

Currency Crises: Mexico and Asia Compared

A Paper prepared for the

International Symposium on Comparative Studies of
Development Models in Latin America and East Asia

(Chinese Academy of Social Sciences
Institute of Latin American Studies)

Beijing, 21-27 June 1998

Dr Manuel A. Fernandez*
United World College of the Adriatic
Italy.

(Draft: 30th April 1998)

Currency Crises: Mexico and Asia Compared

Introduction: What is a Currency Crisis

Currency crises were built into our economic systems from the times mankind learned how to substitute fiduciary money for the solid metallic currencies with intrinsic value. Pidcock has noted the speculative bubble provoked by real estate speculation in Athens in 333 BC (Pidcock, 1998) and scholars who studied Emperor Nero's deeds are not certain if he actually burned Rome down but they have no doubt about him producing a greater evil: eroding the value of the currency by debasing it. Schuler is then correct in saying that "the surprising thing about currency crises is that they still surprise people" (Schuler, 1998, p. 1).

This paper is motivated by some preliminary hypotheses. The overriding attention is given to the role of fundamentals. Can currency crises get divorced from them and become self-sustained either by contagion or by speculative attacks?

Another initial impression that needs testing is whether the Mexican case was the last "canonical" type of crisis and whether the East Asian crisis has brought about a qualitatively different type of crisis. Maybe Asian economies are becoming more "Latin" and Latins are becoming more stable?

Is a currency crisis the necessary effect of unsound fundamentals? As with most economic variables, it is difficult to establish permanent cause-effect relationships in the field of currencies and crises. Certainly, an underlying critical condition in economic fundamentals can give rise to a currency crisis as much as the currency crisis itself can provoke a critical condition in the economy. This is yet another of the multiple cases of mutually inter-related economic variables.

Currency crises normally happen to rigid exchange rate systems although floating systems are not totally immune.¹ The virulence and strength of a crisis, though, is proportional to the level of rigidity of the exchange rate system being used, particularly when the boom/slump vicissitudes of an economy are not commensurate to the necessary accommodation of exchange rates, i.e. when the exchange rate remains inelastic to the laws of the market. Rigidity of an exchange rate represents a distance from an ideal free-floating system and such level of rigidity varies from the absolute fixed rate system to the pegged, to the crawling (or sliding), and to the narrow target zones, the adjustable target zones (like the old European snake) and the dirty/managed-floating system.

Speculation plays an important role as an agent although it does not normally cause a crisis. A speculator is a soothsayer capable, at times, of foreseeing the obvious and capable also of acting accordingly. Rigid systems require monetary authorities to establish a system conducive to the maintenance of the desired parity with the main foreign hard currencies, particularly the US dollar. Whenever such an ability to defend a currency is inexorably undermined by balance of payments deficits and by rapid drain on a country's reserves then the speculators anticipate the outcome

and launch the final devastating attack on such a currency. Blaming the speculators for a crisis is tantamount to blaming the umbrella-carrier for the tempest.

There is a sizeable economic literature devoted to currency crises (see Krugman 1997b and Schuler 1998). The orthodox model is based on the theory underlying commodity price stabilisation schemes such as buffer stocks. Indeed, monetary authorities perform a similar role and, in the event, are bound to face an outcome similar to those failed attempts at keeping commodity prices stable (Krugman 1997b). Two paths are open for successful exchange rate stabilisation: either a country can resort to inexhaustible reserves or the balance of payments performance and the prevailing domestic macroeconomic strategies are conducive to exchange rate stability. Most crises have been unleashed by failure of both conditions. This basic model, as it has happened to other bastions of economic theory, has been enriched with the “expectations” ingredient: Rigid exchange rates will increasingly become more difficult to maintain if consumers, firms and the foreign sector expect and anticipate an eventual devaluation. Enter the speculators, i.e. those who expect gains from the eventual currency collapse, and the crisis will be on today’s papers. Although not impossible, it is difficult to assume that a crisis-stricken currency can also belong to an economy pursuing sound fundamentals. The fact that so many pegged currencies, anchored to stronger currencies, have managed to keep exchange rate stability within the Bretton Wood parameters (i.e. $\pm 2.25\%$ oscillation bands) without undergoing a crisis (Schuler 1998 counts 81 countries in such virtuous condition) imply that currency crises are not inherent to relatively fixed exchange rates systems. A currency under a floating system, on the other hand, can also be the victim of a crisis. The key element is, as ever and in the long run, the performance of an economy with regard to fundamentals, i.e. balance of payments equilibrium and foreign reserves, sound monetary and fiscal discipline, price stability and, particularly, long term perspective of productivity-based growth.

Do the recent crises in Mexico and in Asia fit with the above models? Both crises certainly have similarities but they differ in very important aspects. An anatomical description of each crisis is a necessary condition for a proper comparison.

The Mexican Peso Crisis

The Mexican Peso crisis of 1994 should not have surprised observers as much as it did. On the one hand Mexico belongs into a Latin American financial context in which currency crises have been endemic. From a sample of Latin American, Asian, European and Middle Eastern economies surveyed between 1970 and 1995 it has been found that “Latin American countries suffered, on average, 50 percent more crises per country” than the rest (Kaminsky and Reinhart, 1998 p. 2). On the other, Mexico had already experienced a major currency crisis in 1982 condition that brought to public consciousness the extent and dramaticity of the international debt crisis. In 1982, as in 1994, the peso was pegged to the US dollar at a parity which in essence was not congruent with fundamentals. Although the government at one point in time had declared its intention to defend the existing parity of 26 pesos to the dollar “like a dog”, only two weeks after that pious declaration, on the 19th February 1982,

the support of that rate was abandoned and the exchange rate collapsed to 45 pesos to the dollar (Roubini, 1998b, part 5). The crisis was caused by lax monetary policy, excessive fiscal deficit-financing which led to obvious corollaries: divergent inflation rates with trade partners, fundamentally the US, and evident overvaluation of the peso requiring continuous backing with something that, in such conditions, could not be continuous: Mexican foreign reserves. The February 1982 devaluation to 45 pesos was taken by the market as a signal of central bank impotence which seriously undermined confidence both at home and abroad. By August 1982 the collapse was close to total and the imposition of severe state currency controls happened too late, when capital flight had acquired massive proportions, foreign reserves had become exhausted and, considering the large number of Mexico's friends in similar dire straits in heavily indebted Latin America, the international finance world was set into a state of panic. The risk of Mexico's defaulting on its foreign debt would have developed into a major financial crisis in the US. No wonder the US administration was quick to launch a rescue package of US\$ 4.55 billion (equivalent to US\$ 7.2 billion in constant 1995 dollars) while Mexico was seeking an agreement with the IMF as well as with its main creditors (Lustig, 1997 p. 1). The Peso crisis of 1982 was the dress rehearsal for 1994.

The 1994 peso crisis was the final outcome of a long term process. The years following the 1982 disaster were rich in attempts at finding ways of achieving economic stability. In a fashion similar to Great Britain's years under a "social contract", Mexico's tripartite agreement -embodied in the *Pacto de solidaridad económica* (Pact of Economic Solidarity) signed by labour, employers and the government in 1987- was combined with an incomes policy necessary to forestall the social turmoil arising from an austerity plan destined to tighten monetary policy, achieving fiscal discipline, trade liberalisation and exchange rate stability (Lustig, 1995 p.2). The success in reducing inflation was not sufficient to reach the levels of price stability achieved by trade partners, particularly in the US. Mexico's inflation rates during the early 1990s remained about 5% above US inflation and this divergence from purchasing power parity rapidly led to current account deficits to the tune of US\$ 28 billion by the end of 1994 (Roubini, 1998b, part 5).

The ensuing overvaluation of the peso was worsened by private capital inflows attracted by privatisation schemes and by the high interest rates to which the government had resorted in order to defend the almost fixed exchange rate. These conditions forced Mexico to implement mild reforms to its exchange rate policies. A crawling peg was adopted in 1989 allowing for peso depreciation at a decreasing annual rates. Another reform in 1991 introduced an oscillation band with ceiling and floor levels being progressively enlarged in order to accommodate the vulnerability of the exchange rates. This lasted until December 20, 1994 when the ceiling was widened to 15%, a change that failed to cushion the assaults on the peso. Two days later, as in 1982, the currency could not longer be supported by exhausted reserves and the peso was allowed to float thus breaking to the less informed the news of another currency crisis of unprecedented virulence (Lusting 1995 p. 4). From March to December 1994 foreign reserves had fallen from nearly US\$ 30 billion to around US\$ 5 billion

East Asia

There is already plenty of literature on the East Asian crisis. Still plenty more is in the making as the unfolding of the crisis continues. As ever, there are long term structural factors to consider as well as the immediate factors that unleashed the current crisis.

Long term considerations refer to the debate on whether an Asian miracle existed at all. It was already in 1993 when Krugman questioned the long term prospects of the East Asian economies particularly those of the NIEs (Krugman 1997a and 1998a) and provided a great deal of food for thought in the debate that ensued. The discussion focused on the type of growth achieved by the Asian tigers. Krugman, as well as Alwyn Young, believed that the formidable growth rates achieved were built on the sandy foundations of input-based growth, as opposed to more healthy productivity-based growth. The high growth rates achieved were the product of “high investment rates, mainly though not entirely, financed by domestic saving; a rapidly improving level of education; and the transfer of large numbers of underemployed peasants into the modern sector” (Krugman 1997a) In other words, it was simply another case of what Arthur Lewis had already discovered in 1952 when he was “walking down the road of Bangkok one morning in August 1952” (Lewis 1984, p. 132) i.e. that wage differential between an urban capitalist market and a traditional farming economy provokes the transfer of labour from the traditional to the modern sector at a constant wage and with infinitely elastic supply, thus reducing costs and improving the profitable prospects conducive to high levels of domestic saving (Lewis 1954). The problem of East Asian Economies, Krugman claims, was that low cost supply of labour was not infinite as “a rapidly developing country eventually runs out of peasants” (Krugman 1997a). The current crisis therefore, is simply the predictable denuement of the story: economies based on low total factor productivity growth are bound to meet eventual diminishing returns. If East Asian economies are to keep growing, albeit at moderate rates, they should cross the technological Rubicon: increasing output per unit of input through genuine technological development no longer based on the mere adoption of imported technology. Even then, economic growth will tend to settle at a level compatible with population growth and with technological change and such a level will not warrant the achievement of standards of living currently achieved by developed countries (Kaplan, 1996).

As expected, Krugman’s views are hotly disputed: his likening of East Asian economies to the demised Soviet Union, his empirical findings on factor productivity growth, his underestimation of East Asian’s export performance and of investment rates are all subject to criticism although it is difficult not to fall to the appeal of his iconoclastic approach.²

There is greater consensus on the part of economists who have analysed the immediate or short run conditions that preceded the Asian turmoil and the ensuing currency crises in the various countries. The canonical elements of a typical crisis are

all present but modified by emerging novelties which make the current situation rather special.

In the first place, it is a canonical condition for a currency crisis to have rigid exchange rate systems, as indeed most East Asian economies had, ranging from the currency board system of Hong Kong to the pegging of currencies to the US dollar applied in most of the other economies. For most of the early 1990s in Malaysia the Ringgit was pegged within an oscillation band of 10% at 2.5 to 2.7 ringgit to the US dollar; the Baht in Thailand moved within a narrow range of 25.2 to 25.6 to the dollar, the South Korean Won was subject to flexible pegging allowing for episodic adjustment until 1993 when the oscillation range was narrowed to 770-800 per dollar with successive devaluation to 840 won to the dollar in 1996. Taiwan and Indonesia followed an open real exchange rate targeting with the New Taiwan dollar falling from T\$ 24 per US dollar in 1990 to T\$ 27.8 per US dollar at the end of 1996 whereas in Indonesia the rate fell from Rupiah 1900 to the US dollar in 1990 to R 2400 at the beginning of 1997. In the Philippines the peso was first allowed to fluctuate between 24 to 28 to the dollar from 1990 to 1995 and was fixed at 26.2 between 1995 and 1997. Singapore was rather odd because its currency actually appreciated from S\$ 1.7 in 1990 to S\$ 1.4 at the end of 1996. Finally, the Chinese Yuan was allowed to fall mildly between 1990 and 1993 and then devalued by close to 50% in 1994 when the rate was maintained at a fixed nominal value. (Roubini 1998b part 5)

Table 1. **Comparison of Exchange Rates at 7th Feb. 1997 and 27th March 1998**
(All exchange rates against the US Dollar)

		At 7 Feb. 97	At 27 March 98
China	Yuan	8.2916	8.2792
Hong Kong China	HK\$	7.7473	7.7473
Indonesia	Rupiah	2377.50	8450.00
Japan	Yen	124.655	130.335
Korea (South)	Won	866.250	1378.75
Malaysia	Ringgit	2.4937	3.5750
Philippines	Peso	26.3450	37.3500
Singapore	\$	1.4145	1.5885
Taiwan	T\$	27.5100	32.6160
Thailand	Baht	26.0250	37.8500

Source: **Financial Times**, 10 Feb. 1997 and 30 March 1998

Allowing for some settlement changes, currencies of the East Asian economies seemed to be relatively healthy during the 1990s. Nevertheless, it was progressively becoming more and more difficult to keep currencies within the

pegging levels planned by monetary authorities. Such difficulties mounted in 1997 and precipitated the crisis. Such a crisis was the natural outcome of the accumulation of factors to the point at which they became insurmountable and very explosive. It is not so difficult to explain things once the events have already happened and the advice of those, like Krugman, who warned about the “bahtulism” of East Asian currencies maybe was disregarded as the singing of an anachronistic Cassandra.

Signs of real appreciation of the currencies were apparent from the early 1990s. The cost of a stable currency is the increasing difficulties in keeping a healthy current account. Indeed most of the East Asian economies developed current account deficits during the 6 years preceding the crisis (IMF 1997, p. 7). Within the rigid exchange rate systems in operation a deficit on current account becomes part of a vicious circle. The overvaluation of the currency makes exporting more difficult and this in turn leads to further overvaluation of the currency. The real appreciation of the pegged Asian currencies worsened when the peg itself, i.e. the US dollar, also began to appreciate from 1995 onwards. The appreciation of the currency that was an anchor to the Asian economies pulled further the overvaluation and turned the current account prospects very dire still.

There is also the formidable impact of the currency changes both in China and Japan. At the beginning of 1994 monetary authorities in China decided to unify the official and the swap exchange rates. This decision amounted to a devaluation by 50%, although the fact is recognised that such a devaluation was effective at a weighted rate of around 10% only because about 80% of foreign transactions before the devaluation used to be made at the swap exchange rate which was a rate lower than the official one. The real impact of China on the other Asian partners arose from improvements in competitiveness of the former and the beneficial effects of progressive structural reforms which somewhat eroded further the current account prospects of the other fellow Asian economies. As for Japan, the divergence in US dollar/Yen cross rates worked out as a formidable advantage to the Asian economies before 1995. On one hand the relative appreciation of the Yen opened vast market opportunities to the other Asian economies and, on the other, the relative depreciation of the US dollar led the pegged currencies in the same direction further improving potential trade prospects. This situation changed substantially from mid-1995 onwards when the US dollar began to climb thus reducing the competitiveness of the Asian economies whose currencies were pegged to the dollar (IMF 1997 p. 11-12).

The current account predicament was also negatively affected by external demand becoming relatively slack and international market prices falling in real terms. On the other hand, the tendency towards overheating put pressure on factor costs and reduced profit margins in most East Asian economies. It was this latter effect that produced also asset-price inflation, particularly in real estate into which investment was being diverted after 1995. With currencies kept at an artificially stable level, inflation in the real estate market was actually translated into short term gains, if one measures the appreciation of properties in foreign currency. This was the major market distortion provoked by rigid exchange rate policies during 1997, when the crisis precipitated in full swing.

If currency rates did not give way to accommodate rising asset prices, they caused a similar effect on international interest rate differentials. Stable pegged rates required high interest rates at home and this in turn made foreign borrowing extremely attractive. The inflow of foreign capital produced the illusion of buoyancy and even bonanza, particularly as these flows reinforced the foreign reserve position of monetary authorities. The problem with global financial mobility is that such mobility can happen both inwards and outwards and, when the time came, original flows were reversed leaving a sequel of bankruptcies and massive losses.

The above analysis does not take into consideration the differing performances of the various Asian economies although it does convey a representative picture of the “East Asian crisis” in its globality which is valid for the comparative purposes of this paper.

Comparative Analysis

There are substantial similarities between the Mexican peso crisis and the current Asian crisis. It could be contended that recent events have led to a “Latinisation” of East Asia in two respects: First, the frequency of the crises in East Asia and their geographical spread smack of Latin America in the 1970s and 1980s. Secondly, the massive inflows of foreign capital in the Asian economies suggest also a resemblance with the Latin America of the post oil-shock debt crisis.

In the specific cases of Mexico and East Asia in both cases the deterioration in current account was at the base of the crisis. Maybe the deficit was worse in Mexico, where it accounted for 7% of GDP prior to the crisis in December 1994 (Zandy 1998 p. 1) than in most East Asian economies at the eve of their crisis. Table 2 shows the current account conditions of the East Asian economies in 1996

Table 2. Current Account Balances as Percentage of GDP. 1996

South Korea	-4.89
Indonesia	-3.41
Malaysia	-5.99
Philippines	-5.86
Singapore	16.26
Thailand	-9.18
Hong Kong	0.58
China	-0.34

Source: Nouriel Roubini, **An Introduction to Open Macroeconomics, Currency Crises and the Asian Crisis**, Part 5, 1998
(URL: www.stem.nyu.edu/~nroubini/notes/intromacro.html)

Both regions received plenty of foreign capital inflows but the magnitude was obviously much greater in Asia. The total external debt outstanding in Mexico at the end of 1990 was US\$ 96.8 billion 70% of which borrowed from private sources. This debt required total annual servicing (both interest and principal) of US\$ 12.1 billion and determined a Debt/GNP ratio of 42.1%. The debt service ratio, i.e. the interest/export ratio was then 16.7% (World Bank 1992). Such a heavy burden forced Mexico during 1989-1994 to pay interests to the tune of US\$ 63.5 billion and this was 57.1% of all foreign borrowing requirements (Lopez Villafañe and Olivares 1995).

Is the Mexican experience a signal for what is to befall Asia? The magnitude of foreign borrowing in East Asia prior to the crisis is very impressive. Table 3 provides a partial account of International Bank Lending alone.

Table 3. International Bank Lending to East Asia
(Sums Outstanding at the end of 1996. US \$ billion)

	US Banks	Japanese Banks	European Union Banks	Total International Lending
China	2.7	17.8	26.0	55.0
Hong Kong SAR*	8.7	87.5	86.2	207.2
Indonesia	5.3	22.0	21.0	55.5
South Korea	9.4	24.3	33.8	100.0
Malaysia		2.3	8.2	9.2
Philippines	3.9	1.6	6.3	13.3
Singapore*	5.7	58.8	102.9	189.3
Taiwan Province	3.2	2.7	12.7	22.4
Thailand	5.0	37.5	19.2	70.2
Vietnam	0.2	0.2	1.0	1.5
East Asia Total	46.4	260.6	360.3	736.6

Source: Bank for International Settlements (In IMF **World Economic Outlook**, 1997)

*The data for Hong Kong Special Administrative Region of China and for Singapore reflect the role of those markets as international financial centres.

The total volume of loans to East Asia, put on a long term perspective, adds to the current account problems of the past years. The resulting counterflow of repayments and interest servicing that such a substantial indebtedness requires would weaken the capital account leading to an overall balance of payments deficit which necessarily will contribute to further deterioration in the value of the Asian currencies. This is a situation *deja vue* in the Mexican case and maybe now the East Asian economies are bound to follow a “Mexican path”.

What did each region do with the proceeds of their international borrowing?

Originally, in 1990, Mexico received substantial inflows of portfolio investment particularly once the negotiations of the Brady Plan had been signed in February. Relatively lower interest rates in the United States pushed mutual funds into Mexico in search for better yields. This was further stimulated by Mexico's announcements of privatisation of several enterprises including the banks. (Lustig 1995 p.4) By the end of 1994 though the overvalued exchange rates led to the perception of both foreign and Mexican investors that further investment would no longer be as profitable as expected. The additional foreign investment that reached the Mexican markets was diverted into consumption instead of investments. (De Long, De Long and Sherman 1996 p. 6).

As for Asia, the magnitude of foreign investment inflows was far greater than in Mexico which is natural given the relative differences in size of these two areas (See Table 3). It seems now clear that Asia during the 1990s lived in a financial environment very similar to that of Latin America in the 1970s. In both periods financial markets were loaded with excess liquidity which they tried to push into third markets. Asia was the pole of attraction as much as Latin American in each respective period. The progressive building of such financial inflows increase the vulnerability of a currency when financial flows get suddenly reversed.

In the case of Asia, as much as there was an abundant supply of liquidity in financial markets, there was also the attraction of the Asian markets enjoying high rates of GNP growth and a respectable level of investment absorption during the early 1990s. The problems associated with capital inflows arose from a metamorphosis in the nature of the investments in some particular Asian economies. For as long as financial inflows were placed into long term direct investment the danger of any sudden crisis was averted. If at all, a crisis would have evolved at a pace similar to the process whereby investment had originally built up. The problem arises when inflows are made of short term hot money which can also be removed at short notice leaving in its wake a formidable currency implosion.

The case of Thailand is a paradigm for this condition: The average rate of investment in 1983-89 was 28% of GDP and it was enough to sustain annual growth at around 8% during the same period. The rate of investment rose to around 40% of GDP during 1990-96 but the resulting growth rate increased only to 8 ½ %. Domestic saving was not able to cover 40% of GDP and the shortfall was covered with net capital inflows and current account deficits. The substantial increase in investment rates with only marginal increases in growth led to the perception, among foreign investors, of an eventual inability to yield the expected rates of return. Worse, the perception of eventual default also began to build up. (IMF 1997 p. 69-70)

Such an increase in investment without a commensurate increase in growth rates pointed towards an overheating of the East Asian economies. Inflation in property prices was an obvious sign of such overheating and, given the fact that pegged or rigid currencies were kept at a relatively stable level, it became attractive to move into real estate investment. The vice of real estate inflation, against the

background of a relatively rigid currency, was in practice perceived as a virtue by investors, (i.e. inflation = profits) although it was not difficult to perceive that it could not last forever. In Mexico instead a similar move was from investment into consumption; the property bubble component of the crisis was mainly Asian.

Not all Asian economies faced such dire conditions. Countries in which long term foreign direct investment was a largely prevalent share of total financial flows were well sheltered from the vicissitudes of sudden reversal of trends: China and Vietnam are virtuous examples. The most vulnerable economies were those of South Korea, Malaysia, the Philippines and particularly Thailand where short term inflows reached between 7 to 10% of GDP during 1994-96. (IMF 1997 p. 5-6 and Table 1). It was precisely in those countries where the crisis developed with greater initial momentum. In the comparison between Mexico and East Asia almost every contributing element of the crisis is found in both regions. The difference is in degrees. Let us take one of them: What safeguards exist in terms of regulation and control of the financial markets in each case? This is a fundamental question that challenges the wisdom of economic policies currently implemented in most countries of the world: the swift implementation of liberalisation and free market economics.

Although there were severe cases of poor regulation and control over the banking sector involved with hot money transactions following the process of liberalisation and privatisation, Mexico in this respect had partially learned the lessons of its 1982 crisis and had tried to tighten controls, at least to reduce the effects of a devastating self-inflicted wound: capital flight. Nevertheless neither in Mexico nor in East Asia were supervision and controls adequate to prevent or to face a financial crisis. When policy makers believe in the perfection of free markets their initial bewilderment in the wake of a crisis is usually followed by helplessness when they are forced to take action in spite of their *laissez faire* instincts. Mexico and East Asia are not completely different in the way they reacted to each crisis: strong government intervention and control once the crisis had exploded, mixed with a munificent and forgiving hand. The old model established by Chile in the aftermath of the 1982 currency crisis was somewhat resuscitated in some Asian countries in 1997, particularly in Thailand. In Chile the government intervened 10 large banks that concentrated 45% of the capital and reserves of the whole Chilean financial system and provided them with a US\$ 6 billion bailout (equivalent to 30% of Chile's GNP) during 1983-95. This was then done by a military regime that took pride in leading the country through a pure market path. (Valdes 1995 p. 261-64)

The main difference between the Mexican and the Asian crises lies in the way in which government action is related to the problem **before** the crisis erupted. Governments did not act only to salvage the financial system after the disaster but, to a large extent and before the crisis exploded, provided a protective wing that led to the creation of extensive moral hazard.³ Neither foreign investors, nor domestic intermediaries had incentives to monitor the performance and risk involved in the investments in which they were involved. This because there was the implicit condition of an eventual government bailout in case of difficulties. According to Roubini, moral hazard was supported by objective and practical conditions of the financial markets in some East Asian economies: Some banks were controlled directly

or indirectly by the government and credits were tinged with political favouritism; depositors themselves were given protection so they also had no incentives to monitor the destination and performance of banks' loans and private banks themselves worked on the assumption that a government guarantee was available in case of running into difficulties. The problem of moral hazard had been both substantial and disastrous in the case of Chile in the early 1980s, was relatively smaller in the case of Mexico in the early 1990s and was more widespread in the case of East Asian economies up to the point of the current crisis.

Another significant difference between East Asian economies and Mexico refers to the type of international agreements in which they live. There is a difference when you have solvent friends who can afford to give you a hand during lean years and when your friends are as bankrupt as you yourself are. Such is the case with the contrast between the NAFTA and the ASEAN. On the one hand, the level of market integration envisaged by NAFTA was much deeper than those stipulated on ASEAN's Bangkok Declaration of 1967.⁴ On the other, the fact that NAFTA had been signed and implemented in the years immediately preceding the Mexican currency crisis found very committed members fully prepared to face the crisis head on so that the political prestige of governments, both in Mexico and in the United States, would not be ruined by the crisis.⁵ Indeed, the North American Free Trade Agreement was negotiated and signed by Canada, The United States and Mexico at the end of 1992 and, besides the mutual trade conditions agreed upon there was Mexico's commitment towards a thorough programme of economic reform. To some extent, the peso crisis exploded as a surprise because, in the views of several economists, Mexico was doing the right things: by the spring of 1994 "the government budget had shifted from substantial deficit to surplus, businesses were privatised, tariffs were being lowered ... the inflow of capital had risen from zero to five percent of GDP" (De Long, De Long and Sherman 1996 p. 6). The IMF itself had declared then that "a strong and unqualified endorsement of Mexico's economic management" was in order. (cited by De Long, De Long and Sherman 1996 p. 7) There remained the problem of slack growth and uncompetitive exports, the latter caused by the overvaluation of the peso.

Even when the crisis was in full swing there was the perception that the Mexican economy was more illiquid than insolvent. De Long, De Long and Sherman (p. 8) point to the success of the ensuing peso devaluation as a proof that the problem was simply illiquidity and not insolvency. It is difficult to say the same about some of the East Asian economies because the answer can only come with time allowing for further assessment once the crisis completes its full circle. Mexico, of course, was assisted by its neighbourhood, and now by its almost structural linkage, with the United States at a time when this economy was achieving a solid economic revival. As already mentioned, NAFTA made the big difference. The free trade agreement turned the post crisis devaluation very effective in reversing current account deficits, particularly with the US. The bilateral trade balance alone, which on a monthly basis showed a Mexican deficit of around US\$ 300 million in January 1994, moved to a US\$ 300 million surplus a year later. The Mexican surplus rose to more than US\$ 1.6 billion by May 1995. (Krugman and Obstfeld 1997 p. 470-71)

Mexico was also assisted by the other Latin American economies, if not so actively, passively. Most Latin American economies felt the “tequila effect” but they held firmly to their own currency stability even when pressures became relentless, as in the cases of Argentina and Brazil. In the East Asian economies, instead, there was the domino effect of devaluation that led governments, domestic firms and foreign sectors to the fringes of raving panic as one after the other most currencies depreciated.

The nature and size of the rescue packages in each case merit some discussion. In Mexico, the size of the rescue package agreed upon in February 1995 amounted to the unprecedented value of US\$48.8 billion. The US contributed up to US\$ 20 billion with most of that sum coming from the US’s Exchange Stabilisation Fund.⁶ The size of the Asian rescue packages is higher still and the difference between Mexico and Asia here lies on who is in command of the operation. Certainly the U. S. in the case of Mexico and the IMF in the case of Asia. The immensity of the IMF involvement has also led to an interesting debate which falls beyond the scope of this paper.⁷

Conclusions

If one looks at the anatomy of each currency crisis the fundamental common denominator to be found is the long term factors which created the conditions for the genesis, development and explosion of a crisis. Such long term factors are related to the fundamentals of an economic development strategy. The preceding pages refer to the dismal conditions of some economies. A word is needed to mention the relatively healthier conditions of the absentees. China, Hong Kong, Taiwan province and, to a lesser extent Singapore, are managing to weather the crisis in better conditions than the others. Why? Its the fundamentals my dear John! It is not possible to say that you know a crisis when you see one. Better say that you know the next crisis when you read the column for the current account, the capital account, the inflation rates, the tenor of monetary and fiscal policies and, as the Asian currency crisis teaches us today, the system of regulation and controls of financial flows. A very long term fundamental to see is the one that tells us whether an economy grows simply by consuming greater amounts of exhaustible inputs or whether there is a sustained improvement in total factor productivity.

Although the globality and volume of international transactions increases the danger of contagion, the prevalence of sound fundamental provides the best defence for an economy. Viruses are lethal when they land in the midst of insalubrious conditions.

Latin America is certainly moving towards greater stabilisation whereas Asia is becoming more unstable. The effects of the Mexican peso crisis were more circumscribed than the current Asian crisis whose ripples are still moving into wider and wider circles.

Several interesting issues are left in the “pending tray”. The size and the nature of the rescue packages calls for a redefinition of the new role assumed by the International Monetary Fund. The social costs of the crises also needs greater attention. Much has been said and done to rescue property speculators, banks, and even governments, little is said and done about the common people, those who are always told to wait for the trickle down from economic progress and get instead the massive spillover from failure.⁸

NOTES

¹ Currently there is a very interesting debate regarding this point, James Meigs 1997 argues that Mexico's troubles could have been avoided if Milton Friedman's advice to resort to a floating exchange rate would have been heeded. See Salinas-Leon's lucid criticism of such floating exchange panacea regarding the Mexican peso crisis (Salinas-Leon 1997)

² As a point of curiosity, Roubini remarks on how "Krugman's criticism has been taken quite seriously in Singapore. After denying or minimising for two years the problem, the Singaporean authorities have now officially accepted Krugman views and started a policy drive to increase Total Factor Productivity growth: this is a rare example of an academic paper leading to a major change in economic policies!" (Roubini 1998b Part 3 citing The Wall Street Journal: "Singapore Swing: Krugman was Right", 23 Oct. 1996). For critical notes on Krugman's views see The Economist, 1997a and Kaplan 1996.

³ Moral hazard arises when investment decisions are taken with an external advantage that reduces risks for the investor and increases risks for the investment scheme itself.. The external advantage is normally provided by the government in the form of implicit or explicit guarantees against eventual losses. Paraphrasing Krugman, the moral hazard problem is a case of "heads I win, tails the guarantor loses." (See Krugman 1998a p. 5)

⁴ The Asian Free Trade Area (AFTA) was also formed in 1993 but the main target of reducing tariffs to a maximum of 5% is planned to be started in the year 2008.

⁵ This was the case particularly with the United States. NAFTA had influential detractors, like Raph Nader, Pat Buchanan and Ross Perot, claiming that such an agreement would bring about a major disaster to the U. S. The onset of the peso crisis would have proved them right and this fear moved the Clinton administration into swift action.

⁶ Using the Exchange Stabilisation Fund allowed President Clinton to avoid a congressional vote which was likely to be adverse. See Lustig 1997; White House 1995, 1996a and 1996b; De Long, De Long and Robinson 1996.

⁷ For this debate see The Economist 1998b, Fischer 1998, IMF 1997, Krugman 1998b, Montagnon 1998, Sachs 1997abc and World Bank 1998.

⁸ The president of the World Bank James Wolfensohn declared on April 15 to the press: "With a crisis like this, combined with the impact of droughts and El Niño, you have a very, very large number of people who are being pushed back into poverty" (World Bank News, Volume XVII, No. 8 April 23, 1998). See also the interesting note published by Sydney Jones on the Financial Times (Jones 1998). See also Buyske 1998, and "Asia goes on the Dole", an article published on the Economist edition of April 25, 1998.