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Mexico’s Balance of Payments Crisis (1994-1995)

Introduction

In the early 1990’s, Mexico was being heralded as a model of economic reform. Mexico had turned the corner on decades of economic stagnation and was on its way to becoming a member of the OECD and NAFTA. The 1994 peso crisis revealed that Mexican growth was ultimately a façade, supported by unsustainable monetary and fiscal policies. To examine the Mexican Peso Crisis, we use the balance of payments crisis model, which shows how an expected change in the exchange rate leads to a change in official foreign reserves. In order to hold the exchange rate fixed, the central bank used reserves to finance private capital flow.

I. Origins of the Crisis

The economic crisis that followed Mexico’s devaluation in December of 1994 was a shock to most observers. In the early 1990s, Mexico’s extensive economic reforms had largely reversed the stagnation and instability that plagued the country in the 1980s, and through a foreign
exchange regime pegging the peso to the U.S. dollar, the country was able to curb its chronic high inflation. These reforms made Mexico an attractive destination for foreign capital, leading to an unprecedented boom in portfolio investment. While these flows initially helped to support Mexico’s economic reforms, they would later serve to undermine them and eventually play a central role in the country’s balance of payments crisis.

To understand the causes of Mexico’s balance of payments crisis, it is essential to observe the evolution of the country’s current account deficit. From the very beginning of Mexico’s economic reform process, combating inflation was a focus of Mexico’s policymakers. The primary component of Mexico’s anti-inflationary policy was its exchange rate regime, which was initially fixed to the dollar in 1988 as part of the Pact of Economic Solidarity Plan (or “Pacto”), but later modified to a peg, and at the time of the crisis, to an adjustable band. This exchange rate regime was highly effective in curbing Mexico’s inflationary pressures, but resulted in the appreciation of the peso (nominal exchange rate-based stabilization has long been shown to result in the real appreciation of the local currency, typically due to the time lag between domestic and foreign inflation decreases).

**Capital Inflows of the Early ‘90’s and Current Account Effects**

The peso’s appreciation, when combined with Mexico’s unilateral trade liberalization, fed a surge in the country’s imports, which were rapidly outpacing its exports. This growing trade deficit coincided with the foreign investment boom of the early 1990s. Gross capital flows to Mexico surged from US$3.5 billion in 1989 to US$33.3 billion in 1993, allowing the country to cover its growing trade imbalance and in time run unprecedented current account deficits. Foreign investment flows to Mexico, further exacerbated the overvaluation of the peso, which in turn fueled even greater demand for imports, further worsening the trade deficit. This cycle would prove to a major destabilizing force leading to the balance of payments crisis through its effect on Mexico’s current account balance.

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1 Banco de Mexico
Fundamentally, the balance of payments identity dictates that a current account deficit must be financed by private capital flows or by a decline in foreign exchange reserves. In the period immediately preceding the crisis, Mexico’s private capital flows were more than enough to finance the current account deficit. During 1992 and 1993, Mexico’s current account deficit was US$48 billion, while private capital flows were US$57 billion.\(^2\)

**Dependence on Debt Portfolio Investment**

By relying on foreign investment to finance its current account deficit, Mexico was exposing itself to a great deal of risk. Since 1990, foreign investment in emerging markets had increasingly taken the form of portfolio investment. In the case of Mexico, portfolio investment that was practically non-existent in 1989 had risen to US$28.4 billion in 1993. This was out of gross capital flows of US$33.3 billion in the same year.\(^3\) Portfolio investments are generally more volatile than traditional foreign direct investment and more prone to flight in response to perceived risk.

Mexico’s policymakers were not unaware of the dangers presented by their overvalued currency, growing current account deficit, and reliance on portfolio flows, but they allowed undue optimism to cloud their judgment. The prevailing belief among Mexican policymakers was that the country’s economy would remain attractive to foreign investors long enough for their dependence on foreign capital flows to subside, as the gap between imports and exports gradually closed. This belief was predicated on the increasing competitiveness of the Mexican economy and the successful implementation of NAFTA.

**II. Decline in Investor Confidence and Devaluation**

In 1993 and early 1994, investors continued to pump foreign exchange into the Mexican economy despite evidence of Mexico’s unsustainable current account deficit and its overvalued currency. It would turn out to be a series of political events in 1994, which would begin the process of undermining investor confidence in Mexico. Beginning with the Chiapas uprising at the beginning of the year and culminating with the assassination of the PRI’s presidential candidate in March, Mexico saw its risk premium quickly rise. These political events coincided with the decision by the United States Federal Reserve to raise interest rates in February. The increase in U.S. interest rates altered investment flows away from emerging markets in general, and would compound the effect of Mexico’s increased risk premium. (BOP graph, Point 1 to 3)

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\(^2\) Naim, M. "Mexico's Larger Story." Foreign Policy, No 99, p.112-130, Summer 1995

After the March assassination Mexico experienced a dramatic drop in its foreign capital flows. With declining international investment, Mexico had to finance its current account deficit through the unsustainable depletion of its foreign reserves. By the end of March, Mexico’s foreign reserves had fallen from US$26 billion to US$18 billion.4

Mexico now had two options to stabilize its growing balance of payments imbalance: (i) they could have devalued their exchange rate and relieved the pressure on the current account, or (ii) they could attempt to defend their exchange rate by raising interest rates. They chose the latter, with the expectation that they could wait out the economic turmoil. As is illustrated by the balance of payments crisis model, the increased risk premium resulted in a rightward shift of the expected domestic currency return on foreign currency assets curve. Given that the exchange rate remained fixed (except for a movement from the lower end of the band to the ceiling of the band which acted as a de facto 10% devaluation), interest rates on Mexican treasury certificates, or cetes, shot up to 16.25%5.

**An Expansionary Response to Capital Flight**

In the last quarter of 1994, the Mexican government attempted to counter growing interest rates and monetary contraction, with an extension of domestic credit. This was accomplished through the purchase of private sector securities by the Central Bank at interest rates lower than those demanded by foreign investors. This attempt to sterilize the fall in international reserves would prove to be incompatible with defense of the exchange rate peg.

In an attempt to show the global market that the peso was still strong, the credit was converted into dollars, as was the government’s short-term debt. This dollar-
denominated debt was issued in bills called tesobonos, and were more attractive to foreign investors than “high-risk” peso denominated debt. Thus, by indexing its debt to the dollar, the Mexican government was transferring risk from investors to itself.

Despite Mexico’s efforts to defend their pegged exchange rate, international markets did not find the effort credible and the country’s now outstanding (dollar-denominated) debt made it susceptible to a number of financial shocks. As the expectation of a future devaluation increased, so did the risk premium on holding Mexican debt, further pushing the domestic currency return on foreign currency assets curve to the right, and putting increased upward pressure on interest rates. The government’s expansionary monetary and fiscal policies only accelerated the depletion of their foreign currency reserves, since they led to a fall in domestic interest rates as those in the U.S. continued to rise. Investors could see Mexico’s financial position was unsustainable and as a result they prepared themselves for the inevitable devaluation.

Devaluation and Default

By December of 1994, Mexico’s foreign reserves had dropped to approximately US$10 billion which was not enough to even cover the outstanding US$30 billion held by investors in dollar denominated tesobono debt. After a meeting of the government with the “Pacto”, it was agreed that the ceiling of the band would be raised to allow for 15% devaluation. Within two days of the devaluation on December 20th, it is estimated that US$5 billion left the country. It was obvious that the new exchange rate was not credible and on December 22nd the Mexican government decided to float the currency. Investors left holding peso denominated debt felt betrayed by Mexico’s decision and most observers were shocked that the float was announced without a coherent macroeconomic plan to cope with the aftermath. In the weeks that followed, investors fled Mexico, and nearly brought the country to default.

III. Domestic Policy Reaction

In January of 1995, the Mexican government announced a plan to stem the negative and inflationary effects of the crisis. The plan included a substantial reduction of government spending and a contraction in monetary policy, specifically in the amount of credit that would be available to domestic borrowers. The plan also included an effort to establish a coherent floating exchange rate regime. This move would ensure an accurate market value of the peso in the long-run, avoid repeating an overvaluation of the currency, and help increase export competitiveness.

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6 Sachs, et. al.
7 Naim, M.
Realizing that they could not succeed in fixing the crisis on their own, the government solicited help from foreign entities, primarily from U.S. commercial banks. By February 2005, Mexico had secured a package of loan guarantees and credits that summed to approximately US$52 billion. This also included an IMF loan of US$17.8 billion, the largest in IMF history.⁸

**Bailout and Economic Performance Since the Crisis**

In securing these loans the Mexican government committed to continue its market-based reforms and to implement a program of fiscal austerity. The bailout and reform package were highly effective. Between 1996 and 1999, GDP grew by more than 5% per year. In January of 1997, Mexico paid back the US$13.5 billion in loans from the US government ahead of schedule.

Mexico’s post crisis reforms came at a severe cost to the PRI. In 1997, the PRI lost control of the Mexican congress.⁹ Then in 2000, the PRI lost the presidency of Mexico for the first time in 70 years.¹⁰

**Monetary Policy**

While Central bank autonomy was officially laid out in law in April of 1994, further steps were taken in the period after the crisis to ensure that it was free of political influence.¹¹ Since the mid-1990s, inflation targeting has been the explicit mandate of the Central Bank. They have been fairly effective in this task. Inflation, as measured by changes in consumer prices has fallen from 20% in 1997 to 4.6% in 2004. The Central Bank has been expanding the money supply since the crisis, and as predicted by the balance of payments model, nominal interest rates on Mexican treasury notes have declined to below their pre-crisis level. This trend has greatly diminished the spread between Mexican and U.S. notes, indicating that the risk premium on Mexican debt has come down substantially. The nominal peso to dollar exchange rate depreciated gradually from 7.64 in December 1995 to 11.24 in December 2003.

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⁹ Ibid
¹⁰ “Survey of Mexico: Pride Before the Fall” (October 26, 2000) The Economist
¹¹ Banco de Mexico
http://www.banxico.org.mx/siteBanxicoINGLES/aAcercaBanxico/FSacercaBanxico.html
Fiscal Policy

The federal government has run a primary budget surplus, before interest payment on public debt, of roughly 4% of GDP from 1997 to 2004. Net of interest payments, the budget was in deficit of -0.3% to -1.16% of GDP over the same period. The mix of expansionary monetary policy and conservative fiscal policy has an ambiguous effect on growth under the AA/DD model.

IV. Conclusion

This paper has attempted to demonstrate how the balance of payment model explains the dramatic financial shifts, which took place in Mexico during the 1994-1995 economic crisis. Because of a delay in appropriate fiscal and monetary action on the part of the government, the country became exceedingly vulnerable to changes in foreign capital flows. When Mexico had no choice but to devalue the peso, after exhausting the foreign reserves that had in effect subsidized this delay in government action, the effect on the peso exchange rate was devastating. Though the balance of payments model cannot at times explain why individual countries behave in certain ways, it does help us to analyze what should happen in different scenarios and the consequences of fighting the forces of the model’s equilibrium.