

1996

## The Legal Environment of International Finance: Thinking About Fundamentals

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### Recommended Citation

Merritt B. Fox, *The Legal Environment of International Finance: Thinking About Fundamentals*, 17 MICH. J. INT'L L. 721 (1996).

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# THE LEGAL ENVIRONMENT OF INTERNATIONAL FINANCE: THINKING ABOUT FUNDAMENTALS

HAL S. SCOTT AND PHILIP A. WELLONS, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATIONS*. Westbury, New York: The Foundation Press, Inc., 1995, 2nd ed. xix + 1097 pp.

*Reviewed by Merritt B. Fox\**

The huge increase in cross border capital flows over the last two decades has profoundly important implications for society in general and the law in particular. These flows give rise to a set of legal problems that are sufficiently distinct and coherent to constitute a legal field of their own. Confirming this observation is the development of a specialized legal practice whose members spend the bulk of their time working on such transactions. Nevertheless, a law school course in international finance is a rarity, even at the schools that train most of the students who ultimately join this practice.

The arrival of the first casebook in the area is thus a signal event, particularly so because of its high quality. *International Finance: Transactions, Policy, and Regulation* is bound to encourage the offering of courses in the area and influence their content. In doing so, the book is likely to affect how lawyers practice and hence the development of the law itself. Its publication thus invites an attempt to identify the fundamental features of international finance as a subject of legal inquiry.

Understanding the legal environment in which cross border capital flows occur requires three types of knowledge. The first, and main focus of the Scott and Wellons book, concerns the institutions of international finance: its organizations, practices, products, and regulatory backdrop. The second concerns the political economy of cross border capital flows: why do they take place, what impediments prevent an even greater volume, why do they take their different forms, what are their overall welfare effects, and who is helped and who is hurt by them? The third concerns the rules that directly structure the behavior of parties to these transactions and determine their obligations, rights, and remedies.

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## I. THE INSTITUTIONS OF INTERNATIONAL FINANCE

A reader of this book, unless already deeply engaged in the business of international finance, is certain to become far more sophisticated about its institutions. The authors cover an impressive array of topics using clear, remarkably up-to-date materials, most of which are easily accessible to readers without a technical background.

The authors start with the offering and trading of foreign securities within the United States. Readers are exposed to the different markets existing in the United States and their regulatory frameworks. In addition to the public markets, the authors describe the Rule 144A market, in which securities of foreign issuers may, without registration, be offered and sold to qualified institutional buyers. They also introduce the workings of American Depositary Receipts (ADRs), whereby a U.S. investor can hold a security which represents a share of a foreign issuer but which is publicly traded in the United States, transferable in the U.S. on the books of a U.S. bank, and pays dividends in U.S. dollars.

A number of other topics involving securities are covered as well. The authors describe the structure and regulation of European and Japanese securities markets and the growing importance of competition among the securities markets of the world. Included in this description is a provocative discussion of the possible structural causes of the Japanese stock market crash in the early 1990s and their relation to the country's continuing economic problems. There are careful treatments, both at a national and transnational level, of clearance and settlement mechanisms and of capital adequacy requirements for securities firms. In each case, the discussion is accompanied by a consideration of how the matter affects the risks of transnational securities transactions. The authors also provide descriptions of the markets and regulatory environments for several other kinds of transnationally tradable assets, including Eurobonds, global bonds, the securities of asset securitizations, the securities of privatizing enterprises in emerging market countries, and options and futures. The privatizing enterprises discussion is neatly built on a case study of the privatization of Mexico's Telemex and includes a discussion of the December 1994 peso crisis. The options and futures discussion includes a brief analysis of the Barings collapse and its regulatory lessons.

The book contains extensive materials on exchange rate systems, foreign exchange markets, and the attempt to create a single European currency. There is a particularly good discussion on the costs and benefits of a single currency and of its large political ramifications. The currency exchange materials are presented early in the book, thereby

permitting the later discussions of Eurodollar loans, derivatives and swaps to assume a basic understanding of the relationships among inflation rates, exchange rates, and interest rates.

Finally, the book contains materials on international banking and on payments systems. The authors describe the U.S., European, and Japanese banking systems, with a special emphasis on the regulation of foreign banks and the overseas operations of domestic banks. The Japanese discussion includes an interesting consideration of regulatory reforms in response to the country's early 1990s financial crisis and the continuing "bad loan" problem. There is an intelligent analysis of the problems in judging a bank's capital adequacy in relation to the risks of its loan portfolio and the contributions of the Basle Accord in establishing minimum regulatory standards in this area. The extensive discussion of payments systems — the process by which value is transferred from one party to another through transfers of claims on banks — would help even experienced practitioners better understand this arcane but important element of risk in many international transactions.

## II. THE POLITICAL ECONOMY OF CROSS BORDER CAPITAL FLOWS

Scott and Wellons do not attempt to lay down, in any kind of explicit fashion, a theoretical foundation concerning the phenomenon under study. Bits and pieces are provided along the way through the book, but it is worth considering briefly what a more comprehensive treatment would look like and its potential rewards.

According to neoclassical economic theory, cross border capital flows occur for two reasons. The first concerns differences between nations in their amounts of domestically generated savings relative to the real investment opportunities available within their borders. Imagine this in the context of a world with two countries, *A*, a country with more savings relative to its domestic real investment opportunities and *B*, a country with less savings relative to its domestic opportunities. In the absence of cross border capital flows, these differences will mean that the marginal real investment project in *A* will have a lower expected rate of return than that of the marginal real investment project in *B*. If cross border capital flows are possible, persons with savings in *A* will have incentives to invest them, directly or indirectly, in projects in *B*. More projects will be implemented in *B* and fewer projects will be implemented in *A*. Global economic welfare will be enhanced since the projects that would otherwise have been implemented in *A* have a lower expected return than the ones the flows permit to be implemented in *B*.

Who is hurt and who is helped? Notwithstanding the global gain, the transfer is harmful to labor in *A* since a smaller capital stock will

reduce labor's marginal productivity and hence wages (a point made salient by Patrick Buchanan in this year's presidential campaign).<sup>1</sup> For parallel reasons, it will be harmful to savers in *B*. The gainers are savers in *A* and labor in *B*. In *each* country, the gains of the gainers exceed the losses of losers since each country is taking advantage of the difference between its domestic ratio of wages to return on capital and the ratio of wages to return on capital abroad by, in essence, importing the factor that is relatively cheaper abroad.

The second reason for cross border capital flows suggested by neoclassical theory is that they permit welfare enhancing reallocations of risk. The most important aspect of this is the potential it creates for greater investor diversification. An investor who takes advantage of this potential significantly reduces the amount of risk she incurs in connection with a portfolio having any given expected rate of return. She can thereby improve the tradeoff she faces between risk and return. This happens because the addition of foreign investments to the set of opportunities in which she can invest results in the opportunities having less in common with each other than before. This reduces the "systematic" component of the risk associated with each available opportunity. The remainder — each opportunity's "unsystematic" risk component — can be diversified away. So the investor can construct a portfolio with the same expected return as before, but with less risk.

This risk allocation reason for cross border capital flows has some interesting implications. For instance, it suggests that the flows will go both ways. This is important politically because it will lead different countries to have more similar perspectives: each will have investors that are hostage to the policies of the others. Also, for the flows leaving countries with a relative abundance of savings to ones with a relative shortage of savings, a smaller portion will be in the form of direct investment, and a larger portion will be in the form of more easily diversified publicly traded securities sold to portfolio investors.

The risk-allocation reason for cross border investing also presents a puzzle: why isn't there more of it? U.S. investors, including professionally managed institutional ones, are still far less diversified internationally than finance theory suggests they ought to be.<sup>2</sup> As a result, they

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1. The world, of course, is more complicated than this simple model. For reasons discussed below, there are capital flows going in both directions. The reaction abroad to U.S. policies that reduce capital outflows would probably result in reduced capital inflows as well. If the reduction in inflows were sufficiently great, labor would actually be worse off than if the policies reducing outflows had not been initiated.

2. Investors' "home market bias," the tendency to underdiversify internationally, has received considerable attention by academics and practitioners. See, e.g., Ian Cooper & Evi

appear to be enduring either substantially less returns or substantially more risk than they could be. The explanation may in part involve a sense on the part of most investors that they are likely to do better investing in issuers about which they have more information despite the admonitions of efficient market hypothesis adherents to the contrary.<sup>3</sup> This sense may or may not be an accurate perception of reality today, but in either case it will decline with increasingly global diffusion of information. Other impediments to transnational investing — the cost and difficulty of effecting transactions in foreign markets<sup>4</sup> and the risks associated with inadequate securities firm capital requirements, clearance and settlement systems, and uncoverable exchange rate exposure — are likely to decline over time as well. For example, Scott and Wellons describe in detail current national and multinational efforts to diminish these risks.<sup>5</sup>

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Kaplanis, *Home Bias in Equity Portfolios, Inflation Hedging, and International Capital Market Equilibrium*, 7 *REV. FIN. STUD.* 45 (1994); Kenneth R. French & James M. Poterba, *Investor Diversification and International Equity Markets*, 81 *AMER. ECON. REV.* 222 (1991).

Cooper and Kaplanis develop a model that suggests empirically that a representative U.S. investor who is risk averse at a conventionally estimated level pays dearly for the home country bias in the composition of her portfolio, receiving an annual rate of return in the range of 2% to 6% less than a portfolio of the same risk level but without the bias. Cooper & Kaplanis, *supra*, at 55–57.

3. The efficient market hypothesis suggests that an investor is not at any disadvantage trading in a security for which he does not know publicly available information relating to its value because such information is already reflected in the price at which he buys or sells. This would suggest that the fact that he knows less about foreign issuers than about domestic ones should not deter him from trading in foreign issuer securities and that for any given number of stocks, the way to achieve the portfolio with the best risk/return tradeoff is to choose randomly from among all the world's issuers.

The absence of anything approaching this kind of international diversification is explained in part by the fact that many investors, whether they should, choose their portfolios on the basis of their own beliefs, not randomly. Those beliefs in turn are based on specialized information not possessed by all participants in the market. Such investors are likely to believe that they will do better by concentrating their buying and selling in equities of issuers about which they and their advisers start with natural information advantages. The futures of most issuers are determined more by forces within the borders of their own nation than by forces occurring outside. As I have developed in more detail elsewhere, residents of a given nation have advantages over foreigners in gaining specialized information about events occurring inside their nations. Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 10–11 (University of Michigan Law & Economics Working Paper Series No. 12, 1996) (on file with *Michigan Journal of International Law*).

Other commentators share the view that home bias is primarily explained by the local nature of much of the information to which people have access. Martin S. Feldstein, *Domestic Saving and International Capital Movements in the Long Run and the Short Run*, 21 *EUR. ECON. REV.* 129, 148 (1983); Robert E. Lucas, Jr., *Interest Rates and Currency Prices in a Two-Country World*, 10 *J. MONETARY ECON.* 335, 357 (1982).

4. HAL S. SCOTT & PHILIP A. WELLONS, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION* 869–81 (1995).

5. *Id.* at 264–90, 391–427, 836–54.

Neoclassical theory assumes a world in which investment opportunities in each country are a given, there is no money, and all resources including labor are fully employed. Powerful insights emerge from the resulting model, but relaxing one or more of these assumptions can suggest additional reasons why cross border capital flows occur, as well as why national governments sometimes want to limit them. For example, a country's investment opportunities are not necessarily a given. In some cases, they may exist only if some needed element is provided from abroad. This might be managerial expertise, technology, marketing channels, brand recognition, or other parts of what is most efficiently structured as an integrated enterprise. In such a situation, depending on the particular patterns of information asymmetries and moral hazard problems, the needed foreign element may not be available unless accompanied by capital from the same source. If so, there must be a cross border capital flow, this time in the form of direct investment, whereby a corporation in one country establishes facilities in another. This reason, too, will lead to two-way flows, for example, U.S. auto companies establishing operations in Europe and European auto companies establishing operations here. The introduction of money and multiple currencies into the model suggests yet another reason, related to the interplay of interest rates and expectations concerning future exchange rates, why investors would want to engage in cross border capital transfers. It also suggests why government officials might want to limit these flows in furtherance of their monetary or exchange rate goals even when such regulations might inhibit the cross border flows motivated by welfare-enhancing investor desires to reallocate risk or capital for real investment. The introduction of possible labor unemployment into the model can, in a country politically unable to use macroeconomic tools to stimulate its economy, undermine neoclassical theory's conclusion that capital outflows to higher return projects abroad produce a net gain to the residents of the capital exporting country.

Knowledge of this larger context in which the institutions of international finance operate is helpful in a number of ways to lawyers, investment bankers, commercial bankers, corporate executives, government officials, and scholars. First, this knowledge makes work in international finance more professionally satisfying because it illuminates the positive social functions served by many of the transactions with which such persons are likely to be involved. On a more practical level, the same kind of calculus helps identify potentially value creating transactions — ones that leave both parties better off — the impediments to which can be overcome by imaginative, new kinds of structuring. An example would be a packaging plan for a previously unsecuritized asset that

would generate a combined cash flow with sufficiently predictable characteristics to permit their securitization and the offering of the resulting securities internationally. By providing a new opportunity for greater diversification, this scheme will lower the cost of financing the assets involved — say, home mortgages — and improve investor welfare at the same time. For an advocate, the calculus provides a source of effective arguments in cases where it shows a public gain from a legal or other governmental decision desired by a client. For judges and legislative and administrative officials, it provides a basis for evaluating arguments that advocates put forward. For the counselor, the calculus helps predict the reactions of governmental agents to a client's proposed actions.

Knowledge of this larger context also helps persons in all of these roles identify trends and calculate who will be helped by them and who will be hurt. One example concerns the large gains that can still be obtained from further international diversification and the probable rapid decline in the impediments that have prevented greater diversification so far.<sup>6</sup> These factors suggest that we will see a massive increase in cross border portfolio investment in the next decade or so.<sup>7</sup> One result is likely to be a great increase in transnational competition among securities exchanges. To the extent that countries determine whether to impose their disclosure rules on issuers based on whether the issuers' securities are offered or traded within their borders, this increased competition will create political pressures that might well lead to a disclosure rule race-to-the-bottom.<sup>8</sup> Another result is the likelihood that most major corporations, whatever their nationality, will, through transnational portfolio investment, eventually become majority foreign owned. This has interesting corporate governance implications. For any given corporation, shareholder expectations concerning what constitutes good management

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6. See Fox, *supra* note 3, at 9–22.

7. U.S. investors currently hold approximately \$7 trillion of the total world capitalization of \$17 trillion. James L. Cochrane et al., *Foreign Equities and U.S. Investors: Breaking Down the Barriers Separating Supply and Demand 1* (New York Stock Exchange Working Paper No. 95-04, 1995) (on file with *Michigan Journal of International Law*). Some commentators predict that U.S. investors will double the foreign component of their equity portfolios from 5% to around 10% within the next few years; this translates into \$350 billion moving into foreign equities. *Id.*

8. Fox, *supra* note 3, at 115–28. Addressing a somewhat analogous issue within our domestic federal system of corporate and securities law-making, Lucian Bebchuk has argued that placing the regulation of corporate disclosure under the authority of state corporate law rather than federal securities law would result in a suboptimally low level of disclosure. Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1490–91 (1992).

are likely to change.<sup>9</sup> Also, the shift in ownership pattern is likely to enliven transnational competition in corporate chartering.<sup>10</sup>

Another example of how this knowledge can help predict trends concerns the mix of methods used to channel capital to promising projects in developing countries. Traditionally, much of this was in the form of direct investment by North American and European corporations. Developing countries, however, found it increasingly offensive that decisions having important impacts on their economies were being made from abroad.<sup>11</sup> With the glut of petrodollars starting in mid-1970s, an alternative form of capital transfer was developed, the syndicated Eurodollar loan. It was popular with developing countries in part because it appeared not to have the foreign control problems associated with direct investment. What should have been apparent at the time became obvious with hindsight: funding promising projects in developing countries with long term loans having rates that float corresponding with changes in short term money markets involves an extraordinarily inefficient allocation of risk. The developing country, the party least able to diversify away risk and withstand what is left, ended up with the riskiest position: a levered claim on the project's residual cash flow. The problem was aggravated by a tendency in the next decade for interest rates to be inversely correlated with that cash flow. Adding insult to injury, the control gains turned out to be illusory since most borrowers became unable to meet their obligations. The resulting workouts gave foreigners, such as International Monetary Fund officials, considerable power over local economic policy.

The obvious alternative is to fund promising developing country projects through transnational equity sales to portfolio investors. This

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9. As more investors from country *A* begin to invest in country *B* companies, the investors from country *A* — who have had most of their prior experience with a corporate law regime different from *B*'s — will carry their expectations with them and affect the investor relations climate for firms in country *B*.

10. As a corporation's shareholdings become less dominated by shareholders from its home country, there may be greater acceptance of a change to a foreign country of incorporation. Whether competition in corporate chartering among states within the United States is good or bad has been the subject of considerable debate. See Bebchuk, *supra* note 8; William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation*, 53 J. BUS. 259 (1980); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORGANIZATION 225 (1985); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

11. See, e.g., ANDREAS F. LOWENFELD, *INTERNATIONAL PRIVATE INVESTMENT* 81-185 (1982) (detailing the history of foreign private investment in Chile's copper industry since the early 1900s); HENRY J. STEINER ET AL., *TRANSNATIONAL LEGAL PROBLEMS*, 455-66 (1994) (describing Mexican expropriations of foreign owned agrarian and oil properties between 1915 and 1940).

form of cross border capital flow combines direct investment's superior risk allocation with Eurodollar lending's supposed freedom from foreign control. While the early 1990s speculative enthusiasm among U.S. investors for emerging market equities has dampened somewhat, impediments to this sort of investment should decline. We can reasonably expect over time the development of credible corporate governance structures for the issuers of this equity, fair and efficient markets for these equities to trade in, and more effective national disclosure regimes.<sup>12</sup> With these developments, there should be a large growth in capital raised in this fashion.

### III. RULES DIRECTLY STRUCTURING INTERNATIONAL FINANCE TRANSACTIONS.

The third kind of knowledge needed to understand the legal environment in which cross border capital flows occur concerns the rules that directly structure the behavior of parties to these capital flows and determine their obligations, rights, and remedies under any given set of terms. Again, Scott and Wellons give this relatively little attention. Indicatively, while there is a large number of questions scattered through the book asking students to give advice to policymakers, there are comparatively few questions asking students to give advice to persons actually engaged in cross border transactions.

The distinctive feature about the rules that govern the behavior of parties to cross border financial transactions is the absence of a single, unitary legal system. Consider three examples of the kinds of problems that arise as a result. The first example involves a German firm offering a new issue of its stock. The offering is handled by some German investment banks who are only contacting investors residing in Europe. During a trip to New York, however, the chief executive makes some enthusiastic statements about the firm's future to a room full of reporters from the world's business press. The statements make their way into the *Wall Street Journal* and, predictably, a certain number of Americans place orders with brokers in Germany for the firm's shares. Should the issue be registered under the Securities Exchange Act of 1933 providing

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12. A number of institutional changes, assisted by experts from the developed capitalist countries, are underway in emerging market countries. See, e.g., Robert Rice, *Business and the Law: Clearing the Way for Capital — A Look at a Model Law to Provide the Basis for Workable Secured Lending Regimes in Eastern Europe*, FIN. TIMES, June 14, 1994, at 20; Emily Barker, *Starting from Scratch*, AM. LAW., June 1994, at 42 (describing efforts of the European Bank for Reconstruction and Development to draft laws dealing with security issues in Eastern Europe).

for disclosure in connection with public offerings? If the answer is yes, would this result have been avoided if the chief executive had restrained himself and not made the statement until he was in front of a similar gathering after his return to Germany even though the same *Wall Street Journal* article would have likely resulted? Suppose that the 1933 Act registration is not necessary but after a year of secondary trading on the Frankfurt exchange and on the "pink sheets" in the United States, 3000 U.S. investors own 52% of the firm's outstanding shares. Is the firm now required to start complying with the periodic disclosure requirements under the Securities Exchange Act of 1934 despite the fact that it has not engaged in any focused attempt to acquire U.S. investors? If it is, what are the consequences of failing to comply? These questions involve issues of jurisdiction to prescribe under international law as well as United States policy on extraterritorial application of its securities laws. They are too new to have generated significant case law, but analogies are available from the United States approaches to the question of statutory reach in the areas of criminal law, choice of law, antitrust law, and the antifraud provisions of securities law.<sup>13</sup> Facility in dealing with these kinds of questions is important for an understanding of the legal environment of international finance since such questions come up in connection with a range of securities and banking activities.

The second example involves an Eastern European enterprise whose shareholders, after privatization, are mostly Western European and North American investors. The enterprise accumulates significant assets abroad in the form of bank accounts, inventory, and sales facilities. A backlash election in its home country puts in power a new communist government that seizes the enterprise's assets in return for some subordinated bonds of questionable value. What are the rights of the Western shareholders? If their rights have been violated, where can they get a judgment? If they get one, how do they enforce it? Have any rights of the United States been violated? If so, are there any remedies available that could help the investors and how likely is it that the United States government will pursue them? These questions involve issues of the obligation to protect alien property and sovereign immunity under international law, treaty interpretation, the United States act of state doctrine relating to judicial deference to executive authority, and the U.S. law of federal jurisdiction. The possibility that such a scenario could in fact occur makes the answers important inputs in calculating

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13. See generally STEINER ET AL., *supra* note 11, at 820-994 (describing the transnational reach of national legal systems).

the risks of investing in shares of newly privatized companies in developing and former communist countries.

The third example involves a Eurodollar loan to a similar enterprise in another Eastern European country. The loan is guaranteed by the government. The enterprise's product is the country's principal export and the market for it becomes severely depressed. The enterprise defaults and the government, citing a severe shortage of hard currency reserves, declares a moratorium on honoring its guarantee. Again, the enterprise has significant assets abroad. The same questions arise as in the second example, with the lenders substituting for the shareholders. The possibility that this scenario could take place again makes the answers important for calculating the risks of making the loan in the first place. Also, at the outset of such a transaction, lawyers representing the various parties would want to know how the terms of the documentation would affect the rights and remedies available to the lenders. The same bodies of law applicable to the question in the second example are implicated here. Assuming that properly drafted documentation does increase a lender's rights and remedies, there is also the question of whether that documentation will really improve the lender's position if the scenario does eventuate, given that the matter almost certainly will ultimately be resolved by negotiation, not litigation. The experience of lenders with differing documentation in the Eurodollar loan workouts in the 1980s would be relevant here.

### CONCLUSION

A law, business, or public policy student entering the field of international finance will have a substantial advantage if she takes a course using the Scott and Wellons book. As a teacher in the area, I was delighted at its publication and intend to assign it to my own students. Most practitioners already working in the field will also find it useful reading since few of them know the range of institutional detail provided by these materials.

The book is insufficiently comprehensive, however, to become the kind of classic that defines a field. Nor, with this limited focus, lack of bibliography, and lack of index, is it likely to become a standard reference work. Nevertheless, it is more than just another casebook. Its clear and concise materials illuminate the often mysterious and arcane details of the institutions of international finance and will open up a world about which many, absent its publication, would have remained ignorant. A future edition with a broadened focus would make the book that much more influential.