FEDERAL RESERVE

The Fed's "Tequila Crisis"

A financial crisis in Mexico in the mid-1990s sparked a debate about the Fed's role in international markets and its independence

BY TIM SABLIK

On the day before New Year's Eve in 1994, the Federal Open Market Committee (FOMC) held an emergency conference call. The topic was the rapidly deteriorating financial situation in Mexico. The value of the Mexican peso had fallen sharply, and billions of dollars in foreign investment and credit had fled the country. It was unclear whether Mexico would be able to roll over or service its short-term debt that was rapidly coming due.

There was a concern that if Mexico defaulted, it would spread panic throughout Latin America, as had happened during Mexico's last debt crisis in 1982. Some also feared spillover into the United States, given its new trade ties with Mexico. The North American Free Trade Agreement (NAFTA) had gone into effect in January. Still, Fed Chairman Alan Greenspan was initially somewhat optimistic. Mexico had made meaningful economic reforms since the 1980s.

"The weak underlying economic structure that prevailed in 1982 when the Mexican economy last fell into a swoon clearly is not there," Greenspan said on the Dec. 30 call. "We are obviously dealing with a highly psychological issue and a very significant amount of international financial volatility."

But as the new year unfolded, it quickly became apparent that the storm was not passing and that Mexico would not be able to weather it alone. The Fed was thrust into a debate over how the United States should respond, raising long-standing questions about its involvement in foreign operations and its independence from the Treasury.

Setting the Stage

In many ways, the run-up to what would later be dubbed Mexico's "tequila crisis" looked similar to its last boom and bust. During the 1970s, oil price spikes stemming from the OPEC embargo boosted revenues from Mexico's state-owned oil industry. Near-zero real rates on short-term loans due to rising global inflation made it attractive for the Mexican government to use its new revenue to take on greater debt. For their part, creditors in the United States were eager to lend. Low real rates at home made the yields from investing in developing countries like Mexico attractive.

Things began to unravel quickly in the early 1980s. The Fed under Chairman Paul Volcker began aggressively raising its policy rate to combat inflation, which raised the cost of Mexico's debt as U.S. banks also increased rates on loans. Higher rates at home also made the relatively riskier investments in Latin America less attractive to American investors, and Mexico's access to funding dried up. By August 1982, Mexico's finance minister told officials in the United States and at the International Monetary Fund (IMF) that the country could no longer manage payments on its $80 billion debt. This prompted a crisis throughout Latin America, cutting off Mexico and other countries from international finance markets. The Fed organized bridge loans from central banks around the world that helped Mexico avoid a default, but they were not enough to reduce the principal on the debts. Mexico and other countries were forced to make deep cuts, leading to a "lost decade" of stagnant or negative economic growth.

The crisis prompted major changes in Mexico. President Miguel de la Madrid undertook widespread industry deregulation and privatization and substantially lowered tariffs to open the country to trade. His successor, Carlos Salinas de Gortari, continued this trend. His administration participated in the trade negotiations with the United States that culminated in NAFTA and worked with then-U.S. Treasury Secretary Nicholas Brady

Treasury Secretary Robert Rubin, left, and Federal Reserve Board Chairman Alan Greenspan testify before the Senate Foreign Relations Committee in January 1995 in regards to the Mexican crisis.

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to renegotiate Mexico's outstanding debt in 1989-1990. This allowed Mexico to regain access to international credit markets at the same time that it opened its financial markets to foreign investment and began privatizing its banking sector.

By 1992, most of Mexico's commercial banks had been privatized. This led to a large expansion in consumer credit. Once again, foreign credit flowed into the Mexican government and Mexican firms as well. Just as in the 1970s, U.S. investors were searching for yield due to low interest rates at home following the 1990-1991 recession. Net foreign direct investment in Mexico doubled from roughly $2 billion to more than $4 billion a year.

This Time is Different?

In hindsight, there were signs of another crisis brewing. As it had in the early 1980s, Mexico was running a substantial current account deficit by the early 1990s. From 1988 to 1992, Mexico's current account deficit grew tenfold from $2.4 billion to $24.4 billion. Large current account deficits financed by borrowing often spelled trouble for developing nations; creditors might begin to doubt the country's ability to repay them and decide to pull funding out, sparking a rapid devaluation of the currency.

But there was a feeling in the air that Mexico was no longer a developing country. The financial officials in de la Madrid's and Salinas' administrations overseeing Mexico's market-oriented reforms had been educated in top U.S. economics programs and were well-respected by their counterparts in the United States and Europe. Mexico was welcomed into the Organisation for Economic Co-operation and Development (OECD) in May 1994, the first new member since New Zealand in 1973. Mexico, it seemed, had "arrived."

Thus, initial signs of unrest in 1994 did little to break investors' confidence at first. On Jan. 1, the same day that NAFTA went into effect, a rebel group seized control of several towns in the state of Chiapas in a standoff that lasted nearly two weeks. Violence and kidnappings intensified throughout the year. In March, the leading presidential candidate, Luis Donaldo Colosio-Murrieta (who was also a member of de la Madrid's and Salinas' party), was assassinated. And in September, Mexico's secretary general was also killed.

Mexico had a history of financial turbulence during election years. The Bank of Mexico did not gain its independence until 1993 and came under political pressure to keep interest rates low during elections. This led to recurring bouts of inflation. It attempted to curtail this inflation by managing the peso's exchange rate, but it would inevitably be forced to let the currency devalue. In 1991, the Bank of Mexico established another managed exchange regime for the peso. Its value fluctuated freely but only within a narrow range of rates pegged to the dollar. The Bank of Mexico needed enough reserves on hand in order to credibly defend the peso's floor and ceiling.

As the political unrest in Mexico intensified in 1994, investors began to reconsider their bets on the country's future. At the same time, the Fed initiated the first of six interest rate hikes that year in February, marching the fed funds rate up from 3 percent to 5.5 percent. As in the 1980s, higher rates at home reduced the attractiveness of riskier investments in developing markets.

The real tipping point came in December 1994 after newly elected President Ernesto Zedillo Ponce de León took office. Zedillo replaced Finance Minister Pedro Aspe, who had served under Salinas and who was respected by foreign investors. More than $800 billion in investments poured out of the country as investors feared that Zedillo's administration would renege on the reforms of his predecessors. And to bookend the year of turmoil as it began, a second rebel uprising in Chiapas occurred on Dec. 19.

Under this mounting pressure, the Bank of Mexico could no longer credibly defend its peso peg. It attempted to devalue the peso slightly on Dec. 20. The move sparked additional panic from investors, and another $4.6 billion left the country in two days. The Bank of Mexico was forced to abandon the peg entirely, allowing the peso to devalue sharply from 3.5 pesos per dollar to 5.75 pesos per dollar.

This devaluation threatened to spark a major debt crisis. Throughout the year, the Mexican government had issued short-term debt that guaranteed repayment in dollars (bonds known as tesobonos). The sharp devaluation of the peso relative to the dollar increased the burden of these tesobonos. With markets panicking, it was unlikely that Mexico would be able to secure new loans to roll over its short-term debt before it came due.

The Fed Gets Involved

The Fed had been watching these events with growing concern. On March 22, 1994 — the day before Colosio's assassination, it would turn out — the FOMC held its second meeting of the year, and Mexico was high on the agenda. Fed policymakers discussed a proposal to temporarily increase the Fed's swap line with the Bank of Mexico from $700 million to $3 billion. Mexico had had a standing swap line with the Fed since 1967, but with NAFTA in place, Mexico had requested an increase in its line, an increase that it suggested would befit its now-closer ties to the United States.

The Fed's swap lines were originally established in 1962 during the Bretton Woods monetary system to supplement efforts by the Treasury's Exchange Stabilization Fund (ESF) to maintain the dollar's fixed value to gold. The Fed used swap lines to exchange dollars for foreign currency with a foreign central bank, agreeing to repurchase them at a future date at the same exchange rate. This protected foreign central banks from exchange rate risk, which would in theory reduce their desire to convert dollars to gold and help defend the dollar-gold peg.

The swap lines also allowed foreign central banks to draw on them to supplement their dollar reserves during a crisis. The Bank of Mexico had done this repeatedly during previous crises, which gave some members of the FOMC pause.

"I'm still not satisfied in my own mind as to what is or is not an appropriate use of swap lines per se," Cleveland Fed President Jerry Jordan said at the March 1994 meeting. "When I look at the utilization of our swap lines with Mexico in the past, it's a very troubling pattern." On the other hand, Jordan conceded that if the Fed wanted to continue using the swap lines, then Mexico should be given the same access as any other major trading partner of the United States.

"Mexico wasn't just another emerging market country that was having all these problems anymore, it was our partner in NAFTA," says Michael Bordo of Rutgers University. "Now it was of great strategic importance not to have a huge banking crisis in Mexico that would destabilize the hemisphere."

Following Jordan's objections, then-Richmond Fed President Al Broaddus voiced other concerns. He noted that the swap lines had been set up for a specific purpose that no longer existed. Using them to lend to countries in financial trouble, like Mexico, could be seen as an abuse of the Fed's independence. "It seems clear to me that any loan to Mexico in the current circumstances in essence would be a fiscal action of the U.S. government," Broaddus said at the meeting. "And fiscal actions — expenditures of the government — are supposed to be authorized by Congress."

Additionally, there was a growing consensus among economists in academia and at the Fed that these interventions into foreign exchange markets were ineffective. "I thought that the Fed's foreign exchange market operations undermined the credibility of monetary policy," says Broaddus. The Fed had fought hard throughout the 1980s to build its credibility for pursuing low and stable inflation at home. Intervening in currency markets to prop up another country's currency, particularly if such interventions didn't work, would weaken the credibility of the Fed to achieve its policy goals at home.

But others, such as New York Fed President William McDonough, argued that given the increasing interconnectedness of world markets, the Fed should take a wider view of monetary policy. "I think that one of the functions of the Federal Reserve is to seek monetary stability in a broader framework than just the American economy," he said. "[Mexico] is a country, being on our border, in which serious financial instability would have a very definite possibility of spreading across the border and creating problems in our own markets. So to me it is appropriate to have the swap line used in times of market instability."

The FOMC was pressed into making a decision when Colosio was killed, creating further unrest in financial markets. On a March 24 conference call, the committee voted 8-1 in favor of temporarily increasing the swap line to $3 billion. Broaddus was the lone dissenter, predicting that "ultimately this will do us more harm than good."

The Treasury's Plan

Broaddus' warning was prescient. As the year continued and the crisis in Mexico worsened, the Fed was drawn deeper into the U.S.-led response. The FOMC voted to temporarily increase its swap line to $4.5 billion on Dec. 30, 1994. Again, Broaddus alone dissented.

On Jan. 10, 1995, immediately after he took his oath in the Oval Office, Treasury Secretary Robert Rubin held a meeting with President Bill Clinton and other senior advisers, including the Treasury's top international official, Larry Summers. Rubin and Summers both predicted global catastrophe if Mexico defaulted. They proposed that the United States provide a rescue package of $25 billion — more than 10 times the assistance the U.S. government provided to Mexico in 1982. Ultimately, the proposal was raised to $40 billion, to make sure to calm markets.

Initially, congressional leaders pledged to support the plan. But in the following days, they wavered. Members in both parties questioned putting billions of taxpayer dollars at risk to bail out Mexico and the Wall Street bankers who had made investments there. Congressional opposition to President Clinton was high as well. The Republicans had just won control of the House for the first time in more than 40 years, and many of them were in no hurry to support an unprecedented foreign aid package orchestrated by the Clinton administration as their first action.

As it became clear that Congress would not vote for the plan, Rubin and Summers began looking for alternatives. The IMF was willing to help, but it did not have the resources to support the size of intervention that the Treasury thought necessary to calm markets. To supplement the IMF, they turned to the ESF. The ESF also did not have enough dollars to make the now $20 billion loan that Rubin and Summers envisioned, but it did have substantial foreign currency holdings. They asked the Fed to engage in a swap with the Treasury, exchanging dollars for foreign currencies that the Treasury would agree to buy back at a later date.

Initially, the discussion at the Fed focused on how the Treasury would protect it from any risk should Mexico default on the loan. But at the FOMC's Jan. 31-Feb. 1, 1995, meeting, others joined Broaddus in voicing larger concerns about the Fed's involvement. St. Louis Fed President Thomas Melzer did not agree that the crisis in Mexico represented a "systemic" threat to the United States, and he felt that the Fed was "setting a very bad precedent" by directly funding the Treasury's fiscal operation.

Board Governor Lawrence Lindsey noted that by funding the operation, the Fed was effectively helping the Treasury to subvert the will of Congress. "Our political risk in this is enormous," he said. "A bill that [Congress] opposed was defeated, and now...we are going to go around all the normal processes and pull money out of this little pot people never knew even existed and use that money. Well,

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they selected their particular college over others, 60 percent in the most recent survey (2015) answered it was because its graduates "get good jobs." That share was up 5 percentage points in just three years and was also the highest ever for that question, which has been asked since the 1960s.

Do these converging trends mean that small schools will eventually become obsolete? Carey, of New America, sees potential for many of these schools to turn around, especially by expanding their digital programs and bringing in a broader array of students who can benefit from them. "A school can keep a small and intimate campus for those who want it and still reach thousands more across the country," he notes. "But for many of these small institutions, whatever they do, they need to go beyond their traditional model to stay viable." **EF**

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maybe everyone will forget about it, but I don't think so."

"They will if it works and they won't if it does not work," Chairman Alan Greenspan responded. The FOMC voted in favor of the swap with the Treasury, with Melzer and Lindsey opposing. (Broaddus was not a voting member in 1995, but he too voiced opposition to the arrangement at the meeting.)

A Pyrrhic Success?

The operation accomplished its immediate goals. President Clinton authorized the $20 billion loan from the ESF on Jan. 31, 1995. An additional $17.8 billion from the IMF and $10 billion from the Bank for International Settlements brought the total aid package up to nearly $50 billion. With this assistance, Mexico was able to meet its demands and avoid default, but it did suffer a severe recession. Eventually, its economy recovered and it repaid its loans in full and ahead of schedule.

Still, the event raised a number of lasting questions. Intervening to prevent the default of companies or countries creates a moral hazard problem; international investors might take larger and larger risks in the future if they believe they are protected from the consequences of failure. The 1995 intervention was more than 10 times the size of the loans made to Mexico in 1982. And just two years later, the international community would fund a $118 billion loan to Thailand, Indonesia, and South Korea to prevent another crisis.

The Mexico intervention also raised serious questions for the Fed. The Treasury ultimately never called on the Fed to swap its foreign currencies with dollars to finance the loan to Mexico, but the event still sparked a discussion about how such operations might affect its credibility and independence. By the late 1990s, the FOMC voted to close nearly all of the Fed's swap lines. The decision was short-lived, however. During the financial crisis of 2007-2008 and the subsequent debt crises in Europe, the Fed revived them to provide foreign central banks with dollar liquidity. Continuing the Richmond Fed tradition, then-Richmond Fed President Jeffrey Lacker dissented against the swap arrangements in 2011, reiterating the argument that they amounted to fiscal policy.

"I think Richmond has done a good job keeping this issue in front of the FOMC for a long time, but I can't say we've completely sold them on it," says Broaddus. "That's still a work in progress. And it may always be." **EF**

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