

## MEXICO, CURRENCY REFORM, AND THE STABILIZATION IMPERATIVE

*Roberto Salinas-León*

### The Currency Debate in Mexico

Mexico has relied on a floating exchange rate regime since the dramatic peso collapse of 1994. The enthusiasm for radical monetary reform, whether in the form of unilateral dollarization or the adoption of a currency board system, remains alive in policy speculation surrounding the monetary and financial future of the country. This stems from two sources. First, the exponential growth of commerce under the positive experience with global trade liberalization has transformed the export sector into the primary engine of economic growth. The tradable segment of Mexico's economy has leaped to over 50 percent of total output, and is expected to continue its progressive trend in the next decade. It is estimated that four out of five transactions will be linked to the tradable sector, and so be dollar-denominated (Aspe 2000). A policy shift to reduce currency transactions costs by adopting a common unit of account is, therefore, an attractive option consistent with the expansion of trade and the need for lowering the cost of capital.

The second motivation behind the polemic to reform existing monetary institutions is negative. A consequence of the peso crash in 1994 is that investors focus explicit attention on what David Hale (1996) characterizes as the "quality of the monetary institutions," namely, the details of monetary conduct and the transparency of monetary institutions. The enthusiasm with dollarization, in any of its variations, is grounded in concerns on how to rule out exchange rate risk and thereby enhance the "quality" of a monetary system ravaged by three decades of debt, devaluation, and a long list of unfulfilled promises.

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Roberto Salinas-León is the Executive Director of Policy Analysis for TV Azteca in Mexico City, President of The Economist Conferences Mexico Business Forum, and an Adjunct Scholar of the Cato Institute.

Nevertheless, Mexico's monetary authorities have rejected radical monetary reform in favor of the (restricted) exercise of a floating exchange rate policy, anchored on a gradual monetary policy of mild inflation targeting. The exchange rate system is not a pure float. It is governed by explicit rules of intervention, in the form of occasional dollar sales at preferential rates in case the parity depreciates 2 percent or more in a 24-hour period, and in the form of a systematic policy of international reserve accumulations. The national central bank has adopted an informal, "other things equal," inflation objective that targets a reduction of the price level from its current level of 9 percent to the more internationally accepted level of 3 percent by the end of 2003. This gradualism is both qualified and disappointing. Mexico has the third highest inflation level in Latin America and is consistently bedevilled with variable and high cost of capital. Moreover, in view of the poor track record of its monetary history, the floating exchange rate remains vulnerable to sudden fluctuations in the global markets and to external shocks. An episode of strong currency depreciation in the face of adverse circumstances feeds rapidly into the inflation rate, in view of the large proportion of the national output on external trade, and in view of low credibility expectations fueled by a sequence of exchange rate collapses over the last quarter century. In 1994, the large depreciation signified an increase of 637 percent in the price level, as inflation shot up from 7 percent to 52 percent in a single year, despite the austerity program implemented in 1995. Again, in 1998, the depreciation occasioned by global contagion and the collapse of the ruble translated into an increase of inflation from 14 percent to 18 percent. To date, the vicious cycle of inflation-devaluation-inflation remains to be broken. Eliminating the risk posed by holding peso assets would remove the monetary credibility gap and short-circuit the cycle of systematic monetary erosion.

Mexico's financial authorities wield two arguments against currency reform. The first claim is a variation of Alan Greenspan's off-cited (but characteristically cautious) claim that it remains an open question "whether a sovereign nation, otherwise inclined to policies that are 'off the wagon,' can force itself into 'sobriety' by dollarization." In anti-dollarization form, this is the idea that, if all the proper reforms are established in other fields of public policy (for instance, fiscal discipline, labour market reform, and deregulation), then the choice of a monetary regime becomes a secondary issue at best. Dollarization works only if all other areas of the economic infrastructure are in proper working order (see, e.g., Ortiz 2000). However, in this Panglossian scenario, a floating exchange rate would not be subject to sudden speculative attacks. This argument is popular, but it

begs the question. The issue is precisely whether a nation with such a questionable history in monetary mismanagement should continue to hold on to a currency that has lost over 98 percent of its dollar value in the past 25 years. If all parts of the economic body undergo healing, in the form of structural changes in other policy areas, then there is no reason why this process should not be applied to the weakest and most assailed area, namely, the peso currency.

A second argument to maintain the status quo is that, under a floating exchange rate, the nation is better suited to absorb negative external shocks. The fancy rhetoric of “shock absorption” masks the fact that the (ab)use of depreciation to confront an external shock is merely equivalent to letting real wages fall. The true shock absorber is the real salary of the everyday worker, not the isolated variable of macroeconomic discretionary engineering known as the exchange rate. Colloquially, the argument is often expressed in corporeal terms: dollarization, or radical monetary reform, would be the equivalent of amputating the economy’s right arm. True, but if the right arm is riddled with the terminal cancer of inflation, then amputation would be the policy outcome of proper cost-benefit analysis (Salinas-León 1996, 1998).

## Monetary Rules and Exchange Rate Options

The new conventional wisdom suggests that emerging market countries have only two available options in exchange rate policy. The first option is to adopt a freely floating exchange rate and restrict the exercise of domestic monetary policy to inflation targeting (as in New Zealand). The second option is to adopt what Sebastian Edwards (2000) calls a “super-fixed” exchange rate—a currency board, unilateral dollarization, or the negotiation of a common unit of account. Pegs have fallen out of fashion, as the worst of all possible worlds. In an age of rapid capital mobility and increasing sophistication in financial technologies, it is impossible to manage both exchange rate and interest rate policies simultaneously.

As Robert Mundell (2000:A12) has argued, however, this way of posing the policy dilemma is misplaced. The debate is not between fixed and flexible regimes, but between the monetary rules that underlie the exchange rate systems. A floating rate is consistent with high and low inflation scenarios. A responsible monetary policy—based on inflation targeting or a monetary rule—is the real factor behind exchange rate and price stability under a regime of freely floating exchange rates. The unanticipated variations in exchange rate and interest rate behavior in Mexico during the recent experience

with a flexible system suggests, under this analysis, the practice of an insufficiently responsible monetary policy. The debate, couched in Mundellian fashion, should thus be framed in terms of gradualism as a monetary rule versus the “automatic adjustment process” rule embodied in a completely fixed exchange rate (or no exchange rate).

Indeed, in the period 1995–2000, Mexico has experienced a large degree of financial volatility that can be categorized into four different exchange rate episodes (and a recent fifth mini episode). The first was 1995, when the exchange rate suffered a massive overshooting and interest rates sharply increased. The second was 1996–97, when solid recuperation from the crisis due to balanced structural adjustments led to a dramatic reduction of interest rates, together with a substantial appreciation of the peso. The third was 1998, when the global tidal wave of competitive devaluations again occasioned a 30-percent depreciation of the peso-dollar parity and extremely volatile behavior in benchmark interest rates. The fourth was 1999–2000, when the phenomenon known as “decoupling” enabled Mexico to regain financial and economic strength—and thereby avoid the contagion originally feared after the devaluation of the Brazilian *real*. The two variables under consideration—the interest rate and the exchange rate—responded accordingly: since the outset of 1999, short-term interest rates have fallen to their lowest levels since 1994 and the rate of exchange has remained remarkably stable. The fifth mini episode occurred on the eve of the historic presidential elections, when a wave of irrational expectations not based on fundamentals occasioned a very brief but very erratic behaviour in both variables.

This caricature of Mexico’s recent monetary history captures a fundamental problem with the domestic currency regimes in countries with a credibility gap in their monetary institutions. Indeed, as Barry Eichengreen and Ricardo Hausmann (1999: 330) have stated, in the presence of this credibility gap, financial fragility ensues, because domestic investments will face either a “currency mismatch (projects that generate pesos will be financed in dollars) or maturity mismatch (long-term projects will be financed with short-run loans).” The conclusion is obvious: if authorities allow the currency to fall, bankruptcies will ensue, but if authorities decide to defend the exchange rate, it will occasion defaults on short-term debts. The solution, for these authors, is not a more flexible rate of exchange, but rather no rate of exchange, to wit, radical monetary reform in the form of dollarization.

In effect, this is a variation of the pro-reform arguments which suggest that inflation would be eradicated under dollarization. Inflation is both a monetary and exchange rate phenomenon in Mexico.

The four maxi-devaluations in the period between 1976 and 1998 have been followed by massive price instability. Dollarization would end the inflation-devaluation trap and allow the price level to converge to international dollar levels. In addition, the sharp fall in inflation would permit a reduction and stabilization of interest rates, thereby stimulating real economic growth and improving the allocation of private credit. The spread between U.S. interest rates and Mexican rates would no longer be a function of exchange rate risk, but of institutional or other extra-monetary forms of risk. The convergence of interest rates would improve Mexico's credit rating and attract foreign direct investment. The goal of sustained growth combined with price stability would become a reality. The transparency in the new monetary system would give impetus to fiscal and structural reform, since a policy mistake (eg., a large fiscal deficit) could no longer be "hidden" with monetary instruments (eg., artificially expanding the money supply to finance public largess). So dollarization would constitute an incentive to move faster in improving other fiscal and structural policies.

Against these claims, it is systematically stated that, under a radical currency reform, the role of the central bank as lender of last resort would be lost, which could make the banking system vulnerable in case a run or systemic crisis occurred. A strong alternative lender of last resort facility would have to be developed in order to remove this vulnerability. However, the fragility of the banks is a red herring. Liabilities imposed by the bank bailout after the peso collapse of 1994 exceed 25 percent of gross domestic product. The banking sector remains weak after the bailout, and authorities worry that the loss of a lender of last resort would undermine the capacity of the central bank to supply emergency liquidity in times of trouble (say, in the face of an external shock). However, as Michael Gavin (2000) stated, the existence of weak banks is not an excuse to perpetuate weak monetary systems. A lender of last resort facility under dollarization could not use the inflation tax to finance government bailouts. Moreover, the stabilization involved in radical currency reform would help, rather than hinder, the development of sound banks

### Stability through Monetary Choice

The aggressive efforts in trade and investment liberalization during the past 15 years were implemented to help fulfill the capital needs of the Mexican economy, by creating a reliable investment regime. The 1994 peso devaluation interrupted that process. The challenge posed by the arguments for dollarization is reducible to the claim that

the complete elimination of exchange rate risk would seal a reliable haven for long-term productive investment. The principal obstacle facing the implementation of radical monetary reform is political—it involves the loss of a powerful tool of discretionary economic management, the exchange rate. So, there are vested interests that have to be neutralized in order to turn a viable economic policy option into a political reality.

This transformation could be accomplished under a regime of monetary choice. This alternative does not, by itself, strictly involve dollarization, but rather the more politically correct option of currency decentralization: abolish legal tender monopoly of the peso. This would enable all Mexicans to have a choice among world currencies in conducting transactions, setting prices, issuing payrolls, formulating contracts, or paying taxes. The central bank would have a strong incentive to maintain the value of the domestic monetary unit similar to the strongest competing currencies, lest it lose the benefits of seigniorage. Competition would, as always, deliver the best product and generate a healthy process of creative destruction in the monetary arena. The bet, of course, is that undertaking such a route would eventually lead to spontaneous, or *de facto*, dollarization.

Sebastian Edwards (2000), who is sympathetic to radical monetary reform, nevertheless suggests that the enthusiasm for dollarization is misplaced. The idea, he claims, “is oversold.” It is “not a cure for the common cold” of regional contagion. Yet, from a theoretical basis, the low inflation and high growth benefits of currency competition are extremely attractive. The latter is not a magic wand or policy panacea. But it remains an alternative for a country seeking a money of stable value, lower interest rates, and credibility.

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