Everything in its own time: the political consequences of Mexico's devaluation

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A bitter struggle is currently being waged in Mexico to determine precisely who is responsible for...the devaluation of the Mexican peso.

As a result of this dispute both ex-President Carlos Salinas de Gortari (who left his post on November 30, 1994) and his successor, the current President of the Republic, Ernesto Zedillo, have been forced to participate openly in the discussion of a subject which —until recently— was kept secret from the public: the management of public finances.

The main point of debate revolves around what was done (or not done) in the critical period during the transfer of power —from August 21, 1994, the date of the presidential elections, until December 1, when Zedillo took over the presidency. Historically and practically, this period of transition between one administration and another presented a logical opportunity to carry out whatever adjustments were deemed necessary, in strictly economic if not political terms.

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On previous occasions, the transition period was characterized by the outgoing president's gradual transfer of real, if not formal, power to his successor, who would begin to take control over fundamental government affairs even before the changeover. Of course, this also happens in other countries, with different political systems, and has regularly occurred here in an almost cyclical manner at the end of previous presidential terms.

However, in 1994 Mexico, and at the end of the six-year presidential term of Carlos Salinas, things turned out to be very different. The transfer of power did not occur until the very last moment; and when it did, the new government team —which sought to assure the Mexican public and foreign investors that there would be that "continuity with stability" promised in Zedillo's electoral platform— found itself deprived of the tools it needed in order to maneuver in a very delicate situation. Its inability to provide short-term solutions to the market's demands for exchange-rate stability provoked the abrupt fall of Mexico's currency only a few days after the transfer of power.

By December, the peso was in an extremely vulnerable position. The persistent uncertainty plaguing the markets in the months leading up to the August presidential elections

General Office for Economic Affairs
Secretariat of Foreign Relations

First results of the Program for Overcoming the Economic Emergency of 1995

External Sector
Trade balance.
Over the first two months of 1995, preliminary trade-balance indicators showed the following:

Table 1

HEADING	JAN-FEB 94*	JAN-FEB 95*	%**
Trade balance	**-2,967**	**-78**	**-97.4**
Exports	8,621	11,320	31.3
-petroleum	987	1,335	35.3
-non-petroleum	7,634	9,985	30.8
-manufactures	6,930	8,766	26.5
Imports	11,588	11,398	-1.6
-consumer goods	1,290	1,028	-20.3
-intermediate goods	8,352	8,826	5.7
-capital goods	1,946	1,544	-20.7

* millions of dollars
** percentage growth in comparison with the same period in 1994

had led to erratic behavior in the Stock Exchange throughout the presidential campaign period. The March 1994 assassination of Luis Donaldo Colosio, the original presidential candidate of the Partido Revolucionario Institucional (PRI, the official government party), caused an immediate fall, of around 30 per cent, in the level of the Banco de México's international reserves —which turned out to be a warning of things to come.

Yet of even greater long-term significance, particularly in terms of the eventual fate of the Mexican peso, Colosio's death also brought a substantial modification in the way monetary policy was handled by the Salinas government.

The Banco de México's easing up on public credit, together with the announcement that an emergency credit package of about 6 billion dollars had been made available by the United States Treasury Department, then headed by Lloyd Bentsen, temporarily headed off the need to change the peso/dollar exchange rate.

The increase in internal credit prevented a recession, whose adverse effects during a presidential election could have derailed the smooth transition on which both the PRI and investors had placed their bets. But international reserves continued to fall, reaching a low point in late 1994, although at the same time interest rates remained relatively low and —most importantly— the economy grew by over 3 percent that year. The PRI candidate, Ernesto Zedillo, won the election and President Salinas' strategy for the last year of his term was successful.

In fact, the *financial* aspect of the government's strategy for bringing the Salinas administration to a happy conclusion was based centrally on maintaining the peso's value, within a margin which had previously and repeatedly been worked out with Mexico's key economic sectors and —less formally but no less crucially in practice— with international investors as well.

"The Pact," which was created as an ad hoc institution in late 1987 during Miguel de la Madrid's presidency, brought together the leaders of the most important trade unions and business associations. Over time it became the government's main tool for making and carrying out macroeconomic policy. Periodic agreements were reached within the framework of the Pact regarding salaries, prices and exchange rates —most recently, after the elections of August 21, 1994.

Even after its electoral victory, the government was forced to respond to financial markets' increasing worries about the perception that the peso would be subjected to more pressure at the end of Salinas' term. The official response, which had the backing of president-elect Ernesto Zedillo and his economic team, was to again confirm, during two successive meetings of the Pact (held during the months of September and November, 1994) that "the peso will not be devalued." Zedillo himself was present at the second of these Pact meetings.

The message sent to the markets was clear and unequivocal. The Mexican government's macroeconomic policy would not be modified on the eve of the change in administrations. Even one of the most outspoken economic analysts, David Malpass of Bear Stearns & Co., overconfidently distributed a document which would later turn out to be highly counterproductive, an analysis assuring his clients and subscribers of "15 reasons why the peso will not be devalued." He went so far as to put forward an additional "5 reasons why the peso may strengthen."

"Bottom line: No devaluation. Period," said Malpass and countless other analysts like him. When Legal Research International's Christopher Whalen wrote in *The International Economy* (January 1993) that the peso would be devalued in the near future, high-level criticism (and pressure on the magazine's editors) were not long in coming. There was an extremely broad consensus on the Mexican peso's stability, come what might, until December 1994. Criticism, or even recommendations for alternate policies, were for all intents and purposes excluded.

However, it should be remembered that this consensus was based not only on the enormous credibility of President Salinas' economic team, headed by Finance Minister Pedro Aspe, but fundamentally on a fiscal and monetary policy which, until Colosio's death, had as its main goal the maintenance of the overvalued (and stable) exchange rate between the peso and the dollar.

To achieve this, the government promoted an additional measure which —on top of two renewals of the Pact, Zedillo's agreement to the continuity of Salinas' policies and the fall in international reserves— would allow the peso to maintain its value throughout President Salinas' last year, but would become the specter haunting the current administration. This measure was the growing emission of Treasury bonds, a financial instrument which minimizes exchange-rate risk to bond holders.

During the election campaign, the Salinas government committed itself to covering up to 30 billion dollars in Treasury bonds which, once in the hands of Mexican and foreign investors, became a short-term debt for the Zedillo government. The new president, who holds a doctorate in economics from Yale University, now argues that "I was not aware of the problem represented by the Treasury bonds." And the fact is that nothing was to defuse this financial time bomb.

Table 2

HEADING	JAN*	%**	FEB*	%**
Trade balance	**-530**	**63.7**	**452**	**-130**
Exports	5,698	39.3	5,622	24.0
-petroleum	686	34.3	649	36.4
-non-petroleum	5,012	40.0	4,973	22.6
-manufactures	4,467	35.7	4,299	18.2
Imports	6,228	12.2	5,169	-14.4
-consumer goods	507	-17.7	521	-22.7
-intermediate goods	4,889	22.8	3,937	-9.9
-capital goods	832	-12.9	712	-28.2

* millions of dollars
** percentage growth in comparison with the same period in 1994

	Peso-to-dollar exchange rate*	Interest rates Cetes**	TIIP**
November	3.44	13.74	19.29
December	5.00	20.07	28.02
January	6.15	37.73	46.12
February	5.97	41.69	54.02
March	6.80	90.97	74.51

* Monthly average of same day interbank sale exchange rate.
** 28-day instrument; monthly average. (Note: Cetes are treasury certificates; TIIP is the average interbank interest rate.)

Two new reference rates were recently created: the Interbank Balance Interest Rate (TIIE), with a value of 88.5% on March 31, 1995; and the Nafin Rate (TNF), which was 60.16% in April 1995, the first month of its operation.

The peso's stability (within the "flotation band" established by the Pact) was thereby passed along as the former administration's main legacy to its successor. Zedillo himself accepted that this is how it would be. With its participation in the final Pact meeting, and through the communication established among those who would end up holding the key posts in its economic cabinet (Jaime Serra in the Treasury, Guillermo Ortiz in the Secretariat of Communications and Transport and Luis Téllez in the Office of the Presidency), the incoming government assumed responsibility for continuing the economic policies of its predecessor.

Despite what President Zedillo and those close to him now allege, he never had any kind of solid argument (whether political or intellectual) for dissociating himself from the measures his predecessor took in order to preserve the currency's value within the range established by the last Pact. The "model" seemed successful to all those who had trusted in Salinas; among them, in particular, the person who would become the next President of the Republic.

International Reserves
millions of dollars

1994	
October 31	17,242
December	6,148
1995	
January 30	3,483
February 28	8,978
March 24	7,863
June 2	10,438

Moreover, the peso's stability was in the interests both of Zedillo and Salinas, and thus it is clear that Zedillo did not seize any of the numerous opportunities within his grasp, during the August-December transition period, to work out (whether publicly or privately) a campaign aimed at modifying the financial and monetary terms being bequeathed him by Salinas. Innocently or not, the person who most believed in the success of the "model" was Zedillo himself. Now he is its main hostage.

To free himself of this legacy he has recently tried to link ex-President Salinas' loss of prestige among the majority of the country's population to the reasons for the devaluation, initiating, from the halls of government, a debate about the handling of public finances. Thus, in Mexico, economics has been politicized. And all the previous government's efforts to keep economic policy as an island unto itself have now been frustrated by the broad-ranging discussion over the causes of the "error" which led to devaluation.

While the debate between the followers of Salinas and Zedillo has, until now, prevented the working out of a coherent economic strategy which would allow the country to return to international markets and again enjoy growth and stability, the current government contents itself with presiding over one of the severest recessions in the country's modern history. This has been the most serious practical result of the devaluation. And we are still experiencing its consequences. VM