Lessons Learned: Guillermo Ortiz Martínez

Mercedes Cardona
READERS TAKE NOTICE:

As of April 2024, the YPFS Resource Library’s site domain has changed to https://elischolar.library.yale.edu/ypfs-financial-crisis-resource-library/.

Please be aware that upon clicking any of the URL references to the former Resource Library domains, either https://ypfs.som.yale.edu or https://ypfsresourcelibrary.blob.core.windows.net/, in the "References/Key Program Documents" section of a case study, readers will encounter a "page not found" error.

Readers can still retrieve a given resource cited within this case study on the new site by searching here for the title cited.

This lessons learned is available in Journal of Financial Crises: https://elischolar.library.yale.edu/journal-of-financial-crises/vol6/iss2/8
Regulatory lapses, especially relating to capital adequacy and credit quality, can have enormous, long-lasting consequences and create systemic weaknesses.

On December 1994, as part of a restructuring of the banking system, the Mexican government unexpectedly abandoned its policy of anchoring the peso to the US dollar and allowed it to float freely, triggering a financial crisis. Faced with a possible default on its dollar-denominated bonds (tesobonos), Mexico negotiated a $50 billion assistance package with the United States and International Monetary Fund (IMF). Austerity measures to control the crisis caused significant economic hardships, but by 1996–97, the economy had rebounded and Mexico paid back all outstanding obligations.

The so-called Tequila Crisis had an aspect in common with other crises around the world: regulatory failure. The Mexican government had privatized the financial system after liberalizing governing regulations in the years leading up to the crisis. Before privatization, Mexican banks financed the government through a regime known as the Encaje Legal, where a portion of their deposits was channeled to the government. After privatization, Encaje Legal ended, freeing up deposits that banks could use to expand private sector lending. At the same time, other regulatory changes liberalized trade and investment policies. The North American Free Trade Agreement, signed in 1992, took effect in 1994. Emerging markets were increasingly popular with international investors, and Mexico became a “darling,” leading to large inflows of foreign investment and capital and what has been called a rapid and “disorderly” expansion of credit.

Ortiz Martínez, who was chairman of the privatization committee, acknowledged that the privatization process was perhaps executed too quickly without sufficient due diligence. He explained:

My short description is that the buyers didn’t know what they were buying, and we didn’t know what we were selling. We didn’t really have the time to go deeply into each bank and find out what the real situation was. Because obviously the overdue obligations, when you expand very, very fast, become much smaller in proportion to
the growth of credit, until it explodes. Apparently, the banks were very sound because the amount of overdue obligations was very small, and credit growth was very fast. The banks were very profitable. But of course, that was hiding the underlying credit quality of this expansion, which was not correctly overseen.

In this new era for the Mexican banking system, Ortiz Martínez noted, the crisis was caused by a lack of oversight of credit risk and of the credit quality of bank reserves. “We did not pay sufficient attention, and that’s an understatement, to the situation of the banking system,” Ortiz Martínez explained:

We did not really know the credit quality of the portfolio [on average]. And we did not know whether the reserves that the banks were making were sufficient. Obviously, they were not sufficient ex-post. What we should have done when privatizing the banks should’ve been to devote a lot more resources of the sale of the bank to creating reserves for eventual bad loans, and that didn’t happen.

In the wake of the crisis, many Mexican banks failed or were sold to foreign institutions.

**Even the best policy responses can be undermined by miscommunication and bad execution, which can lead to a loss of confidence.**

The foundation of the newly privatized banking system was not healthy enough to weather the consequences as investment capital began to flee the country following a series of sociopolitical shocks, including the Zapatista uprising in the state of Chiapas and the assassination of presidential candidate Luis Donaldo Colosio in 1994. This was compounded by a doubling of interest rates in the United States from 3% to 6%.

In December 1994, Ortiz Martínez explained, the minister of finance and the Mexican central bank could see international reserves were being depleted and announced a widening of the exchange rate band, which didn’t have the desired effect:

The government decided first to widen the band, and that lasted for about one day—24 or 48 hours, I don’t remember exactly how much. The minister of finance at the time and the central bank gathered all the Mexican bankers and explained the terms of the widening of the band. The mechanics were really blundered because, obviously, the bankers took advantage of this information and they started buying dollars, and they precipitated an already difficult situation into a crisis. Finally, the band was abandoned, and the peso started floating freely, while the finance minister had promised investors prior to this episode that the peso was going to remain within the band and so on. So that was what triggered (the crisis), the last straw. . . .

So, when I started in the Finance Ministry, we had no reserves—zero reserves, or very close to zero reserves. I don’t remember the figure, but probably around $26 billion in tesobonos that were issued were payable in dollars, and that was the situation. We had lost all confidence. Mexico had been a darling of emerging markets, because of NAFTA, and the bright future, and everything I described. So, it was a very difficult start, as you can imagine.
A more measured effort could have spared Mexico the worst of the crisis, Ortiz Martínez explained:

The blunder of the government was how they handled devaluation, and the fact that they did not adjust the band before. They could have widened the exchange rate band, and tightened monetary policy, tightened fiscal policy, in August-September of 1994, and they didn’t do it. That would’ve, if not avoided it, attenuated the magnitude of the crisis. So, then we start 1995, with no reserves and a bunch of debt.

A credible, consistent policy framework creates the conditions to build economic resilience that will aid the financial system in surviving a crisis.

New in office, President Zedillo faced a difficult political situation that required negotiating with Congress, unions, and other sectors. Mexico experienced a 7% contraction in GDP in 1995 and a sharp drop in real wages as inflation shot up and wages stagnated due to austerity. The crisis and the countermeasures extracted a political cost; the Partido Revolucionario Institucional (the Institutional Revolutionary Party, or PRI) lost big in the next midterm elections and in 1997 lost control of the Congress for the first time in 70 years. But the economy bounced back almost wholly, and Mexico regained access to international markets in the following year. Mexico learned to live with the floating exchange rate and put a monetary policy in place consistent with the floating rate, and a mechanism of inflation-targeting at the central bank, said Ortiz Martínez.

The government was able to replenish international reserves and pay back the US loan and other aid ahead of schedule. “So, in that sense, the program was very successful,” Ortiz Martínez said. The speed with which the program’s aims were delivered calmed the waters and avoided social disruption, he said.

In the aftermath of the crisis, it was clear that tighter monetary and banking policy would have helped forestall the worst effects. The relative stability of the Mexican economy through later crises, such as the Global Financial Crisis of 2008 and the disruption of the COVID-19 pandemic, has shown that a credible, consistent policy framework helps build a resilient system. During the pandemic lockdown, Mexico suffered some hardship; “the shock was very large but very short,” he said.

The development of this symbiosis between the existing monetary and fiscal policy regimes derives directly from the lessons of the 1994–95 crisis intervention, and it has really helped the economy going forward, Ortiz Martínez explained.

Those are the two ingredients that are fundamental for economic stability: having a sound banking system . . . and a consistent framework, a consistent, credible policy framework. Because you’re always going to be facing shocks, like COVID and you-name-it.

The point is to increase the resilience of the economy, and the banking system. And if you have a set of policies, good regulation, good capital adequacy, and so on, the capacity to absorb shocks is much greater than if you don’t. It’s as simple as that.
Dated: July 2024

YPFS Lessons Learned No. 2022-06