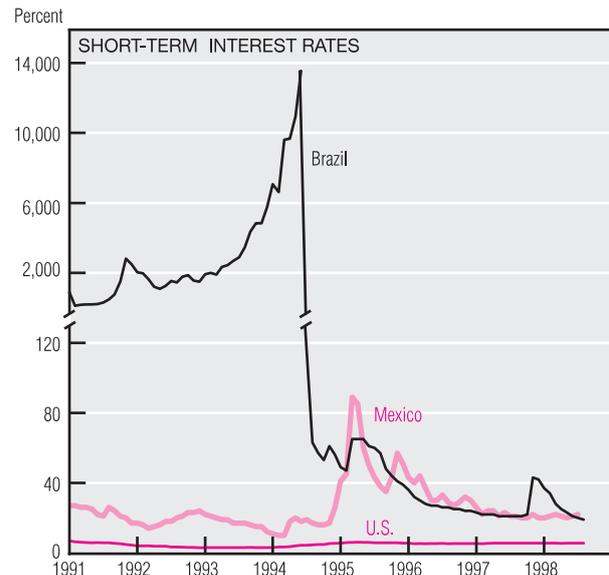
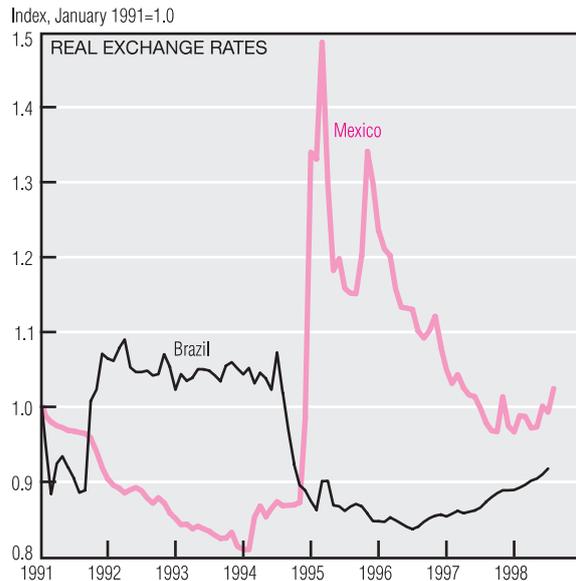
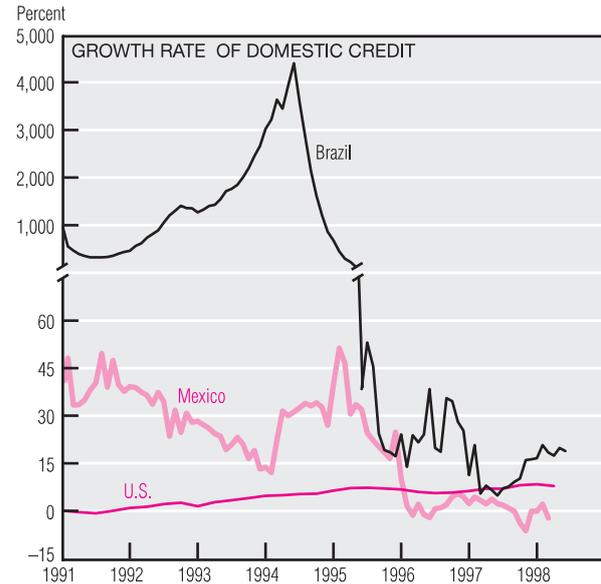
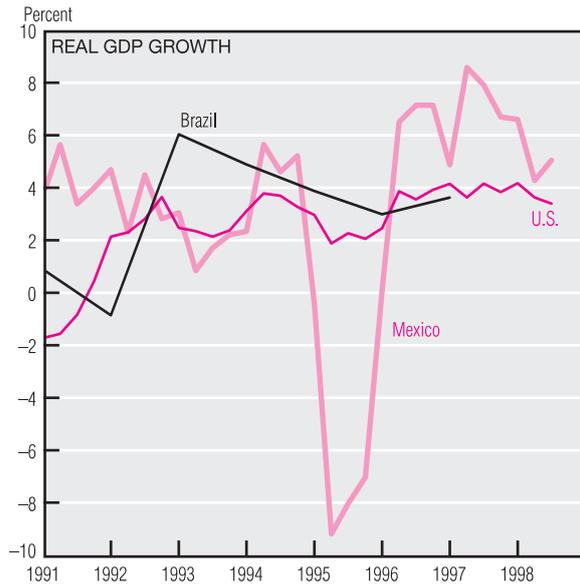


International Developments



SOURCE: International Monetary Fund, *International Financial Statistics*.

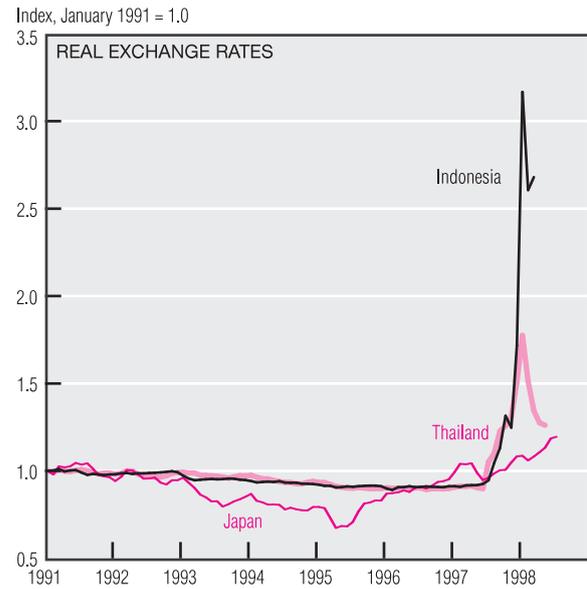
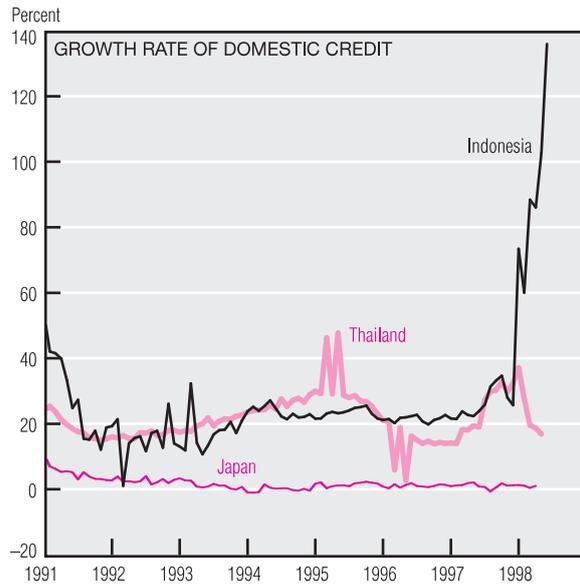
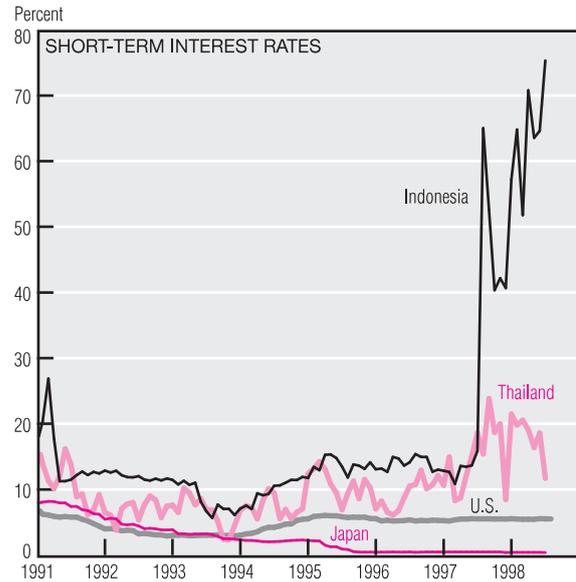
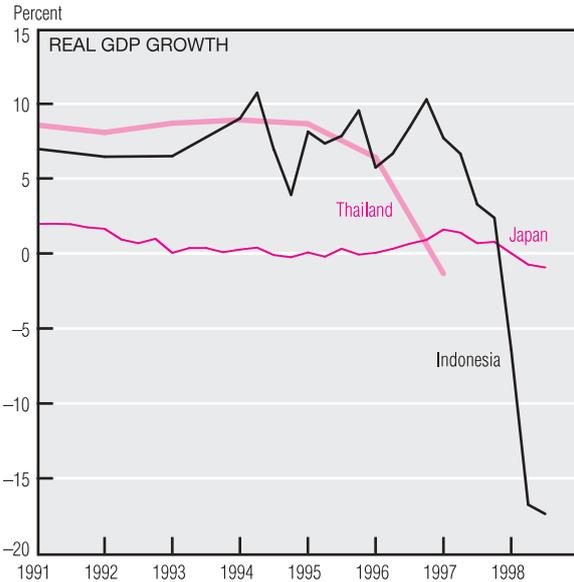
It is tempting to apply lessons from the Mexican currency crisis of 1994–95 to the Asian crises of 1997. A key factor in both regions was the inability of banking supervisors and regulators to pinpoint buildups in bad loan portfolios. High growth rates of domestic credit facilitate these buildups, creating vulnerability to interest rate increases. Such increases might be used to defend a currency against capital outflows, highlighting the role of domestic monetary policy and the exchange rate regime.

A fixed exchange rate requires the central bank to sell its own currency during capital inflows and to buy it during capital outflows. Either way, the impact on the domestic money supply and the banking system must be gauged. A floating exchange rate permits monetary policy independence from the rest of the world but implies riskier foreign exchange markets. Logically, the choice of the exchange rate regime might be linked to the strength of domestic banking supervision and regulation.

External developments also play a key role in currency and banking crises. For example, interest rate increases in industrialized countries contribute to currency crises by stimulating capital outflows. Either a depreciation in the dollar value of the currency or an increase in the foreign inflation rate implies a loss of export competitiveness, with negative implications for real growth. This is consistent with the finding that a slowdown in growth is a useful predictor of currency crises.

(continued on next page)

International Developments (cont.)



SOURCE: International Monetary Fund, *International Financial Statistics*.

Mexico's GDP growth had been strengthening prior to its currency crisis, but in early 1994 domestic credit grew sharply and the real exchange rate for the peso deteriorated. Higher U.S. interest rates pressured the Bank of Mexico to defend its exchange rate vis-à-vis the dollar. Mexican interest rates eventually were allowed to increase, and the peso was allowed to float. Although by many measures the Mexican economy has rebounded (with the help of a multinational financial aid package engineered largely by the U.S.), the real exchange rate remains

higher than it was before the crisis. Although domestic credit growth has slowed, observers remain concerned about the condition of the Mexican banking system.

Similarly, Brazilian credit growth and interest rates skyrocketed in the early 1990s as real growth slowed. Currency revaluations in 1994 put Brazil on a more stable path, and its currency is now tied to the U.S. dollar by means of a "crawling peg."

The currencies of both Thailand and Indonesia were also tied to the dollar, creating dynamics similar to those in Mexico. Although declining

U.S. interest rates in 1992 might have influenced the credit buildup in East Asia, no sudden increase in U.S. rates can be blamed for the capital outflows of 1997.

The proximity of the U.S. to Latin America and of Japan to East Asia suggests that each superpower might lower interest rates to stimulate its neighbors. However, Japanese rates cannot be lowered further. While cutting U.S. rates might help East Asia, the region's recovery will still be heavily influenced by economic events in Japan.