

1996

The Mexican Peso Crisis: Implications for the Regulation of Financial Markets

Douglas W. Arner

Recommended Citation

Douglas W. Arner, *The Mexican Peso Crisis: Implications for the Regulation of Financial Markets*, 2 LAW & BUS. REV. AM. 28 (1996)
<https://scholar.smu.edu/lbra/vol2/iss4/11>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in Law and Business Review of the Americas by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

The Mexican Peso Crisis: Implications for the Regulation of Financial Markets

Douglas W. Arner¹

- I. The Quest for Capital and the Development of International Capital Markets
- II. The Mexican Peso Crisis of 1994-1995
 - A. THE ORIGINS OF THE MEXICAN CRISIS
 - B. THE INTERNATIONAL SITUATION: THE TEQUILA EFFECT
 - C. RESPONSES TO THE MEXICAN PESO CRISIS
 - 1. *International Assistance*
 - 2. *Domestic Responses*
 - D. EVALUATION OF EFFECTIVENESS
- III. Capital Surges and Domestic Market Regulation
 - A. OVERVIEW OF THE REGULATION OF THE MEXICAN FINANCIAL SYSTEM
 - B. IMPACT OF CAPITAL FLOWS ON THE MEXICAN FINANCIAL SYSTEM
 - C. DOMESTIC REGULATORY MEASURES IN RESPONSE TO THE IMPACT OF THE CRISIS
- IV. The International Response to the Threat of Future Capital Surges
 - A. THE IMF RESPONSE: LIQUIDITY AND DISCLOSURE
 - B. THE GROUP OF TEN AND *THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES*
 - 1. *The G-10 Communiqué*
 - 2. *The Working Party Report*
- V. Debt Crises and Liquidity Crises
 - A. BRIEF HISTORY OF DEBT CRISES
 - B. INTERNATIONAL LENDING TODAY
 - C. PROPOSED SOLUTIONS
 - D. PRIVATE DEBT
- VI. Conclusions

1. BA. (literature/economics/political science) (Drury College), J.D. (hons.) (Southern Methodist University School of Law), LL.M. (Banking and Finance Law) (University of London); Research Fellow in Emerging Capital Markets Law at the Centre for Commercial Law Studies, Queen Mary & Westfield College, University of London. This piece forms part of ongoing research the author is presently undertaking at the Centre for Commercial Law Studies in London.

Capital provides the engine for growth in any economy, whether developing or developed, and is by its nature a scarce and costly resource, especially for developing countries² where resources are short and financial systems evolving and fragile. For these reasons, developing countries are increasingly acting to open their financial systems and seek out sources of foreign capital, in many cases as the result of policies directed by international financial institutions such as the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank), as well as by developed countries such as the United States, and regional processes such as the European Union and the NAFTA.

This quest for capital, however, may not be without its drawbacks, as has been recently and graphically demonstrated by Mexico's financial problems beginning in December 1994 and arguably continuing to the present. Mexico, considered a leader among the LDC world, had vigorously pursued just these sorts of policies and had in fact succeeded in encouraging large amounts of foreign capital to flow into its financial system. Due to external factors such as rising U.S. interest rates and the new mobility of international capital flows, as well as internal factors such as perceived political instability, Mexico's economy has been severely set back by a significant liquidity crisis, subsequently termed the Mexican Peso Crisis of 1994-95. The Mexican Peso Crisis has caused havoc in the Mexican economy and also negatively impacted the domestic capital markets of many other emerging economies, especially in Latin America, but also throughout the entire world (popularly dubbed "the Tequila Effect"). Due to perceptions of Mexico's leadership position among LDCs, and to U.S. policy pressures, a massive international rescue package was assembled in 1995 to help Mexico to weather its liquidity crisis, to prevent contagion to other LDCs, and to stave off a potential debt crisis.

In general terms, Mexico experienced what has been termed a "capital surge", both as initial capital flow into an economy in response principally to favourable foreign investor perceptions, with a resulting outward surge back out in a very short time on the advent of an unexpected turn of events, as with the Mexican devaluation of the peso in December 1994. While the domestic problems in Mexico were severe, the problems were not and are not unique. For this reason, regulators in Mexico and in other emerging economies can learn from the Mexican experience and perhaps plan accordingly. Further, the Peso Crisis underlines the need for a coherent international response to similar problems likely to develop in other emerging markets in the future, given that the highly mobile nature of international capital flows is unlikely to slow and in fact may increase.

This article seeks in general terms to address these issues in terms of the Mexican Crisis and the reactions that have followed. The first section discusses the changing pattern of world capital flows, especially to emerging markets. The second section provides a brief overview of the development of the Mexican Peso Crisis of 1994-95 and the international and domestic responses thereto. The third section discusses the implications of the Crisis in

-
2. The terms "developing countries", "emerging markets", and "less developed countries" (LDCs) will be used throughout to refer to countries in the process of attempting to attract foreign investment to their economies through domestic reforms in the interests of encouraging domestic development with no distinction made between the terms. The terms are by their nature imprecise, but can generally be seen only to exclude the developed economies of Europe, North America, and Japan.
-

the broader terms of domestic and international financial regulation. The fourth section deals with the relationship between liquidity crises and debt crises and summarizes the various problems and proposals, both from a sovereign and a private point of view. Finally, the article concludes with a few lessons and recommendations from the Crisis for financial market regulation.

I. The Quest for Capital and the Development of International Capital Markets.

Capital flows to developing countries have increased significantly in recent years, augmenting the possibility that these countries will experience growing financial instability as LDC governments and private sector firms increasingly rely on volatile capital investments that can rapidly be withdrawn.³ Due to a number of factors, including measures to open their economies to foreign investment, some LDCs experienced significant inflows of capital during the early half of the 1990s, with capital flows⁴ increasing from \$39.8 billion in 1990 to a high of \$154.7 billion in 1993 before slowing to \$125.2 billion in 1994.⁵ Figures for 1995 are expected to show that total capital flows to emerging markets, including the economies in transition of Central and Eastern Europe, reached nearly \$230 billion — despite the significant impact of the 1994 Mexican Peso Crisis.⁶

The history of cross-border capital flows teaches caution: at irregular intervals over the last two centuries, public and private sector investment in developing countries has been received with enthusiasm by the international capital markets. The 1820s, the 1880s, the years before World War I, the 1920s, and, most recently, the 1970s, were all periods of massive international lending to developing countries; however, each lending boom was usually followed by a period of painful retrenchment, disillusionment, and recrimination. The last major series of financial problems started in August 1982 when Mexico declared a moratorium on the repayment of certain categories of its external debt. In the following decade, \$400 billion or so of debt obligations were repeatedly rescheduled and, in the end, partially written off under the auspices of the so-called Brady Initiative, and in fact this initiative is still not complete in some countries.⁷

As the figures above indicate, even though the final debris has not been cleared in the wake of the 1982 Debt Crisis, cross-border capital flows are once again in vogue, with aggregate net long-term resource flows to developing countries from private sources

-
3. See generally INTERNATIONAL MONETARY FUND, INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS, PROSPECTS, AND POLICY ISSUES (Aug 1995) [hereinafter INT'L CAPITAL MARKETS].
 4. Capital flows include net foreign direct investment, net portfolio investment, and bank lending
 5. INT'L CAPITAL MARKETS, *supra* note 3, at 2-3, esp Table 1.
 6. Anthony Rowley, *Record Capital Flows to Emerging Markets*, BUSINESS TIMES, Sept 11, 1996, at 1 (citing IMF estimates).
 7. See generally, Rory MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305 (1995) (discussing the background of the 1980s debt crisis); Philip J. Power, *SOVEREIGN DEBT: THE RISE OF THE SECONDARY MARKET AND ITS IMPLICATIONS FOR FUTURE RESTRUCTURINGS*, 64 FORDHAM L. REV. 2701 (1996). As of December 1995, Panama, Peru, and Russia, among others, had not yet finalised comprehensive commercial bank debt rescheduling packages. Lee C. Buchheit, *Cross-Border Lending: What's Different This Time?* 16 NW. J. INT'L L. & BUS. 44 (1995), at 46.
-

increasing roughly fourfold over the five-year period since 1989.⁸ Importantly, recent capital flows to developing countries have been increasingly concentrated in portfolio investments.⁹ Net portfolio flows to developing countries increased more than thirteen-fold from \$6.5 billion in the period 1983-89 to \$88.3 billion in 1993, before decreasing to \$61.7 billion in 1994.¹⁰ Bond placements by developing country borrowers aggregated approximately \$59.3 billion in 1993, compared to \$6.3 billion in 1990.¹¹ One London-based securities dealer calculated that \$160 billion of emerging market equity shares were held by international investors in 1994, whereas in 1987 the number was \$2.4 billion.¹² In Western Hemisphere LDCs especially, capital flows were more concentrated in yield-sensitive, liquid portfolios, with these investments accounting for 66 percent of inflows to these countries between 1990 and 1994, as compared to foreign direct investment (FDI) which only represented 30 percent.¹³

These increased capital flows were the result of several factors:¹⁴ (i) many developing countries restructured their commercial bank debt and implemented sounder macroeconomic policies as well as structural reforms in the 1980s and early 1990s, including financial sector reforms such as placing fewer restrictions on capital flows; (ii) cross-border securities and banking transactions became less costly and more accessible, due to increases in technology and financial innovations; (iii) institutional investors, *i.e.* mutual funds, insurance companies, pension funds, and banks and securities firms engaged in proprietary trading, diversifying their portfolios internationally due to changes in investment theory;¹⁵ and (iv) interest rates fell in industrial countries, thereby increasing the attractiveness of higher yields in LDC markets. These factors are likely to remain prevalent in international financial markets in coming years, and if anything, as estimates of capital flows to developing countries in 1995 indicate, the trend towards foreign investment in developing countries will continue to increase. The experience of the Mexican Peso Crisis of 1994-95, however, suggests that these sorts of capital flows can have potentially devastating effects on an LDC economy if these flows suddenly reverse.

8. See WORLD BANK, 1 WORLD BANK DEBT TABLES 1994-95, at 7, Table 11 (1994).

9. Portfolio capital flows consist of international placements of bonds, issues of equities in international markets, and purchases by foreigners of stocks and other financial market instruments in developing countries' domestic markets INT'L CAPITAL MARKETS, *supra* note 2, at 35.

10. *Id.* at 3, Table 1. Estimates indicate that these sorts of flows increased significantly again in 1995 — much to the surprise of the IMF and many observers. See Rowley, *supra* note 6, at 1.

11. "Capital Flows to Developing Countries," in INTERNATIONAL CAPITAL MARKETS, *supra* note 3, at 42, Table A1.

12. Stephen Fidler, *A Bubble Borne Along on a Wave of Money*, FIN. TIMES, Feb. 3, 1994, at 15.

13. FDI comprised a much higher percentage of capital flows to the East Asian countries. See INT'L CAPITAL MARKETS, *supra* note 3, at 2-3.

14. See *id.* at 3-4.

15. In 1993, assets under management by institutional investors in major industrial countries were approximately \$ 13 trillion, with US. institutional investors accounting for more than 2/3 of this total. *Id.* at 4, n.4.

II. The Mexican Peso Crisis of 1994-1995.

The evidence suggests that the origins of the Peso Crisis can be found in the interplay of a number of complex financial, economic, and political factors that developed in the period prior to December 1994.¹⁶ According to an analysis by the U.S. General Accounting Office (GAO),¹⁷ Mexico's financial crisis originated in the growing inconsistency in 1994 between Mexico's monetary and fiscal policies and its exchange rate system. Due in part to an upcoming presidential election, Mexican authorities were reluctant to take actions in the spring and summer of 1994, such as raising interest rates or devaluing the peso, that could have reduced these inconsistencies. These fundamental policy inconsistencies were exacerbated by the Mexican government's response to several economic and political events that created investor concerns about the likelihood of a currency devaluation and generally reduced investor confidence in the political and economic stability of Mexico. In response to these investor concerns, the Mexican government issued large amounts of short-term, dollar-indexed notes (*tesobonos*), so that by the end of November 1994,¹⁸ Mexico had become particularly vulnerable to a financial market crisis because its foreign exchange reserves had fallen to \$12.9 billion,¹⁹ while it had *tesobono* obligations of \$28.7 billion maturing in 1995.²⁰

-
16. See generally, *Evolution of the Mexican Peso Crisis*, in INT'L CAPITAL MARKETS, *supra* note 3, at 53-64; William A Lovett, *Lessons from the Recent Peso Crisis in Mexico*, 4 TUL. J. INT'L & COMP. L. 143 (1996); Edwin M. Truman, *The Mexican Peso Crisis: Implications for International Finance*, 82 FED. RES. BULL. 199 (Mar. 1996); Magda Kornis, *The Peso Crisis Revisited*, 5 NO. 4 MEX. TRADE & L. REP. 14 (Apr. 1, 1995); *idem.*, *Financial Crisis in Mexico*, 5 NO. 2 MEX. TRADE & L. REP. 5 (Feb. 1, 1995). See also, GAO, MEXICO'S FINANCIAL CRISIS, *infra* note 17.
 17. As a result of the US. commitments resulting from the Peso Crisis, the U.S. General Accounting Office ("GAO") prepared a comprehensive report on Mexico's 1994-95 financial crisis at the request of the Chairman of the House Committee on Banking and Financial Services, James A. Leach. See UNITED STATES GENERAL ACCOUNTING OFFICE, GAO REPORT: MEXICO'S FINANCIAL CRISIS: ORIGINS, ASSISTANCE, AND INITIAL EFFORTS TO RECOVER (GAO/GGD-96-56, Feb. 23, 1996) [hereinafter MEXICO'S FINANCIAL CRISIS]. In preparing the report, the GAO interviewed all major participants from all entities involved, as well as significant private participants, and reviewed substantially every available piece of information regarding its mandate.
 18. During October and November, high-level US. officials cautioned Mexican officials that the peso seemed overvalued and indicated that it was risky to continue the existing exchange rate policy. U.S. officials, however, were undecided about the extent to which the peso was overvalued and if and when financial markets might force Mexico to take action. Moreover, Federal Reserve and Treasury officials apparently did not foresee the magnitude of the crisis that eventually unfolded. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 77- 109.
 19. *Evolution of the Mexican Peso Crisis*, *supra* note 16, at 56.
 20. *Id.* at 61, Table I.3.
-

A. THE ORIGINS OF THE MEXICAN CRISIS.

In a broad sense, policy decisions that Mexican financial authorities took in 1994 need to be considered in the context of Mexico's recent financial and economic history. From the mid-1970s through the late 1980s, Mexico was caught in a destructive cycle of inflation and currency devaluations that seriously set back the country's economic development and eventually culminated in the nationalization of the Mexican banking system in 1982. Further, prior to the 1994 Peso Crisis, Mexico had experienced several financial crises since 1976 and on a number of occasions had received U.S. financial assistance to assist it in dealing with such crises as well as with other difficulties. Prior to 1994, Mexico's last major financial crisis occurred in 1982, when Mexico was unable to meet its obligations to service \$80 billion in mainly dollar-denominated debt obligations to U.S. and foreign banks.²¹

By the late 1980s, however, Mexico had largely resolved its debt crisis and was able to resume economic growth, although it continued to rely to a great extent on foreign investment to finance such growth. Since 1988, Mexico has instituted comprehensive reforms in an effort to make its economy more open, efficient, and competitive, and has sought to address both domestic and international restrictions that limited its economic growth. Most importantly, to attract foreign capital, the Mexican government undertook major structural reforms in the early 1990s designed to make its economy more open to foreign investment. These reforms included privatizing many state-owned enterprises, removing trade barriers, removing restrictions on foreign investment, and reducing inflation and government spending.

In 1994, Mexico entered into the North American Free Trade Agreement (NAFTA) with the U.S. and Canada, further opening Mexico to foreign investment and bolstering foreign investor confidence because investors perceived that with the signing of the NAFTA, Mexico's long-term prospects for stable economic development were likely to improve.²² Finally, in 1994, Mexico became the twenty-fifth member of the Organization for Economic Cooperation and Development (OECD), thereby apparently signalling its full membership in the world economy and its position as a leader in the LDC world.²³

-
21. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 29-31. The Bank of Mexico, Mexico's central bank, ran out of foreign currency reserves following the 1982 oil price drop, and in August 1982, Mexico temporarily suspended repayment of principal on its foreign debt, thus signalling the beginning of the 1982 Debt Crisis. In September, the banking system was nationalised, and strict exchange controls were put in place. *Id.* The Mexican default signalled the beginning of the Debt Crisis of the 1980s. See generally, Stephany Griffith-Jones & Osvaldo Sunkel, DEBT AND DEVELOPMENT CRISES IN LATIN AMERICA: THE END OF AN ILLUSION (1986) and sources cited, *supra* note 7.
 22. For an excellent analysis of the NAFTA provisions and implications, see generally, Judith H Bello, Alan F. Holmer & Joseph J. Norton (eds.), THE NORTH AMERICAN FREE TRADE AGREEMENT: A NEW FRONTIER IN INTERNATIONAL TRADE AND INVESTMENT IN THE AMERICAS (1994).
 23. Mexico was formally invited to become a member of the OECD on 14 April 1994. See Christian Schricke, Mexico, 25th Member of the OECD, 188 OECD OBSERVER 4 (June 1994) (analyzing the accession process).
-

The flow of capital to and from Mexico over the past decade serves to illustrate the effect of its various actions on the perceptions of investors, both foreign and domestic.²⁴ Between 1983 and 1989, Mexico experienced net capital outflows of \$15 billion, reflecting the impact of the 1982 Debt Crisis, but this reversed to net inflows of \$102 billion between 1990 and 1994, signalling the perceived effectiveness of its domestic and international actions.²⁵ The importance of Mexico in terms of its position as a leader among LDCs can be seen from its significance in world capital flows: in 1993, Mexico received \$31 billion of capital inflows — accounting for 20 percent of net capital flows to all LDCs.²⁶

As this evidence suggests, at the beginning of 1994, Mexico was experiencing a boom in foreign investment, related in part to investors' perceptions that Mexico's economy was fundamentally strong, and further bolstered by the approval of NAFTA.²⁷ A substantial part of the financial inflow, however, was in the form of equity and debt portfolio investments that could be withdrawn quickly, especially as the result of declines in investor confidence.

The first significant drop in investor confidence in Mexico in 1994 and the related drop in Mexican foreign currency reserves occurred following the unrest in the state of Chiapas in January and the assassination of Mexican presidential candidate Luis Donaldo Colosio on March 23, 1994.²⁸ As a result, Mexico's foreign currency reserves dropped from a high of \$29.3 billion at the end of February to \$25.9 billion at the end of March to \$17.7 billion by the end of April.²⁹ On March 24, U.S. authorities agreed to make a short-term credit facility available to Mexico, and the peso was allowed to depreciate approximately 1 percent against the dollar, combining with a 7 percent devaluation that had taken place in the month preceding the assassination.³⁰ Further, in April 1994, in connection with the establishment of the North American Financial Group, a consultative body consisting of the finance ministers and central banks of the U.S., Canada, and Mexico, a trilateral agreement was established to make available a short-term credit facility of \$6 billion from the U.S. and Can\$1 billion from Canada.³¹ As well, the Bank of Mexico increased domestic interest rates from 10.1 percent on March 23 to 17.8 percent one month later on short-term (91-day), peso-denominated Mexican government notes (*cetes*) in an attempt to stem the outflow of capital.³²

In spite of higher interest rates, investor demand for *cetes* continued to lag, and investors were demanding higher interest rates on new issues because of their perception that the peso would eventually be subject to a relatively large devaluation. Options available

24. Domestic flows take the form of flight capital, which flows out of and back into an economy such as Mexico with remarkable speed. For an interesting analysis of the magnitude of flight capital in Latin America and other emerging economies, see generally, Rudy Naylor, *HOT MONEY AND THE POLITICS OF DEBT* (1994).

25. INT'L CAPITAL MARKETS, *supra* note 3, at 2-3.

26. *Id.* at 2.

27. For an analysis of capital flows to Mexico in the period preceding December 1994, see José Angel Gurriá, *Capital Flows: The Mexican Case*, in Ricardo French-Davis & Stephany Griffith Jones, *COPING WITH CAPITAL SURGES: THE RETURN OF FINANCE TO LATIN AMERICA* 189 (1995).

28. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 49-51.

29. *Evolution of the Mexican Peso Crisis*, *supra* note 16, at 56-57.

30. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 51-60.

31. *Id.*

32. *Evolution of the Mexican Peso Crisis*, *supra* note 16, at 56.

to the Mexican government at this time included:³³ (i) offering even higher interest rates on *cetes*; (ii) reducing government expenditures to reduce domestic demand, decrease imports, and relieve pressure on the peso; or (iii) devaluing the peso. From the perspective of the Mexican authorities, the first two options were unattractive in a presidential election year because they could have led to a significant downturn in economic activity and could have further weakened Mexico's banking system. The third option, devaluation, was also unattractive since Mexico's success in attracting foreign investment depended significantly on its commitment to maintaining a stable exchange rate, both from the standpoint of perceptions of international investors and in order to continue to reduce the rate of inflation, especially since a stable exchange rate had been an essential ingredient of long-standing agreements between labor, government, and business, with the perception being that these agreements were necessary to ensure continuing domestic stability.

Rather than adopt any of these options, the government chose, in the spring of 1994, to increase its issuance of *tesobonos*, reasoning that since *tesobonos* were dollar-indexed, holders could avoid losses that would otherwise result if Mexico subsequently chose to devalue its currency, and thereby encouraging investment by effectively transferring foreign exchange risk from investors to the Mexican government. As a result, *tesobonos* proved attractive to foreign investors.³⁴

The result of this decision, however, increased Mexico's vulnerability to a financial market crisis as *tesobono* sales rose because many *tesobono* purchasers were portfolio investors who were very sensitive to changes in interest rates and risks. Further, *tesobonos* had short maturities, increasing the threat of changes in contract overflows because investors might not roll them over if investors perceived either an increased risk of a Mexican government default or higher returns elsewhere. While this was not necessarily the best choice in hindsight, Mexico's foreign exchange reserves did in fact stabilise at a level of about \$17.7 billion during the period from the end of April through August, when the Mexican presidential elections came to a conclusion and at which time the Mexican authorities anticipated that investment flows would once again increase.³⁵

Following the election, however, foreign investment flows did not recover to the extent expected by Mexican authorities, in part because peso interest rates were allowed to decline in August and were maintained at that level until December.³⁶ During the fall of 1994, it became increasingly clear to some officials in Mexico, the U.S., and the IMF, that Mexico's mix of monetary, fiscal and exchange policies needed to be adjusted; however, no action was taken.³⁷ The current account deficit worsened during the year, partly as a result of the strengthening of the economy related to a moderate loosening of fiscal policy, in turn motivating a step up in domestic lending.³⁸ Further, imports had surged as the peso

33. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 60-66.

34. Between January and November 1994, *tesobonos* rose from 64% to 70.2% of total foreign investment in Mexican government securities. See *Id.*, at 60-66, esp. Table 2.12 (citing data from the Bank of Mexico).

35. *Id.* See also, *Evolution of the Mexican Peso Crisis*, *supra* note 16, at 54-56.

36. MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 66-73.

37. See generally, *id.* at 76-109. Overall, the GAO's analysis suggests that the U.S. knew of Mexico's problems, but did not think the outcome would be so severe, while IMF simply did not have sufficient information to gauge the extent of the problem or its possible impact. *Id.*

38. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 66-73.

became increasingly overvalued, and Mexico had become heavily exposed to a run on its foreign exchange reserves as a result of substantial *tesobono* financing.³⁹ Moreover, U.S. interest rates became increasingly attractive during this period, thereby diverting capital flows away from Mexico.⁴⁰

In the middle of November 1994, Mexican authorities had to draw down foreign currency reserves in order to meet demands for dollars, at least partially in response to further increases in U.S. interest rates.⁴¹ In late November and early December, renewed fighting in Chiapas and an unfolding scandal surrounding the September 1994 assassination of PRI Secretary General Francisco Ruiz Massieu renewed apprehensions among investors regarding Mexico's political stability, which were compounded further with the release of government figures anticipating a higher current account deficit on December 9, 1994, but without an announcement of any alteration of exchange rate policy.⁴² These factors led to a further loss of confidence among investors, increased redemptions of Mexican securities, and resulted in a significant drop in foreign exchange reserves, to approximately \$10 billion.⁴³ At the same time, Mexican government officials continued to assure investors that the peso would not be devalued even though Mexico's outstanding *tesobono* obligations had reached \$30 billion.⁴⁴

On 20 December, Mexican authorities sought to relieve pressure on the exchange rate by announcing a widening of the peso/dollar exchange rate band, effectively devaluing the peso by approximately 15 percent.⁴⁵ The government, however, did not announce any new fiscal or monetary measures to accompany the devaluation.⁴⁶ This combination resulted in an additional loss of \$4 billion in foreign reserves on December 20-21, forcing the Mexican government to freely float its currency on December 22.⁴⁷ The discrepancy between the stated exchange rate policy of the Mexican government throughout most of 1994 and its devaluation of the peso on December 20, along with its failure to announce any appropriate economic policy measures, significantly reduced investor confidence in the newly elected government and increased fears that default was imminent. Consequently, downward pressure on the peso continued, and by early January 1995, institutional investors realised that *tesobono* redemptions could soon exhaust Mexico's reserves and, in the absence of external assistance, that Mexico might default on its dollar-indexed and dol-

-
39. Outstanding *tesobono* obligations increased from \$ 31 billion at the end of March to \$ 29.2 billion in December. *Evolution of the Mexican Peso Crisis*, *supra* note 16, at 60-62.
 40. Between January 1994 and November 1994, US. 3-month Treasury bill yields rose from 3.04% to 5.45%. MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 56.
 41. On 15 November, the Fed raised the federal funds rate by 3/4 of a percentage point. *Id.*
 42. MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 66-73.
 43. *Evolution of the Mexican Peso Crisis*, *supra* note 16, at 57, Table I8. Interestingly, most of the pressure during this period came from the funds of Mexican nationals leaving the country. INT'L CAPITAL MARKETS, *supra* note 3, at 7-8; see MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 66-73.
 44. MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 66-73.
 45. It is generally agreed that the devaluation was badly mishandled.
 46. An example would have been an increase in interest rates. See generally, *Policy Responses to Previous Surges of Capital Inflows*, in INTERNATIONAL CAPITAL MARKETS 80, *supra* note 3.
 47. INT'L CAPITAL MARKETS, *supra* note 3, at 57.
-

lar-denominated debt — exacerbated by the fact that information beginning to emerge on Mexico indicated that its reserves were lower than had generally been believed.⁴⁸

The Mexican Peso Crisis of 1994-95 was now full-blown, and at this point, Mexico was forced to turn to international sources for assistance.

B. THE INTERNATIONAL SITUATION: THE TEQUILA EFFECT.

Immediately after the Mexican devaluation, most of the larger Western Hemisphere LDCs experienced varying degrees of turbulence in their foreign exchange markets and registered significant declines in their equity markets.⁴⁹ Stock market indexes for emerging markets, compiled by the International Finance Corporation (IFC) showed that markets in Argentina and Brazil in particular suffered heavy trading losses immediately after the Peso Crisis.⁵⁰ Once the international assistance package was announced⁵¹ and the initial reaction subsided, investors began to discriminate significantly against countries such as Argentina and Brazil which were viewed as having the same general characteristics that afflicted Mexico; namely:⁵² (i) low savings rates, (ii) large current account deficits, (iii) weak banking systems, and (iv) significant volumes of short-term debt. While the overall international efforts were significant in reducing the ultimate contagion effect, the resulting lessons taught by international investors are instructive for LDC policies.

C. RESPONSES TO THE MEXICAN PESO CRISIS.

1. *International Assistance.*

Although the Treasury, the U.S. Federal Reserve (Fed), and the IMF purportedly did not anticipate the magnitude of the Peso Crisis, they soon concluded that outside assistance was required to prevent Mexico's financial collapse and to prevent the spread of the crisis to other LDCs. Beyond its direct impact on LDC economies, officials viewed the Crisis as a threat to market-oriented economic reforms that the IMF and the U.S. had urged LDCs to adopt.⁵³

48. *Id.* Mexico had not announced its declines in reserves in November until after the devaluation of the peso in December. *Evolution of the Mexican Peso Crisis*, *supra* note 16, at 56.

49. See INT'L CAPITAL MARKETS, *supra* note 3, at 6-7. See also, section II.C., *infra*.

50. MEXICO'S FINANCIAL CRISIS, *supra* note 16, at 112-13, Tables 41-4.2. See *Evolution of the Mexican Peso Crisis*, *supra* note 16, at 64-69.

51. See *infra*, Section II.C.

52. INTERNATIONAL CAPITAL MARKETS, *supra* note 2, at 6-7.

53. According to the Secretary of the Treasury, as well as government and industry analysts, Mexico has been a paradigm for countries that are striving to put inward-looking, state-controlled models of economic development behind them and move to free market models. The Secretary also noted that new prosperity, based on open markets, encouraging investment, and privatisation of state-controlled industries, is beginning to be realised in these emerging market economies. Other U.S. government officials stated that they believed a spread of Mexico's financial difficulties to other emerging markets could have halted or even reversed the global trend toward market-oriented reform and democratisation. MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 110-114.

As a result, President Clinton announced a U.S. package of loan guarantees of up to \$40 billion for Mexico on 12 January 1995; however, doubts regarding Congressional approval led to its ineffectiveness and withdrawal. Subsequently, on 31 January 1995, President Clinton announced a \$48.8 billion multilateral assistance package. Under this package, the U.S. would provide up to \$20 billion to Mexico through the use of the Exchange Stabilization Facility (ESF) and the Federal Reserve swap network.⁵⁴ On 1 February, the IMF approved an 18-month standby arrangement for Mexico of up to \$17.8 billion. In addition, other countries, under the auspices of the Bank for International Settlements (BIS), agreed to provide a short-term facility of \$10 billion,⁵⁵ and Canada had already provided \$1 billion in December.⁵⁶

The U.S. and international response to the Peso Crisis was one of the largest multilateral economic assistance packages ever extended to any one country. The objectives, then, of the U.S. and IMF assistance packages, following the December devaluation and the subsequent loss of confidence in the peso, were twofold: first, to help Mexico overcome its short-term liquidity crisis, and second, to limit the adverse effects of the Mexican crisis spreading to the economies of other emerging market nations and perhaps beyond.⁵⁷ Along the same lines, the stated purpose of the U.S. assistance package was "to assist Mexico in stabilizing its exchange and financial markets by providing resources to be used in such manner as to facilitate the redemption, refinancing or restructuring of Mexico's short-term debt obligations..."⁵⁸ Some observers opposed any U.S. financial assistance to Mexico, arguing that investors should not be shielded from financial losses, and that neither the danger posed by the spread of Mexico's crisis to other nations nor the risk to U.S. trade, employment, and immigration were sufficient to justify the assistance.⁵⁹ As can be seen by the U.S. response, U.S. officials disagreed.

-
54. A swap arrangement provides for temporary exchanges of currencies between participating countries. Partners in the arrangement can draw on one another's currency by supplying their own currency up to an agreed amount. The swap is usually reversed within a short period of time, but may be rolled over.
55. In early January, BIS announced a \$5 billion facility, later increased to \$10 billion. These funds were short-term and have not been drawn upon by Mexico.
56. Argentina, Brazil and a group of international commercial banks were also to provide funds; however, none of these funds materialised, due in the cases of Argentina and Brazil to the "tequila effect"
57. MEXICO'S FINANCIAL CRISIS, *supra* note 16, at 110-14
58. US-Mexico Framework Agreement for Mexican Economic Stabilization, Feb. 21, 1995, Art. I [hereinafter *Framework Agreement*] (on file with the author).
59. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 117-18
-

Under the package, the U.S. pledged up to \$20 billion in loans and securities guarantees from the ESF.⁶⁰ As part of the amount, the Fed agreed to provide up to \$6 billion in short-term swaps from its pre-existing swap line, and the Treasury agreed to provide backing for the Fed swaps as part of the ESF program by assuring repayment of any short-term drawings that were counted against the \$20 billion limit.⁶¹

Specifically, U.S. assistance was offered through three mechanisms:⁶² (i) short-term currency swaps for up to 90 days, with renewals for a maximum term of 1 year for Treasury swaps and renewals up to three times for Fed swaps; (ii) medium-term currency swaps for up to 5 years; and (iii) securities guarantees under which ESF funds could be used to back up securities issued by the Mexican government for up to 10 years. Under this

-
60. Framework Agreement, *supra* note 57, Art III. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 118-23 & Appendix I, 148-152 (discussing the use of the ESF and Federal Reserve resources). Congress established the ESF in 1934 pursuant to section 10 of the Gold Reserve Act of 1934 "for the purpose of stabilizing the exchange value of the dollar." 31 U.S.C. § 5302. Since its passage, the statute has been amended to broaden its purpose from the stabilisation of the dollar to include the promotion of orderly exchange arrangements and a stable system of exchange rates. See H.R. No. 94-1284, 94th Cong. 2d Sess., 13-14 (1976). The legality of the use of the ESF for this purpose has been questioned. See, e.g., Russell D. Covey, Note: *Adventures in the Zone of Twilight: Separation of Powers and National Economic Security in the Mexican Bailout*, 105 YALE L. J. 1311 (1996); James D. Humphrey II, Student Note: *Foreign Affairs Powers and "The First Crisis of the 21st Century": Congressional vs. Executive Authority and the Stabilization Plan for Mexico*, 17 MICH. J. INT'L L. 181 (1995). The Treasury and the Department of Justice, however, provided legal opinions stating that the requisite legal authority was in fact present. See letter from Edward S. Knight, General Counsel of the Department of the Treasury, to Robert E. Rubin, Secretary of the Treasury, Feb. 21, 1995; and Memorandum from Walter Dellinger, Assistant Attorney General of the U.S. Department of Justice, to Edward S. Knight, General Counsel of the Department of the Treasury, Mar. 2, 1995 (both on file with the author). Not surprisingly, the GAO agreed. MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 114-17.
 61. Framework Agreement, *supra* note 58, Art. III. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 118-123.
 62. To put the U.S. assistance package into place, the U.S. and Mexico entered into four financial agreements: (i) the Framework Agreement, *supra* note 58; (ii) the Oil Proceeds Facility Agreement, Framework Agreement, *supra* note 58, Annex A [hereinafter *Oil Agreement*]; (iii) the Medium-Term Exchange Stabilization Agreement, Feb. 21, 1996; and (iv) the Guarantee Agreement Dated as of February 21, 1995 among The United States Department of the Treasury, and The Government of the United Mexican States, Feb. 21, 1995 [hereinafter *Guarantee Agreement*] (all on file with the author). For an analysis of the package, see Patricia A. Wertman, *Peso Crisis: The Mexican Support Package: A Survey and Analysis*, 5 NO. 8 MEX. TRADE & L. REP. 19 (Aug. 1995) [Part I] (analyzing the structure of the rescue package and public policy issues related to U.S. involvement); *idem.*, *Peso Crisis: The Mexican Support Package: A Survey and Analysis*, 5 NO. 9 MEX. TRADE & L. REP. 9 (Sept. 1995) [Part II] (analyzing protections for U.S. taxpayers and Mexico's use of the package). Note that in fact Mexico has made use of this package and that in fact the U.S. has made a profit on its commitments. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 136-39.
-

package, Mexico effectively pays the same interest rates that other countries pay for short-term currency swaps⁶³ and other longer-term lending.⁶⁴ Further, as part of the package, Mexico agreed to abide by certain economic criteria,⁶⁵ and the U.S. and Mexico entered into an oil agreement to ensure that in the event of a default by Mexico, the U.S. would be repaid through earnings from Mexico's oil exports.⁶⁶

The second largest component of the assistance package for Mexico came from the IMF. The IMF pledged up to \$17.8 billion⁶⁷ in financial assistance in the form of a standby arrangement for Mexico to be disbursed over a period of 18 months. Mexico pays standard rates and fees for this assistance package,⁶⁸ drawings upon which have a maturity of up to five years. This arrangement, conditioned upon Mexico's adherence to strict economic performance criteria, was the largest financing package ever approved by IMF for a member country, both in terms of the amount and the overall percentage of a member's credit quota.⁶⁹

2. Domestic Responses.

As part of the terms and conditions of the international rescue package, the government of Mexico released a new economic plan on March 9, 1995, to address the required

-
63. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 123-27. For example, as of the end of October 1995, this rate was 5.25%.
 64. *Id.* For example, Mexico was charged 9.2% in July 1995 for its longer-term borrowings.
 65. Framework Agreement, *supra* note 58, Arts V, VI. See also Framework Agreement, Annex B, Letter to Michel Camdessus, Managing Director, International Monetary Fund from Guillermo Ortiz Martinez, Secretary of Finance and Public Credit of Mexico & Miguel Mancera Aguayo, Governor, Bank of Mexico, and Mexico-Memorandum of Economic Policies; Annex C, Economic Policy Memorandum; and Annex D, Public Availability of Government and Bank of Mexico Statistical Information.
 66. Oil Agreement, *supra* note 62. Under this mechanism, all of Mexico's foreign oil revenues flow through an account at the Federal Reserve Bank of New York. While these revenues probably would not be sufficient on a daily basis to cover a major default, their existence makes the likelihood of eventual repayment far more likely. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 123-127.
 67. IMF, Camdessus to Recommend that IMF Commit an Additional \$10 billion for Mexico, Raising its Total Commitment to \$178 billion, IMF NEWS BRIEF no. 95/5, Jan. 31, 1995. IMF actually approved assistance for Mexico for up to special drawing rights (SDR) 12.07bn. The SDR is the international reserve asset created and used by the IMF to denominate all its accounts. It is comprised of a basket of five currencies, of which the U.S. dollar is the most significant. *Id.*
 68. *Id.* Interest rates for IMF drawings has been approximately 5% per year, and fees are charged at 25% per year commitment fee for funds remaining available, as well as a .50% usage fee on each drawing. MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 128-31.
 69. See *Id.* at 128-131. The arrangement was 688.4% over 18 months, while the usual cumulative limit is 300%.
-

economic criteria provided in the agreements with the U.S. and the IMF.⁷⁰ Overall, the goals of the plan are to restore financial stability, strengthen public finances and the banking sector, regain confidence, and reinforce the groundwork for long-term sustainable growth. In general terms, the plan addresses monetary policy, exchange rate policy, fiscal policy, banking policy,⁷¹ incomes and social policy, and improved transparency⁷² — all consistent with IMF conditionality.⁷³

Although the government of Mexico has taken steps to improve the Mexican banking system, the banking sector still remains burdened by a non-performing loan level estimated by the World Bank to be about 27 percent of total loans as of 30 September 1995.⁷⁴ The government of Mexico has taken several measures designed to help the banking sector deal with the problems associated with Mexico's financial difficulties; several of these were initiated unilaterally by Mexico, while others were undertaken with the direct support of the international financial community.⁷⁵

Further, in an effort to provide a more efficient market, Mexico is taking steps to introduce new financial instruments that would modernise Mexican financial markets to serve the needs of investors. Importantly, the Bolsa and the Chicago Mercantile Exchange are developing distinct peso and interest futures contracts to create a North American standard for futures trading for pesos and Mexican Treasury interest rates.⁷⁶ The level of volatility in the peso exchange rate is expected to decline with the addition of the peso futures contract, so that international investors can hedge against exchange-rate risk, and Mexico may gradually introduce other derivative financial instruments, such as warrants on individual Mexican securities and options on individual Mexican stocks.⁷⁷

-
70. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 128-31, 133-36; Patricia A Wertman, *Economic Recovery: Mexico's 1995 Economic Program and the IMF*, 5 NO. 6 MEX. TRADE & L. REP. 4 (June 1, 1995); Patricia Wertman, *Peso Crisis: Mexico's 1995 Economic Program and the IMF*, 5 NO. 3 MEX. TRADE & L. REP. 7 (Mar. 1, 1995). Mexico actually proposed an initial economic plan in January 1995; however, without the international rescue package in place, it was largely ignored.
 71. The World Bank, the Inter-American Development Bank (IADB), and other sources agreed to provide up to \$3 billion to strengthen Mexican banks.
 72. The plan included a promise by Mexico that information on foreign currency reserves and domestic credit conditions should be announced on a weekly basis. Such disclosure was also mandated by the Framework Agreement, *supra* note 58, Annex D, *supra* note 65. Presumably, this will be consistent with new IMF disclosure policies. See *infra*, Section III.
 73. Framework Agreement, *supra* note 58, Annex B, *supra* note 65. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 133-136.
 74. *Id.* at 143-146.
 75. See *id.*
 76. *Id.* at 133-136. Peso futures contracts have been trading on the Chicago Mercantile Exchange since April 1995.
 77. For a full discussion of derivatives, their uses, and implications, see GAO, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM (GAO/GGD-94-133, May 18, 1995).
-

D. EVALUATION OF EFFECTIVENESS.

In order to gauge the success of the rescue package, one must look to whether international investor confidence has increased and to whether Mexico has been able to reenter international capital markets — both of which seem to be occurring.⁷⁸ Beyond these factors, the Bolsa has picked up, rising to past its 8 September 1994 level on 8 December 1995, although it has fluctuated considerably.⁷⁹ Overall, then, while serious problems still face Mexico, the international and domestic efforts seem to have been arguably effective.

III. Capital Surges and Domestic Market Regulation.

As will be demonstrated by the following discussion, the weakness of the Mexican banking system was both an important cause of the Crisis and an important consequence thereof as well. For this reason, a short overview of Mexican financial market regulation and its specific efforts both to reform it and to recover from the impact of the Crisis are instructive.

A. OVERVIEW OF THE REGULATION OF THE MEXICAN FINANCIAL SYSTEM.

Following the nationalisation of the banking system in 1982 and the efforts of Mexico to reform its economy in the late 1980s and early 1990s, Mexico has substantially reformed its domestic financial system. In 1990, constitutional amendments and new banking legislation⁸⁰ set the stage for the return of the commercial banking system to private hands,⁸¹ and between June 1991 and July 1992, all of the commercial banks were privatized, most of which became subsidiaries of newly established financial holding companies.⁸² At the same time as the new privatized banking regime was set in place, deposit lending rates, reserve requirements, requirements to lend to specific sectors, and

78. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 139-143, esp tbl. 5.1.

79. *Id.* at 139-143.

80. The Credit Institutions Law (*Ley de Instituciones de Crédito*) was introduced in July 1990 and has been amended on a number of occasions. It replaced an earlier law that was drafted to govern the activities of the banks nationalised in 1982. Together with the Financial Groups Law (*Ley para Regular las Agrupaciones Financieras*), it established the basis for the conglomerate banking model in effect in Mexico today. The Credit Institutions Law was intended to provide an appropriate legal framework for the capital structure, activities and supervision of the reprivatised banking system as well as for the activities of state-owned development banks. Roy A. Karaoglan & Mike Lubrano, *Mexico's Banks After the December 1994 Devaluation—A Chronology of the Government's Response*, 16 NW. J. INT'L L. & BUS. 24, 25 (1995).

81. Mexico's commercial banks, with the exceptions of Citibank and *Banco Obrero*, were nationalised in 1982 in the wake of the Debt Crisis. Prior to the initiation of the privatisation programme, the 58 nationalised banks were reduced to 18 banks through a process of liquidations and mergers. *Id.*

82. *Id.*

other limitations on bank lending activities were significantly deregulated.⁸³

In Mexico, responsibility for financial regulation and supervision is shared among the *Banco de Mexico* (Mexico's central bank),⁸⁴ the Ministry of Finance, and the National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores* or CNBV).⁸⁵ Although steps to improve banking supervision were taken at the time of the privatization of the commercial banks, efforts to fully equip the CNBV to supervise the new system began only in 1994.⁸⁶ As such, one of the principal goals of the new system was to facilitate the effective supervision of financial groups on a consolidated basis by placing the supervisors of Mexico's brokerage houses under the same roof as the supervisors of their banking affiliates. While a basic framework for implementing new policies and procedures for bank inspections had been put in place by CNBV, there was not sufficient time before the onset of the Peso Crisis to prepare an adequate number of trained and experienced inspectors to be fully effective.⁸⁷

Beyond basic supervision, the Credit Institutions Law provided for the establishment of the Bank Fund for Savings Support (*Fondo Bancario para Protección de Ahorro*, or FOBAPROA)⁸⁸ and defined the legal basis for its provisions of "preventive support" to troubled banks.⁸⁹ FOBAPROA's role goes beyond simple deposit insurance, and under the Credit Institutions Law, the fund is required to give notice each December of the types of bank assets it will cover the following year, and the flexibility accorded FOBAPROA under the Credit Institutions Law has permitted it to function as the instrument for a number of the Mexican government's responses to the effects of the Peso Crisis on the banking sector.

Not surprisingly, once privatized, banks competed fiercely to gain market share in the provision of loans, both by increasing the volumes of their existing lines of business and

-
83. "In July 1993, amendments to the Credit Institutions Law and Financial Groups Law were approved which weakened the restrictions on the types of services which could be provided by banks and other financial entities. New regulations were also issued governing the treatment of newly-introduced financial instruments, securities activities of banks, and the establishment of independent credit bureaux." *Id.* at 28.
 84. *Id.* In June 1993, the Mexican Constitution was amended and legislation went into effect granting the *Banco de Mexico* greater autonomy and more clearly defining its functions as those relating to conduct of monetary policy and supervision of the payments system and foreign exchange markets. *Id.*
 85. *Id.* The Credit Institutions Law established the National Banking Commission (created under earlier legislation) as the chief supervisory authority for both private commercial banks and state-owned development banks. *Id.*
 86. *Id.* The Banking and Securities Commission Law (*Ley de la Comisión Nacional Bancaria y de Valores*) went into effect on 1 May 1995, and provided for the merger of the National Banking Commission with the National Securities Commission, the principal regulator of the securities industry. *Id.*
 87. *Id.* at 29-30.
 88. FOBAPROA's operations are funded through annual and special contributions from commercial banks and from credit extended to FOBAPROA by the *Banco de Mexico*. *Id.* at 30.
 89. FOBAPROA is organized as a trust administered by the central bank; however, Article 122 of the Credit Institutions Law establishes that FOBAPROA's policies will be established by a technical committee with members appointed by the Ministry of Finance and Public Credit, CNBV, and the Central Bank. A majority of the members of the technical committee are appointed by the Ministry of Finance. *Id.* at 30.
-

by entering the markets for relatively new financial services, such as home mortgages and credit cards.⁹⁰ Unable to attract conventional deposits fast enough to support new lending,⁹¹ many banks increased their reliance on interbank funding, the bulk of which consisted of lines of credit from foreign banks.⁹² A rapid expansion of lending to private enterprises usually takes place at the cost of a drop-off in portfolio quality, and the development of the Mexican banking system was not an exception.⁹³ Notwithstanding the shortfall in banks provisions,⁹⁴ the banks' capital adequacy ratios improved during the period 1991-94, as the financial authorities instituted a phased increase in the minimum required ratio of net capital to risk-weighted assets, from 6 percent at the end of 1991 to 7 percent by the end of 1992, and then to 8 percent by the end of 1993.⁹⁵

B. IMPACT OF CAPITAL FLOWS ON THE MEXICAN FINANCIAL SYSTEM.

According to Bank of Mexico officials, the fragile state of Mexican commercial banks during 1994 presented a serious challenge to financial authorities' ability to use monetary policy to decrease the current account deficit that eventually necessitated the devaluation and the international rescue package.⁹⁶ Beyond its impact on attempts to prevent the

-
90. Between 1991 and 1994, aggregate assets of the commercial banks increased by 1113 % in nominal terms (64.6% in real terms), equivalent to a real annual growth of 18.1%. In 1994, assets of the commercial banking system averaged new pesos (N\$) 735 billion, equivalent to 58.8% of GDP, compared to 42.5% in 1991. *Id.* at 25-26.
 91. Although deposit mobilisation improved significantly after privatisation, with the ratio of average deposits to GDP increasing from 214% in 1991 to 31.3% in 1994, the rate of growth of loan portfolios outstripped that of deposits. The ratio of loans to deposits increased steadily from 94.1% at the end of 1991 to 113.8% in 1993, and to 124.0% in 1994. *Id.* at 26.
 92. Interbank credit lines increased from the equivalent of N\$34 billion at the end of 1991 (of which N\$23 billion were denominated in foreign currency) to N\$124 billion at the end of 1994 (of which the equivalent of N\$92 billion (\$173 billion) were denominated in foreign currency). *Id.* at 26.
 93. Aggregate past due loans of commercial banks (excluding *Banco Union* and *Banco Cremi*, both of which were already subject to intervention at this time) accounted for 409% of gross loans at the end of 1991, increased to 7.25% by the end of 1993. During the first half of 1994, the ratio increased to 8.30%, before decreasing to 7.33% by year end, largely due to a 27% increase in gross loans during the second half of 1994. *Id.* at 26-27. Note that in analysing the Mexican banking system, it is important to keep in mind that Mexican banks prepare their financial statements under Mexican Generally Accepted Accounting Principles ("Mexican GAAP") and that these differ in a number of important respects from U.S. GAAP, including the definition and treatment of non-performing loans, of provisions, and of the accrual of interest on loans. *Id.* at n. 4.
 94. Aggregate loan-loss provisions more than doubled from nearly N\$50 bn at the end of 1991 to more than N\$13.0 billion by the end of 1993; however, the ratio of provisions to past due loans actually decreased from 50.8% to 42.7% during the two-year interval, before rebounding somewhat to 47.9% by the end of 1994. *Id.* at 27.
 95. The average ration actually increased from 773.% at the end of 1991 to 9.94% in 1993, to 10.27% at the end of September 1994, before decreasing to 9.60% by the end of 1994. *Id.* at 27-28, citing CNBV data.
 96. INTERNATIONAL CAPITAL MARKETS, *supra* note 3, at 8-9; MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 40-49.
-

crisis, the Mexican financial system was severely impacted by the crisis. According to the IMF, overall net capital outflows totalled more than \$11.5 billion in the first quarter of 1995.⁹⁷ As an example, the Bolsa index declined sharply in the wake of the devaluation, falling 39 percent in nominal peso terms from the end of 1994 to February 27, 1995.⁹⁸

After the devaluation, Mexican banks came under pressure in a number of ways.⁹⁹ First, many banks faced an immediate dollar liquidity problem in January because pesos continued to be converted to dollars, and foreign lenders were reluctant to roll over their dollar claims on Mexican banks in significant volume.¹⁰⁰ Second, the banks' capitalization levels were negatively impacted by their dollar-based obligations as the peso continued to decline against the dollar.¹⁰¹ Third, banks' asset quality suffered as the percentage of non-performing loans continued to rise¹⁰² and portfolio values continued to fall¹⁰³ in the face of dramatically rising Mexican interest rates. The overall result of these effects was a significant

97. MEXICO'S FINANCIAL CRISIS, *supra* note 2, at 65.

98. *Id.* at 64 & 65, Chart I.11. During this period, the peso declined 32 percent against the dollar, reaching a low of 7.45 to the dollar — 53 percent below its devaluation level. *Id.* at 63.

99. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 143-146.

100. At the end of 1994, aggregate deposits with the commercial banks (excluding *Union* and *Cremi*) totalled N\$4139 billion, of which 18.3% was denominated in foreign currency and 73.6% consisted of time deposits. As a result of the Peso Crisis, the banks came under significant liquidity pressure as they found it extremely difficult to roll over maturing CDs, and during the first three months of 1995, aggregate foreign currency-denominated deposits with the commercial banks (including *Union* and *Cremi*) decreased by 23% , or by more than \$3.5 billion, to stand at the end of March 1995 at \$11.8 billion, equivalent to 15.8% of total deposits. Although the liquidity assistance provided by FOBAPROA to the commercial banks, amounting to \$3.3 billion during the first quarter of 1995, significantly improved the banks' liquidity position, the liquidity crunch still had significant adverse effects on the banks' average cost of funds, and hence, on their profitability during the first half of 1995. Karaoglan & Lubrano, *supra* note 80, at 32.

101. Although under prevailing regulatory guidelines, banks are required to limit their foreign currency liabilities to no more than 20% of total liabilities, and their open short or long foreign currency positions to no more than 15% of net capital, for the system as a whole, fourth quarter foreign exchange losses totalled about N\$46 billion, equivalent to more than 10% of equity. *Id.* at 31.

102. As previously described, the high rate of growth of Mexico's banking system in the period after privatisation was accompanied by an increase in the level of non-performing loans. As a result of loan-loss provisions due to this increase, combined with the foreign exchange losses, the impairment in the values of securities portfolios, and the unrealised losses from the banks' subsidiaries, the banking system (excluding *Union* and *Cremi*) recorded an aggregate loss before tax of N\$3.5 billion during the fourth quarter of 1994, equivalent to 43% of profits (before tax) during the first three quarters of the year, and to 7.9% of the equity at year end. *Id.* at 33. These effects were further accentuated by the increase of interest rates on consumer debt, mortgages and commercial credit to above 80% during the months immediately following the devaluation, before falling to 30-40% by late spring. *Id.*

103. The banks' aggregate investment portfolio increased by about 84% in 1994 to reach a level of N\$859 billion at the end of the year. The bulk of these investments consisted of fixed income securities (N\$55.8 billion), whose value was impaired by the sharp hike in interest rates. In the aftermath of the devaluation, the CNBV issued in January 1995 a new regulation requiring banks to value their securities at market prices and to disclose their unrealised gains or losses on their financial assets and liabilities in their off-balance sheet accounts as of the end of 1994. Including *Banamex* (Mexico's largest bank and the only bank to show realised losses on its securities portfolio), the losses (both realised and unrealised) amounted to N\$660 million, equivalent to 1.5% of the system's equity at year end. *Id.* at 31-32.

drop in bank capitalization, with the average ratio of net capital to risk-weighted assets of the nineteen major Mexican commercial banks decreasing from 9.40 percent to 7.75 percent.¹⁰⁴

The immediate effects of the December 1994 peso devaluation and the period of high interest rates and economic recession that followed had important repercussions for the Mexican banking and financial systems.¹⁰⁵ The impact of Mexico's current recession on the financial conditions of Mexico's banking system has been serious, especially since Mexico's newly privatized banks still have not resolved all the problems brought with them from the time of nationalisation. Moreover, interest rates have continued to increase, contributing to an already high level of non-performing loans, with delinquent loans as reported by Mexico rising to approximately 17 percent of all bank loans by the end of September 1995. As a result, many of the largest Mexican banks are looking for domestic and foreign investors to provide capital infusions.

C. DOMESTIC REGULATORY MEASURES IN RESPONSE TO THE IMPACT OF THE CRISIS

Since the onset of the crisis, the Mexican government has undertaken a number of important actions designed to assure adequate capitalization of financial institutions and continued public confidence in the banking system.¹⁰⁶ The goal throughout has been to avoid a banking crisis that would exacerbate the contraction in the real economy and to set the stage for a recovery of the financial system based on sound institutions and efficient financial markets. Similar to the probable situation in future liquidity crises in most developing countries, the rapid devaluation of the peso and its after effects hit a relatively new banking system which was still undergoing a process of maturation, with both the banks and the supervisory authorities working to improve their institutional capacity in order to be effective in their new environment.

The steps taken have included amendments to the legal framework for foreign ownership of banks, reinforcement of supervision, programs for recapitalising troubled banks, the introduction of inflation-indexed lending and the provision of indexed funding to banks, a debtor relief program, and direct intervention to those banks that proved unable to weather the crisis and its after effects.¹⁰⁷ Further, Mexican officials are receiving technical assistance from several international organizations, including the World Bank, to help strengthen their supervisory capability, and have received a \$1.7-billion loan to recapitalize the deposit insurance fund of FOBAPROA, thereby allowing it to purchase assets and resolve failing institutions more effectively.¹⁰⁸

The government responded to the banks' immediate needs for liquidity following

104. In fact, at the end of February 1995, nine of the nineteen banks had ratios below 8% as compared to only 3 at the end of 1994. *Id.* at 34, citing CNBV data. The figures exclude *Cremi, Union, Banpais*, and *Oriente*, all of which were then intervened or controlled by FOBAPROA.

105. See INT'L CAPITAL MARKETS, *supra* note 3, at 8-9.

106. Karaoglan & Lubrano, *supra* note 80, at 24.

107. *Id.* See INT'L CAPITAL MARKETS, *supra* note 3, at 143-46.

108. See *id.*

the devaluation with the establishment of a special FOBAPROA window to provide dollar liquidity,¹⁰⁹ while the *Banco de Mexico* provided short-term peso credit in its function as lender of last resort.¹¹⁰ In an effort to attract additional capital to the Mexican banking system, Mexico substantially reduced restrictions on foreign investment,¹¹¹ and Mexico's financial sector legislation was amended in February 1995 to permit foreign individuals and companies as a group to hold up to 49 percent of the voting shares of a Mexican-controlled financial holding company, commercial bank, or brokerage house.¹¹² Further, in order to encourage take-overs or mergers between better capitalized foreign financial institutions and existing Mexican banks, the amendments permitted foreign financial institutions to purchase a controlling interest in any Mexican commercial bank with a market share of less than six percent.¹¹³

-
109. See INT'L CAPITAL MARKETS, *supra* note 17, at 143-146. The banks problems in this regard mirrored those of the government. Under the special window, FOBAPROA provided short-term dollar loans (initially 28 days, but later shortened), at interest rates up to 25% (in order to discourage use of the window except in *extremis*), and requiring as security government securities, debt securities of *Nacional Financiera, S.N.C.* (the state development bank), or equity securities of the recipient bank. On 31 March 1995, total outstanding balances drawn by ten of the commercial banks were about \$3.3 billion, but as the immediate crisis passed, banks were successful in finding cheaper sources of funding, and by August 1995, balances owed to FOBAPROA had been repaid. Karaoglan & Lubrano, *supra* note 80, at 35.
110. See INT'L CAPITAL MARKETS, *supra* note 3, at 143-146. These funds were provided through special credit auctions, initially on an unsecured basis, but after 20 March 1995, requiring banks to post government securities, *Nacional Financiera* securities, or loans provided to prime borrowers in an effort to prevent moral hazard. Outstanding balances stood at the equivalent of \$3.0 billion by 31 March 1995; however, as the immediate crisis passed, banks were able to return to the private money markets. Karaoglan & Lubrano, *supra* note 80, at 35.
111. See INT'L CAPITAL MARKETS, *supra* note 17, at 143-46. Historically, Mexican financial sector legislation has included sharp limits on foreign participation in financial institutions operating in Mexico. Even though these restrictions were relaxed somewhat in anticipation of the entry into force of the North American Free Trade Agreement (NAFTA); however, even under the 1993 amendments to the Credit Institutions Law, foreign-controlled commercial banks were subjected to individual and aggregate market-share limitations, such that no single foreign-controlled bank could represent more than 1.5% of the capital of the Mexican banking system, and all foreign banks taken together could not represent more than 8% of the market. Karaoglan & Lubrano, *supra* note 80, at 36.
112. The previous ceiling for Mexican-controlled commercial banks had been 30%. *Id.* at 36.
113. For a detailed description of the February 1995 amendments, see Lubrano, *Mexico Amends Financial Sector Legislation to Attract Greater Investment and Reinforce Supervision*, 2 NORTH AMER CORP. LAW. 90-93 (1995).
-

In addition, the Mexican government of has taken several measures to bolster the capitalization of the Mexican banking system.¹¹⁴ In an effort to address asset quality problems, Mexico undertook a series of measures throughout 1995 to address the increase in non-performing loans resulting from the peso's devaluation and the subsequent financial turmoil.¹¹⁵ Recognizing the need to deal with the deterioration of asset quality in the banking system at the onset of the financial crisis, Mexican regulators implemented a more stringent system for maintaining adequate loan loss reserves in early 1995.¹¹⁶ Mexico has also created a new program to help banks restructure portions of their loan portfolios to

-
114. In February 1995, it launched the Temporary Capitalisation Programme (*Programma de Capitalizacion Temporal* or PROCAPTE) PROCAPTE is a voluntary programme designed to assist banks that have capitalisation levels that fall below the internationally accepted standard of 8 percent of risk-weighted assets, and is intended to be used by viable banks that are facing short-term capital needs, thus allowing them to continue operating, rather than by problem banks that may require intervention. Under PROCAPTE, whenever a participating bank's capitalisation falls below 8.5%, FOBAPROA may subscribe additional subordinated debentures. Banks in the PROCAPTE programme issue subordinated convertible debentures purchased by FOBAPROA, in an amount sufficient to raise their capitalisation level to 9 percent, and the banks deposit the proceeds in an account at the *Banco de Mexico* which pays interest at the same rate as the debentures. The debt must be repaid in 5 years or FOBAPROA will convert the debt to equity and sell the equity in the private market or simply hold the shares. This has been criticised as potentially resulting in a sort of "creeping" nationalisation. In March 1995, 6 banks entered into the PROCAPTE program and issued approximately \$1 billion in subordinated debt, while a seventh, *Probursa*, had been given additional time to meet minimum requirements in anticipation of its purchase by *Banco Bilbao Vizcaya* (BBV), a Spanish bank and important shareholder. See GAO, at 143-46. See also, Karaoglan & Lubrano, *supra* note 79, at 38-39.
115. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 143-146. See also, Karaoglan & Lubrano, *supra* note 80, at 39-40.
116. Under the legislation, banks are required to maintain reserves for non-performing loans of at least 60 percent, reserves equal to 4 percent of the total loan portfolio, or provisions as required from quarterly loan classifications under earlier rules, whichever is highest Karaoglan & Lubrano, *supra* note 80, at 38. Under the previous system, Mexican banks had discretion in classifying their loan portfolios in five categories. Under that system, banks created loan loss reserves based on requirements for each level of classification. See *Id.*, at 27, n.5. Under this system, in December 1994, provisioning for past due loans across all categories averaged 47.9%. *Id.*
-

increase the likelihood that loans will continue to perform in the face of high inflation and interest rates.¹¹⁷

Notwithstanding the efforts of the Mexican government to improve bank liquidity, bolster the capitalisation of the Mexican banking system, and institute the loan restructuring programme for banks, the state of the Mexican banking system still remains a concern.¹¹⁸ Further, Mexico still faces a number of challenges before the crisis can be considered resolved, including high interest rates, continued volatility in the peso, and weak economic growth.¹¹⁹

IV. The International Response to the Threat of Future Capital Surges.

The profile of international organizations such as the IMF and the World Bank makes them the usual starting point in any discussion of problems in the international financial system. The increasing role of these institutions in development, the IMF's part in the Debt Crisis of the 1980s, and the 50th year anniversary of the Bretton Woods system have made these institutions the focus of debate regarding sovereign liquidity and debt problems. In this regard, the IMF's desire to find a new leadership role in the period after the deterioration of the Bretton Woods system may be seen by its unusual efforts during the Peso Crisis,¹²⁰ given that the IMF's contribution far exceeded the amount that would nor-

117. On 1 April 1995, the Mexican Congress approved legislation permitting the use of an inflation-indexed unit of account for financial transactions (*Unidad de Inversio'n* or UDI). D.O., Apr. 1, 1995, at 2. The programme, the loan restructuring programme, essentially allows loan repayments to be stretched out and weighted more heavily toward the end of the loan by denominating loans in a UDI instrument that is linked to the consumer price index. The borrowers repay a real rate of interest, while the real value of the principal is preserved and amortised over an extended maturity. Unfortunately, the programme has taken off slowly since its implementation in April 1995 due to the need to train both bank personnel and borrowers on its operation and benefits. In addition to the UDI programme, on 23 August 1995, the government instituted a programme to provide direct interest subsidies to certain borrowers from commercial banks. The Agreement of Immediate Support of Bank Debtors (*Acuerdo de Apoyo Inmediato a Deudores de la Banca* or ADE) accelerates the restructuring of non-performing as well as performing loans to viable borrowers by bridging, for a one-year period, the gap between what borrowers were willing to pay and what lenders were willing to accept, and was intended to preempt more extreme measures being promoted by certain borrower pressure groups and to bring loans to viable borrowers back into performing status. Overall, the programme seems to be a success, with most credit card loans and mortgages, as well as a significant portion of business and consumer loans being restructured. See MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 143-46; see also, Karaoglan & Lubrano, *supra* note 80, at 40-43.

118. MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 146.

119. Economic growth for 1995, forecast at the start of the year by the Mexican government to show a decline of 2 percent, has been much worse. *Id.*

120. Zanny Minton-Beddoes, who writes for *The Economist*, has suggested that IMF overreached its capacity, not because of the US. influence on IMF policies, but rather because of its desire for new relevance in a world economy now characterised by instability and private power. See Zanny Minton-Beddoes, *Why IMF Needs Reform*, FOREIGN AFF., May 1995, at 123. See also, Robert Chote, *Weaknesses in IMF Shown by Mexico*, FIN. TIMES, Apr. 25, 1995.

mally be available to a country such as Mexico under IMF rules.¹²¹

In circumstances such as the Peso Crisis, in which financial markets essentially cease to function in terms of access, markets cannot be relied on to provide necessary liquidity,¹²² and for this reason, an international response is probably necessary for the stability of the international and domestic financial systems. During the Peso Crisis, Mexico was faced with a temporary liquidity crisis due to a large number of intertwined factors, some caused by problems within or exacerbated by Mexico, but other not, e.g. increases in U.S. interest rates. As a result of the Crisis and the perceived need to protect the international financial system, the U.S. organized an international response to the crisis. While these efforts may have been *sui generis* due to the importance of Mexico to the U.S. and due to Mexico's prominent position among LDCs, some efforts have since been made to address future liquidity crises and attempt to prevent them from causing long-term negative consequences.

A country can respond to a current account deficit in a number of ways, including: (i) attracting more foreign capital; (ii) allowing its currency to depreciate, thus making imports more expensive and exports cheaper; (iii) tightening monetary and/or fiscal policy to reduce the demand for all goods, including imports; and (iv) using foreign exchange reserves to cover the deficit.¹²³ If a country is unable to correct its current account problems, a liquidity crisis will result in which the country has insufficient reserves to make necessary external payments.

Nations with liquidity problems require new money in order to bridge the problem period and avoid the transition from a temporary liquidity crisis to a more serious debt crisis. There are three obvious sources of new money: first, official sources; second, new debt issues; and third, commercial banks.¹²⁴ During the Peso Crisis, Mexico tapped official sources, namely the U.S. and IMF; however, using government money as the main resource for liquidity is both unsustainable and expensive. New debt issues are unlikely in the present climate, and in fact Mexico was not able to access such sources until six months after the onset of the Crisis, and only then because it already had the official backing of the U.S. and IMF. A six month delay, however, turns a liquidity crisis into a debt crisis, and makes additional issues even more unlikely than previously. Finally, commercial banks will only lend if there is some indication that they will in fact be repaid by what is, by the very nature of the crisis situation, a risky debtor.¹²⁵ For this reason, some commentators argue that if

121. George Graham, *\$50 billion Mexico Aid Plan 'Averted a Global Crisis': 'Exceptional' Support Was Required, Says IMF Chief*, FIN TIMES, Feb. 3, 1995, at 16. IMF's contribution to support Mexico has been estimated at almost one-fifth of IMF's liquid resources and seven times Mexico's quota. *Perspective on a Panic*, FIN. TIMES, Feb. 11, 1995, at 8.

122. According to Bank of Mexico data, for three successive weekly auctions between 27 December 1994 and 10 January 1995, the Mexican government was simply unable to sell *tesobonos*. MEXICO'S FINANCIAL CRISIS, *supra* note 17, at 137.

123. See generally INTERNATIONAL CAPITAL MARKETS, *supra* note 3, at 95-108.

124. See Rory Macmillan, *Towards a Sovereign Debt Work-out System*, 16 NW J. INT'L L. & BUS. 57 (1995), at 104-105. [hereinafter *Debt Work-out System*].

125. *Id.* at 105. If the new money takes priority over the old money, however, commercial banks might in fact be induced to lend. The problem, then, is getting creditors to agree to subordinate their outstanding debt to the new money necessary to provide the liquidity to make payments flow again on the outstanding debt. *Id.*

the underlying problems of debt rescheduling were solved, that the necessary requirements for the provision of new money would fall into place, thereby using the solution to potential debt crises to avert future liquidity crises.¹²⁶ The suggestion is that rescheduling agreements would be promoted because lenders would be "waiting in the wings to lend."¹²⁷

At least three basic changes in the financial environment have some bearing on the character of potential future sovereign liquidity crises.¹²⁸ First, the broader and stronger linkages among domestic and international financial market mean that crises can erupt much more quickly in today's markets and can be far larger in scope than in the past. Second, flows of capital to emerging market economies in the form of purchases of securities have increased greatly in size over the years and have substituted for other types of private capital. Third, when a crisis occurs new finance is unlikely to be forthcoming from those who took the original lending. These changes mean that financing available from official sources is less likely to be sufficient to enable a sovereign debtor experiencing a crisis to meet fully its external financing obligations.¹²⁹ Moreover, provision of official funds to limit private losses raises serious moral hazard risks and could in fact interfere with market discipline.¹³⁰

Given this background, the next sections provide a brief overview of international responses to the threat of future liquidity crises.

A. THE IMF RESPONSE: LIQUIDITY AND DISCLOSURE.

Principally as a reaction to the sudden and overwhelming nature of the Peso Crisis, world leaders agreed to double the emergency funds of the IMF.¹³¹ The "General Agreement to Borrow," whereby IMF may draw upon the fund of the Group of Ten (G-10) governments and Saudi Arabia, is being increased to \$52 billion.¹³² This greatly increases the official lending power of the IMF to deal with the sort of liquidity crises experienced by Mexico, and it enhances the IMF's capacity as a lender of last resort.¹³³ Such an institution, however, poses the classic risk of "moral hazard" as investors may begin to rely on the inter-

126. This solution seems to be supported by the G-10. See *infra*, Section III.B. If an agreement to this effect could not be reached, say within 6 months, Macmillan suggests that perhaps legislation of creditor countries could be amended to provide that following a debt rescheduling agreement that new debt would take priority over old. *Debt Work-out System*, *supra* note 124, at 106.

127. *Debt Work-out System*, *supra* note 124, at 106.

128. WORKING PARTY, THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES, Executive Summary, para 3 (Group of Ten, Apr. 22, 1996), Executive Summary, reprinted in part in WORLD SECS. REG. L. REP. (BNA), Apr. 28, 1996, at 32-34 hereinafter, WORKING PARTY.

129. *Id.*

130. *Id.*

131. Robert Choate, *et al.* IMF Set to Get More Crisis Cash, FIN. TIMES, Oct. 9, 1995.

132. *Id.*

133. The theory of the lender of last resort was first set out by Walter Bagehot. He explained that if there were an institution ready to guarantee liquidity when the lending community doubted the debtor's liquidity, then commercial lenders would have confidence that new loans would be repaid. See Walter Bagehot, LOMBARD STREET 1902.

national community rather than monitoring country risks themselves.¹³⁴ Further, moral hazard poses high potential costs to the public sector because the capital of IMF is supplied by member governments.

As a second response to the Peso Crisis, the IMF has approved the Special Data Dissemination Standard (SDDS) for the provision of economic and financial statistics to the public by member countries, especially those countries that participate in the international capital markets or aspire to do so, and including both industrial and emerging economies.¹³⁵

In the aftermath of the Peso Crisis, the IMF's Interim Committee emphasised at its 26 April 1995 meeting that timely publication by members of comprehensive economic and financial data would give greater transparency to members' economic policies and thereby increase investor confidence and decrease the chances of unexpected surprises that might result in the massive capital outflows that characterized the aftermath of the Peso Crisis. The purpose of the newly-established SDDS is to "guide IMF members in the provision to the public of comprehensive, timely, accessible, and reliable economic and financial statistics in a world of increasing economic and financial integration."¹³⁶ As such, the SDDS comprises four elements: (i) coverage, periodicity, and timeliness of data; (ii) access by the public; (iii) integrity of the disseminated data; and (iv) quality of the disseminated data.¹³⁷ While participation is optional, countries seeking international capital can be expected to comply in order to meet investor demands for comparable information on competing countries.

B. THE GROUP OF TEN AND *THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES*.

Following an invitation by the Group of Seven to the Group of Ten in Halifax in June 1995, the Deputies of the G-10 established a Working Party to consider the issues arising with respect to the orderly resolution of sovereign liquidity crises.¹³⁸ On 22 April 1996, the Ministers and Governors of the Group of Ten nations released a communiqué on international financial emergencies such as the Mexican Peso Crisis based on and endorsing the Working Party Report.¹³⁹

134. See *Debt Work-out System*, *supra* note 124, at 63 (citing Lawrence Summers, *Summers on Mexico, Ten Lessons to Learn*, *ECONOMIST*, Dec 23, 1995, at 62).

135. See *IMF Executive Board Approves the Special Data Dissemination Standard*, IMF PRESS Rel no. 96/18 (Apr. 16, 1996). At an early stage it was decided that two sets of standards should be created, and work is continuing on the General Data Dissemination Standard applicable to all members, of which a proposal is to be considered in late 1996. *Id.*

136. *Id.*

137. See *IMF, Standards for The Dissemination by Countries of Economic and Financial Statistics: The Special Data Dissemination Standard* (April 1996), available on Internet, at [gopher://gopher.imf.org](http://gopher.imf.org). As part of the IMF's efforts at dissemination and timeliness, all data is to be available on the Data Dissemination Standards Bulletin Board (DSBB) by the end of August 1996.

138. WORKING PARTY, *supra* note 128, at 32-34.

139. Group of Ten, COMMUNIQUE OF MINISTERS AND GOVERNORS OF THE GROUP OF TEN NATIONS ON INTERNATIONAL FINANCIAL EMERGENCIES, Apr 22, 1996, reprinted in *WORLD SECS. L. REP. (BNA)*, Apr. 28, 1996, at 32. [hereinafter, G-10].

1. *The G-10 Communiqué.*

In its Communiqué, the G-10 noted the ongoing discussion between the G-10 countries and other countries aimed at developing new financing arrangements which would double the supplementary resources available to IMF under the GAB for coping with these sorts of international financial emergencies.¹⁴⁰ The G-10 affirmed that, given the need to contain moral hazard and the desirability of equitable burden-sharing, first, that neither the debtor countries nor their private creditors should expect to be insulated from any adverse financial consequences of their financial decisions by the provision of large-scale official financing in the event of a crisis, and second, that there should be no presumption that any type of debt would be exempt from payments suspensions or restructurings in any future sovereign liquidity crisis.¹⁴¹ Importantly, the G-10 stated that the current flexible, case-by-case practices and procedures, as developed over the years, are an appropriate starting point for considering how to respond to future sovereign liquidity crises, and that improvements should continue to evolve to meet the needs of specific crises, and stressed that improvements should be lead by private sector groups in developing any new contractual arrangements.¹⁴² Further, they affirmed that the official community's primary role in the resolution of sovereign liquidity crises should remain centered on "the promotion of strong and effective adjustment by debtor countries in the context of IMF-supported programs,"¹⁴³ thereby indicating the continued importance of IMF conditionality and structural adjustment programs.

The G-10 expressed support for the work of international financial organizations such as the Basle Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO), welcomed efforts to increase cooperation among authorities responsible for the supervision and stability of financial markets, and concluded that such organizations provide a helpful basis for further work in this area.¹⁴⁴ The G-10 also emphasized the importance of adherence to "credible and consistent economic policies" and endorsed actions to reinforce market discipline through the establishment of data dissemination standards by IMF, along with the strengthening of surveillance procedures.¹⁴⁵

2. *The Working Party Report.*

In carrying out its work, the Working Party sought to give the highest priority to measures that will help prevent crises from occurring, sought to endorse efforts already underway in other forums to improve market discipline and strengthen the surveillance of sovereign borrowers' economic performance, and attached particular importance to the need for sovereign borrowers to make "timely changes" in their economic policies if conditions change in ways that may lead to reductions in capital inflows.¹⁴⁶

140. *Id.* para. 1.

141. *Id.* para. 3. This latter statement seems directly aimed at holders of LDC bond debt. See *infra*, section V.

142. *Id.* para. 4.

143. *Id.*

144. *Id.* para. 5.

145. *Id.* See *supra* Section IV.A.

146. WORKING PARTY, *supra* note 128, para. 1.

In considering the means to deal with future sovereign liquidity crises, the Working Party concluded that no pre-set procedure could be suitable to all cases; however, it did identify a broad set of desirable principles and features that provide a framework for the development of procedures for handling sovereign liquidity crises in a flexible, case-by-case approach.¹⁴⁷ Any such procedure should have the following features:¹⁴⁸ (i) foster sound economic policies by all debtors; (ii) minimize moral hazard for both creditors and debtors; (iii) rely on market forces and not interfere with the efficient operation of secondary markets in relevant debt instruments; (iv) limit contagion from one debtor's problems to other countries; (v) support credible and sustainable actions and not impose excessive social, political, or economic costs on the debtor; (vi) seek to ensure that burdens associated with the provision of exceptional financing are allocated fairly and within and across different classes of creditors; (vii) strengthen the ability of governments to resist pressures to assume responsibility for the external liabilities of their private sectors; (viii) be suitable for quick and flexible use in a variety of different cases; (ix) be cooperative and non-confrontational, and promote the adoption by debtors and creditors of arrangements to facilitate resolution of liquidity crises; (x) build on existing contractual or other arrangements that facilitate the resolution of crises; and (xi) make use of existing practices and institutions. In terms of policy, the official community's interest in containing systemic risk and its role as a lender to sovereign borrowers means that the official community has a stake, and therefore a role to play, in fostering cooperative efforts by debtors and creditors to contend with unexpected payments problems.¹⁴⁹

The Working Party reached seven broad conclusions in its report.¹⁵⁰ First, it is essential as a basic principle that the terms and conditions of all debt contracts are to be met in full and that market discipline must be preserved.¹⁵¹ In exceptional cases, however, a temporary suspension of debt payments by the debtor may be unavoidable as a part of the process of crisis resolution and as a way of gaining time to put in place a credible adjustment program.¹⁵² Second, neither debtor countries nor their creditors should expect to be insulated from adverse financial consequences by the provision of large-scale official financing in the event of a crisis,¹⁵³ as markets are equipped to assess the risks involved in lending to sovereign borrowers and to set the prices and other terms of the instruments accordingly, and no type of debt will be exempt from future problems and solutions.¹⁵⁴ Third, current practices and procedures emphasizing the importance of adjustment efforts of the debtor country and placing principal responsibilities for work-outs on the private participants are

147. *Id.* para. 4. This approach should be taken in light of the conditions prevailing at the time, the nature and intensity of the crisis, and the circumstances of the debtor. *Id.*

148. *Id.*

149. *Id.* para. 5.

150. *Id.* para. 2.

151. *Id.*

152. *Id.* The Working Party did not consider that it would be feasible to operate any formal mechanism for signalling the official community's approval of a suspension of payments by the debtor. *Id.*, para. 9.

153. The Working Party concluded, however, that it is not possible or desirable to preclude official involvement altogether in the event of a serious crisis, albeit short of the creation of an international bankruptcy forum. *Id.*, para. 5.

154. *Id.* para. 2.

an appropriate starting point, and improvements should be evolutionary.¹⁵⁵ The practices are based on the implementation of an IMF-supported sustainable adjustment program as a major precondition for the cooperative resolution of any crisis.¹⁵⁶ Fourth, international bankruptcy procedures do not appear to provide, either currently or in the foreseeable future, "a feasible or appropriate way" of dealing with sovereign liquidity crises.¹⁵⁷ Fifth, further consideration should be given in "appropriate forums"¹⁵⁸ to ways in which the financial systems in emerging market economies could be strengthened in order to reduce the risks they might pose in the event of a sovereign liquidity crisis.¹⁵⁹ The Working Party recognized that structural weaknesses in the banking systems of debtor countries could seriously aggravate liquidity crises and might pose difficulties for financial systems in lender countries.¹⁶⁰ Sixth, a market-led process to develop for inclusion in sovereign debt instruments contractual provisions that facilitate consultation and cooperation between debtors and their private creditors, as well as within the creditor community, in the event of a crisis would be desirable.¹⁶¹ Seven, it would be advisable for the IMF to review existing policy in regard to lending support prior to full and final resolution of sovereign borrower arrears to private creditors and to consider whether the scope of its application should be extended to other forms of debt not now covered, "while remaining mindful of the need for prudence

-
155. *Id.* According to the Working Party, current practices were developed over the course of the past few decades to contend with real world problems in a pragmatic and flexible manner. Further, they are voluntary and make use of market information and market forces. These practices recognise the distinct perspectives of the three main actors involved in a crisis, *i.e.*, the official community, private creditors, and the sovereign debtor, as well as their common interest in the orderly resolution of any crisis. The practices involve national authorities and multilateral institutions but place principal responsibility on the individual debtor and its creditors. *Id.*, para. 6.
156. *Id.*
157. *Id.* The Working Party did note that further study by "private sector entities" may be warranted. *Id.* According to the Working Party, sovereign debtors have not in the past had a strong need for legal protection against creditors, and moreover, they could not be forced to submit to the jurisdiction of a bankruptcy forum. *Id.*, para. 5.
158. This would presumably mean, at a minimum, the Basle Committee, IOSCO, and IMF
159. WORKING PARTY, *supra* note 128, para. 2.
160. *Id.* para. 7.
161. *Id.* para. 2. Such market initiatives would deserve "official support" as "appropriate." *Id.* The Working Party took the view that certain contractual provisions governing debt contracts can facilitate the resolution of a crisis by fostering dialogue and consultation between the sovereign debtor and its creditors and among creditors, and by reducing the incentive for, or ability of, a small number of dissident creditors to disrupt, delay, or prevent arrangements to support a credible adjustment programme that is acceptable to the vast majority of concerned parties. Such provisions include, *inter alia*, those that (i) provide for the collective representation of debt holders in the event of crisis, (ii) allow for qualified majority voting to alter the terms and conditions of debt contracts, and (iii) require the sharing among creditors of assets received from the debtor. The Working Party noted that in fact such clause have been employed in a limited number of contracts. *Id.*, para. 8.
-

and the maintenance of strict conditionality.”¹⁶² According to the Working Party, such lending can both signal confidence in the debtor country’s policies and longer-term prospects and indicate to unpaid creditors that their interests would be best served by quickly reaching an agreement with the debtor.¹⁶³

The Working Party reached the overall conclusion that there is no need to change current procedures for official bilateral credits and long-term bank claims.¹⁶⁴ It did, however, recognize that there is a need for the principles and procedures for handling sovereign liquidity crises to take into account the new importance of debt in the form of securities and the growing likelihood that some such debt may have to be subject to renegotiation in the future.¹⁶⁵ As for the official community, while it may be able to facilitate dialogue and assist in data collection, the Working Party concluded that market participants should make the decisions regarding any innovations in contractual provisions: “The official community’s primary role in the resolution of sovereign liquidity crises should remain centered on the promotion of strong and effective adjustment by debtor countries in the context of IMF-supported programs, which would need to take into account any recourse to temporary suspensions of payments.”¹⁶⁶

V. Debt Crises and Liquidity Crises.

If a debtor has liquidity problems and cannot meet its debt obligations, the debtor usually needs to borrow in order to maintain debt payments and ongoing financial operations, even in cases where debt is rescheduled.¹⁶⁷ Although such a situation may affect or even threaten the international financial system and the domestic economy of the country experiencing problems, a debt crisis is in reality simply a breakdown in contractual relations between two parties, namely a debtor and its creditors. Unfortunately, the same political pressures that restrained banks from initiating lawsuits and pushed them into debt reschedulings during the 1980s and forced unwilling banks to lend more to debtor governments are unlikely to be present in the future, and today, bondholders would in all probability refuse to increase their exposure based upon their holdings of international debt.¹⁶⁸

162. *Id.* para. 2. Although the Working Party rejected any formal international approval of a suspension of debt payments, it concluded that it would be advisable for IMF Executive Board to consider extending the scope of its current policy of lending, in exceptional circumstances, to a country that faces the prospect of continuing to accumulate arrears on some of its contractual debt-service obligations to private sector creditors, in cases where the country is undertaking a strong adjustment programme and making reasonable efforts to negotiate with its creditors. *Id.*, para. 9.

163. *Id.*

164. *Id.* para. 10.

165. *Id.*

166. *Id.*

167. *Debt Work-out System*, *supra* note 123, at 104

168. *Id.* See generally, MacMillan, *supra* note 7: Power, *supra* note 7, for excellent analyses of the development of the law in this area.

In this context, the Peso Crisis is illustrative of the situation that a sovereign may find itself in: as the Peso Crisis commenced, the Mexican government had approximately \$90 billion of debt outstanding.¹⁶⁹

A. BRIEF HISTORY OF DEBT CRISES.

Debt crises arise in different ways: in the Peso Crisis, the local currency was suddenly massively devalued against the U.S. dollar,¹⁷⁰ while the 1982 Debt Crisis was caused by rising interest rates, causing the external debt burden to be more expensive while falling commodity prices reduced foreign currency reserves from export earnings.¹⁷¹ Debt crises may be the result of liquidity crises,¹⁷² as well as the result of factors beyond the countries' control, such as the various oil shocks of the 1970s and 1980s.¹⁷³

Debt crises are not new phenomena: in the 19th century, Latin America experienced a number of such crises.¹⁷⁴ Starting in the early 1820s, an enormous amount of loans to Latin American states from British investors was followed by mass defaults throughout the middle of the 19th century.¹⁷⁵ Without a legal remedy, bondholders were forced to develop procedures by which they might negotiate payment of some of the

169. INT'L CAPITAL MARKETS, *supra* note 3, at 62.

170. By the end of March 1995, the new peso had fallen by almost 50% in foreign currency terms since the exchange rate was allowed to float in December 1994. WORLD ECONOMIC OUTLOOK, 39 IMF ANNUAL REPORT (Oct. 1995).

171. According to Morgan Guaranty Bank, in 1982, the ratio of debt service payments to exchange was 179% in Argentina, 129% in Mexico, 122% in Brazil, 116% in Chile, and 95% in Venezuela (the five largest debtors). *International Lending: Implications of a Slowdown*, WORLD FIN. MARKETS (Oct. 1982), at 1, tbl. 5. By 1982, the ratio of debts to exports of goods and services had reached 144%, and their ratio of debt to GDP had reached 36%. E. Brau, et al., *Recent Multilateral Debt Reschedulings with Official Bank Creditors*, IMF Occasional Paper No. 25, (1983), at 4, tbl. 1.

172. When a country's foreign reserves run low or the cost of its debt increases, debt payments become more difficult. As the problem becomes more serious, lenders become less willing to lend, thereby increasing the problems of the afflicted LDC. See *Debt Work-out System*, *supra* note 124, at 62.

173. See *World Economic Outlook* (IMF Occasional Paper No. 21 (1983), at 56-57. See also, Vito Tanzi, *Fiscal Policy Responses to Exogenous Shocks in Developing Countries*, 76 AM. ECON. REV. 88 (1986), at 89-90.

174. See Frank Dawson, *THE FIRST LATIN AMERICAN DEBT CRISIS THE CITY OF LONDON AND THE 1822-1825 LOAN BUBBLE 197* (1990); see also, SEC REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, Pt. V (1937), at 120-142.

175. See generally, Dawson, *supra* note 174, chs VI-X. Creditors at this time had no enforceable legal remedies at the time due to the doctrine of sovereign immunity, and local Latin American investors would not entertain suits against their states. *Debt Work-out System*, *supra* note 124, at 81. In the U.S. sovereign immunity was in effect until as late as 1951. See generally *Schooner Exchange v. McFadden*, 11 U.S. 116, 135-46 (1812) (without a waiver, sovereign immunity is a defense). The Tate Letter in 1952 changed the policy to a more restrictive policy of sovereign immunity, denying immunity for a sovereign's commercial activities. See Jack Tate, LETTER FROM THE ACTING LEGAL ADVISOR TO THE ATTORNEY GENERAL (May 25, 1952), reprinted in 26 DEP'T ST. BULL. 984 (1952).

defaulted debt, namely through the creation of bondholder councils.¹⁷⁶

During the early part of the 20th century, foreign governments began to issue large amounts of bonds in the U.S., and again, enormous defaults occurred, particularly during the 1930s, with American creditors being forced to resort to similar measures to those used in the earlier defaults.¹⁷⁷ Unfortunately, bondholder committees were only as effective as the amount of bonds entrusted to them as their power was essentially only in relation to their negotiating strength with the defaulting governments.¹⁷⁸ Finally, while bondholders sometimes pursued remedies through issuing banks, banks tended to remain loyal to the issuers rather than to the bondholders.¹⁷⁹

During the prolonged Debt Crisis of the 1980s, the structure of the debt made it relatively easy for lenders to emerge which guided the creditor banks in the debt negotiations: the vast majority of the debt was in the form of syndicated bank loans, and the commercial banks therefore effectively had representatives which negotiated the debt with the governments. Countries invited the banks to negotiate by forming an advisory committee, with Bank Advisory Committees ("BACs"), consisting of the lead banks which had organized the syndicated loans, emerging. These were informal groups¹⁸⁰ that represented the creditors and gave advice to the country on how best to progress with the restructuring in the interests of what might be acceptable to the wider banking community, and obtained cooperation among the hundreds of creditor banks by making recommendations for a restructuring which they then imposed using their political leverage.

The debt restructuring programs of the 1980s were usually carried out in conjunction with IMF-sponsored economic stabilization and adjustment programs. Most of the countries that have come through the restructuring process, therefore, have done so with economies that have benefited from major structural reforms. Although the reforms generally mandated are not necessarily completely defeasible,¹⁸¹ they at least reflect what investors search for in deciding to invest in an LDC market, although arguably at the same time present just the sort of consequences experienced by Mexico.

-
176. For a description of the development of these mechanisms, see "Debt Work-out System," *supra* note 124, at 81-83.
177. *Debt Work-out System*, *supra* note 124, at 83. See SEC Report, *supra* note 173, at 120-42.
178. See SEC Report, *supra* note 173, at 220 ("Control over deposited bonds and possession of proxies are obviously evidence of authority").
179. *Debt Work-out System*, *supra* note 124, at 84; see SEC Report, at 512-31.
180. "The formation and role of a bank advisory group is informal and without legal recognition, either as a matter of contract or as a matter of law." Alfred Mudge, *Sovereign Debt Restructure: A Perspective of Counsel to Agent Banks, Bank Advisory Groups and Servicing Banks*, 23 COLUM. J. TRANSNAT'L L. 59 (1984), at 64.
181. See Paul Krugman, *Dutch Tulips and Emerging Markets*, FOREIGN AFFAIRS, July/Aug 1995, at 28. Krugman describes the so-called "Washington Consensus" regarding LDC economic policies that developed in the early 1990s as: "Liberize trade, privatize state enterprises, balance the budget, peg the exchange rate, and one will have laid the foundations for an economic takeoff; find a country that has done these things, and there one may confidently expect to realize high returns on investments." *Id.* at 29.
-

B. INTERNATIONAL LENDING TODAY.

The circumstances under which cross-border lending takes place today are significantly different from cross-border lending activities twenty years ago. One consequence of this is that the resolution of future LDC debt problems, if such problems recur, may also be very different from the methods used to resolve the 1982 Debt Crisis. The integration of the world's financial markets over the last twenty years is perhaps the single most important change in cross-border lending, with money flowing into and out of economies with incredible speed, as graphically demonstrated by the Mexican Peso Crisis.¹⁸² Any diminution in investor confidence can be reflected in massive and immediate shifts of capital to the detriment of the LDC borrower.¹⁸³ In this new era of rapidly shifting capital, borrowers are expected to internalise these lessons, at least in theory; however, there are at least two problematic factors:¹⁸⁴ first, despite the efforts of developing countries to distance themselves in the minds of investors from those LDCs experiencing problems, the markets tend not to be very discriminating in this regard, as clearly demonstrated by the so-called "tequila effect"¹⁸⁵; and second, Western-educated bureaucrats have risen to prominence in many countries, and while these individuals understand the economic prerequisites thought necessary to attract foreign capital, the challenge in at least some LDCs is to convince the domestic population that these longer-term objectives are in fact worth enduring despite potentially severe near-term sacrifices.¹⁸⁶

Overall, historical cycles of cross-border lending have not all been alike. A number of factors illustrate the differences between the current cross-border capital flows and those occurring in the 1970s. Factors include differences in the nature of investors, instruments, and borrowers, interest rate bases, use of proceeds, economic reforms, available information, remedies, and disclosure.¹⁸⁷ Most of the lending to LDCs during the 1970s took the form of syndicated commercial bank loans, with banks intermediating petrodollars and

182. See Michael R Sesit, *Mexico's Economic Troubles a Reminder of Risks in Emerging Market Investments*, WALL ST. J., Dec. 28, 1994, at C1, col. 1.

183. See Jonathan Friedland, *Peso Crisis Highlights Diminished Roles of IMF, World Bank in Latin America*, WALL ST. J., Jan. 17, 1995, at A13, col. 3; Fidler, *More Liberal Flows of Funds Creates Instability*, FIN. TIMES, Jan. 27, 1995, at 4, col. 1; Carrington, *Private Capital Flows Can Hurt Poor Nations*, WALL ST. J., Jan. 30, 1995, at A1, col. 5.

184. Buchheit, *supra* note 8, at 55.

185. See *Latin America in the Fallout Zone*, ECONOMIST, Jan 7, 1995, at 59; Floyd Norris, *Mexican Shadow Falls on Emerging Markets*, N.Y. TIMES, Feb. 1, 1995, at D1, col. 2.

186. See Anthony DePalma, *After the Fall: 2 Faces of Mexico's Economy*, N.Y. TIMES, July 16, 1995, at 1, Sec. 3, col. 1.

187. See Buchheit, *supra* note 8, at 47-54.

flight capital between Euromarket depositors and the ultimate LDC borrowers, many of whom funded the flow of petrodollars in the first place. In contrast, cross-border lending in the 1990s has taken place and probably will continue to take place through the mechanism of the international bond markets.¹⁸⁸ In contrast to the potentially systemic consequences of LDC default on commercial bank debt in the 1980s, if future events force issuers to default on these bonds *en masse*, many investors might lose their money but the full weight of the problem will not fall on the commercial banks, their regulators, and their government sponsored deposit insurance agencies.¹⁸⁹

Today, unsecured, medium-term, commercial bank syndicated loans are much less common, at least in the context of LDC financing,¹⁹⁰ although this may be changing somewhat.¹⁹¹ While syndicated loans were often rescheduled during the 1980s, publicly issued bonds were almost never rescheduled during the Debt Crisis.¹⁹² Although investors in the 1990s seem to take some comfort from this recent practice of excluding bonds from the unpleasantness of debt reschedulings, the main reason why bonds were not rescheduled in the 1980s was that there were not very many of them, and moreover, many sovereign borrowers also felt that by maintaining punctual debt servicing of outstanding bonds, international bond markets could be kept available for an eventual re-entry of sovereign borrowers to the international capital markets.¹⁹³ While this recent reluctance to reschedule has in fact encouraged investors in these sorts of instruments,¹⁹⁴ these instruments are certainly not free from risks of default, as has been shown by the history of international bond issues by developing countries. Because bank loans are now less common and bonds have become the lending instrument of choice in LDC financing, a borrower that experiences financial difficulties in the future may find that its outstanding bond debt is simply too large to be ignored or excluded from a request for debt relief, and the mechanics of this process have been the subject of some debate.¹⁹⁵

While until the middle of the 20th century, a lender extending credit to a foreign sovereign did so with no expectation that he could compel repayment of the debt by legal means, today creditor countries such as the U.S. and the U.K. recognise a restrictive theory of sovereign immunity under which sovereigns engaged in commercial activity abroad may be sued in the national courts of other countries.¹⁹⁶ Moreover, drafters of credit agree-

188. *Id.* at 47; *Debt Work-out System*, *supra* note 124, at 80. See WORLD BANK, WORLD DEBT TABLES 1993-94 (1993), at 20-22 [hereinafter 1993-94 WORLD DEBT TABLES].

189. See Buchheit, *supra* note 8, at 48.

190. See 1993-94 DEBT TABLES, *supra* note 188 at 25 ("As in previous years, access to syndicated bank credit was severely restricted for developing countries that had experienced, or are experiencing, debt-servicing difficulties").

191. See Joseph J. Norton, *International Syndicated Lending: The Legal Context for Economic Development in Latin America*, NAFTA L. & BUS. REV. 21, 21-24 (Summer 1996).

192. The Eurobonds and floating rate note issues of most countries were consciously excluded from the rescheduling exercises and were paid on time in full Buchheit, *supra* note 7, at 48.

193. *Id.* at 49.

194. These sentiments are reflected in the publications of major investment banks See Buchheit, *supra* note 8, at 48. n. 17.

195. See Macmillan, *The Next Sovereign Debt Crisis*, *supra* note 7.

196. For example, in the US., the restrictive theory of sovereign immunity is codified in the Foreign Sovereign Immunities Act of 1976, and in the U.K in the State Immunity Act 1978.

ments and bond indentures for sovereign borrowers and government-owned enterprises routinely include express waivers of any immunities to which the borrowers may be entitled.¹⁹⁷ While lenders could have attempted to litigate a solution to the last debt crisis, this was not the solution chosen.¹⁹⁸ If debt problems recur in LDCs in the future, it is not at all clear that negotiated settlements could be achieved without the real threat of litigation by some creditors,¹⁹⁹ despite the arguments that publicly-issued bonds will be treated as a preferred category of debt and serviced faithfully even if other obligations go into default.²⁰⁰

C. PROPOSED SOLUTIONS.

Three factors would make debt rescheduling more difficult in a bond crisis today.²⁰¹ First, it is unlikely that the systemic implications to the international banking industry will be repeated in a sufficient manner to produce pressure on creditors to reschedule *en masse*. Second, bondholders may hope that official sources will provide the necessary liquidity to enable their bonds to be paid in full without a rescheduling. Third, maverick bondholder litigation will almost certainly cause problems.²⁰²

According to one commentator, however, in future sovereign debt crises, potentially resulting from sovereign liquidity crises, debt reschedulings are inevitable simply because

197. See *Debt Work-out System*, *supra* note 124, at 72.

198. See *Avoiding the Nightmare Solution*, INT'L FIN'L L. REV., Aug. 1992, at 19. Several reasons have been advanced to explain this forbearance: the brotherhood of bankers, the fear of prompting a raised eyebrow of disapproval by one's regulator, and a recognition that any widespread resort to lawsuits would jeopardise the renegotiation process and force borrowers into a "bunker" mentality. Buchheit, *supra* note 8, at 53. Legally, the banks could have brought suits over their loans: New York or English law usually controlled the agreements, and neither of these countries apply foreign sovereign immunity to sovereign bonds. *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 617-19 (1992); see also, George R. Delaume, *The Foreign Sovereign Immunities Act and Public Debt Litigation: Some Fifteen Years Later*, 88 AM. J. INT'L L. 257 (1994); George R. Delaume, *Sovereign Immunity and Public Debt*, 23 INT'L LAW. 811 (1989). The nature of syndicated lending further hindered banks from suing on the debt because it is very difficult for member banks to take unilateral action due to contractual provisions, such as sharing clauses generally contained in the agreements. See Lee C. Buchheit, *The Sharing Clause as a Litigation Shield*, INT'L FIN. L. REV., Oct. 1990, at 15.

199. Overall, the arguments against "pressing the button," while other opportunities to recover the debt remain unexplored, are probably persuasive. "Latin American Debt Obligations in the 1990s: Risk Strategies: Remedies and Judicial Enforcement," 16 NW. J. INT'L L. & BUS. 5, 7-8 (1995). Note that under Mexican law, a currency devaluation is not considered an act of God or force majeure. *Id.* at 12.

200. See Buchheit, *supra* note 8, at 53-54.

201. See *Debt Work-out System*, *supra* note 124, at 71-72.

202. Bondholders can expect to obtain judgments in US. and/or U.K. courts. See Macmillan, *The Next Sovereign Debt Crisis*, *supra* note 7. This is fact started to occur and is likely to increase in frequency. *Id.*

there is no alternative since private lending will simply become unavailable.²⁰³ Other sorts of public²⁰⁴ and private finance²⁰⁵ are also unlikely to yield support. Given these realities, the current legal and institutional framework for handling a sovereign debt restructuring has been described as "embarrassing unprepared" to handle the "enormous amount of bonds spread across a vast international market of different types of investors."²⁰⁶

Rory MacMillan has suggested that such a work-out system must accomplish two goals: first, it must enable creditors and debtors to negotiate debt reschedulings whereby the timing of payments is postponed or debt reduction whereby the burden of debt is reduced; and second, it must make new lending to the debtor country possible so as to provide liquidity and restoring it to immediate debt servicing capability.²⁰⁷ Further, three problems must be addressed in setting up such a debt renegotiation system:²⁰⁸ (i) with most sovereign debt taking the form of bonds, there are no obvious parties to play a leadership role when a crisis arises; (ii) there is no coordination mechanism for the large number and variety of ever-changing creditors to act together; and (iii) even if there were such leadership and coordination, creditors have no individual incentive to act together because they lack a solidarity of interests.

Because the vast majority of sovereign debt now takes the form of bonds rather than loans, in a crisis there will be no provision for coordinated representation and leadership. Further, it would be very hard to impose political pressures similar to those imposed on lead banks in the 1980s; moreover, bondholders are not bound together in the same way as lenders organized into loan syndicates.²⁰⁹ Even if a mechanism existed to organize bondholders to act together, collective decisions are not necessarily in their individual interests since no creditor wants to take a loss, the idea being that if some creditors reschedule their debt, those creditors which retain the face value of their debt will "free ride" because the rescheduling increases liquidity and enables the free riders to be paid at face value.²¹⁰ This problem plagued the debt negotiations during the 1980s, but in the first few years the

203. *Debt Work-out System*, *Supra* note 124, at 59. The banks are unlikely to lend to LDCs experiencing problems after their experiences following the 1982 Debt Crisis. *Id.* This was demonstrated in the Peso Crisis when commercial banks were asked by the U.S. government to participate in the rescue plan, but their portion never materialised. See Richard Waters & Leslie Crawford, *Banks Pull Out of \$3bn Role in Mexican Rescue*, *FIN. TIMES*, Mar. 23, 1995, at 20; Timothy O'Brien, *Prospects Look Dim for Bank Loan to Mexico*, *WALL ST. J.*, Feb. 13, 1995, at A3.

204. The U.S. government is unlikely to respond as it did to the Peso Crisis in the future. Further, IMF has stated that it will not intervene. See generally G-10, Section III. B. and note 137, *supra*.

205. Mexico was unable to return to international capital markets for 6 months after the onset of the crisis, with the first issue of Mexican sovereign debt not coming until July 1995. Leslie Crawford, *Mexican Bonds Welcomed*, *FIN. TIMES*, July 11, 1995, at 3. See also, Daniel Dombey, *Mexico to Restructure Debt Through \$500m Bond Issue*, *FIN. TIMES*, July 26, 1995, at 4.

206. *Debt Work-out System*, *supra* note 124, at 59-60.

207. *Id.* at 60.

208. *Id.*

209. In particular, bonds do not contain sharing clauses. See *id.* at 73.

210. *Id.* at 70.

lead banks were able to exert pressure in order to quell opposition.²¹¹ Further, the syndicated loans intended to provide new money involved all the creditors in a single agreement, thus providing strong creditor solidarity and less scope for individual litigation on the part of any single creditor.²¹²

Proposals have begun to emerge for a workable solution to future sovereign debt crises. One suggestion has come from Harvard economist Jeffrey Sachs who has suggested that governments set up a sort of international bankruptcy regime for debtor governments.²¹³ The problem with Sachs' solution, as noted by the G-10, is that it looks to the international institutions such as IMF and the World Bank as an answer: while such a solution seems like the obvious starting point, such a solution could potentially threaten the sovereignty of LDCs by giving the IMF the power to decide when a country would declare a moratorium on its debt.²¹⁴ Further, giving the IMF such legal powers would also revolutionise international financial law, with debt instruments governed by New York or English law suddenly being subject to the uncertainties of the international political order, as the IMF may be subject to unpredictable political influence at the hands of its member governments.²¹⁵ Finally, apart from being politically unacceptable, a sovereign debt workout manager is in all likelihood unnecessary.²¹⁶

At the other end of the spectrum from the Sachs proposal is a proposal by James Hurlock, a lawyer at White & Case.²¹⁷ Hurlock suggests that problems of maverick bondholders could be dealt with by closing the courts to such investors through the amending of sovereign immunity laws so that a sovereign debtor would be immune from law suits in the

211. *Id.*

212. *Id.* at 71.

213. See *id.* at 76-77 (citing Jeffrey Sachs, *Do We Need an International Lender of Last Resort?* (unpublished manuscript, 1995)). Under Sachs' proposal, such a system would give the IMF legal powers analogous to a bankruptcy judge in U.S. Chapter 11 proceedings. The IMF would have the legal authority to declare a moratorium on debt payments, stop legal proceedings, and organise debt workouts. Such a system would reapportion losses to the market, providing a less expensive solution to governments than publicly funded IMF bailouts, and the problems of leadership, coordination, and solidarity could all be solved and imposed by the IMF.

214. *Id.* at 77-78. For this reason, MacMillan suggests that IMF's role should be limited to providing temporary liquidity and conditional structural adjustment programs. *Id.* at 78.

215. The laws of these jurisdictions are typically chosen for their sophistication and predictability

216. See G-10, *supra* note 137.

217. James Hurlock, *The Way Ahead for Sovereign Debt*, EUROMONEY, Aug 1995, at 78-79. Hurlock argues that the problems of leadership and coordination are not significant because corporate debt work-outs are largely "self-executing in that creditors, in concert with the debtor, collectively determine the economic terms upon which the enterprise will be restructured," and that bankruptcy judges in fact play a peripheral role in reorganizations. He argues that a debt workout system does not necessarily require any international institution to play a central role because the difficulties consist of fundamental mechanical problems which do not need governmental supervision, and that in fact debtors and creditors can reach restructuring agreements successfully without official intervention. The real problem, then, is solidarity, i.e. the danger of the maverick bondholder disrupting the negotiations by suing.

midst of a negotiated work-out. Such an approach has been criticised for two reasons:²¹⁸ first, the problems of leadership and coordination are probably much more serious than Hurlock suggest, given the likely complexity of the next sovereign debt crisis; and second, amending sovereign immunities laws in this fashion could create serious moral hazard problems as it could foreseeably bring about a return to the pattern of defaults seen during the 19th and early 20th century.

Other proposals include that of Barry Eichengreen and Richard Portes of the Centre for Economic Policy Research who suggest a three-pronged work-out system,²¹⁹ and that of Rory Macmillan based on historical experiences with bondholder councils in the 19th and 20th centuries.²²⁰ Overall, both the Eichengreen/Portes proposal and Macmillan's proposal are well-thought out, but nonetheless seems to require intelligent and coordinated action by the major creditor country governments — something that may or may not be possible; however, it nonetheless seems largely in line with the thinking of the G-10.

D. PRIVATE DEBT

Investors in the 1990s have a preference for private sector borrowers,²²¹ and the balance of payments financings for sovereign borrowers that characterized the late 1970s are now distinctly out of favor. Private sector borrowers, however, are likely to be caught in

218. See *Debt Work-out System*, *supra* note 124, at 79.

219. Barry Eichengreen, et al, *Crisis, What Crisis? Orderly Workouts for Sovereign Debtors*, (Council for Economic Policy Research, Sept. 1995). First, in order to address the problem of coordination, they endorse the idea of creating one or more bondholder councils which, with the help of a mediation or conciliation service, would negotiate debt reschedulings on behalf of bondholders. Second, they suggest that the lack of solidarity could be solved by an *ex ante* solution: if the legal provisions of future bonds allowed a majority of bondholders to negotiate changes in the essential terms of the bonds, e.g., maturity date, coupon payment date, principal and interest amounts, etc., then bondholder councils could negotiate effectively with the sovereign debtor. Third, they endorse the strengthening of the IMF's ability to provide emergency financing and encourage it to play a legitimising role for countries wishing to renegotiate their debts.

220. *Debt Work-out System*, *supra* note 124, at 86-94. See also, Rory MacMillan, *New Lease on Life for Bondholder Councils*, FIN. TIMES, Aug. 15, 1995, at 11. Under his proposal, U.S. and U.K. legislation would be altered so that indenture trustees would be allowed for sovereign issues, thereby gaining the benefits provided by the lead banks during the Debt Crisis of the 1980s. Further, to deal with the coordination problem, national bondholder councils would be set up in the major issuing jurisdictions, namely the U.S. and the U.K., funded by fees from the issuing of bonds and from rescheduling efforts. Finally, to deal with the solidarity problem, Macmillan suggests, *inter alia*, that rather than granting complete immunity to debtors as in the Hurlock proposal, legislation might be used to vest bondholders rights collectively and exclusively in the bondholder council, but only during debt crises officially declared by either the country of IMF. *Id.* at 94-104.

221. See 1993 PRIVATE MARKET FINANCING, at 19. Private sector issuers accounted for an increasing share of developing country bond issues in 1992, representing 42% of total issuance activity, compared with 31% in 1991 and 8% in 1989. IMF, INTERNATIONAL CAPITAL MARKETS, PART II: SYSTEMIC ISSUES IN INTERNATIONAL FINANCE (1993), at 50. See also, Wolf, *Private Capital Flows After Mexico*, FIN. TIMES, Jan. 23, 1995, at 22, col. 5 ("In 1993, 95 per cent of net private finance flowed to the private sector, while 70 per cent of net long-term flows to developing countries were from private sources to private users, up from 45 per cent in 1990.").

any problems that their sovereign experiences, and accessing assets located abroad may not be as easy as it may appear at first glance. A private sector entity, particularly one that has its own reliable source of foreign currency earnings, may be perfectly creditworthy when viewed in isolation; however, the company may find itself in a predicament as a result of its location in a country whose aggregate foreign exchange inflows are insufficient to pay for the country's necessary imports and external debt service. As a consequence, even the most solvent private sector company may find itself drawn into its government's external debt difficulties, despite its own best efforts. For this reason, rating agencies have long recognized that even the most creditworthy private sector borrower cannot resist its government's call for a centralization of foreign exchange nor can it avoid being swept up in its government's debt problems.²²²

Unlike the predominantly syndicated bank lending of the late 1970s, directed mostly to sovereign and state owned or guaranteed enterprises, private sector borrowers have been the principal beneficiaries of private capital flows in the 1990s.²²³ For this reason, the external debt position of private sector borrowers will be a centerpiece of concern should liquidity problems occur in an emerging market.²²⁴ The precarious position of private sector borrowers was highlighted by the Mexican Peso Crisis of 1994-95.

At the beginning of 1995, outstanding Mexican Eurobonds totalled, collectively, approximately \$20 billion, of which approximately \$13 billion had been issued by private sector Mexican companies.²²⁵ As the Mexican devaluation commenced, the Mexican corporate sector also had substantial foreign currency-denominated bank debt and short-term

-
222. This is commonly known as "sovereign ceiling," the rating agencies' shorthand expression for the proposition that no private sector borrower in a developing country can achieve an external debt rating higher than that of its own sovereign unless the transaction is structured so as to intercept an off-shore stream of foreign currency revenue for the benefit of the debtholders, or through some other special circumstance insulating the company from the effects of the sovereign. See Taylor, *Securitizations Can Overcome 'Sovereign Ceiling'*, in Duff & Phelps Credit Rating Co., *PERSPECTIVES ON EMERGING MARKETS*, Jan. 1995, at 5; *Apasco Outdoes the Sovereign*, *EUROMONEY*, Sept. 1995, at 20.
223. See WORLD BANK, *WORLD DEBT TABLES 1994-95*, Vol 1, at 10. During the mid- 1980s, only approximately \$14 billion of private sector Mexican corporate debt was restructured. See Duncan N. Darrow, et al., *Restructuring Strategies for Mexican Eurobond Debt*, 16 *NW. J. INT'L L. & BUS.* 117 (1995), at 121-123 (discussing the 1980s experiences).
224. Lee C. Buchheit & Ralph Reisner, *Latin American Debt in the 1990s: A New Scenario for Creditors and Debtors*, 16 *NW. J. INT'L L. & BUS.* 1 (1995), at 2. Oddly enough, private sector borrowers during the Debt Crisis of the 1980s did not really have to worry about this problem. In many of the countries undergoing a generalised debt rescheduling during the 1980s, formal programs were established pursuant to which the host government agreed to assume the outstanding indebtedness of private sector borrowers in return for payment of the local currency equivalent of the amount due to the central bank or other monetary authority. Over time, these programs operated to transform most private sector debt into sovereign debt.
225. Cecile Gutscher, *Banks, Construction Firms are Mexico's Most Vulnerable*, *LDC DEBT REPORT*, Jan. 23, 1995, at 1. Since 1988, more than 60 Mexican companies have sold dollar-denominated bonds, primarily in the form of unsecured Eurobonds that are not registered under U.S. securities laws, with most issues in the range of \$50 million to \$200 million, although a few have been in amounts of \$300 million or more. Darrow, *supra* note 123, at 119, 158-160 (listing in tabular form).
-

debt in the form of Euro-commercial paper and Euro-certificates of deposit, which, collectively accounted for another approximately \$33 billion of debt.²²⁶ Most of these outstanding Eurobond issues will mature, with bullet payments, in the next three years,²²⁷ and barring a substantial improvement in the Mexican economy or the perceived creditworthiness of Mexican companies, many Mexican issuers will find it difficult to redeem or refinance their Eurobonds as they mature in the near future.²²⁸ The inability of Mexican issuers to make these payments and to comply with the terms of their debt obligations may trigger a wave of debt restructuring and workouts long before many of the Eurobond maturity payments are due.²²⁹

Beyond the immediate problems facing Mexico, if liquidity problems again afflict one or more developing countries, the fate of private sectors borrowers is not clear for several reasons.²³⁰ First, the stock of private sector debt is far larger today, both in nominal terms and as a percentage of the overall credit exposure of most countries. Second, the special circumstances that induced the governments of the debtor countries to assume or guarantee private sector debt in the 1980s probably will not be replicated in the future. Third, the lenders of the 1990s (principally bondholders) will almost certainly respond differently to the financial problems of their LDC borrowers than did the lenders of the 1970s and 1980s (principally commercial banks).

While the problems of restructuring private sector debt are not so difficult on a practical level as those facing sovereign debt, they are nonetheless significant, and include, *inter alia*, consensual out-of-court restructurings with their bondholders or bankruptcy proceedings in Mexico.²³¹ The implications, however, bear more on the need for prevention and solution of liquidity crises, the need to strengthen domestic banking systems, the need to provide for hedging opportunities, and the need to maintain and increase investor confidence in the domestic financial system in order to encourage the provision of the needed capital to prevent unpleasant long-term impacts on the Mexican private sector, as well as possibly the interests of large holders of Mexican bonds.

226. See Darrow, *et al*, *supra* note 223, at 119-120 (citing First National Bank of Chicago and Mexican Finance Ministry data).

227. In 1995, at least fourteen major issued matured, totalling close to \$900 million; in 1996 and 1997, another 25 private sector issues totalling approximately \$275 billion will mature; and in 1998, more than 20 additional private sector issues will come due, adding another \$3.7 billion. *Id.* at 120.

228. *Id.* at 120.

229. A number of these issuers are apparently already in default under the covenants in their Eurobonds or bank debt, which would give debt holders a legal right to accelerate the debt. See *Id.* at 144-47.

230. See Buchheit & Reisner, *supra* note 224, at 3.

231. Overall, Mexican companies and their bondholders are likely to consider alternatives including temporary covenant relief, partial repayments, posting of collateral, debt-for-debt exchanges, debt-for-equity exchanges, and/or new equity holders. All of these alternatives involve issues of both Mexican and foreign laws, and all parties involved will probably desire to avoid a Mexican bankruptcy (*quiebra*) proceeding if at all possible. See Darrow, *supra* note 223, at 124-153.

VI. Conclusions.

Despite the progress to date, Mexico still faces many problems before the Peso Crisis can be considered resolved. Interest rates continue to be high, the peso continues to be volatile, the banking sector remains strained, and economic growth is weak. The implications of the Mexican Peso Crisis of 1994-95, however, are much larger than the damage to Mexico itself.

Capital surges, such as that experienced by Mexico, are likely to be a recurring threat to developing countries and even to developed countries in the future. Capital flows are not likely to become any less volatile and international financial institutions are not likely to become any more powerful. The key, then, is to look at the Peso Crisis and attempt to draw lessons from it for the regulation of financial markets.

In general terms, the significance of the Peso Crisis for the broader canvas of financial regulation is can be seen on three levels: first, the need for regulation to increase the stability of domestic financial systems in order to allow governments to prevent future crises and to weather the vagaries of international capital movements; second, the need for international disclosure and the provision of a sort of lender of last resort; and third, the potential implications of debt crises in the future that may result from liquidity crises of from other sources. To a large extent, the international financial players have begun to answer these questions, but the real test will be the next Mexico- type situation and the reaction thereto.

Overall, none of these areas implicate any sort of formal law on an international level, but rather implicate the efforts of international "soft" law providers, such as the Basle Committee on Banking Supervision²³² and the International Organization of Securities Commissions (IOSCO).²³³ These groups have been increasingly cooperating recently,²³⁴ and as noted above, their efforts have in fact been commended by the G-10. While neither of these groups has produced a formal statement regarding the implications of the Peso Crisis for financial market regulation, their work in increasing financial market stability continues to be relevant, most especially given the significance that weak domestic banking and financial systems can have in the development and resolution of sovereign liquidity crises.

In terms of domestic regulation, LDCs need to consider the creation of derivatives markets to allow both investors and domestic companies to hedge against foreign exchange risk. At the time leading up to the Peso Crisis, investors did not have access to a reliable futures or forward market to hedge against currency risk. The effect of this absence of a futures market in Mexico, given the difficulty in hedging forward positions, heightened the

232. For a complete analysis of the development and role of the Basle Committee in international and domestic banking supervision, see Joseph J. Norton, *DEVISING INTERNATIONAL BANK SUPERVISORY STANDARDS* (1995).

233. For a description of the recent activities of IOSCO, see IOSCO, *ANNUAL REPORT* (1995).

234. For a plan and description of cooperative efforts between international organizations such as the Basle Committee and IOSCO, see *BASLE COMMITTEE ON BANKING SUPERVISION AND INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, RESPONSE OF THE BASLE COMMITTEE ON BANKING SUPERVISION AND OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS TO THE REQUEST OF THE G-7 HEADS OF GOVERNMENT AT THE JUNE 1995 HALIFAX SUMMIT* (May 1996).

perceived risk of investing in Mexico and negatively affected investor confidence. This is an area that IOSCO is increasingly active in,²³⁵ and further, a number of developing countries including a number of nations in Latin America have already begun the process of developing domestic derivatives markets.

In terms of international institutions, the IMF, while not taking the lead in the Peso Crisis as arguably it should have, has been given additional resources to combat these sorts of problems in the future through the doubling of the GAB. In this regard, two points should be made. First, the international rescue package was to a large extent successful in bridging Mexico's liquidity problems and averting a debt crisis. The potential problem, however, is that responses to these sorts of problems need to be fast, otherwise additional liquidity is of no avail. To this end, the IMF must act as a sort of lender of last resort in times of crises, and moreover, it must act quickly. Second, Mexico is one of the largest recipients of capital flows among all the LDCs. For this reason, a rescue package involving other LDC should not be of the same magnitude as that required for Mexico, and therefore the doubling of the GAB will probably be effective, if the IMF is willing to use it with the requisite speed.

Further, the SDDS should give markets the information necessary to avoid the panic that can follow a surprise such as occurred in January 1995 with Mexico, and should also serve to discipline the country's themselves. One explanation why commercial banks overlent to LDCs during the 1970s is that the banks had remarkably little information about the economies of the debtor countries, their balance of payments positions, investment inflows, aggregate external debt, international reserves, etc. High on banks' list of priorities during the ensuing debt restructurings, therefore, were requirements that the sovereign borrowers provide the creditors with exceptionally detailed economic information on a regular basis, and closely tracking the reports submitted to IMF.²³⁶ For these reasons, the IMF disclosure standards are a welcome addition.

235. See IOSCO, EMERGING MARKETS COMMITTEE, *Legal and Regulatory Framework for Exchange Traded Derivatives*, (June 1996).

236. Buchheit, *supra* note 7, at 52. Most countries that have gone through a generalised debt rescheduling over the past decade now prepare and distribute booklets to their creditors on a quarterly basis containing these economic and financial statistics. Note that these reports were lacking in Mexico due to its seemingly healthy situation.

A new organisation, the Institute of International Finance ("IIF"), was established in 1983 for the purpose of analysing and reporting to its members on economic and financial developments in borrowing countries. See Walter Sterling Surrey & Peri N. Nash, *Bankers Look Beyond the Debt Crisis: The Institute of International Finance, Inc.*, 23 COLUM. J. TRANSNAT'L L. 111 (1984).

Finally, the spector of sovereign debt crises continues to loom, although in a somewhat different form than those of the 1980s. Given the changing climate of international capital flows, developing countries and perhaps even developed countries are likely to be increasingly vulnerable to the "discipline" of international capital markets. Importantly, temporary liquidity crises have the potential to be the source of long-term problems in the form of debt crises in developing countries. These crises pose their own unique problems and may or may not require any sort of concerted international solution.²³⁸ Nonetheless, most proposals to date have been flawed, and if arrangements such as the SDDS and the GAB are insufficient to prevent a future liquidity crisis from developing into a debt crisis, it is unlikely that any sort of restructuring mechanism will be in place.

237. While international solutions may not be forthcoming, it is worth noting that emerging markets can in fact take private steps to help to stem the effects of short-term liquidity crises and hopefully prevent such crises from developing into debt crises. Argentina has in fact recently taken steps in this direction by creating a \$3 billion emergency fund to aid domestic banks facing short-term liquidity problems. The fund is capitalized by a syndicate of international lenders, with payments for the premiums required being provided by domestic banks and collateralized with the central bank. See *Argentina: Payments, Bank Liquidity Fund Planned*, EUROMONEY TRADE FINANCE AND BANKER INTERNATIONAL, Sept. 27, 1996.
