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THE RESTRUCTURING OF MEXICAN FINANCIAL SERVICES AND THE APPLICATION OF CHAPTER 14 OF NAFTA

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ROGERS: Chapter 14 of NAFTA provides generally for an opening of the Mexican financial system to foreign investment and competition but with a big caveat.[1] There is the possibility of the exercise of the safeguard provisions. If the concentration of the percentage of the market in Mexico of foreign-owned institutions in the banking sector exceeds 25%, then the Mexican government can step in and impose the safeguard freeze for up to three years to stall the process.[2] However, under NAFTA there is no further limitation on investment by foreign banks in Mexico.

I would like to ask our panelists to look at some of the issues we may face on January 1, 2000. That is, where are we likely to be in the Mexican financial system at the beginning of the year 2000? What is the bank regulatory and supervisory system likely to be? To what extent are capital markets going to be a resource to provide financing to the Mexican economy? We have talked briefly about the Sociedad Financiera de Objecto Limitado (SOFOL), the limited purpose financial institutions or non-bank banks, but not really about the insurance industry. Some of these institutions may be able to play a role in supporting and helping banks provide credit to the Mexican economy. I would like to start with Mike Lubrano, and ask him where he thinks the bank supervisory system is likely to be in the year 2000?

LUBRANO: This is a very difficult thing to predict. One undeniable area of progress has been in the effective monitoring function of the Banking Commission. When the current President and all the Vice Presidents but one were appointed to the Banking Commission in 1994, they started from scratch. That added to the challenge of dealing with the banking crisis after the devaluation in 1994 and the recession that followed. I think the capacity of the Commission has clearly improved. In fact, as a condition of the World Bank's Financial Sector Restructuring Loan, the Commission agreed to review every major privatized bank on an annual basis, as well as to conduct outside diagnostics on each of the banks. So the capacity has increased dramatically.

That is not to say that there is still not a lot to do. Bank regulation and supervision is something that requires a great deal of institutional capacity and structures

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****** The views expressed here are the panelists' own, and should not be taken to represent those of their employers or other organizations with whom they may be affiliated.

1. North American Free Trade Agreement Between the Government of the United States of America, the Government of Canada and the Government of the United Mexican States, December 17, 1992, Annex VIIB, 32 I.L.M. 1480 [hereinafter NAFTA].

2. *Id.* at Article 1404.

that provide for education of staff. That is very difficult to do in a short time. They have received a great deal of assistance, including some from the United States. The World Bank, the U.S. Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency provided other assistance.

Some developments have aided the Commission. The Banking Commission now has a smaller number of banks to supervise because so many have been intervened and merged; they have much smaller assets than they had at the beginning of 1995. Although many foreign banks have started up, those are not really the subjects of on-site supervision. They hold a very small portion of the assets of the system. By 2001, the Banking Commission would be concerned with eight or ten banks.

Also, as in many countries, the Commission is able to piggyback on supervision by the home country supervisors and regulators. That is, if Bank of Nova Scotia is operating in Mexico, the Canadian authorities are also supervising it. It also has corporate governance supervision. The market supervision is provided through the information they have to give their own shareholders about their operations in Mexico. If you are a supervisor, you have a greater degree of comfort that you are not in there alone. It is another mechanism.

The classic example is the New Zealand model.[3] In New Zealand they have super-simplified their banking supervision because almost their entire banking system is owned by foreign banks. They piggyback on that supervision because they are much smaller than the other countries that are the owners of the banks that operate there. This is also true in Mexico, both in the size of the country and the economy; the economy of the U.S. is much bigger than Mexico's, as is Canada's, so they could piggyback.

A final point is that new accounting rules went into effect for Mexican banks after the crisis. This is another condition of the World Bank loan but something of course that Mexico would have done in any case. Those rules are closer to international standards than the old rules, which varied dramatically in terms of when a loan would be counted as non-paying. The classification and provisioning rules have not really been reformed in Mexico, but they will be at some point. The new accounting rules are closer to international standards than before. They include a bunch of provisional, temporary, measures that permit assets to be treated very differently than they would elsewhere. Particularly, mortgage programs permit mortgages to be treated almost as if they had been executed and the collateral covered before they were recovered. This all amounts to a great deal of regulatory forbearance which, barring some very dramatic change in the political system, can be expected to continue.

ROGERS: We are assuming that whatever happens with the Fondo Bancario para Protección al Ahorro (FOBAPROA) rescue that the banks are going to remain

3. For a bank supervisor's response to the claim that New Zealand's supervision relies on the work of home country supervisors, *see* Dr. Donald T. Brash, Governor, Reserve Bank of New Zealand, An Address to the IMF Conference on: Banking Soundness and Monetary Policy in a World of Global Capital Markets 11,12 (Jan.30,1997)(transcript available from the U.S.- MEXICO. LAW JOURNAL). Dr. Brash rejects the notion that New Zealand is "free riding" on the efforts of the home supervisors by noting that Reserve Bank of New Zealand "remains well informed about the activities and the financial condition of all banks operating in New Zealand and well placed to respond to incipient financial distress where appropriate." However, he does concede that "any host supervisor will -inevitably- rely to some extend on the global supervision of the home supervisor."

somewhat weak and will continue to need additional capital. To what extent can the Mexican government, through its regulatory and supervisory apparatus, encourage the local shareholders of the banks to put in additional capital and what ability do they have to welcome foreign capital?

LUBRANO: I think that much of what has been done since 1994 to assist the Mexican banks has set all sorts of negative incentives for the bank shareholders. It is doubtful that the capital originally in the banks when they were privatized was fairly stated. The quality of the capital was unknown. It is certain that much of it was phony capital; the question is just how much. Attracting more domestic resources to the banks, particularly since the main assets of the banks are loans to companies, may not get you very much. So I am not sure that there is any more reason to create further negative incentives in terms of behavior by creating incentives to re-capitalize the Mexican banks. That is just my personal opinion.

ROGERS: Then in terms of the other kinds of institutions that might be sources of capital for the Mexican economy, what are the alternatives? Before we get to the capital markets, what are the other kinds of existing institutions, what are the capabilities of the securities firms, the commercial paper market, the SOFOLes, the insurance companies?

NADER: It is difficult to predict. I think I have to look backward to try to understand what is going to happen in the future. Some of the accommodations that the system has made to boost capitalization of Mexican banks have had a pervasive effect in a number of financial sectors. I will take two examples - financial leasing, which is a regulated activity in Mexico, and factoring, which is also regulated. The size of the market in each of these two industries has shrunk dramatically in the last two or three years and it has had the reverse effect that most of us thought it would have vis-a-vis some of the NAFTA provisions.[4] Annex VII provides that participation of foreign institutions in most of the financial sectors is subject to market caps and individual market share participation in some instances. That is to increase gradually until the year 2000, when most of the restrictions will go away. This means that leasing and factoring affiliates of U.S. and Canadian companies could have expected to increase their capitalization every year as the market would grow over time. What has happened in these two sectors has been the opposite. Now there are a number of leasing companies that were established as affiliates of foreign financial institutions, that even if they wanted to, cannot increase their capitalization.

By allowing some of the larger banks to accommodate and slow their leasing companies to boost their capitalization level, there is a pervasive effect in the leasing market. It is almost the same in the factoring market. Between now and January 1, 2000, we need to revamp these two focused and special industries which are sources of capital, which in many instances can act much faster than the banks. Some people would ask why the concern about leasing companies if banks can have some of their lending portfolio documented in financial leasing. This is true, but the skills and the infrastructure to do financial leasing in Mexico have proven to be very different than those needed for banking.

4. NAFTA, *supra* note 1, at Annex VII.

Other institutions that could play a role would certainly be non-banks, to the extent foreign players come in with a very focused eye for market niches. Mr. Aiza Haddad was making reference to mortgage lenders that have captured a share of the market through non-banks. I think that there are a number of opportunities and I think that they will happen, but nothing that would have in the next two or three years a major impact in boosting the debt of the financial markets in Mexico.

Insurance companies are the healthiest. Life companies that have also undertaken annuities programs will have to split the annuities by the year 2001. That may give rise to new joint ventures, especially in the field of annuities.

I think the other area where we could see a buildup of capital, although I do not know how much could be deployed to the economy, will be in the pension fund management system. The only purpose of an Administradora de los Fondos de Retiro (AFORE) is to hold stock of mutual funds, which in turn invest retirement funds. Until May of this year, AFOREs were only permitted to own one mutual fund, which would invest primarily in government securities and, to a lesser degree, in rated private sector securities. The regulatory body of AFOREs, despite the wording in the law, has not permitted them to create additional mutual funds that could diversify their investments into equities or infrastructure projects.

My initial reaction was that the prohibition on the creation of additional mutual funds was for two reasons: first, because it is an entity that is basically learning to do its job on the job, it is trying to keep a very small number of activities to be supervised; and second, because of the experience we have had in supervising mutual funds where they have invested basically in papers that no one else wanted to invest. I thought that the decision was driven partly by inexperience and partly by fear.

LUBRANO: That was a beautiful way of putting it: by inexperience and fear. There is also the need to finance the government deficit. To the extent that the pension funds which used to be available to finance the government deficit through the social security system are no longer going that way, having a system which requires most of the money from AFOREs to go toward purchasing government debt solves that problem.

You are absolutely right about the experience of the mutual funds. The World Bank supported the pension reform. When the reformers went public with their plan, one of the first things they said was, "Don't worry; don't worry, we are not going to do it like the mutual fund regulations. That is not our idea. We'll have much tougher regulations." The article that I have written on the topic goes through comparing the weaknesses of the mutual funds to the strengths of the AFORE regulations.[5] We will see how good the supervision proves to be. But that is absolutely right.

ROGERS: Michell, what about the investment capabilities of the insurance companies?

NADER: Except for the two largest insurance companies, the remaining players are building up capital. I think in the next few years we will start seeing life and property and casualty companies growing into a more active lending or investing

5. Mike Lubrano, "Mexico Introduces Legal Framework for Management of Funded Mandatory Pension Scheme," IV NORTH AMERICAN CORPORATE LAWYER 1, 171 (1997).

role than what we have seen in the past few years. All of these companies have been, to a certain extent, successful in shifting from a system that basically required capitalization standards to a more modern system that requires satisfaction of solvency margins. The difference is difficult to explain unless you are an actuary, but I think that as time goes by this will show stronger insurance companies that will be able to free up reserves which could then be devoted to the underlying economy.

ROGERS: Let us talk a little bit about the capital markets. I probably exaggerated the difficulty of getting authorization from Banco de México for securitization programs. There have been a number of securitization programs launched. But the securitizations have been for the most part selling securities to foreign investors. As far as the Mexican local domestic capital market is concerned, do you see that as playing a significant role, given the battering that the Bolsa has taken over the last short period of time?

AIZA HADDAD: I am afraid not. In talking about the Mexican capital market, there are several important issues to consider including surveillance. Mike mentioned that in merging the banking and securities commissions, the existing commission lost a lot of its know-how and its history. On the securities side, I think the levels of confidence that investors currently have in the securities exchange and in particular in matters relating to privileged information and insider trading is extremely low. I think the commission has a lot of work to do to build up that confidence. Not only the commission, but in particular, the Mexican securities exchange and the Mexican broker dealers have a lot of work to do to make sure that people acknowledge that there is some confidence there; not only a very limited group of people who handle very important information can be successful investing in the Mexican securities market. Publicity builds confidence. In Mexico, illegal trade and corruption have only happened in very limited circumstances. When we have had market crashes, a few people have been accused and fingers have been pointed and that is really about it. So I think that confidence in the regulatory system and the surveillance system is a major component of building up the Mexican capital market. On the other hand, I do not know the numbers but I believe that the actual percentage of the total market capitalization represented by individual investors is extremely low. I remember back in 1987 before the crash when comments were made by public officials a lot of very small investors went into the market, made investments and lost their investments, people such as cab drivers and housewives. Even though people say that bankers and people in securities industries have very short memories, individuals do not. I think once someone makes an investment in the securities market and loses his or her savings, they never forget. I think that has an impact on market capitalization in Mexico. As a matter of fact, individuals are inexperienced. It is inexperience, fear, and an absolute lack of confidence. We really have to turn to institutional investors and foreign investors to build up the capitalization of the market.

As Michell was saying, I think that the AFOREs at some point in time are really going to have to play a major role in that development. I have had discussions about the development of these new mutual funds: When are they going to authorize the creation of additional mutual funds? What they have right now is pretty much because mutual funds can only invest in securities. The principal is guaranteed and the percentages that can be allocated in the portfolios of these mutual funds are

represented mostly by government securities. Once we develop a more flexible scheme of investing five mutual funds, then the AFORE mutual funds and the pension mutual funds are going to have a more developed capital market and market capitalization.

ROGERS: We also have issues of transparency, on the side of both equity and debt. On the equity side, you have the anomaly that most Mexican issuers are not issuing securities that represent a controlling position, and that most of the original owners of these companies continue to control them. The ability of the minority capital market investors to get up to date, reliable, full information about the operations of the company, and even to attend shareholders meetings, is sometimes a problem. Can you comment on that?

AIZA HADDAD: I think if you look at developed markets and how they have gotten the way they are today with true pulverized capital in the market when no individual investor will have more than a very small percentage of a company, I think it takes a long time to get there. You still have first or second generation individuals who created these companies, who are emotionally attached to these companies and are not willing to give up control; very simply they are not going to do it. But when time goes by and these generations start multiplying and diversifying and you have cousins and second cousins trying to control the company, that is when the opportunity comes up to really pulverize the capital and have management come in, take over the management side then have the market come in and take over the ownership side. But that does take time.

I think another thing is also important. I know that there have been discussions at the Ministry of Finance to get rid of this almost unique concept that exists in Mexico, that Mexican individuals are exempt from capital gains paying through investments in the securities exchange. I understand that very few countries in the world have that treatment. Even though a Mexican individual is exempt from capital gains when those gains are obtained by securities transactions, that has not been enough. I can think of very few things that can create such a homogenous incentive for people to invest in the securities market and yet that has not really worked as people expected. If that is taken away, then quite frankly I cannot see the future and see what is going to happen with individual investors in the market.

ROGERS: Mike, what is International Finance Corporation's (IFC) view on these issues?

LUBRANO: I was just going to comment on the corporate governance issues you were raising. You are absolutely right; the time when Mexico's securities market will be as atomized as the U.S. is a long way off, if it ever occurs. But the U.S. is the anomalous situation; most Organization for Economic Cooperation and Development (OECD) countries have many listed companies that are still family owned, or owned by a single group. And yet a lot of advance has taken place in corporate governance, particularly in the last ten years, largely in response to the growing importance not of atomized 'mom & pop' investors, but of institutional investors such as mutual funds, and pension funds in particular.

I just wanted to mention that from the beginning of the year, IFC has been closely advising the Chilean Ministry of Finance because they had a very big scandal involving the takeover of Endesa, as it is commonly known, their largest power

company, by a Spanish power company.[6] In the process of that takeover, the management of the company received a very disproportionate payment for their shares because they had managed to capture the control. Those sorts of issues are being dealt with many civil law countries, so it is even easier for Mexico to look to those for guidance. This year at the annual meeting of the World Bank and the International Monetary Fund (IMF), we are running a number of events to bring people together from civil law countries, particularly developing countries, as well as OECD countries to start to address those.

I was going to say that the one bright spot is that the reason this became a massive issue in Chile was that the pension funds in Chile are now enormous. The government will be on the hook in Mexico even more than Chile because the Mexican government guarantees the pension funds will pay a certain minimum amount when each worker retires.

ROGERS: We have been seeing the problems with existing institutions in Mexico and the lack of capital. Is imposing capital controls going to help? It may reduce volatility, but what effect will it have on satisfying the needs for capital in the Mexican system?

CANOVA: Before I get into capital controls, I just want to comment on what I've been hearing. It seems to me that from what Mr. Aiza Haddad and Mr. Lubrano are saying, the private capital markets will not be able to meet the credit needs of Mexico, including both the Mexican public and private sectors, in any way and at any time in the foreseeable future: commercial paper, insurance companies, investment companies, commercial banks, pension funds, mutual funds, project financing, securitized assets. Even if put together, the private capital markets will not accomplish the task. Can you imagine if we had tried to develop Western Europe after World War II just on such private financial vehicles? You ask what institutions will help meet Mexico's credit needs? I have trouble believing that institutions like Merrill Lynch or Union Bank of Switzerland, each of which just lost about a billion dollars on the collapse of the Long-Term Capital Management hedge fund are the types of institutions that will meet Mexico's credit needs.[7] Look at the OECD, an institution that came out of the Marshall Plan.[8] If you really want to start meeting the credit needs of a country like Mexico, you have to think about it on that kind of a scale, such as the IMF stepping up with another allocation of Special Drawing Rights, or an increased role for the World Bank, or the United

6. *See* Elizabeth Love, "Endesa Seeks to Calm Enersis Row," FINANCIAL TIMES, Oct. 24, 1997, at A1.

7. Merrill Lynch & Company was a leading member of the consortium of 14 big financial companies that injected S3.6 billion into the bailout of Long-Term Capital Management L.P. Had the hedge fund collapsed, Merrill Lynch would have incurred much larger losses. *See* Tracy Corrigan, Clay Harris, "Merrill to Cut 3,400 Jobs After Sharp Fall in Profits," FINANCIAL TIMES, Oct. 14, 1998, at 1; Jospeh Kahn, "Merrill Cites $1.4 Billion Exposure to Long-Term," N.Y. TIMES, Oct. 2, 1998, at Cl; Edmund L. Andrews, "Market Place: UBS says it will reduce international lending, as well as risks like investment in distressed loans," N.Y. TIMES, Jan. 26, 1999, at C12. ("Union Bank of Switzerland, the world's second largest bank in terms of assets, announced a 'broad retreat' from lending and investment banking, after losing 790 million Swiss francs late last year through Long-Term Capital Management hedge fund and other big losses in exotic currency futures and other financial derivative products"); John Authers, "BankAnerica in $1.4 Billion Provision," FINANCIAL TIMES, Oct. 15, 1998, at 1 ("BankAmerica, the largest US commercial bank, lost more than $238 million when the Russian ruble collapsed").

8. FRED L. BLOCK, THE ORIGINS OF INTERNATIONAL ECONOMIC DISORDER 171 (1997)(stating that the OECD was the direct descendant of the OEEC, the organization created to divide the Marshall Plan aid). Instead, the OECD has encouraged the predominance of private speculative capital flows. Code of Liberalization of Capital Movements (OECD, Paris 1997).

Nations.[9] I mentioned the Tobin tax proposal – a tax of only one percent on foreign exchange transactions, which now exceed $1.5 trillion daily, would raise something in the order of $700 billion a year.[10] Unless we have those kinds of imaginative, creative proposals on the table and given serious consideration, the credit needs of the Mexican population, like a lot of populations, will not be met. It is impossible to predict the future of such markets for the year 2001. In fact, it is probably as impossible to predict the future of such markets only a month from now.

As far as capital controls go, it seems like such prudential controls would be a necessary first step, possibly controls on short-term capital inflows, to just stabilize the situation so that the crisis does not develop to the point where countries are erecting exchange restrictions all over the globe. It was mentioned that President Zedillo said that there will be no capital controls, and it kind of reminds me of all the proclamations that there will not be a devaluation. Capital controls, like devaluation, require a government to proclaim they will never use them right up to the day they announce them because of the fear of capital flight.[11] I do, however, think there is a real risk that when you start imposing capital controls, you start drying up access to capital markets, and it is very hard to envision a country like Mexico, or any country, going it alone. Prudential controls should be a part of a more comprehensive plan involving the G-7 and the IMF.

When we study the wording of the NAFTA provisions, Article 2104 deals with balance of payments problems.[12] And it does give Mexico the ability to impose capital controls under those kinds of emergency conditions, although it does require Mexico to consult with the IMF at the same time and maybe to be put under the same kind of IMF Article 8 surveillance, with its attendant "conditionality" that would mean a severe economic austerity program.[13]

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9. Special Drawing Rights (SDRs) were first established by an amendment to the IMF Articles of Agreement that went into effect in 1970. Only about $28 billion in SDRs have ever been created. *See* DETEV. F. VAGTS, TRANSNATIONAL BUSINESS PROBLEMS 98 (1998); *See also*, Paul Lewis, "Rich and Poor Nations Split on Aid Plan," N.Y. TIMES, Oct 3, 1994, at D1, D2 (stating that demise of IMF plan to create an additional $52 billion in SDRs for allocation to developing countries and former communist nations).

10. David Felix, THE TOBIN TAX PROPOSAL: BACKGROUND, ISSUES AND PROSPECTS 13(U.N. Development Programme for the World Summit for Social Development Policy Paper, March 1995) (estimating that a tax of 1.0% should raise about 720 billion dollars annually in tax receipts).

11. The Mexican government repeatedly denied that it would devalue the peso just prior to the severe devaluation in December 1994. *See* David E. Sanger and Anthony DePalma, "On Both Sides of the Border, Peso Ills Were Long Ignored," N.Y. TIME, Jan. 24, 1995, at A1, A9 ("the Mexican government repeatedly passed up opportunities to devalue the peso slowly, the U.S. Central Intelligence Agency failed to see the peso devaluation coming, and the Mexican government provided the Clinton administration with a mere half-hour notice of the December 1994 devaluation of the peso"); *See also* ROBERT APONTE, "The Effects of NAFTA on Mexico-United States Immigration," chapter in POLICY CHOICES: FREE TRADE AMONG NAFTA NATIONS 209 (K. Roberts and M. Wilson, eds. Michigan State University Press 1996)(stating that the exchange value of the peso fell about 50 percent between December 1994 and March 1995, "a devastating reduction in purchasing power").

12. NAFTA, *supra* note 1, at Article 2104.

13. NAFTA, *supra* note 1, at Article 2104 (2)(a) requires Mexico to submit any currency account exchange restrictions to the IMF for review under Article VIII of the IMF Articles of Agreement. Article 2104(5) permits Mexico to impose restrictions on international capital transactions, but "only in conjunction with measures imposed on current international transactions under paragraph 2(a)" which requires IMF Article VIII review. Article VIII of the IMF Articles of Agreement restricts member nations from imposing current account exchange restrictions "without the approval of the Fund." 60 Stat, 1401 (1945), T.I.A.S. No. 1501, 2 U.N.T.S. 39, as amended, 20 U.S.T.S. 2775, T.I.A.S. No. 6748, and 29 U.S.T.S. 2203, T.I.A.S. No. 8937 (hereinafter "Articles of Agreement of the International Monetary Fund"), Article VIII.

But another provision of NAFTA permits a member state to adopt reasonable measures for prudential reasons, such as the maintenance of safety and soundness and integrity of financial institutions, and the integrity and stability of the financial system.[14] Article 1410 rings of Chile's prudential controls.[15] In short, capital controls might be seen as a necessary component to development because of the volatility of the financial markets, because of the hot money problem. But while controls might be seen as a necessary component, they will not be sufficient to get the job done. You are absolutely right that we have to look at other institutions that are going to help Mexico and other countries meet their credit needs. The real question is what public institutions should fill that vital role when everyone agrees that private sector institutions, private capital markets, and private financial instruments cannot possibly accomplish the task.

ROGERS: When you talk about additional contributions by the IMF or other financial institutions, aren't you really talking about the taxpayers of the developed countries stepping in and bailing out the developing countries?

CANOVA: I do not think so. My understanding of Special Drawing Rights is that they are issued like fiat money. They used to be called paper gold. The IMF can issue them without increasing quotas from Member States.[16] Secondly, while the Tobin Tax proposal has been largely overlooked, maybe it's time that we start considering some Nobel laureate economists other than Myron Scholes and Robert Merton, the two economists who recently guided the Long Term Capital Management hedge fund into a collapse.[17] But James Tobin is also a Nobel laureate in economics, and he has had this proposal out on the table since the late 1970's.[18] You can go right back to the General Theory of Employment, Interest, and Money, by John Maynard Keynes, published during the Depression, in which Keynes

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14. NAFTA, *supra* note 1, at Article 1410(1)(exceptions for "reasonable measures for prudential reasons, such as... (b) the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions or cross-border financial service providers; and (c) ensuring the integrity and stability of a Party's financial system").

15. *See* Craig Torres, "Chilean Stocks Rise as Government Acts," WALL ST.J., June 29, 1998, at A14 (stating that Chile's prudential controls on short term capital inflows, "known locally as the encage, formerly required investors to leave 30 percent of their investment on deposit at the central bank without interest, or pay a 3 percent tax to recover that deposit").

16. While each Member was originally allocated SDRs in proportion to its IMF quota (i.e., contribution), the IMF has discretionary power to expand the size of SRD allocations. *See* Vagts, *supra* note 13,at 98; Lewis, *supra* note 13. *See also* Francis Stewart, "Back to Keynesianism: Reforming the IMF," IV WORLD POLICY J. 465, 477 (1987)("Currently, however, the IMF must seek explicit approval from donor governments before issuing SDRs, a requirement that has prevented it from playing a more substantial role in maintaining world growth and output").

17. It might be more appropriate to refer to that hedge fund as the "Short-term Speculative Capital" fund. Long-Term Capital Management's partners included Myron Scholes and Robert Merton, two Nobel laureates in Economics, as well as David W. Mullins Jr., a former vice chairman of the Federal Reserve Board. *See* Peter Truell, "An Alchemist who Turned Gold into Lead," N.Y. TIMES, Sept. 25, 1998, at C1, C5. Critics could be forgiven for questioning whether the Federal Reserve Bank of New York would have been so quick to broker a bailout of the fund without such an elite array of partners. *See* Richard W. Stevenson, "Fed Chief Defends U.S. Role in Saving Giant Hedge Fund," N.Y. TIMES, Oct.2, 1998, at A1.

18. Tobin was awarded the Nobel Prize in Economics in 1981. *See* AN ENCYCLOPEDIA OF KEYNESIAN ECONOMICS 605 (T. Cate ed., Edward Elgar Publish Ltd. 1997). For Tobin's original proposal, *see* James Tobin, "The New Economics One Decade Older," THE JANEWAY LECTURES ON HISTORICAL ECONOMICS 88-93 (Princeton University Press, Princeton, 1974); James Tobin, "A Proposal for International Monetary Reform, Presidential Address before the Eastern Economic Association," 1978 EASTERN ECON.J. 153.

advocated a turnover tax on financial markets.[19] Right now in this country there is a sizable tax on labor, the Social Security tax, which levies a combined tax of something like 12.4% on employers and employees.[20] What James Tobin is talking about is a tax of something like one percent, a penny on a dollar, on capital flows. Isn't it time that investors who have done quite well in the marketplace in the past few years, earning double digit returns for quite a while, got out of the wagon and pushed their weight? I do not think it would be a regressive tax on the general taxpayer in the advanced world if you went to a Tobin tax type of solution to find the development money that you need.

ROGERS: The free market, free flow of capital school of economics seems to have dominated the World Bank and the IMF, and the IFC recently. Is that likely to change as a result of the recent turmoil?

LUBRANO: In any case, most of a country's development investment needs have to be satisfied by domestic savings. I do not think there is any case where most of the money comes from abroad; it comes mostly from domestic savings, and Mexico has extremely low domestic savings. The Southeast Asian countries are in trouble, but they have very high domestic savings historically. That is a very big issue that has to be addressed in Mexico.

I think there is a large correlation between income distribution and savings. Countries that have broader, better, income distributions are going to have higher savings. Until we deal with some of the issues that are preventing Mexico from having high savings, including the so-far inability of the financial markets to intermediate it in a fair way or at least in an efficient, predictable way, you are not going to get that domestic savings. No amount of foreign capital will solve the problem.

CANOVA: I think Mike made a very good point. It is hard for a country like Mexico to have the high savings rate with the kind of income distribution it has. It is also hard when real incomes are falling because of a severe economic austerity program, because of high interest rates and fiscal retrenchment. I still would like to suggest that in certain circumstances in very under-developed countries for limited periods of time, it does make sense to rely on global transfers, even government to government transfers. Again, the analogy of the Marshall Plan after World War II is compelling. It would have been somewhat unrealistic to expect the Germans and the French for instance, coming out of that war's devastation, to have the private savings to reconstruct their economic infrastructures.

LUBRANO: One thing; Mexico is not a poor country; the amount of money you are talking about is much larger than the majority of the World Bank's beneficiaries.

CANOVA: I would rather focus on the gap between Mexico's resources and the resources of rich countries and surplus countries, rather than focus on the

19. JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 159-160 (1964)(stating "The introduction of a substantial Government transfer tax on all [financial] transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States").

20. HENNING BONH, "Social Security Reform and Financial Markets," chapter in SOCIAL SECURITY REFORM: CONFERENCE PROCEEDINGS 197 (S. Sass, R. Triest, ed., Federal Reserve Bank of Boston, Conference Series No. 41, June 1997)("combined employer and employee contributions to Social Security's Old Age, Survivors Insurance, and Disability Insurance Funds amount to 12.4 percent of covered payroll").

differences between Mexico and poorer nations. Moreover, it is arguable that the West European recipients of Marshall Plan aid, though devastated by war, were relatively richer that Mexico today. So the amount of money I am talking about is actually commensurate with or even less than previous levels of aid.

LUBRANO: One thing I do also want to mention. Part of the income distribution problem has got to be traceable to the product markets in Mexico, which remain monopolistic and oligopolistic at best. If we could get 100 per cent enforcement of one law in the country, I would pick the anti-monopoly law, the competition law of the country.

ROGERS: To some extent I think we have seen the force of competition in some areas of the Mexican economy, such as the telecommunications area. I think Teléfonos de México (TELMEX) is providing substantially better service than it was a few years ago, largely because of the competition it is facing.

Going back to the issue of foreign capital, before we write off the willingness or interest of foreign sources of capital to assist in this process, I would like to ask Luis Danton to what extent he sees institutions like Citibank, Citigroup, being able to play a role in providing capital for the Mexican economy?

DANTON: It is likely that we will see an increase in participation of the foreign investment in the system. As you explained in your presentation, there has been a consistent trend in such a direction. Part of the debate centers on whether the participation of foreign banks in the system actually provides expertise and improves the system. I am convinced the participation of top tier foreign financial institutions, such as Citibank, does contribute positively. This is very important, given that international events will be increasingly important in shaping what happens in each country. Particularly in the case of Citibank, it contributes a wealth of expertise and international resource. I think that such participation will be reflected in increased competition with the presence of a high quality service provider.

The challenge for Mexican banks is to do what they are expected to do, lend money and get paid. Most of the technical issues have been addressed here on the side of getting paid. Improving guarantees, legal reforms to the bankruptcy laws, and even minor improvements can have a significant effect like improving local registries and bringing them up to a uniform level.

It is difficult to predict what is going to happen with the banks and reform, but what is sure is that we will see this type of absolute insurance that FOBAPROA has provided disappear. It will be replaced with some kind of selective coverage insurance, such as that provided by the FDIC. I think that the banks that have better systems and expertise in place will benefit, from such selective coverage insurance, because they will be perceived as less risky than others are. It is not going to be easy.

The challenge, particularly for Citibank, is to successfully enter into new market niches, such as financing small and medium companies. The challenge is to be perceived as an imbedded bank, as a national bank, as a consumer bank and I think we are achieving that.

The participation of foreign investment and banks will be important to increasing competition in benefit of consumers. The merger between Travelers Group and Citibank will permit Citibank to provide a wider range of services in Mexico than

before. Furthermore, Citibank will develop an incredible experience in debt collection and restructuring with the acquisition of Confia.[21]

Added together, these things will hopefully contribute to having a better banking system, a banking system that actually lends money for productive activities and provides high quality services in consumer banking.

ROGERS: Before we go to questions by the audience, does anyone else have any comment?

CANOVA: I would just like to comment on the issue of income distribution again because it is very important; I think there are a lot of complicated factors that go into Mexico's top-heavy distribution, including some that Mike suggested. But I would also like to repeat my earlier theme of showing a little humility, to recognize that the United States has a very top-heavy distribution.[22] The Federal Reserve conducts a tri-annual Survey of Consumer Finance. The last one showed that the top one percent of the U.S. population now controls more wealth than the bottom ninety percent.[23] It is clear that the top one-half of one percent will soon control more wealth than the bottom ninety percent. We have not had such top-heavy distributions in this country since the late 1920s.[24]

ROGERS: On a final note, would there be a way for something like a hedge fund such as Long Term Capital to be formed in Mexico other than as a SOFOL?

LUBRANO: I think you have two options there: the placement of equity securities and a mutual fund. But I think the way that fund in particular was created was that it was formed more as a closed end private fund that would generally speaking in Mexico probably not be subject to any kind of regulation, to the extent that it was a small group of people making an investment (even if it is a huge investment) together, then passing it on to certain managers. It would probably qualify under a particular provision of the Mexican securities laws as just a money manager. But probably the regulation would be either completely null or de minimis to create a fund such as that. So I think that one in particular would be set up in a couple of days, to the extent that the money is there and the interest is there.

AIZA HADDAD: It is my understanding that some of the hedge funds evade U.S. federal securities laws by having specific exemptions, having less than 100 wealthy, sophisticated investors and off- shore incorporation, for example.[25]

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21. *See* Banking & Securities Commission Assumes Control of Bankrupt Grupo Financiero Abaco, SOURCEMEX ECONOMIC NEWS & ANALYSIS ON MEXICO, Sept 3, 1997 (detailing the Banco Confia purchase).

22. *See* Richard Stevenson, "Fiscal Stones, Glass Houses: Bailout Points Finger Bach Toward the U.S.," N.Y. TIMES, Sept. 26, 1998, at A1.

23. *See* Authur B. Kennickell, Martha Starr-McCluer, and Annika E. Sunden, "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances," 83 FEDERAL RESERVE BULLETIN 21, Table 14 (Jan. 1997); DOUG HENWOOD, WALL STREET 67 (1997); Arthur B. Kennickell and R. Louise Woodburn, Consistent Weight Design for the 1989, 1992, and 1995 SCFs, and the Distribution of Wealth, 30, Table 9 (unpublished Federal Reserve technical paper, revised August 1997); Willem Thorbecke, "Who will pay for Disinflation?: Disinflationary Monetary Policy and the Distribution of Income," Public Policy Brief no.38 (Jerome Levy Economics Institute, Annandale-on -Hudson, New York 1997).

24. *See* Henwood, *id.* at 66 ("wealth is now the most concentrated it's been since the 1920's").

25. *See* "Hearings on H.R. 1495 Before the Subcomm. on Telecommunications and Finance," 104th Cong. (1995) (testimony of Barry P. Barbash, director of Securities and Exchange Commission), (1995 WL 641412)(S.E.C.);"Hearings Before the Subcomm. on Telecommunications and Finance Committee on Commerce, United States Securities and Exchange Commission to Consider Rules Implementing Various Provision of the National Securities Markets Act of 1996," 105th Cong. (1997), (testimony of Barry P. Barbash, director of Security and Exchange Commission), S.E.C.97-29, 1997 WL 155021 (S.E.C.).

LUBRANO: Such funds do not offer securities to the public and thus do not meet the definition of "Investment Company" under the U.S. Investment Act of 1940. So it is not really a securities law issue in the sense of investor protection. Rather it is a securities market stability issue.

AIZA HADDAD: And becoming a banking regulation problem to the degree that banks have really exposed themselves in loans to these hedge funds.

CANOVA: That argues in favor of regulating the banks, what the banks can do in purchasing derivative instruments or in lending to hedge funds.[26]

LUBRANO: Limiting loans to the hedge funds would make it more difficult for the hedge funds to leverage such risk.

ROGERS: Clearly the hedge funds have become a significant potential regulatory issue in the U.S. If something similar were to be formed, or maybe has already been formed perhaps - Raul Salinas' investment fund was a closed-end hedge fund- but if it were to be formed in Mexico, is that something we can look to? We know there are many wealthy individuals in Mexico who are looking for ways to invest their funds. We have explored all the traditional methods, the capital markets, investing in banks, and the like. Is there some new vehicle or some new approach that we have not yet explored?

LUBRANO: I guess what you really mean is more of the private equity fund than a hedge fund. The hedge fund, particularly this one, was basically running an arbitrage operation. We are not looking to make the market more efficient with private, big investors and arbitrage. IFC has investments in a number of private equity funds and our experience has been it is not a huge pipeline for investments in Mexico given the huge size of the Mexican economy. It is expensive money. Private equity money does not seek a low, steady rate of return but rather a large lump sum return at the end. There are not a lot of projects in Mexico that are likely to earn that kind of return. Before I came to IFC, I had the privilege of working on a venture capital fund. It turned around companies that basically had blown up in the 1980s and through the bankruptcy system had managed to evade their creditors for ten years. If we could get the other creditors to take 10¢ on the dollar, we would take the thing over. One of them was Ekco, the company that produces tableware and kitchen appliances. Maybe there is a market for that once the huge overhang of impaired assets in Mexico starts to develop a market.

NADER: Just going back to the private equity investments, unless they want to place securities in the public or they want to have a very active borrowing activity in Mexico, they could be created as unrelated stock companies. A test of what Mike was mentioning is coming up very rapidly. There were maybe 30 or 40 projects of

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26. A recent study by U.S. bank regulators suggested the need for stringent public regulation of hedge funds, including extension of regulation to "offshore" jurisdictions, to prevent further financial meltdowns; but the study did not recommend enhanced regulation of banks, even though it found bank lending to be partly at fault for the Long-Term Capital Management crisis. *See* Timothy L. O'Brien, "Report Finds Banks Failed to Oversee Big Hedge Fund," N.Y. TIMES, Jan. 29, 1999, at C3.(report critical of commercial and investment bank lending to Long-Term Capital Management hedge fund was prepared by the New York Federal Reserve Bank and the U.S. Comptroller of the Currency); *See also* Leslie Wayne, "Congress to Debate Greater Oversight of Hedge Funds," N.Y. TIMES, Oct. 1, 1998, at C1,C3 ("The main regulatory question raised by the Long-Term Capital episode was why banking regulators never saw early warning flags that would have indicated banks had already extended too much credit to an already overly indebted fund. Banks lending to Long-Term Capital are regulated primarily by the Federal Reserve and by the State of New York").

high yield bonds to be issued by Mexican companies, I would say, in the period from September to December. All or most of these have been postponed or taken off the market. Some of the issuers nonetheless are in need of capital and I am sure some of them will be testing private equity sources. What I understand is that the returns expected in this market could be fairly high. We may be on the verge of starting to see very active campaigning by Mexican companies to attract these funds. If they are somewhat successful, this could give rise to a new trend that has not been really significant in Mexico.

ROGERS: We have talked about the transparency and corporate governance issues that may impede investments in private companies on the equity side. We have not really talked about potential transparency issues on the debt side. That is, to the extent that bondholders meetings held in Mexico are sufficiently transparent for foreign bondholders to give them sufficient comfort that in the event of problems they can have an effective voice. Does anyone have any thoughts on that?

NADER: I think as a general rule there is transparency. I think lack of transparency is the exception and one of the benefits of global capital markets is that where markets perceive lack of transparency, the punishment to the issuer can be very severe. Mexican companies have come a long way because if we look at the stock market, most of those companies have gone public in the last 15 to 20 years. It was not until maybe the last ten years where they have placed a significant equity share in the market.

ROGERS: When I talk about lack of transparency on the debt side, what I am thinking of is more in the area of securitizations that have involved transactions where the administration of the special purpose vehicle has not been optimum. The recourse of the bondholders in cases where you had particularly porous transfers, such as transfers of hotel sale receivables, these can lead to very disappointed investors. I do not know if that is a problem of transparency in the process or transparency in the structuring or the efficacy by which you have structured the arrangement under which the special purpose vehicle will operate. Carlos, do you have any thoughts?

AIZA HADDAD: I think that one case in particular had a major negative impact in the market for asset securitization or quasi-securitization, which is what they did. In that case, I think that both issuers, intermediaries and investors have learned from that experience. It is a major experience.

For those of you who are not that familiar with the problem, the issue was acceptance corporations created by a large Mexican hotel company that sold hotel real property to various buyers and then sold off the notes and other receivables that it obtained through those sales. It was really a problem that came up in the due diligence for the transaction. The problem was not so much in the management of the special purpose vehicle or the job that the trustee did in the various trusts that were created, but in particular the underlying transactions and the way that they were carried out. I think that we have all learned from that experience in particular, at least I have personally in looking into the underlying transactions and the way in which they were done. I think people now need to think in particular about the intermediaries that participated in the transactions and to be a lot more careful in looking at the issuers.

Just the fact that they were dollar denominated and that they were generating or were supposed to generate cash flows in dollars because hotels historically generate

cash flows in hard currency I think in a way blinded the intermediaries that participated in that transaction. There was no transparency, John, but I think everyone learned from that experience. I am not saying I do not think it will happen again, but I think it is a good opportunity to make progress so that the next time things like that are done, they are done a lot more carefully.

ROGERS: What would be the advantages of dollarizing the Mexican economy, if any?

CANOVA: I am skeptical about dollarizing any economy. I know Mike might have a different view. A mid-way solution may be what both Hong Kong and Argentina have done with the currency convertibility boards, but such currency boards have still been powerless to prevent speculative runs away from the currencies of those countries.[27] While Argentina's currency board has helped bring the inflation rate down dramatically, such disinflation has occurred at the cost of severe unemployment, currently a double-digit unemployment rate.[28]

LUBRANO: I do not think that a currency board is likely to work in Mexico, because I do not believe that the financial community, or particularly the Mexican public, would have much confidence that it would be run as well as the Argentines have managed to operate theirs. After all, the model is the Hong Kong currency board and I do not think that they are ever going to get that degree of confidence. There have been too many shenanigans, too little transparency in the course of the last four or five years in the handling of Mexico's finances and the financial sector. If you want to have it in dollars, I think you have to get it in dollars; I do not think they can use a currency board.

CANOVA: The currency board model does not seem to provide fail-safe protection. Both Argentina and Hong Kong have been victims of speculative attack in the form of short-term capital outflows. As a consequence, Argentina has been forced to sharply raise interest rates, and Hong Kong has intervened in the open markets on a massive scale, including open market purchases of shares listed on its own stock market.[29]

ROGERS: We would like to have questions from the audience.

JAIME GUERRA, Mexico City: Do you think that the national banking commission has acted in accordance with the law? It seems to me that they always go to an extreme delay in certain circumstances in banking defaults in Mexico.

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27. *See* Ken Warn, "World Crisis Hits Growth Forecast in Argentina," FINANCIAL TIMES, Nov. 24, 1998, at 6; Louise Lucas, "Hong Kong Reveals $15 Billion Spending on Shares," FINANCIAL TIMES, Oct 27, 1998, at 1.

28. *See* Anthony Faiola, "Brazil's Ills Distress Continent; Money Crisis Shakes Investors' Confidence," WASH. POST, Feb 1, 1999, at A1(Argentina's reported unemployment rate at 12.5 percent); Country Report: Argentina: Economy: Unemployment Rate Reaches a Plateau, THE ECONOMIST INTELLIGENCE UNIT, Dec. 5, 1998 (WL 22843246)(Argentina's 13.2 percent unemployment rate was held steady by a reduction in labor supply and lower participation rate); *See also* "Sixty Percent of Buenos Aires Residents Live in Poverty," AGENCE FRANCE-PRESSE, Sept. 7, 1998 (stating that more than 7 million of the capital city's 12 million residents have monthy household incomes below 1000 pesos [$1000], while basic bare-minumum monthly living expenses for typical family exceed 1030 pesos).

29. *See* Ken Warn, "Argentina Forced to Pay Higher Interest Rates," FINANCIAL TIMES, Sept. 16, 1998, at 3 ("because of its proximity to the Brazilian crisis, the interest rate on Argentina's 91- day dollar-denominated Treasury bills, know as Letes, nearly doubled from 7.8 percent on August 11 to 13.96 percent by mid September 1998"); Lucas, *supra* note 28 ("...the Hong Kong government engaged in large open market purchases of private company stock to defend its currency from speculative attack").

My second question is, do you think it is proper for the federal government to bank with private investors in order to compete with them under the same circumstances, and given that banking is also a social function? I mean, can the federal government create a ministry of banking different from the finance banking in order to compete with private investors in Mexico, since banking has a social function?

NADER: On the first question, I think the banking commission clearly has not done its job. Yesterday I mentioned that we have to be fair in looking at people's acts and I think that the volume of work that the banking commission has to undertake is significantly more than what it was doing five years ago. It was only five or six years ago where there were eighteen banks. All of them happened to be owned by the same party and basically at that point we had an economy that was trying to move from state-owned economy to an economy led by the private sector. Banks were not required to do banking; whether lending to a Comisión Federal de Electricidad (CFE) or PEMEX, or any other para-state entity, I think it implied the same analysis. There was basically no analysis because they all were relying on the government's support. My colleagues have said that the banking commission has lost most of its securities expertise. I think the banking commission lost all of its banking expertise because between 1982 and 1992 there was very little or no banking done. That is not to release the banking commission from not doing its job; I am just trying to put it in perspective.

Second, I think the banking commission has been late in many instances. To me one of the most frightening cases is that of Confia. Everyone knew that the bank was on the verge of insolvency and nonetheless they would still permit issuance of bonds by the holding company. Even then, when the damage had been done in the market, they should have stopped trading on those bonds. I think it was too late because of a policing law. It was basically exaggerated because of the deficiencies in the privatization of the banking system.

I think reform to the law of the banking commission is needed. I personally am very skeptical as to the projects of reform unless we start having a banking commission, a central bank and ministry of finance that are staffed by different people. At the end of the day if we have three institutions, but there is one point where all coincide, which is at the board of governors, we are not doing our job. We are creating a lot of inefficiencies, bureaucracy, and it is not going to work unless we have professionals looking at each and every aspect of the system, not the same persons looking at the same system and just moving from one door to another.

ROGERS: And on the second question?

AIZA HADDAD: I am going to be very brief on a couple of things. First of all, I want to touch on the banking and securities commission issue. The legislative amendment proposal right now suggests moving the banking and securities commission over to the central bank. If we create a career for central bankers from the commission to the central bank, if we make that independent from the executive branch of power, I think with time wee will get to a much more efficient surveillance and financial authority.

If I understood the second question correctly, it was whether it is convenient to open up foreign investment openly to banking services, considering that banking service is a public service. I am all for it; I do not see what damage that could cause. I think that competition is the best thing for the public, so to the extent that the

regulatory agencies and statutes are working, it is not really important who owns the banks or who controls the banks. You have appropriate competition for the ultimate benefit of the credit consumers.

CANOVA: May I make one comment? It seems that we did not fully answer the dollarization question; we did not really say what might be wrong with dollarization. It seems to me that by dollarizing their economy, Mexico would in essence be handing monetary policy over to the central bank in the United States. As it is, with liberalized capital accounts, Mexico's monetary policy is pretty limited anyway, but mostly by private market forces. It would probably be more politically dangerous to dollarize. If the Federal Reserve has to tighten the money supply and raise interest rates because it perceives economic growth in the United States to be too strong, it might be politically unpopular, even unacceptable, in Mexico that the tune is being played in Washington, and there would not be other intermediary institutions like the IMF or the international capital markets to take the heat.[30] Finally, dollarization might not be in the best interest of the United States since it could entail a vast expansion on the Federal Reserve's supervisory responsibilities.[31]

GILL: I think we must adjourn and thank this excellent panel - provocative, creative, led by our moderator, John Rogers.

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30. *See* Stephen Fidler, "Dollarization 'Not a Quick Fix,'" FINANCIAL TIMES, Jan. 28, 1999, at 8 ("dollarization could result in loss of monetary policy autonomy and flexibility, as well as the loss of benefits from seignorage, the interest earned by the central bank on the issuance of currency"); Ken Warn and Stephen Fidler, "Argentine Central Bank Presents Plan for Switch to Dollar," FINANCIAL TIMES, Jan. 22, 1999, at 1 ("investors' fears of devaluation, sparked by Brazil's devaluation, forced Argentina to pay a high interest rate premium, and renewed support for plans to dollarize the Argentine economy... dollarization could also leave Argentina's financial system vulnerable if the Federal Reserve does not exercise its 'lender of last resort' powers to stem an Argentine financial crisis").

31. *See* Stephen Fidler and Richard Lapper, "Summers Warns on Dollarization," FINANCIAL TIMES, March 15, 1999, at 1.