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Government bailouts and monetary disequilibrium: common fundamentals in the Mexican and East Asian currency crises

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Abstract

Monetary disequilibrium seems to be a common thread that connects the Mexican and East Asian crises. Both crises have been characterized by governments attempting to minimize the adverse impacts of capital reversals on their domestic financial systems. This backstopping function of the monetary authority is modeled within an escape clause-based currency crisis framework which emphasizes the "nonmechanical" behavior of governments as they trade off various economic policy objectives. © 2000 Elsevier Science Inc. All rights reserved.

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1. Introduction

Net capital flows to emerging economies peaked in the mid 1990s, reaching an all-time high of US$190 billion (bn) in 1996, more than ten times the average annual flow between 1984 and 1989 (Table 1). The increasing globalization of finance and capital flows has,

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Table 1
Net capital flows to developing countries ($ billions), 1984–97

	1984–89[a]	1990–96[a]	1994	1995	1996	1997
Private capital flows	17.8	129.4	133.8	148.2	190.4	139.0
Foreign direct investment	12.2	57.9	76.5	86.5	108.5	126.5
Portfolio investment	4.9	51.1	85.7	22.2	52.7	55.5
Other investment[b]	0.6	20.4	−28.4	39.5	29.3	−43.0
Official flows	27.2	16.8	10.3	32.1	3.2	−3.3
Change in reserves[c]	5.1	−54.8	−42.3	−67.1	−95.2	−57.8

[a] Annual average for the period.
[b] May include official flows.
[c] A minus sign denotes an increase.
Source: IMF.

however, not been an unmitigated blessing, as this period has witnessed several episodes of severe financial turbulence in global currency markets. Indeed, since 1992, currency crises seem to have been the norm rather than the exception.

Specifically, in 1992–93, Europe was faced with the very real possibility of a collapse of the European Exchange Rate Mechanism (ERM). In 1994–95, there was the Mexican currency crisis, which saw a steep devaluation of the peso and brought Mexico to the brink of default. There were also some spillover effects to Argentina and Brazil. Between July 1997 and mid-1998, the world experienced the effects of the East Asian crisis. This crisis started somewhat innocuously with a run on the Thai baht, but spread swiftly to a number of other regional currencies, most notably the Indonesian rupiah, Malaysian ringgit, Philippine peso and Korean won. The currencies of other large emerging economies such as Russia and Brazil also experienced periods of significant market selling and required the assistance of the IMF. The Russian ruble was devalued in August 1998, while the Brazilian real peg was eventually broken in January 1999.

These events have generated much interest in currency crisis models and their corresponding policy implications.[1] Dani Rodrik (Rodrik, 1998) has noted that:

> [a] sad commentary on our understanding of what drives capital flows is that every crisis spawns a new generation of economic models. When a new crisis hits, the previous generation of models is judged to have been inadequate (p. 58).

Undoubtedly, each crisis has certain distinctive features and peculiarities. However, in light of Rodrik's observation, it is important to determine what - if any - common elements exist between some or all of these crises, and to develop a general framework that captures these important commonalties. With this in mind, this paper focuses on the two most studied crises in developing economies in the 1990s, namely, those in Mexico and East Asia (Thailand in particular).

The next section stresses monetary disequilibrium as a common thread connecting the Mexican and East Asian crises, as governments attempted to minimize the adverse impact of capital flow reversals on their domestic financial systems. Section 3 formalizes the lender of last resort role of the monetary authorities in Mexico and East Asia in two closely related

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