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Risk and reward: Currency substitution and acceptance of the Mexican peso by firms in the United States southern frontier

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Abstract

This paper explores the usage of a soft currency in a hard currency environment. A stratified random sample of 300 firms based along the U.S. side of the Texas-Mexico border was utilized to determine the degree and nature of the acceptance of the Mexican peso in retail transactions. Our results suggest about one-quarter of all retail firms in the Texas border MSAs of El Paso, Laredo, and the Lower Rio Grande Valley (McAllen and Brownsville) accept the Mexican peso. A logistical regression to determine what factors were significant in the firm-level decision to accept Mexican pesos indicates that location within the border area, distance from a border crossing, firm size, firm type (retail category), and presence (local, regional or national firm) were all significant in the decision to accept/reject the peso.

JEL classification: M2; L21; F3

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1. Introduction

Tens of thousands of people a day travel north from Mexico and cross the border into Texas, both on foot and in vehicles.[1] A vast majority of these individuals make the trip to the border

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[1] In January 2004, 1,550,125 pedestrians and 3,166,394 vehicles crossed north into Texas from Mexico (Texas Center for Border Economic and Enterprise Development, Texas A&M International University).

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cities specifically to shop, or will shop in conjunction with other activities. A common occurrence in these transactions is the use of Mexican pesos as the medium of exchange and not U.S. dollars.

What makes this shopping "event" of not only practical interest to businesses, but also of academic interest to international economists and international business researchers is the ease of movement of a "soft" currency platform (the Mexican peso) into a "hard" currency economic environment. Retail businessmen and women in the region of study have long understood the efficacy of accepting dual currencies in an attempt to attract and maintain customers. Yet empirical investigations have not addressed the occurrence of the use of a soft currency in a U.S dollar-based economy. This is an understandably unique phenomenon to observe and at the same time theoretically sound in its happening.

The present research seeks to examine to what degree retail transactions take place along the Texas side of the U.S.-Mexican border in Mexican pesos. Additionally, we seek to better understand why the purchase of retail goods and services along the border in Texas take place in Mexican pesos when U.S. dollars are widely available. The remainder of this paper is organized as follows, Section 2 surveys the literature, Section 3 details the methodology, Section 4 describes the data, Section 5 presents the model and results, Section 6 discusses the results, and Section 7 concludes the paper.

2. Literature review

Though a well-developed literature exists detailing the vagaries of foreign currency exchange, particularly from hard to hard currency settings (e.g., the EU and the triad) as well as hard to soft currency environments (e.g., dollarization and currency substitution), there exists no accessible literature on the use of a soft currency in a hard currency nation. We believe our study is the first to examine this phenomenon.

There exists a significant literature on currency substitution.[2] This work has revolved almost exclusively around the demand for foreign money by domestic residents as a hedge against the erosion of purchasing power of domestic currency given high levels of inflation (Tandon & Wang, 2003). The foreign money in question that is being held is exclusively that of the major economies, hard currencies substituting for soft currencies. These studies, which are macroeconomic in their approach, also diverge when defining what exactly currency substitution is. Some use it interchangeably with dollarization, where the store of value, medium of exchange, and unit of account functions are transferred to foreign monies. Or simply, *direct* currency substitution exists when foreign currency acts as a means of payment. For this paper will use the latter definition to the extreme, where payment only takes place in cash (pesos). In addition our focus will be at the firm level.

Extant studies examining border retail environments do provide some helpful insights. Nielsen (2002) provides an interesting theoretical discussion of tax differentials between small and large nations that induce consumers to engage in cross-border shopping behavior, with consumer flows depending upon the marginal cost of the tax. Many of the cross-border shopping studies have focused on the topic of tax differentials between neighboring countries as a motivation for consumers to leave their home country to enjoy lower effective prices (see Ferris, 2000; Kanbur & Keen, 1993; Lucas, 2004; Ohsawa, 1999). This literature is important in helping to explain what

[2] See, for example: Girton and Roper (1981), Brand (1993), Clements and Schwartz (1993), Selcuk (1994) Sturzenegger (1997), Uribe (1997), Alami (2001), Selcuk (2003), Prock, Soydemir, and Abugri, 2003.