

## *Do International Financial Crises Defy Diagnosis?*

**I**N DECEMBER 1994, the world watched the financial meltdown of Mexico in disbelief. Most analysts had regarded Mexico's economic prospects as among the brightest in Latin America, especially after the inception of the North American Free Trade Agreement at the beginning of that year. Mexico's sudden and unexpected collapse started when its central bank devalued the peso about 15 percent on December 20. What was intended as a minor correction triggered a massive capital outflow that forced the Banco de México to abandon the defense of the peso and let it float. Within a month, the peso had lost almost 40 percent of its value. In the form of the so-called tequila effect, the crisis spread to other Latin American countries, especially Argentina, and even to East Asia.

The crisis' devastating effect on emerging markets everywhere finally seemed to be subsiding when, on July 2, 1997, Thailand sought a small correction of its own exchange rate and let its currency float. The pattern seen in Mexico was repeated. A relatively small devaluation of about 20 percent triggered a financial stampede, and by year's end the Thai baht had lost almost 50 percent of its value against the U.S. dollar.

The crisis did not remain confined to Thailand. Like its Mexican counterpart almost three years earlier, the crisis quickly spread to other countries in the region, with Malaysia, Indonesia and South Korea the most affected. Analysts were stunned by such a turn of events in what had been the fastest growing part of the world for two decades. The aftershocks of the financial earthquake were felt as far afield as Latin America (especially Brazil) and Russia.

The dramatic occurrence of financial crises just three years apart has prompted much research. Unfortunately, much paper and ink later, economists have yet to produce any convincing answers. The explanations they offer are typically

little more than working hypotheses, many of them seemingly aimed at making headlines rather than science. Explaining these crises requires hard work, not overnight inspiration. In attempting to understand them, economists and policymakers face the same difficult task as doctors do in researching and curing cancer.

Indeed, there are many parallels between cancer and exchange rate and financial crises. Doctors can recognize cancer and sometimes explain how it works once a person has it, but they usually cannot predict whether and when the disease will strike a particular person. Likewise, economists can recognize a financial or currency crisis when they see one, but they generally are unable to anticipate whether or when it will hit a particular country.

Moreover, doctors know much about metastasis, the process by which cancer in certain organs of the human body can quickly and lethally spread to other organs. Similarly, economists are knowledgeable about the contagion effects of financial crises and how they can spread from one country to the next almost overnight.

Despite recent progress, medical researchers are still far from fully understanding the ultimate causes of cancer, and they often cannot cure or eradicate it as a result. Their situation is analogous to that of economists examining financial and currency crises. Many in the profession who thought they completely understood such occurrences are less sure of it since the Mexican and East Asian crises.

Until those episodes, most economists considered a lack of fiscal discipline the culprit in currency and financial disease. The diagnosis appeared correct because fiscal indiscipline did seem responsible for some crises in the past. From there, economists jumped to the conclusion that fiscal indiscipline is the ultimate cause of all currency crises

and financial meltdowns. But in 1994, Mexico had an exchange rate crisis even though the country was fiscally sound. Because the Mexican crisis defied conventional wisdom, the managing director of the International Monetary Fund dubbed it the first crisis of the 21st century.

What is puzzling about the latest generation of crises is that they seem as unforgiving as cancer: both can strike in the absence of behavior that might have increased the odds of getting the disease. Lung cancer can certainly hit heavy smokers. But some heavy smokers never get the disease, while some people who have never smoked do get lung cancer.

Mexico and East Asian countries were not "heavy smokers," in the sense that by OECD standards, their fiscal accounts were exemplary at the time they were hit by crisis. In fact, Mexican and South Korean policies were considered sound enough to gain the two countries admission into the OECD not long before their respective crises.

But when Thailand's crisis hit and Indonesia's and Malaysia's followed, economists decided that even if current fiscal imbalances (current smoking) were not part of the problem, it must have been the anticipation of future fiscal problems (future smoking) that spooked investors. According to this explanation, the problem in East Asia was not the explicit fiscal deficit but the deficit implicit in fragile financial systems that eventually would require bailouts. Bailouts did, indeed, occur, increasing government debt by as much as 15 percent of GDP in Mexico and South Korea, for example.

This theory is not without its flaws. That a loan is bad becomes obvious to everyone once a borrower has defaulted. To be convincing, such a theory should prove that the loans that went sour were an obviously bad bet before

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## Beyond the Border

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the fact. Such proof will be hard to find because it would imply that the lenders were negligent when they evaluated the loans and decided they were acceptable risks. Do theoretical economists know more than bankers and financial intermediaries about the quality of a loan? Do they know more than those who recommended OECD membership for Mexico and South Korea? Or is this theory just another example of Monday morning quarterbacking?

Despite what remains unknown about cancer, one thing doctors do know is that history seems to play a role in the disease. A person is more likely to get cancer or a particular form of cancer if there is a family history of it. Likewise, countries that experience capital account blowouts and financial meltdowns are often countries that may be behaving well (not smoking) now but have a history of policy instability (smoking in the past) that some in the investment commu-

nity have not forgotten. This does not mean that countries with an exemplary past will always dodge financial crises, any more than patients with no family history of cancer always elude the disease. It does mean that reputation is important in a world where countries of recent virtue are penalized for histories of impropriety, as Mexico and Argentina had. Perhaps one reason Chile was not as seriously hit by the tequila effect was that its most recent improprieties were much farther in the past than Mexico's and Argentina's or, for that matter, Brazil's.

Another thing economists do know is that both Mexico and Thailand had a policy of pegged exchange rates—that is, exchange rates that fell somewhere between fully flexible and absolutely fixed. The apparent commonality has led to speculation that as a result of these financial crises, “the options for currencies have been... hollowed out.’ Governments should let them either float, or fix them permanently (with a currency board, or in a monetary union).” (*The Econ-*

*omist*, November 28, 1998, p. 82)

Such speculation will have to meet scientific standards before it can be regarded as anything more than just that—speculation.

Meanwhile, intellectual honesty requires that economists admit they do not fully understand the currency and financial crises of the late 20th century. Sadly, this means the only sure bet is that many such crises will occur in the 21st century before their causes and cures are found.

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