

Debt Problem of Mexico and Other Latin American Countries

ECN 252

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Purpose of This Course:

One of the objectives of the PVCC Mexico project is to increase access to information about Mexico, which makes sense, due to its size and vicinity.

To provide a better understanding of Mexico, it is truly necessary to promote a better understanding its economy. And to understand the economic situation of Mexico today, it is necessary to dwell with its huge public debt problem. Why and how did it develop? What can be done about it (if anything)? What has be done to solve it? How does it affect the outlook of Mexico into the future? How does all of this affect us? What can we do about it?

Competencies:

At the end of this course, the student should be able to:

1. Explain the domestic problems associated with public debt according to economic theory.
2. Describe international economic concepts (such as the balance of payments, foreign currency reserves and exchange rates) and explain their relationship to macroeconomic variables (such as aggregate output and interest rates).
3. Analyze the effects of public debt on the exchange rate, trade balance and foreign currency reserves, according to economic theory.
4. Explain and discuss the merits of the various forms of foreign exchange intervention, according to economic theory.
5. Describe the circumstances that led to the Mexican crisis of 1982 and its effects on the rest of Latin America. Discuss how such a crisis could have been avoided.
6. Describe the Baker and Brady financial restructuring plans for Mexico and other Latin American countries. Discuss the merits and limitations of these plans.
7. Discuss the possible effects of the NAFTA agreement on Mexico's financial and economic situation.
8. Describe the current financial and economic situation of Mexico. Explore and discuss possible future financial and economic scenarios in Mexico.

Texts:

Parkin: Macroeconomics, 3rd ed., Addison Wesley.

Paul R. Krugman & Maurice Obstfeld: International Economics, 4th ed.
Addison Wesley .

Mohamed A. El-Erian: Mexico's External Debt and the Return to Voluntary Capital Market Financing, IMF Working Paper WP/91/83.

Andrew Feltenstein: Tax Policy: and Trade Liberalization - An Application to Mexico, IMF Working Paper WP/92/108.

Claudio Loser & Eliot Kalter: Mexico: The Strategy: to Achieve Sustained Economic Growth, IMF Occasional Paper, No.99.

Tamin Bayoumi & Barry J Eichengreen: Monetary and Exchange Rate Arrangements for NAFTA, IMF Working Paper WP/93/20.

Guillenno E. Perry: Currency: Boards and External Shocks: How Much Pain, How Much Gain? World Bank Publication.

Shakil Faruqi: Financial Sector Reforms in Asian and Latin American Countries Lessons of Comparative Experience, Work Bank Publication.

Ian M. Little, Richard N. Cooper, W. Max Corden, & Sarath Rajapatirana: Boom Crisis and Adjustment: The Macroeconomic Experience of Developing Countries, 1970-90. World Bank Publication.

Country Analysis of Mexico, The Economist Intelligence Unit.

Overview of the North American Free Trade Agreement, Organization of American States-Trade Unit.

Note to the instructor: The instructor should use the IMF and World Bank publications mainly to draw material for class. The instructor might choose to include in the student's photocopies a few relevant pages of some of these papers, but it would not be realistic to have students read and understand the full length of the papers. The instructor might want to leave the papers on reserve in the library for interested students.

The instructor should use the most current issue of The Economist

Intelligence Unit country analysis of Mexico (or an equivalent source of current data) to discuss the material for week 16.

Outline:

- Week 1: Domestic economic policy and the long-run problems of public debt.
(Parkin pp. 729-731,788,917,857-860)
- Week 2: National Income Accounting and the Balance of Payments.
(Krugman & Obstfeld pp. 303-320)

- Week 6: Price Levels and the Exchange Rate in the Long Run. (Krugman & Obstfeld pp. 421-431)
Output and the Exchange Rate in the Short Run.
(Krugman & Obstfeld pp. 440-451)
- Week 7: Output and the Exchange Rate in the Short Run.
(Krugman & Obstfeld pp. 451-472)
- Week 8: Fixed Exchange Rates and Foreign Exchange Intervention.
(Krugman & Obstfeld pp. 488-504)
- Week 9: Fixed Exchange Rates and Foreign Exchange Intervention. (Krugman & Obstfeld pp.504-512)
Latin American Countries: Debt, Stabilization, and Reform. (Krugman & Obstfeld pp. 684-693)
- Week 10: Applying Economic Theory of Debt, Stabilization, and Reform to Latin American Countries.
(Krugman & Obstfeld pp. 693-715)
- Week 11: Mexican History of Public Debt Problems. (Riding pp. 194-219)
- Week 12: The 1982 Crisis and Its Aftermath.
(Riding pp. 219-226; Little, Cooper, Corden & Rajapatirana)
- Week 13: The Baker and Brady financial restructuring plans for Mexico and other Latin American Countries.
(El-Erian; Farugi; Little, Cooper, Corden & Rajapatirana).
- Week 14: The role of the exchange rate in Mexico.
(Perry; Bayoumi & Eichengreen; Loser & Kalter; Little, Cooper, Corden & Rajapatirana)
- Week 15: NAFTA.
(OAS: Chs. I, 3, II, 12 & 20)
- Week 16: Mexico's Current Economic and Financial Situation and Projections for the Future.
(The Economist Intelligence Unit: Country Fact Sheet; Country Forecast Summary)

Class Requirements:

The student is encouraged to attend all class sessions due to the complexity of the subject matter and the range of material to be covered. The mid-term and final exams may contain questions on topics covered in class discussion that might not have been present in the readings. Missing class might cause the student to miss quiz exams, which will not be offered extemporarily.

Final Project:

The student will be required to hand in a final written project at the end of the semester.

The project will involve extensive bibliographic research any aspect of the Mexican Debt problem that might interest the student and be approved by the instructor. The student should discuss the topic with the instructor during the first week of classes.

The student will have to present to the instructor an outline for his project within the first four weeks of classes.

The student will have to present a rough draft of the project to the instructor by the date of the mid-term exam, for the instructor to evaluate and suggest improvements on.

The student will have to present the final version of the project at least two weeks before the end of the semester.

Grading:

The final grade will be computed according to the following weights:

25% Quiz Exams.

25% Mid-term Exam. 25% Final Exam.

25% Final Project.

Unemployment

Inflation

The two core policy indicators: Real GDP growth and inflation

Fiscal policy in the long-run

A burden for future generations?

Crowding out

Ricardian equivalence

Monetary policy in the long-run

The ripple effect of monetary policy

The exchange rate effects of debt

Discuss the National Income accounting for an Open Economy:

Consumption

Investment

Government purchases

The National Income identity for an open economy

The current account and foreign indebtedness

Savings and the current account Private and government savings

Effects of government budget deficit on current account

The Balance of Payments accounts

Paired transactions and balance of payments identity

The current account

The capital account

The statistical discrepancy

The actors

Characteristics of the market

Spot rates and forward rates

Foreign exchange swaps

Futures and options

The demand for foreign currency assets

Risk and liquidity Interest rates

Exchange rates and asset returns

Return, risk and liquidity in the foreign exchange market

Equilibrium in the foreign exchange market

Interest parity: the basic equilibrium condition

How changes in the current exchange rate affect expected returns

The equilibrium exchange rate

Interest rates, expectations and equilibrium

The effect of changing interest rates on the current exchange rate

The effect of changing expectations on the current exchange rate

How the money supply is determined

The demand for money by individuals

Expected return Risk

Liquidity

Aggregate money demand

The equilibrium interest rate

Equilibrium in the money market

Interest rates and the money supply

Output and the interest rate

The money supply and the exchange rate in the short run

Linking money, the interest rate, and the exchange rate

U.S. Money supply and the Dollar/peso exchange rate

Mexican money supply and the dollar/peso exchange rate

Money, the price level, and the exchange rate in the long run

Money and money prices

The long run effects of money supply changes

Empirical evidence on money supplies and price levels

Inflation and money supply growth in Latin America

Money and the exchange rate in the long run

Inflation and exchange rate dynamics

Short run price rigidity versus long run price flexibility

Money supply growth and hyperinflation in Bolivia

Permanent money supply changes and the exchange rate

Exchange rate overshooting

Absolute PPP and relative PPP

A long run exchange rate model based on PPP

The fundamental equation of the monetary approach

Ongoing inflation, interest parity, and PPP

The Fisher effect

Empirical evidence on PPP and the law of one price

Explaining the problems with PPP

Trade barriers and nontradables

Departures from free competition

International differences in price level measurement

PPP in the short run and in the long run

Why prices are lower in Mexico

International interest rate differences and the real exchange rate

Real interest parity

Output and the Exchange Rate in the Short R

Determinants of aggregate demand in an open economy

Determinants of consumption demand

Determinants of the Current account

How real exchange rate changes affect the current account

How disposable income changes affect the current account

The equation of aggregate demand

The real exchange rate and aggregate demand

Real income and aggregate demand

How output is determined in the short run

Output market equilibrium in the short run: the DD schedule

Output, the exchange rate, and output market equilibrium

Deriving the DD schedule

Factors that shift the DD schedule

Asset market equilibrium in the short run: the AA schedule

Output, the exchange rate, and asset market equilibrium

Short run equilibrium for an open economy: putting the DD and AA schedules together

Temporary changes in monetary and fiscal policy

Monetary policy

Fiscal policy

Policies to maintain full employment

Inflation bias and other problems of policy formulation

Permanent shifts in monetary and fiscal policy

A permanent increase in the money supply

Adjustment to a permanent increase in the money supply

A permanent fiscal expansion

Macroeconomic policies and the current account

Gradual trade flow adjustments and current account dynamics

The J-curve

Exchange rate pass-through and inflation

Mexico's trade balance and the peso's exchange rate

Sterilization

The balance of payments and the money supply

How the central bank fixes the exchange rate

Foreign exchange market equilibrium under a fixed exchange rate

Money Market equilibrium under a fixed exchange rate

A diagrammatic analysis

Stabilization policies with a fixed exchange rate

Monetary policy

Fiscal policy

Changes in the exchange rate

Adjustment to fiscal policy and exchange rates

Foreign exchange market equilibrium under imperfect asset substitutability
The effects of sterilized intervention with imperfect asset substitutability
Evidence on the effects of sterilized intervention
The signaling effect of intervention

Latin American Countries: Debt Stabilization and Reform

Income and wealth in the world economy

Macroeconomic features of Latin American countries

Undeveloped financial markets Government's pervasive role
Inflation and the government budget
Pegged exchange rates, exchange controls, and inconvertible currencies
The structure of Latin American country exports

Latin American countries borrowing and debt

The economics of borrowing by Latin American countries
Alternative forms of capital inflow
Government and publicly guaranteed borrowing

The Paris Club

Borrowing after 1973: oil shocks and floating interest rates

Latin American debt crisis of the 1980s

Leading up to the crisis

Latin American countries in the worldwide recession

The beginning of the crisis

Managing the debt crisis

Renewed capital inflows

Trying to tame inflation in the developing world

The Latin American *Tablitas* of the 1970s

Heterodox versus orthodox stabilization

Stabilization with heterodox elements

Why the currency appreciates in real terms during inflation stabilization

Lessons

The road ahead

Early 20th Century Mexican finances

Early 20th century economic and financial situation of Mexico. Economic effects of the nationalization of the oil industry and of the second world war.

Policies of the 1970s that led to the 1982 financial crisis.

Luis Echeverria Alvarez's presidency.

Jose Lopez Portillo's presidency.

The "ancestral needs" of the Mexican population.

Using oil reserves as collateral for loans.

The "petrolification" of the economy.

The many ways in which the money was squandered.

Corruption.

Where did the dollars go?

Exchange rate policy

The fixed exchange rate policy.

Differences in inflation between the U.S. and Mexico.

The effects on trade.

The crisis.

The international financial markets fail to spot the Mexican financial strains.

International borrowing switches to short term debt.

The "Burro Bonds".

Lopez Portillo' s pledge to defend the peso like a dog.

The devaluation.

The potential impact of Mexico's crisis on America's financial institutions

The fall-out effect of the Mexican debt crisis on other Latin American countries.

The roles of IMF and the World Bank.

Performance and problems of the Baker plans.

Recognizing that the Mexican debt problem was more than a simple short-run liquidity problem.

Rethinking the Baker plan: restructuring the debt from short-term to long-term.

The 1986 crisis: the price of oil drops again.

Setting up the Brady Plan.

The debate on thinking the unthinkable: pardoning part of Mexico's debt.

The three options offered to Mexico's creditors:

- 1) Pardoning part of the debt and restructuring remaining debt into fixed interest bonds.
- 2) Lending new money to Mexico in exchange for not having to pardon any debt.
- 3) Swapping part of Mexico's debt for Mexican assets.

The performance of the Brady plan.

The options creditors chose.

The secondary Mexican debt market and the writing off of Mexican debt.

The economic policies of Salinas.

The performance of the Mexican economy.

The application of the Baker and Brady restructuring plans to other Latin American countries.

Echeverria changes the rules.

Echeverria's unorthodox economic policies and their effect on prices, the external debt, and on the exchange rate.

The mixed blessing of new-found reserves of oil under Echeverria.

Lopez Portillo follows on.

The effect of Lopez Portillo's "petrolification of the economy," on prices, on the external debt, and on the exchange rate.

Political cycle of exchange rate devaluations.

The political expediency of having devaluations right after presidential elections but before the new president begins his term.

The gross over-spending on political campaigns and their effect on prices and the exchange rate.

The problem of political and economic uncertainty during an election year: how worries and expectations lead to devaluations as money flows away to the U.S.

De La Madrid breaks expectations

How De La Madrid managed to avoid devaluations in his presidency.

The Administration of Salinas

Using the exchange rate as a macroeconomic tool to reduce inflation.

Salinas's determination to avoid a devaluation.

The economic forces that led to a devaluation right after Salinas leaves office.

Why Mexico seemed to be doing so good and yet crashed again anyway.

The current situation with Mexico's exchange rate.

The continuing strains of relative inflation on the exchange rate.

A managed exchange rate: today's so-called "floating" exchange rate.

'Why not a truly floating exchange rate?

Using NAFTA to enhance the competitiveness of Mexican industry.

Using NAFTA to make Mexico more attractive to foreign investment.

The joining the rich might just make us richer" argument.

Mexican fears of NAFTA

The inadequacy of Mexican industry to confront open international competition.

The mistrust of foreign investment in Mexico.

The issue of sovereignty.

The possible economic influences of NAFTA

Mexico's long-term growth.

Trade.

The exchange rate.

Mexico's public debt.

The performance of NAFTA so far.

On economic liberalization.

The growing concern on political stability.

The various factions within the PRI.

The opposition parties' progress.

The attitude of the military.

Investment in the future.

Should foreign investors trust Mexico?

What Mexican investors are doing with their money.

Finding ways to stimulate more private savings in Mexico: is Chile a good model to follow on pensions?

Government finances.

The effects of lower inflation and interest rates on government spending.

Increasing revenue without increasing taxes: the benefits of a simpler tax code; Laffer's curve, the black market and lower taxes.

The future of NAFTA.

What the U.S. can do to help.