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International Monetary Fund, International Capital Markets: Developments, Prospects and Policy Issues

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Member States Developments: Mexico

International Monetary Fund, International Capital Markets: Developments, Prospects and Policy Issues (1995)

Controversial. No word in the English language better describes the International Monetary Fund's (IMF) recent edition of its yearly International Capital Markets survey of the world economy and finance. Nearly nine months after the Mexican peso began its slide, the IMF's Research Department has issued this report concluding that the devaluation of the peso was not precipitated by foreign investors, but residents of Mexico.

According to the data which the IMF has accumulated since the initial downfall of the peso in December 1994, "the pressure on Mexico's foreign exchange reserves in the run-up to the devaluation came primarily from residents rather than foreign investors selling their holdings of Mexican securities." The IMF report states:

The available data show that the pressure on Mexico's foreign exchange reserves during 1994, and in particular just prior to the devaluation, came not from the flight of foreign investors or from speculative position-taking by these investors, but from Mexican residents. Foreign investors' net purchases of peso-denominated debt and equity instruments and net foreign direct investment during 1994 came to just over \$9 billion, and official capital inflows were \$2.5 billion. Together with a decline in reserves of \$19 billion, these inflows financed a current account deficit of \$29.5 billion. In the run-up to the devaluation, that is, from November 30 to December 19, foreign investors had net sales of about \$326 million in Mexican government debt securities, and there were net purchases of equity, while reserves fell by \$2.8 billion. For the entire month of December 1994, foreign investors were net sellers of about \$370 million of debt and equity, while Mexican foreign exchange reserves fell by \$6.7 billion, only \$1.7 billion of which was accounted for by the trade deficit. Indeed, foreign investors did not start to sell their Mexican equity holdings in any sizable quantity until February 1995.

The IMF rationalizes its bold conclusion by indicating that resident investors in emerging markets "tend to be the front-runners in a currency crisis" since resident investors are better informed and foreign investors are unable to participate in currency crises in developing countries.

Residents of developing countries are better informed, according to the IMF, because:

there exists a type of information asymmetry in developing countries that is not as pronounced in the major industrial country markets. Domestic residents in developing country emerging markets tend to be closer to sources of information about domestic economic events and prospects than foreign investors. They generally tend to be first in redenominating their domestic financial assets into foreign currency. They also often are the first class of investors back into the market: flight capital, for example, returned to many

emerging markets long before foreign investors saw the investment opportunities.

Next, the report states that the type of international investor which has emerged in the last five years, primarily hedge funds and proprietary traders for multinational financial institutions, has not been nimble enough to react to currency crises in developing countries. The report states:

The primary mechanism of leveraged speculative position-taking (borrowing the currency from domestic banks, against a small margin, and selling the proceeds forward) is not generally available to them. First, central banks in developing countries typically impose constraints on the ability of banks to make a large liquid forward market, or they use moral suasion to inhibit the banking sector from lending for speculative position-taking against the currency. Second, even when such forward markets exist, speculative position-taking by institutions such as hedge funds is frequently curtailed by concerns about the ability of the banking system to deliver on the forward contract after the devaluation.

Both the United States and Mexico do not support the IMF's findings. The Clinton Administration reacted quickly by playing down the report's theory that Mexican residents sparked the initial run on the peso.¹ Instead, White House officials argued that the Clinton Administration did not have time "to care who started the run on the peso" once the peso began its initial free-fall. Perhaps fearing that the International Capital Market report would be utilized by the peso bailout's chief critics, Senator Alfonse D'Amato (R-NY) and Republican presidential candidate Patrick Buchanan, Treasury officials stated that the administration "had to act to stem the Mexican panic from spreading to other markets."²

While the United States focused on the need for the international rescue effort, Mexican Finance Ministry officials condemned the IMF report on the basis that it is impossible to distinguish between holders of equity instruments.³ Alejandro Valenzuela, who is a senior finance ministry official who manages Mexico's austerity and recovery programs, asked, "How can we distinguish a Mexican asset from a foreign asset when we don't have any capital controls?"⁴

Valenzuela's attack against the IMF report is well-founded. The IMF acknowledges that the report's data "should be interpreted with caution as the breakdown by residents versus nonresidents is subject to uncertainty." Unfortunately, the report does not announce this caveat in the report's introduction, but in a mere footnote.

The International Capital Markets report does announce a conclusion which the Clinton Administration and a majority of commentators agree with. The report indicates that:

The successful conclusion of negotiations with the IMF and the announcement of an international support package of nearly \$50 billion (including

1. David LaGesse, *Clinton, IMF Defend Bailout*, Dallas Morning News, Aug. 22, 1995, at 1D.
 2. *Id.*
 3. *Mexico Dismisses IMF Report*, Dallas Morning News, Aug. 23, 1995, at 10D.
 4. *Id.*
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\$17.8 billion from the IMF) was instrumental in containing further spillovers into emerging markets in the Western Hemisphere and Asia.⁵

Clinton Administration officials have been quick to cite this portion of the report to justify the United States participation in the international peso rescue effort which commenced last winter.⁶

The IMF's International Capital Markets is a 202 page report composed of three chapters. The introduction to the report is in chapter one. Chapter two addresses the international financial markets aspects of the current turbulence in emerging markets. It is in this chapter that the IMF's Research Department makes its controversial conclusions regarding the cause of the Mexican peso crisis. Chapter three contains a discussion of international financial supervisory and regulatory issues.

The report is followed by two groups of self-contained background papers. The first group of papers provide background material pertaining to the crisis in emerging markets. This group includes papers concerning: recent trends in capital flows to developing countries; a description of the evolution of the Mexican crisis; an analysis of the Mexico peso crisis from the perspective of speculative attacks literature; a study of macroeconomic policy responses to previous surges of capital flows; a paper concerning capital controls; and two sections on domestic financial sector issues in developing countries. The second group of background materials include: the supervisory and regulatory issues in the industrial countries, including capital adequacy and internal risk management; initiatives relating to derivative markets; mechanisms for international cooperation in financial regulation; the regulatory implications of the Barings failure; and the increasing importance of institutional investors.

A copy of the International Capital Markets report may be obtained from the International Monetary Fund for \$20.00 (\$12.00 to full-time faculty members and students at universities and colleges) by writing to: International Monetary Fund, Publication Services 700 19th Street, N.W., Washington, D.C. 20431 or by calling (202) 623-7430.

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Student Editorial Board

5. A major skirmish between the Clinton Administration and several commentators against Clay Chandler of the Washington Post ensued after Chandler's article, "IMF Ties Peso Crisis to Mexican Investors," stated that the IMF report, "suggests the peso's collapse posed a *relatively modest threat* to the stability of the international financial system, contrary to the warnings made at the time by Treasury Secretary Robert E. Rubin and Fed Chairman Alan Greenspan." Clay Chandler, *IMF Ties Peso Crisis to Mexican Investors*, Wash. Post, Aug. 21, 1995, at A1. Both the White House and the IMF were quick to dispute Chandler's statements. See LaGeese, *supra* note 1, at 1D. Even fellow journalists, such as Jim Landers of the Dallas Morning News, controverted Chandler's reading of the report. See Jim Landers, *Bailout Package for Mexico Helped Keep Financial Crisis from Spreading*, Dallas Morning News, Aug. 28, 1995, at 1D. Landers wrote, "My reading of the IMF report shows the rescue announced in January was essential to keep Mexico's crisis from panicking markets around the world."
6. LaGeese, *supra* note 1, at 1D.