The Mexican Peso Crisis: Comment on Meigs

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James Meigs's (1997) essay constitutes a valuable contribution to the vast literature on the origins and lessons of Mexico's peso collapse in 1994. An adequate response to Meigs's complex argument would require a self-contained effort.[1] My response concentrates on two claims about the peso collapse: (1) if Mexico had implemented a floating regime in 1992, "there would have been no peso crisis"; and (2) given the monetary forces in the period 1991–94, "there was no way to avoid devaluing" under a pegged exchange rate. Both propositions are ambitious, but underestimate the fundamental role of global capital flows in the context of inconsistent public policy. The post-1994 experience with a floating exchange rate underscores that objection.

A Novel Argument

Meigs's argument is novel. Unlike contributions that focus on policy developments in 1994, Meigs locates the causal origins of the peso crisis in the "strategic decision" to peg the peso to the dollar in 1988. The exchange rate stabilization plan was part of a structural reform program that helped reduce inflation from 159 percent in 1987 to 7 percent in 1994. However, Meigs claims that the plan contained the seeds of its own destruction. The significant purchases of foreign exchange during the capital inflow episode of 1991–94 created unsustainable inflationary pressures that made the economy highly vulnerable to "destabilizing speculation." The divergence in price levels between Mexico and the United States in the context of a crawling

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[1]For my full version on the peso collapse, see Salinas-León (1996).

peg system rendered the exchange rate regime unsustainable in the face of unforeseen shocks. By the end of 1994, devaluation was inevitable.

Thus, Meigs believes that if the Carlos Salinas administration had adopted a floating regime in 1992, at the height of massive capital inflows, the crisis could have been avoided. A market-determined rate would have freed the central bank from pursuing a predefined exchange rate target and would have led to "an eventual adjustment of the exchange rate" in accordance with differences in consumer price levels in Mexico and the United States. Moreover, the 1995 inflation would have been nipped in the bud.

Meigs makes an important claim, but the crucial issue is whether a floating regime, by itself, would have been capable of withstanding policy errors that others have identified as the central causes of the peso collapse. A principal virtue of a floating regime is that it acts as a transparent feedback mechanism for policy decisions. Mistakes are punished with capital outflows, which manifest themselves in instant depreciation; and, by the same token, positive developments are rewarded with capital inflows, which generate a stronger exchange rate. Those results are independent of the spread in inflation differentials between countries or the evolution of the balance of payments. In a regime of floating exchange rates, what are relevant are the *movement of global capital flows and the institutional basis of prolonged* inflows of foreign private investment. Those concepts seem underappreciated in Meigs's analysis.

Capital Flows and Floating Exchange Rates

According to Meigs, in a monetarist framework, the increasing divergence in price levels between Mexico and the United States meant "the exchange rate must eventually adjust in order to restore purchasing power parity of the peso." This is the familiar argument that the differences in inflation rates in the period of exchange rate stabilization foreshadowed an inevitable adjustment of the parity. However, *there are reasons to think that purchasing power parity* (PPP) calculations comparing inflation differentials between trade partners constitute an unreliable model for short- and long-run nominal exchange rate behavior.[2] The analysis Meigs advances is inconsistent with the exchange rate environment that has developed in the post-devaluation period.

[2]For an excellent assessment of the misgivings with PPP models as accurate exchange rate predictors, see J.P. Morgan's Emerging Markets Research (1997).

Meigs assumes that, in a monetarist framework of a floating exchange rate regime, the behavior of the peso/dollar parity in 1992 would have adjusted in line with the spread in purchasing power parity. That assumption is gratuitous. Otherwise, a similar adjustment would have occurred in 1995, under a floating exchange rate, in accordance with a spread of nearly 49 percentage points in consumer prices between Mexico (with an inflation rate of 51.9 percent) and the United States (with an inflation rate of 3 percent). Yet, a classic case of exchange rate overshooting occurred in the wake of a brutal collapse of confidence in the peso and a massive suspension of private capital flows. The result: a peso depreciation of over 100 percent, from 3.5 pesos to 7.3 pesos to the dollar.

An example in the opposite direction is supplied by Mexico's experience with a floating regime in the period 1996–97. During that time, the strength of economic recovery has restored confidence and diminished country risk, thereby helping Mexico to once again attract foreign capital. As new private capital inflows have flooded Mexico, the nominal exchange rate has remained remarkably stable, thereby generating fears of an appreciation of the real exchange rate and secret interventions on the part of the central bank to sustain an "artificial" parity.

Mexico's strict monetary policy and fiscal discipline have revitalized the investment climate. If that trend continues, the peso/dollar parity is bound to remain stable, notwithstanding inflation differentials and occasional "destabilizing speculation" linked to political factors or terms-of-trade shocks.

Moreover, the argument that Mexico can become a greater exporter through devaluation is specious. Indeed, in the period 1970–96, leading export nations observed a strong association between real appreciation of their currencies and a large increase in their exports:

- In Chile, real appreciation was 40 percent and the increase in exports 255 percent;
- In South Korea, real appreciation was 36 percent and the increase in exports 331 percent;
- In Japan, real appreciation was 78 percent and the increase in exports 15,509 percent;
- In Hong Kong, 12 years of parity stability coincided with a 500 percent increase in exports;
- In Mexico, despite the 1994 devaluation, real appreciation of the peso reached 36 percent in the relevant time frame, while exports grew 202 percent.

A fundamental lesson embodied in those examples is that other factors must be assessed into competitiveness equations—for instance,

levels of worker productivity, capital flows, the regulatory environment, the impetus of reform, import-led modernization, and, most important, trade liberalization.

Meigs contends that Mexican citizens, unaware of the finer intricacies of monetary policy, would substitute imports for domestic goods because imports were now cheaper due to Mexico's higher inflation rate and the pegged exchange rate. Yet, an important survey conducted by the Center for Economics of the Private Sector, in November of 1994, revealed that 80 percent of 450 polled companies considered the prevailing pegged rate consistent with predicted domestic sales for 1995. The same survey found that businesses ranked an overvalued peso seventh among the factors deemed as obstacles to export competitiveness—far less important than access to information or regulatory costs.[3]

In sum, Meigs seems to underestimate the fundamental role of capital flow movements in his claims about the peso crash. It is arguable that the Salinas government erred by not moving to a float sooner. Nevertheless, the real culprit is bad policy, which is the source of exchange rate volatility under both a pegged and floating regime. As stated above, 1995 represents a good example: mixed signals and wishy-washy public policy on the part of the Ernesto Zedillo administration, including hints about fashioning policy in accordance with the perverse criteria of maintaining balance of payments equilibrium, led to a drastic weakening of the peso.[4]

A Dubious Counterfactual

In short, my proposition is that Meigs is right (on the need for a floating exchange rate regime) for the wrong reasons (such a regime

[3]Meigs alludes to the findings of Dornbusch and Werner (1994) in support of the claim that there was no way to avoid devaluation in 1994. I believe Meigs does himself a disservice by citing that study. The claim that Dornbusch "correctly predicted" the peso devaluation is popular, but false. Dornbusch never predicted the peso collapse of 1994; he recommended the devaluation as a desirable tool of policy: "In Mexico, a sad ending lies ahead unless the currency is devalued." For the full story, see Salinas-León (1997a).

[4]In 1995, the Zedillo government was forced to revise original projections for the exchange rate on four occasions and to acknowledge that the change in the exchange rate regime underestimated the "virulent and violent" reaction of investors and savers to a sudden shift in the parity. It is significant that the unprecedented stampede of capital flight that caused the collapse of the former exchange rate regime took place not in response to a "perceived inconsistency in economic policies," as Miegs suggests, but in the immediate aftermath of the decision to widen the upper limit of the band. This suggests that the resolve to depreciate the peso in the interest of erasing substantial red ink in the external accounts was the fundamental source of the "destabilizing speculation" that devastated the semifixed exchange rate regime. This in not the place to argue the matter, but the point is that the administration seemed under the impression that the autonomous change in the exchange rate regime would not send everyone and anyone running for cover—despite warnings to the contrary by former Minister of Finance Pedro Aspe.

would have avoided the 1994 crisis). If, counterfactually, the Zedillo administration had accompanied the original decision to modify exchange rate policy with a global program of new privatizations (including the state-owned oil industry) as well as a new round of foreign investment liberalization, the results would have been radically different. Rather than the collapse of what was once hailed as a model of emerging market reform, Mexico's nascent market-liberal system would have been rejuvenated. If, by the same token, the recommended adoption of a floating regime had occurred in 1992, in the absence of a strong background of structural reforms, capital would have fled en masse, engendering an avoidable financial collapse.

Indeed, it has become commonplace to characterize the 1994 peso collapse as the first crisis of the 21st century. That interpretation heeds the observation that technological advances in the world of finance have rendered the movement of private capital flows highly sensitive to policy decisions. A fundamental lesson of the peso crisis is that emerging markets should treat capital inflows as transitory and capital outflows as permanent. That risk-management strategy failed in the months preceding the peso crash, as the government bet on a return of foreign investment in short-term instruments that never materialized (Summers 1995). The Zedillo administration calculated an "expected exchange rate" 12–15 percent higher than the rate that prevailed at the time the upper limit of the band was increased. Although the government did not officially recognize the peso devaluation until the first days of 1995, the actual devaluation occurred on December 22, two days after the original modification, when the collapse of market confidence created a rush for dollar assets. The flight from the peso, equivalent to $5 billion, forced authorities to float.

Consequently, it seems adventurous to claim that the simple existence of a floating exchange rate regime in 1992 would have precluded the advent of the 1994 financial crisis. The capital inflow episode that Meigs carefully details would have caused a large appreciation of the peso—and not the modest adjustment forecasted by comparisons with consumer price indices. Conversely, a floating regime in 1994 would not, by itself, have constituted a sufficient condition to avoid the peso collapse. Indeed, the claim that a floating regime would have ruled out a crisis represents an implausible counterfactual. The conditions for generating such an unwelcome development depend far more on capital flows and therefore on the nature of the entire body of public policy.

Exchange Rate Incoherence

Notwithstanding the commitment to a floating regime, the administration's rhetoric on the need to avoid exchange rate overvaluation

has generated a credibility gap in the area of exchange rate policy. This is an important point, for as Meigs correctly proposes, there are several steps authorities can take to enhance the quality of an independent monetary policy designed to achieve price stability. Unfortunately, exchange rate incoherence threatens to undermine the prospects of long-term monetary stability.[5]

Many economies enjoy the benefits of stable currencies and a stable price system, yet combine anti-inflation monetary policy with the flexibility of a floating exchange rate. The cost of the latter is potential volatility, which can only be diminished with credibility in the future direction of monetary policy. In other words, if savers know that the central bank will not sway from its anti-inflation course, and know this on the basis of precedent, there is no need to rush to foreign currencies to protect the value of domestic earnings. This is a hard and time-consuming task, but recent developments seem to suggest that the Bank of Mexico is finally regaining a measure of credibility in financial markets.

The Bank of Mexico categorically insists that a floating regime will be followed, and that monetary policy will be anchored on targets for domestic credit expansion. It is surprising, however, to find authorities at the Ministry of Finance insisting that they will not allow the peso to become "overvalued again." However, to say that a float will be maintained and also say that the exchange rate will not become overvalued embodies a fundamental tension. The former claim entails that the parity will be what it will be—that is, what the foreign exchange markets dictate in accordance with supply and demand, regardless of whether this results in an appreciation or depreciation of the peso. The latter claim, however, implies that the government, not the market, should set the exchange rate. In that case, politics, not economics, is the dominant force.

The stability of the peso during the period 1996–97 has generated the illusion of a problem with real appreciation of the currency and the need for peso depreciation in the interest of export competitiveness. The failure of the parity to adjust to differentials in price levels between Mexico and the United States has led observers to fear secret interventions in the foreign exchange market or to recommend active depreciation. That state of confusion is encouraged by the Zedillo administration's own simplistic abuse of PPP formulae to estimate annual levels for the peso/dollar parity, despite simultaneous claims that under a floating regime it is impossible to predetermine a correct level for the exchange rate.

[5]The remainder of this section is adapted from Salinas-León (1997c).

Pathological fear with a strong peso led authorities to formalize a program for the systematic accumulation of international reserves, in order to short circuit a potential "accelerated appreciation of the currency that could diminish the profitability of tradable goods." That is a fancy way of saying that the authorities will keep some of the investment coming in so that the peso does not revalue, and in turn keep exporters happy, or less concerned about too much investment coming into an undercapitalized economy. Yet, accelerated appreciation is a natural market-driven process in the context of capital inflows following successful stabilization measures.

Thus, observers who suspect secret interventions to sustain the peso beyond levels dictated by inflation differentials have it backward. If the central bank were not amassing dollar reserves, the parity would now be much closer to 7 than 8 pesos to the dollar. The contradiction is obvious: avoiding a market-driven appreciation of the peso is inconsistent with claims that there is no predetermined level of the parity under a floating regime (see Salinas-León 1997b).

Indeed, the irony is that, despite the existence of a floating regime, there is a strong consensus that Mexican authorities should undertake measures to "eventually adjust the value of parity," in order to remove systematic appreciation and avoid the external sector from falling into a deficit. The current fashion, of course, fails to mention that a sure way to accomplish those lofty macroeconomic goals is to suspend all foreign investment or implement a policy of maxi-devaluations. Both options involve depressing the domestic sector in favor of export earnings, with no basis in a more modern productive process. The numbers would thrill the consensus, although the cost for the real economy would be devastating.

The causes and consequences of Mexico's 1994 peso crisis constitute a fascinating topic for policy discussion, and will surely continue to engage policy analysts and academics. The principal lesson of the crisis is obvious: leave the parity alone! On that point, I believe, Meigs and I fully agree.

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