Economic Analysis

Strong MXN?

El Financiero (Mexico)
Carlos Serrano
May 15th, 2023

The exchange rate is at 17.58 pesos per dollar, its lowest since May 2016. The trigger of this latest appreciation movement of the MXN was the publication of inflation data for April in the United States, which fell to 4.9%. Although it is still very high relative to the 2% target, it is well below the peak of 9.1% observed last June. It confirms that the disinflationary process is underway, reinforcing the perception that the cycle of increases of the Federal Reserve has concluded. This perception resulted in a general depreciation of the dollar.

So far this year, the MXN has gained 10% against the dollar, as a result not only of the generalized depreciation of the US currency but also because it has performed better relative to most large emerging currencies—three main factors explain this behavior of the MXN.

First, in a context where most emerging countries implemented substantial fiscal expansions to face the pandemic, Mexico decided not to conduct a fiscal response, making its fiscal accounts look less vulnerable. I do not want to suggest that it was an adequate policy response. On the contrary, Mexico had fiscal space to dedicate public resources to temporarily protecting those groups most affected by the health contingency.

Second, Mexico has no external imbalances, with a moderate current account deficit that I estimate will close this year at around 1% of GDP, lower than that of the rest of the large economies in Latin America. Its financing does not represent problems: portfolio flows are not even required for this. To a significant extent, the significant growth in remittances caused by the strength of the US labor market explains this low current account deficit.

Third, the high short-term rate differential between Mexico and the United States, which, adjusting for risk, makes Mexico one of the most attractive countries to invest in short-term instruments. So far this year, the holding of Cetes by foreign investors has increased by 2.595 million dollars, around double the inflows to these instruments last year.

Does the current exchange rate level mean the MXN is overappreciated? I do not think so. In this regard, when analyzing the real exchange rate -that is adjusting by inflation differentials- between Mexico and the US, we can see that although the peso is appreciated compared to its level in May 2020 (when it lost value significantly due to the environment of risk aversion and uncertainty generated by the pandemic), it is more depreciated in real terms than practically the entire 2000-2015 period. In other words, the peso is not particularly strong compared to what has been observed in the last two decades.

What to expect from the MXN from now on? Although it is a challenging variable to predict, the best performance against other emerging currencies will most likely continue. However, it could depreciate a bit against the dollar and end the year at around 18.50 because the rate differential between Mexico and the US will narrow slightly (I think Banxico will no longer raise the rate at next week's meeting, and the cycle of cuts could begin sooner than in the US).

Of course, there are always risks: a significant drop in oil prices, a conflict within the USMCA, or the emergence of a presidential candidate with proposals that imply the unanchoring of macroeconomic balances could result in much larger depreciations.

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ENQUIRIES TO:
BBVA Research – BBVA: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
bbvaresearch@bbva.com www.bbvaresearch.com