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The Institutional Weaknesses in the International Financial System

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Abstract

Since 1997 a massive amount of effort has gone into improving the international financial architecture. However, at a level more fundamental than that at which the reformers have worked, the architecture is deeply flawed. The international system has no sovereign bankruptcy regime, no financial regulator, and no lender of last resort. Yet these institutions are widely considered essential for the stability of all national financial systems. This article analyses the effect of these fundamental systemic flaws, and what, if anything, can be done about them.

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by

Ross P Buckley*

Since 1997 a massive amount of effort has gone into improving the international financial architecture. However, at a level more fundamental than that at which the reformers have worked, the architecture is deeply flawed. The international system has no sovereign bankruptcy regime, no financial regulator, and no lender of last resort. Yet these institutions are widely considered essential for the stability of all national financial systems. This article analyses the effect of these fundamental systemic flaws, and what, if anything, can be done about them.

It is a mistake to think that our international financial system was designed to deal with contemporary international capital flows or the current international system. It was not.

When in 1944 John Maynard Keynes and Harry Dexter White proposed three international organizations to guide and assist the international economy, the international financial system was utterly different to the one we have today. Nations existed as financial islands. Capital flows between them were miniscule by

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contemporary standards. ¹ Capital controls regulated and often prevented capital flows between nations. ²

The three organisations proposed by Keynes and White at Bretton Woods were the International Monetary Fund, the International Bank for Reconstruction and Development (the 'World Bank') and the International Trade Organisation.

The IMF, in its words, exists "to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment".³

For the World Bank, in its words, its "primary focus is on helping the poorest people and the poorest countries."

The International Trade Organisation, of course, never came in to being after Bretton Woods, due to U.S. misgivings, and it was to be fifty years before the World Trade Organisation was established in 1995.⁵ In its words, the WTO's "main function is to ensure that trade flows as smoothly, predictably and freely as possible."⁶

¹ In 1970 the capital that moved around the globe to support trade in goods and services far exceeded that which moved to support direct and portfolio investment. Today capital flows outweigh trade flows by a factor of over 60 to one: P. Sutherland (1998) *Managing the International Economy in an Age of Globalisation*, The 1998 Per Jacobsson Lecture, the annual meeting of the IMF and the World Bank. Total capital flows were US\$13.4 billion in 1970 and US\$271.6 billion in 2000: *Global Development Finance 2002*, Washington DC, World Bank, 2002, p246.

² See the discussion in RP Buckley, "The Role of Capital Controls in International Financial Crises", (1999) 11 *Bond Law Review*, 231.

³ IMF Homepage, available at http://www.imf.org/external/about.htm, accessed on October 15, 2003. The full text of the Purposes of the IMF can be found in Article I of the Articles of Agreement of the International Monetary Fund, available at http://www.imf.org/external/pubs/ft/aa/aa01.htm, accessed on October 15, 2003.

⁴ "About Us" at the World Bank web site available at http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,.pagePK:43912~piPK:36602,00.html; accessed on October 15, 2003. See also Articles of Agreement of IBRD, Article 1, available at http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,.contentMDK:20049563 ~pagePK:43912~menuPK:58863~piPK:36602,00.html#I1, accessed on October 15, 2003.

⁵ See Agreement Establishing the World Trade Organisation, available at http://www.wto.org/english/docs_e/legal_e/04-wto.doc, accessed on October 15, 2003. For a consideration of the role of the GATT Secretariat in the years before the inception of the WTO, see X Yi-Chong and P Weller, "International Civil Servants and the Multilateral Trade

If Keynes and White had looked at the world and seen today's system – a truly global system with few barriers to the movement of capital -- rather than the largely disconnected series of national financial systems they saw, it is reasonable to suppose they would have insisted the international system have the institutions each national financial system needs to be stable.

To the best of my knowledge, the financial system of every nation in the world includes:

- 1. a bankruptcy regime,
- 2. a financial regulator, and
- 3. a lender of last resort.

Yet each is missing in the international system. None of these functions are provided by the IMF, World Bank or WTO. The impact of the absence of these critical institutions in the international financial system, and what we might be able to do about it, is the subject of this article. Before we consider each missing element, it is important to ask, why do they matter?

Why Do These Deficiencies Matter?

The answer to the question why these deficiencies in the international financial system matter has two parts.

The first part of the answer is that a more stable international financial system will better serve the interests of creditors and debtors alike. Contemporary international finance is characterized by the increasingly frequent occurrence of severe crises.⁷

Negotiations," chapter 5 in RP Buckley (ed), *The WTO and the Doha Round: The Changing Face of World Trade*, Kluwer, London, 2003.

⁶ "The WTO … in brief", available at http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr00_e.htm, accessed on October 15, 2003.

⁷ P Bustelo, C Garcia & I Olivie, "Global and Domestic Factors of Financial Crises in Emerging Economies: Lessons from the East Asian Episodes (1997-1999)", ICEI Working Paper No. 16, Instituto Complutense De Estudios Internacionales, Madrid, November, 1999, 83.

Crises are an inevitable by-product of markets, as markets always overshoot.⁸ Crises are the price one must pay for the other efficiencies of a market system. In the words of Rudi Dornbusch, "[C]rises are good. They discipline both lenders and borrowers and teach them to control risky exposures and limit vulnerability".⁹ However in the past 25 years the frequency of international financial crises has been too high and is increasing. As Alan Greenspan puts it, "With the new more sophisticated financial markets punishing errant government policy behaviour far more profoundly than in the past, vicious cycles are evidently emerging more often."¹⁰ The absence of the three vital elements of all national systems identified here is a major contributing cause.

The second part of the answer focuses upon the impact of these financial crises on the poor in the debtor nations.

In good times, capital flows to developing and least developed nations support growth in those nations and, in bad times, 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." 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

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⁸ See the comments of Arminio Fraga in the IMF Economic Forum, "Financial Markets: Coping with Turbulence", Washington DC, December 1, 1998; available at http://www.imf.org/external/np/tr/1998/TR981201.HTM, accessed on December 2, 2003. See also the comments of Charles Dallara in P Blustein, "When Signs of Trouble Go Unheeded; Thai Crisis Exemplifies Trend in Emerging Markets", *The Washington Post*, Aug 17, 1997, H-01.

⁹ R Dornbusch, "The sunny side of crises", *Journal of Commerce*, Sept 15, 1997, 7A.

Remarks by Chairman Alan Greenspan, Before the Annual Financial Markets Conference of the Federal Reserve Bank of Atlanta, Miami Beach, Florida, February 27, 1998. See also The World Bank, *Global Development Finance 1997*, Vol 1 (Washington, DC: World Bank, 1997) 4; and LC Buchheit, "Cross-Border Lending: What's Different This Time?", 16 *Northwestern Journal of Int'al Law & Business*, 44 at 54-55 (1995)

^{11. &}quot;A Survey; Latin America", Economist, Nov. 13, 1993, at 25.

public health care, public education and public infrastructure.¹² 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 fell far more heavily on the shoulders of the common people and the poor.¹³

As Nora Lustig has written, "Macroeconomic crises, with the exception of wars, are the single most important cause of large increases in . . . poverty." Charles Calomiris put it this way, "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." Either way, the poor pay.

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. ¹⁶ The IMF-led bailouts, invariably described as bailouts of Indonesia, Thailand or Korea, were, in fact, long-term loans to these countries that had to be used to repay the short-term creditors. ¹⁷ These loans thus became debts of

^{12.} Between 1981 and 1986 real GDP per capita fell 10% in Mexico, 16% in Argentina and 27% in Bolivia: H James, "Deep Red—The International Debt Crisis and Its Historical Precedents", *American Scholar*, Summer 1987, at 331, 340. See also JLS Abbey, "Growing out of Debt—The African Problem", in *Third World Debt—Managing the Consequences* 159, 160 (Stephanie Griffith-Jones ed, 1989); JG Castaneda, *Utopia Unarmed* 6-7 (1993); J Dohnal, "Structural Adjustment Programs: A Violation of Rights", (1994) 1 *Australian Journal of Human Rights* 57, 72-74,77; Jésus Silva-Herzog, "The Costs for Latin America's Development", *in Latin America's Debt Crisis—Adjusting to the Past or Planning for the Future?* RA Pastor ed., 1987, 33, 36.

^{13. &}quot;Crisis in Asia Spawns Millions of 'Newly Poor", *Wall Street Journal*, Apr. 6, 1999, at B-5A (According to World Bank's estimates, the Asian crisis plunged many millions into poverty).

^{14.} N Lustig, "Crises and the Poor: Socially Respnsible Macroeconomics", Presidential Address to the Fourth Annual Meeting of the Latin American and Caribbean Economic Association, Santiago, Chile, October 22, 1999 at 2.

^{15.} CW Calomiris, *The IMF's Imprudent Role as Lender of Last Resort*, 17 Cato Journal, Winter 1998, 275, 276-77.

^{16.} See B Eichengreen & M Mussa, *Capital Account Liberalization: Theoretical and Practical Aspects*, IMF Occasional Paper No 172, 1998.

^{17.} J Levinson, "Living Dangerously: Indonesia and the Reality of the Global Economic System", (1998) 7 *Journal of International Law & Practice* 425 at 437-41 & 446.

the nation and the bail-outs were of the creditors, not the debtor nations at all.18 These bail-outs were largely at the expense of the poor in the debtor nations as the funds to service these long-term loans have come from increased taxes and reduced spending on essential social services. 19

For example, let's look at the Philippines. It is not an exceptionally poor country, although it has within it regions of extreme poverty, such as Mindanao. It falls short of qualifying as a Highly Indebted Poor Country under the World Bank's rules, and thus does not qualify for the total debt cancellation extended to HIPCs by the Bank and the IMF in 2005. Nonetheless, the debt burden on the Philippines' is severe: over 34% of government spending in 2006 will go to servicing interest on debt alone, compared to less than 14% on education, less than 5% on defence and only 1.3% on health.²⁰ When one factors in principal repayments as well, the situation becomes utterly intolerable, with total debt service in 2005 consuming almost 60% of government expenditures, and even more in 2006. In 2006, therefore, about twothirds of every peso spent by the Philippines government will be spent on paying interest or repaying principal on its debts. In the words of Habito and Beja, "Ultimately the debt penalty compromises the country's long term human development and economic growth."²²

In summary, the political realities of virtually all debtor nations mean that financial crises hurt the poor in developing and least developed nations far more than they hurt the rich. So let's proceed to analyse the elements that are present in every national financial system, and missing internationally.

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^{18.}CW Calomiris & AH Meltzer, "Fixing the IMF", 56 National Interest, Summer 1999, at 88.

¹⁹ RP Buckley, "The Fatal Flaw in International Finance: The Rich Borrow and the Poor Repay", XIX No 4 World Policy Journal, Winter 2002/3, 59.

²⁰ CF Habito and EL Beja, "Beating the Odds?: The Continuing Saga of a Crisis-Prone Economy", available at www.codengo.org, accessed on October 5, 2006.

²¹ Id at 8. epress Legal Repository

A Bankruptcy Regime

An effective insolvency regime brings many benefits to an economy. The principal benefits and purposes of a personal insolvency system are generally enunciated as being to divide the assets of an insolvent debtor fairly between its creditors, and to allow an insolvent debtor the opportunity to make a fresh start free from the burden of accumulated debt (provided the debtor has not engaged in dishonest or otherwise improper financial conduct).²³

The principal benefits and purposes of a corporate insolvency regime have been identified as being: to restore the company to profitable trading; to maximise returns to creditors; to provide a fair and equitable system for the ranking of claims and to identify the causes of company failure and impose sanctions for culpable management.²⁴

The literature²⁵ invariably overlooks one other important effect of a bankruptcy regime: the credit-allocation effect.²⁶

An effective insolvency regime will improve the allocation of credit within an economy, and thus make the economy more stable. This is because a bankruptcy

²³ D Rose, *Lewis Australian Bankruptcy Law* (Law Book Co, Sydney, 1994) p 1.

²⁴ RM Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell, London, 1997) pp 25-28.

²⁵ The latest edition of the classic Australian text on liquidation, McPherson The Law of Company Liquidation, (4th ed, The Law Book Company Limited, Sydney) enunciates purposes in much the same terms as Sir Roy Goode. Ian Fletcher's classic English text, The Law of Insolvency, (Sweet & Maxwell, London, 1996, pp 4-6) is silent on the issue. The most thorough Australian analysis of the principles that should underpin and guide a modern insolvency law is to be found in the Australian Law Reform Commission Report, the General Insolvency Inquiry of 1988 (the "Harmer Report") Report No 45 (1988). It does not address this credit-allocation effect. The most thorough and thoughtful analysis of the aims and principles of a modern insolvency regime is to be found in Finch's book, Corporate Insolvency Law: Perspectives and Principles (Cambridge University Press, 2002) at 25-26 and yet even the redoubtable Professor Finch does not investigate the credit-allocation effects of an insolvency regime (although she does touch on some related matters in Chapter 4, and specifically at pp 143-144). Indeed the only reference I have been able to locate to this creditallocation effect, is in the Cork Committee Report (Great Britain, Report of the Committee on Insolvency Law and Practice (Cmnd 8558, 1982) into insolvency law and practice in the UK in 1982 which, in the context of a comprehensive enunciation of the aims of a contemporary insolvency regime, states that one aim is "to underpin the credit system".

²⁶ RP Buckley, "The Systemic Benefit of Insolvency Law: A Lacuna in the Australian Literature", (2003) 11 *Insolvency Law Journal* 38.

regime serves to allocate losses between debtors and creditors in the event of bankruptcy and thus tempers the appetite of creditors for risk. Without bankruptcy, banks could garnish a borrower's wages for life to secure repayment of a debt, or threaten the borrower with debtors' prison. With either enforcement mechanism it is reasonable to expect banks would see their position strengthened in recovering debts and thus the need for care in lending diminished.

The importance of the credit-allocation effect of bankruptcy laws is best seen where it is missing: in insolvent sovereign nations and in less developed countries that lack effective insolvency regimes.²⁷

Over 200 years ago Adam Smith wrote in his seminal work that:

"When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor."²⁸

Notwithstanding this injunction from the father of economics, there is still no legal mechanism or body of laws by which a state can declare bankruptcy.

The consequences of this were highlighted in the 1970s when the Chairman of Citibank, Walter Wriston, famously pronounced that "Countries never go bankrupt". This pronouncement was to influence more international lending decisions in the 1970s than any risk analysis, and was a major contribution to the lending frenzy that led to the Latin American and African debt crisis of 1982. Never was a statement more true in form and false in substance than Wriston's. Sovereigns do not become

In the past decade the installation of effective insolvency regimes have been a high priority for Eastern European nations embracing a market economy and for East Asian nations in the wake of the Asian economic crisis of 1997 because, in each case, the absence of such regimes led to highly inefficient allocations of credit within those economies: JC Brada, "The Comparative Economics of Bankruptcy: Dealing with Loss-making Firms in Capitalist, Socialist, and Transitional Economies" (1993) 34 Eastern European Economics 82.

²⁸ Adam Smith, *The Wealth of Nations* (Edward Cannan ed, 1976) Book V, Ch III, p 468.

²⁹ As quoted in Sachs, "Introduction" in J Sachs (ed), *Developing Country Debt and the World Economy* (University of Chicago Press, 1989) p 8.

³⁰ RP Buckley, *Emerging Markets Debt* (Kluwer Law International, London, 1999) pp 5-24.

³¹ SS Golub, "The Political Economy of the Latin American Debt Crisis" (1991) 26 Latin American Research Review 175 at 177.

legally insolvent, because there are no legal rules to effect sovereign insolvency. But the history of the past fifty years tells us that debtor nations usually continue to service their debts, even when as nations they are functionally bankrupt and can do so only by borrowing ever more debt.³² Countries can always repay loans precisely because they can always increase taxes and reduce spending on health, education and nutrition – and at some point with poor countries such reductions in spending lead to unconscionable hardship.

The systemic advantage of bankruptcy is desperately needed at the global level because the existence of a global bankruptcy regime would tend to moderate capital flows to developing countries.³³ Nothing sharpens bankers' minds like the prospect of losing money, and this prospect would be much more imminent and real with some form of bankruptcy regime in place. This systemic advantage would help to ensure that capital flows are more appropriate to the needs and capacities to repay of the respective debtor nations than is today the case. The history of international lending to developing countries is a history of overlending and overborrowing. Financial crises would thus be less frequent and less severe if the prospect of bankruptcy reduced the magnitude of these capital flows.³⁴ Furthermore, in the event of a crisis, the workout would proceed far more rapidly and equitably, and thus the workout costs to creditors and debtors would be much reduced, by a bankruptcy regime.³⁵

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³² See LC Buchheit and GM Gulati, "Sovereign Bonds and the Collective Will", (2002) 51 *Emory Law Journal* 1317.

³³ For a survey of the early literature in this regard, see K Rogoff & J Zettlemeyer, "Early Ideas on Sovereign Bankruptcy Reorganization: A Survey", IMF Working Paper, WP/02/57, March 2002.

³⁴ Excessive capital inflows played a major role in the Debt Crisis of 1982, the Mexican Tequila Crisis of 1995, the East Asian Economic Crisis of 1997 and Russia's meltdown in 1998: see RP Buckley, "A Tale of Two Crises: The Search for the Enduring Lessons of International Financial Reform" (2001) 6 *UCLA Journal of International Law and Foreign Affairs* 1; and RP Buckley, "An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors" (2000) 15 *Banking and Finance Law Review* 431.

³⁵ For the IMF's latest proposals for a sovereign debt restructuring mechanism, see A Krueger, "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring", Speech to the National Economists' Club Annual Members' Dinner, Washington DC, 26 November 2001, available at

http://www.imf.org/external/np/speeches/2001/112601.htm accessed on 13 February 2003; A Krueger, *A New Approach to Sovereign Debt Restructuring* (International Monetary Fund, Washington DC, 2002, available at

http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/index.htm accessed on 13 February 2003); Krueger A, "New Approaches to Sovereign Debt Restructuring: An Update to our Thinking",

Many writers have advocated the establishment of a global bankruptcy court as a way of allocating losses more fairly between lenders and borrowers and of improving the efficiency of the system.³⁶

The comprehensive approach would be to establish a sovereign bankruptcy court (or an ad hoc tribunal for each case) applying a highly developed body of rules and procedure, very much like the International Criminal Court that commenced on July 1, 2002.³⁷ Such a court or tribunals and rules would require years of planning and negotiations to be implemented by a treaty between nations.³⁸

Speech to the Sovereign Debt Workouts: Hopes and Hazards Conference, Institute for International Economics, Washington DC, 1 April 2002, available at http://www.iie.com/papers/krueger0402.htm accessed on 13 February 2003; A Krueger, "Preventing and Resolving Financial Crises: The Role of Sovereign Debt Restructuring", Speech to the Latin American Meeting of the Econometric Society, Sao Paolo, 26 July 2002, available at http://www.imf.org/external/np/speeches/2002/072602.htm accessed on 13 February 2003; A Kreuger, "Sovereign Debt Restructuring: Messy Or Messier?", Speech to the Annual Meeting of the American Economic Association, Washington DC, 4 January 2003, available at http://www.imf.org/external/np/speeches/2003/010403.htm accessed on 13 February 2003; and a Public Information Notice, "IMF Board Discusses Possible Features of a Sovereign Debt Restructuring Mechanism", No 03/06, available at http://www.imf.org/external/np/sec/pn/2003/pn0306.htm accessed on 13 February 2003. For a critique of these proposals see RP Buckley, "The IMF's Proposal for a Sovereign Debt Restructuring Mechanism: An Australian Assessment", (2003) *Australian Journal of International Law* 1.

³⁶ K Raffer, "Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face", (1990) *World Development* 18(2), 301; K Raffer, "International Debts; A Crisis for Whom?", in HW Singer & S Sharma, *Economic Development and World Debt*, London: Macmillan, 1989, 51; SL Schwarcz, "Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach", (2000) 85 *Cornell Law Review*. 956; Hal Scott, "Would a New Bankruptcy Regime Help?", *Brookings Papers on Economic Activity*, Vol 2002, No. 1 334-340, and M White, "Sovereigns in Distress: Do They Need Bankruptcy?" in Brainard WC and Perry GL (eds), *Brookings Papers on Economic Activity* 2002 (No 1, Brookings Institution Press, 2003) p 287. See also the research referred to in K Rogoff & J Zettelmeyer, "Early Ideas on Sovereign Bankruptcy Reorganisation: A Survey", *IMF Working Paper* WP/02/57.

³⁷ Presently, no court has jurisdiction over disputes between a sovereign state and citizens (such as banks or bondholders) of another sovereign state – the International Court of Justice deals only with disputes between sovereign states: M White, *id* at 21. Arbitral tribunals, such as those under the auspices of the International Centre for the Settlement of Investment Disputes (ICSID), do deal with such disputes, but are, of course, not courts: see RP Buckley, "Now We Have Come to the 'ICSID' Party: Are Its Awards Final and Enforceable?" (1992) 14 *Sydney Law Review* 358.

³⁸ The two principal models widely discussed for any such transnational law are Chapters 9 and 11 of the US Bankruptcy Code. Kunibert Raffer has made a very strong case for why Chapter 9 provides the best available precedent for international sovereign bankruptcies: see K Raffer, "Solving Sovereign Debt Overhang by Internationalising Chapter 9 Procedures"

The proposal which is closest to the law in most countries is that developed by the Jubilee framework.³⁹ This envisages a bankruptcy procedure based on Chapter 9 of the US Bankruptcy Code (which deals with municipal bankruptcies) and enforced by an ad hoc independent panel of experts convened for a specific proceeding. The best long-term model for any sovereign bankruptcy regime is undoubtedly Chapter 9 of the US Code⁴⁰ which has worked effectively and efficiently in the bankruptcy of local municipalities within the U.S. and already deals with the issues peculiar to the bankruptcy of governments.

The principal reason we don't have a global sovereign bankruptcy regime is because the creditors believe its absence works in their favour.⁴¹ The banks have argued vociferously against a bankruptcy regime internationally when they accept, and indeed welcome, bankruptcy regimes nationally. Why? In the words of William Rhodes, Senior Vice-Chairman of Citibank,

"the existence of a formal bankruptcy mechanism, whether invoked or not, would cause uncertainty in the markets, deter potential lenders and investors, and drive up the countries' borrowing costs". 42

This is nonsense. National bankruptcy regimes greatly enhance certainty and this serves generally to attract lenders and investors and thus diminish borrowing costs and there is no reason it would be any different internationally. In the IMF's words, "In the domestic context, the existence of a bankruptcy law makes debt markets more efficient. ... The same principle should hold for international capital markets". 43

(2002) *Studien von Zeitfragen*, available at http://www.studien-von-zeitfragen.net/Weltfinanz/RAFFER 1/raffer 1.HTM accessed on September 3, 2005.

³⁹ Ann Pettifor, "Resolving International debt crises – the Jubilee Framework for international insolvency", January 2002, available at www.jubileeplus.org/analysis/reports/jubilee_framework.html; accessed on September 26, 2005.

⁴⁰ See Raffer, op cit n 41; Pettifor, ibid; and PW Rasche, "Argentina: test case for a new approach to insolvency?", *Studien von Zeitfragen*, January 5, 2002.

⁴¹ JD Sachs, "The Roadblock to a Sovereign Bankruptcy Law", (2003) 23:1 Cato Journal.

⁴² Quoted in P Hartcher, "US reigns in IMF with tough debt rules", *Australian Financial Review*, April 22, 2002.

⁴³ See IMF, "Proposals for a Sovereign Debt Restructuring Mechanism (SDRM) A Factsheet", January, 2003, available at http://www.imf.org/external/np/exr/facts/sdrm.htm, accessed on March 6, 2005, at D.5.

Financial markets thrive on certainty. On the other hand, there is currently no formal structure for the resolution of sovereign debt crises and each crisis typically casts a pall for many years on debtor country prospects and bank profits. Debtor countries suffer with no new capital and ever increasing debt loads and banks suffer if they have to keep advancing new funds to enable the debtors to keep paying interest.⁴⁴

William Rhodes is the world's most experienced banker in sovereign debt restructurings. He must know he is speaking nonsense, but does so presumably because he can't admit that the banks like the present arrangement under which, when a crisis hits, the poor in developing countries are consigned to the debtors' prisons of poverty, ill-health and ignorance⁴⁵ so that the loans made by the banks can be repaid.

National bankruptcy regimes seek to ensure the maximum return to creditors while ensuring the debtors have food, housing and the capacity to work. Humane nations tolerate nothing less. We rejected debtors' prisons centuries ago.⁴⁶ The absence of an international bankruptcy regime means people starve, and live without adequate shelter, healthcare and education, while their country's wealth goes to service loans. Why is it that what is considered unacceptable within any developed nation in terms of its people, is considered acceptable by the international financial community when it applies to the people of poor debtor countries?⁴⁷

The IMF, in late 2001, put forward the idea of a Sovereign Debt Restructuring Mechanism as an effective approach to sovereign bankruptcy. The SDRM was not a bankruptcy regime. As it developed over time, it had four principal elements:⁴⁸

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⁴⁴ RP Buckley, "A Tale of Two Crises: The Search for the Enduring Lessons of International Financial Reform" (2001) 6 *UCLA Journal of International Law and Foreign Affairs* 1; at 33-34.

⁴⁵ C Marichal, *A Century of Debt Crises in Latin America* (1989) at 237; and Buckley, *supra* n.30 at 34-36; and Buckley, op cit n 22.

⁴⁶ An excellent analysis of the history of the early common law remedies against debtors, including imprisonment for debt, can be found in *Lewis Australian Bankruptcy Law*, (D Rose QC (ed.), The Law Book Company Limited, 1994) at 7-10.

⁴⁷ Buckley, op cit n 22.

These are drawn from the IMF publication, "Proposals for a Sovereign Debt Restructuring Mechanism (SDRM) A Factsheet", January, 2003, available at http://www.imf.org/external/np/exr/facts/sdrm.htm; accessed on October 1, 2005; and also from Anne Krueger; *A New Approach to Sovereign Debt Restructuring*; (2002) available at http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/index.htm; accessed on October 1, 2005.

- 1. Majority restructuring so as to circumvent the collective action problems that are particularly prevalent with bond financing and to remove the free-riding and rogue creditor problems.
- 2. Deterrence of disruptive litigation by providing for any amounts recovered to be deducted from any eventual residual claims.⁴⁹
- 3. Protection of creditor interests by a restraint on the debtor paying non-priority creditors and by an IMF assurance of good economic conduct by the debtor to give the creditors an assurance the debtor will pursue policies that protect asset values and restore growth.
- 4. Seniority for new lending, so as to attract it to the country.

A SDRM would have involved the appointment of a Sovereign Debt Dispute Resolution Forum (described as independent even though its members were to be nominated and endorsed by the Fund). The Forum would have had power to decide disputes between creditors and between creditors and debtors but its role fell far short of that of a bankruptcy court and the SDRM falls far short of the bankruptcy regimes that are an essential part of all national economic systems.⁵⁰ Specifically there were six problems with the SDRM initiative:

- 1. The determination of whether a nation qualified for debt restructuring was to be made not by the Sovereign Debt Dispute Resolution Forum, as one would expect, but by the IMF.
- 2. The determination of a nation's level of debt sustainability, from which the necessary amount of debt reduction would follow as a matter of logic, was to

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⁴⁹ A far more effective deterrence was the freeze on creditors' actions against the debtor included in the original IMF proposal of the SDRM and subsequently watered down in response to pressure from creditors and the US government.

⁵⁰ A Pettifor and K Raffer, "Report on the IMF's conference on the SDRM, January 22, 2003", unpublished report on file with author.

- be made not by the Sovereign Debt Dispute Resolution Forum, as one would expect, but by the IMF.⁵¹
- 3. The IMF was to discharge these two critical functions while compromised by its status as a major creditor of the debtor, and presumably with one eye upon the recoverability of its own loans. That one should never be a judge in one's own cause is a fundamental principle of natural justice that the SDRM proposal ignored.
- 4. The SDRM applied only to commercial bank debt and left Paris Club, IMF and World Bank debt out of the equation. Thus even considerable debt reductions by commercial creditors may have been insufficient to return a debtor nation to viability as the overall debt burden on the nation may have been insufficiently reduced.
- 5. In an about-face, the IMF dropped the stay on enforcement of claims that is a feature of virtually all domestic bankruptcy regimes. It was replaced by the less effective "Hotchpot rule" under which any amounts recovered by a creditor are deducted from the creditor's eventual entitlements.⁵²
- 6. The laws and rules that the Forum would apply were not drafted so the IMF, in effect, sought support for a process the final form of which was uncertain.

Perhaps unsurprisingly, given it was a creation of the IMF, the SDRM served to entrench the IMF in its role of international economic crisis policeman. However, the IMF's performance of this role has failed to inspire confidence since it took it on in late 1982. The nations in Sub-Saharan Africa that only paid lip service to IMF structural adjustment programs in the 1980s and 1990s enjoyed higher rates of economic growth than those that applied such IMF programs strictly. The IMF's initial policy prescription of budgetary austerity for the nations most affected by the Asian economic crisis in 1997 was wrong, as Joseph Stiglitz, then Chief Economist of

⁵¹ K Raffer, "The IMF's SDRM – Another Form of Simply Disastrous Rescheduling Management?", in C Jochnick & F Preston (eds), *Sovereign Debts at the Crossroads*, Oxford University Press, 2006.

⁵² See K Raffer, "To Stay or Not to Stay – A Short Note on Differing Versions of the SDRM", January 31, 2003, available at http://www.jubilee2000uk.org/latest/raffer310103.htm

the World Bank, identified at the time; and the Fund itself subsequently tacitly admitted it by endorsing expansionary policy settings in those nations.⁵³ Finally, Argentina was a model IMF pupil in the decade up to its catastrophic debt default in late 2001 –an economic meltdown facilitated by IMF-endorsed policies.⁵⁴

The SDRM proposal sought to render more efficient the current, haphazard debt restructuring process without addressing any of the inequities or power imbalances of the present system. In the IMF's words, "We are not proposing a bankruptcy mechanism for countries, but simply a mechanism to facilitate debt workout negotiations between a debtor and its creditors". Yet a bankruptcy mechanism is precisely what is needed. One purpose of a rules-based system is to redress power imbalances by the application of fair and just rules — to replace the law of the jungle under which the most powerful wins with the rule of law. The SDRM failed this test. The rules it would have administered were never formulated, but those rules would have been formulated and later applied not by an independent body, but by an interested party, the IMF itself.

The SDRM proposal encountered strong opposition from major international commercial banks and was shelved at the Spring meeting of the IMF in April, 2003. There is a need for more than an SDRM. Developing and least developed nations, and the international financial system, would be far better served by a carefully crafted set of bankruptcy rules, based on Chapter 9 of the US Bankruptcy Law, and applied and enforced by a truly independent tribunal.

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⁵³ JE Stiglitz, *Globalisation and Its Discontents*, London: Allen Lane, 2002.

⁵⁴ RP Buckley, "Do Cry for the Argentines: An Analysis of Their Crisis", (2003) 17 *Banking and Finance Law Review* 373.

⁵⁵ IMF, "Proposals for a Sovereign Debt Restructuring Mechanism (SDRM) A Factsheet", January, 2003, available at http://www.imf.org/external/np/exr/facts/sdrm.htm, accessed on March 6, 2005, at B.6.

A Global Financial Regulator

Within national financial systems central banks often discharge a number of functions including those of financial regulator and lender of last resort.⁵⁶ This section deals with financial regulation. The next will deal with the lender of last resort function.

Global financial regulation is today handled by bodies such as the Bank for International Settlements and other affiliations of central banks and nations that issue non-binding edicts or recommendations, the implementation of which is left to national authorities. This flexible system provides a great deal of guidance in the form of model laws and regulations and know-how for national authorities that seek to implement effective regulation. It has, however, no direct authority to require such behaviour from national authorities.

A truly global financial regulator would be able to supervise transnational capital flows extended by commercial banks, export credit agencies, supranational institutions and developed country sovereigns. As capital flows, and the operations of capital markets, are now global, so too should be financial regulation. The problems of markets and capital flows being transnational while regulation remains national are obvious.⁵⁷ However, no existing supranational institution has the credibility to be a plausible candidate for the role⁵⁸, and there is almost no appetite, particularly within the U.S., to create another supranational institution.⁵⁹ The decisions of such a regulator would have far reaching consequences for each nation's financial system as, almost inevitably, such decisions would have the effect of favoring one nation's financial system over another. Accordingly, the establishment of a global financial regulator with enforcement powers poses a massive challenge to the sovereignty of

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⁵⁶ For a consideration of the role of central banks in ensuring financial stability, see Garry J Schinasi, "Safeguarding Financial Stability: Theory and Practice", International Monetary Fund, 2006.

⁵⁷ On the need to reconceive our liberal and social democratic values as genuinely global values and then frame the institutions that will sustain and advance them, see C Sampford, "Sovereignty and Intervention" in Campbell and Leiser (eds) <u>Human Rights in Theory and Practice Ashgate</u>, London, 2001.

⁵⁸ J Stay, "Reform of the International Financial architecture: What has been written?" in Underhill & Zhang (eds) *International Financial Governance Under Stress Global Structure Vs National Imperatives* Cambridge, 2003.

⁵⁹ Survey Global finance, "A wealth of Blueprints" ECONOMIST, January 30 1999.

nations. As strong as the need is, for these reasons, the prospects of a global financial regulator are extremely slight.

A Global Lender of Last Resort

Banking is an inherently unstable business as it typically 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) provides stability to each national banking system by committing in advance to lend funds to banks freely and quickly, on good security and at high interest rates in times of need (according to the classic 19th century prescription of Walter Bagehot).⁶⁰ The provision of large amounts of funds quickly and freely discourages runs on banks by depositors as they are assured the bank will have funds to meet their claims. The requirements of good security and high interest rates discourages banks from relying on the lender of last resort's services and avoids the moral hazard that would otherwise flow from the provision of such a service.⁶¹

There is no LoLR in the international system. The International Monetary Fund conditions its loans and the bailouts it orchestrates upon economic reform in the recipient countries so these commitments to lend do not have the unconditional nature required to quell the fears of creditors and investors. Secondly, the IMF typically disburses these funds slowly over time as compliance with the required reforms is proven by the recipients – the funds are not disbursed quickly as required by Bagehot's prescription. Thirdly and finally, especially in the wake of the Asian

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Walter Bagehot, *Lombard Street: a description of the money market*, H. S. King & Co.: London, 1873; Stanley Fischer, "On the need for an International Lender of Last Resort" available at http://www.imf.org/external/np/speeches/1999/010399.htm, accessed on December 20 2003.

Moral hazard arises whenever a financial actor does not bear, or anticipate bearing, the full risk attached to its actions. See LC Buchheit, "Moral Hazards and other delights", IFLR 10 (April 1991) at 10.

⁶² B Eichengreen, "Bailing in the Private Sector: Burden Sharing in International Financial Crisis" (1999) *Fletcher Forum of World Affairs*, 57, 59; JA Frankel "International Lender of Last Resort" June 25 1999, available at http://www.ksghome.harvard.edu/~,jfrankel.academic.ksg/weqfrbosllr.pdf, accessed on December 20 2003; see C Lichtenstein, "The Role of International Law in the 21st Century: The Mexican Crisis: Who should be a country's lender of Last Resort." (1995) *Fordham International Law Journal*, 1769, 1769.

economic crisis of the late 1990s and the IMF's difficulties in securing subscriptions from some member countries, it does not have the resources required to serve as a credible LoLR to sovereign entities and, of course, unlike national central banks it lacks the capacity to print the money required to perform the role.⁶³

There is a clear need for a global LoLR. National LoLRs, such as the central bank of most nations, cannot function as a LoLR for their nation's foreign currency borrowings, precisely because they cannot generate the currency in which the indebtedness is denominated.⁶⁴

No domestic banking system would be stable without such a backstop so it is no surprise that the international system is not particularly stable.⁶⁵ The challenges in implementing an international LoLR are threefold: (i) the fears of some sovereigns that the establishment of such an entity will result in some loss of sovereignty, (ii) the difficulty of ensuring that the LoLR lends only on adequate enforceable security so that exceptional moral hazard is not engendered by its activities⁶⁶, and (iii) the difficulty of providing the LoLR with the resources to do the job.

The sovereignty fears should be far less with a LoLR than with a global financial regulator. Indeed a LoLR detracts little from national sovereignty. After all, the LoLR would merely be serving as a lender to a troubled country – its loans need not be accepted and its existence would not require any reduction in the freedom to act of the country or its judicial system.

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⁶³ Schinasi, op cit n 61; M Weisbrot, "Exceptions and Conditions: Globalisation from Whom?" (1998) *Cornell International Law Journal*, 631, 653; H Kaufmann, "International Lender of Last Resort: Discussion", available at www.bos.frb.org/economic/conf/conf/198p.pdf, accessed on December 20° 2005, 198; Jeffrey Sachs, "The Last Resort" available at http://www.backissues.worldlink.co.uk/articles/2311998143846/23111998150125.htm, accessed on December 20° 2005.

⁶⁴ See, generally, on two models for a global LoLR – one in which the global LoLR injects liquidity into the international financial system, and the other in which it supports national banking systems: see O Jeanne and C Wyplosz, "The International Lender of Last Resort: How Large is Large Enough?", IMF Working Paper, WF/01/76, May 2001.

⁶⁵ See generally J Sachs, "The International Lender of Last Resort: What are the alternatives?" available at http://www.bos.frb.org/economic/conf/conf43/181p.pdf, accessed on December 20° 2003 183.

⁶⁶ F Capie, "Can there be an International Lender of Last Resort?" (1998) *International Finance* 311, 314

However, the provision of adequate security poses very real difficulties indeed. Oil exporting nations such as Mexico could charge future oil revenues to serve as collateral for such a facility. However non-oil exporters may well lack adequate realisable security on the scale required -- it may be necessary to structure some sort of escrow arrangement under which, upon a loan being made by the LoLR, a set proportion of the nation's subsequent export earnings are redirected to a trusted third party to use to secure the loan(s). The difficulty is that in troubled times, which by definition will be the period after a LoLR has been called upon, developing nations invariably need all of their foreign exchange earnings to service existing debt and to acquire the imports needed by their domestic industries. To redirect a substantial proportion of foreign exchange from export earnings into repaying the loans of the LoLR would typically be unsustainable. Accordingly, most countries are going to find the provision of adequate security for the amounts of loans likely to be needed from a LoLR to be extremely problematic, if not downright impossible. For this reason, and the associated massive moral hazard if adequate security is not provided, ⁶⁷ it is difficult to conceive of an effective global LoLR.

Conclusion

The only major structural reform of the international financial architecture that is achievable is a global sovereign bankruptcy regime.

A global bankruptcy court would have to be created by international treaty among the affected nations – the home jurisdictions of the creditors and the debtor nations. Law reform by international treaty is usually grindingly slow. The International Criminal Court was some 55 years in the making. The World Trade Organisation came into being 51 years after it was first proposed as the third of the Bretton Woods institutions. Even the Uniform Customs and Practice for Documentary Credits, which is only a set of standard terms for letters of credit, was in existence for some 40 years, and went through three revisions before gaining widespread usage and acceptance

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⁶⁷ For a consideration of the moral hazard engendered by the IMF-organised bail-outs of Indonesia, Korea and Thailand in 1997 and the ways in which it contributed to Russia's economic meltdown in 1998: see Buckley, "An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors", (2000) 15 *Banking and Finance Law Review* 431.

globally. 68 History is not on the side of expeditious reforms of this type. There is, however, one cause for optimism -- the Basle Accord of the Bank for International Settlements was promulgated to regulate the capital adequacy of banks only some six or so years after the Latin American and African debt crisis of 1982 that gave the reforms impetus.

However the Basle Accord sought to achieve what the international creditor community knew was essential for short-term bank profitability as well as for systemic stability. A global bankruptcy regime seeks to achieve what is essential for the efficiency and stability of the international financial system and while this would most definitely enhance global prosperity and thus bank profitability in the long term, it will not necessarily enhance the bottom line for international banks in the short term. The long-term self-interest of the international banks would be best served, as it is domestically, by an efficient global bankruptcy regime and the more stable international financial system it would deliver. However, more research, and a major educative effort, will be required to prove this to the banks and until they accept and understand it, a global bankruptcy regime is less than likely.

An ad hoc global bankruptcy tribunal administering an agreed body of rules is the most realizable first step in the journey towards a permanent global bankruptcy regime. This remains a major undertaking as a debtor nation and its creditors would have to agree to the rules that would be applied and the constitution of the tribunal that would apply them – and this difficulty is compounded by debtor nations typically having thousands of creditors each holding bonds. Nonetheless as collective action clauses become more widespread in sovereign bond documentation, ⁶⁹ as is rapidly occurring, these practical problems are rendered more manageable.

While forming an ad hoc tribunal and reaching agreement on the applicable rules will prove a challenge for creditors and debtors, it is by no means an insuperable problem. The necessary groundwork for it, however, will be a long period of advocacy and education of the international financial community, so that the banks come to see that

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⁶⁸ See Buckley, "The 1993 Revision of the Uniform Customs and Practice for Documentary Credits", (1995) 28 *George Washington Journal of International Law and Economics* 265.

⁶⁹ See Buchheit and Gulati, op cit n 35.

certainty and fairness in the treatment of bankrupt sovereign debtors is just as much in their interests as it is with bankrupt corporate and individual debtors.

There are two reasons to remain optimistic that a sovereign insolvency regime is achievable. The first is that ideas are more powerful than we often believe, and sovereign bankruptcy is an important idea, whose time may well come. In the words of JM Keynes,

the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachments of ideas ... soon or late, it is ideas, not vested interests, which are dangerous for good or evil. ⁷⁰

The second reason for optimism is that in the renegotiation of its indebtedness in early 2005 Argentina secured the agreement of over three-fourths of its commercial bank creditors to cancel 66% of its debt on a net present value basis. This was a quite unprecedented degree of debt relief for a middle-income country and approaches a result of the magnitude likely to eventuate in such a case from a sovereign bankruptcy proceeding. While the creditors were careful never to utter the 'bankruptcy' word, in effect, the banks were finally forced to treat Argentina as if it were bankrupt, so there is a precedent in substance, if not in form, for sovereign bankruptcy treatment.

⁷⁰ JM Keynes, *The General Theory of Employment, Interest and Money* 383 -384.

⁷¹ Buckley, "Why Are Developing Nations So Slow to Play the Default Card in Renegotiating Their Sovereign Indebtedness?" (2005) *Chicago Journal of International Law* 347 at 362.