

Floor Discussion of the Buira Paper

Ariel Buira started off the discussion by arguing that it is difficult to assess what an unsustainable external position is before a crisis emerges. Buira did not agree that the currency crisis of Mexico was spurred by a too large current account deficit. "There are a number of countries in South East Asia - Thailand, Malaysia and so forth - which have run much larger current account deficits than Mexico, for much longer periods. Singapore, for example, has run a 10% current account deficit for twelve years."

Buira also contested the notion that the Mexican peso was overvalued. "There is a question of definition of what is overvalued. If you mean to say that the currency is overvalued when you have a current account deficit, obviously you are over-valued. If you mean to say that you are not competitive, I would challenge this. Chart 3a in my paper shows that Mexican exports were doing much better than the exports of most of the world. Perhaps one has to distinguish between a current account deficit which results from an imbalance between savings and investment, and the evolution of relative prices. One could equally argue that the US dollar is overvalued because the United States has a current account deficit, but it seems to me that if you go to the US, you will find that prices in the US are lower than in most of the industrial countries. The decline in employment in manufactures to which Charles Siegman refers has to do more with structural change and high productivity than with overvaluation, because output was not declining."

Buira agreed that the Mexican authorities had relied on drawing of reserves, but thought that they had good reasons to do so since it was generally expected that the problem was transitory and there would be a return of confidence. "The financial crisis was essentially of a political nature, having to do with the Chiapas events and the assassination of the candidate of the government party and other political shocks. The Mexican authorities expected that the political uncertainties would be resolved, first with the elections and then with the confirmation of the policies by the new administration. That this did not work out that way was completely unexpected. The so-called 'six-year cycle' is a bit of a caricature. Charles Siegman - and other economists - suggest that presidential elections were constraining policy actions. If that had been the case, Mexico could have tightened policy on August 21, 1994. But there was no need to do this because Mexico's reserves had been stable, and remained stable for a few more months."

Buira did not agree that the Mexican authorities had resorted to heavy short-term borrowing and that, as a result, public debt had increased. "There was a conversion of *Cetes*, which were peso-denominated debts, to *Tesobonos*, which were

also peso-denominated debts but indexed to the exchange rate. There was not a continuous rise in public debt. If you look at public finances - which include the expenses of the development banks and the revenues from privatisation - you see that the overall monetary aggregates declined. Public finances, for purposes of balance of payments on a cash basis, do and should include the revenues from privatisation, and they were in surplus."

Bernd Goos strongly supported Buira's view that there is no simple link between, on the one hand, the overvaluation of a currency and, on the other, the existence of a current account deficit. "Very often, one approaches this issue from the current account position, leading to the conclusion that when you see a deficit the currency must be overvalued and vice versa. I strongly agree with what Ariel Buira just said, that there is no such simple correlation. He gave a very good example when he said that if you look at the US deficit, you would have to come to the conclusion on the basis of that concept that the dollar is overvalued, which I think makes very little sense."

However, Goos agreed with Siegman that Mexico's current account deficit was not sustainable and had to be corrected at some point in time. "I have a lot of sympathy for the analysis presented by Charles Siegman. If you look at the figures, in particular at the current account and the behaviour of consumption and savings, they suggest that the situation was unsustainable. It is oversimplistic to compare the deficits of Mexico with current account deficits in Asia, because they are different in precisely that respect, in terms of behaviour of savings and consumption. So, from that perspective, the situation looked unsustainable."

Bernd Goos disagreed with Buira that there was no reason for concern about Mexico's monetary expansion. "If you look at chart 5, you see that one of the monetary aggregates, nominal M4, is expanding at a rate of growth of 25 to 30% until spring 1994. True, this was followed by a deceleration to below 20%, but then a renewed expansion set in, up to close to 25% later on. I would have thought that such an expansion of monetary growth was not sustainable."

Goos' overall impression was that many of the policies pursued by the Mexican authorities were based on the principle of hope rather than on the worst-case scenario. "With hindsight, one can understand why the Mexican authorities behaved the way they actually did, because there were intermediate improvements and, indeed, the setbacks were caused by political problems and criminal events. But my feeling is that there were clear indications that suggested that tightening would have been appropriate much earlier and to a much larger extent than actually occurred."

According to Goos, three lessons can be learned from the Mexican crisis. "One lesson is that policies should err on the cautious side, particularly in a situation such as that of Mexico, a country which had been undergoing very strong structural reforms and which had had these huge capital inflows. You could not really rely on the sustainability of those flows against the background of the indicators

I just mentioned. The best approach would have been to operate on the basis of the worst-case scenario. It is true that this might imply forgoing some of the benefits of the capital inflows, as Ariel Buira said, but if you look at the situation in which the country is now, it would have been advisable to forgo some of the benefits and not to have been confronted with the big losses and the difficult situation in which the country finds itself today.

Another lesson I would draw, which has not been stressed very much so far, is that a country should beware of short-term external financing, in particular denominated in foreign currency. In the case of Mexico this has clearly accelerated or prompted the crisis.

The final lesson relates to financial market liberalisation. I got the impression from conversations with Mexican officials that the authorities were well aware of the need to tighten monetary policy much more than they actually did, but they were fearful of doing so because of the fragility of the banking system. They were concerned that that might even lead to the collapse of the banking system. Hence, they did not tighten and they allowed the situation to deteriorate even further. From that experience, I'd draw the lesson that financial market liberalisation should not be done prematurely. It should only be done if you have a stable domestic banking system, including an effective supervisory structure that prevents the kinds of problems that worsened the case of Mexico."

Charles Wyplosz challenged the thesis of Buira's paper that it was a clear political problem which had caused the crisis. "I'd like to challenge that thesis, but not on the same ground as the previous discussant. Ariel Buira's argument that there was no clear economic problem is fairly convincing. There was no massive overvaluation and even if there had been some overvaluation - reference was made to some 20% before the event - the actual devaluation that came in December 1994 should have fixed it. Should there have been no crisis, everyone would have said: 'It's fine, that was the correction needed.' But that is exactly the moment the crisis started. So it cannot be just a matter of overvaluation.

Now, Bernd Goos is right that the monetary growth figures were a bit worrisome, but one could argue that this was a normal situation at the end of a period of inflation. Again, it's not an absolutely clear-cut case that the money growth was too lax, although there are some indications of that. But what I would like to argue is that while at first sight there seemed to be no clear economic problem, there was indeed such a problem, not a specific Mexican one but a more general one. The Mexican story should be familiar to us over here in Europe, because it is the result of two phenomena we have witnessed in Europe as well.

First, there is the aftermath of financial deregulation. We saw exactly the same syndrome in the United Kingdom and in various Scandinavian countries when they went through financial deregulation - the same fall in savings, the same deterioration in current account, and the same increase in the financing of private consumption, not investment, through capital inflows. So we know that this is

something that happens after financial deregulation, as it has happened all over, with the same results. The UK and the Scandinavian countries have gone through a massive exchange rate crisis. The reason is that the private sector borrows to finance consumption, and at some point the borrowing has to stop. That is when the crisis hits.

The second aspect of the Mexican crisis which is not generic to Mexico is the aftermath of successful disinflation. We have seen the same phenomenon in Latin America and, closer to home, in Italy. In the aftermath of disinflation, the interest rate is still very high, because credibility takes time to build up. In the meantime, capital flows on a very short-term basis are being sucked in because there is enough credibility to believe that there will not be a devaluation in the next two or three months. The interest yields are so high that it is impossible not to have this surge of capital inflows. So this is a problem which has nothing to do with the particular conditions of Mexico and which has created trouble in several other countries. This is the root of the problem.

In both cases, the problem is not long-term capital inflows, but short-term capital inflows. Therefore I would suggest that instead of looking for specific Mexican aspects and policy mistakes - sure, there were some policy mistakes - we should realise that there are some very generic problems at work here. We should focus our attention much more on the spontaneous capital inflows that take place when these kind of events happen.

There is another lesson that I would like to draw, if only because it has implications for Europe too, and that is the matter of the bandwidth. The picture that Charles Siegman gave us has this graphic representation of the sliding upper floor or lower floor of the peso. By the end, we see that the bandwidth was very large and could have given a feeling of security. A lesson we should remember from the European monetary system is: no matter how wide the band is, when a crisis unfolds, it unfolds, and it really goes through the ceiling very quickly."

Godert Posthumus observed that if the issue was familiar, either Mexico itself or its advisors could have warned Mexico earlier to try to take measures. According to Posthumus the problem was: at what moment should the Mexican authorities have acted? "If you look at chart 1 in Ariel Buira's paper, you see a long-term real appreciation over 4 or 5 years. If you look at chart 2, the current account balance had already been deteriorating for quite some time. It was known that it was short-term financing. But the real problem was at what point during those three or four years should Mexico have decided to act? Should it have acted earlier? Bernd Goos says: 'You should err on the cautious side,' but where does that moment strike?"

Jean-Jacques Rey stressed that it is very easy to look at the Mexican crisis with the benefit of hindsight - "things are much less obvious when you're in the midst of them" - and suggested making a distinction between the period from 1990 to early 1994, and the more recent period from February/March 1994 to the eruption of the crisis.

“It seems to me that this latter period is when the enormous current account deficit started being financed by very short-term capital flows, which considerably increased the vulnerability of the Mexican situation. It increased, indeed, at the time when all these dramatic criminal and political events occurred, and I find it remarkable that confidence was apparently still there during the initial months. To some extent this can be looked at as a market failure. One element that perhaps contributed to the crisis when confidence was so necessary was – and perhaps here I stand to be corrected, it is a question of memory – that when the devaluation was announced in December 1994, there was no impressive adjustment package accompanying the devaluation. This was a very dramatic element in the later evolution of the crisis.

From an economic point of view, it is much more complicated to say whether the Mexican authorities failed during the previous period, 1990 to 1993. There were some elements of overheating in the economy, but when you look at the Mexican economy you also have to take into account the demographic situation in Mexico; this is a country where demographic expansion and urbanisation are phenomenal, and it is crucial for Mexico to create jobs at a tremendous rate. You have to look at the policies being carried out in terms of these real factors as well. The question I have for Ariel Buira is the following: Now that the adjustment is dramatically taking place, with a tremendous reduction in GDP, isn't there a risk that this is also an unsustainable situation?”

Johannes Witteveen thought that Ariel Buira's description of the development of the Mexican situation was rather persuasive. In the view of Witteveen there is a more general problem hidden behind the Mexican crisis. “The main problem behind it is really these enormous capital inflows and their sudden turnaround. That is the general problem that emerges here – this enormous volatility of capital movements, occurring now in the climate of liberalisation. It is not so much the banks but the mutual funds and so on, the funds that react immediately to what they see, and act with a kind of herd instinct. I think that is a major problem.”

Witteveen wondered whether Charles Siegman's suggestion of letting the exchange rate float instead of keeping it fixed would be a good approach. “The question is, as Siegman said, wouldn't it be better then to let exchange rates float in order to dampen capital inflows somewhat? Of course, in a smaller economy, with a large international trade, a more or less freely fluctuating exchange rate is very bad for the real economy, causing serious dislocations. The question is therefore whether in such a case as Mexico's emerging economy, where they have these volatile capital flows, one couldn't consider a dual exchange rate. I know that this causes problems with control and things like that, but I also know that in some cases, for example Belgium or South Africa, this has been used for quite some time, with reasonable success. A dual exchange rate offers the advantage of some regulation of the capital flows without disturbing the real economy.”

Stephany Griffith-Jones observed that Ariel Buira's paper illustrated very clearly the extent to which the Mexican crisis was pushed by a dramatic change in perceptions. "None of us around the table imagined the crisis would have such dramatic proportions."

Nonetheless, Griffith-Jones believed Mexican policymakers could have anticipated a crisis. "One point that is obvious, but which was mentioned only in passing in Ariel's paper, is the increase in US interest rates. And though the political shocks were not known and it could not be forecast that they would continue, the clear upward trend of US interest rates during 1994 should have clearly told Mexican policymakers that the level of capital inflows that had been sustainable in 1993 - with incredibly low interest rates in the United States was not sustainable."

"Another point is how people should react to good and bad news. It's a difficult question. I like the sentence that John Williamson has in a recent paper that says 'All good news should be treated as transitory and all bad news should be treated as permanent'. Perhaps the main criticism one can make of the Mexican authorities, although of many other authorities as well, is that they did it the other way around.

With regard to the comparisons with Asia I think one has to be careful, because Asian countries have a very long-established tradition of macroeconomic stability as well as high savings rates; when one talks to investors, they look at Asian countries differently than they look at Latin America. The very fact that Latin America is more prone to crisis is a bit self-fulfilling. So I think large current account deficits in Asian countries are different, although also a risk.

Finally, I would argue that another interesting difference with Asia is that Asians are much more pragmatic than the Mexicans were, and than most Latin American countries were, on using some kinds of disincentives for short-term inflows. Countries like Korea and Malaysia are very pragmatic and when they see very large inflows they simply put on the brakes. And although this may not be very market-oriented it seems to work quite well," Griffith-Jones observed.