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Globalization in Comparative Perspective: A New Approach to Comparative Law and Legal Thought

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Globalization in Comparative Perspective

A New Approach to Comparative Law & Legal Thought

Tamara Lothian & Katharina Pistor

Motivation

“Globalization in Comparative Perspective” began as an idea for a jointly taught course that would build on our interests and comparative strengths in international finance, investment banking and economic and legal development. Law and legal thought play a crucial role in these different practical and conceptual activities, yet the nature and significance of this role is commonly misunderstood. We felt that a course that explores the relationships among law, finance and development in contemporary emerging market countries would be useful both to the professional development of students and practitioners in law and related fields, and to the deepening of our understanding of legal and institutional diversity in developed and developing countries.

The Course

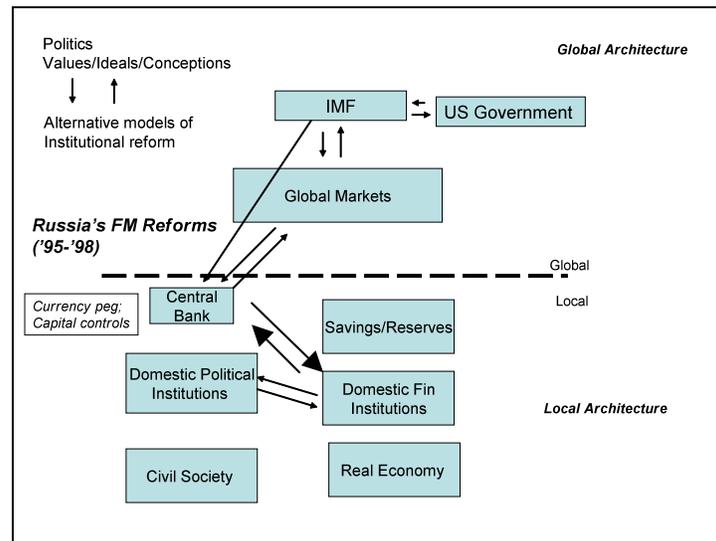
Our course focuses on both the development of financial markets and the structuring of international financial transactions in four leading emerging market countries (Russia, Mexico, China and India.) The juxtaposition is deliberate. A central premise of the course is that financial markets both shape and are shaped by major financial transactions, and that lawyers, bankers and policy makers engaged in these transactions simultaneously engage – whether they know it or not – in the creation of different kinds of financial markets and different programs of financial reform. To do so effectively requires more than an understanding of abstract models of social organization (for example, the economist’s understanding of a market or command economy.) It requires a lawyer’s understanding of legal and institutional detail – the legal and institutional details of existing models of social organization, or the legal and institutional details of alternative models of social organization and social practice.

The core theme of our course is the design and development of alternative practices and arrangements in the area of (emerging market) financial organization. This theme has counterparts in every other area of law and social practice (which is something we could explore in our discussion). The comparative aspect involves the interpretation and analysis of different historically available models (for example, the Anglo-American style of corporate governance and financial regulation; or the East Asian model of government-sponsored financial development and organization.) The legal aspect involves the deconstruction of these different models into their component legal parts. For example, American corporate governance and financial regulation involves strong managers, distant shareholders, a market in corporate control, legal protection for shareholder rights and arms-length regulation and adjudication. The East Asian model differs on each of these points, substituting government for market direction, and relying on state-owned banks, directed credit, and the use of the financial system more generally to promote industrial and development policy.

Moreover, the whole is more than the sum of the parts. Every lawyer knows that every existing economic and political regime is built upon a multitude of legally constructed practices and arrangements. These practices and arrangements can be changed, piece-by-piece and part-by-part. In the contemporary emerging market countries, the practices and arrangements used to define financial markets are – as a matter of fact – subject to an ongoing process of re-definition and re-organization in the ordinary course of financial market development and globalization. The practice of piece-meal reform and institutional change is thus a natural bi-product of international legal and financial practice.

We explore these themes through a series of case studies in international finance and financial market development in different emerging market countries. The goal of these case studies is to explore the interaction between the structuring of financial transactions and the development of different styles of financial organization. Below we sketch two cases: Russia and Argentina.

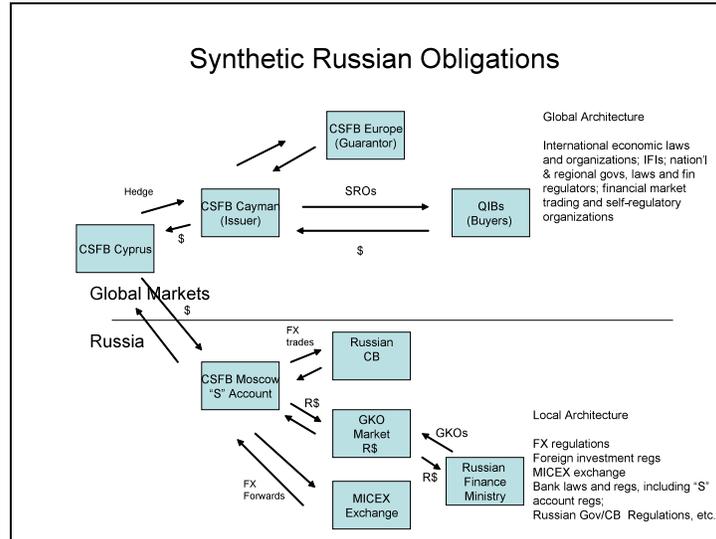
Slide 1: Russia's Partial Financial Sector Reform in the mid 1990s



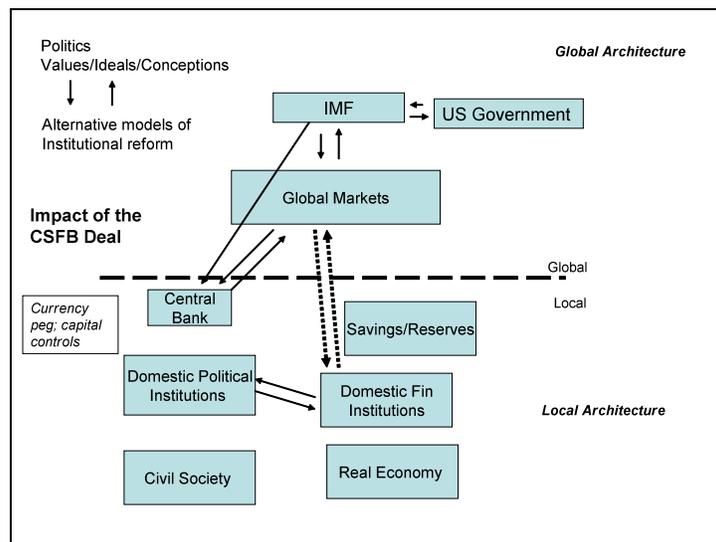
Russia's financial market development is intertwined with its post-soviet reforms. At the outset, financial markets were largely absent. The elected reform path focused on rapid privatization of the real sector and the lowering of entry barriers for new financial institutions (banks, voucher funds, etc.). The government created a set of new institutions for trade in securities, but abstained from attempts to actively restructure the existing real economy or financial institutions. A critical problem was the funding of the state budget. Privatization did not create much revenue; after stabilization was achieved in 1995, recourse to the printing press was cut off; yet, a viable tax system had not been established and much of the economy was too weak to generate taxable income. The Russian government therefore reverted increasingly to debt finance (in addition to loans made available by the IMF), both internationally (in the form of Eurobonds) and domestically (through GKO). Access by foreign investors to the domestic market was limited by a combination of capital controls and rules governing investment in the domestic securities market. The GKO market, however, appeared increasingly attractive to foreign portfolio investors in search of high yields and diversification out of domestic portfolio investments. The CSFB Synthetic Bond Deal provided the legal and financial engineering for giving foreign portfolio investors access to the domestic GKO market. As

a result of this innovation, more than USD 20 billion of international portfolio capital was channeled into the Russian domestic securities system in a period of less than 2 years.

Slide 2: Deal Making as Market Creation: CSFB Synthetic Bonds



Slide 3: The Deal in Context

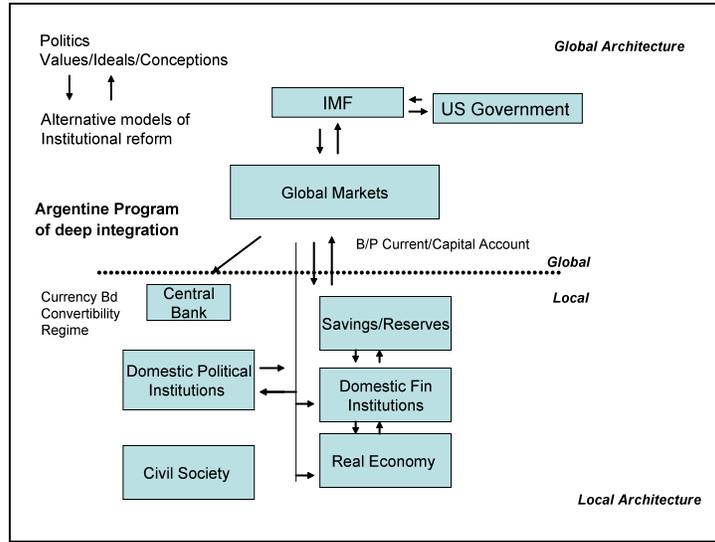


The Synthetic Bond Transaction took advantage of pre-existing institutions – both at the global and at the local level, but stitched them together in new and previously unknown fashion. CSFB negotiated with the Russian government the regulatory regime for the “S-Account”, which allowed CSFB to bring dollars into the country, exchange them for Rubles (through transactions with local banks, subject to the approval of the Central Bank), invest the Rubles into Ruble-denominated GKO’s (in accordance with the regulatory regime for GKO’s) and purchase hedging contracts for the proceeds of these Ruble-denominated investments (which were provided by both local banks and the Moscow Currency Exchange, a consortium of Russian banks and the Moscow City Government). Global investors (Qualified Institutional Buyers) received “Synthetic Bonds” that were pegged to the Russian GKO’s, issued by an already existing Cayman Island subsidiary of CSFB. The transaction thus *created* a global market in Ruble denominated GKO’s. When Russia finally defaulted on its *domestic* debt, international investors lost as their notes had been linked to the GKO’s.

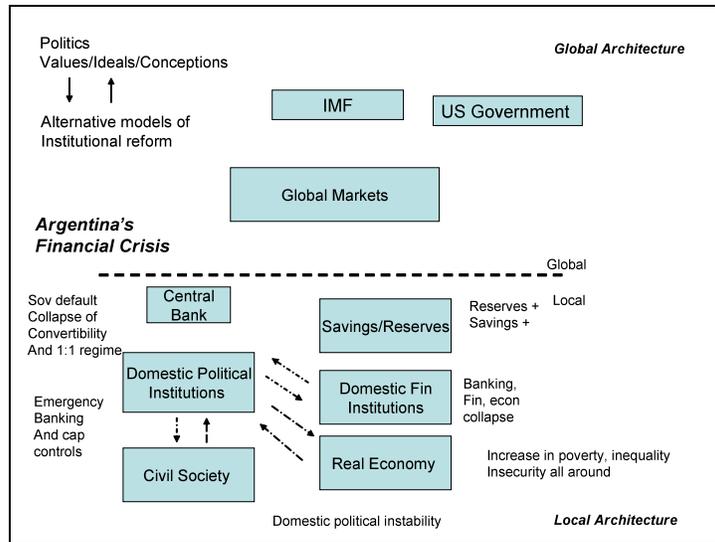
Equally telling, however, is what markets this transaction did *not* create. First, the transaction did not create a domestic market for longer term government debt. Nor did the market for foreign-funded GKO’s include legal or institutional mechanisms that might have cushioned the impact of any sudden change in foreign investor enthusiasm for Russia’s domestic securities market. Second, the transaction had virtually no impact on the real economy, as became evident in the aftermath of the 1998 financial crisis, when the real economy escaped unscathed – and benefiting from the downward adjustment of the currency after the peg was relaxed. None of this was inevitable or dictated by markets as the markets did not pre-exist the transactions that created them.

Slides 4 & 5: Alternative Approach to FM Reform: The Case of Argentina

Argentina's Program of Financial Reform and Globalization



Argentina's Financial Crisis



Argentina's financial meltdown occurred 3 years after the Russian financial crisis, and in a country, which – unlike Russia – had implemented all the “right” reforms from privatization to de-regulation to unqualified liberalization of financial markets. The combined effect of these reforms was that government entities at the federal, provincial

and local levels, as well as private financial and non-financial entities had, in principle, unfettered access to international financial markets – and at their choice in peso-denominated or dollar-denominated currency instruments. Argentina thus exemplifies a system that was deeply penetrated by global finance.

Many legal and institutional innovations contributed to the Argentine program of market-oriented reform. At the center stood the currency board and convertibility regime, which pegged the peso to the US dollar on a 1 to 1 basis, legally prohibited the government from increasing the money supply unless backed by foreign reserves, and made the peso freely convertible into US dollars at the pegged exchange rate of 1:1. This institutional structure was designed to overcome high inflation that had plagued the economy in the 1980s. In the late 1990s the same arrangement prevented an adjustment to real changes in the dollar-peso exchange rate, adversely affecting the competitiveness of Argentina's real sector in international markets. Moreover, when the peg finally broke, it led to a collapse of the financial system as well as the real sector. Again, none of this was inevitable. A currency board could have been designed to allow for periodic assessments of maintaining a strict peg or allowing the currency to float. Moreover, capital controls could have been put in place in order to limit foreign capital inflows as Chile had done before. None of these decision would have come without costs, but nor did the decisions that were taken.

Generalizations

We suggest that it is possible – though challenging – to design a law school course that is capable of providing students and practitioners in law and related disciplines the practical and conceptual tools they need to understand how complex financial transactions and decisions are situated in diverse economic and political settings and can help – actively and intelligently - to shape those settings. The premise of our approach is that the organization and development of law and political economy in the contemporary emerging market countries can be understood as a product (not simply the sum) of a multitude of legally-defined policies and arrangements, each of which can take different form, with different consequences both for the structure and development of markets and

for the failure and success of alternative programs of economic and political reform. Markets are legally and institutionally defined. They are the products of human agency and collective choice, acting within limits set by existing economic and political forces, but never fully determined by those forces. The ability to imagine and to create new legal and institutional arrangements is one of the variables in the equation. It is the variable that the most successful lawyers in practice build their careers on and that law schools (and legal scholarship more generally) should place greater emphasis on.

Suggesting that markets, economies and political systems are created by law and legal institutions does not imply that history does not matter. To the contrary, it re-enforces the importance of historical trajectories of reform and the role of historically-contingent policies, ideas and arrangements in the construction of currently existing economic and political orders. Contrary to prevailing views, however, we suggest that these “path-dependencies” create not only constraints, but also opportunities, which can be used as points of departure for the development of many different kinds of contemporary economic and political orders, especially when informed by the kind of comparative legal and institutional analysis we attempt to develop together with students in our class.

These insights have important implications for the study and practice of law in both developing and developed countries. We acknowledge the existence of legal and institutional diversity in the organization of economic and financial systems. We recognize that some policies and arrangements may be better than others for achieving the values and ideals adopted at different times and different places. But we do not abandon each country to its fate, or, conversely, insist that the only road forward is the road we know from our own experience in the western industrial democracies. Instead, we explore, in institutional, empirical and normative detail, the different approaches that have been or might be taken by contemporary emerging market countries. In this approach, lawyers are at the center rather than the periphery of the analysis, allowing them/us to use their comparative advantage in inventing and imagining new legal and institutional solutions to problems in law and political economy, both in the developing and developed world.