CHAPTER 1
THE GLOBAL CONTEXT:
A DECADE OF FINANCIAL TURMOIL

Introduction. In early February 2002, about two thousand corporate executives, political leaders, and international economists gathered in New York City for the World Economic Forum (WEF). The decision to move the location of the WEF from its traditional site in Davos, Switzerland, to New York City was conceived as a gesture of solidarity for a city digging itself out from the terrorism of 11 September 2001.

Immediately following the 9-11 tragedy, the anti-globalization movement temporarily lost momentum. Planned protest marches on Wall Street, the World Bank, and IMF were abandoned. But recent events show that the anti-globalization movement has lost none of its passion. For instance, on 2 February nearly two thousand protestors gathered in NYC in the bitter cold to demonstrate their opposition to WEF—an evil symbol in their eyes of globalization. At the same time, another sixty thousand people congregated in Puerto Allegre, Brazil, to participate in the World Social Forum—a counter-capitalist counterpart to the WEF.

While President Bush and other heads of state, central bankers, finance ministers, and anti-globalization protesters all look differently at the U.S. and the global economic landscape, they all have good reasons for anxiety. The global economy faces great uncertainty.

The Global Economy

Globalization Fears. In the anti-globalization camp, many concerned citizens—who feel threatened by this global financial turbulence—link arms with environmentalists, trade unionists, and politically powerful Non-Governmental Organizations (NGOs).

- They want a global economy that is less turbulent. They are alarmed by what they see as clear signs that globalization is a terrible thing.
- This coalition also criticizes globalization for exacerbating a host of worries: over the environment, labor rights, human rights, consumer rights, Asian finances, etc.
- Human rights advocates are quick to tell you that Nike exploited Third World workers by paying them dirt-cheap salaries in their unsafe overseas "sweat shops factories." American labor activists also criticized Nike for undermining economic security by "unpatriotically" exporting American jobs overseas in pursuit of greed.

Financial Globalization. Many economists in this camp are quick to blame George Soros and the Wall Street proponents of “runaway globalization” for the Asian economic crisis.

- This group sees the IMF, World Bank, WTO, and a host of other international financial institutions (IFIs) as useful whipping boys to dramatize a decade of the global financial turmoil.
- In the 1990s, exchange rate crises, stock market crashes, and severe economic contractions erupted in Europe, Latin America, and Asia.
- In 1998 the world plunged into the worst economic crisis since the great depression.
- Yet throughout most of the decade the U.S. economy seemed strangely immune to the financial turbulence.

U.S. Economic Slowdown*.* Then in late 2000 and early 2001, U.S. concern turned into alarm. The U.S. stock market crashed. Robust U.S. economic growth is disappearing. U.S. industrial production continues to contract. As a result, a U.S. faltering economy—previously the engine of growth in an otherwise shaky global economy of the 1990s—dragged down other economies around the world.

- The global economic slowdown turned into a global stagnation.
- The fact that much of this anemic global economy rests on financial quicksand makes a lasting economic recovery even more difficult for President Bush and other foreign leaders to navigate.
- This financial quicksand became even more evident in late 2001, when the Argentine government defaulted on its

massive debt. Argentina's rigid foreign exchange regime also collapsed.

A Financial Architecture? As President Bush and his Secretary of Treasury Paul O'Neill mull over what to do about this global financial turmoil, many responsible protesters blame the foreign exchange market and are calling for a whole new "international financial architecture."

- In fact, President Bush's predecessor, President Bill Clinton, blessed this crusade for reform of the foreign exchange market. President Clinton promised,

  "(It is now time for the world to) take the next steps (of implementing a) new financial architecture and long term reform of the global financial system. (This should include) steps to reduce the entire financial system's vulnerability to rapid capital flows and excess leverage."[1]

Back to Bretton Woods? In this regard, some say we should return to the old Bretton Woods fixed exchange rate system in order to create more financial stability and curb international financial turmoil.[2]

- Other observers say the world should move toward floating exchange rate system.
- Still others says each country should do "its own thing" (i.e., what's best for that country).

In any event, the single most important international financial policy decision that President Bush and other heads of state arguably must make is their choice of an international exchange rate regime that will minimize the global financial turbulence.

This chapter will look back at the most spectacular financial crises outside of Asia over the past decade, diagnose what went wrong and recommend an international foreign exchange rate regime (and domestic macroeconomic strategies) that will minimize global financial turbulence. Before we analyze what went wrong and how to get things right in the future, let's take a bird's-eye view of some of the more dramatic financial crises in the past decade.

Financial Crisis in Europe

Rise and Fall of German Optimism. Remember the joy and optimism when the Berlin Wall came tumbling down? November 9th, 1989 was a day of euphoria in both East and West Germany. That feeling of euphoria was still evident at the time of German economic and monetary unification in July 1990 and at the time of political unification in October of that same year.

- In addition, many people envisaged this unified Germany as a new superpower, an economic powerhouse strong enough to carry not only its poor eastern cousin along with it but also the rest of what then was called the European Community (EC). In fact, German Chancellor Helmut Kohl compared German unification to a giant corporate takeover.
- Helmut Kohl did mention in passing that unification would take some time to jell. But no need to worry. The benefits would appear relatively quickly to the East Germans and it wouldn't cost the West Germans much.

After all, how could the process fail with the turbocharged West German economy behind it? Little wonder that East German expectations rose and West Germans became convinced that they need not make any real sacrifices. In fact, Kohl promised "no new taxes."

Dead-Wrong. Unfortunately, Bonn's worry-free view of German unification was dead wrong. Based on this faulty assessment, the German government consistently made one bad decision after another.

- Some of these ill-advised decisions were based on faulty economic assumptions.
- Others were taken for purely short-run political reasons.

Negative Economic Impact. The economic impact of these bad decisions made a difficult East German economic transition much worse.

- Eastern Germany became an economic black hole for Bonn.

- Henceforth, East German economic problems required the lion's share of Bonn's attention, not to mention its disposable resources.
- And as Bonn turned inward to cope with its East German black hole, its self-absorbed German policies worsened the deteriorating monetary and fiscal plight of most of its EC partners.

EC-92. This turn of events was certainly not what most people expected in 1990.

- Back then, the Kohl government was an avid supporter of EC-92, or the process of moving to a single European market on January 1, 1993.
- And as part of the overall economic integration of Europe, Bonn also strongly backed the road to European Monetary Union (EMU).
- The twin pillars of EMU were to be a European central bank and a common European currency (Euro).
- In December 1991, EC leaders signed the Maastricht Treaty that called for EMU to take place as early as 1997 but no later than 1999.

Rise and Fall of Euro-optimism. Back then almost everyone seemed to be a Euro-optimist and confidant that 1992 would symbolize EC cooperation and prosperity as well as the EC-92 milestone for a single European market.

- But 1992 was anything but a successful year for economic integration in Europe.
- In the first three years of the 1990s, financial chaos paid a visit to central Europe in the form of two currency crises.
- The exchange rate mechanism (ERM)—which linked most of the EC currencies in a tight currency band—was created in 1979 to engender stability among exchange rates.
- Instead ERM spawned two spectacular currency crises in September 1992 and August 1993 and several dozen exchange rate re-valuations.
- First the Italian lira and the pound sterling took a beating. After a hysterical defense of their currencies, the UK and Italy finally waved the white flag and opted out of ERM.
- Less than a year later, the French franc was hit. EC finance ministers and central bankers met over the weekend of July 31/August 1 of 1993 in a frantic attempt to save ERM. By Monday ERM was virtually dead. To save the pretense of ERM, EC leaders dramatically widened the currency band by which most of the EC currencies were allowed to fluctuate.

Financial Crisis in Mexico

Rise and Fall of Mexico. Latin America took center stage in the middle of the decade. As in Japan and Europe, we saw the big buildup for the big let down.

For Mexico, the North American Free Trade Agreement (NAFTA)—which came into force on January 1, 1994—was a glorious moment. It symbolized Mexico's new partnership with its northern neighbors. Mexico now stood proudly, on equal political footing with the United States and Canada. NAFTA also symbolized just how far Mexico had come from the agony of the 1982 debt crisis.

Mexico's economy was no longer the object of ridicule. In fact, one and all praised Mexico as building an economy that was now a haven for foreign investors.

Of course it had not been easy. Mexico's financial mistakes led to a debt crisis that devastated the economy. It took years of austere economic reforms to undo the damage. That in turn produced years of economic pain and suffering for the Mexican people. But it appeared that Mexico had finally learned a valuable lesson about the discipline needed for financial stability in the future.

By the early 1990s the bitter medicine seemed to be working. The Mexican economy seemed to be on the right path toward economic recovery. As the memory of the bad times faded, President Salinas could hold his head high. He was the toast of the continent. And so in retrospect, the economic struggle seemed worth it. In short, all was well in Mexico. Or was it?

The Peso Crisis. In December 1994 Mexico experienced a stunning currency crisis only 20 days into the administration of newly inaugurated President Zedillo.

- Just 12 short months after NAFTA came into effect, investor confidence collapsed and investors frantically sold Mexican stocks and debt securities.
- Mexico's pool of foreign currency reserves were insufficient to meet the insatiable demand of investors seeking to convert pesos into U.S. dollars.
- That triggered panic, a relentless run on the peso, and once again another devastating Mexican financial crisis.
- With the specter of national bankruptcy smacking Mexico in the face, Mexico's newly elected Prime Minister Zedillo appealed to the United States and IMF for help.
- The United States responded once again and organized a $50B financial package to rescue the embattled Mexican economy.
- In our next chapter we'll see the parallels between this Mexican peso crisis and the fall of the Thai baht and the ensuing Asian economic crisis. But before we do this, it's important to understand the other global aspects of this financial turmoil.

Financial Crisis in Russia

Russian Meltdown. For instance, in August 1998, Russia took center stage.

- Moscow simultaneously defaulted on its maturing treasury debt and devalued the ruble.
- When the rouble was allowed to float it nose-dived to near worthlessness.
- Nobel Prize winners in economics and numerous international investors who exposed themselves to the ruble with foreign exchange contracts in the Russian debt market were soon jolted.
- Russian banks refused to perform on their forward ruble contracts when the government defaulted on its debt.

Current Financial Turmoil

As we go to press, Turkey and Argentina are simply the most recent victims of this relentless financial turmoil that is ricocheting around the world.

- In other words, President Bush can find little comfort from this inherited legacy of global currency crises, stock market crashes, deflation, recession, public sector insolvency, and political instability all rooted in economic dislocations.
- Given this financial chaos, is anyone really surprised that a backlash is growing against global capitalism?

What's Wrong? You don't have to agree with all the signs the protesters held up in Washington, D.C. in late April 2001 to come to the obvious conclusion that something is wrong with the global economy.

- Why have these financial crises taken place?

Financial Reform? At first glance, the diagnosis and prescriptions seem deceivingly simple.

- Critics of free financial markets say that the current international monetary system that permits free capital markets is "out of control."
- These critics argue that the financial crises cited above are a natural outcome for an economic system that permits the unrestricted flow of capital across borders.
- These capital flows purportedly behave more like "wrecking balls" than pendulums.
- Blame goes to leveraged speculative trading in foreign exchange and fixed income markets.
- These critics also bemoan the dearth of regulations of capital markets and the practice of letting exchange rates float freely.
- In this regard, the UN says, "the current international financial system is unable to safeguard the world economy from financial crises." [3]

Historical Context. In many ways, this yearning to cast the foreign exchange market in a villain's role is not new.

- President Franklin Roosevelt used to criticize currency traders on a routine basis.
- His Treasury Secretary Henry Morgenthau once said that he hoped the Bretton Woods system would "drive the usurious money lenders from the temple of international finance."[4]
- Recently, French President Chirac has criticized these international financiers.
- Malaysian Prime Minister Mahathir also shares this negative view of currency traders:

  "We do not like currency traders. Do we want to see the wealth of nations built up over years be destroyed because currency traders wanted free trade? … Whole regions can be bankrupted by just a few people whose only objective is to enrich themselves and their rich clients." [5]

Two Popular Diagnoses. To sum up, there are two popular explanations for foreign exchange rate crises:

- the speculator hypothesis and
- the capital mobility explanation.

Popular Prescriptions. At first glance, the prescription that will allegedly "cure" this "international financial disease" also appears deceptively simple on the surface.

- Recently, calls for reform have sprung up everywhere demanding the reinvention of what is termed the "international financial architecture."
- This term generally means the foreign exchange market, though it can also refer to international capital movements or by inference to the unregulated trading of large and leveraged investment funds.
- The common claim of the reformers is that changes must be made to the international monetary system to prevent the arrival of fresh waves of financial devastation.

Proposals. The proposals on the table, to name just a few, include:

- Regulation of capital flows (especially to emerging markets),
- Imposition of a tax on foreign exchange transactions,
- Establishment of target zones to limit fluctuations in foreign exchange trading and
- Policing of hedge funds and other trading concerns.[6]

If one buys this logic, how should President Bush and his economic team respond? What should be done?

- Many political leaders around the world are indicting the foreign exchange market and the system that affords mobility to international capital.
- They are urging President Bush to embrace a radical new "international financial architecture" that will "foster more financial stability."
- In other words, they are unwilling to "risk" leaving international financial matters entirely up to the free market."
- Most importantly, they recommend new rules and mechanisms to regulate the volatile international financial system.

Who can argue with this quest for more financial stability? Why shouldn't President Bush support new rules and regulations to tame and stabilize the global financial system? Isn't this open and shut case of a clear diagnosis and a logical prescription as cited above?

A Better Way. Quite the contrary. With all due respect, those people making the case for new financial rules and regulations for international capital markets do not understand what actually causes financial crisis.

- So before we risk "throwing the baby out with the dirty bath water," it is imperative that we all understand what the international capital market is and how it works.
- If we look closely at the new international financial architecture, we discover that many of its recommendations are built on erroneous assumptions.

Misconceptions. These false impressions include the following:

- Ruthless cartel of destructive speculators can hold the world ransom at will,

- Fluctuations in exchange rates serve no economic function in the allocation of economic resources but exist merely for the employment and enrichment of currency traders,
- Market economies are prone to spontaneous and unpredictable implosion simply because they are market economies,
- Foreign exchange rates bear no relation to economic fundamentals,
- Exchange rates often get "out of whack" or "overshoot" and can frequently lead to "premature" rises in the value of currencies.
- Therefore, we should return to a new international financial architecture.
- This new set of rules and regulations for international capital markets would have the world return a neo-Bretton Woods system.
- Proponents of a new Bretton Woods mistakenly think that fixed exchange rates and government management and regulation foster more "financial stability."
- An underlying and unstated assumption here is that the foreign exchange market is a private club run by "fat cats" like George Soros.[7]

***Primacy of Prices*.** Reformers who embrace the new international financial architecture often charge that floating foreign exchange rates are bad because they produce such "undesirable" developments as "excessive volatility," and "premature movements," that often "over-shoot" their optimum positions.

- But can any serious student of economics really explain what is meant by "premature" movements in a free market?
- Would anyone ever say the price of a sweater on a department store shelf has moved down "prematurely?"
- In any normally functioning market prices move up and down in a more or less continuous basis.
- In this regard, critics of open international capital markets mistakenly perceive foreign exchange rates as "toys" for speculators.
- Fact is, exchange rates are prices, not playthings.
- When they move, by a lot or a little, it is for the purpose of achieving equilibrium between supply and demand. [8]

***Normal Volatility*.** That said, the foreign exchange market—like all free markets—can and do go to extremes. But why is it acceptable for stock markets to boom and bust while many see it unacceptable for exchange rates to move up or down? Certainly nobody would suggest we should keep stocks frozen.

Yet many people think we ought to either keep foreign exchange rates pegged or at least have government bureaucrats guide exchange rates. This misconception raises two key questions:

- Can we really expect government bureaucrats to be more omniscient than the free market?
- Can they really dream up fundamentally acceptable levels and keep all movements in exchange rates small in magnitude?

In this chapter we'll see that government bureaucrats tend to cling to unrealistic exchange rates and invariably do more harm than good. While outside forces aggravated the situations we'll study, all of the financial crises we look at in the 1990s were invariably the result of wholly ruinous domestic economic policies rather than the fault of international capital markets.

Two Case Studies. To help us understand these realities, we will explore the economic conditions that produced financial crises in the 1990s in Europe and Mexico.

- In the process we will see how domestic economic policy blunders created these nightmarish economic conditions in Europe, Russia, and Latin America.
- The worst of these ill-advised domestic economic policies was arguably the decision by our case study economies (Mexico, Thailand, Germany, and the United Kingdom) to adopt rigid exchange rate regimes.

European Crises of 1992 and 1993

The first exchange rate crises of note in the 1990s occurred in Europe when a flawed German unity process crashed into an ill-conceived process unifying European exchange rates. The overly optimistic view the European economic and financial landscape 1990s depended heavily upon the successful economic and political incorporation of East Germany into a prosperous, united West Germany.

Curiously enough, hardly anyone questioned the premise that German unification would be economically and financially consistent with European economic integration.

- Unfortunately, the German Bundesbank would respond to the Kohl government's lax fiscal policy with an excessively tight monetary policy.
- This Bundesbank monetary death grip would trigger European recession, financial chaos inside ERM and political disunity in the EC.

***First Mistake*.** The economic difficulties of German unification (and ultimately the rocky road to European integration) can be traced back to a number of costly German unification mistakes.

- The first mistake was in the ratio used to convert Eastern or Ostmarks into Deutschmarks (DM).
- The market value of the Ostmark before GEMU was at best only a quarter of the value of the DM. Many economists would argue that the Ostmark was really worth far less than this. Certainly a strong economic case can be made that the Ostmark should have been purposely devalued at the time of conversion to give East German exports a price advantage in foreign markets.
- Unfortunately, the German government opted to swap Ostmarks for DMs at rates of 1:1 or 2:1 depending on the transaction.[9]

***Pohl's Warning*.** While the conversion ratio was politically attractive, it was shortsighted and ill-advised economics. The ill-fated decision might have been avoided had Bonn consulted the Bundesbank prior to the decision. Unfortunately, no consultation took place. Shortly after Dr. Karl Otto Pohl, President of the Bundesbank, learned about Bonn's ill-fated conversion rate decision he resigned in protest.

At the time of his noisy departure, Pohl correctly predicted that the coalition government's ill-conceived mad dash to German economic and monetary unification (GEMU) would turn out to be, in his words, "a disaster." Why a disaster?

***Overvalued Ostmark*.** In effect, the conversion ratio drastically overvalued the Ostmark, which in turn decisively overpriced East German products.

- Sadly, the German conversion rate amounted to forever pegging the Ostmark at an overvalued rate.
- The non-subsidized price of East German products then became outrageously expensive.
- In short, the exchange rate debacle left East German industries hopelessly noncompetitive, with little to export to their traditional markets.

After this German exchange rate "disaster," none of the former east European communist states complained anymore that having a “rich big brother” in West Germany gave the East Germans an “unfair export advantage!” Ironically, the conversion ratio put East Germany at a disadvantage with other east European exporters such as Poland, which purposely devalued its currency in order to keep its export prices low and competitive.

***Second Mistake*.** Bad as this conversion ratio was in an economic sense, the mistake could have been salvaged somewhat if the conversion ratio had been offset by a reduction in prices in East Germany. A sensible policy, therefore, would have been to let East German wages fall, which in turn would serve to reduce East German prices, thus allowing East German exports to be competitive again. Instead, rising wage parity (between East and West German wages) also killed the East German corporate competitiveness.[10]

Wrong Assumptions. For two years the Kohl government said that unification would be relatively painless to the West Germans, that it could be accomplished quite swiftly in the east, and that the whole process could be implemented without significant tax increases. Bonn was wrong in all three areas. In September 1992, Dr. Kohl finally admitted that his economic mismanagement triggered staggering fiscal and monetary problems.

***Ballooning Costs*.** Meanwhile, the West German corporate sector was in no position to absorb the ballooning costs of unification. Little wonder, therefore, that the burden of absorbing them fell increasingly into the western German public sector, and these costs were ballooning.

***Over-borrowing*.** Instead of cutting unnecessary spending programs and raising taxes to pay for a large share of the DM 180B in net transfers to East Germany, the West German federal, state, and local governments opted for the old American "disease" of over-borrowing on the capital markets. Not so coincidentally, Germany's public sector deficit in 1992 matched the net transfers from West to East Germany. Back in 1993 this swelling German public sector deficit was proportionately higher as a percentage of GNP than that of even the giant U.S. public sector deficit.

***Monetary Death Grip*.** Over-borrowing to defray the ballooning costs of unification triggered an acceleration in the German money supply. As a counterweight to this inflationary pressure, the Bundesbank opted for a tight monetary policy. Fearful of excessive monetary expansion caused by the huge cash flows to East Germany, the German Central Bank kept its short-term interest rates painfully high.

- The Bundesbank hiked short-term interest rates repeatedly.
- From the time of the fall of the Berlin wall to July 16, 1992—a period of 18 months—the Bundesbank raised the discount rate four times, starting from 6% and reaching 8.75%.
- Conflicting Interests. The Bundesbank was the anchor central bank of the EMS.
- Yet it was raising interest rates during the time when other ERM central banks were hoping to guide their interest rates to common lower levels to fight off recession.
- In other words, at a time when the Bundesbank was fighting an overzealous battle against inflation, most of the European economies were trying to fight off recession and desperately wanted to use lower interest rates as a tool in their battle.
- But since EC currencies basically were tied to the DM, no member of the ERM could decisively lower its interest rates until after the Bundesbank lowered its interest rates.
- Worse still, in order to remain in the ERM the other EC members had to adopt overly austere fiscal policies to offset the Bundesbank's tight monetary policy.

***Rising Unemployment*.** In fact, ill-advised German economic policies hammered economic growth in Western Europe and triggered rising unemployment throughout the region.

- At a visceral level, many of the other European states understandably directed their anger at the source of the problem, the German government.
- They saw jobs lost in their countries so that West Germans did not have to pay the true costs of East Germans enjoying a lifestyle far in excess of their true productivity.

In addition to slowing down the economic growth in other European economies, the mismanagement of German unification caused havoc in European financial markets. This financial instability in turn served to undermine the confidence of international traders and therefore limited the success of European economic integration.

How did the process unravel so fast? To grasp the roots of the currency chaos in Europe that the Germans triggered, it helps to understand a little about the European Monetary System (EMS), which was set up as an antidote to the currency instability and dollar weakness in the late 1970s.

- At the core of EMS was the Exchange Rate Mechanism (ERM), a grid of exchange rate parities for participating EC members. [11]

***Financial Turmoil*.** The intended purpose of the ERM was to dampen the volatility of European exchange rates in the period leading up to the launch of the euro.[12] Full interest rate convergence was seen as a necessary precondition to the debut of the single currency.

But ERM was anything but a stabilizing influence.

- The ERM was a fine example of financial engineering run amok, actually induced record levels of volatility in European exchange rates.
- From the time of its inception in March 1979 until the creation of the euro at the start of 1999, the ERM suffered a total of 18 realignments affecting 56 central rates.
- It also spawned two spectacular currency crises, which we will discuss.

Why the crises? For starters, the crisis originated from a form of a fixed exchange rate regime. All the conditions that make for a potentially explosive foreign exchange regime were present.

***Destabilizing Carry Trades*.** The first fault line was the open door for what is known as carry trades in financial circles. Carry trades attract people who have no interest in investing in the country, per se. They are solely motivated by a desire to use carry trades to capture the interest rate differentials between the two currencies. They express this in a number of trading strategies that go long in the domestic currency and go short in the reserve currency.

- In this regard, the ERM was the breeding ground for the most famous carry trade in history.
- In the years leading up to the September 1992 currency crisis, a massive carry trade known as the convergence play developed.[13]

ERM created serious distortions in European capital markets. Despite the apparent exchange rate stability, European currencies featured widely disparate interest rates.

- The interest rate differentials were huge in favor of the high yielding ERM currencies against the low yielding German mark.
- Why settle for the low yield on a deutsche mark when you can get a higher yield on a peseta or a lira without any apparent compensating risk?[14]

Meanwhile, the market assumed that the apparent EC political commitment to EMU displayed at Maastricht meant that the EC's parities were, if anything, more fixed in the rosy future than in the last few comfortable years of ERM. In short, "all was well."

Danish Reject Maastricht Treaty. Or was it? What if this political commitment to EMU was not so rock solid? What would happen to ERM? The first indication that something might be horribly wrong with ERM occurred on 3 June 1992 when a market panic in sterling and the European bond market ensued following the defeat of a Danish referendum on the Maastricht Treaty. Investors were seriously concerned that the entire single currency project might be doomed.

In other words, all it took was the Danish vote against Maastricht in the June 2, 1992, referendum to shatter the contentment of "Euro-phoria" and European financial stability. Doubts over Maastricht destroyed the assumption that ERM parities were virtually fixed. The market then concluded that the combination of high German interest rates and several weak currencies would bring about a currency realignment. And the last thing a currency speculator wanted was to be stuck holding a weak currency after a currency realignment.

In spite of the pro-Maastricht vote in the Irish referendum a few weeks after the Danish vote, pressure began to build against the weaker currencies inside ERM. At such a critical moment in European economic integration, what European currency investors yearned for was an easier Bundesbank monetary policy to decrease the uncertainty of the French vote on Maastricht. Instead the Bundesbank did just the opposite and added fuel to the fire by tightening its monetary policy.

By the end of August, some opinion polls said the French people would vote against Maastricht. That prospect really shook the European currency markets. Nervous currency investors were open to the idea that the Danish "no" vote could somehow be overcome. But if the French people voted against Maastricht, then the treaty would be dead. As the French referendum approached, it was clear that the vote would be extremely close. If the French voted "no," financial discipline within the ERM was sure to break down. Without the goal of a common European currency, those EC countries with weaker currencies would no longer be held to a strict monetary convergence criterion. Gone would be the outside pressure to curb budget deficits or to keep inflation under control.

Currency Time Bomb. The crisis in ERM could have been reduced if the EC finance ministers had taken decisive action and opted for a currency realignment at their meeting in Bath on September 5, 1992. Instead, the EC finance ministers equivocated.

- Not long thereafter, ERM took a direct blow when the Italian lira suffered a speculative attack, finally falling below its ERM floor on Friday, September 11, 1992.
- The Germans and the Italians met and opted for a 7% devaluation of the lira and modest cuts in short-term German interest rates to "calm" the markets.
- Inexplicably, the Bundesbank made no attempt to contact the British over the weekend about a broad realignment.
- As financial chaos spread over the next few of days, the British became livid about this incredibly callous German oversight.

The problem was that the lira devaluation alerted speculators that ERM was now unstable and recession weary countries with weaker currencies could no longer afford to use high interest rates to maintain their ERM parities. Meanwhile, the cuts in German interest rates were too little to allay the fears of European currency investors of being stuck with a collection of weak European currencies that would quickly lose their value if the French voted "no" on Maastricht.

On the eve of the French referendum, nervous investors predictably pushed the panic button.

- They sold massive amounts of weak EC currencies and bought DM as a safe haven in a financial storm.
- By Tuesday, September 15, sterling was in serious trouble.
- It closed in London just a fifth of a pfenning above its ERM floor of 2.778 DM, its lowest ever level in ERM.
- That night sterling suffered a knock-out blow.

Black Wednesday. The stage was set for a day of carnage on the foreign exchange markets. On Black Monday the full crisis erupted two months after the final Bundesbank rate hike of 16 July 1992.

- 16 September 1992 is a day that lives in traders' minds as one of the most chaotic times in modern foreign exchange history.
- Not only was the foreign exchange market in chaos, but stock and bond markets in all of Europe were also in a complete uproar.[15]

Run on Pound**.** Massive selling of the pound sterling took place as it became apparent that the UK had made a massive error in letting a drastically overvalued pound sterling join ERM 23 months earlier.[16]

- In the course of one day, the Bank of England would raise short-term interest rates from 10% to 12% and then announce that it would raise rates again to 15% on the next day, all in defense of the pound.
- The UK fought the market tooth and nail, buying large blocks of its own currency against the mark.
- It didn't work.
- Sterling was being sold like water running out of a tap.

UK Opts out of ERM. Sterling was down and later completely out of ERM. Neither high interest rates nor hurling an estimated 15B pounds into the currency market had any effect. The market knew that the UK could ill afford to keep interest rates high for long in the midst of a British recession. Nor was the UK prepared to lose all of its currency reserves simply to stay in a seriously flawed ERM.

On the afternoon of 16 September, when it became apparent to everyone that the battle was lost, the Bank of England rescinded both interest rate hikes. In the end, the UK as well as Italy surrendered and opted out of ERM and the cause of European integration was dealt a serious blow. In fact, the UK still has not returned to the single currency as of May 2001.

Moreover, the financial costs of the crisis were staggering. Despite heavy Bundesbank intervention, Italian reserves were decimated. Moreover, Anglo-German diplomatic relations was damaged still further by the seeming indifference of the Bundesbank to the British financial crisis.

The French “yes” vote in September 1992 and the Danish “yes" vote on May 18, 1993 saved EMU from disaster. But ERM was another matter. It was hardly the zone of monetary stability it was supposed to be.

Second Crisis**.** Eleven months later, in late July/early August 1993, a second ERM crisis occurred.

- This time the primary targets were the French franc and the Italian lira.
- The catalyst was the Bundesbank's refusal to lower its discount rate at its meeting on July 29.
- The attack on the franc and other weak EC currencies still in ERM was reminiscent of the attack on the British pound and the Italian lira on Black Wednesday in September 1992.
- EC finance ministers and central bankers met in an emergency meeting over the weekend of July 31/August 1.
- By Monday ERM was virtually dead.

Wider ERM. To save the pretense of ERM, EC monetary and finance leaders decided to widen the ERM currency band.

- They widened the margins by which seven of the EC currencies, including the French franc, would be allowed to fluctuate by 15% above or below their nominal exchange values (instead of 2.25% for most of the currencies previously).
- Even with these measures, Spain and Portugal, were forced to devalue one last time on 6 March 1995.

Eventually the European currencies did stabilize and convergence was achieved. But this happened after the 2 August 1993 widening of ERM trading bands to plus or minus 15%. So was ERM really in the interests of the Europeans to have created? In DeRosa's words,

"Convergence was achieved not through manipulation of exchange rates but as a natural result of improved economic conditions … Neither of the ERM crises would have occurred had the EMS not insisted on trying to limit the fluctuations in exchange rates inside Europe. The whole episode should have argued for an open-and-shut case for the economic incompetence of the European ministers who designed the ERM.[17]

Mexico

But if European financial turmoil was spooking investors, the situation in Latin America seemed to be better, especially in Mexico. By the 1980s, Mexico appeared to be transforming its economy into a respectable emerging market success story. NAFTA became effective on 1 January 1994. Things were looking up. But in economics, appearances can be deceiving.

In December 1994 the Mexican peso suddenly was the target of tremendous selling pressure. In a matter of days, the peso declined to less than half of its previous value against the dollar. How could things unravel so fast? The Bank of Mexico would have everyone think that Mexico was a helpless victim of speculative attack and an unjust foreign exchange market. But basic economic analysis argues differently. The fall of the peso was actually due to real economic forces. In other words, the Mexican economy was in far worse shape than it appeared on the surface. And many of the ghosts that haunted Mexico in the past were reappearing in 1994.

An Overvalued Peso. A fatal flaw in Mexico's economic formula began with Mexico's foreign exchange regime. Mexico made the mistake of trying to use a de facto fixed exchange rate regime to "stabilize" the economy. Mexico's "crawling peg" fixed exchange rate regime allowed for only a tiny depreciation over time. The government tried in vain to lean on a virtually fixed exchange rate regime as an "anchor" that would somehow offset inflation, an undisciplined fiscal policy, and an unpredictable climate for foreign investors.

But try as it might, the Bank of Mexico just couldn't get the value of the peso right. It was consistently and sharply overvalued. While the Mexican exchange rate regime was becoming less rigid between 1988 and 1993, it was still not nearly flexible enough to accommodate an inflation rate that was much higher than that of the United States. In Rudi Dornbusch's words:

By 1993, Mexican producer prices had risen in dollars by over 45% since the late 1980s compared with prices in the United States. An overvaluation of at least 25% could be discerned. Growth slowed down (except for election year spending), real interest rates were extremely high … and the external balance shifted towards a massive (capital account surplus). [18]

Given the importance investors attached to the apparent stability of the Mexican exchange rate, surprisingly little attention was given to the fact that the peso was massively overvalued prior to the crisis.

- At about three pesos to the U.S. dollar, the peso was still drastically overvalued (by 30-40 percent) in 1994. That meant Mexico's trade deficit was in big trouble.
- If we look at the more inclusive current account (which includes trade in goods and services), Mexico's deficit had risen to 8% of GDP by 1994. That number was dangerously high by any country's standards.
- There was remarkable complacency about the fact that Mexico's current account deficit had steadily risen from $3.8B in 1988 to $29.5B in 1994.

Impact on Prices. The overvalued peso had severe consequences. It became cheaper to cross the border and buy groceries in Texas than to buy them in Mexico. So Mexican consumers soon became addicted to buying more and more imported goods from the United States.[19]

Trade Imbalance. To cover this trade gap, Mexico had to import more and more foreign capital. This made Mexico's balance of payments increasingly vulnerable if for any reason investor confidence in Mexico began to get jittery or if investors saw better opportunities elsewhere. For awhile in the early 1990s, the large current account deficit was a difficult but manageable problem.

Capital Inflow. That's because capital literally poured into Mexico in the early 1990s.

- During the 1990-93 period, IMF estimates that Mexico received $91B in net international capital flows, with $30B flowing into Mexico in 1993 alone.
- That amounts to roughly one-fifth of that garnered by all developing countries combined.
- But all capital inflows are not the same. For instance, a large chunk of the capital was portfolio capital (stocks and short term bonds) or "hot money" which can leave the country at the speed of light.
- In fact $61B of the $91B in net foreign capital inflows into Mexico was in the form of hot money.

Addictive Carry Trade. Why was so much capital coming into Mexico? To maintain the virtually fixed exchange rate against the U.S. dollar, the Mexican government had to push interest rates far above U.S interest rates. As a result, dollar investors soon became addicted to a carry trade involving peso-denominated short-term government debt issues, known locally as Cetes.

Cetes. These Cetes offered a large step-up from U.S. dollar interest rates with no apparent risk.[20] The common wisdom in financial circles was that the probability of a large devaluation was low. In fact, a devaluation had not taken place for a long time. So a substantial incentive remained for foreign investors to hold pesos as long as they believed that the fixed exchange rate regime could be preserved. The game for any market player was to time the conversion of funds back into dollars before the devaluation and obtain higher than the market return on the dollar.[21]

False Indicator**.** Meanwhile, the Mexican government kept up the trendy economic fallacy that massive amounts of capital flowing into Mexico was somehow a positive sign of "confidence in the economy." Nothing could be further from the truth. Countries like Mexico that have large inflows of foreign capital are frequently not marching toward prosperity. Too often, they are actually courting disaster. The fixed exchange rate regime in Mexico triggered what economists call a gross economic distortion. Or as Rudi Dornbusch puts it, "All the symptoms of a troubled financial situation were in place." [22]

Earlier we saw that carry trades attract people who have no interest in investing in the country, per se. They are solely motivated by a desire to use "carry trades" to capture the interest rate differentials between the two currencies. DeRosa is even more blunt about this grim reality.

Rat Hole. As far as investors cared, the capital flowing into Mexico might as well have been going down a "rat's hole." The entire incentive for investing in Mexico rested on the preservation of the artificially stable exchange rate, rather than on carefully scrutinizing real economic opportunities in Mexico.[23]

Given the importance that investors attached to the apparent stability of the exchange rate, surprisingly little attention was given to the fact that the peso was massively overvalued prior to the crisis.

Wishful Thinking**.** Why didn't foreign investors realize that huge blocks of foreign capital that were stampeding into Mexico might someday turn around and try to leave en masse. Not to worry. The risk of forced devaluation seemed remote. Even if foreign investment fell a bit, Mexico's foreign currency reserves were relatively plentiful, at least for awhile. In fact, Mexico's foreign currency reserves increased dramatically from $6.3B to over $25B between 1990 and 1993. These reserves gave the government a false sense of security. Consequently the government ignored the current account deficit time bomb. And if worse came to worse, the U.S. government or the IMF would probably bail out the investors. As Paul Krugman puts it, "Heads they (the investors) win, tails they win."[24]

The Tide Turns. Mexico's worst fears would soon become a reality. It was bad enough that Mexico's own policies were self-defeating. But by early 1994, the U.S. economic recovery was galloping along. Afraid that this recovery might overheat the economy, the U.S. Federal Reserve started to tighten monetary policy. On 4 February 1994, the Fed hiked interest rates by 1/4 point to counter inflation in the United States. This was the Fed's warning shot. Over the next nine months, the Fed raised the Fed Funds Rate six more times. In the course of the year, the Fed hiked short-term interest rates by a cumulative total of 300 basis points. The final rate hike, of 75 basis points, occurred on 15 November.

Fed Tightens. The Federal Reserve's decision to tighten monetary policy in 1994 is an example of how a policy of a large country can have disastrous indirect and unintended consequences for a smaller neighbor. How much of the peso crisis ought to be assigned to the actions of the Fed? Certainly the Fed's action made it increasingly attractive for investors to chase high interest returns in the United States. That added yet more pressure on the peso, since the peso was pegged to the dollar.

As rising interest rates in the United States began to approach interest rates in Mexico, Wall Street analysts started to tell their investor clients that they could get almost as much of a return on U.S. securities without the risk of Mexico's political instability. Slowly but surely, investors in 1994 started selling peso assets and buying dollar assets.

Chiapas Revolt. Meanwhile, this Fed move could not have come at a worse time for Mexico. A number of other ruinous influences started to heat up that were unique to Mexico at the time. Chief among these internal factors was an acute loss of confidence in the political stability of Mexico. A peasant revolt in Chiapas and the political assassination of Mexican presidential candidate, Luis Donoldo Colosio, caused investors to get jittery about political unrest.

Electoral Economics. Of course, the Bank of Mexico could have matched the Fed's interest rate hikes and kept the lion share of investor money in Mexico. But politics was more important than financial stability to the leaders of Mexico's PRI political party during the first half of 1994. And the logical way for the PRI political party to get re-elected in August of 1994 was to spend money like crazy just before the election. That meant loose fiscal and monetary policies. This quick economic jolt would turn into votes for the PRI.

To make this happen, the Mexican government also announced that privatization and other tough economic reforms would be delayed until after the election. The PRI political operatives figured there'd be plenty of time for a newly elected Zedillo government to "clean up" the financial mess and downward pressure on the peso after the election.

Tesobonos. Zedillo was sworn in as president on 1 December and trouble arrived on his doorstep immediately. In an attempt to boost investor confidence, the Salinas government (which governed before Zedillio) decided to reconfigure the structure of the government debt by introducing a new form of government bond called tesobonos in April 1994. Tesobonos were short-term debt securities that paid in pesos but were indexed to the U.S. dollar. In doing this, the Mexican government effectively issued U.S. dollar denominated debt. In other words, the lower the value of the peso relative to the U.S. dollar, the more pesos the government would owe to the tesobono holders to preserve the dollar value of the debt. By November 1994, 50% of the government debt (or $24 billion) was in the form of tesobonos.

By December 1994, tesobonos represented 2/3 of the Mexican government debt. Financial crises often have their unique signature policy initiatives that go wrong with disastrous consequences. With Mexico, it was the decision to issue the tesobonos. These bonds, being dollar linked, effectively created a financial doomsday machine in the basement of the state treasury. As the crisis progressed, the deterioration in the value of the peso was matched by an upward revaluation of the domestic currency value of the debt. The feedback loop was that as the peso weakened, the government's tesobono debt increased, which in turn put more downward pressure on the peso.[25]

Financial Chaos. And instead of tightening monetary policy by raising interest rates before the election, the Mexican government did just the opposite and began to ease monetary policy in March of 1994. To stimulate economic demand prior to the election, the politicized Mexican central bank dropped interest rates from a peak of 18% in April 1994 to about 14% in August, even as rates rose in the United States and the rest of the world. That spooked the Mexican bond market and billions of U.S. dollars poured out of Mexico and into the United States. Mexico's foreign currency reserves dropped from $25B in 1993 to around $14B by mid 1994.

Thus, Mexico's overly rigid exchange rate regime fatally clashed with its loose monetary and fiscal policies. As the August 1994 election approached, Mexican authorities were reluctant to take actions in the spring and summer of 1994, (such as raising interest rates or responsibly devaluing the peso) that could have reduced this disconnect and avoided the peso crisis. This fundamental policy disconnect was exacerbated by the Mexican government's dithering non-response to several economic and political events.

Run on Pesos. That gave the impression to foreign investors that the Mexican government really didn't know what it was doing. And so investors responded to this financial incoherence by massively selling peso denominated assets and returning to the safe-haven of U.S. dollar investments. When the turmoil struck on December 20, 1994, the government's initial reaction was to defend the peso. The Bank of Mexico reportedly lost $4B intervening to support the peso between December 20 and 22. On December 22, Mexico announced that the peso would be devalued by 15%. It was too little, too late.

Peso Floats Down. Two days later, the selling pressure on the peso was so massive that the government was forced to abandon the fixed exchange rate regime and let the peso float. To make matters worse, the value of Mexico's dollar-linked tesobono debt increased sharply as the peso depreciated. In addition, the depreciation of the peso and the associated rapid rise in domestic interest rates increased the amount of non-performing loans in the Mexican banking system, in part because most loans in Mexico have floating interest rates that quickly reflect market rates.

Tequila Effect. Shortly thereafter, Latin America experienced the "Tequila Effect." The spillover effects largely were confined to Argentina and Brazil. Both stock markets fell. But the largest and most ominous spillover effects to hit Argentina and Brazil came in the foreign exchange markets. Over a three-month period, Argentina spent one-third of its reserves trying to defend its fixed exchange rate regime.

U.S. Bailout. Finally, Mexico ushered in the era of the great supranational crisis bailout program. On 2 January 1995 Robert Rubin, the U.S. Secretary of Treasury, announced an $18B international credit package for Mexico. Later that month President Clinton announced a multilateral assistance package for Mexico that totaled nearly $50 billion. At the time this qualified as the largest financial bailout in history, a dubious honor that would soon be conceded to Southeast Asian nations.

This U.S. government sponsored bailout of the Mexican economy also represents merely another dangerous form of market distortion. When investors come to expect that they can fall back on the U.S. treasury or the IMF to come to their rescue, they stop trying to make careful judgments. In this kind of moral hazard, investors participated in high-risk ventures in Mexico, with little or no economic or social responsibility. They put capital into Mexico only because of the existence of an actual or implied government guarantee of return of principal.

It's time to get rid of such blatant "corporate welfare." In this regard, a number of serious questions are raised by the Mexican bailout. For starters, who exactly got bailed out? The holders of the tesobonos, many being foreign investors and non-Mexican banks, got relief while the ordinary citizens of Mexico were left to suffer economic recession. That's outrageous. As DeRosa points out:

"The case of having free markets rests on the premise that there be a connection between choices and outcomes. Investors need to enjoy the rewards from having taken risks and having made intelligent, informed decisions. Conversely, it is also necessary they suffer disappointment when their choices turn out to be mistakes. Otherwise capital will be allocated to unwise investment projects."[26]

In this way, the Mexican peso crisis bailout of 1995 only accelerated the irresponsible flow of international capital into the economies of Southeast Asia. Unfortunately, none of the Southeast Asian states were watching the Mexican experience. Such inattention would soon haunt the Asian tigers.

Endnotes

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1 Beckner, Steven, “Clinton: Prepares Way For Proposals for Financial Architecture Reforms,” *Market News International*, April 20, 1999.
2 Robert Gilpin, *The Challenge of Global Capitalism*, 2000.
3 United Nations, *Report of the Task Force of the Executive Committee on Economic and Social Affairs*, 1999.
4 Henry Morgenthau, Closing Address to the Bretton Woods Conference, July 22, 1944.
5 David F. DeRosa, *In Defense of Capital Markets*, 2001.
6 *Ibid*., 12.
7 George Soros reportedly made a profit of $1B in a one-way bet by selling the pound sterling short.
8 DeRosa, *Ibid*.
9 The average worked out to be around 1.8:1.
10 For a discussion of this important wage parity mistake, see Leif Roderick Rosenberger, *How German Unification Mistakes Damage West European Economies*, Strategic Studies Institute, U.S. Army War College, 1993.

11 ERM began in March 1979 with eight currencies (the DM, French franc, the Belgian and Luxembourg francs, the Dutch guilder, the Danish krone, Irish punt and Italian lira). Spain joined ERM in June 1989, followed by the UK in October 1990 and Portugal in April 1992. Of the 12 EC members, only Greece chose not to join, largely because its inflation rate was too high to stay in such a relatively tight currency band.

12 Each ERM country was assigned a targeted exchange rate with respect to the ECU called its central rate. Each participating country was responsible for maintaining its currency position with the grid within a tolerance of a predetermined band. Prior to August of 1993, the ERM grid limited the movement of the stronger EC currencies to 2.25% either side of agreed bilateral central rates. The currencies of the weaker economies (Italy, Spain, Portugal and the UK) could fluctuate up to 6% on either side.

13 The ERM carry trade – known as the "convergence play" was expressed with long positions in high-yielding Italian and Spanish debt hedged with short positions in the lower-yielding German mark. Speculators would profit from the high yields on Italian and Spanish paper while using the lower yielding German mark, the anchor reserve currency in ERM, to hedge the currency risk of the lire and the peseta. As long as the ERM held together, meaning no substantial devaluations of the lire or the peseta, the trade made money. It was like getting free interest. DeRosa, p. 59.

14 The attraction of the convergence play was virtually universal. It amounted to government sponsored arbitrage. The ERM was the catalyst money market mutual funds that specialized in the short-term securities of foreign governments with high interest rates. Morningstar, Inc estimated that over $20B of investor money flowed into these funds between 1989 and 1992. The main engine of portfolio performance for these funds was the convergence play. The IMF estimates that the total of such convergence plays could have been as high as $300B.

15 Above all, it was the day of reckoning in financial markets for carry trades known as the convergence play, cited earlier. The exposure for the investor was the cross-exchange rate between the lira, the pound and the peseta against the German mark. When the pound, lira and the peseta were sharply devalued , as were the ERM currencies during the crises of 1992 and 1993, investors suffered huge exchange rate induced capital losses. It was only then that the true risk of the convergence trade became widely appreciated.

16 The crisis featured the famous episode in which George Soros reportedly made $2B from a short sterling/mark position.

17 DeRosa, *Ibid*.

18 Dornbusch, "The Folly, The Crash and Beyond: Economic Policies and the Crisis," in *Mexico 1994: Anatomy of an Emerging Market Crash*, Carnegie Endowment for International Peace, 1999.

19 In this sense, Ross Perot was ill-advised. In reality, the "great sucking sound" was Mexican consumers importing huge amounts of U.S. goods into Mexico.

20 In January 1994 the alluring spread between the Cetes interest rate and comparable U.S. dollar rates was 6.22%, annualized. By July 1994 the spread between the Cetes rate and the U.S. dollar rates had risen to 9.94%. The spread closed to around 7% in early December before the crisis.

21 DeRosa, *Ibid*.

22 Discussions with Professor Dornbusch at his Seminar on International Economics, MIT, Spring 1997.

23 DeRosa, *Ibid*.

24 Discussions with Paul Krugman at MIT during the Spring of 1997.

25 DeRosa, *Ibid*.

26 DeRosa, *Ibid*.