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Mexican Peso Plunges, Partly Due To U.S. Economic Crisis

by LADB Staff
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The Mexican peso has frequently served a role similar to a canary in a coal mine. Whenever the peso tanks, the Mexican economy could be in deep trouble. This was the case in 1982 and 1994, when a sharp devaluation of the peso was followed by severe economic crises. During the past several weeks, the Mexican currency has exhibited the kind of weakness that makes economists nervous. After reaching a six-year high of 9.86 pesos per US$1.00 in August 2008, the Mexican currency has lost about 43% of its value, approaching a level of 15 per US$1.00. The nervousness about the Mexican currency is well-warranted, but there are important differences with the two previous devaluations.

In 1982 and 1994, the currency's weakness was caused more by internal factors than by external problems. For example, the peso's nosedive in 1994 was the result of a faulty strategy of the administration of former President Carlos Salinas de Gortari, who drew foreign indirect investment (FII) into the country by offering short-term securities while failing to shore up the country's foreign reserves. The investors who bought those securities sold heavily in late 1994, following reports of political instability, namely the uprising of the Ejercito Zapatista de Liberacion Nacional (EZLN) in Chiapas (SourceMex, January 04, 1995). Mexican currency approaches 15 pesos per US$1.00 Additionally, authorities in the previous two instances purposely devalued the peso to respond to economic emergencies.

The peso's most recent erosion has been linked directly to external market conditions, specifically the economic downturn in the US and the corresponding decline in the global economy. On Feb. 3, the Mexican currency plunged to 14.57 pesos per US$1.00, driven by growing speculation that that the Mexican economy would experience a growth deficit this year. This was primarily the result of concerns that a sharp downturn in the US would further dampen export demand and reduce the flow of foreign capital into the country. In early February, President Felipe Calderon raised the possibility that Mexico would experience negative GDP growth in 2009 but did not disclose a forecast. "This is a complex and difficult time, but our country is more prepared than during any other crisis to confront these problems," Calderon told reporters at the inauguration ceremony of a hospital in Queretaro state. A possible downturn in the Mexican economy was already anticipated, with the administration previously forecasting zero growth in 2009 (SourceMex, January 14, 2009).

Although the administration will not venture a specific GDP forecast, the Banco de Mexico is projecting extreme weakness in the Mexican economy in 2009. According to the central bank, Mexico's GDP is expected to contract by 1.16% during the year. As recently as January, an average estimation of 31 economists who responded to Banco de Mexico survey showed expectations for a decline of only about 0.11% in Mexico's growth this year. But the Banco de Mexico says the situation is not expected to improve much from the fourth quarter of 2008, when GDP contracted by about 1%. This could translate into the loss of as many as 340,000 jobs in 2009 in Mexico, said the bank. Syndicated columnist Sergio Sarmiento said the peso devaluation is causing enormous damage to

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Mexican businesses, not only by making imports of needed inputs much more expensive but also by affecting the bottom line of businesses that incurred debt in dollars.

The irony of the peso's weakness is that its loss in value has made exports more favorable. The problem is that the US accounts for 80% of Mexico's exports, and the US is hardly in a position to buy much from its southern neighbor. Mexico's strong reliance on the US economy has hit the peso harder than any other currency, although other currencies have not been immune. "Other Latin American currencies have also declined as has the Russian ruble and the British pound, which had previously been considered solid," wrote Sarmiento. "The peso has lost value in part because it is not considered one of the world's strong currencies during a time of crisis."

Opposition leaders criticized the Calderon government for failing to recognize the seriousness of the crisis. "I agree that we should remain calm, and, as the president says, we should avoid the 'catastrophe' mentality," said Sen. Manlio Fabio Beltrones, coordinator of the opposition Partido Revolucionario Institucional (PRI) in the upper house. "Conversely, it is not right to go overboard with optimism during this difficult time." Speculators also blamed for latest plunge Beltrones also criticized the administration for failing to take the proper regulatory steps that could have prevented the precipitous decline in the Mexican currency. "The devaluation of the peso to about 15 pesos per US$1.00 was caused partly by the lack of sufficient government instruments to monitor the crisis in the derivatives market," said the PRI legislative leader.

Others concurred that the peso's decline was driven by market actions. Finance Secretary Agustin Carstens told reporters in New York that maneuvers by a group of investors to buy dollars while selling pesos in order to take profits contributed to the pressure on the Mexican currency. He pledged that the central bank would continue intervening in the market when conditions warranted action. The finance secretary's statements are consistent with comments he made in October 2008 in which he blamed speculators for an abrupt decline in the peso at that time (SourceMex, October 22, 2008). Others also ascribed the peso's recent downturn to speculation. "The fact that volatility continued for several days is sufficient to infer that [the peso's decline] was the result of speculation," said the private-sector think tank, the Centro de Estudios del Sector Privado (CEESP).

The CEESP, which is affiliated with the Consejo Coordinador Empresarial (CCE), praised the Banco de Mexico for its timely operations to prop up the peso. Furthermore, it said the central bank had made it clear that it would enter the market whenever necessary to prop up the Mexican currency. Central bank interventions help stem slide The Banco de Mexico's actions have had a mixed impact on the peso. Since October, it has moved at least three times to prop up the peso by selling its reserves of US dollars, acquiring the equivalent of US$16.6 billion. Two of those interventions occurred in recent weeks, including the purchase of US$400 million worth of pesos in the first week of February.

Analysts say the two latest interventions were timely because the Mexican currency could have easily dropped to 16 pesos per US$1.00 by the early part of February. "We are experiencing a second wave of pressures against the peso and other currencies," said economist Cesar Castro of the Centro de Analisis y Proyecciones Estrategicas de Mexico (CAPEM). "Because of uncertainty, much of the foreign capital is leaving the emerging markets and seeking refuge in US Treasury bonds."

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Other analysts concurred. "[The central bank actions] helped contain the pressures," said Carlos Hermosillo, an analyst at Vector Casas de Bolsa in Mexico City. But the Banco de Mexico has taken other actions that may contribute to the peso's weakness.

For one, it has reduced interest rates to 7.75% from 8.25% to help stimulate the economy. This eliminates one factor that has been propping up the peso: high interest rates. The peso's recent decline has led economists to adjust their predictions for the Mexican currency this year. The Banco de Mexico's most recent survey of 31 economists, conducted Jan. 20-29, showed on average expectation for the Mexican currency to strengthen to 13.5 pesos per US$1.00 by the end of 2009. In contrast, the average projected in a similar survey a few weeks earlier had been for the currency to reach an average of US$12.84 by the end of this year.

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