



Xth Central Banking Operations Meeting

CEMLA and Banco de México

Liquidity provision in the time of Covid-19. How much is enough?

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* The views expressed in this presentation are the ones of the author and do not necessarily reflect those of the Central Bank of Mexico.



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Introduction

- The COVID-19 pandemic has inflicted an unprecedented shock to the global economy and worlds' financial markets. Emerging market economies suffered historically large capital outflows, and abrupt movements in financial asset prices, particularly during March and April.
- Around the globe, policy responses to address financial markets' volatility and the acute deterioration of economic growth expectations were heterogeneous but, most often, included massive monetary stimulus and large packages of fiscal measures to stimulate the economy. The latter policy measures have been more focused on industries and sectors that have been affected the most.
- Banco de México addressed the pandemic with a two-stage approach in four different dimensions.
 - Two stage approach. At first, the priority was to foster the necessary conditions for financial markets to adjust in an orderly manner (policy rates, liquidity provision in money, FX, and fixed income markets). As financial markets started to stabilize, additional facilities were implemented to provide ample liquidity, to offer mechanisms to manage risks, and to strengthen the credit channels in our economy.
 - While following this approach, four different dimensions had to be taken care of: monetary policy, liquidity provision, credit channels and functioning of financial markets.

Policy response

- In response to financial markets' volatility, weaker economic growth, and lower inflation and inflation expectations, the Bank of Mexico has announced several policy measures, targeting four dimensions. If fully implemented, these measures represent about 5% of GDP.

Monetary Policy

- Reduction of target interest rate from 7.00% to 4.50%.
- Expectations point to further reductions in interest rates, with market implied indicators anticipating 4.00% by year end.

Liquidity Provision

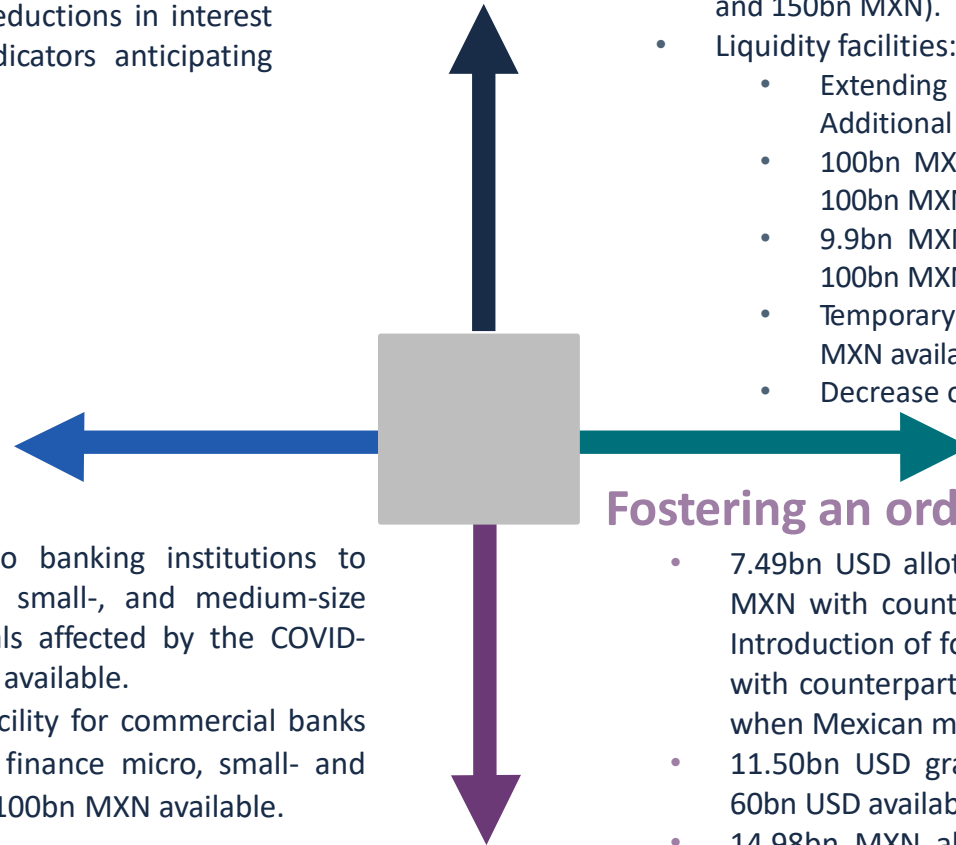
- Increasing liquidity during trading hours to facilitate the optimal functioning of financial markets and payment systems (allotted amount: between 120 and 150bn MXN).
- Liquidity facilities:
 - Extending the securities and counterparts eligible for the Ordinary Additional Liquidity Facility.
 - 100bn MXN allotted in Government Securities Repurchase Facility, of 100bn MXN available.
 - 9.9bn MXN allotted in Corporate Securities Repurchase Facility, of 100bn MXN available.
 - Temporary security swap window for low liquidity instruments, 100bn MXN available.
 - Decrease of 50bn MXN of the Monetary Regulation Deposit.

Credit Channel

- Provision of resources to banking institutions to channel credit to micro, small-, and medium-size enterprises and individuals affected by the COVID-19 pandemic, 250bn MXN available.
- Collateralized financing facility for commercial banks with corporate loans, to finance micro, small- and medium-size enterprises, 100bn MXN available.

Fostering an orderly behavior of market

- 7.49bn USD allotted in Foreign exchange hedges settled by differences in MXN with counterparts domiciled in the country, of 30bn USD available. Introduction of foreign exchange hedges settled by differences in US dollars with counterparts not domiciled in the country, to be traded during hours when Mexican markets are closed.
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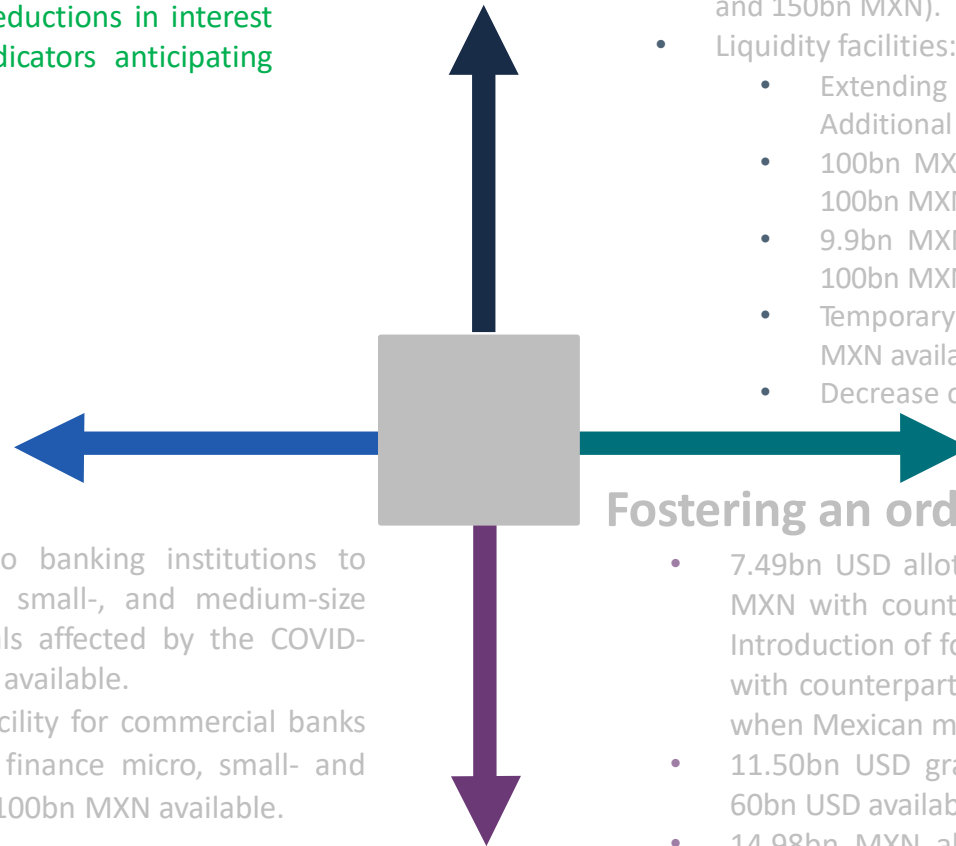
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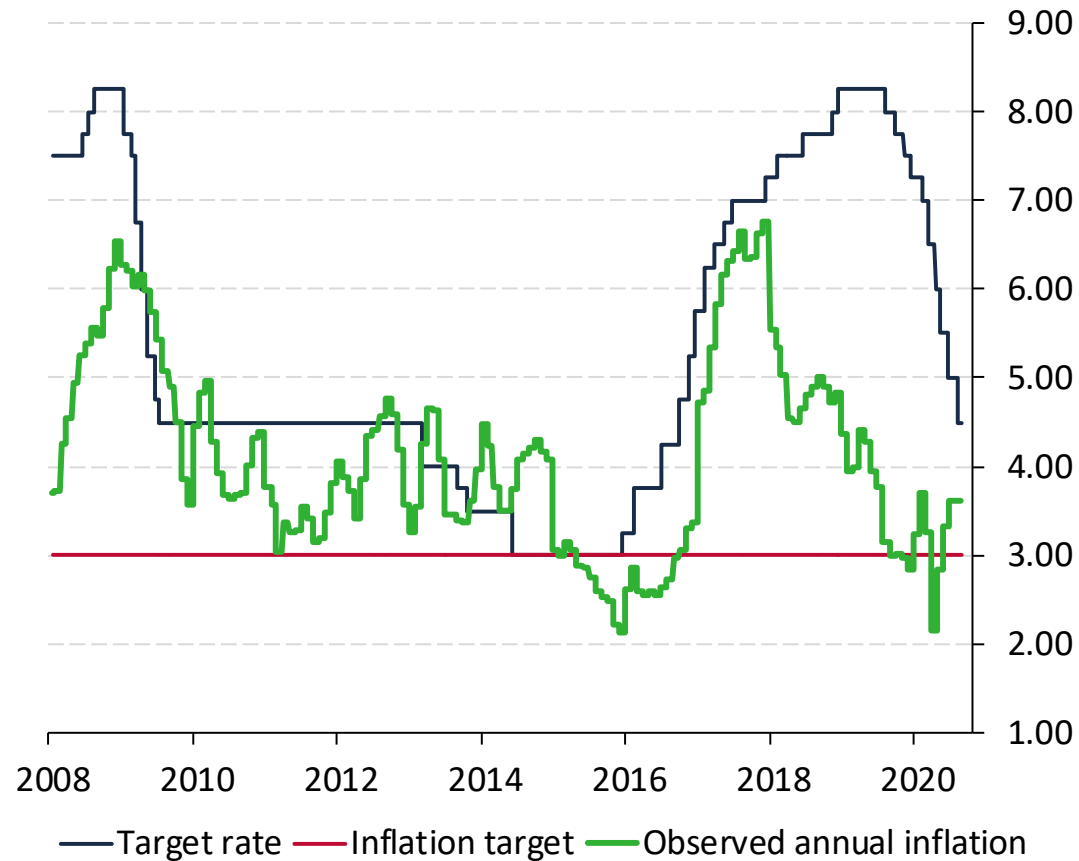
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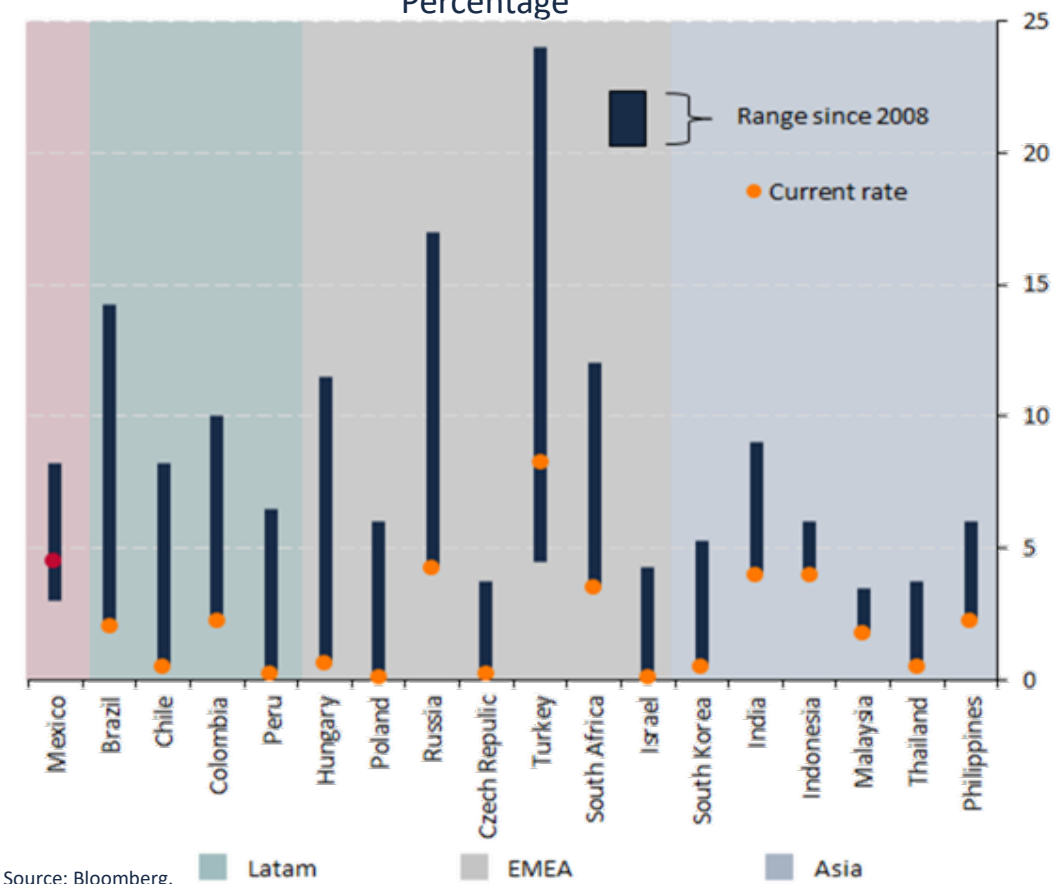
Monetary Policy

- The Bank of Mexico has lowered its reference rate by 375 bps since August 2019, of which 250 bps have been observed after the pandemic started. Yet, the perception from market participants is that there may still be some space for further reductions of our policy rate.

Bank of Mexico's monetary policy reference rate, inflation target and annual inflation rate
Percentage



Reference rate range of emerging economies since 2008 versus their current reference rate level
Percentage



Source: Bloomberg.

Latam

EMEA

Asia

Policy response

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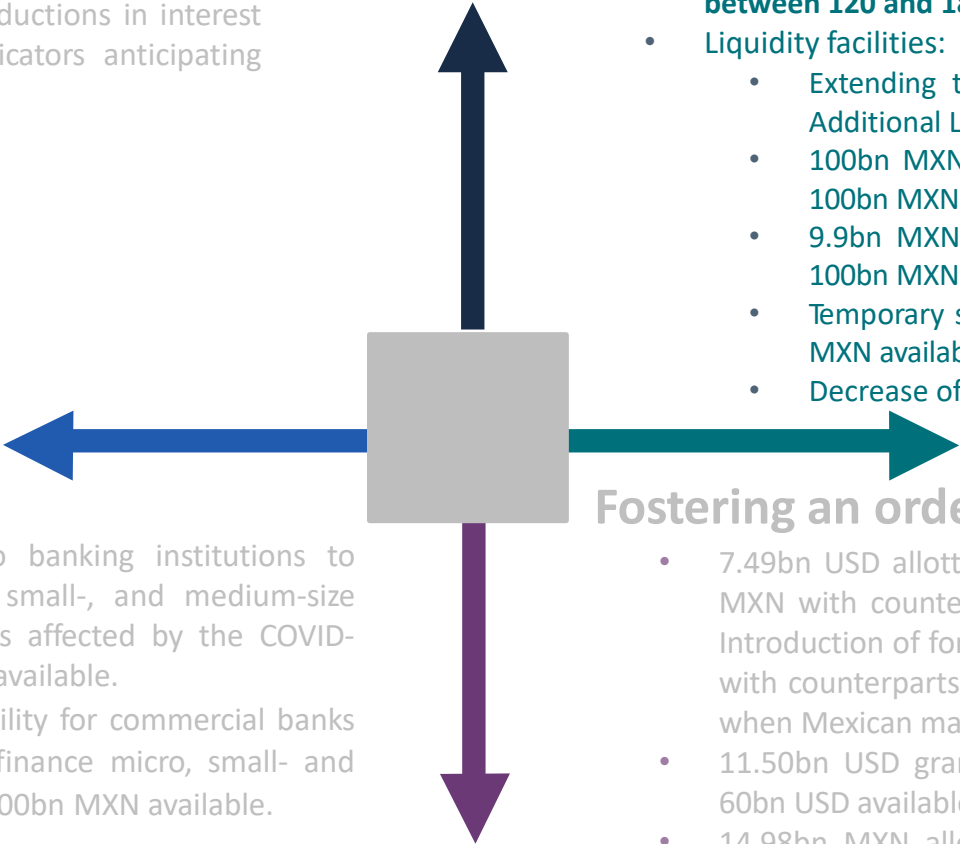
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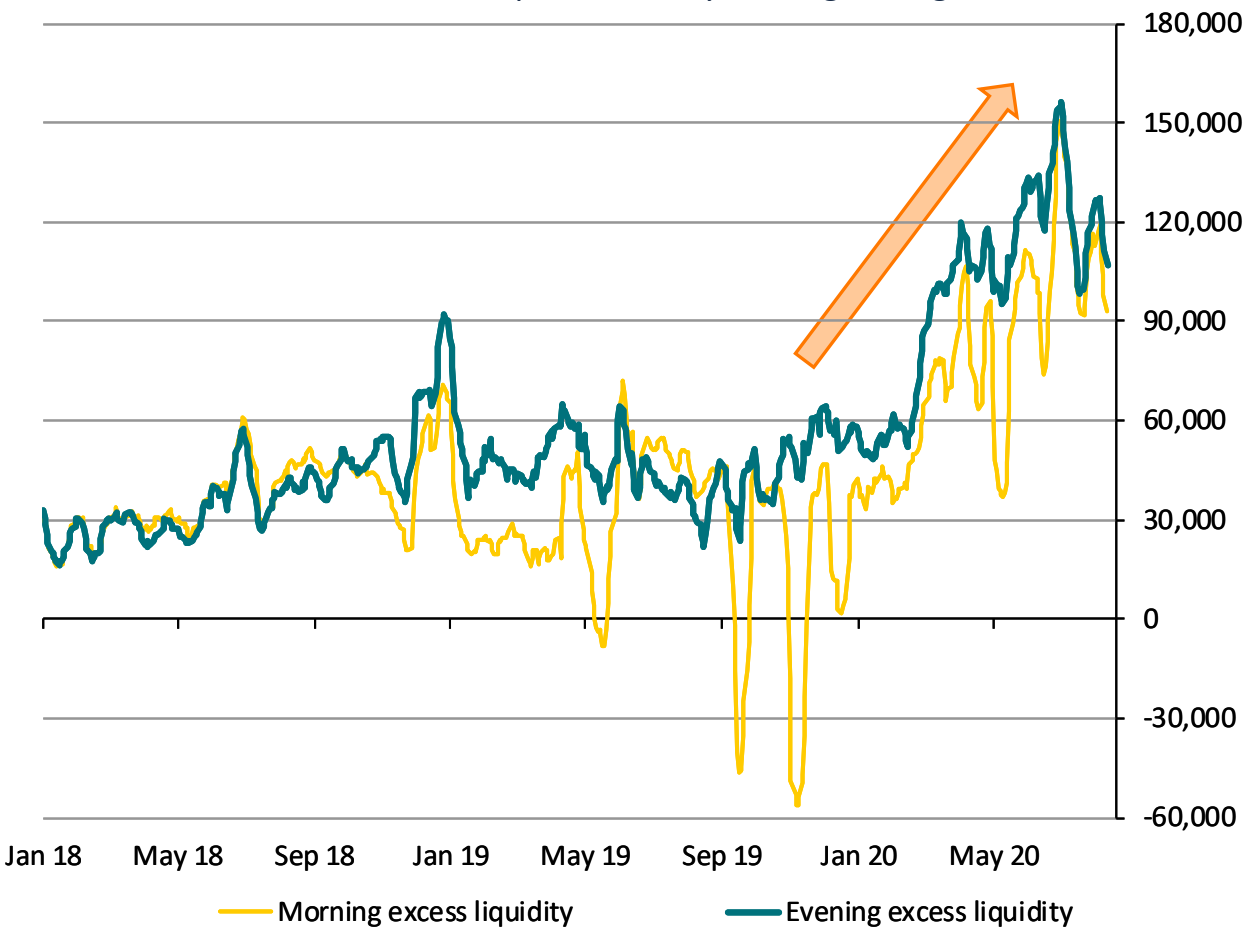
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Liquidity Provision: Open Market Operations

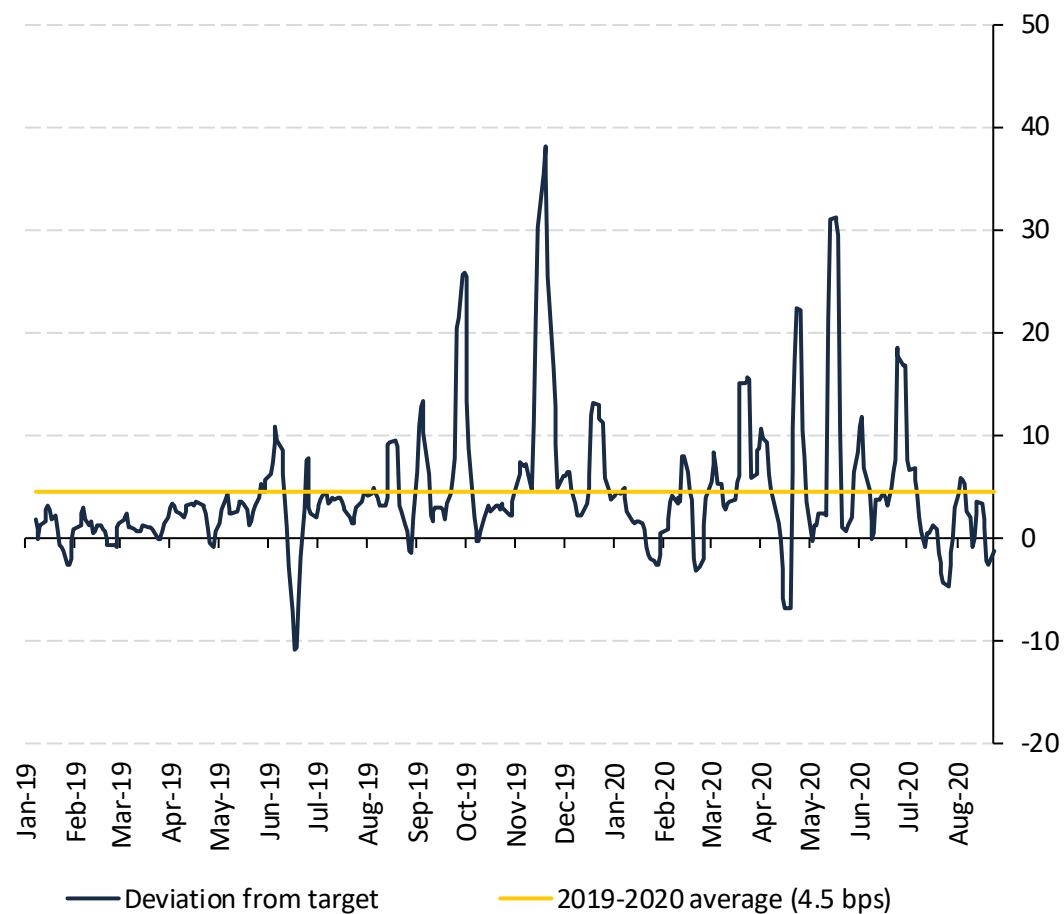
- The Bank of Mexico programs its daily Open Market Operations so that there is an excess liquidity at the opening of markets. In order to avoid funding pressures during the pandemic, Banco de México increased such excess liquidity to historically high levels. In that way, deviations from the target rate were contained, and had no persistence.

Daily morning and evening interventions
Millions of pesos, 10 day moving average



Source: Bank of Mexico.

Overnight interbank funding rate deviations from target rate
Basis points, 5 day moving average

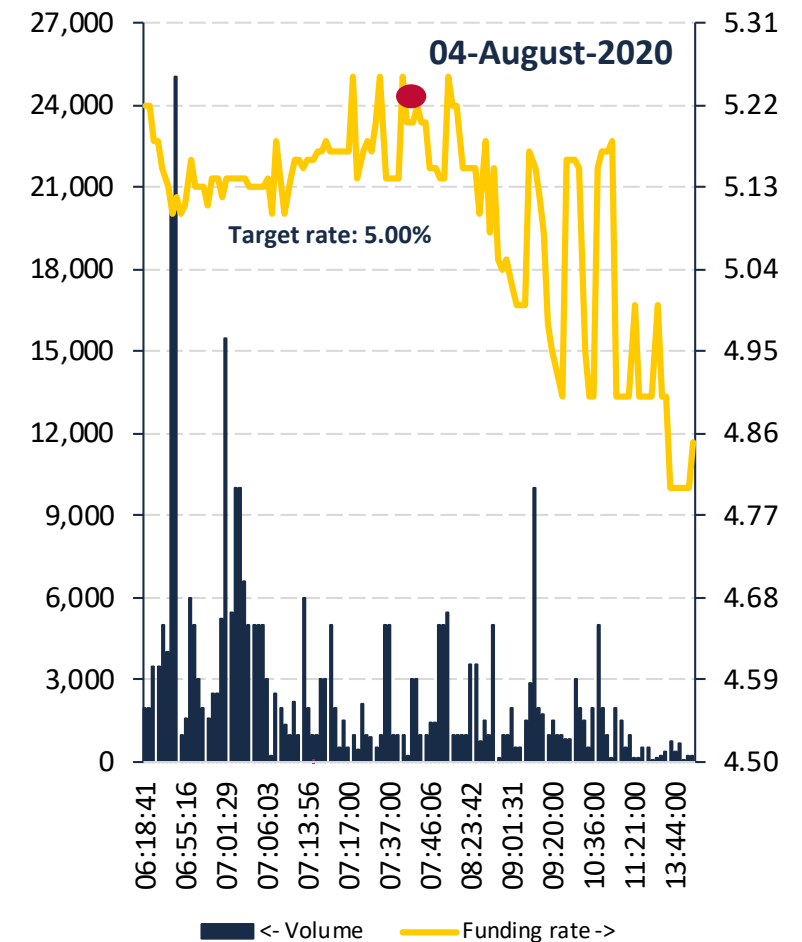
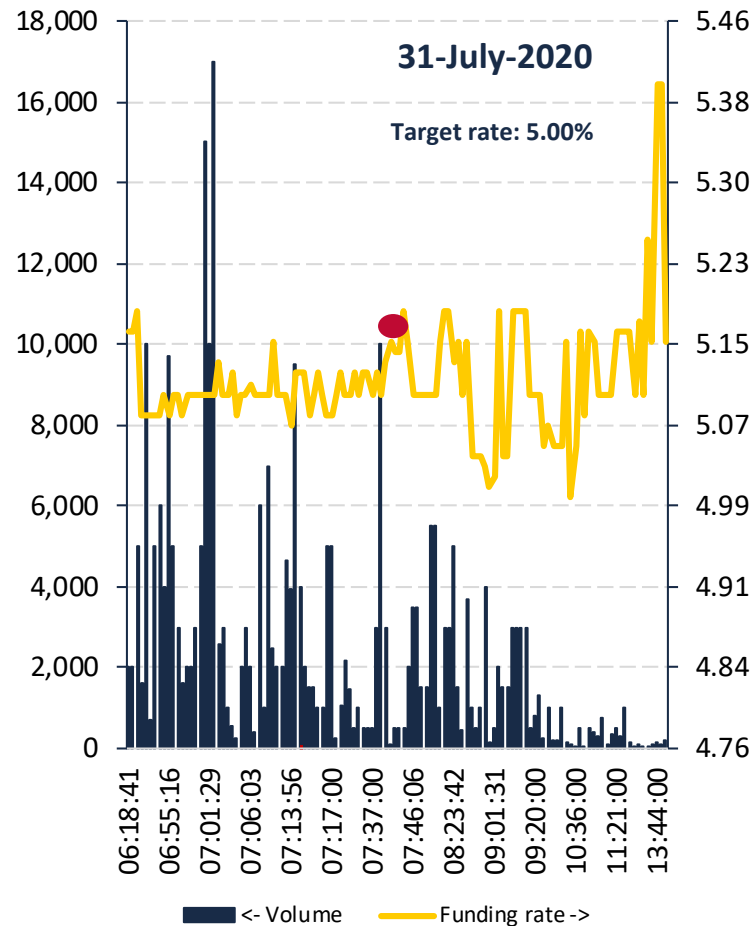
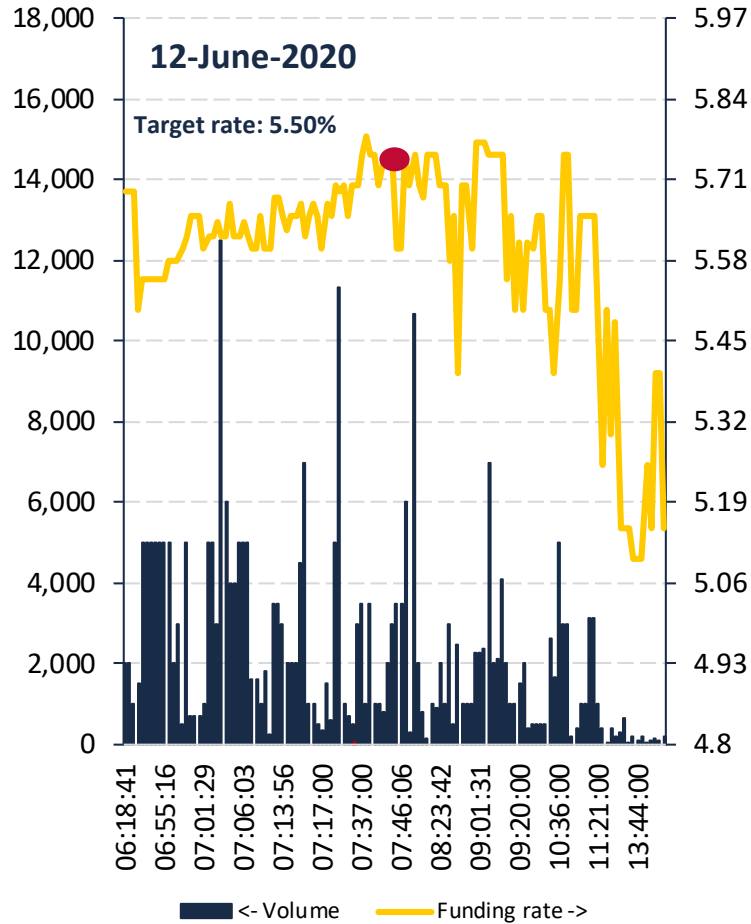


Source: Bank of Mexico.

Liquidity Provision: Open Market Operations

- Banco de México has other options in its policy toolkit for liquidity provision. For example, if there are funding pressures in any given day, Banco de México can provide more liquidity through extraordinary auctions. These operations have proven to be effective to alleviate pressures in the market.

Intraday funding rate in days when extraordinary intra-day liquidity auctions were executed
Millions of pesos / Percentage



Source: Bank of Mexico

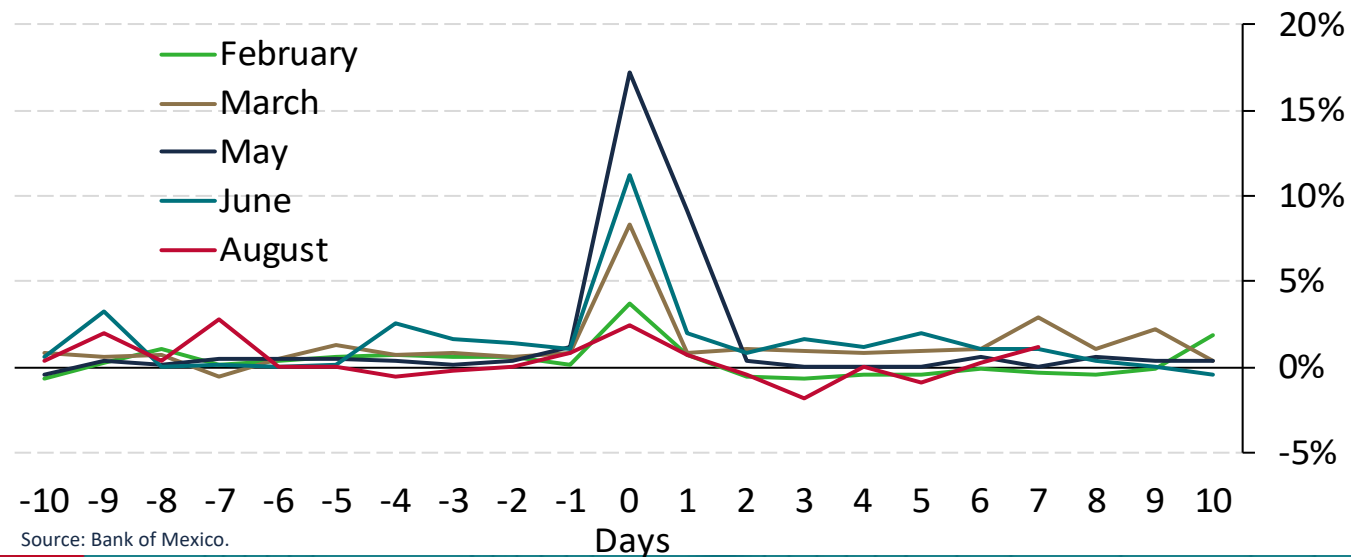
Liquidity Provision: Open Market Operations

- Additionally, on July 8th the Bank of Mexico published modifications to the OMOs implementation.
- Despite their needs, some banking institutions were not willing to bid for the liquidity offered through the OMOs when the maturity of these transactions crossed the date of the monetary policy decision, as the interest rate was fixed at the prevailing policy rate for the full term of the transaction.

Modifications:

- **The policy rate is effective on T+1:** To avoid speculative behavior and offer more certainty regarding the enactment of the new reference rate.
- **Repo rates are adjustable to the policy rate:** To incentivize market participants to fulfil their liquidity needs despite the term of OMO's crossing monetary policy decisions.

Overnight interbank funding rate deviations from target rate around the monetary policy decisions
As percentage of the target rate



Source: Bank of Mexico.

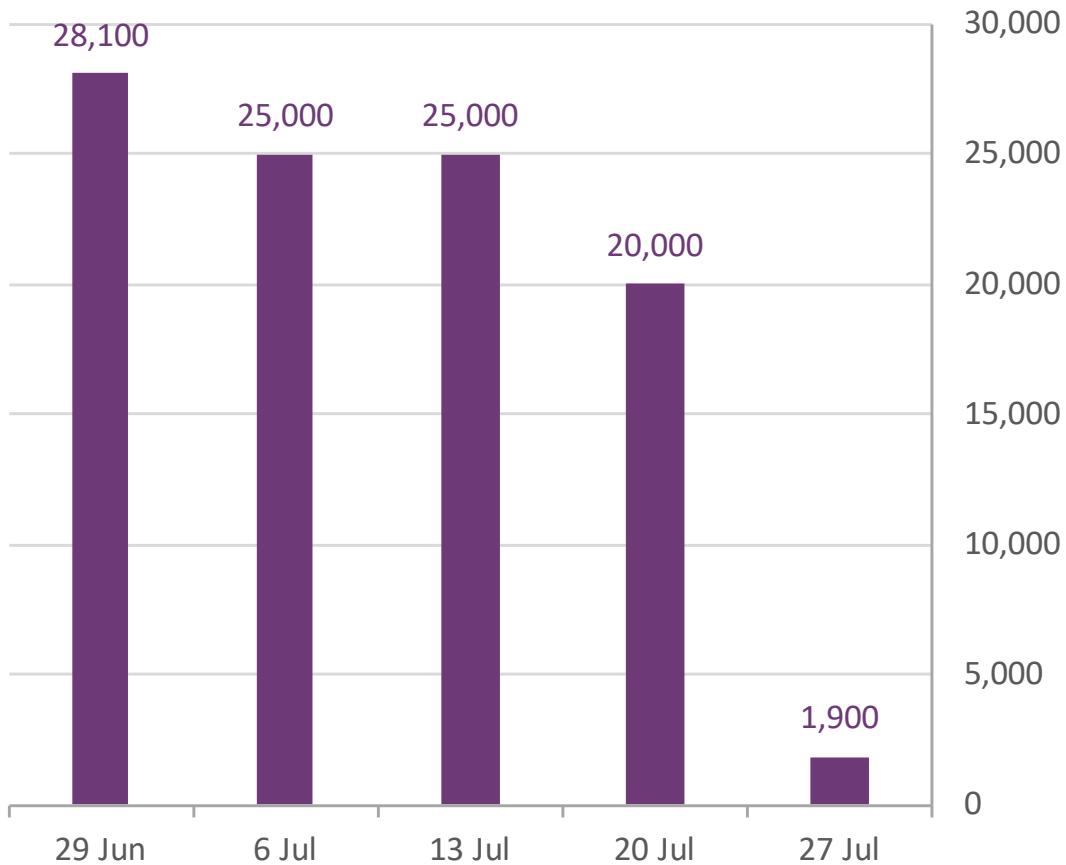
Liquidity Provision: Term Repo Facilities

Facility	Description	Available Amount
Government Securities Repurchase Facility	<ul style="list-style-type: none"> • Term: 3 months. • Cost: 1.02 times the average overnight interbank interest rate during the transaction term. • Collateral: Cetes, Bonos M, Udibonos, Bondes D, BREMS and BPAs. • Objective: provide liquidity to financial institutions holding government debt, without them having to liquidate their positions under highly volatile conditions in financial markets. 	<ul style="list-style-type: none"> • MXN \$100 billion (aprox 4.5 billion usd) • May be adjusted depending on the conditions prevailing in financial markets.
Corporate Securities Repurchase Facility	<ul style="list-style-type: none"> • Term: 3 months. • Cost: 1.03 times the average overnight interbank interest rate during the transaction term. • Collateral: Corporate debt, including bank debt under certain criteria, denominated in local currency, UDIS or any eligible currency (AUD, CAD, USD, NZD, EUR, GBP and JPY). The security must comply with a credit rating set by a minimum of two rating agencies of at least BB+ or equivalent in long term debt denominated in foreign currency, A-2 or equivalent in short term debt denominated in foreign currency, mxA or equivalent in long term debt denominated in local currency or/and mxA-2 or equivalent in short term debt denominated in local currency. 	<ul style="list-style-type: none"> • MXN \$100 billion (aprox 4.5 billion usd) • May be adjusted depending on the conditions prevailing in financial markets

Liquidity provision: Government and Corporate Securities Repurchase Facility

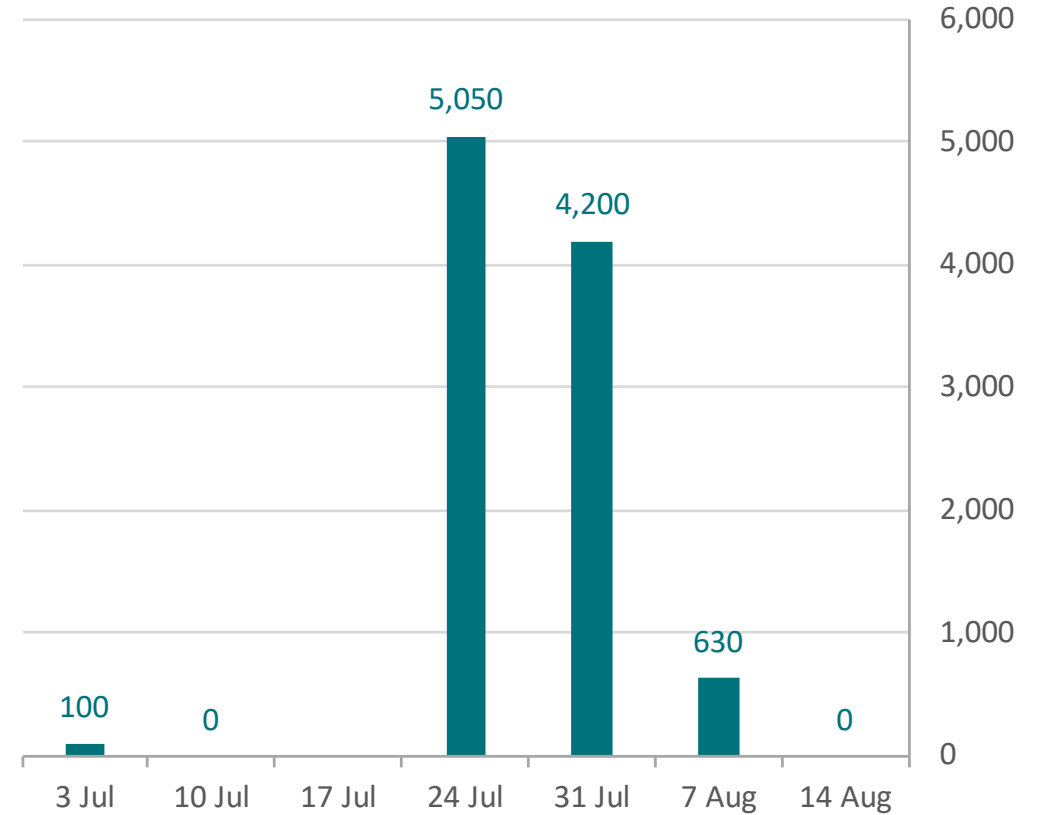
- The resources allocated to the Government Securities Repo facility have been exhausted, while around 90 billion pesos (around 4 billion USD) could still be allocated in the Corporate Securities repurchase facility.

Allotted amount in Government Securities Repurchase Facility auctions
Million of pesos



Source: Bank of Mexico.

Allotted amount in Corporate Securities Repurchase Facility auctions
Million of pesos



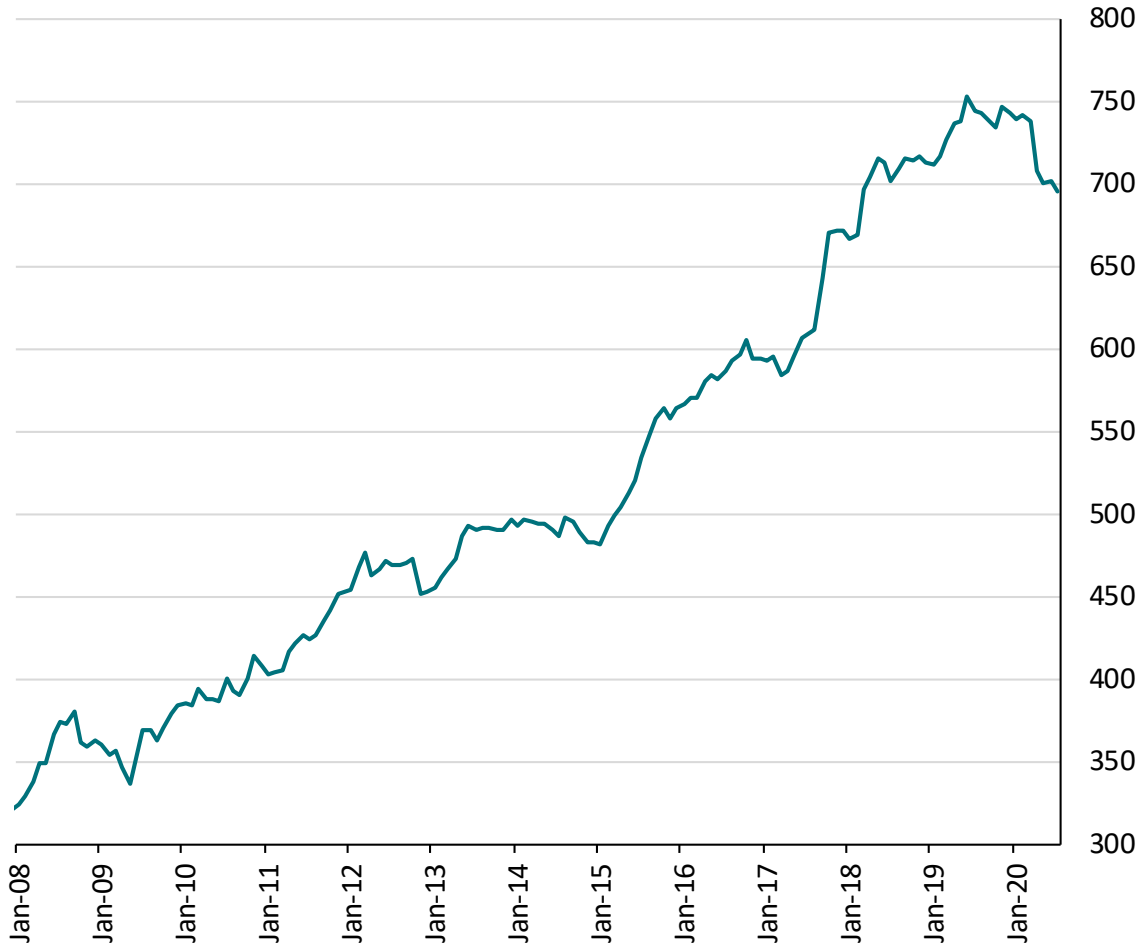
Note: The July 17th auction was suspended due to a change in the regulation. The remaining amount for the facility is 90 billion pesos.

Source: Banco de México.

Liquidity provision: Corporate Repo Operations

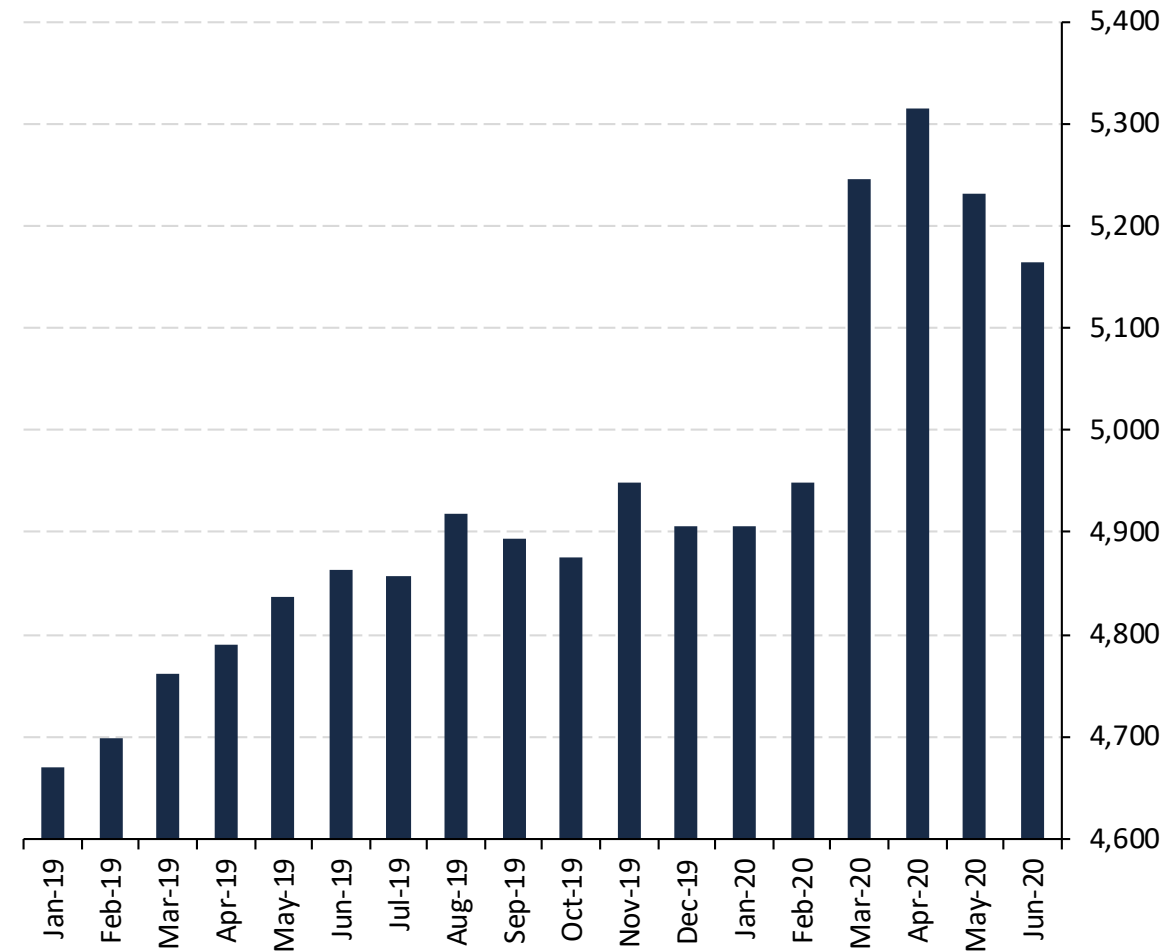
- The primary motivation of the Corporate Securities repurchase facility, apart from providing liquidity to these securities, is to reactivate the corporate debt market to complement bank credit as sources of funding to the private sector.

Outstanding Corporate Debt
Billions of pesos



Source: Bank of Mexico.

Banking Lending to Private Sector
Billions of pesos



Source: Bank of Mexico.

Liquidity provision: Corporate Repo Operations

- To facilitate trading conditions for credit institutions, and stimulate the corporate debt issuance process in the primary market, as well as promote higher liquidity for these securities in the secondary market, on July 15th the Bank of Mexico announced modifications to the facility.
 - **Cost:**
 - The cost of the repo agreement was lowered from 1.10 to 1.03 times the average of Banco de Mexico's overnight interbank interest rate during the transaction term.
 - **Extending the facility to promote primary issuance of corporate securities.**
 - The investors' possibility of extending repurchase agreements with Banco de Mexico for the next 18 months, conditional on having actively participated in the primary auction, receiving an allocation between 5 and 10 percent of the total placement.
 - The investors' possibility of extending repurchase agreements with Banco de México for the next 36 months, conditional on the having actively participated in the primary auction, receiving an allocation greater than 10 percent of the placement or 75 million udis, whichever results less.

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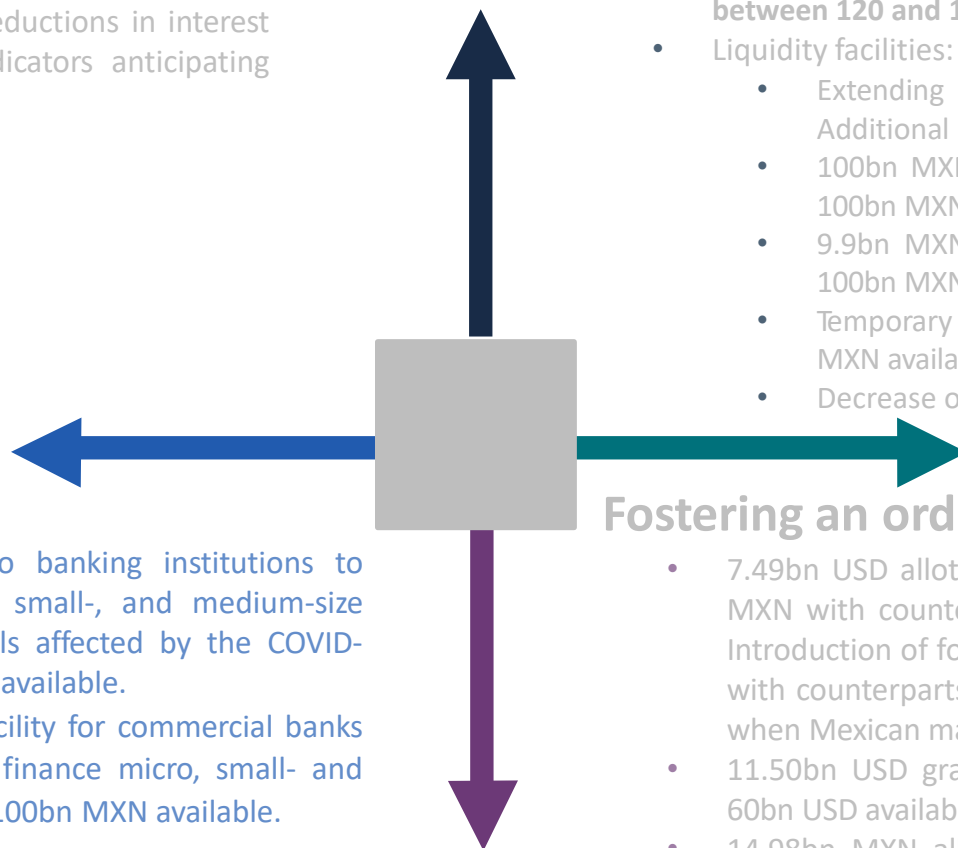
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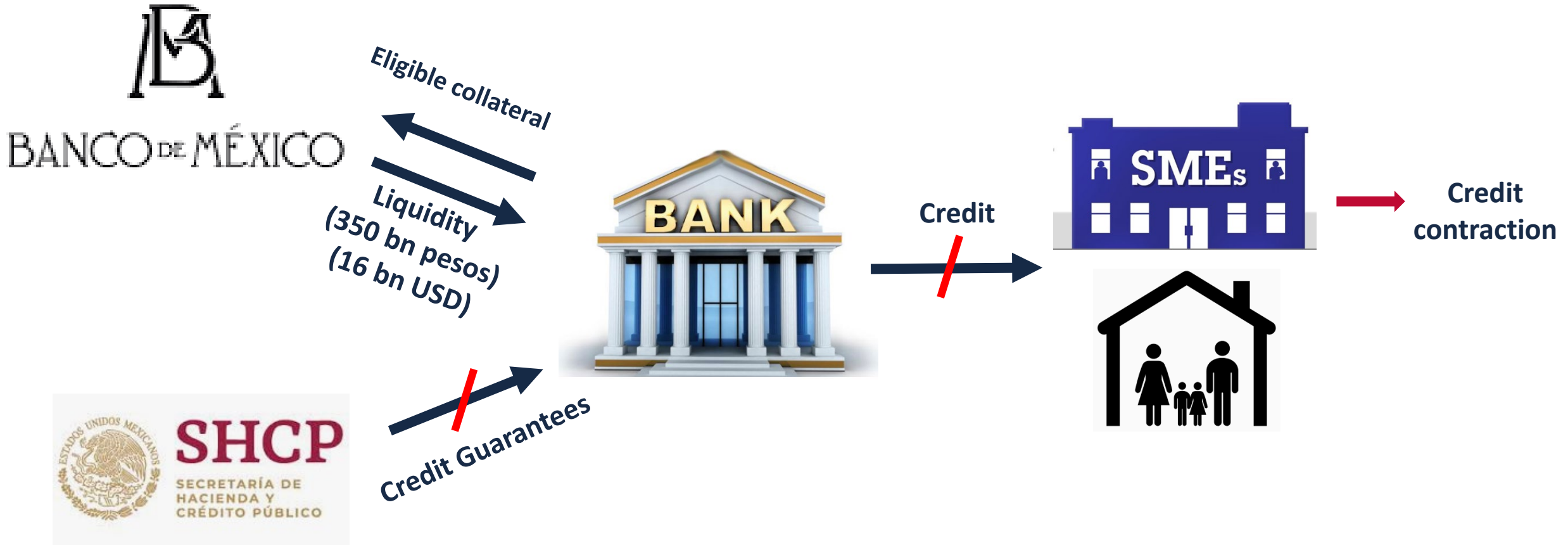
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Credit Channels

- The objective of the announced measures is to avoid pro-cyclical behavior from credit institutions, and prevent the contraction of credit to the private sector.



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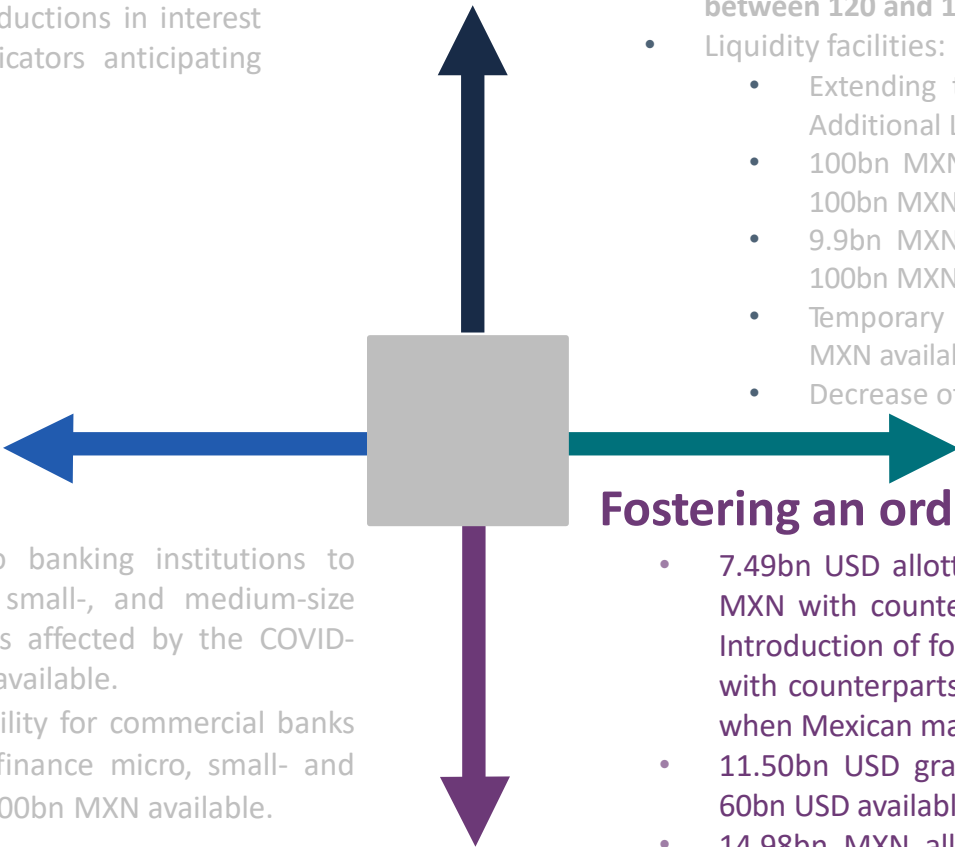
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Policy Response and Market Functioning: Fixed Income

- The Bank of Mexico implemented Debt exchange operations to promote better trading conditions for government securities.

Government bond rates
Percentage



30y/3y yield spread
Basis points



Debt Exchange Operations

Objectives: To promote the proper functioning of the government debt market, Banco de México implemented two government debt exchange receiving long-term securities (10 years and longer) while delivering short-term with maturities of up to 3 years.

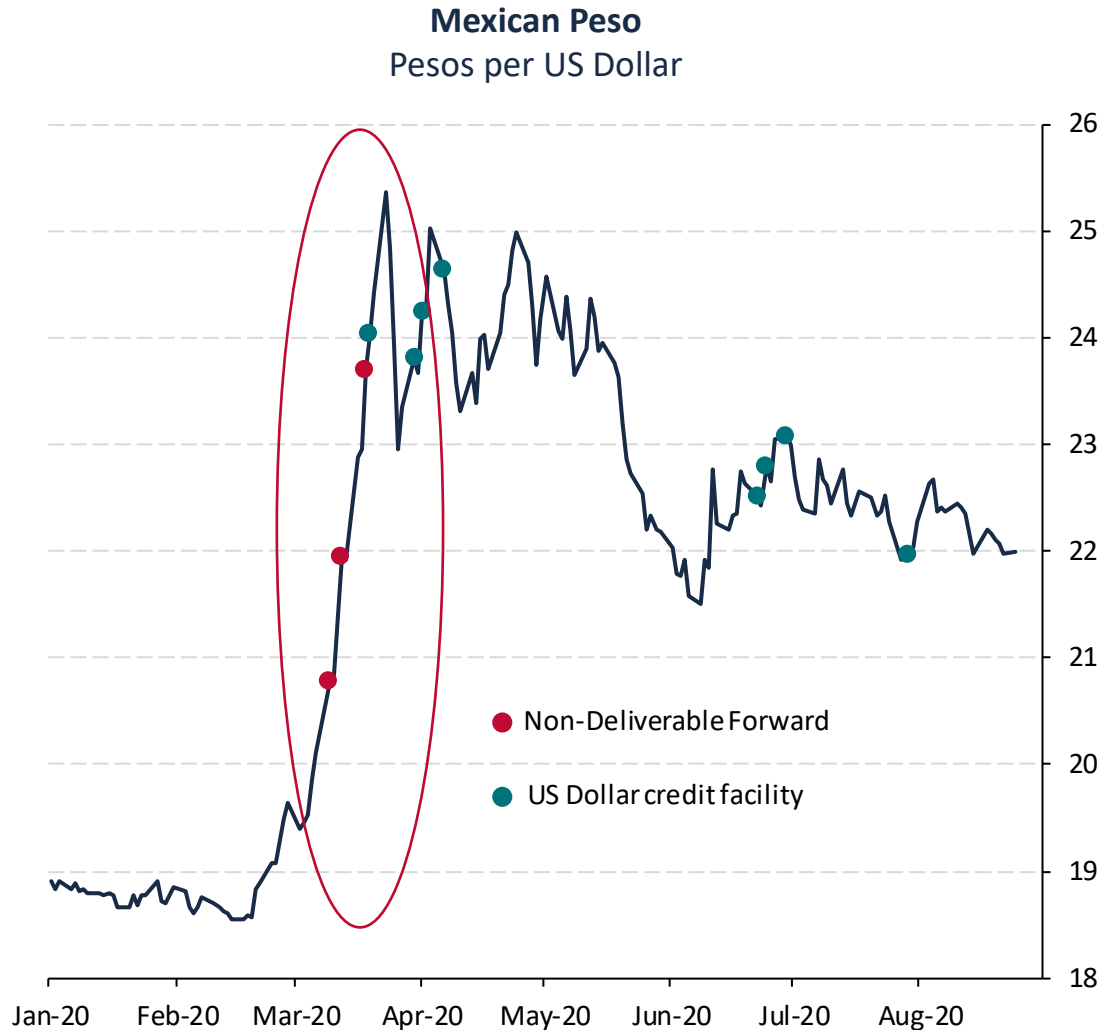
These operations contributed to an orderly adjustment of the Mexican Government debt yield curve, by providing liquidity to long-term securities during periods of heightened volatility.

The size of the program is MXN \$100 billion.

- Amount Outstanding:** MXN 14.98 billion.

Policy response and Market Functioning: FX Market

- Banco de México has an ample toolkit to provide FX liquidity or hedging instruments during periods of heightened volatility. As of late, NDFs settled in MXN have been the policy of choice to provide a hedging mechanism to market participants. USD credit was also extended during this episode, drawing on the USD Federal Reserve Swap line.



Source: Bloomberg.

FX policy toolkit

- Non-Deliverable Forwards settled in MXN**
- Non-Deliverable Forward settled in USD** with counterparts not domiciled in the country and traded during hours when Mexican markets are closed
- USD Credit Auctions**
- Other mechanisms for FX intervention (not recently used)**
 - Discretionary auctions (Mexico and off-shore)
 - USD auctions with minimum price
 - USD auctions without minimum price
 - Dollar purchases through the put option mechanism

Final Remarks

- The COVID-19 pandemic has had a severe impact in the world economy and financial markets. It has also presented extraordinary challenges for central bank policy making.
- Banco de México, acted swiftly to promote an orderly adjustment of financial markets, provide ample liquidity, and maintain the flow of credit to the economy. It also loosened its monetary policy stance as a response to the deterioration of economic activity and inflation remaining close to its target of 3%. As such, the monetary policy rate has been lowered from 7% to 4.5% since the pandemic began.
- Financial markets in EM have had a positive performance in the last few months as policy support has had a positive impact, and as global financial conditions have eased (mainly as a result of monetary policy expansion in advanced economies). As such, EM currencies have appreciated and interest rates have trended lower, reaching historically low levels in the front-end of yield curves in many countries.
- Nonetheless, there are many risk factors that could trigger new episodes of volatility, including the spread of COVID, further deterioration of economic growth, limited policy space in EM, growing fiscal vulnerabilities, possible credit-rating downgrades, and the potential for further capital outflows.
- In that regard, central banks in EM, including Banco de México need to stand ready to act to fulfill their mandates. In doing so, they will foster a better adjustment of financial markets and their economies.



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