

2003

Chile's Free Trade Agreements: Can Their Benefits Survive Chile's Continuing Controls on Foreign Capital?

Evgenia V. Sorokina

Follow this and additional works at: <http://digitalcommons.wcl.american.edu/auilr>



Part of the [International Law Commons](#)

Recommended Citation

Sorokina, Evgenia V. "Chile's Free Trade Agreements: Can Their Benefits Survive Chile's Continuing Controls on Foreign Capital." American University International Law Review 18, no. 5 (2003): 1217-1232.

This Article is brought to you for free and open access by the Washington College of Law Journals & Law Reviews at Digital Commons @ American University Washington College of Law. It has been accepted for inclusion in American University International Law Review by an authorized administrator of Digital Commons @ American University Washington College of Law. For more information, please contact fbrown@wcl.american.edu.

CHILE'S FREE TRADE AGREEMENTS: CAN THEIR BENEFITS SURVIVE CHILE'S CONTINUING CONTROLS ON FOREIGN CAPITAL?

EVGENIA V. SOROKINA*

INTRODUCTION	1217
I. ECONOMIC AND LEGAL BACKGROUND OF FOREIGN INVESTMENT IN CHILE AND LEGAL RESTRICTIONS ON TRANSFER OF CAPITAL	1219
II. ANALYSIS	1224
III. RECOMMENDATIONS	1229
CONCLUSION	1231

INTRODUCTION

In December 2002, Chile and the United States, after more than a decade of negotiation, reached an agreement on the terms of a Free Trade Agreement (“FTA”).¹ The Chile-U.S. FTA is expected to become operational at the end of 2003 or the beginning of 2004.²

* LLM candidate, 2003, American University, Washington College of Law; JD equivalent, Moscow State Law Academy, Russia, 1999. I would like to thank my fellow-students Marcelo Cerna, Eduardo Correa, Marco Opazo, Cristobal Reyes, my friends Pedro Taborga, Jimmy Castillo, and my husband Michael for providing comments and assistance with this paper.

1. See *A Really Big Free Trade Zone*, BUS. WK., Dec. 23, 2002, at 40 (announcing the conclusion of a United States free-trade deal with Chile as part of a broader strategy of the current U.S. administration to build a thirty-four-nation Free Trade Area of the Americas); *Chile y EE.UU Concluyeron con Exito Negociaciones Para TLC [Chile and the United States Successfully Concluded FTA Negotiations]*, ESTRATEGIA, Dec. 12, 2002 (reporting the successful conclusion of Chile-U.S. free trade negotiations and outlining major terms of the agreement), available at <http://www.estrategia.cl/histo/200212/12/economi/ducos.htm> (last

Chile has adopted an international economic policy of trade liberalization to compensate its economy for certain natural disadvantages, such as its small internal market and the country's geographical distance from its largest trade partners.³ Chile has entered into a number of FTAs with other regions and countries, including Mexico, Canada, Central American countries, the European Union, and South Korea.⁴ The Chilean government hopes that recent agreements with the European Union and agreements to be signed with the United States and South Korea will reverse Chile's economic slowdown by increasing the country's export revenues, expanding the infrastructure of export industries, boosting foreign direct investment by up to \$1.3 billion a year, and adding at least one percentage point to the growth of the gross domestic product ("GDP").⁵ The feasibility of these expectations depends on the Chilean government's willingness to adopt further market-

visited Jan. 17, 2003); Clinton Porteous Santiago, *Chile in Free-Trade Deal With U.S.*, AUSTRALIAN FIN. REV., Dec. 13, 2002, at 24 (explaining the importance and mutual benefit for the region of the Free Trade Agreement between Chile and the United States, and discussing some of its terms).

2. See *Acuerdos Comerciales, lo Más Relevante de 2002* [*Trade Agreements: the Most Important of 2002*], ESTRATEGIA, Dec. 23, 2002 (describing free-trade agreements that Chile negotiated or signed in 2002), available at <http://www.estrategia.cl/histo/200212/23/economi/tlceu.htm> (last visited Jan. 17, 2003); *Tratado de Libre Comercio Chile-Estados Unidos ¿De qué se trata?* [*Chile-United States Free Trade Agreement: What is it About?*], GOBIERNO DE CHILE (Jan. 16, 2002) (explaining the importance for Chile of a free-trade agreement with the United States, listing major terms of its draft, and evaluating its impact on Chile's economy), available at http://www.direcon.cl/frame/acuerdos_internacionales/documentos/Doc.%20Ch2.pdf (last visited Mar. 30, 2003).

3. See *Going it Alone – Chile's Trade Agreements*, ECONOMIST, Jan. 4, 2003, at 41 (describing Chile's policy on trade liberalization and its expectations from free trade agreements with the United States, the European Union, and South Korea).

4. See Department of International Economic Relations of Chile's Ministry of Foreign Affairs, *Acuerdos Económicos Internacionales* [*International Economic Treaties*] (listing Chile's bilateral and multilateral international economic treaties and providing their texts or summaries), at http://www.direcon.cl/frame/acuerdos_internacionales/f_regionales.html (last visited Jan. 29, 2003).

5. See *Going it Alone – Chile's Trade Agreements*, *supra* note 3 (commenting on the economic growth Chile expects to experience from free trade agreements with the United States, European Union, and South Korea).

oriented reforms aimed at modernizing Chile's business regulations.⁶ This comment focuses on a single area of Chile's business law that affects foreign direct and portfolio investment in the country: capital, or currency, control measures that restrict withdrawal by foreign investors of their capital funds from Chile.

I. ECONOMIC AND LEGAL BACKGROUND OF FOREIGN INVESTMENT IN CHILE AND LEGAL RESTRICTIONS ON TRANSFER OF CAPITAL

Long before the terms of the Chile-U.S. FTA were agreed to, and despite its small market size, many observers regarded Chile as the most attractive emerging market in South America for foreign investment – combining the benefits of economic stability, political transparency, and relative ease of doing business.⁷

6. See Sebastian Edwards, *Americas: How Chile Can Make the Most of its U.S. Trade Deal*, WALL STREET J., Jan. 3, 2003, at A11 (suggesting that Chile's high expectations of benefits from the Chile-U.S. Free Trade Agreement may not be realistic without a serious effort at reforming economic legislation).

7. See Joseph Contreras, *Open For Business; While the Rest of South America Suffers, Chile is Politically Stable, Relatively Prosperous and Enjoying 'The Best Years in its History'*, NEWSWEEK INT'L, Aug. 12, 2002, at 24 (describing current Chilean political stability and economic prosperity compared to other South American countries). The Economist Intelligence Unit has named Chile Latin America's number one country for foreign investment, above Mexico and Brazil. *Id.* When Berlin's Transparency International Organization surveyed ninety-one countries, it rated Chile among the top twenty nations with the least corruption. *Id.* As the former U.S. Ambassador to Chile, John O'Leary noted, "[i]n my day-to-day experience, what I was hearing was that people quickly understood the ease of doing business. . . . The lack of corruption . . . makes businesses feel comfortable" in Chile. Jonathan Franklin, *Chile Bucks Region's Economic Trend: Stability Keeps Foreign Capital on the Increase*, BOSTON GLOBE, Aug. 11, 2002, at A15 (emphasizing that strict fiscal discipline adopted by Pinochet's government and maintained by successive democratic governments resulted in public sector surpluses and saved Chile from the foreign debt trap suffered by the country's larger and more richly endowed neighbors); see also Rodrigo Cifuentes et al., *Capital Markets in Chile: From Financial Repression to Financial Deepening*, 4 ECON. POLICY PAPERS OF THE CENT. BANK OF CHILE (Aug. 2002) (discussing the evolution of capital markets in Chile), at <http://www.bcentral.cl/eng/studiesandpublications/publications/policies/pdf/dpe04.pdf> (last visited Mar. 31, 2003). Chile's economic stability and sustainable progress stem from structural economic reforms of the 1970s, reform of the banking system and capital markets during the 1980s, and pioneering privatization of its pension system. *Id.* at 5; see also Sean Higgins, *Social Security Privatization*

Apart from buying American depository receipts (“ADR”) issued by Chilean companies on U.S. capital markets, there are two legal frameworks for foreign investment in Chile:⁸ Decree-Law No. 600 of the 1974 Foreign Investment Statute (“DL 600”)⁹ and Chapter XIV of the Compendium of Regulations of Foreign Exchange (“Chapter XIV”),¹⁰ issued by Chile’s Central Bank pursuant to the Organic Constitutional Law On Central Bank (“Central Bank Law”).¹¹ Most foreign investment comes to Chile via DL 600.¹² For many years the

– *Is Chile The Best Model?*, INVESTOR’S BUS. DAILY, July 15, 2002, at A16 (discussing reasons that moved Chile to reform its state-run pay-as-you-go pension system into a private pension fund industry with individual accounts for every worker, and the resulting benefits for workers and the country’s economy).

8. See *Policies and Regulations*, GOBIERNO DE CHILE (containing an overview of Chile’s law governing foreign investment, provided by Chile’s Committee on Foreign Investment), at http://www.gobiernodechile.cl/foreign_investment_in_chile4.html (last visited Mar. 26, 2003).

9. See Foreign Investment Statute, Decree-Law No. 600 (1974) (Chile), D.O., Dec. 16, 1993 [hereinafter Decree-Law No. 600] (providing an English translation of the statute), available at http://www.cochilco.cl/content/b-legislation/dl600_eng.pdf (last visited Mar. 25, 2003).

10. See Compendio de Normas de Cambio Internacionales, Capítulo XIV: Normas Aplicables a los Créditos, Depósitos, Inversiones y Aportes de Capital Provenientes del Exterior [Compendium of Foreign Exchange Regulations, Chapter XIV: Regulations Applicable to Loans, Deposits, Investment and Capital Contribution of Funds of Foreign Origin] (Chile), at <http://www.bcentral.cl/Normas/cnci/CapXIV.pdf> (last visited Jan. 26, 2003) [hereinafter Chapter XIV]; see also Acuerdo del Consejo del Banco Central de Chile [Resolution of the Council of the Central Bank of Chile] No. 961-04-020117 (Chile), Jan. 23, 2002, (approving Chapter XIV), at <http://www.bcentral.cl/Normas/circulares/cnci/circ768.pdf> (last visited Jan. 26, 2003). The Council of the Central Bank has issued a Compendium of Regulations of Foreign Exchange pursuant to its authority to establish the terms and means in which foreign and domestic investors and creditors may use their capital investments in Chile and proceeds thereof, including their repatriation and reinvestment in Chile. See Ley Orgánica Constitucional del Banco Central [Organic Constitutional Law on Central Bank] No. 18.840, art. 47 (Chile), D.O., Oct. 10, 1989, available at <http://www.bcentral.cl/esp/funcionesyorganizacion/leyorganica/ley08.htm> (last visited Mar. 31, 2003).

11. See Organic Constitutional Law on Central Bank, *supra* note 10.

12. See Foreign Investment by Inflow Mechanism: 1974-2002, Jan.-Sept. (containing statistical data on volumes of foreign investment gathered by Chile’s Committee on Foreign Investment), at http://www.cinver.cl/fdi_inchile/fistats.asp

United States has been the largest single source for DL 600 investments.¹³

Enacted in 1974, DL 600 remains a liberal regulation of foreign investment in most respects. There are no restrictions on the share of foreign participation in Chilean companies – up to one hundred percent of a company's capital may be foreign-owned.¹⁴ Additionally, there is no limit on the maximum length of time that a foreign investment may remain in Chile.¹⁵

DL 600 provides for a contractual relationship between Chile and the foreign investor, created by an agreement between Chile's Committee on Foreign Investment, an inter-agency governmental body, acting on behalf of the Republic of Chile, and the foreign entity or individual.¹⁶ DL 600 guarantees a foreign investor the following rights: free repatriation of profits and proceeds from liquidation of reinvested profits at any time;¹⁷ a choice between Chile's ordinary tax regime and the special tax regime;¹⁸ a right to

(last visited Mar. 25, 2003). In 2001, Chile received \$4,733,000 in foreign investment under Decree-Law No. 600 and only \$775,000 under Chapter XIV. *Id.* For the period of January–September of 2002, the ratio is almost the same: \$1,249,000 under Decree-Law No. 600 and \$279,000 under Chapter XIV. *Id.*

13. See Foreign Direct Investment (D.L.600); *FDI Authorized and Materialized by Country of Origin: 1974-2002*, at http://www.cinver.cl/fdi_inchile/fistats.asp (last visited Jan. 26, 2003) (containing statistical data on volumes of foreign investment gathered by Chile's Committee on Foreign Investment). For the period of January 1974 – September 2002, U.S. business entities and individuals invested about \$15,785,000 in Chile, which amounts to 31.7 percent of total foreign investment for the same period of time. *Id.*

14. See Decree-Law No. 600, *supra* note 9 (indicating the liberalness of this statute in regulating foreign investment); *Policies and Regulations*, *supra* note 8 (providing a general overview of Chile's foreign investment law by Chile's Committee on Foreign Investment).

15. See Decree-Law No. 600, *supra* note 9 (emphasizing further Chile's attractiveness to foreign investors).

16. See *id.* art. 3 (providing for a period of time after execution of the investment contract in which an investor may bring in capital – not more than eight years for mining projects and not more than three years for investment in other sectors).

17. See *id.* art. 4 (outlining the rights of a foreign investor).

18. See *id.* art. 7 (providing for an effective, fixed income tax rate of forty-two percent for a ten-year period from commencement of investment project operations). Currently the tax rate of forty-two percent is higher than the income

indemnification for any property loss in case of expropriation, and a right to challenge such expropriation in Chilean courts.¹⁹ DL 600 also imposes the following obligations on foreign investors: not to withdraw and repatriate originally imported and invested capital for one year from the date such capital was brought into Chile;²⁰ not to transfer ownership, use or possession of technology, which is a part of a foreign investment from its original entity, and not to amortize or depreciate such technology;²¹ and to conduct all currency exchange operations for purposes of investment or repatriation of funds through a local banking institution licensed in the Formal Exchange Market.²²

tax rate of the common tax regime, which makes it unreasonable for foreign investors to avail of the special tax regime. *Id.* Under the common tax regime, foreign investors would pay fifteen percent of taxable income on earnings they reinvest in Chile. *See* Decreto-Ley Sobre Impuesto a la Renta [Decree-Law on Income Tax] No. 824, art. 20 (Chile), D.O., Dec. 31, 1974, *available at* <http://www.sii.cl/pagina/jurisprudencia/legislacion/basica/dl824.htm> (last visited Mar. 31, 2003). For repatriated profits, the income tax rate is thirty-five percent. *Id.* art. 58. Besides income tax, companies, including those with foreign investment, are subject to the value added tax ("VAT") in Chile, which applies to all sales of goods, provision of services, imports, in-kind contributions into companies, and sales and lease of corporate assets. *See* Decreto-Ley Sobre Impuesto a las Ventas y Servicios [Decree-Law on Tax on Sales and Services] No. 1.606, art. 8 (Chile), D.O., Dec. 3, 1976, *available at* <http://www.sii.cl/pagina/jurisprudencia/legislacion/basica/dl825.htm> (last visited Mar. 30, 2003). VAT rates vary according to the type of taxable operation. *Id.* The general rate applicable to the majority of operations is eighteen percent. *Id.* art. 14. Exporters recover their VAT paid in the process of production of exported goods and services. *Id.* art. 36.

19. *See* Decree-Law No. 600, *supra* note 9, art. 10 (providing for quick administrative resolution of investors' complaints). Investors may file their complaints on allegedly discriminatory regulations to the Foreign Investment Committee, an inter-agency body charged with negotiation and execution of foreign investment contracts on behalf of Chile. *Id.* The Foreign Investment Committee must rule on complaints within sixty days and, having found discrimination against a foreign investor, must take affirmative steps to remove it or require proper authorities to do so. *Id.* Regardless of whether or not a foreign investor applies to the Foreign Investment Committee, it may also seek redress in a court of law. *Id.*

20. *See id.* art. 4 (imposing restrictions on foreign investors).

21. *See id.* art. 2(c) (limiting actions by foreign investors concerning technology).

22. *See id.* art. 4 (stating that such exchange operations must be made at the most favorable rate). The Formal Exchange Market consists of Chile's banking

An investor, however, is not required to use the framework offered by DL 600, i.e., a foreign entity or individual may bring in funds for any investment purpose, without entering into contracts with Chile's government. In that case, a foreign investor will be subject to Chile's law without any exceptions otherwise negotiable in a DL 600 agreement.²³ Foreign capital may be brought into Chile without any prior agreements or authorizations, and the above-mentioned Chapter XIV addresses procedural issues of currency exchange upon importation of funds and repatriation of profits.²⁴ It provides that all loans, deposits, investments, and equity contributions²⁵ over \$10,000²⁶ from outside Chile must be converted into the national currency on the Formal Exchange Market with notification of Chile's Central Bank.²⁷ Repatriation of funds is also done through the Formal Exchange Market, and the Central Bank must be notified of the transaction.²⁸

The Central Bank also permits another currency control mechanism that authorizes the Central Bank to issue temporary regulations ordering deposit of a reserve of up to forty percent of funds intended to be transferred out of Chile and deposited, loaned or invested in a foreign country.²⁹ It also permits a reserve of up to forty percent of funds coming from abroad and intended to be invested,

institutions and other entities authorized to conduct operations on that market. *See* Organic Constitutional Law on Central Bank, *supra* note 10, art. 41.

23. *See* Decree-Law No. 600, *supra* note 9, art. 11bis(2) (allowing foreign investors who bring in more than \$50,000,000 to negotiate certain favorable tax and accounting treatment, such as accelerated depreciation of certain kinds of property, and extended carryover of losses and start-up expenses); *see also* *Policies and Regulations*, *supra* note 8.

24. *See* Chapter XIV, *supra* note 10.

25. *See id.* sec. 2 (defining broadly loans, deposits, investments, and equity contributions). Loans, for instance, include placement by Chilean companies of convertible debt instruments on foreign capital markets. *Id.*

26. *See id.* sec. 1 (exempting inter-banking transactions, which are regulated separately).

27. *See id.* sec. 3.

28. *See id.* sec. 4.

29. *See* Organic Constitutional Law on Central Bank, *supra* note 10, art. 49 sec. 2.

loaned, or deposited in Chile.³⁰ This reserve provision, called *encaje*, is currently dormant, and was used for the last time during the Asian (including Russian) financial crisis of 1998.³¹ In the case of incoming funds, *encaje* is applicable only to such funds that are transferred to Chile after the effective day of the Central Bank's order and is not applicable to foreign funds that have already been deposited, loaned, or invested in Chile as of that date.³² The Central Bank Law gives the Central Bank the authority to suspend currency exchange operations on the Formal Exchange Market, with the exception of those operations necessary for performance of obligations under import-export transactions.³³ The Central Bank, however, may order the deferral of currency exchange operation necessary for payment under import-export deals for up to one hundred eighty days upon application filed by a party of an import-export contract with a Formal Exchange Market institution.³⁴

II. ANALYSIS

Both of the currency control measures, the one-year restriction on withdrawal of invested funds under DL 600 and *encaje*, are intended to discourage so called *capitales golondrina* ("swallow capital").³⁵ These are foreign funds coming to Chile with the sole purpose of harvesting quick profits from speculative activity on Chilean markets, presumably creating no assets of lasting value but threatening to undermine the country's economy in case of rapid

30. *See id.*

31. *See Trade Negotiations Bog Down on Reserve Requirements*, BUS. NEWS AM., Mar. 19, 2002 (discussing *encaje* and identifying it as a debated issue in the Chile-U.S. free trade negotiations), available at 2002 WL 4437427; *see also Going it Alone – Chile's Trade Agreements*, *supra* note 3 (commenting on Chile's trade agreements).

32. *See Organic Constitutional Law on Central Bank*, *supra* note 10, art. 49.

33. *See id.*

34. *See id.*

35. *See Chile-United States Free Trade Agreement: What is it About?*, *supra* note 2 (discussing the purpose of *capitales golondrina*).

withdrawal.³⁶ While both of these mechanisms negatively affect the volume of foreign investment, each has its own specific implications.

The advantage of investing under DL 600 is that a foreign investment contract is a legally binding document that cannot be unilaterally amended either by the state or by the foreign investor.³⁷ This becomes important in long-term investment projects when a foreign investor acquires substantial illiquid property, such as industrial production facilities. Thus, although DL 600 may also be applied to portfolio investment,³⁸ its contractual structure better serves strategic, or direct, investors.³⁹ Its disadvantage is the mandatory one-year restriction on withdrawal of invested capital, apparently intended to protect Chile's robust but small economy from large capital withdrawal within a short period of time.⁴⁰ Such a provision may deter some foreign investors and increase the "risk premium" that the brave ones may seek to charge their Chilean counterparts.⁴¹

Chile's official opinion proffered by the Foreign Investment Committee ("the Committee") is that the one-year restriction does not affect investors' decisions to bring funds to Chile.⁴² The Committee believes that because every direct investment project by definition takes more than one year to develop and begin generating profits, investors who commit to Chile are not deterred by such a restriction.⁴³ The Committee, however, does not provide any data on

36. See *id.* at 17 (discussing regulatory measures aimed to discourage inflow of *capitales golondrina*).

37. See Decree-Law No. 600, *supra* note 9 (establishing the decree).

38. See *id.* art. 2 (outlining the foreign investment statute).

39. See *id.* (establishing the provisions structure of the statute).

40. See *¿Qué Estamos Negociando Con EEUU? [What are We Negotiating With the United States?]* (discussing measures that restrict withdrawal of foreign funds as a mechanism to protect Chile's economy in times of turmoil in international financial markets), available at <http://www.direcon.cl/html/tcl/negociando.php> (last visited Jan. 29, 2003).

41. See *id.* (explaining some effects of the one-year restriction provision).

42. See *id.* (commenting on the position of the Chilean government).

43. See *Policies and Regulations*, *supra* note 8, (explaining Chile's direct investment program); see also Telephone Interview with Alex Foxley, Special Advisor on Chile-U.S. Free Trade Agreement (Nov. 22, 2002) (addressing why long-term investors are not discouraged by the restrictions).

how many potential investors each year decide not to invest in Chile because of this restriction.⁴⁴ Nor do they provide any estimation of a total surcharge, allocable to the risk associated with the one-year restriction, that Chilean companies have to pay to foreign investors for their capital.⁴⁵

The existing restriction may discourage some potential investors who have never done business or invested in Chile but might otherwise be interested in doing so, and it certainly does not enhance the image of Chilean economic legislation. This restriction is also inconsistent with the broader aims of Chile's recent FTAs.⁴⁶ The country may well expect that foreigners would want to use Chile as a platform for production and export of goods to major world markets, such as the European Union and the United States, thereby taking advantage of eliminated or reduced import tariffs.⁴⁷ However, the continuing one-year restriction on capital withdrawal will not well serve this expectation .

Foreign strategic investors may choose the Chapter XIV approach and thus avoid the one-year restriction under DL 600.⁴⁸ A possible disadvantage of this approach, which might or might not prevail depending on the particular circumstances of an investment project, is the absence of governmental obligations to abide by certain agreed rules with respect to a particular investor.⁴⁹ For instance, accelerated

44. See *Policies and Regulations*, *supra* note 8 (discussing what the Committee provides).

45. See *id.* (noting the regulations of Chile's program).

46. See *Chile-United States Free Trade Agreement: What is it About?*, *supra* note 2, at 31 (describing the free trade agreement with the United States).

47. See *id.* (articulating how the Free Trade Agreement with the United States may make Chile attractive for businesses providing and exporting services related to information technologies); see also *El Presidente Afirma que el TLC Nos Obliga a Ser Más Transparentes, Flexibles y Eficientes [The President Affirms that the FTA Obliges Us to Be More Transparent, Flexible, and Efficient]*, ESTRATEGIA, Dec. 16, 2003 (discussing the interest of businessmen from other Latin American countries in setting up production facilities in Chile in order to export their products free of tariffs from Chile to Europe), available at <http://www.estrategia.cl/histo/200212/16/notas.html> (last visited Mar. 31, 2003).

48. See Decree-Law No. 600, *supra* note 9, art. 11bis(2) (setting forth the one-year time restriction).

49. See *id.* (noting the rules and governmental obligations of the law).

depreciation of long-term capital assets can be provided for in the DL 600 investment contract.⁵⁰ Notwithstanding the choice of legal framework, however, strategic and portfolio investors both are potentially subject to *encaje*.⁵¹

One may regard *encaje* as an involuntary interest-free loan extended to the Chilean government on its demand.⁵² Dormant, but still a potential threat, *encaje* appears responsible for the minuscule presence of foreign institutional investors in Chile's capital market.⁵³ Thus, *encaje* discourages U.S. mutual funds from investing in Chile's capital market because measures such as repatriation restrictions, which are designed to complicate foreign investors' ability to withdraw their money from Chile, also have the effect of making it difficult to comply with mutual fund pricing and liquidity regulations under U.S. laws.⁵⁴

50. *See id.* (stating who is subject to *encaje*).

51. *See* Organic Constitutional Law on Central Bank, *supra* note 10, art. 49 sec. 2 (providing that loans, deposits, and investments in foreign currency that come into Chile or are to be transferred out of the country are subject to *encaje*).

52. *See id.* (giving the Central Bank discretionary power to order that obligatory reserves be interest free or subject to interest rates not in excess of "normal" market interest rates).

53. *See* Cifuentes et al., *supra* note 7, at 7 (providing statistical data on the structure and development of the capital market in Chile, as gathered by Chile's Central Bank). Notwithstanding the growth of Chile's economy, its otherwise investment-friendly legal framework, and its lack of corruption, the commitment of foreign investment funds to Chile steadily declined from 3.06 percent of Chile's GDP in 1995 to 0.98 percent in 2000. *Id.*

54. *See* Letter from Mary S. Podesta, Senior Counsel, The Investment Company Institute, to John B. Taylor, U.S. Under Secretary of Treasury for International Affairs (Jan. 10, 2002) (expressing the support of the U.S. asset management industry to eliminate Chilean restrictions on repatriation of capital by foreign portfolio investors), *available at* http://www.ici.org/chile_repatriate_com.html (last visited Mar. 29, 2003). Historically, U.S. mutual funds have invested in Chile only through ADRs because of liquidity and pricing concerns. *Id.*; *see also* *Trade Negotiations Bog Down on Reserve Requirements*, *supra* note 31 (discussing Chile's unwillingness to eliminate the capital reserve requirement for U.S. investments in Chile). The United States has won no concession from Chile in this area, unless one considers as concessions Chile's pledge to impose *encaje* only in absolutely extreme circumstances and for not more than one year. *Id.*; *see also* Santiago, *supra* note 1, (discussing U.S. compromise on *encaje*); *Chile and the United States Successfully Concluded FTA Negotiations*, *supra* note 1 (announcing that *encaje* as a protective mechanism will not be eliminated, but will be limited to extreme circumstances);

Chile's government seems convinced that *encaje* is a proven and efficient mechanism for *protecting* the Chilean economy in times of financial crisis in international markets.⁵⁵ However, a more efficient protection mechanism is a total ban on foreign portfolio investment.

Meanwhile, the brunt of protection against *capitales golondrina* is borne by Chilean companies, and in particular, by medium size companies that cannot raise cheaper capital to finance their operations and expansion.⁵⁶ Chile's government has already recognized that the high cost of raising funds on internal capital markets is a problem to overcome, and has attacked the problem by passing a group of measures under the current plan of market reforms, *Reforma del Mercado de Capitales I* ("Capital Market Reform I").⁵⁷ However, such measures fall short of removing restrictions on transfers of foreign funds. Portfolio investment by foreigners in minority ownership of well-run Chilean companies is not an option if investors are prevented from promptly rebalancing their portfolio as market conditions change.⁵⁸ Given the fact that the pool of potential foreign portfolio investors exceeds that of potential strategic investors, it is reasonable to propose that Chile's economy in general receives substantially less investment than it could if capital restrictions were removed.

Withdrawal of capital *en mass* is typically caused by dramatically unfavorable political or economic events happening inside the

Going it Alone – Chile's Trade Agreements, *supra* note 3 (discussing the trade relationship between the United States and Chile); *Chile-United States Free Trade Agreement: What is it About?*, *supra* note 2, at 17.

55. See *What are We Negotiating With the United States?*, *supra* note 40 (outlining Chile's policy of negotiation of the FTA with the United States).

56. See *Chile-United States Free Trade Agreement: What is it About?*, *supra* note 2, at 17 (describing regulatory measures aimed discouraging the inflow of *capitales golondrina*).

57. See Cifuentes et al., *supra* note 7, at 9 (discussing the high cost of raising capital on Chile's stock exchange for local small- and medium-sized companies); see also Resumen de la Reforma del Mercado de Capitales [Summary of the Reform of Capital Market] 4 (Apr. 19, 2001) (outlining a complex package of laws liberalizing regulations of capital markets in Chile and that particularly provide for elimination of a capital gain tax on revenue from sales of shares of medium-size corporations listed on the Santiago stock exchange), available at <http://www.minhda.cl/castellano/inicio.html> (last visited Jan. 29, 2003).

58. See Summary of the Reform of Capital Market, *supra* note 57.

country.⁵⁹ Chile has survived, without enforcing *encaje*, through the collapse of the Argentina's economy, the devaluation of currency in Brazil, and the general slow-down in the world economy since the middle of 2000.⁶⁰ It is possible that Chile is overrating the risk of capital flight and underestimating the cost that *encaje* and the DL 600 restriction on withdrawal of invested capital impose on its economy by depriving companies of cheaper funding and discouraging potential investors.⁶¹ In order to take full advantage of the FTAs, Chilean exporting companies will need to lower their costs of production.⁶² Currency restrictions tend to produce exactly the opposite result, by limiting the volume of available capital and by adding risk, thus increasing transaction costs.⁶³ The longer capital restrictions are kept, the longer Chile's "big bang" is postponed.⁶⁴ Observers note that "Chile usually outperforms its neighbors on the way down, but generally underperforms in a rebound."⁶⁵

III. RECOMMENDATIONS

The *encaje* and the DL 600 one-year restriction on withdrawal of capital as protective measures against massive capital flight appear to be unnecessary. This is especially true considering the basic soundness and stability of Chile's economy and transparency of Chile's political system, which have produced a long period of

59. See *id.* (discussing the political and economic conditions in Chile).

60. See Contreras, *supra* note 7 (noting Chile's prosperous economic performance while the rest of South America suffers)

61. See Decree-Law No. 600, *supra* note 9, art. 11bis(2) (stating who is subject to *encaje*).

62. See Contreras, *supra* note 7 (describing Chile's plan to encourage investment).

63. See *id.* (discussing different business plans in South America).

64. See Cifuentes et al., *supra* note 7, at 15 (discussing the aim of Chile's government to develop a strategy of market deregulation bringing about a financial "big bang" similar to those experienced by more developed financial markets in the 1980s and resulting in rapid economic growth).

65. See Jonathan Karp, et al., *Americas: A Year for Most Overseas Investors to Forget*, WALL STREET J., Jan. 2, 2003, at R14 (discussing poor performance of Latin American stock markets in 2002).

growth and a low foreign debt.⁶⁶ They also conflict with Chile's economic policy and goal of keeping pace with more developed countries.⁶⁷

DL 600's one-year restriction is a particularly unnecessary measure. The better solution is to repeal this restriction altogether. A more conservative approach would be movement of the restriction from the list of investor's mandatory obligations to the list of negotiable obligations.⁶⁸ Given the contractual structure of investment projects under DL 600, the question of the minimum time period for foreign investment should be a subject of negotiation.⁶⁹ However, foreign investors should take into account Chile's preference for retaining imported capital as long as possible as well as the particular requirements of individual investment projects.⁷⁰ It may well be that in the case of long-term, large investments such as mining projects, foreign investors may generally be indifferent to the one-year capital withdrawal restriction.⁷¹ However, in the case of smaller investments into projects with shorter operational cycles, such as medium-sized food processing plants or information technology development laboratories, an investor may well be more concerned about the risks posed by any restriction on capital withdrawal.⁷² Relaxing the restriction now, shortly before or after FTAs become operational, would serve Chile's goal of greater diversification in exports.⁷³ Liberalization of capital restriction would

66. See Solid Macroeconomic Fundamentals (providing statistical data on Chile's fiscal balance over the last decade), available at http://www.inversionextranjera.cl//chilesadvantages/solid_macrofundamentals.asp (last visited Mar. 31, 2003).

67. See Decree-Law No. 600, *supra* note 9, art. 11bis(2) (exemplifying the goal of the Chilean government to keep pace with more developed countries).

68. See *id.* (outlining the mandatory obligations and negotiable obligations of investors).

69. See *id.* (establishing the contractual requirements of DL 600).

70. See *id.* (exemplifying Chile's preference for retaining imported capital as long as possible).

71. See Letter from Mary S. Podesta, *supra* note 54 (examining ways in which foreign investment is discouraged in Chile).

72. See *id.*

73. See *id.* (commenting on the types of restrictions that discourage U.S. investment).

also reduce the reluctance of investors to enter less developed and riskier export industries than the more traditional ones, such as mining or agricultural industries.⁷⁴

Similarly, *encaje*, as a supported protection against capital flight, should be eliminated. If Chile is concerned about speculative activity by certain foreign investors, it should differentiate among them and treat each type of player separately.⁷⁵ For instance, pension funds differ from hedge funds in their activity, strategy, and accountability rules. As a provisional measure, for instance, Chile could make *encaje* inapplicable to strategic investors and some portfolio investors, such as traditional U.S. mutual funds or pension funds, and retain *encaje* for potential application to the activities of hedge funds.⁷⁶ Because every transaction of foreign currency over \$10,000 must be conducted through the Formal Exchange Market and reported to the Central Bank, investors may be required to disclose the character of the fund, which will enable the Central Bank to monitor who invests in the capital markets for what purposes, and who may be subject to *encaje* if circumstances warrant.⁷⁷

CONCLUSION

The slowdown of Chile's market reforms is recognized as a reason why Chile's economy has not performed well since the mid-1990s in terms of productivity, growth, and expected returns.⁷⁸ Some skeptics suggest that Chile's euphoria about the Chile-U.S. FTA is premature and, absent a more serious approach to market reforms in Chile,

74. See Solid Macroeconomic Fundamentals, *supra* note 66 (reviewing competitive markets and economies).

75. See *id.* (comparing Chilean trade programs with other countries).

76. See Letter from Mary S. Podesta, *supra* note 54 (discussing U.S. mutual funds).

77. See Organic Constitutional Law on Central Bank, *supra* note 10 (mandating rules for transaction of foreign currency).

78. See Cifuentes et al., *supra* note 7, at 10 (admitting that in the mid-1990s, Chile's government slowed its economic reforms, adversely affecting productivity growth and expected returns). After 1995, Chile continued to grow at a relatively high rate, however, due to benevolent external conditions and an increase in productivity, but controls on capital flows, overregulation, and concentration in several industries prevented the economy from growing at higher rate. *Id.*

potential FTA benefits may be vastly exaggerated.⁷⁹ For Chilean products to be competitive on newly opened markets, Chilean companies must reduce their costs of production.⁸⁰ Cheaper labor alone is unlikely to offset the relatively high shipment costs from Chile to the European Union or United States, or the high cost of capital necessary for Chilean export industries to finance their expanding operations.⁸¹ While the Chilean government cannot change the country's remote geographical position, it can help its producers make their goods more competitive in foreign markets by adopting market-oriented reforms that relax or eliminate controls on the movement of foreign capital.⁸²

79. *See* Edwards, *supra* note 6 (discussing a necessity for Chile to implement market-oriented policies aimed at making Chile's products more competitive abroad).

80. *See id.* (contemplating how Chile can make the most of its U.S. trade deal).

81. *See id.* (commenting on what Chilean export industries need to finance expansion).

82. *See* Letter from Mary S. Podesta, *supra* note 54 (suggesting that Chile relax its restrictions on trade).