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Mexico in Crisis, the U.S. to the Rescue. The Financial Assistance Packages of 1982 and 1995

Nora Lustig Wednesday, January 1, 1997

In January 1995, as in August 1982, Mexico was on the verge of defaulting on its foreign obligations. On both occasions the U.S. government contributed, and helped align the contribution of others, to a financial rescue package to avoid it. However, the characteristics of the 1995 financial assistance package and the support provided by the United States administration were quite different. The relative speed with which Mexico regained access to capital markets and avoided the risk of a systemic crisis in 1995 must be attributed to a large extent precisely to the differences between the two rescue packages.

The first and most important difference lies in the packages' objectives. The 1995 package was meant to solve Mexico's liquidity crisis in full. In contrast, the 1982 package was conceived to provide interim financing to give the Mexican government additional time to negotiate a work-out with its creditors and an accord with the IMF. The difference in the objectives is reflected both in their relative size and the term structure of the loans. In constant dollars the financial assistance arranged in February 1995 of up to US$48.8 billion was roughly seven times larger than the US$4.55 billion (US$7.2 billion in constant 1995 dollars) rescue package arranged in August 1982, and the contribution of the United States of up to US$20 billion was more than three times its contribution of US$3.625 billion (US$5.7 in constant 1995 dollars) in 1982. Furthermore, whereas in 1982 the United States loans were to be repaid in one year, the bulk of the loans extended in 1995—US$10.5 billion of the US$13.5 billion—could be repaid between June 1997 and June 2000. The medium-term quality of the U.S. loans is the next most important difference between the two rescue programs.

The success of the 1995 rescue package is evidenced by the speed with which the Mexican government has been able to return to the international capital markets. As early as April 1995 a Mexican development bank was able to borrow in the international market and between mid-1995 and early 1996, Mexico was able to raise about US$8 billion, with the terms and maturities of the loans improving over the period. In fact, the rescue package was so successful in restoring market confidence that Mexico was able to pay back all of the US$13.5 billion in loans with the U.S. by the end of January 1997, well ahead of schedule. Moreover, although there were a few additional incidents of market volatility, the peso has achieved an acceptable degree of stability since March 1995. Finally, the possibility of the crisis spreading to other countries in the region and other regions as well —to the extent that it existed—was brought to a halt. In contrast to 1982, when many countries in the developing world got trapped in years of stagnation, the liquidity and confidence crisis was really limited to one country: Mexico. The only other country which really was hurt by the after shocks of the Mexican devaluation was Argentina.

In contrast, the 1982 rescue package would turn out to be just the beginning of the long and protracted process of managing Mexico's excessive indebtedness. This process included several concerted debt rescheduling exercises, a debt buy-back, and—finally—the 1990 debt-reduction agreement negotiated under the terms of the Brady Plan. After the 1982 rescue package Mexico received support from the U.S. Federal Reserve and the Department of the Treasury on three other occasions, but always in the form of interim financing while other work-outs were concluded.

In sum, one fundamental difference between the financial assistance packages of 1982 and 1995 is that while the former was followed by a decade of living in "exile" from the international capital markets, the latter was successful in quickly restoring market access. The difference in the outcomes must be related to the size of the financial package and its medium-term quality. As mentioned above, in 1995 the financial rescue package was designed to be large enough to plausibly solve Mexico's liquidity crisis; in 1982, the package was large enough to avoid a Mexican default but for the next six years the country had to go from one rescheduling exercise to another, with the uncertainty of whether Mexico would be able to meet its obligations always lurking on the horizon.

Mexico's ability to re-enter capital markets rather quickly and repay its U.S. loans in advance cannot be solely attributed to the characteristics of the 1995 rescue package despite all its merits. First, despite the external disequilibrium in the years leading up to the crisis, the Mexican economy was in far better shape than in 1982. Second, the external environment was much more adverse in 1982 than in 1995 with world interest rates at record high levels and oil prices falling when oil exports represented 80 percent of Mexico's total exports. Finally, private international capital markets in the mid-nineties were incomparably more developed than in the mid-eighties, when the so-called emerging markets did not have access to much more beyond the credit extended by commercial banks.

Other factors notwithstanding, the differences in the rescue packages are a pivotal element in explaining the differences in outcome. Obviously, one of the main reasons why the 1995 rescue was more ambitious and decisive in its objectives is the way the U.S. administration articulated its response to the Mexican crisis. While in 1982 the U.S. Treasury sought to arrange interim financing to give Mexico time to organize a work-out with commercial banks, in 1995 the administration's aim was to solve Mexico's liquidity crisis in full. In fact, the administration stuck to this objective despite the strong opposition expressed by many in Congress. In fact, the U.S. executive took a notable political risk in rescuing Mexico when it decided to use the Exchange Stabilization Fund monies for an unprecedented amount. This was particularly risky given that the U.S. Congress had implicitly rejected a Mexican rescue package in January when the initial proposal of extending Mexico US$40 billion in loan guarantees could not get enough favorable votes.

Although the 1995 financial assistance package accomplished the objective of solving Mexico's short-term liquidity crisis, one could argue that it is unlikely that a similar program can be repeated in the future. Furthermore, even if it can, a hastened and politically difficult response is not the best option to manage another Mexican or Mexican-like crisis in the future. Given the nature of today's capital markets, similar crises are likely to occur. As a consequence, the need to implement crisis-prevention and crisis-management mechanisms on the part of multilateral institutions seems a natural corollary of the lessons learned from the Mexican crisis. In addition, in the specific case of Mexico, preventing or managing future crises may require—particularly between the United States and Mexico—more intense policy consultation and perhaps different institutional mechanisms from those existing before the peso crisis of 1995.