

# **Overview of the Mexican Government Securities Markets**

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The Mexican domestic securities markets date back to 1978, when short term fixed rate notes were issued for the first time.<sup>1</sup> Over the years, the Banco de Mexico (Banxico) has worked to develop a wide range of government instruments to provide a foundation for conducting monetary policy and for financing the public budget. The Tequila Crisis in 1994/5 had a salutary effect on the government securities market; it resulted in a shift toward improved fiscal discipline, which in turn has impacted positively various areas including the spread of maturities, regulatory environment, and the creation of benchmark issues.

## **Instruments**

The primary government issued securities in Mexico are:

- Zero coupon short term federal treasury certificates (Cetes);
- 3 year or 5 year floating rate bonds with interest payable monthly, quarterly or semiannually (Bondes);
- 3, 5 and 10 year fixed rate bonds with interest payable semiannually (Bonos);
- 5 and 10 year fixed rate inflation indexed bonds with interest payable semiannually (Udibonos);<sup>2</sup> and
- Bonds issued abroad with interest payable semiannually (United Mexican States or UMS bonds).

All bonds are peso denominated save for the UMS series. UMS bonds are also noteworthy in that they serve as the benchmark for the international community as they are geared toward external investors. In addition to the government issued securities, Banxico began to issue its own debt instruments (Brems) in 2000, which are 1 and 3 year floating rate bonds. Moreover, the deposit insurance agency issues floating rate debt with government guarantees.<sup>3</sup>

## **The Prime Market**

Mexico uses a multiple-price auction system for its government securities, with the exception of fixed rate bonds, which are priced by Dutch auction. There are weekly auctions for Cetes and for 3-year floating rate Bondes. There are bi-weekly auctions for 3 and 5 year inflation-indexed Udibonos. Non-competitive bids are only allocated if there is leftover from the competitive process<sup>4</sup>

The schedule for auctions is pre-announced for each quarter, and discloses the type, minimum, and maximum total issuance during the quarter. The auctions occur on Tuesdays via an electronic system and are open to a variety of financial institutions including banks, insurance companies, brokerages, pension and mutual funds. Settlement occurs 48 hours later. The securities are dematerialized and are deposited at an independent company (Indeval).<sup>5</sup>

## **Toward Sounder Fiscal and Monetary Policies**

During the early 1990s growth period, Mexico ran large government budget deficits, helping to contribute to the Tequila Crisis. Since that time, the government has acted to reduce outstanding public debt and to seek a more balanced budget. President Fox's administration has showed a strong commitment to helping stabilize the economy through sound fiscal policy by working with the Congress to reduce budget deficits, projected at 0.3% of GDP for FY 2004.<sup>6</sup> This has taken pressure off of the private sector and reduced crowding out, such that by September 2001 government securities represented less than half the external debt of Mexico.<sup>7</sup>

As shown at right, there has been a major shift in the composition of debt away from foreign borrowing since the Tequila Crisis. At the end of 2003, total public debt was MXP1,556 billion, or 23.05% of GDP, of which 711 billion



was domestic debt and 845 billion was external.<sup>8</sup> The Mexican government has sought to decrease reliance on foreigners by issuing domestic debt over the last years beyond that needed to finance the public deficits.

The reduced government budget deficits and outstanding debt have helped contribute to lower inflation levels. Currently, Banxico uses a target daily settlement balance for banks with the central bank (the corto) as its primary policy instrument. Officially Banxico is targeting a mid 3% rate for inflation with a 1% deviation.<sup>9</sup> In practice, the target rate is 4%; the 4.2% annualized rise in consumer prices as of January 2004 and relative stability of inflation in the last years point to a better functioning economy and renewed confidence in Mexico.<sup>10</sup>

GDP growth has averaged over 4% since the mid 1990s,<sup>11</sup> helping take some of the sting out of the Tequila Crisis, and providing investors with a sense that Mexico is on the right track. In addition, NAFTA has caused greater integration with the US economy, which has helped increase the proportion of traded goods to total GDP and, some argue, will result in increased stability in the Mexican financial sector in future times of crisis. Finally, political reforms and

increased political stability have helped create a more favorable environment domestically and externally for Mexican public debt issuance.

Solid economic growth and better government finances have also contributed to a stable peso. Ironically, Mexico must now concern itself with peso appreciation, which some argue has caused export growth to slow. Nonetheless, this trend toward appreciation serves to make Mexican debt instruments more appealing to international investors, decreasing funding costs and improving liquidity in the debt markets.

### **Major Bond Issuances**

Improvements in economic conditions and government finances have allowed Mexico to develop a strong array of maturities and decrease the interest rate it must pay to investors. Moreover, domestic and international investors have shown a willingness to purchase fixed rate securities in recent years. In October 1999, inflation-indexed bonds were first issued followed by five-year fixed coupon bonds in May 2000 and 10-year fixed coupon bonds in July 2001.<sup>12</sup> As of 2001, floating rate bonds constituted approximately half of the government debt.<sup>13</sup> On the international front, Mexico has augmented its domestic UMS bonds with global bonds issued under New York law, as highlighted below.

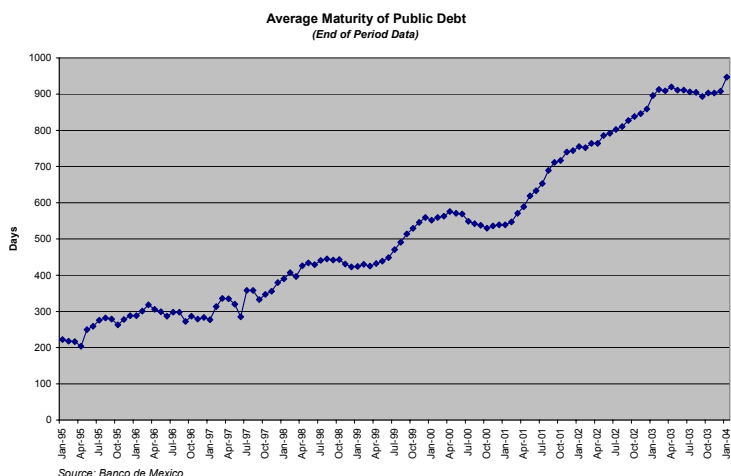
Global Bonds Issuance (UMS)				
Issue Date	Amount (\$ Billions)	Tenor (Years)	Yield to Maturity	Spread vs Equivalent US T-Bonds
May-96	1.75	30	12.39%	552bp
Apr-99	1	6	9.76%	445bp
Aug-00	1.5	5.5	8.58%	241bp
Aug-01	1.5	30	9.02%	335bp
Dec-01	1	29.9	8.77%	347bp
Apr-03	1.5	5.5	4.75%	165bp
Apr-03	1	30	7.63%	270bp

*Source: Ministry of Finance and Public Credit, Mexico*

The UMS series has allowed Mexico to decrease its funding costs versus Brady Bonds, which had yields of 8.31%, adjusting for distortions from their guarantees.<sup>14</sup> By comparison, 30 year dollar-denominated UMS bonds issued in April 2003 (equivalent to Brady Bonds) yielded 7.63%. Long term bond spreads versus US treasuries have narrowed since that time to approach historical lows, and stood at 184 basis points as of March 8, 2004.<sup>15</sup>

### **Moving from Short term to Longer Term funding**

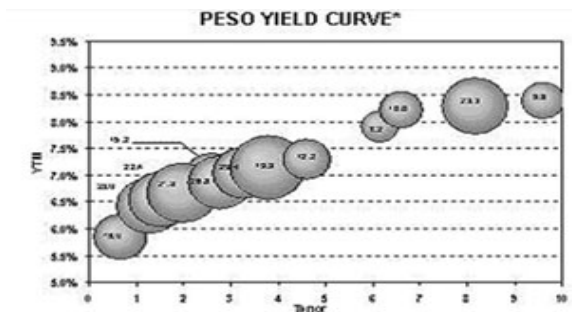
As shown at right, Mexico has been successful in shifting the lengthening the maturity of its public debt, thereby giving the government greater flexibility in managing the economy. During the 1994/5 crisis the average maturity of government debt was approximately



280-300 days. As of the end of January 2004, average maturity had risen to 947 days.<sup>16</sup> Overall, by December 2003, Mexico's short term public debt was just 2.13% of total outstanding public debt.<sup>17</sup>

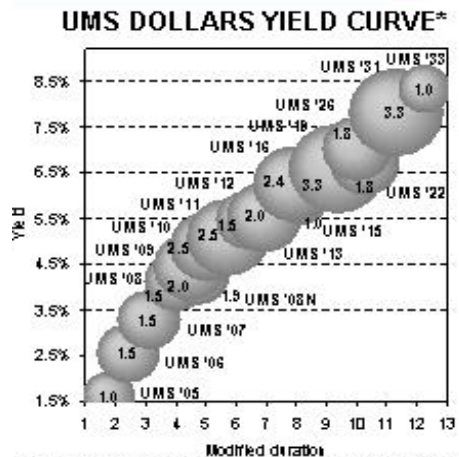
## Developing the Yield Curve

Mexico has also been very successful in developing its domestic and international yield curves. The spread of maturities, shown at right and below, has helped create benchmarks that have spurred an increase in private debt



\*As of May 29, 2003  
Source: Ministry of Finance and Public Credit, Mexico

issuance. Moreover, the broader schedule of payments has given clarity to investors as to the government's ability to finance itself on an ongoing basis, helping to increase stability in the financial system.



\*As of May 7, 2003  
Source: Ministry of Finance and Public Credit, Mexico

Thus, Mexico appears to have successfully standardized its bond issuances and avoided the fragmentation issues that have plagued many other emerging market bond issuers as they seek to develop suitable benchmark instruments.

## Developing a Secondary Market and Investor Base

**Secondary market in government securities**  
(average daily turnover in millions of dollars)

	2000 Q1	2000 Q2	2000 Q3	2000 Q4	2001 Q1	2001 Q2	2001 Q3
Cetes	1,272	1,493	762	680	1,299	503	591
Bondes	163	51	67	70	53	80	121
Udibonos <sup>1</sup>	13	6	4	3	6	7	5
Bonos	51	155	204	864	945	906	1,062

<sup>1</sup> Inflation-indexed bonds.

Source: Banco de México.

The secondary market for Mexican government debt is relatively small and illiquid in the primary securities, as shown above. However, the repo market is fairly well developed in Mexico. Overnight repos stood at approximately \$6 billion as of 2001.<sup>18</sup> These transactions, like all of the secondary market activity, occur over the counter. The vast majority of such transactions are routed through brokers, allowing for increased transparency and price discovery.

Primary market participants such as insurance companies, mutual funds, banks, and brokerages increasingly are active in the secondary market, helping to provide better liquidity for government debt securities. Nevertheless, Mexico's banks remain the most important players in the secondary markets, and have a larger role than they do in most other Latin American countries.<sup>19</sup>

Improved ratings and innovations in instruments have also helped broaden the investor base in Mexican government securities. Standard & Poors upgraded Mexico's foreign currency debt to BBB- on February 7, 2002, such that all three major credit rating agencies (S&P, Moody's and Fitch's) had returned Mexico's bonds to investment grade status.<sup>20</sup> Positive reaction has been strong; with the 5.5 and 30 year global bonds issued in April 2003 were placed primarily with American and European investors.<sup>21</sup> In addition, the inclusion of inflation indexed Udibonos has helped to draw more investors to the market by ensuring positive real

returns. Finally, Mexico has attempted to further diversify its investor base by issuing debt in sterling to complement its dollar denominated offerings; in January 2004, it issued a £500 million 20 year bond at 190 basis points over UK government securities.<sup>22</sup>

### **Regulation, Transparency and Supervision**

Mexico has continued to move to improve the legal, regulatory and supervisory environment for its government securities over the past decade. It established a link between banks accounts at Banxico and the depository institution to provide greater flexibility for payments and deliveries. Mexico's clearing operations also benefit from links to Euroclear and Clearstream providing easier settlement for international investors. Moreover, bankruptcy laws have been revised to give market participants greater latitude and clarity in repo operations.<sup>23</sup>

Banxico has also improved oversight of the domestic derivatives market. After a nascent market failed in the early 1990s due to unwise positions taken by some banks, regulations have been issued in the last several years addressing risk measurement, risk limits and proper reporting procedures. In addition, Mexico has moved to help increase information availability in the form of benchmark market rates. The TIIE is published daily; as the one month interbank rate, it has become the de facto standard for international derivatives traders<sup>24</sup> and is a reference rate for private debt and bank loans.

Mexico's April 2003 \$1 billion global bond issue, governed by New York law, was the first by any emerging market to include collective action clauses.<sup>25</sup> Although statistically significant data are as yet inconclusive, empirical evidence suggests that such clauses result in a discount for the issuer with the likelihood that any workout in the case of default would be more orderly outweighing the loss of individual rights for investors. The clauses included in Mexico's

global bonds address general amendments in payment terms and acceleration and deceleration of payments.<sup>26</sup>

## **Conclusion**

Mexico has made a strong comeback from the 1994/5 crisis and built robust domestic and international government securities markets that appear to be spurring the development of private debt markets. Sound fiscal and monetary policies and the establishment of a strong yield curve with clear benchmarks has allowed Mexico to reduce its financing costs and shift much of its financing from short term obligations to longer term issues.

There are few remaining negative vestiges of past crises in the government securities market; Mexico retired its last Brady Bonds in July 2003.<sup>27</sup> There remain issues with increasing liquidity in the secondary market, and creating a broader derivatives market, but overall, Banxico and the Mexican government appear to have done an excellent job of reinvigorating the government securities markets.

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<sup>1</sup> Sidaoui, José Julian, "The role of the central bank in developing debt markets in Mexico," in "BIS Papers No 11," Basel: Bank for International Settlements, 2002, <http://www.bis.org/publ/bppdf/bispap11n.pdf>, Accessed March 5, 2004, p.151

<sup>2</sup> Ibid, p.153

<sup>3</sup> Ibid, p.153

<sup>4</sup> Developing Government Bond Markets, Washington: The World Bank, 2001, p.156

<sup>5</sup> del Valle, Clemente, "Developing Bond Markets: A Comprehensive View," [www.iadb.org/sds/doc/IFM-ClementeBond-E.pdf](http://www.iadb.org/sds/doc/IFM-ClementeBond-E.pdf), Accessed March 5, 2004, p.26

<sup>6</sup> "The Budget approved for 2004 is consistent with macroeconomic stability and growth," Mexico City: Ministry of Finance and Public Credit, December 30, 2003, p.1

<sup>7</sup> del Valle, p.2

<sup>8</sup> "Economic and Financial Indicators: Public Finances: Total Net Debt of the Public Sector," Mexico City: Banco de Mexico, <http://www.banxico.org.mx/sie/cuadros/ing/CG7.asp>, Accessed March 5, 2004

<sup>9</sup> Franco, David, "Mexico: 2004 Monetary Policy Report...Overall a Nonevent," New York: JP Morgan Economic and Policy Research, January 29, 2004

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- <sup>12</sup> Sidaoui, p.153
- <sup>13</sup> Ibid, p.153
- <sup>14</sup> "5.5-Year and 30-Year Global UMS Bonds Issued in the International Markets," Mexico City: Ministry of Finance and Public Credit, April 8, 2003, p.2
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- <sup>18</sup> Sidaoui, p.154
- <sup>19</sup> del Valle, p.23
- <sup>20</sup> "Standard & Poor's Upgrades Mexico's External Debt to Investment Grade," Mexico City: Ministry of Finance and Public Credit, February 7, 2002
- <sup>21</sup> "5.5-Year and 30-Year Global UMS Bonds Issued in the International Markets," p.2
- <sup>22</sup> "Mexico Sells 500 Mln Stg 20-year Bond," Reuters, January 22, 2004, <http://uk.biz.yahoo.com/040121/80/ek07w.html>, Accessed March 9, 2004
- <sup>23</sup> Sidaoui, p.10
- <sup>24</sup> Giacomelli, Drausio, and Robles, Mario, "Local Fixed Income and FX Trade Recommendations," New York: JP Morgan Emerging Market Research, January 15, 2004, p.1
- <sup>25</sup> "Resolving Sovereign Debt Crises with Collective Action Clauses," *FRBSF Economic Letter*, February 20, 2004, p.1
- <sup>26</sup> Global Financial Stability Report, Washington: International Monetary Fund, September 2003, p.43
- <sup>27</sup> "Quarterly Report on Public Finances and Public Debt Third Quarter of 2003," Mexico City: Ministry of Finance and Public Credit, Mexico, November 4, 2003, p.5

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