Moral Hazard, the IMF, Mexico and Asia

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The 1977 collapse of Asian financial systems is the latest in a series of dramatic financial failures. Each of the troubled Asian countries -- Thailand, Indonesia, Malaysia, Philippines, Korea -- has its own story, and none of the stories is identical. But there is a common core: Mistaken public policies encourage large-scale domestic and foreign borrowing; explicit or implicit guarantees make risks appear lower than they are; an unanticipated event suddenly changes reality and perceptions of risk; industrial, commercial and financial failures grow; the International Monetary Fund (IMF), assisted by the U.S. Treasury and others, lends money to prevent some of the failures.

The $150 billion loss from the failures of U.S. saving and loan institutions in the 1980s was a costly demonstration of what can happen when government policies undermine normal market incentives to be prudent in taking financial risks. The problem is known as moral hazard: when the government guarantees that some or all of an institution's losses will be shifted to taxpayers (through underpriced insurance, IMF bailout, or other “safety net” guarantees), while gains will be kept by the institution's owners, the institution will be led to take excessive risks. An external economic shock--such

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as the unanticipated fall in inflation that lowered future values of
land and property—precipitated the saving and loan collapse. A shock
of this kind can quickly transform moral hazard from a balance-sheet
abstraction to a real calamity to taxpayers and the economic system
as a whole.

The same policy problem, with the same result, may be found in
many countries. Earlier in the decade Japan, Sweden, Finland, and a
host of others faced financial failures. More recently, the problem
countries are in Asia. Although some of these countries have
recognized the problem and attempted to correct it, the IMF, with
help from the U.S. Treasury, appears to be moving in the opposite
direction, increasing problems of moral hazard on an international
scale. First in Mexico and now in Thailand and Indonesia, the IMF has
lent money at low interest rates to shore up insolvent financial
institutions and to protect foreign banks and investors by limiting
their losses. The IMF has now asked for a 45-percent increase in the
quotas of member countries so it will have the resources to intervene
“more effectively” in similar circumstances.

And there will be similar circumstances. International banks and
financial institutions are now more certain that the IMF provides a
safety net protecting them from some or most of their losses. The
financial risks remain, indeed they are increased by moral hazard.
But some of the losses are shifted from the lenders to the IMF and,
therefore, to the taxpayers in developed countries who supply the
capital that the IMF mismanages.
The Mexican Experience

Mexico is an excellent case study of the effects of mistaken domestic policies and IMF and U.S. government "help". The ordinary Mexican citizen may read in his newspaper about the assistance that Mexico gets from its friends at the IMF and the U.S. Treasury. His and her own experience is very different. The real income of Mexicans is today no higher than it was twenty-four years ago—a period of significant economic progress in much of the world—while their burden of debt has increased greatly.

Chart 1 shows Mexico's real external debt in U.S. dollars since 1973. With few exceptions, the debt has increased annually. The exceptions occur in 1984-85, 1988-89, and 1996—each period following by one or two years a presidential election, a financial crisis, and a policy change. Help from the IMF and foreign lenders during or after the crisis raises the real value of debt that Mexican taxpayers owe. The debt reaches a new peak within a few years of each crisis.

Whether debt is good or bad depends on the uses to which the borrowing is put. If borrowing finances increases in productive capital, income increases; the debt can be serviced or repaid from the increased wealth that it helps to generate. If borrowing is used to hold the exchange rate so that private lenders can flee, there are no productive assets to provide interest payments. Or, if the government borrows from the IMF or the U.S. Treasury to pay off investors and speculators, as in Mexico in 1995, the burden falls on Mexican taxpayers.
From 1973 to 1996, total Mexican debt increased fourteen times faster than the per capita income of Mexican citizens. As shown on Chart 2, Mexican real income has fluctuated widely over this period but is not higher now than it was in 1974. In the 35 years shown in Chart 2, real per capita GDP in dollars has grown about 2 percent a year—but all of the growth occurred from 1961 to 1974. Since 1974 real GDP has had periods of rapid growth followed by equally sharp declines.

Chart 2 here

All of the blame for this performance does not go to the IMF and the U.S. Treasury. Mexico's policy actions are the root of the problem. Since the early 1970s, Mexico has followed highly variable policies. Banks have been nationalized and denationalized. Real public sector spending has surged and declined.

Highly variable policies induce large swings in economic activity and, later, in inflation. As production and spending rise, business and consumers increase their borrowing. Once inflation starts to increase, investors borrow to buy land and property as a hedge against inflation. The buildup of debt, a characteristic part of most financial crises, gets underway.

Chart 3 compares the cycle of inflation and disinflation to the growth of money—the monetary base (reserve money growth). The monetary base is the amount of money directly produced by the Bank of Mexico. The chart shows three distinct periods.

Chart 3 here
From 1950 to 1970, inflation remained relatively low and was much less variable than in later years. Mexico was on a fixed exchange rate under the Bretton Woods agreement. Mexican policies underwent significant changes for the worse following the end of the fixed exchange rate system and the oil shocks of 1973. Monetary actions became erratic. Highly inflationary policies were followed by heavy borrowing, then by crises and disinflation. These policies contributed to the debt crisis of 1982, then worsened the effects of the crisis by again inflating and disinflating.

After 1988, policy actions moderated but remained highly variable. Instead of varying between 20 and 80 percent, inflation rates varied between 10 and 30 percent from 1988 to 1996.

How did this happen? Chart 3 suggests that there is not much mystery. Every surge in inflation since 1970 is preceded or accompanied by a surge in the monetary base, every period of disinflation by deceleration of the monetary base.

The Bank of Mexico does not, of course, set out intentionally to wreck the Mexican economy by producing the pattern we see in Chart 3. It does not try to control, and probably does not watch, the monetary base. It controls, or over-controls, an interest rate. It is too slow to raise the interest rate during periods when the economy expands or the Treasury has deficits to finance. To keep the interest rate from rising, the Bank expands the monetary base. This starts the inflation process. After inflation gets out of hand, the Bank raises interest rates, bankrupts many borrowers, and sends the economy into protracted recession to reduce inflation.
Some will see in Mexico's experience evidence in favor of a fixed exchange rate or a currency board. I believe that is the wrong lesson. No policy of either fixed or fluctuating rates can avoid crises if the underlying government policy is as variable as Mexico's policy has been since the early 1970s. And either fixed or fluctuating rates would work well if the underlying fiscal, regulatory, and property rights policies of the Mexican government were stabilizing instead of destabilizing.

International Helping Hands

The U.S. Treasury and the Federal Reserve have been "helping" Mexico since the 1930s. The IMF has been at it since the 1970s. Successive Mexican governments have learned that if they face a crisis, one or both of these friends will lend them money to make the immediate crisis appear less onerous. Investors have learned that they get bailed out, so they continue to invest. I believe that goes far toward explaining why Mexican policy has been erratic and undisciplined at times. The Bank of Mexico and the government take excessive risk and incur large losses for Mexican taxpayers.

The foreigners don't deserve all of the blame, by far, but they contribute. The results have been disastrous for the Mexican economy and its people. Without the IMF and the U.S. Treasury, Mexico would learn to run better policies. There would be less moral hazard and, I believe, better results for Mexicans.

The IMF and the U.S. Treasury have now extended these policies to Asian countries, perhaps postponing a major crisis. But moral
Per Capita GDP (1996 U.S. Dollars)

Market Exchange Rate Basis
Mexico Per Capita GDP, Converted to Real U.S. Dollar Equivalent on

Chart 2
Mexico, Inflation versus Monetary Base Growth
Per Capita GDP (1996 U.S. Dollars)

Mexico Per Capita GDP, Converted to Real U.S. Dollar Equivalent on Market Exchange Rate Basis

CHART 2
Chart 1

Mexico’s Real Total External Debt (1996 Dollars)
hazard is more entrenched. Too much of the world has become “too big and too indebted to fail.”