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Remarks (as Chair) on "Money Across Borders"

Cynthia C. Lichtenstein
Boston College Law School, cynthia.lichtenstein@bc.edu

Money Across Borders

The panel was convened at 10:45 a.m., on Thursday, March 28, by its Chair, Cynthia C. Lichtenstein,* who introduced the panelists: Jane W. D'Arista of the Morin Center for Banking and Financial Law Studies at Boston University School of Law and the Economic Policy Institute, Washington, D.C.; Avinash Persaud of the Morgan Guaranty Bank; and Patrick Juillard of the University of Paris I.

Remarks by Cynthia C. Lichtenstein

At the Bretton Woods Conference in New Hampshire in 1945, the parties drafting the International Monetary Fund Agreement had two major objectives, both centered upon restoring the international community's capacity for exchanges of goods and services. To do so meant mutual promises that, as soon as each member country believed itself capable of returning to free convertibility, it would do so—but only for balances of its currency earned by another country from sales of goods and services. Thus in the original, and indeed present, Article VIII 2(a) of the Fund Agreement, each member promises (once it ceases to take advantage of the Article XIV provisions for countries not yet ready to move to free convertibility) that it will not—without the Fund's approval—"impose restrictions on the making of payments and transfers for current international transactions." Article XIX (now XXX), Explanation of Terms, paragraph (d), explicates the meaning of "payments for current transactions," as turning in substance on whether the transaction involves goods and services for which prompt payment is made between a resident of the country concerned and a nonresident. There is no such promise to remove capital controls and indeed, initially, the international community seems to have assumed that capital controls would be used in appropriate cases. Thus the Fund Agreement (after the First Amendment) in Article VI, Capital Transfers, provides: "A member may not use the Fund's resources to meet a large or sustained outflow of capital . . . and the Fund may request a member to exercise controls to prevent such use of the resources of the Fund."

Another objective of the Bretton Woods Conference, besides encouraging the removal of exchange controls that serve as a barrier to international trade, was to set up a fund that could be used by countries experiencing balance of payments crises—presumably because of difficulties occasioned by other than a "large or sustained outflow of capital." In practice, as is detailed for the period up to 1977 by Sir Joseph Gold, the Fund tended to urge countries to remove capital controls and did not, in utilizing its resources in balance of payments crises, distinguish among causes for the balance of payments deficit.[1]

Nor, over the years, was it only the Fund that took the view that the progressive relaxation of all monetary controls—whether on payment for current transactions or on investment flows—would be good for the international economy. In 1961 OECD, the Organization for Economic Cooperation and Development, the club of industrialized nations, promulgated its Code of Liberalization of Capital Movements. In Article I (a) of the Code, OECD members promised to "progressively abolish between one another . . . restrictions on movements of capital to the extent necessary for effective economic cooperation." Moreover, as all students of the European Economic Community (European Union) know, free movement of capital is one of the four freedoms assumed vital to the creation of the single market.

* Professor, Boston College Law School.

[1] See Joseph Gold, International Capital Movements Under the Law of the International Monetary Fund, IMP Pamphlet (1977); Evans, *Current and Capital Transactions: How the Fund Defines Them*, Fin. & Dev., Sept. 1968, at 30–35.

But the original assumptions of the Drafters of the Fund Agreement—and even of the liberalizers—concerned only certain *types* of movement of capital. A recent issue of the *Economist* lists five types of capital inflows: official grants, official loans, private debt flows, foreign direct investment and portfolio equity investment.[2] It is fair to say that the Drafters did not even contemplate the last. Before 1985, the markets for private equity capital were assumed to be national or at most—with all of the efforts of the Securities & Exchange Commission at integrating U.S. and Canadian capital markets—regional. The Fund's joint Ministerial Committee with the World Bank, the Development Committee, in latter years has been exploring in a Working Group how to increase developing countries' access to private equity capital. But the form in which it might come was not really envisioned.

The paper by Jane D'Arista gives the startling facts. It details the sheer quantum of purchase by global investment funds of the securities of countries engaging in rapid privatization and structural readjustment programs (so-called "emerging markets"). What it does not detail—perhaps because her statements are only "anecdotal"—is the investment approaches of the purchasers of these countries' securities. Of all the forms of inflows listed, only portfolio equity investment (marketable debt securities held by investment funds) can be equated to "hot money," capable of being highly disequilibrating. Official grants, in contrast, are stable and would not need to be returned. Whether official or private, debt is not due until it is due, allowing the macroeconomic managers to plan or restructure the debt, if they will not and cannot pay. Foreign direct investment, which by definition cannot be dumped on sale, will involve long, arduous tripartite negotiations among the seller, the would-be buyer and the government. But if a government has removed most exchange controls, and if it guarantees convertibility of not only payments for current transactions, but also of domestic currency received in a sale of debt or equity securities, then all the "spooked" investment fund manager has to do is to sell the securities for whatever price he/she can get, sell the domestic currency proceeds of those sales for what harder currency he/she chooses, and reinvest wherever it is deemed there will be a higher return. Whether the country in question is maintaining a fixed exchange-rate regime, an adjustable peg or a floating rate, if enough portfolio investors "spook," an exchange crisis is inevitable, as it was with Mexico in December 1994.[3]

In classical theory, when justifying the liberalization of capital controls, the behavior of the departing investor is only the concomitant of the profligacy of the government that had departed from the straight and narrow path of adjustment. Unfortunately, no one has yet demonstrated that investment fund managers as a group are any more rational than bank depositors, nor has anyone explained why it is they decide to run for the exit. Even if the government has had a temporary deficit in the balance of payments, is the discipline of a liquidity crisis the appropriate remedy?

It would seem that the Fund, in the case of Mexico, decided it was not. The rescue was mounted with Fund resources—in amounts larger at the time than had ever been loaned to any country—used to stem the outflow (and to ensure there was no question of transgression of Article VI, reserves were restocked). Mexico in return submitted to a highly painful regime of getting its macroeconomic house back in order.

The international economic community had been alerted. There was, and is, considerable international concern about the possibility that the Mexican crisis is not *sui generis*, that such a crisis could be repeated in another country that has received, in the words of the

[2] ECONOMIST, March 16, 1996, at 78.

[3] For details of that crisis, see Lichtenstein, *The Mexican Crisis, Who Should Be a Country's Lender of Last Resort?*, 18 FORDHAM INT'L L.J. 1769–1777 (1995).

IMF Principles of Fund Surveillance Over Exchange Rate Policies, "unsustainable flows of private capital." The Executive Board of the Fund, on April 10, 1995, amended its Decision on Surveillance to add such flows to the list of developments, those that "might indicate the need for discussion with a member."[4]

The G-7, the group of major industrialized countries that meets regularly to coordinate monetary policies, devoted a good portion of its summit in Halifax, Nova Scotia, in June 1995 to the discussion of the Mexican crisis and what might be done to minimize the possibility of a future crisis.[5] The Halifax Summit suggested to the Fund that it create an emergency financing mechanism. The Executive Board of the Fund, at its Meeting 95/85 on September 12, 1995, considered "a proposed 'emergency financing mechanism' (EFM) which would strengthen the ability of the Fund to respond rapidly in support of members facing a crisis in their external accounts and seeking Fund assistance."[6] Space does not permit an adequate analysis of the elements of this emergency "procedure," as the Directors of the Fund preferred to label it, but the Chairman's summing up stressed that use of emergency procedures would not be a guarantee against sovereign default. The document does make clear that the Fund will, in its surveillance, its consultations with members and all other procedures, pay considerably more attention than it has in the past to the capital accounts of a developing country. The Fund has learned that the combination of liberalization of capital controls and rapid privatization of an economy can be an unpredictable, if not explosive, situation. The elements of the "procedure" stress that the Fund's response to a member's emergency will be determined in part by the degree to which the member has been cooperating (read, "following the Fund's advice") all along.[7]

Another initiative flowing from the Mexican crisis is most interesting—and it represents a first for the fund. The ultimate governing body of the Fund, the Interim Committee, in its April 1995 meeting, asked the Executive Board "to look into ways that the IMF could help establish standards for provision of information to markets, which could guide members in their publication practices." The Halifax Summit echoed the idea and called for a procedure "of public identification of countries" that *do meet* publication standards. The idea seems to be (although this rationale has not been articulated clearly) that informed capital markets are likely to be less volatile; that the prompt, simultaneous release of government statistics, prepared according to adequate and harmonized standards, will be an antidote to runs by investment managers caused by leaks, rumors and the decision to act on "inside" information before one's competitor does. At the least, the idea might help inoculate against such runs. The Statistics Department of the Fund has responded and has placed on the Internet, at gopher://gopher.imf.org, "Standards for Dissemination by Countries of Economic and Financial Statistics, A Discussion Draft."[8]

Finally, the larger group of industrialized countries, the G-10, has set up a Working Group to prepare a report entitled "Sovereign Liquidity Crises," scheduled to appear in April 1996, in time for the next meeting of the Interim Committee. It will be interesting to see if that Report calls for reconsideration of the old freedom of countries under the "rules of the game" to make their own decisions about capital controls—or if capital controls will be seen as ripe for multilateral surveillance and approval by the Fund.

[4] IMF SURVEY, May 22, 1995, at 156.

[5] See *Big Powers Plan a World Economic Bailout Fund*, N.Y. TIMES, June 8, 1995, at D1.

[6] Summing up by the Chairman, Emergency Financing Mechanism Executive Board Meeting 95/85, Sept. 12, 1995 (on file with the author).

[7] IMF SURVEY, p. 154.

[8] A hard copy of the draft is available from: Public Affairs Division, International Monetary Fund, 700 19th St., NW, Room 12-510, Washington, DC 20431 (tel: 202 623 7682; fax: 202 623 6278).