Danger of moral hazard

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

Follow this and additional works at: http://repository.cmu.edu/tepper
Part of the Economic Policy Commons, and the Industrial Organization Commons

Published In
Financial Times.
personal View • Allan Meltzer

Danger of moral hazard

IMF bailouts risk teaching bad lessons to governments and banks alike

One of the most important financial lessons of recent decades is that banks should not be encouraged to take excessive risks. Above all, when they fail, losses should not be shifted to the domestic taxpayer.

There are two common factors lying behind systemic failures. First is a shift from inflation to disinflation. Prices for land, property and other assets incorporate anticipated inflation. When these change quickly, asset prices adjust. If they fall below the value of outstanding debt or mortgages, defaults are triggered.

Second, there is often an implicit - or even explicit - understanding that financial institutions will not be allowed to fail. As the net worth of an institution declines, it may therefore be tempted to increase risk in the hope of earning extra returns to keep it solvent. This lies at the heart of the problem known as "moral hazard": it happens when financial institutions take on more risk, knowing they stand to benefit from increased returns, but will be able to share any losses with taxpayers.

Some countries have taken measures to cut down on the risk of moral hazard. But the International Monetary Fund appears to have moved in the opposite direction.

First in Mexico, and now in Thailand, the IMF has lent money to shore up insolvent financial institutions and protect foreign banks.

IMF has now asked for a 25 per cent increase in the quotas of member countries so it will have the capacity to intervene "more effectively" in similar circumstances.

And there will be similar circumstances. International banks and financial institutions can now act safe in the knowledge that the IMF will provide a safety net to protect them from some, or even most, of their losses. The risks are increased by such moral hazard. Some of the losses are shifted from the lenders to the IMF and, therefore, to taxpayers. In developed countries who supply the capital that the IMF mismanages.

Mexico is an excellent case study of the effects of mistaken policies and of IMF and US government "help". The ordinary Mexican citizen may read about the assistance Mexico gets from its friends at the IMF and the US Treasury. His or her own experience is very different. After the international bailout of 1995, Mexicans now face a greatly increased debt burden and have seen their real incomes plummet.

With few exceptions, Mexico's real external debt has increased annually since the early 1970s. The exceptions occurred in 1984-85, 1988-89, and 1996 but with help from the IMF and foreign lenders, the real value of debt reached a new peak within a few years of each dip.

Debt is neither good nor bad in itself. If borrowing produces an increase in productive capital, then income rises and the debt can be serviced or repaid from the higher wealth that it has helped generate. If, on the other hand, borrowing is used to hold the exchange rate steady so that private lenders can flee, there will be no productive assets to provide interest payments. If the government borrows from the IMF or the US Treasury to pay off investors and speculators, as in Mexico in 1995, the burden falls on domestic taxpayers.

The case of Mexico is illustrative. From 1973 to 1996, total Mexican debt increased 14 times faster than the per capita income of Mexican citizens. The main explanation is that Mexican per capita real income has not risen since 1974. Erratic Mexican government policy lies at the root of the problem. Since the mid-1970s, Mexico has nationalised and then privatised its banks. Real public sector spending has surged and declined.

From 1960 to 1970, inflation remained relatively low and was much less variable than in subsequent years. Mexico was on a fixed exchange rate under the Bretton Woods agreement. After the 1973 oil shock and the end of Mexico's fixed exchange rate, highly inflationary policies led to a series of crises including the 1982 debt crunch and the 1994 devaluation.

From 1985 to 1996, annual inflation rates dropped to between 10 and 30 per cent, compared with rates of between 20 per cent and 80 per cent in the previous decade. Every surge in inflation since 1970 has been preceded or accompanied by a similar surge in the monetary base. While every period of disinflation has coincided with a deceleration of the monetary base.

The Bank of Mexico produces the monetary base. The bank has not set out intentionally to wreck the economy. It does not control, and probably does not watch, the monetary base. It controls, or over-controls, an interest rate. It is too slow to raise interest rates during periods of economic expansion or when the Treasury has debt to sell to the market. To keep the interest rate from rising, the bank expands the monetary base. After inflation gets out of hand, it raises rates, bankrupts a raft of borrowers, and sends the economy into protracted recession.

Some will see in Mexico's experience evidence in favour of a fixed exchange rate or a currency board, in which the domestic money supply is fully backed by hard currency reserves. In my opinion that is the wrong conclusion. The policy - of either fixed or fluctuating rates - can avoid financial crises if the underlying government policy is as variable as Mexico's has been since the 1970s. Either system would work well if the underlying fiscal, regulatory and other policies (such as those governing property rights) were aimed at stability.

Where does this leave the US Treasury and the IMF? The former has been "helping" Mexico since the 1930s; the latter since the 1970s. Successive Mexican governments have learnt that if they face a crisis - Mexican friends will lend them money to mitigate the immediate effects. Investors too have learnt that, if they run into trouble in Mexico, they will get bailed out. So they continue to invest.

That goes a long way towards explaining why Mexican policy has been so erratic and undisciplined. Without the IMF and the US Treasury - and the moral hazard they engender - Mexico would have learned to implement better policies. The same lesson goes for all.

The author is professor of political economy at the Carnegie Mellon University and visiting scholar at the American Enterprise Institute.