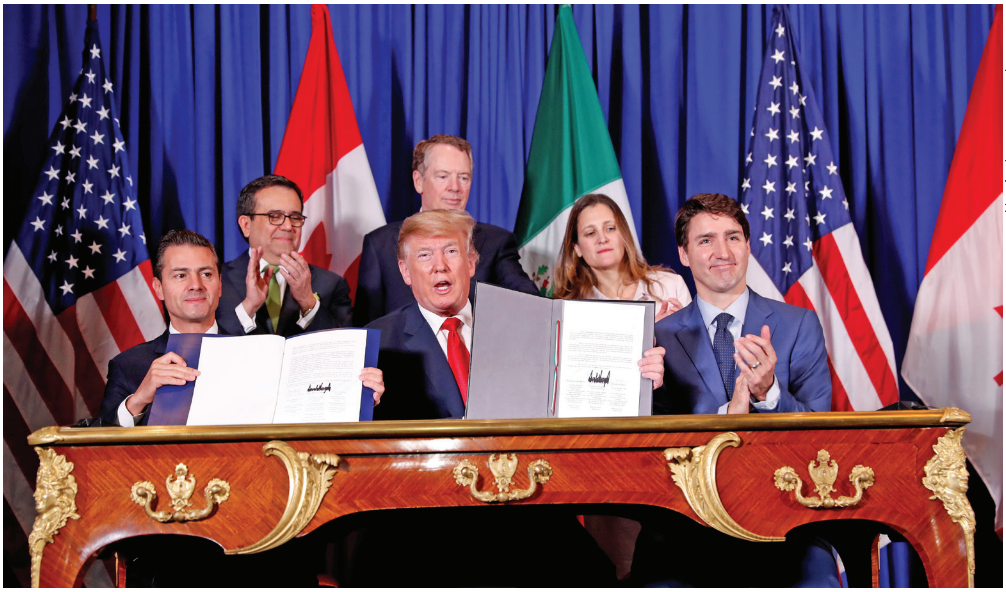
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The USMCA and Exchange Policy: Implications for Mexico[1]

Introduction

The North American Free Trade Agreement (NAFTA) has been replaced by the United States-Mexico-Canada Agreement (USMCA), a new legal regime to regulate trade and investment in North America. In general, the new treaty has few significant amendments, except for the case of the automobile industry, where higher domestic content and a minimum wage that will probably increase production costs are required. Nevertheless, the most relevant provisions of the USMCA are in Chapter 33, in reaction to policies of macroeconomic stability and emulated exchange rates, which mark a significant shift away from traditional treaties toward greater subordination of Mexico's economic policy, revealing Washington's defense of U.S. commercial and financial interests.

The USMCA prohibits manipulation of the exchange rate and defines macroeconomic stability as the fundamental goal of each party's economic policy, thereby restricting manipulation of monetary policy to serve competitive interests through exchange rates, in particular by Mexico. The agreement inhibits the promotion of eco-

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nomic growth and development in order to control inflation, provide macroeconomic stability, and ensure compliance with the terms of the treaty.

It should be remembered that the exchange rate plays a fundamental role in an open economy that depends on its international dealings in both goods and services and financial transactions. In an unregulated economy, the value of the currency affects the definition of prices of goods and profit levels of capital, which, depending on such factors, enter and leave the country in question.

This article analyzes the implications for Mexico of relinquishing control of its monetary policy in the interest of macroeconomic stability and prudent management of inflation, to comply with the USMCA.

Beyond Trade Wars: The Fight for Leadership of the Global Economy

The United States' trade war with China is based on Donald Trump's fundamentalist "America First" foreign policy and is the product of a series of structural problems that have intensified over time: the weakening of the U.S. economy, job flight, progressive inequality in an increasingly financialized economy, and our northern neighbor's chronic tax and trade deficits. Thus, renegotiating NAFTA and the free trade agreement between the United States and South Korea and signing bilateral trade agreements "on the basis of equality and reciprocity" have marked the course of U.S. foreign policy.

In this discourse, the operating rules of the World Trade Organization (WTO) and other multilateral organizations are detrimental to U.S. interests. As a result, the U.S. has proposed abandoning its dispute settlement mechanisms and opted to claim national security as a pretext to impose sanctions and other coercive measures against alleged unfair trade practices that affect its interests. The logic behind this is to actively reduce the U.S. deficit with the world, and in particular *vis-à-vis* Germany, China, Japan, South Korea, Mexico, and Canada, while creating greater demand for U.S. products and services by imposing rules of origin and labor regulations in other countries. The repatriation of U.S. companies and pursuit of international competitiveness in manufactured goods are also on President Trump's agenda as a means of fulfilling his campaign promise of more jobs for U.S. American workers.

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The NAFTA renegotiation is part of Trump's America First policy and entails some substantial changes from traditional trade agreements, governed by multilateralism and the WTO's authority in settling disputes. We appear to be moving ever faster toward a global corporate government where the transnationals have the last word in settling disputes over and above the interests of national governments in strategic sectors like investment, energy, telecommunications, financial services, ecommerce, and patents.

This process is neither natural nor peaceful. Large corporations, especially U.S. and Chinese, are facing off in violent competition defined by the guidelines of new trade agreements in their areas of influence.

Macroeconomic and Exchange Policy

The exchange rate plays a fundamental role in an open economy, which depends on international transactions of both goods and financial services. In an unregulated economy, the value of the currency affects the definition of prices of goods and profit levels of capital, which, depending on these factors, enter and leave the country in question. Thus, the exchange rate directly affects the growth of the gross domestic product (GDP), foreign debt, trade balances, and capital accounts in the balance of payments; hence the relevance of controlling monetary policy and its influence on the exchange rate without preconditions, since the decisions made about management of exchange rates positively or negatively affect the economy's performance as a whole, not only at the macroeconomic level, but for companies as well.

As mentioned above, USMCA Chapter 33 seeks, at least in theory, to strengthen cooperation among the parties in the area of macroeconomic and exchange rate policy. It states that they must adhere to International Monetary Fund (IMF) guidelines and avoid manipulating exchange rates or the international monetary system to benefit their own exports. The chapter contains provisions on transparency, to ensure that the parties make their information public; it allows them to consult among themselves on their macroeconomic and exchange policies and also provides for the creation of a Macroeconomic Committee to oversee the chapter's implementation in North America. Chapter 33 also affirms that market-determined exchange rates are fundamental for smooth macroeconomic adjustment and promote strong, sustainable, balanced growth. It states that the USMCA parties must:

a) Achieve and maintain a market-determined exchange rate regime;
b) Refrain from competitive devaluation, including through intervention in the foreign exchange market;
c) Strengthen underlying economic fundamentals, which reinforces the conditions for macroeconomic and exchange rate stability;
d) Promptly inform another Party and discuss if needed when an intervention has been carried out by the Party with respect to the currency of that other Party.

If any Party breaches these provisions, a state-state dispute proceeding may be initiated to reach a settlement.

It should be noted that Chapter 33 provisions did not explicitly exist in NAFTA. Although the treaty's implementation demanded macroeconomic stability and economic policies to contain inflation, it respected the signatories' decision to manage their exchange policy based on their own commercial needs; now, that possibility has vanished.

With the USMCA's passage, Donald Trump has achieved something historic for U.S. corporations, directly addressing a problem that had undermined his country's interests and which the Trans-Pacific Partnership (TPP) also sought to eliminate: currency manipulation by commercial competitors. For a long time, the United States had tried to discourage manipulation of foreign exchange markets by partners or competitors seeking to gain commercial advantages. The practice has provoked a political reaction against trade agreements and globalization in general.

Thus, currency manipulation became a central issue of trade policy from 2003 to 2013, when the countries most active in this field intervened extensively in foreign exchange markets, with a yearly average of over US$600 billion. Keeping their currencies devalued, they made their exports less costly for the rest of the world and imports

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more expensive for domestic markets, boosting their competitive level and increasing their trade surplus. Exchange rate manipulation was used mainly by Asian oil-exporting countries and financial centers, especially Switzerland and Singapore. Nevertheless, China was the leading currency manipulator, accumulating US$4 billion in reserves and increasing its current account surplus to an exceptional 10 percent of its GDP, which in turn upped the pressure on the U.S. trade deficit. However, China sharply reduced its currency manipulation after 2013, and its current account surplus has dropped to less than 2 percent of its GDP. Nonetheless, some countries have continued to manipulate their currencies at times and may do so again unless trade agreements include provisions to limit the practice.

It should be noted that currency manipulation resulted in transfers of some US$250 billion a year in trade balances from countries with deficits to others with surpluses. As a result, the United States lost at least a million jobs, especially during the Great Recession, when unemployment was already high. European countries also sustained heavy losses. This is precisely what Chapter 33 seeks to avoid.

For Mexico, currency manipulation to devalue the peso is unlikely due to the country's high levels of public and private foreign debt. Also, the obligation to maintain low inflation and macroeconomic stability to guarantee the inflow of capital already restricts its monetary policy. The Mexican Central Bank insists on controlling inflation and maintaining macroeconomic equilibrium and avoiding devaluation of the peso at all costs, as it states in a recent report.

In the executive summary of its October-November 2018 quarterly report, the Central Bank states that Mexico's monetary policy aims to keep inflationary tendencies in check and reinforce the downward trend of annual general inflation to reach its 3 percent target. In its October-November 2018 meeting, its Board of Directors decided to keep its target one-day interbank interest rate at

8.0 percent and closely monitor how inflation performed against the expectations of its medium- and long-term forecasts, also tracking variations in exchange rates and relative monetary positions between Mexico and the United States, as well as the evolution of economic indicators.

Mexico's Central Bank states that, to overcome potential challenges to its economy, Mexico should favor policies of fiscal discipline, price stability, and free trade; thus, it ratifies its commitment to maintain solid macroeconomic conditions as the foundation of an economic policy that, in its view, will drive the nation's growth.

From a macroeconomic perspective, the exchange rate influences the rise and fall of trade flows and the entry or flight of direct foreign and portfolio investment and affects the money market, investment decisions, costs of international credit, and the volume of foreign debt. If an economy opens to international trade, in theory it must maintain high levels of productivity and efficiency to be competitive. If this fails to materialize, the fallback option is a flexible exchange rate that adapts to price differentials between commercial rivals as a means of boosting exports or lowering prices on their imports.

Controlling exchange rates should help a country achieve competitiveness; however, in a context of financial globalization, it serves another important function. Financial liberalization demands macroeconomic stability, which means a stable peso/dollar exchange rate, to guarantee profitability for incoming capital and free convertibility, which ensures earnings in dollars.[2] On the other hand, a policy to control inflation is needed, which entails constant interest rate hikes and guarantees valuation of capital accompanied by constant appreciation of the local currency; in other words, an over-valued peso.

Stable exchange rates are crucial for capital and foreign exchange markets, since they guarantee conditions of confidence and acceptability of the local currency, influx of capital, and acceptance of the country's public and private debt instruments. Thus, a monetary policy that favors the free flow of capital prevents the exchange rate from adapting to the needs of a foreign trade policy where the exchange rate must adapt to differences in prices of goods and services to keep them competitive, favoring productive sectors that drive economic growth and, in theory, reduce trade deficits in the balance of payments.

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Mexico has experienced strong support for the financial sector to the detriment of its productive industries; the constant was a reduction in public spending in an effort to control inflation, triggering greater social imbalances, unemployment, migration, and public and private debt, producing a prolonged economic slump as government failed to implement policies to promote growth and increase domestic productive capacity, including Mexican rural areas and farms. It focused instead on designing austerity policies, which perpetuate sluggish conditions; nevertheless, these austerity policies are the basis for this growth of the financial sector.

Conclusion

The implementation of Chapter 33 only reinforces the lines of economic policy in place since NAFTA was signed. What is new is that now they are not optional, but rather a legally mandated imposition, backed by the threat of terminating the treaty if any of the parties fails to comply. Mexico obviously lacks the freedom to manage its monetary policy at will due to its fragile financial operating conditions. However, the new treaty offers Mexico the chance to improve its situation and regain autonomous control of an economic policy that fosters growth, development, employment, and more robust domestic markets. Our country needs substantial increases in public spending, a shift away from austerity policies, and stronger domestic markets to pull out of the economic slump, all of which are stifled by the chapter in question. VM

Further reading

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Notes

1 This article is an abridged version of the chapter of a book currently at press.

2 Arturo Huerta, *Obstáculos al crecimiento peso fuerte y disciplina fiscal* (Mexico City: Facultad de Economía, UNAM, 2012), p. 32.