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The United States

to the rescue: financial

assistance to Mexico

in 1982 and 1995

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This article analyses the financial rescue measures taken by the United States in the Mexican payments crises of August 1982 and January 1995. On both occasions, Mexico was on the brink of suspending payments on its external debt, and both times this was avoided thanks to rescue measures. The implications of the two financial rescue programmes were very different, however. The measures taken in August 1982 were followed by a period of many years in which Mexico was practically excluded from private loan markets. In contrast, the 1995 rescue programme was quickly followed by renewed access by Mexico to private capital markets. What is the reason for these different reactions by the markets? One important reason is that the amount of resources involved in 1995 was very large, and these were not short-term funds, as they had been in 1982. Although the 1982 financial assistance allowed Mexico to avoid suspending its payments, it was not enough to overcome the country's over-indebtedness. In the following six years, Mexico had to limp from one debt restructuring exercise to another, which created great uncertainty and affected the economy's capacity to achieve a sustained recovery. The success of the 1995 rescue programme was also due to other factors: on the one hand, the external conditions were much less adverse, and on the other, the Mexican economy was in a much better position –after several years of restructuring measures– to respond with an export surge to the changes in the exchange rate that took place in the context of the payments crisis.

I

Introduction

In January 1995, as in August 1982, Mexico was on the verge of defaulting on its foreign obligations. On both occasions the U.S. government arranged a financial rescue package to avoid this. However, the support provided by the United States administration in 1995 was quite different from the previous one. This paper will describe and compare both rescue packages and seek to explain the reasons for some of the main differences in the U.S. response. Although on both occasions there were other key participants—especially the International Monetary Fund (IMF)—this paper will focus on the role played by the United States.

The financial rescue package in 1995 was much larger and its objectives in some respects more ambitious than in 1982. Measured in constant U.S. dollars, the financial assistance arranged in February 1995 (up to US\$ 48.8 billion) was roughly seven times larger than the US\$ 4.55 billion (US\$ 7.2 billion in constant 1995 dollars) rescue package arranged in August 1982,¹ and the contribution of the United States (up to US\$ 20 billion) was more than three times its contribution of US\$ 3.625 billion (US\$ 5.7 billion in constant 1995 dollars) in 1982, although the actual U.S. contribution of US\$ 13.5 billion in 1995 was equivalent to more than twice the 1982 contribution in real terms. Furthermore, whereas in

1982 the United States loans were to be repaid in one year, the bulk of the loans extended in 1995—US\$ 10.5 billion of the total of US\$ 13.5 billion—are to be repaid between June 1997 and June 2000. The medium-term quality of the U.S. loans is, next to their magnitude, the most important difference between the two rescue programmes.² This remains true even though, in actual fact, Mexico took only two years to repay the whole of the United States loans.

There are two items that highlight the overwhelming success of the 1995 rescue measures. Firstly, if success is measured by the time it took Mexico to regain access to international capital markets, the assistance provided in 1995 was incomparably more successful than in 1982. The rescue package negotiated in August 1982 with the U.S. Treasury, the U.S. Federal Reserve and other Central Banks of industrialized nations was designed to provide interim financing. Its ultimate aim was to avoid a banking crisis of international proportions and to give the Mexican Government additional time to negotiate a workout with its creditors and an accord with the IMF. It was not, however, meant to solve the more fundamental problem of Mexico's over-indebtedness: a problem that would haunt that country as well as many others for the rest of the decade. Between 1982 and 1989, Mexico was practically cut off from private voluntary lending of any sort.

In contrast, the U.S./IMF-led rescue package of February 1995 was designed to solve Mexico's liquidity crisis in full, and it was large enough to allow the conversion of a large portion of the short-term Mexican Government debt with the private sector abroad into medium-term debt, primarily with the U.S. Department of the Treasury and the IMF. The success of these measures may be seen from Mexico's rapid recovery of access to private capital markets. As early as April 1995, one of Mexico's

□ This paper greatly benefited from conversations with Jesús Silva Herzog and officials from both governments and multilateral financial institutions. The author is very grateful for their invaluable comments and insights. She also wishes to give very special thanks to Paul Volcker for his comments on an earlier draft. She is also indebted to Michael Armacost, Albert Fishlow, Lincoln Gordon, Carol Graham, Peter Hakim, Steve Kamin, Daniel Marx, Darryl McLeod and Sidney Weintraub for their very helpful comments, corrections and suggestions on earlier drafts. Thanks are also due to Shihua Lu, Janet Herrlinger, Christianne Hall and Rachel Cohen for their valuable assistance. The views expressed in this paper, and any errors it may contain, are of course entirely the responsibility of the author.

¹ This calculation does not include the Extended Fund Facility (EFF) for US\$ 3.7 billion negotiated between the Government of Mexico and the IMF at the end of 1982, because this was not part of the rescue package arranged in August. If this amount is included, then the 1995 package was roughly four times larger than in 1982.

² Previous U.S. financial assistance for Mexico was always in the form of short-term swaps, usually payable within six months, with the exception of the August 1982 loans (General Accounting Office, 1996, p. 150).

State-owned development banks was able to return to the international capital markets, and between mid-1995 and February 1996 the Mexican Government was able to raise more than US\$ 8 billion, with the maturities and terms of the loans improving.³ Furthermore, this access to the capital markets allowed Mexico to pay off all its United States loans long before their maturities.

By the end of January 1997, this debt was repaid in full, although according to the original repayment schedule the medium-term swaps totalling US\$ 10.5 billion were repayable between June 1997 and June 2000.

Secondly, the available data indicate that the rescue package seems to have also succeeded in restoring financial stability in Mexico, as evidenced by the reduced volatility of the peso since November 1995, the drop in domestic interest rates, and the smaller risk premium on Mexican securities denominated in dollars. However, the package was unable to prevent a major recession in Mexico, the largest since the 1930s: in 1995 output fell by close to 7% and real wages by more than 20%. Nevertheless, since 1996 there are signs that economic recovery is under way: the economic growth rate in that year was over 5%. Despite all the merits of the rescue measures, however, a successful recovery should not be solely attributed to the rescue package, for in the mid-1990s the Mexican economy was not characterized by the large fiscal disequilibrium and rigidities in production that prevailed in 1982.⁴ In addition, the international economic environment was substantially more adverse in the 1980s: U.S. interest rates were at record high levels and oil prices were falling sharply.

The question of whether the industrialized world and the multilateral organizations could have put together a financial assistance programme large enough for Mexico in 1982 and whether this would have avoided the 1980s debt crisis will not be addressed here. However, in retrospect it seems fairly clear that the chosen strategy resulted in high costs for the debtor countries. In the case of Mexico, at the outset in 1982 the U.S. Treasury responded with remarkable lack of vision and –partly because of pressure from the Department of Energy– ended up extracting concessional terms from the Mexican

Government as a *quid pro quo* for receiving an advance payment for future oil sales: an arrangement that left the relationship between the two countries strained. Not everybody in the U.S. Government acted so undiplomatically, though. The U.S. Federal Reserve –well aware of the systemic dangers of a Mexican default– not only arranged close to half of the bridge financing in August 1982 (with the collaboration of other Central Banks in the industrialized world), but also set in motion and guided the process for the successive debt negotiations between Mexico and the private commercial banks.

In contrast, the lead role in arranging the February 1995 rescue package was played by the U.S. Treasury, in close collaboration with the U.S. Federal Reserve, and –perhaps because of the lessons learnt from 1982– other U.S. agencies were not involved. The terms of the U.S. financial support were strictly market-driven, and there were no attempts to extract pecuniary concessions from Mexico. This does not mean, however, that the negotiations with the U.S. Treasury went without controversy. In particular, the U.S. Treasury pressed for a macroeconomic policy course that, at least initially, was not the same as the one favoured by the Mexican Government. The U.S. Treasury firmly believed that high short-run domestic interest rates in Mexico were a prerequisite for stabilizing the peso, while the Mexican financial authorities –fearing that high domestic interest rates would be devastating for an already vulnerable banking system– preferred a policy mix that would result in lower domestic interest rates, even at the expense of a weaker (i.e., more devalued) peso.

Although in 1982 the U.S. authorities recognized the need for fundamental changes in Mexico's economic policymaking, they did not get directly involved. The U.S. rescue package was extended on the condition that the Mexican Government would seek an agreement with the IMF. At that time, the Mexican government was running a huge fiscal deficit in an economy protected by high trade barriers, and even after the August rescue package was arranged the government introduced measures which ran counter to the IMF's dictum: for example, in September 1982 it nationalized the banking system and implemented full-fledged exchange controls. To tell the truth, the U.S. Government and the IMF were not really alarmed by these decisions because –although the outgoing President strongly opposed an agreement with the IMF, as well as its policy recommendations–

³ U.S. Department of the Treasury (1996), p. 15 and General Accounting Office (GAO) (1996), pp. 140-141.

⁴ See, for example, Lustig (1992).

it was known that the new administration due to take office in Mexico on 1 December 1982 would pursue an entirely different course. In particular, it would introduce standard IMF-style stabilization measures and phase-in a programme of structural reforms. Nevertheless, an accord with the IMF could not be completed until two or three months later. In contrast, when the 1995 rescue package was being negotiated there was no disagreement between the Mexican Government and the IMF on economic policy in broad terms. The Mexican authorities were firm believers—as they had been since 1983—in market-oriented reforms and were well aware of the need to introduce further austerity measures to stabilize the markets. This basic consensus made it possible to reach a stand-by accord with the IMF very rapidly, for an extraordinarily large amount of money.

Furthermore, the creditors in 1982 were also quite different. In 1982, they were private commercial banks, which held 70% of Mexico's external debt, and "...claims on Mexico by the top nine U.S. commercial banks amounted to 50 percent of their capital", so that a Mexican default would have been an all too real threat to their survival. In 1995, however, the holders of a large portion of the short-term dollar-denominated government debt instruments (the Tesobonos) were primarily foreign portfolio investors.⁵ This difference might explain why it was possible to negotiate voluntary arrangements directly with the creditors in 1982 (and subsequently), but not in 1995. In the case of commercial banks, the U.S. Federal Reserve Bank could act as an arbitrator and

exercise its leverage to convince the banks to participate in the debt rescheduling process. In the case of investment banks or institutional investors, there is no analogous entity. The difference in the origin of the capital flows may also explain why the Central Banks—the commercial banks' lenders of last resort—of other industrialized countries were not as forthcoming in 1995 as they had been in 1982, as reflected in the relatively restricted nature of the US\$ 10 billion contribution made by the Bank for International Settlements (BIS) to the 1995 rescue package. This is why firm leadership was needed from the Treasury and the IMF in order to set up the rescue programme.

Finally, in 1995 the institutional basis for a currency support mechanism was already in place, since in April 1994 the three NAFTA countries signed the North American Framework Agreement (the NAFA) to provide mutual support for their currencies. Although the existence of such a mechanism translated into closer monitoring of Mexico's economy on the part of the United States Treasury and Federal Reserve during 1994 and the potential availability of close to US\$ 7 billion to support the peso, both turned out to be insufficient. The monitoring neither helped to prevent the crisis nor anticipated its magnitude, while the swap funds neither deterred attacks on the peso, nor were they large enough to solve Mexico's subsequent liquidity crisis. Finding more effective mechanisms to reduce the risk of similar crises in Mexico in the future remains a pending task for the governments of Mexico and the United States.

II

The United States to the rescue: 1982

On 13 August 1982, Jesús Silva Herzog, the Mexican Secretary of Finance, went to Washington to confirm in person that the country had run out of reserves and, if nothing was arranged during the weekend, on Monday morning the government would have to announce publicly that Mexico could not meet its payments. Confronted with the fact that Mexico was on

the verge of defaulting on its foreign obligations, the U.S. Treasury arranged a rescue package of US\$ 2 billion over the weekend.⁶ Under the leadership of Paul Volcker, the U.S. Federal Reserve, in turn, arranged a loan of US\$ 1.85 billion, ready a few days later, with contributions from the Federal Reserve Bank, the Exchange Stabilization Fund of the U.S.

⁵ At the end of 1994, the claims on Mexico by the same group of banks which had been in such a vulnerable situation in 1982 amounted to only 15% of their capital (Truman, 1996, p. 12).

⁶ The emergency loan was organized mainly by the Under-Secretary for the Treasury, Tim McNamar.

Treasury⁷ and the Central Banks of other industrialized nations through the Bank for International Settlements.⁸ Both loans were meant to fill the financial gap while an accord with the IMF could be negotiated. An agreement with the IMF was reached at the end of 1982 in the form of an Extended Fund Facility for US\$ 3.7 billion.

In total, the August 1982 U.S.-led rescue package amounted to US\$ 4.55 billion (table 1), of which the United States contributed US\$ 3.625 billion. The U.S. contribution included: i) a US\$ 2 billion loan arranged by the U.S. Treasury (US\$ 1 billion extended through the Commodity Credit Corporation to pay for future purchases of U.S. maize and US\$ 1 billion as advance payment for oil sales by Mexico to the U.S. Strategic Petroleum Reserve); ii) the United States contribution to the rescue package arranged by the U.S. Fed, in the form of a US\$ 600 million one-year loan from the Treasury's Exchange Stabilization Fund and a US\$ 325 million one-year loan extended by the Federal Reserve; and iii) the US\$ 700 million in swaps extended by the Federal Reserve on 4 August 1982, a few days before the famous weekend of 13. Other industrialized nations contributed a total of US\$ 925 million through the Bank for International Settlements. The loans were for a period of one year, and they were paid in full by 23 August 1983.

The US\$ 4.55 billion, however, was only the contribution from official sources. With help from the U.S. Federal Reserve and the IMF, at a meeting that took place on 20 August 1982, the Mexican Government persuaded (some bankers would say forced) the commercial banks to agree to a 90-day suspension of payments of principal. This meeting was the first of several rounds of negotiations with bankers to reschedule debt payments, until the Brady debt-reduction agreement was signed in February 1990.⁹

⁷ The Exchange Stabilization Fund (ESF) was established by section 20 of the Gold Reserve Act of 30 January 1934, with the purpose of promoting a stable system of exchange rates. U.S. monetary authorities have a history of using these resources to assist Mexico, with the understanding that it is ultimately in the U.S. interest to promote an orderly exchange rate system (General Accounting Office, 1996, p. 148).

⁸ The international package was arranged during the same weekend but it took a few days to sort out some difficult issues such as an assured source of payments for the banks.

⁹ For more details on these rounds see Gurría (1988) and Devlin (1989).

TABLE 1

Mexico: Financial rescue package, 1982^a
(Millions of dollars)

Total August 1982 rescue package	4 550
Total from United States	3 625
Federal Reserve	1 025 ^b
Department of the Treasury	600 ^c
Department of Agriculture.	1 000 ^d
Department of Energy	1 000 ^e
BIS (Bank for International Settlements)	925
Memorandum Items:	
IMF	3 700 ^f
Commercial banks	Agreed to a 90-day standstill on principal due ^g

Source: U.S. Federal Reserve and Department of the Treasury.

^a Figures are amounts available (not necessarily drawn) in current dollars. The U.S. and BIS figures correspond to the rescue package arranged in August 1982. The IMF agreement was signed later that year.

^b Short-term swaps, practically all coming due within a year. This figure includes the US\$ 700 million in swaps extended on 4 August 1982.

^c From the Exchange Stabilization Fund. Short-term swap due within a year.

^d From the Commodity Credit Corporation; loan extended to cover future purchases of U.S. corn (maize).

^e To cover future purchases of Mexican oil for the Strategic Petroleum Reserve.

^f Extended Fund Facility; the "letter of intent" was signed in November 1982.

^g This was agreed at a meeting on 20 August 1982.

Despite the fact that, all in all, the United States made a substantial contribution to the financial rescue of Mexico in 1982, and avoided a Mexican default, the relationship between the two countries at the level of the Executive branches became very strained. For one thing, the Mexican Government felt, not without reason, that the U.S. Treasury had been slow to respond in spite of the repeated warnings sent by the Mexican financial authorities. For several months prior to August 1982 the Department of the Treasury appears to have viewed the increasing difficulties encountered by Mexico in borrowing from commercial banks primarily as Mexico's problem, without focusing on the implications a Mexican default would have on the international—and particularly the U.S.—banking system. For the Department of the Treasury, the Mexican Government had misbehaved, running large fiscal deficits financed by external borrowing, and it needed, first of all, to introduce sound economic policies and seek an agreement with the IMF. While it is true that Mexico needed to reduce

its fiscal deficit, this would not have been enough to solve the upcoming foreign exchange shortage. Furthermore, tensions heightened during the negotiations on the short-term US\$ 2 billion loan organized by the Treasury, when the United States tried to force a price deal on Mexican oil sales as part of the conditions of the rescue. The negotiation of the so-called oil deal left Mexican government officials resentful, and –as we shall see– for good reason.

1. Mexico's dilemma: to default or not to default

In the early part of 1982, the Mexican Government –the Finance Ministry in particular– initially contemplated two options, especially after the Bank of America had great difficulty in lining up subscribers for a US\$ 2.5 billion jumbo loan in June. The first was to default without warning and even –some recommended– without any public statement. The second was to work out a “technical” solution with the private banks, the IMF and creditor country governments.¹⁰

The first option was dismissed because it was an instrument of last resort and would leave Mexico in great isolation. In particular, according to Secretary of Finance Silva Herzog's own account his greatest concern was that since Mexico imported between 40% and 50% of its maize consumption a unilateral moratorium could result in a shortage of tortillas –Mexico's staple food– and risk social and political unrest. The second option would take time. An agreement with the IMF would take a few months to work out, and funds would not be available until an adjustment programme could be put together and approved. Moreover, it was not clear if López Portillo, the outgoing President who was to leave office on 30 November 1982, would accept an IMF programme. Apparently, he was strongly opposed to this, almost as a matter of personal pride, for he had begun his term with an IMF programme in place and was not willing to leave the Presidency with his policies bounded by IMF conditionality. Also, as mentioned above, between February and June the U.S. Treasury

did not seem to be fully aware of the seriousness of the situation in Mexico and was not ready to act (Kraft, 1984, p. 11). This response was probably the result of the Treasury's lack of understanding of the full implications of a Mexican default for the United States banking system, together with the desire to put pressure on the Mexican Government to change its economic policies.

In this respect, it might be worth citing Volcker's impressions regarding the United States Government's attitude at that time (Volcker and Gyohten, 1992, pp. 198-199):

“It wasn't hard to see the [Mexican] crisis coming ... The question through the first half of 1982 was not whether Mexico was approaching a crisis but what to do about it. A populist government had refused time and again to trim its economic sails... López Portillo, under attack for personal as well as policy excesses, was in the last year of his six-year term and plainly did not want to confess error. The market sounded a clear warning during February of 1982 in the form of a run on the peso. That provoked a devaluation and a limited austerity programme. Neither action was convincing. ...Silva Herzog and Mancera began visiting Washington about once a month to inform the IMF, the World Bank, the Treasury, and me [Volcker] of the deteriorating situation... Our advice, predictably, was to apply to the Fund for a loan, introduce a really effective programme to reform the domestic economy, and on that basis reduce the hemorrhage of Mexican capital... Their answer was...simple... Their President would not accept it. ...Any possibility would have to await the new President...”

Volcker goes on:

“So, it was a matter of buying time. In an effort to hold things together psychologically, we agreed with considerable unease to extend overnight swap credits once or twice to the Bank of Mexico... Our unease did not arise from any fear of financial loss, but because the ‘window dressing’ disguised the full extent of the pressures on Mexico from the bank lenders and from the Mexicans themselves. [The action was justified] on the basis that Silva Herzog¹¹ was

¹⁰ This is reported in the chronicle written by Kraft (1984) and was confirmed by Ambassador Jesús Silva-Herzog, Secretary of Finance of Mexico at the time.

¹¹ It was already known that Silva-Herzog was incoming President Miguel de la Madrid's choice for Secretary of Finance.

willing to give us his personal assurance that Mexico would seek an IMF programme as soon as the new President had the freedom of action to bring it about."¹²

With no other apparent solution in sight, the Mexican Finance Ministry opted for a third course of action: to visit the Department of the Treasury when money had run out and confront the Washington policy community with a *fait accompli*. Only then would it become clear that if Mexico received no help from the international community of creditor countries, then they—and the United States in particular—would face the threat of a banking crisis of international proportions.

2. Mexico's reserves run out

After the Presidential elections in Mexico, when bank lending finally dried up, the Federal Reserve agreed to activate the swap arrangement that had long existed between the two countries.¹³ On 4 August, a real loan of US\$ 700 million, as opposed to the overnight swaps, was given to Mexico with the aim of tiding the country over the summer while the officials began quiet discussions with the Fund. But since confidence was gone, to everybody's surprise the money that was supposed to last a month or two vanished in almost no time (Volcker and Gyohten, 1992, p. 200).

During the week beginning 9 August, Mexican officials informed their U.S. counterparts that Mexi-

co had run out of reserves, including the US\$ 700 million borrowed four days earlier. The alarm bells began ringing, interrupting more than one peaceful summer vacation, for a Mexican default would in effect threaten the industrialized nations' banking system. To quote Paul Volcker again, the Latin American debt crisis "was just as much of a problem for the First World, which found its banking system suddenly threatened with collapse (*Ibid.*, p. 189). The foreign loans of all banks to developing countries had grown from US\$ 44 billion in 1974 to more than US\$ 360 billion in 1982, of which about US\$ 60 billion was to Mexico. The U.S. banks' share in these loans was about one-third, and for the nine largest U.S. banks Mexican debt was equivalent to 50% of their capital. According to one estimate, if Mexico failed to pay interest for one year, the earnings of the money centre banks could fall by one-third.¹⁴ Mexico and Brazil between them owed enough to strain Citibank and Bank of America, the two largest U.S. banks.¹⁵

3. The weekend rescue package

Thus, when Silva Herzog visited Washington on Friday, 13 August the situation became clear. First, short-term emergency credit had to be made available to Mexico, and this credit had to be arranged literally over the weekend in order to avoid a panic reaction on the following Monday. According to Gurría, Director of External Financing in the Mexican Ministry of Finance, international reserves were less than US\$ 100 million and the week's amortization payments were equal to US\$ 700 million (Leeds and Thompson, 1986, p. 27). Mexico's foreign reserves had to be replenished in order to reassure the international financial community that the country was not only willing but able to meet its immediate obligations. The country's immediate cash-flow

¹² Another account might also give a telling idea of U.S. officials' thinking at the time: "There also was a feeling that until there was an actual crisis, high level [U.S.] officials simply would not focus on the problem. Although some complained that Secretary Regan had turned a deaf ear to the Mexican situation for months prior to the crisis, others felt that his lack of advance action was typical and logical. ...Previous experience with crisis management also convinced some participants that a sense of urgency had to exist before the key actors would be prepared to take the extraordinary measures that were required" (Leeds and Thompson, 1986, p. 25).

¹³ The emergency 24 hour currency swaps with the Federal Reserve took place on 30 April and subsequently in June and July, but the first real loan as opposed to overnight swaps took place on 4 August 1982. Mexico was the only Third World country to have established a swap line with the U.S. Federal Reserve, dating back to 1967, when the first swap between the Federal Reserve and the Bank of Mexico took place (Leeds and Thompson, 1986, p. 16, and General Accounting Office (GAO), 1996, p. 151).

¹⁴ Leeds and Thompson (1986, p. 13) cite Lissakers on this. See also Lissakers (1991).

¹⁵ It is interesting to note that an amount similar to that owed by the Mexican Government in total (to all banks, not just those in the U.S.) was kept in the United States by Mexican nationals. According to one estimate, Mexicans had deposited US\$ 14 billion in the United States and owned about US\$ 30 billion of U.S. real estate.

needs were estimated at US\$ 3.5 billion.¹⁶ It was understood that the U.S. Treasury would organize a short-term loan of US\$ 2 billion or more with funds from within the U.S. Government, while the Federal Reserve would arrange a rescue loan of US\$ 1.5 billion assembled with contributions from the world's central banks. The US\$ 2 billion had to be arranged over the weekend, so officials at the U.S. Department of the Treasury—in particular, Deputy Secretary Tim McNamar—began to seek potential sources immediately.

As the negotiations unfolded and “different options were identified and scrutinized, an ad hoc task force of U.S. government officials was formed, that eventually would include representatives from various corners of the Federal bureaucracy—the Department of Agriculture, the National Security Council, the Office of Management and Budget, the State Department and the Department of Energy.”¹⁷ The idea behind involving many agencies was to increase the number of options and attend to the concerns of the various quarters in the U.S. government. However, it had the disadvantage that since some of the concerns ran counter to each other, the U.S. Treasury ended up having to negotiate both with the Mexican Government and with the other agencies within the U.S. Government.

a) The easy part: the corn agreement

After going through the various alternatives, two were identified in the end.¹⁸ One came from the Department of Agriculture, in the form of a US\$ 1 billion Commodity Credit Corporation concessional loan whereby Mexico agreed to purchase U.S. corn (maize), which was in surplus as a result of the agricultural policy pursued by the United States, in exchange for the loan. This facility had already been used in 1976, proved easy to obtain (it only took about half a day) and was largely uncontroversial.

¹⁶ The cash-flow needs were estimated assuming that Mexico would not negotiate an agreement with the IMF until the incoming President took office in December 1982.

¹⁷ Leeds and Thompson (1986), p. 27. According to a U.S. government official, there was really no “task force”: Tim McNamar from the U.S. Treasury was in charge of putting together the deal.

¹⁸ For a more detailed account, see Leeds and Thompson (1986).

b) The difficult part: the oil deal

Another US\$ 1 billion came in the form of an advance payment for petroleum sales to the U.S. Strategic Petroleum Reserve. This part of the package, however, turned out to be very controversial, to the point that negotiations almost broke down. The Exchange Stabilization Fund (ESF), the main source of the U.S. rescue package in 1995, was also considered.¹⁹ On the advice of his General Counsel, McNamar concluded that it was feasible to use ESF funds, “but only if they would be secured by ‘an assured source of repayment’ (Leeds and Thompson, 1986, p. 29). However, rather than using the ESF to extend the loan and “collateralize” it with oil proceeds, the Department of the Treasury opted for another arrangement, namely, that ESF funds would be used as a “bridge loan” that would have to be repaid within a matter of days and the money would have to come from an entity within the U.S. Government which would be in a position to purchase the oil used as collateral. Since total loans to Mexico were likely to exceed the resources obtained in an IMF agreement, and the “oil deal” could not be completed immediately, it was estimated that this ESF-sourced loan could not be used for a longer period, particularly because it was already envisaged that ESF funds would be applied to the other part of the package whose terms were being arranged by the U.S. Federal Reserve Bank.

Once the decision was made to use the ESF money only for a few days, the next step was to find an agency within the U.S. Government which could buy US\$ 1 billion worth of oil, and agree on a price that was mutually acceptable both for Mexico and the United States. The first agency approached was the Department of Defense, but there were legal impediments preventing this agency from buying crude oil. The second obvious agency was the Department of Energy, which could be interested in buying oil for the Strategic Petroleum Reserve, created in the wake of the 1973-1974 oil crisis, whose task was to create a buffer of oil stocks to guard against future oil shortages. Although this turned out to be the only feasible option, PEMEX and the Strategic Petroleum Reserve had unfortunately had a previous arrangement which

¹⁹ See footnote 7. The first standing swap line between Mexico and the U.S. was established in 1940 (General Accounting Office (GAO) (1996), p. 150).

left both sides discontented.²⁰ Consequently, the Department of Energy entered the negotiations on the so-called "oil deal" with the concern that they "not fall victim to the same errors committed a year earlier" (Leeds and Thompson, 1986, p. 33).

Negotiating the "oil deal" involved several sensitive factors such as the price of the oil, delivery and schedules, and the mix of grades. McNamar's "first substantive proposal ...was for a fixed-term renewable contract to purchase Isthmus crude, along with a suggested delivery date, volume, and a concessional price. The latter...was particularly crucial to the American side, as they wanted to be well compensated for committing to a large advance purchase in a soft oil market" (Leeds and Thompson, 1986, p. 35). According to some accounts, the concessional price was about US\$ 28 per barrel, when the going price in the international market was US\$ 32 (Kraft, 1984, p. 14).

The Mexican delegation "was shocked to learn that [it] could be subject to very hard bargaining" (Leeds and Thompson, 1986, p. 36). Among other things, the Mexican team responded—quite correctly—by saying that granting the United States a concessional price would disrupt Mexico's oil market and other customers could demand similar treatment. There was stalemate, and the negotiations almost broke down. Neither side wanted to run into trouble with their electors for having negotiated a "bad" price for the oil sales. As an alternative, the United States proposed that instead of granting a discount on the price of the oil, the Mexicans might agree "to make up some of the difference by paying a front-end fee to the U.S. for arranging the transaction."²¹

²⁰ The origin of this discontent remains classified information.

²¹ Leeds and Thompson (1986), p. 39. According to one account, initially it was proposed "...that the U.S. loan Mexico US\$ 1 billion against repayment in oil, with the understanding that the loan would bear interest charges. The Americans came up, late Saturday, with a proposal that in return for the US\$ 1 billion loan on Monday, the Mexicans would pay back in oil, over a fifteen-month period, the equivalent of US\$ 1.3 billion: an interest charge of 35%. Oteyza, after a telephone talk with López Portillo, said that it was an outrage, and the Mexicans would not pay more than 20%. López Portillo, according to some accounts, had burst into a flood of profanities and ordered a break in the negotiations. Some Americans clearly sympathized with the Mexicans..." (Kraft, 1984, p. 15).

The negotiation went through several iterations, but the terms of the final agreement remain classified. However, according to Angel Gurría: ²² "Mexico paid an implicit interest rate of about 38%, more than twice the prevailing market interest rate ..." for this loan. On the same matter, Volcker remarks that the "...implied interest was egregiously high, reflecting the need to satisfy the Yankee trading instincts of Budget Bureau and Energy Department officials far removed from any sense of the larger issues at stake and more than slightly sensitive to the possibility of subsequent political criticism. The Mexican oil officials, who would have to pay, quite understandably were furious."²³

Given the future evolution of oil prices, in retrospect perhaps the price offered by the United States was not so bad. The yearly average market price of oil corresponding to a weighted average of Mexico's oil export mix was US\$ 28.70/barrel in 1982. This price is similar to what has been cited as the concessional price of US\$ 28/barrel that the United States requested (Kraft, 1984, p. 14). The problem was, however, that at the time of the negotiations the price proposed by the United States was below the market level.²⁴ In the end, the negotiations on the "oil deal" left the Mexican officials with very bitter feelings. In their view, the United States tried to extract unwarranted pecuniary concessions from a financially cornered Mexico.²⁵ Nevertheless, despite all the tensions, the U.S. Treasury part of the rescue package—the US\$ 2 billion in loans—was completed before the weekend was over.

As we shall see below, in 1995 there were no attempts on the part of the United States to strike advantageous bargains with Mexico. However, the 1995 rescue plan came with much tighter conditions on economic policy. In 1982, the U.S. Government essentially relied on the IMF to set the economic

²² At the time Angel Gurría was, as mentioned above, a senior official of the Ministry of Finance and a prominent member of the Mexican delegation.

²³ Volcker and Gyohten (1992), p. 201. See also Kraft's account of the conversation between Regan and President Reagan (Kraft, 1984, p. 16).

²⁴ Not only below the current level but also lower than the future prices for oil.

²⁵ See, for example, Gurría's acrimonious views on this episode in Gurría (1993), pp. 31-32.

policy conditionality and was satisfied with the personal commitment of Mexico's Secretary of Finance—who it was known would be part of the incoming cabinet—that an agreement with the IMF would be sought by the new administration.²⁶

4. The U.S. Federal Reserve takes the lead

At the same time, the U.S. Federal Reserve Bank was able, under Paul Volcker's leadership, to assemble an international package of credits from central banks and monetary authorities equal to US\$ 1.85 billion, with US\$ 325 million coming from the Federal Reserve itself (table 1).²⁷ The package assembled by the Federal Reserve, however, had another U.S.-sourced component: US\$ 600 million from the Exchange Stabilization Fund (ESF), for which the President had to seek authorization from the U.S. Congress to use ESF funds for a period longer than six months. In total, then, half of the package came from the United States and the rest from other G-10 central banks. As lenders of last resort, the central banks of creditor countries understood the need to act swiftly. Although the most vulnerable banks with respect to Mexico were those of the United States, the rest pitched in either because they had high stakes on the international banking system as a whole or because they thought they might need U.S. help in the future when confronted with similar problems in, for example, Eastern Europe. The mere fact that central banks were not lenders of last resort for portfolio investors may explain, at least in part, the strikingly different response of non-U.S. central banks in 1995.

5. The IMF and the commercial banks

The 1982 rescue package was meant to provide interim financing until Mexico could reach an agreement with its private creditors and the International Monetary Fund. In contrast to 1995, negotiating the amount and conditions of an IMF programme would take several months. Once the short-term bridge loan and other credits were agreed in principle, the next step was to involve the commercial banks. It was estimated that between September and December

1982, the Mexican Government would have to pay US\$ 8.7 billion in amortization and US\$ 2.6 billion in interest: a total of US\$ 11.3 billion. Officials in the United States, Mexico and the IMF decided that the banks "ought to be asked to agree to a 'standstill'" on Mexico's debt payments. At a meeting on 20 August held at the New York Federal Reserve Bank, the commercial banks agreed to give Mexico a 90 day extension on the principal due.²⁸

In the meantime, Mexico worked out an Extended Fund Facility with the IMF for US\$ 3.7 billion; the "letter of intent" was signed on 10 November 1982. However, the Fund's financing would not be sufficient to cover the debt payments coming due in the future months: "The banks in their own self-interest would have to supply the rest. If they failed to do so, then the prospects for interest on their existing loans, much less the chances of repayment, would go a-glimmering" (Volcker and Gyohten, 1992, p. 205).

6. Was the 1982 financial assistance package a success?

For Mexico, the 1982 rescue package would turn out to be just the beginning of the long and protracted process of managing its debt overhang. This process included several concerted debt rescheduling exercises, a debt buy-back, and—finally—the 1990 debt-reduction agreement negotiated under the terms of the Brady Plan.²⁹ After the 1982 rescue package Mexico received support from the U.S. Federal Reserve and the Department of the Treasury on three other occasions, but always in the form of interim financing while other workouts were concluded.³⁰

²⁸ In contrast, the private sector played no role in the 1995 rescue package. Whether the foreign investors holding Mexican paper in 1995 (Tesobonos in particular) could have been convinced to agree to a concerted solution is a point that will not be addressed in this paper. Some analysts argue that Mexican debt was too small a proportion of foreign investors' total holdings and, therefore, there was no obvious incentive to generate collective action in 1995 (see, for example, Truman, 1996). However, it appears that some of the leading U.S. investment banks were potential holders of huge amounts of Tesobonos that some of their borrowers had used as collateral. A Mexican default, then, could conceivably have been very troubling for some of those banks.

²⁹ For more details see, for example, Gurría (1988) and Devlin (1989). The Brady deal is described in the Appendix of Lustig (1992).

²⁶ The incoming president was set to take office on 1 December 1982.

²⁷ The loan was granted on 26 August 1982.

Thus, while the 1982 financial rescue package succeeded in avoiding a unilateral default on the part of Mexico and obviated the potential bankruptcy of major banks (particularly in the United States) and a banking crisis of international proportions, it failed on another fundamental count: Mexico, like many countries in the developing world, would be essentially cut off from voluntary lending

in the international capital markets for almost a decade. Throughout the 1980s, Mexico and other highly indebted countries would not be able to grow, and they faced recurrent bouts of high inflation, with poverty and inequality on the rise. Perhaps as a result of the trauma left by the 1980s, the international community—or at least part of it—acted differently in 1995.

III

The United States to the rescue: 1995

1. Mexico devalues the peso and the markets panic

On 16 December 1994, Mexico's international reserves dropped to around US\$ 11 billion (Banco de México, 1995). Faced with this situation of dwindling international reserves, the Mexican Government called an extraordinary meeting of the "Pacto"—the established mechanism for discussing economic policy with representatives of business and labour—in the evening of 19 December. The following morning, the Secretary of Finance announced an immediate increase to 4 pesos per dollar (an increase of about 15%) of the ceiling of the band within which the dollar was allowed to fluctuate.³¹

The value of the dollar reached the new 4 peso ceiling in no time, and it is estimated that in the course of two days close to US\$ 5 billion of international reserves were lost. The markets were sending a clear message: the new exchange rate ceiling was not credible. On 22 December 1994, the monetary auth-

orities had no other option but to switch to a floating exchange rate: in other words, the Banco de México would no longer intervene to maintain the dollar within a pre-specified band.

A few days later, the Mexican Government faced difficulties in rolling over the Tesobonos (the short-term dollar-denominated debt instruments) coming due on the first Tuesday following the devaluation. This was an ominous sign. Contrary to what many analysts had predicted—and expected—the devaluation did not bring calm to the markets. On the contrary, the devaluation actually caused a major loss of confidence among foreign investors holding Mexican paper. Foreign investors "... realized that their investment strategies had been based on one or more false premises concerning the nature of Mexico's exchange rate regime or the probability that they could liquidate their holdings before any crisis hit" (Truman, 1996, p. 8). They realized that the Mexican Government would not be in a position to service short-term claims without incurring a massive depreciation of the peso and hence that the risk of default was as real as ever.

Given the combination of a high concentration of government debt in short-term instruments denominated in dollars (Tesobonos),³² the fact that a large portion of them (US\$ 17 billion) was in the hands of foreigners, and the low level of international reserves shortly after the devaluation (approximately US\$ 6 billion), portfolio investors began to fear that

³⁰ One of these short-term loans was granted in 1986 when, following the drastic fall in oil prices, the United States and the BIS provided a six-month loan for more than US\$ 1 billion. Subsequently, in September 1989 and March 1990, Mexico received short-term bridge loans for US\$ 2 billion and US\$ 1.3 billion, respectively, during the negotiation of the debt-reduction agreement with the commercial banks.

³¹ These consultations took place at a meeting of the "Pacto." The "Pacto"—set in motion for the first time in December 1987—was a mechanism used to set macroeconomic policy in consultation and with the endorsement of representatives of workers, agricultural producers and the business sector. For more details on the origins and characteristics of the "Pacto", see Aspe, 1993, and Lustig, 1992.

³² This was not fresh debt, but accumulated existing debt which needed to be renegotiated.

the Mexican Government would have no choice but to impose exchange controls and default on the Tesobonos. The spectre of default sent the markets into a panic and placed the peso in danger of collapse. The only way that a full-fledged financial meltdown could be prevented would be by arranging a financial assistance package sufficiently large to convince the markets that the Mexican Government would *not* be forced into a default. As we shall see, the size of the required financial rescue package turned out to be far larger than anybody in the United States or Mexican governments, or in the multilateral organizations, had anticipated.

2. U.S. support: already in place but not enough

In contrast to 1982, when the peso was devalued in December 1994 the support from the United States was already formalized in the North American Framework Agreement (NAFA), signed by the three NAFTA countries in April of that year. In fact, a potential financial support package from the United States, Canada and European central banks had been quietly arranged during the NAFTA vote in early November 1993. At the time there were fears that if NAFTA were not passed by the U.S. Congress the Mexican peso would be subject to a lot of pressure. As a result, the industrialized governments agreed to provide US\$ 12 billion in swaps, of which the United States contributed half. These agreements remained secret and expired on 31 December 1993, without any drawings having been made by Mexico (Wertman, 1995a, p. 6).

Then, on 24 March 1994 (immediately after the assassination of Presidential candidate Colosio), U.S. Treasury Secretary Lloyd Bentsen and the U.S. Federal Reserve Chairman, Alan Greenspan, put in place a US\$ 6 billion swap line, with each agency contributing half.³³ This swap facility was to be available for a couple of months, while the pressure on the peso subsided. However, on 26 April the three countries signed the North American Framework Agreement (NAFA), making permanent the US\$ 6 billion contribution from the United States to a swap arrangement with Mexico and Canada. Under this agreement the Bank of Canada and the Banco de México also expanded their existing swap arrange-

ment from C\$ 200 to C\$ 1 billion (then about US\$ 723 million), while the Federal Reserve and the Canadian central bank reaffirmed their existing US\$ 2 billion swap line.³⁴ One important implication of this agreement was that by implementing it the United States and Canada were giving tacit support to Mexico's decision to keep exchange rate policy unaltered in the aftermath of the assassination.

Non-U.S. support was called upon once again when an additional US\$ 6 billion was quietly put together by Europe and Japan, with the help of the U.S. Federal Reserve, in order to back the peso in the period running up to the August 1994 Presidential elections, when it was recognized that given the uncertainties generated by the assassination of the PRI candidate Luis Donaldo Colosio, it was an awkward time to change the exchange rate policy. Under this US\$ 12 billion contingent swap facility, of which the U.S. would contribute up to half, Mexico ".....would be able to draw until September 30 for a period of 90 days [and] all drawings would have to be repaid by December 30 (General Accounting Office, 1996, p. 88). Mexico did not make any drawings from either facility. This episode reveals that at least up until August 1994 the industrialized nations were implicitly endorsing Mexico's exchange rate policy (and, more broadly, its economic policy).

a) *The United States worries about the peso*

The increase in the potential commitment of financial resources in support of Mexico was accompanied by closer scrutiny of Mexico's economy on the part of the U.S. Treasury and the Federal Reserve. The release of a number of previously classified documents reveals that—especially during 1994—U.S. financial authorities were monitoring economic events in Mexico rather closely, with particular concern for the exchange rate.³⁵ In both the U.S. Treasury and the Federal Reserve the predominant view was that the peso was overvalued, but there was no con-

³³ General Accounting Office (1996), p. 82. This swap facility is subject to annual review.

³⁴ Wertman, 1995b, p. 3. Under the Framework Agreement, Mexico could make multilateral or bilateral drawings; bilateral drawings with the United States Treasury would be governed by the Exchange Stabilization Agreement signed on the same day (Wertman, 1995a, p. 7).

³⁵ These documents were declassified in response to requests by Senator D'Amato, a fierce critic of the U.S. rescue package and of the Clinton administration's policy towards Mexico, and are known as "D'Amato's Annexes". For more on this matter see General Accounting Office (1996), Chapter 3.

sensus on the extent of the overvaluation. Moreover, the recommended course of action was not a sudden change but a gradual one, undertaken as "part of a concerted policy rather than an emergency response to a crisis."³⁶

The U.S. Government's concern with Mexico's decision to stick to the existing exchange rate policy deepened after the country's August 1994 Presidential elections, when capital inflows failed to materialize despite the peaceful PRI victory. In September, the Mexican Government tried to inject confidence into the markets by announcing a new Pacto, which ratified the exchange rate policy. To add to the credibility of this agreement, President-elect Zedillo endorsed it explicitly. The U.S. financial authorities, however, remained skeptical. Larry Summers, then Under-Secretary for International Affairs at the U.S. Treasury, commented:

"The Mexican Government surprised the financial markets with the announcement of a new 'Pact' with business and labor on Saturday. Most significant for us, the agreement maintains the current pace of depreciation of the floor of the exchange rate band at four percent per year".

"The Mexican announcement presents us with two issues. The first is the substantive question of whether they made the right decision on the exchange rate. The view of many credible independent analysts is that the peso is still significantly overvalued. The current account deficit is very high at 7% of GNP..."³⁷

The remarks of another official at the U.S. Treasury are also illustrative of U.S. concerns:

"The uncertain economic prospect of Mexico is of critical interest and of some concern to the U.S. It is possible, but unlikely, that Mexico could request activation of the swap before President Salinas' November 1 State of the Union address".

"Hopes for a stable post-election period and a resumption of capital inflows have not materialized. The announcement of a new Pacto did not have the desired effect of strengthening the peso and was soon offset by renewed concerns over political stability as a result of the Ruiz [Massieu] assassination..."

"Although the immediate financial situation could improve, we remain concerned that the current exchange rate system could inhibit economic growth and widen the already substantial current account deficit..."³⁸

As the uncertainty over Mexico's economy and the sustainability of the exchange rate increased, the U.S. Government became very concerned that Mexico would ask to draw on the contingent commitment agreed under NAFTA to support what was viewed as an unsustainable policy. Given the circumstances, the recommendation of high-level officials at the Treasury was to discourage the consideration of such a request.³⁹ In a memorandum of October 1994 addressed to the Federal Reserve's Chairman, Alan Greenspan, in anticipation of a meeting with Mexican officials, it was said.⁴⁰

"... You may want to indicate that while we understand the reasons why Mexican officials prefer operating with a relatively fixed exchange rate (against the U.S. dollar), there is some concern about the risks and costs of trying to defend an unsustainable exchange rate. It could be costly in terms of Mexico achieving its broader economic growth objectives, could be disturbing for Mexican financial markets, and could be disruptive to U.S. financial and trade relations with Mexico. Mexican officials should be aware that they should not count on the United States for financial support via the Federal Reserve and Treasury lines to sustain an inappropriate exchange rate. The swap lines are intended to deal with what are viewed as transitory market disturbances, not to buttress an unsustainable exchange rate regime."

Reading the available documents leaves one with the impression that officials at the U.S. Treasury and the Fed were observing Mexican markets and policy moves closely and that they disagreed with the Mexican authorities' decision to stick to the exchange rate policy in the aftermath of the Presidential elections. However, the documents also reveal that the United States was not certain about whether

³⁶ Board of Governors of the Federal Reserve System, restricted internal memorandum, "Mexican Exchange Rate Options", 17 August 1994.

³⁷ U.S. Treasury, internal memorandum from Lawrence H. Summers to Secretary Bentsen entitled "Mexico maintains current exchange rate policy in renewal of 'Pacto'", 27 September 1994 (D'Amato's Annexes, p. 364).

³⁸ U.S. Treasury, internal memorandum from Timothy Geithner to Secretary Lloyd Bentsen, 2 October 1994 (D'Amato's Annexes, p. 335).

³⁹ See, for example, Summers's memo to Bentsen, 14 October 1994. (D'Amato's Annexes, p. 301).

⁴⁰ Board of Governors of the Federal Reserve System, internal memorandum from Charles J. Siegman to Chairman Greenspan on "Background Material for October 20 Visit by President-elect Zedillo's Adviser Luis Téllez", 19 October 1994 (D'Amato's Annexes, pp. 383-384).

Mexico would be forced to devalue or,⁴¹ more importantly, it was not aware of the potentially devastating effects that a surprise devaluation would have on market confidence. It is remarkable that there seems to have been no discussion of the risks entailed by, first, the accelerating conversion of peso-denominated securities (CETES) into the dollar-denominated Tesobonos; second, the fact that a large portion of the latter were in the hands of foreign investors; and third, the tendency of the ratio of international reserves to Tesobonos to fall at an increasing pace. Apparently, these issues escaped the scrutiny of the IMF and the World Bank as well. This is most remarkable because the outstanding Tesobonos in the hands of foreigners became one of the fundamental causes of the financial debacle. Like the IMF and the World Bank, the United States authorities were not really prepared for a worst case scenario.

b) *The United States receives no warning of impending change in exchange rate policy*

Although they knew that the peso was under a lot of pressure and a whole range of policy alternatives had been discussed with the Mexicans at various points in the past, the U.S. authorities were not warned in advance of the Mexican Government's decision to change its exchange rate policy, when this finally happened. In a U.S. Treasury memo sent on 19 December, the day before the announced change in the exchange rate band, a U.S. official expresses his concern at the news received from Mexico that the peso was under pressure and worries about the possibility that the "...Mexicans might well make a decision to 'withdraw from the market' before or right after Christmas without consulting us."⁴²

⁴¹ For example, in a memo prepared for Summers, someone remarks that "...There is no obvious event on the immediate horizon likely to concentrate pressure or to force a decision [to devalue]..." (Department of the Treasury, 5 December 1994).

⁴² The author of the memo then goes on to say: "We will not look good if Mexico makes a move without consulting us. ...I fear that a devaluation will have a negative impact on Congressional support for our trade policy initiatives, particularly if it is done unilaterally. The downside of initiating contact is that it could lead to a request for activation of the swap. This does not seem appropriate now. There is no visible pay-out. Investors, it appears, are not worried about the size of the current account deficit or a devaluation. [!] They worry about Chiapas and political unrest spreading. Thus, a devaluation may not bring about a resumption of capital inflows." (U.S. Treasury, memo to Tim Geithner, "Contact with Mexicans before they do something", 19 December 1994 (in D'Amato's Annexes, p. 428).

The fears candidly expressed by the cited U.S. official were well founded. On the same evening that the memo was written the Mexican Government convened an emergency meeting of the Pacto, and the following day, 20 December, Secretary Serra announced that the ceiling of the band within which the dollar was allowed to fluctuate would be raised by 15 per cent. Time had run out both for the Mexican Government and the U.S. Treasury: the change in exchange rate policy occurred when reserves were too low, and with no leeway to prepare an economic plan and organize U.S. financial support to cushion the impact of a devaluation. Prevention had not really worked, so the next step was damage-control.

c) *The financial debacle was not expected*

Although officials at the U.S. Treasury and Federal Reserve sensed that the change in the exchange rate policy had not been well received by the markets, neither the Mexican nor the U.S. Governments anticipated the scale of the breakdown in financial markets that followed. To give an example, in the wake of the devaluation, a Treasury Department official based in Mexico wrote the following:

"... We believe the markets have been waiting for the government to take action on the exchange rate and that capital inflows are likely to pick up. There probably will be considerable volatility in the foreign exchange market for a short period of time, followed by some strengthening of the peso. ... When all the smoke clears, probably by early next year, we expect the peso will settle about 8-12 percent below what it was trading at prior to the new policy....Our best guess is that the devaluation will not affect Mexico's basic macroeconomic course or fundamentally alter the country's brighter economic prospects in 1995. Furthermore, the devaluation has not really caught most sophisticated investors by surprise. In spite of the fact that over the next few days many Mexicans will say we told you so and that this is *deja vu*, the new policy is likely to have a salutary effect, unlike the traumatic effects of past devaluations."⁴³

⁴³ U.S. Treasury, "Bi-Weekly Report on Mexico", 21 December 1994. (D'Amato's Annexes, pp. 432 and 434).

That the perceptions of Mexican and U.S. officials on the potential impact of the 20 December announcement to change the ceiling of the exchange rate band were wrong did not take long to reveal itself. On the day after the devaluation, reserves fell by close to US\$ 5 billion, and on 22 December the Mexican authorities had no alternative but to allow their exchange rate to float.

As of 21 December, the U.S. Treasury became quite intensely involved. In a memo prepared for incoming Secretary Rubin, Larry Summers mentions that outgoing Secretary Bentsen had authorized the activation of the swap line, that the Treasury was advising Mexicans on how to respond to the circumstances, that the New York Federal Reserve Bank was arranging a meeting of Secretary Serra with major financial institutions for the morning of 22 December, and that Summers would give press support. The swap line with Canada was also activated.

However, none of the above actions calmed the markets. Secretary Serra was not well received during the meeting in New York, and a few days later he resigned, being replaced on 29 December by Guillermo Ortíz. Two days earlier the peso reached its 1994 low of 5.7 new pesos to the dollar, and the government had to cancel the auction of Tesobonos because there would not be any buyers at reasonable interest rates. On the same day, the Mexican Government announced that it was preparing a new economic plan that would be presented on 2 January 1995.

Clearly neither the Mexican authorities, nor the U.S. Government, nor the IMF and other financial institutions expected what happened: i.e., that foreign investors—particularly holders of Tesobonos—were not willing to roll over the government securities they held. They wanted to cash them and convert them into dollars as soon as they became due. Since Mexico's reserves plus the swap lines were considerably lower than the amounts coming due in 1995, the spectre of non-convertibility began to roam the halls of Wall Street.

The absence of a clear and well-defined economic plan at the time when the peso was first devalued added to the uncertainty. As has become more evident in retrospect, however, the problem of lack of credibility on the part of market agents was not solely due to the hesitancy of the Mexican authorities. Had it not been for the US\$ 17 billion of Tesobonos in the hands of foreigners, (with some US\$ 10 billion

coming due in January alone), the US\$ 18 billion of foreign currency liabilities of local commercial banks, all falling due in 1995, and so on, there probably would not have been a financial debacle following the devaluation.

3. The rescue package is increased

a) *The increase in the funds provided under the North American Framework Agreement ("NAFA Plus")*

The realization that the source of the monetary instability was the size of the short-term public debt in the form of Tesobonos—and, more importantly, the response to this realization—took a few days. First of all, the U.S. and Mexican authorities realized that the financial rescue provisions made under NAFA would be insufficient. This prompted the arrangement of a US\$ 18 billion package announced on 2 January 1995. The package was composed of an expansion of the U.S. swap facility set up under NAFA from US\$ 6 billion to US\$ 9 billion;⁴⁴ US\$ 5 billion from other governments through the Bank for International Settlements; C\$ 1.5 billion (then about US\$ 1.1 billion) from Canada, which also expanded its contribution beyond the commitments under NAFA; and a potential commitment of US\$ 3 billion from international banks.

It was presumed at the time of the announcement that the total of US\$ 18 billion would calm the market agents, since it covered the outstanding Tesobonos held by foreigners coming due in 1995. However, it did not take care of the certificates of deposit in local banks and other short-term obligations coming due in the year. It was assumed, or hoped, that a large portion of them would be rolled over. This assumption was not shared by Mexico's creditors, however, and the pressure on the peso continued unabated. Through simple arithmetical calculations investors estimated that payments coming due in 1995 (of about US\$ 50 billion, assuming that most of the short-term public and private debt (except inter-bank loans) would not be rolled over) were far greater than

⁴⁴ Half of the additional US\$ 3 billion came from the U.S. Treasury under the "Temporary Exchange Stabilization Agreement" (TESA), signed on 4 January 1995 and set to expire on 3 April 1995. The remaining US\$ 1.5 billion came from the Federal Reserve.

the estimated resources available: international reserves in the Banco de México were about US\$ 6 billion and the first international rescue package was equal to US\$18 billion. Consequently, the rescue package plus the international reserves would barely cover half of Mexico's financial obligations for 1995, estimated at not less than US\$ 50 billion.⁴⁵

By the end of the first week of January, it became clear to Mexican Secretary of Finance Guillermo Ortiz that the problem was much more difficult than anticipated. The news on 6 January that some Mexican banks were unable to renew the certificates of deposit held by foreigners triggered another wave of flight from the peso. It became obvious that there would be great difficulties in rolling over any short-term government debt coming due in the first part of 1995. At this time the Mexican authorities began to discuss the terms of an agreement with the IMF and explore other alternatives of support with the U.S. Treasury.

The sentiment of the markets is well reflected in an anecdote told by a high-level IMF official who recounts that a fund manager stared at him with perplexity when told that the Mexicans had committed themselves to a balanced budget for 1995. The fund manager's reply was a daunting question: had the Mexicans included all the payments of the Tesobonos coming due in 1995 in the expense side of the budget?

4. The US\$ 40 billion in loan guarantees

On 9 January 1995, the Mexican Government drew US\$ 500 million from the United States swap line and C\$ 83 million from the Canadian one. The Banco de México used these resources to intervene in the exchange rate market to stop the run on the peso. However, the peso continued to slide. On 10 January the dollar closed at 5.75 pesos, and stock markets in Mexico and other places in the world were falling

⁴⁵ The estimates of total dollar denominated short-term obligations coming due in 1995 include: US\$ 6.3 billion in amortization of short-term public external debt; US\$ 1 billion in amortization payments to the IMF; approximately US\$ 6 billion in amortization of long-term external public debt; US\$ 6.1 billion of non-bank private sector debt due to banks; US\$ 2.1 billion of non-bank private sector debt due to non-banks; and US\$ 29 billion of Tesobonos (not classified as external debt but denominated in dollars). Adding all this up yields a total of US\$ 50.5 billion coming due in 1995, assuming that the US\$ 24.1 billion of interbank loans would be rolled over.

sharply.⁴⁶ That other markets reacted "in sympathy" with Mexico's is reflected by the evolution of the stripped yields of Brady par bonds for Argentina, Brazil, Bulgaria, Morocco, Nigeria, Poland and the Philippines (Truman, 1996, figures 1 and 2).

Ted Truman, Director of the Division of International Finance of the U.S. Federal Reserve Board, notes:

"When the crisis erupted, investors panicked, not only investors in the Mexican stock market and in Mexico debt instruments but also investors in similar instruments issued by borrowers in other countries, especially countries in the same part of the world or perceived to be in similar circumstances. These contagion sales of assets were induced by at least two types of forces. First, as perceived risks rose and expected returns fell, individual investors were induced to disinvest. Second, institutional holders such as mutual funds faced with actual or threatened redemptions were led to liquidify their holdings not only of Mexican paper but also of the paper of other countries, especially if they could do so while limiting their capital losses. ..." (Truman, 1996, p. 10).

Whether this was the prelude to a financial debacle engulfing the whole of the developing world can certainly not be proved. Nevertheless, there were indications that such a scenario was possible. This ominous possibility and the certainty that Mexico was on the verge of financial collapse prompted President Clinton⁴⁷ to announce, on 11 January, that "...the United States is committed to doing what we can to help Mexico through what is and should be a short-term crisis.⁴⁸ The impact of Clinton's pronouncement let itself be felt almost instantaneously in Mexico's financial markets: the Mexican stock market's index, for example, reversed its downward trend literally a minute after Clinton's speech.

On the following evening Clinton announced his proposal to request authorization from the U.S. Congress to extend US\$ 40 billion to Mexico in loan guarantees: a package modelled on the US\$ 10 billion in loan guarantees provided to Israel in 1992.⁴⁹

⁴⁶ The Mexican Stock Exchange closed down 6.26% on 10 January 1995 (*Newsday Marketline*).

⁴⁷ Following preliminary consultations with the Congressional leadership on the evening of 10 January 1995.

⁴⁸ *Washington Post*, 12 January 1995, Section A, p. 19.

⁴⁹ *Washington Post*, 14 January 1995, Section D, p. 1.

The President secured the support of the Congressional leaders from both parties and, at least initially, a relatively speedy affirmative vote seemed feasible. This assumption turned out to be incorrect, however. Members of Congress from both parties felt very uncomfortable –to say the least– approving a sizeable rescue package for Mexico at the same time that they advocated austerity measures in the United States. Moreover, many of the new Republican members were isolationists and unsympathetic to NAFTA and Mexico. The conditions to be requested from Mexico began to mount and they eventually covered the entire range of bilateral issues: migration, relations with Cuba, extradition practices, narcotics trafficking, and so on. Eventually it became clear that Congressional approval of a bill that would also be acceptable to the Mexican Government could not be secured, at least in the foreseeable future.⁵⁰

5. The IMF comes on board

It may be surprising that the “NAFA plus” assistance package of US\$ 18 billion announced in early January did not involve the IMF. Officials from the IMF did go to Mexico at the end of December, but the Mexican authorities were reluctant to negotiate an agreement with the Fund because they thought it would send a signal of weakness. It was not that the Mexican authorities disagreed fundamentally with the IMF prescriptions, as had been the case with López Portillo in 1982. The main problem was the message: countries which went to the IMF were perceived as having misbehaved. In the case of Mexico in early 1995 the necessary message, at least in the eyes of Mexican officials, was that the Mexican Government had been and would continue to be reliable. The crisis of confidence, it was thought, was based on misperceptions and an agreement with the IMF could strengthen them. This resistance to the IMF probably arose from the prevailing impression –in retrospect, a wrong one– that the market’s reaction was temporary and the situation would soon return to normal: i.e., that short-term obligations coming due in 1995 would be rolled over.⁵¹

⁵⁰ For more details see the account in Montañó (1996).

⁵¹ This perception was shared by many analysts in Mexico. I recall very vividly how at the end of January I had several arguments with various colleagues, trying to convince them that Mexico was facing a very serious economic crisis, perhaps the most serious one in its post-revolutionary era.

The Mexican authorities’ reluctance to go to the IMF vanished when they realized that the panic of the markets was *in crescendo*. In particular, they finally became convinced that an agreement was necessary when the incidents of the non-renewal of certificates of deposits held in a Mexican bank occurred at the end of the first week of January 1995. Around that time, and shortly after the announcement of the Mexican economic plan, Michel Camdessus, the IMF’s Managing Director, said that the Fund would begin negotiations with Mexican authorities. This announcement of an impending agreement with the IMF, however, did not do much in terms of restoring confidence in the markets.

On 26 January 1995, the IMF announced that Mexico had requested an 18-month stand-by arrangement for US\$ 7.8 billion (equivalent to 300 percent of Mexico’s quota). This agreement was prepared, and the quantitative targets were set, under the assumption that the US\$ 40 billion in U.S. loan guarantees would be approved. In essence, the agreement included the same quantitative targets as the Mexican economic plan announced on 2 January in terms of fiscal cutbacks, but the Mexican Government agreed to further tightening in the future if the evolution of the exchange rate and current account deficit made it necessary.

The problem with the IMF agreement was that market agents were not convinced –and rightly so– that the targets in the economic programme of early January were credible.⁵² By the end of January the assumption of an exchange rate of 4.5 new pesos to the dollar and a predicted 19 percent yearly inflation rate for 1995 seemed unrealistic. The endorsement of those targets at the time probably caused more harm to the IMF’s credibility than it helped Mexico’s.

6. The February 1995 rescue package

As mentioned above, towards the end of January it became increasingly evident that the United States

⁵² In reality, the IMF agreement included contingent provisions in terms of tightening the fiscal adjustment, for example, in the event that the outcomes in terms of the stability of the peso and inflation were not achieved. However, the terms of these agreements are always secret, and in this case, given the crisis of confidence, it was considered inappropriate for the IMF to openly question the Mexican programme from the start.

loan guarantee package was not supported in Congress and if submitted to a vote any time soon it would face a defeat. The consequence of this was another round of capital flight, and the peso began its seemingly uncontrollable downward slide once again. This led to the two most dramatic decisions of this episode. On 31 January 1995, President Clinton announced that he would use his executive authority to provide Mexico with up to US\$ 20 billion in loans and loan guarantees through the Exchange Stabilization Fund: the largest use ever made of this facility and more than three times the size of the financial assistance given to Mexico in mid-1982, if measured in real terms. At the same time, Michel Camdessus announced that the IMF would increase the 18-month stand-by arrangement to US\$ 17.8 billion: the largest ever extended by the IMF both in terms of its value and as a percentage of the country's quota.⁵³

In addition to the unprecedented contributions of the U.S. Government and the IMF, the package would include US\$ 10 billion from other industrialized nations through the BIS; US\$ 1 billion from Canada; US\$ 1 billion in currency swaps from Argentina, Brazil, Chile and Colombia (which did not materialize), and US\$ 3 billion in new loans from commercial banks (which did not materialize either). The total came close to US\$ 53 billion. However, only the US\$ 20 billion from the U.S., the US\$ 17.8 billion from the IMF and the US\$ 1 billion from Canada actually became available (table 2), plus loans from the World Bank and the Inter-American Development Bank totalling US\$ 3 billion. Although the BIS loan became available on paper it was not very helpful because of the stringent restrictions on its use. In reality, other industrialized nations viewed Mexico's financial troubles as a United States problem and hence they were not eager to get involved; indeed, it appears that some were even annoyed because they were asked to help.

Of the total rescue package, the US\$ 7.8 billion from the IMF stand-by was made immediately available. One limitation of the rest of the funds was that they would not be available all at once but in tran-

⁵³ Current rules state that an IMF member can borrow an amount equal to 100% of its quota per annum, with a cumulative limit of 300%. The 1 February 1995 agreement was equivalent to an unprecedented 688.4% of Mexico's quota.

TABLE 2

Mexico: Financial rescue package, 1995^a
(Millions of dollars)

<i>Total</i>	48 800
United States	20 000 ^b
(Disbursements by February 1996)	(13 500)
(Outstanding debt as of February 1996)	(10 500) ^c
(Outstanding debt as of August 1996)	(3 500)
(Outstanding debt as of January 1997)	None ^d
IMF	17 800 ^e
(Disbursements by February 1996)	(13 000)
(Outstanding debt as of December 1996)	(11 500) ^f
Canada	1 000 ^g
(Disbursements; maximum)	(350)
(Outstanding debt as of February 1996)	None
BIS	10 000 ^h
(Disbursements)	None

Source: U.S. Department of the Treasury and Federal Reserve.

^a Rescue package announced on 31 January 1995. The figures do not include the initial contributions that failed to materialize.

^b From Exchange Stabilization Fund; maximum amount potentially available. Funds could be used in short-term currency swaps, medium-term loans and security guarantees. For more details see General Accounting Office (1996).

^c Short-term currency swaps; paid by Mexico in full.

^d Medium-term swaps for US\$ 10.5 billion coming due between June 1997 and June 2000; paid off in advance in full.

^e An 18-month stand-by agreement announced on 1 February 1995. Of the total, US\$ 7.8 billion was available immediately.

^f Five-year loan with a 3¼ year grace period.

^g Short-term swaps.

^h Terms were too short-term and conditions too restrictive. Not drawn by Mexico.

ches, and their availability would depend on Mexico's strict compliance with a set of economic conditions and targets. In the case of the ESF loans, their availability would also be affected by domestic political factors in the United States. Due to the vehemence of critics of the U.S. rescue package in Congress, the Administration became increasingly cautious in disbursing the ESF loans to Mexico,⁵⁴ especially when, in general terms, the short-term liquidity problem had been solved.

⁵⁴ The attack on the Administration was spearheaded by Senator Alfonse D'Amato, Chairman of the Senate Banking Committee, who was virulently opposed to the rescue package. D'Amato held several hearings at which the majority of the non-government witnesses were very negative about the package and Mexico. He also launched several bouts of attacks in the press against the major players on the United States side.

7. The terms of the U.S. assistance

The terms of the ESF-based US\$ 20 billion U.S. package were formalized in the "U.S.-Mexico Framework Agreement for Mexican Economic Stabilization", signed on 21 February 1995, which governed the U.S. loan and loan guarantees package for Mexico. The terms specified that disbursements can take place for one year and can be renewed once for six months.⁵⁵ As part of this agreement, and since the use of ESF funds required an assured source of repayment, the Mexican Government agreed to deposit the proceeds of oil export sales by PEMEX and its two export sales subsidiaries in a pass-through special account⁵⁶ at the Federal Reserve Bank of New York.⁵⁷

The "1995 Framework Agreement" also specified that Mexico was to be responsible for the payment of all costs, fees and expenses; reporting, notification, and consultation requirements; and, in the case of medium-term swaps, interest charges sufficient to cover the U.S. Government's credit risk costs. Most importantly, under the agreement the Mexican Government committed itself to comply with the IMF programme and additional requirements set by the U.S. Treasury in its "Economic Policy Memorandum" (Annex C of the Framework Agreement). The latter essentially deepens the policy commitments undertaken by Mexico in the IMF accord. In particular, the Mexican Government agreed not to intervene in the foreign exchange market by using its international reserves but to stabilize the peso via fiscal and monetary policy. In addition, it agreed to regularly disclose information on a number of variables and policy decisions in a systematic and transparent way and proceed with structural reforms.

The announcement of the new rescue package at the end of January halted the peso's nosedive. However, the markets remained jittery until the Mexican Government announced a new economic programme with more realistic and credible targets on 9 March

1995, and the first drawing on the ESF funds took place.⁵⁸

One important element that has received relatively little public attention is the economic policy conditions that the United States financial authorities attached to the rescue package. In particular, U.S. Treasury officials were convinced that in order to stabilize the peso the Mexican authorities would have to raise domestic interest rates to the point of generating positive returns even in the very short run. The Mexican Government, in contrast, favoured the stabilization route that had been pursued in 1983: i.e., a larger depreciation of the peso and lower real domestic interest rates, arguing that high interest rates would deal a devastating blow to an already battered banking system. The United States authorities were concerned that further depreciation of the peso would continue to erode market confidence, cause further runs on that currency, and possibly lead to hyperinflation. Their worst nightmare was that the ESF loans to Mexico would vanish in the form of capital flight, at the same time that the peso would continue on its downward slide. In the end, the views of the Department of the Treasury prevailed, but the discussion was far from smooth.⁵⁹

After the signing of the Agreement, and throughout the period in which Mexico was still in debt to the United States, the Department of the Treasury engaged in activities of monitoring and surveillance which in the past would have been the sole responsibility of the IMF. In February 1995, for example, the U.S. Treasury created a "Mexico Task Force" whose purpose was to monitor Mexico's economy and economic policymaking. This should come as no surprise. In 1982, the United States had lent the equivalent of US\$ 5.7 billion in 1995 dollars and the maturity of the loans was one year. In 1995, in contrast, the U.S. financial assistance was for up to US\$20 billion, and of the US\$ 13.5 billion actually disbursed, US\$ 10.5 billion was in medium-term swaps falling due between June 1997 and June

⁵⁵ The six-month extension was granted at the end of the first year, and the agreement expired on 21 August 1996.

⁵⁶ The pass-through quality of the account means that the proceeds do not accumulate as a stock. For more details on the terms of the U.S. rescue package see General Accounting Office, 1996, chapter 4.

⁵⁷ See "Oil Proceeds Facility Agreement", Annex A of the 1995 Framework Agreement.

⁵⁸ Because the Mexican Government wanted to obtain the endorsement of the members of the old Pacto for the new programme, it was not possible to announce the Mexican programme at the same time as the Framework Agreement, and this of course did not help confidence-building. In the end, the Government was not able to secure the endorsement of the members of the Pacto, because they disagreed with the austerity measures, and it finally announced the programme unilaterally.

⁵⁹ Whether this was the least costly stabilization path is a discussion which goes beyond the objectives of this paper.

2000.⁶⁰ Given the size and the maturities of the current lending programme, it is understandable that the United States would want to monitor economic events in Mexico much more closely than before.

8. Was the financial assistance package a success?

The success of the 1995 rescue package is evidenced by two clear indicators. The first is the speed with which the Mexican Government has been able to return to the international capital markets. As mentioned above, as early as April 1995 a Mexican development bank was able to borrow in the international market, and between mid-1995 and early 1996 Mexico was able to raise about US\$ 8 billion, with the terms and maturities of the loans improving over that period.⁶¹ Moreover, although there were a few additional incidents of market volatility, the peso has achieved an acceptable degree of stability since March 1995, and especially since November of that year.⁶² Indeed, it may be noted that the rescue operation was so successful in restoring market confidence that Mexico was able to pay off the whole of the US\$ 13.5 billion owed to the United States by late

January 1997, although the original repayment schedule provided for maturities between June 1997 and June 2000. The second indicator of the rescue package's success is that the possibility of the crisis spreading to other countries in the region and other regions as well was brought to a halt.⁶³ In contrast with 1982, the liquidity and confidence crisis was limited to a single country: Mexico (Eichengreen and Fishlow, 1996).

Nevertheless, despite all its accomplishments, the financial rescue package was not able to spare Mexico from a major recession, the worst since the Great Depression. During 1995, Mexican output fell by close to 7%, unemployment doubled to reach close to 7%, and real wages contracted by 22%. Although without the financial assistance the situation would undoubtedly have been far worse, it is remarkable that such a big financial support programme did not translate into a softer landing of the Mexican economy. Explaining why this has been the case, however, is a topic beyond the purpose of this paper. The important thing is that Mexico's economic recovery continues along the right lines, as witnessed by the increase in output of over 5% in 1996.

IV

Concluding remarks

The foregoing account brings out one fundamental difference between the financial assistance packages of 1982 and 1995. While the former was followed by a decade of living in "exile" from the international capital markets, the latter was successful in quickly restoring market access. The difference in the outcomes must be related to the size of the financial package and its medium-term nature. As mentioned above, in 1995 the financial rescue package was designed to be large enough to plausibly solve Mexico's liquidity crisis; in 1982, in contrast, while the package

was large enough to avoid a Mexican default the country was obliged for the next six years to go from one rescheduling exercise to another, with the uncertainty of whether it would be able to meet its obligations always lurking on the horizon. The 1995 package's success must also be attributed to two other factors, however. First, despite the external disequilibrium in the years leading up to the crisis, the Mexican economy was in far better shape than in 1982. Second, the external environment was much more adverse in 1982 than in 1995, with world interest rates at record high levels and oil prices falling at a time when oil exports represented 80% of Mexico's total exports.

⁶⁰ For full details of the payments programme for the medium-term swaps, see table 2.

⁶¹ General Accounting Office, 1996, p. 140, and United States Department of the Treasury, 1996.

⁶² Whether this stability in the exchange rate market will continue depends on a number of factors, some economic and some political.

⁶³ Although Argentina had a sharp recession in 1995 it was able to avoid a major crisis of confidence.

To a large extent, the differences in the outcome stem from the differences in the United States response. In 1982, the U.S. Treasury organized a US\$ 2 billion short-term loan only when Mexico's reserves were practically down to zero, despite repeated warnings from the Mexican finance ministry. In addition, the U.S. Treasury put the Mexican Government on the spot by trying to extract a concessional price for oil sales and large fees, thus showing not only political insensitivity but also a lack of awareness of how much it was in the United States' interest to avoid a Mexican default. While the U.S. Federal Reserve was much more sympathetic to Mexico and well aware of the systemic dangers of a Mexican default, the chosen strategy did not solve the more fundamental problem of that country's overindebtedness.

In the more recent episode, U.S. support was present even before the crisis. The Clinton administration showed its commitment to help stave off attacks on Mexico's reserves as early as the Fall of 1993, when during the Congressional vote on NAFTA the U.S. Administration set up a US\$ 6 billion swap arrangement. In April 1994, after the assassination of Luis Donaldo Colosio, the PRI Presidential candidate, anticipating that the peso would be under pressure, the Clinton administration—in collaboration with the Canadian Government—transformed the swap line into a permanent arrangement. And in December of that year, when Mexico was on the verge of a financial collapse after the decision to devalue, the U.S. Administration responded with a series of initiatives that culminated in the unprecedented US\$ 48.8 billion financial rescue package, to which the only real contributors were the U.S. government, with up to US\$ 20 billion, the IMF with US\$ 17.8 billion, and Canada with US\$ 1 billion.⁶⁴

Also, unlike 1982, this time the U.S. Administration did not try to extract from Mexico concessions which were not warranted by market conditions, such as asking that country to sell crude oil to the United States at what was then a sizeable discount. Moreover, the U.S. Executive took a notable political risk in rescuing Mexico. With a hostile and hypercritical Congress that had implicitly rejected a Mexican rescue package in January, the Administration was under a lot of pressure to design a programme that would give quick results in terms of the peso's sta-

bility and would ensure the protection of U.S. taxpayers' money.

Why was the response of the U.S. Administration and the IMF so different in 1995 from what it had been in 1982? Several important reasons can be identified. First, the Clinton Administration had invested an important share of political capital in Mexico's fate with its strong endorsement of NAFTA. A collapse of the Mexican peso would have haunted President Clinton throughout his re-election campaign and turned the adoption of NAFTA—viewed by many as a positive achievement—into a political embarrassment, with likely negative consequences for the project of extending NAFTA and building a free trade area in the Americas. Furthermore, the negotiation of NAFTA brought the U.S. and Mexico closer than ever before in institutional terms. Starting with the Bush administration, and continuing with that of Clinton, the two countries' relationship evolved from one characterized by distrust and resentment to a more constructive and cooperative one.

Second, since de la Madrid's Presidency, and especially under the Salinas administration, the Mexican authorities had won the confidence and praise of the United States Government and the international community at large because of their commitment to price stability and market-oriented reforms. Mexico had become a model debtor and model reformer and was constantly held up as a shining example for other countries. For market-reform advocates, "letting Mexico go" would in effect have meant admitting that despite all their efforts and sacrifices, reforming countries and governments could remain unrewarded, opening the way for the return of political support for populist policies. In contrast, in 1982 Mexico was pursuing all the policies regarded as anathema: a large fiscal deficit, widespread State intervention in the economy, and closed trade and investment regimes.

Third, the difference in the response is explained in part by the differences in the causes and nature of the crises. Policy mistakes notwithstanding, the severity of the markets' reaction that followed the December 1994 devaluation was totally disproportionate. This view was not only fully shared but actively propounded—at least in public—by key members of the U.S. cabinet and high-level officials of the multilateral institutions. In contrast, although the 1982 debacle was triggered by adverse external conditions, it was clearly rooted in fundamental domestic errors in economic policy. Paradoxically, the markets were

⁶⁴ The actual use made of these facilities is shown in table 2.

more tolerant with the mismanagement in 1982 than they were in 1994.

Fourth, the memories of the "lost decade" which followed Mexico's 1982 suspension of payments was fresh in most key policymakers' minds at the U.S. Federal Reserve Board, the U.S. Treasury Department and the multilateral financial institutions. The behaviour of other Latin American—and even some non-Latin American—markets in early January 1995 raised the spectre of another crisis of systemic proportions: something that people in the U.S. Government and the multilateral agencies were not ready to risk. The key players in the U.S. Government and the IMF decided that it was better to be accused of taking unprecedented actions than being blamed later for not acting.

However, as regards the U.S. response in 1982 and 1995, there are other factors that are equally important in terms of accounting for the differences. The Clinton administration acted on the belief that the government can and should play an active role to correct situations where markets fail or where the absence of government action can be very costly; this contrasted with the "laissez-faire" ideology prevalent

in Reagan's cabinet. Moreover, a financial collapse in Mexico could result in increasing tensions between the two nations, particularly as a consequence of the impact of the economic crisis on migration flows.

To conclude, although the 1995 financial assistance package accomplished the objective of solving Mexico's short-term liquidity crisis, one could argue that it is unlikely that a similar programme can be repeated in the future. Furthermore, even if it can, a hasty and politically difficult response is not the best option for handling another Mexican or Mexican-like crisis in the future. Given the nature of today's capital markets, similar crises are quite likely to occur. Consequently, the need for the multilateral institutions to implement crisis-prevention and crisis-management mechanisms seems a natural corollary of the lessons learned from the Mexican crisis. In addition, in the specific case of Mexico, preventing or managing future crises may require closer policy consultation—especially between the United States and Mexico—and perhaps different institutional mechanisms from those existing before the peso crisis of 1995.

(Original: English)

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