The Legal Implications of Financial Sector Reform in Emerging Capital Markets

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INTRODUCTION

This essay explores various legal implications of recent economic trends in "emerging capital markets." More specifically, this essay focuses on the sources of change leading to the creation of emerging market economies, their impact on global capital markets, and certain legal ramifications to be considered in this context.

Who actually belongs to the new international club of emerging capital markets? According to the World Bank, the Big Five emerging economies are China, India, Indonesia, Brazil, and Russia.1 These

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1. See Richard Stevenson, World Bank Report Sees Era of Emerging Economies: New Giants Include Brazil, India and Russia, N.Y. TIMES, Sept. 10, 1997, at D7 (discussing the World Bank's prediction that these countries will become economic powerhouses in the next quarter century); Robert Chote & Mark Suzman,
countries have made a critical transition, at least in the eyes of Western commentators and observers that will fundamentally alter their course in the next decade. Indeed, the World Bank estimates that by 2020 these five countries will double their exports, capturing up to 16.1 percent of total world output.\(^2\)

The transition from a “developing” country to an “emerging capital market” is a new and extremely important concept. This transition reflects an overall change in the general view of development. Emerging market economies are now perceived by the international community as offering a wealth of opportunities in trade, technology transfers, and foreign direct investment (“FDI”). Emerging capital markets also offer the foreign portfolio investor the potential for profit. Moreover—although most of these economies are located in the “developing” world (e.g., Brazil, Mexico, India, and Indonesia)—investing in these economies is no longer associated with the traditional notion of providing “development assistance” is provided to poorer nations. Today, “foreign investment” is increasingly replacing “foreign assistance.”

The preferential trade relations of the past, particularly between the developing world and the industrialized world, have broken down during the past decade. Trade relations and capital investments are now being “rationalized” in a new international economic order that does not conform to post-colonialist relations of the past. Capital, technology, and trade now flow toward new market opportunities wherever they may lie. For perhaps the first time in history, the playing field is level enough to allow anyone to obtain any commodity, product, or service from virtually anywhere by anyone.

Global market integration is a reality, best exemplified by the Internet. An unknown concept a decade ago, the Internet is now an indispensable tool used by millions of people across the globe, many of whom live in the developing world. These relatively new cross-
border exchanges are intensely liberating and have resulted in an explosion of information about emerging market economies. As a result, private actors in the industrialized world have expanded their entrepreneurial interests and forged new connections with the developing world. Thus, private entrepreneurs and investors have entered the development scene on an unprecedented scale. The movement toward more liberalized capital and technology flows is dramatic.

There are two potential causes for this occurrence. First, the failure of state-led economic intervention to produce sustainable development results is key in the developing world. Second, the developing world’s desperate need for capital to finance development has led to large-scale public borrowing from commercial and multilateral banking sources. Commercial lending to sovereign borrowers, however, not only failed to yield concrete development results, but also created a crushing debt burden for many developing nations. Debt servicing drained developing countries of their foreign exchange reserves and depleted the available capital for investment in their own industries and capital infrastructure.

In light of these past strategic failures, many emerging capital economies have critically reexamined the role of the state in encouraging sustained economic growth. State interventionist policies of the past are being abandoned in favor of retrenching the public sector through privatization. Additionally, the popularity of sovereign borrowing, while still an important source of international development financing, is waning. Developing nations now seek equity and bond financing from international money markets on a much more expanded scale. These trends have several important implications worth exploring.

I. THE FAILURE OF STATE-LED ECONOMIC INTERVENTION

Following independence, many newly formed nations in Africa, Asia, the Caribbean, and Latin America seemed to hold promise of self-sufficiency and economic empowerment. This promise in many cases, however, was never really fulfilled. Many nations, including Brazil, India, Mexico, and Tanzania, adopted protectionist policies to shield their markets from outside access and thereby gain self-sufficiency. The idea was to protect newly formed indigenous indus-
tries from collapse due to the competitive pressures of imports from more advanced industrialized nations. By capturing domestic markets, developing countries hoped that their local industries would form a broad industrial base and enable them to compete successfully in international markets.

Unfortunately, import substitution policies produced a number of serious consequences over time. First, by trying to serve their domestic markets exclusively, these developing countries failed to build up export industries that would have added badly needed foreign exchange to their treasury reserves. These countries also propped up selected industries through government subsidies, further protecting these industries from competitive market pressures. Their nascent industries, therefore, had no incentive to manufacture products that would be competitive on the international market. In the long run, these policies failed and did not bring about a dynamic, fast-paced economy that was originally envisioned. In fact, quite the contrary occurred in most cases as many of these developing countries experienced negative economic growth and increasing poverty. Thus, the intervention of the state in the productive sectors of the economy, whether agriculture, heavy industry, or light manufacturing did not seem to work.

The idea of state-led economic growth also has not worked well in the planned economies of Eastern Europe and the former Soviet Union. Beginning with the fall of the Berlin Wall in 1989, the planned economies of Eastern Europe and Central Asia literally imploded, collapsing from their own weight. The heavily state-subsidized industries gradually went bankrupt, as did idea of the Soviet-style State. Now the “transitional economies” of the former Soviet bloc are scrambling to restructure their economies along market-oriented lines. In addition, these countries have completely overhauled their systems of governance by adopting more democratic and representative forms of government.

Thus, we have seen a subtle (as in the cases of developing countries that followed import substitution and other protectionist policies) and a not so subtle (as in Eastern Europe and the former Soviet Union) indictment of the state’s ability to deliver the promise of development. In response, the role of the state is dramatically shifting in the developing world. Many states, particularly emerging capital
markets, are moving away from taking charge of the economy to facilitating economic growth along open market lines.

II. THE NEED FOR CAPITAL INVESTMENT

The developing world's nearly desperate need for capital to finance development has fueled the second principal cause underlying the transition from dependency to global interdependency. It is clear that enormous capital flows are necessary to restructure and modernize the economies of the developing world, whether through the building of modern roads, airports, and seaports; setting up telecommunications networks; or generating the power necessary to support industrial and consumer needs. State-owned enterprises are usually hopelessly undercapitalized and badly managed. Moreover, the past track records of many developing states demonstrate their inability to design, finance, or operate the capital infrastructure necessary to support modern economic growth.

In the past, developing countries have borrowed from commercial banks to finance their fledgling industries and to meet their import needs. Such borrowing, however, led to severe economic imbalances and political consequences, such as seen in Latin America. The Mexican fiscal crisis is a compelling example of this situation. Beginning in the 1980s, the International Monetary Fund ("IMF") and the International Bank for Reconstruction and Development (the "World Bank") urged Mexico to abandon its strategy of import substitution and dismantle its trade barriers to imported goods. The IMF urged the Mexican Government to decrease its heavy dependence on commercial loans and, instead, adopt a program of aggressive trade liberalization and industrialization primarily aimed at attracting hard currency through foreign investment.³

Once the industrialization boom began to fade in 1982, however, Mexico started borrowing heavily from commercial banks in industrialized countries which were then saturated with petrodollar deposits from the Middle East. At the time, lending to Mexico was an attractive option for commercial banks because Mexico is an oil

exporting country whose oil revenues could be easily collateralized.

By the mid to late 1980s, Mexico’s debt crisis became apparent. Even though Mexico followed harsh economic prescriptions of eliminating tax subsidies and import tariffs, cutting public expenditures by reducing government salaries, and instituting an aggressive privatization program, inflation continued to grow. Frequent currency devaluations and the continuing debt obligations being serviced by the Government of Mexico, including the repayment of tesobonos (i.e., government-issued bonds tied to the U.S. dollar but repayable in Mexican pesos), added to the inflationary pressures on the economy. Over forty percent of Mexico’s population slipped below the poverty line.

What was the human cost of the Mexican fiscal crisis? Devaluation and high interest rates caused hyperinflationary conditions that, in turn, led to a recession. Lost jobs during the austerity period over the past two years, foreclosed mortgages, and a sharply increased trade deficit were some of the results of the fiscal crisis. Moreover, Mexico’s capital market lacked the depth and the strength to survive a liquidity crisis of this magnitude. In hindsight, it is easy to say that the Mexican economy should have moved toward long-term investment rather than relying so heavily on volatile short-term financial instruments (such as tesobonos) for financing. Further, it can be argued that the IMF should have worked more closely with the Mexican government to correct trade and economic imbalances before reaching a crisis point, and installed social safety nets to protect the poor.

Unfortunately, Mexico did not have the benefit of hindsight. Faced with the imminent collapse of the economy due to a possible government default on the payment of outstanding tesobonos, the Mexican government received a cash infusion of $50.8 billion in 1995.

5. See id. at 562-63 & n.132.
6. See id. at 565.
consisting of the following: (1) $20 billion in loans and loan guarantees from the United States (collateralized by oil revenues generated by Petroleos Mexicanos, the state-owned oil refinery), (2) $17.8 billion from the IMF, (3) $10 billion from the Bank of International Settlements, (4) $2 billion from Canada and Latin American nations, and (5) $3 billion from commercial banks.\(^8\)

Despite Mexico's fiscal crisis, certain sectors—e.g., mining, power generation, and service industries—experienced growth rates of over 5.5 percent in 1996, and the economy rose over 4.4 percent for the first nine months of 1996 as compared to the same period in 1995.\(^9\) Mexico also paid back $1.5 billion of the $13.4 billion it borrowed from the IMF.\(^10\) Most importantly, however, on January 16, 1997, at a signing ceremony at the White House, the Mexican Government repaid the $13.5 billion it owed to the United States three years ahead of schedule.\(^11\) Paying off its loan led to a rally in stock and bond markets in Mexico, especially since Mexico's oil revenues were no longer being used to collateralize this debt obligation.\(^12\)

Mexico refinanced its high interest loans from the United States with Mexican-issued bonds with fairly high interest rates. Sales of these bonds to European, Asian, and American capital markets allowed Mexico to pay off its debt ahead of schedule. These new bonds will save Mexico about $100 million per year in interest payments otherwise payable to the U.S. Treasury. In addition, U.S. Treasury Secretary Robert Rubin reported that the Treasury made a $580 million profit on the United States loan to Mexico.\(^13\)

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8. See Carrasco & Thomas, supra note 4, at 568.
11. See id.
12. See Patricia Wertman, The Mexican Support Package: A Survey and Analysis, 5 No. 9 MEX. TRADE & L. REP. 19 (Sept. 1995) (discussing the safeguard mechanisms of the U.S. rescue package to Mexico, including the oil proceeds facility). Proceeds of oil exports from Petroleos Mexicanos ("PEMEX") and its two subsidiaries, PMI Comercio Internacional S.A. de C.V. and PMI Trading Ltd., were deposited into a special account at the Federal Reserve Bank of New York. See id.
13. See Wessel & Torres, supra note 10, at A10.
The developing world's experiment with sovereign borrowing from bilateral creditors (e.g., the governments of Organization for Economic Cooperation and Development ("OECD") members such as France, Germany, the United Kingdom, and the United States), and multilateral banking sources (e.g., the IMF and the World Bank), has also been less than satisfactory. Peru, for example, was a heavy borrower from bilateral creditors such as Canada, Finland, Germany, the Netherlands, Switzerland, and the United Kingdom. These sovereign creditors recently forgave about $275 million of Peruvian debt owed to them.\textsuperscript{14} Unfortunately, this amount is still less than one percent of Peru's overall debt of nearly $30 billion.\textsuperscript{15}

In 1985, President Garcia decided to limit debt servicing to not more than ten percent of total export earnings, ultimately defaulting on World Bank and IMF loans, which cut off further credit for Peru.\textsuperscript{16} Peru's debt crisis continued to deepen, and by 1993, debt service payments amounted to 63.7 percent of Peru's export earnings.\textsuperscript{17} In fact, heavy-handed borrowing from the World Bank led Peru to seek bridge loans from the United States and Japan in order to meet its over $1 billion in arrears to the IMF and the World Bank.\textsuperscript{18}

Beginning with the presidency of Alberto Fujimori, Peru engaged in an aggressive program for sovereign debt buy-backs of its own debt to reduce up to $1.4 billion of its overall external debt obligations.\textsuperscript{19} Peru also successfully managed to convert about $10 billion in commercial bank debt into Brady bonds, reducing commercial debt service payments to less than $350 million from previous levels of $600 million a year.\textsuperscript{20}

Peru also began an ambitious privatization program whereby in

\begin{footnotesize}
15. See id.
16. See id.
17. See id.
19. See Lapper, \textit{supra} note 14, at III.
20. See id.
\end{footnotesize}
February 1992 it began to divest its interest in 220 state-owned businesses.\(^\text{21}\) Peru formed a privatization fund in 1994 to manage the privatization process with Banco de Credito del Peru, Chase Manhattan Bank (U.S.), and Midland Bank (U.K.) acting as the initial investors.\(^\text{22}\) Peru met all of the IMF’s macro-economic targets in 1996, and is now devoting over $940 million from its government revenue generated by privatization toward social safety net issues and capital infrastructure growth.\(^\text{23}\)

As these examples illustrate, attempting to fuel the development process by borrowing from commercial or multilateral banks has not been altogether successful. In fact, the macro-economic imbalances resulting from the heavy debt overload incurred by developing countries, have, in most cases, led to the intervention of the IMF. The IMF’s imposition of structural adjustment programs and austerity measures has caused a great deal of disequilibrium in developing societies and, in some cases, made the promise of development even more elusive.

In light of the uneven results of using sovereign borrowing from international creditors as a strategy for development, many developing countries have curtailed sovereign borrowing from commercial and multilateral sources and have begun to rely on equity investment as a means of encouraging economic growth.\(^\text{24}\) Developing countries

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\(^{22}\) Stephen Fidler, *Fund Launched to Invest in Peru Privatization*, FIN. TIMES, Mar. 17, 1994, at 30 (reporting that the fund’s sponsors hoped to raise $250 million in cash and sovereign debt paper).


\(^{24}\) The World Bank is currently questioning its continued relevance in a post-Cold War era as a lender to its sovereign members. Now that global capital markets are more integrated and international capital is highly mobile, the role of the World Bank is being redefined. Should the World Bank support “non-emerging markets” through its lending policies, move away from lending altogether and concentrate on loan guarantees, or find other means of facilitating private investments? In time, the World Bank’s function may diminish in scope, which may ultimately lead to an expansion of the roles of the International Finance Corporation (“IFC”) and the Multilateral Investment Guarantee Agency (“MIGA”), two organizations that provide private sector-related financing and political risk insurance, respectively.
are now trying to attract equity investment from private investors who will become their partners in development, if only for the sole purpose of protecting their investment. International equity investment—rather than public sector borrowing—has emerged as the new road to development. As a result, open access to international finance markets has become increasingly important to both developing and transitional economies.

The impact of this policy shift has been expressed in very dramatic terms. In 1990, official development assistance in the form of bilateral aid primarily from OECD countries amounted to nearly $65 billion, whereas private investment in developing countries was less than half that amount, totaling about $30 billion. Last year, official development assistance slipped to $45 billion, but private investment burgeoned to approximately $245 billion. The tables of public and private finance in the developing world have turned.

The IMF estimates that FDI is the biggest component of private investment in Asian, Latin American, and Eastern European countries, rising to $100 billion in 1996, from $48.8 billion in 1993. In comparison, net portfolio investment in these economies was a modest $43.2 billion in 1996. The foreign sources of finance seemed inexhaustible for emerging market economies benefiting from the tidal wave of foreign investment in their economies, until the balloon


26. See id. (noting the significant change in the source of funds). A study entitled, "The Reality of Aid," based on economic figures of the 21 members of the Organization for Economic Cooperation and Development ("OECD") which was released in the United States by Interaction, a Washington-based organization, reported that official aid from OECD countries fell to $55.8 billion in 1996, a drop of $3.8 billion. According to this study, Japan reduced its official aid by 15 percent between 1995-96, and the United States had the lowest ratio of foreign assistance of all OECD countries. Further, the study found that private aid donations increased spectacularly from $80 billion to $234 billion in 1996. Thus, privately funded assistance furnished to developing countries was four times greater than that provided by official government sources.

27. See Bernard Wysocki, Jr., Distant Echoes: Asian Woes Will Take a Toll on Economies Around the World, WALL ST. J. EUR., Oct. 31, 1997, at 1 (reporting that the developing world worries that the Asian economic crisis will affect it through an overall decline in direct investment).

28. See id. (noting that the increase in investment in the 1990s produced steady economic growth).
burst in late 1997.

The first black cloud on the horizon materialized on July 2, 1997, when Thailand severed the link of its local currency, the baht, to a basket of hard currencies.\(^{29}\) The baht went into a free fall, not unlike the Mexican peso devaluation in December 1994.

When the dollar rose earlier this year, Southeast Asian "tigers" were forced to increase their interest rates.\(^{30}\) Most of the Southeast Asian economies fought valiantly to defend their currencies, but serious competition from China and shrinking export markets for their goods forced a devaluation of their currencies in order to lower the cost of production for exports.\(^{31}\) As a result, the short-term borrowing binge from 1993 to 1996 to finance long-term investments in real estate and other non-export sectors\(^{32}\) became a financial crisis in the making. Rental income from real estate ventures, for example, was earned in local currency, but dollar denominated loans in support of these investments had to be repaid in hard currency by converting devalued currencies.\(^{33}\)

Beleaguered by currency crises stemming from a variety of complex reasons, the Hong Kong, Indonesian, Malaysian, Philippine, Singaporean, South Korean, and Thai stock markets began collapsing like a house of cards, necessitating emergency bail-out packages for Thailand ($17.2 billion), Indonesia ($22 billion), and South Korea ($20 billion).\(^{34}\) Over time, the IMF bail-out package for Indonesia

\(^{29}\) See Many Asian Stock Markets Fall Sharply: Currencies Also Lower; Trading-Rule Change by Malaysia Faulted, N.Y. TIMES, Aug. 29, 1997, at C2 (reporting that the developing world worries that the Asian economic crisis will affect it through an overall decline in direct investment).

\(^{30}\) See The Asian Miracle: Is It Over?, ECONOMIST, Mar. 1, 1997 (discussing the historic growth of the Asian "tigers," economies which have gained a remarkable amount of strength in the last thirty years). Originally, the Asian tigers included Hong Kong, Singapore, South Korea, and Taiwan. Now, the group includes China, Indonesia, Malaysia, and Thailand as well. See also Jeffrey D. Sachs, Asia's Miracle is Alive and Well: Despite Currency Jitters, the Region’s Economies Will Keep on Booming, TIME, Sept. 29, 1997, at 36.

\(^{31}\) See Jeffrey Sachs, The Wrong Medicine for Asia, N.Y. TIMES, Nov. 3, 1997, at A23 (arguing that the IMF must take a different approach to the Asian crisis).

\(^{32}\) See id. (describing the trends that set up the conditions for the crisis).

\(^{33}\) See id. (detailing the dilemma the Asian investors faced).

\(^{34}\) See Art Pine, Unsettled Markets: U.S. to Join the IMF Rescue of Indonesia Asia: Its $3 Billion Contribution is Part of a $22-Billion Contingency Package,
soared to $40 billion. Ultimately, the IMF bail-out package for Korea ballooned to over $57 billion, $24 billion of which has been guaranteed by the South Korean Government. International inves-

L.A. TIMES, Oct. 31, 1997, at D1 (reporting that most of the funds for the Indonesia bailout will come from a billion dollar loan from the IMF and a six to eight billion dollar loan from the World Bank and the Asian Development Bank); see also John Burton, Korean Pride Battered by Plea for $20bn IMF Rescue, FIN. TIMES, Nov. 22, 1997, at 3 (noting that some analysts wonder if the amount requested will be enough to help South Korea through the immediate crisis).


Indeed, as a response to IMF prescriptions for economic recovery, Indonesia has been attempting to shore up its banking industry and improve its overall financial sector by announcing the merger of five private banks as the start of a consolidation of over 240 banks nation-wide. See Seth Mydans, Indonesia Begins the Rescue and Consolidation of Banks: 5 To Merge in Spirit of the I.M.F. Accord, N.Y. TIMES, Jan. 20, 1998, at D3. Moreover, the Indonesian Ministry of Finance announced a new package of reforms aimed at strengthening the banking sector by guaranteeing bank deposits, eliminating restrictions on the foreign ownership of banks, and creating a special agency to oversee the rehabilitation of banks to be merged or liquidated. See Seth Mydans, Indonesia Introduces Key Banking Changes: Guarantees on Deposits and an End to Limits On Foreign Ownership, N.Y. TIMES, Jan. 27, 1998, at D7.


Further, the IMF advocates high interest rates and fiscal austerity for Korea in order to restore confidence in the Korean monetary system and reverse the depreciation of its currency. See Peter Passell, Economic Scene: South Korea is Facing Some Difficult Choices, N.Y.TIMES, Dec. 18, 1997, at D2. These proposed austerity measures have been criticized already by Jeffrey Sachs, Director of the Harvard Institute for International Development, as restricting consumption and investment rather than focusing on restructuring Korea’s industrial and financial sectors. See id. This view is echoed by Joseph Stiglitz, Chief Economist of the World Bank. He argues that in light of the fact that Asian nations have high savings rates, high productivity, and a strong work ethic, such nations should not be treated in the same
tors panicked at the collapsing stock market prices in Southeast Asia and withdrew $1.4 billion from international equity funds in two days alone in October 1997. This amount represents about 4 percent of the total $380 billion held by such international funds. Further, the sovereign debt of Thailand, Indonesia, and Korea was downgraded to "junk" status, seriously affecting their ability to raise capital in international markets, thus forcing them from being an "economic darling to financial pariah in a breathtakingly short period."

A detailed analysis of the complexities of the Southeast Asian currency crises is outside the scope of this essay. However, the temptation of grouping all East Asian countries into a generic financial melt-down should be avoided. The recent currency crisis which first affected Thailand in the summer of 1997, and whose contagion later affected Hong Kong, Indonesia, Korea, the Philippines, and others has an underlying complexity that is fact-specific to each case. To establish a better conceptual grasp of the situation, it may be useful to rely on Fred Bergsten, Director of the Institute for International Economics, who has grouped East Asian countries affected by the recent crisis into three separate categories: the Northeast Asians (Japan and Korea, which have major financial structural problems); the Southeast Asians (Thailand, Indonesia, the Philippines, and Malaysia, which have large external deficits and fragile financial sectors); and the Strong Center (China, Hong Kong, Taiwan, and Singapore, which have large trade surpluses and foreign exchange reserves).
Further, Mr. Bergsten traces the origins of the crisis to the devaluation of the Chinese currency by about forty percent in 1994, and the depreciation of the Japanese yen by over twenty-five percent beginning in 1995. The drop in value of the two major currencies in the region put tremendous pressure on the trade positions of the countries which were later affected by the currency crises, produced large external deficits, and precipitated the collapse of internally weak financial sectors in these nations.

Fortunately, these East Asian markets rebounded after months of tottering on the brink of financial collapse, giving renewed international confidence in the ability of these emerging markets to recover from the worst of the economic panic of the past several months. The IMF may have played a pivotal role in stabilizing these economies by making immediate hard currency infusions available to these nations and by imposing a strict agenda of fiscal disciplinary measures: history will be the judge. Yet, even at this preliminary stage, it is becoming clear that the close cooperation between government, industry, and long-term investment planning for critical sectors of the economy—aspects which were long considered to be sources of strengths for the Southeast Asian tigers—has resulted in less transparency and accountability.

41. See Bergsten, supra note 40, at 1.
43. Indeed, the primacy of the IMF’s role in this crisis was implicitly recognized when Japan’s proposal to establish a separate Asia fund, parallel in function to the IMF, was rejected. The international community agreed that first-line financing should be provided by the IMF with second-line financing to be furnished by Asian nations. See Edward Gargan, Asian Nations Affirm I.M.F. as Primary Provider of Aid: Japanese Plan for Separate Fund is Rejected, N.Y. TIMES, Nov. 20, 1997, at D2.
44. See Clay Chandler, Asian Economies: More Myth than Miracle? New Problems Causing Some of Region’s Nations to Rethink Reliance on Japanese Model, WASH. POST, Nov. 25, 1997, at A1 (noting that “cozy relations” are susceptible to exploitation by friends and relatives of government officials). Some commentators have argued that cronyism, nepotism, and rulership through economic “combines” not only create non-transparent economic conditions making such economies vulnerable to unforeseen financial disasters, but that the recent Asian economic crisis is the region’s initiation into the principles of “democratic capitalism.” The term “democratic capitalism” has been defined to mean, “the combination of a free political society and an open economic system, without control by government-business conspiracy or partnership.” See A.M. Rosenthal, On
The underregulation of private capital markets in these emerging markets has also been a systemic problem. In addition, reckless lending practices and inadequate government supervision has led to weakened banking sectors in these countries, an open invitation to financial disaster. Although not a final or complete solution, both Secretary Rubin and the IMF have urged the disclosure of more financial information by the governments of these emerging market economies. Indeed, the IMF has proposed an early-warning system to ward off economic crises. The system is targeted at 23 emerging capital economies, including Brazil, China, Malaysia, Mexico, Peru, South Korea, and Thailand, who borrow most heavily from international capital markets. IMF officials now urge developing nations to publish periodic financial reports providing accurate information on inflation, the money supply, and foreign exchange reserves so that economic warning signs can be detected early.

The above discussion illustrates the trend in emerging economies to rely on international capital markets to finance their development needs. Foreign investment capital, in theory at least, is now available to most developing nations, with very few exceptions. In order to be perceived as an "emerging capital market" capable of attracting equity financing both domestically and internationally, a developing country must first establish the preconditions of a market economy. Developing countries must actively create a business climate that meets the expectations of the foreign investor; such changes have legal as well as economic ramifications. Developing countries are now considering policy measures and options that differ significantly from their past decision-making in order to attract foreign investors.

45. See Sachs, supra note 31, at A23.
47. See Sanger, supra note 25, at A1; see also IMF Proposes Plan for Early Warning of Economic Crises, WALL ST. J., Feb. 12, 1996, at C18.
48. See IMF Proposes Plan for Early Warning of Economic Crisis, supra note 47, at C18.
49. See id.
50. This discussion will not address the collapsed states of Burundi, Rwanda, Somalia, or the Sudan, nor the authoritarian regimes of Iran, Iraq, North Korea, and Serbia. (This list is illustrative rather than exhaustive).
If, however, their objective is to create stable and sustainable capital markets, they must contend with fierce competition because the stakes are so high.

III. THE NEED FOR STRUCTURAL REFORM

The foregoing discussion was a prelude to introducing the need for structural legal reform in developing societies. Although the phrase “structural legal reform” may connote many different meanings, for purposes of this discussion, the scope of the term is limited to legal reforms necessary to create and sustain emerging capital markets in order to attract foreign equity investment. The new agenda of market integration on a global scale, however, requires a great deal of commitment to very deep and radical changes. This essay proposes three such changes: (1) changing the role of the state, (2) instituting a Rule of Law regime, and (3) encouraging a process of democratization within an emerging capital market.

A. REDEFINING THE ROLE OF THE STATE

The first change requires a careful and studied redefinition of the role of the state in the development process. For the most part, despite the best of intentions, state intervention in the productive sectors of the economy has led to uneven, and sometimes disastrous, results. When newly independent African, Asian, Caribbean, and Latin American countries were starting their development process several decades ago, the state was usually the only creditworthy entity that had any borrowing or other corporate abilities. However, times have drastically changed since then.

The state should be encouraged, in most cases, to move out of manufacturing and other productive sectors of the economy. Eliminating the planned economies of the past, privatizing state-owned industries, and encouraging domestic capital savings and investment will facilitate this transition. Additionally, the governments of developing countries should refocus their attention and resources on regulating markets and facilitating North-South linkages, rather than taking direct responsibility for economic production. Retrenching the public sector, however, does not mean that private sector development is automatically enhanced. The state, for example, may have to retool tax codes, enact company law provisions, pass updated bank-
ruptcy laws, and change the regulatory environment in order to effect a smooth transition to private sector-led economic growth.

Controlling corruption is another serious problem most developing states need to confront in this reform process. Corruption not only distorts and impedes the development process but also repels the market forces that developing countries are now seeking to attract. Rooting out corruption may, ultimately, pose the greatest challenge to developing countries especially after decades of entrenched corruption. Instilling a sense of economic discipline by eliminating corruption, however, is a necessary, albeit painful, task.

Despite recent trends, the state has not withered away or faded from the emerging market scene. The state is still a key player and should not be overwhelmed by the magnitude and pace of these new trends in development. Governments should seek to create new partnerships with private individuals, non-government organizations, and international capital markets to form sustainable linkages for the future in the areas of technology, trade, and finance. Indeed, the role of technology in this context cannot be overstated especially since capital flows are often technology-driven. The challenges facing the governments of developing countries are both complex and exciting.

B. A RULE OF LAW REGIME

Secondly, developing countries need to implement and institutionalize a Rule of Law regime. A country should consider the expectations of the foreign investor and whether it has the means to meet those expectations. Although the question of conforming to the expectations of the foreign investor seems harmless enough, it is not.

The “menu” of expectations that a foreign investor has in evaluating investment opportunities in a particular developing country is quite predictable. The criteria include: (1) a stable economy that is relatively free of political disturbances and interference, (2) a freely convertible currency, (3) repatriable profits, and (4) a legal system that provides adequate redress for conflicts or disputes. This seems simple enough, but the apparent simplicity belies the underlying complexity of these expectations.

To attract the market-driven forces that continue to fuel the process of development, host countries must face the challenge of creating a disciplined business environment. In most developing countries
in Latin America, Africa, and certain parts of Asia, this may entail, at the very least, modernizing their existing legal, regulatory, and judicial systems. At its worst, it may necessitate the creation of entirely new macro-legal systems as in the transitional societies of Eastern Europe and the former Soviet Union. Most transitional economies have already instituted a complete overhaul of their property and commercial laws since the underlying idea of capitalism rests on the individual’s right to own private property. In addition, these countries have drafted and passed laws in support of a new macro-legal framework in areas such as contract, bankruptcy, trade, intellectual property rights, banking, taxation, foreign investment, securities and commodities, labor, the environment, and international dispute settlement. Further, transitional economies are also creating regulatory schemes and appropriate enforcement mechanisms in support of newly passed laws.

Both developing and transitional economies need to ensure that they have a well-educated and independent judiciary able to interpret and enforce new laws which are enacted to support the needs of a market-driven economy. To that end, the curricula of local law schools may need to change in order to conform to the new legal infrastructure that such governments have put in place.

Building a Rule of Law regime is a truly daunting task and one that is being undertaken without the careful planning that should accompany legal reforms. Most importantly, many reforms are being implemented in a haphazard fashion without the benefit of legal history to support these changes. The common law concepts behind the ideas of private property, contracts, and corporate law are complex and stem from the historical experience of the West from the transition of feudalism to mercantile capitalism to more advanced forms of capitalism. These historical transitions occurred over the course of several centuries, not over the course of several years. Therefore, the legislation that is being enacted wholesale by certain transitional economies lacks a historical grounding.

Moreover, in certain instances, importing the legal concepts and the legal institutional framework of the West to attract investment capital may not serve developing countries well. The legal concepts being introduced in Mongolia, for example, in response to the need for antitrust laws to avoid the formation of private monopolies during
the process of privatization, may not fit into Mongolia's existing legal framework and may thereby create the possibility for confusion and uncertainty. In the immediate future, there is bound to be a certain degree of confusion, but in the long-term analysis, do these countries have any other viable choice but to institute these structural legal reforms?

Although the idea of adopting Western forms of legal thought and institutions may seem logical and has often been identified by legal experts as an impediment to progress, at what cost does this transition take place? The cost may be unexpectedly high, especially when indigenous or traditional forms of legal thought and governance are sacrificed in the process. A developing country's own legal conceptual framework, legal history, and institutions may lose their authenticity in this process, and that loss could be permanent. If the idea of global integration includes the complete transformation of the developing world's legal systems to conform with the legal constructs of the West, this trend should cause us some sense of misgiving.

Most of the developing world is already fraught with overriding conflicts of laws, especially where traditional or indigenous forms of legal institutions are pitted against "received" forms of Western legal traditions, a colonial legacy of the developing world. The new demands of becoming an emerging capital market are now being superimposed on this underlying tension. This has led to a great deal of uncertainty and conflict over whether a developing country should change the legal infrastructure and, if so, how and when? Should developing countries address the inherent contradictions in their present legal systems before attempting to incorporate a system of even more complex and alien laws to appease a foreign investor in search of an attractive investment opportunity?

These questions are not easy to answer. Perhaps more disturbingly, however, it is not clear that such questions are being asked by developing countries, or by Western legal experts, in the first place. In the drive to become an emerging capital market and attract foreign capital investment, many developing countries are instituting a new Rule of Law regime. As laudable as their intentions may be, the true nature of what may be sacrificed in this process should not be totally disregarded. By eliminating traditional legal customs, practices, and laws, these countries risk losing a vital part of their legal history and
culture. Developing countries should balance these trade-offs carefully. This balancing act is made even more difficult since competition for new capital investment is fierce. Thus, emerging capital markets face the possibility that if they do not integrate successfully into the global market, their entire development process may be jeopardized. Many developing countries are discovering that an important part of their legal identity may be lost along the way.

C. ENCOURAGING DEMOCRATIZATION

Finally, developing countries are also reconsidering the question of democratization. Why is democratization so often linked to the question of development in the first place? In terms of international global markets, any kind of risk, including political risk, affects the viability of foreign investment in that economy. Therefore, developing countries need to minimize political risks to protect such investments. The host government needs to assure foreign investors that the country is stable, transparent, and not subject to military coups or violent overthrows. Essentially, foreign investors want to know that the host government will honor their commitments and institute agreed-upon economic and other reforms. Of course, in some countries, such as India and many parts of Africa, democratic institutions have been a vibrant and intrinsic part of the fabric of civil society, and no transition to democracy is necessary.

On a more philosophical level, democratization puts the individual on center stage as the sole actor and arbiter of his or her political life. Asserting one’s economic liberty and political freedom permits the expression of one’s free will, be it in the marketplace or in the polling booth. The power of choice and the centrality of the individual within the development process is thus secured. For most of the developing world, however, the individual is not at the center of any universe, either socially or politically. The interests, needs, and expressions of the individual are subsumed within the larger context of family, community, or ethnic/religious group. The idea of putting the individual at the center of the development process—whether it is economic, political, or legal change—may be difficult in some developing societies. It is, nevertheless, a concept that developing societies, in one way or another, will have to confront in their own time.
CONCLUSION

The foregoing discussion links the ideas of structural, economic, and legal reform and the democratic means of governance in a dynamic continuum. Macro-economic reform along with macro-legal change must go hand in hand with greater democratic freedoms if the individual is to express both his or her political and economic will. It is important to remember, however, what is being sacrificed along the way.

Achieving sustainable development is a challenging proposition and is successful when the benefits are balanced against the required sacrifices. When too much is sacrificed too quickly in order to achieve a Western-imposed ideal of economic prosperity, the development equation will ultimately collapse. A developing country needs to make some shrewd calculations concerning the quid pro quo, so to speak, of development.

To make development within a society lasting and truly meaningful, progress must reflect the individual ideals and aspirations of all its peoples. That is a complex challenge, but there is a role for all of us to play in bringing about full and participatory development. We all have a vital part and a vital stake in welcoming the new millennium.