# Mexico Economic Watch

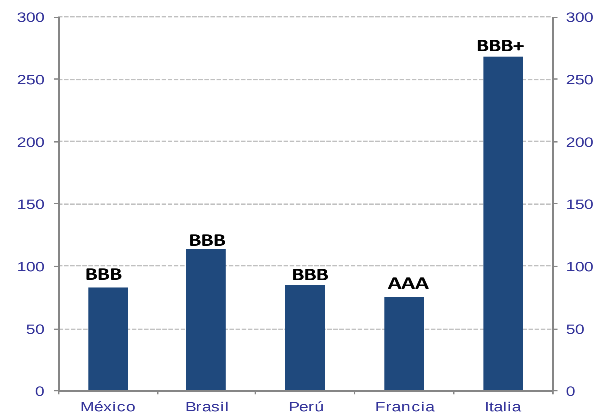
## Room for accumulating reserves in view of the strength of the exchange rate

- **Favorable risk-adjusted returns, increase in global liquidity and expectations of domestic reforms have all contributed to the recent inflow of foreign investment into the country and to strengthening the currency**
- **In view of the peso's strength, Mexico could increase international reserves to move closer to the level maintained by emerging economies with currencies as liquid as the peso**

In its latest monetary policy statement, Banxico referred to the unnecessary tightening of monetary conditions, resulting from the significant increase in capital flows, as an additional element for supporting the cut in the lending rate. However, from the last monetary policy meeting (March 8) to April 16, the peso has appreciated 3.97%, contrary to what was expected with the rate cut. Against this background, the markets have suggested the possibility of some kind of intervention by the authorities in the foreign-exchange market aimed at avoiding the tightening of monetary conditions. When assessing a possible intervention it is important to analyze the nature of the recent appreciation and the foreign-exchange measures taken by the authorities in the recent past.

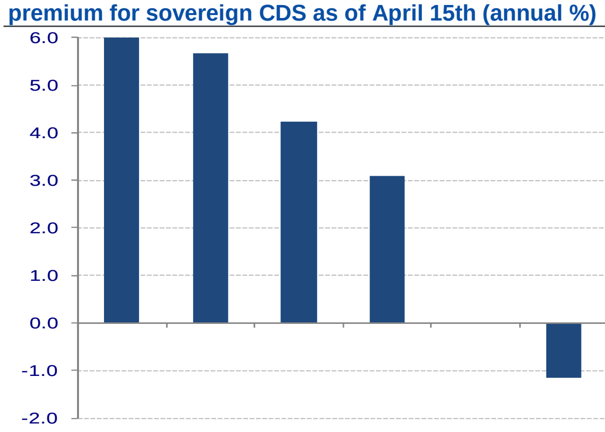
The inflow of foreign investment and the appreciation of the currency following the lending rate cut could be due to the risk-adjusted returns of Mexican debt instruments. In a context of abundant liquidity and search for returns, the prospects of the approval of economic reforms in Mexico are generating increased growth forecasts for the coming years, which in turn are reflected in expectations of an appreciation of the currency. These expectations of appreciation translate into higher expected returns for foreign investors, which combined with Banxico's comment that the recent cut does not represent the beginning of a restrictive cycle, are keeping the returns in dollars of Mexican debt at attractive levels compared to other countries, particularly in the long part of the curve. As regards risk, a possible approval of the fiscal and energy reforms is also linked to a possible upgrade of the country's sovereign debt rating. Over the last year, the spread paid by Mexico's credit default swaps (CDS) has been cut from around 130 to 86 basis points and is even below that of countries with higher sovereign debt ratings (see Chart 1). Thus, not only are the expectations of returns in dollars competitive, but the risk posed by these instruments for foreign investors has been reduced. As an example, Chart 2 shows the expected returns in dollars for each percentage point of credit risk premium for various countries. It can be seen that Mexican debt, even with the recent cut in the monetary rate, and given the prospects of currency appreciation, compares favorably with other countries.

Chart 1
**Credit default swap spreads (basis points) as of April 15th, 2013**




Source: BBVA Research and Bloomberg. The sovereign rating refers to the rating for long-term debt in foreign currency according to Fitch Ratings

Chart 2
**Expected return in USD for each percentage point of risk premium for sovereign CDS as of April 15th (annual %)**



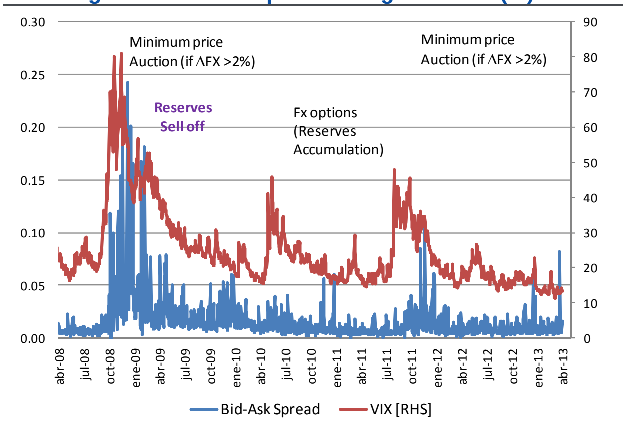

Source: BBVA Research and Bloomberg
Note: Return of the investment in short-term instruments (1 year) in local currency, adjusted for the expected depreciation/appreciation at the end of the first quarter of 2014 according to the median of Bloomberg forecasts

The Exchange Commission's interventions over the last five years in the foreign-exchange market have focused on restoring liquidity in the event of episodes of high-volatility in the financial markets (see Chart 3). As shown in Chart 4, three dollar auction mechanisms have been used over the last five years, in addition to the sale of call options on dollars to build up reserves.[1] In terms of amount, the larger interventions took place in October 2008 when USD 11 billion were sold through one-off auctions after the exchange rate bid-ask spread reached its highest level in the last years. The most recent intervention took place in November 2011 when the mechanism of auctions with floor price was reactivated as a preventive measure for providing liquidity to the foreign-exchange market in view of the prevailing global volatility. Last April, the Exchange Commission discontinued those auctions, considering that the conditions in the financial markets showed that the exchange-rate volatility had eased.

It is worth pointing out that during recent episodes of exchange-rate appreciation there have been no one-off interventions in the market. Even in 2008, when the exchange rate reached levels below 10 pesos per dollar, the only measure taken was to increase the speed of international reserves accumulation after selling USD 8 billion to the federal government to meet some operational needs in foreign currency.

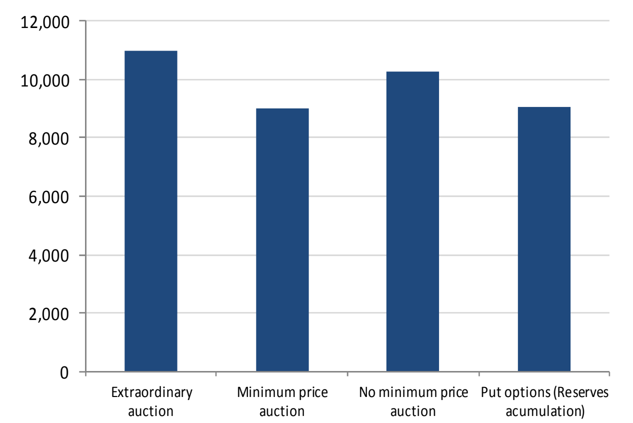
Although an intervention cannot be ruled out, the accumulation of reserves is one of the most viable alternatives in present conditions. On the one hand, Mexico's international reserves account for around 16% of GDP, a lower level than in several emerging economies, particularly if we consider the countries with the most liquid emerging currencies, such as South Korea and Singapore (see Chart 5). The peso is the third most liquid currency among emerging economies, with daily exchange transactions of around 50 billion dollars.[2] In addition, Mexico has been granted a flexible credit facility by the IMF of up to USD 73 billion that gives it unrestricted access to funds at low cost. On the other hand, the holding of Mexican fixed-income bonds by foreigners as a percentage of international reserves has increased from 30% to 72% in only 3 years (see Chart 6). Lastly, the availability of funds denominated in foreign currency is expected to continue due to forecasts of increased global liquidity and the strength of the Mexican economy, appreciating the exchange rate. This data suggests that the environment is favorable and there is room for accumulating international reserves, which contribute to minimize the risks in the face of volatility events that may result in capital outflows, while strengthening the country's solvency outlook.

Chart 3
**Exchange rate bid-ask spread and global risk (%)**




Source: BBVA Research and Bloomberg. The sovereign rating refers to the rating for long-term debt in foreign currency according to Fitch

Chart 4
**Amount allocated per intervention mechanism in the foreign-exchange market (USD million)**




Source: BBVA Research and Banxico

In short, the absence of signs of lack of liquidity in the foreign-exchange market and recent history suggest that the accumulation of international reserves is the first option if a decision is made to act in the foreign-exchange market. Capital inflows and the exchange-rate appreciation seen over the past few weeks seem to be influenced by the expectations of risk-adjusted returns of Mexican assets and global liquidity. Despite the economy's stability, a watchful eye should be kept on the prospects generated by the reforms. If they are not as ambitious as expected or are not implemented adequately, a period of volatility cannot be ruled out.

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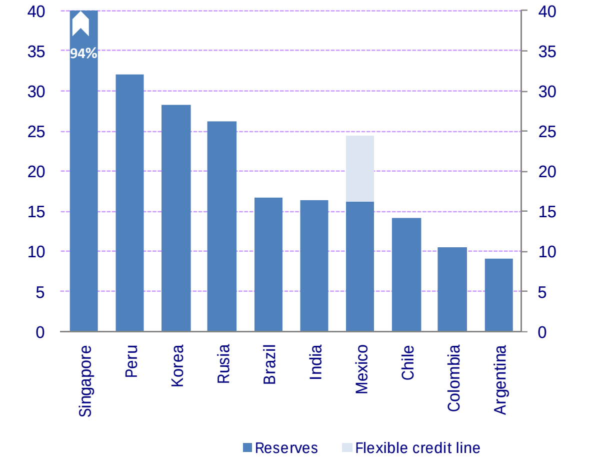
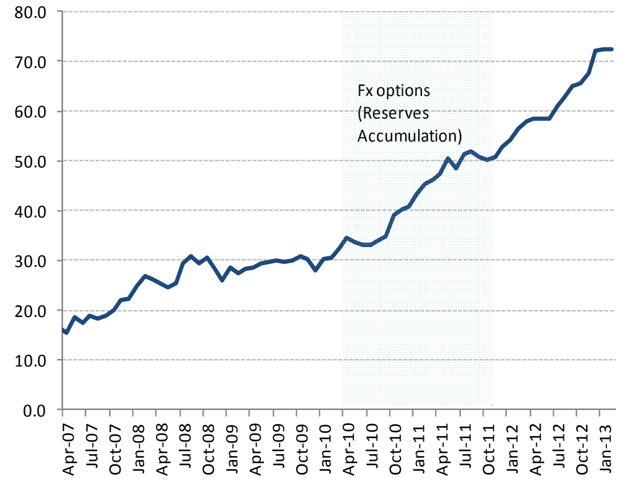
[1] The auctions with floor price offer on a daily basis a pre-established amount of dollars at a minimum exchange rate 2% above the exchange rate for the previous business day. Auctions with no floor price refer to the daily sales of USD 100 million of international reserves implemented from March to September 2009. One-off auctions correspond to the sale of a non pre-established amount of dollars with no floor price that took place in October 2008. The accumulation of reserves through the option mechanism refers to the monthly auction of USD 600 million of put options on dollars sold to the Bank of Mexico established in 2010.
[2] Triennial central bank survey of foreign exchange and derivatives market activity in 2010. BIS.

Chart 5
**International reserves (% GDP)**




Source: BBVA Research, Banxico and Bloomberg

Chart 6
**Holdings of fixed-rate nominal bonds by foreigners (% international reserves)**




Source: BBVA Research and Banxico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