The Mexican Peso Crisis of 1994

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On December 23, 1994 a New York Times headline broke- "MEXICAN PESO CRISIS: THE OVERVIEW: WITH PESO FREED, MEXICAN CURRENCY DROPS 20% MORE". The capitalized characters in this headline are a testament to the momentous circumstance in which panic set and uncertainty loomed over Mexico, its NAFTA partners (the United States and Canada), and the international finance community altogether. Now more than twenty yeas after the crisis, international financial actors face the lingering question: how did currency devaluation turn into a financial crisis? This paper will explain how unmanageable debt in Mexico was brought about by the deregulation of markets and unsound adjustments of the exchange rate. This crisis should be viewed as a lesson to learn for nations in economic expansion.

Background:

The Mexican economy was volatile for the majority of the second half of the 20th century leading up to the Tequila Crisis of 1994. To explain, during the 1980s Mexico was in a time commonly described as *La Década Perdida* ("the lost decade"), a period when the country's economy suffered from a recession greater than that of the United States in the 1930s (Edwards 7). International oil prices were plummeting, high world interest rates persisted, inflation continued to rise, and an overvalued peso kept the Mexican economy struggling its way into the last decade of the century. A noteworthy part of the economic meltdown of the 80's was that the country experienced a large balance of payments deficit stemming from the private sector's holdings of large amounts of US-dollar denominated debt. President Miguel de la Madrid worked to recover the economy by reducing public spending dramatically and encouraged capital inflows in order to ease the balance of the national account. He opened up the capital account

completely and removed capital controls allowing capital to flow freely into the country with little regulation. This was the beginning of the "Mexican Miracle" leading into the Peso Crisis.

Crisis Overview:

In the late 80's and early 90's, the Mexican government underwent major economic reformation: opening their economy to international competition by privatizing and deregulating the federal banks, loosening regulations on business, and fixing the exchange rate. More specifically, a **fixed exchange rate** is a tool used in international finance where the government sets the home exchange rate to that of another currency (typically the United States dollar) all in an effort to keep inflation expectations in check and reduce uncertainty about exchange rate fluctuations (Pugel 466). In addition, the government created the *Pacto* which was a yearly negotiated agreement between the government and business to keep prices and labor wage low. The *Pacto* was reliant on the fact that businesses held down prices and labor withheld demand for higher wages. This agreement was significant in that it was the only successful anti-inflation plan. With these major reforms, investors became convinced that Mexico was a safe and profitable country to invest in.

However, the result of the economic policies under De La Madrid were disappointing as GDP growth hovered around a measly 2.8%, productivity growth and exports remained stagnant, and real wages fell below those of the 1980's crash. For comparison to other nations, Chile's GDP growth at the time was 7.1% and Colombia's was 4.1%, leaving the growth of the Mexican economy far behind that of other Spanish-speaking nations (Edwards 3). Despite these facts, the magnitude of the reforms lured investors into a false sense of stability. As a result, capital inflows began pouring into Mexico. The director of the International Monetary Fund (IMF) even recognized the "Mexican Miracle" for its sound economic policies and predicted economic

recovery in the near future (Edwards 14). Between 1990 and 1993, 91 billion dollars of investments entered Mexico. At that time, 91 billion dollars was more than one half of the investment flowing into Latin America altogether.

In 1993, 8% of Mexico's GDP was comprised of **capital in-flows**; the purchases of domestic assets by foreign household and firms, the majority of which were short term investments (Edwards 13). However, a large portion of the GDP being dependent on short-term assets was not only unsustainable but also catastrophic for the economy. The government claimed that they were not worried about exchange rate fluctuations as they were using a **pegged exchange rate system**, a tool in which "monetary officials buy and sell a currency so as to keep its exchange rate within an officially stipulated band," (Pugel 467). Opposite of what the government believed, deregulation of the markets in order to force growth within the economy became Mexico's greatest downfall.

What went wrong?

The crisis occurred through a series of events both economic and political. In January of 1994, protestors from the *Zapatista* Army of National Liberation gathered in Chiapas, Mexico in a 12 day uprising against the creation of the North American Free Trade Agreement (NAFTA). In the same year, Secretary General José Francisco Ruiz Massieu and Mexican presidential candidate Luis Donaldo Colosio were gunned down, resulting in Colosio's death. This unrest began to make investors question the stability of their investments in Mexico.

Along with these political issues, Mexican financial authorities were faced with the challenge of selling government bonds denominated in pesos. This posed an issue as the inability to rollover these bonds would present a difficulty in generating government revenue. **Rollover** is a term used in the foreign exchange market to describe returns received on currency positions.

The inability to rollover their bonds backed by pesos was a major issue for the Mexican market as the outcome of the economic reform began to look bleaker.

One option the government considered was to offer higher interest rates in an attempt to make these bonds more attractive to investors. As raising the interest rate had the potential to send the economy into a recession more quickly, the monetary authority decided to issue dollar-denominated government bonds in order to roll over the maturing peso-backed bonds. They did this in an attempt to assuage investors' worry of exchange rate risk. If the bonds bought were denominated in dollars, then the peso valuation would not be in question.

The move from peso backed bonds, *Cetes*, to dollars, *Tesobonos*, eventually proved to be fatal. Even more fatal than the move itself was the fact that the government was secretive about the move. The government made this move giving very little insight to investors about what they were thinking and why. With all of this movement, Mexico began looking more uncertain and investors began to become uneasy. By the end of 1994, investors came to the realization that the peso was overvalued due to the rapid inflow of capital over the past few years. Lastly, the government was running out of **foreign reserves**, which are assets held by a central bank in various currencies for the use on balance payments and to influence the foreign exchange rate. The government had been buying pesos with foreign currency to try to hold the exchange rate steady. The amount of foreign reserves it held at the end of 1994 approached 12.5 billion dollars (Edwards 18). The problem here was that 70% of its 27-billion-dollar debt was in foreign reserves. Mexico was stuck. They could not devalue the peso because that would make their debt more costly, and they no longer had the foreign reserves to hold the exchange rate fixed. By dropping the fixed exchange rate, the government risked wild inflation on account of panicked investors in the Mexican economy.

In December of 1994, the government attempted to save the peso by resetting the pegged rate with intention to devalue the peso at a lower level. This caused the financial crisis. Investors became convinced that Mexico was going to default on their debt as soon as the pegged exchange rate and peso were revalued. The revaluation led to a **bandwagon** by a large portion of investors extrapolating the recent trends of the Mexican economy into the future, predicting the trends to be negative (Pugel 439). The exchange rate managed to drop in value from 4 pesos to the dollar to over 7 pesos to the dollar in one week. By 1995, Mexico's GDP fell 6%.

In summary, there are four major factors that led into the Mexican Financial Crisis of 1994. One, the Mexican government over borrowed when they weren't able to generate government revenue. Two, there was exchange-rate risk that affected everyone involved in any trading in the country. Three, there were exogenous shocks caused by the devaluation of the peso and the sudden, rapid flight of investors. Four, the crumbling of the short-term borrowing by Mexico led to something that could be described as nothing more than **contagion** on the domestic front: the spread of negative externalities diffused by the downfall of a particular market (Pugel 521).

The government lost their credibility as a sound international financial actor almost entirely, struggling to sell 28 million pesos in bonds when they were selling 416 million pesos in bonds prior. The government increased interest rates and the peso fell relative to the dollar. With Wall Street up in arms over losing almost 30% of their money, the United States decided to act. The resolution to this crisis was a bailout from the United States

In January of 1995, President Bill Clinton shocked the Treasury Secretary with a proposal to bail out Mexico with a $25 billion loan. Despite backlash, Clinton pushed his plan into congress to be voted on. He argued that if the United States did not step in there would not only

be contagion but also increased illegal immigration into the United States. The United States ended up contributing $20 billion to a $50 billion loan package. This bailout was also comprised of IMF contributing $17.5 billion and other parties, including Canada, the BIS, and other Latin American countries, contributing $12.5 billion. The bailout came with stipulations to keep Mexico from making the same mistake. The new policy had to be inclusive of revised monetary and fiscal policies to create safeguards and strict capital regulation. Mexico complied with the terms of agreement, utilized the funds to stabilize the economy, and even paid back the loans early. The United States ended up making $600 million in profits off of the bailout (Edwards 17).

Can this type of crisis happen again?

In the time of the 24-hour news cycle, it is possible for an event such as the Mexican Peso Crisis to happen again due to the fact that much of this event stemmed from uncertainty linked to information discrepancy. Prior to the financial crisis, news surrounding the Mexican financial markets was mostly positive. Economist Christina Bannier states that media sources originally "proclaimed the reforms to be a major success" emphasizing that in the November before the crisis, "the World Bank argued that, under the new president, the economy would improve rapidly and economic growth would reach its highest level in five years. Investment bankers and fund managers were generally enthusiastic about the Mexican prospects. J. P. Morgan as late as October 1994 and the Swiss Bank Corporation even in December 1994 urged a credit rating upgrade for Mexico," (Bannier 8). Despite the optimism from these international financial actors, many failed to recognize the county's difficulty to roll over its peso denominated debt. By December of 1994, reserves were expected to continue on a downward trend, yet no information was disclosed by the Mexican Central Bank, making investors even more anxious to make a move out of the market.

In relation, some argue that speculative pressure from public information on the value of the Mexican Peso fed this crisis because of the Central Bank's failure to turn private information public. Those on the side of this statement call into question the effectiveness of financial transparency during periods of financial turmoil. Would transparency from the monetary authority regarding the devaluation of the peso have brought the crisis to a halt? Though, to understand the importance of market transparency, one must first understand the significance of how participants in the market react to public information. As discussed in Pugel's *International Economics*, investors are largely unable to predict the movement of exchange rates because of unexpected news. The authors say, "The inability (to predict exchange rates) is based largely on unpredictable news as an influence on the short term exchange rate, but it may also reflect the role of expectations that extrapolate recent trends in the exchange rate leading to **bandwagon** effects and speculative bubbles (Pugel 439). **Speculative bubbles** occur when there is a spike in asset values in a particular industry and have been recognized as precursors to other financial crises when asset prices return to normalized levels (Pugel 456). When investors face uncertainty in the market they tend to speculate, bandwagon, or extrapolate recent trends, and as the value of the Mexican peso grew more uncertain, capital outflows prevailed. By the time the Mexican authority was ready to confirm a devaluation of their currency, they had lost their investors altogether. Nora Lustig from the Brookings Institute writes, "the lack of competence and the absence of a coherent plan at the time the devaluation was announced, added significantly to the climate of uncertainty," (Lustig 1).

Uncertainty affecting the market is not an uncommon obstacle for financial institutions to face. Learning from the Peso Episode, more central banks globally have moved toward transparent policies in an effort to safeguard from speculative pressure. On an international level,

the Mexican financial crisis changed the architecture in which emergency funds are built. Specifically, "after the Mexican crisis and international bailout, the G-7 issued a *communiqué* at the Halifax Summit (in the summer of 1995) that highlighted the need for emergency funding facilities at the IMF that had 'upfront access and faster procedures'," ("Mexico's Financial Crisis of 1994-1995 " 20). In 1997, the supplemental reserve facility was created at the International Monetary Fund, which would allow the organization to lend in areas of bonded debt and help ease similar future financial crises. As an outcome of the *communiqué* and supplemental reserve facility, the IMF extended their lending abilities to focus on combating **sovereign debt** (public or national debt) around the world (Pugel 518). This served useful to nations like Argentina and Thailand who would experience financial crises in the years to follow.

However, the actions by the IMF were not strong enough to stop the impact of the financial crisis on the middle class in Mexico. Senior Economist at the Bank of Canada, Gabriela Galasi says, "Since crises have become a recurrent phenomenon in most Latin American countries, it is important to determine their effect of the social structure, particularly the middle class, which has shown a tendency to experience downward mobility due to external shocks of the past few decades," (Galasi 92). Particularly in Mexico, the Tequila Crisis left many middle class families unable to obtain credit, making it more challenging to maintain small businesses- the main source of income for most middle class Mexican families. A similar trend was recognized in Argentina in 2002 following the Argentine Great Depression.

Closing and why this is an important event

In conclusion, the Mexican Financial Crisis has been a lesson for nations looking to develop their domestic economy and strengthen their international presence. In international finance, states are faced with many choices: floating or fixed exchange rates, lowering or

increasing interest rates, shifts of the money supply, holdings of international reserves, all of which play into the health of a country's capital and financial accounts. Though, using the crisis in Mexico, nations should be cautious of drastically overvaluing and devaluing their currency in short periods of time as seen how speculation of the future exchange rate can dramatically affect a nation's wellbeing.

Mexico has faced difficult times recovering from the Peso Crisis and as a result, a geographical financial divide was created in the nation. Following the crisis, the country "became one of the single largest recipients of foreign direct investment among emerging markets, and saw GDP per capita (US$ PPP) grow from $8,000 in 1995 to approximately $15,000 by 2008," ("Mexico's Financial Crisis of 1994-1995" 21). However, much of the foreign direct investment (FDI) was distributed unevenly with majority of funding given to northern states. Due to the uneven distribution of FDI, the southern states of the country struggle and remain "the poorest area of the country, with the lowest wages and per-capita income, and the lowest levels of education ("Mexico's Financial Crisis of 1994-1995" 21).

As of 2015, optimism for growth in the Mexican economy is slim as the country continues to feel the effects of the Tequila Crisis with little government assistance. The economic issues of the current time are that of low wage rates and poverty. With government corruption acting as a major barrier to economic growth, businesses expansion seems scant. Though, as the peso has continued to hold low value against other currencies, optimism is found where cheap labor attracts global business to the country.

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