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Policy Brief

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Mexico's Macroeconomic Policy Dilemma: How to deal with the "super-peso?"

José Antonio González

Mexico's relationship with its real exchange rate has been tumultuous since its first traumatic balance-of-payments crisis in 1976. Crises reappeared every six years with almost clockwork regularity, coinciding with presidential transitions, and all were blamed on an overvalued peso. Six years after 1994, the peso has again appreciated to historical highs and the same old questions arise: Is the peso overvalued? How could this happen with a floating exchange rate? How has the economy been affected and why are we talking about it now? How does the situation today differ from 1994, and can Mexico avoid another six-year crisis?

Has the peso become overvalued again despite a free-floating exchange rate regime?

Measuring overvaluation is difficult because the equilibrium real exchange is an elusive concept. By historical standards, however, the peso is overvalued. Figure 1 shows two alternative measures of the real exchange rate. The first is the conventional index published by Banco de Mexico (Mexico's Central Bank) based on the ratio of Mexico's consumer price index (CPI) to its 111 largest trading partners. The second measure is based on unit labor costs, a measure of export competitiveness. For both indexes the lines move up for a real depreciation, and they track each other closely.

At the end of March 2001, the CPI-based real exchange rate was 27%, more appreciated in real terms than in November 1994 just prior to that crisis and close to the previous all-time high. The unit labor costs real exchange rate is also high by historical standards. A disturbing fact is that November 1994 is a poor benchmark. After all, many argued that the real exchange rate was grossly overvalued then and that it was a main cause of the 1994 crisis.

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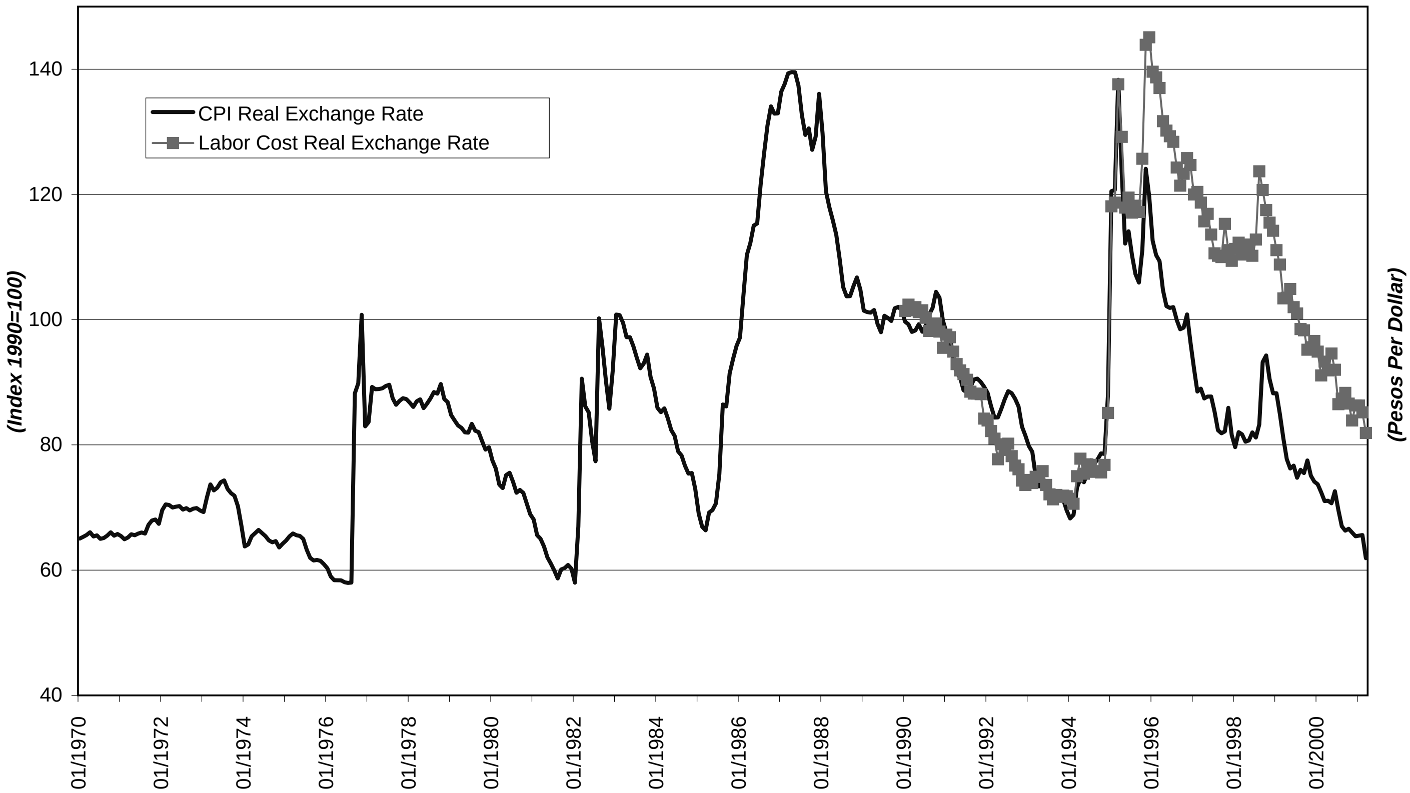


Figure 1: Real Exchange Rates: CPI and Unit Labor Cost Based (source Banxico)

Each balance-of-payments crisis witnessed a pronounced real appreciation of the peso. Is there cause for concern now? As in all previous pre-crisis periods, Mexican policy makers and international investors argue that the current appreciation of the peso is justified. But the crises happened and historically high real appreciation levels resulted in an all-too-familiar pattern: A large current account deficit exposes the country to a "Calvo sudden stop" where liquidity in international capital markets dries up, the country runs out of foreign exchange to finance the deficit and, is forced to devalue, and the economy has to restructure rapidly to increase exports.

The cause of the current overvaluation is a classical capital inflow problem that is hard to resolve under any exchange rate regime. Countries have three options: Let the nominal exchange rate appreciate, install capital controls, or accumulate reserves and prevent capital flows from expanding money supply and increasing inflation (i.e., sterilization). Higher nominal rates have an immediate detrimental effect on exports. Given the U.S.-Mexico links and flows, capital controls are probably not an option. Finally, if flows are sustained, sterilization is

Monetary and Exchange Rate Policy in Mexico Since 1995

Since 1995, the Central Bank has attempted to base monetary and exchange rate policy on explicit rules that limit exposure to international volatility. The Central Bank estimates short-term base money demand and leaves the supply "short" (corto in Spanish) by a pre-announced amount. The Central Bank pays the Cetes rate (Mexico's equivalent of U.S. Treasury bills) if the financial institution is long and twice the Cetes rate if the institution is short with the Central Bank. Thus the "*corto*" applies upward pressure on interest rates.

Central Bank interventions in the exchange market are aimed at avoiding short-term volatility. The Central Bank can sell up to 200 million dollars per day and only if the rate rises 2% above the previous day's close. This eliminates the possibility of a large run on reserves. Similarly, to prevent appreciations and accumulate reserves, the Central Bank places futures options to buy dollars. Although there is no explicit amount, it has always placed 250 million dollars. The Central Bank also has been "absorbing" Pemex's dollar surpluses.

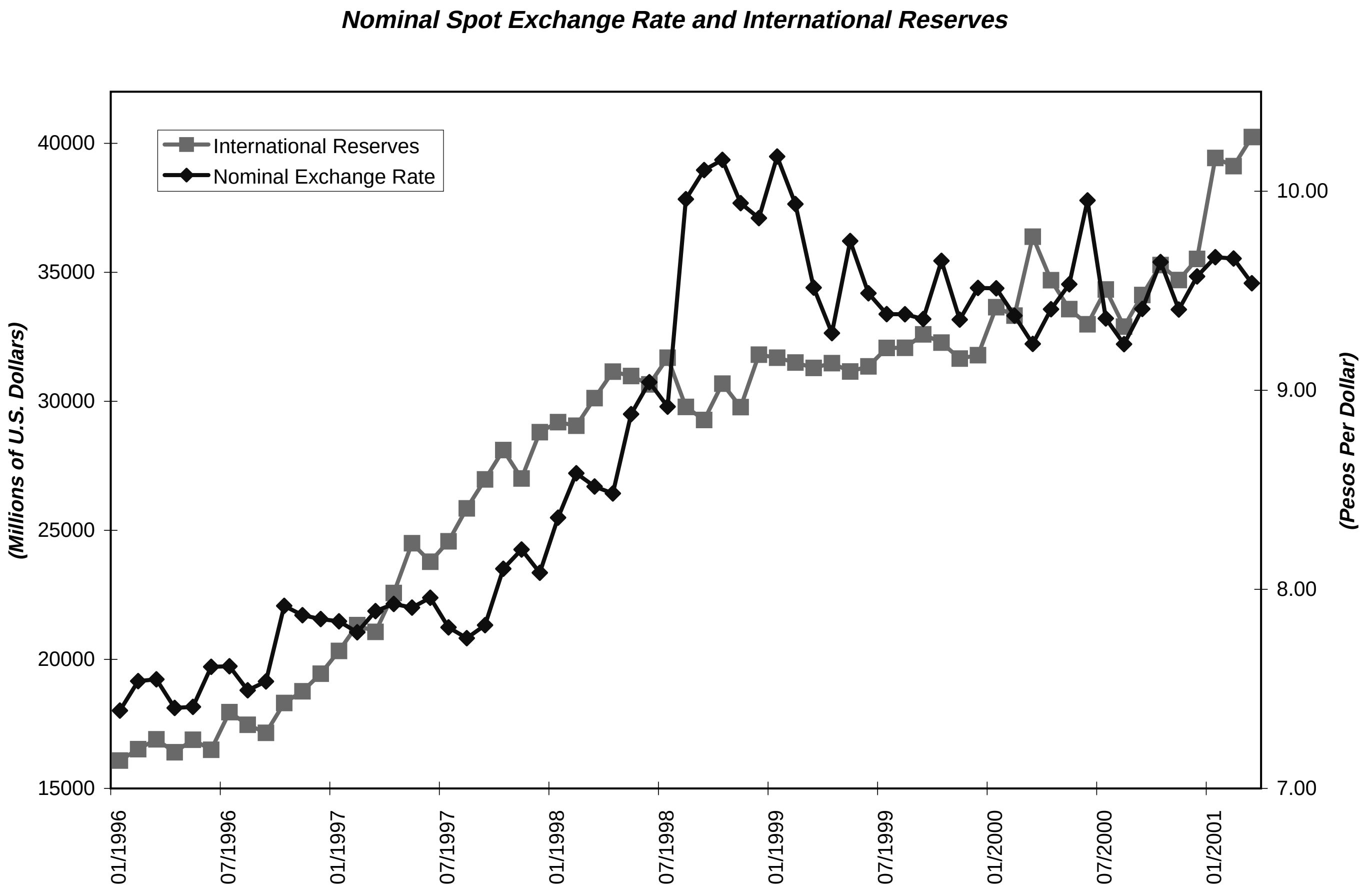


Figure 2: Nominal Exchange Rate and Reserves (source Banxico)

ineffective and can exacerbate matters by raising domestic interest rates and attracting more capital. No option satisfactorily resolves the policy dilemma.

Why are we talking about this now?

The U.S. slowdown exacerbates Mexico's situation.

Figure 2 shows that Mexico accumulated reserves and sterilized much of the capital inflow since 1996 (see Box 1). However, in the last year and half, there actually has been a nominal exchange rate appreciation. The spot exchange rate today is the same as in June 1998, despite an inflation differential with the United States of close to 10%.

The previous crises, especially in 1982 and 1994, were marked by a sudden lack of liquidity due to a rise in U.S. interest rates. By contrast, the current U.S. slowdown is accompanied by falling interest rates. As a result, this time the effect on the Mexican economy is through higher capital flows and lower export demand. With falling U.S. interest rates, investors turned to emerging markets for higher returns and Mexico was an obvious choice.

A sharp slowdown in export growth started in November 2000, while imports continue to grow vigorously due to both the U.S. slowdown and the appreciation of the real exchange rate. The current account deficit in the last quarter of 2000 and the first quarter of 2001 was the largest since the last quarter of 1994. Compared to 1994, the downside is that this time exports are falling. The upsides are that external deficits are smaller as a proportion of GDP; exports and imports are larger, implying a smaller proportional movement can close the current account deficit; there are no dollar liabilities; and most of the capital flows come from Foreign Direct Investment (FDI, see Figure 3 below).

As a result of the fall in exports, output growth in the first quarter of 2001 slowed to 1.9% over the first quarter in 2000. However, if Mexico were to follow the U.S. methodology of comparing output in successive quarters after seasonal adjustments, then Mexico would have had two successive quarters with negative growth. The official growth estimate for 2001 has been revised downwards from 4.5% to 2%.

Monetary policy options

While at the end of 2000 the U.S. economy was slowing and there was no danger of inflation, in Mexico there was still strong wage pressure, the exchange rate was expected to depreciate, a president from a different party was being inaugurated for the first time in 70 years and memories of the "December 1994 mistake" were strongly felt. The Central Bank correctly acted cautiously during the transition. Monetary policy remained restrictive until May 2001. Nevertheless, the fall in aggregate demand and lower international interest rates allowed Mexican interest rates to fall 770 basis points from 17.9% in January 2001 to 10.2% in the last auction in May 2001, the lowest interest rate since March 1994. By comparison U.S. interest rates fell 230 basis points.

To ride out the U.S. slowdown and return to rapid growth, Mexico needs to change its macroeconomic policy mix: Monetary policy needs to be eased and fiscal policy needs to be tightened. Easier money will lower the returns on peso-denominated instruments, making portfolio investment in Mexico less attractive. Tighter fiscal policy will accommodate private capital inflows and prevent a rise in inflation.

It is encouraging that Mexican authorities are moving appropriately on both fronts. On the fiscal side, the Ministry of Hacienda (Treasury) is spending much political capital in getting approval for a fiscal package that eliminates all exemptions to the Value Added Tax. The objective is to reduce the current fiscal deficit of over 3% of GDP by a percentage point per year.

On May 18, the *corto* was reduced for the first time since March 1998 and there is speculation that monetary policy will ease

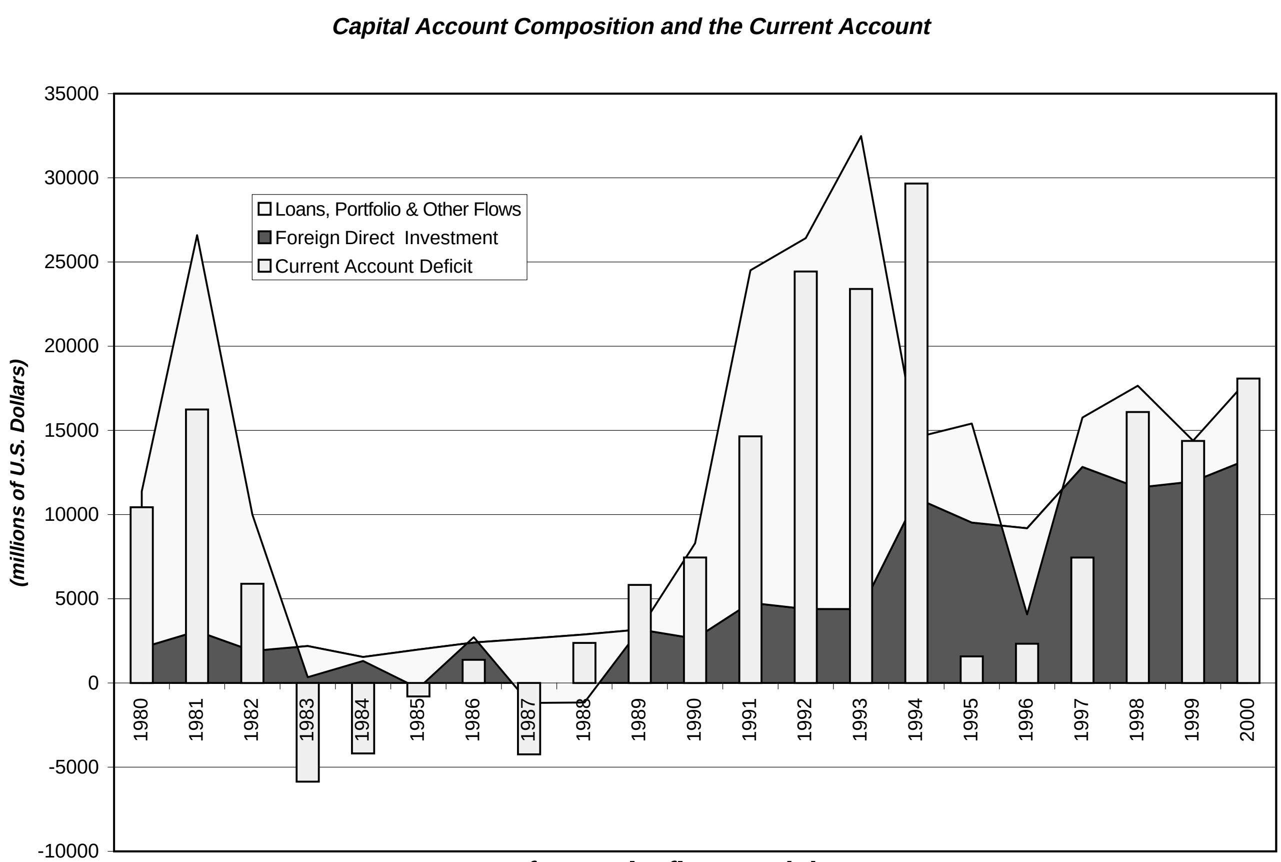


Figure 3: Decomposition of Capital Inflows and the Current Account

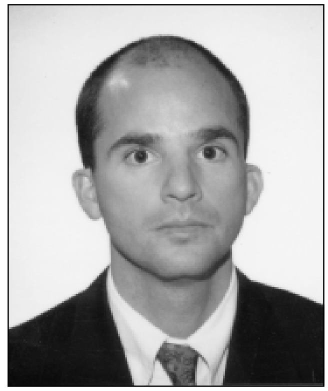
further. The action is expected to lower interest rates further and put pressure on the peso to depreciate. Moreover, although not quite at international levels, inflation for the year is expected to be close to or below the official target of 6.5%, giving monetary authorities room to maneuver.

Starting July 2, 2001, the Central Bank will lower the intervention amounts in the exchange market to zero and let the peso float freely. In theory, given the surplus in the balance of payments, the measure should pressure the peso to appreciate, which is the opposite effect to the reduction in the corto. However, with a freely floating peso, investors will expect higher volatility, which might lower capital flows to Mexico.

There are two short-term developments to consider if Mexico loosens monetary and tightens fiscal policy. The first is that the approval of fiscal measures renews New York's (irrational?) exuberance toward Mexico and capital flows increase despite lower interest rates. The second is that loosening monetary policy might be insufficient to abate portfolio flows and eliminate the balance-of-payments surplus without further appreciation of the peso and deterioration of the current account. The question is relevant because FDI is large and, at least in the short term, unresponsive to interest rates. Figure 3 shows that the current account deficit has been larger than FDI since 1998, implying that portfolio investment is what throws the overall balance of payments into a surplus and puts pressure on the peso to appreciate. If monetary policy could reduce or eliminate portfolio flows through lower returns on peso instruments, the balance of payments would be thrown into a deficit putting pressure on the peso to depreciate.

Will there be a crisis? The answer is "no," as long as there is not another "December mistake" when faced with volatility, and Mexican authorities continue to loosen monetary policy and tighten fiscal policy enough to prevent further appreciation of the peso and deterioration of the current account. If Mexico fails to do so, the current account deficit will continue to grow so long as it can be financed with portfolio investment. As in the past, confidence will decline abruptly and Mexico will face a liquidity sudden stop again.

About the author



José Antonio González is a Senior Research Associate at the Center for Research on Economic Development and Policy Reform (CREDPR) at SIEPR. He is also the Coordinator for the Latin American Program at CREDPR and a Lecturer in Economics. Prior to joining Stanford University, José Antonio was a Senior Country Economist at the World Bank working in Peru, Bolivia, Paraguay, and Panama. He also worked in the Mexican President's staff from 1989-1991. He received his Ph.D. from Harvard University.

His research focuses on development issues in Latin America. He has written on macroeconomic, trade, private finance and labor market policy issues.