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Sluggish Economic Growth Leads To Concerns About Possible Peso Devaluation

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The combination of high domestic interest rates, continued sluggish economic growth, and growing political uncertainty have created concerns among some economic analysts and business organizations that a major devaluation of the peso may be inevitable before the end of this year. For the moment, economic analysts are stopping short of predicting that a devaluation is imminent, especially since the Mexican government currently has ample foreign exchange reserves and a commitment from the US government to help support the value of the peso. At the same time, President Carlos Salinas de Gortari's administration is expected to avoid at all costs implementing a devaluation prior to the Aug. 21 elections, since such a move would be politically damaging to the campaign of the governing party's presidential candidate, Ernesto Zedillo.

But there is widespread concern that Salinas may have to consider devaluing the currency after the balloting, particularly if the national economy does not begin to grow at a rapid pace over the next several months. One business organization, the National Association of Manufacturing Companies (Asociacion Nacional de Industriales de la Transformacion, ANIT), issued a report in late March urging the Salinas administration to allow the value of the peso to slide relative to the US dollar over the next several months, in order to reduce accumulated pressures for a major devaluation later in the year.

Loss of investor confidence

Economists and financial analysts suggest that the possibility of significant economic recovery during the next few months has been undermined by a loss of investor confidence in the Mexican economy. In turn, the drop in investor confidence has been due in large measure to recent political events such as the uprising of the Zapatista National Liberation Army (Ejercito Zapatista de Liberacion Nacional, EZLN) in Chiapas, the kidnapping of prominent banker Alfredo Harp Helu, and the assassination of the ruling party's presidential candidate, Luis Donaldo Colosio.

"Growth will be slower than initially forecast for 1994," read a report released in late March by the Mexican Institute of Finance Executives (Instituto Mexicano de Ejecutivos de Finanzas, IMEF). Early this year, the Salinas administration had projected GDP growth of 2.0% for 1994, although some economic analysts were forecasting growth at only 1.0%. IMEF explained that slow economic growth in the October-December quarter of 1993 was expected to carry over to the first months of 1994, but that a significant recovery was expected to follow later in the year. At the same time, the IMEF pointed out that the Mexican foreign exchange and financial markets have recently been characterized by a nervous and uncertain tone, although no massive flight of capital was evident as of late March.

Still, according to some analysts, foreign investors are very concerned about the prospects for the Mexican economy during the remainder of 1994. "Factors such as expectations of another interest
rate hike [in the US], uncertainty about the exchange rate, and the fall of the Dow Jones are keeping
investors out of the [Mexican Stock Exchange, BMV] market," analyst Jorge Herrera of Vector
brokerage company in Mexico City told the New York Times.

In fact, the exit of capital during March was a significant factor behind the decline in the value of
stock issues at the BMV during the January-March quarter. According to private economic analysts,
foreign investors withdrew roughly US$5.8 billion from the BMV during the month of March alone.
The exit of capital manifested itself in part when foreign investors decided not to roll over short-
term bonds issued by the Mexican government.

According to the Banco de Mexico, total foreign investment at the end of March stood at about US
$50.3 billion, a decline of 10.4% relative to the total in February. In fact, the total foreign investment
as of the end of March was down about 7.9% relative to year-end 1993. A joint BMV/Banco de
Mexico report indicated that investors failed to roll over US$737 million during the week of March
15-22 alone, or the equivalent of about 11% of the US$6.5 billion in foreign funds invested in the
Mexican issues during 1993. The BMV explained that the withdrawal of these foreign funds during
those weeks in March was a major factor in the increase of more than two percentage points in the
Mexican Treasury's 28-day certificates (Cetes) during the last week of March.

According to El Financiero International weekly business newspaper, the pattern continued during
the first week of April, when interest rates for Cetes rose to 14.31%, compared with 8.81% on Feb.
23 and 11.63% on March 30. "[Interest] rates were already high, but investors remain unsure as to
the stability of the country, which was reflected in the huge drop in demand," said analyst Mariano
Fernandez of Bancomer in an interview with El Financiero International.

Concern about 'soft' money in economy

Some business organizations are clearly concerned about the large amount of "soft" money
invested in the Mexican economy. In an April 2 report, the Mexican Employers Confederation
(Confederacion Partronal Mexicana, Coparmex) criticized the Salinas administration for failing to
take steps to stimulate more direct investment, rather than the "speculative" funds placed in stocks
and bonds, which can be easily withdrawn from the country.

According to some analysts, domestic and foreign investors placed their money in Mexican stocks
over the past two years because the peso had remained fairly stable during the period. "The
exchange rate is an important risk, not only for companies but for the strength in the [entire]
financial system," said Arturo Acevedo, research director for Vector. Nevertheless, the sluggish
growth rate has had a clear impact on the foreign exchange market, driving up the peso-dollar
exchange. For example, according to the Wall Street Journal, the peso began to slide in value in
late February, after the Salinas administration reported that GDP growth for 1993 was only 0.4%.
According to the Journal, the value of the peso declined by 8.3% in relation to the US dollar during
the January-March quarter. In fact, because of the loss in the value of the peso, stocks listed on the
Mexican Stock Exchange (BMV) are already down about 20% in dollar terms.

Still, the large amount of foreign exchange reserves in the hands of the Banco de Mexico (central
bank) and strong backing from President Bill Clinton's administration may limit the chances
for further devaluation. Immediately following the March 23 assassination of Colosio, the US announced a US$6 billion line of credit for Mexico to use to prop up the value of the peso in case of a massive sell-off of the Mexican currency. But analysts suggest the move was largely symbolic, since the Banco de Mexico's own reserves of foreign exchange are sufficient to support the peso. In fact, in March the central bank reported foreign exchange reserves totaling US$24.5 billion as of year-end 1993, compared with US$5.9 billion relative to 1992.

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