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The Mexican Peso Crisis of 1995 and Its Aftermath

The financial rescue of Mexico in 1995 constitutes the most extensive use ever made of the ESF to supply credit to a foreign government. The Treasury made $20 billion available to Mexico, and Mexico's maximum drawings peaked at $11.5 billion in medium-term loans, all of which were repaid by January 1997.[1] Despite a drop in income for many social groups in Mexico, the economic results suggest that the rescue was dramatically successful. The episode nonetheless raised far-reaching and vociferously debated questions about the role of the ESF in financial rescues and produced temporary constraints on the Treasury's discretion to use the account.

Origins of the Crisis

In response to fundamental policy reforms under the Carlos Salinas administration, and in anticipation of the North American Free Trade Agreement (NAFTA) entering into force at the beginning of 1994, large amounts of capital flowed into the Mexican economy during the early part of the decade. Mexico received more foreign investment during this period than any of the other emerging markets. While the Mexican government had made substantial progress in implementing reforms and had greatly reduced the rate of inflation, it had also made a number of mis-

1. In addition, the Federal Reserve advanced $1 billion to Mexico, bringing total maximum drawings from the United States to $12.5 billion.

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takes: the banking system was weak, and monetary policy had become overexpansionary, the current account deficit too high, external debt too short-term, and official exchange-rate exposure too large. Anxious to calm foreign investors after the Chiapas uprising and the assassination of the leading candidate for the presidency, the Mexican government had accepted an increasing share of the exchange rate risk of foreign borrowing over the course of 1994. The Mexican position was fundamentally solvent; the crisis was one of illiquidity—a textbook case for an international loan to smooth the adjustment process.

A new government led by President Ernesto Zedillo was inaugurated on 1 December 1994. Facing an untenable situation, its second major act of economic policy after the presentation of its budget to the Mexican Congress was a devaluation of the peso by 15 percent, effective on 20 December. The devaluation aggrieved foreign investors without creating confidence that the new peg could be sustained. Rather than restoring stability to the exchange markets, therefore, the devaluation gave way to a cascading downward movement of the peso against the dollar. By the end of the year, the peso had fallen below 5.5 to the dollar, compared to roughly 3.5 to the dollar before the devaluation, and fluctuated wildly around that level into January 1995.[2]

The Clinton Administration Responds: Plan A

The dramatic fall of the peso presented President Clinton with the most severe economic crisis of his first administration. He had lobbied hard for, and narrowly won, congressional approval of NAFTA. The peso crisis threatened not only to undermine this agreement but also to reverse the economic policy reforms that had been achieved in Mexico. Mexican economic prosperity was clearly endangered and with it American jobs and exports. An economic collapse in Mexico would surely have intensified emigration to the United States. Mexico's crisis also threatened to render hollow the hemisphere-wide summit agreement in Miami only weeks earlier to pursue a Free Trade Area of the Americas (Feinberg 1997, 176-77). The spread of the crisis to other ''emerging market'' countries, of which there were clear signs, could have vitiated economic liberalization within the region and around the world. The peso crisis tested US political leadership in the new global environment of hypermobile capital.

Robert E. Rubin, newly installed as Secretary of the Treasury, and Alan Greenspan, Chairman of the Federal Reserve Board of Governors, prepared a financial rescue package during early January 1995. Presented

2. For elaboration on the causes of the Mexican crisis of 1994-95, see, among other works, Krugman (1995); Naím (1995b); IMF (1995b, 90-97); Folkerts-Landau and Ito (1995); Calvo, Goldstein, and Hochreiter (1996); GAO (1996); Henning (1996); and Edwards and Naím (1997).

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to congressional leaders at midmonth, their initial proposal—referred to here as ''Plan A''—consisted of US government guarantees for up to 10 years on repayment of the principal and interest on private-sector loans to the Mexican government, including bond issues. The plan, which required legislation, had the bipartisan support of the leadership of both houses of the new 104th Congress: Speaker of the House Newt Gingrich (R-GA), House Minority Leader Richard Gephardt (D-MO), Senate Majority Leader Robert J. Dole (R-KA), and Senate Minority Leader Thomas A. Daschle (D-SD). When pressed for specificity on the amount of the loan guarantees that would be necessary, the administration cited the figure of $40 billion. Under Plan A, the Mexican government would pay guarantee fees, to cover the subsidy cost of the guarantees in the federal budget, amounting to about $4 billion. While the guarantees would be recorded in the budget, they would incur no net outlay and would not require an appropriation.[3] Mexico would also pay a supplemental interest rate on any guaranteed borrowing. The guarantees would be contingent on adjustments in Mexican economic policies (Harrison and Hornbeck 1995; GAO 1996, 109).

The proponents of Plan A mobilized an impressive array of supporters. Former Presidents Gerald Ford, Jimmy Carter, and George Bush announced with President Clinton their support of the package. They were joined in supporting the rescue by six former Secretaries of State, five former Secretaries of the Treasury, and six former Secretaries of Commerce (*New York Times*, 31 January 1995). The congressional leadership consolidated the support for the rescue among the political establishment. (Among the leadership, only House Democratic Whip David Bonior (D-MI) opposed the package.) This support nonetheless proved insufficient.

Arrayed against this establishment consensus in favor of the rescue package were two formidable political forces. First, the public did not support the rescue. A *Los Angeles Times* poll taken in late January showed that 81 percent of Americans opposed the granting of loan guarantees to Mexico (*Los Angeles Times*, 24 January 1995). Second, members of Congress were not taking their cue from the leadership. The November 1994 election had been a stunning defeat for the Democrats, transferring control of both houses of Congress to the Republicans, and bringing in the largest freshman class of the post-Watergate era. These freshman Republicans were anxious to carry out their ''revolution'' and did not welcome the distraction that the proposed loan guarantees, the first major policy issue before the newly convened Congress, represented.

As the days went by, an increasing number of senators and representatives voiced their opposition to the proposed Mexican package. Many

3. Plan A was modeled in this respect on loan guarantees previously extended to Israel. See Harrison and Hornbeck (1995).

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objected to the pace at which the administration was disclosing details of the rescue plan. House Banking Committee Chairman Jim Leach (R-IA), a supporter of the plan, recalled the drafting process to be "the most ad hoc process of development of legislation I have experienced in my public life" (Reuters World Service, 25 January 1995). In the House in late January, vote counts showed 130 of 230 Republicans supporting the rescue, but only 40 to 50 of 205 Democrats (*Washington Times,* 21 January 1995). A large majority of the Senate Banking Committee expressed grave reservations or outright opposition to the loan guarantees (US Senate, Committee on Banking, Housing, and Urban Affairs 1995). Support was clearly insufficient and falling. Meanwhile, the peso too was falling, spiking downward to 6.5 to the dollar in late January.

Plan B: Tap the ESF

With a Mexican default only days away, in the assessment of Secretary Rubin (US Senate, Committee on Banking, Housing, and Urban Affairs 1995, 357), the Clinton administration abandoned Plan A on 31 January. During an address to the National Governors Association in Washington, President Clinton announced that rather than introducing his own bill in Congress he would direct the Secretary of the Treasury to extend up to $20 billion in credits to Mexico through the Exchange Stabilization Fund. The Secretary could do so, many learned, at his own discretion and without the approval of Congress. The congressional leadership joined President Clinton in a statement affirming the statutory authority of the administration to act unilaterally and emphasizing that "unique and emergency circumstances" existed, justifying the extension of loans for more than six months (US House, Committee on Banking and Financial Services 1995, 359).

The administration planned to use the ESF in three ways: (1) short-term swaps with maturities of up to 90 days in an amount of up to $9 billion;[4] (2) medium-term loans of up to 5 years; and (3) securities guarantees of up to 10 years. The sum of the amounts of short- and medium-term loans and long-term guarantees was capped at $20 billion. Mexico was to pay an interest rate simply covering the Treasury's cost of funds

4. Including the $1 billion in funds advanced by the Federal Reserve. The funds from the Fed were provided through a standing swap agreement in the amount of $3 billion. At the beginning of January 1995 the Fed opened an additional temporary facility in the amount of $1.5 billion. At the beginning of February it increased the size of the temporary facility to $3 billion, bringing the total under the standing and temporary facilities to $6 billion. The Treasury guaranteed, with the resources of the ESF, all drawings under those facilities that might have been outstanding for more than 12 months (GAO 1996, 109-10, 119). The Treasury Department also maintained a standing swap arrangement of $3 billion with Mexico.

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on the short-term loans but a substantial premium, amounting in the event to more than 3 percentage points, on the medium-term loans. Under a complex contractual arrangement, the revenues from Mexican oil exports would back the repayment of these loans. On the securities guarantees, as under Plan A, Mexico was to be charged a guarantee fee. The loans and guarantees were to be disbursed within one year of the date of the bilateral agreement, with an optional six-month extension (GAO 1996, 120-21). In the event, the guarantees were never used.

In drawing on the ESF, however, the administration confronted a number of problems. In the deliberations over Plan A, Treasury officials had argued to the Congress and the financial markets that something on the order of at least $40 billion would be necessary to rescue Mexico successfully. (The value of outstanding *tesobonos* alone was $28 billion, of which $17 billion were held by foreign mutual funds and other investors and most of the remainder by Mexican banks (*Wall Street Journal,* 13 January 1995; GAO 1996). The available resources within the ESF fell considerably short of this sum. Thus, the administration sought to supplement the ESF with other sources of financing to amass a total package advertised at $48.8 billion. First the Treasury sought a large $10 billion increase in the existing $7.8 billion IMF standby agreement, for a total of $17.8 billion, available over 18 months. Second, the Bank of Canada committed $1 billion in short-term swaps, which had already been made available to Mexico before the end of January. Third, the Bank for International Settlements (BIS) was to extend $10 billion (intended to reduce the IMF's contribution), private banks $3 billion, and Argentina and Brazil $1 billion—although none of these credits was activated (GAO 1996, 109-10). The actual commitments were smaller than the advertised total, but they were nonetheless unprecedented in size. The ESF and IMF credits were to be subject to policy reforms within Mexico, negotiated principally by the staff of the IMF. Separately, the World Bank and the Inter-American Development Bank announced that they would provide $2.25 billion to stabilize and strengthen the Mexican banking system and $1 billion to support social sector programs (US Senate, Committee on Banking, Housing, and Urban Affairs 1995, 356).

To lend dollars to the government of Mexico from the ESF, the Treasury faced a second potential problem. The account held a substantial portion of its liquid resources in German marks and Japanese yen, the legacy of earlier foreign exchange intervention. To ensure that it had dollars on hand to lend to Mexico, the Treasury asked the Federal Reserve to increase its warehousing authority from $5 billion to $20 billion. Conveniently, the Federal Open Market Committee was meeting at the time of Clinton's announcement and approved the increase (FOMC 1995).[5] In the event, the Treasury did not tap this authority.

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5. Governor Lawrence Lindsey and Thomas Melzer, President of the Federal Reserve Bank of St. Louis, dissented, arguing that it was inappropriate for the Fed to participate in this

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The Treasury also moved with dispatch to secure the approval of the Executive Board of the IMF for its contribution to the package. The credit was unprecedented, totaling almost seven times the Mexican quota in the IMF. Conscious of the peso's accelerated depreciation, Secretary Rubin and his lieutenants pressed for a quick decision, providing full documentation on the proposal to the Executive Board less than 24 hours in advance. Again, not every member government went along. The Executive Directors from Britain and Germany registered their protest by abstaining from voting, as did the Executive Directors from four other constituencies led by the Netherlands, Belgium, Switzerland, and Norway, representing in total 34 countries (*Financial Times,* 4 and 16 February 1995).

Congress Reacts

The early signs of success in the Mexican rescue did not silence congressional critics of the package. Opposition to the loan guarantees embodied in Plan A had already become substantial, and the decision to deploy the ESF added new dimensions to the debate. Though the ESF had been in existence for 60 years, many Americans, including members of Congress, learned of the account only with the announcement of Plan B. Having assumed that congressional approval would be required to mount a financial rescue of Mexico, many members were surprised (some relieved, some angered) to learn that this was not in fact the case. Because the deployment of the ESF for Mexico was unprecedented in size and term, many questioned its use for medium-term credits and long-term guarantees. Thus the congressional debate extended beyond NAFTA and ''bailouts'' of mismanaged governments and private investors to congressional-executive relations in international finance.

Congressional committees held numerous hearings on the financial rescue for Mexico over the first half of 1995. The atmosphere was contentious and the exchanges often sharp, demonstrating a substantial breakdown in congressional-executive relations over the substance and execution of the rescue. Secretary Rubin, then Under Secretary Lawrence H. Summers, Assistant Secretary Jeffrey H. Shafer, and Fed Chairman Alan Greenspan testified many times along with officials from other executive agencies and private commentators. Senators and representatives complained repeatedly about the amount and the timeliness of information provided about the program. They questioned in many instances the ability of the President and the Secretary to act with ESF funds. Administration officials explained that the pace of events and negotiations prevented the delivery of more timely information, and they vigorously

way in medium- and long-term financing and that doing so could undermine the Fed's independence (FOMC 1995).

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defended their authority to use the ESF. Their legal claim of sole authority over the ESF was bolstered by two memoranda written by acting Assistant Attorney General Dellinger and Treasury General Counsel Knight, as discussed earlier, in the legal section of chapter 5 (US Senate, Committee on Banking, Housing, and Urban Affairs 1995; US House, Committee on International Relations 1995a, 1995b, and 1995c). The administration's political position, however, was more tenuous.

Various proposals to change or restrict the Treasury's discretion to lend to Mexico from the ESF gave these hearings an edge. On the House side, Representative Steve Stockman (R-TX) introduced a bill at the beginning of February that would have prohibited the use of federal funds for ''any swap, loan, loan guarantee, or grant to Mexico'' without the approval of Congress. Representative Gene Taylor (D-MS) introduced a bill to instruct the Comptroller General to investigate the use of the ESF for Mexico and related matters but lost on a procedural floor vote a few days later (*Washington Times*, 9 February 1995). Speaker Gingrich blasted the administration's critics and praised Clinton's decisiveness in the face of congressional intransigence (*Washington Times*, 2 February 1995), but failed to staunch the assault on the Mexican program. On 1 March, reflecting objections to the pace of disclosure, the House overwhelmingly passed (407 to 27) a resolution demanding that the administration submit all documents concerning the rescue within 14 days. House Banking Committee Chairman Leach convened hearings to review the administration's plan. Representative John LaFalce (D-NY), the second ranking Democrat on the committee, publicly questioned the clarity of the administration's goals in Mexico (Gannett News Service, 9 March 1995).

The most formidable and sustained challenge to the Mexican rescue package came from Senator Alfonse D'Amato (R-NY), Chairman of the Senate Banking Committee. Senator D'Amato had supported Plan A and had predicted that it would be approved by Congress because it involved ''national security'' (*San Diego Union-Tribune*, 14 January 1995). But his position on Plan B shifted in the opposite direction. On 7 March, citing Congress's rights and prerogatives and deteriorating economic conditions in Mexico, he asked Secretary Rubin to halt ESF support for Mexico until his committee could hold hearings, which were convened two days later. After a $3 billion disbursement from the ESF to Mexico on 15 March, Senator D'Amato proposed, as an amendment to an unrelated recessions bill, a requirement that ESF loans larger than $5 billion be explicitly approved by Congress (*Bank Letter*, 20 March 1995). (Representatives Steve Stockman (R-TX), Spencer Bachus (R-AL), and Cliff Stearns (R-FL) proposed parallel legislation in the House.) In proposing his amendment, D'Amato characterized the Mexican rescue package as a ''failure,'' saying that it was being used to support a ''corrupt government, narco dealers, [and] an agriculture secretary who is a billionaire, whose sons are involved

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in narcotics trafficking'' (*Congressional Quarterly Almanac* 1995, 10-17). Lacking sufficient support for passage, this and a related amendment to a supplemental defense appropriations bill also sponsored by Senator D'Amato were set aside for the moment.

Widespread discontent among members of Congress with the level of detail of the information they received on the rescue spawned a series of legislative initiatives culminating in the passage of the Mexican Debt Disclosure Act, which was signed into law by President Clinton on 10 April. Specifically, the Act required (1) the President to report every six months on the Mexican economic program and the status of US loans to the Mexican government; (2) the Secretary of the Treasury to report monthly on bilateral financial transactions; (3) the President to provide numerous documents, classified and unclassified, related to Mexico to the Congress; and (4) the President to certify that there is no projected cost to the US budget arising from the loans, that sources of repayment are assured, that the government of Mexico is pursuing economic reform, and that all required documents have been provided. The new law stated specifically that no loan could be made or swap drawn until the President made these certifications. President Clinton provided the required certification within days. Representative Marcy Kaptur (D-OH), the proponent of the document disclosure resolution of 1 March, nonetheless complained shortly thereafter that the administration was still dragging its feet on disclosure (US House, Committee on Banking and Financial Services, Subcommittee on General Oversight and Investigation 1995). In early May, Speaker Gingrich wrote to President Clinton to say that the administration had already violated the three-week-old act with the recent $3 billion disbursement (*New York Times*, 5 May 1995).

Secretary Rubin provided his first monthly report under this act at the end of May and, having been delegated the task, the President's first semiannual report at the end of June (US Treasury Department 1995a and 1995b). Over the course of the late spring and the summer, the administration provided the documents requested by Congress. The disclosure was extensive: well over 3,000 pages of classified and unclassified internal Treasury memoranda on Mexican financial and exchange rate policy during the months leading up to the peso crisis. The documents provided an extraordinary look into the decision making of the administration on Mexico. Senator D'Amato led an investigation based largely on these materials and in late June released a report along with several hundred pages of documents. He concluded in the report, released on his own authority, that ''the administration was aware of the looming crisis [in Mexico], but failed to alert the Congress or the American people'' and that this use of the ESF was ''unprecedented and legally tenuous'' (D'Amato 1995).

Disclosure did not satisfy most members of Congress, however. In mid-July, Representative Bernard Sanders (Congress's only independent

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member, from Vermont) proposed an amendment to the Treasury and Postal Services appropriations bill for FY1996 that would have blocked all transactions from the ESF.[6] In so doing, Representative Sanders and his supporters sought for the first time to exploit leverage over the Treasury gained nearly two decades earlier when the administrative expenses of the ESF were placed on the appropriated budget. The House voted 245 in favor and 183 against the amendment, with Republicans split 156 to 73 in favor and Democrats split 88 to 110 against (*Congressional Record,* 19 July 1995, H7225-6). The defeat of the administration on this vote sent an important signal about the mood of the Congress.

The Senate, on the other hand, did not support such strong restrictions on the ESF. Senator D'Amato nonetheless scored success with a substitute amendment, this one also to the Treasury and Postal appropriations bill. Introduced in early August, that amendment prohibited the use of appropriated funds to pay the salary of any government official (at the political and civil service levels) to make loans to foreign governments unless the President certified that there was no projected cost and that there was an assured source of repayment. More important, loans of more than $1 billion and 6 months' duration would require the approval of Congress unless the President certified in writing that a foreign financial crisis threatened ''vital United States economic interests'' or ''the stability of the international financial system.'' Congress could object to the presidential waiver of principal and term limitations by passing a binding resolution of disapproval. The President could veto any such resolution of disapproval. But, even if such a veto were sustained, any loan commitment by the Treasury would not be final until the process of certification and disapproval ran its course. Although the amendment contained provisions for expedited procedures on the resolution of disapproval in the Senate, the delay would nonetheless very likely render any financial rescue ineffective.

In presenting his amendment, Senator D'Amato declared that ''billions of taxpayer dollars were wasted, put in jeopardy, and may ultimately be lost because the President used the Exchange Stabilization Fund—the ESF—in an unprecedented action to bail out global speculators.'' Noting that the ESF had operated in relative obscurity and without controversy for more than six decades, Senator D'Amato lamented that the ESF had grown into ''a $40 billion slush fund that is beyond congressional control.'' ''We must not allow ESF to be used to circumvent Congress's constitutional authority to appropriate funds and provide foreign aid'' (*Congressional Record,* 5 August 1995, S11531-11533). Senator D'Amato was joined

6. The amendment was sweeping: ''Sec. 628. None of the funds appropriated by this Act may be used for salaries or expenses of any employee, including any employee of the Executive Office of the President, in connection with the obligation or expenditure of funds in the exchange stabilization fund'' (*Congressional Record,* 19 July 1995, H7215).

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in proposing the amendment by Senators Bob Dole, Ernest Hollings (D-SC), Lauch Faircloth (R-NC), Rod Grams (R-MN), Frank Murkowski (D-AK), and Pete Domenici (R-NM).

Speaking on the floor of the Senate after the introduction of the amendment, Senator Christopher Dodd (D-CT) supported it while at the same time defending the administration's handling of the rescue. Senators Domenici and Robert Bennett (R-UT) were more aggressive. Senator Domenici, Chairman of the Budget Committee, said, ''I really believe it came as a great surprise to many Senators—perhaps all but [Senator D'Amato]—that this fund was around there and could be used. I think the time has come for us to set some legislative limitations on its use, because it is a very vital fund for its originally intended purposes.'' Senator Bennett, recognizing that as an amendment to a budgetary appropriations bill the limitations would lapse at the end of the coming fiscal year, encouraged Senator D'Amato to ''look for a long-term solution'' (*Congressional Record,* 5 August 1995, S11531-11533).

The Senate passed the amendment by voice vote, and the conference committee incorporated it into the final appropriations bill. Although the President threatened to veto the bill, this particular restriction was not on his list of veto targets. Secretary Rubin issued a statement opposing restrictions on the Treasury's ability to act to foster international financial stability but did not threaten a presidential veto. Speaking through a spokesman, he noted that the D'Amato amendment exempted Mexico and did not restrict the Treasury's ability to intervene in the foreign exchange market (*Reuter Business Report,* 6 August 1995). In mid-November, after reconciliation of the House and Senate versions of the legislation, President Clinton signed the bill into law. (Congress renewed these restrictions in the FY1997 appropriation, but allowed them to lapse in FY1998.)

Disbursement and Repayment

Mexico's drawings on the ESF mounted over the course of the spring and summer of 1995, reaching a peak of $11.5 billion in July 1995 (table 5). By October 1995 Mexico began making repayments, and by August 1996 all but $3.5 billion had been repaid (*Washington Post*, 18 and 26 July 1996; *Wall Street Journal*, 26 July 1998, *Financial Times*, 26 July 1998).[7] These repayments, accompanied by strong hints from Mexico that it would fully repay the outstanding balance shortly, defused the issue for President Clinton in the US national election in November 1996. In January 1997 the ESF credits to Mexico were fully redeemed, less than two years after

7. By early 1996, the Federal Reserve had also been fully repaid. The Fed then retired the temporary swap facility with Mexico.

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Table 5 ESF transactions with Mexico, 1995-97 (millions of dollars)

Date	Description	Drawing	Repayment	Balance
1/11/95	Standing swap facility, fully repaid by 3/14/95	250		250
1/13/95	Standing swap facility, fully repaid by 3/14/95	250		500
2/2/95	90-day loan, rolled over three times, fully repaid by 1/29/96	1,000		1,500
3/14/95	Medium-term (2- to 5-year) loan, at 10.16 percent, of which 500 was paid to ESF swap lines of 1/11 and 1/13, fully repaid by 1/16/97	3,000	500	4,000
4/19/95	Medium-term (2- to 5-year) loan, at 10.16 percent, fully repaid by 8/5/96	3,000		7,000
5/19/95	Medium-term (2- to 5-year) loan, at 9.2 percent, fully repaid by 8/5/96	2,000		9,000
7/5/95	Medium-term (2- to 5-year) loan, fully repaid by 1/16/97	2,500		11,500
10/11/95	Repayment		350	11,150
1/29/96	Repayment		650	10,500
8/5/96	Repayment		3,000	7,500
8/5/96	Repayment		2,000	5,500
8/5/96	Repayment		2,000	3,500
1/16/97	Repayment		3,500	0

Note: In parallel with ESF credits, the Federal Reserve lent Mexico $500 million in January 1995 and $1 billion in February 1995, and was repaid $500 million in March 1995, $350 million in October 1995, and $650 million in January 1996.

Sources: Bank of Mexico; *Federal Reserve Bulletin* (3/95, 6/95, 9/95, 12/95, 3/96, 12/96, 3/97); US Treasury Department (1996); Wilson (1997).

the announcement of Plan B (see also Dow Jones News Service, 15 January 1997; *M2 Presswire,* 16 January 1997; US Treasury 1996).

When asked to comment on the repayment, Senator D'Amato issued a one-sentence statement: ''I'm pleased, this shows the importance of vigilant congressional oversight, which helped ensure timely and full repayment'' (Dow Jones News Service, 15 January 1997).

The Treasury Department made a profit on the Mexican loan totaling $580 million, representing the interest rate premium over US Treasury bills paid by Mexico (*M2 Presswire,* 16 January 1997; US Executive Office of the President, press release, 15 January 1997). As is all ESF income, these profits were plowed back into the account's capital and reduced the federal budget deficits over fiscal years 1995 and 1996 by a like amount.

The early repayment had been achieved by massive adjustments on Mexico's part as well as borrowing in the private capital markets. With the agreement with the US Treasury in place, Mexico was able to return to the private markets almost immediately. On 24 April 1995, one of Mexico's development banks borrowed $170 million from a European

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bank at 6 percentage points above the London Inter-Bank Offer Rate (LIBOR). By the end of the year, the Mexican government and its development banks had borrowed at least $5 billion on the eurobond market at maturities of up to 5 years. These bond issues in general paid similarly healthy margins over LIBOR (GAO 1996, 140-41).

Mexican drawings under the standby agreement with the IMF reached a peak of about $13 billion (SDR8.8 billion) in December 1995, raising Mexico's total debt with the IMF to roughly $16 billion (SDR10.6 billion). Repayments, some on an accelerated schedule, reduced total outstanding debt to about $9.4 billion (SDR7.1 billion) by April 1997 and $8.4 billion (SDR6.0 billion) in December 1998 (figure 9). The interest cost paid under the standby agreement, based on the average interest rate prevailing on short-term government bills in the G-5 countries, was considerably lower than the interest on ESF borrowing. It was thus financially sensible for Mexico to repay the ESF before repaying the IMF. There were also political incentives to repay the ESF before the IMF: to help the Clinton administration by reducing domestic political heat and to escape from US conditionality.

Economic Results and Assessment

After falling by 6.2 percent in 1995, Mexican real GDP grew by 5.2 percent in 1996, 7.0 percent in 1997, and about 4.6 percent in 1998 (OECD 1998a, annex table 1). Owing to the depreciation of the peso, consumer price inflation soared to 35 percent in 1995, remained near that level at 34 percent in 1996, and declined to 20 percent in 1997. Mexico's current account deficit, which had reached 7 percent of GDP in 1994, shrank to 0.6 percent in 1995 and 1996 (OECD 1998b, table 5). The current account deficit became somewhat larger in 1997 and was projected to grow to 2.5 percent for 1998 (IMF 1998b, 69). The shaky Mexican banking system was recapitalized at great cost, although political disputes on the terms of the restructuring continue.

A large share of the burden of economic adjustment fell on Mexican workers and the new middle class. Real earnings in manufacturing fell 13.5 percent in 1995 and another 11 percent in 1996. Thus by the end of 1996, real wages had fallen below 1990 levels, and they remained there in 1997 (IMF 1998c, 476-77). But the fall in middle- and lower-class incomes would almost certainly have been accentuated and prolonged if Mexico had not had access to external finance during the crisis and rapidly restored access to international capital markets.

The current account shift embodied a dramatic shift in the US-Mexican bilateral trade balance of $17.8 billion between 1994 and 1995—to a Mexican surplus of $17.4 billion in 1995 (IMF, *Direction of Trade Statistics Yearbook* 1996, 447), which dampened US growth marginally. In the absence of

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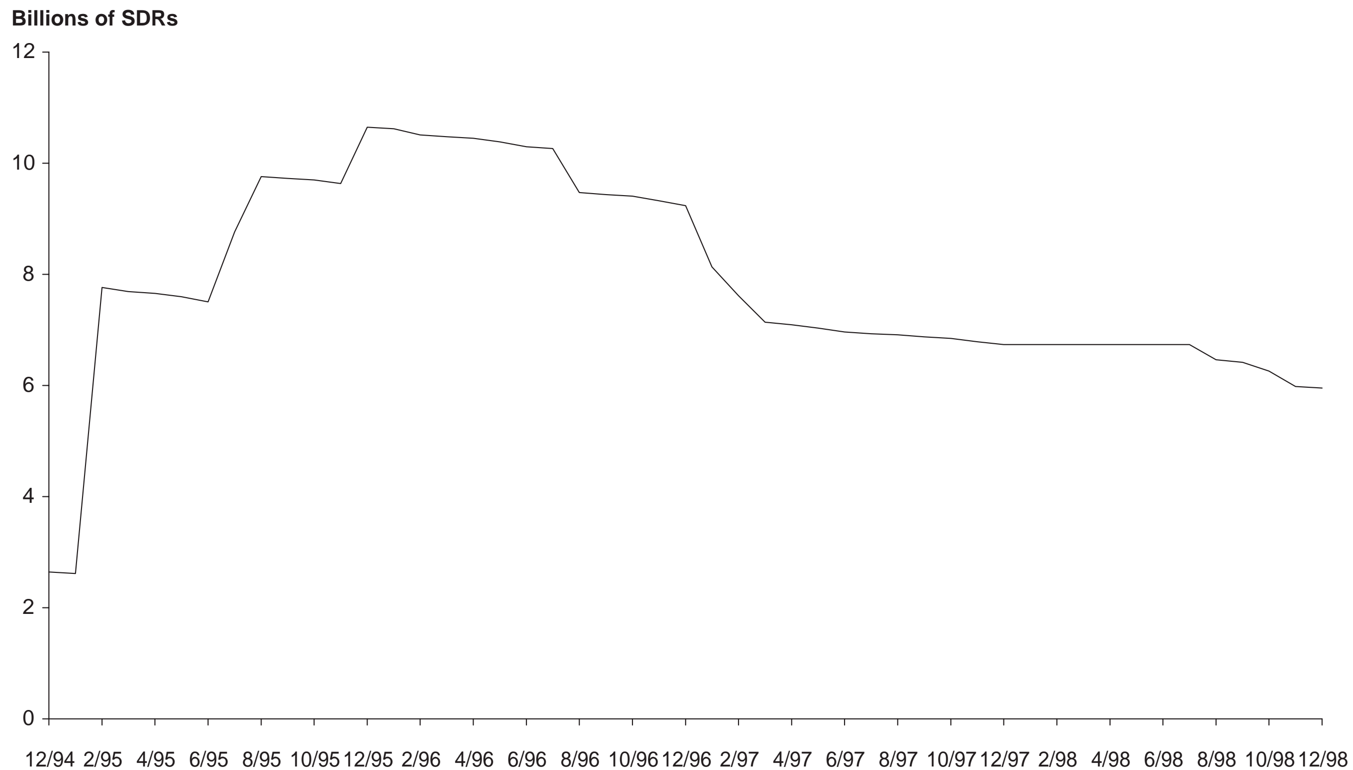
Figure 9 Mexican debt to the IMF, December 1994-December 1998



Source: IMF, *International Financial Statistics* (various issues).

official international support, however, denial of access to foreign capital markets would have been prolonged and Mexico would have suffered a deeper recession and a larger depreciation of the peso. Mexico's adjustment and its adverse impact on the United States would thus have been more severe without the financing from the ESF and the IMF.

The most common critique of the Mexican rescue is that it contributed to moral hazard, causing investors and financial institutions to dismiss risks in subsequent lending, for example, to Asian countries. While there is some validity to this critique, the moral hazard effect can be exaggerated. Many foreign investors did in fact sustain large losses in Mexico as a result of the crisis.[8] Thus the benefits of adjustment smoothing almost certainly outweigh the cost in terms of moral hazard.

Given the foregoing analysis, this study concludes that the Treasury's use of the ESF for Mexico and its sponsorship of Mexico's standby agreement with the IMF have proved to be quite successful.

8. While Calomiris (1998), Lindsey (1998), and Meltzer (1998), for example, emphasize moral hazard, Goldstein (1998, 45-53), Noland, Liu, Robinson, and Wang (1998, 21-24), and Fischer (1999, 5-7), argue that its significance has distinct limits.

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