Economic Analysis

Using international reserves – a bad idea for Mexico's economy

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Carlos Serrano

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A few weeks ago, a group of legislators from Mexico's Labour Party (Partido del Trabajo, PT) said that Parliament should discuss the possibility of using the Central Bank's international reserves in the fight against poverty. I understand that this sounds like an attractive proposition. The Bank of Mexico has around 174 billion dollars in international reserves, roughly 17% of GDP. At first glance, it would seem like a good idea to use these assets to build infrastructure and combat poverty.

In order to assess whether or not this would be a good strategy, we should start by asking what the purpose of international reserves is. The vast majority of the world's central banks keep large amounts of currency in reserve. In fact, over the past decade, these reserves, as held by emerging economies, have increased by over $7 trillion.

So why do the world's central banks keep reserves? In many cases, they are held by countries with fixed or semi-fixed exchange rates. In other words, where there is a commitment to maintaining a stable currency in terms of its value against a benchmark, which in most cases is the US dollar.

In such cases, countries need reserves in order to maintain the value of their domestic currency. However, even countries such as Mexico, which have a flexible exchange rate in which in general terms their currency fluctuates depending on market conditions, keep international reserves. Even during the global financial crisis, which saw the US financial system hit hard, most of the central banks around the world continued to accumulate dollars.

This was a precautionary measure. If there were to be a crash, like the one experienced around the world in 2009 or in Asia in the late 1990s, a country that does not hold international currencies may see a sudden capital outflow, a sharp depreciation of its currency, and a marked fall-off in terms of imports (as there wouldn't be the currency to pay for them), all of which would have a significant negative impact on the economy. Such capital outflows could even occur in countries with solid macro-economic fundamentals within a context of a global credit squeeze in which investors seek refuge in assets they see as being very low risk such as US, German and Swiss government bonds.

Given such a scenario, countries need to have sufficient currency reserves in order to cover their debt obligations and continue to be able to import goods. In certain situations, even in countries with flexible exchange rates, it may be desirable to use international reserves to prevent a collapse of the domestic currency. What is more, the mere fact of having reserves can actually prevent such situations. If the markets see that a country holds sufficient funds in foreign currencies, they know that a speculative attack against its currency will not be successful. On the other hand, if it is felt that a country does not have sufficient reserves and that payment of its external debt could be in danger, there may be a significant outflow of capital.

Nevertheless, holding international reserves is not a free option. Its cost lies in the fact that having such reserves means it will be receiving a lower yield than it might get from local assets. The vast majority of central banks invest their reserves in safe instruments, above all in US Treasury Bonds, which offer much lower returns than local assets do. This brings us to the question as to how much a country should hold in reserves.

It is one that is widely debated by economists. However, in general, there is a consensus that a good strategy is to have sufficient reserves to cover foreign currency debt obligations for a year. Where does Mexico stand if we apply this criterion? The country's reserves just about cover slightly more than a year's debt obligations – not an excessive amount in other words. It would therefore be irresponsible to use them as this will increase Mexico's vulnerability.

I also feel that there is another reason why it would be a serious mistake to even discuss the matter. The country's reserves are administered by the Bank of Mexico. Interfering in this regard would represent a significant eroding of its independence.

CONTACT DETAILS:
BBVA Research – BBVA Bancomer: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Ciudad de México, Mexico
bbvaresearch@bbva.com www.bbvaresearch.com