# Policy Rules and Tequila Lessons: Conclusions from an Economic Conference

THE IMPACT OF the 1994–95 Mexican peso crisis rippled through South America in a wave later dubbed the *tequila effect*. The crisis caught many countries off-guard, especially those, like Argentina, that had implemented ironclad policy rules intended to prevent such financial problems. In the case of Mexico, it was an exchange rate policy rule intended to foster price stability that ultimately proved unsustainable, with calamitous consequences.

Under what circumstances can such rules be sustained? And what special problems do they engender for the countries that adopt them? These topics were addressed in "Policy Rules and Tequila Lessons," a conference sponsored by the Federal Reserve Bank of Dallas' Center for Latin American Economics and the Universidad Torcuato Di Tella in Buenos Aires on August 12–13. The central issue addressed at the conference was the sustainability of fixed exchange rate systems.

Only weeks before the conference, Argentine Minister of Economy Domingo Cavallo had stepped down amid growing concerns about the viability and desirability of that country's policy rules. As Cavallo delivered the opening address to the conference, defending the success of those policies, his successor, Roque Fernández, was proposing tax increases aimed at buttressing their credibility in the midst of 17-percent unemployment.

*Domingo Cavallo, former Argentine Minister of the Economy (left), opened the conference with remarks about his country's efforts to uphold its currency board rule. Dallas Fed President Bob McTeer (right) was a conference cohost.*

## Argentina and the Currency Board Rule

To keep a fixed exchange rate as an anchor against inflation, Argentina since 1991 has adhered to a rule for printing currency called a *currency board rule*. Under such a rule, a country selects a foreign currency, such as the U.S. dollar or the German mark, and a fixed rate at which domestic currency can be exchanged for this foreign currency. In the case of Argentina, the exchange rate was fixed at one peso per U.S. dollar. Then the currency board, which effectively replaces the discretionary policies of a central bank, prints at a fixed exchange rate only enough domestic currency to equal the country's foreign currency reserves. If this rule is strictly followed, then at any time, the currency board is able to buy back any or all of the domestic currency using foreign reserves at the fixed exchange rate. This policy is meant to safeguard against currency devaluations but works only as long as the government maintains the currency board rule.

Under such a rule, the government, in essence, ties its own hands. And although this approach can lead to price level stability, ex post, circumstances often arise that tempt the government to abandon the currency board rule. For example, if a government's debt is becoming increasingly large relative to gross domestic product (GDP), raising the taxes necessary to pay the interest on the debt becomes more difficult. The government then has an incentive to *monetize* the debt — that is, to print money to pay the government's creditors — and in so doing, to violate the currency board rule.

More likely, however, before monetization occurs, investors will notice the increasing debt and anticipate a devaluation. Fearing the losses that would result from a devaluation or seeking to profit from it, these investors could launch a speculative attack against the country's currency, selling the domestic currency to buy foreign currency. The consensus reached at the conference was that, to avert fears of a devaluation, a country following a currency board rule must keep a balanced fiscal budget over time by compensating for fiscal deficits with fiscal surpluses.

On this score, Argentina has been running a series of fiscal deficits that are too large to prevent the growth of debt as a percentage of GDP. The need to allay investors' fears of default or inflation was what motivated Argentina's new minister of economy to propose tax increases despite the country's recent severe recession and a continued 17-percent unemployment rate.

Argentina's struggles with the currency board reflect a key lesson from the conference: monetary and fiscal policies are inextricably intertwined. It is impossible to maintain a fixed exchange rate system without the corresponding support of fiscal policy, as Thomas Sargent stressed in his presentation, "Stabilization Plans and the Feasibility and Credibility of Macroeconomic Policies." Sargent is an economics professor at Stanford University and the University of Chicago.

In a related contribution, University of Minnesota Professor Timothy Kehoe, discussing his research with Harold Cole of the Minneapolis Fed, argued that in addition to the size of the government debt, the maturity structure of the debt is important in maintaining the credibility of a fixed exchange rate system. A concentration of short-term debt must be accompanied by the ability to increase tax revenues substantially in the short run. Otherwise, investors may speculate that the government will not be able to repay its debt.

This was the case in Mexico, where the stock of *tesobonos*—dollar-denominated bonds issued by the Mexican government—that would fall due between December 1994 and May 1995 represented 10 percent of Mexican GDP. Investors reasoned that Mexico could not raise the necessary taxes in just six months in the event the tesobonos could not be rolled over into another debt instrument. Investors' fear of default on tesobonos contributed to a run on Mexican debt and currency that culminated in the December 1994 peso devaluation and the abandonment of Mexico's fixed exchange rate system. Political events also may have been involved in the run against the tesobonos.

## Banking Stability and the Lender of Last Resort

Another aspect of fixed exchange rate systems discussed at the conference was the constraint a fixed exchange rate puts on the government's role as a lender of last resort; printing money to bail out troubled financial institutions violates a currency board rule. Although a government may vow not to act as a lender of last resort, it usually does so in the midst of a financial crisis. Therefore, it is better to decide and announce in advance the explicit conditions under which it may or will not do so. In particular, it is important to decide whether money creation and the inflation tax or legislated taxes will be used to fund the system. Thus, the issue of lender of last resort, traditionally an aspect of monetary policy, is ultimately an issue of fiscal policy as well.

Paradoxically, the availability of a lender of last resort services can make a financial system more prone to crises if it causes financial institutions to take more risks than they would otherwise. In addressing this moral hazard dilemma, conferees agreed that governments can do little to resolve it through regulation. Brown University Professor Peter Garber pointed out that the ever-increasing complexity of financial derivatives markets may prevent even the most skillful regulators from distinguishing between conservative financial behavior and leveraged operations with substantial hidden currency risk.

Columbia University Professor Charles Calomiris, even less optimistic about what governments can do, advocated private disciplining mechanisms. One mechanism he proposed was the use by banks of subordinated debt, debt that is not insured by government. Banks would be required to issue a minimum amount of uninsured debt. When a bank closed, the government would cover depositor losses by liquidating the bank's assets. Holders of the subordinated debt would receive what was left. Thus, the buyers of the debt would have a strong incentive to promote conservative lending and investment decisions by banks to protect their investment.

In any case, as Professor Alan Stockman of the University of Rochester emphasized, the stability of the banking system should be a key factor in the choice of an exchange rate system. Fixed exchange rates are harder to maintain in countries with historically unstable banking systems. A fragile banking sector leads to frequent bailouts, expenditures that make it difficult to achieve the balanced budget policy that ultimately supports fixed exchange rate systems.

## Conclusion

The lessons of the conference underscore the fact that there is no quick and easy fix for a country's currency instability. Dallas Fed President Bob McTeer summarized these lessons in his postconference remarks to the Buenos Aires Stock Exchange: "The conference presentations were all consistent with the emerging consensus within the economics profession that the long-term benefits of economic liberalization, including open capital markets, are worth the short-term costs. They also confirmed the importance of having stable, credible and predictable government policies in place. Were it not for these two factors, the negative impacts stemming from the Mexican peso devaluation—the tequila effect—would have been much worse for Argentina."

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