May 16, 1988 - 88/94

Statement by the General Counsel
on Legal Effects of Approval or Nonapproval
of Exchange Restrictions by the Fund
Executive Board Seminar
June 3, 1988

1. The paper on Legal Effects of Approval or Nonapproval of Exchange Restrictions by the Fund recommends that the Executive Board consider the adoption of an authoritative interpretation of the first sentence of Article VIII, Section 2(b), supplementing the interpretation adopted by the Executive Board in 1949. 1/ This provision reads as follows:

> "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."

2. This provision sets out a rule that is binding on all members and must be applied by their courts. The issue of the application of Article VIII, Section 2(b), first sentence arises when a creditor brings an action in the courts of a member other than the member imposing the exchange control regulations and seeks the enforcement of a claim under a contract that is contrary to these exchange control regulations. According to Article VIII, Section 2(b), first sentence, the creditor's claim is not enforceable in these courts if (i) the exchange control regulations are consistent with the Articles (which means, if they constitute exchange restrictions subject to approval by the Fund, that they have been approved) and (ii) the claim is under a contract that constitutes an exchange contract involving the currency of the member that issued the regulations.

3. To ensure a uniform application of Article VIII, Section 2(b), first sentence by Fund members, some aspects of the provision (in particular, the meaning of "unenforceable") were clarified by the Fund, in an authoritative interpretation, in 1949. 2/ However, other

---

1/ The essential elements of the proposed interpretation are discussed on pp. 62-69 and 88 of the paper. The paper also examines the effects of approval of exchange restrictions on the relations between the Fund and the member imposing the restrictions (Part I) and its effects under the second sentence of Article VIII, Section 2(b) (Part II, pp. 69-70 and 74-78), but no action by the Executive Board on these aspects is proposed.

2/ The 1949 interpretation by the Fund is discussed on pp. 27-30 of the paper.

aspects have not been interpreted by the Fund, as a result of which the provision has not been uniformly applied by the courts of different members. 1/ In the opinion of the staff, this lack of uniformity in the interpretation of Article VIII, Section 2(b) by the courts of different members, and in particular of the terms "exchange contracts," is unsatisfactory. 2/ The Fund could ensure a greater measure of uniformity by adopting an authoritative interpretation of the most important aspects of Article VIII, Section 2(b), first sentence, because such an interpretation would be binding on all members, including their courts.

4. The interpretation proposed by the staff clarifies four elements of the provision:

(a) an "exchange contract" is a contract providing either for a payment or transfer of foreign exchange, or for an international payment or transfer (i.e., a payment between a resident and a nonresident, or a transfer of funds from one country to another);

(b) "exchange control regulations" are regulations pertaining to the acquisition, holding or use of foreign exchange as such, or to the use of domestic or foreign currency in international payments or transfers as such;

(c) a member's currency is "involved" by a contract when either the performance of the contract is to be made from assets located in the member's territory, or a resident of the member is a party to the contract;

(d) the date as of which the conditions of (i) involvement of a member's currency by a contract, (ii) contrariness of the contract to a member's exchange control regulations, and (iii) consistency of the regulations with the Fund's Articles of Agreement must be be assessed is the date on which performance of the contract is sought.

5. The following example illustrates the effect that Article VIII, Section 2(b), first sentence, as interpreted in accordance with the staff's proposal, could have on the outcome of judicial proceedings in the courts of members.

Assume a loan contract was concluded on September 30, 1987 between a bank, resident of country A (lender), and a public or

---

1/ For a description of the different interpretations of the main elements of Article VIII, Section 2(b), first sentence, see pp. 31-60 of the paper.

2/ Why such a lack of uniformity is undesirable is explained in the paper on pp. 60-61 and 87.

private company, resident of country B (borrower). The loan was disbursed upon conclusion of the contract. The contract provides that interest is payable by the borrower on January 1, 1988, in the lender's currency, in an account located in the lender's country. On December 1, 1987, the government of country B issues regulations prohibiting, for a period of two years, the payment of interest by its residents on their foreign debts. This prohibition constitutes an exchange restriction which is contrary to Article VIII, Section 2(a) of the Fund's Articles, unless it is approved by the Fund.

As a consequence, the borrower fails to pay the interest due under the loan on January 1, 1988. The borrower's failure to pay its debt is therefore the result of the exchange restriction imposed by country B and not of its unwillingness or its inability to pay (because of a lack of domestic resources, for instance), which would be a case of default and not an exchange restriction. The lender sues the borrower before the courts of country A (i.e., the country of the lender's residence). How would Article VIII, Section 2(b) affect the outcome of the litigation?

The court will have to determine whether the conditions for the application of the provision are fulfilled. If they are, it will refuse to enforce the claim of the lender. The conditions for the application of Article VIII, Section 2(b), first sentence are the following:

(i) The contract must be an "exchange contract." Under the interpretation proposed by the staff, an international loan contract is an exchange contract because it provides for an international payment (i.e., a payment by a resident of one country to a resident of another country). 1/ When a contract is not an exchange contract, it is not unenforceable under the provision, whether or not it is contrary to a member's exchange control regulations: it falls outside of the scope of the provision altogether.

(ii) The contract must involve the currency of the member that issued the regulations (country B). Pursuant to the staff's interpretation, country B's currency is "involved" in the sense of Article VIII, Section 2(b) either if the loan contract is to be performed with assets located in its territory or if one of its residents is a party to the

---

1/ The courts of some countries have interpreted the terms "exchange contracts" as contracts affecting a member's exchange resources; the loan contract described above would also constitute an exchange contract under that interpretation. In contrast, the courts of other members understand "exchange contracts" to be contracts for the exchange of currencies; a loan contract is not an exchange contract under that interpretation. For a description of these different interpretations in the courts of members, see pp. 31-41 of the paper.

contract. In the example above, country B's currency is involved, since the contract provides for the payment of interest by a resident of country B. 1/

(iii) The contract must be contrary to country B's exchange control regulations. In the example given above, it is clear that country B's regulations prohibit the performance of a clause of the loan contract, namely the payment of interest on January 1, 1988. Under Article VIII, Section 2(b), the court must ascertain whether the contract is contrary to the regulations at the time the creditor seeks the enforcement of its claim in court; it is irrelevant whether the contract was permitted under the regulations of country B that were in force when it was concluded (see (vi) below).

(iv) The regulations of country B to which the contract is contrary must be exchange control regulations. The regulations issued by country B clearly constitute exchange control regulations: they pertain to the use of foreign currency in international payments. They are, therefore, regulations of the type protected by Article VIII, Section 2(b).

(v) The regulations of country B must be consistent with the Articles. The regulations of country B prohibiting payment of interest under international loan contracts involve an exchange restriction subject to approval by the Fund under Article VIII, Section 2(a). Therefore, these regulations are consistent with the Articles only if they are approved by the Fund. 2/ If they are not approved (or if their approval has lapsed; see (vi) below), they are

---

1/ It is possible under Article VIII, Section 2(b) that the currencies of more than one member be involved. For instance, country A's currency is also involved since one of its residents (the lender) is also a party to the contract. This means that Article VIII, Section 2(b) would also operate in favor of any exchange control regulations issued by country A, provided all the other conditions for the application of the provision with respect to such regulations are fulfilled.

2/ As explained on pp. 4-5 of "Legal Effects of Approval or Nonapproval of Exchange Restrictions by the Fund," the Fund has adopted decisions setting out the conditions that must be fulfilled in order for it to approve exchange restrictions. Thus, the Fund is prepared to approve exchange restrictions imposed for balance of payments reasons only if they are necessary and temporary while the member is seeking to eliminate them. The Fund will not normally approve exchange restrictions that are discriminatory as between Fund members. In addition, with respect to exchange restrictions that give rise to external payments arrears, the Fund has stated that its approval of such restrictions would be predicated on a satisfactory program for the elimination of the arrears.

not protected by Article VIII, Section 2(b) and, therefore, the creditor's claim under the loan contract is not unenforceable under the provision.

(vi) The conditions of application of Article VIII, Section 2(b) must be fulfilled on the date the performance of the contract is sought in the court. The relevant date for ascertaining whether the conditions for applying the provision are met is the date on which the court must rule on the creditor's claim. It is not relevant whether or not these conditions were met on the date the contract was concluded.

Thus, the regulations of country B must be approved by the Fund as of the date enforcement is sought from the court. It is not relevant whether they were approved when the loan was concluded: thus, if they were approved at that time, but the approval has lapsed since then and has not been renewed, Article VIII, Section 2(b) does not apply and the creditor's claim is not unenforceable.

Similarly, what is important for purposes of Article VIII, Section 2(b) is whether the contract is prohibited by the regulations at the time its performance is sought, not whether it was prohibited when it was concluded. In the example above, the contract was concluded on September 30, 1987, when there were no exchange control regulations prohibiting its performance: such regulations were introduced on December 1, 1987. Assuming that they are still in force at the time the court must render its judgment, the court will have to declare the contract unenforceable under Article VIII, Section 2(b).

The condition of involvement of country B's currency also must be met on the date the enforcement of the contract is sought in court. For instance, if the borrower, which was a resident of country B at the time the loan contract was concluded, had moved its residence to another country by the time of the court judgment, country B's currency would not be involved under Article VIII, Section 2(b). 1/

If all these conditions are met, the court must reject the creditor's request for enforcement of its claim under the loan contract. The protection afforded to the exchange control regulations of country B will continue, however, only as long as the conditions for the application of Article VIII, Section 2(b) are

---

1/ Unless, of course, the alternative test of involvement of currency was met at that time, namely that the contract is to be performed with assets located in country B's territory (see (ii) above).

fulfilled. If, for instance, the approval by the Fund of the exchange restriction imposed by country B lapses and is not renewed, the creditor's claim under the contract would cease to be unenforceable under Article VIII, Section 2(b).

6. An authoritative interpretation by the Fund pursuant to Article XXIX(a) of the Articles as proposed by the staff would be binding on all members, including their courts. It could be adopted by the Executive Board by a majority of votes cast.