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Mexico 1994 versus Thailand 1997

The current economic crisis here has been compared to the Mexican crisis in 1994. Ivory Tower takes a closer look at the two cases.

THE FACTS

Until 1994, the Mexican economy seemed to be in good shape. Starting from 1988, the administration of President Carlos Salinas had implemented a series of reforms which were praised the world over for their boldness and broad adherence to economic orthodoxy. A large fiscal deficit had been whittled down to a small surplus in 1993—the first year since the Second World War when a surplus was attained. Growth between 1988 and 1993 was moderate, averaging at 3.5 percent. This was not spectacular, but far better than the negative rates of the mid-1980s. Non-oil exports were to grow at the East-Asia-like clip of more than 20 percent in 1994. The nominal exchange rate remained stable since its last stabilization in March 1988 at about 3.10 pesos to the dollar (a wider trading band was permitted for the Mexican peso than for the Thai baht).

Yet in 1995, the Mexican economy was prostrate. The new administration of President Zedillo came in December 1994, amidst a crisis of unimaginable magnitude. The crisis began on December 20, 1994, when the Mexican government first tried to devalue the peso by 15 percent. Within days it ran out of reserves to sustain it and had to float the peso. The currency depreciated rapidly down to 6.40 pesos to the dollar in early 1995, where it stabilized until November 1995, when there was a further slide to 7.70 pesos to the dollar. The government could not roll over its short-term debt. All this happened despite infusions of funds from the U.S. and the IMF totaling 50 billion dollars.

How was it that Mexico, considered a model of a reforming economy which had done all the right things, came to such a sorry pass? Many interpretations are possible, but before we go on to discuss two of the most popular, let me focus on a few salient characteristics of the Mexican economy and finances on which everyone is agreed, and compare these to the Thai situation.

First, Mexico has had a history of inflationary bouts, causing Mexicans and foreigners alike to distrust the government's ability to maintain the value of the currency. The stabilization policy of March 1988, attempted to reduce that mistrust by pegging the peso to the dollar with a band of about 5 percent each way. This exchange rate peg was consciously adopted to provide the anchor that would prevent an inflation of the currency.

The use of a pegged exchange rate as anchor to control domestic inflation is a time-honored device used in many countries, including Thailand. This country has never, since the 1950s, had a history of domestically generated inflation which was severe. Part of the reason is that Thailand had consciously or unconsciously also used the exchange-rate peg as the anchor to control domestic inflation. Fears of a devaluation, and the political costs that follow from it (as demonstrated in 1981 and 1984), have led the authorities to follow a highly conservative fiscal and monetary policy throughout the last four decades. This conservatism in turn has worked to keep the inflation rate low and to help sustain the exchange rate in a self-reinforcing virtuous circle.

The use of the exchange rate as a device to control domestic inflation implies the commitment to persist to one's last in defending the peg. If there was a consistent theme to Dr. Amnuay's strategy during his term in office, it was the firm commitment to the pegged value of the baht. All his other policies (except those pertaining to the wobbly finance companies) followed as a consequence of that commitment.

Second, because of Mexico's history of inflation, a pegged exchange rate was not deemed sufficient to generate an adequate degree of trust among Mexicans and foreigners. The authorities therefore reinforced the pegged exchange rate policy by making the peso fully convertible, and by allowing a free flow of capital into and out of the country. As a result the Mexican peso became fully globalized.

Because of a different history, with longer periods of undisturbed exchange rates, Thailand has not found it necessary to make the currency fully convertible, and its machinery of capital control still remains intact until today. True, that machinery had become a little rusty, as a result of a strategy of liberalization pursued by the Bank of Thailand, at least until May 1997. Consequently, the baht can be said to have been only semi-globalized, and since May even less so.

Third, 1994 was a presidential election year in Mexico. In the past, such a year was marked by a big splurge of government spending in order for the ruling party (which has run Mexico for the past seventy years) to continue winning the election. In 1994, such was not the case. Its economic policy was generally sound. But Mexico was hit by a series of dramatic political crises, involving assassinations, accusations of drug trafficking involving people close to the incumbent president (including his brother), and a rural insurrection. This high political drama undermined confidence in the political system and in the economy.

Box: Chronology of Mexican economic crisis

March 1988: Stabilization of the currency with the peso exchange rate fixed at around 3 pesos to the dollar, but with a flexible band of 5 percent each way.

1988-1993: Growth of GDP averaged 3.5 percent between 1987 and 1992, but fell to 0.5 percent in 1993. Cumulative inflation in Mexico was 135.6 percent between 1988 and 1992, compared to 27.1 percent in the U.S.

January 4, 1994: Uprising of Chiapas peasants in the South.

March 1994: U.S. Federal Reserve Bank raised interest rates, bringing Mexican rates up also; presidential candidate Luis Donaldo Colasio assassinated on the 23rd; beginning of first run on the peso, leading to loss of foreign exchange reserves from a peak of 30 billion in January to 15 billion dollars in April. Loss of foreign reserves sterilized, i.e., the authorities issued domestic credit to prevent a fall in the money supply.

April-June 1994: Nevertheless peso interest rates began to edge up, because of the need of the central bank to draw in foreign exchange to maintain reserve: the premium on interbank rate over the LIBOR rate rose from 8-10 percent in the first quarter to 15-20 percent in the second quarter. Issue of short-term government bills switched from peso-denominated bills to dollar-denominated tesobonos, a trend which continued for the rest of the year. Inward flow of portfolio investment sank from an annualized rate of 15 billion dollars in the first quarter to near zero in the second quarter.

August 1994: Ernesto Zedillo of the ruling party was elected to the Presidency to take office in December.

September 1994: Jose Francisco Ruiz Massieu, secretary-general of the ruling party murdered. Raul Salinas, brother of the president was widely suspected of being the mastermind, and was in fact later arrested in February 1995.

October-December 1994: Outward flow of portfolio investment rose to 10 billion dollars.

November 1994: Further runs on the peso, triggered first by fears that the U.S. Congress would reject the NAFTA agreement and then by accusations made by Mario Ruiz Massieu concerning the September murder of his brother.

December 1994: The crash followed the attempt on the 20th to devalue by 15 percent, which was met with a fresh attack which exhausted the reserves. The peso had to be allowed to float: its value fell from 3.10 pesos to the dollar before the 20th to just a little short of 6 pesos to the dollar, and continued to drop further in later months. The government was unable to roll over its short-term debt at any reasonable rates, and the private sector also became unable to borrow.

December 1994-January 1995: The U.S. government put together an emergency 20-billion-

dollar loan package coming from itself, and another 30 billion from the International Monetary Fund.

Throughout 1995: Mexico faced the consequences of the massive devaluation. Inflation and interest rates soared to reach levels of 100 percent in some months. Deep depression of the economy, with the GNP falling 9.3 percent (annualized rate) in the third quarter, allowed the trade deficit to turn into a surplus within two months of the devaluation. As many financial institutions and private companies faced sharply increased burdens of debt to foreigners with the fall in the value of the peso, there was a systemwide financial crisis. The rescue of financial institutions cost the Mexican government 12 percent of GNP. Outflow of portfolio investment totaled 60 billion dollars.

If the Mexican political scene in 1994 could provide the script for a roller-coaster thriller from Hollywood, the Thai political scene has always provided material for a low comedy. However, the comedians used to be balanced by the straight men from the bureaucracy, particularly from the Bank of Thailand. Unfortunately, in the last few years the latter group crossed over to be the comedians themselves. A commitment to a fixed exchange rate is largely an exercise in the generation and maintenance of confidence. If the people in charge of keeping up that commitment indulge in shenanigans (as in Mexico) or behave in a comical fashion (as here), it does not take long for that confidence to erode and to disappear altogether.

EXPLANATIONS

I now turn to two explanations for the Mexican crisis in 1994. The first explanation focuses on the *flow* variables and the second on *stock* variables. I shall go over each of these in turn.

Mexicans were running a current-account deficit of about 8 percent per year—about the same figure as for Thailand in 1995 and 1996. As in Thailand, a greater part of the current account deficit cannot be accounted for by the public sector which, as we have pointed out, was running a surplus. The deficit can only be accounted for by borrowings by the private sector.

It was diagnosed that the large Mexican deficit was caused by an overvaluation of the peso, because of the excess inflation rate in Mexico compared to its trading partners (primarily the U.S.). The degree of overvaluation that was suggested was considerably larger than in Thailand. Estimates for Mexico began from a low of 20 percent and ranged all the way up to close to 100 percent. Contrast such figures against current estimates of overvaluation of the pre-flotation baht which begin at about 6 percent and range up to only 15 percent, and one can see that the situation in Mexico was much worse. From this one may draw the comforting conclusion that in a crisis, Thailand will not share the terrible fate that befell Mexico in 1994 and 1995.

But there is an alternative explanation for what happened in Mexico which gives less cause for complacency (and events since the flotation have confirmed the more pessimistic view). This focuses on the stock variables, particularly the foreign exchange reserves. The central point is that the size of these reserves has to be substantially larger in a country which has globalized its own currency and economy, to the extent that Mexico and and even Thailand have. Mexico in the beginning of 1994, it is argued, had an inadequate amount, even though it could finance four months of imports—considered in most other cases as adequate.

Normally a pegged exchange rate would require substantial reserves to back it up. However, in the highly globalized world that we live in now, money comes in from many very different sources. More to the point, each of these sources has its money invested in many other host countries so that any one country is only a small part of its portfolio. For the financial investor to abandon a host country is not particularly costly. This makes individual host countries highly susceptible to speculative attacks from these sources. A finite increase in uncertainty can easily lead to a total removal of that country from the portfolio of a given source.

Worse, because most sources of capital hear the same news and are subject to the same fears, they display a strong herdlike behavior. Countries with pegged exchange rates are more susceptible to such herdlike behavior, because the exchange rate peg rewards those that exit earlier from a market and punishes those that exit too late.

This last point can be more easily grasped if we consider, by contrast, a country with a floating exchange rate. When it experiences a run, there would be an immediate depreciation of the currency, slight at first but which would continue if the run also continues. However, once some depreciation does take place, it would make it less and less worthwhile for those that exit later to move out of the currency. A continuous depreciation of the currency would be a self-correcting mechanism that would increasingly stem the outflow. On the other hand, if the country has a pegged exchange rate, and if there is a fear of a large jump downward in the value of the currency, and if that fear is widespread, then everyone would rush to leave in order not to be caught out by a devaluation.

This is what happened in Mexico in spurts throughout 1994, but particularly in the last run in November, which led to the December 20th crash. Mexico started the year with what seemed a healthy foreign exchange reserve of between 25-30 billion dollars. This must be weighed, not against imports as was usually done and still is in Thailand, but against various forms of peso holdings. Indeed, some economists would go so far as to argue that the entire money supply of Mexico put the reserve at risk, as with convertibility, all of the money could in theory be cashed in for dollars.

There were two key points of vulnerability in Mexico: one was short-term public debt, which totaled about 20 billion dollars. At the beginning of the year, most of this debt was in the form of peso-denominated 28-day bills, but by the middle of the year, as the government found it both more expensive (because of increasing peso interest rates) and more difficult to float these bills, it shifted massively to issuing three-month *dollar*-denominated bills (*tesobonos*). This shift made the Mexican monetary authorities even more vulnerable to refusals of investors to continue lending. After the devaluation in December, the Mexican government found it impossible to roll over its *tesobonos*.

The other key point of vulnerability was the financial system which was weak already in the beginning of 1994, but which weakened further as a result of increased dependence on foreign money. Ironically, it was the exposure to devaluation risk that brought on the run that caused the devaluation that eventually did in the financial system in 1995. The government's rescue of the financial system eventually cost the government the equivalent of 12 percent of GNP.

Two economists, Guillermo Calvo and Enrique G. Mendoza, who have studied the Mexican crisis in depth, argue that it is consistent with a story in which:

> "… Surging capital inflows, combined with radical financial liberalization, induce a lending boom in a setup prone to financial fragility. Fragility results from the perverse incentives given to credit markets by the currency peg and explicit or implicit commitment by the central bank to act as lender of last resort. In an extreme case, with short-term bonds financing long-term loans, one can show … that the size of the speculative attack increases with the size of the expected banking-system bailout" (*American Economic Review,* May 1996, page 172).

Sound familiar?

Thailand had what appears to be a massive foreign exchange reserve of 32 billion dollars at the end of June 1997, just before the decision to float. Against this must be considered:

- Private foreign debts totaling about 80 billion dollars, with maturities ranging from one month (bills of exchange) to three or more years;
- Forward commitments of the central bank both onshore and offshore which we now (August 1997) know to total $23 billion;
- The exposure of the Bank of Thailand arising out of its wish to support failing financial institutions, the total size of which is unknown, but the amount thus far disbursed from the Rehabilitation Fund we now know to total 430 billion, a large fraction of which is high-powered money.

The most worrisome aspect is the 80-billion-dollar private debt hanging over this country (the foreign public debt of 16 billion dollars can be ignored as it can be managed by the authorities). As confidence in Thailand ebbed, the willingness of foreign lenders to renew the loans as they fell due began to decline: firms were beginning to find it more and more difficult to get foreigners to refinance short-maturity debts, such as bills of exchange. All of this would lead to a decline in the stock of this debt. As the debt got repaid, the Bank of Thailand would naturally see its foreign exchange reserves decline. To put the matter less flatteringly, the official reserves were increasingly raided to get the

private sector out of its exchange risk.

Another risk arose from the leads and lags in normal trade credit. The value of Thailand's exports and imports totaled $125 billion annually, valued at the pre-flotation exchange rate. Decisions by exporters to postpone the repatriation of proceeds by one month and by importers to prepay or buy forward the exchange rate by one month would lead to a loss of reserves totaling $10 billion. There is no doubt this occurred in the last months before the devaluation.

On top of this, and potentially the biggest risk, there is the problem of failing financial institutions. The central question that is being asked by foreigners is how much money will be created in order to bail these financial institutions out. Before the flotation of the baht, it was estimated that about 100 billion baht had poured out from the Bank of Thailand to help shore up these institutions. We now know that the figure was in fact 430 billion baht (compare the stealth with which this was done to the furor created by the attempt to raise a few measly billion baht from excise tax). There is then the off-balance-sheet avaling of notes of finance companies by the central bank which is leaving it exposed to an unknown extent. These are the commitments that have already been made.

This support has implications for the value of the baht. Under a pegged exchange rate regime, all new money created will flow outward. This remains true despite the imposition of some capital controls that were imposed in May, which restricted the flow of baht to off-shore markets. Now that the baht has been floated, the new money created to shore up financial institutions will create inflationary pressures which will be immediately reflected in the fall in the value of the baht against the dollar.

An economy flat on its back

When the previous two sections first appeared in print in June of this year, the true situation (which we now know to be very dire) was unknown to most observers, including me. Now that the fog of uncertainty has partially lifted, and now that the International Monetary Fund (IMF) has provided a stand-by credit to allow Thailand to see the crisis through, we should be able to make some judgements as to the future course of the Thai economy.

Looking at the situation at this moment, there are five major imbalances in the Thai economy which feed on one another:

1. *Current account imbalance:* The deficit on the current account is caused by excessive borrowing by the Thai private sector from foreign sources since the liberalization of the Thai financial system.

2. *Term imbalance:* The borrowing, particularly from the foreign lenders, was mostly on a short-term basis, but was used for long-term purposes. This, combined with a rigidly pegged exchange rate left the economy vulnerable to sudden runs.

3. *High debt/equity ratio:* Thai corporations were not only borrowing heavily overseas, but also from domestic sources. This left many of them in a highly vulnerable situation.

4. *Insolvency of the financial institutions:* A sharp deterioration in the quality of the financial institutions has made many of them effectively insolvent.

5. *Excessive issuance of money by the central bank:* As the troubles with the financial institutions became known, the Bank of Thailand has been supporting them by issuing money, which has fueled the speculation against the baht, and led to the depletion of net reserves.

The above imbalances are listed roughly according to the line of causation. However, in examining the problems caused by these imbalances and their possible resolution, I shall not follow the same sequence. I shall start first with the problem of the finance companies, which I now consider to be the most urgent problem.

There are two levels of problems with the finance companies: one of illiquidity, which happens when they cannot lay hands on liquid resources fast enough to pay depositors (even though the companies may still be fundamentally sound); and one of insolvency, which happens when their assets have deteriorated so far in quality that the companies' net worth is now negative. Although the illiquidity is the more immediate (and more observable) of the two, the insolvency problem is the more fundamental issue as it generates the illiquidity problem.

For it is true that asset quality across the financial sector has sharply deteriorated over the past year. It is also true that

the Bank of Thailand signaled this deterioration to the public with respect, first to 10 finance companies, then to 16 and finally to 58 companies. It is finally true that depositors in these troubled financial companies fear that they will lose out somewhat in the value of their deposits—at the very least, they fear they will not be able to obtain the funds when they want without a severe penalty, unless they take action fast.

Based on these indubitable facts, a run has taken place every time the Bank of Thailand has announced a new list of firms in trouble. The general run on finance companies led to shortages of liquidity among most of the remaining finance companies and a few of the smaller banks as well.

Widespread though it was, the run did not quite infect the entire financial system. Large commercial banks, and in particular, foreign bank branches were able to recapture the deposits lost from the finance companies. The problem of illiquidity of the finance companies was therefore managed by piping the money from the surplus banks back to the troubled banks and finance companies. In the process, the depositors have been able to get their money back, but the default risk from the insolvent financial institutions has now shifted to the central bank. This will be of some import later if some of these firms were to be liquidated.

The possible insolvency of some of the 58 finance companies is still bedeviling the authorities, and probably will continue to do so for some time. It is not clear by how much the remaining true assets of these companies will fall short of their liabilities to the creditors (both domestic and foreign), to their depositors, and increasingly, to the Financial Institution Development Fund (FIDF) and the Krung Thai Bank (which has been roped in to help out during the emergency). Above all, it is not clear how the loss will be shared. Over time, it has become more and more likely that the FIDF and possibly the Krung Thai Bank will be left with the short end of the stick. The next problem that will have to be faced then is how their loss will be financed.

The FIDF has already spent some 430 billion baht to solve the financial institutions' liquidity problems, and borrowed extensively to do so. It appears that quite a bit came from the Bank of Thailand itself. It is this bit that is causing the most worry as it indicates the possibility that the central bank has been printing money and lending to the FIDF.

The extent to which the central bank has injected money into the system is not clear, but here and there in the monthly statistical report from the Bank (the last issue available is May 1997) we can glean some information. Thus between the end of February and the end of March, the Bank's "Claims on other [i.e., other than commercial banks] financial institutions" shot up from 85 billion baht to 171 billion baht. True on the other side of the balance sheets, something called "Other liabilities" shot up by even more: from 47 billion baht to 165 billion baht. This should suggest that the Bank has acquired this money from somewhere else and did not print the money. What the category "Other liabilities" includes is not obvious, but it includes only one listed subcategory which is "Bank of Thailand bonds." This shot up from 22 billion to 71 billion baht, so we know that this much has been raised somewhere else in the system, but how the rest of the credit flow was financed is lost in the fog that seems to hang perpetually over the FIDF.

In May, another major injection into the "other financial institutions" of close to 40 billion baht occurred, but this time without any similar increase in the item "Other liabilities." What we do observe is a fall in reserves that occurred. Recall the May marked the third run on the baht in the foreign exchange market.

For June, we no longer have access to the Bank's balance sheet, but the figure for the monetary base jumped over 10 percent in one month from 454 billion baht at the end of May to 514 billion baht at the end of June.

At the moment we do not have any figures for the great August run on the financial system that occurred as a result of the closure of 42 finance companies.

I shall leave aside the stunning political implications of a public institution blithely entering into massive commitments and apparently operating without any resource constraint simply because it has the power to print the money (contrast this with the long drawn-out and painful process to control, limit and audit the funds from the central government budget). What I shall concentrate on are the implications of the injection of the new money supply as a result of the FIDF operations.

Two basic macroeconomic propositions are necessary to understand the consequences of the FIDF operations:

- With a pegged exchange-rate regime (that we had before July 2nd), any excessive injection of money into the economy would lead to an outflow of money out of the country sufficient to remove the excess.

- The current account of the balance of payments and the capital account (excluding the movement of reserves) would tend to move in opposite directions (i.e., when one is in surplus, the other would tend to be in deficit), unless there is an expansion or contraction in the supply of money.

Because the foreign capital inflow has almost dried up (capital-account surplus has almost disappeared), then the second proposition suggests that the current-account deficit should narrow significantly. However, because the central bank has been expanding money through its FIDF operations, both current and capital accounts were in deficit together, and the sharp fall in reserves is the result. George Soros and his ilk may appear in our press and to the Bank of Thailand as the people who have robbed us of our reserves, but I believe that the key to understanding our loss in reserves is the Bank's promiscuous issuing of money in the first half of this year.

Now that the IMF has ridden into town, this merry printing of money by the central bank will have to stop. The rescue of the financial system will increasingly be through fiscal rather than monetary means. The extremely stringent fiscal policy imposed by the IMF requires Thailand to run a fiscal surplus of more than 50 billion baht yearly over the next few years. This is probably to make good the FIDF commitments. I surmise that the long-term problem of restoring the financial system as a whole back to viability will be resolved as follows. The authorities will issue bonds to be bestowed on the financial system. They will not be sold in the market, but placed with the remaining finance firms (including those that have acquired other effectively bankrupt firms) to make good the hole caused by careless lending. These bonds will perhaps be exchanged for equity in the said firms. The firms will then have these bonds in the balance sheet in place of their dud loans. Taxpayers will then be paying the annual interest on these bonds. In what has sadly become the norm for the Thai economic system, taxpayers will end up paying for the excesses of our captains of finance and industry (and lately, the carelessness of our central bank), but at least the pain will be spread out over a number of years.

With little capital flowing in, with little money being created as a result of the prostrate situation of the central bank, and with a stringent fiscal policy, the liquidity crunch will worsen considerably. There will be a severe deflation of the economy, marked by very high rates of interest, which in turn will be fueled by the high inflation consequent upon the baht depreciation. The extent of future depreciation will be determined by the size of capital flight or its converse, the return of foreign investors' confidence, and by the stringency of monetary policy. Remember that the Bank of Thailand has to meet its swap contract commitments *and* build up its net reserves. This necessitates an extremely tight monetary policy.

If capital flight continues, we can expect the current account deficit to narrow, and even to turn around and show a surplus (provided of course that the Bank does not print money excessively). But this good showing on the one front of the current-account surplus will take place against a backdrop of a devastated economy everywhere else.

To ameliorate the situation then, investors' confidence will have to return, and funds must be injected into the capital-starved nonfinancial firms. However, these firms face another imbalance of their own. Thai firms already have a very high ratio of debt to equity. Further expansion of debt appears to be nearly impossible without a fresh injection of equity capital, again unlikely in the face of sharply falling stock prices.

Here we arrive at what I believe now to be the fundamental imbalance of the Thai economy. It is abundantly clear that Thai corporations have misinvested a great deal. They have also relied much more heavily on debt relative to equity. During the stock market boom, equity was raised merely to leverage more debt. The dependence on debt rests on the reluctance of family businesses (the vast majority of Thai businesses, even those listed on the stock exchange) to cede control to outsiders. The penalty for such dependence on debt is the vulnerability to financial illiquidity that is going to mark our economy for at least the next six months.

Now that the day of reckoning is at hand, many businesses will be shown to be unviable, and will have to sink. We shall see the "mother of all fire sales" as firms cede control to new owners. Many of the new men that entered the Thai business scene during the boom will disappear. The great banking families will probably capture the commanding heights of the economy. Above all, foreigners will be far more visible, as they will have access to much cheaper capital than the Thais to buy up the assets of the failing firms. Already, with the smell of blood very much in the air, they are eagerly circling the scene.

But, ultimately, the misinvestments that were made are still physically there, and remain productive assets (yes, even those empty condominiums), albeit not as productive as was hoped for. To put these assets into actual use requires them to be revalued downward, and that is the function of the shakeout and the fire sales.

For most of us who are working grunts, who will end up as winners in this high-level boardroom shake-out will make little difference to our lives. What will make the difference will be the time it takes for the shake-out to be completed. The longer the process is drawn out, the longer it will take the economy to recover from the depression, and the larger the shedding of jobs.

To accelerate the shakeout process, a clear articulation of government policy toward the core problems raised by excessive private sector debt is necessary. We have to pray that the government recovers from the near paralysis in strategic decision-making that has marked its behavior since the beginning of the crisis. It is a sign of the times that a prayer is all I can offer.
