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Drawing Lessons from the Mexican Crisis: Preventing and Resolving Financial Crises--the Role of the IMF

Address by Michel Camdessus

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at the 25th Washington Conference of the Council of the Americas on

"Staying the Course: Forging a Free Trade Area in the Americas"

Washington, D.C., May 22, 1995

It is a great pleasure for me to be with you this morning, to share some thoughts on how, as you are considering how to forge a free trade area in the Americas, we in the IMF can create an environment amicable to it, by helping to prevent and resolve the financial crises of the next century. This is certainly the role of the IMF as the central institution of the international monetary system. The recent crisis in Mexico provides a focus for such thoughts. What did it signify, and what are its lessons, for economic policy, for the Americas, for the international community, and for the IMF? But before addressing these questions, we must be clear about how the crisis arose, and how it was managed.

As I shall argue later, the increased challenges we face today in preventing and resolving international financial crises are, paradoxically, to a large extent a consequence of economic progress. Mexico's crisis illustrates this: it can be understood only in the context of the country's economic progress of the past decade. From 1988 to 1993, with the active support of the IMF, Mexico strengthened the process of macroeconomic stabilization and structural transformation that began in the wake of the 1982 debt crisis. Its strategy aimed at attaining external viability and laying the foundations for private-sector-led growth. It was based on tight financial policies; the use of the exchange rate as a nominal anchor; comprehensive structural reforms, including privatization and trade and exchange liberalization; and a major restructuring of external debt.

The result was remarkable success on many fronts. A reduction in the fiscal deficit was achieved that should be an inspiration for many countries. Inflation was reduced from 160 percent in 1987 to 8 percent in 1993. Economic growth recovered from an average not much higher than zero in 1985-88 to 3 percent in 1989-93. The restructuring of external debt paved the way for a resumption of access to international financial markets, and private capital inflows surged, contributing to a large increase in international reserves.

Mexico therefore entered 1994 with a strengthened economy, and an economy more deeply integrated into global markets, with its membership in NAFTA and impending accession to membership of the OECD as well as its commitments to an open exchange and trade regime promising to lock in many of the important reforms it had implemented.

So what went wrong? I would point to a number of factors. First, there were still weaknesses in Mexico's economic position at the start of 1994 that contained the seeds of the crisis that eventually occurred. In particular, the external current account deficit, running at 6 1/2 percent of GDP in 1993, was very large by most standards, and was being financed largely by short-term capital inflows. A steep real appreciation of the peso and a major deterioration in the private sector's saving performance had contributed to the emergence of this deficit. Its sustainability was questionable, and indeed in February last year, at the conclusion of its regular consultation with Mexico, the IMF "stressed the need to lower the external current account deficit...to reduce the economy's vulnerability to a sudden reversal in capital flows."¹

But in the event, Mexico's weak external position was exacerbated in 1994 both by a series of unfavorable developments at home and abroad and by shortcomings in Mexico's policy response, partly owing to the political hiatus following the elections in August. The uprising in Chiapas at the start of the year was the first in a series of dramatic adverse domestic developments that are well known; and also from early 1994 Mexico was confronted with a substantial rise in world interest rates, which prompted international investors to reassess the share of their portfolios invested in emerging markets. All these developments tended to weaken the peso. And the policy response was not adequate, the outgoing administration leaving to the new administration the responsibility of defining the adjustment strategy that was called for. And indeed the country suffered a lot from the frequent Latin American problem of too long a time span between election and inauguration. The peso was allowed to depreciate within its band, but the vulnerability of the economy was increased by the replacement of peso-denominated government debt by Tesobonos, instruments indexed to the U.S. dollar. The current account deficit widened further, to 8 percent of GDP for 1994 as a whole. All these factors contributed to the eruption of the crisis last December.

Before considering the lessons of this experience, we must also be clear about how the crisis was resolved--I am confident enough to use these words today--and turned into a manageable problem. It was not resolved by the devaluation of December 20. Nor was it resolved two days later when, after a further massive loss of international reserves, the peso was allowed to float. This merely delivered another blow to confidence, and the peso continued to depreciate sharply, as financial markets questioned Mexico's ability to service its short-term debt. The fact is that confidence was not restored and the crisis was not resolved until two components were securely in place--a stringent adjustment program designed in close collaboration with the IMF,

and a large-scale international financial rescue package in support of that program. This package has three elements. The IMF approved on February 1 an 18-month stand-by credit of \$17.8 billion in support of Mexico's program for 1995-96, of which \$7.8 billion was made available immediately. The other two elements, both dependent on Mexico's arrangement and policy understandings with the IMF are, of course, \$20 billion in swaps and guarantees from the U.S. Exchange Stabilization Fund, and \$10 billion of short-term support from the G-10 central banks through the BIS (Bank for International Settlements).

The IMF arrangement with Mexico is the largest ever approved for a member country, both in absolute amount and in relation to the country's quota in the Fund. Why such exceptional support? For a very simple reason, which is the very basic mandate of the IMF. Take Article I of our Articles of Agreement--it states that it is the IMF's mission: "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." On January 31 of this year, this was the problem: either large-scale financial assistance was put in place together with the support of the U.S.--and the IMF was the only institution in a position to extend it without delay--or Mexico had no solution other than to resort to "measures destructive of national or international prosperity", such as a moratorium on foreign debt or a reimposition of trade and exchange restrictions, with a major risk of the spread of such measures to a number of countries.

As a matter of fact, there was a distinct risk of systemic repercussions. In the weeks following the eruption of the crisis, equity and currency markets came under pressure, most noticeably in Latin America but also in a number of more distant emerging market economies, including in Asia. These immediate spillover effects indicated that Mexico's crisis could raise doubts, unwarranted by fundamentals, about the viability of policies in other countries as well. A major interruption in the flow of capital to developing countries could have ensued, and thus one of the driving forces of global growth in recent years could have vanished.

But the exceptional assistance provided to Mexico was warranted equally by the strength of the program adopted and Mexico's track record of macroeconomic and structural adjustment. It is ambitious, aiming in particular to cut the external current account deficit to less than 1 percent of GDP in 1995 and to contain the inflationary effect of the peso's depreciation. Economic growth is projected to resume next year. To achieve these goals, the program is centered on a further tightening of the fiscal position and a strong monetary policy. The program also pursues further the strategy of privatization and liberalization of activities previously reserved for the public sector, and includes a number of measures to protect the poorest from the short-term adverse effects of the adjustment process.

There are by now encouraging indications that the program has taken hold. Mexico's trade balance was in surplus in the first quarter, in contrast with a \$4.3 billion deficit in the same quarter of 1994. The peso has recovered from a low of 8.1 per dollar in early March to less than 6, and an easing of domestic interest rates also indicates that the financial situation is stabilizing. Problems certainly remain, but if the authorities continue to implement the program steadfastly and consistently, Mexico's economy is headed toward recovery, and given the acceleration of reforms in this program it should emerge from the crisis--and let me emphasize this--stronger than before.

This has been a testing experience for Mexico and the international financial community. What does it signify, and what are its lessons?

Mexico's crisis has been described as the first financial crisis of the 21st century, meaning the first major financial crisis to hit an emerging market economy in the new world of globalized financial markets. And this says a lot about its significance. The increasing international integration of financial markets in the past 10-15 years has brought great benefits, by fostering a more efficient allocation of global savings and boosting investment and growth in many countries. But there is a downside: vastly increased financial flows across national borders have also made countries that participate in international financial markets more vulnerable to adverse shifts in market sentiment: such shifts, though generally related to concerns about economic fundamentals and policy shortcomings, can often be delayed, sudden, massive, and destabilizing. Furthermore, financial globalization has increased the speed with which disturbances in one country can be transmitted to others. So financial globalization, though both a product of and a contributor to the economic progress of our time, has heightened the challenges of preventing and resolving financial crises.

And it is no accident that this crisis hit one of the most successful developing economies. An essential ingredient in the success of Mexico in the past decade--as with all other successful developing economies--has been its increased openness to the world economy and integration into international financial markets.

Thus, as I said at the beginning, the challenges that now have to be addressed are to a large extent a consequence of economic progress. And it would be an egregious mistake to seek to prevent financial crises by reverting to a closed economic system with exchange controls and less open markets: to do this would be to try to turn the clock back and forego the benefits of globalization. This is well understood by the Mexican authorities, who quite appropriately have been addressing Mexico's problems without resorting to that approach again.

So how should the challenges of financial crises be addressed? What are the lessons from Mexico about the conduct of economic policy, the role of the IMF, and international cooperation more generally?

As regards **economic policy**, I would emphasize four lessons. First,

openness to international financial markets today imposes an obligation of unfailing discipline on economic policy. Vigilance and discipline provide the most effective deterrent and defense against financial market setbacks. Mexico's crisis demonstrated impressively the costs that can arise when a country lowers its guard and allows markets to exercise their discipline instead. A similar lesson was shown, for instance, by Argentina's very quick reaction to the crisis. By transforming the crisis into an opportunity to address in depth the worrying signs of weakness in its provincial banks, Argentina, with strong support from the IDB, World Bank, and IMF, has paid a great service not only to itself but to the Americas and the world at large. With the situation under control in Mexico and Argentina, the systemic risk was well-contained.

Second, large external current account deficits are dangerous, especially when they are being used to support domestic consumption and are being financed by short-term capital inflows. They are dangerous because they are not likely to be sustainable. This applies even when, as in Mexico's case, the fiscal position is strong and the external deficit largely reflects weak private sector saving. With the benefit of hindsight, Mexico's fiscal position should have been even stronger, to contain the country's dependence on easily reversible capital inflows. (Let me add in parentheses here that it is striking that large external deficits and weak national saving performance have been the Achilles' heel of all three NAFTA economies in recent years. In fact, during 1989-93 the United States, Canada, and Mexico were three of the four largest users of foreign capital in the world. Mexico is certainly not the only member of NAFTA that must face the imperative of addressing its economic imbalances.)

Third, Mexico's devaluation in December illustrates not only that it is inherently difficult to adjust a pegged exchange rate even when such a change is called for, but also that sound and credible accompanying macroeconomic measures are essential to provide a firm basis for market expectations and to make the new exchange rate sustainable.

Fourth, Mexico's crisis illustrates the costs of failure to publish regularly and in good time information about key economic indicators. The crisis arose in the way it did partly because the scale of the problem only became apparent at the time of the devaluation, and took the financial markets by surprise. If information about international reserves and other key variables had been published more frequently and with a shorter time lag, the efficiency of market discipline and the chances of a smoother adjustment would clearly have been enhanced.

These are a few of the main lessons that have emerged from Mexico's crisis for individual countries. But what are **the lessons for the IMF?** The crisis and its resolution have confirmed the urgency of action to enable the Fund to provide more help for countries in both preventing and resolving such crises. It has therefore confirmed the appropriateness of the attention we had already been giving, especially in the context of the IMF's 50th anniversary, to the need to ensure that the Fund is fully equipped to serve its purposes in the new

environment of globalization.

The IMF's work in helping to prevent crises is carried out mainly through the exercise of its responsibility for surveillance over the international monetary system and members' exchange rate policies. IMF surveillance is an international cooperative effort aimed at improvements in policies, the prevention of policy mistakes, and the promotion of exchange market stability and sustainable growth. It is conducted mainly through the annual consultations held with all individual member countries and through regular discussions in our Executive Board on the world economic outlook and global financial market developments. In recent years the Fund has taken action to make surveillance more continuous and effective, and significant progress has been made. But Mexico's crisis showed that further adaptations are needed to make surveillance strong enough to minimize the risk of the eruption and spread of crises in the new global environment:

- first, data: stricter requirements need to be applied concerning the regular and timely communication by countries to the IMF of data on key economic indicators; and the Fund also needs to make more use of financial market data in monitoring developments. We shall also be working toward the establishment of standards for the timely publication of economic data by members to enable markets to work more efficiently;
- second, more continuous policy dialogue: not only must countries be willing to keep the IMF informed of developments and seek its opinion on issues they are facing, but the Fund's internal procedures must be adapted to foster dialogue more effectively in the intervals between our regular consultations, particularly when countries have just ended an adjustment program with the Fund;
- third, better focussed surveillance: especially given its limited resources, the Fund must focus more effectively on countries at risk, and countries where financial tensions are most likely to have spillover effects. And surveillance must also focus more carefully on financial flows and their sustainability;
- fourth, more pointed and candid surveillance: in its policy dialogue with member countries the Fund must be prepared to be more critical and demanding--yes, even more critical and demanding than in the past.

These are some of the items on our agenda of action to strengthen surveillance. I fear that implementing it will not be a straightforward matter: experience shows that while countries tend to be very eager for surveillance over others, they are less keen on surveillance over themselves. It will be a critical challenge for international policy cooperation and for the IMF.

But even with the most effective IMF surveillance, crises are likely to occur from time to time; and the IMF must also ensure that it has the

means to provide countries with financial assistance adequate to contribute effectively to their resolution. It was able to do so in the case of Mexico, by resorting to its exceptional circumstances clauses. There have been a number of other large Fund financial arrangements in recent months, most notably in support of programs of stabilization and reform in Argentina, Russia, and Ukraine. Because of these and other expected commitments, the Fund's liquidity position, adequate at present, is projected to weaken considerably over the next two years. The Fund's resources are probably sufficient for our normal business during this period, and if emergencies call for it, the General Arrangements to Borrow (GAB) from some of our largest member countries can be activated. But we must look beyond the next couple of years, and see what action needs to be taken to ensure that the Fund's resources are strong enough to meet the demands the Fund may face in the closing years of this century and beyond. This was agreed by our Interim Committee, and following their preliminary discussion we shall in the next few months be considering a number of courses of action:

- the first priority is the Eleventh General Review of Quotas, which are our member countries' capital subscriptions to the IMF. This review must be initiated expeditiously, and while it should be concluded by March 1998 at the latest we should complete our work earlier if possible, before the end of 1996. This quota review should in my assessment lead roughly to a doubling in quotas, in order to ensure that the size of the Fund keeps pace with the growth in the world economy since the last review in 1990 and takes some account of the increased scale of international financial flows that now characterize the system;
- second, we shall be reviewing the role of the General Arrangements to Borrow and exploring ways to increase the potential resources available to the Fund through borrowing from our members;
- third, when considering ways in which temporary financing could help the IMF discharge its responsibilities at times of emergency, we must consider how the SDR--the international reserve asset that the IMF can create in special circumstances--could be instrumental in the introduction of safety-net arrangements, whereby SDRs could be issued on a temporary basis or lent to countries in support of strong policy programs in the context of a liquidity crisis. I am suggesting that this idea be considered with particular attention together with, but hopefully before, a wide-ranging review of the role and function of the SDR;
- fourth, we shall be examining ways to ensure the continued availability of concessional balance of payments assistance to low-income countries following the expiration within the next few years of the existing enhanced structural adjustment facility (ESAF). One possibility to be considered is the sale of a modest part of the Fund's gold holdings and the use of earnings from the invested profits of such sales, combined with bilateral contributions from member countries, to provide the subsidy element that is needed;

• finally, we shall be exploring the possibility of developing arrangements for more orderly international debt adjustment, taking into account the experience with debt reorganization under national laws. Consideration of this approach raises a number of complex economic, political, and legal issues, and I should emphasize that our work on this is still very exploratory.

So here again we have a full agenda.

I have indicated a number of ways in which the IMF will be seeking in the period ahead to increase its effectiveness in helping countries both to prevent and to resolve financial crises. Some, on the surveillance side, are already being implemented, while others are in stages of preliminary exploration. These efforts are as essential as they are challenging, because the increasing globalization of the world economy makes effective international monetary cooperation at the global level--an effective IMF--more important than ever before. Regional cooperation of course also has an essential role to play, and has contributed vitally to economic progress in Mexico and throughout this hemisphere. But Mexico's crisis had global, not only regional, repercussions; its resolution required financial assistance at the global level; and the adjustment that Mexico is now undergoing, though affecting mainly the United States and other countries in this hemisphere, has been having effects much further afield, including by contributing to some extent to the weakness of the U.S. dollar. Mexico's crisis was of global significance, and its resolution required global cooperation.

In trade relations as in international monetary relations, global cooperation is essential: regional cooperation is important, but it is not enough. NAFTA represents an important achievement in outward-looking regional cooperation that is already contributing to the advancement of prosperity in Mexico and its partner countries. The initiative for a free-trade area in the Americas--the subject of this conference--reflects the strong sense of community in this hemisphere and a conviction that the mutual advantage of nations requires cooperation in economic relations. It was this same conviction that led at the global level to the Uruguay Round agreement. That agreement, with the establishment of the WTO (World Trade Organization), has strengthened the institutional framework for pursuing global trade liberalization through multilateral cooperation. And that is essential. A critical element will be the resolution of trade disputes under strengthened multilateral rules. With the conclusion of the Uruguay Round, one had good reason to expect that unilateralism would recede and that the rule of law would prevail over the law of the jungle. I trust that that expectation can indeed be realized, and that global cooperation will prevail in international trade as in monetary relations.

The next crisis of the 21st century, like Mexico's crisis, will also be of global significance, affecting this hemisphere even if it originates outside it. We must be ready to face it, and for that we must now meet

the challenge of making the IMF as strong and effective as the world economy of the 21st century needs it to be. It is gratifying that the Interim Committee is guiding us in this direction, and I am sure that the G-7 Summit in Halifax next month will give added impetus to our work. And we shall of course be counting on the support of the United States, which has contributed so much to rising global prosperity as a pillar of multilateral economic cooperation in the past 50 years.

1. *Annual Report 1994*, IMF.

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