Self-insurance as a Safeguard Our Entry into Modernity

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President Calderón and the new finance minister, Agustín Carstens.

In northwestern Mexico City, at the Polanco and Santa Fe malls, elegant brand-name boutiques, jewelry stores and perfumes, indigenous only to the world's great capitals, are common. What may surprise some Mexican and foreign tourists visiting the area are the luxury car dealers, selling not only BMWs, which almost any local resident can buy, but also Ferraris, Lamborghinis, Jaguars and others. But the most outstanding feature is that near these dealerships, body-shops abound specializing in armor plating, a sign of car owners' fears due to the insecurity that prevails not only locally or in the capital, but countrywide. And they are not wrong: this area, including Las Lomas, Tecamachalco, Inter-lomas and part of the Cuajimalpa borough, Mexico City's entire northwest, is a real cluster, where the country's upper class lives, eats, studies, works, shops and parties.

Many of these streets, not to mention the exclusive housing developments, are guarded by gates and rent-a-cops. Almost everything is imported, and houses and lots are sold in U.S. dollars. Here are the corporate headquarters of the multinationals that bring capital, as well as the banks and financial institutions that ex-

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port capital. Estimates put Mexican citizens' deposits in U.S. banks alone at more than U.S.$65 billion.

This whole story is repeated, perhaps on a smaller, less luxurious scale, in the country's second- and third-largest cities, Monterrey and Guadalajara. This is all the product of the modernity that came to Mexico from the mid-1980s with the economic opening and integration with the United States through the North American Free Trade Agreement (NAFTA).

Not very far from Mexico City's northwest, in the downtown area and east of there, the whole thing repeats itself but in a socio-economic mirror image. Here, itinerant sales proliferate, vendors setting up stands daily on the sidewalks of previously important avenues, in alleys and even on the streets themselves. Every imaginable kind of import is sold here, mostly "legal" contraband and Mexican-made and imported "pirate" copies of brand-name shoes, clothing, watches and liquor, CDs, videos and computer software and hardware. These informal markets exist not only in the poor areas of Mexico City, but also in those of the other cities. This, together with crime, is a way of life for the thousands or millions of Mexicans who cannot find a regular job in today's modernized formal economy.

This sector of Mexican society, the unemployed, also lives with flight to the United States, but not capital flight: labor flight. An estimated more than half million people try to cross Mexico's northern border every year using all kinds of transportation, and, of course, on foot. This figure, far from dropping with modernity, has increased and changed its profile. Now it is no longer just agricultural workers who literally flee in search of work, but also young people with different levels of schooling. Those who stay abroad —and their numbers are legion— regularly send part of their earnings home to their families in Mexico, making this the second most important source of foreign currency after those accrued from oil exports: about U.S.$20 billion a year.

In a country like Mexico, with an economy that is uneven in many senses, so close to the giant, the United States, foreign currency, particularly U.S. dollars, has been the Achilles heel that has brought about all its economic crises. Suffice it to remember the 1994-1995 crisis, when several events sparked an unusual amount of dollar flight that required a direct loan from the U.S. government of almost U.S.$50 billion, which destroyed forever our country's commercial banking system and left a government debt then estimated at about U.S.$100 billion, which has most certainly grown due to accumulated interest.[1]

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2000 and 2006 were election years and the end of administrations in which financial markets were so unstable that the owners of capital sought liquidity in dollars to cover themselves in case of a devaluation, thereby causing, whether they knew it or not, the much feared devaluation.[2] This concern accentuated in 2000 when the Institutional Revolutionary Party (PRI) was replaced in office by the National Action Party (PAN); and things looked even worse for 2006 because some sectors feared that the left would win the elections, which from their point of view, would cause uncertainty. However, the typical end-of-administration crisis, always a crisis of speculation in foreign currency, did not come about.

Traditionally, the main cause of foreign currency flight was the rumors of a devaluation of the peso, which the outgoing administration was expected to cause to adjust an overvalued currency and assume the political costs of the adjustment. The currency is overvalued when there is a difference between domestic and external inflation requiring frequent adjustments in the exchange rate, which, in turn, causes new inflationary pressures, generating an inflation-devaluation spiral that is difficult to stop. For this reason, the monetary authorities postponed the adjustment as long as they could.

Fears also increased when the traditional deficits in the previous year's foreign trade balance and the trends in the current year were announced. Financial advisors then hastened to recommend that their clients, the investors, divest themselves of Mexican pesos and acquire U.S. dollars, making the devaluation a self-fulfilling prophesy.

The last time something like this happened was in December 1994 when the outgoing Carlos Salinas de Gortari administration (1988-1994) refused to assume the political costs of devaluating a peso that was about 20 percent over-valued, and the incoming Ernesto Zedillo Ponce de León administration (1994-2000) handled exchange rate and monetary policies very badly, which caused the aforementioned financial collapse, with its international consequences. Of course, the devaluation was much larger than what was originally expected, in addition to the fact that the jump in interest rates made private debts to commercial banks unpayable.

Although through the central bank, the state has been the guardian of the country's international reserves (made up mainly of foreign currency), the bank's autonomy, the development of the financial system and of the exchange market make it possible for this market to directly buy and sell foreign currency, and therefore determine the exchange rate. Today, the central bank only intervenes indirectly. This happens as part of the customs of modernity in many countries. Since 1995, Mexican exchange rate policy consists of a flexible regime that leaves the determination of exchange rates for different day-to-day economic and financial operations to the market. Thus, when there is a tendency to have a deficit, the market must react on its own by depreciating the currency and when the tendency is to surplus by raising its value.[3] That is, there is an automatic adjustment. In Mexico, this has not happened: at the end of the last two administrations, the currency has been overvalued, 48 percent in 2000 and 36 percent in 2006, as well as during the entire intermediate period.[4] The exchange rate has remained stable —in other words overvalued—despite the trade deficit mainly due to the large short- and long-term capital inflows, the extraordinary foreign currency earnings from the high price of oil and the remittances sent home by Mexican workers in the United States over recent years.

Maintaining a flexible exchange rate regime with free mobility of capital (both incoming and outgoing), having a trade deficit and simultaneously avoiding speculation has required that the monetary authorities keep international reserves high. This makes real or potential investors believe that the country is capable of resisting strong waves of speculation without substantially affecting its exchange rate, price or interest rate stability. At one point this was called self-insurance. At the end of 2000, gross reserves surpassed U.S.$30 billion, growing steadily until, by 2006, they exceeded U.S.$80 billion.[5]

Since the 1990s, this insurance is common practice in developing economies, which are more vulnerable to external and speculative shocks. Not long ago, the International Monetary Fund recommended maintaining reserves equivalent to the total short-term foreign debt in countries whose access to external credit is uncertain, but only as a starting point, since, in general, these countries should have even higher reserves, depending on different factors like their macro-economic variables, the size and composition of their foreign debt, etc.[6]

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This financial shield consists of ensuring that for every dollar of short-term foreign debt acquired, the central bank acquires another in the currency market and keeps it in the reserve. So as not to leave the purchased dollar idle, the central bank acquires a U.S. government bond (or any other short-term asset) for the same amount; so, what it actually keeps in the reserve is a bond. In order to avoid an internal monetary expansion in the country, the next step is for the central bank to sell the private sector government securities denominated in national currency for the amount of the increase in the reserve, in this case one U.S. dollar. This last step is known as "sterilization" of reserves.[7]

However self-insurance has several adverse consequences for the country that implements it. On the one hand, there is no net transfer of resources from abroad, since the foreign debt acquired is equivalent to the bond or external security purchased. On the other hand, the private sector's general investment capability does not increase since it ends up acquiring government securities in the amount of its external indebtedness. In addition, the interest paid on the external bond or security is usually less than the interest paid on the foreign debt. The spread between one rate and the other is sometimes very large. A moderate estimate of the average social cost of self-insurance in 2004 came to almost one percent of the gross domestic product of developing economies.[8] This seemingly small sum, in the case of Mexico was equivalent to five times the amount earmarked in that same year for the government's Progresa poverty-fighting program.[9]

Some authors say the social cost could be justified if its aim were really to be able to maintain local currency at its real value *vis-à-vis* other currencies, that is, regularly adjusting the exchange rate without generating major speculation, in order to maintain industry's level of competitiveness with the exterior. Otherwise, it would seem a better option to use the reserves to pay off the foreign debt.

In Mexico's case, the private foreign debt has been growing given the lack of internal credit for productive investment, credit that is scarce and expensive. For this reason, local and foreign investors themselves have made sure the peso's exchange rate *vis-à-vis* the dollar stays below its real level, thus avoiding fluctuations that would be very costly for them.

In that sense, in Mexico, we are in an absurd situation: we have a margin of reserves that is enough to pay off almost half our foreign debt or to cover eight months of imports without having any foreign income. However, we maintain a highly overvalued currency that does not aid much in improving the level of international competitiveness.[10] Thus, the wealthy class has a double economic armor-plated safeguard: its imports are indirectly subsidized by the entire society, since the exchange rate is unrealistic. In addition, it can transfer any amount of its money abroad whenever it deems necessary since the practically idle reserves can stand that kind of movement, which we all pay for.

NOTES

[1] I am referring, of course, to the Savings Protection Bank Fund (Fobaproa) later transformed into the Bank Savings Protection Institute (IPAB). See www.ipab.org.mx

[2] This is all that is needed for there to be a dollar drain.

[3] This should happen in a flexible regime, according to Milton Friedman in his "The Case for Flexible Exchange Rates," *Essays in Positive Economics* (Chicago: The University of Chicago Press, 1953).

[4] According to the annual averages of the real exchange rate of the Mexican peso with respect to 111 countries calculated by the Banco de México (www.banxico.org.mx).

[5] Banco de México. At www.banxico.org.mx

[6] See Stanley Fischer, *Opening Remarks at the IMF/World Bank International Reserves: Policy Issues Forum*, Washington, D.C., April 28, 2001. At http://www.imf.org/external/np/speeches/2001/ 042801.htm

[7] See Alan Greenspan, "Currency Reserves and Debt," Remarks before the World Bank Conference on Recent Trends in Reserves Management, Washington, D.C., April 29, 1999, at http://www.federalreserve.gov/BoardDocs/Speeches/1999/19990429.htm.

[8] See Dani Rodrik, "The Social Cost of Foreign Exchange Reserves," paper prepared for presentation at the American Economic Association meetings in Boston (January 2006), to be published in the *International Economic Journal*.

[9] Ibid.

[10] Among OECD countries, Mexico is in last place in competitiveness.