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Monetary policy in the pandemic: the Mexican experience

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Introduction

Almost all countries in the world, if not all, have experienced the pandemic shock brought on by the propagation of the Covid-19 virus. The sudden stop in economic activity instigated by lockdown measures triggered massive disruptions in labor markets, together with a series of demand and supply shocks that had not been dealt with before. The common response from fiscal and monetary authorities worldwide has been countercyclical policies, which means sharp increases in government expenditures and significant expansionary monetary postures. While the health crisis is starting to succumb to vaccination efforts in parts of the world, progress has been vastly uneven throughout regions, while some countries have yet to see the beginning of the flattening of contagion curves and more than 40 countries have yet to apply a single vaccination.

Most of the lessons learnt share a lot of common ground. Many countries, especially those with a profound financial deepening, have enacted massive fiscal stimuli aimed at minimizing job losses and avoiding business closures. The increase in sovereign debt around the world is most likely to be the next big issue to be faced once the pandemic is finally over. Exit strategies from the massive liquidity that is being injected into the world financial system will also likely be another branch in monetary studies. In the future, both fiscal and monetary policy responses will most likely be different from the typical recipes of the past, transformed into some sort of a new orthodoxy.

Yet not all experiences have been the same. Some countries face idiosyncratic characteristics that make following typical recommendations much harder. Fiscal restrictions differ, risk perceptions vary, monetary independences contrast and political situations cannot be compared. Mexico is one these countries that stands out, that has been forced to follow different routes. For starters, the government has decided to enforce strict budget restrictions and not to use debt to finance any expansion of expenditures, which does not allow for any countercyclical fiscal policy. Monetary policy seems to be standing alone, trying to control inflation, inducing a more vigorous economic recovery and maintaining macro prudential conditions in order to preserve financial stability, all at the same time.

Is it possible to achieve these multiple objectives with only one policy instrument? Before trying to answer this question and speculate about the future, I will start by giving a brief background in order to understand how Mexico has arrived at where it is now.

Background

Between 1973 and 1993 Mexico went through two decades of great instability, with inflation averaging 43% per year. The main reason was very high fiscal dominance, created by chronic fiscal deficits that were financed through monetary expansion. In 1983, Mexico was the first country to manifest unmanageable external debt levels which triggered the world financial crisis of the eighties. Inflation soared into triple digit inflation levels and economic growth was absent for almost a decade.

At the beginning of the nineties, Mexico slowly started correcting its disequilibrium, through fiscal retrenchment, the sell-off of public enterprises and the opening up its economy. Not only did it manage to balance the budget, but also to reduce its debt levels. Most of these reforms were deemed successful, but some were neither as transparent as they should have been nor truly solved some of their deep structural problems. For example, many public monopolies were substituted for private monopolies. At the beginning, it solved fiscal imbalances but never created a truly competitive economy, or worse, never corrected its crony capitalism. Massive corruption, weak judicial institutions and a weak regard for the rule of law persisted.

Nevertheless, one very positive achievement was transforming the Central Bank into an autonomous institution, basically guaranteeing the end of fiscal dominance and the reintroduction of the price stability that has persisted over the past 25 years. The first five years were very difficult, but by the beginning of the century the inflation rate was only a one-digit number. Once this was achieved a transition phase towards inflation targeting started and was fully adopted in 2003.

Price stability, monetary dominance and the new role of the Central Bank helped Mexico develop a local debt market and an extension of the government's yield curve. At the start of the century, this curve ended with a one-year bond, however, by 2006 it had extended to 30 years. Once this was achieved, starting in 2008, the Central Bank was able to begin using an interest rate target for the overnight funding market, very similar to what now prevails in most countries.

Since 2003, the inflation rate has averaged 4.1% per year, together with very low volatility. There have only been two bouts of relatively high inflation, in 2008 and 2017, but in both cases the rate never reached 7%. In 2008, inflation peaked at 6.5% as a result of the increases in world commodity prices, while in 2017 it reached a high of 6.8% as a result of a huge once-and-for all increase in gasoline prices. Both cases were brought about by exogenous supply shocks and not by excessive aggregate demand.

Mexico has not truly achieved its inflation target of 3% on a consistent basis. Like most emerging economies, it has continuously faced supply shocks which are harder to control through traditional monetary management. This is evident when pointing out that non-core inflation has averaged 5.7% in the past 18 years, only ending up below 4% on five occasions. By contrast core inflation, which is much more responsive to monetary policy actions, has averaged 3.7% during the same period and has only been above 4% in 3 out of the past 18 years.

Following the taper tantrum in 2013, Mexico faced a couple of years of a continuous weakening of the peso. In spite of this, not only was it able to contain inflation, but it even registered a historical low rate of 2.1%. This allowed it to continue with its monetary expansion phase, until the Federal Reserve started to hike rates in December 2015. However, it once again faced a series of exogenous shocks, including a significant drop in oil prices, forcing the Central Bank to not only replicate the Fed's cycle, but to speed it up by hiking Mexico's rate at a faster pace. Mexico's risk perception increased sharply with Trump's arrival after which the government made a policy error by increasing gasoline prices by over 20% in one fell swoop, pushing inflation to 6.8% by the end of 2017. Even though inflation started coming down in 2018, Mexico faced political uncertainty starting with the 2018 elections and then the arrival of a new government at the end of that year. With inflation above its target and sovereign risk perception remaining high, the Central Bank responded by increasing rates from 3.0% in December 2015 to 8.25% three years later.

Mexico's new government has a very different philosophy than any of the previous governments that it has had in almost a century. Self-described as left-wing, it has proved to be both populist and conservative all at the same time. Its main crusade has been an all-out fight against corruption and the ingrown crony capitalism that has promoted extremely unequal income distribution and widespread poverty. It has tried to be very austere in government expenditures, avoiding financing fiscal expansion through debt and focusing most of its efforts on social programs aimed at lower income segments of the population. In its campaign to end crony capitalism, however, it has created a deep divide with the business sector, which in turn has all but stopped investing. It has created an overall sense of uncertainty and has shown little regard for the rule of law. This caused the economy to enter into a recession phase at some moment in 2019, before the pandemic started. However, this lack of investment problem existed before the current government arrived. In spite of many reforms carried out in 2013, total fixed investment peaked in 2015 and has failed to grow since.

Among its many policies, the present government has pursued an aggressive minimum wage policy, through relatively high increases at the start of each of the last three years. As a result, real mean wages have also increased, something that must be seen as positive given the extremely low average wages that exist. Nevertheless, this policy led to higher price increases in food merchandise prices and other goods with prices susceptible to labor costs, causing core inflation to remain very persistent at levels only slightly below 4.0%.

This explanation reveals the backdrop behind monetary policy up through the end of 2019: a mild recession but increasing sovereign risk and a positive inflation gap. Nevertheless, once headline inflation dropped closer to its target and risk perception improved somewhat, together with the Fed reducing its own rate, the Central Bank felt time had come to start a downward cycle beginning in August 2019. According to my interpretation, this new cycle was initially aimed at moving from a restrictive stance towards neutral territory, not with an intention of transiting toward an outright expansionary phase as long as Mexico had a positive inflation gap.

Thus, between August 2019 and February 2020, the Central Bank reduced its monetary policy rate by 25 basis points from 8.25% to 7.00% on five consecutive occasions - slowly, but continuously, with certain prudence as a result of still high risk perceptions. At the beginning, my thinking was that the Central Bank could reach a rate somewhere near 5.50%, which would have placed its monetary posture in a neutral real rate territory.

However, economic activity fell slightly faster in the last quarter of 2019 while inflation ended the year at 2.8%. With headline inflation slightly below target and the economy falling into a recession, the time had perhaps come for an expansionary monetary phase; there seemed room to easily push the rate down further albeit with certain prudence.

…and then the pandemic arrived

As was the case in most countries, lockdown policies followed, bringing economic activity to an abrupt halt. After a 1.0% drop in the first quarter, GDP fell 16.8% in the second. The Central Bank's first reaction was to speed up the easing cycle by 50 basis points in March, followed up by an additional 50 basis points in an unscheduled announcement in April and coupled together with a ten-point list of additional measures aimed at increasing liquidity, assuring the well-functioning of the payments system and enticing credit expansion for small and medium sized firms.

The largest decline in GDP that Mexico had registered in a single quarter had been a drop of 5.8% in the first quarter of 1995 at the height of the infamous Tequila Crisis. This time, however, the great lockdown caused a 16.8% fall, way beyond anything ever seen. I have been around for a while; I remember well the 1976 devaluation, the lost decade and external debt crisis of the eighties, the Tequila Crisis of 1995 and the Great Recession of 2009. This was far worse than all of that. In April alone, 12.5 million Mexicans lost their jobs and another 8 million were forced to work part-time, earning less than half their previous wages. The extended unemployment rate, equivalent to the U-4 definition used by the U.S. Bureau of Labor Statistics, surged above 33%, meaning that one out of every three Mexicans wanting a job did not have one. Worse still, the U-6 definition of unemployment, which includes part-time employment for economic reasons, went up past 50%. This meant that one out of every two Mexicans who wanted a fulltime job did not have one, equivalent to more than 20 million people.

The Bank of Mexico has one very clear priority mandate: price stability, meaning inflation at 3%, within a variability range of +/- 1%. This means inflation should average 3%, but never be above 4%. Mexico does not have a dual mandate like the U.S. Federal Reserve; nevertheless, monetary policy decisions can never be made outside of the context of cyclical positioning, risk perceptions and financial stability considerations. This means always having to look at the balance of risks of growth and financial stability, together with that of inflation. Even in the context of a positive inflation gap, if one is looking at an almost 30% negative output gap, there is no alternative but to be dovish.

Worse still, the federal government made it very clear that there was not going to be a countercyclical fiscal policy. Using debt to finance expansionary fiscal policies in the eighties ended up being a disaster: a decade without growth in a highly inflationary environment. In the years following the Tequila Crisis, the government used debt to "bail out rich bankers". The current president remembers these experiences vividly and has promised to never again use debt under any circumstance. Mexico thus stayed with fiscal austerity in spite of what every other country was doing and against recommendations of all international institutions. This is without a doubt slowing down the recovery phase. However, Mexico may end up with the benefit of avoiding the major debt hangover that many countries will have to deal with in the upcoming years. Was this the right decision? Only time will let us know.

Looking ahead, Mexico faces an uphill battle. In the first two years of this administration, the government used up all that was available in various fiscal stabilization funds. Oil revenues, which in the previous decades made up a large portion of fiscal income, have fallen to about half of what they used to be. Pemex and CFE, the two largest government enterprises, face huge debt and significant losses that will continue to increase. Expenditures such as pensions and debt service have kept on growing while available resources for public investment have declined for 11 years in a row. Public spending, as measured through national accounts, has failed to contribute to GDP growth. These fiscal restrictions will increase over the next years.

Not only does this leave monetary policy on its own, but with a low level of effectiveness. Compared with most other countries, Mexico has a much lower level of financial inclusion, much less financial deepening, much lower credit penetration and a very high level of informality, all of which hinder the effectiveness of monetary policy. In addition, Mexico's banking system is highly concentrated among seven banks who control almost 80% of the market.

The lockdown brought about both supply and demand disruptions causing huge changes in relative prices, very similar to most other countries. However, in most countries inflation diminished at the beginning of the pandemic, while in Mexico it increased. Changes in household consumption patterns increased the demand for food merchandise and certain non-food goods, while decreasing the demand for many services, especially in

entertainment, travel and restaurants. At the same time, many products faced restrictions in production, causing decreases in supply which in turn caused many prices to increase, in spite of the huge negative output gap. In contrast, in most other countries cyclical conditions prevailed in price formations, leading to negative inflation gaps. In Mexico, however, food prices increased more than in most other countries, while the drop in services was not as strong. Mexico also has higher weights for food merchandise and lower weights for services than other countries. All combined, Mexico has never experienced a negative inflation gap during the pandemic, while the traditional CPI weights under-reported true inflation for households at the time. Part of the problem could well have been that health restrictions reduced potential GDP, making the negative output gap smaller than what models suggested.

Even though monetary policy was left as the only tool, the Central Bank also had to consider that using an aggressive monetary policy response to stimulate the economy by lowering real interest rates, apart from preventing it from achieving its inflation target, could also create problems with the exchange rate and financial stability. It is important to remember that Mexico is a very open economy with almost no restrictions regarding capital flows. The Mexican peso is one of the few emerging market currencies that trades worldwide, 24 hours a day. Given the high interconnection that Mexico has with the U.S., it needs to maintain a higher differential between its monetary policy rate and that of the Federal Reserve, compared to other emerging markets. This means that the Central Bank has to monitor its balance of payment movements carefully and its financial system continuously. What is interesting is that in the second half of last year, exports rebounded to pre-pandemic levels, while imports only recovered partially. This led to a historically high current account surplus. In the third and fourth quarters of 2020, the current account surplus registered 6.6% and 5.8% of GDP, respectively, more than the previous high of 5.2% in the first quarter of 1983. Fortunately, the banking system was in robust conditions prior to the pandemic, with capitalization levels well above Basel III recommendations.

As was pointed out above, the pandemic introduced large distortions in relative prices. Most of these changes, however, are not permanent. Many service prices that fell drastically last year have recovered one year later as lockdown restrictions have been lifted or at least eased. For example, the price of gasoline dropped drastically in April last year as a result of the dramatic decline in travel under lockdown. In April this year, it is expected that the year-over-year increase will be around 35%, pushing non-core inflation up to 12% or more. Combined with other price rebounds, the Bank anticipates headline inflation in April to register a rate somewhere near 6%. With inflation almost at twice its target and expectations for year-end on the rise, there was no choice but to put further easing on hold in the latest decision in March.

Final remarks

Is this just a pause in this easing cycle or has it come to an end? If a terminal point of this cycle has been reached, how long can the pause last before having to make a new movement?

Mexico's recovery phase can be described as difficult and fragile, and is estimated to last more than a couple of years. The most optimistic growth scenario places GDP increasing at 6% this year. Even though 6% sounds impressive and has not been observed yet this century, it is actually a mediocre rebound after falling 8.5% the previous year. It is estimated that the negative output gap, whatever it may be, will prevail throughout the rest of this year. This scenario seems consistent with the need for a continuous monetary expansive stance.

Nevertheless, there has been a surge in inflation in many countries due to base comparison effects that is being labeled as temporary. However, is it really temporary? The balance of risks for inflation is definitely skewed to the upside. World financial volatility seems to have returned as a response to the U.S. fiscal stimulus program, casing yield curves to steepen and the dollar to strengthen. World commodity prices are on the rise and higher maritime transportation costs have been observed. The world economy is forecast to grow rapidly in the aftermath of the pandemic, causing negative output gaps to dissipate. Increased imported inflation with a higher exchange rate clearly poses further risk of inflation. On the domestic front, growing uncertainty pertaining to mid-term elections, real mean wage increases, further hikes in gasoline and electricity prices and an upward revision in mid-term inflation expectations are all evident. Again, this leads back to the possibility that there has been an over-estimation of the size of the negative output gap.

In the context of an improving economy and an upward bias in the balance of inflation risks, it seems Mexico will most likely be on hold for a while. Obviously future decisions are data-driven. But for further easing to take place, core inflation would have to converge to the 3% target quickly and the country would need to experience financial stability on a consistent basis. A very important part of any decision going forward is what the Federal Reserve will do. If it decides to hike sometime before the two-year hiatus that has been promised, there is no doubt that Mexico will have to do the same.

Monetary policy in the upcoming years will face many challenges. Fiscal weakening may eventually lead to country-risk downgrades and even the possibility of losing investment grade status. Higher risk aversion will limit capital inflows and the government's fight with the private sector will continue to prevent investment from growing. Mexico will face mid-term elections in June and it is quite likely that the Bank will confront mounting political pressure from what was been an aggressive legislative body and an overly ambitious president. The Governor of the Central Bank finishes his term at the end of this year; obviously his replacement will be key. While the Bank's main objective is price stability, it is also responsible for macro financial stability and a well-functioning payments system.

Decisions will be made to attempt to find a balance among all these factors, with the additional burden of somehow contributing to the post-pandemic recovery of the economy.

Will it be possible to achieve these multiple objectives with only one policy instrument? Maybe, maybe not. Only time will tell.