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Unwinding Public Interventions in the Financial Sector: An Emerging Market Economy's Perspective

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- They should not be a return to “business as usual”
- As important as *disengagement* from extraordinary interventions will be government *engagement* to prevent future crises
- There is a need for stronger prudential regulation and supervision
- There is also a need to reduce moral hazard to a minimum

EMEs and the Recent Global Financial Crisis

- Initial drastic impact in the real economy: sharp drops in international trade, commodity prices, remittances
- Widespread contagion after Lehman's bankruptcy: investment flows shrank, with a major impact on exchange rates, domestic interest rates, and stock markets
- Some subsidiaries of foreign banks constituted an important source of liquidity for their parent banks. This affected credit in some host countries
  - ➢ Some evidence suggests that since 4Q08 credit growth in EMEs with a large foreign bank presence was lower than in other EMEs
- Financial instability and a fall in output and employment led to the adoption of significant stimulus measures in EMEs
- However, EMEs still depend on the recovery of developed countries
- Measures implemented in developed countries have set the stage for the upturn of the global economy
- Proper exit strategies are crucial to maintaining the growth of the global economy and the improvement of EMEs prospects

Basic Preconditions for Durable and Safe Disengagement

1. Support no longer needed by intermediaries
   - Decrease in demand for support
   - Normalization of market funding sources
   - Completion of strong capital, reserve, and provisioning ratios under “fair value” conditions
2. Guaranteed macroeconomic stability in terms of sustainable monetary and fiscal policies
   - Well-anchored inflation expectations
   - Sound management of public debt
3. Economic recovery clearly underway
   - Essential condition for banks’ return to normal lending

Elements for a Successful Exit Strategy

1. Price support measures to induce a market-based exit:

   Incentives should be set so that demand for support falls as markets normalize

2. Flexibility:

   Execution of exit plans depends on fulfillment of the preconditions and should include contingency plans

3. Reconciliation of new regulatory and supervisory measures with the exit plan:

   Lowering support in the midst of new regulatory requirements should not destabilize the financial system

4. Exploration of possible cross-border effects:

   Information should be shared among jurisdictions and coordinated internationally when possible

2\. Establishment of appropriate communication channels: Transparency is needed to gain legitimacy and avoid surprises

Mexico's Experience in the Mid-90s Crisis (I)

The Mexican crisis of 1994-95 resulted in:

- A sharp depreciation of the peso (over 90% by mid-March 1995)
- A considerable increase in interest rates
- Inflation back at two-digit figures (over 50% in 1995)
- GDP down by 6.2% in 1995

  All these factors affected the capacity of borrowers to honor their debts, causing deterioration in banks' balance sheets

Some of the most important measures launched to stabilize the financial system were:

- A US$ credit window at the central bank for commercial banks
- A blanket guarantee on banks' liabilities
- Programs to recapitalize banks and clean up their balance sheets

Mexico’s Experience in the Mid-90s Crisis (II)

1. A US$ credit window for banks at high rates had the following effects:
    - Allowed banks to honor their US$-denominated debts
    - Outstanding loans from the credit window peaked in April 1995 and were repaid in full by September
    - The high interest rates charged set the incentives for banks to exit support
2. Guarantee on banks’ liabilities
    - Removed gradually starting in 1999 and ending in 2005
3. Recapitalization and clean-up programs
    - Deposit insurance agency bought 2 pesos of NPLs for each peso of new capital injected by shareholders
    - Loss-sharing agreements were tied to acquired NPLs
    - NPLs were acquired with non-tradable promissory notes, thus banks could not sell them to finance lending
    - Recapitalization and a return to normal lending conditions took several years, partly reflecting legal constraints on foreign ownership of banks and poor protection of creditors’ rights

Mexico’s Experience in the Recent Crisis (I)

Measures adopted were transitory or limited in the resources committed and considerably less extensive than in previous crises because of the financial system’s resilience:

- Better regulation and supervision
- High capital adequacy levels
- Notably improved risk management and macroeconomic fundamentals

Three relevant measures:

- Provision of liquidity to FX markets
- Stabilization of the long end of the yield curve
- Support to refinance private commercial paper

Mexico's Experience in the Recent Crisis (II)

1. Liquidity provided to FX markets:
   - US$ auctions held by the central bank
   - Currency swap line agreed with the US Fed for US$30 billion originally ending in April 2009 but extended to October 2009
   - Agreement on a one-year contingent credit line from the IMF for US$47 billion

2. Stabilization of the long end of the yield curve:
   - Interest rate swap auctions conducted by the central bank in October 2009 to mitigate the impact of fluctuations in long-term interest rates
   - Adjustments of securities offerings since 4Q08: reduction of medium- and long-term securities issued and increase in short-term issues
   - Investment funds were allowed temporarily to trade with parties inside their financial groups to facilitate the restructuring of their portfolios

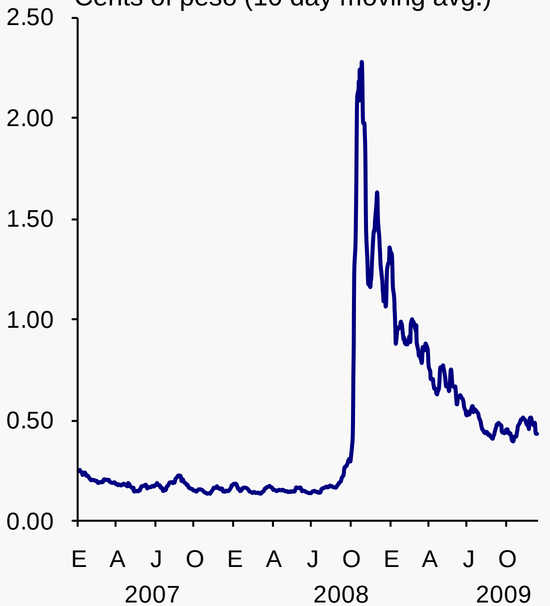
3. Temporary guarantee programs by government-owned development banks to facilitate refinancing of commercial paper:
   - Up to 50% guarantees for businesses and non-bank-, non-mortgage-related financial institutions (closed to new access in July 2009)
   - Up to 65% guarantees to certain mortgage non-bank financial institutions (to conclude in 2010)

Mexico's Experience in the Recent Crisis (III)

Impact of the recent crisis on the Mexican Financial System

Bid/ask spread in the Mexican FX Market (MXN/USD)

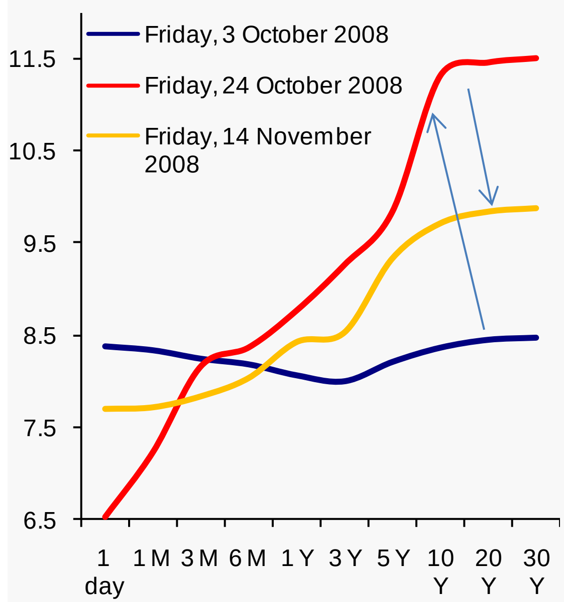
Cents of peso (10 day moving avg.)



Source: Reuters

Government yield curve

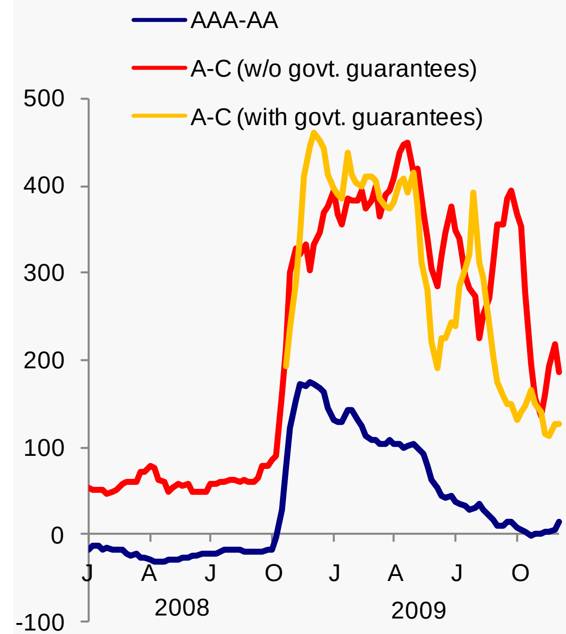
Percentage



Source: Valmer

Commercial paper interest rates

Spread vs. TIIE 28d. Basis points



Source: Bank of Mexico

Concluding remarks

- Careful consideration is needed for the timing of the unwinding of the various public-sector interventions
- The magnitude of the crisis, the interdependency of implemented measures and needed reforms will likely make for a long exit process
- Along with the measures taken will come undesirable effects in terms of moral hazard. Thus, it is imperative to implement a new regulatory and supervisory framework to promote responsible risk-taking, with special attention paid to minimizing the “too-big-to-fail” problem
- Clear leadership and social consensus around exit strategies is essential