

# Mexico: Dealing with international financial uncertainty

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BANCO DE MÉXICO

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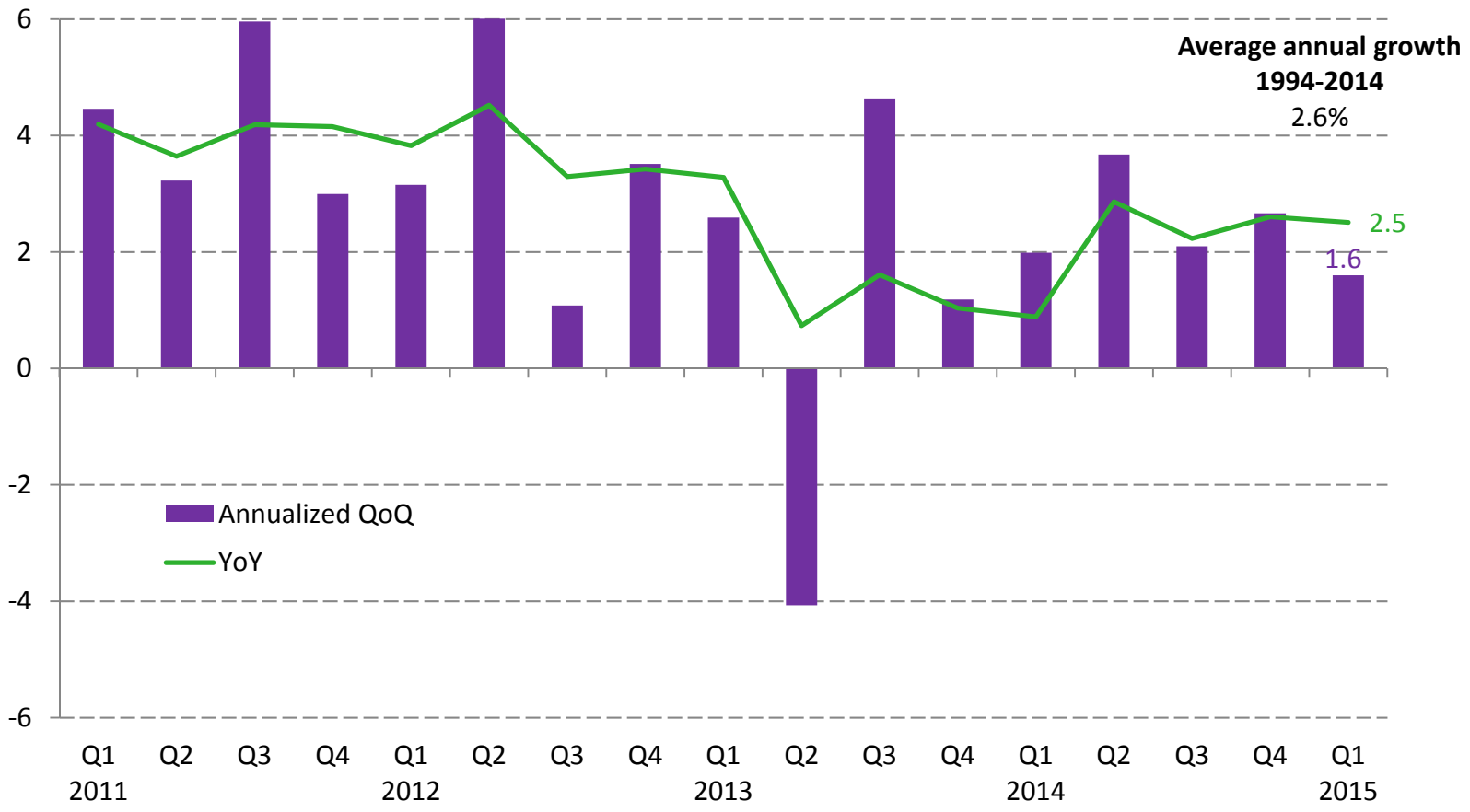
**1** Moderate economic growth

**2** Waiting for the liftoff

**3** Taming inflation

# Since 2014, Mexico's economic recovery has been limited by three major factors

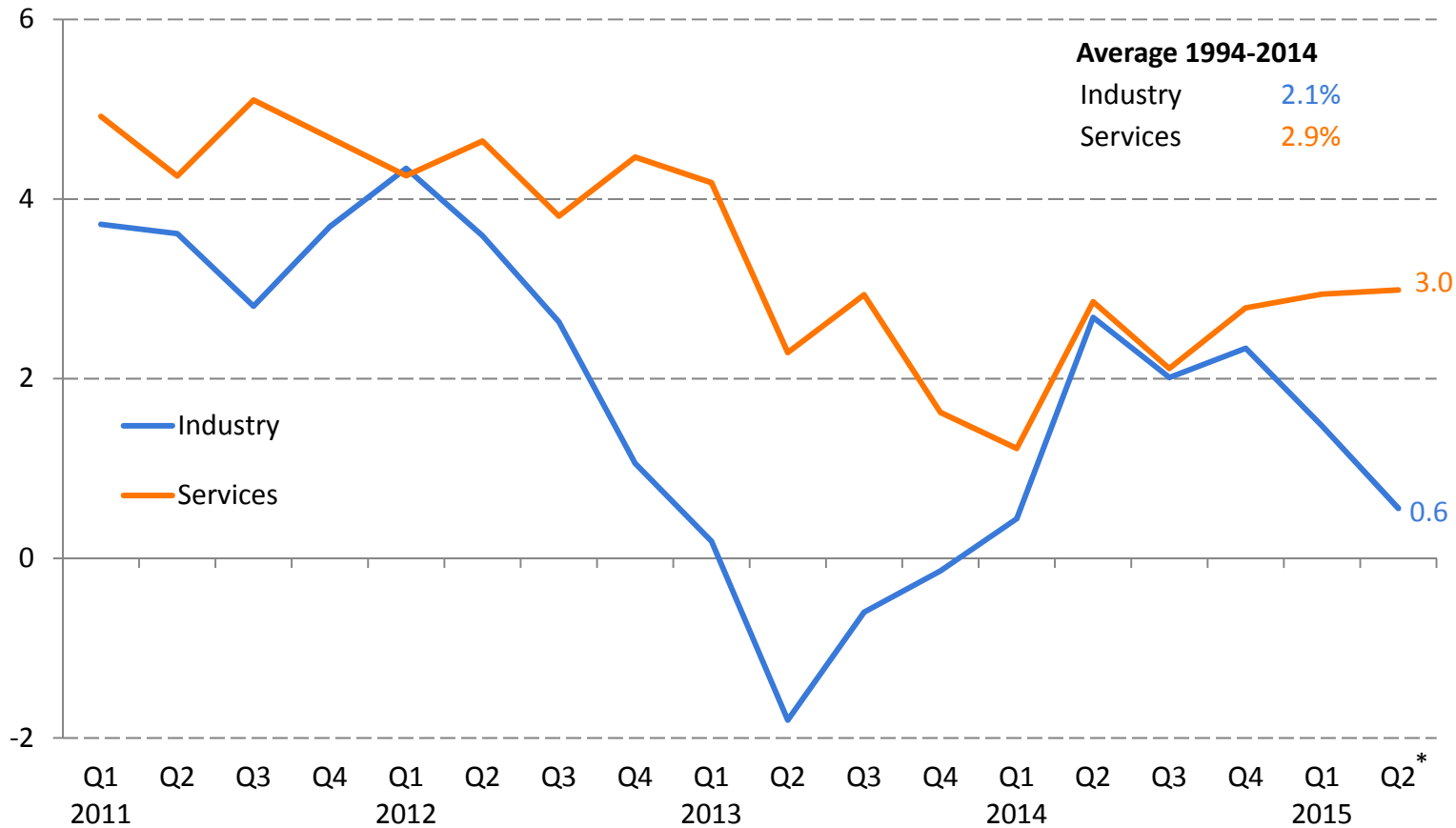
Mexico: GDP  
% change, s.a.



s.a. / Seasonally adjusted  
Source: INEGI

# First, industrial production has been slowing down,

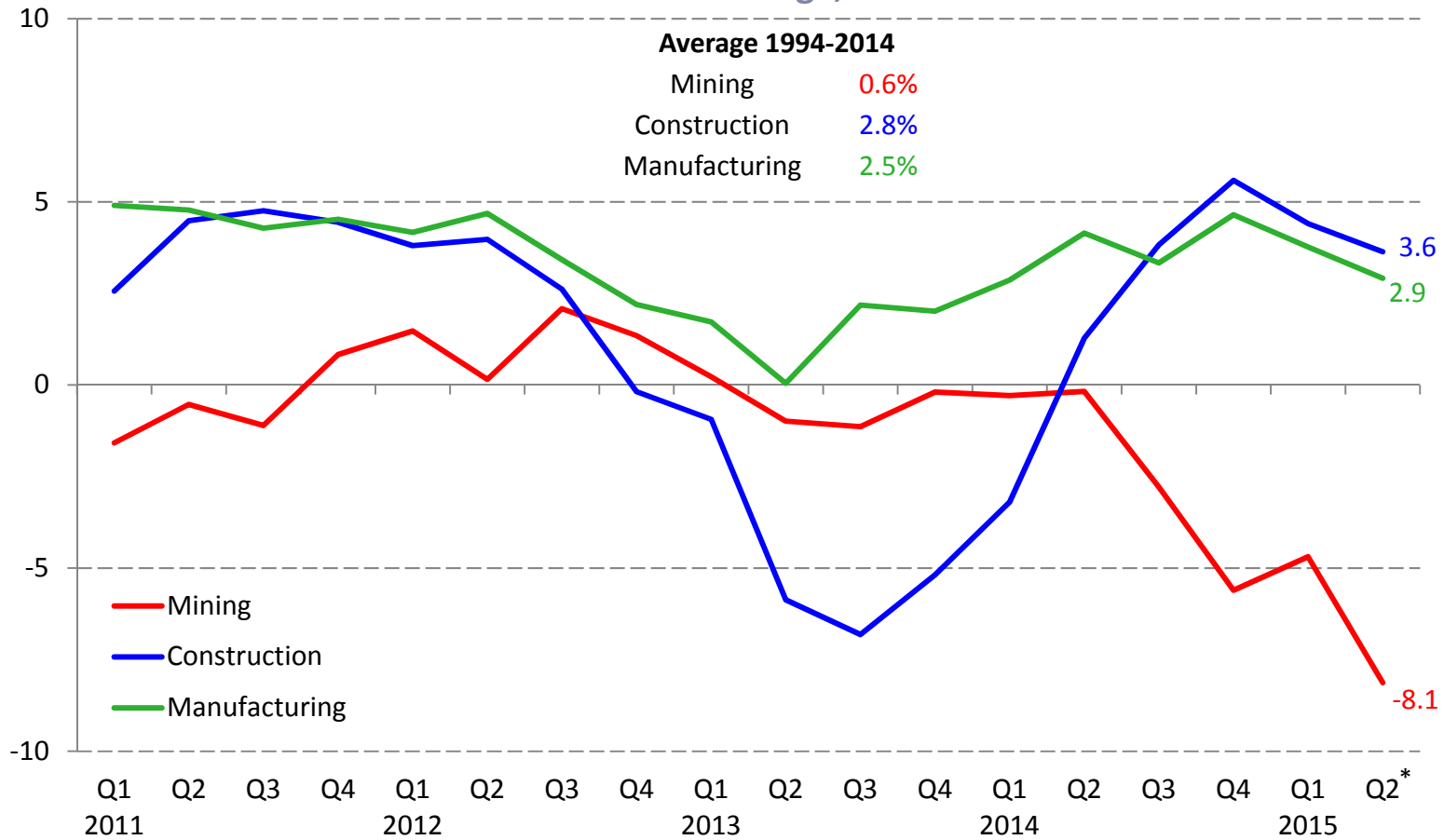
Mexico: GDP by sector  
YoY % change, s.a.



\*/ Based on the April-May average of the Global Economic Activity Indicator  
s.a. / Seasonally adjusted  
Source: INEGI

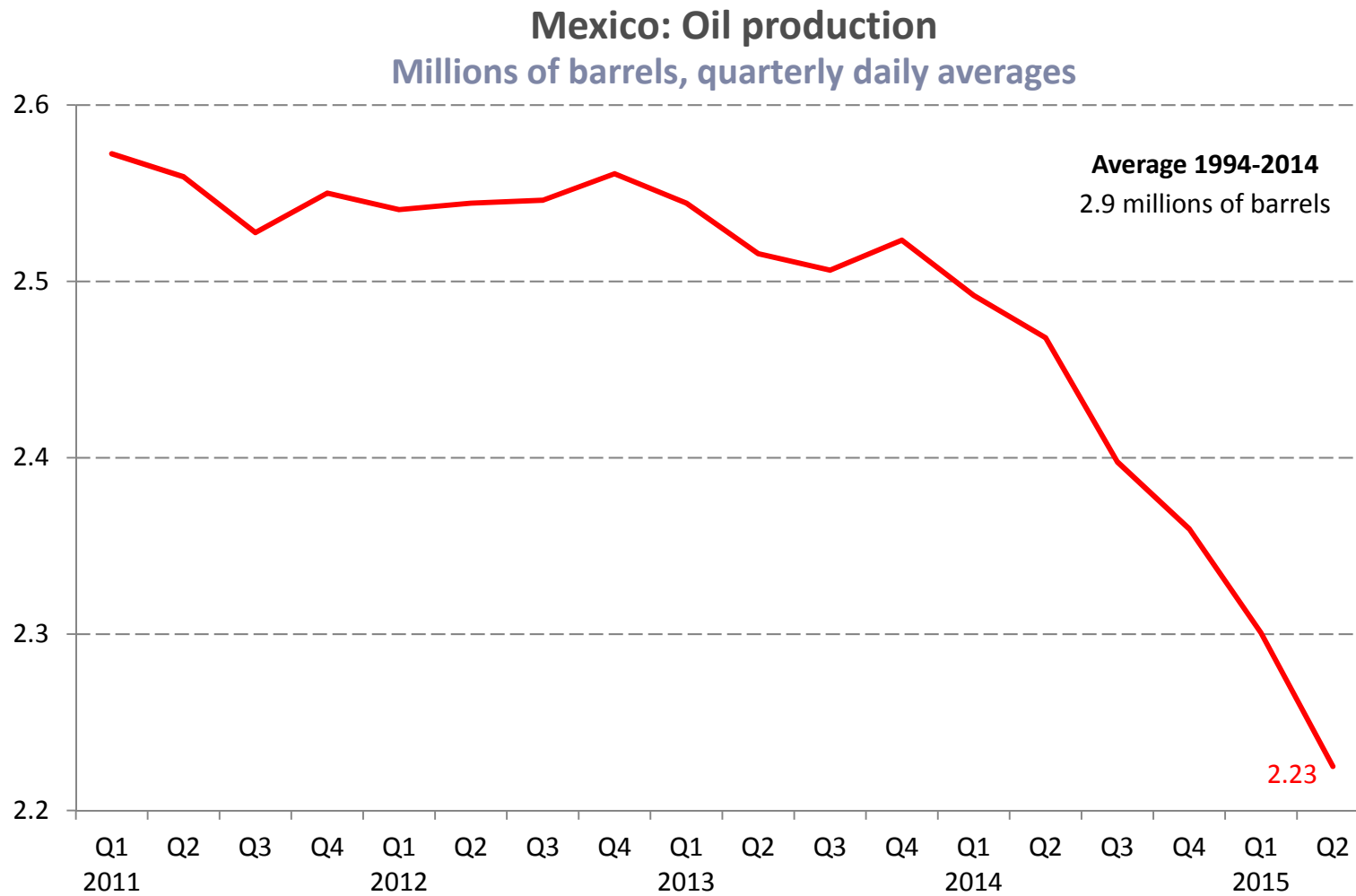
# ... mainly as a result of a persistent contraction in mining output

Mexico: Industrial GDP  
YoY % change, s.a.



\*/ Based on the April-May average of the Global Economic Activity Indicator  
 s.a. / Seasonally adjusted  
 Source: INEGI

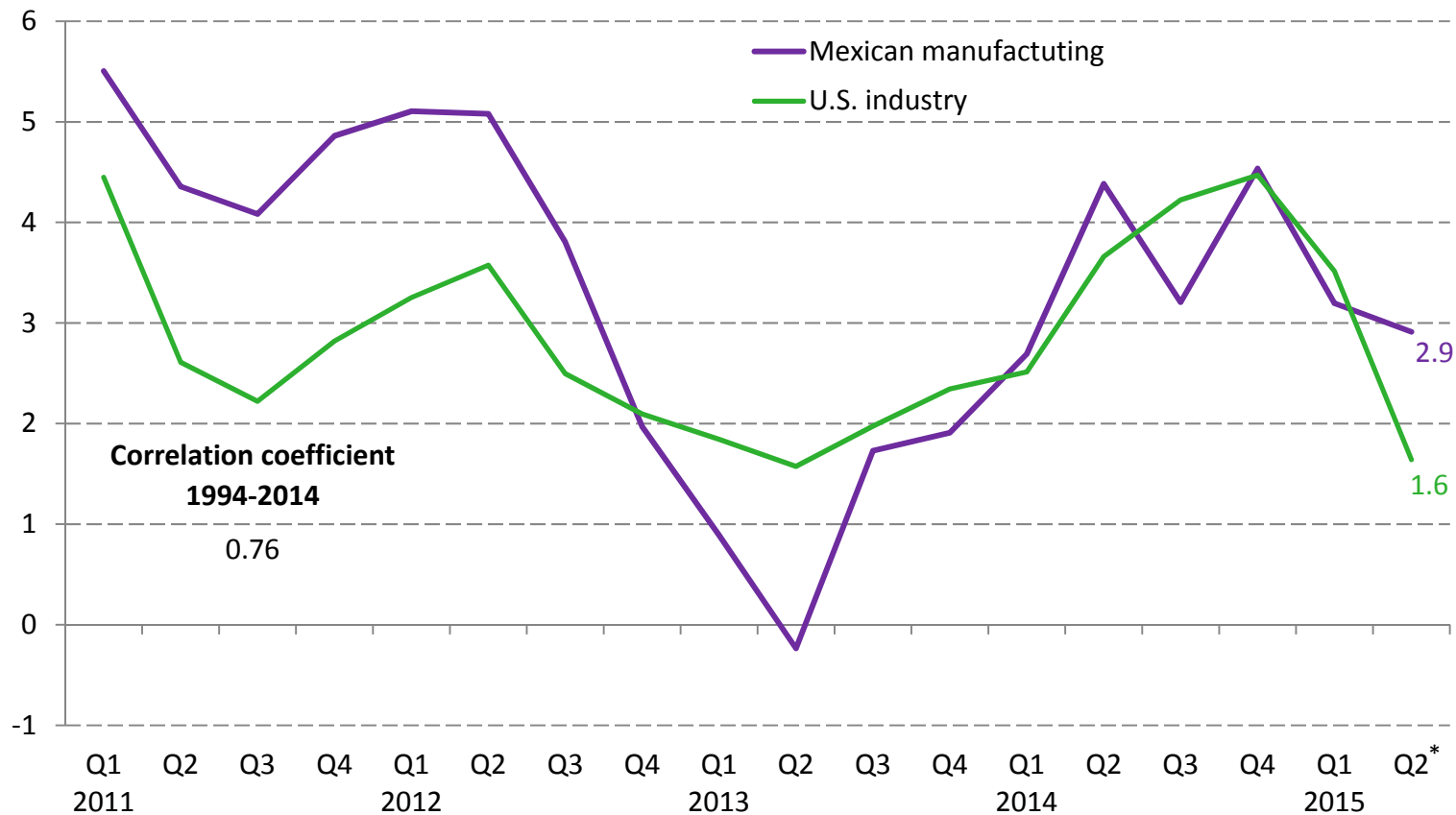
## ... which has been driven by shrinking oil production



Source: INEGI and PEMEX

## Second, manufacturing has been halted largely due to a deceleration of the U.S. industry

The United States and Mexico: Production  
YoY % change, s.a.



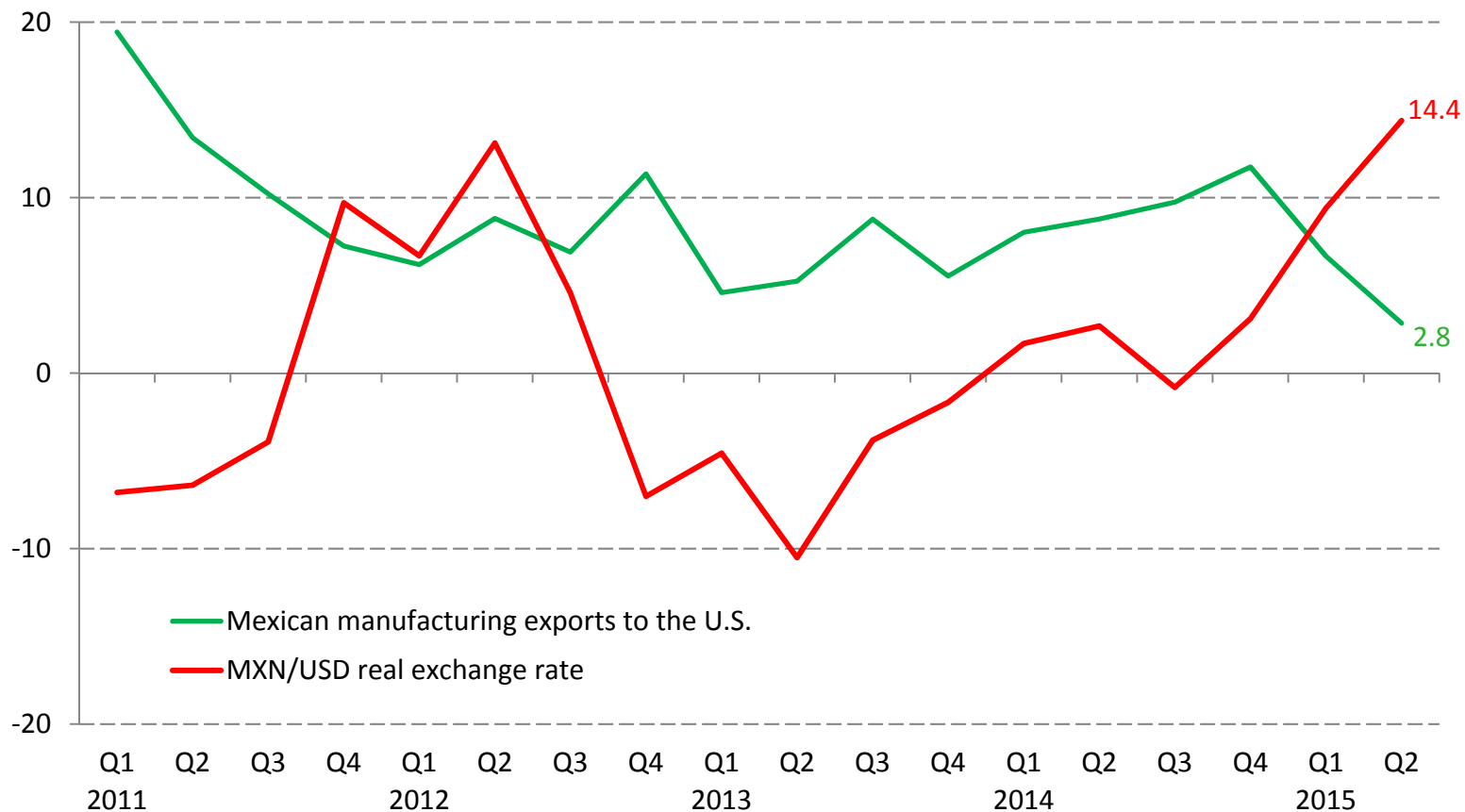
\*/ Mexican manufacturing based on the April-May average

s.a. / Seasonally adjusted

Source: INEGI and U.S. Federal Reserve

# ... which has coincided with less dynamic manufacturing exports to the U.S., in spite of the peso's real depreciation

Mexico: Trade and real exchange rate  
YoY % change, s.a.

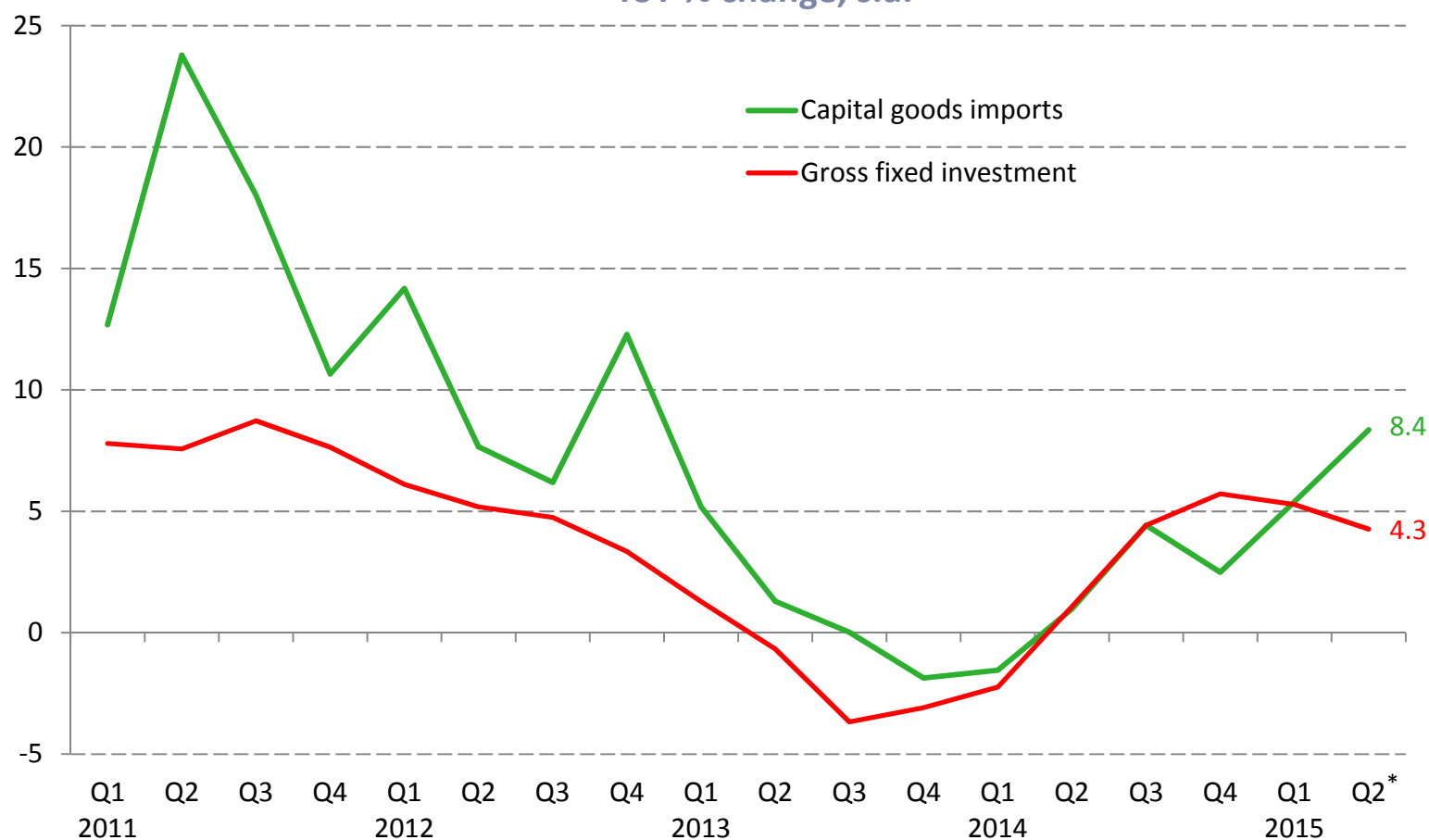


s.a. / Seasonally adjusted except for the real exchange rate  
Source: Banco de México and U.S. Federal Reserve



# Third, domestic spending has remained soft: the increasing trend in investment growth has become weaker

Mexico: Investment and capital imports  
YoY % change, s.a.



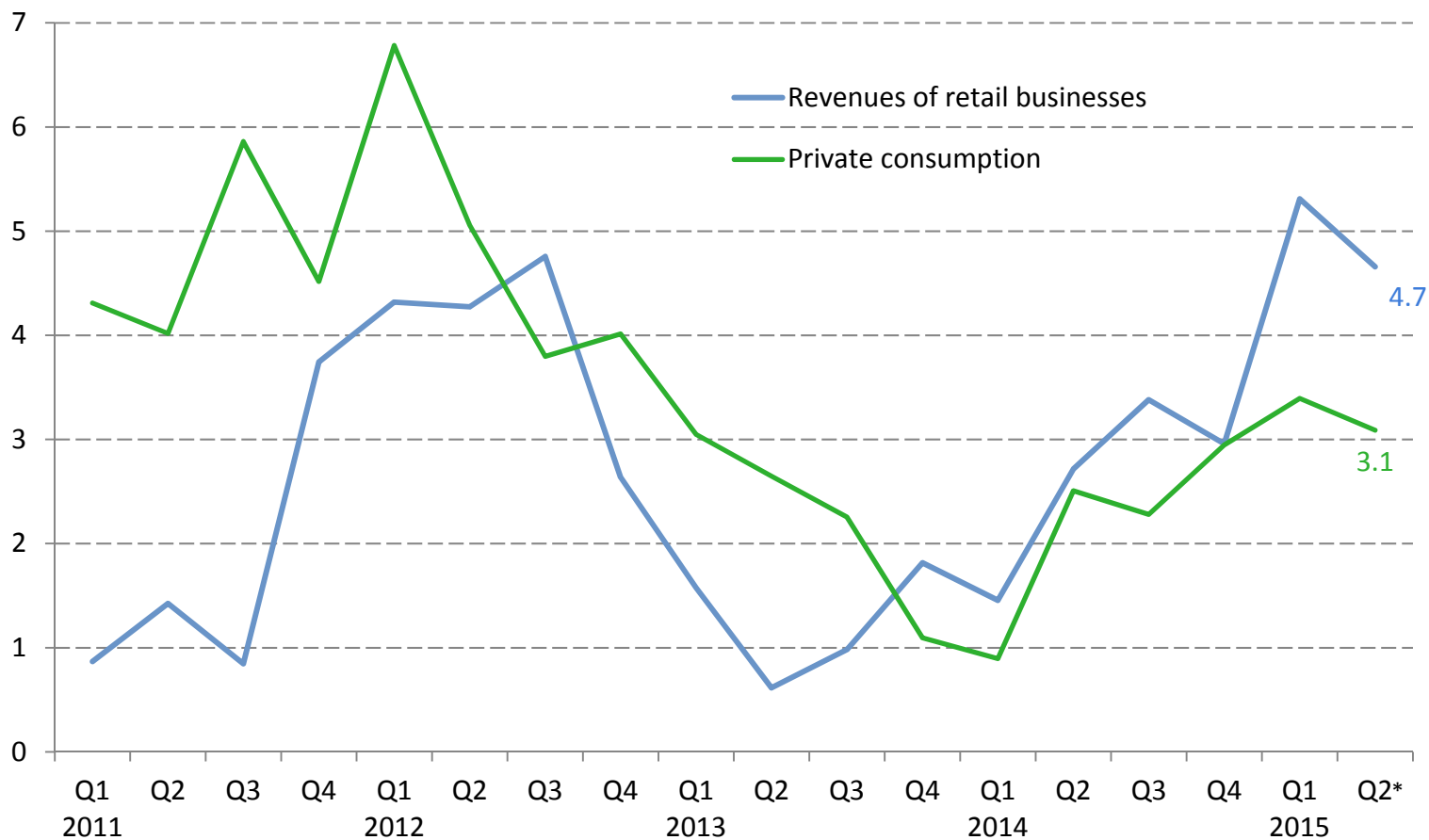
\*/ Gross fixed investment based on the April-May average

s.a. / Seasonally adjusted

Source: INEGI

## ... while consumption rebound has proceeded at a measured pace

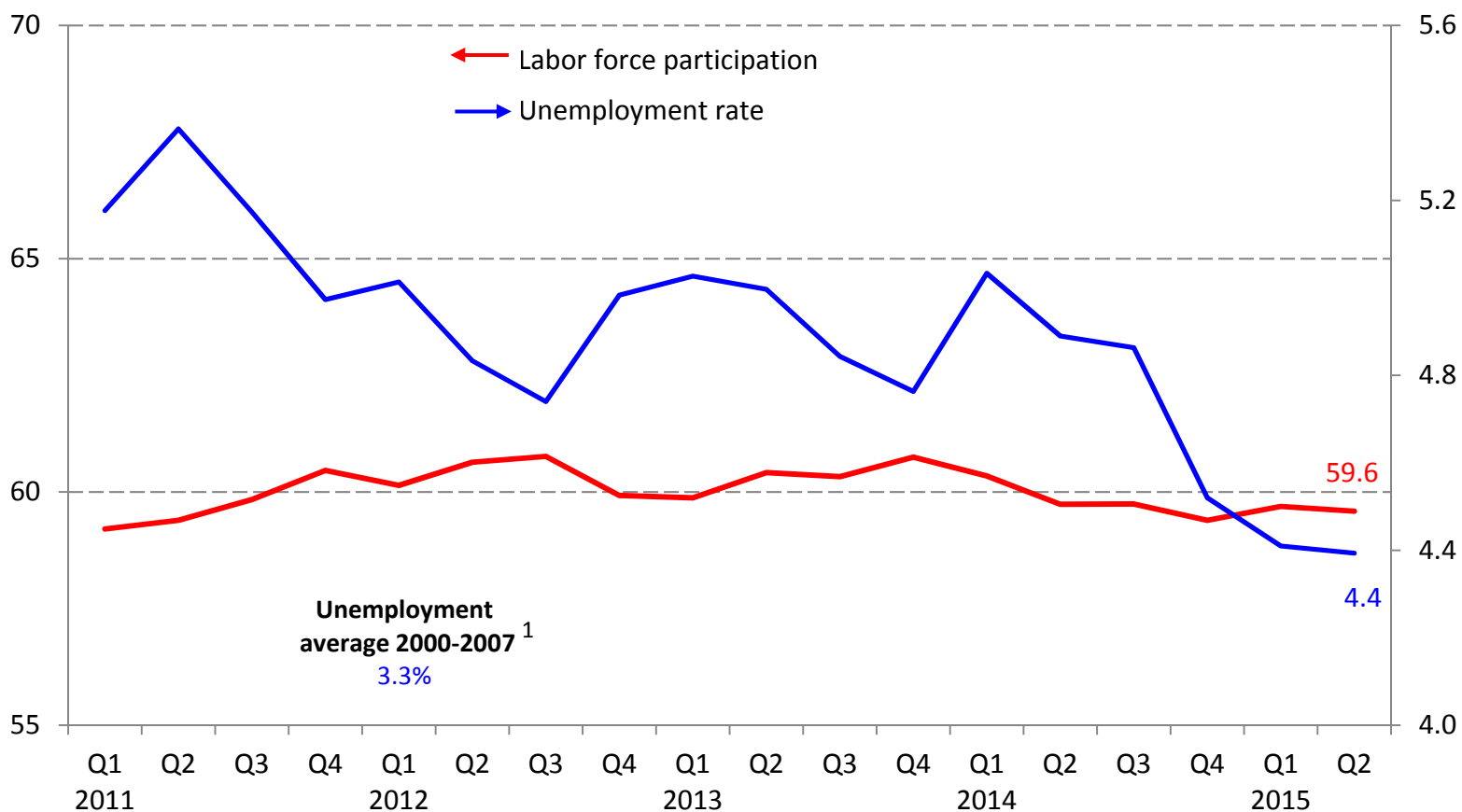
Mexico: Consumption  
YoY % change, s.a.



\*/ Based on the April-May averages  
s.a. / Seasonally adjusted  
Source: ANTAD and INEGI

# The main drag for domestic spending does not seem to be the labor market, where indicators have improved

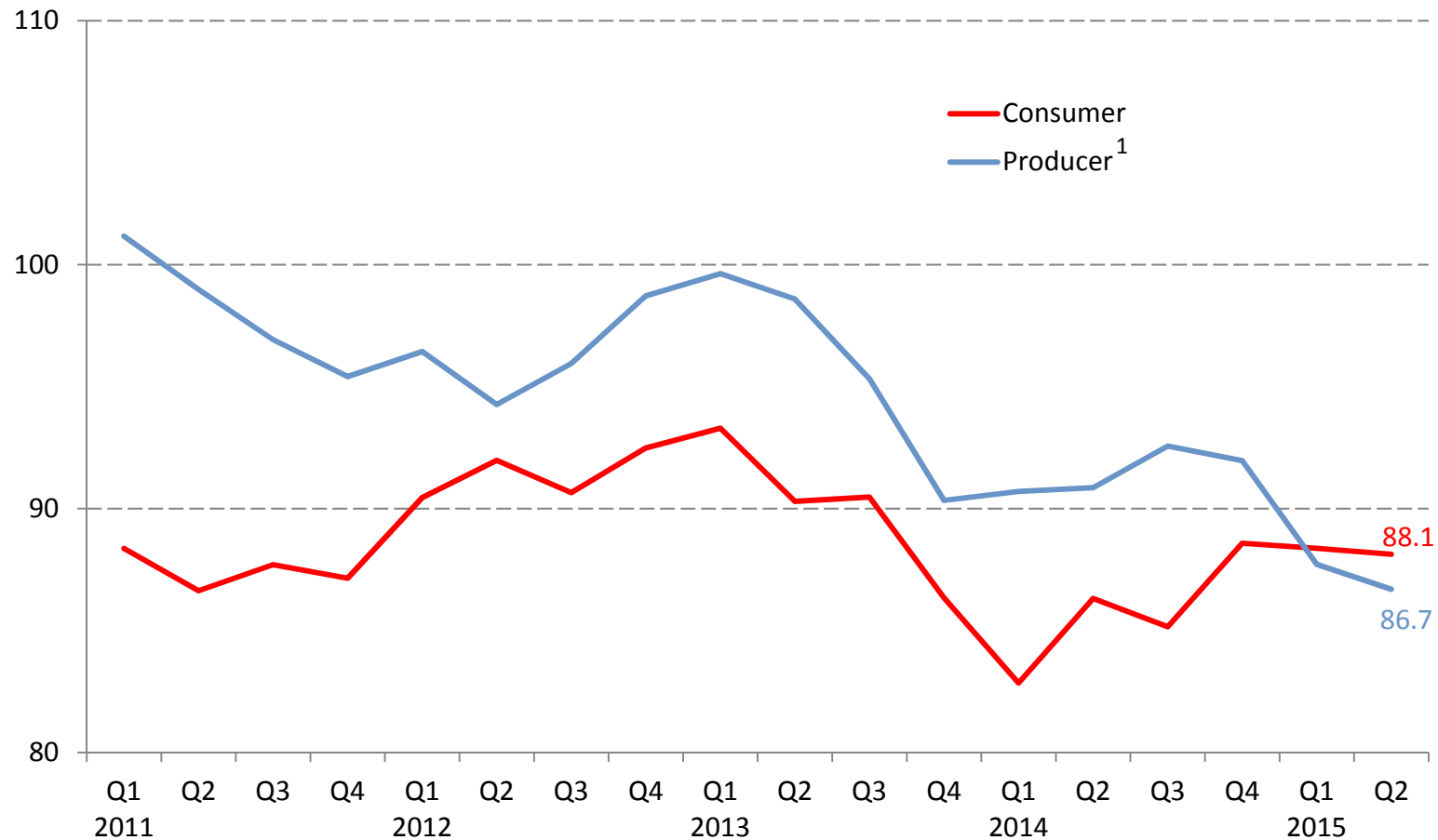
**Mexico: Unemployment and labor force participation**  
 % of EAP and % of 14-year old and older population, s.a.



1/ From April 2000 to December 2004, based on 14-year old and older population; from January 2005 to December 2007, on those 15-year old and older population  
 s.a. / Seasonally adjusted  
 Source: IMSS, INEGI and Banco de México

# A more likely cause relates to disappointing trends in consumer and producer confidence

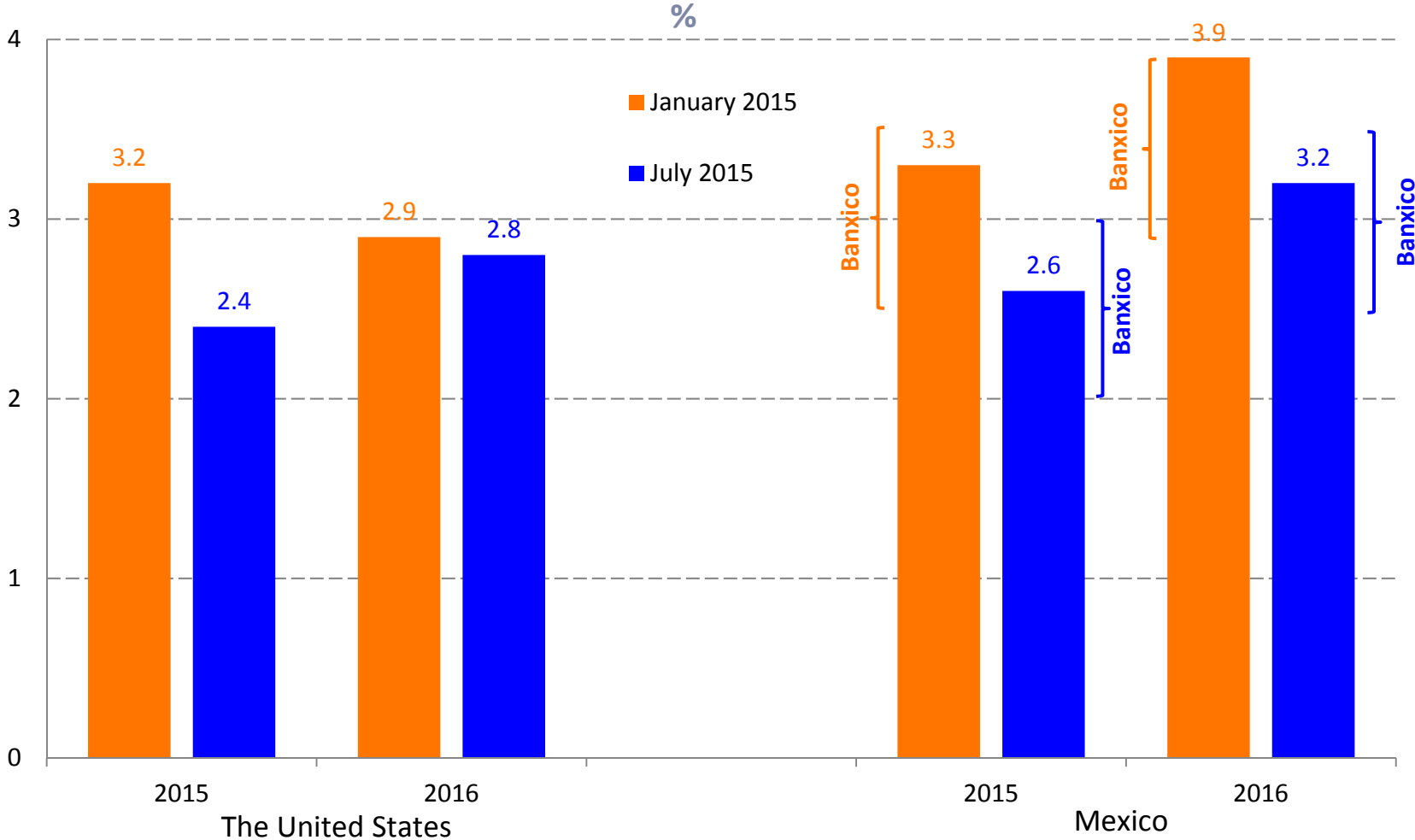
Mexico: Consumer and producer sentiment  
2007 = 100, s.a.



1/ Manufacturing  
s.a. / Seasonally adjusted  
Source: INEGI and Banco de México

# Mexico's GDP growth forecasts have been adjusted downward, together with those of the United States

The United States and Mexico: GDP growth forecasts



Source: Blue Chip and Banco de México

## Downside risks to Mexico's GDP growth scenario might prevail

- Further declines in oil extraction
- U.S. industrial production less robust than expected
- Consumer and producer sentiment remaining weak

## Mexico's reform agenda may foster long-term productivity growth

- Reforms encompass many sectors, including labor, education, the financial system, telecommunications, and energy
- Price and investment impacts may be expected, especially from the telecom and energy reforms
- These impacts and the reforms' effect on potential long-term economic growth will ultimately depend on the quality of implementation
- More significant results can be obtained if the rule of law, public security and physical infrastructure are enhanced

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**1** Moderate economic growth

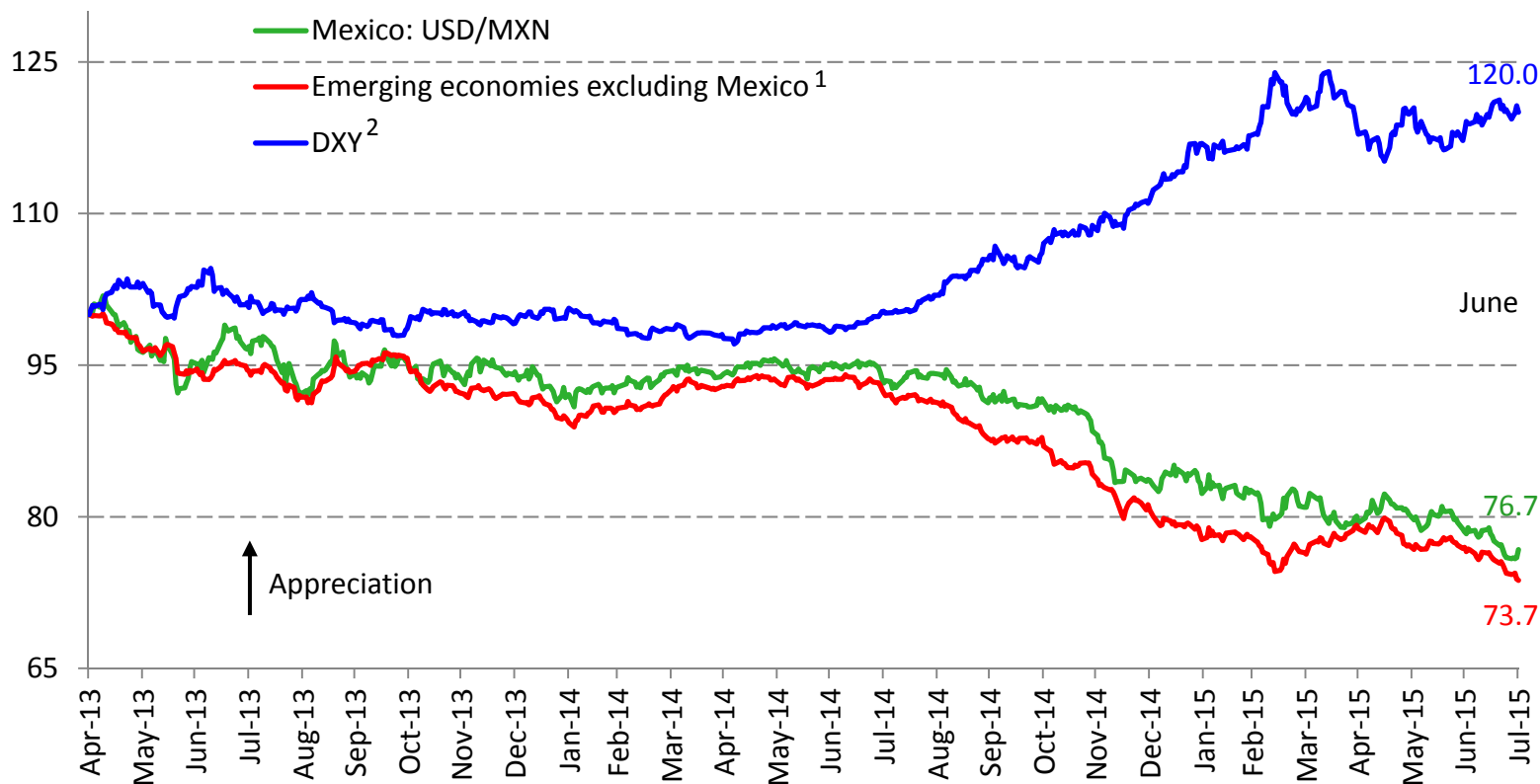
**2** Waiting for the liftoff

**3** Taming inflation



# Expected Fed policy has largely affected EM asset prices: the MXN has depreciated along with other currencies

The United States and emerging economies: Currency exchange rate  
April 30, 2013 = 100

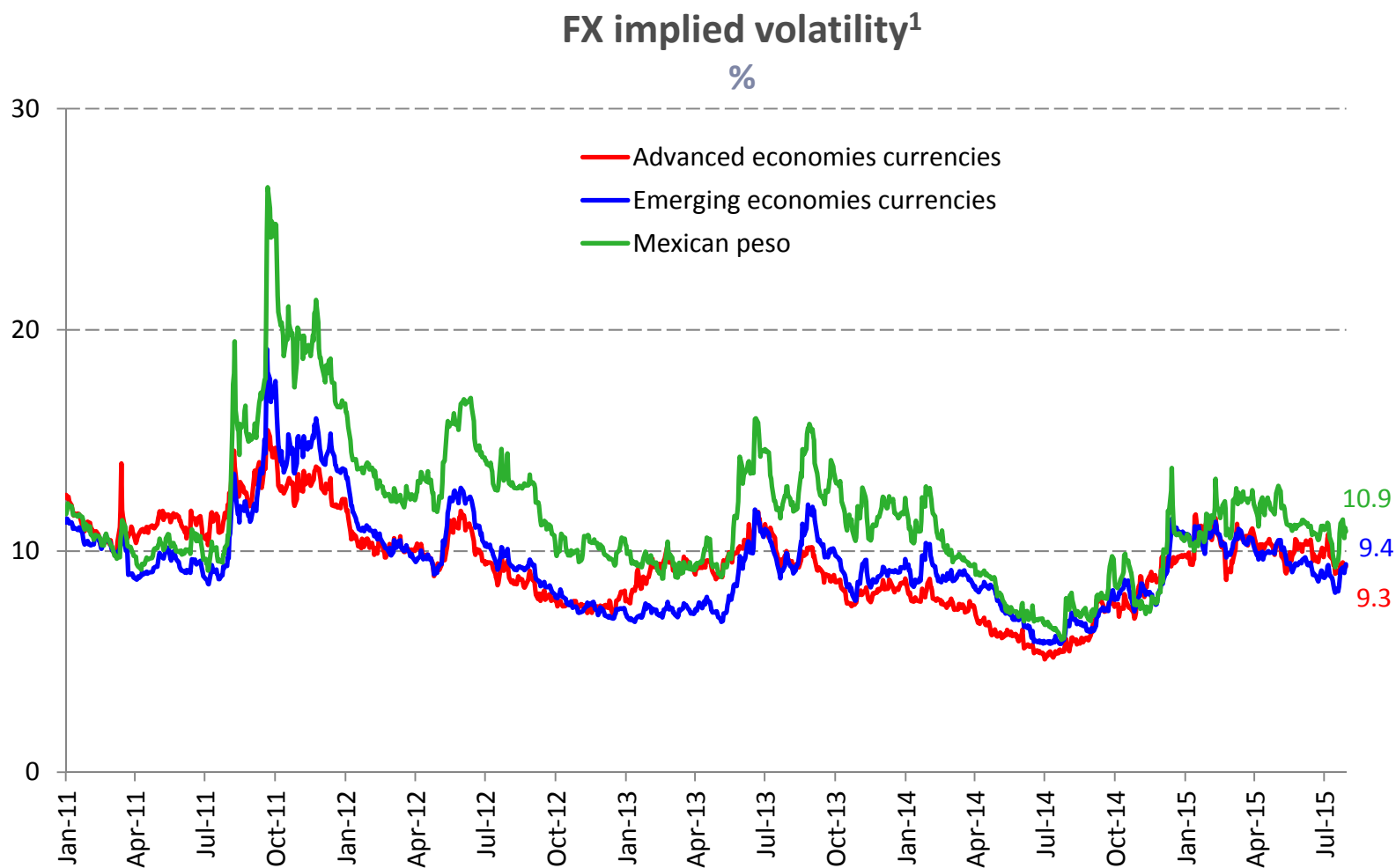


1/ Emerging economies excluding Mexico considers the unweighted average of the value of currencies from Chile, Colombia, Brazil, Russia, Turkey, Poland, the Czech Republic, India, South Korea, Thailand and Indonesia in U.S. dollar terms.

2/ The DXY is a weighted average of the dollar's value relative to the euro (57.6%), the Japanese yen (13.6%), the pound sterling (11.9%), the Canadian dollar (9.1%), the Swedish krona (4.2%), and the Swiss franc (3.6%)

Source: Bloomberg

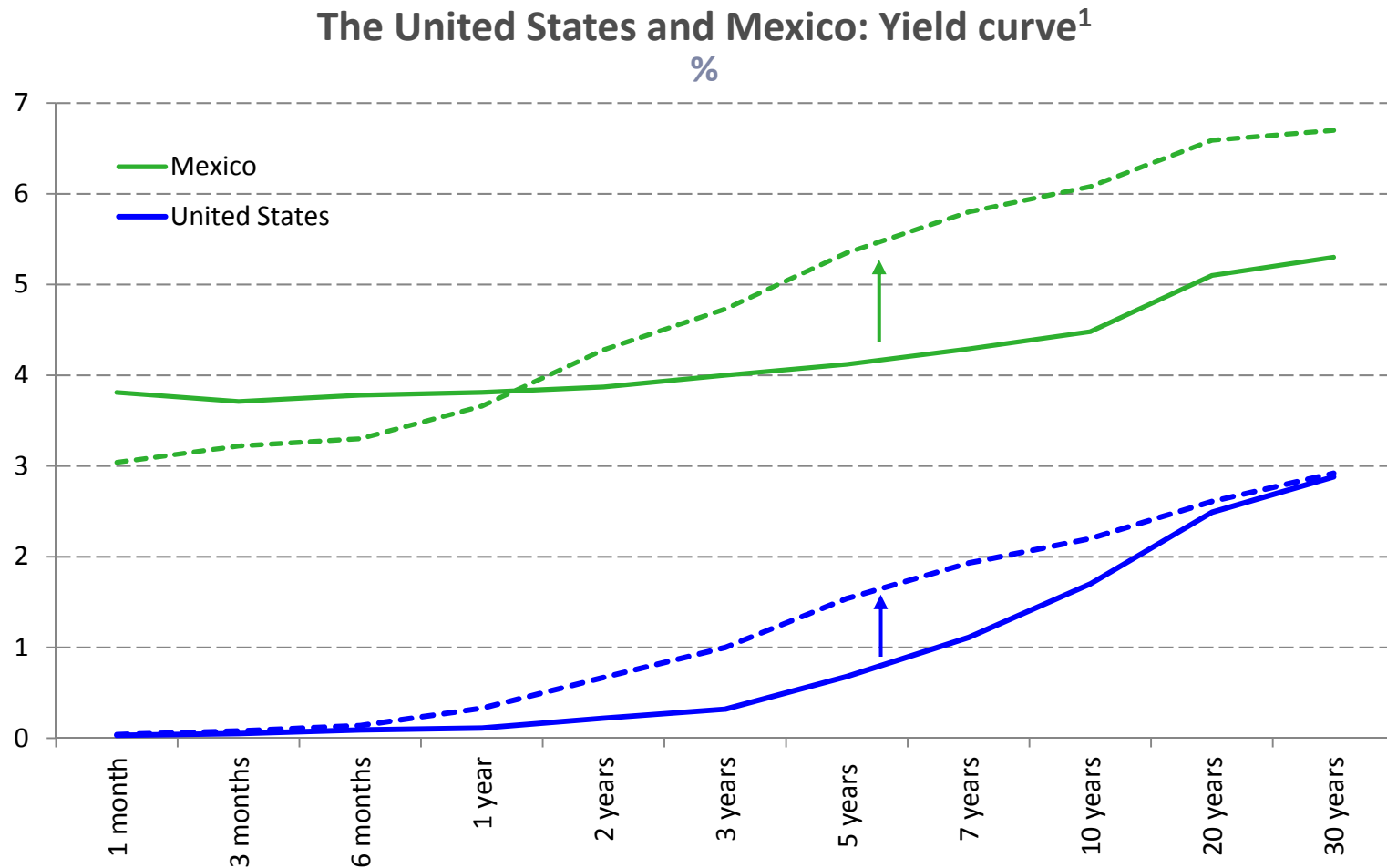
## ... with persistent volatility, although slightly less than in previous turbulence episodes



1/ Three-month implied volatility for "at the money" options. Advanced economies currencies include those of G7 countries. EE currencies include those of South Korea, Mexico, Brazil, India, China, Taiwan, Singapore, Philippines, Poland, Hungary, Russia, Turkey and South Africa

Source: Bloomberg

# Also, Mexico's yield curve has steepened in tandem with that of the United States

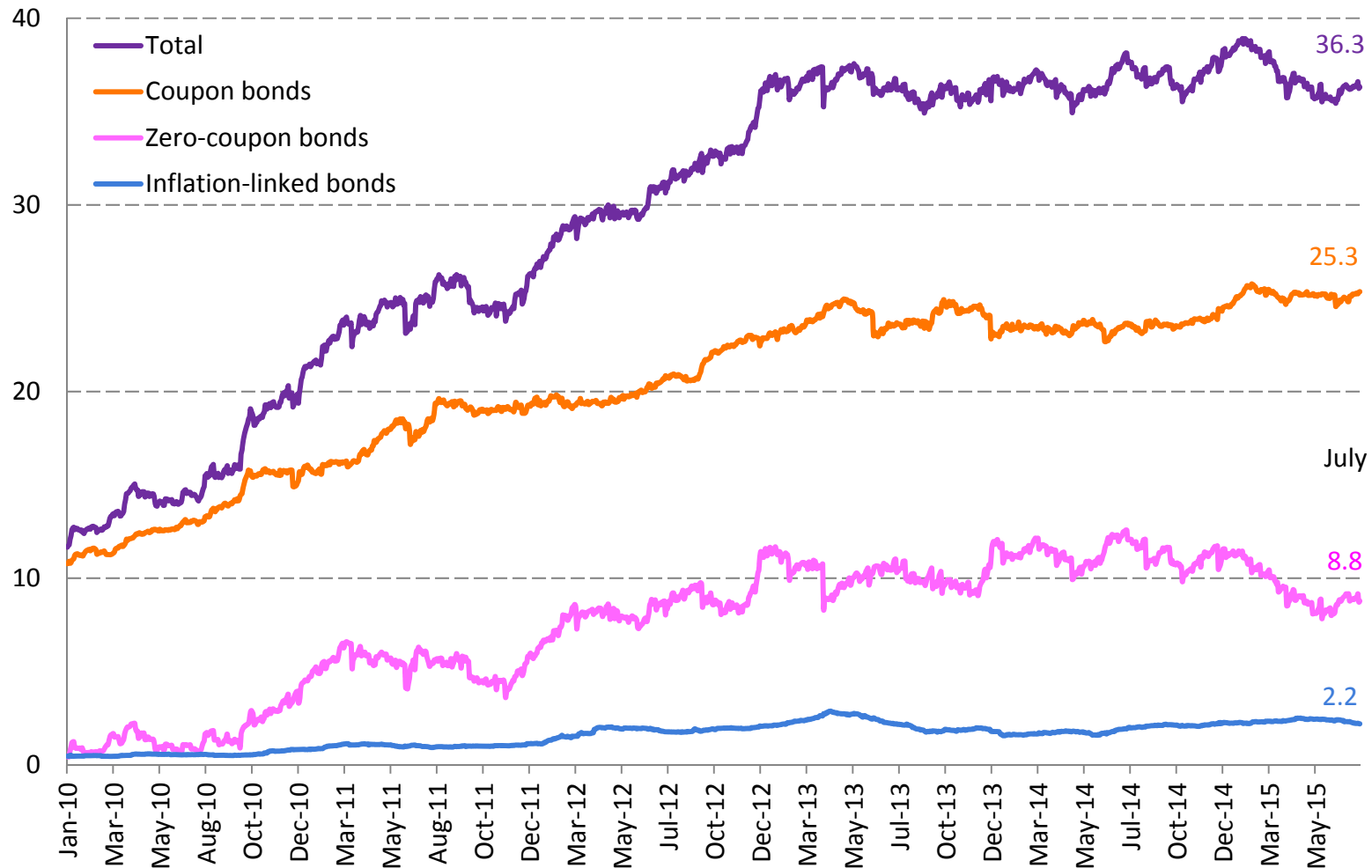


1/ The solid line refers to April 30, 2013 and the dotted line to July 31, 2015

Source: Banco de México

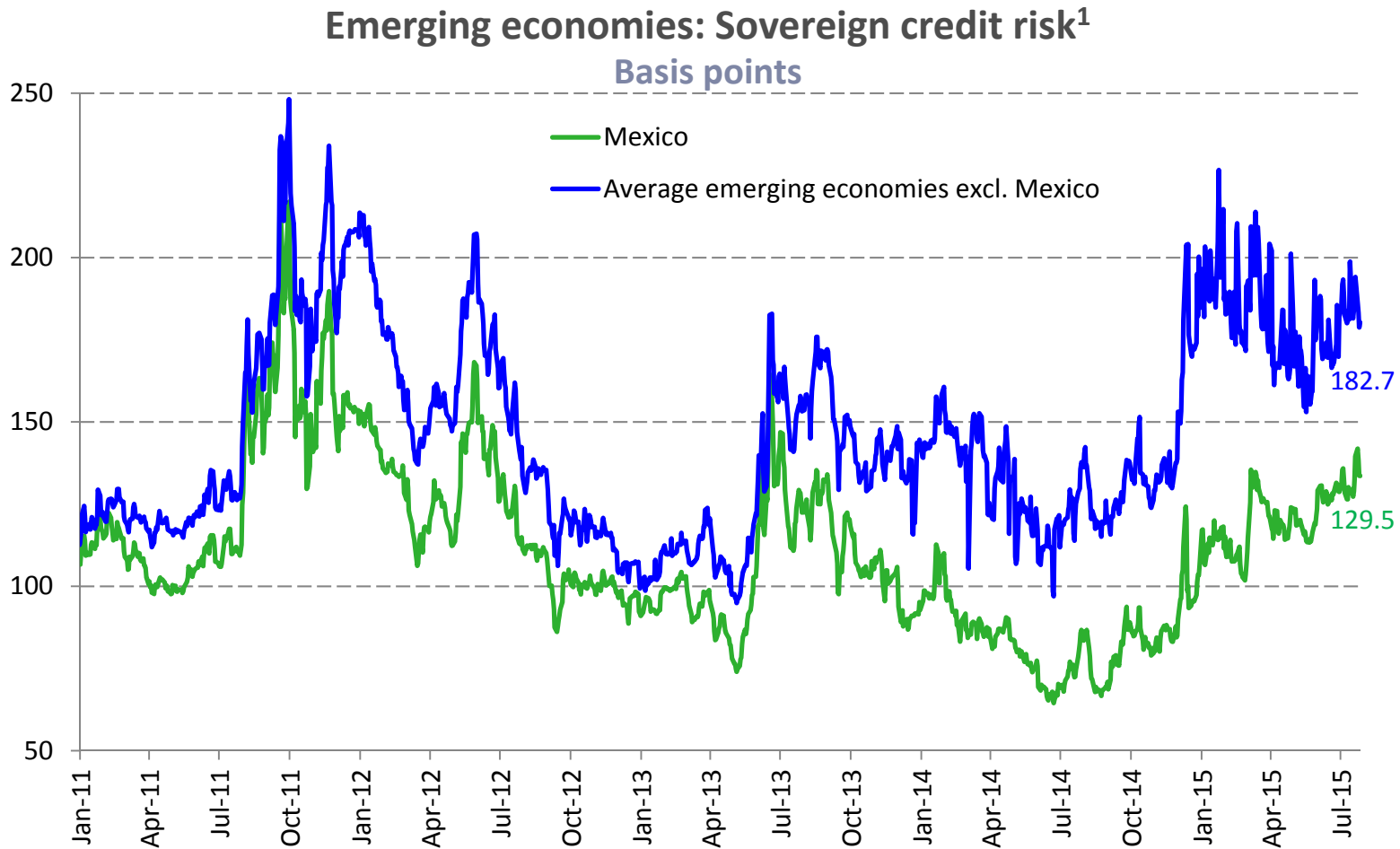
# However, shares of nonresident holdings of peso government bonds have remained relatively stable

Mexico: Nonresident holdings of peso-denominated government securities  
% of total outstanding



Source: Banco de México

# In short, Mexico has faced financial volatility without major disturbances so far



1/ Five-year credit default swaps are defined as default insurance instruments. Based on available data of Brazil, Chile, China, Colombia, South Korea, Peru, Poland, Russia, South Africa and Turkey

Source: Bloomberg

## Nevertheless, heightened uncertainty will likely be the new normal for some time

- The pace and other characteristics of U.S. monetary policy normalization are still unknown
- Even if asset prices have largely incorporated a changing scenario, markets can always be caught off guard, triggering significant turmoil
- Major foreign fund portfolio adjustment cannot be ruled out
- To manage these risks, Mexico needs to further buttress its macroeconomic policy framework, including consolidating the recent efforts in the fiscal realm and timely adjusting the monetary policy stance
- Mexican monetary policy will continue to take into account the relative stance vis-à-vis the United States, among other factors

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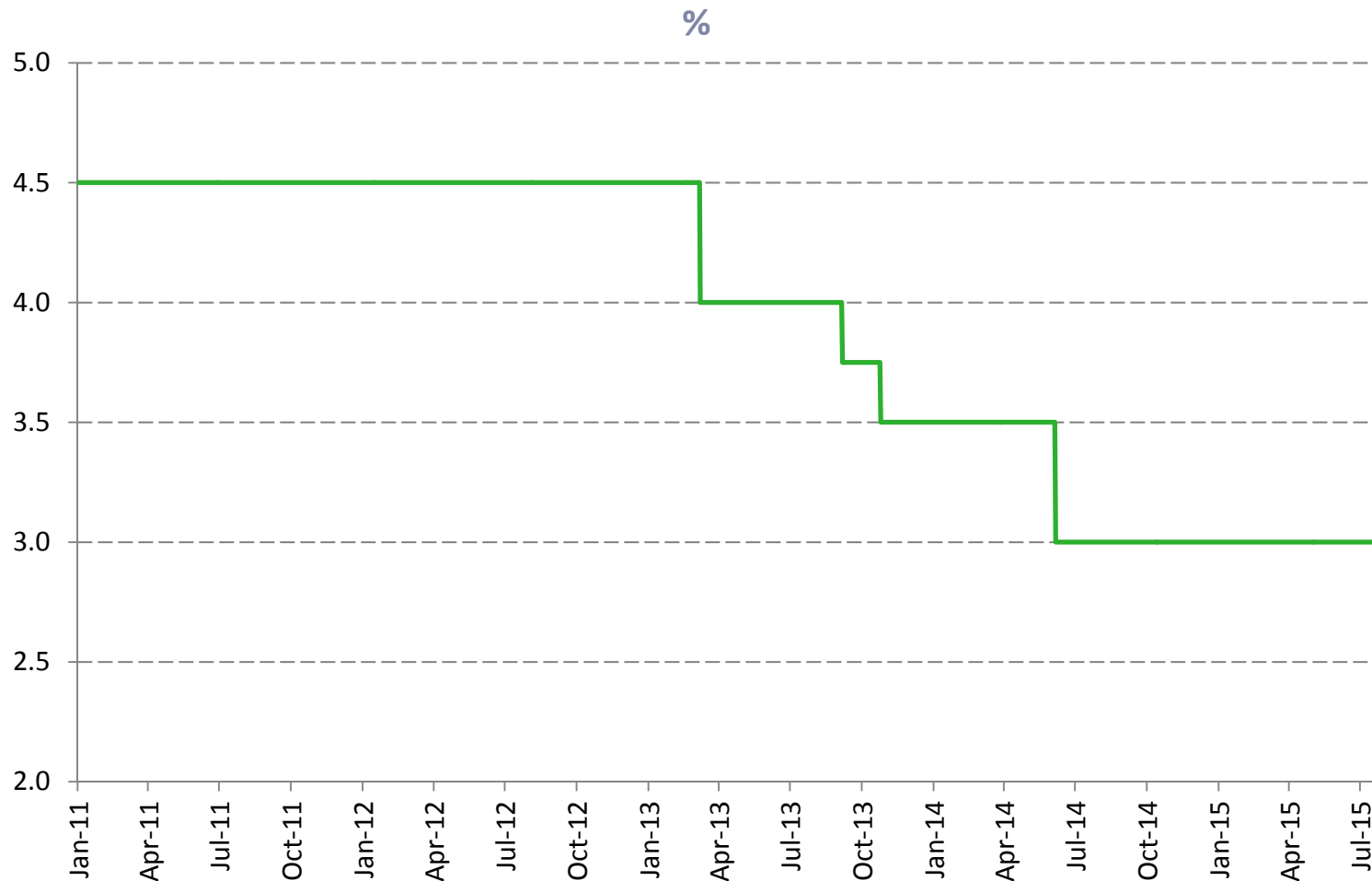
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# Monetary policy has been accommodative in the face of relatively weak economic activity

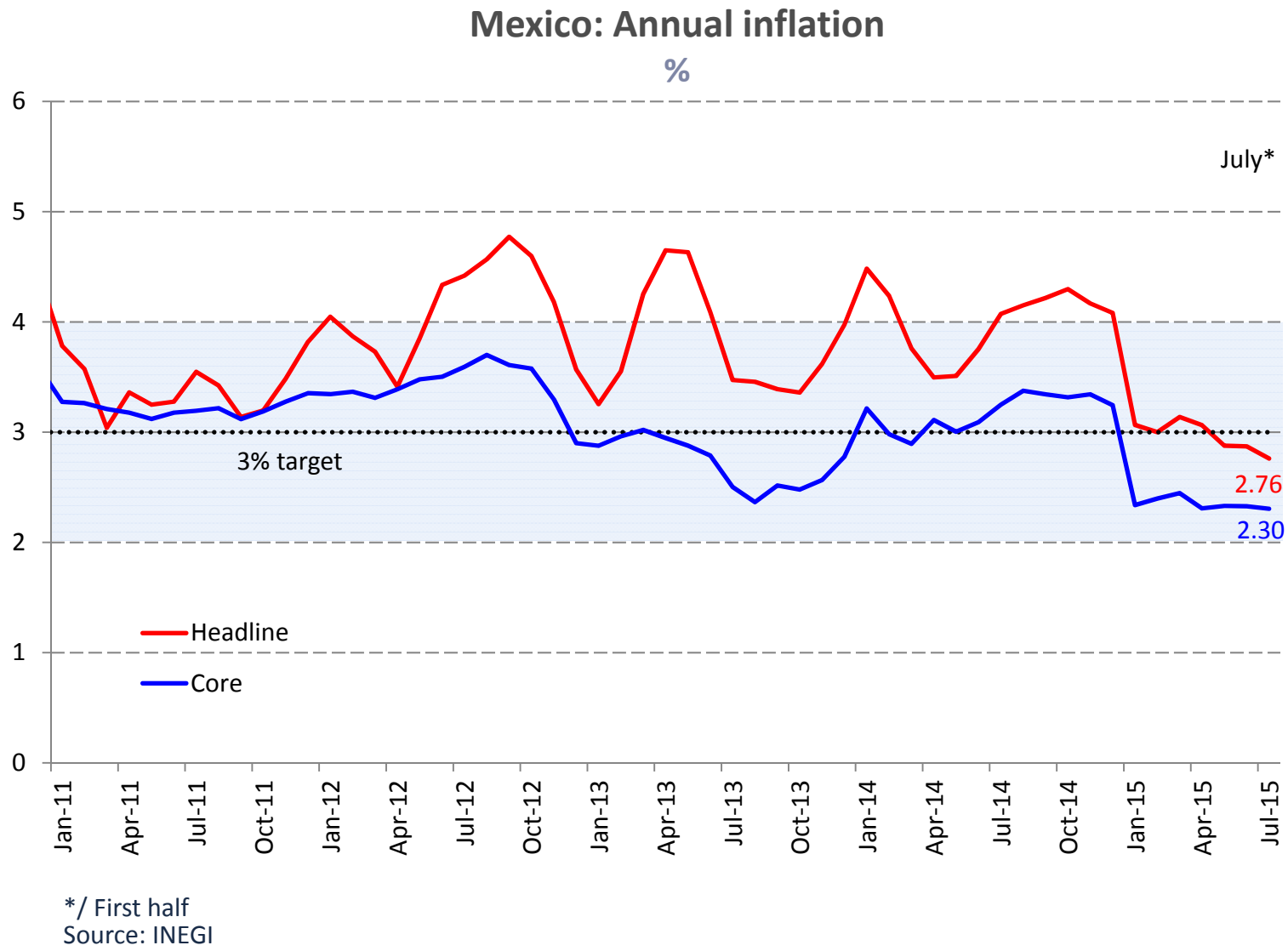
Mexico: Monetary policy target rate



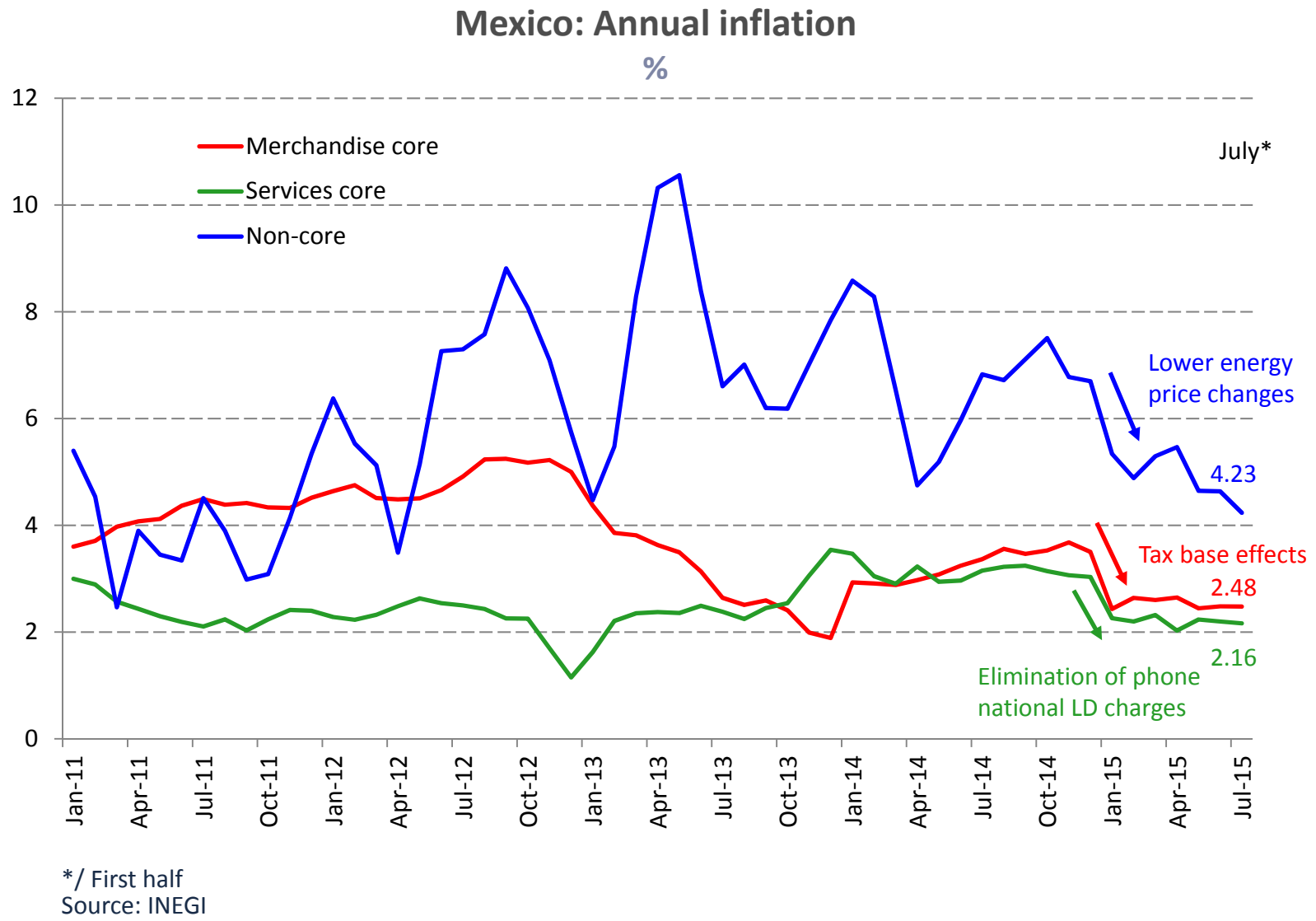
Source: Banco de México



# Annual inflation has remained on target throughout 2015

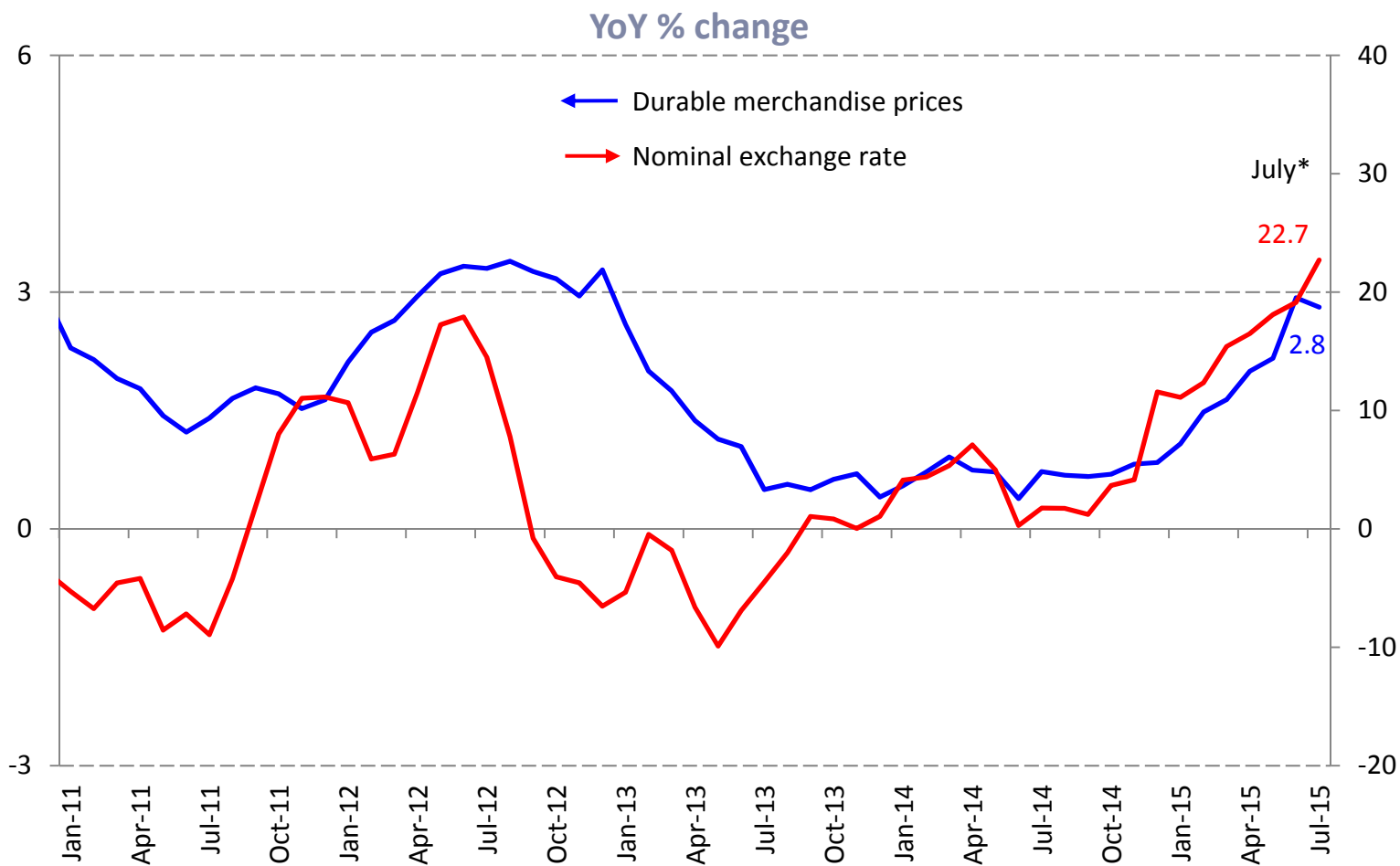


# Positive shocks have helped this performance



## Also, the pass-through from the continuous peso depreciation to prices has been limited

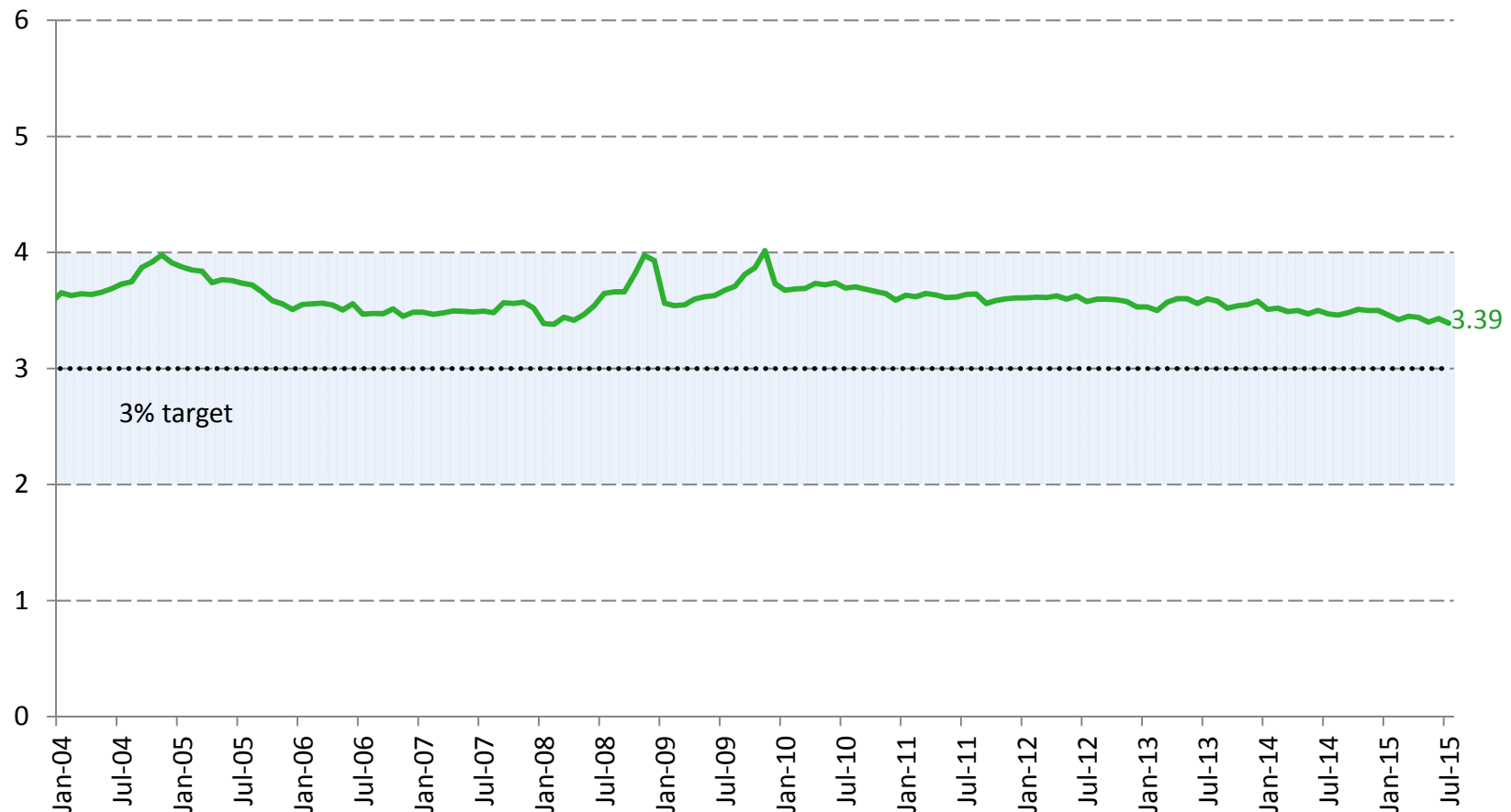
Mexico: Merchandise core prices and nominal exchange rate



\*/ First half for durable merchandise prices  
Source: INEGI

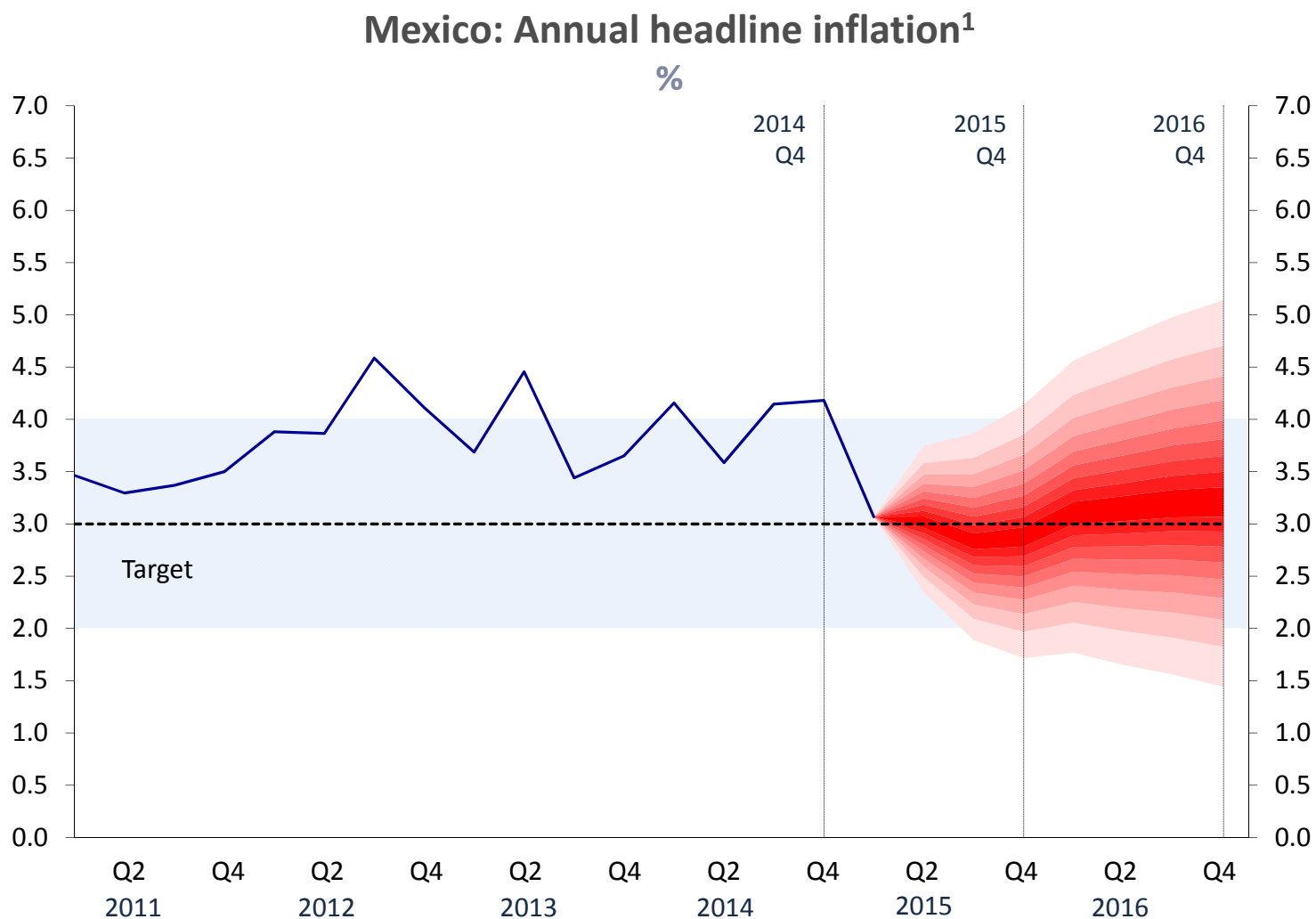
# Medium-term inflation expectations, as measured by surveys, have remained stable, although above target

Mexico: Inflation expectations for one to four years ahead  
Forecast average, %



Source: Banco de México, *Survey of private-sector economic analysts' expectations*

# The Bank of Mexico expects inflation to remain near the permanent target



1/ Quarterly average

Source: Banco de México (2015), *Quarterly Report, January - March 2015*, May

## Upside risks to the inflation outlook should be monitored, especially if second-round effects may emerge

- Positive shocks of 2015 may not recur in the coming years
- Agriculture price increases may revert to their higher historic average
- Given the uncertainty on Mexico's growth potential, economic recovery may bring about aggregate demand pressures
- A sharp depreciation of the peso continues to be an important risk for inflation

## Final remarks

- The recovery of the Mexican economy has been modest, and growth expectations have been adjusted downward
- Structural reforms should support the medium-term economic outlook, but they must be carefully implemented
- Expected near-term U.S. monetary policy normalization could always come with surprises
- Under this scenario, Mexico must strengthen its macroeconomic policy framework
- Monetary policy should ensure that convergence to the permanent inflation target consolidates



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