Title: Mexico: The Balance of Payments during the 1994 Financial Crisis and Beyond
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ABSTRACT

The 1994 Mexican “Peso Crisis” was the most significant financial crisis seen on the American continent during the 1990s. This major event would bring into question the decision to include Mexico in the Canada U.S. Free Trade Agreement to create The North American Free Trade Agreement, since the crisis ensued only months after the agreement was signed in November of 1993. The Mexican government had implemented new export-oriented economic policies beginning in the late 1980’s, which would set the Latin American nation on a path of growth, only to see it derailed in 1994. The communist uprising in the region of Chiapas in January 1994 would only worsen the situation and cause uncertainty in an already turbulent market. The economic severity of the situation would lead the country’s central bank, the Banco de México to search for creative ways to finance the looming deficits in the country’s balance of payment. These economic policies, along with help from the IMF, World Bank and direct loans from the U.S., would eventually allow Mexico to recover and continue on to a path of increased growth and development.

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**Introduction**

Since independence from Spain, Mexico has gone from a mainly agrarian rural society to the world’s 14th largest economy. Mexico’s transformation has seen the mainly rural agrarian society become an urbanized exporting powerhouse, becoming the 14th largest exporter on the planet (World Bank, 2011). Its cheap labour and sunny beaches have also made it a hot spot for US foreign investment. This made the balance of payments of Mexico particularly susceptible to influence from foreign investment and net exports.

In recent history Mexico has seen two major deficits, not including the 2008 financial crisis, in either its current account or capital account, the first being in 1982, which was coined the “Latin American debt crisis” due to deficits arising in several other Latin American countries. The crisis traces its origins to the 1970’s where many Latin American nations used credit from private banks to fund industrialization; such as infrastructure projects, instead of using the traditional funding route to acquire capital for economic development through the IMF (Ferraro, 1994).

When oil prices sky-rocketed in 1973 due to the OPEC oil embargo, commercial banks found themselves with an influx of capital from oil exporting nations. This further fuelled the private banking sector’s willingness to lend to Latin American countries, creating an annual cumulative debt rate of 20.4% (1975-1982). All together the combined external debt of Latin American nations swelled to 315 billion dollars in 1982, up from 75 billion in 1975 (Institute Of Latin American Studies, 1986). During the same period the Mexican Peso became highly overvalued
due to higher oil prices and the United States’ need for other foreign oil sources as many Middle East nations had placed an embargo on the US due to its support of Israel during the Yom Kippur war. These factors would put the Mexican economy at the centre of Latin America’s economic collapse.

After the end of the oil embargo, the price of oil began to drop and soon the US began to raise interest rates in 1979. This decrease in the price of oil would cause revenue from Mexican exports to drop and consequently the value of the peso would drop alongside it. The widening of the US dollar-Peso exchange rate and the increase of American interest rates would exponentially increase the debt that Mexico and other Latin American countries would need to pay back. Finally, in August of 1982, Mexico became the first of many Latin American countries to declare that they could not repay the debt at current interest rates. Mexico’s finance minister, Jesus Silva-Herzog announced a moratorium of 90 days and requested a renegotiation of payment periods (Felix, 1990). The economic policies used to address this major default will be examined later on.

The second time was in 1994 where a self-inflicted currency crisis created a massive deficit in both the capital and current accounts. The third major deficit arose in 2008 during the “global financial crisis” which saw governments scrambling to organize financial bailouts (Santealla 1998). Since Mexico was the sole Latin American country to suffer massive deficits in 1994, it gives a great opportunity to analyse the factors leading up to the deficits in both the current account and capital account. While examining the state of the economy during the
crisis, as well as its aftermath and lasting legacy, this paper will explore this defining event in Mexico’s economic history.

**Background**

From 1987 to 1995 the Mexican economy went from boom to bust in 8 years. The end of those 8 years culminated in major loans being needed to handle the deficits in the capital and current accounts. Creating one of Latin America’s most notorious currency crises and government deficits, this came to be known as the Tequila Crisis. An analysis will be made on how stabilization policies from Mexico’s last recession coupled with policy decisions under the Salinas de Gorteri administration played a major role in the Tequila Crisis, while investigating the effects on the both the capital and current accounts of Mexico.

After the 1982 Latin American debt crisis, Mexico began implementing major stabilization policies conforming to IMF and WB standards. Firstly, a temporary freeze of public sector prices and wages were implemented. Secondly a tighter fiscal policy was adopted through a wider tax and increased policing on tax evasion. Thirdly, the peso was fixed to a pre-announced exchange rate band to stabilize capital flow. These policies, implemented by Mexican president Miguel de la Madrid were meant to cut public debt and increase investment from abroad. (Savastano et al, 1995) They quickly generated increased exports creating major crediting to the current account and giving Mexico its first positive current account in 1989 since the 1982 debt crisis. (WB Databank, 2013)
Continued Economic growth and capital inflow

Once elected in 1988, president Salinas de Gorteri continued to push for economic liberalisation in the hope of generating more growth. Most notably he negotiated the North American Free Trade Agreement, which took effect in January of 1994. Secondly, the Salinas administration liberalized the capital account to allow for increased inflow of foreign funds to enter the country. He accomplished this by privatizing several banks, increasing the band at which the peso was pegged and reduced government interference by eliminating government direct lending and allowing the market to determine the lending and deposit rates. These policies made real GDP growth average 3.5 per cent a year from 89-92, and lowered inflation to (below 10%) by 1993, down from over 20% in 1987. (Savastano et al, 1995) This radical improvement in Mexico’s economic fundamentals and the decline in US interest rates created the perfect environment for foreign capital inflow. It generated a surge in the crediting of the capital accounts coming predominantly in the form of portfolio investments. The total inflow of capital averaged 6% GDP from 1990-1993. (Sidaoui, 2006). This new found interest in the Mexican economy by mostly US investors caused the peso to appreciate in value by 60 per cent between 1988 and 1992 (Savastano et al 1995).

This appreciation in the peso caused net exports to drop substantially, leading the current account deficit to widen from approximately 1.4% of GDP to 7.4% during the same time frame\(^1\). (Haver Analytics, 1998) To address this looming deficit, the Salinas de Gorteri government chose to issue “Tesobonos” in the first

\(^1\) See appendix I
quarter of 1994. The Tesobonos were government bonds, which were dollar-indexed, so investors could avoid losses if Mexico chose to devalue the peso. This “Tesobono” financing effectively transferred the foreign exchange rate risks from investors to the Mexican government, making them attractive to foreign investors. (Mishkin, 1995) However, the Tesobonos would ultimately become a contributing factor to the massive debt crisis later that same year.

**Defining factors leading up to the “December Mistake”**

Two major contributing causes to the “December Mistake” which both happened in 1994, were the change in the US interest rates and the assassination of presidential candidate Luis Donald Colosio coupled with the rebellion in Chiapas. The latter created a wave of financial uncertainty and called into question the political stability of Mexico and the former promoted US investors to invest at home. Both ultimately deterred foreign investment substantially.

In an effort to curb inflation, the United States Federal Bank chose to adopt a higher treasury rate. This marked a reversal in a downward trend, which began in 1990 where the nominal rate dropped from approximately 8% to below 4% by 1993. The sudden increase in the 1994 nominal interest rate to just over 6.5% in under a year would cause US investors to keep their money at home, even retracting some of their foreign investments in Mexico by the end of 1994\(^2\). (US Federal Reserve, 2013) This would become a major factor in the capital accounts deficit.

\(^2\) See appendix II
After months of “attempted” peaceful demonstration, the leftist leaning revolutionary group, the Zapatista Liberation Army (abbreviated as the EZLN in Spanish) declared war on the Mexican government on the 1st of January 1994. The declaration of war was made from the Lancandon jungle in the southern state of Chiapas. The uprising was used as a way to protest NAFTA and the so-called “capitalist ideology” behind it. (Bailey, 2000) This civil unrest could not have come at a worse time for the Mexican government as the political system was preparing for the 1994 general elections set for later that year. The political strife in Mexico traveled to the northern part of the country when the favoured presidential candidate, Luis Donald Colosio was assassinated on March 23rd at a campaign rally in Tijuana, Baja California. With the Mexican federal elections only 6 months away, this created much uncertainty regarding not only the 1994 general elections, but in the Mexican political system as a whole. Leading Mexico’s risk premium to be completely re-evaluated. (Storrs, 1995)

This political uncertainty was reflected in the last quarter of 1994, when the capital accounts suffered massive debiting. This came mostly in the form of private direct investment and portfolio investment from the United States being retracted, fearing economic collapse. Since most of the foreign investment was in the form of more liquid portfolio investment, the US lenders were quick to move the capital out of Mexico, seeing close to 20 billion USD in portfolio investment halved by the fourth quarter of 1994. (Adderley, 2007)

The “December Mistake” and effects on the Economy
Shortly after the election of Ernesto Zedillo in December of 1994 and once emergency meetings with top Mexican businessmen had been held, the Mexican government opted to scrap the pegged exchange rate and let the peso float. The major loss in foreign investment due to Mexico’s new higher risk premium meant that the capital accounts could no longer supper the current account deficit caused by the policies of the Salinas Gorteri administration. (Although the Banco de Mexico initially tried to stop the peso from devaluing by depleting it’s international reserves, the peso finally crashed instantly of implementing a floating exchange rate regime. (Adderley, 2007) It was depreciated from 3 pesos to the US Dollar in November of 1994 to 8 pesos to the US dollar by November of the next year.3(World Bank Data Bank, 2013) This massive currency crisis meant that all banks holding debt in foreign currencies saw it increase exponentially. The issuance of the “Tesobonos” indexed in US dollars aided the total foreign currency obligations to jump from 88.8 billion to 174.4 billion USD. (Edwards, 1997) The Mexican economy suffered substantially from 1994 to 1995, contracting by 10% of the GDP, unemployment increased, real wages dropped by 30%, and inflation jumped from below 10% to over 50%.

The change in currency regimes, which came to be known as the December Mistake, coupled with a high current account deficit and unfavourable investment environment ultimately led to Mexico’s largest deficits since the 1982 Latin American Debt Crisis.

3 See appendix III
Addressing the debt crisis

With over 174.4 billion in debt, newly elected president Ernesto Zedillo had an enormous task ahead of him. The debt crisis was addressed in two main ways, firstly, the Mexican government and central bank worked to re-establish confidence in the financial system and secondly the IMF along with several member countries created a rescue package.

To create confidence in the Mexican banking system, the government used the “Fondo Bancario de Proteccion al ahorro” (FOBAPROA) to guarantee deposits placed in commercial banks. The FOBAPROA was conceived in 1990, under the Salinas de Gortari administration using the capital gained through the privatization of public banks. It was created as a preventative measure following the 1982 financial crisis, which would be used as an emergency measure to assume outstanding debt, capitalize banks and prevent liquidity problems. (Mackey, 1999)

The Banco de Mexico, followed suit by giving a US 46.4$ billion dollar in dollar credits at above-market interest rates to banks (De Luna-Martinez, 2000). This increased liquidity from both the FOBAPROA and Banco de Mexico allowed banks to meet their short-term domestic and foreign currency-denominated debts (Nava-Campo, 2002). This would create increased confidence in the banking system helping to form the base for future investment in the country.

Although a strong confidence in the banking center was needed to create long-term growth, immediate alleviation of the capital account deficit was fulfilled by the IMF and its partners. In February of 1995 Mexico received 48.8 billion dollars in a support package created with credit from not only the IMF but also the United
States, G10 central banks and commercial banks. (Camdessus, 1995) This allowed Mexico to finance its debt and avoid a repeat of the 1982 crisis.

**Factors Contributing to the Balance of Payments**

To understand the 1994 Tequila Crisis and the subsequent effects on the economy, an in depth look at the components of both the current and capital accounts must be taken. An analysis of the principal contributors to the capital and current account deficit and surplus seen from 1987 to 1995 will be made.

It is evident that the largest contributor and mover to the current account deficit or surplus is the net trade in goods. Throughout the years, the current account mirrors the net trade while only being minimally affected by other factors such as net income (investment income minus debt service payments). Therefore the exchange rate of the currency becomes incredibly important in the outcome of the balance of payments. This is apparent, as the current account deficit widens as the currency appreciates and inversely, most surpluses are associated with lower exchange rates.4

The capital account on the other hand was mostly affected by the portfolio investment, then by foreign direct investment. This is due mostly to fact that portfolio investments came in the form of financial assets such as mutual funds and stocks, which are much more liquid, easily traded and come in larger net inflows.

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4 See appendix IV
This often leads portfolio investments to be much more volatile. Foreign direct investment tends to be undertaken by multinational firms and involves the transfer of more than just non-financial assets such as technology and intellectual capital. The same mirror effect as seen in current account with relation to net exports is present with the portfolio investment and the capital accounts curve from 1987 to 1995. (Edwards, 1997)

Therefore the two major contributors of the capital and current accounts deficits and surplus are the portfolio investments and current accounts, respectively.

**Beyond The Tequila Crisis and Concluding Remarks**

After the events of the Tequila Crisis, Mexico saw its economic fundamentals improve substantially. Mexico’s inflation rate continued to drop from 48.95 in 1996 to 2003, where inflation remained constant at approximately 4%. Foreign investment slowly returned, once again, predominantly in portfolio assessments. Contrastingly, Mexico’s export industry has not been so resilient. Without taking into account oil exports, Mexico has maintained a trade deficit since 1997. This has led to very large differences between the capital account and current accounts, creating alternating deficits and surpluses since 1996. (World Bank Data Bank, 2013)

The events leading up to and following the Tequila Crisis have forever changed the Mexican financial system and the balance of payments. Some of these

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5 See appendix V
changes, still present today, include the move to a floating exchange rate and an increased conservative attitude towards lending. This has given Mexico one of the lowest private debt rates in all of Latin America, contributing to its relatively better economic state following the 2008 financial crisis (The Economist, 2012). However, even with economic improvement since the 1994 Crisis, Mexico faces increased political instability due to the drug wars.

It is evident, that the 1994 crisis was a pivotal moment in Mexico's economic history. An analysis of the balance of payments and their major contributors allowed for greater insight into the Mexican economic system and policies of today.
Appendix I

Current Account Deficit (% of GDP)

*Courtesy Haver Analytics
APPENDIX II

US Treasury Rate (2 year nominal) 1988-1995

*Courtesy of the US Federal Reserve
APPENDIX III

Figure 10
Exchange Rate

Currency Unit per $


APPENDIX IV

Relationship of current account, net trade and net income (all in current USD)

*Graph compiled using data from the World Bank*
Appendix V

Foreign direct investment and portfolio investment, 1987-1994
(BOP, current USD)
APPENDIX VI

CPI: Headline, core and non-core inflation

Annual percentage change

*All data courtesy of the Banco de Mexico

Foreign investment

Flows in USD millions

Trade balance excluding oil products

Flows in USD millions

*All data courtesy of the Banco de Mexico
Bibliography


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**Databases used**
