CHAPTER 6

Japan in the Mexican Peso Crisis and Its Repercussions

By 1992, thanks to the Brady Plan, to which the Japanese government contributed billions of dollars, the prospect of Mexican and Latin American recovery looked bright. David Mulford, who pushed the Brady Plan through in 1989 as undersecretary for international affairs at the U.S. Treasury, wrote triumphantly in the *Wall Street Journal* that the U.S. economy had benefited from restored economic growth in the Latin American region and that the United States had begun to expand its new trade partnerships in the Western Hemisphere.[1] The *Economist* was also cautiously optimistic about the positive outcome of the Brady Deals, noting, "The Brady gamblers win, for now."[2]

Good times arrived to many Latin American countries in the early 1990s, as international investors became increasingly attracted to bond and equity issues by these ex-debtors. The Mexican economy started to become even more integrated continentally than before, thanks to the successful negotiations of the North American Free Trade Agreement (NAFTA), which came into effect in January 1994. Mexico became one of the success stories of the emerging market countries, and in 1994 the country even became a member of the OECD.

When the currency and financial crisis hit Mexico in December 1994, the U.S. Clinton administration, along with the IMF, was ready to help, while the Japanese government and the Europeans were quite reluctant.[3] Why was the Japanese government so active in resolving the Mexican debt crisis, with a large official fund committed to the country's debt solution in 1989–90, but so inactive in the Mexican peso crisis?

From the 1980s into the 1990s, a few major changes in the international financial environment and in Japan's political and economic conditions influenced the Japanese actions. First, regarding the international financial environment, the type of financial flows to middle-income developing countries shifted from predominantly bank lending to portfolio investment in stocks and bonds. This shift changed not only the speed of capital movement in and out of the country but also the financial actors involved in the transaction. These changes in the financial actors and the implication of these changes on the strength of institutional linkages among creditors come under my second hypothesis in chapter 1. Beyond that, the apparent changes in the international financial environment has not transformed the fundamental nature of the creditor-debtor dynamics or the necessity for financial crisis management.

Second, the changes in Japan's economic and political conditions have contributed to decreasing the private returns that the Japanese government could expect from international financial crisis management in the 1990s. The relative decline of Japan's economic strength vis-à-vis the United States, with Japan suffering an extended period of recession in the 1990s and with the United States experiencing a long economic boom, might have made the Japanese government reluctant to assist the United States. This shift in relative economic positions has influenced the Japanese government's calculation of its private gains, and thus its behavior in the Mexican peso crisis, in three ways. First, weakening bilateral trade tensions (despite an increasing trade imbalance) decreased the Japanese government's sensitivity to U.S. demands in other fields. Second, Japan's domestic financial weakness abated economic linkages between Japan and the United States, as the Japanese financial sector withdrew from the United States; concomitantly, the U.S. economic strength eliminated one major reason for the Japanese government to intervene in financial crises in Latin America—to boost the U.S. economic recovery (see chaps. 3 and 5). Third, the Japanese government began focusing on Japan's domestic economic and financial problems, which have represented more urgent concerns for the government than have the economic problems of Mexico. In a way, recovery of Japan's economy would, in the mid-1990s, contribute more to the stability of international finance than would the recovery of Mexican finance.

Finally, Japan's domestic political changes, including the LDP's loss of parliamentary majority in 1993, have further influenced the Japanese government's behavior. As political instability continued into the second half of the 1990s, the highly symbiotic relationship between the LDP, the financial bureaucracy (especially the MOF), and Japan's financial sector has transformed, making it less likely for the Japanese government to respond consistently and favorably to Japanese banks' pressures. This domestic political change in Japan contributed to weakening the transnational pressures via institutional linkages as these pressures tried to permeate the Japanese government's policy regarding the peso crisis rescue.

This chapter examines the factors that resulted in the Japanese government's inaction or its lack of involvement in the management of the Mexican peso crisis. The analysis of the chapter uses the same framework as the chapter on the Latin American debt crisis, to illuminate the determining influence of the two major factors affecting the Japanese actions—the presence of private returns and the presence of transnational linkages. After describing the actions taken by Japan and other creditors, particularly the U.S. administration and the IMF, the study examines which factors made the Japanese government a reluctant player in this financial crisis management case. As I have already discussed, a few changes in the domestic and international political economy surrounding Japan from the end of the 1980s into the 1990s changed the Japanese government's attitudes toward the Mexican financial crisis management by reducing Japan's private returns and weakening the power of transnational linkages. In addition, a few other particular factors associated with the Mexican peso crisis, such as U.S. political interests and the corresponding Mexican government's policy, also changed Japan's attitudes toward the crisis.

Japan's Limited Involvement in the Mexican Peso Crisis and the Repercussions of the Crisis (Dependent Variable)

On December 20, 1994, the Mexican government was forced by market pressure to leave the band in which the peso had fluctuated against the U.S. dollar. The Mexican peso was devalued by 15 percent, compelling the Mexican government to change the ceiling of the exchange rate band. Two days later, on December 22, Mexico was forced to allow the peso to float. As Mexico abandoned its pegged exchange rate and moved to a floating currency, the peso continued to come under attack, with corresponding effects on its stock and bond prices. Investors withdrew capital from Mexico during the first few days of the peso devaluation, leaving Mexico's foreign exchange reserve as low as $6 billion.[4] At the same time, Mexico's dollar-denominated short-term bonds, Tesobonos (Bonos de la Tésoreria de la Federación), were maturing—from January through March 1995—and fear existed that Mexico could exhaust its dollar foreign exchange reserve in only a few weeks.[5] Over the next few months, the Mexican stock market dropped by 68 percent in dollar terms (between December 19, 1994, and its low on March 9, 1995).[6] The speed and magnitude by which portfolio capital flows exited from Mexico especially in 1994 sent shock waves through the international financial community.

An international rescue package for Mexico, led by the United States and the BIS, was negotiated during the last few days of 1994. On January 2, 1995, the package was expanded to $18 billion, including $6–9 billion of the U.S. swap facility,[7] $5 billion through the BIS, about $1 billion from Canada, and $3 billion from commercial banks. The U.S. Treasury was quoted as stating that Japan was to contribute "$0.6 to $1 billion" through the BIS arrangement.[8] Unlike Japan's support to the Brady Plan only five years earlier, the amount of Japan's commitment was relatively small within the package and did not come in the form of a bilateral pledge.

To the distress of the Mexican authorities and the creditor governments that agreed to contribute to the rescue package, the peso continued to drop during the first few weeks of January 1995, pulling down the Mexican stock market. Contagion effects were felt in various emerging markets of other middle-income countries, such as Argentina, Brazil, and the Philippines. To stabilize the situation, President Clinton of the United States requested congressional authorization on January 12 to provide Mexico with $40 billion in the form of loan guarantees. At the same time, the administration called for expanding the multilateral rescue package from $18 billion to $25 billion.

As the U.S. Congress stalled its authorization due to domestic opposition during the last weeks of January, the market responded negatively to efforts by Mexico and others to restore credibility. The IMF announced the provision of $7.8 billion (the maximum of the Mexican cumulative limit, equivalent to 300 percent of its quota) in an eighteen-month standby credit for Mexico on January 26, but this did not contain the crisis. In the last weekend of January, the Mexican external balance dropped to a dangerous level, and the Mexican authorities informed the United States and the IMF that Mexico might be forced to default on some of its payment obligations.

In response, the Clinton administration immediately announced a multilateral assistance package of $48.8 billion to manage the Mexican financial crisis, including up to $20 billion in currency swaps and securities guarantees from the U.S. Treasury's ESF. The package also included an increase in the IMF's eighteen-month standby arrangement, to $17.8 billion. This amount was equivalent to 688.4 percent of Mexico's IMF quota, the highest proportion ever allowed to any member country up to that date. The Clinton administration and the IMF also counted on $10 billion through the BIS (i.e., double what was originally discussed) and $1 billion from Canada. In addition, the administration was hoping for $1 billion in currency swaps from Argentina, Brazil, Chile, and Colombia, but this did not materialize. Three billion dollars in new loans from commercial banks were also promised but were never called on by the Mexican government. The World Bank and the Inter-American Development Bank (IDB) also extended a total of $3 billion in loans.[9]

Japan was reluctant to act. Although the Japanese government generally supported the United States, it expressed reservations in this case, as did several European governments.[10] These governments viewed the 1994–95 Mexican financial crisis as a problem for the Americans, who had by far the largest stake in economic interests, political legitimacy, and security concerns (discussed later in this chapter).[11] Nevertheless, Japan at least appeared ready to collaborate with the U.S. initiatives.[12] During a meeting of finance officials from the G-7 countries on February 1, 1995, a Bank of Japan official was quoted as saying that Japan had decided to provide $1.3 billion for the BIS aid package to Mexico.[13] In addition, four Japanese commercial banks—the Bank of Tokyo, the Industrial Bank of Japan, Sumitomo Bank, and Fuji Bank—were petitioned by the U.S. banks to contribute a total of $1.2 billion to the package arranged by commercial banks, led by CitiCorp and Morgan Guarantee. The final commitment these four Japanese banks accepted on January 25, however, was only $0.4 billion.

Thanks to the impressive U.S-IMF rescue package, the Mexican crisis wound down in mid-1995, with some components of the package left unused. In June 1995, the Mexican government declined the BIS loan package, which was, in effect, available only on paper, with its need for high repayment guarantees and stringent restrictions on its use. Mexico also declined the package assembled by the commercial banks in March 1995. Japan showed a few gestures of support for the Mexican rescue during the summer of 1995. For example, the Japanese trading companies extended $0.5 billion in loans to the Commercial Bank of Mexico (Bancomext), with the support of trade insurance by the MITI.[14] The JEXIM Bank resumed loans to Japanese companies intending to invest in Mexico.[15] When the Mexican government floated bonds between July and September 1995, one in U.S. dollars ($1.0 billion) and the other in Japanese yen ($1.1 billion worth), four major Japanese banks (the Bank of Tokyo, Fuji Bank, the Industrial Bank of Japan, and Sumitomo Bank) each bought $20 million.[16] In addition, a new development project through the OECF, including a project for Mexican sewage treatment, began in the fall of 1995. However, it is still striking that Japanese involvement in the Mexican peso crisis was very limited, especially after Japan's significant financial support of the Brady Plan implemented for Mexico just a few years before. Not until June 1996, during Japanese prime minister Ryutaro Hashimoto's visit to Mexico, did the JEXIM Bank extend its untied loans to Mexico, promising $0.5 billion for Mexico's export promotion.[17]

The Mexican peso crisis severely curtailed Mexico's economic growth, but thanks to the devalued peso and booming U.S. economy and to U.S. efforts in terms of both the rescue operation and increased imports, the Mexican external balance stabilized by early 1996 without significant economic support from Japan. On January 16, 1997, Mexican president Ernesto Zedillo announced that Mexico had repaid its entire debt from the rescue package to the U.S. Treasury and thus had concluded the major part of its financial obligations arising from the crisis. Although there remained various economic problems, the most crucial of which was high unemployment, Mexico recorded a strong economic growth of 7 percent by 1997.

The repercussions of the Mexican peso crisis were not, however, limited to Mexico. Argentina had signed the Brady Plan agreement in April 1993, after more than a year of tough negotiations with the IMF and commercial banks. The JEXIM Bank at that time supplied $0.8 billion of the $3.2 billion provided by IFIs to support the purchase of zero coupon bonds. The Mexican Peso crisis of December 20, 1994, severely affected the external financial balance of Argentina. The regional contagion effect, often referred to as the "Tequila Effect," was strongly felt in the country.[18] There was a strong similarity between Mexico and Argentina in the way that the balance of payments was maintained during their booming years of the early 1990s. The Convertibility Plan of a fixed nominal exchange rate inevitably made the Argentine peso expensive, thus making it harder to export and easier to import.[19] This, along with the booming economy, led to a significant current account deficit, but that deficit was compensated by inflowing capital from international investors attracted to Argentina's bonds and equities (thus turning Argentina's capital account positive). As U.S. interest rates rose after February 1994, such external capital flows began to dry up, gradually making Argentina's current account deficit hard to sustain.

As the crisis struck Mexico, foreign capital flows were reversed in Argentina, and international reserves dwindled from an already low $16 billion in December 1994 to $11.2 billion in May 1995. Facing election for a second presidential term in May 1995, Argentine president Carlos Menem and his administration engaged in crisis management immediately after the Mexican crisis.[20] Despite these efforts, the attack on the Argentine currency and stock market continued during the first few months of 1995. Argentina finally turned to the IMF and other public institutions for help. On March 13, 1995, Argentina's economy minister, Domingo Cavallo, announced that Argentina had agreed to receive a loan package of $4.7 billion from the IMF ($2.4 billion), the World Bank ($1.3 billion), and the IDB ($1 billion). The IMF portion came in the form of a twelve-month extension of Argentina's already established EFF credit of $6.3 billion.[21]

To solicit additional bilateral support, Economy Minister Cavallo flew to Tokyo on March 31 to request a rescue package of $1.2 billion from the JEXIM Bank and six Japanese commercial banks (the Bank of Tokyo, Daiichi Bank, Sumitomo Bank, Fuji Bank, the Industrial Bank of Japan, and Long-Term Credit Bank).[22] The JEXIM Bank responded favorably to the Argentine request. The two parties signed a letter of agreement in June, through which the JEXIM Bank pitched in $0.8 billion in untied loans parallel to the IMF's EFF on June 22. In addition to this multilateral and bilateral financial support, the Argentine government privatized hydroelectric dams, nuclear power installations, and petrochemical plants, raising $1 billion. It also subscribed to a "Argentine bond" of $2 billion arranged by thirty transnational commercial banks. Among the Japanese banks, only the Bank of Tokyo participated in the scheme, arranging for $50 million.[23]

In sum, the Japanese government showed hesitation and resistance during the Mexican Peso crisis, although some positive action was taken at the time of the contagion crisis in Argentina. The next sections of this chapter analyze the forces that influenced the Japanese government's behavior.

Crisis Management as a Joint Product

The U.S. Engagement in the Mexican Peso Crisis

Following the December 1994 devaluation of the Mexican peso and its accompanying financial crunch, Mexican foreign minister José Angel Gurría visited Japan. He came to Japan not to request any direct financial rescue package from the Japanese government but to assure Japanese investors that the crisis would not affect foreign investment in Mexico.[24] However, some signs of the spreading crisis kindled serious concerns about the possibility of international financial disaster during the first quarter of 1995.[25] If the crisis continued to threaten both Asia and the value of the U.S. dollar (thus leading to yen appreciation), a major systemic crisis might ensue.[26] Because the Mexican government alone could not contain the problems of rapid devaluation and the decline of its stock prices, trends that could precipitate the departure of billions of dollars from the country, it needed outside forces to conduct crisis management of some sort.

The U.S. government pressured Japan and the other OECD countries, particularly during the early stage of the crisis. Within ten days after the Mexican peso devaluation, a preliminary rescue plan was set up through the BIS. The suggested total amount of this package expanded from $18 billion (January 4) to $40 billion (January 25). The Clinton administration faced two stumbling blocs in attaining the use of the funds. First, the U.S. Congress itself was not easily persuaded by the president's call to rescue Mexico and further burden the U.S. budget, which Congress wanted to balance. In addition, Congress insisted that Japanese and European creditor governments participate in the expanded Mexican rescue plan as a prerequisite to authorization of the rescue package.[27] Second, the other creditor governments, especially in Europe, had become increasingly resentful of the Clinton administration's attempt to ram the Mexican package down their throats.[28] The prolonged debate in Congress and resistance from the other industrial countries negatively influenced the Mexican peso and its stock market.

As the crisis deepened at the end of January 1995, the Clinton administration assembled the final rescue package of $48.8 billion without resorting to authorization from Congress. Germany and five other European countries reacted bitterly against overt U.S. pressure and the hastily arranged rescue deal through the IMF: they debated their withdrawal from the deal at the beginning of February. Japan was not a part of this European group, nor was it very active in these efforts toward collective crisis management. Although one might consider the 1995 response to Mexico by the IMF and the U.S. administration an important instrument that contained the spread of the crisis and produced public goods of international financial stability, the crisis itself was perceived, even by the Japanese, as "the problem of the Americans."[29] This was mainly because many saw that despite possible "public good" implications, successful crisis management would not produce any measurable returns to creditor governments other than the United States.

The Clinton administration considered Mexico its priority and showed an utmost willingness to support the rescue plan. U.S.-Mexican economic relations strengthened from the late 1980s into 1994, as NAFTA was signed in December 1992 and ratified by the U.S. Congress in November 1993. This agreement became effective in January 1994, creating a relative advantage for American producers to expand their market shares in Mexico. NAFTA exempts American and Canadian manufacturers from Mexican tariffs in stages, and it makes it difficult for Japanese products to penetrate Mexico.[30] Mexican trade with the United States has always been substantial, accounting for more than 60 percent of the Mexican total trade value (imports plus exports) during the 1980s. With NAFTA, Mexican trade dependence on the United States increased further, accounting for 74.9 percent of its total trade value in 1994.[31]

The Clinton administration, which had strongly supported this trade arrangement with Mexico, faced elections in 1996. Thus, the administration had to orchestrate a quick Mexican recovery to maintain its credibility. Political considerations drove the U.S. government's—particularly the executive branch's—support of Mexico throughout the rough months.[32] The flow of illegal immigration and drugs from Mexico has also made the country an important security concern for the United States. When divisions in Congress delayed the commitment of a Mexican rescue package of $40 billion, hurting Mexico's currency, the support by the executive branch became unambiguous. The Clinton administration dropped the debate and turned to the Treasury's ESF (normally used for U.S. intervention in the foreign exchange market) to contribute $20 billion without congressional authorization.[33] Furthermore, the Mexican government was aware of the elevated level of U.S. commitment to Mexico. This explains why Mexican government leaders did not even extend an official request to the Japanese government regarding concrete actions in the rescue plan.[34]

Private Returns for Japan

In contrast to the case of the Latin American debt crisis, the Mexican peso crisis presented limited private returns for Japan and thus limited incentive for the Japanese government to share the burden of public goods provision. None of the three kinds of private returns that had previously encouraged the Japanese government to engage actively in the Latin American debt crisis (see chap. 5) were strong factors in the 1994–95 Mexican peso crisis. Meanwhile, the changes in the international and domestic political and economic environment led the Japanese government to focus less on support of the United States or Latin America and more on its own economic weakness.

Three important factors that raised the stakes for the Japanese government at the time of the Latin American debt crisis were (1) the exposure of Japan's private financial sector to the Latin American debtors, (2) the imbalance in the bilateral U.S.-Japanese economic relations and its associated U.S. political pressure, and (3) Japan's own ambitions in the IFIs. None of these factors were strong in the case of the Mexican peso crisis.

The investment and involvement of the Japanese financial sector was quite limited, particularly relative to that of the United States, when the crisis struck Mexico. By the end of 1994 (December), commercial bank loans to Mexico from Japan reached $4 billion, compared to $22.2 billion from the United States.[35] In the Samurai market, there were only a few bond issues from Mexico, totaling ¥55 billion ($550 million at U.S.$1 = ¥100).

The U.S. economy was experiencing a strong boom in the middle of the 1990s, particularly in comparison with the Japanese economy. By 1992, U.S. GDP growth overtook that of Japan (see fig. 2.6) and continued to increase steadily, while Japanese economic growth stagnated notably in the 1990s. Hence, despite Japan's persistent economic interests in the United States, the Japanese government did not have to worry about propping up Latin American countries, including Mexico, to support U.S. economic recovery.

Finally, having acquired the second largest voting position in the IFIs, the Japanese government did not have a pressing agenda to promote in the IMF or the World Bank. The Japanese government did not see substantial gain in acting more positively (beyond quietly supporting the U.S. initiatives by not opposing them), especially considering the major split between the United States and other major powers from Europe in the institution.

International and Domestic Change and Japan's Motivation

Changes in the international and domestic environment from the 1980s into the 1990s further reduced the Japanese government's motivation to become actively involved in support of the United States in the peso crisis management. The end of the cold war in 1989–91 impacted the developments of the international financial market. On one hand, the "triumph of liberalism" or the loss of an alternative economic model gave rise to a market-centered developmental "consensus" in the world and limited the options of developing countries.[36] Developing countries in economic distress in the 1990s had no other choice but to rely on IFIs and request financial assistance from the capital-rich countries of the OECD members. This might have reduced the importance of constructing a solid united front among the creditor governments to keep the debtors in check.[37] On the other hand, the post–World War II anticommunist or anti-Soviet front among the countries of the "West" unraveled. Observations have surfaced that this change was particularly important for U.S.-Japanese relations, because many of the security arrangements between the two countries were made under the cold war structure.[38] As the cold war ended, the real or imaginary threat of the Soviet Union ceased, for the most part, to affect the foreign policy agenda. Japan's growing influence on the IFIs and an increase of regional arrangements in Asia are also attributed somewhat to the post–cold war environment.[39] This type of arrangement among major powers in the world economy has led the Japanese government to promote an alternative model in development.[40]

The change in Japan's economic position in the world between the 1980s and the 1990s led the Japanese government to reevaluate its policy priority. Since the early 1990s, Japan has experienced a severe recession, which came on the heels of a 1990 decline in stock prices when overheated land speculation ended. The dramatic slowing of Japan's annual GDP growth (see fig. 2.6) and the decline in real gross fixed capital formation (see fig. 2.7) are clear signs of Japan's economic slowdown starting in 1992. The recession also caused the government's revenue to decline, and it simultaneously increased the need for public investments to boost the economy.[41] Due to the squeeze from both the supply and demand sides of its budget, the government's reliance on public bonds expanded, from a relatively low level of about 10 percent of its budget in fiscal year 1988 (April 1988–March 1989) to 18.7 percent in fiscal year 1994. In this tight budgetary environment, the growth of Japan's General Account expenditure turned negative in fiscal year 1994 (–5.2 percent) and again in fiscal year 1995 (–2.9 percent). Overall, the national budget moved from a 1 percent GDP surplus in 1993 to an 8 percent GDP deficit in 1995–96.

Missing in the case of the Mexican peso crisis was not, however, the

Japanese government's capacity but its motivation. Despite the tight budgetary condition and the country's economic downturn, Japan's strong economic role in the world of the late 1980s still carried momentum in the first half of the 1990s. Japan has remained a major figure in aid flows to developing countries and a major financial contributor to multilateral organizations, such as the United Nations and the IFIs.[42] Since 1993, Japan has been the largest ODA donor, contributing more than $13 billion a year to Third World development, and Japan's presence in the IFIs has also become prominent, particularly because Japan contributes substantial funds under cofinancing arrangements with the World Bank, the IDB, and the IMF. Japan's voting share in the IMF and the World Bank has increased, and Japan maintains the second most powerful vote in both institutions.[43]

In the private financial sphere, Japanese portfolio investment to the rest of the world increased significantly from the early 1980s through the end of the decade: it rose from $3.7 billion in 1980 to its highest level of $113 billion in 1989.[44] Although this capital outflow declined somewhat in the early 1990s, Japanese portfolio flows regained outflow levels, reaching $82 billion in 1994. Appreciation of the yen in 1994–95 contributed to the increase in the nominal amount of Japan's capital outflows, and the relocation of Japanese firms to cope with the strong yen meant Japanese money followed. In addition, persistently low interest rates in Japan, coupled with Asia's dynamic economic expansion, reversed the previous trend of Japanese capital retreat.[45]

Even at the time of economic downturn in the mid-1990s, Japan's economic capacity to extend financial assistance was not seriously undermined. The Japanese government was not inhibited from allocating resources when it was regarded as absolutely necessary. In August 1997, as the Thai currency crisis affected the Asian economies, the Japanese government took initiatives to assemble a relief package of $17.2 billion, with Japan contributing $4 billion in parallel financing with the IMF.[46] This effort emphasizes the importance of the Japanese government's motivation—particularly in terms of pursuing its private returns under different economic priorities—as the determinant of Japan's behavior toward Mexican peso crisis management.

The speed with which the emergency package for Mexico was assembled made it difficult for the Japanese government to respond. Scholars examining Japanese policy response at the time of the Persian Gulf crisis have noted that the structure of Japanese decision making, which lacked a top-down mechanism, prevented the Japanese government from moving quickly at the time of emergency.[47] The United States could not wait long to solve the Mexican crisis, and the pace it established prevented any solid pressure, external or internal, from permeating the Japanese government's decision-making process. Yet it is puzzling that the Japanese government was able to respond to the 1997

Thai crisis with little more than a one-month span between its currency devaluation and the establishment of the package. Thus, again, the Japanese government's willingness to become involved in such actions becomes the center of the analysis.

The Case of Argentina

The rescue package to Argentina requires explanation, since the overall environment of the crisis was the same for Argentina as for Mexico but Argentina obtained more financial support from Japan. As in the Mexican situation, crisis management in the Argentine case would not have produced a high level of joint products for Japan. But the Japanese government did step in, albeit with small steps, to assist the Argentine government.

Two unique factors in the case of Argentina led the Japanese government to become more engaged. The first factor, which produced private returns in the form of gaining favors from the United States, was the complete immobility of the U.S. Congress in March and April 1995, the time when Argentina needed relief most. After the Clinton administration bypassed Congress and tapped the Treasury's ESF for the U.S. rescue package of $20 billion to Mexico, some U.S. lawmakers furiously attacked the administration's use of "the obscure Treasury fund," claiming it violated the law. The most vehement opponent, Republican Senate Banking Committee chairman Alfonse D'Amato of NewYork, remarked, "[The ESF] is not the president's personal piggy bank," and called for a hearing on the matter.[48] Having been so closely scrutinized in the case of the ESF and facing strong resentments among lawmakers regarding the "Latin American bailouts," the U.S. government became virtually incapable of responding to the Argentine crisis on a bilateral basis. This provided an opportunity for the Japanese government to extend its bilateral political favors to the U.S. administration under siege.

The second factor reveals the shadow of the United States on Japan's decision making: a commitment to the United States is reflected in the minds and attitudes of the policymakers of the countries in crisis. Although the Japanese government received visits from top ministers from both countries, Mexico and Argentina, soon after the crisis hit, the purposes of their visits and the attitudes involved were quite different. Economic Minister Cavallo of Argentina, knowledgeable of the problematic prospect of the U.S. contribution to the Argentine rescue, went to Japan to formally request assistance; Foreign Minister Gurría of Mexico, meanwhile, counting on high U.S. involvement, visited Japan largely to underplay the extent of the crisis.[49] The Japanese government, with its foreign policy gains vis-à-vis both the United States and Argentina in mind, responded to the Argentine request favorably.

Transnational Linkages and Domestic Dynamics

Transnational Institutional Linkages among Financial Sectors

According to a famous phrase by former IMF managing director Michel Camdessus, the debt crisis of the 1980s was the last global financial crisis of the twentieth century, and the Mexican peso crisis represented the first crisis of the twenty-first century.[50] Despite his statement, there is an abundance of commonalties between the two crises. Elements common to both crises are (a) the sequence of a strong surge of capital inflows into the middle-income countries and dramatic outflows following a "crisis of confidence" (in both cases initiated by Mexico) and (b) a heightened financial integration of these middle-income economies into the global capital market via capital flow from major industrial countries (particularly the United States) and repercussions of the crises due to such a link. However, there is an important difference: the presence and absence of transnational institutional linkages among the financial sectors. This contrast has a major implication on the necessity and modality of international crisis management by major creditor governments.

Prior to both crises, there was a dramatic increase of financial flows from capital-rich industrial countries to capital-hungry industrializing Latin American countries within a relatively short period of time.[51] The competition among the lenders and/or investors became quite fierce in the final stage of both booms, when spreads narrowed on the bank lending and newly issued bonds. After awhile, the repayments on such huge loans became unsustainable. This occurred particularly because of the debtors' increasing trade deficits, which resulted from such factors as changes in the external economic environment (e.g., declining terms of trade for goods); real appreciation of the debtors' currencies, which makes their goods less competitive; and increases in debtors' consumption through imports. Significant jitters among all investors followed as a major capital recipient country (Mexico in both cases) demonstrated signs of economic distress in the form of a suspension of interest payments in 1982 and a de-pegging of the currency against the dollar in 1994. An alleged "herd mentality" of investors led to a massive financial retreat from the country as quickly as possible to minimize losses, a process that in turn caused a major financial panic.

Although this dynamic of manias, panics, and crashes[52] seems quite similar in the two crises, there are a few critical differences in terms of what constituted these foreign capital surges to the region. Table 6.1 demonstrates that foreign capital inflow to Latin America just prior to the 1982 crisis was made up mostly of long-term commercial bank lending that functioned as a channel to recycle petrodollars from the bank accounts of industrial countries to the governments of the newly industrializing developing countries in the latter half of 1970s. This was sovereign lending whereby the borrowing governments acted as guarantors of the debt, which took the form of syndicated loans with cross-default clauses for avoiding selective defaults by the debtors.[53] By contrast, after the debt crisis dried up the debtors' access to banks' voluntary lending in the late 1980s, a much higher proportion of foreign capital flows to the region in the early 1990s came through FDI, bond issues, and portfolio equity flows (see table 6.1).[54]

In accordance with the different types of capital flows in the two cases, the financial actors obviously changed. The case of the Latin American debt crisis involved transnational commercial banks engaged in Latin American lending, while the major financial actors involved in the capital surge of the early 1990s included investment banks and such institutional investors as mutual funds, pension funds, and insurance companies.[55] Cline explains:

> In short, the moribund commercial bank financial market for lending to Latin America was being replaced by portfolio security financing. . . . nationals repatriating flight capital provided an important part of the demand for the new, securitized flows to Latin America. There was even a change in vocabulary that signaled the transformation: "emerging markets" becomes the Wall Street phrase to describe Latin America and Asia, with psychological connotations far more buoyant than "LDC debt."[56]

The hedging device for the risks associated with investment in Latin America also changed in the 1990s, which had a major impact on the strength of institutional linkages. From the 1970s into the 1980s, sovereign guarantees, variable interest rates, and cross-default clauses established a (false) sense of lowered risk, and banks were linked to each other through syndication. In the 1990s, the highly liquid nature of portfolio equity flows (sometimes described as "hot money") gave investors quick and easy ways of entrance into and exit from their investments. The former finance minister of Mexico Jesús Silva Herzog characterized this phenomenon as a "twenty-one year old pushing a button," leading to the exit of billions of dollars from Mexico in a matter of seconds in the aftermath of its peso devaluation.[57] Although the behavior of investors fleeing from Mexico appeared uniform, their behavior was united not by institutional linkages but by the herd mentality. Each investor was free to move independently.

The second general similarity between the two periods of capital surge and reversal is the fact that the capital importing countries had become closely integrated into the international capital market and that the economic envi-

TABLE 6.1. Comparison of Net Capital Flows to Seven Latin American Countries, 1982–1997 (in billions of US dollars)

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Total	**26.57**	**4.39**	**6.48**	**1.90**	**7.99**	**12.25**	**−1.10**	**3.94**	**16.19**	**29.44**	**54.37**	**37.97**	**36.81**	**68.22**	**64.58**	**69.81**
Foreign Direct Investment	4.81	3.08	2.85	3.91	2.88	3.60	5.21	5.98	6.53	11.08	13.28	11.98	25.30	27.45	38.88	57.29
IMF	0.99	4.95	2.72	2.59	1.67	1.94	−1.36	−0.30	2.74	−0.98	−2.04	2.51	0.88	15.65	1.30	0.66
Official	3.33	2.54	3.44	3.34	3.93	2.47	2.66	1.56	5.22	1.40	−0.23	2.05	−1.80	8.53	−8.52	−7.12
Banks, long term	18.03	9.61	7.95	2.34	−1.00	2.04	0.23	−6.38	1.80	2.80	10.10	1.13	2.08	3.13	1.42	2.99
Interest arrears	0.00	0.84	1.61	0.85	0.69	3.80	2.48	6.98	7.89	3.01	0.60	−3.80	−5.42	−0.39	−3.76	1.07
Bonds, public & publicly guaranteed	3.96	−0.81	−1.09	−0.91	−1.40	−2.05	−1.53	−1.27	0.10	2.66	−2.46	6.30	6.00	8.17	22.39	8.02
Bonds, private	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.15	0.61	2.01	7.68	14.33	7.82	3.41	7.20	5.42
Subtotal	**31.12**	**20.21**	**17.48**	**12.12**	**6.77**	**11.80**	**7.69**	**6.72**	**24.89**	**21.98**	**26.93**	**34.50**	**34.86**	**65.95**	**58.91**	**68.33**
Residual	−4.55	−15.82	−11.00	−10.22	1.22	0.45	−8.79	−2.78	−8.70	7.46	27.44	3.47	1.95	2.27	5.67	1.48

Source: For years between 1982 and 1992: Cline 1995, 435, table 8.3. For years after 1993: *Global Development Finance,* 1999.
Note: The seven Latin American countries include Argentina, Brazil, Chile, Columbia, Mexico, Peru, and Venezuela.

ronments were driven predominantly by the capital-exporting industrial economies. A heated debate has taken place in international circles of development and finance regarding how capital movements are affected by "push" (low interest rates and unfavorable domestic investment conditions pushing money out from capital-rich countries into the emerging markets) and "pull" (policy reforms, favorable investment conditions, and robust economic fundamentals attracting money from abroad). The debate seems, however, to tilt toward the substantial influence of the economic conditions of industrial countries on the outflow of capital into middle-income regions (the "push" factor).[58]

As I noted in chapter 5, the excess of petrodollars in bank accounts of rich nations and major recessions in the developed world turned capital flows toward the capital-hungry industrializing nations of Latin America in the second half of the 1970s. In the early 1990s, a prolonged recession and low interest rates, along with pressure on the institutional investors to earn good returns, guided the capital to flow to the "emerging markets," with expected high returns.[59] Many argue that, along with the political instability following the assassination of Mexico's presidential candidate Donald Colossio, improvements in U.S. economic conditions, which led to a rise in interest rates in the spring of 1994, triggered significant capital flight from Mexico back to the United States, paving the way to the peso crisis.[60] Although the economic fundamentals and economic policies of emerging market countries do matter, the international financial environments are critical factors that trigger crises.

As a rapid reversal of foreign capital flow occurs after an initial shock, it produces economic and financial repercussions beyond a country's borders, leading to a fear of systemic crisis. These shocks were transmitted through various channels, such as explicit or implicit trade and financial linkages, and through demonstration or contagion effects in the early 1980s. Many developing countries sank along with Mexico. Because of the widespread practice, started in the 1970s, of sovereign and syndicate lending to many developing countries, most of the countries in Latin America, as well as such countries as Cote d'Ivoire and Nigeria, became problem debtors in the 1980s. The list further expanded to the poorest nations of Africa. Most of the countries entered into debt negotiations with creditors, intensifying the threat of systemic crisis.

In the early 1990s, only about twenty countries were referred to as "emerging market" countries, where more than 80 percent of private capital concentrated. Most of these countries were located in Latin America and in Asia, along with some in Eastern Europe.[61] In hindsight, the crisis turned out to be not as serious as the debt crisis of the 1980s, but many unknown factors existed at that point, including the magnitude of the contagion, which made the option of inaction highly dangerous. Contagion effects of the Mexican peso crisis hit other Latin American countries, particularly Argentina. In Latin America, a concentration of Brady deals, a privatization boom, and the intense reinsertion of the Latin American economies into the international capital market in the early 1990s contributed to creating a regional wave of crisis.[62]

The lack of institutional linkages among new actors who have invested in Mexico influenced the way the Japanese government behaved in the peso crisis. Even when the portfolio investment of bonds and securities in Latin America became a hot market, Japanese financial institutions did not have in the region strong institutional ties that would lead them to become underwriters of these instruments. Involvement of Japanese investors had been minimal, and there had not been much structural innovation to engage these investors in the Latin American market. The emerging market in Latin America became, rather, a captured market for those with strong information and institutional channels to the region, capabilities that are concentrated in the United States. As I discussed earlier, in response to the 1994 Mexican crisis, J. P. Morgan and CitiCorp tried to arrange a rescue package of $3 billion among commercial banks. Four major Japanese banks were asked to contribute.[63] The four grudgingly agreed to contribute $0.4 billion, but such requests were a "nuisance" for the Japanese banks, which had already eliminated most of their outstanding debt to Mexico.[64]

Domestic Dynamics

Japan's financial sector has remained cautious about Mexico and Latin America in the 1990s. With a more rigid personnel and institutional structure than that characteristic of the United States, Japanese banks are slow to forget the experience they had lending to the region. In addition, the BIS capital adequacy requirements present a major obstacle.[65] At the same time, as the Asian markets became more stable and attractive and as the Japanese manufacturing sector started operating more in the region, the banks geared their activities toward Asia. Several interviewees commented that the banks' international operations should be seen in a global context; that is, if there is a more profitable, stable, and promising region closer and more familiar to Japan, there is no reason for Japanese banks to go to Latin America.[66] Institutional investors were also cautious toward Latin American investment. Despite government relaxation of the quality guidelines and of quantity of investment abroad, these Japanese investors are still keeping their traditionally risk-averse postures.[67]

By the end of 1994, there were small signs of Japanese mutual fund investment in Mexico, but it was a very limited amount.[68] When the Mexican currency devaluation shocked the world, no Japanese financial institutions were heavily exposed or committed to the country. Thus, there was no pressure from Japanese domestic actors on the Japanese government to rescue them from the crisis.

Because there was no measurable pressure from Japan's financial sector urging the government to act, one cannot analyze the channel through which the domestic pressure worked its way into the decisions regarding the government's commitment to this financial crisis. It is conceivable, however, due to some institutional and political changes in the relationship between the politicians, the bureaucracy, and major business groups, that the link has weakened. Japan's political instability was an important underlying factor contributing to shifts in the early 1990s. In August 1993, the LDP lost its majority position in the lower house of the Diet for the first time in thirty-eight years, and Morihiro Hosokawa, a former LDP member and the leader of the New Japan Party (Nihon Shinto), became Japan's prime minister. Since then, the Japanese Diet has undergone various shufflings and shakings of coalitions.[69] This political instability directly affected the daily business of the Japanese government, causing such difficulties as delays in budget decisions. More important, in the arena of international finance, the close relationship that the longtime governing party, the LDP, had with the Japanese government bureaucracy was disrupted by this change. Some argue that resistance to "reforming" the MOF waned as the LDP—the party that benefited most from its close ties with the MOF—lost its footing in the Diet.[70]

Actually, the underlying forces of change in domestic political constellations in Japan did not come about all at once in 1993; this evolution dated back to the 1980s. Some careful watchers of Japanese politics noted a certain "disincorporation" in Japan, or a "regime shift," much earlier than 1993.[71] Japan's "embedded mercantilism," a characteristic of a typically late industrializer that was supported by the fairly inclusive conservative alliance, began to give way to international liberal economic forces in the mid-1970s. Pressured externally by the appreciation of the yen and by political tensions with its trading partners, and pressured internally by Japan's internationally competitive big businesses, this once powerful conservative alliance began to fall apart piece by piece.[72] Pempel explains that this trend gained salience "as the economy slowed (in the 1990s), as the continuation of once relatively easy intraregime adjustments became increasingly problematic."[73] This issue is further discussed in chapter 8, when I examine the dynamics of the Japanese government's involvement in the management of the 1997 Asian financial crisis.

In sum, strong institutional linkages among transnational banks during the first debt crisis helped translate external pressures from the United States into internal ones in Japan. These linkages were strong in terms of both maintaining well-established rules and arrangements to deal with the debtors and keeping the junior partners, Japanese banks, in line with the interests of American banks. In the 1994 crisis, although a similar follow-the-leader mentality persisted in the Japanese financial sector in dealing with Latin America, neither transnational institutional linkages nor interest in the Mexican rescue were strong. Therefore, the crisis did not generate domestic support from the financial sector to shift the Japanese government's decisions toward active involvement in the rescue plan. Furthermore, and as discussed more in chapter 8 on the Asian financial crisis, the domestic political changes weakened the close and symbiotic relationship between Japan's financial sector and the government, making it harder than before to coordinate actions between Japan's private sector and the government.

Conclusion

The Japanese government's involvement in the Mexican peso crisis was very limited despite the U.S. government's keen interests in managing the financial crisis. The Japanese government, although supportive of the U.S. initiatives, was very reluctant in providing funding to Mexico on a bilateral basis, and Japanese banks also resisted participating in the commercial rescue package. With the European resistance to involvement, the U.S. government and the IMF ended up shouldering the bulk of crisis management costs this time.

The analysis of the Mexican peso crisis indicates conditions required for the Japanese government to act. The Japanese government needed a high level of private returns from the rescue package, in relation both to the United States and to Japan's private financial sector. Such returns did not exist in the case of the Mexican peso crisis. In addition, due to the changes in the international financial environment and the lack of Japan's private sector exposure to Mexico, no transnational linkages were urging the Japanese government to become actively involved in this financial crisis management.

The contrast of the Japanese government's behavior in the Latin American debt crisis and the Mexican peso crisis emphasizes the importance of private gains and pressure channels. A high level of both made the Japanese government active in the debt crisis, while a lack of both made the Japanese government quite reluctant to become involved in the peso crisis.