Mexico Flash: Exchange Rate

Short-term volatility due to the uncertain global environment, but strong domestic fundamentals consistent with appreciation.

In the short term, the peso's exchange rate will be strongly influenced by the uncertainty surrounding the evolution of the European debt crisis, by the data released, in order to assess the strength of the U.S. cycle, and by market expectations on a new round of monetary stimuli. However, **the Mexican economy's fundamentals** (external exposure to the U.S. -the developed area with the most positive activity outlook- and the certainty of domestic macroeconomic policies) **are consistent with a peso appreciation against the dollar**.

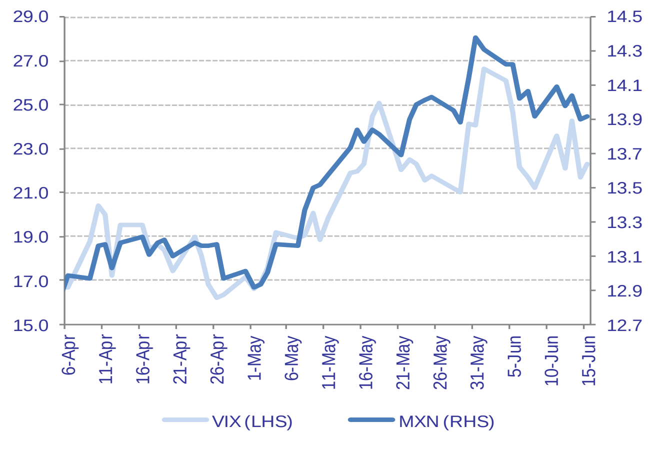
- **The depreciation of the peso in recent months has been the result of increased global risk aversion, derived from the unraveling of the European debt crisis and, more recently, from data that cast doubt on the strength of recovery in the U.S.**

  Since the beginning of May, the exchange rate has depreciated 7.21%, in line with increased global financial volatility due to the unraveling of the debt crisis in the euro zone. This unraveling results from the persistence of a significant exchange risk in the current configuration of the euro zone, which is reflected, for example, in the lack of a positive impact in the markets of the Eurogroup's announcement of aid for the capitalization of some banks in the Spanish financial system. This **close relationship between the peso's exchange rate and global risk aversion** can be explained to a great extent by the fact that the Mexican peso is the third currency within the emerging economies most widely exchanged on the international financial markets, with around USD 50 billion a day according to BIS data (2010). However, this week market expectations of a higher likelihood of the FED announcing next week a new round of monetary stimuli have contributed to stop the peso's devaluation in an uncertain global cyclical environment.

- **The exchange rate will remain volatile in the coming weeks in view of the high number of upcoming events related to the unfolding of the crisis in Europe, the FED meeting and the U.S. cycle data.**

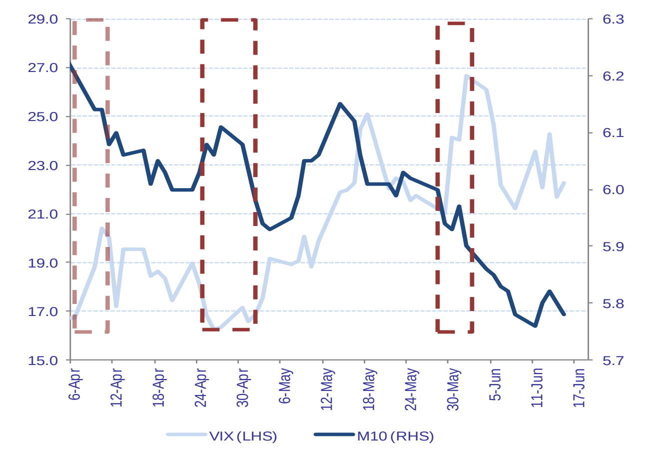
  In the short term it is likely that the peso's exchange rate will remain volatile as a result of the consequences of the outcome of the Greek election, potential global liquidity injections as a consequence of the impact of this outcome and the tone of the Federal Reserve's statement on June 20. In particular, **we believe that the possibilities of the FED implementing a new round of monetary stimuli are limited** and, as a result, **the gains accumulated in the stock and exchange markets in recent days could be reversed**. On the other hand, on the domestic front, the exchange rate depreciation has been associated with the release of surveys that show a closer contest among the main candidates competing for the presidency of the Republic. We believe that **in the current environment of uncertainty surrounding the global economy, the news related to the outcome of the presidential elections would have a marginal effect on the peso's exchange rate parity**. The result of the elections will not represent a challenge to Mexico's macroeconomic stability.

Chart 1
Exchange rate and global risk (ppd and %)



Source: BBVA Research with data from Bloomberg

Chart 2
10Y bond yield and global risk (%)



Source: BBVA Research with data from Bloomberg

- **Insofar as global uncertainty is gradually mitigated, the fundamentals of the Mexican economy, linked to the certainty of the macroeconomic policies and growth in the U.S., are consistent with an appreciation of the peso.**

To the extent that global uncertainty is mitigated, the peso would tend to appreciate supported by the economy's fundamentals and the certainty offered by Mexico's macroeconomic policies. In particular, **the disciplined handling of the fiscal policy** has been reflected in a 2.8% GDP deficit in 2011, while the overall balance of the public sector's gross debt is slightly above 40% of GDP (IMF). These figures are very low compared with those for the developed economies in Europe or the U.S. (see chart). **Institutions have been established in Mexico which offer certainty to the markets, such as the Budget and Treasury Responsibility Act**, which sets out the need for budget stability (although legislation can be passed in order to increase the deficit). In this regard, all the candidates running for the presidency have undertaken to ensure the stability of public finances, an element of certainty in the face of the outcome of the presidential elections. As long as this promise is kept, the peso will be stronger and less volatile.

In addition, **both the abundance of global liquidity and the limited effects, so far, of the European debt crisis on economic activity in the U.S. are factors that support an appreciation of the peso**. Indeed, unlike the situation in many European economies, foreign holdings of fixed-income government securities already account for 44% of the total. In addition, unlike recent episodes of increased risk aversion, **the flows by foreigners are maintained**, to such an extent that the yield rate for long-term bonds has fallen by around 35bp last month, a period particularly subject to global uncertainty. This behavior could be due to **the fact that the abundance of liquidity enables positive yields to be obtained by investing in Mexican debt instruments, even with increased global risk, given the low cost of finance**. However, **if the downward trend in economic activity and employment in the U.S. is confirmed or the lack of agreement in relation to its fiscal policy exacerbates, risk aversion could translate into reduced flows towards Mexico. This would have adverse consequences for interest rates and the exchange rate**. This is not the baseline scenario, but it cannot be ruled out completely either.

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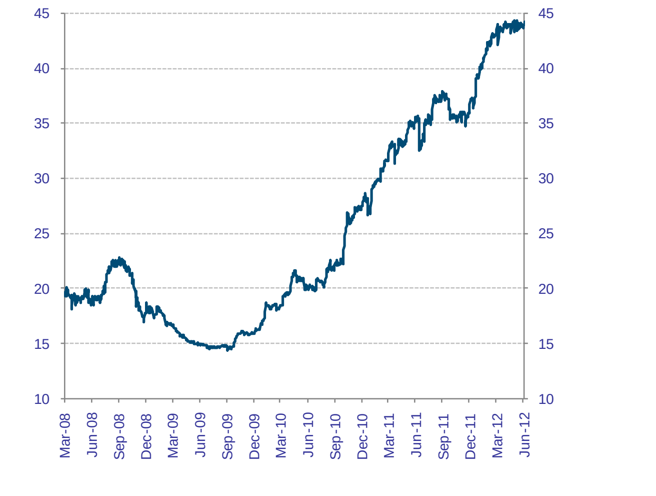
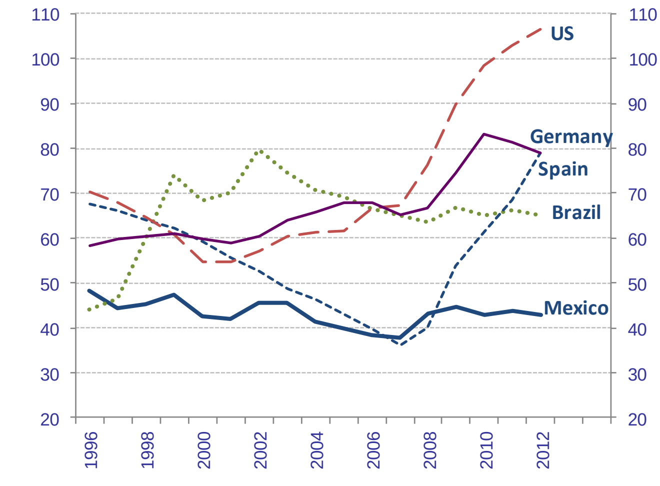
Chart 3
Foreign holdings of Mexican fixed-income government securities (% of total)



Source: BBVA Research with Banxico data

Chart 4
Public debt (% GDP)



Source: BBVA Research with IMF data

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