YPFS Lessons Learned Oral History Project: An Interview with Guillermo Ortiz Martínez

Guillermo Ortiz Martínez

Merecedes Cardona

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Lessons Learned Oral History Project Interview

| Interviewee Name and Crisis Position | Guillermo Ortiz Martínez ¹
Minister of Finance, Mexico |
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<td>Interviewer Name</td>
<td>Mercedes Cardona, Interviewer, Yale Program on Financial Stability</td>
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Introduction:

The Yale Program on Financial Stability (YPFS) interviewed Guillermo Ortiz Martínez regarding his time as Minister of Finance in the Mexican government during the peso crisis of 1994-1995.² 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 instead allow it to float freely. The resulting collapse of the peso left Mexico with a large balance of external debts and almost no foreign exchange reserves, triggering a financial crisis. Faced with a possible default, Mexico negotiated with the US and the International Monetary Fund for an assistance package to help meet its immediate obligations and restructure its debt. Under a strict economic reform plan to weather the crisis, the country experienced significant austerity, but by 1996-97 the economy had rebounded, and Mexico paid back all outstanding obligations under the assistance package.

Mr. Ortiz Martínez served as Undersecretary of Finance and Public Credit in the Mexican Federal Government from 1988 to 1994, became Secretary in December 1994 under the administration of Ernesto Zedillo and served until December 1997. As Undersecretary, he was President of the Bank Privatization Committee and the Chief Negotiator for Mexico during the North American Free Trade Agreement (NAFTA) negotiations in 1991 to 1993. He was Governor of Banco de Mexico from January 1998 to December 2009 and is currently Partner and Member of the Board of BTG Pactual.

This transcript of a telephone interview has been edited for accuracy and clarity.

Transcript

YPFS: This being an oral history, why don't we start with a little bit of a narrative, a recap of the Mexican crisis and its origins. It's been called the first crisis of the 21st century, because it allegedly caught everyone by surprise, and it moved very fast. But this crisis had roots back in the '80s,

¹The opinions expressed during this interview are those of Mr. Ortiz Martínez, and not those any of the institutions with which he is or was affiliated.
²A stylized summary of the key observations and insights gleaned from this interview with Mr. Ortiz Martínez is available here in the Yale Program on Financial Stability's Journal of Financial Crises.
with President José Lopez Portillo’s efforts to nationalize the banks and float the peso, and then Miguel de la Madrid coming into office and trying to roll back some of those changes. Does it go back that far?

Ortiz Martínez: Not really. Everything is connected, but the ’95 crisis is in the context of the (Carlos) Salinas administration. The country had embarked on an important change, in terms of a number of structural reforms that Salinas passed. One very important change was the privatization of the banking system, reforms having to do with land ownership, with religious freedom, and others. The most important one was of course NAFTA. The negotiations of NAFTA concluded in late ’93, early ’94, so Mexico’s future looked pretty bright at the time.

The ’95 crisis started really at the beginning of ’94, with the uprising in Chiapas of the Zapatista movement, which was... someone described it as the first Internet guerilla revolution, because militarily, it was rare, but it was a big mediatic scandal. It affected Salinas, his judgment, and all that. He had been a very good president for five years, and then with the Zapatista crisis, he totally lost it. And just a few months later, the presidential candidate from the PRI [Institutional Revolutionary Party], Colosio, was assassinated. This started a process of deterioration of the Mexican political and economic landscape.

The capital flows that had entered Mexico began to exit, so the government resorted to issuing bonds denominated in dollars to stem capital flight. This swelled quite substantially in the first seven, eight months of 1994. This was not helped of course by [Federal Reserve Chairman] Mr. [Alan] Greenspan in the US, raising interest rates from 3% to 6% in ’94.

So monetary conditions were tightened considerably in the US, these precipitated an increase in risk perception, in emerging markets and in Mexico in particular. Which was compounded by what I mentioned, the big shock of the assassination of Luis Donaldo Colosio, in March ’94. It was not a sudden crisis, it was a whole year in the making. International reserves were being depleted, and the government once again resorted to issuing the tesobonos, the dollar-denominated bonds. So, by the time Zedillo took office in December, the crisis was imminent, so it was not surprising at all.

YPFS: You were looking at essentially a year of social political shocks coming one right after the other, the Zapatistas, the assassination during the election cycle, NAFTA—

Ortiz Martínez: And there was another assassination in September 1994, of a prominent politician (Jose Francisco Ruiz Massieu, governor of Guerrero state). So, it was a combination of these domestic shocks that I have described, plus the doubling of interest rates. Interest rates went from 3% to 6% in one year. That’s a huge number. That had a big impact in capital flows to emerging
markets, including Mexico, which was aggravated by the domestic shocks that I described. So, it was not sudden at all. It was in the making since December, January of that year.

YPFS: And you were at the time in the government, I believe you were undersecretary of Finance?

Ortiz Martínez: I was undersecretary of Finance, and then when Zedillo was inaugurated in December, I was appointed Minister for Communications and Transportation. That lasted for 28 days, until the crisis erupted, and then I became Finance Minister in December ’94.

YPFS: Talk about a poison chalice.

Ortiz Martínez: That’s exactly right.

YPFS: So, when you come into office, what was your first priority when you walked in?

Ortiz Martínez: The reason why Zedillo called me, and switched me to Finance Minister, is because the government had lost credibility. The biggest loss of credibility was the blunder of the devaluation of the peso around December 18, December 19, 1994, which was done very clumsily.

YPFS: How so?

Ortiz Martínez: Well, we had an exchange rate band, and the international reserves were being depleted. So, 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.

That’s what triggered the crisis. 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 was 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.
Ortiz Martínez: We had a current account deficit close to 4% or 5% of GDP, that was manageable. But the shocks I described, 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.

YPFS: Where does fiscal monetary policy fail specifically? Because another factor that's often mentioned, and we just spoke about it, was the inflows of foreign capital. There seems to have been light oversight in the banks, and lending that led to risk.

Ortiz Martínez: That's another story. I was a head of the privatization process at the Ministry of Finance, when we privatized the banks in '92-93. The financial system had been liberalized back in 1990. It's a very long story—we can go on and on, on this—but there was a change of laws that liberalized the financial system. It used to be the case that the banks were financing the government through what was called the Encaje Legal, so a proportion of all the deposits was channeled to the government. This changed almost overnight, and the government was able to develop markets for domestic securities, the “mercado de CETES”, and the banks found themselves with a bunch of cash, a lot of resources that they used to lend to the government, and now they could lend to the private sector.

So, credit expanded very rapidly and disorderly in the early '90s. Credit growth was in the order of 20%-30% per year for three or four years. So when the crisis arrived at the end of '94, the credit expansion by the banking system, which was now private, had exploded a few years before due to the liberalization of the financial sector. So, we had these twin things: the question of the exchange rate, lack of reserves, and so on, and a banking system that had been recently privatized and had been expanding credit very rapidly. Obviously, the process that I conducted as chairman of the privatization committee, had deadlines. This was done in a very short period of time, and not enough diligence was done, either by us, the sellers, or by the buyers.

So, 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.
YPFS: That's an interesting parallel to what we saw in the United States in 2008, and 2009, with the mortgage banking, and shadow banking business, the lack of clarity, and the lack of strong oversight.

Ortiz Martínez: And this was compounded by the fact that the banks were privatized.

YPFS: So how big a priority was it then, when this started to come to light, to shore up these financial institutions, rather than just let them take their losses?

Ortiz Martínez: I think that the mistake we made in privatizing, when we privatized the banking system again, is that we did not really know the credit quality of the portfolio. And we did not know whether the reserves that the banks were making were sufficient. Obviously, they were not sufficient ex-post. So 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.

YPFS: So clarity of the credit risk and the credit quality should have been stronger?

Ortiz Martínez: Yeah, it was very obscure. We had these twin things: the banking system, plus the currency crash and the lack of reserves. Those were the challenges that I faced in the beginning of '95.

YPFS: So where did you even start?

Ortiz Martínez: Obviously, I started talking to the IMF, and to the US Treasury, and the central bank. I had meetings in early January with Larry Summers, and Alan Greenspan. The Secretary of the Treasury had not been appointed yet. It was a process of congressional approval, so Larry was in practice the one who was handling this on the part of the Treasury.

YPFS: And what were those discussions like?

Ortiz Martínez: Obviously, it was in the interest of the US to help Mexico maintain economic stability. So, they ended up lending us $20 billion, the US Treasury, and we got an IMF line of credit for $17 billion, plus money from multi laterals, so the package amounted to close to $50 billion. With that, we had enough money to redeem, to avoid defaulting on the tesobonos, the dollar-denominated Mexican government bonds, to shore up a little bit of reserves. We had a floating exchange rate at the time, which was one of the first emerging markets that actually floated its exchange rate. And we floated, not because we thought that was a better exchange rate regime, but we floated because we had no choice. We had no reserves.
So as finance minister, my thoughts were that once we accumulated sufficient international reserves, we would fall back to a more predictable exchange rate regime. Some band, or something, because the market was hugely unstable, and volatile. The peso went all over the place, and mostly depreciating. On the first few months of 1995, peso went from two to something like six, seven in a matter of weeks or months. Obviously, it was a huge shock.

YPFS:  **Was that understood on the other side of the table? Did they understand the implications, and the danger of contagion across the region?**

Ortiz Martínez: Well, I think that was a main preoccupation on the part of the US Treasury, and they certainly had a very clear picture of the dangers that could occur. That’s why they lent us the money. We negotiated a program with the IMF, and we took very drastic austerity measures, in terms of raising public-sector prices, cutting the budget, raising interest rates. That helped stabilize the macro part towards the end of 1995, because with the rise of interest rates, the amount of nonperforming loans started to shoot up. So, we had a big problem with the banking system.

YPFS:  **Was there any discussion of moral hazard in terms of helping the banks? That was a big conversation on this side of the border during 2008, the idea of the moral hazard in rescuing institutions. Was that at all part of the discussions?**

Ortiz Martínez: That was really not a substantial part of the discussions with the US, or with the IMF, but we were pretty clear that we could not just bail out the banks. So, most of the owners of the banks, ended up losing the banks. The banks changed hands, so there was a lot of foreign banks taking over the domestic banking system.

YPFS:  **Did that add to the volatility and ultimately to the shocks to the economic system?**

Ortiz Martínez: Well, obviously the banking crisis was extremely costly, and shocking. It ended up costing about 20% of GDP over a number of years.

YPFS:  **You mentioned the counter measures to deal with the crisis, and the austerity. That caused a certain amount of financial and economic dislocation to Mexican citizens.**

Ortiz Martínez: The GDP contracted more than 7% in 1995.

YPFS:  **So that pain must have had repercussions politically and socially, considering this whole thing started with the Zapatistas in Chiapas.**

Ortiz Martínez: Yeah, clearly, there was a very difficult political situation for President Zedillo, to handle with Congress, with the unions and so on. But amazingly
there was no big social, or political turmoil in 1995, there were obviously manifestations, and a lot of political maneuvering with the unions, and so on. But given the magnitude of the crisis, and the fall in real wages that took place—because inflation shot up and the wages stayed more or less constant in nominal terms, so there was a big loss in real wages—it did not precipitate a social backlash that you would’ve expected given a situation like this. In part, because there was an agreement between the PRI, and the opposition on some of the measures. Eventually the PRI lost in the midterm elections, they lost congress for the first time in 70 years.

The informal agreement was that the opposition would not agitate socially, but there was no agreement between the government, and the opposition. They were extremely critical of the government, but it was all done within Congress and public discussions. And again, we had manifestations, but no street violence, or major social dislocations, which was certainly a big danger at the time.

YPFS: And then you did manage to shrink the deficit and pay back the debt.

Ortiz Martínez: The program was very successful. It was extremely painful, but it was successful in the sense that the economy contracted 7% in '95, but then it bounced back almost 7% in one year. It bounced like 6%. And we regained access to international markets by mid '95—the second semester of '95, beginning of '96. So we were able to replenish international reserves, and we were able to pay back the US loan way ahead of schedule, and we were able to repay the IMF, also way ahead of schedule. So in that sense, the program was very successful.

YPFS: Might the speed, and determination of success had something to do with calming the waters, so to speak—the fact that you were able to deliver, and deliver quickly, on the aims of the program?

Ortiz Martínez: Yes.

YPFS: So, summing up this crisis: How would you grade the government's response?

Ortiz Martínez: Well, it’s not an impartial judgment because I was in charge.

YPFS: Would you have done anything differently in retrospect?

Ortiz Martínez: In retrospect, I think that the US and the IMF pressured to raise interest rates by too much, and that really aggravated the banking crisis. My main worry was that, obviously, we needed tighter monetary policy and higher rates, but what ended up happening, which is that rates went up 30% in nominal terms, or 30-something percent. That really aggravated the banking crisis. So I think that it was not the direction. It was clear that we needed
tighter policies, but there was overshooting in terms of the monetary adjustment. The interest rates hike later had very undesirable repercussions in terms of aggravating the banking system crisis.

YPFS: Perhaps being a bit more conservative with those interest rates?

Ortiz Martínez: Well, they really twisted the hand of the central bank, and they were forced to raise rates, to elevate much more than was needed. But that was a part, that, in my view, was exaggerated.

YPFS: Looking to the present, how has the legacy of that crisis affected how Mexico responded to COVID-19?

Ortiz Martínez: That's a big jump there. But let's say the main benefits of the crisis, was that with a floating exchange regime, we started putting in place a mechanism of inflation-targeting at the central bank. I was minister of finance for three years, and then I became central bank governor in '98. We learned to live with a floating exchange rate and we started putting together a scheme of monetary policy that was consistent with the floating exchange rate regime, which was totally untested in emerging markets. We started putting together an inflation targeting regime in '99-2000. So the bottom line is that the peso stabilized, and we were able to develop the domestic bond market quite quickly and deeply, so that helped a lot. The consistency between monetary, and fiscal policy regimes, was a byproduct of the crisis that really helped the economy going forward.

YPFS: How did the response to the pandemic dislocation compare to the peso crisis? You have, in this case, more of a social-healthcare aspect. You're not just talking banking, but there is a massive shock to the system.

Ortiz Martínez: No, the pandemic was a major shock, but it was a very short-lived shock, in the sense that there was a huge outflow of capital flows into emerging markets at the beginning of the pandemic. More than a $100 billion, according to the IMF, calculated between March and June, or something like that in 2020. But then you have these extraordinary measures taken by the US central bank, the Treasury, and all this flooding of money—not only in the US, but also in the developed world—that helps stabilize capital flows. So the shock was very large but very short.

For Mexico it was not a problem. We had enough international reserves, and we could deal with capital outflows, and there was no major economic dislocation or financial dislocation because of COVID-19. Obviously, as in many parts of the world, the lockdowns and the stop of economic activity precipitated a very drastic fall in GDP. In 2020 Mexico’s economy shrank by about 8%. It was a shock.

YPFS: About the same as the first year of the peso crisis.
Ortiz Martínez: Exactly, but in a very different environment. This was an external shock caused by a pandemic, and the responses not only in Mexico, but in the whole world, in terms of isolating, and suspending economic activities and so on. You know this story very well.

YPFS: You also had some advice after the crisis, related to the Asian crisis in the late 1990s. I believe you also consulted in the US in 2008. So, what sort of top-down advice would you have for future policymakers facing future crises, like what we may just be going into right now, with inflation being so high?

Ortiz Martínez: The Asian crisis, in a way, had some similarities to the Tequila crisis. It was a crisis of banking systems, and fixed exchange rates, in large parts of Asia. Emerging markets learned the lessons, and they all moved to flexible exchange rate regimes with different degrees of flexibility, and a framework of monetary fiscal policy, which became sustainable. And this is why during the Great Financial Crisis of 2008-2009, remarkably, no emerging markets that had suffered a crisis before—like Mexico in 1995, the Asian crisis, then Russia, Brazil, and so on in 2000, 2001—none of these countries suffered a major financial dislocation as a consequence. Despite the fact that capital flows suffered, emerging markets were able to cope in the Great Financial Crisis.

YPFS: It would be very ironic then that you learned your lessons in the ’90s, and yet it seems the US system needed a little reminding in 2008, especially the part about having clarity around credit quality, and credit risk, among institutions.

Ortiz Martínez: And also, what it meant to let Lehman Brothers go. That was, I think, a huge landmark of the crisis. Obviously, I was very much in contact with US authorities at the time, and I know there was a big debate on what to do. And this is already hugely well-documented in several books, and histories in the US, so we know what happened.

YPFS: Well, it goes back to that moral hazard question that we have talked about: If we step in, what is the message we’re sending? But you were at the time governor of the bank of Mexico, if I’m not mistaken.

Ortiz Martínez: That’s correct.

YPFS: Looking in the horizon, could you see that coming in 2007 and 2008? What were your discussions regarding the stress of the US mortgage market as a domestic US problem, or a potential global contagion?

Ortiz Martínez: Obviously, this was flagged months in advance, and that’s well documented. But since the Mexican crisis, Alan Greenspan was very much involved in it, and we developed a very close relationship. I remember Alan saying that there was no historical precedent of a general downturn in the housing markets in the
US, maybe during the Great Depression. But after the Great Depression, they had not been a generalized downturn nationally in the housing market. So, I think that the US authorities were caught by surprise also as the crisis unfolded, and contagion appeared, and then... we know all what happened.

YPFS:  
Was there any concern in Mexico that if they get a cold, you catch the flu?

Ortiz Martínez: Obviously, we were very concerned. It was a major shock for the world economy, as you know well. But obviously, Mexican banks, and banks in emerging markets in general, were not buying these toxic products. So, there was no inherent weakness in the balance sheets of the banks in Mexico, or in other emerging markets, as a byproduct of what was going on in the US market. With the quality of the subprime mortgages, the repackaging, and all that took place at the time.

YPFS:  
But a wholesale slowdown of US economic activity had to be a concern because of NAFTA.

Ortiz Martínez: Obviously, it was a big shock. We had a contraction of GDP also in 2009, but again, fortunately there was no financial dislocations.

YPFS:  
And once the crisis took hold in the US, you had some meetings with Ben Bernanke, and some of the other officials who were steering through the crisis. Did you give them any advice? And did they take it?

Ortiz Martínez: They didn’t ask for any advice.

YPFS:  
So what lessons do you wish they had applied from your personal experience?

Ortiz Martínez: Well, I think, this crisis was clearly in the making for months. There were people that were flagging signals, that the banks were taking excessive risks, that it was unknown the extent of the risks that they were taking, because the products were very obscure. You had the rating agencies giving AAA ratings, to products that were inherently damaged and unstable. It was a massive regulatory failure, a massive failure on the part of all players, including rating agencies, which played a complicit role. But we’re getting into 2008...

YPFS:  
If you were to write a memo to your younger self about how you want to address a crisis of this magnitude, what would be your advice?

Ortiz Martínez: Well, we did not pay sufficient attention, and that's an understatement, to the situation of the banking system. As I mentioned before, we privatized the banking system in two years, and the quality of the portfolio that we thought was okay when we sold the banks, turned out that it was very lousy. This is not unlike other banking crises in other parts of the world, including the savings
& loan crisis in the US back in the ‘80s. They were regulatory failures, and this is a common thread.

I think that lessons were learned. As you know, the Basel Committee strengthened regulatory capital, and so on. There was a response to that at the global level, and particularly in developed markets. It doesn’t mean that it will not happen again, but the likelihood is smaller, let’s put it that way.

YPFS: Well, if the big lesson is to pay closer attention to the banking system, and the quality of portfolios, have we not learned that lesson? Because it seems like, as you said, this scenario keeps repeating. So is that the biggest lesson to be learned then?

Ortiz Martínez: Well, there's I think two lessons. One is, obviously, the banking system credit quality, and so on, as I mentioned before. The possibility of spillovers and contagion within the domestic financial system, and the repercussions of what’s going on abroad, like the Great Financial Crisis, the impact that it had in the different countries.

But the other big lesson, of course, is consistency of monitoring fiscal policies. Those are the two ingredients that are fundamental for economic stability: having a sound banking system consistent, 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. As simple as that.