Egidio Carlino
Kevin Tarca
Matt Fedderson
Bill Dooley
Rob Goetze

The Mexican Peso Crisis of 1994

In the early 1900's, Mexico underwent a severe recession when the devaluation of the peso sent the country into shambles. After recovering from the peso crisis, Mexico was yet another country affected by the global financial meltdown in 2008. As they continue to recover today, they are economically concerned about mass amounts of unemployment, extremely low real wages, and unequal income distribution.

One of the most severe political shocks that began the Mexican peso crisis occurred on March 23, 1994 when presidential candidate Luis Donaldo Colosio was assassinated. Colosio's candidacy was almost guaranteed at the time, so when the assassination occurred this quickly raised the fear of financial instability and caused a brief financial panic. This immediately caused interest rates to jump, devaluing the peso. The assassination of Colosio was the first of many shocks that continued the Mexican peso crisis of '94.

Another major topic of concern in Mexico is the ongoing drug war that is seemingly tearing the country apart. This war is an ongoing-armed conflict between various drug cartels that are trying to gain control of specific regions and the majority of land in Mexico. Every time the Mexican government or a foreign authority makes an arrest in attempt to control this outrage, the violence picks up and more people are killed.

Mexico is currently slowly recovering from the recent 2008 United States recession. Mexico's market is made up of limited competition due to the presence of several private and public monopolies in almost every single industry.

In the beginning of the 1990's, Mexico was expected to outperform almost every other country in the world due to their spurring growth and latest economic stability. Soon to become a member of NAFTA, Mexico was viewed as a model of economic reform and had high hopes for the continued growth of their economy. Unfortunately, individuals failed to catch on to the fact that the monetary and fiscal policies of Mexico would soon deteriorate and would trigger an immense economic downturn for the country, later known as the Mexican peso crisis of 1994.

Mexico has proven that they are an efficient country to trade with. As of 2010 the total dollar amount of goods exported was $298.5 Billion, up from $229.7 Billion in 2009. This makes them the world's 15th largest exporter. Some main commodities that Mexico is currently exporting include: manufactured goods, oil and oil products, silver, fruits, vegetables, coffee and cotton. The main export partners of Mexico include, but are not limited to, the United States and Canada. The United States currently makes up 73.5%, while Canada only totals to 7%. This is largely due to the ease of trade and the North American Free Trade Agreement, (NAFTA.)

While Mexico proved to be the 15th largest exporter in the world, they also were very similar with importing. The total dollar amount of goods imported reached $234.4 billion in 2009 and then increased to $306 billion in 2010. They are currently the world's 16th largest importer. They are a vast importer of metal working machines, steel mill products, agriculture machinery, and electrical equipment. They also import large numbers of car parts for assembly, repair parts for motor vehicles, and aircrafts as well as aircraft parts. The major players in Mexican importing are once again the United States as well as China and South Korea. The United States accounts for 60.6% while China and South Korea only total for 6.6% and 5.2% respectively.

In the year 2000, after trade became easier as a result of NAFTA, the industrial sector accounted to nearly 90% of total export earnings. The auto industry in particular has a large part of the Mexican production. GM, Ford and Chrysler have all had plants Mexico since the 1930's while others such as Nissan have been late entrants to the country, constructing a plant in the 1960's. Mexico has also established itself as "The Television Capital of the World," because it is the world's largest producer of televisions. They achieved this in 2007 after they passed China and South Korea, and have continued as the number one since. In 2008 they achieved another outstanding production feat; Mexico became the 2nd largest producer of smart phones in the world. They are also now the 3rd largest producer of computers in the world with large numbers of computer companies being both domestic and foreign.

From the very beginning of Mexico's economic reform process, liberation of trade and controlling inflation was a focus of Mexico's policymakers. The new, more stable Mexican economy entered 1994 with the idea of becoming a more developed and industrialized nation in the world. NAFTA and the country's acceptance into the OECD in started the outside world that Mexico was on its way to becoming a legitimate player in the world economy and As a result, Mexican businesses began to import massive amounts of goods. Between 1988 and 1994, imports rose from $19 to $60 billion, an increase of over 300%. One primary reason why businesses were able to do this was because of Mexico’s anti-inflationary policy and fixed exchange rate regime. This initially was fixed to the dollar in 1988 as part of the Pact of Economic Solidarity Plan but later modified to a peg and an eventually to an adjustable band. Due to this policy, the Peso’s appreciation, and Mexico’s new unilateral trade liberalization, Mexican exports were not able to keep up with the rapid growth in exports. The trade deficit coincided with the foreign investment boom of the early 1990s and gross capital flows to Mexico surged from US$3.5 billion in 1989 to US$33.3 billion in 1993. This allowed the country to cover its growing trade imbalance and in time run unprecedented current account deficits although creating overvalue of the Mexican Peso at the same time.

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 come from portfolio investment which is very risky if not managed properly. Mexico’s policymakers failed to take consider this potential danger seriously and it ultimately came to fruition through their overvalued currency, growing current account deficit, and reliance on portfolio flows. The belief among Mexican policymakers was that the country’s economy would be attractive to foreign investors long enough for their dependence on foreign capital flows to diminish as the gap between imports and exports gradually closed. This belief was based the fact of the increasing competitiveness of the Mexican economy and the successful implementation of NAFTA.

The stability in the economy should have a created a sense of future optimism for Mexico but several factors led to Mexico’s demise. Beginning with the Chiapas uprising at the beginning of the year and culminating with the assassination of the 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 1994. To counteract this, in the last quarter of 1994 the Mexican government attempted to counter growing interest rates and monetary contraction with a large 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. The attempt to sterilize the fall in international reserves would ultimately fail and by December of 1994 Mexico's foreign reserves had dropped to approximately US$10 billion, not nearly enough to cover the outstanding US$30 billion held by investors in dollar denominated foreign debt. Mexico had no choice but to float its currency due to the lack of reserves to pay off its debt and would take years to build them up again.

Throughout the early 1990's the nominal exchange rate value of the Mexican Peso was pegged with the United States Dollar in the form of a fixed exchange rate. The stable exchange rate between the Peso and the USD encouraged U.S. investors to participate in Mexico's markets because there is no exchange rate risk for their transactions. At this point in time about 70% of Mexico's trade was with the United States and that made this fixed exchange rate the correct economic policy. Despite the nominal exchange rate not fluctuating because it was pegged to the dollar, the real exchange rate of the peso was depreciating.

The real exchange rate is a reflection of the purchasing power of its currency. Due to the changes in the relative rates of inflation in Mexico and the United States, the cost of Mexican made goods to Mexican consumers was increasing rapidly but the prices for the same goods for U.S. importers remained the same. The inflation rate from 1991 to

1994 had risen 30% compared to the U.S. in that same time. With purchasing power increasing only in terms of U.S. imports, Mexico relied heavily on such goods. The Mexican Government began to subsidize the purchase of U.S. imports and the Mexican people continued to purchase goods from the U.S., increasing the current account trade deficit.

The peso fixed to the USD at $.28 t 1 peso or 3.5 pesos to $1 in 1994 (See Chart 1). Mexican Pesos were leaving the country because the cost of Mexican goods was substantially more expensive than foreign goods. As a result of this the demand for the peso declined and the value of the peso fell as shown in this chart in early 1995 (See Chart 2). On December 20th, 1994 the Mexican Government decided to devalue to Peso 15% and within days decided to lose the connection to the USD and the Peso's value plummeted. (See Chart 3).

Political unrest in the nation caused for much turmoil between 1993 and 1994. The interest rates were skyrocketing throughout this time period on everything from 28-day promissory notes to 182-day CD's. The assassination of Luis Donalda Colosio in March of 1994, lead to an $11 billion dollar decrease in reserves over a 4-week period (See Chart 4). This caused the interest rates to rise due to much of Mexico's debt being in national bonds and Cetes. Rates at this time in 1993 in the U.S. were under 4% for 3 month Treasury Bills; the first time under 4% since 1965. Interest Rates were also affected by Colosio's death as the Central Bank drove them up after his assassination. After the election in 1994 the Central Bank lowered the interest rates again. In early 1995 the interest rate skyrocketed because the Central Bank wanted to tighten the money supply and slow economic growth, (See Chart 5). In 1993 Mexico had international capital inflows of over $30 billion due to the high interest rates domestically and the low rates abroad that the central bank needed to use sterilization to keep the money supply from expanding.

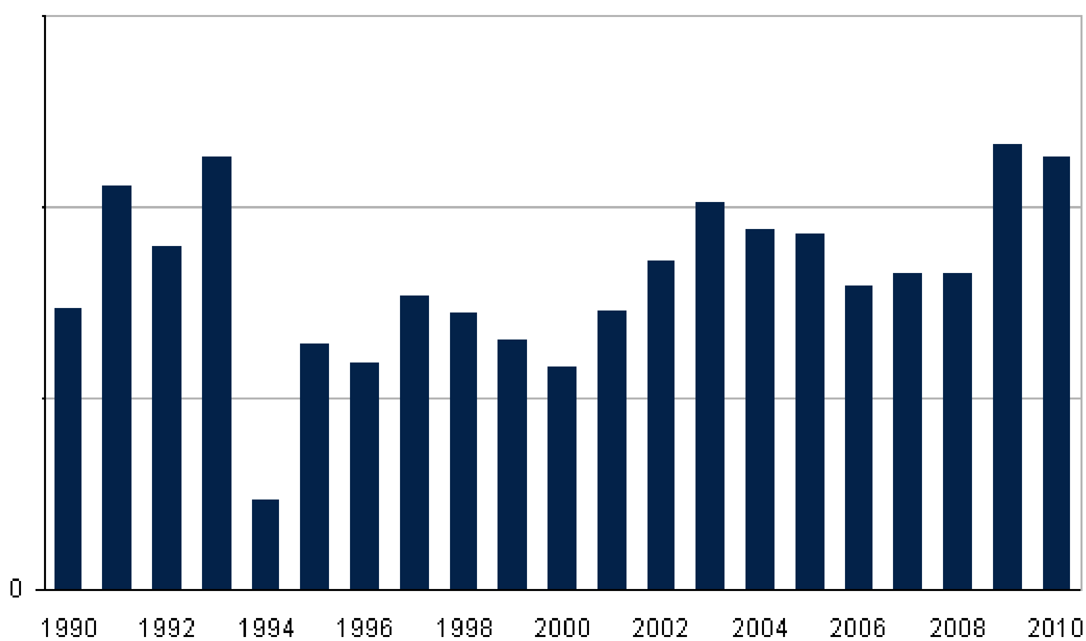
The idea of pegging the Peso to the USD was going to allow Mexico to keep a stable price level. However, a large spread in the Mexican CPI and the U.S. CPI meant Mexicans were exchanging their Pesos for USD and importing goods. Due to Mexico joining NAFTA this was made even easier. In November 1994 the CPI rose 48% due to the continued rise in price of domestic goods compared to imported goods from the U.S (See Chart 6). The purchasing power of the Peso was greatly reduced which led to the CPI skyrocketing from November 1994 until years later (See Chart 7).

The money supply in Mexico had a tale of rapid growth through the late 1980's and early 1990's. From 1989 to 1992 M1 (currency in the hands of the people and demand deposits) had risen 353% from which averaged to a little over 100% growth per year. M2 can show a bit broader spectrum of the money supply including short-term bank deposits and showed growth of 150% from 1989 to 1991. These sudden and drastic increases brought waves of high inflation rates as mentioned earlier and made it difficult for the Central Bank to control the exchange rate while still pegging it to the USD.

In 1995 Mexico had a $7.4 billion trade surplus due to exports being 30% in 1995 opposed to 1994 while imports fell more than 8% (See Chart 8). Leading up to the sharp and sudden real GDP decrease of 9.6% through the 3rd quarter in 1995, Mexico had 3%-4% steady growth in 1993-1994 (See Chart 9). Mexico exports increased due to the extremely low value of their currency and due to this severe depreciation they couldn't purchase imports at a high rate as in recent years. Less and less foreign investment capital was coming into the country at this point also affecting the output of the nation (See Chart 10). With large current account deficits, high interest rates, an extremely low exchange rate and poor consumer confidence Mexico could not support itself and needed to accept aid packages from the U.S. and Canada.

The Financial Crisis that occurred in Mexico was a direct result of the many factors previously explained in this analysis. The order and extent to which these factors occurred is important to note.

The crisis is noted to have begun in February of 1994. However, leading up to the crisis, Mexico grew rapidly until finally starting to control inflation in 1993. Economic expectations improved, both the real estate and financial markets were expanding, and



credit was in abundance. Back to February of 1994, the level of foreign exchange reserves peaked as a result of the past two months' growth.

During this time, capital inflows to Mexico were still relatively strong as a result of the approval of NAFTA by the U.S. Congress. What began to ignite this crisis is a combination between monetary policy in both U.S. and Mexico paired with political movement in Mexico at the time.

In February of 1994, the U.S. raised their interest rates, with expected increases for the future in hope to slow the fast growth the U.S. was experiencing during that time. Rates increased about six or so more times up until the final month of 1994. On the contrary, rates in Mexico fell in the meantime as a result of monetary easing. Aside from this reason for investors to move from Mexican markets to American markets, the assassination of a key presidential candidate, Luis Colosio, further provoked investors to invest elsewhere, increasing the outflow of capital in Mexico during 1994. During this time, both interest rate risk and political risk spiked for the Mexican economy. Mexico began implementing monetary policy tools to offset these instabilities associated in their economy. Shortly after the assassination, monetary policy was tightened, increasing rates. However, this was very short-lived and as we see now, not dramatic enough to prevent what was to happen next. At this point, Mexico's international reserves are falling quickly as seen in the previous graph. To sterilize the impact from the decrease in foreign reserves, domestics credit was increased significantly, increasing the monetary base as well.

What is interesting during this whole period was the shift in government debt held by foreigners. There were two prominent forms of debt at the time that investors sought to for investment, both similar to treasury bills with one big difference: one was denominated in Pesos (Cetes) while the other was denominated in the U.S. dollar (Tesobonos). Investors shifted their investments from say almost three quarters investment in Cetes and less than a quarter investment in Tesobonos, to the complete opposite with less than a quarter in Cetes and over three quarters in Tesobonos. Between both the monetary and political increases in risk associated with the Mexican economy, investors became focused on the exchange rate and worried of devaluation in the Peso, leading them to invest in dollar-denominated investments. To add to this, Tesobonos was a short-term form of financing the Mexican Government, increasing the pressure already associated in their debt problems.

During the second quarter, the Mexican economy saw a steep decrease in the capital account, followed by a small increase in capital market inflows during the third quarter. However, the fourth quarter washed out these inflows by even further capital outflows as investors again pulled back from the Mexican economy. Everything began to spiral out of control when Mexico decided to intervene with a strong devaluation of the Peso. Capital markets around the world reacted poorly of course to this change in their monetary policy, reserves fell sharply and confidence in the Mexican economy was shattered. Mexico was criticized for intervening too late and was ultimately punished in the capital markets.

In conclusion, NAFTA and other economic reform policies were intended to stimulate and expand the Mexican economy. Foreign investors tended to share this same optimism at the time seen by the amount of investment in Mexican markets. Contrary to the optimistic future planned in the early 1990’s, Mexico ended up underperforming other countries around the world. These countries were fortunate enough to learn to manage their capital flows more efficiently after seeing the consequences experienced by Mexico. Mexico’s fixed exchange rate with the United States came to an end after allowing the currency to depreciate roughly 15 percent. After unpegging the exchange rate, allowing a float, the value of their currency plummeted and the exchange rate spiked significantly. Due to this depreciation in the exchange rate, investors fled from the peso denominated CETES to the dollar denominated Tesobonos, shifting a large part of Mexico's financing to a short-term structure (Tesobonos), decreasing the future effects of monetary policy since a large portion of the country's debt will no longer be denominated in the currency of their country. Had Mexico responded sooner with the appropriate fiscal and monetary actions, the country may have been able to avoid or minimize the negative effects of the Mexican peso crisis of 1994.

Chart 1

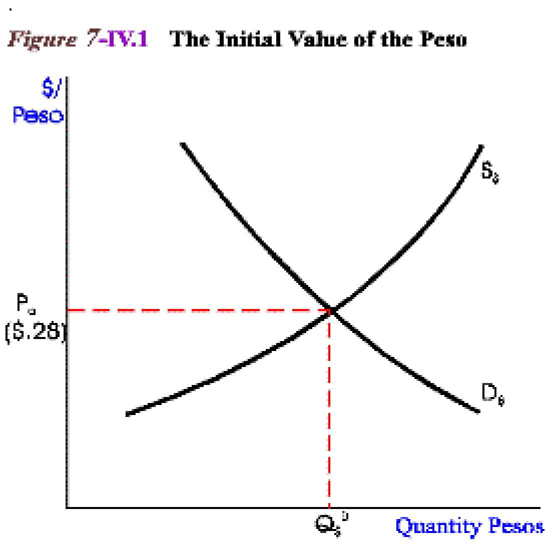


Chart 2

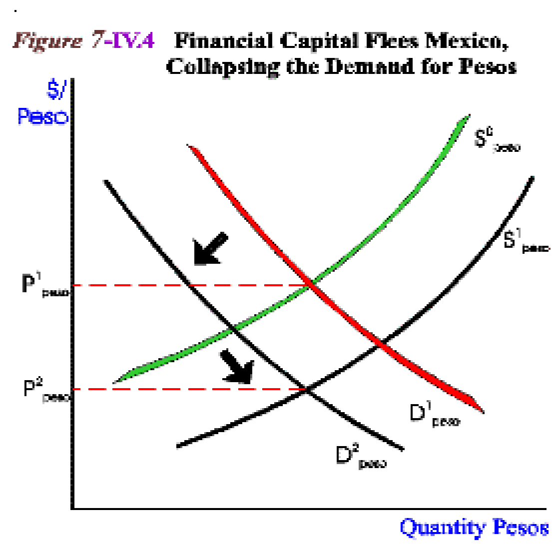


Chart 3

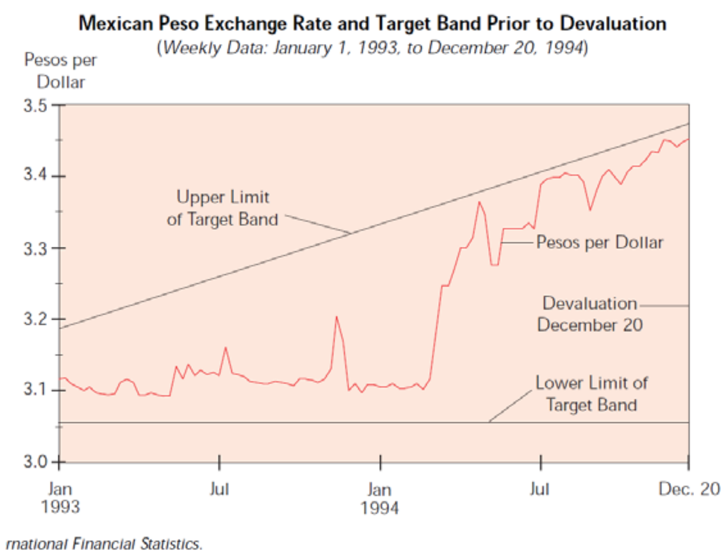
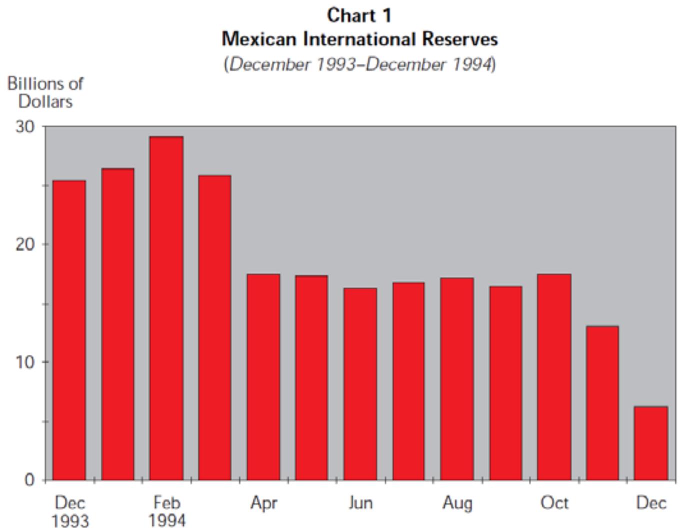
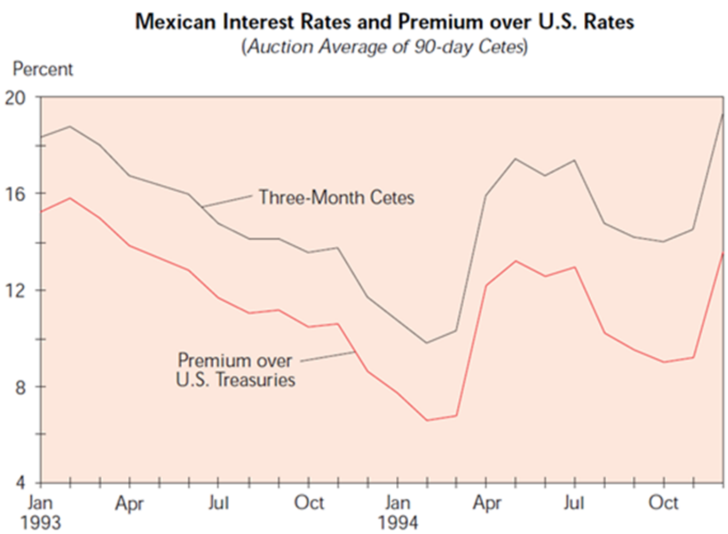


Chart 4



Source: International Monetary Fund (IMF), *International Financial Statistics*.

Chart 5



\nalytics.

Chart 6

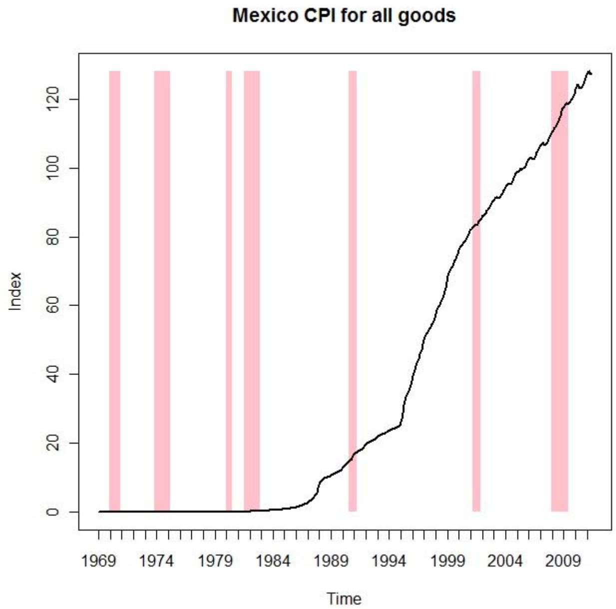


Chart 7

Chart 8

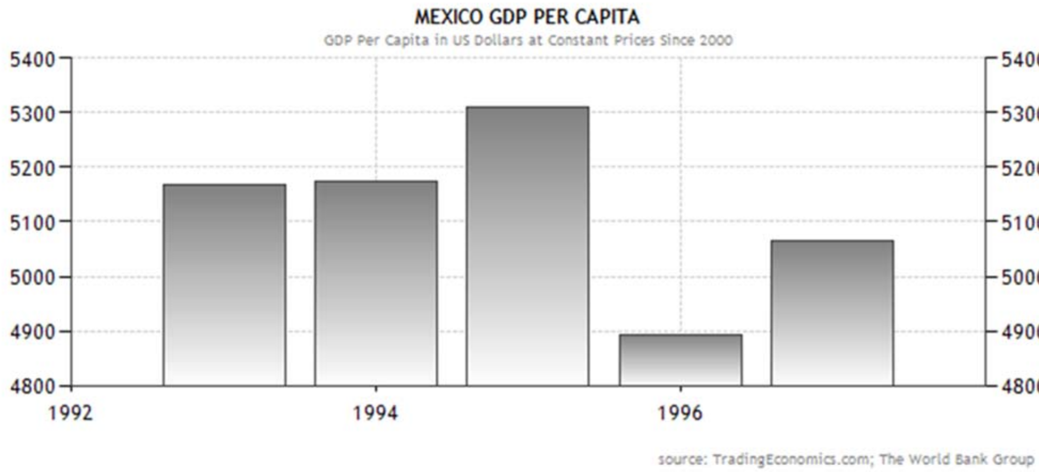


Chart 9

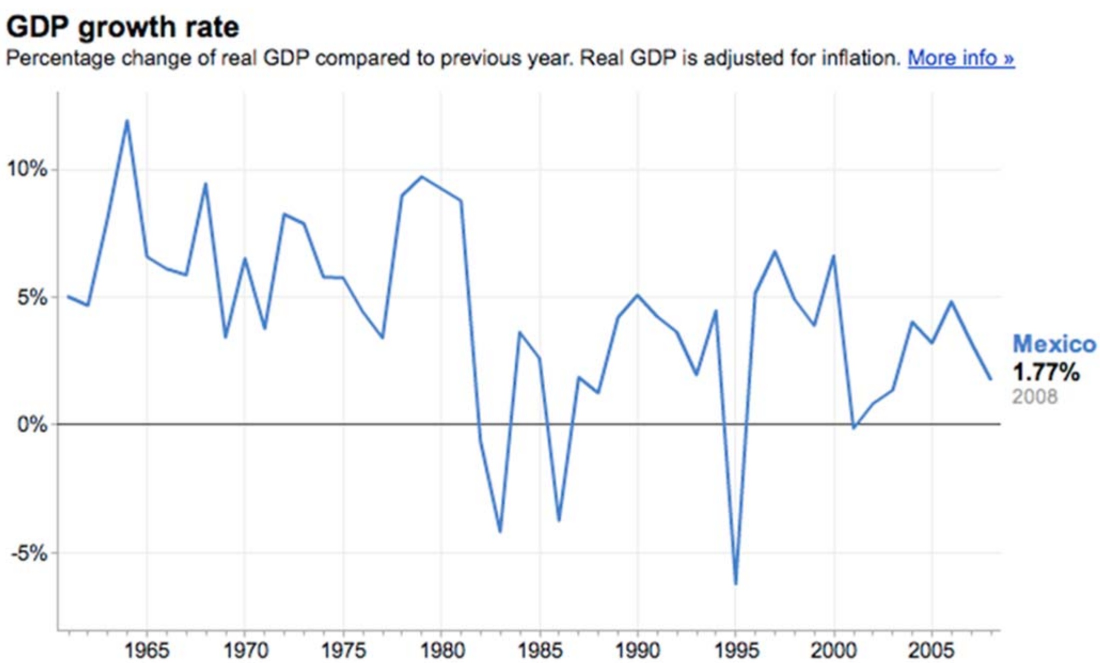


Chart 10

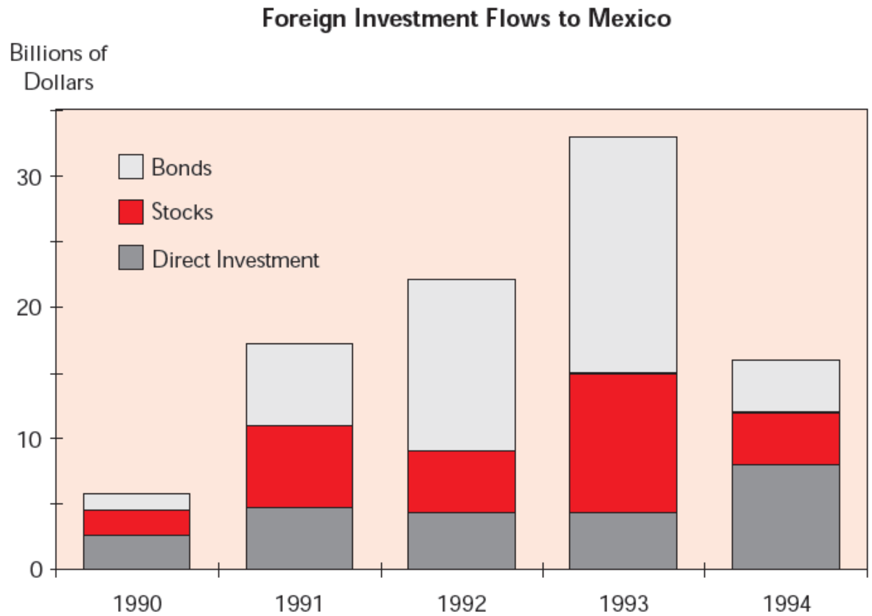
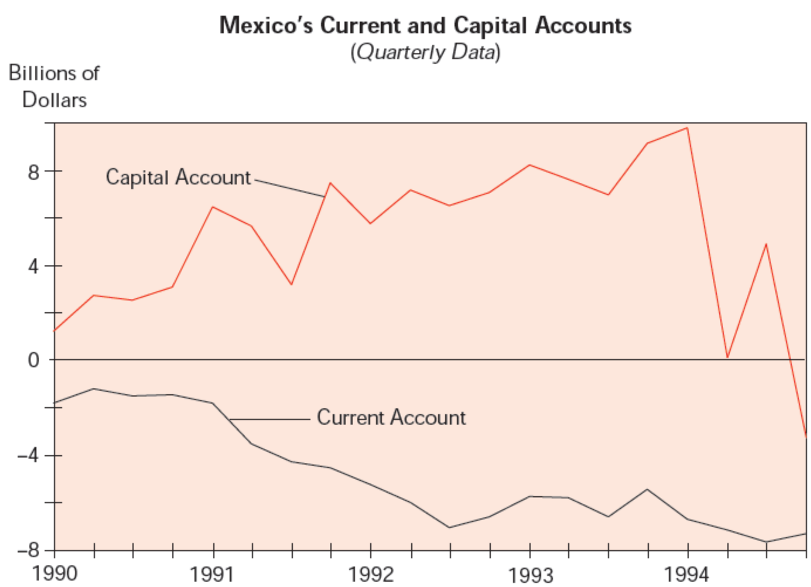


Chart 11



Work Cited

Banco de Mexico. *The Mexican Economy*. 1994 and 1995.

Calvo, G. A., & Mendoza, E. G. (1996, March). *Mexico's Balance-of-Payments Crisis: A Chronice of a Death Foretold.* Retrieved November 17, 2011, from Board of Governors of the Federal Reserve: http://www.federalreserve.gov/pubs/ifdp/1996/545/ifdp545.pdf

International Monetary Fund. *International Financial Statistics*. Various issues.

Mexican Current Account Deficit in the Early 1990's. (n.d.). Retrieved November 17, 2011, from http://www.galbithink.org/topics/mex/cad.htm

Mexican Monetary Lessons. *David R. Cheriton School of Computer Science | University of Waterloo*. Web. 17 Nov. 2011. http://www.cs.uwaterloo.ca/~alopez-o/politics/cj17n1-4.html.

Whitt, Joseph A. "The Mexican Peso Crisis." *Federal Reserve Bank Atlanta*. Web. <http://www.frbatlanta.org/filelegacydocs/j_whi811.pdf>.