Mexico's Monetary Policy under Current Economic and Financial Conditions

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OMFIF Roundtable

London, April 2nd , 2019

BANCO DE MÉXICO

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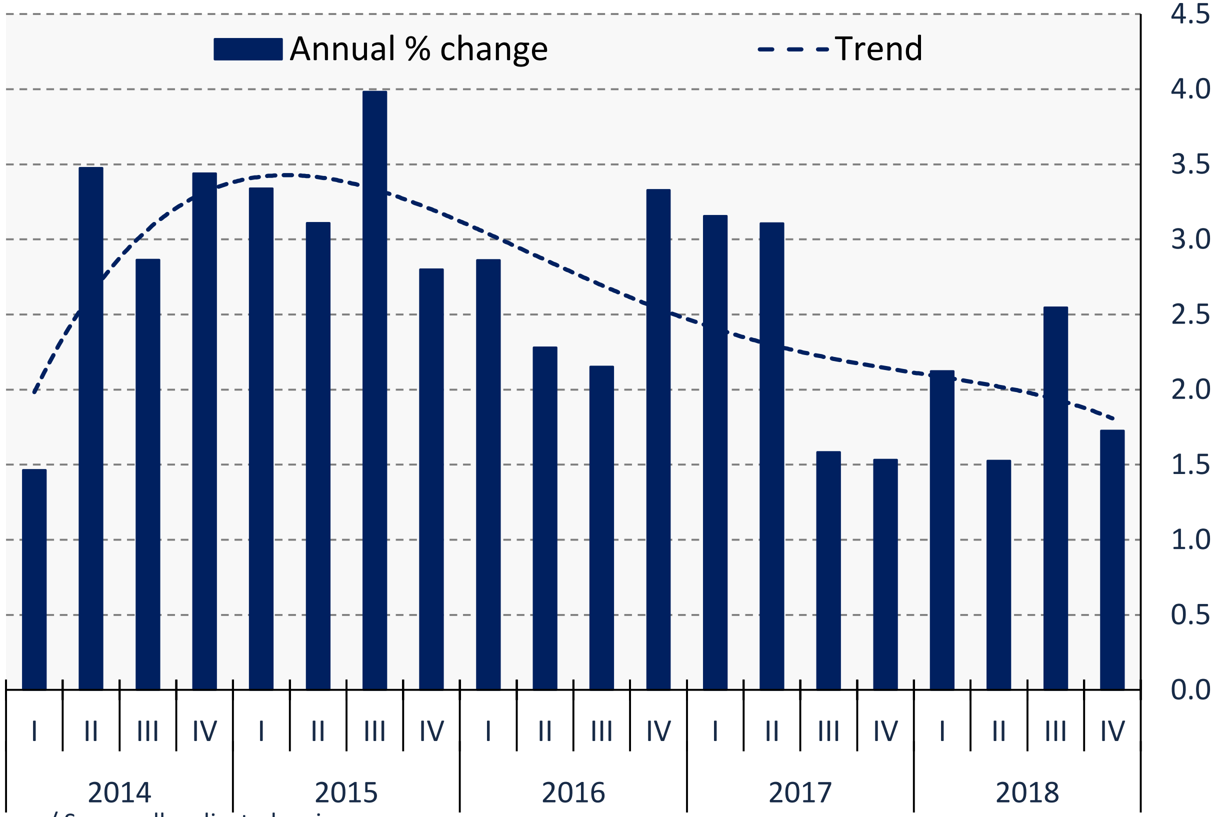
- As in the case of other emerging markets, the Mexican economy is facing a complex external environment:
  - A deceleration of world trade and economic activity.
  - Uncertainty related to trade negotiations between the United States and China.
  - Concerns surrounding the UK exit from the EU.
  - Protectionist trends.
  - Potential for turbulence in international financial markets and volatility of foreign capital flows.
  - Vulnerabilities in China and other emerging market economies.
  - Other political and geopolitical risks.

- This situation is complicated by a number of idiosyncratic factors:
  - Ratification of USMCA.
  - Uncertainty over several elements of public policy.
  - Low levels of business confidence.
  - Financial difficulties at Pemex.
  - Vulnerabilities in the country’s sovereign rating.
  - Structural and institutional obstacles to economic growth.

Economic activity has decelerated since 2016, although still showing an output gap around zero by the end of last year.

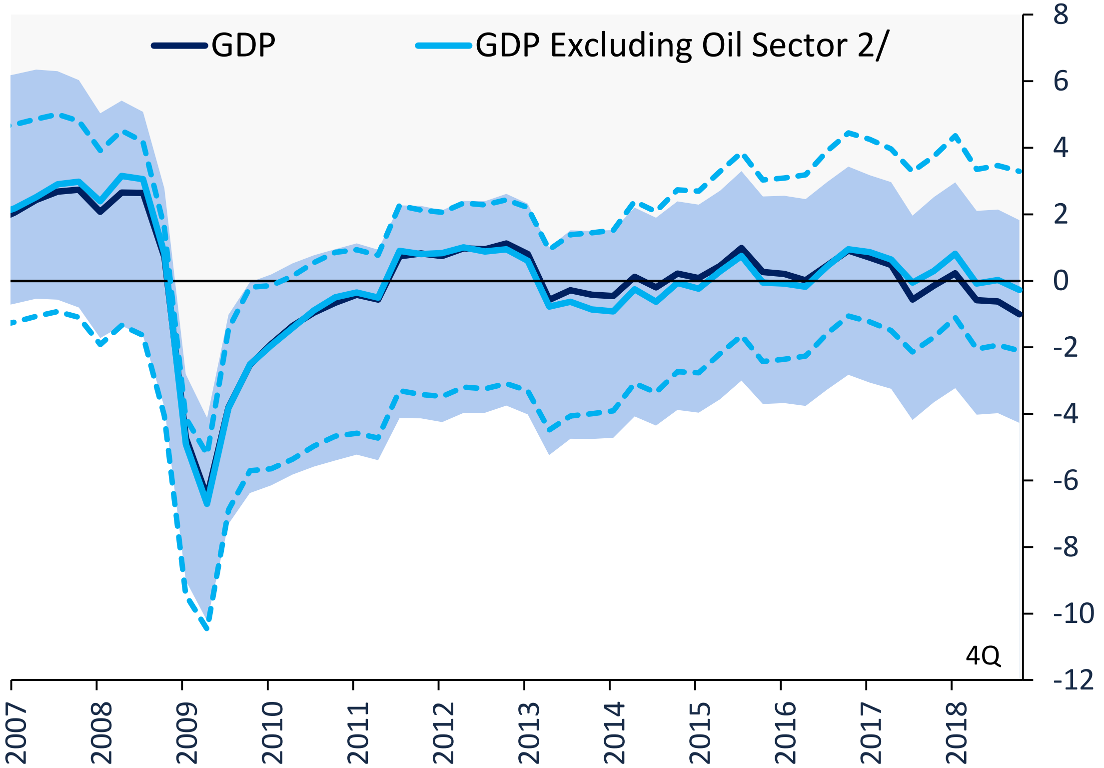
Mexico

Gross Domestic Product
Annual % change, s.a.



s.a./ Seasonally adjusted series.
Note: The dashed line represents a polynomial (order 4) trend.
Source: INEGI.

Output Gap[1/]
% of potencial GDP, s.a.

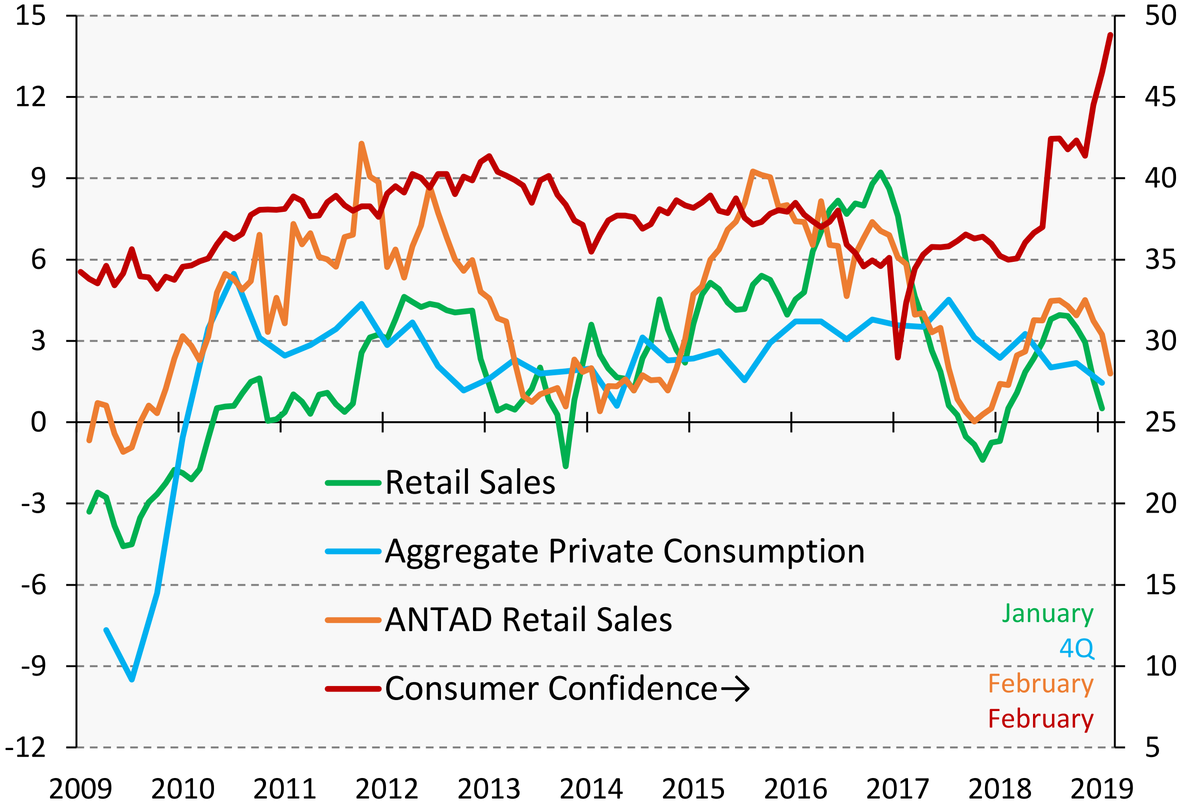


s.a./ Estimated with seasonally adjusted data.
1/ Estimated with the Hodrick-Prescott filter.
2/ It excludes oil and gas extraction, services related to mining and the manufacture of oil and coal products.
Source: Estimated by Banco de México with data from INEGI and Banco de México.

Partly as a result of temporary factors, the deceleration of economic activity was more pronounced at the end of 2018 and at the start of this year. The dynamism of private consumption and exports, particularly to countries other than the US, is beginning to weaken.

Consumer Confidence and Private Consumption

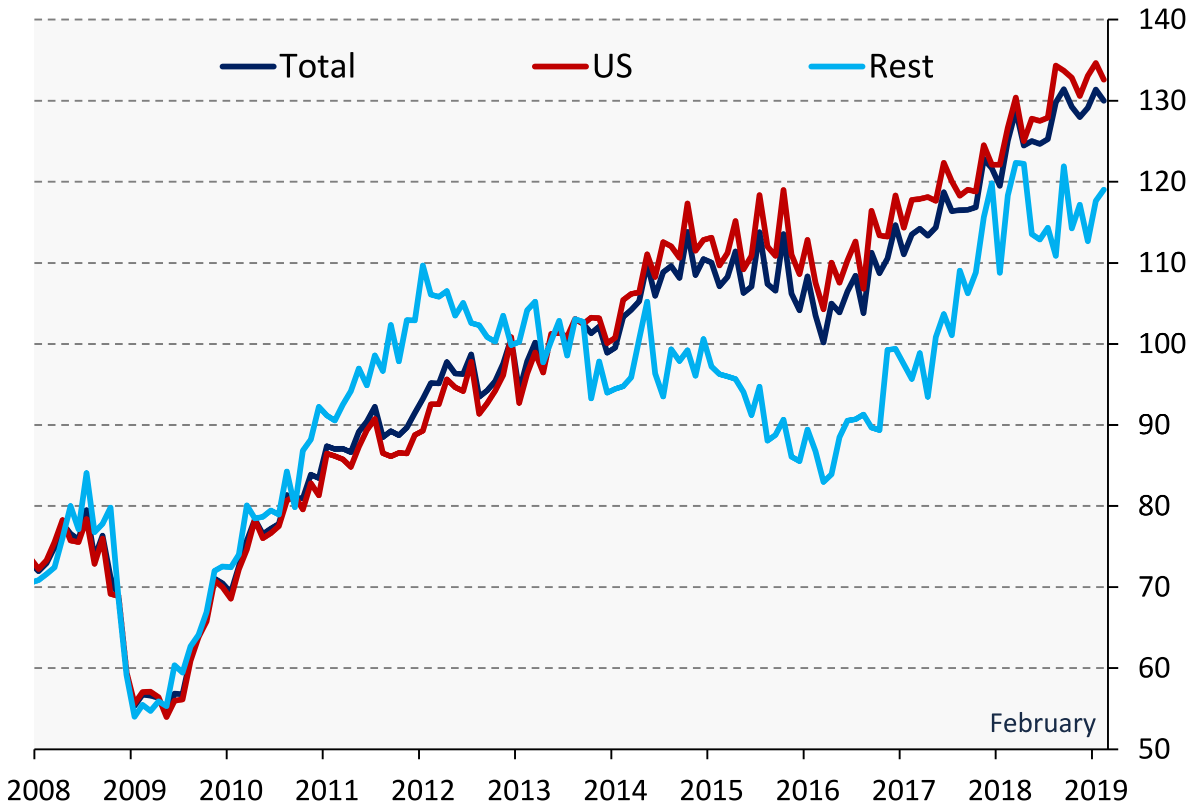
Points and annual % change of the three-month moving average, s.a.



s.a./ Seasonally adjusted series.
Note: Except for Aggregate Private Consumption, annual variations are based on 3-month moving averages.
Source: INEGI

Manufacturing Exports

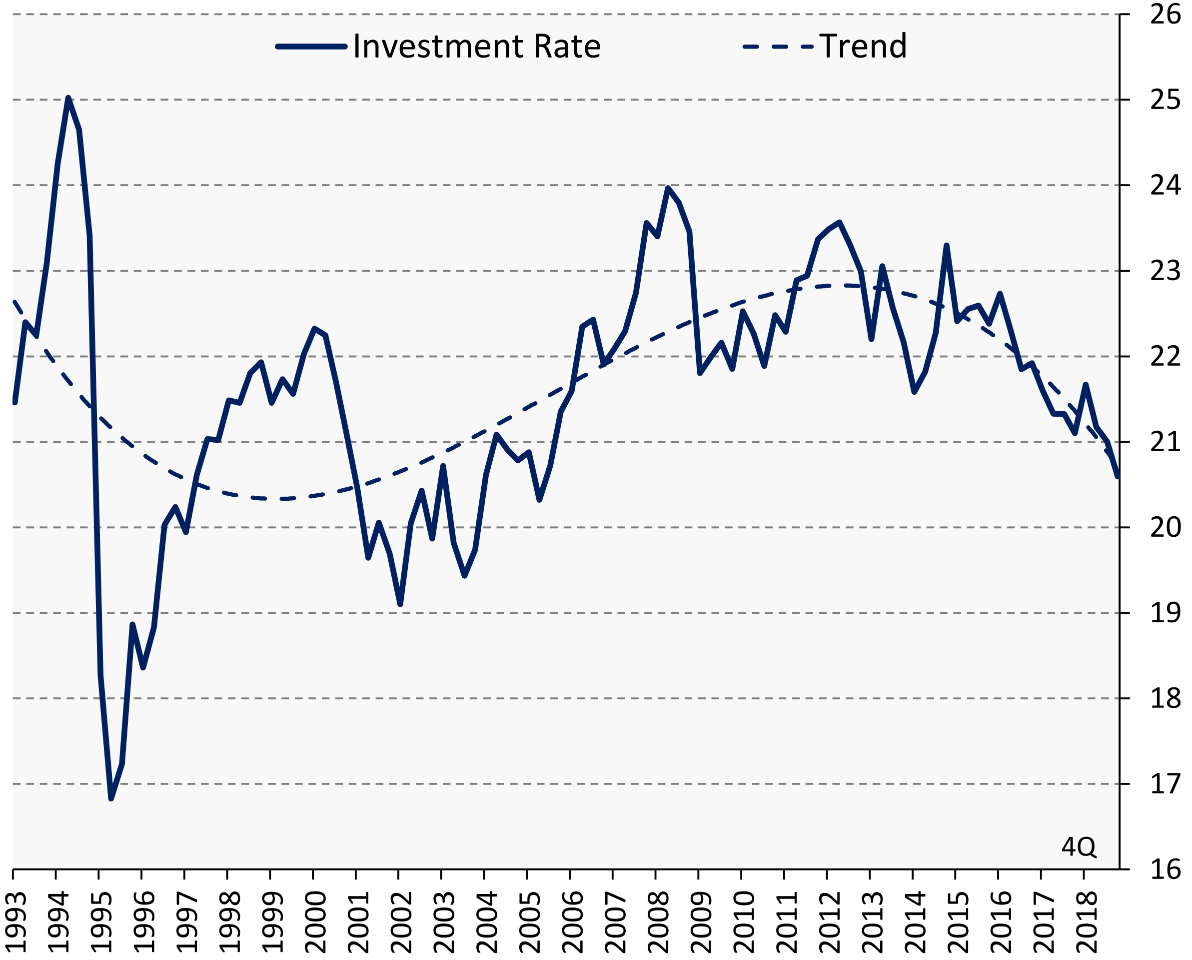
Index 2013 = 100, s.a.



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

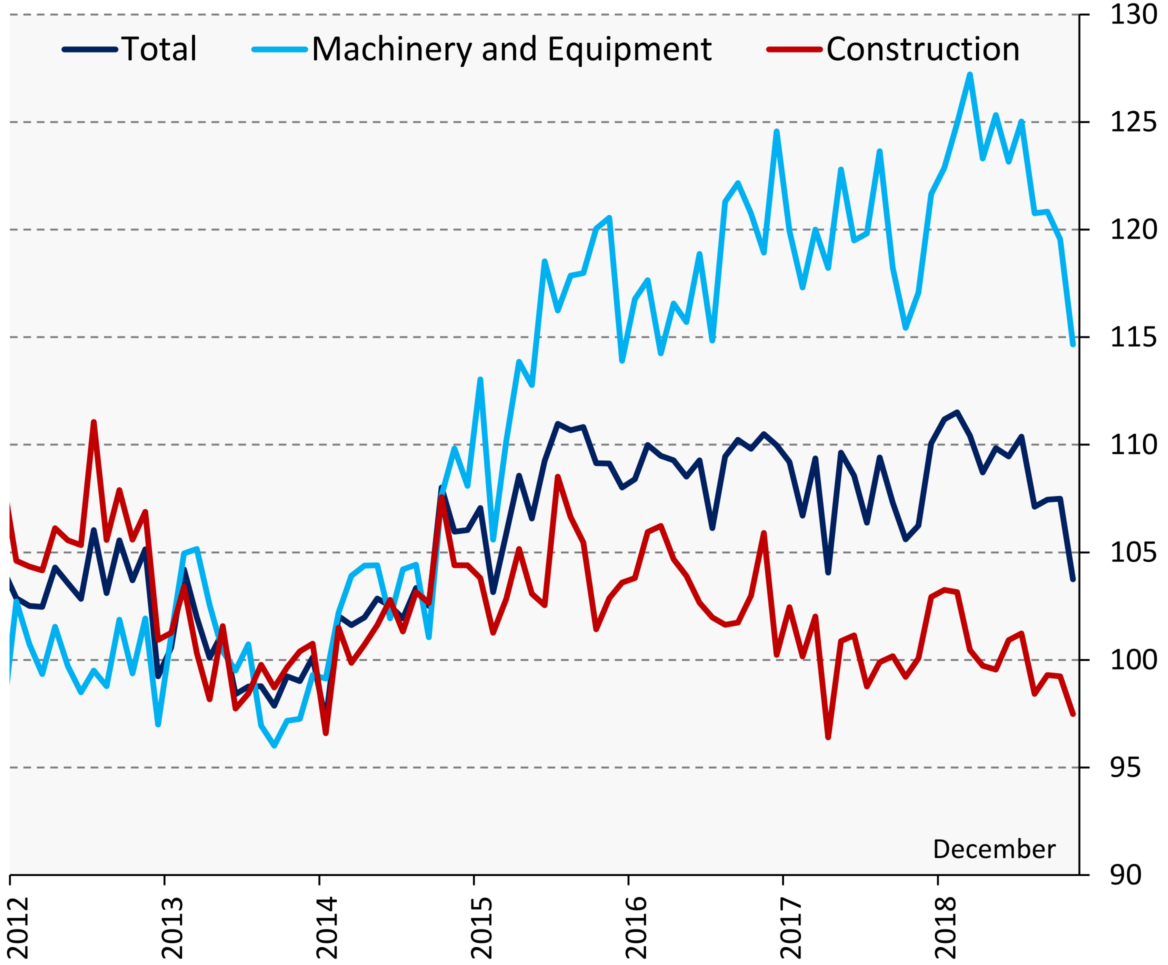
In addition, investment is showing a worrisome trend...

Investment Rate
% of GDP, s.a.



s.a. / Seasonally adjusted series.
Note: The dashed line represents a polynomial (order 4) trend line.
Source: INEGI.

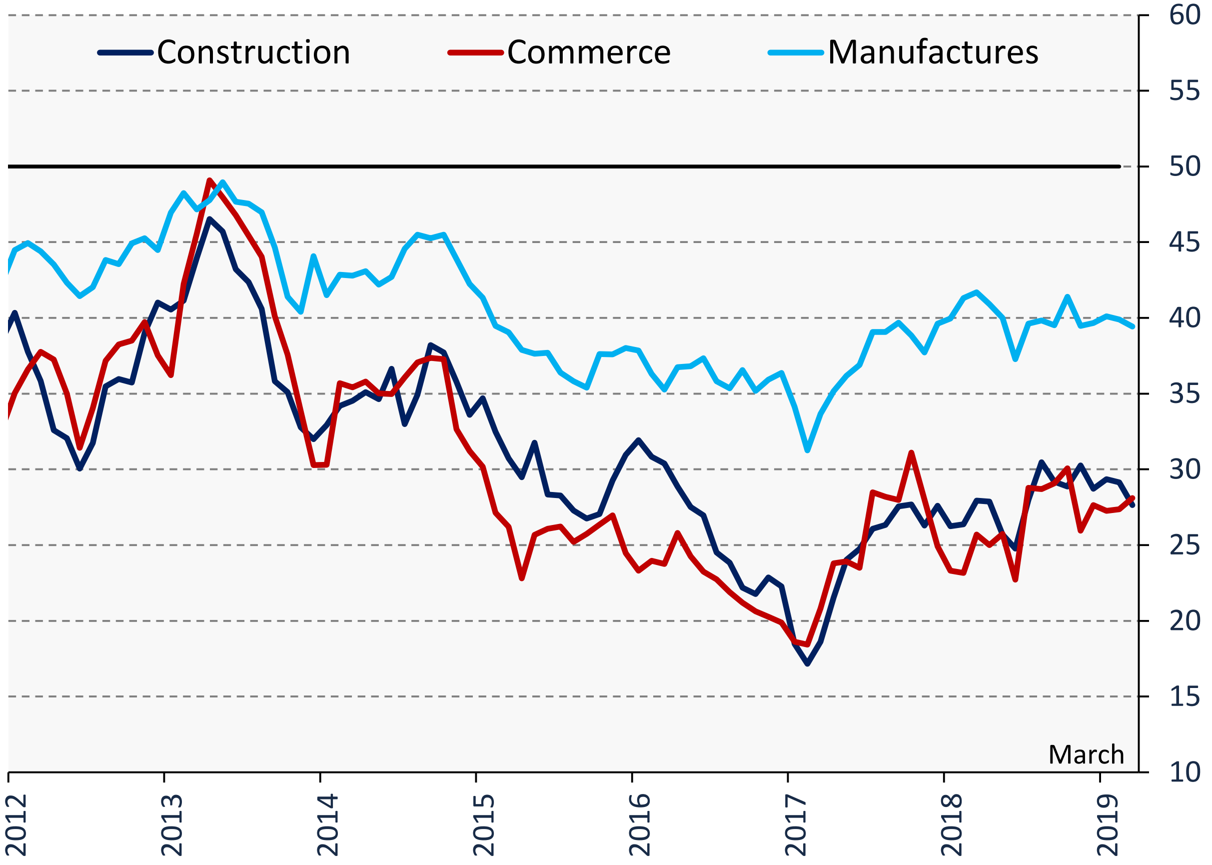
Gross Fixed Investment
Index 2013 = 100, s.a.



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

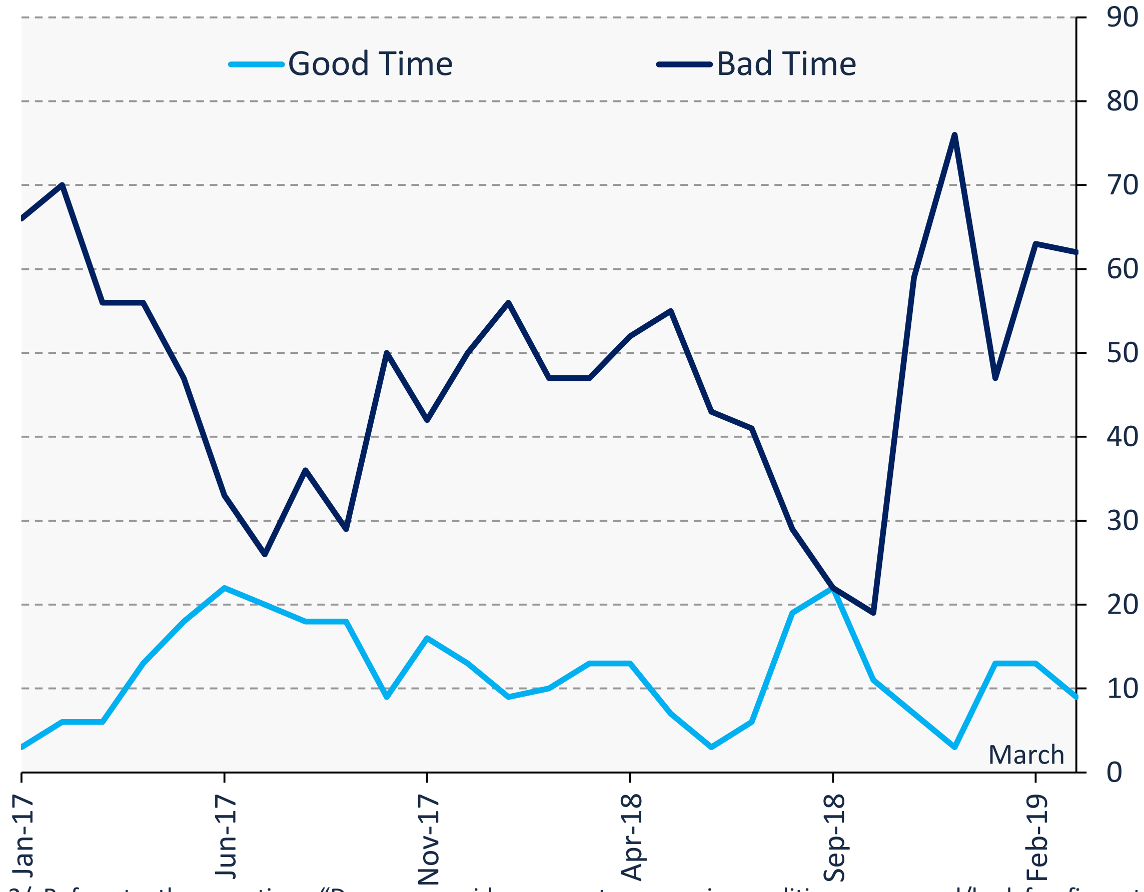
…explained to a significant extent by low levels of confidence.

Right Time to Invest [1/]
Indicators with reference level at 50 points, s.a.



s.a. / Seasonally adjusted series.
1/ Refers to the question: "Considering the current situation of the country and of your firm vs. one year ago, do you believe it is the right time to invest?"
Source: INEGI.

Perception of Adequate Economic Conditions to Invest by Analysts [2/]
% of answers



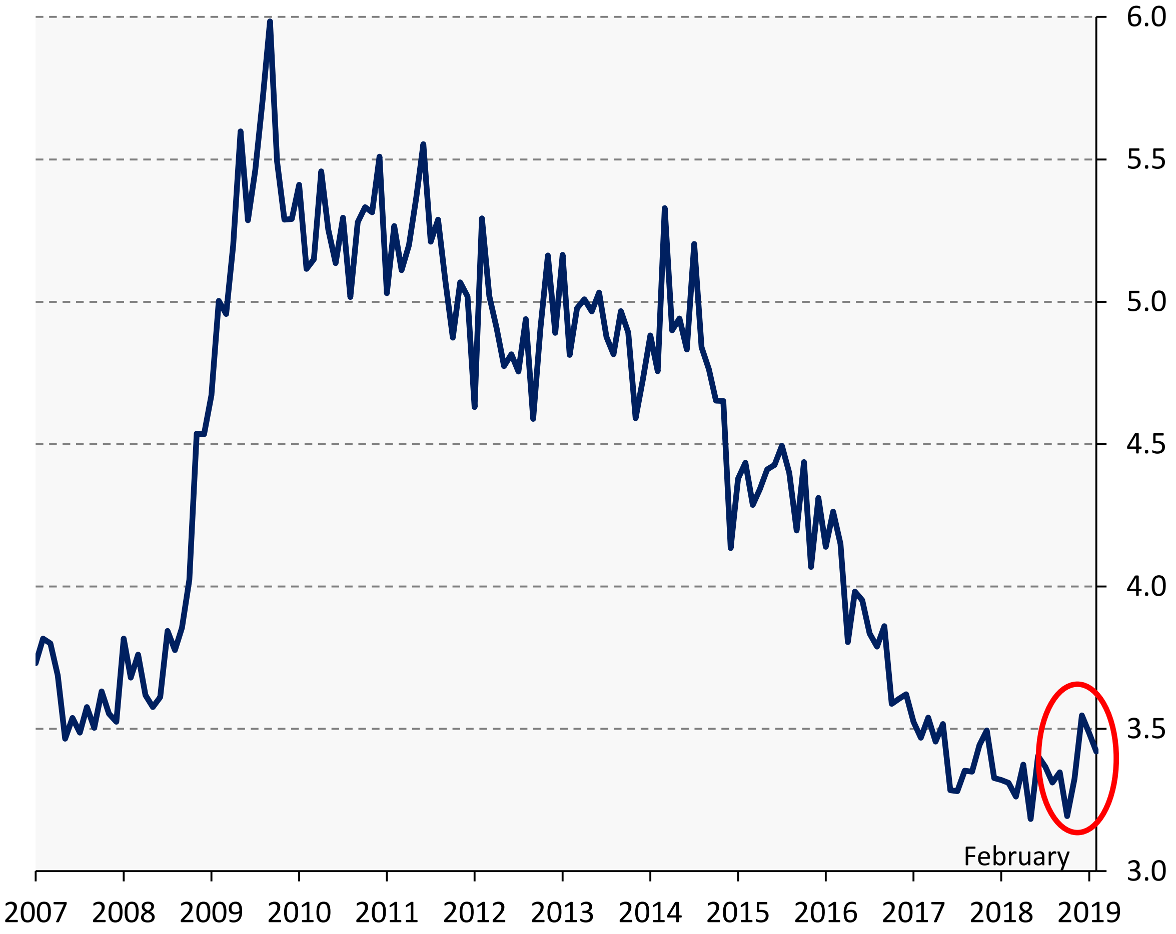
2/ Refers to the question: "Do you consider current economic conditions are good/bad for firms to invest?"
Source: Banco de México.

- Decisive actions are needed to reduce uncertainty and increase investment.
- This is particularly important given:
  - Low rates of potential growth.
  - Poor productivity performance.
  - Existing constraints on public investment.
  - Downside risks to economic growth from other sources.

The labor market, though still tight, has also weakened.

Unemployment Rate

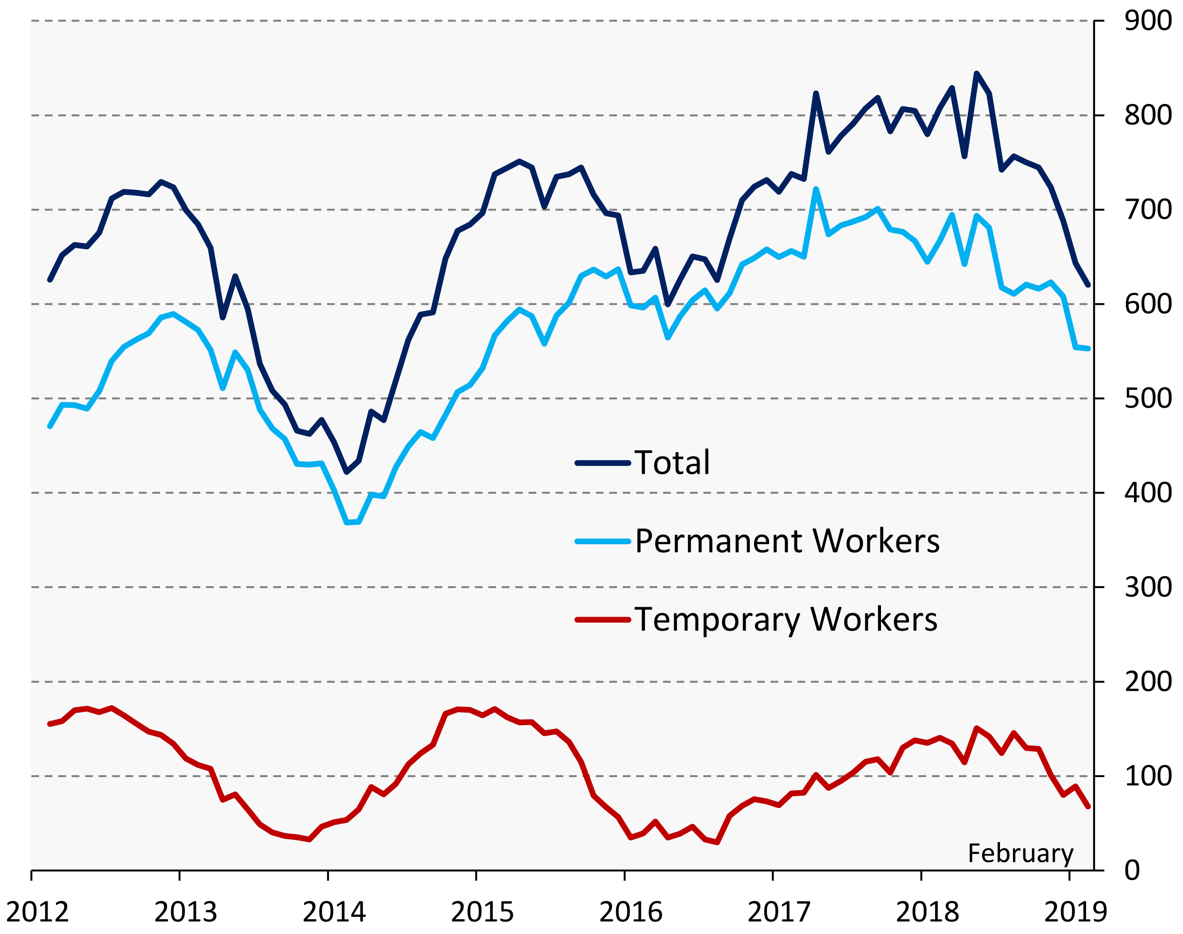
%, s.a.



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

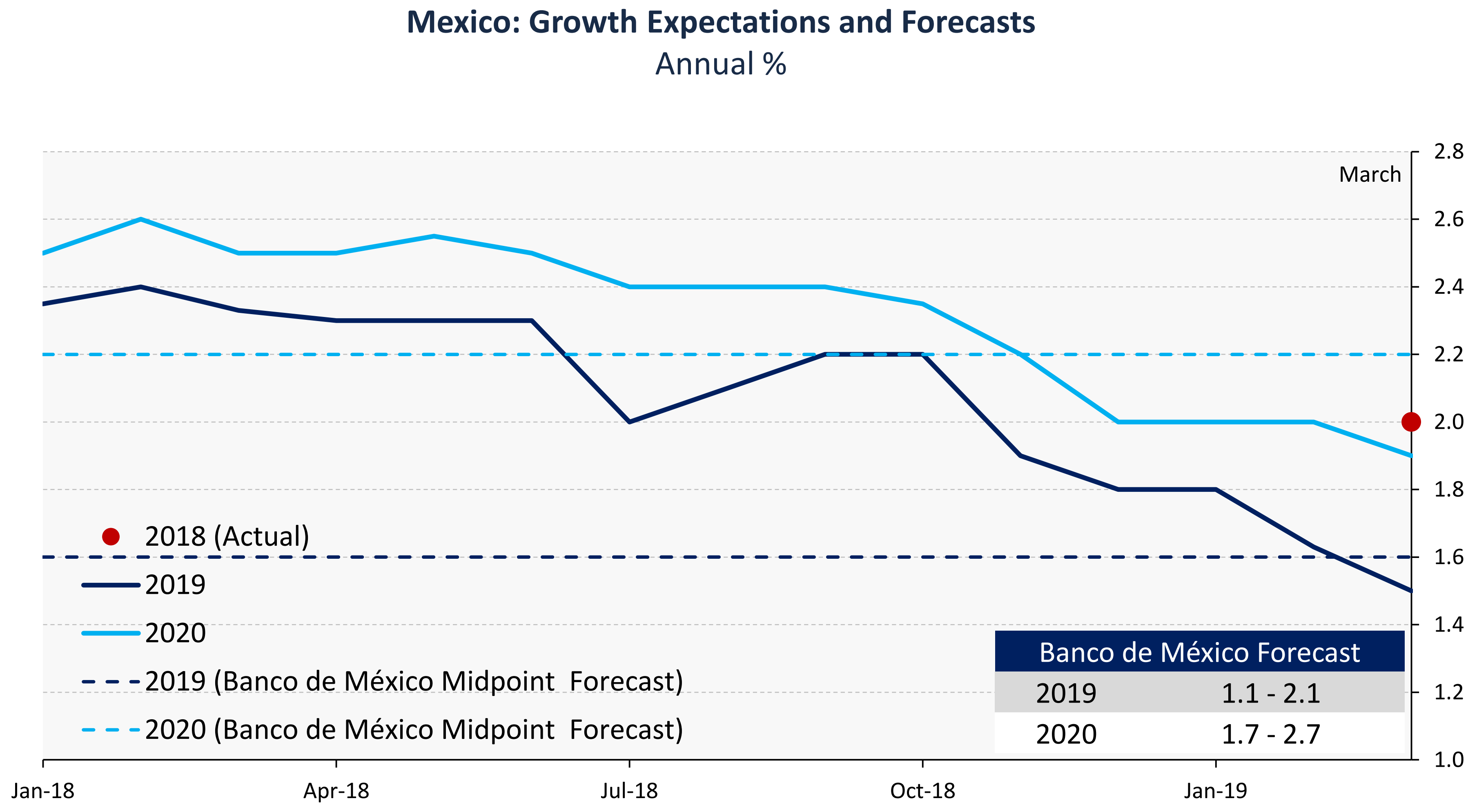
Formal Sector Workers

Absolute annual variation in thousands of workers



Source: IMSS.

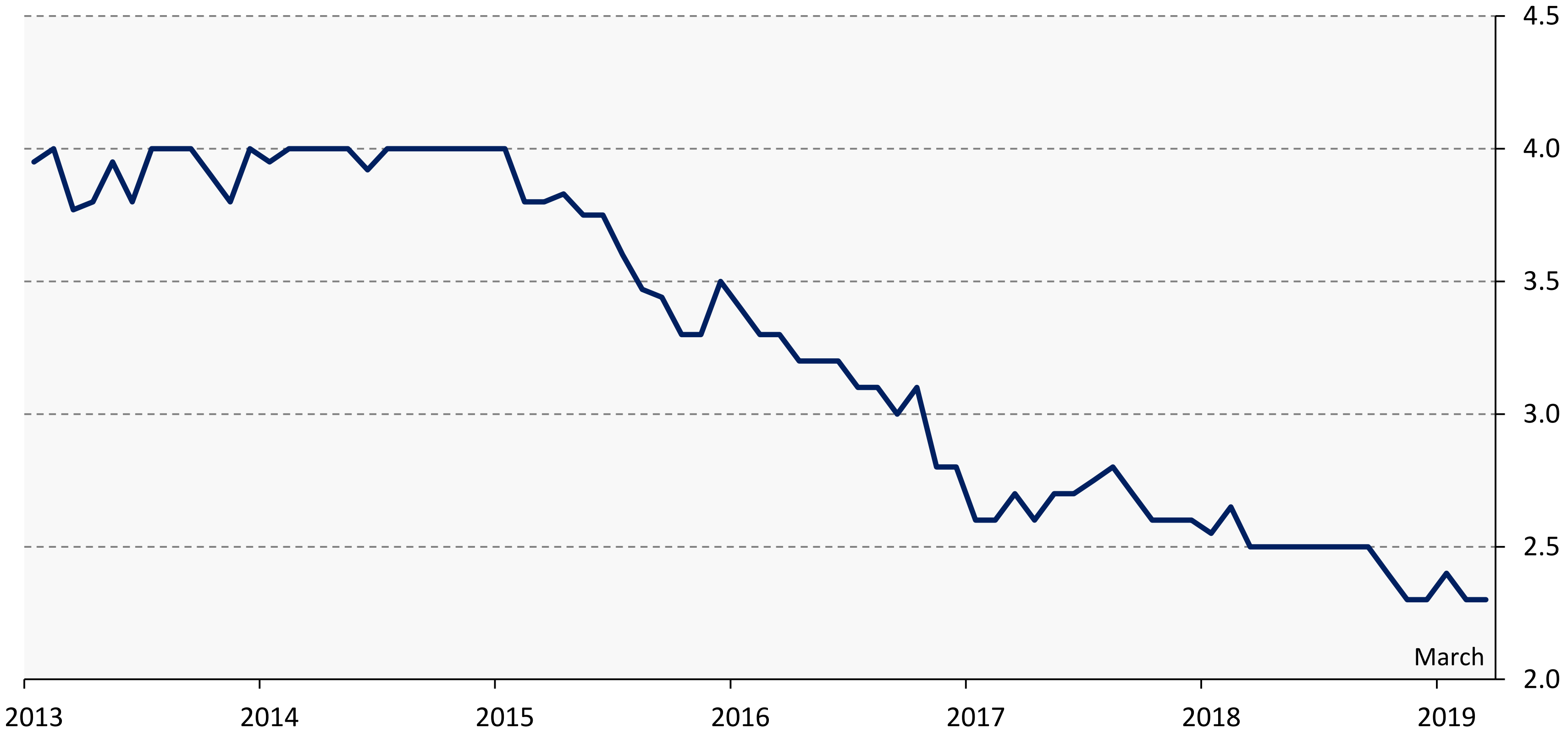
In this context, expectations for GDP growth in 2019-2020 have declined.



Source: Banco de México.

The evolution of analysts’ expectations for the long run is more worrisome.

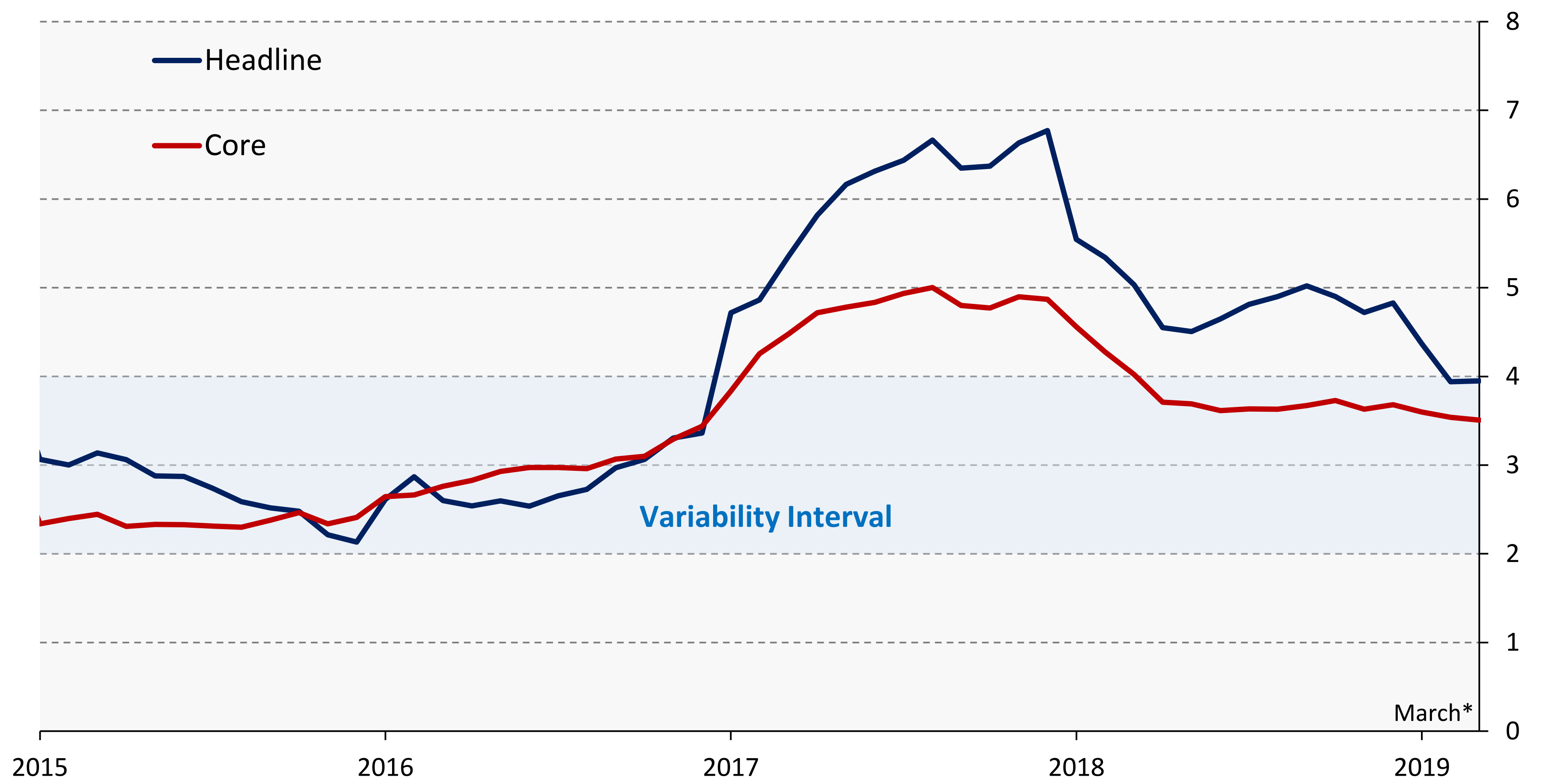
Long-Term Growth Expectations, Next 10 years
Annual %



Source: Banco de México.

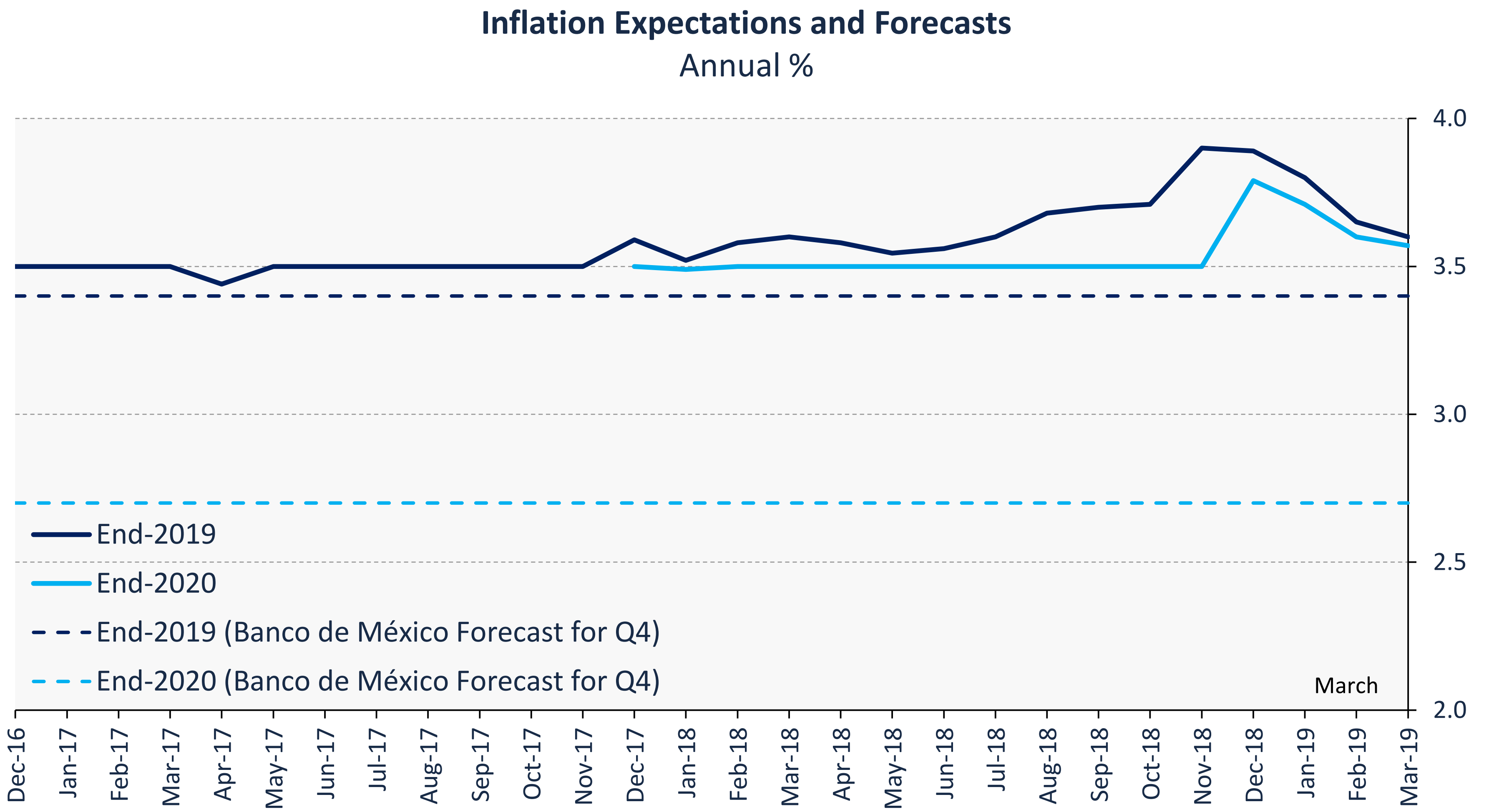
Inflation has fallen significantly since late 2017. However, core inflation has remained stable for nearly a year.

CPI Inflation
Annual %



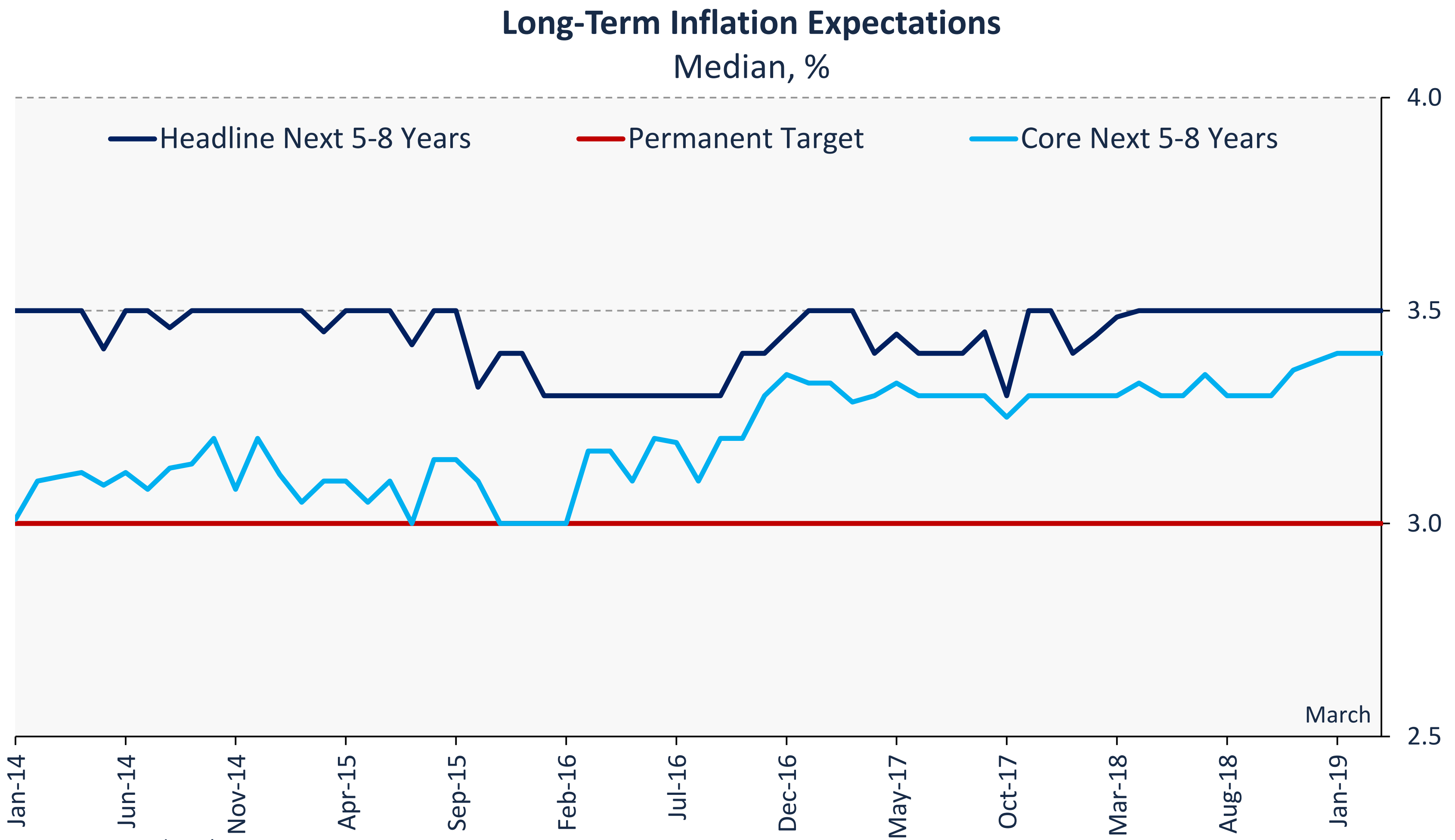
*/ Data through the first fortnight of March 2019.
Source: INEGI.

Inflation expectations for 2019 and 2020 have declined, but they show figures above Banco de México’s projections.



Source: Banco de México.

In addition, long-term inflation expectations, though stable, remain above the 3 percent target and those for general and core inflation seem to be converging.



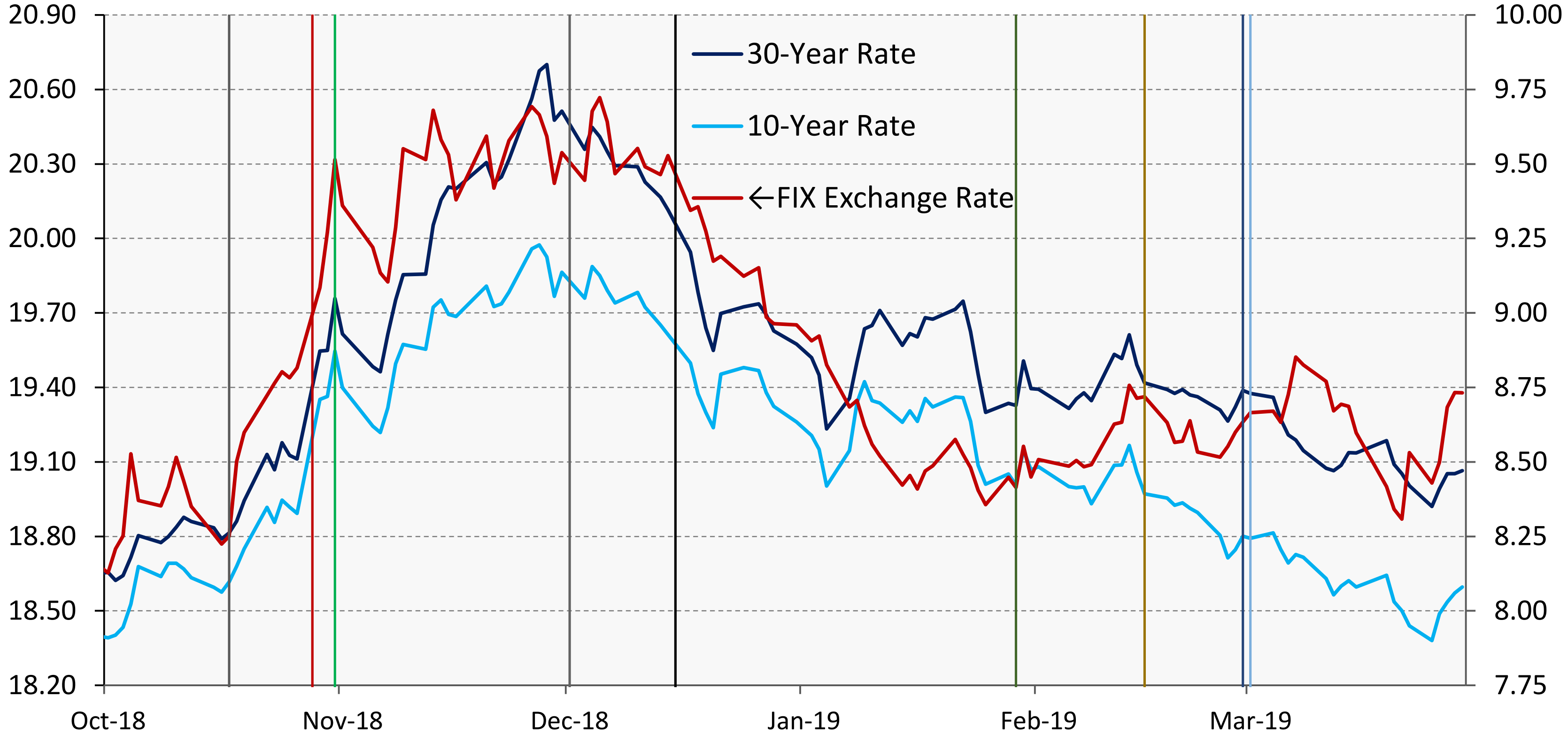
Source: Banco de México.

- The balance of risks for inflation continues to be skewed to the upside:
  - Potential pressures on the exchange rate.
  - Volatility of agricultural and energy prices.
  - Direct and indirect effects of minimum wage adjustments.
  - Risk of a deterioration of public finances.
  - Persistently high core inflation that could contaminate long-term inflation expectations.
  - Potential escalation of protectionist measures at a global level.

Financial markets in Mexico have shown an improvement over the course of this year, but risks remain.

USD/MXN Exchange Rate and Government Bond Interest Rate

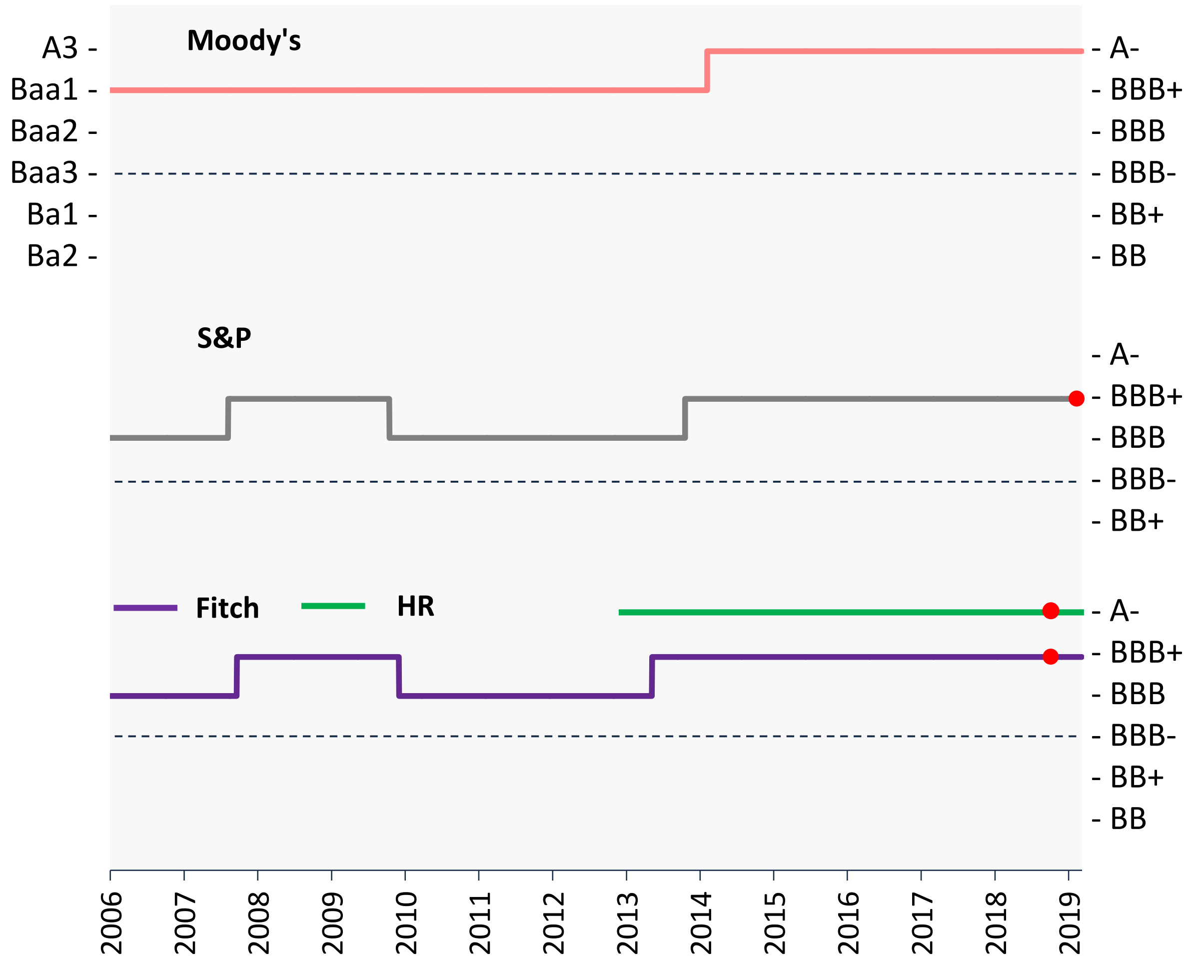
Pesos per dollar and %



Note: Vertical lines on the dates of the following recent events: Moody's communiqué (18-October), cancelation of the NAIM (28-October), Fitch communiqué (31-October), presidency inauguration (1-December), economic package for 2019 announced (15-December), Fitch Ratings communiqué about Pemex downgrade (29-January), Pemex's government aid announcements (15-February & 28-February), Standard & Poor's communiqué about Pemex negative outlook (1-March).
Source: Banco de México and PiP.

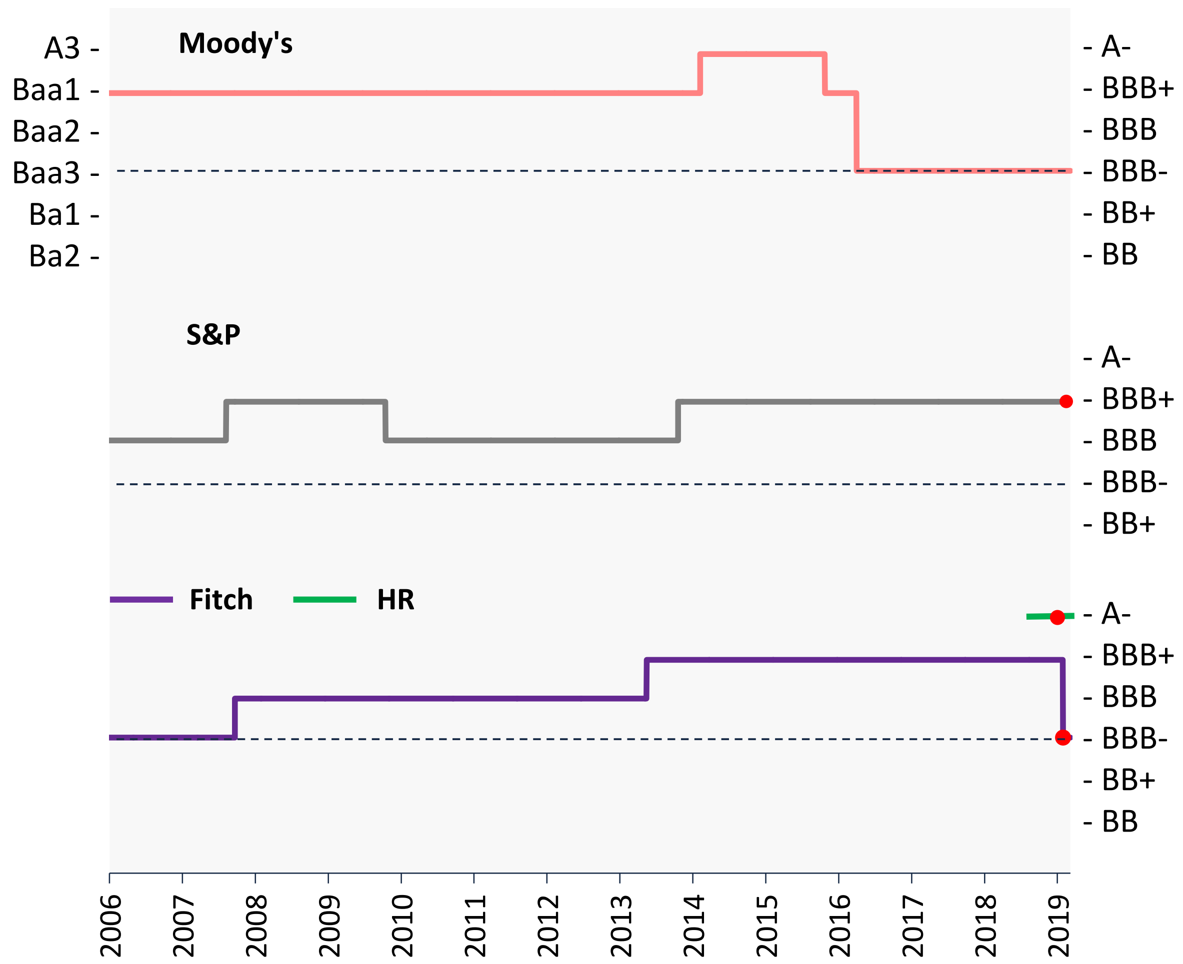
The latter is underlined by recent decisions by several rating agencies.

Mexico



Note: The red dots represent the recent revisions to the rating outlook from stable to negative.
The dotted lines represent the investment grade.
Source: Moody's, Standard & Poor's, HR Ratings and Fitch Ratings.

Pemex



Note: The red dots represent the recent revisions to the rating outlook from stable to negative.
The dotted lines represent the investment grade.
Source: Moody's, Standard & Poor's, HR Ratings and Fitch Ratings.

Recent revisions to Pemex rating or outlook are the result of a combination of factors.

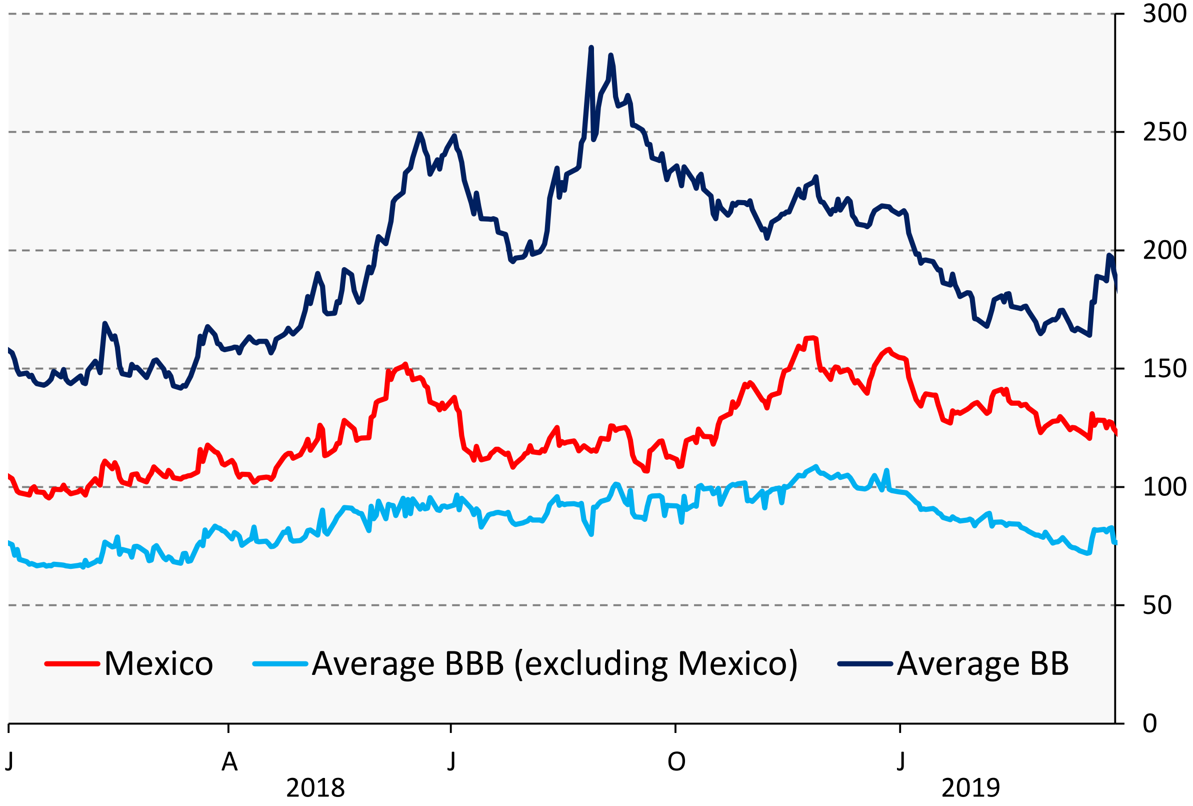
	HR Ratings November 6^{th} , 2018	Fitch Ratings January 29^{th}, 2019	Standard & Poor's March 4^{th}, 2019
Action on Pemex rating or outlook	**Rating Outlook Revised to Negative from Stable (A-)**	**Long-Term Foreign-Currency Issuer Default Rating Downgraded to BBB- from BBB+ (Negative rating outlook)**	**Rating Outlook Revised to Negative from Stable (BBB+)**
Action drivers	• Revision to Mexico's rating outlook from stable to negative on October 30th 2018 led to the modification of Pemex rating outlook. • HR considers that Pemex rating has a direct relation with Mexico's global rating given the implicit guarantee from the Mexican federal government to the enterprise.	• Downgrade reflects continued deterioration of Pemex's standalone credit profile (SCP) as a result of persisting negative Free Cash Flow and material under-investment in the upstream business. • SCP deterioration has led Fitch to lower its assessment of the government's incentive to support the company to "strong" from "very strong". • In Fitch's view, announced support measures for Pemex are not enough to offset the recent deterioration in Pemex's SCP.	• S&P considers that ratings on Pemex mirrors those for the sovereign, since incremental budgetary allocations for Pemex in 2019 and public statements at the time assures that the company will meet all its financial obligations in a timely manner because there is an almost certain likelihood of extraordinary government support. • The drop in Pemex's standalone credit profile is due to: 1. Company's core businesses underperforming relative to S&P previous expectations. 2. Government's plan to restore Pemex's credit fundamentals is limited in scope, particularly to address some of the company's long-term business and financial risks. 3. Execution risk for Pemex is high.

Source: HR Ratings (2018) "Entidades Mexicanas con Calificación en Escala Global", November 6th, 2018; Fitch Ratings (2019) "Fitch Downgrades PEMEX's IDRs to 'BBB-'; Outlook Negative", January 29th, 2019; and, Standard & Poor's (2019) "PEMEX Outlook Revised To Negative On Similar Action On Mexico; SACP Cut to 'b-' From 'bb-' On Weak Credit Fundamentals", May 4th, 2019.

Credit default swaps for both Pemex and the sovereign are above those of counterparts with similar, and even lower, ratings.

Emerging Economies Market Indicators of Domestic Sovereign Credit Risk[1/]

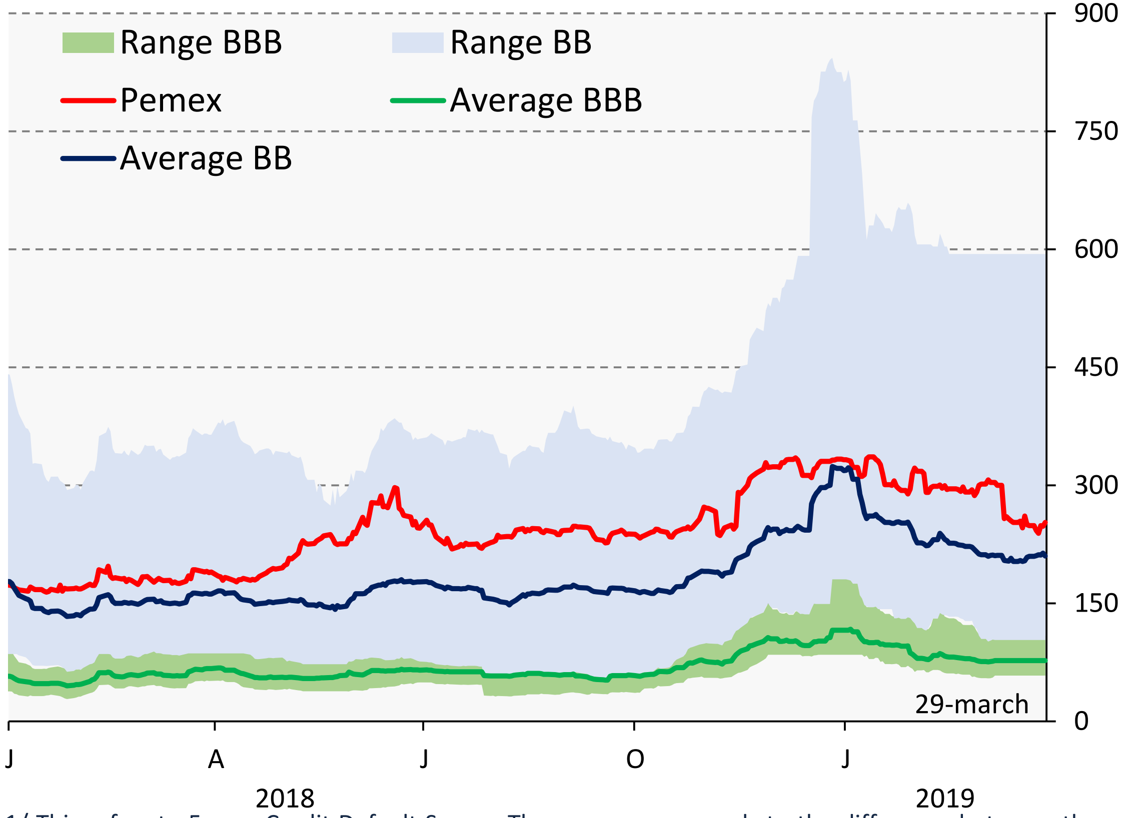
Basis points



1/ This refers to arithmetic mean of the 5-year Credit Default Swaps.
Note: For category BB it includes Brazil and South Africa and for category BBB it includes: Colombia, Hungary, India, Indonesia, Peru, Russia, and Thailand.
Source: Bloomberg and Standard & Poor's.

Market Indicators of Credit Risk for Pemex and Other Oil Companies[1/]

Basis points



1/ This refers to 5-year Credit Default Swaps. The range corresponds to the difference between the maximum and minimum value.
Note: For category BBB it includes Andeavor, Apache, Canadian Natural Resources, Eni, Halliburton, Repsol and Valero Energy and for category BB it includes Anadarko, Devon Energy, Encana, Hess, Nabors, and Petrobras.
Source: Bloomberg and Indeval.

- Challenges for the implementation of monetary policy are evident in a situation characterized by:
  - Weakening economic activity.
- As well as:
  - Persistent core inflation.
  - Balance of risks for inflation biased to the upside.
  - Short- and long-term inflation expectations above Banco de México's projections.

- Under such circumstances, consistent with Banco de México's mandate, monetary policy must focus on achieving the inflation target within the announced time frame.
- At the same time, it is important to take into account:
    - The existing high levels of uncertainty.
    - The need to achieve convergence to the target in an orderly and efficient way.
- This implies the adoption of a prudent approach, with monetary policy decisions carefully considering incoming information and with priority attached to enhancing the credibility of the Central Bank.

- Macroeconomic stability needs an adequate implementation of both monetary and fiscal policies.
- While public finances' targets announced for this year represent a step in the right direction, further efforts are needed to improve Pemex's long-term financial situation, and its productive capacity.
- The latter is crucial for the health of public finances and, in general, for the country's economy.
- In addition, to achieve rates of economic growth consistent with our needs, the structural and institutional factors that have discouraged investment and productivity growth have to be tackled.
- It will also be essential to carefully monitor the implications of the current economic strategy, and to introduce the corresponding corrective actions whenever required.

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