Lecture 7
Crisis in Mexico and Brazil

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2004

The Stagflation that plagued Mexico from 1982 to 1987 convinced Mexico's government to launch its economic reorganization plan aimed at stabilizing the economy and foster economic growth. Seven years later, when the economy had already grew 18% and inflation had gone down from 160% in 1987 to 9% in 1994, Mexico suffered a deep monetary crisis.

The hyperinflationary process of 1993/1994 led Brazil to launch its Plan Real in June of 1994. Five years later, when Brazil had grown 20% and inflation had been reduced from 2000% in 1993 to 4% in 1998, the country suffered a severe monetary crisis.

Governments in both countries understood that they needed to recover their ability to manage the economy if they were to achieve stability and growth. These are two good examples of the reforms that Corrales describes as "more markets as a recipe for more stateness." However, after seven years in the Mexican case and five years in the Brazilian case, the State was unable to prevent the occurrence of monetary and financial crises. Those crises were costly for both countries in terms of forgone income, employment and inflationary pressures.

Both countries experienced the same situation. Markets anticipated the crises and the devaluation. Therefore, the Central Banks had to allow a fall of the International Reserves and an increase in interest rates, whereas decidedly ruled out the likelihood of devaluing the currency. Finally, however, they decided to devaluate. When they did it, they announced a limited devaluation (15% in Mexico, and 14% in Brazil). Notwithstanding, the announcement was followed by a massive demand of foreign exchange and the lost of reserves. In the days that followed, they had no choice but to opt for a floating exchange rate regime, which led to an extreme devaluation of the domestic currency. The new exchange rate system did not help to improve the situation. On the contrary, in both countries it increased the amount of debt outstanding and the risk of a default of the State and many private debtors.

Both countries managed to control the outburst of inflation that followed the devaluation, which in turn demonstrated that the economic reforms at least managed to remove the inflationary inertia that had contributed to fuel the stagflation and the hyperinflation a few years before. Nonetheless, the costs of these crises in terms of unemployment and lost of income eroded the popularity of both the economic reforms and the governments that had fostered them.

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[1] Lecture delivered at the Department of Economics, Harvard University, Spring Term 2004, in the capacity of Robert Kennedy Visiting Professor in Latin American Studies.

Since then the market reforms have lost momentum. It seems that neither Mexico nor Brazil could find the way to achieve sustained economic growth that trickles down the whole population, and to shrink the gap that separates these countries from the most advanced nations in the world.

The following are the questions we are trying to answer in this class: Why the governments were unable to limit the devaluation to the originally planned values? Could those devaluations have been avoided? Could they have changed the exchange rate regime without suffering such deep crises?

The Tequila Crisis

In trying to answer the first question, I find the discussion on a paper by Rudiger Dornbusch and Alejandro Werner entitled “Mexico, Stabilization, Reform and No Growth” really enlightening. Such a discussion took place during a seminar hosted by Brookings Institution in 1994. The authors proposed 20% devaluation without changing the exchange rate system, and set forth that such a devaluation if accompanied by the Solidarity Pact would bring about the real effects needed to foster economic growth. Obviously, the authors blamed the use of the exchange rate as an anchor to control inflation and the overvaluation of the peso that this policy would cause for the reduced economic growth showed by the Mexican economy.

When Guillermo Calvo commented on this paper, he stated that the authors had overlooked the credibility crisis that such policy would cause. Breaking one of the most announced and defended Government policies would foster speculation that would end up in overshooting and severe consequences to the stability of the financial system and the financial solvency of the Mexican government.

In December of 1994, Zedillo’s Administration went ahead and devalued the currency as Dornbusch and Werner had proposed. The crisis that followed unfolded exactly as Calvo had predicted. No matter this so clear experience, in January 1999, the Brazilian authorities made the same mistake. They tried to produce a limited devaluation and kept the exchange rate system after having broken it. In both cases the reaction was exactly the same: excess demand of foreign currency as a consequence of the lost of credibility.

I will not go into all the details in relation to Guillermo Calvo reasoning. I would like however to make a few points. Trying to bring about a small devaluation and keep the exchange rate system was inconsistent with the economic reform both countries had undertaken. We have already explained in previous classes, that such reforms had in their core the abandonment of discretion and unpredictability when it comes to economic policy and the adoption of predictable and credible rules of the game. Hence, the alteration of the exchange rate rule destroyed the government’s credibility and unleashed a destabilizing speculative process.

In order to answer the second question, I think Calvo’s comment and Robert Rubin description on how Clinton Administration handled the Mexican crisis are both useful.

Calvo contends that the Mexican government should have obtained US support to handle the bank run instead of devaluing the currency. In exchange of that support, Mexico should have committed to open investment opportunities and to foster the increase in productivity. From Robert Rubin writings, it is clear to me that who was the Secretary of the Treasury of the US back then considered that it was in the US interest to avoid Mexico's default on its debt. Thus, it is safe to assume that the mutual compromise that Calvo envisioned was perfectly possible. To the best of my knowledge an agreement along those lines had been preliminary discussed when Lloyd Bentsen was the Secretary of the Treasury.

Summing up, the devaluation that took place on December 20, 1994 could have been avoided, exactly as Argentina avoided the devaluation in 1995. Argentina managed to avoid that devaluation despite the Tequila Crisis fueled both a run against the Peso and a bank run that caused a drop in bank deposits in the order of 18%. To me the answer in the Mexican situation was to deepen the economic reforms under way in order to reduce the deficit in the Current Account of the Balance of Payment and therefore be able to correct the misalignment in the relative prices of the economy.

The crisis of Plan Real

The Plan Real was launched in 1994 in order to curb the hyperinflation. It drew heavily from the success stories of Chile, Bolivia, Mexico, Argentina and Peru. As well as the Argentine Plan, the Plan Real was based on a monetary reform that tried to break the inflationary inertia. However, both plans had a different approach toward the use of foreign exchange. The Plan Real did not allow the use of the dollar in domestic financial transactions, nor backed the new domestic currency, the Real, with the international reserves. Nonetheless, markets expected that the Real would keep its value vis a vis the dollar which in turn led to the dramatic reduction in inflationary expectations. The exchange rate was not fixed 1 to 1 to the dollar as in the Argentine case, but it floated around that value for some time. Immediately after the Plan was launched, the Real appreciated the most. Thus, the exchange rate was .80 Real to the Dollar, whereas before the crisis the exchange rate was 1.20 R/u$s

In the four years that followed the launching of the Plan, inflation went down as dramatically as in the Argentine case after the launching of the Convertibility Plan. Nonetheless, in other respects the Brazilian economy did not react as Argentina's economy from 1991 to 1994. Argentina enjoyed a notable increase in productivity and fast economic growth. In Brazil, productivity did not increase much and economic growth was in the order of 3% per annum. Moreover, during the first four years of the Convertibility Plan the fiscal deficit was eliminated, whereas in Brazil during the first four years of the Plan Real the fiscal deficit was on average as high as 6.8% of GDP. By the end of 1998, it was very clear that Brazil needed to deepen the structural reforms in order to foster productivity and cut the fiscal deficit. This kind of policy was particularly needed in Brazil's states, which had dramatically increased their expenditures and debt.

The 1998 Russian Crisis strongly impacted on Brazil's economy, and dramatically exposed the economy's weaknesses, just when the country was about to go to the polls and Fernando Henrique Cardoso reelection was at stake. Financial markets assumed that the government would not deepen the economic reforms fostering productivity and reducing the fiscal deficit, rather the ghost of the devaluation loomed. These expectations were self-fulfilling. The banks and big businesses indebted in dollars increased their demand of assets in dollars in order to match their financial positions.

The government issued new debt to be adjusted by the value of the dollar in such a way that the private sector managed to pass on the foreign exchange risk to the public sector. Once this sort of transfer of currency risk had taken place, the private sector, particularly the industrial sector and the banks of Sao Paulo started to press in favor of devaluation.

When the government tried to cope with this demand by announcing a limited devaluation in the order of 14%, an incredibly large increase in the demand of dollars followed. The Central Bank could not afford a further decline in the international reserves and decided to let the exchange rate to float. Naturally, we know what transpired. The reaction resembled what had happened in Mexico four years before. The overshooting that followed significantly reduced the relative price of non-traded goods and wages and seemed to reinstall inflationary pressures in the economy.

In order to avoid an even deeper crisis, the government had to implement the delayed economic reforms; in particular the states had to adjust their budgets and the Federal Government had to contain the fiscal deficit as well. However, they had to make such harsh decisions amidst a climate of unpopularity and dissatisfaction due to the negative effects that the devaluation brought about. In this context, they could never implement economic reforms aimed at increasing productivity.

In the aftermath of the devaluation, Brazil achieved primary superavit from 1995 to 1998 in the order of 0.2% and from 1999 to 2002 in the neighborhood of 3.6%. However, the devaluation was not the right tool to solve the fiscal disequilibria. On the contrary, the service of the Public Debt increased tremendously; hence the final outcome of the devaluation was an increase in the fiscal deficit, which went up from 6.8% of GDP in 1995-1998 to 7.15% of GDP in 1999-2002.

Simply put, had the government implemented the same fiscal adjustment without the devaluation, the fiscal deficit could have been abridged from 6.8% of the GDP to 3.4% of the GDP. Hence, the economy could have showed a better performance from 1999 on. Furthermore, the costly consequences of Brazil's devaluation on its own economy and on its neighbor's economies, particularly, Uruguay and Argentina's, could have been avoided.

Answers to the questions

Why limited devaluations were not possible after all? To me, the answer is clear: you need to recognize how powerful can be an stabilization policy based on credible rules of the game that creates positive expectations and fosters domestic savings in the domestic currency. Thus, if you break a key rule of such stabilization plan, you bring about a deeply destabilizing speculative reaction, which ends up in a devaluation larger than originally needed in order to revert any exchange rate overvaluation.

The other key question is whether or not these so damaging devaluations, which led to a traumatic floatation of the exchange rate, could have been avoided. I am convinced, they could have. Both in the Mexican and the Brazilian cases, the multilateral organisms and the US Treasury had disclosed their will to support fiscal adjustment programs and economic reforms aimed at increasing productivity. Therefore, the initial devaluations could have been avoided, and could have been replaced by mechanisms aim to gradually change the value of the currency without falling in the destabilizing speculative processes that actually transpired.

Was it likely to change the exchange rate regime without falling into a monetary crisis? I think the answer is yes, it was. Two conditions were, however, necessary. The exchange rate regime could have been changed had existed neither fiscal deficit nor an immediate concentration of foreign debt payments. Hence, fiscal adjustment and foreign debt restructuring are key preconditions to introduce successfully flexibility in the exchange rate regime in such a way that the decision do not lead to a costly monetary and financial crisis.