Alan Greenspan

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<u>Introductory Remarks -- Senate Banking Committee</u>

I am pleased to appear before this Committee today to discuss the Mexican economic and financial situation As you know, Mr Chairman, I have no prepared statement, however, I am prepared to make a few introductory remarks

Because of regrettable delays in implementing effective policies, Mexico's problems have grown larger since I last appeared before this Committee to discuss Mexico on January 31 The major implication is that the necessary policy actions by the Government of Mexico now also have to be stronger if confidence is to be restored to the Mexican economy and financial system However, the burdens on Mexico will be reduced somewhat if it can borrow resources provided by the United States, primarily through the Exchange Stabilization Fund of the U S Treasury, and by the international financial community, primarily through the International Monetary Fund I have characterized this approach as the "least worst" of the various alternatives that currently confront us

Mexico, which had been hobbled for a number of years following the debt crisis of 1982, has more recently gone through a major economic metamorphosis toward significant improvement in its economic and financial structure As a consequence, Mexico has been able to broaden its participation in the global economic and financial environment Over the past decade Mexico has made major strides It has shed what was an inflation prone, highly unstable, economic structure with excessive government involvement and until recently had taken on many of the characteristics of a vibrant economy

As part of efforts to accelerate its move toward status as an industrial country and in a largely successful endeavor to bring down the rate of inflation, the government of Mexico adopted a complex, exchange-rate regime through which the Mexican peso was linked to the U S dollar via a moving exchange-rate band However, the exchange rate policy adopted by Mexico was risky with little tolerance for policy error or capacity to absorb shocks

As 1994 progressed, private foreign investment inflows slowed Mexican authorities evidently believed, or fervently hoped, that the reduction in foreign investor interest was temporary and that after the uncertainty of the August election was behind them, confidence and private capital inflows would reemerge

Meanwhile, it became increasingly clear to many observers during the autumn that the prevailing level of Mexico's exchange rate could not be sustained short of a significant further tightening of monetary policy Mexican authorities apparently were loath to risk recession, which might have been the consequence of such action, hoping instead for a spontaneous return of foreign confidence and capital They were tragically mistaken The chosen alternative to dramatically tightened monetary policy, that is borrowing via Tesobonos and drawing on reserves to intervene in the foreign exchange market, had a limit That limit was reached on December 20, and the defense of the peso came to an abrupt end

To address the potentially contagious situation that subsequently developed, the President and the bipartisan leadership of the Congress have decided to assist Mexico in dealing with its liquidity problems through a program that would ensure potential access to substantial amounts of medium-term funds from the Exchange Stabilization Fund and the International Monetary Fund

The objective of this program is to halt the erosion in Mexico's financing capabilities before it has dramatic impacts far beyond those already evident around the world To repeat, this program, in my judgment, is the least worst of the various initiatives which present themselves as possible solutions to a very unsettling international financial problem My concern is not so much with potential losses to the American taxpayer, which I believe have been minimized, but with what economists call moral hazard where the active involvement of an external guarantor distorts the incentives perceived by investors Nonetheless, I currently see no viable alternative to the type of program that is being pursued

Mexico's economic policies are the key to ensuring that the funds being provided under this program actually do help to stabilize the Mexican economic and financial situation, ultimately only sound policies that are sustained over time will restore investors' confidence in Mexico Under this program, Mexico is being provided with liquidity so that its government has time to implement fundamental actions to deal effectively with the implications of the inflation bubble associated with the peso's depreciation It is essential that the bubble be rapidly defused if stability is to be restored to the Mexican economic and financial system within a reasonable period of time

Unless Mexico's efforts to restore economic stability and financial market confidence succeed, years of economic reforms in Mexico would be threatened by pressures to reimpose controls in many areas of its economy and to reestablish governmental interference in what until recently was Mexico's increasingly vibrant private sector This would be a tragic setback not only for Mexico, but for the United States and the rest of the world as well.