Outline

1. The External Environment and its Impact on Domestic Financial Markets
2. Implications for Economic Growth and Inflation
3. The Economic Policy Framework
4. Final Remarks
The global economy is currently facing a complex situation:

- A rate of growth below its long-term trend, resulting from a weak recovery in advanced economies and a deceleration in emerging market economies.

- A continued moderation in the volume of world trade.

- Low and declining prices of commodities, explained by the combination of demand and supply forces.

- Uncertainty in international financial markets, leading to volatility of capital flows and a tightening of financial conditions for emerging market economies.
The difficult external environment has affected the Mexican economy. GDP growth in the United States surpasses that of most other advanced economies, but industrial output has remained stagnant.

**US: GDP and Industrial Production**

Index I-2014 = 100, s.a.

**US and Mexico: Manufacturing Output**

Index I-2014 = 100, s.a.

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s.a./ Seasonally adjusted.  
Source: Federal Reserve, Bureau of Economic Analysis and Blue Chip.

s.a./ Seasonally adjusted.  
Source: INEGI and Federal Reserve.
In addition, the decline in international oil prices has combined with a sharp reduction in oil output...

**International Oil Prices**  
USD per Barrel

**Mexico: Oil Production**  
Thousand Barrels per Day

Source: Pemex and Bloomberg.

e/ Expected as of September 2015.  
Source: Pemex and SHCP.
...having among other implications a deterioration of the oil trade balance.

Mexico: Oil Trade Balance

% of GDP

- Source: Banco de México and INEGI.
High uncertainty in international financial markets, resulting among others from the expected normalization of monetary policy in the US, has further complicated external conditions for the Mexican economy.

**US: Federal Funds Rate**

Percent


-0.5% 0.0% 0.5% 1.0% 1.5% 2.0% 2.5% 3.0% 3.5% 4.0% 4.5% 5.0%

**Blue Chip (Jan. 2016)**

**FOMC (Dec. 2015)**

**OIS1/ (15 Jan. 2016)**

1/ OIS: Overnight Index Swap.

Sources: Bloomberg, Blue Chip and FOMC.
The exchange rate has worked as an efficient tool for the absorption of these shocks. In general, depreciation of the peso compares favorably with that observed in some commodity-exporting AEs and in other EMEs.

Currency Valuation (against the USD)
Index 1-Jan-2014 = 100

1/ EMEs: Brazil, Chile, Colombia, Hungary, Indonesia, Malaysia, Peru, Poland, Russia, South Africa and Turkey.
Source: Bloomberg, with data through 15 January 2016.
Furthermore, adjustment of the MXN has been orderly, as shown by a relatively low volatility of the exchange rate...

**Implied Volatility in 1-Month FX Options of Selected Emerging Markets**

Percent

Note: The minimum (maximum) value represents the lowest (highest) volatility in the currencies of Brazil, Chile, Colombia, Indonesia, South Africa, South Korea, and Turkey.
Source: Bloomberg, with data through 15 January 2016.
... and the resilience of investments by foreigners in long-term government securities denominated in pesos.

Foreign Participation in MXN-Denominated Government Bond Markets

MXN Billion

1/ In addition to bonds and Cetes, this includes other securities such as Udibonos and Bondes D.
2/ Data through 6 January 2016.
Source: Banco de México.
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The Mexican Economy
In the face of weakness in industrial production in the US and an even more complicated situation in the rest of the world, manufacturing exports have been flat.

Exports of Manufactured Goods
Index 2008 = 100, s.a.

s.a./ Seasonally adjusted.
Source: Banco de México, SAT, SE, and INEGI.
Therefore, support for GDP growth has come mainly from domestic demand.

Private Consumption, ANTAD and Retail Sales
Index 2008 = 100, s.a.

Gross Fixed Capital Formation
Index 2008 = 100, s.a.

s.a./ Seasonally adjusted.
Source: Banco de México, INEGI and ANTAD.
When seen from the supply side, services have been the leading sector, as industrial production has been affected by the decline in oil output and stagnation of this sector in the US.

Global Economic Activity Index

Index 2008 = 100, s.a.

Sources: INEGI.
Economic growth is expected to strengthen in 2016 and 2017. Growth projections have declined, but compare favorably with other Latin American countries, both in terms of level and the extent of downward adjustments.

Real GDP Growth Projections
Annual %

1/ Latin America and the Caribbean.
2/ Median for Chile, Colombia and Peru.

Source: IMF (World Economic Outlook, for April 2010 through October 2015) and World Bank (Global Economic Prospects, for January 2016).
Headline CPI inflation has recorded historical minima for eight straight months, thanks to a low and stable core component and a downward trajectory of non-core inflation.
The pass-through from the MXN depreciation to inflation has been limited and concentrated on the prices of tradable goods, without second round effects.

**Consumer Prices and Foreign Exchange**

Index 2\textsuperscript{nd} fortnight of December 2014 = 100

1/ Data through the second fortnight of December 2015.

Source: INEGI.
The low FX pass-through to domestic prices is explained by the credibility of monetary policy, a negative output gap and an offsetting fall in the prices of several key goods, resulting from both ongoing structural changes in the economy and international developments.

**Consumer Prices of Selected Goods and Services**

**Annual Percent Change**

**Telecommunications**

**Energy**

**Agricultural**

Source: INEGI.
# Outline

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The relatively favorable evolution of the Mexican economy in the face of major shocks has been enabled by an adequate economic policy framework. This includes:

1. A credible monetary policy.

- The implementation of monetary policy has focused on achieving an efficient convergence of inflation to the 3 percent target (i.e. at the lowest possible cost in terms of economic activity).

- Under this rationale, Banco de México responded to both internal and external developments by reducing its benchmark interest rate by 150 basis points from March 2013 to June 2014.

- This allowed to simultaneously reduce the inflation rate and support economic activity.

- On December 17, 2015, Banco de México’s Board decided to increase the target for the overnight interbank rate by 25 basis points to a level of 3.25 percent.
The presence of record low levels of inflation, the expectation of a negative output gap during the period of influence of monetary policy, and stable medium- and long-term inflation expectations supported an unchanged monetary policy stance.

However, with the increase in interest rates in the US, this carried the risk of disorderly capital outflows and an additional depreciation of the exchange rate. This would have endangered both the inflation target and financial stability.

Notwithstanding the interest rate increase, monetary conditions in Mexico remain very lax, due to the significant real exchange rate depreciation.

Looking ahead, Banco de México will remain vigilant of all inflation determinants and medium- and long-term inflation expectations, and particularly of the monetary policy stance relative to the US, the pass-through from the exchange rate to prices, and the evolution of slack in the economy.
2. A timely adjustment of fiscal policy. Even in the face of lower oil prices, the government remains committed to reduce the Public Sector Borrowing Requirements and public debt as a share of GDP.

![Public Sector Borrowing Requirements](https://example.com/borrowing-requirements-graph.png)

**Public Sector Borrowing Requirements**

<table>
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<th>Year</th>
<th>% of GDP</th>
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<tbody>
<tr>
<td>2014</td>
<td>4.6</td>
</tr>
<tr>
<td>2015</td>
<td>4.1</td>
</tr>
<tr>
<td>2016</td>
<td>3.5</td>
</tr>
<tr>
<td>2017</td>
<td>3.0</td>
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<td>2018</td>
<td>2.5</td>
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<tr>
<td>2019</td>
<td>2.5</td>
</tr>
<tr>
<td>2020</td>
<td>2.5</td>
</tr>
<tr>
<td>2021</td>
<td>2.5</td>
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</tbody>
</table>

Source: SHCP.

The Mexican Economy
3. A sound financial system. As suggested, among others, by strong commercial banks...

Capital Adequacy Ratio for Commercial Banks
% of risk-weighted credit exposures

Liquidity Coverage Ratio\(^1\/\)
Percent

1/ The 3-month average LCR for institutions B1-B4 is greater than or equal to 400%.

Source: Banco de México.
...and relatively low levels of private sector debt.

Private Sector Debt
% of GDP

Households

Corporates

AE-10: Australia, Canada, Switzerland, Denmark, Euro Area, United Kingdom, Japan, Norway, Sweden, and United States.
EM-18: Argentina, Brazil, China, Czech Republic, Hong Kong, Hungary, India, Indonesia, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Thailand, and Turkey.

4. A major effort of structural reform.

- This comprises not only several of the key sectors of the economy, but also measures aimed at improving the institutional framework.

- The full impact of the actions taken on potential GDP is going to take time, and constant efforts will be needed to ensure an efficient implementation.

- However, their effect is already evident in a number of areas, including labor markets, competition in the economy, the prices of a number of key inputs, higher private investment in several areas, widespread participation of private firms in oil field auctions, and a more important role of the financial system in supporting growth, among others.
The policies implemented have contributed to recent improvements in the business climate, to levels close to best performers in the emerging world...

Distance to Frontier Score
0-100 Scale

Note: EMEs included: Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Malaysia, Peru, Poland, Russia, South Africa, Thailand, and Turkey.

Note: The bubble size indicates the total number of changes in either the rating or the outlook, from the part of three major agencies, for each country over the last 24 months. A green bubble represents an improvement in the credit rating, while a red bubble represents a negative change. 
Source: Bloomberg.
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To conclude:

- The Mexican economy has shown a relatively good performance in the face of major shocks.

- A gradual strengthening of economic activity is expected in 2016 and in 2017.

- In addition, Mexico is one of the few EMEs where an increase in potential GDP growth is anticipated in coming years.

- Meanwhile, inflation is projected to remain low, rising to levels around the 3 percent target throughout both 2016 and 2017.

- With the recent increase in the federal funds rate signaling confidence of US authorities in the economic outlook, Mexico is likely to benefit in coming years from close links with that economy.
However, external conditions will probably remain very difficult.

Besides going through a particularly complicated juncture, the world economy is facing major challenges of a structural nature.

In view of the above, it will be essential to continue to implement a prudent and flexible monetary policy, adhere to the announced strengthening of public finances, ensure the stability of the financial system, and persevere in the efforts of structural adjustment and transformation of the institutional framework.