

# **Development, the IMF, & Institutional Investors: The Mexican Financial Crisis**

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In this section, we will look at the world of international finance, a world that is becoming increasingly volatile as a result of the growing importance and influence of massive private institutional investors. In addition, we will begin to examine the readiness of the International Monetary Fund (IMF) to step into the financial crises that are driven by the massive capital flows generated by institutional investors as they reflexively flee a country in search of higher returns elsewhere. We will focus on the Mexican crisis of the 1990s as a case study of the various forces at work in international capital markets at that time. It is important to notice two things in assessing the IMF's ability to stem the tide of a financial crisis: (1) the nature of the economic world when the IMF was originally designed and (2) the nature of the international monetary system created in the 1940s.

We will begin with a discussion of the IMF's initial role as post-World War II regulator of currency values. But with the move away from fixed to floating exchange rates in the early 1970s, the IMF had to manufacture a new role for itself. We will then look at the ways in which the IMF began to reassert itself: as an agent of economic surveillance, as lender to developing countries, and as provider of technical assistance to emerging economies.

The section will then turn to the role and impact of giant private institutional investors in the world's market for capital. These institutional investors, despite the benefits they can provide individual investors, manage massive flows of capital that can negatively affect the economies of developing countries. We will describe the Mexican financial crisis of the 1990s as one example of how the institutional investors and their large short-term holdings can leave a country in economic ruin.

The section will conclude with a discussion of how the IMF and the world's major industrialized powers reacted to prevent such crises in the future. Through their summit in Halifax, Nova Scotia, the major industrial countries (the Group of Seven) responded by proposing changes in the ways in which the IMF does its job. The Halifax Summit produced a number of suggestions for reforming the IMF, many of which are now a part of how the IMF operates. As a result of the Halifax Summit recommendations, the IMF adopted new financing mechanisms and new surveillance procedures, resulting in access to

greater public capital sources in times of crisis with the establishment of the New Arrangements to Borrow.

#### *A. The IMF's Role Prior to the 1994-95 Mexican Financial Crisis*

The IMF emerged out of multilateral negotiations in Bretton Woods, New Hampshire following the close of the Second World War. Many of the participants saw much of the political upheaval of the recent past to be a direct consequence of the financial chaos that had preceded World War II. In crafting a new multilateral institution, the IMF's founders sought to regulate the ability of nations to conduct retaliatory trade wars, which in turn could lead to price level instability, unemployment, and international economic disarray. Many of the IMF's principal architects saw the reliability of a fixed exchange rate regime as essential for the long-term expansion of international trade. With this growth in international trade, so it was believed, would come prosperity to a war-ravaged Europe and to the rest of the world.

##### **1. The IMF's Original Mandate was to Supervise Fixed Exchange Rates and to Help Countries Maintain Balance of Payments Equilibrium.**

The IMF's founders wanted the Fund to help countries maintain a sustainable financial position vis a vis their financial transactions with the rest of the world—what experts call "[balance of payments equilibrium](#)." The IMF made short-term loans to member countries experiencing balance of payments crises to help them avoid adopting measures that would harm international trade. Prior to the IMF, if a country wanted to quickly "solve" its balance of payments problems with a trading partner (e.g., the country was not receiving enough income to pay for imports), the country could either impose trade barriers to reduce imports, or it could lower the value of its currency to boost exports. In either case, the balance of payments problem was solved but at the expense of bilateral relations between countries.

The IMF offered a "peace keeping" alternative. Temporary imbalances in a country's balance of payments could be remedied by a short-term loan from the IMF, without altering the official exchange rates the IMF established among member nations. The loan would help the country make internal economic adjustments without breaching its international payment obligations. In this way, the resources of the IMF were available temporarily to every member country to help alleviate balance of payment crises.

The IMF was also the international arbiter of currency valuations under the "par

value" system. According to the Fund's rules (which were not fully adhered to), each country joining the IMF had to establish a par value (setting a fixed value) for its currency in terms of gold or in terms of the United States dollar (which itself was valued in terms of gold). Any subsequent change in a country's par value required the IMF's approval. With fixed exchange rates (currency values), nations were restricted as to the measures they could use to address balance of payments crises.

The IMF's founders were aware of the destabilizing effects that could often accompany private capital movements. In light of this, the IMF's Articles of Agreement required member countries to adhere to rules of convertibility as to current account transactions (*e.g.*, payments in connection with foreign trade) but not as to capital account transactions (*e.g.*, foreign investment). Allowing member countries to regulate the speculative movement of "hot money" would provide another way for government policymakers to regulate balance of payments difficulties without altering the fixed values of their currencies. Convertibility for current account transactions would facilitate international trade, and increase global wealth, while capital controls could keep currency values within the confines of their fixed values.

## **2. The Collapse of the Bretton Woods Par Value System Eliminated a Principal Function of the IMF.**

The most readily convertible currency was the United States dollar. Because of the ease of convertibility, the dollar became the currency of choice for much of international trade. Moreover, the United States' economy was far stronger than the economies of the war-torn countries of Europe and Japan. Over the course of the 1950s and 1960s, the United States dollar became the "reserve currency" under the par value system, meaning that central banks came to hold massive quantities of dollars and that the United States Treasury would, upon request, convert those dollars held by central banks into gold.

During the 1960s, the par value system developed serious strains, especially among the currencies of the large industrial countries, such as Britain, France, Germany and the United States. Short-term capital flows, the kind of "hot money" involved in the Mexican and Asian financial crises, created great upward and downward pressures on major currencies such as the British pound, the French franc, the German mark and the US dollar. These pressures forced countries other than the United States to devalue or revalue their currencies (making them cheaper or more expensive, respectively, in relation to United States dollars).

In the United States' case, everyone knew the dollar had become overvalued. The costs of the Vietnam War and domestic social spending combined with significant outflows of capital led to chronic balance of payments deficits. United States reserves were depleted in the process. The United States government tried unsuccessfully to rectify the problem by imposing capital controls on United States corporations in order to achieve a net reduction in capital outflows and thereby improve the balance of payments. By early 1971, foreign holdings of dollars stood at more than three times the United States stock of gold, the United States balance of payments remained in a deficit position, and the exchange markets had lost confidence in the dollar. Although the devaluation of the dollar could have fixed the problem, United States policy makers refused to accept this option, in part because the par value system made it very difficult for the United States to make effective adjustments to its currency.

Much about the IMF, and the IMF's world, changed dramatically on August 15, 1971. On this date, United States President Richard Nixon unilaterally announced that the United States would no longer automatically exchange foreign holdings of dollars for United States gold reserves. The United States also announced that it would not abide by IMF rules requiring it to buy or sell foreign exchange currencies to maintain the parities between the dollar and foreign currencies. Soon other member countries followed suit and allowed their currencies to "float." Although many observers saw the floats as a temporary response to the current level of speculative capital movements, the change was permanent and marked the end of the fixed exchange rate regime that had long been an integral part of the IMF's mandate.

### **3. The IMF Searched for a New Role to Play on the World's Financial Stage and Moved Toward Greater Surveillance of Member Countries' Economic Policies.**

The next few years were spent trying to revive the international monetary system, and, more pointedly, to revive the relevance of the IMF. Without a par value system of exchange rates, the IMF's principal supervisory role was gone. After long negotiations, the IMF adopted the Second Amendment to the Articles of Agreement, which instituted a wholly different international currency regime from the original Articles. The Second Amendment, which took effect in 1978, allowed each IMF member to choose its own exchange arrangement. Much of what was accomplished in Bretton Woods in 1945 had come undone. The system of fixed rates was replaced by a floating rate system with the major developed countries setting their rates informally amongst themselves and with most other countries pegging their currencies to one of these currencies, or to a basket of

currencies.

With the crash of the par value system, the IMF's principal role had been extinguished. No longer would the IMF's approval be needed before exchange rate alterations. It was now up to the governments of the major industrial powers to decide the values of their currencies. The Second Amendment conceded to the world's currency markets the role of currency valuation, but gave the IMF the power to exercise "firm surveillance" over the exchange rate policies of its member nations. In point of fact, the IMF's surveillance powers were mostly directed at developing countries, while the world's major industrial powers set monetary policies among themselves.

In conjunction with its newly announced surveillance powers, the IMF asserted itself more forcefully into the mechanics of internal economic reforms. In the late 1970s and 1980s, it was the belief of the IMF that the balance-of-payments problems faced by developing countries could not be addressed exclusively by relatively short-term standby arrangements. In response to this perceived shortcoming, the IMF began making loans to developing countries via its so-called "extended facility." Through conditions tied to the use of standby and extended facilities, the IMF became more deeply involved in the structural transformation of developing economies.

#### **4. The IMF (and the World Bank) Took Center Stage During the Debt Crisis of the 1980s.**

In the 1980s, the IMF began to extend its reach even further, now looking at helping countries service their debt obligations. It took a country-by-country approach, whereby it negotiated with all interested parties—private and public—and established adjustment programs to help the country out of its balance of payments crisis. The Fund also negotiated financing arrangements to keep the country solvent. It was the belief of the IMF that private commercial banks had carelessly lent money to developing countries. With this in mind, it insisted that the private commercial bankers help the IMF finance the country's recovery. Without its assistance in the country's recovery, the banks stood to lose a sizable part of their investment. The IMF used this wedge to assure private commercial bank participation.

The crisis arose because developing countries needing to **borrow abroad** turned to international commercial bank lending as a replacement for foreign direct investment (FDI). With the oil shocks of the 1970s, many of the oil producing nations had enormous amounts of United States dollars as a result of skyrocketing prices. These "petrodollars" provided

banks with huge amounts of capital to lend. Many of the Latin American countries took advantage of borrowing opportunities in the 1970s and soon became heavily in debt to these international banks. Unfortunately, many countries defaulted on these obligations and would again need to look to other financial players to fund their post-default expansions.

During the debt crisis of the 1980s, the IMF and the World Bank first helped Mexico and its creditors negotiate a solution. The IMF withheld approval of stand-by arrangements until the commercial bank creditors agreed to deal with Mexico. In addition, the United States Treasury used its power to insure participation by United States commercial banks. This pattern repeated itself with other debtor countries.

#### **5. The Break-up of the Soviet Union Provided Further Opportunity for the IMF to Expand its Mandate and Influence.**

The 1990s saw the collapse of the one-time superpower the Soviet Union. The Cold War had been a drain on the entire Soviet economy and, as a result, the newly independent states (called transitioning economies) were in no condition to jump into the world's free markets. In 1991, at the Houston, Texas economic summit of the heads of state of the Group of Seven (referred to simply as "the G-7" ), the G-7 handed to the IMF the role of leading the industrial world's assistance to the states of the former Soviet Union. Not only would the IMF help channel financial resources to these new countries and their economies, but would now provide "technical assistance" to government officials to help in the development and management of economic strategies.

#### ***B. New Players on the World's Financial Stage: Institutional Investors***

##### **1. The IMF and the World's Financial Regulators Must Now Deal with a New Type of Player in the World's Financial Markets: The Giant Private Institutional Investor.**

The private international capital markets always played a role in world finance. What changed, however, was the size of the investors and the size and speed of the flows of capital into and out of countries. This section will introduce a sample of the various players in the private international capital markets whose influence is expanding in step with the size of the ever increasing holdings around the world. Although there was still substantial FDI, borrowers began looking for an alternative source of capital. And they did so with a vengeance. Institutional, or portfolio investment, went through the roof, increasing more than elevenfold from the late 1980s to 1993.

Portfolio investments are assets in the form of marketable securities (debt and equity) generally held for a short term and generally more liquid than FDI. Portfolio investments can be sold quickly and without any prior notice. With FDI, however, the investor and the company's other ownership interests are linked together for a long term. In return for this stability of ownership, the foreign direct investor receives a degree of influence over the management of a foreign business enterprise.

The share of institutional investment attributable to emerging markets increased dramatically in the 1990s, up 3200% from 1987 to 1993. How much additional capital had institutional investors brought to the world's securities markets? From 1975 to 1993, the total assets of the United States' 300 largest institutional investors (the principal foreign suppliers of capital to Latin America) had grown from \$535 billion to \$7.2 trillion. Up until the Mexican financial crisis in 1995, institutional investors accounted for sixty-six percent of gross capital inflows into Latin America, while FDI accounted for only thirty percent. Many of the institutional investors in Latin America were from the United States, and most of their money found its way to Mexico in response to that country's ongoing economic reforms.

Portfolio investment in emerging markets was significantly more volatile than FDI. For example, while portfolio flows into Mexico went from a net inflow of \$60.8 billion (capital account surplus) in 1994 to a net capital outflow of \$7.5 billion in 1995 (capital account deficit), FDI only fell from \$21.5 billion to \$19.9 billion over the same time span. Despite the "crisis," foreign direct investors still saw the real growth possibilities possible in Mexico. Given that Mexico rebounded relatively quickly from the crisis, the foreign direct investors' long-term strategy appeared to pay off.

**a. Institutional investors take different forms and have different investment strategies, such that some forms of institutional investments may pose greater risks than others.**

Of the various institutional investors, pension funds and insurance companies have been the most prominent players in the capital markets of the developed countries. Although having fewer total assets, mutual funds have grown at a much faster pace than any pension funds or insurance companies. Hedge funds are another important player in the world of institutional investing, yet, because they are largely unregulated, it is difficult to get precise information as to their holdings.

With more and more individual investors turning to managed investment vehicles

(*e.g.*, hedge funds, mutual funds, and pension funds), such large institutional investors make up an even larger part of the investor bases in the world's financial markets. With fewer and fewer decision makers comes greater market concentration of wealth with a corresponding increase in market power.

Each institutional investor is comprised of members (or shareholders) who have bought a share of the institution. Whatever the design of the institutional investor, its goal is the same: maximize members' profits! United States institutional investors easily control the largest pool of funds and U.S. pension funds are the largest of the various classes of institutional investors, which also include mutual funds, hedge funds, and insurance companies. Pension funds and insurance companies have been the traditional leaders of the industrial countries' financial markets. As for international diversification, the mutual funds of Canada, Germany, and the United Kingdom are more diversified than their Japanese or United States counterparts. However, the United States mutual funds appear to be the only ones increasing their international diversification and much of this money finds its way to Latin America.

Turning to the managed investment vehicles, pension funds are financial intermediaries which pool together members' funds for repayment as pensions upon the members' retirements. There are two main types of pension funds that vary according to the distribution of risk between the employee and the employer. In "defined benefit" plans, the sponsor agrees to pay members a pension equal to a set percentage of the employee's final salary. The employer, however, bears some risk in having to top up the fund to keep it in actuarial balance according to the terms of the defined benefit. Defined benefit schemes base the pension benefits received on the level of the member's salary in the last or final few years of employment. This provides the member with protection against inflation and poor investment returns. Even though the employer has been making contributions from the employee's salary over the years, it may not have been enough to satisfy the defined benefits.

By contrast, a "defined contribution" requires no such risk on the part of the employer, as the return to the member is wholly determined by the employee's contribution and the rate of market return. Defined contribution schemes differ in that the employee has no guarantee as to the level of pension actually received during retirement.

Mutual funds are pools of money that are managed by an investment company. Professionals who manage the fund use the pooled contributions to acquire a portfolio of

stocks, bonds, and/or other kinds of securities they believe, based on their research and analysis, will best achieve the fund's objectives. When you buy shares in a mutual fund, you are not buying individual stocks or bonds—you are buying a proportionate share of ownership in the collective portfolio. Some of what the fund earns on its investments is passed on to you periodically in the form of dividend and capital gains distributions; other earnings increase the value of outstanding shares. There are two broad types of mutual funds: closed-end and open-ended.

A closed-end fund initially offers its shares for sale, but then does not issue additional shares and does not buy the shares back. The investment company has a fixed amount of capital to invest equal to the amount received from the initial offering. The shares of the closed-end mutual fund are then traded over an organized exchange with a value determined by investor demand. In contrast, an open-ended mutual fund continuously sells new shares to investors and thus can generate new pools of capital with which to invest. Open-ended funds also redeem their shares by buying them back from investors. Although an open-ended fund has access to a greater supply of investment capital, it can also fall prey to volatile market swings caused by large purchases or redemptions.

A hedge fund is a private investment limited partnership that invests in a variety of securities. There are two types of partners in a hedge fund: a general partner, who starts the hedge fund and the limited partners, who supply most of the investment capital. The general partner is responsible for the fund's trading activity while the limited partners avoid active management positions. For all the services that the general partner provides, the general partner normally receives an incentive fee, usually twenty percent of the fund's net profits. The incentive fee determination will vary from hedge fund to hedge fund and is set out in the partnership agreement. The profits and losses are allocated to all the partners in the partnership based on their percentage ownership.

Hedge funds provide greater investment flexibility because they use financial instruments generally beyond the reach of mutual funds, which are subject to U.S. regulations and disclosure requirements that largely prevent them from using short selling, leverage, concentrated investments, and derivatives. In the 1990s, the number of hedge funds rose by about twenty percent per year and the rate of growth in hedge fund assets was even more rapid. At that time, there were estimated to be 4,000-5,000 hedge funds managing more than \$300 billion. While the number and size of hedge funds were small relative to mutual funds, their growth reflected the importance of this alternative investment category for institutional investors and wealthy individual investors.

In the recent past, the so-called "macro hedge funds" have become more noticeable in their effects on the world's financial markets. Macro hedge funds primarily focus on the opportunities provided by potential currency crises. Because of their ability and willingness to use heavily leveraged investment strategies (i.e., strategies that use borrowed money), the macro hedge fund can take a very large position against a currency while putting up only a fraction of the capital. The risk to the hedge fund is great, but the size of this position can itself begin a run on the currency which then greatly benefits the speculative hedge fund.

**b. Institutional investors make investing safer and easier for the individual investor.**

Why were these behemoth institutional investors so prevalent in the financial marketplace? All investors need to diversify holdings to mitigate market risk. "Market risk" refers to the degree of risk associated with the market for the particular type of investment instrument. Different investment instruments are affected differently by various macroeconomic changes, and thus are at risk under different economic circumstances. A prudent investor, large or small, wants to maximize returns during the "good times," but also wants to guard against catastrophic loss during "bad times." Diversifying a portfolio provides the investor with some protection against various forms of market risk.

The large institutional investor allows a small investor to spread investment capital across a wider range of financial instruments than the small investor could do individually. The small investor would have to pay too much in [transaction costs](#) when spreading only a modest amount of capital over a number of different investments to achieve satisfactory protection from market risk. The large investor pools together an enormous number of small investors and their capital. Measured against the size of this capital pool, the transaction costs of diversification diminish greatly. In addition, institutional investors are managed by professionals with extensive staffs all trained to maximize the returns of the member investors.

**2. Institutional Investors, Despite their Value to Individual Investors, Inject a Large Measure of Instability and Chaos into the World's Financial Markets.**

The small investor poses little danger to the market, or even to a particular stock, because the investor's percentage of ownership is so small. Even the sale of a small investor's entire holdings in a modestly sized publicly traded company will not trigger a sale of the stock. By contrast, large institutional investors can cause large price swings in a particular stock with a large purchase or sale. A large investor's sale of a sizable holding in a

publicly traded stock can potentially trigger sales by other large investors as the other large investors might surmise that the investor selling off the holdings has some information indicating the under-performance of the stock. Even if the company does not suffer from some mysterious malady (*e.g.*, low earnings), such large sales can lead to self-fulfilling prophecies as sale after sale creates the impression that the stock is in trouble.

**a. Institutional investors can wreak havoc when exhibiting herding behavior.**

Investors in any financial instrument, upon seeing other investors behaving a certain way with respect to a particular investment, frequently act in the same way based only on the fact that those other investors are behaving the way they are. There are at least two possible explanations of this "herding" behavior.

One explanation focuses on an investor's belief that some other investors have "private information." This belief can be so strong that it can even overpower the investor's own positive private information. For example, if investor *X* has private knowledge that a particular company is doing well, then investor *X* is likely to hold on to that company's stock. If investor *Y* has private knowledge that the same company will probably announce layoffs in the near future, then investor *Y*, although not selling the stock, might be looking for another reason to sell. Investor *Z* has personal knowledge that the company and its officials will be indicted by the government. In response, *Z* sells all equity interests in the company. Now *Y* has that added reason to sell the stock. And *X*, although in possession of only good private knowledge, also sells because *Y* and *Z* have both sold their interests. In this way, a run on a financial instrument can begin with a small number of large investors privy to negative information.

The second explanation looks at who actually makes the investment decisions. As is the case with all institutional investors, the principal (a shareholder or member) does not make specific investment decisions. The institutional investor has a trained manager making the investment decisions. When a fund manager sees other funds pulling out of an investment (an instrument or a market), that fund manager has a greater incentive to join in the departure than to stick out the investment. Why? If the manager is wrong, and the investment suffers no decline in value, then the manager has performed no worse than the other managers who also pulled out of the investment. By contrast, had the manager stayed and the investment suffered a precipitous decline in value, then that manager would have under-performed as compared to the managers who rightly pulled out. Why do things work

this way? Fund managers are compensated, in large part, on how they perform as compared to other fund managers. The manager, despite private information that an investment is not in trouble, still risks more by sticking it out than by liquidating and finding another investment opportunity.

**b. Institutional investors can affect the value of a developing country's currency simply because of the sheer size of their investments.**

The institutional investor has a darker side when it comes to developing or emerging capital markets. Because of their size and the size of their holdings, foreign institutional investors can affect the macroeconomic realities in emerging economies. They can cause distortions in the value of a country's currency, in the value of the exports and imports relative to the country's trading partners, and they can ultimately lead to the collapse of that country's financial system.

The foreign institutional investor can create difficulties because of the size of its capital inflows into an emerging economy. This is because a large influx of foreign capital can affect the value of the domestic currency. If the value of the domestic currency "floats," then currency traders will pay less for the currency as its supply increases. If the value of the domestic currency is "pegged" or fixed to the value of a foreign currency, then an increase in the money supply will not be met with a change in i.e. lowering of the traded price of the currency. The greater the disparity between the fixed value of the currency and the perceived "true" value of the currency, the greater the potential for attacks on the currency by currency speculators.

Large capital inflows from institutional investors can also lead to "overvaluation" of the domestic currency that is fixed or pegged. The currency's inability to lose value means that the overvalued domestic currency can purchase more imports than it otherwise could. At the same time, the country's exports will suffer because the overvalued currency will make them expensive for consumers abroad. Increased imports combined with decreased exports may lead to troublesome deficits in the country's current account.

The institutional investor can also wreak havoc by creating large capital outflows of foreign capital from emerging economies. When an institutional investor decides to remove its investment from an emerging economy it can further exacerbate the destabilization of the domestic currency. How? The institutional investor sells its investments and receives domestic currency. The investor then converts the domestic currency into the appropriate foreign currency. The institutional investor then leaves with the foreign currency. As a result

of this capital exodus, the host country's foreign currency reserves are depleted. If the currencies are pegged and the peg does not reflect the true economic position of the two currencies, then the host country has parted with more foreign currency than it otherwise should have. As a result, there is a crisis in confidence among those people and institutions holding the domestic currency. To assuage their fears, these holders of domestic currency and instruments denominated in the domestic currency convert their holdings into the "harder" currency making up the Central Bank's foreign reserves. A "hard" currency is a currency that has a stable value and a sizable trading market in the world currency markets. The United States dollar, the British pound, the German mark, and the Japanese yen are all examples of hard currencies.

Secondarily, with the loss of these foreign currency reserves, the host country will then have difficulty servicing those debts (long- and short-term) denominated in the foreign currency. To attract more foreign currency reserves, the host country might raise interest rates as a means of making investment more attractive. However, increasing interest rates can have other effects which do not best serve the economic interests of the host country. For example, increasing interest rates makes borrowing more costly, thereby lowering investment in the economy. This, in turn, leads to an economic slowdown.

### ***C. CASE STUDY: Institutional Investors First Demonstrated Their Destabilizing Power in the Mexican Crisis of the 1990s***

This section will explore the first major crisis of the recent past where large institutional investors left an economy and currency in ruin. The crisis itself surprised most observers of the world's financial markets, including the IMF. After the damage had been done, the United States and the IMF had to "rescue" the Mexican economy from total collapse. Consider whether there needs to be some regulation of the large destabilizing capital flows that helped bring Mexico to her knees, or if better international surveillance of Mexico's economic condition could have helped deter such massive capital outflows.

#### **1. Mexico Looked to Institutional Investors Because it had Only Recently Emerged from a Debt Crisis Involving Private Commercial Banks.**

The Mexico of the 1990s owes much to its recent past. In the 1980s, Mexico suffered a significant debt crisis which forced certain macroeconomic and regulatory changes that led, at least in part, to the crisis in the 1990s. Inflation averaged nearly 70 percent annually, including two years when inflation rose at greater than 100% (1987 and 1988). Consistent with Mexico's traditional trade policies, the 1980s began with import

tariffs set at very high rates. Many of Mexico's major industrial sectors were government-dominated monopolies and this trade approach seemed to serve the government's interests by eliminating foreign-based competition.

Mexico was then shouldering a staggering level of external debt, predominantly to large foreign commercial banks. As much of Mexico's industry was then state owned, many of these loans were to the Mexican government directly. The loans carried floating interest rates which skyrocketed during the United States' recession of the late 1970s and early 1980s. Consequently, the level of Mexican debt was so high that the payments to service the debt (outflows) exceeded the revenue from exports (inflows).

As the world economy began to fall into recession, world trade declined. In addition, many countries passed legislation to protect their own industries and economies. As a result, Mexican exports had greater trouble finding buyers. Mexico also struggled to find new sources of foreign capital, even as capital escaped its borders. Mexico's high inflation rates and high fiscal deficits limited the types of fiscal (tax and spending) and monetary (money supply and interest rates) policies available to the Mexican government to stimulate new growth.

Despite the best of intentions, [negotiated efforts](#) failed to alleviate Mexico's debt crisis. In response to this failure, the Brady Initiative attacked the problem by encouraging negotiated reductions in both the principal and the interest of outstanding debt obligations. This coincided with a growing reluctance on the part of the world's commercial banks to extend Mexico any more credit. The "credit crunch" left Mexican industry searching for new and inexpensive sources of capital to fuel its economic engines.

## **2. Institutional Investors Provided Mexico a Steady Supply of Capital to Drive Mexico's Renewed Economic Success.**

In the late 1980s, Carlos Salinas became President of Mexico. As a firm believer in free markets, President Salinas privatized nearly all of Mexico's state-owned industries. These "new" private companies turned to the growing Mexican equities market. As an illustration, portfolio investment increased from an annual average of \$5.4 billion for the period 1986-90 to \$67.9 billion in 1993 alone. In sum, Mexico reduced its dependence on credit debt by turning to equity financing. This level of equity financing in an emerging economy, as was about to be seen, was not without its own risks.

For the most part, the Salinas reforms were a success. Investment in Mexico surged.

In contrast with Mexico's past policies, tariff rates were set low. In the years 1990-93, Mexico's healthy economic growth averaged more than 3.5% annually. With favorable import prices, merchandise imports soared. As a result of its strong economic growth, Mexico restructured its debt so that it now took only thirty percent of export revenues to service the debt. With the dramatic rise of merchandise imports, Mexico's current account trade deficit reached eight percent of its GDP in 1994.

As sources of capital saw Mexico as a more stable and "user friendly" environment, they increased their holdings of Mexican stocks, all the while bringing more and more capital into Mexico. To make Mexico an even more attractive investment location, the Mexican government instituted a trading band on the peso with the dollar (meaning the value could move within preset limits). This meant that the Mexican government would exchange pesos for dollars or dollars for pesos at a set rate. This transferred any risk of changes of currency value from the investors to the Mexican government. By fixing the value, the Mexican government would not let the markets lower the value of the peso, even if such devaluing would have been an appropriate response to Mexico's changing money supply. As a result, the peg increased investor confidence and more capital found its way into Mexico.

**3. A Currency Crisis Developed as Institutional Investors Pulled their Money out of Mexico, and the Mexican Government then had to Devalue the Mexican Peso.**

With the inflows from these giant private institutional investors came changes in Mexico's underlying economic condition. Slowly, Mexico moved towards devaluing its currency - the peso. The gains Mexico had made since the debt crisis of the 1980s were slowly coming undone.

**a. The Mexican crisis shows how, in a world of giant institutional investors, balancing an account deficit with a capital account surplus can mask trouble.**

The dramatic influx of foreign capital had potentially debilitating effects. Because of the increase in the domestic money supply and the peg to the dollar, Mexico's money supply increased without a corresponding decrease in the value of the peso. An overvalued peso increased imports and decreased exports. When a country spends more on imports than it receives in export proceeds, it is said to have a "current account deficit."

Simultaneously, Mexico financed this current account deficit with a massive surplus

in its "capital account." This meant that Mexico was attracting more capital into the country than it was exporting. So long as Mexico had this capital account surplus, the current account deficit could be sustained without too much fear of a balance of payments crisis. However, the increase in the Mexican money supply fed inflation. The overvalued peso began to strain its peg to the United States dollar. As peso-holders began to speculate that the peg was so far askew from economic reality that the government must devalue the peg, they exchanged their pesos for the far more stable dollar. These speculative exchanges depleted the Central Bank's foreign currency reserves. This cycle then fed upon itself. The more pesos that were exchanged for dollars, the less stable the peg became, as holders of the domestic currency feared that the government would run out of the hard currency and they would be left holding worthless paper. As a result, still more people exchanged pesos for dollars, which, in turn, weakened the peg further and nearly erased the Central Bank's foreign currency reserves.

Mexico also faced an uncertain political future with the assassination of the ruling party's presidential candidate, Luis Donaldo Colosio, in March of 1994, and the assassination of the ruling party's number two man, Jose Francisco Ruiz Massieu, in August of 1994. The ruling party, particularly in the figure of Finance Minister Pedro Aspe, had committed itself to maintaining the peg at all costs. The fear of a ruling party loss in the upcoming elections, or even through uprising, meant ever-declining belief in the viability of the peg. Although the ruling party survived the August elections, the beginning of Ernesto Zedillo's presidency witnessed violence in Chiapas in December of 1994. Uncertainty as to how President Zedillo would react prompted the early stages of "capital flight" from Mexico's private capital markets. Exacerbating the situation, Mexico's reserves of hard currency (dollars) had dwindled from \$25 billion at the beginning of the year to \$6.5 billion at year's end.

**b. With their size and prominence, institutional investors had an inordinate amount of political clout in Mexico.**

Because of the size of their investments, institutional investors could demand access to Mexico's policymakers. With Colosio's assassination, the peso began to show significant weaknesses against the dollar. As one response, a New York investment bank called the Weston Group (which specializes in peso investments on behalf of investors such as Fidelity Investments, Solomon Brothers and George Soros) arranged a private meeting with Mexico's Undersecretary of Finance Guillermo Ortiz and Central Bank officials to discuss Mexico's economic "situation." After the meeting, the institutional investors made it clear to

the Mexican government that continued capital inflows would be in jeopardy without Mexico issuing \$5 billion more in Tesobonos. A Tesobono was a government security that essentially guaranteed the institutional investors that they would not lose money if the government devalued the peso.

In anticipation of a second investor-led meeting, some large institutional investors refused to make further investments in the Mexican market. Almost immediately, short-term interest rates soared to 18% and the stock market tumbled by more than 5%. At the conclusion of this second meeting, Mexico initiated a peso rescue mission similar to that proposed by these influential institutional investors.

**c. As capital fled, Mexico was left with no choice and had to devalue the peso.**

The Mexican government finally devalued the peso on December 20, 1994. To devalue, a government simply states that it will no longer purchase its own currency in exchange for a foreign currency at the previously announced exchange rate. The government could then announce a new peg or it could simply let the currency float in the world currency market. The Mexican government chose a new peg. The rate changed from MexN\$3.4172 to MexN\$4.0016 pesos per dollar. This amounted to a 12% devaluation of the peso.

Unfortunately, many holders of pesos did not believe that this new peg could survive. As a result, more capital fled the country as institutional investors dumped their peso-denominated equities before another anticipated devaluation of the peso. On December 22, 1994, the Mexican government was again forced to devalue the peso and let it float. By March of 1995, the peso was trading at MexN\$7.45 pesos to the dollar.

Mexico had clearly depended too much on the capital of institutional investors. In 1994, foreigners bought 40% of Mexican treasury notes and held stocks accounting for 30% of market capitalization (where market capitalization is equal to the total current trading value of each outstanding share of stock multiplied by the current trading price of the stock.) When this significant sum of money left the country in anticipation of a devaluation, it left Mexico short of capital to run its affairs and short of currency reserves to meet its financial obligations. Together with this capital flight, Mexico's devaluation of the peso crippled the Mexican economy.

***D. Rescuing the Mexican Economy From the Crisis of 1994-95***

## **1. The U.S. Led the IMF Effort to "Save" Mexico and the Free-Market Model of Development.**

What was the world to do? The world, it turned out, did nothing. That is, until the United States told the world of the deal it had already worked out with the IMF. To the dismay of the IMF's other large industrial members, the IMF was ready to commit the largest bailout package ever, and without prior consultation. Moreover, many countries objected to the proposed conditions on the use of the funds as too weak. Despite their initial objections and, in the case of many, their abstentions, the IMF package was approved and the United States' plan took effect.

The United States government organized a multilateral assistance package to the Mexican government with financial commitments approaching \$50 billion dollars. The United States government committed nearly \$20 billion dollars to the rescue package, while the IMF contributed another \$18 billion dollars. Regional banks and other governments contributed the balance. The principal aim of the package was to ease the liquidity crisis in Mexico by converting its short-term debt obligations to long-term debt. Other, and perhaps more important, goals of the rescue effort were to restore investor confidence in the long-term prospects of the Mexican economy, and to reassure countries with economies similar to Mexico's that the free-market model of development was still viable.

## **2. The United States and the IMF Provided Short-Term Credit to Help Solve the Liquidity Crisis.**

As you may recall from the discussion of the origins of the crisis, the Mexican government accumulated an enormous amount of short-term, dollar denominated debt by issuing Tesobonos. Simply stated, the Mexican government owed a lot of people a lot of U.S. dollars, and it was obligated to fully repay its creditors in a short amount of time. In attempting to fight off the speculative assault on its peso-dollar peg, the Mexican government spent almost all of its reserves. After the peg collapsed, the peso instantly lost nearly 25% of its value, making it much more difficult for the government to purchase dollars with pesos. The net result was that Mexico's creditors were owed dollars that the Mexican government simply did not have.

The United States government and the IMF put together a multi-tiered rescue package to alleviate the liquidity crisis in Mexico. The aim of the plan was to convert Mexico's short-term debt into long-term obligations, which could be repaid gradually. Initially, however, Mexico needed a cash injection so that it could meet its obligations, and

so that confidence could be restored in the short-term stability of the Mexican economy.

With this initial goal in mind, the United States extended nearly \$15 billion dollars to the Mexican government by entering into short- and medium-term currency swap agreements. A currency swap of this sort is an agreement between two countries to exchange their currencies at a specified amount, and then to reverse the transaction at a later date. In this case, the United States agreed to give dollars to the Mexican government (because it needed dollars to meet its Tesobono obligations) in exchange for pesos. Three months to a year later (depending on whether it was a short- or medium-term swap), the Mexican government would give the United States dollars in exchange for pesos. The Mexican government would also have to pay an interest charge for the "use" of the dollars.

Meanwhile, the IMF and the Mexican government entered into a stand-by arrangement which, in part, provided Mexico with an immediate cash injection (Special Drawing Rights). Of the nearly \$18 billion in total IMF commitments, almost \$8 billion was available immediately after the agreement was concluded. The other \$10 billion was conditioned on Mexico's meeting certain economic performance criteria—a method termed "conditionality." Those criteria were part of an extensive economic reform package which the Mexican government agreed to implement as a condition of receiving the IMF's assistance. The reforms required by the IMF included reduced government expenditures, increased interest rates, and further privatization of state-owned industries.

Ultimately, Mexico was able to survive its liquidity crisis without having to default on its debt obligations. However, the conditions imposed by the IMF, coupled with the economic disturbance from the peso devaluation, created severe economic hardship throughout the first half of 1995. In order to prevent continued economic (and potentially political) instability in Mexico, in Latin America, and indeed throughout the world, the rescue package also included a plan to allow Mexico to return to the global financial markets and demonstrate its financial strength. The United States and the IMF wanted Mexico to recover quickly and effectively, to reassure the developing countries of the world that the "free market" model Mexico had adopted was still viable, and in fact desirable.

### **3. The United States' Plan Attempted to Return Mexico to the International Financial Markets.**

At the same time the United States and the IMF organized their plan to resolve the liquidity crisis in Mexico, a plan was conceived to convert Mexico's remaining short-term obligations to long-term debt, and in the process demonstrate Mexico's financial strength to

the world. With this goal in mind, the United States agreed to guarantee long-term Mexican government bonds which were to be sold in the international financial markets. In other words, the Mexican government sold bonds to investors in the international markets, and those investors were guaranteed that, in the event the Mexican government was unable to make payments on those bonds, the United States government would meet the outstanding obligations. This guarantee reduced, if not wholly eliminated, the risk of default to potential buyers and allowed the Mexican government to issue its bonds (and thereby acquire the bond-purchasers' money) at a much lower interest rate.

The United States made this guarantee to back the Mexican government, but it also negotiated itself a mechanism to recoup any losses it might incur in the event of Mexican default. If Mexico was unable to make its bond payments and the United States was stuck holding the bill, then the Mexican government agreed to pay back the United States with proceeds from Mexican oil sales. Mexico's state-owned oil company, PEMEX, was required to report financial data to the United States Treasury so that it could be assured that oil revenues would be sufficient to satisfy potential United States obligations.

The net effect of this portion of the overall rescue package was that Mexico was able to quickly return to the international financial markets to start rebuilding its reputation as a successful and stable country in which to invest. The success of these bond offerings allowed the Mexican government to rebuild its foreign reserves and allowed it to pay off its more expensive and shorter-term debt. With the goal of ensuring Mexico's "normal" return to the capital markets, the Mexican government agreed to continue its faithful implementation of the austere reform package designed by the IMF. These reforms were designed to eliminate what were seen as the critical structural defects in the Mexican economy and its financial system. If these problems were solved, the investors that had recently and hurriedly abandoned Mexico would hopefully return and fuel Mexico's future economic development.

#### ***E. The IMF's Post-Crisis Adjustments***

The speed at which foreign institutional investors fled the Mexican stock market, and the severity of the crisis resulting from the peso devaluation, convinced the IMF that it needed to adjust to the new realities of the global economy. Throughout 1994, the IMF had failed to adequately monitor the financial situation that ultimately devastated the Mexican economy. A United States Government Accounting Office Report contains the IMF's admission that it relied on outdated and inaccurate financial data provided to it by the

Mexican government throughout 1994. To help prevent future crises, the IMF was convinced that it needed access to more and better information from member governments. It was also mindful that if crises such as the one that befell Mexico erupted elsewhere, it would need the financial resources to adequately address those situations. It was unlikely that the United States would contribute significantly to future crises. Mexico, after all, was a major United States trading partner, and a prolonged crisis there could have had serious economic and political implications for the United States. With these concerns in mind, the IMF began to consider the adjustments and improvements to its own operations required by the new realities of the global economy.

In June of 1995, the leaders of the G-7 held their annual meeting in Halifax, Nova Scotia. The Halifax Summit was the first occasion for all these leaders to get together since the IMF's adoption of the Mexican bailout package. The Summit's participants all realized that the world's financial markets were no longer anything like those in existence at the inception of the IMF. As a result, they believed that changes had to be made in the way the IMF operated, or there would be little chance of stemming the tide of future crises. These countries called for a number of reforms, including enhanced surveillance to provide early warnings of crises, additional financial mechanisms to help the IMF respond, and a new borrowing arrangement for the IMF to quell fears that the IMF's current holdings were insufficient to respond to crises of the modern financial markets.

### **1. The IMF Instituted Special Data Dissemination Standards to Gather Consistent and Reliable Information about the Workings of Member Countries' Economies.**

The Mexican crisis of the 1990s prodded the IMF to strengthen its surveillance efforts. To this end, the Fund began a drive toward more timely promulgation of vital economic information. The IMF identified certain core economic indicators (e.g.: exchange rates, international reserves, central bank balance sheet, reserve money, broad money, interest rates, consumer prices, external trade, the external current account balance, external debt/debt service, the fiscal balance, and GDP/GNP) and encouraged monthly reporting by all of its member countries. It instituted its Special Data Dissemination Standards (SDDS) as the means by which member countries can voluntarily disclose vital economic information to the Fund and to the world's financial markets. The IMF also created the Dissemination Standards Bulletin Board (DSBB), which discloses the SDDS information to the public. The Fund maintains the DSBB at its World Wide Web site.

The data dissemination standards have two components: general data dissemination

standards aimed at providing guidance to member countries as to how best to publish economic data, and the special data dissemination standards (SDDS) aimed at successfully leading countries into the international capital markets. As for the substance of the information, the IMF chose what it believed to be the "basic data that are most important in shedding light on economic performance and policy." The IMF encouraged countries to go beyond this basic data in their attempts to create greater transparency in international capital markets.

For countries seeking access to the private international capital markets, the SDDS will allow private investors to more accurately assess the risks associated with particular countries, such that the "proper" levels of capital flows move across borders. As for the countries themselves, it is hoped that the private international capital markets will begin to "require" such voluntary reports as a condition of favorable credit terms, or before extending more FDI or portfolio investment. As this timely and comprehensive information becomes more readily available, it is hoped that countries will improve the functioning of their macroeconomic policies to assure the accuracy of the volunteered information.

## **2. The IMF Changed its Surveillance Procedures and Introduced an "Emergency Financing Mechanism" in Response to its Failure to Detect the Onset of the Mexican Financial Crisis.**

The IMF also began to make its surveillance more "continuous." Annually, or occasionally biannually, the IMF goes to its member countries and engages in what are called "Article IV consultations." During an Article IV consultation, staff members travel to the member country and collect economic and financial information and then discuss the country's recent economic developments and potential trends for the future. The staff then prepares a report to be used in the Executive Board's discussions. At the conclusion of the Executive Board's deliberations, the Managing Director of the IMF (the Chairman of the Executive Board) summarizes the views of the Directors in the Fund's Annual Report.

To enhance its surveillance, the IMF began to supplement its Article IV consultations with interim staff visits aimed at gathering information and consulting with member countries in light of trends which seem to indicate emerging financial difficulties, the likes of which might require later IMF intervention. In this vein, the IMF will pay greater attention to capital account developments. And to the degree to which member countries have the potential to generate "spillover" effects, the IMF will more closely follow economic trends.

The IMF also established an Emergency Financing Mechanism aimed at providing rapid responses to the world's future financial crises. Limited only to "exceptional circumstances," the emergency financing mechanism would enable the IMF to facilitate rapid Board approval of well-conditioned financial support. This would have special significance in avoiding spillover effects which could collapse an entire region of the world's economy in a mere matter of days. To qualify for such emergency assistance, the member country must be willing to enter into immediate negotiations with the IMF with a genuine commitment to early implementation of the ensuing agreement.

**3. At the Urging of the World's Financial Community, the IMF Adopted New Arrangements to Borrow to Better Enable the Fund to Respond to Future Crises.**

The New Arrangements to Borrow (NAB) is a lending facility that provides the IMF with greater access to capital in the event that a country's crisis requires more help than the IMF standing alone can give. It was the fear of many at the Halifax Summit that the IMF would not be able to successfully intervene in a country's crisis to prevent the entire region surrounding the crisis from collapsing. The IMF had then been operating under the General Arrangements to Borrow (GAB), which gave the Fund access to borrow from the central banks of eleven countries, under exceptional circumstances. The GAB gave the IMF access to SDR 17 billion, with the approval of the GAB's participant countries. The NAB will double the amount of SDRs available in a crisis to 34 billion available in a crisis (approximately US\$48 billion) and broadens the base of participating countries to twenty-five. It is the hope of the IMF and its supporters that the NAB will allow the IMF to step more quickly and more decisively into a large impending crisis.