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 regime? 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 or even ten-year crisis?

Measuring overvaluation is difficult because the equilibrium real exchange rate 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 México (Mexico’s Central Bank) based on the ratio of Mexico’s consumer price index (CPI) to its 11 largest trading partners. The second measure is based on unit labor costs, a composite of export competitiveness. For both indices 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 than ever before. In November 1994, just prior to the crisis and close to the previous all-time high, the real labor cost real exchange rate was 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.

About the author

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Finally, if flows are sustained, sterilization is necessary and increasing inflation (i.e., sterilization). Higher nominal reserves and prevent capital flows from expanding money supply. The exchange rate appreciate, install capital controls, or accumulate foreign exchange reserves.

Countries have three options: Let the nominal exchange rate float freely, and avoid operating a fixed exchange rate regime. In this regime, the exchange rate is determined by market forces and is not influenced by monetary policy. However, the exchange rate can be volatile and unpredictable, and it can be difficult to maintain a fixed exchange rate regime in the face of changing economic conditions.

By contrast, the current U.S. slowdown is accompanied by a slowdown in the global economy. The U.S. economy is growing at a slower rate than in previous years, and there is a risk of a recession. This has led to a decline in international capital flows and a reduction in the demand for Mexican exports.

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

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

Figure 3: Decomposition of Capital Inflows and the Current Account

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 sovereign inertia in international volatility. The Central Bank estimates short-term baseline money demand and the supply (“real”) is the sum of Spanish, a pre-announced amount. The Central Bank uses to estimate the exchange rate Mexico’s exchange rate is defined as the rate at which U.S. Treasury bills are long and the exchange rate fixed to a rate that is short with the Central Bank. The “corto” applies upward pressure on interest rates.

Central Bank interventions in the foreign exchange market are intended to stabilize short-term movements in the exchange rate. The Central Bank can sell or buy foreign exchange to influence the exchange rate. The Central Bank can take advantage of excess foreign exchange reserves to buy foreign exchange. The Central Bank can sell foreign exchange to buy domestic currency. The Central Bank can also intervene to support the exchange rate.

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 dividend from a different policy was being implemented for the first time in 2001 and memories of the “December 1994 mistake” were strong. The Central Bank constancy acted cautiously during the transition. Monetary policy remained constant until May 2001. Now, the fall in aggregate demand and lower international interest rates allowed Mexican interest rates to fall 170 basis points from 7.9% in January 2001 to 10.2% in the last auction in May 2001, the lowest interest rate since March 1998.

The current account deficit in the last quarter of 2000 and 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 computing outputs in successive quarters after seasonal adjustments, than 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

Why are we talking about this now?

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

What was accomplished by expansionary fiscal policy?
the U.S.-Mexico links and flows, capital controls are probably
nal rates have an immediate detrimental effect on exports. Given
ere and increasing inflation (i.e., sterilization). Higher nomi-
reserves and prevent capital flows from expanding money sup-
conomy has to restructure rapidly to increase exports.
high real appreciation levels resulted in an all-too-familiar
pattern: A large current account deficit exposes the country
to finance the deficit and, is forced to devalue, and the
peso is justified. But the crises happened and historically
in all previous pre-crisis periods, Mexican policy makers and
monetary policy options
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there was no danger of inflation, in Mexico there was still
strong wage pressure, the exchange rate was expected to de-
preciate, a phenomenon from a different party was being inaugu-
rated for the first time in 70 years and memories of the “De-
comber 1994 scenario” were strong. The Central Bank com-
tually acted cautiously during the transition. Monetary
policy options included interventions in the foreign exchange
market as well as other monetary instruments. But Mexican
authorities decided to move forward with a more
cautious and measured approach. The Central Bank
implemented a new “corto” that is a short-term instrument
that applies upward pressure on interest rates.

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

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
computing output in successive quarters after season-adjust-
ment, much of that would be missed and the current account
would close to 0%. The official growth estimate for 2001 has
been revised downwards from 6.5% to 2.5%.

The current account deficit in the last quarter of 2000 and the
U.S. slowdown and the appreciation of the real exchange rate.
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The cause of the current overvaluation is a classical capital flows imbalance, where you have a large current account deficit exposing the country to a “Calvo sudden stop” where liquidity in international capital markets dries up, the country runs out of foreign exchange and the result is a depreciation, a president from a different party was being inaugurated, and memories of the “December 1994 exitito” were strongly felt. The cost of absorbing Pemex’s dollar surpluses, the Central Bank also has been “absorbing” Pemex’s dollar surpluses. The Central Bank pays the Cetes rate (Mexico’s equivalent of U.S. Treasury bills) if the financial institution is long and the interest rate rises 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 possibility of a large run on reserves, the Central Bank has been “absorbing” Pemex’s dollar surpluses.

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 the supply of “short” loans 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 the interest rate rises above that pre-announced amount. The Central Bank then “corto” applies upward pressure on interest rates.

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

### Monetary and Exchange Rate Policy in Mexico Since 1995

Each balance-of-payments crisis witnessed a pronounced real appreciation of the peso in the face of currency crises. As an all-inclusive crisis period, Mexican policymakers and international investors argue that the current appreciation of the peso is justified. But the crises happened and historically the peso is entitled to a 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, in forced to devalue, and the economy has to restructure rapidly to increase exports.

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

### Why are we talking about this now? The U.S. slowdown exacerbates Mexico’s situation.

A sudden stop 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 computing output in successive quarters after season-adjusted, then Mexico would have had two successive quarters with negative growth. The official growth estimates for 2001 have been revised downwards from 2.9% to 2.5.

Figure 3: Decomposition of Capital Inflows and the Current Account

### 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, and a significant amount of output from a different party was being inaugurated for the first time in 70 years and memories of the “December 1994 exitito” were strong. The Central Bank correctly acted cautiously during the transition. The monetary policy must be eased and fiscal policy needs to be tightened. Easy money will favor 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.

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There are two short-term developments to consider if Mexico loses monetary and fiscal credibility. The first is that if the approval of fiscal measures lowers New York’s (irrational?) confidence in the peso and capital outflows rise, the current account deficit will continue to grow 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 prevent the peso to appreciate, which is the opposite effect to the reduction in the corto. However, whether the real floating peso, investors will expect higher volatility, which might lower capital flows to Mexico.

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 Mexico’s chronically overvalued peso, which led it to seek realignments of the exchange rate. The question is whether this is the new strategy.

To deal with the “super-peso?”
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¿Ha la peseta volcado otra vez después de cinco años de flotación? ¿Cómo se maniobra el Banco Central? (El País 6-21-95). The answer is “no,” as long as there is not political pressure on the peso to depreciate.

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