THE IMF AND THE LIBERALIZATION OF CAPITAL MARKETS[*]

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I. INTRODUCTION

What place would be more fitting than Mexico City to reflect on the International Monetary Fund's (the Fund) role in the liberalization of capital markets? The 1994–95 Mexican external debt crisis required an unprecedented amount of external financial assistance, essentially from the United States and from the Fund.[1] Some questioned the appropriateness of this assistance on the ground that it created a "moral hazard" by encouraging sovereign debtors to engage in irresponsible policies and allowing their creditors to be bailed out of their profitable but risky investments.[2] Some even questioned the legality of the Fund's financial assistance on the ground that assistance should be limited to the financing of current, not

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1. *See* William A. Lovett, *Lessons from the Recent Peso Crisis in Mexico*, 4 TUL. J. INT'L & COMP. L. 143, 155, 157–58 (1996); John H. Chun, Note, *"Post-Modern" Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?*, 64 FORDHAM L. REV. 2647, 2661 (1996).

2. *See* Chun, *supra* note 1, at 2662–63.

capital, transactions.[3] Others praised the intervention of the Fund as it enabled Mexico to overcome its difficulties, restored confidence, and perhaps stemmed a potential "Tequila effect"[4] on other countries' external debt both in Latin America and in other parts of the world.[5]

The Mexican debt crisis of 1994–95 demonstrated the ability of the international community to assist one of its members in overcoming a major external liquidity crisis.[6] However, it also revealed two major weaknesses in the current approach to liquidity crises, at least from the standpoint of the Fund and the international community:

(1) the lack of adequate preventive mechanisms to detect potential liquidity crises at an early stage and avoid their occurrence or limit their magnitude;
(2) the lack of consensus on what should be the response of the Fund and the international community when a liquidity crisis occurs.

These two weaknesses have a common origin, traced to the basic tenets of the doctrine that inspired the creation of the Fund: that the resolution of external debt problems due to a major capital outflow was not the responsibility of the Fund, but was the responsibility of the country facing this outflow.[7]

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 frame-

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3. *See generally* Werner F. Ebke, *Article VIII, Section 2(b) of the IMF Articles of Agreement and International Capital Transfers: Perspectives from the German Supreme Court*, 28 INT'L LAW. 761 (1994) [hereinafter Ebke, *Perspectives*] (discussing the applicability of Article VIII, Section 2(b) to current, not capital, transactions).

4. *See* Enrique R. Carrasco & Randall Thomas, *Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis*, 34 COLUM. J. TRANSNAT'L L. 539, 571 (1996) (defining "Tequila effect" as "a serious ripple impact . . . on other Latin American (and developing country) financial markets").

5. *See* Patricia A. Wertman, *The Mexican Support Package: A Survey and Analysis*, MEX. TRADE & L. REP., Sept. 1995, at 9, 9, *available in* WESTLAW, Mextlr database; S. Neal McKnight, Note, *Stepping Stones to Reform: The Use of Capital Controls in Economic Liberalization*, 82 VA. L. REV. 859, 861–62 (1996).

6. *See* Chun, *supra* note 1, at 2660–61 (noting the support from the United States, Canada, and international banks). International assistance met with controversy, however. *See id*. at 2661–63. According to Chun, officials at the Bank for International Settlements (BIS) believed that the United States demonstrated bad faith in prematurely assuming that the BIS loan would be approved rather than considering the bailout as a proposal the BIS had agreed to consider. *See id*. at 2662. Moreover, groups opposed to the $17.8 billion loan from the IMF argued that the funds were to be "used to bail out risk-taking American mutual and pension fund managers" and that the amount of the loan was "shock[ing]." *Id*. Others who supported the loan package were disturbed by the United States' role as a sole "liquidity backstop." *See id*. at 2663.

7. *See* Cynthia C. Lichtenstein, *The Mexican Crisis: Who Should Be a Country's Lender of Last Resort?*, 18 FORDHAM INT'L L.J. 1769, 1775 (1995).

work within which the Fund operates when one of its members faces a capital outflow.

II. 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,[8] 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 and restrictions on capital movements.[9] In contrast with payments and transfers for current international transactions, which cannot be restricted without the approval of the Fund[10] (except under the transitional provisions of Article XIV),[11] international capital inflows and outflows can be restricted by members of the Fund without Fund approval.[12] 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.[13]

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.[14] Reserve tranche purchases 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. A

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8. *See* Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, 60 Stat. 1401, 2 U.N.T.S. 39, *as amended*, Amendment of Articles of Agreement of the International Monetary Fund, May 31, 1968, 20 U.S.T. 2775, 726 U.N.T.S. 266, *as amended*, Second Amendment of Articles of Agreement of the International Monetary Fund, Apr. 30, 1976, 29 U.S.T. 2203, 15 I.L.M. 546 [hereinafter Second Amendment], *as amended*, Third Amendment of the Articles of Agreement Regarding Suspension of Voting Rights, June 28, 1990, 31 I.L.M. 1307.

9. *See* Second Amendment, *supra* note 8, art. VIII, § 2(b), 29 U.S.T. at 2223, 15 I.L.M. at 557; Gerhard Wegen, *2(b) or not 2(b): Fifty Years of Questions—The Practical Implications of Article VIII Section 2(b)*, 62 FORDHAM L. REV. 1931, 1933–34 (1994).

10. *See* Second Amendment, *supra* note 8, art. VIII, § 2(a), 29 U.S.T. at 2223, 15 I.L.M. at 557; Russell J. Bruemmer et al., *Central and Eastern European Law Initiative (CEELI) Currency Exchange Controls: A Concept Paper Prepared for the Government of Bulgaria*, 29 INT'L LAW. 257, 260 (1995).

11. *See* Second Amendment, *supra* note 8, art. XIV, § 2, 29 U.S.T. at 2237, 15 I.L.M. at 565.

12. *See id.* art. VI, § 3, 29 U.S.T. at 2221, 15 I.L.M. at 556; Bruemmer et al., *supra* note 10, at 260, 267.

13. *See* Second Amendment, *supra* note 8, art. VIII, § 3, 29 U.S.T. at 2223–24, 15 I.L.M. at 557; Bruemmer et al., *supra* note 10, at 266; Joseph Gold, *International Monetary Law*, 22 INT'L LAW. 3, 14 (1988).

14. *See* Second Amendment, *supra* note 8, art. VI, §§ 1–2, 29 U.S.T. at 2221, 15 I.L.M. at 555–56. A reserve tranche purchase "means a purchase by a member of special drawing rights or the currency of another member in exchange for its own currency which does not cause the Fund's holdings of the member's currency in the General Resources Account to exceed its quota." *Id*. art. XXX(c), 29 U.S.T. at 2257, 15 I.L.M. at 576.

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.[15]

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.[16] Failure by the member to impose exchange controls at the request of the Fund could result in a declaration of ineligibility.[17] However, this procedure has never been used.

The question arose as to whether the Fund could approve a stand-by arrangement for Mexico, which was facing a large capital outflow.[18] Part of the answer was that the outflow was also due to current payments, including interest on debt.[19] Moreover, Mexico was financing the outflow with its reserves and bilateral loans, while the Fund's resources were essentially used to reconstitute Mexico's reserves and not to meet subsequent capital outflows.[20] 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 access to Fund resources to reconstitute its reserves, although performance criteria are included in the arrangement to avoid any substantial use of these reserves to meet capital outflows.[21]

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

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15. *See id.* art. XXVI, § 2(a), 29 U.S.T. at 2254, 15 I.L.M. at 574 (enabling the Fund to declare members failing to meet its obligations under the Agreement ineligible to use the Fund's general resources); Joseph Gold, *Natural Disasters and Other Emergencies Beyond Control: Assistance by the IMF*, 24 INT'L LAW. 621, 626 & n.11 (1990).

16. *See* Second Amendment, *supra* note 8, art. VI, § 1(a), 29 U.S.T. at 2221, 15 I.L.M. at 555.

17. *See id*. ("If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund.").

18. *See* Carrasco & Thomas, *supra* note 4, at 563–64 (detailing the exodus of capital); Lovett, *supra* note 1, at 155 (describing the controversy within the United States surrounding the initial proposal by President Clinton of $40 billion of support for Mexico). Although the size of the arrangement was unusually large and allowed Mexico to raise the Fund's currency holdings above the 300% cumulative limit that applies generally to purchases in the General Resources Account, the legality of the arrangement was not questioned, as the 300% limit may be exceeded "in exceptional circumstances." *See Access Policy—Guidelines on Access Limits*, IMF Decision No. 10181-(92/132) (Nov. 3, 1992), *in* SELECTED DECISIONS & SELECTED DOCUMENTS INT'L MONETARY FUND, June 30, 1996, at 219, 219.

19. *See Implications of the Devaluation and Economic Situation in Mexico*, MEX. TRADE & L. REP., Mar. 1995, at 12, 12, *available in* WESTLAW, Mextlr database.

20. *See* Lovett, *supra* note 1, at 151, 155.

21. *See* Graeme F. Rea, *Restructuring Sovereign Debt—Will There Be New International Law and Institutions?*, 77 AM. SOC'Y INT'L L. PROC. 312, 315 (1985).

Fund should strengthen its action in the prevention of external liquidity crises.

III. 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, issue bonds repayable in foreign currencies, or buy foreign goods with financing provided by another country's export credit agency. Local banks and other entities may also attract foreign capital by offering high rates of return.[22]

Long-term investments are not a major problem—at least until they have to be repaid—but short-term investments create a permanent uncertainty because any blemish on the country's creditworthiness will trigger a scramble for repayment, a "rush to the exit."[23] To attract foreign capital, Mexico had been offering high interest rates on short-term bonds.[24] As soon as it became apparent that Mexico was running a large current account deficit, confidence evaporated and the capital outflow started.[25]

Early detection of this type of situation is essential, and official statements to reassure foreign creditors will prove ineffective if they are not accompanied by adequate adjustment measures. Unfortunately, as was the case in Mexico as the crisis developed, election periods are the worst possible moment for such measures.[26] Politically, adjustment programs must be initiated well in advance, or they will have to wait until after the election and will be even more painful.

One of the Fund's responsibilities is to exercise surveillance over its members' exchange rate policies,[27] which includes a scrutiny of their potential balance of payments and reserve problems.[28] 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.[29] Obviously, surveillance requires accurate and timely information by the country. Even a short delay in providing information may prevent the Fund

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22. *See* Carrasco & Thomas, *supra* note 4, at 559.

23. *See* McKnight, *supra* note 5, at 872.

24. *See* Carrasco & Thomas, *supra* note 4, at 559, 572; David A. Codevilla, Comment, *Discouraging the Practice of What We Preach:* Saarstahl I, Inland Steel *and the Implementation of the Uruguay Round of GATT 1994,* 3 GEO. MASON INDEP. L. REV. 435, 469 n.202 (1995).

25. *See* Chun, *supra* note 1, at 2658.

26. *See id.* at 2657 n.84 (stating that Mexico's ruling PRI party was facing its most difficult challenge in the 1994 elections in 65 years and "austere economic reforms would have been political suicide").

27. *See* Second Amendment, *supra* note 8, art. IV, § 3, 29 U.S.T. at 2209, 15 I.L.M. at 549; Carrasco & Thomas, *supra* note 4, at 595 & n.319; Rea, *supra* note 21, at 315.

28. *See* Second Amendment, *supra* note 8, art. VIII, § 5, 29 U.S.T. at 2224, 15 I.L.M. at 558; Bruemmer et al., *supra* note 10, at 261.

29. *See* Carrasco & Thomas, *supra* note 4, at 595 & n.319.

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 and its analysis by the Fund.[30]

Another aspect of surveillance is the provision of information to the markets, including banks, bondholders, and investors. 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.[31] The purpose is to define two sets of standards, one less demanding than the other, that will be generally accepted and implemented.[32] The system will soon become operational and should contribute to better and more timely information to market operators.

Prevention is the ideal response if it succeeds. But what happens if a liquidity crisis occurs?

IV. RESOLUTION OF LIQUIDITY CRISES

As explained above, the financing of capital outflows by the Fund is limited under the present Articles. Any extension of Fund assistance to the financing of large or sustained capital outflows would require an amendment of the Articles.[33] Such an extension would require additional resources, most likely made available through a large quota increase or loans to the Fund. Even those members of the Fund who 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[34] illustrates this latter approach: commercial banks were urged to reduce the principal and/or interest of

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30. *See id.* at 595; Wertman, *supra* note 5, at 16–17.

31. *See* Carrasco & Thomas, *supra* note 4, at 595 & n.320; Wertman, *supra* note 5, at 16.

32. *See* Carrasco & Thomas, *supra* note 4, at 595 n.320. The more demanding standard will be applied to countries who have accessed, or seek to access, the capital markets. *See id*.

33. *See* Second Amendment of Articles of Agreement of the International Monetary Fund, *supra* note 8, art. VI, § 1(a), 29 U.S.T. at 2221, 15 I.L.M. at 555; Lichtenstein, *supra* note 7, at 1775. Article VI, § 1(a) provides:

> A member may not use the Fund's general resources to meet a large or sustained outflow of capital except as provided in Section 2 of this Article [entitling members "to make reserve tranche purchases to meet capital transfers"], and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund.

Second Amendment, *supra* note 8, art. VI, § 1(a), 29 U.S.T. at 2221, 15 I.L.M. at 555.

34. In March 1989, U.S. Secretary of the Treasury Nicholas Brady announced an initiative designed to encourage banks to voluntarily reduce the debt burdens of less developed countries. *See* Philip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings*, 64 FORDHAM L. REV. 2701, 2720 (1996).

their claims in exchange for collateral securing future payments to them.[35] Additionally, official creditors in the Paris Club often reschedule their claims and are sometimes willing to forgive part of their claims on developing countries.[36] Rescheduling by commercial banks has also been common practice, usually at a fairly high cost to debtors.[37]

One of the main concerns expressed in official circles during the Mexican debt crisis was the risk of "moral hazard" in the behavior of debtors as well as creditors.[38] 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.[39] 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 risk and continue to yield high returns at the expense of the international community.[40]

Unfortunately, "moral hazard" is more easily denounced than remedied. Suggested remedies include: the Fund levying higher charges on countries that are larger users of its resources, as a deterrent for excessive use of its resources; the international community, probably through the Fund, insisting on some prior concessions by creditors before extending any financial assistance; requiring the debtor country to be prepared to incur arrears to commercial banks or other creditors before qualifying for financial assistance; partially repudiating certain debts by the debtor country; or lastly, establishing a bankruptcy court for sovereign debtors' external debt, which would determine what payments could be made to each creditor or category of creditors, probably with some rescheduling or even partial debt forgiveness.[41]

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35. *See id*. Under the Brady Plan, sovereign loans were converted into bonds and offered publicly. *See id*. The bond proceeds were then used to pay the bank loans. *See id*. This securitization "enable[d] banks to exit completely from the cycle of debt rescheduling and to take troubled sovereign loans off their books forever." *Id*.

36. *See* ALEXIS RIEFFEL, THE ROLE OF THE PARIS CLUB IN MANAGING DEBT PROBLEMS 3 (1985) ("[The Paris Club] represents a set of *procedures* currently used for negotiating arrangements to defer payment obligations on credits extended or guaranteed by creditor-country government agencies to both public-sector and private-sector borrowers in debtor countries unable to meet fully their external debt obligations."). The Paris Club concluded 26 negotiations with 12 counties in its first 22 years; it concluded 56 agreements between 1978 and 1984. *See id*. at 4.

37. *See* Robert Kenneth MacCallum, Note, *Sovereign Debt Restructuring: The Rights and Duties of Commercial Banks* Inter Sese, 1987 COLUM. BUS. L. REV. 425, 425, 438.

38. *See* Chun, *supra* note 1, at 2662–63; Russell Dean Covey, Note, *Adventures in the Zone of Twilight: Separation of Powers and National Economic Security in the Mexican Bailout*, 105 YALE L.J. 1311, 1343 n.162 (1996).

39. *See* Covey, *supra* note 38, at 1343 n.162.

40. *See* McKnight, *supra* note 5, at 879.

41. This last suggestion seems rather unrealistic, or perhaps premature, in the present context of international financial relations. *See* Carrasco & Thomas, *supra* note 4, at 605–06; Chun, *supra* note 1, at 2653 ("A bankruptcy agency . . . is the more effective method for

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 financial sacrifices.[42] The legal basis for this approach would be Article VIII, Section 2(b) of the IMF agreement, which renders illegal exchange contracts that are contrary to a Fund member's exchange control regulations, providing the regulations are consistent with the Fund's Articles.[43] Unfortunately, this provision has been interpreted narrowly in the United States and the United Kingdom because the term "exchange contracts" has generally been defined only as exchanges of currencies.[44] Also, German courts have now taken the view that this provision does not apply to capital movements.[45]

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 may 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. Generally, there are few assets creditors of sovereign debtors can seize to satisfy their claims.[46]

Moreover, a legal analysis reveals that the proposed interpretation would leave a major difficulty unresolved. Even if exchange contracts

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providing the fast, decisive action required to counter the extraordinary speed with which creditors can relocate their money worldwide."); Power, *supra* note 34, at 2766 (arguing that "[t]he creation of an international bankruptcy court is . . . politically infeasible [and] . . . undesirable").

42. *See* James B. Hurlock, *The Way Ahead for Sovereign Debt*, INT'L FIN. L. REV., July 1995, at 10, 12.

43. *See* Second Amendment, *supra* note 8, art. VIII, § 2(b), 29 U.S.T. at 2223, 15 I.L.M. at 557.

44. *See* Werner F. Ebke, *Article VIII, Section 2(b), International Monetary Cooperation, and the Courts*, 23 INT'L LAW. 677, 691 (1989). "English courts, like their American counterparts, have limited the scope of article VIII, section 2(b) 'almost to the point at which the provision vanishes.'" *See id*. (quoting Joseph Gold, *Foreword: Exchange Controls and External Indebtedness: Are the Bretton Woods Concepts Still Workable?*, 7 HOUS. J. INT'L L. 1, 11 (1984)); *see also* John S. Williams, *Extraterritorial Enforcement of Exchange Control Regulations Under the International Monetary Fund Agreement*, 15 VA. J. INT'L L. 319, 336 (1975) (noting that "'[e]xchange contracts' as narrowly defined describes only those contracts in which the exchange of currency or other international media of payment (gold, for example) is the object of international commerce"); Power, *supra* note 34, at 2725 ("Under this interpretation, contracts to borrow and repay U.S. dollars are clearly not 'exchange contracts' within the meaning of Article VIII, section 2(b).").

45. *See* Ebke, *Perspectives*, *supra* note 3, at 761.

46. *See* Hurlock, *supra* note 42, at 11.

were defined very broadly, Article VIII, Section 2(b) would only apply in cases where exchange control regulations are in force. When a government restricts payments from residents to nonresidents, the measure is an exchange restriction to which Article VIII, Section 2(b) applies. However, a decision by a government not to pay its own internal or external debt is only a self-imposed measure. It is not regarded as an exchange restriction or an exchange control measure. This distinction has always been recognized and defaults by sovereign debtors are not regarded as exchange measures within that sovereign's jurisdiction.[47] This issue was identified at the Bretton Woods Conference of 1944, and it was concluded that defaults by governments would not be subject to Fund approval. The Fund, in its interpretation of Article VIII, Section 2(b), may not 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 as the prevention of crises will not necessarily be achieved, other debt crises will occur. Some may even exceed the magnitude of the Mexican crisis. The next crisis may find the Fund without the necessary resources, and the United States unwilling to make the same contribution as in the case of Mexico. Therefore, either ad hoc solutions will continue to be found, or the international community will realize the benefits of concurring on appropriate responses to such crises.

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47. *See* Power, *supra* note 34, at 2735.