CLIFFORD CHANCE

Briefing note

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The Eurozone crisis and exchange controls

Contingency planning around the Eurozone crisis inevitably turns to the possibility of exchange controls, whether in the context of a default by a Eurozone member state or a departure from the Eurozone. What are exchange controls and how will they affect a party's ability to enforce its contractual rights? In this briefing, we consider the legal framework surrounding exchange controls, what agreements they could affect, and how.

The answers to any questions about exchange controls depend upon a combination of international treaties and national law, though the interpretation of the treaties by national courts is not always consistent. When dealing with national law, this briefing focuses mainly on English law because it is commonly used as the governing law for international financial transactions, though other laws may also be relevant.

Question 1: What are exchange controls?

Exchange controls can take many forms, but their immediate aim is to restrict the buying and selling of a national currency or to preserve foreign currency reserves. Controls might include a ban on the conversion of the proceeds of certain assets or by certain categories of person, an obligation to surrender foreign exchange proceeds to the central or local bank, authorisation requirements, minimum stay requirements, quantitative limits, or indirect methods, such as tax charges on capital flows. Exchange controls are most commonly imposed because of concerns about outward flows, but controls can also be imposed to restrict inward flows if, for example, an influx of funds risks damaging an economy.

Exchange controls were a common feature of the global economic system in the period after 1945, but fell out of favour in the 1970s with the collapse of the Bretton Woods system (see Box 1). In recent years, however, they have been used more - whether to limit speculative inflows or, in the case of countries such as Iceland, to prevent potentially massive outflows.

According to a recent report, some two-thirds of the world's population is subject to some sort of exchange controls. Indeed, the International Monetary Fund (IMF) said that the controls introduced by Iceland in 2008 (see Box 2) were "an essential feature of the monetary policy framework, given the scale of the potential outflows." Iceland's Prime Minister described them as one of the tools that ensured that "the lion's share of the [Icelandic] banking collapse was borne by foreign creditors."

Key issues

- Countries are free to impose restrictions on capital movements, but can only restrict payments for current transactions with the consent of the IMF.
- If the IMF consents to controls on current transactions, contracts that breach those controls could be unenforceable through the courts, but are probably not void. Self-help remedies may still be available.
- EU law prohibits exchange controls in all but extreme circumstances, though Eurozone exit could offer a justification.

Question 2: Is there an international legal framework for exchange controls?

Yes, primarily in the IMF's Articles of Agreement. Most states, including all those in the Eurozone, are members of the IMF and are thus bound by the

IMF's Articles of Agreement. These divide exchange controls into two categories: controls on capital movements; and controls on payments for current transactions.

As to the first category, article VI(3) of the IMF's Articles of Agreement allows members to "exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions..." As a result, IMF members can, without obtaining the consent of the IMF, impose capital controls as long as those controls do not affect "current transactions".

On the second category, article VIII(2)(a) provides that "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions." IMF members can, therefore, impose restrictions on current transactions, but they must obtain the consent of the IMF to do so. The IMF does not automatically grant approval, but obtaining approval may not be difficult for a country faced with a severe crisis. For example, in 2008 Iceland sought, and secured, the IMF's consent to restrictions on certain current transactions on the basis that the restrictions were to be temporary and were "imposed for balance of payments reasons and are non-discriminatory" (though the controls did arguably discriminate against foreign bond holders). In the same year, however, the IMF refused the Ukraine permission to impose controls.

This begs the question as to the difference between capital controls and restrictions on current transactions. The IMF's Articles of Agreement define current transactions in somewhat circular fashion as "payments which are not for the purpose of transferring capital" (article XXX(d)), but the definition goes on more helpfully to provide that current transactions include payments in connection with foreign trade, payments in connection with short term banking and credit facilities, interest on loans and payments on other investments, and payments of a moderate amount for amortization of loans and for depreciation of direct investments. The distinction between capital and current transactions is distinctly blurred.

In addition to the IMF's Articles, a state may have entered into a bilateral investment treaty (BIT) with another state with a view to encouraging mutual direct investment by nationals of the two states (eg there is a BIT between Greece and Germany). Some BITs contain provisions relating to exchange controls. A BIT may give individual investors retrospective rights, usually enforceable through arbitration, against a state that introduces exchange controls in breach of the BIT, but BITs seldom provide direct rights against a private sector counterparty or enable controls to be ignored.

The General Agreement on Trade in Services (GATS), a World Trade Organisation treaty, also contains provisions about exchange control. Article XI(1) provides that members must not "apply restrictions on international transfers and payments for current transactions relating to its specific commitments." Article XI(2) goes on to allow members to introduce exchange controls in accordance with the IMF's Articles and with Article XII of GATS. Article XII of GATS permits capital controls if

Box 1

The Bretton Woods system

The Bretton Woods Agreement was negotiated by the Allied powers over the first three weeks of July 1944 at the Mount Washington Hotel, Bretton Woods, New Hampshire.

The participants were acutely aware of the uncoordinated and frequently contradictory "beggar thy neighbour" policies pursued during the depression of the 1930s, and wanted commitments to convertibility of currencies and to free trade. John Maynard Keynes proposed a new international currency, the "bancor", but, reflecting US economic dominance, what emerged was a system of fixed exchange rates based on the US dollar, with only the dollar being required to be convertible into gold.

The commitment to free trade led to the prohibition on exchange controls for current transactions, but states' ability to restrict capital flows gave them some control over their domestic economies and currencies.

Revaluations and devaluations took place within the system, which continued until 1971. Imbalances and a declining US gold coverage risked a run on Fort Knox, and on 15 August 1971 President Nixon unilaterally suspended the convertibility of the dollar into gold. By the mid-1970s, all major currencies had been floated against the dollar.

Fixed exchange rates might have gone (though the Euro arguably reintroduced them for some in a different guise), but the institutions and aspirations of the Bretton Woods Agreement remain. The IMF is still there, and the IBRD is part of the World Bank. Free convertibility of currencies for trade purposes also remains key.

a member is faced with serious balance of payments or external financial difficulties. It may not be difficult for a troubled Eurozone member to justify controls on those bases.

Question 3: Would exchange controls be consistent with the EU's treaties?

Perhaps. Iceland had only to grapple with the EEA's treaties, which are less restrictive than the EU's constitutive instruments. Article 63 of the Treaty on the Functioning of the European Union (TFEU) prohibits "all restrictions" on the movement of capital and on payments between Member States and between Member States and third countries.

EU member states outside the Eurozone are permitted to take "necessary protective measures" when faced by "a sudden crisis in the balance of payments" if the EU itself fails to act sufficiently quickly (article 144(1)), though the European Council can amend or suspend those measures (article 144(3)). Article 143 offers the EU a menu of measures, ending with the Commission authorising the relevant member state "to take protective measures, the conditions and details of which the Commission shall determine."

The only licence given to Eurozone members is in article 65(1)(b) of the TFEU, which provides that article 63 is without prejudice to the right of EU member states to "take measures which are justified on grounds of public policy or public security." This sets a high hurdle, but it is not difficult to envisage a Eurozone member contending that exchange controls were justified on those grounds if, say, it had defaulted on payments to bondholders.

Article 65(3) goes on to provide that measures under article 65(1) "shall not constitute... a disguised restriction on the free movement of capital and payments as defined in Article 63." The meaning of this is not entirely clear - at one extreme, it could prevent any measures that in fact restricted the free movement of capital - but it could merely indicate that controls must genuinely be for reasons of public policy or security, and not, for example, represent a disguised method of protecting domestic industries. Any measures must also be proportionate to the problems faced.

The EU itself can take "safeguard measures with regard to third countries" that are "strictly necessary" if, in exceptional circumstances, movements of capital to and from third countries cause serious difficulties for the operation of economic and monetary union (article 66 of the TFEU). These measures cannot last longer than six months, and are probably limited to capital flows rather than payments on current transactions (though the definition of capital transactions in EU law is wider than for the purposes of the IMF's Articles of Agreement).

Article 66 therefore offers the EU scope to impose extensive restrictions, provided that the EU acts consistently with the IMF's Articles. The width of the power granted is not clear (eg can the EU restrict capital movements within the EU or only between Member States and non-Member States? can measures be re-imposed every six months?) but the EU may be able to squeeze some measures within article 66.

If a state imposing exchange controls were also to leave the EU unilaterally, that state might not be concerned about legality under the EU's treaties. However, courts within states remaining in the EU might be obliged by EU law to regard internal laws passed in breach of the EU's treaties as invalid. If so, those laws might be disregarded for the purposes discussed below. The EU and any state leaving the Eurozone would, nevertheless, have a strong incentive to resolve any issues between them in order to make the process as orderly as possible, which could involve treaty amendments after the event.

Question 4: How do the provisions about exchange controls in international law affect private rights under national laws?

It depends, but potentially severely. The basic rule under article 12 of the EU's Rome I Regulation on the choice of law for contracts is that the law governing a contract determines how the contract must be performed. If the governing law requires payment in euros, then payment must in general be made in euros, notwithstanding any exchange controls imposed by the home state of one of the parties. This is subject to practical and legal issues (eg the jurisdiction in which any dispute is determined, the definition of the currency of payment in the contract and the place of payment - see our earlier briefings relating to the Eurozone crisis for further details), but the general rule remains that foreign legislators cannot change the terms of an English law contract.

"Exchange contracts" are a significant exception to this general rule. This is because article VIII(2)(b) of the IMF's Articles of Agreement provides that "[e]xchange contracts which involve the currency of any member state and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member." IMF members are obliged to take steps to carry out their obligations under the IMF's Articles of Agreement. The UK, as well as the other EU member states and the US, has fulfilled this obligation by, amongst other measures, passing article VIII(2)(b) into domestic law. English and other courts are, therefore, obliged to apply article VIII(2)(b).

Box 2

Iceland's exchange controls

Iceland imposed exchange controls in 2008 with the consent of the IMF. These controls include:

- An obligation on domestic parties to repatriate holdings of foreign currencies they acquire.
- Limitations on the ability to withdraw funds from foreign currency accounts and on the export of cash.
- Prohibition on cross-border movements of domestic and foreign denominated capital.
- Prohibition on foreign exchange transactions between residents and non-residents if the krona is involved.
- Prohibition on borrowing and lending between residents and non-residents.
- Prohibition on guarantees for payments between domestic and foreign parties.
- Prohibition on derivatives involving the krona and a foreign currency.
- Prohibition on investing in securities denominated in a foreign currency (though reinvestment is permitted).

The prohibitions and limits are subject to various exemptions, eg transactions for the purposes of the sale of goods or services, or foreign travel.

Article VIII(2)(b) raises many legal uncertainties, including those discussed below, but, if a contract is an exchange contract and it is in breach of exchange control regulations imposed by any IMF member consistently with the IMF's Articles of Agreement, that contract will be unenforceable in the courts of any IMF member state whatever the governing law of the contract. It may perhaps be arguable that certain foreign exchange controls could be ignored on the ground that they offended public policy (eg because they are discriminatory) or they breach EU law but, absent that, an exchange contract in breach of exchange controls is unenforceable.

Question 5: What is an "exchange contract"?

Difficult to say. There are two main schools of thought. First, some countries (eg France, Germany and Luxembourg) take a wide approach, considering an exchange contract to be any contract that affects the exchange resources of the state in question. This may extend to any contract that requires a party to discharge its obligations in a foreign currency. Secondly, other countries (eg the US, the UK and Belgium) take a narrower view, confining exchange contracts to contracts for the exchange, in substance or in form, of one currency for another. The narrow view is therefore restricted to what would conventionally be called foreign exchange contracts, whether spot or forward, but it is likely that non-deliverable currency derivatives would also be caught.

As a result, if litigation were to take place in a jurisdiction that takes the wide view, there is a greater chance of a contract being rendered unenforceable by exchange controls than if litigation were to take place in courts that take the narrow view. Under both schools of thought, a foreign exchange contract will be unenforceable if it is contrary to exchange control regulations, but under the wide view a foreign currency bond or loan agreement may also be unenforceable.

Despite article VIII(2)(b) of the IMF's Articles of Agreement applying regardless of the governing law of the agreement, the governing law of an exchange contract could still arguably be relevant. If the governing law is that of a country that takes the wide view of what constitutes an exchange contract, it has been argued that all courts must give effect to the wide view because it forms part of the governing law of the contract. That is, however, unlikely. It is more plausible that article VIII(2)(b) takes effect as a conflict of laws rule or as public policy rather than as part of a country's contract law.

Question 6: Does article VIII(2)(b) apply to capital as well as to current transactions?

Probably not. Article VIII(2) as a whole is headed "Avoidance of restrictions on current payments", which suggests that article VIII(2)(b) is limited to current transactions. This is the conclusion reached by the German courts because of the wording of article VIII(2) and because the IMF's Articles of Agreement leave sovereignty over capital controls with member states. This does produce a curious result economically: controls on capital movements, which IMF members are free to impose, would not generally be enforceable outside the state that imposed those controls; but controls on current transactions would be rendered unenforceable by article VIII(2)(b) provided that the IMF approved their imposition. That does, however, appear to be what the IMF's Articles of Agreement say, though there are suggestions that, on the narrow view, exchange contracts might form a distinct category outside either capital or current transactions.

Question 7: Is article VIII(2)(b) retrospective in its effect?

Maybe. At the time exchange controls are introduced, it is inevitable that there will be numerous contracts, some very long term, that have been entered into but not yet fully performed. Though far from clear, it seems likely that article VIII(2)(b) will affect these contracts, rather than only contracts entered into after the exchange controls were introduced. Iceland's exchange controls were retrospective in effect, and it would reduce significantly the effectiveness of exchange controls if they had no effect on agreements extant at the time of the controls' imposition. If, however, article VIII(2)(b) is not retrospective in effect, much of threat arising from article VIII(2)(b) would be removed.

Question 8: Is self-help available?

Probably. The general (but not universal) view, at least under English law, is that article VIII(2)(b) renders an agreement unenforceable but not illegal or void: the agreement exists, but the courts will not enforce it. That probably allows the parties to exercise self-help remedies.

Some contracts may include provisions that address exchange controls (see, in particular, our briefing entitled *The Eurozone Crisis and Derivatives*). Even where the contract is silent on the point, if, for example, one party holds security, that party may be able to enforce against its security provided that doing so does not require court assistance (and, in practice, the security is outside the country that has imposed the exchange controls). Similarly, if one party has a right of set-off, it can exercise that right notwithstanding the inability to enforce one or more of the payment obligations through the courts. It is unlikely that there would be any restitutionary remedy to recover money or other assets taken by self-help remedies.

Another consequence of article VIII(2)(b) rendering an agreement unenforceable but not void is that courts may be able to assist parties once the exchange controls are lifted. At that point, the bar on court involvement will have been removed.

Question 9: What can I do to improve my position?

Probably not a lot, though appropriate structuring of transactions may reduce the impact of exchange controls. If an EU member state defaults on its debts or abandons the euro, it may well impose exchange controls, though what form those controls would take and whether they will comply with EU law or be approved by the IMF can only be a matter of speculation.

If it does impose controls, those with security or other self-help remedies exercisable outside the country in question may be able to protect their interests (though this will depend upon the local law). If not, the position could be affected by the location of any litigation. Foreign denominated obligations may turn out to be unenforceable if proceedings must be brought in the courts of the state in question, but those same difficulties may also extend to courts that take the wide view of an "exchange contract". However, even if a judgment can be secured, the judgment is only of value if it can be enforced against assets owned by the debtor. Finding assets outside the debtor's home state may prove difficult.

Conclusion

At a conference in late 2011, the Confederation of Icelandic Employers complained that Iceland's exchange controls had proved an expensive mistake, and that Iceland still had no viable strategy for lifting them. Many others, including the IMF, disagreed, even though offshore krona holdings worth about 30% of Iceland's GDP have been held captive by Iceland's controls. Exchange controls are now very much back in the contemplation of those states facing economic crises. If the international community uses its sovereign and legislative power to impose exchange controls, there may not ultimately be much that private parties can do to combat them.

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