

**FINANCIAL CRISIS AND BAILOUT:
LEGAL CHALLENGES AND INTERNATIONAL LESSONS
FROM MEXICO, KOREA AND THE UNITED STATES**

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INTRODUCTION

The legal design and implementation of a financial bailout must balance between the need to keep financial institutions afloat and the desire directly to aid debtors and reduce costs to taxpayers. Why do governments and politicians sometimes implement “tougher” legal strategies by passing on costs to bank shareholders, holding managers accountable and taking direct ownership in financial institutions, while others follow more “permissive” strategies often leading to serious problems of corruption and moral hazard?

In this paper, I conduct a comparative-historical analysis of three different domestic responses to financial crises: the cases of Mexico in 1994-1995, South Korea in 1997-1998, and the recent case of the United States in 2008-2009. The objective is to understand the causes of the variation in the design and compliance with bailout legislation. I argue that laws tend to be tougher and more strictly complied with when there is a relative autonomy of the state from the dominant distributional coalitions (independently of the nature of the coalitions). In contrast, “corrupt legislation” (laws intentionally designed to benefit powerful minorities) and rent seeking will tend to predominate when the state is captured or otherwise vulnerable to interest group politics.

My analysis also shows that governments are particularly vulnerable to being captured when leaders are simultaneously both uncertain about their future and in full control of policy. Uncertainty without power leads to political humility and the search for broad based support. Power without concern for one’s immediate future leads to over-confidence and a general lack of urgency. But the toxic mix of uncertainty and authority creates incentives for leaders to use their last minutes in power to “take the bag and run” by cutting deals with external interests in order to assure future prosperity.

In general, the discussion below reveals that the action of distributional coalitions is more important than the particular ideology of the government leadership or the institutional structure of the state at the time. Using Peter Hall’s terminology, “interests” trump “ideas” and “institutions” (Hall, 1989).

In the first section of the paper I outline my theoretical framework. I argue that systems of power/domination and production/exploitation should be analyzed together using a self-conscious political economy approach. Both “economistic” and “state centered” approaches miss the full story, especially at moments of economic crisis. The imbrication of state, market and interest groups is particularly evident today, as the global financial crisis reminds us of the central role the state has in the regulation, bailout and financing of the market under capitalism.

In the second section I discuss the Mexican case. The “Mexican model” stands out as an example of irresponsible government reaction to financial crisis. In 1995, in response to the profound economic crisis of 1994, the Mexican government orchestrated an indiscriminate, across the board bailout of all Mexican banks and their holdings in order to save them from bankruptcy and

then, in 1999, converted FOBAPROA's¹ liabilities into public debt. Due to the flagrant violation of the law and the opacity which predominated during the bailout the fiscal cost reached remarkably high levels².

The political context was one of "authoritarianism under attack", or partial democratization, in which President Ernesto Zedillo wielded a great amount of power but was simultaneously aware that the days of the ruling Institutional Revolutionary Party (PRI) were numbered. Zedillo was also very much at the service of an emerging coalition of domestic corporate monopolists linked to foreign capital flows which had benefited from the equally opaque and corrupt process of privatization which had occurred only a few years beforehand.

In the third section, I compare the Mexican case to the approach taken by government authorities during the South Korean bailout of 1997. Here we see that despite the fact that these two countries are analytically comparable, the results were radically different. In Korea, the government took a much stricter approach to the bailout, forcing bank owners to share responsibility and in many cases directly taking government control over financial institutions. Once again, state autonomy is the central explanatory factor. The protection of the state from the influence of distributional coalitions as well as the specific political context with the arrival of a new reformer as president go a long way to explaining the success of the South Korean bailout.

In the fourth section, I bring in the recent U.S. case. My preliminary analysis shows that instead of following the Korean approach, the U.S. government has behaved in a way dangerously similar to the Mexican government during the 1995 bailout. Conflicts of interest have been prevalent during the U.S. bailout due to the influence of distributional coalitions on public policies. Nevertheless, the change in presidential leadership during the early stages of the crisis may help prevent an outcome as drastic as the Mexican case. Finally, in the last section I summarize my central arguments and offer some general concluding remarks.

I. THEORETICAL APPROACH

We can divide explanations of financial decision-making into two broad schools of thought. On the one hand, there is a large and diverse body of literature that subsumes politics to economics. Such "economistic" perspectives deny the existence of political autonomy and eliminate room for a serious analysis of the socio-political dynamics at play during economic transformations.

¹ During the early 1990s the Mexican government established FOBAPROA or *Fondo Bancario de Protección al Ahorro*. Similar to the Federal Deposit Insurance Corporation (FDIC) in the U.S., its principal objective was to keep banks solvent, safeguard the nation's savings and build public confidence in the re-privatized system (Ortiz Mendoza, 1993).

² The net cost of the bailout was originally supposed to amount to between 5 and 8 percent of GDP in 1995, but ended up reaching 20 percent. Ernesto Zedillo, who was in charge of the bailout, has recently stated that the Mexican bailout was even more expensive than today's U.S. bailout. See "Mas Caro el Fobaproa que el Rescate bancario de los Estados Unidos: Zedillo" *El Economista*, January 28, 2009.

They underscore the role of objective “market forces” emerging out of the international economy and interpret economic change as a relentless transformative process driven primarily by the development of new technologies and more sophisticated financial instruments that increase capital mobility and automatically lead to financial market opening. According to this view, since the objective forces of globalization are the only rules of the game, regulatory frameworks, or “financial repression” do not supply the state with as much control over financial transactions as they once did and the only alternative is ‘to surrender to financial markets’.³

On the other hand, there is an important literature that focuses on the importance of domestic policy decision-making and opens up room for the systematic study of the role of the state. Nevertheless, this kind of analysis tends to be caught within an organizational perspective of the state that incorrectly disconnects politics from economics and detaches domestic from international dynamics. Although this kind of explanation takes political factors seriously, it sees the state as relatively monolithic and an all-powerful machine. For instance, Ben Ross Schneider’s analysis of business-state relations in Latin America during the 20th century offers almost a caricature of this perspective.

The most major variations in patterns of business organization [in Latin America]—weak versus strong, rich versus poor, encompassing versus narrow, politicized versus neutral—can be traced back to actions of state actors and the cumulative effect of these actions over the twentieth century. In other words, states organized or disorganized business (Schneider, 2004: 5).

There is no doubt that states play an important role and that if one tries hard enough one can trace many things back to something the state did or did not do at some moment in time. But such an *a priori* radical, state-centric perspective dangerously paves over the crucial differences in state-society relations which exist at different times and places.

Timothy Kessler’s work exemplifies the state-centric approach as applied specifically to financial management in Mexico. Kessler (1998) sustains that “finance policy represents a resource that the state can manipulate to address the interests of domestic groups that it depends on for political survival.” (1998: P.11.) In Kessler’s view, the Mexican state-party regime unilaterally determines finance policy in order to satisfy its objectives which in the end are driven only by the political and personal interests of policymakers.

The main flaw of this state-centric approach is that it regards governmental process as independent causal forces, rather than arising out of a constant interaction with societal cleavages and economic fluctuations. Peter Gourevitch’s classic study *Politics in Hard Times* (1986) offers an alternative framework. In this text, Gourevitch demonstrates that coalition building is the key to understanding state responses to economic crisis. The author demonstrates

³ See John B. Goodman and Louis W. Pauly, “The Obsolescence of Capital Controls. Economic Management in an Age of Global Markets” in *World Politics* 46 (October 1993), 57-58. and Eric P. Peterson (1995) “Surrendering to Markets” *The Washington Quarterly* 18, num. 2, 1995 p.108

that during such “hard times” it becomes particularly evident that “the choice made among conflicting policy proposals emerges out of politics” (17).

Gourevitch focuses his attention on the different patterns of social support that five industrialized countries (U.S, Sweden, France, Britain and Germany) developed during three important crises: 1873 to 1896, 1929 to 1949, and from 1971 to the eighties. He examines the policy sequences in each country focusing on the demands expressed by various societal actors (labor, corporations, agricultural interests, etc.) and the role of institutional arrangements in shaping the domestic distribution of power in each case. When he analyses the various ways in which these countries broke with economic orthodoxy in the 30s he underlines the construction of an accommodation or partial consensus among social actors.

What the combination of businessmen, farmers, and workers produced, then, was a *political autonomy* that permitted escape from the economic orthodoxies of left and right. Each member of the new coalition got something but it also made concessions. Crisis induced societal actors to bargain, to make trades that in ‘normal’ times they might have found unacceptable. It created a political capacity to take actions that hitherto had seemed politically impossible. (Gourevitch, 1986: P.162, My emphasis)

Gourevitch examines the policy demands expressed by these different societal actors, the role of institutional arrangements in shaping the distribution of power, the linkage between state and society provided by intermediate associations and the influence of economic ideology. His basic interest is to consider the ways that these variables shaped the environment in which politicians operated.

Roger Schoenman’s (2005) discussion of privatization in Eastern Europe also effectively draws a line between economic and exaggerated state-centric perspectives. Schoenman criticizes those analyses which focus exclusively on the speed, the rules and the institutions which have guided economic reforms in the region.

Scholars should rather think about *who* is acting to understand *what* has happened...To understand the actual course of economic policy making in post-socialism and its effects, scholars need to move from a focus on institutions and rules to the power struggles and endowments of competing groups of elites (Schoenman 2005: 41).

The nature of state-society relations is even more important than the specific nature of technical solutions for economic success. We need to bring politics back into our discussions of economic reform. This also means that we should not only focus on *whether or not* the state withdraws or re-regulates at a particular moment in time, but also on *how* the state behaves during the process. Parallel to my own argument, Schoenman brings the state and politics back in to analyses of processes of economic change.

Franz Schurmann also links up state and society in a particularly creative fashion. For Schurmann, although the state has an independent existence and an operating structure of its own; it is also intimately intertwined with the various “currents” of society.

A powerful corporate or bureaucratic organization may embody currents no longer widespread in society, but *their source can always be found in the society past or present*. I propose that the politically significant currents in society relate to three basic matters: the material interests of people (particularly work and jobs); their sense of order, security and justice; and the social and physical quality of their life and that of the people with and among whom they live (Schurmann, 1974: P. 33, My emphasis).

In this conception the state and its leaders are by no means separate from society: “the source” of power “can always be found in the [past or present] society”. Therefore Schurmann reminds us that the act of government requires and is grounded in the constant interpenetration between the different spheres of society.

II. THE MEXICAN BAILOUT

A. Overview

There is a general consensus that in the event of financial crisis, government authorities have the obligation to help recapitalize the banking system to avoid problems from getting out of control. It is not acceptable for public officials to simply stand by and watch as the financial system melts down. But there are numerous ways to organize a bailout operation. Specifically, there is what we will call the “tough” and the “permissive” strategies.

A “tough” strategy would follow the three basic rules set out in a recent text by Liliana Rojas-Suárez, top advisor to the Office of the Chief Economist of the Interamerican Development Bank, and Steven Weisbrod. First, if someone must lose a part of their assets “the bank stockholders should be the first in line”. This is important because in addition to limiting the cost of the restructuring it also generate incentives to restrict extreme risk taking in the future. As De Boyer (1998) has argued:

“The lender of last resort has nothing to do with this [bailout] operation. Those who have the responsibility to solve the problem are the stockholders. The government may intervene in the case of private banks only when the stockholders refuse to cover the losses. However, when that happens and fiscal resources are needed to pay for the missing money, the property of those institutions should be clearly determined.” (De Boyer, 1998:35 Quoted in Nuñez Estrado 2004 p. 169)⁴

⁴ For instance, Article 51 of the French Banking law grants the right to the president of the National Bank Commission, who is also the Governor of the Central Bank, to request the stockholders who exercise the control of the institution in troubles to contribute with the capital needed to solve the financial problem. If they do not accept, the request then is addressed to the other banks. The State intervenes only as a last resource. In case the stockholders in control do not accept the invitation, the property and control are transferred to the ones who make the contribution and assume the responsibility to solve the situation. See: Solís Rosales, Ricardo.

Nevertheless, as we will see below both in the case of Mexico's FOBAPROA and in the case of the Troubled Asset Relief Program (TARP) in the United States, governments tend to follow more permissive strategies by first saving the large stockholders of the principal banks before attending to the small and medium sized debtors.

In the Mexican experience the noncompliance with this first principle was so evident that even the director of the Mexico Department of the World Bank in 1997 declared:

“The truth is that bank stockholders proportionally took up a small part of the losses of the credit institutions and most of the cost will end up being paid by the tax payers. [This] reflects the amount of political influence that [the big investors] can have over the governments of their countries in determining the mechanisms and the forms of bail out”⁵

The second principle outlined out by Rojas-Suárez & Weisbrod refers to the avoidance of moral hazard during the bailout process. Here the argument is that troubled and bankrupt institutions should be prevented from using government supports to run even higher credit risks under the confidence that the government will be there to bail them out. In the Mexican case, this second principle was flagrantly violated when Ortíz Martínez, as Secretary of Finance, consistently refused to close down insolvent banks. As discussed below, instead of nationalizing the banks or closing them down, banks were left on life support at a great cost to taxpayers. The refusal to nationalize or close down the banks was not so much due to a faith in “orthodoxy”, but more to the political context and to the regime's alliance with the emergent distributional coalition.

The third principle speaks to the need to build social legitimation of bank bailouts through communication with and support from society. Here the Mexican bailout was a complete failure. As we have already discussed, the episode was carried out entirely behind closed doors, leaving both the public and Congress entirely in the dark.

Mexico has come to be an international example of what not to do in the face of financial crisis. This is because of the discretion, ineffectiveness and opacity involved in the banking bailout instrumented through FOBAPROA, as well as the flagrant violation of the three basic principles.

“The greatest mistake [of the Mexican experience] was the FOBAPROA operation, which purchased bad credits from the troubled banks. FOBAPROA also failed to adequately punishing the bank stockholders, who usually should be the first to receive the blow. Because of this, the Mexican case is a great lesson for

(1998) “El Banco de México y la Crisis Bancaria” en *Función de la Banca Central en México*. Cámara de Diputados LVII Legislatura, Congreso de la Unión. p.195.

⁵ Lecture of Olivier Lafourcade at the XXV Convention of the Mexican Institute of Finance Executives, December 1997. Quoted in Calva José Luis (2001) *México: Más allá del neoliberalismo*, Plaza y Janes, P. 245.

the Asian banks of *what not to do* in the face of a crisis” (My emphasis)⁶

In a recent World Development Report, the World Bank (2006) has severely questioned the influence of economic elites in the formation of the financial system:

Captured banking systems exchange favors: market power is protected for a few large banks, which tend to lend favorably to a few selected enterprises, which may not be those with the highest expected risk-adjusted returns. (...) Achieving more equal access to finance by broadening financial systems thus can help productive firms that were previously beyond the reach of formal finance. (*World Development Report 2006: Equity and Development*, World Bank September, 20th, 2005: P. 14)

To illustrate the problems which arise in such “capture” situations the World Bank has chosen Mexico as the principle anti-model, whose bank bailout “represented the payment of 125 billion dollars of public funds. That is, a quarter of the GDP of the country.” The fiscal cost of the bank crisis in Mexico is equivalent to four times the 33 billion dollars received by the Mexican state from all of the privatizations during the 90’s. There is evidence that the beneficiaries of credits who maintained close relationships with the bailed out banks were specially favored during the crisis, along with the fact that their political connections allowed them to escape from what could have been significant punishments.

B. History

In 1994 financial crisis hit Mexico. The explosion of speculative activities, insider lending and debt combined with an increase of government spending during the 1994 presidential race and a significant overvaluation of the peso had set the stage for economic collapse. On December 22nd, only three weeks after incoming President Ernesto Zedillo (1994-2000) came to office, the house of cards came tumbling down. The peso lost half its value, foreign investors scrambled to withdraw their money and the economy went into free fall. During 1995, GNP decreased by 6.2%, the exchange rate increased by 100% and unemployment soared. This situation pushed most major Mexican banks to the verge of bankruptcy as debtors defaulted on their loans and creditors quickly withdrew their deposits in search of a more reliable investment climate.

Something had to be done to save Mexico’s system of financial mediation. Zedillo was faced with a crucial economic policy decision. A full menu of options was open to the president, including the re-nationalization of the banks, a partial takeover, an across the board bailout of all banks, a partial bailout of some banks or specific debtors, or simply allowing the existing banks to fail and be replaced by new ones⁷.

⁶ “Latin’s lessons for Asian banks”, *The Economist*, 25 de Julio 1998, Page. 21.

⁷ Nouriel Roubini (2008) points out six different ways in which government-led recapitalization can occur: via purchasing bad assets or loans; an injection of preferred shares; an injection of

The economic orthodoxy of the time called for a careful partial bailout while doing everything possible to avoid multiplying the moral hazards present in any rescue operation (Rojas-Suárez & Waisbrod, 1997). Those responsible for the high level of debt should take a large amount of the hit, those guilty of illegal practices should be punished, and illegal loans should not be covered by bailout programs. Otherwise, the government sends a signal that irresponsible and illegal behavior will not be punished and sets the ground for the worsening of the crisis in the short run and the emergence of a new crisis in the medium to long run.

Mexican law also required a careful approach to any bailout operation. The original law regulating FOBAPROA⁸ did not authorize it to use government funds to bailout banks, limiting it to using only bank security deposits. The Mexican Constitution also requires Congress to formally authorize any new public debt. These legal impediments should have pushed Zedillo to carefully design his bailout strategy, with an eye to public legitimacy and the future health of the banking system.

But Zedillo didn't follow either economic orthodoxy or Mexican law. His government orchestrated an indiscriminate, across the board bailout of all Mexican banks and their holdings. Corruption was rampant throughout the entire process. This was not the best strategy from either a strict technocratic perspective nor from the perspective of public legitimacy and the rule of law. But it was the correct strategy from the point of view of defending the interests of Mexico's emergent distributional coalition. Politics trumped economics.

The political context also played an important role. 1994 was a year of political as well as economic crisis. On January 1st, an indigenous guerrilla group, the Zapatista National Liberation Army (EZLN), emerged in the southern state of Chiapas and declared war on the federal government in protest against neoliberal policies and the dire situation of Mexico's indigenous people. On March 23rd, the ruling party's (Institutional Revolutionary Party, or PRI) original candidate for the upcoming August, 1994 presidential elections, Luis Donaldo Colosio, was assassinated in cold blood during a campaign stop in northern Mexico. On September 28th, the sitting president of the PRI, José Francisco Ruiz Massieu, was assassinated while getting into his car in plain daylight in the middle of downtown Mexico City.

Zedillo came into office as a particularly weak president in desperate need of legitimacy. He was not the originally chosen candidate and he sat atop a fractured PRI and a country in the midst of political crisis. Nevertheless, Zedillo still had full control over state power. The PRI retained full control over Congress in the 1994 elections and still controlled the majority of the state governorships.

common shares; a purchase of subordinated debt; an issuance of bonds to be placed on the banks's balance sheet; an injection of cash; credit lines extended to the banks; and government assumption of government liabilities. Some of these strategies are more effective an efficient than others. For instance, in the discussion below we will see that the strategy of purchasing bad assets, which predominated in both the Mexican and United States cases, is one of the worst ways to recapitalize the financial sector.

⁸ FOBAPROA are the Spanish initials for the Banking Fund for the Protection of Savings, Mexico's equivalent to the FDIC in the United States.

The toxic mix of a desperate need for legitimacy along with authoritarian control created a sense of urgency in which the PRI-government had the incentive to take full advantage of its last moments of power.

The FOBAPROA trust was created by the Law of Credit Institutions passed in July 18 1990.⁹ Article 122 of this law established it as a *preventive mechanism* designed to avoid financial problems with the recently privatized banks

Article 122. Banking institutions should participate in the *preventative mechanism* designed for the protection of savings, whose organization and functioning shall hold to the following:

1. The Central Bank shall administer a trust called the Banking Fund for the Protection of Savings, *whose purpose will be the performance of preventive measures* in order to avoid possible financial problems in the banks, as well as to assure the compliance of the financial obligations under the responsibility of such institutions, which are the express object of protection of the Fund. (Law of Credit Institutions, June 28 1990, P. 42 My emphasis)

FOBAPROA was not supposed to be used as a bailout instrument in the face of a systemic crisis like the one which occurred at the end of 1994. Although FOBAPROA was supposedly the continuation of the FONAPRE (see footnote above) there were a couple of crucial differences in institutional design. First, while FONAPRE was a part of the executive branch, FOBAPROA was a private trust, therefore insulating it from the obligations and demands of legislative control and oversight.

The constitution of the trust by the Government *does not grant the fund the character of entity of the federal public administration*, and therefore, *shall not be subject* to the dispositions applicable to such entities (Article 122 Fraction I. Law of Credit Institutions, June 28 1990, P. 42 My emphasis).

Both the institutional design and the functioning of FOBAPROA therefore led to serious problems of opacity and lack of accountability. Although FOBAPROA

⁹Before the bank nationalization there was no specific mechanism to protect bank deposits, nevertheless the federal government in practice guaranteed the bank sector's obligations 100%. The Fund for the Protection of Savings, FOBAPROA's earliest precursor, was created in 1981. This Fund received deposits from the banks, which it would then use in the event of financial problems. On November 10th 1986, the federal government then created the Fund for the Preventive Support of Bank Institutions (FONAPRE by its Spanish acronym). This fund also received deposits from the banks, which were then available in order to practice "financial operations to support the financial stability of credit institutions and avoid circumstances that may have a negative impact in the timely payment of their obligations" (Cláusula 3^o. del Contrato de Fideicomiso del FONAPRE, y Artículo 77 de la *Ley para Regular el Servicio Público de Banca y Crédito*). With the privatization of the banks at the time of Salinas, the FONAPRE was substituted by FOBAPROA. On October 18th 1990 the agreement which formally created the FOBAPROA, entitled *Modificaciones al Contrato del Fideicomiso FONAPRE*, was approved. (See: Mackey Report, 1999; Di Contzanso, 2005; or Nuñez , 2005.

“was not subject to the rules applicable to public agencies” it was directly run by the government through a “Technical Committee”:

IV. The constitutive contract of the Fund shall foresee the existence of a Technical Committee conformed by representatives of the Ministry of Finance and Public Credit, the Central Bank and the National Commission of Banking and Securities.

The Technical Committee *shall determine the terms and conditions of the supports granted with charge to the Fund*; the deposits, credits and other obligations, and the amount of these objects of express protection, the periodicity with which the ordinary contributions shall be covered, *as well as the rest of the faculties foreseen in the constitutive contract of the Fund.* (Article 122 Subsection IV. Law of Credit Institutions, June 28 1990, P. 43 My emphasis)

Public officials from the Finance ministry, the Central Bank and the National Banking Commission—many of them paradoxically the very same architects of the disastrous bank privatization of 1991-1992—were therefore fully in control of FOBAPROA and simultaneously freed from their obligations to give accounts to Congress since it was formally a private trust. For instance, according to the Superior Federal Auditor, Arturo González de Aragón, during the 1994-1995 bank bailout “the FOBAPROA Technical Committee acted without operation rules and with an excess of discretion in its decisions for the bank bailout and made ready made suits for some banking institutions”¹⁰.

Unfortunately for the operators of FOBAPROA, Subsection IV of Article 122 of the Law of Credit Institutions of Salinas was in direct conflict with the Mexican Constitution. Article 73, subsection VIII of the Constitution states that all public debt must be authorized by the Federal Congress:

“The Federal Congress has the exclusive faculty to set the basis on which the executive may contract loans on the credit of the nation, to approve these loans and to recognize and to authorize payment of the national debt. No loan shall be contracted unless it is for the execution of works that directly produce an increase in public income...”

But Article 122 of the Law of Credit Institutions grants a handful of public servants authority to “*determine the terms and conditions of the supports granted with charge to the Fund*”, thereby authorizing them to take up public debt without the authorization of Congress. In addition, we should point out that the debts acquired by FOBAPROA during the critical years immediately alter the crisis of 94 had little of nothing to do with “the execution of works that directly produce an

¹⁰ Interview with Arturo González de Aragón, Jorge Francisco Moncada: “Fobaproa asunto de ética política y moral pública”, Revista Vértigo P. 12. Año III No. 136, 26 de octubre, 2003. P. 12

increase in public income”. As we will see below, all of this eventually created significant problems for the Zedillo administration.

A second crucial difference between FOBAPROA and FONARE is with regard to the use of public funds. The constitutive contract of FONARE had clearly established that “in no case can the property of the Trust be increased with donations from the federal government with a charge to the budget”¹¹. FOBAPROA throws this provision entirely overboard. The official “Agreement to Compile in a Single Instrument the Constitutive Contract of FOBAPROA” signed in early 1994 by Pedro Aspe, Secretary of Finance, and Miguel Mancera, Governor of the Central Bank, entirely eliminated the contractual provision preventing the use of fiscal funds to capitalize the trust. In addition, the Agreement states that the “Trustee [the Central Bank] will be free of all responsibility” including those incurred as a result of the execution of “urgent acts which have to be realized without the authorization of its Technical Committee”, thereby opening up the margin of discretionary use of the Trust even wider.

In 1996, now under the Zedillo administration, the new Secretary of Treasury, Guillermo Ortiz Martínez and again Mancera as the governor of the Central Bank once more changed the rules of FOBAPROA. This time they gave it meta-constitutional powers, explicitly enabling this private trust to directly indebt itself with charge to public funds **(see Table 1)**

¹¹ Bátiz Vázquez, Bernardo. “Consideraciones Jurídicas sobre la existencia y funcionamiento del FOBAPROA” en *IPAB-FOBAPROA el Debate Continúa*. Instituto de Investigaciones Legislativas, LVII Legislatura de la H. Cámara de Diputados, México 2000.

TABLE 1.
AUTHORIZED FINANCIAL OPERATIONS FOR FONAPRE AND FOBAPROA

FONAPRE & FOBAPROA (1986-1990) (1990-1996)	FOBAPROA (As of May 3 rd , 1996)
<ul style="list-style-type: none"> Finance banking institutions through the use of deposits, credits or loans. 	<ul style="list-style-type: none"> Finance banking institutions or their controlling companies (holdings) through the use of credits, line credits, simple credit accounts, or currency accounts, or by any other operation established by the Market Legislation.
<ul style="list-style-type: none"> Purchase subordinate instruments of debt issued by the banking institutions 	<ul style="list-style-type: none"> Purchase of stocks, subordinate instruments of debt or any other debt instruments issued by the banking institutions or their controlling companies (holdings)
<ul style="list-style-type: none"> Purchase B series shares, according to the Law. 	<ul style="list-style-type: none"> Purchase and sell assets or property titles in order to gain financial improvements for the banking institutions and their controlling companies (holdings)
<ul style="list-style-type: none"> Purchase credits, shares and other assets of the banking institutions 	<ul style="list-style-type: none"> Issue credit titles, allow endorsements and receive obligations in favor of the banking institutions.
<ul style="list-style-type: none"> Offer non-recuperable contributions, when strictly necessary, to cover financial disturbances in the institutions. 	<ul style="list-style-type: none"> Participate in the social capital of those entities participating in FOBAPROA in order to achieve its goals, including those firms that contribute with secondary and complementary services. Besides, this Trust Fund may create alternative trust funds and establish all the necessary alliances that will provide more assistance to the Trust Fund.
	<ul style="list-style-type: none"> Obtain financing Hire complementary or auxiliary services to fulfill the operations and tasks of FOBAPROA
Any other similar and related activities established by the Technical Committee according to the kind of support required.	<ul style="list-style-type: none"> Any other similar and related activities authorized by the Technical Committee of FOBAPROA

Source: *Operative Rules for FONAPRE*, December 24th 1986 and *Modifications to the Agreement for the FOBAPROA Trust (Agreement of Parts)*, May 3rd 1996, clause 3.

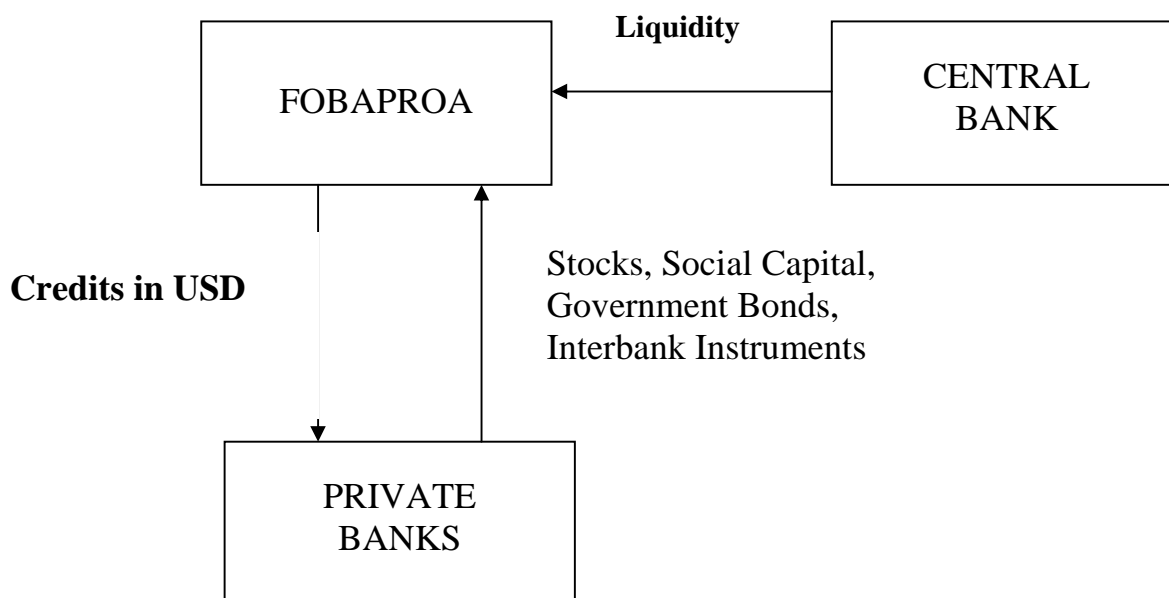
Here we can see that with the 1996 reforms FOBAPROA was enabled to give financial supports and acquire debt and stocks not only to banks but also to the controlling companies or “holdings” of banks. In addition, the trust was no longer limited to using direct monetary supports, but was permitted to use a diversity of financial engineering strategies including lines of credit and “anything else foreseen in the market legislation”, like promissory notes. FOBAPROA was also now allowed to create new subsidiary trusts, issue its own debt instruments and give direct government guarantees (“*avals*”).

These changes were made on the margins of the law, since they were implemented through a simple “agreement” between two top financial officials. In the end they were a massive self-adjudication of expansive powers since their architects were also their direct beneficiaries. Such powers were amply and irresponsibly used by the financial authorities during the bailout.

C. Actors, Mechanics & Operation

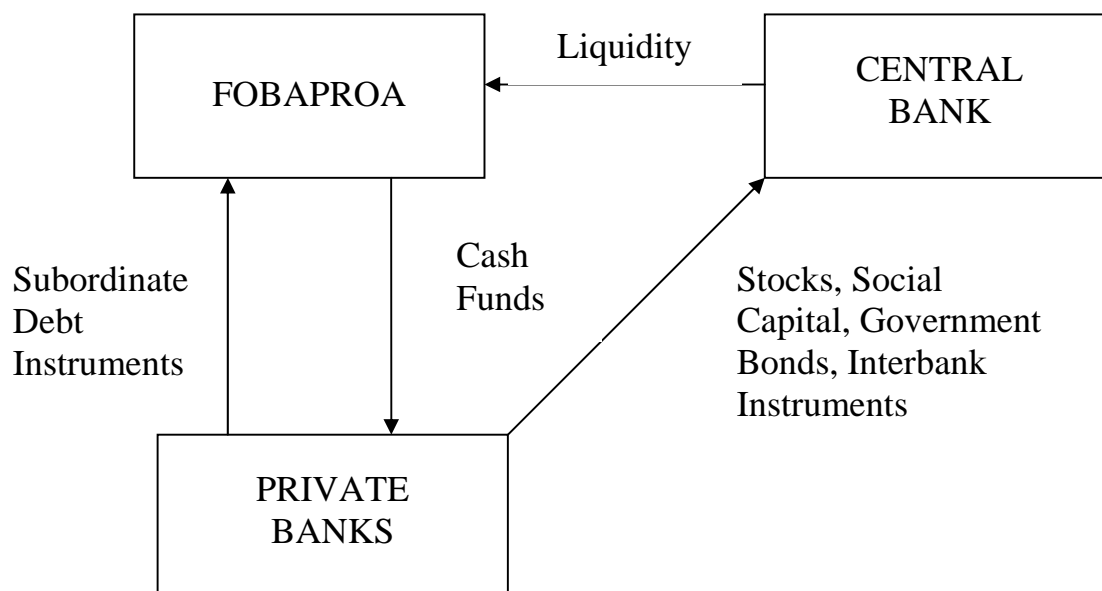
Despite the fact that FOBAPROA was not originally designed to bail out banks, in the face of the December 1994 financial meltdown the financial authorities decided to use their discretionary authority to reinvent the purpose of the trust. Through FOBAPROA, the government implemented five distinct programs to try to help Mexico emerge out of the ashes of crisis: the *Programa de Ventanilla de Liquidez* (The Counter Liquidity Program), the *Programa de Capitalización Temporal* (The Temporary Capitalization Program) (Procapte), the *Programa de Capitalización y Compra de Cartera* (The Capitalization and Debt Purchase Program) (PCCC), *Programa de Intervención y Saneamiento* (Intervention and Recovery Program)(PIS), and the *Programas de Apoyo a Deudores* (Debtors Support Programs)(PAD).

The “Counter Liquidity Program” was the first program to be implemented after the crisis, on January 6th 1995. With this program the Central Bank gave short term dollar denominated credits to banks so that they could maintain payments on their foreign debts. As collateral the banks offered a part of the social capital of the institution or other assets including government bonds or other banking instruments. This program fortunately did not imply any fiscal cost, since the banks paid back the entirety of the loans they received. It also was relatively clear of the legal irregularities which plagued the other FOBAPROA programs. Nevertheless, this program was short lived and used a very small percentage of the total amount of money dedicated to the bailout.

DIAGRAM I. COUNTER LIQUIDITY PROGRAM

The Temporary Capitalization Program (PROCAPTE) was the second program to be implemented. This program began in February of 1995 and consisted of special supports for banks with low levels of capitalization (less than 8%). Through this program the banks could get extra funds to capitalize themselves temporarily until they found alternative sources of funding.

DIAGRAM II. PROCAPTE



As in the case of the Counter Liquidity Program, the PROCAPTE also required bank stocks and financial assets as collateral. This guaranteed that this program wouldn't imply fiscal costs of any type since almost the totality of the credit institutions paid off these short term loans (with the notable exception of Banco Inverlat which lived up to only 28% of its debt) **(See Table 2)**

Bank	Amount received in billions of pesos	Percentage paid back to the government	Fiscal Cost
UNION,	16.753	100 %	No Fiscal Cost
CREMI	6.987	100 %	No Fiscal Cost
BANPAIS	10.483	100 %	No Fiscal Cost
OBRERO	1.187	100 %	No Fiscal Cost
BANORO	2.657	100 %	No Fiscal Cost
INVERLAT	7.283	72%	1.4 MAIN PAYMENT .7 INTEREST PAYMENTS

TOTAL	45.350		2.1
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Source: SHCP y CNVB

Despite the direct channeling of resources to the banks through these two programs, the banks continued to have difficulties during the 1994-1997 period and a dozen institutions had to be intervened by the government through the third program, the Intervention and Recovery Program (**See Table 3**)

Bank	Date of Detection of Problems	Date of Management Intervention	Main Stockholders	Causes of Intervention
Union	Jul, 1994	Sep, 1994	Carlos Cabal Peniche	<ul style="list-style-type: none"> ➤ Self-made loans ➤ Related Lending ➤ Loans to the main bank stockholders so that they could buy shares from the same bank ➤ Financial frauds
Cremi	Feb, 1994	Jul, 1994	Carlos Cabal Peniche	<ul style="list-style-type: none"> ➤ Self-made loans ➤ Related Lending ➤ Loans to the main bank stockholders so that they could buy shares from that same bank ➤ Financial frauds
Interestatal	Mar, 1995	Sep, 1995	Alfonso Garay	<ul style="list-style-type: none"> ➤ Lack of capitalization ➤ Loans to the stockholders from the same bank
Obrero	Sep, 1991	May, 1997	Jorge Eduardo Familiar Haro	<ul style="list-style-type: none"> ➤ Lack of capitalization ➤ Loans to the stockholders from the same bank
Banpais	Sep, 1994	Mar, 1995	Angel Isidoro Rodríguez	<ul style="list-style-type: none"> ➤ Related Lending ➤ Loans to the stockholders from the same bank so that they could buy Banpais Financial Group
Inverlat	Mar, 1994	Mar, 1995	Raymundo Gómez Flores	<ul style="list-style-type: none"> ➤ Lack of capitalization ➤ Related Lending ➤ Loans to the stockholders from the same bank
Oriente	Jun, 1995	Mar, 1995	Ricardo Margain	<ul style="list-style-type: none"> ➤ Related Lending

			Berlang	
Centro	Feb, 1995	Mar, 1995	Hugo Villa Manzo	➤ Related Lending
Anáhuac	Nov, 1996	Nov, 1996	José Luis Sánchez Pizzini y Federico de la Madrid Cordero	➤ Related Lending ➤ Loans to the stockholders from the same bank ➤ Unacceptable practices regarding credit guarantees
Capital	Oct, 1994	May, 1996	Pedro Osorio Gómez	➤ Related Lending ➤ Loans to the stockholders from the same bank ➤ Lack of capitalization
Confía	Mar, 1994	Aug, 1997	Jorge Lankenau Rocha	➤ Related Lending ➤ Loans to the stockholders from the same bank ➤ Off-shore operations ➤ Fraud to the investors
Industrial	Jun, 1996	Feb, 1998	Jorge Martínez Güitrón	➤ Related Lending

Source: CNBV, Mackey Report.

This table shows that for each one of the intervened banks there was evidence of irregular “looting” behavior by the owners. Related lending, credits to businesses directly linked to the lending banks and controlling groups, credits to friends and family of the stockholders as well as bank employees and advisors, loans without collateral or to minors with political connections, financing for the PRI and other similar operations ran rampant throughout the banking sector and led to its collapse.

The Intervention and Recovery Program had already been used before the December 1994 meltdown. In September of 1994 Banco Unión and Banca Cremi, both property of Cabal Peniche, had been intervened. In these banks, the credit expansion had gone beyond imaginable limits¹². Later it would be shown that these credits were related to illegal activities linked to narco-trafficking, money laundering and the funding of the electoral machines of the party of the state, the PRI.

Chong and Lopez-de-Silanes (2005) have demonstrated the central role that related lending played in causing the collapse of the banking system in Mexico. First, the borrowing conditions offered to related parties were substantially better than those available to unrelated ones. Second, the default

¹² In 1992 Banco Union registered a sudden enlargement of its credit portfolio of more than 94%, more than twice the growth of the entire bank system’s portfolio. In 1993, the development of bank system’s credit portfolio reduced a bit but the credit portfolio of this particular bank (Banco Union) increased almost 100%, which was four times the growth of the rest of the banking system.

rate on related loans “was 70 percent compared with only 39 percent for unrelated parties” and recovery rates were 19 to 40 cents per dollar lower for related borrowers than for unrelated ones. Third, related lending “represented about 20 percent of all loans outstanding”. Fourth, the worst-performing loans were those made to persons or companies closest to the controllers of the banks. In short, related loans “were used to divert funds away from banks and to exploit minority shareholders”.

Moreover, as the economy slipped into recession, the fraction of related lending doubled for banks that subsequently went bankrupt, while it increased only slightly for the banks that survived. This suggests that when bankers thought they might lose their investment, they stepped up the rate of looting to extract as much value as possible while they still controlled the bank.” (P.386)

In general, the bank interventions were usually too late in coming. In addition, the recovery process was extremely controversial since the government interveners were controlled in a discretionary manner by the FOBAPROA Technical Committee. It was not at all clear why certain decisions were made for some banks and for some loans and not for other. The bank interventions were supposed to “restructure” the banks’ balance sheets, thereby making them attractive to new buyers. But the opaque nature of the process left a large cloud of doubt, making it appear that the interventions had been designed more to “legalize” and cover up the crimes committed by bankers than to actually put the banking system back on its feet.¹³

The most important program used to “recover” or “cure” troubling banks and thereby prevent formal intervention was the now infamous Capitalization and Debt Purchase Program (PCCC). The formal purpose of the PCCC was to help the banks which were comparatively strong increase their capital through the substitution of their problematic financial assets (non-performing loans), with 10 year promissory notes. These notes were issued by FOBAPROA, and authorized by the Federal Government, and offered attractive interest rates capitalizable every quarter and tied to the interest rates of the CETES, or federal treasury bonds.

The banks who participated in the PCCC chose which loans would be sold to the government. These loans were then sent to a special trust which was administered by the originating bank. In other words, although the government “purchased” the loans, the rights to collect the past due loans were given back to the banks.

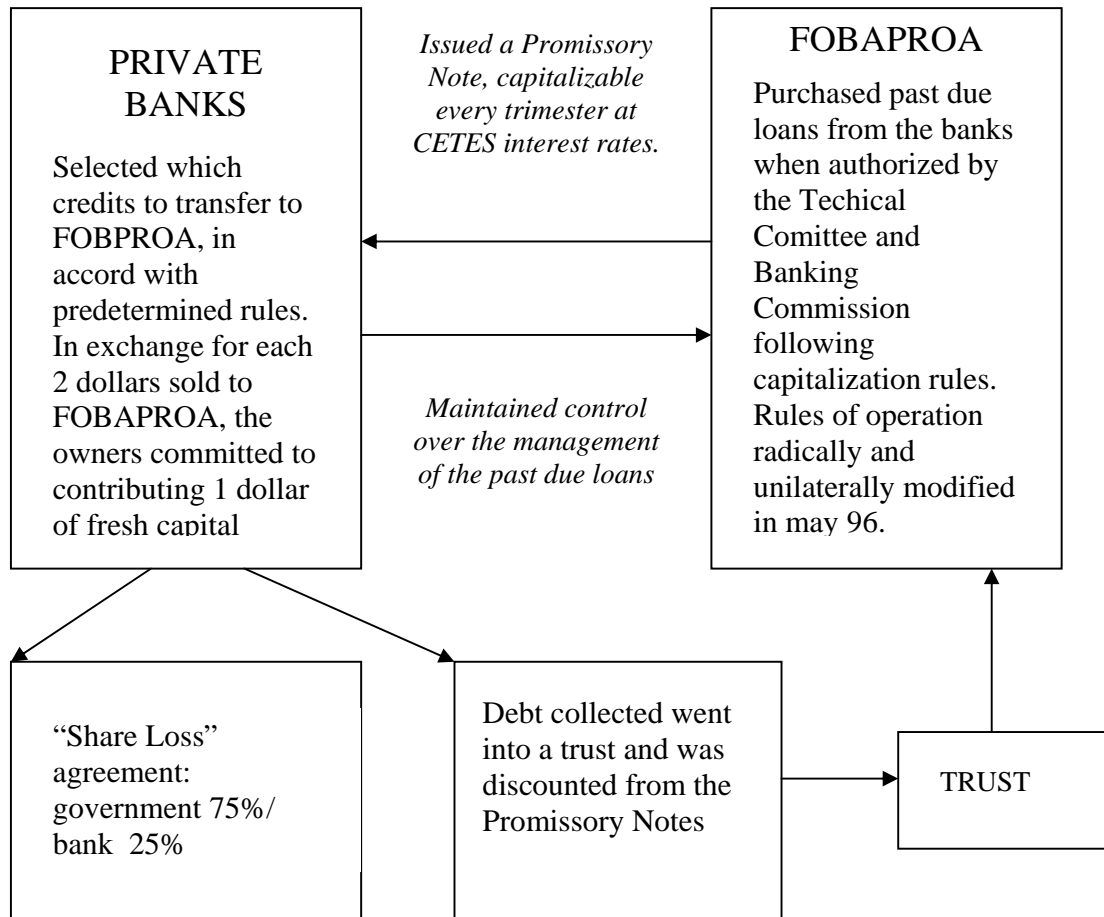
Loans taken over by FOBAPROA were removed from a bank’s balance sheet and transferred to its off-balance accounts. Thus

¹³ The illicit behaviors of the caste of neobankers were so scandalous and so abundant that for political reasons the government only punished a few of them. After the Banca Cremi, Banco Union, Banpais and Confia interventions, it became clear that illicit handlings of this institutions by their owners was a extremely widespread situation. These practices were also prevalent in Banorte, Banco del Sureste, Banco Alianza, Banca Promex, Banco Industrial, Banco Inverlat, Banco Mexicano Banco del Atlántico, y Banca Serfin but in these cases the bankers only lost the institutions, keeping their personal investments relatively safe.

the risk associated with nonperforming loan portfolios accrued to the trust fund, while the banks registered FOBAPROA securities received in this exchange on their balance sheet. These transfers changed the profile of the banks' balances, and in several cases this operation helped attract foreign investors to Mexico's banking sector. (Nadal, 2003: 77)

When the banks failed to collect the unpaid loans a scheme of "shared losses" was implemented. The government absorbed 75% of the loss and the bank the remaining 25%. In Exchange for such a generous scheme of support to the banks, their owners committed to injecting fresh resources into their own banks in a proportion of two to one. For every two dollars purchased by FOBAPROA, the bankers were supposed to deposit a dollar from their own pockets into their own banks. **(See Diagram III)**

DIAGRAM III. PCCC



Nevertheless, the program operated in an entirely opaque manner and did not follow clear legal or technical guidelines. It therefore generated a major political controversy to the extent that some authors have named it “the monster of corruption” (Di Costanzo & Moncada, 2005). For instance, the PCCC loans were supposed to be reviewed by an auditor from the bank and later validated by the authorities of the Banking Commission who then approved their entrance into FOBAPROA. In reality, this process turned out to be more of a cover up operation than a serious attempt to root out fraud. A large part of the non-performing loans which the government purchased were delinquent more due to an intentional rejection on the part of large industrial and financial groups to pay back their loans than due to the real inability to pay on the part of small and medium sized debtors.

For FOBAPROA to authorize an operation through the PCCC, its Technical Committee and the authorities of the Banking Commission had to approve the credits on the basis of certain “general guidelines” which in the end were not so “general” since they were applied in a fully discretionary manner. According to the guidelines FOBAPROA could not acquire the following credits:

- A) Uncollectable credit (illegal credits or with insufficient reserves)
- B) Related credits (loans between partners of the same bank)
- C) Credits discounted with development banks.
- D) Rediscounted credits (previously financed by government development banks)
- E) Credits to bankrupt businesses
- F) Credits denominated in UDIS
- G) Credits under 200 thousand pesos
- H) Credits given to individual persons without business activities

The FOBAPROA Technical Committee consistently bent these rules, first one way for one bank, then another way for the next, etc. up to a point at which there was no longer a “general” set of rules which guided the process. In the end, the bankers threw all of the uncollectable “financial trash” they had into FOBAPROA. In addition, the climate of lack of respect for the rules allowed the bankers to skirt their obligation to deposit one dollar of fresh capital for every two dollars of non-performing loans. Needless to say, all of this led to huge fiscal costs which will have to be covered by the Mexican taxpayers for generations.

An additional problem with the application of both the PCCC and the Intervention programs is that they were systematically used to prop up failing banks which should have been closed down entirely. Mackey has pointed out that:

In general, the costs of supporting the banks which were in a bad state were much higher than what a timely closure would have implied; For instance: in the case of one bank, the initial cost of recapitalization was 11 billion pesos in 1995. The bank was not closed and its present cost estimated by FOBAPROA is 50 billion pesos. In the case of another bank, FOBAPROA granted its support even when the viability study done by the CNVB clearly indicated that the bank was no longer viable under any circumstance.

The cases of INVERLAT, PROMEX, ATLÁNTICO, SERFÍN and BANCRECER are examples of recovery measures, carried out during the bank bailout, which uselessly elevated the fiscal cost of the bailout. For these banks the government invested over 350 billion pesos, and recovered, through the sale of the institutions, only 21.4 billion pesos, that is, only 7 per cent of the total invested.¹⁴

¹⁴ Michael MacKey (1999) *Report on the Comprehensive Evaluation of the Operations and Functions of the Fund for the Protection of Banking Savings 'FOBAPROA', and Quality of*

In short, it would have been much cheaper and effective to close the banks and directly compensate the holders of bank accounts than to keep the banks on “life support”.

On May 23rd, 1995, during a session of the U.S. Senate which monitored the financial package the White House had given to bail out the Mexican government, Alfonso D'Amato, president of the Senate Banking Committee, stated that “The Mexican banking sector is in trouble. With interest rates at 100 per cent, more than 10 billion dollars in non-performing loans and high inflation [52 per cent], the system is being devastated”¹⁵. The Senator also pointed out that the six largest banks in Mexico at the time, which together controlled 80 percent of banking operations, had suffered important losses in the first quarter of 1995. He added that these very same banks used “creative accounting methods and state subsidies” in order to inform that they had obtained profits during the period. The Senator concluded by pointing out that this “financial alchemy is hiding a massive hole in the Mexican banking system”.

The most important “financial alchemy” of the Mexican bankers was in the calculation of past due loans. The Mexican banks, with authorization from the Mexican government, only classified as “past due loans” the amount of the monthly payments which had not been paid after three months. This greatly underestimated the real amount of non-performing loans since it left the lion's share of the principal untouched¹⁶. In total, the amount of past due loans reported by the Mexican banks and authorized by the Banking Commission was approximately 12 times less than the amount it should have been following international accounting standards.¹⁷ This underestimation of the credit risk artificially increased profit margins and allowed the banks to compensate stock holders and attract new investors.

A major problem with the way in which the PCCC operated is that it was entirely illegal and anti-constitutional. As discussed above, the Mexican Constitution (Article 73) clearly establishes that all debt hired out by the Executive must be approved by Congress. When the Technical Committee of FOBAPROA directly acquired the non-performing loans of the bankers, it completely violated this basic precept.

Ironically, the fund which had been designed to “safeguard the savings of the nation” and to prevent the need for bailouts, ended up financing the

Supervision of the FOBAPROA Program 1995-1998. LVII Legislatura de la H. Cámara de Diputados, México 1999.

¹⁵ Alfonso D'Amato: *Report on the Mexican Financial Sector*. Senator from New York, and Chairman, Senate Banking, Housing, and Urban Affairs

¹⁶ According to U.S. bank accounting rules non-performing loans do not only include the missed payments but the total amount of debt which is overdue.

¹⁷ See Calva José Luis (2001) *México: Más allá del neoliberalismo*, Plaza y Janes, P.247; Solís Rosales, Ricardo. (1998) “El Banco de México y la Crisis Bancaria” en *Función de la Banca Central en México*. Cámara de Diputados LVII Legislatura, Congreso de la Unión. p.172. and Chávez Marcos (2003) *El salto hacia el abismo: la pérdida de la soberanía de la banca mexicana*, Procientec, Colegio de México, P. 18

incompetence and corruption of Mexico's political and economic elites. The bailout was carried out in a totally opaque manner, without even informing Congress, let alone public opinion. The great opacity involved led to a diversity of abuses by the bankers. But even more alarming were the abuses by the authorities towards the taxpayers, since the decisions made to save the bankers were made using public funds and increased the fiscal cost in an alarming manner.

III. COMPARING MEXICO AND KOREA

Both Korea and Mexico have undergone intense processes of political and economic liberalization over the past twenty years. Both have recently emerged from dictatorial regimes, opened up their economies and suffered massive financial crises¹⁸. In response to their respective financial crises (1997 in Korea, 1994 in Mexico) both countries were also obliged to orchestrate large scale bailouts of their banking sectors.

But the Korean bailout was very different from the Mexican one. While Mexico applied a "gradualist" approach to its bailout with significant delays and irregularities in response to the crisis, Korea implemented more aggressive tactics which allowed it to significantly reduce the economic and social costs of the bailout. The Mexican strategy was characterized by the reluctance of the authorities to rapidly recognize the magnitude of banks' problems at the early stages of the crisis. Korea relied on a much more proactive program for resolving the banking crisis. Recognition of losses at the early stages of the crisis and willingness of the government to rapidly resolve the crisis led to the establishment of once-for-all solutions. As a result, in Korea small, insolvent institutions were rapidly shut-down, remaining distressed banks were nationalized, and a large part of bad assets was rapidly removed from banks in one-time transactions.

In general, the format of bailout used by the Mexican government was much more "generous" than that used by the Korean authorities. De Luna-Martínez (2000) has acknowledged this:

Mexicans have been generous and flexible enough to allow their banking institutions to gain time to recover. Shareholders have been given wide incentives and enough time to recapitalize their banks. Intervention of banks has been seen as the last policy option. Banks have been intervened only when shareholders fail (usually after several attempts) to inject capital into their institutions or when authorities have found evidence of wide fraudulent activities. The Korean authorities, on the contrary, have been much stricter. Non-viable banks have been rapidly identified and restructured. Weak but viable institutions have received strong support from the government, but at the same

¹⁸ Both countries also became members of the OECD more or least at the same time; Mexico on May 18th, 1994 and Korea on December 12, 1996, ironically just a few months before their respective financial crises.

time their shareholders have had to assume a large part of the losses. Purchases of Non Performing Loans have occurred at market values, while banks' shareholders have been "forced" to rapidly recapitalize their banks. Any capital shortfall has been covered by the government which has become the major shareholder of the Korean banking system.¹⁹

There are three principal ways in which the Mexican and the Korean bailouts were different. First, in Korea the government stepped in and partially nationalized the banks. In a majority of cases the government came to own over two-thirds of bank assets. As De Luna writes, "the government has become the major shareholder of the national banking system". In Mexico nothing of the sort occurred. To the contrary, the Zedillo administration only became the principal owner of the banks' *bad debt* as well as the principal founder of the banks through promissory notes. It did not formally acquire any of the banks' *property or assets*. The tax payers therefore suffered all of the losses without enjoying any of the gains and the moral hazard problem only expanded exponentially.

Second, the Korean government established and strictly followed general principles for evaluating the viability of banks and for deciding on the specific tactics to use in foreclosing or rescuing them. In Korea the government focused on injecting capital directly into the banks and financial institutions. In Mexico, the government bent the rules and applied tailor made solutions for each case. The focus was not so much on strengthening the banks as institutions by injecting capital but on simply purchasing their bad debt.

Third, the Korean bailout followed international best practices with regard to transparency. The public was informed of the specific criteria used for evaluating the viability of banks, offered clear justifications for the public funds used in the bailout, and given complete information on how and why public funds were disbursed in specific cases. To the contrary, the Mexican case is famous for the extreme opacity of its bank bailout (González Aréchiga, 2006).

Why were there such extreme differences in the management of similar financial crises in Mexico and Korea? In principle, the Korean government was just as involved in interest based politics as the Mexican government during its liberalization process. In Korea, market reforms were highly influenced by the *Chaebols*, the powerful industrial conglomerates frequently linked through family ties. These groups had direct influence over financial policy primarily due to their organizational strength and the virtual oligopoly they held over the Korean economy. As Corea Zhang (2003) has pointed out,

As the development of the national economy varied with the performance of these industrial giants, they enjoyed powerful leverage over government policy. The transition to democracy in the late 1980s and the increasing integration of the Korean economy with the international system served to expand the political space for big industrialists and reinforced their role as crucial economic agents (P. 76)

¹⁹ José De Luna-Martínez "Management and Resolution of Banking Crises: Lessons from the República of Korea and Mexico", World Bank Discussion Paper No. 413. Washinton. 2000. P. 22.

Throughout East Asia there is a long history of intimate cooperation between the public and the private sectors. As Haggard (2000) has argued, “close ties between business and government have long been a distinctive feature of many of the rapidly growing Asian economies. (P.135)

Nevertheless, in Korea and other East Asian countries the government has also historically maintained a relatively autonomous relationship to the corporate class. As Peter Evans (1996) has argued, despite the “embeddedness” of the government in the private sector, it has also maintained significant “autonomy” which has allowed it to maintain control over the economy (Jenkins, 1991; Hamilton, 1993). For instance, the process of economic liberalization in Korea was accompanied by active protectionism and even nationalism. “Liberalization efforts were highly selective: overseas borrowing by domestic banks and short-term trade-related flows were liberalized whereas foreign investment in domestic fixed-income assets were restricted and portfolio inflows only partially opened”.²⁰ While in Mexico the state also remained powerful during the “liberalization” process, it has not maintained the same capability for autonomous decision making. To the contrary, it has been systematically captured by powerful interest groups.

In addition to a stronger relative autonomy of the state, Korea also benefited from the specific political context. As in Mexico, the Korean financial meltdown of 1997 occurred at the moment of transition between two presidential terms, between Kim Young Sam (1993-1998) and Kim Dae Jung (1998-2000). But in Korea the crisis occurred immediately *before* the transition instead of afterwards, thereby giving the new president a clear mandate to clean up the problematic situation which the previous president had left. Incoming president Kim Dae Jung was also a relative outsider to the networks of business-government relations that had developed under his predecessors. He was therefore much less directly indebted to million dollar donations and complicities as Zedillo was upon taking office in 1994.

Kim Young Sam had been relatively lax on the bankers and delayed in his response to the crisis. But upon arriving in office, Kim Dae Jung turned things around and immediately established a new independent regulatory agency (The Financial Supervisory Commission, FSC) in order to manage the bank bailout. “All banks were subject to thorough review, on the basis of which five were shut down and merged with others under government direction. A large number of nonbank financial institutions were also shut down” (Haggard, 2000: P. 139). Although the new government negotiated some of the most important elements of the bailout plan with the most important *chaebols* it also gave the FSC broad powers and a wide margin of independent action.

This comparison of the Korean and Mexican bailouts confirms at least two of my hypotheses. First, it lends support to my argument that interest based politics is more important than economic orthodoxy as an explanation for

²⁰ Xiaoke Zhanng, “Political Structures and Financial Liberalization in Pre-Crisis East Asia” in *Studies in Coparative International Development*, Spring 2003 Page 68.

financial policy making in times of crisis. Korea followed orthodoxy more closely than Mexico not because these ideas were felt more powerfully in the East than in the South, but because the state had historically developed the autonomy necessary to implement them and because the political situation favored such actions.

Second, it reveals that we need to go beyond an analysis of formal regime type to an examination of the underlying structure of power of authority. Korea and Mexico were both in the midst of similar democratic transitions, but the nature of their response to similar financial crises was radically different. While the Mexican case was full of corruption, rent-seeking and opacity, the Korean case was relatively open and clean. The presence or absence of formal democracy does not “overdetermine” outcomes on its own.

IV. THE US BAILOUT

The Emergency Economic Stabilization Act (EESA) of 2008 was enacted in response to the current global financial crisis which has its roots in the bursting of the United States housing bubble which reached its peak in approximately 2005–2006. As of that period default rates on subprime mortgages began to increase.

The dominant ideology of deregulation during the eight years of the administration of George W. Bush had greatly increased Wall Street's involvement in higher-risk lending. “Subprime” mortgages increased 292%, from 2003 to 2007.²¹ An increase in loan incentives such as easy initial terms and a long-term trend of rising housing prices encouraged borrowers to take out difficult mortgages in the belief they would be able to quickly refinance at more favorable terms. However, once interest rates began to rise and housing prices started to drop during the 2006–2007 period, refinancing became more difficult.

Defaults and foreclosures increased dramatically as easy initial terms expired, home prices failed to go up as anticipated, and subprime mortgage interest rates reset at a higher level. This situation along with the securitization of the mortgage backed securities and the generation and indiscriminated use of a diversity of financial instruments triggered a global financial crisis through 2007 and 2008. By July 2008, major banks and financial institutions that had borrowed and invested heavily in subprime loans and mortgage backed securities, reported losses of approximately US\$435 billions.²²

The EESA authorizes the US Secretary of the Treasury to spend up to US \$700 billion in order to purchase toxic mortgage assets and other bad debts held by banks and other reckless investors. In theory, the money should help troubled lenders make new loans and keep credit lines open. The government would later try to sell the discounted loan packages at the best possible price. In reality

²¹ Center For Responsible Lending (27 November 2007). ["A Snapshot of the Subprime Market".
http://www.responsiblelending.org/issues/mortgage/quick-references/a-snapshot-of-the-subprime.html](http://www.responsiblelending.org/issues/mortgage/quick-references/a-snapshot-of-the-subprime.html).

²² Wall Street Journal Oct. 11, 2008. Front Page

though, experience shows that this sort of bailout does not solve banking crises. In fact, as in the case of Mexico, it can even end up to be a total failure which mostly benefits – at a huge expense for the US taxpayer – the preferred shareholders of the banks.

The bailout was originally proposed on September 20 by Treasury Secretary Henry Paulson. A key part of the EESA is the Troubled Asset Relief Program (TARP) which was not immediately approved by Congress. After extensive debate and some important amendments, the EESA was finally passed in Congress on October 3rd, 2008 by a vote of 263-171.

As in the case of Mexico and Korea, supporters and authorities proclaimed that the proposed intervention would cost much less than it first appeared and that it was the only alternative possible. For instance, immediately after the bill became law President Bush declared: "I know some Americans have reservations about this legislation. (...) In this situation, action is clearly necessary, and ultimately the cost to taxpayers will be far less than the initial outlay,"²³

The main paradox of the bailout is the ominous vicious cycle that it entails. The central problems of the American economy were created by excessive credit and indebtedness. But the bailout looks to solve this problem by adding insult to injury and infusing more credit into the economy. In addition, in order to fund the bailout the government itself falls further into debt and is forced to squeeze the economy for more tax income thereby creating even deeper economic problems.

The first paragraph of section 101, of the EESA establishes:

"The Secretary is authorized to establish the Troubled Asset Relief Program (or "TARP") to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary." (Section 101, Title I).

The Secretary of the Treasury through the Troubled Asset Relief Program (TARP) is allowed to purchase all kind of toxic assets from any financial institution. The "Office of Financial Stability" is the agency directly created within the Treasury Department with the explicit goal of running this crucial program.

The Emergency Economic Stabilization Act of 2008 also establishes that the \$700 billion US dollars authorized by Congress can be disposed in the following way, the Treasury Secretary has immediate access to the first \$250 billion. Following that, an additional \$100 billion can be authorized by the President "at any time". For the last \$350 billion, the President must notify Congress his intention to grant the additional funding to the Treasury; Congress then has 15 days to pass a resolution disallowing the authority. If Congress fails to pass a resolution opposing the funding within 15 days, or if the resolution passes, but is vetoed by the President, and Congress does not have enough votes to override the veto, the Treasury will receive the final \$350 billion.

²³ "Bush Signs \$700 Billion Financial Bailout Bill," NPR October 3 2008, <http://www-cdn.npr.org/templates/story/story.php?storyId=95336601>

"The authority of the Secretary to purchase troubled assets under this Act shall be limited as follows:

(1) Effective upon the date of enactment of this Act, such authority shall be limited to \$250,000,000,000 outstanding at any one time.

(2) If at any time, the President submits to the Congress a written certification that the Secretary needs to exercise the authority under this paragraph, effective upon such submission, such authority shall be limited to \$350,000,000,000 outstanding at any one time.

(3) If, at any time after the certification in paragraph (2) has been made, the President transmits to the Congress a written report detailing the plan of the Secretary to exercise the authority under this paragraph, unless there is enacted, within 15 calendar days of such transmission, a joint resolution described in subsection (c), effective upon the expiration of such 15-day period, such authority shall be limited to \$700,000,000,000 outstanding at any one time. (Section 115, Title I)

In terms of institutional design it is striking the total leeway and the sweeping discretionary power that this bill grants to the The Secretary of the Treasury (letters "c" and "d" of section 101). The Secretary has the almost unlimited power to determine the mechanisms, terms, occasions and methods of developing the purchases of troubled assets.

(c) The Secretary is authorized to take such actions as the Secretary deems necessary to carry out the authorities in this Act, including, without limitation, the following:

(1) The Secretary shall have direct hiring authority with respect to the appointment of employees to administer this Act. (2) Entering into contracts, including contracts for services authorized by section 3109 of title 5, United States Code. (3) Designating financial institutions as financial agents of the Federal Government, and such institutions shall perform all such reasonable duties related to this Act as financial agents of the Federal Government as may be required. (4) In order to provide the Secretary with the flexibility to manage troubled assets in a manner designed to minimize cost to the taxpayers, establishing vehicles that are authorized, subject to supervision by the Secretary, to purchase, hold, and sell troubled assets and issue obligations. (5) Issuing such regulations and other guidance as may be necessary or appropriate to define terms or carry out the authorities or purposes of this Act.

(d) Program Guidelines.--Before the earlier of the end of the 2-business-day period beginning on the date of the first purchase of troubled assets pursuant to the authority under this section or the end of the 45-day period beginning on the date of enactment of this Act, the Secretary shall publish program guidelines, including the following: (1) Mechanisms for purchasing troubled assets. (2) Methods for pricing and valuing troubled assets. (3) Procedures for selecting asset managers. (4) Criteria for identifying troubled assets for purchase. (Section 101, Title I)

The law does try to stimulate debate and inter-agency coordination in running the TARP since the same section 101 points out that the "Office of Financial Stability" is required to consult with the Board of Governors of the

Federal Reserve System, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, and the Secretary of Housing and Urban Development. Nevertheless, the law does not assign specific roles to each one of these agencies. In the end, the Treasury Department maintains full control as well as the last word over the process.

Beyond the legal flaws and bad institutional design of the EESA and of the newly created "Office of Financial Stability", the bailout entails multiple conflicts of interest.²⁴ The former Treasury Secretary Henry Paulson, initial architect of the bailout, was a Chief Executive Officer of Goldman Sachs Group, one of the main receiving institutions of the bailout. To date, Goldman Sachs has received more than 10 billion dollars under the TARP. It is ironic that a former head of a major investment firm was later in charge of reforming the system that had made him so wealthy.

In addition, in a parallel to the Mexican case, in the United States the government authorities were not satisfied with bailing out the bankers, but also rewarded these very same bankers by putting them in charge of the bailout process itself. While in power, Paulson hired Goldman high executives as advisors in the Treasury and Paulson's former advisors have also joined banks that were benefitted from the bailout.²⁵ Here we see in full operation the famous syndrome of the "revolving door" between the public and the private sectors with all of the problems of conflicts of interest that this implies (Peele & Kaye, 2009).

In February 2008 Paulson invited Steve Shafran, who focused on corporate restructuring at Goldman to work at the Treasury Secretary as a top financial advisor. The unfortunate timing of the entrance of this banker to the government, as the credit crisis worsened and Goldman was forced to implement cutbacks, suggests that this was more of a "personal bailout" for Shafran than any particular need on the part of the government for his particular expertise. Other top officials at the Treasury Department, like Dan Jester and Ken Wilson, were also previously officers at the very same financial institutions the government needed to bailout.

Perhaps the most striking case was the appointment of Neel Kashakari as the head of the "Office of Financial Stability". Kashakari was vice president of Goldman's San Francisco Office where he headed up Goldman's information technology security investment banking. President Barack Obama and his Secretary of Treasury, Timothy Geithner, have not dared to change the leadership of this key office in the bailout since coming into office.

Robert A. Eisenbeis, a former director of research at the Federal Reserve Bank of Atlanta, has argued that instead of looking to hire bankers about to fall into unemployment, the U.S. government should have given priority to people

²⁴ Conflict of interest occurs where, in a specific situation, a public functionary is subject to interests of a personal, private or other nature that conflict with the interests s/he should pursue as a public official. A conflict between the public interest and personal interest is understood to be conduct (of a public functionary) or failure (of a public functionary to act) which undermines trust in his/her impartiality, or by which a public functionary misuses his/her position in order to obtain unauthorized benefit for him or herself or another individual or legal entity. (Peele & Kaye 2009).

²⁵ "Paulson turns to Goldman to unclog credit markets" in USA Today, Oct, 6 2008.

experienced specifically in the area of bailouts. For instance, the officials who worked in the “Resolution Trust Corporation”, the government agency created to deal with the savings and loan crisis of the late 1980s and 1990s, should have been at the top of the list²⁶.

The bailout legislation does not include strong legal provisions with regard to conflicts of interest. It also gives almost total control to the Secretary of Treasury to manage any issues related to conflicts of interest:

“The Secretary shall issue regulations or guidelines necessary to address and manage or to prohibit conflicts of interest that may arise in connection with the administration and execution of the authorities provided under this Act, including—(1) conflicts arising in the selection or hiring of 18 contractors or advisors, including asset managers; (2) the purchase of troubled assets; (3) the management of the troubled assets held; (4) post-employment restrictions on employees; and (5) any other potential conflict of interest, as the Secretary deems necessary or appropriate in the public interest. (Section 108 Title I)

But how is it possible that the secretary of the Treasury can be best suited to determine whether and to what extent he and his subordinates have a conflict of interest? Wouldn't it be better if an outside agency determine what a conflict of interest is?

The fact that the first version of the proposal of the financial bailout exempted Paulson entirely from judicial oversight over the use of the funds is another indication of the problematic intentions of the Bush administration. Specifically, there was a concern that former illegal activity by financial institutions or its executives might be hidden²⁷.

Another problem where conflicts of interest have had a dangerous impact is with regard to the determination of the value of the toxic assets the government acquires. Many of the very same executives who were responsible for creating the crisis through their irresponsible behaviour as bank executives are the people in charge of determining the price at which the government purchases these assets from their former bosses.

In October of 2008, while Paulson struggled to defend his proposal before public opinion and Congress, the Treasury Secretary argued: “This is an investment, not an expenditure, and there is no reason to expect this program will cost taxpayers anything”²⁸. Nevertheless, the most recent reports of the Congressional Oversight Panel created by the bill to review the Treasury Department's management of the TARP, have revealed that the preferred stock the government received in exchange for its initial injection of \$254 billion into the banks only amounted to a market value of \$176 billion at the time, \$78 billion dollars less than the amount the government invested. Elizabeth Warren, professor from Harvard Law School and current chairwoman of the panel, has

²⁶ Eisenbeis has pointed out that: “working at Goldman Sachs doesn't qualify you for doing this job” *Op. Cit.*

²⁷ The original bill led Paul Krugman to declare that Paulson was “demanding dictatorial authority, plus immunity from review ‘by any court or any administrative agency’ Paul Krugman “Cash for Trash”. *The New York Times*, 21 September 2008.

²⁸ Citation

stated: "At various points, Treasury has articulated policy objectives which could result in the program involved paying substantially more for investments than they appear to have been worth at the time of the transaction".²⁹

For example, in return for the \$40 billion that the Treasury Department "invested" in the insurance giant American International Group (AIG), it received shares worth only \$14.8 billion, 37 percent of the price it paid. Another striking case is the purchase of the assets of Morgan Stanley where the government spent \$10 billion and in return only received assets for \$ 5.8 billions, only barely more than half of what the government had paid³⁰.

But the bailout has not only been tainted by opacity, conflicts of interest and over-valued purchases of toxic assets. There have also been episodes of open corporate fraud and looting of public resources. AIG and Morgan Stanley, among other financial institutions, have gotten involved in a series of high profile cases of unethical financial management in which top executives have profited personally from TARP money.

The first case which got public attention is the case of AIG, which had lost an historic 62 billion dollars in the fourth quarter of 2008 alone. After receiving a bailout package worth 170 billion dollars, the insurance giant turned around and proceeded to reward over 165 million dollars in bonuses to its top executives. The company argued that these bonuses were necessary "to retain the best and the brightest talents" to run AIG³¹. It apparently did not seem to matter that precisely these "best and brightest talents" had just squandered \$62 billion dollars of investors funds. Another attempted explanation was that the bonuses were included in contracts which had been signed before the financial bailout and that AIG had no other option but to give the extra money to the executives.

The case of AIG generated an intense debate in the press and the U.S. Congress. Republican Senator Charles Grassley from Iowa even suggested that instead of rewarding the bankers form their failures, the U.S. should follow "the Japanese model" by requiring them to beg for forgiveness and then quit or commit suicide.³²

But statements like these are in the end contradictory since the Congressmen themselves had the opportunity to prevent this type of scandals from the very beginning of the bailout. Nevertheless, they preferred to pass the unjust, inefficient and opaque Bush-Paulson plan which was obviously designed with the intention precisely to grant broad discretion in the use of the government bailout package. Regardless, in an attempt to make up for broader failing, the legislature passed a bill which would specifically tax at a rate between 70% and 90% all bonuses awarded by corporations receiving more than \$5 billion in Treasury aid from the the Troubled Asset Relief Program (TARP).

²⁹ "Treasury Overpaid for Bank Assets in Bailout, Oversight panel says" *The Washington Post*, February 6, 2009.

³⁰ Citation

³¹ Timothy F. Liddy, AIG's president, to Treasury Secretary Tim Geithner

³² "GOP Senator to AIG execs: 'Resign or commit suicide'" *The Raw Story* march 17, 2009. http://rawstory.com/news/2008/Grassley_to_AIG_execs_Resign_or_0317.html

Another important scandal involved the “performance bonuses” which Merrill Lynch & Co. gave to its top executives which had driven the company into the ground, only a few days before the investment bank was taken over by Bank of America³³. \$3.62 billion was handed out to executives, a sum equal to 36.2 percent of the \$10 billion in taxpayer funds that were allocated to Merrill as part of the Troubled Asset Relief Program (TARP). This sum is 22 times larger than the bonuses given to the AIG executives³⁴. Once more we have a clear example of the immorality of the use of public funds through TARP.

It appears that top officials in the Bush administration were not entirely ignorant of these bonuses. Paulson and Fed chief Ben Bernanke met with the top executives at both banks on several occasions during December of 2008 to keep Bank of America on board in the deal to buy Merrill Lynch. Bank of America subsequently received an additional \$20 billion (bringing the total up to \$45 billion) in government funds and a \$118 billion guarantee against potential losses in risky investments³⁵.

These sort of experiences are reminiscent of the Mexican bailout in which government funds were used to line the pockets of individuals instead of helping restart the economy. In both cases, powerful financial interests were allowed to extract part of the bailout packages for their own benefit.

The alternative would be to use the bailout to protect small investors and help home owners in debt. Nouriel Roubini (2008) has argued that purchasing bad assets, as has been the predominant strategy in the cases of Mexico and United States, is a particularly ineffective and inefficient way to recapitalize the financial sector. He has proposed that the government should directly purchase partial equity in the banks, inject further public capital in the form of preferred shares in the financial institutions rather than a mere purchase of bad assets, suspend dividend payments on common shares and even in preferred shares to avoid moral hazard, and finally let insolvent banks and financial institutions disappear.³⁶

Joseph Stiglitz has proposed a different alternative. From his point of view the best strategy would be to issue “preferred shares with warrants (options)” but most importantly “to impose a special financial sector tax to pay for the bailouts conducted so far... also to create a reserve fund so that poor taxpayers won’t have to be called upon again to finance Wall Street’s foolishness”³⁷

The arrival of Barack Obama as president of the United States does offer some hope with regard to the future management of the bailout. For instance, under the Bush administration it would have been hard to imagine Congress acting as it did with regard to the AIG bonuses. In general, Obama has the same advantages as Kim Dae Jung in the Korean case. He is a reformer who is not as

³³ The performance bonuses were determined by Merrill's compensation committee on December 8, 2008, but in previous years, Merrill paid performance bonuses of this type after the end of the year, in January or February of the next year.

³⁴ “Merrill Lynch Bonus Payments Dwarf AIG”, 31 March 2009, http://www.fourwinds10.com/siterun_data/business/corporate_fraud/news.php?q=1238608487

³⁵ Letter, Congressman Dennis Kucinich.

³⁶ Nouriel Roubini, “Not so much bail-out as rip-off”, *The Guardian*, September 29 2008.

³⁷ Joseph Stiglitz, “Henry Paulson’s Shell Game” *The Nation*, September 26, 2008

tied to large corporate interests as his predecessor. He also has the advantage of not being directly responsible for the crisis but having arrived after it had already begun. He can therefore bring a fresh perspective to the issues. In addition, President Obama has an added incentive to deal with the crisis in a transparent and open way since he will be held accountable his actions for the rest of his presidency.

Nevertheless, the structural independence of the U.S. government from large corporate interests is arguably much less than in the Korean case. Evidence of this is that Obama has not radically changed the profile or background of the people in charge of the Treasury Department in general or of the bailout in particular. Neel Kashakari remains head of “The Office of Financial Stability” and Timothy Geithner’s team, like Henry Paulson’s, also has extensive links to Wall Street. Visionary leadership will not be enough if the people who are directly in charge of operating the bailout are not solidly protected from falling into conflicts of interest.

V. Conclusion

The contemporary global economic crisis has reminded us of the inextricable relationship between states and markets which lies at the heart of capitalist development. The spread of “free-market” ideology throughout the world over the last three decades has not meant the unilateral “retreat of the state” from the economy, but a reconfiguration and reorientation of its role in economic matters³⁸. The U.S. bailout has come to remind us precisely of the central role that the state plays in maintaining market economies afloat.

It is therefore particularly important to approach the issues from an interdisciplinary political economy perspective. We need to break with both excessively state-centered, legalistic perspectives as well as with economic, overly technical approaches to the issues. In this paper I have tried to demonstrate the advantages of using such a synthetic approach.

Today’s crisis and the government response to it also confirm the idea that so-called “market reforms” do not necessarily lead to greater autonomy of the state from interest groups. To the contrary, these reforms often imply the self-conscious reshaping of the “distributional coalitions” which sustain government power. In the analysis above, we have seen how interest group politics have played a central role in determining the timing and nature of government bailouts. The groups that influenced the bailout processes were not created out of whole cloth during the rescue operations, but grew in the shadows of the dominant model of deregulation and were ready to pounce on the opportunity of the bailout when it arrived.

The story I tell above about the bailouts in Mexico, South Korea and the United States reveals the importance of interests over and above ideology and

³⁸ Irma E. Sandoval, “Intervencionismo neoliberal y desregulación financiera: evolución institucional del sector bancario en México” *Revista Mexicana de Sociología*, 3 (abril-junio) Instituto de Investigaciones Sociales, UNAM, 2005, Págs. 593-631.

even institutions. Nevertheless, an important underlying theme is about the power of transparency. Interest group politics and conflicts of interest thrive in situations of opacity. One of the most important reasons Mexico's bailout was so fraudulent and full of corruption was because there was little public scrutiny of the details of the process. One of the most important dangers with the contemporary bailout in the U.S. is the broad range of discretionary powers given to the Secretary of the Treasury.

Transparency and accountability have the potential to help neutralize conflicts of interest and produce more efficient outcomes. Indeed, open decision making processes may be even more important in the financial sphere than in other areas. Transparency often appears to fit particularly well with areas of government like social spending, infrastructure and education. Scholars often hesitate at the possibility of extending transparency into more delicate and highly technical areas like financial management or monetary policy. The argument is that in such realms too much publicity may create obstacle to decision making. The results of the present study suggest that such caution is not warranted and may in the end even be harmful.

The political equation is also extremely important. Autonomy and resistance to rent-seeking and corruption is not something which arises on its own through the appointment of "pure" or naturally independent government officials. To the contrary, it is a process which is constructed through politics and with a careful attention to context. In the end, technocratic solutions can only go so far. A truly successful bailout is not only one that distributes costs efficiently, but also one that is fair and just.