Floor Discussion of the Kenen Paper

Bernd Goos observed that there is a tendency to reason that, since capital flows have become so big and so rapid, facilities would be needed that can cope with undesired effects of these flows. Goos wondered whether the idea was not that, if there was a hundred billion dollars moving cross-border, a facility of a similar magnitude would be required.

"What this boils down to is an attitude that the problems under discussion can be solved by throwing money at them, but that is a false proposition and it never works. Even in the past, when capital flows were smaller, these problems could be solved only by adjusting underlying policies so that confidence was re-established. That is the important part, and in that respect I am concerned about these emergency facilities that come up with a huge amount of money before a government has given a clear signal to the markets that policies will change. I am also concerned about the effects created for the markets, in the form of moral hazard. If the markets know that there is a facility of the size of the Mexican rescue package or even larger, then why care? Why not go to whichever country you wish, because you will be bailed out anyway?"

Goos also wondered whether one could really assess the extent to which markets respond to economic fundamentals and the extent to which they respond to political events. "I do not think you can keep these two aspects apart. They are interwoven. The fundamentals are affected continuously by political events. If there is a political problem that raises doubts in the markets as to the extent to which a government will be able to contain the fiscal deficit, this will, of course, affect fundamentals. Therefore, it is no surprise that markets react to fundamentals in a prospective way."

Charles Siegman stressed that the term 'bailing out' has a negative connotation and needed clarification in the context of the discussion about contagion and systemic risks.

"It is clear that Mexico did not get a free ride. It paid a very heavy price. Different investors also paid, in the interval, a price. Moreover, the support package for Mexico was a very highly conditioned type of assistance, which is proving successful in terms of assuring repayment and not drawing on the full capacity of the financial facilities that had been established. This also reflects the stabilisation programme that the Mexican authorities have adopted in response to the crisis. As was pointed out by Jean-Jacques Rey, one of the difficulties of the December 1994 devaluation of the peso was that Mexico did not supplement it by a comprehensive stabilisation programme at that time. The support package has con-

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tributed to the successful implementation of the Mexican stabilisation programme and the reinforcement of market confidence.

Financial authorities outside Mexico were concerned about the risk of Mexico's problem becoming a systemic problem and therefore might have erred on the side of doing more than was necessary. They did not want to test whether the market contagion would spread to the extent that there would be systemic risks. As was pointed out by previous speakers, there was financial fragility not only in the Mexican situation but also in other countries. The stock markets, exchange markets, and banking systems in Latin America and some other marginally emerging market countries were at risk. And the official authorities judged that it was better to err on the side of a financial support programme with conditionality than to do nothing and take the risks of the Mexican problem spreading from country to country. Thus, in the support arrangement for Mexico there was a certain amount of caution involved, much higher than just an individual country facing a problem would have warranted.

That brings me to an observation with regard to the role of the Fund in today's financial environment. The initial purpose of the Fund was to assist individual countries with traditional balance of payments problems. But since countries were not yet confronted with this globalisation of capital markets and were dealing primarily with trade and service imbalances, the orders of magnitude of imbalances were relatively small-scale. As the global economy has changed, the discussion is now whether the Fund should have the capacity to deal with very large movements of capital. The Fund clearly does not have the means, and the question is what role it should play. But to be absenting itself from addressing the impact of very high volatility of capital movements, and to maintain that that is not the role of the Fund, is probably to withdraw too early from the game."

Peter Kenen elaborated on Siegman's observation that the Mexican crisis is typical of the cases one may expect in the future, given the size of capital flows. "We are no longer dealing with just current account adjustment, as Charles and I both pointed out. The difficulty is that because we cannot realistically expect an increase of the size of the Fund appropriate to the circumstances, we are going to be faced with a series of *ad hoc* arrangements for some time to come. The question is: Who qualifies for these *ad hoc* arrangements and how do we back them up? Will even a doubling of the GAB be sufficient to deal with the situation over the next few years? I am frankly very pessimistic.

On a related question, namely the use of surveillance as the trigger mechanism or certification of eligibility for arrangements of this kind and assistance on this scale, I see a major flaw, from which my own proposal suffers as well. Suppose a country is declared ineligible because its policies have gone awry. The Fund is not exactly the world's most confidential institution, and word of this itself getting out into the markets could be disastrous for the country. I do not know what to do about that. It seems to me a very serious problem."

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Reacting to Bernd Goos' remark about the interweaving of economic fundamentals and political events, Peter Kenen admitted that he had overdrawn the case. "I have taken academic licence in contrasting market reactions to political shocks and market reactions to fundamentals, and deliberately overdrew it. It is obvious that a shift in political climate involves a market re-assessment of the capacity to deal with the fundamentals. If a country faces political uncertainty, and yet its economic fundamentals are sound, I do not think the market will worry. If, on the other hand, a country faces some political uncertainties and the fundamentals are not that sound, you have a problem. All I was suggesting is that the markets will not typically react to a gradual deterioration of fundamentals. As long as the political regime is in good standing, the markets will say 'well, they'll handle it'. But when they perceive that the government is no longer politically capable of dealing with the situation, they will overreact - because of the nature of the change in perception. You then need large-scale support."

Frans van Loon confirmed that investors indeed tend to overreact when perception changes. He wondered what could be done to reduce the chance of crisis. "I would suggest that the incidence of sudden changes can be reduced by the provision of systematic, high-quality, well-organised information. The effect of these new, large-scale, international capital flows is certainly that there is a much larger number of decision-makers than before and that there is a vast appetite in the market for all kinds of information. Perhaps a comparison can be made with what companies are doing. A very well-organised shareholder information system -not only financial but a very broad amount of information - has clear benefits. The evidence everywhere is that the value of shares is better maintained if you have an excellent information system combining factual business with, admittedly, good public relations. I would argue strongly in favour of much stronger involvement of official institutions like the IMF, and a substantial improvement in the provision of information.

In that context, I would like to mention that there are sometimes lapses or room between the information available to the official institutions and the market. The confidentiality issue - what knowledge does the US Federal Reserve have, what knowledge does the IMF have, what did the World Bank economic reviews do, and what filters through to the market? Or indeed, what information does the Mexican government, the Banco de México have or what did they publish? There will inevitably have to be some confidentiality, but the price of maintaining confidentiality or having privileged information which will in part not be available to the market may be rising and becoming much more costly. The chance of sudden changes such as those referred to by Peter Kenen and Jack Boorman increases if information is hoarded."

Ariel Buira stressed that there is a widespread misperception that Mexico somehow withheld information from the markets or provided less information in 1994 than it did in previous years. "Let me assure you that this is not the case.

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The Banco de México publishes something like ten thousand statistical series. The only thing that was not provided on a timely basis was the international reserves. This, however, had been a policy which had been followed for the last twenty or thirty years. International reserves were published three or four times a year on given occasions, and the same policy was followed in 1994. The last time information about the international reserves was published before the crisis was November 1, 1994. You saw in Chart 6 that the reserves suffered a very sharp drop following the assassination of Colosio and that they remained stable for around seven months. They started declining again in mid-November, but the same information was available as had been before.

Let me also add that this same information had been thought sufficient by investment fund managers and mutual fund managers, who are generally professionals, to allow them to bring one hundred billion dollars or more into the country.

This is a point which should be made very clear. The problem was not one of information. I agree with Peter Kenen that they were not reading the data, but that they were reading the headlines. When the political instability was setting in, the feeling was that the country was becoming unstable, but I do not think this was an issue concerning the fundamentals. The fundamentals were not different in any significant way from what they had been. This includes the lending of the development banks, which is included in the monetary figures. I also want to stress that there was no significant easing of monetary policy; if anything, monetary policy was tighter in 1994 than in 1993. Moreover, GDP growth was considerably higher in 1994 (1993 was a year of recession pending the uncertainty about the NAFTA approval by the US Congress). I should also mention in passing that the savings rate in Mexico had started to rise in 1993 and in 1994.

Hence in 1991-1994 there was a very sharp impact of the accumulation of various things: the strengthening of public finances, by which the public sector liberated a number of resources that it used to absorb; the increase in capital inflows; the pentup demand, as there had been virtually no consumer credit for a decade; the improved expectations in terms of future income and so forth. So there were a number of things that joined together to produce a sharp expansion in consumer credit. But by the end of 1994 this had levelled off and savings were rising again.

A very good point was raised, however, on the financial fragility of the Mexican banking system. The fact is that the non-performing assets of our banking system were approaching or even in a number of cases were exceeding the level of the capital of the banks. This was certainly a significant problem.

Moreover, as Jean-Jacques Rey said, there are of course demographic pressures in Mexico. The working population is growing by over a million per year and we haven't created enough jobs for over a decade. So the pressure is continuing to build up."

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Coen Voormeulen doubted that the Mexican crisis could have been prevented by better information. "In my view, the discussion about information points out that the most important feature of the whole discussion is not what actually triggered the crisis in 1994 but how it built up during the previous years. If information had been better, perhaps markets would have made a different assessment during the previous years. Ariel Buira mentioned in his paper that non-performing loans had increased substantially over that period. In my view that was a strong indication that the current account position was not sustainable. The banking system is really an important feature in this process. You can argue that markets were looking at headlines, but that is not the issue. They may be looking at headlines, but these headlines are the result of something that has gone wrong over the years before."

Bernd Goos observed that information is important, but that it cannot solve the problem. "One experience which is indicative of this is the ERM crisis in 1992. All the countries involved had elaborate statistical systems and publications. The markets had access to this information and could have responded to it much earlier than they actually did."

Jean-Jacques Rey added that the point is not whether a country like Mexico should have published figures about its international reserves on a more regular basis, or that the publishing of bad figures at the end of November 1994 would have precipitated the crisis, but that the Mexican authorities -knowing that these bad figures were going to be published - would have been forced to accompany this statement by announcing ways to deal with the problem. "That is nearly the only viable route to prevention. One can indeed reinforce surveillance and open a dialogue between the IMF and the authorities, but this dialogue will have to be kept very secret. It is unthinkable that the IMF would go public on the viability of an exchange rate peg. The same is true for the IMF informing the market. The IMF could not inform the market in a more or less confidential manner - that would raise an enormous problem of insider trading. The only thing the IMF could do is send a message on Internet that said 'watch out for Mexico'. This clearly would also precipitate the crisis. It seems to me that the only pressure is really regular disclosure."

Ariel Buira added: "Chart 6 in my paper shows a stretch of stable reserves until mid-November 1994. What happened then? The deputy Attorney General in charge of the investigation of the murder of his brother denounced a cover-up by ministers and high party officials. This led to a loss of nearly 4 billion in reserves. Only a few days later, as soon as the new administration took office, it was faced with a new uprising of the rebels in Chiapas who took 46 municipalities. I suggest that there is no interest rate measure that could have stopped the outflow then. It was not, at that moment, an economic problem. It was the complete loss of confidence in the political stability of a country.

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You can announce reserves and what other measures can you take? You can raise interest rates to 100%, in which case you tell the markets that you are desperate, and in fact, you provoke the crisis that day, or you try to ride it out and see what happens. The hope was that the new administration would give confidence."

Charles Wyplosz, going back to the distinction between political and economic causes of the Mexican crisis, observed that the economics of the exchange rate includes the concept of multiple equilibria. "This concept means that there is not a one-to-one relation-ship between what we call the economic fundamentals and the value of the exchange rate. As Bernd Goos said, the expectations of future policy actions or political difficulties are all factored into the exchange rate, and the markets of course continually can and do assess the situation. So there is a very complicated link between policy actions and the exchange rate, because it is all mediated through expectations. I wanted to make this theoretical point in order to relate it exactly to what we are discussing here. What it means is that the situation can get its own dynamics. For example, Ariel Buira was talking about releasing or not releasing information. Just releasing information can be interpreted by the market in such a way that the market will conclude that there will be a change in exchange rates, or there will be a crisis. It is enough that they believe that this is the natural outcome, for this to become the outcome. We call this self-fulfilling prophecy, and it does happen. So that is an argument.

Jean-Jacques Rey made the point that giving more information forces you to behave yourself. It is a good point. But there is a counter argument, namely that giving information can be misinterpreted, which can then trigger things which do not make sense or which you want to avoid. I believe that going to 7.00 for the exchange rate for Mexico was not what anybody wanted to recommend to Mexico in the first place - it was forced upon it. So there is an argument for secrecy, because the markets do not know for sure what is going on, and may misinterpret the information."

According to Stephany Griffith-Jones, one of the serious problems is how markets perceive information. "If you look at how people spoke about Mexico before December 20, 1994, nobody mentioned the current account deficit. It's not that they didn't know about it, but people didn't analyse it. They focused on Mexico's entry into NAFTA, on low inflation and so forth. Suddenly, after December 20th, the only thing that people focused on was the size of the current account deficit. And indeed, even in analysing other countries - I was in Eastern Europe at the time of the Mexican crisis - people in the markets were saying: 'Hungary is the country in this region that looks most like Mexico, because it has a similar current account deficit.' Obviously, the current account deficit is a very important variable, but there was this obsession then, whereas there had been a complete neglect before. I think these swings are not just linked to the availability of

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information. Everybody knew what the numbers were before and afterwards. The problem is: how do markets react."

Stephany Griffith-Jones wondered why Peter Kenen had said that if Mexico had just stuck to *Cetes* instead of changing them for *Tesobonos,* the situation would have been the same. "My impression is, if there hadn't been this transformation to Tesobonos, things would have been different. First, the crisis could have started sooner. Second, the Mexican government would have taken less of a loss and foreign investors would have taken more of a loss, because there would not have been this exchange rate guarantee, and so the distribution might have been more equable. I do not know how that would have affected the way investors would have reacted: whether this would have precipitated the crisis, or whether it would have diminished the outflow because investors would have been unwilling to take such loss."

Peter Kenen agreed with Griffith-Jones: "If these loans had not been dollar-indexed, then certainly the budgetary costs of servicing them would have been smaller. Those investors who held Tesobonos suffered virtually no loss; those who held peso-denominated assets (Cetes) obviously did suffer losses. So there was that difference. I was merely objecting to Charles Siegman's earlier chart, in which he was netting the Tesobonos against the reserves. What you want to net against the reserves is the totality of short-term claims that can be exercised against the reserves, and not just one particular claim. Suppose Mexico had issued no Tesobonos and only Cetes, and that people had bought them. True, they would have suffered larger exchange losses if they had held them one minute too long, but the problem for Mexico of funding a short-term capital outflow would have been there anyway - slightly different in magnitude, but still there."

On the issue of information, Peter Kenen warned that a clear distinction should be made between what one is asking countries to publish and what one is asking them to provide on a current basis for official surveillance. "You would, for instance, not ask a country to publish its internal working fiscal forecasts. You might ask it to discuss these in an Article IV consultation with the IMF. There are all sorts of things which the government might be willing to provide to the Fund but cannot be expected to provide to the market. While I agree that publication of many more numbers may be useful in alerting the market to what is happening in countries and forcing the security analysts to keep up to date with what's going on, I don't think it solves the problem. I'm also worried about the danger of urging countries to publish data on a uniform basis, because countries are not uniform. The meaning of a particular number is different in one country than it is in another. How many people were sophisticated enough to know that there were development banks in Mexico and that the monetary statistics must be interpreted in light of those? I am terribly worried about the idea that there ought to be a standard international format. Publish frequently, but publish in your own format."

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Peter Kenen added one new element to the lessons that can be learned from the Mexican crisis. "What's puzzling about the Mexican situation - and no one has mentioned this - is that this is one of those rare occasions in which a finance minister repeatedly said the currency would not be devalued and everyone believed it. This is odd, because statements of this kind are very often discounted by sophisticated market operators. But the operators in the Mexican situation were not sophisticated in that sense. After all, for many, this was their first international spree. These were mutual fund managers - people who were not used to this kind of thing, and took the promise of no change in the exchange rate at face value. That is why I suggested that it was appropriate to introduce enough exchange rate flexibility to remind people that exchange risk was real."

Kenen objected to the term 'bail-out' being used in the case of Mexico. "We are not bailing out Mexico. As Ariel Buira said, an awful lot of people took awfully large losses, on equities, peso-denominated liabilities and so forth. There were losses. The issue here was bailing out a country that was going to suffer enormous pain if it did not have this kind of assistance. It's the country and not the investor. True, the Tesobonos created a special problem, and those investors were bailed out. The lesson from that is: limit your short-term obligations in foreign currency."

Ariel Buira explained that the Tesobonos were, in a sense, a policy of signalling commitment to the exchange rate policy. "They were an attempt to keep people in the country. You can, of course, relate that to reserves, but if you are going to do that I would side with Peter Kenen, because what you really have to consider is all liquid claims in the banking system against the reserves. And Mexico is a country where most of the deposits are overnight or less than a week. So what you have to do is maintain confidence that this will hold. If you do not maintain confidence that this will hold, no amount of reserves will face the conversion of M4.

On the very loud and moral hazard - it wasn't exactly very loud nor is there really a moral hazard, except that the cost to Mexico has been enormous, staggering. We have a decline in GDP of 10.5% in the second quarter and we have a doubling of the rate of unemployment. It is not as though it is an easy way out for anyone. In fact, one could argue that there was not enough financing. If the Fund is supposed to help countries overcome their difficulties without measures destructive of national and international prosperity - I think that is what Article I says - there was not enough financing, as this objective was not met. Now, we have heard again a lot about the development banks. The development banks are not a deficit. The development banks normally operate through what we call 'second-story' banks. They lend to commercial banks, which in turn lend to borrowers. They are specialised banks that deal with foreign trade, with industry or whatever. Only the one dealing with agriculture suffers substantial losses from time to time, not the others. The others are as good as any bank anywhere. Besides, the cost of recapitalising the agricultural bank is always included in the budget. It is not as though we are cheating with our fiscal accounts."

Charles Siegman agreed with the thrust of Jean-Jacques Rey's argument that a systematic information release would alert the policymakers somewhat earlier than otherwise to a possible market response and therefore stimulate them to implement a policy package in anticipation.

"I agree, there is a certain amount of prevention in that. On the other hand, the publication of data should not be relied on to solve the potential problem of emerging crises. As Ariel Buira pointed out, in the case of Mexico a lot of data were published. In response to the latest crisis, Mexico has been releasing a considerable amount of data in a more systematic way.

I would like to add one comment about the risks of publication of data, which should not go unmentioned, particularly for the IMF. The IMF is now involved in an exercise of identifying standards of information release and of potentially even certifying countries releasing data according to these standards. But the IMF is on a very slippery slope, where one mistakenly implies that by certifying that countries are issuing a set of data, the IMF is certifying that the data are accurate. The IMF could be very helpful in improving the quality of data, but the certification of data is something the IMF must be very cautious about getting involved in. This is not to suggest that countries necessarily report inaccurate data. But because of the diversity of the content of the data - how they are assembled, what they convey, what is included, what is excluded - which differ from country to country, the IMF ought to be very cautious.

With regard to the Tesobonos discussion, Peter Kenen is quite right that, in the broader sense of the term, the system is vulnerable to all potential drains. No country's reserves are up to meeting all claims. The reason for focusing in this particular exercise on the Tesobonos was as a way of assessing the authorities' response to the loss of reserves. It was dual-featured: allowing reserves to be drained, and simultaneously incurring a noticeable increase in obligations which had due dates, for which a day of reckoning is involved. The day of reckoning was much more applicable to short-term Tesobonos than to other monies. The financial investors had to make their choice between a roll-over and redemption. It is that kind of policy environment to which I tried to relate the exchange rate, the reserves, and the new obligations. But Peter is quite right that in a more convertible world than Mexico was living in, they were vulnerable way beyond the Tesobonos. But 30 billion dollars of additional short-term external debt obligations is a very high-powered risk."

Jack Boorman agreed with Charles Siegman that the IMF ought to be careful not to certify the performance of countries that are providing data. "However, it was not the Fund who even suggested that the Fund should do that, it was the G-7 at the Halifax summit who suggested that the Fund should do that. There

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are various proposals to the Board right now about how to deal with that situation, but none of them is coming from the staff. I don't think it can be done."

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