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Statement of the Shadow Financial Regulatory Committee

on

Emergency Assistance for Mexico

February 13, 1995

On January 31, 1995 nearly $50 billion was mobilized worldwide to assist Mexico. Some observers characterized this as lender-of-last resort assistance for a country. Indeed, striking parallels exist between Mexico's plight and that of a large illiquid bank. Mexico had primarily illiquid assets and many short-term liabilities indexed to the U.S. dollar. When the market lost confidence in Mexico's ability to redeem its liabilities when due, a run began that could have culminated in a default.

The primary case for international assistance to Mexico was the concern for the negative spillover effects which might have occurred if Mexico had not received assistance. These included the possibility of political and economic turmoil in Mexico leading to a deep, prolonged recession and the abandonment of market-oriented reforms. Other heavily indebted countries also began to experience capital outflows even though their fundamental circumstances differed sharply from those of Mexico. This heightened fears of a contagious international transmission of shocks.

The potential damage to U.S. interests was especially serious. Because of its 2,000 mile border with Mexico and the extent of integration between the two economies, a sharp decline in the Mexican economy could lead to larger in flows of illegal immigrants and

a reduction in U.S. exports. More broadly, the collapse of Mexico, which had accomplished many significant economic reforms, could have led other developing countries to reject the market-based economic reforms that have been a cornerstone of U.S. foreign policy since the fall of the Berlin wall.

The problem, however, with emergency guarantees -- as, indeed, with traditional lender-of-last-resort assistance and deposit insurance guarantees -- is that they can create moral hazard. Investors who believe they are protected by implicit guarantees are more likely to take risks. Entities that are funded by investors who believe they will benefit from implicit guarantees will take greater risks for a longer period of time. As a consequence, crises are likely to be larger and to occur more frequently than if investors believed that they would be obliged to live with the consequences of their investments. This is our objection to the Mexican rescue package.

While we believe the case for assisting Mexico was persuasive, we have grave concerns about the bailout of short-term creditors who held dollar-indexed claims. Investors who are protected by official assistance, as they have been in the Mexican rescue, are justified in believing that they will be safe so long as they invest short term. Consequently, countries will find that they can pursue imprudent policies much longer (or delay or avoid corrective policies, such as devaluations) if they can still borrow short term. The legacy of this operation may be larger and more frequent crises around the world. This kind of official assistance undermines the capacity of markets to provide useful discipline over national macroeconomic policies.

We believe that the assistance for Mexico could and should have been structured in a way that strengthens rather than weakens market discipline. The assistance package should have drawn a distinction between old and new debt. Guarantees should have been provided only on a marginal basis, on new lending, but not extended to cover pre-existing debt. At the same time, just as in conventional domestic workout situations, existing debt should be rescheduled with extended maturities and reduced interest rates. Until Mexico is once again able to borrow on market terms without benefit of a guarantee, Mexican policy should be monitored by the IMF, which should endeavor to

function like a bankruptcy court in overseeing domestic workout situations.

This approach would have had several advantages. It would have performed the essential function of enabling Mexico to secure the financing needed to continue normal operations, but it would have required an appreciably smaller pool of guarantees which, in turn, could have been assembled in a shorter time and with less controversy.

Although this approach would have imposed losses on holders of short-term, external debt, investors who purchased Mexican equity shares have already experienced a loss in value due to the performance of the Mexican economy. We see no reason that external debtholders should be protected from the consequences of the policies which they chose to finance. This is especially true since the debtholders who are being rescued enjoyed a high return in the months preceding the crisis. More fundamentally, this is precisely what should happen to strengthen market discipline and reduce the moral hazard problem.

For these reasons, we urge the U.S. government, the IMF and other providers of guarantees to announce promptly that future rescue operations, if any, will be provided on the "marginal" basis stated above, thus reestablishing the important principle for investors of "caveat emptor."

It is the Committee's policy that members abstain from voting on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard C. Aspinwall abstained from voting on this statement. In addition, Mr. Hawke did not participate in the discussion, formulation or preparation of this statement.