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## Tequila Hangover: The Mexican Peso Crisis and Its Aftermath

It was midnight in Madrid, and Pedro Aspe was not even the last speaker on the program. But with his regal bearing, his smooth and practiced delivery, and—above all—his compelling story, the Mexican finance minister had his audience in thrall. Mexico, he asserted convincingly, had been a “pioneer” in transforming its economy from one that was closed to competition, highly controlled and regulated, and wracked by high debt and inflation, into a modern, open, and efficient economic system based on market principles. With substantial help from the IMF and the World Bank, Mexico had carried out a “profound reform of the State” that had put its troubled economic past on the shelf and positioned it well for a stable and growing future.

Aspe was delivering this message to a distinguished audience of the world’s finance ministers and central bank governors, their spouses, and other guests who had gathered at the historic Castillo de Viñuelas in Spain on a lovely, warm late September night in 1994 to commemorate the fiftieth anniversary of the founding of the IMF and the World Bank at Bretton Woods. Other speakers that evening included Michel Camdessus and Lewis Preston, the heads of the two institutions; Wim Duisenberg, the head of the Netherlands central bank and of the governors of the Bank for International Settlements (BIS); and Jacques Polak, who spoke on behalf of his fellow veterans of the Bretton Woods conference, several of whom were also present. Aspe, however, was clearly the star of the evening, introduced by Duisenberg as the “personification of stability . . . based on sound fundamentals.”<sup>1</sup>

One member of the audience knew Aspe particularly well, having been one of his teachers when Aspe was studying for a doctorate in economics at the Massachusetts Institute of Technology (MIT). Stanley Fischer had just moved from MIT to the IMF that month to become the First Deputy Managing Director (FDMD), and he had every reason to believe that Mexico, under the financial direction of his former star student, had, in turn, fairly earned its global reputation as a star student of the IMF. In less than three months, the report card would have to be dramatically rewritten.

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<sup>1</sup>Aspe’s and Duisenberg’s remarks are reproduced in the proceedings of the anniversary conference (Boughton and Lateef, 1995, pp. 123–38).

The foreign exchange crisis that hit Mexico at the end of 1994 was a classic example of a country's stubborn adherence to a "strong" currency. Its origins were deeply rooted in the history of an economy that had experienced election-year excesses and instability for decades. Nonetheless, for Mexico, for its major trading partners from Canada to Argentina, and for the IMF, the crisis also had new and unique facets that justified its being dubbed "the first financial crisis of the twenty-first century."<sup>2</sup> At the IMF, the onset and the management of the crisis induced a great deal of soul-searching. Was the Fund blinded by its admiration for a country that had emerged successfully from earlier Fund-supported programs? How could the Fund have played a more effective role in preventing the crisis? Could (and should) the Fund have avoided being drawn in so deeply in financing its eventual resolution?

## Mexico as Star Student

By December 1994, Stanley Fischer had already earned a reputation as one of the hardest-working people at the IMF. Late-night phone calls and early-morning e-mails from the FDMD formed part of his legend and quickly became the expected norm. Aside from long-standing personal habits, this diligence was Fischer's response to what he had found to be a surprising lack of hard information in the Fund about events and trends in the world economy. So it was not unusual that he was on the phone at 11:00 at night on December 19, talking to Jeffrey R. Shafer (assistant secretary for international affairs at the U.S. Treasury) about financial developments in the Middle East. What was unusual was the bombshell that Shafer was about to drop. By the way, Shafer injected, you know that Mexico is going to

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<sup>2</sup>The origin of this oft-quoted phrase is not clear, but it most likely originated with Camdessus. Rubin and Weisberg (2003) pp. 16–17, credits it to the Speaker of the U.S. House of Representatives, Newt Gingrich, but hedges by noting that Michel Camdessus used the same phrase around the same time and that Gingrich "may not have been the first" to say it. The Mexican finance minister, Guillermo Ortiz Martinez (1998), credited it to Camdessus, as have many others, including Fischer (2001) and this author (Boughton, 2001a) p. 443. To my knowledge, Camdessus's first documented statement of it came at a retreat of the Executive Board on January 26, 1995 (which, if Robert Rubin's recollection is correct, would postdate Gingrich's remark). At the retreat, Camdessus was frustrated by the need to delay consideration of Mexico's request for financial assistance until the staff report could be sent by telex or fax to capitals around the world for consideration by national authorities. In response, he remarked that the Fund was dealing with the first financial crisis of the twenty-first century using the techniques of the nineteenth. Six days later, the U.S. Executive Director, Karin Lissakers (who had been present at the retreat), remarked during a Board meeting that "I think it is not over dramatizing the situation to say that we may in fact be facing, grappling now with the first financial crisis of the twenty-first century." (These two quotations were transcribed by participants in the meetings; they do not appear in official minutes.) In October of that year, Camdessus stated in a speech that the "crisis in Mexico has been described, by *I don't know whom*, as the first financial crisis of the 21st century, meaning the first major crisis to hit an emerging market economy in our new world of globalized financial markets" (emphasis added); see <http://www.imf.org/external/np/sec/mds/1995/mds9513.htm>.



Mexican Finance Minister Pedro Aspe speaking in Madrid, September 1994. (IMF photo)

devalue and float the peso tomorrow. Fischer did not know, and therein hangs the tale.<sup>3</sup>

The most recent consultation with Mexico had been concluded nearly 10 months earlier, on February 28, on the basis of discussions between the IMF staff and the authorities in Mexico City in early December, 1993. At that time, the Mexican economy had been humming along with no major difficulties after four years of good economic growth fueled by large and apparently reliable capital inflows (see Chapter 9). An uprising in the southern state of Chiapas was causing domestic political problems but did not yet pose a threat to economic or financial stability. Indeed, the authorities had been trying

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<sup>3</sup>Throughout this chapter, statements not specifically attributed to documents or publications are based on classified internal Fund documents or on interviews with participants in these events. As described in the Preface, those interviews were conducted on a background basis. Most interviews on this issue with IMF staff and management were conducted during or shortly after the crisis in 1995. Interviews with Mexican, U.S., and European officials were conducted several years later as part of the research for this book.

to discourage speculative inflows by allowing the exchange rate to fluctuate freely within a crawling band and thus create some uncertainty about future movements. Although the 1989 Extended Fund Facility arrangement had been extended to a fourth year in May 1992, Mexico had decided not to draw on it after that date, and the authorities were now in the process of repaying earlier drawings.<sup>4</sup> Uncertainty about whether the U.S. Congress would ratify the North American Free Trade Agreement (NAFTA) had limited investors' interest in Mexico and thus depressed the growth rate in 1993, but since NAFTA had come into effect at the beginning of 1994, Mexico's growth prospects looked much brighter. The Executive Board accordingly expressed mostly positive views, echoing the staff's conclusion that "Mexico's medium-term prospects remain favorable."<sup>5</sup>

The IMF was not completely insouciant about the current account deficit or the exchange rate, even at this early date, but the optimists greatly outnumbered the worriers. Camdessus first expressed concerns to Aspe during a breakfast meeting in July 1993, and he repeated those concerns to the central bank governor, Miguel Mancera, in October. On both occasions, and in the Article IV discussions, the authorities pointed to continued strong growth in Mexico's exports as evidence that the exchange rate was not overvalued. Moreover, they believed that the crawling band policy already gave them sufficient leeway to deal with any pressures that might arise.<sup>6</sup> The staff accepted those arguments, as did most members of the Executive Board. At the meeting to conclude the Article IV consultations in February 1994, Karin Lissakers (United States) urged Mexico to depreciate the peso, and Douglas Smees (Canada) argued more generally for greater flexibility in exchange rate policy. In contrast, Giulio Lanciotti (Italy) embodied the majority in concluding that "the conditions seem to be in place now for a successful hardening of the exchange rate commitment."<sup>7</sup>

Barely three weeks after the Board meeting, Mexico's short-term stability came under threat following the March 23 assassination of Luis Donaldo Colosio, the leading candidate to replace Carlos Salinas de Gortari as president in the August elections. The Bank of Mexico suddenly began to lose foreign exchange reserves at a rapid rate, prompting Camdessus to use a previously scheduled press conference to reassure investors that Mexico's economic policies were "fundamentally sound" and that the "signs of nervousness in the financial markets . . . will be short-lived."<sup>8</sup> More concretely,

<sup>4</sup>For a review of the 1989 EFF arrangement with Mexico, see Boughton (2001b), pp. 510–15. Mexico's peak indebtedness to the Fund in this period was \$6.6 billion in May 1992 (SDR 4.77 billion, or 409 percent of quota). Repayments through end-1994 reduced the balance outstanding to \$3.8 billion (SDR 2.6 billion, or 149 percent of the increased quota).

<sup>5</sup>"Mexico—Staff Report for the 1993 Article IV Consultation" (February 1, 1994), p. 13; and the Chairman's Summing Up, minutes of EBM/94/16 (February 28, 1994), p. 53. The staff and Executive Board conclusions were identical except that the latter added "particularly" before "favorable."

<sup>6</sup>Minutes of EBM/95/33 (April 4, 1995), pp. 1–2.

<sup>7</sup>Minutes of EBM/94/16 (February 28, 1994), pp. 11 (Lissakers), 13 (Smees), and 27 (Lanciotti).

<sup>8</sup>Transcript of press conference of Michel Camdessus, March 24, 1994; IMF archives, OMD/AI, "Surveillance of Mexico" Box 1, Accession 2007-043.

the U.S. Treasury and the U.S. Federal Reserve System responded immediately by establishing a temporary \$6 billion swap line that could be activated only if the IMF Managing Director submitted a “comfort letter” supporting Mexico’s economic and financial policies, which he promptly did.<sup>9</sup> This swap line was made permanent the following month, but by then the capital outflow had ebbed, and Mexico did not draw on it for the rest of the year. Both the U.S. authorities and the IMF staff soon concluded that the financial effect of the Colosio assassination was nothing more than a liquidity crisis that had quickly passed. Although pressures could arise again in connection with election-year uncertainties, everyone seemed confident that the Mexican authorities could manage the situation.<sup>10</sup>

Mexico got a much-needed confidence boost in mid-May, when it became the first new member of the Organization for Economic Cooperation and Development (OECD) since New Zealand in 1973. Now Mexico could—and did—consider itself to be no longer a developing country. It had joined the club of rich industrial nations, and it fully expected to leave its troubled financial past in the dust of its economic progress.

Not everyone, however, was impressed. Many outside commentators were becoming increasingly vocal in calling for a devaluation to correct what they saw as a substantial overvaluation of the peso, which was depressing growth and threatening to stall Mexico’s economic development. Rudiger Dornbusch, the highly respected and knowledgeable MIT economist, led the choir, repeatedly articulating a detailed case in the spring and summer of 1994 that the peso was overvalued by about 20 percent. He concluded that “great damage . . . lies ahead unless the currency is devalued” (Dornbusch and Werner, 1994, p. 287). Discussing that paper in early April, Stanley Fischer (then a colleague of Dornbusch at MIT), among others, agreed with this diagnosis (Dornbusch and Werner, 1994, p. 307). In July, the *Economist* reported that “a growing chorus of financial pundits reckon a devaluation of some sort is likely just after the [August presidential] election, if not before” (July 23, 1994, p. 76).

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<sup>9</sup>The letter was sent to Lloyd Bentsen (secretary of the U.S. Treasury) and Alan Greenspan (chairman of the U.S. Federal Reserve System) on March 24; IMF archives, OMD-AD (Mr. Fischer’s files), Box 11508, Accession 1998-0105-0005, “Mexico Operational File 1994.”

<sup>10</sup>See “Foreign Exchange and Financial Markets in April 1994,” EBD/94/84 (May 17, 1994); and memorandum from Ewart Williams to the Managing Director, “Mexico—Back-to-Office Report” (June 16, 1994); IMF archives, OMD-AD (Mr. Fischer’s files), Box 11508, Accession 1998-0105-0005, “Mexico Operational File 1994.” Also see Lustig (1997). The IMF staff assessment was based on a staff visit to Mexico near the end of May, during which the authorities assured them that they had tightened macroeconomic policies since the assassination and were prepared to float the exchange rate temporarily if necessary; see memorandum from Sterie T. Beza (Director, Western Hemisphere Department) to the Managing Director, “Mexico—Supplement to Back-to-Office Report” (June 16, 1994); IMF archives, OMD-AD (Mr. Fischer’s files), Box 11508, Accession 1998-0105-0005, “Mexico Operational File 1994.” After further informal discussions between the staff and the authorities, Camdessus sent a comfort letter to the BIS on July 21 in support of a proposal by major central banks to renew their “secondary line of reserves” (swap lines) to Mexico. That letter is in IMF archives, OMD/AI, “Surveillance of Mexico” Box 2, Accession 2007-043.

The proximate source of this worry was the external current account, which was in deficit by about 7 percent of GDP.<sup>11</sup> Although the government was running a small surplus in its own accounts, it had to keep rolling over a large stock of short-term securities, a rising portion of which was held by nonresidents. After the Colosio assassination, investors—both domestic and foreign—became wary of holding peso assets. The government countered by increasingly replacing peso-denominated treasury bills (*cetes*) with bills that were payable in pesos but denominated in U.S. dollars (*tesobonos*). Because holders of tesobonos were protected against a devaluation, these bills could be sold at a lower interest rate than *cetes*. The interest rate spread between the two instruments doubled (to 8.7 percentage points) after the Colosio assassination. In response, from end-February to end-November 1994, the government raised the portion of tesobonos in outstanding debt from 6 percent to 50 percent.<sup>12</sup> Although this shift dramatically lowered the government's borrowing cost, it created a large unhedged foreign currency position for the government and thereby raised the potential cost of a devaluation.

A window of opportunity to avoid an exchange crisis opened in August, when Ernesto Zedillo Ponce de León (Colosio's replacement on the ballot) won the presidential election, widely regarded as the cleanest and fairest in Mexican history. Financial markets responded favorably to the prospect of a Zedillo presidency, and the Salinas government could have taken advantage of the calm to engineer a devaluation by adjusting the crawling band. The main advocate for devaluation within the administration was the deputy finance minister, Guillermo Ortiz Martínez, but several other senior officials and some of Zedillo's top advisors were opposed. Ortiz's view was bolstered by an independent study of Mexico's exchange rate policy that had been commissioned secretly by Colosio and then submitted to Zedillo. The paper, prepared by two foreign economists—Sweder van Wijnbergen and Nissan Liviatan—and completed in September, supported the view that the currency needed to be depreciated, preferably by floating the peso. Aspe, Mancera, and ultimately Zedillo all rejected the argument or at least indicated that they preferred to wait until after the new government took office on December 1. They viewed a stable exchange rate as an essential

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<sup>11</sup>For the IMF staff's analysis of the causes of the crisis and the role of the external current account deficit, see Savastano, Roldós, and Santaella (1995). For academic views, see Calvo and Mendoza (1996) and Lustig (1995). For a contrasting analysis by senior officials of the Bank of Mexico, see Gil-Díaz and Carstens (1996), which emphasizes the role of political shocks in addition to financial factors as contributors to the crisis.

<sup>12</sup>Mexico began issuing tesobonos in July 1989, but the amounts outstanding remained small until after the Colosio assassination. On Mexico's debt restructuring in 1994, see Folkerts-Landau and Ito (1995), pp. 55–56.

anchor for the health of the economy, and they believed that their macroeconomic policies were strong enough to sustain it.<sup>13</sup>

The postelection calm was shattered on September 28, with the assassination of José Francisco Ruiz Massieu, the secretary general of the Partido Revolucionario Institucional (PRI), the political party of both Salinas and Zedillo. Remarkably, this second political killing of the year came just one day before Aspe's triumphal speech in Madrid, described in the introduction to this chapter. A few days later, the IMF staff met with the Mexican delegation to the IMF/World Bank Annual Meetings in Madrid and again accepted the glowing official account of economic developments. In a move that Camdessus would later realize was a major mistake for the IMF, both sides agreed that the next Article IV discussions, previously scheduled for December, could safely be postponed by a month or two to give the Zedillo administration time to settle into the job.<sup>14</sup>

By mid-November, allegations that Raul Salinas, brother of the president, was responsible for the killing of Ruíz were gaining enough traction to induce deeper worries about Mexico's political and economic stability.<sup>15</sup> When the U.S. Federal Open Market Committee continued to raise short-term interest rates, capital outflows from Mexico rose sharply. In response, Salinas, Zedillo, and their top economic advisors gathered at Salinas's home on the weekend of November 19–20 to consider—for one last time before the hand over of presidential power—whether to devalue the peso. By this time, Zedillo realized that devaluation was inevitable, and Salinas indicated he was prepared to take responsibility for it if it occurred right away. After many hours of discussion, however, Aspe's firm opposition still prevailed. No action was taken, but Zedillo issued a public statement of support for Salinas's and Aspe's policies, which induced a strengthening of the currency during the last 10 days of the Salinas regime.<sup>16</sup>

Throughout this period of financial turmoil, the IMF had no current information on Mexico's foreign exchange reserves and had to rely on the most recent published

<sup>13</sup>For an indirect reference to the secret Wijnbergen-Liviatan study, see Salinas (2002), p. 1116. The internal rift on this issue was described contemporaneously in the *Financial Times* (September 13, 1994, p. 4): "The possibility of a change in exchange rate policy has been heightened by a reported division between . . . Aspe . . . and the central bank [i.e., Mancera], on the one hand, and . . . Ortiz on the other. The former are believed to support a strong currency . . . ; Mr. Ortiz is said to back a faster devaluation of the currency."

<sup>14</sup>Minutes of meeting of Beza and other IMF staff with Aspe and other Mexican officials on October 5, 1994; IMF archives, "L.A.W. Mexico Project 1995," Accession AR 2007-043, Box 2. For Camdessus's reassessment of the postponement decision (which he misremembered as having been made in mid-November, not early October), see minutes of EBM/95/33 (April 4, 1995), p. 3.

<sup>15</sup>In 1999, Raul Salinas was found guilty of ordering the killing of Ruíz. His conviction was overturned on appeal in 2005.

<sup>16</sup>Aspe's account of this meeting was published in the *Wall Street Journal* (July 14, 1995), p. A13. For Salinas's account, see Salinas (2002), pp. 1091–93.

data.<sup>17</sup> Those figures, for mid-October, showed no significant worsening since April. The staff knew that the Mexican government was relying increasingly on issuing tesobonos, but its information on the magnitude was based primarily on published accounts and thus was a few months out of date. In any case, despite the obvious risks, selling tesobonos seemed to be a rational financial strategy as long as the reserve position was comfortable. Neither the staff nor the Executive Board saw any particular reason to raise alarms about Mexico's financial prospects.

On November 30, it happened that the Executive Board met to discuss a proposal to establish a new lending facility. This "short-term financing facility" would have offered quick-disbursing loans to countries with strong economic policies that were facing adverse conditions for reasons outside their control. To most everyone involved, Mexico seemed to be the shining example of a qualifying country. Even those Directors who opposed creating the new facility expressed admiration for Mexico's economic management. As Willy Kiekens (Belgium) noted at this meeting, "of the three cases presented by the staff, only the Mexican case is a strong one." Stefan Schoenberg (Germany) observed that "the balance of payments pressures" on Mexico (and on two other countries) had "subsided quickly once policy adjustments were made."<sup>18</sup>

The conclusion that the IMF was unaware of the precarious position of Mexico's finances in the weeks and months preceding the crisis is hard to avoid.<sup>19</sup> Several reasons have been advanced for this display of innocence, some unique to the particular case and some deriving more generally from the culture of the institution. Certainly the Mexican authorities had star quality and had all the confidence-instilling appearance of being in firm control. Thus, they could provide limited information about their foreign exchange reserves without being subject to strong criticism. As a new member of NAFTA and the OECD, they were more inclined to share information with the U.S. Treasury than with the IMF. More generally, Fund surveillance suffered at the time from being intermittent. The last full-scale staff mission to Mexico had occurred in December 1993. A small staff visit in May 1994, a brief meeting in Madrid in October, and occasional telephone conversations were not sufficient to keep the staff

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<sup>17</sup>The staff raised concerns about the quality of Mexico's monetary statistics in the course of the December 1993 Article IV discussions. The initial draft of the staff report for that mission noted that although Mexico's monetary data were "generally satisfactory," their "quality and timeliness . . . seem to have deteriorated somewhat." When the authorities objected to this description, the latter phrase was deleted; "Mexico—Staff Report for the 1993 Article IV Consultation," EBS/94/31 (February 1, 1994), p. 10; and EBS/94/31, Correction 1 (February 22, 1994). The May 1994 staff visit did not raise any questions in this area.

<sup>18</sup>See "Short-Term Financing Facility," EBS/94/193 (September 26, 1994), and minutes of EBM/94/104 (November 30, 1994). The quotations are from the minutes, pp. 21 (Kiekens) and 30 (Schoenberg). The other two countries cited in the staff report as possible candidates were Sweden and the Czech Republic. For more on this proposal, see "Emergency Financing and the Supplemental Reserve Facility" in Chapter 5 of this volume.

<sup>19</sup>Several years later, Fischer (2001) admitted that the "IMF and investors simply did not know what was happening to Mexico's reserves in the lead-up to the crisis."



well informed. A great deal of information could be gleaned from the actions and writings of private investors and analysts, but that information was not systematically scrutinized by the staff working on Mexico. Eventually, the Fund absorbed the lessons from these failings, but not in time to help with this case, the first crisis of its kind.<sup>20</sup>

## The Peso Crisis Hits

The crisis began not with a financial shock, but with an outbreak of political chaos. On Monday, December 19, 1994, the Zapatista National Liberation Army came out of hiding in Chiapas and exerted temporary control over a number of towns throughout the state. The Zapatista movement had been building up steam since its original attacks in January, and this sudden success—brief though it would turn out to be—caused both domestic and international investors to reconsider the risk that the new government in Mexico City would be unable to control the economy while fighting an insurgency in the south. Stock and bond prices fell sharply, and the exchange rate (then 3.46 pesos per U.S. dollar) looked more vulnerable than ever. The effects of the Chiapas uprising alone could have been contained, but this shock climaxed a year of growing unrest and assassinations that had already made the financial situation in Mexico precarious.

The only viable option left to the government was to allow the peso to depreciate more rapidly, either in a free float or through an immediate devaluation and a widening of the band. Unfortunately, the government's ability to act was constrained by its commitments under the Pacto de Solidaridad Económica, generally known simply as the Pacto. This arrangement came about in December 1987, when the government formally agreed with business and labor leaders to devalue the peso, establish a *de facto* crawling peg against the dollar, and support the new exchange regime with a package of fiscal and other policies aimed at sharply reducing price and wage inflation and stabilizing the economy.<sup>21</sup> The Pacto participants renegotiated the specific policy agreements annually, but a consistent feature of the Pacto was that the government promised not to alter the exchange regime without first consulting its business and labor partners. In normal circumstances, this commitment helped maintain labor peace, but in the circumstances of December 1994 it proved to be a disastrous constraint.

Zedillo's finance minister, Jaime Serra Puche, had been in office for only a few weeks, and his previous experience had been primarily in trade rather than finance. (As Salinas's secretary of trade and industry, Serra had presided over the NAFTA

<sup>20</sup>For a detailed examination of the shortcomings in the run-up to the peso crisis, see "Mexico—Report on Fund Surveillance, 1993–94," EBS/95/48 (March 23, 1995).

<sup>21</sup>For a brief summary of the origins of the Pacto in the context of the debt crisis of the 1980s, see Boughton (2001b), pp. 451–52. For overviews of the evolution of the agreement, see Aspe (1993) and Dornbusch and Werner (1994), Appendix A.

negotiations.) Nonetheless, he responded immediately to the financial pressure on December 19 by calling a meeting of the Pacto principals for that evening. When the business and labor officials gathered at the headquarters of the labor ministry in Mexico City, Serra boldly proposed allowing the peso to float, but both groups flatly refused. Eventually, those gathered reached a compromise under which the peso would be devalued by 15 percent the next morning, but everyone present realized that this action might not be enough (see Salinas, 2002, pp. 1102–03).<sup>22</sup>

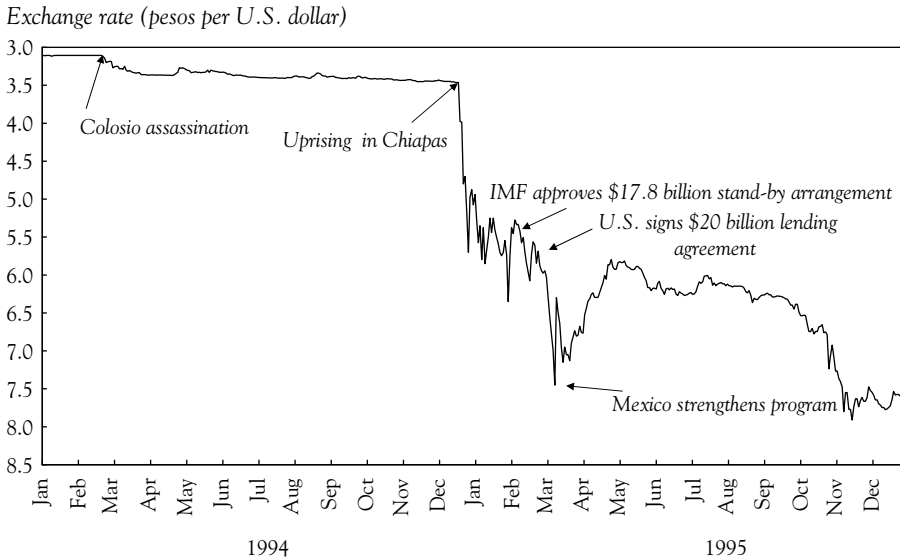
Although no one in the Mexican government seems to have thought it necessary to tell the IMF, their economic team spoke frequently with Shafer and others in the U.S. Treasury and kept them informed as these plans developed. That led to the stunning situation late that night, in which the IMF first learned of the impending devaluation through a casual comment by Shafer to Fischer during a routine telephone conversation (see above, pp. 456–57).

The next morning, Lawrence H. Summers (under secretary for international affairs at the U.S. Treasury) telephoned Fischer and asked him to issue a statement of support for the devaluation. Fischer readily agreed because he believed that Mexico's policies were basically sound except for the obvious need to correct the overvaluation. He telephoned Camdessus, who was vacationing at his family home in the south of France. Fischer then intended to issue a press release, but new developments intervened.

For two days, the Mexican authorities tried desperately to keep the peso within 15 percent of its old level, but they fought a losing battle. Despite a rise in short-term interest rates to 32 percent from 15 percent, the Bank of Mexico continued to lose reserves. (In one week, the loss totaled \$6.4 billion.) Much of the capital outflow apparently derived from Mexican residents sending their money abroad, in all probability led by those who had received early warning of the magnitude of the situation at the Pacto meeting Monday night. By Wednesday afternoon, December 21, Zedillo and Serra had concluded that they would have to float the peso after all. Serra held a second Pacto meeting that evening, and this time no one was able to veto the change.<sup>23</sup>

<sup>22</sup>The specific decision was to lower the floor of the exchange rate band (the depreciation limit) by 15 percent (to 4.0016 pesos per U.S. dollar) and to leave the daily rate of crawl for the widened band unchanged. Because the exchange rate was already at the floor, this action effectively devalued the currency by 15 percent. In addition, the Pacto agreement reached that night included fiscal and credit restraints to be implemented in the coming weeks. The Mexican press communiqué announcing the change was circulated within the Fund as EBD/94/200 (December 21, 1994). For the immediate staff reaction, see memorandum from Claudio Loser to the Acting Managing Director (Fischer), "Mexico—Recent Developments" (Revised), December 20, 1994; IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994."

<sup>23</sup>On the extent and nature of capital outflows, see Folkerts-Landau and Ito (1995), pp. 57–62. On the Pacto meeting, see Salinas (2002), p. 1106. Also see memorandum from Javier Guzmán-Calafell (Advisor to the Executive Director for Mexico) to the Managing Director, "Mexico—Exchange Arrangements," December 22, 1994; IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994."

**Figure 10.1. Mexico: Exchange Rate, 1994–95**

Sources: Bloomberg L.P. and author's notations.

The next day, the peso shot up to 4.8 per dollar, a depreciation of 28 percent from the precrisis level (Figure 10.1).<sup>24</sup>

Fischer called an emergency meeting of the most senior staff for 7:30 Thursday morning to devise a response strategy. To buttress the new policy and to try to prevent a complete collapse of the peso, Mexico was asking the U.S. and Canadian central banks to activate their established swap lines. A normal requirement for doing so would be for the IMF to issue a statement attesting to the soundness of Mexico's economic policies and prospects. Reached again by telephone, Camdessus insisted the Fund could not make such a statement without at least a request from Mexico for a staff visit to assess the situation.

After some initial resistance, the authorities finally agreed to receive a staff visit. Fischer and the staff drafted a statement to be issued immediately and publicly. It took note of Mexico's shift to a "flexible exchange rate regime" and stated that the "actions being adopted by the authorities represent an appropriate policy response to recent market developments" that "will help reinforce the economic recovery that has been

<sup>24</sup>These depreciation percentages are presented in the standard IMF style, as the percentage loss in the value of the domestic currency, measured by the amount of foreign exchange (U.S. dollars) the currency will buy. By this measure, the peso depreciated by 12.8 percent on December 20 and by a cumulative 27.8 percent through December 22. The Mexican authorities used the reciprocal: the percentage increase in the cost of buying foreign exchange. By that measure, the depreciation rates were 14.7 percent and 38.5 percent, respectively.

evident since early 1994 and secure the viability of Mexico's external position."<sup>25</sup> Because Mexico had not asked for any financial help from the IMF, and because the U.S. Treasury seemed willing to take responsibility for whatever help Mexico might need, the IMF—for the moment—could do little more.

In the first two days of the crisis, the Mexican authorities had communicated their intentions only to U.S. Treasury officials, but now they were beginning to reach out to the IMF and to commercial bank creditors. Mancera called Fischer twice on Thursday to ask for the statement of support, while Serra flew to New York to try to calm down bank creditors. The latter effort initially seemed to work, as the peso recovered somewhat on Friday, but the calm did not last.

On Saturday, Christmas Eve, Fischer—who had undergone a long-scheduled surgery on Friday—met again with key staff members at his home to make final plans for the staff visit to Mexico. Claudio M. Loser (Director, Western Hemisphere Department) and a couple of other staff were scheduled to leave for Mexico City for one day of meetings right after Christmas, but in the meantime, Serra and Mancera had both suddenly decided to come to Washington on December 26. That would require postponing Loser's departure by a day or two, but it would give Fischer a chance to clarify in direct talks with the authorities the Fund's expected role.

On Monday, the day after Christmas, normally one of the quietest days of the year in Washington offices, Serra and Mancera spent a long and exhausting day at the Treasury and the Federal Reserve Board explaining their plans and asking for help. U.S. officials were reluctant to make any firm commitments in the absence of a substantial increase in Mexican interest rates to discourage capital outflows, but Mexican officials feared that increasing interest rates would have disastrous effects on the economy. This classic dilemma could not be resolved in a day. The Mexican team finally got to the IMF about 9:30 that evening, where Fischer, Loser, and other staff were waiting. Fischer's entreaties for a stand-by arrangement fell on deaf ears because the Mexican authorities were firmly convinced that they should and could handle the problem bilaterally with the United States. Being forced by circumstance to seek conditional assistance from the IMF was an uncomfortable and embarrassing situation for any government. More specifically, Mexico was a NAFTA participant and a member of the OECD. Having to borrow from the IMF would be a major setback to its reputation as the newest member of the world's advanced economies.

However, Mexico needed to borrow sufficient money from other (non-IMF) sources quickly to stop the free fall of the peso, which on that Boxing Day was trading at about 5.15 pesos to the dollar, down 33 percent from a week earlier. Serra seemed to think it possible, after his meetings with U.S. officials, to cobble together a package of about \$40 billion. Of that, perhaps \$20 billion would come from the United States and Canada in the form of a currency stabilization fund, \$6 billion each from the BIS and from commercial banks, and up to \$2 billion from other

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<sup>25</sup>"IMF Supports Mexico's Exchange Rate Action," NB/94/18 (December 22, 1994).

official creditors. From the Mexican perspective, the IMF needed only to endorse their economic policies.

Fischer had no objection at all to endorsing Mexico's policy program, which looked strong on paper and was backed up by a good track record over the past several years. He was less confident about the country's prospects for getting \$40 billion in official credits without direct financial participation by the IMF. Accordingly, he tried—but failed for the moment—to persuade the officials to ask for a stand-by arrangement. The officials did agree to allow Loser to lead a mission to Mexico—not just an informal staff visit, but a small though full-scale mission—right away, but only on condition that it be kept strictly secret and that it not enter into program negotiations.<sup>26</sup>

When Loser arrived in Mexico City on December 28, he did not feel welcome, and he was uncomfortable with the high level of secrecy surrounding his mission. The authorities made it quite clear that they did not want to discuss policies with the Fund and had no interest in seeking a stand-by arrangement. They rejected a further plea from Fischer to announce that talks were under way. Fischer thought that Mexico would gain credibility by inviting the IMF in, but Mexican officials feared the possibility of a domestic political backlash.

Reinforcing the Mexicans' conviction that they did not need help from the Fund was Summers's continuing view that Mexico was facing a temporary liquidity problem that the United States could handle bilaterally by activating existing swap lines. Summers, who was effectively in charge of international policy at the U.S. Treasury at this time,<sup>27</sup> issued a public statement of support to Mexico on December 29, which gave a brief uptick to the peso and further weakened the case for IMF involvement. Behind the scenes, Andrew Crockett, general manager of the BIS, began soliciting the participation of major central banks in a \$5 billion short-term loan to Mexico to serve as part of an international support package.<sup>28</sup>

The first hint that the stalemate on IMF involvement might be broken came later that day, when Zedillo suddenly named a replacement for Serra as finance minister.

<sup>26</sup>In general, the mandate of a "staff visit" is simply to gather information. A "mission" is intended more as a two-way dialogue in which the staff also may offer policy advice on behalf of the Fund.

<sup>27</sup>Robert E. Rubin had been nominated to replace Lloyd Bentsen as secretary of the Treasury, but he had not yet been confirmed by the U.S. Senate. In the meantime, he had gone on holiday to the Virgin Islands, and Summers was in charge of international affairs; see Rubin and Weisberg (2003), pp. 5–6.

<sup>28</sup>The BIS request was addressed to the central banks of the member countries of the Group of Ten (G10), except for the United States and Canada because those two central banks were providing financial support bilaterally, plus Spain. Although Mexico had not yet asked for a stand-by arrangement with the IMF, Crockett's proposal was contingent on the successful negotiation of such an arrangement, and the BIS loan was intended primarily to serve as a bridge to IMF financing; see letter from Crockett to William J. McDonough (president of the Federal Reserve Bank of New York), December 30, 1994; IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994."

In his stead, he chose Ortiz, who—as a former member of the IMF Executive Board (1984–88)—was more open to the idea of IMF financial support than his predecessors had been. Just three days later, on New Year’s Day, Ortiz called Loser in Washington to say that he had discussed with Zedillo the possibility of having a Fund-supported program. They had agreed to consider it if the Fund was willing to accept the policies that Zedillo was about to announce and not require them to take additional measures. Zedillo would be making a speech the next day (Monday, January 2) announcing the new policies. It would then be up to the Fund to decide whether to concur.

Another day was lost while Zedillo’s team negotiated details of their adjustment program with their Pacto partners. The president then announced the new program on television on January 3, but with no mention of any request for IMF assistance.<sup>29</sup> Fischer then came under pressure from both the U.S. and the Mexican authorities to give the Fund’s blessing to the Zedillo speech, even though he still had no firm indication of what role the Fund might be asked to play. To cover all possibilities, Fischer issued a press release that ended with some convoluted and ambiguous prose. After describing the program that Zedillo had just announced, based on a significant tightening of monetary and fiscal policies, he concluded: “These policies provide a solid basis for discussions on an agreement that could be supported by the use of IMF resources, at the request of the Mexican authorities.”<sup>30</sup> No such request had been made, but Fischer had inferred from conversations with Ortiz and from Loser’s mission report that one might be imminent. Ortiz also hoped that the public show of support from Fischer might improve investor sentiment and obviate the need for the Fund’s financial assistance.

The IMF now entered full crisis mode. It was far from clear that Mexico would have either strong enough economic policies or sufficient external financing to avoid a default or the imposition of exchange controls, either of which could have disastrous consequences that would reach far beyond the country’s borders. Camdessus returned from vacation on January 4 and met informally with Executive Directors. He also spoke by telephone with Ortiz, using what he would later describe as “very strong language” to explain to him why he should seek help from the Fund to stabilize the currency and the economy. From this point on, high-level meetings on Mexico would take place at the Fund almost daily until well into February.

Ortiz flew to New York on January 5, where he met with several hundred bank creditors, investors, and rating agency representatives in the ballroom of the Pierre

<sup>29</sup>The only new element of external financing was the creation of an \$18 billion exchange stabilization fund, to be financed by activating and enlarging (from \$6 billion to \$10 billion) the swap lines with the U.S. and Canadian monetary authorities under the terms of the April 1994 North American Framework Agreement, by drawing on the anticipated \$5 billion loan from the BIS, and by borrowing \$3 billion from a syndicate of commercial banks. (The last element did not materialize.)

<sup>30</sup>“IMF Management Welcomes Mexico’s Comprehensive Economic Program,” NB/95/2 (January 3, 1995).

Hotel. After he explained the steps the government was taking to reduce the external deficit, he found the atmosphere in the room was one of calm acceptance. More important, he was relieved to see the peso rising in value in the hours after the meeting. The next morning, however, while Ortiz and his aides were en route home in a Mexican Air Force plane, he learned the peso was falling again. Fearing that the currency was still under attack, he ordered the pilot to take him to Washington instead. There, he met with Camdessus over lunch, and they announced finally that Mexico was seeking financial assistance from the IMF. More than two weeks had passed since the onset of the crisis, during which the peso had depreciated by 40 percent against the dollar and the flight from tesobonos and other Mexican securities had continued unabated. The fear of a unilateral restructuring and the resulting outflows had not yet subsided, but at least a plan was in place for coping with the crisis.

## What Role for the IMF?

On a first reading, the story up to this point may suggest that the IMF's senior management team was seeking to inject the Fund into the crisis resolution process to give themselves and the institution an important role. The essence of the matter went much deeper. They believed that IMF participation was vital for the workout to succeed, and in retrospect they were correct. Three reasons stand out.

First, no official creditor—including the United States—was willing to advance its own money bilaterally without the IMF's written assurance that Mexico was implementing a sound economic policy program. Camdessus had been providing “comfort letters” to U.S. and other official agencies throughout 1994, but once the crisis erupted in December, he could not continue to do so in good faith without the Fund's direct participation. In practice, that meant that Mexico had to enter into a stand-by arrangement, with all the attendant conditionality.

Second, even with the Fund's seal of approval for Mexico's policies, the amount of money that might be needed to stop a speculative attack on the peso likely exceeded the means of bilateral creditors, or of the IMF and other multilateral agencies acting as a group. By the time Ortiz arrived in Washington on January 6, his staff had calculated that US\$40 billion to US\$50 billion in external debt was coming due in the near term. Because the net foreign exchange reserves of the Bank of Mexico were close to zero, most of the debt would have to be rolled over voluntarily (which was very unlikely), or official creditors would have to guarantee the debt or supplement Mexico's reserves (which would require a very large commitment), or Mexico would have to default on its debt (which everyone involved considered highly undesirable). Concerted multilateral action—which would be difficult or impossible without coordination by the IMF—was the only viable course.

Third, in addition to these concrete issues, the IMF also provided a calming influence. The fear that this situation would spin out of control and end in a Mexican default

despite all best efforts had thrown both Mexican and U.S. officials into a serious panic. Rubin, who took over as secretary of the U.S. Treasury on January 10, has written of his fear of a “meltdown” that “could deal an enormous setback to the spread of market-based economic reforms and globalization” throughout the world. In meetings with Rubin, Ortiz looked “ashen and exhausted.” At the U.S. Treasury, Rubin, Summers, and Shafer all felt “distressed,” “worried,” and under enormous pressure. Before the crisis ended, Summers offered his resignation if the rescue should fail (Rubin and Weisberg, 2003, pp. 5 and 26–31). Camdessus later recalled hearing a trembling in Rubin’s voice during some of their frequent telephone conversations about Mexico. In contrast, Camdessus had an incurable confidence that the recovery effort could not possibly fail, and his optimism was infectious.

For all these reasons, by the time of Ortiz’s stopover in Washington on Friday, January 6, both he and Summers had determined independently to turn to the IMF for help. That weekend, Fischer and Summers met and decided that an official package of loans totaling just \$25 billion (about half of the amount that would soon be falling due) should instill sufficient confidence to get private creditors to roll over the rest voluntarily. For the next few days, this figure became the target for the financing package being assembled. The seed money, but only the seeds, would come from the IMF. It looked unlikely that the Fund could lend Mexico more than 100 percent of its quota (about \$2.5 billion) in 1995, and no other country was expected to offer very much, so the bulk of the \$25 billion would have to come from elsewhere.

The next step was for Loser and a larger staff team to return to Mexico City to negotiate terms for a stand-by arrangement. They arrived on January 10, hoping to complete the talks in no more than a week. After all, Mexico had already floated the currency and had announced a program that went a long way toward correcting the problems that had led to the crisis. The main issue to be resolved concerned fiscal policy. Although lax fiscal policy was not a problem in Mexico, the staff believed that a temporary further tightening was needed to offset the loss of external financing and to restore confidence. Loser’s brief called for him to ask for additional fiscal measures totaling 2 percent of GDP. The authorities were certain to resist this request, but Loser had to try to get as much as he could.<sup>31</sup>

On the same day the mission started, Fischer spoke by telephone with Zedillo’s chief of staff, Luis Téllez (another of Fischer’s former MIT students). Fischer was concerned that none of the principal participants in the mission discussions—himself included—had ever handled this kind of international crisis before. He also sensed that the Mexican authorities were in a panic and unsure of what to do. It would be beneficial, he suggested, if Camdessus—who had helped manage any number of financial crises,

<sup>31</sup>Memorandum from Loser to the Managing Director, “Mexico—Briefing for Mission” (January 10, 1995); IMF archives, OMD-AD (Mr. Narvekar’s files), “Mexico Correspondence Jan. 1995,” Box 9489, Accession 1996-0266-0001.



both as a French official and as Managing Director—got more personally involved. Téllez agreed, and the next morning (January 11) a Mexican presidential jet picked up Camdessus in Washington and flew him to Mexico City to meet with Zedillo. To avoid generating rumors, the mission was kept strictly secret, even from IMF staff at headquarters, and Camdessus returned home late that same night without having been seen.

In his meeting with Zedillo, Camdessus stressed that a successful resolution to the crisis was essential both for Mexico and for the international community. Mexico would have to make an extra effort to strengthen its own finances. If the authorities did, he was prepared to make an “extraordinary effort” to get additional financing, both in the form of higher access to IMF money (possibly going well beyond the \$2.5 billion that was currently being discussed) and more widely.<sup>32</sup> Despite this promising start, and even with Camdessus putting his personal prestige on the line, negotiations between Loser and Ortiz would drag on for more than two weeks.

One reason for the lengthy meetings was simply the difficulty of finding a compromise policy program on which both sides could agree. Ortiz not only wanted to slow down and reduce the magnitude of the required fiscal adjustment, he also wanted some flexibility to handle developments beyond his control. Mexico had pioneered the use of contingency clauses in a Fund arrangement in 1986,<sup>33</sup> and he insisted on repeating the success of that experiment. An announcement by the U.S. Treasury that it would ask the U.S. Congress to authorize a large-scale program of loan guarantees for Mexico strengthened his position. On January 17, Ortiz went again to Washington, where he secured from Camdessus a promise for more flexibility. In the end, the Fund agreed that the base level of fiscal policy could be relatively accommodative, and the authorities agreed to tighten further if demand pressures worsened.

A second reason for the delay was that it was not immediately certain that Camdessus could deliver on his promise of exceptional access to IMF resources. To make the case to the Fund’s Executive Directors, he had to convince them that resolving the Mexican crisis was important not just for Mexico (and for the United States) but for the international financial system and for the world economy. Fischer first expressed concerns about contagion on January 3, when he asked the staff to prepare a study of the risks to other developing countries. The following week, Jack Boorman (Director, Policy Development and Review Department, or PDR) supported this view in stark terms, writing privately to the Managing Director that the “risk of contagion from self-fulfilling investor pessimism constitutes a systemic risk that underlines the need for

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<sup>32</sup>Camdessus informed the Executive Board on January 12, in restricted session. On February 2, during an interview on U.S. television, he revealed publicly that he had made this trip.

<sup>33</sup>That episode is described in Boughton (2001b), pp. 440–53.

extraordinary responses from the Mexican authorities, from the Fund, and from the international financial community more generally.”<sup>34</sup>

Camdessus acted on this advice and made a strong case based on three risks. First, the pullout of investment funds from Mexico could spread to other countries, in what Boorman had called “self-fulfilling investor pessimism.” That pullout could be aggravated by sympathetic declines in stock markets around the world. Second, because Mexico had been extolled as the star performer in profiting from an open and liberal policy regime, its economic collapse could discredit the whole silent revolution in development policy and set back the course of financial globalization. Third, even beyond the developing countries, world economic growth could decline as a result of falling production and shrinking markets.<sup>35</sup>

Camdessus’s arguments left the Fund’s European Executive Directors distinctly unimpressed. When he first made his case to the Board in an informal and restricted meeting on January 12, the Europeans offered two counterarguments. First, most of them were skeptical about the risk of contagion. Even if some investors pulled out of other countries in the region, they reasoned, the aggregate effect was likely to be small. In this view, they drew some support from the Fund’s research staff, who calculated at the time that the effects of the Mexican crisis on economic growth in the United States and in Latin America generally (with the notable exception of Argentina) were likely to be modest and fairly quickly reversed (see IMF, 1995, pp. 11 and 36–37). Second, some Directors, led by Stefan Schoenberg (Germany), argued that it was not proper for the IMF to lend to one country to avoid an adverse effect on another. If there was a risk to, say, Argentina, then the Fund should be lending to Argentina, not Mexico. On that point, most of the senior staff strongly disagreed. Faced with a risk to the international financial system, they reasoned, the IMF should do whatever it could to minimize that risk. In one staff meeting on the crisis, a senior department head scoffed that the German authorities would not acknowledge a systemic risk unless an asteroid was heading toward earth with the potential to wipe out two-thirds of mankind. Clearly, nerves were on edge.

Both of these issues were tentatively resolved on January 26. Although several Executive Directors still opposed granting Mexico exceptional access, Camdessus gave Loser the go-ahead to finalize a request from Mexico for an 18-month stand-by arrangement for 300 percent of quota (SDR 5.3 billion, or about \$7.8 billion). Ortiz and Mancera then signed a Letter of Intent that included the contingency provisions requested by Mexico. A Board meeting was scheduled for February 1 to consider the request.

<sup>34</sup>Memorandum from Boorman to the Managing Director, “Mexico” (January 12, 1995); IMF archives, OMD-AD (Mr. Narvekar’s files), Box 9489, Accession 1996-0266-0001, “Mexico Correspondence Jan. 1995.”

<sup>35</sup>Memorandum from Alexander Mountford (Advisor in the Secretary’s Department) to Leo Van Houtven (Secretary of the Fund), “Mexico: Some Developments” (January 13, 1995); IMF archives, Historian’s files.

## How Much to Lend?

Meanwhile, with capital markets still showing no eagerness to keep their money in Mexico, the early-January target of a \$25 billion financing package was looking much less adequate. In fact, as early as January 12, U.S. Senator Alfonse M. D'Amato (chairman of the Senate Committee on Banking, Housing, and Urban Affairs) suggested that a package of \$40 billion (approximately the amount of Mexico's external very short-term debt) would be much more effective at discouraging a speculative attack (see Rubin and Weisberg, 2003, p. 14).<sup>36</sup> Once that figure entered into the public discourse, it became a minimum from which no retreat was possible. In Alan Greenspan's words, U.S. intervention had to be "massive and fast." Summers likened it to the Colin Powell doctrine of using overwhelming force from the outset of a military engagement.<sup>37</sup> Any retreat from an announced figure would raise doubts about the commitment to succeed.

The problem with providing \$40 billion to bolster Mexico's reserves was that if the move failed to restore confidence swiftly, it would enable all holders of tesobonos to get repaid in full at the undepreciated peso-dollar exchange rate. That could create huge moral hazard problems later on, but the alternative—a default on the debt, possibly accompanied by an economic meltdown—could create much greater problems far more quickly. Regardless of the longer-term consequences, most of the official participants (aside from a large portion of European monetary authorities) decided to focus on solving the crisis at hand.

For much of the second half of January, it looked as if official support for Mexico might total as much as \$55 billion. In addition to the proposed \$7.8 billion IMF standby arrangement, the Bank of Canada was offering \$1.2 billion in short-term financing through a swap arrangement under the terms of the April 1994 North American Framework Agreement, the BIS was prepared to lend \$5 billion to the Bank of Mexico, and the World Bank (specifically, the International Bank for Reconstruction and Development, or IBRD) and the Inter-American Development Bank (IDB) were expected to lend amounts that might total about \$1 billion. The centerpiece, however, was to be the provision of \$40 billion in loan guarantees from the U.S. government. As announced by the U.S. Treasury on January 12, the United States would guarantee the principal on that amount of private sector loans to the Mexican government, in return for which Mexico would pay substantial fees: so large as to cover the anticipated costs and to give Mexico an incentive to exit from the program as early as possible.

<sup>36</sup>Senator D'Amato later became an outspoken critic of the U.S. rescue effort, writing in March 1995 that "this bailout will go down as one of the President's biggest blunders. . . . We should not bail out a mismanaged foreign government" (D'Amato, 1995, p. 24).

<sup>37</sup>Greenspan (2007), pp. 156–60, provides an account of the U.S. response to the Mexican crisis. Summers frequently used the "Powell doctrine" analogy in remarks on the Treasury's response.

The Clinton administration was optimistic that Congress would approve the guarantees, because the congressional leadership team—though dominated by the opposition Republican Party—unanimously supported the proposal. On January 25, however, a hearing by the House Banking Committee went badly when several committee members strongly attacked Rubin for, in their view, trying to bail out Wall Street investors with taxpayers' money. The guarantee plan quickly unraveled at the same time that the IMF was preparing to consider Mexico's request for a stand-by arrangement.

On Saturday (January 28), Ortiz met with Rubin at the Treasury building in Washington and told him that Mexico's financial situation was continuing to deteriorate. The Mexican government would be unable to meet the payments coming due in the next week unless it got immediate help from the United States. President Clinton, Rubin, and other senior U.S. officials then met at the White House to consider alternatives if Congress were to reject the guarantee proposal. The most viable alternative appeared to be for the U.S. Treasury to lend directly to the Mexican government using the resources of the Exchange Stabilization Fund (ESF).<sup>38</sup> That scheme, which would not require congressional approval, had been suggested earlier in the month by Robert Bennett, a Republican Senator with close ties to the Senate leadership, so it was reasonable for the administration to think that it would be well received.<sup>39</sup>

On Sunday, Summers met with his Group of Seven (G7) finance deputy colleagues in Paris. He told them vaguely that alternatives were under consideration, and he was understood to have promised to consult with them before deciding on one. When events quickly moved ahead of him the next day, the lack of consultation would become a major source of irritation to the European deputies.

Throughout the day on Monday, January 30, as the peso fell to 6.35 against the dollar (a 45 percent depreciation since the start of the crisis), the possible collapse of U.S. financing for Mexico dominated discussion at the IMF. In a series of meetings with staff and with Executive Directors from creditor countries, Camdessus explored ways of getting other countries to contribute bilateral financing. Lissakers assured him she was confident the U.S. Congress would approve the \$40 billion in guarantees, but Fischer—who returned to Washington in the afternoon from the World Economic Forum in Davos, Switzerland—reported that congressmen attending the Davos meetings had told him the plan was almost certain to die. By the end of the day, however, none of this discussion had produced any concrete proposals.

<sup>38</sup>The United States had previously lent ESF monies to Mexico on several occasions, beginning in 1936 and including a loan that was part of the initial package to deal with the 1982 debt crisis; see Bordo and Schwartz (2001) and Boughton (2001b), pp. 292–93. For the history of the ESF, see Schwartz (1997) and Henning (1999).

<sup>39</sup>Ortiz's plea is described in Rubin and Weisberg (2003), p. 22; and Clinton (2004), p. 643. For an account of the meetings at the White House and in Paris (see next paragraph), see Graham and others (1995), p. 4. Clinton (2004) attributes the idea of using the ESF to Rubin and Summers, and Greenspan (2007) p. 159, attributes it to Rubin; but Rubin and Weisberg (2003) p. 21, credit Bennett.

That evening, the U.S. government was forced to abandon the guarantee plan when the Speaker of the House of Representatives, Newt Gingrich (Republican of Georgia), telephoned the White House to say that he was pulling the proposal rather than face certain defeat in a floor vote. Clinton's economic team—including Summers, who had rushed back from Paris—met throughout the evening to come up with a single viable alternative. The president himself joined them about 11:00 p.m., and around midnight he accepted their proposal to lend Mexico \$20 billion through the U.S. ESF. That was only half the size of the previously announced plan, and it was unlikely to cover Mexico's needs for long, but it was all that could safely be spared from the Treasury's funds.

Now it was up to the IMF to react. At one o'clock Tuesday morning (January 31), Summers telephoned his jet-lagged friend Fischer (who had also just returned from Europe that day) to tell him the bad news. The administration, he reported, planned to announce the ESF plan at 9:00 that morning. Once he fully woke up, Fischer tried to convince him to delay the announcement until they could beef up the package, because the financial markets—already in turmoil on Monday—would certainly attack the peso again as soon as traders knew of the drastic cuts in official support. Summers, however, felt that nothing more could be done. The New York financial markets would open at 9:30 in the morning, and Rubin was scheduled to testify before a congressional committee at 10:00. Delay seemed impossible.

Fischer now was deeply worried that before the day was over, Mexico would be forced to default and impose strict exchange controls, with devastating consequences for the world economy. As he later admitted, he feared that "Western civilization as we knew it was coming to an end" (Blanchard, 2005, p. 253). Even so, he was loathe to wake his boss at that hour. After a mostly sleepless night, he finally called Camdessus a few minutes before 6:00 a.m. As usual, Camdessus reacted calmly. We are now in a real crisis, he told Fischer, and in a crisis the first rule is not to panic. Camdessus then called his personal assistant, Ruth Saunders, and asked her to call his top advisors immediately for a meeting in his office at 7:30.

By the time Camdessus and Fischer arrived at the Fund, shortly before 7:00 a.m., the Managing Director had devised a bold plan to restore the package close to the \$50 billion magnitude that financial markets had come to expect. First, he would ask the Executive Board to increase the size of the stand-by arrangement from \$7.8 billion to \$17.8 billion. A financial commitment of this magnitude would be completely without precedent and far beyond any operation previously attempted by the IMF, but Camdessus was convinced that the circumstances warranted it.<sup>40</sup> Second, he would ask the Board to approve disbursing all the original \$7.8 billion immediately, rather than in the usual tranches over the life of the arrangement. Separately, Edwin M. Truman (director of the international finance division at the U.S. Federal Reserve Board) had already (around

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<sup>40</sup>The largest commitment by the IMF up to this time was the 1981 extended arrangement with India, totaling \$5.8 billion (SDR 5.0 billion).

1:00 a.m.) called Andrew Crockett (managing director of the BIS) to ask him to double the BIS commitment from \$5 billion to \$10 billion. Together with the commitments from Canada and the United States, that would enable Camdessus and Clinton to announce a new package that morning that was not much smaller than the old one.

At 7:00 a.m., Camdessus was on the telephone with Rubin, with Fischer and Summers listening in. Camdessus, in what Rubin would later describe as “a moment of daring unusual even for him” (Rubin and Weisberg, 2003, p. 23), explained that he planned to ask the Board to approve the much larger amount later in the morning. When Rubin asked him incredulously if he could really deliver that large a loan, Camdessus replied that the Board would have to approve it if they wanted him to stay as Managing Director. All that he asked was that any lending agreement between the U.S. Treasury and Mexico be written so as to not to conflict with IMF conditionality and so as to respect the Fund’s implicit preferred-creditor status.

Next, Camdessus met with his deputies and a few key department heads at 7:30. To get the additional \$10 billion without straining the Fund’s own liquid assets excessively, Camdessus tabled an unusual and seemingly bizarre proposal that became known as “\$10 billion – X.”<sup>41</sup> He would personally try to persuade countries that were not members of the G10 (because the G10 members were already contributing through their participation in the BIS) to lend Mexico up to \$10 billion to fund its exchange stabilization fund. The IMF would still—in principle—augment its own arrangement by \$10 billion, but only to the extent that the solicitation effort fell short.

Boorman and Fischer tried to argue that it would be better to present the request as a positive challenge, in which the IMF would raise its commitment by \$5 billion only if non-G10 countries would also contribute \$5 billion, but Camdessus insisted on his 10 – X proposal. Part of his reasoning was that he believed Mexico did not need an extra \$10 billion for the three years before they would have to start repaying the loan from the IMF. All they needed was to have a large pile of money available for a short period until the crisis passed. The 5 + 5 alternative would take some time to complete and thus would not satisfy Mexico’s immediate needs.

The sun was up now, and time was running out before the New York financial markets would open for the day. Normally the Executive Board meets at 10:00 a.m. and only on Monday, Wednesday, and Friday each week, but for this emergency Camdessus asked Directors to meet at 9:00 on this Tuesday morning in restricted session. When he sketched out his request, some Directors reacted bitterly, led by Huw Evans (United Kingdom) and Schoenberg. It appeared to them that the Managing Director had effectively committed the Fund to this course of action after discussions with the U.S. authorities but without any consultation with the rest of the Executive Board. In reply,

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<sup>41</sup>Camdessus also briefly considered asking the G10 member countries to approve activation of the General Arrangements to Borrow (GAB), but that idea was rejected during this meeting on the grounds that it would require lengthy negotiations and that European skepticism made the outcome uncertain.

Camdessus asked if anyone thought he had any real choice, and he stressed he had made no promises either to Mexico or to the United States, except to bring this request to the Board for consideration. With that, no one objected further to Camdessus's intention to make a public announcement at once, subject to formal consideration of the stand-by arrangement by the Board at their regular meeting the next day.<sup>42</sup>

While this meeting was under way, Clinton was meeting with the congressional leadership team at the White House to secure their support for the revised plan. Rubin managed to get his congressional testimony delayed so that Clinton could announce the new plan himself at 11:15. The IMF Board meeting was adjourned a few minutes after 10:00, and in an extraordinary bit of synchrony, the U.S. president and the IMF issued their announcements at the same time.<sup>43</sup> Unfortunately, the wording of Clinton's statement seemed to suggest that he had asked the IMF to augment its lending to offset the diminishment of the U.S. contribution. ("I have worked with other countries to prepare a new package. As proposed now, it will consist of a \$20 billion share from the [ESF] . . . ; \$17.5 billion [sic] from the International Monetary Fund; and . . . \$10 billion from the [BIS].")<sup>44</sup> This misleading implication that the increase in IMF lending was a U.S. initiative served only to heighten the already simmering resentments in European capitals.

The IMF Executive Board approved the arrangement the next day, February 1, but only after a very long and contentious series of meetings. To give Directors time to seek advice from their national authorities, Camdessus scheduled the Board meeting for the afternoon. When the revised staff report was finally circulated to Directors only at midday, he was forced to postpone the meeting to the evening. (Normally the Board requires a three-week circulation period for such papers.) He spent the day trying to shore up support, while the staff worked to define the terms on which they could ask non-G10 countries to participate in the financing.

The only opposition to the proposed arrangement was coming from western Europe. The hostility of many European officials arose partly because they thought the financial package was excessively large and had the potential to weaken the security of the Fund's financial resources, and partly because they thought it posed a serious moral hazard for private sector creditors. More viscerally, it arose because they felt the deal had been cooked up between the Managing Director and the U.S. authorities without

<sup>42</sup>See minutes of EBM/95/10 (January 31, 1995); additional information is from interviews.

<sup>43</sup>The BIS did not issue a press release at this time. Its announcement was not made until February 13, following the formal approval of the facilities by the BIS's governing board.

<sup>44</sup>Speech to the National Governors' Association at the J.W. Marriott Hotel in Washington, DC (January 31, 1995). The misimpression was compounded that afternoon, when Rubin told a press conference that "through the extraordinary good work of Under Secretary Larry Summers last night, the IMF increased its participation." For the transcripts, see the website of the William J. Clinton Presidential Library (<http://www.clintonlibrary.gov/>). The IMF announcement was released with the headline "Camdessus to Recommend that IMF Commit an Additional \$10 Billion for Mexico, Raising its Total Commitment to \$17.8 Billion," NB/95/5 (January 31, 1995); accessed at <http://www.imf.org/external/np/sec/nb/1995/nb9505.htm>.



The Mexican rescue team at the IMF, 7:30 a.m., January 31: (from left) Jack Boorman, Claudio Loser, Stanley Fischer, Michel Camdessus, Shailendra Anjaria (Director, External Relations Department), Hernan Puentes (Chief Information Officer), and Ruth Saunders. (IMF photo)

broader consultation. Although in fact Camdessus had devised the initiative on his own with no prior consultation with anyone in the U.S. administration, it looked otherwise to many observers, and Camdessus never was able to convince some European officials to the contrary. The German authorities were especially upset, and not only at the Managing Director. They also believed that Summers should have consulted with them before abandoning the \$40 billion guarantee plan and thus effectively forcing the IMF to take up the slack. They instructed Schoenberg to abstain in protest. That got Summers worried because he feared that a split within the G7 might upset the financial markets and undo the benefits of the IMF's support. The G7 finance deputies conferred through a protracted conference call while the Executive Board was in session, but they failed to reach a consensus.

When the Board meeting finally adjourned at 11:30 p.m., seven European chairs—representing approximately 32 percent of the voting power—appeared to be opposed to the stand-by arrangement. Subsequently, five of those asked to be recorded formally as abstaining from the Board decision. Because approval required only a simple majority of votes cast, this protest had no effect on the outcome.<sup>45</sup> It did, however, put the

<sup>45</sup>While the meeting was in progress, confusion arose as to whether approval of the exceptional financing—which also in this case required amending the Fund's currency budget—might require a 70 percent majority of the voting power. It did not, but the possibility added to the tension as the long night progressed.



Managing Director on notice that a sizeable group of shareholders wanted to keep him on a short leash and wanted to ensure that proper procedures were followed if another such crisis should occur. Camdessus, furious at what he considered to be pointless and even hypocritical objections, called the rebels to his office the next day for a meeting. One participant recalled afterward that Camdessus appeared “to have adrenalin coming out of his ears,” but he failed to convince anyone to withdraw the abstention.<sup>46</sup>

The European protest in the Executive Board was directed primarily at the unorthodox procedure by which the arrangement was being increased rather than at the outcome. On Saturday, February 4, the G7 finance ministers and central bank governors, meeting in Toronto, Canada, issued a communiqué fully and unanimously endorsing the IMF agreement.<sup>47</sup>

The package of official financial support for Mexico now totaled \$40 billion, but it appeared to most participants in the discussions to total \$50 billion, and that was the figure that the IMF and the U.S. administration publicly announced. The largest share was provided by the U.S. Treasury, which would lend \$20 billion through the ESF, pending further negotiations on terms, to be made available in early March. The second largest share was provided by the IMF, which would lend the equivalent of \$7.8 billion in a cocktail of currencies, available the next Monday, February 6.<sup>48</sup> The stand-by arrangement approved on February 1 also provided that a review would take place by end-June, after which it could be augmented by \$10 billion. In any case, the sum of any additional loans from governments or central banks and the augmentation of the stand-by arrangement would total \$10 billion.<sup>49</sup> As noted above, the Bank of Canada was activating the

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<sup>46</sup>The five abstaining Directors were Jarle Berge (Norway), Huw Evans (United Kingdom), Oleh Havrylyshyn (Alternate to J. de Beaufort Wijnholds, Netherlands), Krzysztof Link (Alternate to Daniel Kaeser, Switzerland), and Stefan Schoenberg (Germany). During the meeting, Michel Sirat (Alternate to Marc-Antoine Autheman, France) and Johann Prader (Alternate to Willy Kiekens, Belgium) also expressed strong reservations about the proposal; see minutes of EBM/95/11 (February 1, 1995). Sirat had been instructed by the French authorities to convey their concerns but not to object formally. At the end, Prader asked to be recorded as abstaining, but he later withdrew that request on instructions from the Belgian finance minister (and Interim Committee Chairman), Philippe Maystadt. The final decision on recording abstentions was made on the following day, February 3; see minutes of EBM/95/12.

<sup>47</sup>See “Excerpts from the G-7 Finance Ministers and Central Bank Governors Statement from the meeting in Toronto on February 3–4, 1995”; accessed at <http://www.g7.utoronto.ca/finance/g7torfin.htm>.

<sup>48</sup>This drawing was financed in part by selling \$3.7 billion of the Fund’s holdings of SDRs to a group of creditor countries. The rest came from currencies in the Fund’s operational budget, supplied directly by the issuing countries. In all, 15 creditor countries participated in the financing operation.

<sup>49</sup>“Mexico—Stand-By Arrangement,” EBS/95/14, Suppl. 3 (February 2, 1995). In a last-minute amendment, the reference to “non G10 countries” in the draft arrangement was changed to “countries wishing to support Bank of Mexico’s exchange stabilization fund.” At a press conference on February 2, Camdessus stated that if the effort to solicit loans from such members was successful, those funds could be available to Mexico as early as April (following the Fund’s completion of the first scheduled review of the program).

equivalent of \$1.2 billion (CA\$1.5 billion) in swap lines with the Bank of Mexico, and the rest (\$1 billion) was anticipated to be lent by the IBRD and the IDB. The \$10 billion being lent by the BIS was then added to this total to suggest a \$50 billion package. As will be seen below, however, this BIS slice was not really countable.

## The Crisis Is Resolved

The immediate financial crisis was now resolved, or at least postponed. The upfront proceeds and the promise of more allowed Mexico to roll over some outstanding credits and repay the rest for the time being. For the IMF, the next step was to try to secure additional financing to cover the next \$10 billion. Starting on February 2, Camdessus sent letters to 32 governors of central banks that were not members of the G10 and that had relatively strong reserve positions, asking them to lend to an account to be administered by the IMF, “on terms and conditions comparable to those being developed by the BIS.” The quest, however, proved to be more daunting than had been expected, not least because of weak support from within the G10.

On February 11, Camdessus went to Basel, Switzerland, to discuss the Mexican arrangements with the G10 central bank governors, who were holding their monthly meeting at the BIS. The trip was not a success. Several of the European governors, led by Hans Tietmeyer, president of the Deutsche Bundesbank, strongly attacked Camdessus for overstepping the bounds of good practice. The atmosphere was so poisonous that for several months afterward, Camdessus—a former governor of the Banque de France and G10 chairman as well as the head of the IMF—was told that he was no longer welcome to attend these monthly gatherings. (The freeze ended after Camdessus simply invited himself back in July and, over dinner, explained his view of the systemic nature of the Mexican crisis.)

The greatest hurdle was not European opposition but the very nature of the G10 lending. The \$10 billion short-term loan was to be paid into an account at the BIS, and the Bank of Mexico was required to provide liquid collateral for the full amount (in effect, blocking any use of the funds). Because the funds could not be drawn upon, technically they were not even countable as official international reserves. That implied not only that the real value of the official package approved on February 1 was only \$40 billion, but also that any additional lending by other countries on comparable terms would be of no real use to Mexico. Either the non-G10 countries would have to lend on more generous terms than the G10, or the whole solicitation effort would come to naught.

These implications became known only gradually.<sup>50</sup> Not until the British newspaper *Financial Times* published a lengthy report on the Mexican rescue on February 16 did

<sup>50</sup>When Tietmeyer announced the BIS offer of \$10 billion in loans on February 13, he declined to provide any details on the confidential agreement; see “BIS Agrees Mexico Package, Tietmeyer Says,” Reuters News, February 13, 1995; accessed at <http://global.factiva.com>.

officials at the Fund realize fully what they were up against. By that time, only a few non-G10 central banks had replied to Camdessus's appeal, and no reply had yet been positive.<sup>51</sup> Now that it was known that the G10 central banks were not putting up any usable money, and that no other country appeared willing to lend on terms more generous than those of the G10, Camdessus's already quixotic quest to raise \$10 billion outside the G10 was almost surely doomed to fail.

Meanwhile, the Mexican authorities turned their attention to negotiating the terms for the \$20 billion loan from the U.S. Treasury. Ortiz, Mancera, and Téllez all made frequent trips to Washington during the next three weeks, and Ortiz's deputy, Martin Werner, stayed in Washington for daily meetings at the Treasury. The essence of the final deal was that the United States would lend \$3 billion to Mexico immediately and would commit to lending another \$7 billion by end-June 1995 and the remaining \$10 billion "as needed and in stages" thereafter. Disbursements would be subject primarily to Mexico staying in compliance with the IMF-supported policy program and holding sufficient receipts from petroleum exports as collateral in an escrow account at the Federal Reserve Bank of New York. The agreement specified additional policy measures, including a requirement to strengthen reporting of the international reserve position of the Bank of Mexico.<sup>52</sup>

The financial package nearly collapsed at the last moment, owing to a difference in understanding between Camdessus and Rubin. Rubin was convinced Mexico needed medium-term support, and his understanding was that the IMF was fully committed to entering into an 18-month stand-by arrangement with Mexico for \$17.8 billion. The only issue was whether countries outside the G10 would provide additional financing. Camdessus, in contrast, was convinced that Mexico's medium-term finances were sound, and that the main challenge for the international community was to provide financing for a short period as quickly and as forcefully as possible. His understanding was that he would first try to obtain liquid financing from the non-G10 countries on terms similar to those provided by the G10 through the BIS, and that he would later ask the Executive Board to augment the stand-by arrangement to make up any shortfall (the 10 – X proposal). In that view, the portion of the remaining \$10 billion that would be short-term or medium-term financing, and the terms on which Mexico could use the money, would depend entirely on the extent of Camdessus's success in persuading central banks to lend.

Rubin regarded Camdessus's position as insufficient, and on the morning of February 21—with the signing ceremony just hours away—he called Camdessus and

<sup>51</sup>Copies of this correspondence may be found in the IMF archives, OMD-AD (Mr. Narvekar's files), "Mexico – MD's letters Feb 2 – Mar 3/95 and replies," Box 9490, Accession 1996-0266-0002.

<sup>52</sup>For a summary of what was announced publicly, see "Statement by the United States Treasury Secretary," EBD/95/23 (February 21, 1995).

threatened to cancel the U.S. agreement with Mexico unless Camdessus promised to go ahead with the full \$17.8 billion IMF arrangement. Rubin understood Camdessus to promise to go along, but he nonetheless decided to apply further pressure on him and the IMF by going public with the dispute. His official statement at the signing ceremony included this warning:

The IMF recently advised us that it is seeking additional short-term credit from non-G10 countries as part of the \$10 billion portion of the IMF stand-by arrangement. Since the short-term funds from the BIS are considered adequate, we do not believe additional short-term funds are useful. Of course, medium-term participation in the IMF financing facility would be valuable.

Based on our conversations with a number of countries, we fully expect that little or no short-term monies will be forthcoming. Under these circumstances, we also fully expect the additional \$10 billion of medium-term money previously authorized by the IMF will be provided.<sup>53</sup>

With the United States and much of western Europe now lined up against his strategy, with no outside money in prospect, and with considerable questions being raised about the implications of the U.S. agreement for the IMF's preferred-creditor status, Camdessus had no choice but to review the matter again with the Executive Board. In response to a last-minute request by Daniel Kaeser (Switzerland), Camdessus reported on Mexican developments at the beginning of the regularly scheduled Board meeting on February 22.

At the outset of the meeting, Camdessus noted that the Fund had three options: prepare to provide the full \$17.8 billion out of the Fund's own resources; redouble the effort to secure outside financing, perhaps including a new request for medium-term loans; or retract the commitment to provide the extra \$10 billion on the grounds that the related financing was not in place (in effect, calling Rubin's bluff). This drama caused a fair bit of panic around the table. After some discussion, the Board agreed to try to reach a definitive decision at the next meeting, two days later, to give themselves time to consult with their capitals. In the end, the original decision—including the intention to augment the stand-by arrangement by up to \$10 billion at the end of June—was allowed to stand. The Board also agreed that Camdessus would persevere with the effort to secure external financing and would broaden the request to include the option of medium-term lending in tandem with the Fund stand-by arrangement. As initially agreed, the augmentation would be reduced by any contributions from others, regardless of whether the outside financing was short or longer term. Even so, most

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<sup>53</sup>“Statement by the United States Treasury Secretary,” EBD/95/23 (February 21, 1995). Also see Rubin and Weisberg (2003), pp. 30–31.

people around the table understood that raising money this way was nearly hopeless and that the Fund's share of "10 - X" was going to be pretty close to \$10 billion.<sup>54</sup>

The announcement of the U.S. agreement and the IMF's reaffirmation of its commitment did not stop the capital outflow from Mexico or the continuing slide of the peso (Figure 10.1). For the next two weeks, Rubin and Summers were convinced that the rescue operation was going to fail. Summers offered to resign, and Rubin considered whether to renege on the U.S. agreement, but White House officials decided to stay in and hope for the best (see Rubin and Weisberg, 2003, pp. 31–32).

A decision by the Mexican government to strengthen the program finally turned around the situation. The original policy program had been predicated on the assumption that the peso exchange rate would stabilize near early-January levels and that GDP would grow by 4 percent in 1995. Early in March, Ortiz realized that neither assumption was remotely likely to hold, and he informed the IMF he was putting together a new package of tax increases and spending cuts. Loser and a staff team returned to Mexico City for a week to consult on these measures, which Ortiz announced publicly in the evening of March 9. The next day, Fischer issued a public statement welcoming the shift, and within a few days the U.S. Treasury disbursed the first installment (\$3 billion) of its \$20 billion loan.<sup>55</sup> Financial markets reacted enthusiastically: the peso appreciated by 18 percent against the dollar on March 10 and, after a brief reversal, continued to strengthen for the next two months.

Throughout the second quarter of 1995, a degree of calm returned. In mid-April, as Mexico gradually began to return to the international capital market for its external financing, Camdessus called off his effort to raise official money from central banks. Ortiz briefly considered reestablishing a crawling peg for the exchange rate, but the Fund staff discouraged him. At a breakfast meeting in the margins of the spring meeting of the Interim Committee in Washington, Greenspan convinced him that the peso should continue to float. (Some 15 years later, the floating rate regime was still in place.) Although output and employment continued to fall, the authorities allowed themselves to believe—correctly, as it turned out—that a recovery would begin later in the year.

As the end of the quarter approached, the Fund had to decide on a plan for augmenting the stand-by arrangement: on what terms would the promised \$10 billion be

<sup>54</sup>The minutes of the February 22 session (EBM/95/18) state only that the "Managing Director reported on the financial agreement concluded between the United States and Mexico and the statement by the U.S. Treasury Secretary" (p. 3). The minutes for February 24 (EBM/95/19) state only that "Executive Directors met in restricted session to discuss certain issues related to the stand-by arrangement for Mexico" (p. 3). For Camdessus's concluding remarks at the latter meeting, see memorandum from the Secretary to Executive Directors, "EBM/95/19—Restricted Session—Concluding Remarks," (February 24, 1995); IMF archives, OMD-AD (Mr. Narvekar's files), "Mexico Correspondence Feb. 1995," Box 9489, Accession 1996-0266-0001. For Kaeser's request, see his memorandum to the Secretary, "Mexican Rescue Package" (February 22, 1995), in the same file.

<sup>55</sup>See "Mexico—Program Tables," EBS/95/31 (March 10, 1995); and "IMF Welcomes New Mexican Economic Measures," NB/95/8 (March 10, 1995).

made available to Mexico? The U.S. authorities, who had disbursed \$8 billion of their \$20 billion ESF commitment plus a net \$2 billion in central bank currency swaps, faced a similar decision on disbursing the remainder of the ESF. Neither the Fund nor the U.S. Treasury wanted to lend much more than the other, to share the risk fairly evenly. That led to some jockeying for position and some continuing unpleasantness until Camdessus and Summers sat down tête-à-tête over lunch at the Fund in early June and agreed informally on a schedule. The IMF, they decided, would disburse \$2 billion in early July and another \$1.6 billion in August, assuming that Mexico continued to satisfy the Executive Board that it was in compliance with the program conditions. On similar conditions, the United States would disburse \$2 billion to \$3 billion in July, and—in Summers' terms—would keep “the remainder of our \$20 billion commitment available for possible use later in the year if needed.”<sup>56</sup>

With this understanding, the staff proposed to disburse the \$10 billion in six installments, with the first two taking place at end-June and in mid-August (for \$2 billion and \$1.7 billion, respectively). This plan once again upset the European Executive Directors in the Fund because it appeared the Fund was making a firmer financial commitment to Mexico than was the U.S. government. On June 28, two days before the Board was to consider the request, the European Executive Directors sent an unusual joint memorandum to the staff asking them to leave the post-August disbursement schedule unspecified and to indicate “a presumption that, beyond the August purchase, the arrangement will be of a precautionary nature.”<sup>57</sup>

When the Board met on June 30, other Directors did not support the European proposal, fearing that any vagueness about the availability of IMF money would weaken the still-fragile confidence of private investors. They did agree, though, to encourage Mexico not to draw more than was absolutely necessary. Camdessus's Summing Up of the meeting therefore included this paragraph:

Directors generally believed that with the continuation of appropriately tight policies, confidence should be sustained and normal access to international capital markets could be restored. In this context, Executive Directors considered that if the balance of payments and international reserves improved as projected under the program, the authorities would be able to treat the arrangement as precautionary beyond August. Accordingly, Directors welcomed the reiteration by the authorities of their intention to forgo some purchases from the Fund if the economic situation stabilizes and to make early repurchases from the Fund if reserves permit.<sup>58</sup>

<sup>56</sup>Letter from Summers to Camdessus, June 9, 1995; IMF archives, OMD-AD (Mr. Fischer's files), Box 11518, Accession 1998-0106-0006, “Mexico 1995.”

<sup>57</sup>Memorandum from Autheman, Evans, Kaeser, Kiekens, Lanciotti, Schoenberg, Eva Srejber (Sweden), and Wijnholds to Loser and Boorman, “Mexico—Second Review under the stand-by arrangement,” June 28, 1995; IMF archives, OMD-AD (Mr. Narvekar's files), “Mexico – Correspondence June-August 1995,” Box 9490, Accession 1996-0266-0002.

<sup>58</sup>Minutes of EBM/95/64 (June 30, 1995), p. 63.

Economic conditions in Mexico continued to improve slowly, and the authorities indicated in August that they intended not to make further drawings. Unfortunately, within two months, conditions worsened anew, as investors became concerned once again about economic and political stability. Might Zedillo abandon the Fund-supported program and embark on a federal spending spree to pull the economy out of its slump? Investors could not be sure, and a renewal of capital outflows weakened the exchange rate in October and November. When Loser and his team returned to Mexico City at the end of October, they found the authorities receptive to considering fresh ways to bolster confidence. Fischer joined the discussions for two days in mid-November, after which Ortiz decided to request a fourth drawing, primarily to demonstrate to the markets that the Fund was fully behind his policies.

On December 15, 1995, nearly one year after the peso crisis first erupted, the Executive Board approved a fourth drawing, for \$1.7 billion. That disbursement—which would be the last under this stand-by arrangement—brought Mexico’s total IMF borrowings for the year to \$12.9 billion, nearly three-quarters of the Fund’s \$17.8 billion commitment. Mexico’s total borrowing from all official sources in 1995 amounted to about \$28 billion.<sup>59</sup>

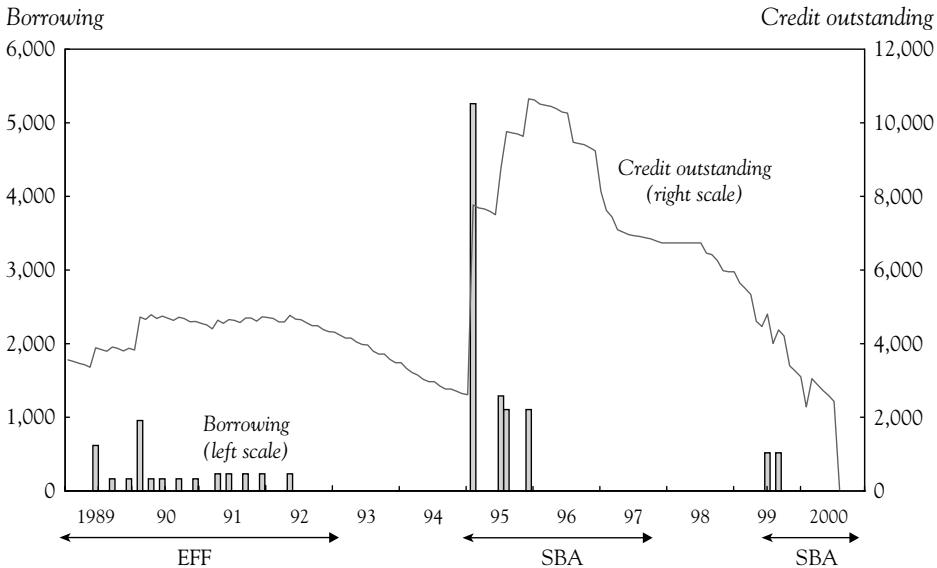
At the end of 1995, Mexico’s outstanding obligations to the Fund were at an all-time peak—for any country up to this time—of \$15.8 billion (SDR 10,648 million), which was more than six times Mexico’s quota (Figure 10.2). But by then the tide was beginning to turn.

As terrible as this year had been for Mexico, and as traumatic as it had been for the IMF, the “first financial crisis of the twenty-first century” had a happy ending. Mexico’s finances continued to strengthen in 1996, and economic growth gradually resumed. The unemployment rate, after peaking in August 1995 at 8 percent, declined to 3 percent by the end of 1997, while GDP growth averaged 6 percent a year. Although Mexico’s finances were adversely affected in 1997–98 by the crises in East Asia, the Russian Federation, and Brazil, its economy weathered those storms better than did most other emerging markets.

In July 1999, to help Mexico “alleviate potential market concerns . . . in the run-up to the presidential elections” in July 2000, and to help smooth the timing of Mexico’s repayments, the Fund approved a new stand-by arrangement in the amount of \$4.2 billion (SDR 3,103 million, or 120 percent of quota). Mexico drew about two-thirds of that sum in three installments through March 2000, while continuing to

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<sup>59</sup>Through September 1995, Mexico borrowed \$12.5 billion from the U.S. monetary authorities and \$237 million from the Bank of Canada. It then began repaying those loans. In June 1995, the World Bank approved \$1.5 billion in loans to Mexico, and the IDB approved \$1.25 billion.

**Figure 10.2. Mexico: Use of Fund Credit, 1989–2000***(In millions of SDRs, monthly data)*

Source: International Financial Statistics.

Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement.

repay earlier drawings. In August 2000, Mexico repaid all of its remaining obligations to the IMF well ahead of schedule, bringing the crisis to a successful conclusion.<sup>60</sup>

## Quarantining the Crisis

In addition to helping Mexico resolve the “tequila” crisis (as it quickly became known), the IMF took steps to try to prevent it from spreading to other emerging markets and to strengthen its own ability to foresee and forestall future crises. The first issue—contagion—was controversial from the outset, and the second—crisis prevention—proved difficult to achieve.

<sup>60</sup>If Mexico had drawn the full amount of the 1999 stand-by arrangement and had then repaid those and earlier drawings on time, it would not have cleared its obligations until 2005. Instead, by 2001 Mexico had become a creditor of the IMF. Mexico also repaid its obligations to the United States ahead of time, completing the process in January 1997, motivated by the high cost of those loans and the necessity of keeping oil revenues in escrow as collateral. Greenspan (2007) p. 159, reports that “the United States actually profited \$500 million on the deal.”



## Limiting Contagion

ON THAT MEMORABLE DAY [JANUARY 31, 1995], WE HAD TO PUT HUGE AMOUNTS OF money on the table to avoid the financial collapse of Mexico and the spill-over effects that in a few hours or days could have forced many Latin American and other countries to resort to exchange controls and debt moratoria and could have caused a dramatic disruption in private capital flows to developing countries.

Michel Camdessus<sup>61</sup>  
 Managing Director of the IMF  
 November, 28 1995

Why the concern about contagion? Why did IMF officials fear that a crisis in Mexico would lead to problems for other countries? The most direct potential effects, though not necessarily the most important, would work through trade links because a downturn in spending in Mexico would depress export demand elsewhere. Although Mexico was an important trading partner for the United States, IMF staff estimates at the time put a ceiling on the negative effect on U.S. economic growth at one-quarter of 1 percent of GDP. For most other countries, the effects would have been even smaller. Empirical estimates, however, are necessarily based on past observed associations. The Fund's most senior officials—notably Camdessus and Fischer, but also Boorman and others—were worried about possible changes in those associations that could lead to negative indirect effects around the world.

Potential contagion through financial markets caused the most immediate fear. If the Mexican crisis made investors reevaluate the risks of disturbances in other emerging markets, then other vulnerable countries—those that otherwise might well have muddled through with little difficulty while relying on a continuing inflow of foreign capital—might be subject to crises as well. A host of speculators, particularly those specializing in Latin American securities, were likely to pounce at the first signs of vulnerability. The first indicators of this type of contagion would be falling prices in equity and bond markets, possibly combined with pressures on the exchange rate manifested by a sharp depreciation or a fall in the country's foreign exchange reserves. Whether this financial contagion was a remote possibility or a serious risk at the end of 1994 depended on investor psychology—"animal spirits," as John Maynard Keynes famously phrased it—and not on measurable economic models. The fact that an active secondary market in the sovereign debt of emerging-market countries was still new and growing made the assessment of risks all the more difficult.

A second fear was of what Fischer sometimes called "intellectual contagion." If Mexico was thought to have been a "star pupil" of IMF policy advice and an adherent

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<sup>61</sup>"Africa and the World," Introductory Remarks by Michel Camdessus, Managing Director of the International Monetary Fund at the Global Coalition for Africa Plenary Conference on Africa's Future and the World, Maastricht, the Netherlands, November 28, 1995; accessed at <http://www.imf.org/external/np/sec/mds/1995/mds9519.htm>.

to free markets and openness, what effect would its crisis have on policymakers and public opinion across Latin America and the developing world? If Mexico was forced to impose exchange controls to protect itself against the vagaries of international trade and capital markets, the backlash against free trade, outward-looking growth strategies, and the role of IMF policy advice could be severe.

Not everyone at the Fund was convinced that these threats were real or that the risks would be greatly aggravated by the crisis in Mexico. Initially, almost the only person in the building who took the contagion threat seriously was Fischer. (Camdessus, who later was equally concerned, was away for the holiday season.) As soon as the crisis started, Fischer worried that it would spread to other emerging markets, especially but not only in Latin America.

On December 21, 1994, the day after the initial peso devaluation, stock market indexes in Buenos Aires and São Paulo dropped by some 6 percent. Fischer immediately called for a senior staff meeting to consider the extent of the threat of contagion to these and other markets. The area department heads who participated in that meeting downplayed the threat, but Fischer was not convinced. He saw a strong parallel between this crisis and the one that had hit Mexico in 1982 and then had spread throughout Latin America, giving rise to a “lost decade” for much of the continent. Even if his colleagues were skeptical, he asked them to pursue the matter further.<sup>62</sup>

Two weeks later, in early January 1995, net capital inflows to Argentina and Brazil clearly were continuing to drop, most probably because of investor concerns stemming from the crisis in Mexico. A staff report prepared for Fischer at that time suggested that a few other countries, notably Hungary and Egypt, were “potentially vulnerable” owing to weak initial conditions, while emerging markets in Asia seemed to be relatively unscathed. Within days, however, equity markets and the secondary markets for Brady bonds and other sovereign debt were declining more widely. In addition to Argentina and Brazil, Chile and Peru were now seeing adverse effects. Before the Fund announced the stand-by arrangement with Mexico at the end of January, several countries outside the region seemed directly vulnerable. Hungary and Turkey were experiencing weaknesses in financial markets, and the central banks of Indonesia, Malaysia, and Thailand were all intervening in substantial amounts to stabilize their currencies. The Philippines was also considered to be at risk of contagion.<sup>63</sup>

<sup>62</sup>See materials for the December 22 meeting, in IMF archives, OMD-AD (Mr. Fischer’s files), Box 11508, Accession 1998-0105-0005, “Mexico Operational File 1994”; and Fischer’s report on the meeting to Camdessus, same date, in IMF archives, OMD-AD (Mr. Narvekar’s files), Box 9489, Accession 1996-0266-0001.

<sup>63</sup>See memorandum from Mark Allen and Steven V. Dunaway (Deputy Director and Division Chief, respectively, in PDR) to the Managing Director, “Contagion Effects from Mexico” (January 4, 1995); memorandum from Boorman to the Managing Director, “Mexico—Systemic Impact of Crisis” (January 12, 1995); untitled note from Narvekar to the Managing Director (February 3, 1995); and memorandum from Kunio Saito (Director, Southeast Asia and Pacific Department) to Mussa and others, “Countries at Risk Post Mexico” (February 7, 1995); all in IMF archives, OMD-AD (Mr. Narvekar’s files), “Mexico Correspondence Feb. 1995,” Box 9489, Accession 1996-0266-0001.

Most of those effects and risks turned out to be temporary, but it was difficult to say with certainty whether contagion from Mexico was just a sniffle or whether a potential pandemic had been averted by the rapid containment of the immediate crisis. Fischer was strongly inclined toward the latter view. In February, he wrote to a sympathetic member of the U.S. Congress, “There can be little doubt that several countries, among them Argentina and Brazil, and some on other continents including Hungary and Turkey, would have been in extreme difficulty today if the financial package had not been assembled.”<sup>64</sup>

Beyond any doubt, Argentina and Brazil faced the most risk of contagion from Mexico. Within a few months, the resolution of the Mexican crisis certainly helped them, as Fischer stated, but they also helped themselves by adjusting their own economic policies. The role of the IMF differed between the two cases.

### **Argentina**

Argentina was on the front line of the battle to contain contagion—because of its unstable economic history, its weak fiscal accounts and controls, and particularly the fragility of its *de facto* currency board arrangement. The central bank was obliged to hold reserve assets at least equal to the monetary base, and by December 1994 it had only a small margin. Capital flight or the withdrawal of foreign deposits would force a monetary contraction that could destabilize the economy and force the authorities to abandon the policies that had worked so well for the previous four years.

Indeed, as soon as the Mexican crisis hit, Argentina faced a sudden large outflow of private capital, including withdrawals of nonresident bank deposits, and a corresponding decline in official reserves. Domestic activity began to contract, and the authorities requested an extension of the country’s Extended Fund Facility (EFF) arrangement, which they had been implementing successfully since its approval in March 1992. The Fund responded positively, and a mission led by Martin Hardy (Assistant Director, Western Hemisphere Department) arrived in Buenos Aires on January 29, just as the Fund’s Executive Board was about to consider Mexico’s request for a stand-by arrangement.

The first round of negotiations did not go well. After three weeks, the mission had not convinced the authorities to agree to take what the Fund staff regarded as the essential measures to tighten fiscal policy sufficiently to stop the capital outflow. Hardy returned to Washington empty-handed on February 23.

Early in March, with the Mexican crisis not yet resolved and Argentina still facing a continuing run on domestic bank deposits and large-scale capital flight, Fischer called the Argentine finance minister, Domingo Cavallo, and warned him that he was taking a large risk by not acting to shore up Argentina’s finances.<sup>65</sup> If Cavallo would

<sup>64</sup>Letter from Fischer to Howard L. Berman (Democrat, California), February 23, 1995; IMF archives, OMD-AD (Mr. Fischer’s files), Box 11518, Accession 1998-0106-0006, “Mexico 1995.”

<sup>65</sup>Cavallo, like several of Mexico’s top finance officials, was a former student of Fischer’s.

agree to raise taxes by the equivalent of 2 percent of GDP, then Fischer would recommend a resumption of financial support for Argentina from the IMF. With presidential elections scheduled for just three months later, and with strong resistance to fiscal discipline from provincial governments, raising tax revenues would not be easy. Nonetheless, after a day's reflection, Cavallo agreed to Fischer's proposal. Fischer then sent Hardy and his mission team back to Buenos Aires, where they arrived on Saturday morning, March 11.<sup>66</sup>

This second mission succeeded quickly, after just a weekend of intensive meetings. On Monday evening, the Fund issued a press release announcing a breakthrough and praising Argentina's willingness to strengthen policies "in the context of unsettled international financial markets."<sup>67</sup> Finalizing the detailed program and drafting the Letter of Intent took another couple of weeks. The Executive Board approved a fourth-year extension and further augmentation of the EFF arrangement on April 6. Several Directors worried aloud about the risks of sticking to a currency board regime without a viable exit strategy, but everyone recognized that abandoning the system in the middle of a crisis could make matters far worse. Argentina's willingness to tighten fiscal policy in very difficult conditions impressed even the Europeans who had objected so strongly to the Mexican rescue two months earlier.

The Fund's support helped Argentina stop the outflow, even though the major vulnerabilities remained in place.<sup>68</sup> Although output in Argentina declined substantially in 1995, its economy—like Mexico's—began to grow again in 1996. Argentina adhered to its tight policies, but it slipped out of technical compliance with the conditions in the EFF program, owing to the effect of the recession on the fiscal deficit. The Fund granted waivers for those slippages, and Argentina made all the scheduled drawings in the fourth and final year of the EFF arrangement. That arrangement expired at the end of March 1996 and was succeeded a week later by a 21-month stand-by arrangement. That arrangement was also broadly successful, until the fall of 1997.

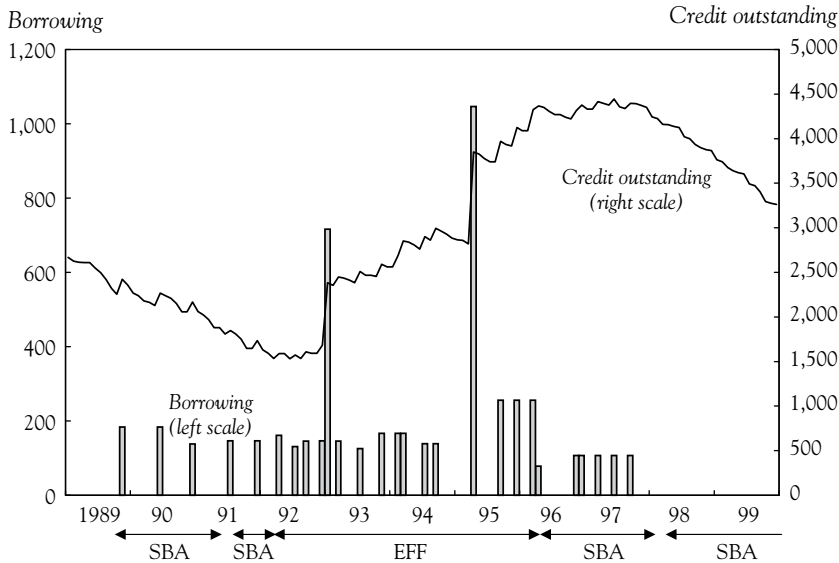
Throughout the 1990s, Argentina had a nearly continuous series of stand-by and extended arrangements (Figure 10.3). Following only intermittent drawings on the compliance-plagued stand-by arrangements of 1989–91 and 1991–92, it drew the full amount of the 1992–96 EFF arrangement (just over SDR 4 billion, equivalent to approximately \$5.8 billion at the average exchange rate) and 85 percent of the 1996–98 stand-by arrangement (SDR 613 million, or \$860 million). In September 1997,

<sup>66</sup>For an overview of these missions, see "Argentina—Ninth Review Under the Extended Arrangement, Request for Waiver of Performance Criteria, and Request for Fourth-Year Extension of the Extended Fund Facility," EBS/95/51, Suppl. 1 (March 29, 1995). Also see Cavallo (1997), pp. 224–25. Additional details are from interviews.

<sup>67</sup>"IMF Praises Argentine Measures, Sees US\$2b Loan Increase," NB/95/9 (March 13, 1995).

<sup>68</sup>See Daseking and others (2004), Chapter 2, for a review of the "buildup of vulnerabilities" in Argentina in the middle years of the decade. That review concluded (p. 22) that the weaknesses "were not sufficiently addressed in IMF-supported programs during this time" and contributed importantly to the subsequent crisis.

**Figure 10.3. Argentina: Use of Fund Credit, 1989–99**  
(In millions of SDRs, monthly data)



Source: International Financial Statistics.

Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement.

Argentina's indebtedness to the Fund peaked at \$6.4 billion (SDR 4.7 billion). By then, fresh turbulence in international markets and weakening domestic support for the government raised a new threat of contagion for Argentina, requiring yet another EFF arrangement (Chapter 12).

### **Brazil**

Brazil, like Argentina, had a long history of macroeconomic instability and was in the early stages of a bold plan to put the economy on a sustainable growth path. Like Argentina, financial contagion from the Mexican crisis hit it hard. In contrast to Argentina, however, Brazil managed to get through without direct financial assistance from the IMF.

Throughout most of 1994, as described in Chapter 9, Brazil's economic policies and performance strengthened remarkably. In February of that year, after consultation with the IMF staff, the government announced a bold scheme, the Plano Real, to wring inflation out of the economy. In April, Brazil reduced and restructured its outstanding external debt through a Brady Plan agreement, and it thereby restored normal relations with its external creditors. The government introduced a new currency, the *real*, in July 1994. Inflation then fell sharply, from nearly 50 percent in June (monthly rate) to less than 2 percent a month in the fourth quarter of the year, and private capital began to flow back into the country.

Preventing the resurgence of capital inflows from importing inflationary pressures and limiting the real appreciation of the *real* presented the two economic policy challenges for Brazil in the second half of 1994. Accordingly, the authorities loosened restrictions on imports of thousands of individual goods and imposed additional restrictions on capital inflows. They also strengthened the package of structural reforms initiated earlier in the year, aimed at promoting the development of private sector activity. The Fund's Executive Board concluded the Article IV consultations in mid-November with words of praise for what Brazil had achieved, tempered with caution about the need for additional stabilizing measures.<sup>69</sup>

The onset of the Mexican peso crisis in December 1994 upset Brazil's uneasy economic balance as capital inflows dried up throughout Latin America. Equity prices fell sharply, and the market price of Brazil's Brady bonds plummeted. In response, the authorities reversed some of the policy changes they had introduced just a few months earlier, retightening import controls and easing controls on capital inflows. Despite heavy intervention, the exchange rate depreciated in the first two months of 1995. On March 6, the authorities announced they were establishing an adjustable band on the exchange rate against the U.S. dollar, designed to allow a small further depreciation. Speculators immediately attacked, forcing the central bank to devalue the currency four days later by adjusting the band. A Fund staff mission led by José Fajgenbaum (Assistant Director, Western Hemisphere Department) arrived later that month and urged the authorities to be more willing to allow the exchange rate to depreciate if speculative pressures continued. The authorities rejected that advice, preferring to hold the line against inflation and other destabilizing pressures. Instead, they raised short-term interest rates, continued to intervene in the exchange market, and accelerated the structural reform program. By May, confidence began to return, and the crisis passed.<sup>70</sup>

In the middle of the crisis in early 1995, Brazil asked the staff to continue to monitor its economic program and agreed to have intensified contacts, with more frequent monitoring of conditions and policy advice. In 1995, the Executive Board met twice to discuss Brazil, in June to review the staff monitoring of Brazil's economic program, and in December to complete the annual Article IV consultation. But Brazil did not ask for financial assistance or even a precautionary stand-by arrangement. In 1996, relations reverted to the standard 12-month consultation cycle.

### **Strengthening Crisis Prevention and Resolution**

Once the Fund's response to the immediate crisis in Mexico was in place, avoiding and minimizing future crises became a high priority. The Fund obviously had done an

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<sup>69</sup>Minutes of EBM/94/100 (November 16, 1994).

<sup>70</sup>These developments are reviewed in "Brazil—Staff Report for Monitoring of Economic Program," EBS/95/92 (June 1, 1995).

inadequate job of foreseeing—much less forestalling—the peso crisis. Whether it was possible to improve on that performance, and how best to try, were less clear. Over the next several months, the Fund took three steps in that direction: more intensive monitoring of major lending arrangements, a comprehensive postmortem of the Mexican crisis, and establishment of a formal rapid-response procedure.

### ***Intensive Monitoring***

Because the Fund's lending to Mexico had to be so heavily front-loaded to restore confidence quickly, the usual safeguard of reviewing policies and performance carefully before each quarterly disbursement was not effective in this case. Instead, the Fund decided to try to monitor developments more or less continuously, so as to be ready to react with fresh policy advice or lending conditions if the need arose. From the time of the stand-by arrangement's approval in February 1995, the staff provided senior management with detailed weekly assessments of economic and financial conditions in Mexico. Initially, those reports were based on frequent staff visits, discussions with the Mexican authorities in Washington, and other ad hoc contacts. Simultaneously, Camdessus and Fischer pressed Ortiz to let the Fund open a resident office in Mexico City. He eventually agreed, and from May 1995 Jan van Houten (formerly Assistant Director, PDR) was posted there as Resident Representative of the IMF.

Intensive monitoring in the field became common practice in other very large lending arrangements in the second half of the 1990s. The most prominent example was Russia, where the Fund maintained an unusually large resident office, sent missions from headquarters every month for three years, and conducted formal monthly reviews in the Executive Board (see Chapter 7). Others included Indonesia and the Republic of Korea beginning about the end of 1997, where frequent missions supplemented the work of Resident Representatives for several months (Chapter 11).

### ***Strengthening Surveillance***

Camdessus quickly realized not only that the Fund had been embarrassed by being caught flat-footed, but also that the problem might not be confined to Mexico. On February 3, 1995, just two days after the Board approved the stand-by arrangement with Mexico, he asked L. Alan Whittome to conduct an in-depth postmortem of the Fund's surveillance over Mexico with the aim of identifying ways to avoid a repeat of the evident failings. As discussed in Chapter 4, the Whittome report made several recommendations for strengthening the Fund's ability to detect the preconditions for financial crises.<sup>71</sup> The Mexican crisis had demonstrated that the standard annual consultation cycle was insufficient in any situation in which major problems might be accumulating. Surveillance had to be continuous. It had to be based on comprehensive and timely data. The staff had to develop better contacts with financial markets and other nongovernmental analysts. The staff should be less deferential to the authorities when it had

<sup>71</sup>"Mexico—Report on Fund Surveillance, 1993–94," EBS/95/48 (March 23, 1995).

reason to doubt the quality of the official analysis. And the staff should write its reports more clearly and forcefully so that its messages could have the right impact.

The Whittome report was a powerful wake-up call to the Fund, garnering a favorable initial internal response.<sup>72</sup> Nonetheless, because many of the problems highlighted in the report seemed to be unique to Mexico and because management insisted on keeping the report's findings secret, it failed to have the lasting impact it deserved. As Chapter 11 shows, many of these shortcomings appeared again in 1997 when the Asian crisis erupted. Only then did the systemic nature of the problem become sufficiently evident.

### **Responding More Effectively**

The Fund's response to the Mexican crisis had to be cobbled together under immense pressure, with little precedent for deciding how to design an effective adjustment program in a few weeks, how to interact with other official creditors, or how to reinstall investor confidence or otherwise induce private creditors to invest in the afflicted country. In addition to devising a plan for managing that case going forward and avoiding repetition elsewhere, the Fund had to develop rules and procedures for responding more systematically if such a crisis should occur in the future.

One aspect of crisis response not examined systematically after the peso crisis was the possibility of involving private sector creditors through official persuasion or requirement. Private sector involvement (PSI) had been a central part of the Fund's handling of the Latin American debt crisis in the 1980s, first through "concerted lending" and later through a menu of debt- and debt-service-reduction schemes (see Boughton, 2001b, Part II). When this new crisis hit, the assumption was that PSI would be neither effective nor desirable. The goal was to restore confidence among bondholders, who had become the main creditors in place of the large international commercial banks that had provided most capital inflows in the previous decade. The option of restructuring the outstanding tesobonos, perhaps by repaying at a depreciated exchange rate, was considered to be too risky because it could have weakened Mexico's ability to attract future inflows on favorable terms. As shown in Chapter 11, not until the Korean crisis struck three years later did the Fund and the major creditor countries develop a strategy for restoring PSI to the response arsenal.

In the immediate aftermath of the Mexican crisis, the strongest impetus for a new set of procedures came from the summit meeting of the heads of state and government of the G7, held in Halifax, Nova Scotia, in mid-June 1995. The G7 leaders asked the IMF to devise an "Emergency Financing Mechanism [EFM] . . . with strong conditionality but with high up-front access and faster procedures to access Fund resources in crisis situations under the 'exceptional circumstances' clause."<sup>73</sup> The Executive Board

<sup>72</sup>See minutes of EBM/95/33 (April 4, 1995).

<sup>73</sup>"The Halifax Summit Review of the International Financial Institutions: Background Document," Section 5; accessed at <http://www.g7.utoronto.ca/summit/1995halifax/financial/index.html>.



approved an EFM in September, not as a new facility but just as a policy statement formalizing how the Fund could react similarly to the way it handled the Mexican crisis if another such emergency were to occur. (The establishment of the EFM is described in Chapter 5.)

Although the Fund established the EFM with the expectation that it would be used rarely, it turned out to be an essential tool for the next several years. As the East Asian crisis unfolded in 1997–98, the Fund invoked its emergency procedures repeatedly. In the following decade, the EFM saw even greater usage, especially in the global crisis of 2008–09. The twenty-first century had indeed arrived a few years early, and Mexico once again proved to be the crucible for developing and testing the crisis responses of the IMF and the international community.

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