The Global Crisis and Mexico: The End of Mexico's Development Model?

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The current global crisis, and the role of the United States in it, has brought into the public light the role of financial derivatives in keeping the global financial system in a constant state of volatility. This, however, is not a new experience for the Mexican economy. These financial instruments were a key factor in triggering the 1995 peso crisis. While international institutions and neoliberal analysts blamed the 1995 crisis on the rigidities of the Mexican economy and the ineffective role of the state in supervising financial institutions, the role of derivatives in causing the collapse of the Mexican economy and setting the conditions for austerity measures and disciplining workers was completely ignored.

This time the role of derivatives as a central aspect causing a global recession and affecting the Mexican economy negatively can not be denied. The derivatives transactions undertaken by Mexican corporations have intensified the effects of the recession in Mexico due to particular structural problems in the Mexican economy compared to other OECD countries. These problems are: the pressures that financial derivatives denominated in U.S. dollars exert on the Mexican peso; the concentration of market power in a few Mexican firms; the heavy reliance on American markets (and remittances from Mexican migrants to the U.S.); and the failures of the development model based on the exploitation of cheap Mexican labour at home and abroad.

CORPORATIONS AND PRESSURES ON THE MEXICAN PESO

Derivatives are often described in economics as a two-party financial contract, the worth of which is derived from the value of some underlying asset. They can be traded in specific market places or by private arrangement called 'over-the-counter' (OTC) transactions.

Some of the derivatives used prior to the 1995 peso crisis were total return swaps. This instrument was mostly used to profit from interest differentials to borrow in U.S. dollars and invest in Mexican pesos. A Mexican bank and a financial firm in Wall Street signed a contract that established that the Mexican firm or bank would pay to the financial institution the 'loan,' and the latter would pay the bank the 'total return' on pre-selected securities. These securities were often short-term peso-denominated public debt.

In this operation, a Mexican corporation agreed to pay the financial firm at LIBOR (the London inter-bank overnight lending rate) plus some additional points on a dollar loan for a short period of time. In exchange, New York investment banks agreed to pay the Mexican entity the return on a given amount of public debt for the same period of time. If the peso did not decrease in value against the U.S. dollar, the returns in public debt remained high and the payment on the dollar loan stayed low.

In this way, Mexican banks could borrow dollars from the Wall Street firm and receive the return from the Mexican bond. When the Mexican peso was under pressure in the mid-90s and devalued, Mexican banks and major firms had to pay their outstanding debt in U.S. dollars. For that reason, they created enormous pressures on the peso when they used lots of dollars to cover their foreign currency obligations. Hence the peso crisis, and the harsh neoliberal austerity imposed on Mexican workers and peasants.

This story is now repeating itself. Over the last years, Mexican corporations did not directly invest extensively in American mortgage-backed securities or credit derivatives linked to those securities. Still, they used derivatives to obtain U.S. dollars at low interest rates, pay these loans with yields in their investment in Mexican pesos and obtain profits from the difference between lending rates in the U.S and investment rates in Mexican pesos.

For instance, Cementos Mexicanos, the third largest cement in the world reported profits by US$ 300 million in 2007. With the credit crunch, the shortage of liquidity in U.S. and an increase in interest rates, CEMEX now owes US $500 million in its derivatives operations. Other important Mexican firms that comprise a large portion of the Mexican stock exchange have also reported millions of losses in their derivatives operations. This has also resulted in an increase of these firms' total debt and decreasing share prices. In order to obtain funds to cancel pending instruments in derivatives and make stocks more attractive for investors, Mexican corporations have decided to cut jobs, close plants and decrease production.

Mexican companies also played a crucial role in the downward pressure on the Mexican peso as these firms ran to cover dollar-denominated debt and positions they had taken in exchange-rate derivatives. This created a shortage of U.S. dollars in the economy, increasing the value of the former vis-à-vis the Mexican currency. In order to maintain confidence of the peso and prevent a more intense speculative run on the currency, the Mexican central bank supplied a large amount of dollars from its international reserves (e.g. the Mexican central bank used 11 percent of its reserves in less than 72 hours at one point over the last months) and increased interest rates on public debt to guarantee the value of the peso.

The actions of the central bank do not entail a direct bailing out of Mexican companies. Still, the supply of cheap dollars at the expense of the public-owned oil company's earnings and the federal budget can and should be considered as an indirect socialization of private losses. On the one hand, the supply of these dollars prevents the Mexican peso from depreciating, and as a result, it stops Mexican corporate debt in derivatives from increasing. On the other hand, the foreign currency provided by the federal government is channelled to the central bank as opposed to social spending.

STRUCTURAL PROBLEMS IN THE MEXICAN ECONOMY

Mexico's President Felipe Calderón claims that that Mexico's banks are solid and the Mexican economy is prepared to face the global economic crisis. However, this takes place in a context of slow economic growth, high unemployment and underemployment and increasing prices vis-à-vis wages. Real wages have been declining annually by almost one percent while inflation has reached four percent. According to Mexico's National Institute of Statistics, 63 percent of people's income is spent on food, leaving very little money for education, housing and health. Also, levels of poverty have not decreased drastically given that 14 percent of the population still live in poverty. This is the legacy of Mexican anti-inflationary policies that kept minimum wages from rising, implemented austerity measures in social spending, privatized land, removed agricultural and food subsidies and increased interest rates to attract investment in the Mexican peso.

Despite the measures carried out by the Mexican government to maintain a "sound" financial system and public finances, the global financial crisis might have a greater impact on the Mexican economy that on its OECD or other Latin American counterparts. The reasons are threefold. First, the concentration of market power in a few firms has negative effects on job creation and the balance-of-payments. The job cuts planned to fulfill the private sector's debt obligations increases the unemployment rate and depresses wages even more due to the large availability of labour. At the same time, these firms are central to the Mexican balance-of-payments because they are one of the main sources of foreign currency into the country via exports and portfolio investment. The diminishing flow of foreign currency through these firms entails the expansion of public debt in Mexican pesos by the Mexican government in order to obtain the foreign currency necessary to maintain the value of the peso.

Second, the Mexican economy faces greater challenges than other countries because of its dependence on American markets for its exports. The economic recession in the United States will lessen the demand for Mexican products, bringing the manufacturing sector to standstill and further decreasing job opportunities for Mexicans. It is worth noting that this export-oriented model has been based on cheap labour in the *maquilas* – factories that import materials on a duty-free and tariff-free basis for assembly and re-export the final product – under deteriorating labour and environmental conditions and weak backward and forward linkages to the national economy.

Third, Mexico relies heavily on remittances from the United States. In fact, remittances have become a special section within Mexico's national accounting and it has served as a pressure valve for the Mexican government. Remittances have released pressure for jobs and social spending because poor families have relied on the money sent from abroad to overcome the lack of job opportunities and low incomes. Remittances have also helped to maintain the value of the Mexican peso, which is crucial for Mexican firms' transaction in derivatives. In 2006, for instance, remittances became the second single source of foreign currency after oil exports. However, the economic recession in the U.S. has affected the flow of remittances sent to Mexico because employment and incomes for undocumented Mexican immigrants have decreased. The Mexican central bank has reported a drop of 12.2 percent in remittances, which is the largest of these cash payments in a single year. This, in turn, creates greater pressures for job creation and social spending in Mexico in order to counteract the negative consequences of the decline of remittances from the United States.

Overall, the power of few firms, the dependence on U.S. markets for exports and remittances and the continuing reliance on a development model based on cheap labour have not only obstructed but also reduced the potential for an economic growth based on a more even distribution of income. This is crucial for the creation of internal market that keeps production moving regardless of the lack of external demand for Mexican goods. Not only the absence of an internal market threatens with paralyzing Mexico's productive sector and creating further unemployment, but also the lack of a social safety net further aggravates the situation of the working people in Mexico. While the Mexican government has implemented social programs that target extreme poverty in Mexico, there are no universal policies that protect people from unemployment, underemployment and depressed wages. These are policies which could benefit those sectors of the population that do not fall under the category of the extreme poor but still live in poverty.

THE LIMITS TO THE MEXICAN GOVERNMENT'S NEW ECONOMIC RECIPE

The Mexican government has reacted to the global crisis in two ways. First, Mexico's financial regulators have responded to the risky positions undertaken by Mexican companies with an investigation in an attempt to reveal the nature of their use of foreign-exchange derivatives. Second, Calderon has implemented a US $4.4 billion emergency spending program to cope with the financial crisis. Calderon has announced that this program will target the construction of energy, highway, railway, education, health, and hydro-agricultural infrastructure works. Also, the program involves the allocation of $12 billion pesos for the construction of a new refinery to reduce dependence on imported refined oil.

The recent measures reflect a policy shift from strict austerity policies, implemented since 1982 and the de-politicization of the 1995 government bail-out program of Mexican banks, toward a government-spending scheme focused on infrastructure. There is also a re-politicization of the financial practices of Mexican firms through an official enquiry. This, however, is not the result of the "good" intentions or the so-called "social democratic" agenda of the Calderon administration and the current LX (60th) Legislature (Congress of Mexico). Rather, it is the reflection of the social discontent with the political system and the economic model, which has been expressed in several protests, the lack of support for Calderon in the 2006 presidential elections, and the severe crisis of credibility for the country's electoral institutions and overall political institutions in Mexico, including the police and courts. As such, the federal government could not respond with the usual supply-side economics prescription of tightening government spending. Instead, it decided to implement a demand-side management strategy focused on infrastructure in order to prevent further social disenchantment with the current economic and political system.

However, this new strategy has several shortcomings. It does not change the balance of power between the private sector and workers. The Mexican government still has the lowest levels of corporate taxation within the OECD and has very little control over short-term capital outflows. This is, in turn, reflected in the severe pressure exerted over the Mexican peso by firms in order to settle derivative obligations in U.S. dollars.

In addition, infrastructural developments do not necessarily translate into the improvement of the living standards of the middle and low income sectors of the population. On the one hand, the infrastructural projects proposed by the Calderon Administration still rely on cheap labour, and therefore only provide a safety valve to unemployment without guaranteeing income redistribution. On the other hand, investment in highways, railroads, energy and hydro-agricultural projects only benefit a small sector of the population, particularly those firms that benefit from cheaper oil prices, faster transportation and large-scale agriculture. At the same time, the rest of the population is excluded from the planning process of these projects, which usually entail community displacement, environmental degradation and low safety standards for workers.

Indeed, the government has planned to channel funds into education and health infrastructure. Still, the inclusive and democratic use of these facilities to improve the health and education levels of the most vulnerable in Mexico is questionable. The reason is the presence of a corrupt leadership within official teachers' union, which controls the operation of public schools, including its infrastructure, and the deficient health services offered to Mexico's poorest through the Popular Health Insurance Program.

The Mexican government's focus on infrastructural projects only reproduces the weaknesses of the Mexican development model in the current context of the global crisis. This poses a double-burden on Mexico's poor, who do not only have to suffer the consequences of the economic strategy based on cheap labour at home and abroad, but also the costs of the global crisis, which has already manifested itself through lower wages, higher food prices and unemployment. The Mexican government needs to go beyond infrastructural investment to implement policies that create a social safety net, make food accessible to people, improve the quality of education at all levels and promote inclusive and participatory urban and economic planning. But this is really a question of new political movements emerging and a rupture in the existing Mexican state and power structures. **R**

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