Comment on "The Mexican Crisis of 1994: An Assessment," by Ariel Buira

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Post Mortem of a Crisis

Seminars on the Mexico currency crisis have become a cottage industry - worldwide, meetings of this sort are being held. Let us hope that the lessons extracted from these seminars at least will be identified and absorbed for the future, so that we will have fewer crises and maybe have more time for reflective thinking rather than policy management by crisis.

In reviewing the developments leading up to the collapse of the peso and the subsequent financial crisis, Ariel Buira dismissed one by one some of the economic and financial explanations of the crisis: the overvaluation of the peso; large, unsustainable current account deficits; the appropriateness of the exchange rate regime; too easy monetary and fiscal policies. He instead maintained "that the crisis originated in a series of unpredictable political and criminal events that changed market sentiments towards Mexico."

In doing a post mortem of a crisis, it is always difficult to identify specific causal factors. Hindsight has two problems. One is our sense that we know more today than we actually knew at the time. In assessing a crisis in retrospect we at times forget this fact and therefore assume we could have acted very differently. In addition, hindsight also blurs our ability to reconstruct exactly what was happening at the time. From my observation post at the time there were increasing warning signals that Mexico was entering, and eventually was actually in, an unsustainable financial position. No doubt the political events in 1994 intensified these circumstances. In 1994, Mexico was heading towards a position where it was vulnerable to adverse shocks, economic as well as political, and therefore, with hindsight, as well as perhaps at the time of the evolving events, the policy course selected by the authorities might have been different had they been more responsive to some of these warning signals. If we are to learn for the future from this particular Mexican crisis, it is essential that policymakers be sensitive to similar alarm bells on a more timely basis and respond accordingly in a more timely fashion.

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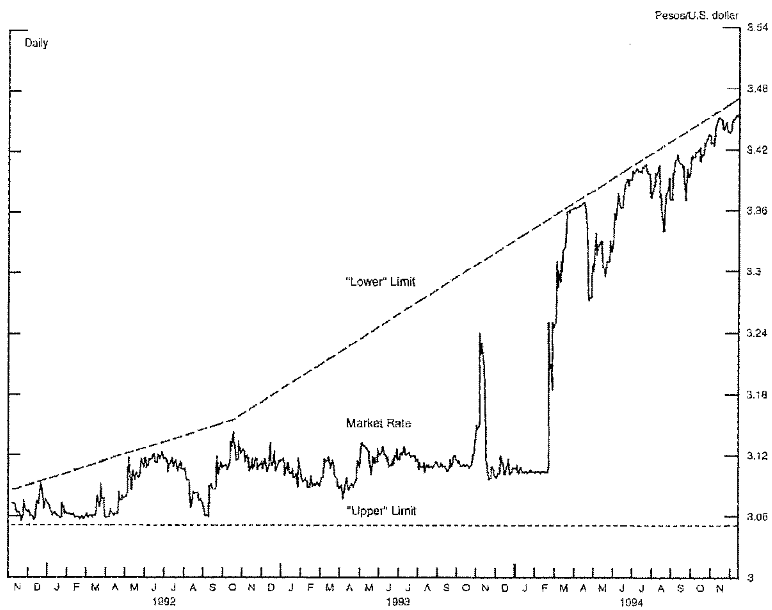
With regard to the question of whether the Mexican peso was overvalued or not, according to many analysts Mexico was able to absorb a considerable amount of the appreciation of the peso it experienced in the early period of its narrow exchange rate arrangement - as pointed out by Ariel - because of the initial undervalued position of the peso and because of very strong productivity changes. However, a good case could nevertheless be made that, given Mexico's relative inflation performance and prospects, the Mexican peso was becoming overvalued. Reasonable people could disagree about the timing and perhaps the amount of the peso overvaluation, but as the year 1994 progressed it was becoming increasingly evident that the peso was losing its competitiveness.

The shift from a reasonably healthy trade and current account position to deficits - and large deficits - provided support that the peso was becoming uncompetitive. Ariel Buira emphasised the point that exports were growing rapidly and that this would indicate that the peso was competitive, but he fails to explain the even more rapid growth of imports at a time when the Mexican economy was far from buoyant. Moreover, the declining employment in manufacturing over the last decade provides some evidence that the tradable sector was being actively restrained by the exchange rate.

Chart 1 Mexican Exchange Rate Changes within the Exchange Rate Band
(November 1991 through mid-December 1994)



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But perhaps the whole debate among academics and policymakers of whether or not Mexico's peso had become overvalued may be somewhat irrelevant. The important point is that enough investors started to conclude that the peso was overvalued and acted accordingly, which spurred a series of speculative attacks. Chart 1, which I circulated, plots the exchange rate developments from 1992 to 1993, and 1994. One notices that the pressure on the peso manifested itself sequentially during 1994, and that the peso stayed under pressure throughout the period starting March-April despite the various policy responses. The market's perception of where the peso was heading was becoming evident month by month.

Policy Options

With regard to the policy response to the various episodes of market pressure on the peso in 1994, Mexican authorities had to choose from a menu of four policy options: (i) tightening monetary and/or fiscal policy; (ii) drawing on reserves; (iii) borrowing to supplement the reserves; and/or (iv) adjusting the exchange rate. Over time, they selected elements of all these four options and actually did tighten monetary policy - at various stages, monetary policy was tightened and they did allow some additional adjustment of the exchange rate, as Ariel pointed out. However, they relied very heavily on drawing on Mexico's international reserves and very heavily on short-term borrowing. With regard to fiscal policy, the focus in Ariel's paper is on the non-financial sector of the public sector accounts only. If one includes the development banks, the deficit in the public sector is 4%, a shift from a more healthy fiscal position earlier. The inclusion of privatisation funds is subject to general debate among economists as to whether it is an appropriate element in determining a country's public sector balance since it is a one-off event. Thus, it would appear that Mexico's fiscal health was deteriorating.

As noted, Mexican policymakers relied heavily on drawing on the reserves and on short-term borrowing. Among the reasons for this is that the policymakers, as was pointed out and re-emphasised by Ariel Buira, thought that the pressure on the peso was due to political shocks which, they were convinced, would only be temporary.

Chart 2, which I circulated, shows the elements of this approach, starting with December 1993 as we move through 1994. It plots gross reserves and the issuing of Tesobonos. But if one also plots reserves net of Tesobonos, one realises that in the early part of the year the reserve position was very strong and the amount of borrowing of short-term dollar-denominated issues was just starting. It was most probably a reasonable approach when the initial pressure on the exchange rate manifested itself. The problem was the continuation of these two elements: drawing on reserves and supplementing resources by short-term borrowing. That is a risky business. A policymaker ought to be very cautious in getting into a position where the ability to meet debt obligations is reduced at the same time as

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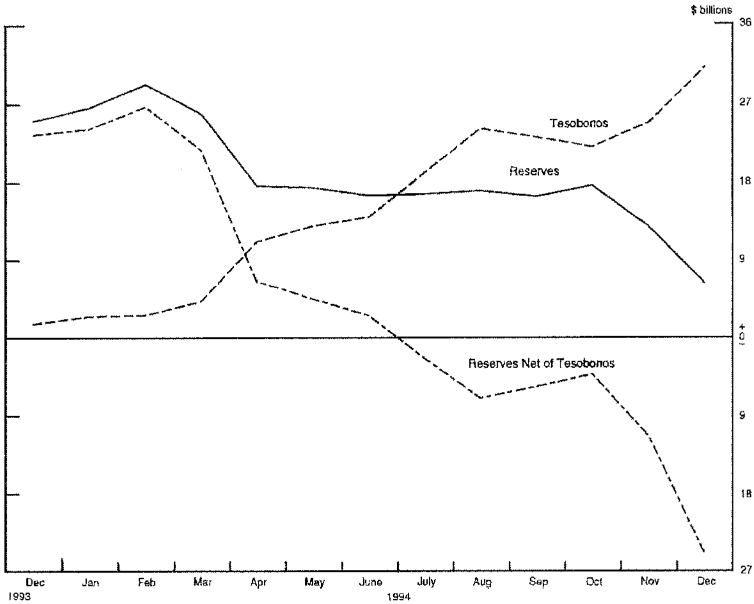
Chart 2 Mexican International Reserves and Tesobonos Outstanding
(December 1993 through mid-December 1994)



additional indebtedness, especially short-term indebtedness, is increased. As 1994 progressed, there were different junctures where, with hindsight, policy-makers should have become exceptionally cautious of both allowing the reserve position to deteriorate and incurring additional short-term debt. Again, reasonable people could disagree, but at some time in 1994 a hold on the drain of reserves and a hold on the additional accumulation of short-term debt would have been appropriate. Chart 2 is pretty graphic in illustrating the various timing points where that could have been identified. Sooner would have been better.

Thus, drawing on one's international reserves and supplementing one's resources by short-term borrowing was a legitimate policy approach as a means of buying time, but only up to a point. As 1994 evolved, the continuation of this approach made Mexico's external financial position increasingly vulnerable and undermined investor confidence in Mexico's capacity to honour its external debt. Thus, Mexico was subjected to repeated and intensified pressures on its exchange rate. Once credibility and market confidence was lost, Ariel Buira may well be right that at that point no reasonable amount of monetary tightening would have been enough to stabilise the situation. However, had the Mexican authorities

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ceased their reliance on the use of the reserves/short-term borrowing option earlier in the year, a very sharp rise in interest rates and a prompter adjustment of the exchange rate might well have been able to prevent an exchange rate crisis from developing into a full-blown economic crisis.

Defending an Exchange Rate in a Volatile Political and Capital Mobility Environment

I would question the contention that political shocks caused the crisis and did not allow the exchange rate to be maintained. It is quite right that some of the political developments in Mexico in 1994 were unique and perhaps once in a lifetime, but the six-year cycle in Mexico is a recurring event, and this was not the first time that Mexico faced serious economic difficulties during an election year. Policymakers needed to prepare themselves for it in 1994. What may have been an adequate policy response in a "normal" or favourable economic and political environment may not be enough in an election year. While the political calendar acted as a constraint to take the timely and adequate policy steps, perhaps understandably so, that was not necessarily the cause of the crisis. The constraint of taking timely policy actions because of political considerations is not the explanation of why the event did eventually occur.

In his paper Ariel notes the paradoxical effects of capital inflows in appreciating the real exchange rate and in widening the current account deficit. He offers some insightful observations in pointing out the psychological dimensions of this problem, in which excessive optimism very quickly gives way to excessive pessimism. It's worth asking whether such huge swings would occur in a floating exchange rate regime as Ariel himself points out, where changes in investor sentiment are reflected perhaps more quickly in the exchange rate, thereby leading to a smoother and more gradual adjustment of expectations over time rather than more abrupt ones. That is an issue that one has to consider. Under floating there may be considerably more day-to-day and week-to-week volatility, but perhaps not the very sharp, abrupt shocks in the exchange rate which undermine confidence, both domestically and externally. The Mexican crisis also confirms the risk of using the exchange rate regime as an inflation stabilisation anchor, as was the case in Mexico and is advocated for other countries. Such a policy has little tolerance for policy error and capacity to absorb shocks, both economic and political. In an environment of very mobile capital, where capital can move rapidly in and out of a country, or out of currency, the tendency for the exchange rate regime under very narrow bands to be sustainable becomes very questionable. Any form of fixed exchange rate regime makes a very good target - not just in Mexico, but in Europe as well, as people have experienced with the breakdown of the ERM, especially when market participants question the adequacy of policies needed to sustain the fixed rate.

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Let me conclude with my comment on the interesting paper by Buira. Ariel himself concedes that in hindsight the policy combination used by the Mexican authorities turned out to be inadequate. Recent statements by other Mexican officials confirm this. President Zedillo, in his Informe in September 1995, referred to a variety of factors in addition to political shocks and a fall in the savings rate. For example, as key contributors he lists the large external imbalance financed with volatile foreign capital, the maturity mismatch in the financial system (short-term liabilities versus long-term assets), the dollarisation of the public debt, and the sharp real appreciation of the peso over time. All of these factors made the Mexican peso vulnerable and all contributed to generating a crisis. Thus adverse shocks, an unsustainable external position, and policy slippage were all at work in 1994 and all contributed to the collapse of the peso. Inadequate timely action at various stages as the problems were becoming more evident and the capital markets were becoming restive aggravated the situation. Policymakers underestimated the risk of not acting forcefully and in timely fashion, at a time when the country's reserve position was still relatively favourable. The market forced the hand of the Mexican authorities, resulting in economic consequences considerably beyond what would have resulted had policymakers acted earlier and more forcefully in 1994. The lessons to be learned are part of our discussion the rest of the day.

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