The Dollarization of Mexico
A Long Road

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Some analysts think that the "dollarization" of the Mexican economy —the substitution of the U.S. dollar for Mexico's national currency, the peso— might be the solution to the country's monetary problems and financial instability. They argue that it would answer problems caused by Mexico's speed in opening up to financial and banking integration (remember the 1994-1995 financial crisis); the peso's instability vis-à-vis the dollar; pressure from businessmen who want a fixed dollar-peso ratio to protect their exports; dollar transactions in certain sectors of the economy, particularly real estate, by the elite; the de facto conversion of economic regions where dollar transactions are common (for example, tourist areas like Cancún); and the fragility of exchange rate arrangements in emerging markets, etc.

This essay will analyze, first, some theoretical factors involved in dollarization in an international or regional monetary system. Second, it will look at some practical considerations. And third, it will submit reasons why I think this is not the time nor are there favorable conditions for the dollarization of the Mexican economy.

Theoretical Questions

The variety of currency exchange systems is a reflection of the different economic circumstances of the world's different countries or groups of countries. From a theoretical point of view, the selection of a currency exchange system is not a question of the first order for the economy's fundamental variables. It may be useful for helping control inflation or other variables at particular moments. What is generally accepted is that the adoption of an exchange regimen is a manifestation of government policy for achieving greater credibility.

Since 1973, currency exchange agreements among International Monetary Fund member countries have included a wide variety of options, from the decision to maintain their exchange rates linked to a single currency or group of currencies to managed flotation and free flotation of their currency. In general, the exchange accords in the International Monetary System are of two main types: a) the formation of regional blocs of monetary stability; b) greater flexibility among the central currencies.

The European Monetary System (EMS) and most developing countries which link their currencies to another (like the U.S. dollar or the French franc) or to a basket of currencies, are part of the first group. Among all the exchange systems in today's international monetary system, the EMS is set up as a cooperative agreement with limited flexibility and is part of a broader project of economic coordination and integration, whose most recent achievement is the confirmation of the European monetary union, the best example of an "optimum monetary zone."[1]

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Several Asian economies, on the other hand, have parity systems or link their currencies to an "anchor" currency, in this case, the U.S. dollar. In the context of the international financial crisis experienced by countries like Mexico, those of South East Asia, Brazil and others, it is being debated whether it is a good idea to maintain the fixed parity with the dollar. In the best of cases, Hong Kong maintains a rigid "monetary council" system with a fixed parity to the U.S. dollar and, given the little manoeuvering room for its currency, cannot devaluate to stimulate competitiveness when confronted with devaluations in the rest of Asia. This caused a sharp drop in its stock markets and a tremendous increase in interest rates as a reaction to the speculation against the Hong Kong dollar.

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The main differences between a system of currency linked to another and regional monetary union are: a) The lack of harmonization of monetary policies of the country whose currency is linked and that of the "anchor" country. This is the case of Mexico vis-à-vis the United States; and b) The absence of an active market to determine the exchange rate of linked currency with regard to the world's other currencies, against which it maintains a floating rate.

It is pertinent to make the following observations about regional monetary systems, which is where the dollarization of Mexico fits given its integration into North America, and more specifically with the United States. Adopting a plan for regional currency integration implies two prerequisites: 1) The different parties must sign a treaty on the question like the European Currency Integration Treaty; and 2) This treaty must create a regional system of central banks.[2]

In addition, certain stages must be complied with, such as the following:

Common currency. Utilization of a unified account in all interregional transactions, its emission to be utilized as means of payment in official regional transactions, the emission of the currency to use it as means of payment in regional transactions among private parties and the declaration of its parity before the International Monetary Fund.

Payment agreement. Broadening out coverage to all intra-regional transactions, including the rediscounting of titles of credit for financing said transactions, a regional system of financing the global balance of payments of all parties (that is to say, all the states participating in the integration process) and joint management of a growing percentage of members' reserves in order to deal with the overall regional balance and to back up currency emissions.

Coordination of monetary policy. The establishment of a regional system of warning indicators and regularization of the voluntary process of periodic consultations, joint management of monetary instruments used to finance intra-regional transactions, regular mandatory reporting and consultation and, lastly, a regional monetary policy, whose relative importance would depend on the degree of interdependence achieved.

Each of these stages, in turn, requires a series of actions, including the establishment of a regional capital market, a common monetary policy of the central banks of member states, the trade integration that would back up currency exchange, etc.

PRACTICAL ASPECTS

Several months ago, the debate on the dollarization of Mexico generated a polemic in which many opposing views were aired.

Every time Mexico's balance of payments goes down or has a deficit, exporters pressure the government to devalue the peso to reactivate foreign trade. The integration of the Mexican economy with the United States in financial and trade matters is deepening. Given this, at least a few argu-

ments in favor of dollarization should be taken into account, among them: It would maintain purchasing power; eliminate exchange rate risk; increase discipline in public spending; imply the disappearance of the influence of political criteria in fixing the parity of Mexican currency and of the link between political risk and economic crisis; and eliminate the cost of maintaining a central bank.

Now, in order for dollarization to be both a de facto and a legal reality, a new institutionality would have to be created that would resolve the dilemma: monetary council or monetary union? Both are forms of monetary institutionality. The first consists of establishing a minimum amount of dollar reserves and determining a fixed parity of the dollar and the peso. Then a monetary council mechanism is created whereby for each dollar that enters Mexico an equivalent number of pesos is put into circulation and vice versa: for each dollar that leaves the country, an equivalent number of pesos would be withdrawn.

Theoretically, a monetary council is characterized by: a) the establishment of a fixed exchange rate between local currency and a very stable foreign hard currency; b) a statement with the force of law that assures full convertibility between the local currency and the foreign hard currency; and c) a monetary rule to fix hard currency reserve levels and the amount of local currency in circulation (basically notes and coins). This rule consists of the monetary council only expanding or reducing the money supply through the purchase or sale, respectively, of hard currency, in all cases at the established exchange rate. In other words, the monetary council acts only as a currency exchange house.[3]

The other option, assessed in the theoretical section, would work in the same way as NAFTA, in which Mexico would irrevocably take on the dollar as its legal tender. Those who in the Mexican debate favor dollarization, favor monetary union as the consolidation of the North American bloc vis-à-vis the European or Asian blocs; in theory this would guaranty long run credibility, security and monetary stability. However —and this “however” is infinite— here is where some critical elements appear: the dollarization of the Mexican economy is neither feasible nor do the appropriate conditions exist for it.

Arguments Against Dollarization

Important technical reasons make dollarizations impossible today.

However, if certain macroeconomic, long range conditions were met, dollarization would be viable, particularly since they would formalize financial integration.

From the perspective of what the United States represents for Mexico, we should take into account the following: dollarization means Mexico’s total dependence on the U.S. economy, which is experiencing a boom today, but that could be reversed in the short or medium term. Another aspect of the debate is a possible rise in interest rates, something which has not been clarified.

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Given this dependence on U.S. economic cycles, there is a risk of our northern neighbor changing its economic policy toward its trade partners. Mexico could also change its general economic policy, particularly with regard to financial matters, as it did with the 1995 financial bailout.

Both before and after NAFTA came into effect, analysts talked about the economic asymmetries between our two countries. As long as Mexico’s economic structure (production, infrastructure, wages, productivity, competitiveness, etc.) continues as it is, dollarization would increase the disparities between the two economies because of

differences in production, trade and the living standards of their inhabitants.[4]

We know full well that the Federal Reserve decides U.S. monetary policy and monetary integration would mean tacit acceptance of that policy. Even though a formal bilateral organism would be created to regulate monetary policy, it is to be expected that the Federal Reserve would be the real decision maker because of the great difference in the two economies.

In the long run, however, the dollarization of North America, including Mexico, is possible as a step in North American economic integration and the U.S. strategy to compete with the Japanese yen and the Deutsche mark, which, together with the U.S. dollar, are the world's three strongest currencies.

The Mexican perspective can be summarized as follows. The Mexican government requires revenue, but dollarization would imply a drop in income due to the loss of commissions normally obtained through the peso's participation in international markets,[5] unless the legalization and institutionalization of dollarization included a distribution of the monetary costs and benefits through compensation funds that would favor the smaller partner as its macroeconomic structure was being strengthened. Also, undoubtedly, Mexico's central bank would no longer have complete autonomy in controlling the absolute value of the currency issued, even with the "legally existing central bank autonomy," because with dollarization, payments would have to be made for the right of issuance to the U.S. Federal Reserve as the currency's country of origin.

The real value of Mexican currency, then, or what is the same, the real exchange rate, linked to buying power, would be threatened, particularly because it would be in constant danger of devaluation or being overvalued. Dollarization, then, is not a good idea because the peso is not a competitive currency.

Another possible effect of a mechanically implemented dollarization would be that if the Mexican economy required other structural adjustments, particularly negative ones, they would have an immediate impact of tending to lower production and employment levels.

Lastly, something not usually considered because of its ideological connotation is the loss of the sovereignty, both psychological and monetary, that Mexicans, as part of the state, have had since independence from Spain, and even more since the loss of more than half our territory to the United States: this has turned the Mexican peso into part of our national identity. This historic characteristic is dwindling because of the real integration with the rest of North America in which trade commitments and the economic dynamic have begun to lead to a de facto delegation of sovereignty.

For all of these reasons, both from the U.S. and Mexican perspectives, the following proposals may contribute to a possible dollarization some monetary policy factors that take into account the asymmetries between Mexico and the United States. Dollarization is not possible without taking them into account:

a) Real, not fictitious, inflation has to be maintained, which means ending trade intermediaryism and monopoly-imposed interest rate hikes and activating production. As Carlos Slim, one of Mexico's most prominent businessmen, says, "The overvaluation of the peso means nothing if it is not linked to a drop in inflation. Now what is needed is lower inflation."[6] Mexico would have to achieve an inflation rate similar to that of the United States.

b) Interest rates would have to be lowered to correspond to production needs and not just to attracting speculative capital. To achieve this, the entrance into Mexico of short-term, destabilizing capital would have to be stopped or control mechanisms established to benefit the domestic economy.[7]

c) The current account also must be balanced, for which medium and small exporters must be given incentives. Also, payments on the service of

the foreign debt should be reduced to no longer depend on external resources.

d) All external contracts and documents regarding international advertising must be denominated in Mexican pesos for a specific period agreed upon by the trade partners until regional prices can be standardized.

e) Productivity must be increased through wage hikes, since the wage gap among the NAFTA partners is enormous and unfavorable to Mexico. This would mean the United States' creating compensation funds to support and raise Mexican productivity.

f) For the only currency in North America to be the U.S. dollar, a high degree of financial stability is needed in Mexico. This implies price and exchange rate stability, the sustainability of public finances and a real convergence between the United States and Mexico.

g) Mexican businessmen and other economic agents as well as the factors of production all require a stable currency that would allow the former to safely enter into international and regional markets and the latter to grow and develop under equal conditions, especially in North American integration.

Dollarization is only possible as an agreed-upon, evolving process, a mature, long-term project of financial integration. VM

Notes

[1] Krugman and Obstfeld, *Economía internacional*, 3rd edition (Mexico City: McGraw Hill, 1996), pp. 727-759.

[2] See Werner Weindenfield and Wolfgang Wessels, *Europa de la A a la Z. Guía de la integración europea* (Brussels: Institut für Europäische Politik-Comisión Europea, 1996) and Christian Chabot N., *Understanding the Euro* (Toronto: McGraw Hill, 1999), pp. 91-117.

[3] David Márquez Ayala, "La pugna por el patrón monetario. III" Reporte Económico, *La Jornada* (Mexico City), 15 February 1999.

[4] "Pierde el salario casi 44% de su valor a partir del inicio del Tratado de Libre Comercio. Ningún resultado positivo para los obreros," *El Financiero* (Mexico City), 8 June 1999, p. 14.

[5] Krugman and Obstfeld, op. cit., pp. 739-746.

[6] "Absurdo, pensar que la dolarización terminará con los problemas del país. Urge corregir la situación monetaria: Slim," *El Financiero* (Mexico City), 29 April 1999, p. 6.

[7] "Peligran las metas económicas pese a las señales de recuperación. Persisten las dudas en el extranjero sobre la fortaleza de México: CEESP," *El Financiero* (Mexico City), 8 June 1999, p. 12.