9-21-2016

Peso Decline Raises Concerns in Mexico about Inflation, Capital Flight

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by Carlos Navarro
Category/Department: Mexico
Published: 2016-09-21

The ongoing slide of the Mexican peso has raised many concerns in Mexico, including the potential increase in prices for consumer goods in the not-so-distant future and the possibility that foreign investors will continue to withdraw much-needed foreign capital from the Mexican economy. Furthermore, some officials worry that the slide in the peso and a recent flight of capital from the country reflect a lack of confidence in the Mexican economy on the part of foreign investors.

The peso has fallen steadily since 2013, when the exchange rate stood at 12 pesos per US$1.00. By September 2016, the Mexican currency had slipped to 19 pesos per US$1.00. External factors appear to be driving the slide, including an expectation that the US Federal Reserve (Fed) could raise US interest rates at any time. A hike in interest rates would have a direct impact on emerging-market currencies like the peso by making investments in US dollars more attractive than investments in other currencies. The Fed has kept interest rates unchanged for each of its last six quarterly meetings, but the mere threat of an increase has kept the peso on edge.

The peso is especially vulnerable in international financial markets because traders use the Mexican currency, which is considered fairly liquid, as a proxy for betting on swings in emerging-market assets.

While the Fed, which is the equivalent of a US central bank, considers its options regarding monetary policy, its Mexican counterpart, the Banco de México (BANXICO), is also pondering actions to keep Mexico’s economy on track. In comments published on BANXICO’s website, deputy governor Manuel Sánchez said the central bank would pay close attention to inflationary pressures stemming from the weak peso while deciding monetary policy.

Mexico’s annual inflation rate reached 2.73% in August, the highest level since February. However, inflation remained below the upper range of the central bank’s target of 2% to 4% for the year despite the peso’s slide. Annual inflation averaged 2.7% in 2015, including a record low rate of 2.1% in December. The inflation rate average for the first seven months of this year was 2.6%.

“Going forward, the implications of exchange-rate developments will remain an important input in monetary policy decisions,” Sánchez added.

The business community is very concerned about the peso, particularly entrepreneurs who own small businesses. If the exchange rate remains weak, many small businesses could go bankrupt, warned Rafael Nieto Tostado, president of the local chapter of the Cámara Nacional de Comercio (CANACO), in the city of Los Mochis in Sinaloa state.

“Without doubt, the exchange rate is going to affect inflation,” Nieto Tostado told reporters. “Many items consumed in Mexico are imported [from the US].”
BANXICO has already increased interest rates by a half-percentage point twice, surprising the financial markets. The first increase occurred in February, after the peso reached a then-record low. The second came in June after the Mexican currency slipped further.

**External pressures**

External political factors remain a concern for Mexican financial officials. The decision by voters in the United Kingdom (UK) on June 23 to leave the European Union (EU) put significant pressure on the peso, which plunged to 19.52 per US$1.00, but recovered gradually in subsequent days (SourceMex, July 6, 2016). The concerns about the impact of the British vote on the global economy had led some analysts to predict that the Mexican currency could eventually fall to 21 pesos per US $1.00.

A more recent development was news from the US electoral campaign. On Sept. 16, a new set of polls indicating that Hillary Rodham Clinton, the candidate for the Democratic Party, had lost much of her lead to her Republican rival, Donald Trump, caused a significant decline in the peso. There is major concern in the financial markets that Trump, if elected, would move to restrict trade with Mexico (SourceMex, Aug. 24, 2016, and Sept. 7, 2016). On the day the polls were released, the Mexican currency fell by 2.2% to about 19.7 pesos per US$1.00.

“Trump is rising in the polls and the Mexican peso is falling.” Christian Lawrence, a currency market strategist at Rabobank NA in New York told Bloomberg news service. If Trump wins, the Mexican peso is going to be the currency that’s worst hit.”

In the same article, Mike Moran, head of economic research for the Americas at Standard Chartered PLC, noted, “[The peso] is getting slammed. The Mexican peso has underperformed the rest of the region for the last few days, and if you look at Trump’s move in the polls, it’s a mirror image. A pertinent issue is how is BANXICO going to react.”

Beyond the external factors, there is concern in Mexico about a lack of confidence on the part of international investors in the Mexican economy. This is evidenced by the gradual and steady flight of capital. In late August, BANXICO reported capital flight of almost US$11.4 billion between January and June, the largest six-month amount in several years. Mexico is highly vulnerable to capital flight because of the strong presence of foreign investors in the country, according to a recent report from the International Monetary Fund (IMF).

“During this period, there was a decline in demand on the part of foreigners for peso-denominated financial instruments, particularly Treasury certificates (Certificados de la Tesorería, CETES),” the central bank said in a report released in August. “This could explain the depreciation of our national currency during the current quarter.”

Analysts said the situation is complicated by the depressed global oil market, which has limited Mexico’s revenues from oil exports (SourceMex, Aug. 31, 2016). The low export revenues have added to Mexico’s current account deficit. “It is worth noting that the balance of payments for oil in the second quarter of the year attained a deficit of US$2.85 billion, while the current account deficit climbed to US$7.85 billion” for the second quarter, analyst Gabriela Siller of Banco BASE said in a guest column in the daily business newspaper El Financiero. (Investopedia defines current account as the sum of the balance of trade [exports minus imports], net income from abroad, and net current transfers.)
According to Siller, Mexico has suffered a deficit in the balance of payments for both the oil market and the current account for 24 consecutive quarters, which is the equivalent of six years.

For opposition lawmakers, the capital flight is of great concern, particularly since Mexico offers interest rates that are much more attractive than those in the US and other countries. According to Sen. Dolores Padierna, deputy floor leader of the center-left Partido de la Revolución Democrática (PRD), the capital flight demonstrates a lack of confidence in the Mexican economy.

Furthermore, Padierna noted that international foreign exchange reserves, which stood at about US$177 billion in June, are insufficient to cover the loss of speculative investment. Foreign reserves represent money or other assets held by a central bank or other monetary authorities to pay liabilities, such as the currency issued by the central bank.

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