

## **An Unusual Suspect? Monetary Sovereignty and Financial Instability**

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### Table of Contents

Abstract .....	245
A. Introduction .....	245
B. Financial Interdependence .....	246
C. ... But Legal Independence .....	248
I. Monetary Sovereignty .....	248
II. International Law Limits on Monetary Sovereignty .....	249
1. IMF Articles of Agreement .....	249
2. The WTO .....	252
3. Customary International Law and General Principles .....	252
a) The Principle of Non-Intervention .....	253
b) The No Harm Principle and the Abuse of Rights Doctrine .....	254
D. Sovereignty in Interdependence? .....	255

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E. Modifying Monetary Sovereignty .....	257
I. Who Exercises Sovereignty?.....	257
II. Why State Sovereignty?.....	258
III. Sovereignty's Substantive and Geographical Reach .....	258
IV. How Should Sovereignty Be Exercised? .....	260
1. Responsibilities of Acting States.....	261
a) Duty to Co-operate .....	261
b) Increase Accountability .....	262
2. Rights of the Affected States.....	263
F. Conclusion.....	265

## Abstract

This article argues that, in an increasingly interdependent world, a state's exercise of its monetary sovereignty through its monetary management policies (monetary policy, exchange rate policy and credit creation regulation) can affect financial stability abroad. Rather than looking for multilateral regulation of monetary management policies, this article argues that the rights and obligations stemming from sovereignty need to be rebalanced to ensure that state sovereignty becomes more compatible with increasing interdependence.

## A. Introduction

Globalization is widely seen as eroding states' power over their economies, but states are not powerless over the economic forces driving globalization. States remain in charge of regulating credit creation within their territories and can shape macro-economic variables, such as the liquidity available to the economy or the level of the exchange rate.

The closer integration of financial markets due to financial services trade liberalization and capital account liberalization has created linkages through which domestic monetary management policies can have an undesired impact on financial stability abroad. These policies were significant factors in the global financial crisis that started in 2007 as well as in earlier episodes of financial instability.<sup>1</sup> To avoid future financial crises, states' behaviour, even if at face value restricted to their own territories, may need to be altered. This article addresses how international law can contribute. Due to the involvement of states either as direct actors or as regulators, monetary management policies are appropriate subjects for study under international law.

The appropriate reach of monetary sovereignty in increasing financial interdependence is a central issue in this article. Given that sovereignty is not an end in itself,<sup>2</sup> but a tool to protect specific values of international relations, it is explored what these values are. Are these values still

<sup>1</sup> I. Macfarlane, *Australia and the International Financial Crisis* (3 December 2008) available at <http://www.lowyinstitute.org/Publication.asp?pid=935> (last visited 24 March 2010), 2.

<sup>2</sup> A. Peters, 'Humanity as the A and  $\Omega$  of Sovereignty', 20 *European Journal of International Law* (2009) 3, 513, 518.

compatible with the interdependence that flows from the closer integration of financial markets or has sovereignty lost its effectiveness to protect them? Do we need to modify sovereignty to improve its effectiveness? Should states' discretion to exercise their monetary sovereignty be limited to protect other states?

## B. Financial Interdependence

This article takes as a given that international law has facilitated – for better or for worse – the closer integration of national financial systems. This is illustrated, notably, by the current global financial crisis.

The creation of a more financially integrated global economy has however been lopsided. While the regulation of global trade and of capital and investment flows has been lifted to the international level, monetary management policies are left to the discretion of states. As a result, trade, capital and investment linkages can transmit the effects of a state's monetary management policies to other states.

Monetary management policies are those policies that manage the price of money and its aggregate supply in an economy. They are a state's monetary policy, which is closely related to its credit creation regulation, and its exchange rate and foreign currency reserves policies.

*Monetary policy* aims to ensure that enough money circulates in the economy to enable economic activity, but not so much as to cause inflation. Central banks set monetary policy by providing the “monetary base”, consisting of currency and the reserves held by commercial banks with the central bank in its role as the bankers' bank.<sup>3</sup>

The monetary base is narrower than an economy's aggregate money supply in which commercial banks play an important direct role through the creation of credit. The central bank's monopoly over the monetary base nevertheless allows it to indirectly influence *credit creation* by commercial banks by regulating the amount of reserves commercial banks have to hold (if any)<sup>4</sup> or by changing the supply of central bank reserves to affect their

<sup>3</sup> B. M. Friedman, ‘Monetary Policy’, in N. J. Smelser & P. B. Baltes (eds), *International Encyclopedia of the Social & Behavioral Sciences* (2001), 9977.

<sup>4</sup> W. J. Baumol & A. S. Blinder, *Macroeconomics: Principles and Policy*, 10th ed. (2007), 270. Some states do not require their banks to hold any reserves at all, but rely on other forms of prudential regulation to ensure the safety of deposits. Reserve ratios have generally become quite low due to competitive pressures in the global market;

“price”, as expressed in the money market interest rate.<sup>5</sup> Since banks pass on this interest rate to their customers, the central bank can indirectly control the interest rates charged to borrowers or paid to depositors.<sup>6</sup> In recent years, credit creation has increasingly taken place on capital markets rather than through traditional commercial banks.<sup>7</sup> Central banks exercise less control over capital market participants, such as hedge funds or investment banks, because they are not subject to the stricter prudential regulation and supervision requirements applicable to traditional banks.<sup>8</sup>

The aggregate money supply in one state, as determined by the monetary base and the amount of credit created by financial institutions, can affect financial stability abroad. For example, if capital moves freely between two states and one has fixed its exchange rate to that of the other, the fixing state has to accept the anchor state’s monetary policies,<sup>9</sup> regardless of whether these suit its economy. Moreover, a state’s regulatory framework governing credit creation can affect other states, as illustrated by the losses suffered by foreign investors in US mortgage-backed securities following the collapse of US sub-prime mortgages.

The currency component of the monetary base links monetary policy and *exchange rate policies*. Central banks intervene on the foreign exchange market to support an exchange rate peg by which the value of their currency is tied to that of another, or, to temper the volatility of a floating exchange rate. Buying the domestic currency using foreign currency reserves reduces the monetary base and, because of the increased demand, appreciates the domestic currency. Conversely, selling the domestic currency in exchange for foreign currency increases the currency component of the monetary base and depreciates the domestic currency.

see M. C. Burda & C. Wyplosz, *Macroeconomics: A European Text*, 4th ed. (2005), 205, 209.

<sup>5</sup> Burda & Wyplosz, *supra* note 4, 212.

<sup>6</sup> *Id.*, 210.

<sup>7</sup> A. Crockett, ‘Rebuilding the Financial Architecture’, 46 *Finance & Development* (2009) 3, 18, 18.

<sup>8</sup> International Monetary Fund, Initial Lessons of the Crisis (6 February 2009) available at <http://www.imf.org/external/np/pp/eng/2009/020609.pdf> (last visited 24 March 2010), 3 [IMF Initial Lessons].

<sup>9</sup> A fundamental principle of macro-economics, known as the “Impossible Trinity”, holds that a state can only have two out of the following three policies: an independent monetary policy, a fixed exchange rate and capital mobility, see J. A. Frieden, ‘Exchange Rate Politics: Contemporary Lessons from American History’, 1 *Review of International Political Economy* (1994) 1, 81, 83.

As an exchange rate is by definition a bilateral relation, changes directly affect prices in both states. Moreover, decisions regarding the accumulation<sup>10</sup> and management of *official foreign currency reserves* link the state accumulating the reserves and the state issuing the reserve currency, especially if the reserves are not kept in currency but are reinvested in the reserve state, as we have seen recently with Chinese investments in US assets. This strategy lowered interest rates in the US<sup>11</sup> and exposed China to US monetary management policies.<sup>12</sup>

## C. ... But Legal Independence

### I. Monetary Sovereignty

The previous section explained how monetary management policies, even if directed towards the domestic economy, can affect other states' monetary management policies. A central question in this article is whether states should take these effects into account when deciding on their domestic monetary management policies.

The starting point is the concept of monetary sovereignty, of which monetary management policies are considered attributes.<sup>13</sup> Monetary sovereignty translates the idea of sovereignty to international monetary relations. It finds its legal basis in an 80 years old decision of the Permanent Court of International Justice holding that "a state is entitled to regulate its own currency".<sup>14</sup>

<sup>10</sup> Reserve accumulation can be justified, e.g. when states need to save current income out of non-renewable resources; see International Monetary Fund, Review of the 1977 Decision—Proposal for a New Decision (22 May 2007) available at <http://www.imf.org/external/np/pp/2007/eng/nd.pdf> (last visited 24 March 2010), paras 41-43 [IMF Companion Paper].

<sup>11</sup> IMF Initial Lessons, *supra* note , 8.

<sup>12</sup> United Nations Conference on Trade and Development, *Trade and Development Report, 2009*, UNCTAD/TDR/2009, 122-123.

<sup>13</sup> R. M. Lastra, *Legal Foundations of International Monetary Stability* (2006), 22-23; F. Gianviti, 'Current Legal Aspects of Monetary Sovereignty', in International Monetary Fund (ed.), *Current Developments in Monetary and Financial Law* (2004), 4-5.

<sup>14</sup> *Case Concerning the Payment of Various Serbian Loans Issued in France and Case Concerning the Payment in Gold of the Brazilian Federal Loans Issued in France* (1929) PCIJ Ser A, Nos 20/21, 44.

In international law, sovereignty is traditionally seen as closely related to “independence”.<sup>15</sup> States exercise authority within their territory to the exclusion of other internal actors (“internal sovereignty”) and of those outside their territory (“external sovereignty”).<sup>16</sup> The delineation between internal and external sovereignty is increasingly porous as the creation of international institutions and of global markets requires internal sovereignty but at the same time affects its exercise.<sup>17</sup> Indeed, the exercise of internal monetary sovereignty is subject to international agreements and customary international law – results of the exercise of external sovereignty.<sup>18</sup> The next section examines international limits on the exercise of internal monetary sovereignty through monetary management policies when this has an impact on other states’ ability to exercise their monetary sovereignty.

## II. International Law Limits on Monetary Sovereignty

### 1. IMF Articles of Agreement

The IMF’s Articles of Agreement<sup>19</sup> contain a basic code of conduct governing the exercise of monetary sovereignty. Article IV stipulates a general duty to collaborate with the IMF and other members to ensure financial and economic stability. This duty is linked to four more specific obligations. Through its bilateral surveillance, the IMF oversees compliance with these obligations.<sup>20</sup>

The 2007 Decision on Bilateral Surveillance over Members’ Policies<sup>21</sup> has shifted the focus of IMF bilateral surveillance to the external impact of monetary management policies by introducing the concept of “external

<sup>15</sup> *Customs Regime between Germany and Austria (Protocol of March 19<sup>th</sup>, 1931)* (1931) PCIJ Series A/B, No. 41 [Customs Regime Case].

<sup>16</sup> Peters, *supra* note , 516.

<sup>17</sup> Sir R. Jennings, 'Sovereignty and International Law', in G. Kreijen (ed.), *State, Sovereignty, and International Governance* (2002), 32.

<sup>18</sup> C. Proctor & F. A. Mann, *Mann on the Legal Aspect of Money*, 6th ed. (2005), 500, footnote 506.

<sup>19</sup> *Articles of Agreement of the International Monetary Fund*, 22 July 1945, 2 U.N.T.S. 39 [IMF Articles of Agreement].

<sup>20</sup> *Id.*, Art. IV(3)(b).

<sup>21</sup> International Monetary Fund, *Bilateral Surveillance over Members’ Policies–2007 Decision* (15 June 2007) available at <http://www.imf.org/external/np/sec/pn/2007/pn0769.htm#decision> (last visited 24 March 2010) [IMF 2007 Surveillance Decision]. Para. 5 of the decision indicates that surveillance extends to exchange rate, monetary, fiscal and financial sector policies.

stability”.<sup>22</sup> This shift acknowledges the potential external effects of states’ monetary management policies on other states and brings global imbalances, such as those between the US and Chinese economies, to the forefront.

The actual obligations imposed on IMF members are however minimal. First, only a few limits apply to a state’s freedom to choose an exchange arrangement: states cannot fix their currency to the value of gold,<sup>23</sup> use discriminatory or multiple currency practices except when authorized or approved by the Fund<sup>24</sup> or manipulate their exchange rate.<sup>25</sup> The latter has gained attention in the past years, in light of the allegations of Chinese currency manipulation.<sup>26</sup>

Although the obligation to avoid manipulating exchange rates is seen as a fairly strong obligation of conduct,<sup>27</sup> its application is subject to strict conditions regarding the state’s purposes and the effects of its actions.<sup>28</sup> In practice, the complexity of determining an exchange rate’s “fair value” combined with a member’s entitlement to the benefit of any reasonable doubt regarding the purpose of their policies<sup>29</sup> has led the IMF’s Executive Board to defer to a member’s choices about the exercise of its monetary sovereignty.<sup>30</sup>

<sup>22</sup> “External stability” is defined in IMF 2007 Surveillance Decision, *Id.*, para. 4 and International Monetary Fund, *2007 Surveillance Decision Companion Paper Excerpts: Material Explicitly Endorsed by the Executive Board* (21 June 2007) available at <http://www.imf.org/external/np/pp/2007/eng/ndexc.pdf> (last visited 24 March 2010), paras 3-4.

<sup>23</sup> IMF Articles of Agreement, *supra* note 19, Art. IV(2)(b).

<sup>24</sup> *Id.*, Art. IV(3).

<sup>25</sup> *Id.*, Art. IV(1)(iii); IMF 2007 Surveillance Decision, *supra* note 21, para. 14, principle A and Annex.

<sup>26</sup> R. W. Staiger & A. O. Sykes, ‘*Currency Manipulation*’ and *World Trade* (13 June 2008) available at <http://ssrn.com/abstract=1151942> (last visited 24 March 2010), 2.

<sup>27</sup> C. D. Zimmerman, *Fundamental Exchange Rate Misalignment and International Law* (10 November 2008) available at <http://ssrn.com/abstract=1300542> (last visited 24 March 2010), 51; C. Proctor, ‘USA v China and the Revaluation of the Renminbi: Exchange Rate Pegs and International Law’, 17 *European Business Law Review* (2006) 5, 1339.

<sup>28</sup> IMF 2007 Surveillance Decision, *supra* note 21, Annex, para. 2.

<sup>29</sup> *Id.*, para. 3.

<sup>30</sup> International Monetary Fund, *The 2007 Surveillance Decision: Revised Operational Guidance* (22 June 2009) available at <http://www.imf.org/external/np/pp/eng/2008/080408.pdf> (last visited 24 March 2010) [IMF Revised Operational Guidance] paras 2-3.

Moreover, even if the IMF would be able to establish exchange rate manipulation, and thus a breach of article IV(1), the only sanction available under its Articles of Agreement is an exclusion from lending.<sup>31</sup> This may be effective for deficit states that rely on IMF loans for funding shortfalls,<sup>32</sup> but is toothless against states that do not require IMF funding and are often important creditors to the IMF.<sup>33</sup>

Second, the other monetary management policies are at most subject to best efforts obligations to ensure stability<sup>34</sup> or to recommendations to counter instability.<sup>35</sup> In addition, specific developments, such as “fundamental exchange rate misalignment” or “monetary policies [...] that provide abnormal encouragement or discouragement of capital flows”, will attract IMF scrutiny.<sup>36</sup> However, IMF scrutiny of the acts that caused these developments does not imply that those acts are presumed to breach of article IV(1).<sup>37</sup> The IMF will thus have to rely on its persuasive power only if it wants to change a member’s monetary management policies.

To conclude, while the IMF Articles of Agreement cover a wide range of domestic policies, states enjoy broad freedom in their monetary management policies. This freedom is strengthened by the obligation on the IMF to pay due regard to members’ circumstances and to respect members’ other policy objectives.<sup>38</sup> This is not necessarily a bad limitation. Various policy mixes, including but not limited to monetary management policies, are possible to achieve domestic and external stability. The decision on which policies should go in this mix should in principle belong to the state. However, to the extent that decisions have a negative external impact, limitations may be required. While the 2007 Surveillance Decision with its concept of external stability is an important step in this direction, its impact on most economies is limited to whatever persuasive power the IMF may

<sup>31</sup> IMF Articles of Agreement, *supra* note 19, Art. XXVI(2)(a).

<sup>32</sup> S. Pattanaik, 'Global Imbalances, Tanking Dollar, and the IMF's Surveillance over Exchange Rate Policies', 27 *Cato Journal* (2007) 3, 318, 322.

<sup>33</sup> Staiger & Sykes, *supra* note , 28; A. Mattoo & A. Subramanian, Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization (January 2008) available at <http://www.petersoninstitute.org/publications/wp/wp08-2.pdf> (last visited 24 March 2010), 7.

<sup>34</sup> IMF Articles of Agreement, *supra* note 19, Art. IV(1)(i) and (ii).

<sup>35</sup> IMF 2007 Surveillance Decision, *supra* note 21, para. 14, B and D.

<sup>36</sup> *Id.*, para. 15.

<sup>37</sup> IMF Companion Paper, *supra* note 10, para. 37.

<sup>38</sup> IMF Articles of Agreement, *supra* note 19, Art. IV(3)(b); IMF 2007 Surveillance Decision, *supra* note 21, paras 9 and 11.

have. The degree of persuasive power depends on many factors such as whether the state is a borrower or a creditor, political considerations within the Executive Board, and the technical and communications skills of the IMF staff members participating in the surveillance mission.<sup>39</sup>

## 2. The WTO

Various authors have recently explored whether WTO rules restrict states' monetary management policies and exchange rate valuations in particular.<sup>40</sup> They have analysed whether the negative effect thereof on other states would be contrary to WTO obligations, such as article I GATT,<sup>41</sup> or whether they allow affected states to take unilateral actions, such as under the Subsidies and Countervailing Measures Agreement.<sup>42</sup> Most of this research concludes that the various WTO obligations do not provide a ground for action against the trade effects of monetary management policies.<sup>43</sup> Others argue that actions are possible, albeit difficult.<sup>44</sup> The WTO is unable to assist states feeling the negative impact of other states' monetary management policies due to the complexity of the relation between these policies and trade volumes.<sup>45</sup>

## 3. Customary International Law and General Principles

International law's purpose has traditionally been to regulate the peaceful co-existence between equal states. To this end, "rules of abstention" limiting a state's exercise of its sovereignty to protect another state's equal sovereign rights have long been part of international law. The

<sup>39</sup> M. Watson, *IMF Surveillance in Europe: Progress in Refocusing. Report by an External Consultant* (2 September 2009) available at <http://www.imf.org/external/np/pp/eng/2008/090208c.pdf> (last visited 24 March 2010), 9.

<sup>40</sup> The most comprehensive analysis is Zimmermann, *supra* note . Other examples are Staiger & Sykes, *supra* note ; Proctor, *supra* note ; M. Benitah, *China's Fixed Exchange Rate for the Yuan: Could the United State Challenge It in the WTO as a Subsidy?* (corrected version) (October 2003) available at <http://www.asil.org/insigh117.cfm> (last visited 24 March 2010).

<sup>41</sup> Proctor, *supra* note 27, 1345-1348; Zimmerman, *supra* note 27, 18-39.

<sup>42</sup> *Agreement on Subsidies and Countervailing Measures*, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1867 U.N.T.S. 14; Zimmerman, *supra* note , 39-46.

<sup>43</sup> Proctor, *supra* note 27, 1345-1348; Staiger & Sykes, *supra* note 26, 28-37.

<sup>44</sup> Benitah, *supra* note 40.

<sup>45</sup> Mattoo & Subramanian, *supra* note , 10.

following sections examine these rules in the context of monetary sovereignty.

#### a) The Principle of Non-Intervention

The principle of non-intervention is an important corollary of sovereignty,<sup>46</sup> but it is nevertheless one of the murkiest topics in international law.<sup>47</sup> The General Assembly Resolutions that have tried to clarify the principle<sup>48</sup> are either unclear about the precise scope of the rights and duties that give it substance or have not been accepted by a substantial group of states.<sup>49</sup>

The main obstacle to applying the principle in the context of monetary management policies lies in the definition of “intervention”. Its standard definition, formulated by Oppenheim, only prohibits dictatorial interventions into the affairs of another state for the purpose of maintaining or changing the existing state of affairs.<sup>50</sup> A coercive element is thus required, but it is unclear how to identify coercion in the absence of (armed) force. In the *Nicaragua* case, the ICJ held that the cessation of US aid to Nicaragua did not amount to a breach of the principle of non-intervention.<sup>51</sup> Although it did not give reasons for this conclusion, the Court presumably was of the opinion that this particular cessation of aid was not severe enough to pre-empt Nicaragua’s sovereign will.<sup>52</sup>

The principle of non-intervention therefore imposes few limits on monetary sovereignty except for situations in which states deliberately use monetary management policies to affect structural change in other states. Situations like these are not common, but instances have arisen in the past.<sup>53</sup>

<sup>46</sup> *Case concerning military and paramilitary activities in and against Nicaragua (Nicaragua v. United States of America)*, Merits, Judgment, ICJ Reports 1986, 14, 106, para. 202 [Nicaragua Case].

<sup>47</sup> M. Jamnejad & M. Wood, 'The Principle of Non-Intervention', 22 *Leiden Journal of International Law* (2009) 2, 345-346.

<sup>48</sup> GA Res. 2131 (XX), 21 December 1965; GA Res. 2625 (XXV), 24 October 1970; GA Res. 36/103, 9 December 1981.

<sup>49</sup> B. R. Roth, 'The Enduring Significance of State Sovereignty', 56 *Florida Law Review* (2004) 5, 1034, footnote 59.

<sup>50</sup> L. Oppenheim & R. F. Roxburgh, *International Law: A Treatise*, 3rd ed. (1920), 222.

<sup>51</sup> *Nicaragua Case*, *supra* note 46, 126, para. 245.

<sup>52</sup> Jamnejad & Wood, *supra* note , 370-371.

<sup>53</sup> Kirshner describes various instances of currency manipulation against and by Iraq in the aftermath of the first Gulf war. Due to economic sanctions, Iraq could no longer import banknotes printed in Switzerland, but had to resort to domestically printed

When the negative external impact of monetary management policies is however of a lesser degree, the principle of non-intervention would not be triggered.

## b) The No Harm Principle and the Abuse of Rights Doctrine

The no harm principle expresses the maxim *sic utere tuo ut alienum non laedas*.<sup>54</sup> Various international sources<sup>55</sup> recognize the obligation of states “not to allow knowingly its territory to be used contrary to the rights of other states”. The no harm principle can limit monetary management policies based on their external impact when harm to the other state and a causal link to the monetary management policies can be identified. Given the complexity of the underlying macro-economic dynamics, this will be problematic.

Closely related to the no harm principle is the abuse of rights doctrine of civil law origins. This doctrine bars states from exercising their sovereign rights in such a way that impedes another state’s enjoyment of its rights or

banknotes. Due to the less sophisticated printing technology, these domestic banknotes were easy to counterfeit and thus less desirable than the original “Swiss” dinars alongside which they continued to circulate. In May 1993, Saddam Hussein ruled that the Swiss dinars were no longer legal tender, but allowed the exchange into Iraqi dinars at parity during one week. During this week, Iraq sealed its border with Jordan; its only open international border. This decision could potentially be seen as an intervention in another state because many Jordanians held the Swiss dinars as a store of value and saw their savings wiped out. Kirshner argues that the currency action was partly directed against the Jordanian King Hussein who had indicated his reluctance to continue supporting Saddam Hussein’s regime. In addition, Saddam Hussein closed the internal border with Kurdistan thereby blocking the Kurds from exchanging the Swiss dinars on which they had been relying. Turkey interpreted the exchange actions as a threat to its stability as it could push Kurdistan towards creating its own currency which would be a highly symbolic step towards independence. See J. Kirshner, ‘Currency and Coercion in the Twenty-First Century’, in D. M. Andrews (ed.), *International Monetary Power* (2006), 142-147.

<sup>54</sup> “Use your own property so that it does not harm others” see S.-L. Hsu, *A Realistic Evaluation of Climate Change Litigation through the Lens of a Hypothetical Lawsuit* (1 February 2008) available at <http://ssrn.com/paper=1014870> (last visited 24 March 2010), 21.

<sup>55</sup> *Trail Smelter Case (United States v Canada)* (16 April 1938 and 11 March 1941), Reports of International Arbitral Awards Vol. III, 1905, 1965; *Corfu Channel (United Kingdom of Great Britain and Northern Ireland v. Albania)*, Merits, International Court of Justice Reports 1949, 4, 22; Stockholm Declaration of the United Nations Conference on the Human Environment, UN Doc A/CONF.48/14/REV.1, 16 June 1972, Principle 21; Rio Declaration, UN Doc A/CONF.151/26 (Vol. I), 14 June 1992, Principle 2.

causes injury to another state. Contrary to the no harm principle, the precise status of the abuse of rights principle in international law is not entirely clear.<sup>56</sup> Nevertheless, it could provide an effective remedy to hold states accountable for their monetary management policies, even though the underlying facts required would only be met in exceptional cases and would not always be easy to establish.<sup>57</sup>

#### D. Sovereignty in Interdependence?

The analysis of existing international obligations regarding monetary management policies shows that on balance monetary sovereignty protects acting states' rights. While this may be inspired by a concern to shield state sovereignty from intrusions by overbearing international institutions, the one-sided focus on protecting acting states overlooks the impact that their actions can have on another state's exercise of its sovereignty in an interdependent world. This impact might not limit the legal authority of the affected state, but the practical consequences are the same if its policy choices are effectively reduced. There is thus an imbalance in the protection of sovereignty by international law in favour of protecting the acting state's legal authority to act and against the affected state's de facto freedom from external interference.

Various avenues are available to states in response to this imbalance in sovereignty and to deal with the tension between legal independence and financial interdependence.

States could agree to co-ordinate the conduct of their monetary or exchange rate policies or to develop multilateral regulation through co-operation. States could achieve this by expanding the IMF's powers or by further developing international financial market standards through the various committees of the Bank for International Settlements. International case law confirms the compatibility of sovereignty pooling with state sovereignty because of states' consent.<sup>58</sup>

This compatibility with state sovereignty is however a major obstacle to its success. No incentives exist for states whose monetary management

<sup>56</sup> M. Byers, 'Abuse of Rights: An Old Principle, a New Age', 47 *McGill Law Journal* (2002) 2, 410.

<sup>57</sup> D. Carreau, *Souveraineté Et Coopération Monétaire Internationale* (1970), 120, 124, 127.

<sup>58</sup> *Case of the S.S. "Wimbledon"*, PCIJ Series A, No. 1 (1923), 25; *Customs Regime Case*, *supra* note 15, 52.

policies have a negative impact abroad to participate in co-operative efforts. The idea of international co-operation works on the premise that participation is a privilege and that non-compliance can be sanctioned with non-participation.<sup>59</sup> When the provision of a global public good relies on the aggregate efforts of all states or when insufficient regulation by one state can undo efforts of others,<sup>60</sup> co-operation is not a privilege, but requires states to sacrifice individual benefits for the sake of the collective. The consent requirement grants states the freedom to decide whether or not they want to make this sacrifice.

A more fundamental response is thus required. The central argument of this article is that the international law regarding sovereignty may need to be modified. A clearer understanding of how sovereignty should be exercised in situations of interdependence can be helpful to reach a better balance between the sovereignty of all states, particularly in situations where international agreements to guide state behaviour are lacking.

Section E elaborates how this rebalancing exercise could involve changes to co-operative international law instruments. These changes could take place through amendments of the relevant treaty instrument or changed interpretations of relevant concepts in cases applying these instruments. Unfortunately, both processes are slow and haphazard in nature. The treaty amendment process moreover suffers from similar issues with consent as the development of a co-operative regulatory solution as it can be questioned whether states in whose favour the balance is currently tipped will be agreeable to change.

In addition to changing co-operative international law instruments, the article suggests a “back to basics” approach. International law emerged to regulate the peaceful co-existence of states by guiding the unilateral exercise of sovereignty through, for example, principles allocating jurisdiction and the principle of non-intervention. This goal of peaceful co-existence is still relevant even though international law today focuses strongly on developing co-operative multilateral solutions, rather than on delineating the scope for individual actions. The relevance continues because, despite closer co-operation and integration between states, differences remain. The international law of co-operation has not superseded the international law of co-existence; both are layers that

<sup>59</sup> W. G. Friedmann, *The Changing Structure of International Law* (1964), 90-93.

<sup>60</sup> For a typology of global public goods, see S. Barrett, *Why Cooperate?: The Incentive to Supply Global Public Goods* (2007).

together make up the structure of international law.<sup>61</sup> Therefore, I suggest a critical reflection of the purpose of these principles governing co-existence to rediscover their significance for an increasingly interdependent world order. As will become clear in the next section, this effort would happen in tandem with changes to co-operative international law instruments as principles of co-existence affect our understanding of sovereignty in co-operative instruments, and vice versa.

## E. Modifying Monetary Sovereignty

Four questions are relevant to give the abstract concept of sovereignty substance: who exercises it; why does it have normative value; over which areas (substantive and geographically) is it exercised; and how should it be exercised?<sup>62</sup> Sovereignty is an inherently flexible concept allowing for different answers to these questions over time.<sup>63</sup>

### I. Who Exercises Sovereignty?

Sovereignty originally rested with the person of the sovereign, but between the 16<sup>th</sup> and the early 19<sup>th</sup> century a gradual evolution took place towards state sovereignty.<sup>64</sup> Other actors, such as international institutions, NGOs and individuals, are emerging on the international scene.<sup>65</sup> It is not

<sup>61</sup> Friedmann, *supra* note 59, 64.

<sup>62</sup> D. Sarooshi, 'The Essentially Contested Nature of the Concept of Sovereignty: Implications for the Exercise by International Organization of Delegated Powers of Government', 25 *Michigan Journal of International Law* (2003-2004) 4, 1107, 1110-1111.

<sup>63</sup> S. Besson, 'Sovereignty in Conflict', in C. Warbrick & S. Tierney (eds), *Towards an 'International Legal Community'? The Sovereignty of States and the Sovereignty of International Law* (2006), 136.

<sup>64</sup> State sovereignty is often traced back to the 1648 Peace of Westphalia. The historical accuracy of such claims has however been challenged, see A. Osiander, 'Sovereignty, International Relations, and the Westphalian Myth', 55 *International Organization* (2001) 2, 251; S. Beaulac, 'The Westphalian Legal Orthodoxy - Myth or Reality?', 2 *Journal of the History of International Law* (2000) 2, 148.

<sup>65</sup> D. Greig, 'International Community', 'Interdependence' and All That Rhetorical Correctness?' in G. Kreijen (ed.), *State, Sovereignty, and International Governance* (2002), 584-596; K. Nicolaidis & J.L. Tong, 'Diversity or Cacophony? The Continuing Debate over New Sources of International Law', 25 *Michigan Journal of International Law* (2003-2004) 4, 1349, 1355.

excluded that they will become stronger in the future.<sup>66</sup> At this stage, however, this is speculative and premature as states still play the central role in international law.<sup>67</sup> The modifications I propose therefore still assume that states exercise sovereignty. This does not mean that the state forms the normative justification for sovereignty. The next section deals with this question.

## II. Why State Sovereignty?

Traditionally, state sovereignty has normative value in international law because it was seen as a tool towards self-determination, self-reliance and self-sufficiency, while at the same time ensuring sovereign equality between states.<sup>68</sup>

Self-determination is still relevant in an interdependent world. The increasing interdependence between states has not reduced the cultural, religious, political and economic differences between them. On the contrary, the closer links due to increasing interdependence have made states, and their citizens, more vulnerable to sovereign decisions of others that are incompatible with their own. Proper protection of the right to self-determination therefore requires a rethink about the exercise of sovereignty to correct imbalances in sovereignty. The next two sections examine what sovereignty should be exercised over and how it should be exercised.

## III. Sovereignty's Substantive and Geographical Reach

Sovereignty is typically exercised over a state's "domestic affairs", i.e. matters that belong to its "domestic jurisdiction" or its "reserved domain".

<sup>66</sup> Sarooshi, *supra* note 62, 1114.

<sup>67</sup> J. Delbrück, 'Structural Changes in the International System and Its Legal Order: International Law in the Era of Globalization', 11 *Schweizerische Zeitschrift für internationales und europäisches Recht* (2001) 1, 13; H. G. Schermers, 'Different Aspects of Sovereignty', in G. Kreijen (ed.), *State, Sovereignty, and International Governance* (2002), 186, 192.

<sup>68</sup> Delbrück, *supra* note 67, 5; Besson, *supra* note 63, 148, 160.

In 1923, the PCIJ issued an Advisory Opinion<sup>69</sup> that is still regarded as the prevailing interpretation of domestic jurisdiction.<sup>70</sup> It held that<sup>71</sup>

“[t]he question whether a certain matter is or is not solely within the jurisdiction of a State is an essentially relative question; it depends upon the development of international relations. [...] [I]t may well happen that, in a matter which [...] is not, in principle, regulated by international law, the right of a State to use its discretion is nevertheless restricted by obligations which it may have undertaken towards other States.”

Given its dependence on the evolution of international law, the definition of domestic affairs is inherently in flux. Applied to monetary management policies, the discussion in Section C.II has shown that international law recognizes the potential external impact of internal actions and prompts states not to exercise their monetary sovereignty in a way that causes a negative external impact. International law is thus moving in the direction of removing monetary management policies that cause a negative external impact from states' domestic jurisdiction. Nevertheless, this process is incomplete, since there is very little in the way of enforceable obligations on states.

Geographically, the reach of sovereignty is traditionally defined by a state's territory.<sup>72</sup> Territorial sovereignty is still valuable for an international legal system consisting of states at different stages of development, at least as long as democratic governance is lacking at the international level. Nevertheless, territorial sovereignty can be harmful in an interdependent world as states are vulnerable to actions taken by other states within the latter's territory in matters where this interdependence manifests itself. And the problem does not just stop at actions of states. Omissions can also cause a negative impact on other states, for example, when states inadequately regulate domestic activities that have a transnational impact, as we have seen in the current global financial crisis.

<sup>69</sup> *Nationality Decrees Issued in Tunis and Morocco (French Zone)*, Advisory Opinion, PCIJ Series B, No. 4 (7 February 1923) [Nationality Decrees].

<sup>70</sup> G. Nolte, 'Article 2 (7)', in B. Simma (ed.), *The Charter of the United Nations: A Commentary* (2002), 157; I. Brownlie, *Principles of Public International Law*, 6th ed. (2003), 291.

<sup>71</sup> Nationality Decrees, *supra* note 69, 24.

<sup>72</sup> *The Case of the S.S. "Lotus"*, PCIJ Series A, No. 10 (1927), 18-19.

Two options are conceivable to make territorial sovereignty more compatible with interdependence. First, we could restrict territorial sovereignty of the acting state to exclude actions having external effect. This could be achieved through international agreements, policy statements from international groups such as the G20, or, by modifications to the principles allocating jurisdiction as a result of objections by states affected by the exercise of territorial sovereignty. While a restriction of territorial sovereignty might seem unlikely, it should be borne in mind that this is not exceptional in international law. Restrictions for the protection of human rights can be cited as example. The second option starts from the premise that modifying sovereignty is not just about directly limiting acting states, but that limits can also be created indirectly by allowing affected states to respond. Current principles allocating jurisdiction do not bar states from exercising jurisdiction over external acts of which the impact is felt within their territory. With respect to monetary management policies, such an exercise of jurisdiction could be relevant to regulate credit creation by foreign financial institutions selling to investors within the state's territory. However, it would face serious enforcement obstacles given that enforcement jurisdiction is strictly territorial. Moreover, exercising jurisdiction over another state's monetary or exchange rate policies would be impossible and undesirable as this would go directly counter to the idea of the independence of states.<sup>73</sup>

#### IV. How Should Sovereignty Be Exercised?

As has been argued, the current rules regarding monetary sovereignty and its exercise are unbalanced due to a one-sided focus on a freedom to act compared to the responsibilities that come with such a wide freedom. As with the analysis of the reach of sovereignty, there are two paths to change how states exercise their sovereignty. First, international law could focus more on responsibilities of acting states. Second, international law could improve how affected states can exercise sovereignty when they experience the negative impact of other states' actions.

<sup>73</sup> My argument is not about doing away with legal independence altogether. Rather it wants to achieve a better balance between the legal independence of one state and the de facto independence of another state which can be curtailed by the exercise of sovereignty of another state.

## 1. Responsibilities of Acting States

International law should ensure that states fully internalize the negative externalities of their actions in the exercise of their monetary sovereignty. Internalization could be stimulated by an explicit duty to co-operate with other states to avoid global financial instability or a negative impact on other states. International law could also create incentives for states to internalize externalities by increasing their accountability.

### a) Duty to Co-operate

Some sources suggest a duty to co-operate with other states, particularly when global public goods are involved.<sup>74</sup> Regarding states' monetary management policies, the IMF Articles of Agreement include a number of obligations "to collaborate" with the IMF and with other members.<sup>75</sup>

Since a duty to co-operate with other states is difficult to reconcile with independence, existing duties to co-operate in international law are mainly of a procedural nature.<sup>76</sup> Even if combined with the principle of good faith, these duties do not require that a solution actually be achieved.<sup>77</sup> Often this will be difficult because states disagree on the existence of a problem, the goals of co-operation or the means towards reaching these goals.<sup>78</sup> The end result may therefore very well be that the agreed solution reflects the lowest common denominator, if an agreement is reached at all.<sup>79</sup> The disagreements within the G20 on how to deal with the financial crisis are illustrative in this respect.

<sup>74</sup> F. X. Perrez, *Cooperative Sovereignty: From Independence to Interdependence in the Structure of International Environmental Law* (2000); M. Buck & R. Verheyen, *International Trade Law and Climate Change – a Positive Way Forward* (July 2001) available at <http://library.fes.de/pdf-files/stabsabteilung/01052.pdf> (last visited 24 March 2010).

<sup>75</sup> IMF Articles of Agreement, *supra* note 19, Art. IV(1), Art. VIII(7).

<sup>76</sup> Buck & Verheyen, *supra* note 74.

<sup>77</sup> Proctor & Mann, *supra* note 18, 562.

<sup>78</sup> Greig, *supra* note 65, 575.

<sup>79</sup> *Id.*, 570.

## b) Increase Accountability

The accountability of states could be increased by providing for accountability in international instruments. For example, some authors argue for the creation of a new WTO rule to cover exchange rate manipulation.<sup>80</sup> This would bring exchange rate manipulation within reach of the WTO dispute settlement mechanism.

Accountability could also be increased by providing for state responsibility when a state's actions affect another state negatively. The International Law Commission (ILC) has already developed principles on the allocation of losses following transboundary harm caused by hazardous activities not prohibited by international law.<sup>81</sup> These draft principles however would need to be modified to allocate losses caused by monetary management policies. Currently, they have the same import<sup>82</sup> as the related ILC Draft Articles on Prevention of Transboundary Harm from Hazardous Activities.<sup>83</sup> These are limited to the *physical* consequences of actions that themselves must be of a physical quality.<sup>84</sup> Neither of these conditions is met in monetary relations. Monetary management policies are intangible actions and their direct consequences are not physical but *pecuniary*. Such consequences were explicitly excluded by the ILC as a type of harm that could trigger responsibility.<sup>85</sup>

Moreover, international "rules of abstention", used to ensure the co-existence between states, could be used to increase states' accountability. For example, the principle of non-intervention could be expanded by adopting a less stringent definition of coercion. Currently, intent on behalf of the acting state to make a structural change in the target state is required. Removing the subjective requirement of intent, while maintaining a high threshold of structural change, could be a solution. As a result, states would

<sup>80</sup> Mattoo & Subramanian, *supra* note , 10.

<sup>81</sup> International Law Commission, Draft Principles on the Allocation of Loss in the Case of Transboundary Harm Arising out of Hazardous Activities with Commentaries, UN Doc A/61/10, available at <http://untreaty.un.org/ilc/reports/2006/2006report.htm> (last visited 24 March 2010), 101-182.

<sup>82</sup> *Id.*, 117-118.

<sup>83</sup> International Law Commission, Draft Articles on Prevention of Transboundary Harm from Hazardous Activities with Commentaries, UN Doc A/56/10 available at <http://untreaty.un.org/ilc/reports/2001/2001report.htm> (last visited 24 March 2010), 144-170.

<sup>84</sup> *Id.*, 151, point 17.

<sup>85</sup> *Id.*, 151, point 16.

be found to intervene in the domestic affairs of another state when their actions bring about structural changes in the affected state, even if these changes were not specifically intended.

Two problems plague the efforts aiming to increase accountability for the external effects of a state's monetary management policies. First, the macro-economic background to establish harm and the causal link between this harm and another state's monetary management policies may simply be too complex. No matter what legal rule is developed, if the underlying economic facts are insufficiently understood, the legal rule will have very little meaning in practice. Second, none of these rules can adequately deal with omissions, e.g. when the negative effect is caused by a lack of regulation of credit creation by financial institutions.

Maybe a solution could be to relax the requirement of causality when an action or omission can be shown to have contributed to financial instability, even if specific instances of harm cannot be linked to these actions or if the harm cannot easily be quantified. This would make it easier for states to rely on rules of abstention against other states whose monetary management policies affect them negatively. Caution should however be taken so as not to cast the net too wide and prohibit benign acts, as many acts have consequences abroad that are not always easily foreseeable.

## 2. Rights of the Affected States

Given the practical problems of limiting acting states' sovereignty, this article proposes to increase the legal responses available to affected states against the negative effect of other states' monetary management policies as an additional step in modifying sovereignty.

Changed rules of co-existence, as discussed in the section E.IV.1.b), could be used as a legal basis for claims by affected states against the acting state. Nevertheless, as pointed out, the complexity of modern interdependence is an obstacle to the effective application in practice of the causality requirement in these rules of co-existence.

Another option could lie in the application of co-operative legal instruments, particularly trade liberalization instruments. The focus on trade liberalization instruments is justified by their important contribution to stimulating the creation and growth of the global economy. Typically, they include exceptions on trade liberalization commitments when other societal

values, such as financial stability or environmental protection, are at stake.<sup>86</sup> However, the problem is that these exceptions are often interpreted to favour the right to trade, even if trade imposes externalities on the trading partners.<sup>87</sup> Given that the problem lies with the interpretation rather than with the actual treaty provisions, an amendment is not necessarily required. Rather, a critical reflection on the values protected by sovereignty and their continued relevance in increasing interdependence may suffice to properly inform the interpretation of the relevant provisions. Better balanced exceptions would allow the affected states to restrict trade when this is required for the protection of other societal values.

Affected states could even consider going further by boycotting any state considered to cause a negative impact. This would signal to the acting state that with trade entitlements comes the responsibility to have an appropriate regulatory framework in place for related issues, such as monetary management in the domestic economy. However, this solution leaves much to be desired for a number of reasons. First, restrictions on trade with a single state go against the idea of non-discrimination that pervades the WTO rules, even if in practice trade sanctions have never explicitly been ruled illegal.<sup>88</sup> Second, boycotts have limited utility in protecting poor developing states against actions or omissions by their large trading partners. Since the highest profile current imbalances in the international monetary system are not divided along traditional North-South

<sup>86</sup> *General Agreement on Tariffs and Trade*, 30 October 1947, 55 U.N.T.S. 194, Art. XX. *Id.*, Arts XII and XVIII(9) and *General Agreement on Trade in Services*, 15 April 1994, 1869 U.N.T.S. 183, Art. XII contain balance-of-payments exceptions. A recent example of approved balance-of-payments restrictions is that of Ecuador, which was permitted to impose quantitative restrictions on imports to improve its balance-of-payments situation, see WTO Committee on Balance-of-Payments Restrictions, Members conclude consultations with Ecuador on balance-of-payments restrictions (4 June 2009) available at [http://www.wto.org/english/news\\_e/news09\\_e/bop\\_04jun09\\_e.htm](http://www.wto.org/english/news_e/news09_e/bop_04jun09_e.htm) (last visited 24 March 2010). The GATS, Annex on Financial Services, section 2(a), contains the “prudential carve-out” providing a debated exception for prudential regulation.

<sup>87</sup> Panel Report, United States – Measures affecting the Cross-Border Supply of Gambling and Betting Services, WT/DS285/R, 10 November 2004, para. 6.316: “sovereign right to regulate [...] ends whenever rights of other members under the GATS are impaired”.

<sup>88</sup> A. F. Lowenfeld, *International Economic Law*, 2nd ed. (2008), 915-916.

lines,<sup>89</sup> boycotts might still usefully come into play between the major economies. Last, but not least, even if only major economies would rely on trade sanctions, the door to potential abuse and to straight up protectionism would be wide open.

## F. Conclusion

This article has argued that the current international law conception of monetary sovereignty – and sovereignty in general – favours the freedom of states to act within their territory as they see fit. This focus overlooks the negative impact state actions can have on other states who, as a result, might see their effective freedom to act reduced, even though they are still legally the highest authority. International law insufficiently recognizes how easily ostensible legal authority can become a practical fiction in situations of increasing interdependence.

Given that sovereignty is a relational concept and not an atomistic one,<sup>90</sup> the rights of a state and its citizens to freely chart their economic course must necessarily be limited by the same rights of other states. This is far from a novel proposition, but instead is fundamental to international law.

To increase the compatibility of sovereignty with interdependence, this article has suggested a double rebalancing in the rights and obligations that stem from sovereignty: first, between the right of sovereign states to be free to act and that to be free from external interference, and, second, between the *de iure* authority to act – which is protected – and the *de facto* freedom to act – which is not effectively protected. The goal is to achieve a less cynical understanding of sovereignty where states cannot simply unload the costs of their actions or of providing a global public good on other states, and where states do not have to stand idly by when they experience an externally sourced negative impact.

To achieve this, this article has looked beyond directly limiting sovereignty. Limits will often be ignored when they run counter to states' individual interests, unless they are backed up by a strong and effective compliance mechanism. Instead, this article has proposed to complement

<sup>89</sup> Current account deficits can be found in the US, UK and Australia, while, e.g., China, Japan and Germany run current account surpluses, see United Nations Conference on Trade and Development, *supra* note .

<sup>90</sup> L. Elliot, 'Sovereignty and the Global Politics of the Environment: Beyond Westphalia?' in T. Jacobsen *et al.* (eds), *Re-Envisioning Sovereignty: The End of Westphalia?* (2008), 193, 195.

limits with stronger rights for the affected states. In the end, the rebalancing exercise is a zero sum game in which some states are allowed to do more, whereas others find their current rights limited.

The end result might only be a second best alternative, but this changed dynamic could create incentives for the acting states to engage in co-operative efforts to bring about a more effective multilateral solution.