VI.

IMF Governance in a Crisis: Mexico, 1994–95

Mexico had begun to experience financial turbulence in March 1994 when strong growth and rising interest rates in the United States prompted investors to reassess portfolios in emerging markets while, on the domestic front, the assassination of presidential candidate Luis Donaldo Colosio heightened investors' concerns. When capital flight reached alarming proportions in March–April 1994, the authorities allowed the peso to depreciate to the top of the exchange rate band, doubled short-term interest rates, and obtained stand-by lines of credit from the United States, Canada, and the BIS. To reduce investors' concerns, the authorities replaced peso-denominated government debt by short-term instruments indexed to the U.S. dollar ("Tesobonos"). The vulnerability of the economy sharply increased when, in a few months' time, the issuance of Tesobonos increased by $22 billion.

The use of the exchange rate as a nominal anchor had led to a significant and persistant real effective appreciation of the peso during 1988–93. This appreciation and continued trade liberalization prompted a widening of the external current account to 6.5 percent of GDP in 1993 from 2 percent of GDP in 1988, and to 8 percent in 1994. While fiscal and wages discipline were maintained, persistent losses of foreign exchange reserves and declining stock market prices during 1994 became indicative of faltering confidence.

On December 20, 1994, shortly after President Ernesto Zedillo took office, the peso was suddenly devalued by 15 percent without flanking macroeconomic measures. A persistent hemorrhage of foreign exchange left the authorities with no alternative but to float the peso. These decisions had a devastating impact on confidence. With massive short-term foreign debt falling due for a total of approximately $50 billion in 1995 as a whole, the announcement, on January 2, 1995, of a U.S.-led swap package of $18 billion did not calm the financial markets.

The Mexican authorities were reluctant to request IMF financial assistance that, they thought, would not be helpful to resolve what they regarded as a confidence crisis. Moreover, Mexico had become a member of the OECD and the North American Free Trade Area (NAFTA) and believed its North American and European friends would extend it the necessary financing without IMF-type conditionality. In European capitals,

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however, the Mexican crisis and its contagion effects in the Latin American region were seen as problems for the United States to handle.

In late December 1994 and early January 1995, IMF staff missions held discussions with Mexican officials. The Managing Director, Michel Camdessus, met with the new Finance Secretary, Guillermo Ortiz, who announced that Mexico would seek IMF assistance. Mr. Camdessus then visited Mexico City for discussions with President Ernesto Zedillo. All through the month of January 1995, the Managing Director kept Board members informed in a series of confidential briefings.

On January 12, 1995, President Clinton requested the U.S. Congress to extend $40 billion in loan guarantees to Mexico. When it became clear that Congress—dominated by the Republican Party—would not give its support, the President withdrew his request on January 30 and announced that he would use his authority to provide Mexico with a much-reduced package of up to $20 billion in loans and loan guarantees through the Exchange Stabilization Fund.

The turn of events with regard to U.S. financial support and the state of extreme uncertainty in Mexico, pending the announcement of a comprehensive policy package, thrust the IMF, de facto, into a position of lender of last resort. This put an unprecedented responsibility on the Managing Director to act immediately and raise IMF financing to a level that would convince investors, cut short the slide in the markets, and mitigate the domestic impact of a crushing adjustment burden.

On January 31, 1995, the day after President Clinton scaled down the U.S. proposal of financial assistance, the Managing Director proposed to the Executive Board that the IMF provide Mexico with SDR 5.25 billion ($7.8 billion, equivalent to 300 percent of Mexico's quota) outright upon approval of a stand-by arrangement, rather than in several tranches as had been considered earlier. In addition, the IMF would stand ready to provide up to SDR 6.81 billion ($10 billion), unless that amount, or part thereof, could be raised from bilateral creditors. The formulation of the latter proposal should be seen in light of the fact that a package of $10 billion from industrial countries through the BIS was unlikely to materialize because of the rigid conditions that were attached to it. Under the circumstances, the Managing Director argued that the IMF had no alternative but to stand ready to provide the additional financing from its own resources.

In an evening meeting on February 1, 1995, which started at 6 p.m. and lasted until midnight, the Executive Board approved a stand-by arrange-

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ment for Mexico in the amounts mentioned above, the largest IMF financing package proposed up to that time; the arrangement would run from February 1, 1995 to August 15, 1996 and would be subject to four Board reviews during that period. Several Western European Board members abstained from voting on the package, however, on the arguments that the proposed financing was too large, that the immediate access to 300 percent of quota was excessive, and that the Mexican policy program was too weak and its assumptions too optimistic.

The arguments with regard to the quality of the Mexican program were well taken. The peso continued to slide until March 9, 1995, when President Zedillo and Finance Secretary Ortiz announced much-strengthened measures that would decisively improve the fiscal position for 1995, tighten monetary policy to provide the nominal anchor for the economy, free wage negotiations, and introduce measures to repair the banking system and the loan restructuring facilities. Shortly thereafter, the peso began to strengthen and Mexico soon regained access to international capital markets. By the third quarter of 1995, real GDP was already rising again, helped by the fact that the basic structure of the economy was in much better shape than before and by a favorable external environment. Nevertheless, the year 1995 as a whole was the worst for Mexico since the debt crisis, with output falling by 6 percent, unemployment doubling, prices rising by more than 50 percent, real wages falling by 11 percent, and the financial system in need of fundamental repair.

In the third review of the program, on December 15, 1995, Executive Directors observed that a new round of turbulence had hit Mexico in October–December 1995 and that the authorities had drawn further on the available IMF financing, to a total of SDR 10.6 billion at the end of 1995. In each of the first three reviews, many Directors noted with concern the delays in the availability of U.S. financing through the Exchange Stabilization Fund. Indeed, the U.S. Congress was looking closely over the shoulder of the Administration. The cost of using U.S. financial assistance was distinctly higher than the cost of IMF credit: in addition to all costs and fees, Mexico had to pay interest charges that covered the credit risk, had to deposit an assured source of repayment (the proceeds of oil export sales), and had to agree to use fiscal and monetary policy, including increases in interest rates as needed, to stabilize the peso. By the time of the fourth review, on August 2, 1996, economic recovery was clearly under way, financial markets had stabilized, the policy conditions of the agree-

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ment were observed with ample margins, and attention was shifting toward urgent structural reforms in the financial system, tax reform, social security reform, and privatization.

In the following years, Mexico's economic performance and external position continued to strengthen and major progress was made in implementing structural reforms. Mexico's determined policies were a wise strategy to avoid the turbulence occasioned by the Asian, Russian, and Brazilian crises. Before the end of 2000, Mexico's borrowing from the IMF had been completely repaid.

In the wake of the Mexican crisis, the Managing Director, Mr. Camdessus, was anxious to draw the lessons for the IMF and its members. Following extensive discussion—based in part on a confidential report on the crisis and Mexico's relations with the IMF, prepared by Sir Alan Whittome, a former senior staff member—the Executive Board took decisions that focused on four areas:

First, new internal procedures to foster a more effective and continuous dialogue in the intervals between regular annual consultations, particularly when countries have just completed an adjustment program with the IMF.

Second, stricter requirements for the regular and timely communication of key economic indicators and of standards for the publication of data to enable markets to function more efficiently. That initiative led to the establishment of the Special Data Dissemination Standard to which members with, or seeking, access to capital markets have been encouraged to subscribe.

Third, more focused scrutiny of the capital account of the balance of payments and the sustainability of capital flows, as well as increased emphasis on developments in the financial sector and in external debt management.

Fourth, more candid, sharp, and transparent surveillance. In its policy dialogue with members, the IMF should be more critical and its analysis more pointed. Informal Board meetings on sensitive country matters were organized, while world economic outlook discussions in the Board were supplemented by periodic discussions of financial markets.

The following observations should be added to conclude this survey of IMF governance and the Mexican crisis of 1994–95.

First, the magnitude of the financial assistance proposed on February 1, 1995, was justified in view of (1) the inevitable impact on market confidence of the scaling down—under pressure from the U.S. Congress—of

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the U.S. Administration's proposal of financial assistance to Mexico to $20 billion from $40 billion; (2) the size of Mexico's short-term external debt of about $50 billion falling due in 1995; (3) the fact that the $10 billion lending package from industrial countries through the BIS was loaded with conditions that proved to be unacceptable to the Mexican authorities; and (4) the continued slide of the peso, which risked becoming a rout in the absence of convincing adjustment policies, which materialized only in March 1995.

Second, the cost of the 1994–95 crisis for the Mexican economy was sharp but short because of the decisive support from the IMF and because the economy had become stronger and more shock resistant. In the 1982 crisis, Mexico had needed several years to recover because the underlying structures, particularly the corporate sector, financial markets, institutions, and legal system, were then much weaker.

Third, the Mexican crisis of 1994–95 was not the first crisis of financial globalization. In fact, the first crises of the new era occurred in Europe, among high-income, industrial countries, such as the Nordic banking crisis, which struck Finland, Norway, and Sweden between the late 1980s and the early 1990s, and the crises of the European Monetary System (EMS) in 1992–93. Several of the principal fault lines of the Nordic and EMS crises appeared again in the Mexican crisis and would reappear, in differing circumstances and degrees, in 1997–98 in the Asian crisis.

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