# IMF conditionality and rule of law: exceptional powers and banking in Malaysia and Venezuela

Gabriel Garcia
University of Wollongong

# IMF CONDITIONALITY AND RULE OF LAW: EXCEPTIONAL POWERS AND BANKING IN MALAYSIA AND VENEZUELA

A thesis submitted in fulfilment of the
requirements for the award of the degree

**DOCTOR OF PHILOSOPHY**

**UNIVERSITY OF WOLLONGONG**

**GABRIEL GARCIA**
**LLB (*magna cum laude*, Central University of Venezuela), LLM (Boston University)**

**FACULTY OF LAW**

**2009**

**CERIFICATION**

I, Gabriel Garcia, declare that this thesis, submitted in fulfilment of the requirements for the award of Doctor of Philosophy, in the Faculty of Law, University of Wollongong, is wholly my own work unless otherwise referenced or acknowledged. The document has not been submitted for qualifications at any other academic institution.

Gabriel Garcia

January 2009

# ABSTRACT

The 1990s was a decade marked by the implementation of market reforms worldwide. Countries in Latin America and Asia experimented with neoliberal programs sponsored by international financial institutions (IFIs) in order to adopt the arrangements required for the functioning of a market economy. The International Monetary Fund (IMF) joined in these efforts and incorporated structural requirements in its programs as conditions for the provision of financial assistance, including requirements associated with the strengthening of governance and the rule of law that limited the scope of *ad hoc* decision making schemes. However, by the end of the 1990s the results of IMF-sponsored reforms were controversial.

This thesis explores, from a legal perspective, IMF conditionality as a mechanism to strengthen the rule of law and the relations between these two concepts and exceptional powers in the banking sector. The main argument developed in this thesis is that in spite of the official discourse regarding the promotion of governance and the rule of law, IMF conditionality did not contribute to strengthening this notion in the 1990s. In contrast, conditionality was involved with episodes of instability and the invocation of states of emergency in some developing countries.

The analysis is undertaken through a comparative case study approach in which the legal responses of the governments of Malaysia and Venezuela to address the financial crises that affected those countries in the 1990s are examined. Malaysia declined the help of the IMF during the crash and instead it implemented its own program to manage the financial turmoil. The Malaysian solution provides useful insights and differences from the *ad hoc* legal management crisis style employed by the Venezuelan government that had the technical and financial assistance of the IMF.

Overall, the findings of this thesis suggest that in the case of Venezuela, IMF conditionality did not contribute to the strengthening of the rule of law and the urgency of the measures contributed to the use of exceptional powers by the Venezuelan government in addressing the banking crisis. In contrast, Malaysia, a nation that adopted its own domestic solution, provides a more adequate legal management approach to a financial crisis that helped to strengthen the rule of law in the banking system.

# ACRONYMS

| | |
|---|---|
| **AD** | Acción Democrática |
| **ADB** | Asian Development Bank |
| **AMCs** | Assets Management Companies |
| **ASEAN** | Association of Southeast Asian Nations |
| **BAFIA** | Banking and Financial Institutions Act 1989 |
| **BANDES** | Economic and Social Development Bank of Venezuela |
| **BCV** | Central Bank of Venezuela |
| **BMF** | Bumiputera Malaysia Finance |
| **BN** | Barisan Nasional |
| **BNM** | Bank Negara Malaysia |
| **CDRC** | Corporate Debts Restructuring Committee |
| **COPEI** | Social Christian Party of Venezuela |
| **CNE** | Venezuelan National Electoral Board |
| **CTV** | Worker Union of Venezuela |
| **CVF** | Corporación Venezolana de Fomento |
| **DANAHARTA** | Pengurusan DANAHARTA Nasional Berhad |
| **DTCs** | Deposit Taking Cooperatives |
| **ESCAR** | Essential Security Cases Regulations 1975 |
| **FEA** | Financial Emergency Act |
| **FEB** | Financial Emergency Board |
| **FEDECAMARAS** | Federacion de Camaras y Asociaciones de Comercio y Producción de Venezuela |
| **FOGADE** | Deposit Guarantee and Banking Protection Fund |
| **FIV** | Investment Fund of Venezuela |
| **FMS** | Federated Malay States |
| **FSAP** | Financial Sector Assessment Program |
| **GDP** | Gross Domestic Product |
| **GNP** | Gross National Product |
| **HDI** | Human Development Index |
| **IADB** | Inter-American Development Bank |
| **IBA** | Islamic Banking Act 1993 |
| **IFIs** | International Financial Institutions |
| **IMF** | International Monetary Fund |
| **ISA** | Internal Security Act |
| **ITs** | Indicative Targets |
| **LOFSA** | Labuan Offshore Financial Services Authority |
| **MCA** | Malay Chinese Association |
| **MCP** | Malayan Communist Party |
| **MIC** | Malayan Indian Congress |
| **MIFC** | Malaysia International Islamic Financial Center |
| **MoF** | Ministry of Finance |
| **MPAJA** | Malayan Peoples Anti-Japanese Army |
| **MVR** | Movimiento Quinta República |
| **NEAC** | National Economic Action Council |

| | |
|---|---|
| **NEP** | New Economic Policy |
| **NERP** | National Economic Recovery Plan |
| **NPLs** | Non Performing Loans |
| **NUDs** | Need and Urgency Decrees |
| **OECD** | Organisation for Economic Co-operation and Development |
| **PAs** | Prior Actions |
| **PAS** | Islamic Party of Malaysia |
| **PETRONAS** | Petroliam Nasional Berhad |
| **PCs** | Performance Criteria |
| **PROTON** | Perusahaan Otomobil Nasional |
| **PRs** | Program Reviews |
| **PRGF** | Poverty Reduction Growth Facility |
| **PSUV** | United Socialist Party of Venezuela |
| **RAP** | Right Accumulation Program |
| **SAC** | National Syariah Advisory Council for Islamic Banking and Takeful |
| **SBs** | Structural Benchmarks |
| **SDRs** | Special Drawing Right |
| **SUDEBAN** | Superintendency of Banks and other Financial Institutions |
| **UMNO** | United Malays National Organization |
| **UMS** | Unfederated Malay States |
| **UNDP** | United Nation Development Programme |
| **UK** | United Kingdom |
| **US** | United States of America |
| **VAT** | Value Added Tax |
| **WB** | World Bank |
| **WWI** | World War I |
| **WWII** | World War II |

# ACKNOWLEDGEMENTS

This thesis has been a long personal and professional journey that started while I worked as a lawyer for the Venezuelan Development Bank (BANDES). During my journey, I became involved with numerous people that in one way or another contributed to my ultimate goal of successfully finishing my project. I want to begin this section by expressing my gratitude to Yelitza Guerra. She was my major strength during all these years at University. I also want to acknowledge the role played by my children, Giancarlo and Veronica, who offered me their love and their patience when I felt a lot of pressure and they stayed quiet, letting me working on my dissertation. I also express my gratitude to my parents Federico and Consuelo who taught me persistence, excellence and, above all, trust in God. I am also grateful to Dr. Haydee Guerra who patiently read my first drafts and with whom I discussed ideas associated with my research project. Thanks for your unconditional support, especially in difficult times.

I must also express my appreciation to my main supervisor, Prof. Christoph Antons, who guided me through my entire project and offered me wisely advice. Prof. Antons introduced me to the study of law in Southeast Asia and gave me the opportunity to be a part of the Centre for Comparative Law and Development Studies in Asia and the Pacific (CLDSAP). I must thank Dr. Rick Mohr who was my first contact with the academic life in Australia. Dr. Mohr acted also as my co-supervisor and his guidance made my first steps in the research world easier. I cannot forget the Dean of the Faculty of Law, Prof. Luke McNamara, who at some point during my research, acted as my co-supervisor and provided me with valuable comments to improve the design of my project. Moreover, I express my gratitude to the Faculty of Law, University of Wollongong that sponsored my participation in various conferences and workshops in which I presented papers associated with this project and assisted me with the edition of this thesis. I also acknowledge the editorial services provided by Dr. Lisa Lines.

Finally, I cannot forget my friends Dr Mehmet Adil and Karina Adil as well as Dr Mary Ann Palma who have made my life far from my country more pleasant. Thank for your friendship and support.

# TABLE OF CONTENT

## TABLES AND FIGURES

# CHAPTER 1

# INTRODUCTION

## 1.1 IMF Conditionality and the Promotion of the Rule of Law in Developing Countries

'To blame the IMF for hardships that countries in crisis face is to blame the doctor for the patient's illness!'[1] The International Monetary Fund (IMF) frequently uses this quotation to defend itself against external criticism that blames the institution for the problems suffered by developing countries. But, did not the IMF have responsibility for the hardship that those nations experienced in the 1990s? The global discontent against the institution and the results obtained through the implementation of IMF-sponsored programs in the 1990s make it difficult to automatically endorse the Fund's statement and exonerate the institution from the problems faced by developing nations.

Created in 1945, the IMF was designed 'to help promote the health of the world economy', preventing crises in the international payment system and providing financial assistance to its members to face balance of payments problems.[2] Guaranteeing the soundness of the international financial system, the Fund would facilitate the expansion of trade, promote a high level of employment and real income, and the faster development of the productive resources of all members.

The IMF undertakes its objectives through the overseeing of financial systems of its country members, the facilitation of technical assistance, and providing financial support to its members to overcome financial difficulties. The latter is subjected to compliance with a set of conditions (conditionality) that were initially associated with macroeconomic indicators. Later, the Fund incorporated structural requirements as conditions for the transfer of financial assistance and began to address areas associated with the strengthening of governance and the rule of law. It was claimed that these areas had to be addressed to achieve economic growth and eradicate

---

1 IMF, *Common Criticisms of the IMF: Some Responses* (2004) IMF <http://www.imf.org/external/np/exr/ccrit/eng/crans.htm#aus> at 16 October 2004.

2 IMF, What Is the International Monetary Fund? (2004) IMF <http://www.imf.org/external/pubs/ft/exrp/what.htm#preface> at 16 October 2004.

poverty.[3] Consequently, countries that suffered a financial collapse in the 1990s and asked for the IMF's assistance were required to implement reforms that, among other goals, sought to create a legal system supportive of good governance and the rule of law that included sound institutions and an adequate regulatory climate conducive to efficient private sector activities.

Efforts of International Financial Institutions (IFIs) oriented to strengthen the rule of law as one of the keys to achieve development was not the first time that law was conceived as an instrument to produce change. It was preceded by a movement that emerged in the 1960s known as 'the law and development movement'. [4] In the case of this pioneer wave, universities and aid agencies mainly from the United States (US) advocated for the rationalisation of law in developing countries through the transplant of foreign legislation and the promotion of the American legal education model. In the 1990s, the law and development wave primarily focused on the rule of law and multilateral agencies such as the World Bank (WB) and the Inter-America Development Bank (IADB) sponsored programs that supported legal and judicial reforms while the IMF incorporated into its financial arrangements conditions that covered legal matters (for instance governance). Most of the actions suggested by IFIs targeted financial and business law.

Under the above premise, the IMF was very active in South America in the 1990s, where it facilitated financial assistance subject to the dismantling of an old legal model that supported the intervention of the state in the economy. The Fund committed to disburse up to 41.5 billion of Special Drawing Rights (SDRs)[5] in the region between 1989 and 1999. Despite this financial aid, South American countries showed few signs of improvement in their overall situation. For instance, there were major financial crises in Argentina, Peru and Venezuela after the implementation of IMF-sponsored programs.[6] The legal systems of these countries coped with

---

3 See for example, the Declaration issued by the IMF Interim Committee during the Fifty-First Annual Meeting of the International Monetary Fund (IMF) Board of Governors in 1996 in IMF, *Summary Proceedings of the Fifty-First Annual Meeting of the Board of Governors* (1996) IMF <http://www.imf.org/external/pubs/ft/sum51/pdf/part05.pdf> at 12 October 2004.

4 See David M. Trubek and Alvaro Santos, 'Introduction: The Third Moment in Law and Development Theory and the Emergence of a New Critical Practice' in Trubek, David M. and Santos, Alvaro (eds), *The New Law and Economic Development/A Critical Appraisal* (2006) 1-18; John Ohnesorge, 'Developing Development Theory: Law and Development Orthodoxies and the Northeast Asian Experience' (2007) 28 *University of Pennsylvania Journal of International Economic Law* 219. The different moments of the law and development movement will be discussed in further details in section 2.3.

5 Special Drawing Right is a reserve asset created by the IMF in 1979. 1 SDR is equivalent to US$ 1.5.

6 See, e.g., Paul Blustein, *And the Money Kept Rolling in (and out) : Wall Street, the IMF, and the Bankrupting of Argentina* (2005); Philip Mauceri 'State Reform, Coalitions, and the Neoliberal Autogolpe in Peru' (1995) 30 *Latin American Research Review* 7-37; Kurt Gerhard Weyland, *The Politics of Market Reform in Fragile*

excessive tensions threatened by coups, social unrest and authoritarianism from the executive branch. It was a decade of Menem's *decretazos*[7] in Argentina, the 'self-coup'[8] of Fujimori in Peru and the reappearance of military coups in Venezuela. Finally, in the 1990s, the promise of reducing poverty had a mixed result and although it decreased in relative terms, it increased in absolute terms with some countries failing in their efforts to reduce it (for example, Venezuela, Paraguay, Ecuador and Colombia).[9]

In spite of the intention of the Fund to promote the strengthening of governance and the rule of law, its conditionality produced greater tensions over the ordinary legal and political arrangements in the developing world because governments were forced to act rapidly to comply with IMF conditions in order to access its financial resources. In South America generally, it was common for the executive to invoke states of emergency and then issue decrees passing the legal reforms required by the Fund. This legal path created doubts about whether conditionality was an adequate tool to push for structural reforms and particularly to strengthen legal systems. In contrast, it was observed that there was tension between the principles contained in the notion of the rule of law and conditionality.

Venezuela was one of the countries where the IMF intervened and sponsored two programs, the Great Turnaround (*el Gran Viraje*) in 1989 and Agenda Venezuela in 1996. Former IMF Managing Director, Michel Camdessus, stated that paternalism, populism and excessive intervention of the state in the economy destroyed institutions in Venezuela and made it necessary to implement the structural reforms suggested by the Fund.[10] However, were distortions of the Venezuelan economy reduced by the IMF's assistance? Did the IMF really help to reconstruct Venezuelan institutions and its legal framework? How did the IMF conditionality and the Venezuelan government's legal strategies interact to apply these programs?

---

*Democracies: Argentina, Brazil, Peru, and Venezuela* (2002). In chapters 7 and 8 of this thesis, the case of Venezuela will be discussed.

7 *Decretazos* were need and urgency decrees (NUDs) issued by Argentinean President Carlos Menem without any constitutional basis. See section 4.6.

8 The events that led to the unconstitutional dissolution of the Congress and the Supreme Court by an emergency decree enacted by Peruvian President Alberto Fujimori in 1992 are popular known as the '*autogolpe* (self-coup)'. See Section 3.4.

9 Economic Commission for Latin America and the Caribbean, 'Social Panorama of Latin America 2001-2002' (ECLAC, 2002) .36. See also Economic Commission for Latin America and the Caribbean, 'Social Panorama of Latin America' (ECLAC, 2004) 6; United Nations Development Programme (UNDP), 'Human Development Report 2003' (UNDP, 2004), 3.

10 Michel Camdessus, *Press Conference* (1997) IMF < http://www.imf.org/external/np/tr/1997/tr970424.htm> at 20 February 2004.

A quick overview of the Venezuelan reality reveals discouraging results. Statistics show that between 1989 and 1999 real Gross Domestic Product (GDP) was 1.4%, inflation 49.4% and unemployment 10%. In the same period, poverty increased from 39.8% to 42%. In addition, reports published by IFIs and other non-governmental organisations indicate a deterioration of Venezuelan legal and democratic institutions, a consistent trend since the second half of the last decade.[11] A similar negative trend is reported in the banking system, which, after the reform sponsored by the Fund, is still considered to have a weak supervisory and regulatory framework, and highly depends on governmental transactions.[12]

The above panorama in which the official discourse of the IMF differs from reality set the background of this research, in which IMF conditionality is studied as a mechanism to strengthen the rule of law. Further, this thesis examines whether or not this tool could assist countries to achieve this goal. The inquiry is also extended to the analysis of exceptional powers as a mechanism to address economic crises and its links with IMF conditionality. The interaction between IMF conditionality and exceptional powers is important in the case of South America, and particularly in Venezuela, where the government employed this emergency approach to address the crisis and comply with IMF conditions.

The interaction between the rule of law, IMF conditionality and exceptional powers raises interesting questions about whether or not conditionality induces governments to implement reforms invoking exceptional powers and whether conditionality and exceptional powers can meet the rule of law standards, support institutional changes and the ultimate goal of development: better living standards for people.

The main argument of this thesis is that IMF conditionality did not contribute to strengthen the rule of law in the 1990s. In contrast, in developing countries conditionality was involved with unstable episodes and the invocation of states of emergency.

---

[11] See Robert Kaufman, Aart Kraay and Massimo Mastruzzi, *Governance Matters V: Governance Indicators for 1996–2005* (2006) World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/WBI/EXTWBIGOVANTCOR/0,,contentMDK:21045419~menuPK:1976990~pagePK:64168445~piPK:64168309~theSitePK:1740530,00.html> at 18 September 2006.

[12] See, e.g. Rodolphe Blavy, 'Assessing Banking Sector Soundness in a Long-term Framework: The Case of Venezuela' (Working Paper WP/06/225 IMF, 2006);

The analysis is undertaken through a comparative case study approach in which the legal responses of Malaysia and Venezuela to address the financial crises that occurred in the 1990s are examined. Before the Asian crisis broke out in 1997, Malaysia enjoyed a sustained economic growth that contributed to the reduction of poverty and, in general, to the improvement of standards of living of Malaysians. The government led the efforts oriented towards the development of the economy, combining selected market-oriented policies with other programs that benefited Malays.

When the crisis erupted, Malaysia declined the assistance of the IMF and instead opted to implement its own program to manage its financial turmoil, keeping some of its pre-crisis developmental goals. The Malaysian solution provides useful insights and differs from the *ad hoc* legal management crisis style employed by the Venezuelan government that had the technical and financial assistance of the IMF.

## 1.2 Significance

In the last few years, various studies have been published that address the use of the rule of law as the centre of the current discourse that guides activities sponsored by IFIs.[13] Development agencies such as the WB, which design specifically labelled 'rule of law' reforms, have occupied most of the focus of scholars while the IMF has attracted less attention, due to its more financially oriented perspective. However, the Fund has adopted policies to target specific areas associated with governance and the rule of law and its conditionality has been specifically used to force legal reforms in financial and business areas. The performance of the Fund in this legal arena has not yet been fully studied.

Additionally, an extensive literature mainly written by economists supports or criticises the programs sponsored by the IMF. Rarely, legal issues associated with the Fund are addressed in this literature. For instance, in a section published at the IMF's website entitled 'Common Criticisms of the IMF: Some Responses', the institution summarises the different arguments against its policies. Among the

[13] See, e.g., David M. Trubek, 'The "Rule of Law' in Development Assistance: Past, Present, and Future' in Trubek, David M. and Santos, Alvaro (eds), *The New Law and Economic Development/A Critical Appraisal* (2006) 74-94; Ohnesorge, above n 4; Joel Ngugi, 'Policing Neo-Liberal Reforms: The Rule of Law as an Enabling and Restrictive Discourse' (2005) 26 *University of Pennsylvania Journal of International Economic Law* 513.

criticism discussed, none could be classified as a legal issue, with only one exception.[14] This apparent disinterest in legal issues associated with the IMF may be due to the fact the institution deals primarily with financial issues. Nevertheless, as stated above, there is a legal component included in IMF financial programs.

The aim of this research is to contribute to the debate about the IMF's policies but from a legal perspective, examining conditionality and its effects on the rule of law in developing countries. This issue is important, especially in the implementation stage of market reforms promoted by the Fund. Law is not a simple means to execute markets reforms and improve macroeconomic indicators. Its use must be connected to the other goals associated with a comprehensive concept of development, including the rule of law. Legal methods adopted by governments to achieve economic goals may affect the legal system of developing countries with negative consequences for other aspects that are also essential to overall success in the development process. It is expected that this research will contribute to the understanding of the implementation of market reforms and how they affect legal institutions.

## 1.3 Research Questions

To assume the analysis of the problem briefly introduced in the first part of this chapter the following research questions have been formulated:

1. What does the rule of law mean in a developing country context?

2. How has IMF conditionality affected the legal methods chosen by governments to meet the financial institutions' requirements?

3. How do legal approaches used by countries submitting to IMF conditionality differ from those that are not when they face a financial crisis?

[14] The only criticism that could be related to legal affairs is about effects of IMF on human rights. The IMF's response to this criticism is suggesting that deregulation of the economy diminishes corruption and '… creates a level playing field for the citizens of a country, thereby promoting the civic rights of individuals'. IMF, above n 1.

4. Has conditionality contributed to building reliable legal institutions and strengthening the rule of law?

5. Has the IMF, looking for macroeconomic results, encouraged governments to use legal approaches that do not completely comply with the rule of law?

6. Are governments not submitted to the conditions of IMF assistance more consistent with their reform programs than those that do have IMF assistance?

7. How do results achieved by reforms differ in countries with the IMF's assistance and those without it?

## 1.4 Analytical Framework

This study assumes a qualitative research approach and relies exclusively on documentary sources. Primary literature includes reports, programs and documents issued by the governments of Malaysia and Venezuela, and the IMF. Articles published in magazines and newspapers have also been used to document facts associated with the crises in both nations. Instruments from the legal systems of Malaysia and Venezuela, and the regulations that govern IMF operations have been also used.

The thesis is divided into two parts. The first part is a theoretical section, which develops an understanding of the rule of law, IMF conditionality and exceptional powers. The second part deals with comparative case studies that involve the banking crises of Malaysia and Venezuela in the 1990s.

### 1.4.1 Theoretical Approach

The first step undertaken to respond to the research questions was to build a conceptual framework. This constitutes the basis of the research and guides the analysis of the case studies. In this section, the rule of law, IMF conditionality and

exceptional powers are examined as well as the connections between these three concepts.

The debate about the rule of law is initially placed within the context of the discussion on law and development. From this perspective, the rule of law is viewed as the centre of the law and development movement during the 1990s. Second, the principles contained in the notion of the rule of law are discussed, considering the formal and substantive frameworks built by different authors. Using the formal approach to the rule of law, the thesis studies the way in which the IMF joined the debate about the strengthening of the rule of law. Finally, combining elements of the formal and substantive approaches, a notion of the rule of law is proposed for developing countries, which serves to assess the legal strategies adopted by the governments of Malaysia and Venezuela to address the financial crises of the 1990s and determine whether they respond to the principles contained in this notion of the rule of law.

This section also contributes to an understanding of IMF conditionality as a tool to strengthen the rule of law and discusses the tension that this mechanism imposes on the rule of law. The approach used to reveal this tension is a legal analysis of IMF agreements and the conditionality incorporated in such documents. The IMF's allegation that its agreements are not legal contracts is challenged using different theoretical frameworks.

Finally, the conceptual framework examines the basis of exceptional powers in the economic realm which is of particular importance in the case of Venezuela whose government employed this legal strategy to manage the banking collapse. The analysis includes a discussion on whether or not exceptional powers could be invoked to address economic crises and the limits under which exceptional powers could be used without putting at risk the notion of the rule of law.

### 1.4.2 Case Studies

The empirical section of this thesis tests the ideas studied in the conceptual framework against the crisis scenario provided by the financial collapses that occurred in Malaysia and Venezuela in the 1990s. A case study approach is useful

to observe how an IMF program could affect the legal method adopted by a developing country to address a banking crisis and to examine how IMF conditionality works in practice to strengthen governance and the rule of law. Secondly, a comparative case studies approach provides an opportunity to review two different styles for the management of financial crises. The first example, Malaysia, decided to address its financial turmoil without the help of IFIs while the second example, Venezuela, had the technical expertise and financial assistance of the IMF.

The study of the Malaysian crisis focuses on the banking component of the National Economy Recovery Plan (NERP), designed by the Malaysian National Economic Action Council (NEAC) led by Prime Minister, Tun Dr. Mahathir bin Mohamad, in 1998. In the case of Venezuela, the object of the analysis is the banking aspect of a program known as Agenda Venezuela, launched by the administration of Venezuelan President Dr. Rafael Caldera with the help of the IMF in 1996. Frequent references would be made to another program sponsored by the Fund in Venezuela in 1989, 'the Great Turnaround', because it contains some of the causes that led to the banking collapse.

Although the financial crisis erupted in Venezuela and Malaysia in 1994 and 1997 respectively, the effects associated with both events went beyond that decade. To illustrate, in the case of Venezuela the crisis was officially terminated in November 2001 when President Hugo Chávez passed the 2001 Banking Act that revoked the state of financial emergency. However, this revocation did not solve many issues associated with the crisis that remained unresolved at the end of 2007.[15] In the case of Malaysia, Pengurusan *DANAHARTA Nasional Berhad* (DANAHARTA), one of the *ad hoc* vehicles created by the Malaysian government to deal with the crisis, ceased operations in 2005. As a result, whilst most of the analyses are focused on the events that occurred in the 1990s, there will be frequent references to more recent issues that are related to the studied crises.

Instead of commencing the empirical section of this research directly with the banking crises and the related events, it seemed necessary to include introductory chapters to both case studies. These preliminary chapters set the historical, legal, social, economic and political background for both countries that helps to clarify the

[15] These unresolved issues will be discussed in chapter 8.

context under in the crises developed, each government's response and the IMF's intervention. This approach would serve to avoid the exclusive reliance on formal law.

The selection of case studies was supported by several reasons. Firstly, the author was a corporate lawyer who worked for many years for Venezuelan governmental financial institutions involved in development issues (the Investment Fund of Venezuela and the Economic and Social Development Bank, BANDES). He worked under different administrations, including those of Presidents Carlos Andrés Pérez, Rafael Caldera and Hugo Chávez but the author was not involved with the institutions that managed the banking crisis in Venezuela.

During all these years of practice with the government, the author was often attracted to study more deeply the connections between law and development and to try to understand the disconnection between both in Venezuela where lawyers working for the state do not usually have time to research, but only to act. It was a challenge to understand why Venezuelan governments tend to respond to problems with the issuance of new legislation, especially emergency decrees, without considering the solutions provided by the existing legal framework and why legislation and decrees passed were not completely enforced. This did not improve with the participation of IFIs in the 1990s. The banking crisis experienced by Venezuela in the 1990s represented an extraordinary case because it included all three main theoretical notions examined in this thesis: the rule of law, IMF conditionality and exceptional powers. Other cases, such as Argentina and Peru, could also have served the purpose but the fact that the author had a better knowledge of the Venezuelan legal system and its reality influenced the final decision.

Secondly, in the research designing stage, the author decided to choose another case to contrast against Venezuela. It was necessary that the other country was a developing one with an economy and population comparable to Venezuela. In addition, it was necessary that the selected country had suffered a financial crisis and the government resolved it without the support of the IMF. The perception was that other neighbouring Latin American countries faced similar problems than those of Venezuela and many of them have been characterised by some erratic path to development. It was thought that Asia could provide a different picture because it is

a region that has a more positive outcome in terms of industrialisation and abatement of poverty.

Applying the above criteria, it was discovered that Malaysia met most of the requirements. Although its GDP, as a measure of the size of the economy, was different, it is comparable and at some point of time, it was similar. Malaysia was one of the nations affected by the Asian crisis but the government responded without the IMF financial assistance and decided to adopt its own rescue plan. Moreover, the fact that in addition to the Malay language (official), English is widely used by governmental agencies, universities and media in Malaysia, provided an additional element for selecting this country.

### 1.4.3 Analysis of Results

The development of the empirical component of the thesis is guided by the conceptual framework. Both case studies focus on the legal management of the crises in the banking sector assumed by the governments of Malaysia and Venezuela and the examination of the rescue plans adopted and how they complied with the formal and substantive attributes of the rule of law, as defined in Chapter 2. This analysis explores legislation or decrees issued by the state as a result of the implementation of their programs. It also pays attention to the approach assumed to issue new norms and whether or not they were dictated exercising exceptional powers. In the latter case, it is analysed whether or not the state was restricted by constitutional provisions. The use of states of emergency, frequent changes of legislation, the issuance of presidential decrees would give a strong indication that the principles of the rule of law were overwhelmed.

To study how IMF conditionality effectively contributed to the rule of law, it is necessary to examine how conditions were negotiated and implemented, as well as its relationship with the Venezuelan legal system. To examine the influence of the IMF in the selection by the Venezuelan government of an *ad hoc* approach to manage the banking crisis the type of assistance provided by the Fund to the Venezuela government is reviewed, the timing of such assistance and the type of conditionality involved in the financial assistance supplied to Venezuela.

Finally, considering a comprehensive understanding of development, a goal-free evaluation approach will be used to review the results achieved by the implementations of the rescue programs in areas such as poverty, access of banking services, political stability and economic indicators. [16] Instead of looking for specific goals in these sectors included in the programs designed by the government of Venezuela and Malaysia, the author will look for overall results beyond the legal system.

## 1.5 Thesis Structure

This thesis is divided into nine chapters. This first chapter introduces the problems associated with the promotion of governance and the rule of law by the IMF. It also contains the research questions and the analytical framework used in this thesis.

Chapter 2 discusses the meaning of the rule of law and searches for an understanding applicable to developing countries. The chapter begins by reviewing the concept of development as a notion that encompasses the rule of law. Secondly, it reviews the literature that examines the rule of law in the development process and the rule of law in the arena of IFIs. Chapter 2 also explains how the IMF participates in the promotion of governance and the rule of law. The last section of this chapter proposes an approach to the rule of law that includes formal and substantive attributes that will be used for the analysis of the case studies. The chapter concludes by providing an understanding of how this notion should be understood in the banking sector.

Chapter 3 focuses on IMF conditionality. It provides an explanation of how conditionality works, including its legal rationality and the different forms of conditionality. The chapter concludes with a discussion of the consequences of IMF conditionality on the democratic and legal systems of developing countries.

Chapter 4 provides the basis for understanding the use of exceptional powers to address economic crises and the possibility of using this tool to ease tensions

[16] For an understanding of a goal-free evaluation, see Michael Scriven, 'Evaluation Ideologies' (1984) 9 *Evaluation Studies Review* 49.

identified between the rule of law and IMF conditionality. This chapter offers some guidelines to harmonise exceptional powers with the rule of law and avoid authoritarianism and excesses associated with its use. The final section of Chapter 4 discusses the use of exceptional powers to resolve banking collapses.

The empirical part of this thesis begins with Chapters 5 and 6, which focus on the Malaysian case. Chapter 5 provides a general framework through which to understand the Southeast Asian country and the chief factors involved in the decision making process of the government. Elements such as Islam and multiculturalism are reviewed for their influence on the definition of social, political and legal arrangements. Chapter 5 also describes the Malaysian legal system, including the main constitutional features such as the structure of the federal government and the exceptional power scheme. Chapter 5 concludes with the analysis of the financial crisis in the deposit-taking cooperative sector that occurred in the 1980s and provides an example of use of exceptional powers to resolve a financial turmoil.

Chapter 6 addresses how the Malaysian government managed the banking distress caused by the Asian crisis. The chapter begins by describing the Malaysian banking sector before the onset of the crisis, including the legal framework in force and the supervisory and regulatory authorities. This section also highlights the two approaches adopted by the government to address the crisis as well as the issues associated with the removal of Deputy Prime Minister Anwar Ibrahim. Chapter 6 focuses on the legal approach assumed by the Malaysian government to rehabilitate the banking system. The last section of the chapter summarises the results achieved by the government with its home-grown approach.

Chapters 7 and 8 focus on the case study of Venezuela. Chapter 7 provides a historical, social, economic, political and legal background that contributes to understanding the conditions under which the 1994 banking crisis erupted, including the role played by the oil production in many aspects of Venezuelan life. Chapter 7 also introduces the main features of the Venezuelan legal system, the structure of the federal government and the situation of the rule of law. The last section of this chapter describes the exceptional regimes incorporated into the Venezuelan legal system.

Chapter 8 specifically deals with the banking crisis that broke out in Venezuela in January 1994. The chapter introduces the main features of the legal banking framework in place at the time of the banking collapse. The chapter also highlights the two programs implemented by the government of Rafael Caldera to tackle the financial turmoil, including the IMF-sponsored Agenda Venezuela. The second section of Chapter 8 provides an analysis of the numerous legal instruments issued by the state to resolve problems in the banking system, including a study of the *ad hoc* scheme that partially displaced the ordinary legal banking framework. This section also examines the assistance provided by the IMF and its connections with the emergency approach assumed by the government. Chapter 8 concludes with an analysis of the results achieved by the government.

Chapter 9 contains the conclusions of this study. This chapter summarises the two case studies and how governments legally managed the problems in the banking sector. Secondly, it addresses the research questions formulated in Chapter 1. The analysis suggests that in spite of the technical and financial assistance provided by the IMF, Venezuela seems to be further away from an ideal notion of the rule of law than Malaysia in the banking system. This conclusion provides a strong case to affirm that IMF conditionality was ineffectual in strengthening the rule of law in Venezuela. Chapter 9 ends by describing how South America and Southeast Asia have tried to build some barrier against future interventions of the Fund and briefly introduce how the subprime crisis that broke out in the US in 2007 could affect the rule of law played by the Fund in developing countries.

# CHAPTER 2

# RULE OF LAW, IMF AND THE BANKING SYSTEM

## 2.1 Introduction

In order to study the reforms caused by the 1990s financial crises, and in particular the legal strategy followed by developing countries, it is necessary to consider the law and development debate that prevailed at that time and the way in which IFIs participated in the discussion in order to design their programs. During that decade, the market rule of law approach was one of the methods most often promoted in order to achieve development.

In the case of the rule of law, the notion was conceived as one of the pillars required to sustain private activities that in turn would have positive results in economic growth and poverty indicators. Thus, IFIs, as law and development advocates, reassumed the idea to encourage development through the use of law, this time focusing on the concept of the rule of law.[1] Programs to strengthen the rule of law were led by the WB and other multilateral development organisations that promoted legal and judicial reforms, (for example, the IADB and the ADB). Nonetheless, the IMF did not withdraw itself from this perspective and joined in these efforts, assuming the issue through the concept of good governance.

To justify the new strategy, the IMF argued that it was burdensome to achieve its financial goals without addressing governance issues that affected the achievement of its monetary objectives. Using this approach, the IMF persuaded developing countries to reform areas of their legal systems to follow pre-established models, similar to those applied in more advanced economies. Different from development international agencies (e.g. WB and the IADB) that provided money to developing countries to undertake specific programs associated with the rule of law (for example: modernization of courts, drafting of financial legislation, etc), the IMF

---

[1] For recent articles that explains how IFIs have undertaken the rule of law efforts, see David M. Trubek, 'The "Rule of Law' in Development Assistance: Past, Present, and Future' in David M. Trubek and Alvaro Santos (eds), *The New Law and Economic Development/A Critical Appraisal* (2006) 74-94; John Ohnesorge, 'Developing Development Theory: Law and Development Orthodoxies and the Northeast Asian Experience' (2007) 28 *University of Pennsylvania Journal of International Economic Law* 219;

addressed the rule of law providing financial resources without indication of how they should be applied but incorporating structural conditions into its financial assistance programs on which depended the disbursement of money.

This chapter will review how and in which context the IMF undertook its efforts towards the rule of law. For this purpose, the chapter will begin by reviewing the concept of 'development' as well as the different approaches assumed by advocates of law and development since the 1960s. This will allow insight into how the notion of the rule of law was placed in the centre of the debate. Secondly, this chapter will review the current discussion about the meaning of the rule of law and analyse the concept from the IMF's perspective. Finally, this chapter will propose an understanding of the rule of law that includes formal and substantive attributes, and discuss how the concept should be approached in the banking system, the area in which the case studies are focused.

## 2.2 Development: From the GNP approach to the Comprehensive Development Framework

Development is a very complex phenomenon that cannot be completely covered in a few pages. It is a term continuously considered by IFIs when they design programs oriented towards assisting their state-clients. Although development is a disputed term, there is little debate over the fact that a remarkable number of nations are still labelled by IFIs as developing. [2]

Though the term was not coined in the twentieth century, most scholars concur that it was in the 1940s that development assumed a predominant role in public policies of poor countries and program-design of IFIs.[3] Initially, development was associated with economic growth and national income.[4] Experts assumed that if a country

[2] For a review of the evolution of the development concept since the 1940s see John Rapley, *Understanding Development. Theory and Practice in the Third World* (2nd ed, 2002).

[3] Noorjahan Bava argues that development or social change, as sociologists preferred to call it, has been known as progress, evolution and modernisation since the eighteenth century. Noorjahan Bava, , 'Development as a Multidimensional Concern' in G. Mudacumura, et al. (eds), *Handbook of Development Policy Studies* (2004). Others consider development was an answer to capitalism erected in the nineteenth century by the Saint-Simonians. See Michael Cowen and Robert Shenton, 'The Invention of Development' in J. Crush (ed), *Power of Development* (1995) 27. See also, Knut Nustad, 'The Development Discourse in the Multilateral System' in M. Boas, et al. (eds), *Global Institutions and Development. Framing the World?* (2004) 13.

[4] See e.g., Harvey Leibenstein, *Economic Backwardness and Economic Growth: Studies in the Theory of Economic Development* (1957). See also Raymond Mikesell, *The Economics of Foreign Aid and Self-*

improved its gross national product (GNP), it would automatically enhance the quality of life of its people. It was believed that the increase of economic growth would contribute to move countries from what the advocates of the theory of modernisation called 'the initial stage' (underdevelopment) to full progress, similar to that experienced by rich Western nations.[5] According to this theory, in order to succeed and mature their economies, poor nations must take the path followed by the First World in order to achieve industrialisation.[6]

Under this vision of development, the Bretton Woods system was formed, primarily by the IMF and WB, and started to operate. As will be explained in more detail later, the IMF was created to help sustain the stability of the international payment system and to avoid financial crises that were often at that time. These crises hurt not only the affected nation, but also its trade partners. Meanwhile, the WB was conceived to support European reconstruction at the end of World War II (WWII). After this task was completed, the WB turned its attention to promote development of the disadvantaged nations.

One of the most important figures behind the establishment of the new institutions was John Maynard Keynes. He conceived a different role for the state in the economy than the one proposed by neo-classical theorists who strictly believed in the market as the unique response to development. He also did not believe in the diminished responsibility given to the state by neo-classicalists. In contrast, Keynes proposed that the state assumed a more active attitude to complement market forces and motivate the economy to supersede recession.[7] Using an expansionary fiscal policy, Keynes argued that the state could contribute to the recovery of the economy. Keynes' advice was followed by Europe during the post-war reconstruction efforts.

Developing countries also began to experiment with policies in which the state had an expanded function in the 1950s. IFIs supported this view, financing programs

---

*sustaining Development* (1983). Although this author recognises that there are other social factors that count for development, he argues 'a country's ability to realize them will depend largely on the growth of its total output of good and services'.

5 See Bert Hoselitz, 'Theories of Stages of Economic Growth' in B. Hoselitz, et al. (eds), *Theories of Economic Growth* (1960).

6 For example, Walt Rostow identifies five stages of growth: the traditional society, the preconditions for take-off, the take-off, the drive to maturity, and the age of high mass-consumption. Walt Rostow, *The Stages of Economic Growth: a Non-Communist Manifesto* (Second. 1971) 4.

7 Donald Mogridge (ed) *The Collected Writing of John Maynard Keynes. Vol. XIII. The General Theory and After* (1973).

constructed on this basis.[8] It was thought that massive infusions of international aid would serve as a 'big push' to aid the development of poor countries.[9] During the 1950s and 1960s, the WB directed 75% of its lending to infrastructure, a sector that could induce economic growth.[10] In this period, governments assumed the main the role of designing policies oriented towards the industrialisation of the economy. It was thought that governmental coordination was essential to guide all of these efforts.

Years later, the economic growth approach to development began to be criticised for its excessive reliance on GNP.[11] Experts noticed that economic growth was not enough to consider a country as developed. In contrast, scholars observed a perversive side of economic growth in developing countries: increasing poverty and an unequal distribution of income.[12]

Discontent with the thin definition of development drove further research in the area and a consensus began to emerge among scholars about the multi-dimensional nature of the term. It was understood that development could not be defined in exclusive economic terms and instead it began to be viewed as an 'umbrella concept' formed by several dimensions.[13] Noorjahan Bava, for instance, claims that development involves political, legal, administrative, social, economic, cultural, environmental, psychological, physical, mental, intellectual, moral, material, spiritual, individual, group, rural, urban, local, sub-national, regional, national, international, and global aspects.[14] The complexity of the notion means that the economic side is important, but is not the sole determinant of development. There were other areas that needed to be considered to achieve development. Experts also underlined that the various components of development were not isolated, but provided an interconnected reason by which they must be treated in a coordinated manner to

---

8 See e.g., Luiz Bresser, 'Economic Reforms and Economic Growth: Efficiency and Politics in Latin America' in L. Bresser, et al. (eds), *Economic Reforms in New Democracies. A Social-Democratic Approach* (1993) 15, 31; M. Shamsul Haque, 'Introduction. Development Discourse and its Challenges and Directions' in G. Mudacumura, et al. (eds), *Handbook of Development Policy Studies* (2004) 1-24, 7.

9 Mikesell, above n 4, 4.

10 Constantine Michalopoulos, 'Assistance for Infrastructure Development' in A. Krueger, et al. (eds), *Aid and Development* (1989).

11 For a critic of the GNP as a development indicator see M. Shamsul Haque, 'The Myths of Economic Growth (GNP)' in G. Mudacumura, et al. (eds), *Handbook of Development Policy Studies* (2004) 89-109.

12 John Paseé-Smith, 'The Persistence of the Gap between Rich and Poor Countries, 1960-1998' in M. Seligson, et al. (eds), *Development and Underdevelopment. The Political Economy of Global Inequality* (2003) 17. See also, Walden Bello, *Dark Victory The United States, Structural Adjustment and Global Poverty* (1994); David Morawetz, *Twenty-five Years of Economic Development, 1950 to 1975* (1978) 9. Morawetz, for instance, points out that countries such as Pakistan, Nigeria and Brazil had high growth but increasing inequalities in the 1970s.

13 Bava, above n 3, 129

14 Ibid.

achieve a successful result. Additionally, it was stressed that the real end of development was the human being and the improvement of his living conditions.[15]

In the international arena, the United Nations Development Programme (UNDP) commenced the use of a holistic approach to development in the beginning of the 1990s and built up a concept that also incorporated the notion of development as the possibility of choosing among different options.[16] Hence, the UNDP defined development as the process of enhancing people's choices in order to enjoy a better educational, health, employment, food and income status, as well as political and economic freedoms.[17] Concurrent with this concept, the UNDP designed a Human Development Index (HDI) that has been annually published since 1990. In this index, more than one hundred nations are categorised according to their development level, considering not only the per capita income level but also other aspects such as literacy, health and life expectancy. There have been some criticisms made on the grounds that the index is limited to categories that are Western-oriented and do not consider other perspectives (for example, culture). However, it provides broader insights about the progress of developing countries in its efforts to improve living conditions each year in more comprehensive terms than the thinner perspective offered by the economic growth approach.[18]

Despite the awareness of a new holistic vision of development, IFIs continued to focus on economic growth in order to design their programs. In the 1980s, after incurring significant foreign debt to finance their state-led models, developing nations were affected by a debt crisis that was particularly pronounced in Latin America. Unable to serve financial obligations, countries turned to the IMF and the WB for help. These institutions that some years ago had promoted the expansionary the role of the state in the economy, this time implemented a different approach and forced developing countries to adopt strict structural adjustment programs following a neoliberal model.

Using the developing countries' need for financial resources as a persuasive weapon, the IMF and the WB forced governments to adopt neoliberal measures and

---

15 Ibid 130.

16 United Nations Development Programme, 'Human Development Report 1990' (UNDP, 1990). See also Amartya Sen, *Development as Freedom* (1999).

17 United Nations Development Programme, above n 16.

18 See e.g., Stephen Morse, 'Greening the United Nations' Human Development Index?' (2003) 11 *Sustainable Development* 183-198.

reduce the role of the state in the economy. Basically, market reforms addressed the ten key issues contained in the so-called 'Washington Consensus.'[19] In the 1990s, this was the predominant development model. The key strategy of the neoliberal recipe was 'less government intervention, more freedom in the market'.[20] The formula would bring prosperity and development.

At the end of the 1990s, the neoliberal theory lost support and criticism against it grew faster than its alleged benefits.[21] The promise that was attached to neoliberal programs about better standards of living was not achieved. On the contrary, neoliberal policies accentuated income distribution problems and poverty, forgetting the key goal of development: better conditions for all human beings.

Due to the discontent with neoliberalism, the WB's President, James Wolfensohn, launched 'the Comprehensive Development Framework' that sought a more holistic approach to development.[22] In his proposal Wolfensohn called for a more inclusive picture of development and stated:

> We cannot adopt a system in which the macroeconomic and financial is considered apart from the structural, social and human aspects, and vice versa. Integration of each of these subjects is imperative at the national level and among the global players.[23]

The Comprehensive Development Framework brought the state back into the development equation and recognised that it played a key role in achieving progress. As a consequence, it was seen as essential to encourage good and clean governments and sponsor reforms in order to achieve this aid. The idea was that better governments and institutional foundations could promote a market that was conducive to progress. Similarly, good governments could not exist without democratic institutions and the rule of law that limit the government action, guaranteeing solid pillars to develop productive activities.

---

19 It includes: fiscal discipline, public expenditure priorities, tax reform, financial liberalisation, unified exchange rates, trade liberalisation, foreign direct investment, privatisation, deregulation and protection of property rights. See John Williamson, 'Latin America Reform: A View from Washington' in H. Costin, et al. (eds), *Economic Reform in Latin America* (1998) 106, 107.

20 Rapley, above n 2, 62.

21 See e.g., Stiglitz, Joseph, *Globalization and Its Discontents* (2003); Bello, above n 12.

22 James Wolfensohn, *A Proposal for a Comprehensive Development Framework* (1999) World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/STRATEGIES/CDF/0,,contentMDK:20072890~menuPK:140147~pagePK:139301~piPK:261885~theSitePK:140576,00.html> at 2 December 2004.

23 Ibid 7.

The IMF and the WB assumed the comprehensive approach to development. Bureaucrats of those institutions officially stated that the goal of economic policies should be the improvement of the lives of human beings and the abatement of poverty, not just the achievement of economic growth.[24]

In spite of the recognition of human beings as the centre of development policies, IFIs continued to promote neoliberal policies. However, many believe that the Comprehensive Development Framework was merely an excuse to facilitate the implementation of market-oriented programs in developing countries.[25] Even the WB continued using its country classification based on per capita income to categorise the world.[26] As a consequence of the excessive focus on economic growth, most market reforms sponsored by IFIs overemphasised the economic factor, forgetting that the creation of a market economy should be considered as a mean to improve the living standards of people and the creation of strong pillars for a sustainable, equitable and democratic development.[27]

## 2.3 From the Law and Development Debate to the Rule of Law Promotion

In the 1960s, concurrent with the debate about the meaning and process of achieving development, scholars began to propose ideas related to using law as a tool to produce social changes. Although there have been lengthy and significant discussions since then, and the original idea was deeply criticised, several of the initial assumptions are still latent in current discussions. This fact is understandable if we consider the fact that the origin of the law and development movement was linked to the aid provided by industrialised countries and today the battleground has moved from bilateral donors to multilateral organisations. Recent articles have divided the history of law and development into three phases: the initial law and

[24] See, e.g., IMF, *Poverty Reduction Strategy Papers. Operational Issues* (1999) IMF <http://www.imf.org/external/np/pdr/prsp/poverty1.htm> at 29 June 2004; The World Bank, 'World Development Report 2002: Building Institution for Markets' (2001)

[25] See e.g., Charles Sampford, 'Reconceiving the Rule of Law for a Globalizing World' in Spencer Zifcak (ed), *Globalisation and the Rule of Law* (2005) 9-31. John Ohnesorge, 'The Rule of Law' (Working Paper Number 1051, University of Wisconsin Law School, 2007).

[26] The most popular classification used by WB is still built on the basis of per capital income. The classification groups nations in four categories: low income, lower middle income, upper middle income and high income countries.

[27] Joseph Stiglitz, 'Whither Reform? Ten Years of the Transition' (Paper presented at the Annual World Bank Conference on Development Economics, Washington, D.C. 1999) 3.

development moment; the neoliberal rule of law; and the rule of law associated with the comprehensive development approach.[28] A similar approach will be adopted here in order to review the literature that focuses on the role played by law in the process of development.

Max Weber was one of the first authors to point out the importance of law for the establishment of an orderly economic system. For Weber, the modern economy developed in the West required a predictable legal system, 'the functioning of which is calculable in accordance with rational rules.'[29] Only the Occident, Weber argued, experienced a complete development of its legal system that was systematically elaborated and separated from other non-legal norms. This rational order, Weber argues, is managed by people who receive legal training. Furthermore, the process uses deductive and rational methods far from irrational primitive normative systems. Weber concludes that thanks to this progress of law, the economy gained the stability and security it needed to flourish. For this author, only countries with this legal rationality were capable of developing and achieving full industrialisation. [30]

Weber's findings and the theory of modernisation contributed to the genesis of a movement known as Law and Development. The initial movement was primarily conceived in the Unites States and it was closely related to the foreign aid policy implemented by the American government during the 1960s to help developing countries in Latin America and Africa. Basically, what this school of thought proposed was the use of 'modern law' as an instrument to achieve social change and development.

The law and development enthusiasts claimed that developing nations should undertake legal reforms to adopt modern law. This law was the opposite of customary law and traditional institutions frequently used in less developed countries. It was alleged that customary law was unsuitable to achieve progress.[31] For law and development scholars, modern law was uniform, transactional,

---

[28] See e.g., David M. Trubek and Alvaro Santos, 'Introduction: The Third Moment in Law and Development Theory and the Emergence of a New Critical Practice' in David M. Trubek and Alvaro Santos (eds), *The New Law and Economic Development/A Critical Appraisal* (2006) 1-18; Ohnesorge, above n 1.

[29] Max Weber, *Economy and Society: An Outline of Interpretive Sociology*, edited by Guenther Roth, Claus Wittich (1978) 337.

[30] However, Weber conceded that England was an exception of a country that achieved development without a rational legal system.

[31] See e.g., Robert Seidman 'Law and Development: a General Model' (1972) 6 *Law and Society Review* 311-342, 315.

purposive, universal, hierarchical, rational and professional.[32] This means that law was formed by a set of formal rules that were applied consistently to all individuals of a society in their transactional relationships in order to accomplish specific purposes.[33] In addition, an organised bureaucracy and well-structured courts would apply modern law.

Another aspect that was emphasised by the initial law and development movement was the relevance of professional, legally trained lawyers who would serve as a bridge between people and courts.[34] The importance of lawyers in the modern law model induced the design of aid programs to improve legal education in Africa and Latin America. Lawyers were considered the key to close the gap between a developing country's reality and the First World.[35] It was conceived that in the West, especially in the US, legal institutions and especially lawyers contributed to the legal development and consequently to the improvement of society. Thus, the model could be copied and applied in developing countries.[36]

In 1972, one of the scholars involved with the original law and development movement, David Trubek, published an article in which he scrutinised the law and development studies.[37] In his article, Trubek criticised what he called the 'core conception of modern law' that erroneously assumed Western law was essential for the development of disadvantaged nations.[38] He argues that the core conception devoted too much effort to the implementation of Western law in developing countries, instead of understanding the legal systems of those nations.

Trubek explains that the core concept was erroneously formulated on the basis of Weber's work because what this author did was explain the factors that contributed to the success of capitalism and identified law as one of those elements. Hence, for Trubek, Weber's findings did not support the assumption that law produces

---

32 Marc Galanter, 'The Modernization of Law' in M. Wiener (ed), *Modernization: the Dynamics of Growth* (1966) 167.

33 Advocates of this movement considered that the law was purposive because it was designed to achieve social goals that were established trough a pluralist process in which 'enables all individuals to secure rules favourable to them, while at the same time ensuring that rules respect the vital interest of all others.' David M. Trubek and Marc Galanter, 'Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development Studies in the United States' (1974) 4 *Wisconsin Law Review* 1062-1102, 1071.

34 Galanter, above n 32, 170.

35 Wolfgang Friedmann, 'The Role of Law and the Function of the Lawyer in the Developing Countries' (1963-64) 17 *Vanderbilt Law Review* 181-191.

36 For a different view see Thomas Franck, 'The New Development: Can America Law and Legal Institutions Help Developing Countries?' (1972) 1972 *Wisconsin Law Review* 767-801.

37 David Trubek, 'Toward a Social Theory of Law: An Essay on the Study of Law and Development' (1972) 82 *The Yale Law Journal* 1-50.

38 Ibid 2.

development. Weber argued that law helped to structure the economy given the legitimacy of the state bureaucracy on the basis of the belief that its decisions were rational.[39] Trubek stated that if the developing countries were not interested in applying a free market approach, then 'Weber's work cannot support any inference that modern law … will cause or contribute to economic development'.[40]

Another relevant criticism of Trubek was the accusation of ethnocentricity of the core concept due to the assumption that instrumentalism was 'necessary for the effective operation of an autonomous legal system'.[41] However, he cautions regarding the danger of promoting instrumentalism in countries that are different from the American pluralism. This method could drive countries towards more authoritarian and less democratic governments. Hence, instrumentalism would be able to contribute to economic growth but worsen other areas like civil rights or other social aspects.

Two years later, in 1974, Trubek and Galanter published an article, 'Scholars in Self-estrangement'[42] declaring the crisis of the law and development studies. Both authors criticised the 'liberal legalism' paradigm that was the base of the law and development movement. Liberal legalism was built considering the United States' system as a model. Trubek and Galanter argue that the model failed because conditions in Third World nations were completely different from those present in the US. To illustrate, advocates of liberal legalism assumed that in the developing world, state institutions were the most important source of social control, like in the US. Forgotten were social and cultural organisations such as tribal or religion groups and the customary law present in developing countries. Trubek and Galanter also criticised liberal legalism because of the differences between the theoretical model and the real conditions presented in the US.

Other authors criticised the law and development movement by supporting their ideas with the dependency theory.[43] According to this theory, poverty in developing nations was caused by the First World. The industrialised West has ruled developing

---

39 Ibid 15.
40 Ibid 16.
41 Ibid 20. By instrumentalism he means the use of law as an instrument to achieve specific goals.
42 Trubek and Galanter, above n 33.
43 See e.g., David Greenberg, 'Law and Development in Light of Dependency Theory' (1980) 3 *Research in Law and Sociology* 129-159.

countries jointly with elite groups for their own convenience.[44] The 'alliance' between international and national factors allowed the drain of raw material from developing countries to developed ones and the import of finished and more expensive goods in the opposite direction. Consequently, the underdeveloped world would be maintained in its state of poverty, and dependent upon the most industrialised nations. Under this arrangement, law is used as an instrument to achieve the goal of industrialised nations.[45]

During this first moment of the law and development movement, efforts were oriented to modernise traditional societies, transplanting legal models from developed nations. The state would have a predominant role in this stage, managing the modernisation process assisted by foreign donors. The 1970s ended and the law and development movement appeared to be mortally wounded. As Merryman explains, at that moment, many of the sponsors and supporters of the movement reduced or suppressed financial aid to American universities and developing countries.[46]

Law and development studies received its second wind in the 1980s, aided by the theory of institutional changes and the work of Douglass North. North affirms that institutions matter and they are determinant of the long-run performance of economies because they have an effect on the costs of exchange and production.[47] For this author 'The inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World'.[48]

North explains his thesis through the comparison between the institutional framework developed since the sixteenth century in England and Spain and how they were transmitted to their American colonies. On one hand, at that time England faced a fiscal crisis which they dealt with the introduction of decentralisation, the creation of the Parliament and the Bank of England. On the other hand, Spain faced a similar crisis adopting a different approach that was characterised by a much more centralised government and a huge body of decrees and legal directives that in

---

44 See e.g., Andre Gunder Frank, Capitalism and Underdevelopment in Latin America: Historical Studies of Chile and Brazil (Rev. and enlarged ed. 1969).

45 Greenberg, above n 43, 140.

46 John Merryman, 'Comparative Law and Social Change: On the Origins, Style, Decline & Revival of the Law and Development Movement' (1977) 25 *American Journal of Comparative Law* 457-491.

47 Douglass North, *Institutions, Institutional Change and Economic Performance* (1990).

48 Ibid 54.

many cases led to bankruptcy, confiscations and insecure property rights.[49] These two different institutional frameworks were transmitted and are reflected in the economic history of the US and Latin America. While the US became an industrialised country, most Latin American nations suffer from constant crises.

IFIs started to design a new strategy on the grounds of North's work, emphasising the importance of the rule of law for a market economy and achieving development. Soon, the IMF became involved with the ex-Soviet republics, assisting them in the building of a legal and institutional framework for a market economy.[50] The IMF also followed a similar path and embarked in efforts to build the rule of law in other developing countries. [51]

As has been emphasised by many authors, this second moment of law and development was inspired by neoliberal theories and was primarily focused on strengthening legislation and institutions associated with business and the private sector.[52] It was believed that economic reforms and the improvement of economic growth would automatically permeate to other aspects of development. As a consequence, developing countries were forced by IFIs to implement legal reforms as a condition to receive financial aid. Changes were inspired by 'the best practice' already applied in developed nations. Typical IFIs' programs focussed on areas such as: legislation required to support trade and foreign investment, liberalisation of financial markets, protection of intellectual property; improvement of courts; and the creation of alternative dispute resolution schemes. It was in this moment that financial crises broke out in Venezuela, Mexico and then in Asia.

The main criticism of the neoliberal rule of law was its excessive market fundamentalism and the importance placed on the transplantation of legislation inspired by norms enforced in developed nations. It seems that advocates of the

---

49 Ibid 114.

50 IMF, *Highlights in the Evolution of IMF Lending* (2004) IMF <http://www.imf.org/external/pubs/ft/exrp/what.htm> at 16 January 2005.

51 See e.g., the Declaration issued by the IMF Interim Committee during the Fifty-First Annual Meeting of the International Monetary Fund (IMF) Board of Governors in 1996, that claimed as one of the goals to encourage sustainable global growth the promotion of 'good governance in all its aspects, including by ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption, as essential elements of a framework within which economies can prosper.' IMF, *Summary Proceedings of the Fifty-First Annual Meeting of the Board of Governors* (1996) IMF <http://www.imf.org/external/pubs/ft/sum51/pdf/part05.pdf> at 12 October 2004.

52 Christoph Antons, 'Law and Development Thinking after the Asian Crisis of 1997' (2001) 20 *Forum of International Development Studies* 205; Trubek, above n 1; Ohnesorge, above n 1.

neoliberal rule of law forgot the lessons learned from the previous moment of law and development.

In the new millennium, the rule of law maintains an important position in IFIs' strategies for development; however, as has been stressed by various scholars, international institutions have tried to reduce neoliberalism in favour of other issues associated with development. This is what Trubek identifies as the third moment of law and development, and what Ohnesorge refers to as the comprehensive development rule of law.[53]

In this third stage, which coincided with the launch of the Comprehensive Development Framework by the WB, the rule of law seemed to be a mechanism through which to guarantee the openness of markets, the protection of human rights and the promotion of democracy.[54] In other words, while the doctrinal position of the third moment still supported neoliberalism and the strengthening of private law, it also recognised the need for the construction of a more comprehensive legal framework that not only encompasses the protection of rights associated with the economy, but also those related to other spheres of the lives of human beings. Using this approach, IFIs started to promote reforms oriented towards the strengthening the market, democracy and human rights. The reforms in these areas have as a common goal the building of a stronger rule of law that could serves as a pillar for the promotion of the market and human rights.[55]

The WB and the IMF subscribed to the new approach, calling for the promotion of the comprehensive model of development that addresses not only economic development but also the social, political, human and legal perspectives of the process. [56] Within the premise of a broader conception of development, the IMF created the Poverty Reduction and Growth Facility (PRGF) in 1999 in order to connect its financial objectives with the goal of reducing poverty. Hence, the IMF's

---

53 Ohnesorge divides the current moment of law and development in two approaches the comprehensive development model and what he calls 'legal origins'. The latter refer to those works in which authors statically test various hypotheses that try to prove a connection between legal system and economic performance. See Ohnesorge, above n 1.

54 Trubek, above n 1.

55 Ibid.

56 Amartya Sen, 'What is the Role of Legal and Judicial Reform in the Development Process?' (Paper presented at the Role of Legal and Judicial Reform in Development, Washington, 5 June 2000).

lending operations accommodate higher public expenditure that is directed to tackle poverty.[57]

The various moments of the law and development movement described above, which Ohnesorge calls the law and development orthodoxy, provide an adequate description of the efforts made in regions like Latin America, Africa and Eastern Europe, but they do not completely explain the efforts made by government across Asia in countries such as Japan, Korea and Taiwan and, more recently, in other Asian nations in which law did not have the relevance that law and development advocates believe it should. As a result, authors such as Frank Upham question the existence of an effective connection between law and development. Upham claims that the rule of law, as it is understood in the Western world, did not exist in Asia, and some nations such as Japan and China were able to grow economically. [58]

Other authors argue the opposite and they undertook research that led to different results. One of the most recognised studies completed in the region was sponsored by the ADB and was led by Katharina Pistor and Philip Wellons.[59] Using six Asian countries (the People's Republic of China, India, Japan, the Republic of Korea, Malaysia and Taipei), Pistor and Wellons studied the role played by law in the economic growth of Asia between 1960 and 1995.

Pistor and Wellons observed that governments played an active role in the economy of the countries studied but the approach to law was different and depended on whether the state or the market allocated resources in the economy. To illustrate, the authors explain that between 1960 and 1980, the state acted as a major player to allocate resources in the economy. In this period, law played a minimal role and was superseded by executive rules that gave governments vast discretionary powers. However, after 1980, when the economic policy changed and governments gave more importance to market-approach policies, law became more important and new legislation was enacted in areas such as business law, securities market, anti-trust and other economic laws in order 'to enhance the predictability and enforcement of market transactions' and reducing the discretionary powers of the

---

57 IMF, *Key Features of IMF Poverty Reduction and Growth Facility (PRGF) Supported Programs* (2000) IMF <http://www.imf.org/external/np/prgf/2000/eng/key.htm> at 29 June 2004.

58 See, e.g., Frank Upham, 'Speculations on Legal Informality: On Winn's "Relational Practices and the Marginalization of Law"' (1994) 28 *Law and Society Review* 233-242; Frank Upham, 'Mythmaking in the Rule of Law Orthodoxy' (Working Paper Number 30 Carnegie Endowment for International Peace, 2002).

59 Katharina Pistor, and Philip Wellons, *The Role of Law and Legal Institutions in Asian Economic Development: 1960-1995* (1999).

state.[60] It is important to note that while in five of six countries studied there was a convergence to a market approach, Malaysia was the only one that experienced a different trend during the period and in which the discretion of the state was accentuated.

More recent research have further scrutinised the role of law in the Asian development process, particularly focusing on the so-called developmental state model.[61] Most of these studies identify a key role played by the state to direct the economy, designing development plans, establishing priority sectors, providing preferential financing and building a network of close relations with key players in the economy. The state supported its intervention on legislation that granted broad discretionary powers to the government to regulate economic matters via administrative guidelines. Additionally, in order to guarantee a better control of the implementation of economic policies, governments' actions were often isolated from judicial scrutiny.

Another feature that characterised the Asian developmental state approach was the actions of the government that look for the integration of traditional concepts into the development process.[62] Antons, for instance, mentions how the Singaporean legal system, through the Maintenance Parents Act, adopts Confucian traditions and grants parents the right to sue their children when they forget their Confucian duty to take care of their parents.[63]

After the Asian financial crisis, the developmental state and the way in which the government used law to achieve its development goals in Asia came under fire. [64] Some experts suggested that the model contributed to the promotion of cronyism throughout the region. Other authors have adopted a more benign criticism and, though recognising the Asian model's success consider that nowadays global

---

60 Ibid 6.

61 Christoph Antons (ed), *Law and Development in East and Southeast Asia* (2003); Christoph Antons and Volkmar Gessner (eds), *Globalisation and Resistance/Law Reform in Asia since the Crisis* (2007); Randall Peerenboom (ed), *Asian Discourses of Rule of Law: Theories and Implementation of Rule of Law in Twelve Asian Countries, France, and the U.S.*(2004).

62 Christoph Antons, 'Law Reform in the 'Developmental States' of East and Southeast Asia: from the Asian Crisis to September 11, 2001 and Beyond' in Antons, Christoph and Gessner, Volkmar (eds), *Globalisation and Resistance/Law Reform in Asia since the Crisis* (2007)

63 Ibid 86.

64 See e.g., Chung H. Lee, Keun Lee and Kangkook Lee, 'Chaebols, Financial Liberalization and Economic Crisis. Transformation of Quasi-Internal Organisation in Korea' in Roy Allen (ed), *The Political Economy of Financial Crises* (2004) 145-163. See Jeffrey Frankel, 'The Asian Model, the Miracle, the Crisis and the Fund' in B.N. Ghosh (ed), *Global Financial Crises and Reforms* (2001) 319-329; Simon Johnson, et al., 'Corporate Governance in the Asian Financial Crisis' (2000) 58 *Journal of Financial Economics* 141-186.

markets make it difficult to operate the economy on a sustainable basis without redefining the role of law.[65] They admit that the discretion exercised by governments to administer a set of administrative regulations was crucial to procure development goals, but the trend is not sustainable in a global economy. This position in some ways coincides with the argument of Pistor and Wellons, which affirms that until 1980 law played a marginal role but, thereafter, governments of five of the six nations studied by them moved from 'state-allocative law to market-allocative law that were more friendly with a market environment and reduced government's discretion'.

## 2.4 The Meaning of the Rule of Law

As has been noted in the previous section, the notion of the rule of law has occupied a key role in IFIs' discourse in order to design their sponsored programs directed to developing countries. However, the term is contested and it is necessary to review its content in order to understand the position assumed by the IMF in its efforts to promote the rule of law in the developing world.

### 2.4.1 Rule of Law: Origins

In international forums, the controversy that surrounds the meaning of the rule of law begins with the term itself, considering the different expressions used to refer to a group of principles according to which in society, citizens and governments are regulated by a publicly known set of general and clear rules that are equally applied to avoid the arbitrariness of man's will. IFIs treat the rule of law, *Rechtsstaat*, *État de Droit*, and *Estado de Derecho* as equivalents. [66] This thesis assumes a similar position and treats all these expressions as equivalent.

In spite of this apparent agreement in global forums, there are authors who differentiate between *Rechtsstaat* and the rule of law. Franz Neumann argues that

---

[65] Gary Goodpaster, 'The Rule of Law, Economic Development & Indonesia' in T. Lindsey (ed), *Indonesia. Law and Society* (1999) 21. See also Richard Boyd, 'The Rule of Law or Law as Instrument of Rule? Law and the Economic Development of Japan with Particular regard to Industrial Policy.' in C. Antons (ed), *Law and Development in East and Southeast Asia* (2003) 154.

[66] See, e.g., The IMF Multilingual Directory at http://www.imf.org/external/np/term/lookup.asp?term_id=56336&lang=all&index=eng&index_langid=1 at 04 June 2007. See also World Bank, *Rule of Law and Development* (2008) World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTLAWJUSTINST/0,,contentMDK:20934363~menuPK:1989584~pagePK:210058~piPK:210062~theSitePK:1974062,00.html> at 13 May 2008.

*Rechtsstaat* and the rule of law share some common elements, but that they differ in other aspects. For this author, one of the distinctions of the German notion is that its essence 'consists in the divorce of the political structure of the state from its legal organization, which alone, that is to say independently of the political structure, is to guarantee freedom and security'.[67] While Neuman argues that the *Rechtsstaat* can exist with independent of the political system that governs a country, he links the rule of law to a liberal democratic model.

In the case of the French term, Laurent Pech affirms that before the beginning of the twentieth century, France did not have an analogous term for the rule of law.[68] It was at that time when *État de Droit* became known as the rule of law equivalent. Nonetheless, the French expression was not directly derived from the rule of law but from the German *Rechtsstaat.*[69] The fact that the term was non-existent in France did not mean that the rule of law's principles were unfamiliar to French citizens. In fact, article XVI of the Declaration of the Rights of Man and the Citizen (1789) already contained some attributes of the rule of law, such as a state limited by law with separation of powers and protection of human rights.[70] In Spain, the term *Estado de Derecho* had a similar history to the French *État de Droit* and authors also identify the vocabulary with the *Rechtsstaat*. In the French and Spanish cases, *Etat de Droit* or *Estado de Derecho* is more an adaptation of the *Rechtsstaat* than an exact translation of the English rule of law.

All the linguistic debate above has not helped establish a first approximation of the notion of the rule of law. We can start our efforts using the maxim that says the rule of law means government of laws, and not of men.[71] Other commentators would choose a more comprehensive definition, some limited to the way in which law is created, and others linking the notion to additional substantive ideas. Most definitions seem very straightforward at first but they contain elements that could be debatable, open to interpretation or include other issues that makes it difficult to establish precise limits.

---

67 Franz Neumann, *the Rule of Law. Political Theory and the Legal System in Modern Society* (1986) 180. To review other authors who differentiate between the rule of law and Rechtsstaat, see Michel Troper, 'The Limits of the Rule of Law' in Cheryl Saunders and Katherine Le Roy (eds), *The Rule of Law* (2003) 81; and Michel Rosenfeld, 'The Rule of Law and the Legitimacy of Constitutional Democracy' (2001) 74 *Southern California Law Review* 1307-1352.

68 Laurent Pech, 'Rule of Law in France' in Randall Peerenboom (ed), Asian Discourses of Rule of Law: Theories and Implementation of Rule of Law in Twelve Asian Countries, France, and the U.S (2004) 79-112.

69 Ibid 80.

70 Ibid 81.

71 See James Harrington, *The Commonwealth of Oceana and a System of Politics* (1992).

Most scholars place the origin of the rule of law as early as Aristotle.[72] However, it was later when a modern doctrine of the rule of law was developed, derived from political confrontations in Europe.[73] One of the first authors to mention 'the empire of laws and not of men' was James Harrington in the *'Commonwealth of Oceana and a System of Politics'* originally published in 1656.[74] Harrington did so quoting the work of an Italian, Donato Giannotti. In the old Continent, there were many contributors to the flourishing of the notion of the rule of law such as John Locke, Charles de Secondat, Baron de Montesquieu and Albert Venn Dicey.

John Locke published his famous work *Two Treatises of Government* in 1690.[75] In this book, Locke explained some of the most essential attributes of the rule of law doctrine. First, Locke stressed the pre-eminence of the legislative power as the law 'which is to govern even the legislative itself'.[76] For this classical author, although the parliament was the supreme power, it could not enact arbitrary law affecting people's rights and make the situation for them worse than the one they had in a state of nature, before they agreed to delegate powers to the legislature.[77] Consequently, the parliament did not have absolute powers. It was limited and therefore the parliament must have produced laws meeting certain standards, such as generality. Other attributes given to the law by Locke was that it should be retrospective and must be known beforehand and applied by authorised judges.

In England another document, the Magna Carta (1215), showed some attributes of the rule of law long before the publication of Locke's work.[78] It established the impossibility of punishing any person without a legal judgment.[79] If the rule of law originated in England, Hayek considers that there were French authors such as Montesquieu and Rousseau who contributed to rationally construct the theoretical

---

72 See, e.g., David Clark, 'The Many Meanings of the Rule of Law' in Kanishka Jayasuriya (ed), *Law, Capitalism and Power in Asia* (1999) 28.

73 For a study of the evolution of the rule of law, see Friedrich A. von Hayek, *The Political Ideal of the Rule of Law* (1955). See also Brian Tamanaha, *On the Rule of Law: History, Politics, Theory* (2004). It is interesting to note that although there is almost a unanimous consensus among the authors about the fact that the rule of law was born in the West, others have commented the existence of some of the attributes of modern the rule of law in ancient China. See Karen Turner, 'Rule of Law Ideals in Early China?' (1992) 6(1) *Journal of Chinese Law* 1-44.

74 Harrington, above n 71, 8.

75 John Locke, *Two Treatises of Government,* The Hafner Library of Classics (1969).

76 Ibid 188.

77 Ibid 189.

78 See Barry Hager, *The Rule of Law. A Lexicon of Policy Makers* (2nd. ed, 2000) 3.

79 'No freemen shall be taken or imprisoned or disseised or exiled or in any way destroyed, nor will we go upon him nor send upon him, except by the lawful judgment of his peers or by the law of the land'. The Avalon Project at Yale Law School, *Magna Carta 1215* (2005) Yale University <http://www.yale.edu/lawweb/avalon/medieval/magframe.htm> at 9 March 2005.

gaps left by the less systematised notions worked out by British writers.[80] In this regard, years after Locke's work, Baron de Montesquieu in his book *The Spirit of the Laws* (1748) provided another invaluable legacy to the rule of law notion when he emphasised the importance of separation of powers to avoid arbitrariness.[81]

Montesquieu built his postulates on the assumption that men who exercise authority tend to abuse their powers and the way to avoid such excess is imposing limits. Montesquieu underlined the threat to liberty imposed by the concentration of executive and legislative powers in the same person. He argued that similar risks existed if the powers of adjudicate were combined with these. Thus, he advocated the separation of the state powers.

Dicey expressly used the term the rule of law in his work *Introduction to the Study of the Law of the Constitution*.[82] According to Dicey, the notion of the rule of law contains three postulates: (i) dominance of law against arbitrariness. Law regulates people and they can be punished only if a law permits so; (ii) all people are equal before law. This means not only that all persons are subjected to the same law, but also law must be applied in an equal manner to individuals that are in similar situations. It also denotes that state officials are also obligated as common citizens to follow laws and respond to the ordinary tribunals; and (iii) individual rights, 'the law of the constitution' are a result of the application and interpretation of courts. [83]

The rule of law doctrine definitely took roots in the Western world with the constitutional development in the US and from there it was extended to other nations, especially to Latin American countries that basically obtained the leading principles of their constitutions from the US. The American Declaration of Independence and the State of Massachusetts Constitution in 1780 were some of the American instruments that delineated the principles contained in the American notion of the rule of law.[84]

---

80 Hayek, above n 73, 15.
81 Montesquieu, *The Spirit of the Laws* (1989).
82 Albert Venn Dicey, *Introduction to the Study of the Law of the Constitution* (Tenth ed, 1959).
83 Ibid 184.
84 Hayek, above n 73, 13; Hager, above n 78, 6. See also, Steven Calabresi, 'The Historical Origins of the Rule of Law in the American Constitutional Order' (2004-2005) 28 *Harvard Journal of Law & Public Policy* 273-280.

### 2.4.2 The Contemporary Meaning of the Rule of Law: The formal and substantive perspectives

At present, among the rule of law advocates, it is widely accepted that in order to affirm that a nation assumes and complies with the rule of law, it is necessary that certain formal attributes be present. However, other theorists have claimed that a government can prescribe its actions according to a set of formal, legal norms and principles without compliance with the rule of law postulates. Thus, it seems that something else, certain content, additional to formal elements, should be included as a part of the rule of law definition to avoid unsatisfactory results. The first theoretical position is called the formal, procedural, thin, or rulebook perception of the rule of law, while the second is known as the substantive or thick approach.

***a) The Formal Conception of the Rule of Law***

In general, advocates of a formal the rule of law consider a legal system has the rule of law virtue when its norms are general, clear, prospective, equally applied, publicly known, relative stable and consistent.[85] In addition, they argue that it is necessary in order to affirm the existence of the rule of law that a country has an independent judiciary that adjudicates cases. All mentioned attributes are related to the way in which law is created and applied.

The formal conception of the rule of law does not require that law fills any specific content, achieves any specific values (for example, justice) or that it be linked with any political or economic systems (for example, democracy or capitalism). A substantive attachment to the rule of law is only a 'promiscuous use' of the term in which it is simply understood as a virtue that must be owned by legal systems.[86]

Others argue that a formal the rule of law is neutral and therefore, 'more likely to be seen as neutral and compatible with a variety of substantive laws actually found in western systems, ranging from more market oriented economies to the welfare state'.[87] Thus, a formal conception would permit an easier application of the rule of law to any state without regard for political or economic affiliation.

---

85 See Joseph Raz, 'The Rule of Law and its Virtue' in Joseph Raz (ed), *The Authority of Law. Essays on Law and Morality* (1979); Lon L Fuller, *The Morality of Law* (Rev. ed 1969).

86 Ibid 211.

87 Clark, above n 72, 32.

According to this school of thought, considering that the rule of law is a virtue, it is utopian to affirm that a legal system enjoys, at the same time, all of the rule of law attributes mentioned above in the perfect combination. Rather, the rule of law implies different elements that can be achieved more or less at different levels. Therefore, it is not a notion able to be measured in exact kilos or centimetres.[88] These imprecise borders of the rule of law contribute to obscure its meaning and help governments and IFIs to accommodate such borders according to their own agendas.[89]

The fundamental goal of a formalistic arrangement of the rule of law is to guarantee stability and predictability through the enactment of publicly known laws that permit citizens, including economic enterprises, to plan their lives and activities according to those norms. Likewise, a formalistic rule of law reduces the arbitrariness of the government, which limits its powers and allows the flourishing of private initiatives. Predictability provided by a 'thin' rule of law has become one of the most precious virtues of a legal system for advocates of capitalism and many have assigned to it capitalism's success. It is here that Weber found his predictable legal system necessary for an economy's prosperity and this is the focus of IFIs, including the IMF, when they sponsor reforms.

In spite of the undisputed importance of the formal attributes of the rule of law, defenders of a more substantive approach are not completely satisfied and claim that the notion must be completed with other features. Some of the classical examples used to demonstrate the inadequacy of the formal approach are Adolf Hitler's Germany, the apartheid regime in South Africa and the segregation policies in the US. It is argued that in all these cases governments complied with the existent legal systems, but with outcomes that did not consider violations of human rights.[90]

Raz recognises shortcomings of a formal approach to the rule of law when he affirms:

---

88 Different indicators have been created to measure the degree of compliance with principles integrated in the notion of the rule of law. Nevertheless, all those constructions are subjective and a focus of criticisms. To know about these types of indicators, their limitations and uses see for example See Robert Kaufman, Aart Kraay and Massimo Mastruzzi, *Governance Matters V: Governance Indicators for 1996–2005* (2006) World Bank.

89 For an article that studies the rule of law as a discursive tool of IFIs see Ohnesorge, above n 25.

90 Regarding the case of the Nazi Germany, see Neumann, above n 67, 293.

> A non-democratic legal system based on the denial of human rights, on extensive poverty, on racial segregation, sexual inequalities, and religious persecution may, in principle, conform to the requirements of the rule of law better than any of the legal systems of the more enlightened Western democracies. This does not mean that it will be better than those Western democracies. It will be an immeasurably worse legal system, but it will excel in one respect: in its conformity to the rule of law.[91]

Some scholars think that this is an unacceptable outcome by reason of which it is essential to complete the notion with other attributes.

***b) The Substantive Rule of Law***

Advocates of a 'thick' construction of the rule of law agree with formalists that the notion requires some formal attribute, such as those enunciated above. Nonetheless, they believe formal elements are insufficient to build the notion of the rule of law. For this school of thought, the material content of law is as important as the procedures used to enact it. Thus, linked with formal attributes of law are substantial ideas like democracy or 'particular economic arrangements (free-market capitalism, central planning, "Asian developmental state" or other varieties of capitalism) or conceptions of human rights (libertarian, classical liberal, social welfare liberal, communitarian, "Asian values", etc.).'[92]

As a consequence of these diverse perspectives, the substantive rule of law school of thought does not look as homogeneous as the formal theory. Different varieties of thick rule of law approaches can be found, depending on which substantive element is linked with the formal attributes. This diversity was faced by the International Commission of Jurists that convened several international meetings between 1955 and 1963 in order to build a consensual definition of the rule of law. At the end, due to the different ideologies represented, the Commission adopted a very broad concept trying to encompass the different tendencies and said that the rule of law:

> Means adherence to those institutions and procedures, not always identical, but broadly similar, which experience and tradition in the different countries of the world, often having themselves varying political structures and economic

---

91 Raz, above n 85, 211.

92 Peerenboom, Randall, 'Varieties of Rule of Law' in Randall Peerenboom (ed), *Asian Discourses-Theories and Implementation of Rule of Law in Twelve Asian Countries, France and the US* (2004) 1-55, 4.

> background, have shown to be essential to protect the individual from arbitrary government and to enable him to enjoy the dignity of man.[93]

Under this concept, it can be difficult to arrive at a unique rule of law conception, because it depends on elements such as culture or political and economic systems that can vary from country to country. On the contrary, the common characteristic that would distinguish all different constructions of the rule of law is its ultimate goal of protecting citizen's rights from arbitrary governments.

Ronald Dworkin, in his work *A Matter of Principle,* (in which he studies adjudication by judges), assumes a thick conception of the rule of law. For Dworkin, judges must decide cases not only on the grounds of formal law but also in consideration of what he calls political principles, that is, individual political rights, for which reason he names his approach the rights conception:

> It assumes that citizens have moral rights and duties with respect to one another, and political rights against the state as a whole. It insists that these moral and political rights be recognized in positive law, so that they may be enforced upon the demand of *individual citizens* through courts or others judicial institutions of the familiar type, so far as this is practicable. The rule of law on this conception is the ideal of rule by an accurate public conception of individual rights. It does not distinguish, as the rule-book conception does, between the rule of law and substantive justice; on the contrary it requires, as part of the ideal of law, that the rule book capture and enforce moral rights.[94]

According to Dworkin, when a judge decides a case, he or she needs to answer questions about the moral rights that each party is entitled to and to resolve the controversy by applying the best theory of justice available to adjudicate the case. In these circumstances, Craig affirms that a substantive conception of the rule of law must be revised in articulation with a particular conception of law and justice.[95] For Dworkin, this conception is what he calls law as integrity that orders magistrates to identify legal rights and obligations, assuming they were created by the same

---

93 Howard Tolley, *The International Commission of Jurists: Global Advocates for Human Rights* (1994) 71.

94 Ronald Dworkin, *A Matter of Principle* (1985), 11.

95 Paul Craig, 'Formal and Substantive Conceptions of the Rule of Law: An Analytical Framework' (1997) Autumn *Public Law* 467, 478.

author, 'the community personified expressing a coherent conception of justice and fairness'.[96]

John Rawls also proposed another frequently commented on substantive formulation of the rule of law. In contrast to Dworkin, he founded his notion not only on justice but also on liberty. Rawls starts by recognising the importance of justice for a legal system, understood as the regular, impartial and fair administration of law. He adds:

> A legal system is a coercive order of public rules addressed to rational persons for the purpose of regulating their conduct and providing the framework for social cooperation. When theses rules are just they establish a basis for legitimate expectations. They constitute grounds upon which persons can rely on one another and rightly object when their expectations are not fulfilled. If the bases of these claims are unsure, so are the boundaries of men's liberties.[97]

One of Rawls' conclusions is that the more just a system, the more it can be considered to operate under the rule of law, resulting in a more secure basis for liberty. Thus, it is clear that lines are drawn by Rawls between the rule of law on one hand, and justice and liberty on the other. According to his construction, it is not possible to think in terms of the rule of law without considering the way in which law is administered and the objective to guarantee the liberty of the people.

Similar to the formalistic school, the substantive conceptions of the rule of law have their critics. Raz initially notes that the rule of law literally means what it says: 'the rule of the law'.[98] He warns that the rule of law 'is not to be confused with democracy, justice, equality (before the law or otherwise), human rights of any kind or respect for persons or for dignity of man'.[99] Many think that to build a rule of law conception supported by other material elements is risky and at the end the essence of the concept can be lost or confused with other ideas.[100]

Another criticism against thick theories of the rule of law is that due to the pluralistic world we live in, it is a fact that the existence of multiple political, economic and

---

96 Ronald Dworkin, *Law's Empire* (1986), 225.
97 Rawl, A Theory of Justice, 235.
98 Raz, above 85, 212. In a later work, Raz recognizes the possibility of linking the rule of law concept with other substantial notions (see Section 2.6.2).
99 Ibid 211.
100 See e.g., Peerenboom, above 92.

social conceptions makes difficult, if not impossible, to achieve some degree of consensus about a substantive content of the rule of law. This situation was experienced in the meetings mentioned above, convened by the International Commission of Jurists to define the rule of law. Although the Berlin Wall fell, globally there still exist diverse trends and conceptions that seem irreconcilable. Western developed nations, Asian countries and developing states of Latin America, Middle East and Africa could have their own opinions about notions like democracy, justice, human rights and liberty that are frequently attached to the concept of the rule of law and are very often influenced by religious, racial and cultural values.

## 2.5 IMF and the Rule of Law

### 2.5.1 Good Governance

Generally, in an international context, academic literature tends to study the rule of law associated with legal or judicial reforms sponsored by the WB or other regional multilateral banks (for example, IADB and the ADB).[101] This occurs because most efforts to strengthen the rule of law and its related attributes have been made through these institutions' programs. The IMF has not ignored this trend and although its objectives are primarily associated with monetary issues, it has joined the battle to reinforce the rule of law. IMF officials have publicly subscribed to this perspective since the 1990s. For instance, Michel Camdessus, a former Managing Director of the Fund, in a speech delivered in France concerning the agenda for the second generation of reforms in Latin America, expressed that:

> The first task is to enforce the rule of law and uphold the professionalism and independence of the judicial system-ensuring that there is prompt and equal justice for all, and giving confidence to all members of society that contracts will be enforced, rights will be protected, and property will be secure.[102]

In similar terms, another IMF Managing Director stated:

---

[101] See e.g., Thomas Carothers, 'The Many Agendas of Rules-of-Law Reform in Latin America' in Pilar Domingo and Rachel Sieder (eds), *Rule of Law in Latin America: The International Promotion of Judicial Reform* (2001) 4; Joel Ngugi, 'Policing Neo-Liberal Reforms: The Rule of Law as an Enabling and Restrictive Discourse' (2005) 26 *University of Pennsylvania Journal of International Economic Law* 513.

[102] Michel Camdessus, 'Old Battle and New Challenges: A Perspective on Latin America' (Speech delivered at the Europe-Latin America Convention, Bordeaux, 20 October 1997).

> I see three critical elements for the foundation of lasting economic and social progress in the hemisphere: First, successful market-based economies have institutions that protect property rights, uphold the rule of law, combat corruption, and promote social stability.[103]

The IMF was always concerned with governance issues.[104] However, the Fund intensified its work on governance at the end of the 1980s when the Bretton Woods institutions reviewed their policies and how they had worked in the developing world. The IMF and the WB agreed that a second generation of reforms had to be designed to tackle structural weakness and bolster economic growth. As a product of that revision, the IMF started to pay more attention to structural reforms, including governance issues.

The propitious environment to put in practice the new institutional approach was the fall of the Soviet Union. After the events that led to the dissolutions of the communist Federation, the IMF emphasised its work on governance and actively participated in different programs designed to assist central and eastern European countries to build legal and institutional frameworks for a market economy.[105] Similar assistance was provided to other countries in Latin America that witnessed how their state-controlled economies and their correlated legal infrastructure were rapidly replaced by a market-oriented framework.[106] At that time, it was argued that changes in the legal sphere and reinforcement of the rule of law were essential in order to support market reforms.[107]

Since the beginning of the global movement on governance, the WB and the IMF worked together to shape the notion in the international arena, especially in issues related to corruption and the benefits derived from initiatives to strengthen

---

[103] Horst Köhler, 'Building Shared Prosperity in the Americas' (Speech delivered at the Special Summit of the Americas, Monterrey, 12 January 2004). See also Anoop Singh, et al., 'Stabilization and Reform In Latin America: A Macroeconomic Perspective on the Experience Since the Early 1990s' (Occasional Paper 238, IMF, 2005); Michel Camdessus, 'The IMF at the Start of the Twenty-first Century: What Has Been Learned? On Which Values Can We Establish a Humanised Globalisation?' in David Vines and Christopher Gilbert (eds), *The IMF and its Critics* (2004) 417.

[104] IMF, 'Review of the Fund's Experience in Governance Issues' (IMF, 2001), 11.

[105] IMF, above n 50.

[106] During the first half of the 1990s, countries such as Argentina, Peru and Venezuela implemented shocking IMF programs. See Delia Ferreira Rubio and Matteo Goretti, 'When the President Governs Alone: The Decretazo in Argentina, 1989-1993' in John Carey and Matthew Soberg Shugart (eds), *Executive Decree Authority* (1998) 33-61.

[107] IIbrahim Shihata, 'Good Governance and the Role of Law in Economic Development' in Ann Seidman, et al. (eds), *Making Development Work. Legislative Reform for Institutional Transformation and Good Governance* (1999) xvii-xxv.

accountability and transparency of governments.[108] Due to the political ramifications of governance, the WB faced serious legal limitations to undertake its efforts in this area. Particularly, Article IV, Section 10 of the Bank's Articles of Agreement prohibits officials to interfere in political affairs or consider political aspects when they decide a matter. Nonetheless, the WB insisted on addressing governance, due to its alleged significance for the success of its programs.[109]

Ibrahim Shihata, a former WB General Counsel, undertook the task to define what the institution should understand by governance within the limits imposed by the Bank's charter. Shihata starts explaining that governance, generally speaking:

> covers the manner in which a community is managed and directed, including the making and administration of policy in matters of political control as well as in such economic issues as may be relevant to the management of the community's resources.[110]

Based on this definition, Shihata argues that there are two types of governance. The first group constitutes governance matters which are clearly consistent with the WB's purpose as they are stated in its Articles of Agreement, and as a result, such issues need to be addressed due to their relevance and effects on the WB's objectives. The other type is governance issues that cover political aspects beyond the Bank's mandate.[111] Excluding the second group, Shihata refines the meaning of the relevant governance that is essential for the WB purpose and affirms that:

> This is the meaning of "good order," not in the sense of maintaining the status quo by the force of the state (law and order) but in the sense of having a system, based on abstract rules which are actually applied and functioning institutions which ensure the appropriate application of such rules. This system of rules and institutions is reflected in the concept of "the rule of law", generally known in different legal systems and often expressed in the familiar phase of a "government of laws and not of men".[112]

---

108 George Abed and Sanjeev Gupta, 'The Economics of Corruption: an Overview' in George Abed and Sanjeev Gupta, (eds), *Governance, Corruption & Economic Performance* (2002) 1.

109 See Ibrahim Shihata, *The World Bank in a Changing World* (1991) ch 2. For a critical article about the position assumed by international financial institutions in governance issues, see Ian Taylor, 'Hegemony, Neoliberal 'Good Governance' and the International Monetary Fund' in M. Bøås, et al. (eds), *Global Institutions and Development* (2004) 124. Ngugi, above 101.

110 Shihata, above n 109, 79.

111 One example of this type of governance could be issues related to political ideologies or systems. Shihata, above n 109, 82.

112 Ibid 85.

Subsuming the discussion of the rule of law into the governance issue, Shihata claims that reforms cannot be effective without the existence of a system that includes workable rules that are in force, known in advance, and that can only be modified following a pre-established procedure, as well as institutions that ensure application of norms and resolution of disputes through binding sentences of independent judges or arbitral agencies. Thus, the WB assumes that by promoting the adoption of 'good governance' by developing nations, such a system can be created or strengthened, if it already exists. Ultimately, good governance is considered a pre-requisite for sustainable growth in market economies that will consequently promote higher standards of living and more economic and social progress.

Despite Shihata's efforts to separate the notion of governance from the political realm, he defines governance in terms of a required element of a market economy; therefore, he assumes a market economy as a benchmark, a conclusion that requires some sort of political analysis. In addition, the WB pushes for reforms that require political discussions that, in normal circumstances, would be undertaken by political bodies (for example, Parliament). Hence, it is difficult to see the notion of governance promoted by the WB as a neutral idea and free of political connotations.[113]

The IMF Articles of the Agreement do not include an explicit prohibition of addressing the political affairs of its members, in similar terms to the one incorporated in the WB constituting charter. Antony Anghie argues that such prohibition was not necessary in the case of the Fund because this institution was designed to provide short-term financial aid and therefore there was no room for political interferences. [114] Under this view, the Fund would provide emergency financial assistance and would not be involved in issues associated with structural reforms. However, the IMF decided to follow the example of its sister institution and justified its participation in the sphere of governance using a similar approach. The IMF argues that, 'the Fund's involvement in governance derives from its mandate to promote macroeconomic stability and sustained noninflationary growth'.[115]

---

113 See Ngugi, above 101.

114 See Antony Anghie, 'Time Present and Time Past: Globalization, International Financial Institutions, and the Third World' (2000) 32 *Journal of International Law and Politics* 243-290, 265 footnote 67.

115 IMF, above n 104, [6].

For its purposes, the IMF defines good governance 'in terms of the effective and transparent management of public resources; and a stable economic, regulatory and legal environment conducive to the sound management and efficient use of private and public resources.'[116]

Although concerns associated with governance were raised earlier by the Fund, it was not until 1996 that an explicit mandate was incorporated into its policies. That year, the IMF Interim Committee Declaration Partnership for Sustainable Global Growth recognised (among the issues that were essential to achieve sustainable growth) the promotion of:

> good governance in all its aspects, including by ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption, as essential elements of a framework within which economies can prosper.[117]

According to this declaration, the Fund must address aspects related to the rule of law as a part of the broader issue of governance. The same approach was later ratified by the Executive Board and incorporated into an IMF policy document entitled *The Role of the IMF in Governance Issues: Guidance Note.*[118] This document, based on the IMF's experience in governance issues, underlines the significance of good governance for macroeconomic stability and sustainable growth and summarises the institution's approach in this area. However, the Guidelines stress that governance is primarily a national issue and the IMF's staff should only address this matter in cases in which it is considered that the domestic authorities have not properly addressed problems in this area that are relevant to the Fund.[119]

The objectives behind the issuance of the Note was: (i) to give a more comprehensive treatment to governance issues that are considered within the IMF areas of expertise; (ii) to develop a more proactive role to promote policies, institutions and administrative systems that reduce risks of corruption and rent seeking practices; (iii) to establish standards for an equitable treatment of all state members in governance issues; and (iv) to coordinate efforts with other IFIs, especially the WB.[120]

---

116 Ibid [7]
117 IMF, above n 51.
118 IMF, *Good Governance/The IMF's Role* (1997).
119 Ibid 3.
120 Ibid 2.

To create a comprehensive treatment for governance issues but, at the same time, establish a clear limit to the IMF involvement in this area, the Executive Board states that the IMF shall work with governance issues in those areas that affect economic aspects, especially in two spheres:

> improving the management of public resources through reforms covering public sector institutions (e.g., the treasury, central bank, public enterprises, civil services, and the official statistics function), including administrative procedures (e.g., expenditure control, budget management, and revenue collection); and supporting the development and maintenance of a transparent and stable economic and regulatory environment conductive to efficient private sector activities (e.g., prices systems, exchange and trade regimes, and banking systems and their related regulations).[121]

The Note asserts that 'in the regulatory and legal areas, IMF advice would focus on taxation, banking sector laws and regulations, and the establishment of free and fair market entry (e.g. tax codes and commercial and central bank laws).'[122] Following this guidance, the IMF promoted changes in a great variety of affairs closely related to the rule of law principles, such as: legal reforms that embodied the enactment of laws associated with commerce; foreign investment; labour; bankruptcy; monopolies; concession contracts; and banking sector reforms, which included the drafting of new banking legislation, central bank laws and privatisation of financial institutions.[123] All these changes were oriented towards the creation of a stable and transparent legal climate for private activities, assuming a formal understanding of the rule of law.

The Note establishes that additional aspects that were also related to the rule of law but not directly within IMF's core areas of responsibilities shall be addressed by other international institutions like the WB, but in close collaboration with the IMF (for example, the enforcement of contracts, civil service reforms, etc).[124] In deciding whether IMF involvement in a governance issues is appropriate

> the staff should be guided by an assessment of whether poor governance would have significant current or potential impact on macroeconomic performance in the

121 Ibid 3.
122 Ibid [6].
123 IMF, above n 104, 10.
124 IMF, above n 118, [6].

> short and medium term and on the ability of the government credibility to pursue policies aimed at external viability and sustainable growth.[125]

With the Guidance Note, the IMF Executive Board also tries to diminish the risks associated with being involved in political affairs and establishes that:

> The IMF's judgments should not be influenced by the nature of a political regime of a country, nor should it interfere in domestic or foreign politics of any member. The IMF should not act on behalf of a member country in influencing another country's political orientation or behaviour.[126]

In spite of this, the IMF forces governments to adopt legal changes in order to transform developing countries' economies into market-oriented ones, which involves a debate that is not exclusively economic but also of a political nature. In fact, conditions included in IMF programs often establish the political agenda in those nations that become involved with this IFI and then the domestic political debate is structured in terms of those who support or reject the IMF program.[127]

### 2.5.2. IMF Mechanisms to Improve Governance

The Guidance Note lists the different methods through which the IMF can address governance issues. There are basically three forms:

***a) Surveillance***

The Articles of the IMF Agreement, section IV (3), gives surveillance powers to the IMF to oversee the international monetary system and ensure the compliance of state members with their obligations under that Agreement. Hence, when IMF officials are reviewing and discussing affairs associated with its purposes with national authorities, they can raise problems with governance that they believe affect macroeconomic indicators and suggest plans of action to correct weaknesses.

---

125 Ibid [9]. The IMF claims that political credibility is a crucial factor for growth. For studies that support similar arguments, see, e.g, Silvio Borner, et al., *Political Credibility and Economic Development* (1995).

126 IMF, above n 118, [7].

127 The political consequences of IMF's intervention in developing country would be further discussed in the second part of this dissertation where the case of Venezuela is discussed.

***b) Technical Assistance***

The IMF can also play a role in the good governance of its state members through technical assistance in matters that are within the core areas of responsibility of the institution. For example, the IMF could advise a country on how to draft economic and financial legislation or on strengthening regulatory and supervisory banking frameworks.

According to the Guidance Note, 'the IMF has assisted its member countries in creating systems that limit the scope for ad hoc decision making, for rent seeking, and for undesirable preferential treatment of individuals or organizations.'[128] This means that the IMF, in principle, does not support states in the implementation of *ad hoc* methods to adopt decisions because this can work against stability and predictability, and in turn facilitate corruption.

Clearly, this principle put forward by the IMF Executive Board is very important, but it is questionable if it is applied in practice when member states implement this type of decision making to comply with the IMF's requirements. For example, in the 1990s, constitutional Presidents Carlos Menem (Argentina), Alberto Fujimori (Peru) and Rafael Caldera (Venezuela) complied with IMF requirements through the adoption of emergency legal measures that I consider a type of *ad hoc* method.

Nowadays, the IMF also actively involves its technical assistance, recommending the adoption of standards and codes of good practice in areas such as: data dissemination; fiscal, monetary and financial policy transparency; and banking, insurance and securities regulations.

***c) Financial Assistance***

The IMF can provide financial assistance to a country in distress and then use conditionality to propose changes that benefit the adoption of good governance:

> The use of conditionality related to governance issues emanates from the IMF's concern with macroeconomic policy design and implementation as the main means to safeguard the use of IMF resources.[129]

[128] IMF, above n 118, 1.
[129] Ibid 8.

In this point, the IMF recognises the role of conditionality as a tool to persuade state members to implement good governance (including those related to the rule of law). However, conditionality as an instrument of pressure to implement good governance could be counter-productive and opposite to the intended goal of strengthening the rule of law. This issue of the apparent tension between conditionality and the rule of law will be discussed further in Chapter 3.

### 2.5.3 Increased IMF Participation in Governance Issues

Although the Guidance intended to restrict the role of the IMF in governance issues, it used broad terms that were extensively applied by the staff. As a consequence, the inclusion of governance issues in programs sponsored by the IMF increased in both number and variety in the 1990s.[130] In the cases of transition economies, Fund staff justified these results by arguing that it was complicated to precisely define the limits of macroeconomic significance of structural conditions in a climate 'where all elements of the transformation may have potentially important macroeconomic ramifications, or in cases where the macroeconomic effects of poor governance may, like termites in the woodwork, remain hidden for a lengthy period'.[131]

In 2001, after reviewing the experience of the institution in governance issues since the enactment of the Guidance Note, the Executive Board recommended to limit the IMF's involvement to economic areas of governance that could have a real and critical macroeconomic impact and coordinate with other multilateral organisations, especially the WB, other issues in which the Fund does not have enough expertise.[132] Further changes were adopted in new Guidelines on Conditionality in 2002, in an effort to draw clearer criteria for the use of conditionality as a mechanism to achieve structural reforms.[133] In spite of IMF's endeavours that were oriented towards improving its approach to governance and conditionality, doubts on a more basic level remain associated with the legitimacy of the Fund's involvement in a political territory that was once exclusive to sovereign states, through the reduction of the problem to a technocratic issue.[134]

---

130 See, IMF, above n 104.
131 Ibid 3.
132 Ibid.
133 Changes on conditionality adopted in 2002 by the Fund will be discussed in Chapter 9.
134 John Ohnesorge, 'The Rule of Law, Economic Development, and the Developmental States of Northeast Asia' in Christoph Antons (ed), *Law and Development in East and Southeast Asia* (2003) 91-127, 94.

Taylor argues convincingly that it may be praiseworthy to address corruption, transparency and general governance in developing countries, but 'conferring the IMF with the ability to determine what constitutes good governance, and the power to implement such prescriptions onto sovereign states is profoundly problematic'.[135] The IMF's approach to governance and the rule of law is incomplete and, in some ways, contradictory. It is incomplete because it is limited to the formal attributes of the rule of law in the economic-legal sphere and the legal reforms promoted by the Fund. It does not consider whether the implementation undermines law and democracy in developing countries.

Further, the IMF method is contradictory because it is based on a political judgement that requires developing nations to undertake institutional reforms, arguing that they affect macroeconomic variables, while the Fund claims that its activities cannot consider political factors. The IMF's lack of clarity has been noticed by countries in the developing world that do not trust in the institution and see the Fund as a foreign intruder that must be avoided.

## 2.6 Building a Concept of the Rule of Law for Developing Countries

In contrast to the formalistic approach assumed by the Fund, developing countries seem to need more than a thin conception of the rule of law in order to achieve success in their efforts to build stronger legal systems that serve as a real leverage to achieve development. Authors like Peerenboom and Sampford warn about the risks associated with formulations of the rule of law that bring other substantive component to the equation. These scholars suggest that in an international context it would be more manageable to work with a formal than a substantive conception of the rule of law.[136] They claim that if the rule of law is studied concurrently with other aspects, such as democracy and human rights, the survival of the notion may depend on the existence of these conceptions and the specific content that each country gives to such material concepts.

Moreover, Peerenboom affirms that the discussions of different thick conceptions of the rule of law are more suited to mature legal systems in which experts often

[135] Taylor, above 109, 133.
[136] Ibid 6; Sampford, above n 25, 19.

discuss issues related to 'constitutional law, judicial interpretation, human rights and separation and balance of powers'.[137] Peerenboom affirms that although it is easy to list the formal attributes of the rule of law, it is not simple for developing countries to achieve them. Hence, it would be enough if they concentrate their efforts on complying with the formal principles integrated in the concept of the rule of law and the creation of an environment in which norms do not change overnight and are applied regularly in a fair manner by competent and independent judges.

In spite of these valid reasons to select a formal conception of the rule of law for this study and although this thesis will compare two nations, Venezuela and Malaysia, that do not share a similar background, a more suitable framework is one that combines most of the attributes given by the formal school of the rule of law linked with two other substantive factors: democracy and development. It would be difficult to study the rule of law without considering the current demands in developing countries for a more effective participation of people in the building of the principles integrated in this notion.[138] In the same way, if it is now admitted that the rule of law is a notion integrated to the comprehensive idea of development, it is important to link both concepts.

In spite of the warnings about the risks of mixing the rule of law and other material concepts, this thesis assumes the challenge of analysing the rule of law in conjunction with the above-mentioned aspects. It is true that by isolating the rule of law it can be better understood on theoretical grounds. However, a developing country does little for its progress if it decides to adopt a conception that guarantees a set of formal rules but does not attend to the democratic process for its creation, and if the model is divorced from a more comprehensive policy of development. Some examples can be found of governments in developing countries that endorsed a formal approach to the rule of law; however, those states were not able to guide their nations to achieve better standards of living for people.

### 2.6.1 The Formal Attributes of the Rule of Law

Among the numerous formal characteristics described as necessary to affirm that the rule of law exists, the following are of particular relevancy to this thesis:

---

137 Peerenboom, above n 92, 14.

138 United Nations Development Program (UNDP), Democracy in Latin America: Towards a Citizens´ Democracy (2004).

***a) Law should be general***

This is one of the most accepted formal attributes of the rule of law. It means that law cannot refer to any particular individual or selected group of people. It assumes that norms regulate all citizens without distinctions or privileges. Nonetheless, as Raz observed, if we understand law in a more broad sense to include not only formal law (enacted by the legislature) but also other types of regulation (for example, norms promulgated by the executive or issued by administrative agencies), then generality loses importance and what becomes crucial is the observance of 'open, stable, clear and general rules… [in] the making of particular laws'.[139]

***b) Laws must be stable***

Law must be enacted with the goal of regulating conduct for a reasonable period. It is difficult to define 'reasonable period' but stable conditions can hardly be created if law and regulations are constantly changed. Incessant amendments create difficulties for people in the observation of legislation and at the same time, make the work of administrative authorities, judges and lawyers harder. In the case of Venezuela and the way in which authorities legally handled the banking crisis, it can be observed how in a short period the President and the congress dictated different and sometimes contradictory regulations that contributed to the uncertainty created by the crisis.

***c) Laws must be publicly known and clear***

Citizens cannot follow the law if they are not aware of its content. Although most national legislations include a provision that assumes that law must be complied with even if it is unknown by the person, the rule of law requires that regulations be published on a timely basis and in a form easily accessible to anyone.[140]

Additionally, publication has to be timely. This requirement seems self-evident; but it is non-existent in some developing nations. Take the case of Venezuela where, generally speaking, almost all legislation and regulations are published in the *Official Gazette* but it is always released with at least a delay of one day, which creates some practical problems.[141]

---

139 Raz, above n 85, .215.

140 For example Article 1 of the Venezuelan Civil Code establishes that law is binding from the moment that it is published in the Official Gazette. After publication, Article 2 of the same Code states that ignorance about a law does not excuse its inobservance.

141 Sometimes delays are longer and practical problems get worse (e.g. an Official Gazette that suppressed the Venezuelan Investment Fund and ceased all its employees, was officially dated 10 May 2001, but the Gazette was released weeks later).

Furthermore, publication itself is not enough to guarantee that citizens have a fair opportunity to comply with law. Clarity enhances that chance. The opposite and incoherent legislation could go against legality.

***d) Laws must be consistently and equally applied***

If law is general and does not make distinctions, then legislators, administrative authorities and judges should not make distinctions either and must apply the law on an equal basis. This does not mean that administrative acts or judgments must be the same, because they resolve particular situations, but they must be issued through the equalitarian application of general norms.

***e) Laws must be prospective***

Laws and regulations are enacted to govern future situations. A norm cannot be retroactive because it will be against stability and legal certainty. In the words of Lon Fuller, 'a retroactive law is truly a monstrosity … To speak of governing or directing conduct today by rules that will be enacted tomorrow is to talk in black prose'.[142] Although it is quite clear that norms cannot be applied to situations that occurred before they were enacted, human history has frequent seen examples of this kind, in which law is used by authoritarian government to fill their purposes.[143]

***f) Independent judiciary***

Montesquieu argues that it was necessary to divide the state's power to avoid absolutism and as mechanism of control among state branches. However, the threat foreseen by the famous philosopher cannot be alluded to without an independent judiciary that can stand against legislative or executive arbitrariness and void unconstitutional or illegal pretensions. In order to comply with these fundamental functions, it is not only necessary that courts have powers to review acts issued by any state authority, but also that their independence is ensured. An independent judiciary guarantees that any dispute that arises from interpretation of any law or regulation, between the state and particulars or among them, would be resolved through conclusive court judgments. Judicial independence is guaranteed through different methods, such as life tenure and proper remuneration. Finally, a judiciary cannot do its job properly if it does not have adequate resources, which can affect

[142] Fuller, above n 85, 53.

[143] See the examples during the National Socialist government in Germany that are well explained by Neumann. Neumann, above n 67, 297.

its efficiency and, consequently, it may be unable to resolve cases in a timely manner. Thus, it is equally important that the judicial branch of a state has an adequate budget to provide judges with competitive salaries, and human and logistic resources.

### 2.6.2 A Democratic Rule of Law

In addition of a formal content, the debate about the rule of law should be also placed in a more comprehensive context and be linked to the concept of democracy, considering the way in which law is created and applied in developing countries.

In its simplest expression, democracy is defined as 'government by the people; government in which the supreme power is vested in the people and exercised by them or by their elected agents under a free electoral system'.[144] In many nations, the essence of democracy and the process itself is exhausted in the above definition. Democracy is limited to election of representatives.

Under this limited view of democracy, after authorities are elected they divorce from their constituencies that find it difficult to participate, for instance in the discussions of new legislation and regulations. It could be said that the product of this form of creating law is legitimate because law is democratically enacted, that is, a democratically elected authority issues it following a pre-established process. Nonetheless, it misses a key element, one that cannot be found in the democratically elected character of authorities from whom the law emanated: participation, making democracy a very limited concept.

Nowadays, the law making process demands more citizen participation or at least the real, reasonable and fair opportunity to participate in the law creation process. As pointed out by Scheuerman, democracy must focus not only on results but also on processes.[145] That is, the discussion of legislation, for instance, should guarantee opportunities for interested groups to speak out their opinions. This issue could help to correct situations like those that often occur in Latin America where law is used to limit participation and fulfil specific political gains.[146] As a result the

---

144 Macquarie Concise Dictionary (3rd Ed. 2003) 295.

145 William Scheuerman, Between the Norm and the Exception/The Frankfurt School and the Rule of Law (1997), 114.

146 See e.g., Miguel Schor, 'Constitutionalism through the Looking Glass of Latin America' (2006) 41 *Texas International Law Journal* 1-38; Ernesto Garzón, 'What is Wrong with the Rule of Law?' (Paper presented at

region is characterised by the existence of a formal *corpus* of norms that are hardly followed by citizens that see such legal body far from their common life.

In the context of the IMF, participation in the design of programs is also an issue. In this scenario, time is more critical and in general, developing countries would not have the time to consult on the actions and conditions that are imposed by this institution. Hence, conditions required by the Fund tend to push developing countries to act quickly in order to obtain financial assistance. The response is often hasty and does not involve a consultation process. This may result in abrogation of the rule of law when governments decide to use a state of emergency that allow them to issue norms without consultation to meet IMF conditions.[147]

Another aspect that it is essential to address under a democratic rule of law is the form in which law is applied by court, legislatures and executive authorities. In an article published in 1994, Raz moved from his initial formal rule of law position to a more substantive approach. The crucial features of his rule of law model 'are its insistence on an open, public administration of justice, with reasoned decisions by an independent judiciary, based on publicly promulgated, prospective, principled legislation'.[148]

Although Raz insists on formal attributes, he adds the necessity for an open and public application of law supported by a principled legislation. In this conception, the rule of law is primarily directed to courts and other administrative authorities that must apply law faithfully, openly and in a principled manner. But, Raz adds, legislative bodies who are the democratic representation of pluralist societies are also obligated to comply with the rule of law. As a consequence, a parliament must make laws that can be applied based on reasoned elements taken from the country's legal culture. Furthermore, a legislature must guarantee the maintenance of a system of courts and other institutions capable of complying with the rule of law requirements.[149]

---

the Seminario en Latinoamérica de Teoría Constitucional y Política (SELA), Puerto Iguazu, Argentina, 8-11 June 2000); Rodrigo Contreras, *La Larga, Tortuosa y Nunca Acabada Construcción del Estado liberal en América Latina* Instituto Internacional de Gobernabilidad de Cataluña <http://www.iigov.org/biblioteca/index.drt> at 7 April 2005.

147 See the discussion in Chapter 4.

148 Raz, Joseph, 'The Politics of the Rule of Law' in Joseph Raz (ed), *Ethics in the Public Domain/Essays in the Morality of Law and Politics* (1994) 354-.362, 358.

149 Ibid 358.

Raz assigns legislation a relevant role in his conception, because he thinks that democratic legislation is crucial 'for the adequate government of a pluralistic society in a continuous process of social and economic change … Only democratic politics can be sufficiently sensitive to the results of change'.[150] In Raz's proposal, not only the legislature plays a key role, but also courts are crucial because they interpret law, create precedents and, using judicial independence, contribute to integrate legislation and doctrine, diminishing the political pressure factor that could more easily affect the parliament.

Raz's construction of the rule of law reinforces democracy in two ways. First of all, the rule of law imposes over legal institutions the obligation of loyalty to legislation that is conceived by a democratic body. At the same time, the rule of law constrains majorities represented in the Parliament because it requires principled legislation. In the case of courts that are not formally accountable to anyone, Raz states, the limits are set when it requires that courts reason and publish their decisions and be open to criticism to ensure compliance with the country's legal culture in terms of values and shared practices. This process, in which legislation and adjudication interact, allows the pacific coexistence of legislation that sometimes attends to short term demands with the fruit of long established traditions through the adjudication of courts.[151]

Although Raz's conception was built on the grounds of the English common law, its main findings are nonetheless applicable to civil law systems, especially as he imposes on courts the duty to apply law faithfully, openly and in a principled manner; characteristics that help to exercise control over the judicial branch. Likewise, his explanation of the legislature's duty to enact laws able to be faithfully applied and to maintain an adequate system of courts and administrative agencies able to apply law in the described manner, is an idea that must be present to ensure any sound legal system. Civil law courts do not create law in the same sense that a common law court does, but their decisions also help to integrate legislation and doctrine and could promote legislative changes.

150 Ibid 358.
151 Ibid 360.

### 2.6.3 The Rule of Law and the Development Process

Finally, if the rule of law has been one of the main concepts used in the last two decades by IFIs in order to intervene in developing countries and promote programs directed to improve the economy and the standards of living of human beings, the notion cannot be divorced from the objectives followed by development policies.

This thesis subscribes to the position that sees development as an umbrella notion that is oriented to improve the standards of living of human beings in a sustainable manner through the effective and comprehensive management of economic, human, social, political and legal variables. Development is not considered to be synonymous with economic growth any more. In contrast, it is a multi-dimensional concept that included a legal dimension which involved the rule of law. As a result, the discussion cannot be limited to that of the rule of law as a simple theoretical notion. It is necessary to connect this definition with reforms in other areas and the development goals that are intrinsic to those programs.

The rule of law is not only a goal itself but is also a component of a comprehensive concept of development. For example, if a program sponsored by a multilateral institution helps to adopt 'modern' legislation that is general, clear and prospective and, at the same time, creates a more attractive business environment for foreign investors, or if a program is directed to improve the judiciary's infrastructure (for example, acquisitions of functional buildings and updated technological equipments), such programs could be considered positive because they address rule of law issues. Further, from a formal rule of law perspective, both programs could be categorised as successful if they make legislation general, clear and prospective or if they support judicial independence. However, this perception would exclude other considerations associated, for instance, the way in which the programs were designed and the trade-off involved in the negotiations with IFIs. Also, the programs would not address how they are linked with other development factors or whether or not the programs have any social or legal costs. In other words, if we question the existence of a rule of law with the democratic elements discussed above and we additionally ask for the positive outcome for the whole development process, would we have the same answers? Responses to these questions seem to be negative.[152]

[152] For instance, Lawyers Committee for Human Rights and the Venezuelan Program for Human Rights Education and Action published a report in 1996 in which they criticised a judicial reform program sponsored by the World

That is not to say that the rule of law plays a supreme role in development. Rather, there is a need to design a strategy that puts together, in a coherent manner, these diverse dimensions of development, attending to the specific political and economical system. It is the only way to avoid programs that tackle different aspects of development in opposite directions (for example, programs that address positively economic aspects while destroying other areas such as political, social and legal arrangements).

Consequently, this thesis proposes a conception of the rule of law that genuinely works together with the other dimensions of development addressed by a program to make a difference in the progress path of developing countries. With this focus, the rule of law not only has the traditional task that, for instance, neoliberalism reserves to it, but it also has the important role of the protection of individual, political, economic and social rights that try to promote human development and give people choices to improve their living standards.[153] In developing countries, this connection between the rule of law and the development process is essential to success and should go beyond the timid intentions associated with the comprehensive approach to development promoted by IFIs over the last few years.

## 2.7 The Rule of Law and Banking Systems

The notion of the rule of law plays an important role in maintaining stability and confidence in the banking system. The rule of law helps banks to operate in a sound environment, safeguarding financial stability.[154] This position is echoed by a former IMF Managing Director who stated:

> The Fund will pay increased attention to the overall institutional and regulatory framework of national financial sectors. This will include assessing whether incentive structures conducive for sound banking are in place; to what extent official safety nets are properly designed; whether the proper legal and regulatory

---

Bank in Venezuela. Among the shortcomings identified by the report that contributed to the low impact of the program were the lack of a broad-based participation in the design of the project and the absence of connections between the specific project and a more comprehensive reform strategy. See Lawyers Committee for Human Rights and the Venezuelan Program for Human Rights Education and Action, *Halfway to Reform: The World Bank and the Venezuelan Justice System* (1996).

153 Sen, above n 16.

154 Basle Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision' (Bank for International Settlements, 1997).

> framework is in place; whether the supervisory capacity and integrity exist to maintain a prudent system; and, finally, whether market forces and prudential oversight are mutually reinforcing.[155]

The involvement of the IMF in the efforts to strengthen the rule of law in the banking system has focused not only on areas directly associated with the regulation and supervision of banks, but also other aspects of the legal infrastructure that may affect financial institutions (for example, insolvency regime, contract, consumer protection, property laws and creditor rights). The Fund has been involved in these other areas because it believes that these aspects must be addressed for a smooth functioning of financial systems.[156] For this reason, during the 1990s it was common to see the Fund assisting countries drafting legislation on central bank and financial institutions as well as legislation related to contracts, commerce and bankruptcy. More recently, the Fund has coordinated its work to strengthen governance in the financial sector through the Financial Sector Assessment Program (FSAP), a joint effort with the WB to promote sound financial policies.[157]

This thesis subscribes to the position of the Basle Committee and the IMF that claims that a strong legal framework, oriented by the principles of the rule of law, can contribute with the creation of a sound banking sector. But, what are the terms of the rule of law in the banking system? The previously discussed attributes of the rule of law for the legal system could be applied in the context of the banking sector. In the following paragraphs, the debate over the rule of law will be translated to the banking arena. The analysis will follow the same structure previously used to study the rule of law (e.g. formal and substantive attributes). The elements of the rule of law in the banking system will later guide the analyses of the two case studies.

### 2.7.1 Formal Attributes

***a) A Strong Legal Framework:***

A climate in which banking regulations are unclear and constantly changing, or in which banking supervisors show weaknesses and do not independently enforce norms in a consistent basis, is a propitious scenario for a banking collapse. On the

---

155 Michel Camdessus, 'The Challenges of a Sound Banking System' (Paper presented at the Seventh Central Banking Seminar, Washington, D.C., 31 January 1997).

156 See IMF, *Financial Sector Assessment/A Handbook*. 2005, Washington, D.C.: IMF.

157 See the information available at http://www.imf.org/external/NP/fsap/fsap.asp

contrary, clear and stable banking legislation and regulations, and accurate enforcement by an independent authority could contribute to the stability of the banking system and create trust among market participants.

Hence, banking legislation has to be created in general terms without considering particular situations. It should also be clear, avoiding inconsistencies among different provisions. As explained earlier, it is expected that law remains unaltered for a reasonable period, facilitating a consistent enforcement. Although the financial system is one of the economic areas that show the fastest innovation pace, participants anticipate that banking authorities will not adopt frequent changes that could produce difficulties for the enforcement of law.

Another key feature that helps to build a strong banking legal framework is the design of the supervisor. The Basel Committee on Banking Supervision states that a supervisor with clear and defined goals is one of the pre-conditions for an effective banking supervision.[158] The supervision and regulation of banks could be reserved to one or various agencies. It could be subsumed into the scope of the central bank's responsibilities or under the umbrella of another separate entity. Supervision could even be the responsibility of a ministry of the government. Often, several entities are involved with the supervision and regulation of banks (for example, central bank, banking superintendency and ministry of finance).

More important than the number of agencies involved in the supervision of a bank is the clarity with which legislation establishes the objectives and responsibilities of regulators. It is essential that the law avoids overlapping responsibilities among regulators and obscure areas that could be used by banks in their own benefits. Legislation must state which agency is in charge of banking supervision and, in the case of multiple entities, specify responsibilities and objectives of each institution to avoid conflicts. This principle is also valid regarding the interaction between specialised supervisory agencies, central banks and the Ministry of Finance that is frequently involved in banking affairs, but from a more political approach.

[158] The Basel Committee on Banking Supervision is a working group of the Bank for International Settlement (BIS), an international institution that serves as a bank for central banks. The Committee is a forum for cooperation on banking supervisory matters and frequently issues guidelines and standards that are voluntarily followed worldwide. More information about the BIS is available at http://www.bis.org/

Second, legislation must address the regulatory powers of the banking supervisors and the processes that have to be followed in order to issue regulations and prudential standards. Legislation also needs to cover the requirements for the issuance of banking licenses. In the same way, supervisors have to be granted powers to enforce legislation and regulations, including monitoring and punitive powers.

***b) Independence of Banking Regulators:***

As the rule of law requires an independent judiciary, a healthy banking system demands an independent supervisor who generates confidence, protects depositors and prevents systemic crises. As central banks sometimes assume the supervision and regulation of banks, it would be useful to draw some differences between the monetary independence of a central bank and the independence that requires a banking regulator.

Independence is one of the key features upon which depends the success of a central bank to achieve its objectives.[159] Nowadays, no modern central bank is conceived without enjoying an adequate degree of independence.[160] This characteristic is particularly essential to seek the main objective of a central bank, that is, promoting price stability. Without independence, the central bank would be affected by the government's interest, which is normally oriented to take more risks and stimulate the economy in order to maintain popularity. In a similar way, without independence, the government may consider that the central bank is part of its agencies and therefore uses central bank's reserves to finance fiscal deficits, disregarding the negative consequences of this action for the whole economy.[161] In contrast, a central bank that independently designs and executes its tasks and uses its instruments of monetary policy (for example, reserve requirements and open market operations) to achieve its goals can better controlled the money available in the economy and, therefore, guarantee price stability, the ultimate goal of a central bank.[162]

---

159 John Head, 'Getting Down to Basics: Strengthening Financial Systems in Developing Countries' (2005) 18 *Transnational Lawyer* 257-282.

160 For instance, the European Union Treaty requires that new EU members have a legal framework that guarantees full institutional, personal and financial independence to their central banks. See Klaus Löber, 'The Process of Enlargement and the Central Banks in the Accession Countries' (2002) 30 *International Business Law* 491-493.

161 Exceptionally and under very strict conditions (e.g. limit amounts and for short periods) the central bank may grant temporal financial assistance to the government. See Head, above n 159.

162 Head, above n 159, 260.

The independence of a central bank is achieved through different mechanisms. One of them is avoiding the inclusion of ministers on the executive board. Another method is the creation of an appointment process that requires the involvement of the executive and the legislative in the selection of presidents and board members of a central bank. Similarly, a central bank's official tenures should be for fixed terms and if possible, longer than the terms of officials involved in their designation. Also the central bank must have independence to manage its own budget, personal and internal affairs.

In addition to monetary independence, a central bank would need independence when it is furnished with the task to supervise and regulate the banking system. This point is also valid if another agency is designated to oversee banks.[163] The existence of an independent banking regulator constitutes one of the preconditions established by the Basle Committee on Banking Supervision in order to create an effective banking supervision.[164] The performance of a banking supervisor can be threatened by the government as well as the banking industry. Political influences and pressure from the supervised institutions may lead to distortion in the supervision and regulation of banks. To isolate the regulator from such potential threats, it must be provided with independence.

Independence of banking authorities comprises four dimensions: regulatory, supervisory, institutional and budgetary.[165] The regulatory dimension refers to the ability of the supervisory institution to issue regulations in order to guarantee a sound banking system. In the exercise of its regulatory powers, the supervisory body should be guided by legislation passed by the parliament. Supervisory independence means that the overseeing agency could freely monitor activities of banks and determine their compliance with legislation and prudential regulations. This dimension includes the possibility that the banking supervisor can perform inspections and impose sanctions in cases of breaches of legal or regulatory obligations.

The third dimension of the independence of banking supervisors refers to the need for appropriate institutional settings for the bank authority that includes a legal

---

163 See Marc Quintyn and Michael Taylor, 'Regulatory and Supervisory Independence and Financial Stability' (2003) 49 *CESifo Economic Studies* 259-294.

164 Basle Committee, above n 154. See also Basle Committee on Banking Supervision, 'Core Principles Methodology' (BIS, 1999)

165 Quintyn and Taylor, above n 163, 267.

separated entity different from other agencies of the government or the parliament. It also means that the regulatory agency has the capacity to organise its own structure. The institutional independence includes the appointment and dismissal mechanisms associated with the president and the members of the board of the banking regulator. As in the case of central banks, a process that involves the executive and the legislative branches could guarantee more independence of the banking supervisor. Similarly, fixed term tenures and restricted causes for dismissals can help to strengthen independence of banking regulators. Finally, bank supervisors need to be able to manage their own budget which should be adequate to guarantee fair salaries, appropriate infrastructure and logistics to perform their duties.

Lastly, banking supervisors need to be isolated from pressure from the banking industry that may lobby, for instance, to avoid prudential regulations or to avoid the intervention of a bank. One mechanism that could avoid this influence over banking authorities is imposing limitations that prevent senior staff of banking supervisory agencies to work for private banks for a specific period after officials terminate their appointments.

### 2.7.2 The Meaning of Democracy and Development in the Financial System

There is not doubt that a banking system can barely develop if legislation and regulations are not general and clear, and the system is not regulated by an independent supervisor. However, as explained earlier, a notion of the rule of law applicable to developing countries requires the integration of formal attributes with democracy and development. This idea is also applicable to the banking sector.

Nonetheless, can democracy and its participation factor exist in the sophisticated sector of banking? Laws and regulations that govern banks are complex and have been developed by experienced lawyers and experts of different fields. It could be difficult to believe that the common citizen or other participants could contribute to enact better banking legislation or that a country could depart from the global harmonisation process that has characterised financial systems in the last two decades. In fact, crises such as those suffered by Asia in the 1990s demonstrate that national financial systems are interdependent and problems that occur in one

continent can affect another. For these reasons, international organisations like the Basle Committee have made efforts in order to convince countries of the necessity to harmonise financial regulations.

However, this global effort cannot obviate local realities and national actors. When authorities draft banking legislation and regulations, it is necessary that they provide opportunities to participate to those who could be affected. Private bankers, depositors and consumer protection organisations, professional associations, universities and research institutions, public entities (such as central banks and deposit insurance agencies), all of these could have something to say to protect their interests or may wish to simply contribute to the drafting of legislations and regulations.

In the context of regulatory governance, Hüpkes, Quintyn and Taylor have studied participation in the rule making process as a mechanism to ensure transparency and therefore accountability for financial sector supervisors.[166] Hüpkes, Quintyn and Taylor state that:

> The greater the extent to which the regulatory agency takes into account [the views of legislators, the financial service industry, customers and general public] as a part of its regulatory rule making, the greater will the legitimacy of its rules be. Thus, an open and public process of consultation during rule making enhances general understanding of the aims and purposes of the rules, helps to ensure that the rules themselves are well-reasoned and properly thought through and, above all, confers a legitimacy on the rules that they would not have if they merely appeared to be outcome of unfettered regulatory discretion.[167]

Hence, financial supervisors should not be misled by the high sophistication of the sector. They must be flexible to accept suggestions from other participants. One example of the risks to approve financial legislation or regulations without an open consultation process occurred in Venezuela. The National Assembly approved a new Credit Card Act according to which shops that accept credit cards as a method of payment must offer that facility free of charge. Nonetheless, Venezuelan small businesses customarily translate banking fees for the use of credit card payment facilities to their customers. With the new legislation, these small businesses are not

[166] Eva Hüpkes, et al., 'The Accountability of Financial Sector Supervisors: Principles and Practice' (Working Paper WP/05/51, IMF, 2005).
[167] Ibid 16.

allowed to translate bank costs to costumers and they will not be able to accept this kind of payment, which negatively affects their sales levels.[168]

The other factor related to democracy that is essential to incorporate to a notion of the rule of law in the banking system is accountability of regulators.[169] Banking authorities are accountable to the general public, the executive and legislative branches. In addition, decisions and regulations issued by the financial supervisors have judicial revision that ensure accountability and avoid arbitrariness.

One of the most elemental mechanisms to ensure accountability of regulator is issuance of principled banking legislation as well as fairly grounded decisions issued by financial supervisors. Acts executed by regulators must agree with the objectives established in the banking legislation. In the same way, legislators have to explain the reason behind enactments to facilitate the faithful application of law. As stated in the explanation of participation in the banking sphere, sophistication cannot be an obstacle to informing the public about financial matters and decisions. On the contrary, it is cardinal that authorities disclose all relevant information to the public

> Many decisions may be too technical for informed public debate, but, as a minimum, the general public needs to understand the purpose for which the agency exists and the principles underlying its approach to specific tasks, including the trade-off and dilemmas it has to confront.[170]

Clear objectives and reasons help to make banking authorities accountable and determine whether or not they are fulfilling their functions in the most efficient way. Moreover, accountability is essential to manage a crisis. In this scenario, banking authorities must disclose objectives that they intend to achieve to resolve the situation and they cannot cite 'confidentiality reasons' to avoid disclosure of their goals. Supervisors and crisis administrators cannot hide behind the complexity or novelty of the problem, to avoid explanations of how they plan to target a financial situation. Lack of clear goals could be expensive because it does not prevent supervisors from trying different solutions without regard for the taxpayers' money and without being accountable for their mistakes.

---

168 Suhelis Tejero Puntes, 'Ley de Tarjetas afectará a 60.000 pequeños comercios de Caracas', El Universal (Caracas), 13 September 2005.

169 For a complete study of accountability on the Financial Sector see Hüpkes, above n 166.

170 Ibid 7.

Finally, it is important to mention in this section the role that banking systems play in the development process, especially in poorer economies in which other financial sources are limited and, for example, the capital market is not usually fully developed. Banking intermediation helps to manage the allocation of funds in the economy. It intermediates between depositors who have an excess of money and investors or borrowers who are willing to expand their capital and therefore want to engage in productive activities that in turn positively affect the economy, creating employment, improving the people standard of living, and therefore, helping to reduce poverty.[171]

The promotion of a sound banking system is not only important to support economic development but also to achieve better social conditions. Consequently, reforms that are designed to be applied in banking systems in the developing world should include this goal. Hence, banking reforms should consider issues such as accessibility to banking services for the population and contribution of loans to the economic growth. On the contrary, reforms could lead to the liberalisation of banks with the increase of foreign participation but with little impact on the economy and on the standards of living of common people.

### 2.7.3 The Rule of Law and Banking Crises

The attributes of the rule of law in the banking system must be ensured not only in normal times but also during a crisis. In cases of financial trouble, an independent bank supervisor must act autonomously to assess the problem using a technical approach. If the management of a banking crisis is lead by governmental authorities, they may be influenced by political cost analysis that could opt for solutions that satisfy voters, but affect tax contributors and the economy as a whole. To illustrate, a government could delay the intervention of a failed bank for political considerations; or decide to offer a blanket guarantee to all depositors affected by a banking crisis. In both cases, consequences of a crisis could be exacerbated for this type of measures made under political assumptions.[172]

---

171 World Bank, above n 24, 75.

172 However, the Basle Committee has said that 'the way in which failures are handled, and their costs borne, is in large part a political matter involving decisions on whether, and the extent to which, public funds should be committed to supporting the banking system. Such matter cannot therefore always be entirely the responsibility of banking supervisors…' Basle Committee, above n 154, 9.

Likewise, the quality of the banking legal framework is determinant in a case of a crisis and it may prove decisive to solve problems in an orderly fashion and to maintain confidence in the system. If a banking collapse occurs, authorities must know, beforehand, how to legally handle it, what available arrangements they have to solve the problem, and the mechanism for the exit of failed banks. It is not a moment for improvisation and the ordinary legislation must foresee the authority that is competent to deal with the problem, the different way to resolve disputes, the procedure to close unviable financial institutions and satisfy creditors and depositors.

According to the IMF, the management of a crisis requires building adequate financial safety nets into the legislation: (i) clear legal framework for liquidity support; (ii) deposit insurance; and (iii) crisis management policies.[173] All of these measures need to be embodied in a clear legislation that must be applied consistently. [174]

The first safety net is associated with the role of lender-of-last-resort. Sometimes a banking crisis hits a nation and banking regulators do not have a clear idea about whether or not the legal system furnishes the central bank with authority to provide liquidity to troublesome banking institutions. Generally, central banks act as a lender-of-last-resort, but if the law does not provide a clear mandate, financial authorities could lose precious time looking for legal support in order to provide liquidity to banks. The lack of clarity could exacerbate a crisis, expanding the effects of a single failed bank to the whole system.

A second essential safety net in case of emergency is deposit insurance that should be in place before a crisis occurs. A deposit insurance scheme could diminish consequences of a banking crash because depositors know that all or part of their savings would be recovered through the insurance scheme, diminishing consequences of a loss of confidence in the financial system. However, the persuasive power of a deposit insurance scheme would depend on the insurance agency's efficiency to respond to depositor's claims. For instance, if the agency takes too much time to reimburse deposits, the public could lose faith in the system and this may affect other healthy banks. Additionally, authorities must apply norms related to deposit insurance consistently and give equal treatment to all depositors.

---

[173] IMF, above n 156, 104.
[174] Ibid.

The equal treatment requires legislation to be clear about the amount limits of claims as well as whether off-shore deposits or those in foreign currency will be covered.

Finally, the IMF affirms that banking legislation must specify powers of banking authorities in case of crises, including which agency will coordinate efforts, faculties of each entity involved in supervision of banks and the powers to deal with non-viable institutions. It would help if banking authorities have a contingency plan beforehand in case of a crisis.

# CHAPTER 3

# IMF CONDITIONALITY: A WAY TO STRENGTHEN RULE OF LAW IN DEVELOPING COUNTRIES?

## 3.1 Introduction

Created in 1945 by 29 countries, the IMF was designed 'to help promote the health of the world economy'.[1] Among the purposes stated by the IMF Articles of Agreement is the avoidance of financial crises in the international payment system and the provision of financial aid to its members that face balance of payment problems. Furthermore, the IMF seeks:

> To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.[2]

At the beginning, it was assumed that the IMF would undertake its purposes overseeing a fixed exchange rate regime (the gold standard) among its state members. This task would help to maintain the stability of a sound international monetary system avoiding the protectionism that caused the 1930s global depression.[3] After the suppression of the gold exchange regime in the 1970s, the IMF turned its attention almost exclusively to developing countries and the management of financial crises.

In its role of supporter of developing nations, the IMF provides technical and financial assistance according to its Articles of Agreement. In the latter case, one of the tools attached to the IMF financial aid has been conditionality, a mechanism that helps to induce macroeconomic and institutional changes considered necessary by the IMF staff to supersede crises and adjust economies to the market. Among the

---

1 IMF, What Is the International Monetary Fund? (2004) IMF <http://www.imf.org/external/pubs/ft/exrp/what.htm#preface> at 16 October 2004.

2 IMF Articles of Agreement, Article I (ii).

3 For an account of how IMF was set in the international financial system see David Vines and Christopher Gilbert, 'The IMF and International Financial Architecture: Solvency and Liquidity' in David Vines and Christopher Gilbert (eds), *The IMF and its Critics* (2004) 8-35.

structural reforms that have been seen as essential by the IMF, governance and the rule of law have occupied an important position and have been covered by some of the conditions negotiated between this financial institution and its state members. However, the attempt to strengthen the rule of law through the use of conditionality raises questions over the adequacy of this mechanism to achieve this goal. The interaction between the rule of law and conditionality poses a real challenge in the case of developing nations where governments confront difficulties to reconcile both notions and they often have recourse to exceptional powers to resolve this dilemma.

The following paragraphs will examine IMF conditionality and whether it can contribute to the strengthening of the rule of law in developing countries.

## 3.2 Understanding IMF Conditionality

### 3.2.1 Conditionality: A definition and history

> When a country borrows from the IMF, its government makes commitments on economic and financial policies—a requirement known as conditionality. Conditionality is a way for the IMF to monitor that its loan is being used effectively in resolving the borrower's economic difficulties, so that the country will be able to repay promptly, and make the funds available to other members in need. [4]

With the above paragraph, the IMF's website begins its explanation about conditionality. In the context of this institution, conditionality refers to a set of policies that a state member agrees to adopt in order to access IMF aid. Using conditionality, the Fund is guaranteed that its resources are used according to its Articles of Agreement. At the same time, conditionality ensures the IMF that it will be repaid and its resources will be available to other members when required. Conditionality means that IMF financial support is not automatically available for state members unless a previous 'agreement' is achieved establishing conditions to which the member must adhere.

Although conditionality was not included in the original IMF Articles of Agreement, controversy surrounding the terms under which the IMF would provide financial

[4] IMF, *IMF Conditionality* (2005) IMF <http://www.imf.org/external/np/exr/facts/conditio.htm> at 12 February 2007.

assistance to its members started with the birth of this institution.[5] During the negotiations that took part primarily between the US and the United Kingdom (UK) during the 1940s to establish the new entity, powers that the future organisation would hold over its members attracted great attention. During those discussions, the American representatives assumed that the Fund should have certain assurances that a member seeking assistance would follow policies consistent with the Fund's objectives.[6] In contrast, British delegates believed that IMF resources should have been automatically available upon request of any member state in crisis.

The Europeans prevailed in the original Articles of Agreement and conditionality was not expressly included. The situation changed after the initial establishment and American directors, through the Executive Board, clearly dominated and proposed most of the decisions that returned conditionality to a relevant position in the use of IMF resources.

As Richard Edwards affirms, the starting point of conditionality was the original Article V Sections 2 and 3 of the IMF Agreement that stated:

> Section 2: Except as otherwise provided in this Agreement, operations on the account of the Fund shall be limited to transactions for the purpose of supplying a member, on the initiative of such member, with the currency of another member in exchange for gold or for the currency of the member desiring to make the purchase.
>
> Section 3 (a): A member shall be entitled to buy the currency of another member from the Fund in exchange for its own currency subject to the following conditions: (i) the member desiring to purchase the currency represents that it is presently needed for making in that currency payments which are consistent with the provisions of this Agreement … [7]

This original provision did not condition the use of IMF resources. In a subsequent decision, the Executive Board established that:

---

5 See Richard W. Edwards Jr., *International Monetary Collaboration* (1985) 232. See also Ariel Buira, *An Analysis of IMF Conditionality* (2002) John F. Kennedy School of Government, Harvard University <http://ksghome.harvard.edu/~drodrik/g24buira.pdf> at 21 May 2005.

6 Buira, above n 5, 3.

7 IMF Articles of Agreement (original text), available at: http://www.imfsite.org/origins/original1.html

> authority to use the resources of the Fund is limited to use in accordance with its purposes to give temporary assistance in financing balance of payments deficits on current account for monetary stabilization operations.[8]

With this act, the Executive Board clarified that the Fund's resources had to be employed according to its objectives. Additionally, the Board made plain that the assistance was of temporary nature. Nonetheless, this 1946 Executive Board decision was not enough to begin with the implementation of conditionality.

A posterior resolution of the Executive Board (No.284-4) reviewed the meaning of the word 'represents' included in Article V (3) (a) (i) and resolved that it meant 'declares'. [9] As a consequence, a country that needed the IMF assistance must declare that it needed the requested currency in order to make payments consistent with the Articles of Agreement. This 1948 decision also allocated on the Fund's head the faculty to challenge the country declaration providing that the currency was not required for payments consistent with IMF provisions. However, in situations in which the institution considered that the declaration made by a state was not correct, 'the Fund may postpone or reject the request, or accept it subject to conditions'.[10]

Despite the efforts made by the Executive Board to regulate how the institution would facilitate its financial assistance, it was not until 1952 when conditionality was first used.[11] That year, other resolutions of the Executive Board made operative the previous decisions and created two types of tranches in order to access the organisation's financial assistance. According to this system, a country had the right to automatically access to a first tranche of resources if it faced financial difficulties (this tranche represented 25% of a member quota).[12] This facility was called 'the gold tranche' and later, the 'reserve tranche'.[13] The members could use this tranche without any imposition from the IMF. Any requirement that exceeded the limit of the reserve tranche required to be attached to certain conditions.[14] Soon after, the IMF

---

8 IMF Executive Board Decision No. 71-2, 26 September 1946, available at: http://www.imf.org/external/pubs/ft/sd/index.asp?decision=71-2

9 IMF Executive Board Decision No. 284-4, 10 March 1948, available at: http://www.imf.org/external/pubs/ft/sd/index.asp?decision=284-4

10 Ibid.

11 Edwards, above n 5, 233.

12 IMF Articles of Agreement (original text), Article V (3) (iii).

13 Currently, Article XXX (c) defines reserve tranche as 'a purchase by a member of special drawing rights or the currency of another member in exchange for its own currency which does not cause the Fund's holdings of the member's currency in the General Resources Account to exceed its quota'.

14 Edwards, above n 5, 234.

organised the first arrangement to support Belgium in June 1952.[15] Later, in October of the same year, the IMF Executive Board adopted Decision No.155 establishing a general policy on conditionality.[16] Further changes were made on the conditionality policy in 1953, 1959 and 1961.[17]

During the initial period, it was common that the IMF included macroeconomic performance clauses in stand-by arrangements. These provisions were often thought as necessary for the success of the member's economic program and were considered objective and easily verifiable, without requiring any subjective judgement of the Fund.[18] Those conditions principally focused on requirements related to macroeconomic variables closely associated with IMF core areas of responsibility.

In 1968, the First Amendment formally incorporated conditionality into the IMF Articles of Agreement, in the terms previously delineated by the Executive Board. In other words, changes underlined the temporary nature of the assistance and the need that resources were used according to the IMF constituting charter.[19] The reformed Article V (3) (c) stated that:

> A member's use of the resources of the Fund shall be in accordance with the purposes of the Fund. The Fund shall adopt policies on the use of its resources that will assist members to solve their balance of payments problems in a manner consistent with the purposes of the Fund and that will establish adequate safeguards for the temporary use of its resources.[20]

At the end of the 1960s, the IMF mostly worked with quantitative conditions and the inclusion of structural conditionality on IMF programs was rare.[21] It was later when the Fund timidly commenced to include qualitative requirements associated with fiscal issues that had political ramifications into its programs. During this decade, however, performance criteria produced certain discomfort for developing countries, especially in 1967 when the Fund negotiated a stand-by arrangement with the UK

---

15 Ibid.

16 Joseph Gold, 'The Law and Practice of the International Monetary Fund with Respect to "Stand-By Arrangements"' (1963) 12 *International and Comparative Law Quarterly* 1-30, 4.

17 Ibid.

18 Ibid 17.

19 See Margaret Garritsen Vries, The International Monetary Fund 1966-1971/The System under Stress (1976), Vol. I: Narrative, 256.

20 Ibid Vol. II, 102.

21 Ibid Vol I, 344; Harold James, ' From Grandmotherliness to Governance/The Evolution of IMF Conditionality' (1998) 35 *Finance & Development* 44-47.

that revealed some differences with other facilities previously agreed by the IMF with other members.

By that time, the UK requested a stand-by arrangement for the amount of US$1.4 billion to deal with a balance of payments crisis that derived in a devaluation of the sterling.[22] An agreement was speedily worked out between the UK and the IMF. With this accord, the Fund accepted selling to UK the required amount in just one transaction instead of different disbursements, as was the Fund's normal practice. Meanwhile, the UK representatives agreed to periodically consult with the Fund and accepted the IMF monitoring.

The UK agreement represented a departure from similar arrangements previously concerted by the IMF and other members, particularly developing nations, in which money was disbursed in several instalments depending on the achievement of performance criteria. For this reason, IMF Board directors who represented developing countries argued that the institution was applying preferential standards to industrialised nations.

The UK stand-by agreement affair produced a revision of the policies related to this type of arrangement that culminated with the approval of a revised policy in 1968. During the debate of the new policy, a discussion arose about whether a consultation scheme or detailed performance criteria should be included in stand-by agreements. One of the main criticisms argued by developing countries against performance provisions was the increasing inclusion of detailed conditions and other clauses in stand-by arrangements that made those documents very rigid.[23] For those nations, the agreement accepted by UK that only included consultation obligations, was more suitable and convenient to their interests than performance criteria.

The agreed reform tried to conciliate demands of the state members and the result was a policy that harmonised the needs for flexibility with the demands for equal treatment for all Fund members. According to the 1968 stand-by arrangement policy, consultation clauses would be included in all stand-by arrangements. It also established that stand-by arrangements that exceeded the reserve tranche would

[22] Garritsen, above n 19, Vol I.
[23] Ibid 346.

incorporate performance criteria clauses that were 'necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives, but no others'.[24] The Executive Board expressed that it was not possible to establish a specific limit on the number or areas of conditions because it depended on the problems faced by each individual country.

Finally, to simplify the IMF agreements, the Executive Board decided that 'in view of the character of stand-by arrangements, language having a contractual flavour will be avoided in the stand-by documents'.[25] In this way, the Board tried to limit the practice of including complex contractual clauses in stand-by agreements.[26]

In the 1970s, due to more criticism against the IMF because of its increasing involvement in conditions that had a political content, the Executive Board issued a document entitled 'The Guidelines on Conditionality' that regulated in more details the use of conditionality embodied in stand-by arrangements. In these Guidelines, the Executive Board limited performance criteria to those associated with macroeconomic variable.[27] However, the same document left a door open for exceptions and stated that, 'performance criteria may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macroeconomic impact'.[28] The staff broadly employed this exception, which facilitated the inclusion of structural conditions. These Guidelines were in force until they were replaced in 2002.

At the end of the 1980s, the IMF use of conditionality resulted in a marked increase in IMF packages, particularly those requirements related to structural changes. This trend was sustained throughout the 1990s. For the IMF Independent Evaluation Office, the expansion was due to the implementation of new arrangements for low-income countries that targeted structural changes to improve growth, and the assistance provided to transition Eastern European countries that needed numerous changes to adapt their institutions to a market economy.[29] Nonetheless, there was a third group of nations that did not classify as either of these two categories but

---

24 Executive Board Decision No. 2603-(68/132), 20 September 1968 in Garritsen, above n 205, Vol II, 197.
25 Ibid.
26 For an example of how stand-by arrangement clauses were written at that time see Gold, above n 16.
27 IMF Executive Board, 'Guidelines on Conditionality/Executive Board Decision No.6056-(79/88), March 2, 1979)' in Stephen Zamora and Ronald Brand (eds), *Basic Documents of International Economic Law* (1990) 391-394.
28 Ibid.
29 Independent Evaluation Office, 'Evaluation of Structural Conditionality in IMF-Supported Programs' (Occasional Paper IMF, 2005), 2.

they also received a dose of structural conditionality after suffering financial crises in the 1990s (for example, Argentina, Venezuela, Peru, Korea, Indonesia and Thailand).

### 3.2.2 Reasons for Conditionality

Since the 1940s, when the Executive Board initiated the shaping of conditionality to provide financial assistance to its state members, this instance has consistently argued that conditionality achieves two main objectives: (i) to guarantee that members use the institution funds to resolve financial problems in a way that is consistent with the Agreement; and (ii) to ensure that the Fund will be repaid and maintain its capacity to assist other members in financial difficulties.[30]

The ability of conditionality to achieve these two objectives and its adequacy to produce structural reforms in developing countries has been widely discussed. An important group of authors claims that conditionality has been ineffective to resolve the main economic problems that it is supposed to address.[31] On the contrary, it has been noticed that the quantitative and qualitative increase of conditionality has produced an increase of IMF program failures.[32]

Similar criticisms have been made associated with the revolving nature of the IMF's resources and the capacity of conditionality to guarantee repayment. Some experts express concerns about the contradiction that exists between debt recovery and other more 'human' purposes of the Fund. These commentators explain that although the IMF must seek the recovery of financial resources provided to state members, there are other objectives included in its constituting document that are as essential as the repayment of IMF 'loans'. Indeed, these additional purposes may be in direct conflict with the goal of safeguarding the institution resources, making it necessary to establish priorities among the different objectives of the Fund.[33] It is the case of the goals associated with the promotion of a high level of employment

---

30 Ibid 4.

31 See e.g., Axel Dreher and Roland Vaubel, 'The Causes and Consequences of IMF Conditionality' (2004) 40 *Emerging Markets Finance and Trade* 26-54; Morris Goldstein, 'IMF Structural Programs' (Paper presented at the Conference on Economic and Financial Crises in Emerging Market Economies, Woodstock, Vermont, 19-21 October 2000); Tony Killick, 'Conditionality and IMF Flexibility' in Alberto Paloni and Maurizio Zanardi (eds), *The IMF, World Bank and Policy Reform* (2006) 253-264.

32 Killick, above n 31.

33 Buira, above n 5.

and real incomes that should be placed above the simple intention of the IMF to recover its money, especially if we consider that this institution is a multinational organisation and not a commercial bank whose main purpose is profitability. In addition, the Articles of Agreement clearly state that correction of financial problems should be performed without resorting to measures that are destructive to national and international prosperity, a goal that could conflict with the IMF's interests in recovering its money (Article I (v)).

Similar contradictions exist with the IMF's idea of strengthening governance and the rule of law as a mechanism to improve macroeconomic fundaments and therefore, safeguard IMF resources. The Executive Board has said that:

> The use of conditionality related to governance issues emanates from the IMF's concern with macroeconomic policy design and implementation as the main means to safeguard the use of IMF resources.[34]

This means that the IMF incorporates conditions associated with governance issues into its programs because the organisation understands that such area has an impact on macroeconomic variables and the improvement of these indicators would be translated in a better chance to recover its resources. According to this explanation, the Fund's concerns for governance is due more to its needs to secure repayment than its willingness to achieve other purposes, such as promotion of employment, real income improvements, or simply to strengthen the rule of law as a mechanism to achieve growth and abate poverty. From this perspective, IMF conditionality looks more like the collateral agreement by a debtor in favour of a commercial bank to guarantee a loan than an instrument to promote the rule of law or other development objectives.

Although conditionality has been attacked from different sides and many experts doubt its effectiveness to protect the IMF's resources and guarantee program success, the organisation still insists on using it and the most recent Fund policies keep a role for this mechanism.

---

[34] IMF, *Good Governance/The IMF's Role* (1997).

### 3.2.3 Faces of Conditionality

The IMF incorporates two categories of conditions into its programs: quantitative and qualitative. The first group is associated with macroeconomic variables, such as level of international reserves, inflation, and public budget deficit. As mentioned above, the IMF initially adopted more quantitative conditions into its programs. These types of conditions respond to clear targets that are easily measurable. Most of these quantity requirements refer to macroeconomic indicators and are consistent with the main objectives of the Fund.

During the 1980s and 1990s, the Fund became more and more involved with qualitative conditionality, although it was an exceptional window established by the 1979 Guidelines on Conditionality. According to these norms, it was necessary that a structural requirement had a material impact on macroeconomic variables in order to be exceptionally included in a program. Nonetheless, the list of structural conditions grew so large that it made it more difficult to assert that all these measures had a determinant impact on macroeconomic indicators.[35]

Whilst quantitative conditionality was more conveniently monitored using clear measures, structural requirements were more complicated to evaluate because they include conditions that could not be measured objectively (for example, changes in policy processes, enactment or amendment of laws or other institutional reforms on the judiciary or public agencies).[36] This situation made conditionality more controversial because it depended on subjective judgements that affect political arrangements in developing countries, a situation that was avoided by the Fund during the 1950s and 1960s.[37]

Over time the IMF developed different tools in order to reduce criticism and cover conditionality on more objective grounds to assess compliance. Depending on the specific requirements, conditions can be added to programs under any of the following headings: Prior Actions (PAs); Performance Criteria (PCs); Structural

---

[35] For instance, Goldstein lists a group of measures that were included in the IMF-sponsored program for Indonesia that could hardly have a macroeconomic impact (e.g. reforestation programs, suspension of an aircraft project, the suppression of a compulsory contribution for charity purposes, etc.). See Goldstein, above n 31.

[36] Independent Evaluation Office, 'Evaluation of Structural Conditionality in IMF-Supported Programs' (Occasional Paper IMF, 2005).

[37] Gold, above n 16, 17.

Benchmarks (SBs); and Program Reviews (PRs). Each one of these mechanisms and the forms they adopt in the field of structural conditionality is explained below.

***a) Prior Actions (PAs)***

PAs are 'measures that a country is expected to adopt before the approval of an IMF arrangement or completion of a review'.[38] This mechanism is one of the favourites of the IMF's staff because it induces governments to rapidly work on the achievement of actions required by the international institution and before countries can access financial resources. After a country complies with the PAs negotiated with the Fund, it includes those actions into a letter of intent addressed to the Executive Board, but at that time, a state has already achieved those PAs (see Fig. 1).

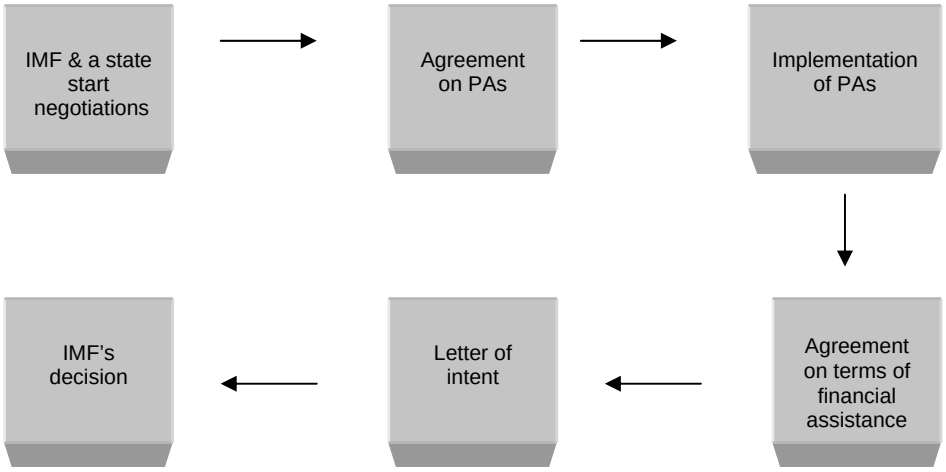



**Figure 1: Prior Actions**

For the power of PAs to persuade countries to comply with IMF requirements in order to access funds, they are equivalent to conditions precedent in a commercial loan agreement.[39] For this reason, PAs have a high implementation rate.[40] If PAs are not met, the IMF will reject any requirement of financial aid, at least temporarily and until the agreed PAs are accomplished.

A prior action may require the enactment of legislation, the strengthening of financial regulation, privatisation of specific industries or foreign exchange liberalisation. Thus, if for instance the promulgation of a privatisation law by the legislative body

[38] Independent Evaluation Office, above 36, 9.
[39] Conditions precedents are requirements that a borrower under a loan agreement must satisfy before the lender is obligated to make the loan.
[40] See IMF, 'Review of the 2002 Conditionality Guidelines/Selected Issues' (IMF, 2005).

has been set as a PA and the government faces difficulties to convince the Congress to pass the law, the executive could face the dilemma to decide between ruling out IMF financial assistance or finding its way through IMF conditionality and pressures for the approval of the required law even if it means to use other more radical mechanisms such as executive decrees to pass a legislative rejected act.

It is important to note that the IMF implicitly recognises that the implementation of PAs requires a very strong political platform, or at least a powerful executive branch. For this reason, the institution has avoided including PAs when the head of the executive branch is in an extremely weak position without political support or without possibilities to rest on exceptional powers.[41]

According to the 2002 IMF Guidelines on Conditionality, PAs are included to guarantee fast implementation of key changes critical for the success of the entire program. In other cases, PAs are included when the IMF has doubts about the real reformist commitment of authorities due to previous experience in which a member have not finalised earlier programs. The reasoning behind this position is that a country with a weak implementation record is more likely to default on IMF conditions and, therefore, the institution seeks to obtain more assurances from these unworthy countries, including the use of more compelling tools such as PAs.

However, it is not clear whether the use of this avenue is effective to persuade governments to complete IMF packages. Although data shows that PAs are implemented in most of the cases (of course, non-compliance means no financial aid), this result does not necessarily mean that programs that include more PAs will have a better implementation record than those than include fewer. Indeed, the IMF has found that 'fund-supported programs with more prior actions are neither more nor less likely to suffer from a program stoppage'.[42]

***b) Performance Criteria (PCs)***

A second tool used for structural conditionality is PCs. They are concrete requirements that need to be implemented by a state member before the IMF disburses agreed amounts of currencies. PCs induce governments to adopt agreed reforms on time and help the IMF to track implementation of programs. Achievements of PCs are often linked to a disbursement schedule. Thus, if a

[41] See for example the case of Argentina mentioned in IMF, above n 40, 61. For a similar situation in Peru see IMF, 'Streamlining Structural Conditionality: Review of Initial Experience' (IMF, 2001) 21.

[42] IMF, above n 40, 62.

country does not comply with performance criteria, it cannot access additional financial resources and the Fund may suspend the entire program. Conditions that can be monitored using clear variables or measures are included in programs as PCs. Examples of typical performance criteria are a specific increase on utility prices or the reduction of public servant salaries. Performance criteria could also refer to the enactment of legislation such as the approval of a banking law that clarifies responsibilities of institutions involved in the supervision of financial institutions.

According to the 1979 Guidelines, performance criteria were limited to those that were necessary to monitor program implementation. The old Guidelines also restricted performance criteria to macroeconomic variables and in exceptional cases, to other indicators that were necessary to address due to their macroeconomic impact. However, the exception became the rule and in the 1990s the IMF often included several structural performance criteria in its supported programs.

Today, the 2002 Guidelines establish that performance criteria apply to clearly specified variables that can be objectively monitored. Likewise, the new Guidelines state that inobservance of performance criteria is reason enough to suspend a program. Nonetheless, the Executive Board can decide not to suspend a program and waive the non-compliance with a PC. On other occasions, the Executive Board can agree to waive a PC provided that it is converted into a Prior Action for a completion of a Program Review.[43] It means that a Program Review will not be completed until a PC that has become a PA has been met.

***c) Structural Benchmarks (SBs)***

A third way to limit a country's assistance is through the imposition of SBs. They facilitate IMF staff to monitor country observance with conditions that could not be objectively monitored but whose compliance ensures that the program is on track. SBs do not affect disbursements 'but trigger discussion on corrective action if not met'.[44] That is, corrective actions could represent the conversion of SBs into PAs or PCs. SBs are preferred over PCs in cases where the lack of implementation would not cause an interruption of IMF financial assistance. SB examples could be

[43] Ibid 12.

[44] Independent Evaluation Office, 'The IMF and the Recent Capital Account Crises/Indonesia, Korea, Brasil' (IMF, 2003) 42.

requirements to move forward in order to pass a new banking or bankruptcy legislation or to progress towards the privatisation of state banks.

Thus, PAs, PCs and SBs are tools that the IMF uses depending on the situation and goals that the institution is trying to address. A single measure, for example the enactment of bankruptcy legislation, could be indistinctly set into an IMF program as a PA, PC or SB. If IMF staff consider that a Bankruptcy Act is indispensable to start any reform and this measure is seen as essential for the success of the entire package or if a country has a poor previous record of completing IMF programs, it is likely that this condition will be set as a PA. This was the case with Indonesia during the Asian financial crisis.[45] Indonesia first agreed on a Letter of Intent with the IMF in October 1997. In this document, the country accepted to implement a set of structural reforms including the revision of the bankruptcy law.[46] However, the economic situation of Indonesia deteriorated in the first months of 1998, including the financial position of the banking system.[47] At the same time, the Indonesian government failed to maintain the desired pace of reforms.[48] For these reasons, the IMF decided to accelerate its strategy to restructure the Indonesian banking system and strengthen the financial legal infrastructure, requiring compliance with several prior actions, including the enactment of bankruptcy law. This target was achieved by the Indonesian government before it signed a Supplementary Memorandum of Economic and Financial Policies in April 1998.

If the new legislation could be enacted in a subsequent phase, but it is still important in order to achieve the program goals, it is likely that the requirement will be included as a PC. To illustrate, in 2003, Bolivia signed a stand-by agreement with the IMF. The main objective of the program was to address economic stagnation that affected that country and laid the basis for a more complete medium-term reform supported by a PRGF.[49] One of the components of the IMF package was the reform of the banking system and the strengthening of the financial and corporate sectors. An immediate need to address the financial sector did not exist,

---

45 Ibid 90.

46 Government of Indonesia, *Letter of Intent and Memorandum on Economic and Financial Policies* (1997) IMF <http://www.imf.org/external/np/loi/103197.htm> at 07 June 2007, [33]. See also Government of Indonesia, *Indonesia-Memorandum of Economic and Financial Policies* (1998) IMF <http://www.imf.org/external/np/loi/011598.htm> at 07 June 2007.

47 Government of Indonesia, *Indonesia-Supplementary Memorandum of Economic and Financial Policies* (1998) IMF <http://www.imf.org/external/np/loi/041098.htm> at 07 June 2007.

48 Ibid.

49 Government of Bolivia, *Bolivia—Letter of Intent, Memorandum of Economic Policies, and Technical Memorandum of Understanding* (2003) IMF <http://www.imf.org/external/np/loi/2003/bol/01/index.htm> at 07 June 2007.

but it was an important middle-term goal. Under this perspective, the IMF included the drafting of a law on bankruptcy and other informal workout mechanisms: an action oriented to improve the legal infrastructure of the banking system as a PC.[50] This law was perceived as a critical element to success in the strengthening of the banking system component but not in the other two areas of the program (for example, budget and monetary policies).

Finally, if the passage of new bankruptcy law is seen as a part of a broader strategy and its inobservance is not perceived to have the importance to justify the suspension of IMF disbursements, the Fund could opt to include the new law as a SB. This was the case with Brazil. In 2002, Brazil faced uncertainty due to a deteriorating external economic climate and great concerns due to an upcoming Presidential election. Financial investors were unclear on whether or not a new government would maintain the macroeconomic policies applied by the country in coordination with the IMF since 2001.[51] The focus of the program was to strengthen macroeconomic indicators. In addition, the Brazilian government agreed to continue promoting a set of structural reforms and was willing to submit to the Congress a draft of a bankruptcy law. This action seemed a desirable measure, but it was not critical to tackle any balance of payment problem of Brazil and it was only included as a structural benchmark.[52]

***d) Program Reviews (PRs)***

Another tool attached to conditionality is PRs, performed by IMF staff to follow up on a country's achievements and compliance with the conditions set in a program. In most cases, during a PR, IMF officials visit the country to collect data and interview domestic authorities. Reviews are performance in a broad-based basis. Reviews serve to determine whether or not a program is on track according to the agreed terms or if waivers or adjustments are necessary. The final decision of a review is made by the Executive Board, which assesses the member performance based on its compliance with prior actions, performance criteria and structural benchmarks.

---

50 Ibid [21].

51 Government of Brazil, *Brazil-Letter of Intent* (2003) IMF <http://www.imf.org/external/np/loi/2003/bra/01/index.htm> at 08 June 2007. The main political concern was that the presidential election was due on October 2002 and the front-runner to win was Luiz Inácio Lula da Silva, a former labour unionist who was supported for leftist parties.

52 Government of Brazil, *Brazil-Letter of Intent*. 2003, IMF: Washington.

***e) Other IMF tools***

Lastly, it is important to note that the 2002 Guidelines on Conditionality included two other instruments associated with conditionality. The first of these tools is called 'financing assurance reviews'. According to the 2002 Guidelines, this mechanism is used when a member has outstanding sovereign external payments in arrears to private creditors or outstanding non-sovereign external payment in arrears due to the imposition of exchange controls. In those cases, the Executive Board must perform a review to study if there are sufficient safeguards for the use of IMF resources and whether the negotiations between creditors and the state do not affect reforms agreed with the institution and the possibility of recovery of its resources. The other conditionality tool incorporated into the IMF arsenal is the Indicative Targets (ITs). ITs are variables that due to substantial uncertainty about economic trends cannot be included as PCs. They may also be used as a quantitative indicator to assess the progress made by a member state in the context of a program review.[53]

## 3.3 Nature of IMF Arrangements: Their adequacy to strengthen governance and the rule of law

As explained previously, the IMF needs assurances that when it assists a member, its resources are used to resolve financial difficulties in a way that is consistent with its Articles of Agreement and ensures the revolving nature of its funds. One of the mechanisms designed by the multilateral institution to accomplish these two objectives was conditionality, a tool that is equivalent, to some extend, to precedent conditions and covenants that a private borrower agrees to set up for a commercial bank to secure a loan. In this regard, for instance, when a corporation is under stressful financial conditions and requires fresh resources to maintain its operations, one of its options is to renegotiate an existing banking loan. It is probable that a bank accepts a refinancing agreement if the institution considers that the company has potential and a competent management that could lead the company to its recovery. However, it is highly probable that the financial institution asks for additional collateral; and perhaps, imposes a set of additional covenants and conditions that the bank perceives could improve the corporation's performance.

---

[53] IMF, *Guidelines on Conditionality* (2002) <http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.pdf> at 29 September 2004

The IMF, when dealing with nations, sometimes appears to assume a similar banking approach; however, a sovereign country faces time constraints and it is submerged in a different type of crisis when it inquires about IMF assistance. Moreover, government decisions are not corporate ones. On the contrary, they have a high political content and are achieved through a complex political process. These decisions typically affect a great number of people. For these reasons, although the IMF assistance may share some attributes with conventional banking practices, it cannot be identical and must be approached from a different perspective.

Upon an examination of the objectives of the IMF and the temporary and emergency nature of the relief provided by that institution, the use of conditionality to produce certain macroeconomic changes can be seen to be necessary. However, when the focus is on conditionality and its adequacy to improve the notion of governance and the rule of law, its juridical construction is too weak to positively affect the rule of law. Further, its content is very ambitious because it includes issues that go beyond the management of emergencies, deforming a tool that was conceived originally to attack crises. To support this statement, it is necessary to scrutinise the nature of IMF facilities and the attached conditionality. This issue is essential to determine the type of authorisation required by IMF state members to accept the institutional financial assistance and its submission to the conditions imposed by a foreign actor as well as to determine whether or not the figure is adequate to strengthen governance and the rule of law.

### 3.3.1 IMF Mechanisms to Provide Financial Assistance

When several countries agreed on the creation of the IMF at the United Nations Monetary and Financial Conference in 1945, they adopted the Articles of Agreement, a treaty that governs how the institution works. This treaty constitutes the most important instrument for the IMF's operations and regulates the rights and obligations between the organisation and its state members. As with any other treaty, the IMF Articles of the Agreement is intended to be legally binding and regulated by international law.[54]

[54] For instance, Vienna Convention on the Law of Treaties.

Among the issues regulated by the Articles of Agreement are the transactions celebrated between the IMF and its members for purposes of financial assistance. One of the objectives of the Fund is to provide members with temporal financial resources to correct balance of payments difficulties (Article I (v)). According to Article V (2) (a) of the current IMF Articles of Agreement:

> Except as otherwise provided in this Agreement, transactions on the account of the Fund shall be limited to transactions for the purposes of supplying a member, on the initiative of such member, with special drawing rights or the currencies of other members from the general resources of the Fund, which shall be held in the General Resources Account, in exchange for the currency of the member desiring to make the purchase.

The first aspect that is worthy of notice is that the financial assistance provided by the IMF to its state members is not in the form of an ordinary loan in which one party, a lender, agrees to provide to another party, a borrower, an amount of money that must be repaid at a later date. In the event of a common loan, a borrower must repay the amount owned plus interest and other charges to its lender according to a settled schedule.

In the context of the IMF's financial assistance, a member in need agrees with the Fund to purchase SDRs or any other usable currency held by the institution in exchange for its own currency with the obligation to repurchase its official money later.[55] Acquiring SDRs or usable currencies, a country is able to resolve its balance of payment problems but it is not obligated to apply the drawn amount in any specific form.[56] The Articles of Agreement authorises the Fund to levy charges to members for the purchases of SDRs or usable currencies. These 'charges' are equivalent to interest rates and other concepts included in a commercial loan and in many cases, Fund documents expressly use similar banking terms.[57]

The second issue that is important to underline from Article V (2) (a) is that a state member in need commences any process that leads to the IMF financial assistance.

---

[55] SDR means Special Drawing Right, a reserve asset created by the IMF in 1979. 'A freely usable currency means a member's currency that the Fund determines (i) is, in fact, widely used to make payments for international transactions, and (ii) is widely traded in the principal exchange markets (Article XXX (f)).

[56] This is contrary to the case of most multilateral developing agencies such as the WB and the IADB that agree to provide loans to their state members to undertake particular projects.

[57] See for instance, IMF, *IMF Lending/A Factsheet* (2006) IMF <http://www.imf.org/external/np/exr/facts/howlend.htm> at 01 March 2007; IMF, 'Financing the Fund's Operations-Review of Issues' (IMF, 2001).

In other words, the decision of whether or not to seek help from the IMF must be made by the individual state member.[58] In this case, the government has to explain why it demands to enter into a transaction with the IMF. After that, the IMF shall review the member proposal and determine whether it is consistent with its Articles of Agreement (Article V (2) (c)). To ensure the correct allocation of resources:

> The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.[59]

Apart from the obligation to adopt policies for the use of its resources and the vague mention to stand-by and similar arrangements, the IMF Articles of Agreement do not clearly explain what legal form IMF financial assistance should take or what type of instrument should be signed between the IMF and its members to set the terms and conditions that govern a specific transaction. The lack of clarity of the IMF Agreement contrasts with the way other IFIs operate. For example, the WB constituting charter and its operational policies transparently state that the Bank provides loans or guarantees to its state members.[60] In order to disburse financial resources, the Bank executes legal loan contracts. The WB General Conditions for Loans indubitable assume that loan agreements are legal, valid and enforceable documents and any controversy derived from such documents shall be resolved by arbitration. [61]

The IMF Executive Board, instead of choosing a simple path to conduct Fund financial assistance, developed a complicated *modus operandi*. As a consequence of this method, the institution uses the term 'arrangement' to refer to the Fund's decision to provide financial assistance to a state member.[62]

---

58 However, we know that in practice, a country that is suffering from a financial crisis is unlikely to find other sources of financial aid before achieving an agreement with the Fund.

59 IMF Articles of the Agreement, Article V (3) (a).

60 See the International Bank for Reconstruction and Development Articles of Agreement, Article III and IV; International Bank for Reconstruction and Development Lending Operations: Choice of Borrower and Contractual Agreement (2004); and International Bank for Reconstruction and Development General Conditions for Loans (2006).

61 International Bank for Reconstruction and Development General Conditions for Loans (2006) Sections 8.01 and 8.04.

62 IMF, above n 57. See also the IMF Articles of Agreement, Article XXX (b) that defines stand-by facilities as an arrangement.

Decades ago, Joseph Gold, a former IMF general counsel, described these arrangements, particularly stand-by agreements (they were one of the first types of arrangements to be developed by the IMF), as 'a novel form of international understanding'.[63] By that time, Gold asserted that these arrangements could not be classified as a loan and claimed that they were closer to an exchange operation in which the organisation exchanges hard currencies for a less strong one. Furthermore, Gold considered that arrangements were not a legal agreement because, among other arguments, there was not an exchange of signatures between the IMF and the state member.[64] In addition, Gold claimed that it was not necessary to clarify the juridical character of a stand-by agreement because the Fund made efforts to deal successfully with practical problems derived from these documents, making it unnecessary to answer that question.

The first stand-by agreements were written in terms that resembled a formal contract.[65] In those documents, it was common to find words such as 'rights' and 'obligations', and in general they were written in the typical style of contracts. In the 1950s and 1960s, there was not any major problem that would cause a need to address the issue of the legal nature of IMF arrangements. However, in 1968, due to the UK stand-by arrangement affair that was previously discussed, a policy was issued recognising the principle informally sustained by IMF officials, according to which stand-by arrangements were not contracts. For the terms used in this policy, it is assumed that this provision was included to address the complaint of developing countries about the rigidity and complexity of performance clauses that at the time were included in those documents. But it did not answer the question about the juridical nature of the IMF arrangement. This solution was acceptable since by that time, and in spite of the criticism about the complexity of stand-by arrangements, they were still less complex than agreements nowadays and they practically excluded structural conditionality, making them more an emergency management tool.

Years later, in the previously mentioned 1979 Guidelines on Conditionality, the Executive Board referred to stand-by as arrangements that 'are not international

---

63 Gold, above n 16, 1.

64 Ibid 12. For a civil law country (e.g. Venezuela) the lack of exchange of signatures does not necessarily rule out the existence of a contract. Contracts can be consensual and legally binding when both parties give their consents that can be proved by different means other than a signed contract. The existence of a contract should not be confused with the most typical mechanism used to prove it: a signed document.

65 Gold's article included examples of typical provisions incorporated in stand-by arrangements in the early days.

agreements and therefore language having a contractual connotation will be avoided in stand-by arrangements and letter of intent'. With the 1979 Guidelines, the Executive Board changed the terms 'avoidance of any contractual flavour', included in the 1968 policy, to a more straightforward proposal that clearly states that arrangements were not contracts and, therefore, they should not be written using a contractual language. The change arrived at a time when structural conditionality played a more determinant role in IMF programs. The current Guidelines on Conditionality approved in 2002 still maintain that IMF arrangements are not international agreements or legal contracts (the policy now includes all arrangements and not only stand-by facilities).[66] Although conditionality became more intrusive, the IMF decided to declare its arrangements as non-legal instruments, putting these documents in a rare juridical category.

Assuming this non-contractual nature of arrangements, the Fund defines these instruments as:

> A decision by the IMF that gives a member the assurance that the institution stands ready to provide foreign exchange or SDRs in accordance with the terms of the decision during a specified period of time. An IMF arrangement—which is not a legal contract—is approved by the Executive Board in support of an economic program under which the member undertakes a set of policy actions to reduce economic imbalances and achieve sustainable growth. Resources used under an arrangement carry with them the obligation to repay the IMF in accordance with the applicable schedule, and to pay charges on outstanding *purchases* (drawings) and loans. [67]

The decision of the Executive Board to assure that a state member can make purchase of SDRs or usable currencies is linked to a compromise by the state to adopt a set of policies and conditions. A government includes these policies and conditions in a letter of intent, a memorandum of understanding and sometimes, a memorandum on economic and financial policies (thereafter the State Documents). The State Documents that are addressed to the IMF Executive Board underline the reforms that a country has agreed to implement.

---

66 IMF, above, n 53, [9]; IMF, *Financial Organization and Operations of the IMF* (6th ed, 2001) 182.

67 See IMF Glossary of Selected Financial Terms at http://www.imf.org/external/np/exr/glossary/showTerm.asp#14 at 23 February 2007. See also the IMF Articles of the Agreement, Article XXX (b).

Although the Fund recognises that the State Documents and the Executive Board decision are two sides of a same response against a crisis, the institution prefers to legally separate both components and categorically refuses the existence of a legal contract.

### 3.3.2. IMF Arrangements: Non-legal contracts?

Thus, the IMF provides its financial assistance using a figure named arrangements, which the institution claims are not legal agreements. However, the character of the matters governed by an IMF arrangement and the mechanisms used by the Fund to implement these instruments cause people to doubt about this statement. To resolve this apparent contradiction, it is essential to determine whether or not the IMF arrangements and the attached conditionality are adequate to address governance and rule of law issues. The importance of this issue is shown through two factors.

First, the nature of arrangements may affect the authorisation level required by a government to enter into an IMF facility. It would not be expected that a non-legal document follows a very complex approval process because it does not contain legal obligations that may affect a country. In contrast, a legal contract seems to be more formal and derives legal consequences for the parties, as it should involve a more complex approval procedure. In turn, the authorisation requirements may affect the suitability of the IMF arrangement as a crisis management tool.

Second, the matters that would be embodied in a non-legal agreement should be different from the subjects included in a legal one. If it is not, then to establish differences between these two figures would be irrelevant. At the same time, the depth of reforms should affect how extensive they are discussed among different national authorities and therefore, it can be expected that a legal contract would produce more discussions and involve the executive and the legislative branches. A non-legal document with no major obligations to reform may only produce negotiations limited to a few national governmental officials.

Hence, these two reasons force us to scrutinise the content of the IMF arrangement to determine if they are really non-legal documents. This thesis begins this process

by defining the term 'arrangement'. The *Macquarie Concise Dictionary* defines this word as 'the act of arranging; the state of being arranged; the manner in which things are arranged; a final settlement; adjustment by agreement; preparatory measure; previous plan, preparation'.[68] The commonly accepted definition of arrangement is sometimes associated with agreement, but this is not necessarily always the case.

If we search for a more technical definition for the term and consult legal dictionaries, we find that, for instance, the Black's Law Dictionary defines arrangement as 'A plan of a debtor for the settlement, satisfaction, or extension of the time payment of his debt'.[69] The legal term means an agreement between a debtor and a creditor containing contractual obligations between both parties in order to repay a pre-existing obligation. In day-to-day banking transactions, an arrangement of this type that governs rights and obligations of lenders and borrowers would definitely have a legal character and it would be legally binding.

While the common meaning of the term arrangement does not completely match the definition for legal contract, the technical/ legal definition of the term does. It could be argued that this legal definition is not completely applicable to IMF arrangements because the Fund's operations are not, strictly speaking, banking transactions. However, the IMF, as a financial institution, conducts its operations in the global financial arena where it is highly influenced by other financial players (e.g banks). This influence can be clearly noticed in the vocabulary used in its documents where IMF technical terms are often confused with the commercial banking language (for example, the Fund often claims that its lending arrangements are similar to a line of credit).[70]

The common and legal definitions quoted above, it could be claimed, were conceived for a domestic context, which is why it is necessary to study the concept of arrangement from a more international perspective, using the notion of international agreements that involves sovereign states. The Black's Law Dictionary provides an understanding of the concept of international agreements and defines them as 'treaties and other agreements of a contractual character between different

---

68 Macquarie Concise Dictionary.

69 Similar definitions were found in other legal dictionaries. See e.g., Oxford Dictionary of Law (6th ed, 2006), Obsborn's Concise Law Dictionary (10th ed, 2005) and Mozley & Whiteley's Law Dictionary (12th ed, 2001).

70 See e.g., IMF, *IMF Lending Arrangements* (2004) IMF <http://www.imf.org/external/np/tre/tad/extarr1.cfm> at 11 July 2004

countries or organisations of states (foreign) creating legal rights and obligations between the parties'.[71]

In similar terms, Christopher Joyner affirms that:

> International treaties and conventions are contract-like agreements between two or more states, usually negotiated for the purpose of creating, modifying, or extinguishing mutual rights and reciprocal obligations. An international agreement establishes a formal relationship between states or international organizations that is intended to be legally binding and governed by international legal rules.[72]

Although the existence of international agreements has been extensively recognised, there has been a discussion about the legal character of these types of contracts. Very often the debate has focused on trying to find in international agreements the same elements that would render legal a domestic contract. Following this approach, for instance, it has been argued that international agreements are not legal documents because they are not enforced by a central coercive authority. Other scholars have moved from this limited view of trying to assimilate international contracts to national legal systems. While they concur that not all international agreements are legal, they agree that international understandings could achieve a legal status if they meet certain criteria.[73]

In international circles, the execution of a legal contract means that failures to comply with its obligations may produce the legal responsibility of the non-compliance party and the other actor would be legitimised to invoke the remedies accepted by international law. On the contrary, a non-legal contract contains a moral commitment that would not have major consequences.[74] The problem is how to differentiate between these two types of international instruments and then how we could classify IMF arrangements. To undertake this task, this chapter will follow the frameworks developed by other authors.

---

71 Black's Law Dictionary. Sixth ed, 1990.

72 Christopher C. Joyner, *International Law in the 21st Century/Rules for Global Governance* (2005) 106.

73 See e.g., Kenneth W. Abbot, et al., 'The Concept of Legalization' (2000) 54 *International Organization* 401-419 (hereafter, I will refer to this article as written by Abbot but it was written by several authors).

74 Commentators use different terms to refer to these two types of international agreements. Some authors differentiate between non-legal agreements and treaties and others use pledges and contracts. See Jack L. Goldsmith and Eric A. Posner, *The Limits of International Law* (2005); Kal Raustiala, 'Form and Substance in International Agreements' (2005) 99 *American Journal of International Law* 581-614.

In the global arena ' "Legalization" refers to a particular set of characteristics that institutions may (or may not) possess. These characteristic are defined along three dimensions: obligations, precision, and delegation'.[75]

According to Abbot, **Obligations** are legal rules and commitments imposing a particular type of binding obligations on states and other subjects (such as international organizations).[76] These legal norms call into play rules, procedures and the tools of the international legal system.[77]

**Precision** means that a rule must clearly specify the type of action that is expected from a state. Precision is not present if the obligation is designed in general terms and makes it difficult for a country to establish the action that the other party expects. In addition, 'For a set of rules, precision implies not just that each rule in the set is unambiguous, but that the rules are related to one another in a non-contradictory way, creating a framework within which case-by-case interpretation can be coherently carried out'.[78]

Finally, under the Abbot model, **delegation** is understood as the acceptance of states and other international actors to transfer authority to third parties (for example, court, arbitrators and administrative instances) to implement and enforce agreements.[79] Under the delegated authority, third party entities can interpret norms and settle disputes. According to this design, a higher degree of legalisation exists if the interpretation and dispute resolution mechanisms are organised on the basis of clear and generally applicable rules, instead of procedures that involve political negotiations between the parties.[80]

Interestingly, applying this model, the authors studied the IMF Articles of the Agreement and concluded that the obligations contained in the treaty (for example, the obligation to make available foreign currency to pay imports and external debt) are not legally binding.[81] However, these authors did not apply the same analysis to the Fund's arrangements.

---

75 Abbot, above n 73, 401.
76 Ibid 408.
77 Ibid 409.
78 Ibid 413.
79 Ibid 415.
80 Ibid.
81 Ibid 407. Beth A. Simmons arrives at similar conclusions. Beth A. Simmons, 'The Legalization of International Monetary Affairs' (2000) 54 *International Organization* 573-602.

Raustiala also develops a conceptual framework to analyse the architecture of international agreements.[82] This commentator accepts that international agreements can be legal or non-legal (he uses the terms contracts and pledges). Raustiala constructs his model using three elements: legality, substance and structure. Although Raustiala designed his model to explain why a country selects a non-legal contract over a legal or vice versa, it can provide some insight in to the different components that are embodied in a legal international contract.

Raustiala begins by explaining that the selection between pledges and contracts is a choice between 'the use of law and the avoidance of law'.[83] For this author, contracts contain legally binding obligations for states, while pledges are limited to political or moral commitments. Raustiala argues that although it could be difficult to differentiate both categories, in practice, governments generally know very well the distinctions between them and they rarely confuse both figures.[84] Raustiala affirms that when a government wants to agree to a pledge without assuming a legal compromise, it would expressly speak out this feature.

Another characteristic of legal contracts, according to Raustiala, is that they often have implications for domestic law and, therefore, their ratification will require legislative approval.[85] A parliamentarian authorisation involves discussions and more time, which are reasons why a government could decide to issue a pledge if it wants to assume a commitment in a faster way. In addition, a pledge may not require disclosing information to the public. Ultimately, Raustiala affirms that to decide between a pledge and contract, a state must consider if it needs flexibility, speed and reservation, or rigidity and publicity.

The second element incorporated into Raustiala's framework is **substance,** which is defined in terms of 'the depth or shallowness of the commitments. Deep agreements require significant changes from the status quo; shallow agreements require little or no change'.[86] For this commentator, pledges generally contain shallow commitments that do not demand radical reforms. In contrast, legal contracts usually contain provisions involving profound changes in order to achieve the assumed obligations. A clear example mentioned by Raustiala is trade agreements

82 Raustiala, above n 74.
83 Ibid 586.
84 Ibid 587.
85 Ibid 589.
86 Ibid 601.

that are normally designed to be very deep and obligate countries to adequate their legal systems and procedures to international standards.

The third element in Raustiala model is **structure**, which refers 'to rules, procedures, and institutional bodies for the collective monitoring and enforcement of parties' performance'.[87] The author discriminates between strong and weak structures. The former are characterised by systems that are able to deliver decisions related to a state performance and may be associated with a sanction.[88] Meanwhile, a weak structure does not include a system of revision, or if it does, then the scheme is expressed in very general terms, without sanctions. Raustiala claims that pledges often lack a determined structure that includes clear reviews and sanctions.[89]

Thus, in order to consider an international agreement to be legal, it is important to look for certain characteristics. The debate about the legal character of international agreements renders ineffectual names given to them. As Joyner claims, 'an international document does not have to be called a treaty to be a binding agreement under international law … different names for international agreements are of little legal consequence'.[90] Hence, instead of determining if IMF arrangements are legal, international agreements rely only on their name and the IMF's declaration included in the Guidelines on Conditionality, a more reliable approach would be to examine their characteristics and review them against the reviewed models.

Through an examination of the above frameworks, it is clear that there are international agreements that can be regarded as legal contracts and not mere moral commitments. Legal international contracts are legally binding agreements that regulate rights and obligations among states or between states and international institutions. These documents are governed by international law and, therefore, they are enforceable through the application of a specific set of norms.[91]

---

87 Ibid 605.

88 Ibid.

89 However, there are few cases in which it is possible to find a pledge that contains a strong structure. Raustiala mentions the Recommendations on Money Laundering of the OECD's Financial Action Task Force (FATF) that includes a review system according to which a state legislation is evaluated by other members. Compliance with recommendations is enforced under the grounds of reputation concerns and the threat of expulsion. Raustiala, above n 74, 607.

90 Joyner, above n 72, 107.

91 Shirley Scott defines international law as 'a system of rules, principles, and concept that govern relations among states and, increasingly, international organizations, individuals, and other actor in world politics.' Shirley V Scott, *International Law in World Politics/ An Introduction* (2004) 1.

From the different ideas of international agreements discussed, it is possible to extract three elements of international legal contracts: (i) international parties (for example, states and international organisations); (ii) a legal component that refers to the regulation of rights and obligations of international actors; and (iii) an institutional enforcement system formed by international norms administered by designed bodies (for example, international courts, arbitrators or administrative entities).

From this three-component approach it is possible to scrutinise the IMF arrangements. It is necessary to note that the analysis of this thesis is focussed on the Fund's arrangements and excludes obligations directly derived from the Articles of the Agreement, which some commentators consider are enforced in a more flexible way. [92] Also this section is limited to a discussion of arrangements agreed under the IMF's general resources account, excluding other facilities such as the PRGF, which is regulated by a different set of norms because this program operates through a trust administered by the Fund.

***a) International Parties***

Initially, it can be seen that IMF arrangements involve two international actors: sovereign states and the IMF, an international financial institution.[93] Regarding to the states, there is no doubt that they can be the subject of rights and obligations in international relations. For instance, when a nation signs a treaty is assuming rights and obligations that are enforceable according to international law.[94]

Conversely, the IMF is an international organisation formed by several sovereign states and governed by the Articles of Agreement. Conforming to this treaty, the institution has a full juridical personality and, therefore, the capacity to contract and assume legal rights and obligations (Article IX).[95]

***b) Legality Component: Rights and obligations***

The second element that needs to be present in order to affirm that a legal agreement exists is a set of rights and obligations for the international parties involved. As Joyner affirms, international agreements create, modify or extinguish

---

92 See for instance, Raustiala, above n 74 and Abbot, above n 73.

93 For an account of the subjects of international Law see Colin Warbrick, 'States and Recognition in International Law' in Malcolm D. Evans (ed), *International Law* (2003) 205-267; Dapo Akande, 'International Organizations' in Malcolm D. Evans (ed), *International Law* (2003) 269-297.

94 Vienna Convention on the Law of Treaties.

95 For more details about the legal capacity of international organisations see Joyner, *above* n 72.

rights and obligations between the contractual parties. Rights and obligations of an international agreement are what Abbot refers to as obligations and precision, while Raustiala includes into his model legality and substance.

The IMF arrangement definition claims that such facilities are only an Executive Board resolution. However, this decision contains a positive declaration that gives a state member certainty and the right to request a specific amount of financial assistance if the state concerned complies with the terms set by the Board. Generally, IMF decisions on arrangements contain details about the amount made available to a state member, disbursement schedule and conditions attached to each allotment. Hence, if a country fulfils the requirements set in the State Documents, it has the right to receive the funds agreed by the Executive Board and the Fund has the obligation to disburse the negotiated amount.

From the state's perspective, there are also obligations. A country that has purchased SDRs or usable currencies through the implementation of an IMF arrangement must repurchase the amount disbursed by the Fund and pay other charges. The last part of the arrangement definition, quoted earlier, contains this obligation when it claims that resources used according to an arrangement 'carry with them the obligation to repay the IMF in accordance with the applicable schedule and to pay charges'. Although the IMF's definition does not state, in plain English, who is the obligated entity, it must be assumed that is the member state that receives the institution's financial aid. Legally speaking, it cannot be argued that a person is entitled to receive payments without considering that another person is obligated to pay. Additionally, the state must implement policies and conditions negotiated with the IMF. If it does not, the institution could suspend the implementation of the arrangement, including the postponement of additional disbursements.

In order to confirm the existence of a legal contract, it is essential to check for legally binding rights and obligations and not for mere political commitments. In the IMF arrangements, state member obligations are designed as real binding understandings. They are embodied in a way that cannot be confused with moral commitments. Besides the provision included into the Guidelines on Conditionality that declares non-legal contracts the IMF arrangements, there are no additional statements that confirm this character. Even the Articles of the Agreement, which is

the treaty approved for all the Fund's members and ratified by their legislative bodies, do not expressly exclude the legal nature of arrangements.[96]

This non-legal contract declaration is controversial if we consider the opinion of Raustiala that affirms that international actors know very well the limits between moral commitments and legal obligations. This is the reason why they tend to publicly ratify this character when they undertake a pledge.[97] However, reviewing different State Documents and IMF press releases, it is not possible to find additional declarations confirming the non-legal character of the arrangement.[98] In contrast, the institution uses terms such as 'credit' or 'agreement', words that tend to be associated with legal contracts. Further, they describe the agreed conditions upon which the Executive Board decision was based.[99]

If the State Documents and the IMF decision match financial assistance with conditions, terms and schedules, it is logical that the Fund does not ratify the non-legal nature of its facility because it would be equivalent to saying that the terms of the assistance are not really binding and therefore a country would be free to decide whether or not it is bound by such terms. However, this represents a contradiction between the formal declaration of the Guidelines, indicating that arrangements are not legal contracts and the real content that include specific obligations and clear instructions of how they must be carried out. As a consequence, the arrangement obligations cannot be considered good will commitments because they force governments to implement policies and take actions to fulfil IMF conditions. As Abbot would argue, the conditions are written in a precise form, specifying what they mean and when they must be achieved. Likewise, countries are obligated to pay administrative charges and other concepts that are all well specified.

On the other hand, IMF conditionality often implies profound changes in the economic realm. It is what Raustiala calls deep changes to the *status quo*. The magnitude of changes can be measured by the amount of laws that a country needs to enact according to an average IMF package. As the IMF sponsored reforms usually contain implications for legal systems in developing countries, it would be

---

96 See Article XXX (b).

97 Raustiala, above n 74, 587.

98 The IMF generally informs the reaching of an arrangement through a press release.

99 See, e.g., IMF, 'IMF Approves Stand-By Credit for Indonesia' (Press Release 97/50, IMF, 1997); IMF, 'IMF Approves Augmentation of Argentina's Stand-By Credit to US$14 Billion and Completes Second Review' (Press Release 01/3, IMF, 2001).

sound to choose a legal form and involve the legislative body in the negotiations of such agreements. Countries such as Costa Rica have assumed this approach and considered IMF arrangements as legal contracts that must be approved by the Congress.[100]

***c) Institutional Enforcement System***

The last component of a legal international contract is Raustiala's structure or Abbot's delegation upon which is based the enforceability of legal contracts. As mentioned earlier, the IMF facilities are governed by the Articles of Agreement, an international treaty that must be understood and executed in good faith.[101] According to the Fund's constituting charter, the Board of Governors and the Executive Board are the two bodies created to carry out the organisation's objectives through the interpretation, implementation and enforcement of the institution's norms. The Articles of Agreement provide for the mechanisms to enforce obligations assumed by the state members. In addition, the Executive Board has enacted a body of policies and regulations that develop further the principles contained in the treaty and the way in which arrangements must be enforced.

The IMF structure contains mechanisms to oversee compliance with the conditions assumed by state-members when they agree to implement a Fund sponsored program. Moreover, the Articles of the Agreements and the different policies put in place by the Executive Board include sanctions in cases of non-compliances with the obligations embodied in the Fund's arrangements. State members have accepted these enforcement norms when they ratified the Articles of Agreement and when they enter in an arrangement with the Fund. For these features, the IMF scheme constitutes a strong structure of enforcement.

The IMF regulations provide different tools to enforce arrangements. The primary safeguards are surveillance and conditionality because the Fund argues that such preventive measures are the first line of defence against overdue financial obligations.[102] However, there is a second line of defence to guarantee enforcement of the obligations contained in IMF arrangements and they are stronger than the preventive actions. These second defence measures are contained in the

---

100 Diana Moller, 'Intervention, Coercion, or Justifiable Need? A Legal Analysis of Structural Adjustment Lending in Costa Rica' (1995) 2 *Southwestern Journal of Law and Trade in the Americas* 483-544.

101 Vienna Convention on the Law of Treaties (1969), Articles 3, 5 and 26.

102 See IMF, 'Review of the Fund's Strategy on Overdue Financial Obligations' (IMF, 2001)

IMF Article of Agreement and the Executive Board Decision No. 12545-(01/84) on the Fund's Strategy's on Overdue Financial Obligations adopted on 22 August 2001 (hereafter referred to as the Strategy).

The Strategy establishes the different options and procedures in case of non-compliance with financial obligations. This Decision and the staff's report that served to support the Executive Board's resolution are particularly relevant to determine the real legal nature of arrangements. While the Guidelines on Conditionality expressly states that IMF arrangements are not legal contracts, the Strategy assumes a different approach and seems to convert a non-legal contract into a full legal international one, listing the 'Legal Sanctions or Remedies' that the Fund can invoke in cases of overdue financial obligations. Due to this apparent conversion produced by breaches of financial obligations, in the Strategy document the Fund expresses itself in terms of rights and obligations, remedies and sanctions, showing a more legal approach.

The Strategy begins by recognising the high financial borders imposed by overdue obligations on other IMF members, stating that, 'failure to meet scheduled obligations to the Fund is a serious breach of the principles that underpin the Fund'.[103] Then, the Strategy explains how the staff shall deal with overdue financial obligations. A leading principle stated in this document is that staff should be flexible and propose an agreement based on the payment capacity of the country concerned.[104] In cases in which a member fails to fulfil any financial obligations and a consensual solution is not possible, the Strategy includes the legal sanctions that the IMF could use against a country. The document basically repeats the remedies provided by the IMF Articles of Agreement.[105] These corrective actions are organised using 'an escalating timetable'. This means that remedies must be applied beginning with the one that is less severe and given a prudential time for voluntary payments.

The first measure that the Fund can invoke to enforce an obligation is to declare a member **ineligible** to use the Fund's General Resource Account (Article XXVI, Section 2 (a)). If the IMF imposes this remedy, a member cannot request to enter

[103] Ibid [23]. See also, IMF, 'Review of the Fund's Strategy on Overdue Financial Obligations' (IMF, 2005).
[104] IMF, above n 102, [30].
[105] All remedies included in the Fund's Strategy on Overdue Financial Obligations are covered by Article XXVI of the IMF Articles of Agreement and can be invoked not only for non-compliance with financial obligation but for failures to fulfil any obligations under the constituting charter.

into a new arrangement with the Fund. The second alternative in the case that a state persists in its breach of financial obligations after the declaration of ineligibility is to **suspend its voting rights** (Articles XXVI, Section 2 (b)). The application of this sanction requires the support of 70% of the total voting powers of the Fund. A third and most radical remedy is a **compulsory withdrawal** of a member state in cases of continuing failure to fulfil a member obligation (Article XXVI, Section 2 (c)). The initiation of a compulsory withdrawal procedure needs a decision of the Board of Governors carried by a majority of the Governors having 85% of the total voting powers.

If any dispute arises between the Fund and a member which has been withdrawn, the controversy shall be submitted to arbitration by a tribunal of three arbitrators, one appointed by the Fund, another by the withdrawn member, and an umpire elected by both parties or by the President of the International Court of Justice in the event of disagreement (Article XXIX (c)). Any other dispute associated with the interpretation of the IMF Articles of Agreement shall be decided by the Executive Board and its decision can be referred to the Board of Governors for a final decision (Article XXIX (a) and (b).

While the IMF has used declarations of ineligibility against countries with overdue financial obligations, suspensions of rights and compulsory withdrawal are rare. For example, during the 1990s the Fund refused to arrange new facilities for countries such as Peru, Sierra Leona, Zambia, Cambodia, Honduras, Panama and Vietnam due to failures to fulfil their financial obligations.[106] In order to repay the arrears, for example, the first three mentioned nations accepted the implementation of a solution called 'the right approach'. Under this scheme, countries agreed on a Rights Accumulation Program (RAP) that allowed them to implement an adjustment package to re-establish a good credit record and accumulate rights for future IMF disbursements through the achievement of different targets mutually accepted by the Fund and the country considered.[107]

In the event of members with long outstanding arrears obligations, instead of invoking the suspension of rights or compulsory withdrawal, the Fund has first followed a negotiating process. In some circumstance, discussions have finished

[106] Ibid [9].
[107] Ibid.

with an agreement acceptable to both parties (for example, Sudan and Liberia). Other non-performing countries have not been able to achieve satisfactory results. As a result, the IMF has implemented the suspension of votes and initiated compulsory withdrawal procedures.[108]

Despite the limited application of IMF sanctions, such remedies exist and make obligations derived from Fund arrangements enforceable. As Raustiala claims, the notion of structure must not be confused with the enforcement effectiveness of an international agreement:

> Structure, as I define it, should not be conflated with whether an agreement is effectively enforced, in the sense of deterring or punishing violations. These are outcomes. Structure refers only to the specific mechanisms or procedures for monitoring the parties' performance and meting out penalties.[109]

In addition to the described legal remedies against a non-compliance state, there are other consequences derived from the failure to fulfil financial obligations. In this regard, the Fund can include special charges and additional interest on overdue obligations to compensate for the lack of due payment.[110] Moreover, the Fund, in order to maintain the value of its currency holdings, may adjust the value of a member's currency and compel a state to pay back additional usable currencies or SDRs to cover any depreciation of value.[111]

Another IMF policy document that tackles possible default from an IMF member state is the Misreporting and Noncompliance Purchase in the General Resources Account Guidelines on Corrective Action, originally enacted in November 1984 and then amended by Decision No. 12249-(00/77) in July 2000. These Guidelines are applicable in cases where a state member has made a purchase of SDRs or usable currencies from the IMF General Resources Account that does not comply with the terms of an arrangement or regulations applicable to the purchase. In this case, the

---

[108] On September 2001 the Fund declared Zimbabwe ineligible to use the general resources account due to overdue financial obligations and lack of cooperation with the Fund. Later in June 2003, the Executive Board suspended the voting rights of Zimbabwe. Finally, because the country had not fulfilled its obligation, the Fund decided to initiate the compulsory withdrawal process in December 2003. However, Zimbabwe made a partial payment in February 2006 and the Executive Board decided to suspend the withdrawal process. See IMF, 'IMF Initiates Compulsory Withdrawal Procedures for Zimbabwe' (Press Release 03/210, IMF, 2003); IMF, 'Zimbabwe Pays its Overdue Financial Obligations to the IMF Under the General Resources Account' (Press Release 06/33, IMF, 2006).

[109] Raustiala, above n 74, 605.

[110] IMF, above n 102, 13.

[111] Ibid [21].

state completed a purchase of usable currency or SDRs from the Fund because it submitted information that later was proved to be incorrect (for example, the state does not complete Prior Actions required by the Fund). In this circumstance, it is expected that the state completes a repurchase of the outstanding amount within a period of 30 days (it is equivalent to a full mandatory prepayment under a commercial loan). The lack of mandatory repurchase may produce the invocation of Article V, Section 5 of the Articles of Agreement; that is, the declaration of ineligibility to use the Fund's general resources account.

Finally, the information about overdue financial obligations is made available to the public, a situation that could produce legal, financial and moral effects. It may have legal consequences because most bonds issued by sovereign states as well as loan agreements in which they are party as a borrower generally include a cross-default clause that consider an event of default the lack of payment to international financial institution. The breach of IMF arrangements brings financial consequences because other fund providers would refuse to facilitate fresh resources to a non-performing country, or if the country finds another source of financing it would be in more expensive terms through higher interest rates. Finally, a country's default will be informed to the public and the country would be exposed to the censure of the international community.

In summary, the existence of two international parties, legal obligations and an institutional enforcement system in the context of IMF arrangements, allow us to conclude that these instruments can be considered legal contracts. They are agreed between state members and the Fund, govern rights and obligations between them; and they are regulated and enforced by a clear set of international norms administered by the IMF's bodies. Obligations embodied in the State Documents and the IMF decisions are far from being a moral or political undertaking. Breaches of those obligations trigger specific legal sanctions, from the payment of overdue penalties to the compulsory withdrawal from the institution in the most serious infractions.

### 3.3.3 IMF Arrangements: Their suitability to strengthen governance and the rule of law

The determination of the legal nature of the IMF arrangements and the conditionality attached could be perceived as a simple matter of internal procedures of the IMF in its dealing with its members. Following this argument and that presented by Gold regarding the significant efforts made by the Fund to resolve any controversy that could jeopardy an arrangement, it could be concluded that it is useless to discuss this matter. Nonetheless, there are legal aspects associated with IMF agreements that cannot be unilaterally resolved by this institution because they refer to questions that need to be answered applying national law. As previously discussed, the legal nature of the Fund's arrangements affects the level of authorisation that a government needs in order to achieve an agreement with the IMF. It also determines the suitability of arrangements and its conditionality to manage a crisis.

It is difficult to assume that arrangements are not legal contracts as the IMF Guidelines on Conditionality claims. To maintain this position would mean that the institution is helping governments to escape from mechanisms of checks and balances imposed by national legislation because as non-legal documents, arrangements would not require major formalities before agreeing to any IMF package.[112] Thus it would appear to be easier for domestic authorities to use the Fund window as a rapid crisis management tool because the decision on whether or not to enter in an arrangement would solely depend on the executive branch criteria, disregarding of the depth of reforms, their legislative implications or the legal consequences for the whole country.

On the contrary, if arrangements are legal contracts as this chapter has concluded, their approval may involve various national authorities (for example, the executive and the legislative bodies) that could render IMF arrangements unsuitable for the management of crises because, for instance, a congressional consent could be more difficult to obtain than the simple signatures of a minister of finance or a central bank president.[113] Moreover, parliamentary processes could be longer and slower, making IMF arrangements and conditionality not suitable to manage a crisis. Several Latin American constitutions require that the legislative branch approves

[112] Edwards and Pahuja have briefly discussed this argument. See, Edward, above n 5; Sundhya Pahuja, 'Technologies of Empire: IMF Conditionality and the Reincription of the North/South Divide' (2000) 13 *Leiden Journal of International Law* 749-813.

[113] According to Article V (1) of the Fund Articles of Agreement, 'Each member shall deal with the Fund only through its Treasury, central bank, stabilization fund, or other similar agency'.

treaties or international agreements, especially those that involve financial undertakings.[114]

Arguing that arrangements are not legal contracts, the IMF Executive Board regulations pave the way for governments to escape from constitutional schemes of checks and balances, allowing the executive to deal with the IMF as an ordinary administrative matter. This solution could have worked during the 1950s and 1960s when stand-by arrangements were limited to comply with a few macroeconomic performance clauses, but not in the 1990s, when more and more structural conditions that require subjective judgments, legislative action and deep reforms were attached to IMF programs. Developing countries representatives, who requested changes during 1960s, never thought that their claims for more flexibility and less rigid clauses would facilitate the inclusion of more conditions by the Fund and the weakness of constitutional control in their countries.

The position of the IMF to consider arrangements and conditionality as non-legal instruments and the existence of conflicting constitutional provisions has created a legal grey zone in the implementation of its programs, a situation that does not agree with the clarity and certainty that demands rule of law principles. IMF's efforts to promote the rule of law should begin by clarifying the nature of its instruments and allowing governments to comply with their own national laws, instead of supporting solutions that produce uncertainty in developing countries.

### 3.4 Democracy, Conditionality and the Rule of Law

In addition to the controversial nature of arrangements, the IMF attached conditions may excess simple administrative issues and generally involve the negotiation of complex legal reforms that call for the enactment or amendment of legislation. A focus on the IMF efforts to strengthen the rule of law demonstrates that the institution usually concentrates its actions to improve financial legal frameworks, modernise financial regulators and liberalise the business environment throughout the enactment of laws that overhaul banking regulations, facilitate trade and promote foreign investment. In this context, during negotiations between the

[114] See Article 56 of the Peruvian Constitution; Section 75 of the Argentinean Constitution; Articles 49 and 52 of the Brazilian constitution; and article 150 and 154 of the Venezuelan Constitution. The Costa Rican constitution has also a similar provision. Interestingly, Costa Rica has assumed that IMF arrangements are international agreements that require congressional approval. See Moller, above n 100.

multilateral institution and governments, the IMF exercises its influence identifying which laws need to be passed or amended and those requirements are translated in terms of prior actions, performance criteria or structural benchmarks.

In a second stage, discussions of legislative actions is not restricted to a list of what laws are needed, but also include the negotiation of the particular content of those laws that are even pre-approved by the IMF.[115] For example, the Fund may require that central bank's independence be strengthened in a specific way or that labour legislation is eased, assuming particular measures in order to attract foreign investment. Hence, the IMF involvement is not limited to asking for the enactment of modification of laws by developing countries. Further, the institutions play a critical role in defining the terms of those changes. This fact can debilitate the autonomy of legislative bodies to discuss and approve new legislation and they can be obligated to pass acts previously negotiated between the executive branch and the IMF, limiting the legislative role to the ratification of legal instruments. Working in this way, conditionality produces a weakness of one of the formal attribute of the rule of law, namely separation of powers.

A similar situation occurs with participation in the designing of programs as well as the drafting, discussion and enactment of legislative changes associated with market reforms. In these circumstances, participation is limited to making the public aware of the already agreed programs discussed between the IMF and the government. National officials frequently avoid adopting changes suggested by other domestic parties, arguing that they would not be accepted by the IMF.[116] Ultimately, participation and the ownership of programs are limited to discussions between some governmental officials and the IMF bureaucrats, debilitating the democratic component of the rule of law.

Limitations on the democratic side could be acceptable if conditionality, as it was during the earlier years, was limited to target the immediate consequences of a financial meltdown. However, now the IMF's conditions also look for institutional improvements. Changes to the latter generally require broader consensus among the different domestic actors but if they are addressed from an IMF conditionality

---

[115] For Instance, in 1994, the Costa Rican Legislative Assembly rejected an IMF agreement on the grounds that the program required the passing of 17 new laws in a way acceptable to the Fund but it did not specify how the laws must have been drafted in order to be accepted by the IMF and other international financial institutions. See Moller, above n 100, 514.

[116] See e.g., El Universal, *La emergencia financiera y el FMI*, in *El Universal*. 1996: Caracas.

approach, they could escape from parliamentary scrutiny and open discussions with other interested parties.

Confining conditionality to deal exclusively with issues directly related to a financial crisis would lead to a more effective tool. In this event, the executive would be authorised to work with the IMF to address a limited number of financial problems. Indeed, a non-contractual instrument that does not have to comply with a complex authorisation process can function as an expeditious tool to manage a crisis. However, this has not been the case of IMF arrangements that, most of the time, go beyond the resolution of the issues associated with a crisis.

The Meltzer Report, a document prepared by a US Congress Commission, arrived at similar conclusions in 2000 and agreed that the IMF's conditionality imposed a great pressure on democracy. The Report affirms that the IMF undermines democratic processes not only in developing countries where it forces political instances to make decisions without adequate discussions, but even in the US where the executive has found 'legal' ways to bypass legislative debates about programs promoted by this institution.[117]

For the majority of the Meltzer Commission, a way to avoid this unfair result is to exclude the IMF from structural reforms and limit its role to the management of crises and lender of last resort.[118] Although this report has been criticised, it is clear that the IMF needs to reduce its influence and limit its conditions to those directly associated with the management of a crisis. This solution can reduce the risks on democracy created by IMF conditionality.

Compliance with a vast set of structural conditions imposed by the IMF is not the only challenge faced by a government when they are negotiating an economic reform. In dealing with requirements that go beyond issues related to a crisis, a government can face not an accommodating parliament that it is willing to approve a pre-discussed legal reform but a very confronting body that would debate each proposed measure. In this circumstance, the undemocratic character of IMF

[117] For instance during the Mexican crisis in the 1990s, the Clinton's administration, exercising exceptional powers, approved a US$20 billion package to aid Mexico through the Exchange Stabilization Fund (a special facility managed by the US Treasury) instead of increasing the American quota in the IMF that required a congressional approval.

[118] International Financial Institution Advisory Commission US Congress, 'Report of the International Financial Institution Advisory Commission' (US Congress, 2000).

arrangements may lead to worse results if governments opt for the invocation of states of emergency and dictated decrees with force of law to go ahead with the changes required by the Fund.

The invocation of exceptional powers may have a constitutional and legal basis, but on other occasions they can be absent and be invoked on the grounds of *ad hoc* extra-juridical arrangements.[119] After all, the IMF would not study whether a government complies with its conditions through constitutional or legal means, rather the institution will determine whether or not the government achieves the conditions incorporated in its programs. Using previous experiences as a reference, the most that could be expected from the IMF is a suspension of a program when a government infringes so clearly constitutional provisions that a reasonable justification is not possible. In this contingency, the reassumption of financial aid seems to depend more on the willingness of the government to follow the IMF's recipe than on its enthusiasm to re-establish the rule of law. The case of Peru when Alberto Fujimori suspended the constitution and dissolved the Congress and the Supreme Court in April 1992, offers a telling illustration of the prevalence of the economic interests over juridical reasons.[120]

Fujimori argued that that such an exceptional measure was necessary to implement an institutional reform and achieve an authentic democracy as well as to promote development and a market economy within a legal and stable framework.[121] Soon the IMF suspended its program with Peru. The government responded with an announcement of the Economy Minister, Carlos Boloña, who reaffirmed the compromise of Peru of continuing to apply 'the International Monetary Fund-approved recipe, with priority given to reducing inflation, stabilizing prices, and cutting public expenditure'.[122] In practice, the closing of the Congress and the Supreme Court allowed the administration to redesign the tax system, increase

---

119 This was the case in Peru and Argentina where presidents imposed exceptional measures to comply with IMF conditions using a mix of constitutional measures and other non-juridical tools. See Delia Ferreira Rubio and Matteo Goretti, 'When the President Governs Alone: The Decretazo in Argentina, 1989-1993' in John Carey John and Matthew Soberg Shugart (eds), *Executive Decree Authority* (1998) 33-61; Gregory Schmidt, 'Presidential Usurpation or Congressional Preference?' in John Carey and Matthew Soberg Shugart (eds), *Executive Decree Authority* (1998) 104-139. Gabriel Garcia, 'El Fondo Monetario Internacional y la Promoción del Estado de Derecho en los Noventa: Condicionalidad y Estados de Excepción en Suramérica' (2007) 1 *Oñati Journal of Emegent Socio-legal Studies* 20-36.

120 Law Decree on the Guidelines for the Government of Emergency and National Reconstruction (Decreto-Ley No. 25.418, denominado Ley de Bases del Gobierno de Emergencia y Reconstrucción Nacional). A Spanish version is available at: http://www.cajpe.org.pe/rij/bases/legisla/peru/rejupe27.htm

121 Law Decree on the Guidelines for the Government of Emergency and National Reconstruction.

122 Christian Science Monitor, 'International Reprisals after Coup Strain Peru's Economic Reforms', Christian Science Monitor (Boston), 14 May 1992.

public expenditures cuts, revamp privatisation plans and assume other actions demanded by the IMF without the political opposition that had blocked their adoption before the coup.[123]

Although Fujimori had used doubtful legal tools in order to carry out his reforms before April 1992, it was the *coup*, a clear extra-constitutional method, which made the IMF openly react against the Peruvian President. However, by the end of 1992, the international press expressed that Peru had achieved most of the macroeconomic targets that have been imposed by the IMF.[124] After an election of a constituent congress that was won by Fujimori's party, the Peruvian President regained international confidence and the IMF approved a $1.4 billion facility in March 1993, even before the approval of a new Constitution in October of that year that was in full force in December. According to financial news, the IMF approved the package 'because of various efforts by the Peruvian government to remedy its economy and clear debts owed to the IMF and other foreign creditors'.[125] That institution omitted that Peru had achieved those results in a short period thanks to the excessive powers concentrated by Fujimori through mechanisms not clearly democratic or legal and contrary to the principles of the rule of law.

Although one of the goals that conditionality addresses is the promotion of governance and the rule of law, the IMF has limited its efforts to measures that have been adequate in other developed nations (for example, pre-package laws). Hence, the Fund assumes that the adoption of those actions would automatically improve the legal system, but it does not consider the consequences of the methods used to implement such measures. A state of exception could be the perfect legal match of conditionality as a path to deal with a crisis and as a mechanism to legitimise sudden institutional changes required by the Fund. But in order to agree with this solution, it would be necessary to analyse the exceptional power tool and see how it works and whether it is a limitless notion. This will be discussed in more detail in the following chapter.

---

123 Ibid. See also Bruce Kay, '"Fujipopulism" and the Liberal State in Peru, 1990-1995' (1996) 38 *Journal of Interamerican Studies and World Affairs* 55-98, 63.

124 Christian Science Monitor, 'Economy Looks Brighter After Peruvian Election', Christian Science Monitor (Boston), 3 December 1992.

125 The Wall Street Journal, 'IMF restores Peru to list of approved borrowers', The Wall Street Journal (New York), 19 March 1993.

It may be understandable that the IMF does not review the legal way in which a country meets its conditions because it may involve a political judgement over the actions of a sovereign state. Nonetheless, if the IMF argues that a country has institutional weaknesses that need to be addressed when entering in an arrangement and includes them as conditions for financial help, the organisation, by its own will, has opened the door to be involved in domestic political issues. The strengthening of the rule of law must be achieved not only considering the transfer of pre-designed models constructed for foreign realities, but also guaranteeing that other principles of the rule of law are not violated during the implementation process.

If conditionality is not modified to discriminate between legal or illegal means and, by contrast, the notion pushes government to act even outside the law to obtain the IMF's financial resources, it is clear that conditionality may become an incentive for governments to use anti-juridical means in order to comply with IMF conditions in the fastest possible way. Eventually, if governments use unclear legal methods but they comply with IMF conditions, it is less probable that the international institution will oppose those means. Acting in this way, conditionality becomes an obstacle that works against structural reforms like governance and the rule of law, because it creates a forced and illegitimate legal system that can be challenged later, bringing more uncertainty to developing countries.

# CHAPTER 4

# EXCEPTIONAL POWERS AND THE RULE OF LAW CHALLENGE

## 4.1 Introduction

A study of the impact of IMF's conditionality on developing countries' legal systems would not be complete if it was limited to an examination of the rule of law and did not extend to an analysis of the notion of exceptional powers that often coincides with IMF's assistance in the resolution of financial crises that affect developing countries.

Different authors recognise that under certain circumstances, authorities may use extraordinary measures, and even actions that are not included in any constitutional or legal body, to address events that threaten a country and cannot be resolved by resorting to the ordinary legal framework. Although such exceptional avenues can endanger the rule of law, it has been recognised as a valid option and furnished in constitutions and legal statutes around the world.

Exceptional events were originally associated with war or internal turmoil. Most recently, extraordinary powers have been extended to economic affairs. Besides resorting to exceptional powers to resolve economic crises, developing countries also seek for the IMF's financial assistance. Thus, if economic collapses are currently considered extraordinary events that justify the invocation of emergency powers, it is not rare that the IMF and states of exception coincide in the same scenario.

However, a problem arises when both tools of economic crisis management, namely the Fund's assistance, and exceptional powers, are directly connected and a government employs a state of emergency to comply faster with conditions imposed by the Fund and, therefore, to gain faster access to economic aid. In this scenario, questions emerge about the possibility to build a notion of the rule of law through the use of exceptional powers. To put it differently, when a country invokes a state of emergency to face a crisis, to discuss a reform program and implement IMF's conditions, including those associated with good governance, can this approach

contribute to building a strong legal system oriented by the principles of the rule of law? Perhaps such an alternative may not be feasible because the rule of law cannot be constructed under a state of exception and such an approach is necessarily condemned to fail. This section will explore this question and examine whether or not it is possible to harmonise the rule of law, exceptional powers and the IMF's conditionality.

## 4.2 Exceptional Powers: A definition

Carl Schmitt, one the most controversial authors to have written about the exception, affirmed that it was not possible to build a definition of this term precisely because it went against its unforeseeable nature.[1] However, an effort must be made in order to approach this matter.

Distinct terms have been suggested to refer to the power exercised by governments to deal with a critical situation using faculties that go beyond their normal capacities: *État de siège*, martial law, state of exception, exceptional powers, state of emergency, regime of exception, emergency powers and dictatorship, to mention just a few.[2] Each of these terms has its own particularities depending on the specific national legislation and history but the common element is the exercise of special powers by the executive to resolve unforeseen problems.

As a first approximation, this chapter uses exceptional powers to refer to the temporary enhancement of governmental authority to address extraordinary circumstances that cannot be dealt with through the implementation of the ordinary mechanisms of government. The juridical system is the source of this reinforcement of powers given to a legally constituted government. Consequently, as will be explained later, this study views exceptional powers as a mechanism that lies within the boundaries of the juridical sphere.

---

1 Carl Schmitt, Political Theology: Four Chapters on the Concept of Sovereignty (1985).

2 In this chapter, I often use 'dictatorship' to refer to a person who exercises constitutional extraordinary powers. This notion is similar to the one used by Roman republicans and Clinton L. Rossiter in his well known work *Constitutional Dictatorship/Crisis Government in the Modern Democracies* (1948). Currently the term 'dictatorship' has a more negative connotation and makes reference to 'someone exercising absolute power, especially one who assumes absolute control in a government without hereditary right or the free consent of the people (Macquarie Concise Dictionary, 3rd Ed.).

Under this initial definition, authority to invoke extraordinary powers can be found on constitutional or legal provisions. In the first scenario, the executive directly exercises extraordinary powers to face emergencies based on a pre-existing constitutional norm. In the latter case, a government invokes exceptional powers based on a previously passed statute or a specific delegating law enacted by the legislative body to face a particular situation. In all these circumstances, the executive acts with extraordinary powers to regulate matters that would be otherwise ruled by the parliamentarian entity.

Exceptional actions adopted by *de facto* governments (for example, authorities that assume power after a *coup d'état*) are beyond the scope of this study. This type of government usually appeals to extra-juridical justifications in order to subvert the existent legal order. This thesis focuses on democratically elected governments that are theoretically bound by valid legal systems and, therefore, formally committed to defend the rule of law.

It must be noted that this chapter is mostly concentrated efforts to understand exceptional powers in the economic sphere, and especially to explore how this tool interacts with the implementation of IMF's programs.

## 4.3 Exceptional Powers in the Economic Domain

Originally, exceptional powers were born indissolubly attached to wars and domestic armed conflicts. In a second stage, extraordinary measures were adopted to face not only violent situations but also to manage economic issues derived from wars or domestic unrests. Later, they were extended to resolve crises exclusively produced by economic events.[3]

When authors such as Machiavelli, Harrington, Locke or Rousseau suggested the implementation of exceptional measures that could transgress the principles of the rule of law, they were thinking about national tumults or foreign invasions as the perfect occasions that could legitimise the implementation of exceptional actions,

[3] See William Scheuerman, 'The Economic State of Emergency' (2000) 21 *Cardozo Law Review* 1869-1894; Rossiter, above n 2.

but they were most likely not considering the extension of the use of emergency measures to other circumstances beyond this type of events.

Under this original idea, France initially designed their emergency scheme, known as state of siege. This figure allowed the concentration of powers in the hands of a general in cases of surrounded fortresses.[4] Later, this tool became more political and transcended the walls of a military fortress. Then, the state of siege transferred exceptional powers to the hands of authorities in order to face wars or domestic disturbances, providing the government faculties similar to those granted to a general in the previous model. This evolution was legally supported by a law enacted in 1791 that authorised the transfer of powers from civil officials to military commanders in cases of foreign attacks.[5] In 1849 and 1878, two laws were issued regulating a more political and less military state of siege. According to the law of 1878, when the state of siege was declared, civil authorities transferred to the military the responsibility to maintain order. Nonetheless, military authorities did not have capacities to assume measures that affected economic areas (for example, modification of taxes or approvals of public loans).[6]

Throughout World War I (WWI), France used the state of siege as the main mechanism to maintain public order and face foreign menaces. At the same time, French authorities employed other emergency tools to manage economic issues caused by the Great War, but the French Parliament rejected any intent to give absolute law making powers to the Cabinet. On the contrary, the Parliament managed the crisis through the enactments of several enabling laws that delegated specific and limited faculties to the Cabinet.[7]

In the inter-war period, the French government relied on enabling legislation to resolve specific economic problems, but it was always under close parliamentarian scrutiny. Prime Minister Poincaré requested an ample delegation of legislative powers to resolve a franc crisis in 1924. Although he proposed a time limit of six months to exercise those special powers, the Parliament rejected his plan, as they

4 Rossiter, above n 2, 80.
5 Ibid.
6 Ibid 86.
7 For example, Rossiter mentions that the Parliament authorised the Cabinet to suspend the effects of civil and commercial obligations in 1914. Rossiter, above n 2, 111.

considered it was not sound to grant such extraordinary capacity to the executive. This led to the end of Poincaré's government.[8]

It was only in 1926 when Poincaré, serving another period as Prime Minister, obtained a broad delegation of powers to implement an extensive economic reform.[9] After that, France witnessed the enactment of various enabling laws by the Parliament that granted the Cabinet broad powers to legislate in economic matters before, during and after World War II (WWII).

The British followed a similar path. The country began to implement exceptional powers in order to cope exclusively with violent events. An early example was the Riot Act 1714, which was passed to suppress disturbances.[10] The English martial law was similar to the French state of siege and was oriented to cope with armed conflicts. Between the end of the nineteenth century and the beginning of the twentieth century, the English Parliament began to issue different statutes that granted special powers to the Cabinet to deal not only with violent situations but also with economic problems (for example, the Bank Holidays Act 1871 and the Mines Regulation Act 1908).[11] During the two World Wars, the British government undertook conflict efforts assuming exceptional powers. In both cases, the Parliament enacted special statutes that authorised the Cabinet to exercise legislative faculties in economic areas.[12]

Germany also followed the path of exceptional powers to resolve economic crises, but in a way that was different from France and the UK. The Weimar Constitution had a specific provision, article 48, which empowered the President to call the army and suspend civil rights in cases in which public safety was threatened or disturbed. Early in the 1920s, article 48 was invoked to suppress local unrest.[13] In this case, the German government made use of article 48 according to its primary task, that is, management of violent situations.

---

8 See Stephen Schuker, *The End of French Predominance in Europe/The Financial Crisis of 1924 and the Adoption of the Dawes Plan* (1976).
9 Rossiter, above n 2, 121.
10 Ibid 137.
11 Ibid.
12 Ibid 151-205.
13 Ibid 38.

Beginning in 1922, various German governments took advantage of the vague wording of article 48 and extended its initial limits to cover economic difficulties.[14] For example, President Friedrich Ebert and the Chancellor Joseph Wirth considered that economic problems threatened public safety and order, as understood by article 48, and therefore, they enacted decrees with force of law that were seen as necessary measures.[15] Thus, the government resorting to an extensive interpretation of article 48 assumed that exceptional powers could be invoked to resolve economic crises. This interpretation facilitated the expeditious management of economic affairs through executive decrees without rest on parliamentarian decisions. Using article 48 between the 1920s and the 1930s to call for exceptional powers, the German Cabinet also relied on enabling laws in which the Reichstag delegated specific powers to the executive to regulate economic matters.[16]

In the US, the Constitution does not have an article similar to Germany's article 48.[17] Nonetheless, this limitation did not stop Presidents from appealing to emergency powers based on congressional delegations or executive interpretations.[18] George Washington, the first American President, exercised exceptional powers granted by the Congress to suppress a rebellion led by a group of citizens opposed to a tax on whisky.[19] Abraham Lincoln followed a more radical course of action at the beginning of the American Civil War when he ordered a series of extraordinary measures, including the expansion of the army without congressional approval, to fight against the secessionist states. Later, in the twentieth century, Woodrow Wilson exercised exceptional powers delegated by the Congress to manage economic problems derived from the US participation in WWI.[20]

It was President Franklin D. Roosevelt who initiated an era of full use of exceptional powers as a main key to deal with an exclusive economic crisis. Facing a high rate of unemployment, the failure of banks, the crash of the stock market, the bankruptcy

---

14 Ibid.
15 Ibid 41.
16 Ibid 44.
17 The only expressly stated emergency measure included in the American Constitution is the possibility to suspend the Writ of Habeas Corpus in case of rebellion or invasion (Section 9).
18 See Special Committee on the Termination of the National Emergency United States Senate, 'Report of the Special Committee on the Termination of the National Emergency' (93-549, United States Senate, 1973); See also Harold Relyea, *National Emergency Powers* (2001) US Department of State <http://fpc.state.gov/documents/organization/6216.pdf#search='emergency%20powers%20statutes%20senate%20report%2093549'> at 23 August 2006; Harold Bruff, 'Judicial Review and the Presidents Statutory Powers' (1982) 68 *Virginia Law Review* 1-61.
19 Relyea, above n 18, 5.
20 Special Committee on the Termination of the National Emergency United States Senate, above 18, 3.

of many businesses and, in general, an extremely difficult economic situation in 1933, Roosevelt declared 'a national emergency' and took measures based on state of war legislation (the Trading with the Enemy Act).[21] Eventually, the Congress ratified most of the actions assumed by Roosevelt and enacted several statutes proposed by the executive, but initially he acted on the grounds of his executive powers.[22]

All of the examples mentioned demonstrate that since the beginning of the twentieth century, industrialised nations have been using exceptional powers to deal with economic issues. Constitutional provisions, legislative delegations and even executive actions have been used by governments to implement states of emergency for the management of economic crises. This trend has been maintained and after the end of WWII, governments of developed countries have continued to rely on economic emergencies to deal with financial distress. For example, the British government relied on emergency powers to fight a wave of industrial strikes and avoid the negative social and economic consequences of those actions in the 1970s.[23]

In 1972, the British government exercised the exceptional powers established in the Industrial Relations Act to face a strike of rail workers and called for a cooling-off period, forcing people to return to work. Due to the failure to compel workers to reassume their activities, the government, exercising another special power granted by the Industrial Relation Act, asked for a referendum in which the workers approved the continuance of industrial actions.[24]

A similar situation occurred with the Emergency Act 1920 and the Emergency Act 1964, which authorised the British government to assume emergency powers in cases of events that interfered with the supply and distribution of food, water, fuel or energy or interfered with the means of locomotion. Recently, the British Parliament passed the Civil Contingencies Act 2004. According to this Act, the government could exercise exceptional powers, providing that an emergency exists. The Act

---

21 Proclamation No. 2039 Declaring Bank Holiday. 6 March 1933. See also Rossiter, above n 2, 257.

22 See for example the Emergency Banking Relief Act 1933. Some of the legal instruments and agencies created during the 1930s marked American life and today some of them remain (e.g. the Banking Act of 1933 that created the Federal Deposit Insurance Corporation (FDIC) and the Securities Act 1933 that conceived the powerful Securities and Exchange Commission (SEC)).

23 According to Andre Gunder Frank, the number of day lost annually in strikes in Britain increased from 2 million in the mid- 1950s to 24 million in 1974. See Andre Gunder Frank, *Crisis: in the World Economy* (1980) 114.

24 See F.T. Blackaby, et al., *British Economic Policy 1960-1974* (1978) 586.

includes in the definition of emergency 'an event or situation which threatens serious damage to human welfare in a place in the United Kingdom.'[25] The same statute defines events that a threat to human welfare is anything that may cause loss of human life, homelessness, damage to property or the disruption of a supply of money, food, water, energy or fuel.[26]

If a situation that can be considered an emergency occurs, the government, exercising exceptional powers, can make emergency regulations to prevent, control or mitigate any aspect or effect derived from the emergency. Section 22 (2) (h) of the Civil Contingencies Act provides that extraordinary powers include the faculty to issue regulations to protect or restoring property, the supply of money and the activities of banks or other financial institutions. Since its enactment, the Civil Contingencies Act has not been tested in the economic realm, but the possibility is open that the government may exercise emergency powers that would address financial issues.

During the second half of the twentieth century, the tendency to rely on exceptional powers to resolve economic issues was also present in the US. In 1970, the American Congress passed the Economic Stabilization Act, delegating Nixon vast powers to freeze prices and salaries.[27] In 1971, Nixon suspended the convertibility of the dollar into gold, the primary principle upon which the international monetary system was based.[28]

After the end of the administration of Nixon, inflationary problems continued to affect the US. As a consequence, Jimmy Carter was forced to issue an Executive Order asking for the incorporation of a clause in government contracts in which contractors guaranteed compliance with the prices and wage standards set by the Council on Wage and Price Stability.[29]

---

25 The Civil Contingencies Act 2004, Section 19 (1) (a).

26 The Civil Contingencies Act 2004, Section 19 (2).

27 Using this special legislation, Nixon froze prices, rents, wages and salaries. Executive Order 11,615, 15 August 1971.

28 See Richard Nixon, *Address to the Nation Outlining a New Economy Policy: "The Challenge of Peace"* (1971) The American Presidency Project <http://www.presidency.ucsb.edu/ws/index.php?pid=3115> at 2007. See also Kenneth Dam, 'From the Gold Clause to the Gold Commission: A Half Century of American Monetary Law' (1983) 50 *University of Chicago Law Review* 504-532.

29 See Executive Order 12092 on Federal Anti-Inflationary Procurement Practices, 1 November 1978. See also Peter Quint, 'The Separation of Powers under Carter' (1984) 62 *Texas Law Review* 785-891.

In January 1995, another case of the invocation of special powers to resolve an economic situation occurred when President Bill Clinton, exercising powers granted by the Gold Reserve Act, authorised the US Department of the Treasury to use the Exchange Stabilization Fund to extend a US$20 billion facility to Mexico in order to face a financial crisis.[30] One of the reasons used to justify this action was the potential negative effects of the Mexican crisis on the US labour market.[31]

Thus, exceptional measures became a useful tool to concentrate powers in the executive's hands to resolve economic crises in the developed world. Those nations frequently resort to extraordinary measures on the ground of statutes or enabling laws issued by legislative bodies that, to some degree, legitimise the use of emergency schemes.

Most developing countries also learned of the 'benefits' of states of exception after they gained independence. In the case of Latin America, newly formed states inherited the authoritarian Spanish style of government. Kings ruled autocratically and the vast territories of America were considered their personal property. Between 1493 and 1523, Spanish America was ruthlessly administrated under this premise by Juan Rodrigo de Fonseca, Bishop of Burgos.[32] In a second phase, Spain started to adjust some of its own institutions to the needs of life in the American colonies and created bodies such as the Council of Indies (1524), viceroys, *audiencias* and other minor official offices like captains-general and *alcaldes mayores*.[33] Spanish-American viceroys, as well as other lower ranked Spanish officials, had vast powers to govern their domains, including people and properties. Viceroys, for instance, could use any mean to control people who challenged the authority.[34]

When Latin American territories achieved their independence from Spain, most constitutions kept a key role for the executive branch and Spaniard officials were substituted by strong presidents. In the case of exceptional powers, Latin American

---

30 US Department of the Treasury, *Exchange Stabilization Fund* (2007) US Department of the Treasury <http://www.treas.gov/offices/international-affairs/esf/index.html> at 20 April 1997.

31 Clinton argued that the crisis threatened 700,000 jobs that depended on exports to Mexico. See William Clinton, *The President's News Conference with President Zedillo* (1995) The American Presidency Project <http://www.presidency.ucsb.edu/ws/index.php?pid=50633> at 20 April 2007.

32 J.H Elliott, *Empires of the Atlantic World/Britain and Spain in America 1492-1830* (2006) 122. For a complete account of the history of the Spanish colonisation of America see John Edwin Fagg, *Latin America/ A General History* (Third Ed., 1977).

33 Fagg, above n 32.

34 Recopilación Leyes de Indias, Libro Tercero, Titulo Cuarto.

independence heroes used the Spanish Constitution of Bayonne as a model.[35] Article 38 of this instrument established that in cases of army uprising the king could request from the Senate the suspension of the imperium of the constitution.[36] Comparable provisions were transplanted in Latin American constitutional charters.

Similar to the industrialised world, Latin American countries initially considered the use of exceptional powers to face foreign or domestic army threat. Emergency schemes were frequently implemented to face domestic unrests and helped governments to suppress political dissidents.[37] Following this path, since the enactment of its first constitution in 1811, almost all Venezuelan constitutions have included a provision for the invocation of exceptional measures in cases of war or domestic unrest.

In a second stage, governments in the region timidly extended special powers to the management of economic problems produced by violent events. It was the case of the 1830, 1858, 1874, 1901 and 1909 Venezuelan constitutions that allowed the government to take financial actions in cases of foreign invasion or domestic army unrests (for example, negotiations of special loans or call for extraordinary contributions).

In a third phase, Latin American governments were more willing to invoke exceptional powers based exclusively on economic grounds.[38] Since then, exceptional powers have been increasingly adopted to manage economic situations in countries such as Argentina, Brazil, Peru, Nicaragua, Costa Rica and Venezuela, which have made use of exceptional measures to confront financial difficulties.[39]

Different from industrialised countries, developing nations have preferred to incorporate into their constitutions provisions that grant the government with the power of invoking exceptional powers for economic reasons (for example,

---

35 Brian Loveman, *The Constitution of Tyranny. Regimes of Exception in Spanish America* (1993) 38. The Constitution of Bayonne was drafted by Napoleon in 1808 but it was never implemented in Spain.

36 '*En caso de sublemación a mano armada, o de inquietudes que amenacen la seguridad de Estado, el Senado, a propuesta del Rey, podrá suspender el imperio de la Constitución por tiempo y en lugares limitados*. Corte de Constitucionalidad de la Republica de Guatemala, La Constitución de Bayona: www.cc.gob.gt at 01 September 2006.

37 See Loveman, above n 35.

38 Since its initial inclusion in 1945, all successive Venezuelan Constitutions have had a provision that allows the government to dictate extraordinary measures to protect the economic and financial life of the Nation.

39 In chapter 7, I will explain in further details the role played by exceptional powers in the Venezuelan economy.

Venezuela, article 337; Peru, article 118; Colombia, article 215, Thailand, article 184; and Malaysia, article 150).

### 4.3.2 Exceptional Powers in the Economic Realm: Are they justified?

The invocation of exceptional powers to tackle economic problems could pose some questions about the validity of this formula. To justify this mechanism in the economic realm, some authors have suggested the likening of extraordinary economic events to wars or domestic unrests.[40] This was literally the reasoning followed by Roosevelt. He claimed that 'I shall ask the Congress for the one remaining instrument to meet the crisis broad executive power to wage a war against the emergency, as great as the power that would be given me if were in fact invaded by a foreign foe'.[41] Roosevelt later proclaimed a bank holiday based on the Trading with the Enemy Act. It was the adaptation of a war legal framework to an economic crisis scenario.

The likening of economic crises to war situations is not only based on rhetoric. As a military conflict may threaten life, infrastructure and private property, deteriorating economic circumstances are seen as a potential trigger of social and political instability that could lead to the remotion of governments and the failure of states. Considering these potential effects, it is argued that an economic crisis could not be efficiently tackled if the state does not have the possibility to use special tools that give authorities flexibility to manage the situation.

The argument about the risks that economic crises imposed on political systems proved to be real during the first half of the twentieth century when industrial actions seriously threatened the stability of the British government, which resorted to emergency powers to control these conflicts. Scheuerman affirms that the first economic emergencies were implemented to address these industrial strikes that not only caused disruption in the distribution of essential goods and the provision of important services but also threatened domestic peace and the political system.[42] Similarly, countries such as Indonesia, Thailand, Argentina, Peru and Venezuela in the 1990s witnessed how financial breakdowns could trigger political instability.

---

40 See for example Rossiter, above n 2; Loveman, above 35.
41 Special Committee on the Termination of the National Emergency United States Senate, above n 18, 4.
42 Scheuerman, above n 3; Loveman, above n 35, 24.

In addition to the assimilation of economic events to a war scenario, Scheuerman has cited another reason to explain why exceptional powers have become so popular to manage financial affairs. He argues that this trend is due to a compression of time and space that causes a preference for the application of economic emergency measures over the normal and very often slow legislative processes.[43] This abbreviation of time and space, Scheuerman argues, is produced by modern telecommunication systems and speedy methods of travel that facilitate business and human interactions. At the same time, in a market economy, transactions became more complex and technical, making the legislative work more difficult.[44] Due to the high speed of the economy, legislators prefer to empower the executive branch with increasing open-end delegations of emergency powers to regulate such businesses.[45]

Economic states of emergency have also been accepted by international law into which the meaning of emergency has been incorporated in broad terms. The texts of international treaties opt to incorporate ambiguous and open-ended terms of exceptional powers that admit their application in the economic realm. Consider the case of International Covenant on Civil and Political Rights, which states:

> In time of public emergency which threatens the life of the Nation and the existence of which is officially proclaimed, the States Parties to the present Covenant may take measures derogating from their obligations under the present Covenant to the extent requires by the exigencies of the situation.[46]

In the same way in Latin America, the American Convention on Human Rights Pact of San Jose, Costa Rica states:

> In time of war, public danger, or other emergency that threatens the independence or security of a State Party, it may take measures derogating from its obligations under the present Convention.[47]

---

43 See Scheuerman, above n 3; Scheuerman, William, 'Global Law in Our High Speed Economy' in Richard Appelbaum, William Felstiner and Volkmar Gessner (eds), *Rules and Networks. The Legal Culture of Global Business Transactions* (2001).

44 William Scheuerman, 'Globalization and Exceptional Powers. The Erosion of Liberal Democracy' (1999) 93 *Radical Philosophy* 14-23, 19.

45 Ibid.

46 International Covenant on Civil and Political Rights, article 4.

47 American Convention on Human Rights "Pact of San Jose, Costa Rica", article 27.

Although the Inter-American Convention specifically mentions war and public dangers as events that can trigger the invocation of exceptional powers, it also includes the term 'other emergency', the same term adopted by the Covenant on Civil and Political Rights. 'Emergency' is a broad term that includes not only violent circumstances, such as war and local disturbances, but can also cover natural disasters or economic situations. According to the *Macquarie Concise Dictionary*, emergency means 'an unforeseen occurrence; a sudden and urgent occasion for action'.[48]

Following the above definition, most economic crises could be considered to be emergencies as they are unforeseen and require rapid and urgent action.[49] In similar terms, Relyea explains that an emergency has three distinctive aspects: it is temporal and unforeseen; it threatens life and well being; and it requires immediate action.[50] All three requirements can be met by an economic or financial crisis.

## 4.4 Limits of Exceptional Powers to Cope Economic Crises

The issue of governments resorting to exceptional power schemes to address economic issues has already been discussed. The assistance provided by the IMF now must be placed into this context of exceptional powers in the economic realm. In Latin America, it has occurred that the executive, pushed by the circumstances, has resorted to states of emergency to enact norms that would contribute to the achievement of the conditions required by the Fund to provide financial assistance, including those requirement oriented to fulfil structural weaknesses. This situation raises questions of whether or not IMF conditions achieved through the exercise of exceptional powers could lead to a stronger governance and the rule of law.

Responses to the above question would depend on the concept of exceptional powers. A restricted understanding of exceptional powers could lead to the consideration that it is a tool with a limited scope whose legal effects could not be extended beyond the extraordinary situation. This means that exceptional powers

---

48 Macquarie Concise Dictionary. Third ed, 2003.

49 The Minimum Standards of Human Rights Norms in a State of Emergency adopted a similar approach and its article 1 (b) states that 'the expression "public emergency" means an exceptional situation of crisis or public danger, actual or imminent, which affects the whole population or the whole population of the area to which the declaration applies and constitutes a threat to the organized life of the community of which the state is composed.

50 Relyea, above n 18, 4.

can only address the issues directly associated with an economic crisis and could not be expanded to reforms of more complex institutional arrangements.

On the contrary, a more broad construction of exceptional powers could allow a high concentration of faculties in the executive, and legitimise extensive and deep changes not only on facts directly related to a crisis but also those issues not closely linked to it that authorities deem as essential to supersede turmoils. Under this view, it would be irrelevant for the Fund if a government invoked exceptional powers to comply with its conditions, provided that they are adopted in the terms negotiated. Of course, considering that the IMF is a global advocate of the rule of law and promotes the reduction of the use of *ad hoc* mechanisms in the legal system of developing countries, it could be expected that the institution should refuse a notion of exceptional powers that is not clearly defined in legal terms.

In the case of the first approach, the Roman dictatorship provides a good example of a limited model of exceptional powers. Under this model, during the republican period, Romans accepted to suspend their complex collegial institutions and concentrated all governmental powers in one person, the dictator, to save the Republic from a grave peril.[51] The dictator had expanded powers and was considered an absolute ruler. Although normal magistrates continued exercising their functions, they were subject to the dictator's authority.[52] Such powers of the exceptional magistrate were oriented to resolve the crisis for which he was appointed. His decisions were not subject to revision by other Roman authorities (such as magistrates or the popular assembly). Throughout early Republic life, Romans often resorted to the dictatorship with positive results.[53]

The effective outcome of the Roman dictatorship was achieved due to the way in which the mechanism was designed. Romans incorporated some features into this institution to avoid distortions that could lead to tyranny. The first essential characteristic of the Roman dictatorship was the manner in which the dictator was

---

[51] To learn how the Roman republic organised the government powers see George Mousourakis, *The Historical and Institutional Context of Roman Law* (2003). See also Matthew Dillon and Lynda Garland, *Ancient Rome/From the Early Republic to the Assassination of Julius Caesar* (2005).

[52] Mousourakis, above n 51, 99.

[53] For a better understanding of the origin of the Roman dictatorship see Rossiter, above n 2. Rossiter mentions that in almost three hundred years, Rome had ninety dictators. However in a second stage of the Republican history, a new form of dictatorship appeared. As Rossiter points out 'Sulla and Caesar assumed the title of dictator, but except in name there was no similarity between their dictatorships and those under the old Republic. Both of these men were dictators in today's accepted sense of the word, with all powers and no restraints, and without any externally'. Rossiter, above n 2, 18.

appointed. The Senate initiated the process of appointment when its members considered that a situation endangered the Republic and the ordinary structure was unable to face the problem. After that, the Senate declared that an extraordinary circumstance existed and asked the consuls to appoint a dictator. Rossiter clarifies that the consuls could also propose the designation of a dictator but the Senate must have authorised the appointment.

Second, a dictator was appointed to preserve the constitutional order, but not to modify or derogate such order.[54] This limitation was essential and although a dictator had vast powers to overcome the emergency, he could not, for instance, create a new magistracy or suppress one that already existed. To perform his duties, the dictator could enact decrees that were equivalent to laws but the validity of such norms expired with the termination of the dictatorship.[55] Third, a dictatorship could not be extended more than six months and dictators frequently accomplished their tasks in a shorter period. Thus, at the beginning of their appointment, dictators knew they had a fixed period to carry out their duties. A fourth restraint that contributed to the success of these dictatorships was that economically speaking, the dictator required the Senate's approval to withdraw public money.[56]

Other authors such as Carl Schmitt (sovereign dictatorship), Giorgio Agamben (*iustitium*) and Oren Gross (extra-legal measures model) think about exceptional powers in more open terms and they claim that the executive could assume any action required to supersede a crisis. Agamben, for instance, argues that the current states of emergency should be understood following the Roman *iustitium* instead of the dictatorship. Agamben explains that the *iustitium* was a figure that suspended the entire legal system and allowed magistrates and common citizens to freely act to overcome the peril, creating a 'space devoid of law'. [57]

On the contrary, for Schmitt, ordinary law cannot be applied during an emergency because it was made to regulate a normal situation. As a consequence, if a normal situation does not exist, the ordinary legal order could not be applied.[58] Based on this premise, Schmitt considers that the person who assumes the powers of a

---

54 Ibid 24.
55 Ibid 25.
56 Ibid 24.
57 Giorgio Agamben, *State of Exception* (2005) 50.
58 Schmitt, above n 1, 13.

dictator during the exception must have unlimited authority to rule, including the suspension of the entire legal order. The dictator exercising these powers could modify or transform the existing juridical system to overcome the crisis.

Finally, Oren Gross considers public officials can act out of the legal sphere when they perceive that such actions are essential to preserve the nation and its citizens against any real peril, on the condition that authorities openly and publicly acknowledge the nature of their enterprise.[59] Gross builds his work based on the Locke's theory of prerogatives indicating that a government must have flexibility in certain circumstances to adopt measures that guarantee the wellbeing of its citizens:

> I suggest that there may be circumstances where the appropriate method of tackling extremely grave national dangers and threats entails going outside the legal order, at times even violating otherwise accepted constitutional principles. … Going completely outside the law in appropriate cases may preserve, rather than undermine, the rule of law in a way that constantly bending the law to accommodate emergencies will not.[60]

The Extra-Legal Measures Model possesses a high risk of inducing authoritarianism; nonetheless, Gross suggests that under his model officials act openly acknowledging their actions. The disclosure of an extra-legal measure facilitated its scrutiny.[61] Such revision can adopt different forms such as a parliamentarian investigation, media campaigns or public demonstrations. As a result of this revision performed by other state branches and the general public, extra-legal actions can be directly or indirectly approved.

## 4.5 Harmonising the Rule of Law and Exceptional Powers

Considering the two types of models reviewed above, extraordinary measures cannot be understood as an absolute notion that grants governments unlimited powers to change all economic, political and legal arrangements of a country. An exceptional scheme without restrictions would negatively affect the rule of law, one of the values that it is intended to protect. Constructions such as the *iustitium* and the Extra-Legal Measures model leave too much discretion for government abuses.

---

59 Oren Gross, 'Chaos and Rules: Should Responses to Violent Crises Always be Constitutional?' (2003)112 *Yale Law Journal* 1011-1134, 1023.

60 Ibid 1097.

61 Ibid 1099.

Therefore, this study aims to discover arguments in favour of extraordinary measures from a limited approach.

In an economic-crisis situation in developing countries, the use of exceptional powers represents a risk on two levels. First, at the domestic level, there is a tendency of the government to rely frequently on special powers and label all difficult situations as emergencies. Consequently, efforts must be made to distinguish between a genuine exceptional circumstance and the government's desire to act as free as possible.

Secondly, IFIs perceive crises as the ideal opportunity to push for the overhaul of an entire institutional framework in developing nations that would be not acceptable in normal times. Pressure exerted by the Fund on its state members in order to accept and implement its conditions contributes to the urgency climate in those nations. Consequently, the IMF would not oppose the use of exceptional powers if it means that a country could achieve faster the required conditions. While this approach may be acceptable in order to rapidly improve economic indicators, the same solution cannot be conceived for the reinforcement of governance and the rule of law. Exceptional tools should not be adopted to design an institutional system that need to last longer and rules normal times.

To control these domestic and international risks, the example of the Roman dictatorship provides some ideas. It is true that the model was not perfect and was designed for a governmental system that is not exactly comparable to modern political structures. Nonetheless, this ancient model imposed limitations to extraordinary powers that made misuses infrequent, (at least during the first stages of the Roman Republic).

In addition, a model based on the Roman dictatorship could be better articulated to the notion of the rule of law, perhaps, more than those proposals that grant broader limits to exceptional powers. It is risky to protect the rule of law assuming a type of *vaccatio legis* in which this principle is not temporally applicable. It may result in the death of this value instead of its recovery. In contrast, the imposition of restraints to the notion of exceptional powers may contribute to fortify the rule of law and make authorities more accountable when they exercise such extraordinary powers avoiding risks associated with authoritarianism. Likewise, a limited exception power

model can help to maintain the separation of powers and the checks and balances among them, features that constitute one of the foundational stones of the principle of the rule of law.

A limited model of exceptional powers should address the issues outlined below.[62]

### 4.5.1 Keeping the Exceptionality of Exceptional Powers

Some authors have challenged the validity of the dichotomy normalcy-exception in its classic form.[63] Basically, they argue if normalcy is the ordinary state of affairs, the state that is present most of the time and, by contrast, exception is a short-lived situation in which the ordinary elements of the norm are not presented, then, this paradigm is not any more valid because the exception has become the dominant state of affairs. In other words, what these commentators say is that the rule becomes the exception and the exception the rule. The comment found support in a world in which more frequently governments rely in exceptional powers to deal with a wide set of day-to-day problems. Nevertheless, it is necessary to distinguish between real emergencies and problems that can be solved using the existing ordinary order.

The first element that could help with the task of discriminating between normalcy and exception must be found in the existing legal framework. Following an argument by Scheuerman when he studies Montesquieu, 'If legislators prove competent at foreseeing future needs, executive action typically should not entail anything more than brief and clearly circumscribed acts of implementation and enforcement'.[64] In a first stage, only unforeseen circumstances could be the object of exceptional powers. This means that if the legal order includes a provision that could serve to manage a particular situation, it may not be necessary to rely on an exception power.

---

[62] Rossiter also proposes eleven points that should guide the design of an emergency scheme in order to avoid abuses. See Rossiter, above n 2, 297. In the same way, in the global context, the International Covenant on Civil and Political Rights adopted by the United Nations General Assembly in 1966 regulates, in a very general form, the invocation of emergency by the signatory members. Moreover, the International Law Association (ILA) drafted the Paris Minimum Standards of Human Rights Norms in a State of Emergency. In this document, ILA underlines the principles that should be followed for state of emergency declarations in order to diminish infringements of human rights. See Subrata Roy Chowdhury, *Rule of Law in a State of Emergency* (1989); International Law Association, 'The Paris Minimum Standards of Human Rights Norms in a State of Emergency' (1985) 79 *American Journal of International Law* 1072-1081

[63] Schmitt, above n 1; Gross above n 59.

[64] William Scheuerman, Liberal Democracy and the Social Acceleration of Time (2004) 37.

In the second place, if the ordinary legal system does not include any specific provision to resolve the threat, they could invoke exceptional powers, but resting in the principles contained in the existing juridical order instead of considering that the executive can support its decision in any kind of meta-juridical fundament.[65]

However, it could happen that despite the existence of a legal answer, the specific provision proves to be unsuitable to resolve the crisis and then, the government needs to resort to emergency measures. This option is possible but authorities must first apply existing regulations before assuming additional risks issuing emergency norms.

Under this perspective, the exception differs from normalcy because the latter is ruled by the ordinary order without rest in any 'special norm'. If we take, for example, the banking system, we observe that most financial legal orders include provision for cases of banking crises and how authorities must proceed in order to resolve a financial turmoil. Hence, the simple breaking out of a banking crisis may not be reason enough to call for exceptional powers. It is necessary that the legislation in force does not contain provisions to address the problem.

### 4.5.2 Checks and Balances between State Branches

Authorities may be inclined to favour forms of government that give them more flexibility and less accountability, a situation that could lead to the excessive use of emergency powers, transforming the exception in the rule. During the Roman Republic, a way to avoid the deformation of the dictatorship institution was creating a structure that allocated clear responsibilities among the officials involved in the implementation of this device. Consequently, the entity that declared the emergency differed from the authority that selected the dictator and officials who participated in the first two steps could not be appointed dictators.

In modern nations, it is not necessary to appoint an outsider (a person different from the one who already occupied a public position) as a dictator. In most legal systems, exceptional powers are exercised by the executive branch. Nonetheless, it

[65] In the case of humans rights, see for example International Law Association, above n 62.

is desirable that the determination of the existence of a real threat and the necessity to resort to the application of exceptional powers be carried out by a different authority, such as parliaments or supreme courts.

Another method to limit exceptional powers is through a post-verification process. That is, a congressional or judicial review of the executive order that declares a state of emergency. That is the case in Venezuela (article 339) and Colombia (articles 214 and 215). This method does not guarantee complete success and presupposes that legislative and judicial bodies are independent from the government in order to be effective. In some cases, a post-verification process has not avoided authoritarianism or misuses of exceptional executive powers, especially in nations where the executive has a strong political influence over other branches.[66]

Check and balance schemes to reduce risks associated with extraordinary measures should not be limited to the verification of the events that justify a declaration of the emergency. Other arrangements can be placed to assure the rational and legal use of the exception (for example, the revision of the acts dictated during the emergency period by the legislative or the judicial branches, and congressional or judicial authority to declare the end of the emergency).

### 4.5.3 Temporality of Exceptional Powers

One of the characteristics of exceptional powers is that they constitute an extraordinary avenue designed to overcome serious difficulties. In order to achieve their objectives, they tend to concentrate powers in the executive branch affecting the normal democratic and legal arrangements. It could be justifiable if such measures contribute to sustain the state. However, an unreasonably long suspension of the normal affairs could facilitate authoritarianism, risks that must be reduced. As Rossiter points out, the objective of the government with exceptional powers is 'end the crisis and restore normal times'.[67] For this reason, the validity of exceptional powers must be limited since the beginning, establishing a specific time.

---

[66] Gabriel Negretto and José Aguilar Rivera, 'Liberalism and Emergency Powers in Latin America: Reflections on Carl Schmitt and the Theory of Constitutional Dictatorship' (1999-2000) 21 *Cardozo Law Review* 1797-1823.

[67] Rossiter, above n 2, 298.

The Paris Minimum Standards of Human Rights Norms in a State of Emergency adopts a similar perspective when it states:

> (a) The declaration of a state of emergency shall never exceed the period strictly required to restore normal condition. (b) The duration of a state of emergency (save in case of war or external aggression) shall be for a fixed term established by the constitution.[68]

If exceptional powers do not achieve their objectives during the timeframe legally established, the ordinary state channels (for example, parliamentarian bodies) must review the situation and look for instruments, which, inserted in the normal order, can help to deal with a crisis. The invocation of exceptional powers by the executive should not be a limitation for the legislative branch in order to search for a way out of the crisis and adopt new legislation that confronts the situation from a normal perspective instead of a prolonged state of emergency.[69]

Due to the time limit on exceptional powers, the government must focus its attention to address the crisis that produces the invocation of those measures. It could be erroneous for a President exercising vast exceptional prerogatives to focus his or her efforts on different and more ambitious goals other than the immediate recovery of the country. To aim to achieve expanded objectives could take a longer period, exceeding the time limits of an exceptional approach.

If the specific time proves to be insufficient, other branches of the state (such as the Congress) should have the faculty to extend the time, probably with the favourable vote of a qualified majority. In addition, the executive can declare the end of the emergency before the expiration of the agreed period if it considers that circumstances that caused the extraordinary situation disappear. On the other hand, the parliament should also keep the right to terminate the emergency at any time.[70]

### 4.5.4 Effects of Exceptional Powers

---

[68] International Law Association, above n 62. See section (A) 3 (a) and (b).

[69] Ibid. See sections (A) 5 and (B) 3 (a) establishes that upon a declaration of a state of emergency, the legislative shall not be dissolved and must continue working according to its functions.

[70] It is the solution adopted by article 339 of the 1999 Venezuelan Constitution and the Paris Standards (Section (A) 6 (a)).

Scholars have extensively examined the consequences that exceptional powers should have on the life of a nation. The debate has been associated with the distinction between commissarial and sovereign dictatorship models.[71] The Roman dictatorship responded to the first model that tries to sustain the existing order instead of transform it. It was thought that the exclusive goal of the dictator was to restore the threatened system. This is understandable if we remember that the institution concentrated too much power in the hands of a single person. Probably, the ancient Romans understood that deep transformations of any kind (for example, social, economic, legal or political), in a scenario where one authority notoriously prevailed over other public officials and common citizens, was not the soundest environment to transform a nation.

Different from the commissarial dictatorship, the sovereign model proposes that the person who assumes the equivalent of a dictator role should not have limits in order to complete his task. According to this position, the dictator is not bound by the existing juridical order that can be modified if required. This idea is presented in Schmitt's *Political Theology* in which he claims that the dictator must have the power to change the entire legal order.

This study conceives exceptional powers in a more limited form than the proposed sovereign model because of its extraordinary and temporal nature. These characteristics should restrain governments to use emergency measures to adopt permanent changes. Authorities must understand exceptional powers as a mandate to restore normalcy and leave further adjustments for later, when the normal conditions for an open and fair debate have been reintroduced.

A first exercise that helps to restrict the effects of exceptional powers is looking at the matters that would be able to be addressed using this method. For instance, if the ordinary legal system proves to be inadequate to face a banking crisis, then the government needs to declare an emergency and address the issues directly associated with the problem. Difficulties arise when a government does not focus on its main goals and tries to embrace other issues that do not require an immediate response extending extraordinary measures to aspects that should be resolved through ordinary and democratic channels. In this case, reforms that go beyond the restoration of normalcy and are implemented using the exceptional avenue could be

[71] See Gross, above n 59; Giorgio Agamben, above n 57, 32.

similar to those changes adopted by a *de facto* regime born from the subversion of the legal system (such as a military coup or an armed revolution).
In the economic realm, risks related to exceptional powers are more difficult to be perceived, probably because economic reforms adopted using this mechanism do not look as radical as a military coup. In this regard, a first page headline describing the suppression of the Congress and the Supreme Court by a decree issued by a *de facto* government would look more dramatic than the amendment of a law by an exceptional decree in order to open the financial sector to the foreign investment. Nonetheless, effects of these programs on the juridical sphere can be as permanent as any measure assumed by a *de facto* government.

In the case of IMF's conditionality, this often requires legal reforms. Those conditions tend to exceed the borders of a crisis and ask for deeper structural transformations. In these circumstances, the government would prefer to invoke exceptional powers to achieve such requirements in a faster manner, avoiding political debates and arguments that the situation requires radical measures. However, the invocation of a state of exception does not legitimate the executive to implement all the conditions imposed by the IMF, especially those that surpass the limits of this emergency scheme.

As previously explained, a concept of the rule of law for developing countries calls for a democratic component in which civil participation must be integrated as one of the characteristics of this principle. This chapter has argued that exceptional powers are a necessary avenue to deal with extraordinary circumstances, but that this solution concentrates powers in the executive's hands, making this solution a less democratic institution. One of the mechanisms to harmonise both competing concepts is reducing the matters that can be addressed using exceptional powers to those directly associated with the event by which the extraordinary measures were invoked. Governments must avoid the temptation to extend extraordinary actions to other issues that can be resolved when normalcy is restored. In the same way, IFIs that allegedly promote the rule of law should be aware of this problem and restrict their programs to a limited set of conditions that does not threaten democracy, governance and the rule of law. It was the position assumed by the IMF during its first decades of operation when the institution only incorporated macroeconomic conditions.

Finally, the validity of exceptional powers must be restricted to the duration of the state of emergency. After the exception is revoked, provisions enacted exercising these special faculties should be also invalidated or submitted to the legislative body for ratification. The Paris Standards assume this approach and state that emergency acts shall not be maintained after the expiration of the abnormal situation.[72] If this limitation were applicable in those cases in which countries have relied on exceptional powers to achieve IMF's conditions, most governments would face serious difficulties to convince the legislative body to ratify many of the law decrees issued to satisfy IFIs' requirements.

## 4.6 Exceptional Powers and the Implementation of Market Reforms

During the 1990s, it was consistently argued that developing countries should have implemented market reforms. Basically, there were two options: a big bang or a gradual approach. In economic circles, the problem has been largely debated without accomplishing a unanimous consensus.[73] Generally speaking, advocates of a shock therapy argue that the different components of a market reform (such as trade liberalisation, privatisation, financial liberalisation, fiscal discipline, public expenditure priorities, tax reform and exchange rates liberalisation) must be applied in a short period. Acting in this way, governments maximise the efficiency of resource allocation, strengthen the credibility of reforms and achieve rapid positive results.

In contrast, gradualists affirm that the several components of a market reforms require time for their application and need a transition period in which they can adjust to one another.[74] Also they suggest that an incremental method facilitates the better management of costs associated with the reform as well as allowing more time for people to gradually adjust to the new changes.

---

72 International Law Association, above n 62, Section (A) 6 (b).

73 For a review of the literature, see for example Saleh Nsouli, et al., 'The Speed of Adjustment and the Sequencing of Economic Reforms: Issues and Guidelines for Policymakers' (Working Paper WP/02/132, IMF, 2002). See also John Mc Millan, 'Avoid Hubris and other lessons for reformers', Finance & Development September (2004); Oleh Havrylyshyn, 'Avoid Hubris but Acknowledge Successes/Lessons from the Postcommunist Transition', Finance & Development September (2004).

74 Mc Millan, above n 73, 36.

Besides the economic angle, the selected method of reforms has some effects in political and juridical realms.[75] In the political arena, the issue is frequently associated with the question of how participatory should be the process of designing and implementing market reforms. One of the arguments defended by rapid approach advocates is that this method avoids what neoliberal reformists like to call 'political obstacles' to refer to those people or organisations that challenge the rationality of market programs. As Przeworki suggests, when governments pursue reforms, they have two choices in dealing with the delivery of programs: to attract the strongest possible support from political parties, labour unions and other civil actors; or to debilitate all of them and implement reforms without opposition and little discussion.[76]

When authorities decide to act unilaterally, one of the preferred instruments to achieve this goal and reduce contention is the declaration of state of emergency and the concentration of power in hands of the President. With this mechanism, the executive puts in place a bypass that reduces discussions or interminable negotiations of economic programs. The question posed by Przeworki is whether a government that invokes a state of siege to limit the opposition capacity and imposes radical economic changes can be considered democratic.[77]

Havrylyshyn responds affirming that a shock therapy approach is not necessarily in opposition to democratic principles. Havrylyshyn explains that some Central Europe countries applied shock reforms to achieve their economic transformation and, at the same time, they were successful strengthening their democratic institutions.[78] Therefore, he concludes, big bang approaches and democracy are not necessarily in opposition to each other. Nonetheless, in Latin America, a region plagued by authoritarian governments, the picture seems to look divergent.

In the 1980s and 1990s, several Latin American nations imposed big bang market reforms. Some programs were initially successful and helped to reduce inflation and improved other macroeconomic indicators. During the same period, electoral democracy expanded for the continent but other elements associated with

---

75 See for example Eduardo Gamarra, 'Market-Oriented Reforms and Democratization in Latin America: Challenges of the 1990s' in W. Smith, et al. (eds), *Latin American Political Economy in the Age of Neoliberal Reform/Theoretical and Comparative Perspectives for the 1990s* (1994) 1-15.

76 Adam Przeworski, Democracy and the Market/Political and Economic Reforms in Eastern Europe and Latin America (1991), p.182.

77 Ibid 182.

78 Havrylyshyn, above n 73, 40.

democracy were absent. Subsequently, people started to perceive that benefits of economic improvement did not reach them. Hence, citizens demanded more participation than the simple vote for governmental appointments in order to reduce poverty and inequality as well as to improve capital income and better labour conditions.[79] They considered that the experienced economic growth was not tied to a modern democratic model. In contrast, Latin American citizens noticed that imposed economic reforms were an obstacle to enjoy more freedom.[80] Consequently, the claim was directed to open participation for the designing of economic polices.

In the legal arena, tension imposed by market reforms was not less important. The pertinent question, adapting Przeworski's inquiry, is whether or not it is possible to promote and defend a rule of law model restricting democracy and using exceptional powers. It seems difficult to positively respond to this query, especially if a notion of the rule of law that includes a democratic component is adopted (see Chapter 2). As the UNDP states, 'Democracy is more than simply a method for deciding who is to rule. It is also a way of building, guaranteeing and broadening freedom, justice and progress, and of organizing the stresses and clashes that ensue from the struggle for power'.[81]

When governments resort to exceptional measures to implement a market reform through a big bang approach, it reduces political opposition, democratic discussion and the speedy implementation of economic programs. In other words, a government increases the speed of market implementation using states of emergency but it negatively affects the rule of law and democracy. As explained earlier, the declaration of emergency is not inadequate *per se*. Wisely used, exceptional measures can lead to the restoration of normalcy. This means that authorities can invoke extraordinary measures to restore the economy but should not extend exceptional powers to aspects beyond the specific emergency. For this reason, nations should avoid pressure from IFIs and especially conditions that seek for more ambitious structural reforms that in normal circumstances would require more realistic timing.[82]

---

79 See especially United Nations Development Program (UNDP), Democracy in Latin America: Towards a Citizens´ Democracy (2004).

80 Ibid.

81 Ibid 36.

82 See, Stephen Grenville, 'The IMF and the Indonesia Crisis' (2004) 40 Bulletin of Indonesian Economic Studies 77-94; Hal Hill, The Indonesian Economy in Crisis/Causes, Consequences and Lessons (1999).

The case of Argentina in the 1990s is an example of the consequences of mixing urgent reforms with other non-urgent proposal. Argentinean authorities followed a big bang approach invoking exceptional powers in the belief that concentrating powers in the hands of the executive, economic changes could be adopted faster and in a more efficient manner. Between 1989 and 1994, President Carlos Menem combined states of emergency declared by the Congress with need and urgency decrees (NUD) to impose a market reform program supported by the IMF.[83] Although the acts of the Congress were in line with the legal framework and set limits for the exercise of exceptional powers, Menem frequently used NUDs in order to bypass congressional limitations. In fact, NUDs were a doubtful emergency tool that did not have a constitutional base.[84]

Menem's style of mixing legal exceptional powers (state of emergency) with an extra-legal emergency tool (NUDs) had an initial positive outcome, facilitating public support. However, the method resulted in authoritarianism and debilitated legal institutions. The lack of effective check and balance mechanisms to limit the executive's powers ended with another economic crisis that forced the appointment of five Presidents in a period of eleven days between December 2001 and January 2002. The crisis also produced that the government declared a moratorium and defaulted on its international financial obligations.[85] In addition, Menem, as other Latin American Presidents who followed the IMF's orthodoxy and invoked extraordinary powers to implement market reforms, at the end of his government faced corruption charges.[86]

Although exceptional powers look like a flexible and efficient instrument for the implementation of fast market reforms, its misuse can affect the equilibrium of the juridical order. Domingo Cavallo, Minister of the Economy during Menem's presidency recognises that:

---

[83] See especially Delia Ferreira Rubio and Matteo Goretti, 'When the President Governs Alone: The Decretazo in Argentina, 1989-1993' in John Carey and Matthew Soberg Shugart (eds), *Executive Decree Authority* (1998) 33-61. For a more detailed account of the different structural conditions required by the IMF in Argentina during the 1990s, see Independent Evaluation Office, 'Evaluation Report/The IMF and Argentina 1991-2001' (IMF, 2004).

[84] It was only in 1994 when a new constitution incorporated the faculty of the President to enact NUDs. See Ferreira, above n 83.

[85] For a more comprehensive account of the role played by the IMF in the Argentinean economy, see Paul Blustein, *And the Money Kept Rolling in (and out): Wall Street, the IMF, and the Bankrupting of Argentina* (2005).

[86] Fujimori, former Peruvian president, is another example of a Latin American official who used exceptional powers to implement market reform sponsored by the IMF and faces corruption charges.

> To pass bills is rather more difficult than issue NUDs [Need and Urgency Decrees]. But ruling through law produces greater legal stability because it creates a sense of more sound and permanent solutions that brings about the necessary conditions to foster investment and consequently economic growth.[87]

Bureaucrats frequently argue that market reforms involve economic decisions and forget to analyse risks that affect legal institutions with sudden changes. Such institutions cannot maintain the pace of changes imposed by big bang approaches and require more time to be adapted. Scholars have warned about dangers that impose on the legal system reforms rushed without empirical research and copying pre-established models.[88] Indeed, it constituted the most important lesson learned from the original law and development movement.

The sudden creation of new legal institutions without adequate analysis and discussion can cause ineffective instruments incapable of achieving their goals. Such devices in turn will produce more legal uncertainty and a divorce between people and norms.[89] Nobody can expect that a legislation that has been drafted in days can be highly effective. The redefinition of a juridical order requires time and effort in trying to understand its particularities. The adoption of legal reforms to implement economic programs without serious analysis is 'a recipe for a policy and law-making disaster'.[90]

A second issue that disturbs legal systems when market reforms are executed through a state of emergency is that new instruments are approved without adequate discussion and limited participation of other actors or groups. When IFIs are involved, the negotiations are generally held by a limited number of people from the government and international organisations. If the debate is opened to the public, governments do not discuss about the nature or the content of the proposed changes and tend to set the discussion in informative terms. National officials

---

87 Cited in Ferreira, above n 83, 36.

88 Robert Seidman, Ann Seidman and Neva Makgetla, 'Big Bang and Decision-Making: What Went Wrong?' (1995) 13 *Boston University International Law Journal* 435-465.

89 During the Asian crisis in 1990s, the IMF, for example, pushed for legal changes in Indonesia. In the case of the insolvency law, Timothy Lindsey reports that authorities were forced to implement in few weeks, changes that had not been adopted in thirty years. See Timothy Lindsey, 'The IMF and the Insolvency Law Reform in Indonesia' (1998) 34 *Bulletin of Indonesian Economic Studies* 119-124. The effectiveness of the reform is not clear and the World Bank recently reported that it takes an average of 5.5 years to complete a bankruptcy procedure in Indonesia to recover 13 US cents for each claimed dollar. World Bank, 'Doing Business in 2006' (World Bank, 2006).

90 Seidman, above n 88, 448.

frequently argue that changes in programs would be unacceptable for multilateral lending organisations.[91]

The limitation in the discussion of reform packages sponsored by IFIs was one of the elements found by the UNDP in a report prepared to address issues that affect democracy in Latin America. Political leaders in that region recognise that governments have lost control and autonomy dealing with internal variants due to the external influences of IFIs.[92] The UNDP reports that a Latin American official expressed that 'Economy policy is not democratically managed ... There is only one model for the region. And anyone who wants to do things differently has to face the fact that it cannot be done, or if he does it, he does it at his own risk'.[93]

The great influence of IFIs in the designing of policies and the lack of ownership of such programs by developing countries explain in part the deficient implementation of IFIs sponsored packages. More than acting, convincing that measures included in programs are necessary for its economy, a country agrees to apply these actions to access financial resources but if, for instance, the economy depends on a commodity and international prices increase, that country is less willing to continue such measures, affecting the continuity of the new policies. This idea coincides with what Stiglitz has called 'the social and organizational capital' that 'cannot be legislated, decreed or in some other way imposed from above'.[94] He points out that a market not only works following economic incentive principles but also, it requires some degree of social trust and a legal order. These social and legal institutions cannot be created overnight without risks of failure in the intent to impose a market reform.[95]

## 4.7 Banking Systems and Exceptional Powers

It could be thought that banking crises have to be irremediably addressed through the use of exceptional powers. Even some experts seem to support Schmitt's theory of exception and claim that there is no possibility to create norms that can

---

91 See for example El Universal, *La emergencia financiera y el FMI*, in *El Universal*. 1996: Caracas.
92 United Nations Development Program, above n 79, 160.
93 Ibid.
94 Joseph Stiglitz, 'Whither Reform? Ten Years of the Transition' (Paper presented at the Annual World Bank Conference on Development Economics, Washington, D.C. 1999) 9.
95 Ibid 8.

regulate all types of potential financial crises.[96] They support the view with the fact that each crisis has its own distinctive characteristics and it would be a mistake to restrict financial regulators. In contrast, it is argued that banking authorities need flexibility to manage financial difficulties and address its particularities, including the possibility to set up an *ad hoc* institutional framework in case of an emergency.[97]

However, it would be risky to grant a broad discretion to create a temporary authority to manage a banking crisis. This thesis supports a restricted crisis management model and looks for a more intermediate solution that produces a balance between pre-established norms and flexibility for banking regulators. Karen Harris suggests that in order to achieve equilibrium it is necessary to include in banking legislation some basic norms to manage banking crises, and other norms that guarantee a certain degree of discretion that allows regulators to target the peculiar features of a specific situation.[98] As Harris explains, an inadequate legislation that does not include flexibility could act as a barrier and obstacle to assume fast actions to tackle a crisis but the absence of essential regulations can exacerbate its effects.[99]

The Basel Committee on Banking Supervision also assumes this middle position and indicates that states need to enact legislation including 'procedures for the efficient resolution of problems in banks'.[100] Chapter 2 explained that there were financial safety nets in case of crisis that if included in the legal framework would contribute to resolve a banking collapse. Hence, a wise banking legislation requires the incorporation of a basis provision to tackle a crash, including an understanding on how banking authorities would assume the management of the crisis as well as mechanisms that could be used to deal with the problems. This authority must be independent and has to participate in the resolution of banking problems including those related to the closure, intervention or merger of distressed institutions.[101]

---

96 See for example Udaibir Das and Marc Quintyn, 'Crisis Prevention and Crisis Management: The Role of Regulatory Governance' (Working Paper WP/02/163, IMF, 2002); Karen Harris, 'Anticipatory Regulation for the Management of Banking Crises' (2005) 38 *Columbia Journal of Law and Social Problems* 251-286.

97 Das, above n 96.

98 Harris, above n 96.

99 Ibid 254.

100 Basle Committee on Banking Supervision, 'Core Principles Methodology' (BIS, 1999); Basle Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision' (Bank for International Settlements, 1997).

101 Basle Committee on Banking Supervision (1999), above n 176, 11.

However, authors like Das and Quintyn prefer that the government creates an *ad hoc* entity to tackle banking crises with a clear and stronger political leadership.[102] They support their opinion with three arguments. First, they claim that banking crises demand extraordinary budgetary resources that exceed financial regulator possibilities. The assignment of fresh financial resources would require political leadership. Second, Das and Quintyn affirm that this situation frequently calls for legislative measures that cannot be achieved without political support. Third, when a crisis hits a country, they claim authorities have to redistribute economic consequences among the different societal groups and probably have to address the dissolution of influential interest groups. A technical supervisor could hardly achieve this goal without a strong political leadership.[103]

Political leadership has an important role during a banking crisis but it cannot supersede the significance of a technical and professional banking regulator. Das and Quintyn's approach relies on a temporal structure that creates an *ad hoc* political instance to manage the crisis and extraordinary regulations to rule the resolution of the problem. They suggest that the *ad hoc* instance needs to have strong political leadership but it leaves too many responsibilities in hands of politicians and transforms financial regulators in mere subordinated agencies. The argument that a strong governmental political leadership can help to push required legislative measures may not be exactly true if the government decides to invoke exceptional powers and create a bypass to avoid congress.

This thesis favours a structure that maintains the leadership of the management of the crisis in hands of a banking regulator that has been previously established, because they have been technically created and trained to deal with this kind of problems. Theoretically, a professional supervisor should have better technical resources to manage a crisis than any political body.

In any case, whether a new *ad hoc* commission or the existing banking supervisor manages the problem, as Das and Quintyn point out, it is essential that implemented procedures respect good governance principles and the rule of law if applicable (e.g. transparency, accountability and independence of the financial regulator).

---

[102] Das, above n 96. See also David Scott, 'A Practical Guide to Managing Systemic Financial Crises/ A Review of Approaches Taken in Indonesia, the Republic of Korea, and Thailand' (Working Paper WPS/2843, The World Bank, 2002).

[103] Das, above n 96, 38.

As previously mentioned, it is also necessary to impose limits to banking supervisors and governments that invoke extraordinary powers to address a banking crisis. Therefore, if a banking authority resolves to rely on exceptional powers, they must act within the existing constitutional and legal limitations. In this regard, they must conform these actions to comply with the legislative goals and policies defined by the parliamentarian authority. It is the first mechanism to control regulators' accountability. This means that during the first stage of a banking crisis, regulators must focus their efforts and limit their powers in achieving the essential goal that is generally established in case of systemic problems: restore confidence in order to contain the financial collapse.

After the restoration of confidence, other phases of the resolution of a banking crisis may not require the exercise of exceptional powers. Authorities should avoid extending emergency powers to other areas that are not related to the banking crash. It is particularly valid regarding actions associated with the exit strategy designed by the government in order to suspend any emergency regulations and re-establish the force of ordinary norms. The distinction is essential because there is a difference between exceptional measures taken to control a systemic crisis and to reduce its negative effects, and those actions that are not fundamental. As in the case of market reforms made in a scenario of banking crisis, when nations need funds to face problems, the government can be obligated to accept conditions that imply deeper reforms that go beyond the banking problem extending the legitimation to undertake reform in the banking sector to other areas far from the financial crisis.[104]

Finally, a third element that must be considered that is attached to the exceptional power of financial institutions is time. As previously explained, a state of emergency cannot last forever and it is necessary to define a time frame in which the financial regulator should resolve the crisis and restore the normal operation of the banking sector.

[104] For example, in the case of the Venezuelan banking crisis, the IMF required changes in the labour legislation and the privatisation of public companies other that the nationalised banks (e.g. telecommunication, steel and aluminium companies) that did not have a direct link with the banking crisis (IMF, 'Venezuela-Staff Report for the 1996 Article IV Consultation and Request for Stand-By Arrangement' (ERS/96/108, IMF, 1996)). I will further discuss the Venezuelan case in Chapters 7 and 8.

## 4.8 Inadequacy of Exceptional Powers to Build a Notion of the Rule of Law

This chapter has observed that exceptional powers should not be thought of as an absolute and omnipresent notion that gives governments a blank cheque to undertake whatever reform it considers necessary to deal with a crisis.

In contrast, a constitutional state of emergency model, like the one adopted for most modern democracies, is deemed as a tool that has a limited scope. First of all, exceptional powers are designed to be used when real emergencies appear, including economic affairs. Second, exceptional powers must be exercised under strict scrutiny of other public branches. Third, a state of emergency has a time limit that makes it difficult to undertake deep reforms without forcing democratic arrangements. Fourth, exceptional powers cope with issues directly associated with the emergency and they cannot be extended to reform structural aspects that require the existence of normal circumstances with balanced political and legal arrangements. Finally, the effects of exceptional power are limited and should not be extended beyond the emergency, making them unsuitable to undertake structural reforms that will remain to rule normal times.

Under these assumptions and considering that the rule of law is one of the most important foundations upon which a state rests, it seems extremely difficult to approach this notion through an exceptional power concept because such a scheme distorts the basic postulates of a society. As a consequence, exceptional powers fail to build a solid bridge between the rule of law and IMF conditions. We cannot accept that institutional changes to the ordinary legal system be approached using an exceptional mechanism that limits democracy and the validity of constitutional arrangements.

Pressure imposed by the IMF on developing countries to strengthen the rule of law through the adoption of laws and other institutions that theoretically promote the notion and therefore serve as leverage for economic growth and abatement of poverty could help. However, it could be a costly error to assume that because those norms embodied the international best practice in economic matters, these measures would simply work in developing nations when they are simply transplanted, disregarding any other social, political and legal factor that affect enforcement. The way in which conditions associated with the adoption of new legislation are implemented can be also important, especially if we consider that discussions between IMF and government officials are affected by the necessity that a country has to access financial resources to deal with economic problems. Facing this dilemma, most governments would take a pragmatic decision and accept the structural measures suggested by the IMF, even if this solution represents a real threat to democracy and the rule of law.

The IMF has not realised this limitation of exceptional powers and it has also assumed a pragmatic position, opting to accept the achievement of its conditions by any means. Most likely, the IMF acts convinced that when its members adopt the recommended structural changes, these nations will automatically improve their institutional arrangements including the rule of law because of the implementation of laws that have proved successful in other parts of the world. However, this organisation underestimates the negative effects produced by the misuse of exceptional powers, a situation that plants seeds that later may grow and cause resentment, the failure of IMF programs and the weakness of legal systems. For all these reasons, it is extremely difficult to strengthen the rule of law through the IMF conditionality, especially when exceptional powers have been used to link both notions.

# CHAPTER 5

# AN INTRODUCTION TO MALAYSIA'S LEGAL SYSTEM

## 5.1 Introduction

This thesis could approach an analysis of the way in which the Malaysian government addresses the financial crisis in the banking sector, limiting the study to the strategy implemented. However, such an analysis would be incomplete because it ignores historical, economic and social factors that affected the decision making process of Malaysian authorities.

During the 1990s, a period that could be labelled as the decade of international financial institution neoliberalism, Malaysia was one of the few cases in which a developing country in financial distress took the risk of designing and implementing an economic program that differed from standard packages sponsored by the IMF. While nations like Russia, Argentina, Mexico, Peru, Venezuela, Brazil, Indonesia, South Korea and Thailand, agreed to apply IMF-designed programs, Malaysia chose another path to economic recovery.

The Malaysian government supported its departure from the IMF's orthodoxy arguing that such resolution was required in order to preserve social harmony and the special status of Malays. In particular, the government claimed that IMF-oriented policies would undermine arrangements put in place since 1969 when racial riots threatened national unity.

These particularities of Malaysia make it necessary to review the social, historical and religious conditions in which Malaysia developed as an independent nation in order to gain a better understanding of the solution selected to face the crisis and how the government connected its development model with the chosen approach. While Malaysia has been regarded as a country in which the government resolves political crises through the implementation of exceptional powers, authorities maintained the employment of such measures at its lowest level when they tackled the consequences of the financial crash in the banking system.

The Malaysian case study is divided into two chapters. In the first chapter (Chapter 5), the objective is to establish the historical background of Malaysia, with a particular focus on the British legal influence and the way in which Islam and an ethnically divided society affected discussions relating to the drafting of the constitution in the 1950s. The second chapter (Chapter 6) will analyse the crisis in the banking system and the legal strategy followed by the government.

Please see print copy for Figure 2

**Figure 2: Map of Malaysia** [1]

## 5.2. A Brief History of Modern Malaysia

Peninsula Malaysia and the Strait of Malacca has been a very active commercial region for centuries. In the thirteenth century, traders from Middle East, India and China engaged in a very diverse trade in the zone. Since then, commerce has been the driving force behind Malaysia's economic history. Trade also exposed the region

[1] One World-Nations Online, *Map of Southeast Asia Region* (2008) One World-Nations Online, <http://www.nationsonli`ne.org/oneworld/> at 17 August 2008.

to Hinduism, Buddhism and Islam. The latter would have a great influence in Malaysia. [2]

The settlement of the Sultanate of Malacca at the beginning of the fifteenth century marked a milestone in the history of Malaysia. It is from this point that most historians trace the evolution of modern Malaysia.[3] After it was founded, Malacca became a recognised international trade port and cultural centre. It was one of the main cities for the trading of goods among the nations located in India, the Middle East, China and Southeast Asia.

At the beginning of the sixteenth century, Malacca flourished as a rich and buoyant port and attracted the attention of Europeans who were looking for new routes and places to settle naval stations in order to expand their trade dominions. The first European country to conquest Malacca was Portugal. The chief objective of the Portuguese was to establish a base and to control the maritime routes and trade in the region.[4] After a first failed attempt in 1509, the Portuguese seized Malacca in 1511. During their rule, the Portuguese forced ships passing the Strait to trade and pay high duties, a reason why most merchants began to avoid Malacca.[5] The city ultimately lost its reputation as a convenient harbour and trade centre.

In 1641, the Dutch expelled the Portuguese from Malacca. Although the Dutch had made Jakarta (Batavia) the centre for their trade operations, the domination of Malacca allowed them to remove the Portuguese from the Straits and to have a better control of the region.[6]

The British were the last European power to rule the Peninsula Malaysia. They established a settlement in Penang, north of the Peninsula Malaysia, in 1786. The occupation of Penang was agreed by a treaty signed between the Sultan of Kedah and the British East India Company.[7] Later in 1819, the British also developed a station in Singapore that was soon transformed into a strategic and commercial port.

---

2 See Andrew Harding, Law, Government and the Constitution in Malaysia (1996) 5.

3 See for example Barbara Watson Andaya and Leonard Andaya, *A History of Malaysia* (1982); Horace Stone, *From Malacca to Malaysia 1400-1965* (1966); C. Mary Turnbull, *A Short History of Malaysia, Singapore and Brunei* (1980); and J. Kennedy, *A History of Malaya A.D. 1400 - 1959* (1962).

4 M.B. Hooker, Law of South-East Asia/ European Laws in South-East Asia (1988) vol 2, 67.

5 Ibid 72. Other authors comment that apart of the monopolistic trade policy put in practice by the Portuguese in Malacca, merchants also abandoned this port due to the high level of corruption of Portuguese officials. See John Bastin and Robin Winks, *Malaysia/Selected Historical Readings* (2nd ed, 1979) 111.

6 Stone, above n 3, 58.

7 Hooker, above n 4, 16.

In 1824, the Dutch and British signed the Treaty of London which divided the Strait Settlements in two spheres of influences. According to the Agreement, the British retained Malacca and other ports located in the Peninsula Malaysia and the Dutch promised not to intervene in the region, while the British accepted to transfer Benkulen and agreed not to interfere in Sumatra and Java.[8]

The British governed Peninsula Malaysia with the local sultans using the residential system. This mechanism allowed British officials called residents 'to advise' local Rajas and Sultans on several matters, especially those associated with the economy. However, the British agreed not to intervene in religion (Islam) or issues relating to Malay customs.[9] As Harding points out, there was no a clear understanding of the extension of these two exceptions and the Malays considered that they were greater than the British assumed.[10] This is understandable if we consider that before the British arrival most matters in the Malay Peninsula were regulated by customary law and the religion of Islam.[11] The residential system gave the impression that local rulers governed on the advice of the British, but most commentators agree that the rulers' powers were more formal than real.[12]

In 1888, the British granted protectorate status to Sarawak, North Borneo and Brunei. After that, in 1896, the Malay Rulers and the British agreed to form the Federated Malay States (FMS) which constituted Perak, Selangor, Negri Sembilan and Pahang.[13] The Malay states of Perlis, Kedah, Trengganu, Kelantan and Johore were known as the Unfederated Malay States (UMS). A Resident-General appointed by the British headed the FMS. The Federation debilitated more the rulers' powers that were exercised by the British residents in consultation with the Resident-General.[14]

In 1909, the British finalised a treaty with Siam, taking control of the Northern territories of Kedah, Kelantan, Perlis and Trengganu.[15] In 1914, the British assumed the administration of Johor in the south part of the Peninsula, making a British General Adviser dependent on the Singaporean Governor rather than the

8 Turnbull, above 3, 98. See also Stone, above n 3, 92
9 Watson, above n 3, 159.
10 Harding, above n 2, 14.
11 Ibid.
12 See e.g., Watson, above n 3,183.
13 Stone, above n 3, 147.
14 Watson, above n 3, 183.
15 Ibid 198.

Sultan, completing their control of the peninsular territories that today form Malaysia.[16]

During WWII, Japanese forces seized Malaysia and ruled for more than three years. During that time, the Malayan Peoples Anti-Japanese Army (MPAJA) led the clandestine opposition against Japanese occupation.[17] After the British regained possession of Malay territories, they struggled to form a Malayan Union integrated by the FMS, the UMS as well as Penang and Malacca, excluding Singapore. The project was approved by the British but it could not be implemented due to the opposition from the Malay people. The alternative model of political organisation supported by Malay groups led by the United Malays National Organization (UMNO) was the Federation of Malaya that was agreed on February 1948.[18] The Federation included the FMS, the UMS, Penang and Malacca. A British High Commissioner was appointed.

The Malayan Communist Party (MCP) considered the materialisation of the Federation as a defeat of its political aspiration and its contribution to the fight against the Japanese occupation. Consequently, they did not support the Federation and instead the MCP was transformed into an insurrectional movement. The British banned the MCP and the High Commissioner declared a state of emergency in 1948 to deal with the communist insurrection. This state of emergency would have had profound consequences for the Malaysian legal system and established the pillars for the regimes of exception in the country. Indeed, the Malaysia Constitution was born under this state of emergency.

In 1949, the British Parliament agreed to establish the independence of Malaysia and a commission was organised to draft a constitution for an independent Malaya in 1956. The constitution was approved and on 31 August 1957 the independence of the Federation of Malaya was proclaimed (*Merdeka*). Years later in 1963, the states grouped in the Federation of Malaya agreed to organise the Federation of Malaysia that congregated the states of the Federation of Malaya, Singapore (it seceded in 1965), Sarawak and Sabah (North Borneo).

---

16 Ibid 200.
17 Ibid 251.
18 Ibid 257. UMNO is a political party funded in the aftermath of the WWII in 1946. It is largely formed by Malays. It became the strongest political party and it has controlled the government since independence, first as a part of a coalition called the Alliance and later, as a part of *Barisan Nasional* (BN).

## 5.3 People of Malaysia

### 5.3.1 A Multi-ethnic Society

In order to study Malaysia, it is necessary to briefly examine the different ethnic groups that coexist in the country. The ethnic composition has deep consequences for the political, social, legal and economic arrangements that operate within Malaysia.

By 2006, the Malaysian population was 26.6 million.[19] Most people live in Peninsula Malaysia (80%). The population is formed by three main groups: *Bumiputera* (61.6%); Chinese (23.3%); and Indian (6.7%).[20] The most widely practiced religion is Islam (60.4%), followed by Buddhism (19.2%), Christianity (9.1%), Hinduism (6.3%) and Confucianism, Taoism and other Chinese religions counting for 2.6%.[21]

During the British domination, they encouraged the settlement of Chinese and Indian immigrants. The Chinese were considered by the British to be a valuable group whose members had useful trade, merchant and agricultural skills.[22] The developing of large-scale tin mining also produced an increase in Chinese immigration in the ninetieth century. At that time, Chinese traders received tin mine concessions and due to a labour shortage, they imported workers from China.[23] An increase in the Indian population also came with the British who employed them in economic activities performed by the Europeans, especially as rubber estate workers.

The immigration strategies employed by the British caused a racial segmentation of economic roles in Malaysia that was inherited for the independent country and in 1970s, for instance, *Bumiputeras* were more agglomerated in rural zones, working in the agriculture sector and public positions.[24] The Indians converged in the plantation activity as well as railways and government while the Chinese focused on trade and

---

19 Email from the Department of Statistics Malaysia to Gabriel Garcia, 17 July 2007.

20 Ibid. *Bumiputera* means 'son of the soil' and it comprises Malays and other indigenous people from Sabah and Sarawak .

21 Department of Statistics Malaysia, *Population And Housing Census 2000* (2005) Department of Statistics Malaysia <http://www.statistics.gov.my/english/frameset_census.php?file=pressdemo> at 11 July 2007.

22 Bastin, above n 5, 257.

23 Stone, above n 3, 99-160.

24 United Nation Development Programme, Malaysia/Achieving the Millennium Development Goals. Success and Challenges (2005) 4.

commerce.[25] The division of labour contributed to exacerbate the animosity among Malays, Chinese and Indians and each group wanted to share the other's sphere of influence.[26] In the case of Malays, they believed that they had been marginalised in their motherland.

### 5.3.2 The New Economic Policy (NEP)

The fragile equilibrium among the different ethnic groups collapsed in 1969. That year, the Alliance, a political coalition formed by three ethnically organised parties, UMNO, the Malay Chinese Association (MCA) and the Malayan Indian Congress (MIC), won the federal elections but they failed to control the two-thirds parliamentarian majority that it had previously enjoyed since *Merdeka*. These results marked a departure from the previous *status quo* that guaranteed an indisputable political control to Malays. Apart from the loss of political control, Malays perceived that their economic situation was worse than the Chinese. This perception was based on the income disparity among the different races and the fact that about 65% of *Bumiputera* were poor, in contrast to 26% of the Chinese and 39% of the Indians.[27]

As a consequence of the election results, racial riots broke out. The *Yang di Pertuan Agong* (the *Agong*) issued a proclamation of emergency under article 150 of the Constitution to address the crisis. Before the state of emergency was invoked, the Parliament had been dissolved and could not be convened because the election had not been completed in all states. Subsequently, the *Agong* issued the Emergency (Essential Powers) Ordinance No 1 1969 on the ground of article 150 (2) of the Malaysian Constitution. According to the Ordinance No.1, the *Agong* was vested with wide powers to make any regulations whatsoever to ensure public safety, the defence of Malaysia, the maintenance of public order and supplies, and services essential to the life of the community. Matters that can be regulated using this Emergency Ordinance include: imprisonment, trial and punishment; seizure of property; and regulation of trading, storage, exportation, importation, production and manufacture.

---

[25] Ibid.

[26] For a work that explains the immigration of Chinese and Hindus to Malacca see Bastin, above n 5.

[27] See Richard Leete, Malaysia from Kampung to Twin Towers/50 years of Economic and Social Development (2007) 141.

The *Agong* also issued the Emergency (Essential Powers) Ordinance No. 2 in which he delegated his legislative and executive powers to a Director of Operations assisted by a National Operations Council.[28] The Director acted as a kind of Roman dictator that exercised broader extraordinary faculties and parallel worked with the ordinary structure of government (such as the Prime Minister).[29]

In order to disperse racial tensions and create adequate conditions for the unification of the country, the *Agong* proclaimed the *Rukunegara* or 'the pillar of the nation' on August 1970.[30] *Rukunegara* is a national philosophy publicised by the government.[31] It states that the nation and its unity would be built based on five principles: belief in God; loyalty to King and the country; upholding the Constitution; the rule of law; and good behaviour and morality.[32]

Later, the Parliament was convened and it passed a constitutional amendment that limited the freedom of speech (article 10 (1)) and avoided discussions of sensitive issues (such as the special status of Malays); while an amendment of the Sedition Act made it a crime to discuss those affairs.[33] On the economic front, authorities prepared a plan, the New Economic Policy (NEP), to address the social imbalances that affected Malays.

The NEP was envisaged by the state to assume the command of the economy and it was incorporated in the First Outline Perspective Plan and the subsequent plans until the Fifth Malaysia Plan.[34] The policy had a unique goal to achieve national unity that would be accomplished with the implementation of two strategies: eradication of poverty; and the restructuring of society through suppression of ethnical classification of economic functions.[35]

---

28 H.P. Lee, *Constitutional Conflicts in Contemporary Malaysia* (1995) 13-14; Cyrus Das, 'The May 13th Riots and Emergency Rule' in Andrew Harding and H.P. Lee (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 103-113.

29 Harding, above n 2, 44.

30 Rais Yatim, *Freedom Under Executive Power in Malaysia/A study of Executive Supremacy* (1995) 30.

31 Ibid. For an analysis of the role played by the *Rukunegara* in the Malaysian reconciliation process see Andrew Harding, 'The Rukunegara Amendments of 1971' in Andrew Harding and H.P. Lee (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 115-133.

32 Economic Planning Unit Prime Minister Department Malaysia, 'Seventh Malaysia Plan 1996-2000' (Economic Planning Unit, 1996) iii.

33 Lee, above n 28, 14. See also Harding, above n 30.

34 Economic Planning Unit Prime Minister Department, 'Malaysia: 30 Years of Poverty Reduction, Growth and Racial Harmony' (World Bank, 2004) 1.

35 Ibid.

In practice, the state intervention under the NEP was oriented to support Malays and diminish the perceived Chinese ascendancy in different aspects of the Malaysian economy. Hence, the government implemented numerous affirmative action programs for *Bumiputera* with the target of increasing employment quotas for Malays in various industrial areas and professions, strengthening *Bumiputera*'s corporate ownership and achieving a better distribution of income among the different ethnic groups. With this aim, the government established programs that grant *Bumiputera* preferential treatment to obtain trade licenses, access to tertiary education and purchase corporate equity, to mention just a few examples.

Although the NEP was officially replaced in 1990 by the National Development Plan 1991-2000 and more recently by the National Vision Policy 2001-2010, the objective of national unity and the affirmative action programs have been maintained. It has produced a passionate debate about whether or not these programs should be kept in detriment of other non-Malay disadvantaged people.[36] Recently, discontent produced by affirmative action programs has been expressed by Indian-Malaysians who have protested against such programs.[37]

In spite of the controversy that surrounded the NEP, Malaysian social indicators show a positive trend in the last three decades. While in 1970 almost half of the Malaysian population was poor, the number was reduced to 16.5% in 1990, and then to 3.8% in 2006.[38] *Bumiputera* have benefited from this trend, and among this group poverty decreased from 65% to 8.3% between 1970 and 2004.[39] Improvement in economic indicators can also be perceived in the per capita GDP that has moved from US$387 in 1970 to US$5,859 in 2006. Malaysia has also improved the income distribution and the Gini coefficient dropped from 0.513 in 1970 to 0.462 in 2004.[40] However, the Gini coefficient has deteriorated since 1999 when it was 0.452.[41]

---

[36] See e.g., Robin Brant, *Malaysia's lingering ethnic divide* (2008) BBC News <http://news.bbc.co.uk/go/pr/fr/-/1/world/asia-pacific/7121534.stm> at 6 April 2008; The Economist, 'Political Tsunami?' The Economist (2008).

[37] The Times of India, 'Ethnic Indian Protest Rock Malaysia', The Times of India 26 November 2007.

[38] World Bank, *10 Years After the Crisis* (2007) 58.

[39] Economic Planning Unit Prime Minister Department, above n 34, 331.

[40] Economic Planning Unit Prime Minister Department, Malaysia, *Ninth Malaysia Plan 2006-2010* (2006) 332.

[41] Ibid.

In terms of the Human Development Index (HDI), Malaysia shows one of the most impressive records in the improvement of human conditions in the last 30 years (see Table 1).[42]

**Table 1: Selected Latin American and Asian countries Human Development Index Growth, 1975-2005**

Please see print copy for Table 1

Source: United Nation Development Programme, 'Human Development Report 2007/2008/Fighting Climate Change: Human Solidarity in a Divided World' (UNDP, 2007).

The numbers show that while Venezuela, for example, had an excellent HDI of 0.719 in 1975, three decades later, it shows a similar HDI of 0.788, an improvement of just 0.069. On the contrary, Malaysia moved from 0.616 to 0.808 in the same period, a difference of 0.192 (see Figure 7 in Chapter 7).

The restructuring of society that sought for a suppression of ethnical classification of economic functions has also achieved some degree of success and now, *Bumiputera* has a larger participation in economic activities such as industry, manufacturing and services.[43] The same could be said regarding the ownership of corporate capital in which Malays passed from 2.4% in 1970 to 18.9% in 2004.[44]

[42] The HDI is a composite measure of human development prepared each year by the United Nations Development Programme. The indicator considers life expectancy, health, education and purchasing power parity. See section 2.2.

[43] See Economic Planning Unit Prime Minister Department, above n 34; see also Leete, above n 27.

[44] See Leete, above n 27, 162.

However, official numbers have been highly disputed with some experts placing the figure in a higher position.[45]

Recent research by Richard Leete concludes that although is difficult to determine the extent to which the affirmative action programs designed under the NEP contributed with the successful eradication of poverty in Malaysia, it is clear that such initiatives helped to improve productivity of rural farmers and boosted development in that area, facilitating the reduction of rural poverty.[46]

## 5.4 Economy

Malaysia was one of the most lucrative British colonies.[47] During the first decades of the twentieth century, the economy was dominated by agriculture and mining.[48] Since 1969, the Malaysian government has assumed a protagonist role in the economy, leading the industrialisation process. However, the government's action has been directed to establish what Tham called 'a selective integration into the world economy'.[49] This selective integration refers to the implementation of limited liberalisation policies combined with the requirements imposed by the NEP and other social policies to advance *Bumiputera's* welfare.

After the British left Malaysia, the new government sought a development model that implied state intervention, designing policies oriented to diversify the economy and promote faster capital accumulation through an import substitution program.[50] Under this view, for instance, the government stimulated oil palm crops and offered incentives to those industries that manufactured imported goods. Those first

---

45 See LJ Wong, *Flaws in EPU's apparent methodology* (2006) malaysiakini <http://www.malaysiakini.com/opinions/58306> at 28 November 2006; Edmund Terence Gomez, *Who owns Corporate Malaysia?* malaysiakini <http://www.malaysiakini.com/opinions/39516> at 11 April 2008; Andy Mukherjee, *Malaysia's `Riot' Bogey Quells Economic Debate* (2006) Bloomberg <http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=azL3LMMQpOTA> at 24 October 2006.

46 Leete, above 27, 175.

47 K.S. Jomo, 'The Malaysian Development Dilemma' in Mushtaq Khan and Kwame Sundaram Jomo (eds), *rents, Rent-Seeking and Economic Development/Theory and Evidence in Asia* (2000) 274-303, 278.

48 For a complete account of Malaysia's economy history, see John Drabble, An Economic History of Malaysia, c. 1800-1990/the Transition to Modern Economy Growth (2000).

49 Siew-Yean Tham, 'New Approaches to Trade and Investment in the Post-Crisis Era: The Case of Malaysia' (Paper presented at the 12th Meeting of the Steering Group of the Committee on Regional Economic Cooperation, Inchon City, Korea, 25-27 October 2000) 8. See also See Bank Negara Malaysia, *the Central Bank and the Financial System/A Decade of Change* (1999).

50 Jomo, above n 47, 284.

experiments focused on primary products.[51] The experience was positive and by 1973, 90% of consumable goods used in the country were produced in Malaysia.[52]

Despite of the achievements of the import-substitution model, it was unsustainable because the domestic market was small and thus it had become saturated. Additionally, the model helped to undermine Malaysian political stability because it favoured foreign corporations and a small group of local companies mainly controlled by Chinese.[53] This environment contributed to the 1969 ethnic riots.

Before the end of the 1960s, the government moved to export-oriented industrialisation. The economic policy of the government included credit facilities, tax deductions and the settlement of free trade zones.[54] This coincided with the launch of the NEP policies.

Malaysia also has oil reserves and, taking advantage of the high prices of the 1970s, the Parliament passed the Petroleum Development Act that facilitated a better control of the whole industry by *Petroliam Nasional Berhad* (PETRONAS), the state-owned oil corporation. High oil revenues served to finance the industrialisation process in Malaysia and the accentuation of the public sector intervention in the economy.[55] The contribution of oil rocketed from a participation of total exports from 3.9% in 1970 to 23.8% in 1980.[56]

At the beginning of the 1980s, the new Prime Minister Mohamad Mahathir decided to promote a heavy industrialisation policy (for example, iron, steel, cement, cars, etc.) inspired by the model implemented in Japan and Korea.[57] This policy was funded primarily through the Heavy Industries Corporation of Malaysia and foreign sources. One of the most emblematic projects developed under the heavy industrialisation policy was *Perusahaan Otomobil Nasional* (PROTON), a joint venture between the Japanese corporation Mitsubishi and the Malaysian government.[58]

---

51 See Drabble, above n 48, 235.
52 Ibid.
53 Jomo, above n 47.
54 United Nation Development Programme, above n 24, 16.
55 Jomo, above n 47, 288.
56 Leete, above n 27, 104.
57 Drabble, above n 48, 200.
58 Kit G. Machado, 'Japanese Transnational Corporations in Malaysia's State Sponsored Heavy Industrialization Drive: The HICOM Automobile and Steel Projects' (1989-1990) 62 *Pacific Affairs* 504-531.

However, conditions forced the government to employ an opposite strategy, looking to rationalise the size of the state. [59] These conditions included: a deterioration of global markets later in the 1980s; the discontent of Mahathir due to the size of the state; the lack of productivity of public enterprises; and the failure to meet NEP targets. The public sector was experiencing a worsening crisis produced by the deterioration of oil prices and the values of other primary products, as well as the recurrent losses of public enterprises. The solution was the implementation of a privatisation program that was extended until the 1990s.

As a product of the different governmental strategies, Malaysia transformed first from an agricultural economy to a primary sector economy; and then, into a more diversified economy in which the secondary and tertiary levels prevailed. Changes experienced by the Malaysian economy contributed to an annual GDP growth average of 6.4% between 1970 and 2006. Likewise, the agriculture sector's contribution to the GDP dropped from 26.7% to 8.2% in that period. A similar change occurred with mining activities that went from 16.5% to 6.6% between 1970 and 2006. Meanwhile the industrial sector jumped from 12.2% to 31.8%.[60] These figures showed how Malaysia, in three decades, was able to achieve a more diversified and developed economy.

The industrialisation process also reshaped exports in Malaysia. In the 1980s agriculture (39.8%) and mining (32.7%) were the major contributors to Malaysian exports and manufacturing was only 22.4%.[61] In 2006, agricultural and forestry products were 12.7% of Malaysian exports and oil and gas 14.8%; while manufactured products represented 72.3% of exports (on which electrical and electronic goods totalised 56.2%).[62] The manufacturing sector represents about 30% of the GDP and it is the most important component of Malaysian economy.[63] Based on those figures, some authors claim that Malaysia is already an industrialised country.[64]

---

59 See Drabble, above n 48, 201. See Edmund Terence Gomez and K.S. Jomo, *Malaysia's Political Economy/Politics, Patronage and Profits* (2nd ed. 1999).

60 United Nation Development Programme, above n 24, 16; Economic Planning Unit, Malaysia,, *Key Economic Indicators* (2007) Economic Planning Unit, Prime Minister Department, Malaysia <http://www.epu.jpm.my/New%20Folder/Figures2007/chapt1.pdf> at 23 August 2007.

61 United Nation Development Programme, above n 24, 17.

62 Department of Statistic Malaysia available at: http://www.statistics.gov.my/english/frameset_keystats.php?fid=a at 16 July 2007.

63 United Nation Development Programme, above n 24, 17.

64 See e.g., Pawel Bozyk, *Globalization and the Transformation of Foreign Economic Policy* (2006); see also Gerald Tan, *The New Industrialising Countries of Asia* (4th ed, 2004).

## 5.5 Legal System

### 5.5.1 Malaysia's Legal Pluralism

Behind the optimistic numbers that show a positive Malaysia that has advanced a considerable path to achieve economic development and abate poverty, there is a legal system that has served to support the implementation of the government's development plans. This legal system has received the influence of three main sources: customary laws, Islam and English common law.

Malay customary law is called *adat*, 'the notion includes … rules of law, what we would describe as canons of morality and justice, respect for tradition, and kingship structures'.[65] With the arrival of Islam to the Peninsula in the fourteenth century, this religion began to have a great influence in the legal system and Muslim laws were applied alongside Malay customary law. While states' constitutions declare Islam as the official religion, they also preserve Malay customs.[66] However, after the arrival of the British, the Malaysian legal system underwent a process of secularisation and Islam was confined to personal laws (such as family and inheritance law).

Among the Europeans who ruled Malay territories, the Portuguese and Dutch contributed little to the Malay legal system. It was the British that had most influence in Malaysia. English law was introduced in Peninsula Malaysia at the beginning of the nineteenth century. It was transplanted through three Charters of Justice in 1807, 1826 and 1855. These Charters made British law enforceable 'subject in its application to the various races to such modifications as are necessary to prevent it from operating unjustly and oppressively'.[67] Based on this provision, courts implemented British law subjected to religious and customary norms. The application of Malay, Indian and Chinese customary laws, as well as Islamic law, was limited to family and inheritance matters on a case by case basis.[68] In very limited cases, English courts administered customary law to resolve financial matters. Hooker mentions two examples: the money-loan association common among Chinese; and money-lending contracts that were practiced among Hindus.[69]

---

65 M.B. Hooker, 'The Challenge of Malay Adat Law in the Realm of Comparative Law' (1973) 22 *International and Comparative Law Quarterly* 492-514, 492.
66 Ibid 508.
67 Poh-Ling Tan, 'Malaysia' in Poh-Ling Tan (ed), *Asian Legal Systems* (1997) 263-313.
68 See M.B. Hooker, A Concise Legal History of South-East Asia (1978).
69 Ibid 373-375.

This mixture of different types of laws made the Malaysian legal system plural in which Malay, Indian and Chinese customary laws were applied by British courts mixed with Islamic law and the common law. In the financial sector, the legal system was modelled following mainly a Western approach, as will be explained in the following chapter. However, a segment of the banking system is regulated under Syariah law.

### 5.5.2 The Constitution of Malaysia

***a) The Drafting of a Constitution in a Multi-Racial Society***

As explained in an earlier section, Malaysia is a multi-ethnic and multi-religious country. This complexity affected the drafting of the Malaysian Constitution and the final result reflects this diversity.

Malaysia adopted a parliamentary constitutional monarchy. The parliamentary system works at federal and state levels. The Constitution promulgated on August 1957 was drafted by a team known as the Reid Commission. This group was formed as a result of the discussions held in London in 1956 among the British authorities, Malay rulers and representatives of the Alliance that had won the 1955 elections. Lord Reid chaired the Commission that also incorporated experts from Australia, India and Pakistan.[70]

The Reid Commission prepared the Constitution and attended a specific set of terms of reference, agreed to at the London Conference: (i) the country would adopt a parliamentary democracy; (ii) the rulers would maintain their political powers as a head of the states; (iii) the head of the federal state would be selected among the rulers; (iv) a common nationality would be given to the people of all states; and (v) it would be agreed a preferential position to Malays.[71]

After the Commission presented its report and a draft of the Constitution in February 1957, the Charter was promulgated with some modifications in August 1957. The Malaysian Constitution followed a Westminster model; nonetheless it also incorporates features that reflected Malaysian particularities such as the adoption of

[70] The other members were Sir Ivor Jennings (United Kingdom), Sir William Mckell (Australia), Justice B Malik (India) and Justice Abdul Hamid (Pakistan).

[71] Abdul Aziz Bari, *Malaysian Constitution/ A Critical Introduction* (2003) 26.

a constitutional monarchy that maintains the favoured positions of Malay rulers; the respect agreed to the Islam and the special privileges for Malays.

***b) Islam in the Malaysian Constitution***

Arab merchants and Sufi missionaries brought Islam to Peninsula Malaysia in the fourteenth century.[72] After Parameswara, the first Sultan of Malacca, converted to Islam, other royal houses followed. As a consequence of this influence, rulers governed their sultanates according to law and norms derived from Islam and Malay customs.[73] The Islamic tradition was maintained in the *Merdeka* Constitution that declares Islam as the official religion (article 3.1). However, the Constitution also grants freedom to practice any other faith.[74]

In spite of the adoption of Islam as the official religion, Malaysia is not considered an Islamic state.[75] The proclamation of an official religion has been understood as a guide for the nature of state ceremonies.[76] Nonetheless, there is a movement that has pushed for the establishment of an Islamic state in Malaysia.[77] This has been the case of the Islamic Party of Malaysia (PAS) that has championed for the adoption of an Islamic state model.[78] Advocates of a stronger role for Islam in the state claim that the separation of religion from politics and socio-economic affairs was influenced by the British but it is a conception that did not find support on the real comprehensive nature of Islam.[79]

Although Islam is highly respected in Malaysia and it is followed by 60% of the population, there is also an important portion of the people who practice other religions, making the adoption of an Islamic state model difficult, especially as the government has always sustained as one of its main goals the maintenance of national harmony. This perspective was ratified by the Prime Minister Datuk Seri Abdullah Ahmad Badawi, during the 2007 UMNO Annual General Assembly, during which he called for mutual respect among the followers of different religions and

---

72 Harding, Andrew, 'The Keris, The Crescent and the Blind Goddess: The State, Islam and the Constitution in Malaysia' (2002) 6 *Singapore Journal of International & Comparative Law* 154-180, 159.

73 Ibid.

74 However this freedom has been limited and there has been a controversy associated with matters relating to conversion to and renouncement of Islam. See Nurjaanah Abdullah, 'Legislating Faith in Malaysia' (2007) 2007 *Singapore Journal of Legal Studies* 264-289.

75 Harding, above n 72.

76 Ibid 158.

77 See Bari, above n 71, 46.

78 PAS strategy to adopt an Islamic state has changed through time and the party has included or excluded this point from its political agenda depending on circunstances. See The Star, 'PAS: Islamic state agenda is still on', The Star 22 April 2008;

79 See e.g., Aidit Ghazali, Development/An Islamic Perspective (1990).

also warned about narrow interpretations of Islam that may cause disturbances among other faiths.[80]

Islam is applied by Syariah courts only to Muslims in matters related to marriage, divorce, adultery, inheritance and other social, cultural and ritual matters.[81] Article 120 (1A) of the Malaysian Constitution states that the High Courts shall not have jurisdiction in respect of any matter within the jurisdiction of the Syariah courts. Nonetheless, they would have power to determine whether or not a decision is made within jurisdictions by Islamic courts.[82] Syariah law also apply to financial institutions involved in Islamic banking business.[83]

Finally, the Constitution defines Malays as a person 'who professes the religion of Islam, habitually speaks the Malay language, conforms to Malay custom'. Hence, the practice of Islam is used by the Constitution as one of the characters that defines a Malay person, a notion that is essential for the legal system and determines whether or not a person can enjoy the special status granted to Malays.[84]

***c) Special Position of Malays***

During the process of drafting the Constitution, the British championed an equalitarian approach that guaranteed the same rights for all races living in the Malaysian territories. This approach was one of the reasons why the previous British Malayan Union proposal did not have local support. Malays considered that it was a risk to concede all the same rights to the Chinese. During the British colonial period, Malay rulers maintained a predominant political position and they were not ready to waive such preferential status in favour of the Chinese that already controlled an important part of the economy. For this reason, in order to balance the Chinese economic power, it was agreed to include in the Constitution several provisions recognising a special position for Malays.[85]

---

80 The Star, 'Datuk Seri Abdullah Ahmad Badawi: Strengthening Confidence-Venturing into a New Era', The Star (Kuala Lumpur), 7 November 2007.

81 Ghazali, above n 79, 131.

82 See Harding, above n 31, 137.

83 See chapter 6.

84 The Constitution grants also a special status to natives of Sarawak and Sabah.

85 Harding points out that the Reid Commission accepted the special position of Malays but it recommended that the privileges be reviewed by the Parliament after 15 years. See, Harding, above n 31, 120.

The idea of equalitarianism defended by the British was included in article 8.1 of the Constitution of Malaysia, which declares, 'All persons are equal before the law and entitled to the equal protection of the law'. Nonetheless, section 8.2 provides that the Constitution could authorise selective discrimination on the grounds of religion, race, descent or birth on matters related to property or the establishing or carrying on of any trade, business, profession, vocation or employment. Based on this norm, another constitutional provision imposes on the *Agong* the responsibility to guarantee the special position of Malays and natives of Sabah and Sarawak (article 153.1). The special status of Malays and natives of Sabah and Sarawak is translated in privileges to be appointed on positions in the public services and scholarships; and preferences to obtain permits or licences for the operation of trade or business (article 153.2).

Additionally, the Constitution ensures that a proportion of places in universities and colleges be reserved to Malays and native of Sabah and Sarawak (article 153.8A). The constitutional special status establishes in the Constitution has been also developed by laws and other administrative regulations that for instance order banks to grant a portion of the total loans to Malays; or mandate companies listed in the Kuala Lumpur Stock Exchange to sell 30% of their shares to *Bumiputera*.

The special status granted by the Constitution to Malays has represented the exclusion of the Chinese-Malaysians and Indians-Malaysians from state programs even, if they are in a disadvantaged position. Currently, Indian-Malays have been involved in protests that have tried to create awareness of the state of poverty that affects this ethnic group and the lack of governmental programs that address the issue.[86]

***d) Structure of the Federal Government***

***The Head of State:*** The *Yang di Pertuan Agong* (the *Agong*) is the head of state. The *Agong* is elected among the Malaysian sultans for a term of five years. Nine of the thirteen Malaysian states have hereditary rulers who are also head of states of their respective states.[87]

[86] Brant, above n 36; The Times of India, above n 37.

[87] Perlis, Kedah, Kelantan, Terengganu, Perak, Selangor, Negeri Sembilan, Pahang and Johor. See Bari, above n 71, 59.

The hereditary nine rulers constitute the Conference of Rulers (*Majlis Raja-Raja*) that selects the *Agong*. The states that do not have hereditary rulers are represented in the Conference by *Yang di Pertua Negeris*. According to the Malaysian Constitution, the *Agong* is elected and can be only removed by the Conference of Rulers (article 32). The *Yang di Pertua Negeris* do not participate in those Conference's proceedings associated with the election or removal of the *Agong* (Fifth Schedule).

The *Agong* is basically a ceremonial figure. The *Agong* performs his executive duties on the advice of the Prime Minister. However, the Constitution reserves to the *Agong* the power to appoint the Prime Minister and the right to refuse a petition to dissolve the Parliament (article 40a.2). Likewise the *Agong* is the supreme commander of the armed forces.

In spite of this ceremonial position of the *Agong*, some authors argue that he may play a key role as the ultimate guardian of the Constitution and protector of the state and its citizens in cases of political instability that lead to dissolution of the legal government.[88] Malaysians have also perceived this need for a more active participation of the *Agong*, perhaps in a similar role than the one played by the King of Thailand. A group of protesters recently directed a petition to the *Agong*, asking for his intervention to improve their political rights.[89]

***The Parliament:*** According to the Constitution, the federal legislative authority consists of the *Agong* and two Houses: the Senate (*Dewan Negara*) and the House of Representatives (*Dewan Rakyat*). The *Agong* does not sit in the Parliament. The Senate has two members elected by each state legislative assembly. The senators of the federal territories are selected by the *Agong*. The other forty members are appointed by the *Agong* among people who 'have rendered distinguished public service or have achieved distinction in the professions, commerce, industry, agriculture, cultural activities or social service or are representative of racial minorities or are capable of representing the interests of aborigines'.[90] Members of the House of Representatives are elected by secret and universal suffrage.

---

88 Ibid 52.
89 See The Economist, 'Not mellow yellow', The Economist 15 November (2007).
90 Article 45 (2).

The Parliament is mainly responsible for the passing of laws and exercises control over the executive. The Parliament also has the power to amend the Constitution with the favourable vote of two-thirds of its members. Laws are enacted by the *Agong* and the two houses acting in agreement.

In the last few years, the Parliament has been passive and basically follows the dictates of the executive. To illustrate, Shad Saleem Faruqi points out that over a period of five years between 1990 and 1995 about 80% of the bills proposed by the government were passed without any change by the Parliament.[91] The passive role played by the Parliament since *Merdeka* is attributed to the fact that the *Barisan Nasional* (BN), the governmental coalition, controlled the two-thirds majority required to take most parliamentarian decisions between *Merdeka* and March 2008.[92] The BN has a very strict party discipline and generally all BN parliament members vote following partisan instructions.[93]

***The Executive:*** The *Agong* is vested with the supreme executive authority which he exercises on the advice of the Prime Minister. In practice, the Prime Minister and his Cabinet lead the government and exercise the powers granted to the executive branch. The Prime Minister is the strongest figure in Malaysian politics and he is selected among the members of the House of Representatives. The Prime Minister is generally the leader of the party or the coalition that controls the parliamentarian majority. The *Agong* appoints the Prime Minister.

The members of the Cabinet are selected by the *Agong* on the advice of the Prime Minister among the members of both Parliamentary Houses. The Cabinet is responsible to the Parliament.

During the financial crisis, Mahathir Mohamad was the Prime Minister. He governed Malaysia between 1981 and 2003. His government is frequently described as a period in which the executive branch increased its powers over the other two branches and other Malaysian institutions.[94] His legal strategies to concentrate state powers were always controversial, such as the 1980s judiciary crisis episode

---

91 Zainon Ahmad and Llew-Ann Phang, *The All-Powerful Executive* (2005) Sun2Surf <http://www.sun2surf.com/article.cfm?id=11381> at 23 May 2006.

92 The Barisan Nasional coalition substituted the Alliance in 1973. It is mainly formed by the UMNO, MCA, MIC and other smaller parties. In the March 2008 elections, BN lost for the first time the two-thirds majority in Parliament.

93 See e.g. Shanker Satyanath, Globalization, Politics, and Financial Turmoil/Asia's Banking Crisis (2006) 95.

94 See Gomez, above n 59.

discussed later in this chapter; or his dispute with the Rulers when he proposed and the Parliament passed a Constitutional amendment that would reduce the *Agong*'s powers (for example, the power to invoke emergencies would be transferred from the *Agong* to the Prime Minister).[95] In spite of this criticism, Mahathir has been also credited as the leader behind the successful industrialisation process experienced by the country.[96]

***The Judiciary:*** The Federal Court is the highest tribunal in Malaysia and jointly with the Court of Appeal, the High Courts and other lowers courts exercises the judicial powers. According to article 122B.1 of the Constitution, judges of the Federal Court, the Court of Appeal and the High Courts, including the Chief Justice of the Federal Court and the President of the Court of Appeal are appointed by the *Agong* acting on the advice of the Prime Minister and after consulting the Conference of Rulers. In practice, the *Agong* ratifies the candidates selected by the Prime Minister. However, it was recently reported that the Conference of Rulers aroused some issues associated with the nomination of a judge proposed by the Prime Minister to fill the vacancy as a Chief Judge of Malaya in 2007, a fact difficult to confirm considering that deliberations related to the appointment of judges cannot be disclosed under the Official Secret Act.[97]

Additionally, in November of 2007, it was reported that the Chief Justice Tun Ahmad Fairuz Sheikh Abdul Rahim retired, although he applied for an extension of his post.[98] The Chief Justice came under fire when he was involved in a controversy caused by the revelation of a video that showed a prominent lawyer having a phone conversation in which he offered judicial appointments.[99]

The judges of the Federal Court can be removed if the Prime Minister requires from the *Agong* under the argument of breach of the code of ethics, mental or physical inability to perform his duties or 'any other cause, properly to discharge the functions

---

95 See Lee, above n 28.

96 Hannah Beech and Baradan Kuppusamy, *"I'm being told you mustn't criticize the Prime Minister"* (2006) Time <http://www.time.com/time/magazine/article/0,9171,1552091,00.html> at 12 November 2007; Jane Perlez, *Mahathir, Malaysia's Autocratic Modernizer, Steps Down* (2003) New York Times <http://query.nytimes.com/gst/fullpage.html?res=9C0CE5DD1330F932A35752C1A9659C8B63&n=Top/Reference/Times%20Topics/People/M/Mohamad,%20Mahathir> at 12 November 2007.

97 Raphael Wong, 'Poser over vacant No.3 judiciary position', The Star 11 August 2007; See also The Star, 'Rulers did not object to candidate for CJM post, says Nazri', The Star 27 August 2007.

98 Chun Wai Wong, 'Rulers to discuss CJ's position', The Star 1 November 2007.

99 Sean Yoong, 'Inquiry exposes links between Malaysia's ex-chief judge, scandal-plagued lawyer', The China Post 18 January 2008. The Royal Commission presented in report in May 2008 and found that the video clip was authentic. See Shaila Koshy, How the commission decided in the Lingam video inquiry, The Star, 21 May 2008.

of his office' (article 125.3). In this case, the *Agong* must appoint a tribunal that will review issues and makes a recommendation.

In 1988, the constitutional process of article 125 was used to remove the Lord President and two justices of the Supreme Court, producing an institutional crisis that still affects the judiciary in Malaysia. The crisis involved not only legal issues related to the control that this branch should play in the country but also political elements that threatened the continuity of Mahathir as a Prime Minister.[100]

The judicial crisis started to grow in 1985 when the abolition of appeals to the Privy Council came into force and the Supreme Court assumed a more activist role in constitutional matters.[101] Between 1986 and 1988, various cases that affected the government were decided by the judiciary. Resolutions of such cases were not completely satisfactory for Mahathir's administration. One of the most emblematic decisions against the government at that time was made in *Berthelsen v Director General of Immigration, Malaysia & Ors*. In this dispute, a foreign correspondent applied for an order of *certiorari* against a notice of cancellation of his employment pass that would force him to leave the country.[102] The High Court refused Berthelsen's action, but the Supreme Court, applying rules of natural justice, ordered that a *certiorari* be issued to suppress the cancellation. The Supreme Court decided the case on the grounds that the Department of Immigration did not provide an opportunity for the accused to present his arguments.

Mahathir was furious and publicly criticised the Supreme Court's decision in the Berthelsen case.[103] He accused the judiciary of usurpation of executive prerogatives.[104]

Another decision that increased criticism against the judiciary was the annulment of article 418A of the Criminal Procedure Code in *Public Prosecutor v Dato' Yap Peng*

---

100 For a complete account of the 1988 Malaysian Judiciary crisis see Yatim, above n 30, ch 7; Lee, above n 28, ch 3; Andrew Harding, 'The 1988 Constitutional Crisis in Malaysia' (1990) 39 *International and Comparative Law Quarterly* 57-81; Visu Sinnadurai, 'The 1988 Judiciary Crisis and its Aftermath' in Andrew Harding and H.P. Lee (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 173-195.

101 Harding, above n 2, 142. Privy Council appeals in criminal and constitutional matters were abolished on 1 January 1978 and all other appeals on 1 January 1985, except for those appellations filed before such dates.

102 The correspondent worked for the Asian Wall Street Journal whose circulation had been banned by the government in September 1986. See Lee, above n 28, 45.

103 Ibid 47.

104 See Boo Teik Khoo, 'Between Law and Politics' in Kanishka Jayasuriya (ed), *Law, Capitalism and Power in Asia/the Rule of Law and Legal Institutions* (1999) 205-232.

in March 1987.[105] Provision 418A granted the Public Prosecutor with the power to issue a certificate requiring a court before which a case was pending to remove it to the High Court at such place as may be specified in the certificate. The High Court decided that this section 'did encroach upon the judicial power of the federation, which under Article 121(1) was vested in the courts.'[106] The Supreme Court dismissed the appellation brought by the Public Prosecutor and agreed that article 418A was an intromission of the legislative and executive branches into the judicial powers of the Federation.[107]

Encouraged by these judicial decisions that he considered contrary to his government, Mahathir proposed a constitutional amendment that, among other things, would limited the powers of the judiciary. The proposed change included the suppression of a phrase in article 121.1 that stated: 'the judicial power of the Federation shall be vested in the two High Courts … and the High Courts … shall have such jurisdiction and powers as may be conferred by or under federal law'.

The Amendment was approved and the new provision now reads as follows: 'There shall be two High Courts … and such inferior courts as may be provided by federal law and the High Courts and inferior courts shall have such jurisdiction and powers as may be conferred by or under federal law'. Until today, the extent of the effects produced by this amendment is still controversial. While some judges of the Federal Court believe the change really restricts the faculties of the judiciary to those powers conferred by or under federal law, others claim that courts are not mere agents of the federal legislature and jurisdictional powers of courts cannot be confined to federal law.[108]

Despite the above cases, experts coincide that the one that pushed Mahathir into an offensive strategy against the judiciary was the so-called 'UMNO 11' case.[109] This lawsuit involved a dispute between two factions of UMNO that were fighting over the control of the party and, as a consequence, the political control of the country if we consider that since independence, the President of UMNO has been also the Prime Minister of Malaysia.

---

105 See Lee, above n 28, 50.
106 Ibid 51
107 Ibid.
108 *PP v. Kok Wah Kuan* [2007] 6 CLJ 341 at 366.
109 Lee, above n 28; Yatim, above n 30.

In the partisan election held for the post of President and Deputy President in 1987, Mahathir won by a narrow margin of 43 votes.[110] A group of eleven members of the defeated faction sought for the annulment of the election based on the illegal status of various branches of UMNO that had not been registered as mandated by the Societies Act 1966. The High Court of Kuala Lumpur declared that due to the unregistered branches, UMNO became an unlawful society and therefore, the election was declared invalid and the previous elected authorities were still in office. The judge also decided that the plaintiff, as a member of UMNO, did not have rights or legal reliefs, which was illegal. The plaintiff appealed to the Supreme Court and in an unprecedented decision, the Lord President agreed that a full bench of nine judges would hear the appellation on 13 June 1988.[111]

The move by the Lord President signalled to Mahathir that the Supreme Court may have decided in favour of the plaintiff.[112] Hence, it was perceived that the future of Mahathir as Prime Minister was in the hands of the Supreme Court, led by Lord President, Tun Salleh Abas, who had expressed a critical position against the interference of the government in judiciary affairs. Indeed, in a letter dated March 1988 and addressed to the *Agong*, the Lord President explained the concerns of the judiciary about the criticism of the Prime Minister on matters associated with the way in which courts performed their duties. The letter had been agreed in a meeting held by various judges from Kuala Lumpur.[113] This letter would provide the excuse for the commencing of a removal procedure against the Lord President.

The *Agong* was disappointed with the letter and asked the Prime Minister to remove the Lord President.[114] Instead, the executive suggested that the *Agong* suspend the Lord President and appoint a tribunal as provided by in article 125 of the Constitution. The tribunal would look at the conduct of the Lord President and submit a recommendation on whether or not he should be removed. The *Agong* accepted the advice of the executive, the Lord President was suspended and the Chief Justice Tan Sri Abdul Hamid Omar was appointed Acting Lord President. The setting of a tribunal was also ordered. The same day that he was appointed, the Acting Lord President suspended the appeal hearing of the UMNO 11 case.[115]

---

110 Lee, above n 28, 52.
111 Ibid 53.
112 Yatim, above n 30, 322.
113 See Lee, above n 28, 45.
114 Ibid, 53.
115 See Yatim, above n 30, 331.

The tribunal constituted to judge the conduct of the Lord President included Hamid who was a potential successor of the accused. Besides, Hamid had attended the judge meeting in which it was decided to address the letter to the *Agong*. Another tribunal member was the Speaker of the Chamber of Representatives who was a retired judge. In spite of the criticism about the inadequate methods employed to select the tribunal's judges and other issues related to the implemented procedure (such as the fact that the process was privately held although the Lord President required a public hearing), the tribunal rendered a report recommending the dismissal of the Lord President. The recommendation was accepted by the *Agong* who ordered the removal of the Lord President that would take effect from 8 August 1988. The same day, the UMNO 11 appeal was heard and dismissed the next day.[116] In November 1988, Hamid was ratified as the Lord President.

Two more judges of the Supreme Court were removed in 1988. In this case, the Supreme Court had issued a limited order restraining the Salleh tribunal from submitting a report to the *Agong* until the tribunal was constituted by other more appropriate members.[117] The *Agong* disagreed and on the advice of the Primer Minister, suspended the five Supreme Court judges that issued the limited order and they were also subject to a removal procedure according to article 125 of the Constitution. The restriction order was later revoked by the Supreme Court that argued that a tribunal constituted under article 125 of the Constitution could not be restrained from its duties.[118] The second tribunal only found merits to recommend the dismissal of two of the five judges.

After the 1988 Constitutional Amendment and the removal of the Lord President and the other two judges of the Supreme Court, the judiciary has been more constrained and judges avoid discussions about the independence of the judiciary.[119]

Recently, in the aftermath of the 2007 judicial scandal caused by the Lingam's video, some have suggested that any serious effort aimed at restructuring the judiciary should begin with the issuance of an apology to the judges removed in 1988.[120] Surprisingly, although Prime Minister Badawi did not offer a formal apology,

---

116 Lee, above n 30, 57.
117 For a detailed account of the facts associated with the Supreme Court's decision see Yatim, above n 30.
118 Ibid 339.
119 Ibid. See also Lee, above n 28.
120 Shad Faruqi, 'Cleansing the judicial system', The Star 2 April 2008. See also The Star, 'Former LP welcomes council's call', The Star 23 August 2006.

he recognised the contributions of the sacked judges to the country and announced ex-gratia payments to them.[121]

## 5.6 The Limits of the Rule of Law in Malaysia

The work of the Reid Commission was inspired by British constitutional principles. The draft prepared by the Commission included an article declaring the supremacy of the Constitution:

> The Constitution shall be the supreme law of the Federation, and any provision of the Constitution of any State or of any law which is repugnant to any provision of this Constitution shall, to the extent of the repugnance, be void. Where any public authority within the Federation or within any state performs any executive act which is inconsistent with any provision of this Constitution or any law, such act shall void. [122]

The final version of the Constitution and subsequent amendments debilitated the original idea contained in the Reid Commission draft and made the supremacy of the Constitution dependable on other variables.[123] Currently, Article 4 of the Constitution that establishes the notion of the rule of law states:

1. This Constitution is the supreme law of the Federation and any law passed after Merdeka Day which is inconsistent with this Constitution shall, to the extent of the inconsistency, be void.

2. The validity of any law shall not be questioned on the ground that -

   (a) it imposes restrictions on the right mentioned in Article 9 (2)[124] but does not relate to the matters mentioned therein; or

   (b) it imposes such restrictions as are mentioned in Article 10 (2)[125] but those restrictions were not deemed necessary or expedient by Parliament for the purposes mentioned in that Article.

---

121 Shad Faruqi, 'Restoring Judicial Dignity', The Star 20 April 2008.
122 Extract cited from Yatim, above n 30, 64.
123 The Constitution of Malaysia has suffered 42 amendments that contained up to 650 changes. See Ahmad, above n 91.
124 Article 9 (2) refers to the freedom of movement.
125 Article 10 (2) refers to freedom of speech, right to assemble peacefully and the right to form associations.

3. The validity of any law made by Parliament or the Legislature of any State shall not be questioned on the ground that it makes provision with respect to any matter with respect to which Parliament or, as the case may be, the Legislature of the State has no power to make laws, except in proceedings for a declaration that the law is invalid on that ground or

   if the law was made by Parliament, in proceedings between the Federation and one or more States;

   if the law was made by Legislature of a State, in proceedings between the Federation and that State.

4. Proceedings for a declaration that a law is invalid on the ground mentioned in Clause (3) (not being proceedings falling within paragraph (a) or (b) of the Clause) shall not be commenced without the leave of a judge of the Supreme Court; and the Federation shall be entitled to be a party to any such proceedings, and so shall any State that would or might be a party to proceedings brought for the same purpose under paragraph (a) or (b) of the Clause.

The government has taken advantage of the re-accommodation of the supremacy of the Constitution and has developed a legal system that allegedly guarantees ethnical harmony, economic development and national security. Since the 1969 racial riots, these factors have played a crucial role in government strategies because it has been claimed that economic disparities among races produced tensions that threatened national security.

The Constitution has served to achieve the above objectives and it has been placed in the apex of this government's strategy since the 1970s when the Parliament passed an amendment that restricted the exercise of individual rights that may affect the building of national harmony among the different races. As a consequence, rights such as freedom of speech were constrained and could not be exercised to discuss matters such as the special position of the Malay people. In the political realm, instruments such as the Internal Security Act (ISA) that was initially conceived to combat communism after the revocation of the British Emergency Ordinance 1948, serves as a tool to penalise those who excess the limits imposed by the government.

In the economic sphere, the objectives of defeating poverty and restructuring the society served to justify the implementation of the NEP and the design of affirmative action programs that would improve the wellbeing of *Bumiputera*. The simple use of affirmative action would not raise major concerns because they have been employed in other countries regarded as holders of a strong rule of law. However, as Harding emphasises, the case of Malaysia is atypical. While most countries recognise special rights for disadvantaged minorities, Malaysia grants preferences to an ethnic cluster that represents about 60% of the population.[126]

In countries in which the Constitution incorporates an unconditional clause that guarantees equal protection to all citizens, positive action programs pose a difficult challenge to authorities that need to legally justify such actions. For instance, in the US, affirmative actions have been challenged over time; however, the Supreme Court has stated that, 'race-based action necessary to further a compelling governmental interest does not violate the Equal Protection Clause so long as it is narrowly tailored to further that interest'.[127]

Malaysia's case is different because since independence, factors such as the special position of Malays have played a relevant factor and the Constitution expressly provides for a divergent treatment that may be more beneficial for *Bumiputera*. This diversion from the principle of equality contained in the notion of the rule of law was based on the perceived disadvantaged position of Malays if compared with Chinese when the Constitution was drafted. The approach seems to find merit in the fact that 70.5% of the *Bumiputera* were poor in 1957, in contrast with 27.4% of the Chinese and 35.7% of the Indians.[128]

In addition to racial issues, religion has been another sensitive matter that has affected the notion of the rule of law in Malaysia. Since independence, there has been a debate about the place of Islam in public affairs with a faction pushing for a more comprehensive role for Islam (for example, extending the application of Syariah law to other areas beyond family matters).[129] The tension was recently recognised by the Prime Minister, Datuk Seri Abdullah Ahmad Badawi who urged for

---

126 Harding, above n 2, 229.
127 *Grutter v Bollinger*, 539 US 306 (2003).
128 Leete, above n 27, 141.
129 See e.g., Ghazali, above n 79.

mutual respect among the believers of different faith in Malaysia. The Prime Minister said:

> The disrespect and extremism shown by one party will elicit a similar response from another party. Violence by one side will breed violence from the other. Therefore, if we want our religion to be respected and understood, let us, in UMNO, show exemplary behaviour by respecting the followers of other religions and their needs.[130]

To accommodate racial, religion, economic and political tensions, the government has resorted to methods such as NEP and restrictions of rights (such as the limitation of the freedom of speech) that could be qualified as undemocratic and lacking of the principles of the rule of law. Experts who have studied Malaysia argue that in spite of the launching of *Rukunegara* in the 1970s that included the rule of law as one of the pillars to build a harmonious nation, the government has delivered its own understanding of the rule of law, avoiding a debate to publicly discuss the issue.[131] For Yatim, the rule of law in Malaysia means 'no more than the rules and regulations made by the government must be followed' and does not include the other well-developed attributes of the rule of law.[132]

Although there are differences between the notions of the rule of law and democracy, there are areas in which both concepts converge. In the discussion in Chapter 2 that presented a notion of the rule of law for developing countries, it was argued that it was necessary to build a concept linked to the notion of democracy. It was claimed that it would be useless to construct a notion far from citizen participation and in which the government, following its own interests or interests imposed from abroad (for example, international financial institutions) would establish a unilateral understanding.

In the case of Malaysia, it seems that there is little room for convergence and the government has been erected as the major player in the building of the notion of the rule of law. Meanwhile, people perceive that the Malaysian understanding of the rule of law is far from what it should be. It happens because the state has restricted the

---

130 The Star, above n 80.

131 See e.g., H.P. Lee, 'Competing Conceptions of Rule of Law in Malaysia' in Randall Peerenboom (ed), *Asian Discourses-Theories and Implementation of Rule of Law in Twelve Asian Countries, France and the US* (2004) 225-247; Yatim, above n 30.

132 Yatim, above n 30, 31.

public debate on the grounds of the high sensitiveness of the issues involved. As a consequence, the Malaysian rule of law is built on the basis of the racial and religious differences among its people and it grants the government the power to resort to ordinary or exceptional legislation to maintain such equilibrium.

In similar terms, limitations to the rule of law are also observed in the democracy practiced in Malaysia in which the former has been used to limit political rights that limit discussions about sensitive issues in the name of national harmony. These restrictions have forced scholars to label Malaysia as a soft-authoritarian or pseudo-democratic regime.[133] These adjectives reflect the coexistence of elements typical of a democratic system mixed with an authoritarian model. Thus, while the country has a government that periodically holds elections and has a multi-party system; the exercise of powers is mostly concentrated in the hands of a Prime Minister who manoeuvres to limit the opposition rights and win elections through electoral models that maximise benefits of favourable votes.

The manipulation of the electoral system has allowed the government to control the two-thirds majority in the Parliament, although *Barisan Nasional* obtained a lower percentage of the total votes.[134] To illustrate, the official coalition obtained 90% of the parliamentary seats, although it attracted only 64% of the total votes in 2004.[135] Results were similar in 2008 and although *Barisan Nasional* lost its two-thirds majority for the first time, it was able to obtain 63% of the parliamentary seats with only 51% of the vote.[136]

In addition to the particularisation of the rule of law concept oriented to racial harmony, economic development and national security, Malaysia is affected by a lack of a clear separation of powers among the executive, the parliament and the judiciary. While the Parliament was organised to oversee the executive, UMNO managed to control the two thirds legislative majority for more than forty years. This

---

133 Peerenboom uses the term ‘soft-authoritarian’. See Peerenboom, Randall, 'Varieties of Rule of Law' in Randall Peerenboom (ed), *Asian Discourses-Theories and Implementation of Rule of Law in Twelve Asian Countries, France and the US* (2004) 1-55, 16. Case prefers ‘pseudo-democracy’. See William Case, 'Malaysia's Resilient Pseudodemocracy' (2001) 12 *Journal of Democracy* 43-57. See also Harold Crouch, 'Malaysia: Neither Authoritarian nor Democratic' in K. Hewison, et al. (eds), *Southeast Asia in the 1990s* (1993) 135-157; Bridget Welsh, 'Attitudes Toward Democracy in Malaysia/Challenges to the Regime?' (1996) 36 *Asian Survey* 882-903.

134 See Case, above n 133.

135 Ibid. See also The Economist, above n 36.

136 The Economist, above n 36.

situation weakened the role of the Parliament as a counterbalance against the powers of the executive.

In a parliamentarian system, the limits between branches are sometimes blurry, but in the case of Malaysia the problem has special connotations for various reasons. First, UMNO has controlled the Prime Minister's office and two-thirds of the votes of the Parliament since independence. It allowed the amendment of the Constitution each time that it was required by the Prime Minister in order to enhance his powers. Besides, the two-thirds majority has been achieved without attracting a similar percentage of votes. Second, one of those constitutional amendments was oriented to diminish the faculties vested in the judiciary. The amendment produced a weakness in the public confidence of the judiciary that was before perceived as independent from the executive's influence.[137] Since then, the judiciary has not recovered its old reputation and while it has been described as a competent and professional, especially dealing with matters related to family, criminal and commercial issues, such positive attributes disappear when disputes are associated with political and business interest that affect UMNO (e.g. the UMNO 11 case).[138]

To summarise, the Malaysia's rule of law has special connotations that give more importance to law and order to achieve governmental stability, economic development and social peace. The result is a model in which authoritarianism and the restriction of individual rights coexist with a restricted version of the rule of law. The government claims that its approach has helped to achieve a successful record on economic growth and the reduction of poverty in the last 50 years.

## 5.7 Exceptional Powers in Malaysia

One of the most common instruments used by the Malaysian government to shape its concept of the rule of law is the invocation of emergency powers. It facilitated the coexistence of the ordinary legal system mixed with norms that belong to an emergency scheme.

---

137 For a more detailed description of the Malaysian judiciary in the 1980s and 1990s, see Khoo, above n 104. See also discussion on section 5.5.2 (d).

138 See Case, above n 133, 46; Lee, above n 131, 244.

States of emergency are not a recent phenomenon is Malaysia. The country has experienced states of emergency since colonial times. British authorities enacted exceptional regulations since 1888 when they issued a Public Order to control disturbances associated with the pugnacity among various Chinese secret societies.[139] This instrument granted the British authorities the powers to issue emergency regulations to address security and public order problems. In 1914, the British introduced the first formal emergency legislation, the Emergency Enactment 1914, to vest in the High Commissioner of the Federated Malay States exceptional powers in times of public emergency.[140] This legislation was designed to manage the situation of emergency associated with WWI. The 1914 Enactment was amended in 1915 to extend powers of the High Commissioner and exercised censorship of publications.[141] The 1914 Enactment was followed by similar legislations enacted in 1917, 1919 and 1930. Most of these norms were designed attending the UK Emergency Power Act 1920.[142] A common feature of the British regulations enacted to manage emergencies was to vest in the High Commissioner vast powers to issue any regulation that was required to address the exceptional situation (for example, the prescription of penalties and trials by court of summary jurisdiction). [143]

One of the most notorious and exceptional measures taken by the British government was the Emergency Ordinance 1948, which was enacted to deal with the Malayan Communist Party's (MCP) insurrection.[144] According to this Ordinance, the High Commissioner had the power to issue regulations reforming the ordinary criminal procedure. Exceptional norms issued based on the Emergency Ordinance 1948 could supersede any written law.[145] The Commissioner could also order arrests and detentions. The Emergency Ordinance 1948 was in force for twelve years when it was terminated by Prime Minister Tunku Abdul Rahman. However, the Emergency Ordinance 1948 was replaced by another legal instrument that contained similar exceptional powers, the Internal Security Act 1960 (ISA).

The Emergency Ordinance 1948 had profound consequences in Malaysia. This regulation affected not only its citizens but also the officials who took over after the

139 Yatim, above n 30, 193.
140 Ibid.
141 Ibid 194.
142 Ibid 195
143 Ibid.
144 Ibid 197.
145 Ibid.

British abandoned the country. While the former accustomed to live in a restricted human rights environment where the most important goals were racial harmony and economic development, authorities learned to manage the nation and its political, social and economic problems through the implementation of exceptional powers.[146]

Since *Merdeka*, the government has officially proclaimed four states of emergency, in 1964, 1966, 1969 and 1977. The first emergency was declared due to Indonesian hostilities against Malaysia that posed a real threat for the national security. At that time, President Sukarno of Indonesia was opposed to the formation of Malaysia and ordered small incursions to Malaysian soil.[147] Indonesia ceased hostilities without major consequences.

The next emergency was proclaimed in 1966 and it was limited to the state of Sarawak. It was invoked to resolve a constitutional impasse related to the removal of the Chief Minister, Dato Stephen Kalong Ningkan. Ningkan irritated the federal government by hiring expatriate officers and supporting secessionist Singapore.[148] Based on a letter signed by 21 of 42 members of the Council Negri (the state legislative body), in which they expressed their lack of confident in Ningkan, the Governor dismissed the Chief Minister. He judicially challenged the move and the High Court declared his removal unlawful on the grounds that a no-confidence vote was required.[149] Restated as a Chief Minister, it depended on Ningkan to summon the Council for a non-confidence vote against himself. The controversy was at a dead end.

Ultimately, the *Agong* declared a state of emergency in Sarawak. Subsequently, the Parliament issued the Emergency (Federal Constitution and Constitution of Sarawak) Act 1966. The Act temporarily amended the Federal Constitution and the Constitution of Sarawak allowing the Governor of that state to summon the Council Negri without the advice of the Chief Minister.[150] After the summons, the Council issued a non-confidence vote and Ningkan was finally removed from office.

---

146 Ibid. See also Crouch, above n 133.
147 See Harding, above n 2; Yatim above n 30.
148 For a detailed account of the Ningkan affair see H.P. Lee, 'The Ningkan Saga: a Chief Minister in the Eye of a Storm' in Andrew Harding and H.P. Lee (eds), *Constitutional Landmark in Malaysia/The First 50 Years 1957-2007* (2007) 77-87; Harding, above n 2, 160.
149 Harding, above n 2, 160.
150 Ibid.

The third emergency occurred in 1969 and was produced by the racial riots that forced the government to invoke a state of emergency.[151] In 1977 the federal government declared a state of emergency as a result of political tensions that broke out between the federal government and the state of Kelantan.[152] That year, the state government was controlled by the PAS and the UMNO tried to take over the government attracting the Chief Minister, Dato Mohamed Nasir, to its side.[153] The UMNO's strategy succeeded but it caused the division of PAS that expelled Nasir. Later, Nasir lost a vote of confidence in the state legislative assembly and then Nasir asked the Regent of Kelantan to dissolve the Assembly. However, the Regent did not act.

As a consequence of the inaction of the Regent, the *Agong* declared a state of emergency in Kelantan, arguing that the security and the economic life of the state had been threatened. Subsequently, the Parliament passed the Emergency Powers (Kelantan) Act 1977 suspending the State Constitution. The emergency Act vested the state executive powers in a Director of Government that acted on the advice of a State Advisory Council. Both were appointed and controlled by the Prime Minister. The scheme lasted almost four months and was finalised when the UMNO and a new political party organised by Nasir won the election.[154]

While the proclamations of emergency invoked in 1964 and 1969 may have been justified and based on real threats to Malaysia (such as Indonesian threats and domestic riots), the emergencies associated with Sarawak and Kelantan were more doubtful. In the latter cases, the federal government used the institution of the state of emergency to manage state political affairs that were not favourable to the federal government.

None of the four emergency proclamations described above have been formally finalised. Whereas political conflicts and the way in which the government has limited individual rights using emergency powers have gained most of the attention of experts, powers granted during the states of emergency have also helped to

---

151 See section 5.3.2

152 For a complete account of the four states of emergency see Yatim, above n 30. For the emergency declared in Kelantan, see Khairil Azmin and Bin Mokhtar, 'The Emergency Powers (Kelantan) Act 1977' in Andrew Harding and H.P. Lee (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007 (2007)* 135-143.

153 Harding, above n 2, 162.

154 Ibid 163.

manage socio-economic affairs in Malaysia. The most clear example of this situation was the 1969 riots that forced the *Agong* to declare a state of emergency

After the resolution of the 1969 riots and the implementation of the various national policies derived from the NEP, the Essential Power Ordinance of 1969 remained in force. It facilitated its invocation in 1986 when the government faced a financial threat produced by a crisis in the co-operative sector.[155] In that opportunity, the government enacted the Emergency (Protection of Depositors) Regulations in 1986. In the most recent 1998 financial crisis, exceptional powers were not used for specific economic purposes.

Today, it is easy for the Malaysian government to invoke exceptional powers to address day-to-day problems. The original Constitutional model was designed to avoid this risk. When the Reid Commission originally drafted the Malaysian Constitution in 1956, its members recognised it was crucial to include an emergency power scheme to facilitate the management of certain exceptional situations. Following this reasoning, the Commission included article 138 (the precursor of the current article 150), which regulates the declaration of state of emergency. The Reid Commission adopted an exceptional power model that was similar to the Roman dictatorship, in the sense that it incorporated various constraints to the power of the *Agong* to resort to this type of prerogative. Article 138 stated:

> (1) If the Federal Government is satisfied that a grave emergency exists whereby the security or economic life of the Federation or of any part thereof is threatened, whether by war or external aggression or internal disturbance, the Yang di-Pertuan Besar may issue a Proclamation of Emergency, in this referred to as a Proclamation.
> (2) When a Proclamation is issued in accordance with the provisions of clause (1), if Parliament is not sitting it shall be the duty of the Yang di-Pertuan Besar to summon Parliament as soon as may be practicable.
> (3) A Proclamation shall be laid before both Houses of Parliament and, if not sooner revoked, shall cease to operate at the expiration of a period of two months from the date of its issue unless, before the expiration of that period, it has been approved by resolutions in both Houses of Parliament.

[155] I will comment further on this crisis later in this chapter.

In spite of the intention of the Reid Commission to draft a wise emergency provision, the promulgation of the Malaysian Constitution was approved with some modifications that affected the model suggested by this Commission. In addition, six additional amendments of article 150 debilitated limitations imposed on the executive branch when it resorts to extraordinary measures, making the Malaysian exceptional power model a convenient instrument for the government to avoid constitutional limits.[156]

The current exceptional powers scheme is integrated in Part XI of the Constitution of Malaysia. This section contains three provisions related to emergencies. Article 149 gives special powers to the Parliament to enact exceptional legislation to face actions that threaten the peace of the country. When exercising this faculty, the Parliament can dictate laws contrary to constitutional provisions that guarantee fundamental rights such as life, freedom and property. The emergency legislation enacted based on article 149 is valid until the Parliament repeals it, without considering whether or not the event that justified its enactment still exists. The well-known Internal Security Act 1960 (ISA) was enacted based on article 149, and therefore, it is an emergency statute with a permanent character that can only be repealed by the Parliament.

Article 151 provides for certain rights under an administrative procedure for those detainees without trial, based on an emergency legislation. In this case, as soon as possible, the detainee must be informed of the basis of his or her detention. He or she would have three months to challenge the detention to an advisory board, whose members are selected by the *Agong*.

Finally, article 150 regulates the proclamation of emergency and the extraordinary faculties that can be exercised by the *Agong* after such a proclamation has been issued. The first paragraph of article 150 (1) states that the *Agong* may issue a proclamation of emergency if he is satisfied that a serious emergency exists that threatens the security, economic life or public order of the Federation. The *Agong* exercises this faculty with the advice of the Prime Minister (Article 40a (1)).[157] In addition, article 150 (2) extends further the exceptional faculties of the *Agong* and

[156] Yatim affirms that article 150 is the most amended constitutional provision. Yatim, above n 30, 209; See also Lee, above n 28; S. Jayakumar, 'Emergency Powers in Malaysia' in T. Mohamed Suffian, et al. (eds), *The Constitution of Malaysia/ its Development: 1957-1977* (1979) 328-369; and Bari, above n 71, 185.

[157] Nonetheless, Bari points out that the Federal Court has stated that the Agong may act in his discretion in issuing an emergency proclamation in certain circumstances. See Bari, above n 71, 189.

provides that he can also invoke an emergency if he believes that a peril is imminent. The Constitution does not assign any function to the Parliament or the judiciary in the determination of whether or not an event exists that justifies the proclamation of an emergency.

In 1983, the government amended this Article and gave the Prime Minister the absolute power to invoke emergencies. However, the Rulers opposed this change and a later Amendment (1984) returned this prerogative to the *Agong*.[158]

Sections 150 (2A) and (2B) grant the *Agong*, always acting with the advice of the Prime Minister, extensive powers to issue proclamations or ordinances in any matter when he thinks it is necessary due to the emergency. In the particular case of ordinances, the provision requires that both House of the Parliament are not sitting. In this situation, ordinances issued by the *Agong* have the same force and effects of parliamentarian acts (Article 150 (2C)). After the Houses of the Parliament are convened, the *Agong* lost his prerogative to legislate, providing that the legislative body does not delegate him that faculty.

Ordinances dictated according to provision (2B) will be in force until they are revoked or annulled by both Houses of Parliament (150 (3)). Also an ordinance issued under Section (2B) can expire after a six month period commencing with the date on which a Proclamation of Emergency ceases to be in force (article 150 (7)). An examination of the content of these two provisions demonstrates that emergency proclamations and ordinances are limited by time. Nonetheless, a termination of emergency proclamations or ordinances hardly occurs in Malaysia. This is because the Parliament has rarely revoked an emergency ordinance issued by the *Agong*. Second, the executive has never clarified the date upon which a Proclamation of Emergency ceases to be in force. As mentioned above, the Proclamations of Emergency issued in 1964, 1966, 1969 and 1977 have not been revoked. Malaysian courts have ratified that a proclamation of emergency, ordinances or regulations under its authority do not cease to be in force due to the passage of time or changes in circumstances.[159]

---

158 See Dato' KC Vohrah, et al., *The Constitution of Malaysia* (5th ed, 2004).
159 Ibid 621.

When the Reid Commission originally completed its work, they drafted an article that established that if a proclamation of emergency was not revoked or approved sooner by the Parliament, then such proclamation would expire at the end of the second month from the date of its issuance (see article 138 (3) drafted by the Reid Commission cited above). A modified version was incorporated into article 150 (3) in the *Merdeka* Constitution that made a differentiation between the proclamation and an ordinance:

> A Proclamation of Emergency and any ordinance promulgated under Clause (2) shall be laid before both Houses of Parliament and, if not sooner, shall cease to be in force:
>
> (a) a Proclamation at the expiration of a period of two months beginning with the date on which it was issued; and
>
> (b) an ordinance at the expiration of a period of fifteen days beginning with the date on which both Houses are first sitting, unless, before the expiration of that period, it has been approved by a resolution of each House of Parliament.[160]

This provision was deleted by the 1960 Constitutional Amendment and instead was included the two mechanisms previously explained, Sections 150 (3) and (7), as the only ways in which a proclamation or an ordinance can be revoked. Reality has proved that it is quite difficult for the application of both methods and, in practice, exceptional regulations have been indefinitely maintained.

Although article 150 (5) provides that during the application of a proclamation of emergency the Parliament will retain its faculty to enact any law that this body considers necessary for reasons of the emergency, it is the executive branch that controlled the management of the extraordinary situation. Indeed, the Parliament has used this faculty to pass legislation proposed by the executive (for example, the Emergency (Essential Powers) Act 1979).

Another exceptional power given by section 150 (6) to the *Agong* and the Parliament is to create norms that can be contrary to constitutional provisions. This regulation has been frequently used to limit human rights, arguing that it is necessary to fight the crises addressed by the government. Nonetheless, Section 150 (6A) does not

[160] Jayakumar, above n 156, 359.

extend the extraordinary powers of the Parliament to matters related to Islamic law, custom of the Malays, native law and custom in the state of Sabah or Sarawak. Hence, the Constitution places more importance on Islam and other indigenous customary law than on the other more universally recognised human rights guarantee by the Constitution (such as freedom of speech). Also the same provision clarifies that neither the Parliament nor the executive can issue provision inconsistent with constitutional regulations associated with religion, citizenship or language.

Finally, Section 150 (8) deserves a special comment. This provision states:

> (8) Notwithstanding anything in this Constitution
>
> (a) The satisfaction of the Yang di-Pertuan Agong mentioned in Clause (1) and Clause (2B) shall be final and conclusive and shall not be challenged or called in question in any court on any ground; and
>
> (b) no court shall have jurisdiction to entertain or determine any application, question or proceeding, in whatever form, on any ground, regarding the validity of:
>
> (i) a Proclamation under Clauses (1) or of a declaration made in such Proclamation to the effect stated in Clause (1);
>
> (ii) the continued operation of such Proclamation;
>
> (iii) any ordinance promulgated under Clause (2B)

This article was included in the Constitution Act (Amendment) 1981 and it debilitates the original institutional exceptional power arrangement adopted by the Malaysian Constitution.[161] This provision suppressed any possibility of judicial review in order to challenge the alleged existence of an emergency that justifies the adoption of exceptional powers, leaving this prerogative exclusively in the hands of the *Agong* and the Prime Minister. This section made useless other restrictions imposed by the Constitution on exceptional powers. It resembles the Schmittian maxim 'Sovereign is he who decides on the exception'.[162] Consequently, the *Agong* and the government have comprehensive powers to deal with an emergency, putting aside important devices that could avoid excess by the state.

---

[161] See Lee, above n 28, 104.

[162] Carl Schmitt, Political Theology: Four Chapters on the Concept of Sovereignty (1985) 5.

Some actions have been brought to courts to challenge the *Agong*'s faculties derived from the invocation of exceptional powers. Courts have been reluctant to decide against the government in cases related to exceptional powers.[163] One of the few cases ruled against the government was Teh Cheng Poh v Public Prosecutor (1979).

Since the different Proclamations of Emergency have not been revoked and the government has continued to rely on this special legal system in order to enact more regulations to manage events that are not necessarily related to the original emergency, the exception has precisely lost its unique nature and became a normal state of affairs in Malaysia.

## 5.8 The Rule of Law, Exceptional Powers and the Management of Financial Crises: The Case of the Essential (Protection of Depositors) Regulations 1986

The exceptional legality derived from the 1969 riots and the legal mechanism implemented by the government to face a situation that has arisen from a co-operative crisis in the 1980s, provides a good example to review the tensions produced between the notion of the rule of law, the executive emergency powers in Malaysia, and the flexibility that the government has to resort to an old emergency scheme to resolve financial difficulties completely unconnected with the causes that originally justified the invocation of such exceptional powers.

As explained above, when the 1969 racial uprising broke out, the *Agong* first issued a Proclamation of Emergency according to article 150 (1) of the Constitution and then the Emergency (Essential Powers) Ordinance 1969 on the grounds of article 150 (2) of the Constitution. As commented earlier, this instrument granted the *Agong* wide powers to issue any regulation that he considered necessary to guarantee public safety and order. The *Agong* delegated later his exceptional faculties to the Director of Operations who enacted several ordinances based on the Emergency (Essential Powers) Ordinance 1969.

[163] Lee, above n 28, 103; Yatim, above n 30, 228.

Until the Parliament reconvened in 1971, the existence of the state of emergency was justified to resolve the exceptional situation derived from the racial riots. However, the National Operations Council ceased to operate and the Parliament reassumed its work but the state of emergency was never lifted. The executive continued enacting ordinances based on article 150 (2) of the Constitution and the Emergency (Essential Powers) Ordinance 1969. Thus, the exceptional power scheme exists parallel to the ordinary system.

It was in 1979, after the Privy Council decided *Teh Cheng Poh v Public Prosecutor*, when the Emergency (Essential Powers) Ordinance 1969 was repealed.[164] On that occasion, the Privy Council declared the nullity of a trial followed against Teh Cheng Poh, an individual against whom the public prosecutor brought charges following a special procedure included in the Essential Security Cases Regulations 1975 (ESCAR), enacted by the *Agong* based on the Emergency (Essential Powers) Ordinance 1969. The Privy Council stated that ESCAR was null because at the time of its enactment in 1975, Parliament had already sat and the *Agong* had consequently lost his faculty to dictate ordinances with force of law by virtue of Article 150 (2B) of the Constitution.[165] Hence, the Privy Council considered that ESCAR and its subsequent amendments were *ultra vires* and therefore invalid.

Despite the partial judicial defeat of the government, the Privy Council avoided answering the most essential question about whether or not a Proclamation of Emergency must be considered to have ceased to be in force due to the events on which the emergency was supported no longer exist.[166] Thus, the Proclamation of Emergency 1969 maintains is validity.

Due to the Privy Council's decision and in order to continue relying on emergency powers, the government proposed the Emergency (Essential Powers) Bill 1979 that was passed by the Parliament using article 150 (5) of the Constitution. According to this provision:

---

164 See footnote 101. For a recent analysis of the The Cheng Poh case see Victor V. Ramraj, 'The Teh Cheng Poh Case' in Andrew Harding and H.P. Lee (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 145-155.

165 Yatim, above n 30, 231.

166 Ibid 232.

> While a Proclamation of Emergency is in force, Parliament may, notwithstanding anything in this Constitution make laws with respect to any matter, if it appears to Parliament that the law is required by reason of the emergency.

Hence, the Parliament considered that the state of emergency proclaimed in 1969 was still in force and passed the Emergency (Essential Powers) Act 1979. The immediate effect of this Act was the validation of all subsidiary legislation enacted or acts executed under the voided Emergency (Essential Powers) Ordinance 1969.

Today, the proclamation of the emergency declared in 1969 is still in force and the Emergency (Essential Powers) Act 1979 has been used to issue other emergency norms. In particular in the case of economic matters, the government enacted the Essential (Protection of Depositors) Regulations 1986 to face a debacle in the cooperative sector. The government acted due to problems associated with a group of deposit taking co-operatives (DTCs) that operated under the Cooperative Act 1963.

Since the 1960s, DTCs spread through Malaysia as an alternative to traditional banks. Cooperatives had minimal supervision and regulatory requirements. The weak regulatory framework allowed DTCs to aggressively attracted deposits and invested funds in volatile sectors like shares and real estate often in companies connected with DTC board members or staff.[167] DTCs were considered to be non-banking financial institutions that could only attract deposits from members; however, a depositor instantaneously became member paying a nominal fee together with his first deposit.[168] The Bank Negara Malaysia (BNM), Malaysian central bank, did not oversee DTCs that were supervised by the Department of Cooperative Development depended on the Ministry of National and Rural Development.[169]

The mismanagement of DTCs was unnoticed until failures of various non-banking finance institutions that illegally took deposits from public, creating panic in the Malaysian financial sector in 1985. The crisis affected DTCs and in July 1986, Kosatu, a DTC with 53,000 members, suspended payments of deposits.[170] Later, another 23 cooperatives ran out of money to pay withdrawals. The crisis affected

---

167 Andrew Sheng, 'Bank Restructuring in Malaysia 1985-88' (Working Paper WPS 54 World Bank, 1989) 14.
168 Ibid 13.
169 Ibid.
170 Ibid.

more than 520,000 members and deposits for an amount of RM 1.5 billion.[171] Authorities were afraid that the cooperative crisis expanded to the banking system, creating a systemic situation.

Due to the threats posed by the cooperatives crash, the government considered that it was essential to empower BNM to act and avoid a worst financial debacle.[172] The executive achieved this goal enacting the Essential (Protection of Depositors) Regulations 1986. Among the powers granted by these Regulations to the BNM were the faculties to investigate into the affairs of DTCs, execute search in offices or residences, take possession of books and documents, and freeze assets of failed cooperatives.

Months later and when it was thought that the cooperative crisis had been controlled, the BNM exercised its emergency powers under the Essential (Protection of Depositors) Regulations 1986 to investigate another cooperative that was not included among the 24 organisations initially questioned by the government. In *Jaffnese v Bank Negara Malaysia*, the appellant argued that the Regulations were repugnant to the Emergency (Essential Powers) Act 1979 and that it was invalid or *ultra vires* the parent Act and cannot be applied because the conditions existing at the time the Regulations were issued were not longer real.[173] The Supreme Court decided that:

> The Yang di-Pertuan Agong's powers under the Emergency (Essential Powers) Act 1979 were to make any regulations whatsoever which he considers desirable or expedient for the purposes mentioned in the Act and the Regulations in our view are related to the purposes contemplated by the said Act, as for example, the maintenance of public order and of supplies and services essential to the life of the community.[174]

Consequently, the court ratified BNM's actions. In addition, the Supreme Court stated that although the Regulations were issued to protect the interests of the depositors of the initial 24 cooperatives investigated by the government, nothing in its norms prevented the BNM from invoking the Regulations to tackle a similar

---

171 Ibid 14.
172 *Jaffnese Co-operative Society Ltd & Ors v Bank Negara Malaysia & Anor* [1989] 3 MLJ 150, 151-153.
173 Ibid 153.
174 Ibid.

situation with other cooperatives if the Bank was satisfied that the legal standards required by the Regulations were presented in this particular case.[175]

The issuance of the Essential (Protection of Depositors) Regulations 1986 and its later application to an additional case that was not included among the institutions originally targeted by these regulations serves to demonstrate how the Malaysian government could act to contain a financial crisis. It could opt to apply the ordinary legal system or to invoke the Proclamation of Emergency 1969 or the Emergency (Essential Powers) Act 1979, which are based on a situation that occurred almost forty years ago to issue new emergency regulations. This option is strengthened by the way in which courts decided the Jaffnese case.

[175] Ibid.

# CHAPTER 6

# THE ASIAN FINANCIAL CRISIS: A BANKING LEGAL PERSPECTIVE

# MALAYSIA

## 6.1 The Malaysian Banking System

By the second half of 1997, Malaysia was praised for having a sound banking system. Indeed, it was stronger and in better shape than other Asian nations affected by the crisis that broke out that year (e.g. Korea, Indonesia and Thailand).[1] However, the system was far from being perfect and the turmoil revealed its defects.

During the British colonial period, business banking in Malaysia was dominated by overseas institutions. The building of a true autochthonous financial system commenced with the creation of the Bank *Negara Tanah Melayu* or Central Bank of Malaya in 1959.[2] It later became the Bank Negara Malaysia (BNM). The Central Bank was regulated by the Central Bank of Malaya Ordinance 1958 that entered in force in January 1959.

When the Central Bank began operations, the major banking players were foreign institutions, and the few domestic institutions that existed were owned by Chinese family groups.[3] At that time, eighteen out of twenty-six commercial banks were owned by foreign capital and they were mainly concentrated in urban centres.[4] Consequently, the Central Bank had a strong interest in promoting domestic capital into the banking system.[5] The government also understood that in order to undertake its development plans, it needed a more locally owned financial sector, willing to accept public directions and reinvest funds in the same country.[6] Contrary

---

1 See for instance Stephan Haggard, *The Political Economy of the Asian Financial Crisis* (2000); Margery Waxman and Nagavalli Annamalai, 'Systemic Bank Insolvency: A Legal Framework for Early Crisis Containment' (Work Bank, 1999).

2 To see a more detailed account of the establishment of the Central Bank of Malaysia see Hock Lock Lee, Central Banking in Malaysia (1987)

3 Edmund Terence Gomez and K.S. Jomo, *Malaysia's Political Economy/Politics, Patronage and Profits* (2nd ed. 1999) 60.

4 Lee, above n 2, 318.

5 Bank Negara Malaysia, the Central Bank and the Financial System/A Decade of Change (1999) 61.

6 Lee, above 2, 319.

to this fact, at that time, most financial institutions were dedicated to finance trade and working capital of large companies and they placed most of the surplus out of Malaysia with their parent banks that invested it elsewhere.[7]

The Central Bank shaped the banking system and promoted domestic investment through a license system that entered in force with the Banking Ordinance 1958. This regulation required that any institution undertaking (or that was willing to assume) banking business apply for a license with the Ministry of Finance, which would consult with the Central Bank. Using banking licenses, the government reduced the possibility of the entry of new foreign banks.

In the second half of the 1960s, the state started to intervene more directly in the financial system and it organised the Bank *Bumiputera*, the first state-owned commercial bank in Malaysia, which was oriented to support Malay entrepreneurs.[8] The Bank *Bumiputera* was followed by other cases in which the government took control of troublesome commercial banks. In the 1970s, the stronger position of the public sector as a shareholder of different financial institutions helped to leverage its development programs, especially those related to NEP. In 1973, the Parliament enacted a new Banking Act in order to strengthen supervision powers of the BNM as well to modernise the regulation of the banking business.[9]

In the beginning of the 1980s, the government used its favourable position in the banking system to provide finance for the heavy industrialisation policy.[10] In the second half of that decade, an economic depression forced the government to take over various banking institutions, which were later privatised. This episode of bank weakness, in addition to the crisis in the deposit taking cooperative sector, pushed the BNM to work on the improving of prudential regulations and strengthen its powers to oversee non-financial institutions. The result of this revision was the Banking and Financial Institutions Act 1989 (BAFIA).

The 1990s began with a Malaysian banking legal structure that was fortified with the reforms produced in the 1980s. During this decade and before the Asian turmoil broke out, banking authorities applied what they called ‘a twin policy of prudent re-

---

7 Ibid.
8 Kok Fay Chin and K.S. Jomo, 'Financial Reform and Crisis in Malaysia' in Masayoshi Tsurumi (ed), *Financial Big Bang in Asia* (2001) 225-249, 229.
9 Bank Negara Malaysia, above n 5, 94.
10 Chin, above n 8, 230.

regulation and structural deregulation'.[11] Thus, parallel with the development of the new banking legislation and the issuance of prudent regulations, other measures were adopted to promote competition among domestic financial institutions. Lending interest rates were liberalised and banks were allowed to establish their own rates. Also, the segmented norms that regulated commercial banks, finance companies and merchant banks in different manner were progressively harmonised in order to create more competition among them. [12]

Despite of the legal changes adopted by the BNM and the Ministry of Finance to fortify the soundness of the banking system, the decade of the 1990s was marked by an overflow of loans associated with real estate and the acquisition of shares, instead of operations oriented to finance the economy, especially the export-oriented sector, which became the most important segment of the Malaysian economy in terms of exports and employment. Hence, borrowing growth exceeded the growth of GDP. Non-tradeable segments, such a property and purchase of shares, constituted 43.2% of credits granted by commercial banks (see Table 2).

**Table 2: Commercial Bank's Loans Property & Manufacturing 1997 Indonesia, Malaysia and Thailand (% of total loans)**

Please see print copy for Table 2

Source: IMF various reports (Indonesia and Thailand). Bank Negara Malaysia, *the Central Bank and the Financial System/ A Decade of Change* (1999).

Besides the financial aspects of government's policies targeting the development of the financial system, such policies also addressed the special status of Malays. Thus, financial authorities designed banking programs that, together with social schemes, advanced *Bumiputera*'s role in the economy. These programs involved efforts to increase *Bumiputera* ownership of banks, including the state share, in detriment of foreign and Chinese-Malaysian participation in licensed institutions. This mechanism worked and helped to elevate the participation of Malays and the government in the banking system from 3.3% to 60-70% between 1970 and 1990.[13]

[11] Economic Planning Unit Prime Minister Department Malaysia, 'Seventh Malaysia Plan 1996-2000' (Economic Planning Unit, 1996) 472.
[12] Bank Negara Malaysia, above n 5, 95.
[13] Gomez, above 3, 60.

Furthermore, BNM and the government designed programs that helped Malays to access credit facilities to start a business or improve their standards of living, charging preferential interest rates. In this regard, apart from the Bank *Bumiputera* initiative, the BNM forced banks to allocate between 20% and 30% of the total outstanding loans to *Bumiputeras*.[14]

By the second half of 1997, the banking system could be described as sound, supported by an average capital adequacy ratio of 12%, higher than the international standard of 8% recommended by the Basel Accord.[15] Meanwhile, Non Performing Loans (NPLs) were about 2.2% of total loans and the ratio of loan provisions to NPLs was close to 100%.[16]

## 6.2 Institutions of the Malaysian Banking System

**Table 3: Malaysia, Banking System**

| Banking System |
| --- |
| • **Bank Negara Malaysia (BNM)**<br>• **Banking Institutions**<br>  ▪ **commercial banks**<br>  ▪ **Islamic banks**<br>  ▪ **finance companies**<br>  ▪ **merchant banks**<br>• **Others**<br>  ▪ **discount houses**<br>  ▪ **representative offices of foreign banks**<br>  ▪ **Offshore banks in Labuan IOFC**[17] |

[14] Bank Negara Malaysia, above n 5, 411.

[15] Ibid 570. The capital adequacy ratio is a set of principles that measures a bank's financial strength. These principles have been developed by the Basel Committee of Banking Supervision and they are voluntarily incorporated in the banking legislation of many countries around the world. For an explanation of the Basel Accord see Laurent Balthazar, *From Basel 1 to Basel 3: The Integration of State-of-the-Art Risk Modeling in Banking Regulation* (2006).

[16] Bank Negara Malaysia, above n 5, 570. Non performing loans are those loans in which principal and interest payments are past due by 30, 90 or 180 days (it depends on the limit set by banking authorities). The average of NPLs versus the total loans helps to measure the quality of banking assets.

[17] The International Offshore Financial Centre (IOFC) was launched in October 1990 by the Malaysian government to promote the economic development of the Labuan region. In the IOFC, banking, financial and insurance companies offer their services regulated by the Offshore Banking Act 1990, the Offshore Insurance Act 1990 and the Offshore Companies Act 1990. All these regulations are enforced by the Labuan Offshore Financial Services Authority (LOFSA). The legal framework that governs the IOFC is business-friendly and it is considered most liberal than the legal framework that governs the banking business in the rest of Malaysia. See Bank Negara Malaysia, above n 5.

By 1997, when the Asian crisis started, the Malaysian financial system comprised three sectors: the banking system; the non-banking institutions; and the capital market.[18] This chapter will focus on the banking system and particularly on the BNM and the banking institutions.

The banking system was segmented by type of business. The Ministry of Finance (MoF) granted licenses to undertake a specific slice of the banking business. More recently, the BNM had implemented a rationalisation program to reduce the number of banks. It produced the organisation of banking groups that involved a commercial bank and other subsidiary institutions engaging in other types of banking business such as investment bank and Islamic banking. They advertise their services as a group.[19] The most relevant actors that coexisted in the banking sector were the BNM, commercial banks, Islamic banking, finance companies and merchant banks.

Commercial banks represent the most important segment of the financial sector. They owned about 61% of banking assets and represented 70% of deposits and loans in 1997.[20] Foreign commercial banks had a share of 12% of the banking assets. [21] By the time the crisis exploded, foreign commercial banks could only own up to 30% of the shares of a domestic bank. Additionally, the few foreign banks that operated in Malaysia were more restricted in their transactions than domestic banks (for example, foreign banks needed to syndicate their loans with a least one domestic bank).[22]

Commercial banks engage in conventional banking business (such as taking deposits and granting loans). Commercial banks are the only authorised to receive demand deposits. They also offer Islamic banking products, establishing a special window or through the organisation of a subsidiary Islamic bank (such as Affin Islamic Bank Berhad, AmIslamic Bank Berhad or RHB Islamic Bank Berhad).

In addition to the conventional banking business, the Malaysian system includes a segment that provides banking services following Syariah law. One of the Syariah

---

18 I am following the description provided by the Bank Negara Malaysia. See Bank Negara Malaysia, above n 5.

19 See for example the cases of Affin Group (http://www.affinbank.com.my), AM Bank Group (http://www.ambg.com.my/), RHB Group (http://www.rhb.com.my/) and Alliance Group (http://www.alliancebank.com.my).

20 Bank Negara Malaysia, above n 5, 390. BNM's statistic includes Islamic banks in this category.

21 Ibid 391.

22 Oh, Soo-Nam, 'Towards a Sustainable Banking Sector - Malaysia' in Asian Development Bank (ed), *Rising to the Challenge in Asia: A Study of Financial Markets* (1998) 33-78, 58.

principles that most affect banking activities is the prohibition to charge or pay interest, the basis of conventional banking.[23] Instead, providers of funds and entrepreneurs share benefits or losses of projects. Hence, if profits are obtained, investors and entrepreneurs share the result following pre-agreed proportions.[24] On the contrary, if the project fails, financial loss is assumed by the investor, while the owner of the project loses his labour.

Under Islamic law, a bank obtains its income from its share in the realised profits of the users of the funds, following a pre-established profit-share agreement.[25] The bank deducts expenses incurred in managing the funds and the remainder is distributed among the bank's shareholders and investment depositors. Following Syariah principles, Malaysian institutions involved in Islamic banking offer deposit-taking products such as currency and savings deposit under the concept of *Al-Wadiah Yad Dhamanah* (guaranteed custody). This means that a bank holds deposits for its customer without the payment of interests and it could use the funds at its own risk.[26] However, deposits are guaranteed by the bank. One of the most popular instruments in Islamic banking is investment deposits under the concept of *Al-Mudharabah* (profit-sharing).[27] In this case, banks and clients share the realised profits according with the arrangements agreed at the time of contracting.

The first full Islamic bank, the Bank Islam Malaysia Berhad (BIMB), was established in 1983. By 1997, there was only one Islamic bank and 52 other banking institutions that offered interest-free schemes.[28] Up until today, the MoF and the BNM have licensed eleven Islamic banks, including three Middle Eastern Islamic banks.[29] By 2006, Islamic banking represented 11.8% of total assets of the banking sector; 15.6% of the total deposits and 11.6% of the loans.[30] More recently, the BNM and the government have promoted the Malaysia International Islamic Financial Center (MIFC) Initiative. The idea is to harmonise Islamic banking practices and attract international banking business through special tax and regulatory treatment.

---

23 For an understanding of how Islamic banking works see Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking/History, Performance and Prospects* (2005).
24 Ibid 28.
25 Ibid 19.
26 Ibid 19.
27 Bank Negara Malaysia, above n 5, 243.
28 Ibid 245. See also Ministry of Finance, 'Economic Report 1998/1999' (1999) 160-166.
29 Kuwait Finance House (Malaysia) commenced operations in 2005 while Al Rajhi Banking & Investment Corporation and Asian Finance Bank started in 2006.
30 Ministry of Finance, 'Economic Report 2006/2007' (Ministry of Finance, 2007) 111.

Another type of banking institutions are the finance companies that engage in the leasing and hire-purchase business, in addition to the conventional banking business of receiving deposits (other than demand deposits) and providing loans. Under a BNM initiative, launched in 2004, the Central Bank encouraged finance companies to merge with their parent commercial banks and the latter would hold both licenses as a commercial bank and a finance company.

The last type of banking institutions are merchant banks that provide consultancy and advisory services associated with corporate and investment matters. These merchant banks also make and manage investments on behalf of other people. In its rationalisation process of capital market intermediaries, the Bank and the MoF promoted the merger of merchant banks, stockbroking firms and discount houses within banking group into investment banks.[31]

## 6.3 The Malaysian Legal Banking Framework

This section is restricted to a study of the three main pieces of legislation that regulated the banking system in 1997 and the most relevant regulatory aspects (for example, banking supervision, prudential regulations, lender of last resort and deposit insurance). By 1997, when the Asian crisis affected Malaysia, the banking system was mainly regulated by:

- The Central Bank of Malaysia Act 1958
- The Banking Financial Institutions Act 1989 (BAFIA)
- The Islamic Banking Act 1993 (IBA)

### 6.3.1 The Central Bank Act 1958

***a) Objectives***

As explained earlier, the Central Bank was launched in 1959 with the Central Bank of Malaysia Ordinance 1958 that later became an Act enacted by the Parliament. According to article 4 of the Central Bank Act, the main objectives of the BNM are: (i) to keep Malaysia's international reserves and safeguard the value of the Ringgit; (ii) to act as a banker and financial adviser to the government; (iii) to promote

[31] Ibid 107.

monetary stability and a sound financial structure; (iv) to promote a reliable and efficient payment and settlement systems and to assure that those systems will be directed to the benefit of Malaysia; and (v) to manage credit to the advantage of the country.

As with any other central bank, the BNM must act to preserve the country's international reserves and to maintain the value of the national currency through the control of inflation. Apart of being the banker of the government, the Central Bank Act orders the Bank to preserve the soundness of the financial structure, which it does by acting as a supervisor and regulator of the banking system.

It is interesting to note that the last two legal objectives require that the BNM promotes the reliability of the payments and settlement systems and manages the country's credit, attending to the advantage of Malaysia. This provision gives the Central Bank and the government the flexibility to pursue its social and redistribution objectives when designing monetary and other financial policies, attending to the very special social characteristics of the country. This is why the BNM has stated that:

> In meeting these objectives, the Bank is guided by the principle that it should act only in the economic interest of the nation and without regard to profit as a primary consideration. Hence, the functions of the Bank are carried out within the context of the broader goals of promoting economic growth, a high level of employment, maintaining stability and a reasonable balance in the country's international payments position, eradicating poverty and restructuring society.[32]

As with many other aspects of Malaysian public policy design, the Central Bank considers the NEP's strategies, as well as those of other development plans, when it formulates and implements its policies. Thus, the Bank must align its objectives with the government's primary goals of fighting poverty, advancing the economic situation of Malays and reducing the identification of work or economic activities with a specific race that is what they refer to as 'restructuring society'.[33] As a consequence, banking policies that discriminate between *Bumiputera* and other Malaysian citizens would be within the limits of the notion of the rule of law

---

[32] Bank Negara Malaysia, *Objectives & Functions* (2007) BNM <http://www.bnm.gov.my/index.php?ch=7&pg=1&ac=1> at 30 October 2007.

[33] See Economic Planning Unit Prime Minister Department, 'Malaysia: 30 Years of Poverty Reduction, Growth and Racial Harmony' (World Bank, 2004).

advanced by the Constitution (for example, special schemes that grant loans to Malays on favourable terms).

***b) BNM's Independence***[34]

The BNM is governed by a Board of Directors formed by a Governor, not more than three Deputy Governors and no less than five but not more than eight directors. There is currently a Governor, three Deputy Governors and five directors in the Board of BNM.

The Governor is in charge of the day-to-day administration of the Bank. The *Agong* appoints the Governor as well as the directors. According to provision 40a of the Constitution of Malaysia, the *Agong* exercises this faculty with the advice of the Primer Minister. Deputy Governors are appointed by the MoF. The *Agong* and the Prime Minister can terminate the appointment of the officials they designate based on the causes listed on article 11 (2) and 12 of the Central Bank Act (for example, resignation, a governor or director becomes of unsound mind or incapable of carrying out his or her duties, bankrupt, convicted or fails to comply with his or her legal obligations).

The Central Bank Act 1958 does not contain any specific provision declaring the independence of the Bank from the government's interference. Indeed, the Bank has been always seen as a part of the executive.[35] This perception is supported by the fact that the Bank's executives are appointed and removed by the government. Nonetheless, BNM's governors have enjoyed the stability to exercise their functions, and since 1959 the Bank has only had seven governors who have served for an average period of seven years.[36]

There have been some cases in which the governor has abruptly terminated his mandate due to pressure from the executive. The first case occurred in 1985 when the third governor of the BNM, Abdul Aziz bin Taha, was forced to resign due to disagreements with a newly appointed MoF, Daim Zainuddin.[37] Another case occurred when BNM Governor Jaffar Hussein resigned his post in April 1994, as a consequence of heavy losses suffered by the Central Bank due to the

---

34 For a discussion on independence of central banks and banking supervisors see section 2.7.1

35 Natasha Hamilton-Hart, Asian States, Asian Bankers/Central Banking in Southeast Asia (2002) 117-121.

36 This average contrasts with the 3.5 years in the case of the Central Bank of Venezuela that has had 19 presidents in 68 years.

37 Hamilton-Hart, above 35, 118.

mismanagement of foreign currency dealings.[38] The last person who resigned as a BNM Governor was Ahmad bin Mohamed Don, who was in charge when the Asian crisis affected Malaysia. He resigned in August 1998 because he did not agree with the rescue program implemented by the government, including the capital control measures adopted.[39]

The perception of the dependency of the BNM on the executive branch is confirmed by the content of Part VI of the Central Bank Act 1958, which regulates the relations between the Bank and the government. First, Section 34 (1) states that the Bank must inform the Minister of Finance about its monetary polices as well as its policies with respect to institutions prepared according to BAFIA, IBA, the Insurance Act 1963, the Takaful Act 1984 and the Money-Changing Act 1998. The Bank also must inform the Minister of Finance on policies related to the Exchange Control Act 1953.

If the Minister of Finance disagrees with any of the above-mentioned policies, he can issue directives to the BNM's Board that will be binding. Consequently, the Bank must take the necessary actions to adequate its policies to the content of the Minister of Finance's directives (Section 34 (2)). The Bank still has the option to ask the House of Representatives to resolve any controversy with the Minister of Finance. Nonetheless, as commented earlier, BN has controlled the Parliament since *Merdeka*, making it difficult for the House of Representatives to rule against directives issued by the MoF.

The second aspect that affects the independence of BNM is Section 33 (1), which allows the Bank to grant temporally advances to the government in cases of budget deficiencies. There are other provisions of the Central Bank Act 1958 that provide more options to the government to obtain the Bank's financial assistance. For instance, the BNM can advance resources to finance seasonal agricultural operations approved by the Ministry of Finance on the recommendation of the Board of the Bank (article 30 (f)). The Act also allows the BNM to make advances to public agencies or corporations (30 (fff)); or establish special investment funds to finance specific projects in the public sector (30 (ffff)). Additionally, the government can

[38] Doug Tsuruoka, 'Early Withdrawal: Malaysia Looks for New Central-Bank Governor' (1994) 157 *Far Eastern Economic Review* 70; S. Sivaselvam, 'Accountability - Is Jaffar Showing the Way?' Business Times 4 April 1994.

[39] Reuters News (1998), Malaysia PM says not introducing capital controls. Reuters News 29/08/1998.

directly receive advances from the Central Bank for up to three months backed by Treasury bills (article 30 (k)).

Due to this close links between the Bank and the government, the BNM has attended various emergency calls to resolves crises on behalf of the state. In some cases, due to the help provided by the Central Bank, it has been involved in functions that are not associated with the tasks of a central bank, such as holding ownership of corporate businesses in sectors like commercial aviation and telecommunications.[40]

***c) Rector of the Banking System and Lender of Last Resort***

The Central Bank is located at the apex of the banking system. The Central Bank Act 1958 orders the BNM to administer, enforce and carry out the provisions of the Islamic Bank Act 1983 and the Banking and Financial Institutions Act 1989. Also in this area, the Central Bank Act gives the BNM the authority to act as a lender of last resort in case any financial institution regulated by BAFIA is likely to become unable to meet its obligations or about to suspend payment (Article 31A). In this situation, the BNM must act with the assent of the Minister of Finance.

### 6.3.2 The Banking and Financial Institutions Act 1989 (BAFIA)

BAFIA was passed by the Parliament in 1989. According to BAFIA, all institutions of the banking system are subject to the BNM's supervision. BAFIA divides the regulatory and supervisory obligations between the Central Bank and the MoF. The following paragraphs will summarise some of the main areas addressed by BAFIA.

***a) Licensing***

BAFIA requires that any person involved in the business of banking applies and obtains a license granted by the Minister of Finance. Applications are made via the BNM, which reviews the request together with the required documentation. After an examination of the application, the Central Bank prepares a recommendation to the Minister of Finance on whether or not the license should be granted. The Minister examines the Bank's opinion and decides if the license will be issued. The Minister of Finance also has the power to revoke a license, on the recommendation of the BNM, in cases of a serious breach of legal obligations.

[40] Hamilton-Hart, above 35, 118.

Furthermore, a licensed institution needs authorisation to open new offices in Malaysia or to acquire a subsidiary in the country. Similar limitations are applied for the opening of office or the acquisition of subsidiaries outside Malaysia. Likewise, representative offices of foreign institutions require written approval from BNM in order to operate in Malaysia.

***b) Prudential Regulations***

The Malaysian banking authorities have adopted the Basel Accord international standards of prudential regulations. The Bank has established limits related to capital funds and liquid assets. In 1994, BNM mandated banks to maintain a capital ratio of 8% that was agreed with the standard set by the Basel Capital Accord.

Trade of licensed institutions' shares is also limited. The Minister of Finance must approve any disposition of shares that represent more than 5% of the total share of any licensed institution. An individual cannot own more than 10% of the share of a licensed institution and this limit goes to 20% in the case of an entity other than an individual. Finally, licensed institutions cannot own shares of other financial institutions or their subsidiaries; that is, they can organise their own subsidiaries but they cannot invest in other banking groups. Most of the restrictions can be waived by the MoF and the BNM on a case-by-case basis.

Moreover, BAFIA orders that each licensed institution appoints an independent auditor and they are obligated to periodically submit financial statements to the Central Bank. Besides this, banks are also required to publish their audited balance annually.

***c) Operations***

As a general rule, BAFIA establishes that licensed institutions cannot provide credits without security (Section 60 (1)); however, Section 60 (2) permits that the BNM sets exceptions and establishes a limit for the granting of non-secured loans. Furthermore, BAFIA instructs the Central Bank to impose limitations on credits to a single person (Section 61) and restricts loans that an institution can grant to its directors or officers (Section 63).

Additionally, BAFIA prohibits licensed institutions to invest in shares of any corporation as well as purchase any immovable property, except for those

necessary for conducting its business (for example, offices). Exceptionally, a licensed bank can acquire corporate shares and immovable properties as a consequence of the realisation of any security given to guarantee a loan, but the bank must dispose of such shares or property not later than twelve months after their acquisition (Section 66 (3)). Over time, the BNM has issued guidelines that allowed banks to invest in shares, units in property trusts and fixed assets up to a limit of the bank's capital base in order to provide more freedom in operations to banks but at the same time, reducing risks associated with these sectors.

***d) Supervisory and Regulatory Powers of the BNM and the MoF***

The BNM supervises the banking system and it has powers to examine, from time to time, the books, transactions and other information of any licensed institution (Section 69). The MoF can also, at any time, request that the BNM examines any licensed institution (Section 70). For the purpose of these examinations, the BNM enjoys vast powers and can have access to books, documents and any other banking records that it may reasonably request.

In the case of more serious situations, BAFIA gives the MoF and the Central Bank authority to take several actions to contain potential crises. For instance, if a bank becomes insolvent, the BNM, with the prior consent of the MoF, can remove any officer, including directors of that licensed institution and appoint other directors or advisors as it may be required for the proper conduct of the bank's business (Section 73). Additionally, the BNM can prohibit the institution to grant further credits. Moreover, the BNM can recommend to the MoF to order the take over of a distressed bank. In this case, the BNM assumes complete control of the business, property and affairs of a licensed institution.

The Minister, on the recommendation of the BNM, can also declare a standstill and prohibit a bank from carrying on its business and authorise the BNM to apply to the High Court for an order staying the initiation or continuance of all or any class of civil actions and procedures by or against the institution for a period up to six months (Section 80).

BAFIA also authorises the BNM, with the approval of the MoF, to issue any necessary regulations that develop the provisions of the banking legislation (section

116 (1)). Likewise, the MoF or the BNM may release circulars associated with any provision of BAFIA (Section 126).

***e) Lender of Last Resort***

The BNM, with the concurrence of the MoF, may grant loans to an institution that is likely to become unable to meet its obligations. It may also acquire the shares of these distressed institutions or grant a loan to another licensed organisation to purchase the shares, properties and liabilities of a distressed bank. In these situations, an Advisory Panel must be established to advise the Minister in matters related to the actions proposed by the BNM as a lender of last resort (Section 31A (2) Central Bank Act 1958 and Section 78 (3) BAFIA).

### 6.3.3 The Islamic Banking Act 1983 (IBA)

This Act was enacted by the Parliament to regulate the Islamic banking business. For IBA, Islamic banking business means 'banking business whose aims and operations do not involve any element which is not approved by the religion of Islam' (Article 2). As stated above, the main features of Islamic banking are the prohibition of interest in all transactions and the conduct of business and trade activities base on fair and legitimate profits.

Any person who is willing to engage in banking business following the Syariah principles requires a license with the MoF (Section 3). The process to obtain an Islamic bank license is similar to the conventional banking license and it is processed through the Central Bank. Likewise, IBA subjects Islamic banking to the supervision of the Central Bank and the MoF. Most prudential norms included within BAFIA are repeated in IBA (for example, limitation on credit to directors and officers; lending limits to a single person, etc.).

From the supervisory and regulatory perspective, the BNM and the MoF have the authority to examine books, accounts, transactions and other information of Islamic banks (Section 31). These authorities can exercise intervention powers in case where an Islamic bank is likely to become unable to meet its obligations. Such faculties include the power to remove and appoint directors and officers in a distressed Islamic bank and assume the whole business of the bank. Moreover, the

Bank and the MoF have powers to issue regulations and guidelines to normalise Islamic banking.

The BNM exercises powers conferred by article 16B of the Central Bank Act 1958 established the National Syariah Advisory Council for Islamic Banking and Takeful (SAC) in 1997.[41] The SAC is the authority in charge of the interpretation of Islamic law for the purposes of the banking business.

In judicial or arbitral procedures relating to Islamic banking business, in order to resolve the case the judge or the arbitrator may take into consideration directives issued by the BNM in matters associated with Islamic banking issues or refer questions to SAC (Section 16B (8)), Central Bank Act 1958). A court must take in consideration the SAC's ruling to arrive at his decision while the SAC's ruling will be binding for an arbitrator. Also, Islamic banks may direct questions to the SAC and they will be bound by the Council's opinions (Section 13A).

In addition to the existence of SAC, IBA mandates that any business that carries on Islamic banking must establish a Syariah advisory body (Section 3 (5) (b)).[42] These Syariah Committees play a key role in the Islamic banking system because they are formed by scholarly advisors who render opinions on the compliance of Islamic banking operations with Syariah law. The Guidelines on the Governance of Syariah Committee for the Islamic Financial Institutions 2004 regulate the establishment and operations of these Committees.

## 6.4 The Rule of Law in the Banking System

Malaysian formal legal infrastructure was in an optimum condition to face the challenges posed by the Asian financial crisis. The three laws discussed paved the way to the creation of a healthy banking system, imposing modern prudential regulations according to international standards and covering the minimum aspects required for a sound banking sector. First, the Central Act 1958, BAFIA and IBA (the banking legislation) clearly established the BNM and MoF's mandates as

[41] Shanthy Rachagan, 'Islamic Banking in Malaysia' (2005) 20 *Journal of International Banking Law and Regulation* 88-94, 91. Takeful is a type of joint guarantee governed under Syariah law.

[42] See Hth Siti Faridah Abd Jabar, 'Addressing Outstanding Issues in Islamic Finance: Malaysia's Initiatives' (2007) 28 *Company Lawyer* 350-352, 350.

supervisory and regulatory authorities, as well as the principles under which they must have performed their duties. The banking legislation was also clear about the remedies and actions that could be exercised by the Bank and the MoF in the case of problems arising associated with licensed institutions. It included the role of lender of last resort that would be assumed by the Central Bank in coordination with the MoF.

Nonetheless, there were a few weaknesses in the legal framework. One of the most notorious legal shortages was the absence of a specific deposit insurance scheme that specified which options depositors would have in cases of bank failures, the amount guaranteed and the authority that would pay the insurance amount. During the Asian crisis, the BNM filled this gap with a blanket guarantee extended to all deposits in commercial banks, finance companies and merchant banks, including deposits of overseas branches of domestic banks.[43]

Another weak aspect of the legal banking framework was the lack of independence of the Central Bank. In spite of the recognised professionalism and the technical competence of BNM officials, the lack of independence from the government affected its capacity to perform its supervisory duties on a consistent basis. For instance, Hamilton describes that in the 1990s, several mergers or takeovers were completed in which the Bank and the MoF accepted that the purchaser exceeded the 20% shareholder limit imposed by BAFIA, not due to technical considerations, but because people involved in the transactions had connections with high profile public servants.[44]

There were also cases in which banks owned by the government were clearly using risky strategies and the Bank intervened when it was too late. It was the case of the *Bumiputera* Malaysia Finance (BMF), a Hong Kong subsidiary of Bank *Bumiputera*. It engaged in several loans to the Carrian Group of Hong Kong, controlled by property tycoon George Tan. Early in the 1980s, the BMF collapsed when Tan's empire disintegrated due to financial problems. The BMF debacle seriously affected Bank *Bumiputera*, whose capital proved insufficient to cover losses in Hong Kong. Due to the huge hole in the financial position of Bank *Bumiputera*, the government

[43] The New Straits Times, '"Local banks, financial institutions are sound", The New Straits Times 21 January 1998. See also Carl-Johan Lindgren, et al., 'Financial Sector Crisis and Restructuring Lessons from Asia' (Occasional Paper Number IMF, 1999). In 2005, the Parliament passed the Malaysian Deposits Insurance Company Act that provided for a banking deposit guarantee scheme.

[44] Hamilton-Hart, above 35, 125.

involved PETRONAS, the Malaysian oil company, in a rescue package according to which the oil corporation acquired a 90% stake in the bank for a price of RM 1 billion and purchased RM 1.26 billion of bad loans.[45] It was suggested that PETRONAS' involvement in the BMF affair was due to the fact that it was Bank *Bumiputera* largest depositor.[46] In spite of the size of the financial problem of Bank *Bumiputera*, the BNM did not act to take pre-emptive measures to avoid the bank's collapse.

In a similar development, it was only in April 1997 that BNM took action to reduce the excessive exposure of the banking system to the real estate and the purchase of share sectors, a measure that should have been taken earlier, before loans to both sectors reached 42% of the total loans of the banking system.

Regarding the manner in which the BNM designed and implemented its policies and the degree of participation of different actors in this process, the BNM did not consult with banks when it drafted legislation or regulations for the sector before 1985. Since 1960, there were meetings that involved the private sector, but bankers could not freely express their opinions in those meetings.[47] In 1985, consultation with the private banking sector was more institutionalised at least with the larger banks.[48] More recently in the 1990s, the BNM has institutionalised a formal dialogue with the actors of the banking sector that provide the opportunity to discuss banking issues, including drafts of legislation and other regulations.[49]

## 6.5 The Asian Crisis and the Banking System

The Malaysian turmoil started as a currency crisis that later affected the banking sector. Prior to July 1997, Malaysia enjoyed very sound macroeconomic indicators (see Table 4). In the four years that preceded 1997, the Malaysian economy had a GDP average growth of 9.25%. However, Malaysia suffered from a chronic deficit in its current account. The country financed this deficit with a huge short-term capital

---

45 Textline Multiple Source Collection (1980-1984), 'Bank Bumiputra Malaysia has finally issued its annual report for 1983', Textline Multiple Source Collection (1980-1984) 23 September 1984.

46 The Business Times, 'The Singapore Business Times comments that Malaysian Finance Minister Daim Zainuddin's timing in announcing the M$2.49 bn rescue package for Bank Bumiputra was perfect', The Business Times 20 September 1984.

47 Hamilton-Hart, above 35, 124.

48 Ibid.

49 See e.g., Shirene Shan, 'Bank Negara Dialogue Next Week', Business Times 20 August 1994.

inflow and foreign borrowing.[50] However, levels of external debts in Malaysia were not as alarmist as those of their Asian neighbours. This excellent macroeconomic profile proved insufficient to isolate Malaysia from the waves of the Asian crisis.

**Table 4: Malaysia Selected Macroeconomic Indicators1993-1998**

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|---|
| GDP Growth (%) | 8.3 | 9.3 | 9.4 | 10 | 7.5 | - 7.5 |
| Growth in Consumer Prices (%) | 3.6 | 3.7 | 3.4 | 3.5 | 2.7 | 5.3 |
| Unemployment (%) | 3.0 | 2.9 | 2.8 | 2.5 | 2.4 | 3.2 |
| Current Account (US$ billion) | - 3.1 | - 5.6 | - 8.6 | - 4.5 | - 5.6 | 9.3 |

Source: various Economic Reports, Ministry of Finance

The crisis began in Thailand in July 1997 when Thai authorities decided to float the baht due to external pressure. The bad news spread rapidly in the region and investors perceived that other Asian nations with similar characteristics (for example, currencies on a pegged exchanged rate regime; and high concentration of foreign short-term debt plus portfolio investments against a weak position of foreign reserves) were also at risks.[51] Therefore, investors withdrew their money out of the region *en masse*, triggering the crisis.

Soon after, other Asian countries followed with similar measures and let their currencies float (such as the Philippines, Indonesia, South Korea, Malaysia, Taiwan and Hong Kong). Asian currencies' values depreciated, producing negative consequences in their economies. The most affected nations were Thailand, Indonesia, South Korea and Malaysia. The first three turned to the IMF for help and launched packages sponsored by this Institution.

Malaysia received the full impact of the crisis at the end of July 1997 when the ringgit started to face waves of speculative attacks from international investors. The

[50] See Chin, above n 8. See also Kok Fay Chin and K.S Jomo, 'From Financial Liberalization to Crisis in Malaysia' in Chung H. Lee (ed), *Financial Liberalization and the Economic Crisis in Asia* (2003) 104-132.

[51] See Masayoshi Tsurumi, 'Introduction: Financial Crisis and System Reform in Asia' in Masayoshi Tsurumi (ed), *Financial Big Bang in Asia* (2001) 1-36.

ringgit-US dollar exchange rate fluctuated between 2.52 at the beginning of the crisis in July 1997 and 4.72 at its peak in January 1998.

Ten years after the crisis broke out, experts are still discussing its causes. Though a debate over what produced the Asian crisis is beyond the scope of this thesis, the two major lines of arguments that offer an explanation of the causes of this crash from a legal perspective must be mentioned briefly.[52]

There is an argument that claims that the causes of the Asian crisis must be found domestically.[53] The advocates of this position specifically point to the style in which people engaged in business in the region and the close links created among politicians, regulators, banks and corporations (crony capitalism).[54] One of the advocates of this position was the former chairman of the US Federal Reserve, Alan Greenspan.[55] For advocates of this position, cronyism prevented regulators from enforcing prudential regulations effectively, debilitating the financial sector and creating the conditions for a crisis.

The major criticism against the crony capitalism theory is that it fails to explain why the crisis affected so many countries in such a short period of time.[56] Additionally, the theory of crony capitalism does not provide an explanation of why nations like Malaysia sustained an enviable economic growth record for a decade without suffering a crisis of similar magnitude.

The second argument claims that the financial turmoil occurred because of external factors and, in particular, because of the premature liberalisation of most financial and banking systems in developing countries.[57] The liberalisation movement was not accompanied by an efficient modernisation of supervisors and regulations.[58] Legislation was not updated to agree with new faculties to regulators and impose restrictions to the new types of transactions that were available for financial

---

52 For a complete account of the causes of the Asian crisis see Haggard, above n 1.

53 Chung H. Lee, Keun Lee and Kangkook Lee, 'Chaebols, Financial Liberalization and Economic Crisis. Transformation of Quasi-Internal Organisation in Korea' in Roy Allen (ed), *The Political Economy of Financial Crises* (2004) 145-163.

54 See Jeffrey Frankel, 'The Asian Model, the Miracle, the Crisis and the Fund' in B.N. Ghosh (ed), *Global Financial Crises and Reforms* (2001) 319-329.

55 K.S. Jomo, 'Malaysian Débacle: Whose Fault?' in Roy Allen (ed), *The Political Economy of Financial Crises* (2004) 164-179, 165.

56 Chin, above n 50, 105.

57 See Jose Antonio Ocampo, Shari Spiegel and Joseph Stiglitz, 'Capital Market Liberalization and Development' in Jose Antonio Ocampo and Joseph Stiglitz (eds), *Capital Market Liberalization and Development* (2008) 1-50.

58 Chin, above n 50.

institutions. This environment of a lack of adequate regulations and supervisors allowed financial institutions to engage in risky transactions and, in some cases, transactions that were oriented towards non-productive sectors such as real estate and purchase of shares. This created a bubble that exploded with the currency crisis. This weakness was exacerbated by the arrival of excessive capital inflows from international investors that exceeded the needs of the real economy.

Other authors, such as Radelet and Sachs, argue that in addition to an incomplete regulatory reform that did not match the fast financial liberalisation, the countries most affected by the crisis also evidenced poor exchange rate policies.[59] In the case of Malaysia, the government had pledged the ringgit to the US dollar. This policy was beneficial for a country that like Malaysia depends on trade because it created stability for importers and exporters. However, Malaysian macroeconomic indicators were not similar to those in the US and it led to an overvaluation of the ringgit.[60]

In the case of Malaysia, both arguments identify the factors that contributed to the debacle. In the 1980s, the BNM took various measures to liberalise the banking sector (such as the deregulation of interest rates and the broadening of the scope of permissible investment for banks). Additionally, the BNM relaxed limitation to lend for property purposes (for example, construction or acquisition of real estate) and purchasing of shares in the capital markets. Although BAFIA strengthened and adjusted prudential regulations to international standards, the BNM did not exercise its powers to properly address the concentration of loans in the property and acquisition of shares sectors. When the values of the ringgit started to deteriorate in the second half of 1997, it impacted on the values of properties and shares that backed loans, affecting the quality of banks' assets.

Conversely, the increased public ownership in the banking system in the 1980s and the later privatisation program that sold those assets to groups closely linked to the government prevented Malaysian banking supervisors from enforcing strict and uniform banking regulations.[61]

---

[59] Steven Radelet and Jeffrey Sachs, 'The East Asian Financial Crisis: Diagnosis, Remedies, Prospects' in Roy Allen (ed), *The Political Economy of Financial Crises* (2004) 1-79.

[60] Ismath Bacha Obiyathulla, 'Malaysia: From Currency to Banking Crisis' (1998) XXXV *Malaysian Journal of Economic Studies* 73-94, 84.

[61] Natasha Hamilton-Hart and K.S Jomo, 'Financial Capacity and Governance in Southeast Asia' in K.S. Jomo (ed), *Southeast Asian Paper Tiger? From Miracle to Debacle and Beyond* (2003) 220-279.

In addition to the weakness of the banking system, the deceleration of the economy negatively affects a company's income and their capacity to serve their banking debts. Hence, NPL rate commenced to deteriorate dramatically and rocketed from 3.6% in June 1997 to 11.4 % at the end of August 1998.[62] The increase of NPLs negatively affected the capital of banking institutions that needed to increase provisions for bad loans.

Another development that exacerbated the crisis in Malaysia was that, at that time, the BNM was executing a program of consolidation of banking institutions to reduce the number of banks and make Malaysian institutions more competitive. Under this plan, the BNM applied a two-tier classification of banks in 1994.[63] The better managed banking institutions with stronger capital base were classified in Tier 1. They could engage in a more diverse menu of banking activities with less regulatory limitations than Tier 2 banks.[64] For instance, Tier 1 banks could issue negotiable instruments up to five times their capital funds.[65] Tier 2 institutions were encouraged to merge with larger institutions or to strengthen their capital position.

By 1997, the Malaysian banking system was formed by 35 commercial banks (22 domestically owned and 13 foreign-controlled).[66] According to the two-Tier classification, only ten commercial banks were classified as Tier 1. The tier classification did not produce the expected results and instead of merging, Tier 2 banks were more eager to boost their profits and generate resources to adjust their capital and be upgraded to Tier 1. As a consequence, they aggressively increased credits, granting loans to speculative sectors such as property, acquisitions of shares and other instruments of the capital markets. When the crisis broke out, people perceived that Tier 2 banks were weaker than Tier 1 institutions. This conception produced a migration of deposits to Tier 1 banks, creating liquidity problems for smaller banks in Tier 2.

62 Ministry of Finance, above n 30, 39 and 157.
63 Oh, above n 22, 41.
64 Ibid 36. A similar classification was later extended to finance companies and merchant banks.
65 Ibid.
66 Ibid.

## 6.6 Government Responses to the Crisis

We need to divide in two stages the government's response to the Asian crisis. In a first stage, the Malaysian government responded with a set of classical neoliberal measures, constricting fiscal and monetary policies and floating the ringgit. In a second phase, the government implemented a set of unorthodox measures oriented to reduce the negative effects of the crisis in the economy. The turning point between the two periods was marked by the dismissal of Anwar Ibrahim as Deputy Prime Minister and Minister of Finance.

### 6.6.1 The Government's Orthodox Response

When the crisis first hit Malaysia in July 1997, the government's reaction was not different to the measures adopted by other Asian nations that had requested the IMF's support (for example, Indonesia, Thailand and Korea). However, Malaysia had a stronger external reserve position to face the financial debacle; and therefore, it avoided having to resort to international assistance.[67]

The Malaysian first program included a restricted fiscal and monetary policy, consisting in a 20% reduction of government expenditure and purchases.[68] Likewise, the BNM raised the interest rate to face the speculative attack against the ringgit. In the banking system, the BNM ordered the reclassification of NPLs, from six months to three months, to identify earlier problematic loans and it requested greater disclosure of financial information by licensed institutions as well as increased general provisions for banks. None of these measures implied the passing of new legislation and they were put in place using the existing regulatory powers of the BNM and the MoF.

Experts claim that this initial set of measures was inspired by the IMF solutions applied in Latin America during the 1980s. Huge fiscal deficits and large external public debts were the crucial problems faced by Latin American governments.[69] This

---

[67] By 30 June 1997, the BNM had international reserves of approximately US$ 28 billion.

[68] See Ministry of Finance, above n 30; Zainal-Abidin Mahani, 'Malaysian Economic Recovery Measures: A response to Crisis Management and for Long-Term Economic Sustainability' (Paper presented at the Economic Crisis in Southeast Asia: Its Social, Political and Cultural Impacts, Bangkok, 17-19 February 2000).

[69] See Nicola Bullard, Walden Bello and Kamal Mallhotra, 'Taming the Tigers: the IMF and the Asian Crisis' (1998) 19 *Third World Quarterly* 505-555; Jeffrey Sachs, 'Power into itself', Financial Times 11 December

was not the case in Asia, where most nations had sound macroeconomic principles and high rates of savings. Indeed, the crisis originated in the private sector, rather than bankrupted governments as it was the case of Latin America.

The orthodox approach did not achieve the expected results. In contrast, the Malaysian economy began to feel the negative impact of a deflationary strategy in the last quarter of 1997. [70] Interest rates increased, bank credits reduced and asset values rapidly deteriorated. These factors were reflected in the banking sector where NPLs started to rise dangerously, especially in loans related to purchase of securities that increase almost 180% in 1998.[71]

### 6.6.2 The Anwar Affair

The dismissal of Anwar Ibrahim as Deputy Prime Minister and Minister of Finance in September 1998 is often associated with his reformist profile and his support of IMF-sponsored strategies that opposed the nationalist and authoritarian approach implemented by Mahathir.[72] Besides this political rivalry between these two leaders, there was an incompatibility between the institutional arrangements implemented by the government of Malaysia since 1969 and the content of IMF's solutions.

By 1997, most people recognised that Anwar would be Mahathir's successor as a leader of the UMNO and therefore, as Prime Minister of Malaysia. He quickly developed his political career, and his influence on UNMO and the government was incontestable.[73] Anwar was perceived as the person who could lead a reform process that would bring transparency and accountability to government practices, combating corruption, cronyism and nepotism that was associated with Mahathir's administration.[74] In the economic sphere, it was thought that reform cemented on liberalisation, following the terms outlined by the IMF would help to achieve these

---

1997; Jeffrey Sachs, 'The Wrong Medicine for Asia', New York Times (New York), 3 November 1997. See also National Economic Action Council, 'National Recovery Plan/Agenda for Action' (NEAC, 1998).

70 Ministry of Finance, above n 30; Mahani, above n 68.

71 Obiyathulla, above n 60, 88.

72 See e.g., Haggard, above 1, 59-64; Gomez, above n 3.

73 Hari Singh, 'Democratisation or Oligarchic Restructuring? The Politics of Reform in Malaysia' (2000) 35 *Government and Opposition* 520-546. For a recent account about the Anwar Affair see Jesse Wu Min Aun, 'The Saga of Anwar Ibrahim' in Andrew Harding and H.P. Lee (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 273-290.

74 See Singh, above n 73; Jason Abbot, 'Vanquishing Banquo's Ghost: The Anwar Ibrahim Affair and its Impact on Malaysian Politics' (2001) 25 *Asian Studies Review* 285-308. Despite Anwar's criticism against cronyism, he was also identified with this type of practices. See Hamilton-Hart, above n 35, 119; Gomez, above n 3, 200.

objectives. Anwar subscribed to IMF orthodoxy in various forums and he was called 'Malaysia's voice of economic reason' by the *Wall Street Journal*.[75]

Correspondently, Anwar, as the Minister of Finance during the first phase of the Asian crisis, promoted measures inspired by an IMF approach to manage the consequences of the crash. It included actions that reduced the economy impetus and he spoke out against intents of building a rescue package oriented to bail out distressed, well-connected companies, using public resources.[76] Some scholars argue that the employment of IMF strategies and the avoidance of public bailouts would help Anwar to debilitate the patronage channels that benefited political and economic elites associated with the government and the UMNO.[77]

At the UMNO annual assembly held in June 1998, there were some skirmishes that triggered the removal of Anwar. The head of the youth wing of the UMNO gave a speech in which he criticised cronyism and corruption in a move that most participants considered was directed against Mahathir.[78] Meanwhile, during the Congress, a book entitled *Fifty Reasons Why Anwar Cannot be Prime Minister* was circulated containing accusations of immoral behavior by Anwar.[79]

The end of the struggle between Mahathir and Anwar is well known. The Prime Minister sacked his Deputy Prime Minister and Minister of Finance on 2 September 1998, the day after the government launched its new, unorthodox economic program. The media reported that Mahathir excluded Anwar from government because he did not have the integrity necessary for public office. Soon, Anwar was charged with five counts of sexual impropriety and five counts of corruption.[80] The first group of charges was related to sodomy and the others were associated with accusations that Anwar abused his office, interfering with the police officers who were conducting an investigation of the sodomy charges. The government detained Anwar invoking the Internal Security Act (ISA) and brought charges of sexual misconduct and abuse of powers, later using the Emergency (Essential Powers) Ordinance No.22/1970. Anwar was sentenced to six years of imprisonment for the

---

75 Abbot, above n 74, 295; Singh, above n 73, 530.

76 See e.g. Anwar Ibrahim, Bringing the Confidence Back/Tighter Fiscal Discipline. Ministerial Statement on Measures to stabilise the national economy at the Parliament on 24 March 1998, published in Kok Wing Lim, Robert Ho You Chai and Mee Fah Yee, *Hidden Agenda* (1998), 99-108. See also Abbot, above n 74.

77 Singh, above n 73.

78 Ibid.

79 Ibid 538.

80 Ibid 286.

abuse of power charges in 1999, a sentence that included political incapacity to opt for public posts.

Besides the political considerations that ended with the removal of Anwar, there were other reasons that produced the refusal of an IMF-oriented avenue to tackle the crisis. While some could argue that the solution advanced by Anwar during the first stage of the crisis and closely associated with the IMF postulates was the best option available at that time, there are experts who claim the formula was not adequate to address the economic problems faced by Asia. The fast implementation of pre-packaged programs in other countries exacerbated the panic throughout Asia, triggered systemic banking crises and worsened the impact of the crisis on the economy (for example, high interest rate, devaluations and increasing unemployment).[81]

In addition, an economic liberalisation based on IMF orthodoxy was perceived as a mechanism that would defeat cronyism and corruption, strengthening the rule of law and improving transparency and accountability of authorities (good governance). This position was influenced by the prevailing discourse in international circles associated with the promotion of the market, democracy and the rule of law. However, the way in which the IMF negotiates its arrangements and makes conditional its financial aid does not guarantee the establishment of more accountable and transparent institutions, especially when they were the product of a restricted discussion between IFIs and governments.[82] In fact, in the cases of Korea, Indonesia and Thailand, it was reported that the IMF imposed its conditions with little or no negotiation at all.[83] A similar situation occurred earlier in countries such Argentina and Peru where the application of IMF programs forced presidents to take over legislative powers in order to comply with IMF conditions. [84]

Malaysian authorities should have shared similar concerns, but the most important issue for authorities was the inconsistence between IMF orthodoxy and the principles under which the government had built its development model that highly

---

81 Mustapa Mohamed,Second Minister of Finance, 'Malaysia: Measures for Economic Recovery' (Paper presented at the International Monetary Fund and Worrld Bank Group Annual Meetings, Washington, D.C., 4 October 1998); Victor Wee, 'How Quick a Recovery?' (1999) 1 *New Voice of Asia* 14-18; Tsurumi, above n 51.

82 See chapter 3 on IMF conditionality and chapter 8 in which the case of Venezuela is discussed.

83 See e.g., Sachs, above n 69. See also Joseph Stiglitz, 'Hipocresía Financiera', El Espectador (Bogotá), 17 November 2007.

84 Gabriel Garcia, 'El Fondo Monetario Internacional y la Promoción del Estado de Derecho en los Noventa: Condicionalidad y Estados de Excepción en Suramérica' (2007) 1 *Oñati Journal of Emergent Socio-legal Studies* 20-36.

considered the well-being of *Bumiputera.* Without entering into the debate that surrounded NEP policies, it was a fact that the NEP inspired most Malaysian public policies since 1969 and the content of such plan was difficult to harmonise with IMF postulates.

A review of the IMF's recommendations in other Asian countries affected by the crisis, as well as in other regions, demonstrates that its programs included:[85]

- 'Facilitation' of financial resources (to avoid the word 'loans')[86] to pay debts to international creditors and to re-establish international reserves that help to stabilise the values of national currencies.
- Obligations for governments to follow restricted monetary and fiscal policies, including reduction of public expenditure, imposition of high interest rates and restriction of domestic credit.
- Restructuring of the financial sector, including the closure of unsound banking institutions and immediate privatisation of nationalised banks; and strengthening of supervision on financial institutions.
- Structural measures that addressed the weakness of the financial sector, including legal reforms to improve transparency and increase competition. It generally included the opening of the banking sector to foreign institutions.

On the other hand, through a consideration of the Malaysian development policies implemented since the 1969 racial riots, it can be observed that they focused not only on the promotion of economic growth, but also on the achievement of a better distribution throughout its diverse ethnic groups. Contrasting this development approach with the points contained in a typical IMF program, it is clear that several of these measures could endanger some of the goals pursued by Malaysian development plans.

In terms of the first aspect of IMF programs and the facilitation of financial resources to re-establish international reserves, it has been often argued that this only helps to increase developing country debt and facilitate the payment of foreign creditors that

---

85 I follow Radelet and Sachs in this part. Radelet, above n 59, 53. See also Lindgren, above n 43, 47.

86 See discussion on IMF's arrangements in Chapters 3.

otherwise could not be repaid due to the lack of international reserves.[87] Therefore, they are resources not invested in the country.

Second, a restricted monetary and fiscal policy would increase the impact of the crisis on the domestic economy in the short-term. This means that the public and the private sectors would reduce expenditure and investment. It would produce unemployment, inflation and perhaps, as it occurred in Venezuela with a society less ethnically diverse, social riots. The economic impact of a deflationary program was perceived by the government during the first months of the crisis when authorities applied an orthodox plan. The importance placed on the maintenance of social and ethnic harmony by the Malaysian government has been demonstrated. It would be harder for the government to maintain social cohesion with a marked contraction of the economy.

Third, in Indonesia, Korea and Thailand, governments were forced to close down financial institutions that exacerbated panic among people and aggravated the consequences of the crisis.[88] Additionally, authorities were forced to pass legal reforms without a great deal of discussion in order to improve the banking legal framework.

Finally, parts of the promoted reforms were targeted towards the opening of the banking system to foreign investors. In the case of Malaysia, the possibility to relax the norms that limited the ownership of foreign institutions would open the risks that international capital would again prevail, as was the case of Venezuela, which will be discussed in Chapter 8. As explained earlier, foreign investors controlled Malaysian financial institutions until the second half of the twentieth century, but the government turned this situation around and reshaped the structure, guaranteeing that domestic capital would control the banking system, for the most part. It facilitated the integration of the banking sector with the government development policies. The government would not accept the return of banking control to foreign players. In contrast, its second program was oriented to regain monetary independence that had been taken away by international investors. Ultimately, a liberalisation of the banking system to foreign capital would make it difficult to

[87] See, e.g., Joseph Stiglitz, *Globalization and Its Discontents* (2003).
[88] Thai authorities closed 55 finance companies, Indonesia 16 banks and Korea 5 banks. See Tsurumi, above n 51, 29.

guarantee the special status of *Bumiputera* granted by the Constitution, both as owners of financial institutions and beneficiaries of special banking programs.

Consequently, the implementation of an IMF approach implied the dismantling of a model that had been in placed for almost 30 years in Malaysia. It seems unlikely that the government would accept this option forced by an international player (i.e. the IMF), especially because it has always promoted the success of the NEP and has refused internal criticism against its pro-Malays policies.

### 6.6.3 The Home-Grown Recovery Plan

In January 1998, the government of Malaysia started its departure from an IMF crisis management model. That month, the government established a consultative committee, the National Economic Action Council (NEAC), which would study and propose actions to address the crisis. The Council was formed by the Prime Minister, Deputy Prime Minister, the BNM Governor, the Chief Ministers (states' representatives), Cabinet ministers, the Chief Secretary and representatives from the private sector (for example, people from industry groups, academia, trade unions, professional associations, media, NGOs and international organisations).[89]

The NEAC also had an Executive Director who coordinated actions of the authorities involved in reviving the economy. Daim Zainuddin, a former Minister of Finance from 1984 to1991, was appointed Executive Director. Commentators believe that the creation of the NEAC and the appointment of Zainuddin as its Executive Director were the first steps oriented to relegate the role of Anwar in the government.[90]

The main document produced by the NEAC was the National Economic Recovery Plan (NERP), presented on July 1998. The NERP was designed to address the weakness that caused the crisis and to revive the economy. The NERP ratified its commitment to an economy oriented by liberal market-based policies without affecting the socio-economic arrangements that existed previous to the turmoil. The NERP anticipated six objectives:

---

[89] Victor Wee, *Mechanism and Policies for National Economic Recovery* (1998) Malaysia Economy Planning Unit <http://www.epu.jpm.my/New%20Folder/NEAC%20Chapter.pdf> at 20 October 2007, 3.

[90] See e.g., Tsun Hang Tey, 'Malaysia: The Fierce Politico-Legal Backlash' (1999) 3 *Singapore Journal of International & Comparative Law* 1-25, .3.

- ***Stabilising the ringgit:*** The crisis commenced with speculative attacks against the ringgit; therefore, it was necessary to stabilise of its value. Among the four actions proposed by the NEAC to protect the ringgit's value, the adoption of currency and capital control measures was the most controversial and experts perceived that Malaysia was closing its doors to foreign investment and international trade. Nonetheless, governmental officials argued that the capital control and exchange rate regime were necessary to avoid speculative short-term transactions and regain monetary independence.[91] A proof of the government claim was that the temporal regime discriminated between the short investment transactions and foreign direct investment.[92] The former were limited while the later were left almost unaltered.

- ***Restoring market confidence:*** As, for the most part, the withdrawal of international investment from Malaysia was due to a generalised panic through Asia, authorities believed that it was essential to restore market confidence that would lead to the economy recovery.

  One of the measures believed to be essential to achieve this goal was to improve transparency and the regulatory environment of business. This included the improved dissemination of financial information as well as the reduction of corruption. Closely related to the war against corruption, the government considered it was necessary to establish clear rules for assisting distressed domestic companies, avoiding cronyism and simple bailouts with public money. Thus, the government clarified that it would not provide rescue packages for individual investors or lenders, except for industries and corporations in strategic sectors of national interest.[93]

  The NERP defined companies in the national interest as 'those that provide benefits to a wide cross-section of the population and help raise their living standards'. While strategic industries and businesses were defined as 'those that contribute to the growth of a specific sector or/and provide important support for other industries and businesses'.[94] In spite of the efforts to clarify

---

91 See Rawi Abdelal and Laura Alfaro, 'Capital and Control' (2003) 46 *Challenge* 36-53.
92 See Mahani, above, n 68.
93 National Economic Action Council, above n 69.
94 Ibid.

which sectors would receive official aid, definitions still left enough discretion to the Malaysian government to act.

The NEAC also recommended that the government consulted with interested parties before designing and implementing any action.

- ***Maintaining financial stability:*** The banking sector was affected by the Asian crisis. The rise of the interest rates, the depreciation of property and security values and the deceleration of the economy negatively impacted on companies that were not in the best capacity to repay their loans. This negative environment was reflected in the increase of NPLs and the subsequent need for banks to increase provisions for bad loans. The NEAC considered that it was of primary interest to Malaysia to guarantee the financial stability and the integrity of the banking system.

  Further, the NEAC suggested the strengthening of the capital market through the improvement of the regulatory framework.

- ***Strengthening economic fundamentals:*** In spite of the sound macroeconomic fundaments, the NEAC considered that there was room for improvement. In areas such as quality of investment and the balance of payments, the Commission suggested the intervention of the government. Also, it was necessary to reduce the current account deficit.

  Furthermore, the NEAC suggested that the government maintained an expansionary policy to reanimate the economy and assumed the efforts that the private sector could not undertake. This strategy should be also supported by a monetary policy that guarantees credit availability for businesses.

- ***Continuing the equity and socio-economic agenda:*** In line with its policy to sustain the socio-economy policies and recognising the negatives effects of the crisis on the population, (for example, the reduction of household income and unemployment), the NEAC recommended a set of actions to reduce those effects, such as the ratification of a program on micro-credits, a price control of specific food products and measures oriented to increase job

opportunities. Additionally, the NEAC suggested the reform of the *Bumiputera* equity ownership approach, to allow sales of *Bumiputera*-owned shares to non-*Bumiputera* as well as the analysis of mechanisms to help *Bumiputera* companies to cope with the crisis.

- ***Revitalising adversely affected sector**:* The crisis negatively impacted on several areas of the Malaysian economy, producing rising costs, a depressed demand and financial problems.[95] For these reasons, the NEAC endorsed the support of twelve sectors: primary commodities and resource-based industries; mining and petroleum; manufacturing and information technology (IT); motor industry; construction; property; infrastructure; transport; freight forwarding; tourism, industrial development finance institutions; and insurance and reinsurance.

  Measures in several of these sectors included the relaxing of regulations that limited the participation of foreign capital (for example, manufacturing and IT, motor industry, property and reinsurance). In the case of oil, NEAC suggested the possibility of reform the Petroleum Development Act 1974 in order to reduce the rights, powers and exclusive privileges accorded to PETRONAS and make more attractive the participation of local companies in oil activities (for example, exploration, exploitation, development and production).[96]

## 6.7. The Legal Approach to the Banking Rehabilitation

As mentioned above, one of the goals of the NERP was to maintain the financial market integrity. This section will examine the strategies designed by the government in order to achieve this objective. Following the NEAC's proposal, the BNM and the government addressed the negative consequences of the Asian crisis in the banking sector, focusing on four aspects:

---

95 Ibid.

96 Ibid. According to, the Petroleum Development Act 1974, PETRONAS is vested with the entire ownership and the exclusive rights, powers, liberties and privileges of exploring, exploiting, winning and obtaining petroleum. The government grants licences for the processing, refining, marketing and distribution of oil products. See www.ktak.gov.my

- Strengthening of the supervision of banks and tightening prudential regulations.
- Reduction and management of NPLs.
- Recapitalisation of banking institutions.
- Creation of a forum to work out debt restructuring of distressed corporations.

In contrast to the approach assumed in the 1980s to resolve the DTCs collapse, during the Asian crash the government decided to rely primarily on the ordinary banking legal framework (for example, the Central Bank Act 1958 and BAFIA) instead of proclaiming a new state of emergency or issuing emergency ordinances based on the old 1969 proclamation of emergency. As explained above, the government only resorted to emergency regulations, specifically ISA and the Emergency (Essential Powers) Ordinance No.22/1970 to cope with the political opposition of Anwar and his followers.

This crisis management style responded to the fact that the Malaysian banking system was strong enough to absorb the first wave of negative effects derived from the crisis. Compared to countries such as Indonesia and Thailand, Malaysia had a relatively strong banking supervision and the banking system had a lower rate of NPLs as well as a better capital adequacy ratios. In addition, Malaysia was less exposed to foreign debts and short-term borrowing than its regional neighbours. Aided by these strong fundaments, the government's response implied a pre-emptive approach, more that a reactionary answer forced by the facts. While financial institutions were directly impacted in Korea, Indonesia and Thailand, requiring prompt response, Malaysian banks were better prepared and extreme measures such as the closure of financial institutions were not required.

When the crisis broke out, and even before, what the BNM did first was to focus on the strengthening of supervision of banks and prudential regulations based on the powers already contained in the Central Bank Act 1958 and BAFIA. One of the initial measures was to limit lending for the property and the purchase of shares sectors in April 1997. The BNM perceived that the system was overexposed to these two categories. This measure was followed for several pre-emptive actions oriented to reduce the impact of the crash on the banking system (see Table 5).

**Table 5: Selected measures adopted by BNM to stabilise the Banking Sector 1997-1998**

Please see print copy for Table 5

Source: Oh Soo-Nam, 'Towards a Sustainable Banking Sector - Malaysia' in Asian Development Bank (ed), *Rising to the Challenge in Asia: A Study of Financial Markets* (1998) 33-78.

Nonetheless, authorities considered that the ordinary legal banking framework did not provide adequate options to manage the NPLs out of the system. In the same way, the BNM was not prepared to take over the work associated with the recapitalisation of banks. Finally, NEAC and the financial authorities claimed that it was necessary to organise a forum that could help distressed corporations and banks to negotiate potential restructuring proposals. To tackle these three points, the government created three *ad hoc* vehicles: DANAHARTA, DANAMODAL and the Corporate Debt Restructuring Committee.

### 6.7.1 DANAHARTA

***a) Creation***

The NEAC identified the increase of NPLs as one of the most serious threats to the stability of the financial system. This situation distracted banks from their main goal of providing credit to the economy. Besides, the increasing of NPLs negatively impacted on the base capital of financial institutions, reducing credit availability. For these reasons, the NEAC recommended the organisation of an entity that subtracted NPLs from the system and could manage, and subsequently dispose the

acquired loans. In order to assume this function, the government incorporated *Pengurusan DANAHARTA Nasional Berhad* (DANAHARTA) in June 1998.

DANAHARTA was organised assuming the form of a corporation according to the Companies Act 1965. The MoF was its sole shareholder. Its two main objectives were: (i) to remove the distraction of managing NPLs from the financial institutions; and (ii) to maximise the recovery value of the NPLs in its portfolio.[97]

DANAHARTA was organised as an asset management company that would manage the NPLs in its portfolio on an account by account basis and it would dispose of assets in a timely manner, seeking to maximise recovery value. Nonetheless, in order to undertake its functions in an effective, efficient and expeditious way, it required certain faculties that were not granted by the ordinary legal framework that involved court actions. To fill this gap, financial authorities drafted the *Pengurusan DANAHARTA Nasional Berhad* Bill that was passed by the Parliament in August 1998 (DANAHARTA Act 1998).

***b) DANAHARTA Act 1998***

This Act passed by the Parliament granted DANAHARTA extraordinary powers to resolve, in an expeditious manner, the risk-situation created by the increase of NPLs. Other countries affected by the Asian crisis, such as Indonesia and Thailand, resorted to emergency executive decrees to create similar asset management companies.[98]

The exceptional powers granted to DANAHARTA by the Act included:

1. The ability to buy assets through statutory vesting.
2. The ability to appoint Special Administrators to manage the affairs of distressed companies.
3. The ability to sell foreclosed assets quickly.
4. The ability to avoid judicial restriction orders.

---

97 Pengurusan DANAHARTA Nasional Berhad, 'Final Report/DANAHARTA' (DANAHARTA, 2005) 10.

98 In the case of Indonesia, the government created the Indonesia Bank Restructuring Agency (IBRA) through a presidential decree in 1998. Thai authorities dictated a decree in 2001, later ratified by the Parliament, to organise the Thai Asset Management Company (TAMC). See Ben Fung, et al., 'Public Asset Management Companies in East Asia/ A Comparative Study' (Working Paper Number Financial Stability Institute, Bank for international Settlements, 2004) 54.

These special powers represented a departure from the ordinary legal system and put DANAHARTA is a better legal position than licensed banks in order to recover NPLs. The Parliament justified the law on the grounds that it was required in the public interest and to revitalise the nation's economy.

***Statutory vesting:*** The Act allowed DANAHARTA to acquire the NPLs from the banks through statutory vesting, enabling DANAHARTA to acquire assets with certainty of title and maximising value. This means that DANAHARTA took the place of the selling bank, assuming the same interest and priority. While an ordinary transfer of a loan may require the consent of the borrower and other people who may have had rights or interests on the credit and the assets that backed the obligation, retarding the process of NPL transfers, the Act allowed the acquisition by DANAHARTA, assuming that interested parties had consented to the transaction. However, the Act preserved third party rights over affected assets.

The Parliament also amended the National Land Code Act to facilitate the sale of properties associated with the NPLs to DANAHARTA and clarified that the vesting certificate was conclusive evidence of the transfer of the NPL. The National Land Code (Amendment) Act 1998 clarified that DANAHARTA could sell its collateral where necessary through a private treaty.

***Special Administrators****:* In the case that DANAHARTA acquired a loan from a bank and a corporate borrower did not fulfil its debt obligations, DANAHARTA had the right to appoint a Special Administrator who would manage the defaulting corporation. This appointment had to be authorised by an Oversight Committee and based on the fact that the designation would maximise value of the loan or was in the public interest.

The Oversight Committee was formed by representatives of the MoF, BNM and the Securities Commission (Section 22 (2)). Decisions of the Oversight Committee were final and binding. They could not be reviewed by any court (Section 22 (4)).

The Special Administrator would take over the control and management of the corporation, including, assets and business. The most important duty of the Special Administrator was to preserve the value of the company's assets. The Act obligated all officers of an intervened corporation to cooperate with the Special Administrator, providing books, and any other relevant information essential for the management of

the corporation's affairs. The Act penalised any contravention to this cooperation duty or the submission of false or misleading information (Section 36 (4)).

While the Special Administrator was performing his or her tasks, an automatic twelve month moratorium took effect (Section 41). During that period, nobody could take legal actions against the company. The moratorium began from the date of the appointment of the Special Administrator and it could be extended for a similar period in case it was necessary to implement the workout proposal. The moratorium in favour of the distressed company helped to maintain it as an ongoing business and limit the options of other lenders and investors.

One of the most important tasks of the Special Administrator was to present a workout proposal, suggesting a financial solution for the corporation (Section 44 (1)). The proposal was then submitted to an Independent Advisor whose appointed was approved by the Oversight Committee. Independent Advisors could be merchant banks, accountant firms or other financial advisor firms. The Independent Advisor reviewed the proposal and prepared a report about its reasonableness.

After it reviewed the proposition and the Independent Advisor's report, DANAHARTA's Board could approve the proposal. In that case, the Special Administrator had to submit the proposal for creditor's approval. A vote of the majority in value of secured credits was required to implement the proposal (Section 46 (4)).

***Foreclosure**:* The DANAHARTA Act and the National Land Code empowered DANAHARTA to carry out foreclosure on a loan's collateralised property without a court order, facilitating the recovering of loan. DANAHARTA could go ahead with the foreclosure when the borrower did not remedy a breach of the loan agreement within 30 days after receiving DANAHARTA's notice.[99] The DANAHARTA Act also allowed disposing of the asset via private agreement which was either by auction, tender or contract.[100]

***Judicial restriction orders:*** The DANAHARTA Act 1998 was amended in 2000. One of the changes incorporated to the Act was article 72 that stated:

---

[99] Pengurusan DANAHARTA Nasional Berhad, above n 97, 14.
[100] Ibid.

Notwithstanding any law, an order of a court cannot be granted:

(a) which stays, restrains or affects the powers of the Corporation, Oversight Committee, Special Administrator or Independent Advisor under this Act;

(b) which stays, restrains or affects any action taken, or proposed to be taken, by the Corporation, Oversight Committee, Special Administrator or Independent Advisor under this Act;

(c) which compels the Corporation, Oversight Committee, Special Administrator or Independent Advisor to do or perform any act and any such order, if granted, shall be void and unenforceable and shall not be the subject of any process of execution whether for the purpose of compelling obedience of the order or otherwise.

This section completely restricted judicial revision of acts performed by DANAHARTA's officials against which affected parties did not have any type of reliefs. Although the special powers of DANAHARTA were inspired by models implemented in other foreign jurisdictions, the exclusion of judicial review made the corporation a very unique figure. The idea behind section 72 was to enable DANAHARTA to execute its duties more rapidly in order to achieve its goals without delays caused by applications for injunctions.

***c) Constitutionality of DANAHARTA Special Powers***

The extraordinary powers granted by the Parliament to DANAHARTA to resolve the NPL problem in a 'fast-track' manner may be considered against the classical notion of the rule of law, especially because it excluded judicial review in most cases and it gave DANAHARTA the powers to be involved in the administration of private companies.

In its Final Report, DANAHARTA argued that although the powers granted to the Corporation could be considered arbitrary, they were inspired by legal models included in legislations of other countries.[101] For instance, the report explained that the special administrator was designed following similar institutions included in the English Insolvency Act 1986 and the Australian Corporation Law in cases of insolvency. Similarly, DANAHARTA's power of non-judicial foreclosure was inspired by Singapore's Conveyancing and Property Law Act 1985.[102] While DANAHARTA's claim may be correct and institutions such as special administrators and non-judicial

[101] Ibid 14.
[102] Ibid 14.

foreclosures are furnished in other foreign legislations, none of them were isolated from being judicially challenged as occurred with DANAHARTA. The exclusion of a judicial review created a strong presumption that the government would be arbitrary in its approach that basically relied on DANAHARTA to resolve controversies associated with the dispositions of NPLs.

A report that studied the role played by public asset management companies (AMCs) in Asia seems to be in line with the position assumed by the Malaysian government during the financial crisis.[103] This study recognises the important of special powers granted to AMCs in order to successfully achieve their goals in a timely manner. According to this report, special powers are particularly important in jurisdictions with a weak legal infrastructure in which laws related to insolvency and bankruptcy are outdated and may pose many obstacles to a timely resolution of NPLs.[104] However, the report did not cover in its analysis the extension of those special powers and whether or not they should restrict judicial review.

Through an analysis of the exceptional powers granted to DANAHARTA using the Roman dictatorship approach discussed in Chapter 2, it could be argued that the Parliament included in the Act some limitations to avoid abuses by the Corporation. It was always clear that DANAHARTA had a finite life span.[105] It was created exclusively to deal with the NPLs. Indeed, DANAHARTA performed all its NPLs acquisitions between 1998 and 2001. After achieving its objectives, DANAHARTA ceased to operate in 2005.

Another characteristic of DANAHARTA was that its Board incorporated representatives of the government, the private sector and the international community (Section 5 (1)). Although the DANAHARTA Act did not define what the term ‘representative of the international community’ meant, non-Malaysians with expertise in international finance were appointed. When DANAHARTA began operations, the MoF designated as directors a combination of current and former public officials from that Ministry and the BNM and representatives of the private sector such as Datuk Megat Zaharuddin Megat Mohd Nor, Chairman of Shell-Malaysia.[106] Representatives of the international community included Radamco

[103] Fung, above n 98.
[104] Ibid 19
[105] Pengurusan DANAHARTA Nasional Berhad, above n 97, 11.
[106] Anita Gabriel, 'DANAHARTA, DANAMODAL name directors', Business Times 25 August 1998.

Pacific Chairman, Eoghan M. McMillan and Alister T. Maitland, former executive director of Australian & New Zealand Banking Group.[107] This structure of the DANAHARTA's Board took into account other perspectives in the decision making process.

Similarly, the DANAHARTA Act included a multi-approval scheme for making key decisions. To illustrate, restructuring proposals that affected a corporate debtor were prepared by the Special Administrator, reviewed by an Independent Advisor; and approved not only by the Board of DANAHARTA but also by the vote of a majority in value of the secured creditors. Another example was the surplus sharing agreements that involved the NPL selling banks in the process of defining the transfer values of loans and the manner in which DANAHARTA would distribute any recovered surplus with the banks. In a similar way, auxiliary officials, like special administrators or firms that offered their services as independent advisors, were appointed by the Board of DANAHARTA but only with the approval of the Oversight Committee.

Despite of the above devices, the constitutionality of the DANAHARTA Act 1998 was judicially challenged by Kekatong, a proprietor of a plot of land that was pledged to guarantee a loan made in favour of a third party.[108] The borrower had defaulted and the original banking creditor sold the loan to DANAHARTA. Then, Kekatong applied to the High Court seeking to restrain DANAHARTA from exercising any rights under the DANAHARTA Act. The High Court decided against Kekatong but the Court of Appeal reversed and found that section 72 of the DANAHARTA Act was unconstitutional and violated article 8 of the Constitution of Malaysia that grants the right of equal protection of the law.

In January 2004, the Federal Court overthrew the Court of Appeal's decision. The Federal Court first stated that the access to justice right was not a fundamental right and, on the contrary, its exercise would depend on parliamentarian acts that may confer, restrain or remove the jurisdiction and powers of a court. In addition, the Federal Court stated 'a law would be regarded as discriminatory only if it discriminates one person or class of persons against other similarly situated and

---

107 Reuters News, 'Malaysia's DANAHARTA names board of directors', Reuters 24 August 1998.
108 *DANAHARTA v Kekatong* [2004] 2 MLJ 257.

denies to the former the privileges that are enjoyed by the latter.'[109] The Court found that DANAHARTA had treated equally all debtors that were in a similar position and, therefore, it did not violate any constitutional provision.

Finally, the Federal Court ruled that the DANAHARTA Act was necessary and justified by public interest as a mechanism to achieve the revitalisation of the Malaysian economy. The Court added that the impossibility to apply for injunctive reliefs was understandable 'to ensure that the object of the Act is not frustrated. That clearly is the purpose of s 72 which applies to all persons in the same position as the respondent'.[110]

### 6.7.2 DANAMODAL

Another of the NEAC's recommendation to contain the potential impact of the Asian crisis in the banking system was to create a special purpose vehicle under the control of the Central Bank in order to recapitalise the banking system.[111] This proposal would avoid BNM's direct involvement in this task and it could focus more on its function as a central bank and banking supervisor.

To implement this measure, the BNM incorporated a wholly owned subsidiary named DANAMODAL in August 1998. There was no legal reform to establish DANAMODAL. The main objective of DANAMODAL was to recapitalise weak banks through a market-approach methodology that guaranteed transparency, prudence and compliance with international standards. It also sought to minimise the use of public funds.[112]

As in the case of DANAHARTA, the Board of DANAMODAL was composed of representatives of the government (the BNM and MoF) and the private sector. In the same way, DANAMODAL hired international well-known firms to act as advisers (for example, Salomon, Smith, Barney and Goldman Sachs).[113]

---

109 Ibid 275.
110 Ibid 287.
111 Zainal-Abidin Mahani, *Rewriting the Rules/The Malaysian Crisis Management Model* (2002).
112 Ibid 157.
113 Ibid160.

Malaysian authorities established a methodology in which they set the requirement of a financial institution to recapitalise as a benchmark, if the capital adequacy ratio was below 9%.[114] Licensed banks that were below this mark were required to strengthen their capital. To achieve this purpose, banks were obligated to search for financial solutions available in the market without relying on public funds. Only when institutions were not able to reconstitute their base capital through market options, DANAMODAL would intervene and propose a recapitalisation plan.

The first evaluation made by DANAMODAL identified that fourteen institutions had a capital adequacy ratio under 9% and required immediate recapitalisation.[115] From these critical institutions, three opted to implement their own financial solutions while the other eleven signed conditional agreements with DANAMODAL in September 1998. Conditional agreements contained the mechanisms that DANAMODAL would use to recapitalise a bank (for example, exchangeable subordinated capital loans and ordinary shares). Transfers of funds were always conditioned on the implementation of DANAMODAL programs, which included the monitoring of the distressed banks. In several cases, DANAMODAL required the appointment of board directors and the achievement of specific financial targets. On other occasions, DANAMODAL took the control of distressed institutions.[116] Only nine banks finalised DANAMODAL proposed plans.

### 6.7.3 Corporate Debts Restructuring Committee (CDRC)

As a consequence of the crisis, an increasing number of companies resorted to Section 176 of the Companies Act 1965 and requested restraining orders from courts. This strategy allowed companies to buy time and work out restructuring agreements with creditors.[117] In the same way, many corporations went into receivership administration and were targeted by winding-up petitions.[118]

In July 1998, in order to facilitate a more friendly approach between debtors and lenders, the government created the CDRC, an informal forum, to speed up the

---

114 The legal ratio was 8%.
115 Mahani, above n 111, 159.
116 Ibid 161.
117 Bank Negara Malaysia, *Introduction to the Corporate Debt Restructuring Committe (CDRC)* (2002) <http://www.bnm.gov.my/index.php?ch=31> at 07 August 2007.
118 Ibid.

restructuring of debts of corporations and avoid the legal ordinary procedures that were perceived as slow and not suitable to face the crisis. The CDRC did not have a legal status. Borrowers and creditors must have voluntarily agreed to resort to the CDRC to work out a solution for a distressed company. The CDRC offered a more extensive set of solutions than the options offered by the legal framework, which tended to be disruptive of the business of a company. The CDRC's solutions would preserve the value of a corporation [119]

While negotiations continued, creditors and debtors signed a standstill agreement to suspend any legal action against the borrower. Further, the debtor was obligated not to incur new debt or dispose of its assets. It should continue to manage and conduct its affairs in the normal course of business.[120]

Initially, the CDRC issued guidelines that would route negotiations in order to make the process fluent. However, the process was slow because it usually involved a large number of creditors and it required a 100% consensus to approve actions such as the signature of the standstill agreement or the provision of fresh money to debtors. In 2001, the guidelines were modified and included specific timelines to ensure the prompt implementation of the restructuring exercise.[121]

The CDRC was involved in those cases that represented the total aggregate bank borrowings of RM 50 million or more and involved two or more banks.[122] The CDRC was led by a Steering Committee that was in charge of conveying meetings between debtors and creditors. As the case of DANAHARTA and DANAMODAL, the CDRC's Steering Committee included representatives from the BNM, the MoF and DANAHARTA as well as members from the private sector.[123]

The function of the CDRC was not only to provide a table for discussions between banks and their clients, but also act as an advisor and mediator. When the CDRC was involved in the restructuring exercise, the Committee appointed an independent consultant who would prepare a restructuring proposal. Then, the proposal was presented to the CDRC, which reviewed the viability and its acceptability for all

---

119 Ibid.
120 Ibid
121 Bank Negara Malaysia, 'BNM Annual Report 2001' (BNM, 2002) 135.
122 In 2001, the parameters were changed to cases that represented total aggregate bank borrowings of RM 100 million with a least five banks.
123 Bank Negara Malaysia, above n 117.

parties involved. Last, if the proposal was accepted by banks, the company and the shareholders, it was implemented. This process was achieved through voluntary negotiations among all the involved parties.

## 6.8 Results of the Home-Grown Malaysian Program

### 6.8.1 Legal Perspective

The legal strategy followed by the Malaysian government to implement the measures necessary to safeguard the banking system did not put aside the ordinary legislation. In contrast, the BNM used the Central Bank Act and BAFIA to take several actions to strengthen its supervisory tasks and improve the regulatory framework.

A factor that stood out in the way in which the government of Malaysia managed the crisis in the banking sector was the clarity to set the objectives that needed to be achieved in order to diminish the consequences of the crisis. In the same way, the strategies designed to achieve the objectives were adequate to the country's reality.

Three *ad hoc* entities were created: DANAHARTA, DANAMODAL and the CDRC. Each one of these entities was carefully designed and provided with clear mandates. Further, functions of the three *ad hoc* entities were coordinated by the MoF and the BNM. Since the kick off, the *ad hoc* entities knew that they were created to execute a finite role and today, all of them have ceased operations. In the case of DANAHARTA, it wound up operations in December 2005, seven and half years after its creation and within the limit of five to twelve years, considered normal for this type of asset management companies.[124]

In spite of the initial fears associated with the government's refusal to resort to the IMF, DANAHARTA, DANAMODAL and CDRC performances were guided by market principles that sought to avoid the use of public funds to bail out private corporations. To guarantee a commercial approach and minimise political interference, the three institutions hired international firms that prepared or reviewed

[124] Fung, above n 98, 16.

proposals that were submitted to DANAHARTA and DANAMODAL boards and the CDRC's Steering Committee.

The institutional arrangement put in place to resolve the problem in the banking system also looked for an equal treatment of all companies affected by the Asian crisis. Nonetheless, in the case of DANAHARTA, there were two situations that were differently treated: the collapses of Sime Bank Group and Bank *Bumiputera*. In the first case, the increase of NPLs affected the capital base of Sime Bank, forcing the BNM to take control of the institution. Later, Sime Bank was merged with RHB Bank Group and as a part of the deal, BNM assumed the NPLs that were transferred to DANAHARTA for their administration.[125] In the case of Bank *Bumiputera*, as a government owned bank, the state directly assumed its rescue and transferred its NPLs to DANAHARTA to facilitate its merger with Bank of Commerce.[126] The willingness of the government to promote mergers of failing banks instead of ordering their closure seems to justify these actions. Without removing NPLs from Sime Bank and Bank *Bumiputera*, it would be difficult to achieve successful merger agreements.

In the configuration of the *ad hoc* institutional arrangements, the government integrated the private sector and particularly banking institution representatives. DANAHARTA went further and included two representatives of the international community. The incorporation of other players other than the government helped to improve the decision making process. It could be said that this crisis management approach completely differed from what has been the position of the government to face crises of political nature and where decisions are restricted to the executive branch and are surrounded by secrecy.

Furthermore, DANAHARTA and DANAMODAL prepared and published periodical reports to inform about their operations. In the case of CDCR, it was obligated to issue a quarterly report on the progress of the restructuring cases managed by the Committee.[127] Besides, the two corporations and the CDRC regularly published online information regarding transactions, operational guidelines changes and other

---

125 Pengurusan DANAHARTA Nasional Berhad, above n 97, 20.

126 Ibid. Bank of Commerce was fully owned by Commerce Asset-Holding Bhd, a company that was listed in the Kuala Lumpur Stock Exchange.

127 Bank Negara Malaysia, n 121, 115.

information of interest for the public. This *modus operandi* contributed to the transparency of the restructuring efforts.

Legal reforms were minimal and limited to the DANAHARTA Act and the National Land Code Amendment. The DANAHARTA Act could be classified as an exceptional act passed by the Parliament that granted extraordinary powers to that Corporation. However, the Parliament carefully delineated such powers and included limits and check and balance devices to avoid abuses.

The most sensitive restriction included in the DANAHARTA Act was the limitation related to the impossibility to seek judicial review or injunction reliefs in favour of people affected by DANAHARTA's actions. The solution was similar to the emergency scheme incorporated in the Constitution of Malaysia in which judicial review is seriously limited. It also responded to the developmental model imposed in many Asian countries in which the administration (DANAHARTA) was granted with wide discretion and its acts were isolated from judicial interference. Interestingly, while other countries that were affected by the crisis and helped by the IMF reforms were oriented to dismantling the developmental state model, the adaptation of the model in Malaysia addressed the problems of the banking system. The Parliament agreed with the method when it passed DANAHARTA Act.

The Malaysian government's response to manage the consequences of the Asian crisis into the banking system through the strengthening of prudential regulation, management of NPLs, recapitalisation and restructuring of corporate debts did not differ greatly from the actions recommended by the IMF in other countries. However, enjoying a stronger external reserve position, Malaysia did not have to resort to the IMF and, therefore, it was able to structure its own set of measures and timing for the implementation of such actions. Perhaps for this reason, an extensive legal reform of the banking legal framework did not occur and it was only after the government tackled the most urgent issues associated with the crisis that the BNM and the Malaysian authorities reviewed and implemented deeper structural reforms of the banking system, following a well structured master plan (see Table 6).[128]

[128] See Bank Negara Malaysia, 'Financial Sector Masterplan: Building a Secure Future (2001).

**Table 6: Selected Malaysia Legal Banking Reforms 1998-2005**

Please see print copy for Table 6

The Malaysian emergency scheme provided a fast-track approach for the resolution of issues that were cardinal to avoid a deeper banking crisis. It combined the enforcement of ordinary legislation (Central Bank Act 1958, BAFIA and ISA) with an exceptional legal solution (DANAHARTA Act) and a flexible informal scheme that facilitated resolution of corporate debts (CDRC).

After the implementation of the NEAC recommendations, the banking system showed a better face. By August 1998, NPLs ratio was 11.4%. This number dropped to a single digit in March 2000 and it was 4.8% in 2006.[129] When DANAHARTA ceased operations in 2005, it achieved a recovery rate of 58%, equivalent to RM 30.4 billion.[130] From that amount, 88% was recovered in cash and the rest, equivalent to RM 3.7 billion, in the form of residual recovery assets (such as physical assets and financial assets). The 58% recovery rate was above the common rate in other countries. [131]

A similar situation occurred with the capitalisation of the banking system. In August 1998, it was calculated that about 20% of the banks had a capital adequacy ratio fewer than 9%, the trigger level established by authorities to consider that a bank required immediate recapitalisation.[132] The capital adequacy ratio for all financial institutions was 12.1% and the ratio was improved to 12.8% in March 1999, a level that was maintained until 2006.[133] By 2003, when DANAMODAL winded down its operations, it had injected an amount of RM 7.6 billion into ten banks affected by the crisis.[134] DANAMODAL recovered RM 6.6 billion.[135] The cost incurred by the

[129] See Pengurusan DANAHARTA Nasional Berhad, above n 97, 46; Bank Negara Malaysia, 'Financial Stability and Payment Systems Report 2006' (BNM, 2007) 15.
[130] Bank Negara Malaysia, 'BNM Annual Report 2005' (BNM, 2006) 132.
[131] The Chinese asset management companies had a recovery rate of 33.6%, Indonesia 34% and Korea 47%. Fung, above n 98.
[132] Mahani, above n 111, 157.
[133] Ibid, 167.
[134] Bank Negara Malaysia, 'BNM Annual Report 2003' (BNM, 2004) 107.

government through DANAHARTA and DANAMODAL amounted to RM 12.6 billion, or 2.5% of the GDP.[136]

Finally, the CDRC was closed in 2002. During its operations, the CDRC successfully completed the restructuring efforts of 48 cases, about 65% of the total cases that sought a resolution through the Committee.[137] The most important goal achieved by the CDRC is that it allowed companies to work out their financial solutions as ongoing businesses, maintaining employment and their contribution to the economy.

### 6.8.2 The Developmental Aspect

From the development process perspective, the Malaysian government was loyal to the principles that guided its pre-crisis development model. It maintained the integrity of the banking system without relinquishing its control to foreign investors. This matter was left for a later stage, when a plan for the consolidation of the existing financial system was completed.[138] The government argued that domestic banks would be better prepared to face foreign competition after the implementation of a merger exercise. The consolidation was successfully completed and 54 domestic banking institutions were reduced to ten banking groups at the end of 2000.[139] To keep control of the banking system was essential for the government to maintain its influence over banks and their contribution to achieve the government development goals.

In similar terms, the government retained its programs oriented to improve standards of living of Malays and still continued protecting Malays according to constitutional postulates. Indeed, the government created new programs to help *Bumiputera* small and medium enterprises to recover from the crisis (e.g. the Entrepreneur Rehabilitation and Development Fund).[140]

---

135 Ibid.
136 Bank Negara Malaysia, above n 130, 133.
137 Bank Negara Malaysia, 'BNM Annual Report 2002' (BNM, 2003) 115.
138 See Bank Negara Malaysia, above n 128.
139 Bank Negara Malaysia, 'BNM Annual Report 2000' (BNM, 2001). The plan was implemented with great controversy because the government initially selected six anchor banks and determined which financial institutions would be absorbed by these six big banks. See Alison Warner, 'The shotgun weddings (Malaysia's financial institutions are ordered to merge)', The Banker 149 884 (1999). Later, the government abandoned this approach and allowed banks to freely negotiate mergers with other institutions.
140 Bank Negara Malaysia, above n 121, 122.

However, it could not be said that *Bumiputera* suffered the consequences of the crisis more than any other ethnic groups. For instance, poverty among *Bumiputera* decreased 28.4% between 1999 and 2002, while among the Chinese population, the reduction was 42.3% (Table 7). Meanwhile, poverty did not change among the Indian-Malaysian population between 1999 and 2002.

**Table 7: Poverty, by Ethnic groups 1999-2002 (%)**

Please see print copy for Table 7

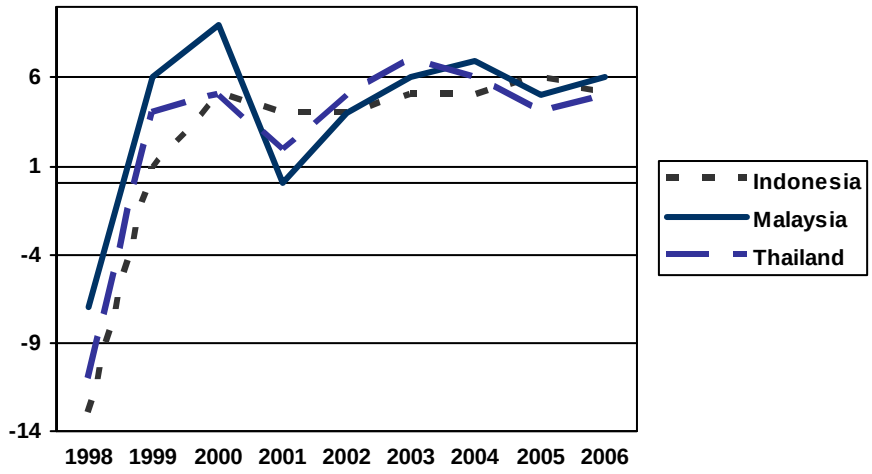
Source: Economic Planning Unit: Ninth Malaysia Plan 2006-2010 and Mid-Term review of the Eight Malaysia Plan 2001-2005.

After the crisis, the Malaysian banking system maintained is strong presence in the economy both in terms of loan/GDP and deposit/GDP as well as number of people with banking accounts. To illustrate, there are 328.97 loan accounts and 1,250.10 deposit accounts per 1,000 people in Malaysia while there are 93.04 and 486.74 respectively in Venezuela.[141]

### 6.8.3 Other Effects of the Government's Management Crisis Program

Although the initial criticism against Mahathir about the way the government addressed the crisis, the country recovered faster than other Asian nations (see Figure 3).

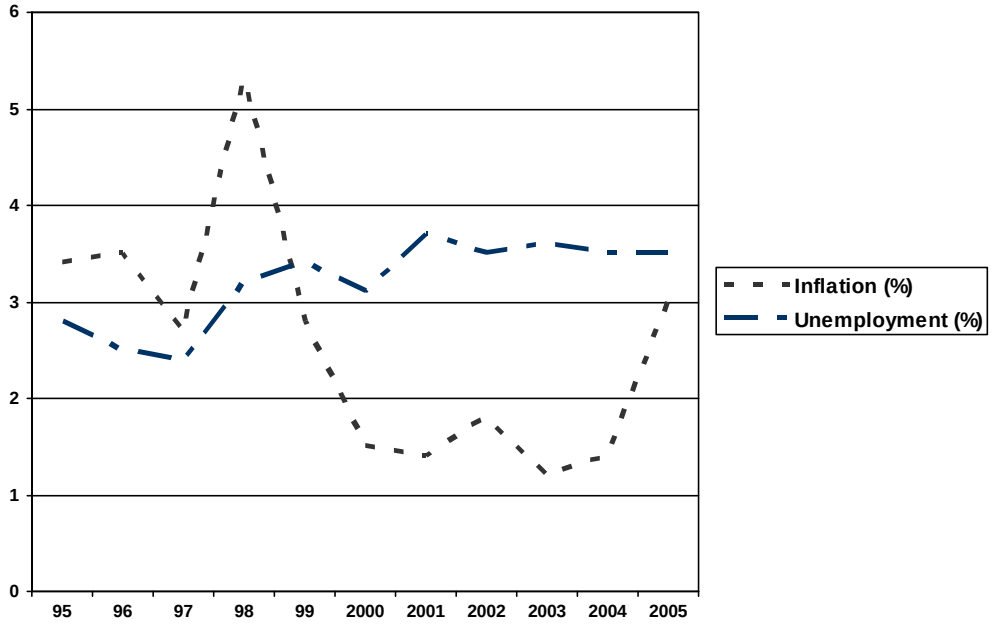
[141] See Thorsten Beck, Asli Demirguc-Kunt and Maria Soledad Martinez Peria, 'Reaching Out: Access to and Use of Banking Services across Countries' (Working Paper WPS3754 World Bank, 2005).




Source: IMF, various reports

**Figure 3: Indonesia, Malaysia and Thailand GDP 1998-2006**

Malaysia was also able to control inflation and unemployment although it could not reduce unemployment to pre-crisis levels. However, unemployment is still manageable and does not exceed 4% (see Figure 4).




**Source: Malaysian Ministry of Finance, Economic Report, various issues**

**Figure 4: Selected Indicators, Malaysia 1995-2005**

The Asian crisis negatively affected people in Malaysia and poverty rose from 6.1% in 1997 to 8.5% in 1999. However, it proved to be a temporary set back. With the quick economic recovery, Malaysia reassumed its steps in order to reduce poverty and it diminished to 6% in 2002 and 3.6% in 2007 (Figure 5). The government is committed to eradicate hardcore poverty and reduce overall poverty to less than 3% by the end of 2010.[142]

Please see print copy for Figure 5

Source: Prime Minister Department Economic Planning Unit, Malaysia, *Ninth Malaysia Plan 2006-2010* (2006).

**Figure 5: Poverty, Malaysia 1997-2007**

Finally, as has been described by some scholars, while countries like Indonesia and Thailand experienced profound political reforms triggered by the crisis, Malaysia maintained the *status quo*.[143] Indeed, BN continued winning elections and retained the two-thirds of the parliamentarian seats. It was only recently that BN lost its two-thirds parliamentarian majority in the election held in March 2008.[144]

142 Economic Planning Unit Prime Minister Department, Malaysia, *Ninth Malaysia Plan 2006-2010* (2006) 340.

143 See e.g., Andrew Harding, 'Southeast Asia, 1997-2003: Two Case Studies on the Politics of Law and Development' in Christoph Antons and Volkmar Gessner (eds), *Globalisation and Resistance/Law Reform in Asia Since the Crisis* (2007) 133-155.

144 I will discuss further political changes produced in Malaysia by the Asian crisis in chapter 9.

# CHAPTER 7

# RULE OF LAW, EXCEPTIONAL POWERS AND THE IMF THE VENEZUELAN EXPERIENCE

## 7.1 Introduction

As an independent country, Venezuela has developed as a mixed-race society that has adopted Catholicism as its main religion. Since the 1920s, oil has played a decisive factor in the policy-making process in Venezuela. Oil has even affected the relationship between the country and the IMF. The government's interest in the Fund's orthodox policies has fluctuated following the trends of the international oil markets. Hence, the government tends to convert to neoliberalism when the market is depressed and resist market forces when prices are high.

Another factor that plays a relevant role in Venezuela is the strong position vested in the executive and the ability of the President to invoke exceptional powers to address extreme situations, a method that has been developed since the country achieved its independence from Spain. During the banking crisis, the preference for states of emergency to deal with economic problems was ratified and it was the approach selected by authorities.

The study of the Venezuelan banking crisis has been divided into two chapters. Chapter 7 provides an historical, social and economic background to the case study of Venezuela, which provides insight into the conditions under which the crisis broke out. This chapter also reviews the legal system of Venezuela, with special reference to the exceptional scheme in place when the crisis affected the country and the structure of the federal government. Chapter 8 studies the banking crisis that broke out in 1994 and the legal response of the Venezuelan government, contrasting the ordinary legal arrangements that existed before the crisis with the emergency laws and regulations enacted to tackle the financial shock.

Please see print copy for Figure 6

**Figure 6: Map of Venezuela** [1]

## 7.2 From Spanish Domination to the Democratic Era: A concise history of Venezuela

In 1498, during his third voyage to America, Christopher Columbus navigated the Venezuelan coasts for the first time. The territory was inhabited by aboriginal tribes

[1] One World-Nations Online, *Political Map of South America* (2008) One World-Nations Online <http://www.nationsonline.org/oneworld/map/south_america_map2.htm> at 17 August 2008

from mainly two groups: the Arawak and the Carib. In contrast to other more complex aboriginal societies (such as the Aztec, the Maya and the Inca), Arawak and Carib cultural attainments and organisation were simple.[2]

Attracted by the pearls worn by its inhabitants, Spaniards established a town, Cadiz, in an island located north of Venezuelan coast in 1500. It was the first town settled in the territory that nowadays is occupied by Venezuela. On shore, the settlement of villages was a hard task because the Spaniards faced the fierce opposition of aborigines, especially from Carib tribes, who combated Europeans until the end of the sixteenth century.[3] Fights against the Spaniards, forced work, aborigine-slave trade and new illnesses brought by the Europeans drastically reduced the aboriginal population during the first century of colonisation in Venezuela.[4]

In 1518, after persistent diligence in order to gain the attention of the Spanish Crown and find a regime that protected aborigines from extinction, friar Bartolomé de las Casas achieved an agreement with the Spanish Kings to establish a special zone on the Venezuelan coasts for the conservation of aborigines and their Christianisation.[5] The idea was to organise a town in which Spanish farmers and their families would live side by side with aborigines, who would learn agriculture and Christian principles. The experiment failed when the aborigines attacked and killed the settlers.

In 1528, Venezuelan territory was organised as a governorship and it was again the object of an agreement when Charles V[6] consented to settle a debt with the Welser Company from Augsburg, transferring his rights to Venezuela.[7] Both parties agreed on capitulations according to which Spaniards expected the Welser Company would establish a commercial colony building towns and exploiting mines.[8] Once in

---

2 John Francis Bannon, Robert Ryal Miller and Peter Masten Dunne, *Latin America* (4th Ed., 1977) 21.

3 A. Arellano Moreno, *Guia de Historia de Venezuela 1498-1968* (2nd ed, 1971).

4 Alonso de Zorita cited by Benjamin Keen, Latin American Civilization/History and Society, 1492 to the Present (8th ed, 2004) 138. See also Bartolomé de las Casas, *Brevísima Relación de la Destrucción de las Indias* (13th ed, 2003).

5 John Edwin Fagg, *Latin America/ A General History* (Third Ed., 1977) 88.

6 Charles V, Holy Roman Emperor (1500-1558), was also known as Charles I of Spain. In addition to the Kingdom of Castile and the Crown of Aragon, he ruled extensive domains in Central, Western and Southern Europe as well as the Spanish colonies in America. He is considered the first Spanish king because he was the first monarch to reign in his own right over both the Kingdom of Castile and the Crown of Aragon. See Joseph Perez, 'Estructura de los Reinos Peninsulares' in Antonio Blanco Freijeiro, et al. (eds), *Historia de España* (1986) 479-491.

7 See Bannon, above n 2, 108-110. See also Fagg, above n 5, 89. Juan Friede, *Los Welser en la Conquista de Venezuela* (1961).

8 In the context of the Spanish American colonisation enterprise, the agreements between explorers and the Spanish Crown were called '*capitulaciones*'. For more details about the capitulation system, see sub-section 7.5.1 in this chapter.

Venezuela, Welser's officials focused their colonisation efforts on exploring inland territories, searching for the mythical city of *El Dorado*. The company was not successful finding the golden city, building towns or establishing a commercial centre, which was the reason why the Spanish King terminated its capitulations in 1548, citing the failure to comply with the agreed conditions.

During the sixteenth and seventeenth centuries, other regions like Mexico, Peru and the Antilles attracted more attention from the Spanish Crown and conquerors than Venezuela, which remained marginalised from the Spanish colonisation process.[9] The second-rank position of Venezuela during the Spanish ruling was reflected in its administrative status. Venezuelan providences always depended on authorities settled in other distant jurisdictions. Initially, Venezuelan provinces were subordinated to the *Real Audiencia* of Santo Domingo. In a second phase, the country depended on the *Real Audiencia* of Bogota and then the New Granada Viceroyalty.

Venezuela gained more important administrative recognition in 1777 when Charles III of Spain issued a Royal Order to reorganise the Captaincy-General of Venezuela and grouped several geographically close providences under the command of a Captain-General in Caracas. The Captain-General had the authority to deal with political and military issues.[10] The Captaincy-General of Venezuela was formed by the providences of Venezuela or Caracas, Trinidad (which was later transferred to the British as a part of the Treaty of Amiens celebrated between United Kingdom, France and Spain in 1802[11]), Cumana, Margarita, Guayana and Maracaibo. The reorganisation of the Captaincy-General of Venezuela was mainly aimed at strengthening the military defences of the Spanish Empire in South America, at a time when the British, the Dutch and the French frequently attacked Venezuelan coasts.

The reorganisation of the Captaincy-General of Venezuela constituted a milestone in its history because it territorially unified the different provinces that would form independent Venezuela. Indeed, the current Constitution states that the territory of

---

9 See Fagg, above n 5, 88-89.

10 For a more detailed explanation of Spanish-American Captaincy-General see C.H.Haring, *The Spanish Empire in America* (1947).

11 Jose Antonio Ferrer Benimeli, 'El Fin del Reformismo' in Antonio Blanco Freijeiro, et al. (eds), *Historia de España* (1986) 749-763, p.758.

Venezuela corresponds with the jurisdiction of the Captaincy-General in 1810 (article 10). [12]

On April 1810, Venezuela began its long and bloody struggle for independence, a process through which the country lost 30% of its population. That year, people from Caracas deposed the Spanish Captain-General and selected a local *Junta*. The movement was made alleging that Napoleon had seized Seville and; therefore, Spaniards were too busy dealing with the French and could not defend the rights of Ferdinand VII, the Spanish King.[13] The local *Junta* would rule in the name of Ferdinand VII.[14]

Soon, the protection of Ferdinand's rights proved to be an excuse to gain independence and the next year, seven Venezuelan provinces formally declared their independence from Spain on 5 July 1811, becoming the first Spanish American colony to proclaim their freedom from the Spanish Empire.[15] In December of the same year, the first Constitution of Venezuela was approved, organising the government of the new republic. After the declaration, the Spanish Crown fought back to recover what it considered its colony. Spaniards regained control of most of the Venezuelan territory in 1812. Between 1812 and 1821, fights between Venezuelans and Spaniards continued and both sides shared control of the country.

When the patriots reconquered Venezuelan northeast provinces and *Guayana* (in the south of the country) in 1819, Simón Bolívar, who became the indisputable political and military leader of the Venezuelan patriots, decided to focus the war efforts on the liberation of New Granada Viceroyalty, located in the west frontiers of Venezuela in the territory that is today occupied by Colombia. He argued that this action would guarantee the total defeat of Spaniards. Bolívar's plans included the promotion of a new Constitution approved in the Venezuelan southern city of Angostura in which he included the initial steps for the future creation of Colombia, a country that would merge Venezuela and New Granada.

---

12 Through the years, Venezuela has lost territory due to claims won by England, Colombia and Brazil.

13 Ferdinand VII (1784-1833) first ascended the Spanish throne in 1808 due to the adjudication of his father Charles IV of Spain. Soon, Ferdinand influenced by Napoleon, returned the throne to his father who adjudicated in favor of Napoleon who appointed his brother, Joseph I, as Spanish King. Ferdinand VII reassumed his reign in 1814. Julio Arostegui, 'Un Nuevo Sistema Político' in Antonio Blanco Freijeiro, et al. (eds), *Historia de España* (1986) 764-800.

14 Bannon, above n 2, 256.

15 For a summary account of the Venezuela's war of independence see Bannon, above n 2, 255-264.

From Angostura, Bolívar marched to liberate New Granada and achieved his goal in 1819 with the Battle of Boyacá. Later in 1821 with the Battle of Carabobo, Bolívar liberated Venezuela. Following Bolívar's plans, both liberated territories were merged into one with the approval of the 1821 Constitution and the creation of Colombia, which also included portions of territories that today are parts of Ecuador and Panama. Using Colombia as a platform, Bolívar was able to liberate Peru and Bolivia.

Although the creation of Colombia contributed to the defeat of the Spanish Crown in South America, the new country did not work well from a political perspective, especially because each region was dominated by local military leaders. Due to regional interests, Bolívar's integration plans failed and Venezuela regained its autonomy in 1830. After secession from Colombia, Venezuela was involved in constant revolts, civil wars and dictatorships. Between 1830 and 1903, 39 revolutions and 127 uprisings were recorded.[16] Those armed events were headed by different local *caudillos* that led private armies and controlled small territorial areas.

Between 1908 and 1935, the country was governed by Juan Vicente Gómez, a strong dictator who defeated regional *caudillos*. He was able to centralise and strengthen the federal government. Gómez also dissolved personal armies and professionalised the national army. His administration initiated the use of oil revenues for the development of the economy, especially in the 1920s when the full exploitation of oil started, led by American, British and Dutch companies.

After the death of Gómez in 1935, there were various attempts to establish a democracy in Venezuela, but they were interrupted by coups. It was only after the overthrow of the last dictator in 1958 that a more stable democracy developed. During the democratic era that runs between 1959 and today, various Presidents have been elected (see Table 8).[17]

---

[16] Francisco Rodriguez, 'Anarchy, State, and Dystopia: Venezuelan Economic Institutions before the Advent of Oil' (2008) XVIII *Bulletin of Latin American Research* 99-118.

[17] Although there is a strong debate about whether or not Chávez's government should be considered democratic, especially after 2003 when he radicalised his government style and assumed a strict control of the other state branches and institutions, I prefer to avoid this discussion that is beyond the goals of this thesis and assume the democratic character of his government considering that he was democratically elected.

**Table 8: Venezuelan Presidents 1959-2008**

| President | Party | Period |
|---|---|---|
| Rómulo Betancourt | *Accion Democratica* (AD) | 1959-1964 |
| Raúl Leoni | AD | 1964-1969 |
| Rafael Caldera | Social Christian Party of Venezuela (COPEI) | 1969-1974 |
| Carlos Andrés Pérez | AD | 1974-1979 |
| Luis Herrera Campins | COPEI | 1979-1984 |
| Jaime Lusinchi | AD | 1984-1989 |
| Carlos Andrés Pérez | AD | 1989-1993 |
| Octavio Lepage (interim President) (1) | AD | May 1993-June 1993 |
| Ramón José Velásquez (interim President) (2) | Independent | June 1993-Feb 1994 |
| Rafael Caldera | *Convergencia* | 1994-1999 |
| Hugo Chávez | *Movimiento V Republica* (MVR) | 1999-2000 |
| Hugo Chávez (3) | MVR | 2001-2007 |
| Hugo Chávez (4) | PSUV (5) | 2007-2013 |

(1) As a President of the Senate, he temporally assumed the presidency after Pérez was removed before the end of his period due to corruption charges.

(2) He was elected by the Congress to terminate the presidential period of Pérez.

(3) He was elected for a new period after the approval of the 1999 Constitution.

(4) He was re-elected for a new six-year period.

(5) MVR was later changed to *Partido Socilista Unido de Venezuela*, PSUV (United Socialist Party of Venezuela).

## 7.3 People from Venezuela

### 7.3.1 Ethnicity

Chapter 5 discussed the role played by ethnicity and Islam in the decision making process of the Malaysian government and its effects on the legal and financial systems. The Venezuelan case is different and there are no major consequences derived from the ethnic or religious arrangements. The Venezuelan estimated population by 2006 was 27 million.[18] 92.8% of the population live in urban centres, a

[18] Instituto Nacional de Estadísticas, *Estadísticas Demográficas* (2008) INE at www.ine.gob.ve at 9 January 2008.

consequence of the oil boom that forced people to emigrate from rural areas to cities in order to find jobs.

It is not possible to extract the racial composition of Venezuelan society from the official numbers. Since the beginning of the twentieth century, official censuses have excluded questions about race. Officials have argued that it was unnecessary because there was no racial discrimination in the country and also due to the high percentage of mixed race people. Today, the same reasons are maintained to exclude ethnicity from official censuses.[19]

The Venezuelan population is the product of the blending of Spaniards, aborigines and Africans. Since Spaniards arrived on the Venezuelan coasts, they mixed with aborigines, especially during the first decades in which Spanish women rarely came to America, procreating *mestizos* (descendents of Spaniards and aborigines).[20] Spaniards also mixed with Africans conceiving what was called *mulato*. Aborigines and African were also involved in inter-racial relations procreating what were called *zambo*s. Today all mixed races are generally referred to as *mestizos*.

The ethnical mixture produced a society in which a high percentage of people are of mixed race. Some studies have calculated this percentage to be somewhere between 67% and 80% of the population, but most sources place the number at 67%.[21] The rest of the population is estimated to be 21% Caucasian, 10% African decedents and 2% aborigines.

In Venezuela, there are no official segregation regulations or policies. However, most indigenous tribes live in isolated areas.[22] Until 2000 when the 1999 Constitution entered in force, regulations, governmental policies and programs were designed without ethnic considerations. Access to social programs was defined in terms of income. Thus, low-income people may have more access to public funded programs.

---

19 Jesus Chucho Garcia, 'La Deuda del Estado Venezolano y los Afrodescendientes' (2007) 12 *Journal of Latin American and Caribbean Anthropology* 223-232.

20 See Haring, above n 10, 197. Spanish laws allowed inter-racial marriages between Spaniards and Indians. See Recopilación de las Leyes de las Indias, Libro Sexto, Titulo Primero.

21 See for example Encyclopedia Britannica Online, *Venezuela* (2008) Encyclopedia Britannica Online <http://www.britannica.com/EBchecked/topic/625197/Venezuela#tab=active~checked%2Citems~checked&title=Venezuela%20--%20Britannica%20Online%20Encyclopedia> at 08 January 2008; Banco de Comercio Exterior, *Perfil de Países* (2003) BANCOEX <http://bancoex.com/perfil_venezuela.asp> at 9 July 2004.

22 Venezuelan indigenous people include *Wayyú, Pumé, Warao Pemón, Yagarana, Yanomami and Yekuana* ethnics.

The 1999 Constitution marked a different approach in democratic Venezuela when it included a chapter in which it recognises and addresses the rights of indigenous people (for example, rights to preserve their languages that are now considered official, rights to maintain their political and economic arrangements, rights to enforce their customary laws, recognition of the collective property of indigenous knowledge, etc). In addition, the Constitution grants an indigenous representation in the National Assembly (three deputies).

### 7.3.2 Religion

Since Pope Alexander VI settled disputes between Spaniards and the Portuguese regarding the new conquered land in 1493, he imposed the obligation to bring inhabitants of discovered territories to the Christian faith.[23] A similar commitment was included by Isabella and Ferdinand, the Catholic Kings of Castile and Aragon, into the Capitulations of *Santa Fe* signed with Christopher Columbus in 1492.[24] When the Spanish conquerors and priests came to America, they complied with this obligation and converted indigenous people.

After independence, the Catholic Church maintained its influence in the new states and, for instance, in the first Venezuelan constitution Catholicism was declared the official faith, prohibiting the practice of other religions. Nonetheless, President Antonio Guzmán Blanco initiated a process of secularisation in 1870s. As a consequence, the state assumed public services that were commonly performed by the Church (for example, registries of birth and cemetery's administration). The 1874 Constitution approved under the administration of Guzmán declared total freedom of religion (article 14.13) that has been maintained since then. Nowadays, the Catholic Church does not have a political or official role in Venezuelan government affairs and 70% of the population is Roman Catholic and another 29% is Protestant [25]

---

[23] See Fagg, above n 5, 67.

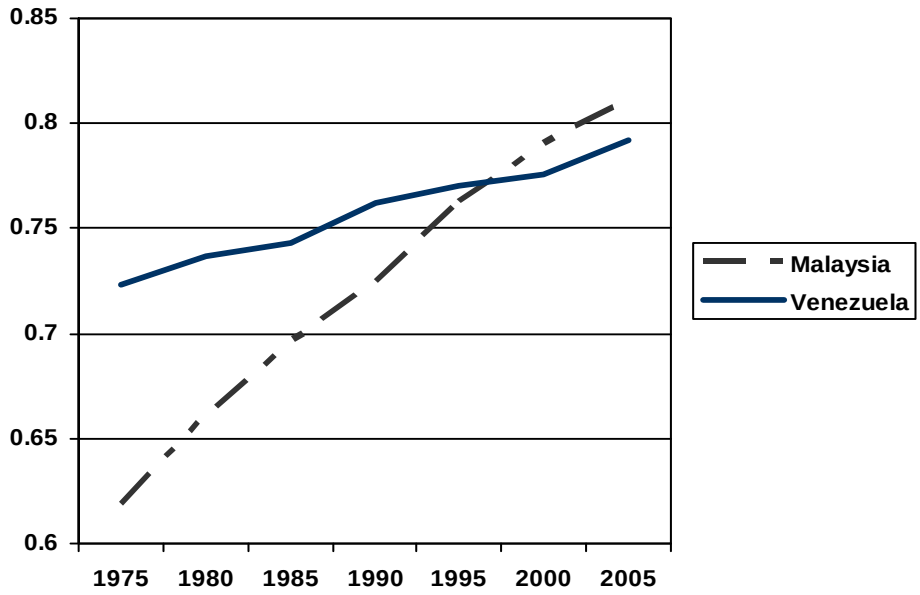
[24] The documents agreed by the Catholic Kings and Columbus that established the conditions under which Columbus would explore new routes and territories in the name of the Kings are known as '*Capitulaciones de Santa Fe*'. They were signed in the city of the same name. See Geoffrey Symcox and Blair Sullivan, *Christopher Columbus and the Enterprise of the Indies-A Brief History with Documents* (2005). For more details about the capitulation system, see sub-section 7.5.1 in this chapter.

[25] US Bureau of Democracy, Human Rights, and Labor, *2006 Report on International Religious Freedom* (2006) US Department of State <http://www.state.gov/g/drl/rls/irf/2006/71347.htm> at 14 November 2007.

### 7.3.3 Poverty

Before the beginning of the extensive exploitation of newly discovered oil-rich fields in the western part of Venezuela in 1920s, the country was predominantly rural and poor.[26] Oil caused the transformation of Venezuela in a large urban centre. A petroleum boom that lasted between the 1920s and the 1970s helped to reduce poverty to the level of 25% of the total population.[27] The picture changed between 1980s and 2000s when oil prices became more volatile and poverty rocketed to levels close to 60%. Only recently with the new boom in oil markets, has poverty been reduced to 28.5% in 2007.[28]

As other economies in Latin America, Venezuela shows an uneven distribution of wealth and the coefficient Gini was 0.420 in 2007. If the analysis is expanded to review the HDI, we observe that the improvement of the living standards of Venezuelans has been slow, and in fact almost imperceptible over the last three decades, in contrast with the fast pace of Malaysia's HDI (see Table 1, Chapter 5 and Figure 7). From being one of the most buoyant developing countries in the world in the 1970s, it became one of the more stagnant in the last thirty years.




Source: UNDP, Human Development Report 2007/2008

**Figure 7: Human Development Index, Malaysia and Venezuela 1975-2005**

.

[26] See Tomás Carrillo Batalla, Cuentas Nacionales de Venezuela 1831-1873 (2001).
[27] Comisión Económica para América Latina y el Caribe (CEPAL), 'Anuario Estadístico 1993' (1993) 47.
[28] Instituto Nacional de Estadísticas (INE), *Pobreza* (2008) <http://www.ine.gob.ve/pobreza/menupobreza.asp> at 30 July 2008.

## 7.4 Economy

### 7.4.1 Venezuela's Dependency on Commodities

The Venezuelan economy has always depended on commodities. During the first years of Spanish domination, the economy was marked by the trade of pearls and slaves. Later, Spanish settlers started to develop an agriculture sector and tobacco became the main source of income in the seventeenth century.[29] In the eighteenth century, a native plant, cacao, substituted tobacco as a main exported product.[30] The production of cacao was deeply affected by the war of independence in which most plantations were lost. When the war was over, producers found it required less time to grow coffee than cacao; hence, they made the transition and coffee became the main product of Venezuela.

### 7.4.2 The Discovery of Black Gold

The twentieth century witnessed a metamorphosis in which Venezuela transformed from an agricultural to an oil-driven nation. The Venezuelan oil industry was established in 1872 when the government granted a concession to Manuel Pulido, a Venezuelan, who organised a company named *Compañía Nacional Petrolia del Táchira*.[31] The governments of Venezuela maintained the principle of the Spanish Crown according to which all subsoil resources and mines were state patrimony and required a concession for exploitation.[32]

At the beginning, the oil production was modest and only satisfied the small local demand. However, the situation radically changed in the first decade of the twentieth century, when the government began to grant concessions to foreign companies. In 1917, oil appeared for the first time in the Venezuelan export statistics.[33] By 1926, oil export values surpassed traditional agricultural exports, which almost disappeared from Venezuelan statistics by the 1950s. [34] Oil represented almost 50% of total Venezuelan exports in 1929.[35]

---

29 See Loring Allen, Venezuelan Economic Development/A Politico-Economic Analysis (1977) 25.
30 Ibid.
31 Ibid 34.
32 Ibid.
33 Ibid 35.
34 Rodriguez, above n 16.
35 Domingo Maza Zavala, 'La Inversión del Ingreso Petrolero Venezolano' (2004) XVIII *Revista BCV* 65-102.

At the end of the 1920s, Venezuela was the largest world exporter of oil and the second producer only behind the US. At the same time that oil occupied all aspects of Venezuela's economic life, the government's dependency on petroleum increased. Hence, from an initial contribution to the total government revenues of 12% in 1920, this number climbed up to 60% in the 1960s, a share that has been maintained until today.

Between 1920 and 1970, Venezuelans experienced one of the most extraordinary economic performances and recorded the highest GDP growth in Latin America, becoming the richest nation in that region with a per capita GDP double that of the regional average.[36] Despite this outstanding record, there was no economic miracle. This success was due to a simple formula. The government practically received all the income derived from the oil extraction that was kept in the country and pumped it into the economy. Oil revenues allowed the state to build infrastructure, establish industries and finance social programs. In contrast to Malaysia where the state has designed well-structured development plans, Venezuelan governments undertook their development efforts without following a comprehensive policy. Government's reliance on oil revenues contributed to neglect other economic sectors that could also contribute with the economy. Venezuelans simply imported manufactured goods and paid them with petro-dollars, a pattern that still remains and makes the country's economy vulnerable to international oil market fluctuations.

It was at the beginning of the 1960s when the government initiated a more structured effort to design and implement an industrial program; an effort that came late in comparison to other Latin American countries.[37] The program involved an import-substitution model and sought to finish with the dependency on oil and imported products.[38] In contrast to Malaysia where the import-substitution model was only briefly applied, the Venezuelan government fully implemented its import-substitution model that lasted until the end of the 1980s. Hence, the state enacted a complex network of laws and regulations to restrict foreign direct investment, provide incentives for local industries and protect domestic enterprises from external competition.[39]

---

[36] Rodriguez, above n 16.
[37] Moises Naim, Paper Tigers and Minotaurs: The Politics of Venezuela's Economic Reforms (1993) 20.
[38] Brian Crisp, 'Development Strategy and Regime Type: Why Doesn't Democracy Matter?' (1998) 33 *Studies in Comparative International Development* 8-41, 13.
[39] Ibid.

On another front, the government commenced the creation of a plethora of companies in the most diverse sectors, such as cement, transport, tourism, telecommunication and electricity. The national industry was designed to satisfy local demand. Protectionism produced a non-competitive, technologically obsolete and highly indebted manufacturing sector.[40] Nonetheless, it survived thanks to the governmental protection and subsidies.

In the 1970s, the government nationalised the oil industry and assumed the management of the whole business. In spite of the absolute control of the oil industry and the high prices of this commodity, at the end of the decade, the country suffered a crisis with negative growth and massive outflow of international reserves. That period also witnessed how the country's external debt increased from US$729 million to US$29.3 billion between 1970 and 1980. A significant amount of the external debt was contracted to complete ambitious projects initiated when the oil price was at its highest peak.

### 7.4.3 The Black Friday

As a consequence of the crisis in international financial markets and the drop in oil prices in the 1980s, Venezuela faced difficulties in repaying its external debt. Due to this uncertainty, capital flew out of Venezuela. To address the crisis, on 18 February 1983, the government implemented a rescue package that included exchange controls, devaluation of the currency and more regulatory protectionism for local producers. That day would be remembered as 'Black Friday' in Venezuelan history. The national currency was devalued and a multi-rate system was established to subsidise imports of essential goods and repayment of external debts. The system became a source of corrupted practices and it did not aid the recovery of the economy.

A subsequent administration designed another economic program that included the restructuring of the external debt but it did not succeed. The decade ended with zero growth and Venezuelan international reserves almost exhausted.

---

[40] For a more detailed history of the Venezuelan private sector see Moises Naim and Antonio Francés, 'The Venezuelan Private Sector: From Courting the State to Courting the Market' in Louis W. Goodman, et al. (eds), *Lessons of the Venezuela Experience* (1995) 165-192.

### 7.4.4 The Great Turnaround

Venezuela was still in a deep economic crisis when Carlos Andrés Pérez assumed his second presidency in February 1989. Pérez was elected with the support of his social democratic party, *Acción Democrática* (AD). Pérez had implemented a populist government style during his first presidency between 1974 and 1979 helped by rocketing oil prices. Memories about this buoyant period contributed to Pérez's electoral victory in December 1988.

In an extravagant ceremony that was called '*La Coronación*' (the Coronation), Pérez assumed the presidency on 2 February 1989. Soon, he shocked friends and foes when he formed his cabinet of ministers with people who had a strong academic background, instead of politicians from his own party, as it had been the tradition in Venezuela. On 14 February, Pérez announced that his administration had signed a Letter of Intent with the IMF that contained a neoliberal program coined 'The Great Turnaround' with the aim of ending years of inward-looking economic policies.[41] The program was implemented without any type of consultation with the Congress, political parties or civil society.[42]

The main objectives of the Great Turnaround were to:'(a) strengthen domestic savings; (b) attract foreign capital; and (c) diversify the economy through a process of adjustment and liberalisation that will reduce imbalances in the economy, increase economic and social efficiency, and reinforce the outward-looking thrust of Venezuela's development strategy'.[43]

Instead of gradual changes, the government resolved to use a 'big bang' approach in order to implement its program. The reform included hasty financial liberalisation, increasing prices of goods and services provided by governmental companies (for example, domestic tariffs of the telephone company, electricity, transport, petroleum products) and a vast privatisation program (e.g. transport, telecommunication, banks, steel and hotels).[44]

---

41 To see a more details analysis of the Great Turnaround Program, see Naim, above n 37.

42 See Crisp, 'Lesson from Economic Reform in the Venezuelan Democracy' (1998) 33 *Latin American Research Review* 7-41.

43 IMF, 'Venezuela-Memorandum on Economic Policy' (EBS/89/34, IMF, 1989) 5.

44 Among the most emblematic measures taken were the 90 percent increase of petrol prices and the 30 percent increment in public transport fees. Both measures contributed to spark widespread riots.

The government did not wait too long to see the first consequences of the implementation of the IMF package. People rioted in the streets, producing chaos and death in February 1989, forcing the government to suspend constitutional rights. The introduction of the program had other tangible impacts on society including high inflation rate (81%), unemployment (9.2%) and a declining of real salaries of 11%.

As a consequence of the implementation of the Great Turnaround, Pérez lost political support, even of his own party causing uncertainty. This led to two failed military coups in 1992, one led by the army Lieutenant Colonel Hugo Chávez who later became the democratic President of Venezuela in 1999 and the other originated in the air force and the navy. In May 1993, Pérez was impeached for allegations of misuse of public funds.[45]

### 7.4.5 Another Economic Crisis and New Leaders

In the last month of 1993, a banking crisis exploded that officially lasted until 2001. After a first intent of the administration of President Rafael Caldera to deal with the crisis using a populist approach, the executive negotiated another deal with the IMF, implementing a new set of neoliberal measures, including more privatisation that this time was expanded to the oil industry that had been nationalised in the 1970s and reserved exclusively to the state apparatus.[46] However, the abrupt fall of the oil prices helped little to achieve a full recovery.

Venezuela entered the new Millennium under the rule of a new *caudillo* elected democratically, President Hugo Chávez. After a timid beginning in which Chávez did not drastically depart from a neoliberal model, he focused on the promotion of a new constitution which was approved in December 1999.[47] Based on the new constitutional instrument, Chavez has launched a 'new' development model coined '21st Century Socialism'. The model is a mixture of nationalist ideas, communism and the old dependency theory of development, popular in Latin America in the

---

45 See Naim, above n 37. The Supreme Court found Pérez guilty in 1996.

46 The process of liberalising the oil industry was called '*la Apertura* (the Opening). See Luis E Giusti, 'La Apertura: The Opening of Venezuela's Oil Industry' (1999) 53 *Journal of International Affairs* 117-128.

47 The new Constitution was promoted by Chávez whose political coalition (*Polo Patriotico*) represented 95% of the Assembly's members. *Polo Patriotico* included Chávez's party, MVR, *Patria para Todos* (PPT), Movimiento al Socialismo (MAS), Movimiento Electoral del Pueblo (MEP) and the Venezuelan Communist Party (PCV). From 131 members, 125 were Chávez's allies, 4 independent and 2 from traditional political parties. Due to a high rate of abstention equivalent to 55.6%, the 1999 Constitution was approved by 32% of the people who had the right to vote. See Consejo Nacional Electoral, *Resultados Electorales Referendo 15/12/1999* (1999) CNE <http://www.cne.gob.ve/estadisticas/e012.pdf> at 11 February 2008.

1970s. Chávez argues that developing countries maintain a poor situation due to the implementation of foreign development models oriented to satisfy overseas interests but negatively affect the autonomy of national policies.[48] Under the new development policy, the state has reassumed the role as a main engine of the economy in order to break the dependency from the US economy and from other domestic traditional economic groups.

To summarise, reliance on commodities (tobacco, cacao, coffee and oil) has been the common pattern of Venezuela economy since the colony. This fact has caused the country's income and the economy, in general, to fluctuate according to commodity's prices in international markets. This situation would be difficult for any government to manage, especially when the commodity is oil. For years, the necessity to diversify the Venezuelan economy has been advocated, but in contrast to Malaysia, where clear results were achieved in three decades, Venezuela did not succeed. Even in the 1970s, when the government (in order to achieve this goal) assumed a heavy intervention into the economy, promoting manufacturing industries, this sector's contribution to the GDP did not exceed 23 % of the total GDP and oil maintained its position as a main source of income. In the 1990s, the contribution of the manufacturing sector was maintained and in the new Millennium decreased to 15.2%.

## 7.5 Venezuelan Legal System

### 7.5.1 The Spanish Legacy

During its rule in America, the Spanish Crown imposed various types of regulations to govern its colonies. A common characteristic of the Spanish legal system in America was the inconsistency in the enforcement of formal law, an issue that would affect Spanish-American independent countries, including Venezuela.

[48] See e.g., Hugo Chávez Frías, 'Discurso con Motivo de la Sesión Inaugural de la IX Reunión Cumbre de Jefes de Estado y de Gobierno del Grupo de los 15' in Presidencia de la Republica Bolivariana de Venezuela (ed), *1999 Año de la Refundación de la República/Selección de Discursos del Presidente de la República Bolivariana de Venezuela, Hugo Chávez Frías* (2005) 47-53, 48.

During the initial stages, a capitulation system was used by the Kings to regulate the exploration and conquest of territories in the New World.[49] Capitulations were agreements negotiated between the Spanish Crown and individuals or companies, containing the rights and obligations for the explorers. Using capitulations, the Crown granted the right to explore, conquer, pacify and settle American territories. Capitulations included the region to be explored, the rights and tittles that the Crown granted to explorers as well as their obligations, particularly, payments in favour of the Kings. Christopher Columbus's enterprise was carried out by the Capitulations of Santa Fe granted by Ferdinand and Isabelle in 1492.

The capitulation system responded to the principle assumed by the Spanish Crown, according to which the American territories were the exclusive property of the King who 'owned the whole area outright, and he ruled or misruled as he would'.[50] In spite of these unlimited powers of the Kings over their colonies, it was understood that they were bound by their capitulations. Hence, individuals saw these agreements as the confirmation of a set of rights that they could enforce. However, capitulations were not strictly enforced and it was common that, for instance, an explorer went beyond his territorial limits and travelled into lands that were granted to another person, causing frequent incidents and judicial claims between conquerors. Even Ferdinand and Isabelle violated the capitulations agreed with Columbus when they were dissatisfied with the Admiral's reports and authorised other people to explore areas that were previously and exclusively granted to Columbus.[51]

During the first years of Spanish conquest, one of the legal issues that caused great concern among Spanish authorities was the legal status of aborigines, or Indians as they were called, and in particular, whether they should be considered human beings and be protected from extermination and abuses. The Spanish Crown

---

[49] According to the Dictionary of the Real Academia Española (22nd Ed), the word capitulation (*capitulación*) has various meanings, including agreement between two parties and a pact containing the terms of surrendering of an army. In English, the term is currently associated with surrender. However, capitulations had a different meaning, in English and Spanish, in the fifteenth century and it was not associated with surrender. It meant 'a series of chapters-capítulos in Spanish- or stated terms or conditions or subheads of an agreement.' (Charles Gibson, 'Conquest, Capitulation, and the Indian Treaties' (1978) 83 *American Historical Review* 1-15.). In the context of the Spanish American colonisation enterprise, the agreements between explorers and the Spanish Crown were called '*capitulaciones*'. Gibson points out that capitulations originally were agreed by the Christian monarchs and local Muslim leaders during the Christian and Moors wars at the end of the fifteen century to list the privileges and conditions imposed by the Spanish conquerors to the newly incorporated Muslim subjects. Capitulations were the results of negotiations between Spaniards and Moors and it was expected that the Spanish Crown obeyed the listed conditions.

[50] Fagg, above n 5, 159.

[51] Ibid 68.

positively answered the question and issued several regulations to protect aborigines such as the *Leyes de Burgos* in 1512 (Laws of Burgos) and the *Nuevas Leyes* in 1542 (New Laws).

The above norms did not stop abuses against aboriginal people and they were constantly violated by Spanish settlers who needed aborigines as a source of cheap labour. In the case of the New Laws, they even produced revolts in American territories because it abolished the *encomienda*, a system that looked for the protection of aborigines in exchange for their labour that degenerated in a kind of forced and inhuman work for Indians.[52] Legal efficiency in America was affected by the interest of settlers on making money as fast as possible and returning rich to Europe, disregarding regulations that were put in place to protect indigenous people. As Alonso de Zorita, a Spanish judge who served in the Indies in the sixteenth century, wrote:

> The wishes of Your Majesty and his Royal Council are well known and are made very plain in the laws that are issued every day in favour of the poor Indians and for their increase and preservation. But these laws are obeyed and not enforced, wherefore there is no end to the destruction of the Indians, nor does anyone care what Your Majesty decrees.[53]

The obeying but not complying (*obedezco pero no cumplo* in Spanish) mentioned by Zorita referred to an old formula incorporated in the medieval Castilian law according to which 'an official or individual receiving a royal order which he considered inappropriate or unjust would symbolically place it on his head while pronouncing the ritual words that he would obey but not comply'.[54] This ritual would give time for reflexion and avoid disputes from turning open confrontations. [55]

The above doctrine was transferred to America and was introduced into the Compilation of the Laws of Indies.[56] Hence, if an official decided to obey, but not comply with a royal order because he considered it oppressive or unjust, he had to inform the Crown, explaining the reasons why he did not comply the order. For Haring, the formula was particularly useful for colonial officials to avoid the execution

---

52 J.H Elliott, *Empires of the Atlantic World/Britain and Spain in America 1492-1830* (2006) 132.
53 Keen, above n 4, 138.
54 Elliott, above n 52, 132.
55 Ibid.
56 Libro Primero, Titulo 1, ley XXII.

of orders enacted in Europe, but difficult to implement in the American territories without causing conflicts or injustice.[57]

Years after the arrival of the Spaniards in America, there were subsequent efforts of the Crown to provide its colonies with a stronger and more homogeneous body of regulations and institutions. After the deaths of Isabella and Ferdinand, their rights over the Spanish American territories were transferred to the successors of the throne of Castile-Leon.[58] As a consequence, Spanish American legal institutions developed attending to Castilian models. Castile had a Roman law system whose norms were codified in the *Siete Partidas*.[59]

Following the council system employed to administer the different kingdoms, the Crown created the Council of Indies (el *Consejo de Indias*) in 1524 to manage its colonies. The Council had an extensive jurisdiction to govern the Spanish colonies, including administrative, legislative and judiciary functions. Viceroyalties, *real audiencias*, governorships, captaincy-general and municipalities completed the Spanish government network.[60]

Since the beginning of the colonisation of America, the Crown, the Council of Indies and other Spanish officials issued innumerable regulations. Such norms constituted a complex and dispersed body of laws that made difficult its enforcement, creating legal uncertainty in the Indies. Following the Castilian legal traditions, Philip II of Spain mandated a compilation of laws in 1570 in order to systemise Spanish regulations applicable in the Indies and facilitate law enforcement.[61] The compilation's work took more than a century to be completed and it was published in 1680 under the title of *La Recopilación de las Leyes de Indias* (The Compilation of the Laws of Indies).

---

57 Haring, above n 10, 113.

58 Elliott, above n 52, 120.

59 Ibid 127.

60 From 1535, the American territory under control of Spaniards was divided in smaller administrative sub-divisions named Viceroyalties (e.g. Viceroyalty of New Spain, Viceroyalty of Peru, Viceroyalty of New Granada and Viceroyalty of Rio de la Plata). Viceroyalties were headed by a viceroy appointed by the King. Different from Spain in which they had a more exclusive judicial function, r*eal audiencias* in America were institutions that primarily acted as courts but also had administrative and legislative functions. *Real audiencias* resolved cases within their jurisdictions. Their administrative tasks were related to overseeing viceroys, governors and captains-general and acting as a consultative body to viceroys. *Real Audiencias* were also permitted to issue local ordinances. A r*eal audiencia* was a collegial entity headed by the viceroy or governor and included various *oidores* (judges) and other minor-ranked officials. In case of absent of the viceroys or governors, the most senior *oidor* temporally filled this position. Captaincies-General and municipalities were smaller territorial subdivisions. For a better understanding of the structure of the Spanish colonial government see Haring, above n 10.

61 Ibid 103. See also Elliot, above n 52, 128.

The Compilation was divided into nine books and contained 218 chapters and grouped more that 6,000 laws that had been issued by Spaniards. Norms were not completely harmonised and the Compilation included some contradictory norms that made its enforcement even more complicated. Although the Compilation incorporated a provision that ordered that laws were to be enforced in the way they were written and that new regulations should be enacted respecting the laws already included in the text,[62] the Compilation did not resolve enforcement problems of the Spanish Crown in America.

The body of Spanish laws was not uniformly applied to people living in America. In contrast, it was constructed establishing a system of privileges distributed using ethnic criteria. Theoretically, Spaniards, Creoles and *mestizos* were legally considered to be equals; however, in practice, the former received the highest posts within the colonial public service and the best commercial opportunities.[63] Although Creoles did not have access to similar benefits, they, descendents of Spanish conquerors, were excluded from paying taxes to the Crown.[64]

Aborigines were legally protected and *caciques* were permitted to keep some degree of power among their people.[65] The Compilation of Laws of Indies recognised the customary laws of aborigines and accepted their enforcement after they were Christianised.[66] However, this was a mere declaration and difficult to apply because the same provision stated that customary law could not be contrary to Christian principles and other Spanish laws. Thus, Spanish laws ordered the subjection of customary laws to Christianity and their own regulations. It made the application of customary laws difficult, if not impossible, because the Crown issued several regulations that affected various aspects of indigenous life and customs. To illustrate, aborigines were polygamous, a practice that was penalised by Spanish laws even if aborigines were not Christian.[67] The Spanish laws also regulated the way in which conflicts among aborigines must be resolved, applying Spanish principles instead of aboriginal law.[68]

---

62 Recopilacion de las Leyes de Indias, Libro Segundo, Titulo Primero, Ley Primera.

63 Haring, above n 10, 195. *Mestizos* were descendents of Spaniards and aborigines. Creole was the English term for '*criollo*'. It refered to people born in the American colonies from Spanish parents who were conquerors. Haring, above n 10, 194-218.

64 Elliot, above n 52, 170.

65 *Caciques* are aboriginal chiefs.

66 Recopilación de las Leyes de Indias, Libro Segundo, Titulo Primero

67 Recopilación de las Leyes de Indias Libro Sexto, Titulo Primero.

68 Recopilación de las Leyes de Indias Libro Quinto, Titulo Diez.

At the end of the sixteenth century, Spanish law clearly prevailed over indigenous norms that had progressively lost influence.[69] However, the European body of formal laws did not prove to be more suitable to rule America. Laws were a mere formality. They were often ignored and not enforced, a characteristic that would be inherited by the new Spanish-American republics in the nineteenth century. It seems that the original limits of the 'obey but not comply' solution were exceeded in America and contributed with the divorce between formal law and reality:

> The breach between the written law and its application goes even deeper in the consideration of Spanish administration in America. Not only special royal mandates, but also general rules and regulations for the routine conduct of office were often ignored in practice by colonial officials in the hope or expectation that, with distance and isolation in their favor, and the delays in communications, they 'could get away with it'.[70]

### 7.5.2 Venezuela and its Constitutional Bases

Venezuela has one of the most extensive constitutional histories in Latin America. The nation was the first to adopt a constitution in Spanish America in 1811.[71] Since that moment, 25 other constitutions have been promulgated in Venezuela, including the current one approved in 1999. However, the Venezuelan constitutionalist Brewer-Carías affirms that not all these texts deserve to be called constitutions because most of them made simple changes that could not be adopted by an amendment because this reform mechanism was not allowed by various constitutions.[72] Instead, full constitutions had to be approved in order to implement simple changes.

Most constitutional changes were adopted to satisfy specific needs of *caudilllos*. Hence, instead of producing legal certainty and political stability, continuous constitutional reforms produced the contrary in Venezuela. As in the Spanish colonial period, constitutions were obeyed but not complied and they were considered to be mere formal texts. This is why one commentator describes

---

69 Elliot, above n 52, 127.
70 Haring,above n 10, 114.
71 Brian Loveman, *The Constitution of Tyranny. Regimes of Exception in Spanish America* (1993).
72 Allan Brewer-Carías, La Constitución de 1999/Derecho Constitucional Venezolano (4 ed, 2004) vol 1, 11.

Venezuelan constitutions as 'little yellow books which are made every year and broken every day'.[73]

The first Constitution was passed after the Declaration of Independence in December 1811. Its existence was ephemeral and lasted less than one year after Spaniards reassumed the control of most part of the country in 1812. This constitution that would influence subsequent charters was inspired by the Constitution of the US. Similar to the US Constitution, the Venezuelan Constitution envisaged a Presidential system formed by an executive, a bicameral congress and a judiciary headed by a supreme court. The constitutional text also copied the federal system of the US and therefore, Venezuela was conceived as a federation of free provinces.

Furthermore, the 1811 Constitution inherited aspects of the class system of the colony. Estates and possessions of the defeated Spanish Empire and its subjects were taken by military heroes that joined Creoles to share the country's wealth.[74] The rights to vote and be elected were limited to free men who knew to read and write, as well as those who had assets to a specific amount. These wealth requirements were maintained also in the Constitution of 1830 that passed after Venezuela separated from Colombia. In spite of the discourse about freedom and equality that prevailed during the war of independence, aborigines and slaves were marginalised and they could not comply with suffrage's requirements.[75] Monetary requirements to be elected President or deputies lasted until 1858 when a new Constitution reaffirmed the abolition of slavery and granted the universal right to vote for men as well as unrestricted rights to be elected as President or representative of the lower congressional chamber.[76] The 1863 Constitution suppressed the monetary condition for senators.

During the first decades of the new Republic, the law was a formal instrument rarely enforced by *caudillos* that relied more on authoritarian mechanisms to maintain order. As previously mentioned, there were many revolts and revolutions in Venezuela between 1830 and 1903 and constitutions served to legitimise the

---

[73] Ernesto Wolf cited in Leo B., 'Executive Power in Venezuela' (1956) 50 *The American Political Science Review* 422-441, 429.

[74] See Carrillo, above n 26.

[75] By the second half of the nineteenth century, aborigines represented not more than 4% of the Venezuelan population that was estimated in 1.5 million. In 1854, the Venezuelan Congress passed an Act to abolish slavery that benefited about 23,000 slaves.

[76] Universal suffrage for women was granted in 1946.

newcomer who seised powers. In this period, constitutions were enacted, amended and repelled but they did not really mark a difference for the strengthening of the Venezuelan legal system. With the overthrow of the last Venezuelan dictator and the establishment of democracy came the passing of the 1961 Constitution that was in force until March 1999 and gave more legal certainty to the nation. This was the Charter in force in the 1990s when the banking crisis broke out.

In 1999, the Venezuelan people approved a new Charter drafted by a democratically elected National Constituent Assembly. Chávez proposed an amendment to this Constitution in 2007, in order to include the possibility of indefinite re-elections for President and to transfer state and municipalities powers to the federal government. In a referendum, people rejected Chávez's proposal in December 2007.

### 7.5.3 Structure of the Federal Government

Venezuela adopted a federal presidential model. However, federalism is more formal than real and the national government controls more powers. Throughout Venezuelan history, there has been tension between federalism and centralism. Indeed, Brewer-Carías argues that Venezuela adopted federalism in 1810 because it was the only model that could be opposed to the Spanish monarchy and facilitate the unification of different provinces that had few common characteristics.[77]

After long struggles between federalism and centralism in Venezuela, the 1961 Constitution adopted a federal structure. However, the national government concentrated most powers and resources. States' faculties were practically limited to organise their political structure [78] (i.e. to govern the way in which the legislative assembly and the governor office would operate, but both entities could only regulate those matters that were not reserved to the federal or local governments). The main source of income for states was an amount granted by the Constitution and transferred by the federal government. Although the Constitution stated that the national Congress would pass a law to regulate the mechanisms for the election of state's governors and council's majors, it also established that the President of the republic would 'temporarily' make the appointments. It took the Congress almost

[77] See Allan Brewer-Carías, 'El Federalismo en la Historia Política Venezolana' (1995) 1 *Provincia*.
[78] See Allan Brewer-Carías, 'El "Estado Federal Descentralizado" y la Centralización de la Federación en Venezuela' (2004) 11 *Provincia* 98-136.

thirty years to pass the act in 1989, contributing to the concentration of powers in the federal executive branch.

Until 1999, Venezuela adopted the traditional separation of powers in three branches: executive, legislative and judiciary. The 1999 Constitution tried to innovate and divided the state apparatus in five arms: the traditional three and two that were new, the electoral and the citizenship branches. The electoral branch includes the National Electoral Board (*Consejo Nacional Electoral,* CNE) while the citizenship branch grouped the People's Ombudsman Office, the Federal Prosecutor Office and the Controller-General Office.[79] There was no real innovation with this distribution of powers because the 1961 Constitution included all the offices integrated in the new two divisions.[80] The structure of federal government at the time when the banking crisis erupted is briefly explained below.

***a) The Executive Branch***

The executive power was vested in the President who was elected by universal suffrage for a term of five years. A President could not run for an immediate re-election and he had to wait for a period of ten years in order to be nominated for another term. The 1999 Constitution extended the Presidential period to six years and allows one consecutive re-election.

The President exercises his or her duties jointly with a council of ministers. The President is the head of state and government. Following the colonial Spanish tradition of strong executive officials (e.g. viceroys and captains-general) and the American Presidential system, Venezuelan constitutionalism places great powers in the President who is not only the maximum civil authority but also the commander-in-chief of Venezuelan armed forces.

Among the President's responsibilities are appointments of ministers, who do not require legislative ratification. The President also manages international relations, including those associated with IFIs (article 190.5 of the 1961 Constitution and 236.4 of the 1999 Constitution).

---

[79] The Controller-General is a type of Auditor General whose main task is to examine federal, state and local governments and their agencies and review their financial operations in order to guarantee compliance with law and financial regulations. To comply with its task the Controller-General Office can perform audits and other studies.

[80] In the previous structure under the 1961 Constitution, the Federal Prosecutor Office had some of the tasks of an ombudsman.

Between 1959 and 1994, two political parties, AD and the Social Christian Party of Venezuela (COPEI) alternated the Presidency (see Table 8). These two parties governed Venezuela following the principles contained in a political agreement called *Pacto de Punto Fijo* (Pact of *Punto Fijo*). The Agreement was signed among the main parties after the deposition of dictator Marcos Pérez Jimenez in 1958 and basically stated a common basic government plan as well as the compromise of defending the democratic system against new intents of subverting it.

In 1994, Rafael Caldera, a former member and founder of COPEI who served as a President between 1969 and 1974, won the Presidency supported by a new party called *Convergencia*. It was the end of the AD-COPEI alliance. Caldera was the President in charge during the banking crisis.

***b) The Legislative Branch***

Venezuelan Congress was vested with the legislative powers and it consisted of two chambers: the Senate and the Chamber of Deputies. Members of both Chambers were elected by universal vote for a term of five years. Additionally, after finishing his term, each President became a life-term senator. The bicameral system was replaced in the 1999 Constitution by a unicameral National Assembly.

The main goal of the old Congress was to legislate as well as to controlling and reviewing the executive's performance. During the Pact of *Punto Fijo* period (1959-1994), AD and COPEI alternated the control of the majority in the Congress. There were opportunities in which the President governed with a majority of his party controlling the Congress. In other opportunities, Presidents did not enjoy the support of a legislative majority and was forced to negotiate with the opposition. Generally speaking, during the same period, the Congress agreed to appoint as Federal Prosecutor and Controller-General candidates who were not identified with the ruling party. These two positions were essential to review the legality and soundness of the federal government's actions and both officials had authority to initiate administrative and judicial procedures against the President and his ministers. This practice contributed to maintain limited the powers of the executive branch. In fact, it facilitated the prosecution and conviction of Carlos Andrés Pérez in 1993.

During the banking crisis, *Convergencia*, Caldera's party and other ally groups only controlled 22% of the members of the Senate and 26% in the lower chamber.

***c) The Judiciary***

The Judiciary was vested in the Supreme Court of Justice and other lower courts. The judiciary is organised at the federal level. There are no state courts. Until 2000, the judiciary was headed by the Supreme Court of Justice organised in three Chambers (Civil Cassation, Penal Cassation and the Political-Administrative).[81] The 1961 Constitution also established an administrative entity, the Judiciary Council (*Consejo de la Judicatura*) to guarantee independence, discipline and efficiency of courts.

According to the 1961 Constitution (article 205) and the 1999 Constitution (article 254), the judiciary and its judges are autonomous and independent. Supreme Court judges were elected by the two-thirds votes of the Congress. The Supreme Court is the final appeal court in Venezuela and it has the power to declare null and void any laws and other acts of the executive or the Congress that conflict with the Constitution.

## 7.6 Venezuela and the Rule of Law

One of the greatest Venezuelan heroes from the War of Independence, Field Marshal Antonio José de Sucre, was overwhelmed by the lack of law enforcement during the years that followed the complete defeat of Spaniards in South America. He declared 'our political edifices are constructed on sand; as strong as we make the walls, as much adornments as we provided them, we cannot overcome the defect of the foundation'.[82] Nowadays, Sucre's words are still valid in a country like Venezuela where the fundaments of the rule of law are weak and stability depends not on formal arrangements but on informal agreements which tie those who exercise powers with interest groups and other allies. As Schor affirms, 'Caudillos,

[81] The 1999 Constitution changed the name of *Corte Suprema de Justicia* to *Tribunal Supremo de Justicia* and added three more Chambers: Constitutional, Electoral and Social chambers.

[82] Cited by Loveman, above n 71, 62.

not constitutions, provided order by relying on personal loyalty, rather than law, to glue society together'.[83]

Latin American Presidents often invoke constitutions and laws in a metaphysical manner, trying to legally support their opportunistic needs.[84] They are aided by the adoption of a strong Presidential model in which the legislative and the judiciary are shadowed by the executive. Juridical manoeuvres to obtain specific gains constitute a strategy that has been used by ideologically different governments. For instance, Presidents such as Fidel Castro (Cuba), Alberto Fujimori (Peru), Carlos Menem (Argentina), Alvaro Uribe (Colombia) and Lucio Gutierrez (Ecuador) have been accused of manipulating the legal system for personal purposes. In the case of Cuba, Castro used to control all sources of powers until he became too ill to govern. In Peru, Ecuador and Argentina, democratically elected Presidents Fujimori, Gutierrez and Menem tried to take control of the Supreme Court through the enactment of special regulations. Finally, in the case of Colombia, President Uribe proposed a constitutional reform because he wanted to be re-elected, a possibility not allowed by the old constitution. As in the case of Malaysia, the accommodation of the legal system to suit transitory requirements of Presidents has led to the results that experts qualify Latin American nations as pseudo-democratic systems with few characteristics of the rule of law.[85]

Venezuela has not escaped from this trend. Since the end of the War of Independence, various Presidents, including those who served during the democratic era, have forced the legal system for their own political gain. Although the 1961 Constitution contained the basic principles to build a solid notion of the rule of law, its enforcement was incomplete and its text frequently violated. The excessive employment of exceptional powers is one of the most used mechanisms to deform the operation of the rule of law. Extraordinary measures were invoked to face communism, control military coups, social unrest and most importantly, to manage the economy.

---

83 Miguel Schor, 'Constitutionalism through the Looking Glass of Latin America' (2006) 41 *Texas International Law Journal* 1-38, 14.

84 See Ernesto Garzón, 'What is Wrong with the Rule of Law?' (Paper presented at the Seminario en Latinoamérica de Teoría Constitucional y Política (SELA), Puerto Iguazu, Argentina, 8-11 June 2000) 98.

85 See e.g., Guillermo O'Donnell, 'Reflections on Contemporary South American Democracies' (2001) 33 *Journal of Latin American Studies* 599-609.

While Malaysia has mainly used exceptional powers to limit political opposition and less frequently to address economic problems, Venezuela is the opposite and emergency measures have been often invoked to cope with the economy. Under suspension of economic rights by issuing law-decrees, the executive assumed the task to legislate on economic matters and produced a complex legal framework full of cumbersome norms that served as a legitimation tool of the desired changes. Nonetheless, law was rarely enforced and after legitimising changes it was left in codes and books far from a serious intent of connecting law with a development program.

The concentration of legislative powers in the executive has also affected the way in which laws and policies are formulated. The lack of democratic participation in the drafting of laws and regulation contributed to the divorce between the legal system and reality. Traditional political parties (such as AD and COPEI) became the exclusive translators of the people's needs and built a wall between the institutions and the people. Ultimately, they were simply the distributors of favours among the people.[86] Poor people who suffered the consequences of poverty found no answers to their problems. This situation facilitated the victory of Chávez in 1998, a leader who uses a frank approach and plain language to communicate with people, although he employs similar methods than those used by the old traditional parties.

On the judiciary side, although in the democratic era the Supreme Court has not been dissolved as on other occasions during the twentieth century (1945, 1947, 1948, 1953 and 1955), the political parties monopolised the control of the judiciary.[87] Domination of the Supreme Court by the parties led to a lack of independence since the beginning of the democratic era.[88] As a result of the dependency of the judiciary on the political parties, courts began to be perceived as corrupt and only responsive

---

[86] Daniel Levine and Brian Crisp, 'Legitimacy, Governability, and Reform in Venezuela' in Louis W. Goodman, et al. (eds), *Lessons of the Venezuelan Experience* (1995) 223-251; John Martz, 'Political Parties and the Democratic Crisis' in Louis W. Goodman, et al. (eds), *Lessons of the Venezuelan Experience* (1995) 31-53; Naim, above n 772,130-133.

[87] See Joel Verner, 'The Independence of Supreme Courts in Latin America: A Review of the Literature' (1984) 16 *Journal of Latin American Studies* 463-506, 493. Rogelio Pérez Perdomo, 'Reforma Judicial, Estado de Derecho y Revolución en Venezuela' in Luis Pásara (ed), *En Busca de una Justicia Distinta. Experiencias de Reforma en América Latina* (2004) 335-374; Rogelio Pérez Perdomo, 'Venezuela 1958-1999: el Derecho en una Democracia Renqueante' in Héctor Fix-Fierro, et al. (eds), *Culturas Jurídicas Latinas de Europa y América en Tiempos de Globalización* (2003) 639-722.

[88] Verner, above n 87; Human Rights Watch, 'Rigging the Rule of Law/Judicial Independence under Siege in Venezuela' (Number 16.3 (B), 2004); Organización de Estados Americanos, 'Informe sobre la Situación de los Derechos Humanos en Venezuela' (OEA/Ser.L/V/II.118, OEA, 2003); Lawyers Committee for Human Rights and the Venezuelan Program for Human Rights Education and Action, *Halfway to Reform: The World Bank and the Venezuelan Justice System* (1996).

to particular political and economic interests associated with what was called judicial tribes.[89]

Likewise, courts became elitist and only accessible for a limited part of the population whereas another part could not access to the judiciary to resolves their disputes. There were formal and informal obstacles to courts. The former was associated with the legal mandate of having legal assistance of a lawyer to access most of the judicial services and the need of paying formal costs (such as attorney's fees, court's fees, etc).[90] Informal obstacles were related to informal costs or bribes paid to court's officials in order to influence results or simply to initiate the judicial process.[91]

During the democratic period, the judiciary has been neglected and considered as a second-rank state branch. Few resources are allocated to the judiciary, resulting in judges and other judicial officials underpaid.[92] Likewise, the judiciary was not properly equipped and did not have an adequate infrastructure. Courts usually had one judge, and a small group of lower officials. Pérez Perdomo describes how the latest technology that the Venezuelan courts had in the second half of the 1990s was a typewriter.[93]

The inoperability of courts resulted in a lack of enforcement of law, destroying one of the essential elements of the rule of law. People opted for other informal mechanisms to resolve their disputes. In the case of commercial controversies, parties preferred to use informal social networks. Using this method, parties agreed to submit their conflicts to a kind of mediator, a third party who was usually a common friend and helped to find a solution acceptable to both parties.[94] In the cases of domestic and neighbour disputes, people tended to use informal methods of resolving conflicts that involved the action of public servants but using mediation instead of a strict legal procedure. In poor Venezuelan *barrios*, there are more

---

89 See Rogelio Pérez Perdomo, 'Una Evaluación de la Reforma Judicial en Venezuela' (Paper presented at the Judicial Reform in Latin America. An Assessment for Policymakers, Washington, 6 June 2006); Richard Mohr, 'Local Court Reforms and 'Global' Law' (2007) 3 *Utrecht Law Review* 41-59.

90 Pérez, above n 89.

91 Ibid 4. Pérez mentions that detainees pay to get a space where to sleep in jail or to be transported from jail to courts to attend their hearings.

92 Less than 1% of the state's budget was dedicated to the judiciary in the 1990s. See Pérez, above n 87.

93 Ibid 341.

94 Rogelio Pérez Perdomo, 'Sistemas Alternativos para el Manejo de Conflictos en Venezuela' (2005) 7 *Reforma Judicial. Revista Mexicana de Justicia* 161-190, 167.

radical informal mechanisms to resolve crimes such as murders or rapes and they include unofficial executions.[95]

The inoperability of the judiciary produces incentives for the citizens to be involved in unlawful practices. The situation has been so bizarre that Arturo Uslar Pietri, one of the most prominent Venezuelan twentieth century intellectuals, criticised the lack of effectiveness of the judiciary that caused a change of moral values. The most clear evidence of this situation is that people who are honest and do not steal public money and comply with are called *pendejos*[96] because they do not take advantage of the widely known fact that the judiciary and, in general, the legal system do not work at all. This belief in the lack of effectiveness of the judiciary finds support in polls conducted in Venezuela that show that 90% of the people consider that the judicial system does not function at all and 53% affirm that it is corrupt.[97]

Since the end of the 1990s, the government has made some efforts to improve the situation of the judiciary. The state doubled resources for the judiciary and it now represents 2% of the national budget. The state also agreed with IFIs on the executions of various programs that have improved the infrastructure and equipment for courts. In spite of these few positive changes, the judiciary remains a second-rank branch and depending on the executive.

During the drafting process of the 1999 Constitution, one of the first acts of the elected Constituent Assembly was to ratify Chávez as the Venezuelan President, declare a national state of emergency and, subsequently, the reorganisation of the legislative and judicial branches. As a consequence, the Congress was dissolved and an *ad hoc* judicial committee was in charge of dismissing and appointing new judges. By 2005, 80% of the judges had temporary appointments.[98]

---

95 See Mohr, above n 89, 49.

96 Pendejo is a moderate insult that means a person is stupid. See Víctor García, *Venezuela: A Cheater's Paradise* (2004) Venezuela Today <http://www.venezuelatoday.net/cheaters_paradise.html> at 11 May 2005.

97 Asociación Civil Consorcio Justicia, *Visión Popular de los Medios Alternos de Resolución de Conflictos (Resumen)* (2003). For similar results see United Nations Development Program, Justicia y Gobernabilidad/Venezuela una Reforma Judicial en Marcha (1998) 143 cited in Human Rights Watch, above n 88, 7.

98 Human Rights Watch, above n 88. See also, Michael Waller, *What to do about Venezuela?* (2005) The Center for Security Policy <http://www.centerforsecuritypolicy.org/What_to_Do.pdf> at 13 May 2005.

## 7.7 Exceptional Regimes in the Venezuelan Constitutional Law

### 7.7.1 Exceptional Powers in Venezuela

In Venezuela, the history of exceptional powers is as old as the Republic's existence.[99] The social, political and economic circumstances that surrounded the war of independence made exceptional powers a very useful tool to overcome all the events relating to such patriotic enterprise.[100] Even after the total victory of the patriot army, Bolívar had to resort to emergency measures to rebuild the economy of Colombia.[101]

Venezuelan preferences for exceptional schemes found an antecedent in the way in which the Spanish Crown ruled its American colonies.[102] A strong executive with vast powers to control the state substituted the figure of Kings but different from the Spanish Crown, the executive could not support its excessive powers in a divine right but in constitutions. Kings exercised their powers in America through Spanish officials, particularly viceroys who had extensive faculties to rule their jurisdiction. The Compilation of the Law of Indies authorised viceroys to use any mean to control people who challenged the authority. [103]

When Latin American countries began to achieve their independence, one of the documents that were considered to draft charters of the independent states was the Bayonne Constitution (1808) prepared to rule Spain and drafted under the influence of Napoleon.[104] This Charter allocated most government powers to the King. Although the Bayonne Constitution was never enforced, it had its influence in America. In fact, the first Venezuelan Constitution incorporated a strong executive branch with supreme powers over the affairs of the nation. Although this Constitution did not include a specific provision about emergencies, there were articles that

---

99 For a study of emergency powers in Venezuela, see Loveman, above n 71. See also Brian Crisp, 'Presidential Decree Authority in Venezuela' in John Carey, et al. (eds), *Executive Decree Authority* (1998) 142-169. For an analysis of the exceptional powers in the new Constitution see Brewer-Carías, above n 72; Claudia Nikken, 'Aproximación Crítica a la Regulación de los Estados de Excepción en Venezuela' (2002) 8 *Ius et Praxis* 171-198.

100 Loveman, above n 71, 138.

101 Carillo, above n 26, 22.

102 For an introduction about the influence of the Spanish Empire on the exceptional regimes adopted by Spanish American countries see Loveman, above n 71.

103 Recopilación Leyes de Indias, Libro tercero, Titulo tercero.

104 Loveman, above n 71, 37-40.

granted enough flexibility to the executive to address local or external threats (articles 100, 134 and 216).[105]

The next Venezuelan Constitution was enacted in 1819 under the leadership of Bolívar. It included article 20, which provided an exceptional scheme in terms similar to article 38 of the Bayonne Constitution and allowed a 'suspension of the *imperium* of the constitution' in cases of domestic or foreign menaces'.[106] The declaration of emergency required confirmation from the Congress. After 1819, the subsequent 24 constitutions have maintained this tradition and have included provisions that allocate special powers to the executive branch in cases of exceptional events.

During most of the Republic's history, exceptional powers were markedly used to cope with violence situations such as civil wars, revolts, coups and social turmoil. With the enactment of the 1961 Constitution, the government continued to rely on extraordinary measures to resolve political crisis, but presidents began to resort more frequently to exceptional powers in order to address economic issues. The executive mainly employed two types of mechanisms to deal with urgent economic matters: suspensions of economic rights and enabling laws. These two mechanisms will be discussed in the following sub-sections, but limited to the economic sphere. This review will focus on the 1961 Constitution that was the text in force when the government faced the 1994 financial crisis and under which the government of Caldera supported its legal strategy to tackle the banking system's collapse.

### 7.7.2 States of Emergency and Suspensions of Rights

***a) Constitutional Provisions***

The 1961 Constitution followed the long tradition of exceptional powers in Venezuela and included a chapter on the emergencies. The first provision of this chapter, article 240, stated:

[105] Ibid 139. Article 216 is especially interesting because it copied the British Riot Act 1714 that allowed the government to disperse any unarmed group that was illegitimated assembled after previous verbal warning.

[106] Ibid 141.

> The President of the Republic may declare a state of emergency in the event of internal or external conflict or whenever there exists good reasons to believe that it may occur.

Article 240 was the equivalent of the proclamation of emergency of article 150 (1) of the Malaysian Constitution. Although article 240 was the main provision of the chapter dedicated to the emergencies, the executive avoided declaring formal states of emergency. This provision was used just once in 1993 to manage a sensitive political situation in two states caused by judicial challenges of local elections and the lack of clarity on whether or not the current state authorities would remain in government while courts decided the controversy.[107]

The second provision related to emergencies in the 1961 Constitution was article 241. The executive invoked more article 241 than states of emergency under article 240 to address political, social or economic instability. According to this clause:

> In case of emergency, of disorder that may disturb the peace of the Republic, or of serious circumstances that affect economic or social life, the President of the Republic may restrict or suspend the constitutional guarantees, or some of them, with the exception of those proclaimed in article 58 and in sections 3 and 7 of article 60.

The above provision granted the President the power to suspend constitutional rights, with the exception of those established in article 58 (right to life) and article 60 sections 3 and 7 (prohibition of detention incommunicado and prohibition of the practice of inhuman treatments or life sentences). While the Malaysian executive could issue norms contrary to constitutional provisions when a proclamation of emergency was in force, article 241 of the Venezuelan Constitution allowed suspensions of some constitutional rights without an explicit declaration of emergency.

When the executive resorted to article 241, it enacted a decree suspending or restricting constitutional rights. Between the 1960s and the 1990s, suspensions of individual and political rights were issued to face communist insurgency, military uprisings, social riots and economic problems. Generally, the executive revoked the

[107] Ibid 165.

suspension of guarantees after it controlled the emergency. In contrast, the economic rights were uninterruptedly restricted for more than thirty years based on article 241.

The 1999 Constitution included a new provision, article 337, which delineates in a better form the invocation of states of emergencies:

> The President of the Republic, at a meeting of the Cabinet of Ministers, shall have the power to decree states of exception. Expressly defined as such are circumstances of a social, economic, political, natural or ecological nature which seriously affect the security of the Nation, institutions and citizens, in the face of which the powers available to cope with such events are insufficient. In such case, the guarantees contained in this Constitution may be temporarily restricted, with the exception of those relating to the right to life, prohibition of incommunicative detention or torture, the right to due process, the right to information and other intangible human rights.

This provision has a more elaborate structure and requires, in order to invoke a state of emergency, not only the existence of an event that affects the nation but also that the ordinary powers be ineffective to cope with such circumstances. The norm also requires a declaration of state of emergency in order to suspend constitutional rights. The 1999 Constitution also includes different types of states of exception depending on the seriousness of the situation.

In 2001, the National Assembly passed the Organic Law of States of Exception in which most of the principles and limitations to exceptional powers included in the Constitution were ratified.[108] The Constitution, together with this Law, provides a more clear and restricted arrangement for the use of exceptional powers in Venezuela. However, the new emergency scheme has not been officially tested and since 2000 when the Constitution entered in force, Chávez has not formally resorted to states of emergency; instead, his government has resorted to extra-juridical mechanisms to resolve difficult situations.[109]

---

[108] Official Gazette No.37.261 15/08/2001.

[109] To illustrate, when the opposition organised a two-month strike against Chávez in December 2003, food became scarce. Chávez's administration responded enacting a decree with an exceptional economic and social development plan that included the purchase, importation and distribution of food by the government. In order to rapidly acquire goods, the Decree established a fast track procedure that excluded public bidding processes as it was mandated by ordinary law. The government did not justify its decree on the basis of the emergency provisions included in the Constitution or the Organic Law of States of Exception; therefore, this decree was not subjected to the emergency constitutional scheme. Although the general strike ended in

Whist the 1961 Constitution granted flexibility to the executive to manage emergency events, it also included checks and balances to limit the President's powers. The first check mechanism required that the President issued orders suspending or restricting rights, acting jointly with the council of ministers (article 241). The same provision was included in article 337 of the 1999 Constitution.

Furthermore, the last paragraph of article 241 of the 1961 Constitution clarified that the restriction or suspension of guarantees did not affect the functions of other state institutions including the Congress and the Supreme Court. This provision was maintained in the 1999 Constitution (Article 339). Thus, in case of emergency, the Congress could continue working and overseeing the executive. Additionally, there was a political control exercised by the Congress that had to approve any suspension or restriction of rights decree (article 242 of the 1961 Constitution and Article 339 of the 1999 Constitution). Further, exceptional decrees could be revoked by the President or the legislative branch prior to expiration upon cessation of the causes that produced the emergency (article 243 of the 1961 Constitution and Article 339 of the 1999 Constitution).

During a state of emergency, the Supreme Court and other courts also maintained their functions and in the 1961 Constitution there was no specific provision that limited the revision of exceptional acts dictated by the President as it is the case in Malaysia. However, courts were reluctant to scrutinise executive emergency decrees based on a theory of 'government acts'.[110] According to this theory, decrees issued by the President in cases of exceptional events were not administrative acts subjected to judicial review.[111] However, the doctrine changed in 1993 when the Supreme Court declared that it had jurisdiction to review this type of acts and voided an emergency decree dictated by President Pérez in November 1992 to face the military coup led by the air force and the navy.[112] The 1999 Constitution is stricter than the previous Charter regarding judicial reviews of emergency decrees and it

---

February 2004, the exceptional food program was extended until November 2006, allowing the administration to purchase goods without public bidding for a long period beyond the emergency event. See also Allan Brewer-Carías, 'El Constitucionalismo y la Emergencia en Venezuela/Entre la Emergencia Formal Excepcional y la Emergencia Anormal Permanente' (Paper presented at the Mesa Redonda Internacional sobre Constitucionalismo en Tiempos de Emergencia, Córdova, Argentina, 24-25 June 2005).

110 Nikken, above n 99, 178.

111 Ibid.

112 See Corte Suprema de Justicia de Venezuela. Sala en Pleno. Sentencia del 16 de marzo de 1993. Ponente Magistrada Joséfina Calcaño de Temeltas. See also Victor Hernández-Mendible, *La Suspensión de Garantías y la Acción de Amparo Constitucional* (1995) Publicaciones Jurídicas Venezolanas <http://www.zur2.com/fcjp/articulos/vrhm95.htm> at 30 April 2005.

contains an automatic judicial revision of all emergency decrees issued by the government (article 339).

The 1961 Constitution also imposed some constraints to avoid the indefinite extension of states of emergency and required the revocation of special decrees when causes that generated the state of emergency disappeared (article 243 of the 1961 Constitution and article 339 of the 1999 Constitution).

The new Constitution provides for a more specific period depending of the exceptional situation. To illustrate, a state of alarm (for example, a crisis due to a natural catastrophe) cannot last more than thirty days. In the case of economic emergency, the Constitution establishes a limit of sixty days. In both examples, the National Assembly may authorise an extension of such periods (article 338).

Finally, an aspect that has remained obscure in the constitutional law of Venezuela is the validity of those norms dictated under an extraordinary decree after the events that produced the emergency ceased to exist. As explained in section 4.5.4, such norms should not have effect after the emergency has ceased but the situation is not clear under Venezuelan constitutional law. The Organic Law of States of Exception states that the President acting with the Council of Ministers may ratify extraordinary measures provide that such actions do not restrain constitutional guarantee or rights (article 6). Some authors have suggested that this faculty extends the validity of exceptional powers beyond the state of emergency.[113]

***b) Suspension of Constitutional Rights and the Economic Realm***

The suspension of rights has been widely used to shape the economy of Venezuela. Among the rights that can be suspended by the President are the right to economic freedom established in article 96 of the 1961 Constitution (article 112 of the 1999 Constitution).[114] As earlier mentioned, the same day that the 1961 Constitution was published in Gazette becoming the 25th Venezuelan Charter, the administration of President Rómulo Betancourt enacted Decree No. 455, suspending the prohibition of arrest without warrant, the inviolability of the home, inviolability of private communications, free transit, free speech, the right of assembly and the right to

[113] Nikken, above n 99, 185

[114] Article 96 stated that 'All citizens can freely choose the lucrative activity of their preference without any restriction other than those imposed by the constitution and laws for reasons of security, health or others of social nature. The law shall impose norms to avoid usury, inadequate rise of prices and any other abusive maneuver oriented to obstruct or restrict the economic liberty.'

protest. He also restricted the right to strike and the right of economic liberty.[115] Betancourt issued the emergency Decree to manage a very unstable situation in Venezuela created by innumerable political, economic and social problems. At that time, the government faced a communist guerrilla sponsored by Cuba and also violence promoted by the Dominican Republic dictator, General Rafael Trujillo who supported the deposed Venezuelan dictator Pérez Jimenez.

Although the suspension of rights was later revoked, the right of economic freedom was uninterruptedly restricted for another thirty years until President Pérez revoked Decree No. 455 in 1991.[116] This emergency allowed democratically elected Presidents to control the economy according to what they considered were the best ways to succeed in the development process. First, Presidents employed exceptional measures to apply an import-substitution model and issued norms to protect local producers from international competition, block foreign investment, and create a vast network of government companies. Later, Presidents allied with IFIs employed similar powers to liberalise the economy and implement neoliberal programs. By the end of the economic emergency period, Presidents had enacted more than 200 law-decrees on the grounds of the restriction of economic rights.[117]

### 7.7.3 Enabling Laws

The second exceptional mechanism extensively used during the Venezuelan democratic era has been enabling laws. According to Article 190 (8) of the 1961 Constitution:

> The powers and duties of the President of the Republic are …
>
> 8. To enact extraordinary measures in economic or financial matters whenever the public interest so requires and he has been authorized to do so by special law;

The first aspect that must be noted about this provision is that it was considered an extraordinary measure justified on events that made ordinary legal methods ineffective. The extraordinary character was also connected with the public interest

---

115 Official Gazette No. 26.463 23/01/1961. Loveman, above n 71, 156.

116 Decree No. 1724 published in the Venezuelan Official Gazette 34.752 on 10 July 1991.

117 Loveman, above n 71, 162. Three year later after the re-establishing of the economic rights by Pérez, Rafael Caldera again restricted these rights in 1994 due to the banking crisis.

in which case, Presidents justified requests for an enabling law with the need of having flexibility to address extraordinary events.

Presidents Betancourt, Velásquez and Caldera justified requests for enabling laws on the grounds of the existence of economic crises that could not be resolved employing ordinary mechanisms.

Second, the extraordinary powers of the President were limited to legislate in economic and financial matters. This term was not expressly defined while the 1961 Constitution was in force. However, the executive usually limited its legislative powers to deal with economic and financial issues such as taxation, banking system, control of prices, etc.[118]

The above executive prerogative was expanded by the 1999 Constitution that suppressed the mention of economic and financial matters and provided that the President may dictate decrees with force of law when the National Assembly authorizes him through an enabling law (article 203 and 236.8). Because the new Constitution does not specify any matter, it is understood that the President if authorised by the National Assembly, can legislate in any issue and the Supreme Court has ratified this position.[119] As a matter of fact, on the two occasions that the National Assembly granted enabling laws to Chávez, based on the 1999 Constitution, he has been authorised to legislate on a variety of issues, such as transformation of the public sector, economy, social affairs, finance, taxes, internal security, science and technology, transport, etc.[120]

The suppression of the limits to delegate powers to the President has caused that the enabling law scheme lost its previous extraordinary character because it does not require the existence of special circumstances. Now this avenue is more accessible for the executive that does not need to justify a request for an enabling law on grounds of extraordinary circumstances and public interest.

---

118 See Crisp, above n 99.

119 See Brewer-Carias, above n 72, 458.

120 Ley que Autoriza al Presidente de la Republica para Dictar Decretos con Rango, Valor y Fuerza de Ley en las Materias que se Delegan. Official Gazette No. 38.617 del 01/02/2007.

In eight of the eleven presidential periods between 1959 and 2007, the executive requested special powers to legislate in areas reserved to the legislative branch (see Table 9).[121]

**Table 9: Enabling Laws in the Democratic Era, 1961-2007**

| President | Year (duration of enabling laws) |
|---|---|
| Rómulo Betancourt | 1961 (one year) |
| Carlos Andrés Pérez | 1974 (one year) |
| Jaime Lusinchi | 1984 (one year) |
| Ramón J. Velásquez (Interim President) | 1993 (four months) |
| Rafael Caldera | 1994 (30 days) |
| Hugo Chávez | 1999 (one year) |
| Hugo Chávez | 2000 (one year) |
| Hugo Chávez | 2007 (18 months) |

Exercising the delegation agreed by the Congress the executive branch has delineated the Venezuelan economy. Areas affected by law-decrees dictated on the ground of enabling laws vary greatly. Using this mechanism, Presidents have assumed classic economic measures, such as the reduction of public servant salaries, the reorganisation and suppression of public institutions, the transformation of the banking system and tax reforms. Nonetheless, there have been other more controversial actions that have been made using enabling laws and have deeply affected the Venezuelan social, economic, legal and political structures, such as the nationalisation of the steel industry in the 1970s, criminal code amendments, the social security system reforms and the transformation of the rural land property scheme.

Suspensions of rights and enabling laws have permitted governments to make decisions that should be considered in a more democratic forum, and many of the allegedly 'urgent' circumstances have not been so. This situation has led to a permanent economic state of exception where the government rules by decrees in normal times, a trend that has been maintained even in periods of oil booms. This trend seems to respond more to a preference of Presidents of having more flexibility

[121] A Presidential period is defined as the time for which a President was elected to govern. In the period 1989-1994, President Carlos Andres Pérez could not finish his period because he was condemned for corruption charges. This period was finished by Ramón José Velásquez. In 2000, Chávez could not finish his first constitutional mandate due to the promulgation of a new Constitution; therefore that period lasted about 18 months (February 1999-August 2000).

to enact legislation without the legislative body participation. The situation is worse when we notice that the constitutional limits have been omitted allowing p``residents to exercise more powers than originally permitted by the Constitution.

If the Malaysian government has been accused of indefinitely maintaining exceptional powers in order to suppress political dissidence, then Venezuelan government should be condemned for the excessive use of emergency norms to limit economic rights.

# CHAPTER 8

# THE VENEZUELAN BANKING CRISIS: EXCEPTIONAL POWERS AND IMF CONDITIONALITY

## 8.1 The Venezuelan Banking System

In Venezuela, the banking business was born in association with the treasury activities of the state in the nineteenth century.[1] The *Banco Colonial Británico*, funded with British capital, was the first bank to begin operations in 1839.[2] This bank had a short existence and ceased to operate in 1849 due to the issuance of a special act (*Ley de Espera y Quita*) that declared an official moratorium and compelled creditors to give up to a six years grace period to defaulting debtors before the bank could foreclose on collateral.[3]

Between the 1830s and the end of the nineteenth century, other banks were established in Venezuela but they also failed to remain open.[4] During these first steps to consolidate a banking system, the destiny of financial institutions was closely related to the political group that controlled the state. Banks acted as a financial agent of the government, which generally granted an exclusive licence to serve the state. Banking services provided to the government included the issuance of notes, the collection of taxes and duties and lending operations.

Links between the government and the banks made financial institutions vulnerable to political changes because often a new administration substituted the financial agent of the previous government.[5] Likewise, there were cases in which banks were forced to finance the state and on a few occasions, bankers went to jail when they refused to grant loans in favour of the government.[6]

In 1882, a new bank, *Banco de Maracaibo*, expressly incorporated into its bylaws a prohibition to do business with the state. Instead, *Banco de Maracaibo* focused on

---

1 See Carrillo Batalla, Tomás, *Cuentas Nacionales de Venezuela 1874-1914* (2002) 69.
2 Ibid 70.
3 Superintendencia de Bancos y otras Instituciones Financieras (SUDEBAN), *Pasado y Presente* (1998) 31.
4 For a review of the evolution of the Venezuelan banking system see SUDEBAN, above n 3.
5 Carrillo, above 1, 72.
6 SUDEBAN, above n 3, 36.

the private sector.[7] This change was followed by another institution, *Banco Comercial de Venezuela*, which expanded its operation to serve the private sector. *Banco Caracas*, founded in 1890, also supported this pattern. The expansion of operations to the private sector by these three banks contributed to the consolidation of a more structured system. As a consequence, the government replaced the various decrees issued to authorised operations of each bank and the Congress passed a Banking Act in 1895. [8]

During this period of consolidation of the banking system, the government refused several foreign initiatives to organise banks in Venezuela.[9] Foreign financial institutions only came to the country accompanying international oil corporations in the 1920s. At that time, the government also participated in the banking sector founding specialised banks (for example, *Banco Agricola y Pecuario* that was dedicated to agriculture and stockbreeding; and *Banco Obrero* that financed the construction of houses for working people).

The *Banco Central de Venezuela* (BCV) was created by law in 1939 to serve as a banker of the government and perform central banking functions. Its capital was partially paid for by the government (51%). The rest of its shares were offered to the public. The BCV assumed the role of financial agent of the state and centralised the issuance of notes. BCV law prohibited financing the treasury needs of the government and it only allowed the central bank to purchase federal government securities. By the time the BCV began operations, the banking system was formed by fourteen institutions: six private, local banks, three state banks and five foreign owned banks.[10]

During the 1950s the banking system experienced an aggressive growth with the opening of 24 new banks.[11] This rate of expansion slowed in the next decade when public sentiment towards domestic financial institutions changed and people preferred to shift their bank deposits to foreign currencies. This lack of confidence was exacerbated by unclear practices in which banks diverted deposits to loans

7 Carrillo, above 1, 72.
8 Ibid.
9 Ibid 73.
10 SUDEBAN, above n 3, 52.
11 Ibid 99.

granted to inter-related companies.[12] However, there was no great crisis and BCV maintained the stability of the sector.

Foreign institutions operating abroad took advantage of the hunger of Venezuelans for foreign financial assets, and advertised campaigns offering dollar denominated instruments. It produced a sentiment of nationalism among banking authorities that were concerned because they could control new entries of foreign banks but there were no provisions that regulated the participation of international finance institutions in the capital of local banks, or norms that restricted domestic deposit-taking activities by non-licensed foreign banks. Hence, the Banking Act was amended prohibiting foreign capital in the banking system as well as the publicity of banking services and deposit-taking activities for non-licensed institutions.[13]

In the 1970s, the oil boom produced the increased involvement of the state in the banking sector. In addition to the entities that had been already founded, the government added more financial institutions that provided loans on preferential terms to establish industries in almost any sector (for example, tourism, transport, cement or manufacturing). Some of these institutions were incorporated not only as commercial banks but also as autonomous public institutes with the independence to manage their own affairs and with little or no accountability. These institutes were not supervised by the Venezuelan banking supervisor. The *Corporacion Venezolana de Fomento*, CVF (1946) and the *Fondo de Inversiones de Venezuela*, FIV (1974) were among the most powerful credit institutions created by the government. The CVF and the FIV became like small kingdoms within the state. The CVF and FIV often took over failed projects and companies, contributing to the excessive growth of the state sector.

Another mechanism implemented by the Venezuelan state that had a marked influence in the banking sector was the establishment of compulsory credit quotas for economic sectors defined as a priority, and maintenance of artificially low interest rates.[14] Experts referred to the situation of the Venezuela banking system as a 'financial repression' because institutions could not operate efficiently due to the numerous governmental impositions.[15]

---

12 Ibid 113.
13 Ibid 164.
14 Moises Naim, Paper Tigers and Minotaurs: The Politics of Venezuela's Economic Reforms (1993) 39.
15 Ibid 39; Morela Arocha and Edgar Rojas, 'La Crisis Bancaria en Venezuela: Antecedentes, Desarrollo e Implicaciones' (1996) XIX *Monetaria* 153-200.

Between the 1970s and 1980s, there were other minor banking incidents that involved the failures of single banks and caused the intervention of authorities such as *Banco Nacional de Descuento* (1978), *Banco de Desarrollo Agropecuario* (1981), *Banco de los Trabajadores* (1982), *Banco de Fomento Comercial de Venezuela*, *Banco de Fomento Regional Zulia* and *Banco Comercial de Maracaibo* (1983). None of these cases caused a systemic banking crisis. In 1985, after a new round of bank interventions by the Superintendency of Banks and Other Financial Institutions (SUDEBAN), the government issued a law-decree creating the *Fondo de Garantía a Protección Bancaria* (FOGADE), an institution that would guarantee deposits in the banking system.

The 1990s commenced with a weak banking system, ill-supervised and undercapitalised. By 1993, the banking system had an average capital/ asset ratio of 7.1%, lower than international standards recommended by the Basel Accord and a Non Performing Loan (NPL) rate of 9.3%.[16] At the end of 1989, there were 41 commercial banks, seventeen mortgage banks, 41 finance companies and 20 savings and loan associations for a grand total of 119 financial institutions. From the 41 commercial banks only two were foreign and they possessed less than 1% of the system's assets. Meanwhile, there were eight government commercial banks that had a share of 12% of the banking assets.[17]

By the first half of the 1990s, the Venezuelan banking system had adopted a specialised banking model in which financial institutions were granted licenses to carry on business within a particular segment of banking. The system mainly included commercial banks, finance companies, mortgage banks and savings and loan associations (*entidades de ahorro y préstamo*). Despite this segmentation of the market, in practice, financial institutions formed groups, generally around a commercial bank.[18] This allowed a financial group to offer a variety of services to its clients.

In the 1990s, commercial banks occupied the most important role in the banking system. They carried on the usual banking business, such as receiving deposits and lending money. They had a share of 50% of the banking assets and attracted

[16] SUDEBAN, above n 3, 300. The IMF provides other numbers that openly differed from SUDEBAN. According to the IMF, NPL's was 12% in 1993 and increased to 20% n 1994. See IMF, 'Venezuela: Recent Economic Developments' (98/117, IMF, 1998) 24.
[17] SUDEBAN, above n 3, 269.
[18] Ibid 267.

70% of deposits.[19] Finance companies were engaged in the leasing and hire-purchase business and basically attended to the industrial sector. Mortgage banks provided financing to real estate developers and granted loans for the acquisitions of houses. Savings and loan associations only granted loans to individuals for the purchase of houses.

## 8.2 The Legal Framework of the Banking System in the 1990s

### 8.2.1 Introduction

By January 1994 when the crisis emerged, the banking system was primarily regulated by two laws: the 1992 Central Bank of Venezuela Act (the 1992 BCV Act) and the 1993 General Act of Banks and Other Financial Institutions (the 1993 Banking Act). Additionally, three entities had supervisory and regulatory tasks over the banking system: the BCV, the SUDEBAN and the FOGADE.

As previously mentioned, soon after assuming his second Presidency in 1989, Carlos Andrés Pérez agreed with the IMF and the WB to implement what was known as 'The Great Turnaround', a neoliberal program that sought the 'modernisation' of the Venezuelan economy. The program incorporated a banking reform component that involved: (i) opening the banking system to foreign investment; (ii) privatisation of publicly owned banks; (iii) the abolition of interest rate control and compulsory credit quotas for preferential sectors; and (iv) the reinforcement of the banking supervisory authorities and strengthening of the legal framework.[20]

The idea behind the financial liberalisation was the modernisation of the system in order to promote and support the economic growth that would be produced by the entire reform program.[21] With the suspension of economic rights still in place since 1961, it was not difficult for Pérez's administration to move rapidly, eliminating interest rate control, compulsory credit quotas and a multi-tier exchange system without congressional approvals.[22]

---

19 Ibid 266.
20 IMF, 'Venezuela-Memorandum on Economic Policy' (EBS/89/34, IMF, 1989).
21 Leonardo Vera, Quiebras Bancarias y Crisis Financieras en Venezuela: Una *Perspectiva Macroeconómica* (1997) 23.
22 See Naim, above n 14,142.

The history was different with the updating of the legal framework and the strengthening of the banking regulators, issues that required legislative actions. According to the Extended Fund Facility agreed with the IMF, the government had to present a banking bill to the Congress during the first year of the agreement (March 1989–March 1990).[23] The government complied with this condition but the legislative branch did not pass the bill.

In spite of this loss of political support, Pérez managed to get enough votes for Congress to pass the BCV Act 1992. The outcome, however, was different for seven other bills associated with the financial sector reform, including banking, the SUDEBAN and the FOGADE bills that were not approved.[24] After the first round of changes, the social discontent produced a crack in the base of Pérez's political support; support that was necessary to carry other legal reforms.

After Ramón José Velásquez assumed the Presidency to complete Pérez's term, Congress granted him an enabling law in August 1993 to legislate in economic and financial matters, including banking regulations. Using this mechanism, the Congress transferred to the President the political costs associated with the approval of a law that would open the doors of the banking sector to foreign investors and would strengthen prudential regulations that would force shareholders to increase capital of banking institutions.

Using this enabling law, Velásquez issued a law-decree in November 1993, passing the 1993 Banking Act. This Act integrated the banking, the SUDEBAN and the FOGADE bills. Hence, instead of the issuance of three different acts, the 1993 Banking Act grouped provisions associated with the three areas. The 1993 Bank Act entered into force on 1 January 1994. Fifteen days later, banking authorities intervened in *Banco Latino*, the second largest bank in the country. This event would trigger the worst banking crisis experienced by Venezuela in modern history, a crisis that affected another seventeen banks.

---

[23] IMF, 'Venezuela-Request for Extended Arrangement' (EBS-89-107, IMF, 1989) 7.

[24] Ramón Crazut, La Legislación Financiera Venezolana y la Crisis Bancaria de 1994 (2000); Francisco Faraco and Romano Suprani, La Crisis Bancaria Venezolana/Análisis Preliminar (1995).

### 8.2.2 Banking Authorities [25]

***a) The Central Bank of Venezuela (BCV)***

BCV was created by law in 1939 in order to centralise the issuance of coins and notes that were in private hands. When the crisis broke out in 1994, BCV was regulated by the 1992 BCV Act. The main features of this law were:

***Objectives:*** According to the 1992 Act, the BCV's key objective was to safeguard the value of the bolivar,[26] keep the adequate monetary, credit and foreign exchange conditions for a harmonious development of the economy; and guarantee the continuity of the payment system.[27]

The Bank was not vested with the role of supervising financial institutions *per se*; however, it had the authority to regulate the credit activities of the banking system and harmonised them with its monetary and fiscal policies in order to achieve the independence of the national economy. The regulation of the credit activities of banks was also associated with other provisions included in the 1993 Banking Act. This Act provided that an opinion of the BCV was required before the SUDEBAN granted authorisations for the opening of financial institutions, the suspension or revocation of banking licenses and the intervention or liquidation of banks.[28]

Nowadays, a law passed in 2005 regulates the BCV (the 2005 BCV Act). The current Act retained the same objectives. Further, the 2005 BCV Act states that the central bank must contribute to the harmonious development of the national economy, attending to the socio-economic regime established in the 1999 Constitution.[29]

***Independence:*** One of the main reasons to pass the 1992 BCV Act was to ensure adequate independence for the central bank to achieve its objectives and avoid

---

[25] Since 1992, the Venezuelan legal banking framework has been characterised by frequent changes. In this period the BCV has been governed by two Acts: first the 1992 BCV Act that was later superseded by the 2001 Act. The latter has been amended twice (2002 and 2005). In the same period, the banking sector has been regulated first by the 1993 Act and later by the 2001 Banking Act. For the purpose of my thesis, I will refer to the legislation in force during the crisis. However, for comparative purposes, I will make references to a more recent legislation. After I completed the writing of my thesis, the Venezuelan government issued a law-decree in July 2008 that contains a new Banking Act. This new legislation will not be assessed in this thesis.

[26] Bolivar was the Venezuelan legal currency (Bs.). Since January 2008, the legal currency is the Bolivar Fuerte (BF). BF 1 is equal to Bs. 1,000.

[27] *Ley del Banco Central de Venezuela*, 1992 article 2.

[28] Ley del Banco Central de Venezuela, 1992, articulo 161, Parágrafo Primero.

[29] Article 299 of the 1999 Constitution states: 'The economic regime of the Bolivarian Republic of Venezuela is based on the principles of social justice, democratisation, efficiency, free competition, protection of the environment, productivity and solidarity, with a view to ensuring overall human development and a dignified and useful existence for the community.'

interference from the government. When the BCV began operations in 1940, the original law assumed a model in which the institution retained a certain degree of independence and avoided financing deficits of the government.[30] The idea was to avoid the problems experienced when private banks were hired to act as the exclusive financial agent for the state and they ended up financing the unlimited needs of the government.

However, in the buoyant 1970s, the BCV Act was amended and the executive branch took control of the appointments of the BCV's President and directors. The amendment also allowed for the BCV to assist the government, funding programs to specific sectors of the economy. Ultimately, the BCV became a kind of development bank and it did not focus on the management of monetary policies.

With the implementation of the neoliberal reform in the 1990s, one of the conditions required by IFIs was to provide the BCV with enough independence to carry out its duties. The Congress did not include in the approved Act an express declaration about the independence of the central bank, but it did provide various tools to reduce the interference of the executive in the central bank's affairs.

The first tool included in the 1992 Act to guarantee independence was the mechanism designed to appoint the bank's authorities. The bank's board was formed by a President and six directors. The head of the bank was appointed by the President of the Republic, but it required the approval of two-thirds of the members of the Senate. Three directors were also designated by the President and the other two were labour representatives, one elected by the Bank's employees and the other by the Central Union of Venezuela (*Central de Trabajadores de Venezuela*, CTV).[31] The last director was appointed among the high-ranking executives of public institutions associated with the economic and financial sectors.

Additionally, the 1992 BCV Act provided for the organisation of a Consultative Council. The Council had five members, including representatives of the BCV, the National Banking Council, FEDECAMARAS, National Economy Council and the

---

30 Manuel Egaña, 'Prólogo de Documentos Relacionados con la Creación del Banco Central de Venezuela' (2007) XXI *BCV* 17-25. See also Crazut, above n 24, 58.

31 According to article 610 of the Venezuelan Labour Act, public institutions and companies owned at least 50% by the government must have a labour representation on the board. The CTV is one of the most important federations of labour unions in Venezuela.

CTV.[32] The objective of the Consultative Council was to provide opinions associated with the monetary and exchange rate policies when it was required by the BCV's President.

In order to guarantee the transparent functioning of the BCV, the 1992 Act ordered the SUDEBAN to oversee the central bank's operations. In the same way, the law compelled the BCV to prepare an annual report and submit it to the Congress. The Act also required that the BCV published its annual reports. Another aspect that limited the influence of the executive in the Bank's activities was the prohibition to grant direct credit to the government (article 55.1).

The 1999 Constitution expressly declares the independence of the BCV. This point was also included in the BCV Act passed in 2005 that provides an express declaration of the independence of the central bank. The independence of the BCV was a matter that was extensively debated in 2007 when President Chávez promoted a constitutional amendment, which included the abolition of such autonomy, among other issues. Chávez argued that the BCV should have actively contributed to the Venezuelan economy, even funding the state and aligning its goals with the government objectives. The amendment of the 1999 Constitution was approved by the National Assembly but was rejected in a national referendum that took place in December 2007.

The 2005 BCV Act has positive and negative aspects associated with the independence of the BCV. On the positive side, the Act contains an express declaration of the central bank's independence and states that the BCV is autonomous in the formulation of its policies and it is not subordinated to the guidelines of the executive branch. Another improvement that guarantees the independence of the BCV authorities from the influence of private sector is the prohibition of the President and directors from occupying positions in private banks for a period of two years after they complete their appointments with the central bank. The current BCV Act also maintains report requirements for the central bank and the SUDEBAN still supervises its operations.

[32] The National Banking Council is a forum that groups representatives of all licensed banks. The National Economy Council was created by a Presidential decree in 1946. The Council advises the government on economic and social issues. Different groups are represented in the Council (e.g. labour unions, academia, BCV and industrial sector such as banking, industry, commerce, agriculture, oil, mining, transportation, fishing and livestock). FEDECAMARAS (*Federacion de Camaras y Asociaciones de Comercio y Producción de Venezuela*) is an entity composed by various chambers of commerce and industries.

However, the 2005 BCV Act changed the mechanism for the designation of the President and the directors. Now the President of the Republic appoints the BCV President and four directors. The other two directors are designated by the National Assembly. Likewise, the new BCV law mandates the BCV to annually transfer a proportion of its profits to the executive, helping to finance the government budget deficit each year.

***Lender of last resort:*** The 1992 BCV Act allowed the central bank to act as a lender of last resort in cases of liquidity crises. This aid could be directly provided to banks for up to 30 days and could be extended for the same period (article 45.6). In exceptional cases, this period could change to 90 days and be extended for a similar period.

***b) The Superintendency of Banks and Other Financial Institutions (SUDEBAN)***

The SUDEBAN was initially created in 1940 as a special service office of the MoF. It was not until the enactment of the 1993 Banking Act that the SUDEBAN achieved legal independence from the MoF.[33]

The key objectives of the SUDEBAN are the inspection, supervision, surveillance, regulation and control of banks and other financial institutions.[34] The 1993 Banking Act would help the SUDEBAN to be a more technical organisation with less political interference. The SUDEBAN enjoys of functional, budgetary and normative autonomy.

In addition, the 1993 Banking Act provided that the superintendent (the head of the SUDEBAN) was appointed by the President of Venezuela with the approval of two-thirds of the Senate's members.[35] The idea behind this disposition was to guarantee the independence of the superintendent. Today, the appointment of the superintendent is an exclusive prerogative of the President of the Republic (2001 Banking Act, article 218).

The main change incorporated into the 1993 Banking Act was to strengthen powers of the SUDEBAN to overseeing not only banking entities operating in Venezuela but also financial subsidiaries and offices operating offshore as well as interrelated non-

[33] *Ley General de Bancos y Otras Instituciones Financieras,* 1993 article 142.
[34] *Ley General de Bancos y Otras Instituciones Financieras*, 1993 article 141.
[35] *Ley General de Bancos y Otras Instituciones Financieras,* 1993 articles 145 and 146.

financial companies established by licensed financial institutions in Venezuela or abroad. This reform facilitated a more integral surveillance of banks.

The 1993 Banking Act also created the SUDEBAN Superior Council. The Council included the Minister of Finance, the President of the BCV and the President of the FOGADE. The superintendent could provide assistance to the Council's meetings but he could not vote. The Council was designed as a forum in which all entities involved with banking supervision could discuss issues affecting the sector. Additionally, the Council's opinions were required in cases of suspension or revocation of banking licenses and interventions or liquidation of financial institutions (article 177).

Supervisory and regulatory powers of the SUDEBAN included the faculty to inspect financial institutions and require any information associated with banking operations that the SUDEBAN may reasonably require to perform its duties. Furthermore, the SUDEBAN had powers to impose administrative measures in cases of breaches of obligations imposed by banking regulations. In the most serious of situations, the SUDEBAN could suspend and revoke banking licenses; and intervene in banks if there were contraventions of legal obligations and liquidity or solvency problems.

***c) The Deposit Guarantee and Banking Protection Fund (FOGADE)***

This entity was launched in 1985 as a response to a minor banking crisis. During that year, the government closed four financial institutions that had been suffering from solvency problems. The authorities considered that the main cause of the banking failures was inadequate supervision. Nevertheless, instead of strengthening the banking supervision, the government responded with a law-decree that created the FOGADE to safeguard public deposits.[36] The FOGADE was organised as an autonomous institution, independent and different from the central government.

During the 1994 crisis, the FOGADE was regulated by the 1993 Banking Act. According to this law, the FOGADE's purposes were: (i) to guarantee public deposits held by banking institutions; (ii) to provide banks with financial assistance in

[36] Vera, above n 21, 21.

cases of liquidity or solvency problems; and (iii) to act as a liquidator in cases of bank liquidation.[37]

The FOGADE was headed by a President who was appointed by the President of Venezuela with the approval of two thirds of the Senate's members.[38] The FOGADE board had six members. Four directors were also appointed by the President of the Republic, one of them from a list presented by the National Banking Council. The other two were labour representatives, one selected by the employees of the FOGADE and another by CTV. The 2001 Banking Act gives the President of the Republic the power to appoint FOGADE's President (article 287).

FOGADE's President and the board were overseen by a General Assembly formed by the MoF, the President of the BCV, the banking superintendent and the President of the National Banking Council.

In addition to the role played by the FOGADE in cases of intervention and liquidation of banks that will be discussed in the following section, the FOGADE has as a key objective to guarantee deposits placed in the banking system. Article 227 of the 1993 Banking Act limited the guarantee to up to one million bolivars per person in each bank. However, the General Assembly with the previous opinion of the BCV had the faculty of increasing this amount.

When facing liquidity problems itself, the FOGADE could request the BCV's financial assistance, which the central bank would provide through loans for up to one year (article 225).

Furthermore, the 1993 Banking Act granted the FOGADE enough autonomy and flexibility to establish the most adequate methods to administer and sell assets acquired from failing banks as a product of financial assistance operations. The FOGADE could execute these tasks either directly, organising a company, acquiring one that was already operating; or hiring individuals or private companies. However, the law required that sales of assets were undertaken through public auctions. Exceptionally, FOGADE's board could authorise a different method, other than public auctions (for example, NPLs could be directly sold to another financial institution, article 237).

---

37 *Ley General de Bancos y Otras Instituciones Financieras*, 1993 article 203.
38 *Ley General de Bancos y Otras Instituciones Financieras,* 1993 article 209.

### 8.2.3 Main Features of the 1993 Banking Act

The 1993 Banking Act was the legislation in force in January 1994 when the first signals of the crisis emerged with the intervention of *Banco Latino*. The main principles promoted within this legislation were the achievement of more operational flexibility for banks, the adoption of international prudential standards, the implementation a universal banking model and opening the banking sector to foreign investors.

***a) Licensing***

The 1993 Banking Act required that financial institutions engaging in banking business had an authorisation of the SUDEBAN. The authorisation would be granted after favourable opinion issued by the BCV and the SUDEBAN Superior Council. Foreign investors were fully permitted to open bank offices or subsidiaries in Venezuela under similar conditions granted to local investors. The SUDEBAN had also the powers to revoke the license of any bank involved in serious breaches of legal obligations. The 1993 Act allowed banks to open new offices without previous authorisation from the SUDEBAN, as long as it was informed.

***b) Prudential Regulations***

The 1993 Banking Act adopted several of the international standards to regulate the banking system. Banks would have had a period of six months to present a plan to the SUDEBAN in which they explained how new standards would be met (article 301).

Changes included strengthening the capital/asset ratio to 8% by December 1995. In addition, the 1993 Banking Act established limits for the purchase of licensed bank shares and required previous SUDEBAN authorisation for acquisitions that represented 10% or more of the total shares of a bank. This authorisation was not required if acquisitions were made in stock exchanges but in this situation, buyers must notify the SUDEBAN.

Moreover, the 1993 Banking Act ordered financial institutions to appoint an independent auditor and banks were obligated to periodically submit financial statements and other information to the SUDEBAN. Finally, banks were required to publish their audited balance annually.

***c) Operations***

The 1993 Banking Act represented a liberalisation of banking activities. Instead of requiring SUDEBAN's previous authorisation to undertake new businesses, the Act allowed banks to do whatever was not expressly prohibited by law. Despite this flexibility, the 1993 Banking Act established several limitations to banks in order to avoid risky operations (article 120). To illustrate, the Act limited the granting of credits without collateral. Furthermore, the Act imposed limitations on credits to a single person and related parties. The law also prohibited banks from granting loans to their directors, officials or any company owned by them or other companies associated with a bank.

Additionally, the 1993 Banking Act restricted licensed institutions from investing in shares of companies or purchasing any immovable property, except for those necessary to conduct business (such as offices). Exceptionally, a licensed bank could acquire corporate shares and immovable properties as a consequence of the realisation of any security given to guarantee a loan (article 122).

***d) Mechanisms for the managing of regulatory, liquidity or solvency problems***

In comparison with the previous legislation, the 1993 Banking Act improved the mechanisms to be used in cases of banking crises. One of the major improvements was the delimitation of responsibilities of the three entities involved in the supervision and regulation of banks. Thus, the BCV was ratified as the head of the financial system and lender of last resort. The SUDEBAN was primarily responsible for bank supervision and regulation; and the FOGADE's task was to guarantee public deposits, financially assist institutions facing liquidity or solvency problems, and act as a banks liquidator. Additionally, the 1993 Banking Act included various mechanisms to resolve crises:

***Pre-emptive measures:*** The first line of defence against banking crises established by the 1993 Banking Act was the supervisory powers of the SUDEBAN. The Act furnished the Superintendency with various administrative measures in cases that it found a bank did not comply with applicable regulations. Thus, the SUDEBAN could issue recommendations to bring the institution within the terms of banking regulations (article 163). The banking authority could also require the establishment of additional provisions or mandatory reserves in cases of doubtful loans or a high rate of NPLs.

In more serious cases, the SUDEBAN could suspend the granting of new loans by a bank, distribution of dividends and even it could order the remotion of banking officials and appoint new ones (article 167) as well as requiring from bank's shareholders the reposition of additional capital (article 168 and 169).

***Financial Assistance:*** According to the 1992 BCV Act, the central bank could provide assistance through discount and rediscount transactions as well as advance operations if a bank experienced temporal liquidity problems. In exceptional cases, if circumstances made it necessary to do so, this period could be extended to 90 days with a similar extension. It required the approval of a qualified majority of the board of directors (article 45).

The 1993 Banking Act also granted the FOGADE the power to provide financial assistance for up to two years (article 229) if a bank faced liquidity problems. The favourable opinion of the BCV was required in order to grant financial assistance to banks. Financial assistance was not available if a bank was subject to intervention or liquidation. The 1993 Banking Act required the FOGADE to discuss a rehabilitation plan with the SUDEBAN before it transferred the financial assistance to banks.

During a transitory period of three years (January 1994 – January 1997), the 1993 Banking Act allowed the FOGADE, with the authorisation of the BCV, to supply financial assistance to banks suffering from liquidity problems if it was necessary to safeguard the stability of the financial system, but on the provision that the failed institution would be subject to a rehabilitation program (article 314). This provision also allowed the BCV to advance financial resources to the FOGADE for up to two years. The financial assistance provided by the BCV to the FOGADE using this article could not exceed the equivalent of two times the mandatory contribution paid by licensed banks to the FOGADE in the two precedent semesters.

***Intervention:*** If the pre-emptive administrative measures did not work, the SUDEBAN had powers to order the intervention in the offending bank. The intervention would require the favourable opinions of the BCV and the SUDEBAN Superior Council. The intervention involved the remotion of the bank management and the appointment of one or various special administrators who would manage the affairs and assets of the intervened bank (article 254). The intervention resolution issued

by the SUDEBAN must have contained a rehabilitation program or a liquidation plan (article 255). In any case, the SUDEBAN had to coordinate the design of such plans with the FOGADE.

***Financial Assistance and Intervention:*** When facing insolvency, the SUDEBAN could order the intervention of a bank and the FOGADE granted financial assistance for up to five years (article 230). But before providing financial resources, the following conditions must have been met: (i) the bank's executive directors had to be removed; (ii) the financial assistance had to be requested by the special administrators; (iii) the FOGADE and the SUDEBAN must have agreed about the operative feasibility of the bank; (iv) the financial assistance had to be less costly than the liquidation of the bank; and (v) the FOGADE had to become the main shareholder.

***Liquidation:*** This was the most extreme measure that could be taken against a delinquent bank. To make this decision, the SUDEBAN needed the favourable decisions of the BCV and the SUDEBAN Superior Council. This measure could be adopted if a bank did not take the corrective actions recommended by the SUDEBAN or when it was recommended during the implementation of a rehabilitation program. In case of liquidation, the FOGADE would take over the assets and business of the bank. The Act allowed the FOGADE to hire individuals or companies to carry on the liquidation.

## 8.3 The Venezuelan Banking Crisis (1994-2001)

At the end of the first year of application of The Great Turnaround and the subsequent liberalisation of the financial sector (December 1989), Venezuela experienced a deterioration of its macroeconomic indicators. The GDP went down 8.6 %, unemployment rose to 9.2% and inflation rocketed to 81%. The following year, the GDP grew 8.5 % and inflation was 36.5% but unemployment increased to 10.4%. In the financial sector, the liberalisation produced a rise of interest rates that motivated more people to invest their savings into the system. However, the increment of deposits did not have a proportional counterpart in the credit side,

producing a dangerous situation of banking disintermediation.[39] In order to finance their costs and generate higher returns, banks diverted resources to the acquisition of state securities that guaranteed a reasonable level of income with relatively low risks. Nonetheless, the high peak of oil prices in 1991 produced an increase of liquidity in the economy and soon, government bonds were insufficient to satisfy the market needs.[40]

By 1993, the macroeconomic situation deteriorated as the oil prices were reduced in international markets, affecting income from exports. Foreign reserves dramatically declined. During 1993, the real GDP suffered a set back of 1.5% and the inflation rate was almost 46%. The interest rate increased as high as 60% and this began to affect borrowers that started to face serious troubles to meet their financial obligations. Deposits into the banking system also received the negative impact of the deterioration of macroeconomic fundaments. People lost confident in the economy and Venezuelans preferred to invest in foreign currencies and instruments using Venezuelan banks' offshore facilities.[41]

Liquidity problems forced many banks to enter into a war to attract more deposits.[42] Aggressive marketing campaigns elevated interest rates to levels close to 70%. Banks engaged in unsound practices and, for example, lent the public's deposits to interrelated companies that did not offer appropriate collaterals and invested the money in risky business. Banks also offered financial unregulated products that were classified as off-balance sheet transactions and were not reflected in the official financial statements of banks that showed an unrealistic condition.

In spite of the existence of clear signs of distress, such as a 9.3% rate of NPLs and a low level of capitalisation, the Venezuelan banking authorities did not act to avoid further deterioration of the system. In contrast, the SUDEBAN approved the opening of new banks while ill-supervised institutions entered in a spiral of unsound practices in attempts to attract more deposits.

The political environment also contributed to the deterioration of Venezuelan economy. Pérez's administration suffered two *coups d'état* (4 February 1992 and 27

---

39 See Arocha, above 15, 166.
40 Ibid 167.
41 Ibid.
42 For a discussion of the deterioration of the Venezuelan banking system in the 1990s, see Faraco, above n 24.

November 1992) and Pérez was removed from the Presidency due to corruption charges in May 1993. To increase the uncertainty in December 1993, Rafael Caldera, a populist candidate with an unclear economic program, was elected President for the period 1994-1999.

By the end of 1993, the problems with *Banco Latino*, the second largest bank, were unsustainable and authorities decided to intervene on 16 January 1994, shutting down its operations. *Banco Latino*'s problems were not unknown to banking authorities. In a report prepared in 1990, the IMF had warned that the BCV had granted financial assistance to *Banco Latino* in an amount that represented twice the capital of the bank.[43] However, no action was taken and some commentators believe it was because the President of the BCV was the former President of *Banco Latino* and maintained close ties with the institution.[44]

By December 1993, the SUDEBAN realised that 71.5 % of *Banco Latino*'s loan portfolio was of poor quality and classified as risky loans (loans in default for at least 30 days). The obvious solution to strengthen the bank's position was that the SUDEBAN required the constitution of additional loan provisions, but this action would sweep out the capital and reserves of the bank.[45] Other private financial institutions studied the possibility of purchasing *Banco Latino* but this option failed when authorities found that problems were worse than expected and *Banco Latino* losses were fifty times larger.[46] Previous reports of *Banco Latino* had not considered that off-balance sheet operations and deposits of the off-shore unit represented a considerable proportion of the bank's business and they were not reflected in the bank's financial statements.[47]

Besides problems derived from the implementation of the 1993 Banking Act, the assumption of a new administration in February 1994 exacerbated the problems with *Banco Latino*. The administration of the interim President Velasquez considered that it must have acted with the blessing of the new administration, while Caldera's team believed it was not their responsibility to participate in the decision making process.[48] The position of Velásquez's team was supported in an unofficial

---

43 Crazut, above n 24, 149.
44 Ibid 148.
45 SUDEBAN, above n 3, 306.
46 Faraco, above n 24, 82.
47 Ibid 82. See also SUDEBAN, above n 3, 309.
48 Crazut, above n 24, 152.

tradition of previous transitions that considered the two month period between elections (the first week of December) and the date of inauguration (the first week of February). As a matter of fact, until 1993, an outgoing administration avoided making crucial decisions that may have affected an incoming government without first consulting the President-elect.

**Table 10: Banks Institution Affected by the Crisis**

| Date of intervention | Institution |
|---|---|
| January 1994 | Banco Latino |
| June 1994 | Banco Maracaibo |
| | Banco Barinas |
| | BANCOR |
| | Banco Amazonas |
| | Banco la Guaira |
| | FIVECA |
| | Banco Construcción |
| | Banco Metropolitano |
| August 1994 | Banco de Venezuela |
| September 1994 | Banco Consolidado |
| December 1994 | Banco Progreso |
| | Banco República |
| February 1995 | Banco Principal |
| | Banco Italo Venezolano |
| | Banco Profesional |
| August 1995 | Banco Empresarial |
| | Banco Andino |

The lack of a timely response and an inadequate information policy were perceived as a weakness of the whole banking system creating rumours, panic and then massive withdrawals from banks considered to be weak, such as *Banco Latino*. Between January 1994 and August 1995, eighteen other institutions were affected by the crisis (see Table 10). All these banks represented 55% of the total deposits in the Venezuelan banking system and 66 % of the banking assets.[49]

[49] SUDEBAN, above n 3.

**Table 11: Key Events Venezuelan Banking Crisis, May 1993-July 1996**

| Date | Political Events | Banking Events |
|---|---|---|
| 20/05/1993 | Removal of President Pérez | |
| 21/05/1993 | Senate President, Octavio Lepage is appointed Acting President | |
| 05/06/1993 | Senator Ramón Velásquez is designated as Venezuela's President | |
| 19/11/1993 | | The 1993 Banking Act is passed |
| 05/12/1993 | Caldera wins Presidential election | |
| 01/01/1994 | | The 1993 Banking Act comes into effect |
| 16/01/1994 | | Banco Latino is closed |
| 02/02/1994 | Caldera takes office | |
| 28/02/1994 | Caldera suspends economic rights | |
| 10/03/1994 | | The Special Law to Protect Depositors and to Regulate the Emergency in Financial Institutions is promulgated |
| 29/06/1994 | | The Financial Emergency Board (FEB) is created |
| First half of 1995 | | IMF negotiation begins |
| 15/04/1996 | | Agenda Venezuela is announced |
| 12/07/1996 | | IMF and Venezuela agreed on a Stand-By Arrangement |

## 8.4 Venezuela's Responses to the Crisis

This chapter's analysis of the Venezuelan crisis will focus on Rafael Caldera's government (1994-1999). Velásquez, Caldera's predecessor, was an emergency President designated due to the removal of Pérez. He governed for a short period (June 1993 – February 1994) and although history could blame him for not acting in a more decisive way in order to diminish the consequences of the banking collapse, Caldera's administration had, most of the time, the responsibility for the management of the crisis.

The management of the banking crisis by Caldera has to be divided in two stages that coincided with the economic programs launched during his government. The first program was known as 'My Letter of Intent to the Venezuela People'. The second Caldera's program was called 'Agenda Venezuela' and it assumed a more neoliberal approach. Thus, while the Malaysian government moved from an

orthodox to a heterodox approach during the Asian crisis, the Venezuelan authorities proceeded in the opposite direction from heterodoxy to orthodoxy.

### 8.4.1 First Approach: 'My Letter of Intent to the Venezuelan People'

The title of Caldera's first program was a criticism against the letter of intent agreed by Pérez with the IMF, which involved the implementation of a neoliberal program.[50] After Chávez's coup was defeated by the armed forces loyal to the government on February 1992, Caldera gave a speech in the Congress and justified the rebel's actions on the grounds that 'the economic policies that had left Venezuelans so poor and in such miserable conditions were a sacrifice that no one had the right to demand in the name of democracy'.[51] Using a similar platform, during his electoral campaign Caldera promised not to apply neoliberalism and his first program attached to this pledge. Caldera was aware of the precarious situation of the economy but the social turmoil caused by the Great Turnaround was still on most Venezuelan minds, and Caldera would not try to revive similar sentiments. Therefore, economic liberalisation, privatisation, new taxes and other market reform measures were not included in the 'Letter of Intent to the Venezuelan People'.

In his inaugural speech (February 1994), Caldera spoke about a new approach that involved 'commitment to solidarity with emphasis on social issues' and a plan 'to change the old disguised-as-modern system that called for economic growth while propping itself up on unrestrained public expenditure'.[52] To achieve these goals, Caldera's approach did not consider restraining public expenditures. On the contrary, he called for a more active role for the state participating in the economy and creating more legal and economic certainty in order to promote investment.[53]

For Caldera, in this first stage, there was no banking crisis. He argued that the failure of *Banco Latino* was an isolated event, and the end of a moral and economic crisis that made visible the perverse practices of some bankers who were playing with public deposits by giving credits to members of the same financial group. A legal reform was not mentioned as a remedy to control the financial problems but

---

50 See section 7.4.4.
51 Naim, above n 14, 102.
52 BBC Monitoring Services: Latin America, 'President Caldera Announces Plans; says VAT will be suspended', 8 February 1994.
53 Ibid.

Caldera promised to punish those considered responsible for the failure of *Banco Latino*. Furthermore, Caldera's administration ensured that all funds held by *Banco Latino* would be returned.[54]

Once in office, the government implemented its approach to revive the economy and its financial system without applying market reforms. The privatisation program was suspended and the value added tax (VAT) introduced months earlier by Velásquez's administration was suppressed. In the banking system, as will be explained in more detail later, Caldera's administration and the Congress issued various emergency laws and decrees in order to control the crisis. However, the *Banco Latino* problem became a systemic crisis that affected more than half of the banking institutions. By the end of 1994, the government had spent about 13% of the GDP trying, unsuccessfully, to stop the crisis.[55] This amount of financial assistance for the banking sector opened a huge fiscal deficit in the government's accounts.

As a consequence of the lack of confidence in the government and the economy, US$3.7 billion flew out of Venezuelan in the first semester of 1994, forcing the government to impose a rigid exchange control both on the current and capital accounts. Although in the second half of 1994 the Venezuelan foreign reserves recovered due to the exchange controls, the drain was not completely stopped and foreign reserves fell by another US$1.7 billion in 1995.

Meanwhile, social indicators deteriorated and showed effects contrary to those intended by Caldera. The unemployment rate increased from 8.7% to 10.3% between 1994 and 1995. Likewise, the purchase power parity decreased from US$4,329 (1994) to US$4,157 (1995).[56] Whereas the inflation rate decreased from 70.8% to 56.6%, it remained high if compared with other Latin American countries. In 1995, poverty levels rose to 66.1% of the population and 36.50% of Venezuelans were extremely poor.[57]

The social solidarity approach failed and the 'Letter of Intent to the Venezuelan People' demonstrated its incapacity to restart the development process. The

---

54 Ibid.

55 Alicia Garcia-Herrero, 'Banking Crisis in Latin America in the 1990s: Lessons from Argentina, Paraguay and Venezuela' (Working Paper 6 March, IMF, 1997) 64. See also Fernando Alvarez, et al., 'Fragilidad Financiera en Venezuela: Determinantes e Indicadores' (Working Paper 25, Banco Central de Venezuela, 2002).

56 Banco Central de Venezuela, 'Mensaje de Fin de Año del Presidente del Banco Central de Venezuela' (2003) 6. Purchasing power parity is a method that permits standard comparison among countries.

57 United Nations Development Programme, 'Informe sobre el Desarrollo Humano en Venezuela' (UNDP, 1997)

economic crisis deepened and the banking problem could not be stopped. As a consequence, the government turned back and began to negotiate a new letter of intent, but this time, with the IMF.

### 8.4.2 Second Approach: Agenda Venezuela

By the first half of 1995, the banking crisis had not seen its end and the weakness of the foreign reserves affected the Venezuelan economy even further. Due to the failure of the first program, Caldera's administration tried a different approach, using the IMF's orthodox methods. The change in policy approach came due to the need of filling the huge fiscal deficit and the unavailability of external financial sources that were reluctant to provide fresh funds to Venezuela before a commitment to apply market reforms was achieved with the IMF. The government was at a dead end. It needed funds and the IMF was the only key to open the access to foreign aid.[58]

After long negotiations between the government and the Fund, Caldera officially launched Agenda Venezuela in April 1996. The government claimed that the new program agreed with the Fund was a social and economic plan.[59] The government argued that it had asked multilateral financial institutions for preferences in social sectors because they knew the purely economic aspects did not resolve countries' problems but may serve to worsen them.[60] The Minister of Finance went further, stating that the Venezuelan negotiators' focus on people first caused the IMF to make 'a 180 degree turn to benefit Venezuela.'[61]

The principal goals of Agenda Venezuela were:

- ***Fiscal Policy:*** Reducing inflation; promoting sustainable economic growth; and strengthening foreign reserves.
- ***Monetary and Exchange Policy****:* Dismantling exchange controls; deregulating interest rates; and reinforcing the Venezuelan Central Bank's autonomy.

---

[58] This is probably why President Caldera, referring to Agenda Venezuela, said 'we have adopted these measures because we must adopt them'. BBC Monitoring Services: Latin America, 'Caldera Announces Economic Measures', 16 April 1996.

[59] Ibid.

[60] Ibid.

[61] BBC Monitoring Services: Latin America, 'Finance Minister Discusses Economic Plan, Negotiations with IMF', 30 April 1996.

- ***Social Policy:*** Increasing emphasis on the primary education system; decentralising health and education support systems; supporting financially micro-enterprises; reforming the social security system and the labour law; strengthening social programs (for example, family subsidy, student food programs, medicine subsidy, student transport subsidy and elderly subsidy and care centres); and increasing public worker wages and old age pensions.
- ***State Reform:*** Restructuring the public administration institutions, simplifying and reducing costs; decentralising and transferring public services and functions to state and municipal governments; and eliminating unnecessary governmental organisations.
- ***Financial Policy:*** Strengthening of bank supervision; reprivatisation of nationalised banks; liquidation of assets of intervened banks; and strengthening of the capital base of private banks.
- ***Investment Policy:*** Changing from an interventionist state to a regulator state; diversifying Venezuelan economy; opening new areas of investment (for example, petroleum, natural gas and petrochemical)[62]; promoting legal reforms to attract and protect foreign investment; and restarting the privatisation process.

Agenda Venezuela articulated broad levels and types of goals. Analysing documents that dealt with this program, it is not clear how the government aimed to achieve them or how they were linked. Rather, the components stressed by government officials were those related to the reduction of the fiscal deficit. During his public appearance to announce the program, President Caldera explained that in order to cure macroeconomic imbalance, petrol prices and the wholesale tax rate would be increased. Indeed, petrol was increased by 500 percent and the wholesale tax 4.5 percent. All of these increments represented radical changes in the government economic policy that in 1994 eliminated the value added tax and froze petrol prices.

To reduce the social impact of the escalation of VAT and petrol prices, the government also increased public servants wages (70%) and old age pensions (100%). The Minister of Finance also explained that abatement of inflation would avoid deterioration of purchasing power and increase of foreign investment would

[62] Since the 1970s the oil industry had been exclusively reserved to the state apparatus. See section 7.4.

reduce unemployment. Similarly, another consideration made was that the Agenda would prioritise those policies that targeted recovery of real income through sustainable, and not inflationary, growth.

Negotiations with the IMF lasted more than one year. This period was used by the Venezuelan government to adopt various PAs required by the IMF. Finally, in July 1996, Venezuela entered into a twelve-month stand-by arrangement with the IMF for a total of US$1.4 billion. The first reaction of the international community was not enthusiastic because they were not convinced of the real commitment of the government to honour the new program and because they did not know how Agenda Venezuela would be implemented.[63]

## 8.5 Legal Aspects of the Banking Crisis

In contrast to the Malaysian case, Venezuela did not follow a well structured legal strategy to face the crisis and instead, in most cases, officials simply adopted a reactionary approach forced by the domino effect of *Banco Latino*. Although banking authorities did not have time to implement changes required by the 1993 Banking Act, this piece of legislation established key tools to manage the crisis. The Congress and Caldera's administration thought differently and they opted for the creation of an *ad hoc* legal and institutional framework. Thus, suspensions of rights, an *ad hoc* board and a new emergency tool created by the Congress, 'the financial emergency', occupied a protagonist role during the crisis.

The following section will analyses the legal strategies put in place by the government and the Congress to address the crisis. Due to the number of instruments issued during the period, this section will follow a chronological order to explain the most important norms enacted during that period.

### 8.5.1 The First Steps of Caldera's Administration: Suspension of rights

On 28 February 1994, a few days after he took office, Caldera issued Decree 51, which suspended economic rights. Decree 51 was the first piece of exceptional

[63] Reuters News, 'Venezuela IMF pact gets lukewarm Wall St Reception', 22 April 1996; LSC Debt Report,Suspicious Players Hold Back on Venezuela, 22 April 1996.

regulation created by Caldera's government. It was dictated based on the 1961 Constitution (article 241), which granted special powers to the President to suspend or restrict constitutional rights in cases of emergency caused by economic or social circumstances. According to Decree 51, financial and economic stability was threatened. As a consequence, suspension of rights was deemed necessary in order to act quickly and take all required steps to restore the soundness of Venezuela's economy and its financial system.

Using the exceptional powers granted by Decree 51, President Caldera dictated Decree 52 on the same day. This Decree was not about fighting the banking problems but aimed at suspending the VAT, one of the prime electoral promises of Caldera. This option was the fastest mechanism by which to suspend a law without congressional approval. Basically, Decree 52 was the only measure taken by the government during the first period of the suspension of economic rights. This period lasted almost four months.

Moreover, in April 1994, the Congress granted Caldera an enabling law to legislate in matters related to taxes. Nonetheless, Caldera did not request exceptional powers to legislate in banking issues.

### 8.5.2 The Financial Emergency

While the executive suspended economic rights in February 1994, the Congress also contributed to the destabilisation of the banking sector when it decided to put aside the 1993 Banking Act and passed the Special Law to Protect Depositors and Regulate the Emergency in Financial Institutions on March 1994 (the 1994 Special Act). As was emphasised at the time, this law was drawn up in only fifteen days.[64]

The Congress tried to achieve three main purposes with the 1994 Special Act: (i) protecting depositors and creditors of financial institutions; (ii) safeguarding the confidence of the financial system; and (iii) regulating the financial emergency. The novelty of the 1994 Special Act was the creation of a new exceptional mechanism called 'the financial emergency':

> A financial emergency exists when all or part of the banking and financial institution system has profitability, liquidity, solvency or other type of problems that

[64] Reuters News, 'Venezuelan Congress Passes Emergency Bank Law', 9 March 1994.

> endanger the banking stability and the economic security of the country and such problems cannot be resolved applying the Banking Act (article 3).

The 1994 Special Act granted the President and the Council of Ministers powers to declare a financial emergency which must have been informed to the Congress (article 3). The financial emergency mechanism was a deviation of the state of emergency and suspensions of rights incorporated in the 1961 Constitution that required the confirmation by the Congress of such exceptional power invocations. The 1994 Special Act did not include time limits for the duration of the financial emergency or any of the other requirements mentioned by the Constitution in cases of emergencies.

Furthermore, the 1994 Special Act did not clearly explain what the effects of the declaration of financial emergency were. It was simply assumed that the banking authorities had additional powers to deal with the banking crisis. Among these faculties were the powers of the SUDEBAN to freeze assets of banks. There were other powers that were similar to those measures already included in the 1993 Banking Act (for example, the BCV's financial assistance for the FOGADE). However, in the 1994 Special Law the financial assistance was subject to fewer limitations.

Additionally, the 1994 Special Act provided that the FOGADE could appoint special administrators if this agency agreed and provided financial assistance. The special administrators had the obligation to present a plan and finish with the rehabilitation or liquidation process within the following year with the possibility to ask for a unique extension of 90 days.

Although the 1993 Banking Act granted the SUDEBAN and the FOGADE extensive powers to deal with a crisis and they could take several administrative measures, banking authorities and the Congress considered that the ordinary law was not enough to manage the banking problems. There was no serious report that technically assessed the 1993 Banking Act and concluded that it was not suitable to protect depositors and safeguard the stability of the banking system, the two main goals of the 1994 Special Act.

In contrast, it seems that the real objective of the Congress with the passing of the 1994 Special Act was to simplify and eliminate legal limits imposed by the 1993 Banking Act and grant extensive powers to banking authorities. To illustrate, according to article 230 of the 1993 Banking Act, it was possible to allocate financial assistance for an intervened bank but it was necessary that the SUDEBAN and the FOGADE agreed about the operative feasibility of such institution and, in their opinions, the financial assistance must have been considered less costly than the liquidation option. With the 1994 Special Act, the FOGADE could agree to provide a bank with financial assistance without studying whether it was the best and least costly option available. Using the 1994 Special Act, eight banks received financial assistance from the FOGADE in the first half of 1994. Later, banking authorities realised that these financial institutions had solvency problems and were not viable businesses, and ordered their liquidation, putting at risk the recovery of the financial aid already provided by the FOGADE.

The second group of norms added to the 1994 Special Act were oriented to protect depositors. The Congress tackled this objective, retroactively rasing FOGADE's insured amount from one million to four million bolivars. This norm was not strictly necessary because article 227 of the 1993 Banking Act already provided for the possibility to increase this sum requiring the sole decision of FOGADE's General Assembly.

Finally, the 1994 Special Act established the norms that would govern the *Banco Latino* intervention process. Although the 1993 Banking Act established the intervention and liquidation mechanisms for banks, the Congress resorted to regulate the particular case of *Banco Latino*. By March when the law was discussed, banking authorities already knew that the crisis not only involved *Banco Latino* but also other financial institutions; however, the intervention process included in the 1994 Special Act only referred to this bank.

Legal provisions incorporated in the 1994 Special Act and associated with *Banco Latino* included norms in which the Congress assumed functions of the judiciary. For instance, the Act decreed a provisory order freezing the assets of the failed bank (article 38) and created a special banking jurisdiction, designating the Supreme Court as the only court with competence to decide summary actions related to *Banco Latino*.

Some authors argue that the real reason behind the passing of the 1994 Special Act was *Banco Latino* and particularly the possibility of extending FOGADE's guarantees to other financial instruments that were not originally covered according to the 1993 Banking Act.[65] This position seems valid since several governmental entities including the FOGADE had investment positions with *Banco Latino*.[66] Likewise, the special administrators of *Banco Latino* were granted powers to recognise and pay with the money provided by the official financial assistance obligations that were contracted by the offshore unit of *Banco Latino* where many Venezuelans and governmental institutions had invested money.[67]

The 1994 Special Act was definitely not a complete technical solution to resolve the systemic crisis that started with the failure of *Banco Latino*. On the contrary, this legislation increased legal uncertainty that subsequently affected other institutions.

### 8.5.3 The Second Suspension of Rights: Disagreements between the Congress and the Executive

Caldera revoked his first suspension of rights (Decree 51) on 2 June 1994. In the revoking Decree 208, Caldera argued that the causes that justified the suspension of rights had ceased and the financial system had overcome the crisis. However, the banking crash was far from over and on 27 June 1994, Caldera issued Decree 241, suspending several constitutional rights, including: economic rights; the prohibition of preventive detention and home searches without judicial order; free transit; and property rights. Authorities argued that the suspension of rights was necessary to address the crisis, including the recovery of financial assistance provided by the FOGADE that has been diverted by bankers. Immediately, as a result of the rights suspension, the government passed two sets of regulations: the Norms to Guarantee the Stability of the Financial System and to Protect Depositors; and the Norms to Seize Assets of Distressed Banks (the 1994 Norms).[68]

The main objective of the 1994 Norms was to centralise the management of the banking crisis is one entity. The BCV President at that time, Antonio Casas, recognised that during the first months of the banking collapse the lack of familiarity

---

65 See Faraco, above n 24, 90-94; Crazut, above n 24, 161-165.
66 See Faraco, above n 24, 93
67 Ibid.
68 Decreto Nº 248, mediante el cual se dictan las Normas para Garantizar la Estabilidad del Sistema Financiero y Proteger a los Depositantes (Official Gazette No. 35.492, 29/06/94) and Decreto Nº 278, mediante el cual se dictan las normas para el aseguramiento de bienes de los bancos intervenidos (G.O. 35.503 15/07/94).

with the new banking legislation caused 'uncoordinated and contradictory decisions' among the different governmental entities, therefore coordination among them was essential.[69] Hence, the 1994 Norms created a Financial Emergency Board (FEB) that centralised the crisis management. The Board's members were the Minister of Finance, the President of the BCV, the banking superintendent, the FOGADE President and three members appointed by the Venezuelan President, one who would act as an executive director. The FEB resembled another entity created by the 1993 Banking Act named the SUDEBAN Superior Council.[70]

The 1994 Norms were quite simple; however, they assigned almost absolute powers in very ambiguous terms to the FEB to decide any issue associated with the crisis and for the establishment of a special banking supervision and control regime that may have reformed norms contained in the 1993 Banking Law. The FEB was not accountable to the Congress. The 1994 Norms allocated on the FEB ample discretion to act and address problems of the banking sector.

Besides the launching of the FEB, the 1994 Norms guaranteed banking authorities the power to temporarily and summarily take possession of assets owned by intervened banks to avoid sales to the detriment of FOGADE's rights. Finally, the 1994 Norms repealed the 1994 Special Act enacted by the Congress.

After the issuance of the new group of emergency decrees, the Congress reacted and did not agree with the existence of circumstances that justified the suspension of rights issued by Caldera. As a consequence, the Congress revoked the Presidential Decree 241 and kept the suspension of rights only regarding the economic rights.[71] President Caldera, in a defiant and unprecedented act in Venezuelan democratic history, promulgated a new Decree 285, ratifying the suspension of the same rights affected by Decree 241. Additionally, Decree 285 con-validated the 1994 Norms and other emergency decrees issued after the issuance of Decree 241. Decree No. 285 was not challenged and the Congress did not exercise its faculty to review this emergency decree. Thanks to the con-

---

69 Antonio Casas, *El Banco Central de Venezuela: Desafíos y Soluciones 1994-1999* (2000)114. See also Matthew Valencia, 'Chaos in Caracas', The Economist 343 8012 (1997).

70 See section 8.2.2 (b).

71 Acuerdo mediante el cual se restituyen las garantías previstas en el ordinal 1º del artículo 60 y en los artículos 62, 64, 99 y 101 de la Constitución, las cuales fueron suspendidas por el Ejecutivo Nacional según Decreto Nº 241 de fecha 27 de junio de 1994 publicado en la Gaceta Oficial Nº 35.490 de esa fecha y se mantiene vigente la suspensión de la garantía prevista en el artículo 96 de la Constitución, contenida en el mismo Decreto.- (See Gaceta Oficial Ext. No 4.754).

validation contained in Decree 285, the 1994 Norms were applied to the resolution of the banking crisis.

**Table 12: Rights Suspension Measures, 1994**

| Date | Event |
|---|---|
| 28/02/1994 | Decree number 51 suspends economic rights |
| 28/02/1994 | Decree number 52 revokes the value added tax. |
| 01/06/1994 | Caldera revokes Decree number 51. |
| 27/06/1994 | Decree number 241 suspends again several civil rights. |
| 29/06/1994 | Norms to Guarantee the Stability of the Financial System and to Protect Depositors are enacted. |
| 15/07/1994 | Norms to Seize Assets of Distressed Banks are enacted |
| 22/07/1994 | Congress revokes decree 241 |
| 22/07/1994 | Decree number 285 ratifies suspension of several rights and con-validates 1994 Norms and other decrees. |

1994 ended with an unclear program for the recovery of the banking system. Concomitantly, legal measures taken by the government appeared to be unarticulated. The legal strategy based on Decree 285 created more concerns and judicial actions were brought against the 1994 Norms. Similarly, the disorganised manner in which the government tackled the crisis facilitated that the financial assistance provided by the BCV and the FOGADE ended in hands of private shareholders and executives of assisted banks and did not have real impact on the resolution of the crisis.

The problem forced authorities to focus its actions on trying to recover money transferred to failed banks. In order to achieve this goal, the government issued more emergency decrees that extended the faculty of the state to take over the assets that guaranteed the financial assistance.[72] At the end of the year, the government expropriated many of these assets trying to reduce its losses.[73]

During the first stage of the banking crisis (January - December 1994), the government went from a position of total denial of the existence of a systemic crisis

[72] See Decree 301 (G.O. No. 3/8/94 on Normas Complementarias del Decreto Nº 278)

[73] Decree 383 (G.O.566 13/10/94 on Decreto Nº 383, mediante el cual se afectan por razones de utilidad pública y se declaran objetos de expropiación forzosa, con sujeción a las formalidades que se establecen, los bienes que en él se señalan).

to a desperate strategy to stop it using exceptional powers. The crisis management was basically aimed at pumping resources into the failed banks without designing a coherent plan that addressed structural weaknesses of the banking system (for example, management of NPLs and a viable capitalisation program). In a second phase in this initial stage, the government's actions focused on the recovery of the financial assistance provided. The main result of the state's strategy was a huge fiscal deficit while the banking system was still affected by the same structural problems.

### 8.5.4 Agenda Venezuela: A new orthodox approach

***a) Initial steps***

To study the legal aspects of Agenda Venezuela and the weight of the Fund's involvement in the decision of the Venezuelan government to keep the management of the crisis through an *ad hoc* approach in 1995 is not an easy task. As explained in Chapter 3, the Fund deals with its state members via the Treasury or the central bank that tend to limit information about negotiations. Additionally, PAs, the first set of conditions required by the Fund, generally are discussed and implemented before an official understanding is agreed between the Fund and a state. As a consequence, it is sometimes difficult to establish whether a country assumes a measure for strictly local reasons or because the government is forced by external factors (e.g. the IMF). Due to the obscurity that surrounds the IMF's negotiations, it is essential to review the events that led to the design and implementation of Agenda Venezuela.

In the beginning of 1995 when the failure of the 'Letter of Intent' of Caldera was clear, economic ministers realised that Venezuela required an infusion of funds from abroad. It is difficult to establish precisely when Caldera's team began to attract the attention of the Fund. In spite of this uncertainty, it is clear that the first half of 1995 saw a series of political and legal manoeuvres that signalled a change in the economic approach of the Venezuelan government.

The transition began with the appointment of a new Minister of Finance, Raul Matos Azocar, by Caldera in February 1995. The same month, Matos insinuated that the

government could seek the financial assistance of the IMF.[74] At this stage, the Venezuelan crisis was not new for the Fund, which closely monitored the events associated with the banking collapse after the failure of The Great Turnaround and the incomplete banking reform implemented during Pérez's Presidency. Indeed, the Fund provided technical assistance to Caldera's administration on the strategy to address the crisis (see Table 13).

**Table 13: IMF Technical Assistance Missions to Venezuela, February 1993-August 1995**

Please see print copy for Table 13

Source: IMF, 'Venezuela-Staff Report for the 1996 Article IV Consultation and Request for Stand-By Arrangement' (ERS/96/108, IMF, 1996)

The content of the IMF's technical assistance to address the banking crisis is uncertain, but there is no public evidence that suggests that the Fund raised the issue associated with the use of an *ad hoc* legal scheme by Caldera's government to tackle banking problems. In contrast, Caldera issued emergency decrees soon after IMF missions visited the country, first in June and July 1994 (1994 Norms) and then, in February 1995 (1995 Norms). As will be explained in the following sub-section, the 1995 Norms decree was particularly important because it granted more discretionary powers to FEB, a change that later would be described by the government, in the documents agreed with the Fund in 1996, as a one of the factors that would ensure the success of the banking restructuring program.[75]

[74] Reuters News, 'Venezuela won't raise gasoline price in 95', Reuter News 20 February 1995.
[75] IMF, 'Venezuela-Staff Report for the 1996 Article IV Consultation and Request for Stand-By Arrangement' (ERS/96/108, IMF, 1996) 50.

***b) Changes in the banking legal framework in 1995***

After the appointment of Matos, Caldera's administration enacted a new emergency decree on the Norms to Regulate the Financial Emergency and the Reorganization of the Financial System (the 1995 Norms) in March 1995.[76] The 1995 Norms maintained the FEB, but the SUDEBAN and the FOGADE were removed. Thus, the members of the FEB were the Minister of Finance, the BCV President and three directors appointed by the President of the Republic, one acting as an executive director. The banking superintendent and FOGADE's President would only attend those meetings to which they were invited.

According to the government, the FOGADE and the SUDEBAN were excluded from the FEB because these entities needed to focus on their central duties of supervising banks and guaranteeing public deposits. Further, it was claimed that these institutions must have been far from political centres, such as the FEB.[77] With the change in the FEB's composition, President Caldera had in fact strengthened his power over the Board, because he directly appointed four of the five members. The Congress was not expressly involved in the overseeing of the FEB.

The reform of the FEB strengthened not only its political powers but also its technical nature because the SUDEBAN and the FOGADE lost control of technical issues and both institutions were placed under the supervision and management of the FEB. Likewise, the 1995 Norms granted the FEB the power to exercise all faculties of the SUDEBAN and the FOGADE established in the 1993 Banking Act, including the power to issue regulations, the intervention of banks, the liquidation of financial institutions and the sale of banks and assets acquired due to financial assistance provided by the government. The FEB's authority was almost unlimited and article 3 of the 1995 Norms stated that 'the Financial Emergency Board shall have the vastest faculties to solve the financial emergency'. Thus, the FEB was furnished with unlimited exceptional power to change the 1993 Banking Act.

The 1995 Norms revived the debate about the constitutionality of the emergency regulations dictated by the executive and, in particular, two issues: first, whether or not exceptional circumstances existed that justified the suspension of constitutional rights; and second whether or not the President could enable the FEB to legislate

[76] Decree No.573 Official Gazette No. 35666 07/03/95.
[77] Casas, above n 69, 101.

matters that were reserved to the Congress.[78] As explained earlier, the Congress did not agree with Caldera about the existence of real events that justified the suspension of guarantees and experts argued that the Decree of suspension was legally weak because it did not mention any specific circumstance of emergency.[79] Additionally, the fact that the FEB could modify the 1993 Banking Act seems to exceed all constitutional limits.

Tensions between the Congress and the executive dissipated when both branches achieved an agreement and the Congress passed the Regulation of the Financial Emergency Act in July 1995 (FEA). The FEA adopted the executive's approach of considering that the country was still facing an emergency situation. Therefore, instead of looking into the 1993 General Banking Act and making the required adjustments to reduce its shortcomings, the Congress maintained the path to manage the crisis with emergency norms.

The new Act grouped all the exceptional regulations promulgated by the government during the financial crisis. The FEA ratified the power of the President, acting with his council of ministers to declare a financial emergency. However, harmonising the legislation with the content of constitutional provisions, the Act required that the declaration of financial emergency was confirmed by the Congress. The Congress also reserved to itself the power to revoke the emergency if that body considered that the events that justified the declaration no longer existed.

Furthermore, the FEA ratified the existence of the FEB and granted it broader powers. The SUDEBAN and the FOGADE maintained their second-rank roles. FEA expressly confirmed the prevalence of emergency laws over ordinary law when it stated that in case of contradictions between the 1993 Banking Act and FEA, the latter would prevail.

Likewise, as in the case of the preceding decrees, the Act authorised the government to provide unlimited financial assistance to intervened or non-intervened banks. This legislation also permitted the selling of shares and assets of distressed banks to foreign investors, a provision that was not innovative since the 1993 Banking Act already allowed the unrestricted participation of foreign investors in the

[78] See José Melich Orsini, 'Suspensión de Garantías y Emergencia Financiera' in Hildegard Rondón De Sansó (ed), *Aspectos Fundamentales de la Emergencia Financiera* (1996) 159-169.

[79] Ibid 163.

banking sector. The FEA confirmed the special powers of the government to seise assets of affected banks and the use of summary judicial procedures to resolve cases associated with the banking crisis.

Another matter addressed by the FEA was the amount covered by FOGADE's insurance that was placed in four million bolivars per depositor, per bank (article 21). Additionally, the law authorised the President of the Republic to update this amount and to extend the guarantee to other financial instruments not originally covered (article 21). Nonetheless, the Act extended the guarantee to ten million bolivars for deposits held in banks that were intervened between June 1994 and July 1995 (article 55).

Finally, the Congress incorporated in FEA an article declaring a financial emergency on the basis of the 'current economic and financial situation'. Hence, after more than eighteen months since the beginning of the crisis, the Venezuelan Congress ratified the existence of a crisis and continued to rely on a non-comprehensive legal answer to resolve a structural problem.

***c) Official negotiations with the IMF***

After the passing of the FEA in July 1995, the government started to show more signs that it sought an arrangement with the IMF. However, official contacts with this institution were initially denied by Venezuelan authorities although the Minister of Finance met with IFIs, including the Fund.[80] Months later, Venezuelan officials admitted that they initiated talks with the IMF but they clarified that they were working on a 'shadow program' that would not require the signing of a letter of intention between Venezuela and the Fund, nor would this institution be compelled to provide financial assistance.[81] The idea behind a shadow program was to improve the image of Venezuela in international markets through the voluntary achievement of macroeconomic goals.

A shadow program was never completed by Venezuela and soon, Minister Matos began to talk not about a shadow program but a loan from the IMF that would aim to meet various conditions and would help to strengthen the banking sector.

[80] Dowjones Newswires, 'Venezuela Looking to Reduce Debt Burden with World Bank, IDB', Downjones Newswires (Caracas), 11 July 1995.

[81] Dowjones Newswires, 'Caldera Govt Eyeing IMF "Shadow Program"', Dowjones Newswires 2 August 1995.

Authorities did not release too many details of the proposed agreement.[82] Even for the Congress it was difficult to obtain information about the negotiations and the executive refused to provide the legislative body with specific terms.[83] It was only in October 1995 that Caldera publicly admitted that the government was negotiating a program with the Fund.[84]

While the government discussed the agreement with the IMF and until an official announcement was publicly made by Caldera (first half of 1995-April 1996), Venezuelan authorities adopted various measures to adapt its fiscal and monetary policies to the IMF's orthodoxy (for example, relaxing exchange controls, devaluation of the currency and increase of petrol prices). In the documents prepared by the government and agreed by the Fund some of these actions were mentioned as 'interim measures', a term that differs from the official 'prior actions.'[85] Most of these measures were really prior actions and the IMF did not finalise the stand-by arrangement with Venezuela until those measures were implemented. In the case of petrol, the rejection of the government to increase prices was the main reason for the long extension of negotiations with the Fund.

***d) Banking aspect of Agenda Venezuela***

The Agenda was finally announced by Caldera in April 1996. The program contained a component referred to the financial sector that included: (i) strengthening of bank supervision; (ii) re-privatisation of nationalised banks and sales of assets of closed and intervened banks; and (iii) strengthening of the capital base of private banks.[86]

According to the Agenda Venezuela, one of the major measures taken by the government to guarantee the successful implementation of the program in the banking sector was the appointment of a technical team headed by a senior official 'this senior official, who will report to the [Financial Emergency Board], will have the authority to make decisions needed to ensure the success of the restructuring program'.[87] This measure corresponded first with the issuance of the 1995 Norms

---

82 Dowjones Newswires, 'Venezuela Seeking Up to $1.5 Billion from IMF', Dowjones Newswires 23 September 1995; Dowjones Newswires, 'IMF Deal to help Ease Forex Controls', Dowjones Newswires 25 September 1995.

83 Reuters News, 'Venezuela looking for a $ 7.5 billion from IMF talks', (New York), 26 September 1995.

84 Dowjones Newswires, 'Caldera Sees Sacrifices for IMF', Dowjones Newswires 26 October 1995.

85 IMF, above n 75, 4. For a discussion of prior actions, see chapter 3.

86 Ibid.

87 Ibid 50.

and then with the enactment of the FEA that reorganised the FEB, strengthened the powers of this Board, subordinated the 1993 Banking Act to the emergency legislation, and downgraded the roles of the SUDEBAN and the FOGADE.

***Strengthening of Banking Supervision:*** The government gave assurances that the SUDEBAN would intensify its supervision of the banking system by performing more inspections of financial institutions.[88] At the same time, the government agreed that it would negotiate 'a comprehensive plan' with the WB and the IADB to improve the institutional and legal capacity of the SUDEBAN by September 1996.

***Privatisation of Nationalised Banks:*** While Malaysian authorities concentrated their major efforts on removing NPLs from the banking system, the Venezuelan government mainly focused on the privatisation of nationalised banks. This task would be carried out between June and December 1996. Re-privatisation of banks was set as a structural benchmark by the Fund and was justified on the grounds that it would help to improve the competitiveness and efficiency of the banking system.[89]

For the Minister Matos, the privatisation of nationalised banks and sales of assets acquired during the crisis was essential to resolve the banking problem. For Matos, the existence of a cumbersome banking legislation prevented a definitive resolution of the crisis and, therefore, it was necessary to change laws and create a fast track to privatise banks and sell assets.[90] From the Minister's perspective, the banking problem seemed to be confined to the difficulties associated with the privatisation process and not caused by other structural factors.[91] For this reason, it was not strange that the government maintained the *ad hoc* scheme and the IMF agreed.

Before engaging in the privatisation efforts, the state conceded that it was necessary to fix a problem caused by the banking authorities' decision to transfer deposits from closed banks to nationalised institutions but without a counterpart earning assets. This movement produced a negative impact that deteriorated the capitalisation of nationalised banks and reduced their possibility to be sold. To solve the problem, the government would issue bonds and assign them to the nationalised banks for an amount equivalent to the value of transferred deposits. The resolution of this

88 Ibid.
89 Casas, above n 69.
90 BBC Monitoring Services, above n 61.
91 Ibid.

situation was perceived so essential by the IMF that it included it as a PA.[92] Indeed, the government started to comply with the condition in December 1995 before the final arrangement with the Fund was achieved.

***Strengthening of Base Capital**:* The FEB and the SUDEBAN would require banks with capital deficiencies to prepare and present a restructuring and recapitalisation plan. After an agreement was achieved, it would be implemented and the FEB and the SUDEBAN would oversee its application. The government guaranteed that capitalisation plans would be strictly enforced and failures to comply with them or refusals to adopt one would cause that the authorities to apply 'the relevant legal procedure'.[93] The government did not create an equivalent of the Malaysian DANAMODAL nor did it announce a specific plan with deadlines.

**Table 14: IMF Conditions Banking Sector** [94]

Please see print copy for Table 14

***d) Shortcomings of Agenda Venezuela in the Banking Sector***

Documents associated with Agenda Venezuela did not contain any measures to abolish the dual legal banking framework nor did it mention it as a source of instability of the banking system. The Agenda did not consider the legal re-empowerment of the SUDEBAN or the FOGADE that were superseded by the *ad hoc* FEB. It could be assumed that the IMF did not consider these issues as relevant for the immediate recovery of the banking sector. NPLs were also absent from Agenda Venezuela and no specific measure were taken although at the beginning of

92 IMF, above n 75, 12
93 Ibid 51.
94 Ibid 69.

1996 the total NPLs was above 12%.[95] During the short period in which Agenda Venezuela was implemented these issues were not addressed.

In contrast, legal reforms undertaken by the Congress during the negotiation period with the Fund were agreed not to cope with the above omissions but to amend FEA to facilitate the privatisation process. The first amendment was approved by the Congress in December 1995 with the aim of cleaning the balances of a group of intervened banks from deposits and investments made by interrelated companies. Transferring these doubtful liabilities from the failed banks to the FOGADE would improve the financial situation of these banks and facilitate the privatisation process. The second amendment of FEA approved by the Congress in April 1996 had a similar purpose to the first one, but in this case the Congress granted the FOGADE the faculty of paying debts owned by the intervened banks to their employees and workers, making those banks more attractive for the privatisation process.

***e) The Role of the Congress during the Negotiation Process***

The Stand-By Arrangement was agreed between the Fund and the executive. The Memorandum of Understanding was signed by the Minister of Finance, the Minister of Planning and the President of the BCV with little participation of the Congress. According to article 126 of the 1961 Constitution, the government could not sign contracts that involved 'the national interest,' excepting those that are necessary for the normal conduct of the state or those permitted by law.

The Constitution did not provide a clear definition of ''national interest', a term highly disputed among Venezuelan academics. Brewer-Carías claims that contracts of national interest are those that involve the federal government and its agents, in contrast to those agreed by states or local councils. Hence, those contracts that involve the federal government and are necessary for the normal conduct of governmental affairs do not require congressional authorisation.[96] However, Brewer-Carías admits that 'the normal conduct of government's affair' is also an open-end term that needs some source of interpretation and then, he proposes that the notion refers to those contracts signed by the federal government under the

[95] IMF, above n 16, 24.

[96] Allan Brewer-Carías, 'Los Contratos de Interés Nacional y su Aprobación Legislativa' (1982) 11 *Revista de Derecho Público* 49-54l.

authority of a law.[97] In contrast, those contracts that involved the federal government and are not regulated by law would require a congressional approval.

Other authors mentioned by Brewer-Carías use different approaches.[98] For instance, Pérez Luciani claims that contracts of national interest are those that, due to their economic or financial magnitude and importance, could have sensible consequences for the state, justifying the legislative control. In similar terms, Fermín Toro Jiménez argues that contracts of national interest are those that involve the federal government and could involve claims from foreign entities.

As previously stated, the IMF's arrangements were not considered international contracts by the Fund, but were regarded as non-contractual arrangements. However, this thesis disagrees with this position because these documents contain elements that make them enforceable according to international law (for example, they involve international parties, contain legal obligations, and are enforced by a formal institutional system).[99]

In the particular circumstances of Agenda Venezuela, although the country was a signatory member of the IMF Articles of the Agreement that were approved by the Congress, this treaty did not establish the terms of the Fund's arrangements, which are governed by the Guidelines approved by the Fund's Executive Board. Additionally, the IMF arrangements of the 1990s involved structural reforms that affected political and economic factors, rather than solely addressing macroeconomic performance clauses as was the case when the Articles of the Agreement were originally approved by the Venezuelan Congress.

Moreover, the Venezuelan government requested the Fund's financial assistance not to deal with a normal situation but a banking crisis that drained the governmental coffers, a situation that was far from being a normal conduct of the state's affairs. Likewise, the program negotiated with the IMF included payment of a debt and fees, and deadlines for the Congress to pass various legal reforms (for example, the Labour Act, the Tax Code and the VAT Act), agreed between the Venezuelan government and the IMF. The terms of the reforms required by the Fund were

---

97 For instance, the 1997 Privatisation Act required that sales of government-owned shares in strategic companies to private corporations must have been authorised by the Congress.

98 See Brewer-Carias, above n 96.

99 See discussion in chapter 3.

specific. To illustrate, the Congress had to increase the VAT from 12.5% to 16.5% and amend the Labour Act to suppress the retroactivity of severance payments associated with the termination of a labour relation, and limit these types of payments 'to reasonable levels'.[100] These factors made it mandatory to submit to the Stand-By Arrangement for the approval of the Congress according to the content of article 126 of the Venezuelan Constitution.

Although Congress' actions were required to comply with the IMF conditions, this body was not directly engaged in the negotiations and congressmen only had limited access to the terms negotiated because it was forced to pass the above-mentioned legal reforms and approved the 1996 national budget that included the debt's payments assumed by the state with the Fund.[101] The pressure imposed by the executive on the Congress emerged in March 1996 before the government achieved a final commitment with the Fund. That month, the legislative body refused to pass the required changes, forcing the government to defer the completion of the agreement with the IMF for a month.[102]

To summarise, through a comparison between the banking components of Agenda Venezuela with its counterpart in Malaysia, it is clear that the latter set clear objectives and developed strategies to resolve the threats posed by the financial crisis. The legal strategy assumed in order to implement the plan was designed using the Central Bank Act and the BAFIA as a basis. Emergency powers were limited to the functioning of DANAHARTA. Meanwhile, in the case of Venezuela, the government stated its goals without clearly explaining how they would be achieved and the legal strategy developed was confusing. To illustrate, they stated that the strengthening of the supervision would be achieved through the increase of inspections by the SUDEBAN, an agency that was not considered trustworthy by the government, which took over its functions and transferred them to the FEB. Furthermore, instead of trying to improve the quality of the SUDEBAN's supervision,

---

100 IMF, above n 75, 14. Before the amendment of the Labour Act passed in 1997 to comply with IMF's condition, when a worker was dismissed or renounced his job, he had the right to receive from an employer a payment equivalent to a month of his last salary multiplied by the number of years that he had worked for that employer. If the worker was dismissed for no legal reason (e.g. because the employer wanted to reduce his labour force), the final payment had to be multiplied by two.

101 Reuters News, 'Venezuelan Tax Reforms Needed for IMF Deal', Reuter News 14 December 1995.

102 Reuters News, 'Matos sees Political Will for IMF talks', Reuter News 01 March 1996; Noti-Sur-Latin American Political Affairs, 'President Rafael Caldera Faces Mounting Protests against Economic Measures', Noti-Sur'Latin American Political Affairs 05 April 1996; Humberto Marquez, 'Government, IMF Seek Support for Tough Reforms', Inter Press Service 12 April 1996.

the immediate goal set was to increase the number of inspections performed by the banking superintendence.

Similarly, the government declared that it would require capitalisation to financial institutions and 'the relevant legal procedures will be applied' if no agreement is reached or shareholders failed to comply with the plan. But the program did not specify which type of legal remedies banking authorities would apply and whether they referred to the 1993 Banking Act or other discretionary action taken by the FEB with its extraordinary powers.

## 8.6 Agenda Venezuela Results in the Banking Sector

### 8.6.1 Strengthening of Banking Supervision

The banking legal framework seemed to be prepared to face the crisis and, to some extent, facilitate its resolution through the improvement of bank supervision incorporated in the 1993 Banking Act. More than an inadequacy of this Act to address the issue of weak supervision, the problem lied in the lack of time provided to the SUDEBAN and the FOGADE to adhere to the new law.

Caldera's administration and the Congress preferred not to test the new Act. Instead, they relied on emergency norms and made the SUDEBAN and the FOGADE dependable on an *ad hoc* Board. However, there was no evidence that the FEB would be more efficient than the SUDEBAN and the FOGADE. Indeed, the FEB would need also to be provided with adequate economic, technical and human resources in order to comply with its duties. In fact, after its creation, the FEB required six months to become fully operational and begin making decisions regarding the eight banks that were closed during the first half of 1994. This demonstrated that the FEB faced similar challenges to those that affected the performance of the SUDEBAN and the FOGADE, this is, lack of expertise, incomplete information about the real situation of banks and deficient resources to act decisively.

When Agenda Venezuela was launched in April 1996, FEA was in force. The participation of the IMF in the designing of the program did not change the

emergency approach assumed by Venezuelan authorities since 1994. In fact, prior actions and benchmarks were associated with the re-privatisation of nationalised banks. None one of the IMF conditions referred to the revocation of FEA or the suppression of FEB. The IMF acceptance of *ad hoc* legal methods to resolve the long lived crisis was inconsistent with the official discourse of this institution that reject the use of *ad hoc* solutions in favour of the rule of law in developing countries as the most expeditious way to achieve economy growth and abate poverty.[103]

As a product of the dual banking legal system, Venezuelan authorities continued applying two set of norms to improve supervision of the banking system: FEA and the 1993 Banking Act, which was partially enforced. After achieving an agreement with the IMF, banking authorities increased their surveillance of the sector. Also, authorities assumed various actions to strengthen the financial system using powers granted by the 1993 General Banking Law, especially those related to the adoption of international standards of prudential regulations.[104] In this regard, during the first half of 1996, the FEB and the SUDEBAN implemented a new account code for banks to make banking data more transparent and forced banks to disclose off-balance sheet operations.

Authorities also issued guidelines for the conversion of specialised banks into universal banks. This action was agreed with the policy of encouraging the transformation of specialised financial institutions into universal banks. Universal banks follow a European model in which a single financial institution can offer a larger variety of financial services that include investment banking and other traditional saving, deposit and lending services. In this case, the financial institution would be granted with a sole license. From the point of view of banking supervisors, universal banking facilitates a more comprehensive supervision of financial groups.

The SUDEBAN internally took some steps to restructure their operations but it was in July 1997 when the IADB and the Superintendency agreed on a program to support structural changes in the SUDEBAN (according to Agenda Venezuela, this program should have been initiated in September 1996). The program was never

[103] See chapter 3.
[104] SUDEBAN, above n 3, 403.

fully applied and it was suspended in 2003 due to difficulties with its implementation.[105]

Although regulatory and supervisory changes were implemented by authorities in order to comply with Agenda Venezuela's financial objectives, the IMF reported in October 1998 a series of negative issues not only related to supervision but also to the regulations of the banking system, when Venezuela had already abandoned the implementation of Agenda Venezuela.[106] IMF's observations came untimely because the institution initially celebrated the way in which Agenda Venezuela was executed and it did not raise the issue of the *ad hoc* scheme before launching its arrangement in July 1996.[107]

The first critical comment of the IMF was regarding the lack of established procedures for a consolidated supervision of financial groups and of off-shore operations of Venezuelan banks, one of the major reasons behind the crisis. Second, the IMF recommended updating the banking legislation, including the revocation of the financial emergency legislation. This second observation was not included in the Stand-By Arrangement, in which there was no mention of the dual banking legal system. It can be assumed that this was because the exceptional nature of the financial emergency legislation facilitated the privatisation process, a priority objective included in the Agenda Venezuela.

The IMF's recommendations were not immediately implemented. The financial emergency was only revoked in November 2001 when Chávez's administration, due to an enabling law that authorised the President to pass the 2001 Banking Act, repealed the FEA and terminated the financial emergency. The 2001 Act dissolved the FEB and reintroduced the supervision and regulation of banks by the SUDEBAN. The financial emergency officially lasted almost eight years.

The exceptional regime of FEA did not completely disappear and an adapted version was captured in the 2001 Banking Act (article 403). However, the new financial emergency regime is more limited than the original model. Now, the exceptional scheme is conceived within the limits of the states of emergency

---

105 Superintendencia de Bancos y otras Instituciones Financieras, 'Informe Anual 2003' (SUDEBAN, 2003)

106 IMF, above n 16.

107 See e.g., IMF, *Michel Camdessus, Managing Director Press Conference* (1996) IMF <http://www.imf.org/external/np/tr/1996/tr961003.htm> at 28 April 2004.

incorporated in the 1999 Constitution and it includes legislative and judicial reviews (article 460). Furthermore, the 2001 Banking Act establishes that in case of a declaration of a financial emergency, a financial emergency board would assume the management of the crisis but within established limits and with the support of the SUDEBAN.

### 8.6.2 Re-privatisation of Nationalised Banks and Sales of Assets

This goal was one to which the IMF and national authorities put more attention and dedicated more resources. Privatisation was one of the most often mentioned terms by government officials as an instrument to solve the financial crisis and improve competitiveness of the financial sector, especially as an entry mechanism for foreign investors.[108] The importance placed on re-privatisation was reflected in the Stand-By Arrangement, in which privatisation of the banks with better chances of attracting foreign investment were included into the program as structural benchmarks.

It can be argued that the re-privatisation of banks was essential to stabilise the financial sector. From a theoretical perspective, however, the strengthening of the legal framework and supervision should have been assumed with the same vehemence. Experts have recognised the importance of privatisation in developing countries as a mechanism to promote competition and consolidate the banking sector, but the World Bank's studies show that privatisation of banks improved the performance of the system when it was executed in a sound regulatory and supervisory environment.[109] Therefore, privatisation is not positive, *per se*, and its positive effects would depend on the quality of banking regulations and supervision in place in a specific country. The case of Malaysia demonstrates that it was possible to rehabilitate the banking system without transferring the control of banks to foreign investors.

The clearest effect of the emphasis placed on re-privatisation was that the nationalised banks rehabilitated by the government were sold by July 1997. The concentration of powers on the FEB and the application of the FEA's provisions played a key role in achieving this result.[110] It is important to note that one of the

---

[108] Casas, above n 69.
[109] The World Bank, 'World Development Report 2002: Building Institution for Markets' (2001).
[110] Garcia-Herrero, above n 55, 61; Pavel Gómez and Rosa González, 'La Autonomía Administrativa de las Instituciones Gubernamentales en Venezuela: El caso de la Superintendencia de Bancos y Otras Instituciones Financieras (SUDEBAN)' (Working Paper 435, Inter-American Development Bank, 2001) 29.

major arguments used by Minister Matos to justify the long lasting Venezuelan crisis was the cumbersome and complicated legal system that involved many authorities and pieces of legislation, which was the reason why the FEA was enacted in 1995 and the FEB was mentioned as one of the key elements for the success of Agenda Venezuela.

The results of the privatisation process were evident. By the first half of 1997, 47% of bank assets were owned by foreign investors compared with not more than 0.5% at the end of 1993.[111] Additionally, the FOGADE sold some other important assets that were acquired from the distressed banks (see Table 15).

**Table 15: Selected Privatisation Transactions by FOGADE** [112]

Please see print copy for Table 15

Transaction over US$ 5 millions *: Assets owned by closed banks.

[111] Gómez, above n 110, 5.
[112] Ibid.

In spite of the successful privatisation processes, it is not clear whether the FOGADE recovered the costs of the financial assistance given to financial institutions. The answer seems to be negative since the government had to assume the huge debt of the FOGADE with the BCV.[113] The total cost of the crisis for the government was approximately US$16.8 billion.[114] Additionally, the FOGADE was left with the liquidation of fourteen banks and the management of a huge and diverse group of assets (for example, buildings, holiday facilities, companies, art objects, cars, etc).

### 8.6.3 Capitalisation of Banks

Since the beginning of the 1990s and before the 1993 Banking Act entered in force, the undercapitalisation of the Venezuelan banking system was a well known fact. However, banking authorities did not have a comprehensive evaluation that could clarify the magnitude of the problem. When the crisis affected Venezuela, the government began to inject financial assistance to distressed banks in a disorderly way, without analysing whether or not they had a liquidity or solvency situation.[115] The financial aid, instead of being used to buy NPLs to improve the quality of the banking sector assets, helped to pay deposits and the capital of banks continued to weaken.[116]

Within the framework established in the Stand-By Arrangement with the IMF, the Venezuelan banking authorities would tighten the capitalisation requirement of banks. The objective was achieved and in 1996 and 1997 the banking system showed a robust 13.7% and 13.3% respectively of capital/ asset ratio.[117] Such numbers represented stronger figures than the 7.15% of 1993. In spite of the positive results, the SUDEBAN recognised that they were achieved by the entrance of foreign banks that acquired the nationalised banks and for the implementation of accounting changes such as a new account code and a new set of guidelines for the

[113] See Section 8.7.1 in this chapter.
[114] The Republic of Venezuela, 'The Republic of Venezuela 9.25% US Dollar-Denominated Unsecured Global Bonds Due 2027' (1997) 25.
[115] See SUDEBAN, above n 3, 351.
[116] See Faraco, above n 24, 94-102
[117] SUDEBAN, above n 3, 378.

registry and valuation of the investment portfolio.[118] In 1998, the SUDEBAN was still calling for a better capitalisation of banks.[119]

### 8.6.4 Disintegration of the Banking Legal Framework

**Table 16: Affected Banks and Mechanisms of Crisis Management**

| Bank | Date of intervention | Mechanism of intervention | Regulation applied |
|---|---|---|---|
| Banco Latino | Jan 94 | Intervention and closing | 1993 Banking Act<br>1994 Special Act |
| Banco Maracaibo<br>Banco Barinas<br>BANCOR<br>Banco Amazonas<br>Banco La Guira<br>FIVECA<br>Banco Construcción<br>Banco Metropolitano | Jun 94 | Unlimited financial assistance and thereafter intervention and closing | 1994 Special Act |
| Banco de Venezuela | Aug 94 | Nationalisation | 1994 Norms |
| Banco Consolidado | Sept 94 | Nationalisation | 1994 Norms |
| Banco República | Dec 94 | Nationalisation | 1994 Norms |
| Banco Progreso | Dec 94 | Nationalisation and closing | 1994 Norms |
| Banco Principal<br>Banco Italo/ Venezolano<br>Banco Profesional | Feb 95 | Nationalisation, deposit migrations to other nationalised banks and then closing | 1994 Norms |
| Banco Empresarial | Aug 95 | Intervention and closing | FEA |
| Banco Andino | Aug 95 | Nationalisation and mandatory merger | FEA |

If the dual system (the 1993 Banking Act and the FEA) was successful for the completion of the re-privatisation process, its effects on other aspects of the banking system are more difficult to assess. Through an examination of, for instance, the mechanisms implemented during the banking crisis to intervene in banks, an inconsistent enforcement of regulations emerges and it can be seen that up to five options were employed: (i) intervention and closing; (ii) unlimited financing and

[118] Ibid.
[119] Ibid 402.

thereafter intervening, (iii) nationalising banks (iv) deposit migrations from closed banks to state owned banks; and (v) mandatory mergers (see Table 16).[120] This uncertainty contributed to the worsening of the crisis because market actors perceived the lack of expertise and clarity of the officials who were managing the crisis.

*Banco Latino*, the first bank to be affected by the crisis, was intervened in by the SUDEBAN according to the provision of the 1993 Banking Act. The authorities appointed special administrators and decided to conduct a closed-door intervention. Later, using the 1994 Special Act, authorities injected new capital to cover payments of deposits and reopened the bank. Subsequently, its liquidation was ordered.

Between January and June 1994, the FOGADE followed another approach and granted financial assistance to a group of eight banks. However, authorities did not establish any specific conditions with which those institutions needed to comply (for example, rehabilitation programs or the removals of directors and officers). This lack of a strict management of the crisis facilitated the diversion of assistance funds that ended up being deposited abroad in private accounts. By June 1994, it was clear that the eight banks faced solvency problems and authorities decided to intervene closing this group of banks. Later in October 1995, the FEB decided to liquidate all these institutions.

In the second half of 1994, the government implemented another method of crisis resolution. Instead of continuing to close banks, authorities decided to take over failed banks, buying their shares for a nominal price and maintaining the operations of the institutions. This process was called nationalisation.[121] Then, the government designed special administrators and assumed the management of the business. The mechanism was successful to manage the failures of *Banco Venezuela* and *Banco Consolidado* that were later re-privatised.

In the case of *Banco Progreso* and *Banco República*, they were initially nationalised by authorities in December 1994. Both banks were owned by the same person who had created a network of inter-related companies that borrowed from these banks. After authorities took over the shares of the two banks, they discovered that they

[120] Ibid. See also Gómez, above n 110, 26.
[121] SUDEBAN, above n 3, 315.

had a dual accounting system to hide illegal banking practices.[122] Due to the magnitude of the fraud, authorities decided to liquidate *Banco Progreso* and only maintained the operations of *Banco República*, which was later privatised.

*Banco Italo Venezolano*, *Banco Professional* and *Banco Principal* were the objects of a different strategy of intervention. Although they were nationalised on similar terms as previous banks, authorities decided they were not viable institutions and recommended their liquidation. Before completing the liquidation, authorities ordered the transfer of deposits from these three banks to other nationalised banks.[123]

In the case of *Banco Andino*, authorities nationalised it but transferred its administration to *Banco Industrial de Venezuela* (BIV), an institution completely owned by the government. BIV had earlier provided 'financial assistance' to *Banco Andino*. Later, the bank was merged with BIV. The last case of bank intervention was *Banco Empresarial*, which was initially intervened in and later liquidated.

### 8.6.5 Ownership of Agenda Venezuela

When the Venezuelan government announced Agenda Venezuela and the Stand-by Agreement with the IMF, Caldera's administration argued that they had negotiated a home-grown program, an opinion ratified by the IMF.[124] It was argued that the main feature of Agenda Venezuela was to promote economic recovery as an instrument to achieve social development.

Despite the fact that the government voiced its satisfaction with Agenda Venezuela, there were doubts about the real commitment of Caldera to fully implement Agenda Venezuela, especially because of his previous critical position against the IMF's policies. It seems that the argument about the social emphasis of the Agenda Venezuela and its unique nature was more a political explanation of why he decided to apply an orthodox program sponsored by the IMF. Months later this fact was confirmed when the government abandoned the program.

---

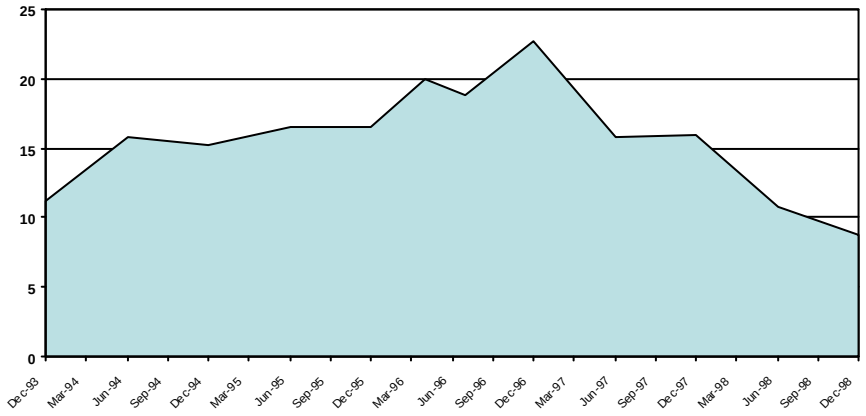
122 Ibid 325-329. Orlando Castro was the owner of both banks. He was convicted of bank fraud in New York where he and other relatives used other New York banks to defraud Venezuelan depositors for more than US$ 15 million. See John Sullivan, New York Jury Convicts Three Venezuelan Bankers of Defrauding Depositors. The New York Times 20/02/1997.

123 See section 8.5.4 (d).

124 See section 8.4.2.

In reality, Agenda Venezuela had the same objectives that were commonly incorporated in other IMF's programs. Hence, rather than having the firm intention to change the social situation in Venezuela with the Agenda, the government included some social issues in a neoliberal program as a way to diminish political opposition against the proposed reforms. The need of filling the huge fiscal deficit looked as a more likely explanation for Agenda Venezuela.

The lack of a strong government commitment to the program was revealed two months after the completion of the Agreement with the IMF when oil prices recovered (see Figure 8). After that, a debate occurred among government officials, opposition parties and experts about whether or not Agenda Venezuela's application should have continued.




Source: OPEC, Annual Statistical Bulletin, various issues.

**Figure 8: Spot Venezuela Reference Oil Basket ($/b), 1993-1998**

With the rise in oil prices, the government was less willing to take further political risks and weakened the impulse of the implementation of the program.[125] Ultimately, the government foresaw a better income from oil exports and suspended the application of Agenda Venezuela, demonstrating that they were not really committed to that program and any of its objectives, even the social goals that, months earlier, had been defended as capable of improving the wellbeing of the Venezuelan people. The revival in oil prices was short-lived and soon Caldera's administration was again facing similar economic problems due to the decline of income. Caldera finished his mandate in February 1999 and left the country still suffering a deep recession.

[125] Weyland, Kurt Gerhard, The Politics of Market Reform in Fragile Democracies: Argentina, Brazil, Peru, and Venezuela (2002).

Similar to the Great Turnaround, Agenda Venezuela was incomplete. In both cases, the lack of the country's ownership of the programs made them dependent on the oil prices, rather than on a real conviction about the positive benefits of their goals.

## 8.7 The Venezuelan Banking System after the Crisis

### 8.7.1 Unresolved Problems

After the first IMF disbursement in 1996, Venezuela did not require more resources from the Stand-By Agreement. A small improvement of the oil prices supported the departure from the international financial institution. By the end of 1997, the President of BCV declared that the crisis was over.[126]

He considered the banking system was better than three years before. Casas supported his opinion on the grounds that bank capitalisation was stronger than in the pre-crisis period. Likewise, banks had a very low rate of NPLs and bank profitability rose from 0.6% in 1996 to 4.5% at the end of 1997.[127] Other authors are not so optimistic and consider that the Venezuelan banking system is not as sound as the banking authorities claim.[128]

Although the worst part of the banking crisis had passed and banking indicators improved, there were several issues that were left unresolved and still affected the system. The most important issue was the lack of payment to 400,000 depositors for a total amount of 18.5 billion bolivars. It was only at the end of 2004, more than ten years later, when the FOGADE finally started to pay this debt. But it only repaid the debt in nominal amounts, without considering interest rate or inflation (the annual average inflation rate was 38.1% between 1994 and 2004). As a consequence, depositors, many of them common people, saw how their savings were diminished.

Another consequence of the crisis that required time to be fixed was the huge debt assumed by the FOGADE with the BCV due to the financial assistance. During 1994, the BCV lent 798 billion bolivars (equivalent to US$4.6 billion, 170 bolivars per

---

126 Casas, above n 69, 263.

127 Ibid 264

128 Rodolphe Blavy, 'Assessing Banking Sector Soundness in a Long-term Framework: The Case of Venezuela' (Working Paper WP/06/225 IMF, 2006); García-Herrero, above n 55.

US$1) to the FOGADE.[129] The FOGADE injected this amount to *Banco Latino* and the other eight banks intervened in during the first half of 1994. As the FOGADE did not repay on time this amount, its debt with the BCV increased by another 533 billion bolivars as a result of interest and overdue fees (US$3.1 billion).[130] It was not until 2004 that the government could pay back FOGADE's debt to the central bank, to the amount of 1,819,885 million bolivars.[131] In contrast to common people, FOGADE's payment to the BCV included interest.

Another issue that has required time to be corrected was the liquidation process of the intervened banks and hundreds of interrelated companies and the sales of many assets owned by the FOGADE as a consequence of the crisis. Reports about the state of this process are contradictory. To illustrate, in the 2005 Annual Report, the SUDEBAN included a broad declaration stating that the liquidation of banks affected by the 1990s crisis had been 95% completed.[132] Nonetheless, the FOGADE currently reflects in its public records that the institution is still working on the liquidation of fourteen of the eighteen banks in which it intervened.[133] Of the other four banks, three were re-privatised and one was merged with the BIV. Additionally, the Bank Superintendent recently declared that the SUDEBAN and the MoF were preparing to transfer the administration of the intervened companies and banks, as well as the acquired assets, to an asset management company, a declaration that is incomprehensible if 95% of the process has been finalised.[134]

### 8.7.2 Effects of Agenda Venezuela on Social Indicators

Some of the improvements experienced by the banking system were wiped out by the deterioration of the economic situation in 1998 (see Table 17). The real GDP growth performance shows an irregular path between the middle 1990s and the beginning of the new Millennium. Other indicators, like inflation, poverty and unemployment, had similar performances.

---

129 Luis Rivero, 'Interpretación Económica de los Auxilios Financieros' (2000) 4 *Cuadernos BCV, Serie Técnica*, 21.

130 Ibid.

131 Banco Central de Venezuela, Informe Analítico de los Estados Financieros Correspondientes al Primero, Segundo, Tercero y Cuarto Trimestre de 2004 (2004).

132 Superintendencia de Bancos y otras Instituciones Financieras, 'Informe Anual 2005' (SUDEBAN, 2005) 68.

133 Fondo de Garantías y Depósitos Bancarios, *Bancos en Liquidación* (2008) FOGADE <http://www.fogade.gov.ve/BancosLig/Bancos.htm> at 9 January 2008.

134 El Universal, 'Otro Ente manejará los Activos de FOGADE', El Universal (Caracas), 11 April 2007.

**Table 17: Venezuela Selected Indicator 1989-2001**

Please see print copy for Table 17

Source: BCV

Although Caldera's government promoted Agenda Venezuela as a social program, the deterioration of indicators such as poverty and unemployment seems to contradict that statement. Likewise, the devaluation of the Venezuelan currency and the still high inflation produced a 43.6% deterioration of the salary, worsening the situation of common workers. Furthermore, budget limitations imposed by the Fund had negative social impacts and, for instance, resources for education were reduced from 3.61% of the GDP to 2.6%.[135]

When Caldera completed his mandate, Venezuela continued to suffer from a delicate economic, social and political situation.

**Table 18: Venezuela, Social Indicators 1990-2002**

Please see print copy for Table 18

Source: ECLAC Social Panorama of Latin America, 2007

[135] Programa Venezolano de Educación-Acción en Derechos Humanos (PROVEA), 'Informe Anual 1995-1996' (PROVEA, 1996)

### 8.7.3 The Banking System and the Economy

The partial implementation of the IMF sponsored Agenda Venezuela was successful to increase foreign investment into the banking system, but it was not clear how such foreign participation could be translated in a better system for the development of the country. After the crisis and the partial implementation of the IMF sponsored program, bancarisation, understood as the actual penetration of banking services within a population, deteriorated. Thus, before the crisis, 60% of Venezuelans used banking services while this figure was reduced to 42.8% in April 1996.[136] Although this indicator improved after the implementation of the IMF program to 52.1% (December 1996) and achieved its highest peak of 62.2% in December 2001, the figure showed signs of deterioration in July 2006 (35.3%).[137] Limits on the use of banking services by Venezuelans are also reflected in the number of loan and deposit accounts of Venezuelans.[138]

In a similar way, when compared with other Latin American countries, the impact of banking credit on the economy has progressively deteriorated in Venezuela and accounts for a marginal 10% of the country's GDP (see Table 19). Instead of readdressing deposits to productive activities, banks prefer to invest in Venezuelan government financial instruments.[139] This situation reflects a serious problem of banking disintermediation.

**Table 19: Bank Credit/GDP Selected Latin American Countries (%)**

Please see print copy for Table 19

Source: Banco Central de Venezuela, 'Informe Económico 2006' (BCV, 2007), p197.

Another phenomenon that affects the banking system is that off-balance transactions are still popular and occupy an important part of the banking business.

136 Victor Salmerón, 'La Banca Baja a la Base de la Pirámide', El Universal (Caracas), 2 January 2007
137 Ibid.
138 See Section 6.8.2.
139 The Venezuelan government has recently designed hybrid financial instruments that combine Venezuelan government's bonds and securities issued by other South American governments (e.g. Argentina and Ecuador).

These instruments are larger than total deposits in the banking system.[140] The most representative off-balance operations are trusts and ceded investments, both of which are deeply involved with operations of the government.[141] The low levels of bancarisation and the small contribution of credit to the economy show that there are still structural weaknesses within the banking system in Venezuela and the banking sector is disconnected from the development process.

[140] Blavy, n 128, 9.

[141] Ibid. Ceded investments are financial instruments that are linked to another security, generally a government bond.

# CHAPTER 9

# CONCLUSIONS

## 9.1 Introduction

This thesis has discussed the problems posed by IMF conditionality as a tool to strengthen the rule of law and the way in which it forced governments to invoke exceptional powers. This final chapter will return to the original research questions and respond to them considering the experience of Malaysia and Venezuela. This section begins by summarising the two case studies and the method governments used to manage legally the problems in the banking sector. Second, it addresses the research questions formulated in Chapter 1. The thesis will conclude by describing how Latin American and Southeast Asian countries have tried to build barriers against future interventions of the IMF, and will briefly introduce the ways in which the subprime crisis that broke out in the US in 2007 could affect the role played by the IMF in developing countries.

## 9.2 Malaysia and Venezuela: Two crises, two stories

The cases of Malaysia and Venezuela tell us different stories about the rule of law, exceptional powers, the assistance provided by the IMF and development in the banking system. Both countries adopted a pseudo-democratic style of government that affected legal systems that did not completely rely on the principles contained in the concept of the rule of law.

The constitutions of both countries included the possibility to invoke states of emergency to address crises, including those of an economic nature. Those exceptional powers were used extensively by Malaysian and Venezuelan governments, frequently exceeding constitutional limits, to resolve economic, political and social problems. Conversely, legal banking frameworks that were in force when crises hit these countries had different settings in each nation but both reflected a certain degree of convergence toward international standards. In spite of these similarities, authorities of both nations responded differently to resolve the

issues associated with the financial crises in the banking sector that broke out in the 1990s.

In the case of Malaysia, after independence in the 1950s, the state worked to create a legal framework for the banking system that facilitated the control of banks by Malay capital and diminished foreign and Chinese-Malaysian investment, a key strategy to support its development policies, particularly the restructuring of society. The state succeeded in its goal and increased government and *Bumiputera*'s participation in banks, as well as implementing financing programs that benefited Malays.

By the second half of the 1990s, Malaysia had built a banking system that was considered sound and strong. It was governed by legislation that progressively adopted international prudential standards. Although the Bank Negara Malaysia (BNM) was not independent and was accused of the lenient treatment of state-owned banks, it was considered a competent supervisor. Its professionalism and technical capacity was considered above average in comparison to other banking regulators in Southeast Asia. Besides the strong banking supervisory and regulatory principles, the Malaysian economy enjoyed healthier economic indicators than other regional neighbours affected by the crash, including a relatively large international reserve position and a more manageable level of short-term debt.

The economic and banking strengths of Malaysia provided authorities with a strong basis to face the Asian financial crisis. Initially, authorities responded to the turmoil with an approach similar to the IMF's recipe applied in other countries affected by the crisis and later, the country moved to a more heterodox solution. In this second stage, authorities focused on four objectives to ameliorate the negative effects of the debacle in the banking sector: strengthening supervision and regulation of banks, removing NPLs from the system, recapitalisation of banks and restructuring of corporate debts.

In contrast to the approach adopted by other Asian countries affected by the crisis and assisted by the Fund, in Malaysia there was no immediate concern for strengthening the rule of law through extensive legal reforms or opening the system to foreign investment. The government was more interested in rehabilitating the

system and reviving credit levels available to the economy, using existing legal tools.

Later, when Malaysian banking authorities considered that the situation was controlled, they moved to specific legal reforms in order to improve areas such as corporate governance, the creation of a deposit insurance scheme and the removal of barriers to foreign investment. These reforms have followed a structured master plan designed by the BNM in 1999 and ratified by the Ninth Malaysia Plan 2006-2010. Without international pressure, Malaysia did not require the completion of prior actions, performance criteria or tough deadlines imposed by IFIs.

Malaysia employed a market approach to achieve various objectives. Further, the entities created to manage the banking problems (such as DANAHARTA, DANAMODAL and the Corporate Debts Restructuring Committee, CDRC) acted in a way that was inspired by market-oriented principles. However, the country was not forced to depart suddenly from its development model oriented towards favouring *Bumiputera* or to dismantle barriers to the entrance of foreign investment in the banking sector. Malaysia chose the pace and content of its own banking reform.

Venezuela was a completely different story. When the country agreed with the IMF to implement the Great Turnaround in 1989, the banking system was in a precarious situation. It was argued that a full legal reform was essential; otherwise, the sector could collapse undercapitalised, with a high rate of NPLs and a poor supervisory and regulatory framework. Legal reforms were designed to end the financial repression that affected Venezuelan banks and assisted the liberalisation of the sector. Likewise, the passing of a new legal framework would strengthen banking supervision. With the support of the IMF, changes were partially undertaken under the administration of Pérez. The 1992 BCV Act was passed in this period. Later, President Velásquez moved forward with the banking legal reform passing the 1993 Banking Act.

Although it had just entered into force, a revitalised legal framework was in place when the crisis broke out in January 1994. What the banking authorities needed was a transitional period to secure their structures and operations under the new laws. Authorities claimed that the new 1993 Banking Act was confusing and it complicated the management of the crisis. Therefore, the government preferred to

invoke exceptional powers to manage the debacle of the banking system. The state of financial emergency allowed the issuance of different emergency norms and the establishment of an *ad hoc* entity, the FEB, which would coordinate the different authorities involved with the regulation and supervision of banks. The IMF initially participated in the resolution of the banking crisis, providing technical assistance to the government on how to address the financial problems.

When the government of Venezuela moved to a financial assistance deal with the IMF in 1996 called Agenda Venezuela, the Fund argued that it was necessary to strengthen banking supervision and regulations; re-privatise nationalised banks and sell other seized banking assets; and strengthen the capital base of private banks. In spite of the fact that the IMF identified the need for a reformulation of the supervisory and regulatory framework, this institution did not demand the suppression of the *ad hoc* legal scheme created by the Venezuelan government to manage the crash, instead, the emergency frame served to expedite the adoption of various of the Fund's conditions. The ordinary legal framework that included the 1993 Banking Act drafted with the assistance of the IMF played a secondary role.

Global and local forces behind Malaysian and Venezuelan solutions pushed the countries in opposite directions. Global forces and the influence of the IMF characterised the initial efforts of Malaysian authorities in order to cope with the consequences of the Asian crisis, resulting in measures that attended to the orthodoxy of the Fund. In a second stage, local forces and Mahathir's nationalism prevailed and helped to design a heterodox approach. The shift contributed to the keeping of economic and social policies that focused *on Bumiputera* and protected local corporations during and after the Asian crisis while leaving the political arrangements almost unaltered.

In contrast, the strong criticism of IMF-sponsored programs contributed to the 1993 election of Caldera who in order to reward his electoral supporters, built an economic recovery package far from IMF neoliberalism. However, Caldera could not sustain his domestic-built program and surrendered to global forces accepting the implementation of the neoliberal-oriented Agenda Venezuela. The change from a social approach to neoliberalism produced more popular repudiation against the Fund's policies and facilitated the victory of Hugo Chávez in December 1998.

## 9.3 IMF Conditionality and the Rule of Law in Developing Countries: Answering the research questions

### 9.3.1 The Meaning of the Rule of Law

The first research question focused on the meaning of the rule of law in a developing country context. Chapter 2 reviewed how IFIs placed great hope in the notion of the rule of law in order to contribute to the development process in the 1990s. It was claimed that the rule of law was one of the pillars to achieve economic growth and eradicate poverty. The Fund advocated a formal approach oriented to creating legal systems supportive of good governance and the rule of law that included sound institutions and an adequate regulatory climate conducive to efficient private sector activities.

In contrast to the formal approach assumed by the Fund, this thesis proposed to follow a model that combines formal and substantive attributes of the rule of law. As a consequence, besides the generality, publicity and consistent application of law; and the demand for an independent judiciary, this thesis advocates for a concept of the rule of law that attends to the current demands of people in developing countries for a more effective participation in the building of the principles inherent in this notion. This participation includes opportunities to discuss new laws and regulations as well as chances to scrutinise actions performed by public authorities.

Furthermore, considering the current promotion of a comprehensive framework for development of which the rule of law is another component, this thesis argues in favour of creating real connections between development and the rule of law. That is, the rule of law should not be considered as an isolated goal but as an objective linked to a more holistic development ideal that helps to improve standards of living for people.

Relating the above formal and substantive components to the banking sector, this thesis explained that formal attributes, such as clarity, equality and stability of law, consistent enforcement and an independent banking supervisor were instrumental to achieving a sound banking system. Likewise, this thesis argued that a legal framework that guarantees a democratic dimension (for example, accountability of banking authorities and participation of people in the drafting of banking laws and

regulations) would contribute with the formal principles of the rule of law to maintain a sound banking system.

Finally, the notion of the rule of law in the banking arena needs to be connected to the development model. The promotion of the notion is not only important to support economic growth but also to achieve better standards of living for people, providing opportunities for participation in productive activities that could reduce poverty and economic and social exclusion.

### 9.3.2 IMF Conditionality and its Effects on the Legal Management of Crises: the ordinary legal framework versus exceptional powers

Trying to scrutinise how IMF conditionality affected the legal approach of a government to deal with a crisis, this study formulated three research questions that were related and thus will be answered together in this section. These questions were: how has IMF conditionality affected the legal methods chosen by governments to meet the financial institutions' requirements? Has the IMF, looking for macroeconomic results, encouraged governments to use legal approaches that do not completely comply with the rule of law? How do legal approaches used by countries submitting to IMF conditionality differ from those that are not when they face a financial crisis?

In the first pages of this dissertation, it was mentioned that the Fund often argued that the institution could not be blamed for the illness of its patients (state members affected by crises). However, did not the IMF contribute to the institutional problems faced by the developing nations that it helped? Perhaps the Fund did not have anything to do with the problems that originally caused the financial crises in the 1990s, but after it was called to assist desperate developing nations, the Fund assumed a broad approach that covered many areas, including social, political and economic matters that were translated into conditions and incorporated into its arrangements.

It was difficult for developing nations to comply with all these IMF conditions in a short period of time without subverting ordinary political and legal arrangements, an aim that was totally the opposite to what was officially intended by the IMF. South American Presidents chose to invoke states of emergency and implemented changes through executive decrees. In spite of initial positive results, soon the IMF

programs turned to chaos, including social unrest and coups in countries such as Peru, Argentina and Venezuela.

Connections between IMF conditionality and the legal method chosen by a government to manage a crisis could be better appreciated if conditionality is analysed from a legal perspective and the case studies of Malaysia and Venezuela are compared.

Chapter 3 explained how conditionality was originally used as an emergency tool to produce macroeconomic changes and achieve certain economic goals. Later, conditionality was extended to structural reforms that were more complex and put at risk the emergency nature of IMF arrangements because, for instance, conditions associated with the rule of law that demanded the enactment of a new legislation could be time consuming and involve more actors than the resolution of an economic issue that could be exclusively decided by the executive. However, the IMF argued that conditions associated with governance not only helped to create a positive climate for investment but also served as a mechanism to safeguard its resources.

South American governments resolved the dilemma of complying with IMF conditionality and having access to funds using exceptional powers, sometimes within the limits of constitutions and in other cases exceeding those limits, subverting the principles contained in the concept of the rule of law and creating a tension between conditionality and this notion.

Indeed, IMF conditionality contributed to the climate of urgency experienced by countries that were suffering serious economic collapses because, in addition to dealing with the immediate financial issues derived from financial turmoil, these nations simultaneously had to negotiate with the Fund complex agreements that involved not only economic issues but also political, social and legal ones. The longer negotiations lasted, the more problems a country had to face without financial assistance.

The IMF developed a system to fast track negotiations and helped nations to avoid legislative bodies, and then; the institution declared that its arrangements were non-legal contracts. However, as stated above, the IMF put on the negotiating table a

broad variety of issues that exceeded economic and financial matters and involved real legal commitments that should have been decided not only by the executive but also by legislative bodies.

To illustrate, when President Pérez decided to agree to the Great Turnaround, which implied the transition from an overprotected to a completely liberalised economy, he agreed with the IMF without initiating any major discussions outside of the selected circle of ministers who negotiated with the IMF. Thus, he took full advantage of the suspension of economic rights that was in force at that time. In the case of Agenda Venezuela, it took longer to achieve a deal with the Fund. There was more extensive debate about whether to sign a letter of intent, although this was limited to the terms already discussed between the Fund and the executive. Ultimately, the decision to go ahead with the stand-by arrangement exclusively depended on Caldera's administration and was not expressly approved by the Congress as the Venezuelan Constitution mandated.

The exclusion of legislative representatives from IMF negotiations did not preclude the adoption of obligations to legal reforms within tough adopt deadlines, which, in some cases, produced protests from the Congress. The obligation of the Venezuelan government to reform the Tax Code under Agenda Venezuela is illustrative of the pressure imposed by Fund's arrangements on legislative bodies. At the beginning, the Congress refused and even forced the suspension of meetings that would lead to the finalisation of the stand-by agreement with the Fund in March 1996. Later, the legislative body was compelled to approve the tax reform in the terms negotiated between the Fund and the government (for example, increasing the VAT from 12.5% to 16.5%). The government claimed that if not approved, it would not be possible to reach an agreement with the Fund with serious consequences for the country.

Another element associated with the Fund that contributes to creating a climate of urgency and forces government to use exceptional powers is Prior Actions (PAs). As explained in Chapter 3, the IMF often requests a country to comply with a group of PAs before it finalises an arrangement. PAs act as a trigger that may improve or worsen a country's situation. If a state complies with the PAs requested by the Fund quickly, it would receive the financial assistance that generally has a positive effect on the international perception and the financial position of a country. Nonetheless,

if PAs are assumed by the government without legislative approval or public consultation and they involve structural reforms, the executive is subverting the rule of law and it could lead to political and social instability. In contrast, if a country delays the adoption of the prior PAs and takes the legal steps to achieve their approval it is possible that tensions increase in the domestic scenario due to the lack of resources to address the crisis and the expectations of a potential arrangement with the Fund.

The case of Venezuela is illustrative of tensions caused by PAs. Among the actions adopted by Pérez under the Great Turnaround was the increase of petrol prices. While the measures had positive financial and international effects, they produced political instability that led to deadly riots. In the case of Agenda Venezuela, Caldera resisted the request of the IMF to increase petrol prices, the main cause of the riots in 1989. Instead, Caldera waited for a miracle or more frankly the recovery of the oil international markets to dump the Fund's financial aid. In the end, the President did not have a choice but to comply with the IMF's PAs and increase petrol prices.

Tensions created by the intervention of the IMF in Venezuela can be better assessed if the legal style of management of a financial crisis adopted by Venezuela is compared with the mechanisms applied by Malaysia, a country that did not experience pressure from the Fund. Considering the history of exceptional powers in both countries and taking into account the intervention of the IMF in the South American nation, it would be expected that governments reacted in a different way.

Malaysia has a long and extensive tradition in the use of exceptional powers to resolve all types of conflicts. Proclamations of emergency and the subsequent maintenance of such proclamations through time have permitted the use of special norms to resolve military, political, social and economic situations. The management of a dual legal system in which ordinary norms coexist alongside exceptional powers that have been invoked but not revoked, permits the Malaysian state to alternate between both kinds of norms and select the most suitable option according to its needs.

The management of financial crises was not different and the Malaysian state used exceptional powers granted by the Constitution to address economic issues in the

aftermath of the 1969 ethnic riots and during the deposit-taking cooperative crisis in the 1980s. However, when the Asian crisis broke out, authorities did not resort to a new or an existing proclamation of emergency or special ordinances to tackle problems in the banking sector. In fact, the major legal change was the passing by the Parliament of the Danaharta Act that granted extraordinary powers to this Corporation in order to purchase, sell and administer NPLs.

The most controversial aspect of DANAHARTA was the restriction of judicial review, a feature similar to the emergency scheme established in the Malaysian Constitution that limits the judicial review of proclamation of emergency. This provision was justified in the name of overcoming the crisis and avoiding acts that could obstruct the efforts articulated by the government. The Federal Court upheld the constitutionality of the Danaharta Act and the corporation was able to comply with its objectives and wound up operations in December 2005. The isolation of DANAHARTA's decisions from judicial review was one of the strongest signals that showed that the Malaysian government would not cease its previous role as a main planner of the economy and intervene when it considered it was necessary.

Venezuela also has a long history of exceptional powers, especially to deal with economic and financial matters. The 1961 Constitution, as in the case of Malaysia, granted exceptional powers to address economic situations. For three decades (1961-1991), the right of economic freedom was suspended. Additionally, Presidents were granted enabling laws to legislate on economic and financial matters on eight occasions between 1959 and 2007. These two types of emergency instruments were invoked on the grounds that the ordinary legislation did not provide the necessary tools to manage economic issues. Although the involvement of the IMF would suggest another course of action, the 1990s banking crisis was no different and it was another opportunity for the invocation of exceptional powers.

As in the case of other Venezuelan governments, Caldera's administration went beyond the constitutional limits that were intended to avoid such authoritarianism. Although a disagreement occurred between the executive and the Congress about the real existence of an emergency in 1994, the President's opinion prevailed and the long period between 1994 and 2001 saw how *ad hoc* norms superseded the ordinary legislation. The 1993 Banking Act and the banking system was regulated and supervised by the FEB, which was granted unlimited powers to resolve the

financial collapse. This long life span and the extraordinary powers of the FEB were insufficient to resolve key issues derived from the crisis such as the repayment of secured deposits, liquidation of banks and sale of banking assets. Several of these problems were resolved after the financial emergency was overcome. It demonstrated that the use of extraordinary powers was not effective in resolving problems derived from the crisis and by contrast, it granted banking authorities excessive discretion, making them unaccountable for mistakes incurred to resolve the turmoil.

The 1961 Venezuelan Constitution included some of the aspects that were discussed in Chapter 4, which could contribute to a sound use of exceptional powers such as various check and balance devices in the hands of the Congress and an explicit declaration of the temporality of the emergency tools. These limitations proved to be insufficient to control the executive branch and Caldera, for instance, ignored the congressional revocation of his decree of suspension of rights in 1994. He issued a new emergency decree suspending the rights restated by the Congress and ratifying all previous acts dictated or executed under the revoked emergency decree.

Similarly, the state never fully enforced the 1993 Banking Act that seemed to have the main tools to face the crisis, creating serious doubts about whether it was actually necessary to resort to an emergency approach. Questions such as whether the alleged lack of coordination among the BCV, the SUDEBAN and the FOGADE at the beginning of the crisis was due to shortcomings of the new legislation or other factors were never asked. It was simply assumed that a crisis existed and an *ad hoc* scheme was required. Consequently, one of the conditions for the invocation of an emergency (reviewed in Chapter 4) was not fulfilled, namely the incapacity of the ordinary legal framework to address the crisis.

Finally, the emergency legal system was enforced for a period that lasted almost eight years between March 1994 and November 2001, making the exception the rule. The long existence of the FEA did not help to strengthen the rule of law and caused more uncertainty among the different banking actors.

In contrast to cases such as Argentina and Peru, where exceptional powers were invoked during the negotiations with the IMF in order to comply with many of the

prior actions and performance criteria required by the Fund, in Venezuela exceptional measures were assumed before Caldera's administration started formal negotiations with the IMF for the subscription of a stand-by arrangement. However, it must be pointed out that from May 1994 the Fund provided technical assistance to Caldera's administration on how to address the banking crash (see Table 20).

**Table 20: Banking Emergency Instruments and IMF Intervention in Venezuela**

| Instrument | Issuing Authority | Date | IMF[1] |
|---|---|---|---|
| Special Law to Protect Depositors and Regulate the Emergency in Financial Institutions | Congress | March 1994 | |
| | | May 1994 | Technical assistance mission for preliminary assessment of the banking crisis |
| Norms to Guarantee the Stability of the Financial System and to Protect Depositors | President | June/July 1994 | Technical assistance mission to advise on a strategy to address the banking crisis |
| | | November 1994 | Technical mission to follow-up on the implementation of the strategy to address the banking crisis |
| | | February 1995 | Technical mission to follow-up on the implementation of the strategy to address the banking crisis and discuss technical assistance needed |
| Norms to Regulate the Financial Emergency and the Reorganization of the Financial System | President | March 1995 | |
| Regulation of the Financial Emergency Act | Congress | July 1995 | |
| | | August 1995 | Negotiation of a Shadow program between IMF and Venezuela |
| | | September 1995 | Negotiation of a Stan-by Agreement between Venezuela and IMF |
| | | July 1996 | Stand-by Agreement |

While it could be assumed that the involvement of the Fund in the management of the Venezuela crisis would lead to an approach that would prefer the 1993 Banking Act to any type of emergency legal scheme, the government and the Congress responded in the opposite way by enacting emergency norms. There is no evidence that suggests that the Fund did not agree with the emergency scheme implemented by the Venezuelan government to face the banking crisis and in contrast the

[1] IMF, 'Venezuela-Staff Report for the 1996 Article IV Consultation and Request for Stand-By Arrangement' (ERS/96/108, IMF, 1996).

emergency arrangement served to comply with IMF conditions. Neither technical assistance nor the stand-by arrangement offers a rejection by the Fund of the *ad hoc* approach assumed by the Venezuelan government.

It could be argued that the Fund did not have enough influence during the first phase of its intervention in Venezuela. It only provided technical assistance to force the government to suppress the emergency approach. However, the silence from the Fund did not change when the stand-by arrangement started to be negotiated during while the IMF was in a very strong position to force a change in approach. During those negotiations, for example, the Fund compelled Caldera's administration to comply with prior actions that were politically unpopular (for example, increasing of petrol prices) but there was no condition that required the suppression of the financial emergency. On the contrary, in the documents associated with the stand-by arrangement, the Venezuelan government mentioned the *ad hoc* banking scheme as one of the aspects which supported the success of the crisis management. It confirmed that the FEB, as it was redefined in 1995, with broader powers and excluding the SUDEBAN and the FOGADE, would be a key feature for the successful resolution of the banking crisis.

The acceptance by the IMF of the management of the crisis through an *ad hoc* scheme contrasts with what was discussed in Chapter 2 in regards to the Fund's promotion of the rule of law, which included limiting the scope of *ad hoc* decision making schemes that could offer opportunities for corruption and rent seeking. The fears of corruption were particularly high in the Venezuelan case in which the government was pushed by the IMF to privatise and sell other banking assets rapidly. It was only in 1998 and after Venezuela had abandoned the implementation of Agenda Venezuela that the IMF recommended the revocation of the financial emergency legislation and more efforts oriented to strengthen the legal banking framework.

The emergency norms and the concentration of powers in the FEB helped the government to comply faster with the Fund's conditions associated with the privatisation of banks and sale of assets. Nonetheless, the *ad hoc* scheme caused uncertainty and weakened the rule of law. As explained in Chapter 8, Minister Matos described the ordinary legal framework as one of the chief obstacles to resolve the financial crisis through the sale of nationalised banks. However, the *ad*

*hoc* scheme allowed the rapid achievement of that objective and compliance with IMF conditionality, bypassing ordinary legal arrangements.

The rapid privatisation of banks would contribute to improving the system and, at the same time, it would help to reduce the financial losses of the government due to the crisis, improving its financial situation. Therefore, the IMF accepted that the Venezuelan government used emergency regulations that did not comply with Venezuelan constitutional limits in order to achieve faster Structural Benchmarks associated with the privatisation of banks, causing the weakness of the rule of law.

To sum up, Malaysia designed its legal response mainly using the ordinary banking legislation in force. In contrast, Venezuelan authorities (assisted by the IMF) opted for an *ad hoc* approach that included a provisional banking authority and emergency norms, which provided the government with more flexibility and less accountability to manage the crisis and comply with IMF conditions associated with the privatisation of banks.

### 9.3.3 IMF Conditionality and the Strengthening of the Rule of Law

The IMF invoked conditionality as a mechanism to strengthen governance and the rule of law; but has conditionality contributed to build reliable legal institutions and strengthening the rule of law? During the discussion in Chapter 3, concerns were expressed about the suitability of conditionality to achieve this goal. These doubts commenced with the instruments employed by the Fund to establish its conditions that are called 'arrangements'. According to the IMF, these instruments are not legal contracts, a solution that could be convenient to avoid parliamentarian approvals. Nonetheless, this thesis has rejected this classification and, in contrast, argued that IMF arrangements were real legal international contracts that contained legal commitments and could be enforced in international forums. Indeed, the Fund has built an enforcement system that allows the institution to implement legal actions and remedies to recover its money. Whereas the Guidelines on Conditionality affirm that IMF arrangements are not legal contracts, the IMF policies enacted to deal with breaches of financial obligations contained in Fund arrangements are drafted in legal terms (for example, the Fund's Strategy's on Overdue Financial Obligations).

This unclear nature of arrangement and conditionality initially enables the executive to bypass legislative bodies and, although IMF agreements frequently incorporate commitments to enact or amend laws, legislators do not participate in the negotiations of those facilities. Hence, conditionality begins its work with a handicap that makes its task to strengthen governance and the rule of law more difficult.

IMF conditionality is not only theoretically weak to promote the rule of law but it is also ineffective in practice. The cases of Malaysia and Venezuela allow a review of 'the contribution' of IMF conditionality to improve the legal banking system in the South American nation in comparison with Malaysia, which preferred to design and apply its own approach. This analysis follows the notion of the rule of law, as discussed in Chapter 2 and summarised in subsection 9.3.1 of this chapter.

It is important to keep in mind the context in which IMF assistance was provided to Venezuela. As has been discussed elsewhere in this dissertation, IFIs focused their attention on the notion of the rule of law in the 1990s in order to contribute to the development process. It was claimed that the rule of law was one of the pillars to achieve economic growth and eradicate poverty. Although the Fund did not finance specific projects, the institution included numerous conditions into its arrangements oriented to address issues associated with governance and the rule of law that were perceived as essential to ensure the success of its programs. Due to this global pro-rule of law climate, it was expected that programs designed with the support of the Fund to help resolve financial crises would be inspired by this notion and would comply with its principles during the subsequent implementation phases.

In spite of the technical and financial support of the IMF, Venezuela seems to be more distant from an ideal the rule of law in the banking system than Malaysia. To support this contention, this section will analyse the rule of law's components in the following paragraphs.

***a) Formal Attributes of* the Rule of Law**

***The Banking Legislation:*** The first element that helps us to assess how the rule of law was affected during the crisis in Malaysia and Venezuela is examining how authorities used law to achieve their goals and implement their strategies to address the crisis. It will be considered whether the state structured its rescue program relying on existing or new legislation and, in the latter case, whether new laws

assumed an emergency approach and whether or not they were enacted by the executive. The enactments or amendments of laws, issuance of executive decrees and the coexistence of ordinary and emergency norms are all factors that negatively affect the clarity, stability, consistency of enforcement and separation of powers, consequently debilitating the rule of law.

When the crisis broke out in Malaysia, the major pieces of legislation that governed banking operations were the Central Bank of Malaysia Act 1958, BAFIA and IBA. During the crisis, they were not significantly amended. This legal platform served to address the crisis. Initial steps assumed by authorities to strengthen banking supervision and regulations were adopted using this existing legal framework. The only relevant legal addition was the Danaharta Act 1998 that was enacted by the Parliament soon after the government launched its heterodox package in 1998.

The stability of the banking legal framework facilitated the application of norms to strengthen the supervisory and regulatory faculties of the BNM and the uniform enforcement of legislation. After the launching of the NERP, goals set to resolve the consequences of the crisis in the banking system remained unchangeable until completed, mainly using the three *ad hoc* entities approach (DANAHARTA-DANAMODAL and CDRC). These vehicles were created with clear goals and from the beginning these agencies designed their strategies and plans in order to achieve those objectives. To illustrate, DANAHARTA was empowered with special faculties through the issuance of an Act that was articulated with the objectives assigned to this Corporation. DANAHARTA established the criteria for the purchase of NPLs, the method to price the loans and a timetable to execute its tasks. The Danaharta Act was amended in 2000 in order to strengthen its powers and to speed up its implementation of existing tasks. This reform did not affect DANAHARTA's main goals which remained the same during the crisis, that is, the extraction of NPLs from the banking system and the maximisation of recovery.

The Venezuelan approach was not as clear as the case of Malaysia. By January 1994 when the crisis broke out, the 1993 Banking Act had entered into force. This Act had been drafted following the advice of the Fund as a part of the Great Turnaround program, and included adequate financial safety nets described as an

essential method to face a banking crisis, namely a legal framework for liquidity support, deposit insurance scheme and crisis management tools.[2]

In spite of the above apparent legal advantage, Venezuelan authorities decided not to completely rely on the 1993 Banking Act and instead opted for a dual legal framework approach that mixed the ordinary legal norms with emergency norms. First, the ordinary legal arrangements that included the 1992 BCV Act and the 1993 Banking Act remained partially in force. Second, on four occasions within a period of sixteen months, authorities replaced the emergency instrument that would serve as a major piece of banking legislation to resolve the crisis (see Table 20). Two were emergency acts passed by the Congress and the other two emergency decrees issued by the President.

In the case of Malaysia, the Parliament passed a special act to grant specific powers to an *ad hoc* agency, but BAFIA continued governing the whole system. In contrast, in the case of Venezuela, authorities sought to replace the 1993 Banking Act, the key legislation that regulated the entire sector, with vague and ill-drafted norms that granted limitless powers to the FEB to address the banking collapse. Article 3 of the 1995 Norms is a clear example of the excessive powers granted to the FEB. It states, 'the financial emergency board shall have the broadest faculties to solve the financial emergency'. Consequently, between 1994 and 2001, the banking sector was governed by a hybrid legal system that heavily depended on the FEB.

The plethora of laws and emergency decrees created more difficulties for consistent enforcement. It caused the Venezuelan authorities to use up to five different strategies to deal with distressed banks. There was not a single criterion to decide, for example, whether or not a bank should have been intervened in, closed or provided with financial assistance. A similar disorder surrounded the payments of deposit insurance with some cases in which depositors received up to Bs. 4 million and in others were paid an amount up to Bs. 10 million.

Confusion also affected decisions associated with the capitalisation of banks in which authorities did not state clear criteria for banks to be forced to agree to a special capitalisation plan and which measures would be taken in case of non-compliance with the terms of such programs. This situation contrasted with the

[2] See section 2.7.3

strategy put in place by DANAMODAL in Malaysia where a limit of 9% of adequacy capital ratio was set as a benchmark and all banks below that mark required immediate recapitalisation. Also DANAMODAL forced banks to search for private sources of financing and any financial assistance provided by this agency was subjected to strict conditions incorporated in a formal agreement.

***Banking Supervisors**:* Another formal aspect of the rule of law that helps in assessing how the notion was affected by the management of the crisis is studying the role played by banking supervisors. In the case of Malaysia, BNM maintained its role as chief supervisor and regulator of the banking system. As a main banking authority, BNM coordinated the whole rescue package deployed to address the effects of the Asian crisis in the sector. In spite of the creation of three *ad hoc* entities such as DANAHARTA, DANAMODAL and CDRC, BNM was kept as a rector of the entire system. To facilitate the coordination of BNM with the *ad hoc* vehicles, the Malaysian central bank designated representatives to the boards of DANAHARTA and DANAMODAL as well as the Steering Committee of CDRC, contributing to a coherent implementation of the measures adopted to keep the banking system sound. BNM was also represented on the NEAC, the entity that designed the economic program and oversaw its implementation.

Despite BNM not being officially independent from the government, it had enough flexibility to implement the rescue plan and to coordinate operations of the three temporary entities. One of the few situations that clouded BNM's performance was the resignation of its governor in August 1998. The exit of the governor was associated with his disagreement with capital and exchange controls introduced by the government.

In Venezuela, the strategy adopted by the government was different. The 1993 Banking Act established limits among tasks that should be undertaken by the three entities vested with banking supervisory and regulatory responsibilities (the BCV, the SUDEBAN and the FOGADE). The Act also included provisions that sought to grant independence to the SUDEBAN and the FOGADE. However, legal provisions were not enough to maintain the clear limits of each institution and the formal independence of supervisors. The executive decided to displace the SUDEBAN from its supervisory and regulatory duties that were transferred to the FEB, using the SUDEBAN as an auxiliary agency. The FOGADE was also forced to depend on

the FEB to exercise its duties. The FEB was an entity more dependent on the executive and it was not made accountable to the Congress. Due to this re-accommodation of the supervisory and regulatory system, all powers but those of the central bank were concentrated in the FEB.

The government's decisions to rely on an *ad hoc* approach were later backed up by the Congress, an action that was difficult to understand since the FEB was managed by officials exclusively appointed by the President.[3] In contrast, the SUDEBAN and the FOGADE's highest officials were designated with the approval of the Senate and both institutions were subjected to the oversight of the Congress.

Furthermore, it was true that coordination of authorities involved with the banking supervision and regulation was essential to address the collapse, but it was incomprehensible why neither the Congress nor the executive relied on the already created SUDEBAN Superior Council. This Council was governed by the 1993 Banking Act. According to this Act, the SUDEBAN Superior Council had powers to decide issues associated with intervention and liquidation of financial institutions as well as powers to order emergency financial assistance for banks with liquidity problems.[4] Likewise, the Council grouped all authorities involved with the supervision of banks, namely, the Minister of Finance, BCV President, FOGADE President and the banking superintendent who was a member but without the right to vote on proposals.

Malaysia foresaw a crisis management structure that kept its main banking supervisor and regulator and opted for the creation of three *ad hoc* operative entities coordinated and supervised by BNM. In contrast, Venezuelan authorities preferred to retain the ordinary agencies SUDEBAN and FOGADE, diminishing their roles and creating an emergency Board to coordinate, oversee and execute the actions required to rehabilitate the banking system.

### *b) Democracy, Development and* the Rule of Law *in the Resolution of the Banking Crises*

Clearly, the Malaysian and Venezuelan governments had dissimilar approaches, which affected the formal attributes of the rule of law. Further, authorities of both nations had opposite perspectives about which principles should guide their actions,

[3] BCV President was the only member of FEB whose appointment was approved by the Senate.
[4] See section 8.2.2

the degree of accountability used to establish their goals and strategies and how far to broaden the base of interest groups involved in the resolution of the crises.

In Malaysia, when the NEAC proposed the NERP, one of the objectives anticipated was to regain market confidence. To achieve this target in the banking sector it was essential to establish clear objectives that would guide the government's rescue actions. Clear guidelines were also necessary to minimise risks of using public funds to rescue unviable banks and corporations.

To achieve the goal of maintaining the stability of the banking system, the government tried to strengthen the supervision of banks; tighten of prudential regulations; reduce and manage the NPLs; recapitalise the system; and create a forum to negotiate debt restructuring of corporations. The first two strategies were basically undertaken through the issuance of regulations, exercising powers already granted by the ordinary legislation.

The other three strategies involved the creation of DANAHARTA, DANAMODAL and CDRC. These entities acted according to market-oriented principles. To design their guidelines and action plans the *ad hoc* vehicles hired national and international well-known firms. The emergency entities also publicly disclosed information about regulations, guidelines, procedures and results of their activities. Additionally, the three *ad hoc* vehicle websites disclosed information about regulatory changes and performance.

From the beginning of the Venezuelan banking crisis, the government did not have the capacity to design a clear plan to tackle financial problems. None of the different programs implemented had clarity in their goals or strategies. This myopia meant, for instance, that when *Banco Latino* was intervened and closed, the government did not have a clear picture of how to address the crash. Consequently, authorities took a long time to decide the next step. This inaction produced instability in the whole banking system. In a similar way, the lack of clear objectives allowed authorities to provide financial assistance to insolvent banks during the first months of the crisis, money that was later lost with great fiscal consequences for the state. Nobody was held accountable for this mismanagement of public money.

Likewise, the lack of a clear official rescue plan made it difficult to assess results achieved against the original goals. Until December 2007, there was no official report, publicly available, issued by the BCV, the SUDEBAN or the FOGADE that outlined the total amount spent in the crisis, the amount recovered, the status of the liquidation process of fourteen of the eighteen closed banks or which tasks were still pending to finalise affairs.[5] The lack of transparency and accountability of Venezuelan banking authorities did not change with the intervention of the IMF. Although some goals were established in Agenda Venezuela, a few of these objectives were seriously undertaken (for example, re-privatisation of banks) while others were pursued with less urgency (for example, strengthening of the legal framework).

Another aspect associated with the rule of law that deserves a mention in this section is the public participation in the process of design and implementation of measures to address the banking problems. When the Malaysian government decided to depart from an orthodox plan to resolve the crisis, it organised the NEAC, which put together people not only from the federal and state governments, but also from other sectors such as industry, trade unions, academia and professional associations. In a similar fashion, DANAHARTA, DANAMODAL and CDRC involved representatives beyond the government sphere such as the private sector, and international and national advisors.

By contrast, the Venezuelan government granted the power of decision making, as well as the discussion and issuance of norms, to the FEB whose members were appointed by the executive and which was not accountable to the Congress. Bodies that were incorporated in the 1993 Banking Act were marginalised, such as the BCV Consultative Council, the SUDEBAN Council or the FOGADE's General Assembly, which had a broader representation and included different sectors of Venezuelan economy and society.

A final aspect of the analysis of the substantive notion associated with the rule of law is the way in which the solutions implemented by the governments of Malaysia and Venezuela were related to their national development models. With the implementation of the NERP, Malaysian authorities ratified the market orientation of

[5] The other four closed banks, three were privatised under the first phase of Agenda Venezuela and one merged with the government-owned *Banco Industrial de Venezuela*.

the rescue plan but they did not renounce the social-economic arrangements that were in place before the onset of the crisis, and particularly those associated with the restructuring of society that favoured *Bumiputera*. Likewise, limitations on the entry of foreign institutions to the Malaysian banking system remained in force. The Ninth Malaysia Plan that coincides with Phases II and III of the Financial System Master Plan seeks a gradual liberalisation of the banking system, including the possibility of introducing foreign competition sometime before the end of 2010.[6] These two facts show that important aspects of the pre-crisis development model were kept alive.

There has been criticism of affirmative action programs that favour *Bumiputera*, which has sparked debate around whether those policies should remain in force, regardless of their detrimental effects on other disadvantaged groups. One may question the Malaysian government's decision to keep them, but it was understandable that the government avoided making a decision about the continuity of these programs. The experience of Venezuela shows that the IMF would not promote a more democratic debate about this type of issue and in the end, it would push for the suppression of social policies in favour of fiscal considerations without studying other options for Malays or the extension of these benefits to other ethnic groups.

In contrast, Venezuela experienced a rollercoaster ride in the development realm. After decades of protectionism and import-substitution policies, the Great Turnaround sponsored by the IMF in 1989 looked for the 'modernisation' of the economy, suddenly opening the country to foreign investment and trade. Efforts to implant a neoliberal model included reforms of various areas of law to adapt the framework to the new reality. Actions were concentrated in business law. However, the model was not fully functioning when Caldera assumed the Presidency. He suspended the neoliberal model, reversed some of the previous legal reforms and began to implement what he called a social approach.

The deep consequences of the banking crisis and its mismanagement by Caldera's administration did not allow the government to continue with the implementation of his social program. In contrast, the government accepted the application of Agenda

[6] Economic Planning Unit, Malaysia Prime Minister Department, *Ninth Malaysia Plan 2006-2010* (2006) 182. The current financial crisis that broke out in the United States may affect the willingness of the government of opening its banking sector to foreign competition. See subsection 9.4.

Venezuela, another neoliberal package, which included more privatisation, an increase in taxes and the adaptation of law to a more favourable climate for foreign investors. Nonetheless, the turn to neoliberalism did not last long and, when the following increase of oil prices materialised, the government suspended Agenda Venezuela and once again turned its back on neoliberalism.

The lack of a clear model of development impacted the banking system. After the partial implementation of Agenda Venezuela, foreign financial institutions obtained a 47% share of the banking market but the reform was not articulated to a comprehensive development plan. Consequently, the change did not have beneficial effects in terms, for instance, of better access for people to banking services or increasing of participation of bank lending into real sectors of the economy.


**Figure 9: Rule of Law Indicator, Malaysia and Venezuela** [7]

In the end, while the Malaysian banking legal system emerged stronger from the Asian crisis, implementing a master plan to gradually prepare the system for a future liberalisation, the Venezuelan banking sector remained weak. Additionally, legal

[7] Regarding the limitations of this type of study, see footnote 88 on chapter 2.

weaknesses remained in Venezuela, leaving loopholes for risky operations by banks. The perception of a stronger legal banking framework in the case of Malaysia and a weaker one in Venezuela coincides with a report published by the World Bank (see figure 9). The report describes in broad terms the strengths and weaknesses of legal system around the world. The rule of law indicator shows similar trends in each country to those observed in the banking sector discussed in this thesis.

When the Fund exited Venezuela, instead of leaving a strengthened supervisory and regulatory framework supportive of the rule of law, the institution left behind a weaker banking sector with a dual legal framework and an *ad hoc* supervisor. In contrast, Malaysia, which rejected the IMF assistance, emerged from its financial crisis with a stronger banking sector and a legal framework that has been progressively reformed to meet international standards. The positive results of the Malaysian legal management of the crisis are limited to the banking system and cannot be translated to other areas such as human rights in which the government has favoured a more restricted approach that clearly differs from the concept of the rule of law discussed in this dissertation.[8]

### 9.3.4 IMF Conditionality and Ownership of Programs

The review of Malaysia and Venezuela suggests that the former maintained the implementation of its home-grown program until the country overcome its crisis, in contrast to Venezuela whose government interrupted the application of the package negotiated with the IMF. This fact relates to the research question on whether governments not beholden to the conditions of IMF assistance are more consistent with their reform programs than those that are. Results are associated with the degree of ownership of the programs implemented in both countries.

When Malaysian authorities declined IMF assistance and formed the NEAC, the government opted for the design of a plan, the NERP, that was home-grown. The NEAC was led by government officials but it also incorporated representatives from other national sectors. The result was a program that integrated market-oriented policies and some of the attributes of the Malaysian pre-crisis development model.

[8] See the discussion on the limits on the rule of law in Malaysia in chapter 5.

Hence, the government fully endorsed its program and incorporated other sectors in the building of the package that contributed to its implementation.

Conversely, the government and the IMF argued that Agenda Venezuela was a home-grown program that primarily focused on the social aspects of the crisis. However, most of the conditions included in the Agenda were common in this type of IMF program in the 1990s. In spite of the argued benefits of Agenda Venezuela, it was rapidly abandoned by the government as soon as the oil prices started to climb due to the high political costs that it imposed on the government. After the suspension of the program, oil prices again declined and Caldera ended his term with similar economic problems and a worse social situation.

The lack of a strong ownership of Agenda Venezuela could be partially blamed for the failure of its implementation. It must be remembered that Caldera was a fierce opponent of IMF orthodoxy during the first part of his administration and he accepted the assistance of this Institution when he ran out of options to resolve the banking collapse. The cessation of Agenda Venezuela as soon as economic conditions improved shows that it was not Caldera's program but the Fund's agenda. In other words, the IMF established the main terms that had to be considered by the government for the design of its program, instead of the other way around. The lack of ownership of the program affected its own existence and the Agenda failed in similar term to the previous Great Turnaround that was also abandoned by the government.

Failures like Agenda Venezuela forced the IMF to revaluate its conditionality policies at the beginning of the new Millennium. For the most part, this revision was limited to the analysis of structural conditionality. As a result of this evaluation, the institution recognised some of the problems and proposed some corrective measures contained in a new Guidelines on Conditionality approved by the Executive Board in 2002. The document underlines a renovated version of conditionality in which the principles of ownership, parsimony, tailoring, coordination and clarity are stressed.[9]

[9] IMF, *Guidelines on Conditionality* (2002) <http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.pdf> at 29 September 2004. See also IMF, *Statement of the IMF Staff/Principles Underlying the Guidelines on Conditionality* (2006) IMF <http://www.imf.org/external/np/pp/eng/2006/010906.pdf> at 20 November 2006.

One of the most criticised aspects of conditionality was that it forced governments to accept programs designed by IMF staff. To address this problem, the Fund decided to strengthen ownership of programs as a mechanism to increase involvement of developing nations in the design and execution of reforms. Based on this principle, the 2002 Guidelines state that members are now mainly responsible for 'the selection, design, and implementation of their economic and financial policies'.[10]

Nonetheless, the transfer of responsibility to national governments was not absolute and, according to the 2002 Guidelines, the IMF still maintains its power to approve disbursements only if the institution is satisfied that the selected policies are consistent with its own provisions and the country is committed to implement the program. Consequently, the IMF retains a great negotiation tool to direct changes and it is most likely that a country whose program is closer to the IMF's pre-conceived model will get access to the Fund's assistance than another nation whose design suggests a departure from the institution's ideal package.

The IMF Independent Evaluation Office prepared a review of the Poverty Reduction Growth Facility (PRGF) in 2004. It concluded

> Participation in the formulation of Poverty Reduction Strategy Papers (PRSPs) was generally more broadly based than in previous approaches, and most stakeholders involved in the process viewed this as a significant improvement. However, the participatory processes were typically not design to strengthen existing domestic institutional processes for policy formulation and accountability (e.g., through parliament) … The PRS process has had limited impact in generating meaningful discussions, outside the narrow official circle, of alternative policy options with respect to the macroeconomic framework and macro-relevant structural reforms[11]

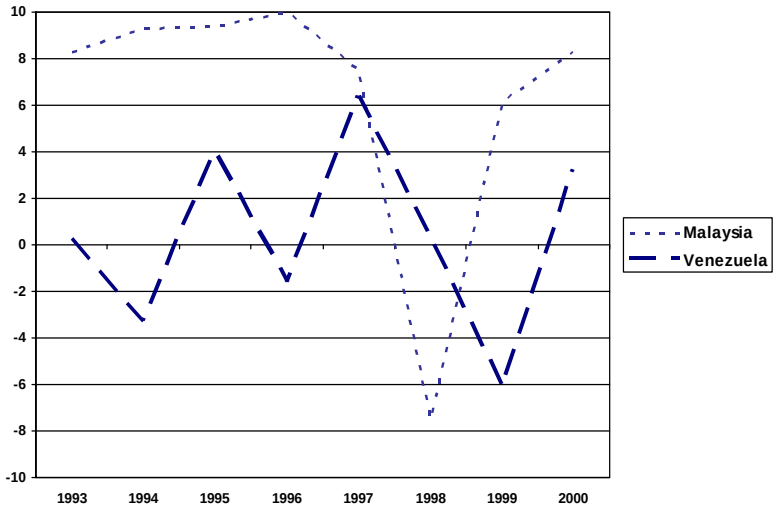
### 9.3.5 Results of the Programs in other Areas

The last research question goes beyond the legal realm to focus on a broader vision of the rescue plans implemented in Venezuela and Malaysia and how the results achieved by reforms differ in countries with the IMF's assistance and those that do

[10] Ibid.
[11] Independent Evaluation Office, 'Evaluation of the IMF's Role in Poverty Reduction Strategy Papers and the Poverty Reduction and Growth Facility' (IMF, 2004) 3.

not have it. Instead of looking the legal sphere, this thesis reviews the overall results achieved by the programs implemented by Malaysia and Venezuela in areas such as economic growth, employment, inflation, poverty and politics.

***a) Economic Indicators***




Source: Malaysia Ministry of Finance, Economic Report, various issues and BCV's website.

**Figure 10: Malaysia and Venezuela Real GDP Growth 1993-2000**

Malaysia quickly recovered from the Asian crisis. After a fall of 7.5% of the real GDP growth in 1998, it grew 6.1 % in 1999 and 8.3% in 2000. Since then, Malaysia has maintained positive growth. Venezuela has had a more erratic record combining good and bad years, depending more on the oil prices than the implementation of a recovery plan (see Figure 10).

Similar trends are observed with other economic indicators. For instance, while in Malaysia the consumer price index increased from 2.7% to 5.3% and unemployment from 2.4% to 3.2% between 1997 and 1998, they decreased to 1.5% and 3.1 respectively in 2000. In the case of Venezuela, after a high inflation of 56.6% in 1995, the rate rocketed to 103% in 1996 with the implementation of Agenda Venezuela. The rate decreased to 37.6% the following year. Meanwhile, there were no major changes in the unemployment level in Venezuela which remained about 11% between 1995 and 1998.

***b) Poverty***

In the case of poverty, the Asian crisis was a temporary set back for Malaysia. Before the crisis, 6.1% of people lived in poverty in 1997. Poverty increased to 8.5% in 1999. However, Malaysia quickly reassumed its trend of the last three decades and poverty diminished to 6% in 2002 and it was recorded at 3.6% at the end of 2007.

Venezuela was not so fortunate. At the beginning of the 1990s, an alarming 39.8% of the population lived in poverty. This number increased with the banking crisis and 48.7% of the population was poor in 1994. With the application of Agenda Venezuela, poverty rocketed to 78.8% in 1996, from 67.8% the previous year.[12] The situation has recently been reversed assisted by the ascending oil prices and a more active role of the government that has dedicated more resources to finance social programs. The government has stated that poverty was 28.5% in 2007, a level still above the 25% recorded in the 1970s but lower than the 1990s.

***c) Political Changes***

If the Asian crisis produced major political changes in Indonesia and Thailand, this was not the case in Malaysia where there was no drafting of a new constitution or overthrowing of the government.[13] During the crisis, the UMNO kept control of the Parliament and Mahathir continued as Prime Minister. In the 1999 general election, *Barisan Nasional* (BN) was able to attract the necessary votes to keep the two-thirds parliamentary majority.[14] However, UMNO lost almost half of Malay votes and the control of two legislative bodies, in the states of Kelantar and Terengganu.[15]

Mahathir stepped down in October 2003 and his Deputy Prime Minister, Abdullah bin Haji Ahmad Badawi, succeeded him. In his first election as Prime Minister in 2004, Badawi recovered 90% of the seats of the Parliament for BN and the UMNO reassumed the control of the legislative assembly of Terengganu. However, in the recent election of March 2008, the official coalition struggled to attract only 51% of the popular vote and retained 63% of parliamentary seats, for the first time losing the two-thirds legislative majority. It is still too early to know the full consequences

---

12 The Republic of Venezuela, 'The Republic of Venezuela 9.25% US Dollar-Denominated Unsecured Global Bonds Due 2027' (1997).

13 See Andrew Harding, 'Southeast Asia, 1997-2003 : Two Case Studies on the Politics of Law and Development' in Christoph Antons and Volkmar Gessner (eds), *Globalisation and Resistance/Law Reform in Asia Since the Crisis* (2007) 133-155

14 See William Case, 'Malaysia's Resilient Pseudodemocracy' (2001) 12 *Journal of Democracy* 43-57.

15 Ibid 51.

of this political re-accommodation but it already looks like a second chapter of the struggles associated with the removal of Anwar from government in 1998. In fact, the former Deputy Prime Minister has assumed the leadership of the opposition and won a by-election in August 2008, a first step to restablish a parliamentary base for the reformist movement that he initiated ten years ago.[16]

In spite of the apparent immutability of Malaysian politics, the Asian financial crisis provided an opportunity to challenge the authority of the UMNO and its leaders and questioned the style of government promoted by Mahathir. However, the former Prime Minister moved rapidly and used all his powers to control the situation with the dismissal and subsequent imprisonment of Anwar. This time, Malaysians may extract valuable lessons from the management of the financial crisis in the banking sector and apply a similar approach in the political realm, opening a debate to discuss issues such as cronyism and corruption in government circles, suppression of the emergency legal system, independence of the judiciary and the continuity of *Bumiputera* policies.

In Venezuela, the interventions of the IMF contributed to the polarisation of the political climate and the Fund's policies took the centre of the political debate. Hence, the application of the Great Turnaround by Pérez debilitated the most traditional and popular Venezuelan political party, AD, and affected COPEI. Both parties shared the government between 1959 and 1994 but since then they have not been in power again. The lack of political support facilitated Pérez's removal in May 1993 and contributed to the electoral victory of Caldera in December of that year. With the promise not resort to the IMF during his campaign, Caldera intended to implement a social approach but he was unlucky and oil prices did not give him room to implement his program. Caldera's decision to ask for the IMF's assistance and his failure to abate the banking crisis ended in dismantling the old political order.

The rejection of the IMF's programs among Venezuelans contributed to the electoral victory in December 1998 of a newcomer to the political spectrum, Hugo Chávez, the leader of the military coup of February 1992 who promised to fight corruption, avoid neoliberal policies and transform the political system with the drafting of a new constitution. With the implementation of his '21st Century Socialism', Chávez has

[16] However, new sodomy charges against Anwar suggest that it will be difficult for him to achieve his political goals. See The Star, 'PKR de facto leader blames Najib for sodomy allegation', The Star (Kuala Lumpur), 18 July 2008.

reshaped not only the domestic economy, legal system and politics but also the regional financial and geopolitical framework has been shaken.[17]

## 9.4 From Global to Regional Pacts: New challenges for the IMF

In the 1990s, the rule of law occupied the centre of the efforts focused on law as an instrument to contribute to the process of development. The IMF joined other IFIs promoting actions that were deemed as essential to strengthening legal systems around the globe. The Fund focussed its work on creating a legal framework supportive of good governance and the rule of law that included sound institutions and an adequate regulatory climate conductive to efficient private sector activities. The approach required a retreat of the government from the economy in favour of market forces. Results were, at least, controversial, and IMF programs ended mixed with economic, social, political and legal instability.

The case of the Venezuelan banking system is illustrative and shows tensions created by IMF assistance. Although Venezuela adopted the 1993 Banking Act, legislation recommended by the Fund which included independent banking supervisors and other safety nets, this law was not decisive and it was put aside when authorities, with the help of the Fund, managed the banking collapse. In the end, results were not as expected and the system of the South American country finished with an important participation of foreign institutions but it was still weak in the face of deep structural problems.

Lessons taught by the law and development movement on the risks of placing too much attention on the transplantation of foreign legal models without sufficient studies of the conditions in the receiving nation were ignored. It was thought that the best practices adopted in the industrialised world would be enough to transform the banking sector of emerging economies.

[17] Chavez has been the promoter of several regional initiatives that seek the reduction of the influence of the IMF and the United States in Latin America. His initiatives included Bank of the South (*Banco del Sur*); the Union of South American Nations (UNASUR); and the Bolivarian Alternative for the Americas, ALBA (*Alternativa Bolivariana para las Americas*) that is promoted as an alternative to the US-sponsored Free Trade Area for the Americas (FTAA or ALCA).

The loss of faith in IMF principles, policies and methods in addition to the financial crisis that broke out in the US in August 2007 is affecting the way in which the Fund does business with developing nations. It is not difficult to identify various strategies that developing countries have deployed to diminish the Fund's influence.

The first strategy and the easiest to implement was the accumulation of international reserves for those nations that suffered crises in the 1990s. These reserves would serve as the first line of defence against a financial crash. Countries took advantage of the favourable conditions in financial markets to accomplish this goal and, for example, developing Asian countries improved their reserves from US$264.9 billion to US$2,108 billion between 1997 and 2007, while the Latin American region increased their reserves from US$170.3 to US$517.6 in the same period.[18] In the cases of Malaysia and Venezuela, the former increased its reserves from US$21.7 billion to US$101.3 billion in the same period while Venezuela increased from US$17.8 billion to US$34.2 billion.

Furthermore, thanks to the favourable economic conditions, various countries decided to fully repay their outstanding debts earlier as a mechanism to terminate the Fund's conditionality and reassume their independence to design public policies (for example, in Argentina, Brazil, Ecuador and Venezuela).[19] In the words of former Argentinean President Nestor Kirchner, 'Paying off the Fund will generate freedom for national decisions'.[20]

Paradoxically, the good financial health of the member states caused an earthquake in the IMF's finance because the anticipated payments of outstanding debts, including those of the biggest debtors (Argentina and Brazil), diminished the IMF's income while the institution's business model depended on lending activities to cover its operating expenditure. [21] As a consequence, the Fund was forced to

---

18 IMF, World Economic Outlook, various issues.

19 The outstanding debts of Argentina and Brazil accounted for US$ 25 billion. See The Economist, 'Kirchner and Lula: different ways to give the Fund the kiss off; Argentina, Brazil and the IMF', The Economist (2005). Venezuela also paid in full its debt with the IMF and Chávez announced that the country would withdraw from the Institution. However, Chávez has found some practical problems in order to materialise his decision because a withdrawal of the Fund is considered an event of default under the legal terms of many of the bonds issued and sold by the Venezuelan government in international markets. See for instance the events of default included in the following documents: Bolivarian Republic of Venezuela, Prospectus Offer to Exchange its US Dollar-Denominated 10.75% Notes due 2013, which have been registered under the Securities Act of 1933 (the "Exchange Notes") for its Outstanding US-Denominated 10.75% Notes due 2013 (2004); Bolivarian Republic of Venezuela, Listing Memorandum 7.65% Bonds due 2025 (2005), available at http://mflrep01.mf.gov.ve/repositorio/Prospecto-de-Emision_984.pdf

20 The Economist, above n 19.

21 See IMF, 'Committee to Study Sustainable Long-Term Financing of the IMF/Final Report' (IMF, 2007).

rethink its operations and it recently approved a new income model that includes the sale of a portion of the institution's gold reserves, the expansion of the Fund's investment strategies to generate higher returns, and the reinstatement of the practice of recovering costs that the IMF incurs in the operations of the trust fund for concessional lending to low-income countries by reimbursing the Fund's General Resource Account for these costs.[22] In addition, the IMF also decided to adopt some of the actions that the institution often recommended to distressed nations: reduction of budget expenditures and staff members.

Emerging economies are also pushing to redesign the structure of the Fund to give them a more relevant role in the process of defining policies and strategies. In 2006 and 2008, IMF members approved two redistributions of quotas that favored 135 countries that, as a group, saw an increase of voting share of 5.4%.[23] The biggest increase in voting share went to China, Korea, India, Brazil and Mexico. [24] It could be said that these reforms represent the beginning of a positive transition to give more powers to non-traditional members of the Fund whose economies today play an important role in the world. Nonetheless, a modest start that did not significantly change the *status quo* or the way in which the IMF makes its decisions.

Another strategy assumed by developing countries has been the organisation of regional arrangements that can be a more reliable and less intrusive source of emergency funds in cases of new financial crises. In the case of Asia, ASEAN + 3 (China, Japan and South Korea) initially agreed under the Chiang Mai Initiative, to a bilateral system of currency swaps to assist nations affected by a crisis.[25] More recently in May 2008, the Ministers of Finance of these countries met in Madrid and ratified their intention of completing the transformation of the Asian initiative into a multilateral agreement that creates a self-managed reserve arrangement governed by a single document.[26]

---

22 Maureen Burke, 'IMF Income Model Has Five Key Elements', IMF Survey Online 8 April (2008); Maureen Burke, 'New Income Model to Set IMF on Firmer Footing/Interview with Michael Kuhn', IMF Survey Online 7 April (2008).

23 IMF Survey Online, 'Directors Back Reforms to Overhaul IMF Quotas and Voice', IMF Survey Online 28 March (2008).

24 For instance China achieved a quota of 4% that it is still below of its 15% contribution to global income. IMF quotas determine voting powers and access to financing of IMF members. Quotas are calculated according to the relative weight of member's economies in the world economy. Quotas are revised every five years (the last one was performed in January 2008). However, the IMF decided *ad hoc* increases in 2006 and 2008 based on the IMF's Medium Term Strategy.

25 See C. Henning Randall, East Asian Financial Cooperation (2002).

26 ASEAN, 'Joint Ministerial Statement of the 11th ASEAN Plus three ASEAN Ministers Meetings' (Madrid, Spain, 4 May 2008).

South American nations have also been involved in the design of alternative options to the IMF. For example, Argentina, Bolivia, Brazil, Ecuador, Paraguay, Uruguay and Venezuela founded *Banco del Sur* in 2007. In its first phase it will work as a development bank, and later it will build an emergency fund to assist members that suffer from financial turmoil.

A final development that must be mentioned is an 'inverse' law and development movement initiated in various South American countries that, instead of promoting legal reforms to embrace a neoliberal model, promotes constitutional reforms to limit future moves to implement such market programs. Following this approach, article 299 of the 1999 Venezuelan Constitution adopt a human development approach and states that the economic regime of Venezuela is based on principles such as social justice and solidarity and must seek to ensure the overall human development and useful existence for the community. Chávez's administration has built his socialist economic model based on this provision. Other countries like Ecuador adopted new constitutions in 2008 and governments have also expressed intentions of using the new charters as a mechanism to dismantle the arrangements inspired by the neoliberal reforms of the 1990s and, at the same time, to incorporate safeguards that prevent the implementation of similar programs in the future.[27]

It will take time to discover whether these strategies will work but it certainly can be said that developing countries now seem better prepared to face financial turmoil than ten years ago and they will avoid calling for IMF financial assistance in the future. This means that law and development enterprises promoted by the Fund will need to make greater efforts to convince developing nations of their benefits and would necessarily require greater attention to regional and local conditions.

Finally, the other issue that could affect the Fund and its relations with member states is the subprime crisis that broke out in the US in 2007, affecting other developed countries. The financial shock affected the basis of the neoliberal model promoted by IFIs. One of these principles states that markets are self-regulating and the government should maintain a reduced role in the economy.[28] The first

---

[27] El Universal, 'Correa Advierte a Iglesia Católica de no Oponerse a su Proyecto en Ecuador', El Universal (Caracas), 26 July 2008.

[28] For recent works that study this topic and criticise the IMF's promotion of financial liberalisation in developing countries see the various contributions in Jose Antonio Ocampo and Joseph Stiglitz, *Capital Market Liberalization and Development* (2008). Particularly, two chapters are insightful**:** Jose Antonio Ocampo, Shari Spiegel and Joseph Stiglitz, 'Capital Market Liberalization and Development' and Joseph Stiglitz, 'Capital Market Liberalization, Globalization, and the IMF'.

actions assumed by the American government to address the crisis seem to point in a different direction.

Preliminary analyses of the causes of the crisis indicate that there were supervisory and regulatory weaknesses that contributed to the collapse.[29] This situation imposes a mandate to review the financial supervisory and regulatory framework. The review is particularly important for emerging economies since the Fund and other global players, such as the Basel Committee, extract the best practices recommended to developing nations from those banking systems that today are in distress.

Apart from the shortcomings of the financial supervision and regulations, the subprime crisis has also exposed the dangers of a liberalised financial market in which sophisticated global players assumed excessive risks that were not properly disclosed to less informed investors. Doubtful strategies employed by financial institutions oriented to deceive small investors have started to emerge with the deterioration of conditions in global financial markets. For instance, Citibank has been accused of putting in place non-transparent accounting methods to hide off-balance-sheet assets used to expand lending without affecting capital. [30] These assets have been heavily impacted by the mortgage crisis in the US and they would produce huge losses for the institution and its shareholders.[31]

Nobody is certain how many other financial institutions could be involved in similar practices around the world. But the US Department of the Treasury is aware of the problem and included among the recommendations listed in its 'Blueprint for the Modernized Financial Regulatory Structure', the creation of a business conduct regulator that has the power to monitor financial firms in key aspects such as consumer protection, business practice and disclosure of information.[32]

Besides the review of the regulatory framework undertaken by US financial regulators, the government has reacted by increasing its intervention in financial markets. First, the supervisory agencies proposed more strict and extensive

---

29 See the US Department of the Treasury, 'The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure' (The US Department of the Treasury, 2008); UK Financial Services Authority, 'The FSA's Internal Audit Review of its Supervision of Northern Rock, and the FSA Management Response' (UK Financial Services Authority, 2008)

30 The Age, 'Citigroup's Mysterious Assets', The Age 15 July

31 Ibid.

32 US Department of the Treasury, above 29, 19.

regulations on financial firms. Second, the state has launched programs to help people to cope with the effects of the crisis and enhanced financial authorities' powers to provide multibillion dollar rescue packages to save private financial institutions in trouble (for example, Fannie Mae, Freddie Mac, the American International Group and Citibank).[33] These actions contradict the common discourse of austerity and reduction of state interference in the economy promoted by the Fund in those developing nations that suffer from financial turmoil and where governments are usually compelled to reduce expenditures and let private financial institutions fail.

In the meantime, and until more in-depth studies of the causes of the crisis are completed, developing countries that saw in Western banks a model to be applied in their own nations are reassessing this view and slowing down the liberalisation of financial markets.[34] This fact seems to justify the gradual approach adopted by Malaysia, which demonstrated that the management of a financial crisis is not only a matter of global affairs but also and primarily a matter of the domestic realm.

[33] See The Economist, 'Help is at Hand', The Economist 28 July (2008).

[34] For instance, Liu Mingkang, chairman of the China Banking Regulatory Commission stated that due to the current turmoil in international financial markets, China was likely to open up its banking sector to foreign investors even more slowly that it has already. See The Economist, 'Pots and Kettles; Finance in Asia', The Economist (2008).

# BIBLIOGRAPHY

**Articles/Books/Reports**


Abbot, Jason, 'Vanquishing Banquo's Ghost: The Anwar Ibrahim Affair and its Impact on Malaysian Politics' (2001) 25 *Asian Studies Review* 285-308.

Abbot, Kenneth W., Keohane, Robert O., Moravcsik, Andrew, Slaughter, Anne-Marie and Snidal, Duncan, 'The Concept of Legalization' (2000) 54 *International Organization* 401-419.

Abdelal, Rawi and Alfaro, Laura, 'Capital and Control' (2003) 46 *Challenge* 36-53.

Abdullah, Nurjaanah, 'Legislating Faith in Malaysia' (2007) 2007 *Singapore Journal of Legal Studies* 264-289.

Abed, George and Gupta, Sanjeev, 'The Economics of Corruption: an Overview' in Abed, George and Gupta, Sanjeev (eds), *Governance, Corruption & Economic Performance* (2002) 1.

Agamben, Giorgio, *State of Exception* (2005).

Akande, Dapo, 'International Organizations' in Evans, Malcolm D. (ed), *International Law* (2003) 269-297.

Allen, Loring, *Venezuelan Economic Development/A Politico-Economic Analysis* (1977).

Anghie, Antony, 'Time Present and Time Past: Globalization, International Financial Institutions, and the Third World' (2000) 32 *Journal of International Law and Politics* 243-290.

Antons, Christoph, 'Analysing Asian Law: The Need for a General Concept' (1995) 13 *Law in Context* 106-123.

Antons, Christoph, 'Law and Development Thinking after the Asian Crisis of 1997' (2001) 20 *Forum of International Development Studies* 205-232.

Antons, Christoph (ed), Law and Development in East and Southeast Asia (2003).

Antons, Christoph, 'Law Reform in the 'Developmental States' of East and Southeast Asia: from the Asian Crisis to September 11, 2001 and Beyond' in Antons, Christoph and Gessner, Volkmar (eds), *Globalisation and Resistance/Law Reform in Asia since the Crisis* (2007).

Antons, Christoph and Gessner, Volkmar (eds), Globalisation and Resistance/Law Reform in Asia Since the Crisis (2007).

Arellano Moreno, A., *Guía de Historia de Venezuela 1498-1968* (2nd ed, 1971).

Arocha, Morela and Rojas, Edgar, 'La Crisis Bancaria en Venezuela: Antecedentes, Desarrollo e Implicaciones' (1996) XIX *Monetaria* 153-200.

Arostegui, Julio, 'Un Nuevo Sistema Político' in Blanco Freijeiro, Antonio, Blanco Freijeiro, Antonio, Mangas, Julio, Martín, Jose Luís, Valdeon, Julio, Domínguez Ortiz, Antonio, Arostegui, Julio Tuñon de Lara, Manuel and Fusi, Juan Pablo (eds), *Historia de España* (1986) 764-800.

Azmin, Khairil and Mokhtar, Bin, 'The Emergency Powers (Kelantan) Act 1977' in Harding, Andrew and Lee, H.P. (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 135-143.

Balthazar, Laurent, *From Basel 1 to Basel 3: The Integration of State-of-the-Art Risk Modeling in Banking Regulation* (2006).

Banco Central de Venezuela, Informe Analítico de los Estados Financieros Correspondientes al Primero, Segundo, Tercero y Cuarto Trimestre de 2004 (2004).

Bank Negara Malaysia, *the Central Bank and the Financial System/A Decade of Change* (1999).

Bank Negara Malaysia, 'BNM Annual Report 2000' (BNM, 2001).

Bank Negara Malaysia, 'Financial Sector Masterplan: Building a Secure Future' (BNM, 2001).

Bank Negara Malaysia, 'BNM Annual Report 2001' (BNM, 2002).

Bank Negara Malaysia, 'BNM Annual Report 2002' (BNM, 2003).

Bank Negara Malaysia, 'BNM Annual Report 2003' (BNM, 2004).

Bank Negara Malaysia, 'BNM Annual Report 2005' (BNM, 2006).

Bank Negara Malaysia, 'Financial Stability and Payment Systems Report 2006' (BNM, 2007).

Bannon, John Francis, Miller, Robert Ryal and Dunne, Peter Masten, *Latin America* (4th Ed., 1977).

Bari, Abdul Aziz, *Malaysian Constitution/ A Critical Introduction* (2003).

Basle Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision' (BIS, 1997).

Basle Committee on Banking Supervision, 'Core Principles Methodology' (BIS, 1999).

Bastin, John and Winks, Robin, *Malaysia/Selected Historical Readings* (2nd ed, 1979).

Bava, Noorjahan, 'Development as a Multidimensional Concern' in Mudacumura, Gedeon and Haque, M. Shamsul (eds), *Handbook of Development Policy Studies* (2004) 125-151.

Bello, Walden, *Dark Victory The United States, Structural Adjustment and Global Poverty* (1994).

Blackaby, Artis, M.J., Elliott, R., Jones, K., Meadows, P., Morgan, A.D., Mottershead, P., Price, R.W.R. and Tew, J.H.B, *British Economic Policy 1960-1974* (1978).

Blustein, Paul, *And the Money Kept Rolling in (and out) : Wall Street, the IMF, and the Bankrupting of Argentina* (2005).

Borner, Silvio, Brunetti, Aymo and Weder, Beatrice, *Political Credibility and Economic Development* (1995).

Boyd, Richard, 'The Rule of Law or Law as Instrument of Rule? Law and the Economic Development of Japan with Particular regard to Industrial Policy.' in Antons, Christoph (ed), *Law and Development in East and Southeast Asia* (2003) 154.

Bozyk, Pawel, *Globalization and the Transformation of Foreign Economic Policy* (2006).

Bresser, Luiz Carlos, 'Economic Reforms and Economic Growth: Efficiency and Politics in Latin America' in Bresser, Luiz, Maravall, José María and Przeworski, Adam (eds), *Economic Reforms in New Democracies. A Social-Democratic Approach* (1993) 15.

Brewer-Carías, Allan, 'Los Contratos de Interés Nacional y su Aprobación Legislativa' (1982) 11 *Revista de Derecho Público* 49-54.

Brewer-Carías, Allan, 'El Federalismo en la Historia Política Venezolana' (1995) 1 *Provincia.*

Brewer-Carías, Allan, 'El "Estado Federal Descentralizado" y la Centralización de la Federación en Venezuela' (2004) 11 *Provincia* 98-136.

Brewer-Carías, Allan, *La Constitución de 1999/Derecho Constitucional Venezolano* (4th ed, 2004).

Bruff, Harold, 'Judicial Review and the Presidents Statutory Powers' (1982) 68 *Virginia Law Review* 1-61.

Bullard, Nicola, Bello, Walden and Mallhotra, Kamal, 'Taming the Tigers: the IMF and the Asian Crisis' (1998) 19 *Third World Quarterly* 505-555.

Burke, Maureen, 'IMF Income Model Has Five Key Elements', IMF Survey Online 8 April (2008); Maureen Burke, 'New Income Model to Set IMF on Firmer Footing/Interview with Michael Kuhn', IMF Survey Online 7 April (2008)

Calabresi, Steven, 'The Historical Origins of the Rule of Law in the American Constitutional Order' (2004-2005) 28 *Harvard Journal of Law & Public Policy* 273-280.

Camdessus, Michel, 'The IMF at the Start of the Twenty-first Century: What Has Been Learned? On Which Values Can We Establish a Humanised

Globalisation?' in David Vines and Christopher Gilbert (eds), *The IMF and its Critics* (2004) 417.

Carothers, Thomas, 'The Many Agendas of Rules-of-Law Reform in Latin America' in Domingo, Pilar and Sieder, Rachel (eds), *Rule of Law in Latin America: The International Promotion of Judicial Reform* (2001) 4-14.

Carrillo Batalla, Tomás, *Cuentas Nacionales de Venezuela 1831-1873* (2001).

Carrillo Batalla, Tomás, *Cuentas Nacionales de Venezuela 1874-1914* (2002).

Casas, Antonio, *El Banco Central de Venezuela: Desafíos y Soluciones 1994-1999* (2000).

Casas, Bartolomé de las, *Brevísima Relación de la Destrucción de las Indias* (13th ed, 2003).

Case, William, 'Malaysia's Resilient Pseudodemocracy' (2001) 12 *Journal of Democracy* 43-57.

Chin, Kok Fay and Jomo, K.S., 'Financial Reform and Crisis in Malaysia' in Tsurumi, Masayoshi (ed), *Financial Big Bang in Asia* (2001) 225-249.

Chin, Kok Fay and Jomo, K.S., 'From Financial Liberalization to Crisis in Malaysia' in Lee, Chung H. (ed), *Financial Liberalization and the Economic Crisis in Asia* (2003) 104-132.

Clark, David, 'The Many Meaning of the Rule of Law' in Jayasuriya, Kanishka (ed), *Law, Capitalism and Power in Asia* (1999) 28-44.

Comisión Económica para América Latina y el Caribe (CEPAL), 'Anuario Estadístico 1993' (1993).

Cowen, Michael and Shenton, Robert, 'The Invention of Development' in Crush, Jonathan (ed), *Power of Development* (1995) 27.

Craig, Paul, 'Formal and Substantive Conceptions of the Rule of Law: An Analytical Framework' (1997) Autumn *Public Law* 467-487.

Crazut, Ramón, *La Legislación Financiera Venezolana y la Crisis Bancaria de 1994* (2000).

Crisp, Brian, 'Development Strategy and Regime Type: Why Doesn't Democracy Matter?' (1998) 33 *Studies in Comparative International Development* 8-41.

Crisp, Brian, 'Lesson from Economic Reform in the Venezuelan Democracy' (1998) 33 *Latin American Research Review* 7-41.

Crisp, Brian, 'Presidential Decree Authority in Venezuela' in Carey, John and Soberg Shugart, Matthew (eds), *Executive Decree Authority* (1998) 142-169.

Crouch, Harold, 'Malaysia: Neither Authoritarian nor Democratic' in Hewison, Kevin, Robison, Richard and Rodan, Garry (eds), *Southeast Asia in the 1990s* (1993) 135-157.

Dam, Kenneth, 'From the Gold Clause to the Gold Commission: A Half century of American Monetary Law' (1983) 50 *University of Chicago Law Review* 504-532.

Das, Cyrus 'The May 13th Riots and Emergency Rule' in Harding, Andrew and Lee, H.P. (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 103-113.

Dicey, Albert Venn, *Introduction to the Study of the Law of the Constitution* (Tenth. 1959).

Dillon, Matthew and Garland, Lynda, *Ancient Rome/From the Early Republic to the Assassination of Julius Caesar* (2005).

Drabble, John, An Economic History of Malaysia, c. 1800-1990/the Transition to Modern Economy Growth (2000).

Dreher, Axel and Vaubel Roland, 'The Causes and Consequences of IMF Conditionality' (2004) 40 *Emerging Markets Finance and Trade* 26-54.

Dworkin, Ronald, *A Matter of Principle* (1985).

Dworkin, Ronald, *Law's Empire* (1986).

Economic Commission for Latin America and the Caribbean, 'Social Panorama of Latin America 2001-2002' (ECLAC, 2002).

Economic Commission for Latin America and the Caribbean, 'Social Panorama of Latin America' (ECLAC, 2004).

Economic Planning Unit Prime Minister Department Malaysia, Seventh Malaysia Plan 1996-2000 (1996).

Economic Planning Unit Prime Minister Department, 'Malaysia: 30 Years of Poverty Reduction, Growth and Racial Harmony' (World Bank, 2004).

Economic Planning Unit, Malaysia Prime Minister Department, *Ninth Malaysia Plan 2006-2010* (2006).

Edwards Jr., Richard W., *International Monetary Collaboration* (1985).

Egaña, Manuel, 'Prólogo de Documentos Relacionados con la Creación del Banco Central de Venezuela' (2007) XXI *BCV* 17-25.

Elliott, J.H., *Empires of the Atlantic World/Britain and Spain in America 1492-1830* (2006).

Fagg, John Edwin, *Latin America/ A General History* (Third Ed., 1977).

Faraco, Francisco and Suprani, Romano, *La Crisis Bancaria Venezolana/Análisis Preliminar* (1995).

Ferrer Benimeli, Jose Antonio, 'El Fin del Reformismo' in Blanco Freijeiro, Antonio, Blanco Freijeiro, Antonio, Mangas, Julio, Martín, Jose Luís, Valdeon, Julio,

Domínguez Ortiz, Antonio, Arostegui, Julio Tuñon de Lara, Manuel and Fusi, Juan Pablo (eds), *Historia de España* (1986) 749-763.

Ferreira Rubio, Delia and Goretti, Matteo, 'When the President Governs Alone: The Decretazo in Argentina, 1989-1993' in Carey, John and Soberg Shugart, Matthew (eds), *Executive Decree Authority* (1998) 33-61.

Franck, Thomas, 'The New Development: Can America Law and Legal Institutions Help Developing Countries?' (1972) 1972 *Wisconsin Law Review* 767-801.

Frank, Andre Gunder, *Capitalism and Underdevelopment in Latin America: Historical Studies of Chile and Brazil* (Rev. and enlarged ed. 1969).

Frank, Andre Gunder, *Crisis: in the World Economy* (1980).

Frankel, Jeffrey, 'The Asian Model, the Miracle, the Crisis and the Fund' in Ghosh, B.N. (ed), *Global Financial Crises and Reforms* (2001) 319-329.

Friede, Juan, *Los Welser en la Conquista de Venezuela* (1961).

Friedmann, Wolfgang, 'The Role of Law and the Function of the Lawyer in the Developing Countries' (1963-64) 17 *Vanderbilt Law Review* 181-191.

Fuller, Lon L, *The Morality of Law* (Rev. ed. 1969).

Galanter, Marc, 'The Modernization of Law' in Wiener, Myron (ed), *Modernization: the Dynamics of Growth* (1966) 167-179.

Gamarra, Eduardo, 'Market-Oriented Reforms and Democratization in Latin America: Challenges of the 1990s' in Smith, Willian, Acuña, Carlos and Gamarra, Eduardo (eds), *Latin American Political Economy in the Age of Neoliberal Reform/Theoretical and Comparative Perspectives for the 1990s* (1994) 1-15.

Garcia, Gabriel, 'El Fondo Monetario Internacional y la Promoción del Estado de Derecho en los Noventa: Condicionalidad y Estados de Excepción en Suramérica' (2007) 1 *Oñati Journal of Emergent Socio-legal Studies* 20-36.

Garcia, Jesús Chucho, 'La Deuda del Estado Venezolano y los Afrodescendientes' (2007) 12 *Journal of Latin American and Caribbean Anthropology* 223-232.

Garritsen Vries, Margaret, The International Monetary Fund 1966-1971/The System under Stress (1976).

Ghazali, Aidit, *Development/An Islamic Perspective* (1990).

Gibson, Charles, 'Conquest, Capitulation, and the Indian Treaties' (1978) 83 *American Historical Review* 1-15.

Ginsburg, Tom, 'Does Law Matter for Economic Development? Evidence from East Asia' (2000) 34 *Law and Society Review* 829-856.

Giusti, Luis E, 'La Apertura: The Opening of Venezuela's Oil Industry' (1999) 53 *Journal of International Affairs* 117-128.

Gold, Joseph, 'The Law and Practice of the International Monetary Fund with Respect to "Stand-By Arrangements"' (1963) 12 *International and Comparative Law Quarterly* 1-30.

Goldsmith, Jack L. and Posner, Eric A., *The Limits of International Law* (2005).

Gomez, Edmund Terence and Jomo, K.S., *Malaysia's Political Economy/Politics, Patronage and Profits* (2nd ed. 1999).

Goodpaster, Gary, 'The Rule of Law, Economic Development & Indonesia' in Lindsey, Timothy (ed), *Indonesia. Law and Society* (1999) 21.

Greenberg, David, 'Law and Development in Light of Dependency Theory' (1980) 3 *Research in Law and Sociology* 129-159.

Grenville, Stephen, 'The IMF and the Indonesia Crisis' (2004) 40 *Bulletin of Indonesian Economic Studies* 77-94.

Gross, Oren, 'Exception and Emergency Powers: The Normless and Exceptionless Exception: Carl Schmitt's Theory of Emergency Powers and the "Norm-Exception" Dichotomy' (2000) 21 *Cardozo Law Review* 1825-1868.

Gross, Oren, 'Chaos and Rules: Should Responses to Violent Crises Always be Constitutional?' (2003) 112 *Yale Law Journal* 1011-1134.

Hager, Barry, *The Rule of Law. A Lexicon for Policy Makers* (2nd, 2000).

Haggard, Stephan, *The Political Economy of the Asian Financial Crisis* (2000).

Hamilton-Hart, Natasha, *Asian States, Asian Bankers/Central Banking in Southeast Asia* (2002).

Hamilton-Hart, Natasha and Jomo, K.S., 'Financial Capacity and Governance in Southeast Asia' in Jomo, K.S. (ed), *Southeast Asian Paper Tiger? From Miracle to Debacle and Beyond* (2003) 220-279.

Haque, M. Shamsul, 'Introduction. Development Discourse and its Challenges and Directions' in Mudacumura, Gedeon and Haque, M. Shamsul (eds), *Handbook of Development Policy Studies* (2004) 1-24.

Haque, M. Shamsul, 'The Myths of Economic Growth (GNP)' in Mudacumura, Gedeon and Haque, M. Shamsul (eds), *Handbook of Development Policy Studies* (2004) 89-109.

Harding, Andrew, 'The 1988 Constitutional Crisis in Malaysia' (1990) 39 *International and Comparative Law Quarterly* 57-81.

Harding, Andrew, Law, Government and the Constitution in Malaysia (1996).

Harding, Andrew, 'The Keris, The Crescent and the Blind Goddess: The State, Islam and the Constitution in Malaysia' (2002) 6 *Singapore Journal of International & Comparative Law* 154-180.

Harding, Andrew, 'Southeast Asia, 1997-2003: Two Case Studies on the Politics of Law and Development' in Antons, Christoph and Gessner, Volkmar (eds), *Globalisation and Resistance/Law Reform in Asia Since the Crisis* (2007) 133-155.

Harding, Andrew 'The Rukunegara Amendments of 1971' in Harding, Andrew and Lee, H.P. (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 115-133.

Haring, C.H., *The Spanish Empire in America* (1947).

Harrington, James, *The Commonwealth of Oceana and a System of Politics* (1992).

Harris, Karen, 'Anticipatory Regulation for the Management of Banking Crises' (2005) 38 *Columbia Journal of Law and Social Problems* 251-286.

Hayek, Friedrich A. von, *The Political Ideal of the Rule of Law* (1955).

Head, John, 'Getting Down to Basics: Strengthening Financial Systems in Developing Countries' (2005) 18 *Transnational Lawyer* 257-282.

Hill, Hal, *The Indonesian Economy in Crisis/Causes, Consequences and Lessons* (1999).

Hooker, M.B., 'The Challengue of Malay Adat Law in the Realm of Comparative Law' (1973) 22 *International and Comparative Law Quarterly* 492-514.

Hooker, M.B., A Concise Legal History of South-East Asia (1978).

Hooker, M.B., *Law of South-East Asia/ European Laws in South-East Asia* (1988).

Hoselitz, Bert, 'Theories of Stages of Economic Growth' in Hoselitz, Bert, Spengler, Joseph, Letiche, J, McKinley, Erskine, Buttrick. John and Bruton, Henry (eds), *Theories of Economic Growth* (1960).

Human Rights Watch, 'Rigging the Rule of Law/Judicial Independence under Siege in Venezuela' (Number 16.3 (B), 2004).

Ibrahim, Anwar, Bringing the Confidence Back/Tighter Fiscal Discipline. Ministerial Statement on Measures to stabilise the national economy at the Parliament on 24 March 1998, published in Kok Wing Lim, Robert Ho You Chai and Mee Fah yee, *Hidden Agenda* (1998), 99-108.

IMF Survey Online, 'Directors Back Reforms to Overhaul IMF Quotas and Voice', IMF Survey Online 28 March (2008).

Independent Evaluation Office, 'The IMF and the Recent Capital Account Crises/Indonesia, Korea, Brazil' (IMF, 2003).

Independent Evaluation Office, 'Evaluation of the IMF's Role in Poverty Reduction Strategy Papers and the Poverty Reduction and Growth Facility' (IMF, 2004).

Independent Evaluation Office, 'Evaluation Report/The IMF and Argentina 1991-2001' (IMF, 2004).

Independent Evaluation Office, 'Evaluation of Structural Conditionality in IMF-Supported Programs' (Occasional Paper IMF, 2005).

International Financial Institution Advisory Commission US Congress, 'Report of the International Financial Institution Advisory Commission' (US Congress, 2000).

International Law Association, 'The Paris Minimum Standards of Human Rights Norms in a State of Emergency' (1985) 79 *American Journal of International Law* 1072-1081.

Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking/History, Performance and Prospects* (2005).

Jabar, Hth Siti Faridah Abd, 'Addressing Outstanding Issues in Islamic Finance: Malaysia's Initiatives' (2007) 28 *Company Lawyer* 350-352.

James, Harold, 'From Grandmotherliness to Governance/The Evolution of IMF Conditionality' (1998) 35 *Finance & Development* 44-47.

Jayakumar, S., 'Emergency Powers in Malaysia' in Mohamed Suffian, Tun, Lee, H.P. and Trindade, F.A. (eds), *The Constitution of Malaysia/ its Development: 1957-1977* (1979) 328-369.

Johnson, Simon, Boone, Peter, Breach, Alasdair and Friedman, Eric, 'Corporate Governance in the Asian Financial Crisis' (2000) 58 *Journal of Financial Economics* 141-186.

Jomo, K.S., 'The Malaysian Development Dilemma' in Khan, Mushtaq H. and Jomo, Kwame Sundaram (eds), *rents, Rent-Seeking and Economic Development/Theory and Evidence in Asia* (2000) 274-303.

Jomo, K.S., 'Malaysian Débacle: Whose Fault?' in Allen, Roy (ed), *The Political Economy of Financial Crises* (2004) 164-179.

Joyner, Christopher C., *International Law in the 21st Century/Rules for Global Governance* (2005).

Kay, Bruce, '"Fujipopulism" and the Liberal State in Peru, 1990-1995' (1996) 38 *Journal of Interamerican Studies and World Affairs* 55-98.

Keen, Benjamin, *Latin American Civilization/History and Society, 1492 to the Present* (8th ed, 2004).

Kennedy, J, *A History of Malaya A.D. 1400 - 1959* (1962).

Keynes, John Maynard, *The General Theory* (1973).

Khoo, Boo Teik, 'Between Law and Politics' in Jayasuriya, Kanishka (ed), *Law, Capitalism and Power in Asia/the Rule of Law and Legal Institutions* (1999) 205-232.

Killick, Tony, 'Conditionality and IMF Flexibility' in Paloni, Alberto and Zanardi, Maurizio (eds), *The IMF, World Bank and Policy Reform* (2006) 253-264.

Lawyers Committee for Human Rights and The Venezuelan Program for Human Rights Education and Action, *Halfway to Reform: The World Bank and the Venezuelan Justice System* (1996).

Lee, Chung H., Lee, Keun and Lee, Kangkook, 'Chaebols, Financial Liberalization and Economic Crisis/ Transformation of Quasi-Internal Organisation in Korea' in Allen, Roy (ed), *The Political Economy of Financial Crises* (2004) 145-163.

Lee, Hock Lock, *Central Banking in Malaysia* (1987).

Lee, H.P., Constitutional *Conflicts in Contemporary Malaysia* (1995).

Lee, H.P., 'Competing Conceptions of Rule of Law in Malaysia' in Peerenboom, Randall (ed), *Asian Discourses-Theories and Implementation of Rule of Law in Twelve Asian Countries, France and the US* (2004) 225-247.

Lee, H.P., 'The Ningkan Saga: a Chief Minister in the Eye of a Storm' in Harding, Andrew and Lee, H.P. (eds), *Constitutional Landmark in Malaysia/The First 50 Years 1957-2007* (2007) 77-87.

Leete, Richard, Malaysia from Kampung to Twin Towers/50 years of Economic and Social Development (2007).

Leibenstein, Harvey, *Economic Backwardness and Economic Growth: Studies in the Theory of Economic Development* (1957).

Levine, Daniel and Crisp, Brian, 'Legitimacy, Governability, and Reform in Venezuela' in Goodman, Louis, Mendelson Forman, Johanna, Naim, Moises, Tulchin, Joseph and Bland, Gary (eds), *Lessons of the Venezuelan Experience* (1995) 223-251.

Lindsey, Timothy, 'The IMF and the Insolvency Law Reform in Indonesia' (1998) 34 *Bulletin of Indonesian Economic Studies* 119-124.

Löber, Klaus, 'The Process of Enlargement and the Central Banks in the Accession Countries' (2002) 30 *International Business Law* 491-493.

Locke, John, *Two Treatises of Government* (1969).

Lott, Leo B, 'Executive Power in Venezuela' (1956) 50 *The American Political Science Review* 422-441.

Loveman, Brian, *The Constitution of Tyranny. Regimes of Exception in Spanish America* (1993).

Machado, Kit G., 'Japanese Transnational Corporations in Malaysia's State Sponsored Heavy Industrialization Drive: The HICOM Automobile and Steel Projects' (1989-1990) 62 *Pacific Affairs* 504-531.

Mahani, Zainal-Abidin, *Rewriting the Rules/The Malaysian Crisis Management Model* (2002).

Martz, John, 'Political Parties and the Democratic Crisis' in Goodman, Louis, Mendelson Forman, Johanna, Naim, Moises, Tulchin, Joseph and Bland, Gary (eds), *Lessons of the Venezuelan Experience* (1995) 31-53.

Mauceri, Philip, 'State Reform, coalitions, and the neoliberal Autogolpe in Peru' (1995) 30 *Latin American Research Review* 7-37.

Maza Zavala, Domingo, 'La Inversión del Ingreso Petrolero Venezolano' (2004) XVIII *Revista BCV* 65-102.

Melich Orsini, José, 'Suspensión de Garantías y Emergencia Financiera' in Rondón De Sansó, Hildegard (ed), *Aspectos Fundamentales de la Emergencia Financiera* (1996) 159-169.

Merryman, John, 'Comparative Law and Social Change: On the Origins, Style, Decline & Revival of the Law and Development Movement' (1977) 25 *American Journal of Comparative Law* 457-491.

Michalopoulos, Constantine, 'Assistance for Infrastructure Development' in Krueger, Anne, Michalopoulos, Constantine and Ruttan, Vernon (eds), *Aid and Development* (1989).

Mikesell, Raymond, *The Economics of Foreign Aid and Self-sustaining Development* (1983).

Ministry of Finance, 'Economic Report 1998/1999' (Ministry of Finance, 1999).

Ministry of Finance, 'Economic Report 2006/2007' (Ministry of Finance, 2007).

Mohr, Richard, 'Local Court Reforms and 'Global' Law' (2007) 3 *Utrecht Law Review* 41-59.

Molyneux, Philip, *Thirty Years of Islamic Banking/History, Performance and Prospects* (2005).

Moller, Diana, 'Intervention, Coercion, or Justifiable Need? A Legal Analysis of Structural Adjustment Lending in Costa Rica' (1995) 2 *Southwestern Journal of Law and Trade in the Americas* 483-544.

Montesquieu, *The Spirit of the Laws* (1989).

Morawetz, David, *Twenty-five Years of Economic Development, 1950 to 1975* (1978).

Morse, Stephen, 'Greening the United Nations' Human Development Index?' (2003) 11 *Sustainable Development* 183-198.

Mousourakis, George, *The Historical and Institutional Context of Roman Law* (2003).

Naim, Moises, *Paper Tigers and Minotaurs: The Politics of Venezuela's Economic Reforms* (1993).

Naim, Moises and Francés, Antonio, 'The Venezuelan Private Sector: From Courting the State to Courting the Market' in Goodman, Louis W., Mendelson Forman, Johanna, Naim, Moises, Tulchin, Joseph and Bland, Gary (eds), *Lessons of the Venezuela Experience* (1995) 165-192.

National Economic Action Council, 'National Recovery Plan/Agenda for Action' (NEAC, 1998).

Negretto, Gabriel and Aguilar Rivera, José, 'Liberalism and Emergency Powers in Latin America: Reflections on Carl Schmitt and the Theory of Constitutional Dictatorship' (1999-2000) 21 *Cardozo Law Review* 1797-1823.

Neumann, Franz, *the Rule of Law. Political Theory and the Legal System in Modern Society* (1986).

Nikken, Claudia, 'Aproximación Crítica a la Regulación de los Estados de Excepción en Venezuela' (2002) 8 *Ius et Praxis* 171-198.

Ngugi, Joel, 'Policing Neo-Liberal Reforms: The Rule of Law as an Enabling and Restrictive Discourse' (2005) 26 *University of Pennsylvania Journal of International Economic Law* 513.

North, Douglass Cecil, *Institutions, Institutional Change and Economic Performance* (1990).

Nustad, Knut, 'The Development Discourse in the Multilateral System' in Bøås, Morten and Mcneill, Desmond (eds), *Global Institutions and Development. Framing the World?* (2004) 13-23.

Obiyathulla, Ismath Bacha, 'Malaysia: From Currency to Banking Crisis' (1998) XXXV *Malaysian Journal of Economic Studies* 73-94.

Ocampo, Jose Antonio and Stiglitz, Joseph, *Capital Market Liberalization and Development* (2008)

Ocampo, Jose Antonio, Spiegel, Shari and Stiglitz, Joseph, 'Capital Market Liberalization and Development' in Ocampo, Jose Antonio and Stiglitz, Joseph (eds), *Capital Market Liberalization and Development* (2008) 1-50.

O'Donnell, Guillermo, 'Reflections on Contemporary South American Democracies' (2001) 33 *Journal of Latin American Studies* 599-609.

Oh, Soo-Nam, 'Towards a Sustainable Banking Sector - Malaysia' in Asian Development Bank (ed), *Rising to the Challenge in Asia: A Study of Financial Markets* (1998) 33-78.

Ohnesorge, John, 'The Rule of Law, Economic Development, and the Developmental States of Northeast Asia' in Antons, Christoph (ed), *Law and Development in East and Southeast Asia* (2003) 91-127.

Ohnesorge, John, 'Developing Development Theory: Law and Development Orthodoxies and the Northeast Asian Experience' (2007) 28 *University of Pennsylvania Journal of International Economic Law* 219.

Ohnesorge, John, 'The Rule of Law' (Working Paper Number 1051, University of Wisconsin Law School, 2007).

Organización de Estados Americanos, 'Informe sobre la Situación de los Derechos Humanos en Venezuela' (OEA/Ser.L/V/II.118, OEA, 2003).

Pahuja, Sundhya, 'Technologies of Empire: IMF Conditionality and the Reincription of the North/South Divide' (2000) 13 *Leiden Journal of International Law* 749-813.

Paseé-Smith, John, 'The Persistence of the gap between Rich and Poor Countries, 1960-1998' in Seligson, Mitchell and John, Paseé-Smith. (eds), *Development and Underdevelopment. The Political Economy of Global Inequality* (2003) 17.

Pech, Laurent, 'Rule of Law in France' in Peerenboom, Randall (ed), *Asian Discourses of Rule of Law: Theories and Implementation of Rule of Law in Twelve Asian Countries, France, and the U.S* (2004) 79-112.

Peerenboom, Randall, 'Varieties of Rule of Law' in Peerenboom, Randall (ed), *Asian Discourses-Theories and Implementation of Rule of Law in Twelve Asian Countries, France and the US* (2004) 1-55.

Peerenboom, Randall (ed), *Asian Discourses of Rule of Law: Theories and Implementation of Rule of Law in Twelve Asian Countries, France, and the U.S.*(2004).

Pengurusan Danaharta Nasional Berhad, 'Final Report/Danaharta' (Danaharta, 2005).

Pérez, Joseph, 'Estructura de los Reinos Peninsulares' in Blanco Freijeiro, Antonio, Blanco Freijeiro, Antonio, Mangas, Julio, Martín, Jose Luís, Valdeon, Julio, Domínguez Ortiz, Antonio, Arostegui, Julio Tuñon de Lara, Manuel and Fusi, Juan Pablo (eds), *Historia de España* (1986) 479-491.

Pérez Perdomo, Rogelio, 'Venezuela 1958-1999: el Derecho en una Democracia Renqueante' in Fix-Fierro, Héctor, Friedman, Lawrence M. and Pérez Perdomo, Rogelio (eds), *Culturas Jurídicas Latinas de Europa y América en Tiempos de Globalización* (2003) 639-722.

Pérez Perdomo, Rogelio, 'Reforma Judicial, Estado de Derecho y Revolución en Venezuela' in Pásara, Luis (ed), *En Busca de una Justicia Distinta. Experiencias de Reforma en América Latina* (2004) 335-374.

Pérez Perdomo, Rogelio, 'Sistemas Alternativos para el Manejo de Conflictos en Venezuela' (2005) 7 *Reforma Judicial. Revista Mexicana de Justicia* 161-190.

Pistor, Katharina, Wellons, Philip and Sachs, Jeffrey, *The Role of Law and Legal Institutions in Asian Economic Development: 1960-1995* (1999).

Programa Venezolano de Educación-Acción en Derechos Humanos (PROVEA), 'Informe Anual 1995-1996' (PROVEA, 1996).

Przeworski, Adam, *Democracy and the Market/Political and Economic Reforms in Eastern Europe and Latin America* (1991).

Quint, Peter, 'The Separation of Powers under Carter' (1984) 62 *Texas Law Review* 785-891.

Quintyn, Marc and Taylor, Michael, 'Regulatory and Supervisory Independence and Financial Stability' (2003) 49 *CESifo Economic Studies* 259-294.

Rachagan, Shanthy, 'Islamic Banking in Malaysia' (2005) 20 *Journal of International Banking Law and Regulation* 88-94.

Radelet, Steven and Sachs, Jeffrey, 'The East Asian Financial Crisis: Diagnosis, Remedies, Prospects' in Allen, Roy (ed), *The Political Economy of Financial Crises* (2004) 1-79.

Ramraj, Victor V., 'The Teh Cheng Poh Case' in Harding, Andrew and Lee, H.P. (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 145-155.

Randall, Henning, East Asian Financial Cooperation (2002)

Rapley, John, *Understanding Development. Theory and Practice in the Third World* (2nd ed, 2002).

Raustiala, Kal, 'Form and Substance in International Agreements' (2005) 99 *American Journal of International Law* 581-614.

Rawls, John, *A Theory of Justice* (1973).

Raz, Joseph, 'The Politics of the Rule of Law' in Raz, Joseph (ed), *Ethics in the Public Domain/Essays in the Morality of Law and Politics* (1994) 354-.362.

Raz, Joseph, 'The Rule of Law and its Virtue' in Raz, Joseph (ed), *The Authority of Law. Essays on Law and Morality* (1979) 210-229.

Rivero, Luis, 'Interpretación Económica de los Auxilios Financieros' (2000) 4 *Cuadernos BCV, Serie Técnica*.

Rodriguez, Francisco, 'Anarchy, State, and Dystopia: Venezuelan Economic Institutions before the Advent of Oil' (2008) XVIII *Bulletin of Latin American Research* 99-118.

Rosenfeld, Michel, 'The Rule of Law and the Legitimacy of Constitutional Democracy' (2001) 74 *Southern California Law Review* 1307-1352.

Rossiter, Clinton L., *Constitutional Dictatorship/Crisis Government in the Modern Democracies* (1948).

Rostow, Walt, *The Stages of Economic Growth: a Non-Communist Manifesto* (Second. 1971).

Roy Chowdhury, Subrata, *Rule of Law in a State of Emergency* (1989).

Sampford, Charles, 'Reconceiving the Rule of Law for a Globalizing World' in Zifcak, Spencer (ed), *Globalisation and the Rule of Law* (2005) 9-31.

Satyanath, Shanker, Globalization, Politics, and Financial Turmoil/Asia's Banking Crisis (2006).

Scheuerman, William, *Between the Norm and the Exception/The Frankfurt School and the Rule of Law* (1997).

Scheuerman, William, 'Globalization and Exceptional Powers. The Erosion of Liberal Democracy' (1999) 93 *Radical Philosophy* 14-23.

Scheuerman, William, 'The Economic State of Emergency' (2000) 21 *Cardozo Law Review* 1869-1894.

Scheuerman, William, 'Global Law in Our High Speed Economy' in Appelbaum, Richard, Felstiner, William and Gessner, Volkmar (eds), *Rules and Networks. the Legal Culture of Global Business Transactions* (2001).

Scheuerman, William, *Liberal Democracy and the Social Acceleration of Time* (2004).

Schmidt, Gregory, 'Presidential Usurpation or Congressional Preference?' in Carey, John and Soberg Shugart, Matthew (eds), *Executive Decree Authority* (1998) 104-139.

Schmitt, Carl, Political Theology: Four Chapters on the Concept of Sovereignty (1985).

Schor, Miguel, 'Constitutionalism Through the Looking Glass of Latin America' (2006) 41 *Texas International Law Journal* 1-38.

Schuker, Stephen, *The End of French Predominance in Europe/The Financial Crisis of 1924 and the Adoption of the Dawes Plan* (1976).

Scott, Shirley V., *International Law in World Politics/ An Introduction* (2004).

Scriven, Michael, 'Evaluation Ideologies' (1984) 9 *Evaluation Studies Review* 49-80.

Seidman, Robert, 'Law and Development: a General Model' (1972) 6 *Law and Society Review* 311-342.

Seidman, Robert, Seidman, Ann and Makgetla, Neva, 'Big Bang and Decision-Making: What Went Wrong?' (1995) 13 *Boston University International Law Journal* 435-465.

Sen, Amartya, *Development as Freedom* (1999).

Shihata, Ibrahim, *The World Bank in a Changing World* (1991).

Shihata, Ibrahim, 'Good Governance and the Rle of Law in Economic Development' in Seidman, Ann, Seidman, Robert and Wälde, Thomas (eds), *Making Development Work. Legislative Reform for Institutional Transformation and Good Governance* (1999) xvii-xxv.

Simmons, Beth A., 'The Legalization of International Monetary Affairs' (2000) 54 *International Organization* 573-602.

Singh, Hari, 'Democratisation or Oligarchic Restructuring? The Politics of Reform in Malaysia' (2000) 35 *Government and Opposition* 520-546.

Sinnadurai, Visu, 'The 1988 Judiciary Crisis and its Aftermath' in Harding, Andrew and Lee, H.P. (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 173-195.

Special Committee on the Termination of the National Emergency United States Senate, 'Report of the Special Committee on the Termination of the National Emergency' (93-549, United States Senate, 1973).

Stiglitz, Joseph, *Globalization and Its Discontents* (2003).

Stiglitz, Joseph 'Capital Market Liberalization, Globalization, and the IMF'.

Stone, Horace, *From Malacca to Malaysia 1400-1965* (1966).

Superintendencia de Bancos y otras Instituciones Financieras, *Pasado y Presente* (1998).

Superintendencia de Bancos y otras Institutciones Financieras, 'Infome Anual 2003' (SUDEBAN, 2003).

Superintendencia de Bancos y otras Institutciones Financieras, 'Informe Anual 2005' (SUDEBAN, 2005).

Symcox, Geoffrey and Sullivan, Blair, *Christopher Columbus and the Enterprise of the Indies-A Brief History with Documents* (2005).

Tamanaha, Brian, *On the Rule of Law: History, Politics, Theory* (2004).

Tan, Gerald, *The New Industrialising Countries of Asia* (4th ed, 2004).

Tan, Poh-Ling, 'Malaysia' in Tan, Poh-Ling (ed), *Asian Legal Systems* (1997) 263-313.

Taylor, Ian, 'Hegemony, Neoliberal 'Good Governance' and the International Monetary Fund' in Bøås, Morten and Mcneill, Desmond (eds), *Global Institutions and Development* (2004) 124-136.

Tey, Tsun Hang, 'Malaysia: The Fierce Politico-Legal Backlash' (1999) 3 *Singapore Journal of International & Comparative Law* 1-25.

Thorsten Beck, Asli Demirguc-Kunt and Maria Soledad Martinez Peria, 'Reaching Out: Access to and Use of Banking Services across Countries' (Working Paper WPS3754 World Bank, 2005).

Tolley, Howard, *The International Commission of Jurists: Global Advocates for Human Rights* (1994).

Troper, Michel, 'The Limits of the Rule of Law' in Saunders, Cheryl and Le Roy, Katherine (eds), *The Rule of Law* (2003) 81.

Trubek, David M., 'Toward a Social Theory of Law: An Essay on the Study of Law and Development' (1972) 82 *The Yale Law Journal* 1-50.

Trubek, David M., 'The "Rule of Law' in Development Assistance: Past, Present, and Future' in Trubek, David M. and Santos, Alvaro (eds), *The New Law and Economic Development/A Critical Appraisal* (2006) 74-94.

Trubek, David M. and Galanter, Marc, 'Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development Studies in the United States' (1974) 4 *Wisconsin Law Review* 1062-1102.

Trubek, David M. and Santos, Alvaro, 'Introduction: The Third Moment in Law and Development theory and the Emergence of a New Critical Practice' in Trubek, David M. and Santos, Alvaro (eds), *The New Law and Economic Development/A Critical Appraisal* (2006) 1-18.

Tsurumi, Masayoshi, 'Introduction: Financial Crisis and System reform in Asia' in Tsurumi, Masayoshi (ed), *Financial Big Bang in Asia* (2001) 1-36.

Tsuruoka, Doug, 'Early Withdrawal: Malaysia Looks for New Central-Bank Governor' (1994) 157 *Far Eastern Economic Review* 70.

Turnbull, C. Mary, *A Short History of Malaysia, Singapore and Brunei* (1980).

Turner, Karen, 'Rule of Law Ideals in Early China?' (1992) 6 *Journal of Chinese Law* 1-44.

United Kingdom Financial Services Authority, 'The FSA's Internal Audit Review of its Supervision of Northern Rock, and the FSA Management Response' (UK Financial Services Authority, 2008)

United Nations Development Programme, 'Human Development Report 1990' (UNDP, 1990).

United Nations Development Programme, 'Informe sobre el Desarrollo Humano en Venezuela' (UNDP, 1997).

United Nations Development Program (UNDP), *Democracy in Latin America: Towards a Citizens´ Democracy* (2004).

United Nations Development Programme (UNDP), 'Human Development Report 2003' (UNDP, 2004).

United Nation Development Programme, Malaysia/Achieving the Milennium Development Goals. Success and Challenges (2005).

United Nation Development Programme, 'Human Development Report 2007/2008/Fighting Climate Change: Human Solidarity in a Divided World' (UNDP, 2007).

United States Department of the Treasury, 'The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure' (US Department of the Treasury, 2008)

Upham, Frank, 'Speculations on Legal Informality: On Winn's "Relational Practices and the Marginalization of Law"' (1994) 28 *Law and Society Review* 233-242.

Vera, Leonardo, *Quiebras Bancarias y Crisis Financieras en Venezuela: Una Perspectiva Macroeconómica* (1997).

Verner, Joel, 'The Independence of Supreme Courts in Latin America: A Review of the Literature' (1984) 16 *Journal of Latin American Studies* 463-506.

Vines, David and Gilbert, Christopher, 'The IMF and International Financial Architecture: Solvency and Liquidity' in Vines, David and Gilbert, Christopher (eds), *The IMF and its Critics* (2004) 8-35.

Vohrah, Dato' KC, Koh, KN Philip and Ling, Peter SW, *The Constitution of Malaysia* (5th ed, 2004).

Warbrick, Colin, 'States and Recognition in International Law' in Evans, Malcolm D. (ed), *International Law* (2003) 205-267.

Watson Andaya, Barbara and Andaya, Leonard, *A History of Malaysia* (1982).

Waxman, Margery and Annamalai, Nagavalli, 'Systemic Bank Insolvency: A Legal Framework for Early Crisis Containment' (Work Bank, 1999).

Weber, Max, *Economy and Society: An Outline of Interpretive Sociology/ Max Weber, edited by Guenther Roth, Claus Wittich* (1978).

Wee, Victor, 'How Quick a Recovery?' (1999) 1 *New Voice of Asia* 14-18.

Welsh, Bridget, 'Attitudes Toward Democracy in Malaysia/Challenges to the Regime?' (1996) 36 *Asian Survey* 882-903.

Weyland, Kurt Gerhard, *The Politics of Market Reform in Fragile Democracies: Argentina, Brazil, Peru, and Venezuela* (2002).

Williamson, John, 'Latin America Reform: A View from Washington' in Costin, Harry and Vanolli, Hector (eds), *Economic Reform in Latin America* (1998) 106-111.

World Bank, 'World Development Report 2002: Building Institution for Markets' (2001).

World Bank, 'Doing Business in 2006' (World Bank, 2006).

World Bank, *10 Years After the Crisis* (2007).

Wu Min Aun, Jesse, 'The Saga of Anwar Ibrahim' in Harding, Andrew and Lee, H.P. (eds), *Constitutional Landmarks in Malaysia/The First 50 Years 1957-2007* (2007) 273-290.

Yatim, Rais, *Freedom Under Executive Power in Malaysia/A study of Executive Supremacy* (1995).

**Constitution/Legislation/Regulations**

**Malaysia**

Banking Financial Institutions Act 1989

Central Bank of Malaysia Act 1958

Constitution of Malaysia 1957

Emergency (Essential Powers) Act 1979

Emergency (Essential Powers) Ordinance No 1 1969

Emergency (Essential Powers) Ordinance No.2 1969

Emergency (Essential Powers) Ordinance No.22/1970

Emergency (Protection of Depositors) Regulations in 1986

Internal Security Act 1960

Islamic Banking Act 1993

Malaysia Deposit Insurance Corporation Act 2005

National Land Code (Amendment) Act 1998

Official Secret Act 1972

*Pengurusan Danaharta Nasional Berhad Act 1998*

Petroleum Development Act 1974

**Venezuela**

Central Bank of Venezuela Act 1992

Central Bank of Venezuela Act 2001

Central Bank of Venezuela Act 2005

Constitution of the Republic of Venezuela 1961

Constitution of the Bolivarian Republic of Venezuela 1999

General Act of Banks and Other Financial Institutions 1993

General Act of Banks and Other Financial Institutions 2001

**Other Jurisdictions**

Civil Contingencies Act 2004 (UK)

Emergency Banking Relief Act of 1933 (US)

Trading with the Enemy Act (US) 1917

**Old legislation**

Recopilación de las Leyes de Indias

**Case law**

Danaharta v Kekatong [2004] 2 MLJ 257.

PP v. Kok Wah Kuan [2007] 6 CLJ 341

*Grutter v Bollinger*, 539 US 306 (2003).

Jaffnese v Bank Negara Malaysia [1989] 3 MLJ 150.

**Treaties**

American Convention on Human Rights "Pact of San Jose, Costa Rica" adopted on 22 November 1969. Entered into force on 18 July 1978.

IMF Articles of the Agreement adopted on 22 July 1944 as amended effective November 11, 1992, by the modifications approved by the Board of Governors in Resolution No. 45-3, adopted June 28, 1990.

International Bank for Reconstruction and Development Articles of Agreement adopted 1 May as amended effective 16 February 1989

International Covenant on Civil and Political Rights adopted on 16 December 1966. Entered into force on 23 March 1976.

Vienna Convention on the Law of Treaties adopted in 1969. Entered into force on 27 January 1980

**IMF regulations/policies/documents**

IMF Articles of Agreement (original text), available at: http://www.imfsite.org/origins/original1.html

IMF Executive Board Decision No. 71-2, 26 September 1946, available at: http://www.imf.org/external/pubs/ft/sd/index.asp?decision=71-2

IMF Executive Board Decision No. 284-4, 10 March 1948, available at: http://www.imf.org/external/pubs/ft/sd/index.asp?decision=284-4

IMF, Executive Board Decision No. 2603-(68/132), 20 September 1968

IMF, Misreporting and Noncompliance Purchase in the general resources Account-Guidelines on Corrective Action (1984). Amended by Decision No. 12249-(00/77) July 2000.

IMF Executive Board, 'Guidelines on Conditionality/Executive Board Decision No.6056-(79/88), March 2, 1979)' in Zamora, Stephen and Brand, Ronald (eds), *Basic Documents of International Economic Law* (1990) 391-394.

IMF, 'Venezuela-Memorandum on Economic Policy' (EBS/89/34, IMF, 1989)

IMF, 'Venezuela-Request for Extended Arrangement' (EBS-89-107, IMF, 1989)

IMF, 'Venezuela-Staff Report for the 1996 Article IV Consultation and Request for Stand-By Arrangement' (ERS/96/108, IMF, 1996)

IMF, *Good Governance/The IMF's Role* (1997).

IMF, 'Venezuela: Recent Economic Developments' (98/117, IMF, 1998)

IMF, Misreporting and Noncompliance Purchase in the General Resources Account-Guidelines on Corrective Action (2000)

IMF, *Financial Organization and Operations of the IMF* (6th ed, 2001).

IMF, 'Financing the Fund's Operations-Review of Issues' (IMF, 2001)

IMF, 'Review of the Fund's Experience in Governance Issues' (IMF, 2001)

IMF, 'Review of the Fund's Strategy on Overdue Financial Obligations' (IMF, 2001)

IMF, Executive Board Decision No. 12545-(01/84) on the Fund's Strategy's on Overdue Financial Obligations adopted on 22 August 2001

IMF, 'Streamlining Structural Conditionality: Review of Initial Experience' (IMF, 2001)

IMF, *Guidelines on Conditionality* (2002) <http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.pdf> at 29 September 2004

IMF, 'Review of the 2002 Conditionality Guidelines/Selected Issues' (IMF, 2005)

IMF, 'Review of the Fund's Strategy on Overdue Financial Obligations' (IMF, 2005)

IMF, *Statement of the IMF Staff/Principles Underlying the Guidelines on Conditionality* (2006) IMF <http://www.imf.org/external/np/pp/eng/2006/010906.pdf> at 20 November 2006

IMF, 'Committee to Study Sustainable Long-Term Financing of the IMF/Final Report' (IMF, 2007)

**Conferences/Working Papers**

Alvarez, Fernando, Arreaza, Adriana, Fernandez, Maria Amelia and Mirabal, Maria Josefa, 'Fragilidad Financiera en Venezuela: Determinantes e Indicadores' (Working Paper Number 25 Banco Central de Venezuela, 2002).

Beck, Thorsten, Demirguc-Kunt, Asli and Martinez Peria, Maria Soledad, 'Reaching Out: Access to and Use of Banking Services across Countries' (Working Paper WPS3754 World Bank, 2005).

Blavy, Rodolphe, 'Assessing Banking Sector Soundness in a Long-term Framework: The Case of Venezuela' (Working Paper WP/06/225 IMF, 2006)

Brewer-Carías, Allan, 'El Constitucionalismo y la Emergencia en Venezuela/Entre la Emergencia Formal Excepcional y la Emergencia Anormal Permanente' (Paper presented at the Mesa Redonda Internacional sobre Constitucionalismo en Tiempos de Emergencia, Córdova, Argentina, 24-25 June 2005).

Camdessus, Michel, 'The Challenges of a Sound Banking System' (Paper presented at the the Seventh Central Banking Seminar, Washington, D.C., 31 January 1997).

Das, Udaibir and Quintyn, Marc, 'Crisis Prevention and Crisis Management: The Role of Regulatory Governance' (Working Paper Number IMF, 2002).

Fung, Ben, George, Jason, Hohl, Stefan, Ma, Guonan, 'Public Asset Management Companies in East Asia/ A Comparative Study' (Working Paper Number Financial Stability Institute, Bank for international Settlements, 2004).

Garcia-Herrero, Alicia, 'Banking Crisis in Latin America in the 1990s: Lessons from Argentina, Paraguay and Venezuela' (Working Paper Number IMF, 1997).

Garzón, Ernesto, 'What is Wrong with the Rule of Law?' (Paper presented at the Seminario en Latinoamérica de Teoría Constitucional y Política (SELA), Puerto Iguazu, Argentina, 8-11 June 2000).

Goldstein, Morris, 'IMF Structural Programs' (Paper presented at the Conference on Economic and Financial Crises in Emerging Market Economies, Woodstock, Vermont, 19-21 October 2000).

Gómez, Pavel and González, Rosa, 'La Autonomía Administrativa de las Instituciones Gubernamentales en Venezuela: El caso de la Superintendencia de Bancos y Otras Instituciones Financieras (SUDEBAN)' (Working Paper Number 435, Inter-American Development Bank, 2001).

Hüpkes, Eva, Quintyn, Marc and Taylor, Michael, 'The Accountability of Financial Sector Supervisors: Principles and Practice' (Working Paper Number IMF, 2005).

Lindgren, Carl-Johan, Baliño, Tomás, Enoch, Charles, Gulde, Anne-Marie, Quintyn, Marc and Teo, Leslie, 'Financial Sector Crisis and Restructuring Lessons from Asia' (Occasional Paper Number IMF, 1999).

Mahani, Zainal-Abidin, 'Malaysian Economic Recovery Measures: A response to Crisis Management and for Long-Term Economic Sustainability' (Paper presented at the Economic Crisis in Southeast Asia: Its Social, Political and Cultural Impacts, Bangkok, 17-19 February 2000).

Mohamed, Mustapa Second Minister of Finance, 'Malaysia: Measures for Economic Recovery' (Paper presented at the International Monetary Fund and Worrld Bank Group Annual Meetings, Washington, D.C., 4 October 1998).

Nsouli, Saleh, Rached, Mounir and Funke, Norbert, 'The Speed of Adjustment and the Sequencing of Economic Reforms: Issues and Guidelines for Policymakers' (Working Paper Number IMF, 2002).

Pérez Perdomo, Rogelio, 'Una Evaluación de la Reforma Judicial en Venezuela' (Paper presented at the Judicial Reform in Latin America. An Assessment for Policymakers, Washington, 6 June 2006).

Scott, David, 'A Practical Guide to Managing Systemic Financial Crises/ A Review of Approaches Taken in Indonesia, the Republic of Korea, and Thailand' (Working Paper WPS/2843, The World Bank, 2002).

Sen, Amartya, 'What is the The Role of Legal and Judicial Reform in the Development Process?' (Paper presented at the The Role of Legal and Judicial Reform in Development, Washington, 5 June 2000 2000).

Sheng, Andrew, 'Bank Restructuring in Malaysia 1985-88' (Working Paper WPS 54 World Bank, 1989).

Singh, Anoop, Belaisch, Agnés, Collyns, Charles, De Masi, Paula, Krieger, Reva, Meredith, Guy and Rennhack, Rober, 'Stabilization and Reform In Latin America: A Macroeconomic Perpective on the Experience Since the Early 1990s' (Occasional Paper Number IMF, 2005).

Stiglitz, Joseph, 'Whither Reform? Ten Years of the Transition' (Paper presented at the Annual World Bank Conference on Development Economics, Washington, D.C., 1999).

Tham, Siew-Yean, 'New Approaches to Trade and Investment in the Post-Crisis Era: The Case of Malaysia' (Paper presented at the 12th Meeting of the Steering Group of the Committee on Regional Economic Cooperation, Inchon City, Korea, 25-27 October 2000)

Upham, Frank, 'Mythmaking in the Rule of Law Orthodoxy' (Working Paper Number Carnegie Endowment for International Peace, 2002).

**Media**

Alonso, Juan Francisco, 'Anulan Fallo que Condenó a ex Presidente de Banco Amazonas', El Universal (Caracas), 12 March 2006.

BBC Monitoring Services: Latin America, 'President Caldera Announces Plans; says VAT will be suspended', 8 February 1994.

BBC Monitoring Services: Latin America, 'Caldera Announces Economic Measures', 16 April 1996.

BBC Monitoring Services: Latin America, 'Finance Minister Discusses Economic Plan, Negociation with IMF', 30 April 1996.

Bernama, *Penang Opts For Balloting And Open Tender* (2008) Bernama <http://bernama.com/bernama/v3/news_lite.php?id=321585 at 12 April 2008;

Bernama, *Guan Eng Promises To Share State's Wealth With All People* (2008) Bernama <http://web7.bernama.com/bernama/v3/news_lite.php?id=320890> at 12 April 2008

Christian Science Monitor, 'International Reprisals after Coup Strain Peru's Economic Reforms', Christian Science Monitor (Boston), 14 May 1992.

Christian Science Monitor, 'Economy Looks Brighter After Peruvian Election', Christian Science Monitor (Boston), 3 December 1992.

Dowjones Newswires, 'Venezuela Looking to Reduce Debt Burden with World Bank, IDB', Downjones Newswires (Caracas), 11 July 1995.

Dowjones Newswires, 'Caldera Govt Eyeing IMF "Shadow Program"', Dowjones Newswires 2 August 1995.

Dowjones Newswires, 'Venezuela Seeking Up to $1.5 Billion from IMF', Dowjones Newswires 23 September 1995.

Dowjones Newswires, 'IMF Deal to help Ease Forex Controls', Dowjones Newswires 25 September 1995.

Dowjones Newswires, 'Caldera Sees Sacrifices for IMF', Dowjones Newswires 26 October 1995.

El Universal, *La emergencia financiera y el FMI*, in *El Universal*. 1996: Caracas.

El Universal, 'Otro Ente manejará los Activos de FOGADE', El Universal (Caracas), 11 April 2007.

El Universal, 'Correa Advierte a Iglesia Católica de no Oponerse a su Proyecto en Ecuador', El Universal (Caracas), 26 July 2008.

Faruqi, Shad, ‘Cleansing the judicial system', The Star 2 April 2008

Faruqi, Shad, ‘Restoring Judicial Dignity', The Star 20 April 2008

Gabriel, Anita, 'Danaharta, Danamodal name directors', Business Times 25 August 1998.

Koshy, Shaila, How the commission decided in the Lingam video inquiry, The Star, 21 May 2008

LSC Debt Report, *Suspicious Players Hold Back on Venezuela*, 22 April 1996.

Marquez, Humberto, 'Government, IMF Seek Support for Tough Reforms', Inter Press Service 12 April 1996.

Noti-Sur-Latin American Political Affairs, 'President Rafael Caldera Faces Mounting Protests against Economic Measures', Noti-Sur'Latin American Political Affairs 05 April 1996

Perlez, Jane, *Mahathir, Malaysia's Autocratic Modernizer, Steps Down* (2003) New York Times <http://query.nytimes.com/gst/fullpage.html?res=9C0CE5DD1330F932A35752C1A9659C8B63&n=Top/Reference/Times%20Topics/People/M/Mohamad,%20Mahathir> at 12 November 2007.

Reuters News, 'Venezuelan Congress Passes Emergency Bank Law', 9 March 1994.

Reuters News, 'Venezuela won't raise gasoline price in 95', Reuter News 20 February 1995

Reuters News, 'Venezuela looking for a $ 7.5 billion from IMF talks', (New York), 26 September 1995.

Reuters News, 'Venezuelan Tax Reforms Needed for IMF Deal', Reuter News 14 December 1995.

Reuters News, 'Matos sees Political Will for IMF talks', Reuter News 01 March 1996

Reuters News, 'Venezuela IMF pact gets lukewarm Wall St Reception', 22 April 996.

Reuters News, 'Malaysia's Danaharta names board of directors', Reuters 24 August 1998.

Reuters News, ‘Malaysia PM says not introducing capital controls’, Reuters 29 August 1998.

Sachs, Jeffrey, 'The Wrong Medicine for Asia', New York Times (New York), 3 November 1997.

Sachs, Jeffrey, 'Power unto itself', Financial Times 11 December 1997.

Salmerón, Victor, 'La Banca Baja a la Base de la Pirámide', El Universal (Caracas), 2 January 2007.

Shari, Izatun, 'Dr Mahathir: I’m ready to be probed', The Star 22 April 2008.
Shirene Shan, 'Bank Negara Dialogue Next Week', Business Times 20 August 1994.

Sivaselvam, S., 'Accountability - Is Jaffar Showing the Way?' Business Times 4 April 1994.

Stiglitz, Joseph, 'Hipocresía Financiera', El Espectador (Bogotá), 17 November 2007.

Sullivan, John New York Jury Convicts Three Venezuelan Bankers of Defrauding Depositors. The New York Times 20/02/1997

Textline Multiple Source Collection (1980-1984), 'Bank Bumiputra Malaysia has finally issued its annual report for 1983', Textline Multiple Source Collection (1980-1984) 23 September 1984

The Age, 'Citigroup's Mysterious Assets', The Age 15 July.

The Business Times, 'The Singapore Business Times comments that Malaysian Finance Minister Daim Zainuddin's timing in announcing the M$2.49 bn rescue package for Bank Bumiputra was perfect', The Business Times 20 September 1984.

The Economist, 'Kirchner and Lula: different ways to give the Fund the kiss off; Argentina, Brazil and the IMF', The Economist (2005)

The Economist, 'Not mellow yellow', The Economist (2007).

The Economist, 'Political Tsunami?' The Economist (2008)

The Economist, 'Help is at Hand', The Economist (2008).

The Economist, 'Pots and Kettles; Finance in Asia', The Economist (2008).

The New Straits Times, '"Local banks, financial institutions are sound", The New Straits Times 21 January 1998.

The Straits Times, 'Penang police to summon chief minister', The Straits Times 2 April 2008.

The Star, 'Former LP welcomes council's call', The Star 23 August 2006.

The Star, 'Rulers did not object to candidate for CJM post, says Nazri', The Star 27 August 2007.

The Star, 'Datuk Seri Abdullah Ahmad Badawi: Strengthening Confidence-Venturing into a New Era', The Star (Kuala Lumpur), 7 November 2007

The Star, 'PAS: Islamic state agenda is still on', The Star 22 April 2008;

The Star, 'PKR de facto leader blames Najib for sodomy allegation', The Star (Kuala Lumpur), 18 July 2008.

The Times of India, 'Ethnic Indian Protest Rock Malaysia', The Times of India 26 November 2007

The Wall Street Journal, 'IMF restores Peru to list of approved borrowers', The Wall Street Journal (New York), 19 March 1993.

Valencia, Matthew, 'Chaos in Caracas', The Economist 343 8012 (1997).

Wong, Chun Wai, 'Rulers to discuss CJ's position', The Star 1 November 2007

Wong, Raphael, 'Poser over vacant No.3 judiciary position', The Star 11 August 2007

Yoong, Sean, 'Inquiry exposes links between Malaysia's ex-chief judge, scandal-plagued lawyer', The China Post 18 January 2008

**Other Sources**

Ahmad, Zainon and Phang, Llew-Ann, *The All-Powerful Executive* (2005) Sun2Surf <http://www.sun2surf.com/article.cfm?id=11381> at 23 May 2006.

Asociación Civil Consorcio Justicia, *Visión Popular de los Medios Alternos de Resolución de Conflictos (Resumen)* (2003).

Banco Central de Venezuela, 'Mensaje de Fin de Año del Presidente del Banco Central de Venezuela' (Banco Central de Venezuela, 2003)

Bank Negara Malaysia, *Introduction to the Corporate Debt Restructuring Committe (CDRC)* (2002) <http://www.bnm.gov.my/index.php?ch=31> at 07 August 2007.

Bank Negara Malaysia, *Objectives & Functions* (2007) BNM <http://www.bnm.gov.my/index.php?ch=7&pg=1&ac=1> at 30 October 2007.

Beech, Hannah and Kuppusamy, Baradan, *"I'm being told you mustn't criticize the Prime Minister"* (2006) Time <http://www.time.com/time/magazine/article/0,9171,1552091,00.html> at 12 November 2007

Brant, Robin, *Malaysia's lingering ethnic divide* (2008) BBC News <http://news.bbc.co.uk/go/pr/fr/-/1/world/asia-pacific/7121534.stm> at 6 April 2008

Buira, Ariel *An Analysis of IMF Conditionality* (2002) John F. Kennedy School of Government, Harvard University <http://ksghome.harvard.edu/~drodrik/g24buira.pdf> at 21 May 2005.

Camdessus, Michel, 'Old Battle and New Challenges: A Perspective on Latin America' (Speech delivered at the Bordeaux, 20 October 1997).

Camdessus, Michel, *Press Conference* (1997) IMF <http://www.imf.org/external/np/tr/1997/tr970424.htm> at 20 February 2004.

Chávez Frías, Hugo, 'Discurso con Motivo de la Sesión Inaugural de la IX Reunión Cumbre de jefes de Estado y de Gobierno del Grupo de los 15' in Venezuela, Presidencia de La República Bolivariana (ed), *1999 Año de la Refundación de la República/Selección de Discursos del Presidente de la República Bolivariana de Venezuela, Hugo Chávez Frías* (2005) 47-53.

Clinton, William, *The President's News Conference with President Zedillo* (1995) The American Presidency Project <http://www.presidency.ucsb.edu/ws/index.php?pid=50633> at 20 April 2007.

Consejo Nacional Electoral, *Resultados Electorales referendo 15/12/1999* (1999) CNE <http://www.cne.gob.ve/estadisticas/e012.pdf> at 11 February 2008.

Contreras, Rodrigo, *La Larga, Tortuosa y Nunca Acabada Construcción del Estado liberal en América Latina* (2005) Instituto Internacional de Gobernabilidad de Cataluña <http://www.iigov.org/biblioteca/index.drt> at 7 April 2005.

Department of Statistics Malaysia, *Population and Housing Census 2000* (2005) Department of Statistics Malaysia <http://www.statistics.gov.my/english/frameset_census.php?file=pressdemo> at 11 July 2007.

Economic Planning Unit Prime Minister Department, Malaysia,, *Key Economic Indicators* (2007) Economic Planning Unit, Prime Minister Department, Malaysia <http://www.epu.jpm.my/New%20Folder/Figures2007/chapt1.pdf> at 23 August 2007.

Email from the Department of Statistics Malaysia to Gabriel Garcia, 17 July 2007

Encyclopedia Britannica Online, *Venezuela* (2008) Encyclopedia Britannica Online <http://www.britannica.com/EBchecked/topic/625197/Venezuela#tab=active~checked%2Citems~checked&title=Venezuela%20--%20Britannica%20Online%20Encyclopedia> at 08 January 2008.

Fondo de Garantías y Depósitos Bancarios, *Bancos en Liquidación* (2008) FOGADE <http://www.fogade.gov.ve/BancosLiq/Bancos.htm> at 9 January 2008.

García, Víctor, *Venezuela: A Cheater's Paradise* (2004) Venezuela Today <http://www.venezuelatoday.net/cheaters_paradise.html> at 11 May 2005.

Gomez, Edmund Terence, *Who owns Corporate Malaysia?* malaysiakini <http://www.malaysiakini.com/opinions/39516> at 11 April 2008

Government of Bolivia, *Bolivia—Letter of Intent, Memorandum of Economic Policies, and Technical Memorandum of Understanding* (2003) IMF <http://www.imf.org/external/np/loi/2003/bol/01/index.htm> at 07 June 2007.

Government of Brazil, *Brazil-Letter of Intent* (2003) IMF <http://www.imf.org/external/np/loi/2003/bra/01/index.htm> at 08 June 2007.

Government of Indonesia, *Indonesia-Memorandum of Economic and Financial Policies* (1998) IMF <http://www.imf.org/external/np/loi/011598.htm> at 07 June 2007

Government of Indonesia, *Indonesia-Supplementary Memorandum of Economic and Financial Policies* (1998) IMF <http://www.imf.org/external/np/loi/041098.htm> at 07 June 2007.

Government of Indonesia, *Letter of Intent and Memorandum on Economic and Financial Policies* (1997) IMF <http://www.imf.org/external/np/loi/103197.htm> at 07 June 2007

Havrylyshyn, Oleh, 'Avoid Hubris but Acknowledge Successes/Lessons from the Postcommunist Transition', Finance & Development September (2004).

Hernández-Mendible, Victor, *La Suspensión de Garantías y la Acción de Amparo Constitucional* (1995) Publicaciones Jurídicas Venezolanas <http://www.zur2.com/fcjp/articulos/vrhm95.htm> at 30 April 2005.

IMF, *Summary Proceedings of the Fifty-First Annual Meeting of the Board of Governors* (1996) IMF <http://www.imf.org/external/pubs/ft/sum51/pdf/part05.pdf> at 12 October 2004.

IMF, *Michel Camdessus, Managing Director Press Conference* (1996) IMF <http://www.imf.org/external/np/tr/1996/tr961003.htm> at 28 April 2004

IMF, 'IMF Approves Stand-By Credit for Indonesia' (Press Release 97/50, IMF, 1997)

IMF, *Poverty Reduction Strategy Papers. Operational Issues* (1999) IMF <http://www.imf.org/external/np/pdr/prsp/poverty1.htm> at 29 June 2004

IMF, *Key Features of IMF Poverty Reduction and Growth Facility (PRGF) Supported Programs* (2000) IMF <http://www.imf.org/external/np/prgf/2000/eng/key.htm> at 29 June 2004.

IMF, 'IMF Approves Augmentation of Argentina's Stand-By Credit to US$ 14 Billion and Completes Second Review' (Press Release 01/3, IMF, 2001)

IMF, 'IMF Initiates Compulsory Withdrawal Procedures for Zimbabwe' (Press Release 03/210, IMF, 2003)

IMF, *IMF Lending Arrangements* (2004) IMF <http://www.imf.org/external/np/tre/tad/extarr1.cfm> at 11 July 2004

IMF, *Common Criticisms of the IMF: Some Responses* (2004) IMF <http://www.imf.org/external/np/exr/ccrit/eng/crans.htm#aus> at 16 October 2004.

IMF, *Highlights in the Evolution of IMF Lending* (2004) IMF <http://www.imf.org/external/pubs/ft/exrp/what.htm> at 16 January 2005.

IMF, What Is the International Monetary Fund? (2004) IMF <http://www.imf.org/external/pubs/ft/exrp/what.htm#preface> at 16 October 2004.

IMF, *IMF Conditionality* (2005) IMF <http://www.imf.org/external/np/exr/facts/conditio.htm> at 12 February 2007

IMF, *Financial Sector Assessment/A Handbook* (2005).

IMF, *IMF Lending/A Factsheet* (2006) IMF <http://www.imf.org/external/np/exr/facts/howlend.htm> at 01 March 2007.

IMF, 'Zimbabwe Pays its Overdue Financial Obligations to the IMF Under the General Resources Account' (Press Release 06/33, IMF, 2006).

IMF Glossary of Selected Financial Terms at <http://www.imf.org/external/np/exr/glossary/index.asp> at 23 February 2007

International Bank for Reconstruction and Development Lending Operations: Choice of Borrower and Contractual Agreement (2004)

International Bank for Reconstruction and Development General Conditions for Loans (2006).

Instituto Nacional de Estadísticas (INE), *Pobreza* (2008) <http://www.ine.gob.ve/pobreza/menupobreza.asp> at 30 July 2008.

Kaufman, Robert, Kraay, Aart and Mastruzzi, Massimo, *Governance Matters V: Governance Indicators for 1996–2005* (2006) World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/WBI/EXTWBIGOVANTCOR/0,,contentMDK:21045419~menuPK:1976990~pagePK:64168445~piPK:64168309~theSitePK:1740530,00.html> at 18 September 2006.

Köhler, Horst, 'Building Shared Prosperity in the Americas' (Speech delivered at the Monterrey, 12 January 2004).

Mc Millan, John, 'Avoid Hubris and other lessons for reformers', Finance & Development September (2004).

Mukherjee, Andy, *Malaysia's `Riot' Bogey Quells Economic Debate* (2006) Bloomberg <http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=azL3LMMQpOTA> at 24 October 2006.

Nixon, Richard, *Address to the Nation Outlining a New Economy Policy: "The Challenge of Peace"* (1971) The American Presidency Project <http://www.presidency.ucsb.edu/ws/index.php?pid=3115> at 2007.

Relyea, Harold, *National Emergency Powers* (2001) US Department of State <http://fpc.state.gov/documents/organization/6216.pdf#search='emergency%20powers%20statutes%20senate%20report%2093549'> at 23 August 2006

The Avalon Project at Yale Law School, *Magna Carta 1215* (2005) Yale University <http://www.yale.edu/lawweb/avalon/medieval/magframe.htm> at 9 March 2005.

The Republic of Venezuela, 'The Republic of Venezuela 9.25% US Dollar-Denominated Unsecured Global Bonds Due 2027' (1997)

US Bureau of Democracy, Human Rights, and Labor,, *2006 Report on International Religious Freedom* (2006) US Department of State <http://www.state.gov/g/drl/rls/irf/2006/71347.htm> at 14 November 2007.

US Department of the Treasury, *Exchange Stabilization Fund* (2007) US Department of the Treasury <http://www.treas.gov/offices/international-affairs/esf/index.html> at 20 April 2997.

Waller, Michael, *What to do about Venezuela?* (2005) The Center for Security Policy <http://www.centerforsecuritypolicy.org/What_to_Do.pdf> at 13 May 2005.

Waxman, Margery and Annamalai, Nagavalli, 'Systemic Bank Insolvency: A Legal Framework for Early Crisis Containment' (Work Bank, 1999)

Wee, Victor, *Mechanism and Policies for National Economic Recovery* (1998) Malaysia Economy Planning Unit <http://www.epu.jpm.my/New%20Folder/NEAC%20Chapter.pdf> at 20 October 2007.

Wolfensohn, James, *A Proposal for a Comprehensive Development Framework* (1999) World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/STRATEGIES/CDF/0,,contentMDK:20072890~menuPK:140147~pagePK:139301~piPK:261885~theSitePK:140576,00.html> at 2 December 2004

Wong, LJ, *Flaws in EPU's apparent methodology* (2006) malaysiakini <http://www.malaysiakini.com/opinions/58306> at 28 November 2006

World Bank, *Rule of Law and Development* (2008) World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTLAWJUSTINST/0,,contentMDK:20934363~menuPK:1989584~pagePK:210058~piPK:210062~theSitePK:1974062,00.html > at 13 May 2008