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Banking and Financial Reform at the Crossroads of the Neoliberal Contagion

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BANKING AND FINANCIAL REFORM AT THE CROSSROADS OF THE NEOLIBERAL CONTAGION*

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I. INTRODUCTION

The banking and financial industries in the United States and Mexico are now at an important crossroads. The paths that are taken will have important repercussions for years to come. In the aftermath of the massive devaluation of the peso in early 1995, Mexico's private banking industry virtually collapsed.[1] As reported by the International Monetary Fund, by early 1995 the peso devaluation had led to a dramatic increase in interest rates to levels as high as 80 percent.[2] This, in turn, made it difficult for millions of borrowers to service their debts, thereby undermining the solvency of Mexican banks.[3] The Mexican government of President Zedillo

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This article is based on a paper presented to the Seventh Annual Conference of the United States-Mexico Law Institute in Santa Fe, New Mexico on October 3, 1998, which came on the heels of the most volatile week of the year in U.S. and global financial markets. The week saw a serious decline in global financial markets, a severe drop in prices in U.S. stock and bond markets, and a multi-billion dollar bailout of a suddenly collapsing hedge fund. Those events necessarily provided the context for this article.

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1. *See* Roy A. Karaoglan and Mike Lubrano, "Mexico's Banks After the December 1994 Devaluation: A Chronology of the Government's Response," 16 N.W. J. INT'L L. & BUS. 1 (1995).

2. DAVID FOLKERTS-LANDAU AND TAKATOSHI ITO, INTERNATIONAL CAPITAL MARKETS: DEVELOPMENT, PROSPECTS, AND POLICY ISSUES 62-63 (International Monetary Fund, Washington, D.C., Aug. 1995).

3. *Id.* (reporting debt-servicing problems of borrowers and resulting decline in asset quality in both "the peso-denominated and foreign currency loan books of Mexican banks").

pushed forward with a $65 billion bank bailout plan, as well as plans to permit foreign ownership of Mexican banking.[4] The continuing upheaval and bailout of the Mexican financial sector has become something of a political lightning-rod, highlighting the extreme schisms between economic classes in Mexico,[5] particularly between elite creditor groups and the debtor class that makes up a vast proportion of the Mexican population.[6]

In contrast to Mexico's difficulties, banking and finance in the United States has bounced back from its earlier setbacks, such as the collapse and bailout of the savings and loan industry, the 1987 stock market decline, and the credit crunch and recession of the early 1990's.[7] The agenda of the U.S. banking industry is now a multifaceted strategy of continued financial innovation, diversification and expansion, often through merger and consolidation.[8] Some of the largest U.S. banks have expanded by merging with or buying other commercial banks and non-bank financial institutions.[9] One of the most notable examples is the announcement of the mega-merger between Citibank and Travelers' Insurance that would create a $70 billion Citigroup.[10] This merger may spell the end of the Glass-Steagall Act's prohibitions that have separated commercial banking from investment banking and insurance.[11]

At first glance there would seem to be little relationship between banking and finance in these two neighboring countries. In Mexico, there is financial retrenchment and a banking industry that struggles for solvency and survival.[12] In contrast, there is an incredible inflation in the great American bull market and the expansion

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4. Mike Lubrano, "Foreign Investment in the Financial Sector of Mexico," 6 U.S.-MEX.L.J. 81 (1998) (Mexico relaxed restrictions to attract foreign investment in its financial sector in the aftermath of the 1994-95 peso crisis); Kenneth Bachman, Scott Benedict, Ricardo Anzaldua, "Financial Services Under the North American Free Trade Agreement: An Overview," 28 INT'L LAW. 291, 305-06 (1994).

5. Lucy Conger, "Mexicans Oppose Rescue Scheme," FINANCIAL TIMES, Sept. 1, 1998, at 4; Julia Preston, "$62 Billion Bank Bailout Plan in Mexico Incites Outrage as Critics Say It Helps the Rich," N.Y. TIMES, July 31, 1998, at A6.

6. Julia Preston, "Wanted Posters in Mexico Now Feature a White Collar," N.Y. TIMES, Oct. 28, 1998, at A14 (formal petitions presented to Mexican Congress to begin impeachment proceedings against Guillermo Ortiz Martinez, former Finance Minister and head of the Bank of Mexico for funding the bank bailout program with government debt).

7. Timothy A. Canova, "The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership," 60:4 BROOKLYN L. REV. 1295, 1330-36 (1995).

8. DEREGULATING FINANCIAL SERVICES: PUBLIC POLICY IN FLUX (ed., G. Kaufman and R. Kormendi, (Ballinger Publishing Co.1986);"Trillion Dollar Banks, BUSINESS WEEK, April 27, 1998, at 32.

9. "Pretty at Citi?", ECONOMIST, April 11, 1998, at 11; "Trillion Dollar Banks," "id.,"at 32, 35 (the new Citigroup will have nearly $700 billion in assets); Michael Siconolfi, "Citicorp Merger with Travelers Signals New Era," WALL ST.J., April 7, 1998, at A1; Rick Brooks, "NationsBank, BankAmerica Holders Vote for $43.02 Billion Merger Plan," WALL ST. J., Sept. 25, 1998, at B7.

10. The sharp decline in the price of bank shares in late 1998 considerably lowered the value of the Citibank-Travelers and the NationsBank-BankAmerica mergers. *See* John Authers, "Travelers, Citicorp merger completes today," FINANCIAL TIMES, Oct. 8, 1998, at 21.

11. Jill Dutt & John M. Berry, "Citicorp-Travelers Deal to Test Old Regulator View," WASH. POST, April 7, 1998, C1; J. Robert Brown, Jr., "The Great Fall: The Consequences of Repealing the Glass-Steagall Act," 2 STAN. J.L. BUS. & FIN. 129 (1995); WOLFGANG H. REINICKE, "CONSOLIDATION OF FEDERAL BANK REGULATION?", REFORMING MONEY AND FINANCE 185-86 (R. Guttmann ed., M.E. Sharpe 1997).

12. Javier Gavito, Aaron Silva, Guillermo Zamarripa, "Mexico's Banking Crisis: Origins, Consequences, and Countermeasures," chapter in REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND 228-45 (G.M. von Furstenberg, ed., Kluwer Academic Publishers, 1997);"Bancomer of Mexico Braces Itself as It Heads Into Rough Waters," WALL ST. J., Oct. 2, 1998, at A10.

of U.S. banking and finance into new geographic and product areas.[13] But Mexico began the process of opening its banks to foreign ownership at the precise time that the agenda of U.S. banks was to branch out into more diverse types of banking and to continue investing in emerging economies.[14] These trends, therefore, indicate the possibility of a "marriage of convenience,"[15] with American commercial and investment banking coming to the rescue of the flailing Mexican banking industry.[16] Hoping to preside over this marriage is a host of ministers that seek to broaden the agenda of a particular type of neoliberal globalization, one marked by increased deregulation, financial liberalization, and privatization.[17]

Such a marriage between U.S. and Mexican banking and finance would of course create significant legal opportunities. Much has been written about the legal details of Mexico's bank bailout and privatization plans,[18] as well as the legal issues involved in the consolidation of U.S. banking and the erosion of the Glass-Steagall Act,[19] and the minutia of the variety of private capital market developments and investment opportunities on both sides of the border.[20]

It is important to step back from the trees and to consider the forest, to step back from the details, and to consider the broader legal and extra-legal developments that often provide the unspoken context for much private financial activity. This would permit an examination of our most fundamental assumptions about the nature of today's globalization of money and finance. This article will consider the context of the global currency contagion, which may threaten the profitability of private financial institutions,[21] the prospects for a marriage between U.S. and Mexican banking, and the economic progress upon which so much of the work of U.S.-Mexican cooperation depends.[22]

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13. *See* notes 8-11, *infra* and accompanying text.

14. *See* notes 4, 8-9, *infra*.

15. Sidney Weintraub, A Marriage of Convenience: Relations Between Mexico and the United States (1990)(likening the relations more as a "mixed marriage" of different cultures). *See* Stephen Zamora, "The Americanization of Mexican Law: Non-Trade Issues in the North American Free Trade Agreement," 24 LAW & POL'Y INT'L BUS. 391, 438 (1993).

16. *See* John E. Rogers & Adrian Zubikarai Arriola, "Foreign Banks in Mexico: on the Verge of a New Era?"7-12 PROGRAM OF THE SEVENTH ANNUAL CONFERENCE, U.S.-MEXICO LAW INSTITUTE (1998).

17. Beyond Bretton Woods: Alternatives to the Global Economic Order (J. Cavanagh et al. eds., Institute for Policy Studies 1994); FIFTY YEARS IS ENOUGH: THE CASE AGAINST THE WORLD BANK AND THE INTERNATIONAL MONETARY FUND (K. Danaher & M. Yunus eds.,South End Press 1994); CHERYL PAYER, THE DEBT TRAP: THE INTERNATIONAL MONETARY FUND AND THE THIRD WORLD(1974).

18. Rogers & Arriola, *supra* note 15.

19. *See* Robert Rowe III and Kenneth A. Guenther, "The Erosion of the Glass-Steagall Act and the Bank Holding Company Act," 115 BANKING L.J. 663 (1998); Note, "The New American Universal Bank," 110 HARV. L. REV. 1310 (1997); "Project: Regulatory Reform: A Survey of the Impact of Regulation and Deregulation on Selected Industries. Regulatory Reform in Transition: The Dismantling of the Glass-Steagall Act," 47 ADMIN. L.REV. 545 (1995); George Benston, The Separation of Commercial and Investment Banking (1990).

20. Ralph Folsom & W. Davis Folsom, Understanding NAFTA AND ITS INTERNATIONAL BUSINESS IMPLICATIONS(1997); SCOTT & WELLONS, INTERNATIONAL FINANCE 768-812 (1997).

21. Joseph Kahn, "Merril Cites $1.4 Billion Exposure to Long-Term," N.Y.TIMES, Oct.2, 1998, at C1; Tracy Corrigan, Clay Harris, "Merrill to Cut 3,400 Jobs After Sharp Fall in Profits," FINANCIAL TIMES, Oct. 14, 1998, at 1; Edmund L. Andrews, "Market Place: UBS says it will reduce international lending, as well as risks like investment in distressed loans," N.Y. TIMES, Jan. 26, 1999, at C12; John Authers, "BankAmerica in $1.4 Billion Provision," FINANCIAL TIMES, Oct. 15, 1998, at 1.

22. The fallout from the Asian contagion has already cost the local economy of New Mexico thousands of jobs. *See* Sue Major Holmes, "Asian Woes Dragged Down N.M.," ALBUQUERQUE J., Dec. 29, 1998, at C3; *See also*, Rob Valletta,"East Asia's Impact on Twelfth District Exports,"Federal Reserve Bank of San Francisco, Economic Letter No 98-35 (Nov. 20, 1998) (slowdown in U.S. manufacturing stemming from Asian recession);

The currency contagion continues to bring tremendous dislocations and hardship to Mexican society.[23] For instance, very high real interest rates and cutbacks in the government's fiscal programs have harmed a wide segment of the Mexican population.[24] Recent financial market developments have also brought fears that Wall Street's bull market could itself be threatened by the widening global financial turmoil.[25] Instead of congratulating ourselves over the opportunity to exploit this crisis environment, we should focus on the potential benefits of a more stable financial regime, one that could create opportunities for private profit while also providing the foundation for renewed prosperity for a wider population than merely the supplicants of high finance.

II. THE CONTEXT OF GLOBAL CONTAGION

A. *Recent Stresses: Banks, Hedge Funds and Derivatives*

The global currency contagion has also offered a shock to the conventional wisdom by striking at U.S.-based financial institutions with so little warning.[26] The sudden meltdown and bailout in October 1998 of a large U.S.-based hedge fund called Long-Term Capital Management, L.P.[27] has shown the very large exposure of American banks from lending many millions of dollars to Long-Term Capital, as well as to hundreds of other hedge funds for highly speculative investments in exotic financial instruments known as derivatives.[28] Regulators are increasingly concerned that the largest U.S. banks have significant credit exposure to derivative trading, particularly to exchange rate contracts,[29] and that the Basle Accord's risk-based capital requirements fail to accurately reflect the risks involved in such derivative trading.[30]

"Treasury Study Shows Effects of Global Financial Situation," Treasury News, Oct.6, 1998 <http://www.treas.gov/press/releases/pr2739.html>.

23. Anthony DePalma, "In Mexico, Hunger for Poor And Middle-Class Hardship," N.Y.TIMES, Jan. 15, 1995, at 1; Allan H. Meltzer, "Clinton's Bailout Was No Favor to Mexicans," WALL ST. J., Feb. 2, 1996, at A11. Julia Preston, "Mexicans Rise in a Rate Rebellion," INT'L HERALD TRIB., April 8, 1996, at 10 (variable interest rates rose above 100 percent; nearly 20 percent of value of all loans were past due).

24. *See* WILLIAM GREIDER, ONE WORLD, READY OR NOT 263, 267(1997) (interest rates on ordinary Mexicans in the hundreds of percent illustrate that developing countries like Mexico "make a kind of deal with the devil when they open themselves to the animal spirits of global capital").

25. Paul Beckett, "Banks Latin Exposure Moves to Fore," WALL ST. J., Sept. 10, 1998, at A3; Robert D. Hershey Jr., "The Sell-off in Stocks Deepen as Markets Plunge Worldwide," N.Y.TIMES, Oct. 2, 1998, at C1.

26. The past Summit meetings of the Group of Seven (G-7) leading industrial countries now seem like annual rituals of complacency, where western leaders failed to address the root causes of contagion, and focused instead on crisis-management. *See* "From Halifax to Lyons: What Has Been Done About Crisis Management?" No. 200, ESSAYS IN INTERNATIONAL FINANCE (1996).

27. Many hedge funds, like Long-Term Capital Management, are structured as limited partnerships, and are open only to "sophisticated investors" who must have a net worth of more than $1 million and an annual income of more than $200,000 in each of the most recent two years. *See* Sharon R. King, "After Hedge Fund Bailout, Tighter Restrictions Are Seen," N.Y. TIMES, Sept. 28, 1998, at C5.

28. Robert D. Hershey Jr., "A Warning To Banks: Scrutinize Hedge Funds," N.Y. TIMES, Dec. 17, 1998, at C4; Daniel P. Cunningham, et. al., "An Introduction to OTC Derivatives," 848 PLI/Corp 121 (1994).

29. Stephen Zamora, "Regulating the Global Banking Network: What Role (If Any) For the IMF?," 62 FORDHAM L. REV. 1953, 1956-57 (1994) ("by 1992, the aggregate credit exposure of ten U.S. banks due to derivative trading had reached $170 billion, or 17.3% of their total assets").

30. *See* George Graham, "Warning on poor lending standards," FINANCIAL TIMES, Oct. 15, 1998, at 8; David Barboza & Jeff Gerth, "On Regulating Derivatives," N.Y. TIMES, Dec. 15, 1998, at C1; Barbara C. Matthews, "Capital Adequacy, Netting, and Derivatives," 2 STAN. J.L. BUS. & FIN. 167 (1995); Bruce S. Darringer,

Although regulators and legal commentators recognize the role of hedge funds and derivative trading in transmitting financial failure across markets,[31] discussion of such dynamics are often confined to experts and technocrats. Consequently, the failures of private financial actors do not receive much blame when financial contagion strikes.[32] Instead, the focus is on the victim countries, their supposed failures, and on policies that place the burdens of adjustment on those victim countries.[33]

The drama surrounding Long-Term Capital Management's mismanagement has exposed a need for greater humility. For instance, in the past several years the United States has been preaching to the rest of the world the dangers of crony capitalism, the dangers of not moving fast enough to close down insolvent banks, and the need for transparency.[34] And then suddenly there was this flagrant wake up call, a reminder that the U.S. is not immune to such folly and crass self-interest.[35]

There are several challenging and frightening aspects of the recent turmoil in financial markets. First is the unpredictability of the onset of financial panic in any particular market. Little more than an unsubstantiated rumor, a disappointing report about earnings or foreign reserves, or even a bearish editorial, triggers a sudden turn in herd mentality to panic selling.[36] Second is the manner in which financial failure in one market is so quickly transmitted around the globe into selling in other financial markets, justly earning the description of "contagion."[37]

There are many damning facts that should not be forgotten once a sense of calm replaces the panic of the fall of 1998: the fact that Long-Term Capital Management, a hedge fund with about $2.3 billion in capitalization, could leverage hundreds of billions of dollars in loans from some of the world's largest private financial institutions, thereby increasing its own exposure to one of systematic proportions;[38] the fact that this hedge fund was directed by Myron Scholes and Robert Merton,

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"Swaps, Banks, and Capital: An Analysis of Swap Risks and a Critical Assessment of the Basle Accord's Treatment of Swaps," 16 U. PA. INT'L BUS. L. 259 (1995).

31. Charles A. Samuelson, Note, "The Fall of Barings: Lessons for Legal Oversight of Derivatives Transactions in the United States," 29 CORNELL INT'L L.J. 767 (1996); J. Christopher Kojima, "Product-Based Solutions to Financial Innovation: The Promise and Danger of Applying Federal Securities Laws to OTC Derivatives," 33 AM. BUS. L.J. 259 (1995); Nancy Worth, "Harmonizing Capital Adequacy Rules for International Banks and Securities Firms," 18 N.C.J. INT'L L. & COM. REG. 133 (1992).

32. In fact, derivatives are often characterized as a solution, rather than a problem, for the investment needs of emerging markets. Ovidio E. Diaz Espino, "Emerging Markets Derivatives Set To Expand," 1017 PLI/CORP 669 (1997).

33. Jeffrey D. Sachs, "The Wrong Medicine for Asia," N.Y. TIMES, Nov. 3, 1998, at A19. ("the currency crisis is not the result of Asian government profligacy. This is a crisis made mainly in the private, albeit under-regulated, financial markets.")

34. For a description of the deregulationist program and assumptions, *see* BRUCE COGGINS, DOES FINANCIAL DEREGULATION WORK? A CRITIQUE OF FREE MARKET APPROACHES 11-30 (1998).

35. Richard Stevenson, "Fiscal Stones, Glass Houses: Bailout Points Finger Back Toward the U.S.," N.Y. TIMES, Sept. 26, 1998, at A1.

36. For instance, the market turned increasingly against the Russian ruble upon publication of a letter in the Financial Times by speculator George Soros predicting the ruble's devaluation; "Soros Urges Russia to Devalue Ruble," FINANCIAL TIMES, Aug. 13, 1998, at 1; "Russian to the Exits:'A Global Margin Call' Rocks Markets, Banks, and Borris Yeltsin" WALL ST.J., August 28, 1998, at A1.

37. Hedge funds burned in Russia's meltdown needed to cover open positions by selling U.S. Treasuries and corporate debt, thereby putting downward pressure on those markets, and undermining the positions of other hedge funds. *See* Gretchen Morgenson, "Hedge Fund Bailout Rattles Investors and Markets," N.Y. TIMES, Sept. 25, 1998, at A1, C4.

38. Floyd Norris, "Risking Everything on One Big Gambler," N.Y. TIMES, Oct. 1, 1998, at A30.

two Nobel laureates in economics who until recently were hailed as financial geniuses;[39] and the fact that the Federal Reserve Bank of New York, rather than permit the meltdown of an obviously insolvent Long-Term Capital Management hedge fund and risk widening the financial crisis, used its offices to broker a $3.65 billion bailout of that hedge fund.[40]

These events suggest the United States is not immune from these evils and weaknesses that we deplore in others, including a frightening lack of financial transparency,[41] hesitation in closing down insolvent financial institutions when to do so risks wider financial and economic carnage, and the so-called "crony capitalism" tendency of ostensibly public-sector regulatory authorities to reach out to help their friends in the private sector.[42] The revelation that among Long-Term Capital Management's partners was David W. Mullins Jr., a former vice chairman of the Federal Reserve Board, is particularly embarrassing.[43] But the class-biased cronyism of the Federal Reserve goes much further.[44] In mid-October 1998, the Federal Reserve's Open Market Committee convened a special emergency meeting, by conference call, to lower short-term interest rates.[45] This was motivated in no small part by a desire to assist not just Long-Term Capital Management, but other hedge funds as well to unwind their exposed positions in the government and private sector bond markets.[46]

Long-Term Capital Management should be seen as a glaring reminder that no country, not even the U.S. economic powerhouse, is immune from the financial contagion, from global market downtrends, or from the human proclivity to hide the truth and help one's cronies. It also suggests the need for greater humility when our so-called experts at the International Monetary Fund (IMF) and the U.S. Treasury Department dispense advice and dictates to others, often as conditions for badly needed financial assistance.[47]

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39. *See* Peter Truell, "An Alchemist Who Turned Gold Into Lead," N.Y. TIMES, Sept. 25, 1998, at C1, C5; Jon Krainer, "The 1997 Nobel Prize in Economics,"Federal Reserve Bank of San Fransisco Letter, No. 98-05 (Feb. 13, 1998); JOHN KENNETH GALBRAITH, THE GREAT CRASH: 1929 58-61, 120, 129-30, (1954)(warning that financial genius is always before the fall).

40. *See* Gretchen Morgenson, "Seeing a Fund as Too Big to Fail, New York Fed Assists Its Bailout," N.Y. TIMES, Sept. 24, 1998, at A1; Richard W. Stevenson, "Fed Chief Defends U.S. Role in Saving Giant Hedge Fund," N.Y.TIMES, Oct. 2, 1998, at A1; Truell, *supra* note 39, at C1, C5.

41. *See also* Melody Petersen, "Trick: Accounting Draws Levitt Criticism," N.Y. TIMES, Sept. 29, 1998, at C8 (Arthur Levitt, chairman of the U.S. Securities and Exchange Commission harshly criticized the use of "accounting hocus-pocus" to manipulate earnings numbers reported to shareholders); Melody Petersen, "U.N. Report Faults Big Accountants in Asia Crisis," N.Y. TIMES, Oct, 24, 1998, at B1.

42. John Plender, "Western crony capitalism," FINANCIAL TIMES, Oct. 3/4, 1998, at 6.

43. Stevenson, *supra* note 40; Truell, *supra* note 39.

44. Canova, *supra* note 7, at 1335 (Federal Reserve provided large interest rate spread as a hidden subsidy to bailout commercial banks).

45. Richard W. Stevenson, "Fed Was Worried About Misinterpretation," N.Y. TIMES, Nov. 20, 1998, at C5 (no formal vote was taken of members of the Federal Reserve's Open Market Committee; the interest rate cut was made under Chairman Greenspan's authority). Minutes of the Fed's October 15th meeting stated that lowering interest rates would Amore likely help to settle volatile financial markets and cushion the effects of more restrictive financial conditions.

46. Bill Barnhart, "Fed Steps In, Stocks Take Off While Many Applaud, Cut is for the Few," CHICAGO TRIBUNE, Oct.16,1998, at 1("the Fed hopes to stimulate enough bidders for risky assets to enable hedge funds and other highly leveraged speculators to sell their positions with the least shock waves possible"); Richard W. Stevenson, "Federal Reserve Cuts Rates Again; Wall St. Surges," N.Y. TIMES, Oct. 16, 1998, at A1, C5.

47. *See* Mark Landler, "U.S. Hedge Fund Bailout Raises Asian Eyebrows," N.Y. TIMES, Sept. 29, 1998, at C8; Nicholas D. Kristof, "Japan Sees Itself as Scapegoat Of Washington in Asia Crisis," N.Y. TIMES, Sept. 21,

For those who remain unconvinced of such lessons, pecuniary concerns stemming from the meltdown and bailout of Long-Term Capital Management may prove more persuasive. The losses incurred by some of our leading private commercial and investment banks, incurred because of their reckless lending to this hedge fund, could hamper their willingness and ability to increase or even maintain their present levels of investment in emerging market economies, including the Mexican banking and financial sector.[48] Long-Term Capital mismanagement, and the specter of other financial losses from banking and hedge fund exposure in derivative markets, could threaten consummation of the marriage of U.S. investors to the rescue of Mexican banking and finance.

B. Origins of Contagion: Capital Account Liberalization and the "Hot Money" Problem

The currency contagion has once again brought economic trouble to Mexico. For instance, in the aftermath of the Russian meltdown, the Mexican peso declined by almost 20 percent in value as capital fled from most emerging markets.[49] Mexico raised interest rates above 40 percent to appease the international currency markets.[50] These high interest rates, when combined with plunging oil revenues and falling domestic demand,[51] will increase the likelihood of future trade and budget deficits, and continuing dependence on foreign capital.

Mexico's recent difficulties should not come as too much of a surprise. The very origins of today's currency contagion can be traced to the 1994-1995 contagion of panic against the Mexican peso. By 1994, Mexico had come to rely heavily on short-term portfolio capital inflows, also referred to as "hot money." Foreigners were buying about 40% of Mexican treasury notes and held securities accounting for 30% of Mexico's stock market capitalization.[52] Foreign portfolio investment in Mexico skyrocketed from an annual average of about $5 billion for the period from 1986 to 1990 to $67 billion in 1993.[53] Between 1989 and 1993, Latin America captured nearly 60% of the short-term portfolio investment flows into emerging markets, and the Mexican stock market rose by nearly 500% in dollar terms during that period.[54] But, as the peso crisis demonstrated, if a country does not protect itself against these short-term hot money inflows, it may become susceptible to a panic, an outflow. After all, what is an outflow problem? It is when everyone starts heading to the door simply because everyone else is heading to the door.[55] There is not necessarily a rational reason behind the panic. We must conclude that Mexico and other emerging market economies had become addicted to short-term capital

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1998, at A1.

48. *See* note 24 infra.

49. Sam Dillon, "Mexican Prices Feel the Squeeze of World Economic Trouble," N.Y. TIMES, Sept. 15, 1998, at C4.

50. *Id.*

51. *Id.* Paul Solman & Robert Corzine, "Commodity Exporters Hit by Slump in World Prices," FINANCIAL TIMES, Dec.11, 1998, at 21.

52. Enrique R. Carrasco and Randall Thomas, "Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis," 34 COLUMBIA J.TRANS.L. 539, 572-73 (1996).

53. *Id.* at 557.

54. *Id.* at 557, 560.

55. Walter Russell Mead, "Rule 1: Don't Panic. Rule 2: Panic First," 130 ESQUIRE 92 (Oct.1998).

inflows and consequently were very vulnerable when those inflows turned suddenly to outflows as a result of changes in mass market psychology.[56]

III. NAFTA'S MASK OF NEOLIBERAL DISCOURSES

In the aftermath of the 1995 peso collapse, there has been an ongoing debate concerning the relative merits of the North American Free Trade Agreement (NAFTA) and the $51 billion international bailout package for Mexico.[57] The U.S. and Mexican governments prefer to characterize both as great success stories. Mexico has repaid the emergency bailout loans with interest,[58] and some studies suggest that since NAFTA there has been a surge in foreign direct investment from the U.S. to Mexico, resulting in an increase of some 600,000 jobs in Mexico.[59] We should, however, consider a wider range of criteria when assessing the results of the NAFTA regime of free capital mobility and the peso collapse and bailout. For instance, a more convincing narrative holds that NAFTA's liberalization of capital flows and the subsequent peso crash and economic austerity have contributed to steep declines in jobs and real incomes for millions of Mexicans,[60] as well as to the recent upsurge in illegal immigration from Mexico to the U.S.[61]

While NAFTA may have contributed to export and job creation in the maquiladoras at the border, NAFTA also required that Mexico substantially liberalize its capital account (i.e., remove restrictions on the inflow and outflow of foreign capital).[62] NAFTA Article 1109 requires that each country "permit all transfers relating to an investment."[63] Contrary to the focus of some commentators,[64] NAFTA's capital liberalization provisions are not confined to

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56. Ricardo French-Davis, "Policy Implications of the Tequila Effect," 41 CHALLENGE 15-43 (1998).

57. Russell Dean Covey, Note, "Adventures in the Zone of Twilight: Separation of Powers and National Economic Security in the Mexican Bailout," 105 YALE L. J. 1311 (1996). The bailout consisted of contributions from the IMF ($18 billion), the Bank for International Settlements ($10 billion), foreign commercial banks ($3 billion), and the U.S. Treasury's Exchange Stabilization Fund ($20 billion). Carrasco & Thomas, *supra* note 52, at 568. Mexico also agreed to put the proceeds from its oil sales through an escrow account with the Federal Reserve Bank of New York as collateral for the U.S. loan. *See* SIDNEY WEINTRAUB, NAFTA AT THREE 63 (1997).

58. David Hale, "Such a Deal: The Much-Maligned Mexico Bailout is Looking Smart, and Not Just for Mexico," WASH. POST, June 2, 1996, at C4.

59. Eusebio Francisco Flores Barraza, "Foreign Exchange Challenges vis-a-vis NAFTA, five years after NAFTA came into force," Presentation to U.S.-Mexico Judicial Exchange Border Conference (March 19, 1999). *See also* Paul Krugman, "The Uncomfortable Truth about NAFTA," 75:5 FOREIGN AFFAIRS 13 (1993) (Krugman did not foresee the substantial depressing effects on Mexican jobs and real income prior to the peso collapse and ensuing economic austerity).

60. Folkerts-Landau, et al, *supra* note 2, at 125-27; Weintraub, *supra* note 57, at 54-68 (acknowledging that NAFTA liberalized capital inflows, yet disclaiming NAFTA responsibility for adverse consequences that followed); Folsom & Folsom, *supra* note 20, at 307-08.

61. David E. Sanger, "Mexico Crisis Seen Spurring Flow of Aliens," N.Y. TIMES, Jan. 18, 1995, at A3; ROBERT APONTE, "The Effects of NAFTA on Mexico-United States Immigration," chapter in POLICY CHOICES: FREE TRADE AMONG NAFTA NATIONS 195-216 (Karen Robert & Mark I. Wilson, eds., Michigan State University Press 1996) (discussing the jobs and immigration debates); SASKIA SASSEN, THE MOBILITY OF LABOR AND CAPITAL 120 (1988).

62. North American Free Trade Agreement Between the Government of the United States of America, the Government of Canada and the Government of the United Mexican States, 32 I.L.M. 1480 (1993) [hereinafter NAFTA], Chapters 11 and 14.

63. *Id.* at Article 1109 (payment of the investment, profits, dividends, interest, capital gains and other fees; such transfers to be made in a freely usable currency at the market rate of exchange).

64. *See* Gloria L. Sandrino, "The NAFTA Investment Chapter and Foreign Direct Investment in Mexico: A Third World Perspective," 27 VAND.J.TRANSNAT'L L. 259 (1994); Jose E. Alvarez, "Critical Theory and the

foreign direct investment (FDI), which usually refers to a foreign investment in fixed plant and equipment.[65] Rather, the NAFTA liberalization provisions also apply to many types of so-called "hot money" investments, such as foreign portfolio investment in stocks and bonds.[66] This process of financial liberalization left Mexico highly dependent on such hot money inflows.[67]

Finally, Chapter 14 of NAFTA provides for a gradual liberalization of foreign ownership of financial institutions and services.[68] The overall result of these NAFTA provisions has been a significant increase in the operation of foreign financial institutions in Mexico,[69] including the dramatic surge of hot money inflows as Mexico became overly dependent on short-term portfolio capital investment to finance its trade and budget deficits.[70]

NAFTA's capital liberalization provisions, the centerpiece of the Mexican government's neoliberal agenda, led directly to the eventual run on the peso.[71] Capital account liberalization set the stage and provided the mechanism for such capital flight.[72] As a consequence of the peso collapse, Mexico was forced to adopt stringent economic austerity measures as a condition for IMF financial assistance.[73] These measures include fiscal and monetary austerity, which have translated into

North American Free Trade Agreement's Chapter Eleven," 28 U. MIAMI INTER-AM.L.REV. 303 (1996-97); Guillermo Emiliano Del Toro, "Foreign Direct Investment in Mexico and the 1994 Crisis: A Legal Perspective," 20 HOUS. J. INT'L L. 1 (1997). These authors either were unaware of the distinction between foreign direct investment (FDI) and portfolio capital, intended for the term FDI to include portfolio capital flows, or were writing before the significance of such hot money flows were apparent.

65. *See* PETER MOLES & NICHOLAS TERRY, THE HANDBOOK OF INTERNATIONAL FINANCIAL TERMS 232, 235 (1997) (foreign direct investment is usually by multinational corporations involving purchase of physical assets in another country; portfolio investment involves purchase of financial instruments such as common stocks or bonds).

66. NAFTA's definition of investment includes equity securities, interests in an enterprise that entitles owner to share of income or profits, loans to affiliates, and debt securities where the original maturity is at least three years. NAFTA, *supra*, note 62, at Art. 1139. Even financial instruments that are not considered short-term (such as equities or debt securities with long maturities) can be sold instantly, and are therefore vulnerable to shifts in market sentiment. *See* "Bank for International Settlements: 68th Annual Report" (Bank for International Settlements, Basle), June 1998, at 129.

67. While not expressly required by NAFTA, the Mexican government came to rely on capital inflows in the form of foreign investment in tesobonos (short-term government debt). Weintraub, *supra* note 57, at 55. But this step was necessary to finance deficits that were made inevitable by NAFTA liberalization of trade in capital goods. Folsom & Folsom, *supra* note 20, at 299.

68. NAFTA, *supra* note 62 at Chapter 14 (provides for rights of establishment of financial institutions, most-favored-nation and national treatment). Annex VII(B) of Chapter 14 set forth Mexico's reservations, commitments, and time-tables with respect to establishment and operation of foreign-owned financial institutions in Mexico.

69. Rogers & Arriola, *supra* note 15, at 6 (Mexico amended its Credit Institutions Law to give effect to Annex VII(B); by mid-1998 at least 17 subsidiaries of foreign banks were operating in Mexico).

70. Folkerts-Landau, *supra* note 2, at 53-55. The restructuring of Mexico's debt from bank loans to "Brady bonds" may also have contributed to the peso crisis of 1995 by increasing the short-term nature of its exposure. *Id.* at 64 (on the steep fall in Mexican Brady bonds in the first quarter of 1995). For details of the Brady bond, *see* FOLSOM, ET AL., INTERNATIONAL BUSINESS TRANSACTIONS 947-48 (1995).

71. Even prior to NAFTA's liberalization of capital flows, the Mexican government had started the process by lifting restrictions on inflows in April 1992 and outflows in November 1991. 1990 was the first year of Mexico's surge in inflows and outflows. *See* Folkerts-Landau, et al, *supra* note 2, at 101-102.

72. *See* notes 52-56, 63-70 *infra* and accompanying text.

73. Carrasco & Thomas, *supra* note 52, at 565-71. Letter of Intent from Guillermo Ortiz Martinez, Secretary of Finance and Public Credit of Mexico, and Miguel Mancera Aguayo, Governor of the Bank of Mexico, to Michel Camdessus, Managing Director of the International Monetary Fund, Jan. 26, 1995 (English translation on file with author).

extremely high real interest rates.[74] When combined with the steep drop in the value of the peso in early 1995, the result has been an escalation in inflation and interest rates and a steep decline in living standards for millions of Mexicans.[75] The free market model has probably resulted in the loss of far more jobs within the interior of Mexico than have been gained in the bustling maquiladoras along the border.[76] Yet the dominant narratives about NAFTA focus exclusively on maquiladora job gains, to the exclusion of the greater general economic austerity job losses.[77]

While the relationship between NAFTA's capital liberalization and Mexico's subsequent economic austerity is widely recognized by policy-makers and analysts, this reality is largely masked by other more dominant discourses that explain Mexico's economic and financial problems in terms that serve elite financial interests. These dominant discourses about development and neoliberal economic reform have "blamed the victim" and promoted U.S. free market cultural values while masking the very real political and structural limitations in transplanting U.S. legal institutions to Mexico and other developing countries.[78] For instance, there are consistent assertions that Mexico's secured transactions and bankruptcy laws are not just deficient, but pre-modern, archaic, and backwards.[79] These same voices contend that Mexico's economic development will remain retarded as long as the Mexican government fails to adopt protections of creditors modeled after the U.S. Uniform Commercial Code.[80]

These discourses are propagated by elite corporate groups within the U.S.[81] that have vested interests in altering particular aspects of Mexico's legal system[82] while

74. Folkerts-Landau, *supra* note 2, at 63; Weintraub, *supra* note 57, at 65. Even after the peso collapse, the Mexican government decided to permit futures trading of the peso on the Chicago Board of Trade. Memorandum of Understanding between the U.S. Commodities Futures Trading Commission and the Mexican Comisión Nacional Bancaria y de Valores, May 11, 1995 <<http:\\www.cftc.gov/opa/backgrounder/mou.html>>.

75. Carrasco & Thomas, *supra* note 52, at 569-71.

76. WORLD ECONOMIC AND SOCIAL SURVEY 1997: TRENDS AND POLICIES IN THE WORLD ECONOMY 34-35 (United Nations, New York, 1997); WORLD EMPLOYMENT REPORT 1998-99 (International Labour Organization, Geneva, 1998); YEARBOOK OF LABOUR STATISTICS 1998 (International Labour Organization, Geneva, 1998); JAIME SUCHLICKI, MEXICO: FROM MONTEZUMA TO NAFTA, CHIAPAS, AND BEYOND 167, 194 (1996).

77. *See* notes 59, 78-80 *infra* and accompanying text.

78. Elizabeth M. Iglesias, "Human Rights in International Economic Law: Locating Latinas/os in the Linkage Debates," 28 U. MIAMI INTER-AM. L. REV. 361, 377-85 (1996-97).

79. *See* Boris Kozolchyk, "What To Do About Mexico's Antiquated Secured Financing Law," (National Law Center for Inter American Free Trade, 1998); Alejandro Garro, "Security Interests in Personal Property in Latin America: A Comparison With Article 9 and a Model For Reform," 9 HOU.J.INT'L L. 157 (1987); Mike Lubrano, "Practical Difficulties in Mexican Workouts and Bankruptcy," NORTH AMERICAN CORPORATE LAWYER, Vol. III (1996); Franklin Gill, Remarks to the Commerce and Trade Workshop of the U.S. Mexico Judicial Exchange Border Conference (March 19-20, 1999).

80. Boris Kozolchyk, "The Basis for Proposed Legislation to Modernize Secured Financing in Mexico," 5 U.S.-MEX.L.J. 43, 52 (1997); John E. Rogers & Carlos de la Garza-Santos, "General Goods: A Case Involving Security Interests in Inventory and Accounts in the United States, Canada and Mexico," 5 U.S.-MEX.L.J. 3 (1997);John M. Wilson-Molina, "Mexico's Current Secured Financing System: The Law, the Registries and the Need for Reform," National Law Center for Inter-American Free Trade, 1997.

81. For instance, the National Law Center for Inter-American Free Trade is well-funded by elite U.S. banking, finance, and corporate contributions. At the top of its agenda is reform of Mexico's secured financing and bankruptcy laws. *See* <http://www.natlaw.com> for information about membership, corporate backing, and its secured financing and other projects. Noticeably absent from its agenda are any proposals to address Mexico's vulnerability to the hot money problem and its continuing economic austerity.

82. Much of the agenda of those propagating the dominant development narratives is to provide additional protections to creditors. *See* notes 79-81 *infra* and accompanying text.

maintaining other aspects that have certainly done far more damage to Mexico's economic development.[83]

A very ethnocentric mind-set permeates these dominant discourses. They conveniently overlook the flaws in the U.S. legal system[84] and in U.S. bankruptcy law.[85] In addition, there seems to be no formal modeling or empirical support for the more dramatic assertions that Mexico's commercial code is the primary and direct cause of the country's economic plight. Finally, these dominant development discourses also overstate the deficiencies in Mexican law. Contrary to the thrust of the dominant narratives, Mexican law provides significant protection of creditors, including provisions for speedy attachment of assets.[86] Recent Mexican Supreme Court decisions undermine debtors' defenses and claims that sharply escalating interest rates are unconscionable and constitute usury or excessive enrichment of creditors.[87]

While there are differences between Mexico's civil law system and the U.S. common law system, there are also significant similarities between U.S. and Mexican commercial law.[88] But the dominant development discourses continue to ignore both the many deficiencies in the U.S. legal system and the fact that Mexican law provides significant protection for creditors.[89]

It is particularly distorting to assert with such condescending authority that Mexico's well-developed commercial law impedes economic development[90] at a time when the neoliberal model has saddled the Mexican population with crippling interest rates that are as high as one hundred or more percent.[91] In the context of such financial conditions, even the most comprehensive legal protections for creditors will not suffice. One cannot draw blood from a stone; and creditors cannot easily stay solvent by trying to collect on debts and attach assets in an economic

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83. Among the most ignored of these dynamics has been those relating to capital account liberalization. *See* notes 169-183, 187-189 *infra* and accompanying text.

84. *See* George A. Akerlof & Paul M. Romer, "Looting: The Economic Underworld of Bankruptcy for Profit," BROOKINGS PAPERS ON ECONOMIC ACTIVITY 2 (Brookings Institute, Washington, D.C.1993); Floyd Norris, "The Rise of Phony Corporate Tax Shelters," N.Y. TIMES, Feb. 8, 1999, at A26.

85. *See* Douglas G. Baird, "Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren," 54 U.CHI.L.REV. 815 (1987); Morris G. Shanker, "The Abuse and Use of Federal Bankruptcy Power," 26 CASE W. RES. L. REV. 3 (1976); Saul Hansell, "Battle Emerging On How To Revise Bankruptcy Law," N.Y. TIMES, Oct. 19, 1997, at 1; Katharine Q. Seelye, "Senate Votes to Curb Bankruptcy Abuse," N.Y. TIMES, Sept. 24, 1998, at A1.

86. Lic. Guadalupe Von Ontiveros, Lic. Raquel Nieblas German, and Lic. Martin Antonio Lugo Romero, Remarks to the Commerce and Trade Workshop of the U.S.-Mexico Judicial Exchange Border Conference (March 19-20, 1999) (all three are Mexican state court judges).

87. *Id. See also* Julia Preston, "Mexico Gets Green Light to Charge Interest on Interest," N.Y. TIMES, Oct. 9, 1998, at C2.

88. *Id.* Likewise, the advent of limited liability in the U.S. was once criticized as inefficient because it transferred business risks to creditors. *See* Paul Halpern, Michael Trebilcock, Stuart Turnbull, "An Economic Analysis of Limited Liability Corporation Law," 30 U. TORONTO L. J. 117 (1980). More recent scholars claim the opposite, that limited liability is a necessary precondition to capital accumulation. But the empirical evidence on such a fundamental question as the relationship of corporation law and economic growth is inconclusive. *See* Phillip I. Blumberg, "Limited Liability and Corporate Groups," 11 J. CORP. L. 573 (1986).

89. For such reasons, combined with the overriding private profit objectives of their proponents, some of these dominant discourses are neocolonial in nature and resemble a type of legal imperialism.

90. A study by the American Law Institute was generally positive in its assessment of Mexican bankruptcy law. *See also* International Statement of Mexican Bankruptcy Law, Tentative Draft (April 15, 1998), Transnational Insolvency Project of the American Law Institute.

91. Greider, *supra* note 22, at 267.

environment in which jobs are disappearing and real incomes are falling, no matter what the legal protections.[92]

Most importantly, the dominant discourses that criticize Mexican commercial culture also serve to crowd out other perspectives that are more critical of the U.S. neoliberal model.[93] The dominant narratives mask and distort more comprehensive descriptions of reality, including narratives that link capital account liberalization to the hot money problem and currency contagion.[94] Critical perspectives are often marginalized as unrealistic, and dismissed because of the attenuated chain of causation of their analyses:[95] i.e., liberalized capital flows contribute to an overvalued peso, which leads to growing trade deficits; this, in turn, leads to an eventual sudden outflow of capital and downward pressure on the peso; as a result, the Bank of Mexico engages in foreign exchange market interventions and raises interest rates to prop up the peso. Finally, the sharply higher interest rates translate into massive job losses, declining incomes, rising bankruptcies and financial failures.[96] Such a sophisticated analysis is empirically verifiable. But, the attenuated causal links in the analysis can not easily compete with the simplistic appeal of the neoliberal and development discourses that free markets always work best and that submerging economies are to blame for their own plight.[97]

The connections between Mexico's economic austerity and social stresses are apparent. The rich live very well in Mexico City, but they live in gilded cages, often afraid to walk the streets of their own city by day or night. This is not out of fear of mere robbery, but fear of kidnapping. The wave of kidnappings sweeping the Mexican capital is not politically motivated in the strict sense, but economically motivated.[98] Some of the ransoms are as little as $100 or less. This kind of

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92. Galbraith, *supra* note 39, at 184.

93. For instance, Professor Pouncy has shown how the underlying, but flawed assumptions of neoclassical economic thought prevent legal scholars from generating a complete understanding of the process of financial innovation. *See* Charles R. P. Pouncy, "Contemporary Financial Innovation: Orthodoxy and Alternatives," 51 SMU L. REV. 505, 556-74 (1998) (dominant narratives often serve to marginalize heterodox post-Keynesian theories that are based on more realistic assumptions).

94. *See* STUART CORBRIDGE, DEBT AND DEVELOPMENT(1993) (dominant narrative interpretations of the third world debt crisis often reflect normative and/or flawed assumptions about development and global economic structures); LARRY ALAN BEAR & RITA MALDONADO-BEAR, FREE MARKETS, FINANCE, ETHICS, AND LAW(1994).

95. Similarly, private legal challenges to the Federal Reserve System have been dismissed for lack of standing because the plaintiffs could not convince the courts that the Federal Reserve's open market operations are causally connected to rising interest rates on private loans and to slower economic growth. *See* Committee for Monetary Reform v. Board of Governors of the Federal Reserve System," 766 F.2d 538, 542 (D.C. Cir. 1985); Bryan v. Federal Open Market Committee, 235 F. Supp. 877, 881-82 (D.Mont. 1964). *See also* Mark F. Bernstein, Note, "The Federal Open Market Committee and the Sharing of Governmental Power With Private Citizens," 75 VA. L. REV. 111 (1989).

96. Stephen Zamora, "Capital Flight and the Creditworthiness of Developing Countries," 83 AM. SOC'Y INT'L L. PROC. 87, 100-105 (1989). Establishment economists often acknowledge the same chain of events, but reach different conclusions about causation. *See* Michael Mussa & Morris Goldstein, Symposium,"The Integration of World Capital Markets," in Changing Capital Markets: Implications for Monetary Policy 292 (Federal Reserve Bank of Kansas City, 1993).

97. *See* ROBERT HEILBRONER AND WILLIAM MILBERG, THE CRISIS OF VISION IN MODERN ECONOMIC THOUGHT(1995); DONALD M. MCCLOSKEY, KNOWLEDGE AND PERSUASION IN ECONOMICS(1994); DONALD M. MCCLOSKEY, THE RHETORIC OF ECONOMICS (1985).

98. *See* Mary Sutter, "Crime Wave Continues to Grip Capital of Mexico, Posing Threat to U.S. Business," J. OF COMMERCE, Aug. 25, 1998, at 1A; Roger Cowe, "Kidnapping: The World's Top Growth Industry,"THE GUARDIAN, Oct. 9, 1998, at 2.

disturbing social disintegration[99] has been accompanied by stagnation in real wages and incomes, greater stratifications in wealth and income, and persistently high levels of joblessness, underemployment and poverty.[100]

The Mexican government's solutions and the advice of the IMF continue to impose a dismal austerity of fiscal retrenchment, cutbacks in public subsidies, and frighteningly high interest rates which have greatly undermined private sector activity.[101] This again suggests the need for greater humility and a reexamination of whether NAFTA's liberalization of short-term portfolio investment, the Mexican peso bailout, and the IMF austerity program have actually been such great success stories.

IV. HOT MONEY AND THE "TEQUILA EFFECT"

While the peso collapse and ensuing economic austerity program brought hardship to Mexican society, these events should also be seen as the origin of many of the most serious global financial difficulties.[102] The term "Tequila Effect" has been used to describe the adverse impact of the peso collapse on the currencies of other emerging market economies.[103] According to the IMF's own surveys, this Tequila effect spread throughout Latin America and East Asia as early as mid-1995.[104] Asian financial markets began to decline in January 1995 "when pressures on Mexico began to intensify."[105] The most pronounced market pressures zeroed in on the Thai baht,[106] followed by other foreign currencies.[107]

This was the very beginning of the "Asian Flu," the severe and sudden collapse of a vast portion of the global economy. For many years, Asian developing countries relied less than Latin developing countries on foreign borrowing from commercial sources, at high or variable interest rates, or in dollar-denominated debt.[108] But as Asian developing countries began competing for foreign investment, many of them dismantled controls on short-term capital inflows and became increasingly susceptible to sudden outflows. East Asia was generally transformed

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99. *See* Tim Padgett, "Cop Crisis," TIME, Aug. 24, 1998, at 14; Sam Dillon, "Murder in Mexico: Reformers Uncover Police Plot," N.Y. TIMES, Feb. 8, 1999, at A8.

100. "World Economic and Social Survey 1997," *supra* note 76, at 34-35 (recession in Mexico fueled sharp increase in open unemployment and poverty rates); "Statistics on Poverty and Income Distribution" (International Labour Organization, Geneva, 1996); Suchlicki, *supra* note 76.

101. The economic austerity also impacts the country's cultural life in countless ways. *See* Henry Tricks, "Mexico considers an end to food and power subsidies," FINANCIAL TIMES, Nov. 6, 1998, at 4; and Julia Preston, "A Museum In Mexico Suddenly Shuts Down," N.Y. TIMES, Sept. 23, 1998, at B1 ("Mexico's finest modern art museum was another victim of austerity and recession").

102. Ricardo French-Davis, "Policy Implications of the Tequila Effect,"1:2 CHALLENGE 15(1998).

103. Carrasco & Thomas, *supra* note 52, at 571-72.

104. Folkerts-Landau, *supra* note 2, at 67.

105. *Id.*

106. Philip Shenon, "A Bad Week In the Asian Markets, Too," N.Y. TIMES, Jan. 16, 1995, at D1.

107. Ramon Moreno,"What Caused East Asia's Financial Crisis?"Federal Reserve Bank of San Fransisco Letter, No.98-24 (Aug. 7, 1998) (collapse of Thai baht in July 1997 set off unprecedented financial crisis in East Asia); Nicholas D. Kristof & Sheryl WuDunn, "Of World Markets, None an Island," N.Y. TIMES, Feb. 17, 1999, at A1, A8.

108. Azizali F. Mohammed, "Contrasting External Debt Experience: Asia and Latin America," in BEYOND ADJUSTMENT: THE ASIAN EXPERIENCE 106-112 (Paul Streeten ed. International Monetary Fund 1988). Many IMF analysts did not see the storm approaching over Asia until it acutally broke. Mussa & Goldstein, *supra* note 96, at 309 (dismissing "hot money" concerns for Asian countries).

from a traditionally conservative financial region to one that relied heavily on short-term private borrowing at market interest rates. This transformation accelerated during the 1990's, encouraged by the neoliberal agenda of the Clinton administration[109] and private financial interests.[110]

When the inevitable sudden outflow of short-term portfolio capital occurred,[111] currencies fell throughout Asia, including Thailand, Indonesia, Malaysia, the Philippines, South Korea, and Hong Kong, threatening the already weak Japanese economy, and putting pressure on the Chinese yuan.[112] Exacerbating the hot money outflows was the dynamic of competitive devaluations of currencies, so destructive during the Great Depression, in which "beggar thy neighbor"currency price wars throw entire regional economies into a downward spiral.[113] As one economist suggested, never before in economic history has so large a part of the world fallen so fast as Asia in the past few years.[114]

As the Asian Flu spread westward, the Russian ruble collapsed,[115] creating the prospect of social unrest and political turmoil in a country of vital geopolitical strategic importance.[116] The potential social and political turmoil in other submerging countries should also not be underestimated.[117]

The Russian bear market quickly threatened confidence in Western bull markets and other emerging markets.[118] For example, a collapse in Brazil, the new front line

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109. A prime mover of the financial neoliberal agenda has been Treasury Secretary Robert E. Rubin, former chairman of Goldman Sachs & Company, an investment bank with a direct interest in capital account liberalization. *See* Nicholas D. Kristof & David E. Sanger, "How U.S. Wooed Asia To Let Cash Flow In," N.Y. TIMES, Feb. 16, 1999, at A1, A10; Gillian Tett, "Japan may open up short-term securities," FINANCIAL TIMES, Aug. 26, 1998, at 1 (Japan to open short-term government debt market to foreign investment, in response to Rubin demands); Greta Steyn, "Rubin Urges S. Africa to Embrace Globalisation," FINANCIAL TIMES, July 15, 1998, at 6.

110. Robert T. Parry, "Development of Financial Services in the Asia Pacific: Issues and Opportunities,"Federal Reserve Bank of San Francisco Letter, No. 96-18 (June 7, 1996) (Parry is president and chief executive officer of the privately-owned Federal Reserve Bank of San Francisco).

111. *See* Peter John, "International bank loans to Asia in $51.7bn downturn," FINANCIAL TIMES, Nov. 30, 1998, at 18 (citing figures published by the Bank for International Settlements of a $51.7 billion (or 14%) drop in bank lending to Asia in first half of 1998); Martin Meyer, "The Asian Disease: Plausible Diagnoses, Possible Remedies: Regulation of Cross-Border Interbank Lending and Derivatives Trade," Public Policy Brief No. 44 (Jerome Levy Economics Institute, Annandale-on Hudson, 1998).

112. *See* Seth Faison, "China's Economic Boss Resists Pressure to Devalue Currency," N.Y. TIMES, Dec. 1, 1997, at A5; Ramon Moreno, "Lessons from Thailand,"Federal Reserve Bank of San Fransisco Letter, No. 97-33 (Nov. 7, 1997); Sheryl WuDunn, "As Japan Goes, So Goes the Neighborhood," N.Y. TIMES, June 16, 1998, at C8; Seth Faison, "Beijing on the Brink?," N.Y. TIMES, Nov. 27, 1997, at A10.

113. Kenneth Kasa, "Contractionary Effects of Devaluation," Federal Reserve Bank of San Fransisco Letter, No. 98-34 (Nov. 13, 1998); Kenneth Kasa, "Export Competition and Contagious Currency Crises," Federal Reserve Bank of San Fransisco Letter, No. 98-1 (Jan. 16, 1998).

114. *See* Paul Krugman, "Saving Asia: It's Time to Get Radical," FORTUNE, Sept. 7, 1998, at 75; EDDY LEE, THE ASIAN FINANCIAL CRISIS: THE CHALLENGE FOR SOCIAL POLICY (1998).

115. *See* David E. Sanger, "Next Asian Crisis?" N.Y. TIMES, May 28, 1998, at A12; *See also* Donald G. McNeil Jr., "A Fierce Run on the Rand Shocks South Africa," N.Y. TIMES, July 1, 1998, at C1; Avi Machlis and Alan Beattie, "Falling Shekel Forces Interest Rate Rise" FINANCIAL TIMES, Oct. 27, 1998, at 6.

116. *See* Mead, *supra* note 55, at 162("Since the end of the Cold War, Western policy toward Russia has been a textbook case in how to drive a people to facism"); Charles William Maynes, "Squandering Triumph," 78:1 FOREIGN AFFAIRS 15 (1999).

117. Seth Mydans, "New Violence Puts Indonesia's Military as a Crossroads," N.Y. TIMES, Nov. 16, 1998, at A1.

118. *See* Diana Jean Schemo, "Possible I.M.F. Bailout Stirs Brazilians' Bitter Memories of 80's," N.Y. TIMES, Oct. 1, 1998, at A17 (speedy transmission of Russian crisis to hot money outflow from Brazil); Peter Fritsch & Michael M. Phillips, "Back to the Brink: Brazil's Devaluation Reignites Global Fears Of Spreading Malaise," WALL ST. J., Jan. 14, 1999, at A1.

in this global battleground,[119] would certainly pose a threat to Mexico. Brazil and Argentina are paying much higher interest rates as a result.[120] This is rather disturbing since Argentina has been hailed by neoliberals as the model of a very well run economy.[121] It has brought down its inflation rate to near zero and its fiscal deficit to approximately 1% of its gross domestic product.[122] Economic and financial fallout could even wash ashore in the U.S. and Western Europe.[123] What is most troubling about the dynamics of currency contagion is that the market seems to indiscriminately discipline bad as well as good economic behavior, and that the punishment is far too excessive.[124]

This is the new political dynamic of our times, in which sovereign governments have lost their ability to pursue policies of high economic growth and full employment.[125] Mexico is a prime example. It has surrendered virtually all controls on hot money capital flows; it has freed its central bank from democratic accountability; and it continues to raise interest rates to keep capital from fleeing.[126] In early 1999, as Mexico's interbank interest rates rose above 40 percent, debt burdens also rose; yet, "faster depreciation of the peso raise[d] foreign debt service payments in peso terms, which also put pressure on the public purse," and necessitated further deep cutbacks in government spending for the poor and struggling middle-class.[127] Yet tight monetary policy and higher interest rates

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119. The IMF eventually pieced together a $41 billion pre-emptive bailout of Brazil. *See* Stephen Fidler & Geoff Dyer, "Brazil receives $41bn in aid," FINANCIAL TIMES, Nov. 15, 1998, at 1. But the assistance package was inherently flawed since it did not address the "hot money" problem. *See* Timothy A. Canova, "Why Brazil Will Fall," 10:11 ECONOMIC REFORM 16(1998); Jeffrey Sachs and Steven Radelet, "Next Stop: Brazil," N.Y. TIMES, Oct. 14, 1998, at A25; Michael M. Weinstein, "Economic Scene: A Few Billion Dollar Fix that Won't Untimately Cure Brazil", N.Y. TIMES, Oct. 29, 1998, at C2.

120. *See* John Barham, "Brazil Lifts Rates As Hard Currency Flees," FINANCIAL TIMES, Jan. 28, 1999, at 9; Geoff Dyer, "Brazil Pushes Up Interest Rates as Real Keeps Falling," FINANCIAL TIMES, Jan. 19, 1999, at 1; Ken Warn, "Argentina Forced to Pay Higher Interest Rates," FINANCIAL TIMES, Sept. 16, 1998, at 3; Geoff Dyer, "Dollar Outflows Put Pressure on Brazil," Financial Times, Oct 16, 1998, at 6 (in 2 months since Russian crisis Brazil lost about $25 billion in reserves from capital flight).

121. *See* Edward C. Snyder, "The Menem Revolution in Argentina: Progress Toward a Hemispheric Free Trade Area," 29 TEXAS INT'L L.J. 95 (1994); Steve H. Hanke, "Don't Cry for Me,"10 INT'L ECONOMY 46 (1996).

122. Argentina's currency board model presents particular danger that a slowdown in capital inflows would quickly translate into loss of reserves by the Central Bank, contraction of the money supply, sharply higher interest rates, and economic slowdown. Alberto F. Aldes, "Currency Boards and Its Implications for Argentina," ECONOMIC RESEARCH 21,22 (Goldman Sachs, Feb. 1995).

123. *See* Jonathan Fuerbringer, "Others' Risk Of Contagion From Brazil," N.Y. TIMES, Feb. 11, 1999, at C1; Clifford Krauss, "Argentines Suffering From Brazil Crisis," N.Y. TIMES, Feb. 8, 1999, at A8; Anthony Faiola, "Ecuadoran Economy Near Collapse; Bank Closures, Proposed Austerity Measures Trigger Widespread Protests," WASH.POST, March 17, 1999, at A22.

124. Joseph Stiglitz, "An Economic Taint South America Doesn't Deserve," N.Y. TIMES, Sept. 16, 1998, at A31; Alan Greenspan, Remarks to annual meeting of the Securities Industry Association, Nov.5, 1998 <http:\\www.bog.frb.us/boarddoc s/speeches/current/19981105.html> ("market discipline today is clearly far more draconian and less forgiving than twenty or thirty years ago").

125. For a representative example of the dilemma often faced by governments of developing countries, *see* IRWIN P. STOTZKY, SILENCING THE GUNS IN HAITI: THE PROMISE OF DELIBERATIVE DEMOCRACY 185 (1997) (Haitian president Preval had "arduous task of balancing two constituencies, one of them being his domestic political followers who oppose free-market reforms, and the other being the international donor nations seeking market reforms").

126. Gerardo Zuniga Villasenor, "Mexico: Anti-Contagion Defences," OXFORD ANALYTICA DAILY BRIEF, Jan. 18, 1999 (copy on file with author) (central bank was made independent of political direction in April 1994).

127. *Id.* (providing that the measures include tax on telephone service and withdrawal of subsidy on tortillas, a food staple. Meanwhile tax revenues continue to decline since the global contagion and austerity programs have undermined the price of Mexican oil exports.)

remain the only politically acceptable solutions to the threat of capital flight, even though such solutions have proven to only compound a country's problems.[128]

Capital controls – government restrictions on the flow of capital between countries – represent an alternative solution. But capital controls are dismissed as an option because "monetary authorities are ideologically opposed to non-market instruments" and by the excuse that Mexico's long border with the U.S. "would render them useless."[129] But these obstacles may merely be another way of saying that the power of private financial markets, and lack of U.S. leadership and cooperation, stand in the way of the use of alternative policy instruments.

A country that ignores the threat of hot money and the dictates of private financial markets faces the very real danger of capital flight and a sharply falling currency. Scholars and journalists have referred to this dilemma as a "dual constituency conundrum" which pits the interests of voters against foreign currency traders and hedge fund managers "who conduct moment-to-moment referendums" on the economic and financial policies of developing and developed nations alike.[130]

How did we get to this kind of a world in which markets punish so severely while sovereign governments are rendered impotent? First, the lessons from Mexico's collapse were not learned.[131] The same causes of Mexico's collapse have been playing out in submerging country after submerging country around the world ever since the Mexican peso collapse.[132] The dismal chain of events includes the liberalization of capital accounts, the dependence on foreign investment, the dependence on a particular type of foreign investment (short term "hot money" portfolio investment), the need to maintain high real interest rates and overvalued exchange rates to attract and maintain sufficient levels of foreign investment, the adverse impact of overvalued exchange rates and high interest rates on a country's trade and budget deficits, and then the inevitable panic and rush to the door, the sudden outflow of capital, often triggered by an unforeseen event, but made inevitable by the unsustainable dependence on hot money to finance burgeoning deficits.[133]

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128. *Id. See also,* Henry, Tricks, "Inflation Blow for Mexican Central Bank," FINANCIAL Times, Jan.8, 1999, at 3.

129. *Id.*

130. Stotzky, *supra* note 125. Presidential candidates (and even coup leaders) of every political stripe now feel compelled to campaign on Wall Street, and to meet with private bankers by video link-ups and at the annual IMF-World Bank meeting. David J. Rothkopf, "Whistle-Stops on Wall Street," N.Y. TIMES, March 8, 1999, at A19. For more on the erosion of traditional national sovereignty, *see also* Miles Kahler, International Institutions and the Political Integration xi, xviii (1995); Canova, *supra* note 7, at 1351-52.

131. IMF analysts committed to capital account liberalization apparently refused to see the dangers building throughout Asia and other emerging market countries. *See also* Mussa & Goldstein, *supra* note 96, at 309 n.51.

132. The global currency contagion has also reduced demand for commodities, further undermining the economic and financial conditions within deficit countries. *See* David Barboza, "The Brazil Effect On Commodities," N.Y. TIMES, Jan. 27, 1999, at C1; Henry Tricks, "Mexican budget hit by cut in oil prices," FINANCIAL TIMES, Dec. 7, 1998, at 4; Jonathan Fuerbringer, "Commodities' Price Slide Victimizes Economies of Several Nations," N.Y. TIMES, Dec. 11, 1998,at C1.

133. Cynthia C. Lichtenstein, "Dealing with Sovereign Liquidity Crises: New International Initiatives for the New World of Volatile Capital Flows To and From Emerging Markets," 29 MCGEORGE L.REV. 1 (1998); Gary Weiss, et al, "The Man Who Moves Markets," BUSINESS WEEK, Aug. 23, 1993, at 50,53 (George Soros view that currency contagion resulting from overvalued currencies, tight monetary policy, high real interest rates); George Soros, "The Capitalist Threat," ATLANTIC MONTHLY, Feb. 1997, at 45.

This neoliberal financial regime has been built on a mixture of free market ideology and crass economic self-interest.[134] For instance, consider the emergence of hedge funds as players in the global financial system. A hedge fund is an unregulated fund of less than 100 wealthy investors who seek to move their capital around the globe in a nanosecond.[135] It was revealing to see Alan Greenspan, the Chairman of the U.S. Federal Reserve Board, in response to questions from the House Banking Committee in the fall of 1998, acknowledged that he did not know even the number of hedge funds that were presently operating in the U.S. or offshore.[136] His ignorance on such a matter may not be entirely unexpected.[137] Hedge funds are not regulated and are not even registered with the Federal Reserve.[138] Greenspan opined that there could be hundreds of other Long Term Capitals out there ready to fail or in the process of failing,[139] which goes far in explaining why the Federal Reserve's Open Market Committee held an emergency meeting in mid-October 1998 to add liquidity to financial markets in a hurry.[140]

It is increasingly clear to a growing number of economists that capital account liberalization is the primary factor within the control of policymakers that is contributing to financial and economic turmoil around the world.[141] As countries dismantled their capital controls, there was a huge expansion in the volume of capital flows. The daily volume of global foreign exchange trading now exceeds $1.5 trillion.[142] In 1977 global foreign exchange trading was about 3-1/2 times the volume of annual global exports; today it is about 64 times that amount. In 1977

134. Keynes may have been overly optimistic when he concluded that "the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas." JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 383 (1964 ed.).

135. Hedge funds operate under Investment Company Act of 1940 exemption for funds of less than 100 private investors; are incorporated offshore; or operate under a 1966 amendment to Federal securities laws that exempts from regulation funds with fewer than 500 "sophisticated" institutions or individuals in which the individuals invest more than $5 million and institutions invest more than $25 million. Leslie Wayne, "Congress to Debate Greater Oversight of Hedge Funds," N.Y. TIMES, Oct. 1, 1998, at C1, C3; Stevenson, *supra* note 40, at B2.

136. Alan Greenspan, Testimony to Committee on Banking and Financial Services, U.S. House of Representatives (Oct. 1, 1998) <http:\\www.bog.frb.us/boarddocs/testimony/1998/19981001.html>. Greenspan warned that any direct U.S. regulation of hedge funds would drive the funds to offshore jurisdiction.; *See* Canova, *supra* note 7, at 1306-09 (race to the bottom necessitates harmonization of financial regulations of competing jursidictions); John Steele Gordon, "History Repeats in Finance Company Bailouts," WALL ST. J., Oct 7, 1998, A22 (reach of regulators must extent to the private financial institutions they are supposed to oversee). *See also* Reed Abelson, "Survey Shows Big Growth In Hedge Fund Popularity," N.Y. TIMES, Oct. 1, 1998, at C3.

137. On the many victims of Greenspan, including his involvement in the Savings and Loan fiasco, *see* MARTIN MAYER, THE BANKERS: THE NEXT GENERATION 370, 402-03 (1997); ALEXANDER COCKBURN & KEN SILVERSTEIN, WASHINGTON BABYLON 276-80 (1996).

138. *See* notes 27-28, 135-136 *infra*.

139. *See* note 136 *infra* Jacob M. Schlesinger & Michael Schroeder, "Greenspan's Hedge-Fund Portrait is Stark," WALL ST. J. Oct 2, 1998, at A3. Joseph Kahn & Peter Truell, "Investors Fear Trouble at Another Hedge Fund," N.Y. TIMES, Sept. 29, 1998, at C1; Stephen Fidler, "Greenspan sees signs of an end to 'investor fright,'"FINANCIAL TIMES, Nov. 6, 1998, at 20.

140. Barnhart, *supra* note 46; Stevenson, *supra* note 40, and accompanying text; Gretchen Morgenson, "Investors View Fed's Rate Cut as Too Timid," N.Y. TIMES, Sept. 30, 1998,at C1.

141. Jagdish Bhagwati, "The Capital Myth," 77 FOREIGN AFFAIRS 7 (1998); KEVIN PHILLIPS, ARROGANT CAPITAL(1994); Greider, *supra* note 22; Martin Wolf, "Wisdom of free flows questioned," FINANCIAL TIMES, Oct. 2, 1998, World Economy and Finance Survey, VI; Nicholas D. Kristof, "As Free-Flowing Capital Sinks Nations, Experts Prepare to 'Rethink System,'" N.Y. TIMES, Sept. 20, 1998, at 6; Robert Kuttner, "Global Financial Crashes are Excesses of Free Markets," ALBQ.J., Sept.11, 1998, at A16.

142. David Felix, "On Drawing General Policy Lessons From Recent Latin American Currency Crises," 20:2 J. POST KEYNESIAN ECONOMICS 191, 200(1998).

the ratio of central banks' global official reserves to daily foreign exchange turnover was about 15 days; today it is only about one day.[143] Therefore the combined total of all central bank reserves equals only about one day's worth of foreign exchange trading.

This begs the question, what chance does a single central bank have to protect its currency by open market interventions in the face of a sustained market reaction against that currency?

When a central bank intervenes in isolation to support its currency against a sustained sell-off, it is in essence handing its foreign reserves over to the speculators, resulting in heavy losses for the central bank and huge profits for private speculators,[144] including hedge funds, foreign exchange departments of commercial banks and other financial institutions.[145] As one market observer noted:

> Currency traders have grown rich by taking positions in the market opposite of those of central banks. . . . The foreign exchange traders make large profits from central bank interventions, which far from stabilizing markets, causes them to be more volatile. . . . Indeed, these days trader and central banker are often one and the same. At least half a dozen former governors of the Federal Reserve now hold high-paying jobs on Wall Street, where they provide advice to currency and bond traders.[146]

How nice it must be for central bankers and their research economists to look forward to such promising future career options with private financial institutions; and how convenient that the same private financial institutions have such an interest in keeping their future employees actively intervening in the currency and bond market.[147] This symbiotic relationship between the regulators and private financial institutions raises important questions about the political process [148] and the democratic accountability of central banks.[149] It also casts doubt on the efficacy of central bank interventions in currency and other markets.[150] But the IMF's other

143. *Id.*

144. *See* Jane D'Arista & Tom Schlesinger, "Reforming the Privatized International Monetary System," 2 FOMC ALERT 1, 2 (Dec. 22, 1998); Sam Dillon, "Mexico's Central Bank Fails in Attempt to Prop Up Peso," N.Y. TIMES, Sept. 11, 1998, at C4.

145. Greider, *supra* note 22, at 240-41 (recounting how speculator George Soros had broken the Bank of England's defense of the British pound in September 1992, and made nearly $1 billion in profit in the process).

146. Michael Lewis, "For Love of Money: Why Central Bankers and Speculators Need Each Other," 74:2 FOREIGN AFFAIRS 137, 139, 141 (1995) (reviewing GREGORY J. MILLMAN, THE VANDALS' CROWN: HOW REBEL CURRENCY TRADERS OVERTHREW THE WORLD'S CENTRAL BANKS (1995)). *See also* STEVEN SOLOMON, THE CONFIDENCE GAME (1995); DANIEL YERGIN & JOSEPH STANISLAW, THE COMMANDING HEIGHTS (1997).

147. *See* Simon Romero, "Brazilian Central Bank Plans A Currency Insider Inquiry," N.Y. TIMES, April 1, 1999, at C6; Simon Romero, "As Brazil Devalued, Some Got Rich," N.Y. TIMES, March 26, 1999, at C4. *See also* Richard K. Lyons, "Explaining Trading Volume in Foreign Exchange: Lessons from Tokyo,"No. 97-38 (Dec. 26, 1997) (dealers who receive advance knowledge of a central bank's currency intervention operations "has superior information for forecasting exchange rate movements").

148. Political scientists have long been concerned with such dynamics of revolving doors, iron triangles, and agency capture by private regulated industries and their interest groups. *See* D. GRIER STEPHENSON, JR., ET AL, AMERICAN GOVERNMENT 258, 522-23 (1992); THEODORE LOWI, THE END OF LIBERALISM 33-35, 58(1979).

149. Timothy A. Canova, "Law School's Blindfold: The Downsizing of the American Dream," BROOK. L. DIG. 19, 25-29 (1996); Bernstein, *supra* note 95; Harold J. Krent, "Fragmenting the Unitary Executive: Congressional Delegations of Administrative Authority Outside the Federal Government," 85 N.W. UNIV. L. REV. 62, 84-85 n.66 (1990); *See also* John Hart Ely, DEMOCRACY AND DISTRUST 131-134 (1980); DAVID SCHOENBROD, POWER WITHOUT RESPONSIBILITY (1993).

150. D'Arista & Schlesinger, *supra* note 144. *See also* Milton Friedman, "The Case for Overhauling the

preferred policy alternative, that of raising interest rates ever higher, also ultimately fails to prop up the currency. Consider the case of Sweden in the early 1990s. The Swedish currency, the Krona, came under speculative attack. The Riksbank, Sweden's central bank, tried to defend the currency by raising interest rates. The Riksbank raised the overnight interest rate to over 500 percent over a two-week period[151] Of course, the Swedish economy and banking system collapsed under the weight of such interest rates, and the strategy utterly failed anyway in its primary objective to support the value of the Krona. Trying to defend the value of a currency with high interest rates is a very dangerous course of action. Along the way, those high interest rates compound the financial and economic crisis, contribute to passive government budget deficits,[152] and to deepening recession. The World Bank acknowledged these dangers in the fall of 1998 when it distanced itself from the IMF. In a rather unprecedented split between such institutions, the World Bank publicly blamed the IMF and U.S. Treasury for making the global financial crisis worse and increasing the hardship for millions of people as a result of programs of economic austerity, high interest rates, and recession.[153]

V. FOUNDATIONS OF THE NEOLIBERAL FINANCIAL REGIME: THE CONTAGION OF NEOLIBERAL REFORM

The proliferation of short-term capital flows has occurred because of conscious government decisions to liberalize their capital accounts, and to abolish any and all kinds of controls on short-term portfolio capital flows.[154] The Articles of Agreement of the International Monetary Fund (the Articles), otherwise known as the 1944 Bretton Woods Agreement,[155] contain a specific provision, Article VI, that expressly provides member countries with a very important policy tool, the right to impose exchange controls and restrictions on capital flows.[156] According to Article VI, "Members may exercise such controls as are necessary to regulate international

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Fed," CHALLENGE, 5(July-Aug.1985) (criticizing the Federal Reserve for "churning" its accounts by unnecessary and excessive buying and selling of government securities to add profits to the bond-dealing operations of its private constituency).

151. Timothy A. Canova, "The Swedish Model Betrayed," 37:3 CHALLENGE 36 (1994).

152. Passive deficits result from slow economic growth, underutilization of resources, declining tax revenues, and/or rising interest costs. Active deficits, on the other hand, result from government spending more than it collects in taxes at full employment. *See* Timothy A. Canova & Lynn Turgeon, "Fighting the Wrong Deficit," in MELTDOWN, *supra* note 182, at 206-07; *See* Gillian Tett, "Japan Warns of $82.6bn tax shortfall," FINANCIAL TIMES, Nov. 25, 1998, at 1 (tax shortfall due to economic slowdown).

153. David E.Sanger,"U.S. and I.M.F. Made Asia Crisis Worse, World Bank Finds," N.Y. TIMES, Dec. 3, 1998, at A1; Mark Landler, "Grim Assessment by U.N. Of Economic Slide in Asia," N.Y. TIMES, Dec. 3, 1998, at A8 (the International Labor Organization reported dramatic worsening in social and economic conditions throughout Asia); James D. Wolfensohn, "The Other Crisis," Address to Annual Meeting of the IMF and World Bank (Oct.6, 1998)http://www.worldbank.org/html/extdr/am98/jdw-sp/am98-en.html.; *See also* David E.Sanger, "As Economies Fail, the I.M.F. Is Ripe with Recriminations,"N.Y.TIMES, Oct.2, 1998, at A1.

154. History has been repeated with the liberalization of capital flows. Unregulated capital flows contributed to the global financial and economic instability of the Great Depression. *See* JOHN GRAY, FALSE DAWN: THE DELUSIONS OF GLOBAL CAPITALISM (1999).

155. Articles of Agreement of the International Monetary Fund [hereinafter Articles], Dec. 27, 1945, 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39, as amended, May 31, 1968, 20 U.S.T. 2775, 726 U.N.T.S. 266, as amended, Apr. 30, 1976, 29 U.S.T. 2203, 15 I.L.M. 546, *as amended* June 28, 1990, 31 I.L.M. 1307.

156. *Id.* Article VI, Section 3. *See* Franhois Gianviti, "The IMF and the Liberalization of Capital Markets," 19 HOUS.J.INT'L L. 773, 776 (1997).

capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions. . ." [157]

This is an important distinction between capital and current transactions. The Articles define current transactions as including payments due in connection with foreign trade, interest due on loans, and net income from other investments, but not payments made for the purpose of transferring capital.[158] The Articles consider current transactions (such as payments for goods and repatriation of profits)[159] as essential for the smooth operation of international trade, and member countries were ordinarily obligated under Article VIII to avoid restrictions on current payments.[160] Article VIII requires members to consult with and obtain the approval of the IMF to impose restrictions on current transactions.[161] Article IV gives the IMF surveillance powers over a wide range of members' economic and financial policies.[162] In contrast, Article VI restrictions on capital transactions require no such IMF consultations or surveillance.

The Articles are very explicit in favoring the use of restrictions on capital transactions over restrictions on current transactions.[163] The chief negotiators at Bretton Woods, Harry Dexter White, the assistant U.S. Treasury Secretary, and John Maynard Keynes, the great British economist, saw the Article VI provision as a crucial instrument to control the kind of speculative capital flows that had occurred before World War II and had destabilized the global economy during the Great Depression.[164] Keynes supported Article VI as "a permanent arrangement [that] accords to every member government the explicit right to control all capital movements. What used to be heresy is now endorsed as orthodox. . . It follows that our right to control the domestic capital market is secured on firmer foundation than ever before."[165]

Article VI was not just a theoretical power; capital controls were widely used throughout Western Europe to shield those countries from speculative capital flows during post-war reconstruction.[166] In fact, for most Western European countries, capital controls remained in place throughout most of the 1950's, and for some

157. Articles, *supra* note 155, Article VI, Section 3.

158. Articles, *supra* note 155, at Article XXX(d). The payment or liquidation of the principal of an investment, including a short-term portfolio investment, would be considered as a capital transaction.

159. Payment of interest due on loans and net income from other investments would constitute repatriation of profits. *See* KEITH S. ROSENN, FOREIGN INVESTMENT IN BRAZIL (1991) (regarding difference between repatriation of profits and capital).

160. Articles, supra note 155, VIII, Section 2. The only exceptions to this prohibition against current restrictions are Article VII, Section 3 (b), the "scarce currency clause", and Article XIV, Section 2, which provides for a transitional period until full current account convertibility. For more on the scarce currency clause, *see* notes 288-291 *infra*, and accompanying text.

161. Articles, *supra* note 155, VIII, Section 2.

162. Articles, *supra* note 155, IV.

163. Articles, *supra* note 155,VI, Section 1(a) also gives the IMF power to demand that "a member to exercise such controls [on capital transfers]"Gianviti, *supra* note 156,776-77.

164. ROBERT W. DIMAND, "Bretton Woods," in AN ENCYCLOPEDIA OF KEYNESIAN ECONOMICS 50-53 (1997). At Bretton Woods, White chaired commission on the IMF, Keynes the commission on the World Bank, and Eduardo Suarez of Mexico the commission on other forms of financial cooperation. *See* Gray, *supra* note 154.

165. "Cooling Down Hot Money," 2 ECONOMIC JUSTICE REP.4 (Ecumenical Coalition for Economic Justice, Toronto, June 1994). Keynes referred to short-term capital movements as "fugitive funds" and attempted to construct a system of national exchange controls between both the sending and receiving countries. *See* Zamora, *supra* note 96, 101.

166. Mussa & Goldstein, *supra* note 96, at 252. *See also* notes 276-278 *infra* and accompanying text.

countries until the early 1990's.[167] Restrictions on hot money capital flows meant Western European countries could pursue high growth and full employment, two of the explicit purposes of the Bretton Woods Agreement,[168] without being overly concerned about the possibility of speculative runs on their currencies.

In recent years, the Article VI policy tool has been undermined and eroded by the IMF itself, through the adoption of a program of capital account liberalization.[169] As recently as the spring of 1998, the IMF was discussing a possible amendment to the Articles to provide for explicit jurisdiction over the process of capital account liberalization.[170] The IMF has focused the burden of adjustment on deficit countries, while virtually ignoring the dynamics of hot money speculative flows that victimize those same countries.[171] Without an explicit mandate and despite the Article VI provision, the IMF has effectively pushed capital liberalization through its surveillance, financing, and technical assistance activities.[172]

It is rather perverse and ironic that at the very moment that a country is sinking under the weight of the hot money problem, it must bend once again to permit even further capital account liberalization as a condition for badly-needed IMF financial assistance.[173] The schizophrenic nature of relations is captured in the so-called Letters of Intent, drafted by and yet formally addressed to the IMF,[174] which list the many steps that the submerging country promises to undertake in exchange for IMF aid, including economic austerity, privatization, and liberalization.[175]

In pushing capital account liberalization, the IMF has been responding to the demands of capital-exporting nations and their private banking and financial constituencies.[176] Likewise, the World Trade Organization (WTO), which is the direct descendant of the General Agreement on Tariffs and Trade (GATT), has strongly pushed the same liberalization agenda.[177] The Organization of Economic

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167. *Id.*

168. Articles, *supra* note 155, at Article I(ii) (among purposes of IMF were to "facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy").

169. Sara Kane, "Seminar Discusses the Orderly Path to Capital Account Liberalization," 27 IMF SURVEY 81, 83 (International Monetary Fund, March 23, 1998); "Capital Movements Under an Amendment of the IMF's Articles," ANNUAL REPORT 1998 74 (International Monetary Fund 1998).

170. *Id.*

171. *See* notes 270-271 *infra* and accompanying text concerning the asymmetrical burden of adjustment on deficit countries.

172. Kane, *supra* note 169.

173. Larry Rohter, "New I.M.F. Aid Pact Further Limits Brazil," N.Y.TIMES, March 9, 1999, C1; Geoff Dyer, "Brazil vows to continue privatization," FINANCIAL TIMES, Nov. 25, 1998, at 7.

174. Some of these Letters of Intent can be found on the IMF's website at <http://www.imf.org/external/np/loi>.

175. Since the U.S. is the dominant power within the IMF, it is not surprising that this agenda is often closely linked with U.S. policy. *See* Nicholas D. Kristof, "Asians Worry That U.S. Aid Is a New Colonialism," N.Y. TIMES, Feb. 17, 1998, at A4. *See also* photo of South Korean protest march against policies imposed by the IMF in which protester was holding a sign that read, "I.M.F., I'M Fired?" N.Y. TIMES, Sept. 30, 1998, at C1.

176. For instance, Ramon Moreno, "GATS and Banking in the Pacific Basin,"Federal Reserve Bank of San Francisco Letter, No. 94-19 (May 13, 1994) (adoption of General Agreement on Trade in Services (GATS) at Uruguay Round of multilateral trade negotiations expected to open Pacific Basin economies to international banking; even though it could raise problems related to "speculative capital flows").

177. *See* Joint Statement by the Heads of the International Monetary Fund, the World Bank and the World Trade Organization, IMF New Brief No. 98/37, Oct. 16, 1998 (urging further liberalization and integration of financial markets); "Financial Services Trade, Capital Flows and Financial Instability," Staff Working Paper ERAD

Cooperation and Development (OECD), a group of about 29 of the more developed nations, has actively pushed for free capital mobility among its members through its own Code of Liberalisation of Capital Accounts (the Code).[178] The Code covers a wide range of capital movements, including hot money flows such as operations in securities, money markets, and foreign exchange.[179]

Mexico's membership in the OECD merits particular attention,[180] because of its significance in terms of the Bank for International Settlement's (BIS) risk-based capital requirements, also know as the Basle Accord.[181] The Basle Accord put a zero weighting on credit risk for the central government debt of all OECD countries, which by mid-1994 included Mexico.[182] Therefore, at the time of the Mexican peso crash, banks from around the globe could hold Mexican government debt securities without providing any capital reserves for credit risk. This combined OECD-BIS stamp of approval was certainly a premature inducement to free flows in a particularly volatile form of capital. This capital, mainly short-term Mexican government debt, resulted in significant losses for U.S. and other banks and necessitated a multibillion dollar bailout package.[183]

The OECD has also been pushing negotiations for a Multilateral Agreement on Investment (MAI) for OECD members and non-members. According to the OECD, the MAI is based on the Code and would "provide legal guarantees" for investments, including the making of portfolio investments.[184] If enacted, the MAI would effectively overturn Article VI of the IMF Articles of Agreement on a grand multilateral scale. For the time being, MAI negotiations have been suspended because of intense opposition by trade unions and environmental groups concerned about the broad rights that MAI would grant to corporations to challenge national laws and regulations.[185]

98-12 (World Trade Organization, Geneva, 1998); Guy de Jonquieres, "Liberalization is good for stability, says WTO study," FINANCIAL TIMES, Dec. 2, 1998, at 9.

178. Cynthia C. Lichtenstein, "The New Financial World of Cross Border Capital Movements: The International Monetary Fund Agreement in light of the 1994 Mexico Peso Crash," in WEBER, (Hrsg.) WAHRUNG UND WIRTSCHAFT, DAS FELD IM RECHT, FESTSCHRIFT FUR PROFESSOR DR. HUGO J. HAHN, NOMOS VERLASGESELLSCHAFT 191, 195 (1997); Christian Weller, "Global Banking," 3 FOREIGN POLICY IN FOCUS 9 (1998).

179. CODE OF LIBERALISATION OF CAPITAL MOVEMENTS (Organization for Economic Co-Operation and Development, 1997)[hereinafter "OECD Code"]. Article 1(d) of this Code obligates all OECD members to "endeavour to extend the measures of liberalisation to all members of the International Monetary Fund".

180. Mexico became a member of the OECD through accession on May 18, 1994. *Id.* at 2.

181. Hal S. Scott, "The Competitive Implications of the Basle Capital Accord," 39 ST.LOUIS UNIV. L. J. 885 (1995).

182. HAL S.SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE 268-69 (1998);MELTDOWN: MONEY, DEBT, AND THE WEALTH OF NATIONS 270, 310 (W. Krehm, ed. COMER Publications 1999). For proposed revisions in risk management standards for banks, *see* "Framework for Supervisory Information about Derivatives and Trading Activities," Joint Report by the BIS Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions (Sept. 1998).

183. Louis Uchitelle, "U.S. Losses In Mexico Assessed," N.Y. TIMES, Dec. 26, 1994, at A6; Kenneth N. Gilpin, "Far-Reaching Effects Seen If Mexico Rescue Is Halted," N.Y. TIMES, Jan. 23, 1995, at D1.

184. "The Siena Declaration," N.Y.TIMES, Nov. 24, 1998, A7 (declaration of the International Forum on Globalization); "The Multilateral Agreement on Investment," OECD Policy Brief No. 2-1997, reprinted on Friends of the Earth web site at <http://www.foe.org/orgs/ga/ten.html>.

185. Samer Iskandar, "France quits investment accord talks," FINANCIAL TIMES, Oct. 15, 1998, at 6; Guy de Jonquieres, "Retreat over OECD pact on investment," FINANCIAL TIMES, Oct. 21, 1998, at 9; Friends of the Earth web site, *supra* note 184.

While the OECD's particular multilateral attempt to enshrine capital liberalization in international law has not met with immediate success, bilateral efforts have. For the past two decades, developed countries have pressured developing countries to liberalize their capital accounts through hundreds of bilateral investment treaties, such as the U.S. State Department's Bilateral Investment Treaty (BIT) program.[186] NAFTA's investment provisions are "a direct descendant of the U.S. model bilateral investment treaty."[187] Not surprisingly, BITs typically define "investment" to include private debt and equity securities, the raw material of hot money flows.[188] By granting U.S. investors the right to freely transfer such investments,[189] the BIT program has undermined the ability of developing countries to adopt Article VI restrictions on capital transfers.

The primary objective of developing countries in negotiating a BIT with the U.S. or some other developed country is to attract foreign investment.[190] As Dean Salacuse argues, while the BIT program "purports to create a symmetrical relationship between the two [contracting] states," in reality an asymmetry exists since the developing country is in need of, and dependent on, U.S. sources for scarce capital investment.[191] According to Dean Vandevelde, "[f]or many developing countries, the BIT represents a tangible way of signaling their receptivity to foreign investment, and thus may seem to assist in attracting capital from the United States and other developed countries."[192] Consequently, the U.S. is in a stronger bargaining position to condition other official benefits for the developing country on that country's agreement to the BIT.[193] Moreover, the BIT is a "confidence-building" measure that sends a green light to the private investment community.[194]

More than 300 BITs have been signed between developed and developing nations.[195] As Salcuse notes, "in thirty years, the nations of the world fashioned an instrument of public international law to create rules for private foreign investments."[196] By requiring bilateral liberalization of capital flows, the BIT program has significantly undermined the important policy instrument of capital controls, a policy option expressly permitted under the IMF Articles of Agreement.[197]

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186. It was during the time of another neoliberal Democrat, the Carter administration, that the BIT program was first launched. *See* Kenneth J. Vandevelde, "U.S. Bilateral Investment Treaties: The Second Wave," 14 MICH. J. INT'L L. 621, 622 (1993).

187. Alvarez, *supra* note 64, at 303-04. The U.S. has negotiated more than 40 BITs with foreign countries. For sample and actual U.S. Bilateral Investment Treaties, *see* http://www.state.gov/www.issues/economic/6proto.html.>

188. *See* Joseph E. Pattison, "The United States-Egypt Bilateral Investment Treaty: A Prototype For Future Negotiation," 16 CORNELL INT'L L. J. 305, 316 (1983); Wayne Sachs, "The New U.S. Bilateral Investment Treaties," 2 INT'L TAX & BUS. LAW. 192, 203-08 (1984).

189. Mark S. Bergman, "Bilateral Investment Protection Treaties: An Examination of the Evolution and Significance of the U.S. Prototype Treaty," 16 N.Y.U.J. INT'L L. & POL. 1, 19-20 (1983).

190. Jeswald W. Salacuse, "BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries," 24:3 THE INT'L LAWYER 655, 661 (1990).

191. *Id.* at 663.

192. Vandevelde, *supra* note 186, at 638.

193. Salacuse, *supra* note 190 , at 661, 663 ("those benefits may include participation in the U.S. foreign investment insurance program, and U.S. political support and economic assistance").

194. *Id.* at 674.

195. *Id.* at 655.

196. *Id.*

197. *Id.*

Therefore, a multilateral framework for dealing with capital account liberalization and restrictions has been largely supplanted by bilateral arrangements which reflect and reproduce the power disparities between capital-exporting countries, private financial institutions and the developing world.[198]

VI. A PATH FOR REFORM

A. *Exchange Rate Stability*

It is clear that the liberalization of global capital flows has contributed to the extreme volatility in exchange rates.[199] Countries have lost their autonomy to pursue expansionary economic policies as they have been forced to compete for foreign investment. This has led to the neutralization of fiscal policy and the ascendency of monetary policy as the one and only policy tool to deal with every policy problem, from inflation to unemployment and exchange rate stability.[200] This over-reliance on monetary policy has in turn contributed to extremely high real interest rates, slower economic growth, and the general retreat from policies of full employment.[201]

In 1994, former Federal Reserve chairman Paul Volcker chaired a commission known as the Bretton Woods Commission. Its work coincided with the 50th anniversary of the Bretton Woods Conference. The Bretton Woods Commission concluded:

> Since the early 1970's, long-term growth in the major industrial countries has been cut in half, from about 5 percent a year to about 2.5 percent a year. Although many factors contributed to this decline in different countries at different times, low growth has been an international problem, and the loss of exchange rate discipline has played a part.[202]

The Commission was surprisingly critical of liberalized exchange rates, and recommended a return to some kind of regime of semi-fixed exchange rates in order to encourage the growth in global trade and economic growth.[203]

If countries could regain some measure of control over hot money speculative capital flows, there is a good chance for a return to exchange rate stability. With

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198. The bilateral approach of the BIT program is contrary to the multilateral principle of the Bretton Woods and GATT post-war trading system. *See* BETH V. YARBROUGH & ROBERT M. YARBROUGH, COOPERATION AND GOVENANCE IN INTERNATIONAL TRADE 5 (1992).

199. *See* MAXWELL WATSON, ET AL, INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS AND PROSPECTS 13 (International Monetary Fund, Washington, D.C., 1988); Bank for International Settlements: 68TH Annual Report, *supra* note 66, at 106; Felix,"On Drawing General Policy Lessons From Recent Latin American Currency Crises," *supra* note.

200. Timothy A. Canova, "The Macroeconomics of William Vickrey," 40:2 CHALLENGE 95 (1997). Former Nobel-laureate Jan Tinbergen often said that we should have at least as many policy tools as there are policy objectives. *See* JAN TINBERGEN, ECONOMIC POLICY: PRINCIPLES AND DESIGN 53-56 (1956).

201. *See* JAMES MEDOFF & ANDREW HARLESS, THE INDEBTED SOCIETY (1996); SIDNEY HOMER & RICHARD SYLLA, A HISTORY OF INTEREST RATES 386, 430 (1991).

202. Bretton Woods Commission. 1994. "Bretton Woods: Looking to the Future," Commission Report, Washington, D.C.: Bretton Woods Commission; Greider, *supra* note 22, at 250.

203. *Id.* Raymond F. Mikesell, "Revisiting Bretton Woods," Public Policy Brief no. 24, (Jerome Levy Economics Institute, Annandale-on-Hudson, 1996); THE BRETTON WOODS-GATT SYSTEM: RETROSPECT AND PROSPECT AFTER FIFTY YEARS (O. Kirshner, ed., M.E.Sharpe 1996).

such stability, there is also a good chance that countries would be empowered to once again pursue full employment and a host of other progressive social policy objectives. Political leaders in Western Europe, particularly in France and Germany, have recognized the need for exchange rate stability,[204] but have had little success with the Clinton administration[205] and have elicited the outright hostility of central bankers.[206]

In order to reform the global financial system to restore stability in exchange rates, a return to some kind of regime of limited use of controls or restrictions on short-term capital inflows is needed. This would entail a reorientation of IMF policy, but one that may already be in its infancy.

During some of the worst months of the global currency contagion, many internationalists came to appreciate the kinds of prudential controls on short-term capital inflows that Chile adopted several years ago.[207] For instance, a foreign investor who wanted to invest or lend within Chile had to deposit 30 percent of such investment or loan into a non-interest bearing account with the central bank for a full year or pay a 3 percent tax to recover that deposit.[208] These prudential limits, known locally as the *encage*, had the effect of cutting down the incentive for short-term borrowing from abroad, and thereby reduced Chile's reliance on short-term capital inflows.[209]

In mid-1998, the established economic orthodoxy was shaken by a high level defection. MIT economist and free-trader Paul Krugman suddenly came out publicly in favor of capital and exchange controls not just controls on capital inflows, but the more pervasive and intrusive controls that were adopted by Malaysia to control exchange operations, current transactions and capital outflows.[210] The highly visible and respected Krugman is now supporting currency and capital controls that are much more pervasive than many critics of the neoliberal contagion had previously dared to advocate.[211]

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204. *See* Ralph Atkins, "Schroder backs plans for currency target zones," FINANCIAL TIMES, Sept. 29, 1998, at 1; Craig R. Whitney, "German Chief Gives France Reassurances About Ties," N.Y. TIMES, Oct. 1, 1998, at A17; David E. Sanger, "Chirac, in U.S., Offers Alternative Approach to Economic Crisis," N.Y. TIMES, Feb. 19, 1999, A5. *See also* Michiyo Nakamoto, "Obuchi to Call for New Currency Era," FINANCIAL TIMES, Jan.6, 1999, at 2; John Grieve Smith, "Managing Exchange Rates," FINANCIAL TIMES, Oct.7, 1998, at 10.

205. It is uncertain whether the Bush administration was moving in the direction of more stability in exchange rates. *See* "Bush: Overhaul Currency Valuation," NEWSDAY, Sept. 21, 1992, at 21.

206. Wolfgang Munchau & Tony Barber, "Bank chiefs reject currency targets," FINANCIAL TIMES, Nov. 22, 1998, at 1.

207. *See* note 141 *infra* and accompanying text.

208. In the summer of 1998 Chile relaxed its capital restrictions under strong political pressure from foreign investors. *See* Craig Torres, "Chilean Stocks Rise as Government Acts," WALL ST. J., June 29, 1998, at A14; Imogen Mark, "Chile may ease capital inflow rule to lift peso," FINANCIAL TIMES, June 26,1998, at 8; Greider, *supra* note 22, at 319, 490n.

209. *See* Ricardo French-Davis, Manuel Agosin, Andras Uthoff, "Capital Movements, Export Strategy, and Macroeconomic Stability in Chile," *in* COPING WITH CAPITAL SUGRES: THE RETURN OF FINANCE TO LATIN AMERICA 99, 136-37 (French-Davis and S. Griffith-Jones, eds. L.Rienner 1995); *See also* Carlos Massad, "The Liberalization of the Capital Account: Chile in the 1990's," "in"SHOULD THE IMF PUSOE CAPITAL- ACCOUNT CONTROVERTIBILITY?, ESSAYS IN INTERNATIONAL FINANCE, No. 207, (R. Cooper ed., Princeton University 1998); "Chile's Experience with Capital Controls,"ANNUAL REPORT 1998, 176 (International Monetary Fund, 1998).

210. Krugman, *supra* note 114, at 78-80; An Open Letter from Paul Krugman to Prime Minister Mahathir, (Sept. 1, 1998) <http://web .mit.edu/krugman/www/mahathir.html.>

211. In light of Krugman's sudden about-face on capital and exchange controls and his late recognition of the Asian glut and deflation, one might expect him to issue an apology for his earlier criticisms of Greider. *See* PAUL KRUGMAN, THE ACCIDENTAL THEORIST 32, 74, 76 (1998).

B. Restrictions on Short-Term Capital Inflows

Throughout much of the past year, there has been a covert discussion taking place in financial circles about capital controls. Joseph Stiglitz, the chief economist of The World Bank, has consistently endorsed "speed bumps" to slow down the pace of global financial speculation, and has expressed sympathy for the Chilean program.[212] Stiglitz pointed to a study showing no correlation between capital account liberalization and economic growth, and suggested that mild restraints on capital flows might help economic growth.[213] In early February 1998, Stanley Fischer, the IMF's first deputy managing director, recognized the need to find ways to deal with the problem of surges of short-term capital across borders.[214] Fischer suggested that the Chilean scheme was one that needed to be considered.[215] More recently, in September 1998, the IMF's Asia-Pacific Director, Hubert Neiss, stated that short-term capital controls may be needed to stem the spread of the currency contagion.[216] Later that same month, the IMF declared that controls on inward movements of capital could be a useful tool for some countries, and that opening economies prematurely to free flows of capital constituted "an accident waiting to happen."[217]

Yet, it seems that each time there appears a crack in the official orthodoxy, the transgressors or their allies at the IMF, Treasury or elsewhere quickly backpedal or even retract their earlier expressions of misgivings about the dangerous direction of today's neoliberal policies.[218] One is tempted to conclude that the prior confessions were made in unguarded moments, under the weight of conscience, only to be retracted when one once again imagines the dangers of expressing the truth and the potential loss of "credibility" in the eyes of the established powers that profit by today's hot money regime.[219] The accepted orthodoxy, it seems, must be maintained at all costs, even if that means that an urgently needed debate is delayed,

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212. *See* "Comment and Analysis," FINANCIAL TIMES, Apr. 17, 1998, at 17; Joseph E. Stiglitz, "Using Tax Policy To Curb Speculative Short-Term Trading," 3 J. FINANCIAL SERVS. RES. 101-15 (1989). *See also* Paul Krugman, "Curfews on Capital Flight: What Are the Options?" at <http://www.web.mit.edu/krugman/www/curfews.html.>.

213. *See* Joseph Stiglitz, "Road to Recovery," Asiaweek, July 17, 1998 reprinted in <http://www.worldbank.org/html/extdr/extme/jsart-aw071798.html.>; James Wilson, "Delegates agree the state has a role to play in the financial sector — but what is it?" FINANCIAL TIMES, July 1, 1998, at 6.

214. Louis Uchitelle, "I.M.F. May Be Closer To Lending-Curb Idea," N.Y. TIMES, Feb. 3, 1998, at C4.

215. *Id.*

216. Bill Tarrant, "I.M.F. Sees Short-Term Capital Controls in Asia," REUTERS, Sept. 14, 1998 (copy on file with author).

217. Stephen Fidler, "IMF admits drawbacks to capital free flow," FINANCIAL TIMES, Sept. 22, 1998, at 9.

218. *See* Michel Camdessus, "Capital Account Liberalization and the Role of the Fund," Remarks to IMF Seminar on Capital Account Liberalization (March 9, 1998); Nancy Dunne, "Summers sees IMF coping with crisis," FINANCIAL TIMES, Oct. 23, 1998, at 5. Lawrence Summers, U.S. deputy treasury secretary has become one of the Clinton administration's chief cheerleaders of capital account liberalization, despite the fact that he supported taxes on financial transactions prior to his tenure in government. *See* Lawrence H. Summers & Victoria P. Summers, "When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax," 3 J. FIN. SERVS. RES. 261-81 (1989).

219. For an example of such "strategic positioning," *see* Enrique R. Carrasco, "Opposition, Justice, Structuralism, and Particularity: Intersections Between LatCrit Theory and Law and Development Studies," 28 U. MIAMI INTER-AM. L. REV. 313, 328-29 (1996-97) (arguing that LatCrits should cautiously support the neoliberal policies of the IMF and World Bank if those LatCrits want policymakers to take their work seriously).

and therefore denied, and that badly conceived policies continue to impose suffering around the world.[220]

However, there is a very real and growing split within the world of finance concerning the pace and degree of financial liberalization, and concerning the use of temporary controls and prudential restrictions on short-term hot money flows.[221] This split is increasingly pushed underground at a time when resurrection of serious discussion is most needed. This covert debate is being played out around the globe in the context of the global contagion and increasingly desperate economic and financial conditions.

In the fall of 1998, Mexican President Zedillo publicly rejected the option of capital controls.[222] Although that option is taboo in the present political environment, such proposals will probably resurface if the currency contagion continues to deepen and spread to Mexico. This raises the question of NAFTA's compatibility with controls on capital flows between Mexico and the U.S. NAFTA Article 2104 would permit restrictions on capital transactions if Mexico were experiencing serious balance of payment problems. But according to Article 2104(5), Mexico could impose such restrictions "only in conjunction with measures imposed on current international transactions." The practical effect of this wording is that Mexico would have to submit to the IMF's surveillance under Article VIII of the IMF's Articles of Agreement.[223] That, of course, is only a prescription for continued economic austerity.

In the alternative, Mexico could invoke NAFTA Article 1410, which permits reasonable measures for prudential reasons such as the maintenance of safety, soundness, and integrity of the financial institutions, and the integrity of the financial system.[224] Therefore, it seems clear that under NAFTA, Mexico could legally impose Chilean-style prudential reserve requirements on short-term capital inflows without swallowing the bitter IMF austerity pill.

In recent years, quite a number of countries have experimented with various programs of capital restrictions and with varying degrees of success.[225] In fact, Chile's *encage* program was by no means the most restrictive. The Chilean program has probably received a great deal of enthusiastic attention because of its relatively modest approach of using the tax system to decrease the financial incentive for short-term portfolio inflows. Other countries such as China and India have remained somewhat sheltered from the currency contagion because of their more restrictive

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220. *See* JOHN KENNETH GALBRAITH, THE AFFLUENT SOCIETY 11 (1958) ("the hallmark of the conventional wisdom is acceptability").

221. *See* Michael M. Weinstein, "Twisting Controls on Currency and Capital," N.Y. TIMES, Sept. 10, 1998, at C1; John Plender, "Taming Wild Money," FINANCIAL TIMES, Oct. 20, 1998, at 17.

222. Richard Lapper, "Zedillo warns against protectionist pressures," FINANCIAL TIMES, Oct. 15, 1998, at 6 (Zedillo claimed that capital controls were doomed to fail). This was not the first time that Yale-educated Zedillo has rejected controls on speculative capital flows. *See* Greider, *supra* note , at 263.

223. NAFTA, *supra* note 62. Article 2104(5) refers to Article 2104(2)(a) which requires IMF Article VIII review (and therefore approval) of any currency account exchange restrictions.

224. NAFTA, *supra* note 62, Article 1410(1).

225. Folkerts-Landau, et al, *supra* note 2, at 83 ("changes in reserve requirements in six countries, including Chile"), 97 ("taxing short-term capital flows, and prudential quantitative limits"), 100-103 ("restrictions on capital inflows, prudential requirements, and controls on capital outflows").

programs of exchange controls on capital (both inflows and outflows) and currency transactions.[226] Yet, the IMF still ignores the lessons of such successes.[227]

Also in the fall of 1998, Brazil imposed some restrictions on short-term capital inflows in response to an increase in capital outflows stemming from the global currency contagion.[228] This was a sharp reversal from Brazil's prior policy. In November 1997, at the peak of the Asian currency crisis, and in keeping with the IMF and U.S. agenda for capital account liberalization, Brazil opened loopholes to attract capital inflows into short-term debt instruments.[229] As a result, Brazil's inflows of hot money soared, leaving the country "vulnerable to investor mood swings."[230] The horse was apparently already out of the barn and Brazil was already too addicted to short-term capital inflows for prudential restrictions on such inflows to be of much help.[231]

That is the danger of waiting until the wolf is already at the door.[232] The cost of delay may be the kind of full-blown financial crises that we have seen in Russia and throughout parts of East Asia. For example, Malaysia adopted exchange restrictions on capital inflows, capital outflows and current transactions that were much more pervasive than any of the prudential restrictions that Chile ever imposed.[233] And yet Malaysia seems to be using the breathing space provided by its exchange controls to boost domestic demand and slowly bring back the foreign investors.[234] Proponents of capital account liberalization fear that Malaysia may succeed in its

226. *See* Peter Passell, "China's stable currency is protecting it for now," N.Y. TIMES, June 25, 1998, at D2 (China seems like an "island of stability" in the Asian financial turmoil because of its exchange controls); Greider, *supra* note 22, at 319; Craig S. Smith, "China Can Spur Growth Without a Devaluation," WALL ST. J., June 22, 1998, at A1 (controls permit China to limit trading in its currency, the yuan, to a "narrow, tightly controlled range").

227. Kenneth Kasa, "Could Russia Have Learned from China?" Federal Reserve Bank of San Fransisco Letter, No. 98-26 (Sept. 4, 1998). The IMF shows no recognition that the most important lesson that Russia should have learned from China's success is to go slower on capital account liberalization. *See* Zuliu Hu & Mohsin S. Khan, "Why Is China Growing So Fast?"ECONOMIC ISSUES (International Monetary Fund, Washington, D.C., 1997) at 8.

228. Geogg Dyer, "Brazil to curb short-term capital inflows," FINANCIAL TIMES, Sept. 30, 1998, at 3. Francisco Lopes, director for monetary policy of Brazil's central bank, said, "One important lesson of the crisis is that you take a lot of risks with large short-term capital inflows."

229. *Id.*

230. *Id.*

231. Geoff Dryer, "Capital Controls for Brazil Rejected," FINANCIAL TIMES, Jan.27 ,1999, at 3. On the inevitable fall of the Brazilian currency. *See* Larry Rohter, "Brazil Devalues Its Currency 8%, Roiling Markets: Wider Effect Seen," N.Y. TIMES, Jan. 14, 1998, at A1.

232. Japan's recent attempt to protect its currency with increased controls elicited strong political opposition from the international investment community. *See* Paul Abrahams & Gillian Tett, "Tokyo to curb short selling to counter market decline," FINANCIAL TIMES, Oct. 2, 1998, at 1; Jane Martinson, "Hedge funds unnerved by short-selling rules," FINANCIAL TIMES, Oct. 23, 1998, at 6; Gillian Tett, "Anger over Japan's new curbs on short selling," FINANCIAL TIMES, Oct. 23, 1998, at 18; Gillian Tett & Michiyo Nakamoto, "Japan's politicians step on stage with hedge funds in their sights," FINANCIAL TIMES, Oct. 28, 1998, at 4.

233. "Malaysia Imposes Controls On Trading in Its Currency," N.Y. TIMES, Sept. 2, 1998, at C2; "Details on Changes in Exchange Control Mechanism," THE MALAYSIAN STAR "reprinted" at <http://www.jaring.my/star/wednesday/ecmnotic.html>.

234. Charles Chan, "Trade Surpluses Strong Signs of an Improving Economy," THE MALAYSIAN STAR, Feb. 11, 1999 (copy on file with author); Sheila McNutty, "Malaysia bank chiefs face sack unless they lend," FINANCIAL TIMES, Nov. 14-15, 1998, at 4; Wong Sulong, "November 1998 Trade Figures Bring More Good News," THE MALAYSIAN STAR, Jan.6, 1999 (copy on file with author); Edward Luce, "Tokyo Backs Malaysian Bond Issue," FINANCIAL TIMES, Dec.11, 1998, at 8; T.J. Tan, "Malaysia to Borrow from Consortium of Foreign Banks," FINANCIAL TIMES, Dec.30, 1998, at 4.

program, at least relative to other Asian countries, and would then present a viable alternative to the IMF model.[235]

The situation is even more severe in Russia where the government, on the brink of default, was forced to call a temporary halt in trading of its currency in the foreign exchange markets and a moratorium on debt repayments.[236] The Russian financial meltdown has had a severe impact on its economy, and threatens the country's political reforms.[237] It is particularly tragic that at least some of these dire consequences could have been avoided had there been greater use of prudential restrictions on short-term capital inflows.

Such restrictions on hot-money capital flows, however, should be seen as necessary, but not sufficient to accomplish the objectives of sustainable economic development. Even if less vulnerable to the dangers of hot-money flight, developing countries would still be confronted with the challenge of obtaining long-term assistance to finance their development efforts.[238] In addition, the leading industrial countries would still need to end the deflationary biases and tendencies of the global economy.[239]

C. *Proposals for a Financial Transaction Turnover Tax*

Among the compelling reform proposals that have been raised is the so-called Tobin Tax, first proposed by the Nobel-laureate economist, James Tobin. It would impose a turnover tax on foreign exchange transactions, an entry-and-exit toll that would be a very small percentage of the transaction, but enough to deter over-speculation.[240] As Tobin said, such a tax would "throw sand in the gears of the speculators."[241]

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235. G.Pierre Goad,"Acceptance of Capital Controls is Spreading," ASIAN WALL ST. J., Sept.2, 1998, at 1; David E. Sanger, "Malaysia's Leader Rattles Meeting of Financial Elite," N.Y. TIMES, Feb. 1, 1999, A10; Alan Cowell, "Annan Fears Backlash Over Global Crisis," N.Y. TIMES, Feb. 1, 1999, A10; David E.Sanger, "Asia's Economic Tigers Growl at World Monetary Conference: Say Opening of Markets Hands Wall Street too much Power," N.Y.TIMES, Sept.22, 1997, at A1.

236. *See* Michael Gordon, "Russians Say Loan By I.M.F. May Fall Short Of The Need," N.Y. TIMES, July 8, 1998, at A1; Celestine Bohlen, "Ruble Rescue Redux," N.Y. TIMES, Aug. 14, 1998, at A6; Celestine Bohlen, "Russia Warns It Might Default if Western Aid Is Withheld," N.Y. TIMES, Sept. 25, 1998, at A10; "Russia: Currency Controls Tightened," N.Y. TIMES, Jan. 12, 1999, at A6.

237. Timothy L. O'Brien, "Horrific Debt, Devastated Economy," N.Y. TIMES, Sept. 15, 1998, at A12; Michael Wines, "Russia's New Leaders Plan to Pay Debt by Printing Money," N.Y. TIMES, Sept. 18, 1998, at A3; Grigory Yavlinsky, "Russia's Phony Capitalism," 77 FOREIGN AFFAIRS 67(1998).

238. Proposals to meet the requirements of long-term development assistance include increasing allocations of Special Drawing Rights, using revenues from a global financial transactions tax, and low-interest or no interest recycling of reserves from surplus to deficit countries. *See* notes 240-263, 273-275 *infra* and accompanying text.

239. Proposals to correct the global economy's deflationary biases and tendencies include relaxing the IMF's severe conditionality requirements, redistributing the burdens of adjustment from deficit to surplus countries, and reducing reliance on monetary policy to maintain domestic price stability. *See* notes 200-201, 264-287 *infra* and accompanying text.

240. James Tobin, "The New Economics One Decade Older," THE JANEWAY LECTURES ON HISTORICAL ECONOMICS(Princeton University Press 1974); THE TOBIN TAX: COPING WITH FINANCIAL VOLATILITY (Mahbub Ul Haq ed., Oxford University Press 1996).

241. *See* Barry Eichengreen, James Tobin, Charles Wyplosz, "Two Cases for Sand in the Wheels of International Finance," 105 ECONOMIC JOURNAL 162-72 (1995); *But see* Paul Davidson, "Are Grains of Sand in the Wheels of International Finance Sufficient To Do the Job When Boulders Are Often Required?" 107 ECONOMIC JOURNAL 671-86 (1997). Jacob A. Frenkel, Symposium,"Overview," in CHANGING CAPITAL MARKETS: IMPLICATIONS FOR MONETARY POLICY 394 (Federal Reserve Bank of Kansas City, 1993).

Many critics of the Tobin Tax proposal claim that such a tax would be unenforceable.[242] But if the objectives are compelling enough, there is no reason that such a program should not elicit wide international support and cooperation, and be effectively implemented, as was the Basle Accord on international capital standards among the ten leading central banks.[243] Most of the world's foreign exchange transactions take place in only five countries.[244] In addition, the same technology that speculators would use to try to evade a Tobin Tax could also be used to enforce such a tax program.[245]

This is another issue on which European leaders are far ahead of U.S. political leaders.[246] And in March 1999, the Canadian Parliament voted to endorse an international tax on financial transactions as part of a program to control currency speculation, making Canada the first G-7 government to formally, though largely symbolically, endorse such a currency transactions tax.[247]

Many of today's free market cheerleaders have criticized the Tobin Tax and other prudential restrictions on short-term portfolio capital flows by claiming that such solutions would prevent countries like Mexico and other emerging markets from getting the capital that they need for development.[248] However, a Tobin Tax of only one percent on foreign exchange transactions could raise more than $700 billion annually, even after counting for reduced trading volume and exemptions to finance the actual sale of real goods and services.[249] Many things could be done with such sums, including a healthy increase in long-term development assistance to developing countries.

D. *Increasing Global Liquidity with Special Drawing Rights*

Back in 1994, before the Mexican peso meltdown and the start of the global currency contagion, the Managing Director of the International Monetary Fund,

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242. Folkerts-Landau, et al., *supra* note 2, at 98-99.

243. *See* Solomon, *supra* note 146, at 414-35; Philip Arestis & Malcolm Sawyer, "How many cheers for the Tobin transactions tax?" 21 CAMBRIDGE J. OF ECO. 753-68 (1997).

244. Greider, *supra* note 22, at 234 (stating, "the City of London remains the world capital of foreign-exchange traders, with daily volume of $460 billion, nearly twice Wall Street's"), and 319 ("the most important foreign-exchange markets are in London, New York, Frankfurt, Tokyo, and Hong Kong").

245. Rodney Schmidt, "A Feasible Foreign Exchange Transactions Tax," (Ottawa: North-South Institute, 1997). All international financial transfers are transacted through Fedwire, CHIPS, or SWIFT, three U.S.-based clearing systems. *See* Gerard Wyrsch, "Treasury Regulation of International Wire Transfer," 20 DENVER J. INT'L L.& POL. 517-21 (1992). Access to the system could be conditioned upon paying a transaction tax. *See* Stephen Zamora, "Remarks,"86 AM.SOC'Y INT'L L.PROC. 201, 204 (1992)("If the world community adopts a closed-circuit system, it will be essential to enter that system in order to take part in the western financial system"). Every computer message or connection linked to the Internet can be identified and traced through a unique code called the Internet protocol address. Such computerized coding should be applied to transnational financial transactions. Edward Wyatt, "Fake Web Posting Leads to Fraud Charge," N.Y. Times, April 16, 1999, C1 (swift tracing of securities fraud suspect in fake posting on Internet demonstrates how difficult it is to venture into cyberspace without leaving footprints).

246. Barbara Crossette, "As World Leaders Confer on Poverty, Mitterand Urges New Tax," N.Y. TIMES, March 12, 1995, at 4.

247. "ADP Tobin Tax Wins," RESULTS (Press Release, March 24, 1999); Shawn McCarthy, "Liberals Vote in Favour of Currency Transaction Tax," GLOBE & MAIL, March 25, 1999, at B5.

248. *See* "The Case for Global Finance," ECONOMIST, Sept. 12, 1998, at 19, 20 (warning that controls would encourage capital flight); David R. Henderson, "Let Capital Flow Freely," WALL ST. J., Sept. 10, 1998, at A22 (capital controls drastically reduce the incentive for foreign investment).

249. David Felix, The Tobin Tax Proposal: Background, Issues and Prospects 13 (U.N. Development Programme for the World Summit for Social Development Policy Paper, March 1995).

Michel Camdessus proposed increasing "Special Drawing Rights," by $52 billion.[250] The Special Drawing Right (SDR), also known as "paper gold," is a global currency that was created by the IMF, first issued in 1970, and used as a reserve asset.[251]

Supporters of the Camdessus proposal recognized that the formerly communist and other poor countries had never received any initial allocation of SDRs.[252] It should be no surprise that many of those countries now lack the reserves with which to fend off speculative attacks against their currencies. Unfortunately, the Camdessus proposal was rejected, and Camdessus was reportedly "roundly criticized by the United States, Germany and Britain, which accused him of empire-building."[253]

It may, however, be more accurate to describe the Camdessus proposal as a failed attempt at empire-breaking, or at least to undermine the dominance of the U.S. dollar and several other major currencies. There is reason to conclude that the global monetary system favors First World surplus and creditor countries, as well as the United States, a chronic deficit country[254] that does not operate under the same constraints as most other deficit countries[255] since its own currency, the U.S. dollar, is the major reserve currency in the world.

According to a 1991 report by the BIS, capital flows have tended to exaggerate trade imbalances.[256] The U.S. and other major industrialized countries may perversely benefit as safe havens for capital fleeing from other countries that are experiencing extreme and acute financial and economic hardship. In contrast, deficit countries typically face capital outflows, as capital tries to beat (and thereby contributes to) a coming devaluation.[257] Attempts by developing countries to defend the value of their currencies with higher interest rates also contribute to larger trade and budget deficits,[258] thereby leaving those developing countries more dependent on hot money inflows.

The Camdessus proposal was not the first time that the IMF had attempted to increase the allocation of SDR's. Such proposals were supported throughout the 1970's by the IMF's previous managing director, Mr. J. de Larosiere.[259] Developing nations also called for increased SDR allocations as part of their demands for a New

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250. Paul Lewis, "Rich and Poor Nations Split on Aid Plan," N.Y. TIMES, Oct. 3, 1994, at D1, D2.

251. SDRs were first established by an amendment to the IMF Articles of Agreement that went into effect in 1970. Only about $28 billion in SDRs have ever been created. *See* DETLEV F. VAGTS, TRANSNATIONAL BUSINESS PROBLEMS 98 (1998).

252. Lewis, *supra* note 146.

253. Jeff Gerth & Elaine Sciolino, "I.M.F. Head: He Speaks, and Money Talks," N.Y. TIMES, April 4, 1996, at A1, A6; Peter Passell, "The Editorial Notebook: New Chips for Bankrupt Countries," March 23, 1984, at A26; Peter Passell, "Economic Scene: An Old Idea is Dusted Off to Aid Russia: Special Drawing Rights," N.Y.TIMES, July 7,1994, at D2.

254. Sylvia Nasar, "Trade Deficit Rises, Setting Record Early," N.Y. TIMES, Jan. 22, 1999, at C1.

255. Even huge and growing U.S. trade and current account deficits are not able to undermine the value of the U.S. dollar, which remains a safe haven during global financial turmoil. *See* Paul Lewis, "U.S. Said to Face Brunt of Economic Crisis," N.Y. TIMES, Oct. 9, 1999, at A8.

256. Philip Turner, "Capital Flows in the 1980s: A Survey of Major Trends," BIS Economic Papers, No. 30 (Basle: Bank for International Settlements, April 1991).

257. *Id.* U.S. interest rates may be lower than rates elsewhere because of such inflows of frightened capital: *See* DOUG HENWOOD, WALL STREET 108 (1997).

258. Sachs & Radelet, *supra* note 119, at A25; Canova & Turgeon, *supra* note 152.

259. MARGARET GARRITSEN DE VRIES, BALANCE OF PAYMENTS ADJUSTMENT, 1945 TO 1986: THE IMF EXPERIENCE 146, 175, 288-89 (1987).

International Economic Order (NIEO) in the context of the so-called North-South dialogue.[260]

Nevertheless, there has been no increase in the allocation of SDRs for nearly eighteen years.[261] Many of the countries that never received an SDR allocation now find themselves without sufficient reserves to fend off financial speculation.[262] Other developing countries that were given SDR allocations many years ago have been harmed by the way the global financial system unfairly punishes developing countries that are experiencing trade and/or budget deficits.[263]

E. Changing the Burdens of Adjustment: Recycling the Surpluses

When trade between nations remain chronically unbalanced, adjustment must be made by either deficit and/or surplus nations.[264] Another approach to the problem of providing sufficient long-term development capital would attempt to place the burden of adjustment on surplus countries by requiring them to recycle their reserves at low or no interest to deficit countries.

In the months leading up to the 1944 Bretton Woods conference, Keynes offered a proposal for an International Clearing Union which would have assessed an interest charge on excess reserves above a country's quota.[265] This, he believed, would remedy the defects in the pre-war adjustment mechanism that put an unequal burden of adjustment on deficit countries, thereby creating a contractionary pressure on world commerce.[266] Keynes claimed that the International Clearing Union plan would pressure adjustment on "any country whose balance of payments with the rest of the world is departing from equilibrium in either direction."[267]

Keynes's proposal was rejected at the Bretton Woods Conference, in favor of the American plan for the International Monetary Fund, which lacked an explicit mechanism for assessing charges against chronic surplus countries.[268] While the

260. NORTH-SOUTH: A PROGRAMME FOR SURVIVAL (Report of the Independent Commission on International Development Issues, MIT Press, 1980), at 211-212 (also known as the Brandt Commission); ROBERT L. ROTHSTEIN, GLOBAL BARGAINING 162 (1979); John Williamson, "The SDR Link," in THE NEW INTERNATIONAL ECONOMIC ORDER: THE NORTH-SOUTH DEBATE 81-104 (Jagdish N. Bhagwati, ed., MIT Press 1977).

261. "Special Drawing Rights," Survey Supplement on the Fund 1996, at <http://www.imf.org/external/pubs/ft/survey/sup0996/10sdr.html.> (last allocation was Jan. 1, 1981 when only SDR 4.1 billion was allocated).

262. In a particularly short-sighted stance, the U.S. Treasury Department opposes offering Russia any new IMF resources. David E. Sanger, "I.M.F. Relents on Aid to Russia, but U.S. Talks Tougher," N.Y. TIMES, March 30, 1999, at A6.

263. While each member country was originally allocated SDRs in proportion to its IMF quota (i.e., contribution), the IMF has discretionary power to expand the size of SDR allocations. Vagts, *supra* note 251, at 98; Lewis, supra note 146; Francis Stewart, "Back to Keynesianism: Reforming the IMF," IV WORLD POLICY J. 3 (1987), 465, 477.

264. Geoffrey Gilbert, "International Clearing Union," chapter in AN ENCYCLOPEDIA OF KEYNESIAN ECONOMICS 256, 257 (Thomas Cate, ed., Edward Elgar Pub.1997).

265. *Id.* at 257; James Crotty, "On Keynes and Capital Flight," 21 J. ECON. LITERATURE 59 (1983).

266. Robert Skidelsky, "Keynes's New Order: The Genesis of the Clearing Union," paper presented at Post-Keynesian Workshop Conference, June 26-July 1, 1998 (draft on file with author).

267. Gilbert, *supra* note 264, at 258.

268. *Id.* (stating that it was not surprising that the American plan prevailed or that it favored surplus countries, given the fact that the U.S. was a surplus country at the time, and enjoyed a "commanding political and economic position").

Articles do contain a "scarce currency clause" to shift some burden of adjustment on surplus countries, that provision has been largely ignored by the IMF.[269]

Throughout its existence, the IMF has consistently demonstrated a bias that places the complete burden of adjustment on deficit countries.[270] When a country's balance of payments is chronically in deficit and its reserves are declining, IMF consultations result in a classic austerity program under which the deficit country deflates its economy by raising interest rates, constraining the growth of the money supply, cutting back on government spending, and raising taxes. As the deficit country falls into recession, its citizens simply lose the means to continue to demand imports from the rest of the world. If the burdens of adjustment were distributed in a more equitable manner, then chronic surplus countries would be compelled to inflate their economies, import more goods and services from the deficit world, and/or recycle their surplus through long-term foreign investment and grants. Not surprisingly, developing countries also urged a more equitable distribution of the burdens of adjustment as part of their calls for a New International Economic Order (NIEO) in the 1970's.[271]

Japan is the classic example of a surplus country that had not recycled its surplus. Japan has out-traded the rest of the world, but it is sitting on a mountain of foreign reserves, and it is now choking on those surpluses.[272] In contrast, after World War II, the United States created the European Recovery Program, also known as the Marshall Plan, in which the U.S. government gave $13 billion (more than $150 billion in today's dollars) in foreign aid in just a four year period, from 1947 to 1951, to Western Europe to rebuild their economies.[273]

The Marshall Plan stimulus was highly successful; by 1951, the Marshall Plan countries had raised their industrial output by 40 percent.[274] We often forget how much West European and U.S. prosperity owes to public-sector investment in long-term infrastructure and technologies,[275] rather than short-term private hot-money flows. Moreover, post-war reconstruction of Western Europe occurred behind the protection of capital and currency controls.[276] Most of Western Europe did not

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269. *See* notes 288-291 infra and accompanying text.

270. NORTH-SOUTH, *supra* note 260, at 213-14.

271. *Id.* (IMF or others should devise means to encourage countries in current account surpluses to make "long-term loans to deficit countries that are undertaking needed adjustment").

272. Paul Abrahams, "Japanese Trade Surplus Climbs To Record $122bn," FINANCIAL TIMES, Jan. 26, 1999, 16; Wayne Angell, "How To Save Japan From Oversaving," WALL ST. J., June 22, 1998, A2. For an early recognition and explanation of Japan's economic weakness, see LYNN TURGEON, STATE AND DISCRIMINATION: THE OTHER SIDE OF THE COLD WAR 98 (1989).

273. LYNN TURGEON, BASTARD KEYNESIANISM: THE EVOLUTION OF ECONOMIC THINKING AND POLICYMAKING SINCE WORLD WAR II 7, 10, 59 (1996); J.M. JONES, THE FIFTEEN WEEKS (1955); Paul Davidson, "Reforming the world's money," 15 J. OF POST-KEYNESIAN ECO. 153, 156 (1992-93); Dimand, *supra* note 164, at 53 (on comparable US aid to Japan and the Anglo-American Financial Agreement, in which the US extended a $3.75 billion line of credit to Britain).

274. John Blum, et. al., THE NATIONAL EXPERIENCE 720 (1977).

275. U.S. post-war prosperity depended in significant part on military expenditures. In early 1950, President Truman signed a secret National Security Council memorandum NSC-68, drafted by Leon Keyseling, the chair of the Council of Economic Advisers, who was also instrumental in drafting the Employment Act of 1946. During the Kennedy administration, economic growth was once again spurred by military spending, space expenditures, and foreign aid. Turgeon, *supra* note 273, at 9-10, 13.17.

276. FRED L. BLOCK, THE ORIGINS OF INTERNATIONAL ECONOMIC DISORDER 109 (1977) (at the beginning of the 1950s "no major European currency was convertible"). *See* Garritsen de Vries, supra note 259, at 30-32.

achieve currency convertibility until the end of 1958;[277] capital controls were not lifted until later. In fact, some larger Western European countries did not fully remove capital controls until the 1990's, obviously well after achieving significant economic development.[278] Yet, today the IMF expects developing countries to reach economic take-off without restricting hot money capital flows.

In omitting the history and success of the Marshall Plan, today's dominant narratives about development serve to misinform public discussion about global capital markets. For instance, in editorializing that capital controls would scare off foreign capital, the Economist offered a photo of a construction site above the caption: "The benefit of foreign capital,"[279] by which the Economist meant "private" foreign capital. This view conveniently ignores the fact that much of Western Europe's post-war construction sites were the result of the Marshall Plan, a public-sector transfer of capital during a time of widespread currency and capital controls.

More revealing is how this view reflects the ethics of a hard core drug dealer. The euphoria of the short-term inflow somehow justifies the addiction,[280] no matter how ephemeral and illusory the prosperity appears after the crash, no matter the inevitable outcome of lost jobs and broken dreams. But the free market pushers of hot money flows do not expect to be the ones waking up with hangovers after the party is over. They will not even imagine such a fate. And their calls for more austerity for deficit countries that have fallen victim to the hot money addiction show that they refuse to accept any degree of responsibility for the results of their actions.[281]

Finally, it is instructive to once again compare the U.S. recycling of its surplus through the Marshall Plan with what Japan has done with its surplus.[282] By recycling its post-war surplus, the U.S. essentially accepted its share of the burden of adjustment. Western Europe used those Marshall Plan funds to purchase American products and to pay American construction companies, and in that way the Marshall Plan helped to sustain demand in the American economy as well.[283] Japan, on the other hand, has sat on its vast surplus of reserves, and instead of recycling through massive foreign aid,[284] Japan has sunk those funds into speculation in stock and real estate markets, and created financial bubbles that

277. *Id.*

278. Mussa & Goldstein, *supra* note 96, at 252.

279. "Time to turn off the tap?" ECONOMIST, Sept. 12, 1998, at 83, 85.

280. Stanley Fischer, "Capital Account Liberalization and the Role of the IMF," 3-5 (International Monetary Fund, Sept 1997); Robert E.Rubin, Remarks to the Dow Jones/ Wall Street Journal's Annual Confernece of the Americas, "Treasury News Press Release" (Oct.1, 1998) http://www.ustreas.gov/press/release/pr2729.html.

281. According to Franhois Gianviti, the General Counsel of the IMF, a basic tenet of the IMF is "that the resolution of external debt problems due to a major capital outflow was not the responsibility of the Fund, but was the responsibility of the country facing this outflow. In an age of liberalization of capital markets, these principles may seem antiquated, but they are still in force and must be observed." Gianviti, *supra* note 156, at 775.

282. *See* note 272 *infra* and accompanying text.

283. Turgeon, *supra* note 273, at 7, 10, 59.

284. Japan has only lately started to focus on recycling its surplus as part of a rescue package for Asia. Frances Williams, "UNCTAD Backs Japan's $100bn Asia aid plan," FINANCIAL TIMES, Oct. 21, 1998, at 9.; Stephen Fidler & Gillian Tett, "Japan joins World Bank to back Asia bonds," FINANCIAL TIMES, Nov. 2, 1998, at 1; *But see* Robert Wade & Frank Venerose, "The Resources Lie Within," Economist, Nov.7, 1998, p 19-21 (stating that in August of 1997, the U.S. Treasury effectively blocked $100 billion Japanese proposal for an Asian Monetary Fund to deal with Asian financial crisis).

inevitably burst.[285] The result has been a dangerous price deflation and recession in the world's second largest economy.[286] The major industrial countries, including the U.S., have also refused to recycle the reserves to ease Russia's transition from communism to market capitalism. It is not suprising that, in the aftermath of the Russian ruble collapse, many Russians now feel betrayed by the West.[287]

F. The Scarce Currency Clause and Other Trade Tactics

Finally, pressure could also be brought to bear on surplus countries to recycle their surpluses through the IMF Articles of Agreement. Article VII is the so-called "scarce currency clause" which permits the IMF to identify a chronic surplus country, declare its currency to be a scarce currency, and permit the rest of the world to discriminate against that country's imports.[288] Unfortunately, the scarce currency clause has never been invoked,[289] and consequently the IMF's approach to adjustment has been "highly asymmetrical" by placing the major burden of policy change and adjustment on deficit countries.[290] But a credible threat to effectively use the scarce currency clause might pressure a surplus country to recycle its reserves to deficit countries.[291]

Even international trade law supports the use of trade restrictions to maintain a balance of payments equilibrium if the restrictions comply with principles of nonselectivity and nondiscrimination. Article 12 of GATT, which has been adopted by the WTO, permits the use of import controls if the achievement and maintenance of full employment generates a high level of demand for imports that threaten a country's monetary reserves.[292] In order to safeguard its external financial position and achieve full employment, a contracting party "may restrict the quantity or value

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285. David P. Hamilton, "So, How Far Has Japan Fallen? Take A Look at These Numbers," WALL ST. J., July 2, 1998, at A19.

286. As a sign of the deflationary dangers in Japan, market interest rates fell below zero, an almost unheard of phenomenon, and the central bank purchased massive amounts of corporate debt in an attempt to stave off a liquidity squeeze. Gillian Tett & Edward Luce, "Yen deposit rates fall to below zero," FINANCIAL TIMES, Nov. 6, 1998, at 1 (depositors willing to accept sub-zero interest rates because of lack of other destinations for yen assets); Gillian Tett & Edward Luce, A Man and machine mystified by negative interest rates," FINANCIAL TIMES, Nov. 10, 1998, 6; Gillian Tett, "Bank of Japan steps in to buy more corporate debt," FINANCIAL TIMES, Oct. 30, 1998, at 22.

287. Michael Wines, "Hostility to U.S. is Now Popular with Russians," N.Y.TIMES, April 12, 1999, at A1, A11; *See also* notes 236-237.

288. *See* Articles, *supra* note 155, Article 7, Section 3(a)(authority to declare a general scarcity of a particular currency), and 3(b) (authorizing any member, after consultation with the Fund, to temporarily impose limitations on the freedom of exchange operations in the scarce currency). Block, *supra* note 274, at 52.

289. The IMF's General Counsel does not even mention the scarce currency clause as an exception to the Articles' prohibition against restrictions on current transactions. Gianviti, *supra* note 156, at 775-76.

290. Stewart, *supra* note 243, at 472. According to Sir Roy Harrod, Article VII, Section 3(b) may violate the multilateral principle at the base of the IMF, thereby making the operation of the scarce currency clause "a purely bilateral matter between each separate member and the scarce currency country." Roy F. Harrod, THE DOLLAR 110 (New York, Harcourt, Brace and Company, 1954).

291. During the 1970's, the IMF's managing director, Mr. De Larosiere urged surplus countries to increase their official development financing to help deficit countries develop infrastructure, their resource base, and sustain their living standards. Garritsen de Vries, *supra* note 259, at 174, 228.

292. Wynne Godley, "A Critical Imbalance in U.S. Trade: The U.S. Balance of Payments, International Indebtedness, and Economic Policy," Public Policy Brief no. 23, at 25 (Jerome Levy Economics Institute, Annandale-on-Hudson, 1995) (the WTO modifications to GATT Article 12 express a preference for "price-based" measures over quantitative controls).

of merchandise permitted to be imported."[293] If properly interpreted and applied, international trade law could be used to encourage chronic surplus countries to bear more of the burdens of adjustment.[294]

VII. FINDING OPPORTUNITY IN STABILITY

The full implications of the range of these proposed reforms are compelling. First and foremost, countries would be free to pursue and maintain economic growth and full employment without excessive fear of currency contagion and economic collapse. Most elected governments are presently caught between a rock and a hard place; they try to respond to the needs of their citizens, but also attempt to placate the demands of industrialized countries, multilateral institutions, and private financial markets.

A reformed and truly progressive global financial architecture that permits full employment would be a return to the original purposes of the Bretton Woods agreement.[295] It would begin to reverse the destructive trends towards high real interest rates, widespread underemployment, slow or declining economic growth, high poverty levels, and stagnant incomes that have beset submerging market countries in recent months and years.[296] These reforms would permit central banks to deliver much lower interest rates and elected governments to use fiscal policy for a broad range of economic and social purposes, without fear that capital would flee a country's currency. While such lower real interest rates would not be cherished by owners of financial capital, they would certainly prove very beneficial for the health of industrial capital and social enterprise.

A more stable regime would present different opportunities for social progress and private profit. There might not be the shotgun marriage of U.S. investment and Mexican banking, but there could be greater opportunities for prosperity and profit in the trade of real goods and services, and increased commerce and tourism between these neighbors.[297] Hopefully some of these broader questions will be introduced in discussions by considering the mechanisms by which today's financial regime has actually impeded progress in Mexico, the United States and around the globe, and by considering the challenges that confront our efforts to reform today's speculative regime into a more stable system of relations.

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293. *Id.*

294. One way for surplus countries to bear adjustment burdens would be encouraging them to import more from deficit countries. *See* Guy de Jonquieres, "US asks EU to ease import curbs to aid world economy," FINANCIAL TIMES, Oct. 19, 1998, at 1; Peter Montagnon & Sheila McNutty, "Attempts at APEC deal fail as Japan resists tariff cuts," FINANCIAL TIMES, Nov. 16, 1998, at 18.

295. *See* note 168 *infra* and accompanying text.

296. "Global Financial Crisis Will Trigger Jump in World Unemployment," (ILO Press Release, Sept. 24,1998) (http://www/ilo.org/public/english/235press/pr/1998/33.html) (more than one billion people – one-third of the world's labor force - are unemployed or underemployed).

297. As part of a program to restore monetary sovereignty and full employment, Keynes sympathized with calls to minimize economic and particularly financial entanglements. *See* John Maynard Keynes, "National Self-Sufficiency," in XXI THE COLLECTED WRITINGS OF JOHN MAYNARD KEYNES 233,236 (D.Moggridge, ed., 1982, MacMillan Cambridge University Press 1933) (stating, "Ideas, knowledge, art, hospitality, travel — these are the things which should of their nature be international. But . . . above all, let finance be primarily national.").