

THE IMF AND THE LIBERALIZATION OF CAPITAL MARKETS

François GIANVITI¹

SUMMARY: I. *Capital Outflows under the Fund's Articles.* II. *Prevention of liquidity crises.* III. *Resolution of liquidity crises.*

What place would be more fitting than Mexico city to reflect on the Fund's role in the liberalization of capital markets? Last year, the Mexican external debt crisis required an unprecedented amount of external financial assistance, essentially from the U. S. and the IMF ("the Fund"). Some questioned the appropriateness of this assistance on the ground that it created a Amoral hazard by encouraging sovereign debtors to engage in irresponsible policies and allowing their creditors to be bailed out of their profitable but risky investments. Some even questioned the legality of the Fund's financial assistance on the ground that the Fund's assistance should be limited to the financing of current, not capital, transactions. Others praised the intervention of the Fund as it enabled Mexico to overcome its difficulties, restored confidence and perhaps stemmed a potential "Tequila effect" on other countries external debt both in Latin America and in other parts of the world.

The Mexican debt crisis of 1994-95, while it demonstrated the ability of the international community to assist one of its members in overcoming a major external liquidity crisis, also revealed two major weaknesses in the current approach to liquidity crises, at least from the standpoint of the Fund and the international community:

- the first one is the lack of adequate preventive mechanisms to detect potential liquidity crises at an early stage, and avoid their occurrence or limit their magnitude;
- the second one is the lack of consensus on what should be the response of the Fund and the international community when a liquidity crisis occurs.

¹ Professor of Law (Paris), General Counsel of the International Monetary Fund. The news expressed by the author are not necessarily those of the fund.

These two weaknesses have a common origin, which can be traced to the basic tenets of the doctrine that inspired the creation of the Fund, namely, that the resolution of external debt problems due to a major capital outflow was not the responsibility of the Fund but the responsibility of the country facing this outflow.

In an age of liberalization of capital markets, these principles may seem antiquated, but they are still in force and must be observed. Therefore, in order to understand the current discussions on the prevention and resolution of liquidity crises, it may be useful to review the legal framework within which the Fund operates when one of its members faces a capital outflow.

I. CAPITAL OUTFLOWS UNDER THE FUND'S ARTICLES

Although the Fund's Articles of Agreement have been amended three times since the Bretton Woods conference of 1944, the provisions on capital movements have remained almost unchanged. They contain three complementary principles.

The first principle is that a member of the Fund retains the right to impose exchange controls, including restrictions, on capital movements. In contrast with payments and transfers for current international transactions, which cannot be restricted without the approval of the Fund (except under the transitional provisions of Article XIV), international capital inflows and outflows can be restricted by members of the Fund without Fund approval. Exchange restrictions on capital movements may even be discriminatory in that they apply to movements to or from certain countries, which is not permitted for current payments or transfers.

The second principle is that a member of the Fund can use its reserves to meet a capital outflow but will not be allowed to use the Fund's general resources to meet a large or sustained outflow (with the exception of reserve tranche purchases, which correspond to the member's contribution in reserve assets to the Fund's capital; a reserve tranche purchase does not constitute financial assistance by the Fund, and a member's reserve tranche position in the Fund is part of the member's external reserves because the member has an unconditional right to draw its reserve tranche, at no cost, unless it has been declared ineligible to use the Fund's general resources).

The third principle is that the Fund may request a member to impose exchange controls on capital movements in order to avoid an excessive use of the Fund's resources. Failure by the member to impose exchange controls at

the request of the Fund could result in a declaration of ineligibility. In fact, this procedure has never been used.

In the case of Mexico, the question did arise whether the Fund could approve a stand-by arrangement for Mexico which was facing a large capital outflow. Part of the answer was that the outflow was also due to current payments, including interest on debt. Moreover, Mexico was financing the outflow out of its reserves and bilateral loans, while the Fund's resources were essentially used to reconstitute Mexico's reserves and would not be used to meet subsequent capital outflows; given the fungibility of reserve assets, actual use of resources is not relevant; what matters is that the country observe the reserve targets set by the Fund. This last point is particularly important. The fact that a country has had a capital outflow does not preclude its access to the Fund's resources to reconstitute its reserves, but performance criteria are included in the arrangement to avoid any substantial use of these reserves to meet capital outflows.

The adjustment measures adopted by Mexico turned out to be sufficient. Therefore, restrictions on capital movements did not have to be introduced and Mexico was able to service its external debt without arrears. However, the main lesson of the Mexican debt crisis was that the Fund should strengthen its action in the prevention of external liquidity crises.

II. PREVENTION OF LIQUIDITY CRISES

Access to international capital markets allows a country to develop its economy and sometimes finance its budget deficit. A country may borrow directly from foreign banks or guarantee loans made by foreign banks to local entities; it may issue bonds repayable in foreign currencies, buy foreign goods with financing provided by another country's export credit agency etc. Local banks and other entities may also attract foreign capital by offering high rates of return.

Long-term investments are not a major problem, at least until they have to be repaid, but short-term investments create a permanent uncertainty as any blemish on the country's creditworthiness will trigger a scramble for repayment, a "rush to the exit". To attract foreign capital Mexico had been offering high interest rates on short-term bonds. Therefore, as soon as it became apparent that Mexico was running a large current account deficit, confidence evaporated and the capital outflow started.

Early detection of this type of situation is essential, and official statements to reassure foreign creditors will soon prove to be ineffective if they are not accompanied by adequate adjustment measures. Unfortunately, election periods are the worst possible moment for such measures. Therefore, adjustment programs must be initiated well in advance, or they will have to wait until after the election and will be even more painful.

It is one of the responsibilities of the Fund to exercise surveillance over its members exchange rate policies, which includes a scrutiny of their potential balance of payments and reserve problems. In this regard, particular attention is given not only to current account transactions but also to capital account transactions, in order to detect potential crises. Obviously, surveillance requires accurate and timely information by the country, and even a short delay in the provision of information may prevent the Fund from detecting an impending crisis when unexpected developments take place over a short period of time. The Mexican debt crisis has shown the need to strengthen the provision of information to the Fund and its analysis by the Fund.

Another aspect is the provision of information to the markets: banks, bondholders, etc. There is no obligation for Fund members to provide information to the markets, but the Fund has taken the initiative of asking its members to subscribe, on a voluntary basis, to a data dissemination system via the Internet. The purpose is to define standards that will be generally accepted and implemented, with two levels: a less demanding one and more demanding one. The system will soon become operational and should contribute to a better and a more timely information of market operators.

Prevention is the ideal response if it succeeds, but what happens if a liquidity crisis occurs?

III. RESOLUTION OF LIQUIDITY CRISES

As explained above, the financing of capital outflows by the Fund is limited under the present Articles. Any extension of the Fund's assistance to the financing of large or sustained capital outflows would require an amendment of the Articles; it would also require additional resources through a large quota increase or loans to the Fund. Even those members of the Fund who may favor an amendment of the Articles to liberalize capital movements may balk at the idea of financing large capital outflows and may prefer more traditional responses such as exchange restrictions, arrears, rescheduling, or even debt forgiveness by creditors. The Brady initiative illustrates this latter approach:

commercial banks were urged to reduce the principal and/or interest of their claims in exchange for collateral securing future payments to them. Official creditors in the Paris Club often reschedule their claims and are sometimes willing to forgive part of their claims on developing countries. Rescheduling by commercial banks has also been common practice, usually at a fairly high cost to debtors.

One of the main concerns that were expressed in official circles during the Mexican debt crisis was the risk of "moral hazard" in the behavior of debtors as well as creditors. On the debtor's side, the expectation of international financial assistance from the Fund at a fairly low cost to the country may encourage lax economic and financial policies. On the creditor's side expectation of a bailout will create a perverse situation where high profits on investments, which should be counterbalanced by correspondingly high risks of nonrepayment, turn out to be free of any risk and continue to yield high returns at the expense of the international community.

Unfortunately, moral hazard is more easily denounced than remedied. Some suggestions have been made:

- the Fund should levy higher charges on countries that are larger users of its resources, as a deterrent for an excessive use of its resources;
- the international community, probably through the Fund, should insist on some prior concessions by creditors before extending any financial assistance;
- the debtor country should be prepared even to incur arrears to commercial banks or other creditors before qualifying for financial assistance;
- partial repudiation of certain debts by the debtor country might even be envisaged;
- a bankruptcy court for sovereign debtors' external debt should be established, which would determine what payments could be made to each creditor or category of creditors, probably with some rescheduling or even partial debt forgiveness, but this ambitious idea seems rather unrealistic, or perhaps premature, in the present context of international financial relations.

Another suggestion was that the Fund should use its existing powers to allow sovereign debtors to default on their external debt until their creditors become reasonable and consent to some financial sacrifices. The legal basis for this approach would be the provision in the Fund's Articles (Article VIII, Section 2(b)) which requires each Fund member not to enforce exchange con-

tracts that are contrary to another Fund member's exchange control regulations, provided these regulations are consistent with the Fund's Articles. Unfortunately, this provision has been interpreted rather restrictively in the U. S. and the U. K. because of the term "exchange contracts" which would refer exclusively to exchanges of currencies. Also, German courts have now taken the view that this provision does not apply to capital movements. In order to overcome these difficulties, the Fund could adopt an authoritative, broad interpretation of Article VIII, Section 2(b): all contracts payable in foreign exchange or entered into with nonresidents—including loans and bonds—would be regarded as exchange contracts, and no distinction would be made between current transactions and capital movements. Assuming that such an interpretation were adopted—which was not found possible in the past—all Fund members would have to make it effective in their courts; in some cases, legislative action might be required. As a political device to help sovereign debtors in their negotiations with their creditors, the suggestion is interesting. However, it probably overestimates the importance of litigation as a threat to sovereign debtors: even where they have waived their immunities, there are generally not so many assets their creditors can seize to collect their claims. Moreover, from the standpoint of legal analysis, the proposed interpretation would not resolve a major difficulty. Even if exchange contracts were defined very broadly, Article VIII, Section 2(b) would only apply in cases where exchange control regulations are in force. Obviously, when a government restricts payments by its residents to nonresidents, the measure is an exchange restriction and Article VIII, Section 2(b) can apply. However, a decision by a government not to pay its own internal or external debt is only a self-imposed measure. It cannot be regarded as an exchange restriction or an exchange control measure. The Fund always makes this distinction and does not regard default by sovereign debtors as exchange measures within its jurisdiction.

Actually, this question had already been identified at the Bretton Woods conference of 1944 and it was concluded that defaults by governments would not be subject to Fund approval. Therefore, the Fund could not in its interpretation of Article VIII, Section 2(b) contradict its own jurisprudence and the legislative history of its Articles. Accordingly, this attractive idea of an authoritative interpretation of Article VIII, Section 2(b), though it would have the merit of unifying its interpretation by national courts, would not resolve the problem of sovereign default on external debt.

At this stage, no clear positive solution has emerged and work will continue both inside and outside the Fund on these issues. Inevitably, as the trend

toward liberalization of capital movements continues, and since prevention of crises will not necessarily be achieved, other debt crises will occur. Some may even exceed the magnitude of the Mexican crisis. The Fund may not have the necessary resources and the U. S. may not be willing to make the same contribution as in the case of Mexico. Therefore, either ad hoc solutions will be found or a consensus will be reached on the appropriate response to such crises.