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Christian M. McNamara
Yale University

June Rhee
Yale University

Andrew Metrick
Yale University

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Restructuring and Forgiveness in Financial Crises A: The Mexican Peso Crisis of 1994-95[1]

Christian M. McNamara[2]
June Rhee[3]
Andrew Metrick[4]

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Abstract

Following a year in which repeated political turmoil sapped investor confidence in Mexico, putting pressure on the peso and draining the country's foreign exchange reserves, on December 22, 1994, the Mexican government sparked a financial crisis by unexpectedly abandoning its policy of anchoring the peso to the US dollar and instead allowing it to float freely. The resulting collapse of the peso left Mexico with $40 billion to $50 billion in external debt (much of it dollar-indexed) coming due in the near term and almost no foreign exchange reserves. Faced with the prospect that Mexico would either default on its obligations or impose exchange controls (with either scenario being seen by many as likely to result in contagion), officials from both the US and abroad scrambled to craft a response to what had been dubbed "the first financial crisis of the twenty-first century" because of its origins in an emerging market economy within globalized financial markets. On January 31, 1995, an assistance package comprised primarily of funds from the US and the IMF was announced. Backed by $20 billion from the US Treasury's Exchange Stabilization Fund (ESF) and a $17.8 billion stand-by arrangement from the IMF, Mexico met its immediate obligations, restructured short-term debt into longer-term debt, and implemented a strict economic reform plan. While the country experienced significant economic hardship in the immediate aftermath of the crisis, by 1996-97 the economy had rebounded, and by 2000 Mexico had paid back all outstanding obligations under the assistance package.

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[1] This case study is one of four Yale Program on Financial Stability (YPFS) case modules considering Restructuring and Forgiveness in Financial Crises. The others are:

- *Restructuring and Forgiveness in Financial Crises B: The Asian Crisis of 1997.*
- *Restructuring and Forgiveness in Financial Crises C: The Swedish Banking Crisis of 1990-94.*
- *Restructuring and Forgiveness in Financial Crises D: The Japanese Financial Crisis of the 1990s.*

Cases are available from the *Journal of Financial Crises.*

[2] Director, New Bagehot Project and Senior Editor, Yale Program on Financial Stability (YPFS), Yale School of Management.

[3] Director, MMS in Systemic Risk and Senior Editor, Yale Program on Financial Stability (YPFS), Yale School of Management.

[4] Janet L. Yellen Professor of Finance and Management, and YPFS Program Director, Yale School of Management.

1. Introduction

Following a year in which repeated political turmoil sapped investor confidence in Mexico, putting pressure on the Mexican peso and draining the country's foreign exchange reserves, on December 22, 1994, the Mexican government sparked a financial crisis by unexpectedly abandoning its policy of anchoring the peso to the US dollar and instead allowing it to float freely. This crisis represented a dramatic reversal for Mexico, which had emerged from a prior crisis in 1982 as what some considered a pioneer in strengthening its economy by transforming it along open, market-based lines. Indeed, by the late 1980s the Mexican economy had largely moved beyond the 1982 crisis and had resumed economic growth. This growth was financed in significant part by foreign investment, and one of the cornerstones of Mexico's economic policy during this period was an exchange rate system designed to stabilize the economy and create certainty for foreign investors.

Beginning in 1988, Mexico established a fixed nominal exchange rate between the peso and the dollar. Given the need for the peso to depreciate against the dollar to prevent real exchange rates from increasing, Mexico later modified this fixed rate to a "crawling peg" in 1989 and a "moving band" in 1991. Still, by 1994 many observers considered the peso overvalued. With a current account deficit of approximately 8% of GDP financed largely by short-term capital inflows and roiled by a series of uprisings and assassinations, Mexico experienced significantly weakened demand for peso assets. In response, the country increasingly relied on the issuance of short-term dollar-indexed notes called tesobonos that shifted foreign exchange risk from investors to the government and left Mexico extremely vulnerable in the event of a devaluation of the peso. When a Zapatista uprising in Chiapas on December 19, 1994, brought matters to a head and gave the Mexican government no choice but to float the peso, the resulting collapse of the peso's value left Mexico with $40 billion to $50 billion in external debt coming due in the near term and almost no foreign exchange reserves to satisfy these obligations.

Faced with the prospect that Mexico would either default on its obligations or impose exchange controls (with either scenario being seen by many as likely to result in contagion), officials from both the US and abroad scrambled to craft a response to what had been dubbed "the first financial crisis of the twenty-first century" because of its origins in an emerging market economy within globalized financial markets. Despite roadblocks that included (i) an initial unwillingness by Mexico to turn to the International Monetary Fund (IMF) for help given what it would signal about its newfound status among the world's advanced economies, (ii) opposition from the United States Congress to any bailout and (iii) resistance from European finance ministers to the proposed extent of the IMF's involvement, an assistance package comprised primarily of funds from the US and the IMF was announced on January 31, 1995. Backed by $20 billion from the US Treasury's Exchange Stabilization Fund (ESF) and a $17.8 billion stand-by arrangement from the IMF, Mexico met its immediate obligations, restructured short-term debt into longer-term debt and implemented a strict economic reform plan. While the country experienced significant economic hardship in the immediate aftermath of the crisis, by 1996-97 the economy had rebounded, and by 2000 Mexico had paid back all outstanding obligations under the assistance package.

The remainder of the case is organized as follows: Section 2 summarizes the conditions that resulted in the Mexican peso crisis. Section 3 provides an overview of the response to the crisis. Sections 4 and 5, in turn, provide more in-depth analysis of the use of the ESF by the United States and the use of a stand-by arrangement by the IMF, respectively. Finally, Section 6 discusses the results produced by this assistance package.

Questions

1. What situations leading up to the crisis were different/similar between the Mexican peso crisis and the Thai baht crisis, and how did these differences/similarities affect the design of the response and intervention by the international community?

2. Which interventions were effective, and what would each government do differently if it were faced with the same crisis now?

3. What are the core factors to consider in designing interventions for future financial crises that are applicable across developed, developing, and emerging markets?

2. Background of the Crisis

Following the successful resolution of a debt crisis that broke out in 1982, Mexico embarked on a program of economic reform that caused many to point to it as a model for the transformative effects of openness and economic liberalization. From 1988 to 1993 the country pursued a strategy aimed at attaining external viability and laying the foundations for private-sector-led growth based on tight financial policies, the use of the exchange rate as a nominal anchor, comprehensive structural reforms including privatization and trade and exchange liberalization, and a major restructuring of external debt (Camdessus 1995). Following nearly a decade of low growth and high inflation, Mexico's GDP averaged 3.9% annual growth from 1989 to 1993, and its rate of inflation fell to single digits for the first time in over twenty years in 1993 (Ortiz Martinez 1998).

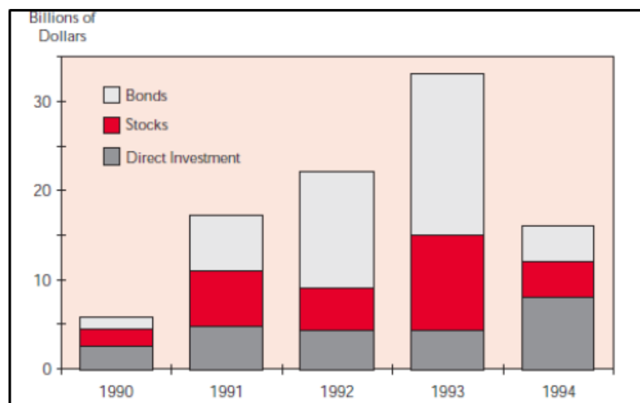
One of the cornerstones of Mexico's economic policy during this period was an exchange rate system designed to stabilize the economy and create certainty for foreign investors. This system was the product of a series of agreements between the government, labor, and business sector to foster social consensus on an evolving package of economic reforms. Known as the Pacto, these tripartite agreements had a stable exchange rate as their anchor, because the commitment to defend an exchange rate requires prudence in monetary and fiscal policy (GAO 1996). The exchange rate regime was thus intended to function as a disciplinary device for the country.

Under the Pacto, in 1988 the Mexican government fixed the nominal exchange rate between the peso and the US dollar. Because differing rates of inflation in the two nations required the peso to depreciate to prevent real exchange rates from increasing, in 1989 Mexico adopted a "crawling peg" system under which the exchange rate was adjusted daily to allow a slow rate of nominal depreciation of the peso to occur over time. In 1991, this system was abandoned in favor of a band within which the peso was allowed to fluctuate. The ceiling of the band was adjusted daily to permit further depreciation of the peso to occur (GAO 1996).

With the Mexican economy seemingly poised for sustainable growth and a degree of foreign exchange certainty provided by Mexico's exchange rate system, capital began to flow into the country at an unprecedented rate. From 1990 to 1994 Mexico attracted approximately $100 billion in total capital, 20% of all capital flows to developing economies (Ortiz Martinez 1998). However, a significant portion of this capital was in the form of debt and equity portfolio investments that could be quickly withdrawn in the event of a loss of investor confidence (GAO 1996). In particular, a major opening of Mexico's capital account in 1988-89 allowed foreign investors to acquire short-term domestic debt. As shown in Figure 1 below, the increase in capital inflows in the early 1990s was due almost entirely to rising

levels of portfolio investment, with total debt and equity inflows dwarfing direct investment by 1992 and 1993.

Figure 1: Capital Flows to Mexico 1990-94



Source: Bank of Mexico.

In addition to leaving Mexico vulnerable to a sudden reverse in investor sentiment, these short-term inflows helped to push the country's external current account deficit as high as 8% of GDP by 1994, which some saw as unsustainable.

In parallel with these developments, the Mexican commercial banking system underwent privatization from 1990 onwards, a process that was characterized by what some have called a lack of adequate supervision and regulation. The result was a dramatic, and some would argue reckless, expansion of credit that eventually resulted in a very weak banking system by 1993. With increased pressure on the peso (particularly in light of sharp increases in U.S. interest rates beginning in 1994), the Bank of Mexico faced the dilemma of potentially needing to raise interest rates to defend the peso yet being aware that doing so could devastate the weakened banking system (Carstens 2015).

This tenuous situation was brought to a head by a series of political crises that roiled the country in 1994. On March 23rd, Mexican presidential candidate Luis Donaldo Colosio was assassinated, triggering a significant drop in investor confidence. As investors fled Mexican assets, the Bank of Mexico's foreign exchange reserves fell from $24.4 billion at the end of March to $17.3 billion by the end of April (GAO 1996). In an attempt to reverse capital outflows, the Bank increased interest rates on short-term, peso-denominated Mexican government notes called "cetes" from 9% to 18%. Yet investors remained wary, as concerns about the possible need to devalue the peso kept them from holding peso-denominated assets even at higher interest rates. In response, the Mexican government became increasingly reliant on the use of "tesobonos," short-term notes payable in pesos like cetes, but with the crucial distinction of being dollar-indexed. This dollar-indexing had the effect of transferring the foreign exchange risk of these investments from investors to the Mexican government. As outstanding tesobono obligations increased from $3.1 billion at the end of March to $29.2 billion in December, Mexico was left extremely vulnerable in the event of a devaluation of the peso (GAO 1996).

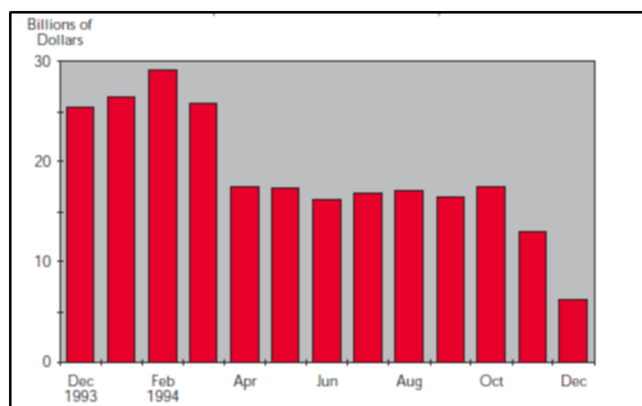
Following a period of relative calm in which foreign exchange levels stabilized at around $17 billion from late-April through the election of Ernesto Zedillo as President in August, fresh scandal again drove down investor confidence. On September 28th, Jose Francisco Ruiz

Massieu, Secretary General of President-Elect Zedillo's political party, was assassinated. Amid allegations of a government cover-up, investors again fled Mexican assets. By November 18th, foreign exchange levels had fallen to $13 billion, putting renewed pressure on the peso. In response, officials from the Bank of Mexico, the outgoing administration of President Salinas and the administration of President-Elect Zedillo met to discuss a potential devaluation of the currency, a move they ultimately rejected for fear that it would cause a loss of confidence and credibility given repeated assurances from the Mexican government throughout 1994 that the peso would not be devalued (GAO 1996).

On December 9, 1994 the Zedillo administration unveiled a proposed budget for 1995 that many observers dismissed as unrealistic. In large part this had to do with the budget assuming a significant increase in the current account deficit at a time when capital was fleeing the country. This capital outflow continued as investors grew concerned about the new administration's commitment to addressing the problems facing Mexico. Within a week of the budget being introduced, foreign exchange reserves had fallen below $10.5 billion (GAO 1996).

Shortly thereafter, the situation reached a breaking point when on December 19th an uprising by a Zapatista insurgency movement succeeded in seizing temporary control of several towns in the Chiapas region of Mexico. With the further erosion of investor confidence that ensued, it became clear that the existing exchange rate could no longer be maintained given dwindling foreign reserves. On the night of the 19th the government called a meeting of its Pacto partners to discuss a proposal to float the peso. Resistance to this proposal from the business sector resulted in an initial devaluation of 15% on December 20th rather than a free float. But attempting to defend this new exchange rate cost the Bank of Mexico half of its remaining foreign exchange reserves in the space of two days, and on December 22nd the Mexican government allowed the peso to float (GAO 1996). As the peso continued to plummet in value through the end of the year, by early January 1995 it was determined that $40 billion to $50 billion in external debt was coming due in the near term and that the Bank of Mexico had almost no foreign exchange reserves remaining with which to meet these obligations (Boughton 2012). See Figure 2 below for a chart of Mexico's foreign exchange reserves from December 1993 to December 1994.

Figure 2: Mexico's Foreign Exchange Reserves, December 1993-December 1994



Source: IMF, International Financial Statistics.

3. The Response to the Crisis—Overview

With the January 1, 1994, implementation of NAFTA, the economies of Mexico and the United States were becoming even more closely integrated than before at the time of the Mexican peso crisis. Already Mexico was the United States' third-largest trading partner, accounting for approximately 10% of US exports and 8% of US imports in 1994 (GAO 1996). The countries also share a border, with social problems in one nation often times spilling over into the other. Summing up the interest many perceived the U.S. as having in Mexico's continued economic stability, President Bill Clinton argued that "there [were] thousands of jobs, billions of dollars of American exports at stake, the potential of an even more serious illegal immigration problem, the spread of financial instability to other countries in our hemisphere, and indeed to other developing countries throughout the world, and the potential of a more serious narcotics trafficking problem" (Clinton 1995).

In addition to these linkages supporting active involvement by the U.S. in resolving Mexico's crisis, Mexico itself may have been reluctant to turn to the broader international community for help. Having joined the ranks of the world's advanced economies through its participation in NAFTA and membership in the OECD, Mexico could well have wanted to avoid the stigma associated with having to borrow from the IMF. Indeed, IMF officials pushed Mexico to seek assistance through the IMF's stand-by arrangement program as early as December 26, 1994, but it was not until more than two weeks later that the Mexican government agreed to do so after the flight from Mexican assets and the depreciation of the peso continued unabated (Boughton 2012).

Perhaps not surprisingly then, early responses to the turmoil in the Mexican economy largely involved bilateral arrangements between Mexico and the United States (and to a lesser extent, Canada). The day after the Colosio assassination in March 1994, the U.S. Treasury and the Federal Reserve announced the creation of a temporary $6 billion currency swap facility pursuant to which Mexico could exchange pesos for dollars for an agreed upon interest rate subject to a subsequent reversal of the transaction at the same exchange rate (GAO 1996). After Mexico's foreign exchange reserves fell by nearly 30% to $17.3 billion from the end of March to the end of April, this facility, along with a $1 billion swap facility with Canada, was made permanent (Ibid.).

Following the December 22nd peso float and the ensuing depreciation, on January 2, 1995, the U.S. and Canada increased these swap facilities to $9 billion and $1.5 billion respectively as part of an $18 billion assistance package that also included $5 billion in loans from G-10 central banks via the Bank for International Settlements (BIS) and approximately $3 billion in loans from a syndicate of international banks (Boughton 2012). When it became clear that much more assistance was necessary, on January 12, 1995, the U.S. announced a proposed plan pursuant to which it would guarantee up to $40 billion in new private sector loans to Mexico in exchange for a guarantee fee and above-market interest rates intended to limit Mexico's use of the guarantee and encourage it to return to the private capital markets as soon as possible (GAO 1996). This proposed plan became the centerpiece of a $55 billion package that was being put together and that also included a projected $7.8 billion stand-by arrangement with the IMF (Boughton 2012).

The proposed $40 billion guarantee required approval by Congress, however. Despite the backing of President Bill Clinton and initial support from Congressional leaders, the guarantee faced mounting opposition from members of Congress who derided it as an attempt to bail out investors with taxpayer money. By January 28th, President Clinton was meeting with Treasury Secretary Robert Rubin and other senior officials to develop alternatives in the event that the guarantee was rejected. On January 30th, Speaker of the

House Newt Gingrich informed Clinton that he was abandoning legislation authorizing the guarantee in the face of certain defeat (Boughton 2012).

Recognizing the need to avoid submitting any plan to a hostile Congress, U.S. officials identified the ESF as a mechanism by which assistance could be provided to Mexico without Congressional approval. As described in greater detail below, the ESF is a currency reserve fund overseen by the Treasury Secretary and employed by the US government to stabilize foreign exchange markets. The legislation establishing the ESF authorizes the Treasury Secretary to use the fund as he or she considers necessary consistent with its aims. The U.S. would thus be able to provide $20 billion in support to Mexico (the most the Treasury felt it could spare) independent of Congress, a plan that President Clinton endorsed on the night of January 30th after learning of the guarantee's demise (Boughton 2012).

With U.S. involvement in the rescue cut from $40 billion to $20 billion, key IMF officials felt pressure to attempt to restore the assistance package as close to the original amount as possible. Informed of the reduction on the morning of January 31st, IMF Managing Director Michel Camdessus immediately devised a plan to increase the size of the IMF's commitment from $7.8 billion to $17.8 billion (Boughton 2012). When the IMF Board allowed Camdessus to publicly announce this proposed increase despite its having angered several European finance ministers, and the BIS agreed to increase its commitment to $10 billion, the financial assistance package for Mexico outlined by President Clinton on January 31st amounted to $48.8 billion broken down as follows:

- US - $20.0 billion
- IMF - $17.8 billion
- BIS - $10.0 billion[5]
- Canada - $1.0 billion

4. The Response to the Crisis—The Exchange Stabilization Fund

With the demise of the $40 billion guarantee proposal having made clear the need to develop a plan that would not require Congressional approval, US officials narrowed in on the ESF as a possible means for providing assistance to Mexico. Established by the Gold Reserve Act of 1934, the ESF was created as a mechanism by which the US government could intervene in foreign exchange markets to influence currency exchange rates. In furtherance of this mission, the ESF can be used to purchase or sell foreign currencies, to hold U.S. foreign exchange and Special Drawing Rights (SDR) assets and to provide financing to foreign governments. (US Treasury 2010). The Gold Reserve Act, as subsequently amended, provides in part that "the Secretary [of the Treasury] …with the approval of the President, may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary." The Act explicitly states that the ESF "is under the exclusive control of the Secretary." (31 U.S.C. §5302).

[5] Because this $10 billion commitment from the BIS required Mexico to post an equivalent amount of liquid collateral and therefore could not be drawn upon as a practical matter, it is not treated in-depth here. See Boughton 2012.

The plan developed by Treasury Secretary Rubin and endorsed by President Clinton called for a commitment of $20 billion consisting of three parts: (i) up to $9 billion in short-term, 90-day currency swaps at the 91-day Treasury bill rate; (ii) up to $20 billion [less amounts outstanding under (i) and (iii)] in medium-term, five-year currency swaps at a rate reflecting the credit risk cost for Mexico; and (iii) up to $20 billion [less amounts outstanding under (i) and (ii)] in guarantees of dollar-denominated debt issued by the Mexican government with a term up to 10 years (GAO 1996). The availability of these funds was conditioned on strict compliance with certain economic, financial, and reporting requirements. For example, no funds would be provided unless U.S. officials were satisfied that Mexico had adequate resources to ensure repayment. To assist in making this determination, U.S. officials could require Mexico to provide certification of its financial records by independent public accountants. Additionally, Mexico was required to submit and update at least annually a financial plan. Each request for funds would then have to describe the intended use for the funds and how it was consistent with the plan. Mexico also agreed to adhere to the economic reform program adopted as part of its stand-by arrangement with the IMF, discussed in greater detail below (Ibid.).

Although the ESF is under the exclusive control of the Treasury Secretary, the Treasury works closely with the Federal Reserve on foreign exchange operations. One way in which this manifests itself is the use of the Fed to warehouse currencies to supplement the U.S. dollar resources of the Treasury and the ESF for financing purchases of foreign currencies and related international operations. The Mexican assistance package required the Fed to warehouse $20 billion in German marks and Japanese yen to support the intervention. A vote taken by the Federal Open Market Committee (FOMC) on January 31st–February 1st to increase the Fed's warehousing limit from $5 billion to $20 billion revealed that opposition to the Mexican rescue was not limited to Congress. Two of the twelve members of the FOMC voted against increasing the limit, citing an absence of information to assess whether developments in Mexico threatened U.S. financial stability and concerns that the Fed could not assist in providing intermediate to long-term financing to facilitate debt restructuring without compromising, or appearing to compromise, the independence of the monetary policy process (Federal Reserve 1995).

With the role of the ESF historically centered around short-term interventions in support of a stable dollar, the proposed use of ESF funds to provide assistance to Mexico, especially in the form of medium-term swaps and guarantees of debt with terms up to 10 years, represented a novel application of the program. US officials were thus aware of a need to ensure that the plan was on solid legal footing. Prior to the execution of definitive agreements establishing the $20 billion package, the Treasury's General Counsel prepared a legal opinion concluding that the proposed use of the ESF was lawful. Having reviewed this opinion at the General Counsel's request, the Department of Justice (DOJ) shared in this conclusion. As the DOJ noted, the legislative history underlying the ESF makes clear that Congress intended "that the President and the Treasury Secretary should retain the flexibility to use the ESF, as they consider necessary, to respond promptly to sudden and unexpected international financial crises that undermine the global currency exchange system and jeopardize vital U.S. economic interests" (DOJ 1995). On February 21, 1995, the U.S. entered into definitive agreements with Mexico establishing the $20 billion program.

5. The Response to the Crisis—The IMF Stand-By Arrangement

Despite the reluctance of Mexican officials to turn to the IMF for assistance (likely owing to concerns about the stigma that would result), as it became increasingly clear that initial bilateral efforts with the United States were not succeeding in quelling the crisis, Mexico

acceded to IMF prodding to request a stand-by arrangement. As the IMF's "workhorse lending instrument for emerging and advanced market economies," the stand-by arrangement program had since its inception in 1952 been used time and again to meet the external financing needs of member countries in crisis (International Monetary Fund 2015). In exchange for funding, countries agreed to undertake economic reforms aimed at resolving the problems that created the need for funding in the first place.

The importance that key IMF officials placed on the IMF's involvement in any Mexican assistance package stemmed from their views on both the potential threat that the crisis posed to other nations and the uniquely vital role they believed the organization could play in the rescue. On this former point, the IMF identified three specific contagion risks. First, that "self-fulfilling investor pessimism" could cause the withdrawal of funds from other nations, especially developing countries. Second, that Mexico's status as a pioneer in openness and economic liberalization could cause its collapse to discredit the entire financial globalization movement. Third, that economic growth could decline as a result of falling production and shrinking markets (Boughton 2012).

With respect to the question of the IMF's uniquely vital role, three elements also stood out to the IMF. First, other potential rescuers including the U.S. were unwilling to commit their own money without the IMF's assurances that Mexico was implementing sound economic reforms, assurances that the IMF found it impossible to give after the crisis without direct involvement in its resolution. Second, particularly after the demise of the $40 billion U.S. guarantee, it would have been unlikely that an adequate amount of support could be secured without the IMF given the size of Mexico's problem. Third, despite Mexican fears of stigma, the IMF's involvement could have a calming affect given the confidence of IMF senior management in the ultimate success of rescue efforts (Boughton 2012).

Notwithstanding these rationales, even within the IMF there was no uniform agreement on its involvement. In particular, the IMF's European Executive Directors questioned how significant the contagion risk actually was (Boughton 2012). Despite these concerns, Managing Director Camdessus authorized his staff to pursue a $7.8 billion stand-by arrangement with Mexico subject to final Board approval. This amount was already an exceptional commitment at three times Mexico's IMF quota. When Camdessus subsequently sought to increase it to $17.8 billion, it became the largest commitment in IMF history to that point, both as a percentage of quota and in absolute terms (Camdessus 1995). To avoid straining the IMF's resources, Camdessus proposed a "$10 billion–X" approach pursuant to which the IMF would seek to raise the additional $10 billion from other countries before ultimately funding however much of that amount remained outstanding (Boughton 2012). This did little to assuage the concerns of the European Directors, whose skepticism of the contagion risk was now compounded by fears that the arrangement was excessively large and had the potential to weaken the IMF's financial position. Furthermore, there was a perception among some European Directors that the increase to $17.8 billion had been orchestrated with U.S. officials without consulting the Executive Board. When the Executive Board voted to approve the $17.8 billion stand-by arrangement on February 1st, the Directors from Germany, the Netherlands, Norway, Switzerland, and the UK abstained in protest (Boughton 2012).

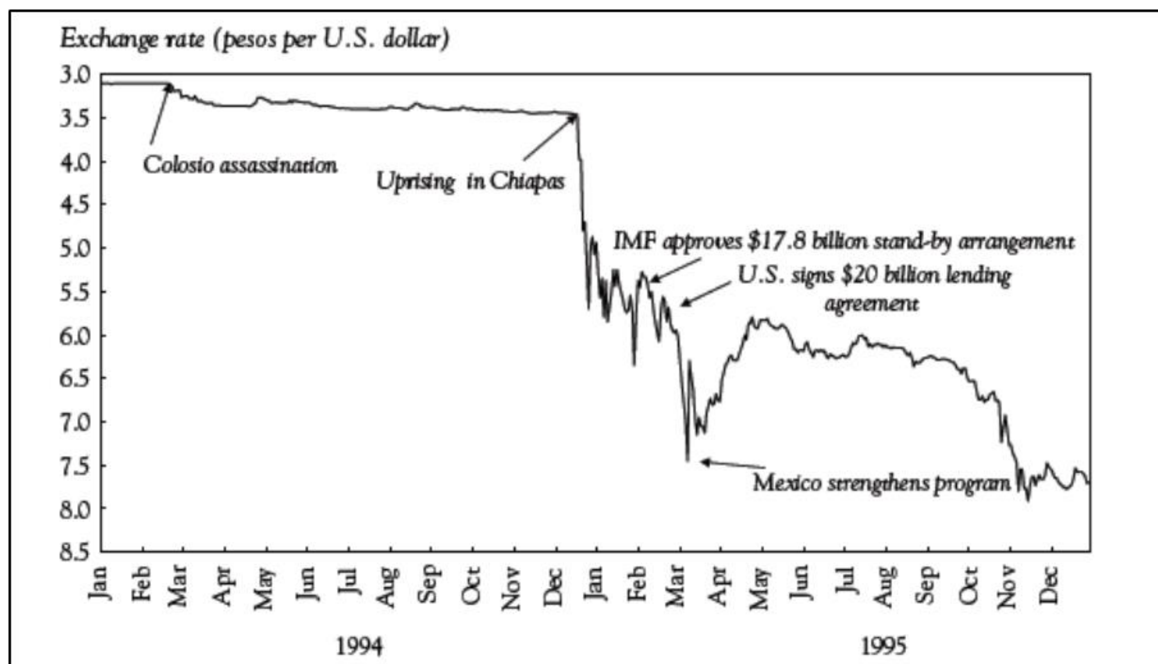
The approved stand-by arrangement was an 18-month agreement that called for the immediate distribution of the initial $7.8 billion amount, itself an exceptional step given the IMF's typical practice of disbursing funds more gradually over the lifetime of the arrangement. Further installments would be paid out over time contingent on Mexico's adherence to an economic reform program developed in consultation with the IMF. The specific near-term objectives of this program were two-fold: reduce the external current account deficit from 8% of GDP in 1994 to 4% of GDP in 1995 and lower the annualized rate

of inflation to approximately 9% in the fourth quarter of 1995 from more than 30% in the first quarter of the year. To achieve these objectives the program called for (a) fiscal tightening; (b) a policy on wages and prices that implied a significant reduction in average real wages and a contribution on the part of labor to set the basis for resumption of economic growth; and (c) a credit policy that placed a limit on the growth of net domestic assets of the Bank of Mexico and reduced the rate of credit expansion by the development banks. Moreover, Mexico would expand its previous privatization efforts to include basic infrastructure such as rails, ports, airports, electricity generation, and radio and telecommunications. The proceeds from the privatization of these activities were to be used for paying off public external debt (International Monetary Fund 1995a).

6. The Outcome of the Response

The introduction of the $20 billion in ESF funds and the $17.8 billion IMF stand-by arrangement did not immediately reverse the capital outflow from Mexico or the further weakening of the peso. As shown in Figure 3 below, from the time that the IMF stand-by arrangement was approved in early February and the U.S. entered into definitive agreements for the ESF funds in mid-February, the peso continued to fall from approximately 5.5 pesos per dollar to almost 7.5 pesos per dollar in early March (Boughton 2012).

Figure 3: Mexican Exchange Rate 1994-95



Source: Boughton 2012.

Some were convinced that the Mexican rescue had failed, and Larry Summers, one of the architects of the U.S.'s involvement, is reported to have offered to resign his position as Undersecretary of International Affairs (Boughton 2012).

The situation did not begin to improve until Mexico undertook a further strengthening of the economic reform program adopted as part of the rescue. On March 9th the Mexican government announced several measures developed in consultation with the IMF which when combined were projected to yield 1.5% of GDP. These included "substantial increases in prices charged by public enterprises, a rise in the value-added tax rate, and expenditure reductions" (International Monetary Fund 1995b). Additionally, a further reduction in development bank lending was announced.

The response to this development was enthusiastic. The IMF put out a press release praising the new measures and the peso appreciated 18% against the dollar on March 10th (Boughton 2012). This strengthening held for the next several months, and by May 1995 Mexico was again able to access the international capital markets with a series of transactions in which it sold bonds with maturities of one to two years at interest rates of LIBOR plus 3% to 6%. (GAO 1996). Mexico also continued receiving funds under the ESF and stand-by arrangement, with the later providing installments of $2 billion and $1.7 billion in June and August after the initial $7.8 billion installment in February.

By October, however, fresh concerns about Mexico's political and economic stability had prompted new capital outflows that put downward pressure on the peso. As seen in Figure 3 above, the exchange rate reached an all-time low for the crisis at almost 8 pesos per dollar. On December 15, 1995, nearly one year after the outbreak of the crisis, Mexico requested a fourth installment under the stand-by arrangement, primarily as a means of demonstrating continued IMF confidence in the country (Boughton 2012). This $1.7 billion disbursement would prove to be the last requested by Mexico under the stand-by arrangement, as continued financial strengthening in 1996 ultimately resulted in the resumption of economic growth.

Figure 4: Mexico's Annual GDP Growth Rate 1994-2000

http://www.tradingeconomics.com/.

As shown in Figure 4 below, after a significant contraction of the Mexican economy in 1995, by 1996 the economy was again growing and would remain so through the end of the decade. Unemployment, which peaked at 7.6% in August 1995, fell to 3.5% by February 1998. Inflation declined from 52% in 1995 to 16% in 1997 (Ortiz Martinez 1998).

All told, Mexico borrowed a total of approximately $28 billion in 1995 as part of its rescue, including approximately $13 billion from each of the IMF and the U.S. (Boughton 2012). In the case of the U.S., this borrowing primarily took the form of medium-term swaps (GAO 1996). In January 1997, Mexico announced its intention to pay off the remaining balance of $3.5 billion owed to the U.S. under the rescue package (International Monetary Fund 1997). By August 2000, Mexico had repaid all amounts owed to the IMF under the $17.8 billion stand-by arrangement and a subsequent July 1999 $4.8 billion stand-by arrangement put in place to ensure stability in the run-up to presidential elections in July 2000. This marked what some describe as the successful conclusion to the crisis (Boughton 2012).

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