Policy Analysis

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W. Lee Hoskins, James W. Coons

W. Lee Hoskins is chairman and CEO of the Huntington National Bank inColumbus, Ohio. He served as president of the Federal Reserve Bank of Clevelandfrom 1987 to 1991. James W. Coons is vice president and chief economist of the Huntington National Bank.

Executive Summary

For the fourth time in the past 20 years, the Mexican economy is in financial distress, largely because of bad monetary policies pursued by Mexican officials. The United States has responded in all four instances by lending money to the Mexican government as a short-term palliative. The cumulative result is a set of perverse incentives for Mexican officials and foreign investors that ensures the "crisis" will reappear on an even larger scale. In addition, the use of the Treasury's Exchange Stabilization Fund and the Federal Reserve to fund an administration's foreign ventures raises constitutional issues about separation of powers and undermines the principle of central bank independence.

There is no way to avoid the costs imposed by bad economic policies of the past. The best course for the future is to encourage market forces, stronger private property rights, price stability, and a floating exchange rate for the peso. Only by strengthening the institutions that produce such results will Mexico raise its standard of living.

Loans from the United States and international agencies such as the International Monetary Fund and the World Bank can arrest a crisis in the short run but are counterproductive in the long run. The new world order is one of market solutions, not government intrusion. To foster such outcomes the United States should pass legislation that eliminates the Treasury's ability to make foreign loans (through the ESF) and that removes the ability of the Federal Reserve (through swap lines) to extend credit to foreign central banks directly or indirectly by funding the ESF. Congress should also withdraw its support for the IMF and the World Bank.

Self-Inflicted Wounds

Financial difficulties and devaluation of the peso have occurred in each of the last four presidential election years in Mexico: 1976, 1982, 1988, and 1994. And each time, the U.S. monetary authorities have responded with a larger loan package.

The seeds of the 1976-77 crisis were sown by the Keynesian-style government spending program launched by President Luis Echeverra Alvarez in 1971. Initiatives aimed at spurring growth and aiding the lower economic classes were financed by borrowing both domestically and from abroad.[1] External debt increased more than threefold from 1970 to 1976.[2] As the program faltered, EcheverrÂ°a lashed out at foreign investors and domestic businessmen for exploiting the country, and capital began to flee. During the final weeks of his administration, EcheverrÂ°a exacerbated fears by expropriating a large amount of private land and distributing it among the poor.[3] Rushing to the

Mexican government's aid, the U.S. Treasury's Exchange Stabilization Fund shelled out $300 million in 1976 and 1977 for "currency stabilization loans" in the wake of the devaluation brought on by balance-of-payments problems. The International Monetary Fund made available $963 million in credits beginning in November 1976.[4]

The 1982 crisis was sparked by capital outflows caused by the expectation that the Mexican government would devalue the peso to deal with the trade imbalance. The administration of President JosÃ‡ LÂ¢pez Portillo did devalue the peso by 40 percent in August and announced the debt moratorium that set off the Third World debt crisis.[5]

A surge in oil revenue allowed LÂ¢pez Portillo to avoid making the necessary free-market reforms and continue the failed policies of EcheverrÂ°a. Proven Mexican oil reserves increased from 15 billion to 72 billion barrels, and oil production surged from 1.2 million barrels per day in 1978 to 2.8 million barrels per day in 1982.[6] The added revenues permitted early repayment of IMF loans. The economic boom driven by the oil-related activity attracted foreign lenders,[7] thus accelerating external debt, which grew more than fourfold from 1976 to 1981.[8] Despite the surge in government revenues, spending increased faster, raising the public-sector share of gross national product from 25 percent in 1970 to 50 percent by 1981 and widening the fiscal deficit.[9] In 1982, when economic crisis erupted, the U.S. Treasury and Federal Reserve extended as much as $1.85 billion in short-term financing to keep Mexico financiallyafloat until the IMF provided longer term financing in January 1983.[10]

In the 1988 crisis, the Fed and the Treasury arranged a short-term bridge loan for Mexico of up to $3.5 billion, pending a package of two to three loans from the IMF. The Fed and the Treasury again combined for a $1.3 billion facility for Mexico in 1990 that was drawn on in the first quarter and repaid within six months.[11] Once again, the catalyst was capital flight sparked by political unrest and devaluation. As an American banker predicted at the time, "Don't think for a minute this is the last chapter. Mexico will be back at the well again, and the United States will once again have to help, if for no other reason than it cannot afford to turn its back."[12]

The Peso's Present Plight

After two failed starts in January 1995, the United States cobbled together an unprecedented financial assistance package for Mexico. From the ESF, the United States extended up to $20 billion in short-term and medium-term loans and long-term loan guarantees. The IMF pledged $17.8 billion, a group of central banks committed $10 billion, Canada pledged $1 billion Canadian, and Latin American countries agreed to pitch in $1 billion for a total financial assistance package of approximately $50 billion.[13]

The reason for the loans was the inability of the Mexican government to redeem maturing tesobonos, short-term debt obligations denominated in dollars. Massive capital outflows driven in part by rising interest rates in the United States and elsewhere and political unrest in Mexico drained foreign exchange reserves and forced the abandonment of the peso peg. Those factors merely fired the gun that was loaded by the pattern of past economic policy transgressions and cocked by recent policy errors. The fundamental cause of the 1994-95 peso crisis was an inflationary monetary policy.

The Real Causes of Recurring Crises

Although the circumstances that led up to the financial strains and subsequent devaluation in each election year differed, the principal cause was the same--bad monetary policy largely driven by electoral politics. The central bank expanded the money supply in an attempt to keep interest rates from rising sharply or to limit the increase during each election year while at the same time attempting to support a fixed or pegged exchange rate. As foreign and domestic investors, wary of inflation and devaluation, began to reduce their exposure, they exchanged pesos for dollars and rapidly depleted the central bank's foreign exchange reserves. The only way to maintain the fixed exchange rate would have been to permit a matching decline in the monetary base.[14] In each case, however, the central bank refused to shrink the monetary base as reserves ran low and was ultimately forced to devalue the peso. The 1988 transcripts of the Federal Open Market Committee show the similarity between those earlier events and the crisis of 1994.[15]

Attention has been incorrectly focused on the size and mobility of capital inflows as the cause of the current crisis.[16] In fact, governments that implement sound economic policies have nothing to fear and much to gain from large inflows of capital. The massive capital outflow in 1994, in combination with the practice of pegging the peso, was the cause of the devaluation in December, but monetary policymakers failed to take appropriate actions in light of capital

movements in 1994 and prior years. The pattern of behavior in financial markets across countries during the latest crisis demonstrates that investors can and do distinguish among economic policies in host countries. Good policies are rewarded and bad policies are punished. Financial markets in Argentina fell more than in Chile or Peru but less than in Mexico. Other developing country markets fared much better.[17] Countries, such as Mexico, that run inflationary monetary policies and at the same time attempt to fix exchange rates are punished quickly and severely by capital outflows. The underlying instability of monetary policies, not capital outflows, is the cause of the current crisis.

Mexico is not alone in learning that lesson. The major central banks of Europe, attempting to support fixed exchange rates inconsistent with underlying economic policies, are believed to have lost up to $6 billion to capital market players in a matter of weeks in the autumn of 1992.[18]

Misguided Measures

The response of U.S. officials to the current turmoil in Mexico is the same as in the past: more loans with more onerous conditions. There are at least three reasons why that is a wrong-headed approach. First, loans or loan guarantees by the United States create a moral hazard that brews trouble in the future. Second, use of the Treasury by the administration to fund foreign states without congressional appropriation raises constitutional issues regarding the separation of powers. The administration's use of the Federal Reserve to fund such loans also violates the principle of central bank independence. Third, the loans help special interests and do nothing to raise living standards for most Mexican citizens.

Moral Hazard

The U.S. government's regular practice of extending guarantees to certain countries experiencing financial difficulties underwrites policies in those countries that otherwise would be untenable. It sends a message to investors, both foreign and domestic, that they can invest with little fear of a total loss. That weakens the integrity of financial contracts and the scrutiny that contracting parties would otherwise apply to each other. It also results in excessive risk taking because a third party bears the risk. That situation is analogous to the moral hazard created by federal deposit insurance. Depositors do not scrutinize banks' financial strengths and weaknesses because they bear no risk of loss. That frees bank officials to take larger risks than they could if there were no deposit insurance. By encouraging excessive risk taking, the federal guarantee threatens large losses to U.S. taxpayers who already have paid $150 billion for the thrift bailout.

The combination of variable and rising inflation with the common practice among savings and loans of borrowing on a short-term basis while lending on a long-term basis erased the net worth of a large number of institutions in the early 1980s. Increases in inflation pushed interest rates paid for short-term deposits above fixed yields on existing longterm loans, turning net interest income negative for many institutions. By the middle of the decade, the busts in the agriculture, oil, and real estate industries worsened the losses. Lax supervisors failed to close institutions and federal deposit insurance allowed them to continue to attract deposits. Because of the guarantee provided by deposit insurance, depositors were free to ignore the increasing risks being taken by savings and loans in attempts to earn back their capital.[19]

That example is directly relevant to the Mexican loan agreement because that agreement de facto extends deposit insurance from the U.S. Treasury to investors in Mexican bonds and depositors in Mexican banks. By establishing a practice of guaranteeing investments in developing countrieswith a third party's money, the U.S. government, the IMF, the World Bank, and other institutions have created a moral hazard. Government officials in developing countries can behave incompetently or criminally and still expect foreign capital inflows. Foreign investors can target high-return investments, with little regard for the associated risk. The result is a growing potential claim on U.S. taxpayers' money.

There is also the potential for creating a two-tiered market, in which loans to national governments are distinguished by whether they are likely to be backed by the United States. The result would be diminished liquidity in some developing countries, investment losses, and fewer willing lenders in nonguarantee markets.[20]

Separation of Powers

The Clinton administration's original proposal of a $40 billion rescue package for Mexico had one redeeming feature: the administration sought congressional authorization, in keeping with the constitutional separation of powers between the executive branch and Congress. Dropping that plan in favor of the smaller program agreed to on February 20amounted to an end-run around the congressional appropriation process. It should be noted that Congress, pleased with the opportunity to sidestep a vexing choice, implicitly endorsed that abuse.

The ESF: History, Abuse, and Partial Reform. The Exchange Stabilization Fund is a relic of the 1934 Gold Reserve Act, sought by President Franklin D. Roosevelt as a means of countering perceived trade advantages secured by Britain through foreign exchange interventions in the early 1930s.[21] By establishing the ESF, section 20 of the Gold Reserve Act gave the secretary of the treasury, in consultation with the president, the ability to intervene in foreign exchange markets and make loans aimed at "stabilizing the foreign exchange value of the dollar." The temporary authority for the ESF provided by the Gold Reserve Act was repeatedly renewed until it was made permanent in 1945.[22]

After the fixed exchange rate regime of Bretton Woods dissolved in 1973, the purpose of the ESF was changed to "being consistent with U.S. obligations in the IMF regarding orderly exchange arrangements and a stable system of exchange rates."[23] In addition to fueling intervention inforeign exchange markets, the ESF has been tapped to finance short-term loans to both developed and developing countries.

The fund was capitalized with $2 billion from the revaluation of U.S. gold holdings and was used to intervene actively in foreign exchange markets during the 1930s. In 1947, $1.8 billion of ESF resources was used to make partial payment of the U.S. quota in the IMF, reducing the balance to $200 million.[24] Congress has made no other appropriations to the ESF, but the interest on U.S. and foreign securities, interest and fees on loans, and net gains from foreign currency transactions have raised the balance to approximately $25 billion.[25]

The lure of the vast discretionary funds proved too much to resist. As one journalist put it, "The only limitation [on ESF spending] has been the sitting Treasury Secretary's imagination."[26] A series of secretaries tapped the ESF to pay the salaries of Central Intelligence Agency and Treasury staffers and diplomats; underwrite luncheons and receptions; and cover lodging, hotel bills, and travel expenses. Apparently, spending for any purpose remotely related to the foreign exchange value of the dollar was considered legitimate. Congress discovered and put an end to those abuses in the late 1970s by requiring that funds be spent only when there was an assured source of repayment.[27]

Because the ESF is not financed with regular appropriations from Congress, it must "borrow" from the Fed when it seeks additional funds. That practice is known as "warehousing" because the Treasury stores or "warehouses" its foreign currencies at the Fed in exchange for dollars that must be paid back later. The Federal Open Market Committee regularly approves "warehouse" lines for Treasury borrowings. The Treasury borrowed heavily against those lines in the late 1980s, and as a result congressional hearings were held in 1990 on the ESF and the Fed's warehousing activities. Loans to the Treasury from the Fed were subsequently discontinued, although the warehousing lines remain in place for future use.

The ESF and Mexico in 1995. After failing to secure congressional approval of a $40 billion loan guarantee for Mexico in mid-January, President Clinton announced an executive order on January 31 giving Mexico access to 1-year and 5-year loans and 10-year securities guarantees amounting to $20 billion from the ESF. On February 21, the Treasury signed an agreement with Mexico on the exact terms and conditions. The United States made available $3 billion on March 14.[28] In the following three months an additional $7billion was disbursed, and $2.5 billion was lent on July 5.[29] The remaining $7.5 billion is still available under the terms of the agreement.

The assistance package is 20 times greater than the largest of the 40 ESF financing agreements extended between January 1980 and June 1994.[30] The president declared the existence of "unique and emergency conditions," as required under 1978 legislation to commit resources of the ESF for more than 6 months in any 12-month period. The largest previously established credit line of $1 billion was extended to Mexico in August 1982. The ESF loan with the longest duration was for $600 million from September 1982 to August 1983.[31]

Additional money is being provided in an equally extraordinary package by the IMF. Under IMF rules, Mexico was able to borrow no more than an additional $3 billion. Under pressure from U.S. officials, the IMF approved a $7.8 billion credit anyway and pledged a further $10 billion after February 1995, provided that Mexico abided by the terms

of a separate agreement. The loan is greater than total IMF lending in 1993 and 1994 combined, twice the amount ever loaned to any other country, and seven times Mexico's allocation.[32] European governments, concerned with aiding their more immediate East European neighbors, were understandably irked by the way the United States pushed the IMF into extending additional credit without seeking approval from them.

The fundamental objection to the involvement of the ESF is that it undermines the separation of powers. A case can be made that circumventing the congressional appropriations process violates Article I of the Constitution. In fact, the Gold Reserve Act itself is of questionable constitutionality, because it gives to the executive branch unreviewable authority to engage in covert actions in international finance--a sphere explicitly reserved solely for Congress by Article I, Section 8, clause 3 (the commerce clause).[33] In effect, the executive branch is financing the restructuring of Mexico's entire short-term, dollar-denominated debt without a congressional appropriation.[34]

Foreign aid has rarely drawn much support in the United States. As a consequence, administrations have attempted to avoid approaching Congress for appropriations for such ventures--the Iran-Contra scheme being a recent extreme example. The ESF has been a source of funds for discretionary executive branch spending, the likes of which Congress sought to prevent. The Constitution limits spending by theTreasury to appropriations approved by Congress. Moreover, the statutory authority for ESF activities pertains only to foreign exchange intervention to support the dollar.[35]

The obligations of the United States under the Articles of Agreement of the IMF, as amended in 1978, include maintenance of the "stability of foreign exchange arrangements." The agreement, however, is to avoid taking steps that destabilize markets, not to use financial resources of the United States to defend arbitrary exchange rates. The intent is to ensure the stability of the auction market mechanism, not of a particular set of prices that might arise from that auction.[36]

Central Bank Independence. The use of the Federal Reserve to fund Treasury activities not only raises questions about the separation of powers between the executive branch and Congress but also damages the principle of an independent central bank. Much effort has gone into keeping the Treasury and the Fed at arm's length from each other to reinforce both the perception and the reality of central bank independence. The comptroller of the currency and the secretary of the treasury originally served as ex officio members of the board of governors of the Federal Reserve System, but the Banking Act of 1935 ended that arrangement. In addition, the Fed does not purchase securities directly from the Treasury, the governors serve staggered terms, and the Fed does not depend on Congress for appropriations. Executive branch influence on the Fed through ESF transactions raises questions about the independence of monetary policymakers to pursue price stability.

Relief for Special Interests

The extension of loans from the U.S. government to the Mexican government favors special interests at the expense of all citizens of Mexico and the United States. The bailout rescues foreign investors who bought Mexican stocks and bonds in search of fat financial returns, Mexican financiers whose close links to government officials keep them in the right places at the right times, and officials of the longgoverning Institutional Revolutionary party who have much at stake. On the other end of the bargain are Mexican citizens who face yet another severe economic recession. American taxpayers bear a significant risk by financing the bailout but stand to gain little for their trouble.[37]

At the end of May, Mexico was estimated to have borrowed more than $20 billion from the U.S. Treasury, FederalReserve, ESF, IMF, and World Bank. It is not clear where all the money has gone, but as of March 31, $14.7 billion of the $17.1 billion that had been borrowed at that point had been spent to redeem public debt, pay off dollar deposits withdrawn from the Mexican banking system, and redeem the foreign debts of privately held Mexican companies.[38] U.S. taxpayers' money appears to have zipped from Washington to Mexico and through the hands of investors and speculators back out of the country.

The tesobonos transactions expose the complex amalgamation of public-private relationships that link the financial and political elite. The mismanagement of economic policy in Mexico in the 1970s carried over into the 1980s, driving domestic interest rates above 100 percent from 1983 to 1985 and above 70 percent from 1986 to 1987. Wealthy investors earned enormous returns until the government could no longer afford to service the debt. In 1989 the Salinas

administration implemented debt-for-equity swaps, transferring ownership of many state enterprises to private hands on favorable terms.[39]

As political instability chased capital abroad in 1993 and 1994, the Mexican government issued dollar-denominated bonds to stem the capital outflow. Mexican taxpayers were exposed to substantial foreign exchange risk in the process. When pressures intensified, officials telegraphed the coming devaluation, and the Banco de MÃ‡xico bought back $4 billion in tesobonos from privileged investors during the first two weeks of December 1994. Large financial companies followed their lead, cashing in close to $15 billion in government debt. That spree wiped out most of Mexico's dollar reserves, removing the wherewithal to defend the peso via foreign exchange intervention.[40]

Other beneficiaries of central bank intervention include U.S. banks, with total outstanding loans to Mexico of approximately $18 billion.[41] The U.S.-led bailout is a reincarnation of the 1985 Baker Plan, which prolonged the illusion that Mexican bank debt remained current by funneling new loans from the IMF and World Bank through Mexico (and other Third World debtors) to foreign commercial banks in the form of debt service payments. In exchange, Mexico agreed to undertake harsh austerity measures. The idea was that the economic reforms would permit Mexico to grow its way out of debt.[42]

The most unfortunate consequence of those developments is the added burden on Mexican citizens, who suffer fewer job opportunities, lower wages, higher prices and taxes, andgrim prospects. Unemployment increased by more than 1 million from the end of 1994 through mid-1995. The unemployment rate rose to 6.6 percent, more than double its level a year ago and the highest mark since the statistics started to be collected in 1983.[43] Real wages now stand approximately 60 percent below 1980 levels in inflationadjusted pesos.[44] The consumer price level was 35 percent higher than a year earlier in June.[45] The price of gasoline will be raised by 48.5 percent by the end of 1995. And the government hiked the national value-added tax from 10 percent to 15 percent, effective April 1.[46] Real GDP contracted at an annual rate of 10.5 percent in the second quarter and is expected to shrink by at least 3 percent for the year, erasing almost all the 1994 gain.[47]

Market Solutions

Four times in the past 20 years, the United States and international agencies have extended loans to Mexico. Each time the loans have been larger and the terms and conditions more intrusive. The proposals for bigger safety nets for emerging economies now being made by leaders of international agencies demonstrate that those institutions have failed in their efforts to promote development and stability. The opposite, progressively less sizable and visible interventions, would be hallmarks of lasting success. The only permanent solution lies in institutional reform that embraces market forces. Reliance on financial assistance from third parties will at best ease pressures temporarily.

Set a Stable Price Level and Credible Monetary Policy

The first step toward a market solution is to curb inflation by reducing growth of the money supply. Attempts to peg the exchange rate by any means other than sound policies are deceitful in the short run and are ultimately destined for failure. In the end, the change in the price level will be identical under fixed and floating regimes, because monetary policy determines the price level. The deceleration in monetary base growth to below 10 percent from 28 percent last November is a move in the right direction.

The second step is to make monetary policy credible. Recent steps toward more timely and comprehensive financial reporting are prudent. Yet a country like Mexico, with a long history of political unrest, monetary mismanagement, and currency devaluation, requires strong statutory measures to establish credibility. Pegging the exchange rate to the dollar does not make monetary policy credible, as the resounding disaster in Mexico makes clear. Discretionary policy aimed at any objective other than price level stability will eventually create inflation or deflation. In the case of Mexico, monetary policy was too loose in 1994 and was inconsistent with the peso pegged at 3.5 to the dollar. Foreign reserves left the country until the peg had to be abandoned.

To be credible, the central bank must have a charter that gives it true independence from the political process and directs it to achieve the single objective of price stability.[48] But words are not enough. The new Bank of Mexico Act, which went into effect in April 1994, was supposed to give the central bank greater independence.[49] Obviously,

it did not. Central bank officials also must be held accountable for achieving price stability, but that is not enough. A properly structured central bank can deliver a stable price level on average, regardless of other economic policies, but monetary policy will be credible only if other economic policies are consistent with the objective of price stability. In addition, credibility depends on time consistency, or the ability of policymakers to keep their promises. No magic pill exists for instantly delivering a credible monetary policy.[50] But a strong statutory objective of price stability, constitutional independence to pursue that objective, and accountability for achieving it can combine over time with successful implementation to build credibility.

The Reserve Bank of New Zealand is an example of a rule-based, accountable central bank that is building credibility. The Reserve Bank of New Zealand Act of 1989 gave the central bank the single objective of maintaining price level stability, which has been defined as a year-to-year change in the Consumer Price Index of between 0 percent and 2 percent. So far, the bank has met that objective almost every year since the enactment of the law.[51] How New Zealand's central bank responds to the challenge posed by the recent rise in inflation will strengthen or undermine its credibility. A single, statutory objective of price stability, the independence to pursue that objective even at the cost of other short-term economic policy goals, and the accountability for doing so are important ingredients for credibility. But performance also matters. The low inflation rates achieved over decades in Japan and Germany have made the Bank of Japan and the Bundesbank among the most credible of central banks.[52]

Let the Peso Float

The third step toward a market solution is to allow markets to determine the price of the peso. Fixed exchange rates are rarely and only accidentally consistent with prevailing economic policies and underlying fundamentals. Most of the time, an arbitrary fixed exchange rate masks and over time amplifies imbalances that eventually surface as major crises. Without the veil of a peso pegged at 3.5 to the dollar in 1994, the policy errors of the Mexican central bank, which included monetary base growth in the neighborhood of 25 percent, would have been evident well before the crisis broke. Investors would have been warned and officials forced to take action to avert the crisis.

Moreover, intervention in foreign currency markets is futile. Transactions intended to change the market's evaluation of a currency do not address the underlying economic conditions that ultimately determine the foreign exchange value of that currency. Coordinated intervention has appeared to be successful in the past only in instances in which it has supported the direction in which the market was already headed.[53]

The performance of Mexico's central bank in 1994 is the latest spectacular example of failed currency intervention. Mexican monetary authorities attempted to hold the peso within a narrow range against the dollar. They intervened regularly in other financial markets to maintain that range, amassing upwards of $30 billion in foreign exchange reserves early in the year.[54] Even that massive stake was insufficient to withstand the selling pressures created by the capital flight that ensued when trouble erupted. By the end of the year, reserves were all but depleted. The only true currency protection comes from sound economic and monetary policies.

Allow Private Debt Negotiations

As the fourth step toward a market solution, Mexican debtors should negotiate directly with private creditors (not governments or international agencies) to arrange conditions and terms of repayment. Giant international agencies may once have been useful in orchestrating the financial and economic interactions among the nations of a compartmentalized world economy. Today they get in the way. Government officials must learn to ride the wave of technology and integrated global markets, because it is too large, complicated, and dynamic for an institution of any size andscope to manage. According to one observer, "The new international financial system is a truly private market that is difficult if not impossible for governments to control."[55]

A significant difference between the current Mexican debt crisis and the 1988 and 1982 episodes is that Mexico's external debt is owed to a much larger number of creditors, many of whom made investments through mutual funds. That does not in any way, however, preclude a market-based solution. Before 1930 all long-term loans consisted of bond issues held by a broad circle of individuals.[56] During the sovereign debt crises of the 1930s, debtors and creditors effectively negotiated significant debt restructurings without the assistance (or interference) of international agencies, usually through bondholder committees.[57]

It is likewise not true that the 1982 debt crisis--in which only a few big investment banks were involved--could not have been resolved by the market. In fact, the measures imposed by governments and intergovernmental agencies magnified the solvency problem and delayed its resolution by treating it as a temporary liquidity problem. In addition to not being needed, Treasury and IMF involvement often stood in the way of viable market solutions. In mid-1987 Treasury secretary James A. Baker III thwarted a plan by Brazilian finance minister Bresser Pereira to swap new securities for outstanding debt, valued using secondary market prices.[58] The Brady Plan later led Brazil, Argentina, the Philippines, and Ecuador to scuttle debt-equity programs.[59] The IMF contributed to the contraction in the supply of credit by holding $3.6 billion hostage to banks' participation in the Brady Plan rescue. The forced writeoffs speeded exits by important lenders, contributing to systemic instability. Mexico's debt burden dipped slightly, but the longer term effect was to reduce the number of willing lenders.[60]

Bold new government financing programs have not provided solutions in the past and are not likely to do so in the future. Rather, governments need only establish a regulatory and legal environment that encourages and facilitates the adjustment of terms, maturities, and principal of debts by creditors and debtors.

The effort by senior G-7 officials to establish a new "emergency financing mechanism" at the IMF to tackle future Mexico-like crises and prevent the destabilization of global finances is misguided. It is particularly so because the collapse of the peso did not pose a systemic risk to the international financial community; indeed, by August 1995 even the IMF recognized that the peso crisis represented only a modest threat to the world financial system.[61] At issue is a proposed doubling of the $28 billion General Arrangements to Borrow facility.[62] Assistance from the GAB has been unsuccessful at achieving reforms, in all too many cases sustaining rather than shuttering inefficient state enterprises. Short-term "adjustment" loans have financed wasteful intervention in foreign exchange markets to support the peso, redeem maturing government securities, and recapitalize insolvent banks.[63] As economist Allan Meltzer observed, "The result is that Mexico has a larger debt while foreign and Mexican holders of bonds have been spared some losses."[64] The record does not justify the status quo, let alone any increase in authority.

Furthermore, proposals to turn the IMF into a bankruptcy judge for countries are unworkable and unnecessary.[65] The lesson of more than a century of sovereign debt crises is that private solutions work when not impeded by government actions. Unlike a domestic bankruptcy court, moreover, the IMF would have no enforcement authority in practice. In the international context, sovereign nations would not be compelled to comply with the fund's rulings. Developing countries' common disregard of IMF conditionality, and the fund's consistent willingness to overlook such breaches, raises significant doubts that the fund could effectively fulfill the role of international bankruptcy judge. Creating such a mission for the IMF would only institutionalize the problems that the latest bailout of Mexico has heightened: moral hazard, special-interest protection, increased debt burden, and postponement of market reforms.

Withdraw from the IMF and the World Bank

After 50 years it is time for the United States to withdraw its support for the IMF and the World Bank. If those institutions were ever needed, they no longer are. Calls for increased responsibilities and more capital are signs of ongoing failure, not justifications for a larger role for those institutions. The activities of the fund and the bank are largely unnecessary, are often counterproductive, and expose taxpayers in industrialized countries to huge potential financial losses. Senate staffers have prepared draft legislation to end U.S. participation in and funding for the IMF and the World Bank, legislation that should be introduced and enacted swiftly.

The breakdown of the fixed exchange rate system some 20 years ago made the IMF a lender without a cause. The institution survived anyway, lending heavily during the oil price shocks in the 1970s, the Latin American debt crises of the 1980s, and the collapse of the Soviet bloc in the 1990s. The emergence of international capital markets weakens the justification for the World Bank. Developing countries attracted $56 billion in foreign direct investment on their own in 1993, dwarfing disbursements by the bank. And privatizations of state-owned enterprises further reduce destinations for development aid.[66]

Even though currencies now fluctuate independently or in blocs, IMF money still fuels foreign exchange intervention--a pointless and costly exercise. At least a portion of the financial assistance provided to Mexico this year has gone to

peg the dollar exchange rate of the peso.[67] That game wastes money, because intervention has no lasting effects and delays necessary economic policy adjustments. The regular IMF practice of extending new loans to prevent defaults by debt-ridden countries creates a moral hazard. It underwrites irresponsible and destructive economic policies by removing the normal incentive for investors to police governments. Loans from the IMF to countries in transition are intended to encourage the development of market economies. Experience, however, reveals that money is often used to maintain subsidies to inefficient state enterprises instead of eliminating them. The outstanding $18 billion IMF pledge to Mexico is effectively propping up inefficient businesses and inhibiting liberalization of the banking system.[68]

The record of the World Bank is no better. Perverse incentives have compromised loan quality, exposing taxpayers in industrialized countries--the ultimate guarantors--to a possible bailout with a price tag comparable with that of the U.S. savings-and-loan bailout. The World Bank routinely extends new loans to governments unable to service existing debts to keep loans current. Such "round tripping" has benefited many foreign private-sector creditors at the expense of debtor-country citizens and has impaired the bank's financial position. Approximately one-fifth of the bank's loan portfolio is round-trip credits. And an internal report leaked in 1992 disclosed that one-third of the bank's $140 billion in projects were failing. Deterioration of the portfolio was deemed "steady and pervasive."[69] Even though the bank is now being paid back more than it lends, its meager reserve for bad loans is troubling. U.S. taxpayers are liable for about $30 billion and the commitment will surely grow, as the World Bank plans to lend another $200 billion in the coming decade.[70]

Fifty years is long enough. It is time for the United States to shift its support from overgrown intergovernmental agencies conceived to address the challenges of a different age to today's powerful and nimble marketplace.

Embrace the Market

The last step toward an enduring market solution in Mexico is a full embrace of free-market principles. Losses of wealth must be recognized. If Mexican enterprises and banks are insolvent, they should be closed, and their creditors should make appropriate compromises on the debts owed. Private property rights should be strengthened and all government-owned commercial operations should be privatized. President Ernesto Zedillo should go beyond his intention to privatize "everything allowed by the constitution" and privatize everything possible, including PEMEX, the stateowned oil complex.[71] That would require amending the Mexican constitution, but that has been done before, when Presi-dent Carlos Salinas de Gortari introduced land reforms.

Markets should be opened further to competition by eliminating all remaining protectionist barriers and subsidies to industry, including lifting all remaining limits on ownership of banks and other commercial entities by foreign investors. Under the North American Free Trade Agreement, participation of foreign commercial banks was limited to 30 percent ownership. Since the outbreak of the crisis, the Mexican government has allowed an increase in foreign ownership, in some cases up to 100 percent. However, foreign investment in the largest banks--those that represent the bulk of the industry--is still severely restricted. Mexican officials should liberalize the rules so that private commercial capital, rather than public debt, is used to rescue solvent but troubled banks.

Conclusion

Those are the steps necessary to finally and completely resolve the ongoing peso crisis. If they had been taken in 1982, Mexico would not still be in financial distress. The prescription will be the same in 2000 and 2006 and 2060. Mexican officials should take the plunge now; eschew the old, failed government model; and embrace the market. That is the best way to safeguard the rich heritage of their great country and raise living standards to their potential.

U.S. officials should have resisted the temptation to tap the quick fix. Although the United States forfeited considerable leverage by signing the agreement on February 21, it can still pressure Mexico to adopt institutional reforms--particularly in the realm of monetary policy--that will all but prevent a replay of the peso crisis.

The threat of serious contagion from the current situation in Mexico to countries that have followed prudent policies is small. Countries that have pursued unsound policies are at risk and will suffer the consequences of investor wrath. Superficial solutions involving government guarantees fail to permanently correct destabilizing policies. Such guarantees create moral hazard and increase systemic risk.

Finally, the United States should withdraw its membership in international financial organizations that once may have promoted development and stability but now encourage irresponsible policies and imprudent risk taking that disrupt markets.

Notes

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