A Commentary from the President

The Dallas Fed's recent conference on exchange rate policy rules and the tequila effect of the Mexican peso crisis took me back to graduate school and my early years at the Fed. In those days—the late 1960s—the Bretton Woods system of fixed exchange rates was on its last legs, and the intellectual case for flexible exchange rates was gaining ascendancy.

An important argument for flexible exchange rates was that they would better insulate domestic economies from external disturbances and provide greater independence for domestic monetary policies. A related claim was that flexible exchange rates would render sticky domestic prices and wages flexible in terms of foreign currencies and thus make international adjustments less harmful to domestic employment. Real wages could adjust without a change in nominal wages.

As I recall, the key to whether flexible rates would perform as touted was the international dominance of trade over capital accounts. Back then, nations traded and capital adjusted to keep overall payments in balance, at least in theory. Nowadays, capital flows dominate, and trade does much of the adjusting. In any case, the recent experiences of Mexico and Argentina bring many of the old issues back to the forefront.

Rather than use flexible exchange rates to achieve insulation and policy independence, Mexico in 1989 began using semifixed rates—a crawling peg—to achieve policy dependence. The idea was that Mexico could import greater price stability from the United States than it could achieve on its own. The central bank thus used the exchange rate as its principal instrument of monetary policy to reduce inflation. That policy—combined with free market reforms, privatization of state-owned enterprises and an opening of Mexican markets to the world—was remarkably successful prior to the financial crisis that culminated in December 1994. Many economists and others have second-guessed Mexican monetary policies during 1994. However, it seems clear to me that the primary and proximate cause of the capital flight that depleted reserves and prompted devaluation was not economic fundamentals but rather political uncertainty stemming from the Chiapas uprising and two political assassinations.

Argentina used its currency board arrangement—intended to fix the country's exchange rate at parity to the U.S. dollar—to renounce independent domestic monetary policies and tie the fate of its economy to the dollar. This arrangement was more rigid than was the Mexican arrangement, presumably because of Argentina's recent history of hyperinflation with its implications for credibility. Argentine policymakers found it necessary to burn their bridges behind them, so to speak.

Once the financial crisis hit both countries, the different outcomes were instructive. Mexico's progress on inflation was eroded by an unintendedly large devaluation, but the devaluation at least sowed the seeds of recovery from the resulting sharp recession. The Mexican economy began to recover after only six months. Argentina's exchange rate and low inflation rate held, but at the expense of a banking crisis and a sharp, lingering recession. Furthermore, under the currency board rule, Argentina has no policy tools to combat the still very high unemployment rate. But given that inflation has been a historically intractable problem in Argentina, that trade-off may well be the correct one for that country.

At the conclusion of our conference, I was asked to summarize some of the "tequila lessons" from a policymaker's perspective. One lesson from both countries' experience is that basically sound economic policies are no guarantee of success. Another lesson is that, operating in the fog of uncertainty, policymakers can never quite know how close they are to the edge of a cliff or how far the fall might be. The appropriateness of Mexican monetary policies during 1994 can be second-guessed, but foresight is never as good as hindsight.

Another obvious lesson is that once the viability of a fixed exchange rate comes into question, it's usually too late to save it. So, no matter how beneficial the fixed rate may have been before the crisis, its demise is usually very costly. Had Mexico had a more flexible rate in the early 1990s, it probably would have been somewhat less successful initially in reducing inflation, but the peso's depreciation during 1994 would probably have been much less severe. Mexico's more recent experience confirms for me the advantages of flexibility. Its peso had settled in at a stable rate of about 7.5 to the dollar for many months, which involved an appreciation in real terms since Mexican inflation exceeded that of its trading partners. The rate has recently adjusted to about 8 to 1 in a smooth transition without a crisis.

Argentina's current dilemma illustrates another policy lesson: the importance of credibility in government and central bank policies. During our August conference, Argentina's policymakers were proposing a tax increase in the midst of high unemployment because they felt they had to reduce their budget deficit to shore up credibility. When credibility is in doubt, policies have to be tougher, or even sometimes perverse, to sustain trust. With credibility, policymakers can be less severe without adverse market reaction. Because of the credibility issue, Argentina's ironclad system of fixed exchange rates is probably necessary and appropriate there. For the United States and, I believe, for Mexico, greater flexibility is desirable.

A final policy lesson brought home to me by the Mexican crisis is just how important correct and credible policies are to our standard of living. Small policy mistakes can lead to horrible results both at home and abroad. In the United States, with our tradition of greater stability, the markets are more forgiving, and we can easily forget the human suffering bad policies can cause.

Bob McTeer

President and CEO, Federal Reserve Bank of Dallas