

How did the financial crisis in Mexico originate



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The financial catastrophe that occurred in Mexico during the 1980's posed an exemplary episode in the history of World recession. A classic case of debt crisis was introduced in this period that took Mexico into a lost decade but it also served valuable lessons about identifying factors and events leading to such debt crisis and in revising financial fundamentals and policies to evade these factors.

In 1960's to 70's, Mexico was in the phase of rapid growth and extensive productivity mainly due to natural resource mobilization. However, growth started to stumble in early 1970's mainly as a responsiveness of firstly increased protectionism, restrictive policies that weakened the financial system and secondly increased government spending and unsystematic growth of public enterprises that caused gradual decline in fiscal discipline and increased dependency on foreign borrowing. Further, external inflationary pressure was building up due to the oil shocks which were curbed by raising the dollar interest rate that created a grave problem in developing countries to service their debt obligations.

The crisis commenced on August 12, 1982 when the authorities of Mexico officially announced it was not able to meet its obligation to service an \$80 billion debt which was mostly dollar dominated. This paper analyses the factors that were responsible for the occurrence of Mexico's debt crisis in the 1980's in the subsequent sections. The foremost section investigates internal events that weakened the financial sector of Mexico primarily due to deteriorating financial discipline and a history of underdeveloped financial system. Next section deals with external events such as oil shocks and increased foreign borrowing that lead to the lost decade of Mexico in the

eighties. The final section comprises of the onset of the crisis and the remedies opted to revive from it. Lastly, the conclusion summarizes the essence of this paper.

Factors responsible for Mexican Debt Crisis in 1980's

There are strings of events that preceded the debt crisis around the eighties which can be studied in two facets: Internal aspects and External aspects. Internal aspects mainly study macroeconomic instability and weak financial discipline that were prevalent in Mexico and how it made its economy vulnerable to debt crisis. On the other hand, External aspects focuses on how global events occurring at that phase affected Mexico's ability to service its debts. The following sections aims to provide a picture on how internal weaknesses coupled with unfavorable externalities led Mexico to financial obscurity.

Internal factors that facilitated Debt Crisis of 1980's

Macroeconomic Instability

The average GDP growth rate of Mexico in the 1960's was around 6.5% exhibiting rapid developments in productivity and resource allocation as seen in Table 1.. The economy was essentially inward oriented and it largely practiced import substitution industrialization (ISI) strategy indicating high trade barriers and selective preferential credit schemes (World Bank, 1998). This protected system helped in attracting private investments but by 1970 this strategy could not sustain due to growing economic distortions.

Table 1. Mexico: Growth of Gross Domestic Product 1950-1997**(Average rate of compounded annual growth in percentage)****Period****GDP****GDP per capita**

1950-60

6.10

2.89

1960-70

6.45

2.93

1970-80

6.68

3.32

1980-90

1.81

-0.44

1990-97

1. 95

0. 64

Source: INEGI 1995

In table 1, Mexico's GDP growth is 6 per cent in average till late 1970's because of sound resource allocation and living standard coupled with protective regulations. However, by 1980's there is a drastic reduction in GDP growth to nominal 1. 81 per cent and a negative downturn in GDP per capita growth. This slump was signaled prior to the crisis when macroeconomic indicators started to show wary results listed in the points below (World Bank, 1998):

As ISI strategy was discarded, the private sector was authorized to lead in investing but it was not fully equipped to execute its intermediating role. This caused misallocation of savings in projects and investment in low return assets in the cost of investing in innovative ventures which ultimately lowered the economic growth.

Such misallocation of resources was amplified with inflow of foreign capital and also extensive asset holdings in foreign currency mainly dollars, augmented financial system's vulnerability.

These distortions led to increase in domestic inflation and the real interest rates also turned negative. Consequently, there was increased capital flight which reduced the portions of funds that were loanable to domestic investors.

The above points signify the onset of macroeconomic instability in Mexico during 1970-1980 when it lowered its guards towards the forthcoming crisis. Had the domestic financial intermediaries and system as a whole been appropriately regulated against misallocation and avoided greater inclination towards foreign impulses then Mexico could have had a stronger standing at least in financial context.

Restrictive FDI policies in early 80's

The government adopted and operated under restrictive law to promote Mexican investment and regulate FDI in 1973. This law created uncertainty between foreign investors since there was widespread discretionary power with the policymakers. The side-effect of such weak foreign investment system was that capital inflows made its way mainly through sovereign bank lending to which Mexico had grown to be largely dependent (World Bank, 1998). This increased the vulnerability since those capital inflows could be by large reversed and there were limited alternatives to those sorts of capital resources.

Weak Fiscal Discipline

One form of persistent government intervention in financial sector was the adoption of repressive policies. This allowed government to have an easy access on private savings to finance its expenditures and deficits which encouraged a rise in government spending and expansion of public enterprises. In 1978 as shown in the Figure 1, there is a step rise from around 19 per cent to above 25 per cent by 1982 whereas the private investment remained low. Hence, such public-sector driven growth

deteriorated fiscal discipline gradually and generated greater dependence on foreign borrowing.

Share of Public and Private Investment in Mexico 1970-1992

Source: World Bank, Mexico 1998

Figure 1

Also, government absorbed an increasing share of banking system deposits by imposing high reserve requirements. The effective reserve ratio rose to 63 per cent in 1973 which largely absorbed the funds to facilitate activities of private enterprises (Buffie, Krause, 1989). This is another insight on how decadent the fiscal framework was and how it soaked up innovation and sophistication from the financial sector that could have transcended the financial environment into more competitive form.

Bank Sector and Stock Market Weaknesses

Mexico, for most parts, had a poorly developed financial markets comprising of weak banking system and stock markets. An empirical study conducted by World Bank in 1998 took a sample of 43 countries and measured the financial market development in terms of banking sector (Bank and Depth) and stock market (Liquidity and MCAP). In table 2, Mexico's Bank and Depth both ranked last (43rd) out of 43 countries, also stock market reflected similar results with Liquidity ranking 37th and MCAP 36th in the year 1970-1994.

Table 2. Ranking Mexico's Financial System (Ranking are based on average period data)

Financial Market Development Indicators

1976-1994

Rank No. Obs

Banking Sector

BANK

DEPTH

43 43

43 43

Stock Market

LIQUIDITY

MCAP

37 43

36 42

Source: World Bank, Mexico 1998

Although Mexico experienced several changes during this phase and this ranking comprised some assumptions, it gives a snapshot of where Mexico stands among many other nations in context of financial repute. Studies show that Mexico's financial system has always been underdeveloped but it <https://assignbuster.com/how-did-the-financial-crisis-in-mexico-originate/>

was not as economically deteriorated in the 60's as of the time since 1970's and 80's. This is because its financial system could not grow along with the international level which is why it set off into macroeconomic instability and the underdeveloped financial system further aggravated its susceptibility towards debt crisis in 1982.

External forces that led to Debt Crisis

The First Oil Shock (1973) and Petrodollar recycling

Real Oil Price

(WTI in constant USD of July 2005)

http://www.grips.ac.jp/teacher/oono/hp/image_f2/lec10_8oil.gif

Source: GRIPS

Figure 1

The sudden hike of oil prices is considered as oil shock and the first oil shock took place in 1973-1974 as clearly seen in Figure 1. This incidence affected Mexico in following ways (Cardoso and Fishlow, 1990): The immediate effect of first oil shock was that there was liquidity crunch and large trade deficits in the economy, so they needed to borrow more. Secondly, the international banks were flushed with excess cash deposited by OPEC (Organization of Petroleum Exporting Countries) which they eagerly loaned to developing countries including Mexico who were in need of funds.

To expand, OPEC gained surplus wealth because of oil price rise which were deposited in dollar accounts located outside US, known as Euro dollar

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deposits. At the same time, oil price rise caused large deficits which increased the demand of loanable funds in Mexico and other countries such as Brazil and Argentina. The international banks with superfluous deposits of oil receipts readily provided loans at variable rate. This formed a cycle of petro dollar recycling.

Petrodollar Recycling

Oil Importing - Developing Countries

OPEC

OPEC

International Commercial Banks Made Oil Payments Dollar Deposits

Loans for Development Projects

Figure 2

Mexico was one of those oil importing countries that made oil payments to OPEC, who in turn deposited them in dollar accounts at international commercial banks as seen in Figure 2. The excess dollar deposits were then recycled as loans by the international banks to many developing countries like Mexico and these countries became gradually dependent on these kinds of loans (GRIPS, 2010). A vicious cycle of excessive lending and borrowing was forming among the participating countries and institutions which structured the basis of debt crisis in the 1980's.

Second Oil Shock (1979)

The bubble exploded in the wake of the second oil shock (1979) (as can be referred to Figure 1 again) when the industrialized countries, which had barely recovered from the first shock, were thrown back into recession. Demand for Mexico's exports collapsed, eventually even the price of petroleum declined sharply (Cardoso and Fishlow, 1990). Interest payments on the debt accumulated during the re-cycling years absorbed a tremendous amount of export earnings and domestic savings, largely because most of the debt was at variable interest rates. At the same time the supply of capital from the rest of the world also dried up.

Increasing Trend of Borrowing

The decade of 1972-1982 constituted of series of overborrowing that was particularly escalated by the first oil shock in 1973. The progression of this trend can be depicted in the graph below:

Latin America's Persistent Debt 1975-1987

Source: IDRC, 1991

Figure 3

In figure 3, an elevating tendency of borrowing by Latin America can be vividly observed. Countries in Latin America including Mexico had a total debt of 68.5 billion dollars in 1975 and it escalated by almost 5 fold i. e. upto to 318.4 billion dollars by 1982 when the crisis occurred. This rate of borrowing and lending was rapidly making Mexico and other Latin countries very vulnerable towards financial adversity but nevertheless they optimistically borrowed unaware of the bubble that could burst into a calamity.

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Increased Dollar interest rates and its adverse effects

In 1979, the chairman of US Federal Reserve Board (American Central Bank) Mr. Paul Volcker initiated anti-inflation campaign which required the Fed to tighten its money supply from 1979-1980. Accordingly, the dollar interest rate shot up sharply even up to 20% a year or above. The objectives of the anti-inflation campaign were met in the long run but in that period this caused economic slowdown in US and in rest of the world (FDIC, 1997). As mentioned in the previous point, Mexico was immensely indebted with huge amounts of funds and the rise of dollar interest rate gravely exacerbated their situation because of following reasons:

Debt service payments rose sharply in effect of rise in dollar interest rate. For this reason, indebted countries like Mexico suddenly had to face great difficulty in servicing their debt payments.

Also, since there was global economic slowdown, the demand of export also fell quantitatively which enlarged their trade deficits in the most inappropriate time as they were in the midst of huge debt burden (GRIPS, 2010).

Next, the world commodity prices of minerals and agricultural goods also declined. Mexico's productivity largely relied on the mobilization of resources such as minerals, agricultural goods and energy and this incidence further degraded its capacity to service its debt.

Furthermore, in early 1980's in response to high interest rate, the value of dollar exchange rate also started to increase. The value of dollar exchange

rate in 1981 was 11 per cent and it rose to 17 per cent in the next year 1982 against strong currencies such as German Mark and Japanese Yen. Since Mexico's debt was mostly dollar denominated the difficulty to meet their debt commitments intensified. Despite such difficulties, Mexico continued to borrow heavily as seen in Figure 3 where overall Latin America's debt doubled from 1979 with 182 billion dollars to 1982 with 318.4 billion dollars (FDIC, 1997).

The Onset of the Debt Crisis in 1982

The previous sections examine some possible factors that led to the eruption of debt crisis in Mexico in the eighties. The underdeveloped and vulnerable financial system of Mexico was hit by series of events, mainly the Federal Reserve's decision to increase the interest rate in order to curb its oil based inflation that slowed down the global economy and triggered the debt crisis. This also caused a sharp decline in commodity prices coupled with slump in the demand of exports. In this scenario, Mexico was derailed from investing in development/productive projects and used its loan to meet up the payments of accrued interest on the current debts which entangled it into a vicious circle of impending debt.

The debt crisis began on August 12, 1982 when the Mexican finance Minister notified the chairman of Federal Reserve, secretary of the treasury and the managing director of IMF that the nation will be unable to meet its \$80 billion debt obligations. In addition there were other 40 developing countries at that time had defaulted on their foreign loans engendering a global bankruptcy crisis by the year end of 1982. In 1983, four major countries of Latin America including Mexico, Brazil, Argentina and Venezuela proposed to restructure <https://assignbuster.com/how-did-the-financial-crisis-in-mexico-originate/>

their loans. The rate of bank lending declined gradually from \$56 billion to \$44 billion (FDIC, 2010).

After the outbreak of the crisis, the nation underwent a lost decade which signifies the stagnation of economy and loss in the social welfare. The debt burden was so huge that most resources were channeled to meet interest payments to commercial banks instead of investing in productive projects that significantly hampered the already underdeveloped financial system. The labor market was also highly distorted because of the rise in informal sector as a result of uncertainty and insecurity in the labor market which signals lower contribution to the economy and overall lower productivity growth (Latin America and Caribbean Region, World Bank, August, 1986). This is when GDP per capita slipped into negative rate and the economic growth degraded, retarding the speed of recovery from the debt burden.

Recovery strategies

Two international organizations namely, World Bank and IMF, conducted new lending facilities (GRIPS, 2010):

World Bank introduced Structural Adjustment Loan (SAL) and Structural Adjustment Credit (SAC) that operated with commercial interest rate and concessional interest rate respectively.

IMF proposed structural adjustment facility (SAF) which worked on the principle of case by case approach via Bank advisory committees.

Also, Brady plan was constructed to enforce market based reductions where indebted countries could buy their own debts in secondary market at

discount. Mexico made full use of this plan and continued to participate in other economic, financial and social reforms.

Conclusion

The financial crisis of Mexico of the eighties partly originated from internal state of affairs that were adversely augmented by sequence of unfavorable external events. Until 1960's Mexico projected healthy GDP growth that averaged 6% annually therefore the set off of the crisis was not perpetuated by gradual decline of output or employment over the years rather the economy was one of the rapidly growing countries in Latin America. However, continuous macroeconomic mismanagement can be observed since 1970's that left Mexico in dwindling financial position.

The internal aspects of Mexico configured a vulnerable scenario and were partially responsible for the debt crisis of the eighties because its macroeconomic instability and fiscal indiscipline drove the economy towards high fiscal deficits that caused its inclination towards foreign borrowing. In the absence of appropriate monitoring mechanisms and laws, most firms, banks and financial markets were incompetent to perform on international setting.

To top it up, there was tremendous misallocation of resources that drained the investment on sophisticated and innovative projects rather the concentration was more on low return assets. For this reason, when government expenditures and number of public sector mounted, Mexico faced high fiscal deficits and thus, even more dependent on foreign borrowing which forms a likely condition for a debt crisis to occur.

Unaware about the forthcoming crisis, Mexico heavily borrowed after the first oil shock which instigates the influence of external events. The primary reason for the debt crisis to take place was the trend of over lending and borrowing by international commercial banks to developing countries like Mexico with the intention of sponsoring development projects but this practice backfired when US Federal Reserve increased the dollar interest rate to curb its oil-based inflation. Debt crisis surged as Mexico its debt-service cost shot up and with falling revenues and huge debt, the nation was unable to meet its debt obligations of August 1982.

Mexico faced a decade long economic stagnation characterized with crippled financial sector, unemployment and uncertainty. IMF and World Bank operated several debt relief strategies that helped Mexico to recover to some extent. However, it is more crucial to restore confidence in domestic producers, labor market and strengthening macroeconomic fundamentals so that resources could be mobilized and capitalized to facilitate economic growth and development.