Remarks by Alejandro Díaz de León, Governor of Banco de México, at the presentation of the book "Foreign Exchange Intervention in Inflation Targeters in Latin America"

Mexico City, March 8th 2019

Good morning, everyone.

On behalf of Banco de México, I am pleased to welcome the IMF delegation, especially of David Lipton, First Deputy Managing Director and Alejandro Werner, Director of the Western Hemisphere Department, as well as this distinguished group of experts and authorities, that includes Jose de Gregorio former governor of Banco Central de Chile and Alexandre Tombini former governor of Banco Central de Brasil, who all have met today to present the book "Foreign Exchange Intervention in Inflation Targeters in Latin America." For Banco de México, it is an honor to host this event.

The book that is being presented today is a valuable analytical and empirical effort, divided into two sections. The first section outlines a theoretical framework and a comparative study on Foreign Exchange (FX)

intervention in some Latin American economies which have adopted an Inflation Targeting (IT) regime.

The second section presents detailed case studies from seven countries, including Mexico (Brazil, Chile, Colombia, Costa Rica, Mexico, Peru and Uruguay). The book offers a comprehensive overview of this issue and is useful for policy makers, market participants and academics.

From a historical perspective, when societies went from using money with intrinsic value to fiat money, adopting the right monetary standard was crucial to preserve people's confidence in the functions of money as a deposit of value, as a unit of account and as a mean of exchange. At that time, monetary standards were mainly based on the direct or indirect convertibility of the currency into a merchandise of intrinsic value, such as gold. This was the prevailing standard during the nineteenth and a large part of the twentieth century, until 1971, when the U.S. suspended the convertibility of the dollar into gold. Thus, the US dollar began fluctuating with respect to other currencies, and other major advanced economies also shifted to more flexible exchange rates.

In the case of emerging market economies (EMEs), authorities continued with a fixed exchange rate with respect to the US dollar. However, in many cases, macroeconomic mismanagement led to unsustainable external imbalances that ended in currency crises.

During the 1990s, several emerging markets, faced currency crisis and a depletion of international reserves, forcing in several cases the adoption of a floating exchange rate regime with a monetary anchor that gradually moved towards the adoption of an inflation targeting regime.

In that process, Latin American economies adopted different FX intervention strategies that have been updated in the last years. This book presents the strategies and operational tactics that were being followed and raises very important questions. For example, what motivates FX interventions? What are the strategies and levels of transparency of FX interventions? How effective have FX interventions been?

I would like to talk briefly about the adoption and results of the floating exchange regime and the IT framework in Mexico. After the crisis of 1994-95, Banco de México was forced to adopt a flexible exchange rate regime.

The central bank faced two main challenges. First, we had to adopt a new nominal anchor, instead of the exchange rate, and, second, we needed to develop a deep and liquid FX market with an efficient price discovery process.

As to the first challenge, that is, replacing the exchange rate as the nominal anchor of the economy, inflation targets began to be the new anchor for economic agents' expectations, a condition that gradually led to the full adoption of IT.

To develop a deep and liquid foreign exchange market, Banco de México needed to make significant adjustments to the regulatory framework. For instance:

1. A full convertibility of the Mexican peso was adopted, even today the peso is one of the few fully convertible EM currencies.

2. A derivatives market was developed, providing market participants the possibility to hedge against exchange rate fluctuations, which is essential to manage FX risks.

3. Regulation was strengthened to avoid the dollarization of the financial system, to reduce currency mismatches and tail risks. In this regard,

bank accounts in foreign currency are only available for corporations, foreign government representations, and citizens living at the border. Also, banks net long-short FX exposures were limited, currently those limits are of 15% of their capital and long term dollar loans required long term financing.

4. In 2008, the Mexican peso has been included in the Continuous Linked Settlement (CLS) system, allowing the currency to trade every day on a 24-hr basis.

As a result of all of these actions, the Mexican foreign exchange market has become one of the most liquid and deep markets among emerging economies. According to the Bank for International Settlements (BIS), the Mexican peso is the second most traded currency among emerging countries, just below the Chinese renminbi. The daily turnover of the Mexican peso is 112 billion US dollars (including both spot and derivatives markets) and most of the volume is traded abroad. In fact, only 20% of the volume is traded with at least one Mexican counterparty. This means that, today, the Mexican peso is more a global than a local currency.

In an exchange market like the one I described, there is a lesser need for FX interventions.

Since the adoption of a flexible exchange rate regime, Mexico's FX Commission (which includes the Ministry of Finance and Banco de México), fully committed with the regime and avoided giving signals about desired levels for the exchange rate, and defined two clear goals for FX interventions.

First, to adjust the pace of foreign reserve accumulation under pre-announced rule-based mechanisms in order to achieve a desired stock. Second, to provide liquidity in high volatility episodes where the price discovery process could be compromised. The most important principle is that interventions do not aim at a particular level of the exchange rate. An overall assessment of the effectiveness of these type of interventions is hard to obtain; however, FX interventions have contributed to attain its objectives, both on the international reserve management component and to promote better FX market conditions during episodes of stress.

The path to development followed by many emerging markets implies the consolidation of an open economy, both in terms of trade and capital flows.

Having an open capital account requires the continuous adoption of sound macroeconomic measures, in which a strong monetary policy anchor (such as the IT framework) and a market-based flexible exchange rate play a key role. In order for these measures to be effective, it is crucial to:

i) develop a deep and liquid foreign exchange market, with a strong investor base (both domestic and external);

ii) build a strong financial and corporate FX resilience; and

iii) consider FX interventions and capital flow management measures as exceptions.

Before I conclude, I would like to share some reflections on Mexico's macroeconomic response to a recent sequence of shocks. In the case of small and open emerging market economies, authorities may implement the so called "leaning against the wind interventions". That is, in the presence of transitory shocks that either lead to an appreciation or depreciation of the currency, authorities intervene against the direction in which the currency is moving.

However, this assumes that authorities can identify in real time the nature of the shocks, whether transitory or permanent. In the presence of shocks

of the latter type, policy actions should facilitate rather than impede the real exchange rate adjustment and the consequent change in relative prices.

In Mexico, during the last years the economy has faced a sequence of adverse and persistent shocks, which led to a tighter external financing constraint. It was necessary to adjust the current account deficit to the lower availability of foreign financial resources and to cope with other structural changes in the external accounts (passing from a large oil trade surplus to a large oil trade deficit).

These required a significant real exchange rate depreciation. In order to contribute to an orderly adjustment of the economy, the macroeconomic policy response involved strengthening public finances and tightening monetary policy. If macroeconomic policy had not been adjusted, inflation would have been significantly higher and economic growth would have been lower than observed.

Ladies and gentlemen:

Banco de México has gladly joined other central banks in this effort led by the IMF to promote a better understanding of FX interventions in Latin

America. This comparative study provides valuable information on the decision making processes involving FX interventions and on the best way of bringing into line such interventions with the transparency and credibility of the IT framework.

I am sure that in the following presentations more policy lessons can be derived.

It is a great honor for Banco de México to host this meeting as a continuation of our long-standing collaboration with the IMF to disseminate new ideas and policy references on a wide range of issues.

Thank you very much and, once more, welcome to Banco de México.