

Current Prospects

The Mexican crisis has led to proposals both for changes in national macroeconomic policies and for international regulation of the global financial system which are reviewed below.

The crisis revealed major problems arising from:

- ❖ the overall strategy followed by Mexico (e.g. maintaining an overvalued exchange rate, an unwillingness to follow the appropriate domestic monetary policy, issuing foreign-currency-denominated debt);
- ❖ the volatility of capital inflows and the consequences of a sudden reversal; and
- ❖ the lack of accepted mechanisms for an 'orderly workout' for a financially distressed country.

We discuss these problems successively in this paper. Here we expand on the background to the 'systemic' problem of providing mechanisms for dealing with sudden reversals of capital flows.

Investors in liquid securities, suddenly confronted with new uncertainties, have an overpowering incentive to scramble for the exits. Like depositors who see their neighbours lining up outside a bank and join the queue in order to liquidate their holdings before the institution's cash reserves are exhausted, investors in government bonds have an incentive to liquidate their holdings when others do likewise, and they grow fearful that the government's limited foreign exchange reserves will be exhausted or the exchange rate will sharply depreciate. So also do holders of corporate securities and short-term bank debt.

A country experiencing a debt run, like a bank experiencing a run by its depositors, may

have no choice but to suspend payments, regardless of the damage to its creditworthiness. On the eve of the crisis, the Mexican government was responsible for more than \$18 billion of dollar-denominated and dollar-indexed liabilities, an amount roughly triple its foreign exchange reserves. And with convertibility for capital account transactions, holders of peso-denominated liabilities could also take funds abroad (as many residents did – see IMF, 1995). Once investors began to liquidate their holdings, the authorities had no recourse. This is because (as had already been shown in early 1994) the fragility of the domestic financial system precluded the kind of sharp increase of interest rates which would have halted such an outflow. (Banks and other financial institutions were already overstretched.)

In these circumstances, it can be exceedingly difficult to restructure government debts – to convert and extend their terms of payment. Bondholders are unsure how much the government is able to pay. Governments are unsure how much the bondholders are willing to accept. Both sides have an incentive to withhold information in bargaining. Besides the problem of strategic behaviour between the creditors and the debtor, there are conflicts among different classes of creditors. Altering the core terms of a bond covenant normally requires the unanimous consent of the bondholders, which may be impossible to obtain. Individual investors will be tempted to refuse any offer of less than a hundred cents on the dollar in the hope of being bought out at full value by the government or other creditors. Small creditors seeking a favourable deal can thus hold up the settlement process indefinitely.

In this climate of uncertainty, potential

providers of additional liquidity will hold back. Lenders will hesitate to provide new money for fear that it will simply go to pay off old creditors. The government and the country will be starved of finance for even highly productive investments.

These problems already existed in the 1980s, but they are even more serious now that securitized instruments have replaced bank loans. There were never more than several hundred banks involved in sovereign debt reschedulings, and bank advisory committees rarely had more than a dozen members. The largest banks could discipline their smaller counterparts, threatening to exclude dissenters from future loan syndicates and to undermine their position within the banking community if they refused to cooperate. Pressure to go along was also applied by a US government which feared that the debt crisis could jeopardize the stability of the financial system. Still, these efforts to secure a quick resolution were only modestly successful. And problems of collective action and strategic behavior, however significant then, are many times greater now. Today there are thousands of small

bondholders whose consent is required to restructure the core terms of loan contracts. The prevalence of bearer bonds makes it difficult even to identify the owner, much less to apply peer pressure. The incentive for any one investor to provide new money to kick-start the debtor's economy is further diminished when all creditors are small relative to the market. It is revealing that IMF attempted to coordinate the provision of private financing for countries in arrears early on in the debt crisis of the 1980s but made no similar effort in 1995.

Subsequently, it has become clear that there is a divergence of view about systemic reform proposals (discussed in Secs. 7 and 8 below). Officials from G7 countries welcome them, as a way of preventing 'excessive lending', which they do not wish to have to make when things go wrong, in the way in which they were forced to bail out Mexico's creditors. Market participants are hostile, suggesting that they still expect to be bailed out again in future. The most fundamental legacy of the Mexico crisis is this conflict of view, which suggests that there is a market imperfection which needs rectification.