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THE ECONOMICS OF THE PESO CRISIS: LIBERALIZATION AND INTERNATIONAL FINANCIAL INTEGRATION

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ABSTRACT

This paper analyzes the peso crisis as a particularly striking example of recurrent shocks associated with a defective model of liberalization in an unstable system of international finance. On the Mexican side, the model of liberalization followed from 1988 to 1994 was unfavorable for sustained growth and exposed the country to increasing dependence on capital inflows because it biased demand toward imports. On the international side, the initially helpful inflow of capital overshot and worsened the country's macroeconomic imbalances, and the following panic aggravated the contractionary impact of the crisis. This pattern followed Chile's experience in the early 1980s with its initial model of liberalization, and was a forerunner of the crises that hit the East Asian countries after their financial liberalizations of the mid 1990s.

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The peso crisis was the first serious setback to the liberalized economic system that Mexico adopted in the 1980s. Its causes were for the most part specific to Mexico but the experience bears many similarities to the ongoing series of crises associated with increasing integration of world capital markets. Are these shocks intrinsic consequences of economic and financial liberalization? Can they be moderated--or even avoided--either by national economic strategies or international coordination?

To many people deeply opposed to liberalization in the first place, the peso crisis was strong evidence that this strategy is a costly mistake. To others, commited to liberalization, it was a worrisome disappointment that ten years of gradual improvement could be swept away so unexpectedly, so swiftly. The blow was certainly serious in the sense of how hard it hit. In 1995, GDP per capita fell 9 percent, back below its level when liberalization began a decade earlier. Something on the order of a million workers lost their jobs, real wages fell 14 percent, the value of the peso was cut in half, the banking system nearly collapsed, and the rate of inflation--so carefully nursed downward through the preceding decade--jumped from 7 to 35 percent.

The more positive side, of course, is the speed with which the economy recovered. Output went back up by 5 percent in 1996 and 7 percent in 1997. Real wages did not match that recovery: they fell a further 11 percent in 1996 despite the rise in output. By mid-1997 GDP per capita had regained its 1994 level but real wages remained one-fourth lower than at that time (OECD 1998, 13 and 24-25).[1]

Was all this essentially a brief interruption to a successful process of development, set off

by exogenous shocks and inappropriate policy responses in 1994, or was it instead a built-in product of an economic strategy that was not working very well in the first place? On the former view, this particular crisis is over: it was "a deep, sharp shock without lasting effects" (Radelet and Sachs 1998, 12). On the latter view, the result is more of a question: did the crisis lead to any significant changes likely to give better results than the first decade of liberalization?

The main hypothesis in this discussion is that the particular way in which Mexico implemented liberalization from 1989 to 1994 was unfavorable for sustained economic growth, adverse to the reduction of poverty and inequality, and practically guaranteed to provoke a breakdown. International capital flows played an important though secondary role. Capital inflows were helpful to start recovery from the depressed conditions of the 1980s, then went too far and contributed to growing macroeconomic imbalance. When they reversed in 1994 they again went too far, at high cost to Mexico.

International capital markets lack any adequate stabilizing mechanism. They were too optimistic about Mexico in the early 1990s and then, when the collapse came, it was as if a switch had turned asset markets over to excessive pessimism about Latin America in general. By 1996 the switch had been turned back to over-optimism, above all in the form of excessive capital flows to East Asia. As in Mexico, growing domestic imbalances in many of the East Asian countries, associated with financial liberalization, were worsening at the same time: interpretations of where to put the blame and where to look for remedies have plenty of room on both the domestic and the international sides. Remedies are needed on both sides.

The first section of this discussion centers on macroeconomic and social imbalances in Mexico and the ways in which they, aggravated by international capital flows, led to crisis.

Section two is focused on the response to crisis in both asset markets and the domains of macroeconomic balance and export performance. Section three relates the peso crisis to the context of global liberalization, violent capital movements, and multilateral intervention to deal with them.

1. Macroeconomic and social imbalances in Mexico

The peso crisis of 1994 grew out of the country's responses to the debt crisis of 1982. The earlier breakdown forced a drastic contraction accompanied by repeated devaluations of the currency. That combination restored external balance but at the costs of prolonged stagnation, falling real wages, worsening income distribution, and repeated bursts of high inflation in reaction to each new devaluation (Sheahan 1991). The governments of Miguel de la Madrid and Carlos Salinas de Gortari needed and carried out major changes in economic strategy to find a more constructive path. The most fundamental change was to reject state-led development in favor of economic liberalization, beginning with trade liberalization from 1985 and accelerating with financial liberalization and privatization under Salinas (Lustig 1998, 114-40). The second most important change, aimed at both macroeconomic and social goals, was a form of incomes policy established through the wage-price pacts negotiated with business and labor each year from 1987 on (Ros 1994, 76-80; Lustig 1998, 50-54; Pastor 1998, 23-24).

The wage-price pacts had at least three goals and far-reaching effects. The most direct goal was to restrain inflation: business agreed to hold down price increases if costs of labor and of imports were restrained, labor to accept wage restraints if they allowed for some increases, and the government to slow down devaluation in order to hold down prices of imports. An accompanying goal, possibly even more important for political purposes, was to stop the

deterioration of real wages associated with steep devaluation and high inflation. That could be seen as an essential component of the persistent efforts of the Salinas government to build support for liberalization, and at the same time for the PRI, by compensating losers from the new economic strategy (Dresser 1997). Beyond that, as a direct consequence of better control of inflation and a more stable exchange rate, the pacts were intended to increase the appeal of Mexico to foreign investors.

The benefits of the pacts, combined with liberalization and fiscal restraint, were clear: inflation came down progressively from 1988 through 1994, real wages began to rise, and the economy began to grow again. With liberalization and greater stability of both prices and exchange rates, foreign direct investment went from $3.2 billion in 1989 to $4.4 billion by 1993. But the really big jump was in portfolio investment, in Mexican stocks and debt instruments: it went from a negative value in 1990 to $28.4 billion by 1993, 85 percent of the capital inflow (IDB 1997, 285). Was this a benefit or a problem? Very much a benefit at first, in aiding the revival of the economy, but then a growing drawback in that the capital flows limited the possibilities of sustained growth and led straight toward the peso crisis.

The counterpart of the greater stability of the nominal exchange rate, supported by the capital inflow, was a sharp appreciation in real terms. The real effective exchange rate as reported by the IDB--the nominal rate corrected for differences between domestic and external inflation--appreciated by 39 percent between 1988 and 1993 (IDB 1997, 285). Imports became progressively cheaper relative to domestic products. That change in relative prices held down the growth of output by diverting demand from domestic products toward imports (Dornbusch 1997; Williamson 1997).[2] The deficit on external current account grew rapidly and the whole system came to depend on a rising capital inflow.

Table 1 brings out the sharp contrast between the weakness of output growth from 1985 through 1994 contrasted to the rapid growth of both imports and the current account deficit. For the nine years to 1994, GDP in total grew at less than half its prior longterm rate, and GDP per capita showed no growth at all. But imports of goods increased at a rate of 17.6 percent a year, almost twice the otherwise impressive growth rate of exports. As estimated in 1990 dollars, imports of goods and non-factor services were equal to 18 percent of GDP in 1989; that ratio rose to 31 percent by 1994 (IDB 1997, 219 and 221).

Tests of the stability of import coefficients bring out a break in trend at or shortly after liberalization in 1985, to a greatly higher income elasticity of demand for imports (Moreno-Brid 1998). Trade liberalization opened up access to products not previously significant in Mexican consumption patterns: increased availability would have raised relative demand for imports even if their prices had not fallen relative to those of domestic products (Espinosa and Noyola 1997). Further, imports were spurred by a spectacular rise of consumer credit: from December 1988 to November 1994 credit card liabilities increased 21 percent a year and direct credit for consumer durables 67 percent a year (Gil-Díaz and Carstens, 191). Beyond both of these stimuli, the fall in prices of imports relative to earnings in pesos had an income effect of its own: it raised Mexican incomes and purchasing power rapidly when expressed in dollars, much more rapidly than real GDP (Wise and Pastor 1998, 48-49).

An increase in the share of spending directed to imports is a natural consequence of removing import barriers; it need not be a problem at all. Trade liberalization favored exports as well as imports: an equal expansion of both would have meant increasing efficiency and rising real income. The reason it became a problem was that imports rose nearly twice as fast as

exports. Trade liberalization made that possible, not inevitable. What made it practically inevitable was the appreciation of the real exchange rate.

The more surprising component of trade behavior was the rapid growth of exports, despite the handicap of currency appreciation. That achievement was made possible by a long prior process of investment and rising efficiency in export industries, and the possibility was kept alive by a key difference between the implications of the real exchange rate for imports and for exports. The standard measure of the real exchange rate reported by the IDB is a useful indicator of change in the relative prices faced by buyers on the import side. For exports, a more relevant measure is the ratio of foreign prices to domestic costs of production. Both indicators showed the same pattern of movement: depreciation from 1983 to 1986 in response to the debt crisis, followed by appreciation from 1986 to 1994. But the degree of depreciation shown by the ratio of external prices to labor costs in the earlier period was far greater than that for the real exchange rate as reported by the IDB, because of the sharp fall in wages relative to prices. Even with subsequent appreciation, Mexican exporters remained competitive (Gil-Díaz and Carstens 1997, 168-71).

Spending rose at rates that could have stimulated faster growth of output, while growth of the labor force and high rates of investment increased capacity for response from the side of supply. That combination could have permitted faster growth but did not because an increasing share of spending was diverted away from domestic producers toward imports. In this sense, weakness of demand--not of aggregate spending but of demand for domestic products--was the main reason for lack of growth, worsening employment conditions, and failure to bring poverty back down to earlier levels.

Table 2 gives estimates by CEPAL of poverty and inequality from 1984 to 1994. They indicate worsening of both up to 1989,

probably due more to the long stagnation of the economy in the 1980s than to effects of liberalization (Wise and Pastor 1998, 46-48). From 1989 to 1994, the incidence of poverty came about half-way back down to its level a decade earlier. Different sources conflict about what happened to inequality: the CEPAL estimates in table 2, based on data for income-in-kind as well as money income, suggest a slight decrease. Estimates based on money income alone indicate instead an equally slight increase (Wise and Pastor, 46-48).[3]

From several directions, the period from 1989 to 1994 could have been exceptionally favorable for reduction of poverty and inequality. Economic growth resumed, though at a modest rate; the government implemented a far-reaching social program (PRONASOL), that surely helped many of the poor; and from 1989 to 1993 real wages in manufacturing increased at the impressive rate of 7 percent a year (IDB 1995, 133). Given all that, the evidence that poverty did not come back down to the pre-liberalization level, and that inequality did not show any clear-cut decrease to offset its earlier worsening, were clear signs of underlying forces working against social gains.

Weakness of growth in employment opportunities--an absolute fall in employment in manufacturing combined with overall growth too slow to keep up with increases in the labor force--made it difficult to get poverty and inequality back down to or below earlier levels. That weakness was aggravated by import liberalization under conditions of currency appreciation: a joint consequence of the wage-price pacts and of the normal, and in part positive, response of international capital to the new context.

Liberalization and its commitment to market forces, when backed up by genuine restraint on inflation, systematically encourages capital inflows. The inflows help hold down inflation, stimulate investment, and make it possible to finance rising current account deficits. But they can become self-reenforcing past any desirable level (McKinnon and Pill, 1998). They stimulate spending and create conditions that look like sustainable prosperity, encouraging yet more capital inflow and yet greater current account deficits: exactly the conditions guaranteed to give rise to a crisis as soon as anything begins to worry the international financial community.

Governments can choose, to some degree, whether to resist or to encourage capital inflows. In the 1990s, the governments of Chile and Colombia managed to establish indirect restraints and to use them, backed up by appropriate monetary policy, to hold down the impacts of capital inflows on their exchange rates and current account balances (Williamson 1997). The Mexican government did not employ such restraints, though at least the central bank intervened to buy foreign exchange in an effort to keep the currency from appreciating beyond the intended limits set by a moving band of target rates. If the exchange rate had been left totally flexible the results would have been worse (Birdsall, Gavin, and Hausmann 1997, 285-86). But the capital flow was not simply an exogenous fact of life: the Salinas government did all it could to encourage foreign investors, reassured them repeatedly that it would not allow significant devaluation, and set the band of allowed rates at levels that permitted appreciation in real terms.

Doubts about the sustainability of this strategy must have been growing, both in Mexico and in the World Bank, but possible actions to change it were held back by the well-founded fear that either a retreat from trade liberalization or any significant devaluation could touch off full-scale capital flight. In that sense, dependence on a rising capital inflow locked the economy into

imbalances that precluded sustained growth. The stalemate might have gone on longer--the crisis might well have been postponed--in the absence of the political and social shocks that hit Mexico in 1994: first the Chiapas rebellion, followed in March by the assassination of the presidential candidate chosen by the PRI, and then by other signs of breakdown in public order (Sachs, Tornell and Velasco 1995; Edwards 1997). Less in the public eye, but surely known to many in the financial sector, the rapid expansion of domestic bank credit, in a poorly regulated banking system shot through with dubious lending practices, had set up conditions for a banking crisis that might have erupted even in the absence of the political shocks (Birdsall, Gavin, and Hausmann 1997; Griffith-Jones 1997). Financial liberalization was no cure-all.

Foreign investors reacted erratically to these disturbances. The capital inflow stopped in March, leaving the enormous current acount deficit temporarily in mid-air, but resumed when the government offered its infamous tesebonos (short-term securities denominated in pesos but indexed to dollars). The Mexican financial sector remained relatively calm through most of the year, aware of the country's well-established electoral cycle: the government never risks a devaluation in periods preceding a presidential election. If it must act, it will only do so <u>after</u> the election (Magaloni 1998). Mexican investors did not react when the price of the dollar was allowed to move to the top of the intended band early in the year, or to the rapidly rising ratio of short-term debt to international reserves in the following months. But when the new Zedillo government realized fully that time was running out, and made its decision to risk a devaluation limited to 15 percent in December, the Mexican financial sector reacted immediately with the sensible conclusion that the day of reckoning was at hand. New York was a day late.

Much of the analysis of the crisis has focused on the political shocks and unhelpful

monetary policies in Mexico in 1994, the failures of anything like adequate supervision of the banking sector, and poor communication of changing financial conditions. All these problems were important but such analysis can miss, or explicitly dismiss, the fundamental question: would Mexico today be better off if the crisis had been avoided, or at least postponed? The basic argument here is that the problems of the underlying economic strategy had become more costly than the crisis itself. Mexico's relative prosperity in the early 1990s depended on initially helpful but fundamentally unsustainable conditions. The wage-price pacts and the capital inflow were effective answers to the combination of inflation and stagnation of the 1980s. But this temporarily successful system "overstayed its welcome" (Wise and Pastor 1998, 44). If foreign investors had slowed down the capital inflow in 1992 or 1993 (without reversing it), or if the Mexican government had taken steps on its side to slow down the growth of imports and currency appreciation, output and employment might have grown more rapidly without any crash at all. Absent corrective measures on either side, the crisis became the costly consequence, but at the same time it enabled Mexico to break out of an economic strategy that was no longer either needed or helpful.

2. The recovery and partial revision of economic strategy

In asset markets, the crisis consisted of a self-reinforcing process of violent capital outflow and runaway depreciation, drastic contraction of credit, and a near-breakdown of the banking system as weakened banks, and many firms, found it impossible to cope with the rising peso costs of service on their debts in dollars. The disappearance of external credit had a multiplying contractionary effect in goods markets through curtailed domestic lending, bringing down production and employment relentlessly. At the same time, the falling value of the peso pulled up

prices of tradable goods and intensified fears of inflation, feeding back into continued selling of the currency. The crisis was both contractionary and inflationary.

The government's first concern was to stop the runaway process of currency depreciation. That required massive international intervention--lines of credit on the previously unheard-of scale of $50 billion--that enabled the government to support the currency convincingly and reassure everyone that scheduled debt payments could be met. It was also considered to require a severe progam of monetary and fiscal restraint. In the context of falling production and employment that strategy aggravated the contraction. It was nevertheless seen as necessary "because financial market participants were fleeing and would only return once confidence in Mexico's fiscal viability was restored" (Birdsall, Gavin, and Hausmann 1997, 284).

The official lending that helped stop the panic was essentially a political decision, led by the U.S. government, in response to fears of the consequences of unchecked private capital markets. It was a recognition, once the chips were down, that private capital flows have gained too much destructive power: that the process of opening up worldwide financial markets could lead to unbearable degrees of volatility.

The means chosen to restrain domestic demand and restore confidence in the government's ability to check inflation--chiefly increased taxes on value added, lower miniumum and average wages, and higher interest rates--were basically regressive. Taxes on interest and dividends, which had been cut in order to encourage investors, were not restored in response to the crisis. These are the kinds of choices naturally associated with an economy dependent on foreign investors: it comes to seem essential to hold down any taxation bearing on capital and to offer lenders high returns to keep access to credit.

A more promising reaction was that the government revised its macroeconomic targets to deal with the underlying problem. Its "Programa Nacional de Financiamiento del Desarrollo 1997-2000" (Pronfide), calls for a limit on the current account deficit and for higher domestic savings and growth. Direct foreign investment would be welcomed as before, but short term borrowing would be discouraged and the current deficit limited to 3 percent of GDP (Villarreal 1997, 659-65; OECD 1998, 61-66).

Once a full-fledged currency crisis gets underway, questions of export performance and current account balance tend to fall out of sight, dominated by expectations in asset markets. The problem is to restore some confidence in the currency and the ability to meet current claims. Still, once past the panic stage, expectations must begin to take account of what is happening to exports. For most developing countries, caught in dependence on primary exports, not much can be done to increase them in the shortrun. But Mexico is no longer in that category. Its comparative advantages still include strength in oil exports but have shifted on balance to industrial exports that can, and did, respond powerfully to the rise in the peso price of foreign exchange.

Manufactures accounted for 74 percent of total exports by 1991 and 83 percent by 1994. When the peso crisis drove up the price of foreign exchange, that created a windfall for industrial exporters and they responded swiftly. Exports of manufactures increased 32 percent in 1995 and a further 10 percent in 1996, for a total gain of $30 billion in two years (OECD 1998, 144). These exports are themselves import-intensive so the net gain in foreign exchange earnings was much less, but it was still adequate to the immediate problem: the deficit on current account was practically wiped out in 1995. Even with the recovery of the economy in 1996 it remained far lower than any prior year in the 1990s (table 1).

Growing strength in industrial export competition has both plus and minus implications. It should favor longrun growth if macroeconomic management can maintain better overall balance, and help speed recovery from the crises that are bound to recur even with good econonomic management. But its employment effects were disappointing in the pre-crisis period. New export firms (as distinct from the maquiladoras) have been relatively capital and skill intensive, adding to an economy-wide trend toward widening wage differentials after liberalization. Employment in manufacturing exports failed to offset contractions in formerly protected industrial activities: total employment in manufacturing in 1994 was only two-thirds its level in 1980 (Alarcón and McKinly 1997, 139). Further, industrial exports favor employment in northern border areas, not in the much poorer southern regions of the country. The latter, with production mainly for local markets and little connection to export opportunities, could be set back by increased competition from imports even while the higher-income regions are growing more rapidly.

The potential for improving employment conditions could be realized more fully if the government holds to the main lines of its plan for 1997-2000, but even then it is an uphill race to keep up with, or ahead of, the rate of growth of the labor force. Sustained GDP growth of at least 6 percent a year is probably necessary to provide adequate employment opportunities and reverse the long downtrend of real wages (OECD 1998). That would require greater restraint on the growth of imports than exercised in the decade up to 1995, to keep them more closely in line with growth of exports. The main ground for optimism is the country's demonstrated capacity to compete strongly in world markets for industrial products. The main shadow in the near term is the set of contractionary pressures on the world economy built up by the closely similar economic crises in East Asia.

3. Mexico's place in the chain of crises

Some of the analyses of the East Asian crises of 1997-98 take pains to distinguish them from the peso crisis, and from Latin American breakdowns in general (Kregal 1998; World Bank 1998). In one sense the distinctions are convincing: the Asian crises differ in significant ways from the debt crisis of 1982 and most other Latin American cases. But in another sense they seem misplaced: the Asian breakdowns have a great deal in common with the essentials of the peso crisis, and that of the newly liberalized Chilean economy in 1981-82. The more useful distinction is between crises under the older Latin American strategy of state-led development and those now characteristic of liberalized economies, or more specifically of those that take the treacherous step to financial liberalization.

The Asian crises were not caused by fiscal deficits, government borrowing to finance them, rising inflation, or current account deficits driven by excess demand. These are familiar characteristics of many Latin American cases, notably including the Mexican debt crisis of 1982. But they were not characteristics of the peso crisis or that of the first fully liberalized economy in Latin America, in Chile.

The Mexican crisis of 1982 was explicable mainly in terms of greatly increased government spending and fiscal deficits, lured by overconfidence in the growth of income from oil exports, while that of 1994 was much more a matter of private sector borrowing and spending in a context of fiscal restraint and falling inflation. The problem was the behavior of the liberalized private sector. The government was responsible in the sense of following a development strategy that led to the crisis, not in that of causing the breakdown by its own excess spending. That was very much the case in the earlier Chilean breakdown as well.

After liberalizing trade and capital movements in the second half of the 1970s, Chile experienced four years of relatively good economic growth, propelled jointly by rising consumption and a strong inflow of private capital. The inflow of private capital was encouraged by liberalization itself, by the government's careful fiscal restraint and conservative character, and by its decision to fix the exchange rate to restrain inflation (Ramos 1986; Edwards and Edwards 1991; Ffrench-Davis and Muñoz 1992; Paus 1994). Chile became a star example of the success of economic liberalization. Until it crashed.

With the exchange rate fixed and external capital pouring in, the current account deficit reached 14 percent of GDP before the great reversal. The spark that put the capital flow into reverse was a collapse of the domestic financial sector: allowed almost unbounded freedom from regulation in the climate of over-enthusiasm for economic liberalization, a small number of insider groups misused banks and financieras in a frenzy of acquisitions (Díaz Alejandro 1985). When many of these loans began to go bad, external lenders suddenly realized that even a conservative economic regime can become risky. They stopped lending abruptly; Chile's GDP per capita fell 15 percent in 1982.

The peso crisis was in many respects a close duplicate of the Chilean example (Sheahan 1997; Pastor 1998, 130-36). Both followed a period of strong capital inflow and rising current account deficits that left the economy vulnerable to any downturn in external financing. In both cases, financial liberalization without careful regulatory supervision led to high-risk and excessive domestic lending. In Chile, the banks cracked first; in Mexico, immediately after the value of the peso plunged. Borrowing in dollars by the banks, to finance loans to firms earning pesos, left both banks and firms in impossible positions when the value of the peso fell in half.[4] The

government intervened by buying portfolios of bad loans (over one-third of the total bank loans outstanding), and took over direct control of the weakest banks, much as the Chilean government had done. The present value of the costs to the government was estimated in early 1998 at about 17 percent of 1997 GDP. The expected addition to the national debt was made public--to intense protests--as $62 billion (OECD 1998, 81-87; New York *Times*, July 31, 1998).

The World Bank analysis differentiates the Asian crisis from those of Latin America on the surprising ground--as if it actually were different--"that private sector financial decisions were the main source of the difficulties. Public sector financing played only a small role." The central features of the problems in the financial sector were "distorted incentives, lax regulatory standards, poorly managed financial liberalization, and inadequate disclosure and supervision encouraging excessive risk taking...Large capital inflows complicated the problems of the financial sector and fueled domestic demand" (World Bank 1998, 29-30). The analysis is convincing; what is difficult to see is how these problems differ in any fundamental way from the crises in Chile in 1981-82 or in Mexico in 1994.

A comparison of crises in Latin America to those in East Asia for two periods, 1970-95 and 1996-97, brings out their much greater severity in Latin America for the earlier period but then a marked change to greater severity in East Asia for the more recent. The authors of that study concluded that earlier differences between the regions had been eroding through overlending to East Asia, "reminiscent of the cycles that followed financial liberalization in many Latin American countries" (Kaminsky and Reinhart 1998, 447).

The effects of current account deficits and currency appreciation leading to crises have been downplayed in some of the most careful interpretations of what happened in East Asia, and

for the peso crisis as well (Birdsall, Gavin, and Hausmann 1997; Reisen 1998; World Bank 1998). Current account deficits are seen as normal and desirable counterparts of international capital flows to developing countries; neither they nor exchange rate appreciation stand out as dependable indicators of the timing of crises. Helmut Reisen clarifies conditions under which a current account deficit could be seen as troublesome, with emphasis on the question of whether it is associated with increasing saving or with rising consumption instead. He distinguishes the problem in Mexico from those in East Asia as one of excessive increases in domestic consumption, rather than the capital inflow itself (Reisen 1998, 297-314). The point is suggestive: Mexican consumption increased at a rate of 4.2 percent a year from 1989 to 1994, compared to 3.9 percent GDP growth. But it should be noted that investment rose even more rapidly, by 15.7 percent a year (OECD 1998, 134). Investment too, not just consumption, can rise too rapidly to permit sustainable growth.

Appreciation of the real exchange rate, like current account deficits, can be either benign or harmful, depending on the context. It can be expected as a normal consequence of international investment that raises productive potential or--as was the case for some of the East Asian countries in earlier decades--of superior productivity growth and export performance. But it can also be associated with weakening competitive conditions and increasing vulnerability, when it depends on over-optimistic capital inflows. Similarly, current account deficits may be healthy, or just innocuous, but when they begin rising persistently that usually signals that something is going wrong: possibly that credit is growing excessively and fueling increases in consumption that cannot be maintained, possibly that financial capital is going into dubious loans, possibly that external debts are rising too rapidly relative to export earnings, or possibly that even efficient

domestic producers are being undercut by artificially cheap imports. In most of the East Asian cases, as in Mexico, all of these problems were relevant.

The East Asians had long been regarded as highly successful in maintaining macroeconomic balance, avoiding high inflation, and developing new exports. Until the 1990s, capital flows to them were subject to restraint and did not provoke any sustained appreciation of real exchange rates. The governments seemed to be practicing consistent policies of maintaining exchange rates favorable for export competition, in contrast to the frequent Latin American practice of using them mainly to restrain inflation. But from the late 1980s some of them began to remove restraints on both domestic banking practices and capital flows, and the others (except China) gradually joined in. They kept nominal exchange rates pegged to the dollar, which worked well in the early 1990s as the dollar itself depreciated relative to the yen and to European currencies. But in 1995 the dollar began to appreciate strongly relative to the yen, in a context of prolonged weakness in the Japanese economy. By staying pegged to the dollar, with rates of inflation that were low by Latin American standards but still higher than those in the industrialized countries, the East Asian governments allowed their currencies to appreciate in real terms (Montiel 1998).

Previously rapid export growth slowed down or stopped in the course of 1996, perhaps in part because of the appreciation though also in response to weakness of demand from Japan and other negative factors in their markets (Radelet and Sachs, 24). Four of the five East Asian countries most severely hit in 1997 had experienced rising ratios of current account deficits to GDP between 1993 and 1996, and in four of the five real exchange rates had been appreciating (table 3). Capital flows to these countries had been mainly in the form of direct investment until

the 1990s but then, as government restraints on foreign borrowing were relaxed under pressure from the international financial community, they changed to portfolio investment and bank lending. For these five countries, net capital inflows increased from $47 billion in 1994 to $93 billion in 1996. Direct foreign investment was a very small fraction of that total: only $5 billion in 1994 and $7 billion in 1996 (Kregal 1998, 18). The role of excessive lending by the international financial community stands out in all these cases. Lax bank regulation inside the countries was fed by excessive lending from outside. The region, and the world economy, were hurt by the absence of restraint on the side of the lending countries, "particularly if the international community believed that there is sufficient risk to the global economy to warrant intervention" (World Bank 1998, 31).

International response to the Asian crisis has included large scale official support as in Mexico, though not led by the United States as in that case. As of early 1998 the intended support packages included $17 billion for Thailand, $33 billion for Indonesia, and $57 billion for Korea (World Bank 1998, 44). The policy prescriptions initially attached to the financing may have done harm as well as good. Their emphasis on austerity and on weaknesses in the domestic economies, in the middle of an acutely contractionary collapse of credit and confidence, may have aggravated financial panic (Radelet and Sachs 1998, 49-70.)

But in fact the extensive manipulation and corruption that quickly came to light badly needed corrective action, pressures by the IMF actually set some corrections in process, and the initial overemphasis on restraint changed quickly. In reaction to the evident consequences of adding deliberate restraint to the effects of capital outflows the IMF reversed itself to permit, or encourage, more expansionary fiscal and monetary orientations. That change was very much in

the right direction: the main danger had become self-reenforcing contraction (Kregel 1998).

The East Asian crises had all the basic characteristics of the peso crisis, even if proportions and sequences differed in many details. Perhaps the difference most favorable to Mexico and unhelpful to the East Asian countries is that Mexico's main export market was expanding and ready to accept rising imports when the peso shock came, while East Asian exports were handicapped by prolonged recession in Japan and by the depreciation of the yen. The worldwide effect has been much more contractionary.

It would seem likely that similar financial crises will continue to hit many countries, and the world economy, at least as long as capital market liberalization continues in its present form. Corrective possibilities would require changes both by the developing countries and by the international financial community. For the developing countries, greater restraint on capital inflows during expansionary periods would be essential. That would require rejection of the common practice under economic liberalization of using the exchange rate primarily as an anchor against inflation. It would probably also require the kinds of monetary and regulatory restraints used by Chile and Colombia to keep down unwanted capital inflows (Williamson 1997). In so far as the international financial institutions have discouraged such modest capital controls, they have contributed to the dangers of recurring crises.

The international institutions and financial center countries are faced with much the same problem that led in the past to the creation of national central banks: private financial markets consistently overdo lending when times are good and contract excessively when doubts arise (McKinnon and Pill 1998; Radelet and Sachs 1998). Within countries, the key functions of central banks are to hold back private lenders when they overdo on the lending side and to offset

contraction when creditors panic. The IMF was created a half-century ago to perform a more limited but similar role for the world economy. Its financial support has often helped favor recovery after crises; what it has lacked is any ability to restrain the excessive capital inflows that made the problems so severe in the first place. To do anything effective about that would require restraints on international capital movements, which would be impossible without support from the industrialized countries. It might be impossible even then. If it is, the costs might still be held down by encouraging, rather than discouraging, capital controls by those developing countries which are overly favored by international lenders, and by national economic strategies that reject the common model of financial liberalization, in favor of lower interest rates and competitive exchange rates.

4. Conclusions

The peso crisis had high shortrun costs and once more set back wages relative to output per capita, reenforcing inequality. But it had a positive side too, by helping Mexico break out of a sterile, self-defeating economic strategy. The economy was becoming ever more dependent on a rising inflow of capital, accompanied by a destructive process of currency appreciation that held down growth by diverting demand toward imports. Trade liberalization should have been helpful--it fostered efficiency and rising exports--but it became damaging instead because currency appreciation made imports artificially cheap relative to domestic production.

The appreciation was strongly favored by capital inflows, both stimulated by temporarily over-optimistic international investors and over-encouraged by deliberate Mexican policies. Dependence on rising capital inflows created a trap for economic policy: any serious move to correct excessive appreciation and release forces more favorable for growth was feared as likely

to touch off a crisis. The fears were correct. The crisis might have been postponed either by tightening monetary policy and accepting contraction early in 1994, or by massive support from the international financial institutions at the time of the small devaluation attempted in December. But it would have been a shame if either course had been adopted. Mexico needed badly to break out of the strategy it was following. The crisis was a high-cost way of forcing some of the changes that should have been adopted years earlier.

The pre-crisis model of liberalization was greatly concerned with restraining inflation and encouraging foreign investors. It succeeded in these objectives until 1994. The costs were that it held down the rate of growth of production and employment, worsened poverty, and built up the conditions for the crisis. The official post-crisis plan, Pronafide, aims--at least in principle--at restraining capital inflows other than direct investment, limiting the current account deficit, and raising the previously feeble rate of growth. If seriously pursued, it would lessen dependence on external capital and improve the chances of reducing both poverty and inequality.

The main factors that led to crisis in Mexico were closely similar to those that generated the following crises in East Asia. The five Asian countries in most trouble had avoided currency appreciation and heavy dependence on external capital relatively well until the mid-1990s but the pressures of the international financial community to remove restraints on financial markets, and the rapid growth of the scale and mobility of international capital, undermined their previously successful orientation. In 1995 and 1996 they all went in the same direction that hurt Mexico: toward greater dependence on capital inflows, currency appreciation, and rising current account deficits. Something that could and should have positive functions--movement of capital from richer to poorer countries--went overboard in dangerous excess. The international financial

community failed to exercise any reasonable restraint and private investors proceeded, as they always do, to pour in too much capital in the first place and then to panic when trouble became visible.

The panics in 1997 exposed extremely weak banking systems in all these countries, as in Mexico, and led to cumulative contraction. Bailing out the banks has been a high-cost part of recovery. But to blame the crises on the weak banking systems, after all the pressure placed on these countries to remove financial controls in the name of liberalization, would mislead understanding of what the real problems were, and remain.

Any adequate solution to the dangers built into this context would require international restraints on private capital markets, an unlikely prospect at present. But individual countries can still take steps to restrain their own dependence on external capital. The common model of economic liberalization, the model followed in Chile up to its crisis in 1982 and Mexico in its turn, goes in the wrong direction and adds to the dangers. The kinds of revisions made in Chile in response, and apparently intended in Mexico now, offer more hope for them and for the world economy as well.

NOTES

1. These changes in real wages refer to average compensation in manufacturing. Miniumum wages in real terms were cut 13 percent in 1995 and 9 percent in 1996 (CEPAL 1998, 22).

2. My own discussion of this agreement, written in 1991, now looks badly half-baked: the emphasis is on stabilization and export incentives, without recognition of the consequences of deviating demand toward imports (Sheahan 1992, 15-27).

3. Other estimates of the degree of inequality, as distinct from the direction of changes, show distinctly higher levels than those reported by CEPAL for all the dates given in table 2. The comprehensive survey of inequality by Deininger and Squire for the World Bank gives gini coefficients for Mexico at the national level far above those reported by CEPAL: .51 for 1984, .55 for 1989, and .50 for 1992 (Deininger and Squire 1996, data base, 34). See also Székely 1996 and Alarcón and McKinley 1997.

4. The currency crash was by no means the only problem for Mexican banks. Over-extended credit, with considerable outright fraud, had led some to the brink of failure well before the crisis. As of late 1998, three bank presidents had been indicted for fraud involving hundreds of millions of dollars, two had fled the country and arrested abroad, and one was actually in jail (New York Times, November 14, 1998).

Table 1. Estimates of poverty and inequality in Mexico, 1984 to 1994.

	Percentage of households below the poverty line			Gini coefficient of inequality[a]	
	total	urban	rural	urban	rural
1984	34	28	45	.32	.32
1989	39	34	49	.42	.35
1992	36	30	46	.41	.34
1994	36	29	47	.41	.33

Note (a): alternative estimates suggest higher Gini coefficents than those given in this source (see text).
Source: CEPAL 1998, 207 and 216.

Table 2. Mexico's GDP per capita, imports, and external current account balance, 1985-96.

	GDP per capita (1990 dollars)	Imports of goods (billion dollars)	Current account balance (billion dollars)
1985	3090	18.4	+ 0.8
1986	2911	16.8	- 1.4
1987	2960	18.8	- 4.2
1988	2933	28.1	- 2.4
1989	2968	34.8	- 5.8
1990	3041	41.6	- 7.4
1991	3085	50.0	- 14.9
1992	3106	62.1	- 24.4
1993	3057	65.4	- 23.4
1994	3113	79.3	- 29.4
1995	2862	72.5	- 0.6
1996	2953	89.5	- 1.8

Growth rates

1985-94	0.1 percent	17.6 percent
1985-96	- 0.4 percent	15.5 percent

Note: the growth rate for exports of goods was 9.6 percent for 1985-94, and 12.3 percent for 1985-96.

Sources: IDB 1996, 263, 287, and 288; IDB 1997, 221, 243, and 245.

Table 3. Changes in East Asian real exchange rates and current account deficits preceding the financial crisis that began in July 1997.

	Real effective exchange rates: % appreciation from 1988-92 average to end-June 1997	Current account balance as percent of GDP	
		1993	1996
Indonesia	5	- 1.3	- 3.4
South Korea	- 13	(- 1)[a]	- 5
Malaysia	13	- 4.5	- 5.2
Philippines	18	- 5.5	- 4.3
Thailand	9	- 5.1	- 7.9

Note (a): South Korea's current account deficit given in column for 1993 is actually its average for 1991-95.

Source: World Bank 1998, 35, 37, and 38.

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