

*Excerpted from the book: Mexico 1994: Anatomy of an Emerging Market Crash*

## **Introduction: Anatomy and Lessons of Mexico 1994**

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The late Chinese premier, Zhou Enlai, was reportedly once asked what he considered the most important consequences of the French Revolution. "Too soon to tell" was the reply. Zhou's comment has sometimes been quoted as if it provided a paradoxical example of supposed Chinese inscrutability. However, to anyone who recognizes communism itself as one of the children of 1789, Zhou's comment seems almost eerily prescient: an informed answer to the question Zhou faced would indeed be significantly different today from the response that would have been given ten or twenty years ago.

Writing in the closing days of 1997, it is tempting to answer questions about the interpretation of the Mexican financial, economic, and political crisis of 1994-95 with the same words that were used by Zhou Enlai. At one level, it is indeed too soon. Developments in Mexico and elsewhere that were set in train or influenced by the crisis are still unfolding; dilemmas that the crisis posed are still unresolved. On the domestic political side, for example, the ongoing process of change in Mexico has produced for the first time in living memory both a Mexican Congress no longer controlled by the governing party (that generated unprecedented debate over the administration's proposed budget) and the first elected mayor of Mexico City (who happens to be the ruling party's most celebrated critic on the Left). On the economic and financial side as well, Mexico is still digesting changes put into motion as a consequence of the events of 1994-95, including, for example, attempts to fundamentally transform the country's previously sheltered and opaque banking industry. Further south, the political system of Argentina is wrestling with proposals for the reform of labor markets that might not be so high on the agenda (or might not have taken the same form) had the Argentine peso not come under attack as a result of "contagion" from Mexico--an attack resisted successfully, but at the cost of an upsurge in open unemployment that the authorities are still seeking to address effectively.

The catalog of open issues could be expanded. Who can say with confidence, for example, how lasting a role the peso crisis may have played in fanning doubts within the United States concerning not only NAFTA specifically but even the broader processes of trade liberalization and integration--doubts that have crippled the Clinton administration's efforts to renew the President's trade negotiating authority? On another front, the rescue package for Mexico, which was hurriedly improvised by U.S. and international officials in the early days of 1995, broke or at least stretched a number of the rules and conventions previously thought to govern international financial dealings and institutions, thereby casting doubt on the adequacy of the old arrangements. Yet as we watch another major crisis unfolding today in East Asia, we see the same frantic signs that the rules are being made up from day to day, and that the world economic community has yet to address systematically the dilemmas that new-style crises pose for its systems of governance.

For one of the things that does already seem clear is that Mexico was the first of a new style of crisis. This recognition has been expressed in different ways. The Managing Director of the International Monetary Fund, Michel Camdessus, reportedly described Mexico as "the first crisis of the twenty-first century." David D. Hale, commenting in this volume on the role that unprecedented private capital mobility played in the origins and unfolding of the events in Mexico, writes of "the first crisis of the post-Cold War boom in securitized capital flows." In launching the present exercise, we were ourselves convinced that Camdessus and Hale were right in singling out Mexico as a unique event that also serves as a harbinger of larger changes--and that, as such, deserves the effort at understanding implied by a book-length analysis. We were also convinced (in spite of Zhou Enlai's implied warning) that, even if it is too soon for a definitive account of the Mexican crisis, there is value in attempting a review--based on the considered perspectives and insights of a diverse range of well-informed observers and participants--focusing primarily on distilling immediate lessons for policy design and implementation. Our objective has been to write a book about Mexico, yet not only about Mexico. The book may be regarded as a case study of how, in contemporary circumstances, national policy-making can become intimately interwoven not only with domestic political considerations but also with the pressures and mandates of capital markets operating on a global scale.

Understanding the way events unfolded in Mexico during the early 1990s continues to be fundamentally important to assessing the mechanics of currency crises. More important, perhaps, the eruption of the East Asian currency crises in the summer and fall of 1997 has raised the question of whether the lessons from Mexico have indeed been learned by policy-makers, private-sector analysts, and international civil servants. More specifically, as a result of the recent events in East Asia, many observers have argued that the international financial organizations--the IMF and the World Bank--and the governments of the advanced countries have failed to revamp the early warning system that was supposed to prevent a repetition of a Mexico-style crisis. (See, for example, the article by Robert Chote in the *Financial Times*, September 19, 1997.)

Despite the proliferation of post mortems on the Mexican crisis, there are still a number of unresolved issues. These include: Should perceptive Wall Street analysts have known that things were getting out of hand? And if they did, why didn't they alert their clients? How much did officials at the U.S. Treasury know about the depth of the Mexican problems? What was the role of the media? Did Mexico's unique political system influence the way in which economic policy was handled in the months preceding the crisis?

The present volume had its genesis in a meeting held at the Carnegie Endowment for International Peace in Washington, D.C., a year and a half after the peso collapse, at which earlier drafts of the papers now included as chapters in the book were presented and debated. Our authors come, as their biographies indicate (see pp. 321-24), from a range of different disciplines and backgrounds. As individuals, they all bring credentials to the table that entitle them to be heard on this subject; as a group, we hope that the diversity of their training and experience, not to mention their sometimes strong

differences in beliefs and interpretations, will be recognized as making the whole greater than the sum of its parts. We ourselves have expressed some of our views in the chapters that appear under our names. As editors, we have not attempted to impose any artificial unity of interpretation on our contributors. In this Introduction, we have two purposes. We endeavor to provide the reader with a roadmap to the main ideas expressed in each of the chapters in the book. We then outline--solely from our own perspective--a view of the key lessons that we believe analysis of the Mexican crisis can offer to other countries around the world, including but not limited to those economies in East Asia that today find themselves occupying Mexico's earlier uncomfortable place on the front pages of the world's newspapers.

## A GUIDE TO THE BOOK

The book opens with three chapters that examine the Mexican crisis primarily from a political perspective.

1. In the first chapter, American political scientist Peter H. Smith argues that the policy course of the Mexican leadership that culminated in the peso crisis--although possibly easy to label as irrational from the economist's perspective--for the most part followed a logic of its own when seen from the viewpoint of the political interests of the key players. Smith sees the longer-term political context for the crisis in the gradual fraying of Mexico's authoritarian and corporatist "perfect dictatorship"--as the coalition around the ruling Institutional Revolutionary Party (PRI) fragmented, electoral competition from the two opposition parties increased, and feuds within the political elite intensified. For Smith, political logic explains such otherwise problematic decisions during 1993-94 as forswearing devaluation, easing domestic monetary policy, and rolling over much of Mexico's public debt via the issue of massive quantities of tesobonos (Mexican government bonds indexed not to the peso but to the U.S. dollar). While minimizing the likelihood that the PRI might actually have lost the 1994 presidential election to its deeply divided opposition, Smith emphasizes that stability served the goals of: first (during 1993), ensuring the consummation of Mexico's membership in NAFTA; and subsequently, securing for then President Carlos Salinas de Gortari a place in Mexican history (and a hoped-for future as the first Director General of the World Trade Organization), as well as protecting the PRI's overall domination of the domestic political scene and the sources of patronage. The one departure from the logic of political rationality that Smith highlights is the clumsy initial handling by the incoming Zedillo administration of the December 1994 devaluation; and this he ascribes largely to the new team's inexperience in working with the financial markets.

While cautious in attributing longer-term political consequences directly to the peso crisis, Smith does emphasize that the process of internal political change in Mexico is an ongoing one, whose end-point is by no means predetermined. Though further democratization and liberalization constitute one possible path, plausible alternatives could involve a resurgence of authoritarianism, or a process of fragmentation and dispersion of power. If there is a broader political lesson to be learned from his analysis of the Mexican crisis, Smith suggests, it may be that better economic management

ultimately requires not just better analysis but changing the political incentives facing policy-makers. Achieving this means further movement in the direction of political opening, electoral competition, and public accountability.

2. For Denise Dresser, a Mexican political scientist, the crisis was rooted in "the conflicting imperatives of economic adjustment and political survival." Dresser sees the Salinas administration as presenting two contrasting identities to the world. The first persona stressed the government's commitment to economic liberalization, deregulation, and privatization. In Dresser's view, marketing the Salinas Mexico to external audiences, including both private investors and the Washington establishment, was very successful. The second (contrasting and more inward) incarnation of the regime deployed multiple instruments of patronage and discretionary intervention in seeking political support through the compensation of strategic domestic interest groups, including those that might see themselves as losing out as a result of liberalization. The glue that was designed to hold the two ill-matched twins together was Salinas's own highly personalized style of "hyper-presidentialism." Dresser presents the political rationale that underlay the administration's dualistic approach, which she sees as the need to broaden the base of support for policies of economic liberalization that might, especially in their earlier stages, directly benefit only a quite narrow set of groups in the country (such as export-oriented businesses); from this perspective, the apparent schizophrenia may be interpreted as reflecting the demands of a transition to a hoped-for new political equilibrium.

Yet Dresser places more emphasis on the contradictions between the two policy imperatives. The need to assuage domestic interests, her discussion suggests, compromised the integrity of market reform objectives in such areas as privatization of public monopolies and regulation of the newly privatized banking sector, and it scared the Salinas government away from any serious attempt to reform social security. Inherent stresses within the model were accentuated by its failure to deliver the goods in the shape of significant economic growth. This helped expose the superficiality of the Salinas model's coalition-building potential, which relied more on pay-offs than on the development of mechanisms for dialogue that might have helped construct a more resilient political consensus. In the run-up to the 1994 election, the administration's need to cultivate support resulted in its following the mutually contradictory policies of monetary and fiscal expansion on the one hand, and a fixed exchange rate on the other. Even after the election, the government resisted adjustment, in Dresser's view, primarily out of concern for the vulnerabilities of the domestic banking sector, a key element in the PRI's political coalition.

Looking beyond the crisis, Dresser sees the Zedillo administration as facing a fresh constellation of challenges and contradictions. If Salinas over-politicized adjustment, she argues, what she sees as Zedillo's attempts to de-politicize policy may create risks of their own. With any "trickle-down" benefits for the mass of the population from further economic liberalization still likely to be slow to materialize, at best, it remains an open question whether Zedillo's forswearing of patronage and his more aggressive pursuit of democratic political reforms will represent a sustainable mix or not.

3. Political scientist Jeffrey A. Frieden focuses on the "domestic politics of exchange rates." He argues at the level of general principle that the exchange rate is a policy variable that is determined politically. It is misleading, in this view, to speak of any specific exchange rate as technically unsustainable, for at the technical level governments always have alternatives (interest rate hikes, deflation) to devaluation. Thus exchange rate sustainability is more usefully seen as a political rather than an economic concept. Both special interests and the broader public can be expected to have a political stake in the level (as well as, separately, the stability or lack thereof) of the exchange rate. Typically, for example, producers of internationally tradable goods (such as exporters) can be expected to favor exchange rate depreciation as being in their own interest. International investors or traders are obviously likely to have a strong preference for a stable exchange rate. The preferences of the population as a whole may be somewhat harder to predict a priori. If unemployment and slow growth are viewed as the alternatives to devaluation, then public sentiment may be expected to prefer depreciation, with its assumed accompaniment of growth. On the other hand, public opinion may also attach importance to the price stability associated with adhering to a stable exchange rate as well as to the inexpensive imported consumer goods that result from an overvalued domestic currency.

In his application of this approach to Mexico, Frieden presents the PRI as unable, in an election year, to afford the political costs of a devaluation, primarily due to its likely adverse impact on politically crucial middle-class and lower-middle-class consumers. The government's hands were further tied by its own prior actions in linking its policy credibility to nominal exchange rate stability. However, the option of engineering a gradual and relatively mild deflationary adjustment became compromised by the political shocks of 1994, including the March assassination of PRI presidential candidate Luis Donaldo Colosio and the September murder of Jose Francisco Ruiz Massieu, the Secretary General of the PRI. The evidence that the shocks and associated elite infighting provided of leadership divisions sapped the PRI's credibility with key constituencies--and hence sabotaged the party's capacity to broker an orderly adjustment process.

With the next chapter, the book's focus shifts from the insights of political science to those of the economics profession.

4. At the heart of Sebastian Edwards's analysis is an exploration of the Mexican experience as a case study in the management of an exchange rate-based stabilization program (that is, a plan under which a country chooses to use a more or less fixed nominal exchange rate as an anchor designed to force domestic inflation down to international levels). Edwards sees such programs as inherently liable to induce currency overvaluation, in part because of inertial momentum in domestic inflation after the exchange rate is fixed. He takes the analysis further by relating Mexico to debates on the optimal sequencing of different economic reforms. Most economists, he indicates, have counseled reforming countries to proceed cautiously in liberalizing capital flows into (and out of) the country, introducing this change only gradually and toward the end of their overall reform program. This advice on sequencing (which Mexico departed from,

largely completing capital account liberalization as early as 1989) partly reflects concern over the potentially disruptive effect of sudden, large inflows of capital.

Any significant inflow on the capital side must logically be matched, if the overall external accounts are to stay roughly in balance, by a deficit of comparable size on the current account (which mainly reflects trade transactions). To accomplish this current-account gap, in turn, an appreciation of the "real" exchange rate (i.e., the exchange rate adjusted for international differences in inflation) is a logical necessity. The appreciation of the real exchange rate can prove excessive and disruptive if there is, temporarily, significant overshooting in the volume of capital inflows relative to their sustainable, longer-term level. Should overshooting occur, then the trend in the real exchange rate will at some stage have to be put into reverse--meaning a real exchange rate depreciation--in order to engineer the rebound on the current account required to offset the slowdown in capital inflows. Edwards's analysis implies that a real depreciation was bound to come sooner or later: however, the Mexican authorities, with their insistence on sticking to a nominal exchange rate anchor, deprived themselves of the preferred policy instrument for implementing real depreciation in an orderly manner.

Against this stylized background, Edwards examines some of the missteps and misunderstandings that led to the crisis. In defending their policy approach at the time, the Mexican authorities emphasized the safety margin afforded by an initial undervaluation of the currency, a degree of flexibility in the exchange rate anchor, and a large cushion of foreign exchange reserves. Crucially, they seem to have remained convinced that a surge in productivity--in response to their reforms and Mexico's 1993 entry into NAFTA--was imminent, and that the resulting boost for competitiveness would take care of any problems on the external side. Relatively few outside observers challenged the prevailing optimism at the time--a rare exception being Dornbusch, who in early 1994 pointed to the dangers posed by a peso overvaluation that he estimated at about 30 percent. Edwards traces the succession of political shocks and policy improvisations of the election year itself, including the relaxation of previously tight monetary and fiscal policies and the government's decision to refinance its own debt largely through the dollar-indexed tesobonos. The account continues with the Salinas administration's refusal to devalue the peso after the election (which Edwards, like Dresser, attributes primarily to concerns over the fragility of the domestic banking system), the initially mis-handled devaluation, the rescue package, and the road back to the restoration of confidence. Summing up, the key lesson of the crisis for Edwards is that exchange rate rigidity is no shortcut--either to price stability or to healthy economic growth.

5. Economist Rudi Dornbusch presents the 1994 crisis as the latest in a long line of financial bubbles in which overeager investors have fed the appetites of irresponsible borrowers. Like Edwards, he sees the increasing overvaluation of the peso in the pre-crisis period as the key to the story, together with what he considers the Salinas administration's "obsessive preoccupation" with inflation (and hence with nominal exchange rate stability). Comparing U.S. and Mexican inflation at the wholesale price level (to avoid distortionary effects at the consumer price level), Dornbusch detects a pre-

crisis real exchange rate appreciation of over 45 percent, which he suggests implies an overvaluation of at least 25 percent. Arguing that, in the early 1990s, aggregate Mexican output could hardly keep up with labor force growth, Dornbusch challenges the reliability of Mexican estimates of manufacturing productivity and labor competitiveness, which have been used (by, among others, Gil-Diaz and Carstens in the present volume) to minimize the extent and significance of exchange rate appreciation in the pre-crisis period. The point is not, Dornbusch emphasizes, that the Salinas reforms as a whole had no substance or merit, but instead that the central error in exchange rate policy constrained the realization of the benefits from generally sound reforms. Once the chance had been missed to devalue in an orderly manner well ahead of the election, the authorities found themselves in a desperate game to buy time, resorting to such expedients as the tesobono bonanza and a domestic credit boom.

For Dornbusch, Argentina and Chile hold up revealing mirrors to the Mexican experience. He sees Argentina's high unemployment rates since 1994 as additional confirmation of the difficulty of achieving real depreciation under a fixed exchange rate, especially when domestic labor markets are comparatively rigid. In Chile's extended period of real income growth, by contrast, he sees benefits to be gained from a more gradualist approach to reducing already moderate inflation rates, accompanied by the flexibility he advocates in nominal exchange rate policy.

6. In his chapter, Wall Street Journal editor Robert L. Bartley takes issue with the Edwards-Dornbusch view of the crisis from the vantage point of a confirmed skeptic of the merits of exchange rate flexibility. For those like himself who believe that the world economy is consummately integrated, he writes, devaluations are not merely folly but themselves shocks likely to disrupt real growth. Part of the promise of the Salinas administration, in Bartley's view, lay precisely in the possibility it seemed to offer of escaping the almost choreographed cycle of boom, bust, and devaluation that had characterized the previous three presidential terms. Even well into the final year of Salinas's administration, Bartley argues, Mexico did not look like a country doomed to devalue: inflation was down to 8 percent, external debt had been halved and was moderate by OECD standards, the fiscal accounts were in balance, and exports were growing rapidly. The current-account deficit that causes Dornbusch and Edwards so much concern seems to Bartley plausibly interpreted as the logical obverse to an inward investment boom sparked by enthusiasm over Mexico's post-NAFTA prospects. Over the course of 1994, however, serious errors were made in monetary policy. If Mexico was serious in defending its fixed exchange rate with the U.S. dollar, its policy-makers needed sooner or later to recognize that their monetary policy would have to follow that of the U.S. Federal Reserve Bank. Instead, the Bank of Mexico followed a policy of sterilization of reserve losses that, in Bartley's words, lay "at the heart of the crisis"-- while the government upped the ante by converting much of its own debt into dollar-indexed tesobonos.

Bartley differs with other commentators in this volume on the eventual inevitability of the devaluation. As late as December 19, 1994, he argues, the authorities could still have chosen the alternative of a sharp tightening of monetary policy to defend the parity (the

ensuing high interest rates would of course have put pressure on the domestic economy, but it is not self-evident that the pain would have been any worse than what followed the devaluation anyway). Better still, for Bartley, would have been the institutionalization of the exchange rate anchor through a currency board arrangement, such as Argentina's Convertibility Plan, which guarantees the convertibility of the domestic currency into U.S. dollars at a fixed rate, and which Bartley presents as producing better results in terms of growth, stability, and political acceptance than the Mexican alternative of devaluation.

7. Francisco Gil-Diaz and Agustin Carstens, writing from their perspective at the Bank of Mexico, subject the analyses of the crisis published by many economists outside Mexico, including some of those in the present volume, to critical scrutiny. Questioning the thesis of peso overvaluation in the pre-crisis period, they point out that--if consumer prices are employed as the indicators of differential inflation--real currency appreciation over the period 1987-94 was only in the 34-39 percent range, which they consider neither unnatural nor excessive, given the efficiency-increasing reforms under way during this period. If relative labor costs are taken as the inflation indicator, which Gil-Diaz and Carstens argue is more meaningful, the real appreciation becomes almost insignificant. As further evidence, they describe Mexico's export growth as "without parallel even among the legendary Asian tigers" and point to overall export growth of more than 17 percent during 1994, when overvaluation should presumably have been at its peak. Gil-Diaz and Carstens would, in addition, modify the picture some authors have painted of sluggish growth in GDP and productivity in Mexico during the early 1990s. A recent updating of sectoral weights in the calculation of GDP, they report, has raised estimated GDP growth for 1989-94 to over 3.9 percent a year; they suggest the expansion would have been still stronger had not uncertainties over NAFTA ratification during 1993 led many in the private sector to postpone planned investments in Mexico.

Gil-Diaz and Carstens also take issue with claims that monetary policy was unduly lax during the pre-crisis period. They point out that the average expansion in the money supply during 1994 (as measured by M1) was only 12 percent, identical to growth in nominal GDP, while the average inter-bank interest rate never fell, after April 1994, below 10 percentage points above LIBOR. Defending the central bank's policy of sterilizing losses in foreign exchange reserves during 1994, the authors contend that the policy's critics are themselves divided over whether a more aggressively restrictive policy would have averted the crisis or sparked economic collapse. In any case, they argue, Mexico's monetary institutions allowed little choice in this regard, as they "were not designed to fight off a speculative attack through sudden quantitative adjustments in credit, nor could they have been adapted overnight." Gil-Diaz and Carstens minimize the extent of any pre-crisis stimulus to the economy from the fiscal accounts, which in the period under review never recorded a deficit of any consequence. They challenge published suggestions that the absolute level of Mexican savings rates in the early 1990s was unusually low by international standards. They also raise questions about the extent (as well as the interpretation) of the decline in savings rates, which some analysts have portrayed as an important pre-crisis source of vulnerability. The authors deny claims that the publication of data on foreign exchange reserves was arbitrarily delayed during 1994,

and they challenge assertions that Mexican nationals benefited from preferential access to information to bail out of pesos ahead of the devaluation.

The authors' own interpretation of the crisis presents Mexico in 1994 as a country that was pursuing an essentially sound reform program but was knocked off course by speculative attacks prompted by the year's remarkable series of political shocks. Given the volume of funds now at play in international markets, they maintain, no government has the resources to resist such a full-blown speculative attack on a fixed exchange rate. At the same time, Gil-Diaz and Carstens do accept that certain aspects of Mexico's policy design may have accentuated the country's vulnerability. They point in particular to serious defects in the financial sector regulatory framework within which many of the Mexican banks had been privatized, including weak supervisory capacity, inadequate accounting standards, failure to enforce appropriate levels of capital adequacy, and problems of "moral hazard" created by indiscriminate government guarantees of bank deposits. Alongside the fragile private banking sector, development banks still in public ownership were responsible for an increasing volume of credit (rising over 1990-94 from 1.0 percent of GDP to 3.7 percent). Changes in accounting conventions removed these flows from the published fiscal deficit, the authors report, and at least half of the development banks' loans could have been considered unsound even in the absence of the subsequent crisis.

8. David D. Hale, writing from the perspective of a senior advisor to international money managers, characterizes the Mexican debacle as the first major crisis of the post-Cold War surge in securitized capital flows to the developing countries now known as "emerging markets." No developing country, he writes, had depended so heavily on securitized flows to finance a large external deficit since before World War I. Hale illustrates the growth--in the United States and other industrial nations--in the volume of private savings managed by institutions such as pension plans and mutual funds. Institutional and personal investors' appetite for returns makes them potentially receptive to new sources of high-yielding investments such as "junk bonds" and, subsequently, emerging markets--a tendency probably encouraged by the drop in U.S. domestic interest rates in the early 1990s. Mexico was able to capitalize to an exceptional degree on the post-Cold War enthusiasm for emerging markets. This partly reflected adroit marketing of the "Mexican miracle" by President Salinas and his Secretary of Finance, Pedro Aspe, who helped lull most market observers into complacency, but was reinforced by the sales efforts of many Wall Street institutions, which moved Mexican paper (both government and corporate) from a specialized, high-risk market niche toward mainstream investors. The collapse of confidence, when it came, was the more violent for being so largely unexpected. However, though the flow of new foreign money stopped almost instantly, available data do not point to a massive selling of Mexican assets by overseas investors--indeed, several studies identify capital flight by Mexican nationals as responsible for draining the reserves.

Hale considers it possible that the inevitable adjustment could have been engineered with less disruption if Secretary of Finance Aspe had been retained in office by incoming President Ernesto Zedillo rather than replaced by Jaime Serra Puche, who--though

prominent as Mexico's chief NAFTA negotiator--was an unknown quantity to most market participants. Hale views the unprecedented post-crisis rescue package for Mexico assembled by the United States and multilateral agencies as defensible ex ante and a success ex post; the alternative of a default could have interrupted reform and liberalization not only in Mexico but also, via contagion effects, among developing countries more broadly. As it is, Mexico regained access to voluntary financing within a matter of months, and no evidence of reform back-tracking has emerged.

Hale then examines how the global economy can be expected to protect itself against future Mexico 1994-style crises. He takes note of discussions on the possible strengthening of official multilateral defense systems, such as expanding the resources available to the IMF. However, he also indicates the importance of private investors protecting themselves better by a more sophisticated awareness of the risk factors in different emerging markets, including the structure of foreign financial flows, the robustness of the domestic banking sector, and the particular country's approach to monetary and exchange rate policy. Aware foreign investors will also consider the external support likely to be available should a country get into difficulties and will keep an eye open for danger signals raised by the behavior of the (often better informed) domestic investor community.

The book continues with a group of chapters presenting the perspectives of senior officials from three multilateral financial organizations closely associated with Mexico before, during, and since the crisis.

9. The chapter contributed by Shahid Javed Burki, World Bank Vice President for Latin America and the Caribbean, concentrates primarily on the policy dialogue between the World Bank and the Mexican authorities in the three years preceding the peso's fall. Burki's central thesis concerns the dilemma faced by official multilateral agencies like the World Bank when they perceive a member country following a high-risk or unsustainable strategy, but are unable through quiet diplomacy to persuade the authorities concerned to change course. Burki argues that World Bank analysts appropriately identified the key issues for Mexican macroeconomic policy over the period 1992-94, including overdependence on potentially volatile capital flows, a sharp decline in domestic savings, mounting risks in the banking sector, and the central need for a change in exchange rate policy (though he concedes the institution was slow to recognize the significance of some of the policy shifts that occurred during 1994, including the tesobono explosion). The Bank presented its analysis and concerns to the Mexican authorities on multiple occasions, and at the highest levels, but while the government accepted some of the less controversial points (such as the need to strengthen supervision in the financial sector), the Bank's message on the exchange rate was firmly rejected.

What should be the public stance of an agency like the World Bank in such a situation? asks Burki. Bank officials know that, if they go public with the full extent of their concerns, they may themselves precipitate an immediate crisis. Yet an excessively uncritical show of public support can be criticized as potentially misleading to private investors. As it was, Burki reports, the World Bank followed a compromise course in

which many of its public statements, while emphasizing Mexico's genuine achievements, alluded to the agency's concerns only in more guarded tones than those used in private with government leaders. Burki sees no obvious alternative to this approach of "speaking with two voices." He argues that agencies like the World Bank are accountable for the quality of the advice they provide to their members (and their public statements should not mislead), but that the multilaterals cannot realistically be expected to ensure that their clients will always accept the advice they give.

10. Complementing Burki's account, the chapter by Claudio M. Loser and Ewart S. Williams of the IMF's Western Hemisphere Department concentrates primarily on the response to and aftermath of the crisis. When the crisis broke, the authors report, some commentators advocated a unilateral suspension of debt payments, which could have been highly disruptive. To their credit, the Mexicans rejected this advice and instead adopted a tough, market-based stabilization program designed in close consultation with the IMF and supported by a large-scale international financial rescue package in which the Fund also played a major role. The adjustment program included a substantial tightening of fiscal and monetary policies, consistent with slashing the current-account deficit to around 1 percent of GDP in 1995. Special safeguards were adopted to allow the banking system time to restructure in an orderly manner and to mitigate the effects of the austerity program on the poor (including protection of basic education and health spending, and emergency employment schemes). In parallel, structural reforms like deregulation and privatization were to be advanced further. The authors discuss the international efforts that assembled an unprecedented financing package of over \$40 billion to support Mexico's adjustment. The IMF's own contribution to the package, close to \$18 billion, constituted the largest such arrangement in the agency's history. The authors contend that the Fund's action, though not without its critics at the time, was consistent with its Articles of Agreement and played an essential role in helping avoid the disruption that a moratorium could have caused.

Loser and Williams argue that the post-crisis package has achieved remarkable success. The current-account deficit was almost eliminated during 1995; domestic savings shot up; and access to voluntary external financing was rapidly resumed. Though output slumped and inflation surged in the first year of the program, by 1996 and 1997 GDP growth was running at healthy levels of 5-6 percent, and inflation was coming down as planned. The authors see the lessons of the crisis for policy-makers as centering on the necessity of combining economic openness with policy discipline, including avoiding large current-account deficits. The IMF itself, they add, has absorbed the need to intensify its monitoring of member countries' economies and to develop better early warning systems. This includes insisting on timely and accurate data on key variables like reserves and external debt. The chapter outlines recent discussions aimed--in view of the larger scale of capital flows in recent years--at expanding the resources available to the Fund.

11. Writing from the Inter-American Development Bank (IDB), Nancy Birdsall, Michael Gavin, and Ricardo Hausmann depict Mexico as following, in somewhat accentuated form, a pattern they have identified in almost twenty episodes of stabilization and reform

in Latin America in recent years. At the start of the sequence, adoption of a major stabilization and reform program stimulates an economic scenario characterized by surging investment and consumption. External capital flows in; improved confidence stimulates remonetization of the economy, thereby enabling domestic banks to launch a lending spree; and even the government's fiscal receipts respond to the general increase in prosperity. The boom cannot continue indefinitely, however, and the economy enters a period of stress that can be expected to culminate in a crisis unless a correction is engineered with some skill. The authors emphasize two particular sources of vulnerability that tend to develop in the course of the upswing. First, governments treat their new revenues as if they were permanent, and they expand their spending *pari passu* (instead of following a more prudent counter-cyclical policy of accumulating surpluses during the good years to help them get through the bad). Second, banks find it hard during a boom to sort out good loans from bad, and thus accumulate a fair proportion of the latter on their books, which will come home to roost once the boom starts to sputter. Additional imbalances also build up, for example on the external account.

Birdsall, Gavin, and Hausmann believe that the above model captures the essential features of the Mexican experience better than accounts that give a starring role to the real exchange rate (which they see as a symptom of problems more than a cause) or to low savings (cross-country studies, they report, have thus far detected no correlation between savings levels and instability). Several actions by the Mexican authorities may well have accentuated the normal sources of financial-sector vulnerability: (a) privatizing and liberalizing domestic banks in advance of strengthening the regulatory and supervisory framework; (b) failing to establish reserve requirements for commercial bank deposits; and (c) using the government's privatization receipts largely to retire debt held by the domestic banks, further fueling the lending boom. On a separate front, countries should keep social protection programs in good repair, in preparation for sudden crises when large numbers of people may temporarily lose employment or suffer serious declines in income. Summing up, the key lessons in the perspective of these authors involve the merits of counter-cyclical fiscal policy and the need for greater awareness of the inherent dangers created by letting lending booms run their course.

12. In the book's closing chapter, Moises Naim places the crisis in its broader international context. Naim's contribution examines the interaction between external forces--including massive capital flows--on the one hand, and the Mexican government's market reforms and domestic political goals and constraints on the other. "The nature of Mexico's disaster," Naim writes, "clearly indicates that national financial crises are no longer what they used to be. The actors, the volumes of money involved, the nature of the crisis, and the dizzying speed of the financial markets' reaction were unprecedented." Fund managers today control sums of money that dwarf the resources now available to institutions such as the IMF and the World Bank. This makes assuaging such managers' concerns a dominant priority for contemporary finance ministers. Pointing to pressure by fund managers on the Mexican authorities to put the interests of foreign investors first, Naim writes that "the conditionalities of the IMF and the World Bank look enlightened and flexible--even benevolent--by comparison." Unlike foreign direct investors, who make a relatively long-term commitment to the host country, today's money managers

can bail out of their positions in a country at the flick of a switch. This facility makes the markets extremely unforgiving of policy-makers' mistakes, which can bring massive and instantaneous punishment. Beyond this, the markets' herd instinct can set up "neighborhood effects," whereby economies showing any sign of vulnerability can be caught in the wake of a crisis originating elsewhere, as the East Asian crisis has highlighted.

At the national level, Naim agrees, the crisis reinforces the premium attached to prudent management of the broad macroeconomic variables (current- and capital-account balances, the exchange rate, fiscal and quasi-fiscal policy, etc.). In Naim's view, as in Peter H. Smith's, better economic management is not just a technical question but one that bears on the political context within which decision-makers operate. The broader interest of the crisis, Naim argues, lies not so much in providing major new insights into the content of prudent macroeconomic policy as in showing the difficulty that even highly qualified officials may experience in actually applying economic best-practice when political pressures point in the other direction. "The intersection of market reforms, domestic politics, and international conditions," he writes, "did not leave the government much room to maneuver." In such a situation, Naim suggests, even "smart guys" may make what (with the benefit of hindsight) look like "dumb mistakes." As the East Asian crisis now also shows, the problem was not the government's lack of information or technical skills. Rather, their incapacity to act on lessons well learned everywhere else was a reflection of what Naim calls "politically induced learning disabilities."

At the international level, the crisis shows that "existing mechanisms of global monetary governance are no longer adequate to deal with a world of integrated, securitized, electronically linked capital markets." With the IMF's resources inadequate to mount a credible rescue for Mexico, Naim reminds the reader, a special ad hoc package had to be improvised; and although the Clinton administration and the Republican leadership in Congress both argued the importance of the issue for wider U.S. interests, the Congress as a whole declined to back U.S. involvement in the rescue, obliging the executive branch to take action on its own responsibility. It is unclear what precedents the international rescue package for Mexico should be seen as setting. Which other countries would be considered sufficiently "strategic" to warrant a similarly tailor-made coalition of rescuers? There are also "moral hazard" issues to be considered: Do rescues of this nature absolve foreign investors of responsibility for indiscriminate lending, thereby encouraging further irresponsibility in the future? Reforming the way the international financial system is governed will take time, Naim concludes. The experts disagree on what can be done, and the difficulties are enormous. Failure to achieve reform, however, will ensure many unhappy surprises in the future.

## LESSONS FROM MEXICO

Tolstoy observed, in the opening to *Anna Karenina*, that while all happy families are alike, every unhappy family is unhappy in its own unique way. A similar comment might usefully be made about countries in deep economic crisis. In preparing this book for publication, we have periodically needed to remind ourselves that Thailand in 1997 is not

Mexico 1994, and that Korea 1997 is different from both. It would indeed be facile to suppose that one can derive from the present volume's analysis of the Mexican case (or from any other source) a cookie-cutter diagnosis that will fit all the details of each of these recent crises--let alone a uniform prescription for their resolution. On the contrary, the world is still learning the variety of shapes and sizes that contemporary crises can take.

This said, we do believe that this book's relatively exhaustive examination of the Mexican experience has a relevance that goes beyond the specific historical episode reviewed. And though the East Asian countries currently caught up in economic turmoil certainly exhibit some major differences from Mexico in 1994--the famously high domestic savings rates in many of the Asian economies, for example--there also seem to be sufficient parallels to make it worthwhile to start thinking about comparative analysis.

Certainly it does not seem to us to stretch the facts to classify Mexico 1994 and East Asia 1997 as, respectively, the first and second of what David D. Hale labeled the "post-Cold War" crises--namely, crises whose evolution is heavily influenced by huge and potentially volatile private capital flows. There are family resemblances. Moises Naim's observations in this volume, first written well before East Asia started to rumble, seem worth repeating: first, we live in a world where mobile capital flows are capable of punishing policy-makers' mistakes massively and almost instantly, and, second, once the markets' herd instinct is aroused, those living in the "neighborhood" of the initial crisis can be exposed to heightened vulnerability. The Asian outbreak encourages us to make more explicit a point that we consider to be at least implied by some of the present book's discussion: There are different patterns of "mistake" that countries can be punished for. A warning, based on Mexico's experience, about the perils of extended large current-account deficits relative to GDP could usefully have received closer attention over recent years from the authorities in Bangkok. Equally clearly, this particular injunction does not fit the stylized facts of the Korean situation. On the other hand, the lessons several of our contributors offer on the vulnerabilities inherent in sheltered and opaque domestic banking sectors, and in a build-up of short-term international debt, appear to us to catch essential aspects of the Korean experience as we understand it. Like Tolstoy's families, in short, countries have more than one way of being unhappy.

Bearing our own caveat firmly in mind--that it may not be necessary to make all the mistakes the Mexicans made for a country to risk punishment (and, conversely, that there are mistakes Mexico more or less avoided that, if committed, could land a country in trouble)--we want to propose here a reasonably compact list of lessons of general validity (even though not all will necessarily be relevant to all countries at all times) that we consider can fairly be derived from the analysis in this book. We should also make it clear that, while our list of lessons certainly reflects the influence of our fellow contributors to the book, we do not mean to imply that all of them would necessarily subscribe to all of the lessons we are distilling here.

1. Policy-makers need to develop a new respect for the power of global financial markets. This is the most fundamental lesson of the past three years, and it underlies almost

everything else we have to say. The level of net capital flows to developing countries, according to World Bank estimates, increased sixfold during 1990-96 (to reach \$265 billion in the latter year) and is now approximately four times higher than at the peak of the 1978-82 commercial-bank lending boom. For countries that are favored by the markets (and these flows are concentrated, with just a dozen countries accounting for 80 percent of the total), the benefits can be very sizable, particularly in what is often a strong initial surge. Wisely used, capital imports can powerfully supplement domestic savings and stimulate growth, as well as help to introduce new technologies and management techniques and increase competition in domestic markets.

Recent crises suggest that host governments have shown a tendency to take the benefits of large capital inflows almost for granted, while giving little thought to (or planning for) the dangers and vulnerabilities which, under certain circumstances, dependence on such flows can entail. We have seen in Mexico, and again in East Asia, the potential for rapid reversals in market sentiment that can put intense pressure on currency parities and, in the short term, shut off a country's access to financial markets almost totally and at any price. Few countries, however, have given sufficiently serious attention to preventive and precautionary measures designed to avoid or mitigate the downside risks.

2. A fixed exchange rate is a hard act to sustain. The sheer volumes of finance now involved in global markets, and the speed with which they can move, make a good deal of earlier thinking about exchange rate management obsolete. To begin with a rather obvious point, as one commentator observed, "reserves aren't what they used to be." In earlier periods, when current-account transactions dominated total foreign exchange trading, it made sense to measure a comfortable safety margin in terms of "months of imports." Nowadays, though, a large developing country can lose \$10 billion of reserves in a single day's trading. But the point goes deeper than this. Mexico and East Asia (as well as other recent cases, for example in Eastern Europe) have shown the strong tendency for the adoption of fixed parities to be followed by real appreciation leading eventually to overvaluation. As one of us (Edwards) demonstrates in his chapter in this volume, a significant portfolio adjustment in foreign investors' desired holdings of a specific country's securities will require, first, a real appreciation in the country's exchange rate, followed later by a real depreciation. Adjustments of this kind are far more easily engineered within a flexible nominal exchange rate policy. An additional concern is the pattern of risks that is set up when private parties (and possibly the government itself) assume that the exchange rate is immutable and proceed to contract debt denominated in foreign currency while investing in domestic assets.

This suggests that, in a reforming economy with a high rate of inflation, a reasonable strategy is to use a fixed exchange rate as a temporary tool to guide expectations and impose discipline during the early phases of the program. After these initial objectives are achieved, and once the fiscal and monetary sides are under control, a switch of anchor will be called for, and a more flexible system--either a managed float or a crawling peg--should be adopted. This was indeed the approach followed with great success by Israel in the late 1980s and Poland during the 1990s. This policy could imply that inflation will

decline more slowly; however, this will be more than offset by the growth, employment, and export expansion benefits of a competitive real exchange rate.

The Mexican authorities considered at several points between 1992 and 1994 switching anchors. However, the notion that a more flexible exchange rate regime would result in slower decline in inflation was considered, in the final analysis, to be unacceptable. In hindsight, we can see the problems with this position: Although inflation could have turned out to be somewhat higher, the flexible rate would have allowed the country to accommodate the external shocks and macroeconomic imbalances of 1993 and 1994 without traumatic consequences. This has, indeed, been a fundamental lesson of recent history in a number of more advanced countries. Several nations that went from a rigid to a flexible exchange rate regime during the 1980s were able to achieve very drastic depreciations--recall the peseta, the escudo, the lira, and the pound--without negative effects on their real side.

Our point is not that it is absolutely impossible to sustain a fixed exchange rate policy. In post-1994 Latin America, Argentina provides an obvious counter-example. It is still possible to debate, as some of our contributors do in this volume, the relative achievements of the Argentine and Mexican models over the post-crisis period. Indeed, if growth is taken as the comparator, the only fair answer may be that the jury is still out.

#### Real GDP Growth Rate

(percent)

Year Argentina Mexico

1995 -4.6 -6.2

1996 4.4 5.1

1997 (est) 7.8 7.0

Source: World Bank.

What these numbers do not fully reflect, however, is the determination that is needed to sustain a fixed exchange rate policy not during the periods of smooth sailing, but during times of acute financial, economic, and political pressure. In this respect, we consider that Argentina in these three years since 1994--with a self-confident president and strong economic teams prepared to take the heat for austerity and high unemployment (17.5 percent in 1995, 16.1 percent as of mid-1997) even during an election year--has been a rare exception rather than a model we would advocate for general adoption. The more common pattern, in which a fixed exchange rate is first adopted, then clung to, and finally abandoned, is one that seems to us to have very little to recommend it.

3. Large, sustained current-account deficits should not be shrugged off. An argument that was heard quite often before the Mexico crisis was that current-account deficits need not concern policy-makers as long as they are the result of decisions by private parties (i.e., as long as they are not the counterpart to a significant fiscal deficit). Both Mexico 1994 and East Asia 1997 have exploded this argument. It is now clear that fiscal deficits are only one of several possible ways for countries to get into trouble. As one of us (Edwards) argues in his chapter, private flows may reach unsustainable levels in relation to GDP, and both Mexico before 1994 and Thailand subsequently were clearly in the danger range.

When capital surges occur, one important question concerns the macroeconomic management of a "soft landing." On this point, we have argued above for the merits of flexible over fixed exchange rate regimes, and we pick up later the arguments for counter-cyclical fiscal and monetary policies, to help avoid the scenario where foreign savings substitute for domestic savings and in essence fund a consumption boom. Of course, it also makes a difference what types of investment the foreign savings end up financing: whether domestic market signals and institutions channel them mainly to productive purposes or, alternatively, to real-estate speculation or politically inspired white-elephant projects.

4. In the presence of volatile capital flows, fiscal and monetary policies must sometimes lean against the wind. Some of the keenest debates among our contributors concern the appropriateness of the fiscal and monetary stance adopted by the Mexican authorities in the pre-crisis period. In brief, the case for the defense is that fiscal policy was basically in balance (apart from possible concern over quasi-fiscal lending by development banks), and that, on the monetary side, there was no practical alternative to the central bank's policy of sterilization. The critics counter that, in a period characterized by heavy capital flows, aiming for fiscal balance may not be enough: In short, the authorities should have followed a counter-cyclical fiscal policy. Also on the monetary side, critics such as Birdsall, Gavin, and Hausmann have been able to point to several specific government actions that fueled rather than restrained the pre-crisis domestic lending boom. Critics also argue that, to the extent that it is true that Mexico approached the crisis with limited alternatives to sterilization of outflows (itself a contested point), this was per se an indictment of the longer-term conduct of monetary policies. We find the critics' case broadly persuasive and consider this to be among the more important of the lessons the Mexico crisis has helped to clarify.

5. Sheltered and opaque domestic financial systems are time bombs waiting to explode. Recent crises have brought home the truth that weak, protected banking sectors involve not merely efficiency losses, but major sources of country risk. Several of our contributors have emphasized the extent to which policy-makers' awareness of the fragility of Mexico's domestic banks constrained domestic macro policies in the months up to and including the peso crisis; both devaluation and further tightening of monetary policy were, reportedly, put off at least partly for this reason. More fundamentally, we can now recognize more readily some of the ways in which banks that are poorly capitalized and supervised (and possibly controlled by groups that either lack banking

experience or are compromised by outside interests) can be tempted--especially in the presence of implicit or explicit public-sector guarantees--to take risks of various kinds that may end up de facto being socialized.

Mexico found out that it was not easy to create a solid regulatory framework effectively and rapidly. The lack of trained personnel--including inspectors and accountants--in many cases slowed down the process, as did the rivalry among different government institutions with overlapping responsibilities. When the peso crisis erupted in December 1994, the supervisory system was still seriously underdeveloped, and Mexico's financial sector was in a rather weak position. The types of policies that could have averted the exchange rate crisis--for example, the tightening of monetary and fiscal policy in 1994--conceivably would have made the situation more pressing on financial institutions. In fact, concerns regarding the strength of the financial system probably influenced--though they certainly do not justify--the decision to strive for a policy of low interest rates in spite of the pressure against the domestic currency. In the end, macroeconomic problems and financial sector weaknesses fed into each other, making a bad situation even worse.

The types of measures that need to be taken to reform and open up diseased financial sectors of this kind are by now reasonably well understood among professionals working in the field internationally. They include enforcing recognized standards of capital adequacy and accounting for problem loans, as well as prudential standards for risk assumption more generally; improving transparency and protection against conflicts of interest; and strengthening regulatory and supervisory capacity. Undoubtedly one of the most effective and timely ways that countries can reinforce fragile financial sectors is to relax or remove earlier restrictions on the participation of foreign banking institutions (in Mexico itself, in the three years since the peso crisis, such measures have raised the share of banking assets in foreign-controlled banks from zero to around a quarter of the total). The barriers to fundamental change all too often lie not at the technical but at the political level, where the opposition of vested interests can conveniently camouflage itself under a veil of nationalism. It is sad that it seems so often to require a major crisis before the obstacles to reform can be overcome; it is all the more important that the crisis, when it does come, be used to take decisive action in this area.

6. Policy-makers need to be concerned not only with the aggregate volume of debt but also, crucially, with its term structure and currency profile. In the Mexican case, the period before the crisis saw, in effect, the conversion of internal to external debt on a large scale. The adoption of the tesobono strategy involved the government itself assuming the exchange rate risk on a major portion of the public debt. In addition, as Birdsall, Gavin, and Hausmann point out, the debt came to be concentrated heavily in short-term instruments. As happened in Mexico, and more recently in Korea, a situation of heavy short-term debt requiring to be turned over in apprehensive markets can spark fears of default and thus help precipitate the eventual crisis.

Governments of course find it tempting, particularly in election years, to buy time by shortening maturities and/or socializing currency risk in their own borrowings rather than to pay the insurance premium associated with longer maturities (or take timely policy

measures to allay market apprehensions). But public debt is not the only concern here. Leaving aside the element of "private" borrowing that is in effect disguised public-sector debt (such as borrowing through publicly controlled development banks), once a currency comes under pressure, the demand for foreign exchange from private borrowers needing to service their short-term borrowings is highly inelastic with respect to price. There are no easy answers to this part of the equation. Regulation of the assets and liabilities of financial-sector institutions could constitute one line of defense but would not address the positions of non-financial corporations. Our own preference for exchange rate flexibility is also influenced in part by concern over the incentives that a fixed rate policy gives to domestic borrowers to borrow heavily in foreign exchange.

7. Providing accurate and timely data on key variables should be considered non-negotiable. One of the central lessons the international community rightly drew from the Mexican crisis concerned the need for data transparency (Loser and Williams discuss in their chapter in this volume some of the initiatives promoted by the IMF after the crisis in an effort to improve data standards). The "tradition" whereby Mexico published official reserve data only three times a year (and on somewhat flexible dates) is one that lenders would no longer be prepared to accept. Indeed, given the day-to-day volatility we noted earlier, it is clear that certain data (including reserves and short-term liabilities) are in times of pressure only meaningful on a virtually "real time" basis. Some consternation was caused (in early December 1997) when it was revealed that data provided to the international community on Korean short-term debt were seriously incomplete. Many market participants have indicated that part of the reason for the sudden and precipitate collapse of confidence in Mexico in December 1994 was the conviction of investors and fund managers that they had been manipulated and misled by the Mexican authorities in their handling of key data. Any short-term gain from data manipulation, we would argue, is liable to be more than wiped out by the subsequent loss of credibility.

Whereas transparency in the publication of official data (such as official reserves and debt) is usually more a matter of political will than of technical capacity, different issues may arise concerning information on the health of the domestic banking sector. This is a particularly difficult case of "asymmetric information," in which those best able to judge the true state of a bank's loan portfolio are insiders, who may have strong incentives to conceal the scale of any problems. This emphasizes the importance of the financial sector reforms discussed in section 5 above.

8. The credibility of policy-makers is fundamentally important. Since credible policy commitments are very difficult to enact and enforce, several countries have endowed their central banks with independence from the government. From a practical point of view, independence means that central bank authorities are appointed for long periods of time that generally do not coincide with those of the elected government. The idea is that an independent central bank will not be subject to the pressures of the political cycle and, thus, will not be tempted to abuse its power to print money and inflate. As with justices to the higher courts, independent central bank directors, once appointed, cannot be removed by the government.

This institutional arrangement has been credited with facilitating the process by which central banks have established policies that strive for long-term stability and not for short-term, ephemeral gains. After all, whereas a government that is about to leave office may be tempted to perform expansionary policies that will, while producing short-term economic stimulus, eventually translate into higher inflation, an independent central bank should attach significant importance to enhancing its reputation. While an elected government is here today but not tomorrow, an independent central bank is here to stay. Given its long-term appointment and the fact that it values its reputation, an independent central bank can commit itself in a credible manner, thereby delivering policies that are welfare-enhancing when compared with alternative discretionary policies.

Although there is evidence that countries with truly independent central banks have lower inflation rates, a complex causality issue is involved. After all, even though in principle an independent bank should deliver a lower rate of inflation, from a practical point of view it might well be the case that countries with a long tradition of stability are the most likely to grant independence to their central banks. Tradition can be so important that in some societies intolerance toward inflation is so widely held that price stability is always high on the policy agenda of the government, reducing the importance of central bank independence. It seems fair to say that, while independent central banks are not a sufficient condition to achieve macroeconomic stability, in most cases they might well be necessary.

Some countries have gone even further in reforming their central bank charters to include price stability as the only goal for which the central bank should strive. Achieving price stability should be understood as a long-term goal, attainable through sustainable monetary, fiscal, and exchange rate policies. Significant short-lived reductions in inflation--attained by overvaluing the currency or engineering a spectacular recession--are rather easy to obtain, but are intrinsically vulnerable to being undone by future policy reversals.

Following the trend that started in Chile in 1989, the Bank of Mexico was granted independence in April 1994. It is by now quite clear that there were several problems with the design of monetary policy during 1994--in particular, the decision to sterilize the decline in reserves after March, in spite of having (for all practical purposes) a fixed exchange rate, is rather puzzling. The alternative policies were either to allow early on--that is in March or April--for greater flexibility of the exchange rate system, accompanied by a tighter macro stance, or to defend the fixed exchange rate with a more restrictive monetary policy. The latter policy would have implied a significant reduction in growth, while the former would have had an impact on prices. As many of our authors have emphasized, the increasingly precarious condition of the banking system complicated policy decisions considerably. The implementation of a restrictive monetary policy would have affected not only economic activity but also the financial health of the banks. Both outcomes spelled trouble for the government, especially given that it was an election year. The central bank finally acted rather as one might expect of an elected government about to leave office: It sold reserves and delayed the much needed adjustment.

If anything, events in Mexico reinforce the importance of having truly independent central banks. They also remind us that institutional changes are much more easily done on paper than in practice. Mexico in 1994 is not an example of the irrelevance of independent central banks. Quite the contrary: It testifies to the fact that meaningful institutional changes ought to be an important element of the broad process of economic reform.

9. Mexico's experience encourages the belief that strong policy measures, well supported, can provide the basis for an early recovery. Mexico's experience after the peso crisis was not painless. Reported urban unemployment levels (which many observers consider incomplete) surged from 3.6 percent in 1994 to 6.3 percent in 1995 (subsequently easing to 5.6 percent in 1996 and 4.1 percent by mid-1997). Not only the poor suffered: Articulate lobbies drew attention to the impact of interest-rate hikes on middle-class debtors and succeeded in winning relief from the authorities. At the same time, as Loser and Williams point out in their chapter, the package that, after a couple of false starts, was adopted and implemented by the Zedillo government--and supported with large, short-term financing from the international community--must in the circumstances be considered a striking success. Mexico's access to voluntary international financing was restored within months of the crisis, growth has resumed at healthy rates, and the country has, as of the time of writing, escaped speculative pressures during the current East Asian crisis. Meanwhile, fundamental policy changes were initiated that have laid the way for the restructuring of the financial sector.

As we write, we are aware of some of the public controversies presently being aired about the detailed design of some of the East Asian rescue packages. Our own review of the lessons from Mexico does not substitute for the detailed knowledge of Asian conditions that would be needed to enter this public debate. However, we do take from the Mexican experience the lesson that successful crisis management calls for a combination of decisive leadership to restore confidence and the willingness to take strong measures to start addressing serious structural problems, including those in the domestic financial sector. If that combination can be put in place, Mexico provides grounds for hoping that a rebound can come about sooner rather than later.

## OPEN QUESTIONS

Our contributors' discussion of the lessons from Mexico has also left us with a number of still very open questions in our own minds. The first of these concerns the implications for the international community's crisis-response capacity. The scale of the Mexican crisis, as this book shows, strained all earlier precedents within the IMF on the volume of funds required for the bailout, and it required creativity on the part of both U.S. and international officials in fashioning a tailor-made response. Over the subsequent three years, the international community has provided a somewhat qualified vote of confidence on the IMF's central role in crisis response: On the one hand, the Fund has been able to fight off potential rivals, such as the Asian Fund in some of its earlier incarnations; on the other, its management has not been able to achieve the expansion in permanent Fund resources it considers necessary. Thus the Asian crisis has inspired the creation of similar

ad hoc coalitions. Commentators increasingly worry about the "moral hazard" dangers that repeated bailouts will pose, but few alternative proposals simultaneously recognize the genuine externalities that a major moratorium might unleash. Further intensification of international "surveillance" will surely emerge from the present crisis, but Burki's question of how to attract the attention of recalcitrant governments has no easy answer.

The second set of questions provoked by this book's discussion of Mexico concerns the political context and consequences of major economic crises. Peter H. Smith argues that the avoidance of economic mismanagement in the future may require not merely better technical advice, but changing the political incentives facing decision-makers. Some years ago, A. K. Sen made the striking observation that no democracy had ever experienced a major famine. Sen's own explanation for this is that democracies are better than other political systems at surfacing information, flashing warning signs, and ensuring that grave suffering is addressed. One cannot make as strong an observation about economic crises, but Smith at least challenges us to consider whether, for similar reasons, we may not expect functioning democracies to do a better job at steering clear of the rocks than more closed political systems. Several of our commentators also connect the crisis of 1994 to the further political liberalization that we have seen subsequently in Mexico. This possibility--that a profound economic crisis may help to open up previously authoritarian domestic political systems--is also of obvious relevance for a number of the countries in East Asia that are currently experiencing financial and economic pressure. The thesis is provocative, but for now we feel obliged to take refuge in the quotation with which we opened: "Too soon to tell."

\* We are extremely grateful to Anthony Ody for his assistance in preparing this introduction. If it weren't for his legendary modesty, his name would be with ours as a co-author.