# What Lessons Does the Mexican Crisis Hold for Recovery in Asia?

The Mexican and the Asian crises have striking similarities. A comparison of the two provides lessons about how emerging economies can safeguard themselves against sudden capital outflows.

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MICHEL CAMDESSUS, the Managing Director of the IMF, described the Mexican crisis in 1994–95 as "the first financial crisis of the twenty-first century" to draw attention to the volume and velocity of the capital flows involved. The similarities between the Mexican crisis and the recent financial crises in some Asian countries are striking. What stand out are the problems of economic policy management faced by emerging nations in a world of highly mobile capital. A comparison of the two crises can help us to understand better their causes and yield some useful lessons about the vulnerability of emerging economies to sudden capital outflows.

The foreign exchange and financial problems encountered by Mexico in 1994–95 and by the Asian economies in 1997–98 caught many by surprise, given that these economies were considered to be fundamentally sound and even held up as models for others to emulate. The huge fiscal deficits or high inflation seen in other countries that have experienced financial crises were not apparent in either Mexico or the Asian countries. Both the Mexican and the Asian crises were preceded by very buoyant financial markets for the assets of the countries in question and, therefore, by major inflows of capital. In both cases, investors abruptly changed their attitudes, leading to bouts of panic and massive outflows of capital. Similarly, the sudden interruption of capital flows unleashed a profound crisis in domestic financial systems, threatening the stability of the productive sectors.

## Prelude to the crises

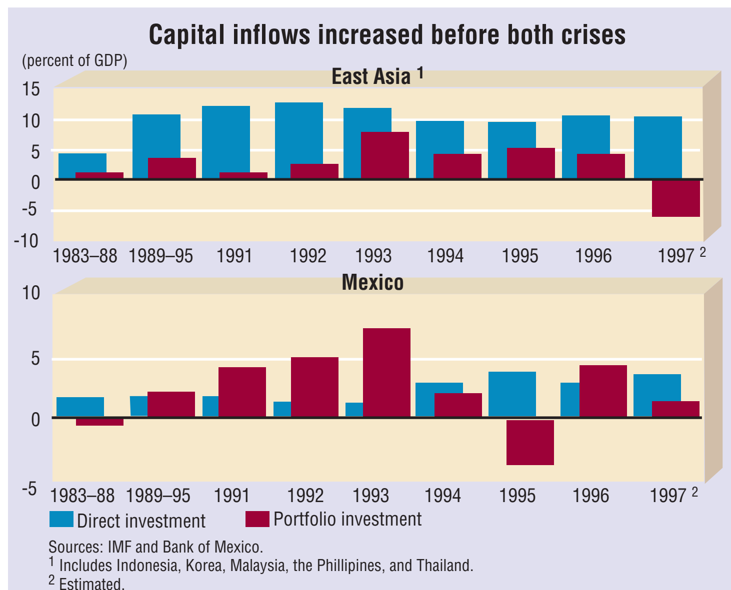
The process of structural change and macroeconomic stabilization initiated in Mexico 12 years ago, and the exceptional economic development of most of the Asian countries from the late 1980s through early 1997, contributed to the very rapid growth of net capital inflows into those countries (see chart). In addition, investors seeking better returns at a time when industrial country markets seemed to offer less profitable opportunities, owing to slow economic growth and lower interest rates, transferred vast amounts of capital to the emerging markets, possibly underestimating the risk in those markets. Mexico and the Asian countries are high on the list of countries that benefited from this behavior.

In both cases, the capital flows contributed to a very pronounced expansion of aggregate demand, a considerable increase in stock and real estate prices, accelerated growth of bank assets and liabilities, and a sizable external current account deficit (Table 1).

Mexico received considerable capital inflows in the years leading up to the crisis of 1994–95. To a large extent, this capital was

attracted by the favorable outlook for the economy after years of macroeconomic stabilization and intensive structural reform. Starting in the mid-1980s, the country had embarked on a program of fiscal consolidation, deregulation, and privatization. It had also undertaken major financial reforms, renegotiated its external debt, and made serious efforts to open up trade, including the signing of the North American Free Trade Agreement (NAFTA).

These policies led to economic recovery after nearly a decade of low growth and high inflation. From 1989 to 1994, Mexico's average GDP growth rate was 3.9 percent, and, in 1993, inflation fell to single-digit levels for the first time in over 20 years. These developments suggested that Mexico was poised to enjoy sustained economic growth. In this context, unprecedented amounts of capital flowed into the country, reaching $104 billion between 1990 and 1994—20 percent of total capital flows to developing economies during that period.



Sources: IMF and Bank of Mexico.
[1] Includes Indonesia, Korea, Malaysia, the Phillipines, and Thailand.
[2] Estimated.

These capital flows helped widen Mexico's external current account deficit to such an extent that investors began to question its sustainability. The Mexican economy became more vulnerable because of this and other factors—notably, rapid growth of bank credit to the private sector, maintenance of an exchange rate peg or anchor, rising international interest rates, and political events and criminal acts that generated considerable uncertainty.

In the Asian countries, some of the capital inflows were short-term flows that were largely absorbed into the financial system. Financial institutions in some countries channeled a large proportion of these funds, with no foreign exchange cover, into risky investment projects, especially in the real estate sector. As a result, the prices of these assets soared, attracting even more investment into the sector. Because the Asian economies were growing at a very fast pace, the negative impact of this type of resource allocation was not immediately apparent. However, prices were pushed up so high that a correction was inevitable, causing a significant gap between the value of the loans and the value of the real estate backing them. As property prices collapsed, banks' overdue portfolios began to swell and the financial system weakened.

Table 1

**Mexico and the Asian countries ran external current account deficits before the crises**

(percent of GDP)

| | 1995 | 1996 | 1997[1] |
|---|---|---|---|
| Indonesia | -3.3 | -3.3 | -2.9 |
| Korea | -2.0 | -4.9 | -2.8 |
| Malaysia | -10.0 | -4.9 | -5.8 |
| Philippines | -4.4 | -4.7 | -4.5 |
| Thailand | -8.0 | -7.9 | -3.9 |
| | **1992** | **1993** | **1994** |
| Mexico | -6.7 | -5.8 | -7.0 |

Sources: IMF; and Bank of Mexico.
[1] Preliminary.

## Exchange rate arrangements

Another pre-crisis feature common to Mexico and the Asian economies was the existence of an exchange rate peg or anchor. This type of exchange rate arrangement is very difficult to defend against speculative attacks, especially when a country's financial system is weak. The interest rate increases required to shore up the exchange rate have a severe negative impact on the financial system and may even cause a crisis in that sector.

Furthermore, exchange rate anchors can cause distortions in the financial system. To the extent that the peg is considered an implicit guarantee that there will be no changes in the value of the currency, it is an incentive to borrow in foreign currencies and encourages the financial and business sectors to incur excessive exchange risk. In addition, with an exchange anchor, investors know that the implicit guarantee of convertibility is limited by the availability of international reserves and a country's capacity to borrow abroad. Consequently, when doubts arise as to the sustainability of its exchange rate arrangement, a country will attract mainly short-term, speculative capital inflows.

In Mexico, as in Asia, appreciation of the real exchange rate, growing short-term external debt, and the size of the external current account deficit, compounded by the weakness of the financial system, exerted strong pressure on the foreign exchange market. Speculative pressures against the peso led to abandonment of the peg and the adoption of a floating exchange rate on December 22, 1994.

Table 2

**The crises caused currencies to depreciate, share prices to drop, and interest rates to soar in some countries**

| | Depreciation of the currency vis-à-vis the dollar | Changes in the share price index | Changes in interest rates |
|---|---|---|---|
| | (percent) | | (basis points) |
| | July 1, 1997–February 16, 1998 | | |
| Indonesia | 231.00 | -81.74 | 2,398 |
| Korea | 83.04 | -63.06 | 965 |
| Malaysia | 55.43 | -58.41 | 373 |
| Philippines | 51.37 | -49.17 | 0 |
| Thailand | 87.09 | -48.37 | -25 |
| | December 2, 1994–March 31,1995 | | |
| Mexico | 98.12 | -28.12 | 5,875 |

Sources: Bloomberg Financial Services L.P.; and Bank of Mexico.

Similarly, as the markets began to question the sustainability of exchange rates in Asia, speculative pressures increased. This occurred against a backdrop of considerable short-term external debt, declining real estate prices, decreasing external competitiveness, and major current account deficits. The Asian countries had problems defending their currencies because of the weakness of their financial systems; speculation increased, leading to the collapse of their exchange arrangements.

In the case of both Mexico and some of the Asian countries, investors' concerns about the sustainability of exchange arrangements in a context of large current account deficits and weak financial systems characterized by inadequate supervision and regulation, coupled with difficulties in the political environment, led to speculative attacks on the countries' currencies. This resulted in drastic devaluations as it became impossible to defend currency parities indefinitely by drawing down reserves and raising interest rates, particularly in light of the weakness of domestic financial systems. Stock markets also plummeted in both Mexico and Asia (Table 2).

## Weakness of financial systems

The banking systems of both Mexico and the Asian countries showed signs of weakness even before the crisis.

In Mexico, the liberalization of the financial sector and the privatization of the banking system were central to the structural reform program. This, together with the availability of more resources as a result of fiscal consolidation and capital inflows, led to the considerable growth of credit to the private sector. From 1989 to 1994, financing from private sector banks expanded at an annual rate of 25 percent, quadrupling as a percentage of GDP (from 13.4 percent in 1988 to 50.7 percent in 1994). Unfortunately, this happened at a time when there was inadequate financial supervision and regulation by the monetary authorities and before the banks could establish the necessary internal controls to ensure that credit would be granted prudently.

As a result of the nationalization of the banks in 1982, commercial banks lost trained and experienced personnel. Also, most funds available for lending in the 1980s were channeled to the federal government, resulting in minimal credit and market risk assessment. Under these circumstances and with the wealth of funds available for lending in the banking system, expertise in granting credit to the private sector, which usually carries greater risk, had been lost.

In Asia, the banks acted to a certain extent as instruments for industrial promotion and not as financial intermediaries devoted to allocating resources to the most productive uses. Banks and industrial groups were closely connected to each other, in addition to having intimate ties with the government. Bank regulation and supervision were generally inadequate and banks' internal controls lax. Market and credit risk assessment was not rigorous and, in some cases, there was no clear commercial basis for granting loans. It was generally believed that the government would not allow the banks to fail and that bank deposits were fully guaranteed. All these factors—which were more or less pronounced, depending on the country—gave rise to imprudent lending practices. In addition, easy access to external resources made it possible to incur debt in foreign currencies without properly evaluating the exchange risk. Consequently, banks ended up financing unprofitable projects with resources carrying an excessively high exchange risk.

## Mexico's response to the crisis

As soon as the Mexican crisis erupted, the government recognized that it was a financial crisis of unprecedented scope that required a number of far-reaching adjustment measures and extraordinary financial support. The challenge for economic policy was not only to reduce the external current account deficit but also to adopt measures to prevent the collapse of the financial and productive sectors. Thus, in addition to fiscal and monetary adjustments, the adoption of a floating exchange rate, and advances in structural reform and market liberalization, the Mexican authorities negotiated an emergency financial package with the U.S. government, the IMF, the World Bank, and the Inter-American Development Bank to avoid suspending payments on the country's external obligations. This financial package was also necessary to prevent the Mexican crisis from spilling over to other countries.

Preventive measures were also taken on the domestic financial market to avoid contagion, by means of a rescue package in support of banks and borrowers alike, and prevent a widespread collapse of financial institutions. The package included the following measures: provision of liquidity in foreign exchange by the central bank to commercial banks to prevent them from becoming delinquent on their foreign obligations, activation of a program to provide temporary capital to banks and a subsequent program to increase the incentives for distressed banks, legal reforms to

allow greater foreign equity participation in banks, and programs to back certain categories of bank debtors.

From the start of the crisis, the government carefully calculated the cost of support to the banking system and its debtors, in order to maintain a sound fiscal position. The fiscal cost of supporting the financial system is estimated at 14.4 percent of GDP for 1997, to be amortized over 30 years during the life of the programs.

The Mexican authorities were aware of the moral hazard problems involved in acting as lender of last resort in both domestic and foreign currency. However, this course of action was preferable to the alternative scenario of a deep and lingering depression and the serious risk of damage to the international financial system.

The measures adopted were certainly very costly. The results, however, have been encouraging. Although GDP declined by 6.2 percent in 1995, it has recovered, with growth of 5.2 percent in 1996 and 7 percent in 1997, the highest rate in 16 years. Other favorable economic indicators include the unemployment rate, which declined from 7.6 percent in August 1995 to 3.5 percent in February 1998; inflation fell from 52 percent in 1995 to 15.7 percent in 1997 and continues to decline.

The floating exchange rate has functioned well. The Bank of Mexico's main objective now is price stability. To that end, it has maintained strict monetary discipline backed by sound fiscal policy. The current account deficit, which averaged 6.7 percent of GDP in 1992–94, was reduced to an average of 1 percent of GDP in 1995–97. International reserves increased by more than $25 billion from January 1995 to January 1998. Total net public sector debt declined from 39 percent of GDP in 1995 to 27 percent of GDP in 1997—currently one of the lowest levels in the countries belonging to the Organization for Economic Cooperation and Development. The rate of domestic saving has increased substantially, from 15 percent of GDP in 1994 to an estimated 24.6 percent in 1997.

## Conclusion

Financial globalization poses major challenges. The current international financial system quickly exposes and punishes countries' economic weaknesses; it also facilitates the worldwide transmission of financial turmoil. It is therefore essential for countries to maintain appropriate and coherent economic policies. Despite the fact that several emerging economies have had serious difficulties with capital flows in recent times, it is important not to limit the mobility of these flows between countries. What is required is the adoption of appropriate measures to reduce the risks that capital flows can create. Macroeconomic fundamentals must be sound, with a strong fiscal position and external equilibrium. But it is especially important to improve the supervision, regulation, and transparency of financial systems. In light of the experiences of the Asian countries in 1997–98, of Mexico in 1994, and of the European Monetary System in 1992, countries should also consider making their exchange rate arrangements more flexible, given the current context of economies open to capital flows moving at high speed from country to country. F&D

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