

**Strong Currency, Weak Economy:
The Case of Mexico**

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The Importance of Nominal Exchange Stability Within the Context of Financial Liberalization

Financial liberalization, free capital movements and consequent capital markets' liberalization, have increased the importance of the exchange rate management, due to its significance in determining capitals' value, as well as the constant impact that financial transactions originate upon the relation of currencies' exchange. Financial investment realized in emergent countries loses in terms of dollars with currency devaluation of such countries, and it earns with nominal stability and the exchange rate value, because this allows it to increase earnings in terms of dollar.

In the face of the importance that exchange rate has within the framework of capital markets' internalization, it makes that its determination is sub-ordinate to international financial capital demands.

Emergent countries' governments and central banks are pushed to operate with low inflation and to homologate it with developed countries to avoid nominal exchange parity anxiety, to save international financial capital's profitability conditions, so that capital flows are positive in their countries. Also, exchange rate stability is necessary within financial liberalization in order to avoid speculative practices that might provoke financial markets instability.

Policies to Achieve Exchange Stability

Latin American economies have no domestic macroeconomic, productive and financial conditions to reduce inflation in order to achieve nominal exchange rate stability. Countries with low productivity and heavy pressure over their macroeconomic fundamentals, have been able to reduce inflation through promoting capital inflows. This allows to cover

current account deficit and to increase international reserves to face attacks coming from international financial markets' fluctuations, to guarantee exchange nominal stability and free convertibility.

Hencefore, policies are directed to expand foreign capital influence within the national atmosphere, among which liberalization's acceleration and economic deregulation are significant, as well as privatization and domestic assets' foreignism, the establishment of profitability conditions, and reliance demanded by such capital. UNCTAD's Report says that "it is very difficult for a country to resist a strong tendency towards capital movements liberalization if links with the international markets are closed through Direct Foreign Investment (DFI) and trade flows". (UNCTAD, 2001, chapter V).

Latin American governments privilege restrictive monetary and fiscal policies considering that these ones would avoid demand's pressure over prices, the foreign sector, and public finances, to reach economic performance that guarantees exchange stability. Fiscal discipline, supported by investment decrease and public expense, as in the privatization process of public assets, expands investment frontiers to national and foreign private capital, promoting its entrance, and domestic currency value. To this process, there is central bank's autonomy, to privilege only restrictive policies that rely on high interest rates aimed at increasing financial profitability to attract capitals. So, defending such postures, there is Carsten Hefeker's position stating that "to achieve credibility, monetary policy regulations are required to prevent inconsistent policies. Fixed exchange rates are seen as an obliged compromise". (Hefeker, 2000, p. 162).

Exchange Value Policy and Foreign Financing

Exchange rate anchorage policy, high interest rates, fiscal discipline and growing national assets' foreignism, being fundamental for the promotion of capital inflows, conform the financing pattern that allows our insertion into globalization, as well as exchange stability and inflation's decrease. In relation to this, María Concepción Tavares says that "exchange

rate over-valuation is a characteristic sign of a financing model of a monetary pattern through foreign indebtedness” (Tavares, 21/06/98).

Inflation’s decrease and exchange nominal stability are not sustained over domestic financial and productive basis, but on capital inflows. Factors concurrence, ad the so called structural reforms of market’s orientation (that have expanded profitability and the international capital influence frontier), have made possible financing that facilitates inflation’s decrease at the Latin American economies.

United States’ economic dynamics during the nineties played a significant role in currency flows to Mexico, through exports growth of this one, as well as through greater capital inflows due to growth expectations compliance, which worked in favor of the nominal exchange rate stability.

When an economy presents fixed or stable exchange rate, and growth expectations, it attracts capitals, these ones generate stock exchange boom that stimulate more capital inflows to such markets. This increases currency supply, which values national currencies and reduces inflation.

When external factors perform an essential role in the nominal exchange stability, this one is highly vulnerable in front of such factors.

At the beginning, the exchange rate is dissociated from purchasing power’s parity and from foreign trade balance’s adjustment.

The economic policy is circumscribed to perform the objective of inflation’s decrease through nominal stability or exchange (valuation) so active exchange policy stops (flexible around domestic prices’ differential versus foreign ones) to adjust trade balance.

Free capital movements, capital markets’ internationalization and growing demands for capital inflows that require Latin American countries, prevent exchange rate’s active use, so

they conduct it to dissociate it from the principle of the purchasing power's parity, because it does not align with the exchange rate in relation to prices' differentials, which is required to guarantee the law of unique price, necessary for commercial goods to sustain the same price in both countries, so it may counteract productivity differentials, both, to protect and to develop the national productive plant in front of imports, to improve national enterprises' accumulation dynamics, and to diminish foreign trade deficit and the growing capital inflows dependence.

The law of unique price stops to operate within the context of financial liberalization, because it would touch profitability levels that financial capital demands, so the exchange rate stops being an adjustment variable of foreign trade deficit, and of industrial policy, to constitute itself into a financial instrument.

Nominal and Real Exchange Rate*

(December 1996 = 100)

Nominal Exchange Rate

NCPI (Mexico)

CPI (US)

Real Exchange Rate

Exchange Value (%)

*December each year

** May 2001

Real Exchange Rate = Nominal E. R.* (Prices Mexico/Prices US)

Real Exchange Rate = [(Real E. R./Nominal E. R.) - 1] *100

Source: Bank of Mexico, Economic Indicators; U.S. Department of Labor, Bureau of Labor Statistics

Government of Mexico has defended nominal exchange rate's stability in spite of facing pressure over the foreign trade balance. In the figure above we can observe exchange rate value of about 31% accumulated from 1996 up to half year 2001. On the other hand, foreign trade balance went from a superavit of 6831 million dollars in 1996, to a deficit of

8049 million dollars in the year 2000. Settlement balance's capital account superavit went from 4069 million dollars to 17920 million dollars in the period.

Current globalization scheme, foreign trade deficit, and the settlement balance's current account stop determining the exchange rate (at least temporarily, while there is enough capital inflows), so that such deficit might be adjusted. Capital inflows and the consequent settlement balance's capital account superavit, makes the exchange rate to stop being determined temporarily by the settlement balance's current account position.

When facing current account deficit through the settlement balance's capital account superavit, nominal exchange stability and high interest rate policy are essential for the financial market's development and for capital inflows. Besides, there is the fact that exchange undervalue does not realize the enough adjustment at the foreign trade balance to be able to reach trade superavit needed to finance foreign debt's service settlements. (In Mexico, at the end of 1994 and the beginning of 1995, the exchange rate was devaluated to be able to adjust foreign deficit, and the achieved trade superavit –about 7 billion dollars– was not enough to finance debt service's burden that was about 14 billion dollars). (Huerta, A., 1997).

Flexible Exchange Rate and Value

After fixed exchange rate led Mexico and other countries to exchange crises, a flexible exchange rate was taken, for it was considered as a better alternative to adjust foreign sector, to face international financial markets fluctuations, and to avoid financial and exchange crises. Exchange regime's supporters point out that it allows larger margins for the economic policy flexibility to reduce interest rates as well as to increase monetary supply, and public expenditure for growth.

Nonetheless, fluctuating exchange rates within the context of financial liberalization is not realized by domestic prices differential versus foreign one, necessary (in principle) to avoid

foreign sector's distortion. This free flotation does not operate, even if the Mexican government is pointing out that it is working with flexible exchange rates.

Exchange rate flexibility is due according to currency's demand and supply, so the government establishes economic policies aimed at increasing supply and decreasing currencies' demand, as well as to have enough settlement balance's capital account superavit to sustain nominal exchange stability and value. This is why financial liberalization is accompanied by fiscal discipline policies (supported by expenditure cut and enterprises sales), by rational and moderate monetary supply, by high interest rates and by permanent privatization and foreignness of enterprises. These policies diminish pressure over prices' demand and the foreign sector, as well as currencies' demand, and on the other hand, they stimulate capital inflows, increasing currency's supply.

In spite of the fact that the government takes the flexible exchange rate, the same economic policies that predominated within the fixed exchange rate regime are still operating, so there are no free margins within the economic policy management that flexible exchange rate offers. Besides, there is constant IMF's support for financial resources' transference for foreign debt's settlement, as well as from World Bank, the United States Federal Reserve to Mexico and other Latin American countries, which allows to support national currencies.

When capital flows are guaranteed, monetary and finance authorities do not adjust exchange rate in relation to domestic prices differential versus foreign prices to adjust foreign trade deficit, so a valued exchange rate is composed, which maintains latent pressures over deficit.

Exchange value is set under competitive disadvantage of national production in front of exports, so it attempts against the enterprises' accumulation dynamics. It de-capitalizes them, it increases unemployment, domestic and foreign indebtedness levels, bank insolvency and instability, as well as foreign trade deficit, so, soon it will generate national currency's devaluation. Cardim de Carvalho, et. al. say that "fixed exchange rates...instead of producing convergence among the region's economies they produce divergence."

(Cardim, et. al., 2001, p. 451), because such policies stress upon competitive differences against the countries that establish them, affecting their accumulation dynamics, and therefore their investment growth. This makes evident the high cost that it implies to realize foreign sector's adjustment through capital inflows.

Flexible exchange rate does not exempt Mexico from possible crises, because such a policy does not protect the productive plant, or the foreign trade balance, so the productive sphere's de-capitalization goes on, as well as bank instability, and macroeconomic imbalances, placing the country within a context of high fragility and vulnerability, due to incapacity to generate endogenous growth conditions to be able to face up foreign shock.

Prices Stability and Interest Rate

The objective of inflation's decrease is introduced by monetary authorities, believing that with this step, interest rates will decrease, pushing investment and economic dynamics. Nonetheless, such a situation does not occur.

Predominant exchange regime has not allowed domestic interest rate's discretionary management in favor of growth, because exchange flexibility has been achieved through currencies demand and supply's behavior, and, with this, the interest rate realizes an active role. Besides, high interest rates predominance is due to the predominant capital's short-term financial character that flows to the country. In spite of the fact that Mexican interest rate has significantly decreased during the second semester in the year 2001, in contrast to previous year (from 18% at the end of the year 2000 to 7% at the beginning of November 2001), it is still keeping an attractive real margin in contrast to the United States' interest rate (that in real terms it is below 1% in November 2001), to be able to continue attracting capitals.

Predominant exchange policy keeps latent pressure over foreign deficit, obliging to establish real high interest rates to avoid capitals' flight and to continue attracting them to

finance such deficit. It is a pernicious cycle that leads to larger foreign indebtedness levels, and to greater international financial capital's presence in all national markets.

So, exchange value is not translated into lower real interest rates, for it demands growing capital inflows. The problem is that interest rates' increase, which obliges nominal exchange stability, impacts upon public finance and upon the productive sector, the bank system and the foreign sector, which goes on demanding high interest rates to attract capitals in order to finance such imbalances. High interest rates make more expensive and hold productive investment and productivity's growth, putting national production into grater competitive disadvantage in front of imports.

Exchange value and high domestic interest rates, take enterprises to look for foreign financing, because this one is cheaper, so the private sector has been significantly increasing its domestic debt. Private sector's foreign debt in Argentine during the decade of the nineties, increased 10 times, and in the case of Mexico, it did six times.

The interrelation between the interest rate and the exchange rate within the context of financial liberalization, lead governments to not having monetary, credit, fiscal and exchange policies to be able to push productive investment. Interest rates and the exchange rate cannot respond to domestic financial and growth needs, but on the contrary they are established according to capital inflow needs. Basil Moore says that "high and low limits – of the domestic interest rate- will depend on the interest rate level worldwide, on the domestic exchange rate level, and on the size of the domestic economy's opening, where the interest rate's differentials induce international capital flows to exchange markets". (Moore, 1988, p. 380). Likewise, María Concepción Tavares says that "we are prisoners of the high interest rate and of the exchange rate, and we are more dependent on financial markets oscillations" (Tavares, 12/10/97).

When profitability is jeopardized by exchange parity's modification expectations, the government increases the interest rate to counteract (through earnings at the money market) loss that the exchange rate modifications might provoke, in order to keep capital at the

domestic market. When the interest rate does not accompany inflation's reduction, it makes possible capital inflows, so the nominal exchange rate adjusts less to the domestic prices' differential versus foreign prices, so low accumulation and insolvency go on, as well as pressure over foreign trade balance and the growing requirements of capital inflows, consequently, exchange risk continues.

It is Intended to Homologue Inflation to the Developed Countries Inflation.

Mexico is pretending to homologue its inflation to United States' inflation to avoid competitiveness loss. The problem is that it is trying to do so through stabilizing the exchange rate in nominal terms. With such exchange parity, it is important low United States' inflation, who is its main commercial associate, specially on trading goods, but domestic growth of non-trading goods' prices goes on, which are the ones that explain the domestic prices' differential versus foreign prices. Such a way of reducing inflation is very expensive and self-defeating for the country. Even if it achieves to reduce inflation through such exchange policy, it will never improve competitiveness in relation to United States, resulting in greater foreign trade deficit, lower capital accumulation dynamics, and greater foreign vulnerability.

International Reserves and Exchange Stability

Mexico is compelled to guarantee large amounts of international reserves to be able to comply with currency's demand and to consolidate nominal exchange stability. In order to achieve large reserves, it privileges monetary, credit, and fiscal policies to avoid foreign deficit to increase and to push reserves. High interest rates are important to guarantee permanent capital inflows to finance current account deficit. It is high interest rates, economic activity contraction, and to keep latent illiquidity and insolvency problems as well as to alien the country, that makes international reserves to increase, making evident the high cost that exchange stability implies. This is also emphasized on the UNCTAD's Report when it points out that "to keep a high reserves level for these purposes would be a very expensive way to prevent financial panic". (UNCTAD, 2001).

Within the context of globalization, the monetary policy links monetary supply to the international reserves' amount in order to guarantee convertibility and the exchange stability's reliance. Such policy belongs to the theory that relates the settlement balance with the monetary supply, which explains the settlement balance's problems with the expanding behavior of the monetary supply. Hence, the intention to reduce pressure over the foreign sector and over the international reserves through restrictive (monetary and fiscal) policies.

When central bank purchases foreign currency to increase international reserves, monetary supply increases. In order of not lowering the interest rate, to stimulate the economy, and to generate pressure over the prices, over the foreign sector and the exchange rate, public debt is issued to take out of circulation the same money that is issued when purchasing currency from capital inflows. Capital inflow's sterilization process realized by the central bank implies foreign debt increment. So, the international reserves' increment, through interest rates increase, goes together with the domestic public debt increment, which makes pressure over public finance.

Even if Latin American governments are preoccupied for maintaining high international reserves to be able to face foreign shock and to guarantee nominal exchange stability, this is not completely guaranteed because stability depends not only on the reserves' amount but, to a great extent, on its composition. It is different if reserves are constituted by resources derived from the settlement balance's current account superavit, or if they come from capitals account superavit. At the same time, it is different if capital inflows are long-term resources, or if they are conformed by short-term highly speculative capital reserves. Besides, it is not international reserves amount what determines exchange stability, but, as it is pointed out by Tavares, "viability to resist against currency depends on the capacity to guarantee uninterrupted and large enough flows which are congruent to our cash needs". (Tavares, 09/11/97). The problem in Mexico and in the rest of Latin America is that these countries are not sure of having permanent capital flows, because of their domestic problems (high foreign sector deficit, and indebtedness' levels) that do not encourage their flow, as well as for the same economies and international markets' instability.

When there is low capital inflow and growing currency's demand, central bank has to sell to satisfy such demand, so reserves diminish, and in the process, it is taking money out of circulation or reducing its domestic debt. This allows it to maintain the relation between reserves and the monetary supply to avoid pressure upon the exchange parity. When international reserves are restricted, the authorities increase interest rates and/or they diminish public expenditure to restrict the economic activity, adjusting money's supply and demand to diminish availability of reserves in order to avoid pressure over prices, over the foreign sector, and over the exchange rate.

When international reserves are not enough to ease speculative currency's demand, nominal exchange stability ends, giving way to the real exchange rate increase, and to the capital market's drop (stock exchange crack), constituting a context of assets devaluation, insolvency, bank instability, and financial crisis.

Nominal Exchange Stability and Restrictive Policies

When the economy is left to free movements of goods and capitals, and exchange value predominates, pressure over the foreign sector deficit increases, and, in order of not aggravating this one and not originating exchange fluctuations that propitiate speculative actions, monetary authorities privilege permanent monetary, credit, fiscal, and wages restrictive adjustments, in order to reduce domestic demand's pressure making the economy to depend on foreign demand.

Fiscal policy has been subordinated to play a significant role within the nominal exchange rate stabilization and in promoting free capital inflows. Therefore, fiscal cuts are realized and public enterprises are privatized to diminish public debt amount in order to reach fiscal discipline and to grant trust in prices' stability and the exchange rate to be able to attract capitals to finance existing deficit.

Capital inflows and policies that promote them, value the currency, decreasing inflation through affecting the accumulation dynamics, restricting investment and deepening

productive setback problems, as well as through increasing pressure over trade deficit. Therefore, it demands more capital inflows to keep exchange stability, therefore it falls into a vicious cycle.

Latin American governments, specially the Mexican government, prefer these policies in spite of their recessive effects, instead of devaluating and reintroducing the predominant economic policy. They consider that real interest rate differential's reduction, and monetary and exchange policies' expansion, would create greater iniquity to the economy, because capital markets would destabilize, with the subsequent invested capital's devaluation, which would propitiate hard capital outflows that would de-capitalize the economy, taking it to moratorium problems, and to a greater international financial system's vulnerability.

Nonetheless, predominant policies do not achieve the desired monetary stability. What it is achieved is nominal exchange rate stability, which is very far from monetary stability. If this one was reached, monetary, credit and fiscal restrictions would not predominate, neither would be allocated governmental titles at very high interest rates to attract capitals to increase reserves to be able to finance nominal exchange stability.

If currency stability is not achieved, it is not because there is lack of discipline within the policies taken up, but it is the consequence of such policies' contradictions, which attempt against productive, financial and macroeconomic conditions. Tavares says that 'the anti-inflationary policy is destined to defeat inflation, but not to guarantee macroeconomic stability. Abrupt opening, exchange over-valuation, and high interest rates look to guarantee prices at any cost, but they destabilize the other macroeconomic variables (activity, consumption, investment, and settlement balance levels), and they dismantle part of the industry and the agriculture without making them more competitive'. (Tavares, 08/97).

Anyway, such situation jeopardizes trust and the exchange stability conditions demanded by financial liberalization, generating negative expectations that hinder capital inflows and propitiate their outflow, provoking crisis.

Therefore, exchange rate fluctuations are so harmful for the economic activity (within the context of free capital movements) that they do not adjust settlement balances' inequity, and they do not finance deficit through capital inflows without altering the nominal exchange rate, because it obliges to establish high interest rates, severe monetary, credit and fiscal restrictive policies, which go against accumulation, the economy's sustained growth, and it sets a situation of high foreign vulnerability when it strongly depends on exports and capital inflows.

Economic Policy for Growth Stops

Within the context of globalization, monetary and fiscal policies cannot dissociate from the objective of nominal exchange stability. Depending on the growing capital inflows to guarantee nominal exchange rate stability, the economic policy stops to be able to face national productive problems, to increase domestic market, productivity, imports substitution and national exports component. Exchange stability policy, Tavares says, creates a "progressive loss of freedom and spaces to manage the closing of our foreign account which pushes us to more severe monetary regimes each time". (Tavares, 09/11/97).

The Exchange Rate is a Macro-price, So its Distortion Has Severe Implications

The exchange rate reflects the relation domestic prices versus foreign prices, so in a context of an open economy, it represents the main economy's price, for to a great extent, on this it depends production's protection, and national employment in front of foreign employment, as well as accumulation dynamics and capitalization levels within the productive sphere. Eatwell and Taylor say that "a change at the exchange rate will affect all domestic prices of all trading goods, in that way, the exchange rate is a macro-price". (Eatwell and Taylor, 2000, p. 70).

Such variables are crucial for the foreign sector's adjustment, as well as the assets value (productive as well as financial) and liabilities, and for the bank's sector stability, so its

determination and management cannot be left in hands of the market's free force, that are commanded by the international financial capital, but it has to respond to the macroeconomic needs for sustained growth.

Nominal exchange rate's stability, and its consequent value, has been used to decrease inflation. The fact that national currency's parity in contrast to dollar moves below inflation and of domestic inflation's differential versus the foreign one (United States, our main commercial associate), determines the relative prices' distortion that acts in favor of imported products and in detriment of national products, that have a higher cost structure in contrast to the imported ones, due to lower productivity levels in contrast to the imported ones. National producers are compelled to fix their prices according to imported products, which are cheaper because of the exchange value. That is to say, they come to be price-takers, giving up earning margins and jeopardizing their capitalization levels (and consequently those who cannot face competence are displaced by imports), therefore, productive accumulation decreases, as well as national production growth and employment. Productive chains are broken, and indebtedness levels increase, as well as foreign trade deficit, which leads to depend even more on capital inflows, therefore it is necessary to maintain high real interest rates.

Exchange value, high interest rates, and fiscal discipline, create revenues distortion, which alter the economic structure. They affect the productive sphere in favor of capital and money markets. This provokes that a large part of capital inflows move towards the non-productive sector reproducing financial and speculative actions against sustained growth.

Exchange Value and Manufacturing Exports

Exchange rate valued in favor of capital inflows affects national exports' growth (specially enterprises that are not integrated to the United States' economy), and it reduces exports national component. It acts in favor of exports realized by transnational enterprises in Mexico, for it allows them to cheapen input costs (specially Asia) in order to improve competitiveness to export with low national aggregate value to United States. Likewise,

exchange value in Mexico favors United States exports towards this country, for its product's competitiveness increases in contrast to Mexican products.

Nominal Exchange Value and Inflation's Decrease Does Not Promote Investment and Growth

Commonly, inflation is blamed for competitiveness loss and for consequent foreign trade deficit, as well as for the countries' financial instability. Nonetheless, these problems present nowadays within a context of low inflation, because it has rested on restrictive policies, and on exchange value, which attempt upon the productive plant's competitiveness and capitalization levels, they increase foreign commercial deficit, insolvency problems, the bank sector's instability, and upon public finance pressure.

So it contradicts the conventional theory's position, which points out that the exchange rate stability and the inflation's decrease are the best option to promote investment and growth, in contrast to the exchange rate devaluation's management, because it creates exchange uncertainty, where there is no certainty upon the future exchange rate, so stockbrokers postpone their investment decisions and they are led to speculation. Nevertheless, fiscal restriction policies, high interest rates and nominal exchange rate, in spite of being directed to guarantee financial capital stability and profitability, they do not represent a better option to stimulate the productive sphere stockbroker's investment decisions, because they are the ones that provoke the domestic market's contraction, low accumulation, greater levels of domestic and foreign over-indebtedness, as well as insolvency and credit restriction, and the foreign sector's deficit, which regress into monetary stability and economic growth detriment.

Therefore, they are "healthy" policies that have predominated in favor of the international financial capital, not in favor of the fiscal and monetary expansion and in low interest rates, as it has traditionally been said by the conventional theory, they are the cause of the economic contraction problems and high foreign vulnerability that Mexico and the rest of the Latin American countries are suffering. These countries have deepened their

underdeveloped structural problems (breaking productive chains, credit restrictions, foreign deficit), jeopardizing endogenous growth capacity, making them dependent on foreign financing and making them vulnerable within the world economy's behavior.

The Exchange Rate Expectations

The expected exchange rate is determined by capital flows, which finance foreign gap and increase international reserves amount. Their behavior lies upon economic growth expectations and upon economic fundamentals behavior, within the perspective that these ones will guarantee, or not, the exchange rate stability and capital revenues. This depends on the expectation that the government will influence upon the economic policy's efficiency to guarantee economic growth, but mainly, upon the fundamentals required for nominal exchange stability. Another significant element of capital flows are the privatization process and the capital market's behavior. So, financial assets value that are quoted within an emergent economy, as well as the macroeconomic indicators, are the ones that greatly influence upon capital flows, therefore the exchange parity determination.

When expectations are favorable for the economy, whether it is because of fiscal or foreign adjustments, or because of economic growth and greater economic liberalization or privatization, they attract capital, which values the exchange rate and increases stock and price's demand in the face of the expected larger dividends. The stock market's boom makes more attractive capital inflows, so the currency is more valued, contributing to the inflation's reduction, to greater credit availability (if capital inflows are enough to generate growth expectations). Nonetheless, these elements are before all financial, exchange and bank crises within the underdeveloped countries. Exchange value, on one hand, increases the foreign sector deficit, and on the other hand, it affects the accumulation dynamics, increasing the enterprises' over-indebtedness levels, and generating insolvency problems that disestablish the bank sector, restricting credit and originating pressure upon public finance, ending in the stockbrokers' expectations change. Capital outflows creates the stock market's crack, accompanied by the exchange rate devaluation. Both crises deepen the bank sector's instability, due to capital's under-valuation and to high interest rates that are

established to hinder capital outflows, due to the economic activity's contraction and to income that it originates, creating insolvency problems.

The economic policy put into practice may not be successful to guarantee macroeconomic balance. Nonetheless, capitals may still be moving towards the economies, if they put into practice high interest rates, budgetary cuts and taxes increase in order to decrease fiscal deficit and foreign trade deficit, and if, besides, they accelerate the privatization process and attractive assets' foreignism. These ones are aimed at influencing upon the economic agent's expectations, and as these ones believe that such policies get rid of inflation and pressure upon the fundamentals, the capital still flows to the country and it keeps within it.

In spite of foreign imbalance, such a situation makes the economy to operate with valued exchange rate, because of capital inflows that finances it and that increments international reserves, which conforms exchange stability expectations, which may change when there are no stability or reimbursement conditions. J. Pinto de Andrade and M. L. Falcao Silva, say that "domestic currency ex-post devaluation by the government depends on the private agents' expectations, and that this last one depends on credibility associated to the government's policies". (Andrade y Silva, 1999, p. 317).

When the economy does not offer macroeconomic stability conditions, (in public finance, and foreign sector), and therefore, it fails to pay capital revenues, or when it has difficulties to deepen the privatization process and strategic assets foreignism to guarantee larger capital flows and settlement conditions, or when it fails to offer or grant them as guarantee to the international capital, this one changes the country's expectations. In front of assets devaluation, whether it is because of policies' inefficiency to preserve nominal exchange rate stability, or because there are no opportunities of larger profitable assets' appropriation, or due to contagious of problems that other economies are experiencing, they look for more secure and profitable markets. On the other hand, financial liberalization facilitates fast capital movements, which are difficult to control in the face of domestic and foreign expectations' change. Mario Presser says that "even though the need to reduce the

exchange rate volatility is recognized, instruments' insufficiency to attend conflict are discovered within a framework of high capitals movement." (Presser, 2000, p. 38).

Quickness with which financial capital acts at the international level in front of changes contrary to its interest, makes it impossible to hold for a long time inflation's decrease with exchange anchorage, through the financing pattern that capital inflows represent, due to uncertainty and volatility, in the face of domestic and foreign problems.

Exchange Stability Cost

Financial liberalization, nominal exchange stability and currency's convertibility are being very expensive for Mexico, for nowadays there are no monetary, credit or fiscal policies for sustained and generalized growth. There is less industry, less agricultural sector and a bank that does not grant credit. There are less national assets, larger domestic and foreign debt, and we are more vulnerable to international fluctuations.

When exchange stability and currency's convertibility is sustained on capital inflows, it represents a high cost for the country. When capital inflows are significant as a financing pattern, they impose high interest rates to the country, as well as restrictive policies, and exchange rate valued parities, with the consequent loss of national production competitiveness, and other effects already mentioned, as well as the national patrimony's permanent sacrifice because they expand profitability and the foreign capital's influence sphere.

When pressure is harder over economic fundamentals, the government finds it difficult to sustain nominal exchange value, for concessions and assets that it has to grant or to transfer to international capital have to be larger.

National enterprises have had to look for international associates to be able to reach liquidity levels and capitalization in order to sustain within the market. In this process, large enterprises that offer better profitability expectations have participated. So, the exchange

stability policy generates a patrimonial adjustment in favor of international capital. The enterprises and assets foreignism process has a high cost, for it implies to finance the economic liberalization policy and the nominal exchange stability, that do not generate endogenous growth conditions, but larger delay and vulnerability.

Currency's Value and the Enterprises and Families Income

Eatwell and Taylor point out that “a weak currency tends to decrease real income flows and the families and enterprises' real wealth” (Eatwell and Taylor, 2000, p. 74). It is worth mentioning that this operates if the enterprises and the families have financial assets, because these ones cheapen with currency's devaluation, and if wages are not adjusted in relation to inflation. On the contrary, if the currency is strong, (valued), it affects income and the enterprises and the families' wealth within the productive sphere, because it originates lack of competitiveness, as well as negative consequences derived from restrictive policies and high interest rates that go together with exchange value.

Anti-inflationary policies diminish enterprises and individual's income, no matter if the acquisition power increases in contrast to dollar, if the enterprises and the individuals' income diminish to acquire goods consumption, affecting above all, national goods.

Also, in the face of the impossibility of using the exchange policy to improve national production competitiveness, and to adjust foreign trade balance, Mexican governmental authorities have pointed out to the entrepreneurs that if they want to improve competitiveness, they have to adjust salaries. Through decreasing real wages it is expected to counteract earning problems that exchange value generates, as well as to decrease more domestic inflation to avoid greater exchange value and greater competitiveness loss. Nevertheless, real wages' drop allows the country to continue with exchange value, but without counteracting negative effects that such exchange parity originates. It only delays exchange adjustment at the expense of greater impoverishment of the population.

Productivity differentials between United States and Mexico are so great in favor of the first one, that in spite of low salaries that Mexico has, its competitiveness and its foreign sector's situation do not improve. Therefore, real salaries decrease does not propitiate greater economic dynamics, but on the contrary, it places Mexican economy into a vicious cycle, because it restricts more the domestic market's growth, and makes it to depend more on exports, and on the dynamics that United States shows, where more than 85% of total exports are channeled, placing itself within a context of high vulnerability in relation to the behavior of such economy.

Capital Inflows Do Not Counteract Negative Effects that the Economy that Generates it Stimulates it.

Problems that are derived from the policy aimed at promoting capital inflows, such as domestic market's contraction, the productive sphere's de-capitalization, and insolvency that restricts credit availability, are not counteracted by such capital inflows, which generally flow to the financial sphere, or is associated to exports.

Capital inflows have not improved the productive sphere, or the bank sector's solvency, or public finance's position of the foreign sector. On the contrary, the policy established in favor of such capital has acted in detriment of the sectors, which places us into greater foreign vulnerability that hinders the economic policy's management for sustained growth.

Economic Liberalization Does not Guarantee Macroeconomic Conditions to Hold the Required Exchange Stability.

To be able to work with stable nominal exchange rate foreign trade superavit is required, and/or larger capital inflows and international reserves, which allows to face foreign shock that are present at the international markets. Nonetheless, the economic liberalization context that operates in Mexico and in the rest of the Latin American economies, does not conform foreign trade superavit to reimburse foreign financial obligations, and besides, it

does not guarantee confidence conditions for permanent capital flows to allow foreign imbalance financing and nominal exchange stability.

Even if economic fundamentals are looked for to be able to sustain exchange stability, these fundamentals are weakened by the currency's value and the accompanying policy, so not only it is not possible to make compatible exchange stability and economic growth, but nominal exchange stability is also weakened.

The way inflation is reduced affects public finance because of accumulation problems that currency's value originates. This one, together with the domestic market's contraction, that derives from contraction policies, reduces taxes collection. Also, the enterprises' over-indebtedness levels increase, they recreate the bank sector's insolvency and instability problems, demanding the government to transfer resources to such sector, increasing public debt and pressure over public finance. At the same time, these ones are also affected because of domestic debt's increase that derives from capital inflows' sterilization. High interest rates that are established to guarantee capital inflows for exchange stability affect public finance, and recreate national bank sector's problems, contracting investment growth.

Foreign sector faces pressure as consequence of the exchange policy and commercial opening, as well as anti-inflationary restriction policies (monetary, credit and fiscal). Current account deficit is not the result of monetary and fiscal expansion as it is pointed out by the conventional theory, but on the contrary, monetary and fiscal restrictive policies that have been predominating, together with high interest rates, act in favor of capital inflows that values the exchange rate. This diminishes competitiveness and affects the productive sphere (breaking productive chains and lower productivity), so supply pressure over trade balance increases.

Pressure upon public finance, the foreign sector, and the bank system, as a result of dominant economic policies, together with the dominant international financing vulnerable

character, weaken nominal exchange stabilization and the achieved inflation's decrease, and it underestimates capital inflows, jeopardizing exchange stabilization and growth.

Exchange Value for a Weak Economy that Questions It

Exchange value does not imply currency's strength or the economy's strength. The economy is weakened, as consequence of effects originated by the same value and the policies that originate them. This problem is present in Mexico as well as in the rest of Latin America. So, for the case of Brazil, Sampaio and Naretto say that "exchange combination valued with high interest rates are adverse to the economic activity. The exchange rate stimulates imports and underestimates domestic production and exports. High interest rates benefited rentier sectors in detriment of domestic producers." (Sampaio and Naretto, 2000, p. 121).

When inflation's decrease rested on capital inflows to be able to finance current account deficit and to maintain nominal exchange stability, it comes to be unsustainable. It only postpones a greater crisis manifestation, for such capital inflows and the economic policy that accompanies it, keeps exchange value and also pressure over foreign trade, and, besides, financial obligations increase derived from capital inflows. This places the economy into insolvency, that hinders capital inflows, outflows, currency devaluation, and financial crisis. R. Blecker says that "debt positions created because of inflows with time are unsustainable, provoking abrupt outflows of speculative capital, which in fact, precipitates settlement balance's crisis and Draconian adjustment policies that reduce growth and create massive unemployment." (Blecker, 1998).

History has put into evidence temporality of exchange anchorage, whether it sustains upon capital inflows, prices control, or severe monetary and fiscal control, demonstrating that the market, sooner or later, corrects the prolonged exchange distortions, at a high devaluatory, inflationary, recessive and highly subordinated cost for international creditors interest.

Exchange Value and Current Recession

Contraction that United States has been presenting since the second semester of the year 2000, has affected exports growth towards that country, which had constituted into it growth motor. This increases foreign trade deficit, as well as capital inflows requirements to be able to cover the gap and to guarantee nominal exchange stabilization. International context change and domestic problems' intensification, as well as settlement problems, tend to hinder capital inflows and to jeopardize nominal exchange stabilization.

There are no endogenous perspectives to face foreign adversity, to diminish foreign trade deficit, and to keep nominal exchange stabilization. The same predominant exchange value policy, as well as the productive plant's destruction and productivity's drop, do not allow to improve competitiveness and to develop imports substitution to have trade superavit and to cover foreign financial obligations.

In front of this, Mexico keeps relative high real interest rates (higher than in United States), as well as credit and fiscal restrictions and exchange value, to avoid capital outflows and to keep on promoting inflows. This places the country into greater competitive and productive disadvantage to be able to face exports contraction, besides such policies are pro-cyclic. Instead of increasing public expense and credit availability, or diminishing real interest rate to be able to improve domestic liquidity and increasing domestic market, and to make the exchange rate flexible in order to counteract exports drop in order to reactivate the economy, it still favors exchange flexibility to avoid capital outflows and a financial crisis. The problem is that nominal exchange stabilization cannot be kept in a context of low accumulation dynamics, greater depression over foreign trade deficit, of high levels of domestic and foreign indebtedness, and of credit restriction, because this places us into a context of high foreign vulnerability that will propitiate the financial crisis that it wants to avoid. International context, as we have already said, is accentuating pressure over the national sector, and it is increasing the private sector's insolvency problems highly indebted in dollars, which separate us from international financial markets, so financing for growth and exchange stability is limited.

Up to Where Can Monetary and Exchange Policy Management be Taken Within the Financial Liberalization?

Latin American monetary authorities cannot make flexible their monetary policy and cannot decrease their real interest rate at the level of the developed countries, to be able to make the exchange rate more flexible, because both variables are key pieces to guarantee the needed capital inflows to finance current account deficit and to avoid speculative practices that provoke financial crisis. Therefore, monetary and fiscal policies subordinate to accomplish nominal exchange stabilization, a condition that financial capital demands to be able to flow to these economies.

Emergent economies' exchange rate cannot be flexible to promote exports and to adjust foreign trade deficit, because the exchange rate devaluation does not meet financial liberalization, because it devalues financial capital that operates in such economies.

Devaluation would originate severe problems within the capital markets and would propitiate their outflow and would hinder their inflow, which would jeopardize foreign deficit financing, such as foreign debt settlement. It would aggravate financial problems of the highly indebted sectors in dollars, whether it is the public sector or the private sector, which would hinder to increase investment to profit from the new exchange parity and to realize productive investment. Interest rates would increase to hinder capital outflows, which would accentuate insolvency problems and bank instability.

Only to adjust relative prices would not guarantee the productive plant's protection or the better competitive position to improve the accumulation dynamics and foreign trade balance. The economic liberalization context has increased imported coefficients and it has destroyed productive chains, so imports show a strong inflexible price, which would hinder devaluation to decrease significantly to be able to adjust foreign trade deficit. Besides, manufacturing exports would not grow significantly, because of high imported coefficients, as well as because of low dynamisms within the economy worldwide, and the strong

investment required to increase productive capacity, which demands credit availability that does not exist due to the bank problems, and that would deepen in front of devaluation.

Devaluation would affect inflation because of productive and financial costs, so the initial effect of relative prices' correction would nullify to improve competitiveness, imports substitution and to increase exports, so investment flows would not be possible in that direction, or the foreign sector, and the economic impulse adjustment would not operate.

How Can Economic Policy Management be Taken?

To avoid permanent pressure over the exchange rate and the interest rate, as well as to take the sovereign management of the economic policy in favor of the productive sphere, and of the generalized and sustained growth in the Latin American economies, it is necessary capital movements control to stop being stuck to the commitment of nominal exchange rates and monetary and fiscal restrictive policies, that separate us from macroeconomic and productive problems attention. At the same time, foreign debt servicing settlement must be reorganized to be able to decrease foreign sector's pressure and capital inflows requirements, not to establish a policy in favor of these ones.

It is necessary to reorganize economic relations with the developed countries to be able to reach better credit flows and investment in the long-run, as well as to achieve better commercial and technological deals, to overcome productive delays, to increase production, and to reconstruct domestic productive chains to be able to improve employment, income and solvency conditions. It is only this way that we may decrease pressure over the foreign sector, reach bank stability, and retake monetary, credit and fiscal policies for growth.

To be able recover sovereign management of the economic policy to fulfill national demands, capital movements have to be regulated as well as capital inflows requirements have to decrease.