

## Speeches by Bob McTeer

### Comparing the Asian Crisis and the Mexican Crisis: One Central Banker's Perspective

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The first financial crisis I witnessed up close and personal was the Maryland S&L crisis in 1985. Maryland is a state on our East Coast. The crisis there was triggered by an unrelated failure in Ohio that broke Ohio's private insurance fund. Ohio is a Midwestern state far from Maryland. The only connection was a similarity—Maryland also had a private insurance fund for its 102 state-chartered S&Ls. The Ohio failure triggered a run on those Maryland S&Ls that required their closure. Most were found to be healthy and were reopened. A few, however, were found to have bad asset problems based on risky lending. Hanky-panky was discovered in a few cases, and some people went to jail.

From that point on, the newspapers treated risky lending and hanky-panky as the cause of the crisis, even though they weren't uncovered until months after it started. Reporters knew better, but the truth was too complicated to report easily. So the complex whole truth gave way to the simple half-truth, which was that corruption caused the crisis. I learned then that the lessons of crises aren't always what they seem. I also learned that dominos don't have to be close to fall on you.

The half-truth lesson was repeated in the Mexican crisis. You may recall that 1994 was a presidential election year in Mexico. The Chiapas rebellion in southern Mexico broke out on January 1, timed for the first day of NAFTA. Then a presidential candidate was assassinated in March. Another assassination occurred later that year. The entire year was filled with political turmoil that caused capital flight. Behind the scenes, the monetary authorities were using up reserves in an effort to avoid devaluation. Along the way, they resorted to "tesobonos," dollar-denominated short-term debt designed to remove exchange-rate risk from their creditors. The authorities assumed—not unreasonably, in my opinion—that capital flight would reverse after the elections. As you know, they lost that bet and attempted a modest devaluation in December 1994 that got out of control. That out-of-control devaluation was later called the first crisis of the new financial era. The Asia crisis was the second. A lesson of the new era apparently was that you can't have small, controlled devaluations any more. It's all or nothing. Another, as I said earlier, is that dominos don't have to be close together to topple one another. Market discipline has become more punishing.

The IMF and the U.S. Treasury put together a "bailout" program to enable Mexico to refinance its short-term foreign debt. The program worked well. Some people, these days, say it worked too well—because of moral hazard considerations. Some say if Mexico hadn't been helped, the Asia crisis wouldn't have happened. I don't know about that. Seems to me a lot of capital was flowing into Asia well before 1995. The idea that failures are preferable to bailouts because of moral hazard was not much comfort during the market turbulence that followed the Russian default. U.S. financial markets weathered the Asian storm for more than a year before the Russian default sent them into a tailspin.

The Mexican peso crisis, like the Maryland S&L crisis, required a simple "cause" and a villain. Commentators finally settled on monetary policy. These days, the political origins of the capital flight are never acknowledged. The complexities and the ambiguities of the peso crisis have faded away. All we hear now is that "Mexican monetary policy was too easy in 1994, an election year." Maybe it was; maybe it wasn't. We studied it, and the truth is not that clear. But if it is the truth, it's only a half truth, not the whole truth. One might even argue that U.S. monetary policy during 1994 was more at fault than Mexican monetary policy. One might argue that, but not me.

As fate would have it, I'm a Baptist, and I know what it means to preach to the choir. I suspect that's what I'm doing here. But I thought the point was worth making that these crises develop their own folklore often divorced from reality.

When the East Asian crisis erupted, I didn't understand it. I never saw it coming. Like everybody else, I thought the Tigers were invincible. Why Thailand, and not someplace else? Why July 1997, and not some other time? And, then, why Indonesia, Malaysia, Korea, the Philippines and the others? Why Mexico, Brazil, Argentina, Chile and other Latin American nations? They'd already had their "tequila crisis" three years earlier. They didn't need to be included in the Mai-Tai crisis. And, finally, why Hong Kong, the paragon of monetary virtue?

The experts haven't boiled the current crisis down to a single sound bite yet, but they're getting close. They've

rounded up the usual list of suspects:

A fragile banking system, with weak supervision, and too much government involvement in allocating credit and directing investment.

Too much reliance on bank lending and relationships, and not enough reliance on impersonal capital markets.

Too much favoritism, or "cronyism"—the inevitable result of government guidance.

Too much following the "Japanese" mercantilist model of state direction and production for export rather than home consumption, leading to excess capacity.

Too much short-term debt.

Too much foreign short-term debt.

Too much unhedged foreign short-term debt.

That last, because of too much faith in fixed exchange rates.

Too much reliance on fixed exchange rates is a personal favorite of mine. When I was in school, I pretty much bought into Milton Friedman's case for flexible exchange rates. I wrote my dissertation on the Canadian experience with flexible exchange rates in the 1950s. The proposition I specifically examined was that countries gain some economic insulation and policy independence through flexible exchange rates.

I started as a young economist at the Richmond Fed in August 1968, just in time for the prolonged breakdown of the Bretton Woods fixed-rate system. As a young economist, I got to write a lot of memos and make a lot of presentations on *this* exchange crisis or *that* crisis, or *this* devaluation or *that* revaluation, because the varied, changing and growing economies tied together with fixed exchange rates couldn't stay in sync. One country would need a policy zig, while another would need to zag—to put it in technical terms.

During this period—the late 1960s and early 1970s—I recall Milton Friedman saying that if we had flexible rates, we wouldn't have exchange-rate or balance-of-payments crises. Sure enough, when the United States closed the gold window and floated in 1971, I didn't get to write many more memos or make speeches on that subject. Later on, if the float got dirty for one reason or another, a memo was called for, but for the United States, floating has worked pretty well. And in recent years, it's been pretty clean. I believe the intervention in support of the yen last June was the first U.S. intervention in over two years.

Of course, my preference for flexible exchange rates puts me in an awkward position in Hong Kong, where rates are not only fixed but "really" fixed—through a currency board arrangement. It turns out, however, that currency boards are also okay with Professor Friedman. And if they're okay with him, they're okay with me.

I had the honor of visiting Professor Friedman last year, and I asked him if he was still a strong advocate of flexible exchange rates. He answered, essentially, that his position had been misunderstood. He thought flexible rates worked well, and really fixed rates (i.e., currency boards) would also work well; it's everything in between that doesn't work. In other words, fixed rates with less than total credibility don't work. He reviewed his position on exchange rates in a recent issue of *Fortune* magazine.

Even before I got the master's blessing, however, I had made my peace with currency boards, based on what we in Texas call, "extenuatin' circumstances." Circumstances having to do with country size, the relative size of the traded and nontraded sectors, size of trading partners, and, especially, with history. For example, Argentina's history of hyperinflation—as recently as the late 1980s—makes it especially imperative that they not fall off the currency-board wagon. Anything less would be like the proverbial "one more drink" for an alcoholic.

That may be almost as true of other countries that went into the current crisis with fixed exchange rates. The recent experience in Mexico and Asia suggests that a fixed rate under pressure is not easy to deal with. It's a bit like riding a tiger, if you'll pardon the expression. How do you dismount? The transition from one fixed rate to another, or to floating, is likely to be nasty.

I believe this is relevant to the current situation in Latin America. Latin American countries with fixed rates have been under great pressure. Their stock markets have taken large hits, and so have their economies as they have raised interest rates drastically to bribe capital to remain. Brazil, the China of Latin America, is especially vulnerable and is in the unusual position of being the widely predicted—almost advertised—scene of the next accident.

Mexico has also been under stress, and its peso has depreciated further during the Asian crisis, from about 7-1/2 to 10 to the U.S. dollar. That's a pretty big hit but not as big as falling off a peg would likely have been. However, a gradual 25 percent to 30 percent depreciation in the current environment is more likely than a 25 percent to 30 percent devaluation. Countries already on a fixed exchange rate when a crisis starts are like a firm in price theory with a kinked demand curve. All alternatives are worse than the status quo.

I said earlier that I didn't see the Asian crisis coming. For that matter, I didn't see the Mexican crisis coming either. In both cases, economic performance appeared good and macro policies seemed sound. In both cases, however, a lot of what we call Monday morning quarterbacking took place. Foresight was lacking, but hindsight was 20/20.

In the case of Asia, however, there was at least one exception. Populist author William Greider, in his book *One World, Ready or Not*, called attention to the overcapacity problem inherent in so many countries competing for capital with low wages and trying to jump-start growth by producing primarily for export. His main concern, however, was the implications for the wages of U.S. workers. Greider also called attention to the U.S. role in the world economy as the consumer of last resort. I like to do my part—by consuming all I can—but there may be a limit to our capacity in that regard. How many countries can run export surpluses simultaneously? If they all devalue or depreciate against the dollar, how do we pay for our consumption? Because of the dollar's role as a reserve currency, potential limits to our ability to pay for trade and current account deficits by borrowing have not received much attention in recent years. But it is conceivable that one day markets might react and surprise everyone with the obvious once again.

Mexico's recovery may have some lessons. Remember that pressure on the Mexican peso built up over about a year, and when the devaluation came it was severe, about 50 percent as I recall. Inflation, which had been brought down to about 7 percent over several years, took off again. And the economy went into a sharp recession. But the devaluation did sow the seeds of the correction. The recession was steep, but the decline lasted only two quarters. Growth resumed in the third quarter, although it took several quarters to reach pre-crisis levels. Obviously, it was an export-led recovery; so the benefits of the devaluation and recovery didn't go to those hardest hit by the inflation and resulting recession. Far more people were hurt by the crisis than were subsequently helped by the rebound, with strains on the social fabric.

As you know, the Mexican crisis hit the fragile Mexican banking system hard. The banks had been privatized only a few years earlier. High prices had been paid for them, and the new owners' efforts to recoup their investment probably didn't lead to the most conservative banking practices. Banking supervision was not up to the task as well. The government—or an agency of the government—"bailed out" many of the banks with newly issued debt.

The export-led recovery was more rapid than most expected, but the fundamentals have still not returned to previous levels. Inflation is still above pre-crisis levels, unemployment is still a problem, and the banking system is still weak and fragile. The Asian crisis has put much new pressure on Mexico. Its stock market declined and interest rates have been pushed way up, putting additional strain on the fragile banking system. The peso, which had appeared to stabilize at around 7-1/2 to the dollar, has declined further to about 10 per dollar—still a more modest decline than a devaluation from a new peg would have been, in my opinion.

One footnote here of possible relevance: the crisis in Mexico occurred during a period of domination of one political party, which probably made the government more effective in dealing with it. Political changes since then—resulting largely from the crisis itself—have caused much second guessing about the way the crisis was handled. In particular, the resolution of the banking crisis, which had been considered a model for others to follow—and may be—has become a contentious political issue four years later.

The Mexican experience since its crisis is probably more relevant to the Asian countries that devalued their currencies, since the devaluation itself provides impetus for output recovery. On the other hand, the devaluation also adds an inflation element not present in countries whose financial markets were damaged but who have been able to avoid devaluation. Devaluation makes output recovery easier but inflation recovery harder. Holding the line on the exchange rate avoids the inflation problem, but makes output recovery harder.

I'll confess that I'm not very familiar with the details of the Hong Kong situation. But I'm reminded of a visit I made to Argentina in 1996, about a year and a half after the Mexican crisis had spread in Latin America in what we called the "tequila effect." Argentina's currency board had held, but at a significant cost in terms of its banking system and very high unemployment rates without any policy tool to deal with it. Even today, its unemployment rate remains very high, even though inflation is near zero and the Argentine peso is as strong as, or stronger than, the dollar. I know that is not encouraging. But even so, as I indicated earlier, Argentina's recent inflation history gives it little choice. Asian

countries that devalued will, of course, have recovery problems more like Mexico's than Argentina's.

To conclude, I'm sorry I don't have any easy answers. But I do have a final thought. Earlier, I gave due credit to William Greider for coming closer than most to seeing the crisis emerging. I would like to give at least equal time to the authors of another recent book, *The Commanding Heights*. Daniel Yergin and Joseph Stanislaw do a great job in chronicling the world-wide movement toward market economies in recent years. That is the most important thing going on to improve world living standards and freedom. However the world's policymakers end up dealing with this crisis, it is imperative that they don't throw the baby out with the bathwater, as they say in Texas. While we must be willing to think new thoughts, even some that have been considered economically incorrect, we must remain true to another Texas verity—dance with the one that brung us. That is to say, any solution adopted to deal with the Asian crisis must build on the unique strengths of East Asia that provided sustained rates of rapid growth and transformed living standards in a single generation.