KLUWER LAW INTERNATIONAL

International Financial System

Policy and Regulation

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AUSTIN BOSTON CHICAGO NEW YORK THE NETHERLANDS

Published by:
Kluwer Law International
PO Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.kluwerlaw.com

Sold and distributed in North, Central and South America by:
Aspen Publishers, Inc.
7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.care@aspenpubl.com

Sold and distributed in all other countries by:
Turpin Distribution Services Ltd.
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom
Email: kluwerlaw@turpin-distribution.com

ISBN 978-90-411-2868-3

To the lights of my life, Ariella, Tara and Marcus;
and to the lighthouse, Rashelle.

About the Author

Ross Buckley is a Professor in the Faculty of Law at the University of New South Wales in Sydney, Australia, an Australia 21 Fellow, and a Senior Fellow of the Tim Fischer Centre for Global Trade & Finance at Bond University. He is the founding Series Editor of the *Global Trade Law Series* of Kluwer of The Hague, Series Co-Editor of Kluwer's *International Banking and Finance Law Series*, and founding editor of the Overseas Law column of the *Australian Law Journal*. He has taught as a Visiting Professor at Northwestern University, Chicago and has consulted to the US Department of Justice, the US Securities and Exchange Commission, Vietnam's Ministry of Trade, Indonesia's Ministry of Finance, and the Australian Tax Office.

Preface

> Lawyers and legal academics are largely absent from the debate about financial crises. The commentary is dominated by economists, many of whom unfortunately vastly oversimplify or even misunderstand the role of law in recent crises.
>
> Frank Partnoy[1]

Partnoy's complaint is a good one.

Lawyers need to get involved. Law schools need more scholars teaching and researching international finance law. Around the world, law schools that believe they ought to teach international trade law, do not teach international finance law. Yet financial flows far exceed trade flows, by a factor of over sixty to one; international financial transactions represent a far greater proportion of the practice of most major law firms than do trade transactions; and international finance, when it goes wrong, brings appalling suffering to the poorest citizens of poor countries. International finance law is important; it is only neglected because it is not understood.

I have written this book for a few reasons. One is to address this widespread lack of understanding with a hopefully accessible and interesting book. Another is to provide a general introduction to the international financial system and its regulation to assist students studying the topic. A third reason is to articulate my take on the system as one that works much to the detriment of the poor nations and the benefit of rich nations, and in particular to the detriment of the poor within poor nations and the benefit of the rich within rich and poor nations alike.

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1. F. Partnoy, 'Why Markets Crash and What Law Can Do about It' (1999–2000) 61 *University of Pittsburgh Law Review*, 741.

In general, this book seeks to learn from history. For, as John Kenneth Galbraith said, '[h]istory has a way of repeating itself in financial matters because of a kind of sophisticated stupidity'.[2] If this book seeks anything, it seeks to work against this sophisticated stupidity for mistakes in the finance of developing countries sacrifice the lives of thousands and the futures of millions.

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2. J. Galbraith, *The Sunday Times*, 25 October 1987. The more well known, similar quotation is from George Santayana, 'Those who cannot remember the past are condemned to repeat it.': Santayana, *Life of Reason* (1950–1956), vol.I, ch.xii.

Acknowledgements

I would like to thank the inimitable 'Dr P', Haig Patapan, who by serving as an unerring sounding board has had much to do with the birth and realization of this project. I would also like to thank Peter Dirou, for allowing me to reuse some of the material from an article we wrote together; and my two research assistants, Hernan Pintos-Lopez and David Yang, whose efforts contributed much towards getting this manuscript finished, and on time.

The publisher and I would like to thank the publishers of the following books and journals for their permission to use in this book parts of the material written by me (and in one case Peter and I) and published in these chapters and articles: 'How to Strengthen the International Financial System by Improving Sovereign Balance Sheet Structures' (2006) 2 *Annals of Economics and Finance*, 257 (with P. Dirou); 'Why Some Developing Countries Are Better Placed than the International Monetary Fund to Develop Policy Responses to the Challenges of Global Capital' 15 *Tulane Journal of International and Comparative Law*, Winter 2006, 121; 'Iraqi Sovereign Debt and Its Curious Global Implications', chapter in *Beyond the Iraq War: The Promises, Perils and Pitfalls of External Interventionism*, Heazle and Islam (eds) (London, Edward Elgar, 2006), 141; 'The Role of the Rule of Law in the Regulation of Global Capital Flows', chapter in *Globalisation and the Rule of Law*, Zifcak (ed.) (Oxford, Routledge, 2005), 140; 'Why Are Developing Nations So Slow to Play the Default Card in Renegotiating Their Sovereign Indebtedness?' [2005] *Chicago Journal of International Law*, 347; 'How the International Financial System, to Its Detriment, Differs from National Systems, and What We Can We Do About It' (2004) 34 *University of Hong Kong Law Journal*, 321; 'Do Cry for the Argentines: An Analysis of Their Crisis' (2003) 17 *Banking & Finance Law Review*, 373; 'The IMF's Proposal for a Sovereign Debt Restructuring Mechanism: An Australian Assessment' [2003] *Australian Journal of International Law*, 1; 'Sovereign Bankruptcy' (2003) 15 *Bond Law Review*, 86; 'The Fatal Flaw in

International Finance: The Rich Borrow and the Poor Repay' XIX No 4 *World Policy Journal*, Winter 2002/2003, 59; 'A Tale of Two Crises: The Search for the Enduring Lessons of International Financial Reform' (2001) 6 *UCLA Journal of International Law and Foreign Affairs*, 1; 'An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors' (2000) 15 *Banking and Finance Law Review*, 431; 'The Role of Capital Controls in International Financial Crises' (1999) 11 *Bond Law Review*, 231; 'The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993' (1998) 21 *Fordham International Law Journal*, 1802 and 'The Transformative Potential of a Secondary Market: Emerging Markets Debt Trading from 1983 to 1989' (1998) 21 *Fordham International Law Journal*, 1152.

Introduction

> Something is wrong with the global financial system. One might think the system would shift money from rich countries, where capital is in abundance, to those where it is scarce, while transferring risk from poor countries to rich ones, which are most able to bear it . . . The current global financial system does none of these things.[1]
>
> Joseph Stiglitz, Nobel Laureate in Economics, former Chief Economist of the World Bank, in 2003.

It is a mistake to think that our international financial system was designed to deal with today's international capital flows. It was not.

When in 1944 John Maynard Keynes and Harry Dexter White proposed three international organizations to guide and assist the international economy, the international financial system was utterly different to the one we have today. Nations existed largely as financial islands. Capital flows between them were miniscule by contemporary standards.[2] Capital controls were in place between national economies to regulate and often prevent transnational capital flows.

Today finance is perhaps our most globalized activity. The price of credit in the US affects the interest rates offered to home buyers in Australia. A currency crisis in Thailand and Hong Kong almost instantly affects share prices in Turkey and Hungary. The economic collapse of Russia sends the values of the 30-year US Treasury Bond to unprecedented highs. These changes have come about

1. J. Stiglitz, 'Dealing With Debt: How to Reform the Global Financial System' (2003) 25 *Harvard International Review* 54, 54.
2. Total debt flows were USD 13.4 billion in 1970, USD 272 billion in 2000 and USD 647 billion in 2006: *Global Development Finance 2002* (Washington DC, World Bank, 2002), p. 246 and *Global Development Finance* 2007, available at http://siteresources.worldbank.org.

principally due to capital account liberalization, the process by which barriers to capital flows between nations are eliminated and financial globalization thus facilitated.

This book has deliberately not addressed the many soft-law regulatory initiatives of the past decade. Much has been done, in the decade following the Asian crisis, in promulgating standards and formulating codes of conduct, that are available for adoption by national regulators. I have not dealt with these developments for two reasons. First, Doug Arner has done a splendid job of doing so in *Financial Stability, Economic Growth and the Role of Law*[3] and reinventing the wheel did not appeal. Secondly, as this book makes clear, I firmly believe that these initiatives, while worthy, are not being made at a sufficiently fundamental level to redress the systemic weaknesses of the international financial system. They are improvements, but to the edges, not the core of the problem.

The book focuses upon why we have a system that is so fundamentally deficient for debtors, but also for creditors, and what can be done about it, both by the debtor nations themselves, and at a system-wide level.

3. Cambridge University Press, 2007.

Table of Contents

Chapter 1

History of the Global Financial System

1.1 HISTORY

Before we consider our current international financial architecture, it is useful to review a little history.

Sovereign debt crises are nothing new. Spain in the sixteenth century and France in the eighteenth are the most commonly cited examples. The sixteenth century King of Spain would sporadically receive shipments of bullion and treasure from his overseas empire. These he used to finance fighting in Italy, France and Holland. Alas, engaging in a war is like building a house, it usually costs more than you intended and can afford. The Spanish King made up the difference by borrowing from banking houses. Periodically, he could not afford the repayments and there was, in modern parlance, a combination of rescheduling and debt relief – maturities were extended and interest rates reduced. This happened more than once: in 1557, 1575, 1596, 1607, 1627 and 1647; to be precise. Yet the bankers had lent so much their fortunes were linked umbilically to those of the Hapsburg Empire and thus they continued to lend. The sixteenth century debt crisis lasted a century.[1]

In the eighteenth century, France funded its repeated and costly wars with England by borrowing from Swiss and Dutch bankers. After almost a century of a similar pattern of defaults, reschedulings and debt relief, the limits of the lenders were reached and the loans stopped. The French monarchy collapsed a few years later.

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1. H. James, 'Deep Red – The International Debt Crisis and Its Historical Precedents' *The American Scholar* 331, 334–336 (Summer 1987). Modern national names are used for convenience to describe geographical regions.