What’s the difference between a speculator and an investor?  
Nothing, a speculator is a normal investor but no investor would ever admit to being a speculator.

In the summer of 1992, there was a speculative attach on the British pound, followed by the Italian lira and the French franc. Don’t assume that attacks can happen only in underdeveloped countries – France was the 4th largest economy in the world at the time.

Anatomy of a crisis

Major events during a currency crisis:

1. Some asset has a price that is too high (usually more apparent in hindsight).
2. Eventually price falls – who leaves the market first? The insiders bail first because they have all the information. Investors and markets also hate surprises because it makes them look dumb (they think they know everything).
3. Collateral melts away – assets are not worth nearly as much.
4. Good loans become bad loans – no collateral means that the loans are no longer backed and banks start calling loans in.
5. Foreign currency loans get bigger in real terms because the exchange rate falls.
6. Working capital dries up – banks need the money to keep from going broke.
7. Supplier credit disappears – everything becomes cash on delivery because the suppliers don’t trust that they’ll get the money later.
8. Wealthy people start to flee to protect their assets.
9. Then everyone leaves and there is a run on bank deposits.

The problem is not that we don’t what is going to happen. We usually know when something is overvalued but we usually try to beat the system to make some money. The problem is that we don’t have any information on timing – we don’t when all of this will take place. There is also lots of human optimism in this kind of market. We know something bad will happen but we believe we’ll get rich first.

Mexican crises of 1982 and 1994-1995

Mexico experienced a currency crisis in 1982 and again in 1994-5. In 1982, Mexico was thought to be ripe for a crisis because of their macroeconomic policies and conditions (they were a bad guy). In 1994, however, they seemed to be doing everything right (they were a good guy). Let’s contrast the two Mexico’s:

<table>
<thead>
<tr>
<th>1982 – bad guy</th>
<th>1994-5 – good guy</th>
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<tbody>
<tr>
<td>Inflation was 100%</td>
<td>Inflation was only 7-8%</td>
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<tr>
<td>Oil was found – 74% of exports</td>
<td>Much less oil exports – 14%</td>
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<tr>
<td>Binge and borrow</td>
<td>Off oil boom euphoria</td>
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</tbody>
</table>
Huge government deficit
government surplus
Protectionist economy w/ import sub.
Export-led economy (NAFTA)
Socialist – gov’t owned 31% of GDP
Privatized everything (except oil)
Big social welfare
Less welfare and labor deregulation
Control of capital and management
Open – no controls (NAFTA)
Large gov’t debts internationally
Small gov’t debts (lots of private)

On the last point, many of the government debts were erased by Brady restructuring them and lots more were bought back by the government (at steep discounts) instead of being repaid. Also the distinction between public and private debts makes almost no difference because it is all in the same currency. *Total country lending is what matters.*

The trigger of the 1982 crisis was the fall in the price of oil. In addition, Volcker was raising U.S. interest rates which made loans more expensive.

For Mexico, the end of the 1980s was a macro success but a micro failure. Growth was up, inflation was under control, and international capital was flowing in, but the standard of living for the bottom two-thirds of the population was falling. In fact, it is still lower today than it was in 1980. This means real wages were falling and resulted in Mexico having the most unequal income distribution in the world.

What caused the 1994-5 crisis? Some possibilities:
1. Overvalued peso – some say it was overvalued, some say it wasn’t…who do you believe? This was caused by higher inflation in Mexico than in the U.S. but still isn’t conclusive.
2. Political shocks – there were two assassinations and a minor revolt. However, these can be the trigger but not the cause (think 1968 America). There must be something else fundamentally wrong with the economy.
3. Mexicans did a surprise devaluation – maybe but the rush of investors leaving the country was already on long before the devaluation.
4. Speculative bubble on how good Mexican investments were – again optimism vs. pessimism. Who do you listen to?
5. Weak institutions – maybe but what about European attacks in 1992?
6. Federal Reserve in U.S. caused it – in 1991, the Fed needed to prop up banks after the S&L crisis so Greenspan dropped interest rates way down. This caused lots of money to flow into Mexico. In 1994, Greenspan raises interest rates 250 basis points over six increases and money come flowing back to the U.S. As a result, Mexico depletes its foreign reserves and everyone starts to rush to the exit.

Most likely, it was a combination of these things that caused the crisis.

What’s the remedy?

Several things helped to bail out the Mexicans in 1995:
1. Clinton loaned Mexico $60 billion which propped up the banks (and has all been repaid).
2. Mexican government practiced fiscal restraint to make budget surplus even larger.
3. Mexico raised interest rates (9% to 35%). This created a huge recession of −10%.
Did it work? Well, yes in a macro sense but no in a micro sense.

Why loan money to Mexico?

Why did the U.S. loan money to Mexico when it would be unwilling to loan to, say, Brazil? If a country goes broke, the entire economy stops functioning and all foreign trade also stops. If such were to happen to Mexico, immigrants would start pouring over the border to the U.S. This is something that the U.S. wants to avoid. It is much harder for immigrants to get here from Brazil so the U.S. doesn’t worry too much about them.