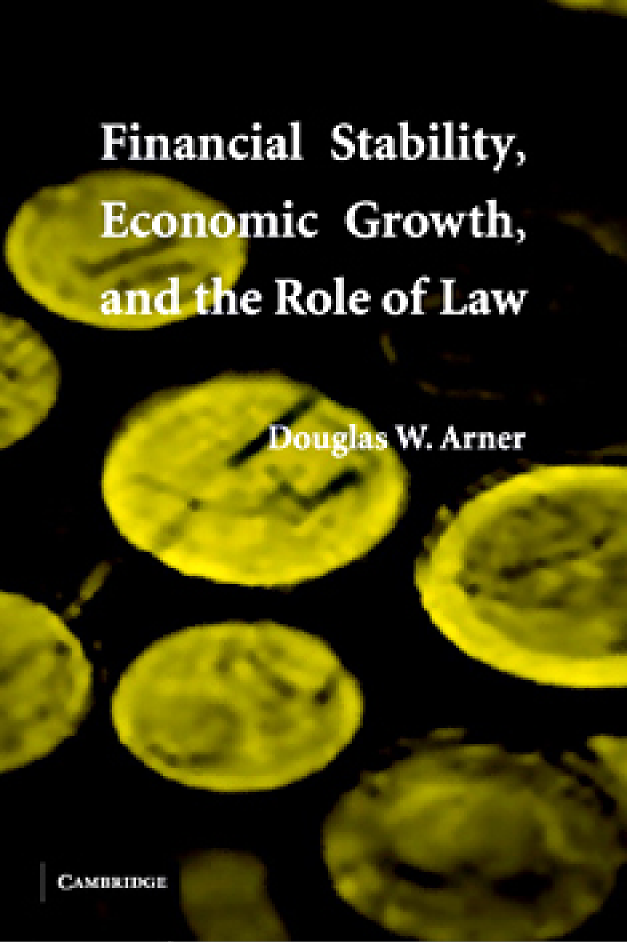

Financial Stability, Economic Growth, and the Role of Law

Douglas W. Arner

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FINANCIAL STABILITY, ECONOMIC GROWTH, AND THE ROLE OF LAW

Financial crises have become an all-too-common occurrence over the past twenty years, largely as a result of changes in finance brought about by increasing internationalization and integration. As domestic financial systems and economies become more interlinked, weaknesses can significantly impact not only individual economies but also markets, financial intermediaries and economies around the world. This volume addresses the twin objectives of financial development in the context of financial stability and the role of law in supporting both. Financial stability (frequently seen as the avoidance of financial crisis) has become an objective of the international financial architecture as well as individual economies and central banks. At the same time, financial development is now seen to play an important role in economic growth. In both financial stability and financial development, law and related institutions have a central role.

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CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE UNIVERSITY PRESS
Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore, São Paulo

Cambridge University Press
The Edinburgh Building, Cambridge CB2 8RU, UK
Published in the United States of America by Cambridge University Press, New York

www.cambridge.org
Information on this title: www.cambridge.org/9780521870474

First published in print format 2007

ISBN-13 978-0-511-28726-8 eBook (Adobe Reader)
ISBN-10 0-511-28726-7 eBook (Adobe Reader)

ISBN-13 978-0-521-87047-4 hardback
ISBN-10 0-521-87047-X hardback

ISBN-13 978-0-521-69056-0 paperback
ISBN-10 0-521-69056-0 paperback

To Pearline, Becky and Chantal

Contents

Introduction

The research underlying this volume began with a question: why do financial crises occur and what can be done to prevent such crises and reduce their impact when they do occur? Today, following a series of financial crises around the world over the past fifteen years, this question to some extent has been answered through the establishment of a system of international standards directed towards the overall goal of financial stability. If one is interested in financial crises, it follows that one is also interested in the broader role of the financial system: clearly, financial crises are deleterious to economic growth, but can the financial system also have positive effects? Likewise, this question is now generally answered in the affirmative: an effectively functioning financial system is important for economic growth, though (as demonstrated by the existence of financial crises) finance also brings risks. The question then becomes how to develop a financial system which supports economic growth (and thereby economic development) in the context of financial stability. The purpose of this volume is to address this question.

In the past fifteen years, the recognition of the importance of law in an economy has increased greatly. It is now commonly accepted that property rights, enforcement of contracts and the rule of law are significant for economic development. Unfortunately, in most cases, the literature – especially the economic literature – has still not progressed significantly beyond this basic realization. The question arises: what do these ideas mean in practice? More precisely, if law is important, what sort of legal infrastructure and institutions are best?

This volume attempts to answer this question in the context of the financial sector – arguably the area of an economy in which law has the greatest importance. Specifically, this volume discusses the relationship among law, finance, and economic growth and development. It argues that law and the related institutional framework are fundamental to economic development generally.

Further, it argues that an effective financial sector is essential to economic growth. On this basis, the volume addresses the question of how laws and institutions should be designed in order to support financial sector development to underpin economic growth in the context of financial stability.

In order to do this, the volume analyses international responses to financial crises in developing, emerging and transition economies[1] at the end of the twentieth and beginning of the twenty-first centuries. The volume argues that financial crises since the Mexican crisis in 1994 have caused a fundamental re-evaluation of the role of financial law and institutions, with the consequent development for the first time of a comprehensive framework of internationally acceptable standards delineating minimum requirements for financial stability.

The author argues, on the basis of recent research, that law has a fundamental role in both financial stability and financial market development, both of which, in turn, are significant for economic growth. The volume analyses the international consensus (formalized through a series of international standards) respecting financial stability which developed following the series of financial crises around the world at the end of the twentieth century. It combines the elements of the key standards which have been developed with research respecting financial development in an effort to provide an understanding of the main legal and institutional elements supporting financial sector stability and development.

The volume discusses whether the international financial architecture, as currently structured, addresses the risks inherent in moving from a closed domestic financial system to an open system integrated into the global financial system. It suggests that the current structure of the international financial architecture has developed as a response to the risks inherent in financial liberalization, domestic restructuring and globalization of finance. However, unlike the structure developed at Bretton Woods at the end of World War II or in the European Union, the current structure of the international financial architecture fails to explicitly link domestic restructuring (addressed by

[1] Throughout, this volume will use the terms "developed", "emerging", "transition" and "developing" economies. Herein, "developed" countries or economies are the advanced nations of North America, Europe and East Asia (Japan, Hong Kong and Singapore). "Emerging economies" are market-based economies which are in the process of moving to "developed" status through integration into the global economic and financial systems. "Transition economies" are formerly centrally planned economies which are in the process of transitioning to market-based economic systems. "Developing" countries or economies are poorer states which are in the process of building economies and financial systems. These general terms reflect related terminology used by the International Monetary Fund.

the current matrix of international financial standards) with financial liberalization (especially in the context of both capital account liberalization and the role of the World Trade Organization [WTO]) and globalization of financial markets (and the role of the international financial institutions in this process). Further, it fails to move coherently beyond the requirements of stability to the requirements of development.

The volume concludes by suggesting that individual governments, regional arrangements and development organizations should take an active interest in the legal and institutional design of financial systems, much in the way that one would pursue major construction or technological development projects, to support financial stability in the context of financial development and in order to enhance economic growth and development.

Following this introduction, the volume proceeds through ten chapters organized into four parts.

FINANCIAL MARKETS AND THE INTERNATIONAL FINANCIAL ARCHITECTURE

The first part discusses the relationship among law and institutions, financial sector development and economic growth, and the international financial architecture.

The part begins, in the first chapter, with a discussion of theories of economic development, suggesting that there is an emerging consensus relating to the importance of an economy's institutional framework, including law and legal infrastructure, in economic growth and development; presents research addressing the role of law in an economy; and argues that law and legal infrastructure have an important role in economic growth, development and finance. The chapter highlights three aspects: first, the fundamental role of law and institutions in economic growth and development; second, the growing body of research suggesting that an effective financial system is necessary to support economic growth; and third, the role of law and institutions in an effective financial system. Second, the chapter discusses the role of finance in economic growth and development, suggesting that the role is both positive and negative. Financial crises and research have highlighted weaknesses in both domestic and international financial systems, as well as the significance of the financial sector – both positive and negative – in economic growth and development more generally. In order to discuss the role of law in financial development, it is first necessary to have a general understanding of the financial sector, what it does, and how it works. The chapter therefore includes a brief introduction to financial systems. This picture of financial systems, however, is only a stylized description, both of domestic and international financial systems. Finally, the chapter also looks at the function of law in finance, and concludes by suggesting that law plays an essential role in financial development, which, in turn, is significant for economic growth and development generally.

The second chapter of this volume discusses the developing international framework addressing the potential negative impact of finance on economic development – namely, the concepts of financial stability and the international financial architecture. It addresses financial stability, its role and the central issue of whether the international financial architecture as currently structured addresses the risks of participation of individual economies, especially developing, emerging and transition economies, in the global financial system. It argues that appropriate law and legal infrastructure are a necessary but not sufficient component of financial stability, economic growth and development. Specifically, Chapter Two discusses financial stability and the significant but incomplete international consensus that has developed in the past decade. This consensus is often discussed in the context of the "new international financial architecture". With this international framework in mind, the remainder of the volume addresses the mechanics of legal infrastructure in finance.

The chapter first looks at the post–World War II design for international financial stability and economic development: the Bretton Woods international economic system and its objectives (financial stability and economic development, based on three pillars: money, finance and investment, and trade). Second, it briefly discusses the changes in the international financial system between the creation of Bretton Woods and the end of the twentieth century: the process of financial market globalization.

The onset of the Mexican financial crisis in 1994 signaled the return of a sort of financial crisis not seen since before the establishment of the Bretton Woods system and its structure of fixed relationships among closed domestic financial systems. Prior to 1944, however, such crises were not uncommon and, in fact, one goal of the design of the Bretton Woods system was to eliminate the possibility of similar financial crises in the future. In many ways, it was remarkably successful; however, following the break up of the fixed exchange rate system in 1973, the gradual return to free movement of capital and the increasing re-integration of financial systems, the stage was set for a return to the sorts of crises common during the nineteenth and early twentieth centuries. Financial crises in emerging economies around the world over the past fifteen years highlight the dangers inherent in financial liberalization without adequate domestic restructuring in the context of participation in increasingly an globalized financial system.

Third, the chapter analyses the international response to the string of financial crises over the past fifteen years: discussions regarding the international financial architecture and the development of a system of international financial standards, comprising the political framework, international financial standards themselves, standard setters and setting, implementation, and monitoring. As a direct result of the Mexican and east Asian crises, the Group of Seven (G-7) and the Group of Ten (G-10) (among others) analysed the causes of and appropriate responses to similar situations in the future. The G-7 issued directions based on the analysis to the international financial organizations and institutions – a pattern that has since solidified into a methodology, perhaps even a system. In regard to financial stability, the G-7 issued directions to international financial organizations (e.g., the Basel Committee on Banking Supervision) to develop standards to address domestic financial sector weaknesses, which were a significant underlying factor in the various crises of the 1990s. The international financial institutions (especially the Bretton Woods institutions) are charged with supporting implementation and monitoring of those standards. In addition, the international financial institutions were directed to implement emergency measures to be used in future crises. The result is the only development respecting the international financial architecture which can really be called "new": a system of international financial standards under which political decisions are taken by the G-7; standards are formulated by international financial organizations; coordinated by the new Financial Stability Forum; and international financial institutions develop mechanisms of implementation, monitoring and response to crises, with the result being translation of international standards into domestic legal systems.

In essence, a system of international financial soft law based on implementation and monitoring of nonbinding standards has been added to the existing international financial architecture. Unfortunately, the system of international financial standards, while significant, does not form a coherent system in the same way as the Bretton Woods system as designed (though not as implemented). The system is designed to address the same issues as the Bretton Woods system (stability and development), but does so in an incomplete manner and, thus, the existing international financial architecture needs to be reviewed in order to appropriately address all three pillars in a coherent and integrated system. The chapter concludes that the current structure of the international financial architecture fails to adequately address the realities of globalized financial markets and that individual countries should undertake coherent reform processes as part of the process of financial integration and development, albeit using the system of international financial standards as a starting point.

From this background, the second and third parts of the volume analyse the specific elements of the legal and institutional framework for a stable and effective financial sector. Specifically, parts two and three discuss the main issues to be considered in financial stability and development, on the basis of international standards and related research. The system of international standards focuses on fifteen "key standards for sound financial systems", organized under three broad headings and twelve key subject areas. The first broad heading, macroeconomic policy and data transparency, is the responsibility of the International Monetary Fund; the second and third (institutional and market infrastructure, and financial regulation and supervision) are the responsibility of a wide variety of different standard-setting organizations. The chapters look at the main elements of the consensus respecting financial stability and summarize research addressing the role of law and institutions in financial market development in an effort to outline the appropriate institutional framework for finance, reflecting current international best practices.

FOUNDATIONS OF FINANCIAL SECTOR DEVELOPMENT

Part II discusses the foundations of financial stability and development. Specifically, we look in Chapter Three at the preconditions for finance – the fundamental elements necessary for finance to develop and function, namely: (1) foundations of financial development and economic growth and (2) institutional underpinnings of finance. Chapter Four, in turn, deals with the role of central banks in financial, monetary and macroeconomic stability. While the system of international financial standards addresses the third area (reflecting an immense amount of research outside the scope of this volume), it does not address the first and second, even though, in fact, foundations and institutional underpinnings may be of at least as great, if not greater, significance for finance and development than macroeconomic policy.

Building on recent research, Chapter Three argues that financial systems require certain legal and institutional elements to be in place in order to function. These include property rights, collateral frameworks and company law, which, in turn, must be set in a framework supporting effective governance providing for enforcement of contracts and commercial dispute resolution. In addition to these institutional foundations, financial sector development occurs best in the context of a stable macroeconomic setting, including appropriate monetary, financial and fiscal policies and frameworks (Chapter Four). In addition, Chapter Four addresses certain responsibilities of central banks and financial authorities, including payment and settlement and government bond markets.

Chapter Five discusses the elements of institutional and market infrastructure which are essential to support the development of an effective, functional financial system. These elements – all addressed by international financial standards – build upon the underpinnings discussed in Chapters Three and Four and are necessary for the financial regulatory systems and structures discussed in Part III to function properly in a market economy. Building on these foundations, Chapter Five looks to the many sorts of legal infrastructure necessary for sophisticated financial systems to function properly – what could be called essential financial infrastructure. It therefore considers the supporting institutional and market infrastructure which is necessary for sophisticated financial systems to develop. Aspects include insolvency regimes, corporate governance, and accounting and auditing systems ("financial information"). These are supported by appropriate measures to protect market integrity and thus confidence in the financial system. It is only when both the foundations and the supporting infrastructure are in place that financial liberalization, regulation and supervision can function properly.

FINANCIAL REGULATION AND SUPERVISION

Part III discusses a central focus of recent international efforts: financial regulation, supervision and liberalization. Specifically, it investigates the primary areas addressed by the system of international financial standards: banking (Chapter Six), nonbank finance (Chapter Seven), and financial liberalization and related issues such as financial conglomerates and financial regulatory structure (Chapter Eight). International financial standards, however, generally only address stability and not the role of development. The volume attempts to take both into account and to consider other areas meriting further attention.

LOOKING FORWARD

Part IV discusses deficiencies in the international financial architecture as currently structured and in the process through which economies address their financial sector legal and institutional frameworks. The volume concludes, first, that international financial standards constitute a necessary but not sufficient requirement for financial stability. Second, the current pseudo-system is inadequately structured to deal with the central issue presented at the outset – that is, the relationships among the requirements for development (namely, liberalization, restructuring and integration), especially as the system discussed interacts with the WTO and its constituent financial services provisions. Third, the current structure of the international financial architecture does not adequately address the issue of crisis resolution.

The final two chapters thus look forward and address the reform of the international financial architecture and financial systems. They focus on the role of the international financial architecture discussed in preceding chapters, including weaknesses of the current system and a brief agenda for possible reform, and discuss issues which need to be considered in developing fully effective financial systems but to date have not been adequately treated by the international financial architecture, including development (especially competition and its relationship to the international framework of the WTO), the interaction between liberalization and regulation, and the systemic context.

Chapter Nine suggests, first, that the system of international financial standards (with its focus on financial stability) does not adequately address certain issues, especially those related to development. It argues that although the system of international standards addresses financial stability comprehensively, it does not address the issue of development to any great extent. In this regard, as standards are revised, developmental issues should be addressed in addition to stability requirements. Further, at present, international standards do not adequately address issues of competition. Especially significant is the fact that the WTO framework governing financial services access has not been incorporated into the system of international financial standards.

Second, chapters nine and ten suggest that, unlike the Bretton Woods or EU structures, the current system of international standards does not adequately address the interlinkages between finance and the international architecture. Specifically, they argue, first, that the current system of financial standards does not address the important issue of the relationship between financial liberalization and financial stability, even though this relationship is addressed by the more formal structure of the EU single financial market project. In addition, as discussed previously, financial systems today have the added complication of their interaction with one another. As a result, economies must consider issues respecting interaction and integration with global and regional financial systems. Unfortunately, the current system of financial standards does not address the important issue of the relationship between financial liberalization and financial stability at a global level. However, this relationship has been addressed at a regional level by the more formal structure of the European Union, which may provide a model for both international and other regional arrangements. Second, the international financial architecture still does not address adequately issues of crisis resolution.

The final chapter discusses financial sector design, including financial and regulatory structure, and a suggestion that individual economies proactively support financial sector development and stability by addressing the legal and institutional framework of their financial and economic systems on a holistic basis in order to achieve the desired results of financial stability and development. Governments may consider a variety of models available for domestic financial structure and for regulatory systems. If law and institutions are important for stable and effective finance, how can officials take advantage of research and best practices in their own systems and what can development professionals and organizations do to assist? The chapter suggests that financial sector development indeed can be influenced and recommends careful analysis and planning by governments and their advisors in order to appropriately address issues of legal infrastructure in financial development in order to secure economic development.

Unfortunately, despite much effort, financial crises continue, with dramatic consequences for development. The volume argues that the current framework provides an important starting point but that significant deficiencies remain. In order to support financial stability, economic growth and economic development, a fresh look should be taken at the international financial architecture in the context of the realities of today's global financial system.

This book has been supported by my interactions with a wide range of individuals and organizations around the world. While it is impossible to acknowledge all of these influences (and I am vastly appreciative of all those I have worked with on related issues over the years), I would like to especially thank the following for their input, support and/or thoughts on related issues: Ernesto Aguirre, Noritaka Akamatsu, James Barth, David Bernstein, William Blair, Charles Booth, Ross Buckley, Joao Farinha, Stefan Gannon, Say Goo, Jorge Guira, Christos Hadjiemmanuil, Vanndy Hem, Angela Itzikowitz, Lolette Kritzinger-van Niekirk, Rosa Lastra, Jing Leng, Julia Leung, José de Luna, Donald McIsaac, Matthew Morgan, Christopher Olive, Jae-Ha Park, Anita Ramasastry, Keith Reid, Gerard Sanders, Norbert Seiler, Heba Shams, Andrew Sheng, Marc Steinberg, Tull Traisorat, George Walker, Wei Wang, Mamiko Yokoi-Arai, Said Zaidansyah, and Zhongfei Zhou.

I would also like to thank the present and former staff of the Asian Development Bank, European Bank for Reconstruction and Development, International Monetary Fund and World Bank, as well as my present and former colleagues at the University of London and the University of Hong Kong.

In addition, I would like to thank Mads Andenas, Charles Chatterjee, Ross Cranston, Chantal Hébert, Paul Lejot, Joseph Norton and Michael Taylor for comments on various drafts. Finally, I would like to thank John Berger, Mary Cadette, Linda Smith and the staff of Cambridge University Press for their highly professional support and production.

All errors of course are my own.

Douglas W. Arner
January 2007

PART ONE

FINANCE AND THE INTERNATIONAL FINANCIAL ARCHITECTURE

1

Law, Finance and Development

Until the mid-1990s, the role of the financial sector in economic development was largely ignored. Today, research increasingly focuses on the central role of the financial sector in economic growth and therefore in economic development more generally.[1] Further, the importance of law in economic development prior to the early 1990s was largely ignored by most economists. Today, it is very difficult to avoid statements highlighting the importance of law and other institutional structures in economic development. Moreover, it is only more recently that the role of law in the financial sector is beginning to be carefully evaluated and understood. These are all significant developments and underscore the theme of this volume: law, legal institutions and regulatory systems ("legal infrastructure") are fundamental to financial stability and financial sector development, which, in turn, are essential to economic growth and development.

This chapter discusses the changing understanding of the role of law and the financial sector in economic growth and development. It begins with a discussion of theories of economic growth and development, suggesting that

[1] Economic development is a term about which much has been written but about which there is no general agreement. See G. Meier and J. Stiglitz (eds), *Frontiers of Development Economics: The Future in Perspective* (Washington DC: World Bank and New York: Oxford University Press, 2001). Today, it is generally agreed that economic development encompasses a range of factors, as indicated by the United Nations Millennium Development Goals ("MDGs") – see United Nations (UN), *United Nations Millennium Declaration, General Assembly Resolution 55/2*, 8 Sep. 2000; UN General Assembly, *Road Map Towards the Implementation of the United Nations Millennium Declaration: Report of the Secretary General*, UN General Assembly 56th Session, A/56/326, 6 Sep. 2001; see also www.developmentgoals.org. Among the most significant factor affecting economic development is economic growth. See World Bank, *2004 Annual Review of Development Effectiveness: The Bank's Contribution to Poverty Reduction*, 2005. As a result, this volume will focus primarily on economic growth.

there is an emerging consensus relating to the importance of institutions, including law and legal institutions, in economic growth and development.

Second, the chapter discusses the role of finance in economic growth and development as highlighted by a series of financial crises over the past decade and a half, suggesting both positive and negative aspects. In order to discuss the role of law in financial development, it is first necessary to have a general understanding of the financial sector, what it does, and how it works. This picture of the financial system, however, is only a stylized description, of both domestic and international financial systems.

Third, we look at the function of law in the financial system. The chapter concludes by suggesting that law plays an essential role in financial development which, in turn, is significant for economic growth and development generally.

1.1. LAW, INSTITUTIONS AND ECONOMIC DEVELOPMENT

Since the early 1990s, the factors supporting economic development have received increasing attention from a variety of sources. Generally speaking, theories of economic development today focus on the roles of geography (or "endowments"), policies and institutions. Geography-based theories arguably explain much of early development, but are less useful in relation to more advanced stages. Theories based upon policies dominated from World War II, culminating in the predominance of market economics and the policies of the Washington Consensus, to the Asian financial crises in the late 1990s. Following the series of financial crises beginning in the mid-1990s, attention has focused on the role of institutions in economic development, with research suggesting that institutions, in fact, may be the dominant underlying factor.

1.1.1. *Geography and Endowments*

Theories based upon geography suggest that economic development results from the essential physical endowments present in a given location, including such things as flora, fauna, climate and geography. Jared Diamond has reinvigorated analysis about the role of physical endowments and their influence on economic development by drawing together the various strands of the biological and physical sciences, anthropology and archaeology, and linking their discoveries to economic development.[2] Arguably, factors relating to endowments were determinative of much of economic development prior to

[2] See J. Diamond, *Guns, Germs, and Steel: The Fates of Human Societies* (New York: W.W. Norton, 1997).

the twentieth century, but are less relevant to contemporary development. At the same time, with global climate change, some of these factors may become increasingly relevant as the twenty-first century progresses.

1.1.2. *Policies*

Since the end of World War II and the creation of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development ("World Bank") at Bretton Woods, New Hampshire in 1944, the focus of development theory and professionals largely has been on design and implementation of appropriate policies supported through aid and assistance, culminating in pre-eminence of the so-called Washington Consensus of stabilization, liberalization and privatization.[3]

William Easterly, in the most accessible account to date, outlines a number of "waves" of development theories focusing on a variety of policies since World War II:

(1) foreign aid to bridge the gap between savings and investment[4],
(2) investment in technology[5],
(3) investment in education[6],
(4) population control[7],
(5) official loans to induce policy reforms[8], and
(6) debt forgiveness to support policy reforms.[9]

Overall, Easterly suggests that all of these have failed because they missed the main goal: aligning incentives to support economic growth which, in turn, reduces poverty.[10] Instead, Easterly in effect argues that the new paradigm must be the creation and maintenance of incentives through effective institutionalization of appropriate policies, thus highlighting the roles of incentives and

[3] See P. Krugman, "Dutch Tulips and Emerging Markets", For. Affairs, Jul./Aug. 1995, p. 28. Krugman describes the so-called "Washington Consensus" regarding economic policies that developed in the early 1990s as:

> Liberalize trade, privatize state enterprises, balance the budget, peg the exchange rate, and one will have laid the foundations for an economic takeoff; find a country that has done these things, and there one may confidently expect to realize high returns on investments.

Id., p. 29.

[4] See W. Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (Cambridge, MA: MIT Press, 2001), ch. 2.

[5] See id., ch. 3.

[6] See id., ch. 4.

[7] See id., ch. 5.

[8] See id., ch. 6.

[9] See id., ch. 7.

[10] See id., Prologue and ch. 1.

institutions in economic growth, which, in turn, underlies development more generally. He argues for focus on institutionalization of policies and incentives in a number of areas highlighted by recent research, including:

(1) Government action is needed to escape the trap of poverty: bad government policies must be removed and all forms of knowledge and capital accumulation, especially technological innovation and research and development, should be subsidized through a fiscal system that does not discourage knowledge accumulation.[11]
(2) Macroeconomic policy is important: governments should avoid creating poor incentives for growth through the elimination of high inflation, black markets, excessive budget deficits, strongly negative real interest rates, restrictions on free trade, excessive red tape, and inadequate public services.[12]
(3) An appropriate institutional framework is vital, especially for reducing corruption: this includes the elimination of red tape, establishment of rules under which governments honour contracts and do not expropriate unjustly, and creation of a meritocratic civil service.[13]
(4) The institutional framework also extends to political arrangements, supporting a stable and public-interested political system, which reduces political polarization and extreme inequality.

Policies thus continue to be important, as they impact on incentives; however, the way in which policies are implemented rests on devising and implementation of the institutional framework.

1.1.3. *Institutions*

The role of institutions in economic development began to receive significant attention in the early 1990s, largely as a result of the requirements of transition from state-ownership and control to market-based economies in the countries of the former Soviet Bloc, combined with the failure of policy-based approaches to achieve significant results.

By the late 1980s, the communist experiment was rapidly coming to an end around the world. With the demise of communism in most economies, the question became how to move from total state ownership and control to a functioning market economy. Followers of Friedrich Hayek, Milton Friedman and the Chicago school of economics focused on "shock therapy": the idea

[11] Id., pp. 168–9 and 192.
[12] Id., pp. 237–9.
[13] Id., p. 252.

that if everything was liberalized and privatized as rapidly as possible (following initial monetary and fiscal stabilization), then a market economy would naturally develop. Unfortunately, this did not work quite as planned; quickly, reformers began to realize the importance of institutions, including law and property rights, in the functioning of a market economy and the complexity of developing these in the context of the transition economies, with implications for development in developing and emerging economies more generally.

It was at this time that theory and experience came together in the "new institutional economics". For Douglass North, institutions are fundamental to economic development. Property rights are embedded in institutions, and institutions provide an incentive structure for economic activity. Economic development will take place if property rights are embedded in institutions designed to provide appropriate incentives. Needless to say, there are many potential pitfalls to success in this simple formulation, which are discussed throughout this volume.

North's theories have been most comprehensively expressed in 1990 in *Institutions, Institutional Change and Economic Performance*[14]; however, his ideas had developed over the previous two decades. In 1973, in *The Rise of the Western World*[15], North and Robert Thomas argued[16]:

> Economic organization is the key to growth; the development of an efficient economic organization in Western Europe accounts for the rise of the West. Efficient organization entails the establishment of institutional arrangements and property rights that create an incentive to channel individual economic effort into activities that bring [economic growth].

In 1981, in *Structure and Change in Economic History*[17], North analysed the structure of economies over time and developed a theory to account for stability and change in those structures.[18] The theory of institutions which he develops is based on three pillars[19]:

(1) a theory of property rights that describes the individual and group incentives in the system;
(2) a theory of the state, since it is the state that specifies and enforces property rights; and

[14] D. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990).
[15] D. North and R. Thomas, *The Rise of the Western World: A New Economic History* (Cambridge: Cambridge University Press, 1973).
[16] Id., p. 1.
[17] D. North, *Structure and Change in Economic History* (New York: W.W. Norton, 1981).
[18] Id., p. 3.
[19] Id., pp. 7–8.

(3) a theory of ideology that explains how different perceptions of reality affect the perceptions of individuals regarding the changing "objective" situation.

In 1990, in *Institutions, Institutional Change and Economic Performance*[20], North[21]:

> provides an outline of a theory of institutions and institutional change. . . . The specification of exactly what institutions are, how they differ from organizations, and how they influence transaction and production costs is the key to much of the analysis. . . . The evolution of institutions that create an hospitable environment for cooperative solutions to complex exchange provides for economic growth.

The question arises as to the meaning of institutions. According to North[22]:

> Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence, they structure incentives in human exchange, whether political, social, or economic. Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change.

Building on this, North sums up the role of institutions[23]:

> Institutions provide the basic structure by which human beings throughout history have created order and attempted to reduce uncertainty in exchange. Together with the technology employed, they determine transaction and transformation costs and hence the profitability and feasibility of engaging in economic activity. They connect the past with the present and the future so that history is a largely incremental story of institutional evolution in which the historical performance of economies can only be understood as a part of a sequential story. And they are the key to understanding the interrelationship between the polity and the economy and the consequences of that interrelationship for economic growth (or stagnation and decline).

1.1.4. *Recent Empirical Evidence*

The results of a 2002 study are striking: Easterly and Ross Levine test the endowment, institution and policy views against each other using cross-country evidence and find, first, evidence that endowments affect development through

[20] North (1990), op. cit., n. 14.
[21] Id., p. vii.
[22] Id., p. 3.
[23] Id., p. 118.

institutions; and second, no evidence that endowments affect country incomes directly other than through institutions, nor do they find any effect of policies on development after controlling for institutions.[24]

Similarly, Dani Rodrik, Arvind Subramanian and Francesco Trebbi test the respective contributions of institutions, endowments and trade in determining cross-country income levels.[25] Their results indicate that the quality of institutions is most important: controlling for institutions, endowments have at best weak direct effects on incomes, although they have a strong indirect effect through institutions; similarly, trade has a positive impact on institutions.

Importantly, both sets of authors agree on two points: their results, while very significant, do not provide much guidance for policy makers and therefore much remains to be done in teasing out exactly what sorts of institutions are most significant and how to implement these in the context of the widely varying circumstances of individual economies.

1.1.5. *The Role of Law*

As discussed earlier, development theory has gone through a number of stages. Development assistance, including that relating to law, has tracked theory.

Thomas Heller suggests that theories relating to the role of law in development have progressed through a series of waves.[26] The first wave, roughly from 1950–65, focused on building national legal systems, in the context of newly independent states. The second wave, the "law and development" movement, developed roughly from 1960–75. The law and development movement focused on enabling technocracy and disabling established elites. After the gradual erosion of law and development, the third wave, roughly from 1985–2000, focused on human rights and constitutionalism. The fourth wave, beginning from around 1990 and still on-going, focuses on the interactions among law, markets and economics. Founded upon Max Weber's ideas of legal certainty, its leading exponents have been North and Mancur Olson. Today, this wave looks at increasingly diverse areas, including intellectual property, corporate governance and competition.

24 W. Easterly and R. Levine, "Tropics, Germs, and Crops: How Endowments Influence Economic Development", NBER Working Paper No. 9106 (Aug. 2002).

25 D. Rodrik, A. Subramanian and F. Trebbi, "Institutions Rule: The Primacy of Institutions over Integration and Geography in Economic Development", IMF Working Paper WP/02/189 (Nov. 2002).

26 See E. Jensen and T. Heller, *Beyond Common Knowledge: Empirical Approaches to the Rule of Law* (Palo Alto: Stanford University Press, 2004).

1.1.6. *The Way Forward*

We began this section with an analysis of the various theories of economic development. Two related quotations from Niall Ferguson and William Easterly sum up the consensus today.

According to Ferguson[27]:

> A country's economic fortunes are determined by a combination of natural endowments (geography, broadly speaking) and human action (history for short): this is economic history's version of the nature-nurture debate. While a persuasive case can be made for the importance of such 'given' factors as the mean temperature, humidity, the prevalence of disease, soil quality, proximity to the sea, latitude and mineral resources in determining economic performance, there seems strong evidence that history too plays a crucial part. In particular, there is good evidence that the imposition of British-style institutions has tended to enhance a country's economic prospects, particularly in those settings where indigenous cultures were relatively weak because of thin (or thinned) population, allowing British institutions to dominate with little dilution. Where the British, like the Spaniards, conquered already sophisticated, urbanized societies, the effects of colonization were more commonly negative, as the colonizers were tempted to engage in plunder rather than to build their own institutions. Indeed, this is perhaps the best available explanation of that 'great divergence' which reduced India and China from being quite possibly the world's most advanced economies in the sixteenth century to relative poverty by the early twentieth.

Easterly goes further[28]:

> We have learned once and for all that there are no magical elixirs to bring a happy ending to our quest for growth. Prosperity happens when all the players in the development game have the right incentives. It happens when government incentives induce technological adaptation, high-quality investment in machines, and high-quality schooling. It happens when donors face incentives that induce them to give aid to countries with good policies where aid will have high payoffs, not to countries with poor policies where aid is wasted. It happens when the poor get opportunities and incentives, which requires government welfare programs that reward rather than penalize earning income. It happens when politics is not polarized between antagonistic

[27] N. Ferguson, *Empire: The Rise and Demise of the British World Order and the Lessons for Global Power* (New York: Basic Books, 2002), pp. 360–1.

[28] Easterly (2001), op. cit., n. 4, p. 289. In his second book, Easterly takes this forward with discussion of methodologies to achieve this goal, focusing on small-scale results. W. Easterly, *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good* (New York: Penguin Press, 2006).

interest groups, but there is a common consensus to invest in the future. Broad and deep development happens when a government that is held accountable for its actions energetically takes up the task of investing in collective goods like health, education, and the rule of law.

To apply today's consensus on development, David Landes suggests that the "ideal growth-and-development society" would have the following characteristics[29]:

(1) knowledge of how to operate, manage and build the instruments of production, and to create, adapt, and master new techniques on the technological frontier;
(2) ability to impart this knowledge and know-how to the young, whether by formal education or apprenticeship training;
(3) selection of people for jobs by competence and relative merit, and promotion and demotion on the basis of performance;
(4) provision of opportunity to individual or collective enterprise, and encouragement of initiative, competition and emulation; and
(5) allowance for people to enjoy and employ the fruits of their labour and enterprise.

Such a society would also possess the kind of political and social institutions that favour the development of these larger goals, for example[30]:

(1) secure rights of private property, the better to encourage savings and investment;
(2) secure rights of personal liberty, against both the abuse of tyranny and private disorder (e.g., crime and corruption);
(3) enforceable rights of contract, explicit and implicit;

29 D. Landes, *The Wealth and Poverty of Nations: Why Some Are So Rich and Others So Poor* (London: Little, Brown, 1998), p. 217.

30 Id., pp. 217–18. Niall Ferguson suggests that the British Empire was beneficial for economic growth in its constituent economies. Ferguson (2002), op. cit., n. 27. According to Ferguson, the British Empire disseminated a number of important features:

(1) the English language,
(2) English forms of land tenure,
(3) Scottish and English banking,
(4) the Common Law,
(5) Protestantism,
(6) team sports,
(7) the limited or "night watchman" state,
(8) representative assemblies, and
(9) the idea of liberty.

Id., p. xxv.

(4) stable government, not necessarily democratic, but itself governed by publicly known rules (i.e., a government of laws rather than men – the "rule of law");
(5) responsive government, that will hear complaints and make redress;
(6) honest government, such that economic actors are not moved to seek advantage and privilege inside or outside the marketplace (i.e, no rents to favour and position); and
(7) moderate, efficient, ungreedy government, holding down taxes, reducing government's claim on the social surplus and avoiding privilege.

These ideas have been adopted and developed by, inter alia, the World Bank.[31] Thus, one can say that there is now a consensus that law and related institutions play a fundamental role in economic growth and development.

1.2. FINANCIAL CRISES IN THE 1990S

In addition to changing views of the role of law and institutions in economic growth and development, the role of the financial sector has also received increasing attention. Two sets of events at the end of the twentieth century changed the way in which the financial sector is viewed: the process of transition from centrally planned to market-based economies (discussed earlier in the context of its importance for analysis of the role of institutions) and a series of financial crises around the world in the 1990s.

Financial crises in Latin America from the end of 1994 and in Asia from mid-1997 have drawn increased attention to the potential dangers of globalization of the international financial system. In order to prevent the collapse of the economies involved and reduce the risk of potential contagion throughout the international financial system, international financial rescues of unprecedented proportions were organized for Mexico, Thailand, Indonesia and South Korea.[32] Including contributions from multilateral and bilateral creditors, these financing packages totaled US$48.8 billion for Mexico in 1995, US$17 billion for Thailand, US$40 billion for Indonesia and US$57 billion for South Korea in 1997. In these respective packages, the contribution of the IMF alone totaled US$52.8 billion: US$17.8 billion for Mexico, US$4 billion for Thailand, US$10 billion for Indonesia and US$21 billion for South Korea.

[31] See World Bank, *World Development Report 2002: Building Institutions for Markets* (New York: Oxford University Press, 2002).

[32] See generally D. Arner, "An Analysis of International Support Packages in the Mexican and Asian Financial Crises", J. Bus. L. 380 (1998).

In addition, subsequent crises and/or international rescues occurred in Russia and Brazil in 1998, Turkey in 2000 and Argentina in 2002.

The magnitude of these international financial rescue packages and their impact on international finance underlines a number of on-going changes in the international financial system. These changes can be seen in respect of the potential dangers to developing, emerging and transition economies of international capital flows, the importance of financial regulation, and in the changing role of the IMF. This section, however, only highlights the basic causes of the crises and the nature of the international rescues organized in order to give the reader a greater understanding of the underlying factors and responses involved in this broader context of change.

1.2.1. *Prelude: 1990–95*

A number of financial crises occurred during the late 1980s and the first half of the 1990s, including in the United States and the Nordic countries (domestic banking crises in developed economies), Europe (an international crisis involving developed country currencies participating in the European Exchange Rate Mechanism – the precursor to the development of the European currency, the euro), and Mexico (an international crisis in an emerging economy, with contagious impact on other emerging economies, especially in Latin America). These crises foreshadowed the sorts of crises that occurred in the second half of the 1990s in developed, emerging, developing and transitioning economies[33] and held important lessons for the crises that occurred around the world in the second half of the 1990s and into the twenty-first century, with recent examples including in Argentina and Turkey.

In many ways, the experiences of the United States in liberalizing its financial system in the 1970s and 1980s as a reaction to the internationalization of financial markets are similar to the crises experienced in other countries throughout the 1990s, not only in developing, emerging and transition economies, but also in the developed economies of western Europe and Japan. The crisis in Mexico and subsequent contagion were largely similar to those which occurred in east Asia, beginning in Thailand in 1997. Crises in Russia, Brazil, Argentina and Turkey followed similar patterns. In other words, the writing was on the wall, but no one outside of the immediately affected countries was reading it. At the same time, however, these crises were considerably different from the developing country debt crisis of the early 1980s, which was largely caused by

[33] See generally D. Arner, M. Yokoi-Arai and Z. Zhou (eds), *Financial Crises in the 1990s: A Global Perspective* (London: British Institute of International and Comparative Law, 2001).

over-borrowing by countries, over-lending by international banks and interest volatility resulting from US efforts to control inflation.[34] Instead, these crises have had much more in common with financial crises prior to the establishment of the Bretton Woods international economic system at the end of World War II.[35]

1.2.2. *The Mexican Financial Crisis: 1994–95*

The first "post-modern" financial crisis, now commonly described as the Mexican peso crisis, erupted in Mexico in 1994 and continued to deepen into 1995.[36] During the 1994–95 crisis, Mexico faced a temporary liquidity crisis due to a large number of intertwined factors, some caused by problems within or exacerbated by Mexico, but others not – for example, increases in US interest rates. As a result of the crisis and the perceived need to protect the international financial system, the United States organized an international response to the crisis. However, following the Mexican crisis, the United States and other leading industrialized economies placed the leading role in addressing future crises on the shoulders of the IMF. As a result, when similar circumstances struck in Thailand, Indonesia and South Korea, among others, in 1997, the IMF led the response, albeit one based very closely on the experiences garnered in Mexico in 1994–95.

The evidence suggests that the origins of the crisis can be found in the interplay of a number of complex financial, economic and political factors that developed in the period prior to December 1994.[37] According to an analysis by the US General Accounting Office[38], Mexico's financial crisis originated

34 See generally J. Frieden, *Debt, Development and Democracy: Modern Political Economy and Latin America, 1965–1985* (Princeton, NJ: Princeton University Press, 1991).

35 The Bretton Woods system is discussed in more detail in Chapter 2.

36 See generally D. Arner, "The Mexican Peso Crisis of 1994–95: Implications for the Regulation of Financial Markets", 2 NAFTA L. & Bus. Rev. 28 (1996).

37 See generally IMF, *International Capital Markets: Developments, Prospects, and Policy Issues*, Aug. 1995, pp. 53–64; W. Lovett, "Lessons from the Recent Peso Crisis in Mexico", 4 Tul. J. Int'l & Comp. L. 143 (1996); E. Truman, "The Mexican Peso Crisis: Implications for International Finance", 82 Fed. Res. Bull. 199 (Mar. 1996); M. Kornis, "The Peso Crisis Revisited", 5 No. 4 Mex. Trade & L. Rep. 14 (1 Apr. 1995); idem, "Financial Crisis in Mexico", 5 No. 2 Mex. Trade & L. Rep. 5 (1 Feb. 1995).

38 As a result of the US commitments resulting from the Mexican crisis, the US General Accounting Office (GAO) prepared a comprehensive report on Mexico's 1994–95 financial crisis at the request of the then-Chairman of the US House of Representatives Committee on Banking and Financial Services, James A. Leach. See US General Accounting Office, *GAO Report: Mexico's Financial Crisis: Origins, Assistance, and Initial Efforts to Recover*, GAO/GGD-96–56, 23 Feb. 1996 ("GAO Mexico Report"). In preparing the report, the GAO interviewed all major participants from all entities involved, as well as significant private participants, and reviewed substantially every available piece of information regarding its mandate.

in the growing inconsistency in 1994 between Mexico's monetary and fiscal policies and its exchange rate system. Due in part to an upcoming presidential election, Mexican authorities were reluctant to take actions in the spring and summer of 1994, such as raising interest rates or devaluing the peso, that could have reduced these inconsistencies. These fundamental policy inconsistencies were exacerbated by the Mexican government's responses to several economic and political events that created investor concerns about the likelihood of a currency devaluation and generally reduced investor confidence in the political and economic stability of Mexico. In response to these investor concerns, the Mexican government issued large amounts of short-term, dollar-indexed notes (*tesobonos*), so that by the end of November 1994[39], Mexico had become particularly vulnerable to a financial crisis because its foreign exchange reserves had fallen to US$12.9 billion[40], while it had *tesobono* obligations of US$28.7 billion maturing in 1995.[41]

The Rescue Package. Although the US Treasury, the US Federal Reserve and the IMF purportedly did not anticipate the magnitude of the crisis, they soon concluded that outside assistance was required to prevent Mexico's financial collapse and to prevent the spread of the crisis to other emerging economies. Beyond its direct impact on other emerging economies, officials viewed the crisis as a threat to market-oriented economic reforms that the IMF and the United States had urged such countries to adopt.[42]

As a result, then–US President Bill Clinton announced a package of loan guarantees of up to US$40 billion for Mexico on 12 January 1995; however, doubts regarding approval by the US Congress led to its ineffectiveness and withdrawal. Subsequently, on 31 January 1995, Clinton announced a

39 During October and November, high-level US officials cautioned Mexican officials that the peso seemed overvalued and indicated that it was risky to continue the existing exchange rate policy. US officials, however, were undecided about the extent to which the peso was overvalued and if and when financial markets might force Mexico to take action. Moreover, Federal Reserve and Treasury officials apparently did not foresee the magnitude of the crisis that eventually unfolded. See id., pp. 77–109.

40 IMF International Capital Markets (1995), op. cit., n. 37, p. 56.

41 Id. at 61, Table 1.3.

42 According to the then-US Secretary of the Treasury, as well as government and industry analysts, Mexico had been a paradigm for countries striving to put inward-looking, state-controlled models of economic development behind them and move to free market models. The Secretary also noted that new prosperity, based on open markets, encouraging investment, and privatization of state-controlled industries, was beginning to be realized in these emerging market economies. Other US government officials stated that they believed a spread of Mexico's financial difficulties to other emerging markets could have halted or even reversed the global trend toward market-oriented reform and democratization. GAO Mexico Report (1996), op. cit., n. 38, pp. 110–14.

US$48.8 billion multilateral assistance package. Under this package, the United States would provide up to US$20 billion to Mexico through the use of the Exchange Stabilization Facility and the Federal Reserve swap network.[43] On 1 February, the IMF approved an eighteen-month stand-by arrangement for Mexico of up to US$17.8 billion. In addition, other countries, under the auspices of the Bank for International Settlements (BIS), agreed to provide a short-term facility of US$10 billion[44], in addition to which Canada had already provided US$1 billion in December 1994.[45]

The US and international response to the Mexican crisis was one of the largest multilateral economic assistance packages ever extended to any one country. The objectives of the US and IMF assistance packages, following the December devaluation and the subsequent loss of confidence in Mexico's currency, were twofold: first, to help Mexico overcome its short-term liquidity crisis, and second, to limit the adverse effects of the Mexican crisis spreading to other economies.[46] Some observers opposed any US financial assistance to Mexico, arguing that investors should not be shielded from financial losses, and that neither the danger posed by the spread of Mexico's crisis to other nations nor the risk to US trade, employment and immigration was sufficient to justify the assistance.[47] As can be seen by the US response, US officials disagreed. At the same time, similar arguments have been raised in relation to each subsequent crisis, although not always with the same result (e.g., Russia and Argentina were not rescued in 1998 and 2002 respectively, while rescues were organized for Brazil in 1998 to prevent a crisis from occurring and for Turkey in 2000).

Domestic Structural Reforms. As part of the terms and conditions of the rescue package, the government of Mexico released an economic plan on 9 March 1995 to address the required economic criteria in the agreements with the United States and the IMF.[48] Overall, the goals of the plan were to restore

43 A swap arrangement provides for temporary exchanges of currencies between participating countries. Partners in the arrangement can draw on one another's currency by supplying their own currency up to an agreed amount. The swap is usually reversed within a short period of time, but may be rolled over.

44 In early January, the BIS announced a US$5 billion faculty, later increased to US$10 billion. These funds were short-term and were not drawn upon by Mexico.

45 Argentina, Brazil and a group of international commercial banks were also to provide funds; however, none of these funds materialized, due – in the cases of Argentina and Brazil – to the "tequila effect".

46 GAO Mexico Report (1996), op. cit., n. 38, pp. 110–14; see US-Mexico Framework Agreement for Mexican Economic Stabilization, 21 Feb. 1995, art. I ("US-Mexico Agreement").

47 See GAO Mexico Report (1996), op. cit., n. 38, pp. 117–18.

48 See id., pp. 128–31, 133–6; P. Wertman, "Economic Recovery: Mexico's 1995 Economic Program and the IMF", 5 No. 6 Mex. Trade & L. Rep. 4 (1 Jun. 1995); idem, "Peso Crisis: Mexico's