AS MEXICO IMPLODED: ACTION AND INACTION IN THE UNITED STATES

Sidney Weintraub

A PUBLICATION OF THE

North·South Center
UNIVERSITY OF MIAMI
1500 Monza Avenue, Coral Gables,
Florida 33146-3027

NORTH-SOUTH AGENDA PAPERS • NUMBER TWENTY-EIGHT

The mission of the North-South Center is to promote better relations and serve as a catalyst for change among the United States, Canada, and the nations of Latin America and the Caribbean by advancing knowledge and understanding of the major political, social, economic, and cultural issues affecting the nations and peoples of the Western Hemisphere.

The views expressed in this Agenda Paper are those of the author, not the North-South Center, which is a nonpartisan, public policy and research institution.

July 1997

ISBN 1-57454-056-4
Printed in the United States of America

Inquiries regarding ordering additional copies of this paper or information on other North-South papers should be addressed to the North-South Center Press, University of Miami, 1500 Monza Avenue, Coral Gables, Florida 33146-3027, U.S.A. Back issues are available for US$5.00 a copy. Call (305) 284-8914, fax (305) 284-5089, or e-mail: mvega@nsc.msmail.miami.edu.

TABLE OF CONTENTS

AS MEXICO IMPLODED: ACTION AND INACTION IN THE UNITED STATES

Sidney Weintraub

Introduction

On December 20, 1994, Mexican financial and monetary authorities raised the band within which the peso was permitted to fluctuate by 15 percent. They expected a short-lived shock, some economic adjustment, and then back to business as usual with a modestly devalued peso. Mexico, after all, had a history of currency devaluations, particularly during the transitions from one administration to another. Beyond that, Mexico was not a world monetary powerhouse and what it did would not normally attract great or sustained international attention.

Instead, the action turned out to be an economic disaster for the Mexican people. It was not back to business as usual, and it became an object lesson in the cruelty of players in the international financial market when they conclude that a nation's economic policy is not worthy of respect. The Mexican experience took on milepost significance; students of the monetary system and players in the financial market now talk of what happened in Mexico in before-and-after terms — before the devaluation and the global consequences afterward.

This paper is part of a larger study that focuses on the decisionmaking in Mexico that led to the peso devaluation and its disastrous consequences. The events in Mexico have been described in many studies and commentaries, and the uniqueness of the larger study, of which this is a part, is its examination of the motives of the key Mexican actors when they took specific decisions — such as accumulating substantial short-term public debt, doing it in the form of dollar-indexed government securities called *tesobonos*, maintaining an overvalued exchange rate beyond its prudent time, following an excessively loose monetary policy, relying heavily on ever-rising volatile capital inflows, and allowing off-budget expenditures of development banks to grow substantially despite public assurances that fiscal policy would be tight.

The Mexican experience has led to many changes in the way official international financial institutions do their business. The International Monetary Fund secured international commitments to enable it to raise massive funds rapidly for use should there be another Mexican-type blowout. Dissemination of information on economic variables of countries has been strengthened. Mexico, along with other countries, now has a web site where this information is available reasonably currently, but still with some delay. Private financial institutions, including pension funds and investment houses, now pay more attention to variables they largely ignored earlier, such as the growth of short-term tesobono sales by the Mexican Treasury. Financial authorities are doing what is normal in the aftermath of an unexpected tragedy — they are preparing themselves to fight repetitions of the last debacle.

What happened in Mexico not only had international repercussions, but the unfolding of the crisis was accompanied by non-Mexican actions and, of course, inactions. The U.S. Treasury and the Federal Reserve Board in Washington tracked developments in Mexico closely in 1994. So did the International Monetary Fund (IMF) and the World Bank. Private financial intermediaries had an obligation to protect the assets of their clients. When the crisis occurred, all these foreign actors, public and private, had to react. Many did in panic; others entered as rescuers.

This paper deals with the foreign component. The questions asked here are similar to those made familiar during the Watergate investigations in the U.S. Congress: What did the foreign actors know, when did they know it, and what did they do? The rescue operation mounted jointly by the U.S. government and the IMF, with contingent backup from many central banks operating through the Bank for International Settlements, made whole most investors in tesobonos. This raised the issue of moral hazard, of why governments and international institutions should rescue investors seeking relatively high returns and how this issue will be treated in the future.

Sidney Weintraub holds the William E. Simon Chair in Political Economy at the Center for Strategic and International Studies; is Professor Emeritus, University of Texas at Austin; and is an Adjunct Senior Research Associate of the North-South Center at the University of Miami.

The public record to assess these issues is far from complete, but much documentation is available, particularly of the thinking and actions of U.S. government agencies. The international financial institutions are more secretive. For this paper, published material has been augmented by information from conversations with key policy actors and private market players, who will be identified unless a commitment was made not to do so in order to elicit frank opinions.

The presentation that follows is largely chronological. It covers thinking outside Mexico regarding events and policies within Mexico that preceded the December 1994 devaluation, actions that were taken (or not taken) on the basis of this analysis, reactions that followed the devaluation, and then the motivations for the peso rescue package.

Tracking Events Before the U.S. and International Rescue Package

Much has been written about the surprise registered by foreign governments, international financial institutions, and private investors at the sudden and drastic collapse of confidence in the peso. There had been expressions of concern by public and private finance experts from outside Mexico as early as 1993 and throughout 1994 about the increasing overvaluation of the peso and growing deficit in the current account of the balance of payments, but, for the most part, these were low-key. The sentiment among the international analysts was that some corrections were needed, that they probably would come in due course, and that would be that. On the whole, the management of economic policy in Mexico was given high praise. Carlos Salinas de Gortari, Mexico's president, and Pedro Aspe, the finance secretary (secretary of the Hacienda), were the darlings of official foreign institutions and market investors. Even the most severe critics did not foresee the extent of the debacle that would follow the raising of the exchange rate band on December 20, 1994.

The behavior of relevant actors outside Mexico will be set forth for the period before the financial rescue package was implemented and then for the post-rescue package time frame. For the convenience of the reader, a brief review of the events in Mexico up to the time of the rescue package is provided in an Annex at the end of this paper.[1] These were the developments to which officials and traders were reacting.

The U.S. Treasury

The material that follows is presented from the public record, which is then amplified from statements obtained in personal interviews. Contextual commentary is interspersed with the description of the events, and concluding commentary is provided as well.

The public record. Lawrence Summers, then undersecretary of the Treasury for international affairs and the senior U.S. official dealing on a regular basis with the Mexican economic situation, has said that as the year 1994 progressed, his assessment of the outcome in Mexico became progressively more pessimistic. He started the year by comparing the Mexican situation with what had happened in Argentina a few years earlier, that there would be an exchange rate adjustment with a temporary adverse effect on economic growth, but, in the end, the country would emerge with a more stable currency and economic recovery. In later months, he compared Mexico with the situation in France a year earlier, when the country faced serious exchange rate problems that were manageable in a technical sense. Just before the crisis erupted, his comparison was with the experience in the United Kingdom not many years before, and he feared that Mexico was headed for a crash.[2]

This exercise in increasingly dire comparisons was ex-post facto reconstruction of Summers' mood during 1994, but it conforms well with the story portrayed in internal Treasury documents — with one exception. The one aspect that looks more like rationalization than expectation is that the Treasury as a whole did not foresee the severity of the crash that occurred after the exchange rate band was lifted. Discussions with other Treasury officials revealed that the professional staff engaged in a speculative pool on how much the peso would depreciate: whether it would be the full 15 percent provided for by the Mexican action on December 20, 1994; more than that; or less. The mean appraisal was that the peso would depreciate by 9 percent — that is, would remain within the new band — and hold there for a while. This would not have been a catastrophic outcome, but rather almost business as usual, with the added advantage of a more properly priced peso. That rosy assessment was proved inaccurate almost immediately, and the Bank of Mexico, after losing about $4 billion of its already dwindled reserves trying to protect the ceiling of the new band, allowed the peso to float on December 22, 1994.

In a series of memoranda starting early in 1994, the Treasury professional staff exhibited low-key concern about the economic situation in Mexico.[3] Thus, Jeffrey Shafer, then assistant secretary for international affairs, on February 10, 1994, advised Summers, who was traveling to Mexico a week later, that the two operational issues on his agenda were the enlargement of the swap line with Mexico and the formation of a consultative mechanism. The motive of these initiatives was to improve financial cooperation in the wake of the North American Free Trade Agreement (NAFTA), which had gone into effect just a month earlier. Summers also was advised to tell Aspe, Mexico's finance secretary, that he was concerned that maintaining the peso at its then nominal level would "at some point" erode Mexico's trade competitiveness.[4] Yes, there was concern about the exchange rate, but it clearly was perfunctory. Other issues had higher priority.

The Treasury had been receiving biweekly reports from its attaché at the U.S. embassy in Mexico City. The report of February 15 raised the issues of the fragility of Mexico's balance of payments situation because of the "large dependence on portfolio investments which are potentially volatile," and the almost sole reliance on interest rate changes, rather than currency adjustments, to attract continued capital inflows. The comment was interesting because in the same report, the embassy noted that the rate on 28-day Mexican treasury bills (*cetes,* as they were called in Mexico) had fallen the week before to their lowest rate ever.

As the chronology of events in the Annex shows, the U.S. Federal Reserve began its program of steady increases in the federal funds rate on February 4, 1994. Shafer, in a memorandum of March 8, noted that rising U.S. interest rates, coinciding with historically low Mexican rates, were leading to a falloff in capital inflows into Mexico.

Somewhat more concern became evident after the assassination of Luis Donaldo Colosio on March 23. On the following day, the managing director of the IMF, Michel Camdessus, sent a letter to Lloyd Bentsen, secretary of the U.S. Treasury, with a copy to Alan Greenspan, chairman of the Federal Reserve Board of Governors, noting the uncertainty this created and suggesting initiatives to provide Mexico with a secondary line of reserves. The tone of the letter was calm, stating that Mexico has "dealt with these pressures." The generally relaxed attitude of the Fund to economic developments in Mexico in 1994 will be covered below.

The Pivotal Events of 1994

An internal memorandum to Shafer at about this time noted that the Bank of Mexico had intervened in financial markets every working day from March 23 to April 5, selling $5.2 billion of its reserves. The interventions slackened after that, but as of April 15, reserves had fallen from $29 billion to $20.2 billion. This memorandum added: "In our view, Mexico's current exchange rate policy is sustainable." This, in general, was the view of the international institutions as well, if not always of the academic community. Rudiger Dornbusch, of the Massachusetts Institute of Technology, in a memorandum for the New York Federal Reserve, argued, as he had elsewhere then and later, that the "exchange rate-based stabilization strategy has led to an overvaluation, a potentially precarious financial situation, and a lack of growth."

Between April and September, many U.S. concerns about the events in Chiapas and the murder of Colosio were put on the back burner. At the end of April, international reserves were $17.3 billion, and they were back to that level by mid-October, with only modest variations up and down in the interim. The murder of José Francisco Ruiz Massieu had no immediate impact on the reserve level. The Mexican presidential election of August 21 went in favor of the PRI, that is, of the establishment, and this also calmed external observers. The loss of reserves did not recur until November. Nevertheless, the Treasury staff on October 27 advised Secretary Bentsen of its concern over exchange rate policy. The peso was trading close to the ceiling of the band, with little room to accommodate additional pressures.

The heightened nervousness of the Treasury — which presumably reflects the deepening pessimism that Summers said he felt as 1994 unfolded — became evident in November. Shafer, on November 18, alerted Bentsen to the weakness of the peso and renewed intervention. In a memorandum of December 5, Summers and Shafer were advised that Mexico's reserves were only slightly above the "critical" $10 billion threshold. The memorandum did not make clear why that was the critical level. The memorandum also noted that the current account deficit at that point was close to 7 percent of GDP. (The deficit for the entire year of 1994 was 7.9 percent of GDP.) Further increases in U.S. short-term interest rates, the memorandum stated, "would hurt." (The U.S. Fed did not act again to raise rates until February 1995.)

In its biweekly report to Summers and Shafer on December 20, the professional staff reported the lifting of the band earlier that day by 15 percent, or 53 centavos, to 4.0016 pesos per dollar. The memorandum continued: "There probably will be considerable volatility in the foreign exchange markets for a short period of time, followed by some strengthening of the peso." The memorandum also concluded that increased inflation in Mexico, which would normally be concomitant with currency devaluation, might not increase in 1995 by much more than 1 percentage point, that is, to about 8 or 9 percent. In fact, the consumer price index in 1995 (December over December) was more than 27 percent.

On December 22, as the Annex shows, the swap line to Mexico under the North American Framework Agreement was activated at $6 billion. This was a response to the Mexican situation, but as it turned out, a feeble one. The severity of the situation still was not recognized. It was clear, however, by January 12, 1995, when President Clinton requested approval from the Congress for a $40 billion loan guarantee program, for which he obtained the concurrence of the congressional leadership, Bob Dole in the Senate and Newt Gingrich in the House. The size of the credit was large, about double what was thought would have to be used, in order to provide an extra degree of assurance to money market operators.

The situation required much more public candor from the Treasury. As the General Accounting Office (GAO) pointed out in its report, the Treasury felt it could not publicly express its concern earlier for fear that this would provoke capital flight.[5] On an instinctive basis, it is hard to quarrel with this judgment, but the capital flight came anyway. Beyond that, the evidence is that while the Treasury was concerned about many of the economic policy measures in Mexico, there was never any expectation of a crash. Had there been, the decision not to go public might have been different. This, of course, is speculation, but not unreasonable. In any event, in remarks on January 20, 1995, Summers did say that, viewed in retrospect, Mexico made "critical errors" in macroeconomic policy during 1994. The major error he cited was Mexico's "unsustainable" exchange rate policy.

An aside may be warranted at this point. Former President Carlos Salinas, on December 4, 1995, sent a letter to Mexican media in which he referred to *el error de diciembre* (the error of December), alluding to the way the devaluation was handled on December 20, 1994. The words "el error de diciembre" and their provenance are widely known in Mexico. Salinas' clear intent was to embed in the public mind that the problems were caused not by the macroeconomic policies earlier in the year when he was president, but by the ineptitude of President Ernesto Zedillo and his cabinet. The remarks by Summers are based on a more conventional interpretation, that the developments in December, inept as they were, were the culmination of earlier policy errors.

The Clinton administration used many arguments to persuade the Congress to authorize the $40 billion line of credit. In testimony before the House Committee on Banking and Financial Services on January 25, 1995, Robert Rubin, secretary of the Treasury, said that what was at stake for the United States was continued growth in U.S. exports, the prevention of augmented illegal immigration from Mexico, and avoidance of financial spillovers across the globe. None of these arguments carried the day, and on January 31, President Clinton announced that the United States would provide credits of up to $20 billion from the Exchange Stabilization Fund (ESF). The ESF was established in 1934 "for the purpose of stabilizing the exchange value of the dollar." It has been used ever since to buy and sell foreign currencies, engage in swaps with foreign countries, and provide guarantees for foreign obligations. ESF usage is normally for reversible and short-term transactions of up to six months, but renewable for additional short periods. Many in Congress challenged the legality of its use and its large size for what they referred to as the Mexican "bailout." The GAO stated in its report that it had "no basis to disagree" with the Treasury's conclusion that ESF resources could be used for the assistance to Mexico.[6]

The $20 billion assistance was contained in three separate packages, short-term currency swaps, medium-term swaps of up to five years, and guarantees for up to 10 years. The interest rates varied by the term of the loans. As noted in the Annex, the ESF credit was one element of a much larger package that in theory amounted to $52.5 billion. The United States achieved the overkill that had been built into the earlier $40 billion legislative proposal.

Interviews. These confirm the impression that the Treasury's thinking was to expect some adjustment problems in Mexico but not catastrophe. Treasury analysts were concerned about the overvalued exchange rate, the large current account deficit, the loss of reserves, and, at various points, the relatively easy monetary policy in the face of rising U.S. interest rates. Little attention was paid to the buildup of tesobonos. It was only after the crash that Summers himself raised the issue of "net" reserves, that is, calculating reserves not merely by subtracting borrowed reserves, but also subtracting short-term dollar (or dollar-equivalent) obligations that could be cashed in outside the control of the Mexican authorities. Summers does not recall any prominent public writings calling attention to the tesobono problem in this light.[7]

In the end, the events of 1994-1995 turned into a debt crisis, not unlike the 1982 Mexican crisis, according to Summers. The origins were different, and the contexts were quite disparate, but the crash of 1995 resulted from the desire of most holders of tesobonos to cash in these dollar-indexed instruments.[8]

Summers was undersecretary, not secretary, of the Treasury. He, of course, knew and from time to time met with Pedro Aspe, the finance secretary of Mexico, but Summers' main point of contact was Guillermo Ortiz, his counterpart. Hierarchy has its own protocol, particularly in a society as formal as that of Mexico. Aspe's main contact in the U.S. Treasury was Lloyd Bentsen, the secretary. Bentsen knew the issues and was remarkably familiar with the U.S. political scene. Nevertheless, there was something of a disconnect in this arrangement. Aspe, in addition to his political position, was a trained economist, a *técnico* in the Mexican scheme of things, as was Summers but not Bentsen.

Would it have made a difference if discussions had been held regularly between technician and technician, given the highly technical nature of the Mexican economic model? There can be no sure answer to this hypothetical question, but possibly the answer is "yes." Summers had some contact with the Governor of the Bank of Mexico, Miguel Mancera, but the main discussions here were between the two central banks. This was a technician-to-technician discussion, with Alan Greenspan and Miguel Mancera at the top and also at secondary levels. These contacts did not change the outcome, but the key policymaker in the Mexican government, other than President Salinas himself, was Pedro Aspe.

Summers has stated that, at its core, he did not have much more information than was available to market players and analysts. He also does not believe that Treasury should be in the business of issuing alerts to investors. As will be noted below, the market players also missed the tesobono dangers.

The final assessment by Summers is that the "bailout" (his word) was correct, as can be seen in retrospect. Mexico was able to enter private markets within months of the crisis, not years, as was the case after its 1982 crisis. The economic decline in 1995 was sharp, but so was the recovery in 1996. As to the problem of moral hazard, Summers said this troubled him, but he doubts there will be similar bailouts in the future. There is a disconnect here, too. The IMF now is gearing itself to respond rapidly to future crises — that is, to bail out countries that get into balance of payments problems due to capital flight. This, to some degree, almost surely must involve some hazard, even if not identical to that faced in the Mexican case.

These views of Summers are generally supported by other Treasury professionals who dealt with the Mexico situation. In my interviews with a number of senior officials, they openly acknowledged that the instinctive judgment of the Treasury following the assassination of Colosio coincided with the Mexican view. The murder was seen as a one-time political event whose fallout would probably subside. These officials were quite explicit that the political repercussions from a single political event normally should not drive economic policy. In fact, as the Mexican foreign reserve data show, market reaction to the Colosio assassination did run its course after about a month.[9]

The Treasury staff, as the written record shows, was concerned then and later about the overvalued peso and the relatively low Mexican interest rate. These officials noted that the reserves lost after the assassination did not return, and they felt they would not return without a more attractive interest rate incentive.

While there was instinctive agreement with the Mexican financial decision to treat the Colosio assassination as a temporary setback, there was less understanding of the Mexican decision not to take some action to recover reserves following the August 1994 elections. Tightening monetary policy at this point would have been welcome. So, too, would have been a decision to let the exchange rate float during, say, September of the interregnum between the election and the assumption of the presidency by Zedillo on December 1, 1994. This would not have been a policy of immediately building up reserves again. Many Mexican scholars and officials felt the same way. What happened instead was that monetary policy actually eased for a time during that period. Treasury officials also commented that during that period, Aspe personally assured foreign bondholders that Mexico would not devalue.

The unease of the Treasury increased later in 1994, in November in particular, when there were internal discussions in Mexico on exchange rate policy. There is now a public record of the meeting, which took place at the home of Salinas on November 20, when exchange rate policy was discussed. The decision at that meeting was to go ahead with the *pacto*, the anti-inflation program involving the government, labor, and business that had as a central element modest daily depreciation of the peso but no abrupt changes.[10]

Treasury officials involved in making policy toward Mexico now admit that they were myopic in not following more closely the buildup of tesobonos and in not fully grasping the significance of this development. It was only after the peso debacle was transformed into a liquidity crisis by Mexico's inability to refinance outstanding, short-term tesobonos under acceptable conditions that Summers and others at Treasury stated that the concept of net reserves should have taken account of the outstanding tesobonos.

The net reserve concept refers generally to gross reserves, less explicitly borrowed reserves that must be repaid. There had been no expectation that the tesobonos would have to be repaid as they matured over the course of 1995, but rather that they would be turned over by issuing new tesobonos. It was only in January 1995, when refinancing was not possible, that Treasury realized that the calculation of net reserves should also include short-term public debt instruments, especially those indexed to the dollar.

What was said earlier merits emphasis: It was not part of the mindset of the U.S. Treasury, just as it was not of the Mexican Hacienda, that refinancing under acceptable conditions would become suddenly impossible. It was only after this realization that the idea of a bailout entered into U.S. policy thinking.

Mexico, by then, was experiencing two financial crises, one of the banking system and the other of national liquidity. The U.S. Treasury had considerable experience in dealing with a banking crisis, and, indeed, it had just gone through one in the domestic savings and loan crash. By contrast, there was less experience in dealing with the more basic national liquidity problem in Mexico. The decision was made to face the national liquidity crisis first — hence, the proposal for a $40 billion credit and, ultimately, the use of the ESF facility for $20 billion — and to leave action on the banking crisis until later.

Treasury knew by December 23, 1994, that its earlier assessment of what would follow the devaluation of December 20 was wrong because calls came from the Mexican Hacienda. The use of the expanded swap lines was not working. The bureaucratic issue in the U.S. government was complex. There was no confirmed Treasury secretary because Bentsen had resigned and Rubin had not yet been confirmed.

The Treasury, by early January, concluded that a peso rescue package was necessary. This judgment, supported by Alan Greenspan, the Fed chairman, was significant in that he was not seen as having a partisan political motive. The Treasury concluded that it had two options for raising the support package, either by legislation or use of the ESF. The legislative route was chosen because Treasury felt that the ESF could not support more than $20 billion of credit and that at least double this figure was needed to persuade the markets that the Treasury intended to succeed. The larger amount was achieved only when the IMF agreed to contribute to the support package.

The motive for and the handling of the rescue package will be discussed later, but it was seen then as a major action. The amounts were huge, certainly compared with previous rescue packages for Mexico or other developing countries. Going ahead with the package, both the failed legislative effort and the ultimate use of the ESF, took considerable courage, something evident from the failure of the legislative proposal despite the support of the leadership of the Republican Party in the Congress. The liquidity crisis in Mexico was seen as serious, in terms of its consequences in Mexico and the potential repercussions in the United States.

The Federal Reserve

The other key actor in the U.S. government was the Federal Reserve system, particularly the Board and its staff in Washington, as well as the New York Fed, which is responsible for market dealing and, therefore, had to keep abreast of foreign currency and economic developments. Both bodies kept a steady watch on Mexico. The policy responsibility for dealing with Mexico on economic matters rested primarily with the Treasury, but the Fed had the advantage of dealing more nonpolitically, as technicians to technicians. This should have stimulated more candor from the Fed than from the Treasury. In fact, this seems to have been the case in internal memoranda.

The public record. The Federal Reserve in Washington had senior staff with longer experience in Mexican affairs than did the Treasury. In addition, one staff member with decades of experience, Yves Maroni, was called back from retirement for temporary service when it appeared that the Mexican economic situation was getting dicey. Maroni wrote a lengthy internal memorandum dated January 28, 1994 (after Chiapas, but before the Colosio assassination and the onset of reserve losses), in which he traced the history of peso movements starting in April 1954, when the peso was devalued from 8.65 pesos to 12.50 pesos to the U.S. dollar. By most reckonings, that devaluation was successful; the 12.50 rate endured until 1976, and Mexico enjoyed solid economic growth in excess of 6 percent a year over that 22-year period. The 1976 devaluation had been years in the making, but was precipitated at the close of the *sexenio* (six-year term) of President Luis Echeverría by years of growing fiscal expenditures designed to reduce income inequalities but which resulted instead in large public sector deficits, mounting inflation, and a growing current account deficit.[11]

Maroni's discussion provides considerable information for persons new to the Mexican economic scene. It describes the currency band within which the peso was permitted to fluctuate, plus the existence since June 1992 of a narrower band that was communicated daily to commercial banks so that they would know the limits at which the Bank of Mexico would intervene in the markets. He characterized the Mexican authorities as being satisfied with the exchange rate setup. He did point out, however, that Mexico's growth rate might become hostage to exchange rate management because the need to attract foreign capital restrained Mexico from lowering interest rates to stimulate the economy.

Mexico's economic growth performance during the Salinas years was, in fact, pedestrian.

After listing and discussing what he thought were the exchange rate options available to Mexico, Maroni concluded that "the present regime is the most appropriate at the present time and for the foreseeable future."

Concern was expressed in an internal memorandum at the Federal Reserve Bank in New York at about this time, on February 3, 1994, stating that the capital flows coming into Mexico to finance the current account deficit "appear to be financing consumption rather than a domestic investment boom."[12] The fear was that this could lead to a debt crisis similar to that of the early 1980s. This commentary, unfortunately for Mexico, turned out to be accurate.

A later internal memorandum at the New York Fed, dated June 3, 1994, estimated that the peso was overvalued by about 20 percent and that while it was possible that the then existing band could be maintained in the near term, the situation was precarious. An internal memorandum on Mexico's exchange rate options prepared by the staff of the Washington Fed on August 17 that year concluded that Mexico might look to the post-electoral period to consider a change in exchange rate policy. Another analytical memo of the Washington Fed two days later explored the exchange rate issue and the probability, under various conditions, of a tesobono default. This was most prescient.

An analyst at the New York Fed, on September 28, commented on the pacto renewal the previous weekend and the fact that it stuck to the anti-inflation priority and made no change in the exchange rate regime. The pacto continued the peso slide of 0.0004 pesos per day, or 4.3 percent on an annual basis at the then exchange rate of 3.0512 pesos to the dollar at the lower end of the band. This rate of depreciation was sufficient to keep the peso from further real appreciation with respect to the dollar, but it did nothing to correct existing overvaluation. The peso was then trading at less than 2 percent below the upper band; thus, there was little room for maneuver. A Washington Fed memorandum of September 29 commented on the pacto as follows: "...in the absence of adjustment to a more competitive level, the peso probably will remain vulnerable to the types of political shocks we have seen take place with dismaying frequency this year."

From what is available in the public record, the Fed, both in Washington and New York, showed more concern that Mexico's exchange rate policy and the growing level of tesobonos would come to no good end. The language in the internal memoranda refers to vulnerabilities, not to certainties.

When Summers commented privately that there was no public record of warnings about the danger of the buildup of tesobonos — that the private markets and analysts were no more farseeing than the public analysts — he probably was unaware of some internal fears at the Washington Fed.

It is unclear just how much and how forcefully these concerns were transmitted to the Bank of Mexico, where the counterparts of the Fed operated, but the views of the Fed were known in Mexico. The emphasis in Mexico remained on reducing inflation; any ideas of overcoming the overvaluation of the peso and the concomitant slower economic growth kept being deferred to the future. The problem, in the end, was that the future came earlier than the Mexican authorities and even their U.S. counterparts anticipated.

Interviews. The most senior officer (other than the governors) at the Washington Fed during this period was Edwin M. (Ted) Truman, staff director of the Board's Division of International Finance. Truman had two decades of experience dealing with Mexican financial issues, longer than any other person of comparable rank in the U.S. government.

Truman said he alerted Summers, when the latter was nominated to be deputy secretary of the Treasury as Robert Rubin moved up to the secretary job, that he would have to deal with the Mexican problem. Summers undoubtedly did not need the warning. One response was the conclusion of the North American Framework Agreement in April 1994, making permanent the $6 billion swap line established earlier, plus the Canadian swap line of C$1 billion. One of the ground rules of this line was that it was not to be used to support the peso, but it is not evident that this stricture was followed.

When NAFTA was under consideration by the U.S. Congress in late 1993, the uncertainty about the outcome put pressure on the peso, which it withstood quite well. As the Fed saw the situation after NAFTA went into effect on January 1, 1994, the financial requirement in Mexico was for a large devaluation, a faster crawl, or a wider band. The upcoming elections in August that year meant that definitive action probably would have to wait until later in 1994. These reflections were shared with officials of the Bank of Mexico, including Miguel Mancera, its governor. One big mistake, as seen from the Fed, was that Mexico did not act in September after Zedillo won the election.

Fed officials met with Mexican authorities in Washington in October. The Mexicans included Pedro Aspe, the finance secretary, and Luis Tellez, who was part of the transition team for incoming President Zedillo and who would later be named the president's chief of staff in Los Pinos, Mexico's equivalent of the White House. These visits are referred to in the GAO report.[13] According to Fed staff, Chairman Greenspan was blunt in his conversations, with the view that the Mexican financial situation was becoming precarious.[14] Aspe reportedly responded that he hoped to defer action on the exchange rate until the first quarter of 1995, using either a free float or a hard peg of the peso, perhaps via a currency board. There was no sense of imminent disaster on the Mexican side.

The Fed felt that another miscalculation was made in November 1994 when the market knew that the Fed once again would raise interest rates, which it did by 0.75 percent on November 15. This provided an opportunity for Mexico to act; instead, another auction of government debt came on the same day.

In his highly publicized letter recounting the meeting at the home of President Salinas on November 20, Aspe states forcefully that it was at his insistence that the peso was not devalued by 15 percent at that time. He gave a number of reasons for his position, particularly that Mexico could not successfully carry out a "small" devaluation and that a peso devaluation at the last moment of a departing administration, unaccompanied by supporting macroeconomic measures, was not an appropriate way to behave. Aspe must be taken at his word, and he has not granted interviews to discuss matters related to financial decisions made at that time that go beyond what is in the public record.

However, there was a sense at the Fed even then that the most adamant opposition to a devaluation came from President Salinas himself. Salinas later gave credence to this view when, in an interview published on three successive days in February 1997 by the Mexico City newspaper *Reforma,* he stated that he had obtained a commitment from Aspe in November 1988, when he invited him to become the secretary of finance, that there would be no "abrupt devaluation" of the peso.[15]

After the devaluation, both the Mexican and U.S. authorities tried to deal with the consequences in traditional ways. These involved activating swap lines and seeking additional lines of credit from U.S. and Canadian banks. None of this worked, and the delay in realizing the extent of the fallout and taking immediate forceful action proved costly. Officers at the Fed (not Truman) have asked themselves if the crisis actually might have been avoided if the United States had acted more quickly. Truman did comment, however, that the issue was treated as a financial, not a macroeconomic problem. He noted that the expenditure of swap money to support the peso only made things worse. The idea of a large loan, or what later became the combined effort of the U.S. Treasury, the IMF, and many central banks, was considered only after much damage was done and after Guillermo Ortiz came to Washington to ponder the next steps.

The IMF and the World Bank

These two multilateral institutions had long played a significant role in supporting Mexico's financial and development policies. Of the two, the IMF was the more important for the kind of short-term financial support required after the December 1994 devaluation. The World Bank's function is essentially long term in nature, but not exclusively so.

International Monetary Fund. The GAO interviewed officials of the IMF in preparing its report. There is, therefore, some public record of IMF thinking about Mexico for the period leading up to the December 1994 devaluation and also of the role of the Fund in contributing to the peso rescue loan. In addition, the documents released by the U.S. Senate Banking Committee under the chairmanship of Senator Alfonse M. D'Amato contained a few papers from the IMF. One of these was an excerpt from the Fund's annual report for the year ending April 30, 1994, which, in the anodyne language that can be called Fundspeak, points to concern over a number of points: the large current account deficit; the vulnerability of Mexico to a sudden reversal in capital flows; the need to augment public and private savings in Mexico; and the fact that continued appreciation of the peso could pose risks to export expansion. To those familiar with interpreting Fundspeak, the understated language bespeaks some heated differences about the situation in Mexico at the time this discussion took place among members of the executive board in February 1994.

In March 1994, after Colosio's assassination, Michel Camdessus, the managing director of the Fund, assured Lloyd Bentsen, U.S. secretary of the Treasury, that Mexico, in the view of the Fund, was "pursuing fundamentally sound economic policies." At about this time, a reportedly secret audit of Fund activities indicated that material that the Mexican government considered inconvenient was excised from the report on the article IV consultations (the consultations summarized in the annual report noted above).[16]

This is not the place to get deeply into Fund practices. If Fund reports were completely frank, governments would be reluctant to cooperate. In addition, the reports themselves could trigger damaging reactions that preclude the kind of corrective action the Fund is seeking. The other side of this dilemma is that secrecy deprives the international public, including market players, of the unvarnished opinions of an institution charged with lending billions of dollars of public funds. The conundrum is not conceptually different from that faced by the

U.S. Treasury. Had the Treasury openly stated its belief that Mexico had to devalue its currency, this could have triggered a run on the peso. If the Fund openly stated that Mexican policy needed some fundamental changes, this, too, could have led to a financial crisis.

The IMF, therefore, relies on Fundspeak. The informed public is literate in this language. Of course, the financial crisis came anyhow, and it probably was worse than if it had been faced squarely earlier. In this constant struggle between openness and secrecy, which in part has a market rationale and in part merely protects negligent government, the compromise usually is to open just a tiny bit more after years of discussion.

Personal discussion with officials of the Fund more or less corroborate the main points of what is in the public record. The IMF worked closely with Mexico over many years, particularly after the debt reschedulings in the 1980s. The article IV consultations took place at the end of 1993. The dialogue was difficult. Government officials from just about all countries seeking IMF support often accuse Fund officials of arrogance. Fund officials dealing with Mexico make the same charge against Mexican officials.

The Fund was concerned that information on key Mexican variables was being made available only after a lag. The Fund, as 1994 proceeded, raised a number of issues, such as the use of development banks to carry out off-budget lending (over the course of 1994, such intermediation, on a net basis, amounted to 3.1 percent of GDP, which meant that fiscal policy was not as tight as advertised), and it goes without saying that the Fund was concerned about the overvalued exchange rate.

Tension was considerable in economic circles in Mexico before the August election. There was some possibility that a non-PRI candidate could become president (Diego Fernández de Cevallos, of the National Action Party, or PAN) and much uncertainty about what policies would follow if he were elected. Things calmed down when Zedillo won what most observers felt was a legitimate victory.

The IMF, like the U.S. Treasury, was aware of the growing issuance of tesobonos and indicated some nervousness about this, but the expressions of concern were low key. The extra vulnerability of the short-term nature of Mexico's public debt was not fully assessed. But the Fund, like other observers, was not contemplating disaster. The article IV consultations for 1994 were actually delayed from November to December by mutual agreement because a new team was taking over in Mexico. When the band was widened on December 20, Mancera, governor of the Bank of Mexico, immediately notified Stanley Fischer, the deputy managing director of the Fund. The staff told the board of the Fund that it thought the devaluation would work. As we now know, it did not.

The Fund sent a small mission to Mexico City during the last week of December 1994. There was some discussion of a new IMF program, but Mexico was reluctant to agree. By then, however, the situation in Mexico was spiraling out of control. The Fund staff prepared a report overnight for management, stressing the lack of support funds either from the Fund or the U.S. Treasury. By the end of January 1995, with some urging from the U.S. Treasury, the managing director decided to advocate what resulted in the $17.8 billion support package from the Fund. Why this figure? It is hard to know, but between the Fund ($17.8 billion) and the ESF ($20 billion), the total came close to the $40 billion that President Clinton initially sought from Congress. The Fund support was approved, but not without considerable opposition from the executive board, particularly the European directors.[17]

World Bank. The Bank, like the Fund, has had a relationship with Mexico over a considerable period. As was the case with the Fund, the Bank was actively engaged in Mexico following the 1982 crisis. At that time, the Bank's philosophy toward emerging countries began to change in favor of promoting more open markets. This was reflected in many Bank publications seeking to demonstrate that countries that had less import protection and were more welcoming to foreign direct investment generally had better economic growth performance than closed economies. This shift in attitude was reflected in dealings with Mexico, where the Bank sought basic structural changes.

These policies were discussed with the Mexican authorities, starting with the administration of Miguel de la Madrid (late 1982 to late 1988), and then accelerated when Carlos Salinas became president (late 1988 to late 1994).[18] Three large loans, each in the $500 million range, were made for structural changes in trade policy, financial matters, and dealing with public enterprises. The Bank later provided assistance to assure that the Brady Plan, providing debt relief to Mexico, was effective and even urged the private market players to support Mexican policies. Mexico, in many respects, became one of the favorites of the Bank, as it was for the U.S. government, in the early 1990s.

Yet, some concern was developing in the Bank, particularly after a large turnover of personnel working on Mexican issues around 1992. The new personnel saw a rising current account deficit, an appreciating peso, an economy growing quite modestly even as it came out of a deep depression, a labor force increasing at about 3 percent a year (and for which the low overall economic growth was insufficient to provide jobs), and low growth in productivity. Investment was flat even as the current account deficit was growing, which indicated declining domestic savings. The Bank sent an unpublicized mission to Mexico in September 1992 to discuss these misgivings. The Bank's concerns became even stronger by late 1992, when it saw little improvement in productivity growth or in domestic savings. Most of the capital inflow to finance the current account deficit was going to consumption, not to investment.

The Bank argued from about September 1992 onward that the Mexican authorities should depreciate the peso (increase the daily slide) more rapidly than was being allowed. This may have had some influence because in October of that year under the pacto, the daily crawl went back to 0.4 of a peso instead of the earlier 0.2. At this point, the Fund endorsed the Mexican government's position to give greater priority to further reducing inflation, rather than dealing more vigorously with the overvalued peso. Mexico, at this time, was mostly sterilizing dollar inflows in order to keep its money supply within money growth targets it had set.

In January 1993, the Bank sent a confidential mission to Mexico to examine the situation. An aide memoire praised Mexico's anti-inflation program but pointed out that this was achieved in part by a substantial appreciation of the exchange rate, a growing current account deficit, and crushing interest rates that had to be kept high to attract capital inflows. The report noted the high failure rate of small and medium-sized firms as a result of the high interest rate. The report also pointed out what by then had become a common refrain among outside observers — that the heavy reliance on volatile capital inflows made Mexico vulnerable to the changing expectations of investors. The report also commented that should a peso depreciation become necessary, the balance sheets of banks and firms that borrowed heavily in dollars would be weakened.

Unfortunately, all these fears became reality in 1994, when there were changes in expectations, a reversal of capital flows, and weakened banks and firms. At the time, however, the Mexican authorities objected to any publication of this critical material, and the aide memoire was not part of the report issued by the Bank. The question of secrecy of institutions that operate with public money arises here, as it did for the Fund and the U.S. Treasury. The Bank is taking steps to reduce the secrecy of its reports, but these measures do not include public disclosure of country concerns as deep as those in the aide memoire. It is not that the Bank was saying things in the aide memoire not also being said by others examining the Mexican scene, but there is a difference between privately stated concerns and official statements by funding institutions.[19] Was Mexico helped by the secrecy? It is doubtful that it was. As stated, the crash, when it came, surely was more severe than it would have been had action been taken earlier.

The weakness of commercial banks in Mexico was a serious concern at the World Bank. It is an interesting coincidence that on the very day, December 20, 1994, that the Mexican crisis erupted, the staff brought a technical assistance loan to the executive board for support to the commercial banks. The staff sentiment was that in light of what was happening in Mexico, this loan was needed more than ever.

Throughout 1994, the Bank made known its sentiment that some action should be taken to reduce the overvaluation of the peso. In February, before the Colosio assassination, the Bank argued that this was a good time to devalue the peso because Mexico would be acting from a position of strength, when international reserves were high. (They reached $29 billion in February, the high point for the year.) The exchange rate issue was raised again after the August elections at a conference in Cuernavaca. Once again, the Mexicans resisted altering policy.

The shift in public debt from cetes, which were denominated in pesos but without any indexation to the dollar, to tesobonos, nominally peso instruments but with a dollar indexation — and effectively, therefore, dollar obligations for the Mexican authorities — grew throughout 1994. The maturities between the two instruments did not differ materially, but the private market was more willing to take the debt risk in Mexico for dollar than for peso obligations. The tesobonos, as is now understood, were, in effect, reserve decumulations. By mid-year, outstanding tesobonos exceeded the Bank of Mexico's foreign reserve holdings, and by the net reserve reckoning, Mexico then had negative reserves. Bank officials assert that they were monitoring the tesobono buildup. It is evident that most private purchasers of tesobonos were not tracking the buildup; if they were, they showed no concern.

At the request of senior Mexican officials, the Bank — in anticipation of the impending change of government — prepared a series of policy options, which were the subject of informal discussions in Cuernavaca in August, cited earlier. Most of the discussion related to sectoral issues in Mexico, but the exchange rate was also an important theme. Guillermo Ortiz, then the number-two Hacienda official, had the reputation in Mexico as being more flexible on altering the exchange rate arrangement than both of his two superiors, the Hacienda secretary, Pedro Aspe, and President Salinas. As is known, the decision was made not to alter exchange rate policy.

There was much speculation in Mexico that Ortiz's position in favor of greater flexibility may have cost him the job of Hacienda secretary in Zedillo's cabinet. Ortiz was appointed secretary of Communications and Transport at the start of the Zedillo administration, only to be brought back to Hacienda as secretary in January 1995, when Jaime Serra Puche resigned after the crisis erupted.

The record shows that World Bank officials had concerns similar to those of the IMF, the U.S. Treasury, and the Federal Reserve. This uneasiness on the exchange rate, the growing current account deficit, and apparently the buildup of tesobonos, was made known to Mexican authorities. What is not known is how forceful the Bank was in pressing its misgivings. The evidence is that the Bank *qua* Bank, as opposed to individual analysts, was not very forceful.[20] The Bank had less leverage than the Fund, whose main business was to deal in exchange rate issues, and the various agencies of the U.S. government, because most of the funds entering Mexico were from private markets, not the Bank.

The Market Players

Different market players (traders, investors, and speculators) viewed Mexico from their own philosophic and practical vantages. Thus, some advocated maintaining the exchange rate at all costs; others favored setting up a currency board that would reduce the monetary policy discretion of the Bank of Mexico; still others wanted a free float; and others, a more aggressive slide. Yet, one can argue that there is a "market" view that is manifested in what the players do. There was something akin to lemming-like behavior during most of the Salinas administration, when portfolio capital streamed into Mexico in huge amounts, enough not only to help finance the large current account deficit but also to augment Mexico's foreign reserves until February 1994. This herd behavior moved in the opposite direction when fears of instability set in after the assassination of Colosio in March 1994 and became a stampede in December of that year, forcing the devaluation on December 20.

In a confidential interview with me, the key person responsible for portfolio investment of one of the largest U.S. mutual funds made clear some of the reasons for this near uniform market view, first favorable to Mexico and then adverse. One reason was the ability to change holdings of government debt from cetes to tesobonos, which persuaded many market players that Mexico had a powerful incentive to keep the peso strong. Beyond that, constant assurances were given by Pedro Aspe that there would be no abrupt peso devaluation. Aspe, as we know, was no longer finance secretary when the devaluation occurred on December 20.

It seems clear that the adverse view of Mexican policy, manifested in the large capital outflow during 1994, was led by private Mexican holders of portfolio capital, as opposed to foreign mutual funds. The IMF, in a post-mortem study released in August 1995, argued that the outward stampede was precipitated by Mexicans and not foreign institutional holders of fixed-income securities.[21] From a substantive viewpoint, the issue is not significant because one must assume that investors, whatever their nationality, will act rationally. Who acted first is interesting, however, from the aspect of who knew or suspected first what the weaknesses were in Mexican economic policy. Were they nationals of the country, or were they foreigners, most of whom had little background in Mexican history and knew little about the internal infighting? If the IMF analysis is correct, the danger signs were seen internally before they were grasped outside Mexico.

One of the arguments implicit in the views of the mutual fund player, who did have considerable information about past Mexican practices, is that the official Mexican authorities did not see themselves or their actions in the way others outside the government or outside the country saw them.[22]

This private investor was quite cynical about the motives of Mexican economic policy during 1994. His conviction was that some 85 percent of economic policy was driven by politics, namely, the desire to make sure that Zedillo won the presidential election in August of that year. He pointed to the unwillingness of the Bank of Mexico to raise interest rates and the large outlays of the public sector through development banks, that is, off-budget. His conclusion was that Mexico — the PRI, really — will have a difficult time in establishing its credibility in 1999-2000 in the lead-up to the presidential election in 2000 because of past experience.

One other investment banker made the following comment to me about his company's experience in 1994: "We trusted Salinas and Aspe and did not withdraw our funds, but we will not make that mistake again."

Mexico was severely criticized after the crisis erupted for its lack of timely publication of foreign reserve and other salient figures. The investor interviewed said that he knew, more or less, the reserve position in early December. He added that the Mexican private sector surely knew this even more precisely. He admitted that the private market in the United States was not paying much attention to the size and short-term nature of the outstanding tesobonos. This information was available for those who wished to know it. Nor, he said, were the foreign market players fully aware of the buildup of short-term foreign credit to the Mexican banks.

He said he reduced his company's position in Mexico during 1994 but did not withdraw completely. He added that he did not recognize the seriousness of the tesobono problem on day one, on December 20, 1994. His firm lost about $4 billion between December 1, when Zedillo was inaugurated, and the time when full withdrawal could be carried out. When asked whether he was angry about the way the devaluation was handled or the fact that there was a devaluation at all, he said, "No," but added that he was disappointed.

The decision to raise the band within which the peso was allowed to float was made at the pacto meeting that began at 10 p.m. on December 19 and ended at about 4 a.m. on December 20. The announcement of this action was made by the Hacienda Secretary, Jaime Serra Puche, in a radio talk at 7 a.m. on December 20. The government argued that there was no evidence that persons who knew of the decision before it was announced took advantage of it by moving capital out of the country. Unfortunately, it is hard to trace the many ways that pesos could be sold short to verify this assertion. Two knowledgeable experts, including this fund manager, said they thought one technique used was to purchase Telmex stock in London and then capture the extra peso return after the devaluation. I was unable to trace such transactions.

A number of outside observers were publicly critical that the Mexican devaluation was carried out at all. Malcolm (Steve) Forbes, Jr., who later in 1996 sought the Republican presidential nomination, was one of these (see below). Jack Kemp, the Republican nominee for vice president in 1996, took a similar position on the sanctity of exchange rates. David Malpass, director for international economics at Bear Stearns in New York, argued that the "Mexican devaluation proved to be a cold shower for devaluationists" and asserted that current account deficits should be seen not as profligacy but that the accompanying capital inflows should be welcomed as sources of investment.[23] The evidence, as noted above, is that these inflows were used more for consumption than investment.

Jorge Mariscal, an analyst at Goldman Sachs who is well informed about Mexico, compared the Mexican situation during 1994 to a speeding car on a winding road, one that had to slow down before it went over the cliff. His conclusion was that the problem was not the exchange rate — exports were increasing nicely — but rather the growth of imports because of low savings, or stated differently, excessive consumption. He also said that he "pretty much knew" the level of reserves at the beginning of December 1994. Mariscal said that many outsiders did not appreciate the fragility of the banks in 1994 and how this put pressure on the Bank of Mexico not to raise interest rates.

Just about all the private market investors and analysts who were interviewed approved the issuance of tesobonos. Their reasoning was quite straightforward, that it provided a degree of extra assurance against a devaluation. Yet, as noted, few of them followed the rapid growth in tesobonos or the extent to which their outstanding level exceeded the level of foreign reserves. When the devaluation occurred on December 20, the reserves stood at $10 billion and outstanding tesobonos at $20 billion. Foreign reserves later fell further, and the tesobonos outstanding rose to a higher level.

Issuing more and more tesobonos became a substitute for other, more fundamental policy changes. The tesobonos provided an exchange rate guarantee to investors in lieu of altering the exchange rate for a more durable corrective. They permitted borrowing from foreign investors at a lower rate than the Bank of Mexico would have to pay to sell cetes, but this did nothing to alter the interest rate situation within the country, as a devaluation would have permitted. The buildup of tesobonos became a substitute for foreign reserve policy, in that the tesobonos outstanding went up and up, while reserves either declined or stagnated. Because it did not have a floating rate, Mexico needed reserves for emergencies, but the issuance of tesobonos offered no more than a temporary security blanket. In the end, the inability to refinance the outstanding tesobonos falling due — the liquidity problem — was what actually brought on the Mexican crisis and led to the large rescue package that was mounted in early 1995. Alan Greenspan, chairman of the Board of Governors of the Fed, known more for his elliptical rather than direct language, was quite explicit about the role tesobonos played:

> The chosen alternative [to maintaining the exchange rate through further tightening of monetary policy and perhaps bringing on a recession] to dramatically tightened monetary policy, borrowing via tesobonos and drawing on reserves to intervene in the foreign exchange market, had a limit. Indeed, the limit was reached on December 20, and the defense of the peso came to an abrupt end.[24]

In light of this background, it is useful to examine the history of tesobono issuance and the role of foreign investors in encouraging this policy. The Bank of Mexico had issued tesobonos as far back as 1988.[25] The amounts before 1994 were not large. They reached about $3 billion in 1993, when they were used for financing purposes toward the end of the year when the outcome of the NAFTA debate in the U.S. Congress was uncertain and, therefore, leading to some instability in portfolio flows to Mexico. However, substantial issuance of tesobonos did not take place until 1994 and kept growing as the year went on.

Many U.S. financial houses and investment bankers and brokers urged Mexico to issue tesobonos as a way out of their dilemma of not wishing to devalue the peso or sharply raise interest rates. The Weston Group took the lead, organizing a consortium called the Weston Forum, which included many leading financial houses.[26] According to a *New Republic* article, the lead organizers of the consortium met with Guillermo Ortiz, the undersecretary of finance, in April 1994 and suggested that Mexico increase its hard currency liabilities rather than further devalue the peso. The *New Republic* article asserts that this was a nonnegotiable demand — do this or funds will be withdrawn from Mexico — whereas Ortiz, in an interview with me, characterized the discussions in softer terms. Ortiz said that the Mexican authorities were prepared to take the exchange rate risk of the tesobonos rather than the available alternatives but miscalculated because nobody expected the inability to refinance the tesobonos to come at one fell swoop.

The Weston Forum experience is rather sobering. Because of its reliance on portfolio capital to finance the current account deficit, plus the unwillingness to devalue the peso or raise interest rates, Mexico had only a single available policy instrument, the sale of tesobonos. Whether the Weston Forum players were engaged in an ultimatum, as the *New Republic* article states, or in a rational discussion of Mexico's options, Mexican authorities were at the mercy of foreign financial intermediaries and national investors. Each side had self-interested motives: the Mexican policy officials who, by consciously limiting their options, needed the capital inflows, and the financial houses, who clearly preferred an exchange rate guarantee for their investments over the risk of a devaluation that would reduce the value of their assets in Mexico. Sovereignty needs some redefinition in this circumstance. Who was the sovereign — the Mexican authorities or the financial intermediaries?

Commentary

Henry Kaufman, who, before his death in June 1997, was one of the most respected private monetary analysts in the United States, cited shortcomings in the actions of three non-Mexican groups in the period leading up to the crisis: the financial community, whose emphasis on short-term profits compromised their objectivity; major governments and multilateral institutions, which did not issue even nuanced statements of caution; and the research community, which did not raise "caution flags."[27] A task force of the Council on Foreign Relations came to similar conclusions about the lack of public candor by the multilateral institutions and the U.S. government and explained these away by the need for secrecy.[28] A front-page article in the *Wall Street Journal* gave a number of reasons for the financial tragedy: IMF complacency, the pressure from the Weston Forum and Mexico's need to convince foreign investors that there would be no devaluation, the failure of the market players to take note of the tesobono buildup, and the lack of urgency in the concerns of the U.S. Treasury.[29]

These are all worthy conclusions. The question of secrecy bears more attention. Policymaking within Mexico in the period leading up to the December 20 devaluation was highly secretive. This was the Mexican tradition, generated over decades of one-party rule. Looking outside Mexico to the official groups — those in the United States and other governments and in the multilateral financial institutions — the tradition of secrecy is also well entrenched. The argument that has always carried the day is that public statements by these groups become a self-fulfilling prophesy and should, therefore, be avoided. The record is clear that this secrecy was practiced in Washington and that private admonitions were transmitted to the Mexican authorities, but public criticism was avoided.

It is unwise to draw a sweeping conclusion from a single case when secrecy did nothing to avoid the disaster that was impending and probably made it worse. Yet, it is hard to believe that some "nuanced" (to use Henry Kaufman's word) indication of displeasure with Mexico's financial policies would have made the situation worse than it turned out to be.

The conclusion I draw is that secrecy goes too far. The international community, acting through the multilateral financial institutions, has a stake in the massive meltdown of one of its members. The U.S. government has a stake in preventing catastrophe and instability in a neighboring country. Governments now speak out on important "internal" issues in other countries, such as human rights and democracy. Is international finance more sensitive than these issues? I think not. I hope the Mexican experience has some influence in modifying current practice.

The Mexican Rescue Package

When the devaluation decision was taken on December 20, Mexico's foreign reserves were $10.4 billion. One day later, on December 21, they dropped to $5.8 billion. The Bank of Mexico squandered $4.5 billion in a vain effort to stop the slide in the value of the peso. A day later, on December 22, the Mexican authorities called it quits and allowed the peso to float. The swap lines with the United States ($6 billion) and Canada (C$1 billion) were activated. Jaime Serra, the finance secretary, came to New York on that day to meet with the financial community, and the meeting was a disaster, according to all participants. The peso kept falling, and a few days later, on December 29, Serra resigned and was replaced by Guillermo Ortiz. An economic austerity plan was announced less than a week later, on January 3, 1995, but it clearly was inadequate. Shortly after that, on January 12, President Clinton proposed legislation for a $40 billion loan guarantee program for Mexico to deal with the liquidity problem and the precipitous drop in the peso. The support of the Republican leadership; Newt Gingrich, the speaker of the House; and Bob Dole, the majority leader of the Senate, did not rescue the initiative.

What follows picks up the thinking that prevailed in the U.S. government and the international institutions, particularly the IMF.

The Public Record

President Clinton kicked off the loan guarantee proposal on January 18, 1995, with the statement that the financial crisis was a danger to Mexico and was "plainly also a danger to the economic future of the United States." This line of reasoning was the main argument used to justify the $40 billion guarantee legislation, but it did not carry the day. The most important advocate of this position was Robert Rubin, secretary of the Treasury. He laid it out initially in an internal White House meeting on January 10, and his argument was accepted by President Clinton later the same day.

Lawrence Summers made a policy speech at Georgetown University on January 20, 1995, in which he said, "Mexico made what in retrospect were critical errors in macroeconomic policy during the last year." He added that unless Mexico were able to refinance maturing tesobonos, this would pose dangers for the United States. Rubin made the same argument in testimony before the House Committee on Banking and Financial Services on January 25. In addition to pointing out the financial risks to the United States from a Mexican default, Rubin raised the specter of an increase of as much as 30 percent in illegal immigration into the United States.

Administration officials made frequent trips to Capitol Hill during the next few days. In addition to Rubin and Summers, the congressional witnesses included Warren Christopher, secretary of State. A few additional arguments were made: a Mexican financial collapse would result in a sharp reduction of U.S. exports, thereby leading to a loss of U.S. jobs; the administration guarantee package should be treated on its financial merits, and extraneous conditions should be excluded. The standard figure on job losses from reduced exports to Mexico was said to be "nearly" or "as many as" 700,000.[30] I have no idea how this number was derived, but it was blatant nonsense, as job losses and gains are not static numbers, and constant adjustments are made in the U.S. economy.[31] It was clear that administration officials were reading from the same script.

In any event, the Congress gave little credence to the testimony of administration officials. Their words were seen as political. Much more attention was paid to the testimony of Alan Greenspan, who on January 25 told the House Banking Committee that a Mexican default "would be a tragic setback… for the United States and the rest of the world as well."[32] Greenspan was seen as being independent of the political influence of the administration.[33]

The usual suspects opposed the guarantee proposal. These, it goes almost without saying, included Ross Perot. Malcolm Forbes, Jr., also was against the guarantee. Forbes' position was a mixture of philosophy and morality. He told the Senate Foreign Relations Committee that when Mexico devalued the peso, "on the advice of U.S. Treasury officials, on the advice of the IMF, and other so-called experts," it gave way "to that temptation of modern economics, the most seductive and destructive of economic drugs, devaluation. Mexico tried to cheat its creditors, and cheat its own people." Later in the same testimony, he stated that devaluation is "immoral and undemocratic."[34]

William Seidman, a former head of the Federal Deposit Insurance Corporation who is respected for his financial expertise, took the position both in congressional testimony and on the op-ed page of the *Wall Street Journal* that co-signing a $40 billion note with Mexico would bail out investors who made a mistake in judgment by investing in Mexico, and just as they expected to keep any gains, so should they suffer their losses. He asserted that a rescue surely would arouse resentment in Mexico when the United States sought to obtain security for its investment.[35] In my opinion, Seidman's first point, on the moral hazard issue, has merit. On the second point, his prediction of official Mexican resentment, he was mostly wrong.

On January 31, 1995, the administration gave up the fight to get legislative approval for the $40 billion guarantee and resorted instead to using loans and guarantees through the ESF, reinforced by assistance from the IMF, plus a number of central banks. The original $40 billion figure had not quite been picked from a hat. The reasoning was that the amount had to be large, at least double what might really be needed, in order to persuade the markets of U.S. seriousness. The $20 billion credit along with guarantees from the ESF was, therefore, considered risky if it stood on its own. The operation came together when the IMF agreed to contribute $17.8 billion to the rescue package.

There were many risks involved in the chosen procedure. As Seidman, Forbes, and others stated, there was no certainty that any of the funds withdrawn by Mexico would be repaid. The U.S. credit, to be sure, had a number of safeguards, particularly the oil facility. Funds from foreign oil sales by Pemex, the Mexican government's oil monopoly, were to be held in an escrow account at the Federal Reserve Bank of New York and could be used in the event Mexico failed to make interest or principal repayments on time. There was much discussion at the time of just how adequate or ironclad the oil facility assurance would be, but in practice it never had to be used because there were no late payments.[36]

In addition, the U.S. Treasury imposed a number of conditions that were closely monitored.[37] These were severe, and it was this type of restriction that gave Seidman pause. Just as the IMF is often portrayed as the villain when things go wrong in a country trying to meet conditions imposed when Fund resources are borrowed, so might the United States be blamed for the shock treatment involved in Mexico's recovery. There was some of this in Mexico in 1995, but the Zedillo administration really bore the brunt of the resentment for the sharp decline in Mexico's GDP that year.

Both the U.S. administration and the management of the IMF took risks. The administration may have been on safe legal ground by using the ESF, but the size and nature of the operation were unusual. This led inevitably to restrictions on future use of the ESF, a reaction that administration officials said they knew would occur. In the case of the IMF credit, it, too, was large, and European allies complained that it was rushed through without sufficient consultation and could use up funds that might be needed elsewhere, for example, in Eastern Europe and Russia. Six European countries abstained in the vote authorizing the IMF credit.[38]

The combination of U.S. and IMF conditionality, combined with President Zedillo's own convictions on the need for a crash program to bring Mexico out of its economic crisis, did squeeze the Mexican population. The GDP decline in 1995 was almost 7 percent (using a 1980 base for calculating this or 6.2 percent using an updated 1993 base). This came on top of modest growth during the previous 12 years, plus the collapse of the Mexican economy in 1982. An argument can be made that economic opening will lead to political opening,[39] but it became evident in 1995 that economic collapse also can result in political turmoil and, in Mexico's case, to a transformation of the political scene.

Yet, from a purely economic viewpoint, the shock treatment worked. Mexico's GDP recovered by more than 5 percent (1993 base) in 1996, recapturing most of the ground lost in 1995. Overall economic growth continued into 1997. Mexico was able to enter international capital markets within six months of the crisis, not six years, as was the case after 1982.

This ability to borrow was significant. On January 16, 1997, Mexico liquidated its debt to the United States under provisions of the rescue package by a prepayment of $3.5 billion plus accrued interest. The funds for this prepayment came in large part from other foreign borrowings at a lower interest rate than the rescue package's rate. Critics of the original credit grumbled that borrowing from Europe to repay the United States was merely a way to help Mexico save face and a public relations effort by the Clinton administration. Yet, refinancing is a normal way for governments to meet obligations, as is evident when one examines how the U.S. government handles its debt. When alternative financing is secured at a lower rate, this is fortunate and not a basis for caustic comment.

All told, the Mexican authorities used $13.5 billion of the U.S. credit, $3 billion in short-term swaps, and $10.5 billion in medium-term swaps. No more than $12.5 billion was outstanding at any one time. Total interest paid under the loan was $1.4 billion, some $580 million more than would have been earned had the funds been invested in U.S. government securities, according to the U.S. Treasury. The sentiment that the credit line had to be larger than the amount expected to be used turned out to be accurate. The Mexican authorities used none of the $10 billion under the potential credits from central banks operating through the Bank for International Settlements. They continue to draw down and make payments, including some prepayments, to the IMF under this transaction.

Interviews

Senior officials of the U.S. Treasury were aware, even before legislation was submitted to authorize the $40 billion guarantee for Mexico, that they had the ESF option. The initial concern was with the amount. Those experienced with the ways of the market sensed that in order to be credible, the loan total should be $40 billion, but the Treasury was reluctant to use more than $20 billion of ESF funds. There were clear sighs of relief, I was told, when the

IMF agreed to provide an additional $17.8 billion. The total figure was larger than that, in excess of $50 billion from all sources. This helped appearances, but it was clear from the outset that the two critical sources of support were from the U.S. Treasury and the IMF.

The interest rates on the U.S. credits were carefully designed not to be confiscatory — as they were in the 1982 rescue package[40] — but Mexico was asked to pay a premium rate both to encourage refinancing and to justify to the U.S. Congress and the informed public the risk that was being entered into. Much was made of the fact that Mexico paid more than the Treasury could have earned from its usual investments. Was this unseemly? In one sense, yes, because the premium interest rate took advantage of a desperate nation. In another sense, not really, because measures had to be put in place to encourage liquidation of the loan (or, more formally, the swaps). I was told that the high interest was deliberate to encourage other financing at a lower rate to permit prepayment. When the final prepayment was made, Treasury officials worked the telephones to get maximum media attention.[41]

Junior members of the Washington Federal Reserve staff wondered aloud in interviews whether the free fall of the peso and the ensuing collapse of the Mexican economy could have been prevented if the United States had acted more quickly. When the United States finally did act, it did so decisively, but it took more than 40 days, from December 20, 1994, to January 31, 1995. This, in part, was a reflection of the misappraisal of the seriousness of the crisis that was about to befall Mexico. Even if the appraisal of market reaction had been accurate, it is not clear that $50 billion could have been generated in the absence of a demonstrated need, and it took time for this to become manifest.

Interviews with IMF officials confirm the bitterness and serious disagreements at the board meeting when the Fund approved its large credit to Mexico. The preparations for the board meeting for that credit took place over one night, after the managing director concluded that the potential repercussions on the international financial situation required the large IMF participation.

Individual market players and analysts had different views on the merits of the international support. It was a “bailout” to opponents and “peso support” to proponents. On the whole, however, it is obvious that the world monetary markets approved. This was demonstrated by their actions in permitting Mexico’s rapid reaccession to ample credit.

Commentary

Two generic arguments were made for opposing the rescue package. One was the moral hazard issue, that governments should not step in to bail out investors, particularly those investing in risky places in order to obtain higher interest rates than they could obtain at home. The second was that the market is sending an unmistakable message when individuals and investment houses rush to withdraw funds, and no favor is done by overriding this message. Instead, what is needed, so the argument goes, is a costly workout to embed the message that policy errors are costly in order to prevent repetition of these errors.

Allan H. Meltzer, a distinguished professor of political economy at Carnegie Mellon University, made both these arguments in a column in the *Wall Street Journal* on February 2, 1996,[42] a year after the peso rescue package was approved. Meltzer’s points were that Mexico got into trouble as a result of poor policy, the bailout was used largely to pay the holders of tesobonos, and the Mexican population suffered grievously during 1995. Each point is undeniable. What Meltzer does not address was whether the outcome would have been worse had Mexico, faced with the reality of collapse, been allowed to default on its debt. Would the Mexican people have been better off in that case? Would the recovery have been as rapid? My conclusion is “no” to both questions.

David Felix, a distinguished economics professor at Washington University in St. Louis, wrote a year earlier that the rescue package would merely validate the policy of relying excessively on volatile portfolio capital.[43] Felix’s starting point was that Mexico’s collapse was like “chickens coming home to roost” for joining highly unequal economies in NAFTA. He never explains why NAFTA brought on faulty Mexican financial policy, other than to assert that it did not permit Mexico to take retrenchment measures earlier. This is nonsense.

The moral hazard issue is troubling. I raised it frequently in interviews with officials from the U.S. government and international agencies, who invariably said that they did not know how to carry out the rescue package without making tesobono investors whole. Either there had to be a rescue package — with all its defects — or Mexico would have to be left to the unkind devices of the market to face whatever tragic consequences this could have had. Moral hazard is not unique to this case. It arises under deposit insurance, it is a feature of many commercial bank rescues taking place around the world, and it was accepted in the U.S. government rescue of the Chrysler Corporation. In bank rescues and deposit insurance, a distinction can be made between shareholders, who are not the objects of the rescue, and depositors. Distinguishing among tesobono holders could not be this straightforward, at least not in this case. From my vantage, this was the least satisfactory aspect of the peso rescue package. It should be kept in mind that not all persons rescued were plutocrats. Many families, such as investors in mutual funds and pension plans, had a stake in the rescue.

Several Mexican bankers told me privately that paying off U.S. investors was the primary motive of the rescue package. This view lacks grace. It assumes that President Clinton was prepared to raise a domestic storm for this end alone. It also lacks decency in that many of the people who made this comment also were investors in tesobonos.

There has been considerable public praise of the rescue package. The most thorough was an article by a trio of experts in the journal *Foreign Affairs*.[44] Their argument was that "the peso support package worked" because what was being dealt with was not a "systemic" but rather a "liquidity" problem, and the rescue package permitted Mexico, albeit painfully, to work its way out of a disastrous situation. David Hale, chief economist of Zurich Kemper Investments, argued that the large foreign assistance package, by preventing a Mexican default, permitted markets to stabilize relatively quickly and enabled Mexico to resume international borrowing by June 1995.[45]

Thomas L. Friedman, in a *New York Times* column, advised against listening to demagogues who assert that Mexico's debt is Mexico's problem.[46] "Mexico owes us $100 billion. That's our problem." Mexico, he argues "*is* home." (Emphasis is his.) Friedman also makes the point that many of the people rescued were investors in mutual and pension funds and not just the managers of these funds.

My view is that the rescue package was a stroke of superb statesmanship, and Secretary Rubin and President Clinton deserve credit for leadership in the face of determined national opposition. Had the support come a month earlier, the damage to the Mexican economy would have been less and the tequila effect less pronounced, but earlier support probably would have been foolhardy in the U.S. context and not merely risky. The decision, taken by a risk-averse U.S. president in the face of public bombast against the rescue, was courageous. It is fortunate for Mexico and U.S.-Mexican relations that the need for this decision came when it did in Clinton's first term. Had the crisis arisen during U.S. electoral year 1996, it is highly likely that Mexico would have been allowed to stew in its own errors without help from the United States. This was evident during the electoral campaign, when Clinton was unwilling to defend NAFTA or free trade in the Americas, both inherently less controversial issues.

The predictors of doom, saying that the loan would not be repaid, were proved wrong. The rescue package has disappeared from view because it did work, and the critics, for the most part, have fallen silent. The only disparagement of the rescue comes from those who believe the market always must be allowed to solve economic problems, whatever the hardship involved, or from those who argue that the nominal exchange rate of any currency must be maintained, whatever the circumstances.

ANNEX: CHRONOLOGY OF KEY EVENTS

January 1, 1994. NAFTA goes into effect. On the same day, there is an uprising in Chiapas by a group calling itself the Zapatista Army of National Liberation (Ejército Zapatista de Liberación Nacional — EZLN).

February 4, 1994. The U.S. Federal Reserve raises the federal funds' rate by one-quarter of a percentage point, the first increase since 1992.

February 21, 1994. The Mexican government opens peace talks with the EZLN.

March 14, 1994. The president of the largest bank and brokerage firm in Mexico, Alfredo Harp Helú, is kidnapped for ransom.

March 22, 1994. The Federal Reserve raises the short-term interest rate by another one-quarter point.

March 23, 1994. PRI presidential candidate Luis Donaldo Colosio is assassinated.

March 24, 1994. The Federal Reserve and the Bank of Mexico open a swap facility of $6 billion. The agreement had been negotiated but not signed in the run-up to NAFTA ratification. As a further measure to reassure market players, the government renews its *pacto* with labor and business.

April 8, 1994. A number of U.S. investment bankers, under a grouping known as the Weston Forum, suggest, among other steps, that the government issue more *tesobonos* as a confidence-building measure.

April 14, 1994. Mexico is formally accepted as a member of the Organization for Economic Cooperation and Development.

April 18, 1994. The Federal Reserve again raises the federal funds rate by one-quarter point.

April 25, 1994. Angel Losada Moreno, the son of the owner of an important supermarket chain, is kidnapped.

April 26, 1994. The North American Framework Agreement (NAFA) is signed, setting up a North American Financial Group. The agreement also makes permanent the $6 billion U.S.-Mexico swap facility and expands a preexisting Canada-Mexico swap line to C$1 billion.

May 17, 1994. The Fed raises the federal funds rate by one-half percentage point.

August 16, 1994. The Fed again raises short-term interest by one-half percentage point.

August 21, 1994. Ernesto Zedillo wins the presidential election.

September 24, 1994. A new wage-price pacto is signed.

September 28, 1994. José Francisco Ruiz Massieu, the secretary general of the PRI, is assassinated.

November 1, 1994. President Carlos Salinas de Gortari delivers his final *Informe*, or state of the union address, which gives no hint of coming trouble.

November 15, 1994. The Fed raises the federal funds rate by three-quarters of a point. This is the sixth increase during 1994. The cumulative total increase is now 2.50 percentage points.

November 23, 1994. Mario Ruiz Massieu, the deputy attorney general, resigns and charges that the government is obstructing his investigation of his brother's murder.

November 20, 1994. What later becomes a highly publicized meeting between key officials of the incoming and outgoing governments, including the two presidents and finance secretaries, is held at President Salinas' house, and the suggestion of a peso devaluation is rejected.

December 1, 1994. Ernesto Zedillo is inaugurated as president of Mexico.

December 19, 1994. Subcomandante Marcos, leader of the Chiapas uprising, announces that the Zapatistas have occupied 38 localities in Chiapas. Even though this claim proves to be exaggerated, the report leads to a sharp fall of the peso.

December 20, 1994. Following a meeting of the pacto, the new finance secretary, Jaime Serra Puche, announces that the ceiling of the peso band will be raised by 15 percent. International reserves at that point are $10.5 billion.

December 22, 1994. Following a fall in reserves to less than $6 billion and a sharp run on the peso, the trading band is dropped, and the peso is permitted to float.

December 28, 1994. A delegation from the IMF arrives in Mexico City.

December 29, 1994. The president announces that Guillermo Ortiz Martínez will replace Jaime Serra as finance secretary.

January 2, 1995. The Mexican government announces a new financial support package of $18 billion — $9 billion from the United States (an increase over the earlier swap line of $6 billion), C$1.5 billion from

Canada, and $5 billion from other central banks operating through the Bank for International Settlements (BIS).

January 6, 1995. The IMF and Mexico announce their intention to enter into negotiations for a standby credit.

January 9, 1995. Mexico announces it made its first drawing from the financial support package, $500 million from the United States and C$83 million from Canada.

January 12, 1995. President Clinton proposes legislation for a $40 billion loan-guarantee package for Mexico.

January 31, 1995. Because of congressional opposition, President Clinton withdraws his proposed legislation for a $40 billion loan guarantee to Mexico. He states that the government will use its executive authority to provide a $20 billion loan package to Mexico, using the Exchange Stabilization Fund (ESF). The total loan package from all sources comes to $52.5 billion — $20 billion from the United States, $17.8 billion from the IMF, $10 billion from other countries through the BIS, $708 million from Canada, $1 billion from Argentina, Brazil, Chile, and Colombia, and $3 billion from international banks.

February 1, 1995. The Fed raises the federal funds rate by another half point.

Source: Patricia A. Wertman, September 27, 1995, "Mexico: Chronology of a Financial Crisis," Congressional Research Service, Library of Congress.

NOTES

1. The chronology draws heavily on Patricia C. Wertman, September 27, 1995, "Mexico: Chronology of a Financial Crisis," Congressional Research Service, Library of Congress.

2. Conversation with Lawrence Summers, October 9, 1996.

3. In its discussion of the peso crisis, the U.S. General Accounting Office (GAO), February 1996, *Mexico's Financial Crisis: Origins, Awareness, Assistance and Initial Efforts to Recover,* GAO/GGD-95-96, 6, reached the same conclusion, that the Treasury saw no compelling need in 1994 for a change in Mexican financial and economic policy.

4. This memorandum and others cited subsequently, unless they are otherwise identified, are from the U.S. Senate Banking Committee, June 29, 1995, "Chronology of the Mexican Economic Crisis," documents released by Senator Alphonse M. D'Amato.

5. GAO 1996, *Mexico's Financial Crisis,* 14.

6. GAO 1996, *Mexico's Financial Crisis,* 8.

7. My view is that Guillermo A. Calvo came closest to this in Calvo, Leonardo Leiderman, and Carmen Reinhart, 1993, "Capital Inflows and Real Exchange Rate Appreciation in Latin America," *IMF Staff Papers* 40, 1 (March), 108-151, but he and his colleagues never really laid out the dangers from heavy use of dollar-indexed, short-term public liabilities.

8. Nora Lustig, 1996, "Mexico in Crisis, the U.S. to the Rescue: The Financial Assistance Packages of 1982 and 1995," discussion paper, The Brookings Institution (June), contains a thorough exposition of the differences between the two incidents.

9. The narrow financial consequences of the Colosio assassination are a different matter from the long-term impact on Mexican politics. Sergio Sarmiento, a widely read columnist and popular television commentator in Mexico, repeatedly made the point that Colosio's murder was a seminal event in modern Mexican history, one that thoroughly changed the course of Mexican politics for the worse.

10. Pedro Aspe gave his account of what happened at what he called the "famous" meeting of November 20 to the Mexican press and in an editorial comment in the *Wall Street Journal* of July 14, 1995. This account is practically the only explanation that Aspe has given about the events of mid- to late 1994, other than what is contained in the public record.

11. Sidney Weintraub, 1981, "Case Study of Economic Stabilization: Mexico," in *Economic Stabilization in Developing Countries,* eds. William R. Cline and Sidney Weintraub (Washington, D.C.: The Brookings Institution), 271-296.

12. Rogelio Ramírez de la O, 1996, "The Mexican Peso Crisis and Recession of 1994-1995: Preventable Then, Avoidable in the Future?" in *The Mexican Peso Crisis,* ed. Riordan Roett (Boulder, Colo.: Lynne Rienner), 13, makes the same point, that resources were misallocated to increase consumption and housing and not manufacturing.

13. See page 92 of the GAO report.

14. Greenspan is normally elliptical in his public pronouncements. However, the word "blunt" was repeated several times during the interviews.

15. Interview reported on February 5, 1997, in *Reforma,* by Ramón Alberto Garza, under the heading: "La cosigna a Aspe: No devaluar." Internet version: www.infosel.com.mx.

16. *Latin American Weekly Report,* May 4, 1995, 191.

17. Wolf Grabendorff, 1996, "Repercussions of the Mexican Monetary Crisis Across the Atlantic: Ripples, Breakers, or a Sea Change in European Perspectives?" in *The Mexican Peso Crisis,* ed. Riordan Roett, 96, refers to the resentment of the EU about the IMF's heavy involvement and inadequate consultation in the peso rescue package.

18. Miguel de la Madrid, in a conversation with me on another subject on April 9, 1997, said that he felt there were no feasible options other than to alter Mexican development policy in light of the economic crisis he faced when he entered office at the end of 1982.

19. I published a modest piece expressing concern about the growing current account deficit at about this time. Sidney Weintraub, 1992, "Evaluación de la balanza de la cuenta corriente de México," *Economía Mexicana* 1, 1 (enero-junio), 249-251.

20. Manuel Suárez-Mier, an official of the Bank of Mexico who served for a number of years in the embassy in Washington, noted in a paper in early 1996, "For the most part Mexico's policies received not only the approval but rave reviews from the multilateral agencies involved." 1996, "The Role of International Agencies in the Management of the World Economy:

The Point of View of a LDC Member Country," Alamos, Sonora (February 23-25).

21. International Monetary Fund, August 1995, *International Capital Markets: Developments, Prospects and Policy Issues* (Washington, D.C.: IMF), 53-79.

22. This argument is supported by interviews with private sector participants engaged in pacto discussions with the Mexican financial and monetary authorities.

23. *Wall Street Journal,* December 20, 1996, op-ed column, A16. Malpass wrote an earlier column for the *Wall Street Journal* in which he argued that Mexico should reverse the devaluation and restore the exchange rate to 3.5 pesos per dollar. David Malpass, January 11, 1995, "The Mexican Peso: 3.5 or Bust," A14.

24. Alan Greenspan, January 25, 1995, testimony before the House Committee on Banking and Financial Services.

25. See Banco de México, *Indicadores Económicos*, various issues. *Indicadores Económicos* is a monthly statistical publication.

26. The existence of this group was first reported in articles from the Mexico bureau of the *Wall Street Journal* during 1994. The first of these, which contained considerable detail, appeared on June 14, 1994, by Craig Torres and Thomas Vogel, Jr., A1. The most complete reporting was an article in the *New Republic*, by Douglas W. Payne, March 13, 1995. Payne reported that the consortium included Fidelity Investments; Trust Company of the West; Scudder, Stevens & Clark; Oppenheimer Management; Putnam Funds Management; Soros Fund Management; Salomon Brothers; Nomura Securities International; and the Weston Group.

27. *Wall Street Journal*, January 26, 1995, "Why Alarm Bells Didn't Ring Over Mexico," op-ed column.

28. Council on Foreign Relations, 1996, *Lessons of the Mexican Peso Crisis*, report of an independent task force (New York: Council on Foreign Relations), 26-28.

29. David Wessel et al.,*Wall Street Journal,* July 6, 1995, "Peso Surprise: How Mexico Crisis Ambushed Top Minds in Officialdom, Finance," A1.

30. The quoted words come from statements by Rubin and Christopher, respectively.

31. See Sidney Weintraub, 1997, *NAFTA at Three: A Progress Report* (Washington, D.C.: Center for Strategic and International Studies) for a discussion of job loss and creation from NAFTA.

32. Alan Greenspan, see note 24.

33. I know this from queries I received from a number of senators after I testified before the Senate Foreign Relations Committee in favor of the guarantee proposal. These senators, even though they were skeptical, were not prepared to dismiss out of hand Greenspan's statements about possible financial damage to the United States in the event of a Mexican debt default.

34. Hearing before Senate Committee on Foreign Relations, January 26, 1995, "Mexico's Economic Situation and U.S. Efforts to Stabilize the Peso," 104th Congress, session 1, U.S. Government Printing Office, 12 and 14.

35. His op-ed column was on January 23, 1995, and his testimony before the Senate Foreign Relations Committee was three days later, on January 26, 1995.

36. GAO 1996, *Mexico's Financial Crisis,* 109-132, contains a discussion of the nature of and conditions placed on U.S. and IMF assistance to Mexico. Treasury Secretary Rubin laid out the details of the U.S. credit to Mexico in a signing ceremony on February 21, 1995.

37. The U.S. Treasury issued monthly reports on the situation in Mexico and on compliance with the loan conditions pursuant to the Mexican Debt Disclosure Act of 1995. The Congress was also provided with semi-annual reports under this act.

38. These were Germany, Great Britain, Denmark, the Netherlands, Belgium, and Switzerland. See Nathaniel C. Nash, *New York Times*,February 13, 1995, "Western Allies Rebuff Clinton in Mexico Vote."

39. I, for one, have made this argument in Sidney Weintraub, 1993, "The Interplay between Economic and Political Opening in Mexico," *Proceedings of the American Philosophical Society* 137, (1).

40. Nora Lustig, June 1996, "Mexico in Crisis, the U.S. to the Rescue."

41. I know this because I was in the office of an editor of the *Los Angeles Times* who told me about the phone call he had received that day from Larry Summers.

42. Allan H. Meltzer, February 2, 1996, "Clinton's Bailout Was No Favor to Mexicans," *Wall Street Journal,* op-ed article, A11.

43. David Felix, February 14, 1995, "NAFTA and the Mexican Peso Crisis," *Washington Times,* op-ed article, A19.

44. Bradford DeLong, Christopher DeLong, and Sherman Robinson, 1996, "The Case for Mexico's Rescue," *Foreign Affairs* 75, 3 (May/June), 8-14.

45. David Hale, June 2, 1996, "Such a Deal! The Much Maligned Mexico Bailout Is Looking Smart — and Not Just for Mexico," *Washington Post,* C.

46. Thomas L. Friedman, January 25, 1995, "Helping Mexico Help Us," *New York Times,*A21.