Mexico’s Monetary Policy and Economic Outlook

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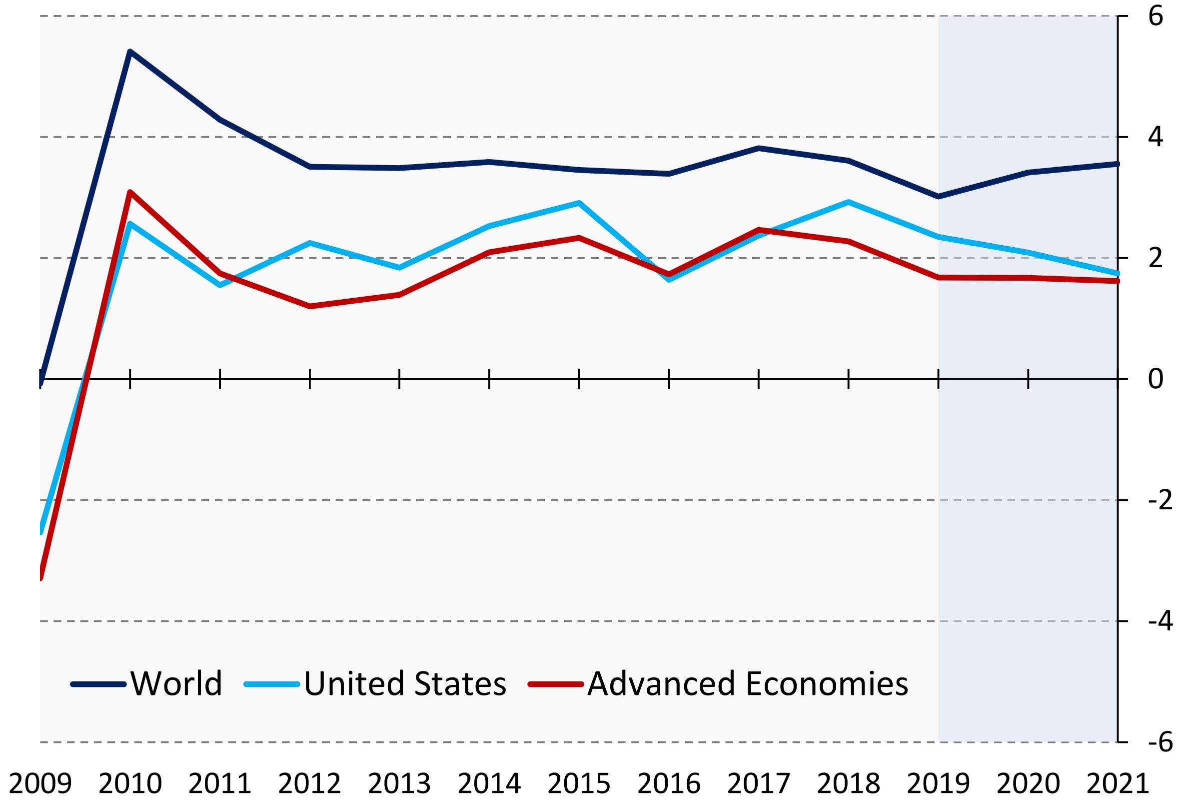
Monetary policy in Mexico faces a challenging situation:

- A complex external environment.
- A weak economic activity with a negative output gap.
- Headline inflation in line with the target, but relatively high core inflation.
- An increase in the perception of country risk.
- A situation of high uncertainty.

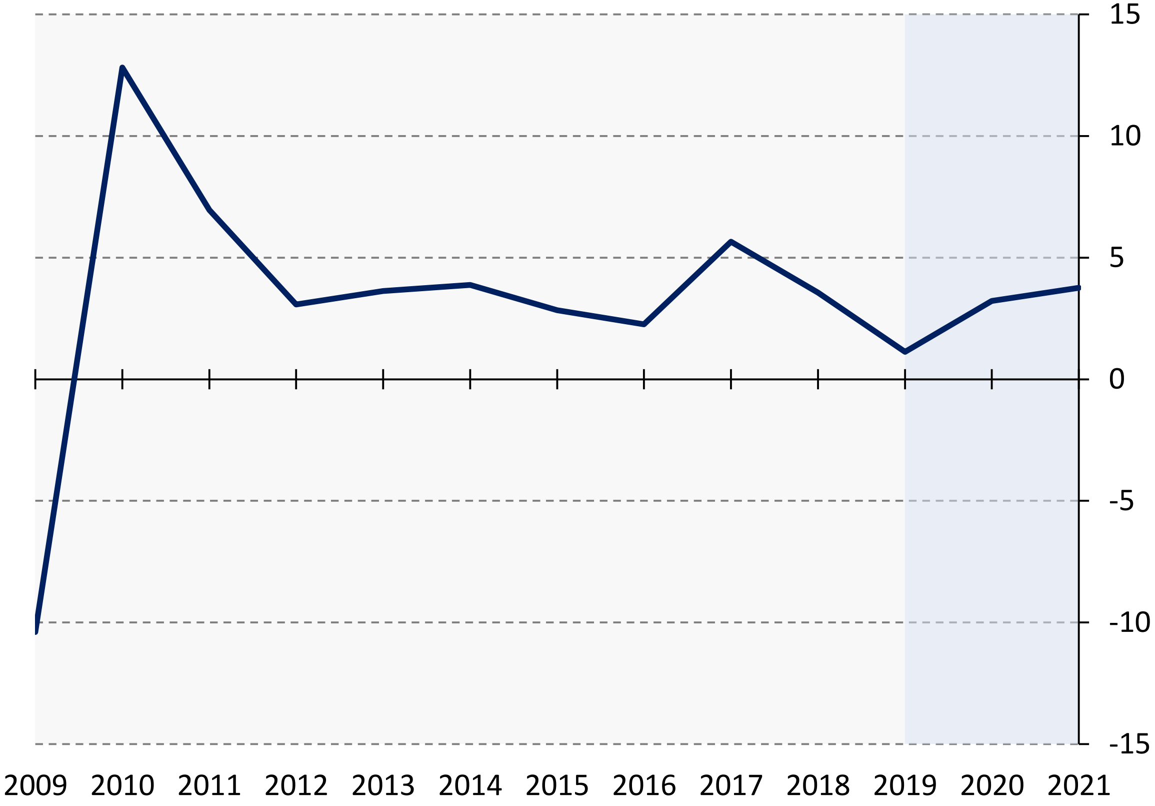
World economic growth and the expansion of global trade have decelerated significantly.

Real Gross Domestic Product
Annual % change



Source: IMF.

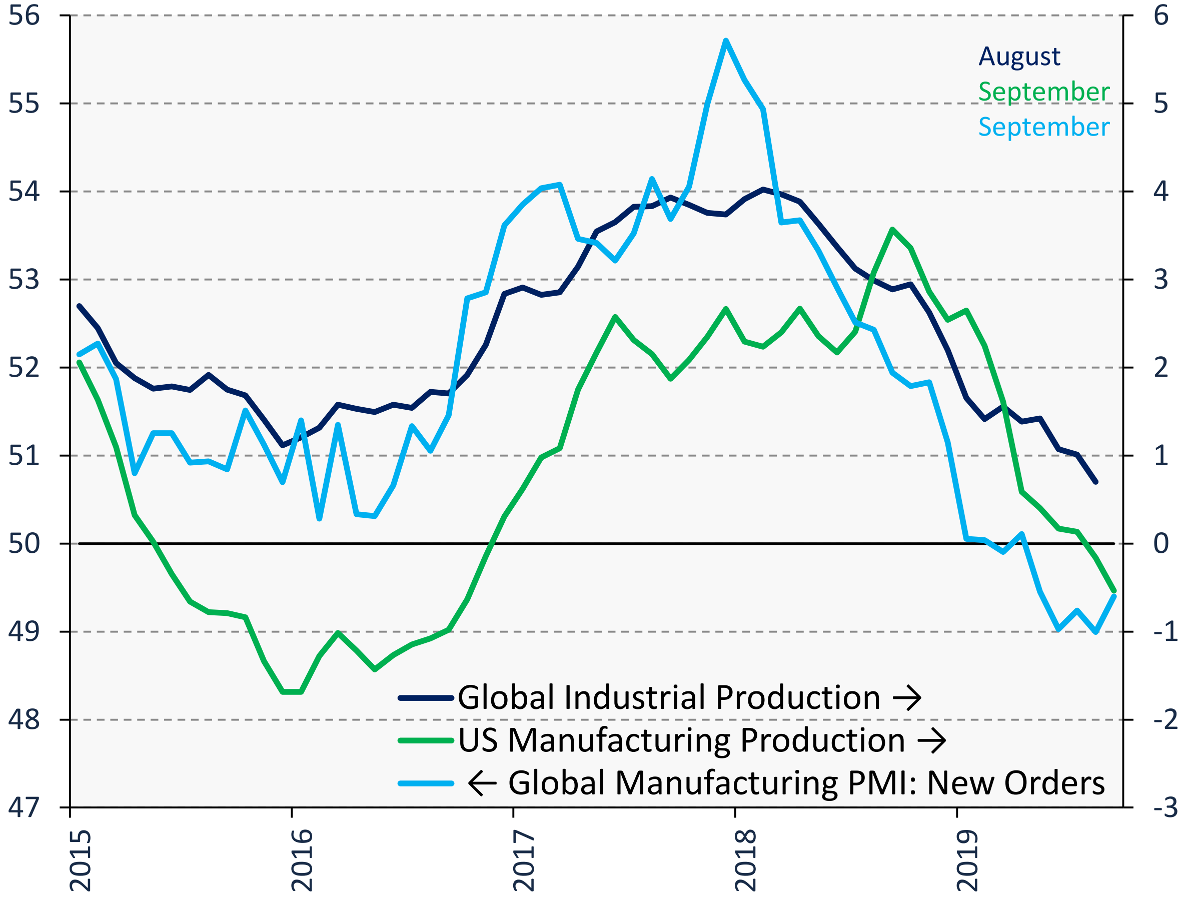
Trade Volume of Goods and Services
Annual % change



Source: IMF.

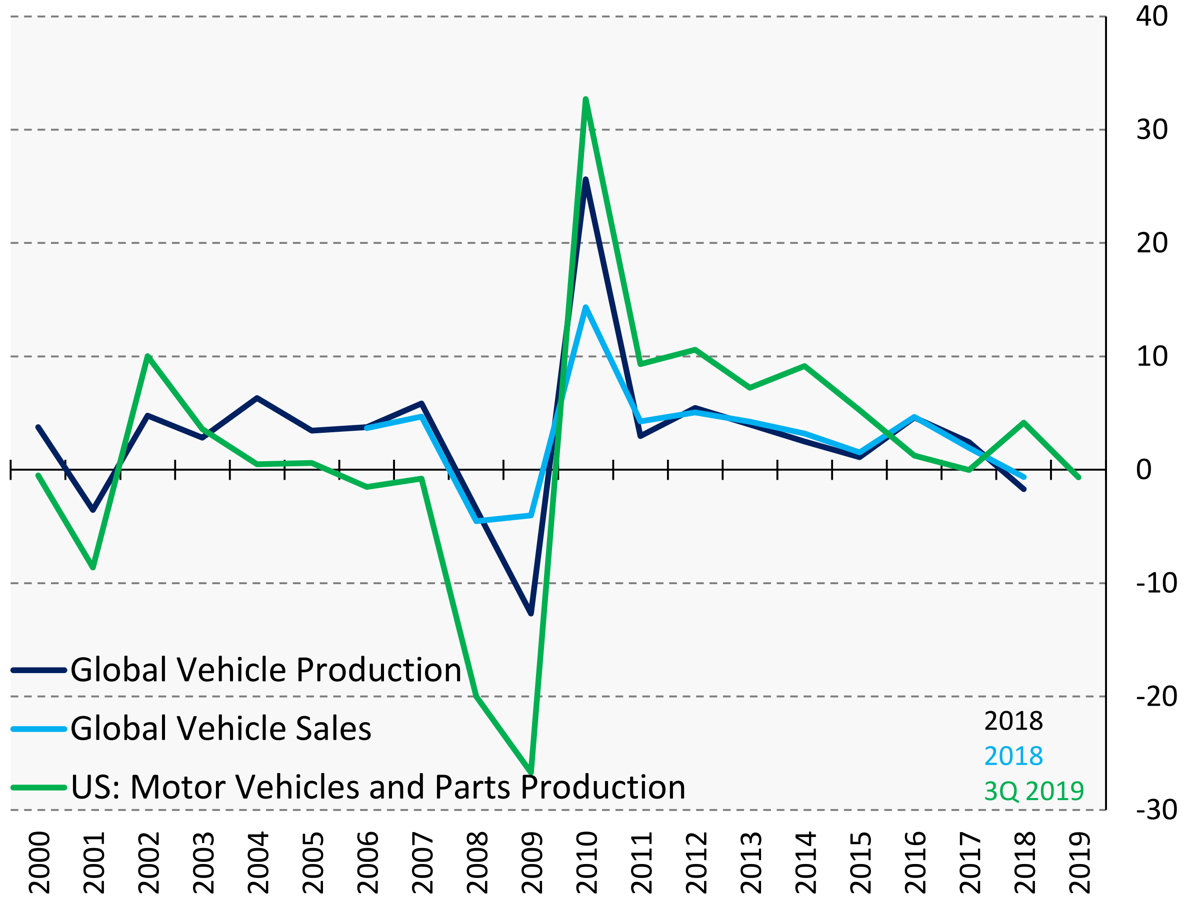
The situation is particularly difficult in the case of industrial output, and especially in the automobile sector.

Economic Activity Indicators
Annual % change of 3-month moving average and diffusion index with a threshold of 50



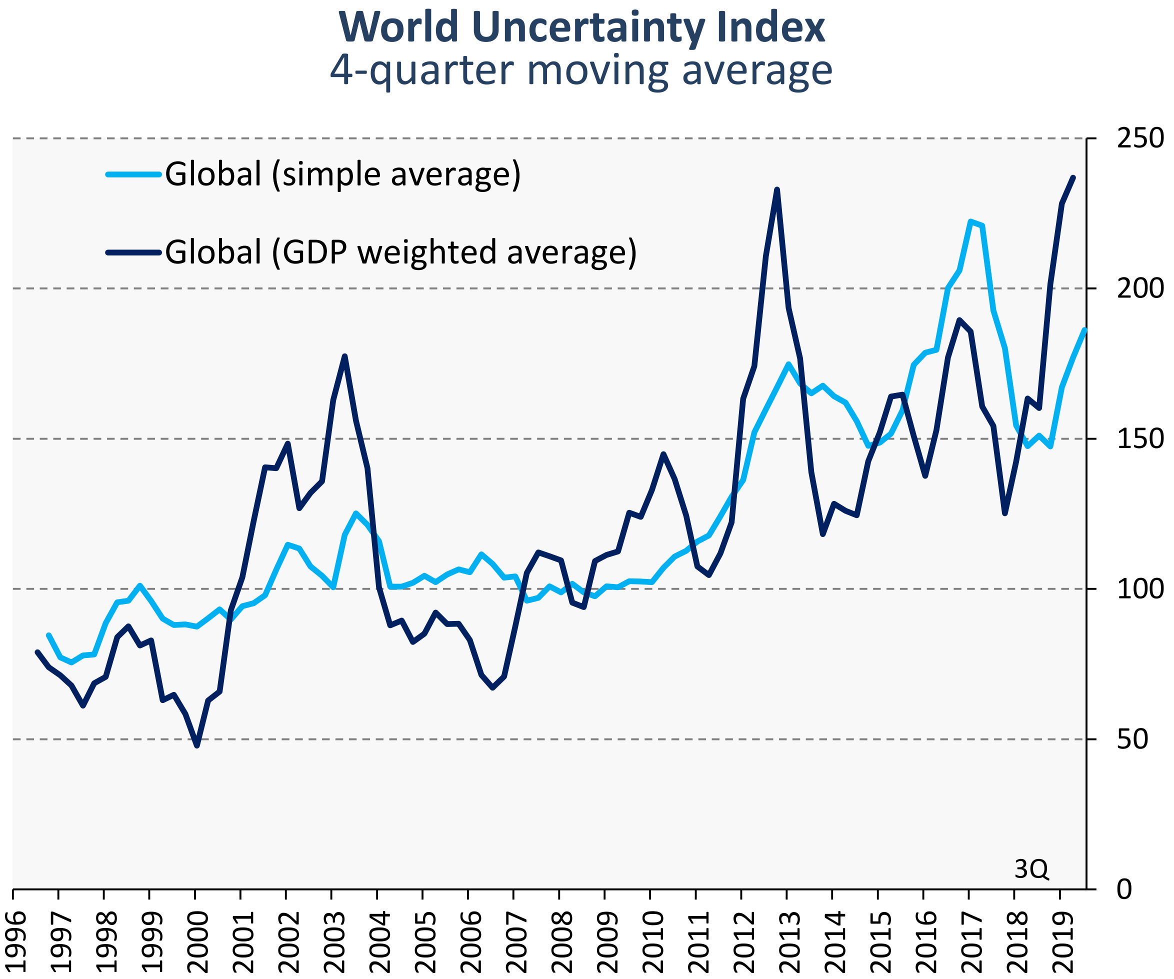
Source: CPB Netherlands, Markit and Federal Reserve.

Sales and Production of New Vehicles and Parts
Annual % change



Source: International Organization of Motor Vehicle Manufacturers and Federal Reserve.

This has been the result to a significant extent of uncertainty, especially from global protectionist trends.



Source: Economic Policy Uncertainty.

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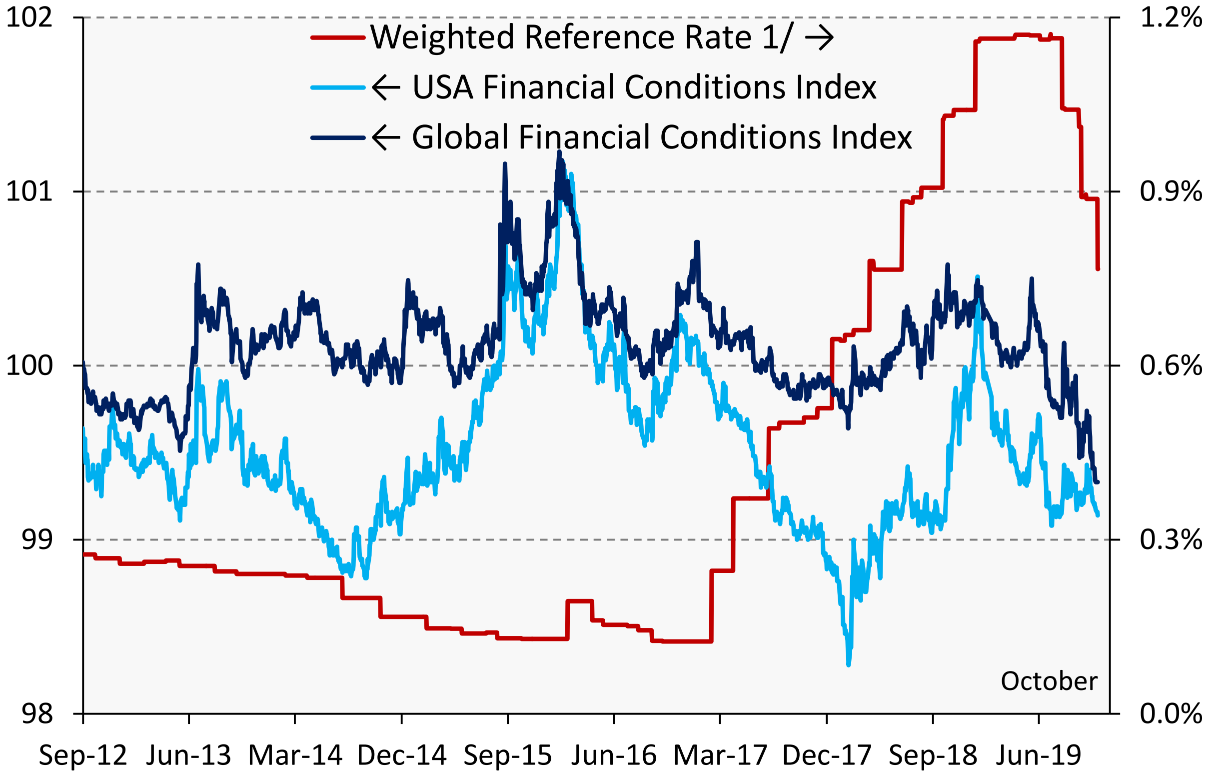
- Other sources of uncertainty include:
  - The possibility of a sharper deceleration of world economic activity.
  - The exit process of the United Kingdom from the European Union.
  - The economic situation of several advanced and emerging market economies.
  - Problems of a political or geopolitical nature in some regions of the world.
- More specifically related to Mexico, the ratification of the trade agreement with the US and Canada is of major importance.

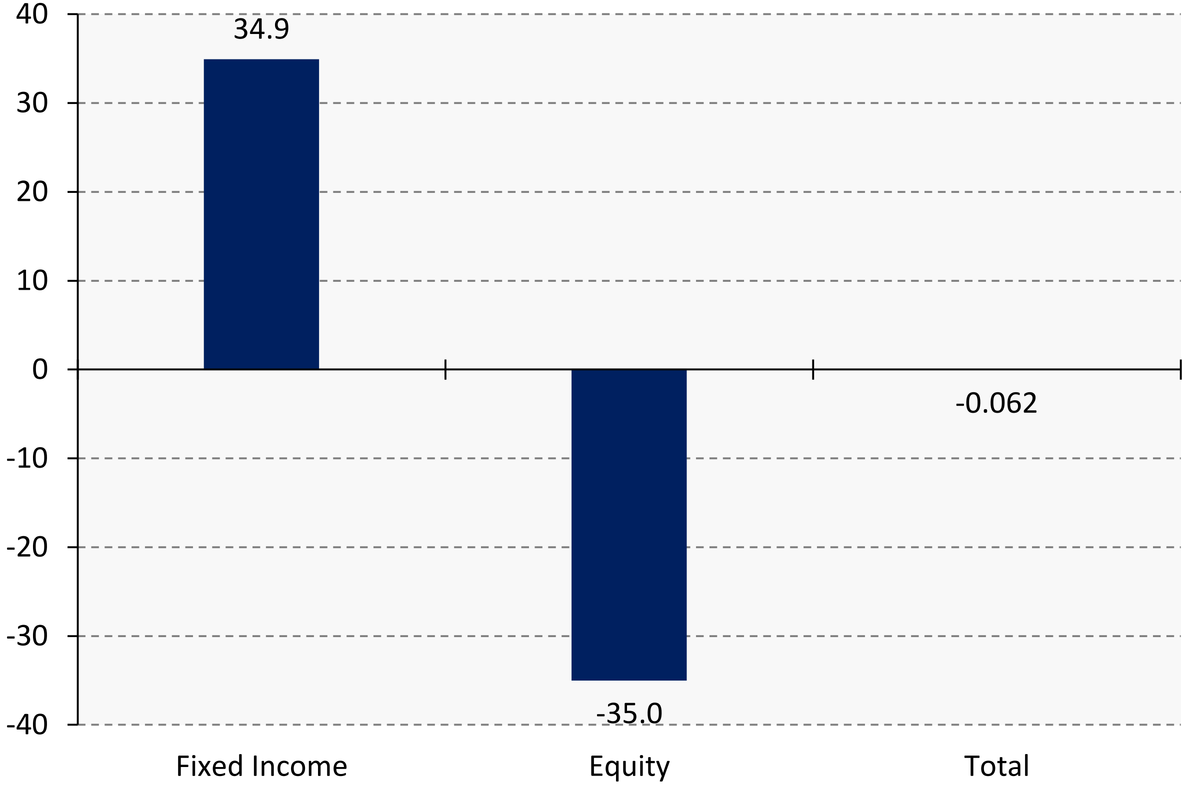
As a result of the weakness of economic activity, many countries have relaxed their monetary policy stance, leading to easier global financial conditions. However, net portfolio capital flows to emerging market economies through this year show slightly negative figures.

Weighted Reference Rate and Financial Condition Index
Units, %



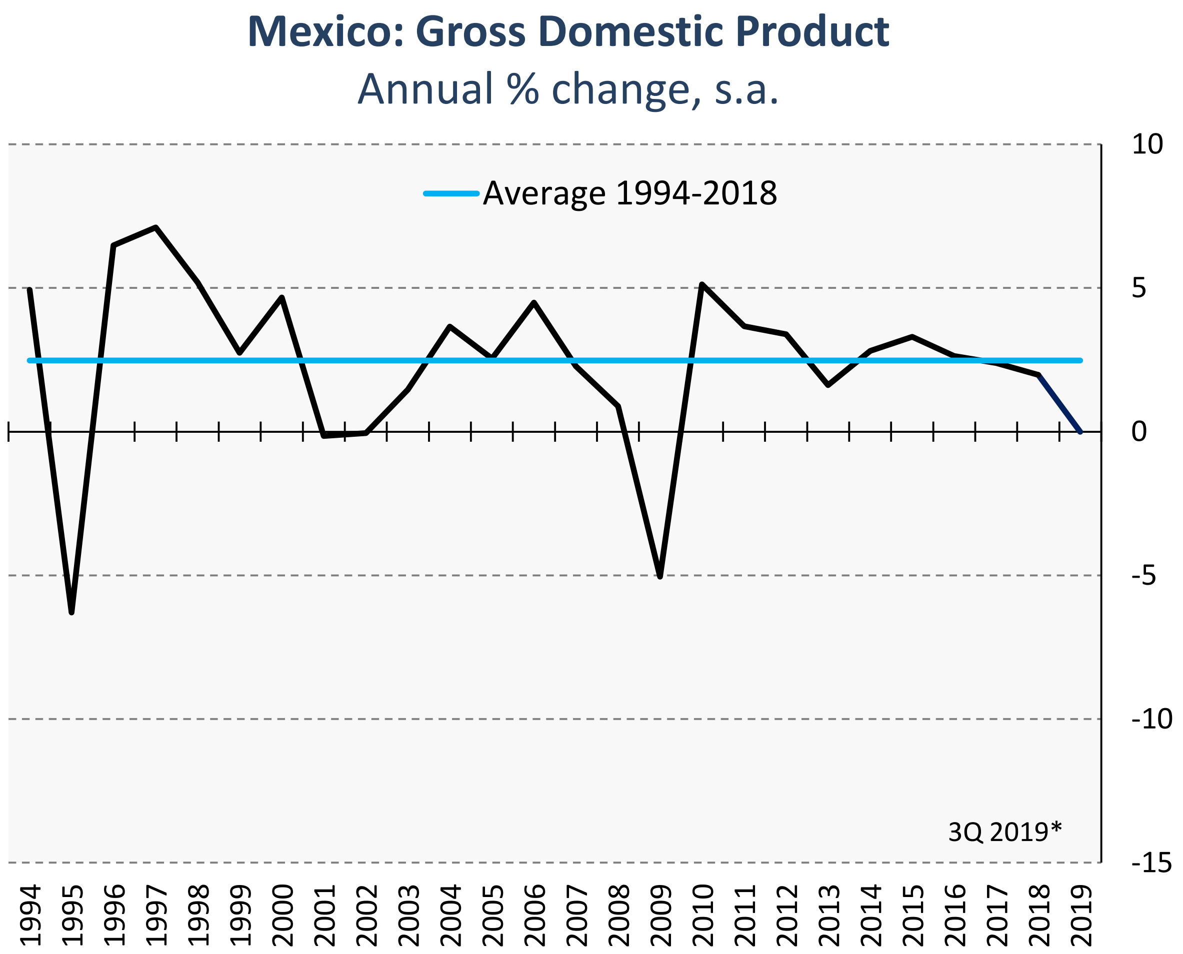
1/ Weights are based on nominal GDP. The sample includes: Canada, Eurozone, Japan, United States and United Kingdom.
Source: Banco de México with data from Bloomberg and Goldman Sachs.

Capital Flows to EMEs[2/]
Billions of US dollars

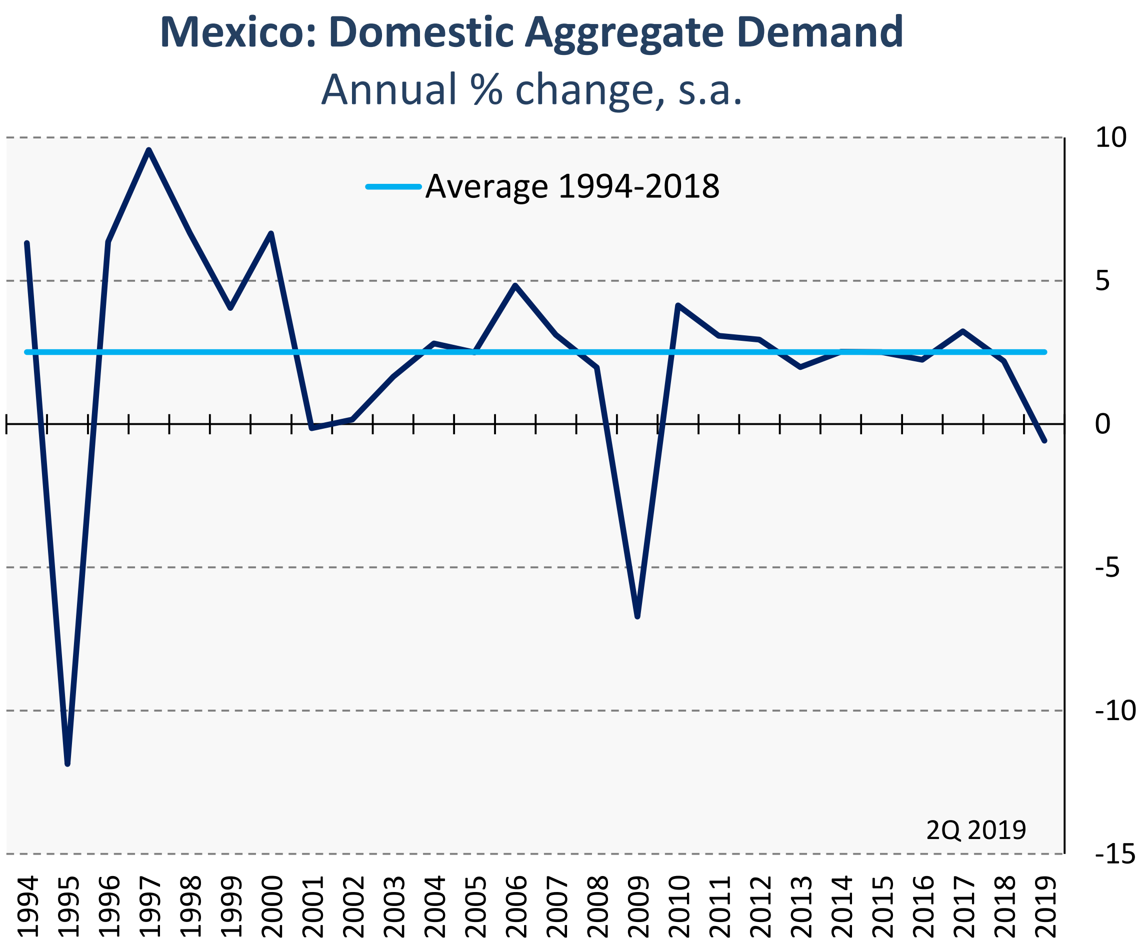


2/ Accumulated flows from January through October 2019.
Source: EPFR.

In Mexico, economic growth has decelerated…



s.a. / Seasonally adjusted series.
*/ Preliminary data for 3Q 2019.
Source: INEGI.



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

… mainly as a result of the evolution of investment.

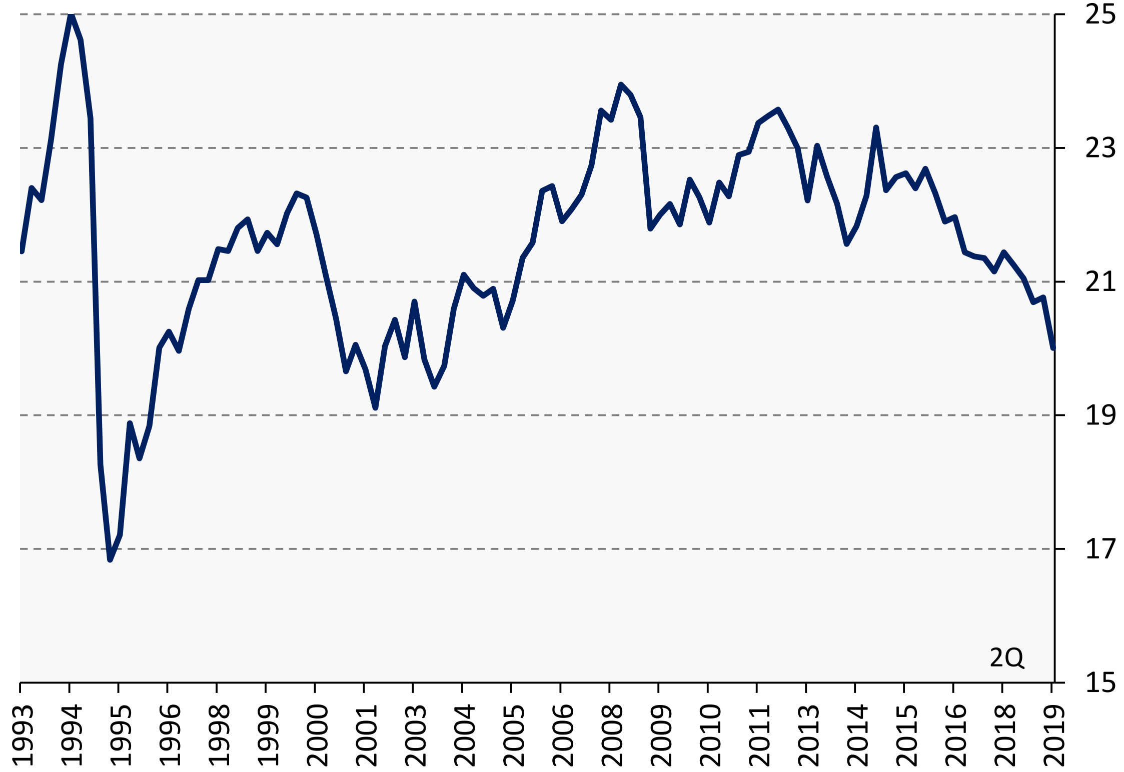
Contributions to the Real GDP Annual Growth (GDP percentage points)			
	2018	I-2019	II-2019
GDP	1.98	0.10	0.32
Total Consumption	1.64	-0.04	0.18
Private Consumption	1.48	0.12	0.40
Public Consumption	0.16	-0.15	-0.23
Total Investment	0.12	-0.70	-1.07
Private Investment	0.15	-0.41	-0.69
Public Investment	-0.02	-0.33	-0.34
Change in Inventories	0.08	0.05	-0.11
Trade Balance (Goods and Services)	-0.24	0.73	0.91

Seasonally adjusted series.
Source: INEGI.

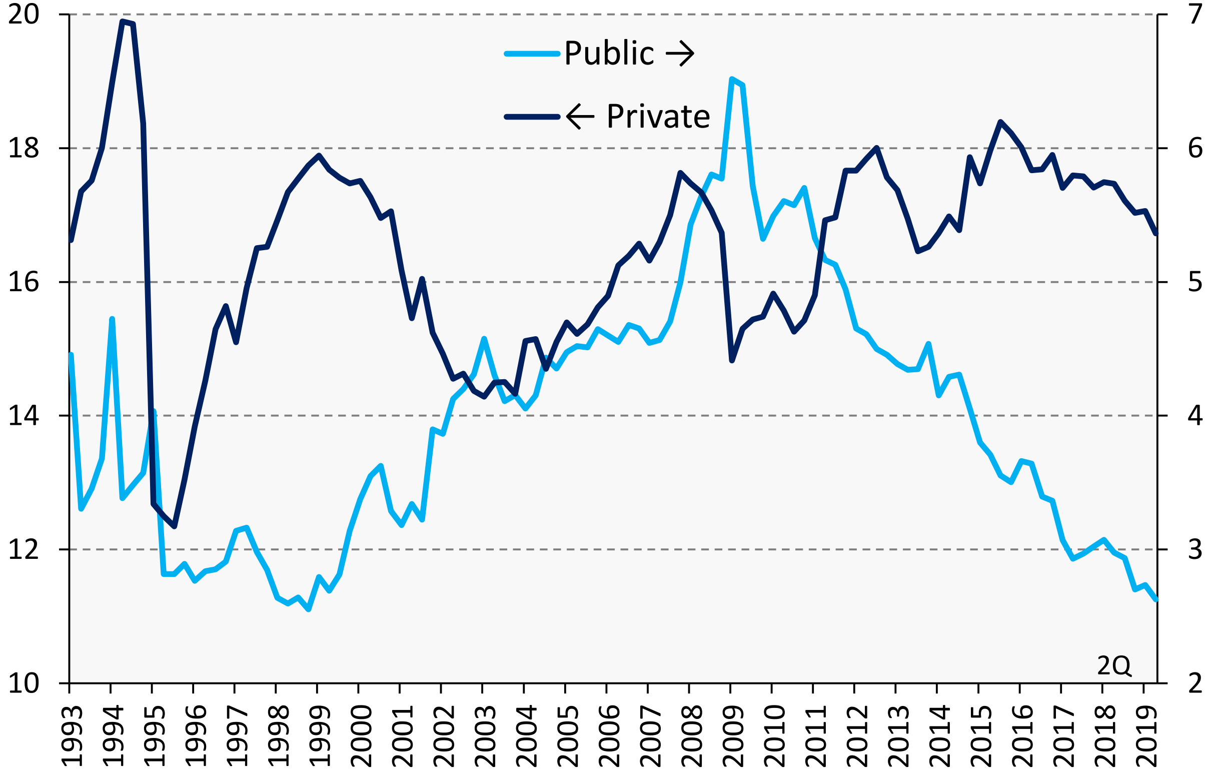
In fact, the downward trend of the investment rate is a source of concern…

Investment

% of GDP, s.a.



s.a. / Seasonally adjusted series.
Note: Total investment rates based on both gross fixed capital formation and inventories.
Source: INEGI.

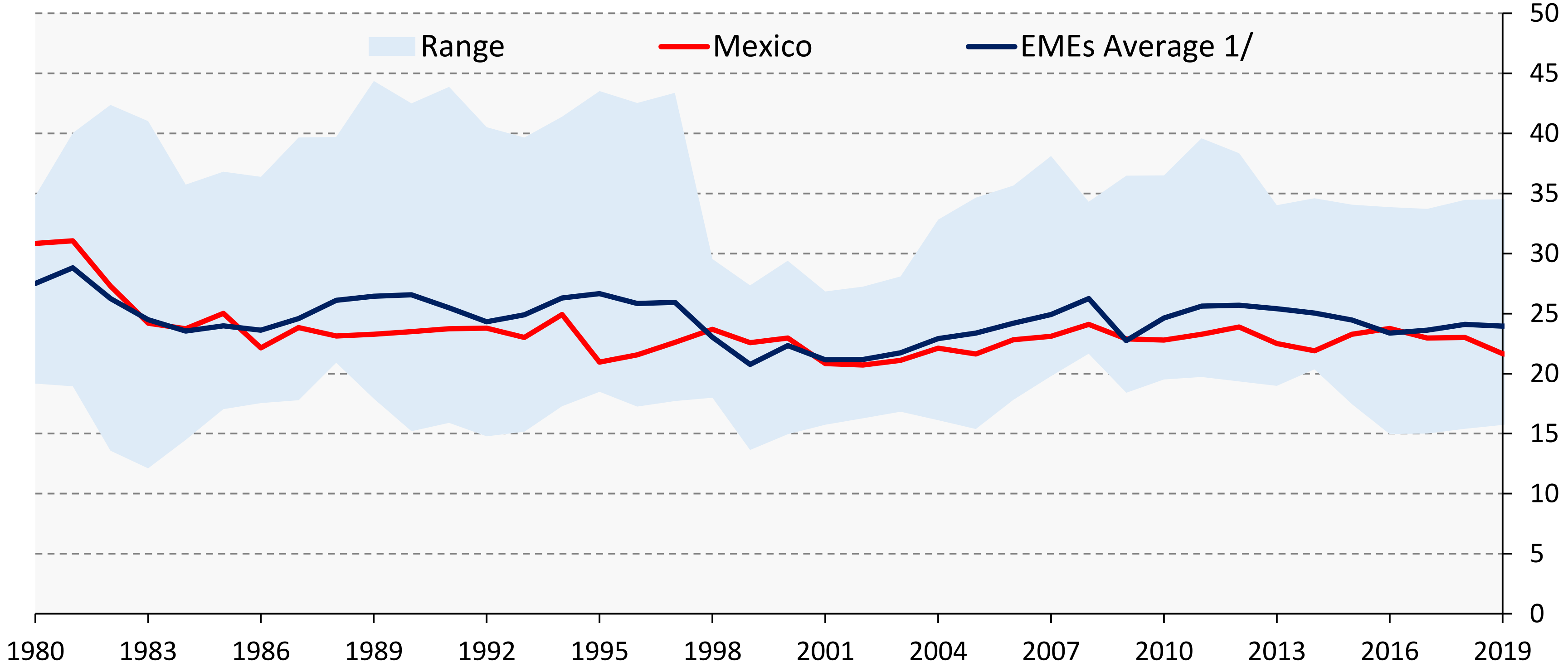


s.a. / Seasonally adjusted series.
Note: Public and private investment rates based on gross fixed capital formation only.
Source: INEGI.

… and more so in view of its low level as compared with other EMEs…

Total Investment

% of GDP

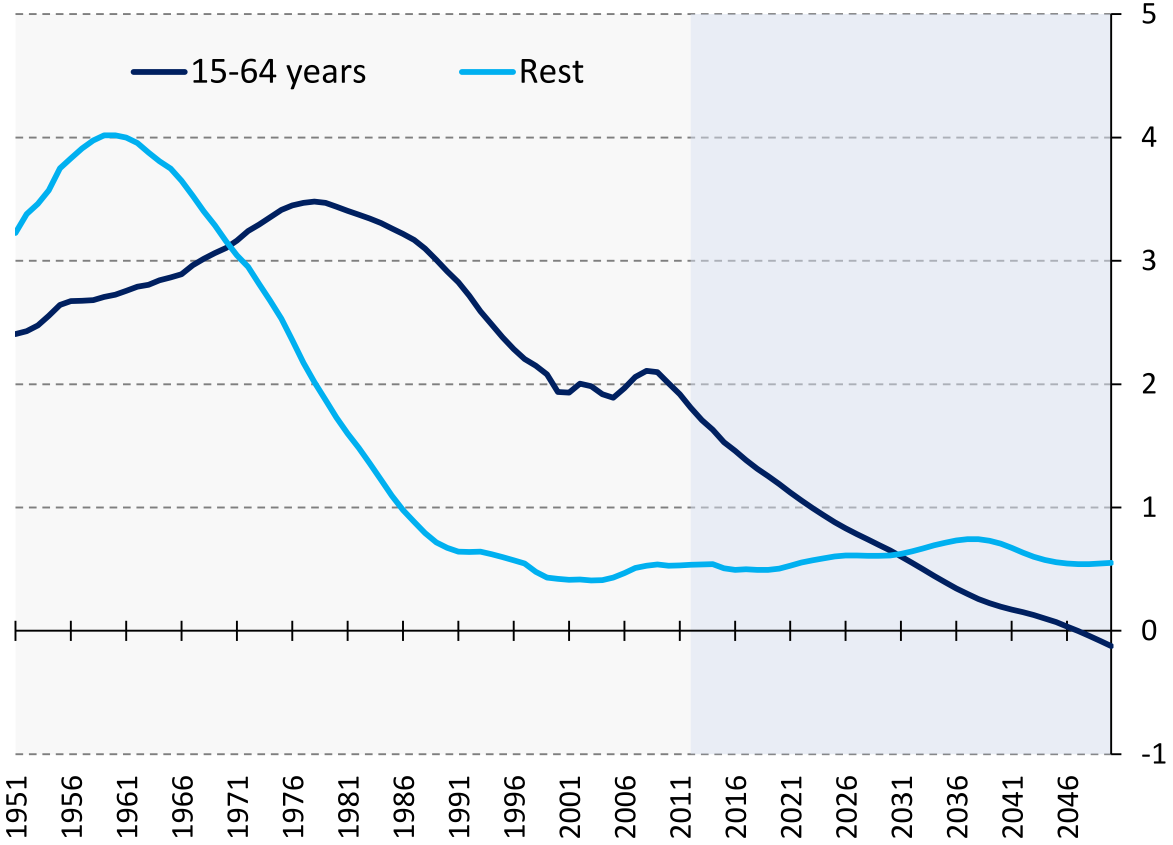


1/ The sample includes: Brazil, Chile, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Poland, South Africa, Thailand and Turkey.
Note: Figures may vary from INEGI statistics due to methodological differences.
Source: IMF.

… and its implications for potential growth, since it combines with declining productivity. These trends should be reversed to take advantage of still-favorable demographic perspectives.

Population

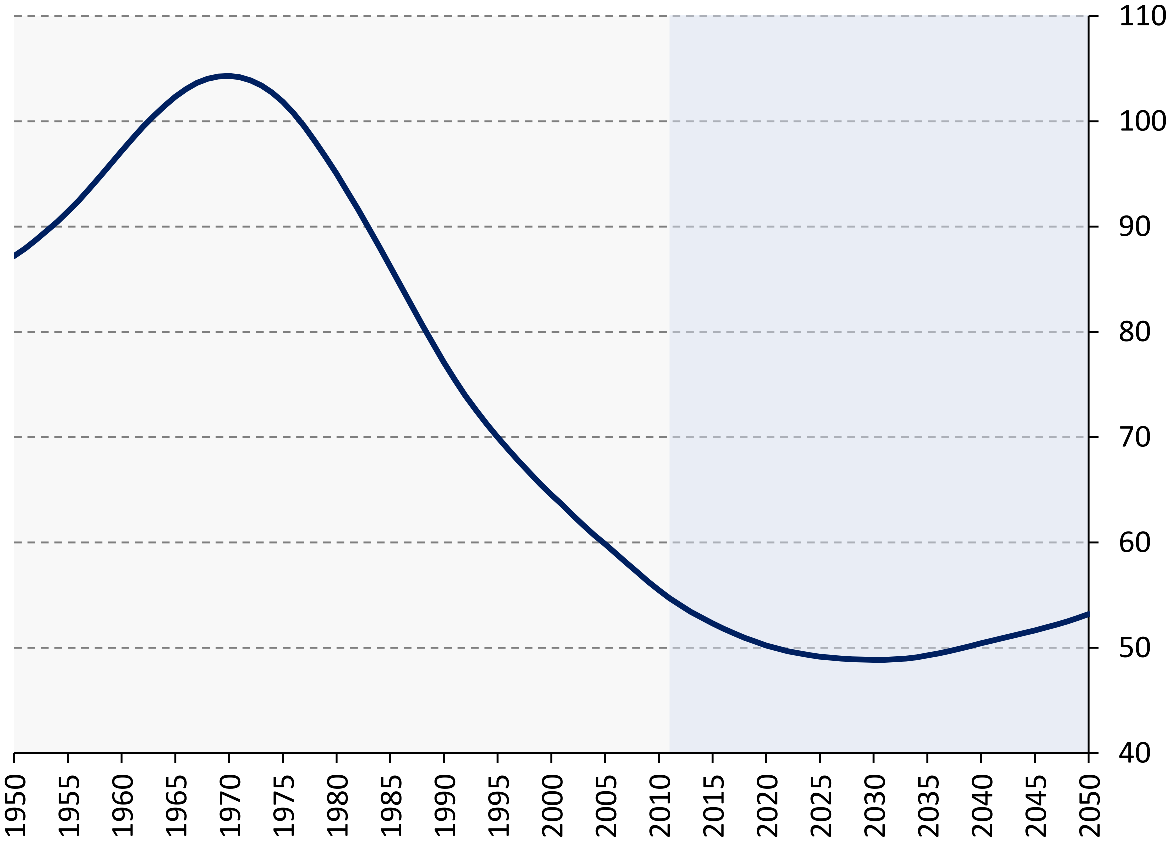
Annual % change



Source: CONAPO.

Age Dependency Ratio

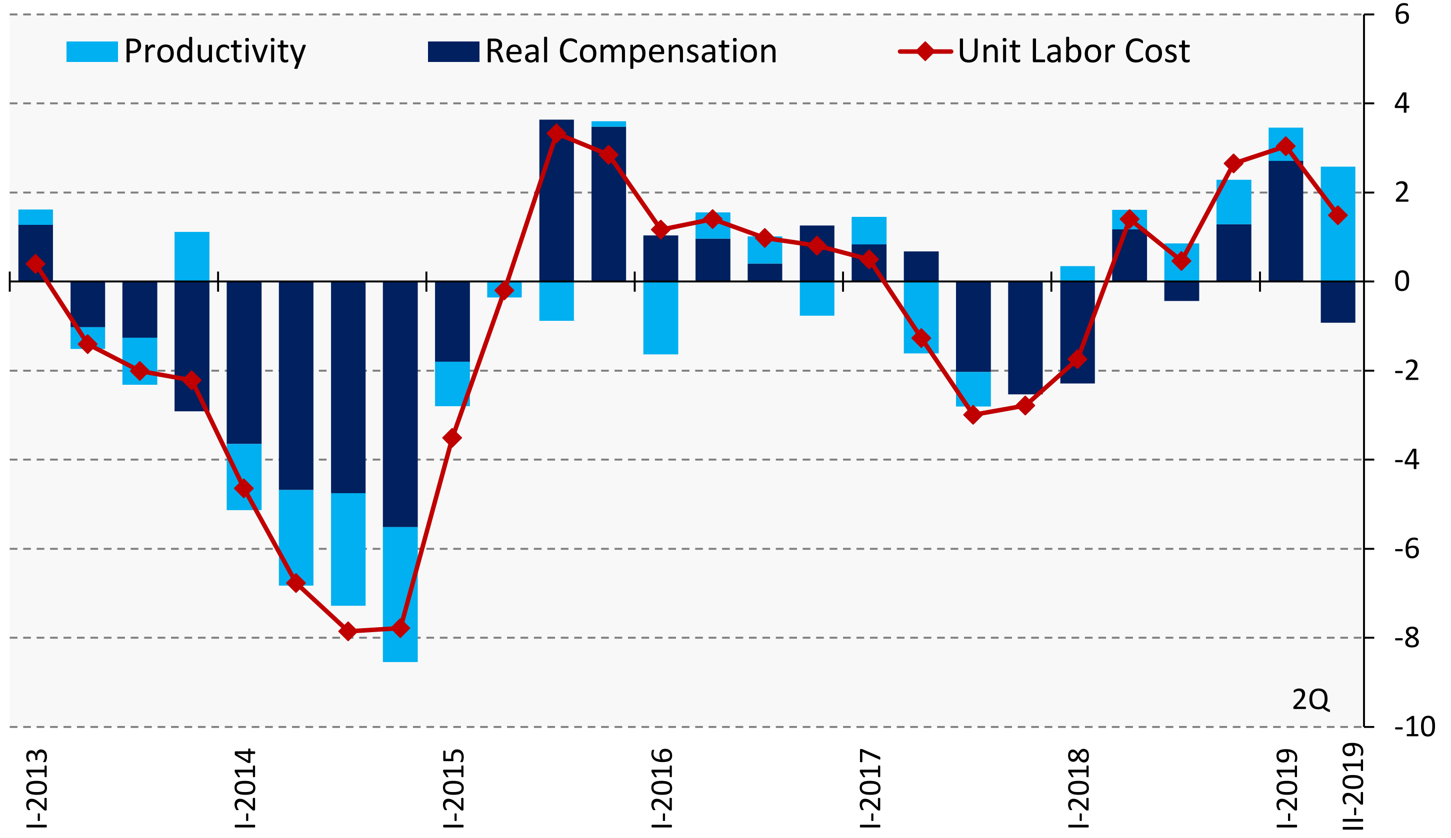
% of working-age population



Note: The age dependency ratio is the ratio of dependents (people younger than 15 or older than 64) to the working-age population (those ages 15-64).
Source: CONAPO.

Despite the weakness of economic activity, unit labor costs have increased.

Productivity and Unit Labor Costs for the Economy[1/]
Annual % change, s.a.



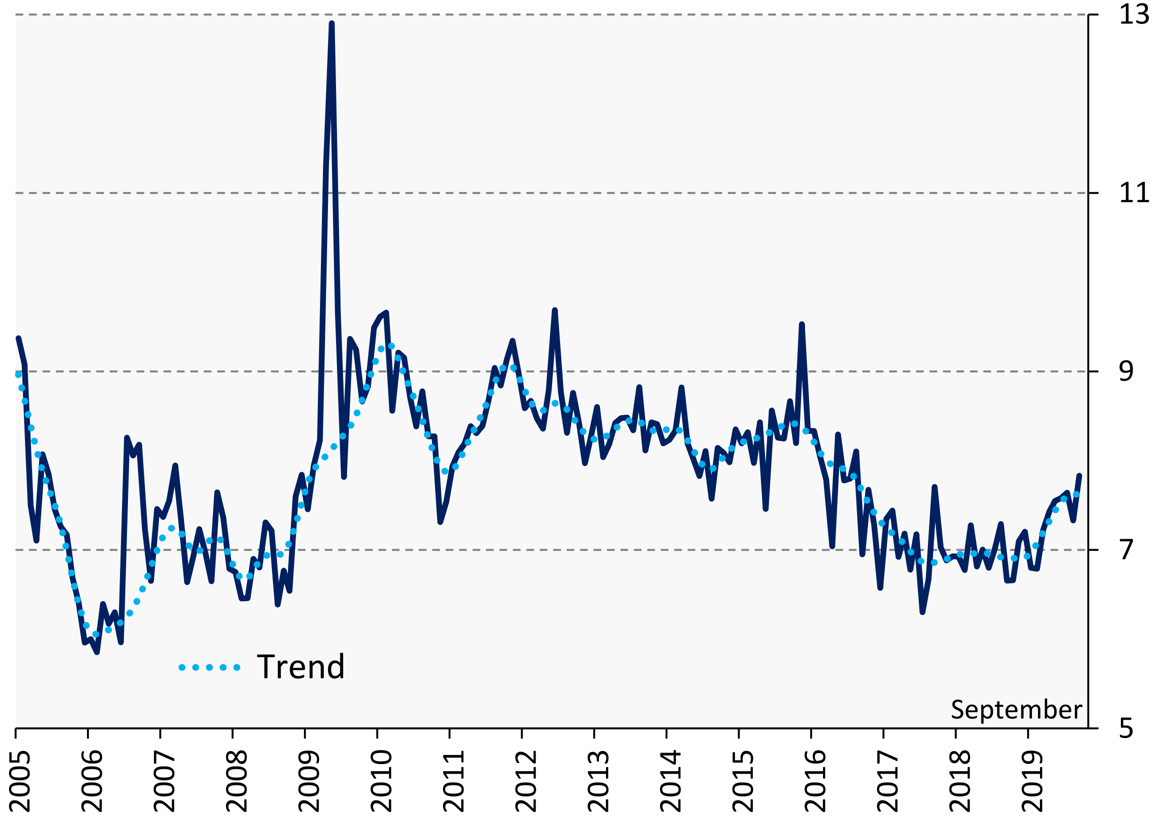
s.a. / Seasonally adjusted series.
1/ Labor productivity based on worked hours.
Source: Banco de México with data from INEGI.

This combination of factors has been reflected in the evolution of the labor market.

Formal Sector Workers
Annual % change, s.a.

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

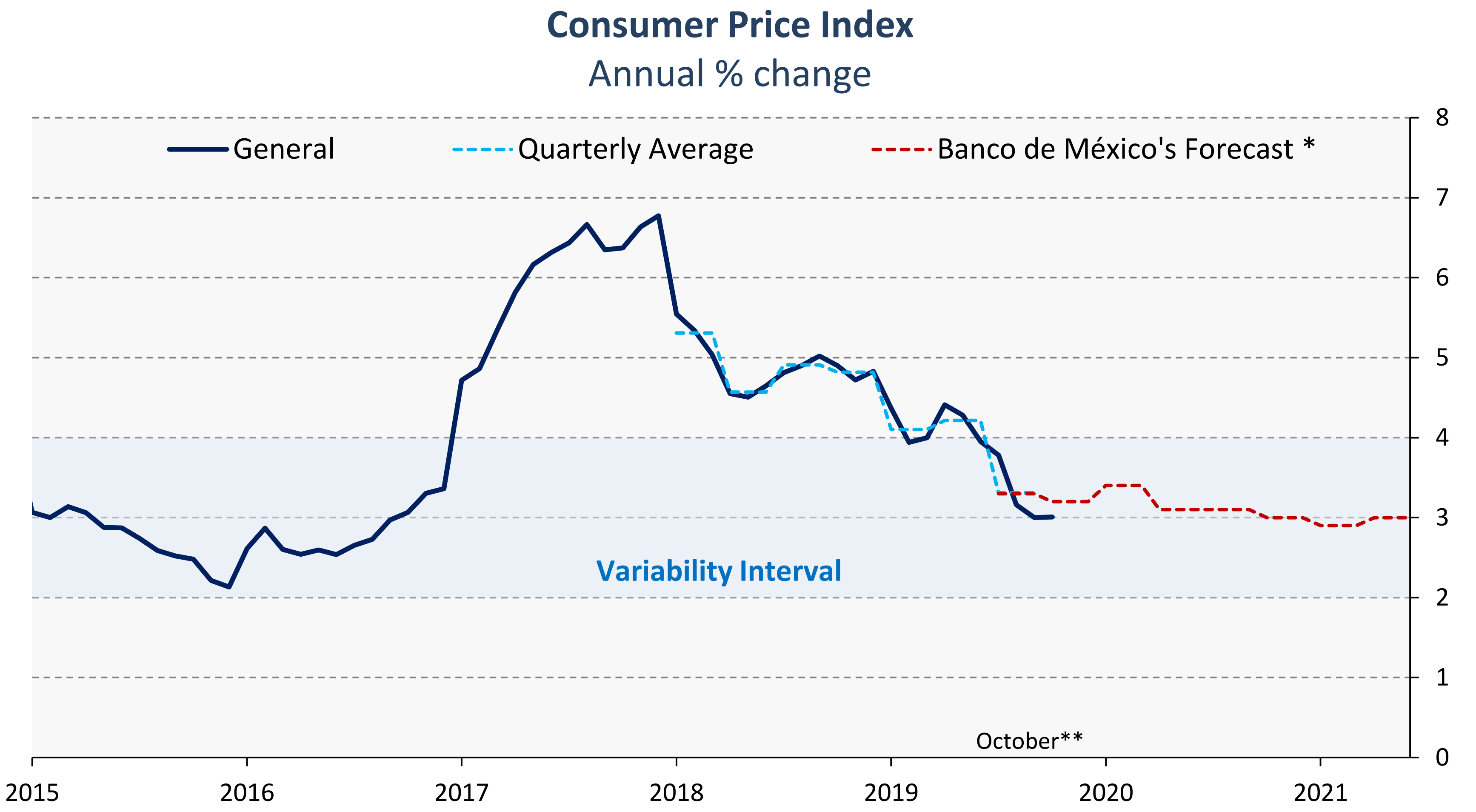
Underemployment Rate
% of working population, s.a.



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

- Economic activity is expected to recover gradually in 2020.
- However, a negative output gap is anticipated for this period.
- In addition, the economy faces a number of downside risks:
  - A sharper-than-expected deceleration of external economic activity, especially in the United States.
  - An increase in global protectionist trends.
  - Delays in the ratification of the USMCA.
  - A further weakening of global industrial production and the automobile sector.
  - A downgrade of sovereign or Pemex credit ratings.
  - Persistent uncertainty related to domestic factors.
  - A continued downward trend in productivity.

Headline inflation has declined faster than anticipated.

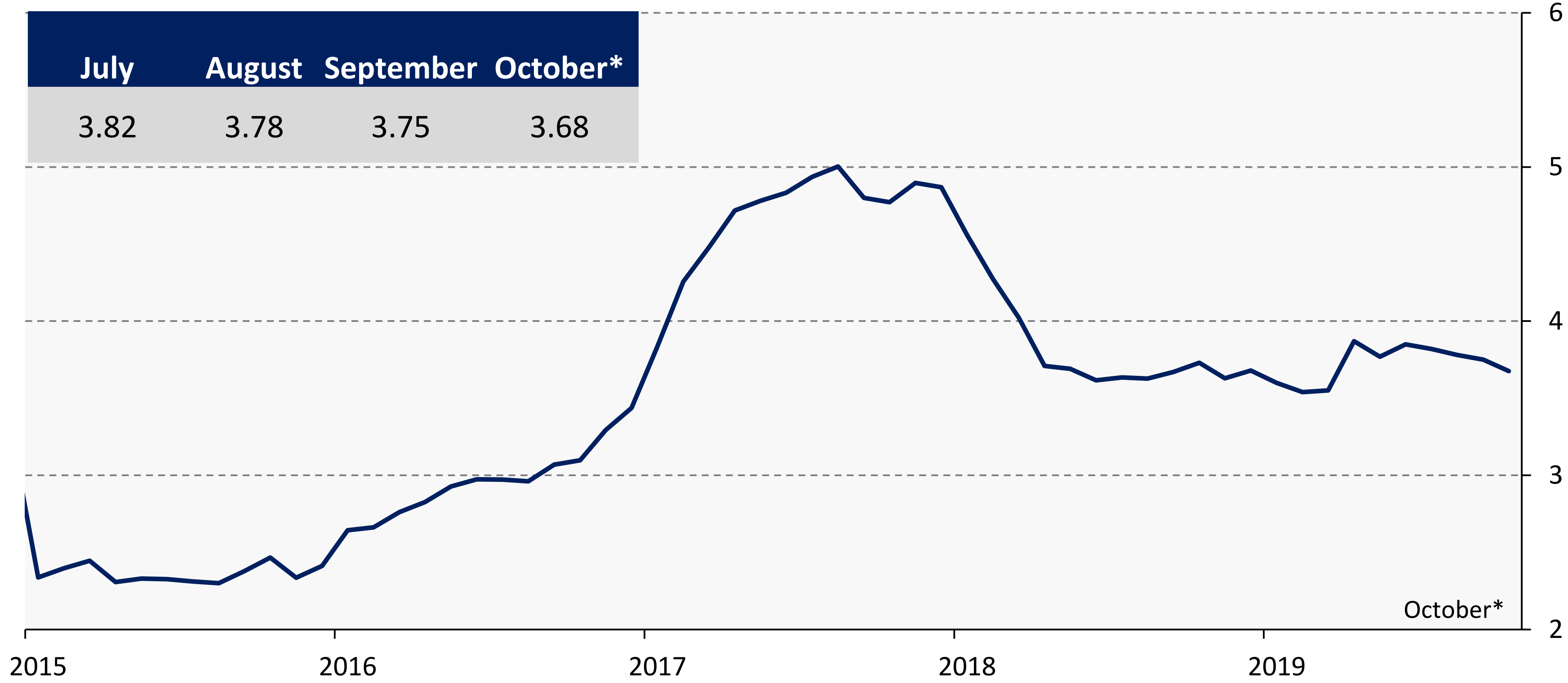


*/ As of August 2019 (latest).
**/ Data through the first fortnight of the month.
Source: Banco de México and INEGI.

However, this is explained by the evolution of non-core inflation. Core inflation remains relatively high, but is beginning to decline.

CPI: Core Inflation
Annual %

July	August	September	October*
3.82	3.78	3.75	3.68



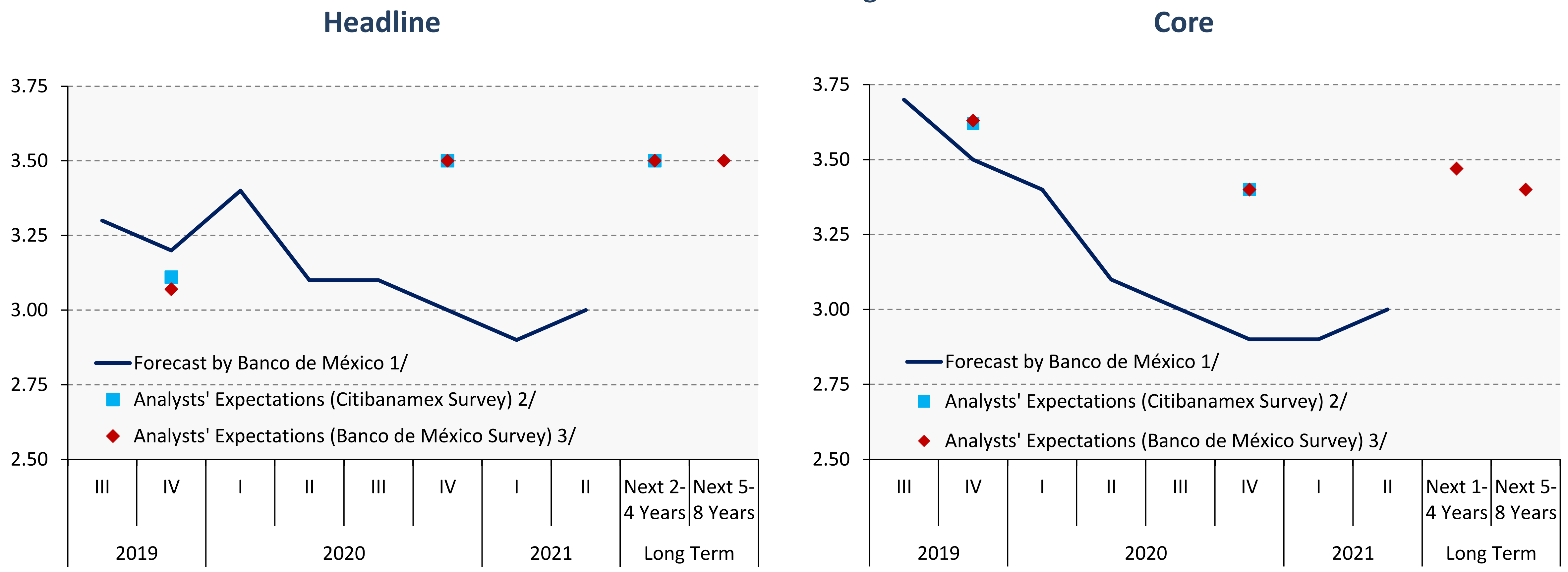
*/ Data through the first fortnight of the month.
Source: INEGI.

- Core inflation should continue to fall in coming months, in view of the weakness of economic activity and as some of the supply shocks that affected it in previous months vanish.
- The Banco de México projects that both headline and core inflation will converge to the 3 percent target during the second half of 2020.
- This is subject to risks in both directions.
  - The evolution of the exchange rate, wages and public finances, among other factors, may exert upward pressures on prices.
  - A negative output gap, in a context of downside risks for economic activity, is the main force in the opposite direction.

Inflation expectations for 2019 have fallen but remain above the Central Bank's projections for 2020 and for the long term.

Consumer Price Index

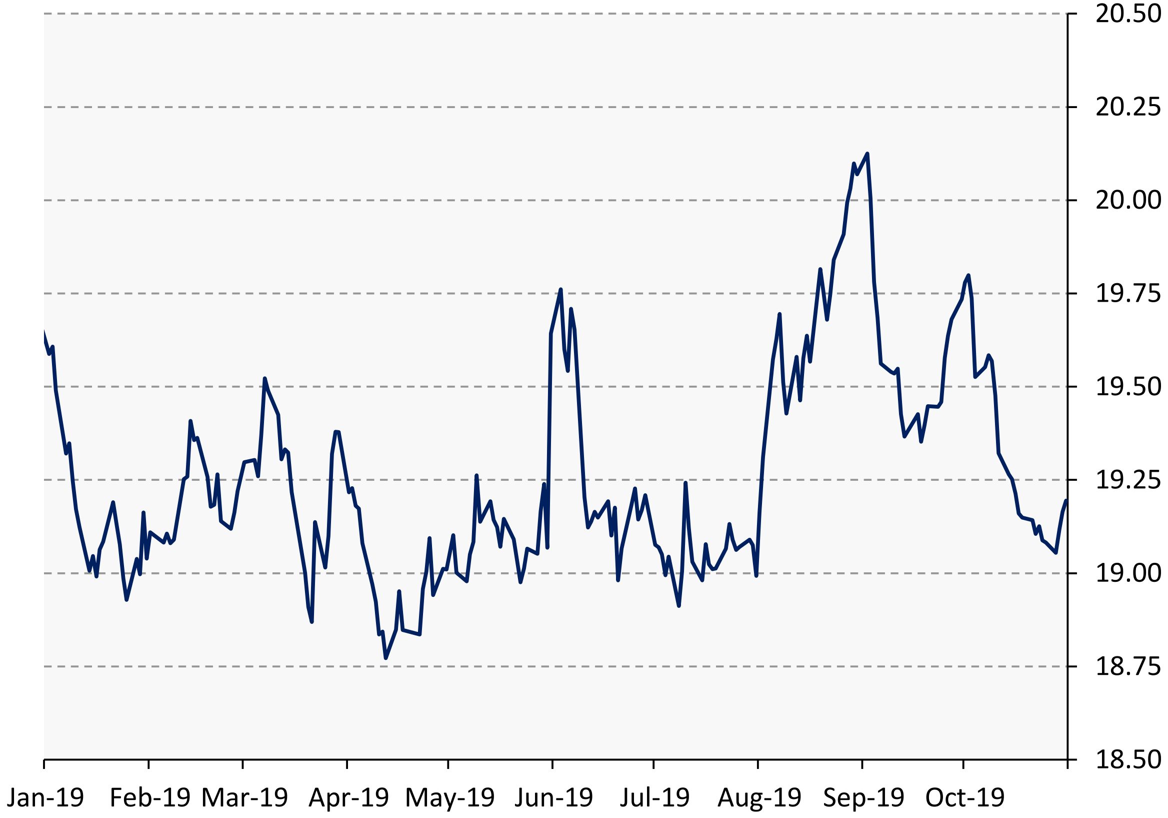
Annual % change



1/ As of August 2019 (latest).
2/ As of the second fortnight of October 2019 (latest).
3/ As of October 2019 (latest).
Source: Banco de México and Citibanamex.

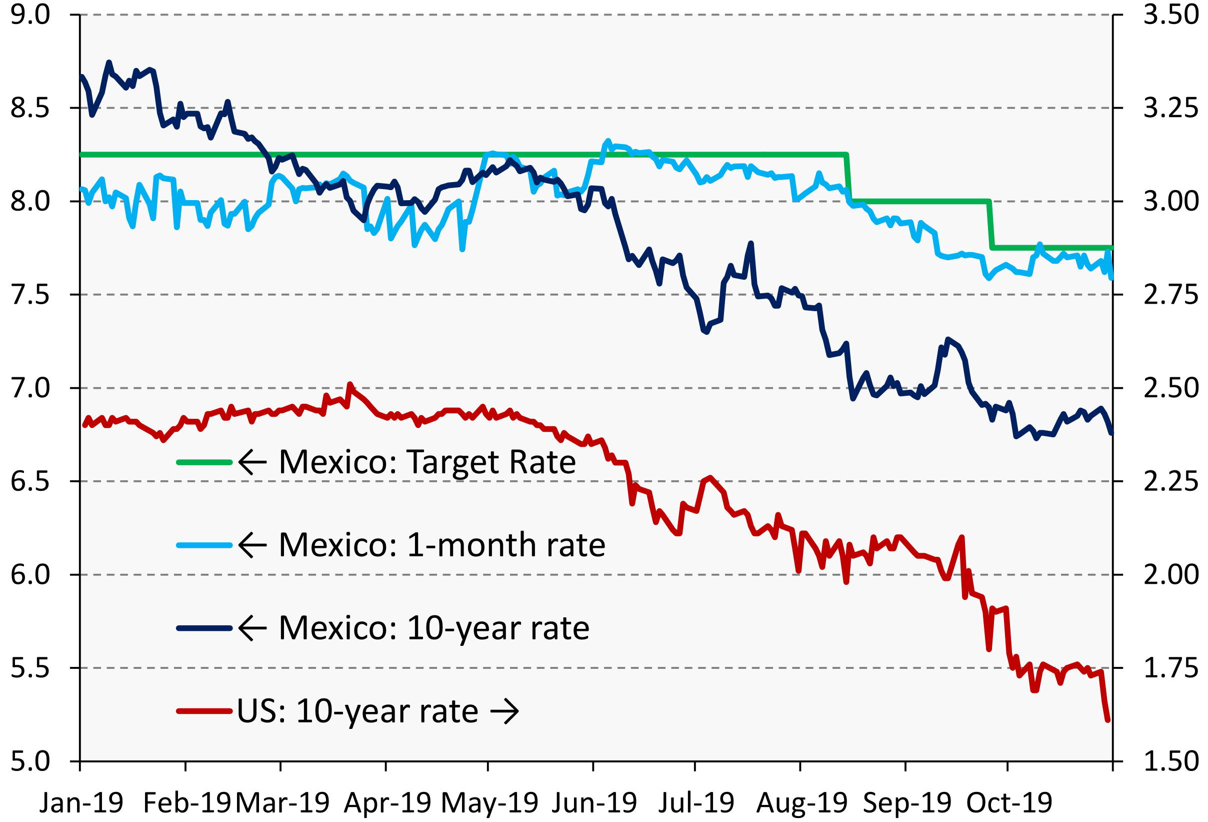
Mainly as a result of external developments, the evolution of domestic financial markets has improved in recent weeks.

Exchange Rate
Mexican pesos per dollar



Source: Banco de México.

Interest Rates
%



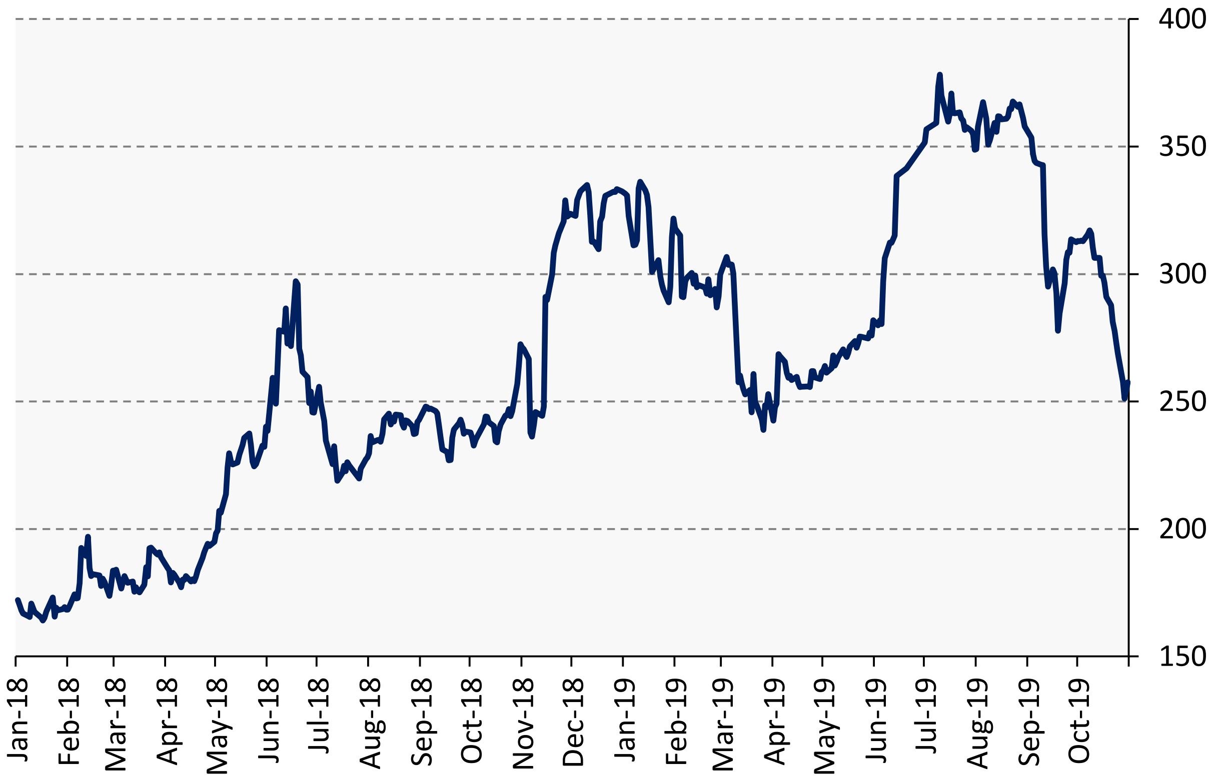
Source: Banco de México, Proveedor Integral de Precios and Federal Reserve.

- The economy continues to face a situation of high uncertainty and important risks.
- One rating agency downgraded the sovereign rating in mid-2019. The main arguments were a combination of possible spillovers from Pemex's worsening credit profile to public finances, a weak macroeconomic outlook, trade tensions, domestic policy uncertainty and ongoing fiscal constraints.
- In addition, the other two main agencies have kept the sovereign rating with a negative outlook. Moreover, the financial situation of Pemex has given rise to concern.

A number of actions recently taken by the government have alleviated Pemex's liquidity problems, with a positive impact on market indicators.

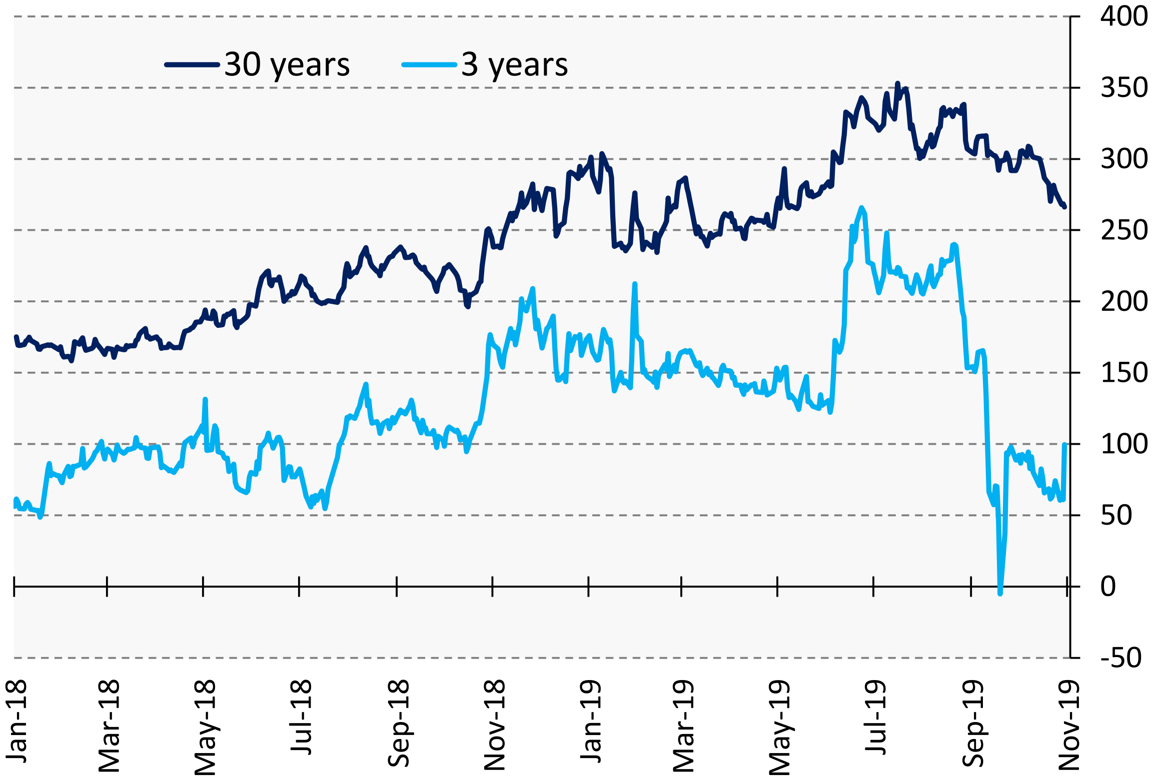
Petróleos Mexicanos

Market Indicators of Credit Risk[1/]



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

Interest Rate Spread[2/]



2/ As measured by Pemex bond interest rate minus the government bond interest rate.
Source: Bloomberg.

- However, the company's long-term challenges remain.
- One of the main risks derives from the possibility of a rating downgrade by one of the agencies, since this would reduce it below investment grade.
- This agency has noted that a downgrade of Mexico's sovereign A3 rating, a lower-than-expected government support to the company, significant increases in Pemex's net debt, an operational performance below projections or a decrease in reserves or reserve replacement, among other factors, can result in a downgrade.
- At the same time, this agency considers that capital spending planned by Pemex for 2019 and 2020 is well below the amounts needed to replace reserves.
- Therefore, the possibility of a downgrade is significant, with the consequent risks for the sovereign rating and financial markets in Mexico.

Under these circumstances, monetary policy continues to face a situation characterized by contrasts.

- A relaxation of monetary policy in the United States.
- Weak economic activity in Mexico.
- Importance of fostering an orderly convergence of inflation to the target.

- Relatively high core inflation.
- Inflation expectations above the target.
- An increase in the perception of country risk.
- A situation of high uncertainty.

- The anticipated convergence of inflation to the target in 2020 and the easing of monetary policy in the United States and other countries, have allowed a reduction in the reference rate in Mexico from 8.25 to 7.75 percent.
- Looking forward, in view of the risks faced, a cautious monetary policy is fundamental, with any adjustments subject to new information and evolving circumstances.
- The atmosphere of uncertainty prevailing in Mexico is to an important extent linked to domestic factors.
- The implementation of decisive actions to tackle this situation would not only open margins of maneuver for monetary policy, but also deal with one of the central factors behind the complex evolution of the economy.
- In addition, it is necessary to undertake any additional economic and institutional measures required to increase productivity and, in general, potential growth.

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