PESOS, POLICIES, AND PREDICTIONS: WHY THE CRISIS--AND WHY THE SURPRISE?

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Celebrated at the December 1994 Summit of the Americas as the pacesetter for regional trade reform, Mexico basked in both the approval of its senior partner in the North American Free Trade Agreement (NAFTA), the United States, and the admiration of its Latin American neighbors eager to secure their own free trade pacts.\(^1\) Returning from the accolades of the Summit to the realities of a desperately shrinking base of international reserves, however, the Mexican government had no choice but to devalue the peso just two weeks later. A step devaluation of 15 percent came on December 20th and a free float—or, better put, a free fall—ensued just two days thereafter.

With panic in the air, the peso continued its decline through the early months of 1995 (See Figure 1). Nervous investors reacted by pulling assets not only from Mexican financial markets but also from Argentina, Brazil, and other Latin American emerging markets. The United States, anxious to restore confidence in a sinking Mexican economy, bypassed a wary Congress and aggressively coordinated with the International Monetary Fund to produce a US$53 billion loan package in late February 1995 (with US$20 billion coming from the U.S., US$18 billion from the Fund, US$10 billion from the Bank of International Settlements, and the rest from commercial banks and others).\(^2\) In March 1995, Mexico sought to further calm financial markets by announcing the outlines of a harsh new adjustment program in Mexico, one reminiscent of the sort of orthodox demand restraint programs common throughout Latin America during the early years of the 1980s debt crisis.

\(^1\)For a review of the Summit and its optimistic tone, see Wiarda (1995).
\(^2\)For a review of the U.S. rescue package and a comparison to the financial assistance rendered during Mexico's 1982 debt crisis, see Lustig (1996).
Figure 1.

Exchange Rate (end of period)
December 1987 - December 1995
The sequence of events in Mexico raises a series of important questions for economic theory and policy. First, why was a financial crisis of this magnitude not anticipated by rational agents, especially those international investors whom economic theory considers to be generally well-informed in their predictions concerning market behavior? Second, was there an alternative to both the policy that provoked the crisis and the policy response that followed---i.e., could Mexico have avoided the debacle of December 1994, and were there any viable alternatives to the austerity plan that followed? Finally, what lessons does the Mexican peso crisis offer, for the future of Mexico and for other Latin American countries still striving to maintain macroeconomic stability in today's context of open markets and greater regional integration?

This paper is organized as a series of responses to these key questions. My argument is as follows: While the timing of the crisis was clearly related to an unfortunate convergence of political pressures and economic mismanagement, the specific causal variable was an overvalued exchange rate that had long required correction. The failure to anticipate the volatile consequences of delayed adjustment was rooted in the ideological priors of Mexican policymakers and international officialdom---both of which held that within a relatively free market, the exchange rate must reflect confidence in the underlying fundamentals of the economy---and in the faith of international investors in the pronouncements of both groups. Moreover, the political costs of devaluation were rightly considered formidable, leading investors to believe that no Mexican President would willingly bring them on.

Waiting, however, merely delayed an ultimately unavoidable correction. One alternative to maintaining the unsustainable parity would have involved initiating a slow and controlled devaluation soon after the real exchange rate began to appreciate above historical levels in 1992. This, however, was precluded by the perception of the Salinas Administration (1988-1994) that any tinkering with the exchange rate would alienate portfolio investors and perhaps jeopardize Mexico's chances at entering NAFTA; instead, delay brought a major crash and financial panic once depreciation was forced upon Mexico. Given the tight corner that Mexican
policymakers had painted themselves into, there was little immediate alternative to the tough adjustment program launched in March 1995, largely because government officials had lost the credibility necessary for a less painful disinflation. Nevertheless, despite yet another heroic attempt at economic stabilization, the medium-term future looks clouded for Mexico and will remain so unless policymakers shift tracks in addressing some fundamental structural weaknesses, several of which are a product of the market reform process itself.

What Happened?³

As with Mexico's 1982 debt crisis, the December 1994 financial shakeout was a long time in the making. The crisis of the early 1980s called into question the inward-looking strategy that had undergirded Mexico's economic development for several decades. That model, state-driven import-substitution-industrialization (ISI), was rooted in both the nationalism of the Mexican Revolution and the subsequent profundización of this ethos under President Lazaro Cardenas (1934-1940), a period which included the acquisition by the state of the assets of international oil producers in Mexico and the first substantial attempts at land reform. However, ISI hit its economic and political stride in the 1960s and the "golden years" of the 1970s, when annual growth rates of nearly 6% suggested that this protectionist strategy had much to offer in terms of the government's modernization and industrialization goals.

In retrospect, GDP growth during the 1960s and 1970s was often driven by increased government spending on both public infrastructure and the subsidization of key state-owned industries. As the 1970s gave way to the 1980s, expansionary public expenditure increasingly relied on borrowed money, as rising oil revenues allowed for freer access to foreign savings. When the debt crisis broke in 1982 and oil prices tumbled through the ensuing decade, it became clear that debt-backed, state-led growth could simply not be sustained---a new development model was needed.

³The longer-term history in this section draws from Lustig (1992), Barkin (1990) and Cockcroft (1983); analysis of the more recent period stems from Pastor and Wise (1994) and Dornbusch and Werner (1994).
With fits and starts, Mexico embarked on what is now viewed as a vigorous program of structural adjustment, including liberalization, privatization, and deregulation. Despite the seeming thematic continuity of this post-1982 "neoliberal" approach, Mexican economic policy actually underwent several important variations over the course of the 1980s. The initial stabilization package prescribed by the De la Madrid administration (1982-1988), for example, was much more focused on macroeconomic stability than microeconomic reform and leaned heavily on the usual tools of currency devaluation and fiscal tightening. Unfortunately, the results were less than impressive: inflation remained stubbornly high while the sharp recession of 1983 was followed by an anemic recovery, then another sharp fall in 1986 as the decline in world oil prices reverberated through the economy. In 1987, inflation stood at 159.2%, an all-time high for modern Mexico, while GDP limped along at a 1.9 percent annual rate.\textsuperscript{4}

The revised neoliberal model adopted by President Salinas in 1988 shifted direction in both micro and macro policy. On the micro side, the Salinas administration was much more far-reaching in its efforts to privatize state enterprises, particularly the banks, and to liberalize both domestic prices and foreign trade and investment. Yet the real centerpiece was a new anti-inflation strategy that sought to break inertial inflation by applying wage and price controls, but against the backdrop of tight fiscal and monetary policy—the latter discipline being the factor that distinguished Mexican incomes policy from the much less successful approach employed by "heterodox" reformers in Argentina, Brazil, and Peru. Moreover, wage and price controls were not simply imposed by fiat; as Budget Secretary under De la Madrid, Salinas helped to design and implement a social "pact" (or Pacto) in 1987 which committed the government, business, and labor to price restraints.\textsuperscript{5} Particularly important was the government's decision to halt the peso's depreciation and to simultaneously liberalize imports, the rationale for the latter

\textsuperscript{4}The "shock therapy" adopted by De la Madrid failed partly because the government underestimated the extent of structural reform necessary to restore external and internal equilibrium. In light of the magnitude of the external shocks affecting Mexico, complete macroeconomic adjustment would have required an increase in access to outside credit and assistance in rescheduling loan payments, neither of which were provided by foreign lenders. For a more complete review of this period, see Nora Lustig, Mexico: The Remaking of an Economy, pp. 34-38.

\textsuperscript{5}See Dornbusch and Werner (1994: 287-289) for a detailed account of the various agreements that came under the rubric of the Pacto from 1987 to 1994.
being that import competition would serve as an additional brake on inflation.\(^6\)

The combination of sound fiscal policy, increased trade liberalization, and a creative incomes policy helped restore some degree of stability to the Mexican macroeconomy. Economic growth during the Salinas years averaged 2.8%, while inflation fell from the aforementioned level of 159.2% in 1987 to 7.1% in 1994. Real interest rates also fell from 16% in 1988 to the 4-6% range in 1991-92, before rising above 8% in 1994; this temporary interest rate decline, combined with an increase in the availability of consumer credit, financed an expansion in domestic aggregate demand which helped propel overall growth and led to a general rise in the sense of consumer well-being.

Yet, while the Mexican government was successful at controlling inflation and facilitating short-term economic growth, the use of the exchange rate as a price "anchor" within the context of the Pacto led to an increasingly overvalued real peso. The first negative consequence of this strategy was reflected in the trade figures: between 1987 and 1993, exports rose 46.5 percent while imports rose by 267.5 percent, reversing Mexico's 1987 trade surplus of US$ 7.2 billion, to a trade deficit of nearly US$ 22.9 billion by 1993; as can be seen in Figure 2, this pattern worsened over 1994.\(^7\) The trade deficit problem was compounded by the government's decision to aggressively increase personal credit for domestic spending. Imports burgeoned as Mexican consumers used their new easily attained credit cards to purchase a wide range of US goods that had previously not been available.\(^8\)

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\(^6\) Mexico had been on a more gradual schedule to liberalize imports in anticipation of its 1986 entry into the GATT, but it moved ahead of its GATT commitments in order to create a second level of price control via import competition; for example, the first Pacto halved the tariff rate and eliminated import permits (see Dornbusch and Werner (1995: 788)). It should be noted that exchange rate fixing was not fully incorporated into the various Pactos until mid-1988, several months prior to the Presidential elections.

\(^7\) Trade figures are taken from the *World Bank's World Tables 1995*, CD-ROM, and do not include *maquila* related imports and exports. IFS figures on the balance of payments now include such imports and exports, having shifted to such accounting several years ago; previously, the net earnings on *maquila* operations were included as services. The shift in accounting improves Mexico's stated trade balance to some degree and is arguably superior on theoretical grounds, but it should be noted that the accounting does not affect the overall current account balance but merely reallocates items within it. I use the *World Bank* accounting of trade in this section, partly because longer-term historical analyses (covering the whole 1980's era) have traditionally used these non-*maquila* series. I also use the IFS figures on international trade in Figure 12 below to maintain consistency; this monthly series also excludes *maquila* operations.

\(^8\) As Oks and van Wijnbergen (1995: 167) note, real consumer credit jumped at an annualized rate exceeding 50 percent between March 1989 and April 1992, fueling imports as well as domestic demand.
To finance the trade imbalance, Mexico turned to foreign investment. Unfortunately, as can be seen in Figure 3, the bulk of incoming capital consisted of highly mobile portfolio investments (the figures for "other flows" include debt-related borrowing which peaked in 1982; the brief resurgence in 1990 and 1991 reflects refinancing in the wake of the implementation of Mexico's Brady Plan for debt relief). While foreign direct investment (FDI) in actual production facilities increased a healthy 57.6 percent from 1989 to 1993, the more mobile portfolio investment rose by more than 8,000 percent. By 1993, portfolio investment accounted for 86.8 percent of total foreign investment in Mexico, compared to just 11.3 percent in 1989.¹⁰

Figure 2.

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¹⁰See the detailed analysis of debt flows in Oks and van Wijnbergen (1995: 161).
¹⁰All data on capital flows are based on the International Monetary Fund's *International Financial Statistics*, CD-ROM, March 1996.
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10 All data on capital flows are based on the International Monetary Fund's International Financial Statistics, CD-ROM, March 1996.
Figure 3.

Annual Capital Flows to Mexico 1980-94
This increased influence of portfolio investors left Mexico susceptible to rapid changes in investor expectations and confidence. As long as investor confidence remained high, the large level of portfolio investment was not particularly worrisome. However, as is evident in the quarterly data reported in Figure 4, the flow of external finance began to dry up in 1994, partly as a result of higher interest rates in the U.S. Just as important were the political crises associated with the Chiapas uprising (which seems to have caused a bigger exodus of Mexican capital—as measured by the usual capital flight variable of net errors and omissions—than a reduction in portfolio investment per se), the assassination of PRI Presidential candidate Luis Colosio in March 1994, and the uncertainties associated with the national elections held in August of that same year.

Figure 4.

Quarterly Capital Flows to Mexico
1993-95
Investors soon began to demand higher interest rates to compensate for both the perceived riskiness of an unstable political environment and ongoing increases in U.S. rates. Eager to calm investors' nerves and concerned that an interest rate hike in mid-1994 would provoke a mild recession as the nation headed into a Presidential election, the government instead converted much of its short-term peso-denominated Cetes debt to dollar-denominated Tesobonos in mid-1994.\textsuperscript{11} Whereas dollar-denominated Tesobonos constituted only 6% of the total foreign holding of government securities in December 1993, just a year later these new financial instruments accounted for 87% of the total.

The conversion to Tesobonos did not stem the tide, particularly as local investors became appropriately worried about the viability of the exchange rate. With trade still far from balance, foreign reserves (minus gold) plummeted from a high of US$29.3 billion in February 1994 to just US$6.3 billion in December 1994, a particularly alarming turn when one realized (and some soon did) that nearly US$30 billion worth of Tesobonos were due to mature in 1995 (see Figure 5).\textsuperscript{12} The decision to announce a step devaluation finally came on December 20, 1994, when dollar reserves were nearly depleted. Two days later, the peso was set to freely float (i.e., sink) as capital continued to hemorrhage outward.

\textsuperscript{11} The reluctance to hike interest rates was also due to legitimate concern about the fragility of the banking system, a topic addressed below. (See Sachs, Tornell, and Velasco 1995: 13)

\textsuperscript{12} These figures are cited from International Financial Statistics, CD-ROM, March 1996; Tesobono obligations are cited from Leme (1995).
Why Wasn't the Crisis Anticipated?

The Mexican case presents a striking anomaly for political economy. The December 20 devaluation and the forces that continued to drive the peso downward seemed to have caught international investors, academic economists, and even many high-ranking officials in the United States (with supposedly close ties to the upper ranks of the Mexican Finance Ministry) completely off guard.\textsuperscript{13} Yet, much of economic theory is built on the assumption that rational actors should be able to anticipate such market movements and to adjust accordingly.\textsuperscript{14} Following this logic, the persistence of investors in Mexican markets—and their shock at the consequent loss in their asset values—is more of a surprise than the devaluation itself.

In the wake of the devaluation, a virtual cottage industry of explanations has cropped up, ranging from Mexico's unexpectedly unstable political environment to the shift from peso-financed government debt into dollar-financed government debt.\textsuperscript{15} But while all of these explanations perhaps shed light on the timing of the crisis, they tell us little about why the crisis was not successfully anticipated. After all, the figures on Tesobono financing were widely known to investors playing in those markets and the political roller-coaster of 1994 could hardly have been a surprise to knowledgeable analysts on Wall Street and policymakers in Washington and elsewhere.\textsuperscript{16}

\textsuperscript{13} As Edwards (1995: 297) reports, a "number of international investment firms were still recommending Mexican securities to their clients" right up until December 20.

\textsuperscript{14} While such assumptions are particularly true of the 'rational expectations' school of macroeconomics, they are part and parcel of most economists' analyses.

\textsuperscript{15} See IMF (1995), Dornbusch, Goldfajn, and Valdés (1995), Sachs, Torneil, and Velasco (1995), and Springer and Molina (1995), among others. Heath (1995) offers a simpler explanation which focuses on money managers choosing new mixes (or target stocks) of Mexican and non-Mexican assets. According to this view, ambitious market reforms prompted high capital inflows from 1988 to 1993, as money managers strove to meet their new asset targets; the 1994 slowdown in flows was natural since this desired stock of assets had been obtained. Heath, however, offers no explanation for why it would take four years (1989-93) to reach this saturation point, as opposed to any other time frame.

\textsuperscript{16} Some investors have claimed that they were not sufficiently informed of Mexico's reserve figures, and there is some truth to this. As the IMF (1995:560) points out, a decline of one-third in international reserves since November 1994 was not announced until after the December devaluation. However, this notion of an information gap fails to explain why money managers seemed to believe that Mexico's current account deficits were sustainable over the longer term. Moreover, as Eichengreen and Fishlow (1996:40) point out, "the virtual unanimity that more and better information is necessary enables portfolio fund managers to find an excuse for their poor predictions. Once there is fuller information, the next crisis will fail to be foreseen for other, and also initially profitable, reasons."
There were some pundits who worried out loud about a coming currency crisis (including Dornbusch and Werner (1994), Pastor (1994), and Pastor and Wise (1994).\textsuperscript{17} As Dornbusch notes, the government seemed to believe that real exchange rate was an economic outcome and \textit{not} a policy tool; from this standpoint, the peso’s appreciation over the 1988-1993 period reflected increasing levels of confidence in the Mexican economy and hence a rise in underlying asset values, implying that the ongoing massive capital inflows were not problematic.\textsuperscript{18} On the other hand, the “disequilibrium” view adopted by Dornbusch and others suggests that the real exchange rate is a “policy-influenced or even policy-dominated variable.”\textsuperscript{19} According to this view, the use of the nominal exchange rate as an anti-inflation tool can produce real appreciation given the lags in reducing inflation (see the monthly data in Figure 6); the challenge is to shift away from exchange rate-targeting at the appropriate point and to live with slightly higher inflation, but stronger trade competitiveness.

\textsuperscript{17} Rogelio Ramirez de la O, a respected business economist in Mexico, wrote little in traditional academic outlets, but was advising investors through late 1993 and 1994 that a devaluation was inevitable.

\textsuperscript{18} In a slightly different take on the peso crisis, Atkeson and Rios-Rull (1995) offer a post-mortem which suggests that Mexico’s exchange rate (and fiscal and monetary) policy was “credible,” the problem arose when Mexican policy makers hit constraints on further international borrowing and, hence, were forced to devalue. Yet, it is difficult to understand how an exchange rate policy can be credible while a government is known to be bumping up against quantity constraints in international credit markets.

Figure 6.

Real Exchange Rate 1980-95
(period av., using Mex. CPI, US WPI)
The Mexican case drives home the point that such an anti-inflation strategy—when not accompanied by a timely shift back to depreciation—can become quite explosive. Interestingly, this negative outcome could easily have been anticipated if economists and investors had compared Mexican macroeconomic policy from 1988-1994 to the similar strategy employed by Chile between 1978-81; in both cases, trade liberalization was combined with a fixed exchange rate as a way to tame domestic inflationary pressures and, in both cases, the exchange rate subsequently collapsed.\textsuperscript{20}

To illustrate the parallels, I periodize the Chilean and Mexican cases along the following lines: (1) pre-reform (including a precipitating crisis, which for Chile was the socialist/populist regime of Salvador Allende, and for Mexico the impending debt crisis during the last years of the Lopez Portillo government from 1976-1982); (2) monetarist stabilization (which for Chile was the initial response of the Pinochet dictatorship that took over in 1973 and for Mexico, the De la Madrid administration's reliance on the traditional macroeconomic tool of devaluation); (3) exchange-rate targeting (which in both cases was coupled with trade liberalization to dampen inflationary pressures); and (4) the aftermath (which is, of course, still unfolding in Mexico but can be roughly projected on the basis of ongoing trends, past experience, and forecaster consensus).\textsuperscript{21} A close look at Table 1 and Figures 7 to 10 suggests just how reminiscent Mexico's crisis is of Chile's a decade earlier: the devaluation, I would argue, was less surprising than the fact that analysts were actually surprised.

\textsuperscript{20} Dornbusch, Goldfajn, and Valdes (1995) also draw a comparison with Chile.
\textsuperscript{21} The periodization scheme for Chile is drawn from the analysis in Pastor (1992) and Ramos (1986). The data for Mexican trade do not include maquila sales; the trends are roughly the same if we include such sales.
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<td>Sources: GDP growth, wage share, and trade from WORLD TABLES, 1995 (CD-ROM). December to December inflation from INTERNATIONAL FINANCIAL STATISTICS. Chilean real exchange rate from Ramos (1986); Mexican real exchange rate calculated using the period average exchange rate, domestic CPI, and U.S. WPI, with all data from WORLD TABLES, 1995 (CD-ROM).</td>
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Figure 7.

GDP Growth Rates, Chile & Mexico

Figure 8.

Inflation Rates, Chile & Mexico
Figure 9.

Real Exchange Rates, Chile & Mexico

Figure 10.

Trade Balance, Chile & Mexico
Why did savvy international investors miss what old-fashioned "exchange rate fundamentals" could have easily predicted? The answer lies, I believe, in three interrelated phenomena: (1) a set of ideological priors that convinced key policy makers and private sector analysts that a country playing so strongly by the market's rules could hardly wind up getting it wrong; (2) a perception that the political costs of devaluation were so prohibitive that no rational Mexican official would even contemplate this option; and, (3) a "herd instinct" on the part of investors that caused the stampede away from Mexican assets to be more dramatic than may have been necessary.

On the first point, it is important to recall that Mexican policymakers underwent a sharp ideological shift during the De la Madrid and Salinas presidencies. The obvious failures of ISI led to a firm embrace of the so-called "Washington Consensus," which held that markets could do little wrong and governments could do little but. While such a belief in the efficacy of the market is usually rendered in microeconomic terms—but for a burdensome regulation or inappropriate price control, markets would clear—there is a highly relevant macroeconomic counterpart.

Consider a macroeconomic equation in which the trade deficit is related to the government and savings deficits:

\[(M-X) = (I-S) + (G-T)\]

In the usual neoliberal story, trade deficits are primarily due to government deficits. The relative lack of concern about the savings deficit (I-S) arises from the view that the presence of "excess" investment opportunities will attract financing in international markets once the capital account is sufficiently liberalized; thus, if the government budget is balanced, large trade imbalances are simply signs that foreign financiers are optimistic about domestic economic prospects.22

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22 Some observers argue that, in fact, the Mexican trade balance was related to a budget deficit, albeit one that was non-traditional. The logic (see, for example, Heath 1995) runs that while public sector spending was largely covered by revenues, Mexican authorities allowed the rapid expansion of credit via the state's development banks (4% of GDP in 1994), a policy that was obscured by the government's 1993 decision to remove such financial intermediation from public sector balance figures. Sachs, Tornell, and Velasco (1994:6) counter that "most or all of such activities do not belong in an economically meaningful definition of a budget deficit," primarily because total lending is only a cost (rather than an asset) in the event of a bad loan and regulations on such development banks (in order to prevent losses)
This was certainly the picture projected in numerous interviews conducted with high-level Mexican policymakers in 1993 and 1994: The budget was more or less balanced, foreign capital was clearly interested in Mexico, and the resulting overvalued exchange rate was thought to reflect a "ratification" of the country's economic policy. A closer analysis would have suggested that Mexico's imbalances were actually the result of low savings and not simply high foreign investment; more wariness about the market would have sent some warning flags that the main form of foreign financing, portfolio investment, was exposing the country to some potentially destabilizing external shocks in the event of a shift in investor sentiment. Instead, both domestic and foreign decision makers bought into the government's own confidence.

This was, in part, because the political costs of a devaluation were perceived as too high, a not unreasonable view in light of the actual aftermath of the December 1994 devaluation. It was thought, for example, that any devaluation would have (and indeed did) slow the flow of portfolio investment (see the discussion of speculative attacks below) and therefore impose a large macroeconomic adjustment burden. Moreover, the peso's overvaluation played a useful political purpose by "masking" an underlying deterioration in income distribution that continued through the Salinas epoch.

As Table 2 indicates, the upper tenth decile of households gained during the 1980s, especially in the first period of "monetarist stabilization," while the bottom 70 percent saw flat or negative returns during the period of more intense market reform under Salinas. The usual distributional conflicts associated with such trends were ameliorated, however, by overvaluation's effect on the sense of general prosperity in Mexico. While real GNP per capita grew at a modest annual rate of 1.0 percent between 1988 and 1994, the growth of dollar GNP per capita skyrocketed at an average annual rate of 12.5 percent (see Table 3). Mexicans, with

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23 Interviews conducted in Mexico City, with follow-ups in 1995. See also the discussion in Heath (1995) as well as the argument along these lines in Aspe (1993: 190-193). Edwards (1995b: 274) concurs that high-level Mexican policymakers thought that since the capital "inflows were largely private ... this was an equilibrium phenomenon that did not call for policy action" and offers statements from the Banco de Mexico which reflects this view.
24 This period of Mexican policy making conforms neatly with models of political economy, in which governments try to solve time inconsistency and credibility problems by committing to a policy which would be extraordinarily costly to reverse—and thereby convince investors of the sustainability of such policies. See Rodrik (1989, 1995).
25 The results of the 1994 household survey are just now being released and are not incorporated into this analysis.
newly issued personal credit cards in hand, felt richer, and there was understandably little incentive for policymakers to remind them that they were not.

Table 2.

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<thead>
<tr>
<th>Household Deciles</th>
<th>1984-89</th>
<th>1989-92</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>2.3</td>
<td>1.7</td>
</tr>
<tr>
<td>I</td>
<td>1.4</td>
<td>-2.6</td>
</tr>
<tr>
<td>II</td>
<td>0.9</td>
<td>-1.2</td>
</tr>
<tr>
<td>III</td>
<td>0.4</td>
<td>0.1</td>
</tr>
<tr>
<td>IV</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>V</td>
<td>0.6</td>
<td>-0.1</td>
</tr>
<tr>
<td>VI</td>
<td>1.1</td>
<td>-0.4</td>
</tr>
<tr>
<td>VII</td>
<td>0.9</td>
<td>0.2</td>
</tr>
<tr>
<td>VIII</td>
<td>0.6</td>
<td>1.2</td>
</tr>
<tr>
<td>IX</td>
<td>1.0</td>
<td>2.1</td>
</tr>
<tr>
<td>X</td>
<td>5.0</td>
<td>3.3</td>
</tr>
</tbody>
</table>

* Households are ordered in terms of income (the first decile includes the poorest, the last deciles the richest).

Note: Real monetary income is calculated with the monthly average consumer price index of the Bank of Mexico for the same period as the household income survey.

Source: INSTITUTO NACIONAL DE ESTADISTICA, GEOGRAFIA E INFORMATICA.
ENCUESTA NACIONAL DE INGRESOS Y GASTOS DE LOS HOGARES TERCER,
Table 3.

Comparison of Real GNP and Dollar Value GNP
1982-1994

<table>
<thead>
<tr>
<th>Mexico</th>
<th>GNP per capita</th>
<th>Real GNP PC Index</th>
<th>Percent change</th>
<th>$GNP per capita</th>
<th>Real GNP PC Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>2,340</td>
<td>100.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>2,280</td>
<td>94.6</td>
<td>-19.7%</td>
<td>2,100</td>
<td>96.3</td>
</tr>
<tr>
<td>1984</td>
<td>2,100</td>
<td>93.3</td>
<td>-7.9%</td>
<td>1,900</td>
<td>97.4</td>
</tr>
<tr>
<td>1985</td>
<td>2,150</td>
<td>97.4</td>
<td>3.8%</td>
<td>1,950</td>
<td>90.5</td>
</tr>
<tr>
<td>1986</td>
<td>1,900</td>
<td>90.5</td>
<td>-9.2%</td>
<td>1,950</td>
<td>91.7</td>
</tr>
<tr>
<td>1987</td>
<td>1,950</td>
<td>91.7</td>
<td>-1.5%</td>
<td>1,950</td>
<td>91.2</td>
</tr>
<tr>
<td>1988</td>
<td>1,900</td>
<td>91.2</td>
<td>2.1%</td>
<td>2,210</td>
<td>92.5</td>
</tr>
<tr>
<td>1989</td>
<td>2,210</td>
<td>92.5</td>
<td>11.1%</td>
<td>2,570</td>
<td>94.3</td>
</tr>
<tr>
<td>1990</td>
<td>2,570</td>
<td>94.3</td>
<td>16.3%</td>
<td>2,800</td>
<td>96.7</td>
</tr>
<tr>
<td>1991</td>
<td>2,800</td>
<td>96.7</td>
<td>16.3%</td>
<td>3,440</td>
<td>97.3</td>
</tr>
<tr>
<td>1992</td>
<td>3,440</td>
<td>97.3</td>
<td>15.1%</td>
<td>3,730</td>
<td>95.7</td>
</tr>
<tr>
<td>1993</td>
<td>3,730</td>
<td>95.7</td>
<td>8.4%</td>
<td>4,010</td>
<td>96.9</td>
</tr>
<tr>
<td>1994</td>
<td>4,010</td>
<td>96.9</td>
<td>7.5%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


However, once reserves fell to a critical level, the government had no choice but to accept the political costs of depreciation. Once the truth was out about the unsustainability of the Mexican peso, financial markets rapidly entered into the "bust" phase of a typical "overlending/revulsion" cycle: In the two day period between the step devaluation and the decision to free-float the peso, Mexico’s international reserves fell by $4 billion.26

In its influential post-mortem of the crisis, the IMF has made much of this "speculative attack" on the peso. In this view of currency crisis, investors, increasingly aware of "deteriorating fundamentals," decide to abandon a particular currency and cash in their gains before the inevitable devaluation.27 This stampede naturally intensifies the economic pressure associated with deteriorating fundamentals and contributes to the overshooting of the exchange rate when it is finally devalued.28

Although this explanation enables us to better understand the severity of the pesos’s decline, as well as the phenomena of attacks, stampedes, and overshooting, it does not capture the element of complete surprise that is the focus of this section. After all, the difference in the

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27 The classic article on speculative attacks remains Krugman (1979); See also the overview in Agenor and Flood (1994).
28 Such overshooting occurred with the steep depreciation of the real rate up until March 1995 (see Figure 6), which was then followed by some recovery of the peso’s value thereafter.
rate of return between peso- and dollar-denominated government debt instruments was not very large through most of 1994, which indicates that few investors were lying in wait for a devaluation. Moreover, "catching on" to the economic fundamentals after the government's desperate measures on December 20 suggests little prescience by economic actors; panicking to abandon the currency instead reflects the usual fragility of financial markets.!

The failure to anticipate, then, was largely due to the belief held by both Mexican policymakers and their international counterparts that there was only one possible outcome for Mexico's market opening, that of success. Compounding this was the perception in Mexico City that any attempt to depreciate the peso would impose prohibitively high political costs. Yet, once these ideological and political thresholds were crossed, the volatile dynamics of financial markets took over, propelling the peso downward. And while the anticipation of these events was entirely possible, it would have required a more realistic assessment of the Mexican strategy from the beginning, as well as a more sober comparison of this strategy with the earlier Chilean experience discussed above.

One factor which prevented such an assessment was the highly exclusionary arrangements which have long characterized the Mexican political system. While the tight insulation of Mexican policymakers was key to their ability to single-handedly force through a sweeping program of liberalization and privatization, insulation and insistence on consensus among the technocrats stifled any constructive dialogue within the government over the need for a shift in the exchange rate. Moreover, removal from popular pressures prevented policy makers from learning how to build a broader "winners circle" from reform. The overall picture suggests that greater policy flexibility and a more democratic and accountable style of

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30. Lustg's (1995) analysis is different in detail, but her insistence that the financial crisis followed (and was due to) the devaluation squares with my notion that any speculative attack came after the Mexican government's announcement and actions on December 20.
31. "To be fair, U.S. Treasury officials were concerned about Mexico's potential overvaluation problem and quietly relayed their concerns to Mexican authorities; obviously, both sides found it easier to downplay this concern for fear of "spooking" the markets into the sort of speculative attack that eventually occurred. See David Wessel, Paul B. Carroll, Thomas T. Vogel, Jr., "How Mexico's Crisis Ambushed Top Minds in Officialdom, Finance," Wall Street Journal, July 6, 1995, p. A1.
32. See Pastor and Wise (1994) for a model of how institutional exclusion can "artificially" shift political costs and benefits and lead to "excessive" (in terms of political sustainability) reform.
management will be key for the full recuperation of the Mexican economy, a point to which the analysis now turns.

Was there an alternative before the crisis---or after?

If the crisis could have been anticipated, could it also have been avoided? In the wake of the crash, many authors have sketched out scenarios of possible "soft landings." Heath (1995), for example, suggests that the Mexican government was hoping that the award of an "investment grade" rating would attract new pension fund-based capital flows, even as exports and foreign direct investment were on the rise; this would have allowed both the exchange rate and growth to be sustained. Others argue that Mexican monetary policy should have been tightened, forcing a peso-protecting recession which would have resulted in a temporary but small adjustment and eventually resuscitated the "Mexican miracle."33

These scenarios, I would suggest, are unrealistic. Portfolio investment and reserves were on the decline through 1994; expecting an investment rating up-grade in this context is as wishful as the notion that typically risk-adverse pension fund investors would come streaming into Mexico in the quantities needed. Tightening monetary policy to defend the peso would also have been problematic, not simply because of election concerns but also because banks were carrying a large portfolio of non-performing loans, a trend which made policymakers fear the prospect of interest rate hikes. It is the latter that probably explains why authorities opted to convert peso-denominated government securities to dollar-denominated ones, hoping thereby to avoid the domestic interest rate hikes necessary to cover the risk of depreciation.

The real issue, as I have suggested above, is whether the government could have engineered a devaluation without triggering a financial panic---particularly since a more neatly executed devaluation could have promoted the surge in exports and foreign direct investment Mexico was counting on in its own "soft landing" scenario. There were at least two opportune

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moments for such a policy. The first was immediately after the March 1994 assassination of PRI presidential candidate, Luis Colosio. While this political event did ratchet up the anxiety level in both domestic and international circles, as reflected by a round of capital flight, such a political shock also created an opportunity to shift policy and cast the blame elsewhere without a major loss of credibility; after all, the U.S. and Canada immediately stepped forward with a US$7 billion swap facility to help cushion this blow. The Mexican government did take advantage of this moment to force through a 10 percent decline in the peso's value, but this gesture was too little, especially this late in the game.

The second opportunity came after the August 1994 elections when President Salinas could have devalued and thereby allowed the newly elected President Zedillo to take office with a more sustainable currency and little of the blame for the depreciation. That he did not is noteworthy, especially since De la Madrid granted Salinas this very same favor by devaluing significantly in 1987 to provide the leeway that allowed Mexico to more or less freeze the exchange rate and employ it as an anti-inflation anchor (see Figure 6). Some have attributed refusal to repay the favor to Salinas to his desire to close his administration on a successful note, and thus clinch his candidacy for the directorship of the new World Trade Organization. While such personal motives are plausible, perhaps more significant was the lack of coordination between the outgoing and incoming economic teams—and the institutional exclusion which had, on the one hand, allowed Salinas and his technocrats to finesse a major economic restructuring, but by the same token had allowed them to ignore the entreaties of Zedillo and especially Guillermo Ortiz, who eventually became Zedillo's Treasury Minister.

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34 Sachs, Tornell, and Velasco (1995:20-21) concur that "it is plausible that the investor community would have understood that the devaluation was prompted by a political disaster which was painfully observable to all;" Dornbusch and Werner (1994: 285) also suggest that there were "several days following the assassination of candidate Colosio during which the nation rallied behind the official party and that could have provided the cover for a realignment." The Zedillo team may have had such a political "cover" in mind in December when it devalued in the wake of an upsurge in fighting in Chiapas, hoping, it seems, that investors would blame Subcomandante Marcos and not Finance Minister Jaime Serra Puche for the depreciation. However, by this late in 1994, reserves were much lower and exchange rate declines were far more likely to provoke a speculative attack. Moreover, the resurgence of conflict in Chiapas was not an entirely unexpected event and did not provide as much political "cover" for the shift in policy. 35 The actual mechanism for the devaluation was to let the peso float up to the top of the exchange rate band that had been established and systematically widened over the previous year. 36 See Rosario Avilés and José Luis Gaona, "The Errors of December, 1994," El Financiero International Edition, December 25, 1995-January 7, 1996, p. 7.
In short, there was an alternative to the crisis—although it would have required some degree of political courage and the willingness of Salinas to "fall on his sword" in order to smooth the way for his successor. However, once the crisis began, there may have been little alternative to the policies undertaken by the Zedillo administration. Significantly, the original adjustment program unveiled in January did little to calm markets or stem inflation. Obviously, no program would have been credible until there was strong evidence that multilateral support would be forthcoming, something not clarified until late January and formally agreed to in mid-February by the US, the IMF, and other Paris Club leaders. With the mammoth US$53 billion loan package in place, the March program was able to halt the slide in the peso, restore some degree of voluntary capital inflows, and calm jittered nerves.

It did so by applying the same sort of orthodox medicine that had been common during the De la Madrid era. This included a tightening of fiscal policy, with reductions in real spending and increases in the value-added tax; tight limits on monetary growth; and a floating exchange rate designed to allow for further depreciation.\(^{37}\) This return to the past raises a significant question: why couldn't the Mexican government simply revive the incomes policies of 1988-94, albeit on the basis of a realigned real exchange rate (and therefore an output mix more tilted to the tradeable goods sectors)?

Again, the answer hinges on credibility. An incomes policy essentially involves an agreement by which business, labor, and government make promises—and keep them. With the government having lost the public's confidence, it has been unable to secure a credible level of sectoral cooperation on a new pact. Thus, inflation had to be fought the old-fashioned way: sharp increases in unemployment and a compression in real wages to signal to foreign investors that Zedillo's team was serious about stabilizing the economy.\(^{38}\) That there were few options to

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\(^{37}\) See CFR (1995:45). In keeping with Mexico's recent emphasis on social "safety nets," the program did include a shift of expenditures toward social and rural programs and the development of a modest public employment scheme for building new infrastructure.

\(^{38}\) See Rodrik (1989) on how governments sometimes need to "overdo" adjustment in order to restore credibility. It should be noted that a new pacto was signed in late October, 1995, but it eschewed exchange rate fixing in favor of a commitment to an anti-inflationary monetary policy. Unfortunately, inflation continued upward in the months following the pact.
this costly form of inflation-fighting may be true—but this does not make it any easier to administer yet another round of austerity to a population reeling from deepening distributional cleavages and frustrated by the unrealistically high expectations that Mexican policymakers had built around NAFTA's implementation.\textsuperscript{39}

\section*{What is the Future for Mexico?}

While there may have been little alternative to orthodox austerity in post-crash Mexico, the results thus far have not been particularly encouraging. In 1995, Mexican GDP plunged by about 6 percent; monthly inflation tapered down after the March and April surges in 1995, but was still unacceptably high and drifting upward by year's end (see Figure 11). Real wages in manufacturing fell by 15-20 percent and unemployment and informal work rose through 1995. The one bright spot was trade, as the peso's devaluation triggered the usual import-dampening effects of a recession, but also a healthy increase in the attractiveness and sales of Mexican exports (see Figure 12).\textsuperscript{40}

\textsuperscript{39}For a more detailed account of the distributional issues, see Pastor and Wise (1996).
\textsuperscript{40}The trade data come from \textit{International Financial Statistics} CD-ROM, March 1996, and, like the historical series presented earlier, do not include maquila operations.
Figure 11.

Monthly Inflation Rate, 1994-95

% change in CPI

0.0% 2.0% 4.0% 6.0% 8.0% 10.0%

Year:Month

CPlinf

Figure 12.

Monthly Trade Performance, 1994-95

(mil US$)

$2,000 $2,500 $3,000 $3,500 $4,000 $4,500 $5,000 $5,500 $6,000

Year:Month

monthlyexim

- Exports - Imports
While the trade turnaround is likely to push the 1996 growth rate closer to 3%, fundamental problems remain. One major drag on future Mexican growth is the ailing and chaotic state of the domestic financial system. The government, as noted earlier, was reluctant to raise interest rates in 1994 for fear of weakening the loan portfolio of the local banks, and now the too-long-postponed devaluation has compounded the problem. The resulting rise in the peso value of the banks' dollar obligations combined with steep interest rate hikes, now threaten the repayment prospects for bank-held loans. The ratio of bad loans doubled between December 1994 and October 1995 (up to 17.7%) and the government has responded by taking over failing banks and buying up non-performing loans from larger banks in order to assure their survival. It is now estimated that a bank bailout will cost $11 billion, just about equal to the proceeds the Salinas administration earned by selling the previously state-owned banks back to the private sector in 1992-93.

Tellingly, the financial crisis has spawned a new social movement of middle-class debtors in Mexico, who feel betrayed by the highly detrimental impact of the government's monetary and exchange rate policies. As noted earlier, consumer credit had been made more readily available during the Salinas era and middle-class Mexicans, still suffering the deprivation of slow growth and income declines of the early 1980s, eagerly borrowed. Predictably, the astronomical interest rates adopted to weather the recent macroeconomic storm have made debt servicing on credit cards and mortgages next to impossible. Consumers blame not themselves but erratic government policies and have formed the so-called "Barzón" movement to seek debt relief.

The Zedillo administration has not taken the Barzón's demands lightly, as it is usually the middle class that prompts major political realignments. The government agreed to a Debtor's Aid Program in September 1995 which included measures to postpone foreclosures

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43 The Barzón movement was originally focused on rural debtors seeking to prevent bank foreclosure on their farms but has since spread to urban areas.
and cap the interest rates affecting most credit card holders for at least one year. While this may bode well for greater economic and political stability, it raises the costs of a bank bailout by forcing the government to absorb interest losses and requiring that the banks continue to hold potentially bad loans.

What is the longer-run future for Mexico? The pessimism prompted by the peso crisis has obscured some of the more constructive features of the country's recent economic restructuring: a developed industrial base, a relatively skilled and hard-working populace, and privileged access via NAFTA to a huge external market. As much as the Zedillo administration has tried to shift the focus to this longer-term picture, there are still two main challenges to a sustainable economic recovery.

First, it is very difficult to hit a viable economic stride, when the short-term scenario remains so unclear; unless inflation can be moderated, credibility restored, and a social consensus achieved, Mexico may simply stagger from crisis to crisis. Second, Zedillo's longer-term development strategy seems to be hampered by the same sort of deep ideological attachments that prevented policymakers from anticipating the December 1994 crisis. The President's "National Development Plan" unveiled in mid-1995 embraces the market wholeheartedly, promising 5 percent annual growth rates even though the country intends to do little in the way of developing new industrial policy or placing limits on the volatile capital flows that shipwrecked Mexico in December 1994.44

Recalling Mexico's resemblance to Chile, it is useful to ask what the latter country did in the wake of its own crisis. Chile wisely abandoned its attachment to fixed exchange rates and learned to live with slightly higher inflation but a more competitive exchange rate, Mexico initially appeared to be following suit although there has been an upward drift in the real value of the peso over 1996. In order to stimulate domestic savings, Chile pursued a creative privatization of worker pensions, an approach that is just getting underway in Mexico.45

45 For details on the new pension fund scheme, see Patricia Goméz, Rafael Paredos, Salvador Rico, and Victor González, "A Pension Fund to Encourage Savings," El Financiero International Edition, April 15-21, 1996, p. 10. some have argued that the new pension scheme will not actually encourage an increase in savings but simply induce a
Chilean policy, however, moved in directions not being mimicked by contemporary Mexico. In order to stare off trade imbalances, Chile temporarily raised domestic tariffs, an option not as readily available to Mexico in the post-NAFTA era. Most significantly, Chile departed from a strictly "hands-off" market-orientation and instituted measures to tame the destabilizing financial surges which still torment Mexico, including taxes on capital movements and requirements that incoming capital commit itself to a minimum stay before being allowed to exit the country. Finally, Chilean policy makers worked toward improving the distribution of income by combining a social safety net scheme with stable macro-economic management, particularly after the Pinochet regime gave way to a democratically elected government.\textsuperscript{46} This last aspect of the Chilean reform process—so crucial for achieving political stability—remains to be tackled in Mexico.

In short, the Chilean recovery involved a blend of orthodox and heterodox policies in order to emerge from crisis and lay the groundwork for more sustainable growth.\textsuperscript{47} Some may suggest that another key element in this turnaround was the authoritarian ability to force through reform. It helps to recall, however, that the Pinochet regime was also responsible for the disaster of the late 1970s—and that the thick insulation of Mexican policymakers proved to be no antidote to bad economic policy. The key to a better economic future, I would suggest, lies not in political exclusion but rather in an increased willingness to be realistic and practical in the determination of new policies.

Indeed, the peso crash of 1994—particularly the failure of policymakers and markets to fully anticipate the problem—suggests the weakness of policy frameworks which are excessively ideological and decision-making institutions which are authoritarian and exclusionary. Mexico now faces a choice between ideology or pragmatism, traditional politics or further democratization. Perhaps the biggest lesson from 1994 is that if we are to avoid another

\textsuperscript{46} For various perspectives on the Chilean reform during the 1980s, see Bosworth, Dornbusch, and Labín (1994).
\textsuperscript{47} Colombia, another relative success in the panorama of Latin American reform, has thrived on a similar combination of orthodox and heterodox policies.
"surprise"—in Mexico or in any other Latin American country—what is likely needed is a bit more modesty about the benefits of market liberalization and a much stronger commitment to openness, transparency, and flexibility in the policymaking process.
Bibliography


