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THE MEXICAN CRISIS: WHO SHOULD BE A COUNTRY'S LENDER OF LAST RESORT?

*Cynthia C. Lichtenstein**

It is possible to view today's Mexican peso crisis as once again proving that there is nothing new under the sun. In 1870, Walter Bagehot, then editor of the *Economist*, wrote a "little" book on the money market of England, advising the Bank of England, on how to deal with both domestic panics (lend) and foreign capital flight (raise the bank rate).¹ Bagehot could not have imagined imposing exchange controls as England would have immediately ceased to be the commercial center of the world.

After World War II, the same nations that met in San Francisco to try to prevent the use of force for the resolution of conflict met at Bretton Woods in New Hampshire to try to ensure that nations should never again resort to trade-devastating exchange controls to try to deal with monetary disorder. Those arrangements, including the International Monetary Fund ("IMF") Agreement,² in addition to providing for multilateral oversight of exchange controls and encouragement of a return to convertibility of currencies, set up a pool of currencies to which a country experiencing an exchange crisis could turn. However, in contradistinction to Bagehot's advice for bank runs — to restore confidence by providing liquidity, lots of it, immediately — Fund aid from the pool took, and takes, a considerable period of time to negotiate between the needy country in crisis and the other countries represented on the Board of the Fund. Thus, since 1945, international monetary history has seen a number of interim rescues, providing temporary liquidity to

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1. WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* (Arno Press 1978) (1915).

2. Articles of Agreement of the International Monetary Fund, 60 Stat. 1401, 3 Bevans 1351 (1945), as amended by 20 U.S.T. 2775, T.I.A.S. No. 6748 (1968) and 29 U.S.T. 2203, T.I.A.S. No. 8937 (1978).

the country in crisis until the longer term aid from the Fund (or other forms of restructuring) can be worked out. The interim rescues have been orchestrated by the central banks of the industrialized nations, orchestrated without a formal legal structure, but with a gentleman's agreement that the amount to be contributed by each to any such rescue will be agreed on a case-by-case basis.³

Even the fact that the latest major U.S. trading partner to be involved in an exchange crisis is Mexico is not new. Recall that it was only in 1982 that there was a "rescue" of Mexico led by the United States when the then Mexican Finance Minister came to Washington and revealed that Mexico would be unable to repay to the private international banking consortiums from which it had borrowed the dollar obligations then due. At that time, the possibility of letting a major Latin ally with whom the United States shares a 3000 mile border "default" was regarded as impossible. Temporary short term financing, both from United States agencies and from the BIS central banks, was arranged literally overnight.⁴ The financing restored liquidity until the private banks could be persuaded by the international community and, especially, by the International Monetary Fund and by the U.S. Treasury to reschedule their loans so as to give the Mexican economy additional time to cope with its indebtedness. This particular story was then followed by a number of other Latin American countries, with the entire episode being called the "Latin debt crisis."⁵ It may also be recalled that Mexico was the first of the countries so indebted to international banks to be able to grow its way out of the debt and to return to the private capital markets. Thus, Mexico has been touted as the "golden boy" of economic reform, structural readjustment, and privatiza-

3. The industrialized countries, the so-called G-10, have been meeting regularly to discuss international monetary cooperation since the early 1960's at the Bank for International Settlements in Basle. Since that time, rescues have been quietly coordinated from there. For a history of such rescues by a Treasury official involved often in the Basle meetings, see P. LISLE WIDMAN, *MAKING INTERNATIONAL MONETARY POLICY* (1983) and RICHARD W. EDWARDS, *INTERNATIONAL MONETARY COLLABORATION* (1985).

4. Congressional hearings held subsequently provide the best source of information on how the U.S. financed its portion of the rescue. For authority on the BIS central banks' participation, see DEANE & PRINGLE, *THE CENTRAL BANKS* 104 (1994).

5. For a history of the debt crisis up to 1994, see LOWENFELD, *INTERNATIONAL MONETARY LAW* (2d ed. 1984). For the U.S. response to its private banks' participation in the lending, see Cynthia C. Lichtenstein, *The U.S. Response to the International Debt Crisis: The International Lending Supervision Act of 1983*, 25 *VIRG. J. OF INT'L L.* 401 (1984).

tion⁶ in the new economy of the 1990's.

Nevertheless, there are some interesting differences between this Mexican debt crisis and the events of 1982. First and foremost, the 1982 crisis, as all post-World War II developed country or newly industrialized country exchange crises, was handled quickly and without large amounts of media attention through use of diplomacy and short term "bridge" multilateral aid.⁷ As noted above, the 1982 Mexican rescue not only involved bridge loans from the G-10 central banks, but the U.S. Treasury Department rounded up the lion's share of the moneys necessary to tide Mexico over until the IMF loan and the bank reschedulings could be put in place by utilizing a combination of Federal Reserve Bank swaps, the Exchange Stabilization Fund, and the interesting device of prepaying to Mexico the Defense Department purchases of oil for oil stockpiling. The real point here, however, is that the whole package was put together virtually overnight.

In contrast, in December 1994, when Mexico once again faced the prospect of default, this time on government obligations that it had issued on the capital markets and that were payable in dollars, the Clinton Administration announced a US\$40 billion program of guarantees for which it determined it would need congressional approval. The markets were hardly calmed by the news that a rescue would be mounted if both Houses of the U.S. Congress voted in favor. The process of "rescue" was delayed into February when, finally realizing that the congressional approval might not be forthcoming, the Clinton Administration "organized" and announced on January 31 to the media a multilateral rescue to which the United States would contribute the US\$20 billion the executive could scrape up without congressional approval. The Clinton Administration also bludgeoned the International Monetary Fund into announcing a standby credit to Mexico of an unprecedented amount (600 percent of Mexico's quota) and persuaded the central bank partners in the BIS to increase the previously agreed upon contribution of US\$5 billion to US\$10 billion.⁸ Last, the signing on Feb-

6. See Anthony DePalma, *U.S. Aid Plan Is Hardly a Cure-all*, N.Y. TIMES, Feb. 23, 1995, at D5.

7. See *supra* note 3.

8. For a complete description of the process — or lack of process, as the case may be — by which the G-10 central banks and the IMF were folded into the eventual rescue

ruary 21 of the actual accord between Mexico and the United States for the newly-coordinated rescue was so delayed that a member of the Mexican Finance Ministry announced that the original Mexican plan for restructuring could no longer be considered viable because the situation had changed considerably since December.⁹ As this is being written, the signing of the accord seems to have calmed the markets, and the peso is no longer in freefall, but it is not possible for anyone to say whether or not the promised US\$50 billion will in fact buy time for Mexico to put its economic house in order.

Is the present lack of confidence in Mexico's capacity to stand up and walk again due solely to these delays? Presumably not. It is possible also to distinguish the handling of this Mexican exchange crisis in two other ways. In 1982, while Mexico was able to not default on its private bank borrowing, it did stem the excruciating outflow of capital by the immediate imposition of exchange controls.¹⁰ For Mexico, which had always prided itself on the convertibility of the peso, the imposition of the exchange controls was at that time an innovation. The banking system was also temporarily nationalized. Here it must be noted that under the *international rules of the game* for exchange controls, the International Monetary Fund Agreement, the imposition of exchange controls to deal with a temporary exchange crisis is permissible.¹¹ If the exchange controls are imposed on *capital* movements, the Fund Agreement does not apply in the first place and members of the Fund are free, in the legal sense (unless otherwise restricted by other treaty obligations), to restrict capital flows into and out of the country in their discretion.¹² If the controls to deal with the crisis are imposed on exchange for what are called "current transactions" (roughly, exchange for trade in goods or services), then the Fund's approval must be received,¹³

package, see George Graham et al., *Mexican Rescue: Bitter Legacy of Battle to Bail Out Mexico*, FIN'L TIMES, Feb. 16, 1995, at 4 [hereinafter *Mexican Rescue*]. See also Douglas Jehl, *Mexican Rescue Plan: A Chronology; Slow Building Despair Led to Decision on Aid*, N.Y. TIMES, Feb. 1, 1995, at 16A.

9. Anthony DePalma, *Economy Reeling: Mexicans Prepare Tough New Steps*, N.Y. TIMES, Feb. 26, 1995, at 1A.

10. Stephen T. Zamora, *Peso-Dollar Economics and the Imposition of Foreign Exchange Controls in Mexico*, 32 AM. J. COMP. L. 99 (1984).

11. I.M.F. Agreement, *supra* note 2, art. IV, 60 Stat. at 1403, 3 Bevans at 1354.

12. *Id.* art. VI, § 3.

13. *Id.* art. VIII, § 2(a).

but the country, working on its crisis, has access to the resources of the Fund. The International Monetary Fund is the internationally agreed-upon multilateral method of providing aid to nations in temporary exchange crises. Because the Fund's aid is always conditioned on economic reform, it is not possible for the Fund to extend bridging loans and to act immediately. In the case of this Mexican crisis, Mexico had been negotiating with the Fund on the terms of a standby arrangement, as the Fund's aid is called, and the Fund had already agreed on conditions as usual to US\$7.9 billion. The additional US\$10.8 billion that was agreed to the night of January 31¹⁴ was presumably provided on the same conditions. It is not at all unusual for the Fund, in working with a country in distress for the extension of a standby arrangement, to agree that the country may deal with its problems by imposing temporary exchange controls.

Why exchange controls were not imposed by Mexico in this latest crisis so as to allow the country to allow some breathing space while putting its economic house in order is related directly to the third reason why the handling of this exchange crisis has been so different. An "exchange crisis" for any country (other than a country whose own currency is used as what is called a reserve currency) simply means not having the reserves available in hard currencies or gold, the original reserve, to exchange for its own currency upon demand. That is the meaning of "convertibility": when foreign holders of the country's currency, the peso, demand the exchange of their holdings for a hard currency, the government either must convert those holdings or impose exchange controls to ration the outflow from its Treasury of its own holdings of reserve currencies. Although reserve currencies are not only the means by which countries support the value of their own currency, they are often the only currencies that sellers to the country of the goods and services that the country needs to import to support its growth or to a burgeoning middle class deriving imported goods will accept. Now for any country (again, other than a country whose own currency is a reserve currency), the only ways to obtain hard currency are to earn it by exports, to borrow it from a multilateral institution

14. George Graham & Stephen Fidler, *Europeans Angry at United States over Mexico: Finance Officials Set to Berate Rubin for Lack of Consultation on Rescue Package*, FIN. TIMES, Feb. 4, 1995, at 3.

such as the World Bank or the Fund, to borrow it from private banks as a number of countries did in the 1970's (and indeed are doing again), or finally, to get it from foreign investors, either in the form of "direct" investment or "portfolio" investment. "Portfolio" investment is today obtained by those countries, such as Mexico, that have access to the capital markets, either by issuing government bonds denominated in or linked to the hard currency¹⁵ or to encourage in these changing times foreign equity mutual funds to purchase shares in privatized industry in the country.

It must also be noted, however — and this again is a big difference of this Mexican exchange crisis from 1982 — that getting access to hard currencies through portfolio investment in the securities of a country needing reserves has very different consequences for the country from either attracting foreign direct investment or even borrowing hard currencies from foreign private banks. Direct investment is not "hot money." It is not possible for direct foreign investors to sell a plant in an exchange market. Equally, foreign banks, while they may sell the asset or even trade in the obligations of countries on their own, cannot demand payment on the loan before it is due. Moreover, foreign banks are, as they were in 1982, subject to governmental pressure to reschedule in the interest of preserving the ally in difficulty. (Indeed in the ultimate longer term rescue plans for the Latin countries, the banks were "persuaded" to put in new money.) This is not the case with the mutual fund and the institutional investor. If the global bond fund or the equity emerging markets fund manager determines that, say, Mexico no longer seems able to add performance to the fund or even will substantially detract, the tesobonos in the bond fund are dumped on the market as are the shares of Mexican companies. If the selling fund sells the bonds or shares for pesos, it demands convertibility of those pesos from, ultimately, the country's central bank and the country's reserves flow out as quickly as they were added to by the portfolio investors. Mexico, with its "miraculous" recovery since 1982 and return to the capital markets, had depended upon these investors for its hard currency; in-

15. These bonds will either be long term or short term Treasury obligations, depending on what the market will accept. Mexico, unfortunately, had recently come to rely heavily on "tesobonos," which are short term obligations tied to the dollar.

deed, one of the methods of attracting these investors was the promise of convertibility and the "fixed" exchange rate of the peso against the dollar.

Why then did Mexico not treat these sudden outflows as they treated in 1982 the dollar deposits in Mexican banks? Because to do so would violate the new rules of the game¹⁶ of what Chairman Greenspan of the Federal Reserve has referred to as "the internationalized capital markets." The possibility that one might impose exchange controls precludes one from access to these capital markets because the last thing that any mutual fund manager can tolerate is the possibility that he or she might not be able to quickly dump a holding and shift elsewhere.

Now we come to the heart of the matter. The International Monetary Fund was originally set up to ensure that exchange difficulties on the part of member nations did not cause the imposition of exchange controls on what is called in the Fund Agreement, rather quaintly, "current transactions," but which means essentially payments for trade. The Fund never set any rules of the game for exchange controls for capital outflows and indeed the Fund Agreement provides that its resources shall not be used to sustain capital outflows.¹⁷ The view has been in the past that investors should take care of themselves. While a country's access to capital markets will be limited by the use of exchange controls and while, all other things being equal, it is desirable to have freedom of capital movements, even the complete liberalization of capital movements in the European Union has a provision¹⁸ allowing each of the Member States to impose, in the event of an exchange crisis, exchange controls temporarily with the concurrence of a monitor. So from the multilateral point of view, the fact that Mexico had misjudged its capacity to fix the

16. These "rules" are not, unlike the Treaty obligations in the Fund Agreement, international legal obligations. They are only the supposed "law" of the capital markets, or capital jungle, depending on your viewpoint. See, e.g., Thomas L. Friedman, *New Mexico*, N.Y. TIMES, Mar. 15, 1995, at 25A.

17. I.M.F. Agreement, *supra* note 2, art. VI, § 1(a), 60 Stat. at 1409, 3 Bevans at 1360.

18. Treaty Establishing the European Community, Feb. 7, 1992, § 109h, [1992] 1 C.M.L.R. 573, 650, *incorporating changes made by* Treaty on European Union, Feb. 7, 1992, O.J. C 224/1 (1992), [1992] 1 C.M.L.R. 719, 31 I.L.M. 247 [hereinafter TEU]. The TEU, *supra*, amended the Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11, 1973 Gr. Brit. T.S. No. 1 (Cmd. 5179-II), *as amended by* Single European Act, O.J. L 169/1 (1987), [1987] 2 C.M.L.R. 741, *in* TREATIES ESTABLISHING THE EUROPEAN COMMUNITIES (EC Off'1 Pub. Off. 1987)).

peso and to continue to pay out its reserves on demand at that dollar-peso rate would not be a matter of international concern.

But, one might rejoin, why was the possibility that Mexico in 1982 might default on its loans to the private international banks a matter of international concern? In 1982, given the lack of capital of at least the U.S. major money center banks, the banks would have put at risk the entire international financial system if they were themselves to be rendered insolvent by the default of their Latin lending, which so much exceeded their capital. Hence the international community had an enormous interest in resolving the Latin debt crisis. How that crisis was resolved is far too long a story to tell here, but there seems to have been at no time any significant disagreement among the G-10 as to the necessity of a resolution to the crisis.

In the case of the present Mexican crisis, that multilateral consensus was and is lacking. The final great difference from 1982 in the handling of this Mexican crisis is the lack of agreement among the G-10 as to the necessity for the rescue. From the point of view of the United States, it may be a geo-political and strategic necessity for the United States to rescue Mexico. Certain members of the G-10, however, in particular Germany and the United Kingdom according to press accounts,¹⁹ were not convinced that the imposition of exchange controls and the refusal to convert pesos to allow the foreign institutional investors to take their capital out of Mexico would represent a risk, so-called "systemic," to the international financial system. The U.S. Treasury disagreed and seems to have believed that Mexican default on its tesobonos and unilateral promise of convertibility for capital outflow would threaten the financial system. Certainly such a default would lead to a breakdown of the new international capital markets, particularly many of the newly-emerging capital markets and their countries' access to foreign exchange through portfolio investment. In short, from the U.S. point of view, failure of Mexico at this time would be failure of economic reform and the miracle of the return of the Latin countries to the capital markets.

The problem is, however, that if that is the way the United

19. See *Mexican Rescue*, *supra* note 8, at 4; George Graham & Stephen Fidler, *Europeans Angry at United States over Mexico: Finance Officials Set to Berate Ruben for Lack of Consultation on Rescue Package*, *FIN. TIMES*, Feb. 4, 1995, at 3.

States saw the issues, the United States should, in the view of the allies, have acted on its own. But the United States could not act on its own. Congress was not about to vote the funds necessary to restore investors' confidence in Mexico. So it would seem that the United States strong-armed its allies and the Fund into putting together the new package. The allies, however, indicated their displeasure by doing something unprecedented. International Monetary Fund lending has always been approved by consensus. This time, Belgium, Germany, the Netherlands, Norway, Switzerland, and the United Kingdom abstained on the vote.²⁰ As for the participation of the central banks under the BIS umbrella, they too went along, because President Clinton in his press announcement had proclaimed that they would participate to the extent of US\$10 billion in the package. But as the *Financial Times* reports and an unnamed Finance Minister remarked, "it must not happen again."²¹

We do not know the end of the story of this Mexican crisis. But we do know the lesson of the particular handling of this particular "international" rescue. If newly industrializing countries like Mexico are to depend for a portion of their reserves upon access to global bond and equity mutual funds, then there must be a multilateral rethinking of the multilateral response to exchange crises in such countries. If, in this new world of open capital markets, countries depend for their inflows of capital upon these markets, and if crises arise, who and by what institutional processes is to make the decision that a multinational, or multilateral institution, rescue should be mounted? It would seem to be the firm intention of the G-7 at the economic summit in Halifax, Nova Scotia this coming June to begin to address this question in this new global financial world.²² It is a question of the utmost importance to capital importing countries.

20. *Id.*

21. See *Mexican Rescue*, *supra* note 8, at 4.

22. Jeffrey D. Sachs, *Personal View: Mexican Precedent for Ukraine*, *FIN. TIMES*, Feb. 17, 1995, at 17; David E. Sanger, *Struggle to Deal with a \$20 Billion Precedent*, *N.Y. TIMES*, Feb. 23, 1995, at 1D.