LESSONS FROM THE RECENT PESO CRISIS IN MEXICO

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I. INTRODUCTION

Lessons from the Mexican foreign exchange and devaluation crises of 1994-95, and the U.S.-IMF bailout efforts that followed, can be drawn with greater detachment now. The biggest mistake involved excessive euphoria about the benefits from heavy capital flows into Mexico as NAFTA was consummated.[1] In retrospect, blame must be laid on both sides of the border for a lack of longer run realism and insufficient supervision of a big surge of investment-trading flows. Major imbalances followed.[2] This put great strain on recently stabilized exchange rates.[3] In the later fall-winter of 1994-95, capital began to flow out of Mexico in panic.[4] A large devaluation soon became unavoidable, with heavy capital losses for many investors and financial institutions.[5] A breakdown of confidence in the Mexican economy (and other

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1. *The Mexico Syndrome, and How to Steer Clear of It*, ECONOMIST, Mar. 18, 1995, at 73-75 [hereinafter *Mexico Syndrome*]. *See generally* DAVID FOLKERTS-LANDAU & TAKATOSHI ITO, INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS, PROSPECTS & POLICY ISSUES 33-95 (1995).

2. *Id.*

3. *Id.*

4. Andres Velasco, *Lessons from the Recent Mexican Crisis*, CV STARR NEWSLETTER (New York University), vol. 13, 1995, at 1.

5. *Mexico Syndrome*, *supra* note 1, at 73.

"emerging market" nations) would hurt the U.S. economy and, along with it, the Clinton administration.[6] The Clinton administration had just suffered a damaging political blow in losing both houses of Congress to the Republican party in the November 1994 elections.[7] Understandably, Clinton's urgent bailout strategy was influenced by the need to contain and limit a financial crisis that flowed from the NAFTA agreement of 1993, in which Clinton had invested heavy political capital.[8] Meanwhile, many U.S. business and financial interests put pressure upon Republican leaders to go along with an extensive and prompt bailout.[9] On the other hand, populist Democrats and Republicans, and many "free market"-oriented conservatives, were largely critical, accusing both the Mexican and U.S. governments of negligence, and doubting the need for any large U.S. governmental participation in the bailout.[10]

II. MEXICAN ECONOMIC POLICIES

Since the late 1930s, Mexico has achieved widespread economic progress.[11] Civil order was re-established, economic growth surged in many areas, and healthier controls over foreign investment were established.[12] PEMEX (the state-owned oil company) became a major source of cash for the government, helping finance broader economic and social development.[13] But gradually, protectionism, state enterprise, and subsidies in many sectors grew more entrenched. This began to limit economic growth somewhat by the 1970s.[14]

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6. *Statement of the Shadow Financial Regulatory Committee on Emergency Assistance for Mexico*, SHADOW FINANCIAL REGULATORY COMMITTEE (Loyola University of Chicago), Feb. 13, 1995.

7. Peter Passell, *A Mexican Payoff: Economists Say U.S. Policy Worked and Capital That Fled Is Returning*, N.Y. TIMES, Oct. 12, 1995, at C5.

8. *Id.*

9. *In the Peso We Trust?*, NATION, Feb. 6, 1995, at 1.

10. Robert Wright, *Let Them Eat Hate*, NEW REPUBLIC, Apr. 24, 1995, at 4. Some European financial interests also complained about a large IMF participation in the bailout, arguing that this was mainly a U.S.-Canada-Mexico problem. On the other hand, European and Japanese investors and financial institutions were involved in Mexico, and more so in other "emerging markets," where a big Mexican collapse could trigger a chain reaction panic resembling a row of falling dominoes.

11. David M. Gould, *Mexico's Tectonic Shift: Will It Be Long Lasting?*, CHALLENGE, Mar.-Apr. 1995, at 26-27.

12. For an analysis of the effects of foreign ownership of Mexican industry, see generally Brian Aitken et al., *Wages and Foreign Ownership: A Comparative Study of Mexico*, WORKING PAPER NO. 5102 (National Bureau of Economic Research, Inc.), May 1995.

13. DANIEL YERGEN, THE PRIZE 278 (1991).

14. Gould, *supra* note 11, at 27.

The biggest bumps in the road had been serious inflation pressure and political strains, especially between 1975 and 1977, and the borrowing binge under Lopez-Portillo, from the late 1970s to the early 1980s, which culminated in a near disastrous default for Mexico on its debt in 1982.[15] Ironically, this debt-overload crisis of the 1980s proved constructive in a painful way, in that Mexicans were provoked to fundamentally re-examine their accumulated economic policies, excessive budget deficits, and overgrown state industries.[16]

Mexico's Partido Revolucionario Institucional (PRI) had shown resilience since the late 1920s as a one-party tent within which business, farmers, workers, and growing government bureaucracy could be peaceably harmonized under extremely powerful, six year-term presidencies.[17] Severe economic hardships, wage reductions, dislocations, slowed growth, and inflation, however, added stress and significant unpopularity through most of the 1980s.[18] In a surprising way, broadened education and a younger generation of talented technocrats brought "consensus-like" economic reforms, greater efficiency, privatization, renewed national determination, and even some political liberalization.[19] Some cuts in public spending, tax increases, fiscal discipline, export growth, greater trade openness, enhanced competitiveness, and partial debt relief from the multinational banks strengthened the Mexican economy.[20]

Impressed with the U.S.-Canada Free Trade Agreement that was negotiated between 1985 and 1988, Mexican leaders decided upon a

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15. *Id.* Between the late 1970s and early 1980s Mexico borrowed too much from multinational banks at floating LIBOR rates, based upon over-optimistic projections that big new offshore oil revenues would keep rising indefinitely. However, world oil prices peaked in 1981, started to slump downwards for a few years, and were cut by more than half after 1986. Meanwhile, the United States and other big creditor nations cracked down on inflation between 1979 and 1985. This brought a period of high world market interest rates and debt service cost, creating a great burden for Mexico. *See* Jose Angel Gurria Trevino, *The Mexican Debt Strategy*, CHALLENGE, Mar.-Apr. 1995, at 34-36.

16. Gould, *supra* note 11, at 27-28.

17. *Viva Amexica! A Survey of Mexico*, ECONOMIST, Oct. 28, 1995, at 7 [hereinafter *Viva Amexica!*].

18. *The Long Haul*, ECONOMIST, Aug. 26, 1995, at 18; Gould, *supra* note 11, at 27-30.

19. *The Long Haul*, *supra* note 18, at 17-19; Sidney Weintraub, *Mexico's Foreign Economic Policy: From Admiration to Disappointment*, CHALLENGE, Mar.-Apr. 1995, at 40.

20. Gould, *supra* note 11, at 28-31; Weintraub, *supra* note 19, at 40-43. In 1985 Mexico joined the General Agreement on Tariffs and Trade of 1947 (GATT), a major symbol of change in direction from an "inward-oriented" protectionist development strategy to an "outward-oriented" export strategy. A rapidly expanded *maquiladora* program encouraged U.S. companies to set up cheap labor processing plants near the Northern border. Gould, *supra* note 11, at 30.

fundamental change in trade policy.[21] Under President Carlos Salinas (1988-94) Mexico proposed the North American Free Trade Agreement between the United States, Mexico, and Canada (NAFTA).[22] It was crafted as a win/win deal for Mexico, with major net gains in foreign investment, employment, production efficiency, and exports, along with sufficient safeguard restrictions and "snap-back tariffs" to ease any significant disruptions for Mexico.[23] Part of the Mexican motivation was also political—to secure the liberalization and reform process.[24]

III. U.S. POLICY RESPONSE AND NAFTA

President Bush promptly welcomed the NAFTA, insisting mainly upon safeguards for U.S. investor interests.[25] But worries from the AFL-CIO and environmental interests in the United States got little sympathy, and in 1992 a draft NAFTA was finalized.[26] At this stage, however, Governor Clinton's campaign against President Bush took increasing momentum, and Mexicans were forced to wait in suspense for the U.S. presidential election and for the eventual transition to a new Clinton administration in late 1992 and early 1993.

Many Democrats from the Northern and "rust belt" states, already suffering substantial job losses from relocation of manufacturing plants to lower wage countries, along with the AFL-CIO and most environmentalists, opposed NAFTA.[27] But President Clinton decided to accept NAFTA with only modest "side agreements" providing limited supervision and safeguards against "import surges," environmental standards degradation, and lower labor standards that might cause job

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21. Gould, *supra* note 11, at 30.

22. Weintraub, *supra* note 19, at 43.

23. GARY CLYDE HUFBAUER & JEFFREY J. SCHOTT, NAFTA: AN ASSESSMENT 3-5 (rev. ed. 1993). Under a "snap-back" tariff regime, a tariff is imposed once the price of imported goods falls to a certain level.

24. Weintraub, *supra* note 19, at 43.

25. *Id.* at 44. U.S. direct investment in Mexico was $11.6 billion at the end of 1991, compared with $.9 billion at the end of 1987. Although Mexico contains only 2.6% of the total $450 billion invested by U.S. companies abroad, it has received 6.7% of all new equity flows in the past three years. *Id.* at 79.

26. The Bush administration was also pressing toward "freer multilateral" trade, with a tentative Dunkel Draft Uruguay GATT Round agreement largely completed in 1992. This project, too, had to wait for the new Clinton administration, and a crystallization of its U.S. trade policy. By late spring 1993, Clinton's U.S. Trade Representative (USTR), Mickey Kantor, signaled eagerness for a GATT deal by November, greatly encouraging free traders.

27. Gwen Ifill, *The Free Trade Accord: Both Sides Assert Gain After Debate Over Trade Accord*, N.Y. TIMES, Nov. 11, 1993, at A1.

displacement.[28] Clinton chose to emphasize the benefits of freer trade, including claims of "net" job gains through greater efficiency, economic growth, and increased U.S. exports.[29] Thus, Clinton aligned himself on trade policy with most Republicans and multinational corporate lobbying interests.[30] This was somewhat risky for Clinton within the Democratic party, bringing substantial internal opposition, although Republican Senate Minority Leader Bob Dole and House Whip Newt Gingrich supported Clinton on these trade issues.[31]

IV. MEXICAN BALANCE OF PAYMENTS POLICIES

Mexico, like most developing and new industrial countries, had learned through hard experience that large current account deficits, with an excess of imports over exports, could not be sustained successfully without heavy, continuing foreign capital investment.[32] Mexico did not want to resubject itself to dependence upon foreign capital, as had occurred during the Diaz era from the 1870s to 1910, and in the Tampico oil fields era of the 1920s to early 1930s. This was partly why Mexico had turned inwards, using tariffs and other import restrictions to encourage domestic industry, import substitution, and a more independent development strategy.[33] In this way, the risk of any significant or sustained current account deficits could be minimized and contained.[34]

But from Mexico's viewpoint, the great new offshore oil boom of the late 1970s and early 1980s was an exceptional growth opportunity, although it turned out badly.[35] Expanding production and exports at higher prices seemed to provide a greatly enlarged basis for borrowing from the world market.[36] Much larger current account deficits could be accommodated, and a surge of new borrowed capital would flow into

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28. *See* HUFBAUER & SCHOTT, *supra* note 23, at 30-32; Keith Bradsher, *The Free Trade Accord,* N.Y. TIMES, Aug. 14, 1993, at 1; *North American Free Trade Agreement Side Accord on Environment, and North American Free Trade Agreement Side Accords on Labor and Import Surges, reprinted in* 10 INT'L TRADE REP. (BNA) 1536, 1536-58 (Sept. 15, 1993).

29. *Id.*

30. Charles Lewis, *The NAFTA-Math: Clinton Got His Trade Deal, but How Many Millions Did It Cost Him?*, WASH. POST, Dec. 26, 1993, at C2.

31. Jurek Martin, *Another One Under His Belt: NAFTA Was A Lesson for Clinton on the Power of His Office*, FIN. TIMES, Nov. 19, 1993, at 25.

32. Weintraub, *supra* note 19, at 42.

33. Gould, *supra* note 11, at 27.

34. *Still Volatile*, ECONOMIST, Dec. 9, 1995, at 19.

35. Gould, *supra* note 11, at 27.

36. Trevino, *supra* note 15, at 34.

Mexican industries, including the large state sector.[37] Unfortunately, when oil prices started declining, and interest rates surged upward, Mexico (like many developing countries) suffered a vicious, unplanned squeeze, as the cost of debt service greatly increased while export revenues declined substantially.[38]

Unfortunately, by summer 1982, Mexico had exhausted its foreign exchange reserves.[39] The "debt overload crisis" was severe for Mexico. Real income declined, growth stalled, and the majority of Mexicans suffered.[40] Then, as multinational banks and the IMF imposed tough terms for debt rescheduling, Mexico was forced to make large debt service payments. Meanwhile, Mexican exports exceeded imports—a reflection of hardship, greatly reduced capital inflows, and slowed investment.[41]

But after Mexico switched economic policies, applied painful "self-discipline," and gradually improved its situation by the end of the 1980s with a more open, outward-oriented development strategy, Mexico regained "credit-worthiness."[42] Quickly, Mexico became attractive as a place for foreign investment in the early 1990s.[43] Mexico moved forward with NAFTA negotiations and a renewed welcome for outside investment, including in privatized companies, partnerships with local business, and *tesobonos*.[44] Capital inflows resumed into Mexico with increasing volume.[45] Portfolio investment, including foreign mutual funds, corporations, and individuals, however, predominated this time, as compared to foreign bank lending of twelve to fifteen years earlier.[46] Most gratifying, part of the new surge of capital inflows was actually a

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37. *Id.*
38. Eighty percent of Mexican exports were oil. *Id.*; Gould, *supra* note 11, at 27.
39. Trevino, *supra* note 15, at 34-35.
40. Gould, *supra* note 11, at 28.
41. Trevino, *supra* note 15, at 35-38.
42. *Id.*; Gould, *supra* note 11, at 28-31; *Viva Amexica!*, *supra* note 17, at 4.
43. Gould, *supra* note 11, at 30; William P. Osterberg, *How Important Are U.S. Capital Flows Into Mexico?*, ECONOMIC COMMENTARY (Federal Reserve Bank of Cleveland), Dec. 1, 1994, at 2.
44. *Tesobonos* are short-term debt securities paid in pesos but indexed to the U.S. dollar. FOLKERTS-LANDAU & ITO, *supra* note 1, at 55; *see also* Gould, *supra* note 11, at 30; Osterberg, *supra* note 43, at 2.
45. Gould, *supra* note 11, at 30; Osterberg, *supra* note 43, at 2.
46. *Viva Amexico!*, *supra* note 17, at 5; Osterberg, *supra* note 43, at 2.

repatriation of Mexican owned capital that had left and leaked out of the country in the earlier troubled years.[47]

V. THE BIG MISTAKES—LACK OF REALISTIC SUPERVISION

The main lessons of the recent Peso Crisis of 1994-95 are that responsible financial and government leaders on both sides of the border failed to provide reasonable foresight, judgment, and supervision.[48] The big surge of capital flows into Mexico was welcomed by its leaders as a blessing and well-earned reward for their "reform" policies, as well as a recompense for the patient sacrifices of the Mexican lower and middle classes. Too little thought was given to the dangers of an unsupervised boom based upon foreign capital inflows that could be quickly reversed by a slump in confidence, a panic, and/or a major devaluation with another siege of heavy capital flight and reversed capital inflows. In the United States, little attention was paid to these risks, as Wall Street and other financial interests got involved in the speculative fever of a Mexican and "emerging markets" investment boom. Meanwhile, U.S. government officials were preoccupied with a wide range of other international and world trade finance issues, together with many domestic U.S. policy controversies.[49]

Understandably, perhaps, top U.S. financial and trade officials largely left Mexico-U.S. trade investment flows to the marketplace, and to the Mexican government's policy-makers. This left most practical supervision efforts to Mexico, with only minimal surveillance by the U.S. Treasury and the International Monetary Fund. Mexico seemed to be doing increasingly well.[50] Many viewed Mexico's evolution from President Miguel de la Madrid through President Salinas (1982-1994) as a "model" of successful economic reform for Latin America and the Enterprise for the America's Initiative.[51] It must be noted, though, that the Mexican economy was still more substantially "managed" than the

47. Andrea Dabrowski, *Mexico's Privatization Plan Under Pressure*, WASH. POST, Sept. 3, 1991, at E1.

48. *See* Velasco, *supra* note 4, at 3.

49. *Viva Amexico!*, *supra* note 17, at 5.

50. *Id.*; *Mexico Syndrome*, *supra* note 1, at 73. The Mexican GDP grew at annual rates of 4.4% in 1990 and 3.6% in 1992; the balances on the capital account for those years were $8.5 billion and $24.5 billion and consumer price increases were down from 131.8% in 1987 to 22.7% in 1991. *See* ECONOMIC AND SOCIAL PROGRESS IN LATIN AMERICA, SPECIAL SECTION, FISCAL DECENTRALIZATION: THE SEARCH FOR EQUITY AND EFFICIENCY 121 (1994) [hereinafter ECONOMIC AND SOCIAL PROGRESS IN LATIN AMERICA].

51. Weintraub, *supra* note 19, at 39-43; Trevino, *supra* note 15, at 38.

U.S. economy so that habits of "supervision" were stronger in Mexico.[52] A further complication in this regard was that Mexico's policy decision-making is more centralized, and the government less open than in the United States.[53] Finally, even though Mexican leaders had been shaping their economic affairs, Mexican planners understood that their statistical data were less complete, that substantial activity evaded strict control or surveillance, and that some leakages, including "hot money" or speculative capital flows, would be hard to prevent.[54]

Nonetheless, it seems clear that both Mexican and U.S. economic policy-makers failed to grasp realistically the likely consequences of very rapid increases in foreign investment into Mexico, substantially rising imports from abroad into Mexico, and much larger current account deficits for Mexico.[55] Certainly some speculators observed these developments realistically, as they took advantage of early warnings to bail out of Mexican markets, to reduce or liquidate their peso holdings, and to move as much capital out as possible into harder currencies in order to limit devaluation losses.[56] Unfortunately, the sharp sag in peso values caused large capital losses to many peso-denominated asset holders, at least in the short-term.[57] Painful lessons for these burned investors could operate for years as a drag upon Mexican investments, reducing capital for peso assets and possibly putting downward pressure on the peso.

By November 1995, the peso had drifted further downward, suggesting to some observers that a continued, significant depreciation of the peso might be unavoidable. On the other hand, the Mexican government and Banco de Mexico mounted a serious support operation in November for the peso with approval from the U.S. Federal Reserve.[58] The future evolution of the peso would depend upon Mexico's "fundamentals," in particular: real growth, limiting government deficits, inflation, adequacy of interest rates, capital flows, political stability, and especially the trade balance and current account and international

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52. Gould, *supra* note 11, at 30-31.
53. *Viva Amexica!*, *supra* note 17, at 7-8.
54. Osterberg, *supra* note 43, at 5.
55. Attempts were made to soften the capital outflow without success. Velasco, *supra* note 4, at 1.
56. FOLKERTS-LANDAU & ITO, *supra* note 1, at 56.
57. From July 1994 to March 1995, the Mexican Bolsa Index (the Mexican analogy to the Dow-Jones Industrial Average) declined, in U.S. dollar terms, almost 70%. *Id.* at 65.
58. Geri Smith, *Surveying the Wreckage,* BUS. WK., Jan. 23, 1995, at 58; *Treasury Dept. Documents Describing Terms & Stabilization Package* (released Feb. 21, 1995).

reserves. The credibility and timeliness of Mexican economic data will be crucial because world capital markets show more confidence in a country if its data can be trusted as reliable and current.

VI. HOW THE PESO CRISIS OF 1994-95 PLAYED OUT

Mexican leaders felt that reasonable stability in the peso's value was necessary for a successful exploitation of the NAFTA growth opportunity or, at least, that the peso should decline only slowly and slightly relative to the dollar.[59] Therefore, as Mexico's "success" between 1990 and 1993 became increasingly evident, the peso to dollar exchange rate was stabilized from 2.8073 in 1990 to 3.0126 in 1991, 3.0947 in 1992, and 3.1152 in 1993.[60] Only later in 1994, when Mexican capital flight began and reduced foreign confidence developed, and when Mexican foreign exchange reserves were drained from a peak of $25 billion to less than $5 billion between January to November 1994, was pressure felt by the peso for a major devaluation.[61]

Interestingly, this period of increased stability, success, and enhanced foreign confidence in Mexico had encouraged some $91 billion of new foreign investments into the country between 1990 and 1993.[62] The increased economic activity, manufacturing, and opportunity which flowed from these investments were welcome to an economy hungering for prosperity and nourishment again.[63] But, ironically, the same stability in the peso's value allowed a major upward surge in Mexican imports, some of which were used for expanding plant, equipment, and

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59. Western Europe's experience with the gradual coordination of their currencies was an obvious model. Thus, the early EC currency "snake," the "snake within a tunnel," the initial versions of the European Monetary System (EMS), and the later versions of EMS all demonstrated that the poorer, less developed areas of a new economic confederation (e.g., the Mediterranean "South" of Europe) had greater difficulty in maintaining fiscal discipline and strict parity, i.e., their currencies kept sliding in value against the Northern core of hard currencies (e.g., led by the Deutschmark and Swiss franc).

60. Gould, *supra* note 11, at 29.

61. FOLKERTS-LANDAU & ITO, *supra* note 1, at 57.

62. *Id.* at 53.

63. During the 1980s, the Mexican economy experienced slow to negative growth. In 1986, the total economy shrunk by 3.7% with a 5.3% decline in manufacturing and a 10.3% decline in construction. The following years were not much better with a meager 1.8% GDP growth in 1987 and 1.2% growth in 1988. ECONOMIC AND SOCIAL PROGRESS IN LATIN AMERICA, *supra* note 50, at 121. During the same period, Mexico had a serious outflow of capital with capital accounts deficits in excess of one billion dollars in 1992. *Id.* at 820. These massive payments gave Mexico the highest debt service ratio in Latin America with 46.5%. *Id.* at 282. The average for the region was only 30.5%. *Id.* at 282.

inventories from abroad.[64] Mexican imports exploded from $12.2 billion in 1987 to $23.4 billion in 1989, $48.2 billion in 1992, and an estimated $59 billion in 1994.[65] In contrast, Mexican exports grew more slowly, and were $20.7 billion in 1987, $22.8 billion in 1989, $27.5 billion in 1992, and about $36 billion in 1994.[66] Thus, the Mexican trade balance deteriorated from an export surplus of $8.4 billion in 1987, to a slight deficit of $-.7 billion in 1989, and reached $-20 billion in 1992 and $-18.5 billion in 1994.[67] Mexico's current account balance declined from a $4.0 billion surplus in 1987 to a $-4.0 billion deficit in 1989, getting much worse with a $-22.8 billion deficit in 1992, and a $-28.8 billion deficit in 1994.[68] As a share of Mexican GDP, the current account deficit (surplus) was 1% of GDP in 1987, -.9% of GDP in 1989, -4.1% in 1992, and -5.2% in 1994.[69] The current account deficits of these later years are simply unsustainable. Mexico was clearly living beyond its means again, as had occurred in the early 1980s.[70]

Mexican policy-makers should have been aware that such an import surge and current account deficits at 1992-94 levels could not last long. However, Mexico needed to present an encouraging prospect of political stability, sound economic policies, and welcome for international investors.[71] During 1992, the NAFTA deal was being finalized with the Bush administration.[72] In 1993, the Clinton administration needed reassurance about NAFTA and faced a tough political fight in Congress over ratification, with a majority of Clinton's House Democrats opposed.[73] In 1994, the new Mexican president was elected, on August 21, and inaugurated, on December 1.[74] All this argued against the political risk of a substantial, destabilizing peso devaluation, which is the normal exchange rate "adjustment" for a country suffering a surge of heavy current account deficits, shrinking foreign exchange reserves, and

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64. Between 1984 and 1989, Mexican imports of goods doubled from $11.3 billion to $23.4 billion. By 1993, they doubled again to $48.9 billion. *Id.*

65. ECONOMIC AND SOCIAL PROGRESS IN LATIN AMERICA, *supra* note 50, at 121.

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* at 121, 239.

70. *Viva Amexica!*, *supra* note 17, at 5.

71. Craig Torres, *Peso's Plunge Rocks Confidence in Investing in Mexico*, WALL ST. J., Dec. 15, 1994, at C1.

72. HUFBAUER & SCHOTT, *supra* note 23, at 1.

73. Martin, *supra* note 31, at 25.

74. FOLKERTS-LANDAU & ITO, *supra* note 1, at 54.

"an over-valued currency."[75] If Mexico had tried a substantial devaluation earlier, say in 1992 or 1993, the NAFTA negotiations might have been endangered, and the good, long-term benefits for Mexico, including renewed foreign investment and widespread privatization, could have been spoiled. Those risks were unacceptable to Mexican policy-makers.

Sadly, bad luck made things tougher for Mexico, as unfortunate political events led to a disruptive peso devaluation. First, an armed uprising of Indian rebels broke out on January 1, 1994, in Chiapas.[76] Next, on March 23, 1994, the PRI's successor to President Salinas, Luis Donaldo Colosio, was assassinated.[77] This provoked a mini-run on the peso that was contained as the peso fell to 3.578 by April 1, 1994, and then recovered somewhat, but capital flight was beginning.[78] On August 21, 1994, the new President Ernesto Zedillo was elected,[79] after the most open and reasonably democratic election campaign in modern Mexican history. On September 28, 1994, however, a top PRI official was shot and his brother, who had been named special prosecutor but later resigned, implicated high ranking PRI officials.[80] By October 10, 1994, the peso had weakened a bit further and reached 3.3925.[81] Meanwhile, the outgoing Salinas administration considered a more substantial devaluation before President Zedillo's inauguration to ease the transition, but ruled it out as too disruptive as the peso had already declined by 10% since March.[82] On Zedillo's inauguration the peso stood at 3.4345 per dollar.[83] On December 10, 1994, the Summit of the America's was held, with President Clinton voicing strong support for a Hemisphere Free Trade Area.[84]

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75. *See* FRANKLIN R. ROOT, INTERNATIONAL TRADE AND INVESTMENT 408-32 (1993)

76. *See* Mark Fineman, *Chiapas Rebels Deploy Forces In Southern Mexico*, L.A. TIMES, Dec. 20, 1994, at A1.

77. Mark Fineman & Sebastian Rotella, *Probes May Indicate Link in Mexican Assassinations; Politics: Feud Ruling Party "Dinosaurs," Reformers Cited. Some Feel Result was Two Murders*, L.A. TIMES, Mar. 2, 1995, at A1.

78. *Currency Exchange,* WALL ST. J., Dec. 1, 1994. Also, during 1994 the inflow of foreign portfolio capital dropped heavily, from $29 billion in 1993 to only $9 billion in 1994, according to some estimates.

79. Andre Reding, *It Isn't the Peso . . . It's the Presidency*, N.Y. TIMES MAG., Apr. 9, 1995, at 54.

80. *See* Laurence Iliff, *Mexican Politician Gunned Down in Car; Suspect Caught*, HOUSTON CHRON., Sept. 29, 1994, at A1.

81. *Currency Exchange,* WALL ST. J., Oct. 11, 1995.

82. *See Viva Amexica!*, *supra* note 17, at 5-7.

83. *Currency Exchange*, WALL ST. J., Oct. 1, 1994.

84. *See* Angus Foster, *US Push For Free Trade in Americas*, FIN. TIMES, Mar. 4, 1996, at 7.

The Chiapas uprising then got worse, as armed rebels suddenly occupied 38 towns, and immediate pressure hit the Mexican Bolsa and the peso.[85] On December 20, 1994, the Mexican government attempted a limited devaluation of 14%, but the next day, the Mexican Finance Minister reluctantly announced that its international reserves were insufficient, and that the peso must freely float.[86] By December 23, 1994, the peso slumped to 5.6 per dollar, a nearly 40% reduction since March 1994.[87] Although, on December 28, 1994, the United States, Canada, and IMF announced that solid assistance would be underway, the peso only briefly recovered to 4.9250 in early January and by February 1, 1995, the peso sunk to 6.100 per dollar.[88] After a $50 billion U.S.-IMF support package was implemented, the peso fluctuated mostly between 5.950 and 6.260 during the period of February through September 1995.[89] But the peso fell somewhat further in October and November, 1995, reaching 7.500, a cumulative fall of 60% since early 1994.[90]

VII. U.S.-IMF BAILOUT AND MEXICAN SELF-DISCIPLINE

In early January 1995, an initial Clinton administration package of $40 billion of U.S. support for Mexico was slated for quick congressional approval, with endorsements from the Federal Reserve, Wall Street, and top Republican leaders.[91] However, this bailout quickly became controversial. Populist Democrats, alarmed at the prospect of further U.S. job losses and shrinking U.S. exports after Mexico's devaluation, challenged the support package.[92] Many Republicans questioned details and demanded a more complete accounting for the bailout, and demanding stronger guarantees of repayment.[93] As congressional approval became questionable, the administration restructured the support package.

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85. *See* Mark Fineman, *Chiapas Rebels Deploy Forces in Southern Mexico*, L.A. TIMES, Dec. 20, 1994, at A1.

86. *See* Louis Uchetelle, *U.S. Losses In Mexico Assessed*, N.Y. TIMES, Dec. 26, 1994, § 1, at 55.

87. *Currency Exchange,* WALL ST. J., Dec. 27, 1995.

88. *See Emerging Market Indicators*, ECONOMIST, Feb. 11, 1995.

89. *Id.*

90. *Id.* By April 1996, the peso seemed to be holding more steadily.

91. Tim Carrington & Thomas T. Vogel, *U.S. Plans to Expand Help to Mexico*; *Loan Guarantees May Reach $40 Billion*, WALL ST. J., Jan. 19, 1995, at A20.

92. Tim Carrington & Jackie Calmes, *U.S. Rescue Plan for Mexico Prompts Conditions from Both Liberals, Conservatives in Congress*, WALL ST. J., Jan. 19, 1995, at A20.

93. *Id.*

On January 1, 1995, Clinton announced a new bailout-emergency loan deal including $20 billion U.S. Treasury emergency support, $17.8 billion of IMF assistance, $10 billion from the Bank for International Settlements (BIS), and $2 billion from Canada and other Latin American countries.[94] Congressional approval was required because U.S. Treasury emergency stabilization funds were employed.[95] Thus, Mexico received a very large bridge loan to allow refinancing of its external dollar denominated *tesobono* obligations and to recreate substantial international reserves.[96]

Mexico, meanwhile, had to implement another painful austerity program.[97] Interest rates were pushed up to encourage domestic saving and reduce capital flight, and thereby created hardships for many businesses.[98] Nonperforming loans at Mexican banks went up sharply.[99] Business failures increased.[100] More fiscal discipline was needed, which put pressures on government spending. Whether more taxes could be levied was, and remains, a serious question. Unemployment increased significantly, with some projecting one million in job losses out of 26 million employed.[101] A major surge of inflation occurred, which has hurt many consumers.[102] Renewed hardships will strain the PRI's popularity.

Mexican exports, however, should be encouraged by a weaker peso, and branch plant-*maquiladora*-like operations should not suffer significantly. Additionally, the greatly increased cost of imports from hard currency areas (like the United States, European Union, and Japan) has cut Mexican imports substantially. Already Mexico's current account deficit has been cut nearly in half to $15 billion by the end of the

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94. Tim Carrington et al., *Quick Fix: Clinton Hastily Drops Mexican Rescue Plan, Gives New Aid Instead*, WALL ST. J., Feb. 1, 1995, at A1.

95. *Id.*

96. Carrington & Calmes, *supra* note 92, at A20; FOLKERTS-LANDAU & ITO, *supra* note 1, at 63. The purposes of the IMF are to promote exchange stability, maintain an orderly exchange arrangement, and to give confidence to members by making sufficient funds available to allow an opportunity to correct maladjustments in the balance of payments system without resorting to measures destructive of national or international balance of payments. *See* ROOT, *supra* note 75, at 546-62.

97. Carrington & Calmes, *supra* note 92, at A20.

98. Weintraub, *supra* note 19, at 43.

99. Carrington et al., *supra* note 94, at A1.

100. *Id.*; FOLKERTS-LANDAU & ITO, *supra* note 1, at 63.

101. As the peso crisis developed, Mexico switched its debt financing mechanism to the Tesobono; which comprised 50% of the value of all Mexican government securities outstanding in November, up from 6% in February 1994. FOLKERTS-LANDAU & ITO, *supra* note 1, at 55.

102. *Id.* at 63.

second quarter, 1995, and the trade deficit has been promptly eliminated, yielding a modest $.5 billion trade surplus by the end of the second quarter, 1995.[103] Additionally, by February 1995, the Mexican surplus had grown to $8.5 billion, while its current account deficit had been largely eliminated.[104] Although further Mexican progress toward external adjustment and "self-discipline" would be needed to fully reassure international capital markets and renew foreign investment flows, movement along the path of recovery has been clear.

Of course, this adjustment process could cut Mexican imports from the United States rather heavily. Now, economists from the United States should concede that their NAFTA impact forecasts for the medium-term need revision.[105] Mexican exports to the United States will be increased as a result of the Mexican crisis and devaluation of 1994-95, and U.S. exports to Mexico will decline.[106] Thus, the hope for U.S. job increases in its export sector from NAFTA are cut significantly, while the incentives for relocating plants to Mexico may be increased.

VIII. CHALLENGES AND PROSPECTS

It is important to distinguish sharply between the 1982 Mexican Debt Overload Crisis and the peso crisis of 1994-95. Although both involved an excessive reliance by Mexico upon a surge of foreign capital investment, international bank lending leading up to 1982, and heavily foreign portfolio investment leading up to 1994, the structure and competitiveness of Mexico's economy has improved greatly. With NAFTA, Mexico moved into the global marketplace. Though painful, the fiscal discipline and privatization movements led by Presidents de la Madrid and Salinas brought more efficiency and economic good health to Mexico. The Mexican economy is fundamentally more sound in the mid-1990s and the educated middle class is stronger now.

Nonetheless, Mexico and the United States need to be more realistic about their closer economic linkage and its complications. Mexico must learn to live with less "boom-bust" sequencing. In particular, it must cool its growth more carefully and limit big surges of foreign capital investment. A steadier, more reliable growth path is

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103. *Emerging Market Indicators*, ECONOMIST, (1995 and 1996).
104. *Id.*
105. Robert L. Bartley, *Money and More: A Mexican Mural*, WALL ST. J., Mar. 13, 1995, at A14. For a discussion of the opposition parties in Mexico, see *Viva Amexica!*, *supra* note 17, at 10.
106. *Viva Amexica!*, *supra* note 17, at 16-17.

desirable for Mexico, with less dependence upon foreign capital inflows. Unfortunately, in some ways, Mexico has less scope to "control" its own fate as its industries, markets, and capital flows become more commingled with the United States, Canada, the rest of the Americas, and the global marketplace.

In this more integrated world marketplace, there are still significant disciplines and penalties against excessive government deficits and/or bank money creation, and against excessive imports, trade, and current account deficits. Speculators start forcing down the value of one's currency. Central banks and treasury Ministries have only limited purchase in stopping these devaluation trends if the "fundamentals" are viewed adversely in world markets.

The United States, led by the Clinton administration, greatly aided Mexico during the 1994-95 peso crisis. The $50 billion support package for Mexico, of which $20 billion came directly from the U.S. Treasury, was generous and it is doubtful that any prompt repayment will be required. Yet, it would be very difficult politically for the United States to mobilize much further assistance or support. Clinton's presidency in the United States is troubled with excessive budget deficits and it is unlikely that sympathy could be developed in Congress for any additional U.S. government lending or aid to Mexico.

Furthermore, the U.S. economy itself is not entirely healthy. Although the Dow Jones stock market index recently reached 5000, which might seem a speculative high to some observers, the "fundamentals" of the U.S. economy are not ideal. We have had stubborn, large U.S. budget deficits since the early 1980s with national debt ballooning from $1,000 billion in 1980 to $5,000 billion in 1995.[107] Chronic and large U.S. trade and current account deficits have become entrenched since 1980, totaling $1,650 billion and $1,450 billion, respectively.[108] The United States is importing too much, not exporting enough, and relying too much on foreign capital. As a result, the U.S. dollar has slumped substantially against the Deutschmark, Swiss franc, and Japanese yen over the last 15 years. U.S. economists could benefit from closer scrutiny of the confidence problems that come to nations that depend too much upon foreign capital for too many years. In the long run, almost every nation must learn to live within its means. This

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107. COUNCIL OF ECONOMIC ADVISORS FOR THE JOINT ECONOMIC COMM., 104TH CONG, 1ST SESS., ECONOMIC INDICATORS 32 (November 1995).

108. *Id.* at 36.

requires avoiding excessive domestic budget deficit and/or bank money creation and preventing any sustained and excessive trade or current account deficits in external economic relationships.

Finally, the United States, Mexico, and Canada (along with other potential members of the NAFTA trading bloc), should realize that economic integration forces more commingling of capital flows, investment activity, and interdependence. Business investors naturally move liquid assets more freely within such an arena. Major discrepancies in real wage costs and rates of return on equity can be expected to influence the movement of capital flows, and to some extent the movement of people. Much closer government attention and better quality data are needed for the NAFTA countries. Speculative surges, based upon doubtful or incomplete information, can be quite disruptive. Although a limited number of speculators may have come out ahead in the peso crisis of 1994-95, in the end, many investors, businesses, employees, and consumers lost substantially. In retrospect, the peso crisis of 1994-95 could have been limited by earlier, broader information about the increasing reliance of Mexico upon greatly increased inflows of foreign investment. Even though markets sometimes display herd-like behavior, participants are less likely to damage themselves, or the countries involved, if they are well informed with current information.