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Sharp Decline in Peso Raises Some Concerns About Economy

by LADB Staff
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The Mexican peso has fallen sharply in recent weeks because of poor economic-growth prospects for this year and a downgrade in the credit rating of the state-run oil company PEMEX. The Mexican currency declined to 11.30 pesos per US$1.00 in early October before rebounding slightly to 11.18 pesos per US$1.00 in mid-October. A major factor was the news that prominent financial-rating company Moody's Investors Service was reviewing the possibility of downgrading US$14.6 billion in bonds issued by PEMEX on the international markets.

A second reason cited for the slide was a statement by Finance Secretary Francisco Gil Diaz that Mexico's GDP growth would only reach 1.5% this year, compared with the 3% growth rate projected by the Fox administration. The weak peso, which has fallen about 8% since the beginning of 2003, has brought back some memories of the 1994 devaluation that plunged the Mexican economy into a recession in 1995.

But the recent decline does not worry some economists, including Guillermo Ortiz Martinez, the chief governor at the central bank (Banco de Mexico). "This is not a cause for concern because we have had previous episodes of volatility," Ortiz Martinez told reporters in early October. "You have to remember that in March of last year the exchange rate also reached 11.30 pesos per US$1.00 and later recovered."

Other economists suggest the weakness of the peso may simply represent a market correction. "There is a strong community of economists who for some time have said the peso was overvalued," said Alberto Equihua Zamora, director of analysis at the employers organization Confederacion Patronal de la Republica Mexican (COPARMEX).

In any case, the Mexican currency is expected to remain volatile for the rest of the year. "The information in the market on volatility points to at least two or three (more) months," said Paulo Leme, emerging markets research director at Goldman Sachs. Leme said growth data and other indicators suggest the Mexican currency has found "a new equilibrium point" at around 11.25 pesos per US$1.00.

Some analysts said Ortiz and Gil may be purposely trying to keep the peso weak to help the Mexican economy recover competitiveness. In particular, a weak peso would benefit Mexican companies that rely on the export market. "My interpretation is that they know that if things start moving in the wrong direction on the fundamentals, there will be a problem with competitiveness," said Alfredo Thorne, chief Latin American economist with JP Morgan in Mexico City.
Concerns about PEMEX credit rating help weaken peso

Analysts said the review of PEMEX finances reflected a deeper concern about the Mexican economy, especially the country's revenue-collection mechanism. For many years PEMEX has accounted for 60% of government revenues, paying a large share of its earnings to the federal treasury in the form of taxes. In contrast, general tax collections account for only about 12% of government revenues. In recent years, the Mexican Congress has discussed reforming the tax system to allow PEMEX to keep a larger share of the revenues, but has not taken any actions because tax reforms have not been approved to replace the funds obtained from PEMEX (see SourceMex, 2001-04-04, 2001-10-03 and 2002-09-11).

The Fox administration is pushing for a reform to Mexico's antiquated tax system to boost government revenues. But any solution will not come until after a "tax convention" scheduled for early 2004 (see SourceMex, 2003-08-06). The major political parties agree with Fox that the tax system is in dire need of revision, but many disagree with the president's proposal to impose a value-added tax (impuesto al valor agregado, IVA) on food and medicines. The center-left Partido de la Revolucion Democratica (PRD) and some members of the former governing Partido Revolucionario Institucional (PRI) are urging Fox to improve the collection rate before increasing taxes.

The oil company's growing debt and the need to finance a massive investment program to replace aging infrastructure and expand its operations has raised major concerns for rating services like Moody's. Some analysts say a change in rating would not significantly inhibit PEMEX's ability to issue bonds, but could cause potential investors to think twice about putting money not only into PEMEX but into other state-run companies that issue sovereign debt.

"A reduction in grade does not mean that PEMEX would lose its investment grade, but perhaps Moody's might reduce the ratings for other companies like the Comision Federal de Electricidad," said Victor Ceja, director of the Mexican securities division of private financial company IXE. "This is a message to the Mexican government that without structural reforms the ratings for sovereign debt could be reduced."

A PEMEX official said the Moody's decision could in the long run benefit Mexico because it would force the federal government and the Congress to take a more serious look at tax reform. "PEMEX will now be able to discuss its tax structure with greater credibility," the official told the Mexico City daily newspaper El Universal.

Some analysts do not see a major restructuring of the Mexican tax system, including the PEMEX fiscal situation, in the near future. "There is a chance for some reform, but it will not be deep reform, which may disappoint business people in Mexico and investors from abroad," said economist Raul Feliz, of the Centro de Investigaciones y Docencia Economica (CIDE). Any reform of PEMEX fiscal status is not likely to involve comprehensive changes because the oil company remains too valuable as a source of revenue. Mexico averted major budget cuts this year because of strong oil-export revenues, which are expected to rise by 50 billion pesos (US$4.4 billion) over initial projections, said Gil.
Some government officials are concerned that the government may not be able to count on earnings from PEMEX oil exports next year to compensate for reduced revenues from other sources. The price of Mexican crude oil was quoted at an average of US$26.34 on Oct. 14, following global trends. But some organizations like the International Energy Agency (IEA) believe prices are too high, given the level of global inventories, which could mean a reduction in 2004.

"A decline in the international price of crude oil would certainly have repercussions on the federal budget because 30% of public expenditures are obtained from oil-export revenues," said PAN Deputy Gustavo Madero Munoz, who chairs the finance committee (Comision de Hacienda in the Chamber of Deputies. "We will have to be very clever in responding to this situation in 2004."

Poor economic growth prospects also fuel peso weakness

Some business leaders took issue with Gil's decision to announce a reduction in the GDP forecast for 2003 by the Secretaria de Hacienda y Credito Publico (SHCP), which they said was a strategy to pressure Congress to approve tax reform. In a statement, the presidents of the Consejo Coordinador Empresarial (CCE), the Confederacion de Camaras Industriales (CONCAMIN), the Confederacion de Camaras Nacionales de Comercio (CONCANACO), and others described the move as "irresponsible."

"The projection from the SHCP is more pessimistic than that of the Banco de Mexico, which retains a forecast of 2%," said the Centro de Estudios Economicos del Sector Privado (CEESP). "This created a disequilibrium in the markets." This is not the first time that key members of the private sector have been at odds with the Fox administration. Prominent business leaders like Dionisio Garza, Leonardo Servitje, and Carlos Slim Helu have criticized the president for a lack of economic leadership and for adopting what they consider inappropriate economic policies (see SourceMex, 2003-06-11 and 2003-07-02).

The Fox administration, meanwhile, envisions next year's budget at 1.5 trillion pesos (US$134 billion). This is one percentage point lower than what was approved for 2003. The preliminary budget assumes a recovery in GDP growth to 3% or 3.5% and annual inflation of 3%. Gil presented the budget plan in separate meetings with legislators from the governing Partido Accion Nacional (PAN) and the PRD.

The SHCP is obligated to submit a budget to Congress by Nov. 15, but a budget plan could be presented by Nov. 1, sources said. Fox's chief economic adviser Eduardo Sojo said the Fox administration is considering the possibility that some fiscal reform will be approved during 2004 and has drafted a second budget reflecting increased tax revenues. "If we end up using the plan that does not have tax reform, we will be unable to meet the needs of society in areas like health and education," said Sojo. In a recent report, the Organization for Economic Development and Cooperation (OECD) said Mexico can sustain a consistent GDP growth rate of 6% if comprehensive tax reform is enacted. Administration officials acknowledge that social programs and public investments could bear the brunt of budget reductions in 2004.

Deputy finance secretary Carlos Hurtado, in testimony before the budget committee (Comision de Presupuesto) of the Chamber of Deputies, estimated next year's reductions in public investments and social programs at almost 109 billion pesos (US$9.7 billion). Hurtado's testimony created major
concerns among members of the committee, particularly PRD legislators. "We cannot be convinced to accept a reduction of 5.4% in expenditures on infrastructure and social expenditures, so we will have to closely scrutinize the administration's proposal," said PRD Deputy Guillermo Huizar, who previously served as finance secretary in the Zacatecas state government.

Huizar and fellow Deputy Clara Brugada, PRD coordinator of social concerns, presented a list of programs that could be targeted for cuts, including expenditures on roads, water infrastructure, and PEMEX projects; federal support to universities; subsidies for medicines; and some funding for agricultural and poverty reduction initiatives like the Alianza para el Campo and Procampo. [Note: Peso-dollar conversions in this article are based on the Interbank rate in effect on Oct. 15, reported at 11.18 pesos per US$1.00] (Sources: Associated Press, 10/01/03; Unomasuno, 09/23/03, 10/02/03, 10/03/03, 10/07/03, 10/08/03; El Universal, 09/25/03, 10/02/03, 10/03/03, 10/06-08/03; Dow Jones news service, 10/08/03; La Cronica de Hoy, 10/02/03, 10/03/03, 10/06/03, 10/07/03, 10/09/03; El Sol de Mexico, 09/26/03, 10/02/03, 10/03/03, 10/07/03, 10/09/03; Notimex, 10/09/03; The Dallas Morning News, 10/06/03, 10/10/03; Reuters, 10/12/03; The Herald, 10/02/03, 10/06/03, 10/13/03; Milenio Diario, 09/15/03, 09/23/03, 10/02/03, 10/07/03, 10/08/03, 10/15/03; El Financiero, 09/23/03, 10/02/03, 10/03/03, 10/06/03, 10/07/03, 10/09/03, 10/13/03, 10/15/03; La Jornada, 10/02/03, 10/03/03, 10/07/03, 10/09/03, 10/10/03, 10/14/03, 10/15/03)

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