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The "Obvious Peso Blunder" at Treasury

By now, many opinion columns have laid responsibility for the Mexican crisis at the doorstep of the Clinton Administration. They have appeared in the *Washington Post*, *Wall Street Journal*, *Washington Times*, and many other places. The mistake that the Mexican government made in 1994 regarding the peso was a "massive miscalculation" (David Malpass, *Wall St. Journal*, 1/11), a mistake so egregious that it should have been obvious to all. It was so egregious that the U.S. Government should have acted to force a different policy on our neighbors. But Clinton Treasury officials were blind. They actually encouraged the Mexicans in their folly. This "may prove to be the worst mistake so far of the Clinton presidency" (Hobart Rowen, *Washington Post* 2/5), "the worst foreign policy blunder of this Administration" (Paul Gigot, *WSJ* 2/24). Perhaps there was even a conspiracy. The American taxpayer and the Mexican citizen, we are told, are now paying the cost (e.g., Robert Kuttner, *International Herald Tribune*, 1/21; William Greider, *Rolling Stone*, 3/9; Christopher Whalen, *Washington Post* 2/5.) Congressmen are demanding from the Administration "that someone should be held accountable" for its obvious blunder.

There is just one problem. Approximately half of these commentators claim that the mistake made by the Mexican government was to have devalued the peso. But the mistake that the other half of the commentators have in mind is that the Mexicans <u>failed to devalue the peso earlier</u>. Some Congressmen may be keeping their options open as to which mistake they want to pin on the Administration.

The first camp believes that devaluation is a medicine that obviously doesn't work, because it merely raises wages and prices proportionately. Bizarrely, they believe that devaluations are so wanton and unusual that when they occur, there must have been a conspiracy on the part of a small camp of "devaluationists", for example in the U.S. Treasury or the International Monetary Fund, to foist this discredited medicine on the gullible country in question. They accuse the Clintonites and the IMF of aiding and abetting the peso travesty. They say that Treasury officials were enthralled by an April 1994 Brookings paper by M.I.T. Professor Rudiger Dornbusch, urging that the Mexicans devalue (Paul Gigot, *WSJ* 2/24; Lawrence Kudlow, *Washington Times*; Robert Novak, *Washington Post*) According to reports in the *Journal*, the Senators and Congressmen who have demanded documents from the Treasury and Fed to establish accountability have in mind that the error was in the direction of encouraging devaluation.

The second camp believes that the error was in *not devaluing earlier*. The growing Mexican trade deficit made it obvious that the country would have to devalue eventually, and the problem was made worse by postponing it. This second camp of critics either accuse the authorities of being asleep at the switch, or hint at a conspiracy between the Clinton Administration and the Salinas Administration to postpone the devaluation until after the NAFTA vote in the U.S. and the presidential election in Mexico (*Washington Post*, 2/13). They accuse the Treasury of arrogantly dismissing the Dornbusch warning. A variant of this view is that, because some NAFTA opponents were on the list of those who pointed out the peso overvaluation ahead of time, it somehow follows that NAFTA caused the crisis (Kuttner, *Int. Herald Tribune*; Greider, *Rolling Stone*).

My own view is that the Mexican policy of anchoring the peso to the dollar in 1988 to bring down inflation was a good one, but that, with some residual inertia remaining in inflation, the dangers of overvaluation grew over time. The economic dangers came to outweigh the economic benefits, probably around March-April of 1994. Money had begun to flee the country, largely as a result of the assassination of candidate Colosio in combination with increases in U.S. interest rates. In retrospect, this would have been a relatively good time to abandon the exchange rate commitment, compared to December 20, the date when the devaluation actually occurred. By then, the country was about to run out of dollar reserves with which to buy unwanted pesos, so that there was literally no longer any choice but to let the value of the peso fall.

I do not know if the U.S. Administration pushed the Mexicans in one direction, or the other, or neither. The IMF, which properly has the job of monitoring debtor countries, has been reported by some observers as having erred in neglecting to question the sustainability of the exchange rate anchor. In other words, it is thought to have done precisely the opposite of what columnists like Novak have accused it of doing.

My own view on the merits of the policy is irrelevant, however, for the point I wish to make here. The point is that everyone likes to cast blame afterwards. The uninitiated newspaper reader would be likely to conclude that commentators unanimously consider the Clinton Treasury to have been negligent and incompetent. Only the careful reader will discern that half of the columns claim that the negligence lay in the mistake of encouraging the Mexicans to devalue, while the other half claim that the negligence consisted of encouraging them to *delay* the devaluation.

It would indeed be interesting to know what, if anything, Washington officials told the Mexicans before December 1994. Congressional investigators, sounding like prosecutors, are proposing to discover this. Whatever the answer, once they get it, they will then say that the Clinton Treasury made an obvious blunder. I propose that those in Congress who think that the right policy was so obvious are obligated to say what they believe Treasury should have done, *before* they get the documentation on what Treasury actually did. Do they believe that the Mexicans should have been encouraged to devalue earlier, or do they believe that they should have been discouraged from devaluing at all?