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Private Sector Proposes to Link Mexican Economy to U.S. Dollar

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The gradual deterioration of the peso this year has led several private economists to urge the government to consider linking the Mexican peso to the US dollar. The Mexican currency, which was quoted at 10.17 per US$1.00 as of Oct. 7, has lost close to 20% of its value since the start of the year. If the erosion of the peso is not stopped, some economists warn, Mexico could fall into a spiral of devaluations and inflation.

The Banco de Mexico (central bank) has tightened the money supply four times so far this year, signaling its intention to push interest rates higher to stem a slide in the peso's value. In turn, interest rates on credit cards surged as high as 70% earlier this year (see SourceMex, 09/30/98). Prominent private organizations like Grupo Banamex- Accival (Banacci) and the Centro de Estudios Economicos del Sector Privado (CEESP) have launched feasibility studies on forming a monetary union with the US and Canada within the framework of the North American Free Trade Agreement (NAFTA).

"By belonging to (NAFTA), our country is undeniably different from other emerging nations," said a CEESP report. "But because there is no explicit or functional monetary provision, [Mexico] loses important advantages as a safe haven for foreign investment." CEESP, which is closely linked with the business organization Consejo Coordinador Empresarial (CEE), acknowledged Mexico would face major disadvantages by linking its economy to the dollar.

For example, the Mexican economy would be governed by US monetary policies and US economic cycles. In addition, Mexico would lose its control of the emission of bills and coins into the economy. "But the advantages of forming a monetary union with the US and Canada far outweigh the disadvantages," said the private-sector think tank. CEESP argues that a link to the US dollar would reduce Mexico's inflation and interest rates to US levels and enhance Mexico's attractiveness to foreign investors. Banacci also resurrected its feasibility studies on linking the Mexican economy to the US dollar.

The studies were postponed when Mexico introduced a floating-exchange-rate policy in 1995 following the devaluation of the peso in late 1994. But the sharp decline in the peso in late August and September created concerns that the floating-rate system may not adequately protect the Mexican currency from global economic turbulence. Banacci's chief economist Alberto Gomez said the studies will consider whether NAFTA could be broadened into a "monetary accord" similar to one planned in the European Union (EU). But despite their support for a possible monetary union with the US and Canada, Banacci and CEESP experts said their organizations are not ready to offer formal proposals on such a union.

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Plan could hurt Mexico's ability to manage economy

While Banacci and CEESP have at least endorsed the move in principle, other private-sector executives appear more cautious. The Asociacion de Banqueros de Mexico (ABM) said the organization supports the floating-rate system, which has been generally positive for Mexico even with its shortcomings. "Until we find a better system, Mexico must retain this scheme, which has proven the most convenient for the country since 1995," said ABM president Carlos Gomez y Gomez. At the same time, Gomez y Gomez said the government should remain open to proposals to create closer links between the Mexican peso and the US dollar. Some private economists have also opposed any plan to eliminate the peso or peg the Mexican currency to the US dollar on a one-to-one basis similar to the prevailing system in Argentina.

Hector Chavez of Santander Investment in Mexico City said eliminating the Mexican government's control over monetary policy could hamper its ability to manage growth and to maintain competitiveness in international trade. "Mexico is a large exporting country, and flexibility with interest rates is essential to exporting," said Chavez. Economist Oscar Vera at Deutsche Morgan Greenfell in Mexico City said the proposal is not feasible in the near term. "I can see this happening in 20 to 30 years, but not before," said Vera. He noted a monetary union at this time would simply convert Mexico into "the 13th district of the US Federal Reserve."

Administration also rejects "dollarization" proposal

President Ernesto Zedillo's administration has also rejected any suggestions to eliminate the floating-rate system and tie the Mexican economy to the US dollar. "We're convinced that Mexico's foreign-exchange system is the most suitable for the circumstances at this time," Finance Secretary Jose Angel Gurria told reporters.

Gurria and other officials denied reports, published in The Wall Street Journal, that said Mexico had already initiated its own feasibility studies on some sort of link to the US dollar. The US newspaper said the Secretaria de Hacienda y Credito Publico (SHCP) and the Banco de Mexico had scheduled a series of meetings with private economists and other financial experts to float the idea of a US-Mexico currency link. In addition, the newspaper said, Mexican monetary authorities had traveled to Argentina and Hong Kong to study how linking their currencies to the US dollar has affected their economies.

In response to the Journal report, Mexico City radio station Radio Red conducted an informal poll of more than 1,300 listeners regarding linking the Mexican economy to the US dollar. The results were surprising, with only 196 callers opposing the move. The SHCP insists no studies are underway on "dollarizing" the Mexican economy. "We are not contemplating any change in our floating-exchange-rate system," said deputy finance minister Martin Werner.

The Mexico City daily newspaper El Universal quoted sources at the Banco de Mexico as saying the central bank had already rejected "dollarizing" the Mexican economy because it would increase the government's costs in responding to economic and financial turbulence. In addition, the central bank sources cited Argentina, which has paid for its relatively low inflation with extremely high

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unemployment. Unemployment reached 18% in Argentina in 1998 and was still at 13.8% in May of this year (see NotiSur, 05/08/98).

Furthermore, the central bank sources told El Universal that negotiating a monetary union within NAFTA would require that the US, Mexico, and Canada agree to other changes in the trade agreement. For example, the three countries would have to negotiate an accord or mechanism giving their workers freedom to work anywhere in the NAFTA region. [Sources: Financial Times (London), 09/23/98; Bloomberg news service, The Wall Street Journal, 09/28/98; The News, 09/24/98, 09/29/98; Excelsior, La Jornada, El Nacional, Novedades, Spanish news service EFE, El Universal, 09/29/98; Associated Press, 09/30/98; El Financiero International, 10/05/98; Reuters, 09/28/98, 10/05/98]

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