

# Political Economy of Devaluation: Mexico 1994

- Mexico's Exchange-Rate Regime
  - Government uses the exchange-rate to stabilize inflation; the peso is fixed to the dollar in 1988.
  - Yet higher inflation in Mexico necessitates depreciation. Government adopts a “Crawling Peg” regime in 1989.
  - In 1991, the crawling peg was replaced with a “Crawling Band” (Figure 1).
  - Fixed exchange rate is 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 of sound monetary and fiscal policies appeared to be working
  - 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.
- Inflation differential with U.S. meant the peso was overvalued (even with the slow, crawling devaluation).
  - Real appreciation of the peso produced a growing current account deficit (Figure 3).
  - But foreign capital kept flowing in and no one was overly concerned with the current account imbalance...until late 1994.

# Mexico Delays Adjustment

- Tension between macro policies and commitment to fixed exchange-rate. Politics key to understanding delay:
  - Upcoming Presidential election
  - Assassination of a presidential candidate leads to a break in investor confidence and int'l reserves fall.
  - Despite raising interest rates, government cannot stem the run
- Three Policy Options:
  1. Offer even higher interest rates on “cetes”.
  2. Reduce government expenditures to reduce domestic demand, decrease imports, and relieve pressure on the peso.
  3. Devalue the peso.
- Actual Choice: None of the above.
  - Govt delays day of reckoning til after the presidential election.
  - Issued “tesobonos”- short-term govt debt indexed to U.S. dollar. Tesobonos were a temporary means of stabilizing int'l reserves and financing the current account deficit.

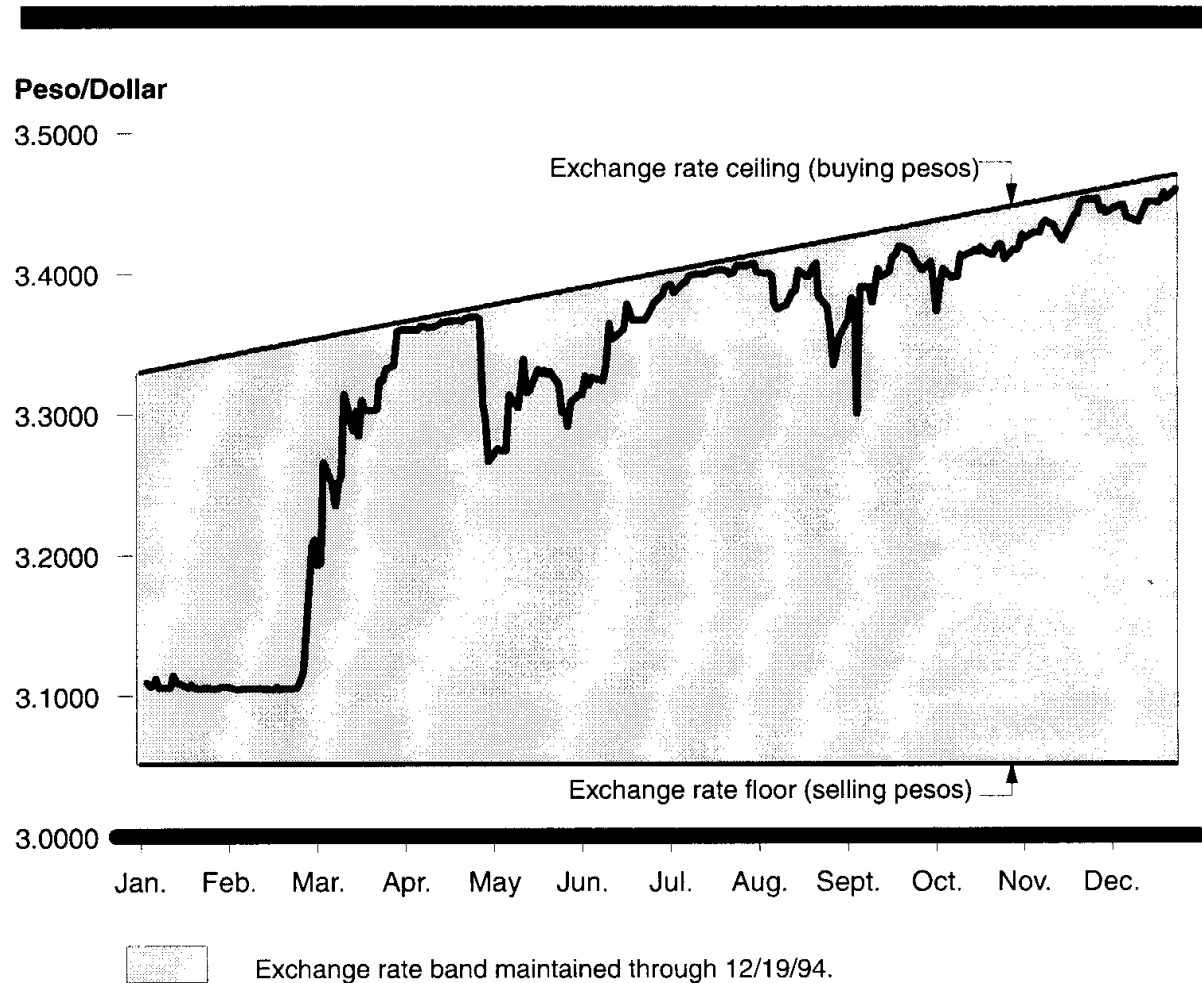
## Tesobonos: Politically Expedient but Costly

- Tesobonos were dollar-indexed, so investors could avoid losses if Mexico subsequently chose to devalue.
  - That is, tesobono financing transferred foreign exchange risk from investors to the Mexican government.
  - As such, tesobonos were attractive to foreign and domestic investors. Tesobono obligations increased from \$3.1 billion in March to \$29.2 billion in December, 1994.
  - The government saw tesobono financing as the best way to postpone the economic and political costs implicit in the other alternatives until after the election (Figure 4).
  - But Mexico became more vulnerable to a financial market crisis because tesobonos had short maturities, which meant that investors might not roll them over if they perceived (1) an increased risk of a Mexican government default or (2) higher returns elsewhere.
  - Mexico also increased its foreign debt overhang, since, after the inevitable devaluation of the peso, repayment of tesobono loans required more pesos (since the debt was indexed in dollars).

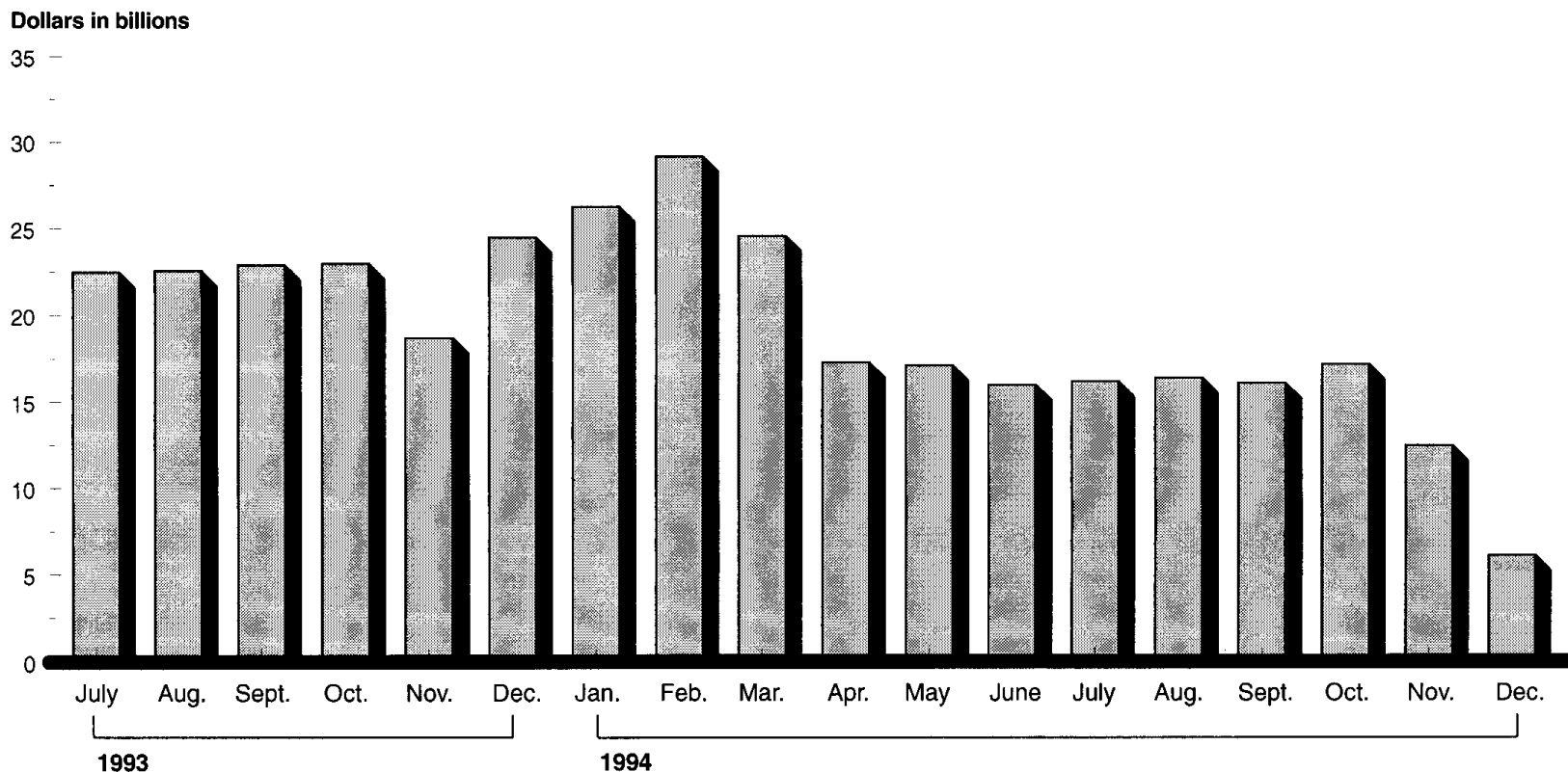
# Inconsistent Macroeconomic Policies

- In the period before presidential elections, Mexican financial authorities adopted exchange rate, fiscal, and monetary policies that accommodated economic growth
  - Exchange rate policy: No action was taken to correct for the real appreciation of the currency.
  - Fiscal policy: Instead of pursuing a policy of fiscal restraint, the Mexican government actually increased spending in 1994.
  - Monetary policy: Accommodated the economic expansion by keeping interest rates low. Central bank sterilized capital outflows.
- Policies increased the current account deficit while postponing action on the overvalued currency
- Day of reckoning
  - Following the election, more political shocks led to renewed capital flight. Foreign reserves declined to the point that the authorities could no longer defend established exchange rate through intervention (Figure 2). The government allowed the peso to float on 12/23/94 (Figure 5).

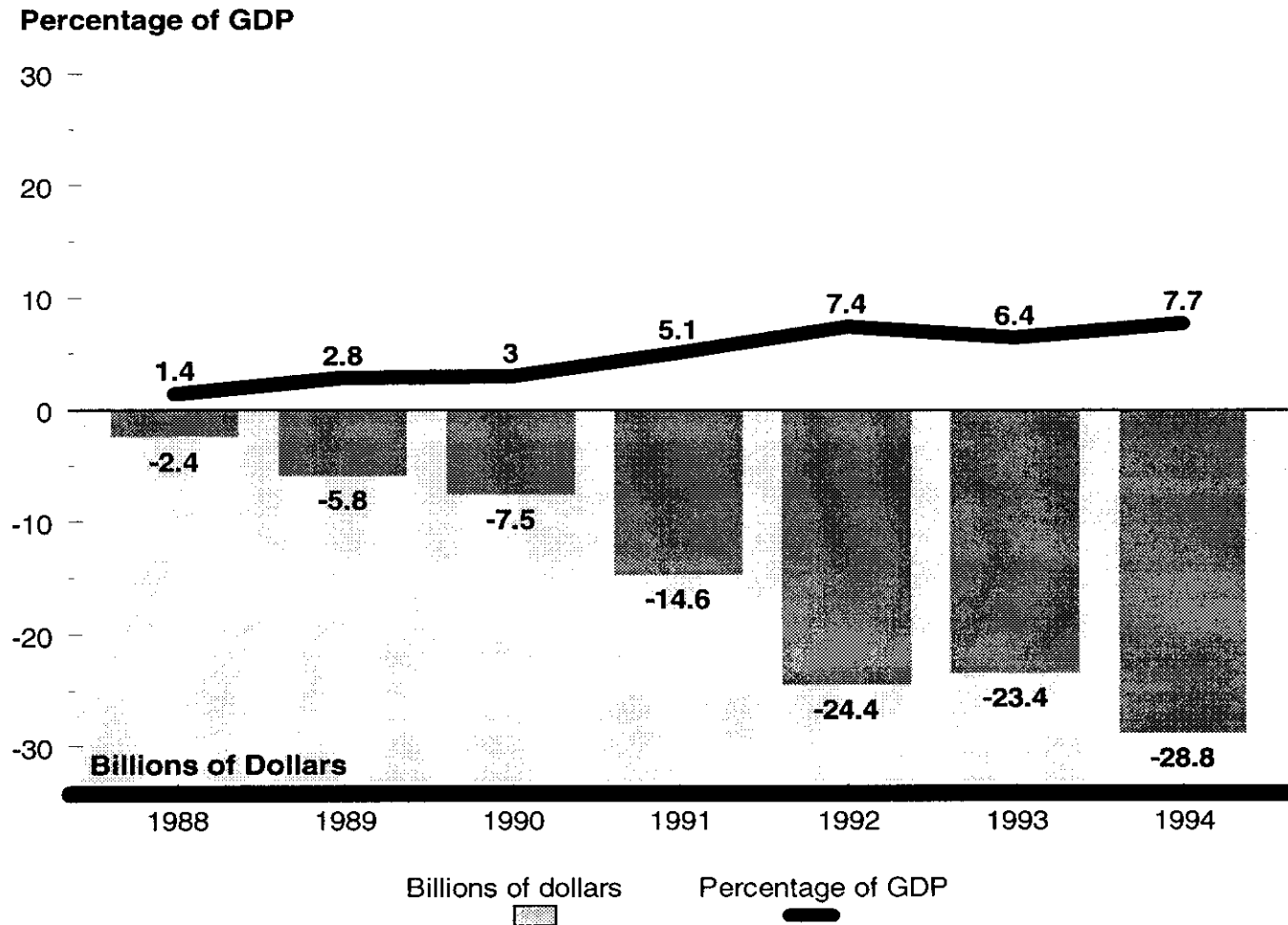
# Figure 1: Mexico's "Crawling Band" Exchange-Rate System, 1994



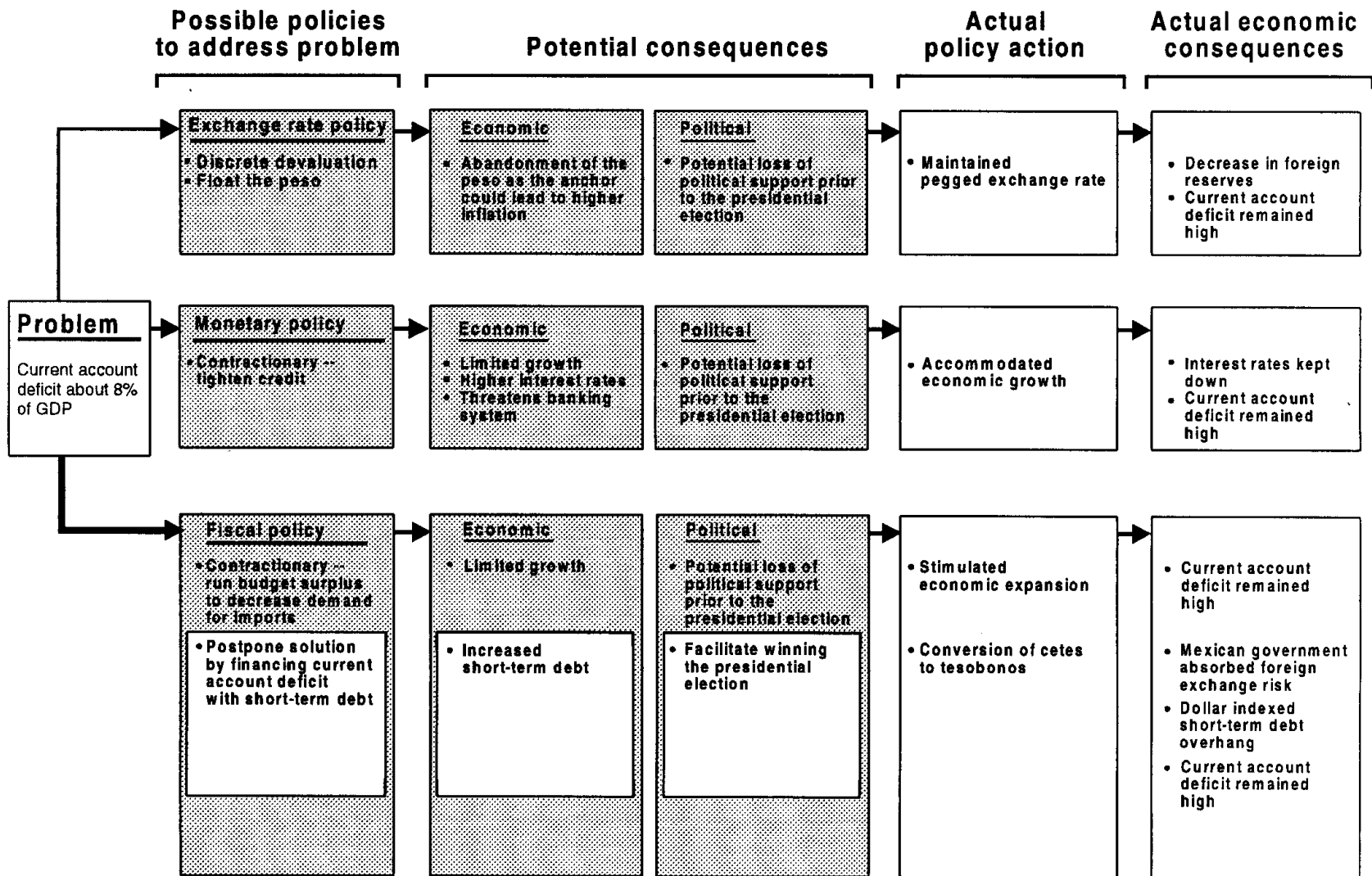
# Figure 2: Mexico's Foreign Exchange Reserves, July 1993 – Dec. 1994



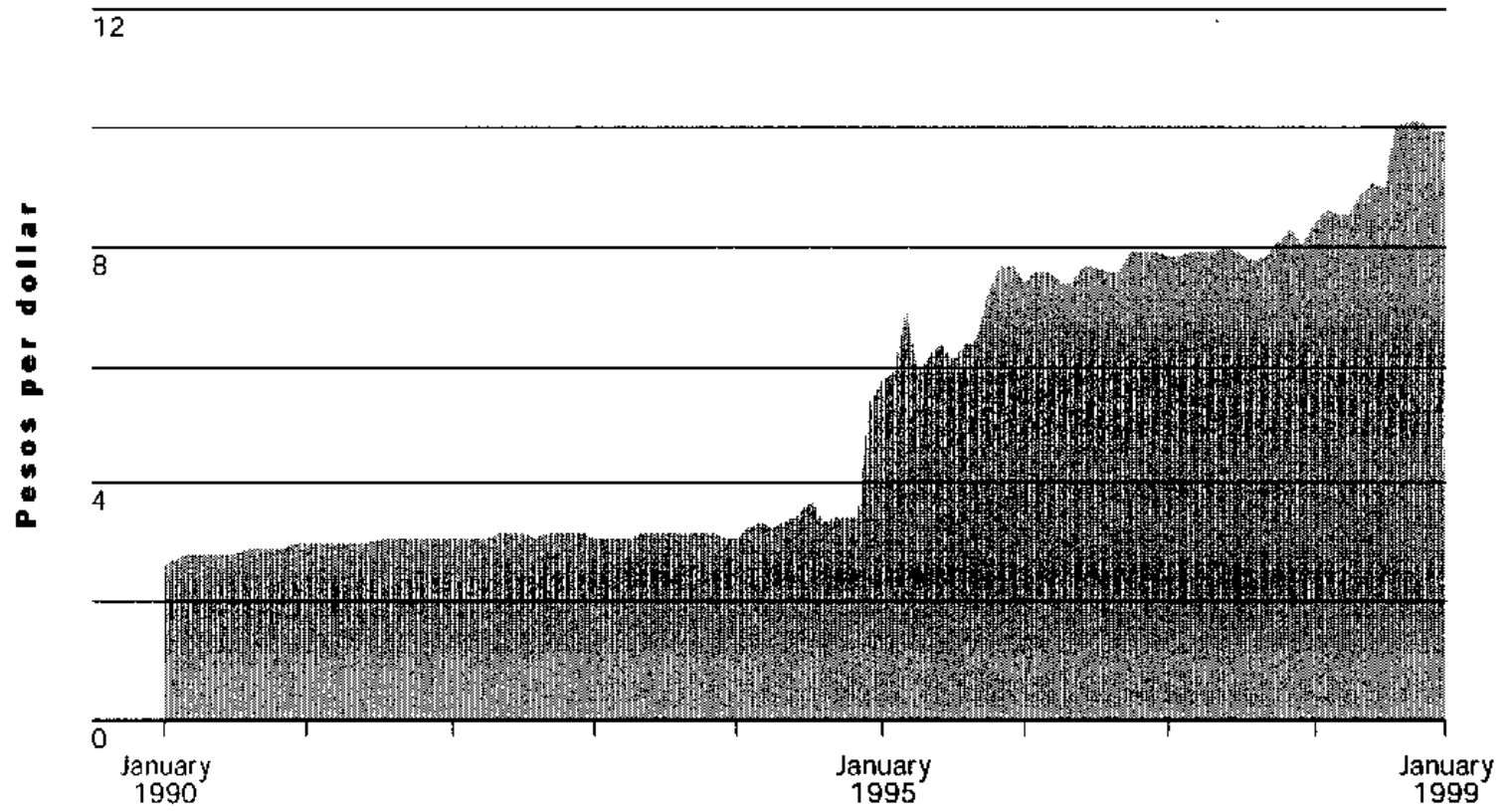
# Figure 3: Mexico's Current Account Deficit, 1988-94



# Figure 4: Political Economy of Devaluation



# Figure 5: Peso – Dollar Exchange Rate, 1990-1998



Source: Haver Analytics