5 Causes and Lessons of the Mexican Peso Crisis

I INTRODUCTION

The speed and the massive scale of the financial crisis that followed the fairly small, initial devaluation of the Mexican peso in December 1994 started an important debate on the causes of this crisis, its large scale and its international consequences. To what extent was the Mexican peso crisis different from previous crises, and therefore should be characterized, as the IMF Managing Director had done (Camdessus, 1995a), as ‘the first major crisis of the 21st century’? What are the main elements which make this crisis different, and what are the elements of continuity with previous crises, suffered both by Mexico and by other countries?

A precise answer to these questions is very crucial, both so as to help avoid ‘Mexico-style’ crises occurring again and to ensure that management of such crises can be improved, so as to reduce the tremendous costs which the Mexican crisis has implied. This analysis is based on the assumption that the Mexican peso crisis (though it had special features) was not unique, and that there is therefore the risk that a ‘Mexico-style’ crisis could be repeated.

In the analysis of the causes of the Mexican peso crisis – and of its depth – consensus is emerging around a variety of factors. These include the large scale of the current account deficit, which had reached almost 8 per cent of GDP in 1993 and 1994, as well as the fact that an important part of this deficit was funded by relatively short term capital inflows. They also include the Mexican authorities’ commitment to a relatively fixed (in nominal terms) exchange rate, and the fact that a somewhat over-valued exchange rate was welcomed by a government strongly committed to reducing inflation very rapidly. They also include the rather lax monetary policy pursued in 1994, as reserves fell sharply. The causes include the fact that such a high proportion of government debt paper was so short term, such a high proportion of it was in the hands of non-residents and that – during 1994 – the government had allowed
the transformation of a large part of its government debt into dollar-denominated paper. Also, among the causes stressed, particularly by Mexican economists, is the ‘mishandling’ of the devaluation, the so-called ‘errors of December’. Last but not least, unexpected extra-economic (political) events, are seen to have played an important part in causing the crisis. The latter factor is particularly highlighted by the Banco de Mexico (Buira, 1995; Gil Diaz and Carstens, 1996; Banco de Mexico, 1995). Indeed, the Banco de Mexico argues that ‘the crisis was fundamentally the outcome of a series of unpredictable political and criminal events’. (Buira, 1995).¹

Though all these causes clearly provide a very important part of the explanation of the peso crisis – and of its severity – it would seem that another sets of factors, which were also important, have either been neglected or not sufficiently emphasized in the growing literature on the Mexican crisis. First, it could be argued that the process of liberalization which had occurred in Mexico in the early 1990s in the financial sector and in the capital account, was perhaps too rapid and, above all, that too many changes occurred at the same time for the economic system to adjust appropriately to so many large changes simultaneously, as well as cope with a large surge of capital inflows. Thus, it could be argued that the Mexican capital account should have been liberalized slower and/or more controls and/or taxes introduced to discourage short-term capital inflows when these surged. In this sense, it is noteworthy that both the IMF (1995a) and the BIS (1995) have recently explicitly recognized that – though having some limitations – measures taken by recipient governments to discourage short-term capital flows may, when combined with other policies that lead to sound macroeconomic fundamentals, play a positive role in managing effectively capital flows and thus reducing the likelihood of a costly financial crisis. Calvo and Goldstein (1995) even imply that measures such as controls/taxes on short-term capital inflows should become part of a revised ‘Washington consensus’.

One particular aspect of the rapid liberalization of the capital account which particularly with the benefit of hindsight, was – or became – problematic was that non-residents were allowed in late 1990, without any restrictions, to buy Mexican government paper, whereas previously they were not allowed to do so.² This was part of a broader liberalization, whereby foreigners were allowed to purchase bonds and money market instruments, as well as shares.

The process of rapid liberalization of the capital account coincided