OnTheRecord

A Conversation with **Banco de México's Governor Agustín Carstens**

Mexico's Economic Reforms Propel Postrecession Rebound

Dr. Carstens has led Mexico's central bank since January 2010, after serving as the government's secretary of finance and as deputy managing director for the International Monetary Fund. He holds a PhD in economics from the University of Chicago and received his undergraduate degree from Mexico's Autonomous Institute of Technology. Carstens recently visited the Federal Reserve Bank of Dallas and met with a group of the Bank's economists.

Q. What is the outlook for 2011 growth, and what are Banco de México's biggest challenges ahead?

A. Since 2010, Mexico has experienced a very strong recovery. Inflation went from 3.5 percent in 2009 to 4.4 percent in 2010, and the increase included the impact of a higher value-added tax. Right now, inflation is back at 3.7 percent. The economy grew very fast in 2010, and it is very likely that it will grow soundly in 2011.

We have been operating under an inflation targeting scheme since 2001 and have been perfecting it over the years. Banco de México has a permanent inflation target of 3 percent and has established a tolerance bound or interval of plus or minus 1 percent. Basically, our policy instrument is the equivalent of the Fed's federal funds rate.

Core inflation [excluding food and energy] has behaved very well. We expect it to be 3 percent at the end of 2011. Noncore inflation is very volatile because it is composed of agricultural prices and government-regulated prices, which in Mexico are important. The price of gasoline, for example, is regulated by the government—sometimes with lags and sometimes with leads relative to its international reference prices. For the last few years, it has been subject to a very rapid rate of adjustment of more than 10 percent per year.

From the point of view of monetary policy management, the main challenge we face is how to deal with noncore inflation: how much of it we can tolerate and how much we need to fight. There is always the consideration that as noncore inflation feeds into core inflation and inflation expectations, the central bank needs to do something about it. Right now, the main challenge we face is the current sharp increase in commodity prices: Is it a one-time relative price change, or is

it something that has a dynamic component that will feed into core inflation?

Another very important dilemma that we face is the influence of U.S. monetary policy on Mexico's monetary policy and how much our stance needs to be judged independently of or in relative proportion to the U.S. In practice, as U.S. monetary policy has become more lax, Mexico's monetary policy has become tighter, without us adjusting the reference rate. This has attracted capital inflows. Thus, the appreciation of the peso versus the dollar has been an important factor in keeping core inflation low.

This certainly implies that when the U.S. starts unwinding its monetary policy stance, our exchange rate will probably be affected in some way. At that point, we might have to make other types of decisions. The two decisions we have to make now are how to react to commodity price increases and how we should adjust or calibrate our monetary policy in terms of the changes in U.S. monetary policy.

Q. How did the Mexican economy handle the global financial crisis?

A. I remember when, as a finance secretary, we prepared the budget for 2009. The macro framework we presented in September 2008 was based on an expected GDP [gross domestic product] growth of 3 percent for 2009. And that was basically the consensus forecast. We were deeply affected when the financial crisis erupted, and Mexico's GDP fell 6.1 percent in 2009. Trade collapsed dramatically after the fall of Lehman Brothers [in September 2008].

In the midst of this turmoil, when all the countries around the world were talking about how they were going to expand fiscal policy, we looked at the worsening public finances and agreed on the need to raise the value-added tax. That kept public finances under control. Partly as a result, we had a very strong rebound in the economy, and that is why we expect GDP to grow between 4.5 and 5 percent in 2011.

Q. What accounted for Mexico's resiliency following the recession?

A. Mexico had two lost decades in terms of growth and development, mostly due to poor macroeconomic management. We had major crises in 1976, 1982 and 1987 and then a financial crisis in 1994, which cost 18 percent of GDP. All of this led to some important institutional changes in banking supervision and regulation, in terms of the central bank and fiscal policy.

Our 1994 banking crisis not only made us put the banking system back into shape, but forced us to take some additional steps. What is happening now is that the world is catching up with Mexico. Since we experienced the banking crisis before other countries, we were more resilient this time around. Our banking system was left unscathed by the recent financial crisis. Mexico is a country that in the near future can rely on the financial sector to support its economic growth.

The other important reforms have been in monetary policy and monetary policy making. Two major steps were taken around

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1993–94 and in 1995. Before that, monetary policy making was clearly under fiscal dominance. The central bank was financing the public deficit, and that led to very stubborn inflation and to an unsustainable fixed-exchange-rate regime. Obviously, the effect of high inflation was extremely detrimental to the Mexican economy and society. Following the reforms, we moved to a floating exchange rate regime and the central bank gained its autonomy. Today, Banco de México has one of the strongest autonomy mandates in the world.

We also have a single monetary policy mandate: the pursuit of price stability.

Compared to other countries, we do not have a mandate of pursuing growth, which I would say, for the most part, is a relief. Our mandate also states that, at the constitutional level, no authority can dictate the central bank's credit policy. It specifies very clearly that we cannot grant any financing to the government. This was a major breakthrough.

The last institutional development has involved fiscal discipline. Before our credit crisis in 1994, there was a lot of creative accounting and very blurry records of public finances with periodic "surprises." Things have cleared up as time has passed. Now, Mexico is completely transparent in its fiscal accounts and, I would say, has developed a very deeply ingrained responsibility in both the federal government and, over the years, in Congress. This has been institutionalized, as it is now set by law. Unless there is an important underlying reason, the budget needs to be balanced. There are some exceptions—in case of a natural disaster or another clear reason to deviate. In those circumstances, the government has to explain to Congress why it is necessary to deviate from the balanced-budget goal and also present a plan to bring the budget back into balance.

Q. What was the significance of adopting a floating exchange rate?

A. In the early 1990s, there was a major problem with policy coordination in a way similar to what Europe is currently experiencing. When you have a fixed exchange rate, you need to have sufficient policy coordination in order to make the rest of the macroeconomic framework consistent with the exchange rate. At that time, Mexico had a relatively lax fiscal policy. We also had problems in the banking sector, and significant capital inflows. At some point, it became obvious that the exchange rate was not consistent with the macroeconomic framework. We began to experience speculative attacks on the peso. All hell broke loose. We had a combination of a balance-of-payments and banking crisis. At that point, we made a very important decision: We got rid of the fixed exchange rate.

Mexico operated under a sort of fixed exchange rate for decades. In the early 1990s, not only Mexico but many emerging countries were under the veil of an economics doctrine, which established that in a small, open economy, a floating exchange rate would never work because it would be extremely volatile and lead to poor economic performance.

Since then, many countries have gradually shifted from fixed to floating exchange rate regimes. I believe these measures have been extremely useful. Moving to flexible rate regimes has really made emerging markets far more resilient. In Mexico, the combination of a flexible exchange rate regime with a strong mandate for the monetary authority has transformed the monetary policy framework established by the central bank into a really solid anchor. This framework certainly proved to have worked well during the most recent global financial crisis.

Q. Mexican banks held up well during the global financial crisis. What accounts for their superior performance? Are there changes planned to comply with Basel III, the international bank regulatory update approved last year?

A. After our crisis in 1994, a major boost was given not only to upgrade our supervisory capacity and our regulatory instruments but, to some extent, to be ahead of the curve. As a matter of fact, many of the standards that are now being addressed and created as part of Basel III are in the process of being implemented in Mexico.

Mexico will implement Basel III in the coming months. Why? Well, because, basically, we are already there. For example, a major advance in Basel III is how much core capital [equity and cash reserve funding] must comprise basic capital. There were many aspects of the capital definition that were weak before—for instance, the provisions for deferred taxes. Liquidity provisions, we have already taken care of.

The Mexican banking system was very resilient to the recent real shock to the economy. Banks continue to be profitable. They have only reduced the rate of credit granting as a precautionary measure, in response to how their operations were unfolding in the rest of the world. To counteract tightening credit—and this was the only important countercyclical measure implemented—authorities used the development bank network to assume part of the credit risk from certain transactions and induce banks to take more risk. These actions turned out very well. Moreover, the program has not cost the Mexican government a cent because there was no intrinsic risk in those transactions.