The wobbly peso

Author: Hanke, Steve H; Walters, Alan.

Publication info: Forbes 154. 1 (Jul 4, 1994): 161.
ProQuest document link

Abstract: The Mexican peso is seriously overvalued, which threatens the success of an otherwise commendable program of economic reform. The critical error of policy was in pegging the peso to the dollar. The Mexican authorities have undertaken to peg the peso today at about 3.3 pesos to the dollar with a tolerance band of some plus or minus 3%. The peg is allowed to "crawl" so that the permitted band is moved downward by 0.0004 pesos a day. Thus, the allowed maximum depreciation per annum is about 0.15 pesos, or 4% per year. The rationale for pegging the peso to the dollar was to combat the inflation that the government had inherited. The peg was to provide a nominal anchor for the peso that would eventually usher in rates of inflation more or less the same as in the US. However, in the interim, the rate of inflation in Mexico has exceeded the US rate of inflation. This inflation gap exceeds the peso depreciation allowed by the crawling peg. Consequently, the peso has become increasingly overvalued. Mexico can do one of 2 things - float the peso or install a currency board-like system.

Full Text: Headnote The Mexican peso is seriously overvalued. This overvaluation threatens the success of an otherwise commendable program of economic reform. ALTHOUGH Ernesto Zedillo, candidate of Mexico's long-dominant Partido Revolucionario Institutional (PRi), holds a narrow lead in polls for the Aug. 21 presidential election, he is being dogged by candidates from two other parties in an increasingly turbulent contest, which has already seen Luis Donaldo Colosio, PRi's first candidate, assassinated. Cuauhtemoc Cardenas, the Partido Revolucionario Democratico's (PRD) candidate, claims that he has received death threats. All this political turmoil comes on top of a dicey.economic situation. The economy was in a state of stag,nation, with a meager growth rate in 1993 of 0.4%, long before the election campaign got under way. And 1994's first quarter shows little promise of recovery. This is a great disappointment to all of us who cheered the reforms that were begun in the last years of de la Madrid's presidency and much accelerated by President Salinas. Mexico has accomplished much. It has substantially opened its economy to world trade, reduced regulation, privatized much of its state sector, reduced the fiscal deficit to less than 2% Of GDP and finally made the Central Bank independent of government. Consequently, inflation has been reduced from more than 22% in 1991 to 7% in 1994. However, in spite of a recovering U.S. economy, Mexico's reforms have delivered miserable real growth. What has gone wrong? We believe that the critical error of policy was in pegging the peso to the dollar. The Mexican authorities have undertaken to peg the peso today at about 3.3 pesos to the dollar with a tolerance band of some plus or minus 3%. The peg is allowed to "crawl" so that the permitted band is moved downward by 0.0004 pesos a day. Thus the allowed maximum depreciation per annum is about 0.15 pesos, or 4% per year. The rationale for pegging the peso to the dollar was to combat the inflation that the government had inherited. The peg was to provide a "nominal anchor" for the peso that would eventually usher in rates of inflation more or less the same as in the U.S. However, in the interim, the rate of inflation in Mexico has exceeded the U.S. rate of inflation. This inflation gap exceeds the peso depreciation allowed by the crawling peg. Consequently, the peso has become increasingly overvalued. An overvalued peso puts a direct squeeze on Mexico's export industries and assists foreigners selling goods to Mexicans. The swelling deficit on the current account of the balance ofpayments is evidence of this effect. This deficit must be financed by net capital imports or, more ominously, by running down official foreign exchange reserves. Persuading portfolio holders to

keep their peso-denominated bonds and bills has been a major task so far and, we suspect, will become all but impossible as we approach the Aug. 21 election. The peg is becoming less and less credible. Consequently, the likelihood of a large movement in the peg (at least 10%) induces many a watchful portfolio holder to sell his peso bonds and buy the security of dollar- denominated government Tesobonos. This capital flight can be contained only by massive increases of peso interest rates. Sure enough: In secondary markets interest rates have risen to 25% per annum. Of course, such interest rate hikes add to the woes of industries already weighed down by an overvalued peso. Indeed, the peg's punishing interest rates guarantee that the recession will continue. Other ways of containing the pressure of capital flight have also been put into place-most noticeably the "swap" facility of $6.73 billion, which was recently agreed upon by the signatories of Nafta. This will no doubt help delay the day of reckoning-but it is a delay, not a settlement. As with all such lines of credit, they come to an end much quicker than anticipated. It has been said that the peso cannot conceivably be devalued be fore the election. Certainly the government will do all in its power to avoid such a contingency, but we are skeptical about its chances for holding the peg. The power of world capital markets to undo even the best-laid plans of presidents and central bankers has been demonstrated quite dramatically in Europe in these 1990s. Mexico can do one of two things-and the sooner the better. As Britain did in 1992, when sterling was unpegged from the deutsche mark, Mexico could float the peso. Alternatively, Mexico could follow Argentina's 1991 currency reform and install a currency board-like system. Under that setup, the peso would be fully backed by U.S. dollar reserves and freely convertible at a permanent fixed rate of 4 pesos to the dollar, which represents about a 16% devaluation from current levels. If Mexico retains its half-baked peg, the Mexican economy will continue to disappoint and investors will be in for a wild roller-coaster ride. It is only by floating or fixing the peso exchange rate that Mexico will deliver in spades the potential promised by its Thatcher-Reagan type reforms.
AuthorAffiliation Steve H. Hanke is a professor of Applied Economics at The Johns Hopkins University in Baltimore and Sir Alan Walters is vice chairman of AIG Trading Group, Inc. in Washington, D.C.

Subject: Pesos; LDCs; Interest rates; Inflation; Emerging markets; Economic policy; Currency devaluation; Reforms; Economic conditions; Currency

Location: Mexico

Classification: 9173: Latin America, 1120: Economic policy&planning

Publication title: Forbes

Volume: 154

Issue: 1

Pages: 161

Number of pages: 1

Publication year: 1994

Publication date: Jul 4, 1994

Year: 1994

Publisher: Forbes

Place of publication: New York

Country of publication: United States

Journal subject: Business And Economics, Business And Economics--Management, Business And Economics--Banking And Finance

ISSN: 00156914

CODEN: FORBA5

Source type: Magazines

Language of publication: English

Document type: PERIODICAL

Accession number: 00879050, 01998234

ProQuest document ID: 194944072

Document URL: http://search.proquest.com/docview/194944072?accountid=11752

Last updated: 2010-06-05

Database: ProQuest Central
