The Dollarization of Mexico

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January of 1999 once again brought surprises to Mexico's fragile economy, which had not yet fully recovered its path of sustained growth. The ills of the Brazilian economy and plummeting international oil prices prompted a 22 percent devaluation of the peso which, added to that of the second half of the previous year, brought the total to more than 40 percent in just a few months.

Beset by recurring devaluations, politicians and businessmen began to sell the idea of a country that needed price stability, economic tranquility and a exchange rate system to take us through the year 2000's change of administrations without any upsets.

On hold since 1995, the polemic about dollarization was reactivated and reached its high point when the Mexican Businessmen's Council, whose members are the country's most powerful and influential businessmen who do most of Mexico's foreign trade, paid a visit to the president's official residence, Los Pinos, to request dollarization in the name of the entire business community.

The government position, voiced by the president himself, is that the free-floating peso system in place since the beginning of the Zedillo administration should be maintained. This economic policy instrument is the main prop of the "transition with stability," a phrase coined when announcing to the public that this time there would be no "end-of-administration crisis," and which has become the campaign slogan aimed at giving the Institutional Revolutionary Party (PRI) a political-electoral edge.

The president's rejection of dollarization has recently been bolstered by signs of economic recovery: in April the peso recovered 15 percent vis-à-vis the dollar; interest rates continue to drop; and public finances are under less pressure because of the increase in international oil prices. However, statements by U.S. Treasury Deputy Secretary Lawrence Summers and Federal Reserve Board Chairman Alan Greenspan[1] at a Senate hearing to the effect that they would support dollarization in Latin America mean that the debate will continue and that dollarization or stabilization will be part of the candidates' government programs in Mexico's presidential race which has already begun, ahead of schedule.

After almost three decades of growing inflation and its corresponding devaluations, three presidential terms during which moderate growth has alternated with severe crises with significant negative growth, economic stability and sustained growth have become key points demanded of the administration as one of the still-unfulfilled promises of the government program.[2]

Stabilization: Possible Alternatives

1. Unilateral Dollarization

Our globalized economy makes for the need to plan and project long-term investments and means that a significant part of the economy carries out most of its operations in dollars, as for example in imports and exports, a considerable portion of financial operations, construction activ-

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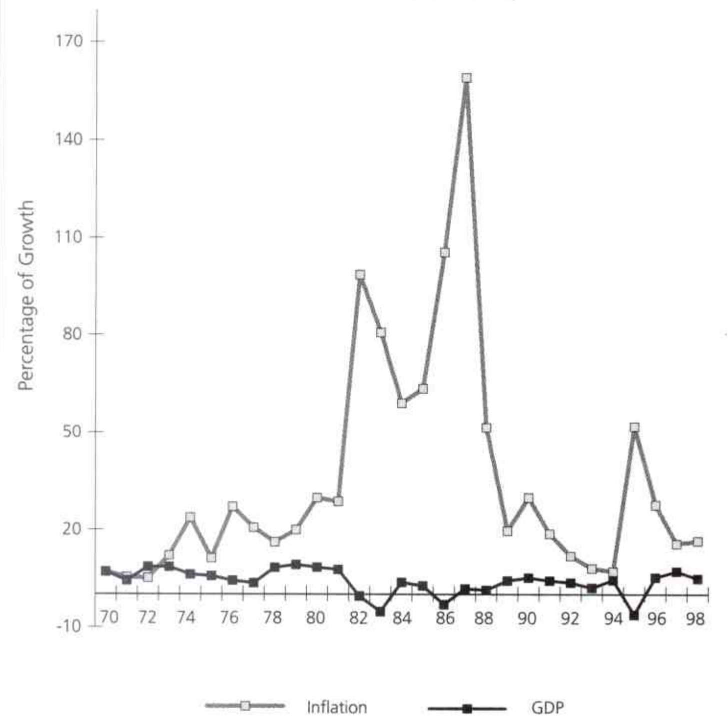


GDP and Inflation Growth (1970-1998)

Source: Banco de México.

ities, purchases and sales in the upper end of the real estate market and, in general, long-term economic activities.

The Mexican business community is betting on the generalization of this kind of operations, because all it requires is making the dollar legal tender and ensuring that this be an autonomous decision of Mexico. However, the most important limitation is the level of dollar reserves and the monetary authorities' inability to print them. In that sense, the functions of the Central Bank as lender of last resort would be very limited because they would depend on the level of international reserves, which in April 1999 came to less than 8 percent of gross domestic product (GDP). For example, more than twice that amount is needed to guarantee the liabilities of the Bank Savings Protection Institute. The comparison of assets and liabilities would be sufficient to reveal the financial sector's insolvency and the government's inability to back them up.

On the other hand, the adoption by decree of another country's currency does not mean that everyone considers that their assets can be denominated in that currency. There is usually resistance and a long process of education would be needed that would be neither inexpensive nor easy to implement. The probably result of such a measure would be the circulation of two different currencies and the resulting generalized confusion.

In addition, we should remember the negative precedent of the "Mexdollars." In the 1980s, the banks opened dollar accounts that were not backed up by hard currency reserves. The intention was to try to stop capital flight and avoid a peso devaluation, but when the 1982 financial and political crisis broke out, the authorities ended up forcibly converting the funds in the dollar bank accounts into pesos at an arbitrarily established exchange rate.

2. A Monetary Council

In this variation of the unilateral adoption of the dollar, a monetary council would replace the Central Bank and assume the functions of emitting bills and coin maintaining a fixed exchange rate with international reserves backing 100 percent the monetary base and ensuring the currency's total convertibility. Because it establishes a fixed-rule monetary policy, it is outside political battles and retains high credibility because it does not finance public spending.

This arrangement's immediate effects of slowing inflation and lowering interest rates make it quite attractive. Countries like Argentina, Hong Kong and Singapore are cited as examples. However, the system depends on having enough hard currency derived from favorable relations abroad, mainly with the country in which the council is set up.

The Argentine model has many supporters in Mexico, but a "tango effect" is expected due to the fact that President Menem's deteriorating political image increasingly highlights the currency's being over-valued, unemployment, low growth rates, the growing foreign debt and capital flight. The general assessment is that the Monetary Stabilization Program has already shown its best results while structural changes to the Argentine economy have been postponed, turning what is simply a socially and economically costly policy instrument into an end in and of itself.

Given that freezing the exchange rate is insufficient for reducing inflation to United States levels, after a few years any product from abroad turns out to be cheaper than local products.

On the other hand, over-valuing the currency mainly affects the export sector, which gets less money for its products and loses dynamism. Today, manufactured exports are the mainstay of the Mexican economy's growth. Also, the aim of economic reconversion (implemented for more than 15 years through the so-called "neoliberal" governments of De la Madrid [1982-1988], Salinas [1988-1994] and Zedillo [1994-2000]) has supposedly been consolidating Mexico as an industrial power through the export of manufactures.

The Mexican economy is now facing the great challenge of achieving monetary stability and sustained growth at the same time. Mexico needs to grow at least 6 percent annually simply to provide jobs for the one million young people who join the work force every year. It has to do this at the same time that more and more imports are required, making for a trade balance deficit and, therefore adjustments in the exchange rate to foster exports and discourage imports by making them more expensive.

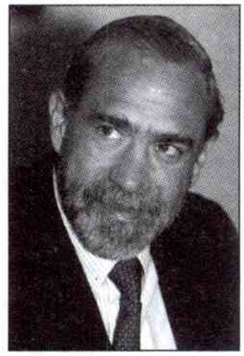
The main difficulty with establishing a monetary council is the elimination of instruments of control (the emission of bills and coinage, the regulation of the commercial banking system, the lender of last resort, etc.), because it leaves to the government only the policy of restricting growth to avert price hikes in a speculative economy which makes a profit off speculation whenever it can.

3. Monetary Union with the United States

The logical result of globalization and the trade agreements should be that in the long run, weak currencies would disappear and unite around a leader currency.

As part of the North American Free Trade Agreement in partnership with the United States and Canada, Mexico's natural destiny is the adoption of the dollar. However, official resistance to the measure goes beyond the loss of "sovereignty" since public finances rest to a great extent on the benefits derived from printing money. In fact, the main criticism that "fiscal discipline" has received is that whenever there is pressure on the economy, the government starts the printing presses. Among the business community's arguments in favor of dollarization is its traditional proposal to limit discretional decisions with which the Banco de México, as it says, "taxes the population with inflation" to finance public spending. What is more, they argue that is how public spending is financed, high levels of corruption are maintained and, in effect, businessmen are controlled.

With the creation of the North American monetary region, the benefits derived from the emission of currency, the seigniorage, would pass to the United States Federal Reserve. Although these earnings are insignificant for the U.S. government budget, for Mexico they are quite important to public finances. However, a larger emission would correspond to the amount of new currency that would have to be bought, which means backing in dollars approximately one-fifth of the value of all the goods and services produced in a year (the GDP). In other words, we would need to triple our international reserves.



Antonio Nava/AVE

Finance Minister José Angel Gurría opposes dollarization.

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4. *The Silver Standard*

Another option for stabilizing the peso and avoiding devaluations is backing the peso with silver. In addition to being a nationalist measure, its defenders say it is a safe solution that would depend on advantageous conditions in national production.

The proposal originally made by Diego Fernández de Cevallos, one of the PAN's most outstanding representatives and a possible presidential hopeful, is presented as an alternative to dollarization. It has more weight as a campaign proposal than as a real option.

Since the silver standard requires using real and not fiduciary resources, as in the previous proposal, we would need to make an initial investment to acquire the new currency, which would also take about one-fifth of the GDP to back the currency in circulation.

An additional problem is that silver production is subject to the same zigzags as the production of other export goods such as coffee, oil, steel, etc.: it is ruled by the international market fluctuations stemming mainly from the participation of volatile capital that have made big profits from speculation in these products.

If we take into consideration that in the last 25 years the price of silver has oscillated between U.S.$2 and U.S.$50 per ounce and that when it passes the U.S.$5 mark, supply increases on secondary markets, we can conclude that, with the adoption of the silver standard, the peso's stability would be more vulnerable than today given the volatility of international markets.

5. *A Sound Economy*

Any measure adopted would have to focus on an efficient, productive economy with solid foundations and sustained growth.

Inflation, low domestic savings, recurring devaluations and, generally, the crises our economy suffers are the result of having permanently operated in unfavorable circumstances and until now without a growth model that would make it possible to overcome the foreign trade deficit.

U.S.$117 billion in exports in 1998, a five-fold increase in only 20 years, is presented as the highest achievement of the so-called "neoliberal" model. The other side of that coin, however, shows us an economy which, in the best of cases, has achieved moderate growth. This means that the success of export-related activities contrast sharply with the virtual stagnation of the rest of the economy.

The best measure for economic stability is having an economy based on growth and a development of all the sectors and a foreign trade balance that is either in equilibrium or that shows a surplus. For this, what is needed is a legal framework with new legislation that provides security to the new conditions of economic opening and globalization, in which volatility and speculation are taxed and productive investments given priority status.

Strengthening the domestic market by putting a priority on productive investment would have immediate results in job creation and the conservation of purchasing power.

Promoting a financial reform would make it possible to efficiently attract and channel both internal and external savings into production and to turn the financial sector into a lever for economic growth. VM

NOTES

[1] Federal Reserve Chairman Alan Greenspan stated February 23, 1999, that his institution had no interest in being a central bank for the region (see *Reforma* [Mexico City] 6 April 1999). Later, on April 21, at a hearing of the Senate Banking Committee, Deputy Secretary Summers and Greenspan talked of U.S. willingness to support dollarization in Latin America (see *Reforma* [Mexico City] 22 April 1999).

[2] Both the National Development Plan of 1995-2000 and the Constitution establish as a priority objective "the stability of the purchasing power of the nation's currency" and stipulate, "Exchange rate policy must systematically avoid an overvaluation of the real exchange rate which would inhibit internal savings and national production."