

Developing Domestic Capital Markets: The Mexican Experience



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Agenda

✓ Introduction

- The Mexican Experience
- Challenges Faced
- Concluding Remarks

Developing Domestic Capital Markets: Definition

- **The discussion will revolve around developing local fixed income markets:**
 - **that have a variety of underlying securities (fixed, floating, inflation-indexed, etc.)**
 - **with long-dated maturities (up to 30 years)**
 - **with enough depth and liquidity along all the yield curve**
 - **where derivatives on the underlying securities are actively traded**

Why develop local fixed income markets?

- **To reduce the vulnerability to external shocks**
 - Drop in appetite for emerging markets risk
- **To reduce FX risk**
- **To foster long term domestic savings**
 - Make resources available to finance long-dated projects (e.g. Infrastructure)
 - Allow hedging of private sector long term liabilities (e.g. pension obligations)
- **To reduce scope for financial crisis stemming from public debt rollover difficulties**

Chronic inability to develop local markets in emerging economies

Reliance on short term debt

High refinancing risk

Issuance of short duration securities

High market (budget) risk



Market size enough to finance only a small portion of public sector liabilities

Causes for underdevelopment of local debt markets

- **Macro instability and recurring financial crises**
- **Lack of solid base of institutional investors**
- **Financial intermediaries unable or unwilling to transform maturities**
 - **Financial sector dominated by banks**
 - **Slow and complicated desintermediation process**
 - **Underdevelopment of mutual fund industry**
- **Weak creditor rights**

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● Challenges Faced

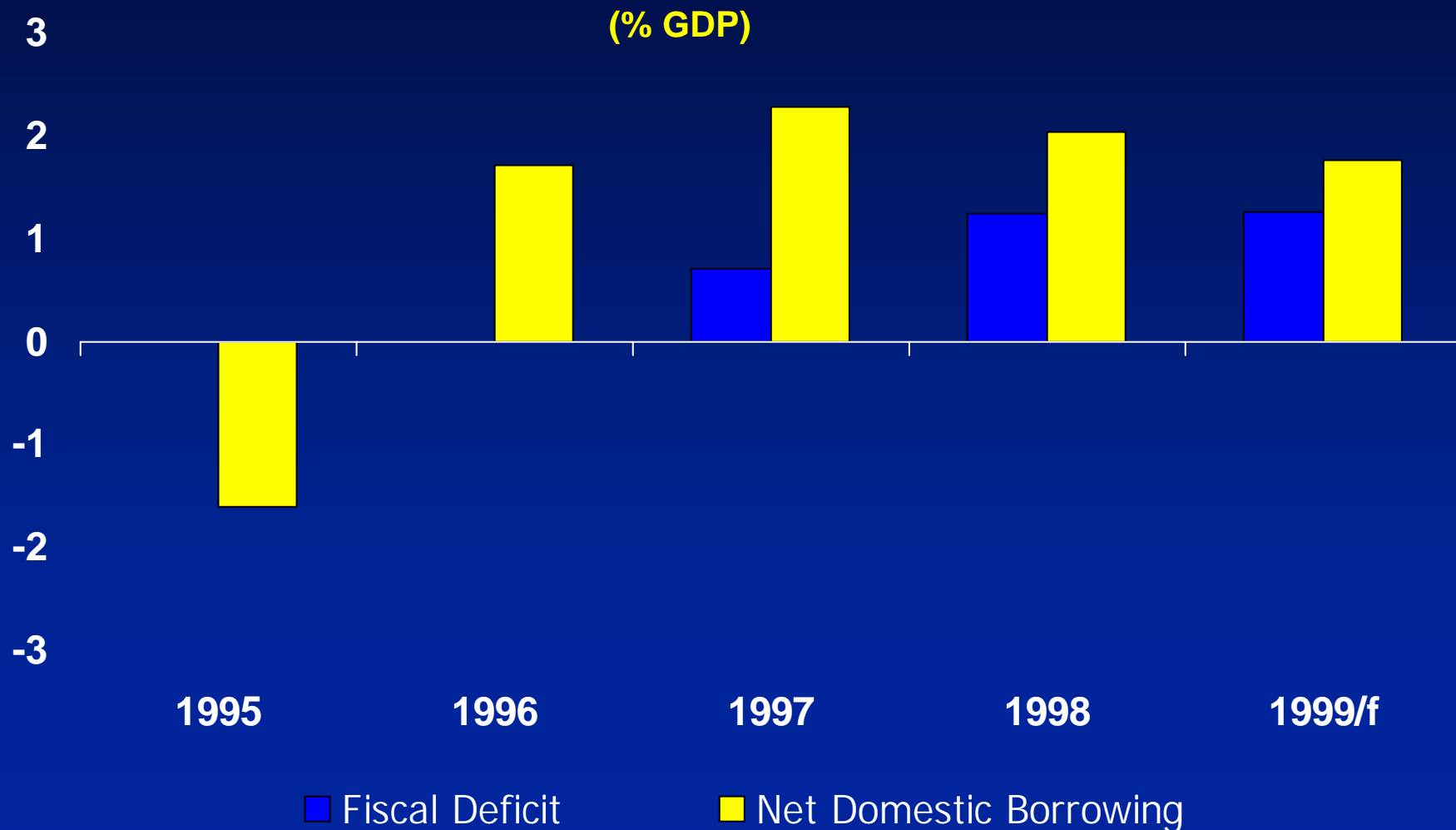
● Concluding Remarks

External debt still accounts for about two thirds of total public debt.



However, since 1996 domestic borrowings have exceeded financing needs...

Fiscal Deficit and Domestic Net Borrowing



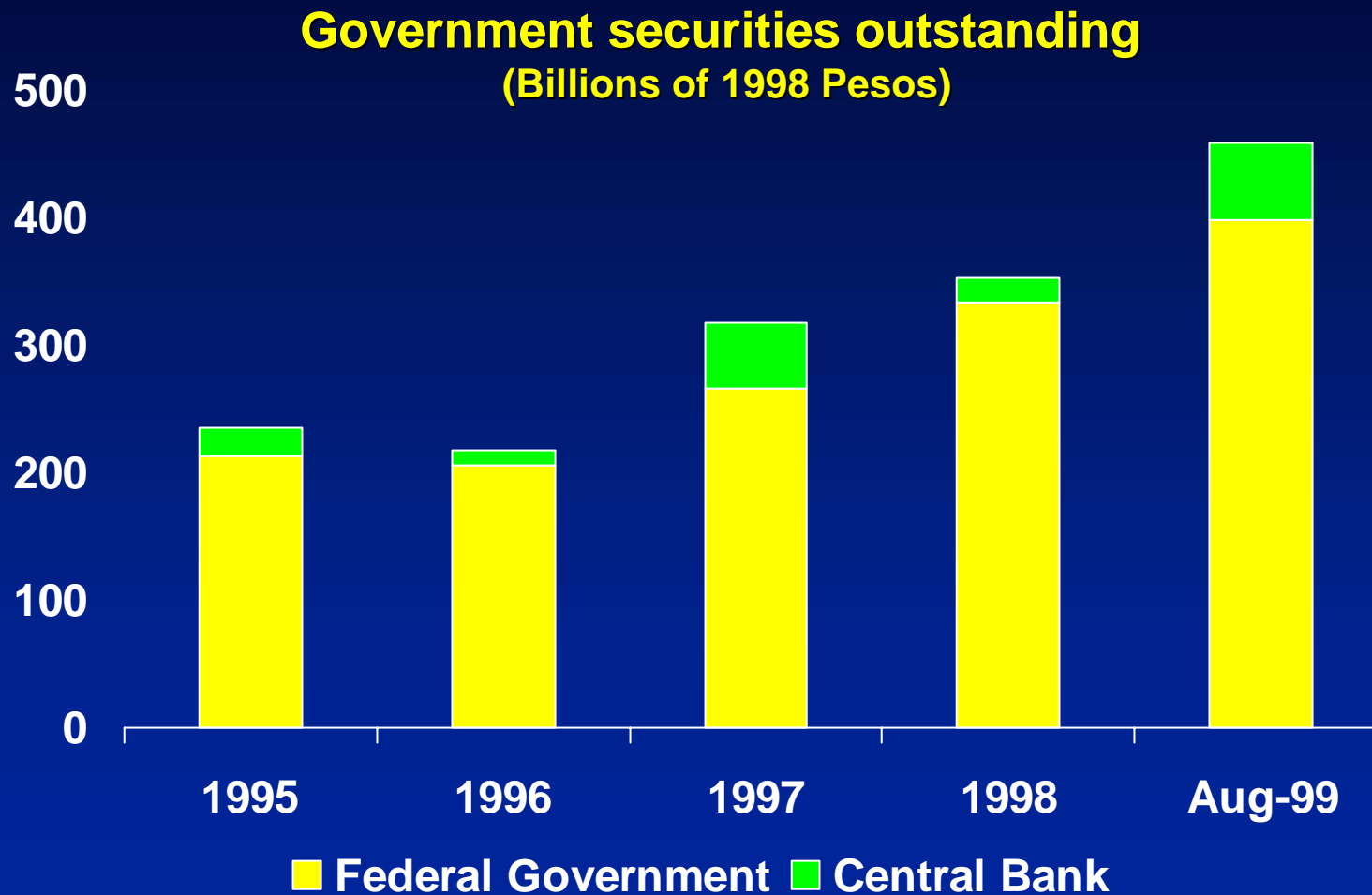
... allowing a reduction of external debt...

Net Public Sector External Debt

(1999US\$ billions)



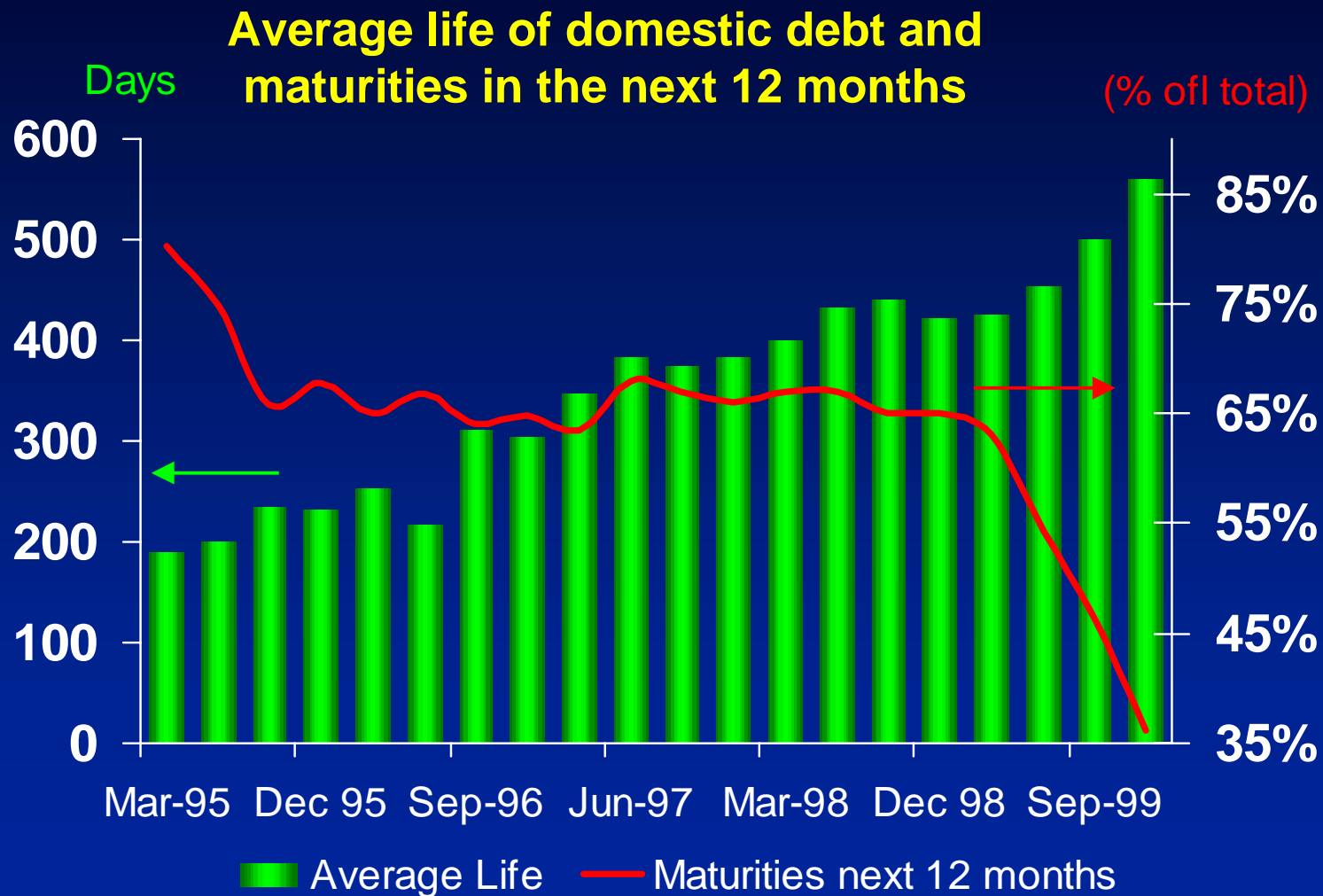
... while domestic debt keeps growing in real terms.



Starting point: Building reputation among domestic and foreign investors

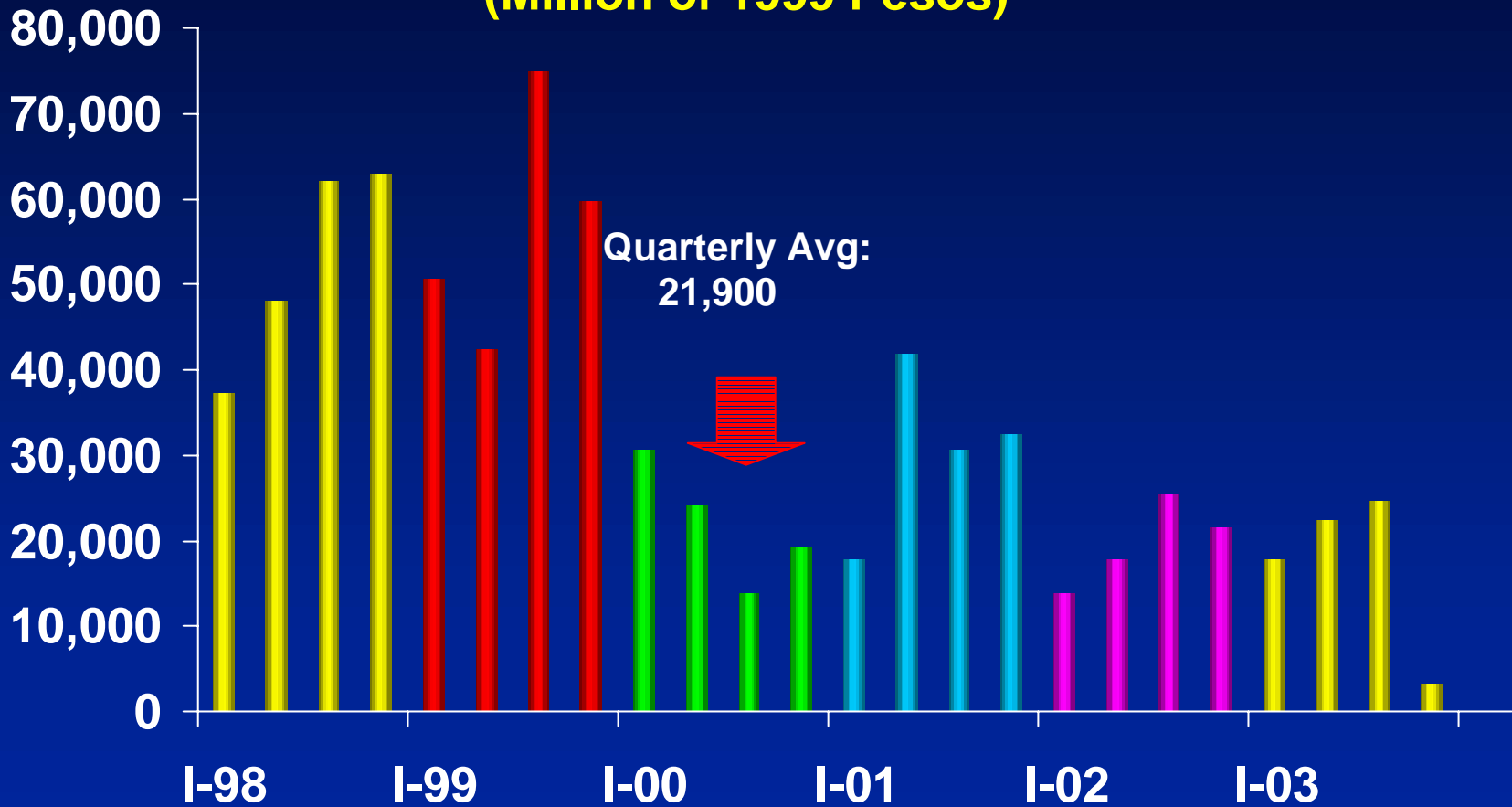
- **Pre-announced calendar of government securities auctions**
 - Gives certainty to the market regarding supply by type of instrument
- **No opportunistic issuance of securities**
 - Issue regularly, independently of rates
- **Transparent and efficient auction, clearing and settlement procedures (DVP systems)**
- **Reopen issues and make them fungible to foster secondary market liquidity**

Top priority: Increase average life of debt and reduce maturities in the near future...



... in order to improve the amortization profile¹⁴
and reduce the refinancing risk.

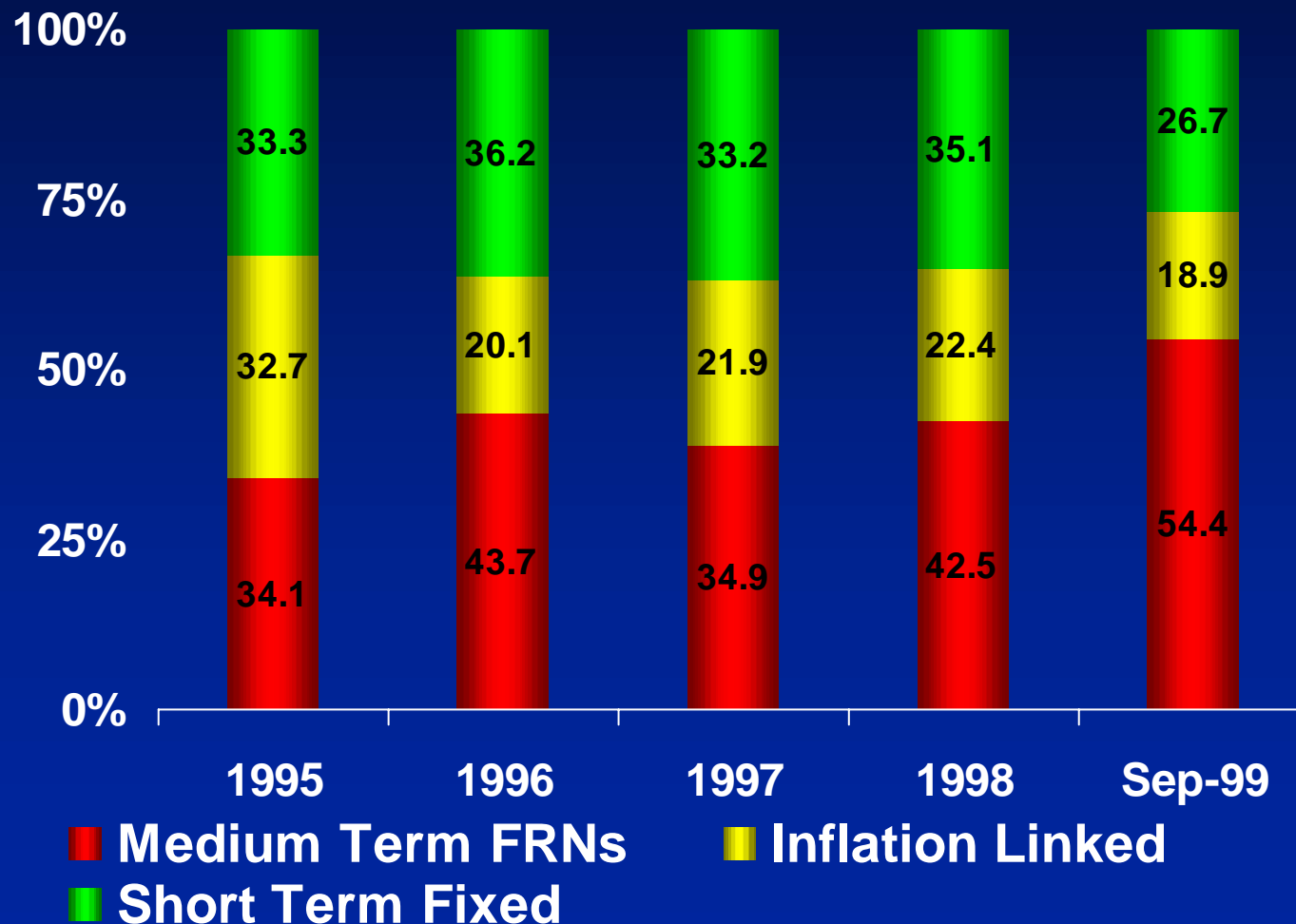
**Amortizations Profile of Domestic Debt as of December 1999
(Million of 1999 Pesos)**



*Without the redemption of 28 and 91 day Cetes.

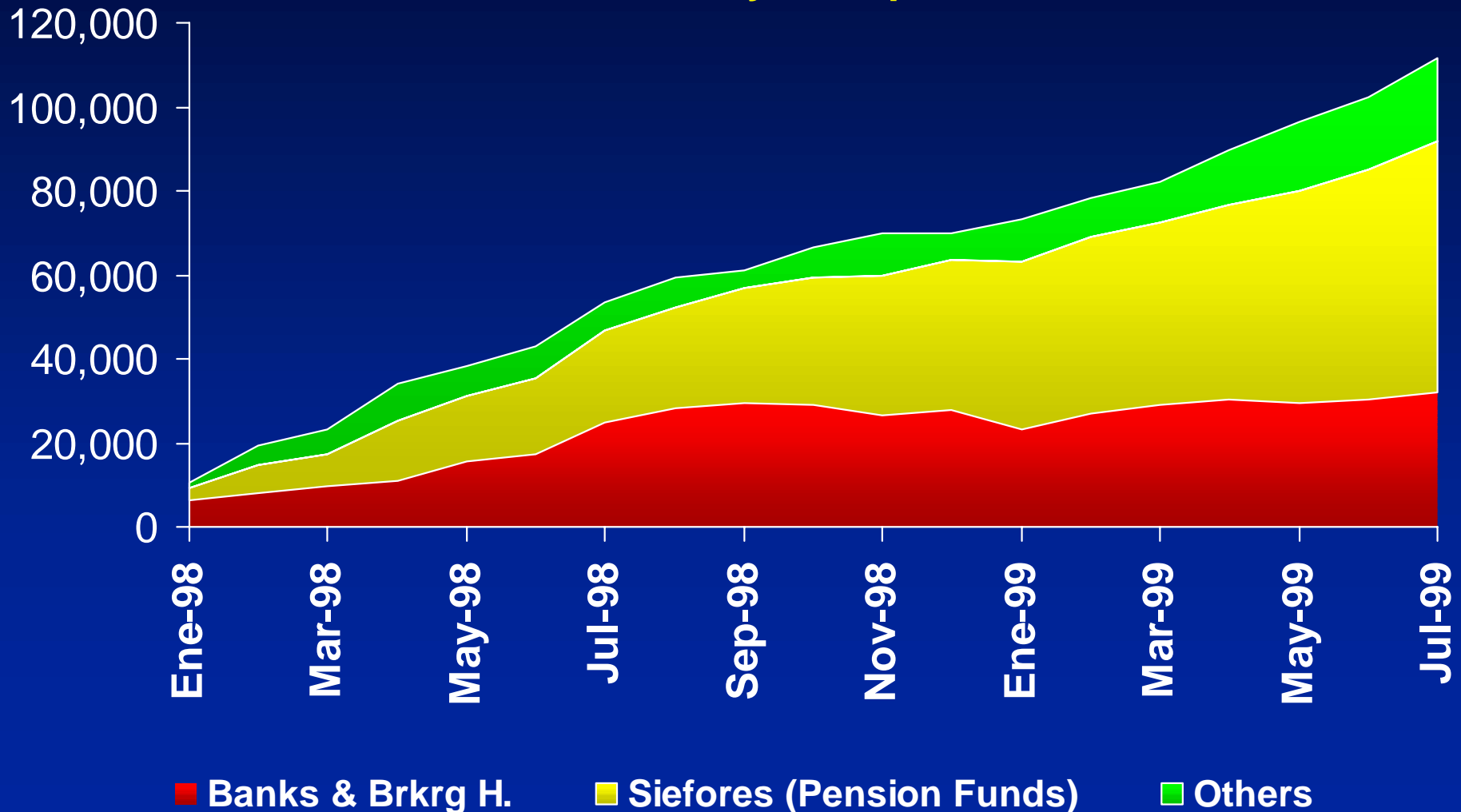
This has been possible mainly through the issuance of medium term FRNs...

Internal debt composition by type of instrument



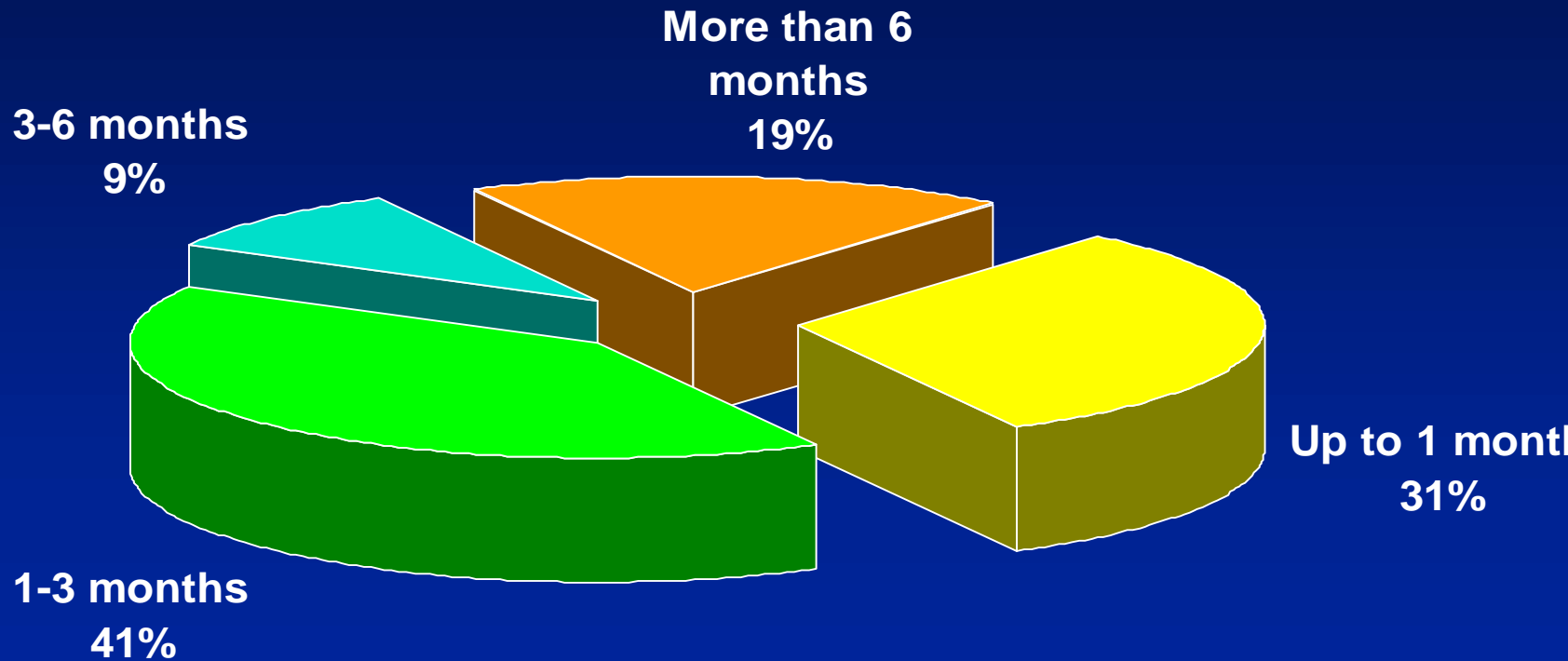
... on the back of the pension funds created from the social security reform.

Holdings of FRNs with 91-day interest refixing periods
Millions of July 1999 pesos



However, FRNs reset rates quite often and impede a lengthening of duration (or decrease of mkt. risk)

Duration of Government Securities (% of total outstanding)



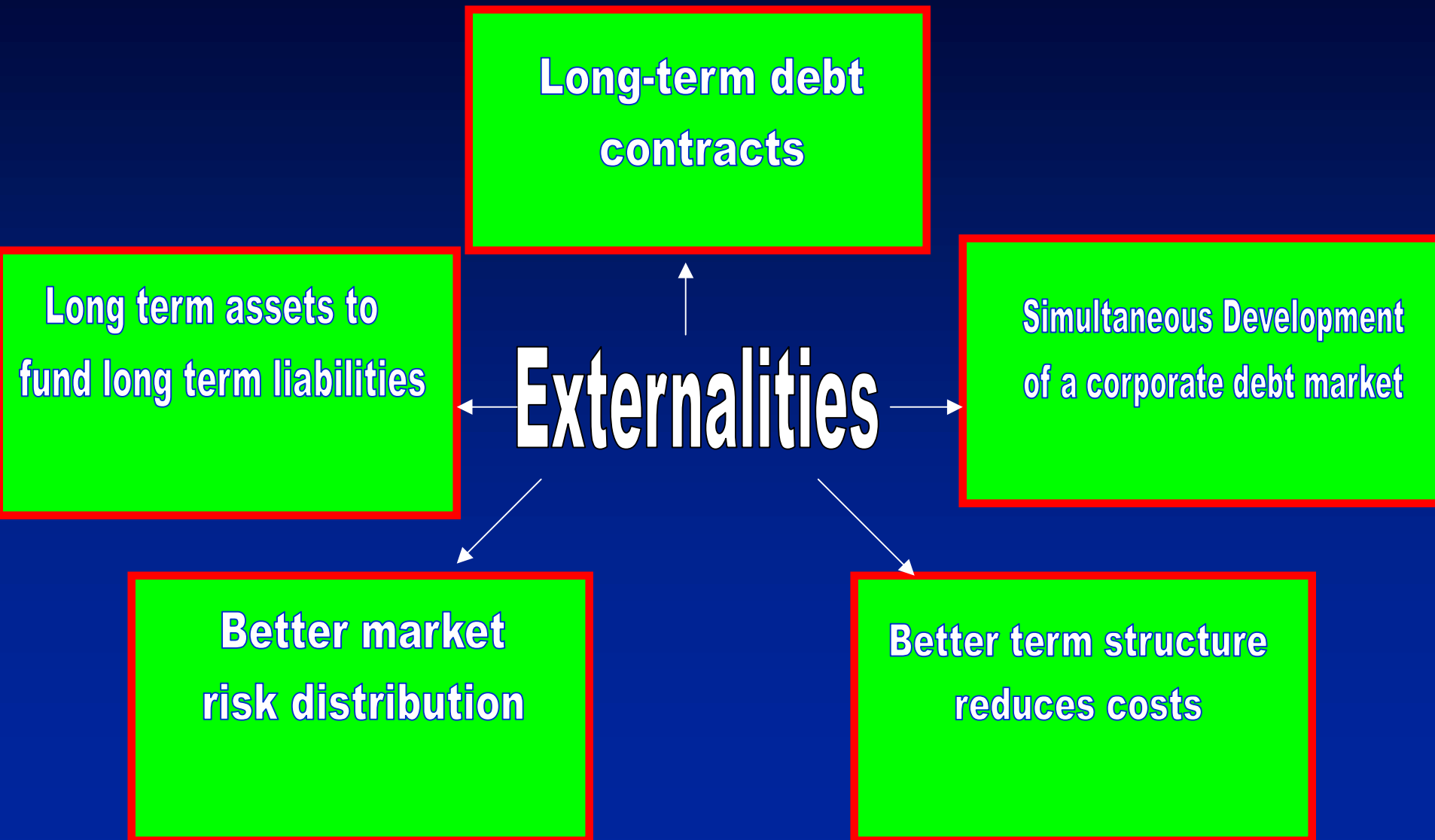
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Take advantage of the breathing space provided by recent lengthening of maturities

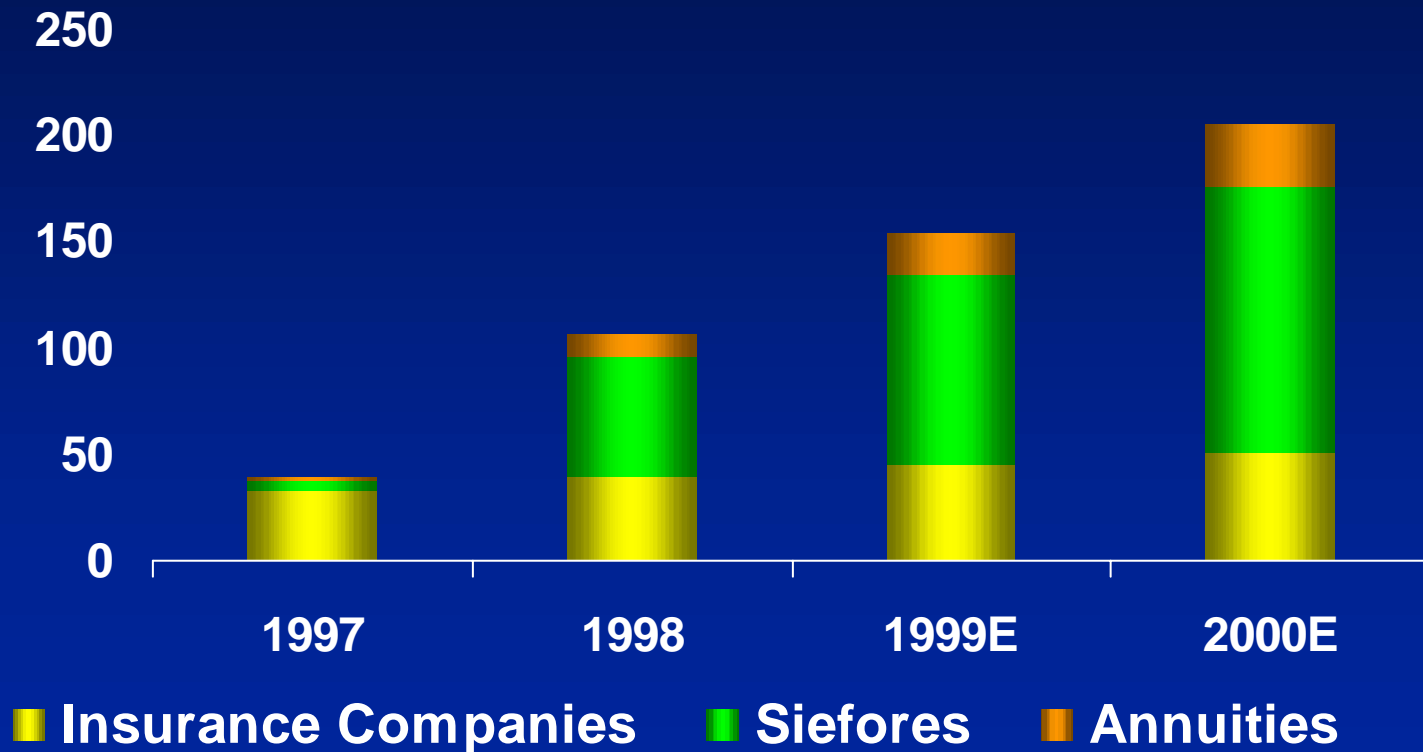
- **Extend yield curve up to three years**
 - Downward inflation trend will foster demand
- **Continue extending maturities of inflation-indexed securities**
 - Recent 10 year issue, planning to go up to 30 years
- **Work on regulatory reforms to increase demand for long-term, long-duration securities**
 - Siefores, Mutual Funds, Insurance Companies, etc.
- **Enhance secondary market liquidity**

Extending nominal and inflation linked yield curves diminish market risks and...



Social Security Reforms will continue to influence demand for government securities...

Institutional Investors' Financial Assets (Billions of Pesos)



...but the regulatory framework must be revised to modify investors' short term view

SIEFORES

- Short duration investments due to regulation
- No fiscal advantages
- Not authorized to deal with derivatives

INSURANCE COMPANIES

- Clarify the mechanisms to deal with derivatives
- Give fiscal incentives to long term savings through life insurance products

MUTUAL FUNDS

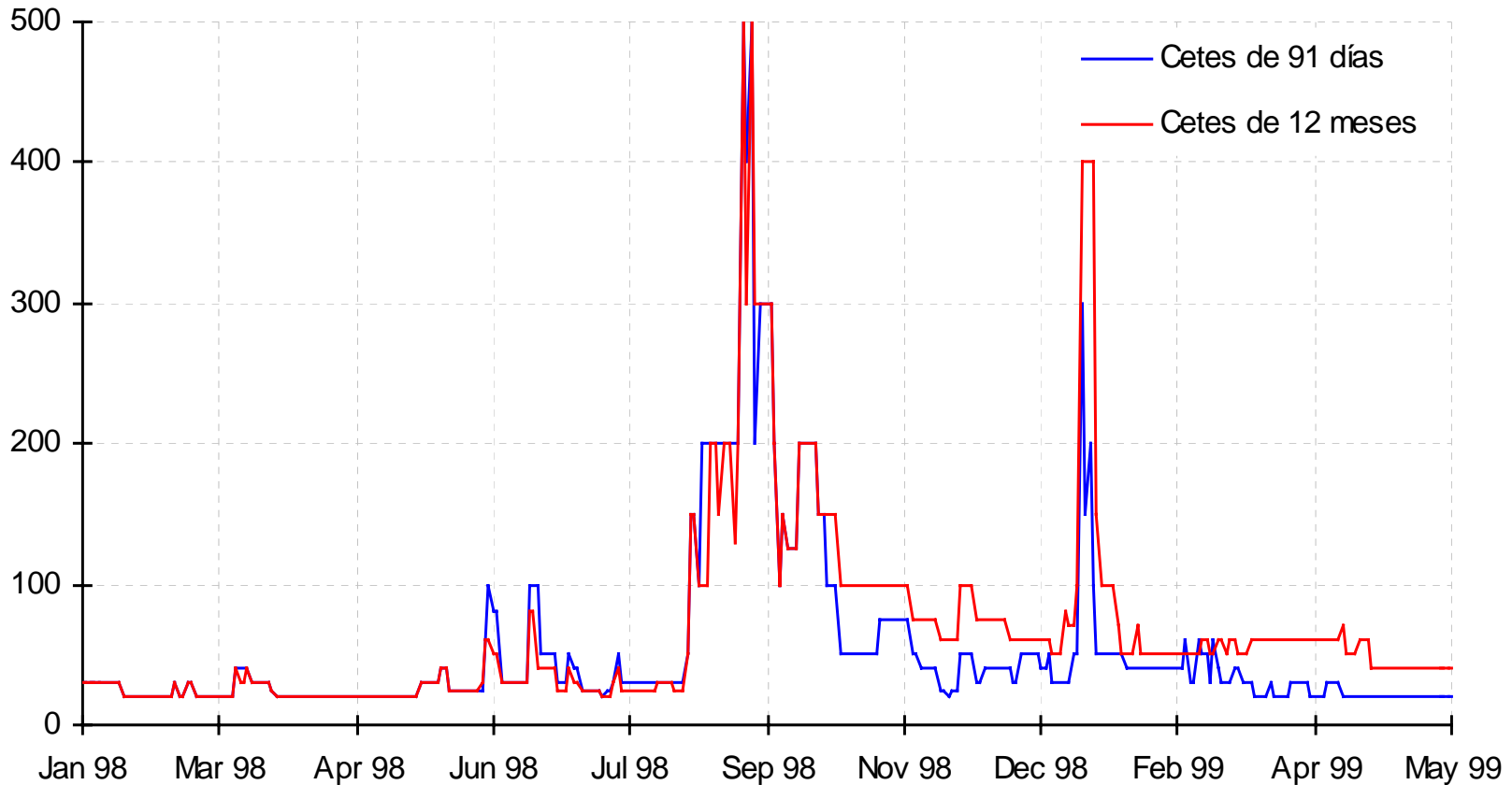
- Not considered as savings vehicle
- Desintermediation process in conflict with banking interests
- Unexploited potential for growth

**Consider reinvestment
risk**

Liquidity is the most pressing factor holding development of domestic market...

Bid-Ask Spreads for Government Securities

Diferencial de compra-venta de Cetes de 91 días y 12 meses
puntos base por año



Source: JP Morgan

Measures to enhance market liquidity

- **Make compensation chamber fully operational**
 - Diminish counterparty risk to a minimum
- **Foster derivatives markets**
 - Overnight index swap market especially important
- **Implement market maker mechanism**
 - Market makers will have the obligation to quote prices both ways for minimum amounts on all “on the run” fixed-rate issues
 - Will get substantial benefits, featuring access to borrowing of government securities (enabling them to take short positions)

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Concluding remarks

- **Government must take an active stance towards developing markets**
- **Macro stability is a necessary condition**
- **Foster institutional investor demand**
- **Extend average life of debt (relying on institutional investors) to reduce refinancing and liquidity risks**
- **Take advantage of breathing space to issue longer duration and develop yield curves**
- **Implement program to increase secondary market liquidity**