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Testimony by

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I am pleased to appear before this Committee today to review the Mexican economic and financial situation and the important efforts underway to avoid a major international financial disruption and to restore market confidence in Mexico.

Mexico's current financial difficulties are best understood in the context of much broader trends in international finance during the last ten to fifteen years--the globalization of finance--in which Mexico in recent years has participated and from which it has benefitted. As a result of very rapid increases in telecommunications and computer-based technologies and products, a dramatic expansion in financial flows across borders and within countries has emerged. The pace has become truly remarkable. These positive technology-based pressures have affected the behavior of markets to a point where governments, even reluctant ones, increasingly felt compelled to deregulate and free up internal credit and financial markets.

While there can be little doubt that these extraordinary changes in global finance have on balance been beneficial in facilitating significant improvements in economic structures and living standards throughout the world, they also have some potential negative consequences. In fact, while the speed of transmission of positive economic events has been an important plus for the world in recent years, it is becoming increasingly obvious, and

Mexico is the first major case, that significant mistakes in macroeconomic policy also reverberate around the world at a prodigious pace. In any event, progress--and indeed developments affecting the emerging global financial system are truly that--is not reversible. We must learn to live with it.

Mexico, which had been hobbled for a number of years following the debt crisis of 1982, has more recently gone through a major economic metamorphosis toward significant improvement in its economic and financial structure. As a consequence, Mexico has been able to broaden its participation in the global economic and financial environment.

Over the past decade Mexico has made major strides. It has shed what was an inflation prone, highly unstable, economic structure with excessive government involvement and has taken on the characteristics of a vibrant economy oriented toward open markets. As a result, in 1990 Mexico was able to reenter the international credit markets on a significant scale. Foreign investors began voluntarily lending to Mexico substantial amounts for the first time since 1982. Shortly thereafter, as is characteristic of the new global financial system, foreign capital investment in Mexico began to accelerate. Indeed, in 1992 and 1993, the inflow of capital was so considerable that the Bank of Mexico had to <u>buy</u> dollars on a substantial scale to prevent the peso from becoming too strong. As a consequence,

Mexico's international reserves increased to well over $25 billion at their peak in early 1994 from under $10 billion in 1990. Nonetheless, Mexico's trade deficit soared and its current account deficit reached approximately six percent of GDP in 1993.

As part of efforts to accelerate its move toward status as an industrial country, the government of Mexico endeavored to link the peso to the U.S. dollar. It adopted a complex, exchange-rate regime through which the Mexican peso was linked to the U.S. dollar via a moving exchange-rate band. Like many nations that have tried to "import" the anti-inflationary policies of another country by locking their exchange rates, to a greater or lesser extent, to the currency of a major trading partner, Mexico hoped to gain quick benefits through significant reductions in inflation. And indeed, Mexico was remarkably successful for several years. The inflation rate fell sharply from almost 160 percent in 1987 to 7 percent by 1994, but at the same time Mexico was losing international competitiveness and its current deficit widened.

However, the exchange rate policy adopted by Mexico was risky with little tolerance for policy error or capacity to absorb shocks. This fact is especially relevant in the context of a world where portfolio investments can shift rapidly into and out of a country. At a minimum, a close adherence to the monetary policy of the host nation is required. The breakdown of the Exchange Rate Mechanism of

the European Monetary System in 1992 was a particularly striking case of trying to lock exchange rates together when comparable economic forces were not close to being identical among the countries.

Moreover, a considerable part of the surge of capital into Mexico in the 1990s has been in portfolio investments, which may move in quite rapidly but also can try to move out just as rapidly, as has been demonstrated in recent months.

Investors' appreciation of the momentum behind Mexico's transformation began to wane in early 1994, at least in substantial part as a consequence of noneconomic events--the Chiapas uprising, political assassination, and the August election. Foreign investors at times became somewhat hesitant. Such hesitation presented problems because Mexico needed to continue to finance the large excess of its imports over its exports which emerged initially as a consequence of the earlier spontaneous capital inflows. Moreover, Mexico not only needed to attract new portfolio and direct investments, but also to hold on to the portfolio investments it already had. Direct investment by its very nature, of course, is largely immobile, but portfolio investments are less so. In this context, simply allowing the trade balance to adjust precipitously to the reversals of capital inflows could well destabilize Mexico's economic and trading relations.

As 1994 progressed, private foreign investment inflows slowed. In their endeavor to support the exchange rate and to finance the very large current account deficit, the Mexican authorities drew down Mexico's foreign exchange reserves. At the same time, Mexico borrowed short term in dollars and in Tesobonos, which are debt obligations the peso value of which is linked to the peso-dollar exchange rate. Mexican authorities evidently believed or fervently hoped that the reduction in foreign investor interest was temporary and that after the uncertainty of the August election was behind them, confidence and private capital inflows would reemerge. If so, they were tragically mistaken.

Meanwhile, it became increasingly clear to many observers during the autumn that the prevailing level of Mexico's exchange rate could not be sustained short of a significant further tightening of monetary policy. But by then it was by no means clear that the degree of tightening required to support the peso was consistent with economic growth. Mexican authorities apparently were loath to risk recession, hoping instead for a spontaneous return of foreign confidence and capital. But in retrospect it is clear that even if private capital inflows had again accelerated, it was unrealistic to expect them to match the pace of 1993, which was arguably unsustainable. The chosen alternative to dramatically tightened monetary policy, borrowing via Tesobonos and drawing on reserves to intervene

in the foreign exchange market, had a limit. Indeed, that limit was reached on December 20, and the defense of the peso came to an abrupt end.

Had the adjustment of the peso been made much earlier in the context of a much tighter monetary regime, it is likely to have resulted in a more limited decline rather than in the abrupt collapse that Mexico experienced.

I suspect that had this episode played out, say a couple of decades ago, when the global financial system was far less sophisticated, the immediate decline in the peso's value would have been far smaller than the more than 30 percent decline experienced since December 20. The ability of foreign and, no doubt, domestic portfolio capital to flee into dollars was far less twenty years ago. Conversely, it probably would not have been possible for Mexico to have attracted so much foreign portfolio capital in the first place.

Looking back, the moving exchange-rate band for the peso apparently failed to compensate fully for the widening differential in prices of tradable goods denominated in dollars compared to such prices denominated in pesos. Accordingly, the peso exchange rate at 3.5 to the U.S. dollar was arguably not sustainable indefinitely short of an unrealistically massive increase in domestic saving in Mexico or a continuation of the very large foreign capital inflows of 1992 and 1993 with such inflows being heavily invested in cost-reducing capital formation. It is

imaginable that such a continuation of private flows could have sustained the exchange rate while bringing the underlying Mexican cost structure into line with 3.5 pesos to the dollar. But the needed level of private capital inflows that would have to have been invested in capital formation--rather than being devoted to increased consumption--could not credibly be sustained. In the end, Mexico's high-risk exchange-rate strategy failed.

As a consequence of Mexico's financial difficulties, and the potential movement of vast, financial resources around the world, the problem that we now face is that there have been withdrawals of capital from a number of widely dispersed nations--industrial as well as developing. If economically advanced Mexico is having difficulties, it is being argued, perhaps the outlook for other nations dependent on foreign capital inflows is suspect more generally. Financial markets in Brazil and Argentina already have felt the repercussions of Mexico's problems. There is also some evidence that similar pressures have emerged in other developing countries, those not even remotely related to Mexico, for example, in Asia and in central Europe, as well as in a few industrial countries.

Financial officials both here and abroad initially thought it possible that the difficulties in Mexico would reach a climax and resolve themselves, and that market adjustments would quickly be made, removing the threat of widespread contagion affecting the international financial

system. Mexican financial markets and the peso continued to fester and showed no evidence of stabilizing, and we at the Treasury and the Federal Reserve concluded that a resolution of the situation was not imminent, short of more dramatic action to confront Mexico's confidence problem.

The situation had moved beyond one capable of being addressed by short-term lending facilities provided by the Exchange Stabilization Fund of the U.S. Treasury, the swap arrangement of the Federal Reserve System, and other central banks acting through the Bank for International Settlements. The decision to implement the type of guarantees of credit market borrowings by Mexico that now appears to be necessary has broad implications that can only be addressed appropriately by the political leadership of this country.

The objective of the proposed guarantee program is to halt the erosion in Mexico's financing capabilities before it has dramatic impacts far beyond those already evident around the world. This program in my judgment is the least worst of the various initiatives which present themselves as possible solutions to a very unsettling international financial problem. Our concerns are not so much with potential losses to the American taxpayer, which we believe will be minimized, but with what economists call moral hazard where the active involvement of an external guarantor distorts the incentives perceived by investors. Thus, appropriate conditionality must be associated with the guarantees to underline the fact that they are being

high cost and on rigorous terms in exceptional circumstances. Moreover, Mexico's economic policies are the key to ensuring that the guarantee facility actually does help to stabilize the Mexican economic and financial situation; ultimately only sound policies that are sustained over time will restore investors' confidence in Mexico. External guarantees can only offer temporary support. Nonetheless, I see no viable alternative to the type of program that is being presented to the Congress if the financial erosion is to be stanched before it threatens to become a wider problem.

I want to emphasize that once the Mexican situation is stabilized, it will be important for the authorities of leading governments to examine closely the lessons to be learned from this latest episode in international finance, and to determine how to deal with similar emerging financial problems that have implications for the health of our free market-based international financial system.

I have no doubt that, as a consequence of the Mexican episode, other developing nations have become sensitized to the problems of depending too heavily on large inflows of foreign portfolio capital. This tendency of the new global financial system should, as a consequence, become largely self correcting in much the same manner that recent losses on derivative instruments have helped to condition those markets.

What happens to Mexico is of particular importance to the United States. Because of the extensive interchanges across our common border, our economic destinies are closely intertwined. Mexico is the third largest market for U.S. exports and the third largest source of U.S. imports, with about $50 billion shipped each way last year. Illegal immigration from Mexico is inversely related to economic growth and progress in Mexico. It is important to the United States politically as well as economically, therefore, that Mexico succeed in reestablishing sustained non-inflationary growth. To achieve this, market confidence in Mexico's economic potential and financial stability must be restored.

However, what happens in Mexico also must be viewed from a larger, historical perspective. The developments of recent weeks also need to be evaluated in the context of the Cold War and its aftermath. It became particularly evident to developing countries over the past decade that the economic and political regime that characterized the Soviet Union was fatally flawed and that the economic structure of the United States and the rest of the industrial world based on free markets and private ownership was clearly a superior model for developing nations to emulate. Indeed, in recent years there has been a remarkable trend in that direction characterized by pervasive privatization, price and wage decontrol, and the development of financial structures as

developing countries endeavored to replicate elements of the advanced free-market economies.

The model of economic and political transition from a rigid state-directed system toward a free-market structure was perceived to be Mexico. Starting from a low base in the mid-1980s, Mexico managed to turn itself around in such an extraordinary way that many of the finance ministers and central bankers of the developing nations looked to, and consulted with, their counterparts in Mexico to learn the mechanisms that the Mexican authorities had employed to achieve near-first-world status. Indeed, in 1994 Mexico was admitted to the OECD, the organization of industrial nations, a de facto badge of first-world status.

Unless Mexico's efforts to restore economic stability and financial market confidence succeed, years of economic reforms in Mexico would be threatened by pressures to reimpose controls in many areas of its economy and to reestablish governmental interference in Mexico's increasingly vibrant private sector. In addition, a reversal of Mexico's economic reforms and a spread of Mexico's financial difficulties to other emerging markets could halt or even reverse the global trend toward market-oriented reform and democratization. This would be a tragic setback not only for these countries, but for the United States and the rest of the world as well.