The peso problem

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In 1994, Mexico was characterized by a series of political crises which, in December, culminated in the massive devaluation of the nation's currency, the peso. The simmering dispute in Chiapas, the assassinations of two of the nation's leading politicians and the kidnapping of a number of leading entrepreneurs all helped to undermine the stability of the currency which began 1994 at the rate of 3.15 to the U.S. dollar and closed the year at a worrying 6 to the dollar.

Although government policies in the twilight days of the Salinas regime have also been cited as a factor further contributing to the peso's slide, retrospective recriminations will not solve the problems the Mexican peso, economy and people will face in the months ahead. Confidence, once shattered, is hard to restore, and the Zedillo government must not be deflected by the faults, real or imagined, of former regimes. Instead it must turn its collective mind to the political and economic problems which this financial crisis begets.

The results of the peso devaluation have been no less catastrophic than the devaluation itself. In an effort to stop further funds fleeing Mexico, short-term interest rates sky-rocketed to as high as 60 percent. These high interest rates are bad, not only for local businessmen who need ready access to cheap finance so as to function effectively in today's competitive global village, but also for mortgages, which form the microeconomic backbone of most developed economies. More than anything else, high interest rates can, as they have in the past, delay the possibility of economic recovery for years, thereby accentuating economic and political instability. The downgrading of Mexican debt will, by forcing Mexican borrowers to pay even higher interest rates on their loans, make the road to recovery even harder.

These effects will be felt most severely among Mexico's hard-pressed middle class and small business communities, whose interest repayments on mortgages and car loans doubled in January 1995. Indeed, it is this group which will bear the brunt of the job losses the government's cutbacks will cause: in real terms their salaries are only 75 percent of what they were in 1982, when the "debt bomb" exploded.

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Given this sector's centrality to the smooth working of a modern economy, Zedillo must increase his efforts to fulfill his election promise that the fruits of Mexico's recent economic growth will trickle down to those whose sacrifices made possible the impressive growth of recent years. The need for ongoing social stability dictates that these groups must, in the national interest, be protected from the worst ravages of the current crisis.

Further, some of the supposed advantages of devaluation might turn out to be dangerous disadvantages. For example, as a result of the peso's slide, Mexican exports to the U.S. should, other things being equal, rise. But other things are far from equal in the U.S. where, for example, Mexican textiles are in direct competition with products from North Carolina, a state whose powerful anti-NAFTA Senator Jesse Helms recently castigated the Mexican government over the devaluation. Price advantages can, in other words, bring political retaliation and, if the peso slides much further, Helms could, in an effort to protect North Carolina's textile industry, garner support from other senators whose constituents' jobs are similarly threatened by a depressed peso.

To take one other example of the paradoxical effects of devaluation: Mexican exports, such as cars, dependent as they are on high-cost imported components, will gain little if anything from the peso's fall. Job losses will almost certainly occur in the Mexican automotive industry —thereby helping to prolong the coming recession.

Thus, though the peso devaluation poses many formidable problems for the Zedillo government, the primary challenge is the loss of confidence, epitomized by the negative comments of Jesse Helms, Ross Perot and others regarding the Mexican market. U.S. investors lost over US $10 billion in Mexico in the dying days of December 1994, and the downgrading of Mexican debt by Duff and Phelps, Salomon's, Morgan's and other credit-rating organizations indicates that the international financial community believes the value of Mexican investments could further vaporize in the short term.

A brief exposition of their exposure to the Mexican peso will explain both their fears and the fears of the Mexican government that they might abandon the country for potentially greener pastures elsewhere. To take but one example: Fidelity Investment, the giant mutual funds company, invested over US $100 million in Mexican securities, a giant sum which is dwarfed by the over US $2 billion exposure of Alliance Capital Management. Indeed Finance Minister Ortiz, during his hectic recent visit to New York, made a special effort to reassure Alliance Capital that their almost US $1 billion in losses can, in time, be recouped.

The difficulty of Ortiz' task can be further appreciated when we consider how peso-linked structured debt notes have complicated the crisis. These notes, which are now coming to maturity, were bought two years ago when the peso was stable, to lock in the high yields of 18 percent and more to be had at that time on Mexican treasury bills (Cetes). Most of these Cetes were bought on margins of 25 percent or less and the sellers are now demanding the remaining 75 percent, thus putting more pressure not only on buyers and the beleaguered peso but also on Ortiz in his difficult job of restoring confidence in Mexico.

It is therefore in the immediate interest of the Mexican government to convince these investors that this setback in the values of both the peso and the Mexican Stock Exchange is only a once-off correction. The credit lines which Mexico's NAFTA partners and the European Union countries have extended, together with the Agreement for Unity to Overcome the Economic Emergency which the government has secured with local business and trade-union leaders, have gone some way to restoring the confidence of the international investment community: the influential Templeton Fund is already urging their clients to buy Telmex and other major Mexican stocks. Reducing public spending, freezing minimum wages and taking US $18 billion in foreign loans all helped prevent the peso from sliding into free fall.

So too did the line of credit which the government extended to domestic banks, which themselves are exposed to several billion dollars of short-term debt. While, thanks to the way it structured its currency positions prior to the devaluation, Banca Serfin will show a modest profit for the devaluation period, most of its competitors will show substantial losses. A run on these banks could prove almost fatal to the government, whose quick action in extending lines of credit to the banks and in temporarily loosening their prudential guide-lines (by allowing the banks to count the loans as capital, thus allowing them to borrow more from other sources) will most likely keep these institutions solvent for as long as the crisis lasts.

However, because confidence cannot be legislated, these measures are not enough to ensure that the crisis —which President Clinton has described as a "short-term liquidity problem"— does not become a financial flash flood wiping away the benefits a decade of economic stability has bequeathed to Mexico. During the Salinas regime alone, inflation was reduced from a crippling 157 percent to a manageable 10 percent, a magnificent achievement for a country which is generally credited with triggering the default crisis of the 1980s.

As this issue goes to press, the current Mexican government is facing its first liquidity test: whether it can meet the interest payments on Cetes, its peso-denominated short-term bills. Given that the government has US $70 billion in short-term debt, the magnitude of its interest rate bill is apparent. Government confidence, given the domestic and international assistance which has been forthcoming, will most likely survive this initial run on funds. However, other challenges will quickly follow.

Money is a coward and, once it runs away, only bold measures will induce the confidence necessary to entice it back. The Zedillo government must therefore urgently institute further reforms to restore the confidence not only of overseas investors but of local Mexican investors as well.

Most importantly, the Mexican peso must, like the Canadian dollar, be allowed to float freely so that it finds its own level in the market place, not an artificial one consistent with the policies of the government of the day on any particular day of trading. If, for example, the British and French governments could not (and now do not care to) defend their respective EMU-pegged currencies against deep-pocketed speculators such as George Soros (whose speculations are credited with knocking the once-mighty British pound sterling out of the EMU ambit), it is certainly ill-advised for the Mexican government to blindly peg the peso to the dollar at the arbitrarily suggested rate of 4.5 to the dollar, and thereby risk losing the (repayable) credit line which has been extended to it.

The U.S. is a world economic power whose currency therefore reacts to world events. Mexico, on the other hand, is a regional economic power, whose currency therefore moves to the beat of a different drum: the pace of economic activity in the Americas. To peg one to the other can only be described as a mismatch destined only for calamitous divorce. The peso, like the other NAFTA currencies, must therefore find its own sustainable level in the market place.

Faith in Mexico as a financial safe haven must be restored to Mexicans who, for well over a decade, have felt it expedient to keep the bulk of their financial assets abroad. To reverse the direction of this cash flow, Mexican financial institutions must be further liberalized and allowed to develop, free from Central Bank attempts to regulate interest rates, the U.S. dollar-denominated products these investors require.

In this regard, Finance Minister Ortiz' plans to introduce a futures market in pesos seem ill-advised for at least two reasons. Besides the fact that the peso is too volatile to allow such a market to function properly, peso-denominated paper cannot hope to reverse this decade-old trend, precisely because it is the fear of a falling peso which most concerns those locals who squirrel away their savings overseas.

Because investors would regard a futures peso-hedging facility as an inferior product to dollars and the other hedging facilities currently available, it is doubtful that the proposed futures market could garner the required depth of funds to enable it to function effectively. It would make more sense for the government to encourage Mexican institutions to develop other hedging products, such as the redeemable gold bars which the Union Bank of Switzerland has recently introduced to the market. Such innovative products would allow investors to keep their funds, free from a fear of further peso devaluations, in Mexico to the benefit both of themselves and of Mexican banks, which would thereby have more and cheaper funds at their disposal.

Indeed, as pointed out in *Voices of Mexico* 30, solving the savings problem is central to solving these wider economic problems. As long as the propensity of Mexicans to invest in their own country remains significantly less than that of the Asians —Mexico's main competitors for funds seeking relatively high returns in the world's major emerging markets— financial instability will remain endemic in Mexico.

Until Mexicans can be induced to invest over longer time horizons in their own country, it will remain much more difficult for Mexico to attract long-term finance from overseas than it will be for Singapore, Malaysia, Taiwan and the other emerging power-houses of the Far East. For these and other related reasons discussed in *Voices of Mexico* 30, the government must prioritize the savings problem.

The devaluation and change in credit ratings have also substantially increased the cost of capital to major government institutions, including Pemex and CFE, respectively the government's monopoly petroleum and electricity companies. These increased costs once again raise the question of Pemex's ownership status.

The issue of Pemex privatization is a major talking point at the moment. Finance Minister Guillermo Ortiz favors greater privatization and Energy Secretary Ignacio Pichardo is opposed to further liberalization. Given Pemex's sheer size —106,000 employees, annual profits of US $20 billion and reserves worth over US $750 billion, and that it now makes up only 15 percent of total exports (as opposed to over 60 percent in 1982)— the government, faced with greater macroeconomic problems, will have to give further consideration to its ownership status.

Although Article 27 of the Mexican Constitution specifically states that natural resources, petroleum included, are the property of the state, the government has of late tended to interpret this provision narrowly. Lease-back arrangements, which some of the former Soviet republics have used with success, might be one vehicle to retain most of Pemex's profits in public hands while allowing private funds to underwrite the vast investments Pemex needs to increase profitability to the level of the world's other major oil companies.

The devaluation has thus presented the Zedillo government with acute challenges which demand bold but palatable remedies. The government's dilemma is accentuated by Mexico's role as a financial barometer for all of Latin America. Falling Mexican markets produced a domino effect throughout the whole continent, the important markets of Brazil and Argentina in particular. However, Zedillo has an extremely able cabinet and, if collectively they can grasp the economic and political nettles manifested in free-falling markets, Mexico can benefit by building its future on increasingly solid foundations.

Its NAFTA partners, and the government's local business and union partners, have given it the required vote of confidence. The markets will, much quicker than history's textbooks, decide if those votes were well-placed or misplaced. So far, the indications, tentative though they are, are positive; if they continue that way, history will record the Zedillo era as the one which finally brought Mexicans their deserved economic rewards for the austerities of the past