



Mexico: The challenges of capital inflows

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Adam Smith Seminar, Schloss Spiez, Switzerland, June 26, 2013



BANCO DE MÉXICO

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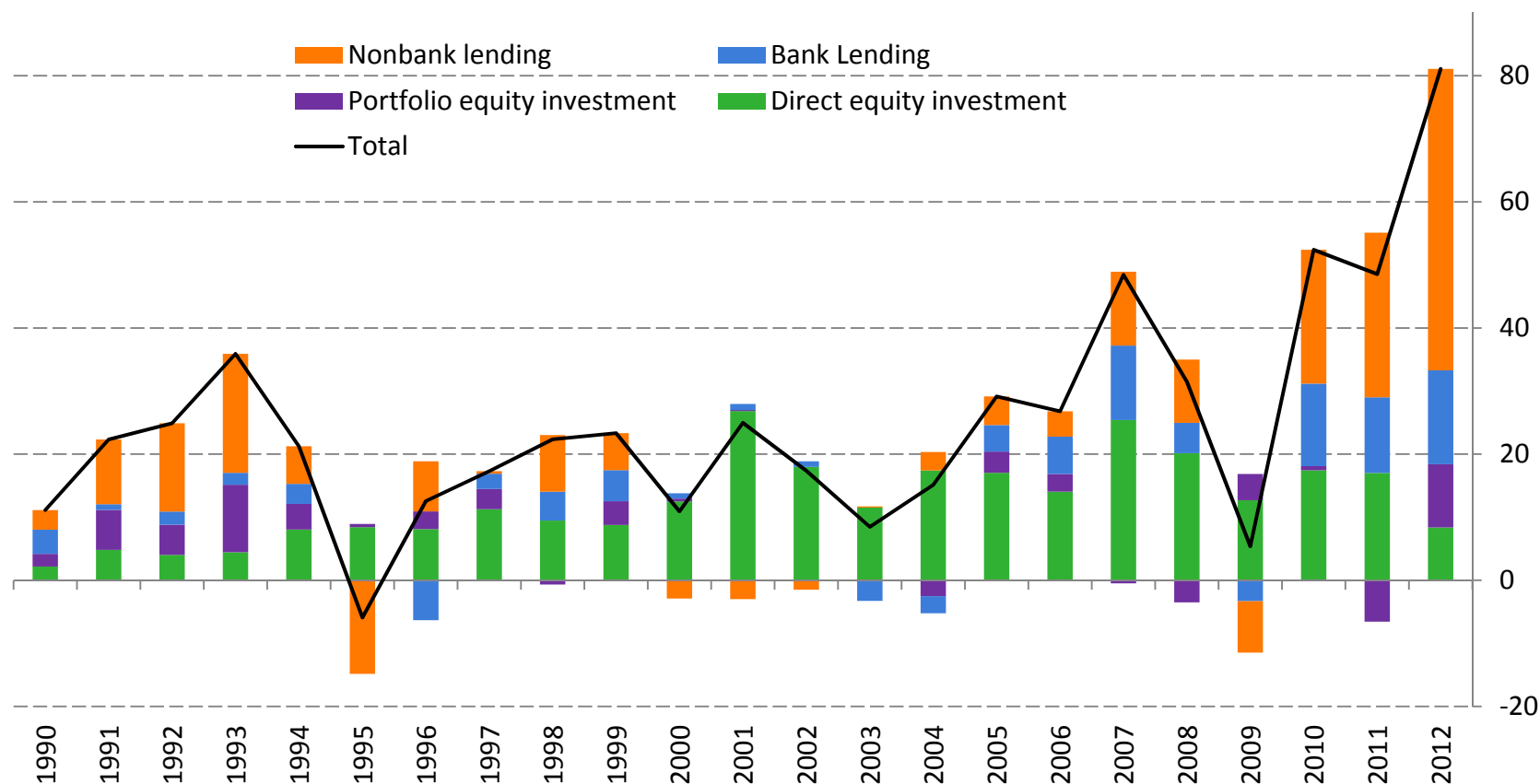
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Like other emerging markets, Mexico recently experienced a surge in net private capital inflows

Mexico: Net Inflows from Private Nonresidents¹
Billions of dollars



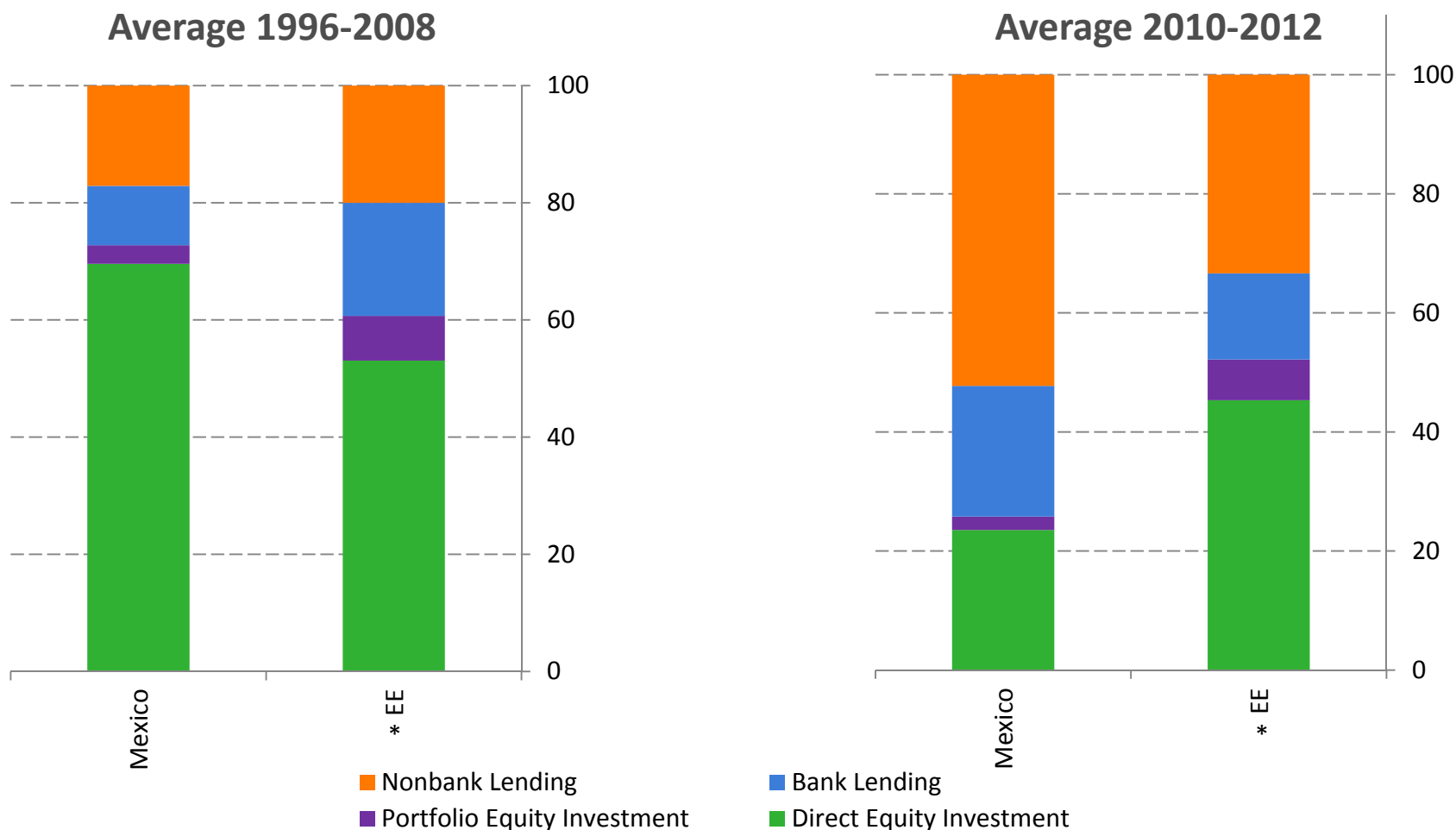
1/ After subtracting capital withdrawals by nonresidents

Source: Own calculations with the Institute of International Finance (IIF) and Banco de México data

What has been unusual is the increase in the share of nonbank lending, especially for Mexico

Net Inflows from Private Nonresidents¹

% of total



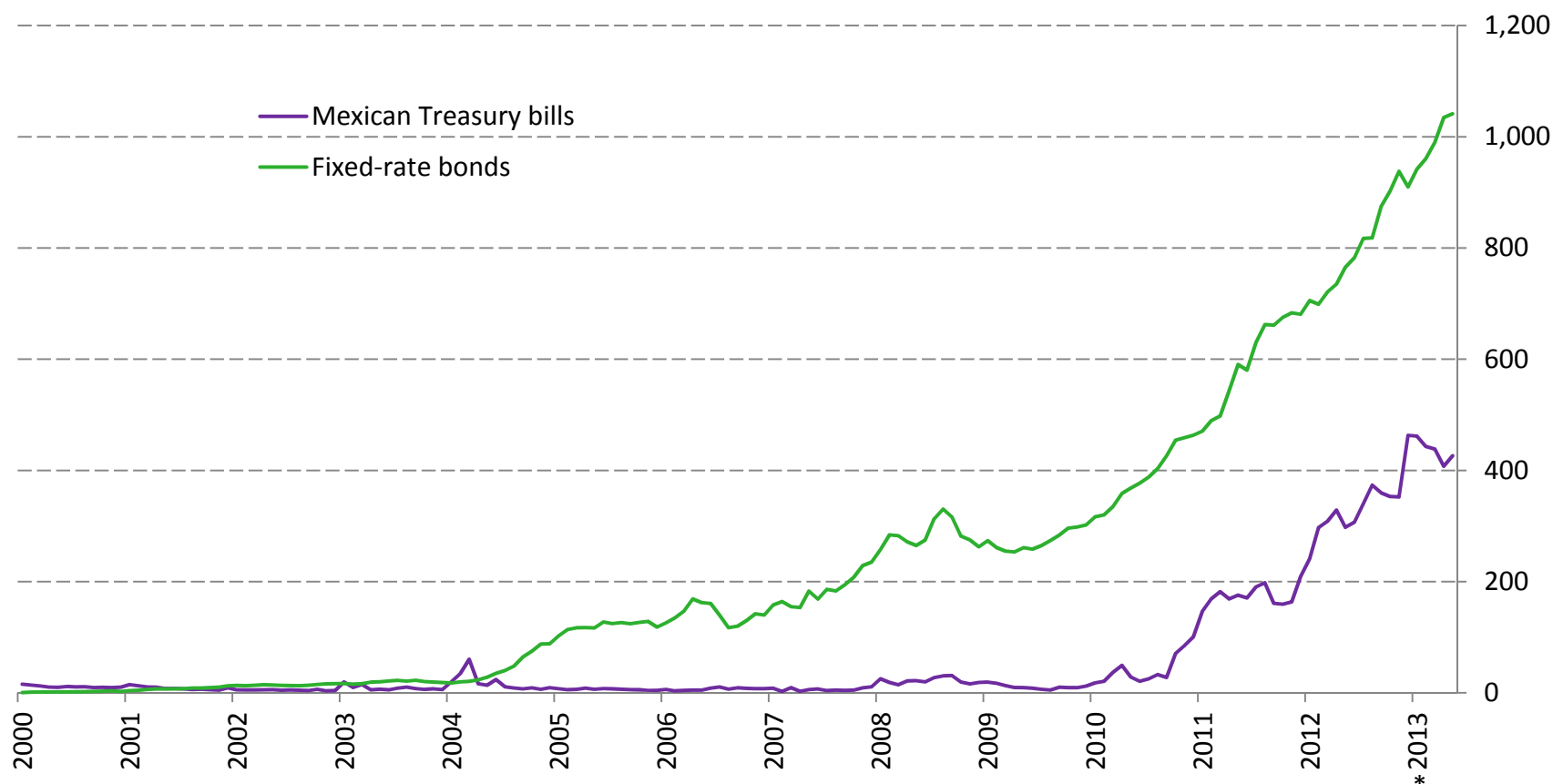
1/ After subtracting capital withdrawals by nonresidents

*/ EE refers to emerging economies

Source: Own calculations with IIF and Banco de México data

A large fraction of capital inflows has been directed to peso-denominated government securities

Peso-denominated Government Securities Held by Foreigners
Billions of constant pesos, December 2010 = 100

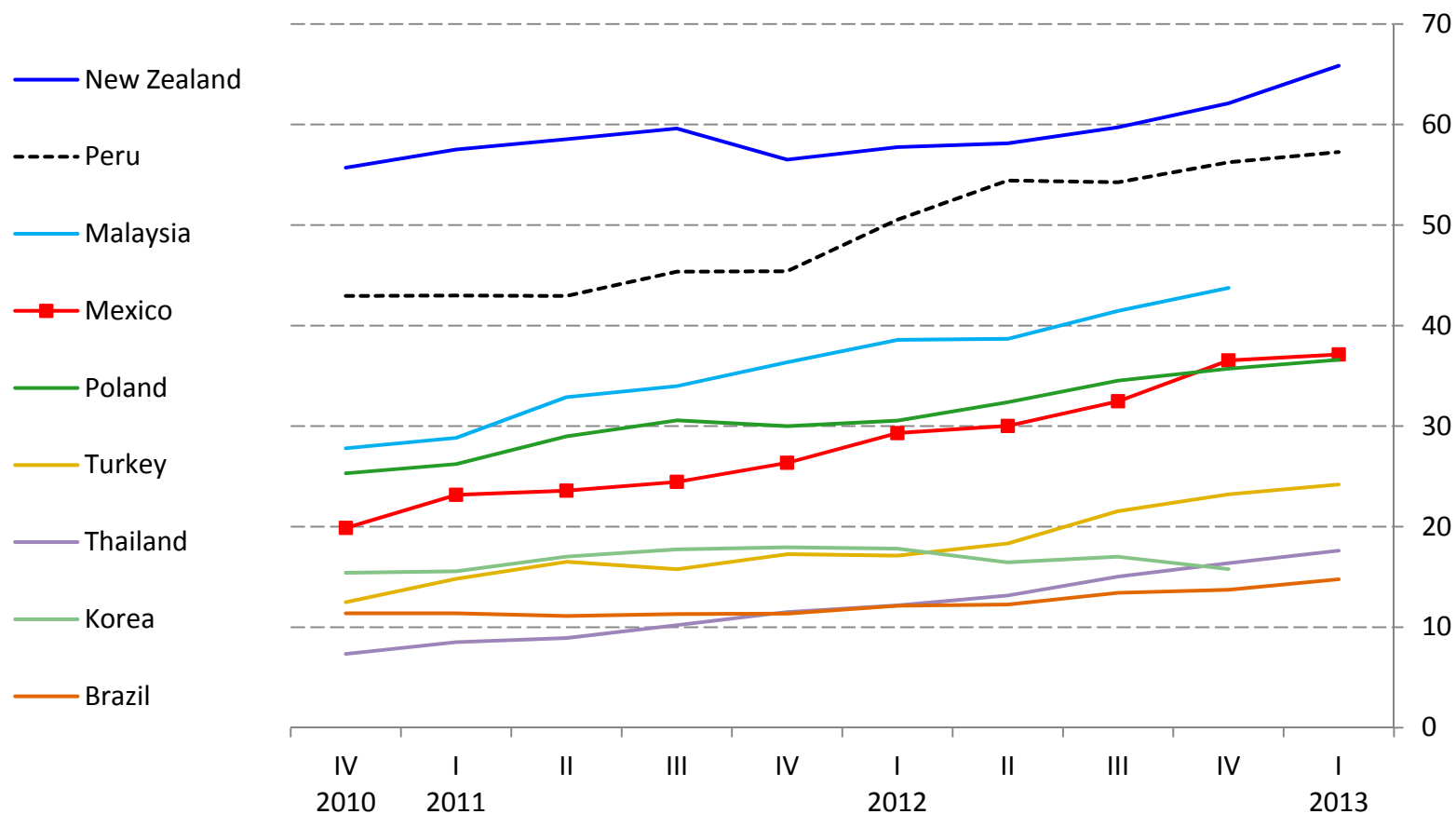


*/ Up to May

Source: Own calculations with Banco de México data

The rising proportion of foreign holdings of local-currency government securities is not the highest among countries

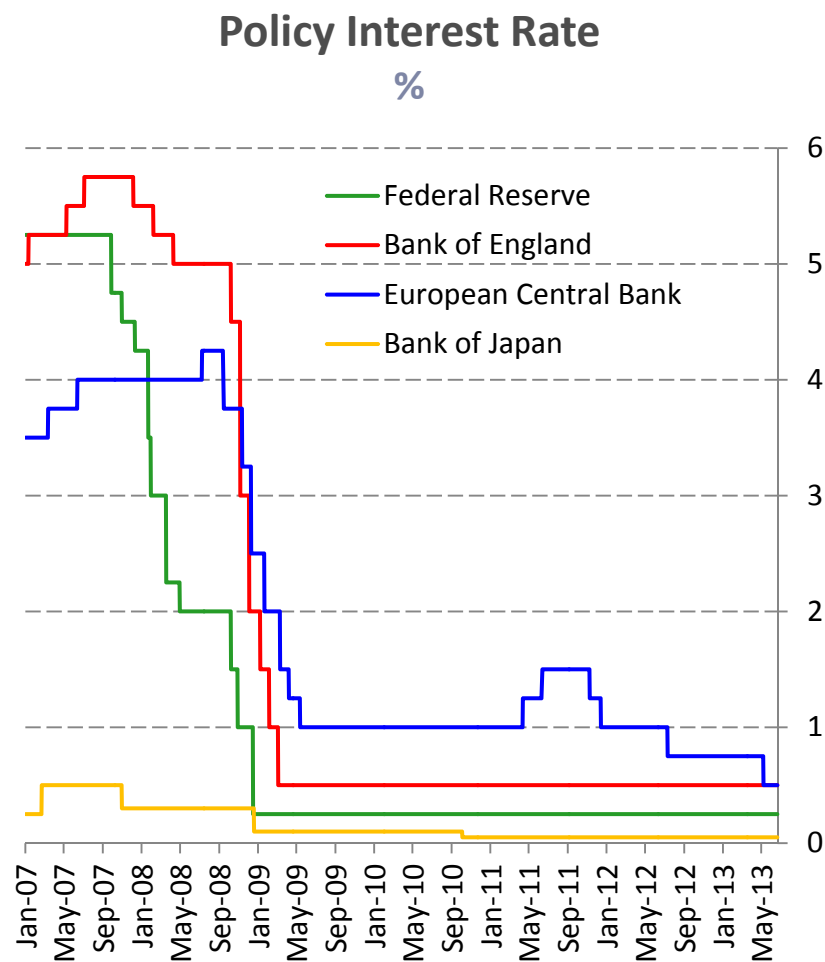
Emerging Economies: Foreign Holdings of Local Government Bonds¹
Percentage of total government securities in circulation



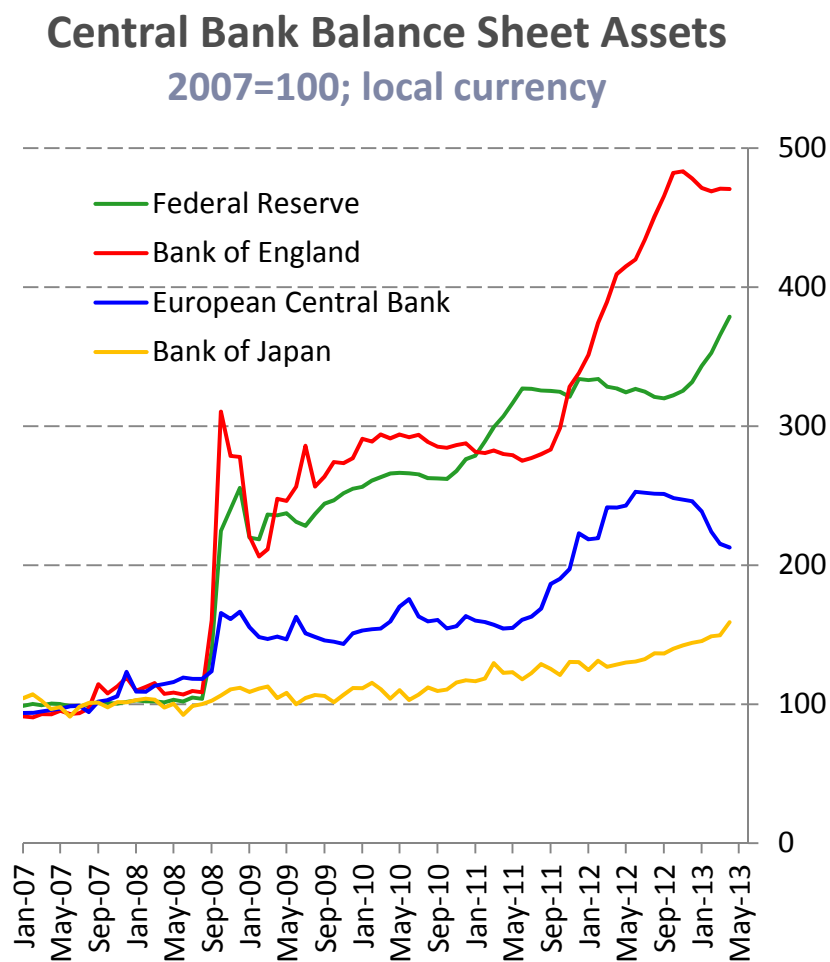
1/ Federal government debt issued on the domestic market, in local currency

Source: Selected countries' central banks and finance ministries

Synchronized capital inflows to emerging economies seem to have stemmed from expansionary monetary policy in advanced nations¹



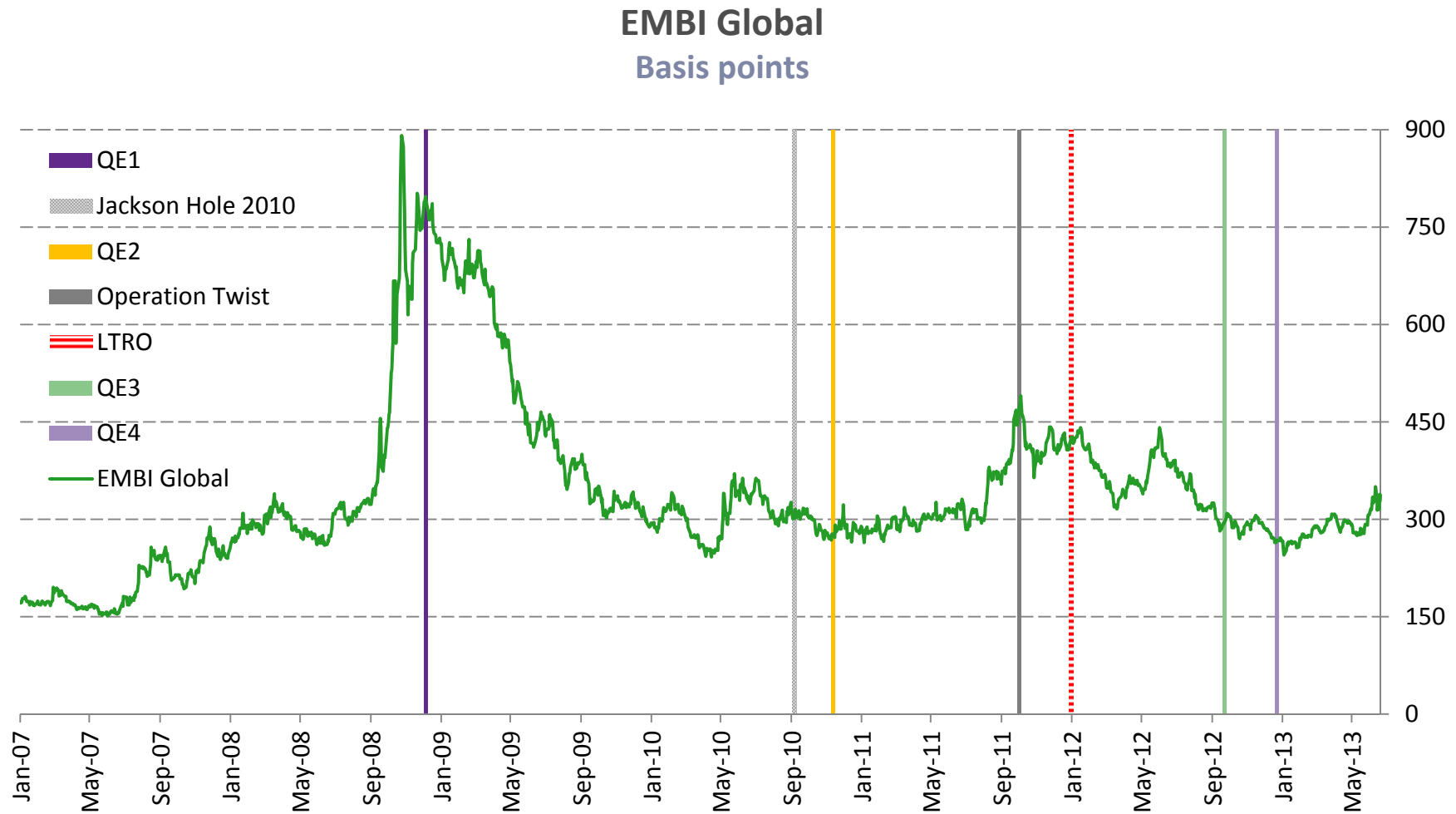
Source: Haver Analytics and central banks' web pages



Source: Haver Analytics

1/ For a discussion of the monetary transmission channel to capital inflows, See Bruno, V. and H.S. Shin (2012), "Capital flows and the risk-taking channel of monetary policy," *BIS Working Papers*

... as well as lower global risk aversion, where fluctuations may not be independent from the previous factor



Source: JP Morgan

Also, some domestic factors may contribute to explaining highly dynamic capital inflows to Mexico

Emerging Economies: Idiosyncratic Factors

	Mexico	Emerging economies ¹
Change in output growth differentials vs. advanced economies from 1981-2009 to 2010-2012 ² (percentage points)	2.7	1.9
Capital account openness ³ (highest degree=100, lowest degree=0)	69.4	50.9
Free-Floating Currency ⁴	Yes	4 out of 30
EMBI Global ⁵ (basis points)	140	282

1/ According to IIF classification. Not all countries provide full data; 2/ Own calculations based on IIF and INEGI data; 3/ Data for 2011. This index measures the country's degree of capital account openness based on the Chinn-Ito index http://web.pdx.edu/~ito/Chinn-Ito_website.htm; 4/ IMF (2012), *Annual Report on Exchange Arrangements and Exchange Restrictions*; 5/ January to May 2013 average, JP Morgan

... including recent progress on structural reforms

- Labor
 - ✓ Permits test training, temporary contracts, and wages per hour; reduces wage compensation after disputes; and eliminates the exclusion clause
- General Government Accounting Law
 - ✓ Requires all levels of government to publish financial data and evaluate the performance of public programs and policies on the Web
- Education
 - ✓ Calls for obligatory assessment of teachers; provides autonomy to the educational evaluation institute; and extends the school day
- Competition and Telecommunications
 - ✓ Provides autonomy to the competition and regulatory bodies; permits more FDI in telecommunications and broadcast radio; puts new licenses for TV frequencies up for auction; allows telecommunications operators to use the local network to provide fixed telephony, private TV and internet services

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Although in principle, capital inflows should be viewed as positive, their abundance could trigger unintended consequences

- Financial imbalances in households, firms and governments, in the form of excessive and unsustainable borrowing
- Bubbles in financial asset prices, in the sense of prolonged price deviations above values consistent with fundamentals

No clear indicators have surfaced of possible widespread financial imbalances

Selected Indicators of Imbalances

	Mexico		Emerging economies ¹	
	2007	2012 ²	2007	2012 ²
Current account balance ³ (% of GDP)	-0.8	-0.8	3.6	1.3
Public-sector borrowing requirements ³ (% of GDP)	0.0	-2.6	2.6	-0.3
Total external debt ^{3,5} (% of GDP)	19.3	30.4	39.2	41.3
Domestic credit to the private sector ⁴ (% of GDP)	21.8	26.1	54.5	59.8
Bank nonperforming loans ⁴ (% total gross loans)	2.4	4.3	2.2	5.7

1/ According to IIF classification. Not all countries provide full data; 2/ Or most recent available data; 3/ IIF; 4/ The World Bank; 5/Includes domestic-currency-denominated government securities held by foreigners

... or financial bubbles. However, evidence could appear

Asset Price Indicators Average

	Mexico		Emerging economies ¹	
	2007	2013 ²	2007	2013 ²
10-year interest rate or nearest equivalent ³ (%)	7.8	5.0	6.2	5.4
Real effective exchange rate ^{4, 5} (2007=100)	100.0	99.0	100.0	107.9
National stock market indices, LCU ^{4, 6} (2007=100)	100.0	147.9	100.0	157.9
Real estate prices ⁷ (2007=100; in constant currency units)	100.0	99.4	100.0	93.3

1/ According to IIF classification. Not all countries provide full data; 2/ Until April except for the real estate price index, which is up to Q1 2013; 3/ IFS; 4/ Haver Analytics; 5/ A figure higher than 100 represents an appreciation; 6/ LCU: Local currency units; 7/ Based on BIS Property Price Statistics, FRED Economic Data and Haver Analytics

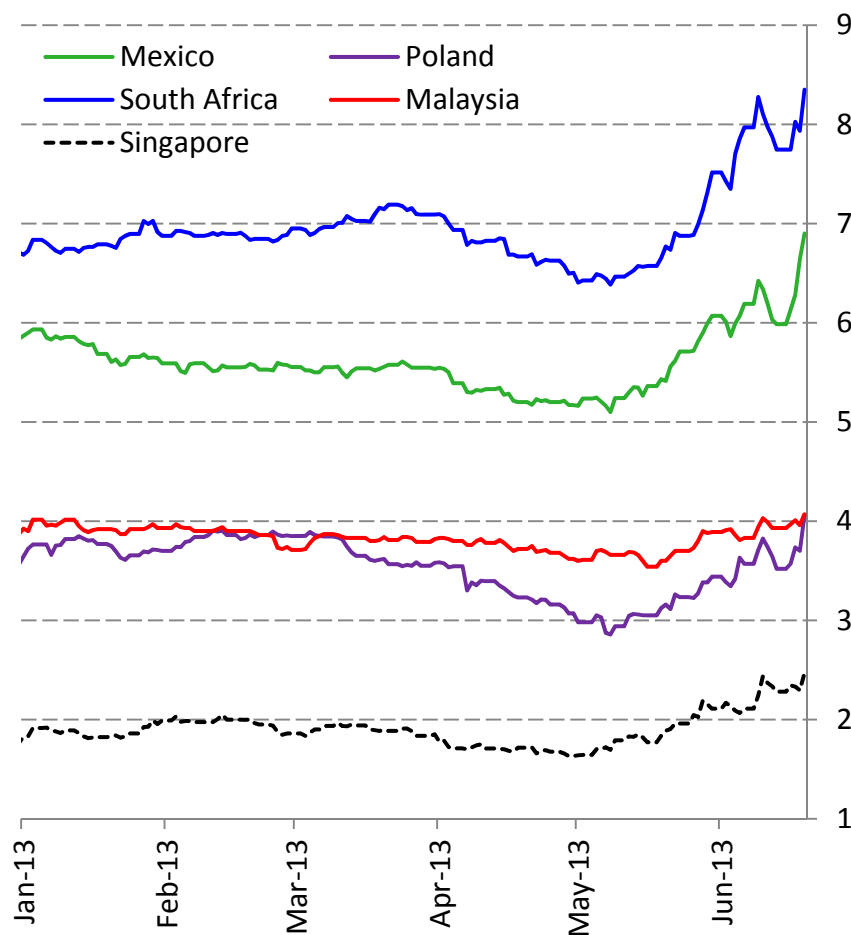
More importantly, experience confirms that booms in capital inflows have often ended in sudden stops

- Sudden stops can occur even if capital inflows do not generate internal financial imbalances or bubbles
- Factors behind capital inflows, above all portfolio funds, can change for reasons not necessarily related to the recipient country; e.g.:
 - ✓ Anticipation of tighter monetary conditions in advanced countries
 - ✓ An increase in global risk aversion
- Effects can be amplified by contagion
- Debtors and savers with exposure to interest-rate and foreign-exchange risks should remain wary

During recent weeks, global market sentiment has changed, reflecting expectations on tapering of U.S. monetary accommodation

10-year Swap Interest Rates¹

%

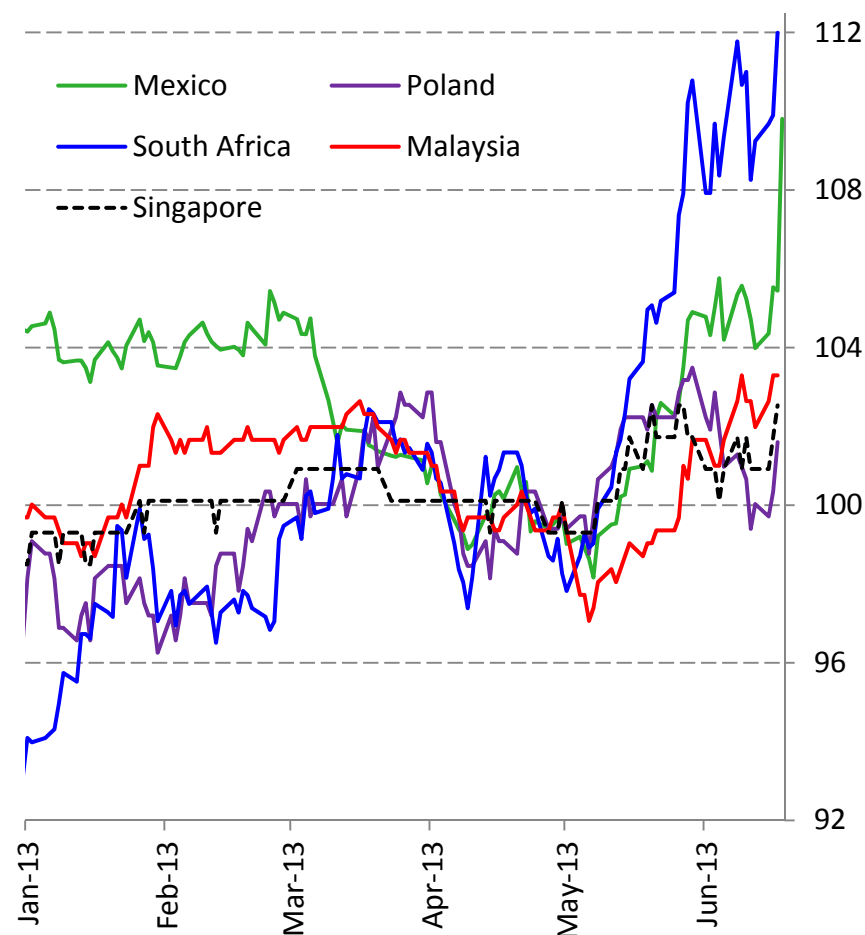


1/ An interest rate swap is the exchange of a set of cash flows with a fixed interest rate for another set with a floating interest rate

Source: Bloomberg

Exchange Rates

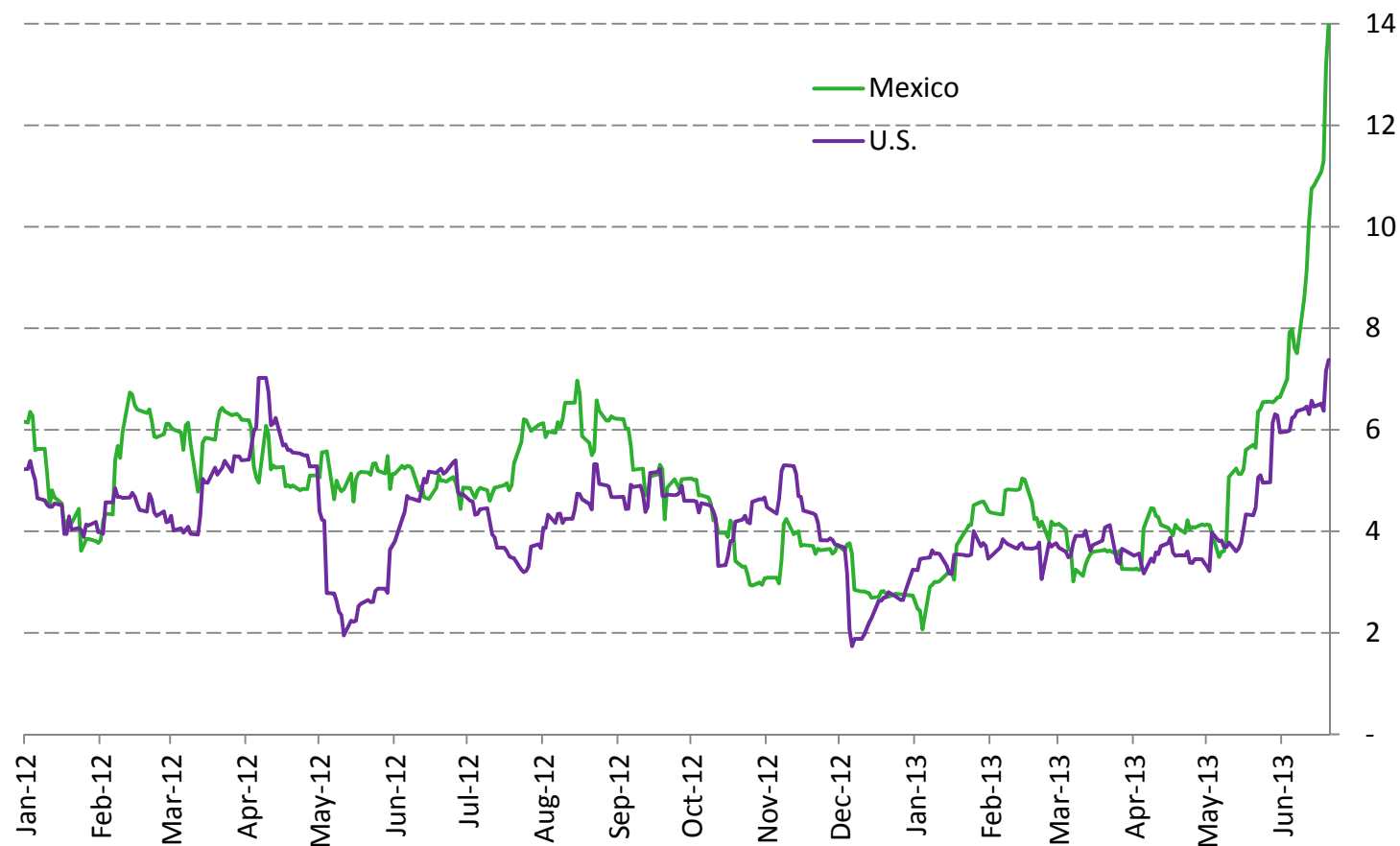
Local currency per U.S. dollar, April 2013=100



Source: Banco de México and Bloomberg

Recent volatility in Mexican financial markets has occurred in tandem with that of the United States

Volatility in 10-year Swap Interest Rates in Mexico and the United States¹
Basis points

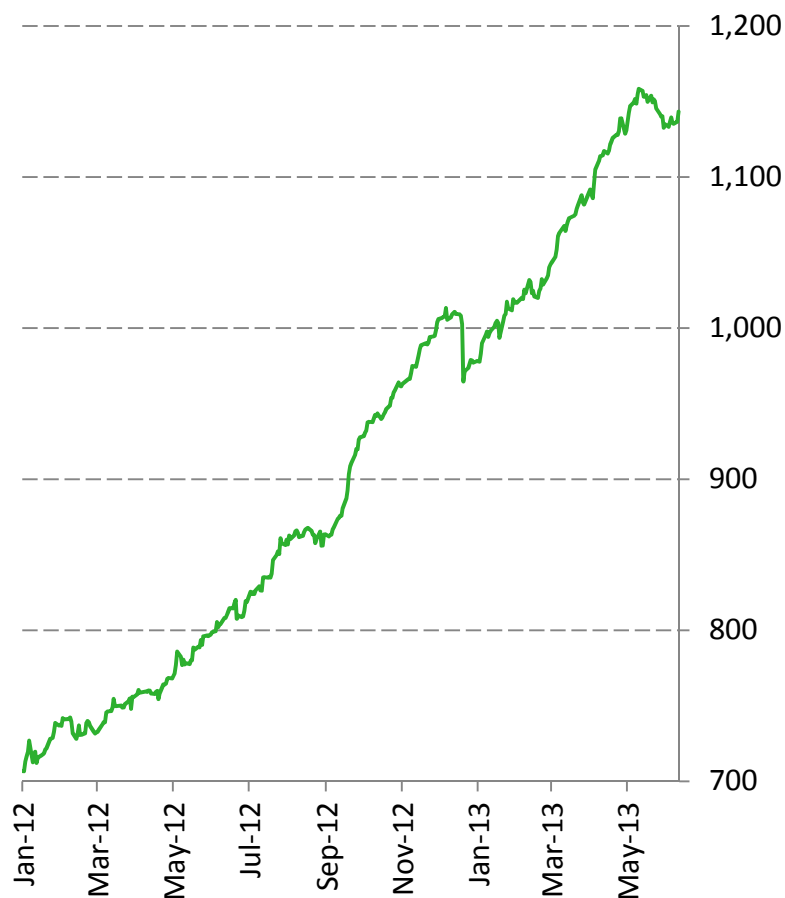


1/ An interest rate swap is the exchange of a set of cash flows with a fixed interest rate for another set with a floating interest rate. Volatility is here defined as the standard deviation of a 20-day moving average of the swap interest rates

Source: Banco de México with Bloomberg data

The reaction of financial markets in Mexico has been orderly

Government Securities Held by Foreigners¹
Billions of pesos



1/ Only includes fixed-rate bonds
Source: Banco de México

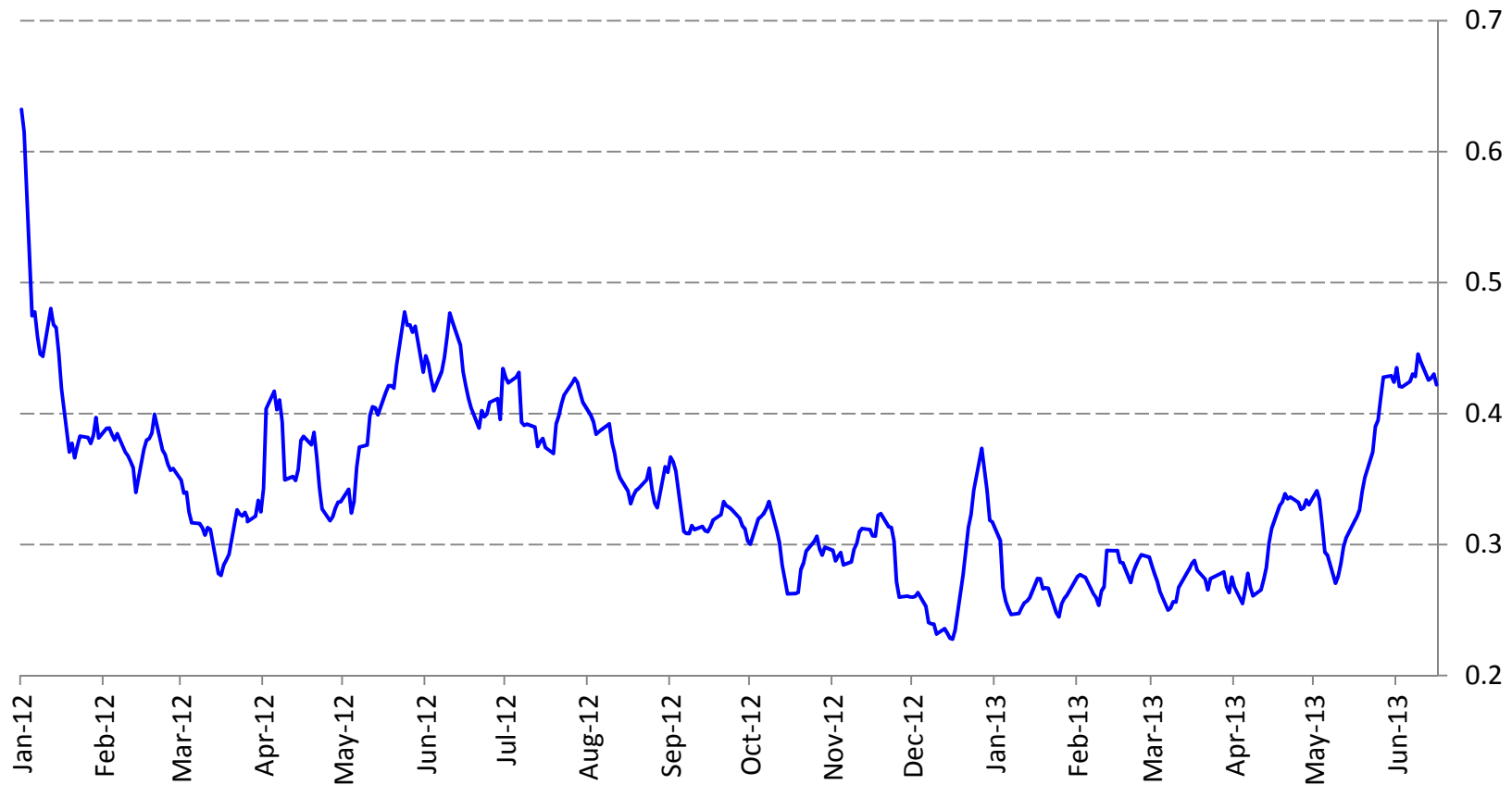
Duration of Government Bond Portfolios Held by Foreigners²
Years



2/ Only includes fixed-rate bonds
Source: Banco de México

FX market volumes have continued to be high and bid-ask spreads have remained slim

Average Peso-per-Dollar Bid-Ask Spread
Pesos, 5-day moving average



Source: Reuters

Policy measures in Mexico have been mainly directed toward mitigating the possible adverse effects of capital inflows

- International reserves and IMF flexible credit line
- Financial System Stability Council
- Financial regulation on banks
 - ✓ Capitalization and provisioning requirements
 - ✓ Limits on related-party lending
 - ✓ Foreign banks can operate only through subsidiaries
 - ✓ Authorization required for significant transfers of assets and liabilities between Mexican subsidiaries and foreign parent banks
 - ✓ Restrictions on FX transactions: deposits, net liabilities, net open position and liquidity ratio
- Such policies can hardly be sufficient; hence authorities should remain vigilant

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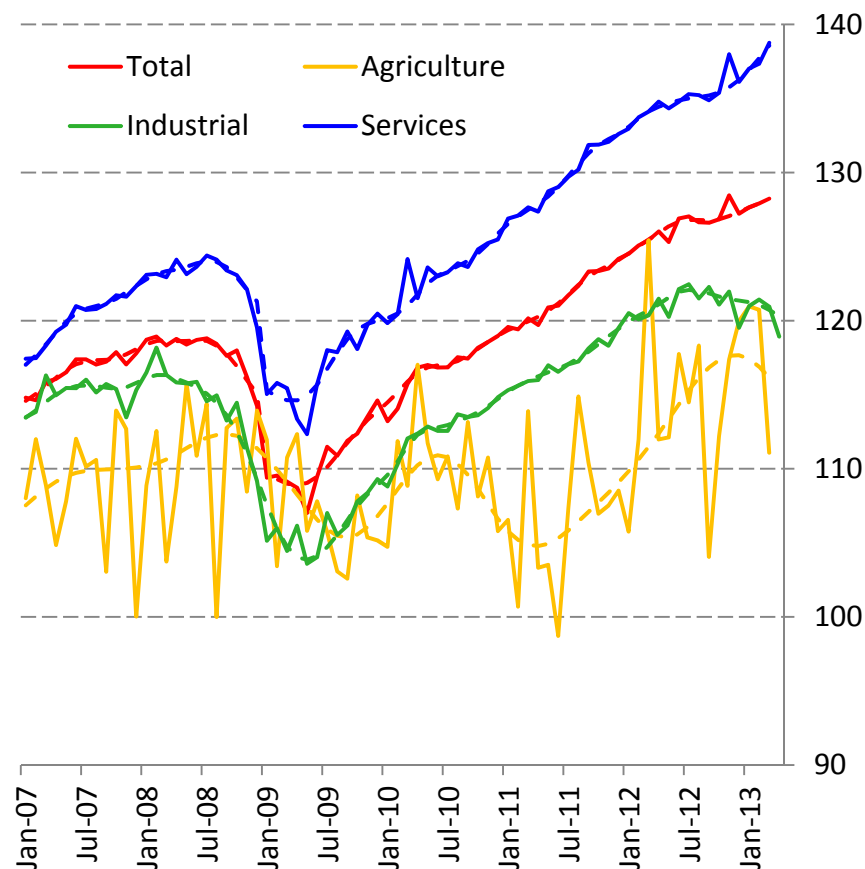
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The Mexican economy has recently shown signs of deceleration reflecting stagnation in industry, especially manufacturing

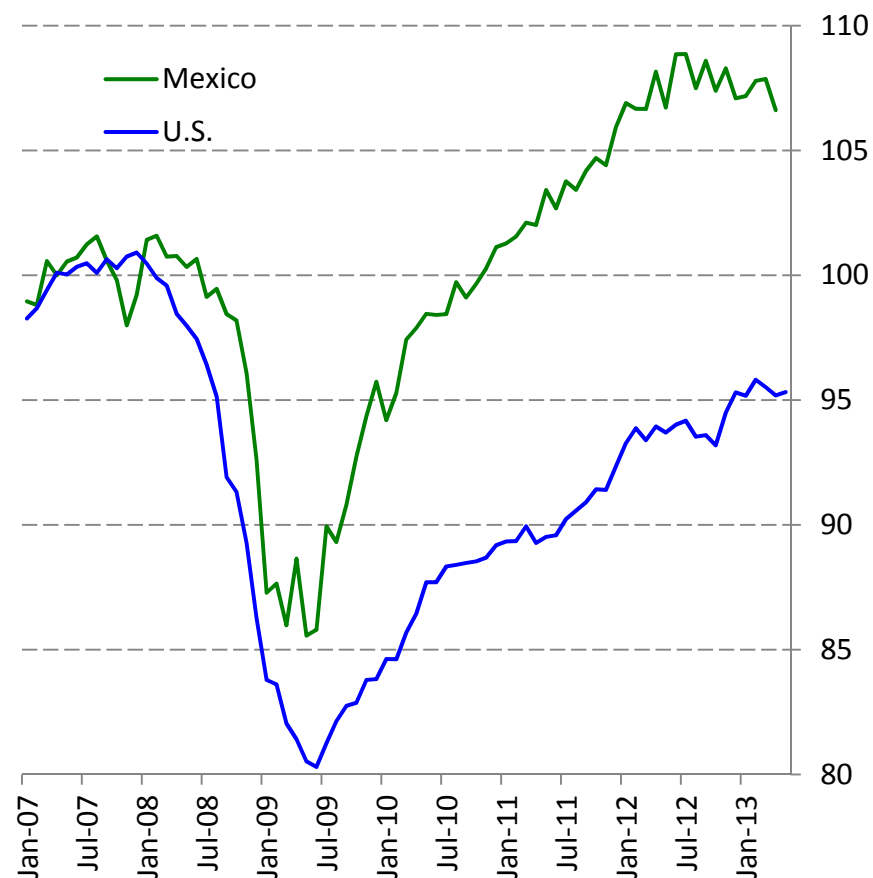
Global Economic Activity Indicator¹
2003=100; s.a.



1/ Data up to March except for industrial data, which is up to April
s.a./ Seasonally adjusted

Source: Mexican National Accounts System (SCNM), INEGI

Manufacturing Output²
2007=100; s.a.



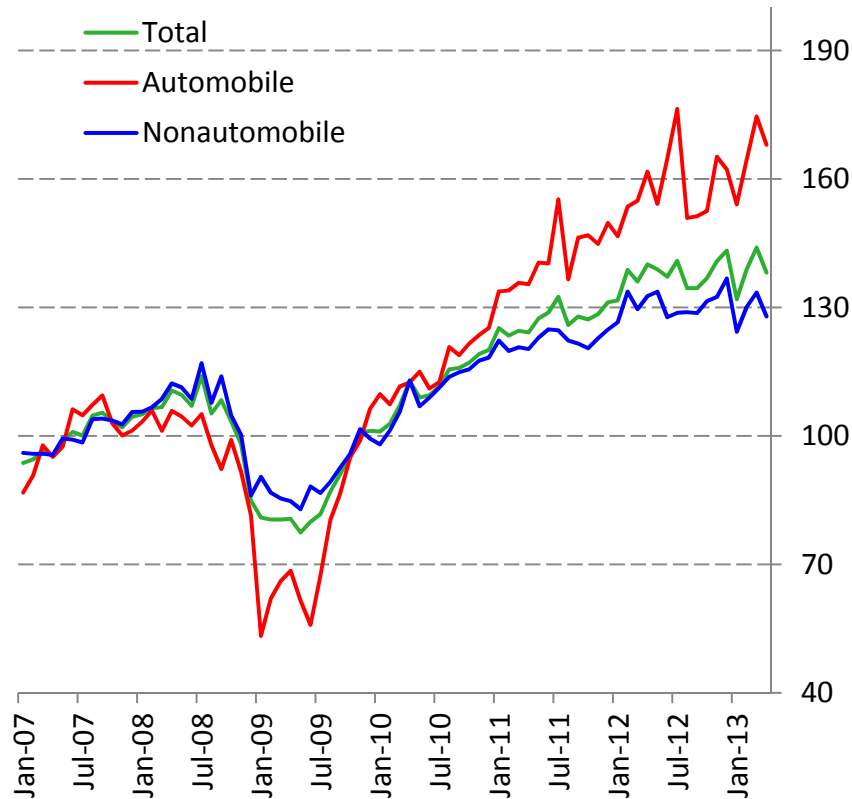
2/ Data up to May for the U.S. and up to April for Mexico
s.a./ Seasonally adjusted

Source: Banco de México and the Federal Reserve

The slowdown in manufacturing results from lower export growth in that sector

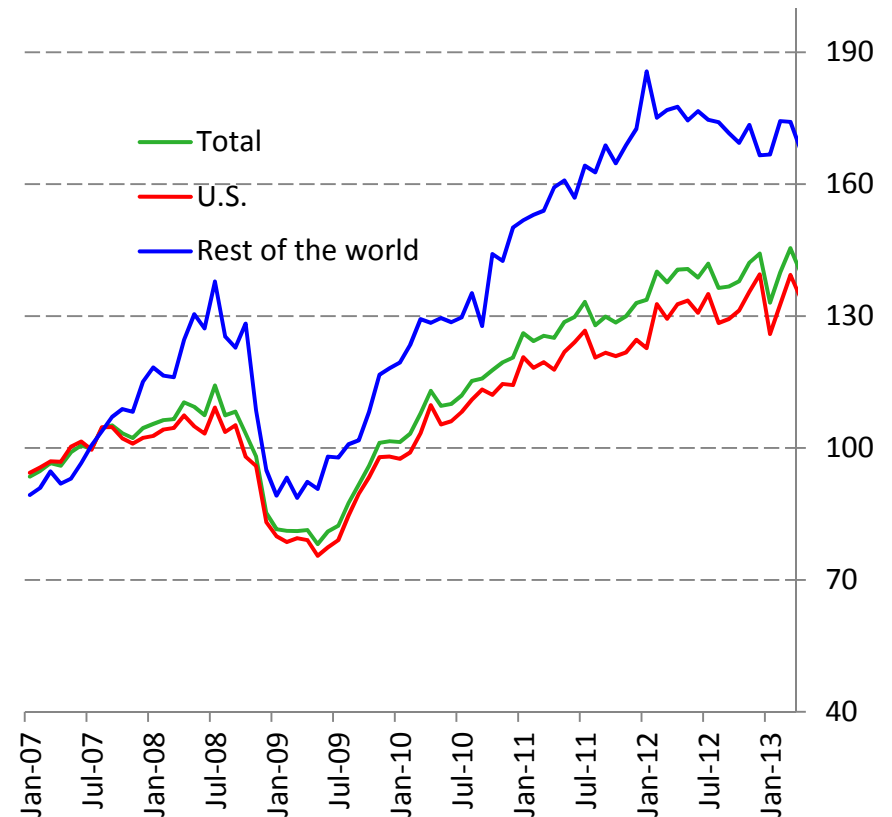
Manufacturing Exports
2007=100; s.a.

By Industry



s.a./ Seasonally adjusted
Source: Banco de México

By Destination

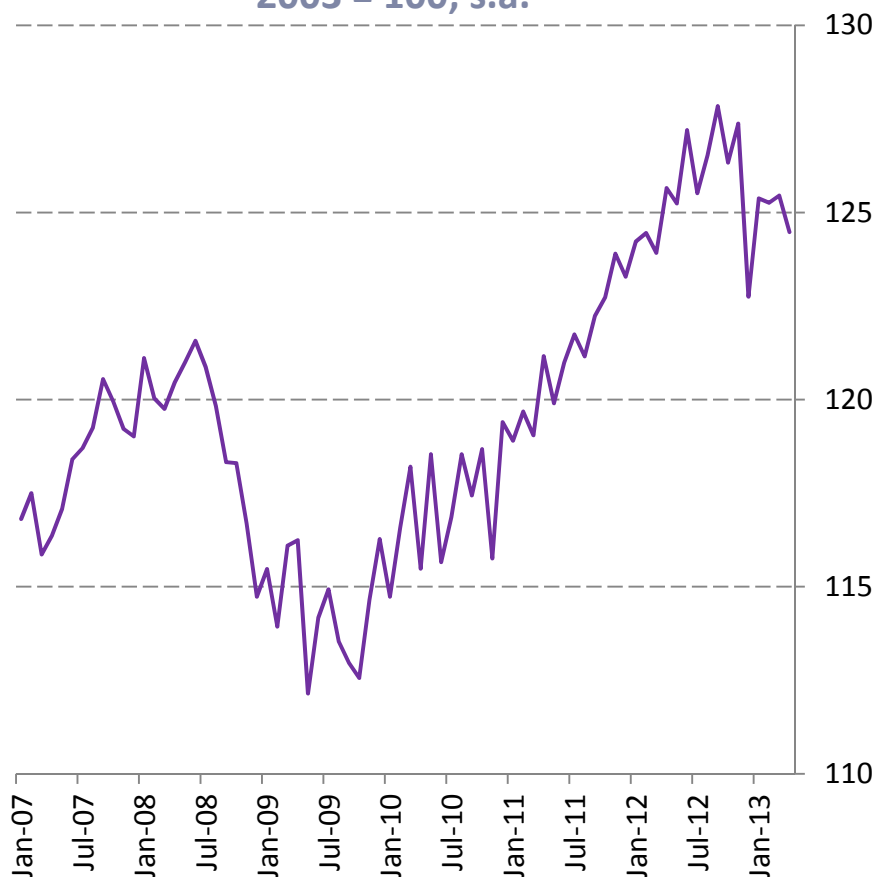


s.a./ Seasonally adjusted
Source: Banco de México

Less dynamic external demand has likely had negative repercussions for domestic retail sales and gross fixed investment

**Retail Sales
in Commercial Establishments**

2003 = 100; s.a.

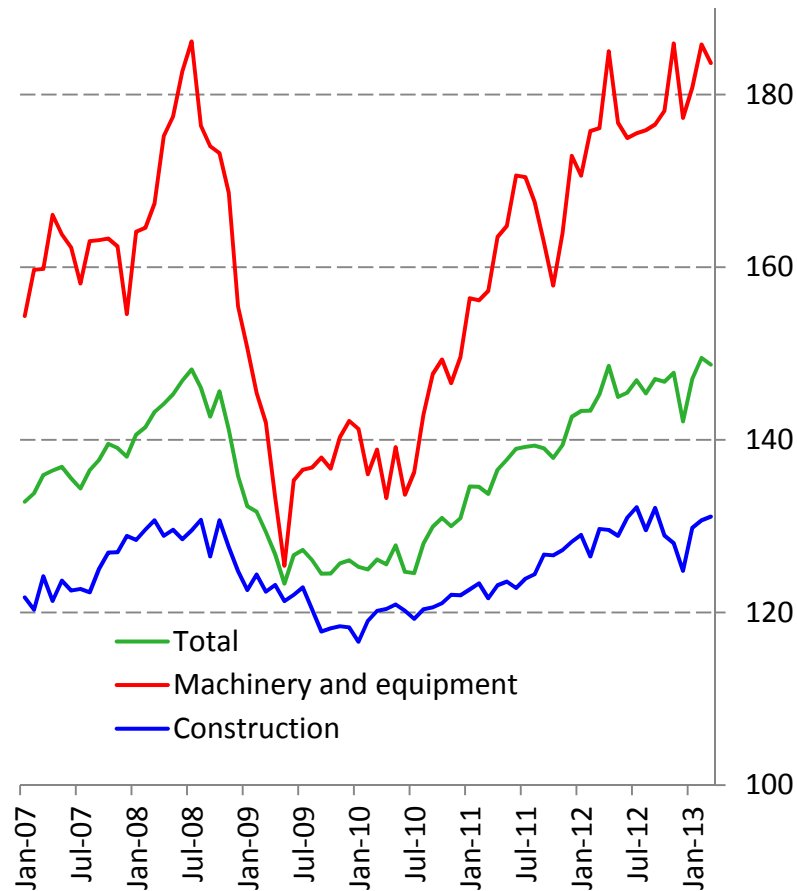


s.a./ Seasonally adjusted

Source: Survey of Commercial Establishments, INEGI

Investment and its Components

2003 = 100; s.a.

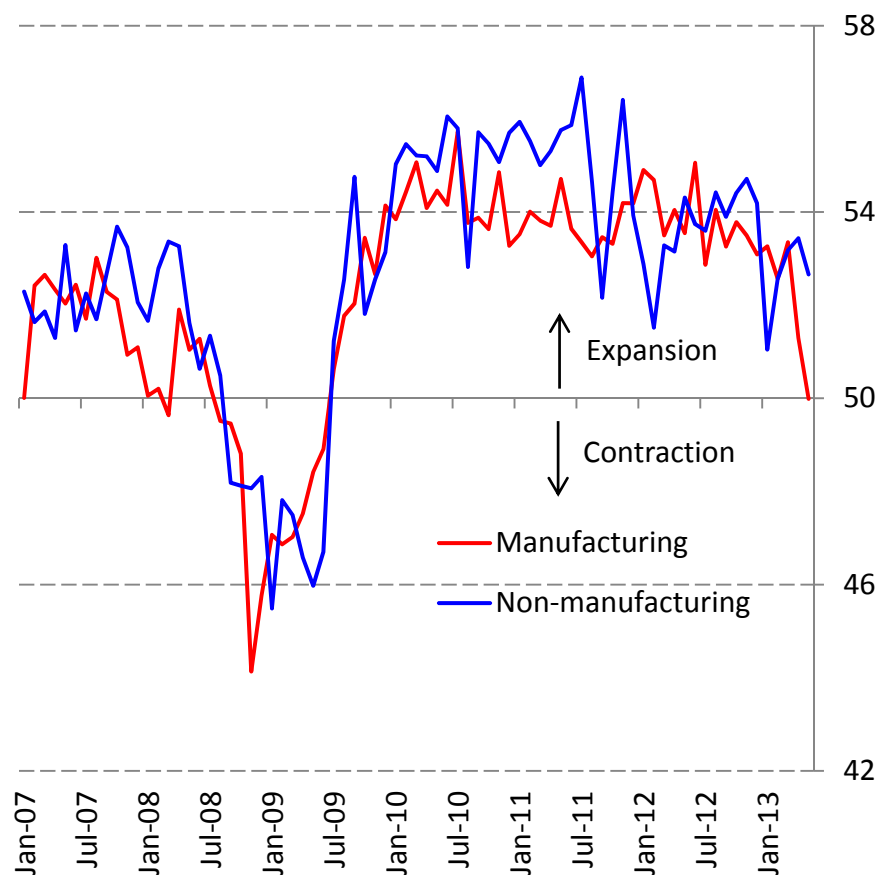


s.a./ Seasonally adjusted

Source: INEGI

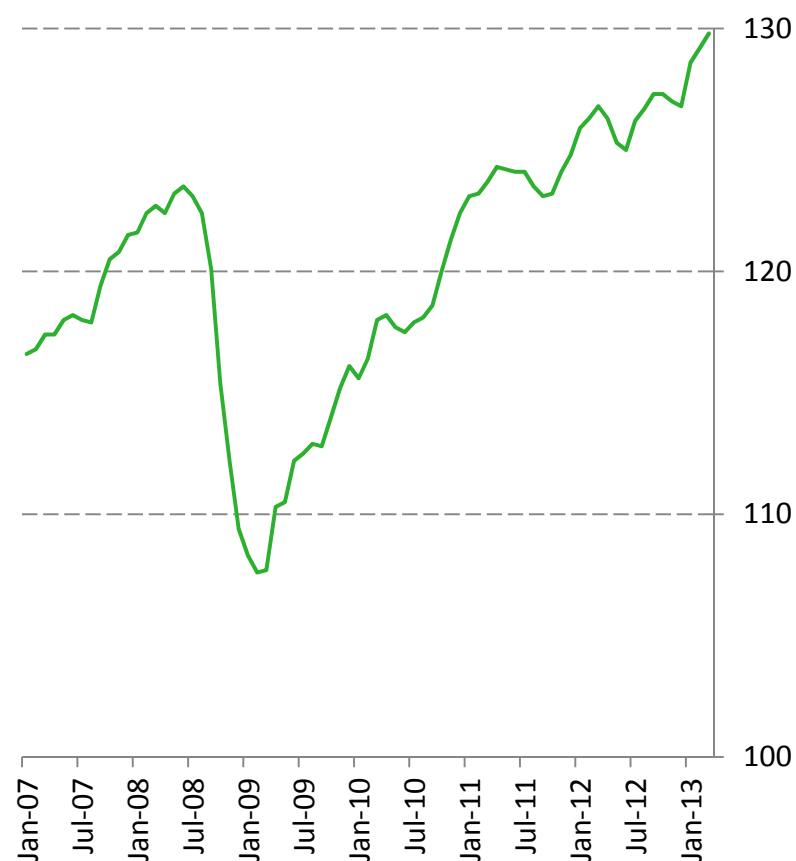
Most forward-looking indicators still suggest that economic performance may improve in the near future

Purchasing Managers Index¹
50 reference points; s.a.



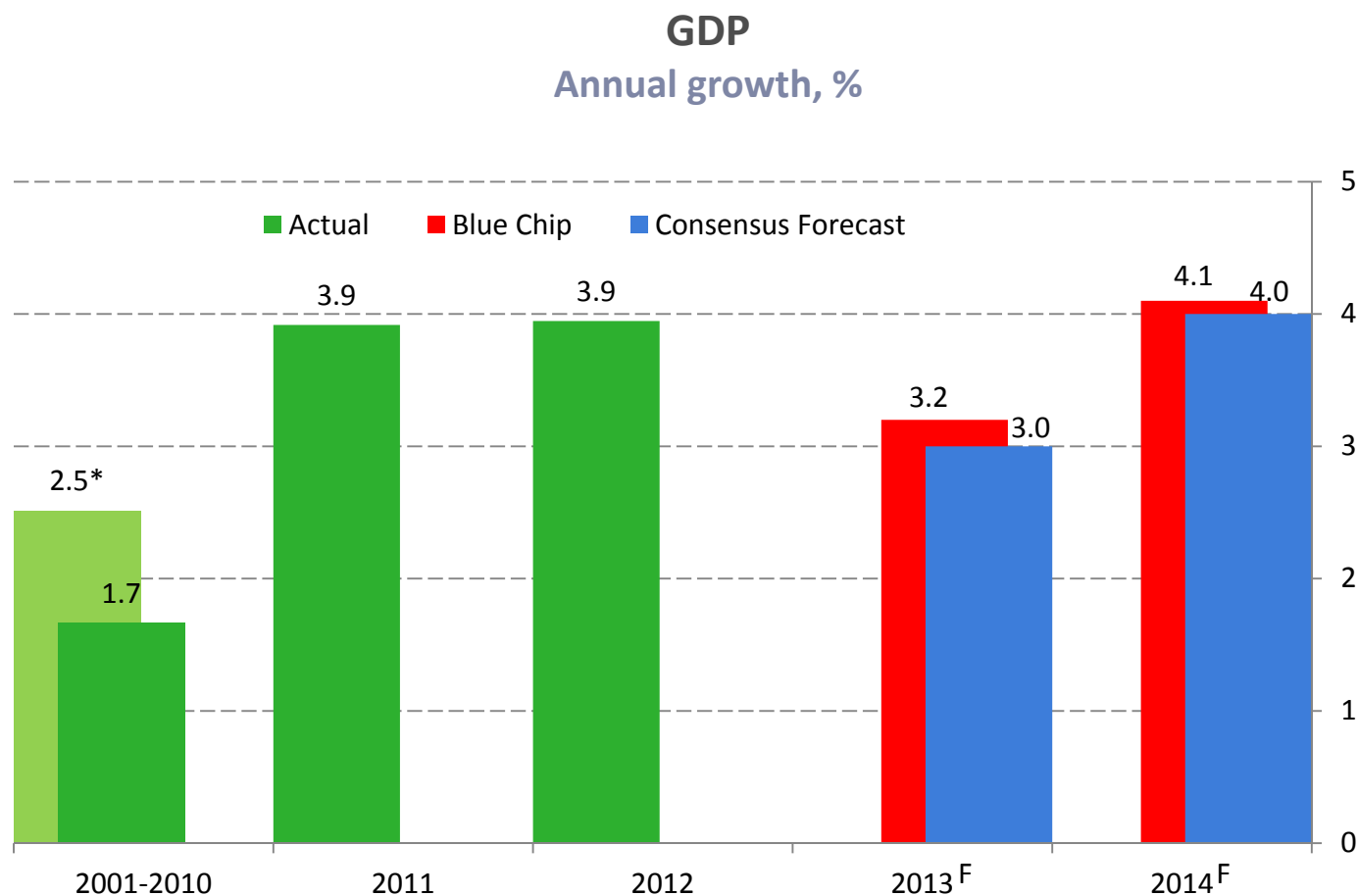
1/ Data adjusted for business size
s.a./ Seasonally adjusted
Source: IMEF

Leading Indicator
2003=100, s.a.



s.a./ Seasonally adjusted
Source: INEGI

Analysts forecast that Mexican GDP growth will be higher in 2014 than this year

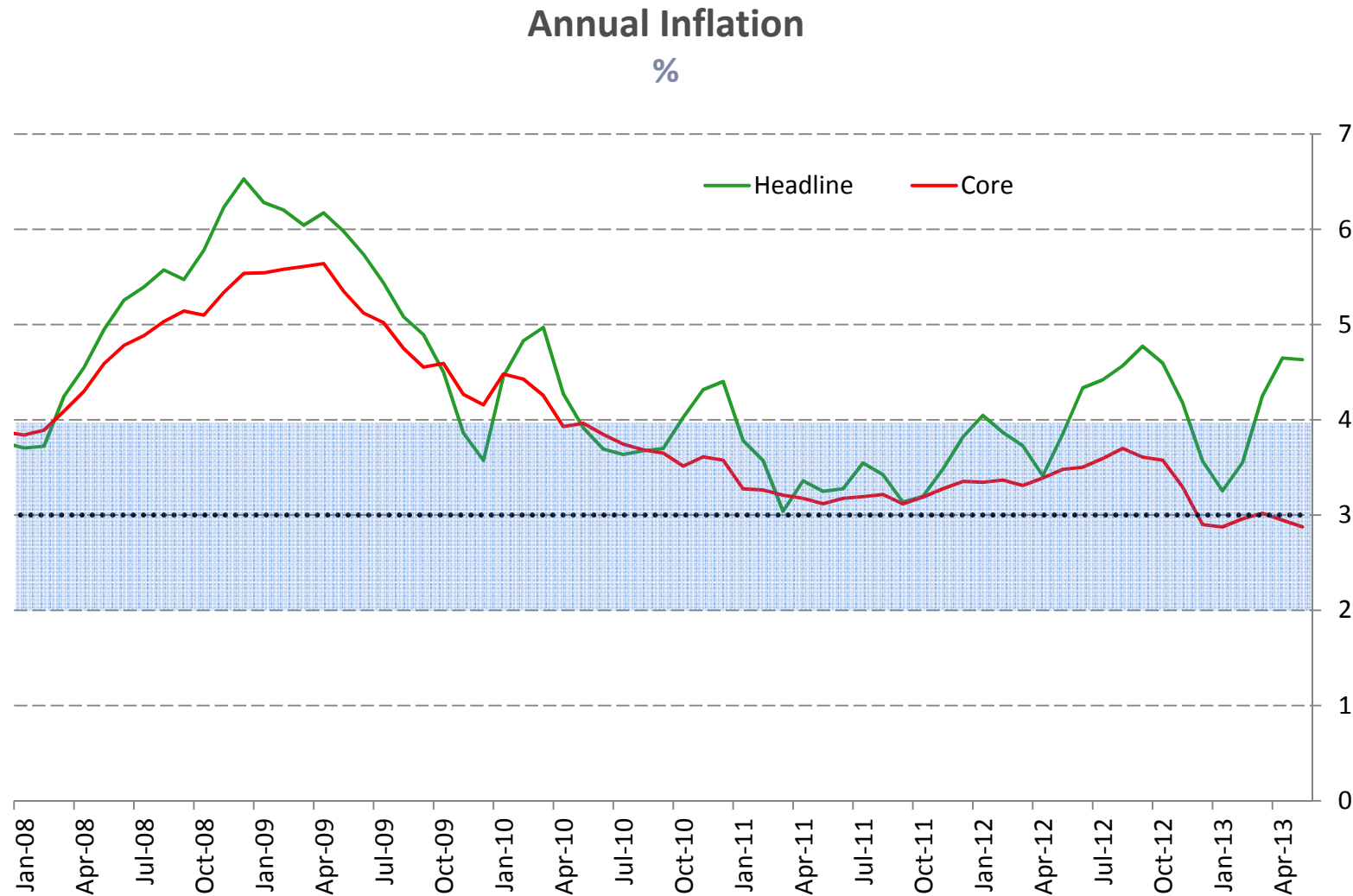


*/ Excluding 2009

F/ Forecast

Source: INEGI. Forecasts, Blue Chip and Latin America Consensus Forecasts, June

Finally, a rise in headline inflation has been the result of supply shocks in noncore components of the CPI

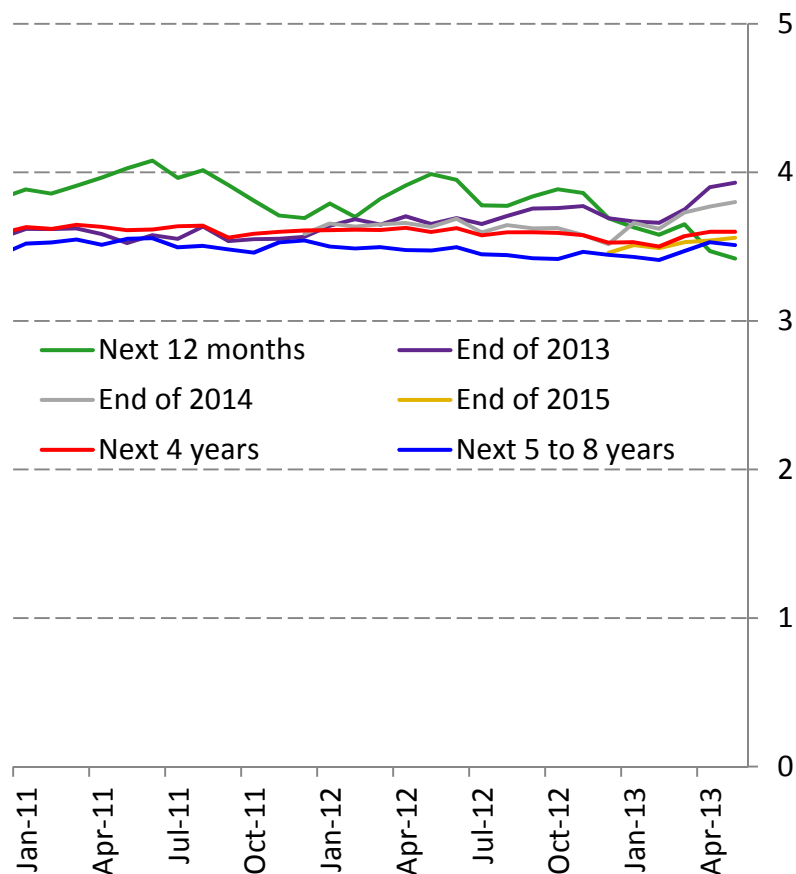


Source: INEGI

Medium- and long-term inflation expectations have remained stable, albeit above the 3 percent target

Analysts' Inflation Expectations

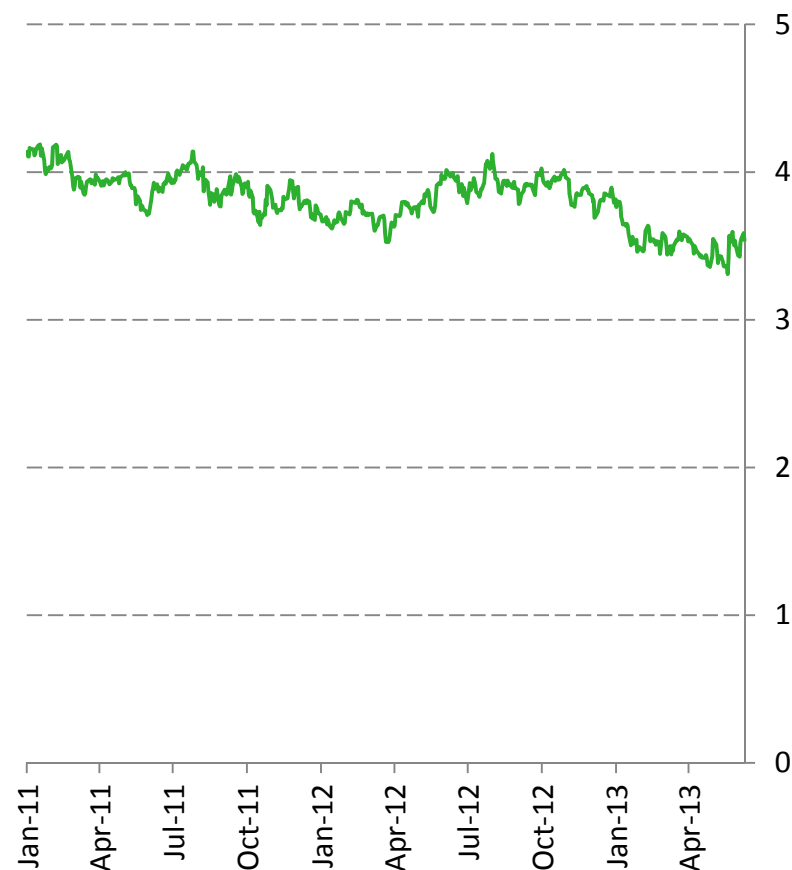
%



Source: Banco de México

Break-even Inflation¹

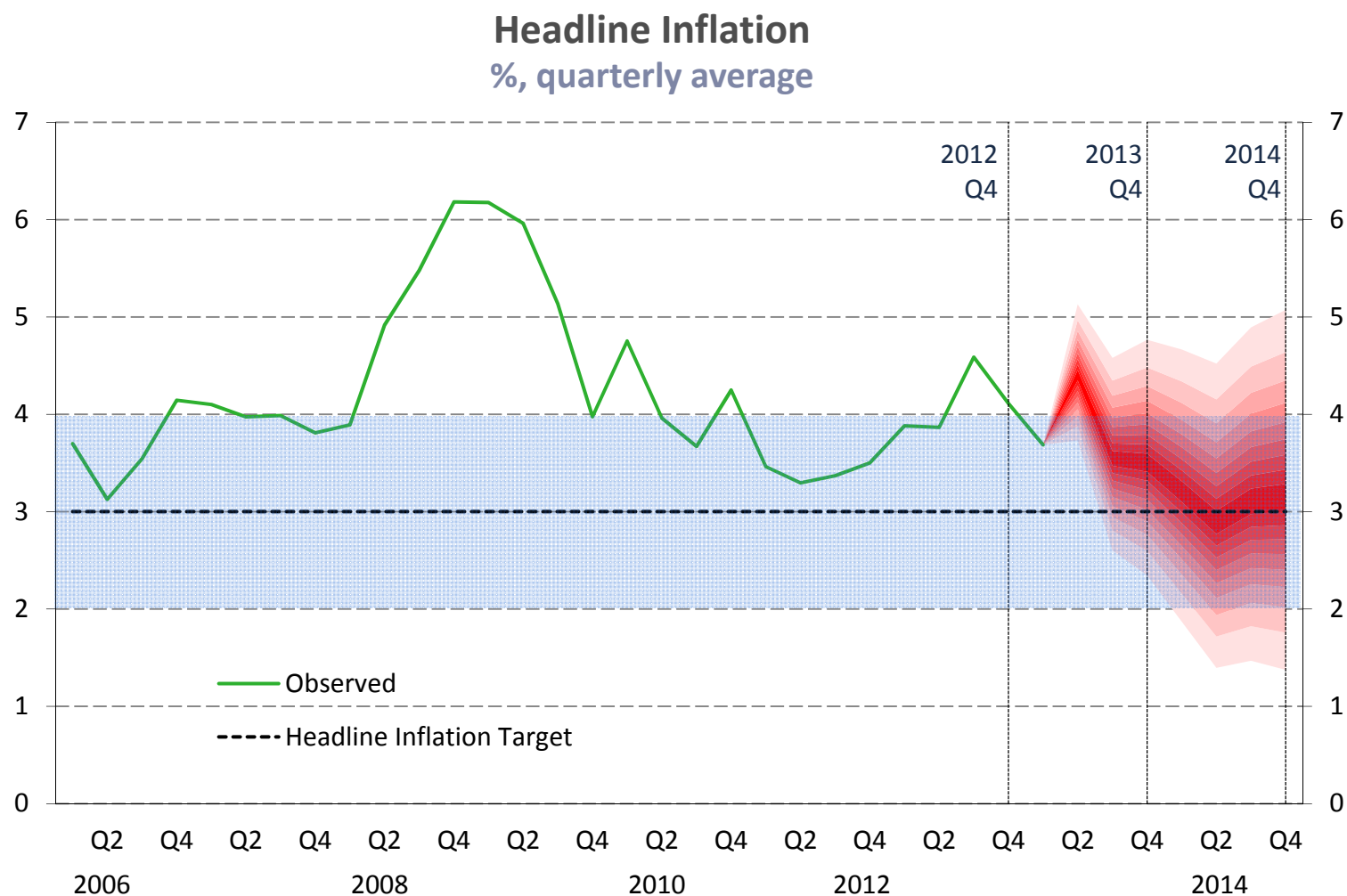
%



1/ Based on 10-year bond nominal and real interest rates in the secondary market

Source: Own calculations with Valmer data

The Bank of Mexico expects inflation to be very close to the permanent target by 2014



Source: Banco de México (2013), *Inflation Report January-March*, April

Concluding remarks

- The recent surge of capital inflows to Mexico has been characterized by a significant increase in the share of portfolio funds
- The reaction of Mexican financial players to recent changes in global market sentiment has been orderly
- Macroprudential measures can hardly be sufficient; hence, authorities should remain vigilant
- Softer economic activity and rising inflation are expected to be transitory, but they pose policy challenges
- There is ample room for raising long-term potential economic growth through structural reforms



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