1994 economic crisis in mexico

History

Abstract

This is a critical analysis essay discussing one of historical financial crisis, with a major focus on its effects, causes, and lessons learnt. Selected historical financial crisis is ‘ 1994 Economic Crisis in Mexico.’ Introduction handles the genesis and description of the crisis with the main body discusses causes, effects and lesson learnt. The conclusion summarizes the findings of the research.

Introduction

The “ 1994 Economic Crisis in Mexico” is referred to as “ The December Mistake” (el error de Diciembre) in Spanish, a term that was derived by the then president Carlos Salinas de Gortari in indication of his successor Ernesto Zedillo’s abrupt turnaround of the earlier government’s policy of stiffmoneycontrols (Horowitz & Ho, 2001). While many analysts concur that devaluation was essential for economic purposes, Salinas followers pointed out that the procedure was mismanaged at the political stage. The crisis broadly known as the Tequila crisis or theMexicanpeso crisis was rooted by the abrupt devaluation of the Mexican peso in late 1994.

According to Whitt (1996), in the early 1990s the Mexican financial organization appeared stable. It was increasing following the 1980s’“ lost decade” (Whitt 1996). Furthermore, inflation was being abridged significantly, international investors were venturing capital into the nation, and billions of dollars had been accumulated by the central bank in reserves. Agreement to cap favorable trade condition with US (Mexico’s largest trade partner) was reached through NAFTA (North American Free Trade

Agreement). However, in less than a year after NAFTA took effect, Mexico experienced economic calamity (Krooth, 1995). In December 1994, the Mexican administration devalued the peso. The economic crisis that ensued cut the peso's worth by half, boosted inflation dilapidation rate, and initiated a harshdepressionin Mexico.

Causes of the crisis

The basic causes of Economic Crisis in Mexico in 1994 are normally ascribed to Salinas de Gortari's strategy decisions while in presidency, which eventually stressed the nation's economies. As in the previous election sequences, a pre-election outlook to motivate the financial system, momentarily and untenably, ensuing a post-election financial instability. The causes of the crisis involved over-valuation of exchange rate and the then account deficit in the Mexican financial system (Purcell, 1998). With these predicaments, numerous additional issues assisted to trigger the crisis: a) elections were conventionally linked to devaluation, b) the increase in American interest rates, c) lack of investor assurance due to politically associated assassinations, d) slack monetary regulations in reaction to the decrease in foreign money flows, e) extension of quasi-fiscal costs via development financial institutions credits, and f) changing fiscal borrowing to temporary, dollar-oriented instruments (Purcell, 1998).

Garber & Lall (1996) notes that several diverse issues could be given as causes of the crisis, but in broad it is the consequence of an unmitigated era of over speculation, concerning both local and international investors. It is evident that during 1994, there were numerous indicators signifying a peso collapse was forthcoming. Most noteworthy was the decrease of foreign exchange reserves, falling from $26B in early 1994, down to a perilously low $2B just prior the American bailout. Subsequently, approximately 80% of the $85B ventured in the country from 1991 to mid-1994 was in the shape of portfolio venture, making just 20% in the type of straight investment. Lastly was the extremely obvious and apparent change from the administration bonds oriented in pesos (the cetes) to those oriented in dollars (tesobonos) for several months. The figure below displays the decline trend.

Fig 1. 1994 Reserves, Cetes and Tesobonos in Mexico

Effects of the crisis

Even though mainstream economists are sensitive to the idea; there is no refuting that Mexico underwent dejection in 1995, as apparent in the fall of GDP of 6. 9%. This was at least compared with a decline of 8. 6% of GDP per capita (Fig. 2: below). From the eruption of the peso disaster in 1994 December up to February 1995 the worth of the Mexican money had dropped by over fifty percent and inflation had risen to 52% in 1995 from 7% in 1994 (Edwards & Mishkin, 1995). The financial crisis brought about the fall of Mexico’s domestic market, compelling consumption to decrease considerably.

As pointed out by Baddeley (2010), there was also a harsh shortage of credit as internal financial institutions struggled with bad loans and wanted to establish reserves following their near collapse in 1994. This meant a virtual loss of credit for SMEs. Although it had started in 1993, this auxiliary enforced the barzonista campaign which was an association of debtors, a lot of whom were farmers, necessitating renegotiation of their amount overdue

(Edwards & Mishkin, 1995). The official joblessness rate rose to a peak of almost 8% in the third quarter of 1995 after being approximately 3% in December 1994 and hanging approximately 6% through much of the dejection period. Although the bureaucrat rate more than two folded in the first half of 1995, it was rather unfair and not an efficient measure.

Fig. 2: GDP and GDP per capita

Lessons Learnt

The first lesson learnt from the 1994 Economic Crisis in Mexico is how hazardous a pegged exchange rate government can be for the up-and-coming market nations. It is obvious that in up-and-coming market nations, a speculative approach on the exchange term that consequence in devaluation can have distressing results on the financial system by destabilizing information flows in economic markets (Diamond, 1984). The second lesson that can be derived from the experience of the Tequila Crisis involves supervision of banking systems. Strong prudential administration of the banking structure is vital to the fitness of up-and-coming market economies and the avoidance of economic crises.

Evidently, good prudential monitoring is significant to developed countries (Diamond, 1984). However, since the outcomes of poor prudential monitoring are so catastrophic in up-and-coming market countries, good prudential monitoring is even more significant in these industrialized countries. The last lesson is that conventional measures employed in industrialized nations to extirpate themselves from economic crises may be retro progressive in rising market countries. In developed nations, the standard recommendation for emerging from an economic predicament is for the central bank to be a loaner of final resort and to seek expansionary financial policy.

Conclusion

The crisis is broadly known as the Tequila crisis or the Mexican peso crisis and was caused by the abrupt devaluation. The causes of the crisis involved over-valuation of exchange rate and the then account deficit in the Mexican financial system. There are three lessons that can be learnt from the crisis: a pegged exchange rate government is dangerous; Strong prudential administration of the banking structure is vital to the fitness for developing economies; and traditional measures used in industrialized countries may not fit emerging markets countries.

REFERENCES:

Baddeley, A. (2010). International financial crisis. Recent advances in learning andmotivation(Vol. 8, pp. 47-90). New York: AcademicPress

Diamond, D. (1984). Financial intermediation and delegated monitoring. Review of Economic Studies 51, 393-414.

Edwards, F. & Mishkin, F. S. (1995). The decline of traditional banking: Implications for financial stability and regulatory policy. Federal Reserve Bank of New York Economic Policy Review 1(3), 27-45

Garber, P. M. & Lall, S. (1996). The role and operation of derivative markets in foreign exchange crises. Brown University, Department of Economics, Providence, RI.

Horowitz, S., & Ho, U. (2001). The political economy of international financial crisis: interest groups, ideologies and institutions. Singapore, ISEAS.

Krooth, R. (1995). Mexico, NAFTA and the Hardships of Progress, McFarland, North Carolina.

Purcell, S. K. (1998). Mexico under Zedillo. Boulder [u. a.], Lynne Rienner.

Whitt, Jr. A. J. (1996). The Mexican Peso Crisis. Economic Review. Federal Reserve Bank of Atlanta. Oxford University Press.

Appendix