

A RETROSPECTIVE ON THE MEXICAN BAILOUT

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According to the conventional view, the International Monetary Fund's bailout of Mexico in 1995 was a success because it restored confidence in the collapsing peso, led to a quick economic recovery, and possibly stemmed the outbreak of a global systemic financial crisis. The bailout, moreover, helped keep Mexico on a market-oriented track. Proponents of those views rarely mention the high costs of the IMF's intervention to ordinary Mexicans, and they downplay the cost—namely in the form of moral hazard—to the world economy. More importantly, policymakers have never seriously considered market-oriented alternatives to official bailouts in Mexico or elsewhere, yet the evidence strongly suggests that market solutions offer greater benefits and lower costs.

Mexico's relationship with the IMF is especially important because the country seems to influence the lending agency almost as much as the agency influences Mexico. One need only recall how Mexico's 1982 announcement that it could not service its foreign debt set off that decade's Third World debt crisis and turned the Fund into a debt-management agency. Although the era of officially led bailouts began at that time, the era of massive bailouts began with the 1994–95 peso crisis, also a transforming event for the IMF. (No doubt the disproportionate influence that Mexico exerts on the world, particularly on the developing world, is largely due to its size and proximity to the United States.)

A proper evaluation of the Mexico-IMF relationship, then, should take into account the experience of the 1980s. For it was in that decade that the flaws of the IMF-led approach began to appear. During that time, the Fund's emergency credit was intended to avert an international financial crisis (the largest U.S. banks had made sovereign loans in excess of their capital) and provide breathing room

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for Mexico and other indebted countries to get their finances in order. As the decade wore on, the Fund increasingly relied on loan conditionality in an effort to promote policy change. In practice, the IMF's role as creditor and third-party negotiator created disincentives for Mexico and its private-sector creditors to agree on a debt workout, thus actually delaying reform. Peter Lindert (1990: 250–51) described that outcome as a “three-party stalemate” and Sebastian Edwards (1989: 39) referred to the IMF as “participating in a big charade” because of the agency's continued lending to countries that had a low probability of achieving balance-of-payments viability.

The IMF thus facilitated a slow transfer of private to public debt during the 1980s. Barry Eichengreen (1999: 71) aptly describes the dynamic:

IMF policy through most of the 1980s was to lend to countries that had fallen into arrears on their external debts only after they had reached an agreement in principle with their creditors. The notion was that the Fund should provide assistance only if the banks contributed to burden sharing by at least clearing away the country's arrears. Eventually, however, experience with the debt crisis raised doubts about this approach. The banks, their balance sheets strengthening as they drew down their Latin American exposure, hardened their positions. Rather than the policy providing the IMF with a lever to encourage burden sharing by the banks, the banks realized they could use it as a club in their battle with governments.

The result for Latin America was greater debt, delayed reform, and a fall in living standards. By redistributing wealth from ordinary Mexican and other Latin American citizens to money-center banks in New York, the IMF enabled those creditors to postpone recognizing losses. Ultimately, the lost decade came to an end when banks began setting aside loan loss reserves and forgiving debts, but that solution would have come earlier, perhaps as early as 1983 or 1984, had the IMF withheld funds and allowed direct negotiation between debtors and creditors. (As others have convincingly written, it is also doubtful that the IMF helped avert a global systemic financial crisis since U.S. banks could always have taken the measures they eventually did and the U.S. Federal Reserve already existed to provide emergency liquidity to them.¹)

The Return of the IMF

As the collapse of the Mexican peso approached in December 1994, two factors assured the sheer size of the forthcoming IMF

¹ See Simon (1983), Lal (1983), and Federal Reserve Bank of Minneapolis (1999).

bailout. The Mexican economy, now much more liberalized and open to capital flows, confronted an unresolved monetary trilemma due to inconsistencies in monetary and exchange rate policies. The IMF had by then also created moral hazard in Mexico due to its having provided emergency aid to the country with every previous episode of irresponsible monetary and fiscal management since 1976.² The expectation by investors and the government alike that a bailout would be provided had already been set.

The \$50 billion rescue package in 1995 created moral hazard on a global scale. In the following years, the Fund responded to the increased frequency and severity of financial crises by providing bailouts to Thailand, South Korea, Indonesia, Russia, Brazil, Turkey, and Argentina, with varied results. But the IMF's third-party intervention precluded direct bargaining between creditors and debtors, in effect discouraging both parties from coming to a rapid resolution in which greater costs are shifted onto the lenders in exchange for real policy change. As in the 1980s, the IMF's socialization of risk in crisis countries implied a redistribution of wealth from the bottom up, as the relatively well-off foreign and domestic investors had their losses cut. And in all cases, rescue loans enabled governments to delay or avoid reform in some or various key areas.

For Mexico, perhaps the most successful crisis country, the costs were considerable. Although the country's economic rebound has been characterized as V-shaped, a study by Anne Krueger and Aaron Tornell (1999) shows that the recovery was not uniform across the economy. Economic improvement had mainly occurred in the tradable sector, whereas in the six years after the outbreak of the peso crisis the nontradable sector experienced a sharp contraction in economic activity followed by only sluggish recuperation (Schneider and Tornell, 2000: 10). This poor performance in Mexico's nontraded goods sector, which makes up about 50 percent of gross domestic product, has resulted from the prolonged credit crunch that domestic firms have faced, which itself resulted from the unresolved problem of nonperforming loans in the Mexican banking sector. Indeed, it was not until 1999, more than four years after the fall of the peso, that the Mexican government began taking steps to open the banking sector to foreign competition. In that regard, Mexico is fairly representative of crisis countries that have acted slowly, if at all, to address severe problems in their protected banking sectors.

² For a review of the causes of, and response to, the 1994–95 peso crisis, see Hoskins and Coons (1995).

Delay in resolving the banking sector's bad-loan portfolio actually made the problem worse. The share of bad loans to total loans tripled from 10 percent to 30 percent from 1994 to 1997 (Krueger and Tornell 1999). In the end, the fiscal expenses alone of cleaning up the banks cost Mexico some 20 percent of GDP. Charles Calomiris, hired by the World Bank and the Mexican government in 1995 to advise on banking reform, notes that the bailout money enabled Mexico not to take financial reform seriously. "It is very hard to undermine the corrupt partnership between powerful industrialist-bankers and governments by giving them both money in exchange for promises to reform in the future" (Calomiris 1998: 278). He added that "Mexico was a very slow recoverer compared to what it could have done if the financial mess had been cleaned up faster, and that there are clear disincentives coming from IMF and U.S. Treasury protection for that process" (IFIAC 2000a: 196).

In this context, claims by U.S. officials that the Mexican bailout was a success because the United States was paid off early—which the Mexican government achieved by contracting debts elsewhere at higher rates—and that the United States actually made money from the deal are disturbing.

The Absence of the IMF

But would the outcome have been worse had the IMF not been involved in bailing out Mexico? The evidence points in the other direction. A careful study by Michael Bordo and Anna Schwartz (2000) looked at crisis countries from 1973 to 1999 and compared those that received IMF assistance with those that did not. After controlling for self-selection bias and other variables, the authors conclude that "turning to the IMF may be harmful to a country's economic performance . . . and that this effect has been amplified since the Mexican crisis" (Bordo and Schwartz 2000: 60).³ Bordo (IFIAC 2000a: 186) added, "Fund programs are doing what they're designed to do, but they do seem to be harmful." Those findings are consistent with those of the bipartisan "Meltzer Commission" report of the U.S. Congress (IFIAC 2000b: 19), which concluded: "Neither the IMF, nor others, has produced much evidence that its policies and actions . . . [cushion] the decline in income and living standards."

³ Bordo and Schwartz (2000: 56) also find that if a country is borrowing from the IMF, its probability of continuing to do so in subsequent years is high, especially for Latin American nations. This is consistent with other findings on IMF dependence (see Vásquez 2000).

We need not speculate about what a world without an IMF would look like. After all, such a world existed during the previous era of globalization, which began in the second half of the 19th century and ended with the outbreak of World War I. Before 1914, countries experiencing financial crises resolved their problems by dealing directly with their creditors. International rescue loans were provided by the private sector, not by governments, and private bondholder committees usually negotiated debt-workouts with the troubled nations. The Bordo and Schwartz study compares the experience of emerging market nations in the pre-1914 era to the current post-Bretton Woods era and arrives at the following findings:

- Resolution of debt crises in the current period has taken longer than in the pre-1914 period.
- Recovery from currency crises occurred more quickly before 1914 than in current times.
- Banking and financial crises cause greater growth declines in the recent period than they did in the previous period.
- The output effect is even more severe in the recent period compared to the earlier period when financial and currency crises occur together.
- Recovery from banking and from twin crises begins earlier in the current period than it did in the pre-1914 period.

Except for the last point, all of those findings suggest a more preferable environment for resolving economic crises during the previous era of global capitalism than is the case today. However, with regard to the last point, Calomiris (2000) notes that in the pre-1913 era, there were no more than seven cases of significant banking system insolvency (defined as losses amounting to more than 1 percent of GDP) and that the median loss amounted to 3 percent of GDP with no cases exceeding 10 percent of GDP. That contrasts sharply with the last two decades, which have seen more than 100 severe banking crises, 20 of which have produced wealth losses of more than 10 percent of GDP. Indeed, in recent years several banking crises have produced losses equivalent to between 30 and 50 percent of GDP (World Bank 2001: 83). In short, banking crises are far more frequent and severe in the current era.

The proliferation of severe financial crises in the recent period is directly related to the proliferation of government-subsidized risk at the domestic level in the form of explicit or implicit guarantees against bank failure. But such moral hazard on the local level has only been encouraged by moral hazard on the international level. Investors

have bet, usually correctly, that even if a country runs out of reserves in an attempt to service debt obligations, the IMF will step in to bail out the country, or rather, the investors.

On repeated occasions, Mexicans have been victims of that dynamic. But the severity of the most recent crisis may finally be pushing Mexico, however slowly, toward implementing more prudent monetary, fiscal, and exchange-rate policies. Recent moves to liberalize the banking sector and the absence of an election-year financial crisis for the first time since the 1970s are positive signs. But if Mexico may be learning those lessons the hard way, neither the IMF nor other client countries appear to be doing so. The Fund continues to foment moral hazard, having provided bailouts to Brazil, Turkey, and Argentina in the past year alone.⁴

Conclusion

As long as the IMF continues playing the role of an international bailout agency, it will continue disrupting healthy relations between creditors and debtors. And its massive interventions will continue to preclude less expensive market solutions in which creditors and debtors quickly renegotiate debts in exchange for real reforms. For the foreseeable future, unfortunately, citizens of the developing world will have to contend with continued episodes of severe financial crisis. Any evaluation of Mexico's uneven recovery since 1995 must recognize such turmoil as an enduring legacy of the Mexican bailout.

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⁴ For a discussion of those bailouts and of the IMF's unchanged role, see Schwartz (2001).

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