

THE VIEW FROM THE UNITED STATES OF THE MEXICAN SITUATION

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Today, I would like to speak with you about the events in Mexico that have lately dominated the international markets and U.S.-Mexican relations. While many of us may be familiar with the details of the U.S. response to the situation, we may not be so knowledgeable about the economic transformation Mexico has undertaken during the past few years. I believe it would be difficult to understand why the U.S. immediately came to the aid of Mexico following the depreciation of the peso on December 20 without understanding some of Mexico's recent history. Therefore, before I go into more detail about the current financial crisis, let me provide some necessary background information.

Economic Reform in Mexico

For many decades, Mexico has been undergoing a far-reaching economic transformation. The revolution in Mexico in the early 20th century established a populist legacy that translated into an economy based on a considerable government role in the economy. In the 1970s and early 1980s, this legacy took the form of protectionist policies and excessive government intervention. High customs and tariffs characterized the Mexican foreign-trade scene, and the activities of foreign investors were severely limited. These conditions caused a number of undesirable consequences: capital flight, inflation, economic stagnation, and, above all, massive external debt. When oil prices began to fall in the 1980s, export earnings fell substantially and aggravated the debt problem in Mexico, as did high interest rates worldwide. These circumstances led

Mexico to default on its international loans in 1982, an action that marked the beginning of what came to be known as the Latin American debt crisis.

By the late 1980s, Mexico's leaders realized that the future development of the country should not be based mainly on spending revenues from oil exports, and they began to lay the groundwork for a transformation to a more market-oriented economy. They began by lowering tariffs and then by introducing other market-oriented reforms, such as combining tight monetary and fiscal policies with price, wage, and exchange-rate controls. These reforms helped to eliminate the government budget deficit. The reforms also succeeded in reducing triple-digit inflation of more than 130 percent annually in 1987 to roughly 7 percent last year. Another important reform measure was the reduction of foreign debt through agreements with the International Monetary Fund, the World Bank, and its creditor banks. As a result, Mexico's external debt as a ratio of GDP was cut in half. In the meantime, the government started to privatize the large number of state-owned businesses, and the progress in this area has been nothing short of phenomenal. From a peak of 1,155 state-owned businesses at the end of 1982, Mexico had only about 225 as of mid-1992.

At the beginning of this decade, Mexico took even more steps to shift to free and open trade, which enabled it to join with the United States and Canada in the North American Free Trade Agreement in 1994. Joining NAFTA was highly significant for Mexico in that it affirmed that the country had officially emerged from the economic crises of the 1980s and indeed from its long-standing policy orientation toward protectionism that, at times, had bordered on isolationism.

All of these changes in Mexico--and other Latin American countries as well--began to bear fruit by the early 1990s. Total foreign investment in Mexico doubled from 1991 to 1993. Manufactured goods as a percentage of exports grew to more than 80 percent in 1993. Growth in output had stabilized at a sustainable rate of near 3 percent last year. Moreover, foreign investors began to lend to Mexico for the first time since 1982. Thus, Mexico, like Chile, was held out as a model of economic reform by most observers, and officials from other countries consulted with government and central bank officials of Mexico to replicate its successes in their own countries. So then, what happened to lead to the events of December 20, 1994?

The Peso Crisis

Until December the value of the Mexican peso had been controlled by the central bank and was linked, or pegged, to the value of the U.S. dollar by means of a controlled exchange rate band. This exchange-rate regime helped Mexico to reduce its inflation rate significantly. However, the inflation rate in Mexico remained above the U.S. rate, and the controlled exchange rate band did not fully compensate for that difference. This situation resulted in a gradual real appreciation of the peso. Over time, the real appreciation of the peso made foreign imports seem very cheap to Mexican consumers, which resulted in a consumption boom and a growing trade deficit.

With hindsight, another problem with this exchange-rate regime is that it could not tolerate very well either errors in policy or unforeseeable events, or "shocks" as economists call them. Two political assassinations and the peasant uprising in Chiapas were one kind of

unpredictable phenomena. They caused investors to lose confidence in Mexico because of the potential for political instability. Another unforeseeable event was the magnitude of the rise in U.S. interest rates in 1994. The Mexican government had been able to keep the peso within its bands by intervening in the markets with its currency reserves. These reserves had been accumulated by borrowing from foreigners, which was a reasonable strategy when interest rates were low. Rising interest rates, however, made this strategy of borrowing foreign funds to maintain reserves much more costly. The combination of these shocks resulted in a substantial reduction in the flow of capital into Mexico and a consequent loss of its foreign exchange reserves. At some point, reserves became so low that it was no longer possible to continue with the same strategies.

At any rate, on December 20, the central bank of Mexico allowed the peso to depreciate by 15 percent against the dollar, hoping that the peso would stabilize at its new lower value. Instead, the peso has fallen by roughly 35 percent against the dollar. The depreciation of the peso caused a financial crisis in Mexico and other emerging countries. The stock market in Mexico has declined nearly 10 percent in peso terms since December 20, and stock markets in Argentina, Brazil, Chile, and Peru have also declined. Moreover, the depreciation has caused interest rates in Mexico to soar. This effect can be seen in the interest rate on the so-called Tesobonos. (These are similar to our Treasury bills except that, although they are traded in pesos, their return is indexed to the dollar.) The interest rate has increased to 25 percent from 7 percent in June.

Response to the Crisis

In response to the peso crisis, both President Zedillo and President Clinton have offered plans, which I will describe briefly in a moment. But first I would like to compare the response to recent difficulties with the way Mexico handled its debt crisis of the early 1980s. During the debt crisis a decade ago, Mexico nationalized banks, reneged on liabilities denominated in dollars by converting them to pesos on the spot, and imposed tighter controls on foreign investors. The reaction by the Mexican government to current developments is quite different. Provisions for foreign ownership, investment, and trade remain intact. Trade barriers have not been reinstated, and privatization continues to be a priority for the Mexican government. In addition, the government has pledged fiscal discipline.

Specifically, President Zedillo announced an emergency economic plan on January 3 after two weeks of negotiations with business leaders, trade unions, and creditors. Under the plan, the Mexican government pledged to cut its expenditures by more than 1 percent of GDP and to speed up its privatization program, including allowing more foreign investment in banking, railroads, and communications. Stringent limits on credit from the central bank to the government and development banks were put in place so as to ensure that the central bank would not be forced to absorb the government debt, a policy that is ultimately a recipe for inflation. The exchange rate would continue to float freely and, finally, increases in wages have been limited to 7 percent.

However, the Zedillo plan was not enough to quell the crisis, and international forces had to be mustered. Despite the announcement of the Zedillo plan, the peso remained weak, the

Mexican stock market kept falling, and interest rates on Mexican debt kept increasing--and, because of a recently released report by the Mexican central bank, we now know that currency reserves were falling to a perilously low level. To prevent a further deterioration, the Clinton administration proposed on January 10 a loan guarantee for \$40 billion worth of Mexican debt. When this plan did not quickly move through Congress, the President used an executive order to provide aid to Mexico in the form of granting \$20 billion from the U.S. exchange stabilization fund. This fund was created by the Gold Reserve Act of 1934 for the purpose of maintaining orderly exchange arrangements, and it is managed by the U.S. Treasury.

This U.S. initiative, combined with loans from the IMF, the Bank for International Settlements, Canada, and four Latin American countries, now comes to about \$50 billion. In return, Mexico will be required to provide an assured source of repayment from the proceeds of the exports of Mexican oil.

What Does It Mean?

Now that I have recapped the events leading up to the current difficulties in Mexico, I would like to explain what I think they mean and where we need to go from here. There are many views of this situation, and economists will be debating for a long time both the long-term and proximate causes of the financial crisis. Some analysts are pointing to the lack of independence of the central bank as a reason; others believe that pegging the peso to the U.S. dollar was misguided. I do not doubt that there was more than one reason for the crisis, but it is not possible for me to go into all of them, nor is it possible for us to understand the real

reasons for the difficulties while we are still so close to them. However, I do have a few thoughts on the subject that I would like to leave with you.

First, it seems clear to me that the fundamentals in Mexico remain positive. This emerging country is basically sound, and I believe it will persevere through its latest economic problems. However, in the short term, strong backing from the United States, which is Mexico's largest trading partner, is absolutely necessary in order to restore confidence in the ability of the Mexican government to handle the financial situation.

Second, I believe it is critical to recognize that financial difficulties of this sort can be expected from time to time in a world that is more tied together through the globalization of finance. While many countries have benefited from the increase of capital flows around the world, it is also true that capital is not fixed. It can just as easily flow out as well as flow into a country. Mexico has felt both sides of this force, as have other countries, including several in Europe in recent years. The point is that isolation is not a better alternative. The benefits of worldwide trade and financial linkages far outweigh the costs associated with this type of crisis.

Where Do We Go From Here?

Now let me address the question of where we should go from here. There are both economic and political arguments as to whether the United States should offer to help Mexico in its current situation. The economic logic in favor of what was done has already been spelled out. Economic arguments against the aid might point to the protection offered to investors who

benefited earlier from growth in Mexico and now would seem to be getting a bail-out on their investments rather than having to absorb their losses.

Political arguments tend more toward trade relations and helping a neighbor in need. Thanks to our trade ties through the North American Free Trade Agreement and the simple matter of our proximity to one another, Mexico is an important partner of the United States and free trade with Mexico has created many jobs in the United States as well as Mexico. I also firmly believe that it would not be in the interest of the U.S. if Mexico were to deteriorate into economic chaos and social unrest.

Once all of these economic and political considerations were weighed, I have no doubt that it was necessary to come to the assistance of Mexico. It is my hope that the focus will return to the positive fundamentals of the Mexican economy and the enormous potential it holds. Having made an agreement with our Mexican neighbors to open our economies to one another, it would have been unacceptable to turn our backs during this time of trouble. It is in our own interest to take reasonable steps to help ensure that a temporary financial crisis does not turn into a long-term economic and political problem that would have serious consequences for the people of both Mexico and the United States.

Conclusion

In conclusion, there are many lessons to be learned from the Mexico situation, but not all are cautionary. At the heart of this story lies the important fact that Mexico has been

successfully transforming its economy to one that is much more market-oriented, more industrialized, and ultimately, more prosperous. The fundamentals are in place for a continuation of this transformation. With sound management of the current financial difficulty, Mexico should be able to emerge from this trying period stronger yet. Such an outcome can only benefit the United States.

This difficult situation has brought to mind an old saying, attributed to Porfirio Díaz, a former president of Mexico at the turn of this century. It goes: "Poor Mexico, so far from God, so close to the United States." On its face, the current crisis in Mexico seems to bear out this saying, but it is my hope that the situation will be resolved in a way that puts this idea to rest once and for all.