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# MEXICAN MELTDOWN:
# NAFTA, DEMOCRACY, AND THE PESO


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Paper presented at a workshop on "*Mexico in the Post-NAFTA Era: Democracy, Civil Society, and Societal Change,*" Centre for Research on Latin America and the Caribbean (CERLAC), York University, 22-24 September 1995.

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# MEXICAN MELTDOWN:
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## Abstract

The devaluation of the Mexican peso in December 1994 triggered a financial panic that required massive intervention by the United States government and the International Monetary Fund in an effort to prevent a full-scale financial collapse. The bailout was driven almost exclusively by a concern for powerful economic interests with a stake in NAFTA. Specifically, it was designed to protect the returns of foreign and domestic investors and restore confidence in Mexico; to safeguard the stability of the international economy and in particular the "emerging markets"; to guarantee the continuation of the process of hemispheric integration; and to assure the stability of the Mexican political system and the restructuring of its economy.

## Introduction

The devaluation of the Mexican peso in December 1994 triggered a financial panic that required massive intervention by the United States government and the International Monetary Fund in an effort to prevent a full-scale financial collapse. By the end of January 1995, President Bill Clinton had cobbled together a package of loan guarantees in excess of $50 billion--the largest socialization of market risk in the history of international finance (Glasgall 995: 38).[1] Massive state intervention was required to launch NAFTA, the centrepiece of market-led economic integration in Latin America: In Karl Polanyi's words, "Laissez-faire was planned" (Polanyi 1944: 141).

It would be a mistake to say that the crisis was unanticipated. In fact, the overvaluation of the peso was widely discussed during much of the Salinas sexenio.[2] The speculative bubble followed by a panic matches the model of financial crises presented by Charles Kindleberger (1989). However, as Jorge Castañeda noted, "not even the most acerbic critics of the previous regime and political system could have imagined a nightmare like the one the nation is now living" (Castañeda 1995: 117).

Only two weeks after the devaluation the losses recorded by foreign investors were estimated at around $10 billion.[3] Some of the biggest losers as a result of the peso devaluation were: Merrill Lynch, which lost 32 percent on assets valued at $938 million between December 15, 1994 and January 10, 1995; Fidelity Latin America, which lost 35 percent on assets valued at $811 million in the same period; and Scudder, which lost 30 percent on $799 million invested in Mexico.[4] Canadian investors were also hurt. The C.I. Latin American Fund, the largest of the 10 Latin funds sold in Canada--with a net worth of $558 million, 29 percent in Mexican currency--lost 17 percent of its value.[5] Mexican firms took an even greater pounding. Between December 1994 and January 1995, Carlos Slim's telephone monopoly (TELMEX) lost $18 billion, or 29 percent of its market value; Zambrano's cement monopoly (CEMEX) lost $4.2 billion, 56 percent of its value; Azcarraga's television monopoly (the pro-government TELEVISA), lost $3.8 billion, 37 percent of its value; and the Monterrey-based Alfa conglomerate lost $1.2 billion, or 41 percent of its value.[6]

U.S. and Canadian investors were forced to defer plans for further projects, while others took losses and left the market. Retailers were among the worst hit by plummeting consumer demand; firms like Wal-Mart and Price Club were forced to hold off on what had been described as the "Malling of Mexico." Sales of everything from automobiles to kitchen appliances dropped as much as 50 percent due to lower incomes and the rising price of consumer credit. The ill-fated Reichman family, a Toronto real estate giant, who had hoped that a boom in the Mexican real estate market would help their ailing empire to recover from its Olympia and York and Canary Wharf fiascos, were forced to scale back plans for building projects in Mexico City. The Bank of Nova Scotia lost 65 percent of the $100 million it invested in the Grupo Financiero Inverlat. Brewer John Labatt Ltd. lost $272 million on its $720 investment in Femsa Cerveza.[7]

The "Tequila effect" spread throughout the so-called "emerging markets," depressing stocks, weakening currencies, and prompting other Latin nations to reconsider accession to NAFTA. Even the U.S. and Canadian dollars came under pressure in the aftermath of the bailout. The market for Brady bonds fell on average by about 2.5 percent, thus adding to the debt problems of other debtor nations. Canada activated a $1 billion line of credit to support the peso. Canadian finance officials had to scramble to come up with evidence that the Canadian dollar was not vulnerable to the same sort of speculative attack. In an effort to defend their policies, Mexican officials made matters worse for the Department of Finance by pointed out that Canada's debt-to-GDP ratio was twice the size of Mexico's.[8]

The crisis also took its toll on the many "experts" and market "gurus" who had predicted that Mexico would pay handsome dividends to investors seeking to invest in "emerging markets." Wall Street analysts at firms like J.P. Morgan & Co., Goldman, Sacks and Co., Bankers Trust Co., and Salomon Brothers Inc. all confidently predicted a stable currency and continued earnings for foreign investors. John Purcell at Solomon Brothers admitted that "there's an inherent problem with analysts wanting to say positive things because investors want to hear about opportunities and not dangers," and then, in his next breath, recommended buying Mexican stocks.[9] By April 1995, Goldman & Sacks reported loses on $5.17 billion in Mexican securities; J.P. Morgan underwrote $2.01 billion in securities (Warnock 1995: 6-7). Bankers Trust, the seventh-largest bank in the U.S. was forced cut 1,400 jobs due to major losses in the first quarter of 1995 due to the downturn in Latin markets. The bank lost a total of $157 million between January and March 1995,compared with a profit of $164 million a year earlier. As a result of the layoffs, Bankers Trust stock closed up $1.25 at $54.25 on the New York Stock Exchange.[10]

Not surprisingly, as Sidney Weintraub noted, reports about the peso crisis "were dominated by hand-wringing about the deteriorating situation. The opinions heard were primarily those of Wall Street firms whose clients had taken a beating; little real analysis of what had motivated the Mexican authorities was provided" (1995: 112). An example of an extreme reaction to the crisis came from Riordan Roett, on leave from Johns Hopkins' School of Advanced International Studies. He wrote a "Political Update" for Chase Manhattan's Emerging Market Group in which he called on the Mexican government to elimination of the Zapatistas in order to demonstrate to foreign investors that Mexico remained politically stable.[11]

The frustration with Mexico was revealed in an extraordinary way when Mexican officials were snubbed by the world's financial community at Davos in Switzerland. Overnight Mexico had been "downgraded" from the darling of the international financial community to a virtual pariah. Of course, the greatest pain was felt by ordinary Mexicans. The economy contracted by 10.5 percent in the second quarter of 1995,[12] 750 million jobs were lost by early March 1995, due to the crisis; nonperforming loans reached one third of all bank portfolios, and two banks (Unión de Credito del Valle de México[13] and Cremi) were taken over by the regulators; and thousands of businesses went bankrupt.

## Causes of the Mexican Meltdown

What caused the financial crisis in Mexico, and how has it affected economic integration? Why did the United States arrange a financial package for Mexico? What was the policy process leading to this result? Which national actors and agencies took the lead? Through what consultative mechanisms were the countries of North America able to reach a consensus on the Mexican bailout? Did the crisis lead policy makers to redefine economic vulnerability? Did the bailout affect the policy consensus on NAFTA? Were the governments of North America prepared to deal with the interplay of domestic and international forces that flows from their actions?

Recognizing that no single factor can account for a financial crisis, this paper adopts the "method of multiple working hypotheses" (Chamberlin 1967). It examines a family of interrelated hypotheses, including: an inappropriate exchange rate; economic mismanagement; political uncertainty; financial speculation and excessive reliance on foreign savings; and problems managing domestic and international coalitions. My purpose is not to falsify any one hypothesis, but to use each to sharpen and refine the others, so that each successive hypothesis encompasses the previous ones.

The most simple--and the most technocratic--explanation for the devaluation was the existence of an inappropriate exchange rate mechanism. The peso was allowed to depreciate gradually within a currency band. As Mexico's current account deficit grew, and its foreign reserves dwindled, financial markets lost confidence in the peso. This led to speculation which forced the government to let the peso float. In this view, the underlying problem was the lack of credibility of the exchange rate mechanism. Had Mexico floated the peso in 1994, the crisis could have been averted.[14]

Important insights are contained in this perspective. For example, Mexico's strategy was inherently unsustainable. Large capital inflows, of which foreign direct investment was a small part, drove up the nominal value of the peso. Central bank efforts to sterilize these inflows by selling domestic bonds pushed up domestic interest rates which induced more capital to flow into Mexico. Major institutional investors like Fidelity Latin American began to refuse to buy Cetes. In an effort to defend the credibility of the exchange rate mechanism, Mexico began to rely increasingly on dollar-denominated Treasury Bonds (Tesobonos), and less on peso-denominated bonds (Cetes).

The overreliance on Tesobonos increased the risk that the government shouldered relative to foreign investors in an effort to maintain Mexico's attractiveness for portfolio investors. Whereas the value of Cetes issued by Mexico decreased from $26.1 billion in 1993 to $7.5 billion in 1994, the value of Tesobonos increased from $1.2 billion in 1993 to 17.8 billion in 1994 (Sachs et al. 1995, Table 9, based on Banco de México data). The combination of growing Tesobono obligations and declining international reserves was a major cause of the loss of investor confidence.

The inappropriateness of the exchange rate mechanism does not explain why a full-scale financial crisis occurred in December 1994. Why did the peso go from being overvalued to seriously undervalued? There must have been other reasons for the lack of confidence in the peso.

One reason for the lack of confidence was economic mismanagement by the Zedillo administration at the time of the devaluation--the so-called "errors of December." A succession of events in 1994--a rebellion in the southern state of Chiapas in January, the assassination of the official candidate in March, the election in August, and the assassination of the Secretary General of the ruling Partido Revolucionario Institucional (PRI) in September--had a cumulative effect on confidence in Mexico.

Figure 1 shows that the devaluation was the last in a succession of events that had the cumulative consequence of undermining confidence in Mexican currency. The bungling of the devaluation in December by Secretary of Finance, Jaime Serra Puche, was simply the last straw. Thus, economic mismanagement alone does not account for the crisis; it too was a reflection of political uncertainty.

Political uncertainty was created by a growing crisis of the Mexican political system. Zedillo demonstrated little of the political acumen necessary to manage the interlocking alliances, elite bargaining, and institutional arrangements that hold together the PRI. Severe tensions existed within Zedillo's cabinet, and between the president and the ruling party. Adding to the dilemmas of the president, the unresolved conflict led by the Ejercito Zapatista de Liberación Nacional (EZLN) in the state of Chiapas weakened the image of the government.

At the beginning of 1994, the last year of the Salinas administration, newspaper headlines began to reveal tensions between conflicting images of Mexico. "Salinas pursues damage control: Mexican revolt risks OECD bid" said one headline in <u>The Globe and Mail</u>. The story, which was more about spin control than counter-insurgency, quoted Salinas as saying "Chiapas is a local problem, in a region of deep poverty, on the border of Central America and where there are lots of Indians."[15] By the end of the year, <u>The Economist</u> ran a story under a title that seemed to be missing an adjective: "The president, the peso, the markets, and those Indians."

The consensus seemed to be that the Zapatistas were to blame for the crisis. Jaime Serra had pointed to Zapatista actions as a cause of the devaluation.[16] Although few Mexicans took this interpretation seriously, one foreign analyst accepted it at face value: "The straw that apparently broke the camel's back and led to the December 20 action was renewed turmoil in Chiapas" said Weintraub. Similarly, <u>The Economist</u> lauded Zedillo's government for its "political deftness" in "pinning elsewhere the blame for the pain" of the devaluation, and noted the "skilful decision" to name Esteban Moctezuma as minister of the interior.[17] He lasted in the post for less than six months.

It was uncertainty caused by political assassinations that did the most to spook investors. In March 1994, when Luis Donaldo Colosio was shot on the hustings in Tijuana, a financial crisis was only averted by timely and effective policy management. The crisis was managed by officials from the Finance Ministry, in particular José Angel Gurría. Gurría was an experienced negotiator, who had participated in Mexico's debt negotiations as well as the financial services negotiations in the NAFTA. In March 1994 he was the head of Nacional Financiera, one of Mexico's powerful development banks. Gurría understood that a major run on the peso could occur.

In an effort to head off a speculative attack, officials at Finance decided to activate a $6 billion swap facility that had been negotiated with the U.S. Treasury (the leading Mexican official responsible was Guillermo Ortiz). Although negotiated "secretly" around the time of the debate between U.S. Vice President Al Gore and NAFTA-critic H. Ross Perot, the swap facility had been known to insiders for months.

To gain time in order to get approval from the U.S. government to activate this Fund, Aspe, Ortiz, Gurría, Miguel Mancera (the head of the central bank), and other finance officials, with the agreement of the President, decided to shut down the Mexican stock market (or Bolsa de Valores) for a day. Ortiz called Lawrence Summers, Undersecretary for International Affairs at the U.S. Treasury, who activated the Exchange Swap Fund. Then the Mexican finance officials "began trying to win back investor confidence by calling everyone they could think of around the world from traders to chief executives."[18] "The performance was magnificent," according to one portfolio manager. "Almost every investment bank and every investor in the U.S. was on the phones from 8 to 9 in the morning and had it all laid out for them by the Mexicans."[19] Salinas also played a key role: he met with business and labour leaders to re-sign the corporatist "pacto economico."

The election played an indirect role in the crisis. Powerful recessionary pressures had begun to manifest themselves during 1993, when percapita income fell for the first time since 1988 (Lustig 1995: 375). Growth of the GDP declined from 4.5 percent in 1990, to 3.6 percent in 1992, to 2.8 percent in 1992, to 0.4 percent in 1993 (1995: 375). The slow down in growth came during an election year, and thus coincided with a typically expansionary phased in the political business cycle. Moreover, U.S. interest rates began to rise in 1994. Rather than allow Mexican interest rates to rise further, thus driving the country into a recession during an election, the Mexican government allowed domestic credit expansion that led to the collapse of reserves (Sachs et al. 1995: 10). Although a recession would have cut imports and improved Mexico's current accounts balance, it would have undermined the popularity of the ruling party at a critical political juncture.

Although the Mexican crisis was partly due to political uncertainty, the government's excessive reliance on foreign savings left it little room for mistakes. During his six-year term of office, President Salinas attempted to finance Mexico's development with short-term "hot money." Prior to 1994, 80 percent of capital flows into Mexico were in the form of portfolio investment--the acquisition of existing assets on the stock market. In 1994, that share declined to 50 percent, as mutual fund managers and other institutional investors began to detect signs of an impending crisis--like the growing current account deficit. Nevertheless, the amount of portfolio investment in Mexico was a far greater share of total capital inflows than in any other country in Latin America, and much of it was encouraged by the prospect that NAFTA would enable Mexico to join the First World.

Between 1984 and 1994 Mexico absorbed more than $94 billion in capital inflows; the capital inflows in 1994 alone amounted to $10 billion (Department of Finance 1995: 6). Meanwhile, domestic savings declined from 22 to 16 percent of GDP between 1988 and 1994.[20] Foreign capital inflows increased the current account deficit. As reserves declined, investors got nervous. Mexico had $28 billion in short-term obligations coming due, and only $6 billion in reserves available (Department of Finance 1995: 9). President Zedillo believes that capital flight due to the peso crisis was greater than during the debt crisis in 1982.[21]

Economic integration requires the construction and maintenance of increasingly complex domestic and international coalitions. The change in administrations in 1994 was accompanied by a profound crisis in Mexican politics which inhibited the Mexican government from maintaining the domestic and foreign support required by the process of economic integration. Zedillo's team told domestic business of its intention to devalue, prompting capital flight; told foreign investors it would not devalue, then did; devalued by too little and then let the peso float as capital flight accelerated; and, failing to win labour and business support, abandoned the corporatist pact mechanism. According to an unclassified analysis of the devaluation by the Canadian Embassy in Mexico City, the financial situation in Mexico in December 1994 was "extremely badly handled by the new government" (Canadian Embassy 1995; see also Cameron 1995).

Salinas repeatedly criticized Zedillo and his ministers for what he called the "errors of December," the bungling the devaluation. However, a report by The Wall Street Journal shows a stubborn resistance to the need for a devaluation on the part of the Salinas government, and a lack of initiative on the part of the Zedillo government. Ernesto Zedillo met with Carlos Salinas in the presence of Pedro Aspe in November, less than two weeks before the transfer of government, and discussed a devaluation of the peso. Aspe opposed the measure, in spite of declining reserves, and Zedillo and Salinas accepted Aspe's position. A similar meeting had been held in September 1994, in which Guillermo Ortiz has favored a devaluation, and no action was taken. Not only had Rudiger Dornbusch, Aspe's former teacher at MIT, insisted on the need for a devaluation; so too had Lloyd Bentsen, U.S. Secretary of the Treasury.[22]

The crisis began in earnest on December 8 when Minister of Finance Jaime Serra outlined his "Economic Criteria for 1995." The document was prepared in consultation with members of the outgoing administration (including former Finance Minister Pedro Aspe, former President Carlos Salinas, and former Undersecretary of Finance, Guillermo Ortiz). Business analysts judged the document insufficient and called for a correction of the current account deficit. Luis Germán Carcoba of the Business Coordinating Council called for a meeting with Serra, which was scheduled for December 15th. Although capital flight had already begun and the peso had risen to the top of the band (3.46 peso to the dollar), Serra remained optimistic.

The next day Serra gave an interview to The Wall Street Journal in which he denied the possibility of a devaluation. The following Monday the peso broke through the official band and the stock market fell by 4 percent. In the evening an emergency meeting was held between Serra, Miguel Mancera (of the Bank of Mexico) and Mexico's bankers, in which it was agreed to widen the band rather than let the peso float: "Naturally, this meeting gave the bankers a head start, since discussions were going on when European and Asian markets were already open, and many were able to make frantic calls to their brokers in the early morning hours to buy dollars before Jaime Serra's ill-fated announcement to the Mexican media....In just a few hours, billions of dollars poured out of the country--in effect, the inexperience of the government in handling such delicate financial matters (i.e., having bankers influencing the decision to free float) led to a run on the country that to a large extent caused the current crisis" (Canadian Embassy 1995). During the run on the peso, Secretary Serra complained that he had just moved into his office and could not find his list of contacts.

An important lesson to learn from this crisis is that private investors--particularly foreign investors--cannot be allowed to determine a country's monetary policies. The advice of fund managers and investment bankers is hard to ignore when they control enormous sums of money. In the aftermath of the Colosio assassination, foreign investors sent the Mexican government a list of suggestions to bolster the currency. According to The Wall Street Journal, "To lend weight to their advice, the funds said they were willing to pour an additional $17 billion into Mexico this year if the government enacted reforms."[23] The efforts of private investors to lobby governments to adopt policies that maximize their returns raises questions about democracy and the nation state, especially when the government under pressure is politically weak and vulnerable to short-term speculative flows of capital. "Who says you have to be elected to influence policy?" said one fund manager: "The market is saying to policymakers `We're your watchdog.'"[24]

**The Mexican Loan-Guarantee Package.**

The bailout revealed cracks in the international financial system: six European members of the International Monetary Fund--Britain, Germany, Denmark, the Netherlands, Belgium, and Switzerland--abstained on the vote to provide $17 billion in loans to Mexico. They said the plan was pushed through too hastily (documents were received only an hour before the meeting to vote on the package), and without regard for the

IMF's other obligations or problems of moral hazard.[25] U.S. officials noted that the speed of the markets had outstripped the ability of bureaucratic agencies like the Fund to respond.

There is a world of difference between financial markets in 1944, when the Fund was conceived, and 1994.[26] This was recognized by the G-7 in Halifax later in the year, when the IMF was asked to create an "Emergency Financing Mechanism" for countries facing capital flight. This mechanism institutionalizes the Mexican-bailout style socialization of risk, and potentially passes the burden onto taxpayers.[27]

The emergency bailout, combined with Mexico's domestic adjustment measures, only addressed part of the problem. Under the terms of the bailout package assembled by the United States, Mexico will receive $20 billion in loans with up to ten year maturities through the Treasury's Exchange Stabilization Fund. The Federal Reserve agreed to provide short-term bridge financing of up to $6 billion. The other industrialized nations would provide an additional $10 billion in credit through the Bank for International Settlements (BIS).

President Clinton's pressure on the BIS to contribute to the Mexican bailout was not openly resisted, but the enthusiasm of European central bankers was minimal. The International Monetary Fund extended $17.8 billion in credit. $7.8 billion (300 percent of Mexico's IMF quota) were made immediately available. The remaining $10 billion were set aside to be provided to the extent that the government central banks in the BIS fall short of their $10 billion target. Overall, the IMF provided 688 percent of the quota for which Mexico was eligible, the largest ever financing package approved by the Fund (IMF 1995). In fact, the total bailout packages includes money that is far from secure. Most of the real, hard money is from the U.S., which is why it can set the lending conditions. It is unlikely that any further money could come from outside the NAFTA partners.[28]

Clinton's bailout was so unpopular domestically that he was unable to get it past Republicans and Democrats in Congress, some of whom wondered why similar steps were not taken to bailout Orange County or U.S. workers in distress. The measure had to be taken using executive powers to spend through the exchange stabilization funds of the U.S. Treasury and by strong-arming the IMF.

The irony of offering public money to promote what was supposed to be a market-based "miracle" was not lost on Wall Street. As The Wall Street Journal noted: "Mr. Camdessus argues that the intervention has been required to underpin the credibility of the market-oriented approach to development. What it does is undermine it. It does so by substituting official for private capital, by offering implicit insurance to private capital flows, by making unsound private finance more probable and, most important, by indicating a lack of confidence in the self correcting capacity of financial markets" (Quoted in Asaria 1995: 15). Other observers were no less critical. Mark Fineman of the Los Angeles Times reported: "Three weeks after it started receiving one of the biggest and most controversial credit packages in U.S. history, the Mexican government has spent a fifth of the $20 billion in promised U.S. loans to pay off American insurance companies, mutual fund investors, Wall Street brokerage houses, Mexican banks and the richest of Mexico's rich."[29] The U.S. sent an initial instalment of $5.2 billion to Mexican accounts at the Federal Reserve Bank in New York on March 15. "Much of the money never left New York, where it was used to redeem the high-profit bonds, held primarily by major American institutions, Wall Street speculators and wealthy Mexicans who bought the securities largely through non-taxable offshore corporations."[30] As of early April, as much as 90 percent of the securities the Mexican government had bought back went into the bank accounts of U.S. investors or Mexicans living abroad.[31]

The crisis will further concentrate wealth, in a country where a handful of families run the economy, major industrial and consumer goods groups are dominated by monopolies and duopolies, and there are no taxes on inheritance or capital gains in the Bolsa. According to the Institutional Investor, Carlos Slim--reputed to be Salinas's *prestanombre*--owns and controls about 25 percent of the capital in the stock market in Mexico, largely through his ownership of the recently privatized telephone company, TELMEX.[32] The same source reports that Carlos Cabal Peniche used his cabinet connections to receive loans from the government development bank Nacional Financiera, as well as illicit loans from his own banks, to build up a massive conglomerate in the food industry. In 1994 the Federal Competition Commission discovered that major banks and brokerage houses--including Banamex, Serfin, and Probursa--were colluding to fix prices on Mexican Treasury Bills (Cetes).

In late April, Mexico received another $3 billion from the "Exchange Stabilization Fund" of the Federal Reserve Bank, bringing the total used to over $8 billion of a maximum of $20 billion available through that source. By then, Mexico had paid off half of its Tesobonos: obligations that stood at $29.2 billion at the start of the year had been reduced to $15.5 billion. Mexico also drew heavily on the IMF's initial $7 billion advance, as well as funds from the Swiss-based International Bank of Settlements, to redeem over $13 billion in Tesobonos.

U.S. Secretary of the Treasury, Robert Rubin said that the release of fresh funds demonstrated that Mexico was fully complying with the conditions of the bailout. The first $10 billion would come from the US between February and June 1995, as long as Mexico complied with targets. The remainder would be made available subsequently, as necessary.[33] By August, 1995, Mexico's reserves had climbed back to $15.7 billion; $26 billion in Tesobonos had been paid off, leaving only $3.1 billion due; and the Mexican government had shifted back to issuing peso-denominated bonds.[34]

The bailout package imposed strict conditionality measures on monetary and fiscal policy and foreign borrowing. Loan guarantees will be backed by oil revenues held as collateral by the Federal Reserve Bank of New York. Mexico would have to buy back the pesos it has exchanged for dollars with the United States at 2.25 percent or more over Treasury bill rates of varying maturities.[35] The terms included the unusual accounting practice that every withdrawal of funds would have to be approved in advance by the U.S. Treasury, which would oversee how all the money was spent. The Mexican government also set up a fund, backed by the World Bank, to ensure that local banks met the minimum capitalization levels required by regulators--again, a form of socialized risk.

The United States executive arranged the financial package for Mexico because it believed that Mexican financial stability was in the interests of the U.S. economy. A financial meltdown in Mexico could have repercussions throughout the "emerging markets" of Latin America and Eastern Europe and could ultimately result in a loss of jobs at home. Nevertheless, the idea of bailing out a foreign country was unacceptable to members of the Congress, many of whom accused the President of being too concerned for wealthy investors and speculators. Congress's refusal to ratify the package forced the president to act by executive decree.

As a result of the peso crisis, conditionality has permeated every level of Mexican society. The Asociación de Banqueros de México (ABM) negotiated with Hacienda to resolve the problem of the nonperforming debts (cartera vencida, or debts over three months due). They agreed, grudgingly, to a Accord to Support Debtors (Acuerdo para el Apoyo a Deudores, ADE). This plan included: a temporary reduction or moratoria on interest payments, suspension of judicial proceedings, restructuring of credit, and limitations on what banks can demand from debtors. The costs of the program would be jointly shared by the banks and the government. This would be a one-time only restructuring, after which all debtors would be responsible for their obligations. Interest rates would be reduced. Interest on credit cards could be reduced from 69 to 38.5 percent; from 91 to 31 percent on personal loans; from 56 to 25 percent for business and farm debts. However, in order to benefit from the program, debtors would have to sign "letters of intent." In these letters, debtors would accept the terms of debt restructuring.[36]

A debtors coalition called El Barzón, formed in August 1993 by the National Confederation of Farm and Forest Producers (Confederación Nacional de Productores Agropecuarios y Forestales) and the National Union of Farm, Industrial, Commercial, and Service Providers (Unión Nacional de Productores Agropecuarios, Industriales, Comerciantes, y Prestadores de Servicios), rejected the plan to restructure their debt. The coalition split into two groups--one allied with the ruling party and the other, "El Nuevo Barzón," which is more militant. The *barzonista* movement is a genuine debtors cartel in which members refuse to pay the banks, or pay only part of their debts and place the rest in escrow accounts. It represents a significant collective response to the crisis affecting Mexican households.

For El Barzón, the ADE and other similar plans represented at best bromides, and at worst mechanisms to enforce compliance with illegal debts. Moreover, it was negotiated without the participation of the most important player: the debtors.[37] El Barzón proposed a restructuring of debt that would place most of the burden on the banks and the government while providing substantial relief to farmers and other producers. The disputed the total amount of debt, refusing to accept bank practices like charging penalties on late payments, and then adding the penalties to the principal and charging more interest and penalties on the principal!

The protests of the "barzonistas" attracted considerable attention in 1995 as the problem of domestic debt spread. They attacked the government for being concerned exclusively with the interests of the bankers, and threatened widespread disruption. Indeed, in August, they were able to demonstrate a national presence by holding simultaneous marches throughout the major cities and states of Mexico--including Nuevo León, Tamaulipas, Hidalgo, Sonora, Coahuila, Mazatlán, Potosí, Querétaro, Campeche, Yucatan, Jalisco--in protest against the ADE.[38]

The crisis exposed flaws in the consensual knowledge upon which the support for NAFTA was based. Market analysts reinforced one another in an unsustainable Ponzi game. Governments and trade policy experts also played a role in promoting NAFTA by emphasizing its benefits and ignoring the costs of integration. Congress demanded to know whether the U.S. government knew about the deteriorating situation in Mexico and failed to act or make that knowledge public. Robert Ruben, Secretary of the Treasury, insisted that there were regular contacts between the Treasury and Mexico's Secretary of Finance and that the United States had repeatedly warned Mexico about the dangers of its growing current accounts deficit.

Others criticized the way the crisis was handled by the United States administration (Castañeda 1995). In particular, the Treasury took no steps to halt the slide of the peso during the critical first week of the devaluation, and then took a month to cobble together the bailout package: "This has not been a stellar performance: not by the Mexicans; not by the United States government..." said Sidney Weintraub (1995: 112). Whereas contacts between Presidents Bush and Salinas were regular and smooth, relations between Clinton and Zedillo were chaotic and sporadic.

The emergency measures were premised on the belief that policy errors were responsible for the crisis, and confidence could be restored through fresh infusions of capital accompanied by tight conditionality. However, as my research will demonstrate, the crisis in Mexico went deeper. Loan guarantees are likely to cover Mexico's short-term obligations, impose discipline on economic policy making, and stimulate reforms in isolated areas (like the publication of timely and reliable statistics of Mexico's foreign exchange reserves by the Bank of Mexico). This, however, will be insufficient to restore confidence in Mexico.

During 1995 Mexico will have to transfer $57.8 billion dollars abroad to meet its public and private financial obligations--18 percent of the expected GDP. This represents twice the debt payments made by Mexico from its independence to the oil boom in the 1970s.[39] By mid-year, Mexico owed $14.7 billion to the IMF

Mexico continued its past practice of too-close concertation and consultation with large business interests, and exclusion of the vast majority of the population whose income, jobs, debts, mortgages, and security had been affected by the crisis. The management of the crisis reflected that long road ahead in terms of the aspects of democratization that go beyond elections: managing state-society relations, equalizing access to information, protecting consumers, breaking up monopolies, democratizing credit, improving access to financial institutions, and reducing the arbitrariness that characterizes the management of the vast discretionary power of the central state.

**Conclusion: The Lessons of the Devaluation**

Writing in the late 1930s, Karl Polanyi argued that:

> the idea of a self-adjusting market implied a stark utopia. Such an institution could not exist for any length of time without annihilating the human and natural substance of society; it would have physically destroyed man and transformed his surroundings into a wilderness. Inevitably, society took measures to protect itself, but whatever measures it took impaired the self-regulation of the market, disorganized industrial life, and thus endangered society in yet another way. It was this dilemma which forced the development of the market system into a definite groove and finally disrupted the social organization based upon it (Polanyi 1944: 3-4).

A number of lessons can be drawn from the peso crisis that are similar to Polanyi's observations. First, stable markets require government intervention. Markets cannot exist outside of a stable framework of regulatory rules. Without such a framework, markets are inherently unstable. Liberal economic theory denies this by conceptualizing the state as a neutral umpire whose role is restricted to enforcing contracts into which individuals voluntarily enter. The state is present in the creation of all contracts, and plays a fundamental role in determining every dimension of economic life including the role of the state itself--thus the paradox of market liberalization is that it is led by the state!

The bailout will not lead to domestic political reforms in Mexico, reduce vulnerability to financial speculation and reliance on portfolio investment, or create better consultative mechanisms between the NAFTA partners, especially Mexico and the United States. In short, the countries of North America appear to have been unprepared to deal with the interplay of domestic and international forces that flows from closer economic integration.

The second major lesson concerns democracy. How democratic are the forms of state intervention in the economy associated with the process of hemispheric economic integration? I have argued that the new forms of state intervention are driven almost exclusively by a concern to protect powerful economic interests which have a stake in this process, and not with the interests of the majority of the population in any of the three NAFTA signatories. Whether it is the domestic restructuring of the debt in Mexico, or the IMF role in the bailout, these forms of government intervention have been driven by a narrow purpose: to protect the returns of foreign and domestic investors and restore confidence in Mexico; to safeguard the stability of the international economy and in particular the "emerging markets"; to guarantee the continuation of the process of hemispheric integration; and to assure the stability of the Mexican political system and the restructuring of its economy.

## End Notes

1. According to The Economist, $40 billion amounts to 10 percent of Mexican GDP, and twice what the United States spends on foreign aid every year. "Rescuing the sombrero," The Economist, 21 January 1995, p. 18.

2. Rudiger Dornbusch and Alejandro Werner (1994) had warned that the peso was overvalued in a paper published by the Brookings Institution. Gary C. Hufbauer and Jeffrey J. Schott also noted the problem (1993: 4). As early as 1993 the "possibility that Mexico could face another loss of faith by foreign investors, a round of capital flight, and a large devaluation" was "a matter for nervous speculation in Mexico" (Grinspun and Cameron 1993: 37).

3. The Financial Post, 5 January 1995, p.6.

4. The New York Times, 11 January 1995.

5. Rudy Luukko, "Lessons of the Mexico massacre," Financial Times of Canada, 7-13 January 1995, p. 8.

6. "Power to the Plutocrats," Institutional Investor, February 1995. A recent editorial in Mexico's opposition newspaper La Jornada called attention to the fact that, in the middle of one of worst economic crises in 50 years, companies quoted on the Mexican stock market are showing substantial profits! The

editorial explained this paradox by describing how Mexico's biggest firms have learned to protect their earnings: they are making money on the exchange rate, and passing higher costs onto consumers. It's an often-repeated story in Latin America: rich firms, with liquid assets, passing on the burden of adjustment to the rest of the economy, and adding to their wealth through unproductive (and often illegal) speculation. The editorial ends by lamenting the "casino economy" created by neoliberal governments, which has given rise to speculation and privilege in the midst of misery and unemployment. See "No todo esta perdido (esta en la Bolas)," La Jornada, 20 August 1995.

7. Andrew Willis, "Pounded by the peso's fall," Maclean's, 3 April 1995, p. 38.

8. For analysis of Canada-Mexico relations, see Grinspun et al. (1995).

9. E.S. Browning, "Top analysts blind-sided by Mexico's debacle," The Globe and Mail, 7 January 1995 (reprinted from The Wall Street Journal).

10. "Bankers Trust Cutting 1,400 Jobs," Business Briefs from the "News and Observer Times" (Raleigh, N.C.), News & Observer Printing Co., April 18, 1995.

11. According to Roett, "there are three areas in which the current monetary crisis can undermine political stability: The first is Chiapas; the second is the upcoming state elections; and the third is the role of the labour unions, and their relationship to the government and the governing PRI." He went on to argue that "While Chiapas, in our opinion does not pose a fundamental threat to Mexican political stability, it is perceived to be so by many in the investment community. The government will need to eliminate the Zapatistas to demonstrate their effective control of the national territory and security policy." Further more, argued Roett, the PRI might have to resort to fraud in upcoming state election: "The Zedillo administration will need to consider carefully whether or not to allow opposition victories if fairly won at the ballot box." Finally, Roett called on the Mexican government to reject workers' demands for higher wages in order to preserve the economic program. See Riordan Roett, "Mexico-Political Update," Chase Manhattan's Emerging Markets Group, January 13, 1995; Ken Silverstein, "Wall Street Declares War on Zapatistas," CovertAction, No. 52, Spring 1995.

12. "SHCP: cayó el PIB 10.5% en abril-junio," La Jornada, 16 August 1995.

13. A major shareholder in Unión del Credito was Luís Yáñez, husband of Adriana Salinas. Adriana, the sister of Carlos and Raúl Salinas, had divorced José Francisco Ruíz Massieu, the recently slain General Secretary of the PRI. The lawyer for Unión de Credito was José Angel Garza Hurtado, who had previously defended a government employee in the Office of the President linked to the controversy over Ruíz Massieu's death. ") Avances en el Caso Ruíz Massieu?" (Editorial) La Jornada, 7 September 1995.

14. Interview with senior official of the Bank of Canada, Ottawa, 1 March 1995.

15. Madelaine Drohan, "Salinas pursues damage control: Mexican revolt risks OECD bid," The Globe and Mail, 31 January 1995, p. B1.

16. "Acuerdan devaluar hasta 15% el peso," La Jornada, 21 December 1994.

17. "The president, the peso, the markets and those Indians," The Economist, 24 December-6 January 1995, p. 43.

18. Craig Torres, "How Mexico's Behind-the Scenes Tactic And a Secret Pact Averted Market Panic," The Wall Street Journal, 28 March 1994, p. A6.

19. Craig Torres, "How Mexico's Behind-the Scenes Tactivs And a Secret Pact Averted Market Panic," The Wall Street Journal, 28 March 1994, p. A6.

20. These numbers come from President Zedillo's 1995 address to the nation. "La ciudadanía, motor del avance político: Zedillo," La Jornada, 2 September

1995.

21. According to the Federal Reserve Bank of the United States, Mexican investors increased their deposits in U.S. banks from $12.6 billion to 16.8 billion in 1994--in spite of a massive withdrawal of over $6 billion from U.S. institutions by the Bank of Mexico. "Fuga de 4,200 mdd a EU en enero-febrero," La Jornada, 11 July 1995.

22. Carlos Fernández-Vega, "Entre la ficción y la perversión," La Jornada, 8 July 1995.

23. Craig Torres, "Some Mutual Funds Wield Growing Clout in Developing Nations: As Investments Abroad Rise Managers Take On Role Similar to Banks, IMF." The Wall Street Journal, 14 June 1994, p. 1.

24. "Borderless Finance: Fuel for Growth," Business Week, "Special 1994 Business Issue," 24 January 1995, p. 41.

25. Nathaniel Nash, "Western Allies Rebuff Clinton in Mexico Vote: 6 Europeans Abstain On Support at I.M.F." The New York Times, 3 February 1995, p. A1, A6.

26. "A fork in the IMF's road," The Economist, 28 January 1995, p. 14.

27. Jeffrey Sachs proposed that the IMF should offer bankruptcy protection for entire countries, in the way that governments offer bankruptcy protection to firms. Greg Ip, "Are Taxpayers on the Hook for G-7 Plans for Reform?" The Financial Post, 23 June 1995, p. 10. See also Department of Finance (1995: 9-10).

28. I am grateful to Lawrence Whitehead for these observations.

29. Mark Fineman, "U.S. Loans to Mexico Used Mostly to Pay Investors," Los Angeles Times, 4 April 1995.

30. Mark Fineman, "U.S. Loans to Mexico Used Mostly to Pay Investors," Los Angeles Times, 4 April 1995.

31. Mark Fineman, "U.S. Loans to Mexico Used Mostly to Pay Investors," Los Angeles Times, 4 April 1995.

32. "Power to the Plutocrats," Institutional Investor, February 1995.

33. "Se ejercerán el 21 de abril y se pargarán mediante swaps: SHCP," La Jornada, 18 April 1995.

34. "La transferencia, 204% mayor que todo el saldo de 1821 a 1976," La Jornada, 10 September 1995.

35. "Band-aid," The Economist, 25 February 1995, p. 79.

36. "N$15 mil millones, costo del plan; gobierno y banca se dividirán la carga," La Jornada, 24 August 1995.

37. Carlos Fernández-Vega, "El sexto de la temporada," La Jornada, 27 August 1995.

38. "Organizaron deudores marchas, mítines y bloqueos en varios estados," La Jornada, 29 August 1995.

39. "La transferencia, 204% mayor que todo el saldo de 1821 a 1976," La Jornada, 10 September 1995.

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