FSF's original mandate[88] (ie '(a) assess vulnerabilities affecting the global financial system, and identify and review, on a timely and ongoing basis within a

[80] Giovanoli (n 77) 27. While the FSB continues the FSF's work on the comprehensive Compendium of Standards (<http://www.financialstabilityboard.org/cos/index.htm> accessed 1 July 2013) the focus now lies on the Key Standards for Sound Financial Systems, ie on standards in 12 policy areas taken from the larger compendium, having been designated by the FSB as deserving priority implementation. For detail, see Subsection II.B.3 of this chapter.

[81] Giovanoli (n 1) 110–11. For a discussion of the challenges arising from limited FSF membership, see Robert Delonis, 'International Financial Standards and Codes: Mandatory Regulation Without Representation' (2004) 36 NYU JILP 563, 631–3.

[82] Giovanoli (n 1) 111.

[83] These six bodies are: the BCBS, the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Accounting Standards Board (IASB), the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commissions (IOSCO).

[84] For a detailed overview of the FSB's membership, including of all the national authorities that are represented, see Annex A to the Charter of the FSB as amended and endorsed in June 2012 by G-20 leaders at the G-20 Los Cabos Summit (see above n 70). <http://www.financialstabilityboard.org/ publications/r_120809.pdf> accessed 1 July 2013.

[85] The objectives of the FSB are set forth in Article 1 of its Charter:

The [FSB] is established to coordinate at the international level the work of national financial authorities and international [SSBs] in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. In collaboration with the [IFIs], the FSB will address vulnerabilities affecting financial systems in the interest of global financial stability.

[86] FSB Charter, Article 5(2).

[87] FSB Charter, Article 9(1).

[88] Giovanoli (n 1) 111.

macroprudential perspective, the regulatory, supervisory and related actions needed to address them, and their outcomes' as well as '(b) promote coordination and information exchange among authorities responsible for financial stability'),[89] the mandate of the re-established FSB has been significantly enlarged. The FSB will now also:

(c) monitor and advise on market developments and their implications for regulatory policy;

(d) advise on and monitor best practice in meeting regulatory standards;

(e) undertake joint strategic reviews of and coordinate the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities and addressing gaps;

(f) set guidelines for and support the establishment of supervisory colleges;

(g) support contingency planning for cross-border crisis management, particularly with respect to systemically important firms;

(h) collaborate with the [IMF] to conduct Early Warning Exercises; and

(i) promote member jurisdictions' implementation of agreed commitments, standards and policy recommendations through monitoring of implementation, peer review and disclosure; and

(j) undertake any other tasks agreed by its Members in the course of its activities and within the framework of this Charter.[90]

The FSB's Charter, as amended in June 2012, charges the FSB with two additional tasks: firstly, to 'promote and help coordinate the alignment of the activities of the SSBs to address any overlaps or gaps and clarify demarcations in light of changes in national and regional regulatory structures relating to prudential and systemic risk, market integrity and investor and consumer protection, infrastructure, as well as accounting and auditing';[91] and secondly, to 'address regulatory gaps that pose risk to financial stability, *develop or coordinate development of standards and principles*, in collaboration with the SSBs and others, as warranted, *in areas which do not fall within the functional domain of another international standard setting body, or on issues that have cross-sectoral implications*'.[92] Thus, contrary to its predecessor, the FSF, which merely had a coordinating role, it is expected from the FSB that it does not only coordinate the work of the various other SSBs but that it becomes itself active as a standard-setter where warranted by potential cross-sectoral implications of a given issue and the existence of any potential gaps in the substantive coverage of the mandates of other SSBs.

[89] FSB Charter, Article 2(1)(a) and (b).

[90] FSB Charter, Article (2)(1)(c)–(j). Item (j) was only added with the amendment of the FSB Charter endorsed in June 2012 at the G-20 Los Cabos Summit. The other tasks were slightly refined at that occasion.

[91] FSB Charter, Article 2(2).

[92] FSB Charter, Article 2(3), emphasis added.

The FSB possesses a permanent Secretariat,[93] hosted by the BIS in Basle.[94] Besides the Secretariat, the internal structure of the FSB comprises the earlier mentioned Plenary as its main decision-making body,[95] a Steering Committee in charge of everyday management,[96] somewhat analogous to the IMF's Executive Board, as well as a Chairperson appointed by the Plenary for a term of three years, renewable once.[97] In addition, Standing Committees on (1) Assessment of Vulnerabilities,[98] (2) Standards Implementation,[99] (3) Supervisory and Regulatory Cooperation,[100] and (4) Budget and Resources[101] have been established by the Plenary which may set up additional Standing Committees as well as working groups.[102] In addition, the FSB has put into place six so-called Regional Consultative Groups for (1) Asia, (2) the Americas, (3) the Commonwealth of Independent States, (4) Europe, (5) the Middle East and North Africa, as well as (6) Sub-Saharan Africa.[103]

As originally established in 2009, the FSB seemed to lack legal personality, both under international law (in the absence of a constituent treaty) and private law (in the absence of corporate will and of any act of incorporation or registration).[104] This has changed on 28 January 2013 when the Plenary of the FSB adopted the Articles of Association of the FSB.[105] It thereby established, under Article 60 of the Swiss Civil Code, an association by the name of Financial Stability Board (FSB),[106] domiciled in Basle and funded by the BIS on the basis of a renewable multi-year funding agreement and voluntary contributions by its members.[107] Hence, the FSB now possesses legal personality under Swiss private law.

It still remains that, in the discharge of its various reporting, coordination as well as standard-setting tasks under its expanded mandate, the FSB as a soft-law entity par excellence has to rely entirely on peer pressure and the pressure arising from highly sensitive and nervous financial markets to achieve its objectives. The FSB Charter explicitly states that it 'is not intended to create any legal rights or obligations'.[108]

Peer pressure is also the only means for ensuring that the FSB's members honour their membership commitments as set forth in the FSB Charter,[109] namely to:

(a) pursue the maintenance of financial stability;

(b) maintain the openness and transparency of the financial sector;

[93] FSB Charter, Articles 7(7) and 22.

[94] FSB Charter, Articles 7(7) and 22. See also Giovanoli (n 1) 113.

[95] FSB Charter, Article 7(1). For detail on the Plenary's responsibilities and on practical issues related to its work, see FSB Charter, Articles 9–11.

[96] FSB Charter, Articles 7(2). For the composition and responsibilities of the FSB's Steering Committee, see FSB Charter, Articles 12–13.

[97] FSB Charter, Articles 7(6) and 21.

[98] FSB Charter, Article 14.

[99] FSB Charter, Article 16.

[100] FSB Charter, Article 15.

[101] FSB Charter, Article 17.

[102] FSB Charter, Article 9(3)(g).

[103] FSB Charter, Article 20 and Annex B.

[104] Giovanoli (n 1) 109.

[105] Articles of Association of the Financial Stability Board (FSB) (28 January 2013), available at <http://www.financialstabilityboard.org/publications/r_130128aoa.pdf> accessed 1 July 2013.

[106] FSB Charter, Article 1(1).

[107] FSB Charter, Article 7.

[108] FSB Charter, Article 23.

[109] FSB Charter, Article 6(1).

(c) implement international financial standards;
(d) undergo periodic peer reviews (notably via the FSAP as administered jointly by the IMF and the World Bank);[110] and
(e) take part in implementation monitoring of agreed commitments, standards, and policy recommendations.[111]

Overall, there is little doubt that the re-establishment of the FSB with both a significantly broadened mandate and a more inclusive membership should be viewed as the key achievement of the first series of G-20 summits. At the same time, the FSB does not seem to suffer from the same legitimacy deficit as did the G-20 as the self-appointed steering board of the world economy.[112] Certainly, the FSB is not an international organization and lacks legal personality under international law. However, even though its detailed and very specific mandate as discussed in this section is not based on an international treaty, considerable weight should be given to the fact that the FSB counts two multilateral organizations—the IMF and the World Bank—among its members. At least indirectly, and to some limited extent, each of the 188 member states of the Bretton Woods sisters may therefore be considered participating in the crucial work undertaken by the FSB in pursuit of global financial stability. At the same time, the fact that the FSB, just as the G-20, operates in a very transparent manner and exclusively serves to promote globally shared values, such as financial stability and financial integrity, two of the key constituent values of contemporary monetary sovereignty as analysed in this monograph, may be viewed as mitigating the legitimacy concerns that arise from the fact that only a few members of the international community are directly represented on the FSB.

Just as the G-20, the FSB was borne out of the need to provide rapid responses to truly global challenges at a time of crisis. However, whereas the G-20 is not likely to move beyond the status of serving as a rather informal forum for the world's biggest economies to coordinate their policies and global reform efforts, the FSB has gradually been equipped with a more permanent organizational structure and is therefore likely to remain a crucial component of the reorganized IFA. It could still be argued, of course, that in order to further buttress the FSB's legitimacy, its members should either seek to obtain an explicit multilateral mandate or to re-establish the FSB as an international organization with non-exclusive membership. Doing so would likely strengthen the FSB in the discharge of its crucial oversight function, which is aimed at detecting vulnerabilities in the financial system, and also in its role as coordinator of the various efforts undertaken by domestic regulatory and supervisory authorities, by SSBs and by the IFIs to promote global financial stability. This being said, the recent establishment of the FSB as an association under Swiss private law leaves no doubt that, at least for the time being, the members of the FSB have opted to embark on a different path.

110 For detail on the FSAP, see Subsections III.A.2 and III.A.3 below.
111 FSB Charter, Article 6(1).
112 See the related comments in Section I.A above.

On a separate note, the FSB's major role in the reorganized IFA underlines the need to address a major deficiency in the design of both the FSB and most international financial SSBs: the lack of clear mechanisms for holding these bodies and their members accountable for outright failures in the discharge of their functions, such as, for example, the promotion of a financial standard that turns out to be harmful.[113]

Turning to the relationship between the FSB and the IMF, the following section offers the opportunity to look at the practical operation of several key tasks of the FSB.

B. The FSB and its relationship with the IMF put into perspective

After a brief overview of the fundamental division of labour between the FSB and the IMF (Subsection 1), this section looks into the Early Warning Exercise (EWE), which is being undertaken jointly by the FSB and the IMF (Subsection 2), as well as into the FSB's work on Key Standards for Sound Financial Systems (Subsection 3).

1. The underlying division of labour

The IMF and the FSB are of fundamentally different legal nature. Whereas the IMF is a fully-fledged international organization with 188 members, the FSB possesses only legal personality as an association under Swiss private law[114] and is composed of a rather limited hybrid membership of states, IFIs,[115] national authorities, and international SSBs. However, their various differences have never prevented the FSF/FSB and the Fund from cooperating closely out of recognition that, although their respective responsibilities are not identical, they are nevertheless closely related and complementary. During the Global Financial Crisis, the IMF and the former FSF decided to enhance their collaboration and jointly provided the necessary clarification on how they see their respective roles and responsibilities. This clarification took the form of a joint letter by Dominique Strauss-Kahn, then IMF Managing Director, and Mario Draghi, then Chairman of the FSF, dated 13 November 2008, to G-20 Ministers and Governors meeting a couple of days later at the inaugural G-20 Washington Summit. The essential points of that letter, which applies also to the relationship between the IMF and the FSB as the FSF's successor,[116] are the following:[117]

[113] See Giovanoli (n 1) 114.

[114] As analysed in the preceding section, prior to 28 January 2013, the FSB lacked even that type of legal personality.

[115] As noted earlier, the IMF is a formal member of the FSB (the IMF Executive Board formally approved the IMF's acceptance of membership in the FSB on 8 September 2010, see IMF, 'IMF Executive Board Approves Fund Membership in the Financial Stability Board', Public Information Notice (PIN) No 10/133 (27 September 2010) <http://www.imf.org/external/np/sec/pn/2010/pn10133.htm> accessed 1 July 2013). By contrast, as noted in Chapter 4, membership in the IMF is reserved to states, which limits the FSB's role in the Fund to that of an observer at selected meetings of the IMF Executive Board.

[116] Giovanoli (n 1) 115.

[117] IMF and FSF, Joint letter from Dominique Strauss-Kahn, IMF Managing Director, and Mario Draghi, FSF Chairman, to G-20 Ministers and Governors (13 November 2008) <http://www.financialstabilityboard.org/publications/r_081113.pdf> accessed 1 July 2013.

1. Surveillance of the global financial system is the responsibility of the IMF.
2. Elaboration of international financial sector supervisory and regulatory policies and standards, and coordination across the various [SSBs], is the principal task of the [FSB]. The IMF participates in this work and provides relevant inputs as a member of the [FSB].
3. Implementation of policies in the financial sector is the responsibility of national authorities, who are accountable to national legislators and governments. The IMF assesses authorities' implementation of such policies through FSAPs, ROSCs [ie Reports on the Observance of Standards and Codes[118]] and Article IVs [ie as part of IMF surveillance[119]].
4. The IMF and the [FSB] will cooperate in conducting [EWEs]. The IMF assesses macrofinancial risks and systemic vulnerabilities. The [FSB] assesses financial system vulnerabilities, drawing on the analyses of its member bodies, including the IMF. Where appropriate, the IMF and [FSB] may provide joint risk assessments and mitigation reports.

At the G-20 London Summit in April 2009, G-20 leaders agreed that the FSB and the IMF should collaborate to conduct EWEs 'on the build up of macroeconomic and financial risks and the actions needed to address them'.[120]

2. The joint FSB-IMF Early Warning Exercise

The main purpose of the semi-annually conducted EWE,[121] one of the G-20's first reactions to the Global Financial Crisis, is not to predict the timing and dimension of a future crisis but 'to identify the vulnerabilities and triggers that could precipitate systemic crises, and [to identify] risk-mitigating policies, including those that would require international cooperation'.[122] The EWE's perspective on systemic risks and vulnerabilities faced by the financial system is thus an integrated one, with the Fund taking 'a leading role on economic, macro-financial and sovereign risk concerns, and the FSB on financial system regulatory and supervisory issues'.[123] Both participating institutions undertake a broad range of empirical analyses as part of the EWE, and gather market information and expert opinions through consultations with various participants on financial markets, various country authorities, and academics.[124] The related research is partly conducted exclusively for the

[118] For detail on the Fund's work on FSAPs and ROSCs, see Subsection III.A.1 below.

[119] For detail on bilateral and multilateral surveillance as undertaken by the Fund on the basis of IMF Article IV, see Chapter 2, Section II.B, as well as Chapter 3, Sections I.A and I.B, of this monograph.

[120] G-20 London Summit Declaration (n 33) para 15.

[121] On the underlying economic challenge, see Atish R Ghosh, Jonathan D Ostry, and Natalia Tamirisa, 'Anticipating the Next Crisis: What Can Early Warning Systems be Expected to Deliver?' (September 2009) Finance and Development 35–7 <http://www.imf.org/external/pubs/ft/fandd/2009/09/pdf/ghosh.pdf> accessed 1 July 2013.

[122] IMF, 'IMF-FSB Early Warning Exercise' (Factsheet) (20 March 2013) <http://www.imf.org/external/np/exr/facts/ewe.htm> accessed 1 July 2013.

[123] IMF (n 122).

[124] For an insightful, detailed, study of the design of the EWE and of the analytical toolset employed on the Fund's side, see IMF, 'The IMF-FSB Early Warning Exercise: Design and

EWE, and partly as a by-product of other work undertaken by the Fund and the FSB. As such, the EWE has become a vital element of the Fund's efforts to strengthen surveillance, in particular with respect to cross-sectoral and cross-border spillovers, as well as economic, financial, and fiscal risks, and is therefore conducted in close coordination with the World Economic Outlook (WEO), the Global Financial Stability Report (GFSR), and the Fiscal Monitor, the Fund's main publications on multilateral surveillance.[125] The IMF uses its various surveillance activities to follow up on policy recommendation issued as part of the EWE.[126] The key output of the EWE is a report on risks and vulnerabilities, prepared in close cooperation between IMF and FSB staff,[127] to the International Monetary and Financial Committee (IMFC).[128] This report is confidential to avoid overly sensitive reactions of financial markets to the EWE's conclusions, thereby encouraging the participating institutions to candour in their assessments.

Whether the EWE will contribute to avoiding a future crisis from occurring or whether it will at least attenuate the negative effects of such a crisis, remains to be seen. What can be said with certainty at this stage is that the crosscutting nature of the risks and vulnerabilities examined as part of the EWE amply justifies the attempt to combine the unique expertise of both the IMF and the FSB (including notably the expertise coming from the FSB's hybrid membership), and to bring their respective views to bear on an exercise which, by its very nature, requires an approach that goes beyond the core expertise of any of the participating institutions viewed in isolation. Hence, the EWE seems to be an original and timely response by the international community, following the initiative of the G-20, to promote the stability of the global financial system.

The final subsection of this chapter part will now take a look at another outstanding element of the FSB's work, resulting from a task taken over from its predecessor, the FSF: the designation of Key Standards for Sound Financial Systems.

3. The FSB's Key Standards for Sound Financial Systems

As part of its work on the comprehensive Compendium of Standards, jointly produced by the various SSBs on the FSB, the FSB has designated so-called Key Standards for Sound Financial Systems, covering 12 different policy areas. The FSB believes that these Key Standards for Sound Financial Systems '[deserve] of priority implementation depending on country circumstances'.[129] As of 1 July 2013, the

Methodological Toolkit' (September 2010) <http://www.imf.org/external/np/pp/eng/2010/090110.pdf> accessed 1 July 2013.

[125] IMF (n 122). [126] IMF (n 122). [127] IMF (n 124) 4.

[128] The IMFC is the main advisory body to the IMF Board of Governors. It normally meets twice a year (usually at the spring and fall meetings of the IMF and World Bank) to advise the IMF on the direction of its work. The IMFC, whose composition reflects that of the IMF Executive Board, has 24 members (usually ministers and central bank governors), drawn from the members on the Board of Governors (IMF (n 124) fn 2).

[129] FSB website, 'Key Standards for Sound Financial Systems' <http://www.financialstabilityboard.org/cos/key_standards.htm> accessed 1 July 2013.

list of key standards, which is regularly reviewed by the FSB in light of economic and regulatory developments, comprises:[130]

Area	*Standard*	*Issuing Body*
Macroeconomic Policy and Data Transparency:		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices on Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard	IMF
	General Data Dissemination System	IMF
Financial Regulation and Supervision:		
Banking supervision	Core Principles for Effective Banking Supervision	BCBS
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Core Principles	IAIS
Institutional and Market Infrastructure:		
Crisis resolution and deposit insurance	Core Principles for Effective Deposit Insurance Systems	BCBS/IADI[131]
Insolvency	Insolvency and Creditor Rights	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting and Auditing	International Financial Reporting Standards (IFRS)	IASB
	International Standards on Auditing (ISA)	IAASB[132]
Payment, clearing and settlement	Principles for Financial Markets Infrastructure	CPSS[133]/IOSCO
Market integrity	FATF Recommendations on Combating Money Laundering and the Financing of Terrorism & Proliferation	FATF

[130] The following tabular overview of the Key Standards for Sound Financial Systems is taken from the FSB's website (n 129), which provides detailed information on each of these key standards and on the respective issuing standard-setting bodies (<http://www.financialstabilityboard.org/cos/wssb.htm>), including links to their respective websites providing additional information. The shortcuts of institutions that have not yet been introduced earlier are explained in the three following footnotes.

[131] IADI: International Association of Deposit Insurers, <http://www.iadi.org> accessed 1 July 2013.

[132] IAASB: International Auditing and Assurance Standards Board, <http://www.ifac.org/IAASB> accessed 1 July 2013.

[133] CPSS: Committee on Payments and Settlement Systems, <http://www.bis.org./cpss/index.htm> accessed 1 July 2013.

The fact that none of these standards constitutes binding international law[134] has the advantage of improving their acceptability in the eyes of state leaders since the latter are assured that they will preserve maximum domestic regulatory autonomy. Domestic regulators are thus able to ensure that implementation fits into the country's 'overall strategy for economic and financial sector development, taking account of its stage of development, level of institutional capacity, and other domestic factors'.[135]

Over the past few years, in light of the restricted membership of the FSF/FSB, and in the absence of some sort of global finance authority with multilateral membership,[136] it is the IMF that has emerged as the central actor in promoting the successful implementation of the Key Standards on Sound Financial Systems, formerly designated by the FSF and now by the FSB. This takes us directly into the third, and final, part of this chapter.

III. The Evolving Role of an Evolving IMF in the International Financial Architecture

This third part looks at the key features and recent reforms of the Fund's work on global financial stability (Section A) prior to assessing the major overhauls of the IMF's governance structure that were initiated in 2008 and 2010 (Section B).

A. The Fund's work on global financial stability: key features and recent reforms put into perspective

The Fund's role in the EWE has been examined above.[137] This section looks briefly into the work on standards and codes undertaken jointly by the IMF and the World Bank (Subsection 1) before focusing on the FSAP and its 2009 reform (Subsection 2). Finally, this section provides a thorough assessment of the 2010 reform of the FSAP in the broader context of the IMF's revision of its surveillance mandate (Subsection 3).

1. Ensuring the continued relevance of the IMF's and the World Bank's work on standards and codes

In 1999, as part of the various initiatives aimed at strengthening the IFA in the wake of the East Asian financial crisis, the IMF and the World Bank launched a joint Standards and Codes Initiative (SCI).[138] As part of the SCI, the IMF and the

[134] As noted in Section II.A above, even for states that are members of the FSB and have thus committed to implement these standards, the latter are not formally binding.

[135] FSB website, 'Why are Standards Important?' <http://www.financialstabilityboard.org/cos/wasi.htm> accessed 1 July 2013.

[136] For a brief discussion on whether, in order to effectively promote the stability of the global financial system, a new international organization serving as a global finance authority should be set up, see the conclusion to this chapter.

[137] See Subsection II.B.2 of this chapter.

[138] As noted earlier, both the original G-20 and the former FSF were created that same year. So was the Fund's FSAP which is intrinsically linked to the SCI and which will be examined in the two following subsections.

World Bank recognized international standards in 12 areas related to their work,[139] this list of standards being identical to the FSB's Key Standards for Sound Financial Systems.[140] At the request of individual members, their respective observance of these standards and codes is assessed by the IMF, the World Bank, and, as far as the standards on anti-money laundering and combating the financing of terrorism are concerned, by the FATF. The results of these assessments are summarized in so-called Reports on the Observance of Standards and Codes (ROSCs) with follow-up assessments being undertaken to achieve factual updates.[141] Whereas members are solely responsible for deciding whether and how they wish to implement ROSC recommendations, developing countries often request technical assistance from the IMF and other international bodies for this purpose.[142] Besides its overarching goal of promoting both domestic and global financial stability through 'the development, dissemination, adoption, and implementation of international standards and codes',[143] the SCI pursues three intermediate objectives: to 'strengthen member countries' economic institutions by improving transparency and promoting good governance, inform IMF surveillance and the Bank's Country Assistance Strategies, and inform market participants to discriminate better among investment opportunities'.[144] Publication of ROSCs, like participation in the first place, is voluntary. However, since the inception of the SCI in 1999, most IMF members have undergone an assessment at least once. As reported by the Fund, as of end-February 2013, 'most of the IMF's 188 member countries had completed one or more ROSC modules. A total of 1,276 ROSCs have been produced, of which about 63 per cent were published'.[145] Taking into account the universal membership of the IMF and the World Bank, as contrasted by the limited inclusiveness of most international SSBs and even of the enlarged FSB, these figures underline the SCI's potential for promoting standards and codes on a truly global scale.[146]

Although they play an increasingly important role in informing IMF surveillance, the assessments undertaken in preparation of ROSCs are, strictly speaking,

[139] For the detailed list of standards, see IMF, 'Standards and Codes: The Role of the IMF' (Factsheet) (20 March 2013) <http://www.imf.org/external/np/exr/facts/sc.htm> accessed 1 July 2013.

[140] Slight variations between the two lists may occur when updates are made at different times, but the management of the two lists of standards is closely coordinated.

[141] IMF (n 139).

[142] IMF (n 139). On the issue of technical assistance as provided by the Fund, see Chapter 2, Section II.B, of this monograph.

[143] IMF, 'IMF Executive Board Concludes Review of Standards and Codes Initiative', PIN No 11/38 (22 March 2011) <http://www.imf.org/external/np/sec/pn/2011/pn1138.htm> accessed 1 July 2013.

[144] IMF (n 143).

[145] IMF (n 139).

[146] For an insightful study of the extent to which the implementation of financial standards is being indirectly promoted by the WTO, see Régis Bismuth, 'Financial Sector Regulation and Financial Services Liberalization at the Crossroads: The Relevance of International Financial Standards in WTO Law' (2010) 44 *Journal of World Trade* 489.

technical assistance.[147] With respect to the FSAP, the same can no longer be said for the entirety of the Fund's membership, since in 2010 the FSAP has been made a compulsory element of Article IV consultations for those IMF members with systemically important financial sectors, which currently concerns 25 members.[148] With this caveat in mind, let us look at a concise explanation given by François Gianviti, a former IMF general counsel:

> [T]he Fund cannot expand the scope of its surveillance beyond the provisions of [IMF] Article IV. A finding of noncompliance with standards and codes would not constitute a finding of breach of obligation under the Articles. FSAP reports [but for the 25 members with systemically important financial sectors] and ROSCs are not by themselves an exercise of surveillance; participation is voluntary . . . and the rules of technical assistance apply . . . FSAP reports [both those undertaken on a compulsory basis as a result of the 2010 reform of the FSAP and those undertaken voluntarily] 'feed into' surveillance, i.e., [they] provide material which deepens the Fund's understanding of the member's circumstances . . . Actually, while expanding the sources of information available to the Fund in the exercise of surveillance, FSAP reports and ROSCs illustrate the evolution of surveillance from an assertion of jurisdictional powers as contemplated by the Fund's Articles to a policy dialogue coupled with peer pressure.[149]

Consistent with the above, the latest review, in March 2011, of the SCI by the Fund's Executive Board concluded that increased efforts were needed to integrate ROSC findings into IMF surveillance, notably by following up on macro-relevant ROSC recommendations in bilateral surveillance, and also that more cross-country work should be undertaken.[150] The Executive Board stressed the importance of ensuring that ROSC recommendations are in line with specific countries' needs, in order to promote country ownership of ROSCs,[151] thereby promoting the successful implementation of standards and codes as well as the SCI's underlying objectives, ie increased domestic and global financial stability.

Finally, it should not be forgotten that conditionality continues to be the Fund's most powerful tool for promoting the observance of standards and codes by members relying on financial assistance from the Fund,[152] and also for motivating these members to eliminate financial sector weaknesses, identified as part of FSAP assessments.

[147] For detail on this point, see Lastra (n 10) 405.

[148] For a detailed analysis of the 2010 reform of the FSAP as part of a fundamental reorientation of IMF financial surveillance, see Subsection III.A.3 below.

[149] François Gianviti, 'Legal Aspects of the Financial Sector Assessment Program (FSAP)', paper presented at the IMF Seminar on Current Developments in Monetary and Financial Law (7–17 May 2002) <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/gianv2.pdf> accessed 1 July 2013.

[150] IMF (n 143). The 2005 review of the SCI by the Executive Board had already called for a better integration of ROSC findings into surveillance. See IMF, 'IMF Executive Board Reviews the Standards and Codes Initiative', PIN No 05/106 (8 August 2005) <http://www.imf.org/external/np/sec/pn/2005/pn05106.htm> accessed 1 July 2013.

[151] IMF (n 143).

[152] For a detailed analysis of the sophisticated implementation techniques and evolving normative effects of IMF and World Bank conditionality, see Chapter 2, Section II.A, of this monograph.

2. The Financial Sector Assessment Program and its 2009 reform in reaction to the Global Financial Crisis

The FSAP, a comprehensive in-depth analysis of a country's financial sector, was also established in 1999 and is also run jointly by the IMF and the World Bank. Joint teams are in charge of conducting financial sector assessments in low-income and emerging market countries. In advanced economies, the Fund is solely in charge.[153] The focus of FSAP assessments is always two-fold: 'to gauge the stability of the financial sector and to assess its potential contribution to growth and development'.[154] As further explained by the Fund:

> To assess stability, FSAPs examine the soundness of the banking and other financial sectors; the quality of bank, insurance, and financial market supervision against accepted international standards; and the ability of supervisors and financial safety nets to respond effectively in case of a crisis. To assess developmental needs, FSAPs examine the legal framework and [the] financial infrastructure—such as the payments and settlements system, identify obstacles to the sector's competitiveness and efficiency, and evaluate the framework for oversight, market integrity, and consumer protection.[155]

The results of these assessments are presented by IMF and World Bank staff in separate reports, called Financial System Stability Assessments (FSSAs)[156] and Financial Sector Assessments (FSAs) respectively, to the Executive Boards of both institutions. Prioritized policy recommendations are given to member states in order to guide them in the process of rectifying any identified weaknesses. If need be, technical assistance is made available for the implementation of the recommendations made as part of the FSAP.

As noted earlier, until September 2010, when it was made mandatory for 25 jurisdictions with systemically important financial sectors,[157] participation in the FSAP had been a voluntary exercise for the entirety of the Fund's membership. However, it appears that despite this formally voluntary nature, there had always been significant peer pressure on IMF members to participate in FSAP assessments. Thus, at the time when the FSAP was made compulsory for parts of the Fund's membership, more than 125 IMF members had undergone FSAP assessments (many of them more than once), and several dozens of additional FSAP assessments were underway.[158] Following the Global Financial Crisis, demand for FSAP

[153] IMF, 'Financial Sector Assessment Program: Frequently Asked Questions' (3 October 2012) <http://www.imf.org/external/np/fsap/faq/index.htm> accessed 1 July 2013.

[154] IMF, 'The Financial Sector Assessment Program (FSAP)' (Factsheet) (15 March 2013) <http://www.imf.org/external/np/exr/facts/fsap.htm> accessed 1 July 2013.

[155] IMF, 'IMF Executive Board Reviews Experience with the Financial Sector Assessment Program, Options for the Future, and Complementary Reforms in Surveillance and the Assessment of Standards and Codes', PIN No 09/123 (29 September 2009) <http://www.imf.org/external/np/sec/pn/2009/pn09123.htm> accessed 1 July 2013.

[156] Due to their close connection, a significant proportion of ROSCs are published as part of such FSSAs.

[157] For detail on this crucial 2010 reform of the FSAP, see Subsection III.A.3 below.

[158] IMF, 'IMF Releases Background Material for its Assessment of the United States under the Financial Sector Assessment Program', Press Release No 10/197 (14 May 2010) <http://www.imf.org/external/np/sec/pr/2010/pr10197.htm> accessed 1 July 2013.

assessments has been rising significantly. Notably, all members of the FSB have formally committed to undergo regular assessments.[159] For the US as the world's largest economy a first-time assessment was completed in May 2010.[160]

In September 2009, the IMF Executive Board reviewed the experience with the FSAP over the first ten years of its existence and discussed options for strengthening the programme in light of the Global Financial Crisis which exposed several weaknesses of the FSAP, notably the fact that liquidity risks and cross-border or cross-market linkages were underappreciated as sources of risk and that recommendations were not clear and country-specific enough.[161] This led to an improvement of the mechanism's analytical tools and assessment methodologies. It also led to the introduction of a Risk Assessment Matrix designed to render FSAP stability assessments more systematic, candid, and transparent, as well as to the replacement of 'one-size-fits-all' assessments with more flexible modular assessments, tailored to specific country needs.[162]

The Fund also considers the 2009 FSAP review to be an important step forward in its broader strategy to strengthen macrofinancial surveillance.[163] In line with the IMF's Surveillance Priorities for 2008–2011,[164] stating that strengthening the global financial system and improving the analysis of financial stability are among the main objectives of IMF surveillance, the Fund has begun to put a stronger focus on financial sector issues in Article IV consultations.[165] Unsurprisingly, the potential integration of findings from financial sector assessments undertaken as part of the ROSCs and FSAPs into the Fund's mandatory surveillance process has raised concerns over the limits, under the IMF's mandate, of a stronger focus of the

159 See FSB Charter, Article 6(1)(d).

160 The detailed reports related to the FSAP assessments undertaken with respect to the US as well as other IMF members are available on the IMF website at <http://www.imf.org/external/NP/fsap/fsap.aspx> accessed 1 July 2013.

161 IMF (n 154).

162 IMF (n 154). For a summary of the discussion of the various reform proposals by the Fund's Executive Board, see IMF (n 155). See also IMF, 'Revised Approach to Financial Regulation and Supervision Standards Assessments in FSAP Updates' (28 August 2009) <http://www.imf.org/external/np/pp/eng/2009/082809D.pdf> accessed 1 July 2013; as well as IMF and World Bank, 'The Financial Sector Assessment Program After Ten Years: Experience and Reforms for the Next Decade' (28 August 2009) <http://www.imf.org/external/np/pp/eng/2009/082809B.pdf> accessed 1 July 2013.

163 IMF (n 155).

164 For the IMF's surveillance priorities for 2008 to 2011 see IMF, Decision No 14436-(09/102), 'Statement of Surveillance Priorities—Revisions of Economic Priorities and Progress on Operational Priorities' (25 September 2009), in *Selected Decisions and Selected Documents of the International Monetary Fund* [*Selected Decisions*] (36th issue, Washington DC, 31 December 2011) 48, 49 available at <http://www.imf.org/external/pubs/ft/sd/index.asp?decision=14436-(09/102)> accessed 1 July 2013. See also IMF, 'IMF Executive Board Revises Surveillance Priorities for 2008–2011', Press Release No 09/336 (29 September 2009) <http://www.imf.org/external/np/sec/pr/2009/pr09336.htm> accessed 1 July 2013.

165 For detail, see IMF, 'Financial Sector and Bilateral Surveillance—Toward Further Integration' (28 August 2009) <http://www.imf.org/external/np/pp/eng/2009/082809A.pdf> accessed 1 July 2013.

Fund's work on financial stability.[166] The following subsection looks into precisely this issue and into the 2010 reform of the FSAP.

3. The 2010 reform of the Financial Sector Assessment Program as a vital part of the Fund's revision of its surveillance mandate

Considered in the light of the experiences made in the context of the Global Financial Crisis and previous financial crises, the Fund's strengthened focus on financial sector issues in its surveillance activities may indeed be viewed as an important and necessary reorientation of the Fund's work that has the potential to foster the stability of the global financial system. Feeding detailed findings obtained through FSAP and ROSC assessments and related cross-country experience into bilateral and multilateral surveillance is likely to enhance the efficiency and meaningfulness of the Fund's surveillance activities. One should not overlook, however, that the inclusion of policy recommendations made in FSSAs and ROSCs into bilateral surveillance would inevitably increase the normative effect of these instruments. Consistent with the analysis provided earlier in this monograph,[167] the Fund's surveillance activities, the technical assistance it provides, and the joint IMF-World Bank efforts on financial sector assessment and on standards and codes may thus validly be regarded as forming one intrinsically linked bundle of techniques with which the Fund can decisively shape domestic policies. The normative effects of conditionality further add to this picture.[168]

From an economic point of view, there is indeed little doubt that strengthening macrofinancial surveillance is an appropriate response to the ever-increasing integration of global financial markets.[169] However, the Fund's policy shift in this regard raises the question as to whether the IMF's new approach to financial sector surveillance amounts to a subtle transgression of its own mandate. Thus, at its October 2009 meeting in Istanbul, the IMFC called on the Fund 'to review its mandate to cover the full range of macroeconomic and financial sector policies that bear on global stability'.[170] Over the course of the following years, various IMF departments reviewed the IMF's mandate and explored possibilities for improving macrofinancial surveillance without having to embark on the tedious process of amending the Fund's Articles.

The Fund's mandate, set forth in detail in IMF Article I, covers a wide range of issues which can be broadly divided in the three categories (i) lending, (ii) oversight, and (iii) advisory powers.[171] The unifying theme, defining scope and content of the powers conferred upon the IMF, has always been the promotion of the

[166] IMF (n 155). [167] See Chapter 2, Section II.B.

[168] For detail on the evolving normative effects of IMF and World Bank conditionality, see Chapter 2, Section II.A, of this monograph.

[169] Analysing this crucial economic issue obviously lies beyond the scope and purpose of this chapter and, indeed, this monograph.

[170] IMF, 'Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund', Press Release No 09/347 (4 October 2009) <http://www.imf.org/external/np/sec/pr/2009/pr09347.htm> accessed 1 July 2013.

[171] See IMF, 'The Fund's Mandate—The Legal Framework' (22 February 2010) para 4 <http://www.imf.org/external/np/pp/eng/2010/022210.pdf> accessed 1 July 2013.

international *monetary* system,[172] which, according to the Fund, 'is comprised of, and limited to, those arrangements that directly control the balance of payments of members'.[173] As noted earlier,[174] in its 2012 ISD, the Fund has explicitly defined the international monetary system as comprising (i) the rules governing foreign exchange arrangements and rates; (ii) the rules governing the making of payments and transfers for current international transactions; (iii) the rules governing the regulation of international capital flows; and (iv) the arrangements under which international reserves are held.[175] Thus, it should be stressed that the Fund continues to adhere to a very technical definition under which the international *monetary* system is clearly distinct from the international *financial* system.

As commonly understood, the international *financial* system is indeed a much broader concept than the international monetary system. Thus, the former encompasses both private and official participants in global financial markets, with private actors dominating the system these days.[176] By contrast, the international *monetary* system, while being an integral part of the international financial system, is limited to 'the set of rules, conventions, and institutions that govern and condition official actions and policies affecting the international economy and financial system: exchange rate regimes, intervention policies, the size and composition of reserve holdings, mechanism of official financial support, etc.'.[177]

This being said, does the Fund's reliance on a strictly technical definition of the international *monetary* system mean that it should not be concerned at all about the international *financial* system? Under the impact of the Global Financial Crisis, the Fund has finally come to realize that it is not possible to durably secure the stability of the international monetary system without also looking after the stability of the international financial system more broadly. In other words, the Fund has come to realize that continuing to draw an overly strict distinction between the international monetary and the international financial systems—a distinction that disregards the intrinsic relationship and interaction between both systems—would be artificial and out of touch with economic reality. However, since the Fund's Articles do not explicitly charge the Fund with the oversight of the international financial system, it is perfectly understandable the Fund has always shown great caution not to be perceived by its members as exceeding its mandate.

Certainly, as analysed in detail earlier in this monograph,[178] it is already since the reforms introduced by the Second Amendment of the Fund's Articles in 1978 that

[172] IMF (n 171) para 5. [173] IMF (n 171) para 5.

[174] See Chapter 3, Section III.B, of this monograph.

[175] IMF, 2012 ISD (n 58) para 10.

[176] See, eg, the definitions of both systems explained and discussed by the current vice chair of the Fed's Board of Governors: Janet L Yellen, 'Improving the international monetary and financial system', speech given at the International Symposium of the Banque de France: Regulation in the Face of Global Imbalances (4 March 2011), available at <http://www.federalreserve.gov/newsevents/speech/yellen20110304a.htm> accessed 1 July 2013.

[177] Edwin M Truman, 'The International Monetary System and Global Imbalances', Policy Paper (Peterson Institute for International Economics, January 2010) 3, available at <http://www.iie.com/publications/papers/truman0110.pdf> accessed 1 July 2013.

[178] See the detailed analysis in Chapter 3, Sections I.A and I.B.

'the Fund's discharge of its responsibility regarding the stability of the external payments of its members requires it to be involved in analysing, assessing and advising on domestic conditions and policies, including domestic *financial* conditions and policies'.[179] However, as analysed earlier,[180] and as explained by the Fund, it still remains that under the existing legal framework 'the Fund's authority in the domestic area is derivative; i.e., the basis of this authority is derived from the potential impact of domestic conditions and policies on the balance of payments of individual members and on the overall international monetary system'.[181] These observations underline the extent to which the IMF is limited under its current mandate, at least when interpreted in a narrow sense,[182] when it comes to guiding its members in the conduct of their domestic economic and financial policies.

The above state of affairs has not been decisively changed by the fact that, with its 2012 ISD, the Fund has adopted an additional principle E ('A Member should seek to avoid domestic economic and financial policies that give rise to domestic instability') pursuant to IMF Article IV:1 to guide IMF members in the conduct of their domestic economic and financial policies.[183] While this new principle may indeed help to reduce the perceived exchange-rate bias of the Fund's surveillance framework, making it clear that bilateral surveillance extends not only to exchange rate policies, but also to monetary, fiscal, and financial sector policies, the Fund remains very limited in what it can do to effectively push a member to adjust its conduct of these policies to the extent that it does not jeopardize present or prospective balance of payments stability.

In order to enhance the quality of the Fund's oversight of domestic financial sector policies, undertaken to the extent that the latter might give rise to balance of payments instability, the IMF Executive Board has decided on 21 September 2010 to integrate financial stability assessments under the FSAP into Article IV surveillance on a mandatory basis for IMF members with systemically important financial sectors.[184] As analysed convincingly by the Fund's Legal Department, a differentiated treatment of members depending on whether they dispose of systemically important financial markets as determined under objective criteria, does not violate

179 IMF (n 171) para 6.

180 See Chapter 3, Section I.B.

181 IMF (n 171) para 6.

182 For an interesting suggestion that the terms 'international monetary cooperation' in IMF Article I(i) and I(vi) and the terms 'international monetary system' in IMF Article IV:3(a) should be interpreted more broadly these days as referring to 'international monetary and financial cooperation' and the 'international monetary and financial system' respectively, see Rosa M Lastra, 'The Role of the IMF as a Global Financial Authority' in Christoph Herrmann and Jörg P Terhechte (eds), *European Yearbook of International Economic Law 2011* (Springer, Berlin and Heidelberg 2011), 121.

183 See the detailed analysis in Chapter 3, Section I.B.

184 See IMF, 'IMF Executive Board Discusses Integrating Stability Assessments into Article IV Surveillance', PIN No 10/135 (27 September 2010) <http://www.imf.org/external/np/sec/pn/2010/pn10135.htm> accessed 1 July 2013. For the full text of the decision, see IMF, Decision No 14736-(10/92), 'Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance' (21 September 2010) in *Selected Decisions* (n 164) 134, available at <http://www.imf.org/external/pubs/ft/sd/index.asp?decision=14736-(10/92)> accessed 1 July 2013.

the IMF's fundamental principle of uniformity of treatment.[185] The IMF has singled out 25 of its members as having systemically important financial sectors,[186] taking into account both the size and interconnectedness[187] of each country's financial sector.[188] This group of countries covers almost 90 per cent of the global financial system and 80 per cent of global economic activity and includes 15 G-20 members and a majority of FSB members.[189] Each of the selected countries has to undergo a financial stability assessment under the FSAP at least every five years.

As explained by the Fund, these mandatory financial stability assessments will comprise three elements:

(1) An evaluation of the source, probability, and potential impact of the main risks to macrofinancial stability in the near term, based on an analysis of the structure and soundness of the financial system and its interlinkages with the rest of the economy;
(2) An assessment of each countries' financial stability policy framework, involving an evaluation of the effectiveness of financial sector supervision against international standards; and
(3) An assessment of the authorities' capacity to manage and resolve a financial crisis should the risks materialize, looking at the country's liquidity management framework, financial safety nets; crisis preparedness and crisis resolution frameworks.[190]

Overall, it seems plausible to expect that the 2010 reform of the FSAP, with regular assessments now being mandatory for members with systemically important financial sectors, will improve the effectiveness of IMF surveillance of macrofinancial stability. However, one should not overlook the fact that the integration of mandatory FSAP assessments into the Fund's surveillance process alone changes neither the voluntary nature of the recommendations made as part of FSSAs nor the soft nature of the obligations under IMF Articles IV:1(i) and (ii) as analysed in detail earlier in this monograph.[191] The integration of mandatory financial sector

[185] IMF (n 171), para 14. See also Sean Hagan, 'Enhancing the IMF's Regulatory Authority' in Cottier, Jackson, and Lastra (eds) (n 3) 396, 400–3 (Sean Hagan is currently Director of the Fund's Legal Department and IMF general counsel).

[186] In alphabetical order, these 25 jurisdictions are: Australia, Austria, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, Italy, Japan, India, Ireland, Luxembourg, Mexico, the Netherlands, Russia, Singapore, South Korea, Spain, Sweden, Switzerland, Turkey, the UK, and the US (IMF, 'IMF Expanding Surveillance to Require Mandatory Financial Stability Assessments of Countries with Systemically Important Financial Sectors', Press Release No 10/357 (27 September 2010) <http://www.imf.org/external/np/sec/pr/2010/pr10357.htm> accessed 1 July 2013).

[187] For different lists of these 25 jurisdictions in the order of overall rank, size rank, and interconnectedness rank, see IMF, 'Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance' 14 (27 August 2010) <http://www.imf.org/external/np/pp/eng/2010/082710.pdf> accessed 1 July 2013.

[188] For the applicable methodology (subject to periodic review), see IMF, 'Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance: Background Material' 3–15 (27 August 2010) <http://www.imf.org/external/np/pp/eng/2010/082710a.pdf> accessed 1 July 2013.

[189] IMF (n 186).

[190] IMF (n 186).

[191] See Chapter 3, Sections I.A and I.B.

assessments into the Article IV consultations with the 25 systemically most important jurisdictions is likely to enable the Fund to provide these members with better-informed recommendations as to policy reorientations needed to enhance global financial stability. However, with the exception of the highly unlikely event that a member is found in breach of its obligations under the code of conduct in IMF Article IV:1, it still remains that the extent to which the Fund will be able to promote global financial stability under its existing legal framework depends crucially on the willingness of individual members to cooperate with Fund staff and to modify their policies in reaction to non-binding recommendations. Hence, despite the fact that the 2009 and 2010 reforms of the FSAP have strengthened macrofinancial surveillance as undertaken by the Fund, the final responsibility for the promotion of financial stability and financial integrity as key values of contemporary monetary sovereignty continues to reside with individual member states.

Approaching the end of this section, a few additional comments are warranted with regard to the Fund's 2012 ISD. Triggered by the 2011 Triennial Surveillance Review, as mentioned earlier, the 2012 ISD should be applauded for increasing the focus on financial sector issues not only in the Fund's *bilateral* surveillance but also in its *multilateral* surveillance. Thus, the 2012 ISD contributed, inter alia, to specifying the meaning of the Fund's multilateral surveillance mandate which is based on the rather vague terms of IMF Article IV:3(a) ('The Fund shall oversee the international monetary system in order to ensure its effective operation . . . '). In relevant parts, the 2012 ISD explicitly states:

> The scope of multilateral surveillance is determined by the obligation of the Fund under Article IV Section 3 (a) to oversee the international monetary system in order to ensure its effective operation. . . . It is recognized that, typically, the international monetary system may only operate effectively in an environment of global economic and financial stability, and that its effective operation contributes to such stability. Both global economic and financial stability and the effective operation of the international monetary system may be affected by, among other factors, members' own balance of payments and domestic stability, *economic and financial interconnections among members' economies and potential spillovers from members' economic and financial policies* through balance of payments and other channels. . . . The policies of members that may be relevant for this purpose include exchange rate, monetary, fiscal, *and financial sector policies* and policies respecting capital flows.[192]

Thus, this aspect of the 2012 ISD may have been influenced by a policy paper issued in January 2010 by the Fund's Strategy, Policy, and Review Departments. That paper noted that an Executive Board decision specifying 'that the financial sector is an integral, even if derived, part of the Fund's systemic oversight mandate' might be an 'alternative to amending the IMF Agreement's narrowing reference to the "international monetary system"'.[193] It still remains, of course, that contrary to the provisions providing the legal basis for the Fund's bilateral surveillance activities, the Fund's Articles do not contain any substantive obligations for IMF

[192] IMF, 2012 ISD (n 58) paras 9–12, emphasis added.

[193] IMF, 'The Fund's Mandate—An Overview', para 8 (22 January 2010) <http://www.imf.org/external/np/pp/eng/2010/012210a.pdf> accessed 1 July 2013.

members with regard to potential policy adjustments that might be recommended by the Fund in the process of multilateral surveillance.[194] This is true notwithstanding the fact that, as noted earlier,[195] the 2012 ISD laid out for the first time an explicit framework for potential multilateral consultations to follow up on worrisome findings obtained through the Fund's multilateral surveillance activities.

Finally, the 2011 Triennial Surveillance Reviews also prompted the Fund to develop a so-called Strategy for Financial Surveillance.[196] Adopted by the Executive Board on 19 September 2012,[197] the Strategy 'takes stock of the innovations and gaps in the IMF's financial surveillance during the past decade and proposes concrete and prioritized steps to further strengthen financial surveillance'.[198] In a nutshell, it sets forth a detailed three-prong strategy seeking (i) to strengthen the analytical underpinnings of macrofinancial risk assessments and policy advice; (ii) to upgrade the instruments and products of financial surveillance to foster an integrated policy response to risks; and (iii) to engage more actively with stakeholders in order to improve the traction and impact of financial surveillance.[199] Overall, while it appears plausible to expect that the 2012 Financial Surveillance Strategy will indeed increase the effectiveness of the Fund's financial surveillance activities, it would seem too early to embark on a detailed assessment of this initiative at this stage and in the context of the present study.

Having completed this assessment of the key features and the recent reforms of the Fund's work on global financial stability, this final part now turns its attention to the major overhaul of the IMF's governance structure which has been undertaken since 2008 in order to strengthen the Fund's legitimacy and effectiveness in fulfilling its evolving tasks.

B. The 2008 and 2010 overhauls of IMF governance: increasing the Fund's legitimacy and effectiveness in fulfilling its evolving role

Contrary to most other international organizations (notably the WTO), the IMF (as well as its sister organization, the World Bank) does not function according to the principle 'one member, one vote', but is a quota-based institution, with the quota shares of members largely determining their respective voting power in institutional decisions. As noted earlier,[200] upon joining the Fund, each member is assigned an initial quota, broadly reflecting its economic size and characteristics compared to other members. Quotas are expressed in Special Drawing Rights (SDRs)[201] and determine three key aspects of every member's institutional and

[194] IMF (n 171) para 25.

[195] See Chapter 3, Section I.B.

[196] IMF, 'The IMF's Financial Surveillance Strategy' (28 August 2012) <http://www.imf.org/external/np/pp/eng/2012/082812.pdf> accessed 1 July 2013.

[197] See IMF, 'IMF Sets Out a Strategy for Financial Surveillance', PIN No 12/111 (21 September 2012) <http://www.imf.org/external/np/sec/pn/2012/pn12111.htm> accessed 1 July 2013.

[198] IMF (n 197).

[199] IMF (n 196) 1–2.

[200] See Chapter 2, Subsection II.A.1, of this monograph.

[201] For detail on the Fund's SDRs, see again Chapter 2, Subsection II.A.1 (notably n 113 therein).

financial relationship with the Fund:[202] its subscription, ie the amount of financial resources that every new member has to provide to the Fund in order for its membership to become fully effective,[203] its voting power,[204] and its regular access to the Fund's financial resources.[205] Adjustments of total quotas and quota shares of IMF members may take place either following a so-called 'general review of quotas' by the Fund's Board of Governors, with such a general review having to be undertaken at least every five years as determined by IMF Article III:2(a), or at any time as ad hoc adjustments according to IMF Article III:2(b).[206] In order to become effective, any adjustment of quotas requires approval by an 85 per cent majority of the total voting power held by IMF members.[207]

In 2008 and 2010, out of recognition that the existing quota and voting shares needed to be realigned to reflect the evolving relative weight of IMF members in the global economy, the IMF initiated two far-reaching governance reforms.[208] These reforms, while leaving the quota-based nature of the Fund intact, will have the effect of enhancing the participation and influence in the Fund of emerging market and developing countries. Taken together, the 2008 and 2010 reforms constitute the biggest-ever overhaul of IMF governance, and have been hailed by the IMF Managing Director as reflecting the membership's commitment to strengthen the credibility, legitimacy and effectiveness of the organization's efforts to promote global financial stability.[209]

[202] For an insightful analysis of quotas as determining the institutional and financial relationship of IMF members with the Fund, of the Fund's financial structure, as well as of the legal and economic characteristics of SDRs, see Lastra (n 10) 379–93.

[203] According to IMF Article III:1, each member's subscription shall be equal to its quota. Up to 25 per cent of a member's subscription has to be paid in SDRs or in freely usable currencies as determined by the Fund (at present: USD, EUR, GBP, and JPY), while the remainder may be paid in the member's domestic currency.

[204] The votes of IMF members consist of an equal number of so-called basic votes (initially 250 per member, but the reforms undertaken since 2008 include a gradual increase that will result in almost a tripling of these basic votes) plus one additional vote per SDR 100,000 of quota. As a consequence, there are major differences in influence between members. For example, as of 28 August 2013, the US as the IMF's largest member held 421,961 votes (16.75 per cent of total votes) and Tuvalu, as the smallest member, had merely 755 votes (0.03 per cent of total votes). For a regularly updated overview of quotas and voting power of IMF members, see <http://www.imf.org/external/np/sec/memdir/members.aspx>.

[205] For the modalities of access to IMF financing, see Chapter 2, Subsection II.A.1, of this monograph.

[206] For a detailed overview of the two types of quota adjustments, see, eg, Lastra (n 10) 382–3. The 2008 and 2010 governance reforms amount to an ad hoc adjustment and an adjustment resulting from a regular general review of quotas respectively.

[207] According to IMF Article III:2(c). As for any other major IMF decision requiring an 85 per cent majority of the total voting power, the US is the only IMF member disposing of a factual veto power due to the fact that it holds a voting share of well beyond 15 per cent as noted above. This pattern remains unaffected by the 2008 and 2010 reforms addressed below.

[208] Regularly updated links to the key documents related to the deliberations by the IMF Executive Board on the 2008 and 2010 governance reforms are contained in IMF, 'IMF Quota and Governance Publications' <http://www.imf.org/external/np/fin/quotas/pubs/index.htm> accessed 1 July 2013.

[209] IMF, 'IMF Board of Governors Adopts Quota and Voice Reforms by Large Margin', Press Release No 08/93 (29 April 2008) <http://www.imf.org/external/np/sec/pr/2008/pr0893.htm>; and IMF, 'IMF Executive Board Approves Major Overhaul of Quotas and Governance', Press Release No 10/418 (5 November 2010) <http://www.imf.org/external/np/sec/pr/2010/pr10418.htm> (both accessed 1 July 2013).

The first of the two ambitious reform packages on the Fund's quotas and governance,[210] the 2008 Quota and Voice Reforms, which had been approved by the IMF Board of Governors on 28 April 2008,[211] entered into force on 3 March 2011, following ratification of the Amendment on Voice and Participation to the Fund's Articles by the required majority[212] of 117 members representing 85 per cent of the Fund's total voting power.[213] Most notably, the 2008 Quota and Voice Reforms achieved the following:[214] firstly, quota increases for 54 IMF members amounting to SDR 20.8 billion,[215] thereby realizing a significant realignment of quota shares with changing economic realities; secondly, an almost tripling of the basic votes of each member (combined with a mechanism that will prevent the decline of the ratio of basic votes to total votes), thereby improving the relative influence of the IMF's poorest members; and thirdly, the possibility for Executive Directors representing seven or more members (ie Executive Directors of smaller IMF members) to appoint a second Alternate Executive Director after the next regular elections of Executive Directors in 2012.[216]

The second reform package resulted from the 14th General Review of Quotas and was approved by the Fund's Board of Governors on 15 December 2010.[217] Since it involves an amendment of the Fund's Articles, to become effective, this 2010 reform, too, will have to be ratified by at least three-fifths of the Fund's members representing at least 85 per cent of the total voting power.[218] The key elements of the 2010 reform concern the quotas and voting shares of IMF

[210] For insightful analysis related to the Fund's governance reforms, see also Sean Hagan, 'Reforming the IMF', in Giovanoli and Devos (eds) (n 4) 40.

[211] IMF, 'IMF Board of Governors Adopts . . . ' (n 209).

[212] Amendments to the Fund's Articles enter into force on the day the IMF certifies that three-fifths of members holding at least 85 per cent of the Fund's total voting power have ratified the amendment.

[213] IMF, 'The IMF's 2008 Quota and Voice Reforms Take Effect', Press Release No 11/64 (3 March 2011) <http://www.imf.org/external/np/sec/pr/2011/pr1164.htm> accessed 1 July 2013.

[214] See IMF (n 213). For a more detailed overview of the various reform elements, see IMF, 'IMF Executive Board Recommends Reforms to Overhaul Quota and Voice', Press Release No 08/64 (28 March 2008) <http://www.imf.org/external/np/sec/pr/2008/pr0864.htm> accessed 1 July 2013.

[215] For a detailed overview, by the IMF Finance Department, of the quota and voting shares both of individual IMF members and of different categories of countries before and after the implementation of the 2008 and 2010 reforms, see <http://www.imf.org/external/np/sec/pr/2011/pdfs/quota_tbl.pdf> accessed 1 July 2013. According to IMF Article III:2(d), in order for an increase of a member's quota to become effective, the member concerned must have consented to the increase and must have paid its subscription.

[216] For a regularly updated overview of the composition of the Fund's Executive Board, specifying which IMF members are represented by a joint, elected, Executive Director, see IMF, 'IMF Executive Directors and Voting Power' <http://www.imf.org/external/np/sec/memdir/eds.aspx> accessed 1 July 2013.

[217] See IMF, 'IMF Board of Governors Approves Major Quota and Governance Reforms', Press Release No 10/477 (16 December 2010) <http://www.imf.org/external/np/sec/pr/2010/pr10477.htm> accessed 1 July 2013.

[218] IMF members originally pledged to complete the ratification process by the Annual Meeting of the Fund's Board of Governors in October 2012 (see IMF (n 217)). As of 5 August 2013, the ratification process had not yet been completed. For the precise ratification status, showing which IMF members (showing also their respective voting shares) have completed ratification, see IMF, 'Acceptances of the Proposed Amendment of the Articles of Agreement on Reform of the Executive Board and Consents to 2010 Quota Increase' (last updated 5 August 2013) <http://www.imf.org/external/np/sec/misc/consents.htm> accessed 28 August 2013. G-20 leaders as well as G-20 finance ministers and central bank

members, as well as the size and composition of the Executive Board. Specifically, the 2010 reform will: firstly, double total quotas to about SDR 476.8 billion; secondly, in the light of changing economic realities, shift more than 6 per cent of quota shares from members that are currently over-represented in the Fund to under-represented ones, and shift more than 6 per cent of quota shares to dynamic emerging market and developing countries, while at the same time protecting the quota and voting shares of the Fund's poorest members;[219] thirdly, move to an all-elected Executive Board, thereby abolishing the category of appointed Executive Directors which currently favours the IMF's five largest shareholders; fourthly, provide for a more balanced representation of IMF members on the Executive Board, with advanced European countries having committed to reduce their combined representation by two chairs; fifthly, and finally, maintain the size of the Executive Board at 24 members, with a review of its composition being undertaken every eight years.[220]

Once the reform package resulting from the 14th General Review of Quotas has entered into force and has been fully implemented, it will lead to an unprecedented increase of 100 per cent in total quotas,[221] and, even more importantly, to a major realignment of quota and voting shares in order to better reflect the evolving relative weights of IMF members in the global economy.[222] The example of China is a perfect illustration of this realignment. Before the 2008 and 2010 reforms, China's voting share (2.928) was less than half that of Germany (5.968) and Japan (6.108), the IMF's third and second largest shareholders respectively. Canada held precisely the same voting share as China, putting both countries in a shared eighth place in respect of voting power. Upon the entering into force and full implementation of both the 2008 and 2010 reforms, China will move up to third position, with a voting share (6.071) that will be significantly larger than that of Germany (5.308) and just slightly smaller than that of Japan (6.138). The new voting share of Canada (2.214) will amount to just over a third of that of China.[223] In addition to China, three other emerging economies—Brazil, India, and Russia—will figure among the IMF's new ten largest shareholders.[224]

governors have reiterated commitments to make progress on this front. See Section I.B above, in particular n 67–9.

[219] On the preceding elements (quotas and votes) of the 2010 reform, see IMF, 'IMF Quotas' (Factsheet) (31 March 2013) <http://www.imf.org/external/np/exr/facts/quotas.htm> accessed 1 July 2013.

[220] On the preceding reform elements relating to the future size and composition of the IMF Executive Board, see IMF, 'IMF Executive Board Approves . . . ' (n 209).

[221] In comparison, the 13th, 12th, and 10th General Reviews of Quotas did not lead to any quota increase. The three last General Reviews of Quotas (before the 14th) to result in a quota increase were the 11th Review (Resolution adopted in January 1998: overall quota increase of 45 per cent), the 9th Review (June 1990: 50 per cent), and the 8th Review (March 1983: 47.5 per cent). For an overview of all General Reviews of Quotas, see IMF (n 219).

[222] See IMF (n 219).

[223] These figures are taken from the earlier mentioned table comparing quota and voting shares of all IMF members before and after implementation of the 2008 and 2010 reforms. See n 215 above.

[224] See n 215 above. See also IMF (n 219).

Overall, it is certainly no coincidence that the major overhaul of IMF governance resulting from the 2008 and 2010 reforms, the greatest such overhaul in the Fund's history, was achieved in the wake of the Global Financial Crisis. The crisis taught the international community that the IMF would have to assume a greater role in promoting global financial stability and that, far from becoming an increasingly irrelevant institution, it would have to emerge from the crisis as one of the three main pillars of the reorganized IFA. In light of the fact that the Fund's increasingly important regulatory authority[225] is largely built on the use of a variety of normative tools that are not binding in a formal legal sense,[226] IMF members rightly recognized that, in order for the Fund to successfully fulfil its evolving responsibilities, the institution's declining legitimacy and credibility had to be improved.[227] A major adjustment of the formal influence held by individual IMF members, to reflect the major changes in the relative economic weight of IMF members, may certainly be regarded as being key in that regard. Although further adjustments will be unavoidable under evolving economic circumstances, there is little doubt that the 2008 and 2010 reforms indeed constitute a vital contribution to increasing the legitimacy and credibility of the Fund, which, in turn, is highly likely to increase the institution's effectiveness in fulfilling its evolving tasks.

In this context one could ask, of course, whether it is still timely for the IMF to remain a quota-based institution. Fundamental differences between members regarding their respective absolute influence on the organization's decision-making process are inherent in that structure, even if that influence is perfectly adjusted to the new relative weight of emerging economies and preserves the influence of the poorest members from declining any further. The voting share of the US, which will have slightly decreased (from 17.023 to 16.479), is certainly the main source of concern in this context. Though not at all an exaggeration of the relative economic weight of the US, its new voting share will still leave the US unrivalled in its role as the IMF's most influential member, with a voting share almost triple that of Japan and China. Whereas the IMF's quota-based nature may currently still be acceptable to large parts of the international community, it may well be necessary for the IMF to react to evolving beliefs of what determines the Fund's legitimacy and shift to the widespread 'one member, one vote' pattern in order to continue to achieve a broad acceptance, among its membership, of the institution's decisions and to ensure the effectiveness of its work.

[225] For related analysis, see Hagan (n 185).

[226] On the evolving normative effect of the IMF's toolset, see Chapter 2, Section II, of this monograph.

[227] The earlier-mentioned failure of the Washington Consensus is no doubt the single most important reason for the gradual decline, over the past two decades, of the Fund's legitimacy and its gradual loss of credibility as impartial adviser among large parts of its membership, notably among Latin American countries. See Chapter 2, n 168, of this monograph. An impressive illustration of this declining legitimacy can be found in the fact that both Brazil and Argentina opted for an early repayment of their respective IMF loans in 2005 and 2006, in order to get rid of IMF conditionality. For a recent study of the complex relationship between the IMF and Latin American countries since World War Two, see Claudia Kedar, *The International Monetary Fund and Latin America: The Argentine Puzzle in Context* (Temple University Press, Philadelphia 2013).

Furthermore, the IMF as an institution may become constrained, in order to preserve its legitimacy, to abandon the factual veto power which the US has on all major IMF decisions. There has never been an objective reason for the arbitrary 85 per cent threshold other than the fact that the main shareholder held more than 15 per cent of the total votes. Since amendments to the Fund's Articles cannot be achieved without the consent of the US, this issue may well constitute a future test case of the extent to which the US, as the world's main economy, exercises its sovereign powers in the realm of money in a manner that is consistent with the concept of contemporary monetary sovereignty as analysed in this monograph.

Looked at in isolation, if the US were to renounce its veto right by agreeing to a lowering of the relevant threshold to, let's say, two-thirds of the Fund's voting power, it would undoubtedly have lost a significant amount of absolute influence in the Fund. However, doing so might be widely considered as having increased the IMF's legitimacy, thereby strengthening the institution in its efforts to promote global monetary and financial stability. This would ultimately also benefit the US. Hence, any decision by the US to renounce its factual veto right in the Fund might properly have to be regarded not as the acceptance of a further erosion of US monetary sovereignty, but as an effective and timely exercise of the that sovereignty.[228]

Regarding the 2008 and 2010 reforms, the same can be said in respect of those IMF members that have renounced parts of their vested rights and have accepted seeing their individual influence in the Fund decline in order to increase the organization's overall legitimacy and effectiveness in promoting the greater common good. For example, the commitment by advanced European countries to reduce their combined representation on the IMF Executive Board by two seats, apparently made without any major compensating concessions, is an excellent illustration of such a renouncement of national direct influence for the sake of promoting the constituent values incorporated in, and expressed by, contemporary monetary sovereignty.

Conclusion

Like other economic and financial crises before it, the Global Financial Crisis has triggered a major restructuring of the IFA. This chapter has taken a closer look at the three entities that have emerged as the main pillars of the reorganized IFA: the G-20 as the self-appointed steering board of the world economy, the FSB with its expanded mandate and membership, and the IMF, whose membership seems determined to increase the institution's legitimacy and effectiveness in order for it to assume a stronger role in the promotion of global financial stability. The precise way in which the international community has restructured the IFA in the wake of

[228] For related arguments on whether the increasing regionalization of monetary sovereignty constitutes the surrender or an effective exercise of monetary sovereignty, see Chapter 4, Section III.C, of this monograph.

the Crisis, and the many regulatory initiatives launched in order to strengthen both domestic and global financial stability, all indicate that the promotion of the constituent key values of contemporary monetary sovereignty—financial integrity and stability, accountability, transparency, and subsidiarity—is indeed being perceived by state leaders as an increasingly important benchmark for the appropriate exercise of sovereign powers in the realm of money.

Many of the reform projects embarked on by the international community in the wake of the Global Financial Crisis are clearly enshrined in a long-term perspective, notably, the major overhaul of IMF governance aimed at increasing the organization's credibility, legitimacy and effectiveness. This gives reason to believe that the understanding of contemporary monetary sovereignty as truly cooperative sovereignty, ie as the joint promotion of the concept's constituent values, in other words its understanding not as the abandonment but as an effective exercise of sovereign powers, is gaining increasingly broad, and possibly long lasting, recognition among state leaders.

The above view is further supported by various reforms undertaken by states on the regional level that could not be analysed in this chapter with its narrower focus on the IFA. The reforms undertaken in the EU are the outstanding example of such regional reform efforts: EU members, with their strongly integrated financial markets, have reacted to the Global Financial Crisis with major reforms producing an unparalleled restructuring of the European financial architecture whose two main pillars now are, firstly, a supranational coordination framework of financial supervision as part of the European System of Financial Supervisors (ESFS) (constituted by three new institutions, namely the European Banking Authority (EBA),[229] the European Insurance and Occupational Pensions Authority (EIOPA),[230] and the European Securities and Markets Authority (ESMA),[231] as well as the respective national supervision authorities) in charge of micro-prudential supervision and, secondly, a new European Systemic Risk Board (ESRB)[232] for macroprudential supervision.[233]

Finally, the fact that the precise design of domestic financial regulation and supervision, which also lay beyond the scope of this chapter, continues to vary from one state to another, despite major harmonization efforts over the past decades, does not conflict with the concept of contemporary monetary sovereignty as applied throughout this monograph. A responsible exercise of contemporary monetary sovereignty does not necessarily imply that individual states have to agree to the creation of a World Financial Authority (WFA) charged with the establishment

[229] For detailed information on the EBA's legal framework and its activities, see its website at <http://www.eba.europa.eu>.

[230] See the EIOPA's website at <http://eiopa.europa.eu>.

[231] See the ESMA's website at <http://www.esma.europa.eu>.

[232] See the ESRB's website at <http://www.esrb.europa.eu>.

[233] For a succinct presentation of the reorganization of the European financial architecture, see, eg, Luis Garicano and Rosa M Lastra, 'Towards a New Architecture for Financial Stability: Seven Principles' in Cottier, Jackson and Lastra (eds) (n 3) 72, 77–80.

of binding legal rules on all aspects of financial regulation and supervision.[234] To the extent that a stability-enhancing harmonization of domestic regulatory and supervisory regimes can be achieved via soft-law standards and informal policy coordination, the existing multilayered approach may be by far superior to the introduction of far-reaching binding legal rules, under normative aspects such as accountability, subsidiarity and, ultimately, legitimacy.

[234] This being said, this author fully agrees with Lastra's suggestion that when it comes to the future of financial crisis management and global financial supervision, the IMF would be uniquely qualified and thus perfectly placed to assume the role of a WFA should the international community decide to further strengthen international cooperation in these fields by the means of binding law combined with an effective sanctions mechanism. See Lastra (n 182) and Rosa M Lastra, 'The Quest for International Financial Regulation', Inaugural Lecture (23 March 2011) <http://www.law.qmul.ac.uk/docs/podcasts/50504.pdf> accessed 1 July 2013. Obviously, despite falling short of the creation of a new international organization, such a reform would require a fundamental revision of the Fund's Articles and would have to go well beyond the current tinkering at the margins of the Fund's existing mandate analysed in the final section of this chapter.

Concluding Remarks

The starting point and recurrent theme of this monograph has been to analyse whether the concept of monetary sovereignty is subject to evolution under the impact of ever-increasing financial integration and economic globalization, and to provide a framework for assessing what this implies. In so doing, this monograph has aimed to contribute to a better understanding of both the contemporary exercise of sovereign powers in the realm of money (as understood in a wider sense) and of the driving forces behind the evolution of international law in this crucial field, located as it is at the crossroads of economics, law, and politics, as well as of the three traditional pillars of international economic law, ie international trade, foreign investment, and monetary law. Many of the findings obtained throughout this monograph are not narrowly limited to the exercise of sovereign powers in monetary and financial matters but are more broadly applicable to the concept of sovereignty in general and inform our understanding of what it means for a state to be sovereign under contemporary economic constraints and evolving economic circumstances.

Chapter 1 of this monograph has explained why the contemporary concept of monetary sovereignty proposed by this monograph is not static but dynamic in nature and is therefore able to adapt to a changing economic environment. Due to the inherently dual nature of sovereignty as a concept having not only positive but also constantly evolving normative components, monetary sovereignty cannot, by its very nature, become eroded under the impact of legal and economic constraints. These constraints play a crucial role, though, in defining which steps need to be taken in order to promote global monetary and financial stability, financial integrity, accountability, and the other core values incorporated in the contemporary concept of monetary sovereignty as analysed throughout this monograph.

Chapter 2 has examined the ongoing hybridization process of international monetary law that results from constant changes in the formal and material sources of this increasingly complex body of law, from the unsuitability of the rigid categories of 'hard' and 'soft' law for appropriately characterizing all recent normative evolutions in this field, and from the rise in importance of private and transnational monetary law as intrinsic elements of contemporary international monetary law. As elaborated in this chapter, in order to fully understand, and be in a position to assess, contemporary developments in monetary and financial matters, one has to resist the temptation of oversimplifying the relevant issues by trying to squeeze them into existing legal categories and avoid an overly narrow focus on the purely legal aspects of a problem without taking into account the ultimately dominating role of economic constraints to which policymakers are subject. As explained, this also turns the promotion of the sovereign values incorporated in, and expressed by, the contemporary concept of monetary sovereignty as analysed in this monograph, into an increasingly complex undertaking.

Chapter 3 has analysed the extent to which the maintenance of an undervalued real exchange rate as part of a strategy of export-led growth can be dealt with effectively under existing international monetary and trade law. Intrinsically related, this chapter has examined the key aspects on which the IMF's code of conduct would require reform in order to successfully tackle contemporary challenges to the stability of the international monetary system, such as global current account imbalances. As argued in this chapter, the stakes of reforming the code of conduct in IMF Article IV:1 are high. The paralysis of the law that continues to arise from IMF Article IV:1(iii), despite the 2007 and 2012 overhaul of the Fund's surveillance mechanism, gives reason to believe that the IMF's relevance and credibility as the guardian of the stability of the international monetary and financial system may otherwise become eroded. This chapter concluded, inter alia, that, in order to secure durable systemic stability, agreeing on binding and enforceable rules on current account imbalances, requiring equal efforts from surplus and deficit countries, might ultimately become unavoidable.

Chapter 4 has looked into various aspects of the increasing regionalization of monetary sovereignty, ie the ongoing phenomenon that many states worldwide are seeking stronger economic integration and have embarked on paths towards creating economic and monetary unions—the Global Financial Crisis and sovereign debt crisis in the eurozone notwithstanding. Vast transfers of state competences to the organs of a monetary union imply, by definition, that the participating states renounce, at least temporarily, the independent exercise of these competences. However, as elaborated in this chapter, to the extent that agreeing to such transfers is what provides a state's population with a maximum of monetary and financial stability under contemporary economic constraints, it appears appropriate to analyse the underlying transfers of sovereign powers not as a surrender of monetary sovereignty, but as an effective exercise of the latter under the special form of cooperative sovereignty. The various reforms recently undertaken by the members of the eurozone in order to strengthen the fiscal and macroeconomic governance of the EMU legal framework illustrate that, in order to ensure the long-term sustainability of their monetary union, the participating states have no alternative to accepting limitations on the exercise of their domestic economic and fiscal policies. This, however, does not contradict but rather confirms the overall conclusion that the worldwide trend, since the onset of globalization in the 1960s, towards the creation of monetary and economic unions is still best explained as an attempt by the participating states to regain, jointly, a margin of manoeuvre that they were about to lose, or had already lost, individually under the impact of economic globalization and financial integration.

Chapter 5 has assessed the precise way in which the international community has restructured the international financial architecture in the wake of the Global Financial Crisis. The many regulatory initiatives launched in order to strengthen both domestic and global financial stability all indicate that the promotion of the constituent key values of the contemporary concept of monetary sovereignty as analysed in this monograph—monetary and financial stability, financial integrity, accountability, transparency, and subsidiarity—is indeed being perceived by state leaders as an increasingly important benchmark for the appropriate exercise of sovereign powers in monetary and financial matters.

Overall, there is little doubt that most, if not all, daily questions relating to specific rights and obligations of states, international organizations, and private persons in monetary and financial matters can be asked and resolved effectively without having recourse to the concept of monetary sovereignty.[1] The conceptual revision of monetary sovereignty and the analysis of the contemporary exercise of related sovereign powers undertaken in this monograph certainly do not contradict this realistic observation. Many of the substantial insights achieved through this monograph could indeed have been obtained without making the slightest reference to the concept of monetary sovereignty. Yet, as this monograph has attempted to show, to the extent that we are interested not only in knowing what the law is today, but also in gaining a better understanding of the driving and shaping forces behind the evolution of international law in the realm of money (as understood in a wider sense) as an increasingly hybrid body of law, the concept of monetary sovereignty is more than a mere framework for debate. In addition, the concept of monetary sovereignty is still relevant as a legal concept for evaluating the contemporary exercise of sovereign powers in monetary and financial matters.

In light of the fact that many of the reform projects launched by the international community to promote global and regional monetary and financial stability, to foster the integrity of financial markets, and to strengthen the accountability, legitimacy, and effectiveness of the competent institutions, are still underway, it is still too early to make a final judgment on whether the Global Financial Crisis has triggered a pivotal paradigm change with respect to how states exercise the sovereign powers which have been subject to scrutiny throughout this monograph.

As the recovery of the world economy gains pace, the economic constraints pushing state leaders to exercise the sovereign powers in the realm of money as truly cooperative sovereignty may be felt less violently by those in power. Hence, it seems plausible to expect that the return of good economic times will again raise the temptation for state leaders to be guided in their actions by the arguably outdated understanding of sovereignty as being merely the sum of exclusive state competences and the absence of interference from outside. The fact that the international community has so far struggled, as illustrated by the related statements by the G-20, to provide satisfactory solutions to the interrelated issues of exchange rate misalignment, current account imbalances, and foreign exchange accumulation, analysed in detail as part of Chapter 3 of this monograph, support this rather sceptical view. At least for the moment, the unpleasant truth may be not only that formal and enforceable international law has reached its limits with regard to the treatment of these crucial issues, but also that the willingness of states to effectively cooperate, both formally and informally, on these and other, politically

[1] For Vaughan Lowe's critical observation to this effect as regards the concept of sovereignty in general, see the conclusion to Chapter 1 of this monograph.

sensitive, issues, as part of what this monograph has termed the cooperative exercise of monetary sovereignty, is rather limited.

It still remains true, however, that many of the numerous reform projects embarked on by the international community in the wake of the Global Financial Crisis are clearly enshrined in a long-term perspective. The major overhaul of the IMF's governance structure may be regarded as an outstanding example in this context. As analysed in Chapter 5, this set of reforms, the biggest governance reform ever in the Fund's history, serves to reflect the changing economic weights of IMF members, thereby increasing the credibility, legitimacy, and effectiveness of the Fund as the guardian of the international monetary and financial system. This, and the worldwide trend towards what this monograph has termed the increasing regionalization of monetary sovereignty, give reason to adopt a somewhat optimistic stance. It seems indeed that the understanding of contemporary monetary sovereignty as truly cooperative sovereignty, with its contemporary exercise amounting more and more to a joint promotion of the concept's constituent values, is gaining increasingly broad, and possibly long lasting, recognition among state leaders.

It emerges from this monograph that the voluntary acceptance of significant legal constraints on formerly exclusive state competences, as part of international cooperation in monetary and financial matters, does not ring the death knell for a state's monetary sovereignty. Rather, in the light of economic constraints arising from globalization and financial integration, renouncing the unfettered exercise of certain sovereign powers should be regarded as an effective contemporary means for states to reassert their monetary sovereignty under the special form of cooperative sovereignty. They thereby regain jointly a margin of manoeuvre with respect to sovereign powers in the realm of money and finance whose isolated exercise had previously become more and more ineffective and illusory under the impact of economic globalization and financial integration.

On the regional level, and provided the economic conditions for creating and sustaining a viable monetary union are continuously met, a similar conclusion can be drawn regarding the outright transfer of far-reaching sovereign powers to an economic and monetary union. In light of the ongoing trials and tribulations of the eurozone it seems important to recall at this stage that, independent of what the underlying treaty framework may say, the sovereign choice to participate in a monetary union, is not under all circumstances irrevocable. The overarching goal of promoting the constituent values of contemporary monetary sovereignty continues to provide crucial guidance to the states participating in a monetary union. On balance, and depending on the precise economic circumstances, this may well lead one day to the conclusion that one or several states leave a given monetary union. Such a step would seem appropriate if continued membership in a weakened monetary union were to significantly endanger, on balance, the achievement of domestic and regional monetary and financial stability or of any other of the constituent values of contemporary monetary sovereignty. Let us hope that future case studies of this crucial issue will not emerge soon in the context of the EMU, which, despite its various trials and tribulations addressed in this monograph, continues to be the outstanding illustration of a rather successful exercise of monetary sovereignty as truly cooperative sovereignty.

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