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A TALE OF TWO CRISES: THE SEARCH FOR THE ENDURING REFORMS OF THE INTERNATIONAL FINANCIAL SYSTEM

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A Tale of Two Crises: The Search for the Enduring Reforms of the International Financial System

by

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The Asian economic crisis of 1997 spawned a vast analytical literature and a reconsideration of the international financial architecture. This article seeks a broader perspective on these issues by comparing the causes of the debt crisis of 1982 with those of the Asian crisis. These two crises are the most significant of the last fifty years. Their joint analysis reveals seven enduring lessons of international financial reform that need to be incorporated in any revisions to the international financial system.

The debt crisis that erupted in August 1982 was the most damaging and far reaching financial crisis of the late 20th century. It spawned a voluminous

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literature.[1] Of late we have had crises in Mexico in 1994, East Asia in 1997, Russia in 1998 and Brazil in early 1999. These more recent crises have served to supersede the debt crisis in the public imagination to the extent that that we hear nonsense such as the repeated descriptions of the Asian crisis as "the most severe crisis of the last fifty years".[2]

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[1] This footnote could list many hundreds of references. For a sample of some I have found helpful, see: D. DELAMAIDE, DEBT SHOCK (1984); EICHENGREEN & LINDERT, THE INTERNATIONAL DEBT CRISIS IN HISTORICAL PERSPECTIVE (1989); WN Eskridge, *Les Jeux Sont Faits: Structural Origins of the International Debt Problem*, 25 VA. J. INT'L L. 281 (1985); J Levinson, *The International Financial System: A Flawed Architecture*, 23 FLETCHER FORUM OF WORLD AFFAIRS 1 (1999); C MARICHAL, A CENTURY OF DEBT CRISES IN LATIN AMERICA 95 (1989); J.D. Sachs, *Introduction* to DEVELOPING COUNTRY DEBT AND THE WORLD ECONOMY, 1-33, 7 (J.D. Sachs ed., Univ. of Chicago Press 1989); UNITED NATIONS ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARRIBBEAN & UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS ("ECLAC/CTC"), TRANSNATIONAL BANK BEHAVIOUR AND THE INTERNATIONAL DEBT CRISIS, (1989); and P.A. WELLONS, PASSING THE BUCK - BANKS, GOVERNMENTS AND THIRD WORLD DEBT (1987). For the most penetrating brief analysis of the debt crisis, see Levinson, *id.* at 1-16.

[2] Michel Camdessus, Development and Poverty Reduction: a Multilateral Approach, An Address by the Managing Director of the IMF at the Tenth United Nations Conference on Trade and Development, Bangkok, Thailand, (Feb. 13, 2000). See also Gengatharen who states the Asian crisis is probably the worst economic crisis on record and worse than the Great Depression: R. Gengatharen, *Destabilising Financial Flows: Are Capital Controls the Solution*, LAWASIA JOURNAL 12, 13 [1999].

The debt crisis brought the international financial system to the edge of total collapse – the Asian crisis had no such effect. The total exposure of U.S. banks to developing countries at year-end 1982 was 287.7% of total capital. Exposure to Latin America alone represented some 176.5% of bank capital. The 1983 exposure of the nine largest U.S. banks to only three countries, Mexico, Brazil and Argentina, was 115% of the capital of those banks. Sachs, *supra* note 1, at 11). A repudiation by one major debtor at this time could readily have led to a total collapse of the short-term interbank market upon which most banks rely for liquidity.

Likewise, the impact of the debt crisis on the debtor nations was far more widespread, severe, and long-reaching than that of the Asian crisis. The debt crisis affected all of Latin America and most of sub-Saharan Africa. The Asian crisis affected Indonesia, Korea, Malaysia, the Philippines and Thailand. The impact of the debt crisis was much more severe: Indonesia has been the only Asian country to suffer as severely as did the debt crisis countries (J. GENTLEMAN, MEXICAN OIL AND DEPENDENT DEVELOPMENT 224 (1984); and J.F. Torres & R. Landa, *The Changing Times: Foreign Investment in Mexico*, 23 INT'L LAW & POL. 801, 822 (1991). The debt crisis lasted from 1982 until around 1993 for most Latin American countries and until the

This article seeks to re-examine the debt crisis in light of our more recent experiences of financial crises. "Those who cannot remember the past are condemned to repeat it."[3] and mistakes in the finance of developing countries cost the lives of thousands and sacrifice the futures of millions.[4]

The methodology of this article is to compare the causes of, and lessons from, the debt crisis with the causes of, and lessons from, the Asian crisis with reference, as appropriate, to the Mexican, Russian and Brazilian experiences. There are certain similarities among each of these four financial crises of the 1990s. The debt crisis of the 1980s was in many ways quite a different type of crisis. The goal of this article is to identify the lessons that have held good throughout the last thirty years of international financial history and across these two different types of crisis. These, it is postulated, will be the lessons most likely to be of relevance in these early years of the next century as we seek to improve the architecture of the international financial system.

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debt relief initiatives of 1999 for sub-Saharan Africa. In contrast, by the end of 1999 only Indonesia was not well on the way to recovery from the Asian crisis of 1997: EAST ASIA ANALYTICAL UNIT, ASIA'S FINANCIAL MARKETS: CAPITALISING ON REFORM 37 (1999).

[3] GEORGE SANTAYANA, LIFE OF REASON ch. xii (1950-6) *cited in* OXFORD DICTIONARY OF QUOTATIONS 414 (1979).

[4] Between 1981 and 1986 real GDP per capita fell 10% in Mexico, 16% in Argentina and 27% in Bolivia: James, *Deep Red – The International Debt Crisis and Its Historical Precedents*, THE AMERICAN SCHOLAR 331, 340 (1987). See also Abbey, *Growing out of debt – the African problem in* THIRD WORLD DEBT – MANAGING THE CONSEQUENCES 159, 160 (Griffith-Jones ed., 1989); Hossein Askari, *Third World Debt and Financial Innovation - The Experiences of Chile and Mexico* (Paris: Development Centre of the OECD, 1991) at 19; CASTANEDA, UTOPIA UNARMED 5 (1993); Dohnal, *Structural Adjustment Programs: A Violation of Rights* 1 *Austl. J. of Hum. Rts* 57, 72-74 & 77 (1994); EICHENGREEN & LINDERT, *supra* note 1, at 262-63; Green, *Hidden fist hits the buffers*, NEW INTERNATIONALIST, 35 (October 1995), Mansell, *Legal Aspects of International Debt*, 18 JOURNAL OF LAW AND SOCIETY 381, 388-90 (1991); MARICHAL, *supra* note 1, at 237; Silva-Herzog, *The Costs for Latin America's Development in* LATIN AMERICA'S DEBT CRISIS – ADJUSTING TO THE PAST OR PLANNING FOR THE FUTURE? 35 (Pastor ed., 1987).

The Debt Crisis of 1982

The principal cause of the debt crisis is simple. The borrowers borrowed too much and the lenders lent too much. In particular, the borrowers failed to put the borrowed funds to work to earn a return higher than the interest rate on the funds; as is required if debt is to be repaid. And the lenders lent knowing that the funds, in the main, were not being put to such productive uses. The debt crisis was most aptly named – it was primarily a crisis brought on by too much borrowing and too much lending.

The massive flows of debt began in earnest to Latin America in the early 1970s and already by mid-1974 some bankers were expressing grave concerns. In the words of David Rockefeller, Chairman of Chase Manhattan Bank, as reported on the front page of *The Wall Street Journal*, June 6, 1974:

> "Channeling massive flows of oil dollars from dollar-rich to dollar-poor countries once seemed easily manageable. But now it looks more troublesome ... My own view ... is that the process of recycling through the banking system may already be close to the end for some countries, and in general it is doubtful this technique can bridge the [payments] gap for more than a year or at the most 18 months."[5]

[5] C. Stabler, *Mideast Oil Money Proves Burdensome*, THE WALL STREET JOURNAL, June 6, 1974, at 1, 29, *reprinted in* WELLONS, *supra* note 1, at 23). Of course, other bankers were of a different view. Walter Wriston, Chairman of Citibank, was quoted in the same WALL STREET JOURNAL article as saying, "The Great Crisis ... ain't going to happen".

Likewise, in 1976 Emma Rothschild wrote that, "The question for the financial system is not whether these debts will be dishonored. Rather, it is an issue of when, and how, and where."[6]

But I am ahead of myself. Let's go back to the beginning: to the origins of the loans.

The Loans of the 1970s – Their Origins & Destinations

The traditional sources of foreign capital for the region before 1970 were foreign investment in bonds, direct investment, official loans and supplier's credits.[7] In this regard, the development of South America parallels that of North America. The development of the United States in the nineteenth century was mainly financed by issuing bonds, principally to European non-bank investors,[8] and the

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[6] As *quoted in* DELAMAIDE, *supra* note 1, at 15.

[7] F.G. DAWSON, THE FIRST LATIN AMERICAN DEBT CRISIS: THE CITY OF LONDON AND THE 1822-1825 LOAN BUBBLE 237 (1990); DELAMAIDE, *supra* note 1, at 49; R.A. DEBS DL ROBERTS ET AL., FINANCE FOR DEVELOPING COUNTRIES - ALTERNATIVE SOURCES OF FINANCE - DEBT SWAPS 10 (1987);and MARILYN E SKILES, LATIN AMERICAN INTERNATIONAL LOAN DEFAULTS IN THE 1930S: LESSONS FOR THE 1980S? 41-42 (Federal Reserve Bank of New York, Research Paper No. 8812, 1988). Stallings notes that foreign investment in Latin American stocks was practically nonexistent before the 1940s and that suppliers credits only became significant after WWII: see B. STALLINGS, BANKER TO THE THIRD WORLD: U.S. PORTFOLIO INVESTMENT IN LATIN AMERICA, 1900-1986 109-110 (1987).

[8] DELAMAIDE, *supra* note 1, at 49; and CLEONA LEWIS, AMERICA'S STAKE IN INTERNATIONAL INVESTMENTS 17-24, 30, 35, 36-39, 45-48 (1938).

defaults, of which there were plenty,[9] therefore did not threaten the financial system.

In the early 1970s major commercial banks began to lend to Latin America. The lenders were now banks, not investors in bonds or projects or exports to the region.[10] For the first time in history the major thrust of development finance was commercial bank lending.[11] The stakes had suddenly been dramatically increased and few seemed aware of the change. Any major default would now hurt a relatively small group of major banks and the repercussions could potentially disable the entire international financial system.

The Lenders

So which banks were making these loans? A United Nations study identified three groups of lenders -- leaders, challengers and followers -- in these terms:[12]

> "The 'leader' banks were all United States banks and essentially dominated syndicated lending in the 1970s. They were Citicorp, Chase Manhattan, BankAmerica, J.P. Morgan and Manufacturers Hanover.

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9 DELAMAIDE, *id*. and LEWIS, *id*.at 25-26, 35, 45-46.

10 Barry Eichengreen & Richard Portes, *After the Deluge: Default, Negotiation, and Readjustment during the Interwar Years, in* EICHENGREEN & LINDERT, *supra* note 1, at ch. 2, 40-41.

11 DEBS, ROBERTS & ET AL., *supra* note 7, at 10; and DELAMAIDE, *supra* note 1, at 49.

12 ECLAC/CTC, *supra* note 1.

> "The 'challenger' banks were from North America, Europe and Japan and competed aggressively with the leaders for the lending business. They included Lloyds, Bank of Montreal, Bank of Tokyo, Bankers Trust, Chemical, Canadian Imperial Bank of Commerce, Toronto Dominion, Commerzbank, Bank of Nova Scotia and Long Term Credit Bank of Japan.
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> "The 'follower' banks were all non-U.S. and had a strong interest in lending to the region without being as aggressive as the leaders and challengers. They included National Westminster, Deutsche Bank, Barclays, Dresdner, West Deutsche LB, Royal Bank of Canada, Midland Bank, Credit Lyonnais, Industrial Bank of Japan and Banque Nationale de Paris.

In addition, thousands of other banks participated in one or more syndicated loans to the region.[13] Different groups of lenders lent for different reasons. The leaders were very aggressive in marketing these loans and came to "depend on income from special deals with riskier clients willing to pay higher fees, commissions and interest to gain market access."[14] The leaders lent principally to maximise this quarter's profits and less to gain market share. In contrast, the challenger banks, seeking a higher international profile, were more motivated by increased market

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[13] Brazil had over 450 bank creditors in 1982 (see UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS, DEBT EQUITY CONVERSIONS - A GUIDE FOR DECISION-MAKERS 23 (1990) (hereafter "UNCTC")) and over 1,500 U.S. banks were involved in lending to the region: DAWSON, *supra* note 7, at 238.

[14] *Id.* at 24. The lead banks in the 1970s became rather addicted to the "profit hit" from fees from large syndicated loans. As regulatory initiatives in 1983 identified, "'front-end' fees in international lending, when taken into bank income in the quarter or year in which they are charged, provide a potentially unhealthy added incentive for banks to seek out international loans in order to boost earnings immediately.": Lee C. Buchheit, *Tightening controls on international lending by US banks* INT'L FIN. LAW REV. 14, 15 (May, 1983).

share than by profits.[15] The motivation of the follower banks was more mixed -- the international lending boom was as an opportunity to earn higher profits and gain an increased international profile.

The leader banks opened up most of these markets. Initially, they led the charge in lending to Argentina, Brazil and Mexico. The challengers soon acquired proficiency in this business and began to acquire market share by undercutting interest rates and fees. Rather than compete too aggressively on the basis of price, the leaders established new markets by lending to nations such as Bolivia, Peru and Uruguay and to private sector corporations.[16]

The Borrowers

The nature of the lenders in the 1970s was not the only factor without significant historical precedent. In earlier lending booms, such as the 1920s, the majority of loans were to national, provincial or municipal governments.[17] In the 1970s the majority of loans were to the major industrial, petroleum and energy corporations of the region (many of which were wholly or partially state-owned). The other major borrowers were the state-owned development banks which sought foreign

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[15] UNCTC, *supra* note 13, at 23.

[16] ECLAC/CTC, *supra* note 1, at 89, 105.

funds to relend in their own countries on a wide range of industrial projects as Latin America strove to fulfill its promise as the world's new economic powerhouse.[18]

Causes of the Latin American and African Debt Crisis

Many commentators are in no doubt as to the causes of the crisis - it is simply that they disagree one with the other.[19] The consensus of many bankers is well expressed by Rimmer de Vries:

> The attention lavished on LDC debt problems since 1982 has built a consensus on the root causes of the trouble -- the debtor's inappropriate demand management and resource allocation policies prior to 1982, and their inadequate adjustment to the adverse global environment that followed.[20]

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[17] MARICHAL, *supra* note 1, at 235; E. Jorgensen & J. Sachs, *Default and Renegotiation of Latin American Foreign Bonds in the Interwar Period, in* EICHENGREEN & LINDERT, *supra* note 1, at ch. 3, 53.

[18] MARICHAL, *id.* The most important corporate borrower in the international financial markets in this period was Pemex, the Mexican oil company, and other major borrowers, were Petrobras and Electrobras of Brazil, Ecopetrol of Columbia, Agua y Energia of Argentina and Petroperu.

[19] Few topics engender such polarised debate as the causes of the crisis. Some writers even disagree with themselves: "The U.S. [financial community], however, deserves very little direct blame for the debt problem ... To be sure, many U.S. banks behaved irresponsibly in the 1970s by making vast sums of credit available to Latin American countries which were becoming ever less credit worthy": E. W. Hannan & E. L. Hudgins, *A U.S. Strategy for Latin America's Debts,* THE BACKGROUNDER (Washington D.C.) Apr. 7, 1986.

[20] Rimmer de Vries, Morgan Guaranty Trust Company, Economic and trade adjustment in the United States and other industrial countries and The LDC debt issue: Problems and Prospects, Statement to The Asahi-Zeit Symposium, Tokyo 21 (Mar. 29-30, 1988).

Fifteen years after the debt crisis, the initial response of the IMF and the creditors to the Asian crisis echoed the same 'blame-the-debtors' sentiments. To pretend the loans and investments were sound when made and have since gone off the rails due to the debtors' fault is the most convenient fiction for creditors and investors. However, from a broader perspective than that of these parties, the causes of the debt crisis are more numerous and varied. Four are generally identified: petro-dollar recycling, bank behaviour, debtor nations' policies, and external factors such as interest and exchange rates. Each will be considered.

Recycling of OPEC Funds

In 1974 a new reason for lending to Latin America came out of the east - the OPEC cartel.[21] The quadrupling of oil prices by OPEC in 1973-74[22] resulted in a large transfer of funds to OPEC which, in turn, deposited them in western banks. By the end of 1975, $13.8 billion had flowed from OPEC into the six largest U.S. banks.[23] The oil price rises had initiated a recession in industrial countries so

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[21] "OPEC" is the acronym for the Organisation of Petroleum Exporting Countries.

[22] The price of oil was $3.01 per barrel in July 1973. It was raised by OPEC to $4.11 on October 16 and $11.65 effective from January 1, 1974: *Selected Statistics on World Oil*, HBS CASE SERVICES, No 380 - 144.

[23] Bank of America, Citibank, Chase Manhattan, Manufacturers Hanover, JP Morgan and Chemical, in that order. See PHILIP A. WELLONS, WORLD MONEY AND CREDIT - THE CRISIS AND ITS CAUSES 23 (1983).

demand for these funds was weak.[24] However, the banks found a market in the countries that then were known as less developed countries (LDCs) and now are called the emerging markets. While the industrial world adjusted and reduced its demand for oil, adjustment was far slower in Latin America and other LDCs that were bent on a path of industrialisation, on 'catching up'. The process came to be known as recycling. Funds flowed from Latin America and the developed nations to OPEC to pay for the oil; from OPEC to the major banks as Euromarket deposits and from the banks to Latin America as loans. Once again, a surplus of capital in creditor countries was funding a lending boom in Latin America.[25]

This recycling of OPEC funds was presented as a positive social good for the world economy: "banks were applauded for smoothing the transition to higher oil prices".[26] Yet there was another aspect to it. The trade and lending policies France, Germany, Japan, and the United Kingdom adopted in response to the first oil shock were designed to improve their trade balances and generate the funds for

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[24] DELAMAIDE, *supra* note 1, at 35.

[25] Dawson identified this factor as a necessary pre-condition for the first Latin American debt crisis in the 1820s and the most recent one in the 1980s: see DAWSON, *supra* note 7, at 244. See also MARICHAL, *supra* note 1, at 95 and STALLINGS, *supra* note 7, at 294-295.

[26] See also J.W. Child, *The Limits of Creditors' Rights: The Case of Third World Debt*, 9:1 *Social Philosophy & Policy* 114, 138 (1992); and ROBERT SOLOMON, THE INTERNATIONAL MONETARY SYSTEM, 1945 - 1981, ch. XVII, 316-333 (1982).

oil.[27] Much of the export drive of these nations was aimed at LDCs, "in effect shifting to them the G-5 trade deficits with OPEC and using bank credits to make the shift possible".[28] The massive southward flow of funds in the 1970s permitted the LDCs to increase imports from the developed nations which sustained economic growth in the developed world.

In short, in the 1970s LDCs chose to consume goods from the developed world and oil from OPEC nations on a deferred payment plan. The banks, with encouragement from their home governments,[29] chose to fund this deferred payment plan. The banks, their home governments and the borrowers all benefited from the plan in the short-term. No one gave much attention to the question of repayment.

Bank Behaviour

The leader banks identified earlier contributed directly to the lending boom of the 1970s. As a United Nations study discovered:

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[27] WELLONS, *supra* note 1, at 58-63. The fifth G-5 nation, the United States opted for an inflationary response to the oil shock: *id.* at 59.

[28] *Id.* The clearest example of this is France which in 1973, before the oil shock, had a trade surplus of $500 million with its former colonies in Africa. Five years later France had a surplus of $2.2 billion with those same former colonies. See WELLONS, *id.* at 61-62.

[29] Wellons argues persuasively that the role of the G-5 governments is often understated in analyses of the debt crisis: WELLONS, *id.* at 53.

> "leaders showed a greater tendency to aggressively sell higher priced loan packages to borrowers traditionally denied access to international credit markets altogether or who were at least denied such large amounts of funds. Although there was no alteration in the risk characteristics which relegated them to the margin of international borrowing, these borrowers suddenly found leaders seeking to persuade them to take on huge credits which they had not contemplated borrowing."[30]

In other, more pithy, words, "the banks sent salesmen to Mexico, not analysts."[31] This behaviour accorded with history.[32] The lending booms of the 1870s[33] and 1920s[34] were fueled by hard salesmanship, paid agents and bribes to officials of borrowing countries. Bribery was so common in the 1920s that only two major U.S. banks refrained from it.[35]

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30 ECLAC/CTC, *supra* note 1, at 11-12.

31 DELAMAIDE, *supra* note 1, at 102. On the issue of aggressive salesmanship of these loans, see also P. Konz, *The Third World Debt Crisis*, 12 HASTINGS INTERNATIONAL AND COMPARATIVE LAW REVIEW 527, 528 (1989). Consider also the perspective of a loan officer, "As a domestic credit analyst, I was taught to develop reasonable asset security for all loans unless the borrower was of impeccable means and integrity. As an international loan officer, I was taught to forget about that, and instead to develop a set of rationales that would make the home office feel good about the loan, even though, technically, it was 'unsecured'": S.C. Gwynne, *Adventures in the Loan Trade*, HARPERS', Sept. 1983, at 22, 24.

32 In investigating a spate of loans to Latin America that all rapidly went into default, a subcommittee of the English House of Commons found that banks "seem to have been regardless of the financial resources of the borrowing State; such resources, if inquired into, would have been found to have been totally inadequate to meet the liabilities incurred." (The *Report from the Select Committee on Loans to Foreign States* at x1vi (1875). These words, perfectly apposite in 1985, are from an investigation in 1875 into the lending frenzy of 1870 - 1873.

33 LELAND JENKS, THE MIGRATION OF BRITISH CAPITAL TO 1875 292, 293 (1927).

34 SKILES, *supra* note 7.

35 *Id.*

In hindsight, the overlending of the banks to the region was a major cause of the debt crisis.[36] A number of commentators believe the leader banks consciously overlent to the region.[37] In the words of Harvard economist, Jeffrey Sachs,

> "Few banks, apparently, were concerned with the question of whether the debtor countries would be willing and able to service their debts if debt servicing had to come out of national resources rather than out of new loans. This issue seemed to be an abstract concern, at least through the end of the 1970s. ... New lending to repay old loans made sense in the circumstances."[38]

There were many reasons for the lending boom of the 1970s. One of the principal ones - surplus capital in the northern hemisphere - has already been considered.[39] There are at least another eight: the passage of time and ignorance of history, the inexperience of the banks, the quest for greater profits, the promotion of individual bankers' careers, the strength of the borrowers' economies, the rise of syndicated lending, the innovation of floating rate interest and the position of U.S. banks at home. Each will be considered.

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[36] ECLAC/CTC, *supra* note 1, at 50-51.

[37] *Id.* at 24.

[38] Sachs, *supra* note 1, at 9.

[39] See analysis in "Recycling of OPEC Funds" in the text accompanying n 21.

Time and Ignorance of History

Enough time had elapsed since the defaults of the 1930s for a new generation of bankers to be in control of lending and to 'rediscover' Latin America.[40] Banking, as an industry, has a short memory,[41] and international financial history is not part of the education of most bankers. In the words of Frank Griffith Dawson,

> "the semi-comic, semi-tragic first Latin American debt crisis and its aftermath demonstrate that when financiers and investors choose to ignore history, they are destined to repeat the disasters of the past on an even grander scale."[42]

The indisputable fact that, "since independence, debt crises have been a permanent feature of the history of Latin America, being linked to the boom and bust cycles of the economies of the region"[43] did nothing to slow the lending frenzy of the 1970s.[44]

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[40] DAWSON, *supra* note 7, at 237.

[41] EICHENGREEN & LINDERT, *supra* note 1, at 4.

[42] DAWSON, *supra* note 7, at 236. John Kenneth Galbraith has expressed much the same thought: "History has a way of repeating itself in financial matters because of a kind of sophisticated stupidity": J. K. Galbraith, *Insanity of 1929 repeats itself*, THE SUNDAY TIMES, Oct. 25, 1987, at 35.

[43] MARICHAL, *supra* note 1, at 238.

[44] In fairness, such cycles also occur in other markets, such as real estate, but perhaps not quite to the spectacular degree that they do in Latin America. Furthermore, banks tend to give individual treatment to each real estate loan and don't as readily exacerbate the cyclical nature of the market by refusing to roll over all loans secured on real estate in a particular area because of a downturn in the market.

Inexperience of the Banks

It is easy to assume the bankers making the massive loans of the 1970s were experienced in lending to LDC sovereigns and corporations. Usually they were not.[45] In the early 1980s the chief economist of the Bank for International Settlements said

> "Banks have had a hundred years to learn how to make a loan to the butcher on the corner. They've had only ten years to learn how to evaluate a sovereign risk."[46]

Most of the creditor banks took their first steps in the early 1970s into a whole new field of lending.[47] Many of the smaller banks were simply playing "follow

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[45] Gwynne, in analysing the loan selling industry of the 1970s said, "The world of international banking is now full of aggressive, bright, but hopelessly inexperienced lenders in their mid-twenties ... Their bosses are often bright but hopelessly inexperienced twenty-nine year old vice presidents with ... so little credit training they would have trouble with a simple retail installment loan. *Their* bosses, sitting on the senior loan committee, are pragmatic, nuts-and-bolts bankers whose grasp of local banking is profound, ... [but who] are fish out of water when it comes to international lending": Gwynne, *supra* note 31, at 23. In particular, the banks overlooked the extraordinarily high performance correlations between debtors across the LDC sector which mean that when defaults occur, they tend to occur across the sector. This is a classic error in modern portfolio theory and banks should have had a far closer eye on their overall portfolio risk: Interview with Michael Pettis, now a Managing Director at Bear Stearns & Co, (Apr. 24, 1993) ("Pettis Interview I").

[46] Statement of Alexandre Lamfalussy, *quoted in* DELAMAIDE, *supra* note 1, at 50.

[47] For one of the best summaries of what most of the banks needed to know in the 1970s, and did not, see: R. D. Sloan, *The Third World Debt Crisis: Where We have Been and Where We Are Going* THE WASHINGTON QUARTERLY 103, 105 (1988).

the leader". They entered into a new field of lending with little capacity to make independent credit decisions.[48]

The definitive expression of this collective inexperience was the now famous credo of the leading international banker of the day. Walter Wriston was Chairman of Citicorp when he made the pronouncement that was to influence more international lending decisions in the 1970s than any risk analysis: "Countries never go bankrupt".[49] Never was a statement more true in form and false in substance.[50] Sovereigns do not become legally insolvent, because there are no legal rules to effect a sovereign insolvency, but investors can certainly go bankrupt from lending to such borrowers.[51]

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[48] Many of the smaller banks had little, if any, appreciation of Latin America and the complexities of lending to sovereigns and corporations in LDCs and little, if any, capacity in-house to analyse the issues in this international context. (WELLONS, *supra* note 1, at 231-35). They simply relied on the large lead banks. In the words of an OECD study, "there is ample evidence that during the boom of the international syndicated loan market many banks participated in lending syndicates on the basis of inadequate independent loan evaluation but relying on the assessment of lead managers" (OECD, PRUDENTIAL SUPERVISION IN BANKING 125 (1987). After 1982 many smaller banks felt misled by their bigger brethren and strongly resisted subsequent extensions of credit as part of the rescheduling process (ECLAC/CTC, *supra* note 1, at 61).

[49] As *quoted in* Sachs, *supra* note 1, at 8.

[50] S. S. Golub, *The Political Economy of the Latin American Debt Crisis* 26:1 LATIN AMERICAN RESEARCH REVIEW 175, 177 (1991).

[51] *Id.*; and DELAMAIDE, *supra* note 1, at 98.

Bank Profitability & Market Share

The leader banks went south looking for profits and the challenger banks went south looking to become leader banks, i.e. in search of increased market share. Each had other motivations -- the leader banks were losing market share in the domestic market and the challengers certainly sought profits -- but these were the two principal motivations of the groups of banks that led the charge into Latin America, and profits and market share they found. For instance, Citibank derived a remarkable 72 percent of its overall earnings in 1976 from its international operations[52] and derived more profits in 1977 from its Brazilian business alone than from its entire United States operations.[53] The margins on these loans in the early 1970s were up to two percentage points above banks' costs of funds.[54] This was lucrative business, in the short-term.

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[52] Sachs, *supra* note 1, at 8.

[53] DELAMAIDE, *supra* note 1, at 117.

[54] Statement of CT Conover, Comptroller of the Currency, before the Subcommitte on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs, Washington, D.C. OCCQJ 17, 18 (Apr. 21, 1983); see also LINDERT & MORTON, *supra* note 4, at 230. The loans were typically medium term floating rate loans, priced at a set margin above the cost to the banks of obtaining matching funding in the London interbank market which is known as "Libor" - the London Interbank Offered Rate. For further information on Libor, see L. C. Buchheit, *How to negotiate the LIBOR definition*, INT'L FIN. LAW. REV. 35 (1993).

The Promotion of Bankers' Careers

A grossly undervalued contributor to the lending boom was the career reward structure for individual bankers. Employees are very efficient at identifying, and doing, precisely what gets rewarded in an organisation, irrespective of the stated policies of the organisation.[55] Bonuses were large and promotion quick for bankers in the 1970s, and bonuses and promotions were based on the amount of business done,[56] not the 'quality' of that business. In the mid-1970s bankers could lend aggressively secure in the knowledge that the resulting boost to their careers would see them promoted, possibly to another country and often in another bank, before the risks of those loans crystallised.[57] In analysing a loan to a Philipino company, Gwynne noted that,

> "by the time the borrower suspended its debt payments [some two and a half years into the loan], *all* of the loan officers who had worked on it had moved on to other banks. Such rapid job movement is common in banking ... Thus many of the people who make the big international loans are not around to collect them when they go bad."[58]

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[55] S. Kerr, *The Folly of Rewarding A While Hoping for B*, ACADEMY OF MANAGEMENT JOURNAL 769-783 (1975); and CYN D. FISHER ET AL., *HUMAN RESOURCE MANAGEMENT* 570-622 (1993).

[56] Gwynne, *supra* note 31, at 25 saying, "your job performance is rated according to how many loans you make."

[57] Levinson, *supra* note 1, at 5.

[58] *Id.* at 26.

When errors of judgment do not become apparent for many years the normal primary sanction for error -- being identified with the mistake -- fails to exert much influence. Careful, sober, boring risk analysis was vital in the 1970s and the behaviour least likely to advance a bankers' career.

Strong Debtor Economies

The region had been showing impressive economic growth for a number of years and was commonly thought to be the next economic powerhouse.[59] Many believed that Argentina, Brazil and Mexico in particular would industrialise and enjoy the sort of sustained economic growth that in fact occurred in South-East Asia. The major Latin American nations were perceived to enjoy the same cheap educated workforce as the Asian nations, with a generous dollop of natural resources and proximity to Western markets thrown in for good measure.[60]

Syndicated Lending

The development of syndicated lending enabled banks to assemble the vast amounts of funds required. Syndicated lending originated in the U.S. domestic

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[59] DUNCAN GREEN, SILENT REVOLUTION -- THE RISE OF MARKET ECONOMICS IN LATIN AMERICA 17 (1995).

[60] These views were not without foundation. Mexico's economy had grown on average 6 per cent per annum from 1940 until 1970, and Brazil's had boomed from 1968 until 1973, growing at an average annual rate of 11 per cent (see Landa, op cit n 2 at 814; and Delamaide, op cit n 1 at 55-56). The flaws in the economic systems of these countries, while serious, were not immediately apparent.

market and first appeared in the London eurocurrency market in the late 1960s.[61] Before syndication, such massive loans were beyond the capacity of any one bank and so bond issues were the traditional debt finance vehicle.[62] Syndication was very profitable for the lead banks due to the raft of fees involved, such as an agent's fee for administering the loan and a commitment fee for making the facility available.

Floating Interest Rates

The other technical innovation that made possible the use of loans for development finance was floating interest rates. Borrowers sought funds for five to seven years. Banks could fund themselves in the euromarkets to make these loans for periods of only up to six months. The solution was to set the interest rate on the loans as a floating rate that is reset every three or six months at some specified margin over the bank's cost of funds in the euromarket – usually represented by LIBOR (the London Interbank Offered Rate).[63] From the bank's perspective, this solution neatly transferred the interest rate risk to the debtors.

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[61] J. N. Brooks, *Participation and Syndicated Loans: Intercreditor Fiduciary Duties for Lead and Agent Banks under US Law*, BUTTERWORTHS J. OF INT'L BANKING & FIN. LAW 275 (1995).

[62] WELLONS, *supra* note 1, at 175.

[63] Levinson, *supra* note 1, at 3.

The Position of U.S. Banks at Home

In the early 1970s the major U.S. banks were losing market share in their home markets which made expansion abroad attractive.[64]

Another factor in the lending frenzy which has been overlooked by most commentators was the effect of the U.S. banking system reforms implemented in response to the financial crisis of the 1930s.[65] The Glass-Steagall Act[66] separated investment banking from commercial banking. While this prohibition did not extend to the actions of U.S. banks abroad,[67] it severely restrained the growth of U.S. banks domestically. The other troublesome legacy of post-1929 banking reform was the prohibition on inter-state banking. In the case of Citibank and Chase Manhattan, for instance, the recession in their home state, New York, severely limited lending opportunities there. As the rest of the country and new lines of business were closed to them, overseas operations were the obvious avenue for growth.

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[64] The large New York banks, for instance, went from having 15.7% of total bank assets in 1965 to only 13.7% in 1975 (including the loans to Latin America of the early 1970s): WELLONS, *supra* note 23 at 27.

[65] DAWSON, *supra* note 7, at 237.

[66] The principal provisions of the Glass Steagall Act are in sections 16, 20, 21 and 32 of the Banking Act of 1933.

[67] Regulation K, Fed. Res., § 211.

So, for these eight reasons, the banks overlent grossly to the region. Let's consider now the part the debtors played in the creating the crisis.

Debtor Nation Policies

There was a common pattern of economic policies and factors among the debtor nations that contributed to or worsened the crisis. These included bloated budget deficits, overvalued exchange rates, anti-export trade regimes, capital flight and corruption.[68] Each will be considered.

Large Budget Deficits

Great inequalities of personal income characterise most Latin American economies. The resulting fierce political conflicts too often lead to high budget deficits as governments struggle to resist the claims of pressure groups and to tax appropriately the economic elites.[69] Foreign borrowing in the 1970s provided a way to bridge the gap between excessive government spending and inadequate taxation revenues.

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[68] For the first three of these factors, see Sachs, *supra* note 1, at 6.

[69] *Id.* at 12.

Overvalued Exchange Rates

Overvalued exchange rates favour urban workers and local manufacturing at the expense of the agricultural sector and tend to restrict inflation.[70] Leaving their exchange rates overvalued therefore neatly reflected the political power realities of most of the debtor nations, and tended to restrain one of the region's recurring nightmares, hyperinflation. Accordingly many of the debtor nations' exchange rates were overvalued for most of the 1970s. Overvalued exchange rates also encourage import-consumption and the acquisition of foreign assets by private citizens[71] (capital flight) and these effects were to prove very costly for the region's economies.

Anti-export Trade Regimes

Most debtor countries had pursued a policy of economic self-sufficiency and promoted import reduction over export expansion.[72] Import-substitution and economic self-sufficiency fitted well with the nationalistic pride of most of the debtor nations and protection of local industries was a common response to local

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[70] *Id.* at 15.

[71] UNITED STATES INTERNATIONAL TRADE COMMISSION, (hereafter "USITC"), THE EFFECT OF DEVELOPING COUNTRY DEBT-SERVICING PROBLEMS ON U.S. TRADE", A REPORT TO THE SUBCOMMITTEE ON TRADE OF THE HOUSE WAYS AND MEANS COMMITTEE, Investigation No 332-234, USITC Pub No 1950, 3 (1987).

[72] De R. V. Steveninck, *Import Substitution and the Debt Crisis in Latin America* 3:2 TINBERGEN INSTITUTE RESEARCH BULLETIN 133 (1991).

political conflicts and demands. Protectionist policies discourage exports and encourage the production of import-competing and nontradable goods.[73] Unfortunately these policy choices are not economically efficient.[74]

Capital Flight

Capital flight refers to the accumulation of foreign assets by the private sector (often at the same time as the public sector is incurring increasing foreign debt). Thus in the 1970s Mexico accumulated some $75 billion of foreign debts, while its private sector accumulated perhaps $40 billion of foreign assets.[75] In 1980-1981, 84 percent of the tremendous increase in foreign loans to Argentina was offset by the outflow of private capital, and for Venezuela the figure was over 100 percent, i.e. the outflow of private capital from Venezuela in those two years exceeded the inflow of foreign loans.[76] This was partly the result of overvalued exchange rates: astute locals knew the cyclical nature of Latin American

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[73] Sachs, *supra* note 1, at 13.

[74] This is borne out by the comparison with East Asia which also borrowed recycled petro-dollars at this time. The Asian nations tended to invest in export-oriented industries, with good results: USITC Pub 1950, *supra* note 71, at 3.

[75] Sachs, *supra* note 1, at 12.

[76] *Id.* at 9. See also, WORLD BANK, WORLD DEVELOPMENT REPORT 64 (1985) where the World Bank estimated that for the three countries with the most severe problem, Argentina, Mexico and Venezuela, capital flight in the period 1979 - 1982 amounted to an astonishing 67% of capital inflows. There is a similarity between capital flight and the mergers and acquisition boom in the U.S. in the late 1980s: both resulted in equity being replaced by debt, with damaging consequences for tax revenues in each case. See also Green, op cit n 59 at 21-22.

economies far better than did the international banks and preferred to keep their riches abroad. Another reason capital moved offshore was to distance itself from its tainted origin.

Corruption

There is a pattern in many Latin American countries, which amounts almost to a tradition, of corruption in government and major projects.[77] Statistics are understandably scant, but a significant portion of the foreign loans were never put to their intended productive uses which made more difficult the task of earning sufficient foreign exchange to repay the loans.

In summary, the debt crisis would never have eventuated if the loans had been put to productive uses that generated returns in foreign currency greater than the cost of debt service.[78] For the reasons enumerated above, that was rarely the case, and efficient use of such vast sums was always going to be highly improbable and in direct contradiction to the region's history.

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[77] As Carlos Marichal has said, "It is well known that the principal beneficiaries were the technocrats, generals, and businessmen who received secret commissions and contracts on the huge flow of foreign funds. In no period of modern Latin American history has financial corruption reached such heights.": MARICHAL, *supra* note 1, at 238.

[78] See also the consideration of the uses to which the borrowed funds were put in PETER BAUER, THE THIRD WORLD DEBT CRISIS - CAN'T PAY OR WON'T PAY? 5 (1990).

External Factors

There are five external factors which precipitated the debt crisis. However, by 1982 debt levels were so high that while these factors determined the timing of the outbreak of the crisis,[79] they were not the cause of it. A crisis was inevitable.[80]

The five external factors are as follows: interest rate increases, exchange rate movements, falls in commodity prices, a worldwide recession, and the cessation of petro-dollar recycling.[81]

Interest Rate Increases

Euromarket interest rates doubled between 1978 and 1981.[82] This was a direct result of the stringent monetary policy adopted by the developed countries in

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[79] M. B. Goldman, *Confronting Third World Debt: The Baker and Brady Plans*, BACKGROUNDER (Washington DC) No 559, Jan. 22, 1987; and R. Dornbusch, *Debt Problems and the World Macroeconomy*, *in* Sachs (ed), *supra* note 1, at 310, ch. 16 (1989).

[80] C. Huhne, *Some Lessons of the Debt Crisis: Never Again?*, *in* INTERNATIONAL ECONOMICS AND FINANCIAL MARKETS -- THE AMEX BANK REVIEW PRIZE ESSAYS, ch.5, 85 (1989).

[81] Authors invariably cite the first three factors. The fourth - the worldwide recession - receives slightly less attention and the fifth - the cessation of petro-dollar recycling - receives almost none.

[82] Askari, *supra* note 4, at 20. Eurodollar rates peaked at 19.5% in March 1980: USITC Pub No 1950, *supra* note 71, at 4. Calculations of the real interest rates at this time (the nominal rates adjusted for the rate of inflation in world trade) show that the real Libor passed 18% in late 1981: see Dornbusch, in Sachs (ed), *supra* note 1, at 302.

response to the second "oil shock" in 1979-80.[83] As Robert Pastor said, "The effect on the borrowing developing nations was catastrophic, but few realized it until it was too late".[84] This factor is included as an external cause of the crisis because it is customary to do so. However, the interest rate rises were a direct result of monetary policy in developed countries, particularly the United States, and so were external only to the debtors.

Adverse Exchange Rate Movements

While less than half of the loans came from U.S. commercial banks, nearly all were denominated in U.S. dollars.[85] The strong appreciation of the U.S. dollar against the currencies of other developed countries from late 1980 until early 1985 meant that the debtor nations had to export ever greater amounts to non-U.S. markets to earn the same amount of U.S. dollars.[86]

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[83] R. A. Pastor, *The Debt Crisis: A Financial or a Development Problem?* in LATIN AMERICA'S DEBT CRISIS - ADJUSTING TO THE PAST OR PLANNING FOR THE FUTURE 7 - 8 (Robert A Pastor ed., 1987); Sachs, *supra* note 1, at 8; and USITC Pub No 1950, *supra* note 71, at 4.

[84] Pastor, *id.* at 8.

[85] USITC Pub No 1950, *supra* note 71, at 5.

[86] *Id*.

Falls in Commodity Prices

Decreasing commodity prices are routinely listed as one of the major external contributors to the crisis.[87] Commodity exports were vital to the economies of the region and prices had declined on average some 33 per cent by 1982.[88] But it is in the nature of commodity prices to fluctuate widely. Such prices rose steadily throughout the 1970s.[89] Their steep fall was virtually assured in the next recession. The decline in commodity prices in the early 1980s was not so severe so as to be an immediate cause of the crisis.[90]

The Worldwide Recession

The severe tightening of monetary policy in most developed countries in response to the second dramatic oil price rise in 1979 and 1980, plunged the developed world into an economic downturn in 1980 which reached its low point in 1982.[91]

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[87] Sachs, *supra* note 1, at 6; DELAMAIDE, *supra* note 1, at 27; and Askari, *supra* note 4, at 19.

[88] DELAMAIDE, *supra* note 1, at 28. Wheat and copper's prices were down about 25%, coffee was down over 30% and sugar had fallen a precipitous 70%: see USITC Pub 1950, *supra* note 71, at 4.

[89] Dornbusch, in Sachs (ed), *supra* note 1, at 303.

[90] *Id*. However, their continued decline until 1986 raised the costs of continued debt service and adjustment dramatically for many debtor nations. By 1986 commodity prices were at only 40% of their peak levels in the 1970s.

[91] LANDA, *supra* note 2, at 820; and USITC Pub No 1950, *supra* note 71 at 5.

The quantities and prices of debtor nations' exports of both commodities and goods therefore decreased, at precisely the time interest rates were increasing.

Cessation of Petro-dollar Recycling

Net bank deposits from OPEC revenues were $40 billion in 1980; $2.5 billion in 1981; and negative $10 billion in each of 1982 & 1983, i.e. OPEC investors withdrew $10 billion each year.[92] This drying up of the source of the capital flow to Latin America receives surprisingly little attention in most analyses of the debt crisis. Yet it certainly contributed to higher interest rates and to the banks turning off the flow of funds so quickly in 1982.

Conclusion

All of the external factors had some role to play in bringing about the crisis in late 1982 and the most significant was the dramatic rise in interest rates.[93] Yet this factor was external only to the debtor nations. It was the direct result of policy decisions in the U.S. and other OECD nations. The developed world, in acting to prevent domestic inflation, imposed a frightful cost on the less developed world under the very loans the OECD governments had encouraged their banks to make.

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[92] USITC Pub No 1950, *id.* at 4.

[93] *Id.*

Of all the external factors perhaps only the appreciation in the U.S. currency and the cessation of petro-dollar recycling would have been difficult to predict. Interest rates and commodity prices fluctuate greatly and the international economy periodically undergoes a recession. The direct causal links between interest rate rises and worldwide recession, and between worldwide recession and commodity prices, mean that this combination of external factors was predictable: the only uncertainty was when it would happen. The borrowers and the banks had together created an economic relationship that could not withstand the normal vicissitudes of international economic life.

The Asian Economic Crisis of 1997

The Asian problems began in Thailand in June 1997. Foreign money had flooded into Thailand and fuelled speculative markets in real estate and stocks and heavy domestic consumption that contributed to a massive current-account deficit.[94] The current-account deficit and an overvalued currency linked Thailand's situation to that of Mexico's in late 1994; and the results were the same -- Thailand spent most of its foreign exchange reserves defending the value of its

[94] A current account deficit is the extent to which the value of imports of goods and services plus the net interest on foreign debts exceeds the value of exports of goods and services: M Feldstein, *A Self-Help Guide for Emerging Markets*, FOREIGN AFFAIRS 93 (Mar./Apr 1999). See also P. Passell, *Economic Scene; For a new generation of Asian tigers, a harsh currency lesson*, THE NEW YORK TIMES, July 24, 1997, at D-2, col. 1.

currency against speculators before being forced to allow it to float on July 2. And, as with Mexico, its value fell through the floor, losing some 40 percent in four months and 50 percent in six.[95] In the following weeks the contagion spread to Malaysia and the Philippines.[96]

Nonetheless, it was not until October that the currency crisis, as it was then termed, deepened across the sector. The precipitating event was intense speculation on the Hong Kong dollar which triggered a sustained plunge in Hong Kong share prices.[97] East Asia's troubles have attracted numerous names. Initially it was termed a currency crisis, later briefly a debt crisis, then an economic crisis, and now most often is referred to simply as "the Asian crisis". How should it be characterised?

A currency crisis arises when a nation no longer has the wherewithal to intervene in the markets to support the value of its currency and the currency then has to be allowed to float. If its value has been supported by government intervention this almost always results in a sharp devaluation. Debt crises are the result of a

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[95] R. Arensman, *Economy stall in Thailand has a familiar look*, THE DENVER POST, Nov. 2, 1997, at L-01.

[96] P. Blustein, *Investors Reconsider Big Emerging-Markets Bets*, THE WASHINGTON POST, July 20, 1997, at H-01. In the second half of 1997 Malaysia's currency depreciated 44% and its stock market plunged 50%: *IMF happy with Malaysia, but says there is room for improvement*, THE AUSTRALIAN, April 29, 1998, at 32, col. 2.

[97] P. Chan, *Banks jittery over emerging market debt*, SOUTH CHINA MORNING POST, Oct. 29, 1997, at 3.

nation's total indebtedness exceeding its capacity to meet repayments. The resources available to meet repayments are foreign exchange reserves, export earnings and funds from refinancing – and the immediate cause of many debt crises is the cessation of the latter. The traditional measures of this capacity are debt export and debt service ratios. A debt export ratio is the ratio of a nation's total debt to its export earnings. A debt service ratio is the ratio of the sum of a nation's interest and principal amortisation payments to its export earnings. These ratios are seen as a measure of a country's capacity to service its foreign debt as exports generate the ongoing foreign exchange used for this purpose.[98]

Debt crises are generally characterised by debt export ratios over 200 percent and debt service ratios over 20 percent.[99] These ratios for the East Asia and Pacific region were 99 percent and 12 percent respectively in 1996,[100] whereas the debt service ratio for Latin America in 1996 was 30%. Regional averages can, of course, mislead. Indonesia's 1996 debt export ratio of 220 percent and its debt service ratio of 34 percent suggests a debt crisis for that country – which is one of the reasons that recovery from the crisis has been so much slower in Indonesia

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[98] On these ratios, see Sachs, *supra* note 1, at 7.

[99] The view of a Morgan Guaranty study *cited in* Aronson, *International Lending and* Debt, 6:4 THE WASHINGTON QUARTERLY 62 (1982) at 68.

[100] THE WORLD BANK, GLOBAL DEVELOPMENT FINANCE 1997, vol. 1, 160 (1997).

than in the other Asian countries.[101] However, the debt export ratios of Korea, Malaysia, and Thailand were all substantially lower than those of Argentina, Brazil and Mexico in 1996 and the debt export ratio for East Asia and the Pacific in 1997 was 103 percent, compared to Latin America's 193 percent. In addition, the debt export and debt service ratios for East Asia and the Pacific were substantially lower in 1997 than in 1992.[102] Accordingly, the Asian crisis was in no conventional sense a debt crisis. It also differed from the debt crisis of 1982 and the Mexican peso crisis of 1994-95 in that the troublesome indebtedness was that of the private, not the public or quasi-public, sector and that it occurred within "a benign international environment with low interest rates and solid growth in output and exports".[103] It was initially a currency crisis and developed into a more generalised economic crisis, at least for Indonesia, Thailand, and Korea, the three most severely affected countries.

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[101] See *supra* note 2.

[102] THE WORLD BANK, GLOBAL DEVELOPMENT FINANCE 1998, vol. 1, 33, 124, 128 (1998).

[103] *Id.* at 4, 30.

Causes of the Asian Economic Crisis

The four principal causes of the Asian economic crisis were: (i) the type and extent of indebtedness (ii) financial sector weaknesses, (iii) fixed local exchange rates, and (iv) a region-wide loss of confidence. Each will be considered.

Type and Extent of Indebtedness

This cause of the Asian crisis is the one with the greatest parallels in Latin America and Africa fifteen years before. We will commence with the inappropriate types of indebtedness and then look at why so much debt flowed to the region in the early and mid-1990s.

Type of Indebtedness

The particular type of debt that contributed significantly to East Asia's economic problems was short-term debt, particularly that denominated in local currency. We will commence by considering short-term debt, then add in the impact of it being in local currency.[104]

[104] For short-term debt "accurate information is not widely available from debtors. By its nature, short-term debt is difficult to monitor [and] loan-by-loan registration is normally impractical": GLOBAL DEVELOPMENT FINANCE 1998, *supra* note 102, at 144, 24. Nonetheless, this is no small market -- it had a total capitalisation of about $850 billion at year-end 1996: S. Kandler, *Local Currency Markets Offer Promise and Risk*, 10 EMERGING MARKETS DEBT REPORT, Feb 3, 1997. The World Bank's figure for the stock of domestic bonds during 1995/1996 is $813 billion (GLOBAL DEVELOPMENT

Short-term indebtedness increased significantly in 1995 and 1996 across the region, with the increase concentrated in China, Indonesia and Thailand.[105] The build up of short-term debt was not a region-wide phenomenon. The ratio of short-term to total debt in the countries of the region in mid-1997 ranged from 67 percent in Korea and 46 percent in Thailand, to 19 percent in the Philippines.[106]

The primary problem with foreign investment in the short-term debt of emerging markets[107] nations is the fluidity of the investment. Adverse economic news is likely to result in the debt not being rolled over upon maturity and thus in net capital outflows.[108] This is a risk analogous to capital flight. The secondary problem is that such capital outflows may foment a collapse in investor confidence in the economy.

When the short-term debt is denominated in local currency, volatility is heightened because a substantial devaluation will decimate a local currency

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FINANCE 1998, *id.* at 25) which tends to confirm Ms Kandler's figure for year-end 1996.

[105] GLOBAL DEVELOPMENT FINANCE 1997, *supra* note 100, at 160.

[106] *Id.* at 35.

[107] The term "emerging market" was coined in about 1984 by the International Finance Corporation while seeking a title for a LDC investment fund. The IFC had previously promoted the Third World Investment Trust, but its acronym was considered unhelpful. The Emerging Markets Growth Fund, on the other hand, was a marketable name. See A. Soulard, *The Role of Multilateral Financial Institutions in Bringing Developing Companies to U.S. Markets*, 17 FORDHAM INT'L L.J. S145, S147 (1994). The name began to gain popularity in 1990 and soon had broad appeal as a non-perjorative alternative to "third world" or "less developed countries".

portfolio. Accordingly, the first signs of a devaluation will prompt a severe sell-off. The reliance on local currency short-term bonds intensified the Asian economic crisis once it commenced.[109]

Extent of Indebtedness

The extent of indebtedness which contributed to the Asian troubles was itself the product of (i) excess liquidity in the developed world; and (ii) the role of cross-over investors. Each will be considered.

Excess Liquidity in the Developed World

Every one of the lending booms in Latin America was predicated upon excess liquidity in the northern hemisphere.[110] The principal lending booms to Latin America were in the 1820s,[111] the 1860s,[112] the 1920s[113] and the 1970s.[114] And,

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108 *Asian dominoes*, 1215 INT'L FIN. REV., Jan 10, 1998.

109 The World Bank has summarised the combined effect of short-term and local currency debt, in these terms: "[t]he build up of short-term, unhedged debt left East Asian economies vulnerable to a sudden collapse of confidence. ... The loss of confidence led to capital outflows, and thus to depreciating currencies and falling asset prices, which further strained private balance sheets and so proved self-fulfilling": GLOBAL DEVELOPMENT FINANCE 1998, *supra* note 102, at 31. See also S. Sugisaki, Economic Crises in Asia, Address at the 1998 Harvard Asia Business Conference, Harvard Business School, (Jan. 30, 1998).

110 DAWSON, *supra* note 7, at 244; MARICHAL, *supra* note 1, at 95; and Stallings, *supra* note 7, at 294-295.

111 DELAMAIDE, *supra* note 1, at 96; MARICHAL, *id.* at 43 & 59; and generally, DAWSON, *id*.

112 DELAMAIDE, *id.* at 95, 96, 99, 120.

113 Skiles, *supra* note 7 at 1, 17; and MARICHAL, *supra* note 1 at 212-213.

in each case, these capital flows led to economic collapses -- in 1828, 1873, 1930 and 1982, respectively. The pattern continued with Mexico's peso crisis in late 1994. The preceding two years, 1993 and 1994, had seen record capital flows into Mexico at a time of excess liquidity in the U.S. in particular.[115]

The story was precisely the same in Asia. Western capital poured into East Asian countries in record quantities in the two years to June, 1997. East Asian stocks and bonds were being acquired by U.S. and European investors scornful of the low interest rates on offer in their home countries and fearful that the U.S. stock market had reached unsustainable heights.[116] Liquidity was at a peak in the U.S. and flowed into emerging markets nations.[117]

The conventional view of international capital flows is that developed country investors rationally and continually evaluate emerging markets investment opportunities and when these opportunities, on a risk adjusted basis, offer returns in excess of those available domestically, capital flows into the emerging

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[114] See generally, DELAMAIDE, *supra* note 1; and MARICHAL, *supra* note 1.

[115] C. Makin, *Doesn't anybody remember risk*?, INSTITUTIONAL INVESTOR 41 (April 1994); and M.Tobin, *Emerging Markets trading house -- Chase delivers the goods*, 1061 INT'L FIN. REV., (Dec. 17, 1994).

[116] Blustein, *supra* note 96.

[117] M. Pettis, *Can Financial Crises be Prevented?*, an unfinished paper, June 1998; and M. Pettis, *The New Dance of the Millions? -- Liability Management and the Next Debt Crisis*, CHALLENGE: THE MAGAZINE OF ECONOMIC AFFAIRS, (Aug. 1998).

markets.[118] This can be described as an "investment-pull" model. The analytical focus is on the emerging markets nation itself and the assumption is that "*growth prospects precede investment inflows*".[119] This model assumes that capital flows across international borders to emerging markets nations on the same basis as it moves around within a developed economy. For this reason, it is an appealing model but it is contradicted by economic history.

The prospects for growth in Latin America in the 1970s weren't markedly superior to those in the 1960s. But in the 1970s the OPEC oil price rise led to excess liquidity and a lending boom to Latin America resulted.[120] East Asia's growth prospects weren't better in the early to mid-1990s than in the 1980s, but there was far more liquidity in developed nations in the 1990s which depressed returns in those markets and led to massive capital flows to some East Asian countries.[121] The focus of this "capital-push" model is on liquidity in the developed world and the assumption is that "*capital inflow precedes and causes growth*".[122] The magnitude of these capital flows relative to the size of the

[118] Levinson, *supra* note 1, at 21; Pettis, *Can Financial Crises be Prevented?, id.*.

[119] *Id.*at 1. (emphasis in original)

[120] DELAMAIDE, *supra* note 1, at 35.

[121] GLOBAL DEVELOPMENT FINANCE 1997, *supra* note 100, at 160; and GLOBAL DEVELOPMENT FINANCE 1998, *supra* note 102, at 9, 31.

[122] Pettis, *Can Financial Crises be Prevented?, supra* note 117, at 2 (emphasis in original).

recipient markets leads to major investment-driven growth and any sharp decrease in flows is, because of their relative magnitude, inherently destabilising.

The "capital-push" model is less logically satisfying than the "investment-pull" model because it suggests international financial markets aren't rational and scientific in their operation. It suggests that early in the cycle when little capital is flowing to the emerging markets, psychological factors such as the ease and security of investing at home tend to predominate, and later in the cycle when copious quantities of capital are flowing to the emerging markets and they are thus performing strongly, a generalised discounting of risk and bandwagon effect come strongly into play. "Capital-push" is the only model that accords with economic history. Further support for it is lent by the response of the capital markets to the Asian crisis in 1997 and the Russian crisis in 1998. In Alan Greenspan's words, the workings of the international capital markets in the Asian crisis were based on a "visceral engulfing fear".[123]

The Central Role of Cross-over Investors

Cross-over is the term for mainstream institutional investors that add emerging market bonds to their portfolios for higher yield. They include multinational

[123] *Quoted in* P. Kelly, *IMF tightens the screws on Suharto*, THE AUSTRALIAN, Mar. 11, 1998, at 13.

corporations, pension funds, insurance companies, high-yield (junk bond) funds, high-grade bond funds and hedge funds.[124] These funds control such vast amounts of capital that their typical five percent allocation to the emerging markets far exceeds the capitalisation of specialist emerging markets funds.[125]

The unprecedented inflows to capital markets in the early-to-mid-1990s shrivelled fixed income yields in the developed countries. Institutional investors began to cross over into non-traditional markets in search of higher yields.[126] They began to invest substantially in emerging markets bonds in the bull run of 1993 but fled the market when the bears growled in 1994 and 1995.[127] They returned in far greater numbers in the bull run of 1996.[128]

With their higher credit ratings, East Asian issuers appealed in particular to cross-over investors.[129] The flow of capital allowed yields to decline so dramatically

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[124] P. Eavis, *The crossover factor*, 4 EMERGING MARKETS INVESTOR, 16, 17 (May 1997); and *Emerging Markets Trends*, 1167 IFR (Jan. 25, 1997).

[125] For instance, in 1997 the 182 SEC-registered high yield funds tracked by Lipper Analytical have about $70 billion in assets, compared to the $2 billion in assets of the 21 SEC-registered emerging markets bond funds: Eavis, *id.*

[126] *Crossing the line*, 1151 IFR (Sept. 21, 1996).

[127] Buckley, *Globalisation and the Emerging Debt Markets*, OCCASIONAL PAPER OF THE GROUP OF THIRTY (forthcoming 2000).

[128] In the first eight months of 1996, U.S. Treasuries returned minus 2.8 %; U.S. corporate bonds, 0.6 %; U.S. junk bonds, 6.3 %; and emerging markets bonds, 15.7%: Eavis, *The crossover factor*, *supra* note 124, at 16; and *Crossing over takes hold*, 1177 IFR (Mar. 8, 1997).

[129] *Latin America: Back with a vengeance*, 1151 IFR (Sept. 21, 1996).

that Indonesia was able to issue $400 million of ten-year Yankee bonds at only one percentage point over U.S. Treasuries[130] – emerging markets investors were severely underestimating the country risk.[131]

The cross-over phenomenon is, in essence, the story of a broad array of money managers becoming comfortable with higher risk investments and learning to leaven their portfolio with some higher risk assets in the quest for a higher overall return.[132] The flood of cross-over investment caused the yields on the traditional emerging market instruments, Brady, euro and global bonds, to fall sharply. The traditional emerging market money that had brought these bonds to prominence moved on in search of higher yield, principally to local market short-term bonds.[133] Cross-over investors also acquired much of the record $90 billion of new emerging markets bond issues in 1996.[134] Indeed, as 1996 progressed more and more underwriters began to sell new emerging markets issues from their high

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[130] *Sovereign bond deal of the year*, 8 ASIAMONEY, 38 (Feb., 1997).

[131] For instance, the Czech Export Bank was able to obtain a three-year $150 million revolving credit (syndicated loan) priced at a mere 12.5 basis points over Libor: *Eastern Europe: Tidal wave of foreign finance*, 1151 IFR (Sept. 21, 1996).

[132] Keith Mullin, *Yield: the opium of global investors*, 1200 IFR, (Sept. 13, 1997).

[133] Buckley, *supra* note 127; and *Eastern Europe: Tidal wave of foreign finance*, 1151 INT'L FIN. REV. (Sept. 21, 1996).

[134] *Prospect '97*, 4 EMERGING MARKETS INVESTOR, 14 (Jan. 1997); and *International Bond Issuance: A Banner Year*, 4 EMERGING MARKETS INVESTOR, 3 (Jan. 1997). Cf the slightly lower figures in GLOBAL DEVELOPMENT FINANCE 1997, *supra* note 100.

yield or high grade desks, rather than emerging markets desks, in recognition of the destination of the majority of the bonds.[135]

The cross-over investors thus drove the traditional emerging markets money from the established markets so that it, in turn, supported the sharp growth in issuance of local market short-term bonds. Without the cross-over phenomenon, the total indebtedness of East Asia would have been significantly less by mid-1997 – a fact not appreciated in most analyses of the crisis.

Financial Sector Weaknesses

This cause of the crisis has two facets: (i) the inability of local financial sectors to intermediate increased capital flows efficiently, and (ii) the premature liberalisation of local financial markets.

Failure to Intermediate Capital Flows Effectively

One of the few traits shared among the five principal nations of the Asian economic crisis was an inadequately sophisticated and supervised local financial sector. The local financial system proved unable to serve as an effective intermediary and allocate the funds to productive uses. The capital inflows often

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[135] *Crossing over takes hold, supra* note 128. For instance, 85% of the $700 million bond issue by Grupo Televisa, a Mexican media company, in May 1996 was sold to cross-over investors: *Crossing the line, supra* note 126.

ended up in property and stock market investments, driving up the price of those assets in speculative bubbles.[136] Such investments cannot generate the foreign currency needed to repay foreign currency debt. Indeed, it is suggested that a useful indicator of whether capital flows to an emerging market nation are excessive is the destination of the funds. When the great majority of incoming foreign capital is being used to increase the productive capacity of a nation, local regulators should be able to be reasonably comfortable. When the majority of incoming foreign capital is funding a boom in the local stock and/or real estate markets it is time for local regulators to adopt measures to make their nation a less attractive destination for foreign capital.

Disclosure and regulatory standards were inadequate across the region.[137] Faced with a steep yield curve,[138] local banks succumbed to the dangerous temptation to borrow short and lend long and did so, in the main, without hedging their foreign exchange exposures.

This lack of adequate prudential regulation was compounded by the moral hazard engendered by the crony capitalism prevalent in many countries in the region.

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[136] Sugisaki, *supra* note 109.

[137] GLOBAL DEVELOPMENT FINANCE 1998, *supra* note 102, at 4.

[138] A yield curve is a graph which plots yield of fixed interest securities against their time to maturity. A steep yield curve means yields on longer term securities are much higher than on shorter term securities.

Local banks were often owned and controlled by people with strong connections to the ruling political party and their frequent choice of highly risky, highly lucrative funding strategies was doubtless influenced by the prospect of a local bail-out should the risks result in losses.

Indiscriminate international borrowing and domestic lending had been common throughout the region, and when the bubble burst domestic banks were in crisis in many countries, particularly Indonesia, Korea and Thailand.[139] The productive capacity of the region had far outstripped the sophistication and regulation of its financial sectors.

The Premature Liberalisation of Local Financial Markets

In Thailand's case, foreign money had flooded into the economy (i) directly as institutional investors invested in stocks and bonds, particularly short-term local market bonds, and (ii) indirectly as Thai banks borrowed heavily from their foreign counterparts through the Bangkok International Banking Facility established in 1993.[140]

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[139] R. Dornbusch, *A Bail-out Won't Do the Trick in Korea*, BUSINESS WEEK (Dec.8, 1997) at 26; and R. Garran, *Korea Crisis*, THE AUSTRALIAN, (Nov.19, 1997) at 36, col 1.

[140] H. Chow, *Crawling from the wreckage*, 4 EMERGING MARKETS INVESTOR 15 (July/August, 1997).

With the benefit of hindsight, the Bangkok International Banking Facility was established too early, before effective prudential controls and supervision were in place and functioning well. As the IMF has identified, "a robust financial system underpinned by effective regulation and supervision of financial institutions"[141] is the overriding precondition to a nation liberalising its capital controls. Thailand, Indonesia and Korea, in particular, had opened their economies to international capital flows without reinforcing the stability of their domestic banking sector in these ways.[142]

The dangers of premature liberalisation of local financial markets is well made by the minimal effect of the Asian economic crisis on the Republic of China.[143] Taiwan's local financial sector is closed to foreign banks and its financial markets are largely closed to foreign speculators through a system of strict limits on inflows and outflows of portfolio investment.[144]

Taiwan's heavily controlled financial markets and huge foreign exchange reserves served it exceedingly well. Taiwan is highly unusual in its capacity to fund its

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141 INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTLOOK 9 (May 1998).

142 *Id.* at 6.

143 R. Watanabe, *Legal Aspects of Taiwan's Ambition to become an Asia-Pacific Regional Financial Centre - Realisable or Not?* 74 (1997) (SJD thesis, Bond University).

144 *Id.* at 64-68.

dramatic growth internally[145] and the author is not recommending a path of financial isolation. However, Taiwan's experience underlines that appropriate regulation and supervision must precede financial market liberalisation to gain the benefits of greater access to international capital without the destabilising effects of massive capital flows.

Fixed Exchange Rates

Fixed exchange rates appeal to developing countries because they offer lower costs of credit and lower rates of inflation and provide discipline against monetary or fiscal excesses by government.[146] Fixed exchange rates have proven critical in breaking wage-price-currency spirals that had led to ruinous inflation in nations such as Argentina and in promoting exports (through slightly undervalued exchange rates) and a stable external environment in times of export-led growth in Asia.[147]

The cost of credit is lowered under a fixed exchange rate regime as borrowers will typically trust to the peg and borrow in foreign currency (at rates invariably lower than local currency rates).[148] Furthermore, a fixed exchange rate imposes a

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[145] To which its massive foreign exchange reserves are a testament.

[146] M. Feldstein, *supra* note 94; and B Eichengreen & R Hausmann, *Exchange Rates and Financial Fragility*, NBER Working Paper No 7418, Nov. 1999 (visited Mar. 27, 2000) <www.nber.org/papers/w7418>.

[147] I. Viscio, *The recent experience with capital flows to emerging market economies*, 65 OECD ECON. OUTLOOK, June 1, 1998, at 177.

[148] Viscio, *id.*; and P. Bustelo, C. Garcia et al., *Global and Domestic Factors of Financial Crises in Emerging Economies: Lessons from the East Asian Episodes (1997-1999),* ICEI Working Paper No. 16, Nov. 1999, Instituto Complutense De Estudios Internacionales, Madrid.

potentially useful discipline on debtor governments: as a lax monetary policy that permits inflation will also erode the value of the currency, a government committed to a fixed exchange rate is forced to eschew the politically attractive option of increasing the money supply to meet the demands of domestic pressure groups.

However, fixed exchange rates pose their own political and economic problems. When the economy of a nation with a fixed exchange rate is performing less strongly than that of the nation(s) to whose currency its currency is fixed, the peg requires adjustment or the fixed currency will become overvalued. Choosing to devalue the nation'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 there was a national election in Mexico in August 1994 and a peso crisis four months later: a government about to face the electorate was unable 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. The depreciation of the yen from mid-1995 onwards provided a further twist in the Asian context. As the 1990s progressed, East Asian economies began moving increasingly into high-tech exports in which they were competing with Japan. However their exchange rates were, in the main, pegged to an appreciating US dollar while, from mid-1995 onwards, their principal competitor enjoyed a depreciating yen.[149]

Accordingly it is very easy, with a fixed rate regime, for a nation's currency to become overvalued. It happened in Mexico in 1993 and 1994, in Thailand and

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[149] EAST ASIA ANALYTICAL UNIT, ASIA'S FINANCIAL MARKETS: CAPITALISING ON REFORM, DEPT OF FOREIGN AFFAIRS AND TRADE, COMMONWEALTH OF AUSTRALIA 22 (1999).

Indonesia in 1996-97, and in Russia in 1997-98. And smaller economies lack the resources to defend the value of their currency against speculative attack.[150]

The other problem with fixed exchange rates is that they encourage excessive borrowing in foreign currency. Borrowers, like most people, believe what they want to believe, and so choose to take the lower interest rates that are usually on offer abroad and trust to the fixed exchange rate to deal with the currency risk. As the Asian crisis demonstrated conclusively, this behaviour is highly risky and masks the real cost of borrowing in a foreign currency: the currency risk doesn't go away merely because one's domestic currency is pegged to the foreign currency. Exchange rate uncertainty, healthily, tends to keep borrowers at home.[151]

A pure floating exchange rate is not strictly necessary, a managed flexible rate, provided it is managed in a sensible and market responsive manner, is usually enough. However a fixed rate, in the contemporary world of massive capital flows, is an invitation to trouble.

An overvalued fixed exchange rate was at the heart of each of the Mexican peso crisis of late 1994, the Asian crisis of 1997, the Russian collapse of 1998 and Brazil's devaluation of early 1999.[152] The overwhelming policy lesson of the past

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[150] To understand speculative attacks on currencies, it is necessary to understand that speculators can sell currency they do not own. Now, of course, if you or I try that with a car or boat the local constabulary will soon be a calling. However, investors can simply borrow a currency such as baht or rupiah, sell it for a hard currency, such as US dollars, and then trust to a fall in the value of the baht or rupiah before they have to repurchase it to repay the borrowing. Accordingly, there can, in the short term, be waves of currency sales that are not preceded by currency purchases and such is the mechanism of speculative attacks: A.S. Blinder, *Eight Steps to a New Financial Order*, FOREIGN AFFAIRS, 50 (Sept.-Oct., 1999).

[151] *Keeping the hot money out*, THE ECONOMIST, (Jan.1998).

[152] Blinder, *supra* note 150.

five years is that flexible exchange rates provide a real measure of protection against a currency crisis and accompanying economic problems.[153]

Region-wide Loss of Confidence

The severity of the Asian economic crisis has exceeded the combined effect of its various causes[154] and can only be explained as the result of a region-wide loss of confidence. This was the common factor that turned quite different economic troubles in five countries into a regional crisis.[155] The loss of confidence led to an outflow of capital -- both domestic capital flight and a halt in external re-financing. This led to currency depreciation and to the uncovering of massive, unhedged, foreign exchange exposures and severely damaged balance sheets of local corporations.[156]

That the investment markets should have treated the whole of East Asia as one region might appear at first glance to be remarkably unsophisticated. The economies of Korea, Thailand and Indonesia have quite different strengths and weaknesses. Indeed, these economies have little in common beyond inadequately regulated and supervised local financial sectors.

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[153] LH MEYER, LESSONS FROM THE ASIAN CRISIS: A CENTRAL BANKER'S PERSPECTIVE, Levy Economics Institute Working Paper No. 276, Aug. 1999.

[154] GLOBAL DEVELOPMENT FINANCE 1998, *supra* note 102, at 40.

[155] *Id.* at 30.

This inability to distinguish between countries is unsophisticated if the task of market participants is to predict the economic fundamentals of each economy in the future. However, the primary task of market participants is to estimate the value the market will put on the debt in the future, not some underlying fundamental value (whatever that may be).[157] As the principal investors in emerging markets invest across all of the countries in a region, a sharp decline in values in one nations' debts will prompt the sale of some of the debts of other nations to meet margin calls or cover losses arising from the price declines.[158] Furthermore, the tendency to view the emerging markets as one entity was well established in the tequila effect of 1995 in which Mexico's peso crisis resulted in a sell-off across the entire emerging markets sector -- in nations as diverse as Argentina,[159] the Philippines,[160] Hungary[161] and Thailand.[162] Accordingly, from

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[156] *Id*. at 5.

[157] In the words of Lord Keynes, "the energies and skill of the professional investor and speculator are mainly occupied … not with making superior long-term forecasts of the probable yield of an investment over its whole life , but with foreseeing changes in the conventional basis of valuation a short time ahead … Moreover, this behavior is an inevitable result of an investment market … For it is not sensible to pay 25 for an investment of which you believe the prospective yield to justify a value of 30, if you also believe that the market will value it at 20 three months hence.": JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY 154-55 (1967). For a fuller analysis, see Buckley, *Globalisation and the Emerging Debt Markets*, OCCASIONAL PAPER OF THE GROUP OF THIRTY (forthcoming 2000).

[158] Buckley, *id.*.

[159] *Equity and Privatisation -- Proceed with caution*, 1124 IFR (Mar. 16, 1996); and *Tequila hangover -- a year to forget*, 1112 IFR (Dec. 16, 1995).

[160] G. Platt, *Mexican Virus Fells Emerging Markets But Prognosis Good Among Healthiest*, JOURNAL OF COMMERCE, 2A (May 4, 1995).

the perspective of each separate investor, a loss of confidence in the entire region, and thus an exodus from lending and investment to the region, was rational.

Conclusion and Lessons

The debt crisis and Asian economic crisis were quite different types of crises. The Asian crisis arose far more from private sector activities than did the debt crisis.[163] The Asian crisis was in part the result of misallocated investment, not over consumption as was the debt crisis. The Asian crisis, with the exception of Indonesia, was in large measure a crisis of confidence: as the other nations' rapid recovery from it has attested. The debt crisis was the result of unsustainable debt levels, it was not principally a crisis of perceptions. Nonetheless, a comparison of the causes of the two crises does suggest some common lessons. And so we come to the goal of this journey through crisis: to identify the lessons that could have been learned from the experiences of the 1970s and 1980s and that held good throughout the 1990s. What are these enduring lessons that we should bring to the task of reforming the international financial architecture in the early years of this next century? This study suggests there are at least seven:

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[161] *Tequila slammers*, 1064 INT'L FIN. REV. (Jan. 14, 1995).

[162] *Id.* For a far more detailed consideration of the tequila effect see Buckley, *supra* note 157.

1. In the contemporary world, fixed exchange rates are a high risk strategy and some sort of floating rate is much to be preferred.

2. The denomination of most of a nation's foreign debt in foreign currency is likewise risky.

3. Much more of the debt needs of emerging markets need to be funded with long-term local currency denominated capital.

4. The infrastructure and regulation of local capital markets need to be developed extensively.

5. Capital tends to flow recklessly to emerging markets in times of surplus liquidity in the developed world.

6. Foreign direct investment and equity investment offer major benefits over debt financing.

7. It is time to reconfigure the allocation of responsibility for international lending and investment.

Each lesson will be considered.

1. The Benefits of Floating Exchange Rates

The attractiveness of fixed exchange rates, with their capacity to keep a cap on inflation, impose fiscal and monetary discipline on the domestic government and

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[163] J Stiglitz, Statement to the Meeting of Finance Ministers of ASEAN *plus* 6 with the IMF and the World Bank", Kuala Lumpur, Malaysia (Dec. 1, 1997).

provide stability for exporters, is understandable. However their disadvantages outweigh those advantages. Fixed exchange rates are often politically difficult to devalue when they become overvalued as over time they naturally tend to do. Overvalued rates lead to burgeoning current account deficits, capital flight and, ultimately, to a currency crisis. The costs of crises, as seen in the 1980s and since 1997, are massive. Floating exchange rates provide a substantial degree of insurance against currency crises.

2. The High Risks of Foreign Currency Borrowing

The second lesson from the debt crisis and the Asian crisis is that borrowing in foreign currency imposes a tremendous currency risk on the borrowing nation. Hedging on such a scale is extremely expensive and rarely done. Denominating loans and bonds in foreign currency increases the amount of indebtedness as it encourages lenders to discount the currency risk. This is an illusion. As both the debt crisis and Asian crisis demonstrate, if the currency risk is with the borrower due to the denomination of the debt, in times of trouble it is transferred to the lender by the incapacity of the borrower to service the debt.

Denominating loans in foreign currency also encourages borrowing as it reduces the interest rate on the debt (because lenders are not factoring in the currency risk). The interest rates that best reflect the real risks of borrowing by such borrowers are those on their local currency indebtedness. The accepted custom of denominating loans and bonds for emerging market nations in foreign currency masks the real cost of funds and encourages excessive indebtedness.

3. *The Need for Long-Term Local Currency Capital*

The third lesson is the pressing need for emerging market nations to raise long-term capital in their own currencies. The principal source of local currency capital to date has been short-term local market bonds. However, the short tenor of these instruments brings with it tremendous instability. Long-term local currency capital markets will allow emerging market debtors to raise capital with the currency risk on the investors. Returns to investors will be greater when times are good, as debtors will have to pay more to borrow in their currency, and less when times are bad, through the operation of the exchange rate. Such a repayment profile is well adapted to avert the types of crises we saw in the 1980s and 1990s. Debtors should be anxious to pay the higher premia required to raise long-term capital and local currency denominated capital. Whilst issuers cannot move much ahead of the investor base in these matters, remarkably, debtors positively sought short term and foreign currency denominated debt in the periods preceding the recent crises. Debtors strove for the lowest cost of funds and were not willing to pay for more appropriate tenors and currencies for their debt.

The lead of the supranational institutions in long term local currency debt issuance needs to be well supported by the debtors, who should be anxious to issue in their own currency at every opportunity. Ratings agencies need to reflect the lower real risks of default in their ratings of local currency bond issues. International assistance, particularly in the form of market and regulatory expertise, is required to enable emerging markets nations to develop their local capital markets. Further research is required on other potential measures to promote local currency capital raising.

4 The Need to Develop Local Capital Markets

Bond and equity markets transfer risks directly to investors, not through banks. This is highly desirable both because banking is an inherently unstable industry and because, in emerging markets nations, banks are often subject to considerable pressure to make finance available to certain debtors for non-commercial reasons.[164] This element of crony capitalism was a major contributing cause to the debt crisis and the Asian crisis. Furthermore, local capital markets facilitate

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[164] *The Crisis in Emerging Financial Markets: A World Bank-Brookings Conference Report*, available at http://www.brook.edu/es/international.1999/report1.html, visited on March 20, 2000.

the raising of long-term local currency capital through bond issues, as recommended above, and improve the allocation of capital within an economy.[165]

International assistance, particularly in the form of market and regulatory expertise, is required to enable emerging markets nations to develop their local capital markets. The World Bank is assisting in this regard. Emerging markets nations need to make it a high priority.

5. International Capital Flows as a Product of Developed World Liquidity

Every developing country financial crisis from 1828 to 1998 was preceded by a period of high liquidity in the developed world that funded large capital flows to the developing countries. At times of high liquidity in developed nations, bank regulators in both developed and emerging economies should be on the look out for excessive capital flows to emerging markets (excessive flows being those that fund local consumption or fuel local asset market bubbles rather than those that fund an expansion in a nation's productive capacity. The primary task of both local and international bank regulators -- to maintain the safety and soundness of their domestic banking systems -- requires vigilance and control over the amount

[165] J Wurgler, Financial Markets and the Allocation of Capital, unpublished paper, draft of Apr. 3, 2000. Wurgler found the efficiency of capital allocation to be positively correlated with the amount of firm-specific information in local stock markets and with the legal protection of minority shareholders.

the international banks and institutional investors are lending to and investing in emerging markets nations.

6. The Benefits of Foreign Direct Investment and Equity Over Debt

Perhaps the principal lesson of the debt crisis was the foreign direct investment and equity investment are far preferable to debt for recipient nations because FDI and equity include an automatic risk sharing, and loss sharing, mechanism in the event of economic troubles.[166] Nonetheless, bank lending played a central role in the Asian crisis. This is because the current financial system includes some strong structural biases towards debt, particularly bank loans. These biases include (i) the explicit, or more often, implicit insurance of bank deposits in most countries, which expands the banking sector; (ii) the severely under developed nature of local emerging market equity markets, and (iii) the use of bail-out funds to bailout bank creditors, not debtors.[167]

These factors are compounded by the high degree of family ownership and close control of companies in Asia. In the past Asian controlling shareholders have

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[166] K Rogoff, *International Institutions for Reducing Global Financial Instability*, NBER Working Paper No. W7265, July 1999, *available at* http://www.nber.org/papers/w7265, visited on March 20, 2000.

[167] Rogoff, *id.* at 28-29.

resisted sharing ownership broadly, yet equity finance is the most suitable form of finance for most emerging market economies.[168]

Debtor nations need to invest heavily in the development of their local equity markets and consider carefully before accepting bail-out packages that require bail-out funds to be used entirely for the discharge of indebtedness.[169]

7. The Urgent Need for a New Perspective on Responsibility in International Lending and Investment

It is time for a new framework for allocating responsibility in international lending and investment. 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. 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

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[168] M. Westlake, *What future for the emerging markets?*, 5 EMERGING MARKETS INVESTOR, Sept., 1998, 6 at 7.

[169] For a detailed consideration of possible approaches to the use of bail-out funds, see Ross. P. Buckley, *National Sovereignty in the Era of Hot Money: Strategic Options for Asian Nations*, KLUWER YEARBOOK ON INTERNATIONAL ECONOMIC AND FINANCIAL LAW (forthcoming 1999).

entirely the debtors' fault.[170] This is a convenient fiction for international banks and investors, nothing more. However, it is a fiction with severe consequences.

In the debt crisis, this fiction meant the 1980s became the lost decade for Latin America and sub-Saharan Africa – a decade in which the absence of debt relief meant more people in abject poverty and further decay of vital infrastructure each year. The view that the responsibility for the debt crisis lay principally on the debtors justified the creditors in their strong opposition to debt relief. In the end it was the mounting risk to democracy in Latin America that prompted the U.S. Treasury to embrace the very limited amount of debt relief inherent in the Brady Plan and to 'persuade' banks to that point of view.[171] Appalling human suffering resulted from the resistance to debt relief, and thus from the fictional belief that bad international debts are purely the debtors fault.

In the Asian crisis, this fiction meant the IMF bail-outs of the Asian debtors could be, and were, made available for the purpose of fully repaying short-term bank debt – the very debt that, through its instability, had triggered the crisis and the very debt that through high interest rates the banks had been well rewarded for holding. Such bail-outs were highly counterproductive. They rewarded creditors

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[170] Levinson, *supra* note 1, at 36-37.

[171] Ross P. Buckley, The *Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993*, 21 FORDHAM INT'L L. J. 1802, 1803-1818.

for investing in the most destabilising form of debt and did nothing for those creditors who had extended long-term debt: precisely the type of debt that should be encouraged. A default on such short-term 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 and thus to Russia's crisis in August 1998).[172] Allowing a default on this debt would also have freed these funds to be used to recapitalise the local banks, improve the local financial systems and stimulate the local economies.[173] 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.[174] The IMF made the wrong call on

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[172] Buckley, *supra* note 127.

[173] SCOTT & WELLONS, *supra* note 1, at 1243.

[174] In Latin America, IMF structural adjustment programs tended to increase disparities in wealth (GREEN, *supra* note 59, at 92). SAPs meant the disadvantaged suffered most (James, *Deep Red - The international Debt Crisis and Its Historical Precedents*, THE AM. SCHOLAR 340 (Summer 1987) but brought "magnificent returns to the rich" (*A survey of Latin America*, THE ECONOMIST, (U.K. ed) (Nov 13, 1993). 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": D. E. Sanger, *Ideas & Trends; Maybe a Bankrupt Nation Isn't the Worst Thing in the World*, THE NEW YORK TIMES, Oct 12, 1997, at section 4, p 6, col 1.

the use of bail out funds for the Asian debtors because it was viewing the situation from the wrong perspective and analysing it in terms of the wrong framework of responsibility. And the costs of this decision are being borne today by, among others, the young children in Indonesia and Thailand without enough food to eat and whose families cannot afford to keep them in school.

It is time, now, to reconfigure the framework for allocating responsibility for international loans and investments so as to recognise that international lending and borrowing is a joint endeavour for which each party is responsible.