Political Economy of a Crisis: Mexico 1994

• Mexico’s Exchange-Rate Regime
  – Govt used the exchange-rate to stabilize inflation; the peso is fixed to the dollar in 1988.
  – In 1991, the crawling peg was replaced with a “Crawling Band” (Figure 1).
  – Fixed exchange rate was the anchor for economic policy, i.e., the means to reduce inflation, discipline fiscal policy, and provide a more predictable climate for foreign investors.
Successes and Failures

• Until late 1994, Mexico's strategy appeared to be having its intended effects.
  – Government spending was down.
  – Foreign capital investment was large.
  – Foreign exchange reserves were large (Figure 2)
  – Inflation had been steadily reduced – but not to US levels.

• But inflation differential with the U.S. meant the peso was overvalued, even with the crawling devaluation.
  – Real appreciation of the peso, in turn, produced an ever growing current account deficit (Figure 3).
  – But foreign capital kept flowing in and no one was overly concerned with the current account deficit…until late 1994.
Mexico Delays Adjustment

• **Politics** is key to understanding the delay
  – Presidential election
  – Assassination of a presidential candidate leads to a break in investor confidence and fall in int’l reserves
  – Despite raising interest rates, government cannot stem the run

• **Policy Options:**
  1. Raise interest rates (problem: upcoming election)
  2. Reduce gov’t expenditures to reduce domestic demand, decrease imports, and relieve pressure on the peso (problem: upcoming election)
  3. Devalue the peso (problem: upcoming election)

• **Actual Choice:** None of the above.
  – Gov’t chose to delay the day of reckoning until after the presidential election by issuing “tesobonos” (short-term gov’t debt indexed to the dollar)
Figure 1: Mexico’s “Crawling Band” Exchange-Rate System, 1994

March 23: Colosio Assassination

Exchange rate ceiling (buying pesos)

Exchange rate floor (selling pesos)

Exchange rate band maintained through 12/19/94.
Figure 2: Mexico’s Foreign Exchange Reserves, July 1993 – Dec. 1994
Figure 3: Mexico’s Current Account Deficit, 1988-94
Figure 4: Political Economy of Devaluation

Possible policies to address problem

- Exchange rate policy
  - Discretionary devaluation
  - Float the peso

- Monetary policy
  - Contractionary - tighten credit

- Fiscal policy
  - Contractionary - run budget surplus to decrease demand for imports
  - Postpone solution by financing current account deficit with short-term debt

Potential consequences

- Economic
  - Abandonment of the peso as the anchor could lead to higher inflation
  - Limited growth
  - Higher interest rates
  - Threatens banking system
  - Increased short-term debt

- Political
  - Potential loss of political support prior to the presidential election
  - Stimulate winning the presidential election
  - Facilitate winning the presidential election

Actual policy action

- Maintained pegged exchange rate
- Accommodated economic growth
- Stimulated economic expansion

Actual economic consequences

- Decrease in foreign reserves
- Current account deficit remained high
- Interest rates kept down
- Current account deficit remained high
- Current account deficit remained high
- Mexican government absorbed foreign exchange risk
- Dollar indexed short-term debt overhang
- Current account deficit remained high

Legend:
- Course of action taken by the Mexican government and resulting consequences
- Possible policy actions and potential consequences
Figure 5: Peso – Dollar Exchange Rate, 1990-1998

Source: Haver Analytics