

Beyond the Border

The Tequila Effect

By devaluing its currency on December 20, 1994, Mexico inadvertently initiated what Latin America has started to call "the tequila effect" and what Michel Camdessus, managing director of the International Monetary Fund (IMF), has dubbed "the first financial crisis of the 21st century."

Effects of Mexico's peso devaluation rippled through the financial markets of the so-called emerging economies with unexpected intensity. It hit the stock markets of Poland, Turkey, South Korea,

high concentration of short-term government debt (Table 2).

Why, then, are investors reacting in the same way to countries with different economic fundamentals? It is difficult to explain this tequila effect without taking two factors into account. First, financial links among the economies of Latin America were much more intertwined than most analysts initially thought, and second, the Mexican exchange rate crisis caught many Latin American economies in the middle of very deep and radical structural reforms.

One of the countries most adversely affected, Argentina, was implementing several new financial policies, including

a new convertibility law and a complete overhaul of the financial sector. Under the convertibility law, the central bank of Argentina can "print" one peso only if it receives one additional dollar (or its equivalent in other hard currencies). This law severely limits

the central bank's ability to act as a lender of last resort or to provide deposit insurance (bailing out financial institutions or depositors by printing money would violate the convertibility law). The Achilles' heel of this law is that, without a lender of last resort, the fear of a bank run could trigger one. For that reason, in early 1994 Argentina introduced regulatory changes in its financial system, with the ultimate goal of achieving full compliance of all its financial institutions with the international capital standards outlined in the Basle Accord. The peso devaluation disrupted this process—to the extent that a financial institution heavily exposed in Mexican government bonds and securi-

ties became insolvent as the price of those assets fell. The fear of a generalized bank run, preemptive withdrawals, capital outflows and reallocation of funds among financial institutions that followed forced Argentina to request the assistance of the IMF and to adopt fiscal austerity measures that in the absence of the tequila effect wouldn't have been needed to sustain its convertibility law of a 1:1 peso-dollar exchange rate.

The tequila spillover didn't stop in Argentina. Brazil, also in the midst of overhauling its financial system, is one of Argentina's strongest trading partners. Fear of a crisis in one country quickly transfers to the other. Unlike Argentina, Brazil could not support the speculative attack against its currency and was forced to devalue. Chile's economy is also highly integrated with Argentina's. Over the past four years, more than two-thirds of all Chilean investment abroad has gone to Argentina. These economic and financial links may explain why Chile's stock market began to weaken in March 1995 as well.

However valid these *ex post* wisdom explanations, Tables 1 and 2 suggest important objective differences between the Mexican economy and those of other Latin American countries. Why, then, have domestic and foreign investors alike treated them with the same lack of confidence? Perhaps the answer lies in their common, pre-1990s past: a long history of huge budget deficits, runaway inflation, protectionist policies, even default on foreign debt payments. To some investors, Latin American economies may look like a consumer who has recently filed for bankruptcy. A tainted credit history limits a person's access to credit, especially in times of financial turmoil and scarce capital.

Countries, like consumers, need sound economic policies for quite some time to clean up their credit records. During periods of reform, a country runs the risk that any setback will be attributed to its reforms, and not to the unfortunate timing that may catch the country half-way into a process it failed to adopt much earlier. Along with technical expertise and political goodwill, successful reform may require a bit of lucky timing. If so, the solution to temporary setbacks is to keep reforms intact so opportunity will find these economies ready the next time it arises. Chile did exactly that in 1982, despite a financial crisis and a 14-percent decline in GDP. The reward: a "Latin American tiger," with 1983-94 average annual GDP growth per capita of 4.6 percent.

—Carlos E. Zarazaga

TABLE 1
A Look at the Economic Health of Five Latin American Countries

	Argentina	Brazil	Chile	Mexico	Peru
1991—GDP growth ¹	8.9	1.2	6.1	3.6	2.8
Current account balance ²	-1.6	0	0	-5.3	-7.6
1992—GDP growth ¹	8.7	-9	10.3	2.8	-2.3
Current account balance ²	-3.7	1.6	-1.9	-7.8	-9.2
1993—GDP growth ¹	6.0	4.1	6.0	.4	6.4
Current account balance ²	-2.6	-1	-5.0	-7.0	-5.2
1994—GDP growth ¹	6.5	5.3	4.4	3.0	12.0
Current account balance ²	-3.5	-5	-1.1	-7.0	-4.3

¹Annual rate.

²As a percentage of GNP.

Taiwan and Hong Kong, but especially those of Latin America. By the end of February, Argentina's stock market had dropped 32.1 percent, Brazil's 33.6 percent and Peru's 28.7 percent.

It appears as if on December 21 investors lost the optimism toward Latin American economies they'd had just the day before. Mexico's large current account deficit and government short-term debt may have been harbingers of the Mexican crisis. But what followed in the rest of Latin America defies explanation in terms of macroeconomic indicators.

Since 1990, the economies of Argentina, Brazil and Peru have been growing two or more times faster than Mexico's (Table 1). Besides gross domestic product (GDP) growth, the current account balance as a percentage of GDP is another important gauge of economic performance because it measures a country's ability to repay its foreign debt. When this rate exceeds the rate of growth of the economy for a sustained period, an external debt crisis may be mounting. Of the economies listed in Table 1, none but Mexico's has consistently crossed this threshold. Nor have the four other economies had Mexico's

TABLE 2
External Debt of Five Latin American Countries, 1994

	Total external debt as a percentage of GDP	Short-term* external debt as a percentage of GDP
Argentina	31	3.6
Brazil	26	6
Chile	43	8.3
Mexico	46	17.5
Peru	54.1	5.6

*One year or less.