The Tequila Crisis: 1994

Author's name

Institution

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Introduction

The Mexican peso crisis of 1994 was a major financial crisis that had a devastating impact on the Mexican economy, as well as on other emerging economies in Latin America and Asia. After implementing a series of imprudent economic policies, in December 1994, the Mexican government was left with no choice but to abandon the peg with the U.S. dollar, thus causing the peso to depreciate considerably. By the end of December 1994, the currency had lost 35% of its value, stock prices had collapsed, and interest rates had been increased significantly (Beziz & Petit, 1997; van der Molen, 2013). To prevent Mexico from defaulting, the United States and the International Monetary Fund intervened with a $50 billion bailout package that produced somewhat mixed results: on the one hand, the risk of an even worse financial crisis was averted, and contagion to vulnerable economies was limited; on the other hand, Mexico ended up experiencing a severe economic recession that resulted in widespread poverty and political instability. The Mexican peso crisis is also known as the tequila crisis due to its impact on Brazil and other southern American economies (Uribe, 1996).

Background

To fully appreciate the causes and effects of the tequila crisis, it is important to first analyze the events and decisions that preceded the devaluation of the peso. As Watkins (n.d.) observes, the crisis occurred a year after Mexico had signed the North American Free Trade Agreement. At that time, Mexico was regarded as a promising market with solid economic indicators and a relatively stable political climate; despite having experienced a major financial crisis in 1982, the country had managed to implement a range of structural reforms that facilitated its recovery (Watkins, n.d.). 1983 was a very good year for Mexico: trade was expected to intensify, as a result, NAFTA and ad hoc programs were developed to address problems related to education and healthcare (Watkins, n.d.). 1984, on the other hand, was marked by violent revolts, political instability and poor decisions. The year began with a radical activist starting a revolt in Chiapas, one of the thirty-two federal entities

that make up Mexico; in an effort to win the 1994 presidential election, the outgoing administration tried to impress the voting public by implementing a series of imprudent economic policies intended to promote short-term economic growth – without really considering the long-term consequences of such measures (Watkins, n.d.).

As Watkins (n.d.) observes, the outgoing president, Miguel Salinas de Gotari, was against the idea of devaluing the peso during his office and postponed the devaluation until December 1994 – when it became unavoidable. According to the U.S. Government Accountability Office, the 1994 peso crisis resulted primarily from a lack of consistency between Mexico's fiscal/monetary policies and its exchange rate system (GAO, 1996). Although this inconsistency could have been reduced by raising interest rates and devaluing the peso, de Gotari was so focused on helping his presidential candidate, Luis Donaldo Colosia, win the upcoming presidential election that he failed to make Mexico's economic sustainability his top priority. After Colosio's unexpected assassination, de Gotari found himself operating in a very unstable environment where investor confidence was declining, Mexico's trade deficit was growing and a severe financial crisis was approaching (GAO, 1996).

Description of the Crisis

Between March and November 1994, the Mexican government found it increasingly difficult to maintain the peso's peg to the U.S. dollar. As political instability grew and investor confidence deteriorated, the country witnessed a significant flight of capital that widened the then account deficit (MSG, n.d.; van der Molen, 2013). The situation got even worse when the U.S. Federal Reserve raised its policy rate by 250 bps, thus prompting investors to liquidate their USD-denominated Mexican debt to invest in U.S. treasuries, which not only generated higher returns but also carried less risk (van der Molen, 2013). To stop investors from moving their capital out of the country, the Mexican government started issuing short-term USD-denominated notes called *tesobonos* (van der Molen, 2013). By the beginning of December 1994, Mexico's foreign exchange reserves had plummeted to

$12.5 billion and investors had bought $30 billion worth of *tesobonos* – which were due to mature in the first three months of 1995 (Kenen, 2001).

After a brief period of relative stability, in November 1994, $3 billion was unexpectedly moved out of the country, thus making it even more challenging for the government to continue its exchange rate policy (GAO, 1996). On December 1, a new government led by President Zedillo took office while pressure on the peso kept rising (van der Molen, 2013). Investors were so sceptical that $855 million was pulled out of the country after the new Finance Minister told the Wall Street Journal that the government had no intention to devaluate the peso on December 15 (van der Molen, 2013). By December 20, the situation had become so unsustainable that the Central Bank of Mexico announced a slight devaluation of the peso (van der Molen, 2013). Between December 21 and 22, an additional $4.6 billion – which accounted for approximately 50% of the foreign exchange reserves held by the central bank – flew out of the country, thus forcing the government to rethink its monetary policy. Up to that point, the value of the peso had been fixed against the value of the U.S. dollar as part of an unorthodox exchange system which came to be known as "the crawling peg;" as the U.S. Government Accountability Office reports, the crawling peg was relatively flexible in that it allowed the peso-dollar exchange rate to fluctuate within a pre-set band (GAO, 1996). This way, the peso was allowed to depreciate at a rate that the Mexican government deemed safe (GAO, 1996). However, following the aforementioned events, the peso was so far overvalued that Mexico was about to default on its USD-denominated and indexed debt (GAO, 1996).

The currency crisis officially began on December 22, when the Mexican Central Bank allowed the peso to float, thus causing the currency to depreciate by as much as 35% in less than a week (van der Molen, 2013). Had the move been made a few weeks before, the Mexican Central Bank might have avoided losing nearly three quarters of its foreign exchange reserves (GAO, 1994). As table 1 shows, Mexico's foreign exchange reserves fell from $24.5 billion in 1993 to $6.1 billion in 1994, whereas its current account deficit rose from $23.4 billion in 1993 to $29.7 billion in 1994. Furthermore, with the peso significantly stronger than it should have been, local consumers and

businesses took advantage of the situation by importing more goods, thus causing Mexico's trade deficit to go from $13.5 billion in 1993 to $18.5 billion in 1994 (tables 1 and 2).

Causes

When a major financial crisis occurs, it is usually because of multiple underlying issues. In the Mexican case, the peso crisis stemmed from four primary causes:

1. An unsustainable exchange rate policy
2. Poor prudential supervision
3. A fragile financial system
4. An unstable political climate

As Mishkin (1999) explains, a pegged exchange rate regime can be very dangerous for an emerging market like Mexico because when a domestic currency depreciates, its depreciation always involves a devaluation. In response to such devaluation, monetary authorities are left with no choice but to raise interest rates, thus triggering a rise in indebtedness that eventually deteriorates the financial performance of both local banks and firms; at this point, a full-scale financial crisis becomes inevitable. According to Mishkin (1999, pp. 1526-1527), the 1994 Mexican crisis and the 1997 Asian crisis are clear examples of what can happen when a developing country opts for a pegged exchange rate regime: all that it takes for a whole economy to collapse is a single slip. In Mexico, the devaluation of the peso resulted from two main factors: 1) a massive flight of capital triggered by adverse political events and investors' lack of confidence in the Mexican government (although political instability contributed to the outflows, it is fair to point out that speculators also played a key role in fuelling the crisis); and 2) a sudden hike in U.S. interest rates. Mexico's pegged exchange rate regime originated in 1988, when the nominal value of the peso was fixed against the U.S. dollar in an effort to promote economic stability, reduce inflation, attract foreign investors and prevent a currency crisis (GAO, 1996).

The main problem with a pegged exchange regime, like the one implemented by the Mexican government in the late 1980s, is that those who are supposed to administrate the nation's finances cannot see how overvalued or undervalued a currency really is. Although today's economists agree that an overvalued peso played a key role in triggering Mexico's crisis, back in 1994, nobody in Mexico seemed to think that the peso was overvalued (Neely, 1996). As Mishkin (1999, p. 1528) points out, poor prudential supervision also contributed to the 1994 crisis. In the early 1990s, Mexico's banking system was very fragile and undeniably unprepared for a foreign exchange crisis. Like other developing countries, Mexico lacked a fully developed financial market, which meant that the banking sector was entirely responsible for channelling funds to those who were most likely to put them to good use (Mishkin, 1999, p. 1528). In view of these considerations, one can easily see how poor prudential supervision in a developing country can easily result in a banking crisis bringing down the whole economy, which is exactly what happened in Mexico.

As previously mentioned, an unexpected revolt in the state of Chiapas and the assassination of a presidential candidate contributed greatly to the crisis by triggering massive capital outflows. Instead of taking immediate action, the then administration did nothing to reassure investors for fear that any corrective measure would cost the Institutional Revolutionary Party – president de Gortari's political party – the upcoming presidential election. Short-term political considerations coupled with a dangerous lack of awareness and experience prevented the Mexican government from appreciating the gravity of the situation. As Neely (1996) reports, right before the crisis unfolded, economists at the Bank of Mexico refused to admit that the real exchange rate of the peso was overvalued – and understandably so. Before 1994, there was very little pressure on the peso, meaning that the markets were positive about the country's prospects; for years, the Bank of Mexico had been accumulating foreign exchange reserves and exports had been growing, which certainly explains why the Mexican government failed to see how dangerously overvalued the peso was (Neely, 1996).

Consequences

The peso crisis had a devastating impact on multiple stakeholders. When the peso began depreciating, Mexican banks, which had accumulated a considerable amount of foreign currency debt and had foreign currency claims on Mexican companies, experienced a severe liquidity crisis that prevented them from meeting their financial obligations (Kenen, 2001). Furthermore, when Mexico's Central Bank raised interest rates in an effort to counter continuous capital outflows, the debtors, who had borrowed large sums at variable rates, started falling behind on their loan payments – given the length of the crisis, it is no wonder that many of them ended up defaulting, thus putting additional pressure on local banks (Kenen, 2001). Although the crisis stemmed primarily from financial fragility and political instability, Mexican banks, businesses and consumers were the ones who paid the highest price. The devaluation of the peso triggered a severe credit crunch which made it even more difficult for the country to recover and had a detrimental impact on key economic indicators:

- GDP fell from $527.8 billion in 1994 to $360 billion in 1995 (World Bank, 2019).
- GDP per capita fell from $9 million in 1994 to $8.4 million in 1995 (World Bank, 2019).
- Inflation soared from 6.9% in 1994 to 34.9% in 1995 (Graph 1).
- Foreign Direct Investment (net inflows) fell from $10.9 billion in 1994 to $9.5 billion in 1995 (World Bank, 2019).
- GNI per capita dropped from $5,310 in 1994 to $4,790 in 1995 (World Bank, 2019).

Impact on Financial Markets

Despite being commonly regarded as a currency crisis, the 1994 Mexican crisis did not only affect the foreign exchange market. When the peso was devaluated, those who had invested in the Mexican stock market or had purchased other peso-denominated instruments felt tricked by the Mexican government, which had previously announced that the peso would remain stable (Lusting, 1995). As Lusting (1995) points out, investors perceived the move as a serious breach of contract and promptly pulled their funds out of the capital, thus destabilising Mexico's stock market. As

reported by the Los Angeles Times (1994), in November 1994 (a month before the actual crisis began), Mexico's key stock market index plummeted after investors had collectively dumped their Telmex shares; the move resulted in the 37-share Bolsa index losing 126.62 points in just one day. To fully appreciate the ramifications of the sell-off, it's sufficient to say that Telmex (Telefonos de Mexico) was the country's benchmark stock, meaning that when its share price fell, other Mexican stocks seemed more expensive. The devaluation of the peso also had a devastating impact on Mexico's bond market, which at the time consisted primarily of *tesobonos*. As Levich (1998, p. 9) observes, before the assassination of Colosio, the Mexican government relied on four debt instruments to raise capital, three of which were denominated in pesos. After the assassination, the government converted its peso-denominated debt into USD-indexed *tesobonos*, which had a very short maturity period. As political uncertainty increased, the value of the peso kept declining, thus leading to an interest rate hike and a considerable decrease in the prices of Mexican bonds (Levich, 1998, p. 9).

Effects on the Global Economy

When discussing the ramifications of the Mexican crisis, experts often use the expression "tequila effect" to refer to the negative impact that the devaluation of the Mexican peso had on other emerging market economies. Argentine and Brazilian stock prices plummeted; the Argentine peso, the Philippine peso, the Hong Kong dollar and the Thai baht were targeted by speculators; spreads on Argentinian, Brazilian and Philippine bonds rose considerably (Kenen, 2001). Among the victims of the "tequila effect," Argentina was undeniably hit the hardest, losing over 30% of its foreign exchange reserves in the three months that followed the devaluation of the Mexican peso (Kenen, 2001).

As investors started retreating from the country, Argentina experienced a full-scale banking crisis that left it no with choice but to seek assistance from the World Bank and the IMF (Kenen, 2001). Although some have hypothesized that contagion was limited to Mexico's trade partners,

such an explanation cannot possibly justify the impact of the "tequila effect" on Argentina, whose trade volume with Mexico was hardly significant (Kenen, 2001). According to Kenen (2001, p. 25), it is more likely that the crisis spread via asset-market channels rather than trade ones: frightened by what was happening in Mexico, investors pulled out of many developing countries, especially the ones that reminded them of Mexico in terms of exchange rate policies, low foreign exchange reserves and fragile banks.

Government Responses (Authorities' Economic Issues to Solve the Crisis)

The Mexican government's response to the peso crisis was inadequate and untimely. When the peso came under pressure, the government allowed the peso/dollar exchange rate to fluctuate within a slightly wider band; unfortunately, the move was not supported by any fiscal or monetary measures, meaning that when the peso started losing value, the government's inaction cost the central bank $4 billion in foreign reserves (GAO, 1996). After reassuring investors that the peso would not be devaluated, on December 22, the government switched from a pegged exchange rate regime to a free floating one, once again without announcing any new economic measures (GAO, 1996). As investor confidence plummeted and downward pressure on the peso increased, it became clear that Mexico was no longer able to meet its financial obligations. Despite U.S. officials' attempts to persuade Mexican officials that their exchange rate policy was very risky and that some sort of intervention was in order, their ability to influence their counterparts was limited because Mexico was – and still is – a sovereign nation (GAO, 1996).

When U.S. officials realized that Mexico would soon default on its peso and USD-denominated debt, President Clinton coordinated a bailout package which enabled the Mexican government to restructure its short-term public debt whilst increasing market liquidity (Wilson, Saunders, & Caprio, 2000). Although nobody expected Mexico's currency crisis to result in a full-scale international financial crisis, the United States and the IMF soon concluded that external assistance was required to prevent the country from collapsing (GAO, 1996). In January 1995,

President Clinton announced a multilateral assistance package of nearly $50 billion –$20 billion came from the United States, nearly $18 billion from the IMF, $10 billion from the Bank for International Settlements, and the rest from Canada and various Latin American nations. As part of the bailout agreement, the United States and the IMF took Mexico's oil export revenues as collateral (GAO, 1996).

Conclusion

The 1994 Tequila Crisis was a severe financial crisis that stemmed from multiple factors and had a devastating impact not only on Mexico, where it originated, but also on several emerging-market countries. The main cause of the crisis was an imprudent exchange rate system implemented by the Mexican government in the late 1980s' in an effort to stabilize the economy. To create an investor-friendly environment, the government opted for a pegged exchange rate system without taking any precautions against a sudden devaluation of the peso. As Mishkin (1999, pp. 1526-1527) points out, the main problem with developing countries implementing pegged exchange rate regimes is that a single slip can cause immense harm to the economy – which is exactly what happened in Mexico in 1994. When the Federal Reserve raised its benchmark interest rate, the peso started depreciating at an unprecedented rate; at that point, all that it took for investors to lose confidence in the Mexican government was an unexpected revolt in Chiapas and the assassination of a presidential candidate. Due to the government's reluctance to take immediate action, the devaluation of the peso destabilized the entire banking system, thus triggering a full-scale financial crisis that ended up spreading to other emerging-market countries, especially Argentina.

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Tables and Charts

Year	Balance of Trade	Current Account	Direct Foreign Investment	Portfolio Investment	Gross International Reserves	Total External Debt	Public Sector External Debt	Interest Payments
1989	0.4	-5.8	6.6	0.4	6.6	95.3	76.1	9.3
1990	-0.9	-7.5	10.2	3.4	10.2	104.3	77.8	9.2
1991	-7.3	-14.6	17.5	12.8	17.5	116.5	80	9.2
1992	-15.9	-24.4	18.6	18	18.6	117.5	75.8	9.6
1993	-13.5	-23.4	24.5	28.9	24.5	131.7	78.7	10.9
1994	-18.5	-29.7	6.1	8.2	6.1	142.2	85.4	11.8
1995	7.1	-1.6	15.7	-9.7	15.7	169.9	100.9	13.6
1996	6.5	-2.3	17.5	14.1	17.5	167.5	98.3	13.5
1997	0.6	-7.5	28.0	5	28	154.7	na	12.4

Table 1. Mexico's Economic Indicators (1989-1997)

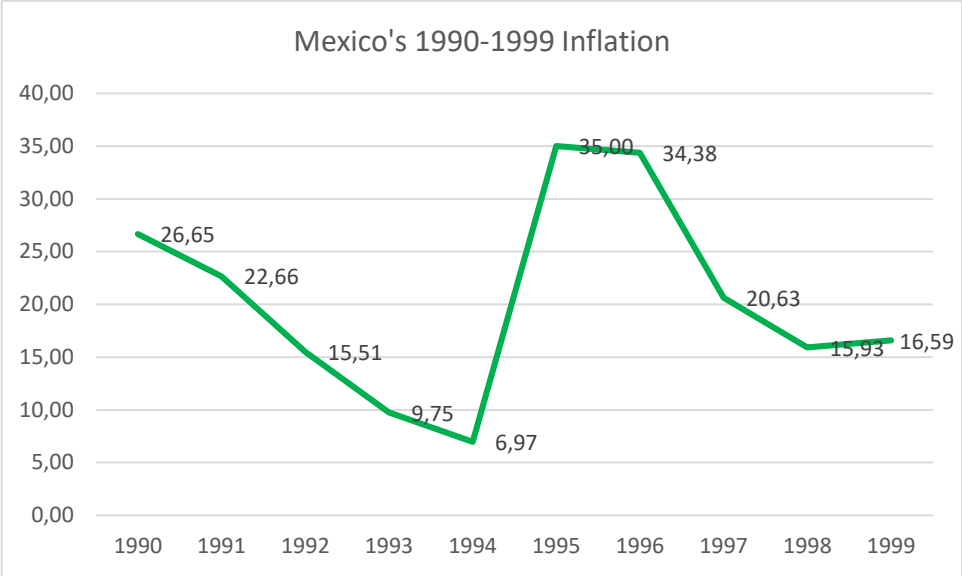
Source: Watkins, n.d.

Item	1993	1994:1	1994:2	1994:3	1994:4	1995:1	1995:2	1995:3	1995:4	1996:1	1996:2	1996:3	1996:4
Exports of goods FOB	12,972	13,776	15,068	15,064	16,974	18,787	19,631	20,087	21,036	21,870	23,607	24,247	26,275
Imports of goods FOB	16,342	18,073	19,618	19,859	21,796	18,190	17,033	17,873	19,358	19,936	21,410	22,835	25,288
Trade balance	−3,370	−4,297	−4,550	−4,794	−4,822	597	2,599	2,215	1,678	1,934	2,197	1,413	987
Balance on goods, services, and income	−6,760	−7,593	−8,503	−8,957	−8,391	−2,228	−726	−1,525	−1,057	−1,106	−935	−2,019	−2,799
Current account balance	−5,850	−6,782	−7,476	−7,908	−7,496	−1,355	356	−450	−128	−105	296	−829	−1,691
Direct investment (net)	1,097	3,152	3,283	2,814	1,723	1,983	2,914	2,255	2,375	2,028	1,780	2,004	3,374
Portfolio investment (net)	7,089	7,983	1,540	3,257	−5,364	−7,517	−3,998	−414	1,552	1,303	2,913	9,007	738
Other investment (net)	254	664	−1,743	−1,635	113	−3,185	−1,447	−4,165	−840	−3,826	−3,322	−8,687	−1,179
Monetary authorities	—	—	—	—	—	—	—	—	−788	−1,459	—	—	—
Government	−284	−1,471	−343	−262	−310	−863	−117	−2,477	47	145	−329	−8,308	−330
Banks	485	350	321	−953	2,196	−3,633	−1,741	−2,216	784	−1,900	−1,369	−1,313	804
Other sectors	53	1,785	−1,721	−420	−1,774	1,311	412	528	−883	−612	−1,624	934	−1,653
Financial balance	8,440	11,799	3,080	4,436	−3,528	−8,719	−2,531	−2,324	3,088	−496	1,371	2,324	2,933
Net errors and omissions	−782	−4,534	−3,909	3,903	1,217	−1,924	690	543	−3,557	629	−1,479	−70	978
Overall balance	1,808	484	−8,305	430	−9,808	−11,998	−1,484	−2,232	−597	29	188	1,426	2,221
Increase (−) in reserve assets	−1,514	−107	8,654	−140	9,991	−691	−3,229	−4,666	−1,062	224	75	−175	−1,930
Use (+) of IMF credit	−294	−377	−348	−290	−183	7,452	−287	3,416	1,369	−253	−263	−1,250	−291
Exceptional financing	—	—	—	—	—	5,237	5,000	3,482	291	—	—	—	—

FOB = free on board

Table 2. Mexico's Balance of Payments – Quarterly Data in $ Millions

Source: https://www.piie.com/publications/chapters_preview/335/2iie2970.pdf



Graph. 1. Mexico's 1990-1999 Inflation

Source: World Bank, 2019