

THE ESSENTIAL FLAW IN THE GLOBALISATION OF CAPITAL MARKETS: ITS IMPACT ON HUMAN RIGHTS IN DEVELOPING COUNTRIES

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The global economy has changed profoundly in the past thirty years. In 1970, the capital that moved around the globe to support the trade in goods and services far exceeded the capital that moved to support both direct and portfolio investment. Today, capital flows outweigh trade flows by a factor of over sixty-to-one.¹ Indeed, today “the debt flows to the emerging markets are going to . . . come from . . . pension funds and mutual funds, . . . not from bank balance sheets.”² Today, institutional investors have assumed a central role in international capital flows.³

Globalisation is all about the convergence of markets. It has found its fullest expression in international financial markets⁴ due to the ease with

* Executive Director and Professor, Tim Fischer Centre for Global Trade and Finance, Bond University. My sincere thanks to the Australian Research Council for the grant that supported this work and to James Walsh for his assistance with the research.

1. Peter D. Sutherland, Managing the International Economy in an Age of Globalisation, Remarks at the 1998 Per Jacobsson Lecture, the annual meeting of the IMF and the World Bank (Oct. 4, 1998), available at <http://www.odc.org/commentary/pdsjacobsson.html> (last visited Oct. 5, 2001). As Sebastian Edwards has indicated, “Economists have long recognized that cross-border capital movements pose a difficult policy issue. In the absence of strong financial supervision in either lending or borrowing countries, unregulated capital flows may . . . be misallocated, . . . generating waves of major disruptions in the receiving nations.” SEBASTIAN EDWARDS, HOW EFFECTIVE ARE CAPITAL CONTROLS? 25 (Nat’l Bureau of Econ. Research, Working Paper No. 7413, 1999) available at <http://www.nber.org/papers/w7413>.

2. Mitchell Martin, *Wall Street Sees Red at U.S. Plan for Bondholders to Accept More Risk*, INT’L HERALD TRIB., Apr. 26, 1999, at 16 (quoting Charles Dallara, Managing Editor of the Institute of International Finance).

3. The rise in influence of mutual funds began in the early to mid-1990s when commentators noted “a new phenomenon in Latin America where mutual fund managers—not bankers—can bring an economy to its knees.” Kevin G. Hall, *Latin America Economies Vulnerable to Uninformed Investing Decisions*, J. OF COM., Apr. 28, 1995, at 3A.

4. Sutherland, *supra* note 1, at 2; JOSEPH A. CAMILLERI & JIM FALK, THE END OF SOVEREIGNTY 77-78 (1992); Juan Ayuso & Roberto Blanco, Has Financial Market Integration Increased During the 1990s?, Presentation at a conference of the Bank for International Settlements: “International Financial Markets and the Implications for Monetary and Financial Stability” (Oct. 25-26, 1999), available at <http://www.bis.org/publ/confer08.htm>.

which capital moves around the globe. In today's world, money is moved by strokes on a keyboard in response to information on computer screens.⁵ Globalisation is a product of the computer and communications revolutions, the growth in multinational enterprises, the tremendous increase in international institutional investment, and the international victory of free market capitalism in the battle of ideologies and the associated reductions in national barriers to trade and capital.⁶ While these elements of globalisation are relatively new, globalisation is not a new phenomenon. The Roman Empire was the most important force for globalisation the world had seen,⁷ and, more recently, financial globalisation was so strong in the late nineteenth and early twentieth centuries that, on some measures, the scale of international capital flows relative to Gross Domestic Product (GDP) are still to be repeated.⁸

Globalisation is a broad church, a process with many facets. This article addresses the impact of globalisation on capital markets and the impact of globalised capital markets on human rights in developing countries.

5. Globalisation has been defined as "the increasing tendency toward an interconnected worldwide investment and business environment." Investorwords investing glossary, at <http://www.investorwords.com.html>; and "the tendency toward a worldwide investment environment, and the integration of national capital markets." Yahoo Finance Financial Glossary at <http://biz.yahoo.com/f/g/bfglog.html>.

6. John H. Farrar, *The New Financial Architecture and Effective Corporate Governance*, 33 INT'L LAW. 927, 931 (1999).

7. John Braithwaite, *Sovereignty and Globalisation of Business Regulation*, in TREATY-MAKING AND AUSTRALIA 115, 119 (Alston & Chiam eds., 1995); JOHN BRAITHWAITE & PETER DRAHOS, *GLOBAL BUSINESS REGULATION* 40-45 (2000).

8. The net capital outflow from the UK before 1914 peaked at some 9% of GNP and the proportion was almost as high for France, Germany and Holland, the other major creditor countries. These proportions have not been achieved since. Likewise, current account deficits of the principal capital importing countries, Argentina, Australia and Canada, were over 10% for long periods. These levels have only been achieved by developing countries for short periods, which typically have been followed by very difficult adjustments. Barry Eichengreen & Michael Mussa, *Capital Account Liberalization: Theoretical and Practical Aspects*, 35(4) FIN. & DEV., Dec. 1998, (IMF Occasional Paper No 172) at 31, available at <http://www.imf.org/external/pubs/ft/fandd/1998/12/eichen.htm>. While net capital flows relative to GDP were, if anything, higher pre-1914 than today, gross flows are much higher today. Furthermore, investment pre-1914 was overwhelmingly in the bonds of governments, railways, mining companies and public utilities. Some 85% of overseas portfolio investment was in the bonds of governments (that can raise taxes) or industries with substantial tangible and transparent assets. This was a rational choice of investment target given the relatively poor information available. *Id.* at 32-34.

I. THE GLOBALISATION OF CAPITAL MARKETS

The globalisation of capital markets includes the following phenomena and trends:⁹

1. Massive Capital Flows: Massive capital flows are a fact of life and foreign investors, in particular, are opportunists.¹⁰ Foreign investors quickly move money into an economy in large quantities¹¹ and quickly remove it at the first sight of gathering storm clouds (Mexico in late 1994, Asia in 1997, and Russia in 1998).¹²

2. Investor Behavior: The nature and management of investors changed radically in the 1990s. The proportion of capital controlled by the large institutional investors (mutual funds, pension funds, and insurance companies) increased dramatically.¹³ Hedge funds brought aggressive new investment techniques to bear.¹⁴ More significantly, but with less publicity, virtually all major commercial and investment banks and securities firms established departments that functioned as hedge funds.¹⁵ These funds make extensive use of leverage and derivatives as well as the capacity to move in to and out of markets swiftly. Indeed, the entire money management sector has become far more performance-driven, less risk-averse and more inclined to use leverage heavily.¹⁶

3. Access to Information: Access to up to the minute information facilitates investment decisions at great distances, while supplying

9. The following factors owe much to Henry Kaufman, *Protecting against the next financial crisis: the need to reform global financial oversight, the IMF, and monetary policy goals*, 34 BUS. ECON. 56 (1999).

10. Gerhard Aschinger, *Why Do Currency Crises Arise and How Could They be Avoided?*, 36(3) INTERECONOMICS 152, 153-54 (2001).

11. From 1992 until the Mexican crisis, capital inflows into Mexico were at 7% of GDP. SEBASTIAN EDWARDS & MIGUEL A. SAVASTANO, *THE MORNING AFTER: THE MEXICAN PESO IN THE AFTERMATH OF THE 1994 CURRENCY CRISIS* 13 (Nat'l Bureau of Econ. Research, Working Paper No. 6516, 1998) available at <http://www.nber.org/papers/w6516>. Indonesia, Korea and Thailand were recipients of capital inflows prior to 1997, which in Thailand reached 15.5% of its GDP from 1994-1996. Joseph Joyce, *The IMF and Global Financial Crises* 43(4) CHALLENGE 88, 93 (2000).

12. See Joyce, *supra* note 11, at 88. At the beginning of the Mexico crisis the Bank of Mexico lost US \$4 billion of reserves in one day after authorities announced a 15% rise in the exchange rate ceiling without other macroeconomic policy changes. EDWARDS, *supra* note 11 at 13.

13. For instance, U.S. mutual funds assets increased over four times between 1990 and 1997 from US \$1,067 billion to US \$4,490 billion. U.S. DEPT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 533 (118th ed. 1998).

14. Claire Makin, *Doesn't Anybody Remember Risk?*, INSTITUTIONAL INVESTOR, Apr. 1994, at 41.

15. *Id.*

16. As Makin wrote in 1994: "Strategies once deemed to be on the wilder, forbidden shores of the business are being eagerly embraced by mainline institutional investors." *Id.* at 41.

foreign investors with relatively homogenised information.¹⁷ Before the communications revolution, long-term investment was often the only sensible approach to foreign investment. Today, however, an investment portfolio in Brazil can be managed as aggressively and intensively as if it were a portfolio in one's own country, yet the sources of information upon which investment decisions will be based are far less diverse than if it was in one's own country, with predictable consequences for investor behaviour.

4. Hedging Risks: Modern financial derivatives provide tremendous opportunities for hedging risks, but are perhaps more often used to facilitate speculation and as integral elements of volatility inducing activities.¹⁸ Certainly "an increased use of derivatives leads to higher cross-border capital flows . . . thus leading to a rise in the asymmetry of information and therefore, a rise in financial volatility."¹⁹

5. Myth of Liquidity: In contemporary capital markets with efficient depository and settlement systems, liquidity can be temptingly easy to believe in. 'If it trades like a global bond and settles like a global bond it must have the other characteristics of a global bond.' Capital markets that are deep and efficient in good times can rapidly become thin and illiquid in bad times. This is especially true of secondary markets in debt and access to new money through debt issues.²⁰

6. Integrated Markets: Due to the above factors, capital markets in the debt and equity of developed and developing nations are integrated and interdependent today to an unprecedented degree.²¹

Each of these aspects of globalisation tends to increase the volume of portfolio capital flows to emerging market nations and the volatility of such flows.²² Indeed, there is considerable evidence that the globalisation of financial markets increases the volatility of such markets.²³

The globalisation of capital markets gives countries access to new sources of capital, and capital drives economic growth.²⁴ This is globalisa-

17. Aschinger, *supra* note 10, at 153.

18. *See id.*

19. PABLO BUSTELO ET AL., GLOBAL AND DOMESTIC FACTORS OF FINANCIAL CRISES IN EMERGING ECONOMIES: LESSONS FROM THE EAST ASIAN EPISODES (1997-1999) 72 (ICEI Working Paper No. 16, 1999) available at <http://www.ucm.es/info/icei>.

20. *See generally* Ross P. Buckley, *Emerging Markets Debt: An Analysis of the Secondary Market*, KLUWER LAW INT'L (1999).

21. Ayuso, *supra* note 4, at 193. For instance, Russia's economic troubles in August 1998 sent yields on the U.S. long bond to unprecedented lows and affected even U.S. municipal bonds. Jeremy Grant & John Labate, *Investors Seek Safety in Bonds*, FIN. TIMES (London), Aug. 22, 1998, at 8.

22. Aschinger, *supra* note 10, at 153.

23. Ayuso, *supra* note 4, at 182; BUSTELO ET AL., *supra* note 19, at 68.

24. Robert G. King & Ross Levine, *Finance and Growth: Schumpeter Might Be Right*, QUARTERLY JOURNAL OF ECONOMICS, Aug. 1993, at 717; Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, AM. ECON. REV., June 1998, at 537.

tion's great attraction. However, as the international debt crisis that erupted in 1982, and the more recent currency and financial crises in Mexico, Asia and Russia have demonstrated, generous access to foreign capital is often far from a good thing for developing countries. Mexico's crisis at the end of 1994 arose largely from a fixed²⁵ and overvalued exchange rate.²⁶ Choosing to devalue one's currency is often difficult for politicians as it risks inflation and may well be seen domestically as evidence of a failure in economic leadership. It is no coincidence that Mexico's national election and peso crisis were close in time:²⁷ a government about to face the electorate failed to make the tough but necessary decisions, and preferred, very humanly, to hope that a change in economic conditions might intervene to avert a crisis.²⁸

The Asian Economic Crisis that erupted in Thailand in mid-1997 and proceeded to spread throughout East Asia had exchange rate elements to it,²⁹ but was far more of an economic crisis.³⁰ It was a crisis brought on by exces-

25. Mexico used this as the basis for the *Pacto de Solidaridad*, the exchange rate-based stabilization program that was implemented in full force in 1988. PEDRO ASPE, ECONOMIC TRANSFORMATION THE MEXICAN WAY 49; SEBASTIAN EDWARDS, ON CRISIS PREVENTION: LESSONS FROM MEXICO AND EAST ASIA 4 (Nat'l Bureau of Econ. Research, Working Paper No. 7233, July 1999) available at <http://www.nber.org/papers/w7233>.

26. Before the crisis some believed the peso would require a 20-30% devaluation to reach equilibrium. A year after the peg was abandoned, it had lost almost one half of its value. EDWARDS & SAVASTANO, *supra* note 11, at 7. See also SEBASTIAN EDWARDS, A TALE OF TWO CRISES: CHILE AND MEXICO 13 (Nat'l Bureau of Econ. Research, Working Paper No. 6516, 1998) available at <http://www.nber.org/papers/w6516>; Jeffrey D. Sachs, Aaron Tornell & Andres Velasco, *Financial Crises in Emerging Markets: The Lessons of 1995*, 1 BROOKING PAPERS ON ECONOMIC ACTIVITY 147, at Table 9 (1996); Aschinger, *supra* note 10, at 156-57.

27. Indeed President Zedillo was sworn into office on December 1, and on December 20 the authorities lifted the ceiling of the exchange rate band by 15%. EDWARDS & SAVASTANO, *supra* note 11, at 13.

28. In fact, the Mexican politicians claimed their nation was experiencing the 'best of times.' EDWARDS, *supra* note 26, at 2. Further, NAFTA had just been signed and Mexico was about to join the Organisation for Economic Cooperation and Development (OECD). *Id.* at 6; Aschinger, *supra* note 10, at 156-57.

29. EDWARDS, *supra* note 26, at 5. Intense speculation by hedge funds and others, betting that fixed exchange rates would be allowed to float, and fall, was the trigger for the crisis, but not its cause. This speculation was effected by selling East Asian currencies short (i.e. entering into a contract to sell a currency in the future that you presently don't hold, in anticipation of being able to buy it in the market at a cheaper price when it is required to close out the contract). The speculators, at most, affected the timing, and perhaps the severity of the loss of confidence in the region. *Id.*

30. However, not a traditional economic crisis brought about by poor fiscal and monetary discipline. In the words of Laurence Meyer, a member of the Board of Governors of the US Federal Reserve System,

By conventional standards, the monetary and fiscal policies of the developing Asian economies prior to the crisis were largely disciplined and appropriate. . . . Consumer price inflation . . . was relatively subdued [and] fiscal policy also appears to have been disciplined. . . . Therefore, another important lesson of the Asian crisis is that sound macroeconomic policies alone do not preclude crises.

LAURENCE H. MEYER, LESSONS FROM THE ASIAN CRISIS: A CENTRAL BANKER'S PERSPECTIVE 5 (Levy Econ. Institute, Working Paper No. 276, 1999).

sive borrowing and lending,³¹ inefficient domestic financial sectors,³² crony capitalism,³³ and a loss of confidence in the region by foreign investors³⁴ and creditors.³⁵ The depreciation of the yen beginning in mid-1995 provided a further twist in the Asian context. As the 1990s progressed, East Asian economies began moving increasingly into the high-tech exports market, where they were forced to compete with Japan. However their exchange rates were, for the most part, pegged to an appreciating US dollar³⁶ while, from mid-1995 onwards, their principal competitor enjoyed a depreciating currency.³⁷

Russia's economic crisis had a genesis all its own. It was the product of the collapse of the political, economic and governmental systems of that nation.³⁸ This collapse was associated with the country's move from centuries of feudal and then communist rule to a free enterprise system in which tax collection proved to be an almost insurmountable hurdle,³⁹ and the rule of

31. MANUEL F. MONTES, *THE CURRENCY CRISIS IN SOUTHEAST ASIA* 12-15(1998); see GIANCARLO CORSETTI ET AL., *WHAT CAUSED THE ASIAN CURRENCY CRISIS? PART I: A MACROECONOMIC OVERVIEW* 28 (Nat'l Bureau of Econ. Research, Working Paper No. 6833, 1998); GIANCARLO CORSETTI ET AL., *WHAT CAUSED THE ASIAN CURRENCY CRISIS? PART II: THE POLICY DEBATE* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 6834, 1998); *ASIA'S FINANCIAL CRISIS: CAUSES, EFFECTS AND AFTERSHOCKS, UNDERSTANDING GLOBAL ISSUES* 4-5 (Richard Buckley ed., 1998) [*hereinafter* Asia's Financial Crisis]. See also Jared Levinson, "Living Dangerously": *Indonesia and the Reality of the Global Economic System*, 7 J. INT'L L. & PRAC. 425, 437-41 (1998) (analysis of the contribution to the crisis of imprudent lending by the IMF and World Bank).

32. Gregory W. Noble & John Ravenhill, *Causes and Consequences of the Asian Financial Crisis*, in *THE ASIAN FINANCIAL CRISIS* 1, 2-4 (Gregory W. Noble & John Ravenhill, eds., 2000); MARCUS NOLAND ET AL., *GLOBAL ECONOMIC EFFECTS OF THE ASIAN CURRENCY DEVALUATIONS* 3 (Institute for International Economics, Policy Analyses in International Economics No. 56, 1998); Aschinger, *supra* note 10, at 157.

33. See Levinson, *supra* note 31, at 431-37 (analyzing of the role "crony capitalism" played in the crisis in Indonesia, the country where it is most highly developed).

34. Noble & Ravenhill, *supra* note 32, at 2; CORSETTI ET AL., *supra* note 31, at 1.

35. Ross P. Buckley, *An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors*, 15 BANK. & FIN. L. REV. 431, 441-42 (2000); Ross P. Buckley, *Six Lessons for Banking Regulators from the Asian Economic Crisis*, in *PERSPECTIVES ON BANKING, FINANCE & CREDIT LAW* 51, 60 (Wickrema Weerasooria ed., 1999).

36. MONTES, *supra* note 31, at xiii; Noble & Ravenhill, *supra* note 32, at 5-6; EDWARDS, *supra* note 25, at 5; Aschinger, *supra* note 10, at 156-57. Pre-crisis 1990's Thailand had a peg of 25.2 to 25.6 baht to the US dollar. Malaysia maintained a 10% band of 2.5 to 2.7 ringgit to the US dollar. The Philippines' peg was fixed at 26.2 peso to the US dollar after 1995, previously moving in a 15% band of 24 to 28 peso to the US dollar. And Indonesia had a crawling peg, which began at 1,900 rupiah to the US dollar in 1990 and moved to 2,400 rupiah to the US dollar in 1997. NOLAND ET AL., *supra* note 32, at 5 n.10.

37. EAST ASIA ANALYTICAL UNIT, DEPT OF FOREIGN AFFAIRS AND TRADE, COMMONWEALTH OF AUSTRALIA, *ASIA'S FINANCIAL MARKETS: CAPITALISING ON REFORM* 22 (1999); CORSETTI ET AL., *supra* note 31, at 14; NOLAND ET AL., *supra* note 32 at 5; EDWARDS, *supra* note 25, at 5.

38. Asia's Financial Crisis, *supra* note 31, at 14-15.

39. OLIVER BLANCHARD & ANDREI SHLEIFER, *FEDERALISM WITH AND WITHOUT POLITICAL CENTRALIZATION: CHINA VERSUS RUSSIA* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 7616, 2000).

law failed badly.⁴⁰ Global capital did however worsen the eventual collapse in Russia in August of 1998 by flooding into the nation throughout 1997 and in the first several months of 1998.⁴¹ Capital flowed there in reliance on Russia's geo-political significance ensuring an International Monetary Fund (IMF) bail-out of creditors.⁴² However, the IMF would not lend in to an economic policy vacuum and hopefully had learned a lesson from the preceding year with the bailouts of Indonesia, Thailand and Korea. These bailouts led to precisely the moral hazard of investors and creditors sending money into Russia, not in the expectation that it would be repaid by Russia (once the interest rate on Russian government short-term debt instruments reached levels as high as fifty to sixty percent in mid-1998, repayment was clearly impossible), but solely in the expectation that the loans would be repaid by an IMF-led bailout.⁴³

A slick intellectual trick is often perpetrated here. Free trade in goods and services is generally accepted among economists as welfare enhancing. Free trade tends, at times, to cause severe change and economic dislocation in countries, but overall the result of free trade is a wealthier world. The trick is to assert that what holds for goods, holds for money. Isn't money just another good? Legally it is often treated as such.⁴⁴ Experience however, tells us otherwise; capital, unlike goods, must be repaid.

Capital is only welfare enhancing if it is put to productive uses that generate returns in excess of the cost of the capital. The failure by Latin America to generate productive returns with the massive loans of the 1970s led to the debt crisis of the 1980s. Likewise, the incapacity of the East Asian financial systems to channel the increased capital flows of the early and mid-1990s into productive uses contributed significantly to the Asian crisis of 1997.⁴⁵ The Asian economies were performing strongly before foreign capital flows into the region increased due to local capital market liberalisation, surplus liquidity in the U.S., and the dissuasive effect the Mexican peso cri-

40. Russian European Center for Economic Policy, *Russian Economic Trends: Monthly Update*, Sept. 4, 1998, at 5, at <http://www.hhs.se/site/ret/update/sep98/September.pdf>.

41. See Clifford S. Poirot, Jr., *Financial Integration under Conditions of Chaotic Hysteresis: The Russian Financial Crisis of 1998* 23(3) JOURNAL OF POST KEYNESIAN ECONOMICS 485, 500-03 (2001) (discussing the history of financial investment from 1995-1998).

42. Barry Eichengreen, *Is Greater Private-Sector Burden Sharing Impossible?* 1 (May 1999) (IMF Conference, Key Issues in Reform of the International Monetary and Financial System) at <http://emlab.berkeley.edu/users/eichengr/swoboda.pdf>. There is no doubt that the IMF's willingness to certify Russian fiscal progression added to the problem. Poirot, *supra* note 41, at 502.

43. Aschinger, *supra* note 10, at 157 (arguing that moral hazard arising from expected financial assistance from the IMF is a factor which may trigger a crisis); BARRY EICHENGREEN & CHRISTOF RÜHL, THE BAIL-IN PROBLEM: SYSTEMATIC GOALS, AD HOC MEANS 5 (Nat'l Bureau of Econ. Research, Working Paper No. 7653. April 2000) at <http://papers.nber.org/papers/w7653>.

44. FRITZ A. MANN, THE LEGAL ASPECT OF MONEY: WITH SPECIAL REFERENCE TO COMPARATIVE PRIVATE AND PUBLIC INTERNATIONAL LAW (5th ed. 1992).

45. NOLAND ET AL., *supra* note 32, at 3, 8, 9.

sis in late 1994 had on further capital flows to Latin America.⁴⁶ It is therefore not surprising that the increased capital flows of the 1990s ended up fueling speculative bubbles in local stock and real estate markets.

The clearest lesson of the recent economic crises is that unfettered capital mobility is not necessarily welfare enhancing and not an unmitigated good.⁴⁷

II. IMPACT ON HUMAN RIGHTS IN DEVELOPING COUNTRIES

The globalisation of capital markets leads to greater international portfolio capital flows and "increases the vulnerability of emerging markets to crises."⁴⁸ In good times, these flows support growth in developing countries. In bad times, they cause untold and appalling human suffering. The key lies in who portfolio capital flows serve in good times and who they harm in bad times.

The huge loans to Latin America of the 1970s brought "massive returns to the rich."⁴⁹ However, when these loans had to be repaid in the 1980s they were repaid by increasing taxes, reducing price supports on essential items and cutting spending on public health care, public education and public infrastructure.⁵⁰ The rich benefited from the loans, the common people and the poor repaid them.

Likewise in Asia, the boom in portfolio capital flows and lending to the region in the early to mid-1990s principally benefited the rich. The dislocation and impoverishment brought on by the crisis in 1997 has, however, fallen far more heavily on the shoulders of the common people and the poor.⁵¹ With the exception of Indonesia,⁵² Asia is recovering more quickly

46. See generally Ross P. Buckley, *An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors*, 15 BANK. & FIN. L. REV. 431 (2000).

47. See Nora Lustig, *Crises and the Poor: Socially Responsible Macroeconomics*, Presidential Address to the Fourth Annual Meeting of the Latin American and Caribbean Economic Association, Santiago, Chile (Oct. 22, 1999) at <http://muse.jhu.edu/demo/eco/1/1.1lustig.html>.

48. BUSTELO ET AL., *supra* note 19, at 83.

49. *A Survey; Latin America*, ECONOMIST, Nov. 13, 1993, at 25.

50. Between 1981 and 1986 real GDP per capita fell 10% in Mexico, 16% in Argentina and 27% in Bolivia. Harold James, *Deep Red—The International Debt Crisis and Its Historical Precedents*, AMERICAN SCHOLAR, Summer 1987, at 331, 340. See also Joseph L.S. Abbey, *Growing out of Debt—The African Problem*, in THIRD WORLD DEBT—MANAGING THE CONSEQUENCES 159, 160 (Stephanie Griffith-Jones ed, 1989); JORGE G. CASTANEDA, UTOPIA UNARMED 6-7 (1993); Jerry Dohnal, *Structural Adjustment Programs: A Violation of Rights*, 1 AUSTRALIAN J. HUM. RTS. 57, 72-74, 77 (1994); Duncan Green, *Hidden Fist Hits the Buffers*, NEW INTERNATIONALIST, Oct. 1995, at 35; Wade Mansell, *Legal Aspects of International Debt* 18 J.L. & SOC'Y 381, 388-90 (1991); Jesús Silva-Herzog, *The Costs for Latin America's Development*, in LATIN AMERICA'S DEBT CRISIS—ADJUSTING TO THE PAST OR PLANNING FOR THE FUTURE? 33, 36 (Robert A. Pastor ed., 1987).

51. *Crisis in Asia Spawns Millions of 'Newly Poor'*, WALL ST. J., Apr. 6, 1999, at B-5A (According to World Bank's estimates, the Asian crisis has plunged many millions into poverty).

from its crisis than either Latin America or sub-Saharan Africa were able to recover from the 1982 crisis. Nonetheless, the profound difference between those who benefit from international capital, and those who pay for it, has been maintained.

As Nora Lustig has written, "Macroeconomic crises, with the exception of wars, are the single most important cause of large increases in . . . poverty,"⁵³ or in Charles Calomiris' words, "When the crisis has passed, the big winners are the wealthy, politically influential risk takers, and the biggest losers are the taxpayers in countries like Mexico or Indonesia."⁵⁴

This transferal of responsibility onto the poor is depressingly consistent. After the debt crisis broke in 1982, the international banks required that all loans, corporate and sovereign, be brought under the sovereign guarantee as a way of facilitating rescheduling negotiations. Forcing governments to become loan guarantors dramatically improved the security of the banks. The largest banks benefited the most from this stratagem, as they held the highest proportion of loans compared to the less creditworthy private sector. Unsurprisingly, these were the banks in charge of the rescheduling negotiations.⁵⁵

In East Asia, in 1997, the great majority of the debt was held in the private sector, but this did not stop the taxpayers in the debtor countries from eventually bearing the costs of repaying the loans.⁵⁶ The IMF-led bailouts, invariably described as bailouts of Indonesia, Thailand or Korea,⁵⁷ were, in fact, long-term loans to these countries that had to be used to repay the short-term creditors.⁵⁸ These loans thus became debts of the nation and the bailouts were of the creditors, not the debtor nations at all.⁵⁹ Indeed, even though the IMF identified poor local prudential regulation and underdeveloped local capital markets as two of the principal contributing causes to the crisis, the IMF-orchestrated bailouts contained not one dollar to correct these weaknesses.

Such bail-outs must stop. In the Asian context, the bail-outs rewarded the short-term creditors who had helped precipitate the crisis and did nothing for the creditors who had advanced the type of debt that needs to be encour-

52. See Levinson, *supra* note 31, at 448-51. One year after the crisis, the ILO estimated that an additional 20% of the Indonesian population would fall into poverty. The World Bank further estimated that unemployment had tripled and real wages had decreased 40-60%. Asia's Financial Crisis, *supra* note 31, at 12-13.

53. Lustig, *supra* note 47, at 2.

54. Charles W. Calomiris, *The IMF's Imprudent Role as Lender of Last Resort*, 17 *CATO J.*, Winter 1998, 275, 276-77.

55. Buckley, *supra* note 20, at 43.

56. See Eichengreen, *supra* note 42, at 1.

57. The IMF coordinated loans to these three countries totaling over \$115 billion. Asia's Financial Crisis, *supra* note 31, at 11.

58. Levinson, *supra* note 31, at 446.

59. Charles W. Calomiris & Allen H. Meltzer, *Fixing the IMF*, 56 *NAT'L INTEREST*, Summer 1999, at 88.

aged: long-term debt.⁶⁰ The bail-outs were very damaging for the poor of Asia⁶¹ and virtually guaranteed the creditor behaviour that in 1998 greatly exacerbated Russia's crisis.

There are alternatives to the extremes of managed defaults on the one hand, or bail-outs, on the other. The principal ones are a sovereign bankruptcy court and a global lender of last resort.

A sovereign bankruptcy court would certainly be one way of allocating losses more equitably between lenders and borrowers and of improving the efficacy of the system.⁶² However, the establishment of such a court would require a quite implausible surrender of national sovereignty. A nation's courts would need to subordinate themselves to a global bankruptcy court, much as Britain's courts are subordinate to the EU courts on matters of concurrent jurisdiction. There is simply no prospect of such a major step in the foreseeable future. No existing supranational institution has the credibility and broad basis of acceptance to undertake this role. There is no present prospect of sufficient political will to support the creation of a global sovereign bankruptcy court.⁶³

A global lender of last resort would, likewise, offer much to the stability of the international financial system. Banking is inherently unstable, as it usually involves banks holding illiquid assets (such as long-term mortgages) and highly liquid liabilities (such as short-term deposits). A lender of last resort (LoLR) commits in advance to lend funds to banks freely and quickly, on good security and at high interest rates, in times of need.⁶⁴ As noted by Walter Bagehot in 1873, providing large amounts of funds quickly and freely discourages runs on banks by depositors, because they are assured the bank will have funds to meet their claims.⁶⁵ The requirements of good security and high interest rates discourages banks from relying on the LoLR's services and avoids the moral hazard that would otherwise flow from the provision of such a service.⁶⁶

60. In fact, countries such as Chile, Colombia and Slovenia encourage long-term debt by placing capital controls on short-term inflows. CORSETTI ET AL., *supra* note 31, at 22 (Part II: Policy Debate).

61. Richard Buckley argues that this was due to the IMF turning a currency crisis into an economic crisis, which leads to large unemployment and an increase in prices. Asia's Financial Crisis, *supra* note 31, at 11.

62. See generally Steven L Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 962 (2000) (discussing the need for an international bankruptcy court).

63. See KENNETH S. ROGOFF, INTERNATIONAL INSTITUTIONS FOR REDUCING GLOBAL FINANCIAL INSTABILITY 16-17 (Nat'l Bureau of Econ. Research, Working Paper No. 7265, Jul. 1999) available at <http://papers.nber.org/papers/w7265>; Alan S. Blinder, *Eight Steps to a New Financial Order*, FOREIGN AFFAIRS, Sept.-Oct. 1999, at 50, 60 (1999).

64. WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 96-97 (Richard D. Irwin, Inc. 1962) (1873).

65. *Id.* at 97.

66. *Id.* Moral hazard arises whenever a financial actor does not bear, or anticipate bearing, the full risk attached to its actions.

There is no global LoLR. The IMF conditions its loans upon economic reform in the recipient countries, so these commitments to lend are not unconditional, as is required to quell the fears of creditors and investors. Furthermore, the IMF disburses these funds slowly over time as compliance is established by the recipients, not disbursed quickly as required by Bagehot's famed prescription.⁶⁷ Finally, especially in the wake of the Asian economic crisis that commenced in 1997, and the IMF's difficulties in securing subscriptions from some member countries, the IMF simply does not have resources of the magnitude required to serve as a credible LoLR to sovereign entities.

There is, however, a clear need for a global LoLR. No domestic banking system would be stable without such a backstop, so it comes as no surprise that the international banking system is not particularly stable. The implementation challenges with an international LoLR includes the difficulty of ensuring it lends only on adequate enforceable security, so as to limit moral hazard, and the difficulty of providing it with the required resources.⁶⁸

The sovereignty fears should be far less with a LoLR than with a global bankruptcy court, and should not prove insurmountable. After all, the LoLR would merely be serving as a lender to a troubled country, and its existence would not require any reduction in the freedom to act of the country or its judicial system.

Providing adequate security, however, poses very real difficulties. Oil exporting nations, such as Mexico, can charge future oil revenues to serve as collateral for such a facility. Non-oil exporters, however, may well lack adequate realisable security on the scale required and it may be necessary to structure some sort of escrow arrangement. Under such an escrow agreement, once the LoLR makes a loan, a set proportion of the nation's subsequent export earnings would be redirected to a trusted third party to serve as security for the loans.

Nonetheless, the only structural change to the international financial architecture with any prospect of realisation is that of a global LoLR. This is certainly an end worth working towards. Realistically, it is also an end that is many, many years away. In the meantime, we need to reconceptualise the role of creditors and debtors in the current international financial system.

III. CONCLUSION

The role of creditors and investors in the creation of excessive indebtedness is widely overlooked. This is not surprising. Most commentators on the international financial system, academic and journalistic, are from developed countries and, as a result, they incline towards the perspective of the credi-

67. ROGOFF, *supra* note 63, at 15 ("Lend freely, to temporarily illiquid but solvent banks, a penalty rates and using collateral that would be good under non-crisis circumstances" citing Bagehot (1873)).

68. ROGOFF, *supra* note 63, at 9, 14.

tors and investors. It is this perspective that tends to dominate the national debate on these matters. However, it is time for a new framework for understanding responsibility in international lending and investment.

As it is, our modern financial system fails utterly to protect the innocent bystanders. Borrowers should repay their debts, even when it is painful to do so. Banks and investors who make errors should suffer the consequences. The common people of debtor nations should not bear the primary burden of financial crises, yet, almost invariably, they do.

Creditors and investors who make poor lending or investment decisions in the domestic context suffer the consequences. The ultimate sanction of bankruptcy provides a way out from under crippling debt for the debtor and typically results in substantial losses for creditors of, and investors in, the debtor. However, there is no equivalent to bankruptcy protection for sovereign debtors and, as we have considered, the development of a global sovereign bankruptcy court is highly unlikely. Indeed, it is almost as if the protection of bankruptcy has been replaced in the international context by a presumption that bad loans and bad investments are entirely the debtors' fault. This is a convenient fiction for international banks and investors, nothing more. However, it is a fiction with severe consequences.

The IMF bail-outs of the Asian debtors were made available to repay short-term bank debt. A default on such debt would have avoided the severe moral hazard occasioned by this use of the bail-out funds which, incidentally, contributed directly to the market extending excessive credit to Russia in late 1997 and early 1998, thus leading to Russia's crisis in August 1998.⁶⁹ Allowing a default on this debt would also have freed these bail-out funds to be used to recapitalize the local banks, improve the local financial systems and stimulate the local economies.⁷⁰ To use these funds to, in effect, bail out the international banks rather than the debtors is only defensible in a framework of moral responsibility that holds the creditors blameless. Yet bad loans usually involve errors of judgment by both parties and the consequences of those errors should be shared. This is especially so as the burdens on the debtors usually fall on those least able to bear them—the poor and disadvantaged.⁷¹

The repayment process in times of crisis is generally directed and orchestrated by the IMF. In Latin America and Africa in the 1980s, the IMF's

69. Asia's Financial Crisis, *supra* note 31, at 14-15.

70. HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 1248 (7th ed. 2000).

71. In Latin America, IMF structural adjustment programs tended to increase disparities in wealth. DUNCAN GREEN, SILENT REVOLUTION—THE RISE OF MARKET ECONOMICS IN LATIN AMERICA 92 (1995). SAPs meant the disadvantaged suffered most. Harold James, *supra* note 50 at 340; but brought "magnificent returns to the rich" *A Survey: Latin America, supra* note 49, at 25. In one commentator's words, "[t]he austerity program the Mexican government put in place when its economy faltered was a devastating blow to the country's working poor, but the big investors emerged largely unscathed." David E. Sanger, *Ideas & Trends; Maybe a Bankrupt Nation Isn't the Worst Thing in the World*, N.Y. TIMES, Oct. 12, 1997, § 4, at 6.

structural adjustment programs (SAPs) infringed upon numerous basic human rights.⁷² After initially advocating and requiring a fiscal austerity that deepened the Asian crisis, the IMF all but admitted its initial stance was wrong, and agreed to reflationary policies in many of the countries that have aided the region in its recovery from the crisis. Nonetheless, there are children today in Indonesia, Korea and Thailand who are hungry or have to work, rather than attend school, because of the impoverishment and economic dislocation brought about by the Asian crisis,⁷³ a crisis to which international capital flows contributed significantly.

It is time for a new allocation of responsibility in international lending that sees losses shared more evenly between creditors and debtors in times of trouble. We have to move beyond the assumption, so very convenient for the international financial community, that excessive capital flows to developing countries are always cases of excessive borrowing and never of excessive lending. Losses from poor lending decisions for such loans must be allowed to fall on the creditors, as they do for domestic loans. This one change of the international financial architecture that is realistically achievable in the short to medium term. Allowing creditors to bear the consequences of their lending decisions will minimise the great injustice inherent in the current allocation of responsibility in the international financial system. In addition, by minimising moral hazard and focusing creditor's minds more sharply upon their lending decisions, this change will serve to make the international financial system more stable and less crisis prone.

72. See Dohnal, *supra* note 50, at 57 (describing SAPs as a violation of economic human rights); Levinson, *supra* note 31, at 446-48 (discussing the impact of SAPs on Indonesia).

73. Bill Powell, *The Great Betrayal*, NEWSWEEK, Aug. 3, 1998, at 21 (Atlantic ed.) (arguing that the toll of Asia's economic crisis can be measured in "soaring joblessness, deepening poverty and increasing desperation"). See also Levinson, *supra* note 31, at 452-56.

