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Are Latin America and East Asia an Ocean Apart - The Connecting Currents of Asian Financial Crises

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"Are Latin America and East Asia an Ocean Apart?" The Connecting Currents of Asian Financial Crises

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"The global financial system has been evolving rapidly in recent years. New technology has radically reduced the costs of borrowing and lending across national borders, facilitating the development of new instruments and drawing in new players. One result has been a massive increase in capital flows . . . This burgeoning global system has been demonstrated to be a highly efficient structure that has significantly facilitated cross-border trade in goods and services and, accordingly, has made a substantial contribution to standards of living world-wide. Its efficiency exposes and punishes underlying economic weaknesses swiftly and decisively. Regrettably, it also appears to have facilitated the transmission of financial disturbances far more effectively that ever before."[1]

"Small open economies are like rowing boats on an open sea. One cannot predict when they might capsize; bad steering increases the chances of disaster and a leaky boat makes it inevitable. But their chances of being broadsided by a wave are significant no matter how well they are steered and no matter how seaworthy they are."[2]

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1. Alan Greenspan, Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services, U.S. House of Representatives, (Jan. 30, 1998).
2. J. Stiglitz, *Boats, Planes and Capital Flows*, FIN. TIMES, Mar. 25, 1998.

I. Introductory Remarks.

How to prevent domestic financial crises and the impact of international contagion from such crises is a most important and current topic, especially given the potential threat of these sorts of crises to the development process, as most recently evidenced by the East Asian financial crises. Nonetheless, no matter how successful the solutions may be to a given financial crisis in a given country, any financial crisis in any country is an expensive and unpleasant situation, with potentially, extremely negative consequences (economic, social, and political) for the financial system and economy of the country individually, its region, and possibly the international financial system and economy as a whole. Latin America is very familiar with these sorts of issues following its own financial and currency problems during the 1980s and the 1994 Mexican Peso devaluation.[3]

By their very nature, mechanisms for resolving financial crises are necessarily of an *ex post* nature.[4] While a number of *ex ante* measures may be taken, unfortunately in most areas there is no final agreement as to what is necessary and of greatest value in this respect. In that regard, this article discusses some of the developing mechanisms for preventing these sorts of crises in the domestic law reform efforts of emerging markets and developing countries. While some Latin American countries, like Brazil and Argentina, have made significant progress in this respect, persisting trade deficit and high indebtedness in hard currency represent a risk for the system and should be carefully prevented by their regulatory bodies.

Following a discussion of recent financial crises in Mexico and East Asia and their implications, this article discusses what emerging market countries can do to develop their domestic financial systems to help prevent the sorts of crises that have been so damaging to countries such as Mexico, Bulgaria, and Thailand, among others. Further, the article considers what appears to be an emerging international consensus in regard to the question of financial stability in emerging economies -- a development that this author regards as of significance from a number of different levels, from the domestic to the regional to the international.[5]

Unfortunately, despite the significant progress that may be made at the international and regional levels, the final response to financial crises must of necessity be at a domestic level (as, perhaps, coordinated on a regional/sub-regional level). Because of that, the author would like to draw from his experiences a few observations in respect to the needs of domestic law reform (as consistent with regional developments) in regard to crisis prevention and the development of financial stability. Finally, the article concludes with a few suggestions for the sorts of themes and issues that must be addressed in this process, particularly, the implications for Latin American countries.

3. *See generally* R. HAUSMANN & L. ROJAS-SUÁREZ, BANKING CRISES IN LATIN AMERICA (1996).
4. For a discussion of ex post measures in a variety of contexts, *see* BANK FAILURES AND BANK INSOLVENCY LAW IN EMERGING MARKETS (R. Lastra & H. Schiffman eds., forthcoming 1998).
5. For a more detailed discussion of these developments, *see* J. Norton & D. Arner, "International Cooperative Efforts and Implications for Law Reform," in R. Lastra & H. Schiffman, *op. cit.*, n.8.

II. Recent International Financial Crises.

While most discussion today centres on the recent East Asian financial crises commencing with Thailand's devaluation of the *baht* and request for international assistance in the summer of 1997, these were not the first international financial crises of their kind. In fact, similar crises were quite common in the nineteenth century, as has been documented in some detail by Professor Charles Kindleberger.[6] More recently, Mexico experienced a liquidity crisis in many ways similar to those in East Asia, which bears discussion as background to any consideration of the situation in East Asia today.

A. The Mexican Peso Crisis of 1994-95.[7]

Beginning in December 1994, Mexico experienced the onset of a severe liquidity crisis, subsequently termed the "Mexican Peso Crisis," the effects of which continue today in ongoing efforts to resolve Mexico's troubled financial institutions. The onset of the Mexican crisis became readily apparent as the large net inflows of capital, primarily from portfolio investors (and including the return of significant flight capital), that followed Mexico's accession to the North American Free Trade Agreement (NAFTA) and admission to the Organization for Economic Cooperation and Development (OECD) declined abruptly with perceptions of political instability following the assassination of presidential candidate Colosio in March 1994.[8] Outflows continued to increase due to continued perceptions of political instability in Mexico, and were further exacerbated by rising interest rates in the United States.

As a result of the impending exhaustion of its foreign currency reserves, on December 20, 1994, the Mexican Government unilaterally devalued the peso by fifteen percent, which resulted in the loss of almost U.S.$4 billion in foreign exchange reserves in two days; and on December 22, 1994, the Mexican Government allowed the peso to float from its previously fixed exchange rate parity with the U.S. dollar. The fact that the Mexican Government repeatedly announced that it would not devalue and float the peso substantially undermined market confidence when these actions were in fact effectuated. Further, as perceived uncertainties developed over the accuracy and extent of released Mexican economic data, the short-term impact of President Ernesto Zedillo's emergency economic relief plans on the Mexican economy was viewed to be highly uncertain. This, in turn, led

6. *See generally* C. Kindleberger, Manias, Panics and Crashes: A History of Financial Crises (rev. ed. 1989).
7. Portions of this section are taken from J. Norton, *The Mexican Peso Crisis and the Future of Financial Integration in the Americas, in* The Changing Nature of International Law in the Twenty-First Century, at ch. 12 (J. Norton, M. Andenas & M. Footer eds. forthcoming 1998). For a more detailed discussion, *see, inter alia,* D. Arner, *The Mexican Peso Crisis of 1994-95: Implications for the Regulation of Financial Markets,* 2 NAFTA Rev. 28 (1996).
8. *See* United States General Accounting Office, *GAO Report: Mexico's Financial Crisis: Origins, Assistance, and Initial Efforts to Recover* (GAO/GGD-96-56, Feb. 23, 1996). *See generally Evolution of the Mexican Peso Crisis, in* I.M.F., International Capital Markets: Developments, Prospects, and Policy Issues 53-64 (Aug. 1995); William A. Lovett, *Lessons from the Recent Peso Crisis in Mexico,* 4 Tul. J. Int'l & Comp. L. 143 (1996); Edwin M. Truman, *The Mexican Peso Crisis: Implications for International Finance,* 82 Fed. Res. Bull. 199 (Mar. 1996); Magda Kornis, *The Peso Crisis Revisited,* 5 NO. 4 Mex. Trade & L. Rep. 14 (Apr. 1, 1995); *idem., Financial Crisis in Mexico,* 5 NO. 2 Mex. Trade & L. Rep. 5 (Feb. 1, 1995).

investors to question Mexico's ability to service its short-term debt obligations, mainly in the form of dollar-denominated *tesobonos.* This all but extinguished institutional investor interest in subsequent *tesobono* auctions in early January 1995. By the end of January 1995, the peso had lost nearly twenty percent of its value against the U.S. dollar, and the Bolsa had fallen another thirty percent.

While the U.S. Treasury, U.S. Federal Reserve, and International Monetary Fund (IMF) officials purportedly did not anticipate the magnitude of the liquidity crisis despite the fact that they engaged in frequent consultations with Mexican Government and monetary officials, these institutions quickly concluded, however, that outside assistance would be required to prevent the imminent collapse of the Mexican banking and financial system and to limit the contagion effect of the crisis to other developing countries in the Americas and Asia. Importantly, the U.S. and international monetary officials viewed the crisis as a direct threat to the market-oriented economic and legal reforms the IMF and the United States had successfully urged both Mexico and other developing countries to adopt, and that had in the case of Mexico in fact served as the preconditions for the NAFTA. Further, the resulting U.S.-induced financial assistance package assembled by officials in the Clinton Administration made clear that the United States viewed such assistance to Mexico as a political and moral necessity following the entry into force of the NAFTA.

For these reasons, President Clinton announced a U.S. package of loan guarantees of up to U.S.$40 billion for Mexico on January 12, 1995, but concerns regarding Congressional approval led to its withdrawal. In addition, on January 31, 1995, President Clinton announced a U.S.$48.8 billion multilateral financial assistance package to Mexico consisting of a facility of U.S. reserves (U.S.$20 billion) collateralized by Mexican oil export revenues, loans from the IMF (U.S.$17.8 billion), loans from foreign governments assembled through the Bank for International Settlements (BIS) (U.S.$10 billion), and other sources, primarily commercial banks.

The package assembled by the Clinton Administration, the IMF, and the BIS served temporarily to calm institutional investors and international banks; but, further perceived uncertainties as to its ultimate approval by the U.S. Congress and whether the foreign exchange reserve figures disclosed by the Mexican Government were accurate quickly eroded any temporary confidence in this respect. Institutional investors continued to liquidate their positions in Mexican equity and debt securities, and currency traders continued aggressively to sell the peso. Thus, by March 1995, the peso reached a low of 7.45 to the U.S. dollar, and as the Banco de Mexico attempted to defend the peso from free-fall, Mexican interest rates rose to nearly eighty percent.

Perhaps more importantly for other developing countries, especially those in Latin America, the Mexican crisis procured a fundamental reevaluation of risk in emerging markets, which led to an uneven rebalancing of institutional investor debt and equity portfolios. This widespread portfolio rebalancing was the mechanism for transmitting the Mexican disturbance to other emerging markets. Immediately following the Mexican devaluation, and continuing over the first quarter of 1995, the uncertainty over the scope and prospects for a successful U.S.-induced rescue package (and the common acceptance that, if successfully completed, this would be a "one time deal"), caused most of the larger Latin American countries (especially Argentina, Brazil, and Venezuela) to experience relative degrees of volatility in their foreign exchange markets and noticeable declines in their equity markets, respectively, due to repercussions from the Mexican crisis.

Specifically, the international markets penalized countries that were viewed as suffering from similar characteristics to those underlying the Mexican crisis. Such characteristics included (i) low savings rates, (ii) large current account deficits, (iii) fragile banking systems, and (iv) significant volumes of short-term sovereign debt.[9] Although the overall international response to the ensuing Mexican liquidity crisis significantly reduced this so-called "Tequila Effect," the resulting lessons of overt reliance on potentially volatile capital flows from international investors should have been quite instructive for future regional policymaking in the Americas and elsewhere.

While several countries in Asia were in fact affected by the Tequila Effect,[10] they did not address their own potential vulnerabilities despite certain underlying similarities, perhaps because they viewed their own "Asian Model of Development," with its distinguishing high rates of personal savings and channeling of foreign capital into investment rather than domestic consumption, as producing some sort of "immunity" from the underlying changes in international capital flows. As subsequent events have shown, they were not wise to ignore the experiences of Mexico in 1994-95.

B. The Asian Financial Crises of 1997-98.

Notwithstanding the significant analyses of and international reactions to the 1994-95 Mexican crisis,[11] the scenario was repeated in all too similar a fashion in Thailand in 1997, with contagion severely impacting numerous countries in East Asia, resulting in international bailouts for first Thailand, followed by Indonesia and South Korea. The immediate cause of the onset of the crisis in Thailand, followed by Indonesia and South Korea, was a reversal of capital flows, upon which the economies of all three countries had become dependent. According to estimates by the Institute of International Finance,[12] net private in-flows to the five East Asian countries hardest hit by the crisis (Indonesia, South Korea, Malaysia, the Philippines, and Thailand) decreased from U.S.$93bn to U.S.$12.1bn, a reversal of U.S.$105bn on a combined pre-shock GDP of approximately U.S.$935bn, or approximately eleven percent of GDP. Of that U.S.$105bn decline, U.S.$77bn was in the form of commercial bank lending, U.S.$24bn in portfolio equity, and U.S.$5bn in non-bank lending, while direct investment remained constant at approximately U.S.$7bn. In contrast to the situation in Mexico, these flows had not been used to fund domestic consumption, but rather to fund extraordinarily high rates of investment (much of which

9. *See Turbulence in the Capital Markets, in* I.M.F., op. cit., n.13, at 6. *See also IMF Background Paper III, Mexican Foreign Exchange Market Crises From the Perspective of the Speculative Attack Literature, in* International Capital Markets: Developments, Prospects, and Policy Issues 70-79 (Aug. 1995).

10. Contagion from the Mexican liquidity crisis also extended to Asian developing countries, as most of these countries' currencies came under speculative attack in January 1995, resulting in investor liquidations of equity shares and ensuing reductions in equity prices in Indonesia, Malaysia, Singapore, Hong Kong and the Philippines of nearly 10 percent across the board by the end of January 1995 alone. Hong Kong's currency board exchange rate in particular experienced massive speculative pressure, thus forcing the Hong Kong Monetary Authority to tighten liquidity and force overnight interest rates to increase by five percentage points in January 13, 1995. *See* sources cited previous note.

11. For a discussion, *see* D. Arner, *op. cit.*, n.12.

12. *See* Institute of International Finance, *Capital Flows to Emerging Market Economies* (Jan. 29, 1998) <www.iif.com>.

were in speculative areas such as real estate, which created an exaggerated "asset price bubble").[13] Unfortunately, as currencies were defended, foreign exchange reserves were exhausted to the point where they were insufficient to cover the large stock of short-term foreign debt coming due. As a result, international bailouts became necessary in mid-late 1997 in Thailand, Indonesia, and South Korea.[14] Including contributions from multilateral and bilateral creditors, these financing packages totalled U.S.$17bn for Thailand, U.S.$40bn for Indonesia, and U.S.$57bn for South Korea.

Considerable consequences of the Asian crisis were felt in Latin American economies due to a loss of confidence in emerging markets by investors that produced a strong flow of capital out of the region. Brazil, one of the most affected countries, had to considerably raise interest rates and to implement a strong fiscal adjustment programme to protect the Real (Brazilian currency) value.[15] Fears of a Brazilian devaluation spread to other countries and in the case of Argentina, it led to hesitation in the stock exchange. The concern in Argentina was obvious: Brazil has become its most important MERCOSUR partner and a devaluation of the Real would put in risk the Argentine convertibility system due to a loss of competitiveness of its exports/imports to Brazil. On the other hand, strong adjustment and recession in the Brazilian economy would also lead to a serious decrease in exports to Brazil from Argentina and other Latin American countries.[16]

Two main alternative hypotheses have emerged in regard to the causes of the recent East Asian financial crisis.[17] Under the first view, espoused principally by Jeffrey Sachs of the Harvard Institute for International Development (HIID), financial panic resulting from sudden shifts in market expectations and confidence, in the face of otherwise sound fundamentals, was the key source of the initial turmoil and resultant contagion.[18] Under the second view, led by Paul Krugman of Massachusetts Institute of Technology (MIT), the crisis reflected an unsustainable deterioration in economic fundamentals and poor policies in the countries effected.[19] Even under this view, however, market overreaction and "herd behaviour" of investors caused the crisis to be more severe than warranted by the underlying weaknesses that led to the initial declines.

A third view incorporating elements of both fundamental weaknesses and international panic appears, however, to be the most appropriate description of the situation. Essentially, the initial onset of the crisis was made possible by fundamental errors and weaknesses, but the market reaction to these vulnerabilities as their extent was revealed

13. *See* I.M.F., *World Economic Outlook: Interim Assessment* (Dec. 1997), at 3-4 & Box 1, at 10-11.
14. For more detailed discussion, *see* T. Traissorat, *Thailand's Financial Crisis* 2 Y.B. INT'L FIN. L. (forthcoming 1998); Y. Shim, *South Korea's Financial Crisis* & D. Arner, *An Analysis of International Support Packages in the Mexican and Asian Financial Crises*, 2 Y.B. INT'L FIN. L. (forthcoming 1998).
15. *See Brasil defiende el real con un duro adjust fiscal*, LA NACIÓN, Nov. 10, 1997.
16. *See Complica al país la crisis en Brasil*, LA NACIÓN, Oct. 31, 1997; *Con la vista puesta en el gran vecino*, LA NACIÓN, Nov. 3, 1997; *Afectará a la Argentina el adjust en Brasil*, LA NACIÓN, Nov. 12, 1997.
17. *See* G. Corsetti, P. Presenti & N. Roubini, *What caused the Asian currency and financial crisis?, (visited* Aug. 12, 1998) <http://www.stern.nyu.edu/~nroubini/asia/AsianCrisis.pdf>.
18. *See* S. Radelet & J. Sachs, *The Onset of the East Asian Financial Crisis*, (visited Aug. 12, 1998) available at <http://www.hiid.harvard.edu/pub/other/eaonset.pdf> for the most comprehensive exposition of this model.
19. These ideas are expressed in a variety of speeches and papers by Paul Krugman, which can generally be found at <http://web.mit.edu/krugman/www>. *See also*, Corsetti et al., *op. cit.*, n.20, for a summary of these ideas.

was overdone.[20] This is based on a model of "self-fulfilling" crises, under which existing vulnerabilities make a crisis a possibility, but not a certainty. Unfortunately, the analysis to date does not suggest at what point underlying vulnerabilities will move from being the potential for a crisis and the point at which a crisis is a certainty. In this vein, according to Alan Greenspan, Chairman of the U.S. Federal Reserve Board, once the crisis was triggered by Thailand's forced abandonment of its exchange rate peg, it was apparently the combination of pegged exchange rates, high leverage ratios, weak banking and financial systems, declining demand in Thailand and elsewhere, and increased competition from countries such as China and India that transformed a correction into a collapse.[21]

This author suggests that in the face of potential self-fulfilling crises, countries should act in advance (*i.e.*, to take preemptive action) to reduce their potential vulnerabilities, both to an initial crisis and to contagion resulting from the onset of a crisis elsewhere, whether through panic, fundamental problems or the unpredictable potentialities of vulnerabilities. In effect, a main emphasis of this presentation concerns the importance of ongoing and meaningful ("bottom-up") economic, financial, and commercial law reform in Latin America.

Rather than look in detail at the factual background to the crisis in Asia, this article will instead focus on the vulnerabilities that caused or exacerbated the crisis and suggest what individual countries might do to reduce not only their own vulnerability to crisis but also to the possible contagion from crisis elsewhere. In addition, while there is at present extensive debate taking place about the role of the "architecture of the international financial system"[22] in both preventing and responding to crises, my focus will not be on the international financial system, but rather on the policies of individual countries within that system.

III. Implications of Recent East Asian Financial Crises.

Given that crises of these sorts were not uncommon in developing countries during the nineteenth century,[23] it can be prognosticated that in the unstable macro-environment of the twenty-first century, further crises are certainly possible if not likely, especially given that the underlying lessons of the Mexican crisis were not translated into reforms in other countries, especially in East Asia, despite the clear need to do so. A preliminary goal of this article then is to attempt to describe the lessons of Mexico and East Asia and their implications for emerging market economies and especially for Latin America.

20. The best explanation of this viewpoint is that of Charles Wyplosz of the Graduate Institute of International Studies, Geneva, and the Centre for Economic Policy Research in London. *See* C. Wyplosz, "Globalized Financial Markets and Financial Crises," conference paper for "Coping with Financial Crises in Developing and Transition Countries: Regulatory and Supervisory Challenges in a New Era of Global Finance," Forum on Debt and Development, Amsterdam (Mar. 16-17, 1998) (available at <http://heiwww.unige.ch/~wyplosz/fondad.pdf>). *See also* R. Dornbusch, *Asian Crisis Themes* (visited Feb. 1998) <http://web.mit.edu/rudi/www/asianc.htm>.
21. *See* Greenspan Testimony, *supra* note 1. *See also* I.M.F. Staff, *The Asian Crisis. Causes and Cures*, FIN. & DEV., June 1998, at 18.
22. *See, e.g.*, M. Camdessus, *The Role of the IMF: Past, Present, and Future*, Remarks by Michel Camdessus, Managing Director of the International Monetary Fund, at the Annual Meeting of the Bretton Woods Committee, Washington, D. C., Feb. 13, 1998, I.M.F. Speech 98/4 (available at <www.imf.org>).
23. *See generally* C. Kindleberger, *op. cit.*, n.11.

A. UNDERLYING CAUSES OF THE CRISES.

The underlying factors that eventually resulted in the financial crises in East Asia can be seen in over-valued and pegged real exchange rates, weak and unsupervised banking sectors with perceived implicit political guarantees, and ill-effected and dysfunctional financial market liberalization in the context of poor exchange rate and banking policies.[24]

First, exchange rate misalignment developed as a result of appreciation of the Japanese yen beginning in 1985 which led to aggressive monetary expansion in Japan, eventually resulting in asset price bubbles, first in Japan and later in a number of countries of East Asia. Second, this flow of capital was directed into fragile, bank-centered financial systems. Authorities in these systems permitted the development of serious asset-liability mismatches, with banks financing long-term domestic lending through short-term foreign currency borrowing. Involvement of foreign institutions was discouraged, except as lenders to domestic institutions, and domestic financial systems were politicized, with financial decisions being influenced both by government intervention and corruption, leading to perceptions of implicit government guarantees. Third, as export growth weakened due to exogenous factors such as the reduction in prices of computer chips due to excessive production (resulting from excessive government-directed investment), depreciation of the yen following the bursting of the Japanese bubble and the Chinese devaluation of 1994, the bad loans began to drag the financial systems away from supplying necessary credit to the economy. Finally, foreign lenders, rather than suffering from moral hazard as a result of the Mexican bailout, did not adequately predict the coming downturn. In addition, they perceived their positions to be protected as a result of domestic political factors.

Specific causes of the recent East Asian financial crises, then, can be delineated: exchange rate misalignments; weak financial institutions and weak financial supervision and regulation; a dramatic export slowdown; moral hazard leading to improper borrowing and lending decisions; improper sequencing of liberalization; and political instability and uncertainty.[25] Even Radelet and Sachs agree that the vulnerability to the crises resulted from macroeco-

24. T.N. Srinivasan, Comments on Jeff Sachs' presentation in the session "Emerging Market and Financial Crises," USAID Economic Growth Training Workshop, Leesburg, VA (Sept.29- Oct. 3, 1997) (available at <http://www.stern.nyu.edu/~nroubini/asia/SACHS.pdf>).

25. *See* M. Noland, *The Financial Crisis in Asia*, Statement by Marcus Noland, Senior Fellow, Institute for International Economics, before the Subcommittees on Asian and Pacific Affairs, and International Economic Policy and Trade of the International Relations Committee, US House of Representatives, Feb. 3, 1998. Similarly, Corsetti et al., *op. cit.*, n.20, identify five fundamental causes of the East Asian financial crisis, factors which were generally also present in the earlier crisis in Mexico in 1994-95. For an analysis of the Mexican crisis and its implications (which were largely ignored in East Asia), *see* Arner, *supra*, note 11. These five factors identified are briefly:

REAL APPRECIATION AND CURRENT ACCOUNT IMBALANCES, as a result of i) a reduction in Japanese demand due to their own financial stagnation; ii) the appreciation of the dollar relative to the yen, leading to a worsening of competitiveness among those East Asian countries whose currencies were effectively pegged to the US dollar; and iii) reductions in foreign demand for semi-conductors and other products, generally as a result of overcapacity.

A VICIOUS CIRCLE OF COMPETITIVE DEVALUATIONS, worsened by the initial devaluation of China in 1994, and worsened by the initial devaluation in China which led to games of competitive devaluation between countries seeking to remain competitive, culminating in pressure on the Hong Kong peg in late 1997.

nomic imbalances, weak financial institutions, widespread corruption leading to moral hazard problems, and inadequate legal foundations in each of the affected countries.[26]

It is important to point out that many of the weaknesses observed in the Asian Crisis can be currently seen in some Latin American countries: *e.g.*, Argentina has received a warning from the IMF in order to reduce its increasing trade deficit.[27] Opinions from the IMF have suggested that Argentina should increase capital reserve requirements for banks as well as interest rates in order to "decelerate" its economy, decreasing internal consumption and increasing exports.[28]

Moreover, during its recent participation at the meeting of ADEBA (Asociacion de Bancos Argentinos) in Buenos Aires, Professor Paul Krugman expressed his concern about the viability of the Argentine convertibility system in the long term[29] due to its possible lack of flexibility in the face of any financial crisis.

This concern is understandable when considering that in a system like the Argentine one, the Central Bank must perform a Currency Board role at the same time that it performs a Lender of Last Resort role. Problems could arise in case of significant financial difficulties where the Central Bank should protect the value of the currency, keeping enough reserves in hard currency and – at the same time – provide financial assistance to troubled institutions.[30]

EXCESSIVE INVESTMENT IN SPECULATIVE PROJECTS, facilitated by three factors: i) political direction of capital into certain industries; ii) moral hazard problems; and iii) low interest rates and high monetary supply growth in Japan that caused capital to flow to higher yielding countries. The eventual result was the creation of domestic asset price bubbles, financed often by unhedged foreign currency borrowing.

MORAL HAZARD EFFECTS OF IMPLICIT AND EXPLICIT GOVERNMENT BAILOUT GUARANTEES. The demand boom underlying foreign indebtedness was directly related to investor (both foreign and domestic) perceptions that political motivations would lead to the bailout of financial institutions and companies that ran into potential difficulties. These effects were magnified as the countries' financial systems were deregulated in the early 1990s, leading to increased international exposures, without the development of effective domestic regulation and supervision.

ACCUMULATION OF SHORT-TERM FOREIGN-CURRENCY DENOMINATED DEBT. In East Asia, a large fraction of foreign debt accumulation took the form of short-term foreign-currency denominated and unhedged bank loans, whether to corporates or more generally to financial institutions. This process was exacerbated by foreign investor over-optimism and lack of diligence, potentially as a result of the Mexican bailout in 1995, and by perceptions of implicit government guarantees of politicized financial institutions and corporates. Due to the lack of effective securities markets in these countries, liabilities primarily took the form of short-term debt.

26. *See* Radelet & Sachs, *supra* note 18, at 31-32.
27. *See Roque Fernandez prepara una explicacion para el FMI*, CLARIN, Mar. 14, 1998; *El FMI exige al gobierno otro adjust economico*, CLARIN, Mar. 18, 1998; *Basic instincts say stick with the dollar*, FIN. TIMES, May 5, 1998. *See also Grave: Deficit de Argentina y Brasil iguala a Asia*, AMBITO FINANCIERO, Jan. 20, 1998.
28. *See* El Cronista en Internet, *Frenarian la economia con encajes* (Mar. 18, 1998) <http://www.cronista.com/Dia/Econ15.htm>.
29. *See Krugman: La convertibilidad es como un chaleco de fuerza*, AMBITO FINANCIERO, May 19, 1998.
30. *See* Caprio, Gerard Jr., Michael Dooley, Danny Leipziger and Carl Walsh, "The Lender of Last Resort Function under a Currency Board. The case of Argentina", The World Bank Policy Research Department. Finance and Private Sector Development Division, September, 1996. Policy Research Working Paper 1648. For a discussion of this thesis in a wider context, *see* B. EICHENGREEN, GLOBALIZING CAPITAL: A HISTORY OF THE INTERNATIONAL MONETARY SYSTEM (1996).

However, it must be said that during the Mexican Peso devaluation of 1994, Argentina strengthened its tools for crisis management through the creation of two trusts for the assistance of troubled financial institutions[31] and the implementation of a deposit insurance system, defined by the law as limited, private, mandatory, and financed by banks and investors. These improved tools for crisis management allowed Argentina to face illiquidity problems of nine financial institutions, among which just one needed to be submitted to liquidation procedures (Caja de Crédito Pavón). At the same time, seven other financial institutions were acquired by others banks (Banco Caseros, Banco Buci, Banco de Azul, Coopesur, Platense and Banco de Credito Provincial, which reappeared in the market with the name "Mercobank" and Banco Patricios), and one institution is under a suspension applied by the BCRA (Banco Medefin, which actually seems to be near to a liquidation procedure).[32]

B. SELECTIVE UNDERLYING VULNERABILITIES.

The following is a brief discussion of three underlying vulnerabilities respecting financial crises. Other significant factors will be dealt in a more integrated manner in Part IV of this article.

1. *Moral Hazard and the Role of the Banking System.*

Most analyses agree on a fundamental role of the banking system in explaining both the East Asian crises and the earlier Mexican crisis. This line of reasoning suggests that a significant problem in these cases was excessive bank lending following financial market liberalization. Domestic banking crises are common in developing countries for a variety of reasons; often they are the result of bad lending practices, exacerbated by political influences on bank lending or actual policy lending to state-owned enterprises or politically favored enterprises. These problems are exacerbated when banks' source of funds is borrowing in unhedged foreign currency, because in the event of currency pressures, domestic on-loans go into default, worsening domestic lenders' balance sheets as their own currency position worsens due to external unhedged borrowing. Given investor overreaction leading to denial of roll-over treatment for existing debt, a domestic crisis quickly takes on regional and even international proportions. Importantly, all of these problems were worsened by a financial system that is fragile, and poorly regulated and supervised.

It has long been realized that financial intermediaries whose liabilities are guaranteed by the government pose a serious problem of moral hazard: the U.S. savings and loan debacle being the classic example.[33] The case in East Asia, however, is more murky because creditors of financial institutions did not receive explicit guarantees, but rather perceived

31. Presidential Decree No. 286/95 has created the trust called "Fondo Fiduciario para el Desarrollo Provincial" (Provincial Development Fiduciary Fund) aimed to help troubled provincial banks subject to privati-ation processes. Private banks can receive assistance from another trust, called "Fondo Fiduciario de Capitali-ación Bancaria" (Fiduciary Fund for Banking Capitali-ation") created by Presidential Decree No. 298/97.

32. *See* Javier Blanco, *Evitar los contagios*, LA NACIÓN, Mar. 20, 1998. *See also El Mayo se quedaría con el Banco Patricios*, AMBITO FINANCIERO, May 18, 1998.

33. P. Krugman, *What happened to Asia?* (Jan. 1998) <http://web.mit.edu/krugman/www/DISINTER.html>. For a detailed discussion, *see* J. Olsen, *Banks in Distress: Misdirection in Public Policy and Law* (forthcoming 1998).

that they would be protected from risk due to implicit guarantees, enforced by the politicization of the financial system. Moral hazard implications must be made both credible and explicit: if there is no deposit insurance scheme then precommitment to non-bailout policies must be explicit.

Other deficiencies related to the banking system have been observed in the case of Mexico. Although there have been achievements obtained since 1995, its financial system is still vulnerable to major financial shocks (although this is a common feature in all Latin American financial systems).

Furthermore, the Mexican banking system gives room to problems originating in moral hazard: the mechanisms of intervention, recapitalization and bailouts of troubled institutions in Mexico, the existence of debtor aid programs that might encourage some debtors to defer the payment of their obligations to receive government assistance, and the lack of an appropriate deposit insurance system with a "de facto" 100% deposit coverage by the government since from the beginning of the crisis it has indicated that it will fully guarantee commercial banks' obligations, except subordinated debt.[34]

At the same time, a weak bankruptcy system and a -some times- merely formal performance of banking regulations add more troubles to the Mexican banking system. These issues continue to unease foreign investors[35] and they need to be properly dealt with and solved by the Mexican authorities.

2. *Improper Sequencing of Liberalization.*

Analysis suggests that financial market liberalization may be the best predictor of financial crisis: this has been true in Latin America and the United States in the 1980s, in Europe in the early 1990s, in Mexico in 1994, and in Asia in 1997.[36] In East Asia, financial liberalization lifted some restrictions, including on-bank lending to real estate, before putting in place a sound regulatory framework.[37]

In terms of self-fulfilling crises, financial liberalization makes attacks possible and exposes underlying vulnerabilities to the vagaries of international capital markets. The lesson is that financial liberalization should only be contemplated when the situation is ripe. First, significant financial weaknesses, such as banking system weaknesses, large external debt, high unemployment, and unsettled macroeconomic conditions, must be eliminated. Second, countries that accept full capital mobility must sacrifice either fixed exchange rates or monetary policy independence. Monetary policy independence requires a reasonably flexible exchange rate, while a tight exchange rate requires the abandonment of monetary policy independence, for instance through a currency board arrangement. Full capital liberalization should be the last step of this process.

34. *See* Sri-Ram Ayer, *Anatomy of Mexico's Banking System Following the Peso Crisis,* WORLD BANK SECTOR REP. (1996), at 19.
35. In May 1998, Moody's Investors Service cautioned that Mexican banking system is still affected by extremely weak financial fundamentals and that Mexico has the lowest banking strength rating (E+) of any major country in Latin America.
36. *See* Wyplosz, *supra* note 20, at 2, 10-11.
37. *See* J. Stiglitz, *Bad Private-Sector Decisions,* WALL ST. J., Feb. 4, 1998, at A22.

3. *Political Instability and Uncertainty.*

As in Mexico, perceptions of political uncertainty and instability were very significant causes of the initial confidence crisis among external investors in East Asia. Much as in Mexico, perceptions of the weakness and inability of the Thai Government to deal with underlying economic problems, uncertainty over the continued health and political viability of President Suharto in Indonesia, and the December elections in South Korea caused investors to question the political stability of the three countries which eventually required bailouts. While countries such as Malaysia and the Philippines were also badly effected, their perceived levels of political stability were viewed much more favorably than in the bailout candidates. Political problems also impeded the implementation of appropriate political responses to the impending and developing financial problems, most especially in Indonesia. While the initial responses in Thailand and South Korea were the occasion of much uncertainty, the situation was quickly taken in hand and perceptions of political stability and eventual successful reform yielded rapid benefits, giving hope for a rapid turn around, as has in fact occurred in Mexico. Indonesia's continued vacillation has undermined perceptions of its economic situation and led to the present unrest.

A lesson from the East Asian and Mexican financial crises is that countries with weak and indecisive governments and institutions in conjunction with other underlying vulnerabilities are more likely to suffer external or internal confidence crises than those with perceived strong and decisive governments and capable institutions. Further, such governments and institutions have the potential to severely worsen the effect of any crisis or contagion through their ineptitude. The case of Indonesia is inescapable; moreover, the lessons for Russia, among others, are clear. In this regard, Latin American countries should recognize that international perceptions of political instability will weaken international confidence and increase vulnerability to international capital withdrawal.

C. WITHSTANDING FUTURE CRISES.

The collective interconnection of major developing countries into the international financial system implies that disturbances in any other market, whether developed or developing, can be rapidly translated in the form of financial contagion into developed or developing markets. Empirical investigations by the IMF and other international organizations have confirmed that the increase in cross-border capital flows over the past ten years, most notably through portfolio investment, has bound national capital markets more closely together and that the cross-border translation of disturbances can occur with unnerving speed. This concept was reinforced by the ensuing contagion from the Mexican and East Asian crises extending to other countries in the region and world-wide, as most countries in these regions, even those with fundamentally sound economic indicators, experienced temporary exchange and equity market disturbances during the respective crises.[38]

According to Alan Greenspan, vicious crisis cycles such as that in Mexico in 1994 and Asia in 1997 may in fact be "a defining characteristic" of today's high-tech international financial system.[39] As a result, while human panic reactions may not be controllable, at least the imbalances that exacerbate them can be addressed, preferably in advance.

38. *See* I.M.F., *International Capital Markets: Developments, Prospects and Key Policy Issues* (Nov. 1997); *id., International Capital Markets* (Aug. 1995), *op. cit.*, n.13.

39. Greenspan Testimony Jan. 30, *supra* note 1.

According to Stanley Fischer, First Deputy Managing Director of the IMF, in order to avoid crises, a country needs both sound macroeconomic policies and a strong financial system.[40] A sound macroeconomic policy framework is one that promotes growth by keeping inflation low, the budget deficit small, and the current account sustainable. This is traditional IMF fare, and is reflected in the IMF's recent consultations with various countries in Latin America.

The focus on the importance of a country's financial system is a more relative development. The critical role of the strength of the financial system was becoming clear before the Mexican crisis; it was crystal clear in that crisis and its aftermath; and it has been equally clear in the East Asian crises and their aftermath. In this respect, Greenspan notes eight factors that have been present in international and economic disruptions, but which appear in more stark relief today, namely:[41] excessive leverage;[42] interest rate and currency risk;[43] weak banking systems;[44] interbank funding, especially in foreign currencies;[45] moral hazard;[46] weak central banks;[47] underdeveloped securities markets;[48] and inadequate legal structures.[49]

40. S. Fischer, *How to Avoid International Financial Crises and the Role of the International Monetary Fund*, 15th Annual Cato Institute Monetary Conference, October 14, 1997, Washington D.C., (Oct. 14, 1997) <http://www.imf.org/external/np/speeches/1997/101497.htm>.
41. Greenspan Testimony Jan. 30, *supra* note 1.
42. Exceptionally high leverage is often a symptom of excessive risk-taking that leaves financial systems and economies vulnerable to loss of confidence. This concern is particularly relevant to banks and other financial intermediaries, whose assets typically are less liquid than their liabilities and so depend on confidence in the payment of liabilities for their continued viability. Further, excessive leverage can create problems for lenders that can in turn spread to other borrowers that rely on those lenders. This is particularly the case in Korea and in Japan. *Id.*
43. Banks, because of their nature, lend long and fund short, thereby incurring interest rate or liquidity risk. This exposes them to shocks, especially those institutions with low capital-asset ratios. These problems are exacerbated when financial intermediaries borrow in unhedged foreign currency, with the result of potential bank runs following the collapse of the domestic currency. *Id.*
44. When banks are undercapitalized, have lax lending standards, and are subject to weak supervision and regulation, they become a source of systemic risk, both domestically and internationally. *Id.*
45. Despite its importance for distributing savings to their most valued use, short-term interbank funding, especially cross-border, may turn out to be the "Achilles' heel" of an international financial system that is subject to wide variations in confidence. *Id.*
46. The expectation that monetary authorities or international financial institutions will come to the rescue of failing financial systems and unsound investments has clearly engendered a significant element of moral hazard and excessive risk-taking. Further, the dividing line between public and private liabilities too often becomes blurred. Interest and currency risk-taking, excessive leverage, weak financial systems, and inappropriate interbank funding are all encouraged by the existence of a excessive safety net (*e.g.*, U.S. S&L crisis) or perceptions of the existence of an excessive safety net (e.g., East Asia). *Id.*
47. To effectively support a stable currency, central banks need to be independent, *i.e.*, their monetary policy decisions are not subject to the dictates of political authorities. *Id.*
48. Recent adverse banking experiences have emphasized the problems that can arise if banks are almost the sole source of financial intermediation. Their breakdown induces a sharp weakening in economic growth. Therefore, a wider range of non-bank institutions, including viable debt and equity markets, are important safeguards of economic activity when banking fails. *Id.*
49. An effective competitive market system requires a rule of law that severely delimits government's arbitrary intrusion into commercial disputes. While defaults and restructuring are in some cir-

This author would suggest that in fact all of these problems are "law-based failures" and must be addressed in that context.

IV. Law Reform and Financial Stability.

Consistent with the notion of "law-based failures," scholars, governments, international institutions, and business now recognize that one of the most important aspects of economic growth for any economy is financial stability,[50] and that financial stability is based on the underlying legal and financial infrastructure in an economy. For the first time, an international consensus is developing on exactly what is necessary in the way of legal and financial infrastructure for financial stability.[51] The consensus in this area is that in order to develop economically, emerging markets must have in place appropriate structures to guarantee financial stability, especially given the increasing mobility of international capital and the reliance of emerging markets on that capital to fund their own development processes. Further, as Japan is experiencing today, an effective financial infrastructure is as necessary to a developed economy as to an emerging economy, such as Thailand, although as both Thailand and Mexico have experienced, it can be less precipitous for a developed economy to extricate itself from problems than for an emerging economy.

In developing financial stability and the requisite legal infrastructure, four issues seem to be paramount: (i) a robust financial system, including an independent central bank; (ii) corporate governance and the creation of an effective incentive and monitoring structure for corporate performance; (iii) strengthening and expanding domestic capital markets; and (iv) the need for an effective insolvency regime combined with the creation of a social safety net, in order to resolve businesses and prevent political and social instability.

A. Building Robust Financial Systems.

Experience has shown that a robust financial system is one of the most important components of successful and sustainable development. A robust financial system allows a country to mobilize domestic savings and international finance and to channel these resources to productive, growth-enhancing investments.[52] Further, the existence of an independent central bank enables a country to have pre-determined and credible objectives underlying financial stability.[53]

Many of the elements required for building robust financial systems are now understood. In response to an initiative at the Lyon Summit of the Group of Seven in June 1996,

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cumstances unavoidable and in fact a beneficial element of renewal in a market economy, an efficient bankruptcy statute is required to aid in this process, including in the case of cross-border defaults. *Id.*

50. This consensus was recently detailed in the Report of the Group of Ten (G-10) Working Party on Financial Stability in Emerging Markets, *Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems* (visited Apr. 1997) <http://www.bis.org>.
51. These ideas are being increasingly formalized: *see* I.M.F., *Financial Stability in Emerging Markets* (Dec. 1997).
52. *See, inter alia*, E.P. Davis, Debt, Financial Fragility and Systemic Risk (1995).
53. *See generally* R. Lastra, Central Banking and Banking Regulation (1996).

representatives of the countries in the Group of Ten and of emerging market economies have jointly sought to develop a strategy for fostering financial stability in countries experiencing rapid economic growth and undergoing substantial changes in their financial systems.[54] In their Report, the G-10 focused on three key elements necessary to the development of a robust financial system: (1) creation of an institutional setting and financial infrastructure necessary for a sound credit culture and effective market functioning; (2) promotion of the functioning of markets so that owners, directors, investors, and other actual and potential stakeholders exercise adequate discipline over financial institutions; and (3) creation of regulatory and supervisory arrangements that complement and support the operation of market discipline.[55] The creation of an independent central bank with clearly defined objectives should be added to this list.

Importantly, given that a safe and efficient financial system is essential for the functioning of any economy, the G-7 at their Lyon Summit in 1996, in the wake of the Mexican Peso Crisis of 1994-95, directed the international financial institutions, especially the IMF, the World Bank, and the Basle Committee on Banking Supervision, to develop standards for financial regulation to be implemented in both developed and developing countries, as well as to develop solutions for domestic crises with international implications, such as the Mexican Crisis.[56]

As a result, the international financial organizations (IFOs) have been producing standards in a number of areas: the Basle Committee on Banking Supervision (Basle Committee) published its Core Principles for Effective Banking Supervision (recently finalized);[57] the International Association of Insurance Supervisors (IAIS) published supervisory principles in September 1997;[58] the International Organisation of Securities Commissions (IOSCO) will soon present securities principles;[59] and the International Accounting Standards Committee (IASC) will present a comprehensive set of international accounting standards to the membership of IOSCO for approval in July of this year.[60] In addition, the Joint Forum on Financial Conglomerates (a cooperative effort of the Basle Committee, IOSCO, and the IAIS) is also to produce some sort of "principles" document.[61]

54. *See* G-10 Report, *supra* note 50, at 1.
55. *Id.* at 3-4.
56. *Id.* at 49.
57. Basle Committee on Banking Supervision, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (Sept. 1997). *See generally* the BIS website for further information at <http://www.bis.org>.
58. Information concerning the IAIS can be found at <http://www.naic.org/otherinf/iais/iaistoc.htm>.
59. Information concerning IOSCO and its available documents can be found at its Internet home made at <http://www.iosco.org>.
60. *See* IOSCO, *Annual Report 1996*. *See also* the website of the IASC at <http://www.iasc.org.uk>.
61. According to a recent BIS Press Release: The Joint Forum on Financial Conglomerates (Joint Forum) was established in early 1996 under the aegis of the Basle Committee on Banking Supervision (Basle Committee), the International Organi‿ation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to take forward the work of the Tripartite Group whose report was released in July 1995. The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. Thirteen countries are represented in the Joint Forum: Australia, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Swit‿erland, United Kingdom and United States. The EU Commission is attending in an observer capacity. In accordance with its mandate which was agreed by the Basle Committee, IOSCO and the IAIS (collectively "the parent

Latin American countries should consider becoming further involved with these international efforts in order to bring more stability into their financial systems, taking into account these international developments as one methodology for the establishment of an internationally accepted "floor" for regional efforts aimed at development, increased market access within the region and eventually internationally.

1. *Effective Banking Regulation and Supervision.*

Recent work by the Basle Committee (composed of the G-10 central bank governors) and others has shown that one of the most prevalent problems in any emerging economy is effective regulation and supervision of the banking system. In essence, the goal is the combination of strong incentives for prudential behaviour with an effective regulatory system.[62] Incentives are provided through capital requirements and franchise value, *i.e.*, the value of future profits; while regulation should focus on every level of financial activity, from risk management to individual transactions.

While of fundamental importance, capital adequacy has to be judged on the basis of the risk characteristics relevant to banks in each country and the Basle risk-based capital adequacy standards must be taken as guides or minimums, and certainly not as a maximum of capital adequacy irrespective of country specific factors.[63] In addition, supervision and regulation should address excess non-performing loans expeditiously.[64]

The Basle Core Principles present the basic outline for effective banking supervision and are intended to serve as a basic reference for supervisory and other public authorities in all countries and internationally. Essentially, the Basle Committee has prepared a list of twenty-five basic principles that should underlie the banking supervisory policies and structures. These principles are then enumerated in a *Compendium* of existing Basle Committee documents, which are cross-referenced in the Core Principles and are intended to expand upon them and explain their application and are to be periodically updated, as additional documents are released.[65]

In terms of the twenty-five Core Principles themselves, they are divided into seven sections: preconditions for effective banking supervision (Principle 1), licensing and structure (Principles 2 to 5), prudential regulations and requirements (Principles 6 to 15),

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organizations"), the Joint Forum has reviewed various means to facilitate the exchange of information between supervisors within their own sectors and between supervisors in different sectors and has investigated legal or other barriers which could impede the exchange of information between supervisors within their own sectors and between supervisors in different sectors. Also, based on its mandate, the Joint Forum has examined ways to enhance supervisory coordination, including the benefits and drawbacks to establishing criteria to identify and define the responsibilities of a coordinator, and is working on developing principles toward the more effective supervision of regulated firms within financial conglomerates. Basle Committee, *Press Release: Supervision of Financial Conglomerates* (Feb. 1998) <http://www.bis.org>.

62. *See* J. Stiglitz, Statement to the Meeting of Finance Ministers of ASEAN plus 6 with the I.M.F. and the World Bank by Joseph Stiglitz, Senior Vice President and Chief Economist, The World Bank, Kuala Lumpur, Malaysia (Dec.1, 1997) <http://www.worldbank.org/html/extdr/extme/jssp120197.htm>.
63. Srinivasan, *supra* note 24.
64. Greenspan Testimony Jan.30, *supra* note 1.
65. Basle Committee on Banking Supervision, *Compendium of Documents Produced by the Basle Committee on Banking Supervision* (Apr. 1997) (updated).

methods of ongoing banking supervision (Principles 16 to 20), information requirements (Principle 21), formal powers of supervisors (Principle 22), and cross-border banking (Principles 23 to 25). While these Principles are very instructive in terms of coverage and issues, they nonetheless must be implemented by domestic authorities individually.

In terms of basic structural issues, there are three that appear to be of the most significance, and these need to be addressed each in turn. First, decision-makers must address the question of whether banking supervision should be placed under the ambit of the central bank. Second, given the increasing trend internationally towards universal banking, the question is whether regulation of banks should be taken from an institutional or a functional basis. Third, decision-makers must address the issues which arise from the increasing prominence of financial conglomerates, and the regulatory structural questions that these issues raise, namely whether a single financial regulatory scheme is a logical step in an evolution of regulatory approaches. Each of these decisions requires complex analysis, from both a political and a legal standpoint, in order to assure that domestic goals are adequately addressed.

2. *Lending Infrastructure, Corporate Governance, and Hedging Markets.*

Beyond the various emerging "Core Principles," recent studies have suggested a number of factors that are of importance in the development of a stable and effective banking system. Of special importance are the development of adequate lending infrastructure, effective corporate governance for banks, and access to derivatives markets.[66]

First, an adequate lending infrastructure is based on the problem of mismatches between bank lending and borrowing ("duration"). An adequate lending infrastructure essentially enables banks to extend the time horizon of their loans through greater security. In this regard, two aspects of lending infrastructure are especially important: an effective system for taking security and the development of credit rating systems and/or agencies. An effective system for the taking of security allows banks to be more confident that they will be able to realize collateral taken on loans.[67] Providing a system of registering and taking security therefore provides two functions for bankers: first, it allows them to reduce monitoring costs because their investment is protected; and second, it provides greater certainty in making lending decisions, thereby increasing the number of such decisions that will be made. The development of credit rating systems and agencies serves similar functions in that they decrease the need for initial research and subsequent monitoring, thereby reducing the cost of credit and increasing lending and loan maturities.

Second, effective corporate governance for banks is necessary to avoid the sorts of problems faced by the United States during the S&L crisis of the 1980s. Banks must be adequately capitalized so that their investors have incentives to protect their own investments by making careful borrowing and lending decisions. As an aspect of this, banks must know that they will be allowed to fail if they make bad decisions; otherwise, the provision of cap-

66. *See, inter alia,* P. HONOHAN, BANKING SYSTEM FAILURES IN DEVELOPING AND TRANSITION COUNTRIES: DIAGNOSIS AND PREDICTIONS, (BIS Working Paper No. 39, Jan. 1997); M. GOLDSTEIN & P. TURNER, BANKING CRISES IN EMERGING ECONOMIES: ORIGINS AND POLICY OPTIONS, (BIS Economic Paper No. 46, Oct. 1996).

67. For a thorough discussion of the role of secured transactions, *see* EMERGING FINANCIAL MARKETS AND SECURED TRANSACTIONS (J. Norton & M. Andenas eds., 1998).

ital has no real disciplinary effect. This is another aspect of the "moral hazard" problem mentioned throughout this paper. Further, managers must be responsible to owners – also achievable through adequate capitalization and limitation of moral hazard.

Third, banks and other financial institutions need to have access to advanced risk reduction and hedging techniques, especially as currencies move closer to full convertibility. During the Mexican Crisis, the lack of access to risk sharing and hedging techniques contributed to the severity of the impact of the crisis on the domestic financial system. During the East Asia crises, because of perceptions of currency stability, borrowers and lenders did not protect their foreign currency positions through hedging activities. In this regard, domestic derivatives markets should be developed, albeit very carefully, due to the complexities and potential dangers of these sorts of financial instruments. Recent standards by IOSCO are instructive in this respect. The development of some Latin American countries capabilities in this regard are instructive for emerging markets around the world.

B. Effective Corporate Governance.

In terms of improving the productivity of assets, a vital consideration is corporate governance. Without effective corporate governance, companies will not become more productive and efficient. Importantly, no single form of corporate governance model has emerged as dominate, but the important consideration is that corporations are in some way accountable to and monitored by their owners – whether public or private. Fundamentally, corporate governance is a reflection of policy choices, but it is also a reflection of underlying legal choices in the organization of companies and financial relationships.[68] Policy-makers must realize that the legal framework of business and finance relationships will determine the outcome of the economy's corporate governance system. Further, corporate governance concerns, especially in respect to the protection of minority shareholders' rights, are of great importance to both international and domestic investors. While numerous countries have been looking at these issues around the world, no international consensus yet exists. The OECD, however, may attempt to synthesize some sort of statement of international principles of corporate governance.

In line with increasing international concern in respect to corporate governance, this is an important issue that Latin American countries must address. While conglomerates are beginning to desegregate to some extent, the historical concentration of ownership and cross-linkages needs to be addressed, not only to encourage the involvement of international investors, but also to bring a larger portion of the population into the financial system and reduce efficiency-reducing structures while enhancing capital market liquidity.

C. Strengthening Domestic Capital Markets.

Domestic capital markets serve as an additional outlet for savings and mechanism for the generation of investment; however, they take time to develop, especially the understanding of their dangers posed to investors, as is especially clear from the political instability caused by the collapsing of pyramid schemes in Albania. Another, less threatening,

68. For development of this thesis in the context of the U.S., *see* M. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994).

situation can be seen in Shanghai where riots have occurred over share allocations.[69] This situation is a danger in that there exists the possibility of the development of a classic "bubble market" in which share prices are pushed too high too quickly, and then when investor confidence is shaken by some event, crashes very quickly and with potentially damaging consequences, as happened in the United Kingdom in 1719[70] and the United States in 1929.[71] In both cases, the crash led to severe economic consequences and a strong legal and popular reaction against capital markets.

This brings to light the need, then, for the second level of building blocks (following the creation of a general corporate infrastructure) necessary for the further expansion of domestic capital markets: a system of securities regulation that fosters market confidence through transparency and investor protection. As has been clearly shown by the development of the U.S. securities markets and the increasing convergence of domestic securities regulatory regimes internationally, as demonstrated by harmonization in Europe and proposals in Japan, transparency and a strong system of securities regulation fosters confidence in domestic capital markets, increasing investment and efficiency.[72]

In order to increase international investment and its role as a potential engine for development, Latin American countries need to address these problems because the capital market is not only a mechanism to attract portfolio investment, but also to attract foreign direct investment (FDI) and venture capital investors, to whom the stock exchange and its provision of liquidity provides a necessary and attractive means of eventual exit. Some Latin American countries at this time have poorly developed capital markets and corporate legal infrastructures, the development of which should be considered.

As one mechanism of developing domestic capital markets, further privatization is an obvious (and generally effective) choice.[73] While there may be political obstacles in some countries in the region to such a process, some Latin American countries have implemented large processes of privatization, *e.g.*, Argentina has privatized some important financial institutions like the Banco Hipotecario Nacional and Caja Nacional de Ahorro y Seguro, and has recently announced its intention of privatizing the Banco de la Nacion Argentina,[74] the largest Argentine bank currently holding U.S.$9bn in deposits and 526 branches.

Finally, as already mentioned, the development of domestic derivatives markets for risk sharing and hedging are important to financial stability and also allows investors (especially institutions) to protect their investments from adverse shocks to currency rates.

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69. *See* M. Wan, *The Securities System in* CHINA, IN RISK AND REGULATION IN CHINESE FINANCIAL MARKETS (J. Norton & Y. Huang, eds., forthcoming 1998).
70. *See* J. CARSWELL, THE SOUTH SEA BUBBLE (1960).
71. *See* J. GALBRAITH, THE GREAT CRASH OF 1929 (1954).
72. For development of this hypothesis in the context of the U.S., *see* J. SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (1982). In the context of Europe, *see* B. STEIL, THE EUROPEAN EQUITY MARKETS (1996).
73. *Cf.* J. Norton, *Reflections on Developing Capital Markets and Securities Regulation in the Countries of Central and Eastern Europe, in,* DEVELOPING CAPITAL MARKETS IN MIDDLE AND EASTERN EUROPE (MARKETS AND SECURITIES REGULATION IN THE COUNTRIES OF CENTRAL AND EASTERN EUROPE (K. Hopt ed., forthcoming 1998).
74. *El Gobierno convocara a bancos del exterior para privatizar el Nacion, Clarin, Aug. 11, 1997; Solo aspectos para privatizar el Nacion opondra el FREPASO,* AMBITO FINANCIERO, Oct. 11, 1997; *La venta del Nacion, en el centro del debate,* LA NACION, Oct. 11, 1997.

However, addressing the risks posed by the development of derivatives markets are complex and must be approached carefully. At the same time, as experiences in Russia have shown, if these sorts of products are necessary or viewed as desirable, they will develop independently of regulatory efforts. For that reason, it is best to take a considered approach to their development that moves in tandem (or just ahead of) market needs.

D. AN EFFECTIVE INSOLVENCY REGIME COMBINED WITH A CLEAR AND PREDEFINED SOCIAL SAFETY NET.

Not all banks and other firms will be capable of survival, nor should they. As one aspect of corporate governance, those that are not should be faced with a viable threat of bankruptcy.[75] Unfortunately, at the moment, many banks and other corporates in developing countries are simply "too big to fail" because of their vital role in social and political stability. This indicates the necessity for important government policy choices in these areas. In most cases, an effective insolvency regime must be combined with an effective social safety net in order to allow banks and other companies to become insolvent without severe domestic consequences.

The dangers inherent in this situation can be clearly seen from the recent riots in South Korea resulting from intended government changes to the system of lifetime employment there. Further, in order to decrease moral hazard, any safety net for depositors must be clearly and explicitly defined before the onset of any crisis situation. Some Latin American countries have chosen to have an explicit deposit insurance system, which helped to provide a credible commitment and attract small depositors into the system who might otherwise have remained outside.[76]

V. Law Reform in the Search for Financial Stability and Sustainable Development in Latin America.

While legal standards and themes are of high significance, they are in fact the easy part of the process: the difficult process of implementation in countries around the world still lies ahead. This is the point where countries must make their own decisions; however, this author thinks it is useful to note not only a few themes, but also certain suggestions in this regard.

A. INSIGHTS INTO THE DOMESTIC ECONOMIC AND FINANCIAL LAW REFORM PROCESS IN EMERGING MARKETS.

Five words can be seen to embody the lessons of recent financial crises for the law reform process: "chance," "coherence," "sequencing," "evaluation," and "interconnection."[77]

Chance. While academic analysis perhaps can categorize the development of different countries in different tiers and groupings, analysis and experience indicates the law reform

75. For an excellent and unique compilation concerning legal and economic issues of international and comparative insolvency, *see* J. BHANDARI & L. WEISS, CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES (1996).

76. *See, inter alia*, H. KAUFMAN, THE U.S. FINANCIAL SYSTEMS (1995).

77. These thoughts were originally presented in Norton, *supra* note 73. *See also* J. Norton & D. Arner, *International Cooperative Efforts and Implications for Law Reform, in* BANKING FAILURES AND BANK INSOLVENCY LAW IN EMERGING MARKETS (R. Lastra & H. Schiffman eds., forthcoming 1998).

in each country is sui generis and should be treated as such. Elements of chance have certainly been present in numerous country situations; but, the broader lesson is that each country presents an individual setting for law reform. Quite simply, there is no universal model! Given Latin America increasing involvement in the development and its increasing assimilation of international models, there exists a need to re-focus certain elements of the domestic educational structure to take account of these developments and their underlying rationales.

Coherence. According to many writers, a country may *not* need to adopt one total system, but often should "pick and choose" as it appears to be best in defined situations. However, such an amalgam should be a "mosaic," which implies coordination and coherence. Uncoordinated, piecemeal adaptations may, in the long-term, be counterproductive.

For these reasons, it is important that reforms and liberalizations are not done in a piecemeal fashion, but according to a broader picture of the eventual goal. It is in this respect that the need for careful analysis of any potential underlying problems remaining must be done and these problems attended to before they are exposed to the waves of the international financial system.

Sequencing. The "European Union model" is based on this concept. However, sequencing is not a mechanical process, but should be customized and "fine-tuned" on a country-by-country basis. The need is to approach law reform from a "made-to-order" and not from a "ready-made" perspective. As has been demonstrated, improper sequencing (*i.e.* liberalization preceding strengthening) of financial reforms has been a critical underlying factor in many financial crises. In light of the need for coherence, proper sequencing must also be carefully attended to. This must especially be the situation in the case of financial harmonization and liberalization within Latin America. Moreover, regional agreements like MERCOSUR and the Andean Pact should foster the process of harmonization among their member countries.

Evaluation. Clearly, economic law reform efforts to date have been largely unscientific processes, with little or no built in procedures to ensure accountability, monitoring and reevaluation. The need for appropriate and on-going monitoring and evaluation mechanisms are perhaps the ultimate challenge for IFOs, IFIs, and concerned emerging economies. As can be seen, temporary success is not sufficient evaluation. Domestic efforts must focus on determining potential problems before they are exposed by the market and treating them decisively and effectively. As noted before, small open economies do not have the luxuries that large economies do in this respect.

Interconnection. Today, various areas of law reform are inextricably interconnected (*e.g.*, banking with securities law reform). The need for interconnection of related and interlinked areas of law reform cannot be understated, although it is sometimes neglected, even in the "developed" world. Once again, underlying problems such as those described in the context of corporate governance need to be addressed before they impact some seemingly unrelated (and potentially economically significant) variable or vulnerability.[78]

With these thoughts in mind, different nations may need to adopt solutions corresponding to their different levels of development and their different needs, especially in relation to the financial sector; however, this must be done carefully, thoughtfully, and

78. Some suggest that this may be a problem in South Africa: *see* J. Sikhakhane, *Open Season: Some Are More Equal than Others*, FIN. MAIL, Apr. 10, 1998.

rationally--not simply at the behest of foreign investors or the IMF or even out of desire for early admission to the World Trade Organization (WTO).

B. OTHER UNDERLYING ISSUES.

In terms of domestic implementation (as well as international standard setting), a number of other related issues flow throughout any analysis of specific issues to be addressed in respect to devising appropriate legal infrastructures, namely:

- accounting and auditing standards,
- transparency,
- a strong Rule of Law and the reduction of corruption, and
- the creation of a favorable international investment environment.

1. *Accounting and Auditing Standards.*

Accounting standards clarify relationships and encourage investment, both domestic and foreign, because they provide an understandable common language for businesspeople to communicate about their businesses and finances.[79] In addition, internationally accepted accounting standards encourage investment because they provide transparency and comprehensibility. For these reasons, consistent accounting standards are absolutely essential for the success of continued financial stability and development in any emerging market economy. With the accounting profession applying internationally accepted accounting standards that should not be compromised, companies will gain greater experience and confidence with accounting systems and practices, thereby increasing their own role in the international financial system. Perhaps more importantly, business people in emerging markets will find that clear systems of accounting are not only good for encouraging foreign investment, but also for their own internal management purposes and maintenance of profitability in the long term.

Consistent accounting standards are absolutely essential for the success of enterprise reform in any country. Accounting standards clarify relationships and encourage investment, both domestic and foreign. Further, accounting standards are the basis of the operational fiction that in many cases allows financial institutions to continue to exist in the face of probable technical insolvency. While accounting standards must eventually be internationalized in order to provide transparency for both domestic and international investors, this process can be gradual as internal problems are eliminated, currencies move towards convertibility, and markets open to international capital.

In regard to international accounting standards, IOSCO and the IASC have committed to the development of international accounting standards for securities and companies by July 1998.[80] This development is of massive importance to all countries wishing to participate in international capital markets. The development of such standards marks the creation of a truly international language of finance and investment, allowing comparisons to be made directly between investments in different markets. For that reason, all countries (including the United States) would do well to consider the developments in this area and to work to use and facilitate the use of such international standards.

79. *See, e.g.*, D. Mercado, *Evolving Accounting Standards in the International Markets*, PRACTISING L. INST., (Corporate Law and Practice Course Handbook Series No. B4-7166, Oct. 1996).

80. *See* IOSCO, ANN. REP. (1996). *See also* IASC <http://www.iasc.org.uk>.

Some countries like Mexico, Brazil, Argentina, and Venezuela with their more developed accounting and auditing standards and profession, can serve as an important aid for other Latin America countries much in the same way that Hong Kong SAR serves this purpose for China.[81] Further, Latin America's involvement in IFO processes and assimilation of their efforts should be encouraged.

2. *Transparency.*

Transparency is necessary so that all the various players understand the rules of the game, so that the game can continue successfully.[82] As the recent experiences of Japan, South Korea, and Thailand have shown, legal and financial transparency is of the utmost importance in the long term successful development of an effective financial system.[83] The emerging international consensus on the requirements for financial stability is built on the principle of transparency, and for this reason, the financial and legal infrastructure of any emerging market must be transparent. Moreover, the advantages of transparency are a baseline for financial and legal development and resulting financial stability and economic success.

Transparency is necessary not only for international investors, but for domestic investors as well. Transparency is necessary in whatever solution that a government chooses to resolve banking problems, because without it, investors, companies, banks, and markets will not understand and will not have confidence in the process chosen. It is necessary in accounting so that investors can determine values for productive and non-productive assets and make decisions accordingly. It is necessary for banks in order to lengthen loan horizons and evaluate borrowing and lending decisions. It also is necessary for capital markets in order for investors to understand the nature and risks of investing in securities and thereby to prevent the potentially disastrous rise and collapse of stock market bubbles. Finally, it further is necessary for international investors to make comparisons and to make secure and well-thought-out business decisions, which will benefit not only themselves, but companies making choices that encourage investment and eventual success in the market.

Both the Mexican and the East Asian crises were triggered and exacerbated partly when investors found out that reserves were smaller than they had thought and that short-term debt was higher.[84] One of the many lessons drawn from Mexico and East Asia is that the extent of the crisis was worsened by the poor quality of information supplied to both the official sector (including the IMF) and the markets. The East Asian crises reinforces the argument for better and more timely provision of information, including information on central bank forward operations. There are two arguments in this regard: (i) better informed markets are likely to make better decisions, and in both Mexico and in Asia, this would have meant that markets withdrew funds sooner than they did, thereby hastening adjustment; and (ii) the obligation to publish information on certain interventions would

81. For a development of this thesis, *see* J. Norton, *Hong Kong SAR: Maintenance of the Financial Infrastructure Necessary for the Development of an International Finance Centre for Greater China,* HK L. J. (forthcoming July/Aug. 1998).
82. *See, e.g.,* L. Lowenstein, *Essay: Financial Transparency and Corporate Governance: You Manage What You Measure,* 96 COLUM. L. REV. 1335 (June 1996) (discussing the importance of transparency in the US financial system).
83. *See, e.g.,* S. Sugawara, *Market Troubles Felt Far and Wide,* INT'L HERALD TRIB. (Nov. 8, 1997) at 1.
84. Stiglitz, *supra* note 2.

affect the extent and nature of those interventions, helping to prevent some unwise decisions. In this regard, at the moment, the IMF is only seeking to further strengthen its Special Data Dissemination Standard (SDDS); however, it is quite possible that stronger measures will soon be forthcoming.

According to Greenspan, the primary protection from adverse financial disturbances is effective counterpart surveillance and hence, government regulation and supervision should seek to produce an environment in which counterparties can most effectively oversee the credit risks of potential transactions.[85] In this respect, a "major improvement" in transparency, including both accounting and public disclosure, is essential. However, given the financial crises earlier in the decade in Norway, Sweden, and Finland – countries with highly transparent economic systems and advanced institutional frameworks – more transparency is probably not sufficient in and of itself.[86]

3. A Strong Rule of Law and the Reduction of Corruption.

The emerging international consensus is that a transparent, predictable, and enforceable legal regime underlies successful economic development.[87] It is important for investors and businesses to feel that their investments are safe and can be protected in order to provide the necessary confidence in the financial system.

The "Rule of Law" as to economic or other societal regulation is of little practical value unless fair and effective enforcement can be attained and sustained. As such, regulatory authorities require adequate personnel and technological capabilities to ensure effective enforcement. The enforcement must also be fair, both substantively and procedurally: this will require transparent and judicially reviewable administrative processes. Also, administrative enforcement cannot entirely be fair and effective without an independent, well-educated, and non-corrupt judiciary.

Corruption can undermine the reform process by reducing public confidence.[88] As corruption increases, confidence in the fairness and openness of the financial system decreases, causing investment to decrease and move to other shores. In this regard, the recent experiences of Hong Kong are instructive: its system must be allowed to continue its anti-corruption efforts in order to maintain its status. However, Singapore has become increasingly competitive: while its legal system is viewed as very strict, it is also viewed as largely uncorrupt. Thus, for example, if Hong Kong SAR is increasingly viewed as a less fair and open place for business, then business will increasingly move to Singapore, with its strict, but fair and non-corrupt system.[89]

85. Greenspan, *supra* note 1.
86. *See* Stiglit-, *supra* note 37. It may be argued, however, that in the context of these countries, problems were exacerbated by the existence of implicit government guarantees and explicit currency pegs similar to those that finally in fact led to the crises in Asia and Mexico. *Id.*
87. *See* G-10 Report, *supra* note 50.
88. For detailed information on the impact of corruption and international efforts to combat it, *see* the home page of Transparency International, an organisation formed to monitor and encourage international efforts against corruption, <http://www.transparency.de/>.
89. *See* C. Kin-man, *Combating Corruption and the ICAC, in* THE OTHER HONG KONG REPORT 1997 101 (J. Cheng ed., 1997).

While corruption in some countries such as China, Russia, and certain countries of Latin America is of international concern, it nonetheless must always be a concern in any country. From the standpoint of general financial stability, if corruption is too pervasive, confidence in the financial system will weaken and investment and stability will decrease. From the standpoint of banking, if corruption palpably exists, banks may be weakened by insider lending practices, such as has been the case in Thailand -- these are the moral hazard problems discussed earlier and commonly referred to as "crony capitalism." Finally, from the standpoint of capital markets, corruption can cause wariness to invest due to perceptions of a "rigged" market or can, in fact, shake confidence to such an extent that the market collapses. Corruption, in fact, can be seen as the primary cause of the collapse of the U.K. stock market at the time of the South Sea Bubble in the early 1700s.[90]

Corruption, however, does not necessarily equate with the absolute requirement of arm's length business transactions. In some cultures, such a solution is obviously impossible; however, a few requirements are probably in order: maximum lending limits to a single borrower in line with international standards, prohibition and punishment of market manipulation, and the punishment of self-dealing, perhaps through the development of corporate fiduciary duties. Obviously, such minimums protect ownership interests, as well as enhance general confidence in the financial system, and so should be strongly implemented.

Given Latin America's unique situation and the strong domestic and international perceptions of the existence of corruption and crony-capitalism, efforts in this respect are of great significance. Most importantly, these problems undermine domestic confidence in capital markets, the financial system, the judicial system, and individual perceptions of potential for development and success. Unfortunately, as an American, coming from a system that often suffers the same sorts of criticisms, I cannot offer any internationally accepted solution. However, efforts such as those of the Truth and Reconciliation Commission in South Africa are obviously extremely important. Further, efforts to update laws on monopolies and insider lending and dealing, along with appropriate enforcement of these sorts of provisions, would help to reduce perceptions of a rigged financial and judicial system and increase domestic, as well as international, participation.

4. *Favourable Environment for International Investment.*

International investment encourages growth and the transfer of know-how; however, as shown by experiences in other countries (*e.g.*, Mexico in 1994-95 and Thailand, Indonesia, and South Korea in 1997-98), international investment can also have its dangers.[91] In terms of the creation of an environment favourable to international investors, developing countries probably have two primary focuses: first, attracting foreign investment; and second, access of domestic companies to international capital markets.

In order to advance the process of foreign investment, the factors already discussed are of prime importance, *i.e.*, international banking standards, effective corporate governance, improving domestic capital markets, an effective insolvency regime, international accounting standards, transparency, and enhancing the rule of law and reducing corruption. The combination of effective implementation of the above should ensure the confidence of foreign investors.

90. *See* CARSWELL, *supra* note 70.
91. *See, e.g.*, Norton & Arner, *supra* note 5.

Second, in regard to access to international capital markets, the same set of factors is once again implicated; however, a few comments are worth highlighting. Even more so with international markets than with domestic investors, international investors must understand the nature of the government's policy solution before they will be willing to take part in it. Only with such transparency and certainty will such investors have the necessary confidence to take part in the process. Further, as a vital aspect of the process, any access to international capital will require transparent and effective accounting standards. Without this basic device, domestic companies will not be able to list their shares on other markets and international investors will likewise not be able to evaluate and invest unless they understand the relevant accounting standards.

VI. Concluding Remarks.

Unfortunately, despite our best efforts, we do not seem to be able to present any comprehensive solution to the problems of financial law reform in emerging markets. While the emerging international consensus is very important and useful in terms of general standard setting and detailing of policy options, no one choice is always appropriate, but rather must be tailored individually in each case. In this regard, it is obviously important to Latin America to learn any lessons that it can from the experiences of Mexico and East Asia in order not only to avoid these sorts of crises, but also to enhance its own path of development.

A. Continuing Problems.

Looking specifically at the overall problems likely to continue to effect the financial systems in many emerging markets for the near future, the following come to mind: the weakness of banking institutions, the prevalence of corruption and crony-capitalism, the lack of effective and consistent regulatory enforcement, the lack of sophisticated and efficient judicial mechanisms for the resolution of financial disputes, the inexperience of market participants, and the shortage of domestic savings. In Latin America, the shortage of domestic savings and the inexperience of a large percentage of the population in conjunction with significant unemployment would appear to be the most significant problems, rather than inadequacies in the domestic financial environment.

At a more fundamental level, the inefficiencies of general corporate law and of investment firm regulation, and in particular the absence of appropriate solutions to questions of conflicts of interests and insider dominance in corporate governance and securities activities, are likely to impede the smooth and rapid maturation of financial systems. While the financial system of some Latin American countries is well-developed, these sorts of problems are likely to be of major importance in the near future, given Latin America's need to develop confidence and broaden participation in its financial system.

These are all problems without easy, quick or necessarily direct solutions. However, in the final analysis, one can agree on a few points. First, the international standard setting process is encouraging in that in the past little attention was paid directly to this very important issue and little was done directly to address these fundamental problems. Second, the role of intergovernmental organizations (whether on a world-wide, regional or sub-regional level) and of internationally-oriented domestic institutions in weaving together the strands for sustainable financial and economic development in transitioning and emerging

economies cannot be underestimated, yet they cannot be overestimated. This role can be viewed as largely directive (in a general sense) and supportive of a particular country's national commitment to true market, legal, political, and social reform.

The fundamental reform problems are long-term and will depend upon the building of an appropriate legal and educational infrastructure within a particular country, along with the development of a cultural ethos conducive to the development of transparent, open, and non-corrupt financial markets and financial institutions and a judicial and administrative framework staffed and supported by a well-trained and honest bureaucracy and legal and accounting profession. We are not talking solely about economic reform or transition, but more broadly about legal, social, political, educational, and cultural reform. Also, in terms of Latin America, we are not speaking of only domestic reform, but about developing realistic, viable, and workable mechanisms for pursuing this reform process on an appropriate regional basis.

However, increased cooperation on the international, regional, and national levels, can shine considerable light on the formulation, implementation, and (as yet to be directed to any significant degree) in the monitoring and evaluation stages of meaningful economic and law reform in emerging economies, particularly as these reform efforts are geared to the development of viable and sustainable financial markets. It is in this respect that international cooperative efforts within the educational system can be of immense importance to the long-term development of Latin America. Academic linkages to the rest of the world need to be strengthened in order to provide the basis for the development of Latin American human capital necessary for true social, political, and economic development.

B. SHORT-TERM CAPITAL FLOWS.

Some are now arguing that short-term capital flows such as those that triggered the recent financial crises in Mexico and East Asia do not bring ancillary benefits, but instead only increase the vulnerability of an economy, especially in situations such as East Asia where high domestic savings rates existed and resulted in mis-allocation of marginal investment.[92] Even the editors of the *Financial Times* (London) agree that the case for early and complete freedom for international capital flows has been damaged and that the question is how to maximize the benefits of capital flows to developing countries, while minimizing both the number of panics and the damage they cause.[93] The question, and it is a complex one that no one knows the answer to, is how to do this. Joseph Stiglitz, Senior Vice President and Chief Economist of the World Bank, suggests that at the domestic level, first, tax, regulatory, and policy distortions that may have stimulated such flows and encouraged short-term foreign borrowing, such as the Bangkok International Banking Facilities, need to be eliminated. Second, capital in-flow inhibitions, such as those in Chile (essentially a tax on short-maturity loans), may be appropriate. The suggestion being that these, together with solid fundamentals and a sound financial system, may be the reason that Chile has been relatively unaffected by recent crises.

Latin America has been significantly affected by capital flows in recent years. These effects, while sometimes negative, have not resulted in the melt-down of the domestic

92. STIGLITZ, *supra* note 2.
93. *Asia: Regulating Capital Flows*, FIN. TIMES, Mar. 25, 1998.

financial system or the reversal of the reform process, as could have been the result without the presence of these factors. In the future, however, because Latin America needs international capital for development, it would do well to focus on mechanisms such as lending infrastructure and domestic currency markets to encourage longer-term, domestic currency lending, while at the same time increasing its international reserves.

C. REGIONAL RESPONSES TO FINANCIAL CRISES AND LATIN AMERICA.

The globalization of financial markets has increased the complexity of the international financial system and the volume and size of international capital flows. These complexities present new challenges and opportunities to international trade arrangements, law reform, and economic development. In the 1996 Lyon Summit *Economic Communiqué*, the G-7 nations asserted that, in calling for the strengthening of economic and monetary cooperation, their respective economic policies would continue to be coordinated towards sustaining non-inflationary growth and that its finance ministers would continue to cooperate closely on economic policy and in the foreign exchange markets.[94] The G-7 declared that strong and mutually beneficial growth in trade and investment "will be sustainable and therefore most beneficial to all if conducted within a strong multilateral framework of rules," thus reaffirming the central role of the WTO and the pre-eminence of multilateral rules to serve as the framework for regional initiatives.[95]

According to Stiglitz,[96] in addition to global standards and risk protection, a complementary regional response is also warranted, primarily because contagion effects have tended to be strongest within the region of the country immediately effected. Further, regional neighbors may be better poised both for cost effective surveillance, and for effective peer monitoring. Possible mechanisms include funding, surveillance, and technical cooperation.

Beyond the high profile efforts of the European Union, other regional organizations are beginning to venture into the financial sphere. Of most recent note, of course, are the recent initiatives being taken in Southeast Asia, through the Association of South East Asian Nations (ASEAN). Beyond Southeast Asia, NAFTA and MERCOSUR are both increasingly influential in the sphere of financial regulation and supervision within their respective member countries, and should become even more so if the preliminary international work currently underway following the April 1998 Second Summit of the Americas held in Santiago, Chile is any indication of the future.

In the case of Latin America, MERCOSUR offers a chance of regional coordination of efforts in order to prevent financial crisis. Although the existence of recognized asymmetries among MERCOSUR countries, related to different fiscal treatment of foreign investors, different participation in the banking system, and considerable differences of size among the financial markets of state members,[97] it retains a considerable advantage when compared with other integration experiences: all states in MERCOSUR have a civil law tradition and their legal systems do not present major differences, and regulators should take advantage of this feature.

94. *See, e.g.*, TEXT, *Economic Communiqué From G-7 Summit, Lyon, France* (issued June 28, 1996), reprinted in 13 INT'L TRADE REP. (BNA) 1104 (1996).

95. *Id.*

96. STIGLITZ, *supra* note 62.

97. Paiva Abreu, *Financial Integration in the MERCOSUR countries*, INTEGRATION & TRADE, Jan.-Apr. 1997, at 79.

Currently, although the authorities of MERCOSUR have not yet produced an ordered body of regulatory rules, there has already been a first approach to this regional harmonization of banking regulation related to the issue of two Decisions (10/93 and 12/94) by the Common Market Council and one Resolution (1/96) by the Common Market Group.[98] At the same time, there has been a cautious approach to the idea of a common currency for MERCOSUR, albeit this possibility is still far to be agreed and implemented by member states.[99]

However, MERCOSUR rules face a serious pitfall: although the Treaty of Mercosur states they shall be binding for all their members, they need to be implemented by each state in its own territory and there has not been foreseen any enforcement procedures in case of nonimplementation.

Briefly, the Decision 10/93 is related to minimum capital requirements and takes into account the evaluation of assets risk of banks. It has been implemented by Argentina through the Communication "A" 2136 of the BCRA, and by Brazil through the Resolution 2099 of 17-8-94 of the Central Bank of Brazil. Paraguay has implemented it through the General Law on Banks, Financial Institutions and other Credit Institutions No. 861 of 24-6-96, and in Uruguay the Board of Directors of the Central Bank is currently considering its implementation.

Regarding Decision 12/94, it comprises rules on consolidated supervision and it has been implemented by Argentina through the Communication "A" 2227, and partially implemented by Brazil through the Resolution No. 2302 of 25-7-96 of the Brazilian Central Bank. In Paraguay, the Law No. 861 states that consolidated supervision shall be implemented by the Superintendent of Banks, but this body has still not been created. Uruguay has not implemented the Decision.

Resolution 1/96 is related to the assets classification of the financial institutions and is only applied by Argentina through the Communication "A" 2216.

D. Success Factors in Development.

This author would like to leave with a few optimistic thoughts. It is important while looking at the negatives of recent crises, not to forget the positive lessons that have underpinned the successful growth of the East Asian countries over the past decades.[100] Some of the most important features of East Asia's development were sound macroeconomic fundamentals, including high savings; a commitment to education; technologically advanced factories; a relatively egalitarian distribution of income; and an aggressive pursuit of foreign exports. These elements are still present, not only suggesting that East Asia's future will be bright, but further that these elements can continue to provide a model for successful development throughout the world.[101]

I think these elements are instructive for Latin America. First, in order to increase macroeconomic stability, unemployment needs to be addressed; however, the numbers are so massive that this question seems almost insurmountable. While an immediate solution

98. *See* María C. Pasin, *Avances obtenidos en materia de asuntos financieros*, Revista de Derecho del Mercosur, May 1997, at 196.

99. *See* La Nación Online (Comercio Exterior) the articles of Luis A. Stoup and Daniel Bianchi on the common currency of Mercosur <http://www.lanacion.com.ar/suples/ccioext980203/cext1.htm>.

100. *See* World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (1993).

101. Stiglit_, *supra* note 37.

is not possible, steps can be taken that over time will generate improvement. In this respect, longer-term commitments should be made to improving education throughout the population. Only in this way will the groundwork be laid for successful development and rising incomes.

Another idea that might bear consideration would be the development of a securitized mortgage market (enhanced with appropriate tax incentives), resembling that in the United States.[102] Instructive success is currently being achieved on a similar scheme in Hong Kong.[103] Such a development provides a mechanism to strengthen domestic capital markets, increase investment in housing, encourage savings and investment, and economic participation through home ownership. Further, it provides a mechanism to draw in long-term foreign investment into the domestic capital markets, providing the potential for growth in the housing market and related employment in the construction industry. While this is but a small thought, ultimate success will not be created from any single idea, but rather through the development of an inclusive culture that encourages economic participation and is underpinned by respect for the rule of law.

E. Meaning for the "New Banking Law."

What might all this mean for the future teaching of banking law in Latin American countries?

In terms of the future expanding regulatory content of "banking law" for legal education, general and specific efforts towards international supervisory and regulatory convergence respecting international banks and securities firms (and other international financial institutions) should undoubtedly be of continuing importance to legal educators as we approach and enter the twenty-first century. Improved convergence in the regulation and supervision of financial conglomerates, derivatives, disclosure of trading activities, and effective money laundering measures are all on the current agenda of the international bank and securities authorities.

This taken into consideration, one quickly realizes that the nature of the banking business (and of banking institutions and of financial markets) is in a dramatic state of metamorphosis. This metamorphosis is not only one of market interconnections, but of national-regional-international interdependence. On the educational institution side, a close interdisciplinary and international coordination among leading Latin American and international Universities would appear to be highly desirable. In all events, the study of the "New Banking Law" in the twenty-first century in Latin America (and elsewhere) will be influenced radically by this on-going metamorphosis.

As to commercial law, it speaks for itself that many of the activities of banking institutions (such as the taking of deposits and dealing in checks and other negotiable instruments, credit instruments, the taking of security), a viable insolvency regime, and effective dispute resolution mechanisms will remain "core" aspects of any future banking law. Further, the bank-customer relationship (whether as depositor or lender) will continue to

102. For a discussion of the securitisation and the elements necessary to underpin a successful system, D. Barbour, J. Norton & T. Slover, *Securitisation in Emerging Markets*, *in* 2 Y.B. INT'L FIN. L. (forthcoming 1998).

103. For details, *see* the website of the Hong Kong Monetary Authority, Hong Kong SAR's *de facto* central bank, < http://www.info.gov.hk/hkma>.

be essentially contractual and commercial in nature. Yet, the increasing role of electronic technology in banking and financial services will raise new legal issues that will need to be addressed by an evolving commercial law. In any event, commercial law must remain an important, integral, core component of the "New Banking Law."

Also, to the private law dimensions of the "New Banking Law," this will be heavily influenced by technological and product innovations in the increasing cross-border dimensions of banking/financial transactions.

Comparative understanding of the legal experiences of others (*e.g.* United States, Japan, European Union, Asia) will be highly desirable, as will be an understanding of the international legal implications of the international convergence and cooperative processes underlying the financial markets/institutions area. Further, a better understanding of private international law (conflict of laws) will be critical as financial transactions are increasingly becoming cross-border in nature.

In logically thinking through an optimum educational matrix for the study of banking law in Latin America in the twenty-first century, the importance of interconnecting the following also becomes clear: accounting principle, taxation rules, corporate law, property security and bankruptcy laws, and the development of legal approaches to new financial market innovations (*e.g.* swaps/derivatives and asset securitization).

Overall, the future for legal education in Latin America should not be clouded by legal, cultural or ideological nostalgia, but should embrace academic innovation, openness, and even daring in creating an educational process of transmission and assimilation. Such an approach is sure to lead to a greater intelligibility and receptivity (domestically, subregional, regionally, and internationally) of the ongoing changes and innovations in the financial services areas. All of this should contribute to even higher academic standards in legal teaching and scholarship.