How Can Future Currency Crises à la Mexico Be Prevented?

Peter B. Kenen

Introduction

The answer to this question depends crucially on the meaning attached to the term "crisis." If the question asks how we can tranquillise capital markets in order to protect national economies from the need to adjust to fluctuations in cross-border capital flows, the answer is simple: We can't. If the question asks how we can minimise the disruption to national economies resulting from fluctuations in cross-border flows, the answer is complicated. It is, in fact, more complicated than suggested by recent official pronouncements, which seem to be saying that capital markets will behave benignly if governments can get the "fundamentals" right. That will not always happen. On the one hand, the behaviour of capital markets is not always governed by the fundamentals. On the other hand, governments will not always get them right. It is therefore necessary to ask 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 confront it. I start by explaining my strong statement about markets and fundamentals. Next, I ask how governments can reduce the vulnerability of their economies to the volatility of cross-border flows, *ex ante* and *ex post.* Finally, I look at the ways in which international institutions, especially the International Monetary Fund, can help governments cope with fluctuations in cross-border flows.

Markets and Fundamentals

What happened in the first half of 1994, when Mexico's troubles began to build up? Was there a major deterioration in the fundamentals? Or did something else go wrong?

There was some deterioration in the fundamentals, but not very much. The current account deficit was bigger in the first quarter of 1994 than it was in the previous quarter, but no bigger than it was in the quarter before that. The monetary base, while slightly higher than it was in the previous quarter, was very stable in the first half of 1994. The real exchange rate was levelling out, after

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

appreciating steadily from 1988 to 1993, and the inflation rate was still falling. The gap between Mexican and US interest rates narrowed during the first quarter of 1994, due to the increase in US rates, but widened again in the second quarter.

It is now agreed, with the benefit of hindsight, that Mexico's current account deficit was too large and that the peso was thus overvalued. But that was no less clear before the cessation of capital inflows in the spring of 1994, which set the stage for the subsequent exchange rate crisis. The cessation was not due to a sharp shift in the markets' views about the economic outlook. It was due to a shift in views about the political outlook and, in particular, the political fate of the policy-making team in which markets had great confidence - the team that was deified before the crisis but demonised after it. The shift in the markets' views cannot be ascribed to a change in the way that markets were reading the Mexican numbers. It must be ascribed to the way that markets were reading the Mexican headlines - the news of unrest in Chiapas and the Colosio assassination.

If markets have confidence in a government's ability to maintain or restore economic stability without changing policy parameters abruptly, they do not react strongly to a gradual deterioration in the fundamentals. If their confidence is shaken by bad news, they are apt to react very strongly indeed, even if there has been no appreciable change in the fundamentals. That is what happened in the Mexican case. It is also what happened in the Italian case two years before. The capital outflow that started in August 1992, which led to the departure of the lira from the EMS, was not due to deterioration in the fundamentals. It was due to a change in the markets' views about the political situation - the strength of the Italian government's commitment to reduce its budget deficit. This change was due in turn to reports of a change in French public opinion regarding the Maastricht treaty. If French voters were to reject the treaty, the Italian government would have less incentive - and political cover - to face its fiscal problems and defend the lira.

These assertions have two implications. First, the markets' view about a particular country will always be volatile, not subject to gradual reassessment in the light of underlying economic trends. This conclusion challenges the newly popular view that the prompt production of economic statistics can, by itself, contribute substantially to the stabilisation of capital flows. Second, a country cannot protect itself from the volatility of capital markets unless it is willing and able to forgo some of the benefits of capital inflows, to limit the inflows themselves, or to make policy changes with the speed and vigour required to offset any unforeseen shock to confidence. Let me expand on these possibilities.

The Benefits and Costs of Capital Inflows

A country confronting a capital inflow faces a difficult choice. If it does not allow the inflow to affect the domestic economy in any important way, apart from

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

raising the prices of the financial assets that foreign investors seek to buy, it cannot benefit appreciably from the capital inflow. Suppose that the central bank intervenes in the foreign exchange market to keep the home currency from appreciating and is able to sterilise the monetary impact of its intervention. There will not be any significant change in aggregate demand and no change in the current account balance. The additional claims held by foreign investors - the counterpart of the capital inflow - will be matched by the additional foreign claims held by the central bank.

This is, of course, the optimal response when a capital inflow is thought to be temporary, but it will be costly and difficult if the inflow is large or long-lasting. It will be costly because the rate of return on the claims acquired by foreign investors will usually exceed the rate of return on the reserves acquired by the central bank. It will be difficult because the central bank may not be able to sterilise a large increase in reserves without raising domestic interest rates, which will usually produce a larger capital inflow.[1]

To take this course of action, moreover, is also to forgo the main benefit of a capital inflow - the ability to borrow real resources by running a current account deficit - and is thus the wrong one to take if the capital inflow can be expected to continue for a long time. To run a current account deficit, however, a government must let its country's currency appreciate in real terms, and there are two ways to do that. The central bank can intervene, as before, to keep the nominal exchange rate from changing but allow the resulting increase in reserves to raise the money supply and domestic price level. Alternatively, the central bank can abstain from intervening and let the nominal exchange rate change in response to the capital inflow.

There are three reasons to let the nominal exchange rate change. First, a change in the nominal rate is more readily reversed than a change in the price level. Second, the change in the nominal rate depresses the home currency prices of traded goods, whereas a one-off increase in the price level may ignite inflationary expectations. Third, a change in the nominal exchange rate serves to remind foreign investors that exchange rate risks are real, which will curb their appetite for assets denominated in the currency of the capital-importing country and thus limit the inflow itself.

But any attempt to exploit a capital inflow by running a current account deficit runs the risk of reversing the inflow by casting doubt on the sustainability of the situation. Markets do not like deficits - neither budget deficits nor current account deficits. They are particularly nervous about current account deficits that are not fully matched by an increase in domestic investment (which may be why markets have been less nervous about the current account deficits of Asian

1. A number of developing countries have tried to offset capital inflows by sterilised intervention but were forced to abandon the effort because the inflows were big or long-lasting; see International Monetary Fund, *International Capital Markets*, Washington, 1995.

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

countries than those of Latin American countries). I know of no way to define in advance a sustainable current account deficit, although its size is surely larger when it is indeed matched by an increase in investment.[2] It is probably wise to err on the side of caution and thus to start worrying if the current account deficit exceeds 3 or 4% of GDP. If the capital inflow is larger than that, as it was in the Mexican case from 1991 to 1993, the current account deficit must be held down by using sterilised intervention to limit the appreciation of the home currency or by repelling part of the capital inflow when sterilisation is too difficult or costly.

How can one repel a capital inflow? Most economists, officials, and market participants agree that controls on capital outflows are not very effective and can be counterproductive, but there is less agreement about controls on capital inflows. They appear to have been effective in curbing capital inflows to several countries - the Chilean case is widely cited - and there is an a priori reason for expecting them to be more effective than controls on outflows. When owners of capital want to remove it from a particular country, it is usually because they fear large losses. Hence, they are prepared to incur the costs of avoiding or evading controls on capital outflows. When owners of capital want to invest in a particular country, by contrast, it is usually because they expect to earn modest profits compared to those they could earn by investing elsewhere. Hence, they may not be prepared to incur the costs of avoiding or evading controls on capital inflows.[3] They will go elsewhere.

Coping with Capital Outflows

If a country attracts more foreign capital than it can absorb safely by running a moderate current account deficit, it can surely count on suffering very large capital outflows later.[4] But no capital-importing country can avoid them completely - not even one that manages those inflows successfully. Too many things can go wrong at home and abroad. How, then, can a country minimise the impact of those outflows?

---

2. I am puzzled by the popular assertion that a current account deficit is less likely to be sustainable if a country is running a large budget deficit - unless this is merely another way to say that the current account deficit should be matched by an increase of investment rather than an increase of public or private consumption. I am all the more puzzled when countries are told to reduce their budget deficits because they want to raise their current account deficits but are also told to reduce their budget deficits because they want to cut their current account deficits. But this advice comes largely from central bankers, who always favour smaller budget deficits.

3. This point is made in the 1995 IMF report cited above, which is remarkably tolerant of taxes and direct controls aimed at limiting capital inflows.

4. When I refer here to outflows, I have in mind reductions in inflows as well as outright outflows. A reduction in inflows, however, can induce actual outflows, including capital flight. This seems to have happened in the Mexican case, where there was at first a sharp fall in inflows of foreign capital and then, at the time of the devaluation, a large outflow of domestic capital; see the account in the IMF report cited above.

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

The size of the outflow can itself be limited by raising domestic interest rates, but the size of the requisite increase will depend on the markets' expectations concerning a country's currency. If markets expect a large depreciation or devaluation, a very large increase will be needed to limit if not halt the capital outflow, and the recent experience of Mexico shows how costly that can be - not only to debtors, including the government, who must pay the very high interest rates, but also to creditors, whose debtors can no longer meet their obligations. Banks and other financial intermediaries are especially vulnerable. They are hit twice by high interest rates - as debtors who must pay higher rates to their depositors, and as creditors who cannot collect from their debtors. If the banks are fragile initially, as they were in Mexico and Argentina, a temporary increase of interest rates can have permanent effects on the banking system. If the government has to step in, moreover, the fiscal effects can be large.

The adverse effects of high interest rates are, of course, compounded when the home currency is allowed to depreciate or is devalued deliberately and some of the foreigners' claims on the country are denominated in foreign currencies. These extra effects can be minimised by limiting severely the amounts of foreign currency debt that firms, banks, and the government may incur. It is especially important to limit the stock of short-term foreign currency debt and to spread the maturity dates on stocks of long-term debt. Mexico's currency crisis became a debt crisis because the Mexican government had issued large amounts of short-term dollar-indexed debt, the so-called *Tesobonos,* to minimise the drain on Mexico's reserves when foreigners began to run down their holdings of peso-denominated debt, the so-called *Cetes.*

It is better, however, to avoid these additional problems completely by defending the domestic currency when capital outflows begin, rather than letting it depreciate.[5] If the currency can be defended successfully, it will not be necessary to raise domestic interest rates hugely (i.e. to offset expectations of a change in the exchange rate). If the capital outflow continues, of course, it will be both necessary and appropriate to let the domestic currency depreciate or to devalue it deliberately, because the current account deficit must be reduced.

A successful defense of the exchange rate, however, may not be possible without international assistance. If a capital-importing country runs a current account deficit, it will not increase its reserves by enough to offset fully the increase of foreigners' claims. When an inflow gives way to an outflow, moreover, the latter can be larger than the former, because the exodus of foreign capital can induce an exodus of domestic capital. This brings me to my final topic: the role of the international community and, specifically, the role of the IMF.

5. Defending the currency does not necessarily mean pegging it rigidly. It does mean, however, that the authorities should not change their exchange rate arrangements abruptly. On this definition, a country that has kept its exchange rate within a band should not widen or shift the band suddenly. If the band has been "crawling" at a specified rate, it should not be allowed to crawl faster.

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

The Case for International Assistance

At the start of the 1982 debt crisis, every effort was made to postpone the day on which banks would have to recognise losses, because of concerns about the effects on the banks' capital and thus on confidence in the banking system. Debt rescheduling could not give way to debt reduction until the banks had built up their capital enough to take the necessary losses.

In 1994, by contrast, many of Mexico's creditors took losses right away because of sharp falls in the foreign currency values of their peso-denominated claims. But most of those creditors were not badly hurt, as their claims on Mexico were not very large compared to their total assets or, more importantly, their net worth. It was not immediately obvious then that the new Mexican crisis threatened the stability of the international financial system. Nevertheless, the US Treasury and IMF came to the aid of Mexico on an unprecedented scale. Why?

Many observers invoke NAFTA and other special links between Mexico and the United States to explain why the US Treasury wanted to help Mexico. Some of them go on to explain that the IMF got involved when Congressional opposition kept the United States from going forward on its own. No package after one had been promised would be the worst of all possible outcomes from the Mexican standpoint, but other observers argue that the Mexican crisis threatened to have systemic consequences and that the IMF had therefore to act as lender of last resort to the system.

This claim is not persuasive. There is ample evidence of contagion in the wake of the Mexican crisis, just as there was in 1982. Stock markets plunged in several emerging market countries, and several currencies came under pressure, but contagion is not synonymous with systemic risk. The international financial system would not have been badly damaged had there been acute crises in several emerging market countries. Without the promise of large-scale financial support, of course, Mexico might have been forced to suspend redemptions of Tesobonos, and this might have been more serious - a blow to confidence in the unwritten rules of the financial system. Still some might say that it would have been wiser to face that possibility than to bail out a government that had made serious errors.

All of these issues, however, arise from the basic misconception that the IMF was created to cope with systemic risk and thus act as lender of last resort when that risk arises. If that were the case, of course, the IMF would never come to the aid of Costa Rica or Sierra Leone, not even Peru or Nigeria. They are too small to threaten the stability of the international financial system. The IMF was meant to solve one important systemic problem - to help its members forswear beggar-thy-neighbour policies when dealing with balance of payments deficits; with help from the IMF, they could buy the time required to implement less harmful policies. But the IMF had a larger purpose: to provide a framework for collective support in times of individual distress.

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

Several years ago, Max Corden compared the IMF to an insurance company, because it protects its members from certain calamities. I objected to that analogy. Although there is an actuarial relationship between the premiums charged by an insurance company and its total payments to its policyholders, the premiums paid by an individual policyholder do not limit the benefits paid to that policyholder when a calamity strikes. The benefits, moreover, are not loans; the policyholder does not have to pay them back. Because most drawings on the IMF must be repaid, and the amounts that members can draw are normally determined by their quotas, which also determine their subscriptions, the IMF is more like a credit union. Relations among its members are based on the principle of mutual support.[6]

The size of the IMF itself was based implicitly on the supposition that its resources would be used to finance temporary current account deficits; in fact, the IMF was forbidden to make its resources available for offsetting capital flows. With the growth and globalisation of financial markets, however, reserve credit needs have risen enormously. There is thus some truth in the claim that the huge support package for Mexico was the first twenty-first-century package. There is thus a strong case for a very large increase in IMF quotas to give the Fund the resources it will need and allow it to provide large-scale assistance to its members within its traditional quota-based framework. However, there is not likely to be any such increase for the next few years. No one can hope to steer it through US Congress, which will surely say that the US Treasury, having used the IMF to circumvent Congressional opposition to its original plan for Mexico, is now asking the Congress to reimburse the IMF. Nor will there be support from those European countries that had their own objections to the role of the Fund in the Mexican crisis.

Other, stop-gap solutions are being discussed, including an enlargement of the General Arrangements to Borrow (GAB), but they have one drawback: large-scale assistance to a single country on the scale required to cope with a big capital outflow will still call for *ad hoc* exceptions to the quota-based rules governing access to IMF credit. I have therefore proposed a different approach, designed expressly to deal with the special problems of emerging market countries - those that run the risk of sudden and large capital outflows. At a previous FONDAD meeting I made this suggestion:

> The staff of the Fund could recommend that such countries undertake to build up their reserves. The target could be formulated in flow or stock terms ... Once such targets were agreed, the staff could recommend that

6. See W.M. Corden, "Is There an Important Role for an International Reserve Asset Such as the SDR?" in G.M. von Furstenberg, ed., *International Money and Credit,* International Monetary Fund, 1983, and my reply in P.B. Kenen, *Financing, Adjustment, and the International Monetary Fund,* the Brookings Institution, 1986. (I went on to argue that Corden's analogy is flawed for another reason. It led him to treat the problem of moral hazard as the rationale for conditionality. The problem of moral hazard calls for preventive measures rather than corrective measures; it may justify IMF surveillance but not conditionality.)

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

> the countries meeting them be promised supplementary access to Fund credit, above and beyond their ordinary drawing rights. The amounts of supplementary credit would be geared to each country's reserve target. ... The supplementary credit would be made available under the conditions normally applied to drawings in the first credit tranche, without imposing onerous policy conditions; it would be made available *pari passu* with the use of the countries' own reserves.[7]

This proposal could easily become the basis for creating a new IMF facility, which may be called for convenience the Contributed Resources Facility (CRF).

The CRF would be open to any developing country willing to deposit some of its reserves with the CRF in exchange for the right to draw a multiple of its deposit when facing a sudden, severe balance of payments problem of the sort usually associated with a large capital outflow. The liquidity of the CRF could be protected by enlarging the GAB and amending the conditions on which it can be activated; drawings on the CRF large enough to impair its liquidity would be deemed to constitute an "impairment of the international monetary system" and thus be a basis for activating the GAB.

A country's right to draw on the CRF would depend on its willingness to submit to intensive IMF surveillance. That process would involve a continuing dialogue with the Fund concerning the country's actual and contingent policies - those the country should pursue to achieve and maintain a sustainable balance of payments position and those it should adopt if faced by a very large capital outflow. A country drawing on the CRF might be expected to make an IMF ordinary drawing at the same time but should not have to defer a drawing on the CRF until it has negotiated the terms and conditions of an ordinary drawing.

This proposal has two advantages over most other proposals for dealing with exceptional situations. First, it would not involve any discrimination between large and small countries; participation would be voluntary and open to every developing country regardless of size. (An absolute or quota-based floor and ceiling might nevertheless be imposed on each participant's contribution to make sure that the CRF will be of significant size and to protect its liquidity against a drawing by a single, dominant participant.) Second, the proposal would not require *ad hoc* exceptions to the Fund's quota-based policies, because it would involve the use of additional resources contributed by the participants themselves.

The proposal has an obvious disadvantage. If a disagreement between a country and the Fund regarding the country's actual or contingent policies would lead automatically to a suspension of the country's right to draw on the CRF, many countries might be quite reluctant to participate. Each country would have to

---

7. See P.B. Kenen, "Reforming the International Monetary System: An Agenda for the Developing Countries," in J.J. Teunissen, ed., *The Pursuit of Reform*, Fondad, 1993.

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

weigh the advantage of participation - the ability to draw a multiple of its reserve deposit - against the risk of participation - the risk of being barred from using its reserve deposit. Clearly, the attractiveness of participation would depend on the size of the multiple, but if it were made large enough to attract wide-spread participation, a single drawing by a big participant could impair the liquidity of the CRF. Alternatively, participation could be made more attractive by reducing the risk that disagreement between a country and the Fund would bar a country from drawing on the CRF. Relaxing the rigor of surveillance, however, might cause the industrial countries - the parties to the GAB - to oppose creation of the CRF or insist on restricting use of the GAB to maintain the liquidity of the CRF. These issues require more thought.

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org