

# The Americas: Don't Fret About Mexico 's Strong Peso By Sebastian Edwards

04/14/2000

The Wall Street Journal

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In spite of Moody's recent upgrade of Mexico 's sovereign debt, there is an unmistakable sense of unease among old Mexico hands on Wall Street.

As the July presidential election nears, analysts and investors are growing more vocal about whether Mexico might once again be rocked by a major economic crisis, as has been the case at the close of each six-year presidential term since 1976. According to Goldman Sachs, the probability of Mexico facing a currency crisis in the near future has increased by one-third during the past two months. The prominent New York investment house also claims that the odds of a crisis erupting in Mexico are only slightly lower than of one happening in Venezuela, a recognized basket case among emerging markets.

Many skeptics base their concerns on two interrelated factors: First, Mexico 's current-account deficit -- a broad measure of the country's international trade imbalance -- is expected to grow to almost \$20 billion by the end of this year, up from \$7 billion in 1997. Second, the Mexican peso has shown remarkable strength over the past 12 months. After weakening to a low of 11 pesos to the dollar in late 1998, Mexico 's exchange rate has rallied to around 9.2 pesos a dollar to 9.3 pesos a dollar. This strengthening has been so pronounced that many Wall Street analysts have argued that the peso is currently overvalued by as much as 20%. This view, however, is largely based on inadequate and outmoded economic models, and ignores some important recent trends in the Mexican economy. The strong peso is, in fact, a sign of economic health.

A currency is overvalued if the authorities maintain its value at an artificially high level while the country runs large current-account deficits. The government can create an overvalued currency in one of two ways: by depleting its international reserves, or if there is borrowing from abroad at an unsustainable pace. Most currency overvaluations are almost invariably the result of lax fiscal and/or monetary policies.

This was the situation in 1993-94, when Mexico was borrowing at the

explosive rate of 8% of gross domestic product annually; it simultaneously used up almost \$20 billion of international reserves to finance gigantic current-account deficits. At the time -- in the middle of an election year -- the government both loosened fiscal policy and continued to provide ample liquidity in pesos, even after the public greatly reduced its demand for money.

Though it is easy to recognize overvaluation after the fact, it is very difficult to do so in real time. For this reason most forecasters resort to methods that use historical comparisons. The most common approach uses the value of the currency in a given year as a benchmark (the year 1995 is the most popular now for analyzing the peso ), measuring whether the exchange rate is "fairly" valued. If the accumulated differential between Mexican and U.S. inflation is greater than the depreciation of the currency over the same time, it is pronounced overvalued. This method indicates that the peso has experienced a real appreciation of approximately 20% since 1995. But appreciation is not the same as overvaluation and one can occur without the other.

The proper way to evaluate whether an exchange rate is overvalued is to consider the evolution of the current-account deficit, monetary and fiscal policy, and those variables that determine a country's ability to compete internationally, such as productivity, terms of trade and trade links. In Mexico 's case, most of the conditions that applied in 1995 have changed dramatically.

When these factors are analyzed carefully, it is clear that the peso 's strength is fully justified on fundamental economic grounds. Indeed, when the current-account deficit is measured relative to GDP (as it should be), its projected level for 2000 and 2001 are 3.8% and 3.2% of GDP respectively, significantly lower than the 8% experienced in 1993 and 1994, and well within sustainable levels. In fact, according to a recent study by Deutsche Bank, Mexico is only one of two Latin American countries -- the other one is Chile -- whose current-account deficit is on a sustainable path. Oil prices are up, Mexican productivity is improving, there is a newly signed trade pact with the European Union, political pluralism is growing and the banking sector has taken steps towards recapitalization. The fiscal deficit -- currently at 1% of GDP -- is lower than that of most industrialized countries. These positive developments have encouraged an influx of portfolio capital, contributing to the strengthening of the peso .

Under these changing conditions there is no reason for the real value of the peso to be the same as in 1995. Furthermore, under the leadership of Guillermo Ortiz , Mexico 's central-bank governor, monetary policy has been prudent. In fact, in spite of some analysts' suspicions that the peso is not really freely floating, there is no evidence that the bank has secretly

intervened during the past two or three years. Moreover the country currently holds enough foreign exchange to withstand a major global liquidity squeeze.

All of this contrasts sharply with events in 1994 when, in the months prior to the August presidential election, productivity was stagnant, the trade imbalance was moving towards 9% of GDP and reserves were being rapidly depleted.

This does not mean that Mexico 's future prosperity is assured. Nor does it mean that the value of the peso should remain forever at its current level. If fundamental economic conditions worsen, the value of the floating peso will weaken and the central bank will have to let the market operate, allowing the peso to find its new equilibrium level. Not doing this would ignite, this time legitimately, concerns about Mexico 's commitment to a freely floating peso .

Mexico 's next administration should step up deregulation, privatize the electrical sector and approve the bankruptcy law. Labor-market reforms are a must if increased international competitiveness is to be attained. Yet even with an unfinished reform agenda, Mexico 's external sector management has improved significantly during the past few years. The main danger in the months to come does not come from an overvalued peso , but from any disappointment the U.S. economy might serve up. A major economic slow down -- whether it is Federal Reserve-induced or a result of a stock-market crash -- will, without a doubt, have a significant effect south of the Rio Grande.