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The monetary pendulum in Mexico

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First World priorities and the need for nations to coexist in harmony have given rise in each period to a set of rules constituting the international economic order. This is a shifting order, in which national goals move alternatively towards and away from those of an international nature. The objective of the gold standard was to uphold monetary convertibility, if necessary at the expense of national objectives. By contrast, the Bretton Woods system inverted the terms of the equation by making governments responsible for employment and growth. The monetary pendulum is now swinging back again, from nationalism to cosmopolitanism. In the case of Mexico, owing to failures of adaptation, this latest shift has translated into an all-out struggle against inflation that has brought the country to a state of chronic near-stagnation, leaving it trailing in the rear of the world development process.

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I

Introduction

National policies have been conditioned to varying degrees by economic paradigms, the dominant outlook of the first World and the unavoidable need to organize the world economy around a set of rules that must be complied with if nations are to coexist in harmony. Of course, any international order will be subject to conflicts and to asymmetries in compliance; nonetheless, the advantages of joining this order or the disadvantages of staying outside it are particularly intense for peripheral countries.

An essential part of the economic arrangements among nations are the monetary and currency regimes that underpin reciprocal transactions. The abolition of frontiers, the emergence of new economies of world importance and the technological revolution have made change indispensable and agreements much more complicated to reach.

Since the introduction of the gold standard, monetary regimes have been influenced by ideological factors serving to explain, rationalize and implement the distribution of benefits, costs and responsibilities in each world economic order.

This article aims to provide a brief review of the historical swings in the monetary pendulum, emphasizing movements that have opened and narrowed the gap between purely national goals and those of a cosmopolitan nature. The consequences of these movements for development are significant, and they show how completely factors of an ideological nature have become intertwined with the economic life of nations.

II

From the gold standard to Bretton Woods

Although they may be masked, it is possible to recognize the swings of the ideological pendulum governing the long-standing opposition between the demands of the international order and the democratic demands of each country, which are plainly revealed in monetary policies. Until the First World War, the dominant ideologies, together with the weakness of workers' parties and restrictions on the voting franchise, meant that the former demands prevailed over the latter, particularly as trade increased under the influence of the British Empire. The central objective of the gold standard was to underpin monetary convertibility in the most draconian way, with the costs being met by deficit countries.[1] Accordingly, governments and central banks used unpopular measures to combat balance-of-payments deficits, deflating economies by raising interest rates and reducing the money supply; i.e., depressing development, imports and prices.[2]

Subsequently, the devastating repercussions of the great crisis of the 1930s, universal suffrage and the rise of social democratic parties upset political balances and economic paradigms. Citizens increased their sovereign power over the course of national life, colonialism disappeared, the rising spiral of international trade was broken and economies grew as never before. Keynesian policies and the Second World War brought the world out of depression and guided the logic of national strategies, to the point where the State was held responsible for full employment and growth in each country.

As a result, the currency system of the gold standard collapsed and the regulatory power of central banks was weakened; countries raised barriers to trade and capital flows. In the international order, existing agreements were wound up and the so-called Bretton Woods institutions were created. There arose a new monetary/currency regime that, unlike the previous

[1] See Bloomfield (1959) and Eichengreen (1996a).

[2] Besides representing a government commitment to the prevention or limitation of currency fluctuations, fixed parities serve as a nominal anchor for productive agents' operations and expectations about the behaviour of monetary policy.

one, did not stipulate fixed exchange rates. Instead, these could be revised whenever a country could show that it was suffering from a fundamental imbalance and the International Monetary Fund (IMF) accepted this. The IMF itself provided some balance-of-payments financing and permitted national controls on capital movements and, in practice, on trade in goods and services as well.

The system that came out of Bretton Woods reflected political changes that had made it unviable to use deflation in deficit countries as the only way of correcting payment imbalances, and that had opened the way for the most intense period of world economic development in history, particularly in peripheral areas. Parities could be adjusted to eliminate external deficits at lower cost to the country concerned. In turn, controls made it possible to avoid the effects of sudden or speculative capital movements and moderate the build-up of adverse trade balances.

Nonetheless, the agreement only allowed parities to be altered when serious imbalances existed and were recognized by IMF, which reduced exchange-rate flexibility in practice. Before acknowledging an imperative need for devaluation, before admitting that monetary policy had failed, governments and central banks strove to keep the exchange rate unaltered, heightening the opposition between external adjustment and national development goals. For this purpose, they had instruments available to them for increasing protection (tariffs, import permits, etc.) and correcting payment imbalances, at least temporarily.

Meanwhile, under pressure from the United States, the Bretton Woods system sought to re-establish monetary convertibility as a prerequisite for strong growth in international trade. A failed attempt was made to do this with the pound sterling (1947) by means of the Havana Charter, which sought to create an international trade organization; progress with the General Agreement on Tariff and Trade (GATT) was initially modest as well, while the creation of the European Payments Union (1950-1958) was regional rather than multilateral in its approach.

These early efforts foreshadowed, however, the beginning of another swing in the pendulum, away from nationalism and back towards cosmopolitanism. To begin with, attempts to reintroduce universal monetary convertibility came up against conflicts of interest among the developed countries. The European nations, devastated by war, stood out against trade liberalization; to rectify their balance-of-payments situations they would need substantial currency devaluations which would damage the living standards of their populations without fully alleviating the constraints on their production and export capacities (in 1947 Europe had a combined deficit of US$ 7.5 billion).[3] For its part, the United States believed that convertibility was indispensable to create a climate of fair competition for its exports. To help solve the problem, the United States Government agreed to provide substantially greater financing to Europe under the Marshall Plan and other arrangements.

Between 1959 and 1961 the European countries restored current-account convertibility, but left capital-account controls in place. The monetary policy pendulum continued to swing away from economic nationalism as the interests of countries in the developed world became more and more convergent, although not all the difficulties disappeared and new problems arose.

From then on, as the payment imbalances of Europe and Japan were corrected and trade, investment flows and the operations of international firms all increased, the number and power of private-sector actors on the world stage multiplied, while the influence of national governments waned accordingly. Countries began to restore convertibility for transactions on the balance-of-payments current account, making it harder and harder to apply effective capital-account controls, until these too were dismantled in most countries.

From the 1960s onward, Europe and Japan grew and increased their trade, becoming attractive destinations for foreign investment, while the United States began to display persistent trade imbalances.[4] Paradoxically, the dollar was consolidating its position as a reserve currency just as the disequilibria in the United States balance of payments were increasing, creating the danger that the country might decide to relinquish gold-dollar convertibility, thus provoking serious liquidity problems in the world (the Triffin dilemma)[5] and the consequent collapse of the Bretton Woods currency system.

[3] In 1949 the European countries devalued their currencies by about 30% yet were still unable to remove import controls. The way was thereby opened, however, to a solution of their balance-of-payments problems (see Eichengreen, 1996a, p. 98).

[4] As early as 1960 the United States balance of payments was displaying weaknesses that would be considerably accentuated by spending on the Vietnam War and the Great Society projects implemented at the same time.

[5] See Triffin (1960).

III

After Bretton Woods

The post-war monetary system, which rested on the commitment of the United States to upholding the fixed price of gold, was eroded not only by the risks stemming from cumulative United States deficits, but also by the fact that central banks kept most of their reserves in dollars. In 1971, with its reserves shrinking rapidly and the alternative solution of deflating the economy ruled out, the United States abandoned its commitment to the unlimited sale of gold at a price of 35 dollars an ounce, bringing down the Bretton Woods currency regime. Subsequently a variety of currency regimes were tried, but these gradually moved towards the extremes of more or less free flotation on the one hand and fixed parities on the other,[6] creating in the process serious currency misalignments between countries, speculative movements, volatility and contagion that are far from having been rectified.

These developments returned the main responsibility for anchoring the world monetary system to national authorities, closely supervised by the multilateral organizations (World Bank, International Monetary Fund, World Trade Organization). For governments to adopt roles analogous to those they had under the gold standard entails costs, since meeting the standards and requirements of the international order means adopting policies and overruling objections in defiance of the popular will. Furthermore, there are asymmetries in the way the international rules are observed: they are inflexible for the developing world, even in the case of emerging countries, and lax for the developed nations, as is shown by the size of United States external payment imbalances and by government deficits that now stand at between 4% and 8% of GDP in Europe, Japan and the United States.[7]

In the last three decades an undeniable paradox has arisen. While in theory countries are free to choose the currency regime they want, even one that gives a maximum of autonomy to their domestic policies, the international order requires each country to have an open economy and stable prices to remove risks to financial and trade flows, the variables with which hegemonic transnational interests are mainly concerned.

In line with these developments, ideological paradigms have shifted so that, rather than development and employment, it is now the control of inflation that is exalted as the leading social objective. This way of thinking has meant that national governments and their institutions are routinely suspected of seeking political advantage at the expense of the fundamental macroeconomic balances. There is ideological mistrust of the behaviour of the State and full confidence in the markets. Consequently, fiscal policy is often criticized for inducing spending that is too high for the natural rate of growth or employment. The criterion of budgetary balance is embraced in all circumstances, i.e., there has been an implicit renunciation of the use of fiscal measures for developmental or counter-cyclical purposes.

In the sphere of monetary policy, the new approach extends not only to policy design, but to the design of institutions as well. The postmodern view of central banking emphasizes the need to solve what are known as "time-inconsistency" problems, i.e., the inconsistency that arises when governments announce anti-inflation policies and then act against them in pursuit of political or electoral gains that economic theory usually assumes to be transitory. The real or imagined discredit into which governments have fallen has resulted in central banks being made independent so that they can pursue price stabilization objectives without political contamination.[8] External credibility is put first.

[6] The systems tried have ranged from dollarization and currency boards, exchange rates fixed against a particular currency or basket of currencies, fixed or adjustable bands and crawling pegs to managed and free floats, among others. See Mussa and others (2000), Cartens and Werner (1999) and Ibarra and Moreno-Brid (2001). Fixed exchange-rate regimes have gradually become fewer. They are generally adopted by economies that are either small or integrating (like those of Europe) or have chosen the path of dollarization. See Eichengreen and Freden (1998), Obstfeld (1997), Ibarra and Moreno-Brid (2001) and Hauke and Schuler (1993).

[7] The fiscal deficits of the emerging and developing countries now average 3% of output (1.5% in Mexico), while in the advanced nations they average 4% (United States 5.9%, Japan 8.2%, Germany 4%, France 4.1%). The data are from IMF (2004).

[8] Although governments can produce monetary and inflationary surprises, these efforts will fail, argues the theory, if economic agents anticipate them, so that the result will be more inflation without positive effects for development (see Barro and Gordon, 1983, pp. 101-121). More general or detailed approaches can be found in Rogoff (1985, pp. 1169-1190), Giavazzi and Pagano (1988, pp. 1055-1082) and Bernhard and others (2002, pp. 693-723).

Even so, the fact that central banks have less intrinsic credibility in a floating regime means that a complementary fiscal policy anchor is required in the form of a commitment to reducing budget deficits and ensuring that any spending growth is financed from taxes or through open market operations (deferred taxes) that balance out its monetary impact. Fiscal accounts in balance or surplus, independent central banks and the abolition of industrial policies represent a most impressive surrender of economic sovereignty by the Latin American countries, which some of them have taken or been prepared to take to the extreme of abolishing their national currencies, i.e., dollarization (or the creation of so-called currency boards), even in the absence of institutions and agreements for mutual support and participation in the design of joint economic policies, like those of the European Union. If these processes continued, the ultimate outcome would be monetary or economic unions in which the costs would be borne asymmetrically not by the dominant country, but by its periphery.

In short, the use of a combined fiscal and monetary anchor is an approach which is calculated to win external credibility for government anti-inflation policies, but which severely reduces the room for manoeuvre of domestic public policies and gives than a markedly procyclical and undemocratic character. In other words, it represents an effort to bear down on price and interest-rate differences between countries by means of deflation until these variables match those of the leading countries, ignoring the different institutional arrangements and configurations of political forces in each nation.

In this swing back of the monetary pendulum, however, there is one difference from the earlier gold standard. Previously, recessionary policies were implemented as imbalances arose; now they are introduced pre-emptively, condemning many peripheral countries to a kind of chronic near-stagnation that prevents them from resolving the structural failings underlying payment imbalances. The monetary dilemma then comes down to the opposition between external credibility and democratic domestic scrutiny of public policies.

When it comes to currencies, the aspects emphasized by the economic paradigms have shifted with the new circumstances. In the 1990s the debate about the problem of crises moved away from methods of avoiding high and growing imbalances in the current account and unsustainable capital flows, or ideas about the comparative flexibility of prices, wages and interest rates, always with national objectives of growth and employment in mind. The analytical focus of anti-crisis policy now centres on how to maintain and increase international capital flows, while underlying this is the objective of price stabilization in economies. Thus, governments are no longer seeking room for monetary manoeuvre to pursue developmental goals, but have sacrificed monetary policy independence almost entirely to the demands of globalization.[9]

IV

The Mexican response

Mexico is no exception. The independence granted to the Bank of Mexico by a 1993 law sets it the single or overriding objective of combating inflation, while constraining lending to the government. As in other cases, it is unclear whether institutional independence extends only to the use of monetary instruments or includes the unilateral power to set goals of national scope that might differ from or even contradict those of the government and legislature themselves.

Certainly, our recent and not-so-recent history contains instances of governments using and abusing monetary and exchange-rate policy to avoid the political sacrifices involved in prompt action to achieve an indispensable economic adjustment. But the history of the Bank of Mexico and its trusts also contains successes: by channelling private- and public-sector

[9] Summers argues that the prerequisites for reducing the risk of financial and currency crises concern the capital account of the balance of payments, while he makes no mention of current-account problems, treating them as subordinate to the former. According to this way of thinking, foreign investment and lending play a leading role in the developing world, despite the volatility of such flows. These prerequisites are as follows: i) to maintain or create a strong financial system (well-capitalized and well-supervised banks, effective corporate governance codes, the rule of law, contract protection) that can make substantial debt build-ups sustainable; ii) to adopt a fixed-rate or free-floating currency regime to facilitate access to capital markets; iii) to have a stable macroeconomic climate that minimizes monetary and fiscal risks; iv) to build up reserves in proportion to the country's liabilities (see Summers, 2000, pp. 1-16).

funds into new production capacity (along with the development banks), they paved the way for the period of most rapid growth in the country's history, lasting from 1940 until 1980.[10]

Capital-account liberalization exposed the country to volatility, particularly where short-term capital flows were concerned.[11] Sharp movements in the values of the main international currencies (euro, dollar, yen) and recent instances of financial contagion show that developing countries are unlikely to find shelter from destabilizing financial movements when these arise in a globalized economy.

In our case, furthermore, inflation was combated with interest rates that were high by international standards, creating incentives for outside investors to bring in short-term funds that remained in the country only so long as expectations of devaluation did not increase. The resultant overvaluation of the currency can be combated only by costly sterilization measures and reserve build-ups, while there is also an inherent risk that capital inflows might dry up or even be abruptly reversed, as happened between 1994 and 1995. This tendency towards overvaluation intensified in the 1990s as foreign investors bought into numerous public- and private-sector companies, giving rise to large currency inflows that were not used to significantly increase production or export capacity.

The outcome has been a deflationary adjustment process that has been successful in bringing Mexican inflation down towards United States levels. The historical price paid has been an overvalued currency, which has undermined the competitiveness of domestic producers, and a retreat from the strategy of outward-oriented growth and consequent failure to capitalize on demand in international markets.

Abandonment of the fixed parity regime was due, then, to two central factors that perhaps have little to do with development objectives as such. Mexico traditionally used fixed dollar-linked exchange rates as an anchor for monetary policy and, in general, for all public policies. The importance of this function was not minor: it provided certainty in a country where a hegemonic party ran a semi-authoritarian government whose decisions and actions were often opaque to the outside world, to economic agents and to citizens. Until the late 1980s the annual report of the President to Congress was almost the only document which, besides dwelling on government achievements, gave a clue to changes of economic and political direction. Here the amount of international reserves was stated and the information asymmetries between the government on the one hand, and political parties and citizens on the other, were partially remedied. However, trade and financial liberalization left the Mexican economy defenceless in the face of unrestricted —and not always stabilizing— capital and goods flows, and of contagion from external crises.[12] From the national policy perspective, meanwhile, it was and is desirable to avoid the devaluation crises that have tended to occur every six years, chiefly owing to the build-up of price differences with the outside world and their consequences in the form of trade deficits or unserviceable debts. Flotation provides an escape route for both problems, but demands greater monetary and fiscal rigour and greater sacrifices of growth if the goal of reducing price pressures (whether originating in the real economy or in problems of credibility) and bringing domestic inflation closer to the United States level is to be met.

Nor does flotation resolve all possible excesses in public policies, although it may well change their direction. The incentives have now been reversed: the temptation for independent central banks is not so much to facilitate economic expansion, whether sustainable or unsustainable, as to raise interest rates more than necessary or allow the currency to become overvalued to win a temporary and costly advantage in the fight against inflation, their sole or main responsibility. The lower growth that results reduces the incentive to invest, innovate and improve competitiveness, while the higher costs thus artificially generated for domestic producers make it easier for them to be displaced by foreign suppliers,[13] increasing

[10] In addition to the *cajones crediticios*, which lent to activities deemed to be of priority, the main providers of funding were the Fideicomisos Instituidos en Relación con la Agricultura (agriculture trusts) (FIRA), the Fondo de Fomento de las Exportaciones de Productos Manufacturados (manufacturing export promotion fund), the Fondo de Equipamiento Industrial (industrial equipment fund) (FONEI), the Fondo de Operación y Financiamiento Bancario de la Vivienda (housing operation and bank financing fund) (FOVI), the Fondo Nacional de Fomento al Turismo (national tourism development fund) (FONATUR) and the Fondo para el Desarrollo Comercial (business development fund) (FIDEC).

[11] The advantages or disadvantages of capital-account opening have been the subject of intense international debate; leading critics include Tobin, Bhagwati and Rodrik. See Ul Haq, Kaul and Grunberg (1996), Bhagwati (1998) and Rodrik (1998).

[12] See Garber and Svensson (1995, pp. 1865-1912), Obstfeld and Rogoff (2002, pp. 503-535), Bergsten and Williamson (2003) and Eichengreen (1996b).

[13] See Ibarra (1999, pp. 139-160 and 2001, pp. 259-280). See also Villarreal (2003).

import dependency. Thus the circle of stabilizing stagnation is closed, as development incentives are repeatedly reduced and the competitive position of domestic companies in outside markets worsens.

Despite a degree of correction recently, the peso has been almost systematically overvalued between devaluation crises. Although this temporarily reduces inflationary pressures, it damages domestic producers. This is one of the factors accounting for the loss of external markets and for trade deficits averaging some US$ 9 billion, while Latin America as a whole is in surplus (US$ 27 billion in 2003).[14] By contrast, China, Japan, the Republic of Korea and Taiwan province of China have deliberately kept their currencies undervalued to bolster their export trade by means of direct interventions in the currency markets, even where this has contravened IMF rules.[15]

Fiscal policy completes the anti-inflationary anchor of monetary management by deliberately keeping fiscal deficits below the developing-country average[16] and reducing public spending automatically, by law, whenever government revenues fall, irrespective of the position of the economy in the business cycle.

V
Conclusion

To sum up, the country has been drawn into a strategic vacuum that is relegating it to permanent near-stagnation or to a position in the rear of the international development process. The old is not working, and the new cannot be made to work. On the one hand, market and financial opening, the intensification of world technological change and the new forms of economic hegemony have made protectionist strategies anachronistic and unviable. On the other, the anti-inflationary obsession of cosmopolitan globalizers has resulted in our case in policies that are undermining the outward-oriented growth strategy. The use of high interest rates, an overvalued currency and balanced budgets (not just in the current account but in the capital account as well) as stabilization tools is confronting Mexican producers, directly and indirectly, with the Herculean task of not only making up the historical lead enjoyed by the world's best producers, but of doing so under the artificial constraint of an economic policy that is reducing their competitiveness.

This strategic vacuum has effects not only in periods of deflation themselves, when the aim is to bring price rises down to international levels, but well beyond them. The resultant deficits in human capital formation, physical investment, technological modernization and participation in transnational production and trade networks often prove, over long years, to be difficult or impossible to make up. Achieving balance in social goals and their reflection of public policies is, unquestionably, the crucial unfulfilled task of national policy.

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[14] The figures are from ECLAC (2003).

[15] The reserves of these four countries now total more than US$ 1.7 trillion, clear evidence of the enormous currency misalignments in the world and of the need to reconstruct the monetary architecture of the world order (see Bergsten, 2004).

[16] See the figures in note 7.

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