



Mexico's Monetary Policy: Outlook and Challenges

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4th BBVA Latin American Local Markets Conference

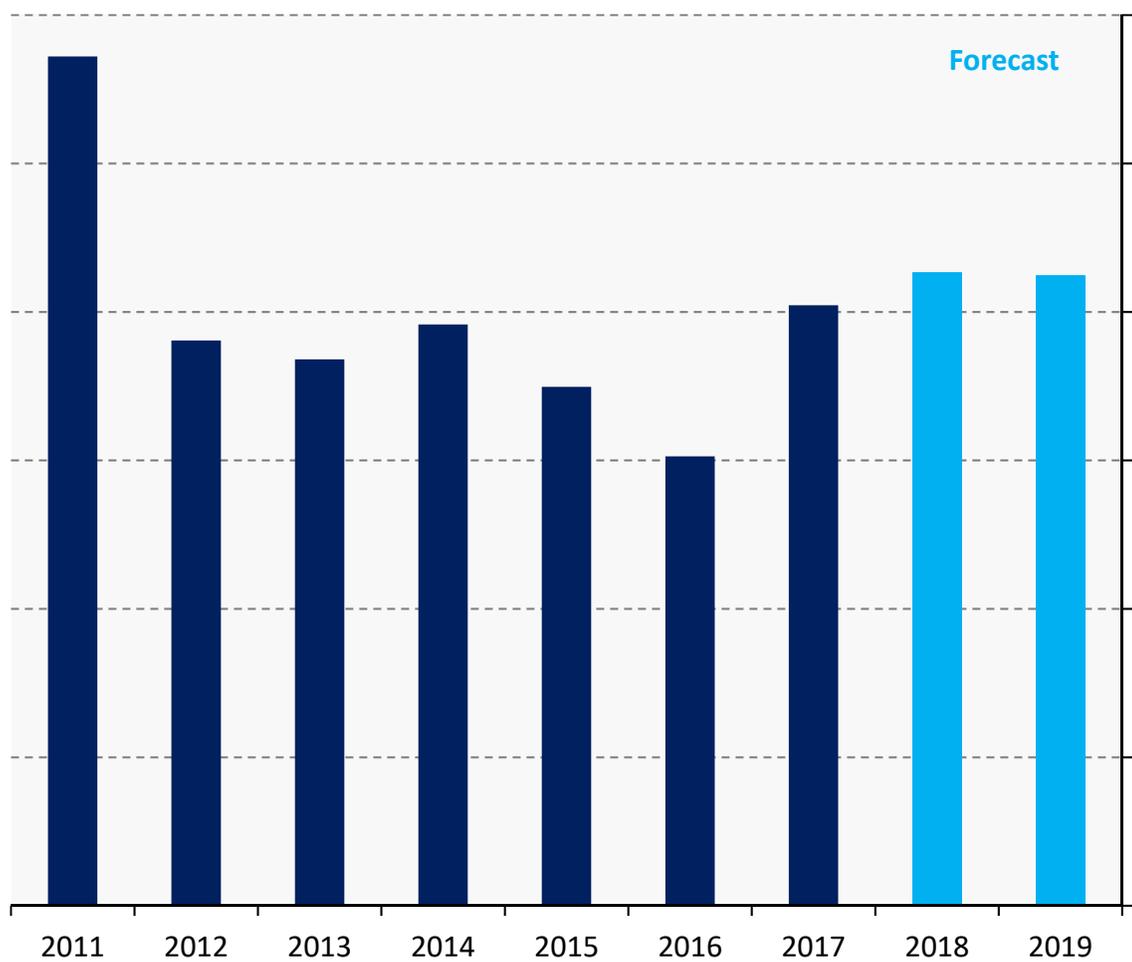
London, 15 January 2018



BANCO DE MÉXICO

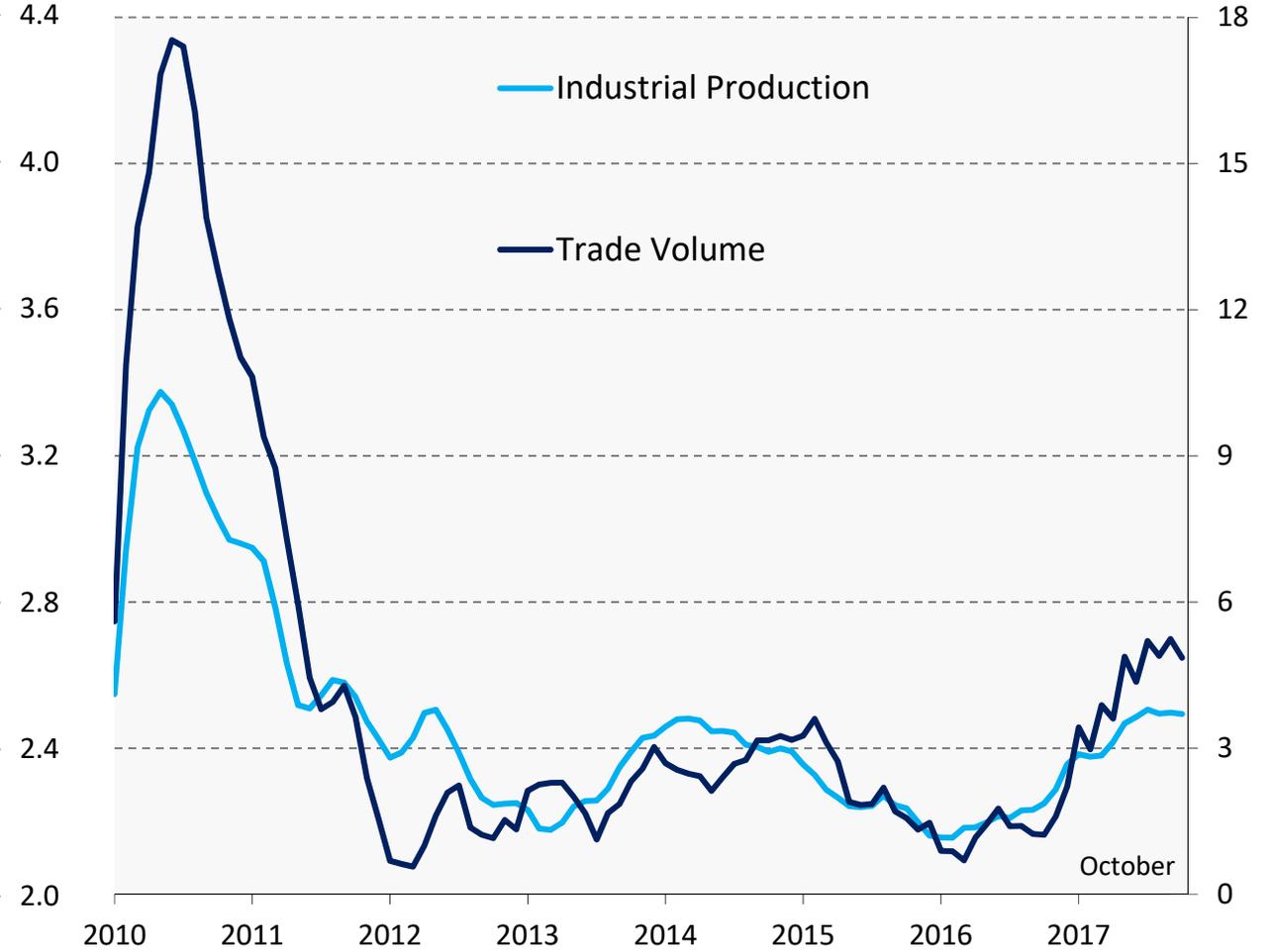
The global economy is estimated to have expanded in 2017 at its fastest pace in 6 years, and a further, albeit moderate, strengthening is expected for 2018-19.

World Gross Domestic Product
Annual % change



Source: IMF (World Economic Outlook, October 2017).

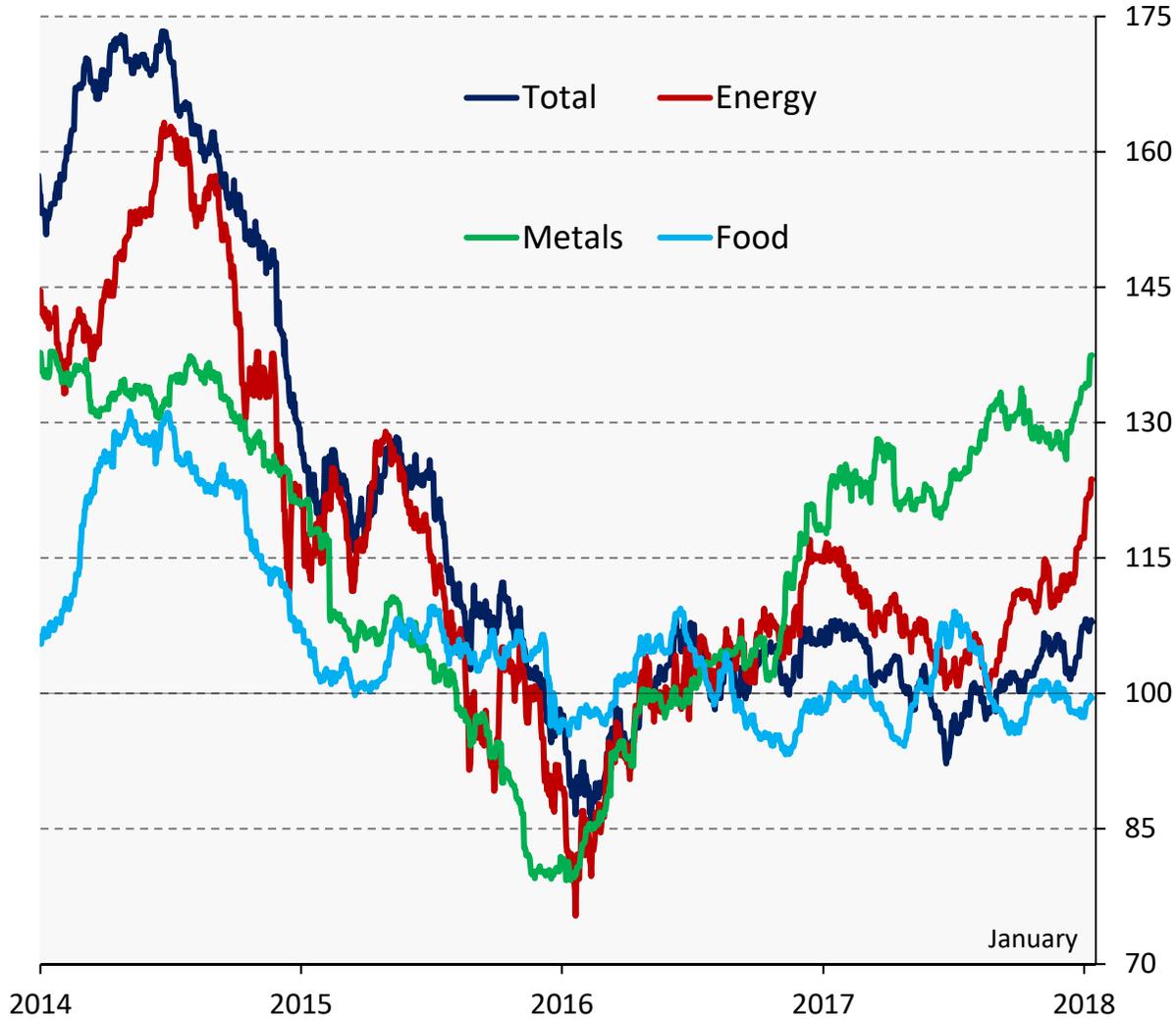
World Trade Volume and Industrial Production
Annual % change of the 3-month moving average, s.a.



s.a. / Seasonally adjusted series.
Source: CPB Netherlands.

In addition, commodity prices, including oil, have recovered.

Commodity Prices^{1/}
Index 2016 = 100



^{1/} It refers to the Thomson Reuters Commodity Index.
Source: Bloomberg.

Mexican Crude Oil Basket
US dollars per barrel



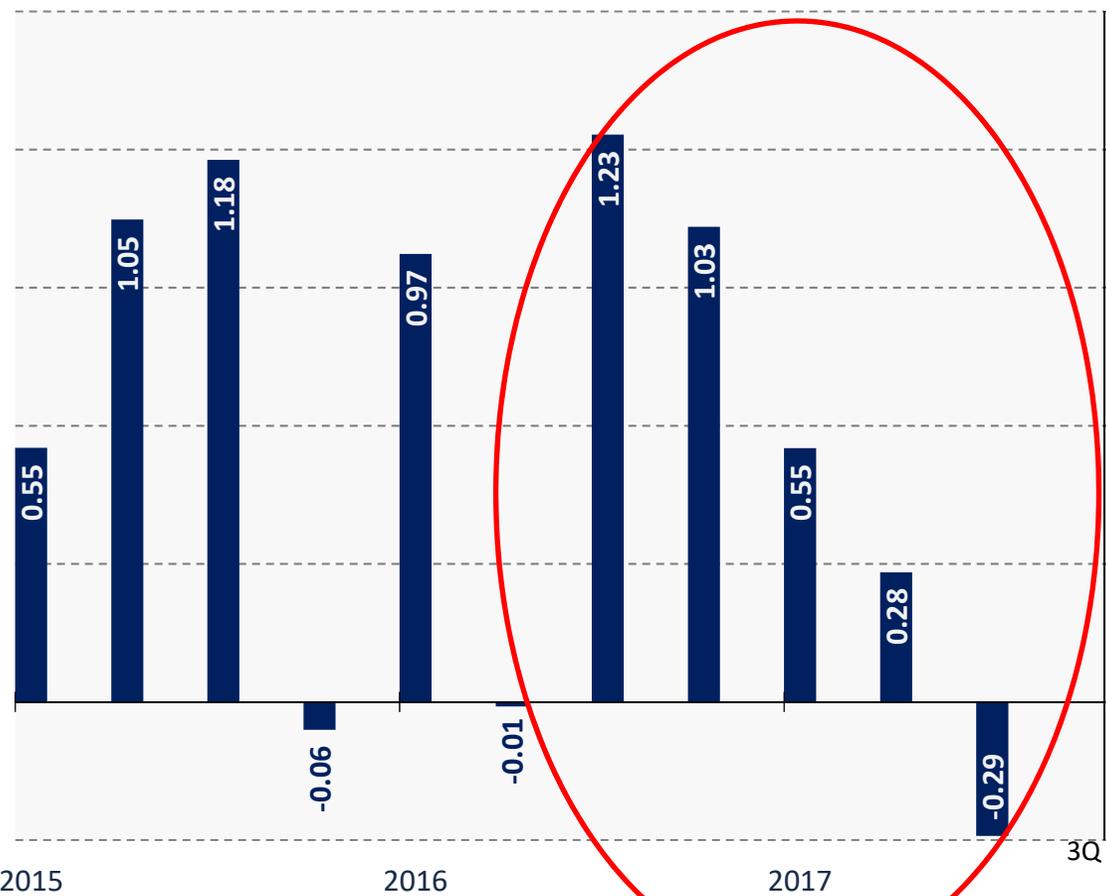
Source: Bloomberg.

- However, the outlook continues to display important downside risks:
 - Possibility of surprises in the normalization of monetary policy in some advanced economies, particularly in the United States.
 - Risks derived from the fiscal reform in that country.
 - The potential implications of a further turn towards protectionism.
 - Possible overvaluation of financial assets in several advanced and emerging market economies.
 - Swings in global investor sentiment that may tighten external financial conditions faced by emerging market economies.
 - Persistent geopolitical tensions and difficulties of a political nature in some countries and regions.

The Mexican economy continues to record moderate although weakening rates of growth.

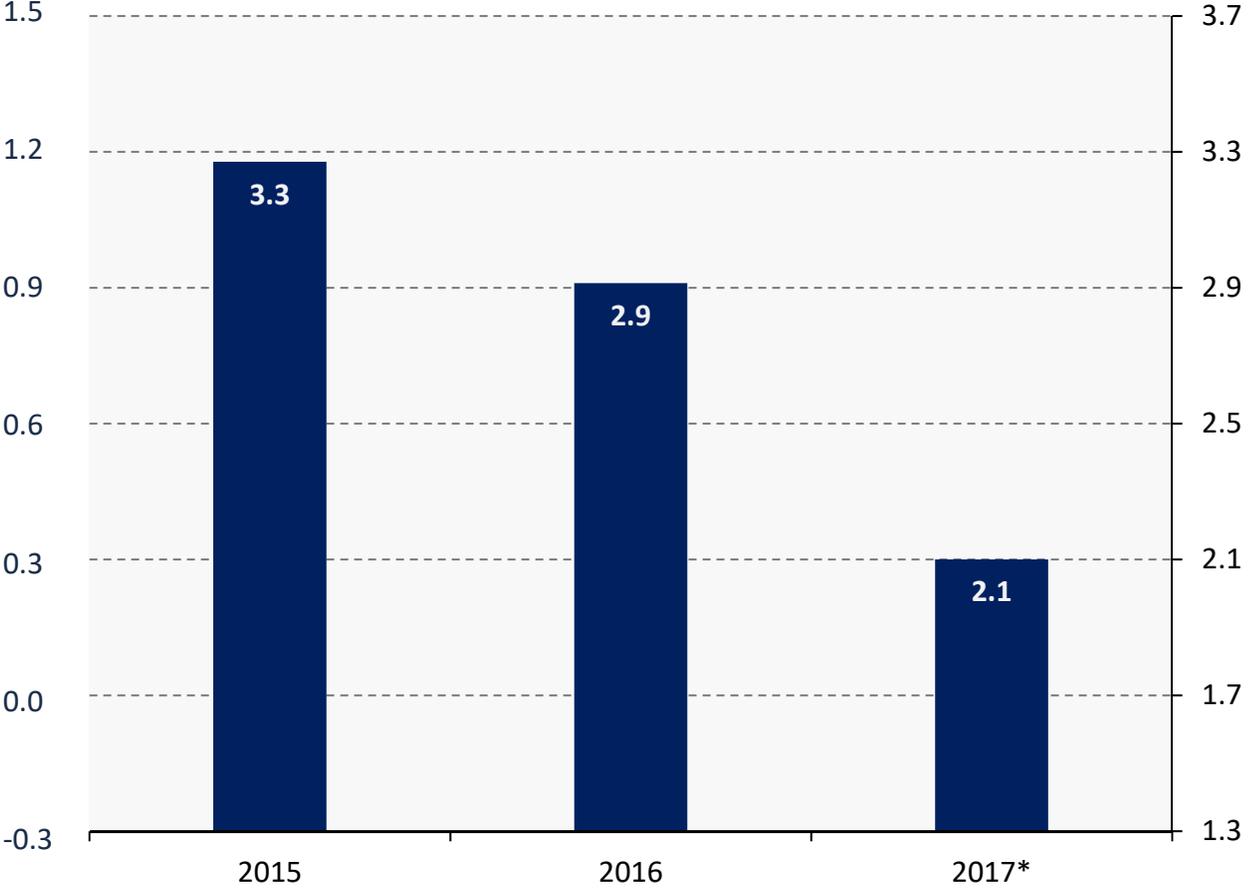
Gross Domestic Product

Quarterly % change, s.a.



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

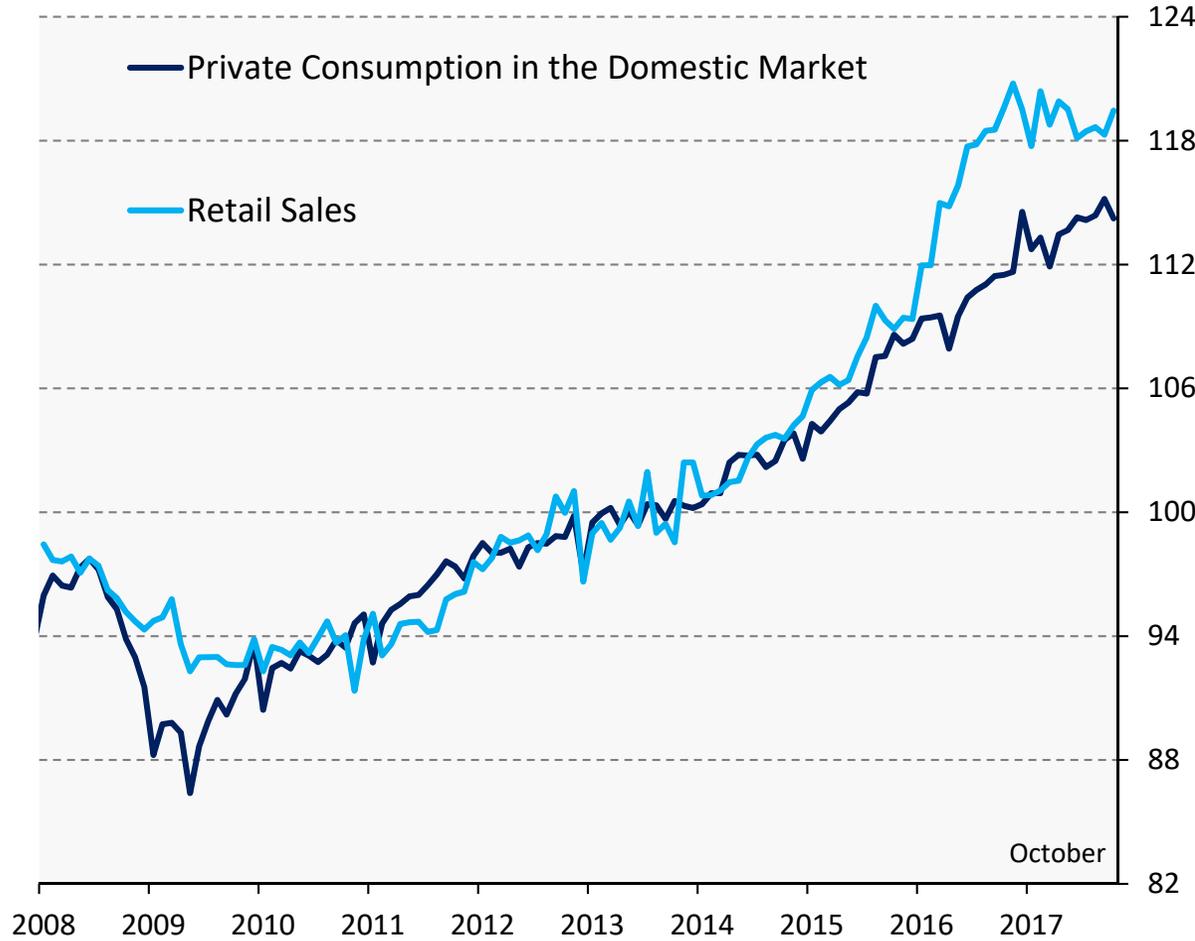
Annual % change



* / Expected.
Source: INEGI and Citibanamex.

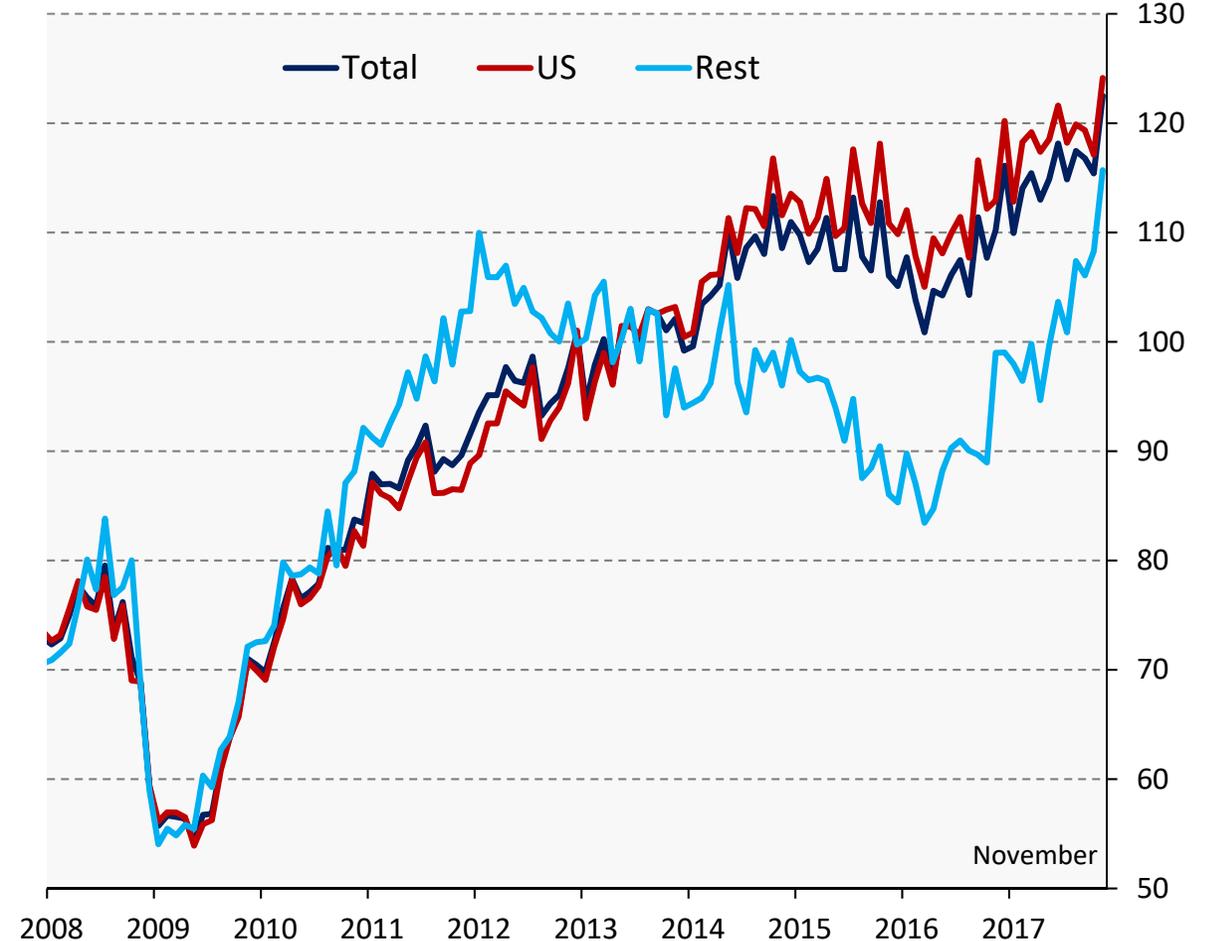
Aggregate demand is still supported by domestic consumption and exports, although some signs of deceleration are observed.

Private Consumption
Index 2013 = 100, s.a.



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

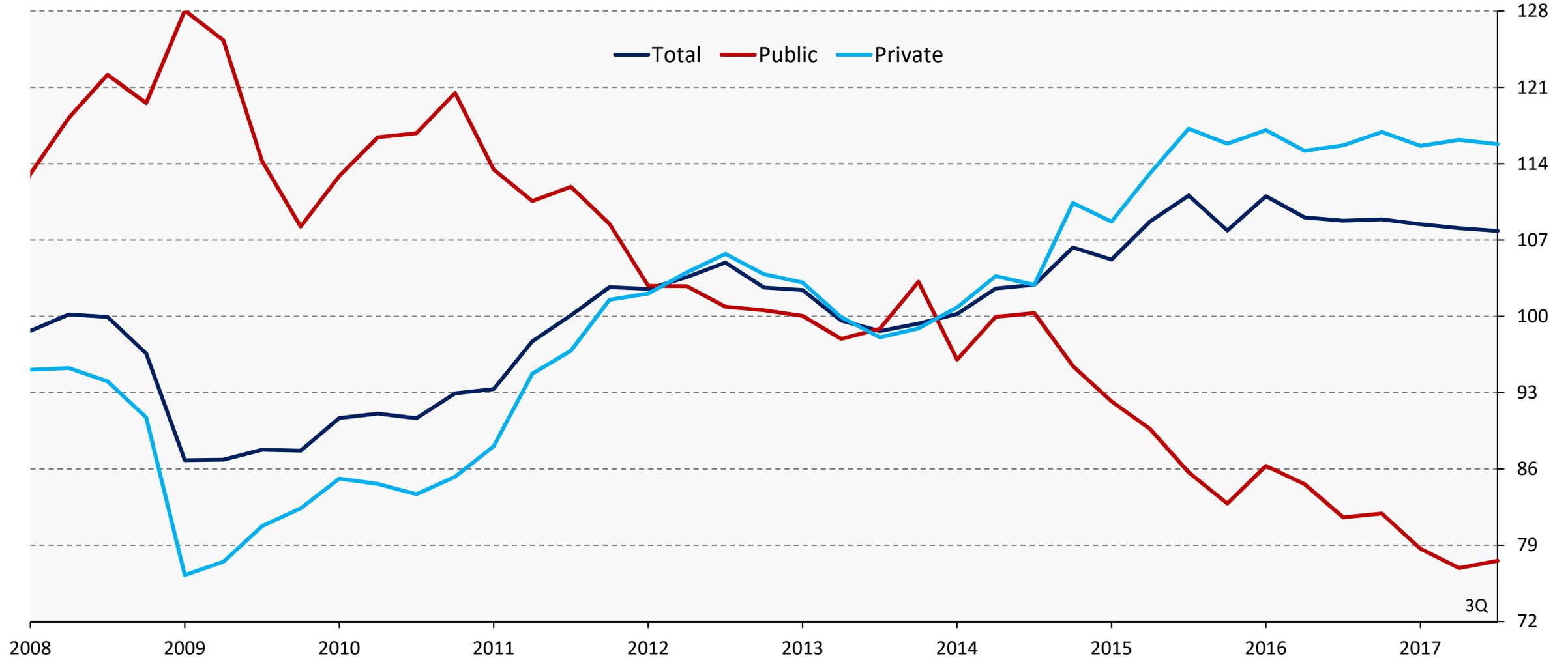
Manufacturing Exports
Index 2013 = 100, s.a.



s.a. / Seasonally adjusted series.
Source: Banco de México, INEGI, SAT and SE.

On the other hand, investment remains weak.

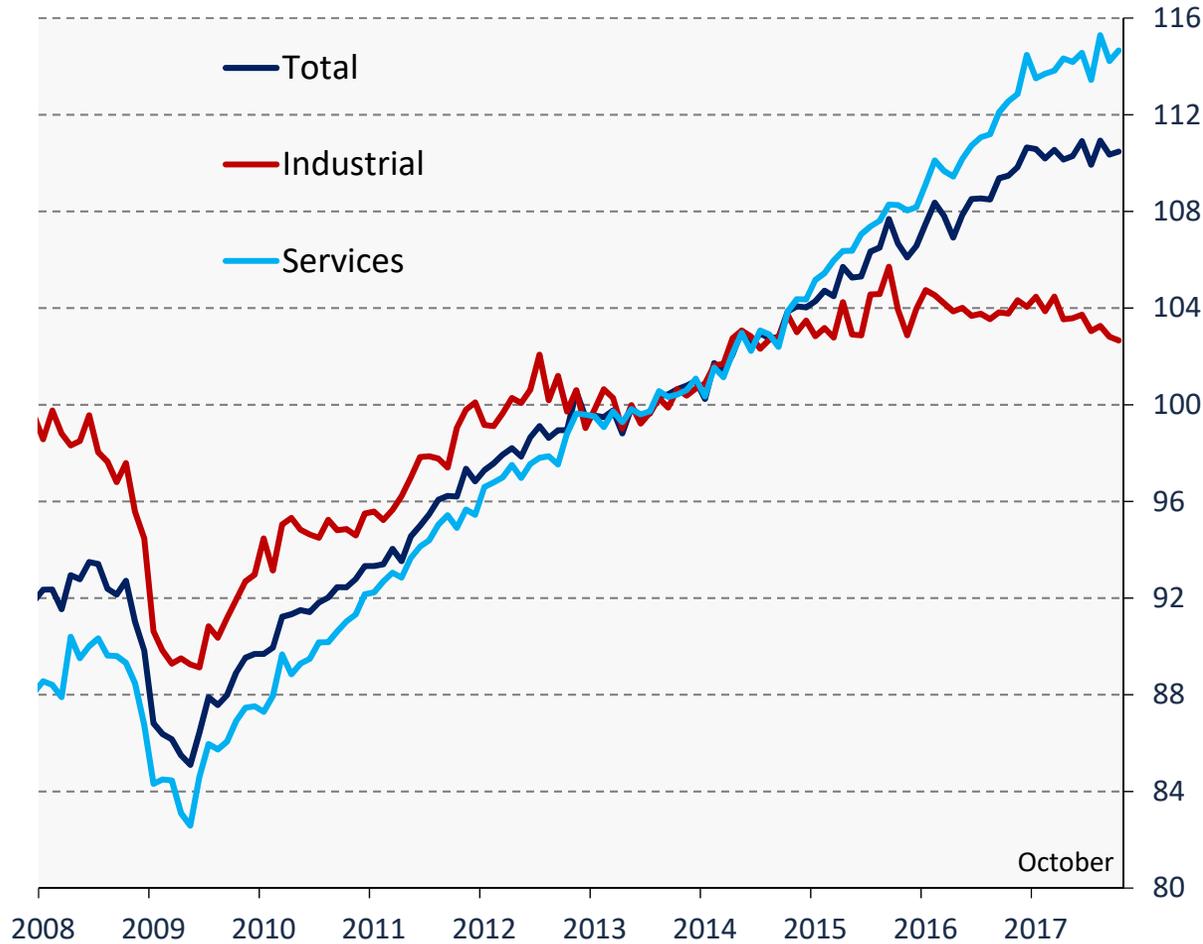
Gross Fixed Investment
Index 2013 = 100, s.a.



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

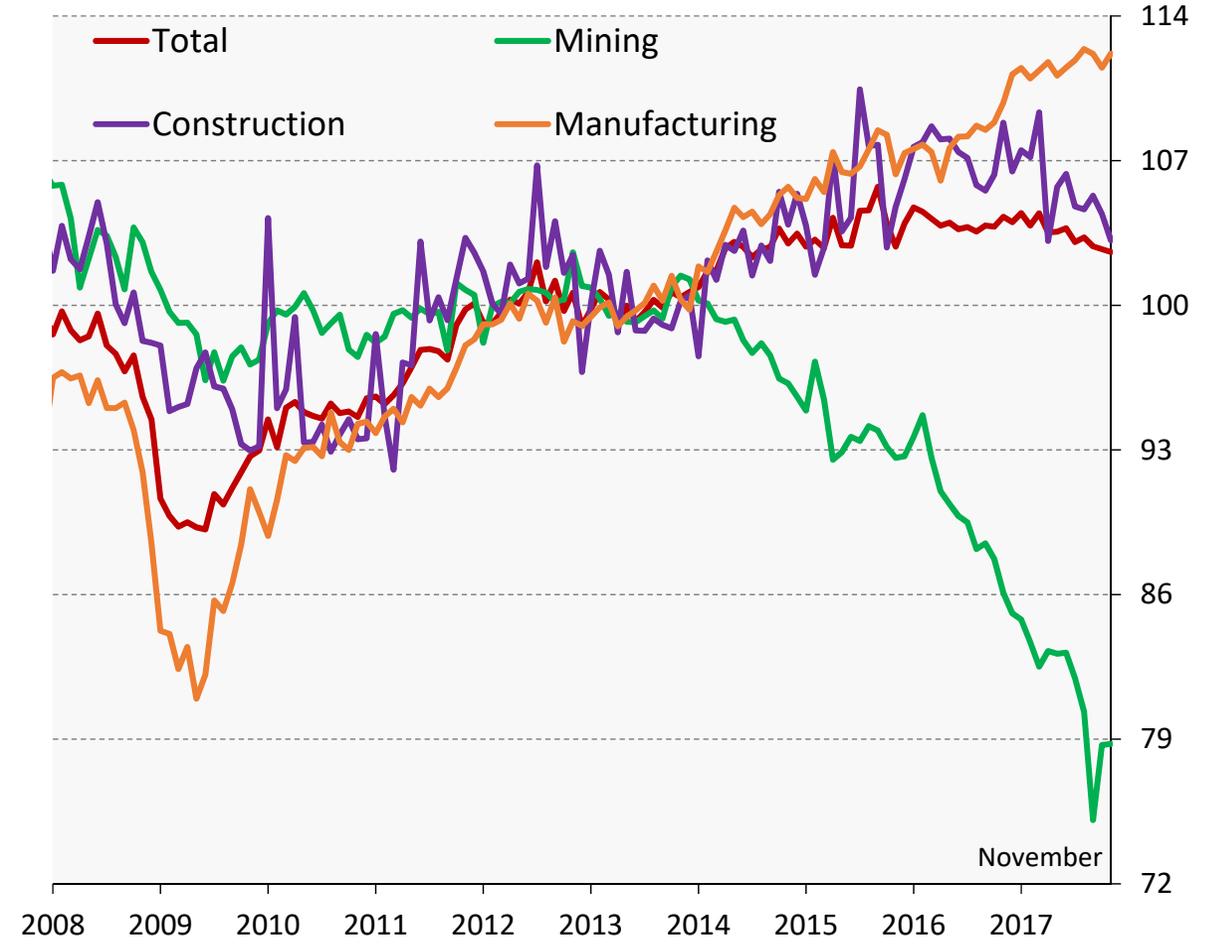
On the supply side, the favorable performance of the services sector is partly countered by the contraction of industrial activity.

Global Economic Activity
Index 2013 = 100, s.a.



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

Industrial Production
Index 2013 = 100, s.a.



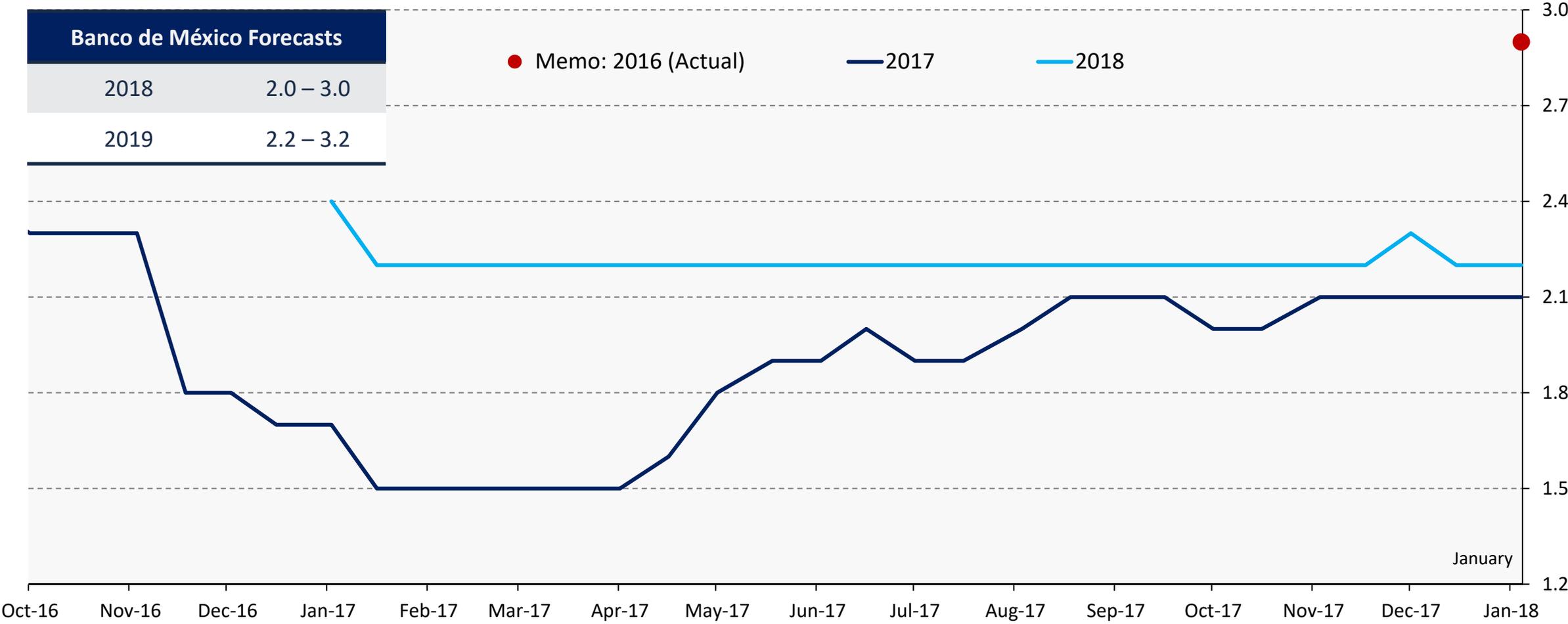
s.a. / Seasonally adjusted series.
Source: INEGI.

Economic activity is estimated to have decelerated in 2017, although less than initially anticipated, while a gradual uplift is expected for this and next year.

Real GDP Growth Expectations
Annual %

Banco de México Forecasts	
2018	2.0 – 3.0
2019	2.2 – 3.2

● Memo: 2016 (Actual) — 2017 — 2018

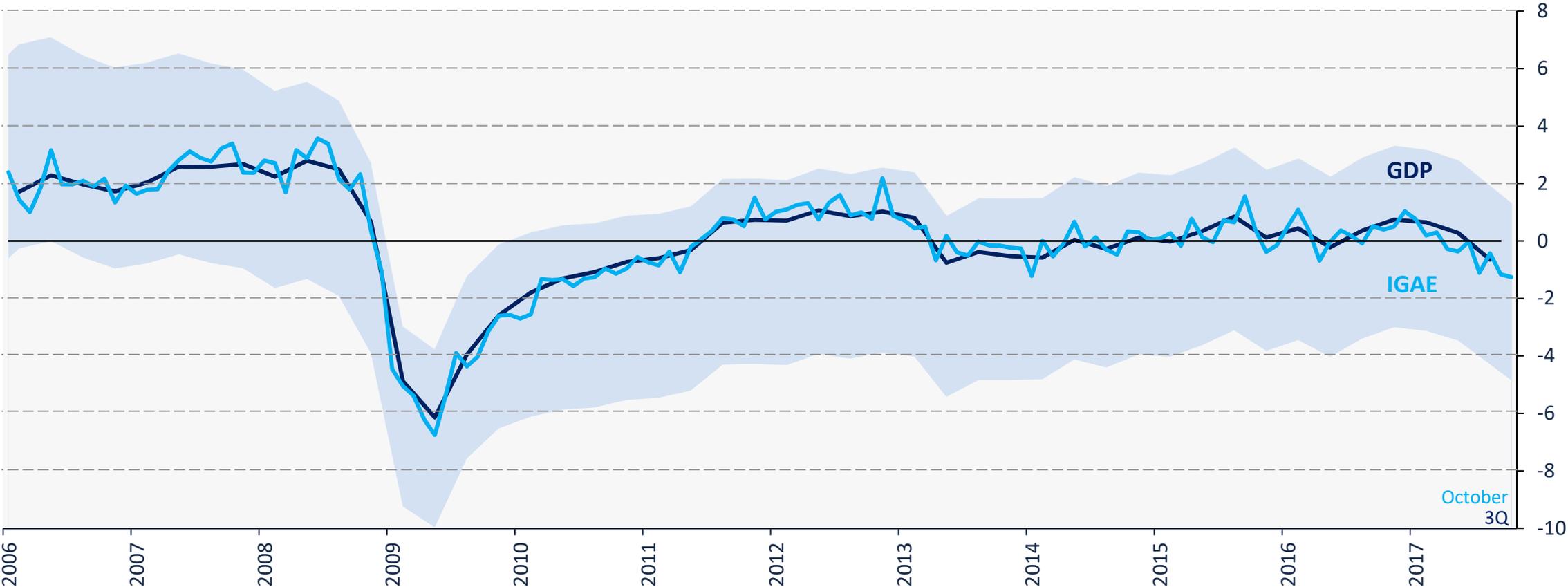


Source: Banco de México and Citibanamex.

- The balance of risks for Banco de México's growth projections for 2018 is tilted to the downside:
 - Uncertainty related to NAFTA, or adverse outcomes in the ongoing renegotiation, may affect the trajectory of investment.
 - Overall domestic demand may be further affected by concerns about this year's electoral process.
 - Notwithstanding the generally favorable expected evolution of the global economy, potential bouts of volatility in international financial markets cannot be ruled out as a result, among others, of:
 - ✓ Normalization of monetary policy in the United States.
 - ✓ Potential effects of fiscal stimulus in that country.
 - ✓ Events of a political or geopolitical nature.

Current estimates point to the absence of demand pressures on prices, a situation that is anticipated to persist during the period of influence of monetary policy.

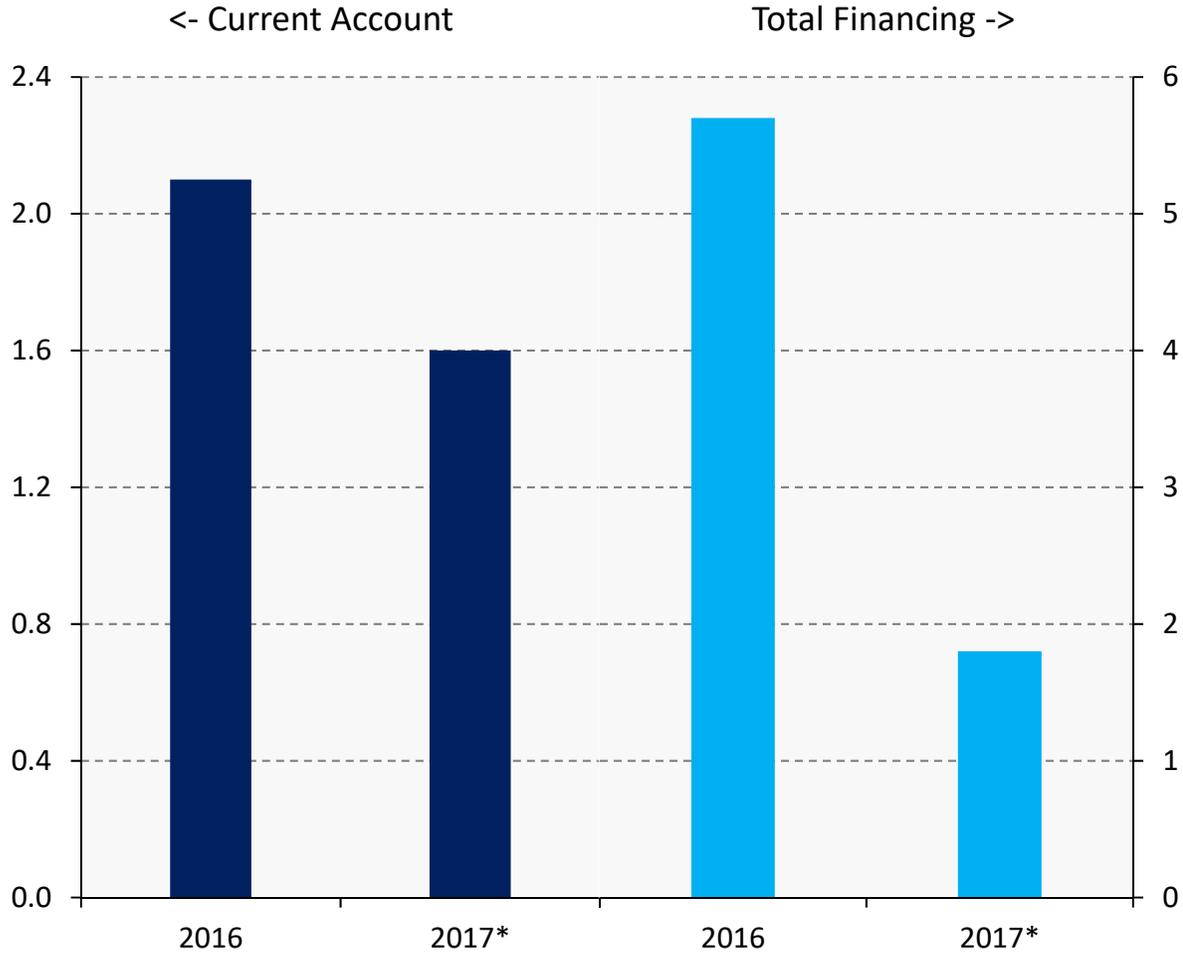
Output Gap
% of potential, s.a.



Note: The shaded area corresponds to the confidence interval.
s.a. / Seasonally adjusted series.
Source: Banco de México.

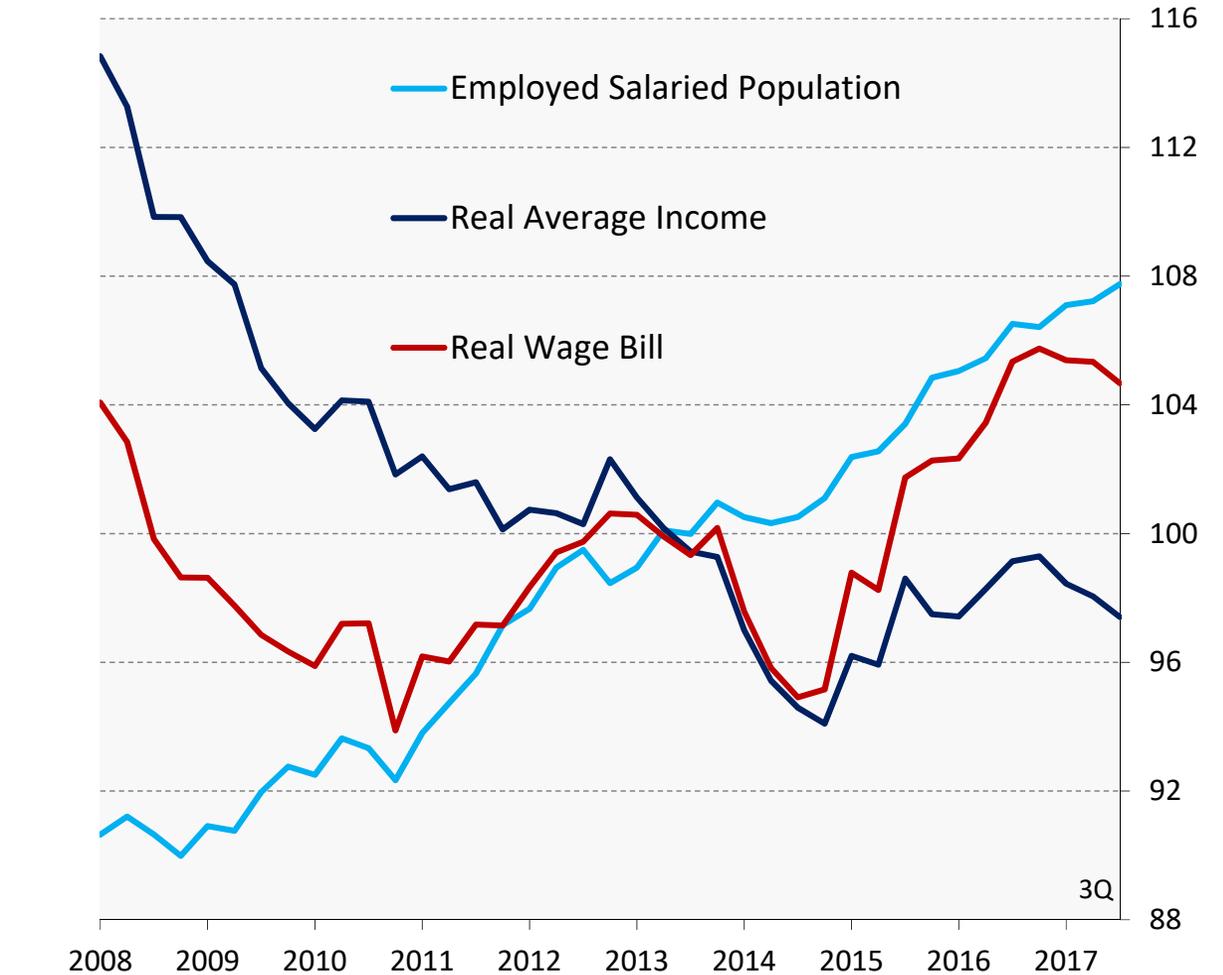
Other indicators also suggest this is case at present.

Current Account and Total Financing to the Non-Financial Private Sector
% of GDP and annual % change



*/ Data through the third quarter.
Source: Banco de México and INEGI.

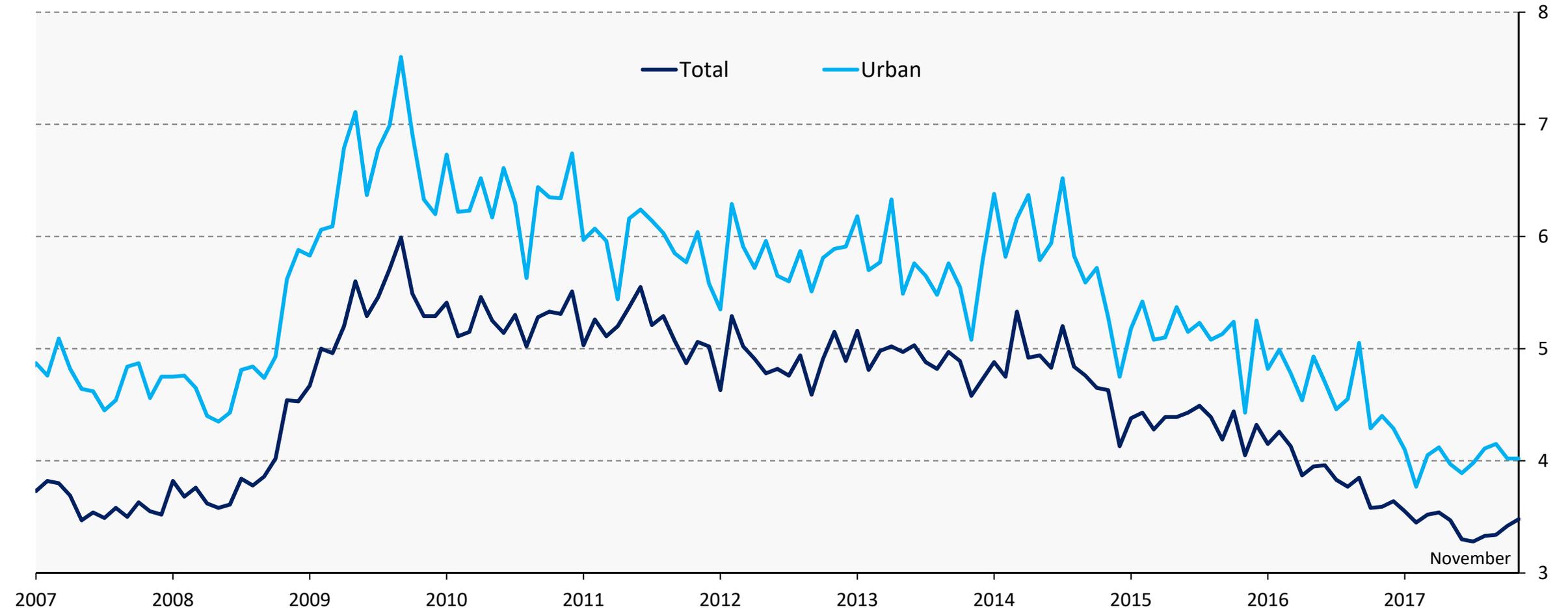
Real Total Wage Bill
Index 2013 = 100, s.a.



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

However, in light of the marked decline in labor market slack, it will be important to continue monitoring carefully the evolution of aggregate demand.

Unemployment Rate
%, s.a.



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

Headline inflation has been running above expectations as a result of the behavior of its core and non-core components, although with a stronger impact from the latter.

CPI Inflation and Contributions

Annual %, %-points and %

	December 2016	December 2017	Difference
Headline CPI (annual %)	3.36	6.77	+3.41
			<u>Contributions (%):</u>
Core	3.44	4.87	31.7
Merchandise	4.05	6.17	21.8
Services	2.92	3.76	9.9
Non-Core	3.13	12.62	68.3
Agricultural	4.15	9.75	15.7
Energy and Others	2.49	14.44	52.6

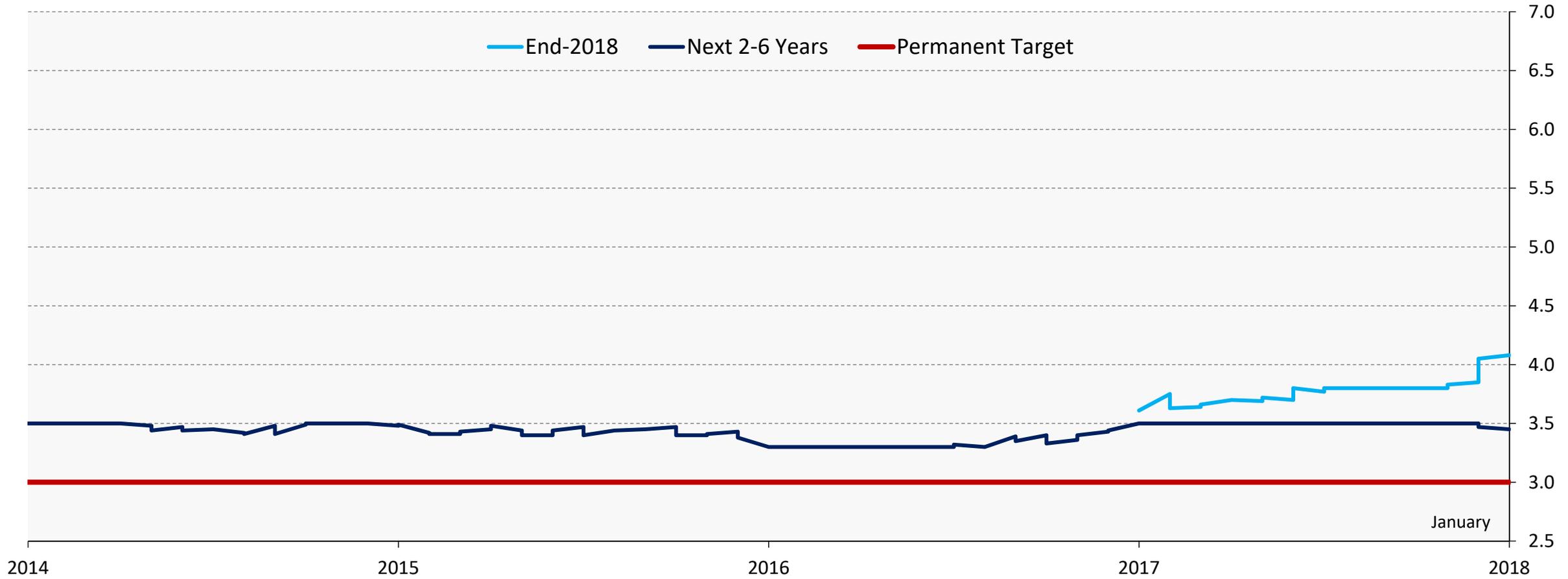
Source: INEGI.

□ Inflationary pressures have resulted from:

- Depreciation of the peso.
- Higher energy prices.
- Minimum wage adjustments.
- Base effects on telecom prices.
- Increases in agricultural prices.

While a sharp decline is projected for 2018, inflation expectations for the end of the year have increased. Stable long-term inflation expectations suggest no second round effects from the recent shocks.

Short- and Long-Term Inflation Expectations
Annual %

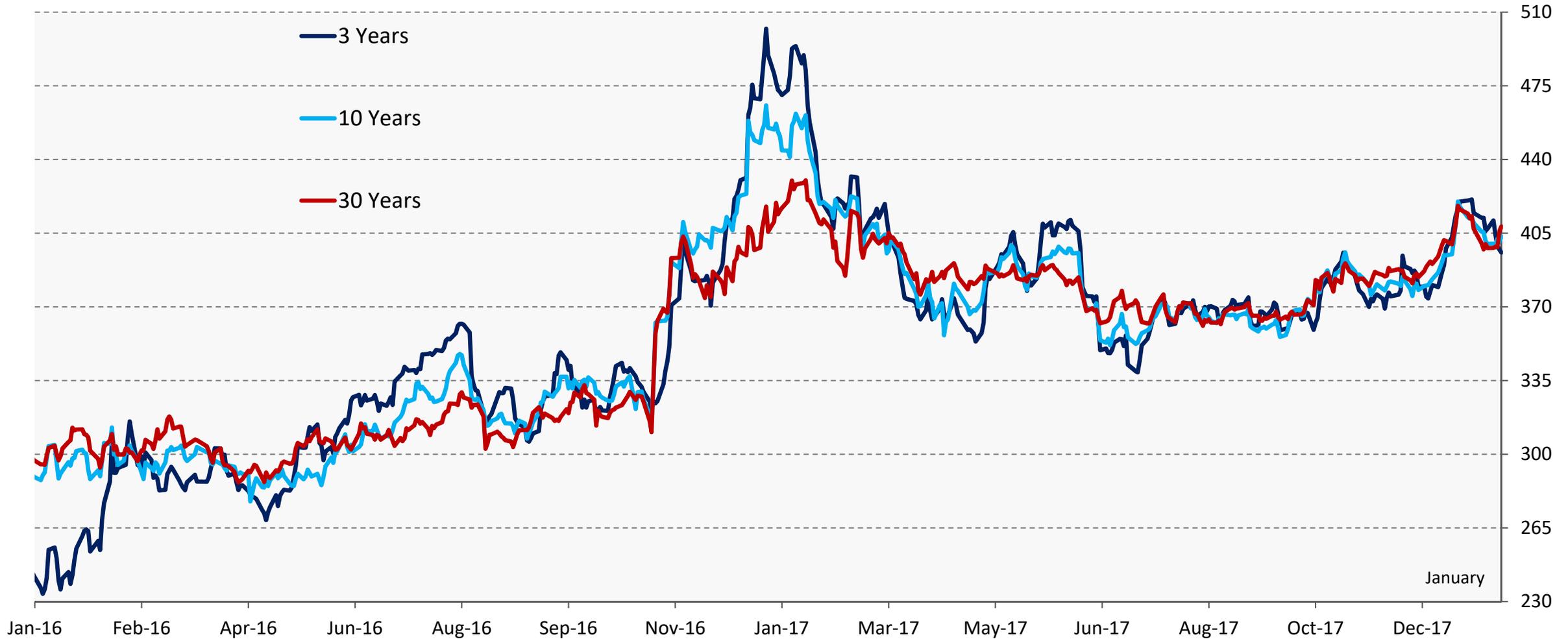


Source: INEGI and Citibanamex.

- The balance of risks for the convergence of inflation to the target by year's end is tilted to the upside:
 - Monetary policy normalization in the United States.
 - Fiscal reform in that country.
 - NAFTA renegotiation.
 - Mexico's elections.
 - Uncertainty regarding the trajectory of non-core prices.

Furthermore, breakevens suggest upside risks for inflation over the long term.

Inflation Breakevens^{1/}
Basis Points

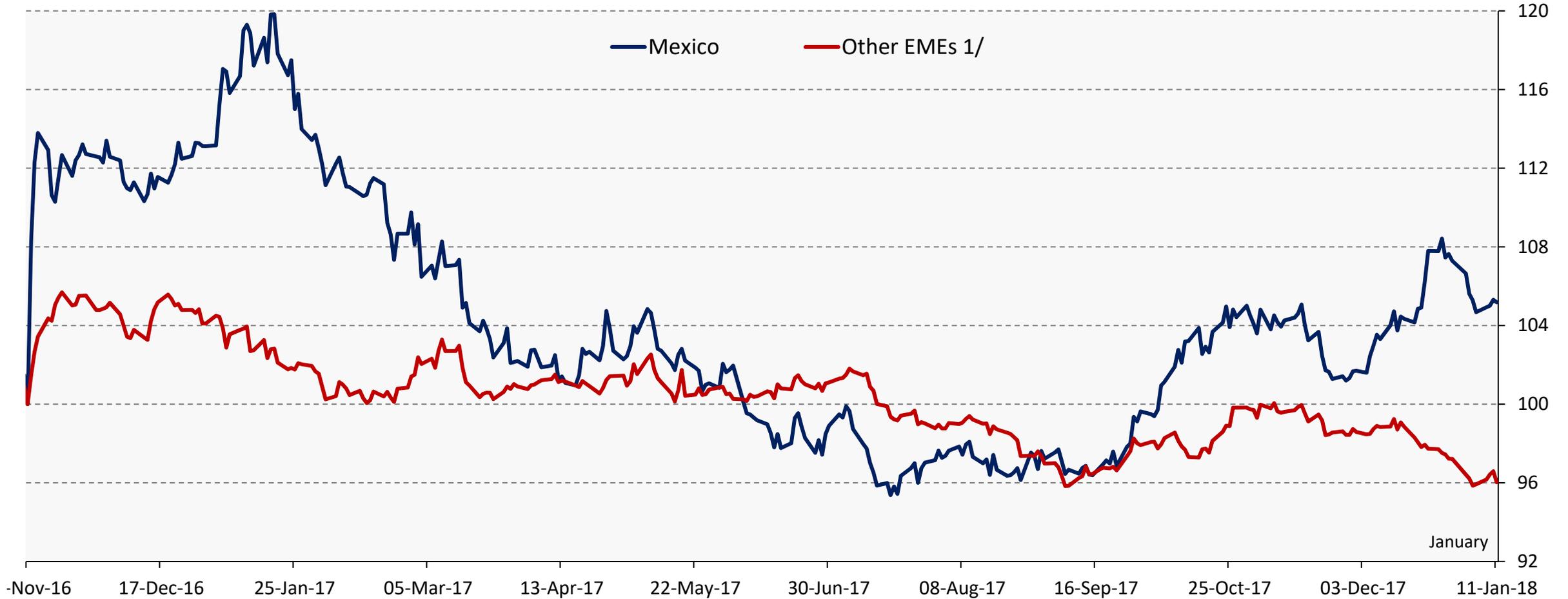


^{1/} Difference between yields on nominal and real (inflation-protected) bonds. In addition to expected inflation, this measure includes other (e.g. inflationary, liquidity and term) risk premia.
Source: Banco de México with data from PiP.

As a result of factors of both domestic and external nature, pressures on the Mexican peso have resumed in recent months, in an environment characterized by heightened volatility.

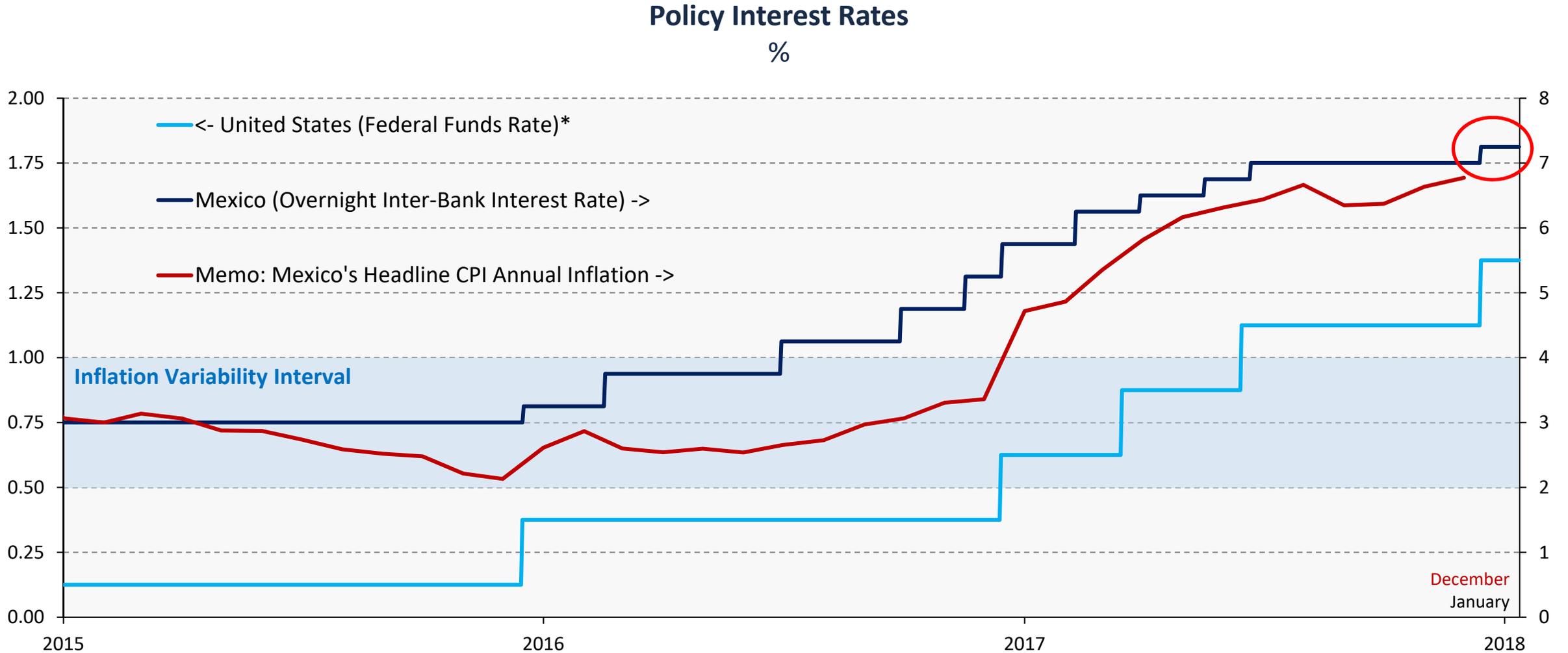
Emerging Market Economies: Exchange Rates with Respect to the USD

Index 8-Nov-2016 = 100



1/ Median for Brazil, Chile, Colombia, Korea, Peru, Poland, South Africa and Turkey.
Source: Bloomberg.

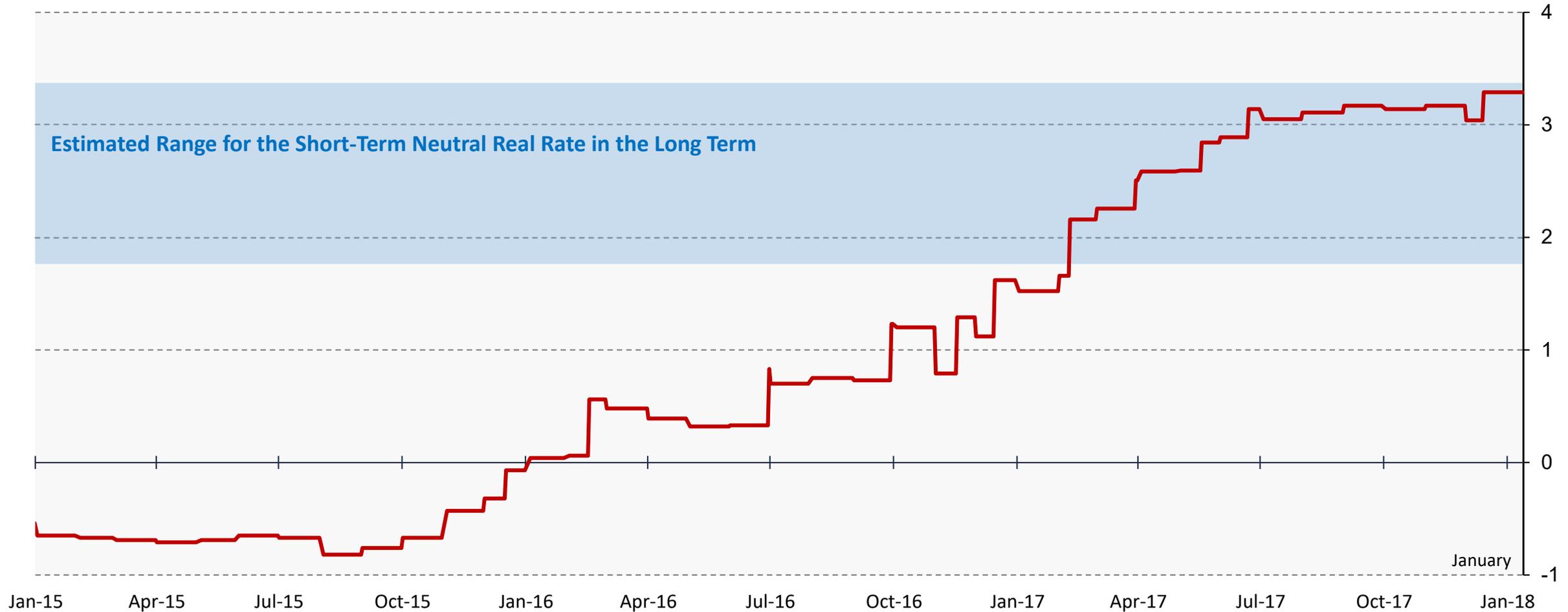
In response to inflationary pressures and the challenges resulting from the upward adjustment of interest rates in the US, the reference rate in Mexico was increased in December 2017. Thus, the monetary policy rate in Mexico has risen by 425 basis points since December 2015.



* / Mid-point of the target range from 16 December 2008 onwards.
 Source: Banco de México, INEGI and Federal Reserve.

However, the real reference rate remains within estimates of the interval for the neutral monetary policy rate in the long term.

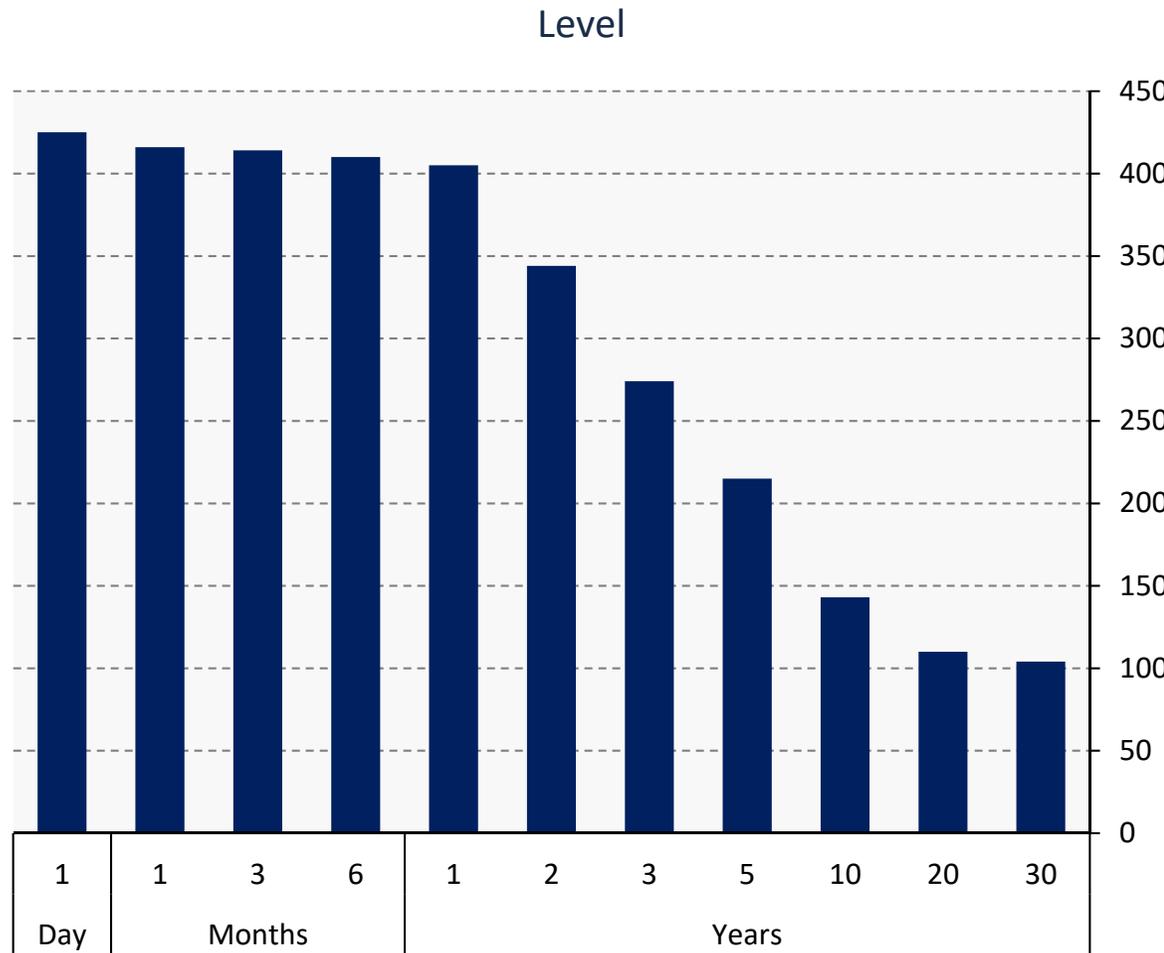
Short-Term Ex-Ante Real Rate^{1/}
%



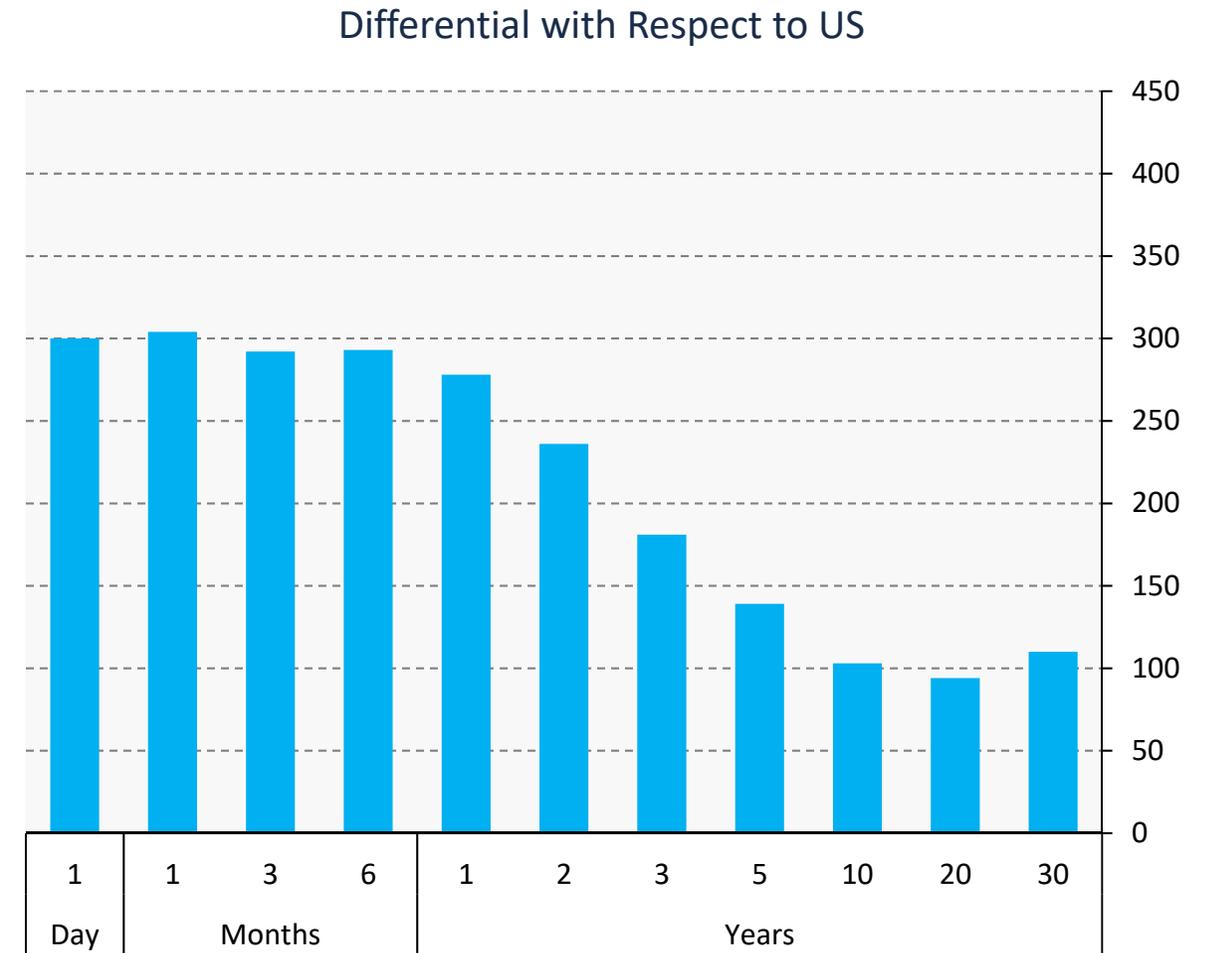
^{1/} The short-term ex-ante real rate is constructed using the Target for the Overnight Interbank Interest Rate and 12-month inflation expectations from the Banco de México Survey.
Source: Banco de México.

Monetary policy actions have contributed to a flattening of the yield curve and a widening of interest rate differentials with the United States.

Change in Domestic Interest Rates since 1 December 2015
Basis Points



Source: Banco de México and PiP.

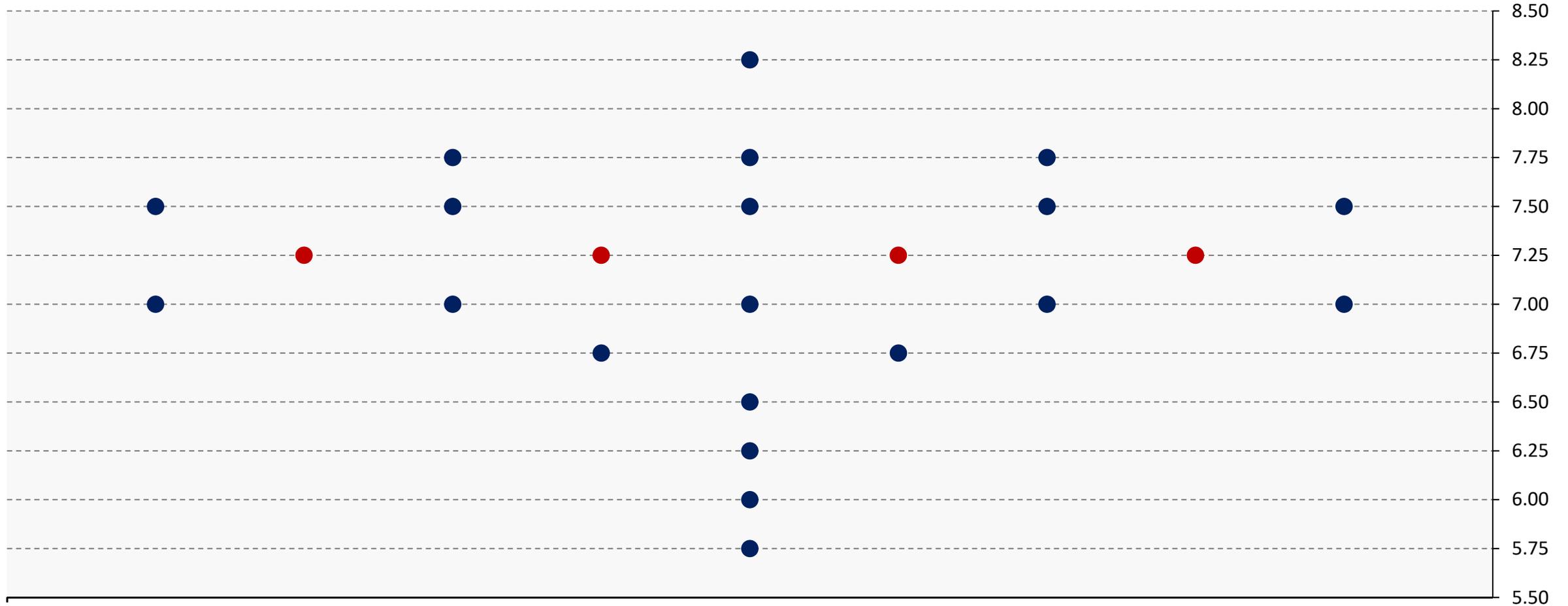


Source: Banco de México, PiP and US Department of the Treasury.

Monetary policy will be implemented in a context of higher than usual uncertainty in coming months. Analysts' expectations for the reference rate in 2018 show wide dispersion...

Mexico: Analysts' Expectations for the Monetary Policy Rate by End-2018^{1/}

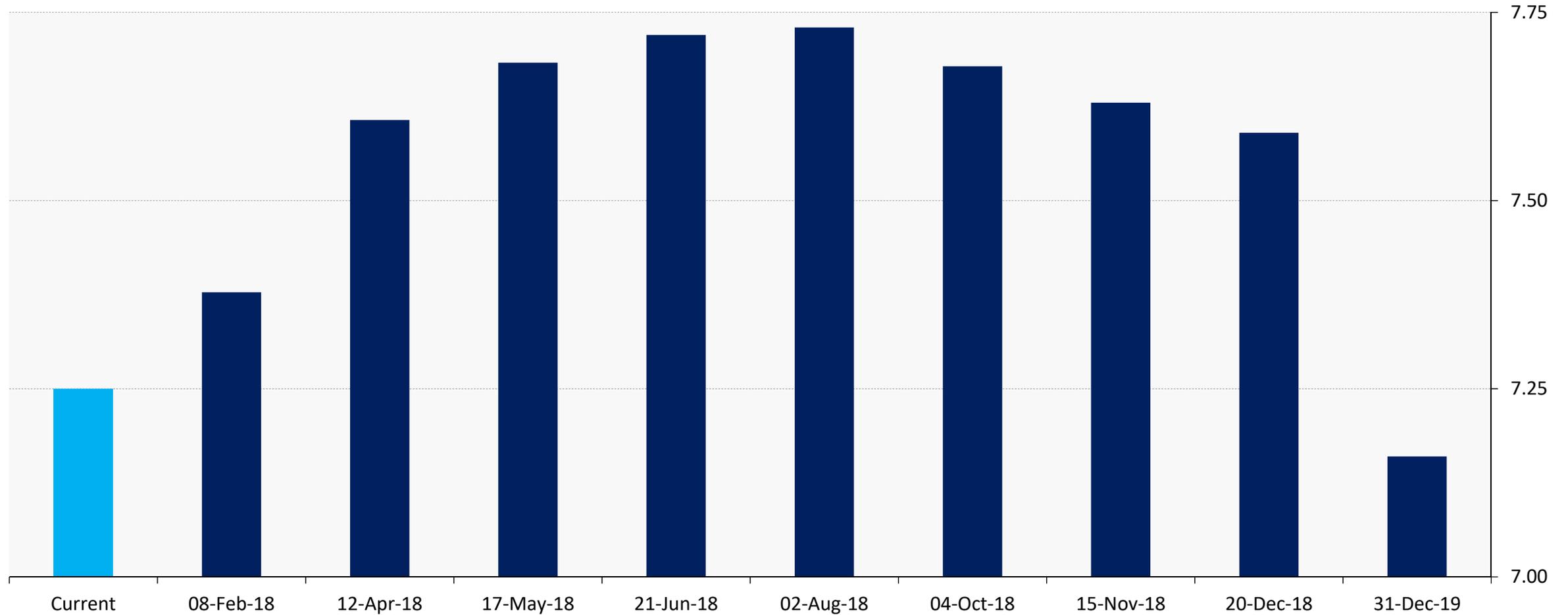
%



^{1/} As of 8 January 2018.
Source: Citibanamex.

... while those derived from market instruments point to an upward trend in 2018 and a decline in 2019.

Mexico: Market Expectations for the Monetary Policy Rate^{1/}
%



^{1/} Implied in 28-day TIE swaps, as of 12 January 2018.
Source: Banco de México with data from PiP.

- ❑ Even though no demand pressures on prices are anticipated, there is a risk of an unanchoring of inflation expectations as a result of recent or future shocks.
- ❑ In particular, the exchange rate of the peso may be subject to significant volatility, especially during the first half of 2018.
- ❑ Therefore, additional upward adjustments to the reference rate may be required, even in the very short term.

- The implementation of monetary policy will need to consider carefully:
 - On the one hand, the high inflation readings, the persistence of inflationary pressures and the risks faced.
 - On the other hand, the deceleration phase the economy is going through, the expected absence of demand pressures on prices, and the nature of the shocks affecting inflation.
- More generally, the monetary policy stance should be adjusted as ongoing and expected conditions require it, so that the convergence of inflation to the target is achieved at a pace consistent with the preservation of the Central Bank's credibility and the minimization of costs for economic activity.

- ❑ Beyond actions on the monetary policy front, further measures in other areas will be needed to achieve adequate and sustainable rates of economic growth:
 - Ensuring the long-term strength of public finances.
 - Preserving financial stability
 - Consolidating ongoing efforts of structural adjustment and deepening reforms in a number of key areas, including the rule of law, insecurity and corruption.



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