CLIFFORD CHANCE

Briefing note

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The euro area and capital controls

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

The answers to any questions about capital 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 capital controls?

Capital controls can take many forms, but their immediate aim is to restrict the buying and selling of a national currency or to preserve currency within a country. 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, restrictions on payments outside the country and/or restrictions on bank withdrawals; they may also include indirect methods, such as tax charges on capital flows.

Capital 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.

Capital 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 and Cyprus, to prevent potentially massive outflows.

According to a recent report, some two-thirds of the world's population is subject to some sort of capital controls. Indeed, the International Monetary Fund (IMF) said that the controls introduced by Iceland in 2008 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 any controls in all but extreme circumstances, though protecting banks or exit from the euro area could offer a justification.

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

Yes, primarily in the IMF's Articles of Agreement. Most states, including all those in the euro area, are members of the IMF and are thus bound by the IMF's Articles of Agreement. These divide capital 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 if certain safeguards are met. 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 2013, Cyprus obtained the IMF's consent to capital controls (see Box 2). Cyprus's controls were finally lifted in April 2015, but Iceland's remain in place.

This begs the question as to the difference between controls on capital and restrictions on current transactions. The IMF's Articles of Agreement define current transactions in a 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. However, 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 (e.g. there is a BIT between Greece and Germany). Some BITs contain provisions relating to capital controls. A BIT may give individual investors retrospective rights, usually enforceable through arbitration, against a state that introduces 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 capital controls. Article XI(1)

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 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.

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 capital controls in accordance with the IMF's Articles and with Article XII of GATS. Article XII of GATS permits capital controls if a member is faced with serious balance of payments or external financial difficulties. It may not be difficult for a troubled euro area member to justify controls on those bases.

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

Perhaps. 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 euro area 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 euro area 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 what Cyprus relied on, with the acquiescence of the European Commission, for the introduction of its capital controls in 2013.

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 restrict 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 capital 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 euro area 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 capital 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 capital controls imposed by the home state of one of the parties. This is subject to practical and legal issues (e.g. 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 briefings relating to the Greek debt crisis for further details), but the general rule remains that foreign legislators cannot change the terms of an English law contract.

Box 2

Cyprus's capital controls

Cyprus imposed capital controls in 2013 with the consent of the IMF. These controls initially included:

- Cash withdrawals were limited to €300 per person per day.
- Cashing of cheques was prohibited, but cheques could be paid into bank accounts.
- Payments of up to €5000 per day falling within the normal course of business and with supporting documentation were permitted.
- Payments over €5000 required approval.
- Payment of salaries for employees was permitted upon presentation of supporting documentation.
- Payments or transfers outside Cyprus, whether via debit, credit and/or prepaid cards, could not exceed €5000 per person per month per bank.
- Cashless payments or transfers of deposits to accounts held abroad were prohibited.
- Fixed term deposits could not be broken other than to repay a loan to the same bank.
- When fixed term deposits matured, 10% could be transferred to a current account, the maturity on the balance being extended for one month.
- Payments not completed before the controls came into force were subject to the controls.

"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).

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 capital 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 capital controls could be ignored on the ground that they offended public policy (eg because they are discriminatory) or that they breach EU law but, absent anything of that sort, an exchange contract in breach of capital controls is unenforceable.

Question 5: What is an "exchange contract"?

Difficult to say. There are two main schools of thought. First, some countries (e.g. France 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, even its own currency.

Secondly, other countries (e.g. the UK, the US 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 capital 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 capital control regulations, but under the wide view a foreign currency bond or loan agreement may, for example, 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 generally not be enforceable outside the state that imposed those controls; but controls on current transactions in respect of exchange contracts 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.

This issue is of less relevance in those countries that take a narrow view of what constitutes an exchange contract. On the narrow view, exchange contracts form a distinct category outside either capital or current transactions.

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

Probably. At the time capital 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 capital controls were introduced. Iceland's and Cyprus's capital controls were retrospective in effect, and it would reduce significantly the effectiveness of controls if they had no impact 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 (including, in particular, derivatives) may include provisions that address capital controls. 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 capital 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 capital 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 capital controls. If an EU member state defaults on its debts, abandons the euro or needs to protect its banks, it may well impose capital 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 controls are imposed, 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 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 capital 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. Iceland's controls remain in place; Cyprus's only lasted two years, their severity diminishing over time.

Capital controls are now very much back in the contemplation of states facing economic crises. If the international community uses its sovereign and legislative power to impose capital controls, there may not ultimately be much that private parties can do to combat them.

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