Discussion of the History of Mexico

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This chapter does an impressive job of covering, with a significant amount of detail, the last half century of Mexico's macroeconomic history. The use of an analytical framework centered on the government's consolidated budget constraint gives the chapter a useful, but incomplete, structure for describing and analyzing such a long period. The chapter clearly establishes that the currency and financial crisis of 1982 was deeply rooted in fiscal mismanagement. However, after that period, the sources of the increase in inflation from 1986 to 1995 can hardly be associated with fiscal dominance. The chapter also does a very nice job of describing the transition of the monetary policy framework in Mexico toward an inflation-targeting regime during the last twenty-five years. Given the magnitude of the topic covered in this chapter, these comments will focus on complementing it by concentrating on the following seven themes.

First, a key feature of the monetary policy framework in a small open economy is its exchange rate regime. So describing how the exchange rate regime evolved in Mexico during this period is important, as it influences how the transmission from fiscal and monetary variables to inflation happened. During the period covered in the chapter, Mexico moved from a fixed exchange rate regime to a fully floating regime. During this transition, Mexico experimented with managed floating regimes, capital controls, crawling pegs, and crawling bands (see Table 1).

During the nonfloating periods, the transmission from fiscal dominance to inflation is diminished during a first stage by the control of traded goods prices implied by the fixed or predetermined exchange rate. Therefore, the nontradable goods component should be a better indicator to pick up this dynamic in the early stages of this process. However, the inconsistency between the fixed or managed rate and the expansion of the money supply needed to finance the public-sector deficit eventually shows up in a decline in international reserves. Once this process intensifies, the central bank is forced to devalue the currency, and inflation increases. This is the pattern present in the 1982 and 1994 crises. Although both these crises were preceded by a deterioration of the fiscal stance (see Figure 3 in the chapter), I concur with the author that in the second case, debt dynamics did not point toward unsustainability, and other factors were a more important source of the collapse of the peso. In future work, it will be useful to complement the analysis by including the

Table 1. Summary of Mexico's exchange rate regimes since 1954

Date	Regime	Exchange rates	Quotes*	
			Beginning	End
April 19, 1954–August 31, 1976	Fixed	Fixed	$ 12.50	$ 12.50
September 1, 1976–August 5, 1982	Managed floating rate	Currency/ document transactions	$ 20.50	$ 48.79
August 6, 1982–August 31, 1982	Multiple exchange rate	General	$ 75.33	$ 104.00
		Preferential †	$ 49.13	$ 49.81
		Mexdollar ‡	$ 69.50	$ 69.50
September 1, 1982–December 19, 1982	Generalized exchange rates, control	Preferential	$ 50.00	$ 70.00
		Ordinary	$ 70.00	$ 70.00
December 20, 1982–August 4, 1985	Exchange's control	Controlled	$ 95.05	$ 281.34
		Special	$ 70.00	$ 281.51
		Free	$ 149.25	$ 344.50
August 5, 1985–November 10, 1991	Regulated float	Managed equilibrium	$ 282.30	$ 3,073.00
		Free	$ 344.50	$ 3,068.90
November 11, 1991–December 21, 1994	Exchange rate bands with managed slippage	FIX	$3,074.03	N$ 3.9970
December 22, 1994–present	Free float	FIX	N$ 4.88	-

Source: Banco de Mexico

Note: *Buy/sell average. Guide: $ = "old pesos"; N$ = "new pesos."

evolution of international reserves and breaking down the behavior of inflation into its tradable and nontradable components.

Second, the chapter points to two very interesting periods that might deserve further comments. The first period is the 1976 crisis, in which the Mexican peso was devalued by 55 percent and the pass-through to inflation was relatively low (compared with the 1982 and 1994 experiences). Therefore, a deeper discussion regarding the role of fiscal policies, external factors, the credibility of the central bank, and other issues in shaping this successful devaluation is needed. The second interesting period is from 1985 to 1987, when inflation accelerated while the primary surplus continued to increase. Again, an attempt to measure the role of policies and external factors such as the decline in the price of oil and the 1985 earthquakes would be needed. With respect to the role of policies, it is in this period when the central bank embarked on a more aggressive crawling-peg strategy, aimed at containing the appreciation of the real exchange rate. As a result, it might be possible that during this period, Mexico lost its nominal anchor.

Third, in the discussion of the period that followed the 1982 crisis, the author praises the fiscal effort made and implies that nominal instability was the product of other forces. However, the chapter does not attempt to undertake a debt sustainability analysis to establish that the fiscal effort was sufficient to stabilize the debt ratios. This exercise is needed because even after the important fiscal adjustment, many voices argued that the country was facing a debt overhang problem. Actually, it was only after the Brady Plan (1989) took place that Mexico was able to move forward and embark on a successful stabilization process.

Fourth, an interesting extension of the fiscal dominance model that is developed in the chapter to describe the 1994 crisis would be to allow for the materialization of contingent liabilities associated with financial system crises, as developed in Velasco (1987). In this case, it is the future monetization of this fiscal pressure that leads to the crisis. The chapter also discusses the possibility that the materialization of this financial crisis might be contingent on a discrete devaluation, opening the door to multiple equilibria. Another extension of the model that is not discussed is also related to third-generation models of speculative attacks that focus on the possibility of multiple equilibria associated with the foreign exchange market (FX) or short-term debt. All these issues were clearly present in Mexico at the time, as the financial sector was extremely vulnerable and public debt was short term and heavily dollarized.

Fifth, an interesting discussion in the chapter is the role played by central bank independence to achieve long-lasting nominal stability in Mexico. The chapter argues that the granting of constitutional independence was key to breaking fiscal dominance. However, as is clearly shown in the chapter, an important fiscal adjustment preceded the granting of independence to the central bank. And the additional effort undertaken after the currency depreciation is similar to that undertaken after the 1982 crisis, when the central bank was not independent. In addition, during 1995 Mexico entered into a large International Monetary Fund–U.S. Treasury financial support package that allowed the country to repay its future debt obligations and carried significant policy commitments. Thus it is difficult to establish causality from central bank independence to financial and policy variables when other important elements came into play. Moving a bit further from the 1995 policy reaction, the governments that were in place from 1995 to 2018 had a very defined orthodox bias regarding fiscal policy and low inflation. So in this period we might have seen an outcome that was more the product of fully aligned objectives between fiscal and monetary policies rather than the institutional strength granted to the central bank by its new charter. In this regard, the Latin American experience is interesting to study, since we can look at the case of fully independent central banks (Chile, Colombia, and Peru) as supporting the thesis that independence is key to breaking fiscal dominance on one side, but we can also look at the Brazilian experience with a less independent central bank achieving stability, even under a very weak fiscal stance.

Sixth, the chapter is silent regarding the evolution of fiscal institutions in Mexico. In 2006, Mexico passed a new fiscal responsibility law that included a balanced budget rule, a rule-based system to set the price of oil in the budget, and other fiscal discipline elements. This framework has been modified a few times since then. An assessment of the role of these adjustments to Mexico's institutions in the recent evolution of fiscal policy would be a nice extension to be undertaken in future work.

Finally, the section on the convergence to an inflation target concludes with the assertion that monetary policy in Mexico has become as credible as in any developed country. While I fully agree that the structural change that took place in the monetary framework, supported by fiscal sustainability, has anchored inflation expectations, at least three elements for Banco de Mexico to achieve a developed country's level of credibility are clear challenges. First, when confronted with negative supply shocks, Banco de Mexico still increases interest rates to avoid an unanchoring of inflation expectations, making monetary policy procyclical. Second, Banco de Mexico still overreacts to exchange rate movements, both with interest rates and with direct FX interventions, compared to advanced countries' central banks. This also calls for a deeper discussion of the FX intervention policies carried out by Banco de Mexico. Third and last, Banco de Mexico still needs to anchor medium-term inflation expectations to the inflation target. For a long time now, market participants' inflation expectations have been slightly above the target. This is the last frontier in Banco de Mexico's quest for full credibility, as its medium-term inflation target is not fully internalized by market participants and price setters in the economy.

Reference

Velasco, Andres. 1987. "Financial Crises and Balance of Payments Crises: A Simple Model of the Southern Cone Experience." *Journal of Development Economics* 27 (1–2): 263–83.