

LESSONS FOR ASIA FROM MEXICO

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The Mexico crisis of 1994–95 and the recent wave of currency crises in Asia obviously surprised many international monetary experts in securities firms, governments, international financial institutions, universities, and the world financial press. What can the Mexico experience tell us about why so many experts were surprised in both cases and about how they might avoid such surprises in the future?

First, not everyone was surprised by the Mexico crisis. Some Mexican and foreign investors and speculators were clearly ready for it. They did not broadcast warnings to the general public; they merely acted with their clients' money and their own by selling peso assets for dollars when they decided the time was ripe. Many hedged in futures markets or through buying *Tesobonos* (dollar-linked Mexican government bonds) well before the crisis. They had seen devaluations before. A similar alertness of investors and speculators clearly was a feature of the crises in Asia as well.

At least one economist predicted the Mexico crisis publicly and well in advance. In May 1992, Milton Friedman told the Cato Monetary Conference in Mexico City that Mexico's pegged-exchange-rate policy was unsustainable. He said it was time to set the peso free or else to reduce the rate of monetary growth. He thought that any one who looked at the same numbers on relative rates of growth of Mexican and U.S. money supplies and relative rates of Mexican and U.S. price inflation that he did should have come to the same conclusion (Meigs 1997: 36–38). Apparently, however, few other experts saw what he saw or came to the same conclusion when he did.¹

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¹One Mexican economist who did was Luis Pazos, at the Centro de Investigaciones Sobre la Libre Empresa (CISLE) in Mexico City. Inspired by conversations with Milton Friedman, he wrote many articles and three books on the dangers of exchange-market intervention (Pazos 1993, 1994, 1995, 1996).

Friedman's success in predicting the Mexico crisis raises two questions for investigators trying to find what went wrong in Asia: (1) How could he predict from information available in May 1992 the devaluation of the peso and the crisis which followed more than two years later? (2) Could the kinds of information he considered for Mexico help to explain why the pegged-exchange-rate currencies of the Asian tigers came unstuck in 1997? I believe the answer is yes.

Who Was Surprised by the Mexico Crisis?

Economists, with rare exceptions, did not warn their peers or the general public that a policy of fixing exchange rates (or permitting only small appreciations or depreciations) was likely to fail and that the failure could inflict severe costs on people who had expected the authorities to succeed in controlling the exchange rate. Economists should be faulted for not reminding the public about historical evidence from many countries, including Mexico, that governments can control inflation rates or exchange rates, but not both at the same time. Controlling one requires relinquishing control over the other. The currently popular prescription for currency boards, for example, would control exchange rates by automatically allowing money supply, prices, and wages to rise or to fall whenever foreign-exchange flows into or out of a country's currency board at a fixed exchange rate.

At the beginning of the Mexican experiment with pegged exchange rates in 1988, many economists inside and outside of Mexico adopted the beguiling idea that fixing the peso/dollar exchange rate would also control inflation, thereby fulfilling two objectives with one policy. Fixing the peso to the dollar would provide an anchor for Mexico's price level, or so they argued.

Investors, bankers, business managers, and consumers, both Mexican and foreign, who believed those economists, acted as though they assumed that pegging the peso to the dollar would virtually eliminate exchange-rate risk, inflation risk, and default risk (risk that people or firms borrowing dollars would be unable to obtain enough dollars to repay on the original contractual terms if the peso/dollar rate were to change).

In 1994 and 1995, however, people who had based contracts on those comforting assumptions about the peso/dollar rate found they had been wrong on all three counts:

The authorities proved unable to maintain control of the peso/dollar rate. The rate changed from 3.44 pesos per dollar in November 1994 to 7.66 pesos per dollar in November 1995, with most of the change occurring within a few days after December 20, 1994. Mexican and

foreign investors holding Mexican assets found the dollar value of those assets cut roughly in half overnight.

Despite the success in bringing inflation down in the early years of the pegging policy, Mexico's Consumer Price Index (CPI) rose by nearly 50 percent from November 1994 to November 1995, as prices of imported goods in the index more than doubled. This sudden increase in the cost of living imposed great suffering on those Mexican consumers whose peso incomes remained fixed or declined.

A final, devastating consequence of the peso devaluation came when foreign lenders and investors doubted the ability of both government and private borrowers in Mexico to meet their dollar obligations in early 1995. That fall in lenders' confidence converted an exchange crisis into a potential default crisis and greatly reduced the supply of foreign capital.

Early accounts of the 1997-98 crises in Thailand, the Philippines, Malaysia, Indonesia, and South Korea are strikingly similar to those of the Mexican crisis. Investors, bankers, business managers, and consumers, inside and outside of those countries, evidently expected the authorities to be able to control exchange rates. They also expected inflation risks to be low. Furthermore, many lenders and borrowers evidently had so much confidence in the ability of the authorities to control exchange rates that they loaned or borrowed dollars and other foreign currencies without hedging against the risk of a change in exchange rates. Like their counterparts in Mexico several years earlier, they eventually found they had been wrong on all three counts.

The fears of governmental default were painful for Mexico and its creditors while they lasted, but they proved to be unfounded. The government was able to reduce its short-term dollar obligations, including nearly \$30 billion in dollar-linked *Tesobonos*, in 1995 with the help of the package of loans put together by the governments of the United States and Canada, the IMF, the World Bank, and the Interamerican Development Bank. However, banks and many other private, unhedged lenders and borrowers of dollars in Mexico suffered losses.

In 1998, the much larger proposed packages of loans to Asian countries from the IMF and possibly other agencies may similarly relieve fears of default in Asia. But these proposed loans, or "bailouts," raise a suspicion that some international lenders and borrowers thought they learned from Mexico's experience that they would not have to bear the full costs if they happened to be wrong in their assumptions about exchange rates and associated default risks. They might be able to shift some of those risks to the governments and taxpayers of the countries supplying the official aid. Expectations of

possible IMF and other official aid in case of exchange-rate breakdowns thus may have increased the total costs of the 1997–98 Asian crises. When dollars and other foreign capital flooded into Asia, expectations of official aid would have made lenders and borrowers less vigilant than they otherwise would have been.

What Should Investors in Asia Have Learned from Mexico?

The first lesson is that pegged-exchange-rate systems are extremely sensitive to domestic political developments or external shocks that affect investors' expectations. In today's fluid international financial markets, a small change in the stock demand for the capital assets of a country can cause a large, sudden change in the rate of flow of capital into, or out of, the country. Or, a change in investors' estimates of relative risks and returns can reverse direction of the net capital flow. Such changes in rates and directions of capital flows can put large, sudden pressures on exchange rates to appreciate or depreciate. The authorities might be unable to offset those pressures, as Mexico found in 1994 and the Asian countries found in 1997.

That is not a new lesson. Mexico provides only one of many cases illustrating effects of volatile international capital flows on exchange rates. However, Mexico provides an unusually clear case. For example, Mexico's success in bringing inflation down in the early 1990s, and its program of privatizations, trade liberalization, and other structural reforms, clearly increased capital inflows from Mexican and foreign investors. Political disturbances clearly influenced Mexican and foreign investors to move capital out of Mexico in 1994. Wide swings in U.S. interest rates and in total returns on U.S. common stocks between 1988 and 1994, and other external shocks, also contributed to pressures on the peso/dollar rate through influencing capital flows. Sharing a bathtub with an elephant can be dangerous.

Textbook treatments of the problems faced by governments and central banks trying to control exchange rates in the face of changing capital flows argue that a government can offset the effects of capital flows on exchange rates through buying or selling dollars or other foreign exchange. Governments also are expected to influence directions and rates of capital flows by raising or lowering interest rates or by imposing various direct controls on exchange transactions. Nevertheless, those instruments can fail, as they have in many countries many times.

The judgment of Francisco Gil-Díaz and Agustín Carstens on that point is compelling. Writing from their experience at the Banco de

México, they said in 1996, "A massive speculative attack on a currency whose authorities are committed to maintain a band cannot be resisted, certainly not in the present environment where the speed and amount of resources that move everyday in world financial markets quite simply overwhelm authorities" (Gil-Díaz and Carstens 1996: 20).² Their judgment was certainly borne out by the subsequent experience of Thailand, the Philippines, Malaysia, Indonesia, and South Korea.

The second major lesson is that the causes of an exchange crisis are not to be found in what happens during the crisis itself. The causes of Mexico's crisis gradually accumulated several years earlier, in 1990–93, when Mexico was attracting large capital inflows.

Most accounts of currency crises, however, emphasize what the authorities could or should do to prevent the exchange rate from *falling* under speculators' attacks when capital flows *out*. That is often too late. Mexico's experience indicates that a currency crisis could be avoided by permitting the exchange rate to *rise* when capital flows *in*. I believe that if Mexico had adopted market-determined exchange rates in 1988 or soon thereafter, instead of trying to control the peso/dollar exchange rate, there would have been no peso crisis in 1994–95 (Meigs 1997).

If the Banco de México had not been obliged to keep the peso/dollar rate within a specified band, the peso would have appreciated against the dollar for much of the time between 1989 and 1994. I suspect the same thing was true in Asia in those years and later. Allowing the peso to appreciate when capital flowed in would have made Mexican exporters unhappy but Mexican monetary base and the money supply (pesos) would not have been inflated by the capital inflows. To keep their currencies from rising against the dollar, when capital flowed in, the central banks of Mexico, Thailand, the Philippines, Malaysia, Indonesia, and South Korea bought dollars and other foreign exchange with newly created monetary base, thus expanding their domestic money stocks. Mexican monetary aggregates, for example, grew more rapidly than those of the United States, despite Banco de México efforts to offset reserve purchases with reductions in net domestic credit (selling Mexican securities, i.e. "sterilizing"). That was one of the danger signs Friedman noticed in May 1992 (Meigs 1997: 50, Fig. 5).

The third, and perhaps most interesting, lesson from Mexico is that a country trying to apply orthodox, conservative, noninflationary

²For authoritative IMF surveys of the evolution of financial markets and instruments that reduce the power of governments and central banks to regulate exchange rates, see Goldstein et al. (1993) and Goldstein and Folkerts-Landau (1993, 1994)

monetary and fiscal policies could still be risking an exchange crisis, if it persists in trying to manage its exchange rate at the same time. The danger is insidious because it may escape notice for years. As we saw above, Mexican monetary aggregates grew more rapidly than their counterparts in the United States between 1988 and 1994. But Mexican monetary expansion rates in that period were much lower than they had been before 1988. Responding to the sharp slowdown in monetary expansion, Mexico's inflation rate fell from a peak rate of 180 percent per year (year-to-year) in February 1988 to a low of 6.7 percent in September 1994 (as measured by the Consumer Price Index). Inflation reached its lowest point in many years just three months before the exchange crisis. The federal budget was brought into balance. Mexico's foreign exchange reserves—conventionally viewed as a key indicator of a government's ability to defend its exchange rate—rose from a level of \$6.3 billion at the end of 1989 to a peak of \$29.2 billion in February 1994, eight months before the devaluation. Mexico's structural reform program was one of the most ambitious in the world.

During the period of the capital inflows, 1990–93, Mexico was an outstanding success story, attracting \$91 billion in net capital inflows, or roughly one-fifth of all net inflows to developing countries (Folkerts-Landau and Ito 1995: 53). It is truly ironic that Mexico's success in attracting capital, earned by doing many things well, gradually made the pegged-exchange-rate policy less sustainable.

I believe much the same thing could be said about Thailand, the Philippines, Malaysia, Indonesia, and South Korea, although presenting the evidence for this conclusion is beyond the scope of this paper. It is apparent, however, that those countries generally had large capital inflows, lower inflation rates and lower monetary expansion rates than they did in earlier years, budgets in near balance, growing foreign-exchange reserves, and structural improvements of many sorts underway. It should not be surprising, therefore, that confidence in their ability to manage exchange rates remained high for a long time.

Money, Prices, and Exchange Rates

Potential trouble for Mexico's policy of managing the exchange rate showed up early in consumer prices. Although Mexico's inflation *rate* fell toward the U.S. inflation rate, the *level* of Mexican consumer prices continued to rise in relation to the level of U.S. consumer prices (Meigs 1997: 40, Fig. 2). Friedman noticed the growing spread between Mexican and U.S. consumer prices in 1992. So did Mexican consumers. By November 1994, Mexican consumer prices had risen

187 percent following adoption of the pegging policy in February 1988, while U.S. prices had risen 29 percent. (Widening the exchange-rate-target band offset some but not all of the growing disparity in price levels.)

The gap between prices of Mexican and U.S. consumer goods indicated by comparing Mexican and U.S. indices actually was understated. Holding the exchange rate fixed or nearly fixed was equivalent to maintaining price ceilings on the imported goods included in the Mexican CPI. When the peso was allowed to float in December 1994, prices of those goods went up at a shocking rate, pushing the whole Mexican CPI upward.

Accumulating foreign exchange reserves to prevent appreciation of the exchange rate when capital flowed in increased the growth rate of Mexico's money supply, thus supplying upward pressure on Mexican prices and wages. Pressure to change the exchange-rate peg—as an alternative to putting more downward pressure on Mexican prices and wages—thus gradually increased. Furthermore, the direction of an eventual adjustment was clear; it could only go one way. All that was needed in order to start a run on the peso was some random political or external shock to investors' and speculators' expectations. That came in December 1994.

This highly compressed account of Mexico's experience leaves out many important details. However, despite the great differences in institutions and economic structures in Mexico and Asia, I believe it provides some useful lessons for analyzing the Asian crises and identifying some clues for investors to watch in the future.

I recommend the following lessons from Mexico for people trying to understand the currency crises in Asia:

- Do not concentrate on what the concerned central banks and governments could have done, or should have done, just before each crash. Seeds of the crises were planted years earlier when the decisions were made to peg exchange rates.
- Examine cumulative changes in domestic price levels relative to those in the country or countries to which currencies are pegged.
- Trace the effects of exchange-market interventions and changes in foreign-exchange reserves on national monetary bases and other monetary aggregates relative to their counterparts in the target country or countries. A long buildup of foreign-exchange reserves should be taken as a danger signal, rather than as a sign of strength, for governments and central banks trying to manage exchange rates.

Such simple lessons might help governments and central banks to avoid problems in the future. And they might help investors and

speculators to avoid painful surprises if governments persist in trying to manage the unmanageable.

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