Beyond the Border

The Roots of Mexico's Peso Crisis

The recent peso devaluation and volatility have unnerved international financial markets and raised questions about the viability of the Mexican economy. The key to understanding the crisis and the events that led up to it lies in understanding its roots in Mexico's economic reform, especially the Mexican exchange rate policy.

During the mid-1980s and well before the passage of the North American Free Trade Agreement (NAFTA), Mexico began a drive to become more competitive in international markets. Mexico liberalized rules on trade and foreign investment, privatized public firms and reduced unnecessary regulation. Although Mexico's transformation into a more open economy was by no means complete, the country had made significant strides toward freer markets.

As Mexico began to open markets, it also sought to curb inflation. The key element of its monetary policy was the use of the exchange rate as a nominal anchor—that is, Mexico would keep its domestic prices tethered to international prices by targeting the nominal exchange rate. During the initial stages of reform, the exchange rate was fixed to the dollar. Later, the exchange rate was held to a preannounced rate of daily depreciation. In 1991, the exchange rate was allowed to float within a widening band. At first, the top of the band rose 20 centavos (0.0002 new pesos) per dollar per day, then the band was increased to 40 centavos (0.0004 new pesos) per dollar per day (*Chart 1*).

By keeping the exchange rate closely tied to the dollar, especially during the early stages of reform, Mexico could keep exchange rate volatility low and give investors a simple means of monitoring Mexican monetary policy. If expected inflation was higher in Mexico than in the United States or prospects for growth weakened relative to those of the United States, investors' would take dollars from Mexico and seek better returns in the United States. This capital movement would lead to upward pressure on the exchange rate as people who held pesos bought U.S. dollars. If the exchange rate stayed within the band, Mexico would have to tighten monetary policy and increase interest rates to attract dollars back into the country. As long as the exchange rate policy remained credible and Mexico adhered to it, analysts could watch the movement of foreign reserves and anticipate what would happen to monetary policy.

Of course, exchange rate policy alone does not make low inflation credible. Low inflation is made credible only through low and stable monetary growth. Over the long run, monetary policy is what keeps exchange rate policy credible, not the other way around. If monetary policy is too loose and is inconsistent with maintaining the exchange rate, foreign reserves leave the country. Without any foreign reserves to defend the exchange rate, the exchange rate policy has to be abandoned.

From 1987 through 1993, Mexico's monetary policy had been consistent with low inflation and maintaining policymakers' exchange rate targets. Inflation fell from a high of nearly 160 percent in 1987 to around 7 percent in 1994. During 1994, however, political uncertainty in Mexico and rising interest rates in the United States created pressures that began to drain Mexican foreign reserves. Investors began to perceive increasing risks in the Mexican market, but returns were not increasing accordingly, so investors took their money elsewhere. Foreign reserves fell from around $25 billion at the end of 1993 to about $16 billion in July 1994 (*Chart 2*).

The election of President Ernesto Zedillo in August 1994 brought new confidence to Mexico's policies and boosted foreign reserves and the peso. Afterward, however, there were signs of investor uncertainty, and money began flowing out of Mexico again. Without dramatically higher interest rates, foreign reserves continued to leave the country. On December 20, under pressure from foreign exchange markets and with dwindling foreign exchange reserves, Mexico loosened its exchange rate band. The next day, after investor's made a run on the peso, Mexico abandoned the exchange rate band entirely.

If Mexico had increased interest rates after the 1994 presidential elections, perhaps the country could have avoided the lost credibility and higher short-run inflation caused by abandoning the exchange rate policy. But at the time, many analysts were predicting higher investor confidence and appreciation of the peso with the continuation of policies under the Zedillo administration.

Mexico might have avoided its exchange rate problems by letting the peso float after the elections. A floating exchange rate allows a country to weather domestic and international economic shocks without dramatic changes in domestic monetary policy and without casting doubt on the credibility of basic policies. Now that Mexico is floating its exchange rate, economic ups and downs will not generate speculation against any particular exchange rate policy. As long as monetary restraint continues, inflation—over the long run—will remain moderate.

— David M. Gould
William C. Gruben

CHART 1
Peso–Dollar Exchange Rate

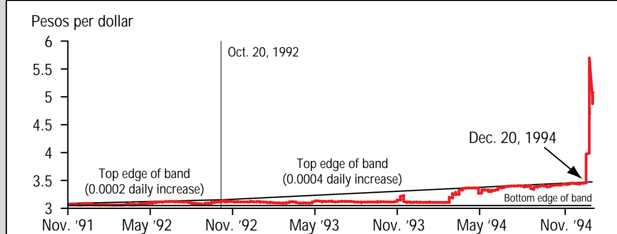
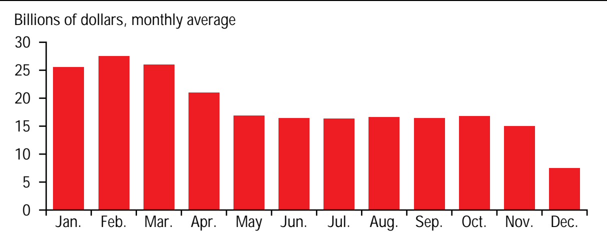


CHART 2
Mexico's Stock of Net International Reserves, 1994



SOURCE OF PRIMARY DATA: Banco de México.