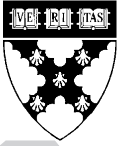

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Mexico in Debt

On December 1, 1994, Ernesto Zedillo Ponce de León took over as Mexico's president from his predecessor Carlos Salinas. Just three weeks later—on December 20—the Mexican stock market (known as the *Bolsa*) dropped 150 points. Foreign exchange reserves were already down from $25 billion at the start of the year to around $6 billion—less than one month of imports. The government had no choice but to float the peso. Financial markets reacted chaotically, sending the Mexican currency into a free-fall. The peso lost more than 35% of its value in just three weeks, falling from 3.4 pesos/dollar on December 20 to 5.7 pesos/dollar on January 9. Capital fled the country at an alarming rate. The economic strategies of Zedillo's predecessors Miguel de la Madrid Hurtado and Carlos Salinas de Gortari, whose reforms had won global admiration, were now in serious trouble.[1] Added to this was a peasant uprising in the southern state of Chiapas and damaging allegations of corruption in Zedillo's political party—the Partido Revolucionario Institucional (PRI). Barely a month into his job, the new president already had his work cut out for him.

Modern Mexico

Mexico is the 13th largest nation in the world, with a population in 1994 of approximately 93 million people.[2] The country's 1990 census showed that 71% of the population lived in cities and 29% in rural areas; 38% was under 14 years old.[3] Forty-eight percent of Mexico's land is suitable for livestock, 29% is forested and 18% is arable. The country shares a 1,760-mile border with the United States.

Modern Mexico was built after the devastation of the 1910 revolution -- a revolt against the 30-year dictatorship of Porfirio Díaz and U.S. "imperialism"—in which an estimated one million lives were lost. That bloody legacy shaped the national conscience and motivated policymakers and the population to search for nonviolent means of conflict resolution. The new Constitution in 1917 gave

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[1] The World Bank, *Trends in Developing Economies* (Washington D.C., 1996), p. 337; and George C. Lodge, "Mexico 1995: The Crisis Returns," HBS case no. 795-126.

[2] International Monetary Fund, *International Financial Statistics*.

[3] 1990 Mexican Census data.

Research Associate Eilene Zimmerman prepared this case under the supervision of Professor Richard H.K. Vietor as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. This case draws heavily on "Mexico: Escaping from the Debt Crisis?" by Professor Helen Shapiro, HBS case no. 390-174.

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the state a leading role in national development and contained strong nationalist provisions. The state took on an arbitrating role between capital and labor and promised concessions regarding maximum working hours, minimum wages, and union rights. A six-year presidency was established which prohibited successive terms of office and granted primacy to the executive over the legislature and judiciary.

The current political system dates back to 1929, when the revolutionary elite founded the Partido Revolucionario Institucional or PRI. Over the years noncompetitive elections were institutionalized within an officially multi-party, pluralistic framework.[4] The PRI had never lost an election, although the legitimacy of the results of the 1988 and 1994 presidential elections had been questioned.

After World War II, Mexico followed a deliberate policy of import substitution to reduce its dependence on raw material exports and imported manufactured goods. The fledgling manufacturing sector was protected from foreign competition by tariffs and quantitative restrictions on imports. In the 1950s, those restrictions covered about 10% of domestic production, rising to 60% in the 1970s and 100% in 1982-83. The government provided low-interest, long-term loans to industry through state investment banks. The public sector also invested directly in infrastructure and basic industries such as steel and petroleum.

In spite of revolutionary constraints, foreign investors responded well to the import substitution policies, and from 1950 to 1970 foreign direct investment (FDI) increased five-fold, with the United States, swamping all other investors. From 1954 to 1970 Mexico followed a policy it termed "stabilized development" (*desarrollo estabilizador*), which involved relatively tight fiscal policies and government restraint in using unsupported central bank credits to finance increased spending. As a result, average annual growth rates in per capita income of over 3% were accompanied by low inflation and a fixed exchange-rate regime.

By the mid-1960s, however, underlying problems in the system became apparent. Growth rates were slowing, agricultural production decreased, and exports of manufactured goods stagnated. The economy had become even more dependent on imported capital goods, and between 1965 and 1970 the current account deficit ballooned from US$367 million to US$946 million. With this economic stagnation came social unrest. In the summer of 1968 a series of peaceful student demonstrations were violently surpressed by the government, resulting in the army's massacre of hundreds on October 2. The PRI's use of outright repression precipitated further opposition. Grassroots movements began to organize outside the PRI umbrella, calling for increased democracy.

President Luis Echeverría (1970-1976) attempted to restore legitimacy and accommodate competing claims on the system through aggressive fiscal policies. In an attempt to increase the slackened growth rate and relieve infrastructural bottlenecks, the state increased investment and encouraged import substitution in intermediate and capital goods. But revenues failed to match the increasing fiscal demands on the state. Fiscal and current account deficits increased and inflation rose to an annual rate of 30%. In 1973, moreover, severe restrictions were placed on foreign investment. By August 1976 the situation had reached crisis proportions; for the first time since 1954, the president was forced to devalue the peso by more than 40%, from 12 to 19 pesos per dollar.

In 1977 the government of José López Portillo instituted an austerity program which improved the balance of payments by the following year. New oil discoveries led to increasingly optimistic estimates of the country's oil reserves, which in turn attracted foreign credit at low interest rates. López Portillo terminated a stabilization agreement previously reached with the International Monetary Fund and ushered in the era of the "Mexican Miracle." A development boom ensued, with rapid growth in state expenditures, especially for oil, agriculture and tourism. Public sector outlays as

[4]Donald E. Schulz, *Mexico in Crisis*, Strategic Studies Institute at the U.S. Army War College, 1995.

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a share of GNP went from 25% in 1970 to 42% in 1980. Nearly half of that investment was for oil exploration and production. López Portillo targeted oil exports at 1.3 million barrels a day, on top of 1.2 mmb/d for domestic use.

The "miracle" however, did not reach everyone. At the end of the 1970s, 35% to 40% of all households earned a total income below the prevailing minimum wage; approximately 20% of the population in 1979 was suffering from malnutrition; 45% did not receive adequate health care. Approximately 50% of all homes lacked running water and sewage services, and 25% had no electricity. The lowest 20% of all households held 3% of national income while the top 20% held 41% of that income.[5]

Imports were growing at a faster rate than exports as the fixed exchange rate became overvalued. The budget deficit grew to 17% of GDP in the last year of the López Portillo administration. Public external debt nearly doubled from US$40 billion to US$78billion in just two years. Anticipating a devaluation, investors began to move out of pesos. When oil prices began to soften in 1981, government income fell below projections. In February 1982, after vowing to "defend the peso like a dog," López Portillo was forced to devalue. By June, capital was leaving the country at a rate as high as US$400 million a day. On August 12, 1982, the so-called Mexdollar accounts—dollar-denominated deposits held in Mexican banks—were frozen.

When U.S. Secretary of the Treasury Donald Regan said to Mexican Finance Secretary Silva Herzog, "Mr. Secretary, you have a big problem," Silva Herzog replied, "No, Mr. Secretary, I'm sorry to tell you but *we* have a problem." On August 15, Mexico fired "the shot heard around the world" and announced it could no longer meet interest payments on its foreign debt. The country plunged into a period of financial crisis and economic stagnation unprecedented since the Great Depression.[6]

In September, López Portillo nationalized the banking system and inaugurated exchange controls. His surprise move, orchestrated by a small group of presidential intimates, sent shock waves through the private sector, shattering what little confidence remained. Although the move rallied popular support in the short-run, it aggravated capital flight and ruptured the implicit contract between the private sector and the government. In December, with foreign debt at US$91 billion, Mexico signed a stand-by agreement with the IMF, pledging to reduce the deficit, restrict growth in the money supply, devalue the peso, welcome foreign investment, privatize state-owned companies, restrain wages and charge fees for public services.

Up until the economic crisis in 1982, the stability of Mexico's political system had been based on its capacity to maintain order and security and increase living standards, even in the face of rapid population growth and a highly unequal distribution of wealth. The government maintained a systemic equilibrium in the short-to-intermediate run but was unable to prevent long-term decay, both politically and economically. Rather than addressing the deeper, more fundamental problems that were undermining the system, reforms were designed to buy time through piecemeal adjustments. The result, by the 1980s, was a generalized crisis that increasingly encompassed the entire system.[7]

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[5]World Bank, *World Bank Report*, 1987.

[6]Donald E. Schulz, *Mexico in Crisis*, Strategic Studies Institute at the U.S. Army War College, 1995.

[7]Ibid.

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The 1982 Crisis and de la Madrid

The inauguration of de la Madrid in the immediate aftermath of the 1982 crisis signaled a resurgence in the PRI's technocratic wing. De la Madrid was a 47-year old Harvard Kennedy School graduate who had spent most of his career in the Treasury and central bank. He appointed an ideologically cohesive Cabinet, with Silva Herzog remaining as Secretary of the Treasury and Carlos Salinas, also from the Treasury, becoming Secretary of Planning and Budget. The new president's first task was to repair relations with the private sector, but he could not reverse the bank nationalizations. Although this disappointed the private sector, de la Madrid said he could "not reverse the decision for political reasons and because the nationalization was already introduced into the constitution."[8]

The administration rapidly indemnified stockholders for the bank nationalizations and within two years, all nonfinancial assets held by the banks were sold back to the private sector. But because of nationalization, throughout the 1980s Mexican banks were little more than an extension of government. Lending to the private sector was insubstantial—credit was directed to Mexican companies by the whim of politicians rather than allocated on market criteria.[9] Regulations were eased so that certain banking activity could be undertaken by mixed enterprises with significant private participation, and private brokerage houses were granted wide latitude to finance transactions in domestic capital markets.

Budget cutting was intense, particularly during the first two years of de la Madrid's presidency. Subsidies for basic commodities were cut, public sector prices were increased for items such as electricity and gasoline, and the value-added tax was raised. In real terms, government spending on investment fell to 1960s levels. The real exchange rate and real wages were the principal instruments used to balance the external accounts and generate the surplus needed to service the debt. It was hoped that a sharply devalued peso would spark the growth and diversification of exports. The counterpart to deep devaluation was a sharp cut in the real wage, as import prices soared. Prior to 1982, nominal minimum wages were indexed to rates of past inflation; from 1983, minimum wages were set in accordance with expected inflation rates, which over this period were grossly underestimated. Tight fiscal and monetary policies were maintained until 1985, when the budget was loosened for the mid-term elections. In the meantime, Jesus Herzog worked with Paul Volcker to get much of Mexico's foreign debt rescheduled—stretched out over 14 years.

Then, in September 1985, a series of devastating earthquakes rocked Mexico City, causing thousands of deaths and physical damage of up to US$5 billion. On that same day the IMF suspended payment on its previous Extended Fund Facility agreement, setting the stage for bitter negotiations throughout the following year. Shortly thereafter oil prices took a nose-dive, falling as low as US$8.54 barrel in July 1986. This resulted in a US$10 billion loss in export revenues.

Private investment was not recuperating well enough to make up for the reduction in public investment. Despite export growth, the net effect of fiscal, monetary, and exchange reforms was deep recession. Employment growth had averaged 4% during the 1970s, not counting irregular or "off-the-books" employment in the informal sector. From 1982 to 1986 it fell to only .2%, while the labor force grew an estimated 3.6%. The World Bank estimated that by 1986, 20% of the workforce was employed in the informal sector or in the United States.

In October 1987 the Mexican stock market crashed, two weeks before the U.S. stock market collapsed. It had been the fastest-rising exchange in the world, becoming especially attractive after the 1986 peso devaluation. In the first nine months of 1987 alone, the market's value had gone up 330%. Much of this activity was speculative. The market lost 74% of its value less than 40 days after the

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[8]Interview with President de la Madrid conducted by Professor Helen Shapiro in January 1990.

[9]Professor Huw Pill, "Mexico (A): From Stabilized Development to Debt Crisis," HBS case no. 797-096.

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crash, and this triggered a new wave of capital flight and further peso devaluation. Inflation was hitting an annual rate of 159%. A new policy direction was needed.

The Pacto

In December 1987 the administration introduced an unorthodox program of stabilization and reform. Macroeconomic stabilization was implemented through the introduction of the *Pacto*—an agreement between government and representatives of business, unions, and agriculture to cooperate and coordinate wage bargaining and price setting. Proponents of this approach argued that fiscal deficits were as much a result of inflation as they were a cause of it. Inflation had achieved a momentum all its own: expectations of inflation encouraged unions to demand higher wages to protect their members' standard of living, but this only succeeded in raising labor costs and prices, thereby validating the original expectations of inflation. Inflation required the government to pay ever-higher rates of interest on its debt, raising the deficit even further. Coordination in wage and price setting was required to break the inflationary spiral. [10]

The government worked with labor and the private sector to coordinate wage and price adjustments and impose a wage and price freeze. The peso was devalued by 22%. The maximum tariff on imports was reduced from 40% to 20%. Government expenditures were cut and revenues increased. Credit became extremely tight. Restrictions on foreign direct investment were eased, and in 1984 the government in many sectors abandoned its revolutionary principles, allowing 100% foreign-owned subsidiaries. In 1986-1987 IBM, and later Hewlett-Packard and Apple, were permitted to set up wholly owned subsidiaries.

An old exception to foreign investment restrictions was Mexico's special in-bond or *maquiladora* program, which dated back to the 1960s. Only permitted along the U.S. border, *maquiladoras* were essentially assembly operations. U.S. law said that goods assembled in Mexico and re-exported to the United States for final sale would be taxed only on the value added in Mexico. One hundred percent foreign ownership of *maquiladoras* was allowed and at the end of 1986, 90% were U.S.-owned.

Mexico entered the GATT in August 1986, after having declined to do so in 1980. Over the next three years, the average tariff rates were dropped from 23% to 12.5%. Many of the import licenses and quotas were to be freed up over an eight-year period. Surcharges of up to 50% of base tariff rates were allowed until December 1994. Entry into GATT by Mexico signified the country's ongoing commitment to liberalizing its trade policies.

Privatizing state-owned firms also became a priority of the de la Madrid administration, but it began slowly, with only 23 firms divested in 1983-1984. In February 1985, a new economic package was announced which targeted 765 firms to be privatized through 1988. The 116 firms sold through mid-1988 netted about US$422 million. In the last months of the de la Madrid administration, Aeromexico was added, for US$300 million.

De la Madrid's government hoped to improve the economy's competitiveness enough to maintain the current account deficit. This was done through increased private investment, including that from foreigners attracted by confidence in the stable exchange rate, anti-inflation policies and productivity gains made possible by structural reforms.[11]

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[10]Ibid.

[11]The World Bank, *Trends in Developing Economies* (Washington D.C., 1996), p.337.

Political Reaction

Compared with many other indebted Latin American countries, Mexico imposed tough austerity measures and was one of the few to cut government spending and shrink its budget deficit. Silva Herzog said the reason this was possible in Mexico was its one-party system. "Even though you have opposition growing on the right and the left, the basic decisions . . . are still under the control of the majority party. . . I think that is a good part of the answer," he said, "having a kind of monolithical political system."[12] President de la Madrid offered his explanation as well: "I believe that on the one hand, here in Mexico we—the government—had clearer ideas, a greater conviction in what we had to do. And on the other hand, the political organization of Mexico has institutions that are more developed, more mature, with a workers' movement that is more coherent, in solidarity with the government, and business organizations with which we could discuss and negotiate."

Nevertheless, the government's policies did elicit a strong response from some sectors of the population. The left organized and leftist parties began to make some electoral gains. Social forces that had previously been co-opted or excluded from the political system gave birth to new organizations, most of which focused on very specific demands. By the end of the 1980s hundreds of independent nongovernmental organizations had been formed. Their ranks included political parties and business, labor, peasant, mass media, and human rights groups.[13] The political right was more organized and less fragmented, uniting within the National Action Party (PAN) which has historically been the PRI's main opposition party. PAN gathered strength in the 1980s and came close to winning governorships in some northern states. The party and its candidate, Manuel Clouthier, campaigned for even greater economic liberalization and for the democratization of the electoral process in order to gain a greater political voice within the PRI-dominated system.

The most serious electoral challenge to the PRI came from within its own ranks. Tension was growing between the traditional dominant *políticos* and the *técnicos* who had come to dominate national policymaking under de la Madrid. Many old-guard politicos viewed reform measures such as privatizing state-owned enterprises and reducing subsidies as a betrayal of their party's revolutionary heritage. Those who favored traditional economic solutions got frozen out of power. In October 1987 some of these elements left the party to form an opposition movement under the leadership of Cuauhtémoc Cardenás and Porfirio Muñoz Ledo.[14] Cardenás criticized the administration for abandoning the PRI's commitment to social justice and national self-determination and argued that these views were not getting sufficient representation in the selection process of de la Madrid's successor. Cardenás was essentially purged from the party but the split within the PRI allowed the fragmented opposition social movements to organize politically. Cardenás declared himself a candidate for president and the coalition of left-wing parties withdrew their candidate from the race in order to support him. A new coalition, the National Democratic Front (FDN), was formed.

The 1988 elections marked the most serious challenge to the hegemony of the ruling party since its consolidation in the 1930s. Historically, presidential elections had been a ritualistic ratification of candidates chosen behind closed doors by the PRI's political elite. For the first time the PRI's candidate, Carlos Salinas, faced organized opposition parties from the left and right. On election day, July 6, many traditional PRI voters abstained or joined the opposition. When the early returns showed Cardenás in the lead, the government's computers went dead, allegedly for "environmental reasons." After a week's delay in which Cardenás ballots were found "floating down rivers and smoldering in roadside bonfires," the official results were released: Salinas had won 50.7% of the

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[12]Interview with Silva Herzog conducted and translated by Professor Helen Shapiro in January 1990.

[13]Donald E. Schulz, *Mexico in Crisis*, Strategic Studies Institute at the U.S. Army War College, 1995.

[14]Ibid.

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vote, the narrowest margin of victory in the PRI's history. The opposition gained almost half the seats in the Chamber of Deputies and four seats in the Senate. [15]

Carlos Salinas

Amid this political and economic turmoil President Carlos Salinas de Gortari began his *sexenio* (6-year term). Salinas, like his predecessor, was a graduate of Harvard University with a Ph.D. in political economy. During the campaign, Salinas stressed that his would be a "modernizing" presidency. He promised both economic and political reform. But Salinas was acutely aware of the risks: undermining the PRI and jeopardizing political stability. He concluded the two reforms would proceed "at different rhythms," with economics taking priority, though the two were inextricably linked.[16] "The focal point of state reform," said Salinas, "is to reach decisions that benefit the people, to resolve the dilemma between property to be managed or justice to be dispersed, between a more proprietary state or a more just state."[17]

In the first months of his presidency, Salinas took a series of headline-grabbing actions to show he was serious about cleaning up government. The most striking was his arrest of Joaquín Hernández Galicia, or "La Quina," president of the Oil Workers Union, on charges of assassination, job peddling and fraud. The union represented 210,000 PEMEX workers and had been a pillar of the PRI. It was financially the most powerful union group in Latin America. La Quina had long been accused of corrupt and wasteful management. He had initially opposed Salinas' candidacy and quietly backed Cardenas. On January 10, 1989 Salinas sent in the army which demolished La Quina's front door with a bazooka and arrested him.

Turning to the private sector, Salinas locked up financier Eduardo Legorreta, who had contributed to his campaign, and four associates for securities fraud surrounding the stock market crash of 1987. In April, he jailed notorious drug trafficker, Miguel Felix Gallardo. And on November 1, having just delivered his first state of the nation address (*informe*), Salinas attended the inauguration of Ernesto Ruffo Appel as governor of Baja California Norte. Ruffo was a member of the right-wing opposition party PAN, and was the first person allowed to win a state governorship from outside the ruling PRI. By being present at Ruffo's inauguration Salinas was emphasizing his stated commitment to opening up the political process.[18]

Economic Reforms

In his state of the nation address Salinas repeated his government's commitment to modernization and reform. He stressed that key concerns were controlling inflation and boosting investment and production. And he said agriculture was the sector of the economy which presented the country with its most serious challenge.

Salinas followed the strategy he had helped formulate during the de la Madrid government. He renewed the *Pacto,* maintained wage and price controls, and allowed the exchange rate to devalue by one peso a day. He expanded the privatization program by putting Telemex on the selling block.

In May 1989 the government announced a sweeping liberalization of foreign investment regulations. It revoked remaining restrictions on foreign investors to minority ownership positions

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[15]Ibid.

[16]Ibid.

[17] Interview with Carlos Salinas conducted and translated by Professor Helen Shapiro in January 1990.

[18]*The Economist*, *EIU Country Report No. 1, 1990, Mexico* (London, UK).

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and opened new areas to foreign investment. The new rules allowed 100% ownership in the tourism sector and the *maquiladoras*, hopefully to generate foreign exchange. *Maquiladora* legislation was aimed at expanding the industry and increasing the benefits to the domestic economy, primarily the generation of employment.[19]

Negotiating better terms on Mexico's foreign debt was a critical component of Salinas's strategy. Debt reduction was required to free the necessary resources to resume noninflationary growth. In April 1989, Mexico signed a $3.64 billion, three-year loan agreement with the IMF. This was to help build up reserves, which had declined as Salinas defended the peso in an effort to reduce inflation. Mexico then reached a landmark agreement with its foreign bank creditors in July 1989. The banks had been pressured by U.S. Treasury Secretary Nicholas Brady to reduce the volume of existing debt, instead of simply piling on additional debt to maintain interest payments. Although the final agreement, signed in February 1990, involved some debt forgiveness and injections of new lending, its main feature was the conversion of bank debt into so-called "Brady Bonds." These were 30-year zero-coupon bonds guaranteed by the U.S. Treasury on the collateral of Mexican oil revenues. They required no servicing in the years before maturity, but only a single balloon payment in 30-years' time. This freed resources for development of the domestic economy in the intervening period.[20] It reduced the debt burden by as much as 20% and cut annual payments by US$3 billion over the next four years.

In January 1990 Salinas announced a program for reactivating the agricultural sector. Bean prices would be doubled, and the guarantee prices for maize, rice, and wheat were also raised. The government also announced it would liquidate Azúcar SA, the state sugar company, and Tabamex, the state tobacco company. The development of agri-business in seven selected areas was seen as a third aspect of the reform program. The government ended the country's land redistribution policy, a legacy of the revolution, giving farmers grouped together in *ejidos* (communal holdings) title to their land. This threatened to weaken PRI influence in rural areas (land or money given in exchange for votes) but Salinas saw that the dire poverty in which many of the approximately 20 million rural inhabitants lived was a far greater danger to long-term political stability.[21]

The Recovery

Though he was hailed by *Fortune* magazine as one of 1989's top 25 business leaders and his structural reforms termed "Salinastroika," the president walked an economic and political tightrope at home. A *Los Angeles Times* poll taken a year after the election showed that although only a quarter of the population believed that Salinas had actually won, 79% gave him a positive presidential approval rating. Economic growth had reached 3% in 1989; inflation was down to about 20% (from 159% in 1987) aided by imports; and price controls were in place. Though GDP growth slowed some in 1991, per capital national income kept rising (to US$1,900, compared with US$1,710 in 1988).[22]

As U.S. interest rates fell during the early 1990s in response to recession, investors seeking high yields increasingly looked to the emerging markets. Mexico was in a prime position to receive a disproportionate share of these funds. Moreover, the investment community shared Mexican confidence in the prospects for economic reform. The mistakes of previous years were being aggressively reversed. New York fund managers scrambled to send money south to gain an early stake in Mexico's embryonic economic miracle. The country was caught in a virtuous cycle of reform, growing confidence, greater capital inflows and accelerating expenditure growth. As capital flooded

[19]Ibid.

[20]Professor Huw Pill, "Mexico (A): From Stabilized Development to Debt Crisis," HBS case no. 797-096.

[21]*The Economist, EIU Country Report No. 1, 1990, and No. 1, 1992, Mexico* (London, UK).

[22]Donald E. Schulz, *Mexico in Crisis*, Strategic Studies Institute at the U.S. Army War College, 1995.

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into the country it stimulated domestic consumption and investment. Economic activity swelled tax revenues and further improved public finances. The apparent success of reform and stabilization made further liberalization and continued wage and price restraint under the *Pacto* more palatable to the parties concerned. Privatization of large state-owned firms, including the banks, took place during the 1990s; US$22 billion came in from the sale of 200 enterprises between 1988-1993.[23] Success in reducing inflation and raising the fiscal surplus only served to bolster foreign confidence and encourage even greater capital inflows.

Some argued that these gains were tenuous: the fiscal surplus was a product of creative accounting rather than actual improvements in financial control. Spending was moved off-balance sheet to non-governmental organizations like development banks. The reduction in inflation was an artifact of administrative *diktat* rather than improved monetary control. The parties to the *Pacto* were responsible for setting a large proportion of the prices that entered the statistical definition of inflation. But these facts were largely ignored in the clamor of the times. [24]

The peso's real exchange rate seemed to appreciate in the early 1990s. The peso/dollar rate had been confined within a fluctuation band since 1991. The lower boundary of the band declined a small amount each day, allowing for a gradual depreciation. But the magnitude of capital inflows kept the rate at the top of the band. There were incipient pressures for appreciation, rather than depreciation. From late 1992, the peso's exchange rate against the dollar demonstrated remarkable stability, evidence in the government's eyes of the success of reform and foreign confidence in Mexico's future. But some disagreed. Increasingly vocal critics argued the strength of the peso was evidence of macroeconomic mismanagement. A stable *nominal* exchange rate had resulted in an appreciating *real* exchange rate. The prices of Mexican goods, when converted to dollars at the market rate, were rising more rapidly than those of their American equivalents. The current account deficit was evidence of rapidly declining international competitiveness. Slumping exports were causing domestic economic stagnation.[25]

Nevertheless, Salinas's reforms were popular. Under his administration, social spending rose substantially, even as the overall budget deficit was reduced. Between 1988 and 1994, spending on education more than doubled; spending on health care and social security rose by 82% and on urban development by 51%. Thirteen-and-a-half million more people were provided with potable water, 11.5 million with sewage services, and 4 million with electricity —all under President Salinas. By mid-term, Salinas was viewed as a strong leader with a vision of the future that appealed to millions of Mexicans. By entering into a partnership with the Bush administration to adopt free trade, he had acquired hemisphere-wide stature.

Under these conditions the PRI made a dramatic recovery from the political trauma of 1988. The party—with a few exceptions—swept state and local elections in 1989 and 1990, culminating in their smashing victory in the August 1991 midterm elections.[26]

NAFTA

In November 1993 the U.S. Congress ratified NAFTA and ushered in a new era in U.S.-Mexican relations, Mexican economic development, and in Mexico's political evolution. Passage had not been easy and was attained only after a prolonged and fierce political struggle that included the

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[23] Professor Kenneth A. Froot, "The 1994-95 Mexican Peso Crisis," HBS case no. 296-056, and *The Economist*, *EIU Country Report No. 1, 1993, Mexico* (London, UK).

[24]Professor Huw Pill, "Mexico (C): Reform and Crisis 1987-1994," HBS case no. 797-050.

[25]Ibid.

[26]Donald E. Schulz, *Mexico in Crisis*, Strategic Studies Institute at the U.S. Army War College, 1995.

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negotiation of side agreements designed to make the pact more palatable to U.S. critics. In the months preceding the vote Salinas had even distanced himself slightly from the agreement, seeking to deflate public expectations in the event the agreement was rejected.

The 1,400-page NAFTA document was essentially a treaty between Mexico, the United States, and Canada that converted all quotas between the countries to tariffs and removed all tariffs on trade over a 10-year period (except in special cases where the schedule is 15 years). NAFTA began as an attempt by Salinas to cement his reforms and ensure Mexico's competitiveness in the world economy. The treaty was initialed by President George Bush, Canadian Prime Minister Brain Mulroney, and Carlos Salinas in December 1992. Tariffs on approximately 50% of the 9,000 traded items covered by the treaty would disappear immediately, on another 15% within 5 years, and on all remaining goods over the next 10 years. Mexico would also immediately eliminate any remaining licensing requirements and quotas, except for agriculture, autos, energy, and textiles. Sectors most sensitive to import competition were granted 15-year transition periods, and procedures were established to allow countries to reimpose tariffs in response to damaging import surges.

For textiles and apparel, duties would be phased out over a 10-year period and NAFTA would take precedence over the existing Multifiber Agreement. To prevent other countries from using Mexico as an export platform to the United States or Canada, rules of origin required that all goods be produced from yarn made in North America; for cotton and man-made fiber yarns, the fiber itself had to originate in one of the three countries. The U.S. would immediately remove import quotas on goods that met the rule-of-origin standard from Mexico and gradually remove import quotas on Mexican goods that did not meet the rules of origin. For automobiles, the rule of origin was set at 62.5% for a zero tariff. After 10 years, 62.5% of the value added had to be sourced in North America. In addition, Mexico's trade-balancing requirements would be phased out, and its domestic-content requirements would fall to 29% of value added in 10 years. In agriculture, tariffs would be lowered over 10 years, except for corn and soybeans in Mexico—15 years—and the same for orange juice and sugar in the United States. This would indeed be hard on Mexico's 10 million *ejidos* (small revolutionary-era farms).

NAFTA stipulated that U.S. and Canadian firms could bid on as much as 50% of the service contracts offered by the government's oil and electricity monopoly. This would increase to 80% over 8 years and to 100% in 10 years. In the oil fields firms would be allowed to compete only for "performance" contracts, which gave them a bonus for superior service, but not for "risk" contracts, which gave them a share of the oil itself (petroleum was exempted from NAFTA on constitutional grounds). The agreement also dealt with sanitary standards, dumping, government procurement, air service, telecommunications, financial services, social services, land transportation, and intellectual property.

President Clinton grudgingly endorsed free trade but the work rules and environmental standards were weak and had to be renegotiated in 1993. Dispute settlement panels were strengthened, and penalties were included for environmental noncompliance. Congress approved the treaty in the fall, and Bill Clinton signed it into law in December.

With NAFTA now in place, the Mexico of the 1990s—it was said—was about to enter the front ranks of trading nations, reforming and modernizing its industrial system and nationalist economic structure. The nation was now led by reform-minded technocrats who understood that Mexico must embrace global integration if it wished to prosper. In Mexico as well as in the United States, these progressive assumptions were articulated as the common understanding of the Mexican reality framed the context of NAFTA.[27]

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[27]William Greider, *One World Ready Or Not: The Manic Logic of Global Capitalism* (New York: Simon & Schuster, 1997), pp. 259-260.

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The Fall

By the end of 1993 it appeared that Mexico seemed transformed. Its accession to the Organization for Economic Cooperation and Development (OECD) conferred on her membership in what had traditionally been regarded as the "rich countries' club." [28] The signing of the NAFTA agreement by Salinas was a high point in his *sexenio*. With Mexico's new standing in the world, the country soon became a main beneficiary of an unprecedented surge in private capital flow, a favorite son among "emerging markets." Between 1990 and 1994 Mexico became the world's second-largest recipient (after China) of foreign private investment.[29]

Beneath the surface however, trouble was brewing. Since 1990 economic growth had steadily declined, from a growth rate of 4.4% in 1990, to 3.6% in 1991, to 2.6% in 1992. In 1993 it grew only .4% (manufacturing actually shrank 5%). By the end of 1993, the country was experiencing negative growth.[30] Job creation also slowed. Fewer than 500,000 new jobs were created in 1992, compared with 600,000 in 1991. At the same time, privatization, the introduction of new technologies, economic deceleration, and business failures eliminated many other jobs (labor sources put the figure as high at 400,000), leaving the net gain at the end of 1992 far short of the 1 million or so openings the economy needed to generate each year to absorb the new arrivals in the labor market. [31]

From 1992, bad loans in the banking system began to mount, although because Mexican accounting standards failed to meet international standards, the magnitude of the problem was not immediately apparent abroad. Perversely, the lack of regulation allowed the emergence of bad loans to encourage more destabilizing bank behavior, rather than conservatism. Close relationships between banks and industrial companies—often cemented by family ties which were opaque to the minimal official regulation—allowed banks to extend credit to affiliated companies or bank insiders, never expecting to be repaid. The absence of legal and regulatory infrastructure allowed such problems to multiply.[32]

At the macroeconomic level, the spending boom initiated by reform and facilitated by financial liberalization had caused a catastrophic collapse in private saving. Private savings went from 21.8% of GDP in 1983 to 15.7% in 1989 and dropped to 12.1% in 1994. Consumption and imports rose much more quickly than income because an overvalued currency made for inexpensive imports. Individuals denied foreign goods for so long were determined to obtain them while they had the chance. Foreign cars, appliances, and clothes demonstrated the rewards of Salinas's painful austerity programs. Even though public saving rose as the fiscal accounts moved into surplus, the precipitous decline of saving by the private sector implied a collapse in overall national saving. The implications of this for Mexico's development strategy were profound. If she could not generate the financial resources to fund investment and development herself, Mexico had to rely on financing from the rest of the world. Low national savings meant Mexican economic growth was dependent on continued inflows of foreign capital—the mechanism for transferring foreign savings into the Mexican economy.[33]

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[28]Professor Huw Pill, "Mexico (A): From Stabilized Development to Debt Crisis," HBS case no. 797-096.

[29]Moisés Naím, "Mexico's Larger Story," *Foreign Policy* (Summer 1995).

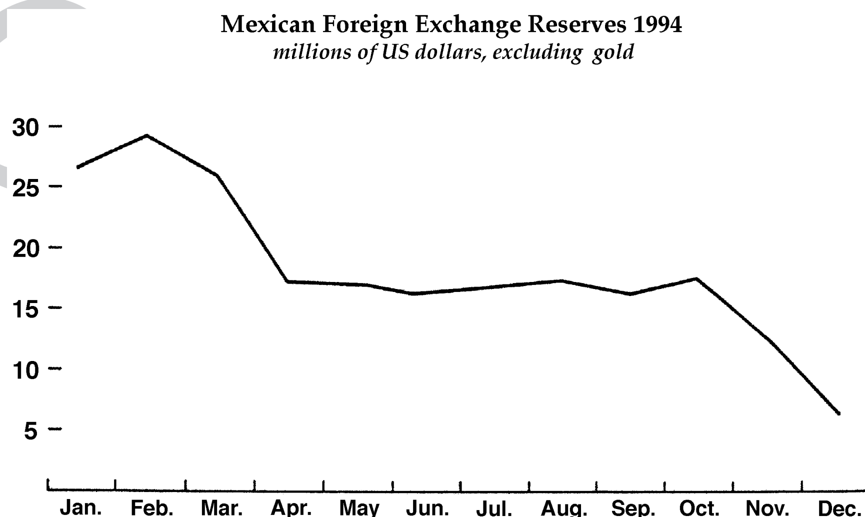
[30]Donald E. Schulz, *Mexico in Crisis*, Strategic Studies Institute at the U.S. Army War College, 1995.

[31]*The Economist*, *EIU Country Report No. 1, 1993, Mexico* (London, UK).

[32]Professor Huw Pill, "Mexico (A): From Stabilized Development to Debt Crisis," HBS case no. 797-096.

[33]Ibid.

Mexico relied increasingly on its short-term capital (cash, stocks, and bonds) rather than foreign direct investment. The use of short-term capital was a testament to the sophistication of the Mexican economy, adjusting quickly to receive these inflows. Though short-term capital investment was a way to kickstart the economy, its downside was that the capital could be withdrawn as fast as it came in. Between 1991 and 1993, net foreign capital inflows into Mexico amounted to $78 billion, while foreign direct investment totaled only US$14 billion.[34]



Source: International Monetary Fund, *Capital Markets Report* (August 1995)

Drug-related violence and corruption, meanwhile, muddied the waters of recovery. By 1993, roughly a dozen major drug lords and several minor ones were in control of drug cartels, and they were increasingly engaged in turf wars. During the first 5 months of the year over 80 people were killed in Culiacán, a city that had acquired the nickname, "Little Medellín"; and most killings were believed to be drug-related. In May Cardinal Juan Jesús Posadas Ocampo and several other people were gunned down at point-blank range at the Guadalajara airport during a shoot-out between rival gangs. The government maintained the Cardinal's murder was a case of mistaken identity, but critical questions remained unanswered. At the time, unidentified officials had ordered the delay of a Tijuana-bound Aeromexico passenger jet, allowing eight of the gunmen to board. Even after it became apparent to investigators on the ground that some of the killers had escaped by plane, Mexican officials made no effort to halt the jet or meet it in Tijuana. Upon arrival, the gunmen simply walked away.[35]

1994

Champagne corks should have been popping in Mexico City on New Year's Day 1994, the day NAFTA was to take effect, to mark a new era for Mexico. Instead, an hour into the new year the Zapatista National Liberation Army (EZLN) assaulted and captured four cities in the Los Altos region of Mexico's southernmost state, Chiapas. For 24 hours rebels held the city of San Cristóbal de las Casas before retreating into the mountains. Disaffected and disenfranchised, the poor agrarian

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[34]Douglas P. Handler, "The Mexican Economy in Perspective," published on the internet by AC Nielsen Company, Inc., March 1995.

[35]Donald E. Schulz, *Mexico in Crisis*, Strategic Studies Institute at the U.S. Army War College, 1995.

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economy of the south stood to gain little from the introduction of free trade with the United States. The uprising caught Salinas by surprise and shocked the Mexican public. The violence ushered in a multifaceted political crisis that brought into question prospects for Mexican democracy, economic development, and continued political stability.[36]

The rebellion had been developing for several years. In the two-and-a-half decades prior to the uprising, a variety of groups had been active in promoting peasant organizational activities. The reasons for disaffection were many. Though Chiapas was a rich land containing fertile farmlands, pastures, and forests, and was a major source of the nation's coffee, its wealth was maldistributed. According to available statistics, a little over a hundred people—just .16% of all coffee farmers—controlled 12% of the coffee lands. Some 6,000 families held over 3 million hectares of cattle land—the equivalent to almost half the territory of all of the state's rural landholdings. A third of the households in Chiapas at the time were without electricity, 41.6% were without drinking water, and 58.8% lacked drainage.

The government responded to events in Chiapas with uncertainty. The Salinas administration tried to downplay the situation and deflect criticism by declaring the rebellion to be the work of external forces trying to destabilize Mexico. The government blamed Central American guerrillas, the drug cartels, and even the Catholic Church. The Mexican army was criticized for its slow response to the rebellion, but it was soon evident that political leaders had disregarded warning signs of trouble in the region. In March 1993, for example, the bodies of two junior military officers had been found hacked to pieces and buried in a shallow pit outside an Indian village in the Los Altos region. The heinous nature of this crime should have served as a warning that serious problems existed.

On January 12, Salinas declared a unilateral cease-fire in the region. By that time the Mexican army's presence had swelled from approximately 2,000 soldiers to over 14,000—more than enough to cordon off the Zapatistas' stronghold in the Lacandona jungle. By mid-January Congress passed an amnesty decree, clearing the way for peace negotiations.[37]

On March 23, Luis Donaldo Colosio, the PRI candidate for president—Salinas's hand-picked successor—was gunned down at a campaign rally in Tijuana. Colosio had vowed during the campaign to continue Salinas's reforms and continue the *Pactos*. His assassination was thought to be a conspiracy among those in the PRI who opposed reform. Suddenly, economic reform seemed in jeopardy. Foreign confidence was severely jolted and the inflow of foreign capital dried up and began to reverse. To protect themselves from the financial consequences of possible devaluation, Mexicans again moved their savings offshore to safe dollar accounts in Miami and elsewhere.

Banco de Mexico was suddenly faced with reserve losses. The exchange rate, which had remained resolutely glued to the top of the fluctuation band for most of the preceding period, dropped to the bottom. Some argued that the currency depreciation brought on by Colosio's assassination was a blessing in disguise. Export growth picked up. At the same time, the Federal Reserve in Washington was raising U.S. interest rates. The Fed raised interest rates six times during 1994 after having left the rate at 3.0% since September 1992. On Feb. 4 it raised the federal funds rate 25 basis points; on March 22, another 25 points; on April 18, the Fed raised it 25 points again; on May

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[36]Donald E. Schulz and Stephen J. Wager,*The Awakening: The Zapatista Revolt and Its Implications for Civil-Military Relations and the Future of Mexico*, Strategic Studies Institute at the U.S. Army War College, December 1994; Professor Huw Pill, "Mexico (A): Reform and Crisis 1987-1994," HBS case no. 797-050.

[37]Donald E. Schultz and Stephen J. Wager, *The Awakening: The Zapatista Revolt and Its Implications for Civil-Military Relations and the Future of Mexico*, Strategic Studies Institute at the U.S. Army War College., December 1994.

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17, 50 points; on Aug. 16, another 50 points, and on Nov. 15 the Fed announced an unexpectedly large 75 basis point increase.[38]

Authorities in Mexico decided to absorb the effect of the political shock on the capital account by raising interest rates and using reserves held at the central bank to maintain the value of the peso and prevent capital outflows. To maintain the gross level of reserves, the government borrowed more dollars from abroad. In doing so they assumed the exchange rate risk on capital inflows that had previously been borne by foreign—particularly American—investors. The vehicle for this borrowing was the issuance of *tesobonos*—short-term Mexican government debt instruments indexed to the dollar. The government shifted its borrowing from *cetes*, domestic currency-denominated Mexican Treasury bills, and longer-term peso debt into *tesobonos* through the summer and fall of 1994 in order to replenish the central bank's stock of dollar reserves. As a result, the maturity of the public debt was shortening, while simultaneously its currency denomination became increasingly biased toward dollars. The government was making itself vulnerable to a liquidity crisis: if the *tesobono* debt could not be rolled over—as it had to be every three months given its short maturity—the central bank would simply not have enough dollars on hand to satisfy foreign creditors and finance the still-vast current account deficit.[39]

During 1994, Mexico pursued a strategy of retiring *cetes* and other, longer-term debt instruments and replacing them with *tesobonos*. In fact, during 1994, the fraction of outstanding government debt funded thorough *tesobonos* increased from about 15% to over 71%. After Colosio's murder, the administration allowed the peso to fall from 3.1 to 3.4 new pesos/dollar (the new peso was one-thousandth of the old peso), the bottom of the allowable band. International reserves were used to buy up unwanted peso-denominated obligations and peso-denominated debts were replaced with *tesobonos*. These events helped increase peso interest rates from about 10% to 18% during March and April and falling to 14% in August. In December 1993, the *tesobono* interest rate (3-month maturity) was 5. 09% per month; it fell briefly in January and February of 1994 and then steadily climbed. The first week of January 1995 the *tesobono* interest rate was 12.49%, making the interest rate differential between it and U.S. Treasury Bills 6.94%.[40]

Ernesto Zedillo Ponce de León

On August 21, 1994, the Mexican people elected Ernesto Zedillo Ponce de León to be their next president. He won slightly over 50% of the vote in what was regarded as a reasonably honest election. But his election did not restore foreign confidence and as a result, the renewed capital inflows anticipated by policymakers did not materialize. Instead of having a stabilizing influence, the election was overshadowed by another political assassination.

In late September PRI Secretary General José Francisco Ruiz Massieu was assassinated. Massieu was to have been leader of the PRI caucus in the Chamber of Deputies and as such he had been expected to play a crucial role in brokering the reforms planned by Zedillo. He was also the brother of Deputy Attorney General Mario Ruiz Massieu, who had presided over several high-profile drug raids, including the arrest of members of the Tijuana-based cartel accused of having killed Cardinal Posadas. Mario Ruiz had publicly vowed to jail the country's largest drug lords, and investigators speculated that his brother's killing was intended to send the attorney general a message to "back off." But shortly afterwards Mario Ruiz resigned his position, accusing his boss, the attorney

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[38] Professor Kenneth A. Froot, "The 1994-95 Mexican Peso Crisis," HBS case no. 296-056.

[39]Professor Huw Pill, "Mexico (A): From Stabilized Development to Debt Crisis," HBS case no. 797-096.

[40] Professor Kenneth A. Froot, "The 1994-95 Mexican Peso Crisis," HBS case no. 296-056.

general, of obstructing the investigation into his brother's murder.[41] After Zedillo took office he appointed Antonio Lozano, a member of the PAN party, as the new attorney general, signaling his desire to see the investigation into Ruiz Massieu's death continue.

Mexico's problems were deepening. The trade deficit was worsening as the peso became more overvalued. During the spring and summer of 1994, Carlos Salinas was preoccupied with the presidential campaign, and with foreign exchange reserves falling, he refused to admit that foreign investors' demand for Mexican assets was declining. They issued more *tesobonos* and encouraged investors who feared devaluation to keep their capital in the country.[42]

Then, just three weeks into Zedillo's term, the peso took a nose-dive, falling from 3.4 pesos to the dollar to 5.7. The flow of foreign capital into Mexico dried up; the country had reached the bottom of its reserves. Zedillo's first move was to replace his finance minister, Jaime Serra Puche, with Guillermo Ortiz, a Stanford Ph.D. known as a straight-talking "tough guy."[43]

Zedillo freed the peso and market reaction was severe. The peso fell 50%, far more than the 20% economists deemed necessary to restore equilibrium. Each investor in Mexico feared that other investors would pull their money out no matter what the cost and that the last investors to withdraw would lose the most as a result of hyperinflation, as the Mexican government frantically printed pesos to cover its peso-denominated debts. Capital controls might trap money in Mexico indefinitely, eroding its value. And a formal default would repeat Mexico's earlier commercial bank crisis of 1982.[44]

Arbitrage buying in the early 1990s had also contributed to Mexico's woes. By borrowing, for example, in New York's money market, where interest rates at the time were comparatively low, an investor could buy Mexican stocks or short-term government notes and capture the spread between returns of 5% to 6% in America and 12% to 14% in Mexico. As more investors were inspired to do this the price of Mexican stocks soared and the *Bolsa* index doubled, tripled, even quadrupled during a span of only three years. But after the 1994 crash investors panicked and fled overnight en masse. [45]

The devaluation lowered the price of Mexican exports—a desirable effect—but it also made imports more expensive, provoking inflation and lowering the Mexican standard of living. Interest rates shot up. Mexican companies who had borrowed dollars now faced bankruptcy. And American companies in Mexico would receive fewer dollars for their peso sales.[46] By March a quarter of a million more Mexicans had joined the ranks of the unemployed. [47]

With US$5 billion in reserves and US$23 billion in *tesobono* liabilities and no one willing to lend hard currency, Mexico faced two painful alternatives. The government could push interest rates sky-high in a bid to keep capital in the country, causing a Great Depression; or it could lose its ability to borrow and start rapidly printing money to meet its obligations, resulting in a spiral of hyperinflation and depreciation. To make things worse, the panic had spread—the so-called Tequila

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[41]Donald E. Schulz, *Mexico in Crisis*, Strategic Studies Institute at the U.S. Army War College, 1995.

[42]Bradford De Long, Christopher De Long and Sherman Robinson, "The Case for Mexico's Rescue," *Foreign Affairs*, May/June 1996.

[43]Professor George C. Lodge, "Mexico 1995: The Crisis Returns," HBS case no. 795-126, March 30, 1995.

[44]Bradford De Long, Christopher De Long and Sherman Robinson, "The Case for Mexico's Rescue," *Foreign Affairs* (May/June 1996).

[45]William Greider, *One World Ready Or Not: The Manic Logic of Global Capitalism* (New York: Simon & Schuster) p. 261.

[46]Professor George C. Lodge, "Mexico 1995: The Crisis Returns," HBS case no. 795-126.

[47]Moisés Naím, "Mexico's Larger Story," *Foreign Policy* (Summer 1995).

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Effect—raising the possibility that developing countries throughout the world would be forced into contractionary policies leading to recessions.[48]

The question facing President Zedillo at the beginning of 1995 was this: Where would Mexico go from here? Zedillo had pledged to defend democratization by distancing the government from the PRI and curbing the powers of the presidency. The state's massive assistance to the party, he said, would be ended; and the PRI's candidate-selection process would be opened up by the introduction of primary elections. In his inaugural address Zedillo had criticized the Salinas administration for tolerating graft, lax law enforcement, and neglect of the nation's poor. He promised to fight against poverty and reform the corruption-ridden judicial system. [49] But the new president now faced the country's fourth crisis in 20 years—not only an economic one, but a crisis that was equally political and social. Would Zedillo be able to provide the strong leadership necessary to restore confidence in Mexico and rebuild its economy? Or would the cycle of crisis-reform-recovery-crisis be repeated during his *sexenio* as well?

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[48]Bradford De Long, Christopher De Long and Sherman Robinson, "The Case for Mexico's Rescue," *Foreign Affairs* (May/June 1996).

[49]Donald E. Schulz, *Mexico in Crisis*, Strategic Studies Institute at the U.S. Army War College, 1995.

Exhibit 1 Mexico's Real GNP 1976 - 1994 (billions of 1987 Mexican new pesos)

	1976	1980	1981	1982	1983	1984	1985	1986	1987	1988	1990	1992	1993[a]	1994
Gross national product	131.17	171.54	185.25	177.98	172.48	179.83	186.67	177.19	183.75	187.12	204.0	218.21	218.67	226.3
Exports	13.74	20.92	23.35	28.43	32.39	34.13	32.62	34.34	37.69	39.88	42.28	44.91	46.47	60.9
Imports	22.43	42.04	49.49	30.76	20.36	23.99	26.62	23.32	25.88	35.37	51.39	72.48	71.61	79.4
Private consumption	96.13	126.76	137.33	128.42	119.47	124.73	129.90	126.29	127.27	132.24	154.03	174.49	174.44	na
General government consumption		13.64	15.04	15.34	15.76	16.80	16.95	17.2	17.0	16.91	17.29	18.37	18.92	na
Gross domestic investment	36.81	58.94	67.60	51.19	37.39	39.66	43.75	34.37	37.23	41.60	48.33	59.39	57.41	na
Average annual GNP growth rate (%)	4.9	7.6	8.0	-3.9	-3.1	4.3	3.8	-5.1	3.7	1.8	4.4	3.4	.02	3.5

Sources: World Bank, *World Tables 1995*; *The Economist*, *EIU Country Report Mexico 4th Qtr. 1996*
[a] World Bank estimates

Exhibit 2 **Mexican Budget Deficit 1980 - 1992**
(% of GDP)

	Total[1]	Primary[2]
1980	-7.9	-3.2
1981	-14.8	-8.3
1982	-17.6	-7.6
1983	-9.0	+5.8
1984	-8.7	+4.8
1985	-10.0	+4.5
1986	-16.0	+2.2
1987	-15.8	+4.9
1989	-5.3	+3.7
1991	-.2	+2.2
1992	+ 0.2	+5.6
1993	+0.3	na
1994	-0.7	na

Sources: "Mexico Escaping from Debt Crisis?" HBS case #390-174, Helen Shapiro and "Mexico (A): From Stablilized Development to Debt Crisis," HBS case #797-096, Huw Pill; International Monetary Fund, *International Financial Statistics*.
[1] Public sector borrowing requirement.
[2] The difference between receipts and expenditures, excluding public debt.

Exhibit 3 US Merchandise Trade with Mexico

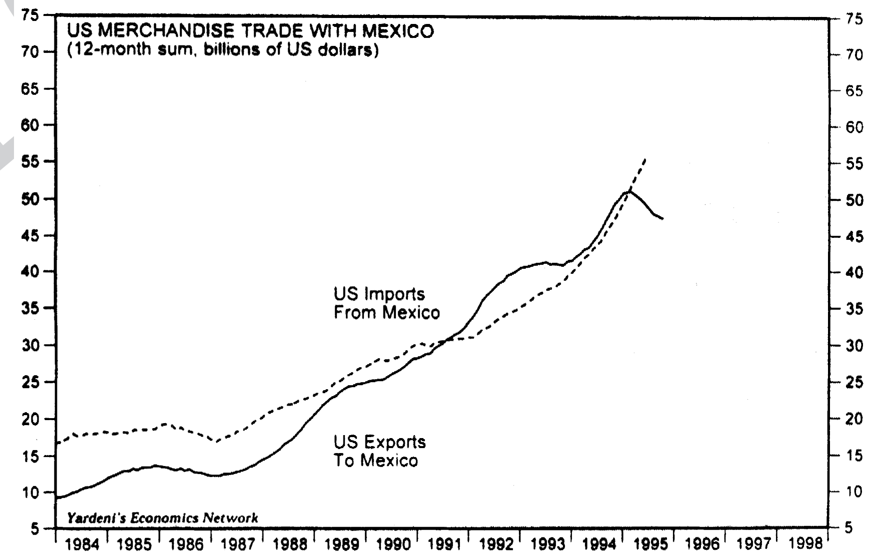


Exhibit 4 Mexico's Money Supply, Inflation, Real Wages, Exchange Rate and Interest Rates (billions of new Mexican pesos)

	1976	1980	1982	1984	1986	1987	1988	1990	1991	1992	1993	1994
M1 money supply		1.43	3.33	9.19	23.61	58.55	52.72	173.66	258.55	316.44	367.27	na
Yearly % change		39.0	53.0	66.0	60.0	57.0	-10.0	81.0	49.0	22.0	16.0	----
Inflation	15.7	26.3	63.0	65.4	106.0	140.0	51.7	26.6	22.7	15.5	9.7	7.3
Real wage index[a] (1978=100)	100.0	96.0	100.0	72.0	69.0	68.0	69.2	79.1	82.7	85.3	na	na
Exchange rate *(old pesos/dollar)*	19.95	22.95	22.95[b]	185.2	637.88	1,405.81	2,292.5	2,812.6	3,018.4	3,094.9	3,115.6	3,375.1[c]

Sources: World Bank, *World Tables 1995*; The Economist, *EIU Country Reports Mexico*; "Mexico: Escaping From The Debt Crisis?" HBS case no. 390-174, by Professor Helen Shapiro; and "Mexico 1995: The Crisis Returns," HBS case no. 795-126, by Professor George Cabot Lodge.

[a]After 1987, figures refer to real output per employee [b]In February the peso devalued to 57.2; in August it devalued further, to 115."

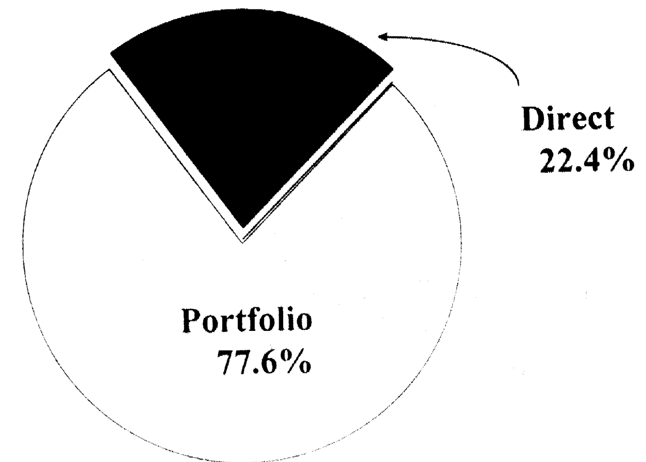
[c] In 1994, Mexico issued the newvo peso = 1,000 old pesos. Thus, 3,375 old pesos = 3.375 new pesos

Exhibit 5 Interest Rates, 1982-1993

	Mexican T-bills Ninety Days	U.S. Ninety-Day T-Bills
1982	48.41	10.7
1984	49.47	9.6
1986	88.57	6.0
1988	69.15	6.7
1990	34.76	7.5
1991	19.28	5.4
1992	15.62	3.4
1993	14.93	3.0
1994	20.47	4.3

Sources: IPADE, Sintesis Y Expectativas Economicas De Mexico; "Mexico: Escaping From the Debt Crisis?" HBS case no. 390-174, Helen Shapiro; "Mexico 1995: The Crisis Returns," HBS case no. 795-126, George C. Lodge.; Economic Report of the President; 1997 and IMF, International Financial Statistics.

Exhibit 6 Mexico's Foreign Investment - 1993



source: IMF Data

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Exhibit 7a Mexico's Current Account, 1976-1994 (millions of US dollars)

	1976	1979	1980	1981	1982	1983	1985	1987	1989	1991	1992	1993 (est)	1994
Merchandise exports	4,980.0	11,517.0	15,512.0	23,307.0	24,055	25,953	26,757	27,600.0	35,171.0	42,688.0	46,196.0	51,886.0	60,882.0
Tourism	833	1,443	1,671	1,760	1,406	1,624	1,719	2,274	na	8,790	9,190	9,350	6,363.0
Merchandise imports	6,564.0	12,149.0	18,897.0	27,184.0	17,011	11,848	18,359	18,812.0	28,082.0	49,967.0	62,129.0	65,366.5	79,345.0
Balance of trade	-1,584.0	632.0	-3,385.0	-3,877.0	7,044	14,105	8,398.0	8,788.0	7,089.0	-7,279.0	-15,933.0	-13,480.5	-18,465.0
Interest on debt[b]	na	3,737	5,437	7,573	11,059	10,163	6,450	4,927	7,915.8	6,405.2	5,971.3	5,534.1	9,107.0
Current account[a]	-2,303.0	-2,763.0	-10,700.0	-16,507.0	-6,193	5,472	1,077.0	4,105.0	- 5,930.0	-14,853.2	-24,803.6	-23,392.7	-29,663.0
Long-term net capital	5,299.0	5,198.0	10,535.0	19,183.0	16,661	7,828	861.0	2,756.0	3,723.0	20,509.0	20,586.0	30,416.4	20,254.0
Direct investments	541.0	1,327.0	2,186.0	3,076.0	1,900	2,192	1,984.0	2,635.0	3,176.0	4,761.5	4,392.8	4,900.5	10,792.0
Loans	4,504.0	4,081.0	6,820.6	12,498.7	7,968.7	2,356	-22.3	3,778.9	-1,459.4	3,887.1	-347.5	3,055.7	3,000.0
Disbursements	6,489.4	12,139.6	11,580.7	17,002.9	12,500	7,187.7	5,049.9	7,174.0	3,973.6	8,141.1	11,896.9	15,783.8	11,500.0
Repayments	1,985.4	8,058.6	4,760.1	4,054.2	4,531.1	4,831	5,072.2	3,395.1	5,433.0	4,254.0	12,244.4	12,728.1	-8,500.0
Other long-term capital	254	-210	1,528.4	3,608.3	6,792.3	3,279	-1,100.7	-3,657	2,006.4	11,860.4	16,540.7	22,460.2	4,100.0
Other net capital	-4,130.4	-1,923.0	- 573.0	-1,540.0	-14,210	-12,260	-5,581.0	-2,967.0	1,825.0	2,051.2	7,112.6	-6,177.7	3,400.0
Errors & omissions	na	703.0	-1,961.0	-8,373.0	-6,580	-1,022	-2,133.0	-2,709.0	2,775.0	-2,279.0	-1,266.0	-2,931.0	-1,200.0

Sources World Bank, *World Tables 1995*; International Monetary Fund, *International Financial Statistics*; "Mexico: Escaping from the Debt Crisis? HBS case no. 390-174, Helen Shapiro; IPADE.

[a] After Off. Transfers

[b] Combined public and private sector interest payments

Exhibit 7b Mexico's Savings Rate (% of GDP)

	1987	1989	1990	1991	1992	1993 (es
Gross National Savings	22.8	19.1	19.6	17.2	16.2	14
Gross Domestic Savings	25.3	21.2	20.7	19.3	17.7	15.9

Note: Gross National Savings (GNS) is a GNP-based measure and therefore includes factor payments to overseas residents. Because of Mexi large external debt, such factor payments were considerable. Hence the large discrepancy between GNS and the GDP-based measure

Exhibit 8 Mexican External Debt 1976 - 1993

	1976	1980	1982	1984	1985	1987	1989	1990	1991	1992	1993 *(est)*
Total external debt *(US$bn)*	23.97	57.38	86.08	94.82	96.87	109.47	93.84	106.3	115.36	113.42	118.03
Long-term debt *(US$bn)*	20.52	41.21	59.87	88.38	91.42	103.67	85.18	89.94	93.51	88.89	90.75
Short-term debt (*US$bn*)	3.45	16.16	26.21	6.44	5.45	5.8	8.66	16.08	21.86	24.53	27.28
Total debt as % of GDP	31%	29%	50%	59%	63%	79%	46%	44%	40%	34%	34%

Source: World Bank, *World Tables 1995*

Exhibit 9 Composition of Trade, 1976-1994

	1976	1980	1982	1984	1986	1988	1990	1992	1994
Imports ($mns)	6,300	18,832	14,422	11,255	11,432	18,903	29,799	62,125	80,170
Intermediate Goods	498	2,012	1,099	1,696	783	1,396	17,930	42,830	56,542
Capital Goods	3,806	11,209	8,400	7,833	7,632	12,950	6,809	11,550	13,322
Consumer Goods	1,930	5,174	4,502	2,573	2,954	4,031	5,069	7,744	9,511
Exports ($mns)	3,655	15,134	21,006	24,196	16,301	20,658	26,773	46,106	61,964
of which:									
Agriculture	1,175	1,528	2,024	1,306	2,098	1,672	2,165	2,112	3,329
Chemical	227	390	442	756	830	1,397	3,126	4,329	2,773
Machinery[a]	203	242	229	711	1,082	1,837	13,831	20,983	24,307
Transportation	183	425	413	1,581	2,043	3,539	5,389	7,945	8,905
Oil	890	9,952	15,896	14,959	5,813	5,786	11,353	10,710	8,533
Textiles	156	201	150	119	310	510	1,217	1,962	941

Source: "Mexico: Escaping from the Debt Crisis? " HBS case no. 390-174, Helen Shapiro; *The Economist*, [a]Exports to major trading partners, Japan and United States.

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Exhibit 10 Mexico's Petroleum Production

	1976	1979	1980	1981	1982	1984	1986	1987	1988	1990	1992	1994
Daily oil production (mns of barrels)	.90	1.46	1.9	2.31	2.75	2.81	2.43	2.62	2.59	2.97	3.12	3.14
Amount for export (mns of barrels per day)	.20	.78	.82	1.06	1.34	1.47	1.30	1.35	1.31	1.28	1.43	1.36
Export price per barrel (US$)	12.19	19.60	33.25	38.50	32.50	27.88	12.25	18.40	12.10	24.30[a]	20.52[a]	17.19[a]

Sources: *BP Statistical Review of World Energy 1996*; *World Oil Trends 1997*, Arthur Anderson, Cambridge Energy Research Associates; "Mexico: Escaping from the Debt Crisis?" HBS case no. 390-174, Prof. Helen Shapiro.

[a] The average nominal price for West Texas Intermediate crude oil.

Exhibit 11 Mexico's External Public and Private Debt to Banks, 1976-1988

	External Debt ($ billions)	% Debt to US Banks	% Maturity Under One Year
Dec. 1976	17.9	59.78	40.78
Dec. 1977	20.3	55.17	40.89
Dec. 1978	23.3	45.49	31.33
Dec. 1979	30.9	36.89	34.63
Dec. 1980	42.5	36.94	44.24
Dec. 1981	56.9	37.79	48.68
Dec. 1982	77.1	38.23	52.27
Dec. 1983	93.8	36.99	50.50
Dec. 1984	96.4	35.98	29.22
Dec. 1985	97.0	32.51	32.46
Dec. 1986	101.7	30.44	23.09
Dec. 1987	102.3	28.83	25.24
Dec. 1988	100.4	25.44	26.78

Source: "Mexico: Escaping from the Debt Crisis? " HBS case no. 390-174, Helen Shapiro.

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Exhibit 12 Comparative Social and Economic Indicators

	Mexico	Zambia	India	China	Singapore
Population (mid-1994)	88.5	9.2	914	1,191	2.9
Population growth rate					
(1980-1990)	2.0	3.5	2.1	1.5	1.7
(1990-1994)	2.0	3.0	1.8	1.2	2.0
Urban population	75	43	27	29	100
Life expectancy at birth	71	47	62	69	75
Public education (secondary enrollment)	57	16	48	54	58+
Adult literacy rate (1995)	90	78	52	81	91
GNP per capita in 1994 ($$)	4,180	350	320	530	22,500
GNP per capita (PPP, 1994)	7,040	860	1,280	2,510	21,900
Income distribution					
lowest quintile	4.1	3.9	8.5	6.2	5.1
second lowest quintile	7.8	8.0	12.1	10.5	9.9
middle quintile	12.5	13.8	15.8	15.8	14.6
second highest quintile	20.2	23.8	21.1	23.6	21.4
highest quintile	55.3	50.4	42.6	43.9	48.9

source: World Bank, *World Development Report 1996*

Exhibit 13 Tariff Levels in Mexico, 1982-92 (*percent*)

Tariff Statistic	1982	1986	1992
Average tariff	27.0	22.6	13.1
Trade-weighted average	16.4	13.1	11.1
Tariff dispersion[1]	24.8	14.1	4.5

Source: Taken from "Mexico (A) Reform and Crisis 1987-1994," HBS case no. 797-050, Professor Huw Pill.

[1] A measure of the uniformity of the tariff. A value of one would imply all imports face the same tariff. Greater tariff dispersion (where this statistic is higher) will be more disruptive since the domestic price system is subject to greater distortion.

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Exhibit 14 Chronology of Major Events During 1994

1994

January 1	NAFTA takes effect. Chiapas rebels seize six towns.
February 4	US Federal Reserve raises federal funds rate 25 basis points, having left the rate unchanged at 3% since September 1992.
March 22	US Federal Reserve raises rates another 25 basis points.
March 23	Mexican presidential candidate Luis Donaldo Colosio is assassinated.
April 18	US Federal Reserve raises rates another 25 basis points.
May 17	US Federal Reserve raises rates by 50 basis points.
August 16	US Federal Reserve raises rates another 50 basis points.
August 21	Victory for PRI candidate Ernesto Zedillo in the Mexican presidential elections.
September 28	Jose Francisco Ruiz Massieu, Secretary General of Mexico's ruling PRI party, is assassinated.
November 15	US Federal Reserve raises rates by 75 basis points.
November 23	Mexican Deputy Attorney General resigns, alleging a cover-up of the murder of his brother, PRI Secretary General Massieu.
December 1	New Mexican government under Zedillo takes office.
December 19	Further violence in Chiapas.
December 20	Banco de Mexico announced 15% shift in the intervention limits for the *peso*, an effective devaluation of the Mexican currency.
December 22	Banco de Mexico withdraws from the foreign exchange market, allowing the *peso* to float against all other currencies.

Source: Adapted from **Exhibit 1** of "Mexico (A) Reform and Crisis 1987-1994," HBS case no. 797-050, Prof. Huw Pill.

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