Mexico’s Monetary Policy and Economic Outlook
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United States-Mexico Chamber of Commerce, California Regional Chapter
Los Angeles, November 16th, 2018

* The opinions and views expressed in this document are the sole responsibility of the author and do not necessarily represent the institutional position of the Banco de México or of its Board of Governors as a whole.
The Mexican economy continues to be immersed in a situation of high uncertainty as a result of both external and domestic factors. Externally:

- The global economic recovery appears to have peaked, as recent downward revisions render growth projections stable over this year and the next.

- In addition, global activity has become less balanced and asynchronous, with growth trajectories diverging among individual economies and regions.

- Consistent with the above, global trade growth is expected to follow a moderate downward trajectory in coming years, to levels well below those recorded pre-crisis.
Moreover, the balance of risks for the outlook remains tilted to the downside, and seems to have deteriorated further in recent months.

- Environment of increased trade protectionism, highlighted by the ongoing tensions between China and the US.
- Potentially faster-than-expected normalization of monetary policy in the US and other advanced economies.
- Fears of a steeper-than-expected deceleration of the Chinese economy.
- Political and geopolitical difficulties in some systemically important economies at the regional or global level (e.g. Brexit, Italy budget).
- Highly volatile international financial markets, further stirred by the sharp adjustments in oil prices of recent.
- Persistent vulnerabilities in some emerging market economies, with some going through episodes of acute stress.
Some of the elements of uncertainty more specifically related to Mexico have improved recently:

- Conclusion of USMCA negotiations.
- The electoral process in Mexico.

At the same time, other sources of concern have emerged:

- Recent decisions and the orientation of public policy in Mexico in coming years.
- Implications of recent changes in the composition of the US Congress for the trade agreement with Mexico and Canada.
The Mexican economy has continued to show resilience to shocks and to this environment of uncertainty. However, economic growth remains relatively low.

**Gross Domestic Product**
- Annual % change, s.a.

**Source:** INEGI

**Gross Domestic Product**
- Index 1Q-2011=100, s.a.

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s.a./ Seasonally adjusted series.
Source: INEGI

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Mexico’s Monetary Policy and Economic Outlook

5
Economic activity continues to be supported by private consumption and exports.

**Private Consumption**
Index 2013 = 100, s.a.

- Aggregate Private Consumption
- Private Consumption in the Domestic Market
- Retail Sales

**Manufacturing Exports**
Index 2013 = 100, s.a.

- Total
- US
- Rest

s.a. / Seasonally adjusted series.
Source: INEGI
However, both the recent and the long-term evolution of investment are worrisome.

**Investment**

Index 2013 = 100, s.a.

- Total Aggregate Investment
- Public Aggregate Investment
- Private Aggregate Investment
- Gross Fixed Investment

**Investment Rate**

% of GDP

s.a. / Seasonally adjusted series.

Source: INEGI.
Estimates of the output gap around zero...

**Output Gap**

\% of potential GDP, s.a.

**Total**

- **GDP**
- **IGAE**

**Excluding the Oil Sector**

- **GDP Excluding Oil**
- **IGAE Excluding Oil**

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s.a./ Estimated with seasonally adjusted data.

1/ Estimated with preliminary data for 3Q-18 GDP and implicit IGAE for September 2018.

2/ It excludes oil and gas extraction, services related to mining and the manufacture of oil and coal products.

Source: Estimated by Banco de México with data from INEGI and Banco de México.
... are supported by a wide range of indicators.

Principal Component Analysis

Monthly Indicators

Quarterly Indicators

Note: Index constructed based on the Model Confidence Set (MCS) methodology. Blue lines correspond to the first principal components of sets that include 11 indicators at the monthly frequency and 12 indicators at the quarterly frequency. Gray lines correspond to the individual slack indicators.

Source: Banco de México with data from INEGI.
Conditions in the labor market remain tight...

Unemployment Rate
%
- Total
- Urban
- Underemployment

Labor Force Participation Rate
%
- Participation
- Average 2005-2018

s.a. / Seasonally adjusted series.
Source: INEGI.
... but no excessive wage pressures are observed.

### Average Wage of Salaried Workers\(^1\)/
#### Annual % change

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal</th>
<th>Real*</th>
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<tbody>
<tr>
<td>2008</td>
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</table>

Note: Data for 3Q-18 estimated by Banco de México based on INEGI’s preliminary estimate for GDP. s.a. / Seasonally adjusted series.

1/ Labor productivity based on worked hours.

Source: INEGI and Banco de México with data from INEGI.

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### Labor Productivity\(^{1/}\) and Unitary Labor Cost

<table>
<thead>
<tr>
<th>Year</th>
<th>Labor Productivity</th>
<th>Unitary Labor Cost</th>
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<tbody>
<tr>
<td>2006</td>
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Note: Data for 3Q-18 estimated by Banco de México based on INEGI’s preliminary estimate for GDP. s.a. / Seasonally adjusted series.

1/ Labor productivity based on worked hours.

Source: INEGI and Banco de México with data from INEGI.
GDP is expected to expand below potential during the next couple of years.

In addition, the balance of risks for these projections is tilted to the downside:

- External environment.
- First year of a new administration.
- Uncertainty derived from public policy.
- Ratification of USMCA with a new US Congress.
Inflation has remained high, mainly as a result of the evolution of its non-core component.
Consequently, inflation projections have been adjusted upwards.

**Banco de México’s CPI Inflation Forecast**

**Annual %**

**Headline**

<table>
<thead>
<tr>
<th></th>
<th>November 2017</th>
<th>February 2018</th>
<th>May 2018</th>
<th>August 2018</th>
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<tbody>
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<td>2018</td>
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**Core**

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<tr>
<th></th>
<th>November 2017</th>
<th>February 2018</th>
<th>May 2018</th>
<th>August 2018</th>
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</thead>
<tbody>
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</tbody>
</table>

Source: Banco de México.
At present, inflation runs above the most recent Banco de México’s projections.
Inflation expectations for this year and the next have increased as a result of a combination of factors.

### Inflation Expectations

<table>
<thead>
<tr>
<th>Annual %</th>
<th>Source: Citibanamex</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.0</td>
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<td>3.2</td>
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<td>3.4</td>
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<td>3.6</td>
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<td>3.8</td>
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<td>4.4</td>
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<td>4.6</td>
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<td>4.8</td>
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</tbody>
</table>

- **Dec-17**
- **Jan-18**
- **Feb-18**
- **Mar-18**
- **Apr-18**
- **May-18**
- **Jun-18**
- **Jul-18**
- **Aug-18**
- **Sep-18**
- **Oct-18**
- **Nov-18**

Source: Citibanamex.
Long-term inflation expectations based on surveys have remained stable, but inflation breakevens have increased sharply.

**Long-Term Inflation Expectations**

<table>
<thead>
<tr>
<th>Year</th>
<th>Inflation Expectations for the Next 2-6 Years</th>
<th>Permanent Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>3.0%</td>
<td>3.0%</td>
</tr>
<tr>
<td>2015</td>
<td>2.8%</td>
<td>3.0%</td>
</tr>
<tr>
<td>2016</td>
<td>3.0%</td>
<td>3.0%</td>
</tr>
<tr>
<td>2017</td>
<td>3.2%</td>
<td>3.0%</td>
</tr>
<tr>
<td>2018</td>
<td>3.5%</td>
<td>3.0%</td>
</tr>
</tbody>
</table>

**Inflation Breakevens**

<table>
<thead>
<tr>
<th>Year</th>
<th>3 Years</th>
<th>10 Years</th>
<th>30 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>2.5</td>
<td>2.8</td>
<td>3.0</td>
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<tr>
<td>2015</td>
<td>2.8</td>
<td>3.0</td>
<td>3.2</td>
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<tr>
<td>2016</td>
<td>3.0</td>
<td>3.2</td>
<td>3.5</td>
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<tr>
<td>2017</td>
<td>3.2</td>
<td>3.5</td>
<td>3.8</td>
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<tr>
<td>2018</td>
<td>3.5</td>
<td>3.8</td>
<td>4.0</td>
</tr>
</tbody>
</table>

**Source:** Banco de México and Citibanamex.

1/ Difference between yields on nominal and real (inflation-protected) bonds. In addition to expected inflation, this measure includes other (e.g., inflationary, liquidity and term) risk premia.

**Source:** Banco de México with data from PiP.
The balance of risks for inflation remains biased to the upside and has deteriorated. The main risk factors include:

- The evolution of the exchange rate in the current context of uncertainty.
- The possibility of additional shocks from energy or other components of non-core inflation.
- Wage pressures resulting from either tight conditions in the labor market or increases in the minimum wage inconsistent with the evolution of productivity.
The exchange rate has shown a considerable depreciation in recent weeks, while indicators of the economy’s credit risk have deteriorated.

**USD/MXN Exchange Rate and Market Indicators of Domestic Sovereign Credit Risk**

1/ This refers to 5-year Credit Default Swaps.

Note: Vertical lines on the dates of the following recent events: Moody’s communiqué (18-October), cancelation of the NAIM (28-October), HR Ratings communiqué (30-October), Fitch communiqué (31-October) and bank commissions initiative (8-November).

Source: Banco de México and Bloomberg.
Exchange rate expectations for the end of this year and the next have moved upwards.

USD/MXN Exchange Rate Expectations
Pesos per dollar

Source: Citibanamex.
At the same time, domestic interest rates have increased sharply... and the stock exchange has declined.

Note: Vertical lines on the dates of the following recent events: Moody’s communiqué (18-October), cancelation of the NAIM (28-October), HR Ratings communiqué (30-October), Fitch communiqué (31-October) and bank commissions initiative (8-November).

Source: Bloomberg.
The predominance of domestic factors in the recent behavior of financial markets in Mexico is evident when considering the evolution of these variables in other EMEs.

**Exchange Rate**
Index 17-Oct-2018=100

**Emerging Economies**

**Market Indicators of Domestic Sovereign Credit Risk**
Index 17-Oct-2018=100

1/ This refers to 5-year Credit Default Swaps. Source: Bloomberg.
Emerging Economies

Nominal Interest Rates
Change in basis points since 17-Oct-2018

- Mexico: -120
- Brazil
- Russia
- Poland
- Chile
- Colombia
- Hungary
- Malaysia
- Thailand
- Peru
- South Africa
- Indonesia
- India

Note: 30-year nominal interest rate. Source: Bloomberg.

Stock Market
% change since 17-Oct-2018

- Mexico: -120
- Colombia
- Russia
- Peru
- Turkey
- Brazil
- Korea
- South Africa
- Chile
- Malaysia
- Thailand
- Poland
- Hungary
- Russia
- Brazil
- Turkey
- Peru
- Mexico
- Indonesia
- India

Note: USD-denominated valuations. Source: Bloomberg.
Notwithstanding the magnitude of the adjustment in domestic financial markets, declines in government bond holdings by non-residents remain moderate relative to previous episodes.

Accumulated government securities' flows after economic events
% of the securities held by non-residents

Source: Banco de México with Indeval data.
Concern among rating agencies reflects a combination of factors.

<table>
<thead>
<tr>
<th>Action</th>
<th>Comment on incoming Mexican government’s plan to abolish oil exports</th>
<th>Rating Outlook on Sovereign Debt Revised to Negative from Stable</th>
</tr>
</thead>
</table>
| **Highlighted Issues** | • Pemex's operating cash flow would decline and become more volatile as activities focus on refining  
  • Pemex's credit quality would weaken depending on how much crude it needs to import for refining activities  
  • The loss of oil revenue from Pemex could substantially widen Mexico's fiscal deficit  
  | • Investor confidence eroded after the new Mexico City airport project was cancelled  
  • In this outcome, the basis for the decision (i.e. via public consultation) played a significant role  
  • Deterioration of public finances as a result of cancellation of airport project, exchange rate depreciation and higher long-term interest rates deriving from heightened country risk and diminished confidence  
  • Eroded confidence and credibility in contract fulfillment would dent investment, both domestic and foreign, and hence economic growth  
  | Deteriorating balance of risks associated with policy uncertainty, especially in regards the fiscal stance, under the incoming administration:  
  • Continuation of previously approved reforms, e.g. in the energy sector, could stall  
  • Contingent liabilities for the sovereign from Pemex can increase in part as a result of proposals for large capital investments (i.e. new refining capacity to substitute for gasoline imports)  
  • Negative signal to investors from the decision to cancel the construction of a new Mexico City airport  
  • Other policy proposals might result in lower investment and growth than currently expected  

Moody’s October 18th  
HR Ratings October 30th  
Fitch October 31st
All in all, monetary policy in Mexico faces currently a complex juncture, in an environment characterized by:

- Inflation (both headline and core) running above the Central Bank’s forecasts.
- A persistently high core inflation rate.
- New shocks on prices deriving from exchange rate depreciation.
- A balance of risks for inflation tilted to the upside, which has deteriorated recently.
- Increased risks of second-round effects.
- Additional difficulties in achieving the inflation target over the forecast horizon.
In this context, the Banco de México’s Board decided on November 15th to increase the reference interest rate by 25 basis points to a level of 8 percent.

Since late 2015, the Board has increased the monetary policy rate by a total of 500 basis points.

The Board is committed to adjust monetary policy timely to achieve convergence to the target.

In view of the risks for inflation envisaged, additional increases in the policy rate may be needed, even in the short term.
The Mexican economy continues to be immersed in a situation of high uncertainty.

- The favorable effects from the conclusion of both the USMCA negotiation and the electoral process have been offset by a combination of factors.
- Heightened tensions originating abroad have not been accompanied by domestic efforts leading to an environment of improved certainty.
- It is of the utmost importance to keep in mind that, in the absence of decisive policy measures aimed at enhancing market confidence, the risks are substantial.
- Given the openness of Mexico’s economy to capital flows, the margin for error is overly narrow, as market responses are instantaneous and the potential consequences tend to be considerable and long-lasting.
In addition, notwithstanding some recent improvement, Mexico’s competitiveness needs to be further enhanced.

Source: The Global Competitiveness Index Dataset, World Economic Forum.
Further to macroeconomic and financial stability, confidence on the economy must be built on the basis of solid foundations, including:

- A careful and adequate planning and execution of public expenditure.
- Structural measures aimed at increasing productivity.
- Decisive actions to fight insecurity and corruption.
- An environment of respect for the rule of law, clear and enforceable “rules of the game”, and in general a strong institutional framework that stimulates and supports private investment.

Only through sustained efforts in these fronts will the economy be able to raise its growth potential.

It is important to note that, at present, maximum rates of economic growth in Mexico consistent with macroeconomic stability are modest and might even be in decline.