A Mexican Tragedy

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

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Published In
Wall Street Journal, as "Clinton's Bailout was No Favor to Mexicans".
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By:
Allan H. Meltzer
Carnegie Mellon University
and
American Enterprise Institute

On Monday Mexico repaid to the U.S. $1.3 billion in loans made last year during the peso crisis. From all the hype, one might assume that the crisis has passed and that the Mexican people are enjoying prosperity. If the Treasury and the IMF believe this story, why not cancel the $20 billion in additional lending promised to Mexico last year.

Yes, Mexico is once again able to borrow in the international debt markets. The repayment is primarily an exchange of U.S. credit for German credit. But Mexicans themselves continue to suffer the consequences of devaluation: high unemployment, high inflation and an extraordinary risk premium in interest rates reflecting market skepticism about Mexico's future prospects.

The direct causes of Mexico's problems in 1994 are well-known and thoroughly understood: Mexico's central bank -- the Bank of Mexico -- failed to raise interest rates enough to slow money growth and stop a run on the currency.

Back in 1994, the Mexican government increased spending and lending, much of it off-budget. And the central bank pumped in money to hold down the rise in interest rates on government debt. Inflationary policies did not end with the August election, and neither the incoming nor the outgoing government gave a sign that inflationary policies would be checked. The 1995 budget plan showed no reduction in spending and no plan to tighten policy.

The allegation that foreign investor flight capital caused the drop in reserves is unfounded. Rapid money growth came at a time when Mexicans themselves were showing their concern about Mexico's policies. Mexican residents (net) stopped buying government securities in February 1994. In contrast, foreigners increased their
holdings of Mexican government securities in 1994 by 50%, to more than 100 billion pesos. Foreigners continued to purchase Mexican debt as late as December. Large net sales by foreigners did not begin until February 1995, after the devaluation.

After the Mexican government devalued the currency, the IMF and the U.S. government loaned money to Mexico on the pretext that they were (1) helping Mexico and (2) preventing an international financial crisis. Both claims are false. Most of the loans were used to repay holders of Mexican government bonds who were speculating on the currency while raking in large spreads over lower risk G-7 bonds. The loans mainly enriched the speculators. The Mexican population suffered a decline in wealth and income.

A global financial system that had survived several devaluations of the British pound, the French franc and the U.S. dollar was surely able to cope with the consequences of another in a series of Mexican devaluations. Arguments to the contrary were never more than a propaganda barrage from the U.S. government and the financial services industry to get a reluctant U.S. Congress and a generally hostile U.S. public to approve new loans to Mexico thereby bailing out speculators. This strategy failed, and the U.S. government resorted to back-door, off-budget financing and help from the IMF.

A common explanation of the crisis is overvaluation of the peso after adjusting for differences in inflation between Mexico and the United States. This explains 7 to 10% real appreciation of the peso since 1992, a small part of the 40% devaluation in 1994.

Much more telling, I believe, was the inflationary policy of the Mexican government. Starting in June, annual rates of increase in producer prices were higher in 1994 than in 1993, and each month’s reported inflation was higher than the previous month’s. By December, the annual increase in producer prices was 9.1%, nearly twice the rate of December 1993.

Mexicans had enough experience with inflationary policies to know that the likely aftermath was devaluation. The rational response was to take the money and run for dollars.
Mexico could have avoided devaluation if it had ended its inflationary policies after the election, even as late as mid-November. The proper policy was to announce reductions in spending and money growth. The latter would have required higher interest rates and possibly a recession, but interest rates would not have reached the peak levels of early 1995 -- 80 to 100%. Any recession would have been far less severe than the deep recession that followed the devaluation and continues to date.

Mexico used most of its reserves and its subsequent borrowings to redeem dollar denominated debt and to defend the falling peso. This was a mistake. Defending the peso exchange rate after December enabled foreign owners to sell Mexican assets on more favorable terms, so they had an incentive to sell. A free float would have made it more costly to convert pesos to dollars and, therefore, would have reduced the flight to the dollar. Furthermore, instead of paying off the Mexican debt as it came due, Mexico should have forced renegotiation and an extension of the debt's maturity. Holders had demanded a premium for taking the risk of holding the Mexican debt. When the risk came due, the Mexican government paid off the creditors and shifted the burden to the Mexican public for the benefit of the debt holders.

Mexico's problems were not the result of a sudden mania by speculators. They were caused by the inflationary policies of the Mexican government during an election year and the continuation of these policies after the election. Political instability had a role but interest rates and exchange rates were stable from April to October. Speculators bet heavily against the peso in November and December because they perceived correctly that Mexican policy was on a course to devaluation.

The policy of the Mexican government was flawed. But the U.S. government and the IMF contributed by their willingness to lend and "help" the Mexican government with loans, followed by debt restructurings and forgiveness. These offers, made in the name of humane assistance, encourage the behavior that causes the problem. For much the same reason that deposit insurance encouraged weak U.S. banks and S&Ls to engage in risky behavior, international lenders like the IMF and the World Bank encourage weak governments to take risky gambles.

The task for Mexico is to stop trying to fool investors by repaying borrowing and
concentrate on reforming its political and economic institutions to gain the confidence that is lacking.