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# Capital inflows, bank deregulation and financial institutions: from repression to crash? Argentina and South Korea compared.

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# Capital inflows, bank deregulation and financial institutions: from repression to crash? Argentina and South Korea compared.

Leonardo E. Stanley

## Summary

The present financial crisis can trace its roots to the early 1970s, when the collapse of the *Bretton Woods* (BW) institutions interrupted a system based on fixed exchange rates and capital account controls. Under the new framework, developing countries were urged to liberalize their capital account, deregulate their financial sector and, sooner than later, institutionalize it. This paper analyzes the liberalization wave from a wide perspective, focusing on the experiences of two emerging economies: Argentina and the Republic of Korea.

At the macro level, Argentina reintroduced several measures directed to control short-term capital movements after the 2001 crisis, though some have been partially reversed since 2003. The new administration also opted for a managed exchange rate, a policy option that permitted Argentina to obtain a twin surplus at the fiscal and external front along reinstating foreign exchange accumulation. The international financial crisis and perceived macro inconsistency began to attenuate economic agent's enthusiasm and investor confidence. Henceforth, in a regional context marked by the return of capitals inflows Argentina observed a revival in capital flights (i.e.: increasing dollarization at private agents portfolios).

Liberalization in Korea started in the late 1980s. A conjunction of stable foreign exchange plus attractive interest rates pulled foreign investors into the country, at the cost of increasing financial vulnerability. At the aftermath of the 1997 financial crisis Korea turned definitively toward the neoliberal path, moving away from capital controls. The effectiveness of this option has been contested as the crisis revisited the country in 2008. As massive capitals inflows return, authorities have no option but to (re) introduce prudential regulatory measures.

At the micro level, the paper succinctly explores the transformation experienced in both countries' financial markets. The Argentinean and Korean experiences also illustrate that the prospects of maturity and currency mismatch problems are important under a deregulated environment. Henceforth, regulating cross-border transactions becomes imperative. Korea´s recent measures to restrict private borrowing are working in that direction. From an institutional perspective, Argentina´s experience could be illuminating for the costs imposed on their policy space and after observing all legal constraints proposed at the KORUS FTA.

"*Unrestrained convertibility in the capital account is in fact a luxury, desirable in itself, enjoyed by a handful of countries which have either a very developed or a very underdeveloped domestic financial system*". Carlos Diaz – Alejandro, 1985

## 1. Introduction

In the past, foreign shocks spread to national economies mainly through trade channels, and transmission of such shocks took time. After globalization and increasing capital account liberalization, most cross-border transactions are financial related, delinked from trade. Henceforth, shocks arrive at domestic financial markets almost immediately. When coupled with financial deregulation, completely freeing capital flows has been shown to increase the probability of a crisis. But, as stated by Diaz Alejandro (1985), destabilizing effects are accentuated in poorly developed domestic financial systems. In lieu of the latest and recent crises, many emerging economies are taking a more nuanced opinion on the role of short-term capital inflows, recognizing that financial funds may give rise to asset bubbles and macro instability.

To some extent, the actual situation began its trend after the collapse of the *Bretton Woods* system in the earliest 1970s, which led to a new flexible exchange rate system and the dismantling of controls on capital flows. The shift towards free markets was accelerated with the coming to power of Margaret Thatcher and Ronald Reagan in 1979 and 1980 respectively. The predominant neoliberal vision perceived increased financial activity as beneficial for development and, Keynesian-Mynskian caveats were set aside. By the same token, the efficient market hypothesis substituted Keynes´ *beauty contest* parabola of how financial market actually behaves. That was the central message arriving from the developed world, and being vociferated by the International Financial Institutions (IFIs), throughout a collective of instructions enclosed under the Washington Consensus. Henceforth, rescue packages originated at the International Monetary Fund (IMF) or World Bank (WB) lending practices, introduced new clauses of financial deregulation and capital account convertibility. Under this new framework, developing countries were urged to liberalize their capital accounts and deregulate their financial sector. In other words, a micro-macro initiative was under operation. Sooner than later Wall Street and the US government began to move forwards the institutionalization of this scenario, both at the bilateral and multilateral foray.

International investment agreement (IIAs)[1] would swiftly become the centre of a new legal framework supporting the liberalization task[2]. Financial liberalization was also integrated at the

[1] Among others, IIAs include the following: Bilateral Investment Treaties (BITs), Free Trade Agreements (FTAs), Regional Trade Agreements (RTAs), and Economic Partnership Agreements (EPAs).

[2] Initially built-in a bilateral format, investment liberalization will spread later under a free trade scheme. Particularly, following the signal of the North American Free Trade Agreement (NAFTA).

Uruguay round, and numerous new instruments were soon launched at the newly created WTO, including those introduced by the General Agreement on Trade in Services (GATS)[3]. Henceforth, either on a bilateral or multilateral basis, developing and emerging economies passed through a [legal or institutional] process of financial deregulation and capital account liberalization.

The paper analyses the liberalization wave, at both macro and micro levels, and its legal consequences for developing and emerging countries. In a first section, it considers the financial, monetary and exchange rate policy options adopted by Argentina and South Korea (hereinafter Korea) in the recent past. This section also attempts to reflect upon how these countries were adjusting their policy choices when the Impossible Trinity (commonly referred as the Trilemma) became fully operative. The second section introduces a brief analysis of banking regulation and market structure in both countries; a brief analysis of financial repression, and a discussion regarding how this system of transformation altered the conducts if private agents (if at all). Certainly, the deepening of domestic and international financial markets has influenced the responses posed by the trilemma. In a third section, the paper looks at the financial services institutional transformation launched at both the multilateral and bilateral level—which may be preventing the regulation of capital flows across the developing world. In a final section some conclusions are drawn, scrutinizing the experiences of market liberalization and financial crash suffered by Argentina and Korea in recent years, and how certain rules dampen their latest policy responses.

[3] It might be also consider the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), and the Trade-Related Investment Measures Agreements (TRIMs)

## 2. A Micro–Macro approach

### 2.1 Macro: The case for capital controls

The impossible trinity is a term used in discussing the problems associated with creating a stable international financial system. It refers to the impossibility to achieve simultaneously the contradicting but desirable goals of fixing its exchange rate (to foster stabilization of trade and growth), of running an independent monetary policy (to achieve domestic monetary policy goals) and of freeing capital flows (for an optimal allocation of resources). According to the Mundell-Fleming model, a small, open economy cannot achieve all three of these policy goals at the same time: in pursuing any two of these goals, a nation must forgo the third.

Under the golden standard, the *trilemma* was fully operative. Capital flows were almost unfettered and currencies tied to gold. Henceforth, monetary policy was absent from the policy discussion authorities incapable to manipulate interest rates. External shocks were passing through the national economy without further restrictions, and economies progressed alongside capital inflows movements. The financial architecture settled down as *Bretton Woods* radically altered the previous scheme, introducing a more stable albeit more closed regime. National currencies were now pegged to the US dollar, which in turn, was tied to gold. International financial markets were small, highly regulated and generally categorized as "repressed" given that monetary authorities determined credit allocation. Nearly all countries maintained capital controls on both inflows and outflows[4]". But, at the beginning of the seventies the previous consensus collapsed, and perceptions [over the costs and benefits of regulate the capital account] began to change drastically. The system of fixed exchange rates broke down, and a new market-oriented era began. The new global scenario was one of high liquidity. The world observed an unprecedented growth in financial products, and private capital flows began to return to the South. Unfortunately, such an abrupt change came deprived of provisions, neither at the macro front nor in the regulatory sphere. Developing countries were clearly less protected, henceforth; they became exposed to further macro instability along with being deprived of accurate regulatory tools. Among the consequences generated by uncontrolled capital movements is their effect on the real exchange rate, by increasing volatility with significant costs to the "real" economy[5]. In an open market environment interest rate

[4] Capital controls could take a quantitative or qualitative character, affecting inflows and / or outflows. Among the regulations affecting capital inflows could be mentioned those introducing minimum stay requirement or limiting local agents (domestic firms and residents) from borrowing in foreign currencies, or the introduction of unremunerated reserve requirement (URR). Exchange controls or taxes / restrictions on outflows could be cited as an example of management techniques affecting outflows. Price-based techniques include the Tobin tax or the URR, whereas quantitative – based measures include quantitative limits on foreign ownership of domestic companies stock or reporting requirement and quantitative limits on borrowing from abroad.

[5] Uncontrolled capital flows could alternative be mitigated by encouraging local firms to invest abroad (outward FDI) or by maintaining a permissive policy towards capital controls, thus helping investors to invest abroad (i.e.: capital flights). A sterilization policy, although fiscal costs could become important if widely used.

determination becomes problematic, furthermore, as monetary authorities were now simultaneously dealing with monetary and exchange rate consequences. Henceforth, policy – makers were confronted with a new problem when dealing with inflation. Interest rate tools have limited affective since raising short-term rates induce speculators from everywhere to enter into the market (the so-called "*carry-trade*" effect)[6]. Exchange rate influence is not only limited on trade related effects, but additionally its impact spawned to net capital gains obtained by private agents external holdings, the so –called "*valuation effect*" (Lane and Shambaugh, 2009).

Despite these concerns, a true *crusade* against financial regulation and capital controls was unleashed, and monetary authorities at developing countries were seen as the territory to conquest. Financial services also advanced in that direction, and liberalization and deregulation transformed the banking industry. A regulated financial system finally transformed into a market based one, and financial institutions converted into powerful actors. The financial boom began to transform into a bust, somewhere between 2004 to 2008. Risk seeking by voracious investors reached unprecedented levels, and capital inflows began to flood into emerging markets profiting from high yields and *calm waters*. And then, the Lehman Brothers collapse, and the "*perfect storm*" began. Exceptions remained important among developing countries and regions alike. In particular, with respect to the exchange rate system to be followed, the opportunity and degree of capital account opening, or concerning the monetary policy[7]. In the last years, the accumulation of international reserves gave more leeway to emerging economies (Frenkel, 2007; Aizenman et.al., 2009)[8], but exceptions remained active as the Korean case exemplifies. Nonetheless, and above all, those playing at the vertex of the triangle became more exposed, whereas cautious middle range countries performed relatively well.

The following paragraphs introduce the experiences of Argentina and Korea, including the main policy responses introduced by authorities in both countries in the aftermath of their crises. Political options were certainly extreme during the nineties, and Argentina certainly qualifies as an example of the "vertex policy approach". Policy options at Korea were refocused as well, particularly at the aftermath of Asian crisis. The experience obtained on those days, including

[6] In a carry trade, an investor holds a high-yielding ("target") currency assets financed with a low-yielding ("funding") currency liability. In the present context, Argentinean Peso and Korean won qualifies are considered target currency, whereas US dollar and Japanese yen are considered as funding currencies.

[7] In this sense, several countries in Asia pegged their currency with the dollar in order to catching up the US economy. Asian countries were also particularly cautious with respect to the policy timing, maintaining controls on the capital account for years. Sequencing was as well important in deregulating the banking system at Asian countries, as nowadays exemplifies China.

[8] *Frenkel* introduces a thought-provoking idea: the trilemma is false as a general theorem. According the author, in a context signed by an excess supply of international currency, the central bank can simultaneously control the exchange rate and the interest rate (Frenkel, 2007; page 30). *Aizenman*, by contrast, sustain that international reserves reduce the constraints faced by the (open) economy but the trilemma remains latent. In particular, international reserves can reduce both the probability of a sudden stop and the deep of the resulting output collapse when the sudden stop occurs (Aizenman et.al., 2009; page 2).

the ineffectiveness of the orthodox policies being introduced, put Korean authorities on alert, and opting from moving away from the vertexes.

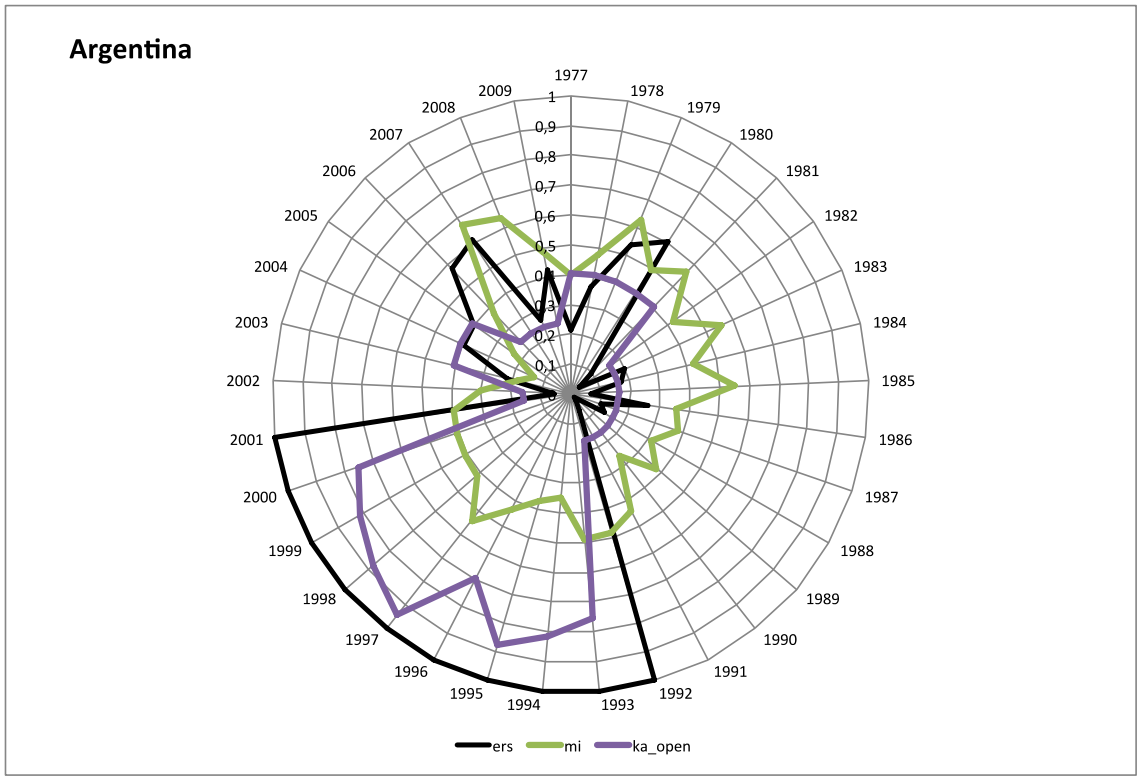
### *Argentina*

Until the mid-1970s Argentina followed a strategy of import substitution industrialization (ISI), performing an average 4,4% of GDP growth during 1964-74 period. Under the ISI model the state became an important economic actor, including a leading role in the financial front through the fixing of interest rates and by rationing resources to (selected) investors or projects. Capital inflows and outflows were strictly limited, including important restrictions on remittances and limitations in foreign exchange transactions. Notwithstanding, in 1975 the country suffered a huge macroeconomic crisis. In order to curb the crisis the dictatorship launched an ambitious liberalization package, a shock therapy to remove or reduce a number of controls over the economy. Such measures included the reduction of trade barriers, the gradual removal of capital controls and the freeing of interest rates. The stabilization program introduced a new exchange rate regime: a preannounced rate of crawl (the "tablita"), captivating financial investors the most, as it promised important and (apparently) safe returns. But, ignoring theoretical premises, the programme led to a substantial real exchange rate appreciation, inducing a rapid increase in current account deficits and foreign debts (Frenkel and Rapetti, 2010)[9]. The program's credibility went under stress, in particular, after the Central Bank of Argentina (CBA) was forced to rescue several banks from systematic failure in March 1980. Problems aggravated thereafter, as the monetary authority was required to finance the public sector deficit. Henceforth, and in order to seduce investors, the government raised interest rates on peso deposits[10]. An opportunity for arbitrage was evident. At early 1981, a balance of payment crisis marked the end for the dictatorship duple *Videla – Martinez de Hoz*.

**Graph 1: Trilemma index for Argentina (1977-2009)**

[9] The monetary approach to the balance of payments was the theoretical support behind "*the tablita*". The scheme stipulated the irrelevance of the credit account position, since capital inflows would automatically and passively compensate for any deficit.

[10] Under the new legislation passed in 1977, banks were allowed to accept deposits in foreign currencies by non-residents. Initially, investors were obliged to kept deposits for a year, but the requirement was soon relaxed until its abandonment in 1979. A year later, the interest rate differential adjusted by preannounced depreciation was approximately 3% per month.




Source: Aizenmann et. al. (2009)[11]

At the aftermath of the crisis, the Argentina economy reversed prior liberalization measures, reintroducing most of the previously dismantled controls, including those affecting the capital account. Nevertheless, the economy remained very constrained due to high external debt and low commodity prices[12]. In the spring of 1989, inflation spiralled out of control, and President *R. Alfonsín* was forced to resign six months ahead of schedule. With the arrival of C. Menem in power, and after a series of failed stabilization attempts, the government introduced the *convertibility plan*, establishing a one-to-one dollar-peso exchange rate (AR$/U$1), guaranteeing the full convertibility of pesos into U$ dollars[13]. Dollarization of the local economy was highly encouraged by the national government, by making it legally feasible to write contracts in foreign currencies and to allow foreign currencies to be used as an alternative means of payments. After introducing the plan the government discarded monetary policy autonomy, forcing authorities to keep interest rates and inflation closely aligned to the US. More or less simultaneously, Argentina embarked in a process of trade deregulation and liberalization, and tariffs and other barriers to trade in goods were (practically) eliminated.

[11] The three variables measured in the graph are: i) ERSs: Exchange rate stability, ii) MI: monetary Independence and, iii) KA_OPEN: Financial Openness / Integration. Further details at the Annex, more information at http://web.pdx.edu/~ito/trilemma_indexes.htm

[12] During the period 1981-89, average real GDP decreased by -0,7 % annually.

[13] The plan required the monetary base to be backed with international reserves (2/3) and dollar-denominated Argentina central bank securities at market prices (1/3). Argentina's Central Bank was effectively converted into a currency board that could only issue domestic currency in exchange for foreign currency at a fixed rate.

Likewise, authorities lifted almost all previous restrictions on international investments, including those banning or limiting foreign participation in key economic sectors[14]. Finally, the government also eased all previous regulations affecting the movement of capital, including previous requirements on exporters' earnings in the country and / or allowing private firms acting in the utilities sector to expatriate their windfall gains without any exchange control restraint.

Privatization soon became one of the pillars of the new economic programme, enabling the government to reduce its external debt, remove the financial liabilities generated by public utilities from the public sphere, and last, but not least, attract fresh FDI[15]. Argentina's macroeconomic performance improved notably and the country entered a solid upward spiral of growth, with the economy expanding by around 9% per year in 1994 and, also experiencing an important increase in productivity. However, the exposure of the economy to international capital flows volatility was immense[16]. And, suddenly, the Tequila crisis arrived. The economy slumped, with gross domestic product falling by 2,8 % in 1995. IFIs lead by the IMF granted a voluminous financial assistance package (Frenkel and Rappeti, 2010) but also Menem and Cavallo played tough enough, allowing interest rates to increase up to 40% and raising (unpopular) taxes (basically, VAT rate from 18 to 21 per cent). In other words, they demonstrated their commitment to the model and to the economy orthodoxy. Contentedly the challenge was quickly overcome, and the economy recovered in 1996. Henceforth, Argentina became a showcase of successful reform in LAC and President Menem was hailed as an example to follow in the 1998 annual meeting of the IMF and World Bank in Washington[17]. Thinks were not equal, however, after a new series of financial crises broke out, starting in East Asia. In 1998, the Argentine economy slipped into a downward spiral towards depression and crisis. A year later, Argentina's GDP experienced a 3,4% plunge, mostly driven by a massive fall in investment (13,6%). Decreasing consumption, on the other hand, relapsed trade balance deficits as imports almost collapsed. As public debt keep increasing (surpassing the $ 100 billion barrier in 1999), foreign investors began to carefully observe the Argentinean fiscal

[14] In 1994, the country granted foreign investors the national treatment status, including those participating at the financial sector.

[15] Privatization revenues, on the other hand, postponed the resolution of the historical low saving rate of the Argentina. The problem will become more accurate at the end of the nineties, when public deficits began to increase *pari passu* with foreign investors demands of greater fiscal discipline.

[16] The scope for sterilization operations was reduced under the convertibility plan.

[17] As exemplified by the enthusiastically words pronounced by the former IMF Director *Michael Camdenssus* at the occasion "[*I*]*n many respects the experience of Argentina in recent years has been exemplary, including in particular the adoption of the proper strategy at the beginning of the 1990s and the very courageous adaptation of it when the tequila crisis put the overall subcontinent at risk of major turmoil… [S]o clearly, Argentina has a story to tell the world: a story which is about the importance of fiscal discipline, of structural change, and of monetary policy rigorously maintained*".

deficit[18]. However, as the government offered higher yields they kept on buying Argentinean bonds[19]. Once the new elected government of *De la Rua* took office in December 1999 recession was installed. Nevertheless, investing banks and rating agencies maintained their "interest" in the country, continuing the selling of Argentinean bonds all around the world, particularly among less informed investors in Europe and Japan[20,21]. In order to sustain the convertibility plan, the government also agreed to a three-year standby arrangement for $ 7,2 billion in March 2000, augmented by $ 13,7 billion at January 2001. The bailout agreement (the "blindaje") was an initiative commonly introduced by the Fund in order to assist emerging countries at financial distress[22]. In September 2001, the IMF loan was newly extended up to $ 22 billion from which, $ 3 billion were used in support of a possible debt-restructuring operation.

Macroeconomic perceptions among the domestic private sector plunged and unemployment and social indicators worsened as the new economic team chose to reassure foreign investors' expectations by introducing a tightening fiscal policy. But the new package did not help in reversing pessimistic perceptions from economic agents, condemning the convertibility to fall. A significant reversal in capital flows take place thereafter.

[18] Fiscal deficit should be attributed to the raising debt service faced by the Argentinean government, which originally responded to external shocks. Firstly, by the US Fed´s began to increase short-term interest rates in February 1994. Secondly, a series of financial collapses beginning in Mexico, raise the costs of funds for emerging markets. Finally, rates continue to increase as investors began to doubt over the sustainability of the Argentinean currency board.

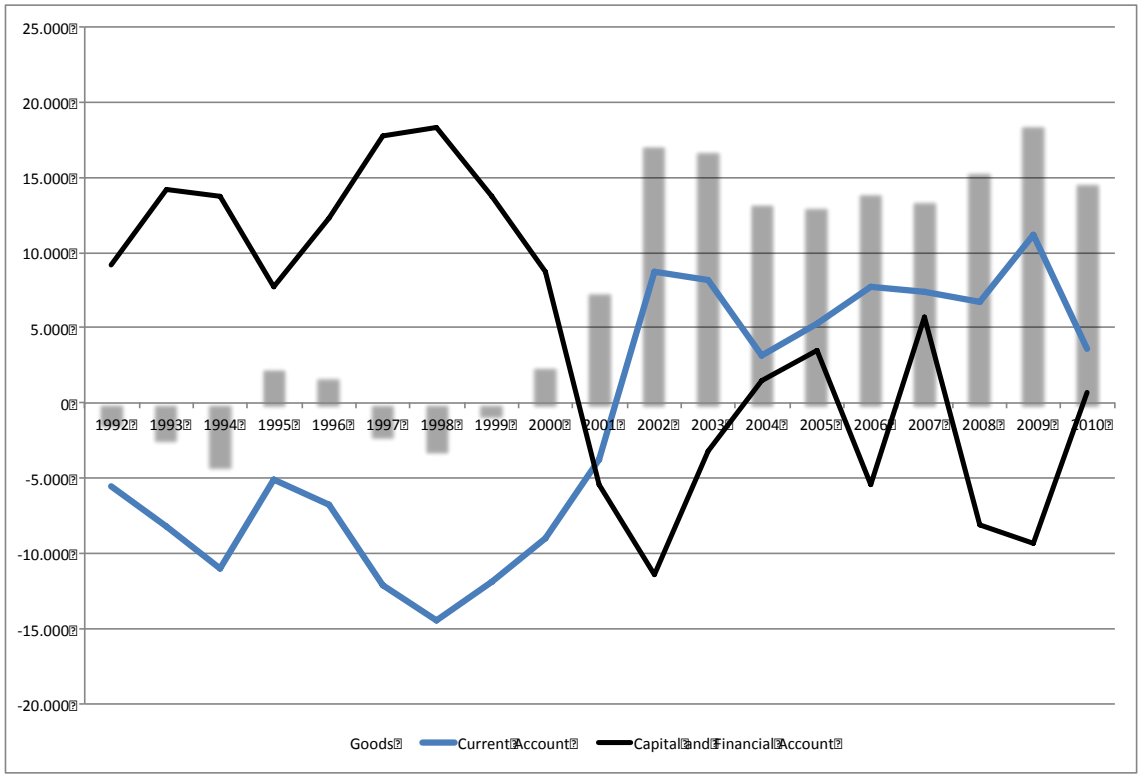
[19] The influence of investment banks and rating agencies in attracting foreign investors was superb, although they certainly not forced local authorities to avoid a prudent fiscal policy.

[20] Syndicated investment banks tailored a number of their offering to Europe attracted by regulatory leaks, and small investors appetite for higher yields. Consequently, Italian retail investors were among those convinced to sue Argentine at the (international) tribunals to claim for the full payment of their bonds.

[21] From January to September 2000, the Argentine government borrowed nearly $ 6 billion by selling dollar-denominated bonds, at interest rate from 11 3/8 % to 12 % It borrowed another $ 4 billion – plus by selling euro denominated bonds, mostly to European retail investors, paying annual interest of 8 1/8 % to 10 ¼ % (Blustein, 2005).

[22] By fixing the loan at U$ 14 billion, the bank surpassed in excess Argentine's lending limits.

**Graph 2: Argentina – Trade and Capital Account trends (1992-2010)**




Source: INDEC

In a last ditch effort to rescue the convertibility plan and impede massive capital outflows and a generalized run on banks, the government introduced financial controls (termed the "*corralito*" or little corral"). Foreign currency transactions were also prohibited, preventing local and foreign investors from making transfers funds abroad. A month later, in January 2002, the peso was officially devalued, and all the bank deposits and debts were converted in pesos (now called "*corralon*"), and transformed into bonds[23]. When the crisis finally installed, the government launched several controls, reversing previous liberalization measures on the capital account[24]. In particular, it became mandatory to convert to domestic currency 100% of foreign exchange receipts from goods and services exports. The CBA introduced a 90 days residence requirement [to be further extended up to 1-year residence period][25] and a 30% tax on incoming funds. Restrictions were also affecting commercial operations; as currencies requirements from importers required BCRA approval whereas exporters were obliged to vend their currencies earnings to the BCRA.

[23] Dollar deposits were converted at 1,4 pesos to the dollar, while dollar loans were subject to one-to-one conversions.

[24] As Argentina maintained its capital account open until the latest days of the convertibility scheme, outflows of capital augmented during 2000-01 ($ 23 billions left the country in that period). Controls were reintroduced at December 2001, but funds poured out throughout the stock market channel.

[25] BCRA A/3712 September 2002. It would be extended to 180 days one year later (BCRA A/3972), and up to 1 year (BCRA A/4359).

The crisis led Argentina to default on his external debt mounting U$ 102,6 billion, however. Thereinafter, economic authorities initiated a true pilgrimage towards the main financial markets and international courts that, unfortunately, continues. At the time, Argentinean bonds encompassed almost ¼ of total emerging market debt, involving more than 150 bonds issued in seven currencies under eight jurisdictions[26]. Bondholders surpassed 700,000 including retail and institutional holders, and some investment funds or vulture investors who typically buy up the grossly undervalued debt of countries in financial distress with the expectation of demanding repayment on original terms. When the restructuring process was launched the IMF set aside, to what became one of the major market failures in international financial markets (Francis, 2005). Argentine negotiators, nonetheless, obtained a great deal: a significant "haircut" on the old package, a significant lengthening of maturity for the new bonds along an important reduction in interest payments. Surprisingly enough, whereas in past debt renegotiations process investors were only accepting some among the previous measures, Argentinean negotiators obtained all three (Economist, 2005). The deal finally obtained a 76,1% of private holders adhesion[27], certainly below previous sovereign debt restructuration process but well above previous expectations[28]. Thereafter Argentina became a pariah, however, been effectively shut out of the international financial markets.

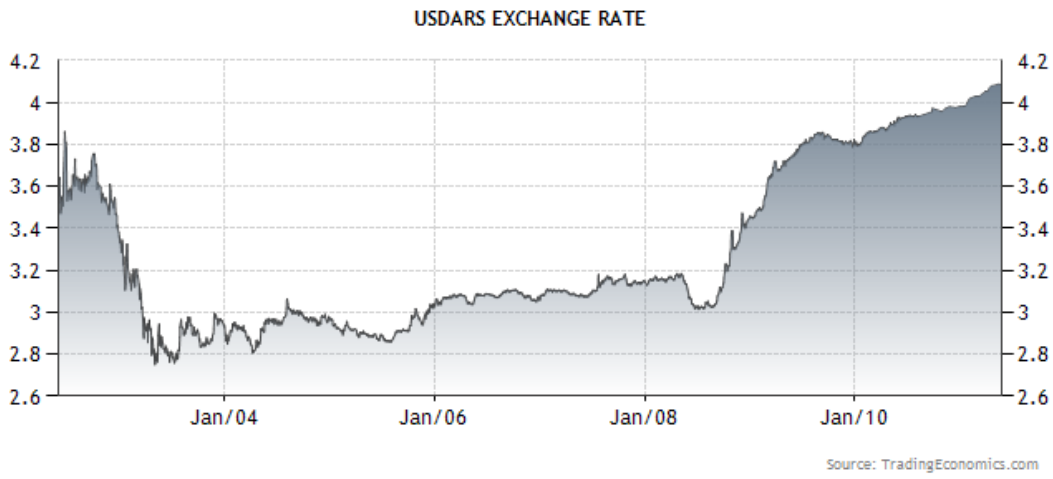
The local economy began its recuperation thereafter, to great extent, thanks to the re-instatement of a stable and competitive real or *managed floating* exchange rate policy (Frenkel and Rappetti, 2010). During the 2003-2009 period, Argentina's GDP grew at an astonishing rate of 8,5%. The economy rapidly moved towards a significant foreign exchange surplus, as a devaluated peso cum a commodity price boom generated a positive balance of trade. The surplus allowed the government to accumulate an important amount of foreign reserves, besides forcing the BCRA to launch an aggressive sterilisation policy in order to control for currency appreciation. Appreciation was also prevented by a series of prepayments of foreign debt, particular those cancelling official loans with the IMF, and payments connected with the restructuring process.

**Graph 3: US – Argentinean Peso Exchange Rate (June 2002 – June 2011)**

[26] When the swap finally took place, the restructuring involved accounted for only 55% of Argentina total debt, however. All bonds issued after the cut-off date of 31/12/01 were excluded from eligible debt. BODENs and provincial guaranteed bonds were also exempted from the deal, likewise the case of debt owed to multilateral financial institutions and bilateral creditors (Paris Club), both of which maintained their "preferred creditor" status.

[27] This percentage was further expanded in 2010, when the Argentinean government decided to reopen its 2005 debt Exchange. A total of approximately U$ 12.86 billion of eligible debt was tendered into the Exchange launched on April 30, bringing the total amount of debt restructured to 92,6%. The final settlement of the 2010 debt Exchange took place on August 11, for bondholders that didn´t participate in the early tranche that closed on May 14 and settled on May 17 (http://en.wikipedia.org/wiki/Argentine_debt_restructuring)

[28] All main groups participated at the process, including institutional investors, hedge funds, savvy investors and almost all Argentine domestic investors. The government also obtained the adherence of the Argentine Bond Restructuring Agency (ABRA), representing retail investors in Germany and Austria. Italian investors and vulture funds, by contrast, opposed resistance.




Since 2003, the government began to relax some controls, although regulatory measures were introduced on the capital account. Firstly, the above - mentioned 365 days extension on the minimum stay requirement, including new financial borrowing traded in the domestic FX market and rollovers of non-financial private sector and financial sector residents´ external liabilities. The government also introduced a 30% non-accruing mandatory deposit on financial capital inflows in order to discourage the entry of speculative funds. Capital controls would be reinstated following the international financial crisis, permitting to extend capital inflows permanency, but not stopping Argentinean chronic problem with capital flights.

**Table 1: Argentina, capital flights after the convertibility collapse (2002-2011)**

| Year | Annual Capital Flights (U$ MM) | Accumulated Capital Flights (U$ MM) | Capital Flights as a percentage of GDP | Capital Flights as a percentage of FX reserves |
|---|---|---|---|---|
| **2002** | $ 12.879,00 | $ 12.879,00 | 12,54% | 122,78% |
| **2003** | $ 2.826,00 | $ 15.705,00 | 2,18% | 19,97% |
| **2004** | $ 1.414,00 | $ 17.119,00 | 0,92% | 7,49% |
| **2005** | $ 659,00 | $ 16.460,00 | -0,36% | -2,42% |
| **2006** | $ 2.695,00 | $ 19.155,00 | 1,26% | 8,72% |
| **2007** | $ 8.617,00 | $ 27.772,00 | 3,29% | 19,29% |
| **2008** | $ 20.777,00 | $ 48.549,00 | 6,33% | 46,32% |
| **2009** | $ 11.771,00 | $ 60.320,00 | 3,80% | 25,54% |
| **2010** | $ 11.400,00 | $ 71.720,00 | 3,25% | 22,92% |
| **2011 (*)** | $ 17.000,00 | $ 88.720,00 | 4,53% | 33,93% |

Notes: (*) 2011 capital flights annual value, estimate;(**) GDP 2011 value, estimate (***) Date FX reserves 08/19/2011)
Source: Gaggero et. al. (2010), Central Bank of Argentina (BCRA website) and IECO reports.

Capital outflows were basically responding to the growing political tension that followed the Resolution 125 - Presidential Decree increasing export taxes on Argentina´s main agricultural

exports crops (repealed by President Fernandez de Kirchner after the Senate withheld its approval), as by the apprehension generated among investors by the Presidential Decree transferring all private pensions funds to the ANSES at December 2008. The irruption of the international crisis certainly stressed the local economy further, inducing local investors to seek refuge in the U$ dollar. As a result of both, internal and external factors, outflows surpassed U$ 20 billions in 2008. Though the economy proved resilient to the international financial crisis, local agents´ expectation continued waning alarmed by the inconsistences of the macro model. Inflation began to accelerate, explained by tightened conditions in the labour market, a low rate of capital expansion at the industry level and excess demand in the non-tradable sector, but also by a latent public deficit originated in the intricate web of subsidies granted by the government to different sectors and constituencies. As a result, the former competitive exchange rate is vanishing. The government has also discontinued its previously proactive policy of reserve accumulation. Local currency appreciation and excess demand have also stimulated a persistent increase in imports, beginning to shrink the former whopping trade surplus. Macro inconsistency might also be detrimental to the sterilization policy followed, particularly if the exchange rate continues to appreciate and inflation intensifies.

### *Korea*

From the 1960s until the end of the 1980s Korea an export-led growth model inspired economic policy[29]. The miracle rested on a particular mix of market incentives and state direction, together with a highly repressed financial market (Amsden, 1994; Chang, 2008). Domestic savings (plus international aid) financed capital accumulation during this period, whereas capital inflows either in the form of portfolio investment or FDI were not in attendance. Industrial policy guided financial system behaviour, and (national) banks funds were basically directed to the productive sector[30]. Loans were mainly allocated according to the government choice and its policy goals, facilitating the expansion of large business conglomerates. Capital controls affected several areas, from foreign exchange and currency restrictions to foreign investment. FDI inflows were subject to strict restrictions if not directly banning it. FDI outflows, in turn, required from official approval. Trade policy was also under government scrutiny, particularly on the imports side. As experienced by other Asian countries, and after a brief experiment with floating, the Korean won was formally pegged to the dollar and it would remain so until 1980. Thereafter and until early 1995, the *won* rested pegged to a basket of

[29] Since General Park launched its wide-ranged economic reform (1963) to the crisis (1997), the real per capita income growth averaged more than 6% annually.

[30] General Parker Lee launched the development project in the early 1960s. Under this regime, the government-channelled funds to those firms that had succeeded in exporting its goods – originally, light manufacturing goods such as textile and apparel and footwear. A decade later, the government introduced the Heavy and Chemical Industry Promotion Plan (HCIP), targeting 6 heavy manufacturing industries for development. The plan favoured the creation of large business conglomerates *(Chaebols*).

currencies but, in practice, it remained pegged to the US dollar. After that, exchange rate flexibility went up considerably – obviously, when comparing with Asian standards. Likewise, international capital flows were highly controlled and financial repression widely extended (Noland, 2005). The local currency was nonconvertible and, as experienced by other developing countries, the Korean government also discouraged any offshore market in won or won-denominated instruments.

Liberalization began to gain momentum in the late 1980s, and finally adopted in the 1990s[31]. FDI flows increased, and direct investments surpassed bank loans as the dominant form of foreign investment. Authorities also phased out previous restrictions preventing foreign investors to participate at the local stock market, although maintaining a 10% ceiling on private firms´ equity. Henceforth, local firms were also permitted to contract loan-term commercial loans abroad. A conjunction of stable foreign exchange plus attractive interest rate pulled foreign investors into the country, particularly short-term capitals, however[32]. Speculative financial agents transformed short-term funds into long-term loans, mostly benefiting Korean conglomerates. But the scheme also increased private agents financial vulnerability. The devaluation of Thailand´s Bath suddenly interrupted the previous calm, and the government was forced to accept a sharp depreciation of the national currency. When international lenders started to refuse to roll over short-term loans, *Chaebols* began to experience an important maturity-mismatching problem involving foreign currency assets and liabilities (Choi and Lee, 2006). Notwithstanding the liberalization measures, financial repression and capital controls were maintained and foreign participation in financial markets were still limited (Nolan, 2005), expecting for local and international interest rates to converge (Kim and Yang, 2010), but the approach would be sooner reversed.

At the aftermath of the 1997 financial crisis Korea turned definitively toward the neoliberal path. The Kim Dae-Jung government accepted the mainstream view and implemented the restructuring programme suggested by the IMF (Turner, 2010; Lee, 2010; Kim and Yang, 2010), a package deeply backed by the US government (Crotty and Lee, 2005)[33]. Authorities raised the short-term interest rate along imposing a restrictive fiscal policy (Crotty and Lee, 2005). The financial sector was at the centre of the changes to the economic system, as the government identified financial repression and *chaebol* corporate governance as the main culprit

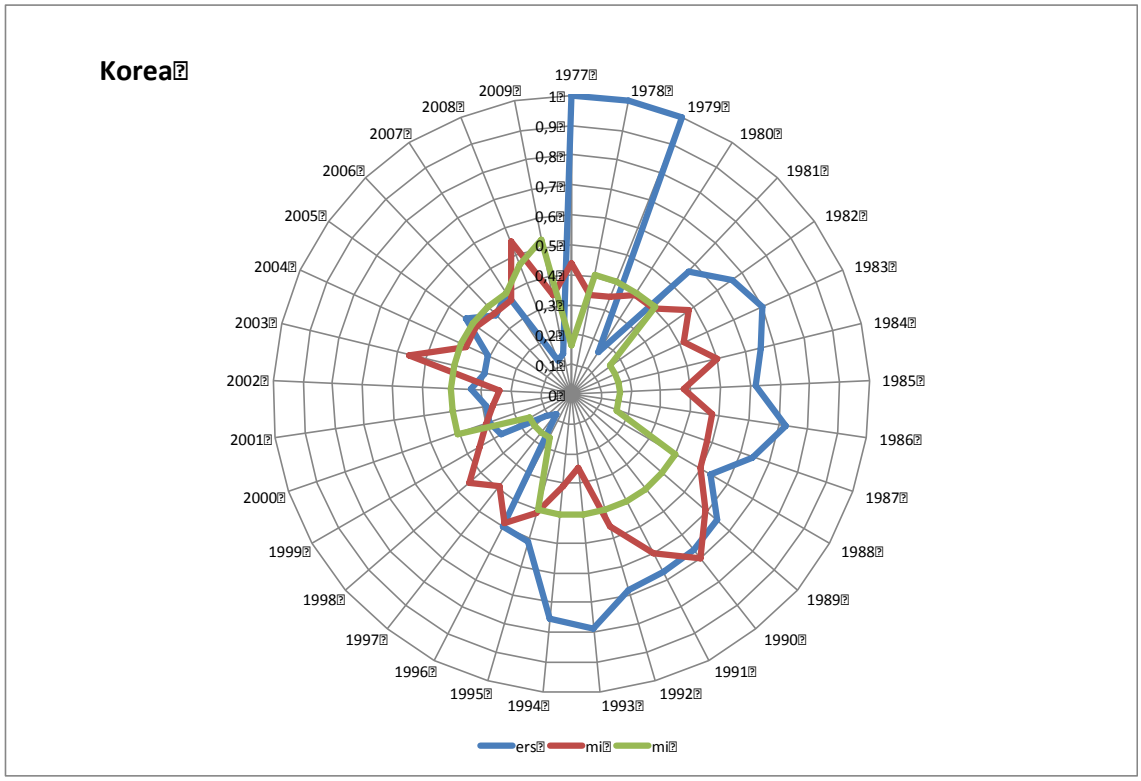
[31] In adopting the package, pressure from the US was important, certainly. But, Korea interest to join the OECD also pushed in the same direction.

[32] By the time of the crisis, short-term debt was about 7 times the amount of Korean foreign reserves

[33] "The IMF´s major shareholder governments made no secret of their view that IMF assistance should be accompanied by strong reforms. The U.S. authorities in particular insisted that strong reforms should be a condition of IMF support" (IMF, 2003, p. 185, quoted at Crotty and Lee, 2005).

of the crisis[34]. The government adopted a profound liberalization package implying more deregulation and privatization, particularly to restore external confidence, and the country began to receipt large inflows of FDI. Capital markets were also fully opened.

**Graph 4: Trilemma Index for Korea (1997-2009)**




Source: Aizenman et.al. (2009)

The government went further from the IMF package, deepening the original trade liberalization programme[35]. In terms of investments and business environment, foreigners were highly benefited (Noland, 2005; Lee, 2010)[36]. FDI deregulation continued its pace, and the 1998 Foreign Investment Promotion Act (FIPA) removed many of the former restrictions[37], including

[34] An important number of *chaebols* enter into bankruptcy (including Hanbo Steel and Kia Motors), dragging their lenders with them (as, for example, *Seoul Bank* and *Korea First Bank*) (Sohn, 2002). Those who survived were coerced to merge, receiving in exchange extensive tax benefits and financial support (Amsden, 2001).

[35] Liberalization was undertaken in two rounds. Under the first the government eliminated subsidies and the import diversification program (IDP), reduced the number of items subject to adjustment tariffs, revised import procedures and (partially) liberalized the services sector. At the second round, the focus was on reducing regulations on trade (Sohn et.al., 2002).

[36] At December 1997 the government increased the foreign ownership ceiling in Korean companies up to 55%, to finally fully liberalize in May 1998.

[37] At September 2001, some 1029 business areas were entirely open to foreign investment with only 8 business areas partially open (primary industry (rice and barley; beef cattle framing, and fishery); wholesaling of meat; publication of newspapers and periodicals; energy industry; maritime transportation; air transportation; telecommunications; and specially chartered banks such export-import banks) and 2 areas entirely closed (radio and TV and broadcasting) to foreign investors. A year later, around 99,8% of all business sectors were open to foreign investments (Sohn, et.al., 2002).

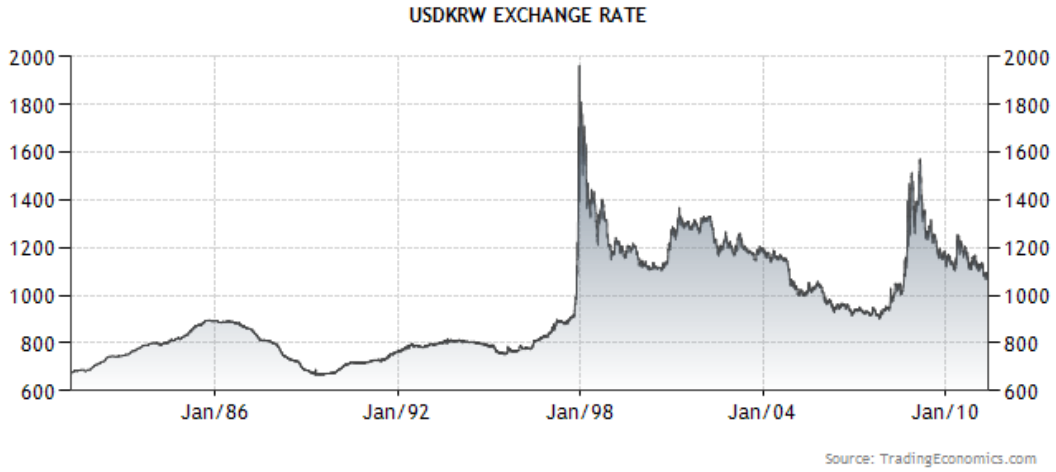
those preventing foreign investors´ remittances during serious external shocks. Authorities also lifted previous regulations impeding the external issuance of corporate bonds and previous limitations on holdings. The bypassing of the Foreign Exchange Transaction Act, in turn, replaced the positive list system by a negative one, automatically permitting all capital account transactions except those expressly forbidden (Kim and Yang, 2010). The government also allowed long-term deposits by non-residents in domestic financial institutions, plus further deregulation of domestic firms´ short-term borrowing, and began to accept foreign currency transactions by all financial institutions and individuals (Lee, 2010; Kim and Yang, 2010). Restrictions on remittances were completely lifted, guaranteeing foreign investors unconditional transfers of funds, even under circumstances of exogenous shocks (Sohn, et.al.; 2002).

Liberalization of the capital and foreign exchange markets increased foreign capital inflows into the economy thereafter, but at the price of rising volatility and macro inconsistencies. At the micro level, credits began to redirect towards private consumption (Nolan, 2005; Lee, 2010), also swelling a real estate booming. Deregulation measures in the M&A introduced under FIPA plus a depreciated *won* and lower asset prices encouraged foreign companies to enter in the Korean market (Sohn, et.al., 2002; Lee, 2010).

Macroeconomic numbers not accompanied the government, at least during their first year (Lee, 2010), with GDP plunging a 6,9% whereas consumption reduced by 10,6%. IMF recessive policies were suffered the most by the corporate sector, as credit crunch left Korean firms with lesser funds. As a result, corporate investment collapsed in 1998, and fixed investment shrank by more than twenty per cent (Lee, 2010)[38]. Henceforward, Korea initiated a new macro trend, where investments became less relevant and private consumption incentivised. The Korean economy bounced back to positive 10,7% GDP growth in 1999. A depreciated won, on the other hand, generated an important export recovery, generating a trade surplus of U$ 41,7 billion which, in turn, permitted to build an important volume of foreign exchange reserves.

[38] The fall in gross investment ascended to 22,9%. The low investment ratio persisted even after the 2004 recovery.

**Graph 5: US – Won Exchange Rate**




After a short period, capital account liberalization pushed the won towards revaluation, however. In order to sterilize funds, the government required domestic financial institutions either to purchase monetary stabilization bonds (MSBs) or to accept a variable deposit requirement (VDR). Open market operations were not just rising government´s fiscal costs but also increasing BOK vulnerability to interest rate differences and exchange rate fluctuations (Kim, et.al.; 2008). Expectations on local currency appreciation, also induced financial agents to invest in foreign equities and other assets, and even utilized yen carry trade to buy domestic bonds.

In order to impede exchange rate appreciation, the re-introduction of capital controls would have performed as a feasible alternative (Rodrik, 200.; Crotty and Lee, 2005). Instead, Korean authorities launched a set of policy measures encouraging capital outflows, particularly inducing private agents´ capital flights. Real estate investment abroad by Korean residents increased from U$ 22 million in 2005 to U$ 2,7 billions in 2007. Overseas equity investment also augmented during these years, but less spectacularly: from U$ 11 billion to U$ 50 billions. But, although liberalization of residents' investments abroad could ease pressure on the currency and prevent bubbles at home, it might no prevent currency mismatches. Liberalization measures, furthermore, performs under an asymmetric base (i.e.: capitals that have already flight the country are not always returning, or not all of them).

**Table 2: KOREA, Trends in Capital Flows (U$ Billions)**

| Year | Concept | FDI | Porfolio Investment | Equity Investment | Bond Investment | Bank Borrowing | Trade Credits | Other | Gross Inflows |
|---|---|---|---|---|---|---|---|---|---|
| 2001 | Inflows | 3,5 | 11,7 | 10,3 | 1,4 | -13,2 | -2,8 | -1,2 | -2,0 |
| | Outflows | 2,4 | 5,1 | 0,5 | 4,6 | -3,1 | 1,2 | -4,9 | 0,7 |
| | *Net* | *1,1* | *6,6* | *9,8* | *-3,2* | *-10,1* | *-4,0* | *3,7* | *-2,7* |
| 2002 | Inflows | 2,4 | 4,5 | 0,4 | 4,1 | 1,9 | 3,5 | 0,0 | 12,3 |
| | Outflows | 2,6 | 3,8 | 1,5 | 2,3 | -4,8 | 0,7 | 2,7 | 5,0 |
| | *Net* | *-0,2* | *0,7* | *-1,1* | *1,8* | *6,7* | *2,8* | *-2,7* | *7,3* |
| 2003 | Inflows | 3,5 | 21,5 | 14,4 | 7,1 | -5,0 | 6,3 | 1,2 | 27,5 |
| | Outflows | 3,4 | 3,6 | 2,0 | 1,6 | 4,5 | 0,0 | 0,7 | 12,2 |
| | *Net* | *0,1* | *17,9* | *12,4* | *5,5* | *-9,5* | *6,3* | *0,5* | *15,3* |
| 2004 | Inflows | 9,2 | 16,0 | 9,5 | 6,5 | -0,9 | 8,1 | -2,9 | 29,5 |
| | Outflows | 4,7 | 7,4 | 3,6 | 3,8 | 2,4 | 1,0 | 4,7 | 20,2 |
| | *Net* | *4,5* | *8,6* | *5,9* | *2,7* | *-3,3* | *7,1* | *-7,6* | *9,3* |
| 2005 | Inflows | 6,3 | 9,0 | 3,3 | 5,7 | 1,0 | 7,8 | 0,6 | 24,7 |
| | Outflows | 4,7 | 7,4 | 3,6 | 3,8 | 2,4 | 1,0 | 4,7 | 20,2 |
| | *Net* | *1,6* | *1,6* | *-0,3* | *1,9* | *-1,4* | *6,8* | *-4,1* | *4,5* |
| 2006 | Inflows | 3,6 | -0,4 | -8,4 | 8,0 | 44,2 | 13,1 | -0,9 | 59,5 |
| | Outflows | 8,1 | 22,4 | 15,3 | 7,1 | 1,3 | 1,6 | 5,1 | 38,4 |
| | *Net* | *-4,5* | *-22,8* | *-23,7* | *0,9* | *42,9* | *11,5* | *-6,0* | *21,1* |
| 2007 | Inflows | 1,6 | 23,4 | -28,7 | 52,1 | 41,6 | 13,6 | 4,7 | 84,7 |
| | Outflows | 15,3 | 42,4 | 52,4 | -10,0 | 10,3 | 2,0 | 6,1 | 76,1 |
| | *Net* | *-13,7* | *-19,0* | *-81,1* | *62,1* | *31,3* | *11,6* | *-1,4* | *8,6* |

Source: Ahn (2008)

Portfolio flows turned negative in 2006, however, as foreigners decide to go short in their Korean positions (BOK, 2009; Lee, 2010; Kim and Yang, 2010). Likewise, the direct investment balance turned into a deficit. Nevertheless, the Korean banking system continued to pull foreign capitals as the BOK maintained an interest rate differential in order to suppress real estate price rise. The strength of the won plus a 4,25% benchmark interest rate contrasted with the weakness of the yen and a benchmark rate fixed at 0,5%, in what turned to be an ideal environment for speculative carry trade operations (Forbes "*South Korea Attacks the Carry Trade*", 08-06.07)[39].

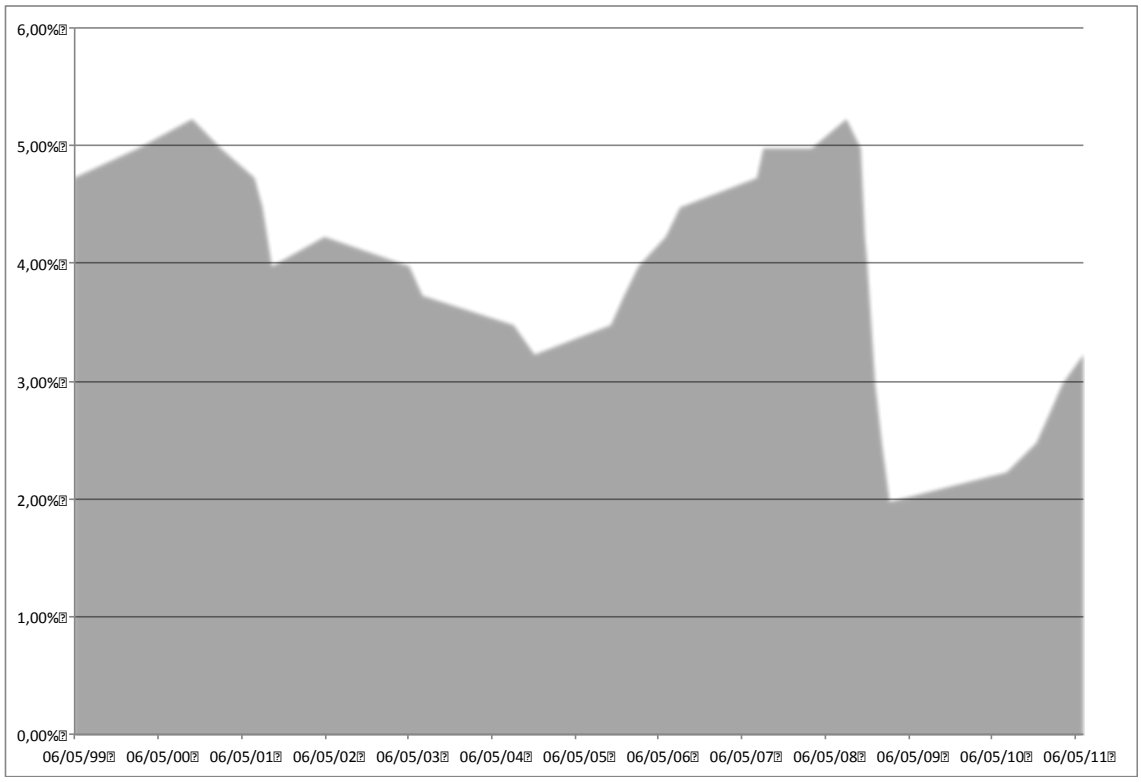
During the two-year period (2006-07) net borrowings totalized U$ 74,2 billions. This coupled with a positive trade credit position permitted the capital account to remain in surplus. But expectations on the local financial system strength reverted once the subprime crisis arrived. As a consequence, the banking sector suffered from de-leverage as it was not able to rollover its short-term debt (Kim, undated). Raising expectations on exchange rate appreciation, on the other hand, led foreign investors to rescind derivative contracts and remain liquid (Kim and Yang, 2010; BOK, 2010). Likewise, from early 2008 foreigners, including hedge funds, began to undo their positions at the Korea´s stock market, and the KOSPI plummeted. In sum, all the above led to the collapse of stock prices and instability of the domestic financial and foreign exchange market (Kim et. al., 2008; Lee, et.al., 2010). Local currency highly depreciated against the US dollar falling to 1,500 by mid-November 2008, despite the huge amounts of

[39] In order to confront the yen-led carry trade, the BOK began to restrict domestic borrowing in foreign currencies. This regulatory measures leave foreign-currency loans only available to manufacturers making capital investments overseas and companies paying for overseas projects

foreign reserves held by the Korean government[40] and the swap arrangements obtained with the US FED. In sum, and despite the alleged resilience of their macro, Korea became one of the hardest hit economies in the world.

In order to confront the crisis, and in contrast to their earlier reaction, the government now conducted an aggressive expansionary fiscal policy, including a generous stimulus package (Cho, 2010; Kim, undated). The package also lessened interest rates (see next graph)[41], again in sharp contrast to what observed during the Asian crisis.

**Graph 6: Korea Base Rate (1999-2011)**




Source: Bank of Korea (http://eng.bok.or.kr)

Nevertheless, Korea ranked among the most affected for the crisis, forcing monetary authorities to assist financial entities in distress (Goldstein and Xie, 2009)[42]. Henceforth, and despite their advocacy towards financial liberalization and capital account openness, the government recently began to rethink over the convenience to (re) introduce controls in order to curb capital inflows, including a withholding tax on foreign investors´ bond holdings along further limits on currency

[40] As September 2008, Korea ranked 6th among the largest holders of foreign exchange reserves. Considering 21 emerging economies, Goldstein and Xie (2008) observed that, at the time of the crisis Korea showed the largest decline in reserves.

[41] Since March 2008 the overnight call rate settled by monetary authorities has been changed to the "Bank of Korea Base Rate" observed in the graph.

[42] This, in turn, responds to the high dependence of Korean banks on international wholesale funding (see next section).

forward trading[43] (FT, *S Korea Plans capital controls*, October 19, 2010)[44]. At June 2010 the government introduced the *"Plan to Mitigate the Volatility of Capital Flows*". A month later authorities launched new measures in order to stop the won from appreciating and to regulate foreign currency loans. As an example, it might be tightening the cap on banks´ holdings of foreign – exchange derivatives. Furthermore, in order to tackle speculators, South Korean regulators began to audit of how banks should handle foreign-currency derivatives. On October 2010 the Ministry of Finance imposed a limit on banks 'holdings of currency derivatives, of 250 % of equity capital on foreign banks and 50 % on domestic banks to reduce volatility in capital flows (Bloomberg, 2010). Likewise, on December 8, 2010 the National Assembly passed a bill that will from January 1st tax interest income from treasury and central bank bonds by as much as 14% and put a 20% levy on capital gains from their sale.

**Table 3: Korea –prudential measures introduced since 2010**

| Sector | Policy Tool | Examples | Data |
|---|---|---|---|
| Banking Sector | Limits to direct and indirect FX exposure | Capped FX forward positions of banks relative to their equity capital. Reduce FX hedging limit from 125% to 100% of exports receipts. | jun-10 |
| | New measures to reduce FX bank loans. | FX financing loans to local residents to overseas use only, exceptions available for SME manufacturers | jun-10 |
| | Limits on bank´s holdings of FX derivatives contracts | A 250% on foreign banks and 50% on domestic banks | oct-10 |
| | Watchdog´s Control - Stress Test | Increasing pressure over foreign currency liquidity conditions for local banks | jul-11 |
| Capital Market Sector | Band on Kimchi bonds | In order to prevent excessive foreign debt, the government banned financial firms to participate in the foreign currency-denominated bond market | jul-11 |
| Macro | Controls | A 14 per cent withholding tax on foreign purchases of treasury and monetary stabilizations bonds (to bring back in line with the tax on resident purchases of bonds. | Jan 2011 |
| | | Stability Levy on non-deposit FX liabilities. | During 2011 |

Source: IMF (2011[a, b and c]), FT and China Daily

## 2.2. Micro: Financial development and banking regulation

The provision of financial services has undergone a transformative expansion in the last decades, moving away from a largely domestic market to an increasingly internationalized space.

As capital flows could be transformed into bank liabilities almost instantly, it could generate currency and maturity mismatches in the balance sheets of private sector debtors, involving both banks and productive firms. Currency mismatch might be observed when balance sheets are heavily tilted towards foreign-currency-denominated debt and local-currency-denominated assets and/or earnings. Maturity mismatch, in turn, arises when long-term loans are hedged on

[43] Yoon Jeung-hyun, South Korea's financial minister declarations at the Parliament "*We are preparing to counter the potential problems that liquidity flows into emerging countries sparked by low interest rates worldwide can cause*".

[44] As mentioned in previous paragraphs, Korean authorities reintroduced capital controls in 2007, in order to prevent yen-carry trade. At the same time the government began an international campaign in order to stop carry trade (Korea.net "Korea urges international cooperation against carry trade" Aug 3, 2007). A growing military tension in the Korean Peninsula also induced authorities to regulate capital flows (Bloomberg, "South Korea Imposes Levy on Foreign Exchange Borrowings to Stop Outflows" December 20, 2010

short-term liabilities. In the event of sharp currency depreciation financial stability becomes under risk. Even if firms do not default, depreciations may have substantial welfare effects through the balance sheet effect (i.e.: a wealth redistribution effect)[45]. When foreign currency results vastly use in contracts, exchange rate variations directly affect the structure of property rights. Henceforth, regulating cross-border transactions becomes imperative. A series of options are available, including the introduction of reserve requirements on cross-border inflows or the prohibition of certain commercial transactions as, for example, those associated with lending in foreign currencies.

The massive entrance of foreign banks was another important change. For the IFIs the arrival of transnational banks would be enhancing EMEs banking system and reinforcing their safeguard nets. But expectations turned to be unbounded. Unlike the case of trade integration, in the case of financial integration a "threshold" is important for a country to get the full benefits.

Ultimately, at the time of considering financial deepening economist were only analysing efficiency gains. But financial liberalization has also greatest implications in terms of financial stability, since larger cross-border financial exposures entangles greater scope for heightened domestic market volatility. After considering the experience of Argentina and Korea, and comparing to what observed among the "emerging giants" (i.e.: China and India), the point to analyse is whether the idea of the more a country is financially integrated the greater the degree of domestic financial development remains valid? Or, more general, whether financial openness is always good for developing countries? (Dorrucci et.al., 2009)[46].

### *Argentina*

Under the ISI model, the Argentinean financial sector was characterized by financial repression affecting both prices and quantities, along a strong participation of state-owned banks. Financial liberalization transformed the former, whereas the passing of the Financial Entities Law altered the banking industry structure. Financial deregulation continued its pace under Menem,

The financial sector was particularly affected by the Mexican crisis (bank deposits plunged by

[45] The effects generated by a movement in the real exchange rate (RER) are greater, however. A modification in the RER affects the trade balance, basically, by pushing exports (pulling imports) if the new rate becomes under (over) valued. Structuralist, in turn, also highlights their effect on income distribution RER changes affects the balance of payments and output and employment levels (Frenkel and Rapetti, 2010).

[46] Several authors before have posed these questions. On the one hand, *Rodrik and Subramanian* (2008) argues that lifting capital flows restrictions too early in financial underdeveloped economies may undermine domestic financial development. *Prasad, Rajan and Subramanian* (2006), on the other hand, give evidence of the "puzzle" of financial openness and growth being positively correlated in mature economies, but negatively in developing countries. A recent paper by Morin Shularick and Alan Taylor documents the growth of leverage and credit extension driven by liberalization and financial innovation, but finds little empirical support for the proposition that this two factors influencing growth for the countries in the sample (Shularik and Taylor, "Credit booms goes bust: monetary policy, leverage cycles and financial crisis: 1870-2008" NBER Working Paper Nº 15512).

18% as a result), forcing the government to assist financial entities in problems. Amongst other measures undertaken by the government, authorities bypassed new legislation encouraging the arrival of foreign entities[47]. Correspondingly, the government required authorised banks to conform up to a *strong* "market evaluation" test (colloquially known as the BASIC system) and enforcing them to match the Basle plus regulations. Accordingly, the number of entities in operation drastically reduced, with foreigners gaining prominence [48] At the same time the government was advancing in the privatization process, getting rid of practically everything with the sole exception of the two leading SOBs (National Bank and the Buenos Aires Provincial Bank).

**Table 4: Argentina – Financial Intermediation, selected years (millions of $ and per cent)**
Source: BCRA

| Private Secto | Year | | Public Bar | Private National Bar | Private Foreign Banks | Non-Bank Financial Intermediar | Total |
|---|---|---|---|---|---|---|---|
| **Loans** | 1995 | $ | $ 20.797,40 | $ 18.693,56 | $ 11.685,89 | $ 701,41 | **$ 51.878,26** |
| | | % | 40,1% | 36,0% | 22,5% | 1,4% | **100,0%** |
| | 1998 | $ | $ 21.735,86 | $ 15.261,38 | $ 32.453,59 | $ 1.672,51 | **$ 71.123,34** |
| | | % | 30,6% | 21,5% | 45,6% | 2,4% | **100,0%** |
| | 2000 | $ | $ 16.680,00 | $ 12.811,00 | $ 31.441,00 | $ 1.952,00 | **$ 62.884,00** |
| | | % | 26,5% | 20,4% | 50,0% | 3,1% | **100,0%** |
| | 2003 | $ | $ 9.662,00 | $ 9.433,00 | $ 12.772,00 | $ 511,00 | **$ 32.378,00** |
| | | % | 29,8% | 29,1% | 39,4% | 1,6% | **100,0%** |
| | 2006 | $ | $ 19.259,00 | $ 26.939,00 | $ 28.059,00 | $ 2.597,00 | **$ 76.854,00** |
| | | % | 25,1% | 35,1% | 36,5% | 3,4% | **100,0%** |
| | 2008 | $ | $ 39.223,83 | $ 47.391,82 | $ 44.485,73 | $ 5.677,30 | **$ 136.778,68** |
| | | % | 28,7% | 34,6% | 32,5% | 4,2% | **100,0%** |
| | 2010 | $ | $ 55.655,29 | $ 75.842,20 | $ 64.984,33 | $ 6.656,79 | **$ 203.138,60** |
| | | % | 27,4% | 37,3% | 32,0% | 3,3% | **100,0%** |
| **Deposits** | 1995 | $ | $ 13.088,30 | $ 16.208,35 | $ 10.671,72 | $ 323,78 | **$ 40.292,15** |
| | | % | 32,5% | 40,2% | 26,5% | 0,8% | **100,0%** |
| | 1998 | $ | $ 20.363,04 | $ 16.981,86 | $ 32.916,27 | $ 386,62 | **$ 70.647,79** |
| | | % | 28,8% | 24,0% | 46,6% | 0,5% | **100,0%** |
| | 2000 | $ | $ 22.092,00 | $ 14.799,00 | $ 41.118,00 | $ 389,00 | **$ 78.398,00** |
| | | % | 28,2% | 18,9% | 52,4% | 0,5% | **100,0%** |
| | 2003 | $ | $ 27.653,00 | $ 17.025,00 | $ 30.072,00 | $ 201,00 | **$ 74.951,00** |
| | | % | 36,9% | 22,7% | 40,1% | 0,3% | **100,0%** |
| | 2006 | $ | $ 37.229,00 | $ 38.496,00 | $ 47.218,00 | $ 408,00 | **$ 123.351,00** |
| | | % | 30,2% | 31,2% | 38,3% | 0,3% | **100,0%** |
| | 2008 | $ | $ 51.575,12 | $ 53.188,01 | $ 60.988,01 | $ 627,09 | **$ 166.378,24** |
| | | % | 31,0% | 32,0% | 36,7% | 0,4% | **100,0%** |
| | 2010 | $ | $ 83.193,15 | $ 87.203,30 | $ 85.999,96 | $ 1.202,39 | **$ 257.598,80** |
| | | % | 32,3% | 33,9% | 33,4% | 0,5% | **100,0%** |

Source: CBA

When evaluating the role of foreign banks, the picture is more nuanced than expected. Interest

[47] Menem´s administration has previously modified the *Law of Financial Entities* granting national treatment to foreign banks and removing a former ban on market entrance.

[48] Whereas in 1994 foreigners have a mere 15% of total assets of the local banking system, their market share increased to 55% in 1998 and 73% in 2000 (De la Torre, Levy Yeyati and Schmukler, 2003), denationalization process that coincided with an accelerating progression towards banking concentration (Burdisso and D´Amato, 1999; Damill, et.al., 2010). The number of entities in operation reduced from 205 to 168, nine banks concentrated 67% of all deposits, and with 2 public institutions leading the list and six out of seven followers were foreign owned banks (Economist; March 4th 2000).

rates spreads did not reduce despite the efficiency gains obtained by the [financial] system. Foreign banks were certainly more cautions when extending credits, although they not performed better in terms of allocation. Independently of their origin, all commercial banks were redirecting funds towards private consumption, real estate mortgage and commercial (short-term) lending. Loans began to be curtailed following the Asian crisis, to plummet thereafter. Public sector entities continue to be favoured by private banks lending however and despite weaker repayment guarantees exhibited by the State, demonstrating that their rent-seeking interest have not changed. Interest rate arbitrage was further encouraged by foreign banks as they benefited the most by confronting lower hedging costs (Damill, et.al., 2010). When the crisis arrived, however, asymmetric *pesification* exacerbated banks' balance sheet problems[49]. As financial risk increased they began to reduce their exposure (Dominguez and Tesar, 2005), unmasking their proclaimed fortress – in particular, when looking at the limited assistance from headquarters to subsidiaries in distress (Moguillansky, et.al., 2004; Damill, et.al, 2010)[50]. Mandatory pesification, however, reduced the previous currency mismatch of the economy as a whole from 80% to less than 7%.

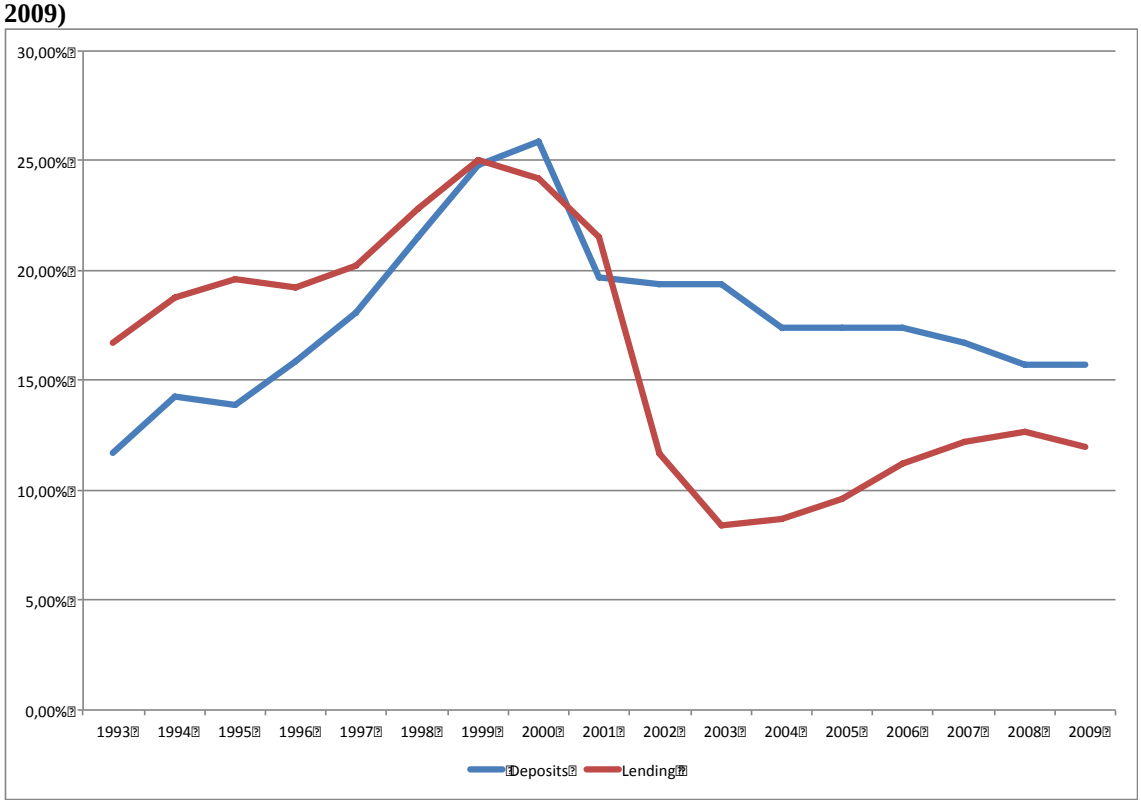
On the regulatory side, it worth to remember that under the currency board the Argentine banking system was heavily exposed to a devaluation of the peso against the US dollar. In order to preserve the solvency of the financial system, the government introduced strong capital requirements, going beyond 8% recommended by the Basle Committee. Likewise, financial entities were enforced to observe important liquidity provisions – although under the convertibility plan banks were exposed to a limited deposit insurance scheme. The regulatory front showed several weaknesses, however. Structurally, the financial system resulted powerless to confront a change in relative prices (i.e.: exchange rate parity). Alternatives were also absent for private agents dealing with repayment problems originated by exchange rate movements. As the fiscal burden deteriorated exchange risk was amplified, forcing monetary authorities to

[49] As explained by Blustein (2005, p. 192-3) "*To head off mass bankruptcy, the government decreed that most people who had borrowed in dollars could repay their loans in depreciated pesos, at the rate of one peso per dollar. At the same time, to appease savers, the authorities announced deposits would be converted at a different rate – 1.4 pesos per dollar. As a result, the banking system, which was already on its knees, was rendered prostrate. The disparity between what banks could collect form their borrowers, and what they owed their deposits, added up to billions of dollars in new losses….As for depositors, they felt cheated, notwithstanding the concession the government had given them…Their angry reaction lead to a deepening of the banking system's woes, as thousands of them obtained court orders requiring the return of their deposits in full, and money began draining anew from the banking system…".* As a consequence of the pesification, the U$ 100 billions that were in banks automatically transformed into $ 100 billions, despite the fact the currency rate moved to $ 1,40 per US dollar.

[50] In the case of the U.S. *legislation establish that a bank ins not obliged to pay deposits made in a subsidiary abroad if it is unable to do so because: a) a state of war, insurrection or civil revolt exists; or b) because it is prevented by an action or instrument of the government of the host country, undertaken without explicit agreement with the bank. This law was added to the existing legislation in 1994, after Citibank was taken to court by depositors in the Philippines and Vietnam and lost the respective cases* [Section 25C of the Federal Reserve Act, section 326 of the Riegle-Neal Interstate Banking and Branching Efficiency Act, codified in 12 US Code Section 633] (Moguillansky, et. al., 2004). Foreign banks´ balance sheets were also disturbed by their own mismatching problem, as they were forced to cancel (former) credits in foreign currency with their headquarters.

increase interest rates in order to maintain investors´ interest in Argentina[51]. Consequently, the bank system became overexposed to a sovereign default (increasing bank's solvency problem) and, additionally crowding out funds from private agents. High regulatory standards introduced via Basle Accord also failed to prevent the excessive risk introduced by public sector lending (Damill, et.al., 2010).

**Graph 7: Argentinean Banking System, private deposits and lending as a percentage of GDP (1993-2009)**




Source: BCRA

Following the crisis, the government introduced important changes in prudential regulation; beginning by modifying its terms of adherence to the 1988 Basle Accord and reducing the minimum risk-weighted regulatory capital coefficient back to 8%. Monetary authorities also banned foreign currency lending to private agents (except for those having incomes in U$). Likewise, the CBA introduced a ceiling to commercial banks on their liquidity holdings of foreign currencies. The crisis has certainly affected the structure of the Argentinean banking industry, stimulating a new process of market concentration. But, in contrast to what observed in previous experiences, the banking system has not attracted new deposits or generated new lending opportunities and the sector remained stagnant (see previous figure).

[51] After the arrival of the crisis in 1998, the fiscal burden deteriorated progressively, both at national and provincial level. As recession advanced, some provinces were forced to introduce cuasi-money.

### *Korea*

Korea not only suffered two foreign currency liquidity crises within a decade of interlude, but also it has transformed its banking industry in the last thirty years.

Financial repression and capital controls were two of the pillars of the development strategy followed by the government (Nolan, 2005), which originally proved highly successful. Repression peaked at the early 1960s, after the government nationalized commercial banks. Twenty years later the government reprivatize them, initiating a deregulatory process that removed former ceilings on interest rate and moderated government-directed lending. Financial deregulation gained new impetus at mid-1990s, now with the government easing former entry conditions, including the abolishment of the economic need test previously mandated for foreign bank investment. Advances were also important in reducing former restrictions on foreign exchange transactions.

During the early 90s, economic authorities began to bypass a series of normative changes removing former differences among MBCs (long-term lending) and Investment Financial Companies (IFCs) (short-term lending), particularly benefiting former IFCs as they were previously prevented to enter into the foreign exchange business. A favourably interest rate differentials would be behind the strong connection between financial sector (short term) foreign liabilities and Korean Chaebols (long term) foreign liabilities. But bank´s short-term foreign liabilities augmented significantly with the differential. When international lenders started to refuse to roll over short-term loans to financial institutions, Korean firms began to experience an important maturity-mismatching problem (Choi and Lee, 2006; Lee, 2010).

The crisis forced the closing of 139 financial institutions, along the compulsory merger of another 20 non-viable institutions. For Choi and Lee (2006), the collapse of financial institutions was the result of a weakness regulatory environment and a rather complex supervisory system [52]. After the crisis, the government reinforced banking regulation, introducing a set of strict prudential regulation as indicated by the Bank for International Settlements (BIS) (Lee, 2010), including a BIS capital adequacy ratio for MBCs (Choi and Lee, 2006). At the same time, authorities bypassed new rules in order to avoid maturity mismatches in bank's foreign currency assets and safeguard key variable systems such as those related to deposit requirements (VDR) (Lee, 2010).

[52] Among various supervisory institutions participating in banking supervision: the Ministry of Finance and Economics (MOFE), the Office of Bank Supervision (OBS) and the Bank of Korea (BOK). In 1999, Korean authorities integrated four supervisory bodies (the Office of Bank Supervision, Securities Supervisory Body (SSB), Insurance Supervisory Board (ISB), and Non-bank Supervisory Authority (NBSA) into a single new entity (the Financial Supervisory Service.

As observed in Argentina, monetary authorities in Korea also encouraged the entry of foreign banks, either by acquiring or by equity participation (Yi, et. al., 2009; Lee, 2010)[53]. Under the new FIPA guidelines foreigners were now allowed for a 100 per cent ownership, increasing their share in the banking industry passed from 16,4% in 1997 to 50,2% in 2003, and 57,8% in 2007 (Kim, Kim and Suh, 2008)[54]. Enthusiasm though, was not unlimited among Korean policy - makers. In December 2000, the government announced the abandonment of its announced plan to sell its majority stake in *Chohung Bank* and *Hanvit Bank*, and its minority stake in Korea First Bank and Korea Exchange Bank (Yi, et.al, 2009). The government has also maintained its majority stake at Woori Bank, Korea´s largest financial group by assets (FT, May 11, 2011). Financial relevance of State-owned banks (SOBs) remains relevant, with the Korean Development Bank (KDB), the Expo-Import Bank of Korea and Korea Finance Corporation regaining importance.

The crisis also transformed Korea´s capital markets (Lee, 2010), hereinafter domestic investors became entitled to invest abroad, whereas non – residents were allowed to make deposits and open accounts denominated in Korean won. Liberalization measures helped the benchmark KOSPI index to rise, although it remained highly volatile. In other words, the opening of both the bond and securities markets amplified the channels for capital inflows and outflows.

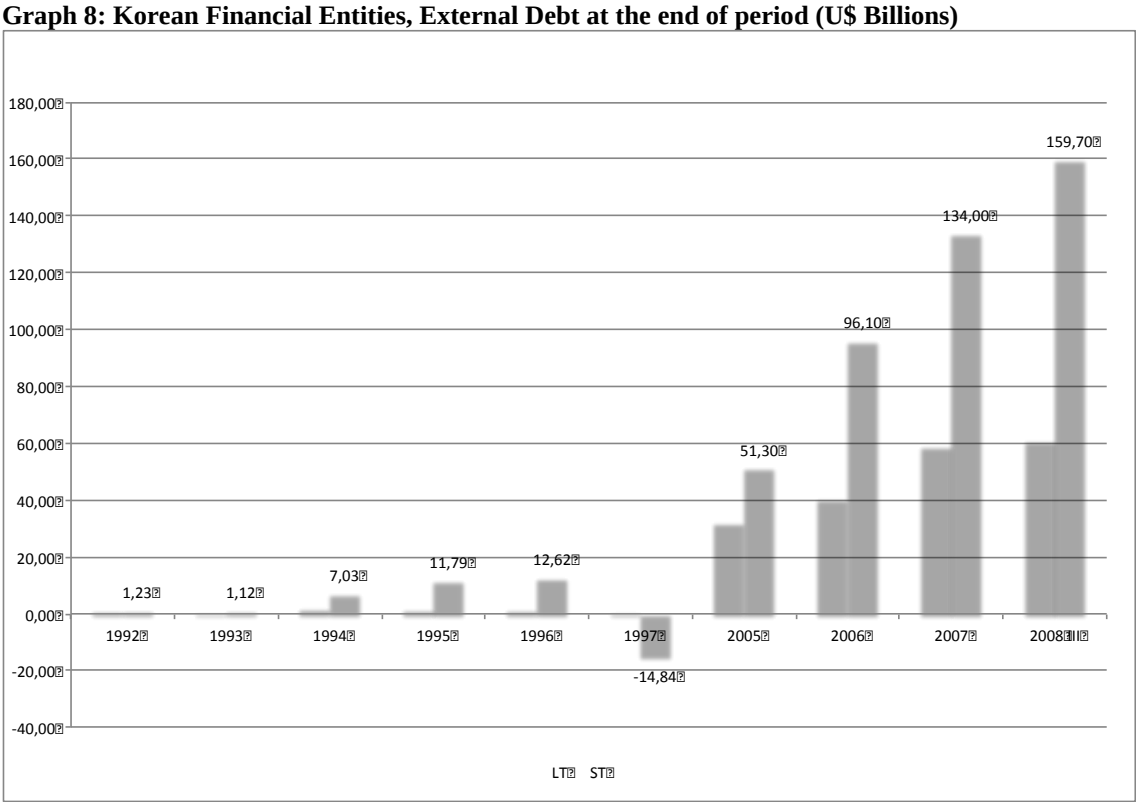
Henceforth, and despite all the above institutional changes, at the hike of the 2008 financial turmoil economic agents began to redirect funds abroad (Lee et.al., 2010)[55]. But, the problem was predated. Since 2006 the external debt began to increase rapidly, a phenomenon largely attributed to loans related to trading in derivatives market to be repaid by future foreign exchange revenue (Kim, Kim and Suh, 2008; Lee, 2010). Korean banks were hedging exporter´s (shipbuilding) credit risks throughout swap operations. But, again, in order to make the funding costs cheaper they were borrowing USD with short-term maturity. To sum up, Korean banking industry went throughout a new maturity mismatch problem, again involving foreign currency assets and liabilities.

[53] Foreign banks could enter at the Korean banking sector in three different ways: either through foreign bank branches making corporate loans, through running both its retail and wholesale level bank business under its own brand name, or through directly acquiring stock ownership in the stock market (Yi, et.al., 2009).

[54] FDI in the financial sector increased form $ 341 million in 1997, to $ 2.580 in 1999, and to $ 1.925 in 2000. Of the seven major domestic banks (Kookmin Bank, Woori Bank, Hana Bank, Shinhan Bank, Korean Exchange Bank, Korean Citi Bank, Standard Chartered First Bank), only Woori Bank was not foreign owned at the end of 2006 (Yi, et.al., 2009, p. 131). At this year, US banks controlled 25% of the local market and three of the top ten foreign banks operating in the country were from this country (USITC, 2010)

[55] As Korea has achieved perfect capital market liberalization both local and foreigners' investors were withdrawing funds. Local investors were allowed to buy real estates abroad without restrictions, whereas offshore funds and overseas funds domiciled in domestic jurisdiction were also permitted to outbound foreign equity related investment.

**Graph 8: Korean Financial Entities, External Debt at the end of period (U$ Billions)**




Source: Kim, Kim and Suh (2008) and Lee (2010)

When Lehman Brothers collapse, banks began to suffer from de-leverage. As a result, and resembling the 1997 crisis, the economy was again experiencing another problematic currency-mismatch; with banks performing among the most affected players[56]. Henceforth, and overall, the crisis confirmed the "pro-cyclicality of the banking sector. But, contrarily to what experienced a decade before, the government is not fully in agree with denationalizing the banking industry. POBs or local investors are heading the list of financial institutions, and the government has little interest to sell them to foreign investors (FT, May 11 2011). On the other hand, prudential measures adopted by the government (at both macro and micro levels), succeeded in preventing bank´s external debt from returning to pre-crisis levels (IMF, 2011a). Korean authorities repealed former deregulatory measures, particularly those easing restrictions on FX lending. Correspondingly, and in order to tackle both the financial crisis and won appreciation, monetary authorities have also decided to prevent the use of *Kimchi* bonds (FT, July 19, 2011)

[56] During 2006 - I Quarter to 2008 - III Quarter, U$ 168 billion flowed into Korea. From this total, U$ 137,4 billions were funded by the banking sector. After 2008 - IV Quarter, and despite the Korean government declared a loan guarantee, lenders withdrew from banks U$ 59 billion (Kim, undated).

## 3. An Institutional perspective

### 3.1 Liberalization at both multilateral and bilateral

A "regulatory consensus" was floating in academic circles since the *Bretton Woods* Conference, drawing the attention from policy makers[57]. The consensus broke up with the collapse of the dollar-standard in 1971 however, signalling the beginning of a new era of financial liberalization and market deregulation.

Thereafter, a relatively small group of investor countries, led by the USA, took advantage of the unique historical events to implement a strong push towards foreign investment liberalization among developing countries and economies in transition. These changes resulted from the increasing negotiating strength among capital exporting countries and weakening negotiating strength (coupled with greater external vulnerability) at capital importing countries. From the early 1980s onwards American negotiators pulled developing nations to open their financial markets and to bring capital convertibility. The objective was finally achieved with the signature of the GATS, which became a constitutive part of the newly constituted WTO (Hoeckman & Kostecki, 2009)[58]. WTO financial commitments, in particular, are included in the GATS Annexes on Financial Services, the Second and Fifth Protocols of the GATS (commonly referred under the Financial Services Agreement – FSA), the Understanding on Commitments in Financial Services, and countries´ GATS schedules of financial services commitments.

Somewhat GATS ended to dent financial regulation at local level, particularly over those members that committed themselves to a "standstill" rule (Raghavan, 2009; TWN, 2010)[59]. In relation to the introduction of prudential regulation, although the WTO / GATS Annex on Financial Services contain a "carve out" provision ensuring that the agreement will not undermine domestic law or regulations[60], this guarantee presents several loopholes that ultimately could prevent the introduction of new regulation (Public Citizen, 2009; TWN, 2010;

[57] IMF [original] Chapter VI explicitly recognized all member countries had the right to control capital movements.

[58] The agreement included all internationally – related services, defining four ways or modes of trading services. Mode 1 includes services supplied from one country to another. Mode 2 encompasses consumers or firms making use of a service in another country (officially consumption abroad). Mode 3 relates to those operations involving a foreign company setting up subsidiaries or branches to provide services in another country (officially commercial presence). Finally, mode 4 includes individuals travelling from their country to supply services in another (presence of natural persons).

[59] The approbation prevented them from rolling back deregulation (or liberalization) for the ambitious financial services they commit

[60] "*Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement*".

Gosh, 2010)[61]. Once a commitment has been made allowing for certain kinds of financial activity, the country cannot impose any prudential regulation if they run counters such commitment. In other words, once committed to deregulate a country cannot easily undo their legislation (Gosh, 2010)[62]. Similarly, commitments made under mode 1 (Cross-border supply) and mode 3 (Commercial presence) might lead signatory countries to open its capital account (Gallagher, 2010)[63]. Paradoxically some WTO members, mostly OECD countries but some emerging economies as well introduced more liberalizing commitments than requested. As a result of this market – friendly behaviour, some countries (37 over 100) compromised to inhibit themselves in the use of capital controls (Gallagher, 2010)[64].

WTO members are also entitled to undertake prudential measures[65], including the use of temporary non-discriminatory restrictions on payments and transfers in the event of a serious balance-of-payments problem and external financing difficulties (WTO, 1997)[66]. Members were certainly not obliged to impose restrictions on capital transactions in a way inconsistent with the specific commitment they had assumed with regard to such transactions (WTO, 2010b). Additional exceptions were always available as WTO commitments followed a "positive list" approach. In other words, the multilateral avenue was leaving developing countries some room to introduce exceptionalities or prudential measures.

As a result, capital exporters countries considered investment-related rules settled at the Uruguay Round suddenly outdate. Henceforth, negotiators from developed countries went for more at the Doha Round (Public Citizen, 2009), with the European representatives been among

[61] Prudential measures could be challenged if they are undermining the regulatory constraints otherwise established in the agreement. The absence of any definition for "prudential regulation", left the issue subject to interpretation by WTO dispute resolution panels.

[62] Gosh (2010) exemplifies the point with the case of policies directed to limit the size or total number of financial services suppliers in those sectors in which liberalization commitments have been made ("covered sectors"). Similarly, he also mentions the limitation a country has at banning risky financial services once it has been previously committed.

[63] In particular, Footnote 8 at GATS Article XVI (Market Access) and Article XI (2). Taking together, these provisions indicate that a country making commitments in the mode 1 and 3 may explicitly be required to open its capital account. Nevertheless, the author recognizes that some exceptions may apply.

[64] The list includes: Argentina, Australia, Bahrain, Canada, China – Hong Kong, China – Macao, Ecuador, Estonia, Gabon, Gambia, Hungary, Iceland, Indonesia, Japan, Kuwait, Kyrgyzstan, Latvia, Malawi, Mauritius, Mongolia, Mozambique, New Zealand, Nigeria, Norway, Panama, Philippines, Qatar, Romania, Sierra Leone, Singapore, Solomon Islands, South Africa, Switzerland, Tunisia, Turkey, United Arab Emirates, and United States.

[65] Commitments appears in *schedules*, listing the sectors being opened, the extent of market access being given along any limitation on national treatment introduced by the parties.

[66] In particular, countries could invoke balance of payments problems following GATS, whose Article XII – Paragraph 1 states "*In the event of serious balance-of payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, inter alia, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition*".

the more aggressive instigators (Blustein, 2009). Nevertheless, and away from industrialized economies pressures, a group of developing countries were accepting these harsher rules[67]. Developed countries promptly realize this additional concession, becoming excited to institutionalize it. Henceforth, they began to promote further compromises at new PTAs.

### *Liberalization at the bilateral and regional level: To the infinity and beyond*

Bilateral Investment Agreements (BITs) made their appearance on the international scene at the instigation of (European) capital exporters countries seeking more protection, as a way to depoliticize investment-related disputes. BITs fundamental provisions include a wide variety of principles and rules, counting those asserting the non-discriminative treatment among foreign investors (including the Most Favoured Nation, MNF clause), entry and establishment conditions, definition of investors and investments, specific dispute settlement provisions, and free transfer of payments. The numbers of PTAs (originally BITs, later RTAs & FTAs) really exploded after the Uruguay Round, and were mainly directed to increase foreign investors guarantees along the prosecution of more pro-market policies (liberalization) among Latin America and Eastern European countries.

The US became the main diffuser of the bilateral scheme in this new era, whose agreements became basically oriented to improve market access [for their transnational companies]. The signature of the NAFTA agreement in 1994 would become the first step in that direction (Manger, 2009)[68] and, certainly very influential in the region (Sauvé, 2006). Under this new scheme, foreign investment liberalization translated, among others, into a broad definition of investment, increasing restrictions on expropriations along other WTO plus requirements. The model also advanced in protecting the free transference of funds, introducing an absolute standard with mostly no exceptions (as those related to balance of payments crisis)[69]. Likewise, it also followed a "negative list" approach, practically eliminating all previous exceptions[70]. In short, specific clauses in US RTAs and many BITs affected the way that host States could impact the operations of the foreign investment established in their territory, including more

[67] Undoubtedly, commitments to open markets are the outcome of negotiations [although members have different degrees of freedom at the negotiation table]. Comparing data on specific GATS commitments for financial services with measures of actual policy in this sector for 123 countries, Barth, Caprio and Levine (2006) conclude that, in practice, applied policy is much more liberal than what committed to in the GATS.

[68] The framework introduced at NAFTA Chapter 11 would become known as "the 1994 model". This model text was replaced by a modified version in 2004. The Obama administration is currently working in a new version.

[69] In the vocabulary of US BITs, funds could be transferred [by the foreign investor] freely and without any delay. FTAs, however, recognized the balance of payments crisis exception.

[70] By virtue of the negative list approach, everything goes liberalized unless the countries list the exceptions to the market access at the time of signing the FTA. Two particular problems: a) at the time of listing, the government may not know that a particular financial instrument actually present (and not being listed), could become dangerous later; and, b) even if the government is aware of all current financial instruments, because of the list of exceptions is decided once and for all at the time of signing the FTA, the government cannot list as an exception financial instrument that come into existence in the future (TWN, 2010).

stringent conditions towards financial liberalization. In this sense, the 2004 model BIT essentially forces partners to liberalize their capital accounts, regardless of the nation's institutional capacity (Anderson et. al., 2009). Henceforth, host country policy room for capital controls or safeguards provisions are practically inexistent.

US FTAs have also advanced in the sovereign-debt restructuring issue, an issue still missing at the multilateral level. As Wall Street banks become very active in the issuing of sovereign bonds, legal practitioners followed the US approach requiring bondholder's unanimity before proceeding to changes. But the presence of this clause introduces a collective action problem, rendering practically impossible any renegotiation process and, henceforth, merely benefiting vulture funds. The point was under discussion at the international front introduced by US Deputy Treasure Secretary John Taylor. IMF former deputy Anne Krueger presented the sovereign debt-restructuring scheme (SDR) as an alternative. Market participants opposed to both, sustaining not alternative but bondholders unanimity. On this direction, they began to consider the convenience of the IIAs scheme, as an increasing number of FTAs defining sovereign bonds as covered investment. The issue is treated in the same line at the special annex on sovereign debt restructuring included at the latest FTAs negotiated by the US (Gallagher, 2011).

George H. W. Bush initiative "Agenda for American Renewal" was certainly very ambitious in terms of financial deregulation and capital account liberalization. If Republicans refused to walk out on this guiding principle, with the assumption of Barak Obama at the Presidency other voices began to be heard.[71] But, as the Korean experience will describe, the initial push towards financial reform and institutional change ended to be very weak. Even after initiated the financial crisis the US refused to allow for any sort of capital controls on the FTAs under negotiations (Anderson, 2009; TWN, 2010). At the end, once more Wall Street's interest prevailed, and US negotiators maintained their former ideals of financial liberalization and bank deregulation.

## 3.2 Argentina institutional path towards globalization

Foreign investment has played a very important but volatile role in the Argentine economy in the last 30 years, strong during the 1970s and the 1990s, when inflows reached highs of 8% of

[71] Towards this end, the Obama's administration launched the Advisory Committee on International Economic Policy Submits Reports on Review of US Model Bilateral Investment Treaty, settled at the Department of State, the committee advices the US government in international economic policy, including a review on the US model BITs (US Department of State, 2009). In the same direction, Congressman *Michal Michaud* (D-Maine), launched a proposal to modify US BITs model in order to preserve "the ability of each country that is a party to such agreement to regulate foreign investment in a manner consistent with the needs and priorities of each such country", and that "allows each party that is a party to such trade agreement to place prudential restrictions on speculative capital to reduce global financial instability and trade volatility" (Michaud, 2009 quoted at Gallagher 2010, page 18).

GDP (Mortimore and Stanley, 2010). These highs were associated with three different types of investor. First, in the 1970s, transnational banks that extended large syndicated loans; then, in the 1990s, with financial intermediaries who lent voluminous sums in bonds and TNCs that made very significant direct investments. In other words, Argentina was attractive to a multitude of different foreign investors but in an on-again-off-again manner.

Argentina's new ability to attract foreign capital was based in good part on improved market prospects in the context of the neo-liberal reform program introduced by the Menem government in the early 1990s. The Convertibility Law was fundamental to stabilize the economy, based on the introduction of a fixed one-to-one dollar-peso exchange rate, after the inflationary chaos that followed the debt crisis. Although costly in economic policy terms, as it effectively tied the hands of national policymakers in fiscal and monetary matters, the plan greatly enhanced Argentina's credibility with the international investor community and the Washington-based international financial institutions.

In the hope of attracting much greater quantities of foreign investment Argentina has also signed over 50 BITs, providing increased protection to foreign investors.[72] More or less simultaneously the Menem administration moved ahead with an ambitious program of privatizations along a wide deregulation and liberalization process. Along macro objectives, privatizations also helped the government in their quest for credibility, tying the fate of the privatized firms inextricably to the success of the convertibility plan.

On 23 December 2001 Argentina shook the international financial community by announcing a default on its external public debt of over US$ 100 billion – by the time, a quarter of all debt traded in the emerging bonds market. In January 2002, the Argentine peso declined to one third of its former (convertibility) value and the Government "pesified" public utility rates (converting dollar-denominated contract provisions to pesos). The collapse of economic policy and the sharp deterioration of the business environment after successive administrations demonstrated that the Menem government had painted Argentina into a corner and the current government it was both unable and unwilling to abide by the terms of the existing contracts. This produced a sharp reaction from foreign investors, which was manifest in a torrent (more

[72] Argentina has more BITs in force (54) than any other LAC country. It has 16 with industrialized countries, such as Australia, Austria, Belgium and Luxembourg, Canada, Denmark, Finland, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States, as well as 38 with other countries, namely, Algeria, Armenia, Bolivia, Bulgaria, Chile, China, Costa Rica, Croatia, Cuba, Czech Republic, Ecuador, Egypt, El Salvador, Guatemala, Hungary, India, Indonesia, Israel, Jamaica, Korea, Lithuania, Malaysia, Mexico, Morocco, Nicaragua, Panama, Peru, Philippines, Poland, Romania, Russian Federation, South Africa, Thailand, Tunisia, Turkey, Ukraine, Venezuela, and Viet Nam,

than 45) of ICSID lawsuits[73] that raised the country's contingent liabilities to around US$ 20 billion[74].

Three years later and with no help whatsoever from the IMF, Argentina shed its default status when its unilateral offer was widely accepted by external public debt bondholders. Argentina achieved what no country had achieved before (Economist, 2005), that is, the bondholders not only accepted a large cut in principal, but also agreed to a lengthening of maturity and a reduction in the interest rates to be paid. The outcome of the swap far exceeded Argentina's expectations, especially given that it had worked out its default unilaterally without the intervention of the international financial institutions or the assistance of G-7 governments. A group of unsatisfied bondholders, however, went to courts (US tribunals). Tough a few among them, mostly Italian bondholders, opted for ICSID facilities. In June 2010, Argentina reopened its debt exchange, bringing the total amount of restructured debt to 92,6%. The high level of acceptance observed at this occasion might be attributed to the substantial share of distressed bonds held by banks (U$ 10 billion over a total of U$ 20 billion) plus the portion in the hands of institutional investors (U$ 4 billion) [75]. Vulture funds ended with an important portion of Argentinean distressed sovereign debt, obtained at deeply discounted rates in order to speculate in litigation against the country. Obviously, they have not interest to participate at the restructuration process. Vulture funds, opted to litigate at the New York tribunals[76] whereas Italian bondholders directed their claims at ICSID tribunals[77].

The abrupt end of exchange rate parity also opened a front of dispute with foreign investors (Stanley, 2004). Under the agreements signed in the 1990s, they felt that they were entitled to full compensation from the Government, particularly those with some kind of interest in public utilities and the energy industry (gas and electric power). Along the guarantees conceded

[73] It should be mentioned that five of these were filed while the convertibility regime was still in place. At ICSID were registered 43 cases, whereas 3 cases were filled under the UNCITRAL rules. Awards have been issued in 12 cases (3 of them denying jurisdictions of the Claimants, 1 later suspended); an annulment decision has been issued in only one case and requests for annulment are pending in other six cases; one award is being challenged before the Washington, DC courts. Seventeen cases are still pending (plus one recently launched but unrelated to the 2001 crisis), and proceedings have been suspended or discontinued in 18 cases.

[74] US President Roosevelt introduced a similar policy in 1933, when passed a resolution nullifying the gold clauses in both private and public debt contracts. The validity of the resolution was challenged in court, but the Supreme Court upheld it.

[75] The rest was in hands of individuals and other creditors (iMarketNews.com, March 23, 2010). This second restructuration, however, did not include defaulted Brady bonds (DowJones.com. December 6, 2010).

[76] As most of the bonds issued by Argentina recognized New York jurisdiction, claims were filled at the US and US District Judge Thomas Griesa took charge of the claims

[77] The list of cases is: ICSID case ARB/07/5 (*Giovanna A. Beccara and Others v Argentina Republic*), case ARB/07/8 (*Giovanni Alemanni and Others v Argentina Republic*) and, case ARB/08/9 (*Giovanni Alpi and Others v Argentina Republic*). The fist one involved an enormous class-action style claim filed almost 195.000 Italian nationals and seek U$ 4.4 billion in compensation. The Alemanni case involves a small fraction of claimants asking for a lower amount of reimbursement. The third collective of claimants are reclaiming for a debt of € 6,5 million plus U$ 560,000 (Luke Peterson, "Argentina Faces a Third Treaty Claim by Holdout Bondholders: Experts differ as to Prospects).

through BITs, investors also profited from advantages related to national regulations (for example, rates set in dollars and indexed to the United States wholesale price index). As a result, national legislative provisions, regulatory terms and the BIT network bound the contractual framework[78].

The mechanism, which helped the Menem government to demonstrate its commitment to the new international standards, will become the main base for foreign investors' legal proceedings. The spirit of the restrictions self-imposed by Argentina (the convertibility scheme combined with the BITs) was to minimize the possibility of contract renegotiation with privatized firms, as the magnitude of the commitments made too costly any alteration. Ultimately, the crisis demonstrated the intrinsic "incompleteness" of the contract scheme implicit in the regulation of the privatized firms. The emergency measures adopted by the government affected the economic and financial equation of foreign investors. In the case of the regulated sectors most of the disputes brought after 2002 cited the effects of the devaluation on contracts in general and on the rate-setting system in particular. Foreign investors maintained that the Government of Argentina had agreed to assume the exchange-rate risk then broke its promise in January 2002. Whatever the reasons, the filing of cases could be interpreted as a strategic move towards positioning at the renegotiation stance (utilities) or until settlement courts (for those asking for total reimbursement - bondholders). Hence, after the economic emergency legislation was passed and the lawsuits filed, there ensued a wrangle between the Argentine Government, the foreign investors and the Washington financial institutions (World Bank and IMF)[79].

When the Argentine crisis broke out the international system failed to provide a solution to either the losses of foreign investors caused by the country's inability to apply the rates stipulated in the original contracts or the sovereign default. Foreign direct investors were shocked to find that the World Bank was unable to oblige the Argentine authorities to abide by the original terms of utility contracts. The bondholders found that the IMF was unable to force the Argentine Government to renegotiate its debt under any kind of pre-existing scheme or

[78] Thus, seeking to attract foreign investors and guarantee the success of the reforms, the neo-liberal Menem government ended up accepting a system of "complete" contracts, and thereby accepting risks that normally would be shouldered by the foreign investor. Argentinean sovereign bonds were also affected by the problem of "complete" contracts (Stanley, 2009).

[79] The Argentine response began by challenging the arbitral tribunal, questioning its transparency, the process by which the arbitration panel was selected and the fact that the foreign investors were allowed to engage in forum shopping, i.e. select the tribunal most likely to provide a favourable judgment. By the same token, Argentina threatened not to recognize ICSID's jurisdiction, claiming that cases should be heard in the local courts first. Lastly, the Government's also denied that the steps it had taken after declaring the economic emergency (i.e., pesification and rate freezes) amounted to indirect expropriation. Since all the lawsuits cited a single cause, the logic of the economic emergency legislation was central to the Government's strategy. With its proposals rejected and its arguments disallowed, the Government shifted its stance. One of its lines of approach was to seek to have the privatized firms withdraw their suits as a goodwill gesture in the context of contract renegotiation. Another, in view of the arbitration tribunal's award in the CMS case, was the Government's suggestion that it might not acknowledge any possible awards. Anyway, at the end, the government played an "accommodate" strategy (Mortimore and Stanley, 2009).

provide assistance to bondholders who opted not to accept the swap offer —"holdouts"— in the hope of a better deal from the Government of Argentina. For its part, the Argentine Government, in its dual capacity as host country and debtor, was appalled by the functioning of the international system, because of the way it explicitly favoured foreign investors, the lack of objectivity of the international financial institutions (basically IMF) and attempts to condition the country's economic policy to fulfilment of (by then impossible) international commitments. As a result, and in view of the social dimension of the crisis, that is between 1999 and 2003 the proportion of Argentines living below the poverty line doubled, from 27.1 to 54.7% of the population, the Government found itself forced to choose between using scarce resources to alleviate the economic and social suffering of the Argentine population caused by the crises and allocating them to meet their international obligations to foreign investors. Action taken by the Argentina government spawned, in turn, "*the greatest wave of claims by foreign investors against a single host country in recent history*" (Alvarez and Khamsi, 2009).

Ultimately, the international finance and investment community, which had celebrated Argentina's adoption of a risky neoliberal policy framework failed to provide the country with specific solutions to resolve the multiple crises it was facing. It proved to be another example of one government limiting the policy options of succeeding governments to deal with the crises provoked in large part by the policies of the former. Finally, the BITs network later became a conduit for IA-ISDS demands by the bondholders that had not accept the unilateral swap offered years earlier. This left the impression that the IA-ISDS system was warped to serve foreign investor interests at any cost.

### 3.3 The KORUS FTA and Korea rupture with the past

Korea was an active contributor of the bilateral scheme in the past, signing its first BIT with Germany in 1964. Korea participation continued and actually has more than 70 BITs in force[80]. Agreements were following the traditional objective of "protecting" foreign investments from sovereign's will.

Korea´s objectives would transmute from protection to liberalization as the country embraced a pro-market strategy. The pursuit of a new type of instrument PTAs/FTAs might be suggesting

[80] Korea signed a total of 77 BITs, of which 68 were finally ratified and became legally binding. A total of thirty-seven agreements were signed in the nineties, but sixteen in the previous years and fifteen in the 2000s. Partners include: Albania, Algeria, Argentina, Austria, Bangladesh, Belarus, Belgium and Luxembourg, Bolivia, Brazil (not ratified), Brunei Darussalam, Burkina Faso (not ratified), Cambodia Chile China Congo DR, Costa Rica Czech Republic, Denmark, Egypt, El Salvador, Finland, France, Germany, Greece, Guatemala Honduras, Hong Kong (China), Hungary, India, Indonesia. Iran (not ratified), Israel, Italy, Jamaica (not ratified), Japan, Jordan, Kazakhstan, Kuwait (not ratified), Lao PDR, Latvia, Lithuania, Malaysia, Mauritania (not ratified), Mexico, Mongolia, Netherlands (not ratified), Nicaragua, Nigeria, Oman, Pakistan, Panama, Paraguay, Peru, Philippines, Poland, Portugal, Qatar, Romania, Russian Federation, Saudi Arabia (not ratified), Senegal, Slovakia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Tajikistan, Thailand, Trinidad and Tobago, Tunisia, Turkey, Ukraine, United Arab Emirates, United Kingdom, Tanzania D.R. (not ratified), Uzbekistan, and Vietnam

the institutionalization of this movement. In order to introduce the FTA scheme the government commenced negotiations with different partners around the world beginning with Chile[81], Thereafter, negotiations were launched with Singapore, the European Free Trade Association (EFTA), the Association of Southeast Asian Nations (ASEAN)[82], the European Union (EU)[83] and India, whereas actually it maintain talks with Japan[84], Canada, Mexico, Australia, New Zealand, Malaysia and MERCOSUR. Enthusiasm for the new scheme is also behind FTA negotiations with the US.

The political relationship between the US and Korea could be considered to be special and resilient[85], although their trade relationship has not been exempted from disagreements. Foreign investment, in turn, has always remained a sensitive topic (Cooper, et.al.; 2010), reflecting the US interest at the Korean market, and the Korean continuing refusal to opening the economy[86]. Differences, however, began to be set aside at the late 1980s - early 1990s, marking the passing of a new era of market friendly development. The completion of the Uruguay Round at 1995, and Korea accession to the OECD in 1996, strengthened this trend. But, and despite commitments assumed in order to join the Organization for Economic Co-operation and Development (OECD), Korea refused to fully liberalized its capital account (Kim and Yang, 2010). Likewise, despite authorities enthusiasm on the bilateral front, they never become interested in signing an agreement with the US. Nevertheless, after the crisis the push towards financial liberalization and bank deregulation continued its pace, now with the additional support of the IMF.

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[81] Chile became the first country to have negotiations with, as Korea recognized the political experience in the subject of his partner and, also, the complementarities between both economies. The most difficult talks were those dealing with agricultural issues.

[82] The Framework Agreement on Comprehensive Economic Cooperation (the FTA agreement) was negotiated sequentially. The investment chapter was finally signed at June, 2009, three years later than the agreement on goods and two from the signature of the one dealing with services (*ASEAN-Korea FTA on Investment signed*. At Bilaterals.org, posted by Bernama, June 2, 2009).

[83] To become effective at July the 1st 2011, if ratified by the European Parliament (*EU signs free-trade deal with South Korea, its first with an Asian nation"* Reuters, Oct 10 2010) and introducing pressure over the US FTA approval ("*Obama gov´t want Congress to approve Korea FTA beforte July: Kirk*" Yonhap, 2011/01/12.

[84] Japan is Korea's second trading partner, but confronted with a growing trade deficit Korean policy-makers were concerned about the possibility of economic subordination with Japan. Besides economic policy questions, Korea´s society also questioned the role of Japan in the early twenty-century (Cheong, 2002). Nevertheless, Ogura Kazuo, then Japanese Ambassador to Korea, officially launched discussions at September 1998. A month later, under President Kim Dae-Jung visit to Japan, parts agreed to initiated a joint-study on the issue

[85] The US – South Korea military alliance has more than fifty years. Strategically, it not only serves as a buffer against the North Korean dictatorship but also to deter China´s increasing power in the region.

[86] Disagreement reflected, in part, the Asian prejudice to American investors legal demands. Although Asian countries were among the most fervent adherents to BITs, none of their countries signed a bilateral agreement with the US (Stanley, 2008). However, South Korea and US negotiated an agreement but failed over US opposition to South Korea's so-called screen quota on domestic films and the latter's resistance to lifting or reducing it (Cooper, 2010).

Talks with the US were launched at Washington, in June 2006[87]. A year later the two countries signed the proposed U.S. - Korea Free Trade Agreement (KORUS FTA), which remains pending from Congressional approbation in Korea[88] and the US[89], with objections resting among both sides[90]. In occasion of the G-20 meeting at Korea, both countries agreed to re-launch conversations in order to finally approve the agreement.

KORUS FTA structure resembles the structure of other FTAs previously signed by the US, including the recently FTA signed with Dominican Republic and a group of Central American countries (DR-CAFTA). The general principles settled down in the agreement include a far-reaching definition of investment[91], the principle of national treatment, the most-favoured-nation treatment, the minimum standard of treatment. Likewise, KORUS FTA also set limits on expropriation of covered investments, allowing [foreign investors] for the free transfer of financial capital pertaining to covered investment both into and out of the country[92]. Correspondingly to most modern agreements, KORUS FTA establishes procedures for the settlement of investor-state disputes.

According to the agreement, Korea committed to reduce barriers to trade and investment in its services sector, including the financial one. The two countries committed to provide national treatment and most-favoured-nation treatment to the services imports from each other; promoted transparency in the development and implementations of regulations in services providing timely notice of decisions on government permission to sell services; prohibit limits on market access; prohibit foreign direct investment requirements, such as export and local content

[87] In the late 80s the US government became firstly interested at Korean openness. Talks among partners began over Korea's large merchandise trade surplus with the US favoured by an undervalued won – as for the US negotiations (Amsden, 2001; page 329).

[88] The KORUS would, soon or later, be approved at South Korea, as the ruling party controls the Unicameral National Assembly. Furthermore, the Assembly's Foreign Affairs, Trade and Unification Committee has already approved the agreement (Cooper; et.al., 2010).

[89] Negotiations in the US Congress were conducted under the Trade Promotion Authority (TPA). In order the agreement to enter into force, the Congress should approve implementation legislation. It is expected that President Barack Obama will submit the agreement to Congress at January 2011, but the agreement continues stalled (Korea´s Legal.org: http://www.koreaexpertwitness.com/blog/news/korus-fta-stalled-again).

[90] During the last Presidential meeting on November 11, 2010, South Korea's President, *Lee Myung-bak* and US President *Barack Obama* announced that they had not resolved the outstanding issues, as: agriculture (including beef, rice, oranges, and sanitary and phytosanitary provisions); automobiles; textiles and apparel; and other manufactured goods (capital goods machinery and equipment; electronic products and components; and, steel)

[91] KORUS FTA includes: investment agreements between a government and a foreign firm with respect to natural resources, certain procurement construction activities and more; investment authorizations; enterprises; shares, stock, and other forms of equity participation in an enterprise; bonds, debentures, other debt instruments, and loans; futures, options, and other derivatives; turnkey, construction, management; production, concession, revenue-sharing, and other similar contracts; intellectual property rights; licenses, authorizations, permits, and similar rights conferred pursuant to domestic law; and other tangible and intangible, movable or immovable property, and related property rights, such as leases, mortgages, liens, and pledges.

[92] Originally Korean negotiators wanted safeguards applicable in case of foreign exchange crisis, a petition refused by the US. At the end, parts agreed to introduce safeguard at the cost of maintaining financial liberalization (Ahn, 2008).

requirement and employment mandates[93]; and, prohibit restrictions on the type of business entity through which a service provider could provide a service[94]. The agreement allows U.S. companies to supply financial services on a cross-border basis, including management services for investment funds and international transit insurances. Furthermore, it guarantees the right to full American ownership of a financial institution in Korea. In addition, the agreement commits partners to refrain from limiting the size of financial institutions (PublicWatch, 2010). Likewise, the two countries agreed to the "negative list" approach in making commitments in services – a really valuable principle obtained by US negotiators. Commitments are *ratcheted*, meaning that when new services emerge in one of the economies, the FTA automatically covers those services – unless identified as an exception (Cooper; et.al, 2010). The agreement also lacks of any safeguard clause regarding sovereign-debt restructuring, despite the historical debt restructuring following the 1997 financial crisis (Gallagher, 2011). In relation to the capital control issue, the KORUS FTA financial chapter might be read as forbidding any limit to the transfer of capital (PublicWatch, 2010). Prudential regulations in the financial sector might also be deemed illegal under the new treaty (Gallagher, 2010b).

The agreement has, without doubt, important diplomatic and security implications (Schott, 2007; Cooper, et.al., 2010). From an economic perspective, the agreement could reinforce trade and investment flows between partners[95]. For the US the agreement entails a diplomatic victory, which helps to restricts the increasing Chinese influence in Asia (Ahn, 2008; Cooper, et.al., 2010). Looking at the financial and other services chapters[96], it became evident that the US obtained a great deal (Cooper, et.al.; 2010)[97], certainly, a "model agreement in financial services" (), "no better, more sophisticated trade arrangement for financial firms" (Toppeta, 2010)[98]. In particular, under the terms of the FTA Korea's remaining nontariff impediments to

[93] Under chapter 13, neither party could require financial institutions of the other party to hire individuals of a particular nationality as senior managers or other essential personnel, nor could a party require more than a minority of the board of directors to be nationals or residents of the other party (USITC, 2010, at page 4-9)

[94] In particular, each party would be required to permit a financial institution of the other party to provide new financial services on the same basis that it permits its own domestic institutions to provide (USITC, 2010, at page 4-9).

[95] Korea is the United States seventh-largest trading partner based on total trade. The US merchandises trade balance with Korea moved from a $ 2,9 billion surplus in 1996 to a $ 13,9 billion deficit in 2006. In 2005, US services exports to Korea were approximately $ 10,3 billion, and US services imports from Korea were $ 6,3 billion. On the other hand, the US holds the largest single-country share of FDI stock in Korea, with 30% (USITC, 2010).

[96] Trade in services cut across several chapters of the KORUS FTA: Chapter 12 (cross-border trade in services); Chapter 13 (financial services); and Chapter 15 (Telecommunications); Chapter 11 (foreign investment); among others.

[97] See, for example, a collection of statements of support for the US-Korea Trade Agreement at the US White House web page.

[98]Remarks made by William J. Toppeta, President – International MetLife. April 6.

banking services stands at 29%, well below the actual 76% accepted by Korea at GATS[99]. Citigroup´s Laure Lane and corporate co-chair of the US-Korea FTA Business Coalition, made a similar statement, qualifying it as "the best financial chapter negotiated in a free trade agreement to date"[100]. KORUS FTA obtained the support of both, big trade unions and business associations (US government, 2010). As a result, the US service sector is particularly exultant with KORUS FTA approval, as the agreement includes liberalization measures "in excess of the current General Agreement on Trade in Services (GATS) regime" (USITC, 2010). [101] Surprisingly enough, instead of focusing on the increased access to the US market, South Korean negotiators emphasized "*the medium and long-term gains that would stem from increased allocative efficiency of the South Korean economy, particularly in the services industries*".

[99] Non-tariff impediments are condensed in a measure: the tariff equivalent (TE), which measures the percentage increase in prices due to trade impediments relative to the price that would exist in the absence of trade restrictions.

[100] Laure Lane participates as corporate co-chair of the US-Korea FTA Business Coalition.

[101] However, the agreements have also its detractors in the US, among them NGO Public Citizen's Trade Watch, whose doubts relate to the increasing rights granted to South Korean investors, which could end challenging US judiciary autonomy.

## 4. Conclusions

Since the early 1970s international capital flows increased dramatically, although inflows were certainly not aside from cyclical downturns and sudden stops. A group of Southern American countries experimenting with financial liberalization abruptly became aware of these sorts of problems. But policy responses remained oriented towards ease the domestic market up from government intervention. Developing countries policy space remained uncontested, however, as legal constraints were absent at the international level. Twenty years later a group of emerging economies embarked on a neoliberal path, including the reduction (or elimination) of controls on capital inflows. A group among acquiesced to institutionalize this stance, either by accepting more liberalizing commitments at the WTO/GATS sphere or by virtue of the signature of BITs or FTAs. From this day forward and from an institutional perspective, capital market liberalization began to undermine their policy autonomy.

By mid-90s, however, the Washington Consensus become under attack. Economic instability in countries like Mexico, Thailand, Russia and Brazil highlighted the growing uncertainty and risk attached to policies like this. Regime expiration only became visible after the Argentina collapse but few in the North became aware of the magnitude of the problem. Opinion altered after the arrival of the international financial crisis, inciting policy – makers to undertake a more pro-active regulatory policy towards capital inflows. Policy choices and regulatory measures could be contested, however, as Wall Street ambitions towards capital account liberalization and financial deregulation remains intact.

### A hard learning process: Lesson 1 – Argentina

The vagaries of the relationship between foreign investors and host countries sometimes favoured the former, and sometimes benefited the latter. In the 1990s, however, the balance tipped excessively towards foreign investors, as they had managed to enhance the guarantees and legal certainty that developing countries and transition economies provided, by introducing into their contracts with debtors a series of clauses waiving sovereign immunity in the case of default (as the transnational banks had done in the 1970s under the syndicated loan system). Foreign investor's guarantees and advantages were then further expanded as the bilateral scheme became more widespread and a dispute settlement mechanism was introduced enabling them to sue the host country directly. Argentina became the first sovereign nation to experience the muscle of this new scheme.

The Argentinean case results interesting, furthermore, because it also exemplifies the malfunctioning of capital controls. During the 2001-02 crisis investors profited from the legal loopholes at stock market in order to legally flight capitals abroad. In particular, investors used their bank deposits either to purchase Argentine stocks listed at the NYSE [an equity termed

American Depository Receipts (ADRs)] or, to a lesser extent, throughout the purchasing of shares of non-Argentinean firms at the local stock market [the so called, CEDEARs]. Capital flights resurged under the Kirchner administration, as investors lost confidence on the macroeconomic programme following the crisis with the rural constituency, the outright nationalization of the private pension scheme and the intervention on the National Statistic Office (INDEC). Uncertainty among investors rose thereafter, initiating a new phase of capital flights. The collapse of Lehman Brothers at September 2008 and the subsequently international financial crisis stressed investors further. The first case demonstrates the relevance of properly closing legal leaks as investors quickly profited from all legal loopholes to flow out their capital from the country. The second highlights the ineffectiveness of capital controls if macroeconomic policies are not properly functioning.

In relation to the *trilemma,* Argentina certainly played at the vertex during the 90s. The irruption of the crisis radically changes the macroeconomic approach. Argentina reintroduced several measures controlling capital movements and re-regulating the financial system, measures to be partially reverted since 2003. At the same time, the economic team embarked into a managed exchange rate scheme, leading to an increasing trade balance surplus along a lightening fiscal position. This new scenario was also characterized by the accumulation of an important amount of foreign reserves. The international financial crisis and some inconsistency observed at the macroeconomic programme began to attenuate economic agents' enthusiasm and investor´s confidence. Deceleration in the foreign reserve accumulation policy followed could put the economy more vulnerable to sudden stops and, henceforth, more exposed to macro volatility. In other words, despite resting away from the vertex, the constraints posed by the trilemma could suddenly be activated. At the micro level, the banking industry passed through a new process of market concentration. But, the industry performance remained modest as private agents continue to distrust on banks.

From an institutional perspective, and considering the recent financial crisis, it might be constructive to reconsider the Argentina experience at ICSID. At the beginning of the new millennium, and following the collapse of the economy, social disruption and a massive political turmoil, foreign investors rushed to international arbitrational courts in order to maintain their privileges. After considering the Argentinean experience, some legal scholars were wondering why foreign investors claims against the US have not yet materialized (Peterson, 2009; Reed, 2010). The appraisal being followed should not be considered, however, as deterring institutional construction. The quality of institutions remains vital for domestic financial development, although some rules could be controversial. The arrival of foreign investments might be also beneficial, though some investments could be detrimental to national development. BITs signed by Argentina in the nineties are still binding, as the government

neither refuses to denounce them nor not even attempted to renegotiate the existing treaties at their expiration date. At the same time, Argentina still lacks a clear strategy towards foreign investments, including an ineffective policy towards international capital flows.

## A hard learning process: Lesson 2 – Korea

At the institutional front, differences are striking. Korea differentiated from Argentina (and other Latin American countries) by having refused to participate in any bilateral investment agreement with the US - a decision might have prevented Korea from been legally challenged at the aftermath of the previous crises. An approval of the KORUS FTA, hereafter, might be increasing the fiscal costs of an eventual new crisis. Furthermore, foreign investors might be legally entitled to contest some of the latest governmental measures such as those re-introducing capital controls. The signature of the KORUS FTA might be useful to Korea in maintaining their ambitions to become a regional financial hub but at the cost of reducing their policy space.

In relation to the monetary *trilemma* and the Korean response, authorities in the nineties opted to move away from capital controls introducing instead a set of policy measures to prevent the appreciation of the won. But, the efficacy of this option became contested when financial volatility returned. Volatility, in turn, turns more pronounced than before, as the economy became more vulnerable to international markets. Henceforth, the Korean economy increased their vulnerabilities to sudden large-scale withdrawals of foreign capital. In other words, as the capital account happens to be more open and the bank industry more deregulated, chances for increasing volatility are becoming more important, showing how relevant is to better manage financial opening or to advance in the controlling of capital inflows (Kim, undated, Kim et. al 2010).

However, once international capital flows make their reappearance Korean authorities neglected its former advocacy towards financial liberalization and capital account openness. The governmental *Plan to Mitigate the Volatility of Capital Flows*, launched at June 2010, particularly stress the importance of "*a reduction of banks´ excessive short-term borrowing, the reining – in of unnecessary and non-urgent demand for foreign currency and strengthening the management of the soundness of banks´ foreign exchange business*" (BOK, 2010).

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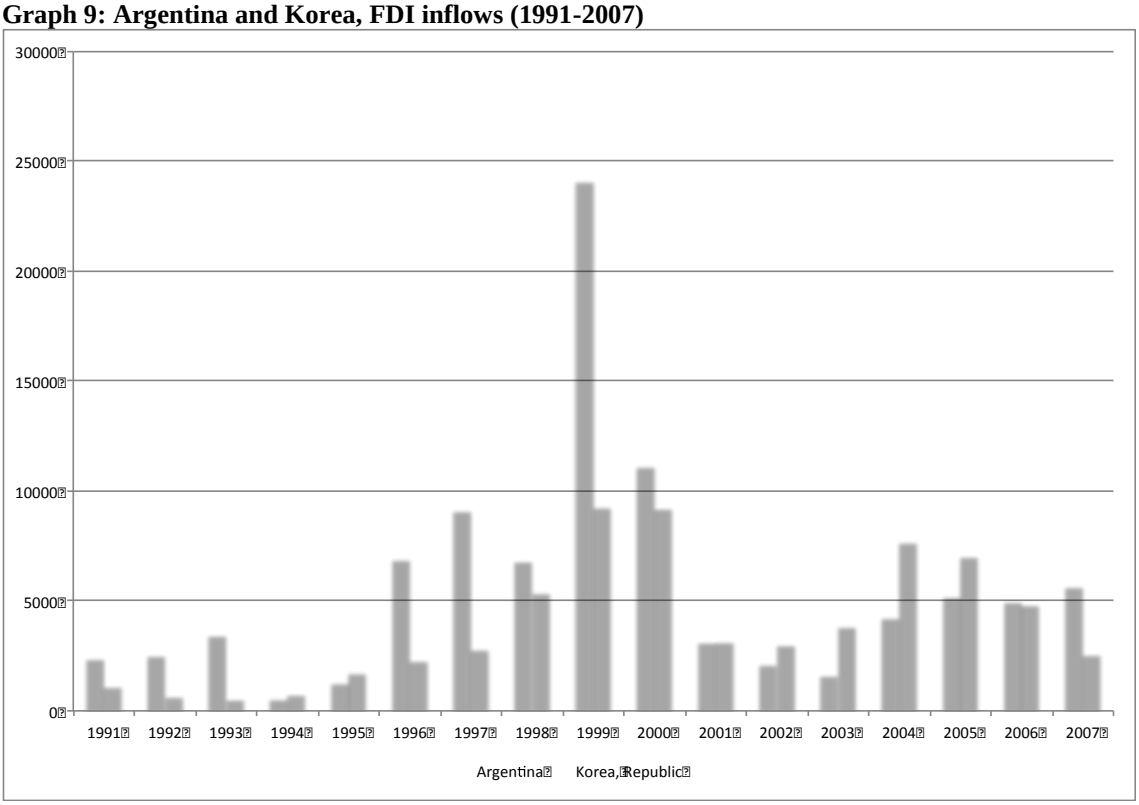
## Annex

**Table 5: Argentina and Korea Republic, basic indicators (1980-2010)**

| Year | Argentina | | | Korea | | |
|---|---|---|---|---|---|---|
| | GDP Current Prices (U$ Dollars, Billions) | GDP per capita (U$ Dollars) | Current Account Balance (U$ Dollars, Billions) | GDP Current Prices (U$ Dollars, Billions) | GDP per capita (U$ Dollars) | Current Account Balance (U$ Dollars, Billions) |
| 1980 | 209.005 | 7.477,83 | -2.573 | 64.385 | 1.689 | -5.312 |
| 1981 | 169.749 | 5.966,58 | -5.721 | 72.399 | 1.870 | -4.607 |
| 1982 | 84.292 | 2.913,66 | -2.917 | 77.524 | 1.971 | -2.551 |
| 1983 | 103.983 | 3.544,07 | -2.436 | 85.962 | 2.154 | -1.524 |
| 1984 | 116.751 | 3.912,58 | -2.495 | 94.945 | 2.350 | -1.293 |
| 1985 | 88.182 | 2.905,51 | -1 | 98.502 | 2.414 | -1 |
| 1986 | 106.038 | 3.449,53 | -2.859 | 113.737 | 2.760 | 4.709 |
| 1987 | 108.718 | 3.496,89 | -4.235 | 143.378 | 3.445 | 10.058 |
| 1988 | 127.343 | 4.046,48 | -1.572 | 192.113 | 4.571 | 14.505 |
| 1989 | 81.701 | 2.564,37 | 1.095 | 236.233 | 5.565 | 5.344 |
| 1990 | 141.329 | 4.344,56 | 4.665 | 270.405 | 6.308 | -2.014 |
| 1991 | 189.583 | 5.750,17 | 0 | 315.575 | 7.289 | -8.417 |
| 1992 | 228.763 | 6.845,08 | -6.468 | 338.171 | 7.730 | -4.095 |
| 1993 | 236.491 | 6.972,55 | -8.043 | 372.209 | 8.422 | 1 |
| 1994 | 257.425 | 7.493,51 | -10.981 | 435.590 | 9.757 | -4.024 |
| 1995 | 258.017 | 7.418,73 | -5.104 | 531.139 | 11.779 | -8.665 |
| 1996 | 272.219 | 7.734,46 | -6.754 | 573.001 | 12.587 | -23.120 |
| 1997 | 292.988 | 8.229,00 | -12.118 | 532.239 | 11.582 | -8.287 |
| 1998 | 299.080 | 8.306,54 | -14.467 | 357.510 | 7.724 | 40.371 |
| 1999 | 283.761 | 7.795,95 | -11.909 | 461.808 | 9.906 | 24.522 |
| 2000 | 284.540 | 7.735,45 | -8.955 | 533.385 | 11.347 | 12.251 |
| 2001 | 269.098 | 7.242,35 | -3.782 | 504.584 | 10.655 | 8.033 |
| 2002 | 102.723 | 2.738,14 | 8.768 | 575.930 | 12.094 | 5.394 |
| 2003 | 129.544 | 3.420,78 | 8.142 | 643.760 | 13.451 | 11.950 |
| 2004 | 153.005 | 4.002,64 | 2.658 | 721.976 | 15.029 | 28.174 |
| 2005 | 183.001 | 4.741,91 | 4.700 | 844.866 | 17.551 | 14.981 |
| 2006 | 214.042 | 5.492,40 | 6.772 | 951.773 | 19.707 | 5.385 |
| 2007 | 262.041 | 6.658,16 | 5.923 | 1.049.239 | 21.653 | 5.876 |
| 2008 | 328.028 | 8.253,18 | 4.807 | 931.405 | 19.162 | -5.776 |
| 2009 | 310.057 | 7.725,46 | 6.189 | 832.512 | 17.074 | 42.668 |
| 2010 e | 351.015 | 8.662,99 | 6.016 | 986.256 | 20.165 | 26.041 |

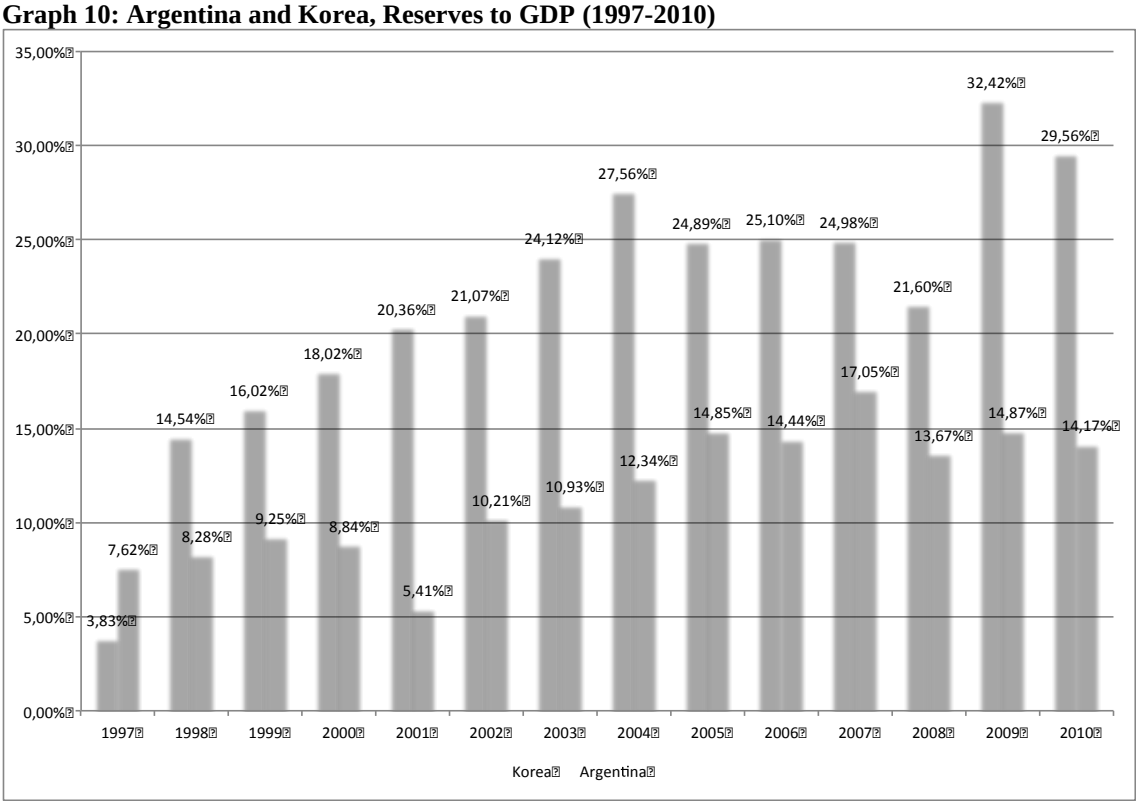
**Source: IMF**

**Graph 9: Argentina and Korea, FDI inflows (1991-2007)**




Source: UNCTAD

**Graph 10: Argentina and Korea, Reserves to GDP (1997-2010)**




Source: IMF Database

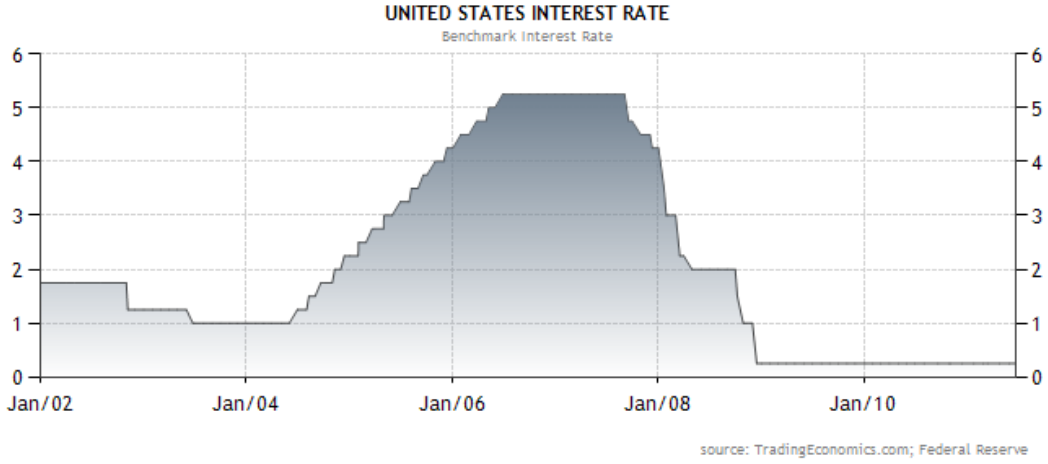
**Table 6: Financial repression and financial liberalization, Argentina and Korea compared**

| Country | Capital Account | Domestic Financial Secto | Stock Market | Liberalization Index |
|---|---|---|---|---|
| Argentina | Apr 76 - Nov 78 PL | Jan 77 - May 82 FL | Jan 77 - Feb 82 PL | Jan 77 - Nov 78 PL |
| | Dec 78 - Feb 82 FL | Jun 82 - Sep 87 R | Mar 82 - Dec 88 R | Dec 78 - Dec 88 R |
| | Mar 82 - Nov 89 R | Oct 87 - Oct 01 FL | Jan 89 - Oct 01 FL | Jan 89 - May 91 R |
| | Dec 89 - Oct 01 FL | Nov 01 - Nov 02 R | Nov 01 - Jun 04 R | Jan 89 - Nov 89 PL |
| | Feb 02 - Mar 03 PL | Dec 02 - FL | Jul 04 FL | Dec 89 - Oct 01 FL |
| | Apr 03 - May 05 FL | | | Nov 01 - Nov 02 R |
| | Jun 05 - PL | | | Dec 02 - Jun 04 PL |
| | | | | Jul 04 FL |
| Korea | Jan 93 - Dec 95 (PL) | Jan 88 - Dec 94 (PL) | Jan 91 - Apr 98 PL | Jan 93 - Dec 95 PL |
| | Jan 96 (FL) | Jan 95 (FL) | May 98 FL | Jan 96 FL |

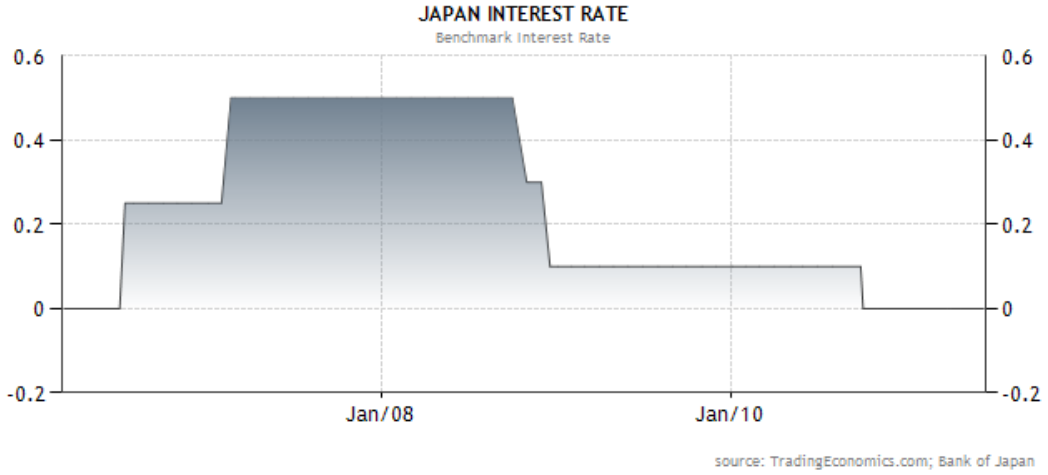
Source: Smuckler

Notes: (R) Financial repression; (PL), Partial Liberalization (FL) Full Liberalization.

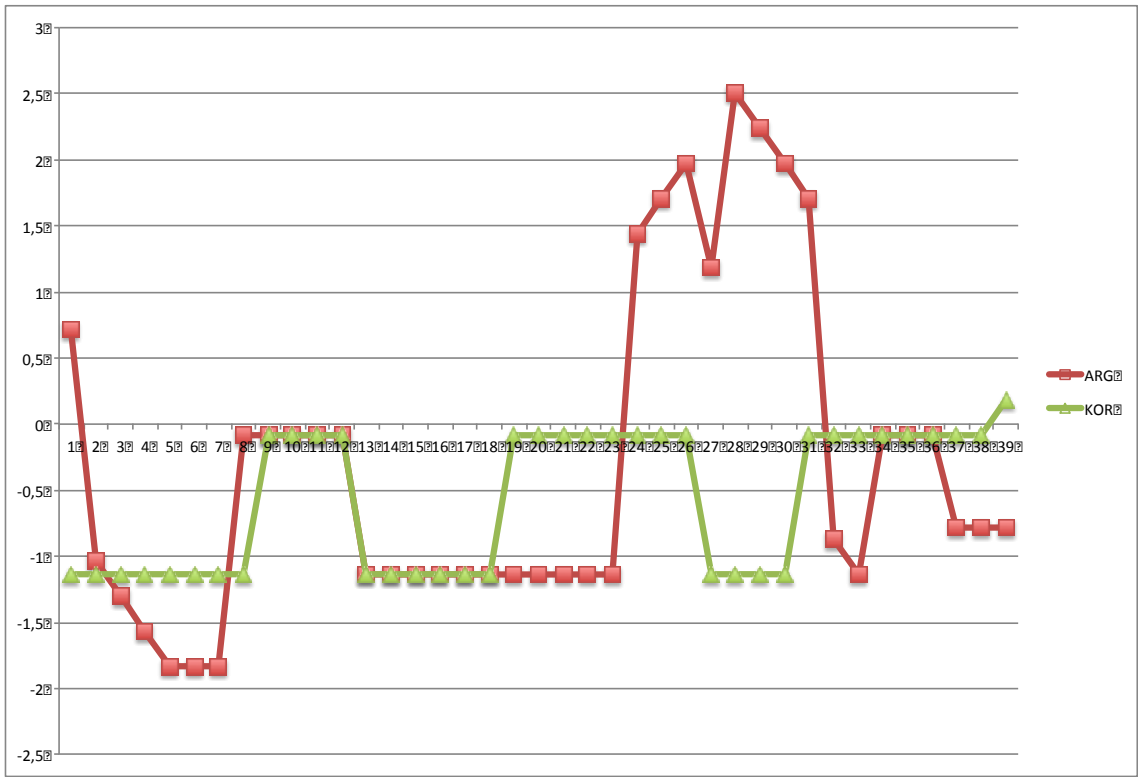
**Graph 11: Interest rates at borrowing countries - US benchmark interest rate**




**Graph 12: Interest rates at borrowing countries – Japan benchmark interest rate**



**Graph 13: Measuring the Trilemma, the Chin – Ito Capital Account Index**




Source: Chin and Ito (2007).

Chin-Ito capital account openness index (KAOPEN) is one index measuring the degree of capital restrictions and regulations imposed by a country. It measures a country´s international financial openness on a scale from -2,54 to +2,54, with the former value indicating a completely closed capital account, and the later indicating full liberalization.

The IMF annual reports on exchange arrangements and exchange restrictions (AREAR) analysing data on thirteen different categories of capital transactions. One problem with those indexes is that they are not capturing differences in the intensity of capital control enforcement.

In a separated paper, professors Joshua Aizenman, Chinn and Hiro Ito expanded the above indicator, including two new indexes trying to measure the trilemma – as observed in the graphs included at the main text. Monetary autonomy or independence (MI) is measured by the (lack of) interest rate correlation with base country interest rate, whereas exchange rate stability (ERS) by the inverse of the standard deviation of the monthly nominal exchange rate changes between the home country and the base country. MI maximum and minimum values are 1 and 0, with higher values meaning more monetary policy independence. For the ERS index, if the rate of monthly change in the exchange rate stayed within +/- 0,33 per cent bands, the exchange rate is consider to be fixed, and assigned a value of 1. Higher values of this index indicate a more stable movement of the exchange rate against the currency of the base country. The paper also introduce a fourth index measuring the ratio of international reserves to GDP, as the author recognizes the particular relevance of foreign reserves accumulation to shield the national economy against financial speculators along to reduce macro volatility.