

Draft Talk for Thermo-Electron Officers, April 7, 1995

2 topics - Intl & Natl. M.P.

Today I plan to trace the developments that led to the peso crisis and the wider upheavals in the foreign exchange markets. I'll also outline some lessons and questions emerging from these events, since, in an integrated world economy, such turmoil may recur with growing frequency.

Most analysts agree that Mexico's pre-1994 monetary and fiscal policies, while not perfect, need not have led to disaster. Real interest rates had been rising for years, and Mexico's fiscal stance compared favorably with that of some industrial nations. Still, once confidence was shaken by political events, Mexican policies greatly aggravated the situation. After the Colosio murder last March, the government had two choices -- to devalue the overvalued peso or to tighten policy significantly. In fact, it did neither. Rather, the government spent down its sizable stock of foreign exchange reserves to keep the peso within its crawling band while it increased its offers of tesobonos, short-term

securities payable in pesos but indexed to the dollar. From January to December, the Mexicans let their reserves fall from \$27 billion to \$6 billion while the stock of tesobonos outstanding rose from \$2 billion to \$31 billion. This policy led to a devaluation under highly adverse conditions.

Since the devaluation, Mexico's compelling need has been to restore confidence that investor returns will not be devoured by soaring inflation or ongoing peso devaluation. The \$50 billion international rescue package, including the \$20 billion U.S. share, is intended to give Mexico the resources to stabilize the peso and redeem maturing tesobonos it cannot roll over into long-term debt.

Unfortunately, restoring confidence after a devaluation is not easy. A large devaluation often spurs a surge in inflation, while the stringent policies required to curb consumption and price spikes produce recession and bankruptcies. Such conditions are not conducive to a massive reflow of foreign capital. And, in Mexico, circumstances have not been optimal. The devaluation was inept, international support was uncertain, and the Mexican

government was very slow to announce a credible policy response. Early on, analysts thought the peso would stabilize at about 5.0 pesos per dollar, real GDP would be flat in 1995, inflation might be limited to 20 percent, and the current account deficit would be halved. By the time Sr. Ortiz outlined the Mexican policy package on March 9, he had to assume that the peso would recover to 6.5 pesos per dollar, real GDP will fall by 2 percent in 1995, annual inflation will be over 40 percent and the current account deficit will almost vanish, falling by \$27 billion in one year. In other words, the Mexican people face economic adjustments far harsher than first expected.

Sadly, the Mexican crisis has hurt other developing countries as well. In particular, Brazil and Argentina have been adversely affected, even though their payments and reserve positions are quite different from Mexico's. For example, because of capital flight provoked by the Mexican crisis, Argentina now faces recession rather than the 4.5 percent growth once forecast for this year. Since 1991, when Argentina adopted reforms under

which every peso in circulation is backed by a U.S. dollar, hyperinflation has dropped to a 5 percent annual rate, and the country has enjoyed 7 percent annual growth. Since December, however, capital outflows have set off a contractionary spiral that resulted in government austerity, soaring interest rates, and a run on the banks. Thus, Argentina has had to turn to the IMF and others for funds to develop a lender-of-last-resort facility.

Investors have also taken an increasingly sceptical look at the currencies of industrial countries with large fiscal or current account deficits and political uncertainties. In Canada, the 1994 government deficit amounted to 6 percent of GDP, foreigners usually finance about one-fourth of the deficit, rating agencies have announced downgrades, and Quebec separatism lurks; so, the Canadian currency has fallen to a series of new lows against the U.S. dollar, despite sharp increases in short-term rates.

In Europe, meanwhile, the French franc, the lira, the peseta, and the pound all fell to historic lows against the mark despite much intervention and spikes in short-term interest rates. While

French fundamentals remain akin to Germany's, in Spain and Italy, underlying conditions are less promising. Beyond their political scandals, Spain and Italy also have huge fiscal deficits compared to GDP. Although the 1992-93 crisis had already widened the ERM currency bands to 15 percent, by late February the peseta was threatening to breach even that generous limit. Thus, on March 5, Spain and Portugal devalued by 7 and 3.5 percent.

Although the U.S. dollar has drifted down for months, on March 2 its fall abruptly turned precipitous. Prominent among media explanations for the dollar's sudden weakness were: 1) market participants understood Chairman Greenspan to say that the Fed had stopped raising rates, while the Bundesbank was widely expected to tighten; and 2) the Mexican crisis will enlarge the U.S. trade deficit and the Fed might hesitate to raise interest rates for fear of worsening Mexico's problems. Other factors include Japanese year-end window-dressing, the failure of the balanced-budget amendment, and a secular decline in the global importance of the U.S. economy and investors' related desire to

diversify their assets. The run on the dollar abated when Mr. Greenspan testified that another interest rate rise was not beyond question and when the Bundesbank actually lowered official rates on March 30. Since then, however, the dollar has resumed falling. Currently, it stands 11 and <sup>14</sup>~~13~~ percent below year-end values versus the mark and the yen. Against a basket of 45 currencies, adjusted for inflation, the dollar has fallen about 7 percent. So far, U.S. officials have not been greatly worried about the impact of the dollar's recent fall on demand or inflation. The effect on Japan, with its relatively weak recovery, is more serious.

Indeed, the impact of the recent currency shifts will generally be greater abroad than in the relatively self-contained United States. These consequences include a more abrupt and steeper slowdown in Latin America than previously expected or needed to correct emerging disequilibria, with the result that promising economic and political reforms could become derailed. Other developing and non-core European nations will also find borrowing abroad more costly; in particular, lenders are turning a wary eye

on the Philippines, Italy, Greece, and Turkey as they seek the "next Mexico." More broadly, recent events reduce the likelihood that any country will act as lender of last resort in the global arena. The successful conclusion of the EMS or a further expansion of NAFTA also seem more remote. In sum, the net result appears to be increased sympathy for isolationism.

What have we learned over the past few weeks? On the whole, the experience has reinforced lessons we already knew. For example, official intervention in a foreign exchange crisis is only rarely useful; governments do not have the resources to impress the trillion-dollar-a-day currency markets unless they act when private investors have turned indecisive. Moreover, a crisis involving many individual investors is harder to damp than a crisis involving a handful of big banks. In addition, countries depending on foreign capital must run scrupulously conservative fiscal and monetary policies; otherwise, they face a damaging crisis on a moment's notice. But, recent events have also shown that speculative attacks can create or aggravate crises that were not

inevitable. Efforts to peg exchange rates can be defeated when speculative capital flows drain reserves. And crises can become self-fulfilling when capital outflows make a once tenable policy unsustainable. The collapse of the ERM in 1992-93 occurred largely because the cost of retaining a tight link to the strong mark was deemed too high -- in terms of exorbitant interest rates and lost employment -- to be sustained when most of Europe was in recession. In Argentina, capital outflows created a vicious cycle when the resulting domestic contraction and spreading banking crisis placed the convertibility plan in doubt.

How can governments gain more room to manoeuvre when speculators can ruin a once-viable policy in days? History shows that capital controls are futile and undesirable. Alternatively, Keynes, Tobin, and others have argued for a global tax on all foreign exchange transactions. While such a tax might add weight to fundamentals versus speculative instincts, critics find this idea just as unworkable as capital controls.

Some theorists suggest the global monetary system needs a

lender of last resort. In most domestic banking systems, a lender of last resort lends freely at high rates to stem a run on an institution whose collapse poses a systemic risk. The IMF was not designed to act in that capacity, and national governments find it hard to fill the gap. In any context, however, creating a lender of last resort raises issues of precedent and moral hazard. Thus, many observers stress the need for added government discipline, shared information, and investor prudence. Another proposal currently being aired involves finding a way to apply bankruptcy protection to nations. In the wake of recent events, such issues are likely to get -- and deserve -- renewed debate.