Central Banks

Banxico: Sound and Decisive Additional Measures to Promote Orderly Behavior of Financial Markets, Strengthen Credit-Granting Channels and Provide Liquidity for the Healthy Development of the Financial System

The effectiveness of the measures will depend on monetary policy taking a more relaxed stance and a significant fiscal boost being realized, complemented by a program of guarantees for development banking

Javier Amador / Alfonso Gurza / Iván Martínez / Arnulfo Rodríguez / Carlos Serrano / Mariana Torán
April 22, 2020

The Bank of Mexico released a series of measures to improve the functioning of financial markets, strengthen credit granting and the functioning of debt and exchange markets. In its statement, the central bank recognizes the potential adverse effects of the COVID-19 health emergency and of the sharp fall in oil prices on the domestic economy and the proper functioning of financial markets, particularly the exchange and fixed-income markets, where it has already identified a fall in depth, less liquidity and deterioration of its operation. In total, the measures announced to support the financial system amount to up to MXN 750 billion (€28 billion), or 3.3% of the gross domestic product (including measures implemented so far). In general terms, this is an appropriate set of actions with the potential to create conditions to solve the observed liquidity problems and to put financial intermediaries in a position to finance the economy, especially families and micro, small and medium-sized enterprises (MSMEs).

These unprecedented measures to support liquidity in financial markets were necessary, are well-focused and well received. They constitute positive progress as the economy urgently required measures on three fronts: (i) financial markets' liquidity, (ii) monetary stance and (iii) fiscal policy.

We believe that the liquidity measures announced by Banxico are comprehensive and well designed, meaning that this front would be covered by addressing the problems of liquidity that have been observed across the various markets and that—sooner rather than later—could have resulted in a credit and solvency crisis, which would involve pro-cyclical movements at the worst possible time.

Moreover, in a separate statement, Banxico took another step in terms of the adequacy of monetary policy by reducing, at an unscheduled meeting, the monetary rate by 50 bps to 6.0%. We believe that the continuation (and desirable acceleration) of the downward cycle will more successfully position the liquidity measures. It is important to emphasize that lower interest rates, more in line with the context of a deep economic downturn and with downward price pressures more than offsetting upward pressures, would boost the implemented liquidity measures. Likewise, both actions in tandem (i.e. liquidity measures and lower interest rates) will avoid pro-cyclical movements in the economy in the near future, better placing it for its eventual recovery.

A more appropriate (and prompt) monetary policy stance would not only address the needs of the economy in terms of the scope of traditional monetary policy, but would also strengthen the liquidity measures, while at the same time opening the door to an expansive fiscal policy if, in the near future, the government is convinced of its urgency and necessity.

1. Increased Liquidity During Operating Hours to Facilitate the Optimal Functioning of Financial Markets and Payment Systems.

Banxico announced that it will continue to provide, as it has done so far, daily excess liquidity to the money market in order to promote an orderly functioning. The announcement is welcome and will help to maintain the funding rate around its target, avoiding low liquidity rallies.

2. Extension of Securities Eligible for FLAO (*Facilidad de Liquidez Adicional Ordinaria* — Ordinary Additional Liquidity Facility), Foreign Exchange Hedging Operations and USD Credit Operations.

With the aim of providing liquidity to securities, Banxico has expanded the scope of debt securities eligible for FLAO repo transactions, of guarantees for the operations of collateral for foreign exchange hedges settled by differences in MXN, and for USD credit auctions. This is in addition to the reduction in the cost of FLAO to 1.1 times the target of the Banxico overnight interbank interest rate (from 2.0 to 2.2 times) which came into force on April 1 as part of the central bank's initial set of liquidity measures.

Eligible securities in domestic currency must now have credit ratings equal to or higher than "A" on a national scale, or those equivalent to "BB+" on a global scale for securities denominated in foreign currency, issued by at least two rating agencies. Until now, credit quality criteria required ratings equal to or higher than "AA" or its equivalent.

This is an appropriate measure that addresses growing liquidity needs and is supported by the measures previously taken by Banxico (cost reduction). In addition, the relaxation in the eligibility criteria will allow, among others, Pemex securities to be used for these purposes.

3. Broadening of FLAO Eligible Counterparties.

Banxico has decided to give development banks access to FLAO. This is a timely measure in the face of difficulties that have been identified in terms of market liquidity, but also in order to allow increased resources to be channeled to its borrowers.

4. Government Securities Term Repurchase Window.

In order to provide liquidity to financial institutions holding government securities, Banxico will implement an extended window for repurchasing these securities in longer than usual terms. This will be at a cost equivalent to 1.02 times the average of the overnight interbank interest rate during the term of the operation. The initial amount of the program will be MXN 100 billion.

This is a very good measure considering difficulties in government bond markets, which in the last few days have been characterized by the absence of ask and bid positions; this will give back liquidity to the market and its participants, preventing them from being forced to fire-saleassets. In addition, it will favor the recovery of longer-term stock segments, which have been relatively more affected by recent weeks' uncertainty and volatility.

5. Temporary Securities Swap Window.

Banxico will implement a security swap facility, so that eligible institutions can deliver debt securities in exchange for government securities, with the obligation to return them later. The securities eligible for this operation must meet FLAO credit quality criteria (relaxed as part of measure 2 above). The amount for the program will be up to MXN 100 billion and may be adjusted later.

The measure will increase the liquidity of debt markets and support the reactivation of the primary corporate debt market, particularly in light of recent failed peso-denominated debt offerings.

6. FRTC (*Facilidad de Reporto de Títulos Corporativos* — Corporate Securities Repurchase Facility).

Complementary to the previous measure, Banxico seeks to provide liquidity to corporate securities through repurchases from credit institutions. Thus addressing the low operation and liquidity situation of the short-term corporate debt certificate and long-term corporate debt markets, specifically those issued by private non-financial institutions residing in Mexico (which meet the above-mentioned FLAO eligibility criteria). The cost of the facility will be 1.1 times the average of the Bank of Mexico overnight interbank interest, appropriately higher than that applicable to government securities repos reviewed under point 4 above.

The measure is welcome and will favor both the reactivation of the corporate debt market—facilitating financing to its participants—and the provision of liquidity to credit institutions.

It would be positive if Banxico also established a program for purchasing corporate assets. Unlike government securities, where a justified constraint for the financing of the government by Bank of Mexico exists, the acquisition of corporate securities would be an important incentive for the provision of credit to the economy.

7. Provision of Resources to Banking Institutions to Channel Credit to Micro, Small, and Medium-Size Enterprises and Individuals Affected by the Pandemic.

The measure which, in the first instance, will consist of releasing the total Monetary Regulation Deposits is considered correct as it will make important resources available to institutions which, before the reduction of MXN 50 billion on April 1, amounted to about MXN 320 billion (€12 billion). This sum will now be available for institutions to meet their liquidity needs, as well as to increase financing for the economy.

In addition, and if necessary, Banxico will provide commercial and development banks with financing guaranteed with securities that meet FLAO eligibility criteria. This possibility, which we certainly think is appropriate, can be enhanced by the decisive support from development banks' granting of guarantees, so that the boost to financing benefits, not only from higher levels of liquidity, but also from the incentive of risk mitigation from those guarantees.

It is important to remember that the contingent balance backed by the guarantee and counter-guarantee trusts administered by development banks is not recorded as public debt. It is therefore of particular importance that such trusts be excluded from the Decree ordering the extinction or termination of public trusts, public mandates and similar ones published in early April.

Finally, in addition to this measure, it would be appropriate to establish a program aimed at supporting companies other than MSMEs, benefiting those that are large employers, with the aim of preserving jobs and increasing the chance of survival of those that were viable before the crisis. In any case, this should be implemented by means of an independent scheme to prevent its beneficiaries from displacing or crowding-out smaller companies.

8. Collateralized Financing Facility for Commercial Banks With Corporate Loans, to Finance Micro, Small and Medium-Size Enterprises.

In order to address the problem faced by commercial banking institutions by the loss in liquidity resulting from the intensive use of credit lines by their corporate clients in the crisis, Bank of Mexico will establish a temporary term financing facility (between 18 and 24 months), guaranteed by credits to corporates that issue debt securities, provided that they have two credit ratings of at least "A" on a local scale. The program will cost the same as the target overnight interbank interest rate and will initially be for a total of up MXN 100 billion.

In this way, comercial banks would be able to obtain resources to financeindividuals and MSMEs. As in the previous case, the registration and monitoring of the new credits associated with this facility will be done through a development bank, a development finance institution or directly by Banxico.

We agree that this measure compensates for the decline in liquidity to offer bank financing (resulting from the use of corporate credit lines), thus mitigating the possible displacement or "crowding out" of smaller firms. It would be desirable to establish that as long as the rating of the company whose credit guarantees financing remains above the required minimum, subsequent ratings downgrades should not result in the suspension or cancelation of access to the facility.

9. Government Securities.

Banxico will trade government securities, receiving long-term securities (10 years or more) in exchange for others with maturities of up to 3 years. The program’s initial size will be of up to MXN 100 billion.

This measure contributes to providing liquidity in the relatively less liquid sections of the curve (long-term) , promoting improved performance of the government debt market during episodes of financial volatility that result in higher risk premiums and disruptions for some terms of the yield curve.

10. Foreign Exchange Hedges Settled by Differences in US Dollars With Counterparts Not Domiciled in the Country, to Be Traded During Hours When Domestic Markets Are Closed.

The Bank of Mexico, acting on instructions from the Foreign Exchange Commission (“Comisión de Cambios”, the joint Banxico and SHCP body in charge of the country’s foreign exchange policy), considers appropriate to incorporate into its exchange market intervention tools the possibility of carrying out foreign exchange hedge operations settled by differences in US dollars. This is to promote orderly trading conditions in the exchange market, particularly during the

Asian and European sessions. This new tool will operate within and under the same terms of the current Foreign Exchange Hedge program.

We consider this measure adequate in view of the notable lack of liquidity in the foreign exchange market (the bid-ask spread has been at levels similar to those observed during the 2008 crisis) despite the use of various instruments (e.g. dollar swap lines and foreign exchange hedge operations settled by differences in Mexican pesos). The fact that the Foreign Exchange Commission has instruments for conducting hedge transactions settled by differences in US dollars by institutions not domiciled in the country can increase the effectiveness of the instrument itself, particularly in a context of increased global demand for the US currency. This measure is also relevant given the increased hedging costs of the peso-dollar parity and its adverse effects on foreign government bond demand. Finally, the measure could help mitigate abrupt movements in exchange-rate trading before the opening of markets in North America.