

Lessons of the Mexican Peso Crisis

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John C. Whitehead, Chairman
Marie-Josée Kravis, Project Director

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What the United States and the international community have done for Mexico is unique. No other country, with the exception of Canada, could muster such support from the U.S. government. The Mexican peso crisis, therefore, is not a bellweather of currency troubles in emerging economies or a model of how such problems are likely to be handled.

The task force of leading scholars, business people, and policy analysts assembled by the Council on Foreign Relations views the causes of Mexico's problems as primarily domestic. It warns that the type of massive international support to other countries, as suggested by the U.S. Treasury Secretary Robert Rubin, could dampen their commitment to domestic reform in Mexico and other emerging economies, and finally assesses the ability of the international financial system to deal with Mexico-style financial implosions.

The report concludes that "all parties would be wise to be mindful of the market, those who would intervene should bear the burden of proof."

Introduction

A year ago, on December 20, 1994, the Mexican government responded to a looming liquidity crisis by devaluing the peso, thereby unleashing financial turmoil on a global scale. Since then, a reexamination of the events surrounding the peso devaluation has intensified rather than resolved the debate about the management of currency crises in emerging economies. Interventionists believe more strongly than ever that governments and international institutions can and should play a central role in preventing or stemming such financial implosions. Free marketeers have reaffirmed their basic conviction that sound domestic policies which reflect market forces are the most effective remedy for dealing with these situations and disciplining mishandlers. Yet, despite their enduring

contention on policy fundamentals, interventionists and free marketeers have found some important common ground as a result of the peso crisis. They agree that developing countries should be far more vigilant over budget and trade deficits, loose bank credit, low domestic savings, and excessive reliance on foreign investment to fuel domestic consumption, as opposed to capital formation. They agree that the international community and private investors must demand far greater openness on the financial affairs of developing countries and that international institutions should improve their surveillance.

Equally important, neither contending party sees the Mexican peso crisis as a bellwether of currency troubles in emerging economies or as a model of how such problems are likely to be handled.

Mexico is unique in many ways; namely, it is a big and important neighbor of the United States. As its problems were developing, Mexico was at the heart of Americas hot political debate about passage of the North American Free Trade Agreement (NAFTA). This made it very difficult politically for U.S. leaders to challenge the Mexican government to adopt tough monetary and fiscal measures that could have averted the subsequent crisis. Once the peso crisis did unfold, U.S. concerns about its effects on immigration and American regional economic and political strategy provided further justification for massive U.S. and International Monetary Fund (IMF) assistance. What the United States and the international community have done for Mexico is clearly unique to other countries, with the possible exception of Canada, could have mustered such support from the U.S. government. The lesson: policymakers must consider the special features of each emerging economy.

These are the main findings and recommendations of the six-month-long independent Task Force sponsored by the Council on Foreign Relations. The Council assembled the Task Force under the chairmanship of the Honorable John Whitehead, former head of Goldman Sachs and former deputy secretary of the U.S. State Department, and under the direction of Marie-Jose Kravis, an adjunct senior fellow at the Council. The group included business leaders, scholars, and former policymakers.

While the Task Force did not achieve unanimity between interventionists and free marketeers, the weight of discussions did fall toward greater reliance on market forces. This general thrust differs somewhat from both the current IMF position and the views enunciated recently at the IMF-World Bank annual meeting. The majority of the Task Force members view the causes of Mexicos problems as primarily domestic and warn that the type of massive international financial support to other countries that has been suggested, notably by U.S. Treasury Secretary Robert Rubin, could dampen a recipient countrys commitment to domestic adjustment. They contend that the role of the international community is in supporting economic, legal, and regulatory measures that favor market-based reform, competition, and accountability. They also argue that the investment risk associated with a developing country must be assessed and consequently borne by investors. They contend that, other than the typical short-term overreaction of markets, contagion risks are relatively limited.

Others, who consider the social and economic costs of domestic tightening too substantial, believe international financial assistance is necessary to prevent market contagion and soften the effects of recession. They argue, as did Secretary Rubin at the annual meeting of the IMF, for more formal emergency financing procedures to help deal with future financial crises and for criteria to determine levels of financial assistance in such circumstances.

The Mexican peso crisis presents a tangled and complex web. The first purpose of the Task Force was to unravel that tale and explain what happened and why without regard to fear, favor, partisanship, or personalities. The second objective was to explore ways to avert such crises in the future. The third goal was to assess the ability of the international financial system to deal with such crises once they erupt and gauge what, if any, outside intervention should be made to dampen adverse effects on other economies.

A year ago, the Task Force saw the main weaknesses of the Mexican economy as stemming from the following:

In 1994, Mexican monetary and fiscal expansion was much too rapid.

Large inflows of foreign capital called for greater fiscal discipline, especially because they were reversible, and should not have been used to finance domestic consumption.

Savings were too weak to sustain investment needs.

The structure of the banking system and the increased role of Mexican development banks allowed credit to grow much too vigorously, especially at the smaller, weaker banks.

Insufficient attention was given to the expansion of the current account deficit.

The government's decision to issue debt with short-term maturities and exchange rate guarantees was, at the very least, imprudent.

Given rising U.S. and international interest rates, investors, especially foreign investors, neglected to consider all of the above warning signals of Mexico's financial strain.

Failure to address those domestic economic problems combined with political instability to heighten uncertainty about Mexico's prospects. Recent studies indicate that Mexican investors grasped the fragility of the situation much more aptly and sooner than did foreign investors and observers. Thus Mexican, not foreign, investors triggered the initial outflow of capital in November and early December 1994.

What might have prevented the crisis? Proponents of fixed exchange rates argue that the volatility of international capital flows warranted a vigorous defense of the Mexican currency and, hence, more stringent management of monetary and fiscal policies. They

acknowledge the policies inherent and high risk of recession, but maintain that such a recession or economic slowdown would have been less inflationary than the actual one after the December devaluation.

Advocates of exchange rate flexibility argue that competitiveness and a sustainable current account position could only have been achieved through a well-managed, early devaluation of the peso and taxes or controls on capital inflows. Had the Mexican authorities handled the devaluation in a more orderly fashion, the recession might have been milder and briefer. Although these views are clearly irreconcilable and frame the debate about intervention, they do not preclude concurrence that the Mexican government mishandled the devaluation with its mixed signals and failure to introduce strict adjustment measures. Likewise, the vacillating commitment of the United States and the international community toward assistance heightened the confusion.

Should Mexico, the United States, and the world have reacted differently? Mexico left investors with the impression that they had been tricked and should have made its situation and intentions clear at the outset. Furthermore, a credible program of adjustment should have accompanied any announcement of devaluation.

The Task Force remained divided about the role of the United States and the IMF and about the level of risk to be assumed by the investment community. There was general agreement about the difficulties inherent in implementing measures such as an emergency funding mechanism or in creating institutions such as an international bankruptcy court. Even calls for increased surveillance raised questions. Who, for example, will vouchsafe the data's reliability? How would recalcitrant countries be forced to comply? A more general concern revolves around the international community's failure to deal with lender-of-last-resort responsibility.

Great policy debates are rarely resolved. But certain events do illuminate the landscape and provide lessons that one ignores only at peril. In this case, the first lesson is how quickly market discipline can be eroded in periods of rising economic confidence. It is also clear that devaluation is neither a panacea nor a cost-free substitute for sound monetary and fiscal policies. The Mexican crisis has turned out to be a wake-up call for other emerging economies and reinforces the need to deepen and accelerate the reform process: raising domestic savings, increasing private investment in infrastructure, facilitating the creation of new business, privatizing, and deregulating industries. The crisis should encourage governments to play a more active role in protecting consumers, strengthening the banking system, improving financial disclosure, restricting conflict of interest, preventing insider trading, and establishing more transparent rules for doing business. These domestic measures are more significant and necessary for long-term prosperity than reliance on international assistance. Other governments and international institutions must continue to exert pressure for greater transparency and accountability. Surprise worsens a crisis and exaggerates its effects. In any case, all parties would be wise to be mindful of the market; those who would intervene should bear the burden of proof.

I. What Happened?

On December 20, 1994, the new administration of President Ernesto Zedillo Ponce de Len broadened the band in which the Mexican peso was allowed to float against the U.S. dollar, in effect permitting a peso devaluation of 15 percent. The market reacted by intensifying speculative attacks on Mexico's currency. Hard-currency reserves fell precipitously. Two days later, the peso was allowed to float freely against the dollar, triggering a further flight of capital, which in turn precipitated a currency crisis. In the ensuing months, the peso plummeted to an exchange rate of seven and a half to one U.S. dollar, its lowest level in two decades, dropping below levels reached in the depths of the 1982 debt crisis. While the peso initially recovered, it continues to be under pressure and, in recent weeks, has reached record lows. Inflation remains well over 40 percent. The banking system has been weakened; real interest rates and unemployment have surged. Increases in Mexican exports and a sharp reduction in imports have improved the current account deficit, but financial markets are volatile and confidence in the government has been severely shaken. On October 10, 1995, when the Mexican government decided not to sell six-month and one-year treasury bills, many feared that Mexico was trying to cap interest rates. The peso dropped 1.5 percent. Suspension of T-bill sales the following week pushed the peso down further. Meanwhile data for the second quarter of 1995 show a 10.5 percent decline in GDP compared to the same period in 1994 and no real signs of recovery.

How did Mexico get into this mess? The general view of the Task Force is that the crisis reflects both fundamental shortcomings of the Mexican economy and counterproductive responses to large, unexpected shocks in early 1994. Until then, Mexico appeared to be emerging from the 1980s with much greater fiscal and monetary discipline. In 1987, in the wake of another major financial crisis and currency devaluation, Mexico had instituted extensive reforms under the Pact of Stability and Economic Growth to slash inflation and sustain economic growth. These reforms involved a crawling-peg exchange rate regime, liberalization of trade and capital flows, enhanced property rights, reduced marginal income, value-added tax rates, and cuts in government spending.

The election of Carlos Salinas de Gortari as president in 1988 reinforced the commitment of government leaders to the stabilization program. The budget deficit was sharply reduced and inflation declined steadily. The traditional statist, autarkist political economy was supplanted by a wave of privatizations and encouragement of foreign investment. To integrate Mexico with the United States and Canada under NAFTA, and to comply with its new membership status in the General Agreement on Tariffs and Trade (GATT), the government opened the economy to freer trade in goods, services, and assets. Mexico also sought to increase capital inflows with the explicit goal of achieving balance-of-payments equilibrium by financing current account deficits of about five percent of GDP.

During the six years of the Salinas administration, growth in GDP averaged 3.3 percent per year, hardly spectacular for a developing country.¹ Nevertheless, despite falling real wages the general state of the Mexican economy was perceived as healthy. Investor confidence in and enthusiasm for the Mexican economy and the Salinas administration

were buoyant, as were expectations accompanying Mexican accession to NAFTA. On the whole, fiscal adjustment was successful. The federal government reduced its fiscal deficit from 16 percent of GDP in 1987 to a negligible 0.3 percent in 1994. The adjustment effort, combined with revenue from privatization, allowed the federal government to halve the stock of net public sector debt by 1994, bringing the ratio of debt to GDP below the Organization for Economic Cooperation and Development average.

In 1994, however, the course of fiscal policy changed; federal expenditures rose significantly, and spending by the Mexican state governments and domestic industrial development banks soared, causing an expansion of credit equivalent to 4.4 percent of GDP. Together those expenditures yielded an actual deficit of approximately 4.7 percent of GDP, the highest since 1989. Keeping Mexico's current account under control would have required higher public sector savings because successful reforms tend to fuel growth in private consumption.

Meanwhile, sharp increases in commercial bank credit and higher private domestic spending, relatively low growth, and high unemployment contributed to reducing private domestic savings from 21 percent of GDP in 1989 to 11 percent in 1994. This was the wrong direction. Mexico needed, and still needs, a savings and investment rate of 24 percent of GDP to achieve the 5 percent growth rate necessary to ensure rising employment and living standards, according to the Mexican Treasury Department. Figure 1 shows the marked decrease in private savings during recent years.

During this time, modernization and economic restructuring pressures led to a substantial increase in total investment needs. The gap between savings and investment widened, intensifying Mexico's reliance on foreign capital, which not only helped finance investment but also fed a consumption boom.

The Growing Gap Between Savings and Investment

The gap between domestic savings and investment and the increasing reliance on foreign savings caused Mexico's current account deficit to soar to eight percent of GDP in 1994, exceeding the government goal of five percent. Because the current account deficit was largely financed by foreign capital, private external debt also increased by an amount equivalent to four percent of GDP. The adverse current account posed no problem while Mexico could balance its trade deficits with investment flows. In fact, Mexico ran current account deficits of \$25 billion in 1992 and \$23 billion in 1993, yet managed to accumulate reserves while the peso was trading at 3.1 to the dollar. Nevertheless, the large and growing current account deficit and a declining rate of savings made Mexico highly vulnerable to speculation and shocks that could interrupt capital inflows. This was especially so because, as shown in table 1, the capital inflows were mostly portfolio investment, which tends to be more volatile than direct foreign investment.

In Mexico's case, investment failed to increase as rapidly as capital inflows. As displayed in figure 2, the ratio of investment to GDP rose by 1.5 percentage points while the consumption ratio jumped by almost 3 percentage points. As mentioned earlier, public

sector expenditures expanded in 1994, exacerbating the problems caused by the consumption boom.

The Unraveling of Stability

Foreign direct investment was stable in the 1990-93 period and actually increased in 1993⁹⁴, but attacks on the peso began in the last quarter of 1993. The currency was successfully defended, which in a sense generated false optimism inside and outside the government. In March 1994, a sharp drop in portfolio flows occurred, in the wake of the assassination of the leading Institutional Revolutionary Party (PRI) presidential candidate, Luis Donaldo Colosio, and a rise, in relative terms, of U.S. interest rates. The Salinas administration responded by devaluing the peso from 3.1 to 3.5 per dollar (11 percent), but did not alter the existing exchange band. It also used its foreign exchange reserves to buy pesos and, for a time, boosted interest rates for 28-day government notes (cetes) from 9.6 percent to 18 percent. The United States and Canadian authorities established a swap line of credit of \$6.7 billion to help the Banco de Mexico defend the peso. Historically, Mexican reserves have always been low, even when the peso was strengthening. Thus, the Salinas government remained confident in its ability to defend its currency. Moreover, Mexico gambled on no further shocks. Reserves more or less stabilized from April to early November at about \$14 billion.² Mexican authorities were reassured by this relative calm which, combined with falling interest rates on government paper and the absence of inflationary pressures, suggested that foreign confidence in Mexico's exchange regime remained.

However, political turmoil events in Chiapas, the assassination of Jos Francisco Ruz Massieu, and a series of political kidnappings continued to erode confidence in Mexico's polity. The peso came under renewed pressure when the tensions between the government and the Zapatista insurgents intensified in December. Meanwhile, the persistent rise in foreign interest rates should have provided a floor for rates on both peso (cetes) and dollar-indexed (tesobonos) government paper. Likewise, the ongoing substitution of cetes for tesobonos, a short-term debt instrument denominated in pesos but guaranteed in terms of U.S. dollars, and the drop in stock market prices beginning in mid-September should have triggered questions about the assumed stability of the demand for money. But the Mexican government, as would most other governments, preferred to delay painful and politically risky adjustment.

Mexican investors, less myopic and better informed than their foreign counterparts, adjusted as it became clear that certain currency shocks were not transitory. A recent IMF study points out that the pressure on Mexico's foreign exchange reserves in the run-up to the devaluation came primarily from residents rather than foreign investors selling their holding of Mexican securities.³ The IMF report shows that foreign investors sold \$326 million worth of government debt and, contrary to conventional wisdom, actually increased their net holdings of equities between the end of November 1994 and the December 20 devaluation. During the entire month of December, foreign investors sold only \$370 million worth of debt and equity, but reserves dropped \$6.7 billion. Since only

\$1.7 billion of this slide can be attributed to the trade deficit, it would appear that well-informed Mexicans were rapidly shifting from peso assets to dollars.

By December 19, when Mexico announced the devaluation, the fragility of the government's finances had become clear to all investors. The markets realized that the Banco de Mexico lacked sufficient resources to redeem, if need be, short-term dollar-denominated debt instruments (tesobonos), amounting to \$10 billion in U.S. dollars and coming due in the first quarter of 1995. A liquidity crisis developed when it was finally confirmed that Mexico's international reserves had dropped below \$6 billion. Nevertheless, as the IMF points out, foreign investors did not start to sell their Mexican equity holdings in any sizable quantity until February 1995.

The Role of Monetary Policy

Monetary policy played a critical role in the crisis. Beginning in April 1994, the government initiated an easy money policy to stimulate economic growth before the elections and provide liquidity for the banking system. The Banco de Mexico appears not to have behaved as the independent entity the government claimed it had become. Although the Task Force was divided on a number of basic issues, there was general agreement that monetary policy in 1994 was too expansive. Indeed, interest rates on 28-day cetes dropped from a peak of 18 percent in April to about 13.5 percent in November, while the United States and other countries were raising interest rates. In 1994, both Mexico's external and internal imbalances emerged, yet the government continued to run down reserves rather than raise interest rates to more fully address these imbalances. To the contrary, domestic credit expanded at a frenetic pace. While the growth of the narrow money supply appears to have been moderate, the increase of central bank credit to the financial system, notably to development banks, amounted to 400 percent from mid-1993 to mid-1994. Moreover, in the first nine months of 1994, assets of small and relatively risky banks grew by 25 percent compared with 14 percent at larger, more stable banks. The flow of loans by the government to private banks was not counted as part of the fiscal deficit because the loans were classified as new assets. Such a credit expansion, combined with a drop in foreign capital inflows, put downward pressure on the peso. The government expected capital inflows to resume after the election, and it was right. Yet uncertainty about Mexico's political and economic stability did not subside, and that environment reduced the attractiveness of investing in Mexico. Rising U.S. interest rates continued to lower the relative return for investing in a riskier economy, and that type of effect was not confined to Mexico. Since early 1994, foreign reserve accumulation had leveled off in most developing countries in response to increases in international interest rates. In 1994, net portfolio investment in developing countries fell to \$62 billion from \$88 billion in 1993. Greater competition from other emerging economies caused a sharper slowdown in capital flows to Mexico. Capital flight was not merely an issue of speculative outflows of foreign capital. The fact that monetary pressure also came from Mexican residents seeking to acquire foreign assets confirms the central importance of sound money and confidence in monetary stability. The challenge for Mexican authorities was to adjust policies before markets forced a more costly resolution.

The Task Force remained divided about the policy options that Mexico might have considered early in 1994. Broadly speaking, two major options were debated: maintaining the exchange rate peg and tightening monetary and fiscal policy, or devaluing the peso earlier and placing controls on capital flows. Nevertheless, the Task Force reached agreement that both fiscal and monetary policies had become imprudent, especially toward mid-1994. Although there were some concerns expressed that contractionary monetary policy might have further weakened an already fragile banking system, there was agreement that the unprecedented rise in interest rates following the devaluation exacerbated problems of credit quality and the financial position of Mexican banks. As of December 1994, foreign currency loans represented almost a third of total loans by Mexican banks. Moodys Investor Service estimated that almost 25 percent of these dollar loans went to firms without any clear source of foreign income.⁴

The Change in the Structure of Debt Financing

The Task Force also felt strongly that, having failed to restrain monetary and credit expansion, the government exacerbated its problems by rolling over its debt into short-term obligations and assuming the foreign exchange risk as well. Instead of selling ordinary treasury securities to absorb the excess supply of pesos, the Mexican government decided to issue dollar-linked debt. Beginning in April 1994, the government issued about \$30 billion of tesobonos. The tesobonos carried no foreign exchange risk for foreign investors and, as quasi-substitutes for the U.S. dollar, actually reduced the demand for dollars by foreign and domestic investors. The government was effectively increasing the supply of pesos. A policy designed to sell peso-denominated securities as opposed to redeeming them would have pushed short-term interest rates higher, but a restoration of confidence in the pesos stability might have stabilized capital flows and brought interest rates down. In any event, the Mexican government faced a false choice between letting interest rates rise or letting the peso fall, since interest rates rose dramatically in the wake of the devaluation.

A Pause in Structural Adjustment

Between the outbreak of the Zapatista unrest in Chiapas in January 1994 and the August presidential elections, the government slowed the pace of economic reform. For example, it delayed the planned privatization of the petrochemical industry and postponed social security and pension reform. The long-term needs of the Mexican economy—promotion of savings, competition, and efficiency—were relegated to short-term electoral politics, suggesting a weakening of the government's resolve to achieve structural reform. Paradoxically, financial liberalization continued without measures to strengthen supervision and monitoring capabilities or policies that might have deepened and stabilized capital markets. The Mexican government tried to forestall the looming crisis by maintaining a pegged exchange rate and expanding public spending as well as domestic credit, but the loss of reserves was unsustainable. Devaluation was chosen. The double game the government had played by not disclosing earlier the extent of reserve depletion exacerbated suspicion by investors who felt they had been tricked. To make matters worse, investor confidence was shattered by contradictory signals from the

Mexican government before and immediately after the devaluation, the governments failure to propose credible measures to rein in domestic demand and tighten monetary policy, and the conspicuous absence of measures to stabilize the value of the peso.

II. Was the Current Account Deficit Sustainable?

Mexicos burgeoning trade account deficit over the past several years must be seen in the context of the general evolution of its national economy: tariff barriers were very high until Mexico joined the GATT in 1986, and the demand for imports soared when tariffs fell. From 1982 to 1988, the Mexican economy and its rate of investment stagnated. Demand for capital goods rose markedly when growth resumed. Preparations for competition in an expanded North American market prompted urgency in Mexican companies modernization plans, boosting demand for imports. Later, in 1994, Mexicos emergence from more than a year of stagnation stimulated a further surge in imports. Mexicos trade and current account deficits were financed by enormous capital inflows. Between 1991 and 1993 more than \$75 billion in U.S. dollars in foreign capital entered Mexico and financed current account deficits totaling \$62 billion. The countrys foreign exchange reserves also grew by \$15 billion. As noted earlier, the bulk of the capital inflow represented portfolio investment as well as the repatriation of Mexican capital; such flows tend to be extremely sensitive to variance in economic and political conditions.

The trends in Mexicos capital account in the early 1990s reflect other important factors: a preference by Mexican companies for borrowing abroad due to the high cost of capital in Mexico and an attraction by foreign investors to the Mexican money market precisely because of those high interest rates. The rise of equity financing and the international diversification of mutual funds, pension funds, and life insurance companies swelled the demand for equities in emerging markets. Rising U.S. interest rates, an economic slowdown in Mexico in 1993, and political tensions in 1994 severely dampened those trends. Whether capital inflows and the financing of the current account deficit would have been sustainable in the absence of political turmoil and rising international interest rates remains questionable.

A recent Group of Thirty report suggests that a simple analysis of likely real growth and inflation would have indicated that a deficit equal to 3.5 percent of GDP, with reasonable growth, was the maximum sustainable level.⁵ Senior U.S. Treasury Department officials have suggested that current account deficits exceeding five percent of GDP portend danger. The target set by the Salinas government was a current account deficit of five percent of GDP; it eventually went to more than eight percent.

Is there an optimum level for a current account deficit? As a general rule, current account deficits are perfectly healthy and desirable as long as they are financed by voluntary inflows of foreign direct and portfolio investment that together exceed domestic investments abroad. Trouble arises when current account deficits are financed by government borrowing from abroad, drawing down foreign exchange reserves, or central

bank accumulation of currencies issued by countries that are incurring current account deficits.

When investors sense that a central bank is low on reserves, they flee a country, especially when investments in local currency financial instruments exceed the stock of international reserves. At this point, the exchange rate becomes governed solely by portfolio considerations, and the reversal of capital flows is generally followed by an overshooting of the exchange rate, far beyond what is needed for competitiveness. If economic policies are credible, an exchange rate could climb back to an equilibrium. If economic policies are not credible, an equilibrium exchange rate will settle at a much weaker level. This was the case in Mexico.

The threshold beyond which it becomes impossible to finance a current account deficit with voluntary capital inflows has yet to be defined precisely.⁶ Many of the economies that have successfully made a rapid transition from the status of less developed to newly industrialized (such as South Korea) have relied on rapid increases in imports; long periods of trade and current account deficits have been financed by capital inflows. From 1953 to 1980, South Korea's net capital inflows averaged nine percent of GDP annually. This eventually led to severe balance-of-payments problems in the late 1970s that required IMF support, but not to a crisis as severe as Mexico's. In the nineteenth century, the newly industrialized United States relied heavily on imported capital and ran chronic international deficits. More recently, Asian countries such as Malaysia and Thailand have run large current account deficits, prompting some concerns in international financial markets. But, generally speaking, these countries have had high rates of internal savings and employed foreign capital as a supplement for investment rather than consumption.

Current account deficits are a macroeconomic phenomenon caused by a gap between investment and domestic savings, one that must be filled by net foreign investment. In Mexico, the ratio of savings to GDP fell while investment rose. When private capital flows are insufficient to finance a gap between investment and domestic savings, policies must be adopted to increase domestic savings, attract more foreign capital, or reduce investment.

Policies to promote savings have seemed successful in countries such as Chile, Japan, and many newly industrializing Asian countries, but those medium-term options were not practical as capital flight loomed in Mexico's financial markets. Surprisingly, Mexico's bail-out agreement with the IMF and the U.S. government fails to focus on raising long-term savings. However, changes in Mexican taxes and transfers to encourage savings and policies that would help sustain high capital inflows (accelerated privatization and deregulation, institutional and political reform) are now being discussed. A government task force is drafting legislation to create mandatory privately managed individual pension plans. There was general agreement within the Task Force that at the very least such measures should have been implemented as a supplement to devaluation. The Mexican crisis was not simply one of confidence. Mexico was highly dependent on foreign savings, which increased its vulnerability to changing world market conditions. Even proponents of devaluation agreed that the decision to devalue was poorly handled

and that accompanying measures to tighten fiscal and monetary policy and increase long-term savings might have attenuated the free fall of the peso and the explosion of interest rates.

Was the Peso Overvalued?

The Task Force generally agreed that the peso had become overvalued in 1994, though the extent of the overvaluation was hotly debated.⁷ The most contentious issues pertained to the policy options available to Mexico to correct the perceived overvaluation. Some argued that the 11 percent devaluation that followed the Colosio assassination in March had relieved much of the appreciation and that inflation would have continued to subside if the government had implemented stricter monetary and fiscal policies. Such measures would have reduced the pesos overvaluation and slowed GDP and import growth. Others maintained that the overvaluation of the peso was so large that market speculation against the currency was inevitable, especially given the inadequate level of reserves. They argued that, at least in the short-term, productivity growth would not have been rapid enough to generate a boom in exports to offset the increase in imports. The only way to control the growing trade and current account deficit was to discourage capital inflows and boost exports via devaluation.

Both sides agreed that tighter U.S. monetary policy was not in Mexico's interests. The combination of changing international interest rates and Mexico's political uncertainty and electoral politics exacerbated divisions within the Salinas administration and made the management of economic policy much more difficult. Besides, a tripartite agreement with business and unions—the Pacto—caused the government to rule out an early peso depreciation and a contractionary program.

Both supporters and opponents of devaluation also agreed that fiscal and especially monetary policies in 1994 had become too lax. If the flow of new currency and bank reserves in Mexico had been somehow tied to international reserves demand in general and demand for imports in particular, it would not have expanded so rapidly. Import contraction might have provoked a recession, but probably nothing like the 1995 debacle.

The Choice of Exchange Rate Regimes

The exchange rate regime best suited for Mexico was the subject of heated debates among Task Force members. Floating and fixed regimes were considered. Floating regimes allow a country to adjust monetary policy without worrying about exchange rates. They facilitate adjustment to external shocks through the exchange rate rather than through more painful domestic belt-tightening. For these same reasons, however, they carry the risk of more volatility, lax monetary policy, and inflation. Some members of the Task Force favored a floating regime, arguing that political pressures to cope with economic shocks would constantly undermine a fixed or pegged exchange rate regime and tempt speculators to attack it. They also argued that financial innovations such as derivatives and cross-border investment would make capital controls or the raising of interest rates to defend a currency either impossible or politically intolerable. Proponents

of floating regimes acknowledged that central banks in developing countries encounter serious problems when they float their currencies. These central banks tend to have limited credibility, so they seek to acquire and maintain confidence in their currencies through high interest rates. But the cost of such policies is high, as the Mexican government has painfully learned. The surge in interest rates that immediately followed devaluation triggered a decline in economic growth, more debt defaults, and a sharp increase in non-performing loans.

An alternative to floating regimes is the establishment of a currency board.⁸ In 1991, Argentina installed a currency board to rein in hyperinflation. Its peso is backed by U.S. dollar reserves and trades at a fixed rate with the dollar. In addition to giving Argentina a fixed exchange rate, the currency board requires transparency: all assets and liabilities of Argentinas central bank, or currency board, are reported on a daily basis.

Many observers believe that this regime, combined with the liberalization of the Argentine economy, are the key elements behind the countrys success in achieving the lowest inflation rate in Latin America and a recent economic boom. However, the existence of a currency board did not insulate Argentina from the troubles of the Mexican peso. Under a currency board, capital outflows lead automatically to a tightening of credit and thus to lower spending. Hence, speculation against the Argentine peso caused the current account deficit to shrink rapidly. The economy contracted severely, prices fell, and the banking system was put under severe stress and is now in the process of being consolidated. Argentina had to appeal for IMF assistance but on a more modest scale than did Mexico. The severity of Mexican inflation and recession exceeds anything occurring in Argentina.

The Argentine government seems determined to hold the peso-dollar exchange rate at one to one and to maintain the currency board. The government has concluded that, as irksome as a currency boards constraints might appear, strict monetary discipline is the best way to maintain confidence in its peso. The reelection of the president may have intensified this commitment, although there is no assurance that Argentina will avert a financial and currency crisis.

Currency boards are not without drawbacks. They were most popular from the late nineteenth century until shortly after World War II, when the ratio of money to income was generally higher in all countries than today and currency played a larger role in the domestic monetary system. The picture now is very mixed. Hong Kong is a large money center but not a cash economy. When its board was installed, Argentina had a relatively small monetary base because hyperinflation had reduced the real demand for local money. In Mexico, the recent depletion of reserves and the weak banking system would be important constraints if the country established a currency board. Mexico might lack the resources to defend its exchange rate.

Indeed, a currency board would require Mexico to overcome several technical and political obstacles. Because Mexico does not have enough foreign reserves to cover all the central banks liabilities, it would have to use its credit lines to borrow the required

reserves and repay them with a currency board's profits. Moreover, with a currency board Mexico would have to set a fixed exchange rate with the U.S. dollar. This should not pose a serious technical problem since a rate approximating the current floating rate would probably be suitable and leave Mexican exports highly competitive.

The political obstacles to establishing a currency board might be more difficult to overcome. Mexico has a tradition of wage and price controls. For a currency board to operate properly, all prices, with the exception of the exchange rate, must be flexible to accommodate changes in monetary policy. Consequently, Mexico would have to refrain from wage, price, and interest rate controls; this would imply major political as well as economic adjustment.

The Choice of Capital Account Policies

Should developing countries attempt to control short-term capital inflows? Capital mobility, like free trade in goods and services, promotes a more efficient allocation of global resources. Although capital controls impede textbook efficiency, controls on the level or character of capital inflows are very much in vogue, at least as a second-best option to protect against sharp gyrations in capital flows. The oft-cited model is Chile. In 1982, following a turbulent decade of experimentation with market-based reforms, industrial policy, and selective privatization, Chile moved to a floating exchange rate system and allowed successive currency devaluations to encourage economic competitiveness. That same year, Chile's economy contracted 14 percent in real peso terms. In dollar terms, the drop was 25 percent in 1982, followed by more falls in the subsequent three years. By the end of 1985, Chile's GDP valued in dollars had, in effect, been cut in half. Since 1985, however, Chile's economic growth has been among the more rapid and stable in Latin America, a trend that has led many to cite Chile as a model for Mexico's economic transformation. Chile's experience with controls on capital inflows—namely a special tax whose rate diminishes if capital is held in the country for at least one year, high minimum reserve requirements on foreign borrowing, explicit controls on the amount of foreign investment allowed in the country, and restrictions on repatriation of money by foreigners—has revived the notion of a more gradualist approach to economic liberalization.

Chile has not been the only country to favor restrictions on capital inflows. Constraints on foreign borrowing, higher reserve requirements on foreign inflows, and limits on banks' offshore borrowing and foreign exchange transactions are common throughout Asia. Would such policies be useful for Mexico?

Recent studies suggest that capital-control taxes can mitigate the problem of speculative capital flows at their root.⁹ These same studies conclude that controls have only a brief period of optimum effectiveness because the private sector rapidly finds ways around them.¹⁰ If that happens, the scope of controls may have to be increased, causing further distortions. This is not an insignificant consideration given Mexico's geographical proximity and close commercial ties to the United States. A tax also may be difficult to implement if government authorities enjoy less than full credibility, as is currently the

case in Mexico. Besides, the ability to resort to synthetic positions in derivative markets makes taxation of foreign exchange transactions much more complicated.

Chiles development has followed a very different path from that of Mexico. First, Chiles recent economic miracle was preceded by a protracted recession and a collapse of the banking system. Second, Chile was an early recipient of capital inflows, which probably placed it in a better position to apply controls. Third, economic policy reform was conducted by a dictatorship whereas Mexican policy is vitally influenced by electoral considerations. Fourth, Mexicos economy is much more closely integrated with that of the United States. Finally, restrictions on short-term capital inflows are hardly the core or the distinguishing feature of Chiles economic success.

Fundamental among Chiles reforms are the creation of private social security funds and fiscal policies that encourage savings. Currently, 93 percent of eligible Chilean workers participate in a social security system administered by private fund managers who compete vigorously for that business. Account balances have grown to \$25 billion, an amount equivalent to half of the Chilean GDP, and 14 percent of the countrys stock market. Chile has achieved the highest savings rate in Latin America 26 percent of GDP, more than twice that of Mexico. This has clearly deepened and broadened its capital markets and reduced reliance on foreign capital.

Mexicos political and economic makeup as well as its proximity to the United States suggest that structural reforms aimed at increasing long-term savings and deepening capital markets through social security and tax reform may be more suited to its current challenges than short-term capital controls. Moreover, persistent doubts about Mexicos long-term economic plans and political stability make introduction of capital controls problematic at this point. Capital controls are a form of default because they limit, without compensation, the rights of investors to freely move capital or investment proceeds across borders. Controls introduced in a time of financial stress would not merely dampen positive capital inflows, they would encourage capital flight. The best insurance against a sudden reversal in capital flows is a high degree of credibility and clear, market-oriented policies. One obvious lesson of the Mexican crisis is that international capital markets have become brutally unforgiving of unsound economic policies.

The use of capital controls as a second-best temporary measure may be better suited to smaller countries that face large capital flows. In fact, countries that have put controls on short-term capital inflows, notably Chile, Colombia, and several Asian countries, have found that they enhance financial stability. The cost is a loss of efficiency and foregone access to capital, a price some countries are willing to pay during a transition. At this point, the price for Mexico might be too steep.

III: Who Knew What, When?

For many observers, though not all, the Mexican crisis came as a surprise. The NAFTA debate, for example, had left many Americans believing that Mexico would attract huge

inflows of investment in plant and equipment, cease to buy American goods, and take away American jobs. In the event, not only was the giant sucking sound predicted by former presidential candidate Ross Perot inaudible, but almost the reverse happened. Mexico's trade deficit surged, foreign direct investment was more or less stable, and portfolio capital inflows eventually dwindled. As early as 1992, some observers of the Mexican scene began alluding to serious weaknesses. In 1993, a number of economists and large financial institutions began to discuss the threat of devaluation. Moodys Investor Service gave a sub-investment grade rating for Mexico. And there was a general appreciation in financial markets that the peso was overvalued. But debate focused on whether Mexican policies would be adequate to sufficiently reduce the need for devaluation. In 1994, the World Bank warned that financial flows to Mexico were unsustainable.¹¹ Earlier that year, the Mexican government itself provided a de facto signal of imminent problems when it issued short-term debt instruments (tesobonos) carrying no foreign exchange risk. Had full disclosure of Mexican reserves been provided at that time, markets would certainly have been more cautious. In any case, it now appears that well-informed Mexicans fled the peso on a grand scale well before most markets were apprised of the looming crisis.

Why was nothing done to avert a crisis? Why were investors so myopic? From Mexico's standpoint, an unfortunate combination of electoral uncertainty, political turmoil, corruption, and a long hiatus between administrations delayed effective actions. Full financial information was not forthcoming to all investors. However, enough signals were apparent to at least encourage caution. The inability to hedge currency risks in the absence of a forward market should also have caused investors to be more prudent. Yet, blind faith in the Mexican government, a failure of analysis, and poor information led to unsound investment decisions.

Fad, fashion, and disregard for warning signals fed expectations. But the very nature of modern private capital flows and securitized finance meant that changes in expectations, when they would occur, would create much greater swings in markets than did commercial bank lending a decade ago. Some investors were uneasy about Mexico and began to curtail capital inflows late in 1993, but lack of attention and information prevented markets from understanding the full extent of Mexico's looming crisis.

As a case study, Mexico's recent brush with market discipline has important implications for developing countries. Portfolio capital inflows are much more sensitive to economic changes than are syndicated bank loans. Markets today react much more vigorously, if not more quickly, than do banks. Getting myriad investors to work together and have confidence in a country is much more difficult than getting a large number of bankers to collaborate.

Why did the U.S. government not take action earlier? The NAFTA debate did not encourage transparency. The August 1994 Mexican election and the December 1994 Miami summit also militated against more open discussions of Mexico's vulnerabilities. It has now become clear that, as early as the spring of 1993, the CIA privately warned the U.S. Treasury Department of the dangers of a Mexican collapse. During the summer of

1994, the Treasury Department privately warned Mexican lenders that continued financing of Mexico's current account might not be sustainable. In September 1994, Secretary of the Treasury Lloyd Bentsen alerted the Mexican authorities himself to the ominous implications of delaying adjustment. Publicly, however, he continued to express support for Mexican policies. As late as December 9, 1994, President Clinton was praising Mexico as a fine example of economic development.

The World Bank and the IMF were bound by rules of secrecy, and their role in informing markets was diminished by their tendency to sanitize reports critical of member countries. Besides, in a world of securitized finance, their role has become more marginal. According to the World Bank, between 1989 and 1994 official aid to developing countries rose to \$54.5 billion from \$42.6 billion, whereas total private capital flows jumped to \$172 billion from \$41.9 billion.

IV: Was the Response Appropriate?

In the aftermath of the Mexican debacle, markets in Argentina, Thailand, Spain, Hong Kong, Sweden, Italy, Canada, and Russia experienced varying degrees of turbulence. Already in 1994, gradual declines in equity and bond prices in emerging markets had signaled a market correction that was not considered out of the ordinary. The Mexican debacle, although limited virtually to one country, triggered a more active reevaluation of risk and rebalancing of institutional portfolios. Contagion was contained, however, because of the extent of economic policy reform in the developing world. Government budgets are now in better balance and inflation has moderated. Many of the major emerging countries have implemented reforms to strengthen settlement and clearance systems and trading mechanisms. In Asia savings rates are high, and even in Latin America policy credibility has improved dramatically since the 1980s. If anything, the Mexican crisis has reinforced commitments to reform in the developing world and made clear that countries with low savings rates, large current account deficits, weak banking systems, and significant volumes of short-term debt are much more vulnerable than countries with sound fundamentals.

Would the situation have been as benign without the exceptional support provided by the U.S. government and the IMF? Is this a model for dealing with similar situations should they occur? The Task Force was unable to agree whether U.S. and IMF assistance played a key role in containing the tequila effect. The announcement by President Clinton of massive loan guarantees calmed markets in mid-January. And when it became clear that Congress would not approve the rescue package, the peso came under renewed pressure, which tends to support the argument that the package played a crucial role in reassuring markets. However, despite the IMF-U.S. package announced in February, it was not until April, after the March 9 announcement by the Mexican government of a very strict adjustment program, that financial markets began to settle.

While there was general agreement within the Task Force that the Mexican adjustment program announced by the United States, with the support of the IMF, does contain elements that stabilize the peso, concern was expressed about the monetary and fiscal

policy components and the underlying economic assumptions.¹² Under the plan, Mexico must halve its current account deficit to 4 percent of GDP in 1995 and 3.5 percent in 1996. Inflation, estimated at 40 percent during the first half of 1995, would have to drop to 9 percent by the last quarter, a goal that now appears unattainable. The plan calls for monetary growth of only \$10 billion in 1995 compared to Mexico's growth of \$60 billion in 1994. The IMF also assumes that Mexico's merchandise exports would grow 25 percent in 1995, with economic growth of 1.5 percent in 1995 and 4 percent in 1996.

The program tends to address monetary problems through fiscal solutions with a major focus on spending restraint and privatization. The March 9 program announced by the Mexican government began to address structural reforms designed to bolster domestic savings, reform social security, and modernize labor laws. Likewise, the October 29 pact reached with business and unions emphasizes fiscal and monetary discipline as well as structural reform. Whether those measures could have been introduced without the external pressure of the IMF and the United States remains an open question. But the Mexican government continues to send confusing signals about its interest rate and exchange rate policies, as we have seen all too well in the latter part of 1995.

V: Lessons for the Future

In the wake of the Mexican peso crisis, the Group of Seven and Group of Ten countries have agreed on numerous measures to stabilize the international system and avoid a similar crisis. Many, if not most, of those actions would enhance the powers and the role of the IMF. Numerous other measures to reduce the likelihood that debtor countries will follow policies that lead to financial crises have been suggested. Such proposals have included measures enhancing the transparency of markets by creating an official international source of timely economic data. Many market participants, including the G-7 leaders, have called for publication or public dissemination of the IMF's so-called consultation reports and staff reviews. This would provide access to the IMF's assessment of borrowing countries' economic policies and prospects. The G-7 leaders have asked the IMF not only to insist on full and timely reporting of standard sets of data by member countries, but to establish a procedure for the regular identification of countries that comply with those benchmarks. Also, several measures have been agreed upon to augment the ability of the international financial system to absorb any crisis that may emerge such as the creation of an Emergency Financing Mechanism that could provide faster access to IMF arrangements with strong conditionality and larger up-front disbursements in crisis situations. This fund could be used to counteract and overpower short-term market forces, thereby dampening fears of a confidence crisis. In addition, numerous experts have advocated the establishment of an international bankruptcy court to adjudicate disputes involving sovereign debtors.

Unfortunately, each of these measures has serious drawbacks. Even the relatively modest proposal to have greater transparency by the more timely provision of economic data raises difficult questions: If the IMF is to take responsibility for collecting and disseminating timely market-sensitive data, who will vouchsafe the data's reliability? The IMF could be compelled to take a much more active role in the design and operation of

national data collection systems. If so, under what terms would it have access to sensitive information? How would recalcitrant countries be forced to comply? In the Mexican case, the issue appears to have become less critical, at least for the time being, because markets have forced the Mexican authorities to expand the timeliness and scope of their data releases. Clearly, the hurdle requirement for disclosure has been raised.

The release of heretofore restricted IMF reports is more controversial. If IMF staff reports acquire the status of officially sanctioned credit ratings, the nature of the relationships between IMF officials and member governments could be altered. The goal of greater access to basic economic and policy analysis could be hampered.

The more ambitious proposals have even more fundamental problems. For example, the creation of a giant Emergency Financing Mechanism may result in a moral hazard, encouraging countries to follow unwise policies and investors to take unwarranted risks. Mexico has had several financial crises and received increasing amounts of assistance from the U.S. government each time (\$1.8 billion in 1982, \$3.5 billion in 1988, and \$20 billion in 1994). Moreover, an explicit offer to blunt market forces with a massive intervention on a discretionary basis may not necessarily reduce market volatility.

Similarly, proposals for the creation of an international bankruptcy court present numerous problems. The powers of existing domestic bankruptcy courts are decisive: the courts have the power to dictate the disposal of assets of the bankrupt firm. Bankruptcy proceedings typically result in successful negotiations because the disputants know the court can impose a settlement if one is not reached voluntarily. That such powers over national assets could be awarded an international tribunal, however well-intentioned, is difficult to imagine. The idea of an international bankruptcy court does, however, have some merit; it makes clear the fact that no feasible system of managing future crises can rely solely on public resources.

A key weakness of the proposals advanced to date for dealing with Mexico-type crises has been their failure in a world of securitized finance to address the current lack of clarity in lender-of-last-resort responsibilities. Part of this ambiguity has stemmed from uncertainty about the systemic impacts of a large-scale default or rescheduling of international bond holdings or a failure of firms whose equity is held internationally. In contrast to the 1982 debt crisis, when the bulk of private cross-border investment in developing countries took the form of syndicated bank loans, it now appears impossible to assemble a representative group of bond holders to negotiate an orderly rescheduling.

Moreover, it is not clear who should be responsible if the rescheduling of sovereign debts such as the tesobonos resulted in the illiquidity or insolvency of non-bank financial institutions in other countries. Some Task Force members felt that a combination of market forces and national authorities should have been left to deal with the Mexican crisis without recourse to multilateral funding. In that case, any resulting institutional failures such as the potential impact of Mexican bank failures on U.S. banks or the liquidity problems of U.S. mutual fund managers could have been left to relevant national authorities. Some argued that the lenders or investors, some of whom had reaped large

returns in the previous two to three years, should have been expected to eat their losses. The role played by domestic investors in fleeing the peso before the devaluation lends a degree of suspicion to the real benefits reaped from the bail-out. As the injection of international funds was used to redeem tesobonos, purchasers of those instruments were the most direct beneficiaries of the rescue package. The result, some argued, is that Mexico has a larger debt, a lower living standard, high inflation, and falling wages, and foreign and Mexican bondholders have avoided some losses.

Others argued just as forcefully that it was the rapid response of the U.S. government that prevented the crisis from spreading. One year after the onset of the peso crisis, Mexico successfully returned to international capital markets and paid off nearly all the tesobonos. The Mexican president has also attempted to use the crisis and IMF and U.S. conditions to strengthen the political and economic reform process.

There was general agreement, however, that the creation of clear lender-of-last-resort responsibility, the strengthening of domestic financial markets, deregulation, and measures to further integrate world capital markets are required. If the basic principles underpinning cross-border financial flows were more firmly established, the sorting out of regulatory and supe

VI: Conclusions

The Mexican crisis reaffirms important lessons regarding economic development. First, world capital flows and financial conditions are largely determined by the industrialized countries, and reliance by developing countries on foreign capital requires vigilance and discipline in maintaining market confidence. Devaluation is not a panacea or a cost-free substitute for sound fiscal and monetary policies. In 1994, Mexican fiscal and monetary policies were not responsive to changing market conditions and clearly were major factors in the ensuing crisis. Second, Mexico's problems have focused attention not only on the size of public debt but also on its structure and denomination. Countries have been cautioned about the accumulation of short-term debt and excessive reliance on portfolio investment without measures to rollover risk (such as, sufficient reserves).

Third, the crisis has catalyzed support for economic liberalization and market-based reforms. While initial reactions tended to question the paradigm of market-oriented reforms, the Mexican crisis has alerted leaders from many countries to deepen and accelerate their reforms. Mexico's turmoil has strengthened support for structural measures: raising domestic savings, increasing private investment in infrastructure, aiding the creation of new business, reforming labor codes and educational systems, accelerating privatization, and deregulation. In this context, the state must play a more active role in developing institutions that encourage competition, protect the consumer, improve financial disclosure, restrict conflict of interest, prevent insider trading, and more clearly establish rules for doing business. In a similar vein, domestic banking systems must be strengthened to absorb interest rate increases that might be required to defend the exchange rate.

Measures that encourage domestic savings merit special attention. This applies to countries as diverse as the United States, the United Kingdom, Canada, Sweden, Denmark, Turkey, Ireland, and Belgium, as well as to many developing countries. If savings rates had been higher in Mexico, investment needs could have been met with much less foreign capital. Given Mexico's savings gap, the problem was not that capital inflows were too large but rather that they fell off sharply as political and economic uncertainties mounted and, in the end, were too small to meet the country's needs. On the domestic front, priority must be given to tax levels and legislation and other measures that will raise the savings rate. At the international and multilateral level, measures must be sought to accelerate the growth of world savings.

This is not strictly a development issue. Savings demand by industrialized countries is likely to outstrip that of the developing world. From 1989 to 1993, for example, the United States absorbed nearly 25 percent of total world savings. The combination of dissaving, largely by governments, in the industrialized countries and rapid growth in developing countries, notably China, Brazil, and India is likely to put pressure on saving. These pressures will expose policy imbalances and structural weaknesses everywhere.

Finally, it is necessary for Mexico and other developing countries to voluntarily improve their national data collection systems and the timeliness of the information they disseminate. Reliance on coercive or regulatory measures imposed by the IMF is not sufficient. Mexico and other developing countries must also introduce strict measures to regulate insider trading and adopt appropriate securities laws, rules, and regulations.

Additional intervention such as controls on capital inflows, the creation of large multilateral funding facilities, and devaluations, while perhaps capable of providing short-term relief, often create market distortions and costs and should not supplant sound fiscal, monetary, and structural domestic policies. The limited scope for achieving negotiated debt restructuring with private creditors and investors intensifies the need for developing countries to manage macroeconomic policy and financial risks prudently. The mix of policies will vary from country to country, but ultimately the soundness of domestic policy will be the critical factor in assessing the prospects and risk profile of emerging and industrial economies.