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Political Institutions, Power Distribution and the Resolution of Financial Crises

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ABSTRACT

Political Institutions, Power Distribution and the Resolution of Financial Crises

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This research investigates under what conditions political institutions may induce longer and more expensive financial crisis resolutions by assessing the impact of power distribution on government responses to crisis situations. A new model is elaborated in which power distribution plays a key role in the evolution of financial crises, from their onset to their final resolution. The model allows for the examination of government responses to financial crises along two dimensions: the capacity to resolve the crisis in a timely and decisive fashion, and the extent to which fiscal resources are redistributed to the financial sector.

Two key arguments are developed. First, power concentration in the executive may facilitate responses to financial crises because it minimizes coordination problems and obstructions to the implementation of necessary measures. Second, power concentration implies less competition for public resources and fewer checks on their allocation. As a result, veto holders have more room to follow their own agendas or impose their priorities. During financial crises, this may result in larger fiscal transfers to the financial sector. Support for these arguments comes from two statistical studies on the duration and fiscal cost of 40 crisis episodes across the world, and the analysis of the 1994-95 financial crisis in Mexico.

The statistical studies show that there is a significant relationship between power distribution and the duration and fiscal cost of financial crises. Relevant evidence was also found connecting variations in power distribution to the probability of observing anti-crisis measures –

some of which clearly target the financial sector – that significantly increase the price tag of the crises. The Mexican case illustrates how variations in the power of the president shaped the evolution of the 1994-95 financial crisis through their impact on the decision process related to the containment, management and resolution of the crisis.

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To Pedro and Camila

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Chapter 1: Introduction – Financial Crises, Political Institutions and Government Responses

1.1. INTRODUCTION

This research investigates under what conditions political institutions are more likely to induce longer and more expensive financial crisis resolutions. The main objective in this regard is to assess the impact of power distribution across political institutions on government responses to financial crises. For this purpose, a new model is elaborated in which power distribution plays a key role in the evolution of financial crises, from their onset to their final resolution. The model allows for the examination of government responses to financial crises along two dimensions: the capacity to resolve the crisis in a timely and decisive fashion, and the extent to which fiscal resources are redistributed to the financial sector.

The dissertation develops two main arguments. On the one hand, power concentration in the executive may facilitate responses to financial crises because it tends to minimize coordination problems and obstructions to the implementation of necessary measures. On the other, power concentration implies less competition for public resources and fewer checks on how they are allocated. As a result, veto power holders have more room to follow their own political agendas or impose their policy priorities. In the context of financial crises, this may result in larger fiscal transfers to the financial sector. Empirical evidence in support of these arguments comes from two statistical studies focused on the duration and fiscal cost of financial crises, and a detailed qualitative analysis of the 1994-95 financial crisis in Mexico.

There are two distinct but ultimately interconnected motivations to this study. One of them is essentially empirical and refers to the recurrence of financial crises across the globe during the last thirty years. The other one is primarily theoretical but with important empirical implications – it involves the relationship between political institutions on the one hand, and economic and policy outcomes on the other.

During the last three decades financial crises have been one of the most common and non-discriminatory phenomena in the world as less developed nations, emerging markets and industrial economies alike have been hit.[1] While there is a significant variation in the duration and (micro and macro) economic effects of these crises, an observable common thread is government involvement in their management and resolution. Independent analysts and observers of international financial markets, and more recently international organizations such as the IMF and the World Bank, have emphasized the importance of a prompt and effective government intervention to contain and resolve these distressful events as expediently and inexpensively as possible. The conditions under which governments are more likely to respond promptly and effectively to financial crisis situations, however, remain largely unknown and under-studied.

In general, we know governments may react differently to similar problems. It is also now widely accepted that political institutions present politicians, government officials and economic agents with incentives and constraints that, in turn, shape their individual and

[1]According to Caprio and Klingebiel during the last thirty years over 130 countries, comprising almost three fourths of IMF's membership, have experienced significant financial sector problems. Of these, roughly 93 countries have suffered from 112 episodes of financial crisis. Included in their account are countries as distant as Ghana and Norway, the United States and Indonesia, or Ecuador and New Zealand; and as different as Brazil and the Czech Republic, France and Malaysia, Egypt and Paraguay, or Senegal and Poland: Gerard Caprio and Daniela Klingebiel, "Episodes of Systemic and Borderline Banking Crises", in *Managing the Real and Fiscal Effects of Banking Crises*, ed. Daniela Klingebiel and Luc Laeven (DC: The World Bank, 2002)

collective behavior. Decision-making processes are thus at least partially defined by those institutions as are, ultimately, policy choices and the tangible economic outcomes they produce. An increasing body of literature has made important contributions to our understanding of how political institutions might shape decisions and outcomes but there is still a lot to be learned about the systematic effects, if any, those institutions have. Particularly lacking are empirical studies testing those connections across a large number of countries – including non-OECD economies.

This dissertation contributes to fill those gaps. Theoretically, the model here presented allows for a more comprehensive understanding of financial crises by identifying the political conditions that define the incentive structure and the capacity of governments to respond to these events in a timely and decisive fashion, as well as to redistribute the cost associated with crisis resolution. Empirically, it enhances our knowledge of the systematic effects variations in political institutions have on the policy process and the production of certain economic/financial outcomes. The statistical studies show that there is a significant relationship between power distribution and the duration and fiscal cost of financial crises. Relevant evidence was also found connecting variations in power distribution to the probability of observing anti-crisis measures – some of which clearly target the financial sector – that significantly increase the price tag associated with resolving the crises. The examination of the Mexican case demonstrates how variations in the power of the president shaped the evolution of the 1994-95 financial crisis through their impact on the decision process related to the containment, management and resolution of the crisis.

1.2. RESPONDING TO FINANCIAL CRISES: A BRIEF LITERATURE REVIEW.

Economists have dominated the study of financial crises. Most of their theoretical and empirical work has been centered on the micro- and macro-economic factors that determine the emergence, or increase the probability of systemic failure (Caprio 1998, Chang and Velasco 1998, Kaminiski 1998, Kaufman 1999). Some applied economic studies have addressed the problem of financial crisis resolution focusing on recommending particular policy strategies as more efficient or cost-effective (Amieva-Huerta and Urriza-González 2000, Dziobek and Pazarbasioglu 1999, Honohan and Klingebiel 2000). This work has made important contributions to our understanding of financial crises but, for the most part, tends to consider institutions and politics as exogenous factors.

Fewer analyses have made reference to the importance of timely and effective government intervention as a requisite for successful crisis management and resolution. Lindgren, Garcia and Saal (1996) claimed that delay in addressing unsound banks is rarely effective and usually detrimental insofar as unsound banks tend to take on even more risk or may be looted by insiders, which not only prolongs instability but ultimately increases resolution costs. Caprio and Klingebiel (1996) found that the common link between different types of bank failure is that the initial losses, whatever their cause, often multiply when prompt corrective action is not taken. De Luna (2000) suggests that prompt and effective control of systemic risks is a pre-condition for rapid and successful resolution of financial crises. The main problem with these analyses is that they almost take government effectiveness for granted, in other words, they fail to address the problematic – political – aspects of government involvement in the crisis.

The collapses of the 1990s in Latin America, and especially in Asia, raised the interest of political scientists in financial crises. Some scholars have analyzed the political – international, regional, and domestic – causes of the crises with an emphasis on the Asian experience (Cumings, MacIntyre, Pempel, and Winters 1999). Others have examined the consequences of these crises for foreign policy regimes and political institutions, again with an emphasis on the Asian crisis (Horowitz and Heo 2001).

Only a handful of studies have considered the impact of political factors on crisis resolution. Haggard (2000) compares democratic and non-democratic Asian countries in terms of their capability to implement wide-ranging reforms in response to the crisis and concludes that, while close business-government relations complicated the process, non-democratic governments had no apparent advantages over democratic ones. Montinola (1999) has explored the effects of variations in the level of institutionalized constraints chief executives face on the probability of recovery from financial crises. She finds that countries with more institutionally constrained executives have a higher probability of resolving their crisis in a particular year than those with less constrained counterparts.

My research builds on these important findings but develops a different analytic framework to allow for a more comprehensive examination of the impact of political institutions on the decision-making process.

1.3. A MODEL OF POWER DISTRIBUTION AND RESPONSES TO FINANCIAL CRISES.

The central theme of this study is that different politico-institutional arrangements produce variations in power distribution; these variations, in turn, have important and systematic

consequences for the decision-making process and, ultimately, policy outcomes. Financial crises provide an excellent opportunity to test these relationships because they have emerged in virtually all types of institutional settings. Crisis experiences across the world also present a significant degree of variation in terms of their duration, their fiscal cost, and the choice of instruments aimed at their management and resolution.

Contrary to what is generally assumed, financial crises are not the same as currency crises. Whereas currency crises regularly involve a sudden movement in the exchange rate and a sharp decline in capital flows, financial crises tend to originate in the banking sector and are generally accompanied by a collapse in asset prices. In addition, financial crises are usually associated to a debt problem in the real sector which eventually translates into higher levels of non-performing loans. Financial crises can occur without a currency crisis, as witnessed in Russia and many cases in Africa, where the main problem has been the insolvency of the banking system. Similarly, mild currency crises involve neither a corporate debt problem nor a banking crisis, as was the case of the 1992 Exchange Rate Mechanism in the European Monetary Union. Severe currency crises, however, can – and usually do – trigger crises in both the banking and real sectors. This study focuses on systemic bank-based financial crises, regardless of whether other financial institutions or a currency crisis are involved.

Critical distress in a country's banking system can show up in many ways. While massive bank runs may be the most obvious illustration, it can also manifest in a sharp decline in the value of bank assets and the collapse of several financial firms. In any case, financial crises not only disrupt the credit and payment systems, but can also induce economic recession and well as deterioration of overall living standards. Finally, as employees lose their jobs, pensions

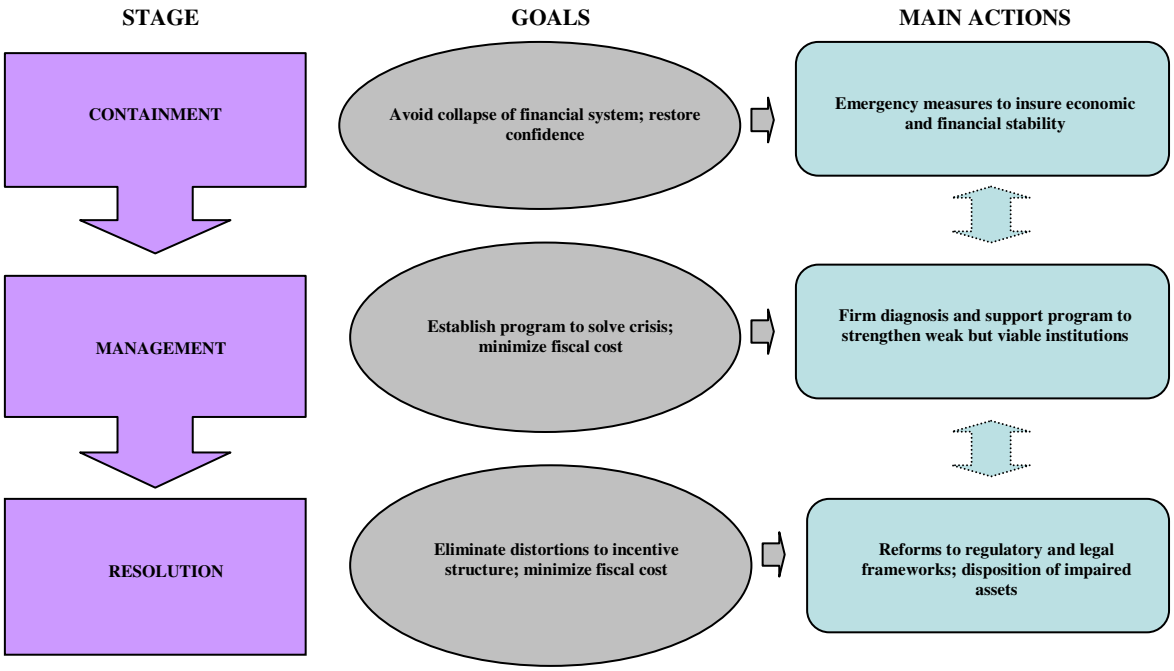
disappear, deposits are frozen, and personal savings are depleted, financial crises may also lead to an increase in civil unrest, breakouts of public riots, and even the fall of governments.

Perhaps for these reasons, rarely do governments abstain from intervening in a financial crisis though, at least theoretically, intervention is not – and should not be – their automatically preferred choice. To understand how power distribution has an effect on the evolution of financial crises it is useful to conceptualize government intervention in such events as a process of quasi-sequential stages. I distinguish three main stages – containment, management, and resolution – each one with distinct objectives (see Figure 1.1). While these stages can be treated as discrete components for analytical purposes, in reality they may overlap and exhibit path-dependent features.

During the containment stage, authorities should seek to avoid de collapse of the financial system – due to massive deposit withdrawals or capital flight – and promptly restore investor/depositor confidence. The management stage involves activities of firm diagnosis, as well as the design and implementation of a crisis-fighting strategy. The main goal at this stage is to establish a comprehensive and realistic program to solve the crisis – a program that quickly strengthens weak but viable financial institutions. During the resolution stage, governments should try to eliminate distortions and weaknesses in the legal and regulatory frameworks by introducing the necessary reforms, and to minimize the fiscal burden of the crisis resolution by finding appropriate ways to manage and dispose of impaired financial assets.

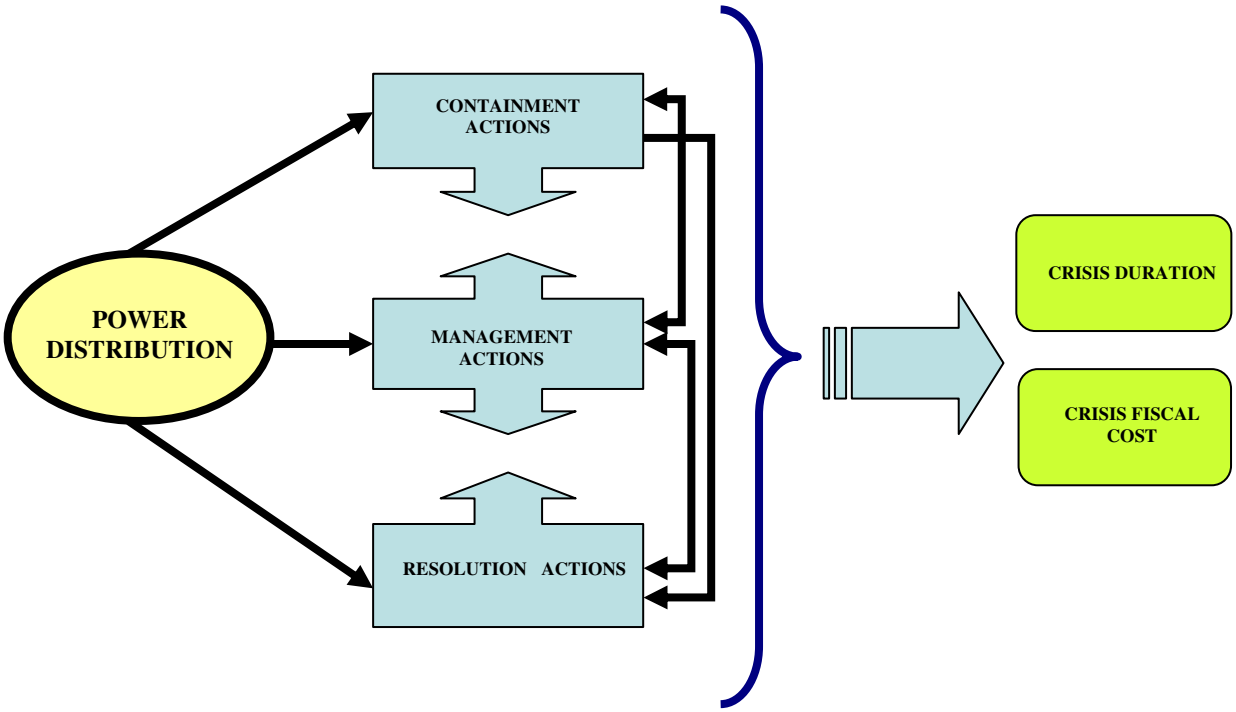
Political concerns are likely to arise throughout the whole process for three main reasons. First, multiple institutional and organizational actors with different preferences and agendas may be involved in making key decisions.

Figure 1.1: Stages of government intervention in financial crises



During the containment and management stages the burden falls essentially on the executive branch (i.e. finance ministry, central bank, and financial markets regulator/supervisor) but in the resolution stage, decision-making extends beyond government to include the legislature and sometimes even the judiciary. Second, the nature of the decisions that have to be made at each stage also varies. The containment stage, for instance, may require the implementation of emergency measures aimed at securing macro-economic stability, while the management and resolution stages typically involve sector-specific support programs. Finally, decisions made throughout the process are likely to affect a number of social groups – bank owners and managers, borrowers, depositors and, of course, taxpayers – at least some of which may try to influence politicians and government officials to make decisions favorable to them.

Figure 1.2: Power distribution and government intervention in financial crises



This study claims that responses to financial crises are limited by the capacity of governments to manage and resolve such distressful events. Such capacity, in turn, is a function of the distribution of power political institutions produce. A distribution of power identifies the actors with effective decision authority in the polity that (a) need to coordinate in order to deal with a financial crisis (or any type of emergency situation for that matter), and (b) compete for available public resources (checking on their allocation as well). Figure 1.2 illustrates the basic relationship between power distribution, the stages of government intervention in the crisis and real outcomes.

The coordination problem is certainly one important limit to how decisively governments can take control of financial crises and how effectively they address its resolution. In consequence, the research argues that power concentration may facilitate expedite and decisive

interventions in financial crises because it creates the conditions for (a) rapidly mobilizing and allocating necessary resources – material, human, monetary – towards managing the crisis, (b) quickly overcoming coordination and consistency problems in strategy design and implementation, and (c) swiftly overcoming obstructions to the implementation of required measures and the passage of necessary legislation. In other words, power concentration is more likely to be an advantage in the management and resolution stages of the crisis.

That power concentration may induce shorter-lived financial crises does not necessarily mean it will lead to fiscally inexpensive ones. In fact, this study also contends that, since more dispersed distributions of decision-making authority tend to encourage a tighter grip on fiscal resources, they are more likely to decrease the probability of making direct – and disproportionate – transfers to special groups during financial crises. In this case, power concentration implies less competition for public resources and fewer checks on how such resources are allocated. This means that veto power holders may have more maneuvering room to follow their own political agendas or impose their policy priorities. In these circumstances, a financial crisis may increase decision-makers' inclination to assist the financial sector regardless of the political influence it may be able to exert. An important implication of this argument is that, at least in theory, there might be a trade off between the fiscal cost and the duration of financial crises.

My analytical framework is informed by theoretical contributions on the consequences of political fragmentation and polarization for macro-economic efficiency and economic reform (Alesina and Drazen 1991, Spolaore 1992, Rodrik 1993, Haggard and Kaufman 1995), as well as those on comparative institutions along the veto players tradition (Tsebelis 2000, Keefer 2000,

Haggard and McCubbins 2001). The main insight from this literature is that policy-making may be blocked when those who are affected by specific decisions have the capacity to veto initiatives not to their liking. This implies that the influence of a particular group is kept in check as long as enough interests are provided with veto power. The approach thus suggests that the multiplicity of veto players or veto points clearly affects the capacity of governments to produce efficient and effective policy outcomes.

1.4. THE DEPENDENT VARIABLES.

The dissertation considers three dependent variables: (a) the capacity of governments to quickly and effectively intervene in financial crisis situations, (b) the extent to which governments are willing to transfer fiscal resources to special groups affected during the crisis, and (c) the specific policies governments choose to manage de crisis and/or transfer fiscal resources. While direct observation of these variables is more feasible in case study analysis, statistical work requires indicators that, while closely related to the actual variables of interest, are better suited (i.e. more operational) in the context of a large-N quantitative study.

Measures of crisis duration and time to recovery from crisis will be used to proxy the capacity of governments to intervene in financial crises. Recovery time follows a relatively simple formula (one plus the number of years that real GDP growth rates are below 10-year trend rates). Establishing the duration of a crisis, in contrast, depends extensively on expert opinion and, as a result, these measures are naturally more prone to error. It is worth using both measures because they are likely to complement each other and provide a more comprehensive assessment

of the impact of power dispersion on the timing and decisiveness of governments' reaction to financial crises.

To quantify the impact of power dispersion on the decision to authorize fiscal transfers to sectors affected by financial crises, the study will use a continuous-like variable that takes on values equal to the fiscal costs reported for each crisis episode included in the sample. The fiscal cost of a financial crisis is the summation of all public outlays incurred to shore-up and restructure the financial system – the final figure is usually presented as a proportion of GDP.

While this is a useful first step, the international experience shows that governments use different strategies to make those resource transfers and, most importantly, that their ultimate fiscal impact varies significantly. For this reason, this study will also examine the extent to which power dispersion determines the choice of three policies found to be particularly expensive from the fiscal point of view: explicit deposit guarantees, open-ended liquidity support and forbearance.

Deposit guarantees are formal insurance schemes that fully or partially protect depositors – bank liabilities – in the event of bank failure. Open-ended liquidity support refers to measures such as central bank credit, government deposits, and long-term financing provided at arms length and without clear limits and/or time frames. Finally, forbearing severely undercapitalized and/or insolvent institutions normally means either allowing their continued operation under existing management, and/or relaxing certain financial regulations (i.e. prudential standards such as loan classifications and loan loss provisioning requirements) on a temporary basis.

1.5. DEFINING AND MEASURING POWER DISTRIBUTION.

Power distribution basically refers to the allocation of decision-making authority amongst a number of political actors. There is a variety of ways in which power distribution can be measured, some of them more direct than others. Generally speaking there are two major groups of variables, formal institutional arrangements and temporal institutional features.

Table 1.1: Power distribution variables

Variable	Description
Constitutional features	
Regime type	Democratic vs. Non-democratic
Political system	Presidential vs. Parliamentary
Legislative system	Unicameral vs. Bicameral
Electoral system	
Voting rules (lower chamber only)	Plurality vs. Proportional Representation
Voting rules (all chambers)	Plurality vs. Proportional Representation
Party system	
Political parties	Parties effectively competing and gaining representation
Legislative fragmentation	Chance that two random draws will produce two legislators form different parties
Power concentration/dispersion	
Constraints on chief executive	Institutionalized constraints on decision-making powers
Divided government	Different parties control the executive and the legislature
Coalition size	Number of parties integrating governing coalition
Government fragmentation	Chance that two random draws will produce two government members from different parties
Effective vetoes	Total number of veto players

Formal institutional arrangements are the constitutional, legislative, and electoral systems. Temporal institutional features include the number of veto players, the existence of divided government, coalition size, the effective number of political parties, and legislative fragmentation. This study considers all the indicators included in each group and categorizes them according to the degree to which they approximate actual power concentration/dispersion. At the most aggregate level, authoritarian or totalitarian regimes will tend to exhibit greater levels of institutionalized power concentration than their democratic counterparts. Moving down

one level, presidentialism – which entails separating the executive from the legislature – and bicameralism – dividing the legislature in more than one chamber –, are the best known techniques of distributing power.

The extent to which parliamentary or presidential systems grant more authority to the executive branch remains the subject of some controversy. Some scholars have argued that presidential systems are vulnerable to executive isolation, divided government, and the problem of the lame duck (Linz and Valenzuela 1994). In parliamentary systems, by contrast, executive and legislative powers are fused, divided government is judged impossible and weak governments can be removed through votes of no confidence. For some experts, these formal features of parliamentary democracy enhance executive authority. There is important theoretical and empirical evidence to suggest that the problem of divided government is not exclusive to presidential systems, particularly in cases of minority coalitions. Laver and Shepsle (1996), for instance, define a government to be unified whenever a single party both forms the political executive and commands a majority in the legislature; Alesina and Rosenthal (1995) argue that single party minority governments in parliamentary systems are the most directly comparable cases of divided government with countries like the United States. Moreover, large coalitions, a feature strongly correlated with parliamentary systems, have been shown to have important negative effects over the policy decision-making process (Roubini and Sachs 1989, Spolaore 1992).

The nature of the legislative system has also been considered a manifestation of power dispersion. Tsebelis and Money (1997), for instance, have argued that bicameral legislatures increase the number of veto power instances in the system and, as a consequence, are more likely

to contribute to decision-making delays. The presidential-parliamentary and unicameral-bicameral dichotomies are no doubt important and will receive consideration in this study. There are limits, however, to the analytical use of such broad categories, particularly when the analysis involves comparisons across similar systems.

Politically fragmented systems are characterized by a large number of political parties participating in elections or gaining seats in the legislature. Electoral systems are frequently mentioned in the comparative institutional literature as key determinants of the size of the party system (Shugart and Taagepera 1989, Cox 1997, Cox and McCubbins 2001). Proportional representation systems are thought to encourage the existence of a large number of smaller parties with relatively narrow or highly localized bases of support. Simple majority vote, on the contrary, would tend to produce reasonably more cohesive systems where parties have broader constituencies. A variable describing the type of electoral system is included in this analysis. Yet, we should acknowledge that such variable may not be able to capture how many parties are actually significant both in political contests and in legislative decision-making, which is particularly important to proxy the level of competition across preferences. For this reason, an indicator measuring the number of effective parties is considered.

Finally, there is a set of indicators that more closely capture actual power distribution across political actors: the constraints on the chief executive, the presence of divided government, the size of the governing coalition, levels of government and legislative fragmentation, and the number of effective veto players in the system.

The extent to which the decision-making powers of the chief executives are institutionally constrained is an indicator of power concentration vis-à-vis other political actors.

For instance, a relatively unconstrained executive may frequently ignore, revise or suspend constitutional restrictions to her power and, in an extreme case, even dismiss the legislature at her pleasure. At the other end of the range, highly constrained executives are typically found in systems in which accountability groups (or institutional checks) have equal or greater power than the executive. This study borrows such indicator from the Polity IV dataset (Marshall, Jaggers and Gurr 2004).

Divided government is another way of looking at power distribution between the executive and the legislature. In presidential countries divided government occurs when a party other than the president's controls the legislature. Divided government is perhaps one of the most obvious consequences of the separation of powers typical of presidential systems and has been associated with difficulty in passing major policy changes and increased levels of policy stability (Alesina and Rosenthal 1995, Fiorina 1992 and1996, Norpath 2001, Bowling and Ferguson 2001). While there is some debate as to the extent to which divided government is observed in parliamentary democracies, the definition is here extended to situations in which a minority government is in place. Under a unified government, power distribution is assumed to be more concentrated than under divided government.

Coalitions are perhaps the clearest instance of power-sharing in government. Although coalition governments are more frequently observed in parliamentary systems, there are instances in which cabinets in presidential systems do include members of other parties as a way for the executive to insure the support of a winning legislative coalition, like Brazil (Amorim Neto 2002). Coalition governments have also been associated with delays in undertaking necessary fiscal adjustments (Perotti 1998), larger budget deficits (Roubini and Sachs 1989,

Grilli, Masciandaro and Tabellini 1991), larger government spending (Kontopoulos and Perotti 1999, Scarstascini and Crane 2001) and, in general, a more pronounced status-quo bias in the face of adverse shocks (Alesina and Drazen 1991). A variable describing the size of the governing coalition is considered in this study. Power concentration is assumed to decrease in the number of coalition members.

The role of the legislature in the policy-making process is determined not only by constitutional restrictions on the scope of its initiative and veto authority, but also by its composition and the relative strength of government and opposition coalitions. One measure commonly used to characterize the internal structure of legislators is the fragmentation of the legislature. Greater fragmentation could be taken to imply a larger number of actors willing to act independently in the consideration of a given policy change. Similar measures are used to capture the fragmentation of government coalitions.

The number of effective veto players is a key element in the description of any political system because it measures the number of decision makers whose agreement is necessary before policies can be changed. The fewer the veto players the more concentrated the distribution of decision-making authority is assumed to be, while more dispersed distributions imply a greater number of veto players.

1.6. METHODOLOGICAL APPROACH.

The dissertation relies heavily on statistical techniques and case studies to achieve its purposes. The statistical work is aimed at identifying general patterns of relationship between the dependent and independent variables and at quantifying the impact of power dispersion on the

duration and fiscal cost of financial crises, and on a selected group of fiscally expensive policy responses. Qualitative methodologies are used in order to complement the empirical evidence from quantitative analysis but, most importantly, to test the research hypotheses in a much more detailed context – one, in principle, capable of providing further insight into the causal mechanisms being explored.

For the statistical analyses, economic, financial and political information on a large number of countries was collected in order to construct an adequate data set for the research. Complete and reliable data was found for thirty-five countries which have collectively experienced forty crisis episodes. These are the observations that made it to the final sample used for this dissertation. Of course, there have been more instances of financial crisis than those included here. In fact, judging by some accounts, the sample is relatively small. Still, it is possible to obtain valuable insights subject to generalization as the sample does include representatives from all regions of the world, all income levels and, most importantly, a variety of politico-institutional settings.

Three types of statistical experiments were conducted for this study using three different functional forms. To examine the impact of power distribution on the duration of financial crises we need a model to predict how long it will take for the crisis to end, given that country *i* is already in crisis, as a function of a set of political and other control variables. The standard linear model does not work well with duration data because, since all duration values are strictly positive, they violate the normality assumption necessary for OLS models. The most appropriate form for duration data is the hazard model. Hazard models have been used in political science to study cabinet governments (Strom 1985, King et. al. 1990, Warwick 1992 and 1994, Alt and

King 1994), international conflicts (Beck et. al. 1998), wars (Bennett and Stam 1996) and, more recently, the constraining power of international treaties (Simmons 2000; Simmons and Hopkins 2005) and UN peacekeeping missions (Gilligan and Sergenti 2006).

Simply put, hazard models have a dependent variable – the hazard rate – that measures how long it takes for something to happen. In the context of crisis durations, the hazard rate denotes the probability that a crisis in country *i* will end at time *t*, given that the crisis has lasted until that moment. There are several probability distributions that can be used to model duration data and all of them make the assumption that the hazard rate changes as a function of time. The main difference among them is the specification of the hazard rate over time. This study assumes that the hazard decreases monotonically with time and, in consequence, follows a Weibull distribution.

Standard ordinary least squares (OLS) models and probit models – both widely known in political science – are used to analyze the impact of power distribution on the fiscal cost of the crisis and the choice of fiscally expensive policy instruments. The standard OLS model seems appropriate in the case of fiscal costs because the variable behaves in a quasi-continuous fashion. In contrast, all variables on policy choices are categorical – they describe the use (or non-use) of specific instruments – a feature that warrants the use of probit or logit models.

The qualitative part of the dissertation focuses on developing a case study on the Mexican 1994-95 financial crisis in detail. The study reconstructs the crisis containment, management and resolution process from the onset in December of 1994 and until 1999, when relevant financial reforms finally passed in Congress and were enacted.

The way in which the Mexican government handled and finally resolved the 1994 financial crisis provides with enough rich detail not only to test the dissertation's research hypotheses but also to assess the merits and limitations of the statistical models and the relationships found in the quantitative experiments. It is a case worth studying in the context of this dissertation not only because the 1994 crisis has been one of the most dramatic and transcendental episodes recorded, but also because its development and resolution occurred as the country was experiencing a major political transition. While most of the crisis management was done under conditions of heavy power concentration at the hands of the executive, crisis resolution suddenly faced a more even distribution of authority between the President and Congress, and a deeply divided and polarized legislature as well. As a consequence, it is possible to compare the decision processes associated with a single crisis episode across two different levels of power dispersion holding everything else relatively constant.

1.7. OUTLINE OF THE DISSERTATION.

The rest of the dissertation develops as follows. Chapters 2 and 3 contain the main results from a number of statistical experiments conducted on crisis duration, fiscal cost and policy variables. The evidence presented in Chapter 2 shows a strong and positive relationship between power dispersion and crisis duration that centers on divided government. It also revealed the constitutional features, particularly separation of powers, as one of the most important factors explaining delayed crisis resolutions. In addition, the results suggest power dispersion may have differentiated effects depending on the extent to which the measurement of crisis duration is sensitive to macroeconomic fundamentals.

In Chapter 3 the main results suggest that it is political competition, rather than power dispersion, that drives down the fiscal cost of financial crises. Once more there is strong evidence suggesting that presidential systems are more likely to authorize significantly larger amounts of fiscal resources in support of troubled financial institutions. Experiments conducted on a sub-sample of democratic countries, however, had an interesting outcome: rather than an obstacle, power dispersion – expressed as the size of the governing coalition – has a significant but positive relationship to larger fiscal outlays during financial crises. The analysis of expensive measures (i.e. liquidity support, deposit insurance, and forbearance) reveals interesting contrasts. Greater levels of political competition and power dispersion exercise a clearly negative effect on the probability of observing direct fiscal transfers to the financial sector (i.e. liquidity support) in general. The impact of these factors on measures that clearly target the financial sector but do not involve visible changes in the status quo (i.e. forbearance) is more inconsistent and even divergent between democratic and non-democratic countries. Something similar happens with measures that unclearly benefit the financial sector but involve a change in the status quo (i.e. deposit insurance). In this case, the results show that while democratic countries and divided governments are more likely to implement these measures in general, the probability of doing so in democracies is decreasing in the number of veto points.

Chapters 4 and 5 are dedicated to the analysis of the Mexican financial crisis of 1994-95 and its resolution. The focus of Chapter 4 is on the Mexican government's handling of the crisis the first four years into it. During these years, political power was heavily concentrated in the hands of the president and crisis management was the exclusive purview of the executive branch. Chapter 4 begins by examining the sources of presidential power in Mexico

emphasizing the importance of executive control over the dominant party (PRI) machinery and the overall structure of political opportunity in the country. It then shows how power concentration made it possible to re-create a privatized financial system heavily protected and prone to moral hazard, a factor at the roots of the 1994-95 financial crisis.

Chapter 4 also discusses the onset and management of the crisis paying special attention to the variety of programs the government put in place to assist the financial system. The analysis of the containment and management stages of the crisis shows that power concentration facilitated an increasingly expensive bailout to be conducted with large discretion and without major questioning or obstacles. It also shows, however, that while power concentration may increase decisiveness (understood as the capacity to alter the status quo), it will not necessarily lead to more consistent and effective crisis interventions in the absence of an adequate support (i.e. bureaucratic) structure in charge of crisis management.

Chapter 5 examines the crisis resolution process under a significantly more dispersed power distribution. The mid-term elections of 1997 produced the first divided government in Mexico since 1929 when the opposition to the PRI won 52 percent of the total seats in the Chamber of Deputies. For the first time in many years, the Mexican Congress had the opportunity to become a veto player for real – and both the conservative PAN and the left-leaning PRD took advantage of it significantly eroding presidential power. This Chapter examines how the financial reform package President Zedillo sent to Congress in March of 1998 with the aim of resolving the financial crisis became the first major opportunity for the opposition-dominated Chamber of Deputies to assert their new role and establish its credentials towards the general elections of 2000. It then shows that, while the new balance of power

brought needed transparency and order to the crisis management process, it delayed final resolution and contributed to a more expensive outcome.

Chapter 6 concludes the dissertation introducing a brief comparative angle and exploring directions for future research; it also discusses a few policy implications from the main findings.

Chapter 2: Power Distribution and Government Interventions in Financial Crises

2.1. INTRODUCTION

If government intervention in a financial crisis is warranted, this should be carried out in a timely and effective fashion. In other words, governments need to take control and resolve the crisis as soon as possible in order to minimize moral hazard problems and avoid major repercussions to the real economy.

The international experience with financial crises suggests that some governments have been more capable than others at controlling and resolving such distressful events. If indeed government intervention makes a difference, the question is what factors facilitate or hamper a prompt and decisive response to the crisis. One key argument in this study is that power concentration may conduce to expedite and decisive interventions in financial crises because it creates the conditions for (a) rapidly mobilizing and allocating necessary resources – material, human, monetary – towards managing and resolving the crisis, (b) quickly overcoming coordination and consistency problems in strategy design and implementation, and (c) swiftly removing obstructions to the implementation of required measures and the passage of necessary legislation. In other words, power concentration may help resolve the coordination problems likely to arise when the agreement of multiple actors is necessary to follow a particular course of action.

Following this argument, financial crises are expected to last longer in countries were decision-making power is more dispersedly distributed than in those where authority is concentrated in the chief executive. This chapter tests this proposition on a sample of forty

country-crisis episodes using hazard models. While evidence is found to support the claim that power concentration may lead to shorter crises, the picture that emerges from this analysis suggests that concentration is not always a decisive advantage.

2.2. TIMELY INTERVENTIONS IN FINANCIAL CRISES: AVAILABLE EXPLANATIONS.

For experts and observers of financial systems across the world, the timely introduction of corrective measures during a financial crisis is the key to controlling its consequences for the public budget and the economy as a whole. This claim is based on the risks posed by moral hazard. Banks with negative or low net worth, and that operate under limited liability (because of implicit or explicit depositor protections), have incentives to undertake excessive risks in an attempt to recover their investments.[2] The longer these problem banks are allowed to operate, the higher is the probability of a longer crisis and the greater the risk of massive public intervention.

Some empirical studies substantiate this claim. Caprio and Klingebiel (1996), for instance, have found that the common link between different types of bank failure is that the initial losses, whatever their cause, often multiply when prompt corrective action is not taken. Moreover, Lindgren, Garcia and Saal (1996) show that delay in addressing unsound banks is rarely effective and usually detrimental insofar as unsound banks tend to take on even more risk or may be looted by insiders, which ultimately increases resolution costs.

The literature on financial crises has not addressed these issues sufficiently. Explanations for why some countries impose corrective measures faster than others have been rather scarce. Because avoiding systemic failures may require the transfer of public funds to the banking

[2]Typically these banks invest in projects that, if successful, would provide large gains but their probability of success is really low. Risky projects like these thus tend, on average, to produce major losses.

system, some economists have suggested that delay could be the result of severe resource constraints (Rojas-Suarez and Weisbrod 1997).

Because limited access to debt and financial markets is more common for developing countries, the argument implies that crises would be much harder to put under control and resolve in these nations than in industrial countries. Available evidence, however, does not provide straightforward support for this claim. True, financial crises in developing countries tend to be, on average, more expensive than their counterparts in industrial nations. They are not, however, necessarily shorter in duration or milder in socio-economic effects. Moreover, this perspective fails to provide adequate causal mechanisms to explain why the financial constraint is more likely to be the main obstacle to promptly control and resolve the crisis when other (i.e. non-financial) corrective measures could be available to decision-makers.

Another approach suggests that delay in taking corrective action against crises is a function of their "perceived cost" (Frydl 1999). According to this view, when authorities decide to take action, they will choose the cheapest policy option. A higher number of policy options may increase the prospects of undertaking cheaper actions. If waiting a longer time means more options, and more options mean lower costs, decision-making delays may lead to a less costly crisis, despite de moral hazard incentives involved. However, if the first impressions of the size of a problem are large, the authorities may be very prompt in their response provided they assume that conditions are deteriorating at a rate commensurate with the initial size of the problem. As a consequence, crises that show a high perceived cost will have a short action lag and, probably (if the initial actions are vigorous) a relatively low cost.

The usefulness of this approach is questionable for a number of reasons. First, it is not clear whether waiting longer to act systematically increases the number of policy choices. Second, proving that initial perceptions influence the authorities' action lag looks almost like a titanic task, unless it is assumed that crises that ended up being less expensive do, in fact, reflect initial perceptions of high cost and, therefore, rapid action. Finally, this approach assumes that financial crises are faced by unitary actors with almost perfect information, while failing to provide an explanation of how decision-makers calculate and internalize the costs they perceive.

What seems to be implicit in all these arguments is that, in the face of a financial crisis, authorities must be willing and capable of a timely and effective response – even if it involves the use of important amounts of public funds. Incentives to do so are likely to vary across countries and may very well depend on the politico-institutional environment in which decision-makers operate.

2.3. COORDINATION FAILURES, POWER DISTRIBUTION AND INTERVENTION IN FINANCIAL CRISES.

Chapter 1 develops a three-stage model of government intervention in financial crises in which power concentration facilitates their control, management and resolution because it is more likely to minimize coordination problems. This connection has been explored before in other contexts. Early accounts of a now well established strand of scholarly literature on the politics of economic reform in developing countries argued that for economic adjustments to take place there had to be a disruptive event (i.e. a crisis) that opens the door to major political change and reduces the leverage of those groups interested in maintaining the status quo. In these

circumstances, governments may enjoy – or be granted – special powers that, in turn, facilitate the introduction of much needed – and much delayed – economic reforms (Haggard and Webb 1993).

Further developments in this tradition have strongly emphasized the importance of concentrating authority at the hands of the executive to overcome the collective action problems and distributive conflicts associated with the introduction of economic reform. In a comparative study on a set of developing countries Haggard and Kaufman (1995) find that granting expansive legislative powers or decree authority to the executive is quite useful in situations where fragmented and polarized systems exacerbate partisan rivalries, magnify conflicts among organized interests, and weaken the capacity of the executive to initiate reforms. More recent contributions directly examining the connection between political institutions and public policy in presidential systems have found that *regime decisiveness*, or the capacity to introduce policy change, decreases in the number of veto players in the system and the extent to which they are separated by *purpose* (Shugart and Haggard 2001).[3]

Although belonging to a completely different tradition, game-theoretic models designed originally to explain the timing of fiscal stabilizations arrive at quite similar conclusions. The common thread in this literature is that as decision-making processes become more polarized and fragmented, the ability to agree on efficient policies (i.e. significant fiscal consolidations) is reduced (Perotti 1998).

[3]By separation of purpose the authors refer to the extent to which the electoral fates of veto players are independent from each other: Matthew S. Shugart and Stephan Haggard, "Institutions and Public Policy in Presidential Systems", in ed. Stephan Haggard and Matthew D. McCubbins*, Presidents, Parliaments, and Policy* (Cambridge University Press, 2001).

The pioneers here are Alesina and Drazen (1991) who observed that many countries do not introduce stabilization measures after incurring large deficits even though it has become apparent that current policies are unsustainable and that a change in policy will have to be adopted eventually. They model this situation as a war-of-attrition game between two incompletely informed players who need to agree on a fiscal stabilization plan. The stabilization plan is basically an agreement on how taxes are to be distributed between the two groups. Delays result from the coordination problem associated with the distributional struggle and the uncertainty each group has about the other's strength (i.e. how costly it is for the other to postpone stabilization). The optimal concession time is determined by equating the marginal cost with the marginal benefit of waiting. The marginal cost is the utility cost of living another instant in an unstable and distorted economy. The marginal benefit is given by the conditional probability that the other group will concede in the next instant multiplied by the difference in utility between being a winner or a loser. What this means essentially is that the cycle is broken only until one of the groups grows powerful enough (i.e. after a decisive victory in elections) to impose its preferred plan to the other.

Variations of the basic war-of-attrition model have expanded the analysis or focused on specific institutional features that may exacerbate the coordination problem (Spolaore 1992, Rodrik 1993). In any case, a key conclusion emerges. First, countries are more likely to introduce fiscal stabilizations sooner when their political institutions make it relatively more difficult for opposing groups to veto programs not to their liking. More generally, macroeconomic policy reforms will be adopted sooner in systems characterized by relatively low

levels of power dispersion as they make it easier for one group to consolidate its position (and impose its preferred distribution of the costs of reform) vis-à-vis the rest.

Direct empirical tests on these predictions, though not abundant, are quite suggestive. Roubini and Sachs (1989), for example, have found that coalition and divided governments are positively correlated with higher budget deficits in OECD countries. In addition, the comparative work reviewed earlier provides additional – if indirect – support for the idea that power dispersion aggravates coordination problems and produces stalemate.

There are other equally important implications to greater power dispersion: it tends to reflect higher levels of political competition and electoral uncertainty. A more scattered distribution of decision-making authority means there are more opportunities for outsiders to challenge the position of incumbents. Electoral uncertainty for the incumbent government, in turn, may worsen in the presence of a major crisis. If resolving the crisis becomes an important issue in the competition for political power, incumbent governments may have incentives to deal with it as soon as possible by introducing the necessary measures.

These issues have been explored – though not extensively – in a number of pieces analyzing major stabilization efforts in developing and post-communist countries (Bates and Krueger 1993, Geddes 1994, Hellman 1996). The most important point to be made here about these studies is that their findings do challenge key predictions of the war-of-attrition framework but, since the evidence is limited, they can only suggest that further analysis and systematic testing are necessary.

In the context of systemic financial distress, rational delay models can be very helpful to understand the conditions under which decision-makers are more likely to promptly and

effectively take control of the situation. Financial crises are complex events the resolution of which involves multiple decisions and typically a large number of actors. Coordination and distributional problems are likely to arise for at least two main reasons. On the one hand, multiple institutional and organizational actors with different preferences and agendas may be involved in making key decisions. On the other, these decisions may affect a number of potentially powerful interest groups. In addition, the availability and potential use of public funds to assist troubled banks raises the issue of how such disbursements are going to be absorbed or, in other words, how will the fiscal burden of solving the crisis be distributed across different social groups (i.e. taxpayers, bank owners, borrowers, and the like).

Given these considerations, we should expect countries where the distribution of decision-making authority is more dispersed to delay intervention in the crisis and, as a result, have a harder time getting control and resolving it. Yet, because dispersed power distributions and higher levels of political competition go hand in hand, political incentives in favor of promptly addressing the problem cannot be discounted, particularly as elections approach. If, indeed, this is the case, we should expect the proximity of electoral contests to have a negative impact on rational delays. If solving the crisis becomes a major issue in the struggle for political power and the number of policy choices is limited, opponents may be more likely to cooperate with incumbents. Alternatively, decisive intervention in the crisis may only come after a clear electoral victory for either the incumbent or any opponent.

2.4. THE DEPENDENT VARIABLE: MEASURING TIMELY AND EFFECTIVE INTERVENTIONS IN FINANCIAL CRISES.

Conducting a large-n, systematic study of how power dispersion affects government responses to financial crises is complicated for a number of reasons. Identifying and measuring the dependent variable is certainly one of them mostly because observing the timing and the decisiveness of each intervention over the length of the crisis is practically impossible across a large number of cases. In consequence, we have to rely on what is available.

The World Bank (WB) and the International Monetary Fund (IMF) have over the years collected fairly reliable data on the duration of a number of crisis episodes and the time it has taken these economies to recover from them. It is interesting to distinguish between these two sets of data because the duration of the crisis does not always coincide with recovery time. In fact, the correlation coefficient between these two variables in the sample is positive but statistically insignificant.[4] At least part of the explanation for this can be found in the way each variable is measured.

While recovery time follows a relatively simple, standard definition, measuring the duration of a crisis is no simple matter. Recovery time may be measured following the IMF's rule to determine the year of recovery: one plus the number of years that real GDP growth rates are below trend (10-year) rates. In contrast, establishing the duration of a crisis needs to take into consideration a number of issues. On the one hand, financial crises are similar to recessions in that they spread out diffusely over time, with no clear beginning or end. There is no consensus as to what sort of objective indicators can be used for dating crisis episodes and no universal arbiter

[4]The correlation coefficient is 0.1703 with a p-value of 0.2936.

in charge of doing so. As a result, analysts frequently turn to expert opinion to identify the beginning and the end of financial crises. Expert judgment is, of course, subject to error. Experts might over or underestimate the crisis dates even purposefully, if their reputations are at stake. In addition, their opinions might not be representative of the broader range of expectations in markets and economy. In the absence of a better approach, however, we can only expect that the more expert opinions we can gather, the closer we can get to the truth.

While the estimation of crisis duration may take macro-economic conditions and GDP fluctuations into account, it is also influenced by perceptions on the behavior of key banking sector indicators. Recovery time, in contrast, is directly associated with GDP growth rates. Yet, although production depends on a variety of factors exogenous to the crisis, major financial upheavals almost always have effects on the real economy. We can thus reasonably assume that there is a positive and significant correlation between the promptness and decisiveness of government intervention in financial crises and the duration and recovery time of each episode other things being equal.

The dependent variable *duration* equals the number of years the country in is crisis from the onset. The variable *recovery* is equal to the number of years GDP growth rates were below 10-year average trends plus one.

2.5. THE SAMPLE.

An original data set was created for the purposes of this study. The sample includes 40 crisis episodes in 35 countries across the world for which complete and reliable data are available (Table A.2.1 in the Data and Statistical Appendix presents information on the duration and

recovery time associated with each episode). The typical crisis in this sample has lasted four years (mean equal to 4.43 years). If we exclude episodes in progress – or abnormally long episodes – this value does not change much (the median remains 4 years while the mean values are 4.37 and 4.03 years respectively). As for recovery time, the typical economy in the sample was able to rebound after 3 years (mean equal to 3.75 years) and this estimate did not change much after excluding episodes in progress (mean equal to 3.31 years) or abnormally long recovery periods (mean equal to 2.97 years).

There have been more instances of financial crisis than those included in this sample. In fact, judging by some accounts, the sample is relatively small (and the number of observations considered in each experiment may adjust downwards due to missing data). It is still possible, however, to obtain valuable insights subject to generalization as it pretty much includes representatives from all regions of the world, all income levels and, most importantly, a variety of politico-institutional settings.

2.6. THE DEPENDENT VARIABLES: POWER DISPERSION AND OTHER CONTROLS.

Two types of independent variables were used: power dispersion variables and control variables. The choice of power dispersion variables follows the discussion in Chapter 1. Summary statistics and detailed descriptions of how these variables were constructed and the data sources can be found in Table A.2.2 in the Data and Statistical Appendix. The power dispersion variables are grouped in categories that correspond to different institutional levels.

At the constitutional level we can find regime type (i.e. whether the country is a democracy or not), the political system (i.e. presidential or parliamentary), and the legislative

system (i.e. unicameral or bicameral). Moving down one level, we have the rules and norms that govern elections for the executive and the legislature. The next level includes features of the party system, particularly the number of parties effectively competing in electoral contests and gaining representation. A variable closely related to the effective number of parties is the level of legislative fragmentation. The last category in this group includes variables that more closely describe the level of power dispersion in the polity or its consequences for executive power: the presence of divided government, the number of effective vetoes, the size of the governing coalition, government fragmentation and the degree of institutionalized constraints on the chief executive.

In addition to the power dispersion variables, the study also incorporates variables that measure the proximity of elections (i.e. time to elections at crisis onset, years left in office for current government at the crisis onset, and years current government has been in office at the time the crisis starts) in order to test the hypothesis that such events may create incentives to accelerate crisis intervention and resolution. While not explicitly addressed by the literature discussed earlier, the role of special groups is worth considering. In a context of imperfect and incomplete information, bank owners and managers may attempt to delay government intervention in their institutions either because they are willing to make every effort to salvage their investment, or because they see an opportunity for looting. In either case, if successful, they could contribute to a longer crisis and a more painful recovery. This study explores this possibility through the use of a proxy variable for the influence of bank owners and managers: the size of the financial sector relative to GDP.

The control variables are intended to capture the effects of exogenous factors on the duration of the financial crisis and the time it takes for the economy to recover from it. Detailed descriptions of all these variables as well as data sources can be found in the Data and Statistical Appendix. Two groups of control variables are considered in the analyses: macro-economic and banking sector performance indicators.

Macro-economic indicators are necessary to control for the adverse effects of economic shocks – such as cyclical output downturns, terms of trade deterioration, and declines in asset prices, for example – on the capacity of bank borrowers to service their debts and the level of exposure of financial institutions. The main indicators in this group are: real interest rates, GDP growth, change in equity prices, current account as a proportion of GDP, fiscal balance as a proportion of GDP, change in terms of trade, and foreign debt as a proportion of GDP. In addition, a couple of binary variables have been constructed to account for income level and regional effects. It should be mentioned that this group of variables is likely to work better to explain *duration* than to explain *recovery*. This is due to the strong relationship this latter variable has with GDP changes. Explaining GDP changes requires the use of other variables (such as rate of capital formation and productivity, for instance) not considered in this study. As a consequence, all the results on *recovery* should be taken with even greater caution.

The behavior of banking institutions prior to the crisis may also exercise an important influence on how quickly the financial sector can recover from a crisis. The international experience shows that crises originated in macro-economic shocks tend to aggravate whenever factors such as strong pre-crisis credit expansions, capitalization problems or a weak liquidity

position are present. A variable that captures whether the origins of the crisis were predominantly micro or not has also been considered.

It is important to mention at this point that other factors that may have an impact on the capacity of countries to quickly recover from a financial crises will not be considered in these analysis due mostly to lack to sufficient data. This is the case of historical information on the regulatory environment governing the financial sector and the evolution of economic institutions such as property rights protection and contract enforcement. There are theoretical and anecdotal reasons to believe these are variables that may either get in the way or facilitate recovery from financial crises. Unfortunately, not enough data is available to use with the type of statistical models we need and which we know turn to explain.

2.7. METHODOLOGY: ESTIMATING THE EFFECTS OF POWER DISPERSION WITH THE HELP OF HAZARD MODELS.

The main purpose of this chapter is to quantify the impact of power distribution on the ability of governments to promptly respond and resolve financial crises. As discussed previously, both the duration of the crisis and the time it took for the economy to recover from it proxy for effective government intervention – once other relevant factors are controlled for as well.

The most appropriate statistical technique to analyze the impact of power distribution on the duration of and recovery from financial crises is the use of hazard models. Simply put, hazard models have a dependent variable – the hazard rate – that measures how long it takes for something to happen. In other words, the hazard rate is the probability of experiencing an event at time t (or in the interval $t \ldots t+s$), given that the observation is at risk at time t.

All models in this class make the assumption that the hazard rate changes as a function of time, either the time since the last event or some other factor. The shape of the hazard rate function, however, is one of the key distinguishing features of different models for duration data. In fact, the hazard function *h(t)* completely determines the probability distribution of the time until an event (or the time between events when events are repeatable).

The most basic way to model duration is to assume that *h(t)* is a function of a set of explanatory variables X_1, X_2,…X_n but not of time. A hazard that is constant over time implies an exponential distribution for the time until the event occurs. The simplicity of the exponential model is outweighed by its major caveat, namely, that specifying a constant hazard is usually unrealistic. Most likely, the hazard increases or decreases with time. If the assumption of a constant hazard is relaxed, and the hazard is allowed to increase or decrease monotonically with time, the basic exponential model generates a Weibull distribution of the form: $h(t) = \lambda(1/\sigma)(\lambda t)^{1/\sigma-1}$.

In the Weibull hazard function, the parameter λ is a constant (i.e. baseline hazard) and σ determines the shape of the distribution (i.e. the nature of the time dependence) so that when:

- $\sigma = 1$, the hazard rate is constant (i.e. exponential distribution),
- $\sigma < 1$, the hazard rate is decreasing over time, and
- $\sigma > 1$, the hazard rate is increasing over time.

Because it is reasonable to expect that the duration of and the recovery from financial crises to be partially a function of time, I use a Weibull model to estimate the effects of power dispersion. For an estimation with *i* covariates, the Weibull distribution is transformed into a conditional hazard function of the form: $h(t; X_i) = \lambda(1/\sigma)(\lambda t)^{1/\sigma-1} e^{-\beta Xi}$.

Interpreting the coefficient estimates from a Weibull model is not straightforward as their effects are calculated on the log of the hazard. As a result, the size of the coefficients cannot give a clear indication of the magnitude of the effects of the covariates on the duration of and recovery from the crises.[5] Still, it is possible to identify right away the direction in which the covariates affect the time to resolution/recovery (positive and negative coefficients predict longer and shorter crises/recoveries respectively) and the significance of the relationships.

One method to illustrate the effects of a particular variable is to estimate and compare predicted durations under different actual values of that variable while holding the other variables constant. This method begins from a hypothetical case in which the values of all the variables but one are set to their mean or to some other typical observed value. Changing the values of that one variable of interest can demonstrate how unit changes in that variable will affect the predicted crisis duration in that hypothetical case.[6]

In order to facilitate the discussion of the regression results below a series of simulation exercises were conducted using this method. For these purposes, four hypothetical cases were constructed from information in the sample: the typical sample case, the typical developing country case, the typical Latin American country case, and the typical democratic country case. In each case, the variable being examined was allowed to vary while the remaining variables were fixed to either the mean or the median for their particular group (see Table A.2.3 in the Data and Statistical Appendix for details).

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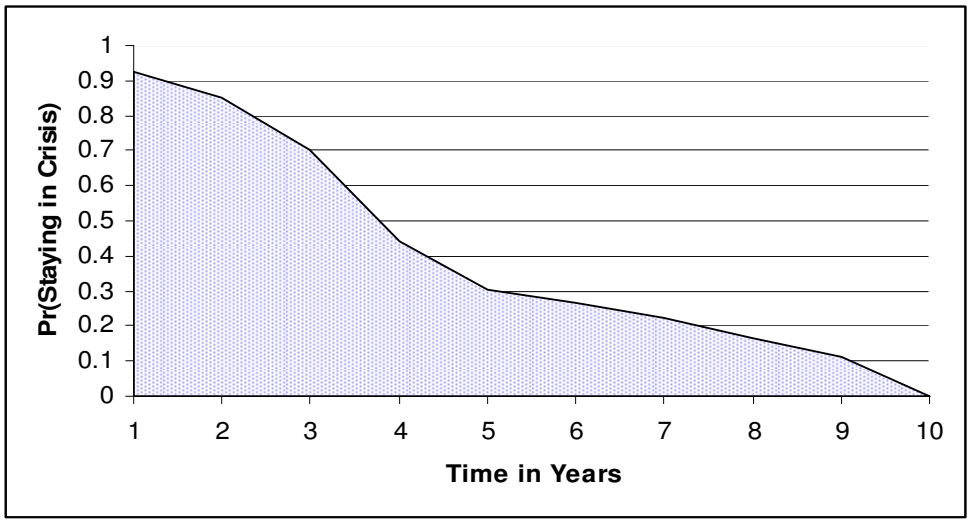
[5]The most intuitive explanation can be obtained by exponentiating the coefficients (i.e. taking their anti-logs). In this case, for each unit increase in an explanatory variable X_i, the hazard is multiplied by its exponentiated coefficient.

[6]Following Bennett and Stam's (1996) correction of Greene, the predicted stabilization delay is estimated as $E[t \mid x_i] = \exp(\beta' x_i) * \Gamma(\sigma + 1)$.

2.8. RESULTS AND INTERPRETATION: CRISIS DURATION.

To have a clearer picture of how the probability of ending the crisis is affected by time alone the Kaplan-Meier estimator is a very useful visual aid. The Kaplan-Meier estimator essentially describes a survival function over time for all un-censored observations in the sample. Graph 2.1 shows that the probability of a longer crisis declines at a relatively constant rate during the first four years after the onset and, should it last longer than that, between the fifth and ninth year into the crisis.

Graph 2.1. Kaplan-Meier Survival Estimate for Crisis Duration as a Function of Time



It would appear, however, that the probability of being one additional year in crisis declines faster during this latter period than before the four-year mark. After the tenth year into the crisis the function declines at a much faster rate but this is probably because our sample does not include any crisis episode lasting longer than eleven years. In sum, time does play a role in the duration of a financial crisis. Time alone would put an end to the crisis regardless of any other intervening factor. Other factors may have, nonetheless, the capacity to accelerate or hinder the

resolution of and recovery from the crisis. It is to the analysis of those factors that we now turn our attention.

Table 2.1 presents the main statistical results from a number of experiments on crisis duration. Considering the high correlations between study variables across categories the statistical analysis proceeded in stages. In addition to the variables describing special interests and electoral incentives, constitutional features were examined first. After that, another set of regressions was run omitting constitutional features and using electoral and party system variables; finally power concentration/dispersion variables were tested.

Table 2.1. Constitutional features and crisis duration – regression results

Standard errors adjusted for clustering on id[1]

Dependent variable: time to the end of the crisis

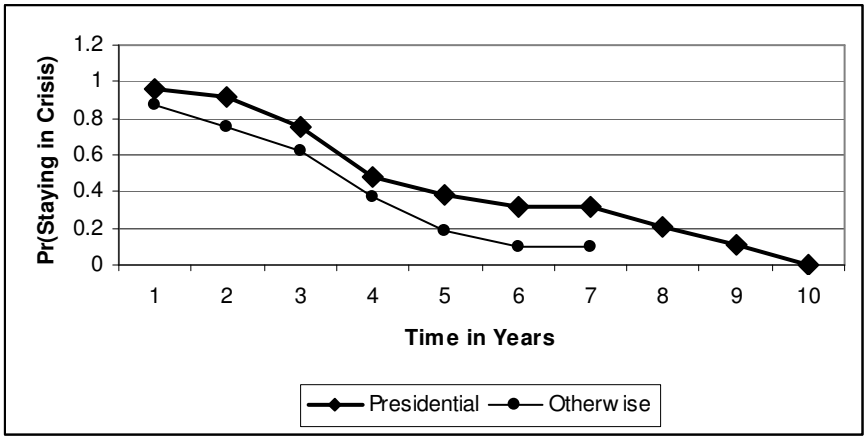
Independent variables	Model 1	Model 2	Model 3
Political system	0.448**	0.539**	0.467**
	(0.179)	(0.190)	(0.177)
Size of financial sector	0.010**	0.016**	0.015**
	(0.005)	(0.005)	(0.005)
Time in office at t	-0.013*	-0.019**	-0.018**
	(0.007)	(0.009)	(0.009)
Democracy*Time in office			-0.425*
			(0.230)
Economic growth		-0.027	-0.027
		(0.019)	(0.020)
Interest rate changes		-0.001**	-0.001**
		(0.0001)	(0.0001)
Economic openness		-0.044**	-0.039*
		(0.022)	(0.022)
Constant	1.038**	0.675*	0.817**
	(0.281)	(0.356)	(0.332)
N	38	38	38
σ	2.284	2.567	2.718
	(0.347)	(0.367)	(0.365)
Wald χ^2	9.96	55.55	60.15
Prob > χ^2	0.0189	0.0000	0.0000

(1)Account for the fact that there is independence across observations from different countries but not across those from the same country.

(*)Significant at the 10% level; (**) Significant at the 5% level or better.

Of all the constitutional features considered, only the political system had a consistent impact on the duration of financial crises. According to the results, crisis would tend to last longer in countries with presidential systems (political system = 1) than otherwise. In principle, this suggests that separation of powers does in fact get in the way of effective intervention in crisis situations. This result holds regardless of regime type or legislative system.[7] Graph 2.2 below illustrates the relationship between crisis duration and the two categories of political system.

Graph 2.2. Kaplan-Meier Survival Estimates by Political System



The survival estimates show that, while in both cases the probability of staying one additional year in crisis declines gradually over time, this probability decreases much faster for non-presidential countries.

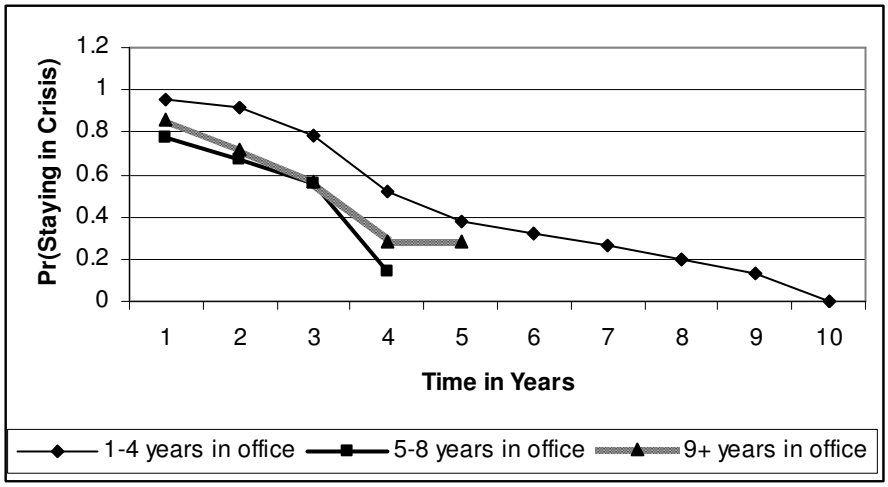
Using Model 3 from Table 2.1 changes in predicted crisis duration were estimated for the four hypothetical cases mentioned earlier. According to the results (see Table A.2.4. in the Data and Statistical Appendix), having a presidential system added roughly 16 months to the

[7]A variety of model specifications were run using these two variables together with political system. None of them was ever significant while the coefficients on political system remained unaltered.

typical case in the sample, 2 years to the typical developing country, and 10 months to the typical Latin American country. The typical democratic country in the sample is not presidential, which saved them two years of crisis.

Another interesting result from Table 2.1 is the coefficient on time in office, which was negative and significant across model specifications. According to the results, the more time the government facing the crisis has been in office at the time the crisis hits, the sooner the crisis is likely to end. This result would be consistent with the hypothesis that the proximity of elections creates incentives in favor of effective intervention in the crisis. Another possible interpretation is that the longer a government has been in office, the more experience it has and the better positioned it is to react and negotiate a prompt resolution with other relevant actors.

Graph 2.3. Kaplan-Meier Survival Estimates for Time in Office at Crisis Onset



Graph 2.3 above shows the survival estimates for time in office. In this case, the original continuous-like variable was transformed into a categorical variable according to the following rules:

- If government has been in office for more than one and up to four years, then time in office is equal to zero;
- If government has been in office for at least five and no more than eight years, then time is office is equal to one; and
- If government has been in office for nine years or more, then time in office is equal to two.

Governments who manage to stay in power between five and eight years (typically longer presidential terms or re-elected governments) do have a better chance at controlling and resolving the crisis sooner than their counterparts who have been in office for less than five years or more than eight. The worst cases are those for which governments stay in office for one to four years. In these cases the probability of staying in crisis declines much more gradually just as the life of the crisis extends beyond the ten-year mark. The most puzzling result concerns governments who have been in power for nine years or more at the time the crisis hits. The fact that in all cases these governments are found in non-democratic settings would seem to provide further support for the idea that experience plays an important role in the capacity to deal with a financial crisis effectively.

Results from simulations using the four hypothetical cases are for the most part in line with the previous findings (see Table A.2.4 in the Data and Statistical Appendix). Simulations added two additional years to the average time in office for the government facing the crisis in each hypothetical country. All four cases reported smaller expected durations, but the gains appear modest when compared to those on political system. The best scenario is actually for the government of the typical country in the sample (in office for six years already) because two

more years added to her tenure would translate into approximately 6 months less of crisis duration. The government in the typical developing country (in office for 7 years already on average) would reduce the crisis duration in a little less than 3 months by staying two more years in office. In the typical Latin American country (average tenure = 5 years) the reduction is equal to more or less 4 months. Finally, the typical democratic country in the sample (average tenure = 3 years) would see savings of almost 5 months in the duration of the crisis if its government were to be in office two more years.

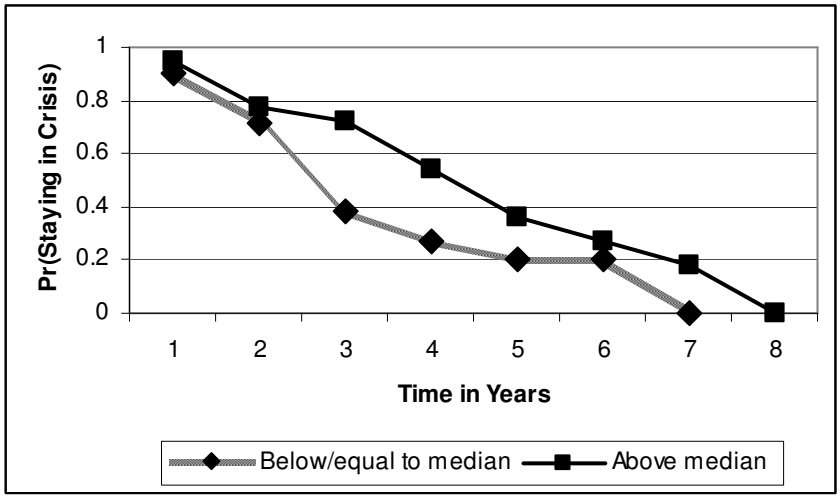
If instead of adding two years to the average government tenure in the hypothetical cases, two years are subtracted, the crisis duration increases – as expected – but the magnitude of this increase is larger than that of the decrease associated with longer tenures. In the typical country, the crisis would last in excess of 8 more months, in the typical developing country only 2 more months, and the in the typical Latin American and democratic countries approximately 7 more months.

Also interesting are the results on financial sector size, a proxy for the political influence of financiers as well as bank managers and owners. The coefficient on this variable is consistently positive and significant, suggesting that larger financial sectors tend to contribute to longer financial crises.

Graph 2.4 below provides some visual confirmation to the regression results. In this case the original variable was also transformed into a discrete categorical variable in order for the Kaplan-Meier graph to work as a useful visual aid. The variable transformation was done as follows: for values equal or below the median value (42.61 percent of GDP), financial sector size was equated to 0; and for values above the median (42.61 percent of GDP), financial sector size

was equated to 1.The graph shows that the probability of staying an additional year in crisis for countries with smaller financial systems declines more rapidly after the first two years into the crisis. In contrast, crises tend to last longer in countries with larger financial sectors.

Graph 2.4: Kaplan-Meier Survival Estimates by Financial Sector Size



Simulations adding one standard deviation to the typical financial sector size in each hypothetical case yielded the following results: for the typical sample country, the duration of the crisis increases by 14 months; for the developing country, almost 2 years; for the Latin American country, in excess of 9 months; and for the typical democratic country, roughly 14 months. Reductions of equal magnitude to the size of the financial sector in each case also yielded across the board shorter crisis durations, but the magnitude of the change was smaller: in the typical country, roughly 1 year; in the typical developing country, approximately 1 and a half years; in the typical Latin American country, a little more than 6 months; and in the democratic country, approximately 8 months.

While these results appear to support the hypotheses that influential financiers may get in the way of an expedite crisis resolution, in reality interpretations on this variable should proceed with caution. Because it measures size as a proportion of GDP, it is a good approximation to the structural importance of the sector in the economy.

Table 2.2 Power dispersion and crisis duration – regression results

Standard errors adjusted for clustering on id[1]

Dependent variable: time to the end of the crisis

Independent variables	Model 1	Model 2	Model 3	Model 4[Ω]
Political system			0.411*	0.215
			(0.214)	(0.314)
Divided government	0.355*	0.508**	0.334	0.134
	(0.191)	(0.189)	(0.227)	(0.323)
Political system*Divided government				0.677**
				(0.328)
Size of financial sector	0.011*	0.016**	0.019**	0.027**
	(0.006)	(0.005)	(0.006)	(0.009)
Time in office at t	0.016	0.015	0.002	-0.113*
	(0.018)	(0.017)	(0.014)	(0.063)
Democracy*Time in office	-0.689**	-0.756**	-0.663**	
	(0.291)	(0.246)	(0.273)	
Economic growth		-0.031	-0.033	-0.065
		(0.027)	(0.028)	(0.101)
Interest rate changes		-0.001**	-0.001**	-0.001**
		(0.0001)	(0.0001)	(0.0001)
Economic openness		-0.056*	-0.048*	-0.097*
		(0.034)	(0.028)	(0.057)
Constant	1.109**	0.673**	0.484	0.133
	(0.312)	(0.322)	(0.375)	(0.699)
N	32	32	32	22
σ	2.309	2.571	2.713	3.076
	(0.381)	(0.447)	(0.479)	(0.839)
Wald χ^2	7.32	54.90	74.29	134.68
Prob > χ^2	0.1201	0.0000	0.0000	0.0000

(1)Account for the fact that there is independence across observations from different countries but not across those from the same country.

(*)Significant at the 10% level; (**) Significant at the 5% level or better.

([Ω])Model run on a sub-sample of democratic countries only.

Financial sector size, however, is a problematic measure of political influence because it does not capture issues such as organization, cohesion, homogeneity or representation. Coefficients on this variable may thus be capturing effects other than political influence. One possibility is that decision-makers in countries with larger financial sectors have a harder time

calculating the costs of delay vis-à-vis those of quick action and decide to proceed more carefully. Another is simply that a lot more needs to be done before a crisis can be considered controlled and resolved in countries with larger financial systems. Considering the multiplicity of possible interpretations, these issues are more likely to be resolved via qualitative research.

Let us now discuss the performance of the remaining power distribution variables. The main results are presented in Table 2.2. Divided government was the only institutional manifestation of power dispersion to have any explanatory power over crisis duration. Results from Models 1 and 2 show a positive relation between the presence of divided government and longer crisis durations which suggests they find it more difficult to control and resolve financial crises. Although divided government is not exclusive to presidential systems (minority governments in parliamentary systems are a form of divided government), it is commonly believed to have greater incidence in this type of institutional setting. Indeed, most cases of divided government in the sample (64 percent to be exact) are to be found in presidential countries. Notice that the introduction of political system in a model with divided government renders the latter insignificant.

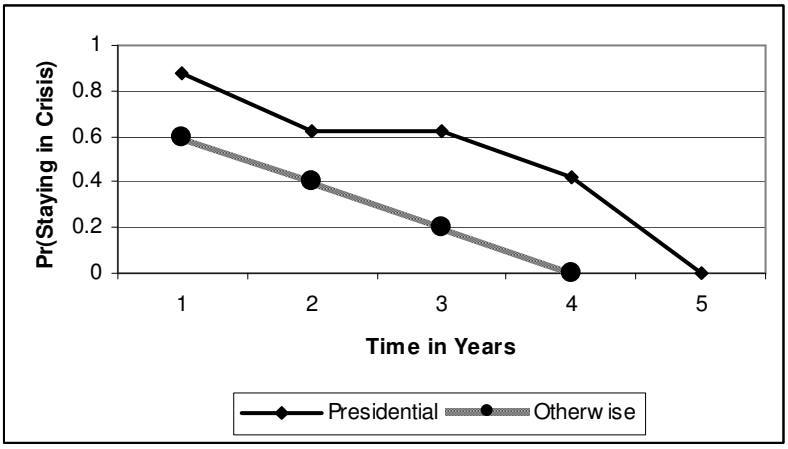
Regressions run excluding non-democratic countries did not affect the sign or statistical significance of divided government. When observations were filtered by political system, however, divided government was only significant for presidential countries. In parliamentary countries divided government remained positive but lost all statistical importance.

The typical country in the sample is presidential but does not exhibit divided government. Simulations based on Model 3 show that, under divided government, the expected duration of the crisis in this country would be almost a year longer. For the hypothetical developing country

case, which is also presidential and does not exhibit divided government, the duration of the crisis under divided government would increase by almost 22 months. Latin American countries have, for the most part, presidential systems and, unlike in the previous hypothetical countries, governments here are typically divided. Results from the simulation exercises show that a unified government in the typical Latin American country would reduce the crisis duration by a little more than seven months. Finally, the typical democratic country in this sample is not presidential but tends to have divided government. In this case, the reduction in the crisis duration associated with a unified government lies in the vicinity of one year.

Indeed, it looks like divided governments in presidential systems make a difference in terms of crisis duration. Further visual confirmation can be found in Graph 2.5 below. All the episodes graphed below coincided with instances of divided government. Clearly, the probability of staying in crisis for presidential countries with divided government declines at a much slower rate than for non-presidential countries even when they exhibit divided government (i.e. minority government).

Graph 2.5. Kaplan-Meier Survival Estimates for Political System by Divided Government



In sum, since divided government is a manifestation of power dispersion across the executive and the legislature, the results suggest that it is at those stages when both institutional actors need to coordinate that delays are more likely to happen – delays that, in turn, induce longer crisis management and resolution processes.

2.9 RESULTS AND INTERPRETATION: RECOVERY TIME.

Let us now turn to the other dependent variable being analyzed in this chapter, namely, the time it takes for economies to recover after the onset of the financial crisis. Graph 2.6 shows that the probability of staying in crisis declines faster during the first three years into the crisis. After that, the probability continues to decline as a function of time at a steady but slower rate.

Graph 2.6. Kaplan-Meier Survival Estimate for Recovery Time

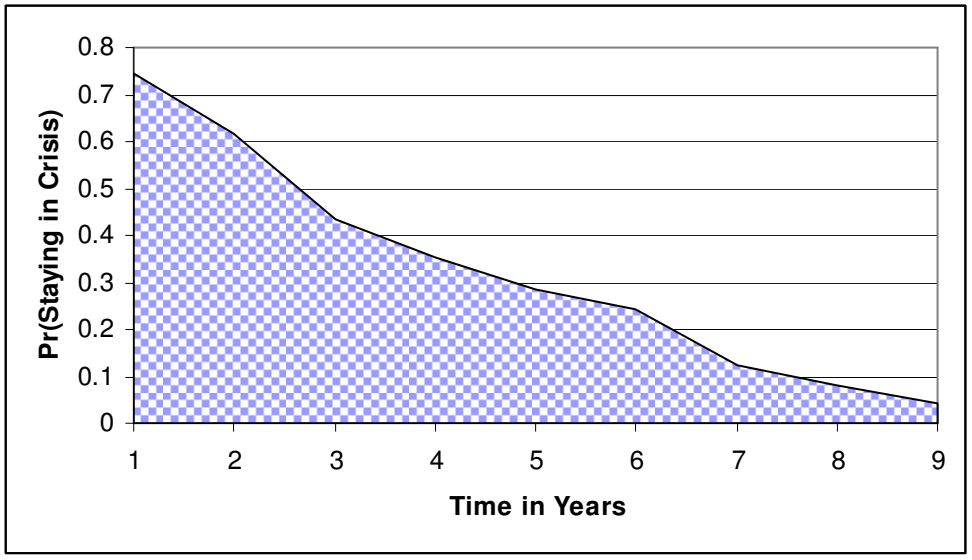


Table 2.3 below presents the main results from experiments run on recovery time using a multivariate approach. Just as before, the analyses proceeded in stages, looking at one category of variables at a time. The examination of constitutional features yielded rather inconsistent

results but, for the most part, neither regime type, nor political system or legislative system turned out significant to explain recovery time. One interesting exception is democracy in the full model (Model 3) that produces a positive and significant coefficient. Given the way in which recovery time is measured, this is likely the result of interactions between democracy and the economic covariates, particularly economic growth and openness.

Table 2.3 Constitutional features and recovery time – regression results

Standard errors adjusted for clustering on id[1]

Dependent variable: time to recovery

Independent variables	Model 1	Model 2	Model 3
Democracy	0.093 (0.278)	0.401 (0.375)	2.058** (0.541)
Political system	-0.261 (0.300)	0.241 (0.299)	-0.351 (0.263)
Financial sector size	0.009 (0.008)	0.008 (0.009)	0.015** (0.007)
Time in office	0.049** (0.018)	0.056** (0.022)	0.116** (0.027)
Democracy*Time in office		-0.088 (0.072)	-0.251** (0.092)
Economic growth			0.114** (0.038)
Interest rate changes			0.006** (0.002)
Economic openness			-0.121** (0.035)
Constant			-1.524** (0.467)
N	37	37	37
σ	1.594 (0.178)	1.616 (0.181)	2.114 (0.252)
Wald χ^2	12.86	12.43	68.69
Prob > χ^2	0.0120	0.0293	0.0000

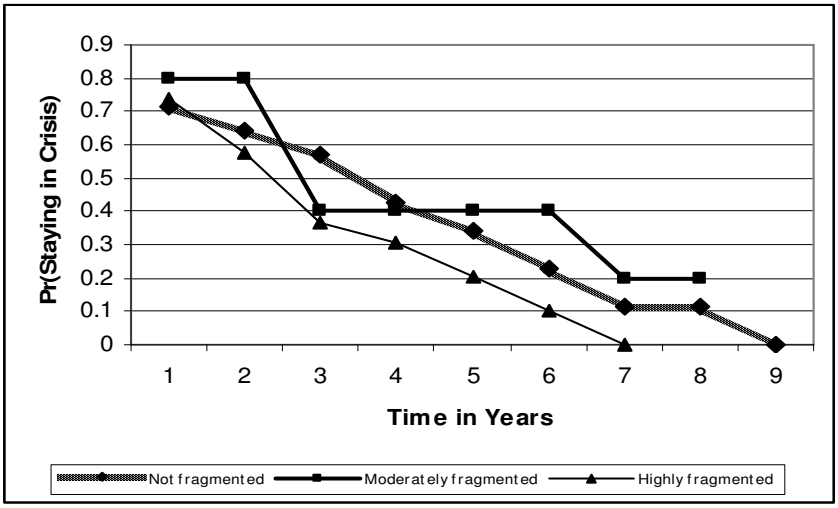
(1)Account for the fact that there is independence across observations from different countries but not across those from the same country.

(*)Significant at the 10% level; (**) Significant at the 5% level or better.

Something similar happens with the size of the financial sector. In the case of crisis durations, larger values of this variable were consistently associated with longer crises and coefficients were always significant. Here, coefficients on financial sector size remain positive

but they are only significant in the presence of macro-economic indicators, particularly measures of economic openness. Like in the analysis of crisis duration, the results indicate that time in office is consistently significant to explain recovery time, but the direction of the effect is the opposite. The coefficient on this variable suggests that the more time governments have spent in office by the time the crisis hits, the longer recovery will take.

Graph 2.7. Kaplan-Meier Survival Estimate for Opposition Fragmentation



As mentioned previously, some governments in the sample have remained in office for abnormally long periods of time – all of them non-democratic.[8] Therefore, an interaction term between democracy and time in office was used again to see the extent to which these cases are driving the results. Model 3 above shows that the coefficient on the interaction term is negative and significant. Democratically elected governments who have in office longer by the time the crisis hits tend to speed up recovery. This result supports the idea that the proximity of electoral

[8]These are countries in which, by the sample cut-off year or the year the country recovered from the crisis, governments have stayed in office between 10-20 years (Chile, Egypt, Malaysia, Philippines) or more than that (Cote d'Ivoire and Indonesia).

contests may create incentives for governments to intervene in the crisis. The fact that the coefficient on time in office remains positive and significant could, in principle, reinforce this interpretation.

In all statistical experiments on recovery time using other power dispersion variables, the one indicator consistently significant to explain recovery time was fragmentation of the opposition.

Graph 2.7 depicts the survival estimates for opposition fragmentation transformed into a three-value categorical variable. The transformation was done according to the following criteria:

- If opposition fragmentation was equal to zero, then it was equal to zero in the transformed variable;
- For values of opposition fragmentation greater than zero but smaller or equal to the median (40.27), the new value was set to one; and
- For values of opposition fragmentation above the median (40.27), the new value was set to two.

The graph shows that the probability of staying in crisis decreases faster for countries in which governments face highly fragmented oppositions, particularly during the first three years into the crisis. Recovery tends to be slower in the other two categories but, while countries where the opposition is unified (or inexistent) follow a relatively smooth pattern, those with moderately fragmented oppositions seem prone to a more erratic behavior.

More importantly, the regression results in Table 2.4 confirm that countries where governments face a more fragmented opposition do recover faster from financial crises. The results hold even when political system and democracy are incorporated to the model.[9]

Table 2.4 Power dispersion and recovery time – regression results

Standard errors adjusted for clustering on id[1]

Dependent variable: time to recovery

Independent variables	Model 1	Model 2	Model 3 $^{\Omega}$	Model 5 $^{\Omega}$	Model 6 $^{\Omega}$
Democracy		1.360**			
		(0.564)			
Political system		-0.787**	-0.474*		0.093
		(0.284)	(0.283)		(0.224)
Opposition fragmentation	-0.011**	-0.011**	-0.016**		
	(0.004)	(0.004)	(0.004)		
Number of effective vetoes				-0.292**	
				(0.146)	
Number of effective parties					-0.122**
					(0.044)
Financial sector size	0.025**	0.013*	0.025**	0.028**	0.026**
	(0.007)	(0.007)	(0.007)	(0.007)	(0.006)
Time in office at t	0.021	0.095**	0.058	-0.085	-0.018
	(0.013)	(0.029)	(0.055)	(0.062)	(0.047)
Democracy*Time in office		-0.141*			
		(0.082)			
Economic growth	0.021	0.090**	-0.030	-0.067	-0.046
	(0.021)	(0.034)	(0.030)	(0.051)	(0.031)
Interest rate changes	-0.001	0.003	-0.005**	-0.006	-0.003
	(0.002)	(0.002)	(0.002)	(0.004)	(0.002)
Economic openness	-0.086**	-0.095**	-0.117**	-0.146**	-0.140**
	(0.039)	(0.031)	(0.039)	(0.033)	(0.025)
Constant	0.185	-0.163	0.758	1.211**	0.359
	(0.356)	(0.732)	(0.411)	(0.572)	(0.358)
N	37	37	21	21	21
σ	1.976	2.461	2.900	2.328	2.408
	(0.309)	(0.502)	(0.698)	(0.400)	(0.524)
Wald χ^2	32.95	90.70	109.48	56.11	117.66
Prob > χ^2	0.0000	0.0000	0.0000	0.0000	0.0000

(1)Account for the fact that there is independence across observations from different countries but not across those from the same country.

(*)Significant at the 10% level; (**) Significant at the 5% level or better.

($^{\Omega}$)Models run on a sub-sample of democratic countries only.

[9]Opposition fragmentation and democracy have a positive but insignificant correlation (0.2058 with a p-value of 0.2151). However, opposition fragmentation and political system are negatively and significantly correlated (-0.4429 with a p-value of 0.0054).

This finding, while interesting, tells us little about how power distribution impacts recovery from crisis. A fragmented opposition is more commonly observed in systems that encourage the existence of multiple parties (through some form of proportional representation voting rules). Higher levels of legislative fragmentation and larger government coalitions may also accompany fragmented oppositions. None of these other factors turned out significant, however, in the analysis of recovery time for the whole sample.

As in the analysis of crisis duration, there are reasons to believe power dispersion variables do not perform better because the sample contains a large number of observations from non-democratic countries where variations in power distribution are either inexistent or more difficult to assess. With this in mind, further tests were run on a sub-sample of democratic countries only. The picture that emerges is quite different from that obtained on crisis duration.

Notice in Model 3 from Table 2.4 above that the coefficient on opposition fragmentation is still negative and significant to explain recovery time. Results on political system are for the most part consistent with earlier output and indicate that separation of power is associated with faster recoveries. More importantly, further tests revealed that power dispersion in democratic countries is not an obstacle, but rather a facilitator, of economic recovery after a financial crisis. In a variety of model specifications both the number of effective vetoes and the number of effective parties were significantly associated to shorter crisis recovery periods. The results suggest that democratic systems characterized by greater competition and a multiplicity of veto points are better equipped to intervene in financial crises faster and more effectively than in democracies where power is more concentrated.

When power dispersion variables were examined in models of crisis duration using a sub-sample of democratic countries it was found that divided government, especially in presidential countries, was associated with longer crises. Coefficients on effective vetoes and parties were never significant but the direction of the effect was the same as that of divided government (i.e. positive). In models of recovery time for democratic countries only, divided government was never significant, but the sign was consistent with those on effective vetoes and parties (i.e. negative). Power dispersion thus appears to consistently exercise opposite effects on the duration of the crisis and the time it takes for the economy to recover from it.

An explanation for these contrasting results may be found in what recovery and duration are really measuring. As discussed earlier, these two variables are not necessarily equivalent and may, in fact, be capturing government responses that emphasize either the macro-economic or the banking-sector side of financial crises. While recovery time is a rather straightforward, objective indicator based on GDP fluctuations, crisis duration involves judgments based not only on macro-economic fundamentals but on banking sector indicators as well. In consequence, recovery time is more likely to pick up the effects of stabilization policies that, if successful, quickly translate into economic recovery. Crisis duration, in contrast, is probably more sensitive to policies targeting problem banks – in addition to macro-economic policies.

If this is true, the results for democratic countries suggest that, in the event of a financial crisis, higher levels of competition tend to outweigh potential coordination problems where power distributions are more dispersed but only in the first stage of the crisis – when the focus is on containing the problem, stabilizing the economy and recover investor confidence. Once we move to the next stages, when the sense of urgency has decreased and government responses

become sector-specific, distributional considerations are more likely to get in the way of successfully managing and resolving the crisis.

2.10. CONCLUSION.

The main point of theories that stress coordination failure as the main obstacle to policy reform is that the adoption of efficiency-enhancing economic policies is more likely to be delayed when power is more dispersed because, in these conditions, uncertainty over the distribution of the costs associated with these policies is higher and deciding actors do not have, in principle, the capacity to impose their preferred solutions on each other.

This chapter set out to examine the extent to which this framework could predict longer financial crisis durations and longer recovery periods. The results presented earlier must be considered with caution as they originate from a relatively small sample and variables potentially measured with error. Furthermore, it is always difficult to compare hazard models in terms of goodness-of-fit, as there are no statistics similar to those available for the standard linear model. Finally, the sample may also be affected by selection bias, a problem for which no standard correcting mechanism has been identified in the case of survival models.

That said, the evidence suggests that the effects of power dispersion are indeed relevant but not uniform across circumstances. When it comes to dealing with complex problems such as financial crises, more dispersed power distributions – expressed in a multiplicity of veto points and political parties – may generate strong enough incentives to undertake efficient policies at those stages when the stakes are high and quick but broad reactions (i.e. in the form of macro stabilization policies) are necessary to avoid an economic and financial collapse. Yet, once

governments need to move into the management and resolution stages of the crisis, power dispersion exhibits effects closer to those predicted by coordination failure theories.

Those theories also posit that there are intervening variables that may transform the incentive structure of decision-makers so that a solution to the coordination problem may be found or imposed. Particularly important in this regard are electoral contests. Some evidence was found that the proximity of elections, especially in democratic settings, appears to encourage shorter crisis durations and recovery periods but the results were not consistently significant. For the whole sample, elections seem to be much more relevant for crisis durations than they are for recovery time – and they are certainly not relevant to explain recovery in democratic systems. In any case, the results on power dispersion hold regardless of contextual factors such as the proximity of elections.

While not a key hypothesis to test in this analysis, the significant effects found on variables that proxy interest group influence deserves a few comments. Rather unexpectedly, the power of financiers seems to significantly affect crises duration and, to a lesser extent, recovery time. As Chapter 3 will argue, interest group influence is more commonly considered in the analysis of redistributive policies and other sector-specific measures. In addition, the variable used here to capture de influence of bank owners and managers is rather imperfect as a proxy for political influence insofar as it basically describes the size of the financial sector – and not other factors such as organization and/or representation. With this in mind, it is possible that the findings in this chapter only mean that crisis control, resolution and recovery are simply more difficult to achieve in countries with larger financial sectors not only because of how much work has to be done but also because of the greater impact this sector would have on the real economy.

Finally, the findings here presented are relevant for theoretical and empirical discussions about the role of institutions and institutional manifestations in shaping the decision-making process and specific economic outcomes. Specifically, they suggest that the efficiency-friendly effects of power dispersion (i.e. competition for office and for policy-making control) may vary depending on the nature of the decisions that have to be made at any point during the resolution of such a complex problem like a financial crisis. Separating those effects, however, may require a much closer examination at the crisis resolution and recovery processes. For this task, the two dependent variables used in this study have major limitations: they are extremely aggregated and, in consequence, do not distinguish between the different stages involved in managing and resolving the crisis or the policy decisions that have to be made at each stage. In this sense, a more detailed analysis of a few cases would be the logical next step.

Chapter 3: Power Distribution, the Fiscal Cost of Financial Crises, and Policy Choices

3.1. INTRODUCTION.

We have established previously that very rarely do governments abstain from intervening in a financial crisis. How they choose to intervene can make an enormous difference to the fiscal burden society as a whole would have to bear in the form of either higher taxes or spending cuts. The fiscal cost of financial crises has been a contentious issue and not only because in many cases it has reached significant proportions of the affected countries' GDP. In the eyes of many, the fiscal cost also reflects inefficient redistributions of resources to special interests at the expense of the public at large. The decision to bailout the financial system is a complex one because many factors come into play including, quite possibly, the influence – political, structural or both – of banks and other financial institutions. Yet, governments across the world face different sets of constraints and incentives that make them more or less receptive to the influence of special interests, and determine the extent to which they can impose their own policy preferences.

The second key argument in this study is that, while power concentration may facilitate expedite and decisive financial crisis resolutions, it is more likely to lead to more fiscally expensive ones because there is less competition over public resources and less checks on how they are allocated. In these circumstances, the probability of channeling fiscal resources to the financial sector and implementing obviously targeted measures would tend to increase but not

necessarily (or not exclusively) because of the sector's lobbying capacity – the crisis itself boots their leverage as financial collapse threatens the overall economy.

The chapter explores this argument in two stages. The first stage looks at the relationship between power dispersion and the total fiscal cost of the crisis. The international experience shows that governments use a variety of measures to assist their financial institutions, the majority of which ends up having a fiscal impact. Nonetheless, research has shown that while fiscal cost is a function of the measures implemented to deal with the crisis, their ultimate effect varies significantly. In judging the political economy of financial crisis intervention then, we need not only look at the final price tag but also at the choice of fiscally expensive strategies. In a second stage, the connection between power dispersion and three costly measures (open-ended liquidity support, deposit insurance, and forbearance) is evaluated.

While the findings here presented provide general support for the argument, they also present a number of interesting puzzles that certainly warrant further research and testing.

3.2. ECONOMIC RATIONALITY AND FINANCIAL BAILOUTS.

We may start our discussion by asking ourselves why governments decide to assist their financial systems in times of distress. This question is relevant because, at least according to pure economic rationale, this is not – and should not be – their automatically preferred choice.

Arguments in favor of financial assistance tend to stress the negative impact of the externalities associated with bank failure. These externalities emerge from the links between banks and the real economy and the role of financial intermediaries in the payments system.

According to this view, governments intervene to solve financial crises because they fear the economic effects of generalized financial collapse. This argument is not without merit.

First, bank failures may be different from firm failures in the number of economic agents that will be potentially affected. While the collapse of a firm will certainly affect its owners, workers and management – and even have some impact on the market where it participates – the failure of a bank will potentially affect thousands of depositors, creditors (including other banks) and borrowers. If a bank is unable to repay its creditors and starts calling in loans, it could induce the kind of financial shock wave that destroys many solvent firms and sound banks. If one bank fails, or is expected to fail, creditors may remove money from otherwise sound banks, as they might be unable to distinguish between solvent and insolvent institutions. Bank runs may, in turn, force banks to get rid of their assets and call in loans in an accelerated, emergency-like, fashion. In addition, bank failures may significantly disrupt the flow of credit to real economy agents forcing them to either contract production or, if they can, borrow abroad, increasing their vulnerability to exchange rate fluctuations.[10] Another important effect of credit crunches is their tendency to depress aggregate demand in the economy.

The second major externality associated with bank failures is the potential disruption to the payments system that results from banks being unable to settle the claims they hold against each other. Because clearance systems regularly handle significantly large sums of money, a

[10]Stiglitz and Weiss were among the first to call attention on the credit rationing problems that result from the adverse selection (high-risk borrowers willing to take up loans under a very high interest rate) and risk-aversion (on the part of banks) effects induced by initial credit contractions at the onset of a banking crisis. Because bankers will find further increases in the interest rate to their disadvantage, a failure in the credit market may follow: Joseph E. Stiglitz and Andrew Weiss, "Credit Rationing in Markets with Imperfect Information" in *The American Economic Review*, Vol. 71, No. 3 (Jun., 1981), pp. 393-410.

generalized payments failure may translate into economic paralysis as firms and individuals cannot carry on their regular transactions.

Despite these considerations, governments may choose not to intervene in a banking crisis. After all, sound banks may benefit from bank failures; provided they are perceived as sound, depositors would tend to redeposit their money in these banks.[11] Such banks could also buy assets of weak banks, which may result in a stronger banking system. Furthermore, the failure of one insolvent bank is less likely to lead to liquidity crises where modern financial markets can provide substantial resources to overcome short-term liquidity problems. The scenario of a payments system collapse is also unlikely, as central banks usually guarantee (either explicitly or implicitly) payments in the case of default.

Opponents of public intervention in financial crises have regularly used these arguments as a starting point to claim that bank rescues or bailouts can only encourage irresponsible behavior in the future since banks will not have incentives to avoid excessive risk-taking. In their view, the threat of bankruptcy is the best incentive bank owners, managers and liability holders have in favor of controlling risk (Goodhart et.al. 1998). The moral hazard problem is not limited to banks. Detractors of deposit insurance schemes have argued that guaranteed returns might tempt depositors to put their money in high-risk, high-return banks. This can further aggravate the weakness of the overall financial system and magnify the cost of potential future restructuring efforts (Dellas, Diba and Garber 1996).[12] If this logic is correct, depositors should

[11]Argentina's 1995 banking crisis is a case in point. During 1995 a significant amount of deposits was transferred from cooperative and public banks to private – domestic and foreign – financial institutions. The resolution of this crisis is one of the most inexpensive and short-lived in record.

[12]The authors have argued that this played an important role in the United States's savings and loans crisis. The Federal Savings and Loans Insurance Corporation charged a flat insurance premium of 1/12 of 1 percent on savings and loans deposits despite the high risk of their assets, and the rapid, sharp industry-wide increase in portfolio risk.

also be forced to share some of the crisis' cost insofar as they benefited from interest payments or other services provided by a bank that could really not afford to do so.[13]

In sum, for opponents of financial rescue operations, the best government response to financial distress should consist of tightening the belt around lending and portfolio abuses, replacing bank management, forcing insolvent banks to merge with solvent institutions, shutting down insolvent institutions, and aggressively pursuing defaulting borrowers in insolvent banks. This strategy would not only avoid "gambling for resurrection" on the part of banks with low or negative net worth – it would also keep bank failure externalities on check and minimize the fiscal burden society would have to bear.[14]

Without attempting to settle this debate, the previous discussion shows that there is no clear-cut efficiency rationale for financially assisting banks in the event of a crisis and, in turn, suggests that bailout decisions may be at least partially motivated by political concerns. The next section discusses this possibility – and the related implications – in more detail.

In fact, the premium was not raised until 1985 (to 5/24 of 1 percent). As a result, many financially distressed savings and loans institutions responded by offering higher than market interest rates on deposits, thereby attracting more funds, and investing in high-yield, high-risk assets: Harris Dellas, Behzad Diba and Peter Garber, "Resolving Failed Banks: The U.S. S&L Experience", Discussion Paper 96-E-22, Institute For Monetary and Economic Studies-Bank of Japan, 1996.

[13]This logic mostly applies to large depositors (e.g. corporations and other financial institutions) since they are best equipped to monitor banking performance.

[14]The term "gambling for resurrection" was introduced by Akerlof and Romer to describe a moral hazard problem that may arise at the onset of banking crises. Banks with negative or low net worth, and that operate under limited liability (because of explicit or implicit depositor protections), have incentives to undertake excessive risks in an attempt to recover their investments. They are likely to invest in projects with a low probability of a high payoff but which do not cover their risk and, therefore, pose an expected loss. The longer these problem banks are allowed to operate the higher the risk of massive losses and larger public interventions: George A. Akerlof and Paul M. Romer, "Looting: The Economic Underworld of Bankruptcy for Profit", NBER Working Paper No. R1869, April 1994.

3.3. POLITICS AND FINANCIAL BAILOUTS.

One important conclusion from the previous section is that governments need not provide financial assistance to banks in order to shield the country from the consequences of a crisis. Yet, time and again they do and frequently with significant distributional consequences. Although a welfare-maximizing rationale on the part of government cannot be discounted, it is fair to claim that, at least in the short run, bank owners and managers may benefit from a variety of measures, including (but not limited to) fiscal and quasi-fiscal transfers.

Consider, for instance, the government forbearance of severely undercapitalized or insolvent institutions as opposed to their intervention. A theoretical justification for this approach stresses the need to provide some breathing room for otherwise responsible institutions and their managers in the event of an unpredictable shock – the theory obviously assumes that these institutions would be able to recover on their own. In practice, however, it is difficult to determine exactly how responsible such institutions have been because, at best, bank regulators and supervisors only have imperfect information about the extent to which management has contributed to the banks' problems. In these circumstances, forbearance is only likely to encourage excessive risk-taking and even looting. In the end, losses will accumulate and these banks will have to be intervened anyway, but at a much higher cost.[15]

[15]Akerlof and Romer discuss the cases of Albania and Benin, for example, where governments did not intervene and losses approached 100 percent of national income. Social unrest, civil war and violent regime changes tended to follow, and depositors were rarely indemnified: Ibid. White analyses the savings and loans crisis in the United States. Savings and loans institutions first incurred significant losses during 1980-82, mostly due to maturity mismatches. Authorities then allowed them to offer adjustable rate mortgages, consumer credit, and commercial real estate loans. While these institutions were able to reduce the share of home loans in their total assets as a result, the new policy created the incentives for them to move to areas where they did not have the necessary expertise. In addition, this expansion was not accompanied by adequate prudential regulation and supervision on the part of American authorities. Other policy measures that might have contributed to the crisis were the relaxation of interest rate ceilings on deposits, the increase in deposit insurance limits, and the decision to tolerate these institutions reporting their assets at values higher than standard accounting rules allowed: Lawrence J. White, *The S&L*

The question then arises: why do governments forbear? One possibility is lack of capacity to intervene in all troubled institutions during a crisis. Another is to let bank owners hang on to their business in order to increase profits as much as possible before intervention and, maybe, even get a rent in the process.

Government forbearance can be even more damaging because it is typically not used in isolation. Rather, forbearance tends to be accompanied by open-ended liquidity support schemes. In theory, liquidity support may be a good idea during a crisis as an emergency measure for fundamentally solvent banks with short-term liquidity problems preventing them from meeting their obligations. To be effective and minimize moral hazard problems, this type of assistance needs to be (credibly) provided for a limited time and in limited amounts at penal (i.e. above-market) interest rates (to encourage recipients to repay early), and should be contingent on the shareholders presenting a restructuring plan for the bank.

In practice, however, it may be difficult for authorities to distinguish between illiquid and insolvent institutions, particularly if adequate oversight does not exist.[16] Also, they may lack the institutional means necessary to make credible commitments (i.e. threats) and extract performance in exchange for support. As a result then, liquidity support schemes frequently just pump up artificial life into already failed banks delaying crisis recognition and increasing the

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Debacle: Public Policy Lessons for Bank and Thrift Regulation (Oxford University Press, 1991). In a recent paper, La Porta, López de Silanés and Zamarripa (2002), find compelling and significant evidence of looting in Mexican commercial banks prior to the 1994-95 financial crisis and even throughout 1995: Rafael La Porta, Florencio Lopez-de-Silanes and Guillermo Zamarripa, "Related Lending", NBER Working Paper 8848, 2002.

[16]The main problem seems to be the composition of bank assets, which may include a large proportion of junk bonds, non-performing portfolios and other assets with no ready market value. Lack of transparency in accounting standards does not help either.

costs of intervention.[17] The only likely beneficiaries here are the owners and managers of irresponsible institutions who take advantage of government forbearance and financial assistance for their own benefit at the expense of taxpayers. The obvious question is: Why do governments let this happen? At least two possible answers arise, both of which will be presented in a rather simple manner for the moment. A common official position is that banks cannot be allowed to fail and depositors to lose their savings without causing irreversible damage to the economy. An alternative explanation would stress the influence of the banking sector and even other interest groups such as large depositors.

Finally, consider the (perhaps slightly more complex) case of deposit insurance introduced in response to financial crises. Such schemes may exercise a positive influence on the bank restructuring process if they can reduce the incentive of market participants to withdraw funds from banks by providing a guarantee on their savings. This protection is particularly relevant in the case of small depositors since they are typically unable to appraise the quality of banks' portfolios. By doing this, deposit insurance schemes may even encourage competition.[18] Deposit insurance schemes can also contribute to discourage lobbying for (potentially more expensive) alternatives or the multiplication of lawsuits against financial institutions, all of which usually delay crisis resolution and may increase fiscal costs.

Available evidence shows, however, that whenever deposit insurance schemes have been absent, the cost of the crisis has been significantly lower (García 1999, Honohan and Klingebiel 2002). The explanation in this case is related to the main challenge in designing deposit

[17]During the 1994 crisis in Venezuela, for example, eight banks were granted special liquidity lines to deal with massive withdrawals because they were believed to be illiquid but solvent. A few months later all these banks were unable to repay and had to be intervened.

[18]This argument rests on the assumption that, under certain circumstances, depositors may uncritically avoid smaller financial institutions and favor state-owned banks, large private banks, or foreign banks.

insurance, namely, providing credible protection without encouraging moral hazard. On the one hand, depositors must believe their savings will be protected in the event of a crisis in order to avoid a generalized panic. On the other, coverage must be limited enough to encourage large market participants to monitor bank soundness. In reality, however, risk pricing is extremely complicated given the difficulty to forecast financial crises and, as a result, most deposit insurance schemes establish inadequate risk premia.[19] In many countries the situation is even worse due to the lack of sufficient public resources to back up guarantees, and the absence of adequate regulation and supervision. In these cases, deposit insurance is more a threat than a safeguard to financial stability.

Given the potential disadvantages, the decision to establish deposit insurance may be politically motivated. Depositors, after all, are voters too and public scrutiny may compel governments to show responsibility and concern for their well-being – especially if elections take place during a crisis. Universal or quasi-universal coverage, however, invites a few market participants (mainly banks and large investors) to profit at the expense of the general public. In the eyes of many, this is only evidence of collusion between government and powerful interest groups.

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[19]Under this policy, insurance premia vary with the risk level of each individual bank, so that weak or poorly capitalized banks are forced to pay more. In order to avoid adverse selection, the deposit insurance scheme is made compulsory for all financial institutions. A study by Garcia analyzes 17 cases in which an expected cost of crisis was calculated and used to establish target levels for deposit insurance schemes (often expressed as a proportion of the total number of guaranteed deposits). The study finds that in only four of these cases it was possible to accumulate enough funds to meet the target: Gillian Garcia, "Deposit Insurance: Actual and Good Practices", IMF Working Paper WP/99/54, 1999.

3.4. FINANCIAL CRISES AND THE POLITICAL ECONOMY OF POLICY-MAKING.

If indeed financial bailouts are at least partially the result of political considerations, the obvious question then becomes under what conditions are governments more likely to choose this course of action. Pluralist perspectives on policy-making would argue that policy is designed to favor those interest groups capable of offering the greatest support to politicians.[20] According to this view, bank bailouts would occur for two reasons. First, powerful groups with at stake in the banking system may find the absence of government help sub-optimal and will push for a more active role. Second, the bargaining power of those involved could have shifted with the crisis, forcing politicians to adopt policies according to the new balance of interest group demands.

Following this rationale, the impetus for government assistance will come from banks, creditors, and depositors but the final outcome would depend on these groups' relative balance of power at the bargaining table. This, in turn, is the product of a variety of factors, most importantly, the group's position in the economy and their capacity for organized behavior. In any case, it is argued, bailouts are little more than politically motivated, inefficient, wealth transfers from the less well off to the extremely wealthy.[21]

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[20]This theory was originally developed by Stigler (1971) to explain regulatory policy. It was later refined by Pelzman (1976) and generalized by Becker (1983) and others. Applications to financial markets can be found in Frieden (1991), Hamada and Horiuchi (1987), Hammond and Knott (1988), Rosenbluth (1989), Goodman (1991), Posen (1993), Clark (1993, 1994), and Keefer (2002).

[21]Referring to international bailouts of private bankers in Asia, Calomiris (1998) argues that they "perpetuate financial inefficiency and crony capitalism by providing the political cover for transfers of resources from the middle class to governing kleptocrats". Moreover, "[international] bailouts cannot disguise themselves behind the veil of legitimate panic prevention. Rather, they are designed to channel taxpayer wealth into the hands of insolvent banks and their claimants to insulate the politically powerful from the losses produced by their own excessive risk taking": Charles W. Calomiris, "The IMF as Imprudent Lender of Last Resort" in *Cato Journal*, Vol. 17, No. 3 (Winter), 1998.

Although some observed bailouts may substantiate this account, the pluralist approach assumes government officials and politicians bear no cost in bailing out the financial system. Contrasting, more state-centered approaches see policy rather as a reflection of purposive behavior on the part of government officials in order to further their own interests (Goodman 1991, Bates and Kruger 1993, Lukauskas 1997). Unlike the pluralist approach, this framework considers that government does not simply respond to the demands voiced by particular interest groups. Rather, government officials are a driving force behind policy formulation insofar as they need to ensure their political survival. This claim highlights the competitive nature of the political arena and the way in which those who prevail in the competition for office must respond to the pressures and incentives that originate within it in search for political support. According to this perspective, governments will be forced to consider how intervening to solve a banking crisis may advance or hurt their (re) election probabilities.

A now increasing body of literature studies how political institutions affect policy decision-making. Some scholars have explored the extent to which different institutional arrangements facilitate or hinder the production of private benefits (as opposed to public goods or general welfare-maximizing policies). Persson, Roland and Tabellini (1997, 2001) for instance, discuss the problem looking at basic constitutional features such as presidentialism vs. parliamentarism. Lizzeri and Persico (2001) concentrate their analysis on variations in electoral systems. Other studies focus more specifically on the policy consequences of variations in the allocation of authority across relevant decision-makers in the system, as well as the ideological distance between them (Tsebelis 1995 and 2000, Alesina and Drazen 1991, Spolaore 1992, Humphreys and Bates 2001, Keefer 2001, Haggard, McCubbins et. al. 2002).

The key insight from this body of work is that changing policy becomes increasingly costly as the number of parties to a negotiation increases. This implies that the influence of a particular group is kept in check as long as enough divergent interests are provided with veto power.[22] In the context of financial crises, this framework suggests that fiscal transfers to the financial sector should be a decreasing function of power dispersion, at least to the extent that expenditures target a particular group disproportionately or the transfer strategies lack a broader (i.e. public) appeal.

The following sections test the hypothesis on a number of dependent variables that capture cross-national variations in the total fiscal cost of the crisis and in the probability of choosing three expensive measures: deposit insurance, forbearance and liquidity support. Alternative hypotheses derived from the pluralistic (i.e. interest group influence) and state-centered approaches (i.e. competition for political power) are also evaluated.

3.5. THE DEPENDENT VARIABLE: FISCAL COSTS AND BAILOUT STRATEGIES.

One way of measuring the magnitude and even the severity of a financial crisis is to quantify its fiscal cost, which is usually defined as the ratio of the total public outlays incurred to shore-up and restructure the financial system as a proportion of GDP.

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[22]It is important to mention that the literature on pork barrel spending has suggested that greater numbers of veto players may have an effect opposite to the one described above. Schwartz, for instance, argues that incentives to redistribute resources to narrow interests are increasing in the number of veto players because the benefits each can obtain from attending broader constituencies decreases with number: Thomas Schwartz, "Representation as Agency and the Pork Barrel Paradox" in Public Choice, Vol. 78, No. 1 (January), 1994. Shugart and Haggard claim that this is a particularly pervasive effect of presidential systems because, in addition to a separation of powers, there is actual separation of purpose between the executive and the legislature which makes legislators less interested in providing national policy: Matthew S. Shugart and Stephan Haggard, "Institutions and Public Policy in Presidential Systems" in ed. Stephan Haggard and Mathew D. McCubbins, *Presidents, Parliaments, and Policy* (Cambridge University Press, 2001).

Work on the determinants of the fiscal cost of financial crises is not abundant and has, for the most part, focused on documenting and evaluating international experiences in the use of different policy instruments. Thanks to this work we now know that governments tend to adopt one or more of the following measures:

(a) *Liquidity support*, comprising measures such as central bank credit, government deposits, and long-term financing.

(b) *Deposit freezes,* which immobilizes most or all bank liabilities and tightens the financial system's liquidity;

(c) *Deposit guarantees*, which are formal insurance schemes to fully or partially protect depositors – bank liabilities – in the event of bank failure;

(d) *Forbearance* of severely undercapitalized and/or insolvent institutions either by way of allowing their continued operation under existing management or a replacement, or by temporarily relaxing financial regulations including prudential standards such as loan classifications and loan loss provisioning requirements;

(e) *Repeated re-capitalizations* to insolvent or marginally insolvent institutions yet considered viable in the form of equity or through the issuing of hybrid debt instruments or subordinated debt[23];

(f) *Asset management corporations* to acquire, restructure and sell impaired (non-performing) bank assets; and

(g) *Debt-relief programs* to help borrowers meet their obligations and thus indirectly assist troubled banks.

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[23]Hybrid debt instruments are characterized by the following conditions: they are unsecured, subordinated and fully paid-up, they are not redeemable at the initiative of the holder or without prior consent of the supervisory authority, they are available to participate in losses without the bank being obliged to cease trading, and debt service obligations can be deferred. Subordinated debt usually has minimum maturity of five years, is subject to specific amortization arrangements, and represents no more than 50% of banks core capital.

Most economists and financial experts have focused on recommending or discrediting these measures on the basis of economic theory and a number of case observations (Amieva and Urriza 2000, Daniel 1997, Enoch et. al. 1999). Although it had been generally believed that each one of those policies added differently to the fiscal cost of the crises, it was not until recently that policy research became more systematic at quantifying the impact of individual policies for a larger number of countries.

The paper by Honohan and Klingebiel (2000) is the landmark study in this regard. Using a sample of forty crisis episodes around the world for which data on costs and the nature of the resolution and intervention policies was available, they developed a model to measure the individual contribution of each policy to the total fiscal outlays associated with the crisis as a proportion of GDP. Their empirical findings reveal that, holding economic and financial fundamentals constant, all the policies mentioned above (with the exception of deposit freezes) have a sizable impact on fiscal costs. Only three of them, however, were consistently and highly significant across all their model specifications: deposit guarantees, liquidity support and forbearance. The policy-specific analysis in this chapter will focus on these three instruments.

3.6. METHODOLOGY: SAMPLE DATA, VARIABLES AND STATISTICAL MODELS.

The main purpose of this chapter is to quantify the impact of power dispersion on the magnitude of the total fiscal transfers made to resolve financial crises and on the choice of bailout strategies in order to understand under what institutional conditions are special interests more likely to be benefited. The study is conducted considering a number of variables that

capture variations in power distributions across polities controlling for a number of factors that may have an incidence as well.

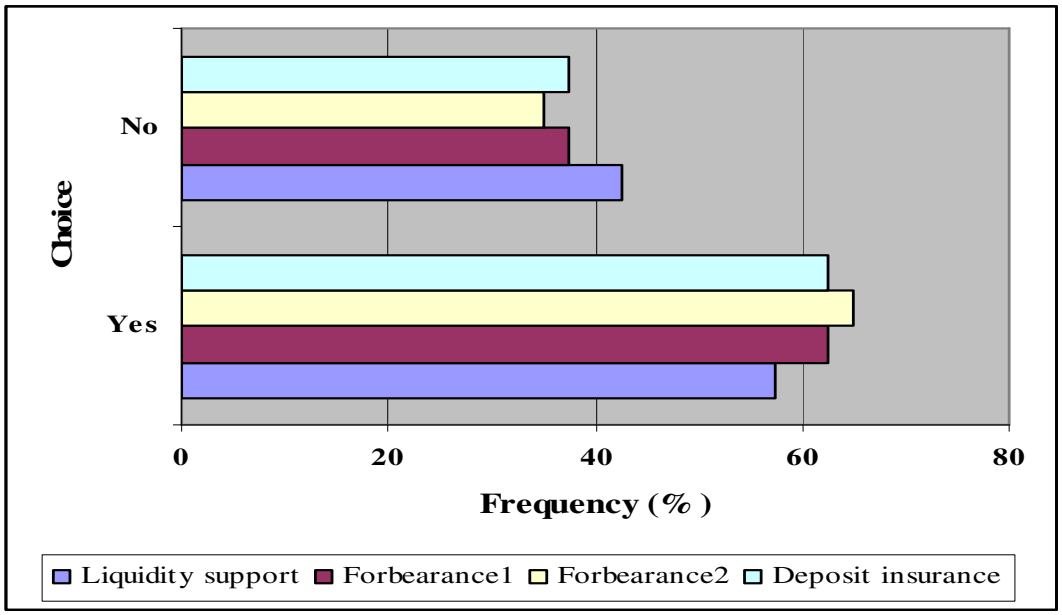
The sample in this case includes the same country-crisis episodes used in Chapter 2 (40 crisis episodes in 35 countries across the world for which complete and reliable data on fiscal costs and government responses to the crisis are available). Table A.2.6 in the Data and Statistical Appendix presents information on the fiscal costs associated with each episode.

On average, countries in this sample have spent in excess of 12 per cent of their GDP to assist their financial systems. Outlays have been larger in non-democratic and developing countries. On average, democratic countries (including relatively new democracies) have used approximately 9 per cent of their GDP while in non-democratic countries the typical bailout accounts for almost 20 per cent. Similarly, financial crises in developing countries have taken a larger toll with a little more than 14 per cent of GDP whereas those in the industrialized world have represented a more moderate – though still significant – 8 percent of GDP on average.

Chart 3.1 above provides information on the in-sample incidence of those assistance measures found fiscally expensive (see Table A.2.7 in the Data and Statistical Appendix for a comprehensive breakdown). With a few exceptions, the majority of countries in the sample have recurred to these instruments in order to deal with financial crises.

Once more, it should be pointed out that this sample is not exhaustive. As before, a large number of country-crisis episodes have been left out due to lack of reliable data. In addition, the total number of observations considered in each experiment may adjust downwards if missing data exist for a particular variable being used. Despite these shortcomings, it is still possible to obtain valuable, general insights from the results.

Graph 3.1 Frequency of expensive assistance measures in sample



Two types of dependent variables have been defined for this analysis: (a) a continuous-like variable which takes on values equal to the fiscal costs reported for each crisis episode in the sample; and (b) categorical variables describing the use (or non-use) of the policy instruments identified previously as particularly expensive.

The independent variables used have been classified in two groups: study variables and control variables. The choice of study variables pretty much follows the discussion from Chapter 1 and are very similar to those used in Chapter 2 but have been adjusted to conform to different econometric techniques. Summary statistics for all the study variables by sub-category, as well as detailed descriptions and sources, may be found in Table A.2.8 in the Data and Statistical Appendix.

The control group comprises variables describing economic and banking industry conditions. These descriptors are necessary because many crises were triggered or exacerbated

by exogenous economic shocks and/or difficulties being experienced by members of the financial industry (Caprio and Klingebiel 1995, Gorton 1988, Kaminsky and Reinhart 1998, Lindgren et. al. 1997). Macro-economic variables, such as the interest rate or GDP growth for instance, may have an effect on fiscal cost measures because they partially determine the nominal value and real magnitude of banks' assets and liabilities. Likewise, banking system indicators capture their accounting position and risk exposure, factors that have a direct incidence on the amount of fiscal transfers to the financial sector. In addition, it is not unreasonable to assume that governments keep track of both macro-economic and banking sector indicators when making policy decisions about how to assist their financial systems.

The control variables used here are very similar to those used in Chapter 2 but they have been adapted for different econometric techniques. In brief, the macro-economic variables are: real interest rates on deposits, GDP growth, change in equity prices, current account as a proportion of GDP, fiscal balance as a proportion of GDP, change in terms of trade, and foreign debt as a proportion of GDP. Also used were variables that control for income level, regional effects, and previous crisis experiences. The micro-economic (banking industry) control group includes measures of capitalization, bank borrowing, and liquidity. A variable that captures whether the origins of the crisis were predominantly microeconomic or not was also tested.

Due to the nature of this sample, it was possible to use available indicators on economic institutions, specifically, the efficiency and reliability of the rule of law. Previous studies have shown that inadequate legal systems, incapable of protecting property rights and enforcing contracts, may increase the probability of a more expensive financial crisis.[24] To take these

[24]For example, inadequate contract enforcement can make asset recovery more difficult in cases of loan default.

potential relationships into account the study uses, whenever possible, measures of the quality of the legal system and of contract enforcement.

Finally, the analysis makes use of two types of statistical models. First, to explain variations in the total fiscal cost of crises, a series of standard linear models were specified. Second, to estimate the probability of choosing a particular policy instrument, a succession of probit models was constructed.

3.7. RESULTS AND INTERPRETATION: TOTAL FISCAL COSTS.

This section looks at the main results obtained on the total amount of fiscal transfers associated with the crisis resolutions. All bailout and other crisis-fighting strategies were consciously excluded from the analyses in order to identify directly the effects, if any, of power dispersion. It is important to mention at the outset that the results may be capturing the effects of missing policy variables and it is for this reason that further experiments – using bailout strategies as dependent variables – are necessary. For now, the results are intended to answer two main questions: Under what institutional conditions are decision-makers more likely to authorize significant transfers of public resources to the financial sector during a crisis? Does power dispersion facilitate or hinder authorization of such transfers?

The main results of linear regressions run on total fiscal costs are presented in Table 3.1 above. Because a good number of observations in the sample come from non-democratic countries it was worth testing whether regime type, *per se*, was an important factor. Model 1 below shows that democracy is only borderline significant, but has a sizable negative effect on total fiscal costs.

Another constitutional feature, the political system (i.e. presidential or otherwise), has a positive and sizable effect on fiscal cost that is also statistically significant. The coefficient on political system suggests that, on average, total transfers to the financial sector tend to be between 8 to 11 percentage points larger in presidential systems.

Table 3.1 Fiscal cost – regression results for whole sample

Dependent variable: total fiscal cost

Standard errors (in parenthesis) adjusted for clustering[1]

Dependent variables	Model 1	Model 2	Model 3
Democracy	-8.546* (4.951)	-7.651 (5.874)	
Political system	8.637** (3.639)	9.641** (3.716)	10.78** (3.394)
Size of financial sector	0.175** (0.066)	0.169** (0.085)	0.192** (0.076)
Time to next elections at t	0.105 (1.291)	-0.099 (1.360)	0.051 (1.334)
Per capita GDP t-1		0.0000 (0.0004)	-0.0003 (0.0003)
GDP growth t		-0.347 (0.248)	-0.384* (0.225)
GDP growth t-1		0.773 (0.507)	0.928* (0.542)
Constant	5.523 (7.525)	2.805 (7.759)	-2.271 (5.162)
N	39	38	38
N (Clusters)	33	32	32
F	4.65	4.19	3.89
Prob > F	0.0045	0.0024	0.0052
R^2	0.2735	0.3404	0.2929
Root MSE	12.439	12.615	12.849

[1]Adjusted standard errors account for the fact there is independence across observations from different countries but not necessarily across those from the same country.

(*)Significant at the 10% level; (**)Significant at the 5% level or better.

Without controlling for any other relevant factors yet, Model 1 also shows that the size of the financial sector has a positive and statistically significant effect on total fiscal costs – crisis-related fiscal outlays increase in 0.18 percentage points for every one percent increase in the size of the financial sector relative to GDP. The expected contribution of financial sector size to fiscal costs is in the order of 7 percentage points.

Model 2 presents the results of the model estimated with controls. Of all the micro and macro economic variables considered in the experiments only GDP growth had explanatory power over variations in fiscal cost. While other variables had the expected signs, they were not statistically significant. That GDP growth loses significance when entered into the full model is the result of having democracy in the equation (compare Models 2 and 3). The coefficients indicate that where economic fundamentals seem healthier the resulting fiscal cost tends to be higher. That better income levels ex-ante result in higher fiscal costs suggests that governments may be more willing and capable of making transfers to the financial sector in those circumstances than when growth dips – as typically happens when the crisis hits – and voters may be more resentful of such actions. That no micro-economic control variable was significant suggests that the decision of how much fiscal resources will be transferred to the financial sector during a crisis does not depend on how healthy banks actually are, or are thought to be, a finding that may support the idea of a political rationale for bailouts but not conclusively.[25]

Hypotheses related to electoral incentives and the quality of the rule of law were tested in all model specifications. No evidence was found on any of these factors having a significant effect of the fiscal cost of crises. None of the variables intended to capture the timing of elections yielded statistically significant results. The coefficient on the proximity of elections, the variable in the data set that best captures electoral incentives, illustrates this point. While it indicates that the further away next elections are the larger fiscal outlays tend to be, the coefficient was never significant in any model specification. In fact, while proximity of elections is only somewhat

[25]An alternative interpretation could be that authorities are simply unable to distinguish between technically failed from troubled but viable banks and decide to support the entire system.

correlated with democracy and GDP per capita, the coefficient is so tiny in magnitude that is quite sensitive to the introduction and/or exclusion of these variables.[26]

The index variable specifically measuring the extent to which property rights are protected and contracts rightfully enforced (quality of legal institutions) always yielded a negative coefficient (which suggests that better economic institutions are indeed correlated with lower fiscal costs) but was never statistically significant. Notice that the coefficient on per capita GDP – another variable that proxies institutional quality – is also negative (except when democracy is present) and not significant in any model specification.

The remaining study variables were tested excluding all constitutional features. These were later added to the models as "controls" of sorts when appropriate. The main results are presented in Table 3.2 below.

All the power dispersion/competition variables turned out negative in a variety of regressions but only the level of constraints on executive authority and the index of electoral competition proved significant to explain variations in fiscal cost when used in isolation. The coefficients indicated that a more constrained executive and more competitive elections are both negatively associated with fiscal costs. Yet, while for every additional constraint on the executive's authority (on a scale from 0 to 7) the fiscal cost decreases in nearly 2 percentage points, every move along the competition index reduces the fiscal cost by approximately 8 percentage points at least, according to the results.

[26]The correlations between proximity of elections, on the one hand, and democracy and GDP per capita on the other are negative but not significant at typically accepted levels: proximity of elections and democracy = -0.2932 (p = 0.0663); proximity of elections and GDP per capita = -0.4045 (p = 0.0118).

Table 3.2 Fiscal cost – regression results for whole sample

Dependent variable: total fiscal cost

Standard errors (in parenthesis) adjusted for clustering[1]

Dependent variables	Model 1	Model 2	Model 3
Democracy	-4.754 (9.302)		-5.535 (4.965)
Political system	7.941* (4.226)		9.961** (3.703)
Constraints on executive	-1.196** (3.046)		
Electoral competition index		-9.276* (5.011)	-8.265* (4.605)
Size of financial sector	0.182** (0.071)	0.114 (0.072)	0.138 (0.102)
Time to next elections at t	-0.108 (1.265)	0.568 (1.153)	-0.419 (1.129)
Per capita GDP t-1			0.0002 (0.0005)
GDP growth t			-0.072 (0.331)
GDP growth t-1			0.811* (0.441)
Constant	10.02 (13.95)	30.95** (15.78)	24.76 (15.36)
N	39	39	38
N (Clusters)	33	33	32
F	3.95	2.10	3.68
Prob > F	0.0067	0.1204	0.0040
R^2	0.2787	0.2490	0.4611
Root MSE	12.581	12.465	11.598

[1]Adjusted standard errors account for the fact there is independence across observations from different countries but not necessarily across those from the same country.

(*)Significant at the 10% level; (**)Significant at the 5% level or better.

Once democracy and political system were entered into the equation, the level of constraints on the executive lost all significance. In the case of democracy, this is not surprising at all (in fact, the correlation between democracy and constraints on the executive authority is 0.8732 (p = 0.0000).[27] A bit more interesting is the correlation between executive constraints and political system, which is negative and highly significant somehow suggesting that chief executives in presidential systems tend to concentrate more power.[28]

[27]The constraints on executive authority index is one of the criteria taken into consideration to score countries across the democratic dimension in the Polity data set. Both the constraints index and the democracy variable used in this sample come from this source.

[28]The correlation between political system and constraints on executive authority is -0.5290 (p = 0.0004).

The story of the competition index is somewhat different. Because this variable was recoded in the sample to take on only three possible values (i.e. 0 to 3, indicating low, average and high levels of electoral competition), its correlation with both democracy and political system is much weaker.[29] Notice in Models 2 and 3 above that the result on the competition index is robust to the introduction of constitutional features and macro-economic controls. The coefficient, however, is not significant at generally accepted levels. Notice in Models 3 and 4 that financial sector size loses all significance, a result directly related to the absence of political system in these equations.

While these results are generally supportive of a negative relationship between power dispersion and the magnitude of transfers to the financial sector, coefficients on the relevant variables do not behave consistently, nor are they robustly significant across specifications. The strongest evidence comes from highly aggregated variables, specially the political system.

Certainly, democratic regimes are typically characterized by higher levels of authority fragmentation than non-democratic ones and, in fact, democracy is highly and significantly correlated with all the variables describing power dispersion and political competition in the sample. Yet, variations in power distribution and competition across democracies constitute a meaningful reality that such an aggregated variable does not capture.

The degree of authority concentration in presidential (as opposed to parliamentary) systems has been the subject of a long-lasting debate and arguments have been advanced suggesting more or less de facto concentration in presidential systems (see discussion in Chapter 1). In this sample, political system is significantly associated with most variables describing

[29]The correlation between democracy and the competition index is 0.2792 (p = 0.0810), and between political system and the competition index is -0.0908 (p = 0.5772).

power dispersion and with some of the variables capturing political competition. Most notably, presidential systems (political system = 1) are negatively correlated with the size of the governing coalition, the level of opposition fragmentation, the number of effective vetoes, and the degree of constraints on executive authority.[30] Of all the variables categorized as describing electoral competition, presidential systems are only significantly (and negatively) correlated with the number of effective political parties. Unfortunately none of those variables was found significant to explain variations in fiscal cost with the exception of the competition index, but even in this case the result is only borderline significant.

It is still possible that the poor performance of the power dispersion and electoral competition variables has to do with the fact that the sample includes a good number of observations from non-democratic countries. In non-democratic contexts, it is more difficult to observe and quantify political fragmentation and competition. Additionally, the fact that some of the correlations discussed above were affected by the exclusion of non-democratic countries suggests further tests are worth undertaking.

Table 3.3 presents the main results from regressions run on a sub-sample of democratic countries only. Models 1 and 2 illustrate that earlier results do not hold. Although still positive, neither political system nor the competition index are significant here, nor is any of the income variables relevant to explain variations in fiscal cost in democratic settings. Further experiments revealed that all variables measuring power dispersion/political competition turned out positive,

[30]The correlation coefficients and p values are as follows: between political system and coalition size = -0.4702, p = 0.0025; between political system and opposition fragmentation = -0.3537, p = 0.0471; between political system and effective vetoes = -0.3687, p = 0.0209; and between political system and executive constraints = -0.5290, p = 0.0004.

but only the size of the governing coalition was significantly associated with more expensive financial crises (see Model 3).

Table 3.3 Fiscal cost – regression results for democratic countries only

Dependent variable: total fiscal cost

Standard errors (in parenthesis) adjusted for clustering[1]

Dependent variables	Model 1	Model 2	Model 3
Political system	2.619 (4.374)	1.428 (4.669)	
Electoral competition index		3.815 (3.687)	
Size of governing coalition			3.955** (1.194)
Size of financial sector	0.156** (0.075)	0.179** (0.085)	0.033 (0.054)
Time to next elections at t	1.637 (1.145)	1.211 (1.213)	2.193* (1.311)
Per capita GDP t-1	-0.0002 (0.0004)	-0.0004 (0.0005)	0.0001 (0.0003)
GDP growth t	-0.258 (0.353)	-0.288 (0.390)	0.183 (0.355)
GDP growth t-1	0.134 (0.511)	0.097 (0.512)	0.181 (0.517)
Constant	-3.158 (3.712)	-11.41 (8.157)	-6.604 (4.486)
N	24	24	24
N (Clusters)	23	23	23
F	1.81	1.87	8.44
Prob > F	0.1428	0.1234	0.0001
R^2	0.3488	0.3754	0.5050
Root MSE	8.2919	8.3702	7.2289

[1]Adjusted standard errors account for the fact there is independence across observations from different countries but not across those from the same country.

(*)Significant at the 10% level; (**)Significant at the 5% level or better.

According to the results, every additional member in the governing coalition would increase fiscal costs by approximately 4 percentage points. Notice that for the first time an electoral variable acquires some salience in the models. The coefficient on the proximity of elections, while only significant at the 10 percent level, suggests that transfers to the financial sector are more likely to be authorized the further away the next electoral contest is in the calendar. More specifically, each additional year before the next elections translates into a 2 percentage point increase in fiscal costs. The size of the financial sector, however, becomes

insignificant once again after political system is excluded from the equation, suggesting that transfers would be made more autonomously than expected.

These results and those obtained earlier on the whole sample offer interesting contrasts. At the very least, they suggest that, despite their strong and positive correlation, political competition and power dispersion do not necessarily produce the same outcomes. They also seem to play out differently in democratic and non-democratic countries (i.e. emerging democracies) as well as in parliamentary and presidential systems. A similar general conclusion applies to the role of the financial sector. Before moving forward on this discussion, let us examine the results from probit models on expensive crisis-related strategies.

3.8. RESULTS AND INTERPRETATION: EXPENSIVE POLICIES.

In this section we examine the impact of power dispersion and electoral competition on the choice of the three bailout strategies deemed to be more fiscally expensive: deposit insurance, forbearance, and liquidity support. We argued earlier that not all policy instruments are created equal and the statistical results presented here show that, for the most part, this is true.

3.8.1. Deposit insurance.

The most relevant results from the probit regressions on deposit insurance can be found in Table 3.4. The evaluation of constitutional features in this case revealed that only regime type was relevant to explain the choice of deposit insurance. As reported below, democratic countries (democracy = 1) are significantly more likely to use deposit insurance than non-democratic ones. Presidential systems (political system = 1) were always less likely – and countries with bicameral

legislatures more likely – than their counterparts to use deposit insurance, but these features were never significant in any model specification.[31]

Table 3.4 Deposit insurance – probit results for whole sample

Dependent variable: deposit insurance after time t

Standard errors (in parenthesis) adjusted for clustering[1]

Dependent variables	Model 1	Model 2	Model 3	Model 4	Model 5
Democracy	1.704**	2.003**			1.521
	(0.668)	(0.964)			(0.957)
Divided government			1.626**	1.435**	0.998
			(0.581)	(0.705)	(0.694)
Size of deposit base	0.012	0.013	0.015*	0.017*	0.014
	(0.009)	(0.010)	(0.008)	(0.311)	(0.009)
Elections at time t	0.364	0.608	0.387	0.703	0.532
	(0.473)	(0.640)	(0.471)	(0.591)	(0.602)
Previous insurance[2]	-1.658**	-1.982**	-1.510**	-1.477**	-1.934**
	(0.522)	(0.726)	(0.586)	(0.577)	(0.651)
GDP per capita t-1		-0.0002*		-0.0001	-0.0002*
		(0.0001)		(0.0001)	(0.0001)
GDP growth t-1		-0.103		-0.147*	-0.082
		(0.075)		(0.088)	(0.072)
Capital flows		-0.314		-0.434	-0.229
		(0.363)		(0.331)	(0.341)
Level of bank reserves		-0.364		-0.221	-0.349
		(0.348)		(0.355)	(0.348)
Constant	-1.965	-5.878**	-1.678**	0.617	0.316
	(0.863)	(3.007)	(0.690)	(2.282)	(2.504)
N	39	37	38	37	37
Log-likelihood	-16.007785	-10.936138	-14.768552	-12.626614	-11.423065
Wald χ^2	10.66	31.60	12.71	25.61	24.45
Prob > χ^2	0.0307	0.0002	0.0128	0.0012	0.0036

[1]Adjusted standard errors account for the fact there is independence across observations from different countries but not across those from the same country.

[2]This variable controls for the fact that 16 countries had established deposit insurance schemes before the crisis episodes under observation.

(*)Significant at the 10% level; (**)Significant at the 5% level or better.

Although it could be argued that deposit insurance schemes benefit irresponsible bank managers and owners because it encourages them to take higher risks, the fact remains that many insurance schemes require that banks set aside a proportion of funds to establish and sustain them (funds typically backed up by government guarantees). It is unclear then whether a

[31]There is a somewhat significant and negative correlation between democracy and political system (-0.3831, p=0.0147) but the results cannot be attributable to this factor since models run excluding democracy and using only political system yielded very similar results. The correlation between democracy and legislative system is positive but not significant (0.2135, p = 0.2181).

financial system affected by a crisis would favor the creation of deposit insurance at least in the short run. The statistical analysis did not yield any meaningful result in this regard. While experiments showed that the financial sector is rather disinclined to support deposit insurance – coefficients on financial sector size were always negative – the results were never significant. In contrast, the size of the deposit base – while equally non-significant – always returned a positive coefficient and one that seemed to fit much better in the equation. After all, the main idea behind deposit insurance schemes (theoretically at least) is to protect depositors and, in consequence, a larger deposit base in a financial system under crisis is more likely to create an incentive in favor of some kind of shield.

Deposit insurance schemes need to be credible in order to achieve its purposes and that credibility depends in part on the quality of economic institutions. No evidence was found, however, on the connection between deposit insurance and institutional quality: coefficients on the quality of legal institutions index, while always positive, were never significant. No evidence could be found either on electoral considerations playing a meaningful role either in the decision to create a deposit insurance. None of the variables capturing electoral incentives produced statistically significant coefficients but all of them pointed in the same direction: deposit insurance is more likely to be put in place if the crisis coincides with an electoral year or as the incumbents' term is coming to an end and elections draw near. Elections at time t (i.e. electoral year coincides with the onset of the crisis) was chosen to illustrate this point.

As expected, the presence of deposit insurance before the onset of the crisis has a negative and significant coefficient. Model 2 presents the main results using other micro and macro economic controls. As expected, higher levels of bank reserves and the availability of

mobile capital tend to decrease the likelihood of creating deposit insurance. Something similar can be said about economic fundamentals: more prosperous societies and higher growth rates ex-ante both decrease the probability of observing deposit insurance in response to a financial crisis. Not all these variables, however, remained significant once entered into the model. Notice that the introduction of controls does not affect the results obtained from a condensed model (Model 1) but significantly improve its fit and explanatory power.

To evaluate the impact of variables measuring power dispersion/political competition on the probability of observing deposit insurance after the crisis democracy had to be excluded due to correlation problems. After removing democracy, variables such as government fragmentation, number of effective vetoes, and the index of electoral competition were somewhat significant in a number of specifications but only divided government showed consistency and high statistical significance across the board. The main results are reported in models 3 and 4 in Table 3.4 above. The coefficient on divided government suggests that whenever the party of the president does not control a majority in the legislature (in presidential systems) or a minority government is in place (in parliamentary system) deposit insurance schemes are more likely to be created in the event of a financial crisis. Yet, as expected, there is a high correlation between divided government and democracy so it is possible that the coefficient on the former is picking up the effects of the later – now missing – variable. Notice in Model 5 that when both variables enter the equation none of them is significant. The fit of the model seems to be better, however, when only divided government is used (and democracy is excluded).

Once again experiments on sub-samples of democratic and non-democratic countries were conducted to further evaluate the power dispersion/competition variables. As before, the

main shortcoming here is the drastic reduction in the number of observations which results in a variety of estimation problems. For this reason, all estimations had to proceed using condensed model versions, that is, specifications that excluded variables that while theoretically relevant proved insignificant throughout.[32]

Table 3.5 Deposit insurance – probit results for democratic countries only

Dependent variable: deposit insurance after time t

Standard errors (in parenthesis) adjusted for clustering[1]

Dependent variables	Model 1	Model 2	Model 3
Political system	-1.338* (0.765)		-1.058 (0.830)
Effective vetoes		-0.882** (0.298)	-0.908** (0.366)
Previous insurance[2]	-1.361** (0.604)	-1.779** (0.825)	-2.292** (1.084)
GDP per capita t-1	-0.0002** (0.0001)	-0.0001 (0.0001)	-0.0002* (0.0001)
GDP growth t-1	-0.128 (0.119)	-0.139* (0.077)	-0.107 (0.086)
Constant	2.318 (0.891)	4.296** (1.069)	5.811** (2.200)
N	24	24	24
Log-likelihood	-9.6928962	-7.6630806	-7.0465772
Wald χ^2	12.88	18.51	14.07
Prob > χ^2	0.0245	0.0010	0.0289

[1]Adjusted standard errors account for the fact there is independence across observations from different countries but not across those from the same country.

[2]This variable controls for the fact that 16 countries had established deposit insurance schemes before the crisis episodes under observation.

(*)Significant at the 10% level; (**)Significant at the 5% level or better.

The main results are presented in Table 3.5 above. Testing constitutional features once more yielded only a barely significant and positive coefficient for political system as Model 1 illustrates (divided government was positive but always insignificant). Further experiments with the dispersion/competition variables revealed, however, that the number of effective vetoes was highly significant and negative, suggesting that power dispersion in democratic societies

[32]This was the case of variables such as size of the deposit base, capital flows, level of bank reserves and elections at time t. Most of these variables turned out insignificant when used in regressions on the whole sample but were left in the model for their theoretical relevance without compromising proper estimation.

decreases the likelihood of creating deposit insurance schemes. This result is robust to different model specifications using other study and control variables. Notice, for instance, that the coefficient on effective vetoes is not affected by political system (Model 3).

While it would have been interesting to compare these results to similar output from non-democratic countries, this was impossible because there is only one instance in that sub-sample of a deposit insurance scheme put in place after the crisis hit. This explains in good part why the results on power dispersion are much better when non-democratic countries are not used in the regression and validates the fact that the effect of more dispersed distributions of decision-making authority on the probability of deposit insurance is negative.

3.8.2. Forbearance.

The analysis of forbearance considers two variables (both binary) based on those originally developed by Honohan and Klingebiel (2002) to represent progressively less liberal approaches. Under forbearance type 1, banks known to be severely undercapitalized were nonetheless permitted to continue operations under existing management. Forbearance type 2 captures whether (a) regulations (in particular loan classification and loan loss provisioning) were relaxed, (b) the current regulatory framework was not enforced for at least a twelve-month period, and/or (c) competition was restricted.[33]

An important assumption in the analysis of forbearance type 2 is that authorities have a very good idea of the situation of problem banks and yet decide to avoid intervention and/or

[33]The two types of forbearance are not mutually exclusive and have been frequently used in combination. Yet, there is no statistically significant correlation between them (0.0812, p=0.6184). This suggests that the decision to use one of them is independent of any previous forbearance choice.

make fiscal and quasi-fiscal transfers in the meantime. If these institutions end up being intervened at a later date, the cost to society is likely to be much higher. Suspicions of collusion between government and bank owners and managers tend to arise when this type of forbearance is observed because it frequently happens that those institutions receive public assistance and still end up being intervened at a later date with a greater cost to society. Unfortunately no data on bank interventions is available for all the countries in the sample but of all the two types of forbearance analyzed here, type 1 is the one more closely correlated with open-ended liquidity support (0.2742 with p = 0.0868). Since this correlation is only borderline significant, however, the sample cannot provide strong evidence to support the claim that these two strategies tend to be implemented in conjunction.

Table 3.6 Forbearance type 1 – probit results for whole sample

Dependent variable: forbearance type 1

Standard errors (in parenthesis) adjusted for clustering[1]

Dependent variables	Model 1	Model 2	Model 3	Model 4
Number of effective vetoes	0.444** (0.177)		0.633** (0.306)	
Electoral competition index		0.703** (0.307)		0.999** (0.451)
Quality of legal system	-0.392** (0.127)	-0.246** (0.121)	-0.812** (0.279)	-0.460** (0.221)
Size of financial sector	0.025* (0.015)	0.026* (0.016)	0.045** (0.023)	0.053** (0.026)
Time to elections from t	-0.395 (0.465)	-0.022 (0.143)		
GDP growth t			0.106* (0.064)	0.124** (0.053)
GDP growth t-1			-0.336** (0.114)	-0.329** (0.087)
Bank liquidity			-0.074* (0.041)	-0.015 (0.044)
Constant	0.382 (0.797)	-1.274 (1.513)	2.907** (1.445)	-0.851 (1.953)
N	37	38	36	36
Log-likelihood	-18.226727	-19.879606	-10.710526	-11.522068
Wald χ^2	11.67	10.08	11.89	20.33
Prob > χ^2	0.0200	0.0391	0.0646	0.0049

[1]Adjusted standard errors account for the fact there is independence across observations from different countries but not across those from the same country.

(*)Significant at the 10% level; (**)Significant at the 5% level or better.

The main results from the statistical analysis of forbearance type 1 are included in Table 3.6 above. Neither democracy nor any other constitutional feature was found to be significant to explain the decision to use forbearance type 1. Rather, the number of effective vetoes and electoral competition appeared highly significant and robust throughout a variety of model specifications. The coefficients on effective vetoes and the competition index are positive, indicating that forbearance type 1 is more likely to happen in polities characterized by more veto points and electoral competition. In addition, notice that both the quality of legal institutions and financial sector size are significant. The coefficient on legal institutions quality is negative, suggesting that where property rights protection and contract enforcement are better, forbearance type 1 is less likely to be observed. The coefficient on financial sector size is positive, indicating that where the financial sector is larger, the probability of authorities intervening to remove existing management in openly troubled banks tends to decrease significantly. No evidence was found, however, on electoral incentives playing a meaningful role.

Notice that despite the importance of macro and micro controls, the main results hold. Only those control variables included in Models 3 and 4 were found to be more consistently significant to explain forbearance type 1; other indicators were generally not significant, nor did their introduction to the model affected key findings. There was, however, one exception worth noting here. Coefficients on the level of bank reserves – when introduced to the equation – were always negative and insignificant but its introduction always had a negative effect on financial sector size (coefficients on this variable became less or not significant). This variable is interesting not only because it describes the proportion of total deposits in the financial system that are backed up at any one time – it also captures the extent to which governments intervene in

the financial system via reserve requirements. This result suggests that in financial systems characterized by high levels of government intervention, not only may forbearance be less likely to happen – the industry may have less influence overall as well.[34]

The second type of forbearance is different from the previous two in that regulations are relaxed or the current regulatory framework is not enforced for at least a twelve-month period to allow banks to re-capitalize on a flow basis or, alternatively, competition is restricted. Of the two, this is the most "active" kind of forbearance and, in some respects, the most controversial as well.

Table 3.7 Forbearance type 2 – probit results for whole sample

Dependent variable: forbearance type 2

Standard errors (in parenthesis) adjusted for clustering[1]

Dependent variables	Model 1	Model 2	Model 3	Model 4
Democracy	-1.204* (0.671)	-1.395** (0.708)	-1.418** (0.697)	
Political system	1.041* (0.563)	1.619** (0.627)	1.283** (0.579)	
Constraints on executive				-0.475** (0.194)
Size of financial sector	0.441* (0.258)	0.012 (0.014)	0.023** (0.010)	0.008 (0.013)
Elections at t	-1.089** (0.499)	-1.734** (0.614)	-1.274** (0.488)	-1.271** (0.549)
Per capita GDP t-1		-0.0001 (0.0001)	-0.00003 (0.0001)	-0.0001 (0.0001)
GDP growth t-1		-0.131* (0.073)	-0.101 (0.074)	-0.097 (0.084)
Level of bank reserves		-0.037* (0.022)		-0.035 (0.024)
Constant	0.185 (1.033)	2.867 (1.785)	0.799 (0.926)	5.148** (2.011)
N	39	38	38	38
Log-likelihood	-17.41227	-14.159884	-15.101741	-16.437873
Wald χ^2	10.17	21.67	17.72	10.16
Prob > χ^2	0.0376	0.0029	0.0070	0.1180

[1]Adjusted standard errors account for the fact there is independence across observations from different countries but not across those from the same country.

(*)Significant at the 10% level; (**)Significant at the 5% level or better.

[34]There is a significant and negative correlation between the size of the financial sector and the level of bank reserves. The coefficient is = -0.5134 with a p = 0.0008.

The main results from experiments on forbearance type 2 are presented in Table 3.7 above. Model 1 shows that constitutional features such as regime type or political system are only moderately significant to explain the choice of this strategy. Yet, these features exercise opposite effects: while governments in democratic countries are less likely to adopt this strategy, executives in presidential systems would be more prone to it.

Interestingly, no evidence was found on the role of the quality of legal institutions. While coefficients on this variable always had the right sign (i.e. negative – suggesting that as property rights protection and contract enforcement improve the likelihood of forbearance type 2 decreases) they were never significant.

Perhaps even more interesting are the results on variables measuring electoral incentives. Of the three indicators considered, the one more consistently significant was a dummy variable that equals one if elections coincide with the onset of the crisis and equals zero otherwise. The sign on this coefficient is always negative, suggesting that the probability of using forbearance type 2 decreases significantly in an electoral year – even if that year coincides with the beginning of the crisis. Coefficients on other electoral incentive variables are consistent with this finding – that on the proximity of elections, for instance, was always positive.[35]

Measures such as those captured by forbearance type 2 are rarely visible to the general public. In more open systems, however, political entrepreneurs or adversaries can get a hold on government's actions more easily and use them to their advantage in political campaigns. Available theory argues that democratically elected governments are less sensitive to interest

[35]This variable was significant in some specifications only but the direction of the effect was always positive. The proximity of elections is increasing in the number of years before an election takes place counting from t (the onset of the crisis). The positive sign then suggest that the further away elections are form the beginning of the crisis, the more likely forbearance type 2 would be.

group pressures in an electoral year. If forbearance type 2 is something bank managers and owners would bargain for, that would explain the results on elections at time t. The results on financial sector size suggest that the probability of observing forbearance type 2 during a crisis is higher wherever the financial sector is larger. The coefficient on this variable, however, was not consistently significant at generally accepted levels.

In Model 2 above we can see that the introduction of controls affects all variables in the equation with the exception of elections at time t. Notice in particular how the coefficient on financial sector size is now much smaller and insignificant. This is due to the inclusion of bank reserves, as Model 3 illustrates. As mentioned earlier, the correlation between this variable and the size of the financial sector is negative and significant. The coefficient on bank reserves suggests, once more, that wherever governments have a tighter grip on the financial sector, the likelihood of observing forbearance type 2 decreases.

Of all the variables measuring power dispersion and political competition, only the level of constraints on the executive authority was significant to explain the choice of forbearance type 2. Notice in Model 4 above that the coefficient on this variable is negative and highly significant suggesting that where executive power is more restricted the likelihood of forbearance type 2 decreases. Given the results on constitutional variables (democracy and political system) for the whole sample, the strong correlation between constraints on the executive and those constitutional features, and the limited variation it presents across democratic countries additional experiments were conducted once more on a sub-sample of democratic countries.

The main results are presented in Table 3.8 below. The basic model (Model 1) remains pretty much unaltered after non-democratic countries were left out but the same cannot be said

about the model that uses constraints on the executive instead (Model 2). As expected, this variable is useful to evaluate democratic countries vis-à-vis non-democratic ones but not to compare across democracies. Instead, the study variable that turned out significant to explain the occurrence of forbearance type 2 was the number of effective political parties. As can be seen in Models 3, the coefficient does not have the expected sign, suggesting that political competition increases the probability of observing forbearance type 2.

Table 3.8 Forbearance type 2 – probit results for democratic countries only

Dependent variable: forbearance type 3

Standard errors (in parenthesis) adjusted for clustering[1]

Dependent variables	Model 1	Model 2	Model 3	Model 4
Political system (A)	1.871* (0.981)			4.095* (2.127)
Constraints on executive		0.213 (0.592)		
Effective parties (B)			0.379** (0.182)	0.771* (0.403)
Interaction A*B				-0.641 (0.512)
Size of financial sector	0.016 (0.017)	0.018 (0.016)	0.021 (0.016)	0.024* (0.018)
Elections at t	-2.981** (0.967)	-1.671** (0.491)	-2.174** (0.728)	-3.557** (0.996)
Per capita GDP t-1	-0.0001* (0.0001)	-0.0001* (0.0001)	-0.0001* (0.0001)	-0.0002** (0.0001)
GDP growth t-1	-0.119 (0.087)	-0.039 (0.087)	-0.006 (0.117)	0.006 (0.141)
Level of bank reserves	-0.061* (0.035)	-0.016 (0.020)	-0.019 (0.027)	-0.063** (0.032)
Constant	2.839 (2.021)	0.015 (4.256)	0.251 (1.531)	0.347 (2.251)
N	24	24	24	24
Log-likelihood	-9.1363151	-11.012189	-9.9143168	-7.7565407
Wald χ^2	14.59	17.73	17.92	17.93
Prob > χ^2	0.0237	0.0070	0.0064	0.0218

[1]Adjusted standard errors account for the fact there is independence across observations from different countries but not across those from the same country.

(*)Significant at the 10% level; (**)Significant at the 5% level or better.

The correlation between effective parties and political system, while negative, is not significant in this sub-sample (-0.1063, p = 0.6053) but regressions run using both variables affected the coefficient on effective parties as Model 5 illustrates. Notice, however, that the fit of

the model appears to be better when political system is excluded – and, in fact, this coefficient remained barely significant all the way. An interaction term between political system and the number of effective parties yielded a negative coefficient, which would suggest that more competitive presidential systems are less likely to authorize forbearance type 2. This coefficient is, unfortunately, not statistically significant.

3.8.3. Open-ended liquidity support.

Of all the bailout measures employed during financial crises, open-ended liquidity support is perhaps the most common and, together with capitalization schemes (not very common in this sample), the one most obviously transferring public resources to the financial sector. Table 3.9 below presents the main results from a number of statistical experiments using liquidity support as dependent variable.

Unlike other strategies analyzed here liquidity support is not sensitive to any constitutional feature as Models 1 and 2 illustrate. Coefficients on democracy, for instance, while always negative, were never significant. Those on the political and legislative systems were always positive but never significant either. Variables capturing the quality of legal institutions yielded negative but statistically insignificant results.

Some macro and micro indicators performed better on average than constitutional features. Economic growth exercises a negative effect on the probability of governments providing liquidity support as it is expected that, under better macro-economic conditions, the financial system would be in better shape to face liquidity problems – and even mild insolvency – and the level of non-performing loans would be kept under control.

Table 3.9 Liquidity support – probit results for whole sample

Dependent variable: liquidity support

Standard errors (in parenthesis) adjusted for clustering[1]

Dependent variables	Model 1	Model 2	Model 3	Model 4	Model 5
Democracy	-0.525 (0.611)	-0.569 (0.667)			
Political system	0.044 (0.570)	0.076 (0.608)			
Effective parties			-0.233** (0.101)		
Governing coalition size				-0.149* (0.078)	
Effective vetoes					-0.181* (0.108)
Size of financial sector	0.018 (0.013)	0.021 (0.014)	0.024** (0.016)	0.022* (0.013)	0.019* (0.011)
Time to elections at t	0.255 (0.172)	0.358 (0.231)	0.305 (0.191)	0.265 (0.165)	0.253 (0.173)
GDP growth t	-0.106* (0.063)	-0.143* (0.077)	-0.102 (0.066)	-0.092* (0.049)	-0.091* (0.052)
GDP growth t - 1	-0.113 (0.076)	-0.203* (0.118)	-0.135* (0.078)	-0.066 (0.067)	-0.123* (0.071)
Bank borrowing	0.057* (0.031)	0.066 (0.042)	0.063** (0.031)	0.057** (0.029)	0.050* (0.031)
Budget balance		0.239** (0.081)			
Constant	-1.340 (1.135)	-1.186 (1.450)	-1.371 (1.081)	-1.752* (0.982)	-1.066 (1.090)
N	37	34	37	36	37
Log-likelihood	-18.917927	-15.870691	-18.233844	-18.824822	-18.707526
Wald χ^2	12.43	15.02	14.40	18.34	17.75
Prob > χ^2	0.0872	0.0587	0.0255	0.0054	0.0069

[1]Adjusted standard errors account for the fact there is independence across observations from different countries but not across those from the same country.

(*)Significant at the 10% level; (**)Significant at the 5% level or better.

The level of bank borrowing before the onset of the crisis is a relevant variable and suggests that financial systems already borrowing heavily from the central bank are more likely to receive liquidity support once the crisis starts. Another macro indicator that produced consistently significant coefficients was the budget balance. Coefficients on this variable were always positive and significant, suggesting that governments are more likely to finance troubled banks when public finances are healthier. As shown in Model 2, introducing this variable into the

equation reduces the number of observations and alters some of the results on the other control variables but not those on constitutional features.

In general, power dispersion and electoral competition variables performed better in the regressions but most of them were unable to achieve levels of significance beyond the 10 percent level. In all cases, coefficients on these variables were negative. The best results were obtained on the number of effective parties and, to a lesser extent, on the number of effective vetoes. Models 3 to 5 show that liquidity support is less likely to happen in contexts characterized by a more fragmented party system and more dispersed distributions of decision-making authority. Models using the budget balance did not yield significantly different results on the key variables.

Coefficients on financial sector size are always positive – which suggests that liquidity support is more likely to be observed wherever the financial sector is larger – although they tend to be just moderately significant across model specifications. Even though it might be reasonable to expect this variable to have a stronger effect in the case of liquidity support, the fact that it is so common a strategy makes the results not entirely surprising and suggest that governments decide to adopt this strategy much more autonomously than otherwise expected. The evidence on variables measuring electoral incentives provides additional support to this conclusion. Notice that while the coefficients on the proximity of elections are always positive – indicating that the proximity of elections discourages the use of liquidity support – they are never significant.

3.9. CONCLUSION.

The main purpose of this chapter has been to quantify the impact of power dispersion on the total amount of public resources transferred to the financial sector in times of crisis and on the choice

of measures to – directly or indirectly – transfer those resources. In a nutshell, the statistical experiments undertaken for this purpose attempted to determine the institutional conditions under which such transfers are larger and more likely to occur.

The general findings on total fiscal cost suggest that competition for political power may have a stronger negative effect on the decision to transfer resources to the financial sector than the distribution of such power. Nonetheless, these results are somewhat sensitive to democratic status and strongly affected by political system (i.e. presidential vs. otherwise). Democratic societies, in contrast, do not exhibit any meaningful relationship between levels of electoral competition and the amount of public money invested in financial crises. Fiscal outlays in democratic societies respond significantly to variations in power dispersion – expressed as differences in the size of governing coalitions – but the effect runs in a direction opposite to expectations. The results suggest that larger coalitions, where decision authority is more fragmented, tend to authorize larger disbursements of public money to assist financial sectors in crisis. While observed in some presidential regimes, coalition governments are more common in parliamentary systems. In the sample used here, 90 percent of governments in which two or more parties participate correspond to no-presidential countries.

Previous theoretical and empirical contributions in the political economy of fiscal policy tradition (Persson, Rolland and Tabellini 1997 and 2000, Diermeier and Feddersen 1998) argue that the legislative cohesion typically found in parliamentary systems leads to more public spending and larger fiscal deficits. In order to maintain a stable majority, governments in these systems pursue the joint interests of those voting for the parties in the coalition, which ultimately leads to more generous and broadly targeted fiscal policy. The separation of legislative powers

that characterizes presidential systems, on the other hand, induces greater control over spending but fiscal policy is more likely to target powerful minorities.

If crisis-related fiscal disbursements are seen as pure government expenditure, then the results for democratic countries seem fairly consistent with the legislative cohesion argument, but not those for the whole sample. The key to this puzzle might be in the actual composition of such crisis-related expenditures. The analysis assumed fiscal costs proxy the willingness to target public money to the banking industry, which may or may not be influential ex ante but whose leverage would certainly increase with the crisis. In lieu of the evidence, this assumption might not be entirely accurate. Other results from the statistical analysis seem to hint in this direction.

That the size of the financial sector (a proxy variable for its influence) is positive and (for the most part) consistently significant suggests that crisis-related expenditures are more likely to be targeted to the banking industry in presidential systems relative to other regimes, particularly in emerging democracies. Greater political competition, however, modifies the incentive structure for presidential executives and this, in turn, translates into smaller fiscal transfers. Crisis-related expenditures in coalition democracies are indeed larger than in those observed in presidential systems but the size of the financial sector is no longer significant to explain variations. It is possible then that, even though the fiscal costs of financial crises are larger in these countries, the measures generating such costs – directly or indirectly – would have a broader appeal.

The analysis of specific strategies undertaken during financial crises yielded equally interesting results. The evidence shows that indeed not all policies are created equally and that power distribution, political competition and the constitutional makeup of the country may have

differentiated effects on the probability of observing a particular crisis policy. Of the three measures considered here, only open-ended liquidity support constitutes a direct and observable transfer of public resources to the financial sector. Here the evidence strongly supports the main argument of this chapter, namely, that where there are more checks on how fiscal resources are used (or simply more competition over how they should be allocated), targeted measures are less likely to be adopted, even if the financial sector is highly influential and actively demands assistance.

Results on the other measures are less clear-cut. The two types of forbearance analyzed can be considered targeted measures but do not involve an obvious disbursement of public resources (at least not immediately). Forbearance type 1, which "allows" the owners and managers of troubled institutions to "gamble for resurrection", is more likely to be observed in polities where, as discussed earlier, the disbursement of targeted fiscal resources is more difficult: countries where authority is fragmented (more veto points), or where the level of electoral competition creates incentives to target broader constituencies. Not surprisingly, the probability of observing this type of forbearance increases significantly as well where the financial sector is more influential.

Given the controversial nature of forbearance type 2, it is not surprising that democracies and more constrained executives are, in general, less likely to authorize its use during a financial crisis and, according to the results, even less so if elections are close. Presidential regimes, on the other hand, seem more inclined to follow this path even in democratic countries – a result that seems consistent with the idea that presidential regimes are more sensitive to the needs of special groups. The link between presidentialism and forbearance type 2 is weaker in democratic

countries (as expected, given the results on the whole sample) and it becomes negative as competition for political power increases. Interestingly, financial sector influence is not a determinant of forbearance type 2 therefore, if presidential systems are more likely to use it, it is not in response to industry leverage but, rather, an issue of bureaucratic control. After all, regulatory and supervisory authorities (those in charge of monitoring and enforcing compliance with rules and regulations) are typically under the purview of the executive branch and, in presidential systems, they are not subject to portfolio allocations across different parties.

Finally, of all the measures considered here the one more clearly targeted to a broader audience is deposit insurance, even in those cases where coverage is full and universal (and arguably overprotects those depositors capable of following market trends). Given its more "public" appeal (and even quasi-public good qualities) it is not surprising that, as the results show, democratic countries are significantly more likely to adopt this policy in the event of a crisis (the overwhelming majority of pre-existing deposit insurance schemes are also found in democratic countries). In democratic countries, however, the probability of observing deposit insurance decreases with presidential systems and in the number of veto gates. These results appear to contradict earlier findings on open-ended liquidity support. Yet, a graphical examination of deposit insurance choices against the number of veto points in democratic countries hints at an interesting difference between the two policies. Despite the relatively small number of cases, it is possible to distinguish two different patterns in Charts A.3.1 and A.3.2 (see Appendix to this chapter): while positive observations on liquidity support are clearly decreasing in the number of veto points, those on deposit insurance present a more complex (non-linear) behavior.

This simple comparison implies that the probability of adopting policies aimed at broader constituencies does increase in the number of veto points but up to a point – beyond that threshold, the marginal contribution of an additional veto player becomes negative. While this may appear supportive of theories predicting less "national" or "public" policy as the number of vetoes in the system increase, the observations presented here suggest further research is necessary.

In sum, the evidence in this chapter suggests that, while power dispersion may affect the willingness of governments to authorize fiscal transfers to the financial sector and shape decisions about specific – fiscally expensive – measures, the magnitude and direction of such effects are far from uniform and unidirectional. Rather, the picture that emerges is one in which constitutional features interact with institutional manifestations – and even with interest groups – in complex ways.

With regards to the financial sector, the focal interest group in this research, the findings suggest that the influence of bankers and financiers over decisions that directly affect them may be less definitive than otherwise imagined or predicted. In other words, the decision to assist the financial sector during a crisis may be more autonomous than expected – making interest group pressure, at best, only a necessary condition to explain redistributive decisions.

The previous discussion demonstrates that the findings of this study are relevant for theoretical and empirical discussions on the role institutions – and institutional manifestations – play in shaping the influence of interest groups, in the making of fiscal and redistributive decisions, and on determining policy outcomes in general. The results also have important policy implications associated with the management of financial crises. Recommendations on what

governments should do in the event of a crisis, and what factors they should ponder when deciding between alternative strategies, must take into consideration the institutional context in which decision-makers operate and, particularly, how such context affects their willingness and capacity to make specific decisions.

Chapter 4: The Executive and the Management of Mexico's 1994-95 Financial Crisis

4.1. INTRODUCTION.

From the previous chapters we have learned that power distribution affects the capacity of national governments to control and resolve financial crises. They have also established that those same factors impinge on the willingness of decision-makers to transfer public resources to sectors affected by the crisis, and influence the probability of using particularly expensive crisis management strategies.

Generally speaking, the way in which the Mexican government handled and finally resolved the 1994 financial crisis provides us with enough rich detail to assess the extents and limits of the correlations observed earlier and understand at least some of their underlying causal mechanisms. The 1994 financial crisis was by no means the first to be experienced in the country but it has certainly been one of the worst in recent history.[36] The Mexican government quickly became involved in the process with a complex, multi-front strategy allegedly aimed at restoring confidence, bring back stability and insure the viability of credit markets. The strategy would prove to be scattered and lacking decisiveness, ambitious in its goals while inadequate in its means, much more reactive than pro-active. In the end, the Mexican government avoided a

[36]Mexico is one of the few countries to have experienced more than one episode of financial crisis. In contemporary history, the most recent reference before 1994 would be the debt-and-development crisis of the early 1980s. As will become clear later, the resolution strategies devised to weather that crisis had an important bearing on the events leading to the 1994 episode. It is fair to say that the economy has never been able to fully recover from the 1980s debacle although it could be argued that structural conditions are indeed different and, therefore, a comparison between the two episodes is problematic. The focus of this chapter is mostly on the 1994 episode even though references to the 1980s crisis have to be made as the narrative unfolds because the link between the two events is quite strong from both an economic and a political stand point.

generalized financial collapse, as it had set out to do, but at a very high price – from both the fiscal and political stand points.

This chapter and the following one claim that the nature of power distribution and political competition in Mexico - and their transformations during the last ten years – can at least partially explain both the timing and content of decisions made with regards to the handling and resolution of the crisis. First, the traditional concentration of power at the hands of the Mexican president contributed to set the stage for the crisis by facilitating the development of a heavily concentrated, highly protected, poorly supervised and risk-prone financial system. In exchange for the political support of big business and powerful financiers and the flow of much needed public resources, the Mexican government was left ill-equipped to deal with a generalized solvency problem in the banking sector. As a consequence, the patchy and accidented strategy implemented had major shortcomings on key fronts: the prompt assessment and recognition of losses, the adoption of adequate and decisive corrective measures to address problem banks, the minimization of moral hazard on all sides of the credit market and, ultimately, the ability to extract performance from the banking industry in exchange for support.

Second, power concentration also made it possible for an increasingly expensive bailout, conducted in a largely discretional and obscure fashion, to proceed practically unquestioned and unimpeded. By mid-1999 the fiscal cost of the Mexican crisis was estimated at 19.3 percent of the country's GDP.[37] Of course, such breathtaking figures are explained in part by the variety of support programs the Mexican government put in place to assist practically all parties affected by

[37]While not an outlier, the Mexican crisis of 1994 is, in the context of the sample used previously, significantly expensive. The recorded fiscal cost is almost six percentage points higher than the average fiscal cost for the whole sample (placing this episode at the 75th percentile). This proportion is much higher than the corresponding average value for democratic countries (approximately 9 percent of GDP) and more than five percentage points above the average for developing countries (slightly more than 14 percent of GDP).

the crisis. Yet, the heaviest fiscal burden came from repeated capitalizations and non-performing loan purchases. These measures, in the eyes of many, only benefited bank owners, bank managers and large corporate debtors at the expense of the public at large. The issue became highly contentious and politicized, and eventually sealed the fate of the Institutional Revolutionary Party (PRI) in the 2000 general elections.

Third, the nature of power distribution in Mexico changed dramatically in the summer of 1997, when the long-ruling PRI lost control of Congress for the first time since its creation. By then, even though the crisis was considered to be well under control – at least by the authorities – and the economy had already recovered, the restructuring process in the financial sector was far from over.[38] In fact, a lot of work still needed to be done before the crisis could be considered resolved. The new balance of power – now tilted in favor of the legislature – brought much needed transparency and order to the entire resolution process. Yet, it delayed the adoption of important reforms and, most importantly, failed to provide a final and satisfactory solution to the problem of non-performing loans. At the end of the day, this probably cancelled out whatever opportunities were left to further reduce the fiscal cost of the crisis for future generations.

The Mexican case is worth studying in the context of this dissertation not only because the 1994 crisis has been one of the most dramatic and transcendental episodes recorded, but also because its development and resolution occurred as the country was experiencing a major political transition. While most of the crisis management was done under conditions of heavy power concentration at the hands of the executive, crisis resolution suddenly faced a more even distribution of authority between the President and Congress, and a deeply divided and polarized

[38]Even though the crisis was itself long-lasting, the Mexican economy was able to recover in record time (within two years, which puts this episode at the 30th percentile in our sample).

legislature as well. As a consequence, it is possible to compare the decision processes associated with a single crisis episode across two different levels of power dispersion.

This chapter focuses on the management of the crisis, a process that coincided with a still powerful executive. Chapter 5 will examine the crisis resolution under a much less concentrated power distribution.

4.2. MEXICO'S POWERFULEXECUTIVE.

The Mexican constitution is presidential and establishes independent legislative and judiciary branches while insisting on the separation of powers. The Mexican president is elected every six years by plurality vote and can never be re-elected or reappointed. The Mexican Congress is bicameral: the Chamber of Deputies is elected for three-year terms and the Senate for six years (concurrent with the presidential term). Both chambers are elected through mixed systems, using first-past-the-post and list proportional representation.

Nonetheless, Mexico's transition to full democratic status is relatively recent. For many decades Mexico held regular elections, had reasonably orderly transitions from one president to the next, and mostly worked within a constitutional framework that resembles that of the United States. Yet, while not ruled by the military, Mexico had a one-party dominated authoritarian regime and an exceptionally strong president.

Such power, however, did not necessarily stem from formal (i.e. constitutional) prerogatives. A number of important studies have shown that, for instance, Congress is the one branch with most policy-making, oversight and regulatory powers (Orozco Henriquez 1988, Casar 2002). Yet, the country's contemporary history reveals that Congress has typically chosen to delegate or abdicate powers to the executive. The president does enjoy, of course, a variety of

legislative powers that include (limited) veto powers, the right to initiate proposals, rule-making authority and (limited) decree powers. If only formal features are taken into consideration, however, the Mexican executive is much less strong than his counterparts in Argentina or Russia, and even those in Brazil or the United States (Shugart and Haggard 2002).[39] In addition, unlike in other presidential systems, the Mexican executive does not have the power to call referenda or plebiscites, nor the right to convene Congress to extraordinary sessions (Casar 2002).

Students of Mexican politics tend to agree that the strength of the Mexican president is better explained by a number of non-constitutional conditions and informal rules – some of which have institutional roots – that defined and governed the relationship between the president and his party, the PRI. For the most part of Mexico's contemporary political history, the PRI was the overly dominant party. Since the passing of the first Electoral Law in 1946 and until 1988, the PRI had been able to control at least two thirds of the legislative seats; between1988 and 1997 it was still able to hold an absolute majority. The incumbent party's advantage and resulting majorities were repeatedly guaranteed not only by manipulation, but also by an electoral system that, though gradually eroded by a variety of reforms, managed to limit competition and participation and to keep the electoral processes under executive control (Molinar 1991).

PRI majorities guaranteed unified governments but this, by itself, was not enough to insure the president would get his way. Party discipline is another important factor in this regard

[39]Shugart and Haggard's construct a power index for a variety of presidential systems that results from adding up the scores assigned to each of the following features: package veto, item veto, decree power, and exclusive authority to introduce bills in specified policy areas. The scores go from 0 to 2, increasing in strength. Argentina and Russia have the highest scores with 6 and 5 respectively. Brazil has a score of 3 and the United States 2. The Mexican executive scores 1 on this index: Matthew S. Shugart and Stephan Haggard, "Institutions and Public Policy in Presidential Systems", in ed. Stephan Haggard and Mathew D. McCubbins*, Presidents, Parliaments, and Policy* (Cambridge University Press, 2001), pp. 79-81.

(Weldon 2002) and such discipline was ultimately accorded to the president himself, recognized as the undisputed leader of his party.[40] The high levels of discipline found in PRI members throughout most of the party's history are basically the result of heavily centralized nomination processes where the approval of the party's National Committee and, ultimately, the president's blessing used to be essential to advance a political – or bureaucratic – career (Langston 1996). After all, the president had the prerogative to allocate a large variety of political and bureaucratic positions and to even choose his successor. Institutional factors such as the no-reelection clause and the system-wide prohibition to run independent candidacies only reinforced members' incentives in favor of discipline to the party and the president's line (Molinar 1991, Casar 2002).

The scheme that so well served the interests of the PRI and its presidents began to dismantle after the general elections of 1988, when Carlos Salinas de Gortari was officially victorious by a very small margin in a contest characterized by widespread vote-counting irregularities, political criticism and popular protest. The PRI lost for the first time its ability to make constitutional changes as it could only secure 52 percent of the seats in the Chamber of Deputies.

Salinas represented the triumph of a new group inside the PRI: the technocrats. These highly educated individuals – most of them with postgraduate degrees from American universities – had been pushing for a smaller government and more open markets and naturally became closer to those groups inside the private sector that benefited from economic and financial liberalization, namely, the largest Mexican companies and the owners of non-bank financial institutions. His questioned legitimacy was quickly forgotten by the general population

[40]Interestingly, the party does have a chairman of sorts but the position is officially that of Secretary General. Until recently, the Secretary General of the PRI would never openly challenge the president's leadership.

as he proved to be a strong and capable leader but, most importantly, he conquered what many thought was unconquerable: inflation. His economic modernization policies alienated the more traditional sectors in the PRI, but he was rather skillful in the construction of new political alliances – for instance, with the church and, most importantly, with the more pliable sectors inside the right-wing opposition. In short, Salinas had been able to turn a weak start into one of the strongest and more successful administrations in the country's recent history.

While political competition had already set in for good and divisions between the "old guard" and the technocrats inside the PRI were certainly growing, it would still be a while before presidential power became significantly constrained. In fact, the last PRI president, Ernesto Zedillo, would begin his administration with the presidential power practically intact in spite of the political turmoil the year 1994 brought to the country.

Salinas' brilliant record as president was severely tainted that year. In January, the very month NAFTA was going into effect, the Zapatista rebellion in Chiapas put a question mark on the country's alleged social and political stability. On March 23rd, the then official presidential candidate, Luis Donaldo Colosio, was murdered in a campaign event, something that did not happen in the country since the 1930s. With general elections taking place in July, Salinas was forced to choose a substitute presidential candidate.

General elections took place on July 2nd amidst widespread uncertainty about the future stability of political institutions. Salinas was now forced to choose a substitute presidential candidate with the acquiescence of a divided but still compliant PRI. The final decision favored Ernesto Zedillo, a little known but highly respected economist who, inside government and party circles, was regarded as a very competent technocrat but rather unskilled politician. And yet, his

apolitical *persona*, which kept him at a safe distance from the so-called old guard PRI members, turned out to be a huge advantage under the circumstances. As Manlio Fabio Beltrones, a senior PRI member significantly close to the presidential candidate decision process, would say many years later, Zedillo "was not part of any group nor had he made commitments to any group. It was known he had a relationship with José Córdoba Montoya, but that is why it was agreed that he would distance himself from [Zedillo]. With Zedillo as a candidate, no group inside the PRI could claim it was losing or winning"(El Universal, August 14, 2000).[41]

Very soon after his victory, however, Zedillo began breaking non-written rules. He quickly declared there would be a "safe distance" between himself and his party, something that enraged some *priístas* and confused others. With the Colossio and Ruiz Massieu murders pending resolution, he made another unprecedented departure from political custom when he appointed a PAN member, Antonio Lozano Gracia, as Attorney General. Later, he would publicly break with his predecessor when he had Raúl Salinas arrested for the murder of José Francisco Ruiz Massieu. And yet, during his first three years in office, Zedillo enjoyed full support from the PRI majority in Congress.

After the crisis hit, and during his entire administration, Zedillo was subject to challenge from all political fronts and almost every organized social group. Nonetheless, during the first three years in government, he and his team enjoyed pretty much the same degree of autonomy former PRI governments had enjoyed for most of the century. Diego Fernández de Cevallos, a major PAN leader and presidential candidate in the 1994 contest would comment: "[Zedillo] is more considerate towards the Legislative branch and perhaps a bit more open to the press [but]

[41]Jose Cordoba Montoya was Carlos Salinas' Chief of Staff and one of the most influential figures during that administration. It was well known at the time he had "sponsored" Zedillo's career in Salinas' cabinet.

he is as or even more authoritarian than his predecessors…Dr. Zedillo decides anyway he wants…he's turned everybody against him and yet does whatever he wants in economic and fiscal matters. I think this is the most dramatic expression of authoritarianism" (Proceso, November 13, 1995). It is hard to find a better example to illustrate this point than the way the financial crisis was handled. Throughout most of the crisis period, the Zedillo administration demonstrated a deep commitment to deal with the problem in the way they thought was best, regardless of what everybody else thought or argued. In the short run, he paid the price of such relative autonomy on other fronts where the traditional sectors inside the PRI struggled to defend their vested interests in Tabasco, Chiapas and Guerrero.[42]

In the summer of 1997, however, things would change for him significantly. The July mid-term elections produced the first divided government since 1929. As the PRI majority in Congress shrank dramatically, so did the president's room for maneuver.

4.3. THE FINANCIAL SYSTEM BEFORE THE COLLAPSE.

The Mexican financial system of 1994-95 was the product of major upheavals and structural reforms that took place during most of the 1980s and early 1990s, many of which can only be properly understood in the context of the strong executive described in the previous section. Of these, two clearly stand out: the bank expropriation of 1982 and the re-privatization begun in

[42]In Tabasco, after a controversial process in which the governor, Roberto Madrazo, was accused of violating a number of electoral laws and campaign finance regulations, Zedillo ended up supporting him. In Chiapas, Zedillo showed continued ambivalence towards the Zapatista conflict, sometimes favoring dialogue, some others the use of public force. It was widely believed that peace negotiations during the Zedillo administration did not progress significantly because the president either unable or unwilling to restrain local chiefs and politicians. Finally, in Guerrero, after paramilitary forces acting on the orders of the local PRI murdered a group of peasants, Zedillo was severely criticized for his response to the event and his authority over the most reactionary segments of his party was questioned.

1992. The events themselves – and the way in which they were carried out – had important consequences for the future: they contributed to set the stage for what is now believed to be the worst financial crisis in Mexico's recent history.

As a result of severe balance of payments problems the Mexican government was forced to devalue the peso on February 26, 1982. Massive capital flight and the consequent depletion of international reserves ensued. On August of that year the country announced it could no longer meet its short-term, dollar-denominated obligations. On September 1st then president, José López Portillo, in a dramatic demonstration of executive power, took everyone by surprise when he unilaterally announced the expropriation of all private banks and the implementation of capital controls on the occasion of his final state of the union before Congress.

The expropriation of private banks had many consequences but, for our purposes, three stand out as particularly important. First, it froze credit markets and intermediation capacities. Second, the move significantly alienated private investors and businesses who, though used to and even accepting of government intrusions, felt the expropriation was absolutely unconstitutional and demanded restitution. Finally, the expropriation indirectly contributed to the development of an alternative financial market and to the emergence of new financial elite.

The new monopoly government exercised on banking and credit services allowed for the consolidation of the financial system in exchange for a highly restricted environment for financial operations. New regulations required that half of total deposits be kept in reserve at the central bank and that nearly 80 percent of total bank assets be directed to the purchase of government securities. Additionally, between 5 and 6 percent of total bank credit had to be allocated to selected sectors where state enterprises benefited the most. Only about 25 percent of

total bank credit ended up financing private investment (Lustig 1990). In short, the end of international credit made the expropriated banks a primary source for public sector financing, covering massive fiscal deficits at the expense of financial intermediation.[43]

With the expropriation, the traditional elite of bankers and financiers was virtually replaced with government appointees. In addition, since banks no longer performed intermediary functions in the credit market, they lost most of their risk-assessment capabilities. Something similar happened to Comisión Nacional Bancaria (CNB), the entity responsible for bank supervision. A state-owned banking system rendered its functions practically meaningless and, though it did not disappear, it lost considerable human capital and saw its activities mostly frozen during the major part of the 1980s and early 1990s.

Former bank owners, though outraged by the expropriation, were either unable or unwilling to respond to it in a unified way. The damage perpetrated against their property rights, however, had a major negative effect on their confidence in government and increased the risk of investing in Mexico (Maxfield 1989, Elizondo 2001). For Lopez Portillo's successors, who had an alternative development model in mind, recovering investor confidence and repairing the severed relationship with the private sector was a top priority for Mexico's future economic prospects. Both Miguel de la Madrid, but specially Carlos Salinas, would invest heavily in articulating a new alliance with big business and financiers.

With de la Madrid, the government accelerated compensation to previous bank owners and granted key members of the entrepreneurial community preferential access to the decision-

[43]In fact, Lustig reports that from 1982 to 1988, commercial bank absorption of capital as a proportion of GDP dropped from almost 20 to less than 13 percent. While in 1980 commercial banks' share of capital within the financial system stood at 96 percent, by 1987 it had fallen to just 72 percent: Nora Lustig, Mexico: The Remaking of an Economy (Brookings Institution Press,1998).

making process in matters that could directly affect them. Through a complex bailout scheme called Ficorca, the government also came to the rescue of those firms for which the 1982 devaluation had brought severe liquidity problems.

The government also made it attractive for the old financial elite – and many smart newcomers – to explore promising business opportunities in non-bank financial markets that focused their services on insurance, stock brokerage, leasing and warehousing. With the help of government regulation (tight on banks and somewhat favorable to them) and generalized economic instability, these financial institutions began to successfully compete for savings and created a parallel financial market beyond state control in which the Mexican stock exchange became the star segment.[44]

In addition to imposing an orthodox adjustment package to bring the Mexican economy under control, the De la Madrid government began to gradually introduce a new development strategy based on open markets. By the end of his administration privatization of public enterprises and economic liberalization were well under way, the latter reaching a breaking point in 1986 when the country joined the General Agreement on Tariffs and Trade (GATT). After many years of austerity and adjustment, Salina's Pact for Economic Solidarity (PSE) seemed to be the mechanism that would finally bring some control to triple digit inflation rates.[45] The

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[44]Between 1982 and 1988 the assets of non-bank financial institutions rose from 9.1 to 32.1 percent of total assets in the financial system. According to one estimation, the share of the Mexican stock exchange of total savings increased dramatically during the 1980s – from 12 percent in 1982 to 44 percent in 1998 (El Financiero, May 8, 1990). The expansion reflected in large part the increased issuance of CETES – short-term government debt instruments comparable to US Treasury Bills, deregulation of capital markets and fiscal incentives, and the success of Ficorca to resurrect major corporate players in the stock market. Unable to compete with brokerage firms, the banking sector experienced a significant decline. Domestic bank absorption of capital as a proportion of GDP fell from around 20 percent in 1982 to less than 13 percent in 1988, while their share of capital in the financial system went from 96 percent to 72 percent during the same period. (El Financiero, May 8, 1990).

[45]Carlos Salinas de Gortari was the architect of the PSE when he was De la Madrid's Budget and Planning Minister. The *Pacto* was a rather heterodox stabilization scheme that sought to cut spending, control prices and open trade still

Pact's basic scheme would see successful renewals throughout the following *sexenio*, when Salinas was president. Most important for the immediate future was the Pact's provision to introduce a new exchange rate regime based on a fixed peg as a nominal anchor; the idea was to provide a credible mechanism through which inflationary expectations would decrease.

And indeed, perhaps Salinas' most impressive achievement was the rapid control of the inflation. But he did much more than that. The economic transformation started with De la Madrid accelerated dramatically during his administration. The government aggressively pursued economic stabilization and liberalization programs that included privatization, further budget reductions, removal of certain restrictions on foreign direct investment, and economic integration to the North American market (which would reach a climax with NAFTA).

On the financial front, some of the most important early measures included the de-regulation of deposit and lending rates, the elimination of the mandatory requirement for commercial banks to hold long-term government paper to maturity, and the removal of reserve requirements and liquidity coefficients. However, the most important change to the status quo in the financial sector would be the re-privatization of commercial banks approved by Congress in June of 1990.[46] Privatization of commercial banks was particularly accelerated between 1991 and 1992, when eighteen banks were sold to private hands; by 1993 virtually all banks had been privatized.

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further with the acquiesce of business and labor. The Pacts also represented a renewed alliance between government and business as well as a reaffirmation of government's control over political resources, particularly organized labor.

[46]Mexican government's share of commercial banks accounted to approximately 70% of total assets. The other 30% had already been sold to private hands almost immediately after nationalization. Although former bank owners were given preference in this early re-privatization process, most of the shares ended up in the hands of non-financial groups who had made a fortune during the stock market boom.

The way in which re-privatization was carried out had important consequences for the short-term evolution of credit markets in Mexico. At the time, the privatization process was considered a success for the Mexican government and was praised by the international community as being efficient and transparent. Yet, perhaps the most outstanding fact about the re-privatization of Mexican banks was how lucrative the entire operation was for the government. According to one source, the banks were sold for an average of more than three times their book value and nearly fifteen times the previous year's earnings. In total, the Mexican government received approximately $12 billion dollars for the transaction (Gruben and McComb 1993).

The new bank owners knew they had paid a very high price for the banks but there were generalized high expectations about economic stability and growth that made the transaction a good business anyway. More importantly, however, they knew their business would be safeguarded enough by laws and regulations (or rather lack of) that would allow them to quickly recover their investments.[47]

A few months after privatization passed in Congress two other important laws were approved: the Financial Groups Law and the Credit Institutions Law. These laws contained provisions for which the new financial elite had been bargaining for years (Minushkin and Parker 2002).

The Financial Groups Law relaxed important restrictions on the operation of financial firms by allowing the establishment of conglomerate banking (where a single holding company

[47]As an interesting indication that prices paid for the banks were overly high, the privatizing authorities asked a number of consulting firms to conduct an independent valuation of all credit institutions. Their conclusion was that the Ministry of Finance would have to return approximately $1.4 billion pesos to buyers as a result of adjustments in the value of real estate and asset portfolio (El Financiero, June 14, 1998).

carries out separate commercial banking, brokerage, and other financial services activities). The Credit Institutions Law was aimed at providing a legal framework for the capital structure and operations of a commercial banking system subsequent to privatization. The Law set the maximum levels of foreign investment in Mexico's financial institutions – then mostly domestically controlled – and of the capital stock ownership by individual investors.

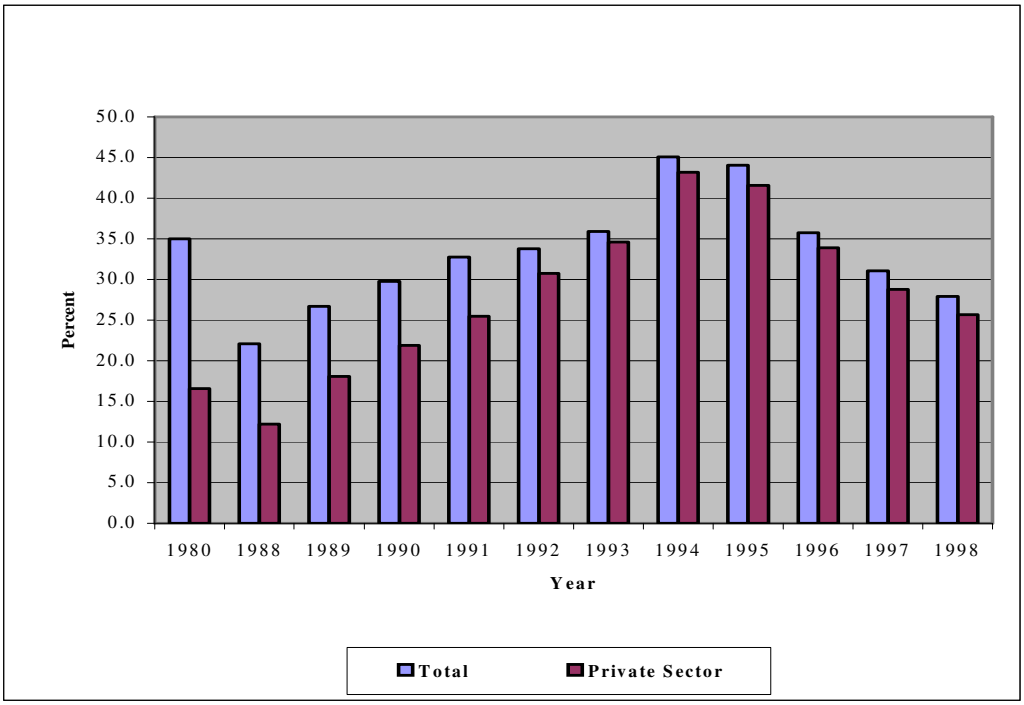
A key provision in this law was the establishment of the Bank Fund for the Protection of Savings (Fobaproa), which would acquire notorious fame after the crisis. Fobaproa was created as a trust to be administered by Banco de México (the central bank) with the idea of providing support to troubled banks in the form of universal savings guarantees. A technical committee – whose members would be appointed by the Ministry of Finance, the Banco de México, and the National Banking and Securities Commission (CNBV) – would make all decisions on the terms and conditions under which support was to be granted under Fobaproa. The Law determined that the trust was to be constituted with annual and special contributions from commercial banks, as well as allocations from the central bank.

In addition, the Mexican negotiators to NAFTA were able to extract important concessions for the financial industry. The Treaty stipulated strict ceilings on foreign participation in Mexico's financial sector. No U.S. or Canadian bank was initially allowed to buy a Mexican bank until 1998, and even then, foreign acquisitions were to be limited to banks with less than 4 percent market share. Moreover, the combined total of all foreign banks could not

exceed 8 percent of net capital until the year 2000. Finally, even though a few new bank licenses were granted between 1990 and 1994, market restrictions remained heavy.[48]

The new bank owners found themselves operating in a rather propitious environment where incentives to undertake high-risk-but-high-payoff activities were strong. In exchange for the high prices paid for the commercial banks, the new financiers had protection and a quite favorable regulatory environment. It is not surprising then that credit expanded the way it did. As Graph 4.1 shows, credit grew steadily over the 1990s to reach a climax in 1994-95.

Graph 4.1 Credit Growth as a Proportion of GDP*



Year-end GDP
Source: Banco de México and Comisión Nacional Bancaria y de Valores.

[48]The minimum level of capitalization required to charter a new bank was set at 0.5 percent of combined capital and reserves of the entire banking system. By 1993, that figure represented almost $30 million. Many economists concluded that such requirements excluded a large proportion of would-be entrants while, in fact, protecting current market participants (McComb et al. 1994).

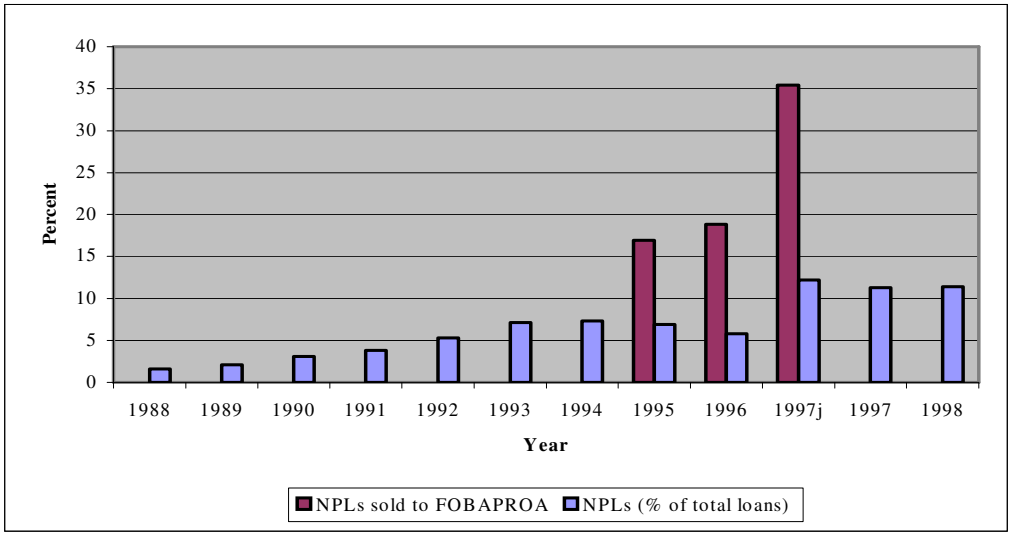
In terms of economic size, Mexico occupied the fifteenth place in the world; in contrast, it was the world's sixth economy in credit card use (El Financiero, May 22, 1992) which speaks to the extraordinary expansion of consumer credit too, even despite the relatively high interest rates banks were charging. A study conducted a couple of years after the privatization concluded that the comparatively high interest rate spreads charged by Mexican banks was important evidence of monopoly power and lack of competition (Gavito and Trigueros 1994).

Back then, however, no opposition was openly articulated against these developments. With political power still heavily concentrated in the hands of the president, those groups regarded as important were being stimulated and protected while less important actors were kept under tight control with the help of the official party's machinery and the Pacts.

Perhaps the sector more clearly affected by protection to the financial industry was that constituted by small and medium businesses. Typically excluded from bank credit before 1982, their situation did not change much after the expropriation (Sales Gutiérrez 1992, Maxfield 1989). Under the new re-privatized banks small business loans were still scarce and expensive, but at least the credit supply had increased.

In addition, small and medium businesses did not have much political clout, nor were they able to articulate an effective opposition to government's policies. The PRI had been able to control the organizational resources of its representative association, Canacintra, and, as a result, they were rendered practically powerless to stop the rapid progress of trade liberalization and other measures that threatened the interests of their members (Davis 1992, Shadlen 1997).

Graph 4.2: Evolution of Non-Performing Loans



(*) Year-end figures except for 1997. The first bar for 1997 corresponds to January and the second one is the year-end figure. Both have been introduced here to account for the changes in accounting practices that took place that year.
Source: Banco de México and Comisión Nacional Bancaria y de Valores.

For opposition parties the subject simply did not seem relevant enough to turn it into an electoral issue. The political left and some legislators from the National Action Party (PAN) had openly opposed the re-privatization of banks but after that law received Congressional approval, no other financial sector issues were raised in any meaningful way. While some members may have endorsed it privately, neither the PRD nor the PAN openly campaigned in favor of greater competition in the financial sector. During the second half of Salinas' term, other issues such as NAFTA and the Zapatista rebellion in 1994 were much more important to the opposition's agenda.

Over time the privatization process became subject of heavy scrutiny and criticism and has often been blamed for setting the stage for the financial crisis of 1994-95. In fact, as early as 1993 analysts and authorities began to seriously worry about the rapid deterioration of banks' loan portfolio, as Graph 4.2 illustrates. In fact, according to some analysts, it was this concern

that made Mexico's financial authorities more reluctant to increase interest rates in order to counter the massive capital flight that preceded the peso collapse (Edwards, 1998).

Despite the rise in non-performing loans being so notorious, financial authorities did little to correct the situation, except in those cases where widespread fraudulent practices were not only obvious but were also affecting Mexico's image with international investors. By November of 1994, the Mexican government had intervened in Banco Union and Banca Cremi for these reasons.

4.4. PRELUDE TO THE CRISIS: POLITICAL UNCERTAINTY AND FINANCIAL VOLATILITY.

For most people, 1994 was to be the year when Mexico would enter a new era whose outlines had been shaped and guided by the strong hand and capable leadership of President Carlos Salinas de Gortari. This was the year Salinas would step down from the presidency with a high probability that, given the stellar nature of his economic achievements at home, he would go on to become the first chairman of the World Trade Organization (WTO), the newly organized successor to the General Agreement on Tariffs and Trade (GATT). It was expected that Mexico's incoming president would be able to build upon this legacy to consolidate the economic gains made under the previous administrations. Prevailing public opinion looked forward to a new, improved Mexico: a newly industrialized nation, a member of the so-called "first world".

The succession of events that took place that year, however, shattered all those expectations. Following the Zapatista uprising in January and the assassination of PRI's

presidential candidate in March, massive capital outflows decreased international reserves from more than 28 billion dollars to half that number by July. This was also an electoral year.

The elections recorded an exceptional level of participation (beyond 77 percent of the eligible vote) and were considered the cleanest in Mexico's contemporary history. Colossio's replacement, Ernesto Zedillo, won with the lowest margin ever received by a PRI presidential candidate (50.2 percent of the vote) but enjoyed a legitimacy his predecessor did not. And despite the fact that many Mexicans believed the PRI had something to do with Colossio's murder, the party also participated from this renewed legitimacy – having won the majority in Congress, the PRI could claim a victory without fraud for the first time in many, many years.

Happiness would not last long. A peaceful solution to the Zapatista rebellion continued to escape the authorities as tensions heightened. On September 28 then PRI's Secretary General, José Francisco Ruiz Massieu, was murdered. Such adverse political developments generated new rounds of concern and instability, which typically translate into capital flight. Since earlier that year, Banco de México had been repeatedly intervening in open market operations in order to maintain attractive interest rates. In addition, increasingly sophisticated risk-hedging instruments were being offered to investors.[49]

Unfortunately, none of these strategies worked in the long run. By the time Zedillo took office major economic indicators were rapidly deteriorating. An overvalued currency and a growing balance of payments gap[50], higher interest rates in the United States, and the large

[49]Among these, the infamous Tesobonos became dominant. Tesobonos were government bonds with exchange rate guarantees intended to sustain capital inflows by reducing currency risk for investors.

[50]The cornerstone of Salinas' stabilization program was the exchange rate which meant a self-binding commitment to adjust all policies so as to guarantee its stability. At the end of 1991 a crawling peg system was introduced in order to increase Banco de Mexico's flexibility in monetary policy. Under this system, the peso was allowed to fluctuate within a pre-established band. The system works as long as the exchange rate does not consistently hit the

amount of short-term, dollar-denominated debt accumulated[51] shot up negative market expectations about the capacity of the Mexican government to sustain the exchange rate regime and service its obligations. Between November and December the level of international reserves in Banco de México fell dramatically from 16.2 to 11.1 billion dollars, but on December 19 alone portfolio investors suddenly withdrew more than 3 billion dollars from the country's capital markets. This put enormous pressure on the exchange rate. On December 20, the Mexican authorities called a highest-level emergency meeting with the Pacto members – representatives of business, labor and other interest groups – to discuss the possibility of "a mini-devaluation". The result of this meeting was a disaster: Mexico's international reserves plunged to 6 billion dollars in two days.[52] The Mexican government was no longer able to resist another speculative attack on the peso and on December 22, without the acquiescence of either business or labor, the government let the peso float freely against the dollar. The exchange rate increased 67 percent with respect to beginning-of-the-month figures, interest rates soared, financial markets became highly volatile and Mexico plunged into a depression.

The collapse of the peso constituted a major blow to Mexico's financial system as both banks and firms underwent significant foreign exchange losses. Sharp increases in interest rates

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limits of the band because, in those cases, monetary authorities are forced to defend the currency as if there was a fixed exchange rate regime. For the most part of 1992 and 1993, the peso showed a consistent tendency towards appreciation. Currency overvaluation had a negative effect on the balance of payments. A short-lived trade surplus in 1987 quickly turned into a 14 billion dollar deficit by 1991. The sustainability of the Mexican model, in lieu of a growing balance of payments gap, became a source of increasing concern throughout the second half of the Salinas' administration.

[51]By April of 1994 the balance from Tesobonos represented more than 5 billion dollars; by the end of that year, the balance surpassed the 20 billion-dollar mark. Because the large majority of Tesobonos were short-term contracts, very soon markets began to suspect the Mexican government would have trouble servicing its commitments given the economic conditions.

[52]Former president Carlos Salinas de Gortari would point to this meeting as the key factor triggering the crisis and would baptize it as "the December mistake".

along with the rapid drop of economic output that followed the devaluation prevented many borrowers from servicing their debt and this, in turn, induced a rapid deterioration in bank loan portfolios. The liquidity crisis that ensued was further aggravated by banks' inability to rollover their short-term foreign currency liabilities after the devaluation.

It would be a mistake, however, to assign full responsibility to the currency devaluation for the financial crisis that followed; as we have seen earlier, the health of the Mexican financial system was already compromised well before the peso crash. The crisis, however, made their problems more than evident and jeopardized the stability of the entire financial system.

4.5. GOVERNMENT RESPONSES 1994-1998.

Between 1994 and 1997 the Mexican government's response to financial crisis can be described as reactive rather than proactive, erratic (i.e. sometimes rushed, sometimes delayed), rather discretional in its application, lacking transparency and accountability, and quite inflexible in its overall approach. During this period the crisis was handled inside the executive branch mainly by the CNBV and Fobaproa; Banco de México and the Ministry of Finance had some involvement as well, but much more limited.

4.5.1. Early reactions.

At the beginning of the crisis, the Zedillo administration saw the problem as one of short-term liquidity and confidence. On the one hand, international investors were getting really nervous over the government's capacity to service its $30 billion-dollar debt from *Tesobonos* due in 1995. Like his predecessors, Zedillo knew very well the consequences of failing to fulfill its

commitments for a country that depends so much on foreign financing. On the other, Mexican banks had a large foreign-exchange exposure and were proving increasingly unable to rollover their foreign currency-denominated debt after the devaluation of the peso. While authorities were aware of the precarious situation of many financial institutions before December of 1994, they appeared convinced this was a temporary situation that would improve with macro-economic recovery.

As a consequence, the government focused its efforts during the first few months into the crisis at recovering the confidence of international investors in the Mexican economy and the financial system. Lacking domestic resources, the administration invested time and political capital into securing international support, particularly that of the United States. In March of 1995, after much debate and controversy, assistance came in the form of a 48.8 billion-dollar package orchestrated by the U.S. with the IMF and other donor countries.[53] In addition, a credit line equivalent to 2.8 billion dollars was negotiated with the World Bank and the Inter-American Development Bank with the sole purpose of helping the financial system refinance their foreign currency denominated debt. As a result, Banco de México was able to supply emergency credit to those banks with dangerous foreign-exchange exposure at above-market interest rates.[54] A total of sixteen banks participated in this program for a total disbursement of $3.9 billion dollars.

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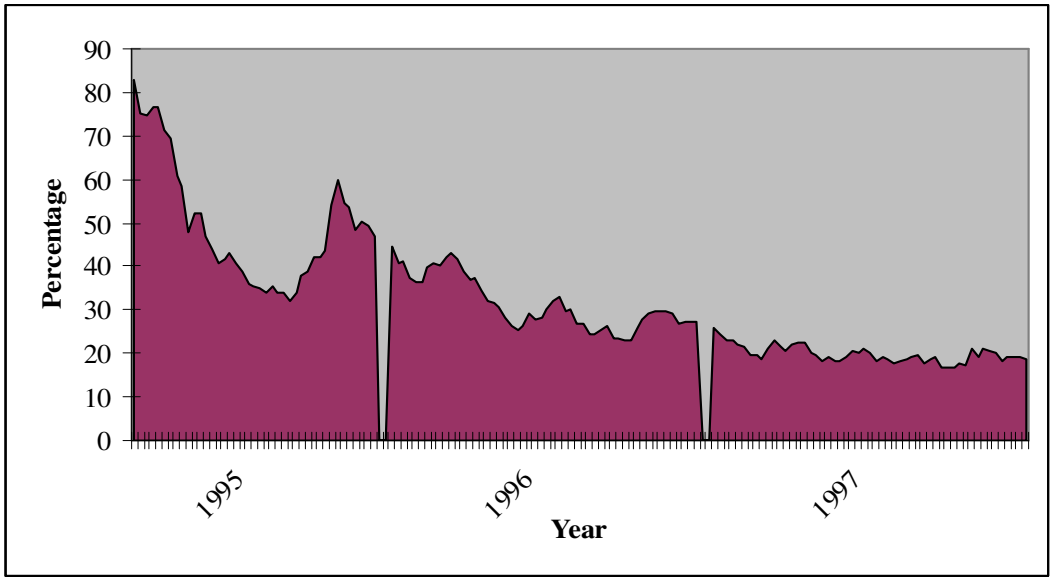
[53]The move was highly controversial in both Mexico and the United States. In the United States the Republican-dominated Congress raised strenuous objections to Clinton's proposal of bolstering Mexico's financial solvency. Since legislators threatened to reject it, the Treasury Department resorted to the rarely-used Exchange Stabilization Fund (ESF) to make a $20 billion-dollar credit line available to Banco de México without Congressional approval. The rest of the money came from IMF (17.8 billion), Bank of Canada (1.1 billion) and the Bank for International Settlements (10 billion).

[54]Dziobeck (1998) reports Banco de México using two different interest rates: 25% and 17.5%, the lower rate applicable only to outstanding balances below a threshold set by the central bank: Claudia Dziobeck, "Market-based Policy Instruments for Systemic Bank Restructuring", IMF Working Paper No. 98/113, 1998.

The program rules generated positive incentives for banks to start repaying their loans rapidly.[55] In fact, by September of 1995 all credits had been entirely serviced.

Even though this international rescue package was instrumental in Mexico's subsequent macro-economic recovery and the return of international capital, it did very little to restore the living standards of regular Mexicans and to address the fragility of the country's financial institutions.[56] If economic conditions made it difficult for many borrowers to repay their loans, skyrocketing interest rates made it irrational (see Graph 4.3). As a result, many banks did not have sufficient capital to cover losses, nor were they able to earn interest income as interest rates made borrowing so expensive that credit stagnated.

Graph 4.3 Short-term interest rates: 28-day government paper (Cetes), 1995-1997



Source: Own elaboration using data from Banco de México's statistical data base.

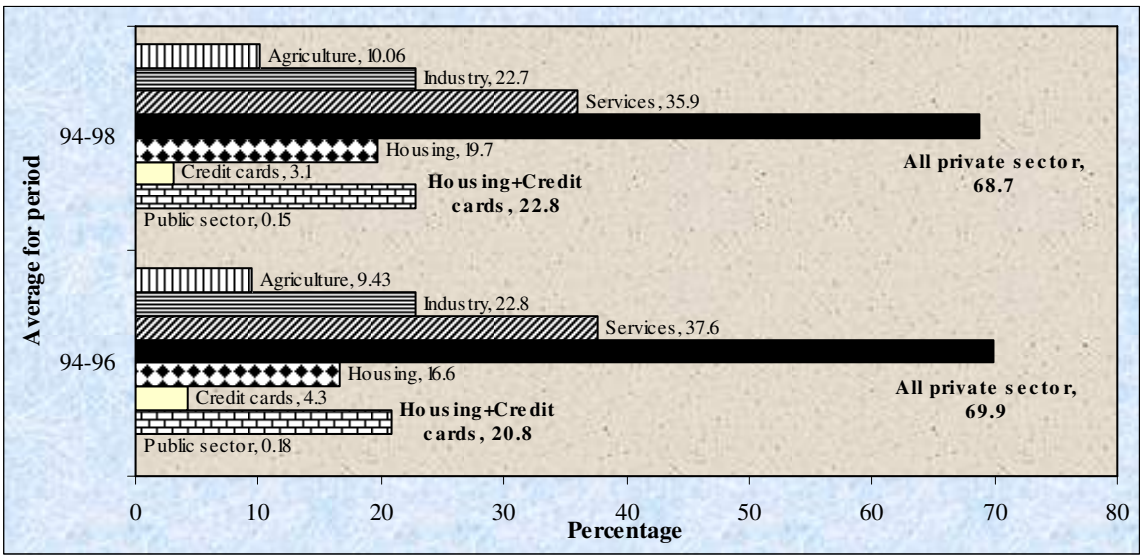
[55]Penal interest rates could be reduced after the bank had repaid pre-established proportions of the total loan.
[56]The U.S.-orchestrated support was released on the condition that Mexico met IMF's conditions regarding monetary and fiscal policy as well as structural reform: tighten the money supply, reduce fiscal expenditures to achieve a surplus, and continue the privatization efforts, among other reforms. Interestingly, the Mexican government also committed to continue removing restrictions to foreign – most notably U.S. – investment in Mexico's financial institutions.

By the end of 1995 the share of non-performing loans had reached 16.9% - a figure significantly higher than the 7.3% reported at year-end 1994 (see Graph 4.2). By then it had become clear to the authorities that short-term liquidity was only one aspect of the problem and that many banks were suffering from severe capitalization problems to the point of being technically insolvent. As a result, other measures had to be put in place.

4.5.2. Debt relief and restructuring programs.

On December of 1994 interest rates had jumped from roughly 14 percent to 31 percent in less than two weeks; throughout the first quarter of 1995 the move continued upwards until late March, when short-term rates on government bonds (Cetes) reached 83 percent (see Graph 4.3). With the economy in shambles and bank rates on loans soaring, most borrowers found it increasingly difficult to service their debts. Additionally, in a good number of cases outstanding balances plus interest accumulated exceeded the value of collaterals and guarantees.

Graph 4.4 Share of non-performing loans by sector



Source: Own elaboration based on data from Banco de México statistical data base.

Concerned over the growth of the non-performing portfolio since 1993, the Mexican authorities expected this problem to become much worse under increasing interest rates. The government also rightly assessed that the private sector had the largest proportion of past-due loans (see Graph 4.4 above).

The problem, however, was perceived to be temporary – businesses facing cash flow shortages and having difficulty paying off their loans would see their situation improve with the economy. In the meantime, the government decided to provide some assistance to these businesses in order to make sure they continued repaying their credits and, in consequence, banks could also improve their liquidity position. The first major debt-relief scheme, the UDI Restructuring Program, was thus mostly aimed at the private sector.

The UDIs were inflation-indexed investment units and loans restructured under their umbrella offered the benefit of quasi-constant payments throughout the loan's life. Debtors would pay more total interest on the loan over the long run but monthly payments would be much smaller during the first few years than with typical repayment schedules. The expectation was that the UDI program would be used by companies suffering from serious cash flow problems – as a result of the recession and increased interest burden – but otherwise viable. Credits restructured under the UDI program would provide a grace period in which only the interest and none of the principal had to be paid. Banks were allowed to take the UDI-restructured loans off their balance sheets. The original UDI program was later expanded to include mortgage loans and certain kinds of consumer credit.

The UDI program did not meet with much success. First, there was much confusion about its workings and commercial banks – through which the program would work – failed to make

adequate promotion of it amongst their clients. Second, while business people generally understood that the prime virtue of restructuring debt in UDIs was liquidity in the first two or three years after closing the deal, they were uncertain about future economic growth and macro-economic stability, particularly as it relates to inflation. During the first year in operation, less than 4 percent of the annual goal amount set by Banco de Mexico had been restructured in UDIs (Levin, 1995).[57] Finally, there was a major setback to the UDI program two years after its introduction when the nominal value of the UDI rose by 84 percent while actual inflation had only increased by 66 percent – and worse, salaries had only gone up by 44 percent during the same period (El Universal, April 26, 1997).[58]

Dangerous levels of non-performing loans, however, were not limited to the private sector. Middle class consumers and mortgage holders were also finding increasingly difficult to service their debts and many believed bank rates were becoming short of abusive. In addition, many small industrial and rural businesses could not meet the requirements to restructure in UDIs or found the program's long-run implications unacceptable. Desperate by their situation and angry at the government because of the crisis, many of them joined *El Barzón* to express their grievances and press demands.[59]

A small rural movement nobody had heard of in large cities, *El Barzón* quickly turned into a half-million member organization in the weeks following the onset of the crisis and

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[57]Levin reports that the maximum amount reported to had been restructured under the UDIs program was $3 billion pesos while standard restructuring of past-due business loans outside the UDI system (essentially overdue debt renegotiated over a longer term) came to over 300,000 credits totaling $30 billion pesos.

[58]The value of the UDI is determined by Banco de Mexico based on increases registered by the National Consumer Price Index (CPI).

[59]*El Barzón* takes its name from an old song about dire conditions in the countryside during the early 20th century and before the Mexican revolution of 1910. The song is about a poor peasant who must take a loan from his *patrón* (the landowner) in order to buy a used yoke (*barzón*). The loan conditions are such that the peasant remains in debt for life (i.e. interest payments accumulate faster than he can pay them off).

continued to expand rapidly during 1995 and 1996. Juan José Quirino, the organization's national coordinator at that time, noted that "this is a middle-class movement. The middle class is being destroyed by the economic policies of the government" (The Houston Chronicle, February 26, 1995). It was estimated that 40 percent of *El Barzon's* membership in 1996 came from small business in the cities and "many of the protesters were businesspeople and professionals – the same constituency that had initially supported the market reforms of the Salinas era" (Williams 1996, pp. 18-19).

Its members have never denied their obligations – they recognize both their debts and their obligation to repay – but declared to be unwilling to pay what they considered to be usurious interest rates, or to remain uninformed of their legal rights with respect to banking transactions. In fact, *El Barzón* gained more respect amongst the population and more attention from the authorities and banks themselves when they signed an agreement with the Mexican Bar Association. Under such agreement, the organization was able to offer advice and legal resources to bank debtors willing to confront their creditors and negotiate with them.[60] In addition to taking advantage of debtor rights via the legal system, *El Barzón* showed an impressive capacity for organization and mobilization – they would as quickly put together public protests outside the main central bank offices in Mexico City as they shut down private banks across different states.

Through their public demonstrations and a well executed publicity campaign, *El Barzón* called attention to the credit problem faced by the small business owner or farmer, the first time

[60]The president of the Mexican Bar Association publicly accused the banks of acting abusively and breaking the law (El Financiero, April 5, 1995). In April of 1995 El Barzon delivered 400,000 remittances of debt to Nafin and the Superior Court, declaring their debt obligations to be invalid. These documents charged bank managers of fraud through usury (La Jornada, April 24, 1995).

home owner, and the regular credit card user, who practically had been excluded from the first debt-relief plans instrumented by the Mexican government.[61]

For the most part, the Mexican government did not officially engage in negotiations with *El Barzón* – neither did it ever recognize the organization as a legitimate vehicle of representation for debtors. In discourse at least, authorities considered the organization as a group of irresponsible people promoting the culture of "no-payment". Yet, they were concerned about the possibility of mass default on bank loans[62] and the consequences that might have on investor confidence, particularly if moratoria was to be accompanied by violent public demonstrations against the federal government.

Interestingly, more traditional sectors inside the PRI also became increasingly concerned not only with *El Barzón's* rapid success and its potential consequences, but also with the lack of flexibility and responsiveness on the part of Mexican authorities. In July of 1995 two committees in the PRI-dominated Senate declared permanent sessions to keep an eye on how the banking sector was responding to debtors' claims. But more to the point, then PRI Senator Fernando Solana declared publicly that "[authorities] should stop looking after the interests of financiers only without thinking of the people's interests. It is time we start looking at what is happening in Mexico's streets and country side…" (Proceso, July 31, 1995).

In response to these pressures, the Mexican government – in close consultation with the Association of Mexican Bankers – developed and implemented a variety of additional debt-relief

[61]According to one count, the original restructuring plan through UDIs excluded about 95 percent of El Barzón's membership (El Financiero, April 5, 1995).

[62]El Barzón was already threatening a national moratorium on bank payments that exceeded 50 percent real interest. In a society where the "no-payment" culture is widespread, this seemed like a highly credible threat. Moreover, outdated bankruptcy laws and an inefficient judicial system made it virtually impossible to collect collateral from non-paying debtors.

schemes which, like the UDI program, made use of fiscal resources administered by commercial banks to subsidize discounts and interest rate allowances. The majority of these programs were targeted to specific groups such as mortgage loan holders, borrowers engaged in agricultural and fishing activities, as well as small and medium size businesses. Benefits offered under these programs included discounts on outstanding balances (differentiated by magnitude) as long as eligible debtors had kept their payments current and/or restructured their loans.

After the UDI program's disappointing performance, another umbrella scheme was created in August of 1995. The Agreement for the Immediate Support of Bank Debtors (ADE) offered a temporary interest rate subsidy tied to debt restructuring. Unlike the UDI program, the ADE was more inclusive as it was made available to all kinds of credit card and consumer loan holders, as well as for housing and private sector credits. At least in the short run, the ADE proved moderately more successful than the UDI program. Until February of 1997, when it was officially closed, approximately 93.1 percent of all eligible loans had been restructured under the ADE program representing approximately $321.7 billion pesos.

And yet, despite the already large sums of public money invested in these programs, the proportion of non-performing private sector loans accumulating in the financial system continued to be alarming. According to one estimation, for every hundred productive units, fifty-three were being unable to repay their loans and more than thirteen had already suspended loan repayments for over a year (El Financiero, October 1st, 1996). A small group of large firms, however, concentrated around 9 percent of the system's total loan portfolio and claimed to be experiencing severe problems to service their bank debts (La Jornada, May 10, 1996). Given the magnitude of such liabilities and the sheer weight of these firms in the Mexican economy, the

government set up a restructuring support and mediation committee called the Coordinating Unit for Business-Bank Settlement (Ucabe).

In principle working mostly as a "facilitator" in negotiations between banks and firms, Ucabe attempted to work out case-by-case solutions for debt restructuring that would avoid embargoes, bankruptcies, or more payment suspensions. Ucabe was intended to be a temporary scheme and all assets involved in the negotiation process between banks and firms would be eventually sold off. As part of several restructuring processes, banks received firm equity as a form of re-payment but the idea was to quickly get rid of them, even giving preference to original holders. According to a former Ucabe member, the committee helped approximately 90 companies to restructure their bank debt, assuming full responsibility for 51 of them (the remaining restructuring processes were supervised by other entities); of these, 41 cases were considered complete successes, with a total amount of restructured loans equivalent to roughly $6 billion dollars (Mulás 2001).

For reasons that would be explained in the following sections, despite these efforts to address debt relief, throughout 1995 – and the entire crisis, indeed – the Mexican government directed most measures to the banking sector. In any case, the Mexican government became the "owner" of nearly 350 billion pesos in business and real estate assets via loan purchases made by Fobaproa. More than 80 percent of those assets corresponded to private sector loans for which businesses had committed their plant facilities, cash flows, productive processes, as well as land and other receivables. Such businesses (about 150,000 units) typically had debt levels beyond 80 percent. (El Financierio, January 23, 1997).

4.5.3. Regulation and supervision.

One major problem in the Mexican financial crisis was the inability or unwillingness of the authorities to measure the true extent of bank loses. While valuation of assets and liabilities at market prices is difficult in periods of financial distress and volatility, existing accounting practices may further complicate the task if they are not up to international standards.

In the Mexican case, the authorities were quite flexible with regards to what banks were allowed to report. Recognition of banks' losses was thus difficult because prevailing accounting standards permitted income to accrue interest on non-performing loans, bad loans could be rolled over, and existing loan classification and provisioning rules were not strict (De Luna 2000).

While this flexibility allowed banks to remain in good standing on paper, it soon became clear to the authorities that it was becoming an obstacle to assessing the real impact of government support programs. As a result, on January of 1996 the CNBV announced that banks would now be required to report their balance sheets according to international practices. The capitalization index was raised to 10 percent and provisions for non-performing loans were set at 50 percent minimum (CNBV 1996). Banks were now to report their balances and non-performing loans according to the US GAAP methodology.[63]

Throughout that year however, it became increasingly evident that many banks were technically insolvent, a situation that would be made much worse after the introduction of tougher accounting standards. Perhaps for this reason, it took more than a year for the new standards to be actually applied. On January of 1997, the CNBV announced that this time it was

[63]Under the new system, the value of past due loans is reported as the total unpaid balance of the loan. Under the old standard, only missed payments were entered as past due and the outstanding balance could still accrue interest. With the GAAP system, the outstanding balance is considered past due after a set number of payments (varying by type of loan) is missed (CNBV, 1996).

for real and accompanied such news with another announcement: banks unable to meet capitalization requirements under the new standards would not receive any support from government (El Financiero, January 14, 1997).

The announcement raised a wave of speculation about which banks would actually be able to meet the new standards. In the end, increased transparency had a price. After repeatedly declaring that there would not be any more rounds of loan purchases towards capitalization, Fobaproa surprised everybody when it announced the purchase of bad loans for a total of 25.9 billion pesos to Banamex, Bancomer, Bital, Atlantico and Bancrecer (El Financiero, January 27, 1997).

In the eyes of many analysts, the operation was intended to ease the transition of benefited banks to the new accounting standards. But for banks the measure implied duress, as Francisco Gonzalez Martinez, then Director General of Bancrecer, would comment, "…it was very tough medicine because with [the new standards] the balance of non-performing loans almost tripled and that required an aggressive constitution of provisions and zero profits" (El Financiero, December 11, 1997).[64]

4.5.4. Intervention and restructuring operations.

Between 1994 and 1998 the Mexican government determined the managerial intervention of twelve commercial banks (Table 4.1) and put six more under restructuring operations (Table 4.2). No other process was launched after 1998.

[64]And yet, anecdotal evidence obtained in interviews with bank managers at Banorte and BBV, for instance, suggested the application of the new standards was done incompletely or with enormous flexibility. In interviews with the author, government officials at the CNBV and Banco de México reluctantly confirmed such perceptions.

Table 4.1. Evolution of government intervened banks

Bank	Market share*	Government intervention		Government support	Status	
		Date	***Motive***		***As of 1998***	***Current***
Unión	2.7%	09/94	Fraud	Credit[1]	Restructured; branch network sold to Promex in 1996	Liquidated (2001-03) In bankruptcy since 2003
Cremi	2.3%	09/94	Fraud	Credit	Restructured; branch network sold to BBVA in 1996	Liquidated (2001-06)
Banpaís	3.5%	03/95	Related lending	Credit, Procapte[2] and PCCC[3]	Restructured and sold to Banorte in 1997	--
Interestatal	0.1%	09/95	Irregular credits	Credit	Branch network sold to Atlántico in 1997	Liquidated (2001-06)
Oriente	0.5%	10/95	Insolvency	Credit	Restructured; branch network sold to BBVA in 1996	Liquidated (2001-06)
Obrero	0.4%	11/95	Insolvency	Procapte and PCCC	Restructured; branch network sold to Afirme in 1997	Liquidated (2001-03) In bankruptcy since 2003
Pronorte	0.03%	01/96	Insolvency	None	Intervened	Liquidated (2001-05)
Sureste	0.4%	05/96	Insolvency	Credit	Intervened	Liquidated (2001-05)
Capital	0.1%	05/96	Insolvency	Credit	Intervened	In liquidation since 2001
Anáhuac	-	11/96	Irregular credits	None	Intervened	Liquidated (2001-06)
Confía	2.1%	08/97	Fraud	Credit and Procapte	Restructured and sold to Citibank in 1998	--
Industrial	0.2%	02/98	Irregular credits	None	Intervened	Liquidated (2001-06)

(*)Share of the bank in the system's total assets as of 1994, according to information from CNBV. ($^{\Omega}$)All liquidation processes started in 2001. (^{1})Refers to a simple credit from Fobaproa guaranteed with equity. (^{2})Refers to the Temporary Capitalization Program administered by Fobaproa. (^{3})Refers to the Capitalization and Loan Purchase Program administered by Fobaproa.

Interventions and restructurings are complex and time-consuming processes with a direct and significant impact on the crisis resolution and its fiscal costs. In the Mexican case, interventions and restructurings turned out to be the most expensive operations associated with the bank rescue and most of them took a very long time to complete. By the beginning of 1998

even those interventions started before the onset of the crisis were still ongoing. As we will see in later sections, a few more years would pass before any resolution was achieved. As for the fiscal cost, official figures for early 1998 reported all bank rescue operations totaling 545.8 billion pesos or roughly 14.4 percent or the country's GDP. Of these, interventions and restructurings represented approximately 45.3 billion pesos or 8.3 percent of GDP.[65]

The impact of intervention and restructuring operations depends heavily on the authority in charge of implementing, coordinating and supervising them. While most people identified the bank rescue with Fobaproa, it was actually the National Banking and Securities Commission (CNBV) the government entity responsible for coordinating all crisis management operations, including bank interventions and restructurings.

While not all banks in a crisis may warrant the same treatment, in the Mexican case the rules determining when a bank had to be intervened and/or restructured were broad and vague. The law entitles the CNBV to conduct managerial interventions in order to suspend, normalize or resolve all operations that threaten bank solvency, stability or liquidity, including those considered irregular or illegal. The CNBV also has, *de facto*, the authority to restructure banking institutions. The law does not provide more specific guidelines, nor were operational rules developed. In consequence, the authority had ample room to exercise discretion.

Available evidence suggests that interventions were reserved for cases of massive fraud or really small market participants. And even those in which fraud or major irregularities triggered the intervention had a relatively small share of the system's total assets. Two of the most publicized fraud cases were Banco Unión and Banca Cremi, both intervened before the

[65]Next in line were Fobaproa's loan purchases and mortgage debt relief schemes, which at that time represented 2.6 and 1.2 percent of GDP. The share of all the other programs combined was roughly 2.3 percent of GDP.

peso devaluation and which, together, accounted for roughly 5 percent of the market. Perhaps the one exception was the case of Banpaís, the eight-largest bank with approximately 3.5 percent of the market, seized very early in the crisis as a result of flagrant irregularities. Unlike Unión and Cremi, however, Banpaís had American depository receipts being traded in the New York Stock Exchange for almost a year (The New York Times, March 4, 1995), which may have provided incentives for the authorities to intervene despite the size. The last official case of fraud-related intervention was that of Banca Confia, an institution that in 1994 accounted for only 2.1 percent of total assets in the system. The remaining intervened banks represented less than 2 percent of the market.

Table 4.2. Evolution of government restructured banks

Bank	**Market share***	**Government support**	**Status**	
			As of 1998	***Current***
Serfín	12.1%	Credit[1], Procapte[2] and two rounds under the PCCC[3]	Still operating	Restructured (1999-00) and sold to Santander in 2000
Inverlat	5.6%	Credit and Procapte	Still operating; 55% sold to Scotiabank	Restructured (1999-00) and remaining 45% sold to Scotiabank in 2000
Bancrecer	2.7%	None	Still operating	Restructured (1999-01) and sold to Banorte in 2001
Promex	2.3%	Two rounds under the PCCC	Still operating	Restructured (1999-00) and sold to Bancomer in 2000
Mexicano	6.4%	One round under the PCCC	Restructured and sold to Santander in 1997	--
Centro	2.0%	Procapte	Restructured and sold to Banorte in 1997	--
Atlántico	5.5%	Procapte and two rounds under the PCCC	Restructured and sold to Bital in 1998	--

(*)Share of the bank in the system's total assets as of 1994, according to information from CNBV. ([1])Refers to a simple credit from Fobaproa guaranteed with equity. ([2])Refers to the Temporary Capitalization Program administered by Fobaproa. ([3])Refers to the Capitalization and Loan Purchase Program administered by Fobaproa.

Once intervention took place, Fobaproa guaranteed the institution's solvency through the opening of credit lines and other support mechanisms, and took the bank's shares as guarantee. Fobaproa assumed all losses and provided the necessary capital for the bank to attain the required regulatory levels. The intervened bank was then either sold or liquidated, depending on its business value (determined by the CNBV). If liquidation was chosen, the branch network was sold with the buyer assuming all liabilities. In compensation, a promissory note was issued by the selling bank establishing its obligation to pay off all liabilities at a future date. The intervening authority kept in charge of realizing all assets and dealing with all pending judicial matters.

In general, interventions associated with fraud were decided fairly quickly with one controversial exception: Banca Confia. The magnitude of irregularities in Confia warranted intervention since April of 1995 when its low capitalization levels made it participate in Procapte and was actually the last bank to exit this program. That did not mean good news – a few months later Confia entered Fobaproa's loan purchase program. According to the program's general rule, the Mexican government would support the participating bank with double the amount of fresh capital injected by stockholders. After selling off loans to Fobaproa for a total of 8.7 billion pesos, stockholders were supposed to contribute roughly 4.3 billion pesos in fresh capital. Nonetheless, the bank's capital position did not improve at all: in December of 1995 amounted to 1.6 billion pesos and in June of 1996 it went down to 1.5 billion; towards December of 1996, when the bank completed a second loan purchase round with Fobaproa, its capital was 1.6 billion pesos (El Financiero, September 14, 1997).

Despite all the irregularities, the Mexican authorities put off Confia's intervention until 1997. In March of that year, all bank executives and senior officers were instructed to report directly to CNBV supervisors. In 1997 Citibank took control of Banca Confia. Instead of restructuring the bank, the Mexican government decided to sell it at a discount to make it more attractive for Citigroup to absorb the entire – and highly deteriorated – loan portfolio.[66] Interestingly, the resolution of Confia was actually the cheapest of those where major fraud was involved. The deal proved highly controversial as its completion coincided with the indictment and arrest of previous owner, Jorge Lankenau, on fraud charges and involved the government backing up Confia's bad loan portfolio for an estimated USD 1 billion. The deal's terms under an increasingly explosive political environment made into a highly controversial issue.

Table 4.3: Intervention and restructuring operations – Fiscal cost per bank
(Billion pesos updated to December of 2004)

Intervened and liquidated		***Intervened and restructured***		***Restructured only***	
Bank	**Cost**	**Bank**	**Cost**	**Bank**	**Cost**
Union	140.9	Banpais	66.5	Bancrecer	132.7
Cremi	65.6	Confia	43.1	Serfin	122.2
Oriente	24.0			Inverlat	88.4
Obrero	15.6			Mexicano	42.6
Interestatal	8.4			Atlantico	36.8
Capital	8.0			Promex	26.7
Pronorte	0.3			Centro	23.8
Total	**262.8**		**109.6**		**473,2**

Sureste, Anáhuac and Industrial are excluded because they did not entail any fiscal cost: Sureste paid off the credit it received from Fobaproa; Anáhuac and Industrial did not receive any fiscal support.
Source: Secretaría de Hacienda y Crédito Público (SHCP) and Auditoría Superior de la Federación, Cámara de Diputados.

Restructuring, on the other hand, appears to be an option reserved for troubled banks with greater market share and where the CNBV found no evidence of flagrant fraud or irregular

[66]Citibank paid USD 45 million for Confia with the promise of injecting an additional USD 175 million in capital. The Mexican government agreed to back up all of Confia's bad loans, a commitment estimated at USD 1 billion.

operations. It is quite possible the authority considered all these banks to be viable and, in consequence, support via Fobaproa was arranged for them to remain operational and pay off depositors. In the end, all these banks were either merged with other institutions or acquired by international investors but not without first absorbing substantial amounts of fiscal resources.

Table 4.3 shows that restructuring operations were overall more expensive than interventions and do not necessarily reflect each bank's market size. While this does not necessarily constitute evidence of undue preference for a particular bank, it does raise the question of how much wiser it would have been to intervene – and then restructure – more institutions to minimize fiscal drain. As a top-level official at the CNBV confessed: "if [the CNBV] had followed the law to the letter, there is no doubt many more banks would have had to be intervened… or even nationalized".[67]

Particularly salient in this regard is the case of Banca Serfin. It was well known early in the crisis that Serfin, the third largest bank, was one of the most affected in terms of loan portfolio deterioration. Acquired by the powerful Grupo Fnanciero Obsa, headed by the powerful Sada dynasty, in $2.8 billion pesos, Serfin was injected capital and participated from the loan purchase program in a significant way. The CNBV never dictated a managerial intervention but early in 1996, in lieu of the Sada family's difficulties raising the necessary capital to keep their bank, Serfin's management was replaced on the "strong recommendation" of the authorities. The new team was made up of bankers with extensive public administration experience – in fact, its head was close friends with Guillermo Ortíz, governor of Banco de México. Unofficially, the move was seen as a de facto intervention without the bank having to fall in Fobaproa's hands –

[67]In personal interview with the author on condition of anonymity.

with the consequent fiscal and political cost (El Financiero, February 20, 1996).[68] Despite the new management, however, Serfin proved to be ineffective at raising the necessary capital in the face of continuously deteriorating assets.

By the time the bank rescue became the most salient issue in the political debate, opposition from the right was openly calling for Serfin's intervention and questioning the terms of governmental support to this institution. As PAN legislator Gerardo Buganza, a key financial negotiator in the Chamber of Deputies, pointed out, "the intervention of Banca Serfin would have a lower cost than its rescue…[…]…promissory notes in Fobaproa's hands represent 53.6 billion pesos while its capital only amounts to 8.7 billion." (El Financiero, October 15, 1998). But fiscal cost was not the only concern. Another PAN legislator, Felipe de Jesus Cantú, would comment that, "there are very strange operations [in Serfin]; there is great favoritism towards this bank on the part of the CNBV" while PRD representative Cuauhtémoc Velasco asked, "Why has [Serfin] not been intervened? There are much more irregularities here than in any other bank already under intervention"(El Financiero, October 21, 1998).[69]

While no doubt the most publicized, Serfin was not the only case in which intervention might have been called for and the authority decided to only clean it up instead. The CNBV knew about the precarious situation of Banco Inverlat – another very expensive restructuring – since 1995, when the bank reported a capitalization index close to 2.5 percent, but chose not to

[68]There was also some speculation about the authorities' interest in preparing Serfin to be acquired by a foreign institution.

[69]The terms under which certain operations intended to support Serfin's capitalization were conducted are unique in that they cannot be found elsewhere in the system. In one of those operations, for instance, Fobaproa, guaranteed the value of HSBC's investment in Serfin (after that bank acquired 19.9 percent of the group's social capital) against market fluctuations. The agreement established that if after six years the average market value of such investment is lower than the amount originally invested, Fobaproa would pay off the difference. (El Financiero, October 21, 1998) While Serfin's franchise value and other considerations may have warranted such special treatment, it did not look good in the eyes of public opinion and opposition legislators.

intervene. Audits conducted in 2003 concluded that by not doing so, the CNBV failed to act according to its legal attributions and faculties (ASF 2004).

Whether interventions are less or more fiscally expensive than restructurings is a subject of debate. It is also unclear the extent to which the Mexican authorities considered the potential fiscal cost of intervention versus restructuring as a guideline for their decisions regarding each bank. In interviews with the author some officials involved in the rescue at CNBV and Banco de México suggested that the international experience they had available to inform their decisions suggested interventions tend to be more costly than other approaches and, as a consequence, fewer interventions than strictly warranted were undertaken. It also transpired that the highest cadres in government shared the belief that widespread intervention would be seen as a de facto bank re-expropriation, something that would put a question mark on the government's commitment to market principles – thus affecting investor confidence – and possibly induce a generalized panic and consequent bank runs.

While these concerns may have been real, the fact remains that decisions about what to do with a bank became the sole purview of the CNBV and were made on the basis of the agency's own assessments. Rarely were independent audit firms invited to perform diagnostics and when they were, the authority never used the resulting evaluations to make a decision (De Luna, 2000). Bank viability was determined on a case by case basis without the authority, in the process, establishing more detailed criteria and standard procedures. In general, banks were allowed to stay in the market until evidence of fraudulent activities was found or shareholders were deemed incapable to inject fresh capital into their troubled institutions. For the most part, the CNBV kept silent about the rationale for their decisions except in highly publicized cases.

4.5.5. The CNBV and the management of the crisis.

As the agency suddenly in charge of managing the crisis, the CNBV had many limitations. For one, it was poorly equipped to undertake the tasks assigned to it. To manage the crisis, the CNBV relied on its own staff, which was already committed to supervisory responsibilities and, therefore, could not focus exclusively on dealing with the crisis. In addition, the years of public banking severely affected the agency's institutional capacity to understand and treat troubled banks. As if this was not enough, a former high ranking official at CNBV commented that the team in charge of the crisis had just arrived and was totally unprepared to face something of such magnitude; they were forced to learn along the way under quite strenuous circumstances.[70]

There were no specific or clear guidelines for administrative and/or managerial interventions so, as a result, they had to be conducted in an improvised, if not sloppy, fashion, not producing the necessary reports or documentation to facilitate third party evaluations or to guarantee the consistency and efficiency of all procedures.

In addition, all operations involving financial support had to be done via Fobaproa, which was a separate entity. Eduardo Fernández, CNBV's chairman, was a member of Fobaproa's Technical Committee but had absolutely no authority over it. In practice, it was the Ministry of Finance that had more leverage over both the Fund and the CNBV. For instance, a number of times the CNBV declared the end of all rescue programs only to be outranked by the Ministry of Finance authorizing new loan purchases or debt relief schemes.[71]

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[70]Enrique de la Madrid, former Vice-President at CNBV, in interview with the author.

[71]Throughout 1996, for instance, the CNBV repeatedly stated that all support programs for banks and debtors had concluded, including the loan purchase and capitalization program (Procapte). In January of 1997, however, almost simultaneous to the announcement about the introduction of US GAAP accounting standards, a new round of purchases was authorized for Banamex, Bancomer, Bital, Atlántico, and Bancrecer in the amount of 25.9 billion pesos. Mexican and international analysts were surprised, particularly in the case of Banamex and Bancomer

4.5.6. Capitalization and loan purchases.

The capitalization and loan purchase programs implemented between 1995 and 1997 followed the same gradual and reactive approach observed in measures discussed earlier to deal with the financial crisis. Rather than developing a comprehensive, proactive strategy, the Mexican government dealt with the issues that they popped up. The schemes presented in this section also share important features with the intervention and restructuring operations discussed earlier. One of them refers to the differentiated, case-by-case approach followed by the authorities in the implementation of each program. A second one concerns the absence of clear and specific operational rules guiding decision making under these programs and the resulting high levels of discretion exercised. A third, and final one, involves a variety of organizational capacity problems that got in the way of effective resolution.

The Mexican government implemented two capitalization programs. The first one, the Temporary Capitalization Program (Procapte), was intended as a short-term solution for banks with capitalization levels falling below the regulatory requirement as a consequence of the peso crisis; the main idea was to help them improve their asset position in the face of increasing non-performing loans and tighter accounting standards. While Procapte brought some relief to the system, it soon became clear that banks' problems were much deeper and extended than originally thought. As a result, a new and more ambitious scheme was designed to keep banks afloat: the Loan Purchase for Capitalization Program (PCCC).

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because the authority had also repeatedly said these banks would only be allowed to make one loan transfer to Fobaproa. According to some analysts, the new purchases would reduce the expected rate of increase in the level of non-performing loans for the entire system under the new accounting standards (El Financiero, January 27, 1997). Later that year, the government authorized a new purchase of mortgage loans for a total of 10.3 billion pesos from Banca Serfin in order to pave the way for HSBC to buy 19.9 percent of the financial group and thus inject some fresh capital.

Through Procapte banks were allowed to issue and sell to Fobaproa five-year convertible bonds in order to take their capital-to-assets ratio above the minimum standard of 8 per cent set at Basel. The government was entitled to take over those banks unable to convert their debt into equity capital. In addition, banks were charged higher inter-bank interest rates and were prohibited from issuing other subordinated debt until they exited the program. In a way, Procapte was conceived as a complement to Fobaproa's deposit insurance functions and Banco de México's liquidity support in dollars in an attempt to restore the confidence of domestic and international markets in the country's financial system. Indeed, no single case of bank run occurred, public confidence in the banking system was preserved and most banks were able to return to the international capital markets and continue borrowing in foreign currency at similar rates to those prevailing before the crisis.

The problem is that Mexican banks were not only facing liquidity problems or temporary capital shortfalls – they were enduring deep insolvency exacerbated by the economic crisis. Authorities, however, were incapable – or unwilling – to recognize the magnitude of the problem. Procapte fell short of solving the main causes of banks' problems. A total of seven banks participated in this program (see Table 4.4). Of these, three were intervened (Banpaís, Obrero and Confia) and four required further capitalization and major restructuring (Serfin, Inverlat, Centro and Atlántico). The good news is Procapte did not carry any cost to taxpayers – by the time it was discontinued (June 1997) all participating institutions had paid off their obligations. The bad news is that all those banks were already under government intervention, or had begun to sell non-performing loans to the government.

Under the PCCC, banks were able to exchange delinquent loans for ten-year, zero-coupon, non-tradable government-issued bonds on the condition bank shareholders increase their capital by one peso for every two pesos of bad loans transferred to Fobaproa. Participating banks were also required to set aside approximately 25 percent of the total debt transferred in the form of reserves. The bonds accrued interest over their term but were payable only at maturity. Finally, banks kept responsibility for the administration and recovery of the portfolio sold according to their policies and procedures while government supervised both management and results.

Table 4.4. Evolution of government capitalized banks

Bank	**Market share***	**Government support**		**Status**	
		***Procapte*[1]**	***PCCC*[2]**	***As of 1998***	***Current***
Banamex	20.0%	No	Yes	Still in operation	Sold to Citibank in
Bancomer	17.2%	No	Yes	Still in operation	Sold to BBVA
Serfin	12.1%	Yes	Yes	Still in operation	Sold to Santander
Mexicano	6.4%	No	Yes	Acquired by Santander	--
Inverlat	5.6%	Yes	No	Majority sold to Scotiabank	Sold to Scotiabank in 2000
Bital	5.2%	Yes	Yes	Still in operation	Sold to HSBC in 2001
Atlántico	5.5%	Yes	Yes	Sold to Bital	--
Banpaís	3.5%	Yes	Yes	Sold to Banorte	--
Promex	2.3%	No	Yes	Still in operation	Sold to Bancomer in 2000
Confia	2.1%	Yes	No	Sold to Citibank	--
Banorte	2.1%	No	Yes	Still in operation	Still in operation
Centro	2.0%	Yes	No	Sold to Banorte	--
Obrero	0.4%	Yes	No	Branch network sold to Afirme	
BBV	--	No	Yes	Still in operation	Still in operation

(*)Share of the bank in the system's total assets as of 1994, according to information from CNBV. ([1])Refers to the Temporary Capitalization Program administered by Fobaproa. ([2])Refers to the Capitalization via Loan Purchases Program administered by Fobaproa.

It was not a bad deal for the banking industry at all. "With the stroke of a pen, a million-peso loan that had no chance of being collected in full was transformed at 75 percent of book

value into an instrument backed by the government" (Willoughby and Conger 1998). In addition, all banks were allowed to participate in the scheme, except those under government intervention. Finally, the bad loans were bought at the highest possible price (face value less provisions), with the bank assuming only 25 percent of resulting losses (Fobaproa would absorb the rest).

A total of ten banks participated in the PCCC for an updated (2004) fiscal cost of 111.1 billion pesos. Of these, only two have survived. six required government support twice (Promex, Serfin, Bital, Atlántico, Banorte and Probursa) and three of them were later intervened by the authorities (Atlántico, Promex and Serfin).

Although conditions for participation in the loan purchase program were in principle the same for all banks, in practice substantial differences were observed in the prices at which Fobaproa purchased loan portfolios from different banks. While Fobaproa paid 92 and 90 cents for each peso to Banamex and Banco del Atlántico respectively, loans purchased from Bancomer were paid at 87 cents on the peso and those from Serfin and Banorte/Bancen for example were paid at 75 cents on the peso (El Financiero, February 19, 1996). In response to the disclosure of such "unequal" treatment, a high level official from the Ministry of Finance commented: "the rules were general but treatment to all participants cannot be uniform because some of them have certain weaknesses and others greater capacity in some areas" (El Financiero, February 19, 1996). At some point the banks favored in terms of prices were indeed weaker and perhaps in greater need of support (Atlántico or Promex for instance) but others were supposed to be the stars (i.e. Banamex and Bancomer) and yet received quite a generous treatment on the part of Fobaproa. Additionally, while the large majority of banks sold off an average of 19 percent of

their loan portfolios, Probursa (BBV) and Mexicano sold off in excess of 50 percent (El Financiero, December 24, 1996).

Although virtually all banks participated from these programs, the greatest support was concentrated in four banks: Serfin, Banamex, Mexicano and Bancomer; Banamex and Bancomer being the ones receiving the largest capital injections and selling off to Fobaproa the largest values in non-performing loans (El Economista, March 14, 1996).[72]

4.6. THE BAILOUT'S SCORE.

By 1996, the magnitude of bad loans acquired by Fobaproa was already so big that a new agency was created with the purpose of valuating and disposing of impaired assets. This agency, a small (fifty-employee) subsidiary of Fobaproa, was established with the purpose of "creating a secondary market for bank assets acquired by the government, including loan portfolios purchased through the capitalization and other support programs". Unofficially, it was estimated that during the first three years of operation, the agency would be able to recover approximately 30 percent of the market value of those assets in an orderly fashion (El Financiero, May 29, 1996). In addition, it was argued, the agency would help stabilize asset prices to avoid selling them off cheap should the need for liquidity emerged, and enjoyed an advantageous position to "negotiate an adequate solution to the debt problems of the main companies" because it had the capacity to sell loans and assets (El Financiero, May 31, 1996). Ultimately, this should help reduce the fiscal cost of the bank bailout.[73]

[72]Bancomer and Banamex had captured, until March of 1996, 47 percent of total capital injections and had transferred to Fobaproa about 44 percent of the total face value of non-performing loans.

[73]The entity was called Agency for Asset Valuation and Sale (VVA would be the Spanish acronym). According to one of VVA's former directors, Javier Márquez Diez Canedo, in interview with the author, VVA was closely

Despite all the (international) praise, the new agency did not live long. On August 31st, 1997 it was itself liquidated after conducting only one public tender in which assets were sold at an average 50.5 percent discount. In the end Fobaproa ended up absorbing VVA's functions because "concentrating responsibilities allows for greater efficiency in the recovery of [Fobaproa's] assets"(El Financiero, August 12, 1997). The main problem thus appears to have been the absence of an adequate mandate for VVA and a multiplicity of actors involved in the process – Banco de México, Fobaproa, the CNBV and a variety of bank committees.[74]

Unlike similar schemes in other parts of the world – including the United States where the RTC provided a partial model – the creation of VVA did not involve the transfer of bank assets to the resolution entity; in fact, Mexican banks kept control and management rights over those assets at all times. And Mexican banks proved either unable or unwilling to provide VVA with all the information necessary to integrate each credit file and estimate its market value. As Eduardo Fernández, CNBV's chairman, had later to recognize "when we created VVA we all assumed the information about guarantees, legal documents and credit files were in much better condition. The main problem we have had so far is that we do not have clear and adequate information to valuate and sell those assets and to answer the questions of potential buyers" (El Financiero, April 27, 1998).

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modeled to the US Resolution Trust Company and the Swedish Securum, both of them agencies developed with similar purposes after the savings and loans crisis in the case of the US and the agency created by the Swedish government two years after their banking crisis of 1990. Despite the RTC and Securum serving as models for the Mexican VVA there were important differences to consider. In the same interview, Javier Márquez pointed out that while the majority of assets in Fobaproa were commercial and industrial credits, much more difficult to allocate in secondary markets, about 70 percent of those of Securum were physical (i.e. machinery, equipment, real estate) and those of RTC were real estate and mortgage collateral.

[74]Javier Márquez confirmed these perceptions in interview with the author but seemed to believe an even bigger problem facing VVA was the inability and/or unwillingness of officials from Fobaproa and the CNBV to resist pressures from the banking sector with regards to the prices at which assets should be sold.

There were some previous indications that this could happen because expectations were probably unreasonably high. In 1995, for instance, a real state sealed-bid auction was conducted by LaSalle Partners of Chicago on behalf of five of Mexico's largest banks. A total of 371 properties that had come into the banks' hands as a result of the crisis were offered. Under a depressed market, most bids came in at half – or less – of the book value the banks had registered. In the end, the banks balked and agreed to sell off only 79 properties, preferring to avoid the write-downs the other sales would have required. In the words of Ernesto Ure, the executive who handled the auction, "The reluctance of the banks to confront market realities proved to be a major obstacle" (The New York Times, April 6, 1996). Rafael Bello, Head Strategist for Morgan Stanley would comment that "…it was difficult to close any deals [on bank impaired assets] because banks were not willing to recognize the real prices of the loans" (El Financiero, March 7, 1998).

Another problem facing asset recovery was the absence of an industry specializing in asset management. This was particularly problematic in the case of intervened banks because, during the process, borrowers recurrently stop payments and neither the authority nor the banks under intervention could provide adequate infrastructures for asset management. Unfortunately, roughly 53 percent of Fobaproa's portfolio came from such intervened institutions (IPAB 1999).

Indeed, Fobaproa would finish 1997 unable to dispose of the large majority of assets it had absorbed and facing an increasingly hard-to-handle financial situation. However, up to that moment, it had been able to keep the financial system alive. It is interesting to point out that around the time the first bank interventions took place but before the crisis hit, the Fund was a source of differences between bankers and authorities. In the banker's eyes, Fobaproa's

unlimited protection in the face of Union and Cremi's outright fraud and inefficiency impinged a moral hazard on "well-managed, decent institutions". Referring to the same subject but already shaken by the crisis, the same bankers would say, through ABM's chairman, that, "now is not the time to change the operating rules of Fobaproa, the savior of bankrupt banks" (El Financiero, June 24, 1996).

4.7. CONCLUSION.

The main argument of this chapter has been that the overly strong character of the Mexican presidency made a significant contribution to the causes of the 1994-95 financial crisis and at least partially explains the nature and the cost of the strategy implemented to contain and manage the crisis. The previous sections examined the sources of presidential power in Mexico emphasizing the role of the president's party, the PRI, to maintain control of Congress and all legislative activity. Also discussed was the way in which power concentration shaped the financial system in Mexico since the expropriation of 1982 turning it into a concentrated, uncompetitive, and risky industry.

Troubles in the financial sector began well before the crisis thanks to reckless lending practices and the inability – or unwillingness – of the authorities to properly supervise bank behavior.[75] This chapter illustrates how power concentration facilitated the orchestration of a rapid response to the financial crisis under a very clear mandate: the financial system was to be assisted and no banks would be allowed to fail. The strategy implemented in response, however,

[75]In his report to Congress, auditor Michael Mackey concludes that CNBV's regulatory and supervisory activities relied on two sources of information: bank data (provided by the banks themselves) and rumors: Michael W. Mackey, "Report of Michael W. Mackey on the Comprehensive Evaluation of the Operations and Functions of the Fund for the Protection of Bank Savings "FOBAPROA" and Quality of Supervision of the FOBAPROA Program 1995-1998", July 1994.

suffered from major shortcomings – most of them the result of a crisis manager ill-equipped to deal with a problem of this magnitude. Evidence presented in this chapter suggests that the lack of organizational capacity and resources (including authority) made it very difficult for the CNBV to implement a more decisive strategy towards bank interventions and restructurings, which in the end, contributed to a longer crisis period. Finally, this chapter shows how power concentration made it possible for Zedillo and his collaborators in the CNBV and Fobaproa to conduct a bank rescue characterized by its lack of transparency, its excessive discretion over the use of public resources and, ultimately, its very high cost to taxpayers.

Despite the huge public investment already made, the Mexican financial sector would end 1997 in very bad shape. With borrowers still unable – and unwilling – to repay, insufficient capitalization, liquidity problems, and low profitability, banks were really struggling to survive. In this context, of course, banks were unable to return to business as usual (i.e. loan money) and were having a hard time keeping their banks from going to different –most likely foreign – hands. With their public image tainted by the scandal and discredit brought by former colleagues (Cabal Peniche and Angel Rodriguez), and by DEA's accusations of money laundering in association with the Casablanca Operation, Mexican banks were really going through perhaps their worst moment in history.

Chapter 5: Congress and the Resolution of the Mexican Financial Crisis

5.1. INTRODUCTION.

The previous chapter argued that power concentration at the hands of the Mexican president made a significant contribution to creating the conditions for a financial crisis to quickly spread out. It also showed how the executive headed by President Zedillo enjoyed enough power and authority to orchestrate a quick but expensive response to crisis that materialized in a very generous bailout for the financial sector. Crisis management was characterized by secrecy and discretion – decision-makers faced no scrutiny or opposition to their mandate, namely, to save banks at all costs.

After the PRI lost the majority in Congress (following the 1997 mid-term elections), the balance of power in Mexico changed in favor of the legislature. This chapter shows how the new power distribution contributed to delay crisis resolution for as long as the cost of maintaining the status quo was smaller than that of voting with an increasingly discredited party in government. In the end, a compromise of sorts was reached – one tailored to provide a politically feasible outcome at the expense of a more cost-efficient solution to the crisis.

Despite initial stumbles, the Mexican government quickly moved to address the macro-economic instability caused by the peso devaluation. But the devaluation had long lasting consequences for the economies of regular Mexicans who, despite government rhetoric, did not feel the recovery in their pockets – quite the opposite, wages and purchasing power continued to decline. For many, the devaluation had shrunk their savings and multiplied their bank debt.

Disappointment ran high amongst those who struggled to make ends meet and service their obligations while the government poured significant amounts of cash into the banking system.

As mid-term elections approached, political pressure on government and the ruling party were mounting. Not only were different groups voicing their discontent about the administration's handling of the financial crisis, but also opinion polls revealed no party would win a majority in Congress (Reforma, June 27, 1997). In addition, the PRI was facing strong competition in places where it had traditionally been dominant and, for the first time, a Mexico City mayor was going to be elected and everything pointed towards the likely victory of Cuauhtémoc Cárdenas, a leader from the leftist PRD.

In these circumstances, the Mexican authorities somewhat intensified their efforts at convincing the population the economy was doing better. President Zedillo frequently traveled outside the capital promoting his success at pulling Mexico out of its deepest economic slump in decades while opening new schools, roads, electrical grids and health clinics. Yet, in what could be considered a confirmation of the Zedillo government's commitment to macro-economic stability above all else, authorities largely refrained from relaxing economic policies in order to lure voter favor. In this regard, the opinion of the Chief Economist at the American Chamber of Commerce in Mexico, one of many independent analysts monitoring the country's economy, is quite suggestive: "I can't say there is absolutely no election spending […] but I don't see anything that indicates the government has deviated in any important way. It's pretty impressive that they have stayed so much on track"(The New York Times, May 29, 1997).

The government failed to convince the majority of Mexicans that things were getting better and, as a result, they punished the PRI at the polls as never before. The electoral results

gave opposition parties 52 percent of the total seats in the lower house, more than enough to take away PRI's control over the decision-making process. The opposition was split ideologically and it was unclear how this was going to play out against the PRI in the near future. For the moment though, both the PAN and the PRD quickly appointed leaders to key committees during the first session – which the 239 PRI representatives boycotted.

The mid-term legislative elections of 1997 dramatically altered the institutional balance of power in the country against the executive and in favor of the legislature. Although the traditionally dominant PRI had been losing electoral ground throughout the years, the results of the 1997 elections constituted a major, and somewhat unexpected, blow to the interests and aspirations of party members but, most importantly, it forever altered the nature of the political game. Yet, it would take some time before political actors could fully realize the implications of such change and alter their expectations and strategies accordingly.

5.2. THE MEXICAN CONGRESS AS A VETO PLAYER.

On paper the Mexican Congress has always been a strong institution. The Constitution guarantees its independence from the president, provides it with enough mechanisms for checking the executive branch, and endows it with a large number of legislative prerogatives in the economic, political, administrative, judicial, and social spheres (Orozco Henriquez 1988, Casar 2002). An overview of Mexico's contemporary legislative history, however, shows an entirely different picture – one in which Congress is a weak and subordinated institution, unable or unwilling to exercise its constitutional mandate.

Congress in Mexico has played a rather poor role in law making. Historically, congresspersons have rarely introduced law proposals and, for the most part, they have shown a propensity to unanimously approve executive bills without substantial discussions, delays or amendments.[76] Congressional checking of presidential powers has not been a common practice either, even though the Constitution grants Congress authority over issues ranging from confirmation of appointments to the power to impeach the head of the executive for high treason or severe offenses against the common order (Casar 2002, Weldon 2002).

The legislature that emerged from the mid-term elections in 1997 significantly eroded the partisan ties between the president and Congress that permitted extensive executive domination over the legislative process. Without changes to the institutional rules, opposition parties found themselves for the first time not only with the power to pass and block laws, but also with the opportunity, legitimacy and resources to assert their role vis-à-vis the PRI should a propitious moment arise. In the context of the 1994-95 financial crisis, this meant investigating and questioning the executive's actions and, ultimately, subjecting the ruling party's economic policies to much needed – if highly embarrassing – public scrutiny.

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[76]Systematic collection of data on initiatives and voting decisions is fairly recent but reveals interesting patterns. Between 1982 and 1985, while 56 percent of initiatives were introduced by House members (especially by the opposition), the rate of approval went overwhelmingly in favor of the executive. During this period, the executive's share of the total number of bills passed was 92 percent, which means it was able to get approval on 97 percent of initiatives sent to Congress. The picture is no different for the period between 1985 and 1988. Original data is from B. Nacif: Benito Nacif Hernández, "The Mexican Chamber of Deputies: The Political Significance of Non Consecutive Reelection", Ph.D. Dissertation, University of Oxford, 1995, cited by M.A. Casar: Maria Amparo Casar, "Executive-Legislative Relations: The Case of Mexico (1946-1997)", in ed. Scott Morgenstern and Benito Nacif, *Legislative Politics in Latin America* (Cambridge University Press, 2002): 126. The pattern started to change significantly as opposition parties gained more space in Congress. Between 1991 and 1994 the rate of approval of initiatives coming from the Chamber of Deputies increased to 25 percent. Original data is from C. Martínez: Cecilia Martínez Gallardo, "Las Legislaturas Pequenas: La Evolucion del Sistema de Comisiones en la Camara de Diputados de Mexico, 1824-2000", Unpublished manuscript, 1998, cited by M. A. Casar, Ibid: 127.

That said, it would still be some time before the opposition fully understood the issues involved in the financial crisis and had the opportunity to exploit the situation to their political benefit. Towards the end of 1997, however, the magnitude of the crisis was becoming evident to everyone. Although the economy reactivated between 1996 and 1998, the share of non-performing loans remained abnormally high.[77] Authorities tried very hard to downplay it, but the bank rescue itself was acquiring alarming proportions: by then Fobaproa had accumulated about $65 billion dollars in liabilities, and experts estimated only about a third of such amount would ever be recovered. According to some calculations, by the end of 1997 the government would have invested the equivalent to 12 percent of GDP – roughly ten times the Ministry of Education's budget and twenty times the total resources devoted to public health – to shore up a financial system that, at the end of the day, not only remained unhealthy but was unable – or unwilling – to reactivate the credit supply. A business leader would comment that the bank rescue was "society's rescue of an industry hostile to debtors" (El Financiero, May 4, 1996).

And, indeed, as debtors still struggled to service their obligations, stopped payments, or went to trial against their banks, the possibility of a massive default remained real. Perhaps more importantly, organized debtors saw a potential ally in the opposition-dominated legislature and, after a series of top-level meetings with the leaders of the right-wing PAN and the left-wing PRD, they were able to insert themselves in the legislative agenda. A variety of key legislators began calling for new debt-relief programs – some of which proposed reductions of up to 50 percent of outstanding balances – echoing those put forth by *El Barzón*. Of greater consequence; however, would be the creation of the first banking sub-committee on October of 1997. Members

[77]Despite massive bad loan transfers to Fobaproa, the rate of non-performing loans was above 10 percent – much higher than what is generally considered reasonable. See Graph 4.2 in Chapter 4 for details.

of the Budget and Treasury committees, with the support of all party leaders (even the PRI), established the banking sub-committee in order to "review and investigate" all government decisions in support of the banking system but, most importantly, to "finally set boundaries to the excessive discretion with which public resources [had] been used in this matter" (El Financiero, October 22, 1997).

Legislators involved in the investigations began to voice concerns about the legality of transferring fiscal resources to the banks without the authorization of Congress, the lack of transparency surrounding Fobaproa's operations, and potential corruption between government officials and a few bankers now being prosecuted for fraud and other white-collar crimes. Yet, the legislature remained at the margins of the crisis resolution process and, in consequence, no open conflict with the executive had developed. The situation would soon change.

5.3. AIMING AT CRISIS RESOLUTION: THE 1998 FINANCIAL REFORM PACKAGE.

It took the Zedillo administration more than four years to produce a coherent and comprehensive strategy aimed at resolving the financial crisis. Such strategy took the form of a package of reforms and provisions submitted to the consideration of Congress on March 26th and 31st of 1998.

The package contained a number of initiatives aimed at dealing with what government considered major obstacles to successful financial recovery and, in many ways, also represented a lukewarm acknowledgment of some of the institutional problems and shortcomings leading to or worsening the crisis. The proposed legislation thus sought to strengthen regulation and

supervision, facilitate bank capitalization, improve the legal framework, and reform the deposit insurance system. All provisions were contained in three key pieces of legislation.

The first one would modify the Law of Banco de México in order to increase the autonomy of that central institute. This proposal would leave virtually all authority to determine monetary policy in the hands of Banco de México. As a result, the Exchange Commission – controlled by the Ministry of Finance – would be dissolved so that central bank could have exclusive control over both monetary and exchange rate policies. The Ministry of Finance would still be able to voice concerns as the federal government's financial policy representative, but final policy decisions would be Banco de México's exclusive purview. This initiative seemed the logical consequence of all the controversies associated with the government's handling of the exchange rate before (with Salinas) and after the onset of the financial crisis. As officials from the central bank declared, the new law would "significantly curb executive power in exchange rate matters, where discretion has been the norm, [in order to] avoid populist measures" (El Financiero, March 30, 1998). Skeptics charged that the real impact of this measure would be small, however, because in a free-floating system exchange rate policy is limited to open market operations. In other words, it was the decision to abandon a managed exchange rate system in favor of the market that had pull the breaks on excessive presidential authority over financial matters. Yet, this initiative would meet the resistance of opposition legislators, as we will see below.

The second initiative included modifications to the Law of the National Securities and Banking Commission (CNBV) and to the laws governing financial groups, banks and brokerage firms. In the first case, the goal was to increase the autonomy of the National Securities and

Banking Commission (CNBV), the main bank regulatory and supervisory body, by removing it from the Ministry of Finance's control and placing it under the authority of Banco de México. A six-member Board would govern the new CNBV: three of them from the central bank (the governor and two deputy governors), the CNBV's president, and two officials from the Ministry of Finance. While the head of the CNBV would remain a presidential appointee, her tenure would be a fixed six-year term (with the possibility of re-appointment) and, during it, she would be banned from engaging in any outside political or business activities.

In this fashion, the executive sought to further isolate financial regulation and supervision from political pressures and presidential manipulation, accusations of which were significantly tainting the crisis management and resolution processes. The measure was also perceived as a way to improve the efficiency and quality of CNBV's performance by encouraging the consolidation of a strong professional civil service like that found at Banco de México. The severe criticisms that would be voiced against the CNBV for its role in managing the financial crisis made this proposal the more important. Yet, as we will see, legislators – consciously or not – paid little attention to it until much later.

The executive also proposed modifications to the laws governing financial groups, banks and brokerage firms in order to open capitalization alternatives to a highly depleted banking system. The new laws would eliminate remaining restrictions on foreign direct investment in Mexican financial institutions. The move was justified on the ground that lifting those restrictions would attract the fresh capital the country's banking system desperately needed.

At the beginning of the crisis, the Mexican government decided to raise the ceiling on the foreign ownership of local and regional financial institutions – beyond the limit established by

NAFTA – to help bolster their solvency. Changes to these laws approved in 1995 allowed foreign companies to own up to 20 percent of any Mexican bank as long as its assets amounted to a maximum of 6 percent of total banking capital.[78] While the 1995 law provided some breathing room to the financial system, it also made sure the top three banks, Bancomer, Banamex and Serfin, stayed in national hands. By 1998, however, even these banks (perhaps most obviously Serfin) were in trouble and stockholders were finding it increasingly difficult to raise the capital necessary to bring their banks back to health. Removing all remaining barriers to foreign ownership was seen as the banking system's best hope for acquiring the strength to deal with the challenges it had to face. In addition, and most importantly, it was likely to be quickest route towards re-activating the supply of credit commercial and industrial firms badly needed.

While legislators generally understood – and some of them even agreed with – the arguments above, the proposal was not well received in Congress. Resistance, however, was less the product of nationalistic sentiments than of generalized concerns with the lack of transparency and the inconsistency with which recent foreign sales had been conducted. It was for this reason that the proposal turned out controversial, as we will see below.

Finally, the third initiative – closely patterned after the U.S. savings and loans crisis resolution – sought to get rid of Fobaproa and replace it with two new agencies. One of them, the

[78]As a result of this decision, smaller foreign banks stepped in with capital and technical expertise to help nurse the industry back to health. A significant portion of Mexico's banking system then fell under foreign control (Marichal, 1997). Spain's Banco Bilbao Vizcaya led the way, buying out the troubled GF Mercantil Probursa as well as branch offices of two smaller banks. Santander, another Spanish bank, bought three-quarters of Banco Mexicano and purchased GF Invermex in October 1996, providing it instantly with the market penetration of 250 outlets. After revealing alarming levels of nonperforming loans, Inverlat sold 50 percent of its equity to the Canadian Bank of Nova Scotia. By May of 1996, about a quarter of Banorte was owned by thirty-five U.S. and British mutual funds. Even second ranked Bancomer had sold 16 percent of its shares to the Bank of Montreal in March of 1996, while number three Serfin sold as much as a quarter of its equity to Hong Kong's HSBC.

Guarantee Deposit Fund (Fogade), would take over Fobaproa's deposit insurance functions but would no longer offer universal guarantees on deposits. Rather, the new scheme would gradually roll back the coverage to a maximum of 500 thousand UDIs (equivalent to between USD 100,000 – 120,000) by 2008. The second agency, the Asset Recovery Commission (Corebi), would be in charge of the inventory, administration and sale of assets acquired by Fobapora during the crisis. Corebi's key goal was to reduce the fiscal cost of the bailout program over a six-year period by means of streamlining the process of asset disposition, through direct sale or transfer of collection rights to third party investors, to put in place strict reporting requirements for any such sale and to provide for administrative oversight.

As part of this third initiative, the executive requested Congress to formally incorporate all liabilities associated with the financial bailout into public sector debt,

> Fourth. Obligations acquired by [Fobaproa] and [Fameval] and backed by the Federal Government, as well as the obligations of banking institutions under the intervention of [CNBV] and supported by [Fobaproa] itself, will now be part of the Federal Government's direct public debt. Consolidation of these liabilities will be for 552.3 billion pesos and should be formalized on December 31st of 1999 at the latest. [79]

The magnitude of the fiscal cost associated with the bank rescue was truly astonishing, particularly if we consider the size of Mexico's financial sector at the time (roughly 30 percent of GDP). There are reasons to believe even the authorities did not expect the cost to be so high. According to senior level officials at Banco de México and the Ministry of Finance, authorities only became fully aware of the bailout's dimensions in 1998, around the time the reform package

[79]Comisión de Investigación sobre el Instituto para la Protección del Ahorro Bancario (IPAB), *Informe final de la investigación sobre el IPAB* (México: Cámara de Diputados, 2006): 75.

was being prepared to be sent to Congress.[80] This is consistent with the way information about government disbursements was disclosed in the national press – figures and estimations would change quite frequently, just as expectations of ending the bailout were soon squashed by announcements of new rounds of loan portfolio purchases.[81]

The disastrous experience with asset recovery during 1996-97 (see Chapter 4), the still fragile situation of most banks (despite Fobaproa's support) together with all the pending interventions and restructurings, and the mounting pressures from the industrial and commercial sectors to re-activate credit lead the Mexican government to consider alternatives to selling off Fobaproa's assets. This did not mean abandoning the idea altogether, but the fact remained that disposing of those assets was proving a daunting task, the market was not paying for them what had been expected (or what was politically acceptable), and the cost to the public of keeping those assets immobilized was certainly getting out of hand. Incorporating Fobaproa's liabilities as public debt would, it was argued, provide the authorities with more flexibility to schedule and re-schedule pay-offs and, through a wider variety of instruments, finance the debt over time. Theoretically, this would reduce the fiscal burden of the bailout in the long run – or would at least make it more manageable. The official position also stressed the importance of this measure to reinforce depositors' confidence in the banking system (and avoid a bank run) and to improve banks' liquidity (and lending capacity) in the short run.

The proposition, however, entailed a very high political cost. Officially accepting Fobaproa's liabilities into public debt represented the largest increase in domestic debt in

[80]Personal interviews with the author – comments made on condition of anonymity.
[81]It is important to point out, however, that variations in fiscal cost estimations were also the product of unstable interest rates throughout the period associated with a consistently high risk premium. The Mexican government showed a slight tendency towards underestimating the risk premium in its fiscal cost estimations.

Mexico's history, from about 28 percent of GDP to nearly 42 percent (El Financiero, February 20, 1998). While it was argued that the resulting debt service would not increase that much, it was not entirely unreasonable to expect that public spending in "socially sensitive" areas could be negatively affected.[82] Most importantly, perhaps, the Mexican government always had a hard time selling its response to the crisis, and particularly Fobaproa's operations, to the public opinion. The majority of Mexicans seemed to believe the Fund only served the purpose of bailing out PRI's wealthy and corrupt allies. The financial package now before Congress was no different in this regard – it was difficult to justify it as a program aimed at helping regular people. A poll conducted in June of 1998 revealed that 55 percent of those surveyed believed the financial package benefited bank owners while only 27 percent agreed it strengthened the banking system (The Wall Street Journal, June 3, 1998).

Given the high stakes involved and the delicate nature of the issue, it was reasonable to expect the executive to do some intensive lobbying in Congress before actually submitting the financial package for legislative approval. There were only a few informal meetings between government officials and some Deputies from the PRI and the PAN about a month before the reforms were officially introduced so legislators had a general idea of what the reform package would look like, but details were never disclosed ahead of time to the opposition despite repeated requests for information that would support the Congressional assessment of Fobaproa and the bank rescue.

[82]The Ministry of Finance argued that the domestic debt service as a proportion of GDP, even after absorbing all of Fobaproa's liabilities, would actually be smaller in 1999 and 2000 (3.6 and 3.2 percent respectively) than during the 1995-97 period (5.1, 4.4, and 4 percent respectively) and very similar to that authorized for 1998, which accounted for 3.4 percent of GDP (El Financiero, April 5, 1998).

In general, opposition legislators acknowledged that Fobaproa's liabilities were already public debt. Then independent Congressman Marcelo Ebrard, also head of the investigative sub-committee on the bank rescue, pointed out that legislators were willing to "regularize" Fobaproa's assets because, "in the end, it is all public debt", as long as they were provided with all the information necessary to conduct internal audits on the Fund's operations (El Financiero, February 25, 1998). PAN legislator Fauzi Hamdan, chairman of the Chamber of Deputies' Financial Oversight Committee, was of a similar opinion, "for us Deputies, this has always been public debt, even though it was not officially recognized as such…[…]…but the executive cannot expect us to simply rubber-stamp his initiative like it was done in the past, we have a public mandate and the obligation to investigate".[83]

The bottom line is that the opposition-dominated Congress wanted a high political price for formally approving the Fund's liabilities as public debt and seemed to believe that, under the circumstances, the government may very well pay it off. Certain that further digging would reveal outright wrong-doings and corruption, the opposition saw this as an opportunity to expose and discredit the ruling party in preparation for the general elections of 2000.

In the end, political struggle over the tiny transitory provision put a hold on the entire reform package and, ultimately, delayed the resolution of the financial crisis. On a brighter note, however, the debate brought to light – perhaps like never before – many of the decision-making practices of a system characterized by heavy power concentration.

[83]In personal interview with the author.

5.4. DEBATING THE BAILOUT UNDER DIVIDED GOVERNMENT AND LEGISLATIVE FRAGMENTATION.

Despite the urgency with which government and the financial community wanted Congress to discuss and approve the financial package, opposition legislators were not ready to do so. Neither the PAN nor the PRD wanted to assume the cost of siding with the PRI without obtaining some kind of benefit either in the form of pork (discussion of 1999's budget was not that far in the calendar), support for valued legislation[84], or votes in coming electoral contests at the state and local levels. In any case, the dominant strategy for the opposition – at least in the short run – was to discredit the government's proposal as much as possible while simultaneously establishing its own credentials. Initially, the opposition presented a unified front against Transitory Provision Four along two fronts: one the one hand, it was argued, the bailout had been unconstitutional; on the other, enough reason was found to suspect collusion between government and bankers, specially those already being prosecuted for fraud and other white-collar crimes. As a result, legislators from both the PAN and the PRD embarked on investigation into Fobaproa's records – one that would consume significant time and resources and, in consequence, put the entire legislative agenda on stand by.

Opposition legislators claimed that the bank rescue violated the Constitution, the Public Debt Law and the Credit Institutions Law because Fobaproa's liabilities were never authorized by Congress and the Fund was used for purposes other than those legally established (El

[84]A high priority in the opposition's agenda was political reform. For the PAN, allowing for a second round in presidential contests was critical to increase the party's chances at winning in 2000 by capturing all the anti-PRI vote; the PRD wanted legislation allowing Mexicans living abroad to vote for president (without having to leave their countries of residence) convinced that those votes would significantly favor PRD candidates.

Financiero, March 31st, 1998).[85] In their opinion, there was enough evidence of illegality to initiate impeachment procedures against Banco de México's governor, Guillermo Ortíz (previously the Minister of Finance), former central bank governor Miguel Mancera, and the CNBV's chairman, Eduardo Fernández.

Government officials denied these allegations. The official position was perhaps best argued by the Fiscal Attorney General, Ismael Gómez Gordillo in an interview with the popular political magazine *Proceso*. In a nutshell, Mr. Gómez argued that Article 122 of the Credit Institutions Law clearly specified the "exceptional" nature of Fobaproa as a public trust and not a government agency. In addition, while the Fund was formally created by the federal government through the Ministry of Finance, its patrimony consisted only of contributions made by private financial institutions. In this logic, Fobaproa was never subject to the rules and regulations applicable to public administration entities, such as the Public Debt Law. The Fiscal Attorney sustained as well that fiscal resources allocated through Fobaproa were not contributions to the Fund's patrimony but, rather, subsidies "clearly specified as such in the Budget Laws of 1995, 1996 and 1997 – all of them approved by Congress" (Proceso, June 7th, 1998).

Mr. Gómez may have been right but his arguments failed to convince the opposition as well as many experts and ordinary citizens. True, the Fund was created with the contributions of commercial banks essentially as a deposit insurance scheme – and one of the very few around the

[85]Article 73, Fraction VIII of the Constitution establishes that Congress should provide the guidelines for the Executive's contracting of public debt and has the authority to recognize and order the payment of such debt; the Article also specifies that Congress must approve all amounts of public debt on a yearly basis. The Public Debt Law, which regulates the application of Article 73, Fraction VIII of the Constitution, states that Congress will authorize the amount of net domestic and external debt necessary to finance the government and other federal public entities. Finally, Article 112 of the Credit Institutions Law contains all provisions for the creation and operation of Fobaproa. The Fund was conceived as a trust to be administered by Banco de México with the idea of providing support to troubled banks in the form of universal savings guarantees. The trust was to be constituted with annual and special contributions from commercial banks, as well as allocations from the central bank.

world to offer complete protection over deposits. It was not conceived with a systemic crisis in mind, nor was it prepared to effectively execute the variety of programs put in place to rescue the banking sector. Very quickly Fobaproa proved insufficient to deal with a crisis of this magnitude. As the Fund ran out of resources and began purchasing non-performing portfolios in exchange for government guarantees, Fobaproa's obligations became *de facto* contingent public debt. In fact, the nature of the Fund changed so much that by 1996 it actually resembled a decentralized government agency. It was hard to sustain the "exceptionality" of Fobaproa under these circumstances.

It is interesting to point out that, included in the introduction to the reform package, the government proposed to reform Article Nine of the Public Debt Law so that Congress would authorize, on an annual basis, the total amount of contingent public debt the Executive could back up with government guarantees. In addition, the Executive would have the obligation to inform periodically about the evolution of such contingent public debt. In a way, this represents an early acknowledgement of how much the balance of power had changed between the Executive and Congress, and of the increased scrutiny Executive decision-making would be subject to in the future.

The debate over the legality of Fobaproa was soon overshadowed by investigations into the Fund's operations but it was never settled. Although with different intensities, both the PAN and the PRD sustained their position that the Fund had violated important legal provisions despite mounting pressures from both government and business to pass the reforms. José Angel Gurría, Minister of Finance, would declare that "if Fobaproa's liabilities are not consolidated as public debt, the country would incur a cost of at least 5 billion pesos per year" in interest

payments (El Financiero, April 21, 1998). Business leader Roberto Salinas León maintained that, while Fobaproa may have badly mismanaged the bank rescue, "the government is right that, without formally recognizing the liabilities of the Fund as public debt, a bank run remains possible" (El Economista, June 25th, 1998). Eduardo Fernández, chairman of the CNBV sentenced "if the [financial] reform is not approved this month or the next, and the process takes longer, we are going to have a major solvency problem in the banking system" (El Financiero, July 20th, 1998). Major analysts and observers also reminded Congress how important it was for the sake of Mexico's financial system to pass the reforms: "without the approval of Congress, the government bonds which comprise a large portion of the healthy assets of Mexican banks will become worthless pieces of paper" (Financial Times, June 18th, 1998).

And yet, investing significant political capital, the opposition repeatedly refused to convert Fobaproa's liabilities into direct public debt and conditioned any progress in the negotiations over the financial reform package on the government releasing all the "necessary" information for a thorough investigation into the Fund. Both the PAN and the PRD claimed an investigation was necessary because of the dubious circumstances surrounding many of Fobaproa's operations. The highly publicized cases of Unión, Cremi, Banpaís and, more recently, Confia, were only the beginning.

One of the most notorious characters in Mexico's financial debacle was Carlos Cabal Peniche, known to have been close to the Salinas family, especially to Raúl Salinas de Gortari[86],

[86]Early in the Zedillo administration Raul Salinas de Gortari was arrested on charges of masterminding the murder of his ex-brother in law (and PRI's Secretary General) Jose Francisco Ruiz Massieu. In January of 1999 he was convicted and sentenced to 50 years in prison for the murder. He has also been accused of money laundering and "inexplicable enrichment".

and who contributed large sums of money to a number of PRI political campaigns.[87] During the privatization process Cabal Peniche bought Banco Unión and Banca Cremi, both of which he allegedly sacked for several hundred million dollars. A few months before Zedillo took office, the CNBV moved in on his banking empire after having detected major "irregularities". Cabal temporarily avoided prosecution by fleeing the country.[88]

Another infamous personality was Angel "El Divino" Rodríguez, once chairman of Banpaís, whose claim to fame came from allegedly plucking USD 400 million from his bank. The bank collapsed soon afterwards under a myriad of bad loans that eventually found their way onto Fobaproa's books, while "El Divino" escaped to Spain. He was extradited in 1998 to face charges of fraud and embezzlement. With the help of his family and lawyers, he soon launched a media offensive against key government officials such as CNBV's chairman Eduardo Fernández and Banco de México's governor Guillermo Ortíz. He declared, for instance, that Guillermo Ortíz had endorsed him to receive credits from Fobaproa because they were close friends and allies. In addition, "El Divino" made public the "generosity" of Eduardo Fernández with a selected group of the country's largest firms (such as Alfa, Bancomer, Vitro, Mexicana, Cintra, and Camino Real, among others), whose debts had been sold to Fobaproa even though they were completely solvent (El Financiero, June 5, 1998).[89]

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[87]Carlos Salinas de Gortari, Ernesto Zedillo and Roberto Madrazo were the most salient figures amongst those politicians supposedly benefited by Cabal Peniche's generosity. The scandal was not only about the contributions themselves but also about the allegation that at least some of this money had dubious origins.

[88]Cabal Peniche was finally found and arrested in Melbourne, Australia on November of 1998. While he fought extradition fiercely, the Mexican government was able to bring him back to the country to face twenty-two criminal charges. To date, however, federal prosecutors have been unable to get a conviction on any of them (some charges have actually been dropped – others are still pending).

[89]Like in the case of Carlos Cabal Peniche, most of the charges brought against Angel Isidoro Rodriguez have not resulted in convictions. Only in 2004 did he lose an important appeal before the Supreme Court. The Court sustained an earlier conviction on tax evasion and ordered him to pay $300 million pesos (about USD 30 million) to the Treasury.

To complete the group there was Jorge Lankenau. Once the chairman of Grupo Financiero Abaco-Confia, he was indicted and convicted on charges of fraud, racketeering and tax evasion towards the end of 1997. From his "residence" – as he used to call the Topo Chico penitentiary where he was serving his sentence – he accused Eduardo Fernández of using egregious criteria for purchasing new loans under Fobaproa and demanded a thorough investigation into the CNBV's decision-making processes. Most irritating for him was, however, the fact that Confia was being sold to Citibank for a price he deemed "a gift".[90] He practically accused Fernández of putting him in jail as a result of his opposition to the Citibank deal: "[Fernández] threatened me a few times, especially when I talked to president Ernesto Zedillo, when I tried to defend the institution I presided…[…]…Eduardo Fernández called me and told me that the next time I tried to speak to Mr. Zedillo he was going to raise accusations against me because I could not obstruct his plans to take over Confia and give it to Citibank as a gift" (El Financiero, April 16th, 1998).[91]

Authorities in general were too careful to address these accusations directly, but they were forced to recognize the controversial nature of a large proportion of loans absorbed by Fobaproa. Central bank governor Guillermo Ortíz had to admit, though cryptically, that "there were loans made that everyone knew were made by some banks, in conditions under which they should not have been loaned" (El Financiero, May 27th, 1998). Making particular reference to the

[90]Confia was sold to Citibank for a price reportedly not much higher than the bank's book value (Wall Street Journal, May 12, 1998). The sale price and the incentives worked out by the Mexican government in order to close the deal (see Chapter 4) resulted in political controversy. Authorities were accused of offering inappropriate concessions for investors to take over ailing banks.

[91]Lankenau left the Topo Chico penitentiary on bail in December of 2005 after spending eight years in jail without trial and/or conviction. His lawyers reached a settlement with about half of his accusers, who agreed to withdraw all charges against him. After that, he won an appeal that allowed him to go free on bail. He is now facing trial for all pending charges.

case of Angel "El Divino" Rodríguez, a more defensive Eduardo Fernández would declare, "…there are cases of rich businessmen and poor businesses because, under the current legal framework, shareholders are only responsible for losses amounting to their contribution to the firm's total capital…[as a result]…firms go bankrupt and the government, when facing a banking problem like the one we have been through in Mexico, has no choice but to protect savings and keep worthless credit portfolios; finally it is the taxpayer that ends up paying for this…I believe this should be considered a very serious crime" (El Financiero, June 3rd, 1998).[92]

In a country that barely trusts its institutions it is not entirely surprising that such declarations were taken to mean that much more instances of favoritism and corruption were to be found. The opposition was convinced – or at least appeared to be – that Cabal Peniche, Angel Rodriguez and Lankenau were only the tip of the iceberg and that Fobaproa had for sure assimilated the debt not only of known criminals, but also that of other solvent borrowers that happened to be wealthy allies of the government. PAN legislators, for instance, would comment in press conference that "investigations must go deep down because we do not want anymore of those bad businessmen who have done so much damage to the country…[…]…creating "ghost" firms and receiving support from Fobaproa" (El Financiero, May 12th, 1998). Marcelo Ebrard, a prominent member of one of the investigative committees wondered "Why do 90 million Mexicans have to pay the obligations incurred by 440,000 large debtors, of which only 604 make up half the total amount?" (Reforma, June 10th, 1998). And PRD representative Carlos Heredia would declare that "the portfolio bought by Fobaproa was acquired with discretionary powers of

[92]Eduardo Fernández made this comment in a radio interview conducted only a couple of days after Angel Rodríguez's lawyers managed to keep him out of prison, even though a warrant for his arrest had been issued and served. This resulted in a huge wave of public indignation.

government officials and coziness between bank owners and government officials" (Willoughby and Conger 1998).

The decision-making process regarding Fobaproa's operations proved controversial enough to conveniently reinforce the perception of collusion. All of Fobaproa's operations were decided by its Technical Committee, a body composed y representatives of the Ministry of Finance, the central bank, and the CNBV. Despite enjoying the authority to generate its own rules and norms, the Technical Committee never made use of such faculty (it was subsequently eliminated in 1996). While members of the Technical Committee were all public servants and, as such, expected to protect the public interest, none of the government agencies represented had any legal power over Fobaproa. Banco de México was in charge of managing the Fund's resources but was not required to conduct audits on their use. Moreover, neither the Ministry of Finance, nor the CNBV were subject to a specific mandate to regulate or supervise Fobaproa's operations. In the absence of general guidelines, clear and precise operation rules, and adequate supervisory and control mechanisms, the Technical Committee acted with a high degree of discretion.

At best, such a context knocks down incentives to do things carefully and transparently – something not entirely surprising in a country where accountability had never been a major concern. A large proportion of the loans purchased by Fobaproa lacked information considered critical to well-integrated credit files such as the credit and payment history of the borrower, evidence that all guarantees on a loan had been properly notarized and legally registered, or promissory notes (particularly in the case of commercial loans). Moreover, the sale of loans from bankrupt business was originally prohibited and yet, a large number of these loans ended up in

Fobaproa because examination of the purchased portfolios was poor – if not absent.[93] Finally, as discussed in the previous chapter, the Technical Committee's discretion was nowhere more evident than in the application of the two-for-one rule originally defined for the capitalization and loan purchase program – this rule was, in fact, rarely respected.

Nobody had been able to actually prove political malfeasance and yet, a growing sentiment among the population was that Fobaproa represented an agreement between the highest levels of government and big business to pass on their losses to the general public. A poll conducted at the time revealed that 69.4 percent of respondents believed there have been corruption in the sale of bank assets to Fobaproa, 64.6 percent considered the Fund had only benefited bankers (vis-à-vis depositors), and 70.7 percent did not approve of the authorities' handling of the crisis (El Financiero, August 3rd, 1998). In consequence, the Congressional Committee on Technical Contracting authorized an in-depth accounting audit of Fobaproa. Interestingly enough, it was the PRD who, in order to prevent collusion with financial authorities, and to ensure transparency and impartiality, had early insisted that the auditing team be composed entirely of foreigners (El Financiero, May 27, 1998).

Meanwhile, a form of dialogue between top level government officials and a parliamentary group that included all major parties in the House kept open the possibility of reaching some sort of agreement on the financial reforms. Negotiations, however, were far from productive because any resolution on the entire package was tied to the conflict over Fobaproa's assets – a knot that, despite all the pressures from the business and financial communities, would not be unraveled for some time. On the one hand, opposition parties seemed convinced that,

[93]This assessment is the product of a number of interviews the author conducted with officials at the CNBV, the Banco de Mexico, and the Agency for Asset Valuation and Sale (VVA), now extinct (see Chapter 4).

while something eventually needed to be done to resolve the Fobaproa problem, approving the conversion of its assets into public debt would not give votes to anybody – at least not as long as they were unable to specifically allocate blame and fully discredit the governing party. As a consequence, they insisted on having full access to the names of the banks and the borrowers attached to every loan sold to Fobaproa, as well as to all the financial supervision reports and documents concerning corrective measures applied by the CNBV between 1995 and 1997. In doing this, the opposition was also conveniently exploiting and igniting the public sentiment against the Fund and the bank bailout to their advantage.

The government's attitude did not facilitate negotiations either and, in many ways, helped advance the cause of the opposition – at least in the short run. For the most part, financial authorities appeared unwilling to compromise on the proposal to consolidate Fobaproa's assets into public debt, or on any other item in the legislative agenda that mattered to the opposition – and that perhaps would have facilitated negotiations on the financial package. Instead, they resorted to a pressure campaign that, from a variety of fronts, warned against the dangers of another economic and financial meltdown should Congress fail to approve the financial package. In this way, the Mexican government expected that the threat of being blamed and punished at the polls for another crisis would be enough incentive for opposition legislators, particularly those from the conservative and pro-business PAN, to move forward.

In this, authorities counted with the backup of the business community. In an unprecedented move, representatives from the eight most important business groups in the country and members of the powerful Mexican Council of Businessmen (CMHN) held a meeting with key legislators from the PAN and PRD on June 11th of 1998 in which the PRI acted as

mediator. The businessmen urged legislators to approve the reforms in order to avoid more financial and economic difficulties to the country. [94] Of all government officials, the CNBV's chairman, Eduardo Fernández, would be one of the most vocal in this regard, "if the reform is not approved this month, or the next one, and the process takes longer, we are going to have a major solvency problem in the banking system" (El Financiero, July 20th, 1998).

In addition, financial authorities denied, at all times, the information requested by legislators arguing that its release would violate bank and fiduciary secrecy, both protected by law.[95] While this might have been true, the context made it look like the government was actually hiding something and critics like PRD's chairman Andrés Manuel López Obrador charged that "any attempt to make the debt of a handful of private people public makes full information indispensable" (New York Times, August 7, 1998).

During the first week of August of 1998, a group of PRD legislators headed by López Obrador revealed a list of the top 310 names of businesses and individuals whose defaulted loans represented approximately 20 percent of the portfolio assimilated by Fobaproa until 1996. The list, presented by the PRD as a collection of "beneficiaries of the Fund's magnanimity", was almost the equivalent of a "Who's Who in Mexican Business" since it included such major firms

[94] After the meeting, PRD legislator Alfonso Ramirez Cuellar commented that, "markets need to get used to democracy too" and PAN leader Rogelio Sada Zambrano pointed out, "they asked us to approve the financial package right away, but we reminded them that they have always been with the PRI, and that both the PRI and the government are responsible for the financial collapse, not us" (El Financiero, June 12th, 1998).

[95] Arguably, the main goal here is to protect the privacy of borrowers and lenders by shielding them from public exposure and demands to make their accounting information public. A recent study by the OECD (2004) concluded, however, that respect for bank secrecy in Mexico may actually prevent due process in criminal cases involving money laundering and bribery. About a year later, the Mexican Senate approved a major reform to the Credit Institutions Law in order to allow the Auditor General and the Federal Electoral Institute to directly request information on financial operations without going through the CNBV (El Universal, December 22, 2005). This reform can be considered, at least to some extent, a long-delayed outcome of the debate on bank and fiduciary secrecy during the financial crisis. Possibly, however, the reform would not have become a reality without a number of major campaign finance scandals (one involving Pemex and the PRI, the other involving former president Fox) calling attention on the need to improve transparency in this regard.

as Sidek and Synkro ($ 3,144 million pesos), Salinas y Rocha ($2,814 million pesos), Gutsa/World Trade Center Mexico ($1,489 million pesos), Autobuses Estrella Blanca ($1,489 million pesos), Grupo Financiero Havre ($343.5 million pesos), and the Taesa ($433 million pesos), among others (La Jornada, August 3rd, 1998). The list also included the names of three well-known former bankers: Cabal Peniche, Rodríguez Sáenz and Lankenau Rocha.

The disclosure angered the business community who, presenting a rare unified front, did not wait long to respond. Eduardo Bours, chairman of the Entrepreneurial Coordinating Council (CCE) would qualify the list as "unacceptable and biased", while Carlos Gómez y Gómez, chairman of the Mexican Association of Bankers (ABM) found, "unacceptable…the objective of capitalizing social unrest with political purposes at the expense of Mexico's economic and financial viability" (El Financiero, August 5, 1998). One day later, the chairmen of the Confederation of Industrial Chambers (Concamin), the Transformation Industry National Chamber (Canacintra) and the National Agrarian Council (CNA), pointed out that PRD's attitudes had a negative effect on confidence and certainty, and only aggravated financial sector problems (El Economista, August 6, 1998).

Government officials and PRI legislators were forced to defend their actions and the presidential initiative. Javier Arrigunaga, director of Fobaproa, declared, "the idea that Fobaproa benefited big businesses and borrowers is false…[the Fund] supported the banking system in order to reduce the damage the crisis would cause on the economy and the people" (El Universal, August 5, 1998). The leader of the PRI faction in the lower house, Arturo Nunez, asked all Deputies to "go to their districts and explain to their constituents what Fobaproa really is…[…]…because it is not the monster the opposition says it is", while a group of PRI Senators

accused PRD members of increasing country-risk with their actions (El Universal, August 5, 1998).

Finally, while more cautious overall in their reaction, PAN leaders close to the business community felt compelled to make a statement. Rogelio Sada Zambrano, for instance, commented, "it is vicious and dangerous of the PRD to declare all businesses and individuals in Fobaproa 'white collar' criminals…[…] being a businessman is not synonymous with being a felon" (El Universal, August 6, 1998).

This was not the end of it for the PRD. A few days later, the same group threatened to reveal two new lists – this time, with the names of government officials and PRI politicians supposedly benefited by Fobaproa. PRD Senator Amalia García charged that, "the government is trying to present as insolvent a number of businessmen linked to Fobaproa who have made important donations to the PRI" (El Financiero, August 9, 1998). In addition, they decided to launch an offensive against the PAN accusing this party of "holding an ambivalent position with regards to the government and Fobaproa" and of accepting "incomplete and biased" information from the authorities (La Jornada, August 9, 1998).

From that moment on, the more radical faction inside the PRD would only gain more strength, leaving its own negotiating moderates in Congress less room to maneuver. Already thinking in the presidential elections of the year 2000, the PRD leadership seemed convinced that their dominant strategy was to discredit all other political forces (which eventually implied rejecting any negotiated solution to the Fobaproa problem) and separating themselves as the only option consistently defending just causes. In doing this, however, the PRD not only helped prepare the ground for an eventual political compromise between the PRI and the PAN – it also

ended up alienating the majority of the population and, in so doing, paved the way for the PAN's triumph in the 2000 presidential election.

5.5. FORGING A POLITICAL COMPROMISE.

As the summer of 1998 was drawing to a close, the legislative gridlock over the financial reform package – more specifically, over consolidating Fobaproa's assets into public debt – began to threaten other important items in the legislative agenda such as the review and approval of next year's (1999) budget.

The turmoil in worldwide emerging markets caused by the Russian and Asian crises, and a downturn in the US stock market contributed to already clouding economic prospects as interest rates remained painfully high, which raised fears of new loan defaults. In the short run, uncertainty about the future of Mexican banks – in lieu of the Fobaproa debate – was driving down bank valuations and, consequently, much needed investment in the sector. Under these circumstances it was practically impossible for banks to re-establish their lending capabilities and for businesses to move on. Gridlock over what to do with Fobaproa's assets had also delayed a final solution to the debt problem of many firms (mostly small and medium-sized) and individuals – something the opposition had demanded from the very beginning.

With general elections taking place in the year 2000, postponing a decision on the matter could turn the controversial Fund into a major item in the competition for political power – a possibility that played differently into the calculations of all political actors. In this regard, the party that stood to lose it all was the PRI, but risks were quite high for the PAN as well.

As the PRD radicalized its discourse around the bank bailout, the PAN found itself playing a pivotal role – a unique opportunity for the party to position itself as the strongest contender for the 2000 election. To fully capitalize such opportunity, however, the PAN faced a number of challenges. On the one hand, the party's commitment to its business constituency created a strong incentive to find a solution to the Fobaproa problem and approve the executive's reform package. On the other, to win the 2000 elections the party needed more than the support of the business community. In this sense, cooperating with the PRI could endanger the party's ability to attract voters from other social sectors if they viewed it as a sell out – a perception the Left was both exploiting and encouraging.

Not surprisingly, the PAN posture was not only more cautious and restrained in general – it also actively sought to keep the PRD involved in the negotiations with the PRI and the authorities so that a "consensus" solution to the Fobaproa problem could be found; one that would require all parties to internalize part of the associated political cost. With time, as extremists in the PRD grew stronger, the prospects of reaching an agreement between the major political forces only looked dimmer. Facing its own internal divisions over how to proceed, the party came to realize the only way out was to push for its own solution while rejecting the government plan.

The PAN's proposal, officially announced on August 20, 1998, sustained the illegality of government actions during the bank rescue and, in consequence, refused to consolidate Fobaproa's liabilities into public debt. Interestingly, however, the party desisted on demanding the resignation of key public figures. The proposal admitted banks needed help but demanded that the cost to taxpayers be minimized. Therefore, external audits would be conducted to

determine the real value of Fobaproa's assets and the magnitude of the losses to be realized, as well as to identify irregular and/or illegal operations. Once audits concluded, assistance (in the form of new instruments substituting the Fobaproa bond) would be offered conditional upon banks accepting a larger share of the losses derived from the unrecoverable loans originally transferred to the Fund (instead of the generous 25 percent granted by government). In addition, depending on their performance at loan recovery, banks would be required to make regular and extraordinary contributions to help finance the fiscal cost of the rescue. Fobaproa would be eliminated and its portfolio transferred to a new decentralized public entity with participation in the federal budget. The new agency would have deposit insurance functions (but limited in a way similar to that in the executive's proposal), would be responsible for the management and disposal of impaired assets, and would supervise the loan recovery efforts of banks participating in the new program.

Last, but not least, the PAN proposal also incorporated what had been the core PRD demand for a long time (and an issue overlooked in the original reform package), namely, that small debtors be given discounts on their outstanding balances in order to make repayment more manageable. The party suggested discounts ranging between 35 and 60 percent for home-owners, and small and medium-sized firms and farmers only.

In general, reactions to the plan were positive both inside and outside the legislature where comments such as "this is a serious proposal" from ABN's chairman and the Ministry of Finance, and "[the proposal] is responsible and interesting" from PRI leaders immediately followed (El Financiero, August 22, 1998). An official response from the PRI, which was undergoing its own internal struggle, would not be much longer.

The Fobaproa controversy did not cause the internal fractures that would eventually send the PRI on a downward spiral, but it certainly made them deeper. The financial crisis and the Fobaproa scandal jeopardized the prestige of the technocrats, whom more traditional sectors blamed for the party's devastating defeat in the 1997 mid-term general elections and its gradual vote loss throughout the country.[96] With both the PAN and the PRD making important electoral advances and accusing the government and the PRI of favoritism and corruption in the handling of the financial crisis, party officials and legislators became increasingly concerned over the possibility of losing the 2000 presidential election.

As conditions deteriorated and pressure mounted, PRI legislators came to realize that negotiation and compromise were necessary in order to find a way out of the Fobaproa problem and pass the financial reforms. Six months of discussion and gridlock had demonstrated, however, that a staunch defense of the executive's proposal was not conducing to any deal. On August 12, after meeting with top party leaders, PRI Deputies – who were increasingly questioning not only the handling of the crisis but also the neo-liberal economic policy – "broke ranks" with the authorities by publicly declaring that, while the PRI fraction in the Chamber of Deputies was supportive of president Zedillo, such support was conditioned upon the executive's release of all information relative to Fobaproa's operations and a commitment to reduce the bailout's fiscal cost to the maximum extent possible (El Financiero, August 13, 1998). In addition, PRI legislators promised to present a "comprehensive proposal" to "strengthen" the presidential initiatives included in the financial reform package. While this move fell

[96]In state and local elections during 1998, the PRI was able to keep traditional strongholds (such as Yucatán, Durango, Oaxaca and Veracruz) and even recapture the governorship of Chihuahua from the PAN. Yet, the party lost Aguascalientes and Zacatecas to the opposition for the first time. In addition, election results confirmed the continued erosion of PRI support, particularly in urban areas, and the increasing level of competition for political power.

significantly short of a split (the PRI proposal did not reject or compromise the president's), it was meaningful for at least two reasons. First, it showed a PRI willing and capable of acting independently of the president. Second, by addressing some of the debate's key issues, it increased the chances of finding a viable solution to the Fobaproa problem – via a deal with the PAN – and, in consequence, of achieving the priceless financial stability the Zedillo administration was so invested on.

On August 23, hardly three days after the PAN, PRI leaders and legislators officially announced their position, which presented important coincidences with that of the PAN. While still supporting Zedillo's idea of consolidating Fobaproa's assets into public debt, the PRI backed up the idea of reducing the bailout's cost by increasing bank co-responsibility, deepening investigations on potentially illegal operations, and rigorously analyzing the Fund's loan purchases. The party also recognized the need to improve prudential supervision and the legal framework in order to properly punish "white-collar criminals" and prevent future crises.

Despite rejecting any wrong-doing (or illegality) in the management of the crisis, the PRI accepted the possibility of discussing, in the future, the extent to which the measures taken during the crisis were the most appropriate (El Universal, August 24, 1998). Finally, the party sponsored discounts for small debtors but went a bit further than the PAN by proposing additional incentives for those who had continued servicing their debts despite the crisis.

There were enough coincidences between the PAN and the PRI proposals to move negotiations forward, even in spite of PRD's withdrawal from the negotiating table. However, key issues such as information disclosure and the allocation of political responsibility would

require more time as they became entangled with internal party divisions, particularly inside the PAN.

In September of 1998, the PRD announced they would present a proposal to initiate impeachment procedures against central bank governor Guillermo Ortíz and CNBV's chairman Eduardo Fernández (El Financiero, September 24, 1998). A group of PAN legislators had joined the initiative after insisting on these two officials' resignation and threatening to force their party's withdrawal from negotiations. Such announcements only worsened an already complicated picture in which decisions on the 1999 budget could not be delayed any further without risking financial and economic stability, the legislative agenda was frozen, and election time was knocking at the door.

Despite pressures from business leaders, financiers, debtors and the general public, as well as deteriorating financial and economic conditions, the intervention of key figures of *panismo* proved necessary to bring all PAN legislators together.[97] That, an the introduction of a new clause to the party's proposal according to which Guillermo Ortíz and Eduardo Fernández would be prohibited from participating in the governing board of Fobaproa's institutional replacement (El Financiero, December 12, 1998).

Final obstacles were removed as the Ministry of Finance yielded enough ground to persuade PAN legislative leaders, as well as the restive leadership of the ruling PRI, that the government was now prepared to share sufficient information on Fobaproa debt and borrower

[97]One of them was president-to-be Vicente Fox, the other one was Diego Fernandez de Cevallos. Other participants included the governors of Nuevo León, Baja California, Aguascalientes and Querétaro.

identities to permit a thorough congressional investigation in tandem with the independent audit without jeopardizing secrecy principles – something the PAN leadership always understood.[98]

On December 12, 1998, more than nine months after being sent to Congress and much to the dismay of the Left, the financial package went back to the floor. Of the three key pieces of legislation originally sent to Congress, however, only the one repackaged in the PAN's proposal and the provision to eliminate ceilings on foreign ownership of national financial institutions were voted upon and approved by overwhelming majority.

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5.6. AFTER THE COMPROMISE: HIGHER COSTS AND AN INCOMPLETE REFORM.

Negotiators appeared quite satisfied with the outcome and did not hold back on self-congratulatory comments to the press for rising above politics and saving the country from collapse. For PAN legislators, they were also responses to rumors of a deal with government according to which the party had approved Fobaproa in exchange for Vicente Fox's triumph in the 2000 presidential race. PAN's chairman Felipe Calderon would declare,

"We, in the PAN, have behaved with absolute responsibility, proposed a viable solution and put the interests of our citizens and of Mexico at the top and, in doing that, we have demonstrated we are a political force that offers alternatives and solutions…[…]…and a solution to the bank rescue could not have been delayed any longer without causing irreversible damage to many generations of Mexicans" (El Financiero, December 13, 1998)

There were no major differences between PAN's original proposal and the legislation approved on December 12. Fobaproa would be replaced by the now called Bank Deposit

[98]From author interviews with PAN legislator Fauzi Hamdan, chairman of the Financial Oversight Committee in the Chamber of Deputies.

Protection Institute (IPAB). All of the Fund's obligations would be transferred to the new entity but would not be recognized as public debt. Instead, such obligations would be financed on an annual basis through the federal budget, provided they received congressional approval. Pending accounting audits, Fobaproa bonds would be exchanged for new IPAB-guaranteed titles on non-recovered loans under a less generous loss-sharing scheme (i.e. above the 25-30 percent originally agreed with Fobaproa). The deal withheld public outlays for coverage of loans exceeding five million pesos and included smaller credit card and mortgage obligations previously excluded. Small and medium-sized firms, farmers and home-owners also benefited from additional discounts on their debts outstanding, the cost of which would be partially absorbed by the financial sector at the same level used so far. Public officials who had participated in the bailout were prohibited from serving on IPAB's board.

The compromise represented a way to deflect public criticism by making the banks responsible for the largest business debts, which were also considered to be more collectible by the banks themselves, and by forcing them to absorb a larger share of the losses. By eliminating remaining restrictions on foreign ownership in the financial sector, as the executive had asked, banks were pushed to find alternative sources of capital. On the downside, the agreement encouraged moral hazard amongst smaller debtors whose loans would probably remain unpaid and become irrecoverable.

The core of the PAN-PRI agreement of December of 1998, that is, the mechanism to handle and dispose of all impaired assets absorbed by Fobaproa, was not good news to many analysts and observers. Critics charged the compromise, by not transferring such assets to public debt but financing them from special budget allocations, amounted to a legal fiction that

essentially repackaged Zedillo's original proposal in a more politically acceptable form at the expense of greater transparency, efficiency and stability. These charges were not without some merit. While those assets constitute *de facto* public debt they are not included as part of the public balance. In consequence, economic agents cannot readily evaluate their impact on national income and expenditures, and have a harder time projecting how they would evolve and be amortized over time.

In addition, while their IPAB-guaranteed back ups can now be negotiated in the stock market, they still lack the attributes of regular government bonds which, even when they are short-term, can be renegotiated and rescheduled with more flexibility. It is for this reason that, at the time (and even today), the debt consolidation alternative, for a fiscal burden of that magnitude, was more cost-efficient from a strictly economic point of view. Instead, the decision to finance those assets on an annual basis turned the bailout into a permanent time bomb for the public finances.

By the time the (incomplete) financial package was approved, the 552 billion pesos Zedillo wanted recognized as public debt had turned into 631 billion (SHCP, 1999), roughly an 14 percent increase over a period of nine months. The increase did not result from any new assistance measures or restructuring operations but actually from the slow-down in asset recovery activities and the interest generated on the Fobaproa bonds. By March of 1999 the figure amounted to 688 billion (IPAB, 2000).

Such bad news would only be compounded by the findings of external audits. On September of 1998, and after a few months wait, Congress and Canadian accountant Michael W. Mackey signed a contract hiring him to coordinate a comprehensive evaluation of all of

Fobaproa's operations and restructuring processes. In fulfilling his task, Mackey cited many obstacles from banks and the financial authorities. Both Fobaproa and the CNVB, he declared to the press, were extremely reluctant to provide information, while banks strongly objected to grant access to their client files (El Financiero, July 12, 1999). For these reasons, he claimed, it was only possible to conduct a financial review and not a full audit (El Financiero, July 23, 1999).[99]

Mackey's final report proved controversial but not necessarily for the reasons the opposition expected. He added another – if not entirely surprising – blow to an already quite beaten CNVB by concluding that the agency had performed quite poorly in terms of bank supervision before and during the crisis, and in conducting intervention processes. The report recognized, however, that the CNVB had been extremely limited in terms of infrastructure, resources and mandate to undertake an adequate supervision and impose corrective measures (Mackey, 1999).

But the biggest controversy would come in the form of the infamous "reportable transactions", a series of irregular – but not necessarily illegal – dealings that might require further investigation.[100] The amount of reportable transactions represented a relatively small share of the total assets now being transferred from Fobaproa to IPAB and, perhaps more

[99]Rather candidly, Mackey would later comment in a radio interview that Fobaproa had been the most difficult assignment of his entire career.

[100]In the Mackey report, three types of "reportable transactions" are described: (a) Credits that did not satisfy the original criteria established by Fobaproa's Technical Committee for their acquisition under the PCCC. In many cases, both the CNVB and Fobaproa modified the terms of agreement to accept those credits; (b) Transactions through which banks granted financing to related and/or affiliated parties and that, as a consequence, became practically irrecoverable; and (c) Transactions being reviewed by the CNBV under suspicion of illegality (Mackey, 1999).

importantly, the large majority of such transactions had already been identified – and disclosed – by the CNBV before proceeding to actual managerial interventions or judicial processes.[101]

For the PRI and the government, Mackey's results constituted a vindication of sorts. For the opposition, particularly for the PAN, they were quite disappointing – understandable, after having invested so much in the audits expecting to reduce the fiscal cost of the bailout, and hoping to turn the results into a powerful weapon against the PRI.

In these circumstances, the brand new IPAB – whose inauguration had been delayed until May of 1999 due to party disagreements over who should be the board members – became the subject of intense political pressure from all sides not only to quickly tackle pending restructurings and asset recovery processes at the smallest possible cost, but also to begin investigations into the reportable transactions Mackey had identified. Yet, with interest rates still relatively high and the quality of absorbed assets significantly deteriorated, IPAB was forced to report that the nominal value of the bank rescue had increased to an astonishing 873 billion or 19.3 of the country's GDP and, as a result, the amount of resources necessary to service these obligations the following fiscal year had to be higher than expected (El Universal, September 11, 1999).

And once again, the bank bailout became a source of political conflict as a very tight budget for 2000 made significant cuts in areas the opposition seemed to consider critical for its electoral prospects that year: education, agriculture, social programs and state and local transfers (CIDE, 2000). Both the PAN and the PRD insisted on cutting short IPAB's requested funds

[101]Based on Mackey's own calculations the share amounted to 11 percent of total assets in Fobaproa (Mackey, 1999). This figure was later confirmed by the Ministry of Finance and Banco de México (El Financiero, July 15, 1999).

while the PRI opposed. Budget negotiations, however, cannot take very long because the budget bill is always introduced in September and should be voted by December at the latest. There is no legal provision for instances in which no budget is approved by that deadline and bureaucrats and politicians alike fear such a situation would lead to chaos and economic volatility. In the end, a budget was voted on time without altering the amount of public resources destined to IPAB. This cycle would repeat itself every year since then.

This legislature also managed to approve another important piece of legislation related to the financial crisis before leaving. On November 23, 1999 president Zedillo sent a proposal to reform the 1943 Bankruptcy and Payment Suspension Law – legislation considered not only outdated but also an active promoter of moral hazard in modern markets. The Law was in fact considered a major obstacle to the development of more effective credit markets because it made it really difficult for financial institutions to collect on their loans or seize collateral. At the time of the debate over Fobaproa, all political parties had eagerly made a commitment to review and modify the Law and, this time, the executive took the time to negotiate the content of the reforms with all factions in Congress before sending the law to Chambers. Subsequent debates were not free of political conflict but a final version of the bill, acceptable to all parties, was approved on April 26, 2000.

With the presidential race already well under way and general elections taking place in only a few weeks, legislators had little time available to work off many more pending pieces of legislation, including those to strengthen the autonomy of Banco de México and give autonomy to the CNBV. These would prove extremely difficult to work out because, once all parties realized the implications of these bills for executive power, they could not agree on the optimal

balance between institutional autonomy and presidential authority. On three occasions since the end of the crisis have these proposals being discussed, amended, and discussed again: 2001, 2003 and 2005. No basic agreements have emerged so far.

5.7. CONCLUSION.

After the historic results of the 1997 mid-term election in which the PRI lost the majority in Congress the balance of power between the executive and the legislature in Mexico has changed significantly, positioning Congress as an active veto player and eroding the extraordinary authority Mexican presidents used to enjoy. As this chapter shows, the combination of divided government and a polarized legislature significantly delayed the resolution of the 1994-95 financial crisis and was unable to provide a satisfactory mechanism to deal with all the impaired assets in the system.

In spite of all the exposures, accusations and circus surrounding the Fobaproa debate, the opposition-dominated Congress brought much needed transparency to a decision-making process not accustomed to scrutiny and accountability. In doing so, legislators even involved the Judiciary – something never seen before – in the resolution of constitutional disputes between the executive and the legislatures over the right of the later to access all information on the loans absorbed by Fobaproa – despite bank secrecy laws. The Congressional audits on financial rescue operations undertaken in 1998 established a tradition that continues to this day as a condition to approve federal allocations to IPAB. Following an initiative from the PRD, the Chamber of Deputies established a special committee to follow up and supervise IPAB's operations and programs since the year 2000. Between 1998 and 2004 successive committees have conducted an

average of 13 audits per year on all the programs associated with the bank rescue as well as other issues of concern (Comisión IPAB, 2006).

It is difficult to estimate the magnitude of the savings, if any, that consolidating Fobaproa's debt (now IPAB's) into public debt would have produced. Nonetheless, the fact that those liabilities are kept in a separate accounting is a constant remainder that, after all these years, the price tag is still huge and will continue to be so for a good number of years (Table 5.1 below).

Table 5.1 Bailout costs as of year-end 2004 in billion pesos

Program	Cost	% Paid	% Balance	% of total	% of GDP[1]
Debt relief schemes[2]	168.3	68.3	31.7	12.7	2.29
Bank support programs[3]	1,079.8	32.9	67.1	81.4	14.69
Fiscal cost	1,248.1			94.1	16.98
Cost absorbed by banks	77.9			5.9	1.1
Total cost of bailout	1,326.0			100.0	18.04

([1])2004 GDP figure used: 7,350.4 billion pesos. (2)Includes general debt-relief schemes, ADE, and specific programs for housing, agriculture, small and medium firms, and states and municipalities. (3)Includes Banco de México's temporary liquidity support program, the Temporary Capitalization Program (Procapte), the Capitalization and Loan Purchase Program (PCCC), and all intervention and restructuring operations.
Source: SHCP, Criterios Generales de Política Económica 2005.

Chapter 6: Conclusion
The Political Economy of Government Responses to Financial Crises

"The banking system will never take you to paradise, but it can bury you in hell in an afternoon"
Julio Maria Sanguinetti

"Future financial crises are almost surely inevitable and could be even more severe. The markets are getting bigger, information is moving faster, flows are larger, and trade and capital markets have continued to integrate...It's also important to point out that no one can predict in what area-real estate, emerging markets, or whatever else-the next crisis will occur."
Robert Rubin, 2003

6.1. INTRODUCTION.

Ten years after the last wave of financial crises (i.e. South-East Asia and Russia) countries across the world, and the global economy as well, are still vulnerable to such distressful events, as the Argentine financial crisis of 2001 and the current sub-prime mortgage crisis in the U.S. illustrate. Argentina's economic collapse was telegraphed far enough in advance that key political and financial actors in Latin America and other developing countries had sufficient time to take preventive measures against contagion. For this reason, Argentina's crisis, for all the devastating effects it had domestically, did not lead to a regional, let alone world-wide, financial crisis, as occurred in Asia in 1997 or following the Mexican meltdown of 1994-95. This is not the case of the current sub-prime crisis originated in the United States, the repercussions of which are being felt all over the world thanks to the marvels of financial engineering and the internationalization of financial markets. The sub-prime mortgage crisis is unlikely to be the last financial crisis the world will have to deal with. In consequence, understanding the conditions under which countries are better able to handle such distressful events becomes of the utmost importance.

This dissertation has focused on the institutional aspects of government involvement in financial crises arguing that power distribution across political actors plays a central role in shaping responses to financial crises and, as a result, determine both the decisiveness and the

cost-efficiency with which such problems will be dealt with. The preceding chapters have examined this relationship along two dimensions: (a) the capacity of governments to orchestrate a timely and decisive response to contain, manage and resolve the crisis, and (b) the willingness to redistribute public resources to the financial sector – in association with such crisis response – at the expense of society as a whole. Modeling government intervention in financial crises as a process of three interdependent and relatively sequential stages – each subject to political conflict – the analysis develops two arguments about the consequences of political institutions and power distribution for policy-making and policy outcomes.

The first argument concerns decisiveness. In this case, the proposition is that more concentrated distributions of power (at the hands of the executive) are more likely to facilitate resource mobilization and allocation, minimize coordination and consistency problems common in strategy design and execution, and overcome political obstacles to the legislative approval and the implementation of necessary policy measures. In other words, power concentration helps executives move through the stages described in the model and, ideally, resolve the crisis (i.e. complete the sequence) as soon as possible.

The second argument speaks to the cost-efficiency of government responses to financial crises. Here the claim is that insofar as power concentration implies less competition for public resources and fewer checks on how they are allocated, veto power holders have more room to follow their own political agendas or impose their policy priorities. In a context of financial crisis, this may result in larger fiscal transfers to the financial sector – transfers that will ultimately be absorbed in the form of higher taxes or spending cuts (both of which entail a cost to

society). Power concentration may thus lead to (potentially) disproportionate redistributions of fiscal resources to special interests – regardless of such groups' intrinsic political strength.

The empirical analysis of these arguments proceeded at two levels. At a more general level, three large-N statistical studies were conducted on a sample of 35 countries that collectively experienced 40 crisis episodes. At a more detailed level, an encompassing qualitative study of the Mexican financial crisis of 1994-95 was developed. Together, these studies provided evidence in support of the two arguments mentioned above but also revealed interesting puzzles that need further investigation. Overall, the combined results present a quite complex picture – one in which the impact of power distribution over policy-making and policy outcomes is far from unidirectional and straightforward.

6.2. POWER DISTRIBUTION AND GOVERNMENT DECISIVENESS.

In Chapter 2 a series of statistical experiments were conducted under the assumption that, other things equal, timely and effective (i.e. decisive) government responses to financial crises would reduce crisis duration and accelerate time to recovery. Following the analytical framework, the expectation was that intervention capacity would turn out to be a negative function of power dispersion.

The main findings on crisis duration generally support this expectation but also suggest that not all forms of power dispersion are equally relevant. More specifically, strong and statistically significant relationships are limited to separation of powers and divided government. While the separation of powers characterizing presidential systems *per se* tells us little about how strong or weak the chief executive is vis-à-vis other actors, the presence of divided government

establishes, at least in principle, a clear limitation on the executive's capacity to impose her legislative agenda. Thus, the evidence suggests that power dispersion affects the government's response capacity to financial crises when legislative cooperation is necessary to move forward along a particular course of action. In this context, decision-making delays result from the difference between the political costs of inaction (i.e. vetting or amending) and those of accepting the opponent's proposal. The resolution of the Mexican financial crisis of 1994-95 examined with detail in Chapter 5 illustrates how the interaction of separation of powers and divided government conspired to significantly delay the passage of important legislation associated with the management and disposition of impaired assets, as well as other measures to strengthen the financial system. As a consequence, not only did the price tag of the bank rescue increased nominally and in real terms, but important bank intervention, restructuring and liquidation processes were put on stand by which, in the medium run, also added to market uncertainty and to the fiscal cost of the crisis.

The Mexican case also highlights the difficulty of deviating from the status quo (i.e. enact as policy change) for a divided government that, *in addition*, faces a fragmented and increasingly polarized legislature. Had the Zedillo government introduced the financial reform package before the PRI lost the majority in Congress, the story would have been different. Most likely, after more than sixty years of uncontested power, the PRI executive did not anticipate finding so much resistance or, alternatively, underestimated the effects of the crisis on the preferences of the electorate.[102]

[102]Most of the actors interviewed by the author offered this perspective. An alternative view suggested that the government did not send the reform package to Congress earlier because the magnitude of the bank rescue remained pretty much uncertain until early 1998.

The bank rescue that began in 1995 had been one of the most fiscally expensive and unpopular operations in recent Mexican history. No wonder the opposition-dominated Congress, after being presented with a *fait accompli*, refused to share with the party in government the political cost of formalizing the bailout as long as it could benefit from differing legislative action. Soon, however, it became increasingly difficult for opposition parties to sustain a unified front in lieu of internal divisions as well as major differences in their constituent base and preferences. Once the status quo began to rapidly deteriorate, the prospective electoral gains from non-cooperating seemed still positive for the PRD but became rather unclear for the PAN. In this context, negotiation and agreement developed into a more attractive option for the pivotal party – the conservative PAN.

An analysis of the financial crisis resolution process in Mexico underscores how divided government and legislative fragmentation may slow down decision-making processes but, like the statistical analysis, ignores the potential effect of institutional devices established to prevent a state of permanent gridlock. In other contexts where divided government and legislative fragmentation are common, chief executives have been provided with institutional mechanisms – such as extensive decree and/or veto powers, or the exclusive authority to introduce bills in certain policy areas – to significantly extend their decision-making authority. Brazil is in this sense a good point of comparison.

An initial view of the Brazilian political system reveals a highly fragmented picture – one in which political power is widely dispersed across institutions but also across sub-national units vis-à-vis the central government. Unlike Mexico, Brazil is characterized by a multiplicity of political parties competing in elections and gaining legislative seats. As a result, the Brazilian

Congress is, by some accounts, one of the most fragmented legislatures in the world. From the return of democratic elections in 1985 to the present, the effective number of parties has ranged from a minimum of three in the mid-1980s to a maximum of nine in the early 1990s.[103] Parties in Brazil are also considered to be comparatively undisciplined and lacking a national focus (Mainwaring 1997). An important consequence of such party system fragmentation is that no Brazilian president has carried a Congressional majority since the return of democracy and every one of them has had to rely on cabinet coalitions to secure a legislative majority.

Based only on this account, the Brazilian executive appears rather weak. The Constitution of 1988, however, provides for a president with very strong legislative powers. In addition to (package and item) veto powers (stronger in practice than in theory) and the exclusive right to introduce bills in a wide variety of policy areas,[104] Brazilian presidents enjoy significant decree powers in the form of *medidas provisórias* (provisional measures).[105] The extensive use of provisional measures has lead scholars to conclude that the president in Brazil really dominates the legislative agenda (Figueiredo and Limongi 1997 and 2000, Power 1998).

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[103]Legislative fragmentation in Brazil may vary within a single legislature as a result of frequent party switching on the part of federal deputies. Nicolau, for instance, argues that party switching is one of the major causes of Brazil's legislative fragmentation because legislators frequently leave one party to create a new one: Jairo M. Nicolau, *Multipartidarismo e Democracia: Um Estudo sobre o Sistema Partidario Brasileiro 1985-94* (Rio de Janeiro: Fundacao Getulio Vargas, 1996).

[104]Package veto refers to a veto on the entire bill; item veto refers to a veto on parts of the bill. According to the 1988 Constitution, presidential vetoes can be overridden fairly easily (simple majority). In practice, however, legislative fragmentation in the Brazilian congress is such that even obtaining a simple majority is a challenge (Mainwaring 1997, Amorim 2002). Some of the policy areas in which the executive enjoys exclusive initiation rights are: budget, armed forces, public personnel and public administration.

[105]Provisional measures have immediate force of law but must be submitted to Congress. If not converted into law within 30 days, they lose effectiveness. Figueiredo and Limongi have shown that, while originally conceived for emergency situations, provisional measures have been used repeatedly for economic policy: Argelina Cheibub Figueiredo and Fernando Limongi, "Presidential Power, Legislative Organization, and Party Behavior in Brazil" in *Comparative Politics*, Vol. 32, No. 2 (January), 2000: pp. 151-170.

After the introduction of the economic stabilization plan known as the *Plano Real*, Brazil experienced significant financial sector problems in both private commercial and state public institutions. State public banks had been typically exposed to government default since a large proportion of their lending activity went directly to finance state government projects. As a result, they were heavily dependent on official financing (particularly from the central bank) and inflation-related gains to stay moderately afloat. After the introduction of the Real Plan, state public banks deteriorated quickly and significantly to the point of threatening the overall health of the financial system and, ultimately, the success of stabilization efforts.[106] Public bank failures, in turn, contributed to deteriorate even more the already precarious fiscal position of state and local governments. Responding to this situation, in August of 1996 the federal government issued Provisional Measure No. 1514 that laid out the bases for a program to reduce the presence of state governments in the financial system (PROES).

PROES was a conditional bailout through which the federal government acquired control over decisions related to the future of state banks in exchange for the renegotiation of state government debt under subsidized conditions.[107] Even though the offer of a fiscal bailout may

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[106]After the abrupt reduction of inflation induced by the Real Plan, the gains public banks obtained from investing float almost disappeared while loan portfolios expanded and their quality deteriorated. In addition, loan interest rates were inadequate to cover real costs and public sector finance sources had their subsidy element reduced by the fall of inflation rates. As a result, the accumulated losses eroded the banks' capital base and their owners, the state governments, being in such bad shape financially as well, were unable to provide the necessary capital to correct their banks' financial structure. According to one count, by late 1995 approximately 72 percent of public banks were technically – if not actually – insolvent: R.P. Cysne and S.G.S. da Costa, "Reflexos do Plano Real sobre o sistema bancario brasileiro" in *Revista Brasileira de Economia,* Vol. 51, No. 3 (July-September), 1997: pp. 325–346.

[107]Under PROES, the federal government acquired the right to any or more of the following: 1) purchase control of a financial institution in order to privatize or liquidate it, 2) finance the transformation of the financial institution into a development agency (limited to one per state and subject to tighter capital requirements and lending regulations); 3) finance adjustments in the financial institution necessary to prepare it for privatization, 4) purchase contractual credits that the financial institution had against the state government and its controlled entities, and/or 5) in exceptional cases, finance the restructuring of the financial institution including its capitalization and the "professionalization" of its management. Funding for all transactions under PROES would be provided by the central bank as necessary. To qualify for this program, state public banks had to be in the process of privatization or

have been critical to entice state governments into accepting the transformation (and even the extinction) of their banks, the right of the federal government to issue provisional measures (by temporarily isolating the crisis management process from the political pressures of coalition allies and legislators) gave the executive at least two advantages – a head start in the negotiation process vis-à-vis state governments, and enough room to move into the resolution process before conditions deteriorated even further.

A full examination of the Brazilian case is clearly beyond the scope of this chapter but a clear contrast with the Mexican experience emerges from this brief account. Presidential power in Mexico came from control over his party – and his party's control over the legislature – and not from formal (i.e. constitutional) prerogatives or delegated authority. It is not entirely surprising then that a situation of divided government and legislative fragmentation created a legislative gridlock from which the only way out was a significant deterioration in the status quo. Yet, that the Mexican president had such strong decree powers as his Brazilian counterparts does not necessarily imply he would have used them, or that their use would produce the same outcome. This certainly reinforces the need for additional comparative research on the consequences of variations in presidential legislative powers for decision-making.

Finally, another important insight from the study of the Mexican crisis concerns the distribution of authority inside the executive branch, that is, the allocation of human, financial and administrative resources aimed at crisis management. Absent from the statistical analysis due to the lack of historical and reliable data for all cases, this factor is of the utmost importance

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transformation into a non-financial institution (such as a development agency), or assume the rights and obligations of an institution involved in the process (Garman, Leite and Marques 1998, Ness 2000, McQuerry 2001).

to overcome coordination and consistency problems in strategy design and implementation, which ultimately feed into the overall crisis resolution process.

Chapter 4 illustrated how the still quite powerful Zedillo administration made use of a variety of resources available to the executive in order to take charge of the financial crisis almost immediately. While the first response came from Banco de México in the form of an emergency discount facility in dollars, quickly it became necessary to bring the CNBV and a little known organization called Fobaproa on board. Very soon it was the CNBV the one in charge of crisis management. One of the greatest challenges the CNBV had to face, however, was the lack of necessary resources – including enough authority – to design and implement a comprehensive and consistent (and credible) strategy to manage and resolve the crisis.

Again, a comparison with the Brazilian experience is interesting. In Brazil, the central bank concentrates the functions that in Mexico – at the time of the crisis – were accorded to Banco de México, the CNBV and Fobaproa.[108] Brazil's central bank has ample and well defined mandates with regards to the intervention and restructuring of financial institutions in cases of insolvency, bad management, and violation of laws and regulations. Institutions in these circumstances are placed by the central bank under three possible special regimes: intervention, temporary special management and extrajudicial liquidation.[109] In response to the financial

[108]In the case of Fobaproa the statement refers to the de facto functions assumed during the crisis, not to the deposit insurance functions for which it was originally created. As a consequence of the banking crisis of the mid-1990s, a deposit insurance scheme was created in Brazil (the Fundo Garantidor de Créditos) through a resolution from the Conselho Monetario Nacional (National Monetary Council). The FGC is a private institution of compulsory membership for all financial institutions in the country. The Fund is constituted with compulsory contributions for its members and coverage is limited to up to R$20,000 per depositor approximately in cases of intervention, extrajudicial liquidation and bankruptcy as determined by the central bank.

[109]The central bank is entitled by law to take action, at its discretion, against any particular financial institution that meets the criteria for intervention and/or restructuring. It also has discretion over decisions about which special regime should be applied (BCB, 2000). Under any special regime, management is replaced by an *Interventor*, a Liquidator, and a Board of Directors appointed by the central bank to implement the restructuring process. Replaced

turmoil brought about by the Real Plan, Provisional Measure No. 1179 and Resolution No. 2208 were issued to create the Program of Incentives for the Restructuring and Strengthening of the National Financial System (PROER) and the central bank was granted additional powers to undertake preventive measures whenever financial institutions were not meeting system requirements or were demonstrating serious liquidity/solvency problems.[110] Under PROER, between November of 1995 and December of 1998, the central bank had been able to resolve 33 banks, of which 12 were closed and the rest were either sold or restructured (BCB, 2001).

This comparison between Mexico's and Brazil's crisis management capabilities are striking and raise interesting questions – not fully addressed in the dissertation – about the extent to which power distribution across political actors determines authority distribution inside the bureaucracy, and about the dynamic interactions between the two spheres. Addressing these issues, however, is crucial for a better understanding of the policy cycle associated with crisis management and resolution – or any other major public decision for that matter – and certainly warrants further quantitative and qualitative research.

6.3. POWER DISTRIBUTION AND THE TRANSFER OF PUBLIC RESOURCES.

In Chapter 3 the connection between power dispersion and the willingness to transfer public resources to the financial sector was explored in two stages with the help of statistical techniques. First, the total fiscal cost of the crisis was used as dependent variable assuming that,

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management and majority shareholders assume joint responsibility for the institution's uncovered liabilities and, during the restructuring process, are not allowed to sell any of their properties (Maia, 2001).

[110]The central bank could now prescribe higher levels of capitalization, transfer of stockholder control or mergers and acquisitions for faltering banks, and the confiscation of certain failing banks' assets (BCB, 2001).

at least on average, direct transfers to the financial sector are the dominant component of fiscal cost figures.

While fiscal cost is a function of measures adopted during the crisis, the final effect of these measures is not the same. Clearly, not all measures constitute direct transfers to the financial sector but all of them are usually enacted to assist troubled financial institutions. The downside is that, by creating moral hazard situations, these measures may increase the amount of loses the public is forced to absorb. The three strategies found to be particularly damaging in this regard are liquidity support, forbearance, and deposit guarantees. Chapter 3 also explored the connection between power dispersion and the probability of observing each one of these measures.

Following the analytical framework, the general expectation was that there would be a negative relationship between greater levels of power dispersion and transfers to the financial sector. The main hypothesis was further tested in the context of the Mexican 1994-95 financial crisis. Chapters 4 and 5 provide a detailed discussion on the government's management of the crisis, and the variety of measures put in place to resolve it, in order to present a more comprehensive examination of the mechanisms linking a powerful executive with an expensive crisis management strategy favorable to moral hazard and quite generous to the banking system. Once again, the picture that emerges from both the statistical and the qualitative analyses supports the main argument but adds interesting complexities to a discussion about the role of institutions and power distribution in the policy-making process.

The main findings from the statistical analysis on fiscal cost indicate that more competitive elections and, to a lesser extent, greater constraints on the authority of chief

executives may create incentives to minimize the disbursement of public monies in response to a financial crisis. In principle, then, the results support the argument that the greater competition for public resources associated with larger numbers of actors with veto over how such resources are allocated makes targeted spending more difficult, even in crisis situations. These statistical relationships, however, were not strong enough under conventional standards. More compelling in this regard is the evidence found on specific measures, particularly, open-ended liquidity support – one of the variables best capturing direct fiscal transfers to the financial sector. In this case, competition for political power and more dispersed distributions of decision-making authority (e.g. larger coalition sizes and more actors with veto power) significantly decrease the probability of the financial sector receiving (unlimited) liquidity assistance during a crisis.

Evidence from the Mexican case is generally supportive of these results. The Mexican experience shows that, while some borrowers received some assistance in order to restructure their loans and continue servicing them, during the crisis management stage the financial sector absorbed the overwhelming majority of fiscal resources in the form of long-term loans, repeated rounds of non-performing loan purchases and restructuring operations. Moreover, the terms and conditions under which such support was provided seemed rather generous, at least compared to what other governments have done.

During the 1997 crisis, the Korean government also put in place a capitalization scheme based on non-performing loan purchases from commercial banks similar to those undertaken by Fobaproa. As reported by De Luna (2000) however, there are important differences between the Korean and the Mexican approaches. First, unlike the PCCC in Mexico, the Korean program restricted access to banks involved in mergers and acquisitions of weak institutions. Second,

loans in Korea were purchased at a maximum of 55 percent of face value and there were strictly enforced rules about what kind of loans could be bought. In Mexico, loans were bought at face value (the highest possible value, less provisions) and, as discussed extensively in Chapter 4, the rules concerning what kinds of loans were acceptable for purchase were significantly more flexible. Finally, in Mexico the original loss-sharing mechanism established for the collection of non-performing loans was 25 percent for banks and the rest for Fobaproa (the mechanism was modified afterwards, see Chapter 5). In contrast, Korean banks selling non-performing loans to the government were already absorbing a large loss to begin with given the pricing mechanism established by the government.

The PROES program in Brazil did not involve non-performing loan purchases with fiscal resources. Rather, it was based on a special central bank credit line to banks in need of liquidity and/or funds for restructuring. To back up these loans, banks pledged collateral (such as real state or Brady bonds) valued at 120 percent of the loan. The program also gave the central bank more control over mergers by requiring that institutions seeking to acquire troubled banks get central bank approval, obtain majority shareholder approval for the purchase of another bank, retire all merger costs within five years, and assume the liabilities of the institution being acquired. In return, eligible banks could receive lines of credit from the central bank to fund bank mergers and acquisitions (BCB 2000 and 2001). A related measure promoted mergers over the establishment of new banks by increasing reserve requirements to 32 percent of total capital for new banks but allowing merged banks to maintain only 8 percent of capital in reserve (Christie 1995).

As discussed in Chapter 5, the transition to a more balanced distribution of power between the executive and the legislature in Mexico created enough space for the opposition to expose the ruling party and its "preferential treatment" of bankers and financiers during the crisis. The opposition thus pressured for expanded debt-relief programs to include groups of small debtors who had been particularly vocal and politically active through *El Barzón* and other movements, but that had been excluded from the president's original proposal. From a fiscal perspective, this resulted into a marginal increase in the total cost of the bailout and may have even induced further moral hazard, but the price tag of the rescue was already quite large so, in comparison, programs targeted to debtors seemed minimal.

The statistical evidence also suggests that more influential financial sectors tend to drive up the fiscal cost of financial crises and the probability of receiving liquidity support, particularly in presidential systems. The variable used to proxy this influence, however, is extremely limited and, as discussed earlier (see Chapter 2) is perhaps a better approximation to structural than to political power. In any case, the Mexican experience appears to substantiate these results but does not necessarily support the collusion or capture hypotheses. True, it is widely known that throughout the entire crisis management process and even afterwards the Association of Mexican Bankers (ABM) provided a forum through which a variety of measures associated with the bailout were proposed and discussed with the authorities (Minushkin and Parker 2002). The government approach to the bailout, however, seems more motivated by a (perhaps excessive) concern with economic and financial stability that, under the circumstances, contributed to leverage the position of the financial sector. The circumstances here refer not only to the crisis

itself, but also to an institutional environment that did not create accountability expectations or significant political pressures to consider alternatives.

The analysis of other expensive policies yielded mixed results with regards to the impact of power dispersion and the influence of the financial sector. Power dispersion tends to increase the probability of adopting targeted measures not involving fiscal disbursements but that may be actively pursued by the financial sector in order to "buy some time" (forbearance type 1). On the flip side, power dispersion discourages the relaxation or non-enforcement of standards and regulation (forbearance type 2) and, perhaps more surprisingly, the adoption of deposit insurance schemes in response to the crisis – two choices that, in principle, are not significantly responsive to variations in the influence of the financial sector. In light of these findings, Mexico may be a bit exceptional because Fobaproa already existed when the crisis hit and the government used both types of forbearance. Moreover, Fobaproa's design seems supportive of an overall scheme intended to protect the newly privatized banks and encourage excessive risk-taking on the part of the new owners in an attempt to quickly recover their investment.

Most deposit insurance schemes do not work like Fobaproa used to, and concerns over the trade-off between avoiding panic and encouraging moral hazard are certainly driving decisions about establishing these schemes across the world. The results so far suggest that power dispersion tends to favor avoiding moral hazard. In the Mexican case, however, divided government did not eliminate deposit insurance altogether and, as a matter of fact, the proposal to reform the scheme and restrict coverage came from the executive. In sum, the findings here suggest that further research is necessary to better understand how, if at all, variations in power distribution are associated with different degrees of tolerance for moral hazard.

6.4. FINAL REMARKS.

As the sub-prime debacle continues to unfold in the United States, and financial markets continue to develop far more rapidly than the capacity – and willingness – of governments and international organizations to regulate them and safeguard their stability, we are once again reminded that financial crises may very well be part of our reality. The devastating consequences of financial crises – increasingly felt beyond borders – time and again make a compelling case in favor of discerning not only the conditions that make them possible, but also the circumstances that may facilitate their handling and resolution.

The evidence and analyses included in the preceding chapters suggest that the relative failure or success at dealing with financial crises cannot be understood without considering the opportunities and constraints different institutional environments create for political actors with veto power. Perhaps more importantly however, they also highlight the value of studying government action as a complex process – rather than as single decisions – in order to fully understand the intricate mechanisms through which institutions and/or institutional manifestations excersice their effects on policy-making. Under such an approach, the impact of power dispersion is not uniformly efficiency-friendly or a guarantee of indecisiveness; rather, it depends on the nature of the decisions that have to be made at any point during the process of responding to a problem as multifaceted as a financial crisis.

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Data and Statistical Appendix

A.1. VARIABLE DEFINITIONS AND SOURCES.

Bank borrowing – Average annual borrowing from the central bank as a percentage of total deposits; data from IMF's International Financial Indicators.

Bank reserves – Average annual cash plus reserves in the central bank as a percentage of total liabilities/deposits; data from IMF's International Financial Statistics.

Capital flows – Average annual ratio of money and quasi-money (M2) to foreign exchange reserves in central bank; variable definition and data from IMF's International Financial Statistics.

Claims on government – Average annual share of government in total bank claims, data from IMF's International Financial Statistics.

Constraints on executive power – Level of constraints on the decision-making authority of the executive; 1-7 increasing in constraints; from Polity IV: Regime Authority Characteristics and Transitions Dataset: www.systemicpeace.org/inscr/inscr.htm

Credit growth/GDP – Average annual growth in bank credit as a proportion of GDP; data from IMF's International Financial Statistics.

Current account balance/GDP – Average annual current account balance as a proportion of GDP; data from IMF's International Financial Statistics.

Divided government – Different parties controlling the executive and the legislature (=1) or otherwise (=0); data on party composition of executives and legislatures from various country and archive sources.

Economic growth – Average annual real GDP growth rate; data from IMF's International Financial Statistics.

Effective vetoes – Number of veto players; variable definition and data from Beck, et.al. (2001).

Electoral system (in lower chamber and, if applicable, all chambers) – Proportional representation (=1) or otherwise (=0).

Exchange rate – Average annual rate of change of the exchange rate; data from IMF's International Financial Statistics.

External debt/GDP – Average annual short-term external debt as a proportion of GDP; data from World Bank's World Development Indicators.

Governing coalition size – Number of parties integrating coalition; various country and archive sources.

Government budget surplus – Average annual central government fiscal balance as a percentage of GDP; data from IMF's International Financial Statistics (IMF).

Government fragmentation – Probability that two random draws will produce two government members from different parties; variable definition and data from Beck, et.al. (2001).

Growth rate differential – Average annual growth difference between country *i* and average growth of G-7 countries; data from IMF's International Financial Statistics and the World Bank's World Development Indicators.

Inflation – Average annual rate of change of GDP deflator; data from IMF's International Financial Statistics.

Interest rate – Average annual change in real short-term interest rates; data from IMF's International Financial Statistics.

Interest rate differential – Average annual difference between domestic and G-7 interest rates; data from IMF's International Financial Statistics.

Legislative fragmentation – Probability that two random draws will produce two legislators from different parties; variable definition and data from Beck, et.al. (2001).

Legislative system – Bicameral (=1) or otherwise (=0).

Liquidity risk – Average annual loan to deposit ratio; data from IMF's International Financial Statistics.

Number of effective political parties (in lower chamber and, if applicable, all chambers) – Follows Laakso and Taagepera's algorithm $N = 1/\sum p_i^2$, (the reciprocal of the Herfindahl index) where p_i denotes the *i*th party's fraction of the vote; data on election results is from various country and archive sources.

Openness to trade – Average annual value of imports and exports as a proportion of GDP; variable definition and data are from IMF's World Economic Outlook and World Bank's World Development Indicators.

Opposition fragmentation – Probability that two random draws will produce two opposition legislators from different parties; variable definition and data from Beck, et.al. (2001).

Per capita income – Real GDP per capita growth rate; data from World Bank's World Development Indicators.

Political system – Presidential (=1) or otherwise (=0); from various country and archive sources.

Previous crisis – If country *i* experienced a crisis episode before the one(s) included in sample (=1) or otherwise (=0); from Caprio and Klingebiel (2002) and Demirguc-Kunt and Detragiache (1998).

Regime type – Democratic (=1) or otherwise (=0); from Polity IV: Regime Authority Characteristics and Transitions Dataset: www.systemicpeace.org/inscr/inscr.htm

Terms of trade – Average annual change in terms of trade; variable definition and data from IMF's World Economic Outlook and World Bank's World Development Indicators.

Twins – If country *i* experienced currency and financial crises simultaneously (=1) or otherwise (=0); from Demirguc-Kunt and Detragiache (1998) and Kaminsky and Reinhart (1999).

A.2. TABLES AND FIGURES

Table A.2.1: Duration and Recovery Time (in years) of Sample Crisis Episodes

Country-Episode	Crisis Year	Duration of Crisis	Recovery Time[1]
Argentina	1980	3	4
Argentina	1995	1	3
Australia	1989	1	1
Brazil	1994	3	1
Bulgaria	1996-97	2	3
Chile	1981	3	9
Colombia	1982	6	5
Cote d'Ivoire	1988	4	7
Czech Republic	1991	3	1
Ecuador	1996	5	1
Egypt	1991	2	1
Finland	1991	4	7
France	1994	2	1
Ghana	1982	8	2
Hungary	1991	5	3
Indonesia	1992	3	9
Indonesia	1997	4	6*
Japan	1992	11*	11*
Malaysia	1985	4	4
Malaysia	1997	4	6*
Mexico	1994	7	2
New Zealand	1987	4	7
Norway	1987	7	8
Paraguay	1995	6	1
Philippines	1982-83	5	5
Philippines	1998	3	5*
Poland	1992	4	1
Senegal	1988	4	1
Slovenia	1991	3	2
South Korea	1997	4	3
Spain	1977	9	1
Sri Lanka	1989	5	3
Sweden	1991	4	3
Thailand	1983	5	2
Thailand	1997	4	6*
Turkey	1982	4	1
Turkey	1994	1	2
United States	1981	11	3
Uruguay	1981	4	6
Venezuela	1994	4	4
Median[@]		*4*	*3*
Mean[@]		*4.425*	*3.750*
Standard Deviation[@]		*2.159*	*2.734*

(*) Episodes considered to be in progress as of the end of 2002.
Source: Caprio, Gerard, and Daniela Klingebiel (2002), except for (@): own calculations, (1): own calculations using IMF's formula (1 + number of years GDP grew below 10-year trend rates).

Table A.2.2: Summary Statistics for Independent Study Variables

	Median		Mean		S.D.		Min		Max		N	
Group/Variable	***Dur***	***Rec***	***Dur***	***Rec***	***Dur***	***Rec***	***Dur***	***Rec***	***Dur***	***Rec***	***Dur***	***Rec***
Power Dispersion												
Number of vetoes	3	3	2.9	2.9	1.6	1.6	1	1	6	6	38	38
Polarization	0	0	0.5	0.5	0.9	0.8	0	0	2	2	34	33
Size of governing coalition	1	1	2.2	2.2	2.6	2.7	0	0	14	14	39	38
Government fragmentation	0	0	20.4	19.1	26.1	25.0	0	0	70.8	68.0	39	38
Opposition fragmentation	43.2	40.3	38.0	36.7	33.6	32.9	0	0	99.9	99.9	39	38
Legislative fragmentation	57.5	57.0	48.3	47.3	29.3	28.9	0	0	88.8	88.8	39	38
Executive constraints	6	6	5.0	4.9	2.2	2.3	1	1	7	7	40	39
Divided government	0	0	0.4	0.4	0.6	0.6	0	0	1	1	34	33
Electoral Competition												
Number of parties	2.7	2.6	3.1	3.0	2.5	2.4	0	0	12.2	12.2	40	39
Legislative elections	7	7	5.9	5.8	2.1	2.1	1	1	7	7	39	38
Executive elections	7	7	5.7	5.7	2.1	2.1	2	2	7	7	39	38
Voting rules (House only)	0	0	0.4	0.5	0.6	0.6	0	0	1	1	33	32
Voting rules (all)	1	1	0.7	0.6	0.7	0.7	0	0	2	2	33	32
Constitutional Features												
Democracy	1	1	0.6	0.6	0.6	0.6	0	0	1	1	40	39
Political system	1	1	0.6	0.6	0.6	0.6	0	0	1	1	40	39
Legislative system	1	1	0.6	0.6	0.5	0.5	0	0	1	1	36	35
Special Interests												
Size of financial sector	39.8	39.7	45.9	45.1	22.8	22.4	16.59	16.59	108.2	108.2	39	38
Proximity of Elections												
Time to elections at t	1	1	1.4	1.5	2.1	2.2	0	0	10	10	39	38
Years left in office at t	2	2	1.9	2.0	2.0	2.0	0	0	7	7	35	35
Time in office at t	4	4	6.2	6.3	7.5	7.6	1	1	30	30	39	38

Table A.2.3: Summary Statistics for Simulations based on Hypothetical Cases

Variable	Sample case	Developing country	Latin American country	Democratic country
Political system	Presidential (=1)	Presidential (=1)	Presidential (=1)	Other (=0)
Divided government	No (=0)	No (=0)	Yes (=1)	Yes (=1)
Financial sector size	45.93 (22.79)	41.63 (21.79)	33.34 (16.89)	47.25 (22.04)
Time in office at t	6.2	7.3	4.8	2.8
Economic growth	3.28	3.58	4.28	2.22
Real interest rate	82.28	105.58	255.46	111.59
Current account/GDP	-4.21	-4.48	-4.24	-3.47
Democracy	Yes (=1)	No (=0)	Yes (=1)	All
Crisis duration	4 years	4	4	4
Recovery at cut-off or earlier	Yes (=1)	Yes (=1)	Yes (=1)	Yes (=1)

Values for "political system" and divided government are group medians. All other values are means with standard deviations in parenthesis when necessary for simulations. The ratio of the current account balance to GDP is used to proxy the country's degree of economic openness.

Table A.2.4: Changes in Predicted Crisis Duration for Hypothetical Cases

Typical country case	Base prediction	Political system	Financial sector size +	Financial sector size -	Time in office +	Time in office -
Whole sample	4.24	2.94 (-1.3)	5.47 (+1.2)	3.25 (-1)	3.72 (-0.5)	4.97 (+0.7)
Developing	5.53	3.51 (-2)	7.31 (+1.8)	4.07 (-1.5)	5.30 (-0.2)	5.76 (+0.2)
Latin American	3.39	2.51 (-0.9)	4.17 (+0.8)	2.85 (-0.5)	3.11 (-0.3)	3.94 (+0.6)
Democratic	3.42	5.33 (+1.9)	4.57 (+1.2)	2.74 (-0.7)	3.02 (-0.4)	3.97 (+0.6)

Estimations are based on Model 3 in Table 2.2. Simulations on financial sector size were conducted adding/subtracting one standard deviation to the mean value for each hypothetical case. Simulations on time in office added/subtracted two years to the mean value for each case.

Table A.2.5: Changes in Predicted Crisis Duration for Hypothetical Cases

Typical country case	Base prediction	Political system	Divided government	Financial sector size +	Financial sector size -	Time in office +	Time in office -
Whole sample	3.15	2.52 (-0.6)	4.08 (+0.9)	3.99 (+0.8)	2.68 (-0.5)	2.95 (-0.2)	6.74 (+3.6)
Developing	5.57	3.52 (-2)	7.41 (+1.8)	8.00 (+2.4)	3.79 (-1.8)	5.47 (-0.1)	5.65 (+0.1)
Latin American	3.35	2.59 (-0.8)	2.76 (-0.6)	4.44 (+1.1)	2.71 (-0.6)	2.88 (-0.5)	4.18 (+0.8)
Democratic	3.99	6.21 (+2.2)	2.97 (-1)	5.70 (+1.7)	2.96 (-1)	3.31 (-0.7)	4.91 (+0.9)

Estimations are based on Model 3 from Table 2.3. Simulations on financial sector size were conducted adding/subtracting one standard deviation to the mean value for each hypothetical case. Simulations on time in office added/subtracted two years to the mean value for each case.

Table A.2.6: Fiscal Cost of Sample Crises

Country-Episode	Crisis Year	Fiscal Cost (% of GDP)
Argentina	1980	55.1
Argentina	1995	0.5
Australia	1989	1.9
Brazil	1994	13.2
Bulgaria	1996-97	13.0
Chile	1981	41.2
Colombia	1982	5.0
Cote d'Ivoire	1988	25.0
Czech Republic	1991	12.0
Ecuador	1996	13.0
Egypt	1991	0.5
Finland	1991	11.0
France	1994	0.7
Ghana	1982	3.0
Hungary	1991	10.0
Indonesia	1992	3.8
Indonesia	1997	50.0
Japan	1992	20.0
Malaysia	1985	4.7
Malaysia	1997	16.4
Mexico	1994	19.3
New Zealand	1987	1.0
Norway	1987	8.0
Paraguay	1995	5.1
Philippines	1982-83	13.2
Philippines	1998	0.6
Poland	1992	3.5
Senegal	1988	9.6
Slovenia	1991	14.6
South Korea	1997	26.5
Spain	1977	5.6
Sri Lanka	1989	5.0
Sweden	1991	4.0
Thailand	1983	2.0
Thailand	1997	32.8
Turkey	1982	2.5
Turkey	1994	1.1
United States	1981	3.2
Uruguay	1981	31.2
Venezuela	1994	22.0
Median[@]		*8.800*
Mean[@]		*12.770*
Standard Deviation[@]		*13.627*

Source: Honohan, Patrick, and Daniela Klingebiel (2002), except for (@): own calculations.

Table A.2.7: Distribution of Bailout Components in Sample

Component	Yes*	Percent	No*	Percent
Open-ended liquidity support	23	57.50	17	42.50
Deposit insurance	25	62.50	15	37.50
Forbearance type 1	9	22.50	31	77.50
Forbearance type 2	25	62.50	15	37.50
Forbearance type 3	26	65.00	14	35.00
Deposit freeze	14	36.84	24	63.16
Repeated re-capitalization	9	22.50	31	77.50
Debt-relief program	9	22.50	31	77.50

(*) As reported by Honohan, Patrick, and Daniela Klingebiel (2002).

Table A.2.8: Summary Statistics for Independent Study Variables

Group/Variable	Median	Mean	S.D.	Min	Max	N
Power Dispersion						
Effective number of vetoes	3	3.0	1.7	1	8	39
Polarization	0	0.6	0.9	0	2	37
Size of governing coalition	1	2.2	2.4	1	13	39
Government fragmentation	1.0	19.3	23.8	0	71.9	37
Opposition fragmentation	54.4	50.1	27.6	0	90.4	32
Legislative fragmentation	59.7	52.9	26.1	0	89.2	37
Executive constraints	6	5.2	2.0	1	7	40
Divided government	0	0.2	0.4	0	1	39
Electoral Competition						
Effective number of parties	2.6	2.9	2.1	0	8.5	40
Competition index	3	2.8	0.7	1	3	40
Voting rules (House only)	0	0.5	0.5	0	1	34
Voting rules (all)	1	0.7	0.7	0	2	34
Constitutional Features						
Democracy	1	0.7	0.5	0	1	40
Political system	1	0.5	0.6	0	1	40
Legislative system	0	0.4	0.5	0	1	35
Special Interests						
Size of financial sector (M2)/GDP	39.8	45.9	22.9	16.6	108.2	39
Proximity of Elections						
Time to elections at t	3	3.0	1.9	1	10	40
Elections at t	0	0.5	0.5	0	1	40
Government time in office at t	2	1.9	1.9	0	7	38

Figure A.2.1: Frequency of Deposit Insurance Observations by Veto Points (Democratic countries only)

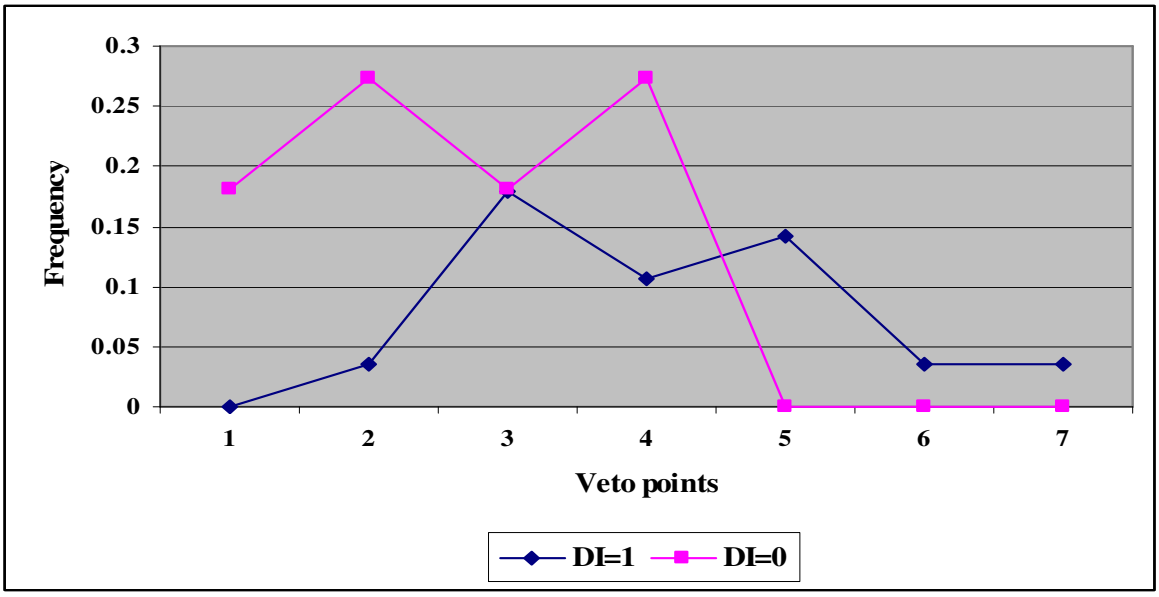

Figure A.2.2: Frequency of Liquidity Support Observations by Veto Points (Democratic countries only)