Can Currency Crises Be Prevented or Better Managed?

Lessons from Mexico

Edited by
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FONDAD
The Hague

Forum on Debt and Development (FONDAD)

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Proceedings of a Seminar on "Can Currency Crises Be Prevented or Better Managed? Lessons from the Mexican Crisis," held at De Nederlandsche Bank on 18 September 1995, organised by the Forum on Debt and Development, with the co-sponsorship of the Department for Development Cooperation of the Netherlands Ministry of Foreign Affairs and De Nederlandsche Bank.

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The views expressed in this book do not necessarily represent those of the Forum on Debt and Development or De Nederlandsche Bank.

CIP-DATA KONINKLIJKE BIBLIOTHEEK, DEN HAAG

Can currency crises be prevented or better managed? :
lessons from Mexico / Ariel Buira ... [et al.] ; ed. by
Jan Joost Teunissen. - The Hague : FONDAD. - Ill.
Proceedings of a seminar on "Can currency crises be
prevented or better managed? Lessons from the Mexican
crisis", held at De Nederlandsche Bank on 18 September
1995, organised by the Forum on Debt and Development. -
With ref.
ISBN 90-74208-07-X
Subject headings: currency crises ; Mexico ; 1994 /
international monetary policy / financial management.

This publication was made possible thanks to the support of the Department for Development Cooperation of the Netherlands Ministry of Foreign Affairs and De Nederlandsche Bank.

Additional copies may be ordered from FONDAD at
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FONDAD, The Hague, 1996, www.fondad.org

Abbreviations

ADR	American Depositary Receipt
BIS	Bank for International Settlements
CRF	Contributed Resources Facility
ERM	Exchange Rate Mechanism (European)
EMS	European Monetary System
ESF	Exchange Stabilisation Fund
FDI	Foreign Direct Investment
GAB	General Arrangements to Borrow
GDP	Gross Domestic Product
G-3	Group of Three (Germany, Japan, US)
G-7	Group of Seven (Canada, France, Germany, Italy, Japan, UK, US)
G-10	Group of Ten (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, UK, US)
ILOLR	International Lender of Last Resort
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Cooperation and Development
PPP	Purchasing Power Parity
UK	United Kingdom
US	United States

Preface

As a former executive director of the International Monetary Fund and having left the IMF only recently, I still felt very much involved when the Mexican crisis erupted in December 1994. But since I could follow the unfolding events in 1995 solely as an outsider, I was grateful for the invitation of the Forum on Debt and Development to chair a meeting of an international group of outstanding experts who were closely involved with the Mexican crisis and its aftermath. The seminar on which this book reports created a welcome moment to discuss the many sides of past and future currency crises in a quiet setting. It was the kind of gathering you can have only after the crisis has happened and not when you are still in the middle of it.

When the IMF decided to act as a "crisis manager" in the beginning of 1995, my own feeling was that the Mexican authorities could have acted more forcefully at an earlier stage, and that the financial market could have foreseen that Mexico's current account deficit was going to be unsustainable. I must confess, however, that it is very difficult for policymakers to identify the elements which constitute an unsustainable situation before a crisis has emerged, and to judge what the moment is to act and take unpopular measures. Moreover, policymakers are rightly concerned about not starting the crisis themselves. So I agree that one should err on the side of caution, as one of the participants in the seminar said. Likewise, market participants may find it difficult not to extend loans and make portfolio investments when everybody still considers it profitable and safe. With the benefit of hindsight, of course, things look different.

One of the basic questions that was addressed in the seminar was whether currency crises can be prevented. My own answer is no, at least not always, because we live in a real world where mistakes are made by authorities as well as by markets. However, it should also be realised that currency crises do correct mistakes, though in a rather painful way. In fact, one of the ways to manage a currency crisis is to do nothing, because the financial market will do the job and correct misalignments. This and other ways of managing currency crises was the other basic question addressed at the seminar.

One of the other ways of managing a currency crisis is to provide emergency finance to the country in trouble, to enable it to support its currency, to finance its debts, and thus soften the impact of the crisis. The argument in favour of this option is that doing nothing may lead to very great damage to the country, the financial markets or even the global economy. A convincing case can therefore be made that policymakers cannot just leave it to the markets: a local crisis may

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develop into a systemic crisis, obliging financial authorities to come up with a financial rescue package.

Currency crises come unexpectedly, in different circumstances and in different forms. In the liberalised international capital markets we have today, very large capital movements take place within a few days, even hours. The decision to support a country which suffers from a large and immediate capital outflow therefore has to be taken in a very short time if a payment moratorium is to be prevented. In the case of the Mexican crisis the US government and the IMF acted very fast indeed, and put together a financial assistance programme for Mexico of an unprecedented size. In my view, this raises the important question of whether the costs of the crisis have been shared properly by markets and governments. Of course, the financial support extended by the international community to Mexico, through the IMF, has to be repaid by Mexico. But if no support programme had been carried out, wouldn't the capital providers - mainly institutional investors rather than banks, as was the case in the debt crisis of the 1980s - have suffered the losses they ought to have run as a result of assuming commercial risk, at least in the short term? After all, the capital providers had received a return on their investments which reflected higher risks than when they had invested in long-term US bonds, for example. The seminar therefore also discussed another basic question: the feasibility of work-out arrangements for both borrowers and lenders to make sure that the costs of a crisis are shared in a more satisfactory way.

There are many lessons to be learned from the Mexican crisis. Generally, in my view, participants in financial markets should not be protected from their own mistakes, but the markets should be protected from the mistakes of the participants. The contributions included in this book provide profound insights into a problem which is of concern to policymakers, private actors and the public at large in many parts of the world. I hope that this book will help decisionmakers in governments, central banks, and financial markets to prevent the next crisis, and if they fail to do so, to manage it better.

Godert A. Posthumus

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Introduction

Private capital flows are moving freely around the world and are playing an increasingly important role in individual countries as well as in the global economy. They can either promote economic development or suddenly provoke economic instability and create serious crises. A recent example is the Mexican currency crisis that erupted in December 1994.

The latest Mexican crisis has caused concern that similar crises may occur in the future. Policy-oriented researchers and high-level policymakers are therefore puzzling out how new Mexico-style crises can be prevented or better managed, and how the risks can be shared more equally between governments and markets. In the light of these challenges, the Forum on Debt and Development (Fondad) and De Nederlandsche Bank held a seminar to stimulate creative and practically-oriented thinking about the prevention and management of currency crises.

A small group of eminent academics, policymakers and bankers was invited to discuss in four subsequent sessions the following questions: (i) Could the Mexican authorities have prevented or better managed the crisis? (ii) What would be the ways in which future currency crises à la Mexico could be prevented? (iii) How can future currency crises be managed better? (iv) What would be viable long-run strategies, and do short-run measures fit in with such objectives?

Each of the four sessions began with the presentation of a paper written by well-known experts Ariel Buira, Peter Kenen, Stephany Griffith-Jones, and Charles Wyplosz (with Barry Eichengreen as a co-author). The papers were followed by commentaries by Charles Siegman (US Federal Reserve Board), Jack Boorman (International Monetary Fund), William White (Bank for International Settlements), and Coen Voormeulen (De Nederlandsche Bank), and by plenary discussions. These three ingredients - the papers, commentaries and discussions - constitute the content of this book.

The first paper, by Ariel Buira, reviews the three main hypotheses that have been advanced to explain the Mexican crisis: Was it the result of an unsustainable current account, of lax economic policies, or of unpredictable political events? Buira, who as a Deputy Governor of the Bank of Mexico has been closely involved in the events, gives a full and in-depth account. He also considers some broad issues that the Mexican crisis raises.

In the second paper, Peter Kenen addresses the more general issue of how the disruption to national economies that results from fluctuations in cross-border flows can be minimised. In particular, he raises the question of how governments can protect their economies *ex ante* from the volatility of capital flows and what they can do *ex post* to minimise the effects of that volatility when they must

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confront it. Kenen also looks at the ways in which international institutions, especially the International Monetary Fund, can help governments cope with fluctuations in cross-border flows.

In the third paper, Stephany Griffith-Jones considers the new features of recent and possible future currency crises. Griffith-Jones focuses in particular on the growing importance of global institutional investors and suggests how the flows that originate from these global investors and go to emerging markets could be regulated. Griffith-Jones also examines some of the current proposals for currency crisis management.

In the fourth paper, by Charles Wyplosz and Barry Eichengreen, the authors draw out some lessons from exchange rate crises that have occurred over the last thirty years in a large number of industrial countries. In particular, they look at the consequences for the choice of exchange rate regime. According to Wyplosz and Eichengreen, the old debate was about adopting either a fixed or a freely floating regime. Current world economic developments point, however, in their view, to a different choice. The long-run tendency is toward a tripartite monetary world centred around the currency zones of the United States, Western Europe and Japan, Wyplosz and Eichengreen argue. And, given the liberalisation of capital movements, the debate will therefore be forced to make a drastic choice between either a full floating or a complete elimination of exchange rates by establishing a (regional, and eventually world) currency union.

This book arises from a three-year research project set up by Fondad, which aims to explore how regional integration as well as multilateral cooperation can be promoted, in a mutually reinforcing manner, at the same time. At a conference held in 1995 in Santiago de Chile - reflected in our publication *Regionalism and the Global Economy: The Case of Latin America and the Caribbean* - the Mexican currency crisis was one of the hot topics. We are grateful to De Nederlandsche Bank for enabling us to organise another, thorough debate on the lessons to be learned from Mexico-style currency crises by co-sponsoring a seminar at its premises in Amsterdam. We are also grateful for the continuing and solid support of the Dutch Ministry of Foreign Affairs. Special thanks go to Stephany Griffith-Jones and Coen Voormeulen who have been of great help in preparing the seminar from which this book results.

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January 1996

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