Mexico’s Recent Road to Stability

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Outline

1. The Need for Economic Stability

2. Towards a *Mexican Great Moderation*?

3. Stabilization: Strategy and Challenges

4. Economic Outlook
Economic stability has regained attention

- Economic stability refers to a lengthy period of low volatility in real economic variables

- In the United States, the period from 1984 to 2007, which revealed such characteristics, was known as The Great Moderation.

- The topic was popular in past decades but left the spotlight because it was taken for granted in many countries.

- However, as a result of the recent global financial crisis, it has regained attention.

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Economic stability is desirable

- Economic stability avoids welfare losses
  - Most humans dislike uncertainty
  - The size of welfare losses is debated

- Many economists consider governments should try to lessen economic fluctuations

- However, there is a tradeoff between the costs and expected benefits from government intervention, which is hard to evaluate

Economic and price stability could be associated

- Central banks are concerned with attaining price stability

- In practice, economic stability tends to be associated with an environment of low and stable inflation

- The cost of economic instability increases with volatile consumption spending, as in emerging economies

- High and unstable inflation imposes large costs, especially on low income population

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Except for the 1976-1995 period, the U.S. and Mexico exhibit similar output volatility.

Mexico and U.S. Total Output Fluctuations
(Deviations from a Hodrick-Prescott trend of GDP)

Source: BEA and INEGI (own calculations).
... and inflation volatility as well

Inflation
(December to December CPI % change)

Source: BLS and Banco de México.
A new era of economic stability seemingly emerged

- In 1995, Mexico suffered a significant economic contraction, a large currency devaluation and a surge in inflation.

- Since 1996, and excluding the years of the recent global crisis, most economic indicators have followed a smoother path.

- We can call this recent period *The Mexican Great Moderation*.
As in the U.S., inflation has decreased and become less volatile.

**Mexico: CPI inflation**
(End of year annual % rate)

**United States: CPI inflation**
(End of year annual % rate)

Source: Banxico

Source: BLS
Economic and price stability have come together

Volatility in Output and Prices
(Standard deviation of annual growth, %)

<table>
<thead>
<tr>
<th></th>
<th>Mexico</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>4.0</td>
<td>2.4</td>
</tr>
<tr>
<td>Consumer Prices</td>
<td>37.7</td>
<td>7.7</td>
</tr>
</tbody>
</table>

Source: IMF, Banco de México, BEA, Federal Reserve, and BLS
In Mexico, the causes of stability seem clearer

- The main cause of the U.S. Great Moderation is still being debated\(^1\)
  - “Good luck” or
  - Monetary policy

- The causes of Mexico’s stability period seem to be clearer: notably, better economic policies
  - A stronger fiscal position
  - An improved monetary policy framework

... and “good luck” from abroad

The main source of instability was fiscal fragility

- It is easier to assign a greater weight to improved economic policy in Mexico, because there was much to correct.

- The main source of instability was fiscal mismanagement and vulnerability to external shocks.

- High and volatile government expenditure and unsustainable public debt, especially foreign and dollar-linked debt, induced recurrent crises.
From 1973 to 1982, the fiscal deficit was partly financed by the central bank.

Although in 1983 such practice was abandoned, a policy of continuous currency devaluations was implemented, pushing inflation up.

In 1987, a stability pact was attained based on a fixed-exchange rate regime.

However, among other factors, mounting short-term Tesobonos led to a balance of payments crisis, recession and inflation in 1995.
Increased fiscal deficits have preceded inflation

Mexico: Public Sector Borrowing Requirements and CPI Inflation
(Percentage points of GDP and annual rate of growth in %)

Sources: Banco de México and INEGI
High volatility caused the impression that Mexico’s economic activity had little correlation with that of the U.S. prior to the *Mexican Great Moderation*.

Since 1996, the correlation between GDPs and industrial productions became higher.

However, controlling for exchange rate volatility, this correlation was already high before.
Industrial cycles were already similar

Industrial Cycles with Raw Data
(Deviation from a HP trend)

- Detrended Mex Industrial Production
- Detrended US Industrial Production

Source: Federal Reserve and INEGI.

Industrial Cycles with Adjusted Data
(Deviation from a HP trend)

- Detrended Mex Adjusted Industrial Production
- Detrended US Industrial Production

Source: Federal Reserve and INEGI.

Note: The lines of the left were obtained applying the Hodrick-Prescott (HP) filter to annual data. The Mexican line on the right was obtained after controlling for the real exchange rate and the 1987 stabilization plan.
Did the *Mexican Great Moderation* end with the recent crisis?

- The impact of the recent global crisis was substantial
  - The Mexican peso depreciated almost 40% between September 2008 and March 2009
  - Output fell by 6.5% in 2009

- However, this crisis was not caused by domestic economic policy but by a large external shock

- As long as good policies continue, prolonged instability is not unavoidable
The global crisis involved a widespread “flight to safety”

**Mexican Peso Exchange Rate and U.S. Effective Exchange Rate**

(Index January 2008=100)

Source: Banco de México and Federal Reserve

1/ EER is US dollar effective exchange rate against currencies of a large group of major US trading partners.
Mexico’s GDP and U.S. Industrial Production
(Index December 2007=100, s. a.)

s. a.: Seasonally adjusted
Source: Federal Reserve and INEGI
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Stabilization required the reversal of fiscal dominance

- Flexible exchange-rate regime

- Low fiscal deficit on a more sustainable basis
  - Enhancement of revenue sources
  - Automatic expenditure cuts in case of revenue shortfalls
  - Federal Act of Budget and Fiscal Responsibility

- Better public debt management
  - Lower exposure to foreign currency
  - Development of domestic debt markets for long-term maturities
… and the strengthening of monetary policy

- Effective independence of the central bank
  - Isolation from fiscal pressures

- Credibility based on consistent monetary policies and commitment to targets

- Evidence that monetary policy contributed to reduce economic volatility

- No evidence of “sacrifice ratio” during disinflation
  - Years of faster growth during the *Mexican Great Moderation* coincided with the largest declines of inflation
  - The external environment was favorable

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Challenges for fiscal and monetary policies

- Further strengthen the fiscal position
  - Reduce revenue dependence on oil
  - Improve tax efficiency and effectiveness
  - Increase spending efficiency

- Consolidate price stability at the 3% inflation target
  - Avoid regressions to past mistakes
  - Awareness of the limits of what monetary policy can and cannot do
Mexico’s challenge for long-term growth

Mexico and U.S. Total Factor Productivity
(Index 1980=100)

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World economic recovery will continue

- Since mid 2009 the world economy has been recovering, although at different paces among regions and countries.

- The U.S. rebound has encompassed all components of aggregate demand.

- High unemployment and low consumer confidence in the U.S. probably contribute to explain some recent signs of lower dynamism.

- An accommodative monetary policy in the U.S. is expected to continue.

- U.S. growth is likely to slow down during the next two years; nevertheless, the event of a “double dip” seems distant.
The Mexican economy is expected to perform favorably

- During the first half of 2010, Mexican GDP exhibited a positive annual change

- The main driver of the upturn has been the U.S. demand for Mexican manufacturing exports

- Domestic spending, especially investment, and construction have been the laggards

- The expected range for GDP growth is 4.0-5.0% in 2010 and 3.2-4.2% in 2011

- After a transitory mild upsurge at the end of 2010, inflation is expected to converge to around 3% in 2011
Final remarks

- Mexico has suffered long periods of economic and price instability that have severely depressed living standards.

- Since 1996 a new stability era seems to have emerged based on sound fiscal and monetary policies.

- The recent global crisis does not have to imply a return to instability.

- Strengthening fiscal and monetary foundations can widen the stability benefits in the future.

- Reforms to enhance productivity and thereby the economy’s long-term growth potential should be a high priority.