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The High Cost of the Strong Peso and Its Temporary Nature: The Case of Mexico

by

Arturo Huerta-González
Universidad Nacional Autónoma de México

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Levy Economics Institute
P.O. Box 5000
Annandale-on-Hudson, NY 12504-5000
http://www.levyinstitute.org

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ABSTRACT

The article analyzes why exchange rate stability has been prioritized in Mexico and why the national currency has appreciated; which policies and factors have made this possible, the costs and consequences of the strong peso, and its sustainability and temporality are also examined. Mexico's economy does not have the endogenous conditions necessary to maintain such a strong currency—which has relied on the inflow of capital, thus exposing the economy to high vulnerability vis-à-vis the behavior of capital flows. The exchange rate stability has been very costly, due to the fact that there is no longer an economic policy in favor of growth; furthermore, the entry of capital leads to continuous productive imbalances which are behind the external deficit. In essence, Mexico has fallen into the Ponzi effect, whereby debt covers the deficit and pays off debt.

This article posits that an effective, flexible exchange rate should be used to lower the interest rate and increase public spending in favor of growth and employment, and that economic policy should aim to encourage import substitution and increase the domestic value added of exports in order to reduce the external deficit and capital inflow requirements. This should be accompanied by regulating the movement of goods and capital to avoid speculation and protect domestic production from imports, in turn allowing for a more flexible economic policy in favor of the productive sector and employment. Lastly, the article proposes that the economy should be financed with its own currency to boost growth potential and reduce the foreign trade deficit in order to avoid relying on external financing.

KEYWORDS: Government and the Monetary System, Financial Markets and the Macroeconomy, Fiscal and Monetary Policy in Development, Policy Designs and Consistency, Financial Markets and the Macroeconomy, Comparative or Joint Analysis of Fiscal and Monetary Policy, Stabilization, Foreign Exchange Policy, Factor Movement Policy

JEL CODES: E42, E43, E44, E63, O23, O24

1. THE MEXICAN ECONOMY DOES NOT HAVE ENDOGENOUS CONDITIONS TO STABILIZE THE EXCHANGE RATE

Mexico's economy has been characterized by a foreign trade deficit in a context of economic growth. The foreign trade deficit should seemingly lead to a devaluation of the currency in order to reduce imports by making them more expensive, as well as to make the peso and domestic production cheaper and increase exports to reduce the foreign trade deficit. This has traditionally been accompanied by restrictive monetary and fiscal policies to reduce economic activity and imports, thus lowering the foreign trade deficit. However, this has not been done. The exchange rate has been kept stable, which makes the dollar and imports cheaper and increases the foreign trade deficit. In order to prevent this from devaluing the currency, capital inflows have been promoted, either through foreign debt or foreign direct investment and portfolio investment, which finance the foreign trade deficit and maintain exchange rate stability.

2. EXCHANGE RATE STABILITY SUPPORTED BY CAPITAL INFLOWS

The exchange rate is mainly influenced by the foreign trade balance, the current account balance, the financial account of the balance of payments (capital inflows), the internal and external interest rate, the internal and external price level, economic growth, the growth of Mexico's main trading partner, and the attractive assets that the country offers to capital inflows. Mexico is running a deficit in the foreign trade and current account balance of the balance of payments, which puts pressure on the exchange rate. Domestic inflation is higher than that of the United States—Mexico's main trading partner—which is detrimental to Mexico's competitiveness and also exerts pressure on the exchange rate. The domestic economy is experiencing low growth, which discourages the entry of foreign investment which could be channeled to produce for the domestic market and is another factor that pressures the exchange rate. The world economy is slowing and the US economy is implementing protectionist policies that tend to slow down exports, which will put pressure on the exchange rate. The government of López Obrador (2018–24) has limited the participation of foreign direct investment in strategic sectors, so economics is less attractive to capital inflows. Acting in favor of the stability and appreciation of the exchange rate is the internal interest rate differential with respect to the external interest rate, which promotes capital inflows, generates surpluses in the balance of payments financial account, and increases international reserves, keeping the exchange rate stable and appreciated. In addition, remittances have a positive effect on the current account balance and the exchange rate. There is also the inflow of foreign direct investment that enters the country in order to export. It is, therefore, the inflow of capital that makes exchange rate stability possible and maintains the free mobility of goods and capital and the external sector deficit.

3. AN ECONOMY DEPENDENT ON CAPITAL INFLOWS

The economy depends on remittances, financial capital inflows, foreign direct investment, money laundering, and foreign indebtedness—such as IMF credits and swaps. All of these elements drive the foreign trade deficit, the payment of foreign debt, and the maintenance of international reserves that ensure peso–dollar convertibility at the existing exchange rate.

The capital inflows being promoted are not aimed at increasing productive investment to overcome the output lags which are behind the foreign trade deficit; rather, they are mainly channeled to consumption in the case of remittances, and to money and capital markets to profit from the high interest rates of the public debt and the returns offered by the Mexican Stock Exchange.

The government navigates the obstacle to growth caused by the productive lags and the external deficit by promoting capital inflows, instead of solving the productive problems and modifying economic policies which have increased imports and the foreign trade deficit. It opts for a solution that only postpones and amplifies the problems of the economy, since capital inflows increase the payment of obligations derived therefrom and the economy fails to generate payment conditions.

4. ECONOMIC POLICY FOR PROMOTING CAPITAL INFLOWS TO STABILIZE THE EXCHANGE RATE

Even though the monetary and fiscal authorities say they are working with a flexible exchange rate, they do everything possible to keep the exchange rate stable and their decisions even appreciate the currency. The authorities favor restrictive policies that affect the supply and demand of foreign currency in order to maintain exchange rate stability. On the one hand, high interest rates and fiscal austerity attract capital, which increases the supply of dollars. On the other hand, they restrict economic activity and the demand for imports and dollars, so that the supply of dollars is greater than the demand, thus lowering its price and strengthening the peso.

In order for capital to flow into the economy, economic policy aims at ensuring conditions of profitability and payment. That is why high interest rates and primary surpluses or low primary deficits are established.

Fiscal austerity encourages the entry of dollars, both because it avoids demand pressures on prices and the exchange rate, and assures profitability for capital inflows, and, on the other hand, it stimulates the entry of capital to invest in areas where the government has ceased to do so. The appreciation of the exchange rate stimulates the entry of financial capital, because it profits from the high interest rate, or from the investment it undertakes, and when withdrawn from the country, the dollar is cheaper than when it entered.

5. THE IMPACT OF PRIORITIZING EXCHANGE RATE STABILITY ON GROWTH-ORIENTED MONETARY AND FISCAL POLICIES

The free mobility of capital requires working with a stable exchange rate, since capital loses value if the currency is devalued. To stabilize the exchange rate, capital inflows are favored to finance the external deficit and increase international reserves. Exchange rate stability is favored so that the free movement of capital does not speculate against the peso.

The downside of this option is that economic authorities lack an economic policy to stimulate growth and adjust the foreign trade deficit. By favoring exchange rate stability, the exchange rate cannot be modified by incorporating the price and productivity differential between Mexico and its main trading partner in order to maintain competitiveness, avoid foreign trade deficits, and ensure a greater internal multiplier effect of domestic demand. This is in addition to the increased foreign indebtedness and foreignizing of the national economy, used to promote capital inflows and increase international reserves in order to maintain exchange rate stability and the convertibility of the currency at the same exchange rate.

The entry of capital and the policy that promotes it, rather than contributing to economic growth, distorts it, due to relative prices. Exchange rate appreciation makes the dollar and imports cheaper, which reduces the competitiveness of domestic production—displaced by imports—and increases output imbalances and the foreign trade deficit, while slowing economic activity. By reducing the competitiveness of domestic production, companies maintain low wages to offset this loss of competitiveness, which reduces domestic consumption. An appreciated exchange rate also reduces the purchasing power of remittances in local currency, which reduces consumption growth. The high-interest-rate policy (established to promote capital inflows) is another distortion of relative prices, since it favors financial investment to the detriment of productive investment, in addition to increasing the cost of servicing the debt. This harms public and private finances given their high levels of indebtedness, reducing their spending and investment capacity and, therefore, economic activity. This weakens the return offered on capital inflows, as well as the repayment of the financial obligations that accrue from it.

6. THE EXTERNAL DEFICIT IS ADDRESSED BY PROMOTING CAPITAL INFLOWS, WHICH FURTHER ACCENTUATES THE DEFICIT

Before the 1980s, developing economies were concerned with reducing their foreign trade deficits to eliminate dependence on capital inflows and avoid falling into external debt. To this end, they regulated foreign trade, implemented industrial and agricultural policies, and devalued their currencies to avoid growing foreign trade deficits. With the onset of globalization and the free mobility of capital, this changed.

The external deficit began to be addressed by generating surpluses in the balance-of-payments financial account by promoting capital inflows, both through the increase in foreign debt and the inflow of financial capital and foreign direct investment, as well as through the sale of national companies and investment inflows for export. This temporarily cushions the negative effect of the external deficit on economic growth and the exchange rate. The large inflow of financial capital encouraged by high interest rates buys public debt with which the government pays the cost of the accumulated debt.

The policy, aimed at promoting capital inflows, in turn, reduces productive investment and appreciates the currency, which increases the import ratio and the foreign trade deficit. In addition, the transfer of resources for debt service payments puts pressure on the current account deficit. Jan Kregel points out that “capital flows are the real cause of international imbalances” (2010).

Having secured capital inflows to finance the external deficit, Mexican authorities are not concerned with addressing the productive problems behind the foreign trade deficit, nor do they modify the policies that increase this deficit. On the contrary, the policies they establish to promote capital inflows continue to increase the external sector deficit, so the economy continues to require capital inflows to finance the deficit. Instead of using capital inflows to increase productive investment which would increase productivity and reduce output imbalances and the foreign trade deficit, policies favoring capital inflows act in favor of financial investment and not the productive sector, so that supply pressures on the trade deficit continue.

The prevailing policies have led the economy to fall into a vicious cycle, as they keep latent and growing pressures on the external deficit and dependence on capital inflows, so the economic policy that favors capital inflows continues.

7. THE ECONOMY HAS FALLEN INTO A PONZI SCHEME

The policies of high interest rates, fiscal austerity, exchange rate stability, and free movement of goods and capital—which have prevailed in recent decades, by acting against productive growth—increase the external sector deficit and the economy's dependence on capital inflows. This leads to economic policies that promote capital inflows, thus resorting to more debt to pay debt. This is a consequence of the fact that the economy does not generate endogenous conditions for payment, or for maintaining the free mobility of goods and capital and exchange rate stability, which is unsustainable. Sebastian-Llie Pragoz and Camila Oprean Stan point out that "countries that experience large inflows of capital are more likely to experience debt crises" (2022, 143). This occurs because such capital is not directed to generate wealth that guarantees the repayment of the obligations that arise from it.

As long as the economy continues to depend on capital inflows, economic policy will favor the financial sector and so the conditions for an economic policy in favor of the productive sector and full employment will be lacking.

The government is more concerned with being well regarded by the rating agencies and so fiscal austerity and high interest rates prevail in order to keep the capital flowing in to pay the debt, instead of having an economic policy that addresses the structural problems behind the external deficit and makes the economy dependent on capital inflows. The real obstacles to growth are the productive lags and low productivity, manifested in the external deficit, making Mexico dependent on capital inflows.

8. THE CURRENT ACCOUNT DEFICIT TEMPORARILY SUSTAINED BY CAPITAL INFLOWS

The foreign trade deficit does not exert pressure on the exchange rate when the economy has capital inflows to finance it. The problem is that this is not permanent, because the inflow of capital leads to the payment of financial obligations. As the foreign trade deficit continues, Mexico falls into debt to pay debt, increasing the country's risk of being unable to pay, given that their dependence on such capital continuing to flow in, thus placing the country in a context of high vulnerability and fragility.

Since there are no conditions for debt payment and since there are no longer attractive investment opportunities for capital to continue flowing in, capital will cease to enter the country. Additionally, if remittances are insufficient to finance the external deficit, a balance-of-payments crisis will occur, since it will not be able to finance the trade deficit and debt payment. GDP will have to be restricted and the currency devalued to generate foreign trade surpluses to cover debt-service payments.

9. THE VULNERABILITY OF THE ECONOMY INCREASES

Since the economy fails to grow and pressures on public finances continue (with a fiscal deficit in 2024 of 5.9 percent of GDP due to the high interest rate), the country risk tends to increase, especially due to the financial sector´s speculation against the peso—as a pushback to the constitutional reforms announced by the government. The current administration's term in office ends on September 30, 2024.

The slowdown of the national economy is a factor which has an impact on the expectations of economic agents in the sense that, as economic growth slows, investment options are reduced, due to the lower levels of profitability. For its part, the government experiences a downturn in tax revenues and is forced to increase social expenditures to alleviate poverty, putting pressure on public finances. This lowers profitability expectations offered to external investments that buy public debt, and therefore tends to reduce investment inflows, leading to their outflow.

If the economy ceases to be attractive to capital, be it foreign direct investment or portfolio investment (in the latter case because the economy suffers from foreign exchange risk), capital will cease flowing into the economy and will even reverse course, making the external deficit unsustainable. Kregel (2010) points out that "the size of the deficit is determined by the confidence of international investors that a country can continue to increase its external borrowing to meet its debt commitment." If there are insufficient capital flows to cover the debt payment and the foreign trade deficit, economic activity will have to be restricted and the currency devalued to generate forced savings in order to have a foreign trade surplus that can cover the debt payment, as happened in the debt crisis of 1982–87. The free mobility of goods and capital will be reduced and the temporary nature of the policies that have caused the recurrent crises and stagnation of the economy in recent decades will become evident.

As national income decreases, debtors' spending and investment is reduced and their debt repayment capacity is reduced, which diminishes banking and financial stability.

10. THE PRESSURES ON THE EXCHANGE RATE AS A CONSEQUENCE OF ELECTION RESULTS

In view of the electoral majority that Morena and its coalition parties obtained in the June 2, 2024 elections—which will allow them to make constitutional changes in Congress—the financial markets reacted by speculating against the Mexican peso and the Mexican Stock Exchange (BMV). On May 31, 2024, the exchange rate was 16.96 pesos per dollar, and on June 7, 2024, it was 18.39, which implies a 7.8 percent drop of the peso against the dollar. The same week the BMV had a 3.1 percent drop. As a result of the change in the exchange rate, there are pundits pointing out that inflation is on the horizon. This exchange rate movement is not relevant, given that the peso has been overvalued in recent years. The peso–dollar parity reached 25 pesos per dollar in March 2020. In the following table and graph we can see that the exchange rate was overvalued from 1996 to 2015 and then devalued until 2022. The 1996 exchange rate was taken as the base because the Mexican economy grew and had a foreign trade surplus that year, so the corresponding exchange rate is taken as the equilibrium reference. This reference incorporated the price differential between Mexico and the United States US and maintained the desired competitiveness to achieve growth with a foreign trade surplus. The exchange rate on June 18, 2024 was 18.43 pesos to the dollar, maintaining an appreciation of 4.2 percent.

This change reflects the fact that the economy continues to work with a cheap dollar to the detriment of domestic production due to it being crowded out by cheap imports, hence the slower growth of the domestic economy and the continuing foreign trade deficit.

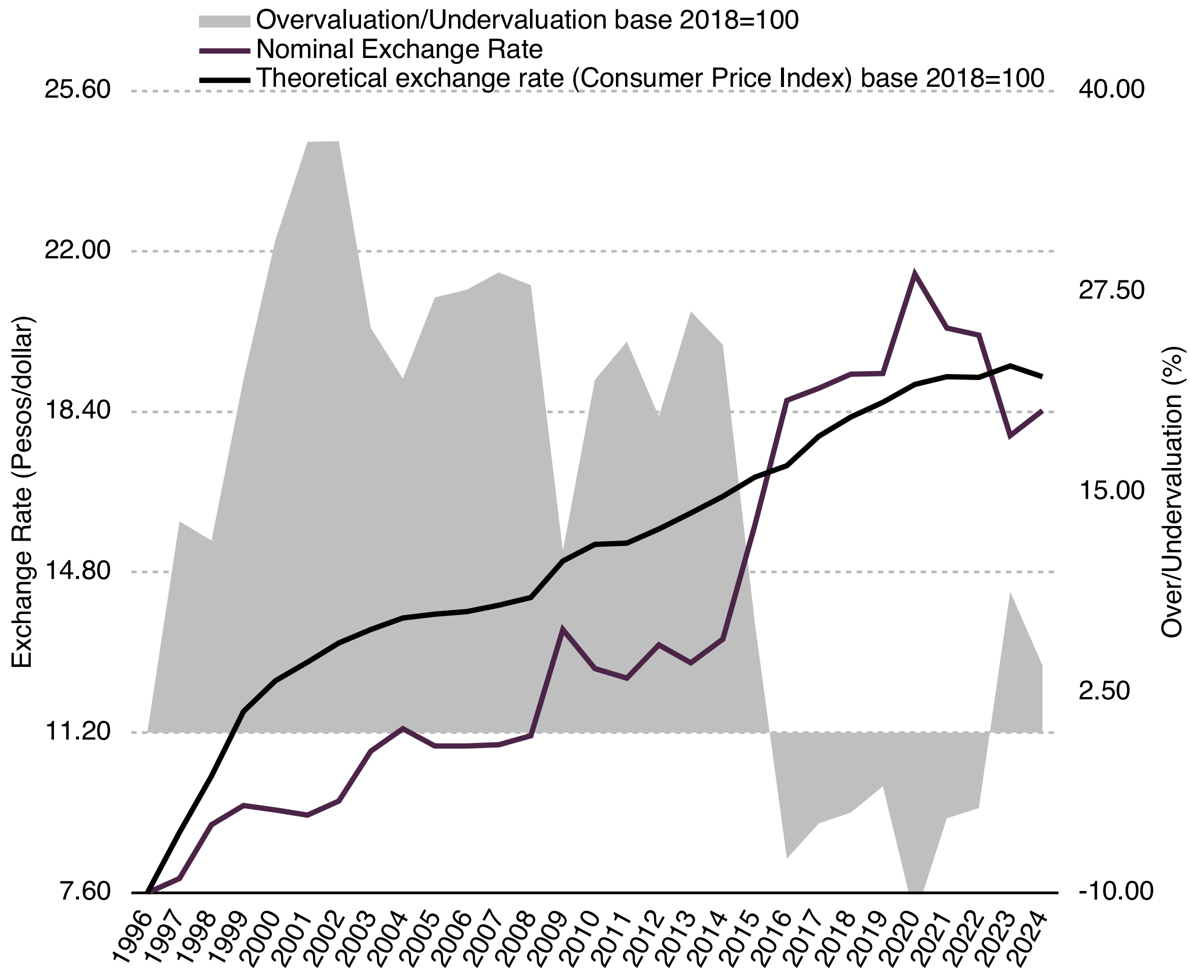
Table 1. Mexico: Nominal and Theoretical Exchange Rates 1996–2024*

Year	Nominal Exchange rate	Theoretical exchange rate (Consumer price index); base 2018=100	Overvaluation/Undervaluation; base 2018=100
1996	7.60	7.60	0.00
1997	7.92	8.96	13.17
1998	9.14	10.23	11.97
1999	9.56	11.67	22.05
2000	9.46	12.36	30.72
2001	9.34	12.78	36.83
2002	9.66	13.22	36.89
2003	10.79	13.51	25.23
2004	11.29	13.78	22.07
2005	10.90	13.86	27.16
2006	10.90	13.91	27.64
2007	10.93	14.06	28.68
2008	11.13	14.24	27.92
2009	13.51	15.04	11.33
2010	12.64	15.42	22.01
2011	12.42	15.45	24.40
2012	13.17	15.76	19.70
2013	12.77	16.13	26.27
2014	13.29	16.51	24.19
2015	15.85	16.94	6.83
2016	18.66	17.20	-7.86
2017	18.93	17.86	-5.65
2018	19.24	18.28	-4.98
2019	19.26	18.61	-3.35
2020	21.49	19.01	-11.56
2021	20.28	19.19	-5.37
2022	20.12	19.17	-4.71
2023	17.86	19.43	8.78
2024	18.42	19.19	4.20

The tendency of financial capital to speculate against the peso and the capital market is a sign of political pressure on the government and congress to prevent them from legislating to strengthen the power of the government and society to the detriment of the monied class. Big capital uses its economic power to subordinate political power (government and congress) so they continue to act according to their interests. This interference threatens national sovereignty.

Voters decided on Mexico's future at the ballot box on June 2, and financial capital must respect the outcome, despite the fact that it expected other results. In order to calm the financial markets, the current Secretary of Finance (who will continue in the next administration), announced on June 4, that the new government will maintain macroeconomic stability, fiscal discipline, reduction of public debt, and respect for the autonomy of the Bank of Mexico, thus demonstrating that it will continue to govern for the financial sector. But despite this statement, monied interests have continued to speculate, in the hope that no constitutional changes will be made in the political sphere, reflecting a clear violation of the country's autonomy and sovereignty.

As long as Mexico continues to depend on the inflow of capital and its unhindered mobility and pressures on the peso endure, economic policy will continue to favor the financial sector, with high interest rates and fiscal austerity. There will be little room for an economic policy that promotes the productive sector and full employment, since this requires low interest rates and increased public spending at a time when all factors indicate that this will not happen. If the financial sector is not regulated in favor of the productive sector and employment, stagnation, inflation, and pressure on the exchange rate continues, while companies and families are unable to pay their debts and the financial stability sought by the financial sector will be compromised, revealing the contradictions derived from the policies promoted by the government.



11. THE ROLE OF A FLEXIBLE EXCHANGE RATE IN SUPPORTING PRODUCTIVE SECTOR GROWTH AND EMPLOYMENT

The flexible exchange rate can be left to the market to determine, or it can incorporate the price and productivity differential between Mexico and its main trading partner (or partners), to maintain the purchasing power of the currency in both countries, as well as the competitive position of domestic products. Thus, the value of a good would have the same value in both countries and would not lose competitiveness vis-à-vis imports from its trading partner. This would encourage an economic policy in favor of productive development—in contrast to a fixed exchange rate, which often leads to high interest rates, fiscal austerity to reduce inflationary pressures, and efforts to stimulate capital inflows to maintain exchange rate stability and ensure sufficient international reserves for currency convertibility.

If there is a flexible exchange rate, international reserves would not be required, since the convertibility of the currency would be at the exchange rate existing at that moment. In this scenario, there is no need to have high interest rates and fiscal austerity to encourage capital inflows in order to have international reserves and exchange rate stability. Furthermore, with a flexible exchange rate and economic policies in favor of the productive sector, the pressures on the external sector would be reduced, stabilizing the exchange rate and avoiding its undesirable volatility.

With the free movement of capital, the exchange rate became a financial variable; thus, it ceased to be an instrument for industrial and agricultural policy, for adjusting the foreign trade deficit, and for making monetary and fiscal policy more flexible in favor of growth and employment. Palley (2007) points out that "the exchange rate has been considered a financial matter that is separated from the real world of trade."

With a flexible exchange rate, Mexico need not worry about having international reserves, and thus would not need to promote capital inflows, allowing authorities to lower the interest rate and increase public spending to substitute imports and increase the domestic value of exports. The latter, in turn, would decrease the foreign trade deficit, counteract the fall in consumption and private investment, stop economic stagnation, as well as avoid recession and speculative practices.

12. REGULATION OF THE BANKING AND EXTERNAL SECTORS FOR A GROWTH-FOCUSED ECONOMIC POLICY

The financial sector must be regulated to ensure cheap credit for the productive sector, as well as to regulate the movement of goods and capital, to protect domestic production from imports, and to avoid speculative practices which put pressure on the exchange rate and destabilize the financial market. Grabel (2011) points out that "policy makers deployed capital controls to promote autonomous national policies to promote financial and monetary stability and protect domestic industrial sectors from external control and competition." Likewise, Harvey (2009) favors the "need to control short-term capital flows in order for governments to maintain economic policy flexibility."

By boosting productive activity and national income, low inflation and high employment would be compatible. This would feed back into the demand for credit for investment. Credit would be available to make investment materialize and a more sustained dynamic in favor of productive growth and employment would be achieved, with an outlook that national income would grow above the interest rate to ensure banking stability.

13. THE ECONOMY SHOULD NOT DEPEND ON EXTERNAL FINANCING

The economy should not depend on external financing, but should, instead, use and leverage internal resources; restrictions such as central bank autonomy and fiscal austerity should not be imposed by government fiat.

When resorting to external financing, the economy must generate enough foreign currency to cover financial obligations; the problem is that the economy does not generate foreign trade surpluses under growth conditions. Additionally, when it resorts to external indebtedness, the economy is subject to the guidelines of international rating agencies and the behavior of international financial markets.

There are those who believe that, by promoting the entry of foreign direct investment, the economy can grow. These investments come to Mexico mainly to export, taking advantage of cheap labor and geographic proximity to the world's main market, but do not have a significant impact on domestic dynamics because they work with a high import coefficient. Giving priority to the entry of financial capital becomes very expensive due to the high interest rate, affecting public and private finances, and reducing the spending and investment capacity of both sectors to the detriment of domestic output and in favor of the banking–financial sector. This is unsustainable as it contracts economic activity and increases insolvency problems and country risk, which will reduce capital inflows and provoke capital outflows.

As long as Mexico continues to depend on capital inflows and free capital mobility, economic policy will continue to favor the financial sector, with high interest rates and fiscal austerity, meaning the country will lack the conditions for an economic policy that favors the productive sector and full employment.

14. MEXICO CANNOT PERMANENTLY RELY ON DEBT IF PAYMENT CONDITIONS ARE NOT GENERATED

Since consumption and investment are financed with credit, debts will have to be repaid sooner rather than later. The debt repayment capacity will depend on the behavior of the interest rate, as well as on debtors' income. If the interest rate rises and if economic activity fails to generate sufficient income to repay the debt, consumption and investment will have to be restricted to meet financial obligations, slowing economic growth. Johnson and Matthijs (2022) point out that "the rate of growth...depends on how consumption is financed and the extent of the external constraint" (202). The high public and private debt burden reduces the capacity for spending and investment and, thus, the growth of the domestic market. The problem is that external market growth is dominated mainly by transnational companies that work with a high import component, which does not disseminate internally and company profits are transferred to their home countries.

The foreign trade deficit tends to slow growth if there is no capital inflow to finance it. The problem is that this inflow is promoted through high interest rates, which slow investment and economic growth and increase debt, placing pressure on spending and investment capacity.

15. EXTERNAL FINANCING NOT REQUIRED FOR ECONOMIC STABILITY

Mexico's economy cannot be sustained by the inflow of financial capital, since it is not channeled to the productive sector to boost growth and ensure conditions for repayment of the financial obligations derived from such an inflow. Furthermore, a policy that promotes inflows acts against the productive sector and increases the foreign trade deficit, leading the economy to fall into a vicious circle of continuing to depend on capital inflows. These inflows destabilize rather than stabilize the economy, because they appreciate the currency, reduce domestic output, and increase foreign trade and the current account deficit. Foreign direct investment has not had a positive impact on economic activity, nor on the external deficit.

Observers repeatedly note the external obstacle to growth. For example, Filho and Jayme (2013) point out that "insufficient foreign exchange sets a ceiling for the growth rate of aggregate demand and long-term growth." This approach places the external deficit (scarcity of foreign exchange) as a restriction on long-term economic growth. The external deficit is the result of domestic productive lags and low productivity and serves as an obstacle to growth. The shortage of foreign currency can be overcome if the economy is financed with domestic currency to substitute imports and increase the domestic value of exports in order to reduce the foreign trade deficit and the limitation to growth that this creates, since it cannot be financed.

Mexico's economy must be financed with its currency and—for the peso to be accepted—the economy must offer options of profitability in the productive sector so that it will be invested therein. Pesos will be accepted to pay taxes and to invest in the productive sector so as to obtain profits, also in pesos.

Mexico needs to reduce the foreign trade deficit to reduce dependence on capital inflows and have a pro-growth economic policy to increase employment and have financial stability. This would increase consumption and investment and boost the income of companies and individuals, allowing them to cover their debts.

The financial sector must be regulated in favor of the productive sector and employment, in order to address productive lags and reduce the need for imports and foreign currency to finance them.

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