Mexico 1982: Fixed Exchange Rates and Shoddy Policies

KANIKA TALWAR

Abstract:
Although Mexico was not the first indebted economy to erupt, nor the largest, nor the one with the most serious economic or financial problems, the 1982 Mexican crisis was the one that alerted the world to the possibility of a systemic collapse: a crisis that could spread to other countries and threaten the stability of the international financial system.

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1. Introduction

Mexico's story begins in the early 1950s, with the devaluation of the peso in 1954 meaning that the Mexican economy entered a phase of high growth and low inflation that would last until the end of the 1960s. This period has since come to be known as the era of Stabilizing Development (SD). The main objectives of economic policy during SD were to increase private sector savings and capital accumulation, maintain price stability, increase real wages and keep the exchange rate fixed at 12.5 pesos per dollar. All in all, fiscal and monetary policies were coordinated with a view to preserving a fixed exchange rate and overall price stability. The growth rate of the monetary base was strictly controlled and it was well understood that if the fiscal deficit exceeded the level consistent with the planned rate of monetary expansion, expenditures were to be lowered until the gap was eliminated.

2. The eruption of crisis

The 1970s saw Luis Echverria rise to the presidency, and his administration changed policies radically. After contractionary measures were temporarily imposed in 1971 to reduce the payments deficit, an enormous fiscal expansion took place. In the next five years, general government employment doubled and the share of total public sector spending in GDP rose from 20.5% to 30%. An attempt at tax reforms failed in 1972, meaning that the fiscal deficit soared to 10% of GDP in 1975 and 1976. Unlike in the preceding Diaz Ordaz government, a large portion of the deficit was financed by borrowing from the Central Bank, and not extracted from the commercial banking system through the imposition of high reserve ratios. The growth rate of the monetary base accelerated from 19.8% in 1972 to 33.8% in 1975 and the share of seignorage in GDP rose to triple the average level of the 1960s. Another important shift in monetary policy concerned the management of interest rates. Whereas real deposit rates were maintained at positive levels throughout SD, after 1972 nominal interest rates were not adjusted upward in step with increases in inflation, and as real rates turned negative the Mexican miracle terminated abruptly, with negative real deposit rates slowing the growth of bank funds, and higher reserve requirements causing the supply of credit to the private sector to diminish sharply.

Meanwhile, on the international front, as the nominal exchange rate remained pegged at 12.5 pesos per dollar, the real exchange rate fell rapidly and the current account deficit deteriorated until it reached 5.1% of GDP in 1975. The reluctance to raise domestic interest rates in the face of higher inflation and a clearly overvalued peso caused the overall BoP to deteriorate to an even greater extent. Capital flight ensued, with $3.6bn leaving the country in 1975 and 1976. This BoP deficit was reflected in rapidly rising foreign debt levels. From a figure of $6.3bn at the start of 1971, the total foreign debt more than quadrupled to $27.9bn by the end of 1976. Almost all of this debt was taken out by the public sector from the commercial banks.

In 1976, the economic program of the President Echeverria collapsed under extreme BoP pressures. Extensive import controls were imposed and parastatal expenditures were sharply reduced, but little was done to check spending by other branches of the government or to curb monetary expansion. As a result, though the burden of debt service was not exceptionally high, the current account deficit remained sizeable, capital flight persisted and the central bank's stock of forex reserves became severely depleted. On 31st August, the peso was devalued nearly 100% and the economy went into a recession. During the last four months of the year, manufacturing sector employment fell 4.2%, the inflation rate surged to 60%, and there were frequent threats of bank runs. Shortly before Lopez Portillo's inauguration as President, negotiations began on the terms for a standby agreement with the IMF.

The Lopez Portillo government soon reached an agreement with the IMF on a stabilization program to be implemented in stages over three years. The program called for the usual mix of trade liberalization and monetary and fiscal austerity. In its first year, the program was fairly successful. The fiscal deficit was lowered from 9.9% to 6.7% of GDP, the inflation rate declined from 27.2% to 20.7%, and the current account deficit fell by over $2bn in 1977. GDP growth slowed further to 3.4%, but the decline was far less severe than anticipated.

However, once oil reserves were discovered by PEMEX, the state oil company, in the late 1970s, the hope was that oil revenues would stabilize the economy. But this only circumvented the dangers of immediate crisis, without resolving the economy's structural problems. Mexico became a net petroleum exporter and pressure grew to expand public spending. The number of state owned enterprises quadrupled to 1,200 under President Portillo (1976-1982). Mexico borrowed $78bn by 1981 to finance several projects. The state's share of fixed capital formation increased to 50%. As inflation surpassed 25%, the peso became overvalued, and the competiveness of exports, apart from oil, diminished. Recession in the US reduced demand for Mexican goods, while a sharp increase in interest rates there reduced the money supply, and put pressure on Mexico's debt servicing, as US banks had lent the country $25bn. Mexico was poorly positioned when oil prices fell in response to a weakening world economy in the early 1980s. At the same time, trade liberalization combined with real exchange rate appreciation lowered the real price of imported goods approximately 28% from 1977 to 1981, provoking an increase in demand. Between 1978 and 1980, real imports of capital goods and intermediate inputs increased by more than 100%. The cost of servicing Mexico's debt reached $16 billion, more than its revenues from oil.

In August 1982 the Mexican finance minister indicated that his nation could no longer meet interest payments, and requested a 90-day rollover of the payments of the principal to prepare toward definite restructuring financial package.

3. The Aftermath

Mexico's economic indicators pointed towards crisis. GDP contracted by 0.6% in 1982 and 4.2% in 1983, while the inflation reached 58.92% in 1982. Output fell in all industries, unemployment jumped towards 15%, while more than half the workforce was underemployed. By the year end, approximately 40 nations were in arrears in their interest payments, and a year later 27 nations including the four major Latin American countries of Mexico, Brazil, Venezuela, and Argentina were in negotiations to restructure their existing loans.

Adverse external shocks and the burden of servicing the debt made some deterioration in the economy's performance inevitable. Over 1983-86, Mexico's terms of trade (adjusted for changes in world market interest rates) declined 42.2%, the most severe blow coming in 1986 with the collapse of world market oil prices. The worsening terms of trade coupled with debt service claiming 40-50% of total current account income forced an extraordinary degree of import compression upon the private sector, leading to stagflation pressures.

4. Role of External Shocks

While Mexico's structural framework played a large role in the 1982 crisis, it is important to note that external shocks to goods and asset markets in the form of oil price changes, capital flow shifts, or interest rate changes were instrumental in the situation playing out as it did. The boom and bust cycle in Mexico began with a favorable external shock-an increase in oil exports (following a discovery), a fall in world interest rates, and liberalization of trade/capital flows. This shock was followed by large capital inflows, increased fiscal expenditures, an expansion of the domestic money supply, higher inflation, and an appreciation of the real exchange rate. However, this process eventually became unsustainable. A smooth adjustment of the real exchange rate, however, was precluded by the combination of the government's commitment to the controlled nominal exchange rate and the downward stickiness of prices and wages. So the economy was stuck with an overvalued real rate, which generated the expectation of a future devaluation and consequent increase in the price of foreign goods. This in turn fuelled an import boom and a flight of capital that reduced the foreign reserves of the central bank and eventually led to the collapse. Had the government instead adopted a flexible exchange rate, the favourable external shock and the resulting capital inflows would have appreciated the exchange rate. This would have reduced aggregate demand and the incentive to borrow.

5. Debt Restructuring

In 1982, the government began with the debt restructuring with a two-year respite from large scale debt service payments, granted by US commercial banks. On 10 December 1982, an agreement was reached with the commercial banks to reschedule USD 23bn of capital payments on the public sector debt coming due between 23 August 1982 and 31 December 1984. During the same period a wide-ranging stabilization program was agreed with the IMF. The program also included structural reforms. At the time of the Mexican default, debt often exceeded the capital base of many of international banks. Therefore, many feared that the banking system would collapse. In the face of falling economic growth rates and rising inflation a plan proposed by US Treasury secretary was launched. Under the "Baker plan", high-debt countries would get new access to medium-term loans, in addition to rolling over of amortization of old loans. In June 1983, the "Paris Club", representing creditor governments, rescheduled Mexico's sovereign debt owed to major creditor countries (World Bank, 2004). With access to capital markets restored, it was hoped that the economic reforms would allow the debtors to grow out of debt. However, capital outflows went up instead of going down, inflation further went up, investment fell and over the period 1982-1988, no economic growth took place in Mexico at all. Consequently, external debt rose to 78% of GDP in 1987, marking the failure of the "Baker Plan".

In September 1989, the "Brady plan" was agreed, conforming the concept of debt relief. Under this plan the US commercial bank creditors were forced to accept a smaller safer payment stream in exchange for original claim that clearly could not be serviced in full. The Mexican government and the Bank Advisory Committee represent the commercial bank creditors, thus reached an agreement on a financing package covering the period 1989-92, restructuring approximately USD 49.8bn of Mexico's external debt. Since the plan only covered restructuring long-term debt with commercial banks roughly half of the debt was involved. The banks had three option now:

1. They could exchange old loans for new bonds at a discount of 35% of their face value, keeping interest rates at market levels.
2. They could exchange old debt for face-value new bonds (called par bonds) at fixed interest rates of 6.25%.
3. They could provide additional loans over the next three years equivalent to 25% of the banks' initial medium- and long-term loans, which implied no debt relief but the provision of new money.

Most banks opted for the par bond (47%), other banks chose to reduce the principal (40%) and few offered new loans (13%).

This plan substantially improved Mexico's ability to service its external debt by reducing interest and principal payments.

6. Structural Reforms

In December 1982, Mexico also underwent structural reforms, which was a condition for receiving the IMF loan. These reforms included: fiscal austerity, privatization of state-owned companies, reductions in trade barriers, industrial deregulation, and foreign investment liberalization. The budget deficit reduced from 17.6% in 1982 to 8.9% in 1983.

Also the tax system underwent a number of reforms, encouraging capital inflows and raising sanctions for tax evasion. The government also initiated a process of financial market liberalization. Ceilings on commercial banks' deposit interest rates were removed.

7. Conclusion

The Mexico Crisis of 1982 was a result of shoddy economic policies. A smooth transition from fixed exchange rate to a flexible one would have saved the country from such a crisis. What happened in Latin America [and Eastern Europe and Africa] during the 1980s would later be repeated in South-East Asia in the late 90s, and to some extent, in Europe at present. To quote Hegel here, that history repeats itself, wouldn't be wrong. However, it would be more appropriate to echo Marx: the first time as tragedy, the second time as farce.

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