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Microeconomic Risks Of Anti-Inflation Policies
Reflections on the Case of Mexico

At the time of this writing, Mexico's Central Bank (Banxico) target interest rate has risen to 10 percent, the highest since it began being used as a monetary policy instrument. It will also very probably go even higher by the end of this year, since analysts agree that the last 2022 meeting of the Governing Board will decide to adjust the rate upwards to 10.5 percent.[1]

Beyond whether the prediction of the hike turns out to be true, the expectation about a more restrictive monetary policy exists because the problem it attempts to attack has not been overcome: inflation above the monetary authorities' 2- to 4-percent target.

While Mexico's inflation peaked at 8.7 percent in August and September 2022 and dropped slightly in October to 8.41 percent, given that underlying inflation has continued to grow, the numbers for the last three months do not indicate that it will rapidly move toward Banxico's target.[2]

Inflation containment and a marginal overall price reduction in the last month of the year seem to be more linked to the evolution of non-underlying inflation. The latter includes everything with more volatile prices, which have benefitted from the recent reduction in energy prices.

It is true that we must not understand inflation in Mexico as isolated. Most countries are experiencing significantly higher inflation rates than those of the last two decades. In 2021, during the worldwide economic recovery, analysts discussed whether inflation at that time was transitory or permanent, and whether it stemmed from supply or demand.

At the end of 2022, it became clear that inflation is persistent in the medium term and that inflationary pressures mainly come from increases in energy, food, and raw material prices, in addition to the bottlenecks in the main

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international value chains. All these factors originate in geopolitical issues, such as high oil prices compared to those prevailing in 2020, and the war between Russia and the Ukraine, which destabilizes an important raw material producing region and impacts the global industrial supply chain. Of course, today's inflation can also largely be explained by the health and economic crises the world faced in 2020.

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Anti-Inflation Economic Policies

In this scenario of economic recovery and high prices, what is of most concern is that no consensus exists about the best economic policies for moving toward each country's central bank target inflation levels.

Strategies such as speeding up the energy transition to renewable sources and even redesigning international value chains have been discussed. The aim would be to decrease productive vulnerability in the face of a shock such as lockdowns and company closures. However, these are long-term options.

Opinions have polarized about how to contain inflation in the short term. Some think there should be restrictive monetary policy that would significantly raise interest rates, not because that would have a short-term effect on prices, but because it could anchor long-term inflationary expectations. Others of us, however, think that simply using a more restrictive monetary policy will not help because the sources of this inflation are production costs and not a greater demand for products. We conclude that, to the contrary, this could condemn most of the world's economies to a new period of slow growth, in which those who would suffer most would be poor countries and particularly the lowest-income households.

Disputes about the economic policies to be applied exist both in the developed countries like the United States and Europe, as well as developing countries such as Mexico. They show policy makers' inability to analyze an economic problem based on the conditions that cause it, without recourse to dogma, but also without understanding that the current crisis caused by a pandemic is unprecedented and requires its own instruments for attacking it.

Regardless of how much interest-rate hikes are justified as necessary for anchoring long-term inflationary expectations, it is certainly the case that when the U.S. Federal Reserve announces the normalization of its monetary policy and increases interest rates and also insinuates that the increases will continue, this distorts the functioning of the international financial system as a whole, and above all, spurs the rest of the world to accelerate their reference rate increases. As a result, international financial institutions have reduced their economic growth predictions in almost all countries for 2022 and 2023.

In our country, Banxico began raising its target one-day interest rate very early to try to ease inflation; with the U.S. hike, it raised its interest rate by seventy-five base points on June 23, 2022. To date, it has effected four hikes of this magnitude, raising the target interest rate to the record highs mentioned above. However, as indicated, these increases have not been useful in containing inflation.

The ineffectiveness of the interest rate for controlling short-term inflation contrasts with the immediate effects that it will have on the Mexican economy. In the first place, higher interest rates are already reflected in the interest rates for consumer, automotive, or mortgage credit, and even of commercial credit, which affects those thinking of taking out a new loan.

The increase in the target interest rate also impacts the same-day funding rate. The rate for 28-day Treasury Certificates (Cetes) went from a monthly average of 4.2 percent in June 2021, the month when Banxico's policy began toughening up, to 8.93 percent in October 2022 —this last figure does not include the latest increase of 0.75 percent that brought the target interest rate up to 10 percent. This meant that the financial cost of public funding, including non-programmable public spending, increased significantly and will force adjustments in that spending or an increase in the fiscal deficit. At the end of the day, this means that resources that could be used to promote production or in school cafeterias and communities, etc., will have to be used to pay higher interest to holders of government bonds, who are mostly in the financial sector.

In contrast, one of the unconventional measures the Mexican government has used and that has been most effective in containing inflation is not levying special taxes (IEPS) on gasoline and diesel. It has also established greater control and supervision on the sale of propane gas, which is consumed by a large number of Mexican families. This undoubtedly lessens inflationary pressure, since fuel prices have had less impact on inflation, at least in recent months.

However, the price of fruit, vegetables, and meat products continue to be high, affecting the most families who have to use a larger percent of their income to purchase food. This means that they affect those with the smallest economic resources or those in the lowest deciles of personal income distribution.

Undoubtedly inflation is a matter for concern, above all in a global context such as the one we are currently experiencing, but monetary and fiscal authorities must be able to discern the scope and consequences of the policies they implement.

Shock policies such as a drastic rise in the interest rate, which aim to contain inflation on the demand side when its origins are in the supply side, will not be effective and could condemn our economy to expanding the slow growth horizon and exacerbating inequality. VM

Notes

1 And this is exactly what happened: it was adjusted upwards to 10.5 percent. See "Banxico sube a récord de 10.50% la tasa de interés para intentar frenar la inflación," *Forbes*, December 15, 2022, https://www.forbes.com.mx/banxico-sube-a-10-50-la-tasa-de-interes-para-intentar-frenar-la-inflacion/#:~:text=%E2%80%9CLa%20Junta%20de%20Gobierno%20del,de%202022%E2%80%9D%2C%20inform%C3%B3%20Banxico. [Editor's Note.]

2 The information is from the National Institute for Statistics and Geography (INEGI). Underlying inflation is the component of the National Consumer Price Index (INPC) that corresponds to less volatile goods and services. INEGI, "Índice Nacional de Precios al Consumidor," October 2022, https://www.inegi.org.mx/contenidos/saladeprensa/boletines/2022/inpc_2q/inpc_2q2022_11.pdf.