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Fiscal Policy and Inflation**

The relationship between fiscal policy and inflation has given rise to considerable debate among economic theorists. For classical thinkers and monetarists, any active fiscal policy, meaning policy that involves increased public spending or deficits, will necessarily increase inflation. Even monetarists have held that when the state intervenes to contain unemployment through fiscal policy, it does so at the cost of higher inflation, and claim that in the long term inflation is likely to continue to rise while employment stagnates. Therefore, for these orthodox schools of thought, fiscal spending and greater state intervention hinder the growth of production and increase inflation.[1] On the other hand, for heterodox thinkers like Keynes, neo-Keynesians, and post-Keynesians, an expansive fiscal policy that makes use of active spending helps combat involuntary shutdowns and stimulate economic growth, by encouraging aggregate demand without accelerating inflation.

The fact is that a partial view of the orthodox approach to state intervention in the economy has proved inviable as a means of resolving economic contraction and inflation, because this approach fails to identify the structural problems behind those two phenomena. In Mexico's case, evidence exists that, in the period of stabilizing growth, the use of public spending as an engine of growth and fiscal policy as countercyclical management had a positive impact on economic growth, which in turn helped keep inflation down. Thus, low inflation was a consequence of economic growth and not vice-versa (see Graph 1). This approach was abandoned in the late nineteen-seventies, when fiscal policy became procyclical, in line with the orthodox policies cited above; as a result, in response to recurrent crises, public spending was reduced instead of increased to attenuate crashes.

This shift in policy focus gave rise to the crisis of the 1980s. Since then, in parallel with the implementation of policies of economic deregulation, such as the elimination of trade barriers and financial liberalization, the economy has been incapable of returning to stable, sustained growth. Far from it, crises have become more severe and longer lasting.

Subsequently, starting in 2000 with the implementation of the Inflation Targets Model (MMI), the central bank (Banxico) has focused its efforts on achieving the established target of 3 percent (+/-1 percent. This has favored stability over economic growth and, since it was first implemented, has been decisive in Mexico's failure to build a solid economy with strong foundations to withstand the impacts produced by a recession like that taking place at present.

Thus, starting in the 1980s, and more markedly in the 1990s, fiscal policy has embraced a procyclical approach to ensure control of prices, renouncing its function of offsetting the level of economic activity. In other words, it has been subordinated to the prime directive of maintaining monetary stability, meaning control of prices.[2] The goal of keeping the public deficit down, as a condition to control inflation, has limited the capacity for public spending to expand aggregate demand and combat economic recession.[3] This is how the goal of public spending changed, starting in 1988, as it renounced its role as a direct driver of economic activity to assume that of an instrument used to stabilize currency and prices.

Since late 2021, Mexico's inflation has soared far beyond Banxico's target, reporting an average level of 9.3 percent through October 2022, its highest in twenty-two years. Although more recently inflation has begun to drop, we have no way of knowing what to expect if forecasts of a recession in 2023 prove correct.[4]

Added to what appears to be an increasingly difficult situation, the World Bank updated its forecasts for eco-

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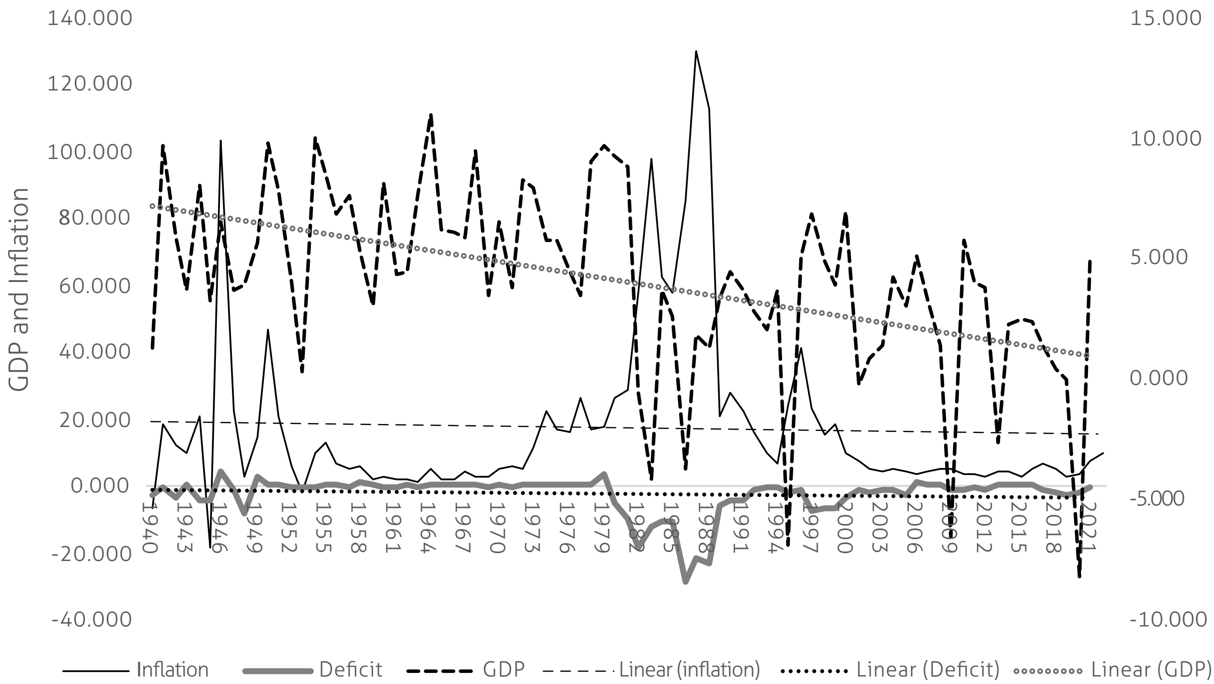
Graph 1

Relationship between gross domestic product, inflation, and primary deficit



Source: Prepared by the author with data from the National Institute of Statistics and Geography (INEGI) and Banxico.

nomic growth, scaling back its forecast from 2.1 to 1.7 percent for 2022, in response to high inflation and a slumping U.S. economy. This is a dangerous scenario since it could trigger global stagflation and stagnation.

In this context, we need to bear in mind that production in the Mexican economy remains below pre-pandemic levels, without solid foundations or economic dynamism to power a short-term recovery, all this compounding the impact the economy will absorb due to prevailing conditions and the position of the current administration, which continues to rely on an orthodox approach (procyclical use of fiscal policy and restrictive monetary policy), which leave a limited margin of action to coordinate policies to favor economic growth.

In general, as we see in Graph 1, the historical relationship between gross domestic product (GDP), inflation, and primary deficit comprises three stages. The first, from 1960 to 1975, was characterized by more stable growth in the sense that GDP fluctuations were less pronounced, with growth accompanied by price stability and low primary deficits. In this stage, GDP growth clearly helps keep pressure off prices and public finances.

The second stage, from 1976 to 1987, was marked by abrupt changes in GDP growth, causing monetary instability and a deterioration of public finances, demanding that fiscal policy maintain economic stability. Finally, in the third stage, encompassing the years 1988 to 2021, macroeconomic adjustment and financial stability policies have failed to restore economic growth, which has been highly irregular. All this has the result that efforts to improve public finances and control inflation have rested on the contraction of economic activity.

Conclusions

As shown in this article, the neoclassical and monetarist approaches deny the effectiveness of fiscal policy as a means of stimulating economic growth through variations in aggregate demand because, they claim, the public deficit creates economic stagnation as well as higher inflation and public debt in the long term. For their part, Keynes and the post-Keynesians posit that a countercyclical fiscal policy helps combat involuntary stoppage

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and stimulate economic growth by promoting aggregate demand.

Conventional orthodox approaches are based on the assumptions of exogenous money and savings, flexible prices and wages, and full employment of the productive factors, to arrive at the conclusion that fiscal policy is incapable of reactivating economic growth; far from it, they see it as a driver of inflation and economic recession. On the other hand, heterodox approaches, which share the principle of effective demand, posit the existence of endogenous money and underused installed capacity to claim that fiscal policy is a powerful instrument for increasing aggregate demand, and by extension, for stimulating economic growth.

The fact is that both monetary and fiscal policy have an impact on the level of aggregate demand, although monetary policy directly influences the level of prices. To soften this impact, coordinated implementation of the two policies is needed, with the aim of maintaining sustained and stable growth of GDP and employment.

Inflation targeting as an objective of monetary policy is feasible only if we assume that inflation is a monetary phenomenon and monetary policy has no real effects, which means that the monetary supply is exogenous and controllable. Furthermore, if we accept that inflation is a "demand phenomenon" and monetary supply is endogenous, fiscal policy is an alternative instrument for achieving the inflation target on the side of boosting the aggregate supply. In the latter perspective, public spending will not necessarily cause inflation, nor is it an indicator of inefficient public management, since the state is part of the monetary circuit and, as a result, is subject to the principle of effective demand.

In Mexico's case, an economic restructuring based on deregulation of the foreign and financial sectors has produced substantial instability in growth, accompanied by repression of inflation. The latter phenomenon has rested on the contraction of public spending which, from a driver of economic activity has been transformed into a mechanism used to stabilize the currency and the financial sector.

Consequently, as long as policymakers choose to prioritize monetary stability, fiscal discipline will be an indispensable requisite to combat inflation, to the detriment of growth of GDP and employment. In the prevailing economic conditions, Mexico needs to rethink the role of its current fiscal policy by restoring its countercyclical function, through increased public deficit spending, and revive the active role of the state to mitigate periods of recession by using public spending as an incentive for economic growth, since the current procyclical policy, whose sole aim is to balance prices, has produced conditions of economic imbalance, high unemployment, and inequitable income distribution. These changes demand a revision of the central bank's autonomy, since to the extent that the operation of monetary policy is separated from the goals of gdp and employment growth, fiscal policy will be incapable of producing countercyclical effects. VM

Notes

1 Monetarism, which rests on the basic principles of the neoclassical school, holds that state intervention in the economy is the cause of inflation and recession. As a result, it demands reduced government involvement. In its place, monetarists propose policies that adjust aggregate demand and local currency devaluations, which cause contraction of economic activity, and in consequence unemployment. In general, they propose anti-inflationary policies based on a contractionary fiscal and monetary policy, which means high interest rates and contraction of public spending, which have exacerbated the structural imbalances that keep prices stable at the cost of low economic growth and high unemployment. Their radical position is clear when they affirm that public sector action will destroy all the economic progress achieved by free market forces. They even claim that "it will destroy human freedom." See Milton Friedman, *La economía monetarista* (Barcelona: Gedisa, 1991).

2 This approach to fiscal policy is a product of the neoclassical-monetarist thesis that establishes a causal relationship between public deficit and inflation.

3 Noemi Levy Orlik, *Cambios institucionales del sector financiero y su efecto sobre el fondeo de la inversión en México, 1960-1994* (Mexico City: Facultad de Economía, Universidad Nacional Autónoma de México, 1999).

4 With the aim of lowering inflation, Banxico is resorting to increasing interest rates as one of its key mechanisms to contain prices. Since adopting it as the primary signaling instrument of monetary policy in 2008, interest rate rose to 10 percent in November 2022, marking a historic high, which has an indirect negative effect on people who want to take out loans, since they become more expensive. This also affects loans for purchasing automobiles and homes, as well as interest charged on credit card debt.