THE ECONOMIC CAUSES AND
EFFECTS OF THE 1976 DEVALUATION
OF THE MEXICAN PESO

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DEDICATION

To my Creator, my grandmother Leonor Reyes Saucedo, my mother Rosalia Reyes Saucedo, my wife Rita Delgado de Sanchez, my daughter Leonor Reyes Sanchez Delgado, and to Mexico, my country.

THE ECONOMIC CAUSES AND EFFECTS OF THE

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TABLE OF CONTENTS

		Page
ACKNOWLEDGMENTS		iv
LIST OF TABLES		vii
LIST OF FIGURES		viii
Chapter		
I.	INTRODUCTION	1
	Purpose and Sequence of Study	5
II.	THE ANALYTICAL AND INSTITUTIONAL BACKGROUND OF INTERNATIONAL FINANCE AND THE ECONOMICS OF DEVALUATION	7
	International Finance and International Economics	7
	International Monetary Experience Since 1870	8
	Fixed versus Flexible Exchange Rates	14
	The Economics of a Devaluation	18
	Major Effects of Devaluation	23
III.	BACKGROUND CONDITIONS OF THE MEXICAN ECONOMY UP TO 1970	26
IV.	CAUSES AND EFFECTS OF THE 1976 PESO DEVALUATION	34
	Balance of Payments on Current Account	34
	Inflation	35
	The OPEC Crisis	38
	Import-Substitution-Industrialization	39
	Confidence Crisis	42
	Consequences of the 1976 Peso Devaluation	46
	Inflationary Forces Persist	47

Chapter Page

Will Petroleoum Save the Day. 49

Current Situation 51

V. SUMMARY AND CONCLUSIONS. 55

NOTES 61

APPENDIX 63

BIBLIOGRAPHY 72

LIST OF TABLES

		Page
Tables in Text		
2.1	PAR VALUE CHANGES, DEVELOPED COUNTRIES, 1958 TO AUGUST 1971	12
Tables in Appendix		
I.	GROSS DOMESTIC PRODUCT, PER CAPITA, MEXICO, SELECTED YEARS 1940-1976.	63
II.	MEXICO: GROSS INVESTMENT AND DOMESTIC SAVINGS, SELECTED YEARS, 1950-1977	64
III.	MEXICO: AGRICULTURAL AND INDUSTRIAL OUTPUT, SELECTED YEARS, 1940-1976.	65
IV.	PARITY OF THE MEXICAN PESO WITH THE UNITED STATES DOLLAR, SELECTED PERIODS, 1940-1978	66
V(A).	MEXICO: DISTRIBUTION OF FAMILY INCOMES	67
V(B).	DISTRIBUTION OF INCOME BY DECILES	68
V(C).	MEXICO: GINI COEFFICIENT FOR SELECTED YEARS.	69
VI.	MEXICO'S NATIONAL CONSUMER PRICE INDEX SINCE 1968	70
VII.	DEFICIT ON MEXICO'S CURRENT ACCOUNT, 1965-1979.	71

LIST OF FIGURES

Figure	Page
2.1	9

CHAPTER I

INTRODUCTION

Mexico, like other third world nations, is striving to achieve economic development. To the student of economic development, the Mexican example offers an interesting laboratory because of the stark contrast between economic development and economic growth. Economic growth is a quantitative concept easily measured and displayed in statistical form, and aside from quibbles over technical matters concerning data gathering and processing, there is general agreement on the primary ingredients of economic growth. Virtually all economists associate economic growth with increases in output measured in real terms, i.e., after the influence of price changes has been deleted, or the increase in real output in per capita terms. While development also includes quantitative elements, it is a more comprehensive and debatable concept. It embraces normative assessments concerning who shares in material growth and who participates in the whole political, economic, social and cultural process. As Kindleberger says:

> Economic development is generally defined to include improvements in material welfare, especially for persons with the lowest incomes; the erradication of mass poverty with its correlates of illiteracy, disease and early death; changes in the composition of inputs and outputs that generally include shifts in the underlying structure of production away from agricultural toward industrial activities; the organization of the economy in such a way that productive employment is general among the working age population rather than the situation of a privileged minority; and the correspondingly greater participation of broadly based groups in making decisions about the directions, economic and otherwise, in which they should move to improve their welfare (1977:1).

Clearly Mexico meets some of these criteria. The crude death rate has fallen from 26.6 per year in 1930 to 9.7 per year in 1970 (Lopez Rosado, 1975:498). In 1970, 94.4% of children between the ages of 7 and 13 attended school (Statistical Abstract of Latin America, 1977, 1978:118). Literacy rates for those above 6 years of age rose from 42% in 1940 to 62.2% in 1960 (Ross, 1971:104). And, with a per capita annual income of close to 1,000 dollars, Mexico is regarded as an advanced developing country (Urquidi, 1978:7: Economist, April 1978:3).

In view of these trends, certainly encouraging when considered in isolation, why do many, including the previously mentioned Victor L. Urquidi, one of Mexico's leading economists and educators, claim that Mexico falls far short of achieving economic development (1978:12). Aside from some important social and political shortcomings, the two main economic deficiencies are the highly skewed distribution of income within Mexico and the lack of productive employment opportunities. James and Evans (1979b) point out that income is sharply skewed favoring the high income groups considering 1950, 1958, 1963 and 1969 . In the late 1960's the top 5% of Mexican families received the same proportion of income as did the lower 80% of families. The four studies also indicated that from 1950 through the 1960's, the lower 70% of families were receiving a smaller share of the total income. And if one takes into account differential impacts of price changes on different income groups, it is possible that the lowest 40% of Mexican families have lost ground in absolute terms as well.[1]

Turning to the problem of providing productive employment opportunities, according to the best available data (1) 9% of Mexico's labor force is visibly unemployed (U. S. Department of Labor, 1979:1), (2) when estimates

of underemployment are included, approximately 25% of the labor force is "unemployed equivalent" (PREALC, 1976:38), (3) when educated guesses are made which include those who drop out of the labor force or never enter it because of job scarcity, approximately one-third of the potential labor supply is "unemployed equivalent" (Casimir, 1976:165), and (4) approximately one-half the labor force is un - or underemployed to some degree (Trejo Reyes, 1975: 677).

In summary, México, in spite of four decades of sustained economic growth at an impressive rate, is still striving to achieve economic development which will, among other things, increase the share of the disadvantaged classes enjoying the fruits of growth and concomitantly broaden the opportunities for obtaining productive employment. Against this economic backdrop, the present thesis will investigate one recent economic phenomenon, namely the devaluation of the Mexican peso late in 1976. This abrupt change in the value of the peso, itself symptomatic of underlying economic problems, will be utilized as a diagnostic tool for uncovering imbalances in the Mexican domestic economy as well as in external economic relations.

On August 31, 1976, Mario Ramon Beteta, Secretary of Hacienda y Credito Publico, the equivalent of Mexico's Treasury Department, and Ernesto Fernandez Hurtado, President of Banco de México, the Mexican central bank, announced that the peso would abandon the exchange rate of 12.50 per U.S. dollar. The following day President Luis Echeverría confirmed in his final State of the Union address that the old exchange rate, which had been in effect since 1954, would no longer be defended. The peso, at least temporarily, was going to be permitted to "float", a process whereby the market forces of the supply and demand for Mexican pesos would determine the value

of the peso relative to other currencies.

Before September 12, 1976, after which a fixed rate of exchange was reinstated, there were widely divergent rates of peso conversion existing simultaneously within Mexico, presumably because of imperfect knowledge on the part of buyer and seller. On September 2, the peso exchanged 20/1 to the U. S. dollar in Acapulco, Guadalajara, Cuernavaca, Tlaxcala, Ciudad Juárez and Reynosa, but in Nuevo Laredo and Cozumel the rate was 25/1. Incredibly, in Matamoros two rates, 17.50 and 30/1 existed at the same time. (Comercio Exterior, 1976:1028).

Turmoil reigned during the month following the devaluation. Prices rose sharply, convertibility into dollars was hindred, flight of capital occured, and generally it was a chaotic event. An article in the New York Times on September 2, mentioned that the peso devaluation would bring forth "a short term of inflation and uncertainty', and that the devaluation would inflict heavy losses, especially on Americans who had been investing in Mexico for several years (NYT Sep. 2, 1976). The Wall Street Journal agreed that the heaviest losses would be on long term investors who had taken advantage of high interest rates offered by Mexican banks and Government. (WSJ Sep. 2, 1976).

A question arises: Why was the Mexican devaluation such a jolt to Mexico as well as the international economic community? After all, Mexico had devalued before--and certainly many Latin American countries such as Argentina, Brazil and Peru devalue frequently, and Chile's currency depreciates daily.

Perhaps the 1976 peso devaluation came as such a shock because Mexico had enjoyed a considerable period of monetary stability. In the 1960's

the International Monetary Fund had put the Mexican peso on a strong currency basis along with the dollar, pound sterling and Swiss frank (Lopez Rosado, 1970:227). Mexico's annual rate of growth in Mexico City wholesale prices between 1958 and 1969 was only 2.2% while the consumer price index rose slightly less than 4% per year, a remarkable record for countries attempting to industrialize rapidly, (RESM, September, 1973:303 and 315). Monetarist economists had begun looking to Mexico as an example of successful economic growth without excessive inflationary consequences. Thus, in view of this impressive record, the steep inflation beginning in 1972, rapid deterioration of the current account and the consequent devaluation, came as a jolt and disappointment to the international financial community and the bulk of the Mexican population.

Purpose and Sequence of the Study

What bearing does the recent behavior of the peso have on the larger Mexican developmental scene? The present study will attempt to provide some of the answers to this question by (1) identifying immediate short-run causes of the devaluation, (2) comparing the theoretical consequences of a devaluation with the actual trends in Mexico since late 1976 and (3) deriving policy lessons for the Mexican Economy from the entire experience.

Chapter 2 provides the analytical and institutional background material for the study by examining the merits of fixed versus flexible exchange rates, reviews selectively the history of the international monetary system, and sets forth the basic theoretical economic analysis of a typical currency devaluation. Chapter 3 presents the main historical contours of the recent Mexican economic evolution, while Chapter 4 compares the theory of

devaluation with the actual experiences of Mexico. The final chapter assesses policy implications and sets forth the conclusions of the study.

CHAPTER II

THE ANALYTICAL AND INSTITUTIONAL BACKGROUND OF INTERNATIONAL FINANCE AND THE ECONOMICS OF DEVALUATION

International Finance and International Economics

International Economics deals with the movement of goods, services (including financial services), people and technology across international boundaries. The heart of international trade, of course, is the movement of goods and services. This is important to any country because complete self sufficiency would decrease efficiency in production as well as "efficiency" in terms of consumer satisfaction. Presumably, each country will tend to export what it can produce relatively more efficiently, and import what it can produce relatively less efficiently. This law of comparative advantage as a criteria for international trade, formulated by David Ricardo in the second decade of the last century, originally relied on a labor theory of value. Comparative advantage was calculated in terms of the amount of labor embodied in the products traded. Although Ricardo's law has been challenged, specifically by the Structuralists and Dependency theorists of Latin America, orthodox thinking would hold that the principle of comparative advantage is still valid as a justification for commerce among nations. Modern analysis, however, has replaced the outmoded labor theory of value with the concept of opportunity cost (Wexler, 1972:59).

Since the doctrine of comparative advantage in now standard fare in elementary economics texts, no further details are needed here except to point

out that the unfettered (by and large) movement of goods and services across international boundaries should increase world welfare and, under ordinary circumstances, the welfare of each participating nation. The primary role of a viable international financial arrangement can be stated simply: it should facilitate or "lubricate" this flow of goods and services with the least possible amount of friction, while providing sufficient financial inducements for the participants. One of the central criteria for measuring the success of a set of international financial arrangements is the ability to sustain a healthy trade in such a way that there is the right amount of international purchasing power, and that the distribution of such liquidity remains distributed such that no country begins to "run out of chips." Too much international liquidity is thought to encourage world wide inflation; too little leads to global unemployment. Maldistribution of international liquidity inevitably leads the illiquid nations to resort to a variety of measures departing from free trade.

International Monetary Experience Since 1870

For a while, dating from the middle of the eighteenth century, it appeared that a satisfactory basis for international financial adjustment was at hand in the form of David Hume's "specie flow mechanism" under the gold standard. Governments commit themselves to buy and sell gold for a specified price in their own currency. The ratio of the gold parties in the participating countries will determine the exchange rates among countries. Finally, banking authorities within each country agree (the "rules of the game") to adjust the domestic money supply upward with inflows of gold and downward when gold flows out.