

# **Responses to Mexico's Crisis: The Short Run and the Long Run**

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**Session I --- The Crises and the Markets  
The Alamos Alliance II  
Alamos, Sonora, Mexico**

**Saturday, February 11, 1995  
9:15 a.m.**

NOTE: The panel's topic is "crises," not crisis. Perhaps the plural refers to the plunge in the peso, the decline of the stock market, the collapse of Mexico's access to foreign credit markets, and the threat of default on short-term debt. Alternatively, those might all be considered one financial crisis, and the others might be the recent political crises -- the assassination of the presidential candidate and the renewed uprising in Chiapas. (Also, was a state governor assassinated?) No doubt the political crises have contributed to the financial crises by making foreign investors wary, but it is hard to imagine that the adverse political events outweigh the favorable effect of the ongoing liberalization of Mexico's economy. So, the root cause of the financial crises probably is that excessive official foreign borrowing, money creation (relative to demand), and peso support made foreign investors expect debt servicing difficulties, rising inflation, and peso devaluation.

### **I. Response to Introduction; Gracious Greetings; Etc.**

### **II. The Immediate Problem**

- A. Probably, this will have been spelled out by Francisco Gil Diaz and/or Sebastian Edwards.

### **III. Mexico's Response**

- A. Probably, this will have been spelled out by Francisco Gil Diaz.

#### IV. The U.S. Response (co-signer or creditor?)

- A. When Congress refused to approve a co-signer proposal, that proposal was replaced by a creditor program that did not require Congressional approval.
- B. The Loan Guarantee (Co-Signer) Proposal.
  - 1. Details of the proposal.
    - a. The U.S. Treasury would guarantee up to \$40 billion of notes sold by the Mexican government to private investors.
    - b. Mexico would pledge the proceeds of its oil exports to reimburse the U.S. Treasury if it has to make good on its guarantee.
  - 2. Criticisms of the proposal.
    - a. Populists see it as a bailout of rich U.S. and foreign investors and of a foreign country.
      - (1) "Polls indicate 70% to 80% of Americans oppose a financial rescue package for Mexico...." [The Wall Street Journal, 2/1/95].
      - (2) The Mexican public seems to oppose it also, but for different reasons. "Surveys in Mexico City have shown that an overwhelming majority of Mexicans oppose accepting such assistance from the United States, feeling that it compromises their nation's sovereignty" [New York Times, 1/31/95].

- b. Foreign aid shouldn't be increased at a time when domestic programs are being cut to reduce the deficit.
  - c. Aid reduces the pressure on Mexico to make necessary changes in their domestic policies (moral hazard).
3. Political dynamics that prevented its adoption.
- a. The Republican leadership (Dole and Gingrich) favored it but couldn't get Republicans to vote for the program that is disliked by the general public unless Democrats would also vote for it.
  - b. Senator Phil Gramm appeared to oppose the measure because he is dependent on populist financial support for his 1996 presidential bid.
4. On January 31, President Clinton abandoned efforts to obtain Congressional approval for the loan guarantee program, replacing it with a creditor program.

C. The Creditor Program

- 1. The Exchange Stabilization Fund (ESF) will provide up to \$20 billion in 3- to 10-year credits to Mexico.
- 2. The ESF is a subsidiary of the U.S. Treasury. It does not rely on Congressional appropriations, and its use does not require Congressional approval. However, Congressional leaders have expressed their support for using the ESF in this program.
  - a. (One could take issue with this use of the ESF, but doing so in

this forum and at this time seems unwise.)

3. The IMF increased its previous \$7.8 billion commitment for 5-year loans to \$17.8 billion.
4. Short-term credits were pledged by the BIS (\$10 billion), Canada (C\$1 billion), and several Latin American nations (\$1 billion).
5. Criticisms: The general public is unlikely to see this program as any different from the loan guarantee proposal. Their criticisms will be the same.

D. Moral Hazard in Assistance Programs

1. The moral hazard in any assistance program is that aid helps to avoid or delay the consequences of past mistakes, thereby reducing the incentives of **lenders and borrowers** to be prudent in the future.

E. Conditionality

1. To offset that moral hazard, several conditions are being attached to this program.
2. The conditions are also intended to protect U.S. taxpayer interests.
3. The Wall Street Journal (2/1/95) says the US and IMF credits "are subject to a number of still undisclosed economic conditions. They include:
  - a. limits on domestic credit and money-supply growth,
  - b. (limits on) fiscal deficits,
  - c. (limits on) external borrowing by the public sector...

- d. information-sharing requirements...
  - e. provisions aimed at preserving the independence of Mexico's central bank."
  - f. "Mexico, as was previously planned, will agree to divert proceeds from the sale of its oil to the Federal Reserve Bank of New York as collateral."
4. "Other sorts of conditions that Congress had been discussing -- involving immigration, labor rights and a host of political issues -- won't be attached."

## V. Evaluating the Responses

- A. How wise are the responses of Mexico, IMF, BIS, US, and other nations to the crisis?
- B. The important litmus test for judging those responses is the situation a year from now and beyond.
- C. Responses were successful if the following happens:
  - 1. The peso exchange rate stabilizes without exchange controls or central bank intervention.
  - 2. Mexicans repatriate private wealth held abroad.
  - 3. Interest rates fall as premiums for inflation expectations or peso depreciation are reduced.
  - 4. The Mexican government is able to routinely roll over its tesobono debt.

5. Drawings of US, IMF, and BIS credits are being repaid ahead of schedule.

D. Responses were inadequate if the following happens:

1. Inflation rate is high and rising.
2. The peso is supported by intervention and/or exchange controls.
3. Interest rates are high and rising.
4. Credit markets are periodically apprehensive that the Mexican government might not be able to roll over its tesobono debt.
5. Additional drawings are being made on the US, IMF and BIS lines of credit.
6. Informed observers are doubting that conditions attached to the loan package are being met.

## **VI. Some Fundamentals of Good Policy for any Nation.**

A. There is a basic set of policies appropriate for any nation that wants to prosper, whether in North America, South America, Western Europe, Eastern Europe, or anywhere.

1. These policies lead to prosperity, and they also lead to favorable reactions from international financial markets participants.

B. All nations follow these principles to some degree, and, to some degree, all nations fail to fully embrace them.

C. In general, rules and institutions affect prosperity as follows:

1. If they improve markets---they enhance prosperity.

2. If they interfere with markets---they retard prosperity.

D. Examples of prosperity-enhancing actions are:

1. Protecting and respecting property rights.
2. Providing courts that interpret/enforce contracts fairly.
3. Respecting freedom of speech and press.
4. Respecting economic freedoms to invest, to choose field of study, and to choose occupation and employment.

E. Examples of prosperity-retarding rules are:

1. Wage and price controls.
2. Interest rate controls.
3. Credit allocation and industrial policy.
4. Controls on foreign exchange transactions and capital flows.
5. Trade restrictions.

## VII. Some Policy Rules

A. Let me now suggest some specific monetary and fiscal policy rules that improve the operation of markets and thereby enhance prosperity.

B. **RULE:** Limit the use of discretion by monetary and fiscal policymakers.

1. Households and businesses will face less uncertainty.
  - a. They can make better decisions about consumption, saving, investment, and production.
2. Fewer short-sighted, politically-motivated policies will be imposed.

- C. **RULE:** Monetary policy should pursue sound money.
1. Sound money enhances prosperity in three ways:
    - a. It avoids capricious redistributions of wealth.
      - (1) Resources won't be used to avoid redistribution.
      - (2) So, it is akin to a technological advance.
    - b. It encourages saving and investment.
      - (1) Inflation interacts with tax system to discourage saving and investment.
    - c. It facilitates planning of production, consumption, and saving.
  2. False dichotomy.
- D. **RULE:** Government should mandate that the central bank achieve price level stability by a certain date and maintain it thereafter.
1. The mandate would increase the central bank's credibility.
  2. Credibility would facilitate achieving sound money.
- E. **RULE:** Government should mandate that monetary authorities have no objectives regarding short-run growth of output, employment, or other real magnitudes.
1. Sound money helps with all of these in long run.
  2. Using monetary policy to pursue them directly in short run sometimes impedes their achievement in the long run.

- F. **RULE:** Government should not manipulate its budget deficit for countercyclical purposes.
1. Changes in the levels of government expenditures or tax revenues have little lasting effect on total spending in the economy.
  2. No balanced-budget multiplier.
  3. No deficit-spending multiplier.
  4. Any effect is transitory and quickly reversed.
- G. **RULE:** Tax proposals and spending proposals should be evaluated for their effects on incentives and resource allocation.
1. They can affect incentives to work, save, and invest.
  2. They can shift resources between consumption and investment.
  3. In these ways, government spending and taxing can change the long-run growth path of output.
- H. **RULE:** Government should not impose taxes that discourage working, saving, investing, inventing, innovating, or owning and using productive resources.
1. To tax something is to discourage it.
  2. The primary incidence of taxation should fall on consumed income.
  3. A tax burden on individuals can't be avoided by levying taxes on businesses. Only individuals ultimately pay taxes.
  4. Tax policies should be evaluated by considering whether individuals bear the tax in their roles as workers, consumers, or investors.

- I. **RULE:** Policymakers and voters should not act on the myth that the burden of taxation is determined by the current level of tax revenues.
1. True tax burden is determined by the amount of government spending.
  2. Ultimately, all government expenditures must be financed by:
    - a. present or future explicit taxation,
    - b. government money creation,
    - c. or gifts from foreign sources.
  3. Actions that reduce current tax revenue without decreasing either present or future government expenditures do not constitute a reduction in actual tax burdens.
  4. Conversely, decisions that reduce either the current level or the growth of government expenditures from what they otherwise would have been are a genuine reduction in tax burdens, even if explicit tax revenue is not altered.
- J. **RULE:** Deficit spending should not be thought of as an alternative to taxation.
1. It is a method of deferring explicit taxation.
  2. It can encourage taxing through inflation.
    - a. Inflationary monetary policy can be viewed as an instrument of taxation.

- K. **RULE:** Deficit spending should be financed with inflation-indexed bonds.
1. Indexing reduces the temptation for government to finance its expenditures through inflation.
- M. **RULE:** Government should do only those few things that the market economy clearly cannot do well.
1. Because such a standard is difficult to apply, an alternative approach is to set a specific limit on government spending that can be altered only by constitutional amendment or super-majority of the legislature.
  2. The limit could be expressed as a share of national income or as a rate of growth.
  3. Part of the objective is to create an effective budget constraint on the government wherein opportunity cost cannot be ignored.
- N. **RULE:** Support programs should be means-tested so that income transfers to middle- and upper-income members of society are avoided.
- O. **TWO RULES** for retirement programs:
1. Government may choose to mandate, but should not administer them.
  2. They should be fully funded to avoid the negative effects on saving of redistributive pay-as-you-go schemes.

## VIII. Conclusion