Monetary Policy Outlook for Mexico
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## Outline

1. **Monetary Policy in Mexico**
   - Evolution of the Mexican Economy
   - Inflation and its Determinants
   - Macroeconomic Policy Response
   - Final Remarks
Monetary policy in Mexico is implemented at present in a complex environment:

- A negative output gap, with forecasts suggesting that it will remain in negative territory through end-2017.

- A rate of inflation that has remained under the 3 percent target for 17 months.

- On the other hand, an important depreciation of the peso, with potential inflationary consequences.
This was reflected in the dispersion of analysts’ expectations on the reference rate prior to the last monetary policy decision.

Mexico: Analysts’ Expectations for Next Monetary Policy Rate Adjustment¹/

Basis points

1/ As of 26 September 2016.
Source: Banco de México, Banamex, Reuters and analysts’ reports.
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The pace of economic activity moderated significantly during the second quarter of 2016, affected in part by factors of a transitory nature.

Mexico: Gross Domestic Product
Annual %, s.a.

s.a./ Seasonally adjusted.
Source: INEGI.
The most recent information points to an upturn of economic activity in the third quarter, although with signs of deceleration. Services have continued to provide the main stimulus on the supply side, but trend growth in this sector seems to be slowing.

**Mexico: IGAE 1/**
Index 2008 = 100, s.a.

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1/ Monthly GDP proxy.
S.a./ Seasonally adjusted.
Source: INEGI.
On the demand side, economic activity has been supported mainly by private consumption, which also shows indications of losing speed. Investment has remained weak.
The downward trend in manufacturing exports seems to have stopped, but they remain sluggish. The expected recovery of industrial output in the United States would stimulate external sales.

Exports
Index 2008 = 100 \(^1\)

- **Total**
- **Non-Oil**
- **Manufactures**

Mexican Non-Oil Exports and US Industrial Production
Index 2008 = 100, s. a.

- **< Mexican Non-Oil Exports**
- **US Industrial Production ->**

1/ Trend data. Source: SAT, Secretaría de Economía, Banco de México and INEGI.

s. a. / Seasonally adjusted. Source: SAT, Secretaría de Economía, Banco de México, INEGI, Blue Chip and Federal Reserve.
Labor market indicators send mixed signals, but in general they are consistent with a gradual deceleration of economic activity.

Unemployment Rate and Employed Population
% (s.a.) and million workers

Source: INEGI.

Nominal Wages 1/
Annual % change

1/ Daily average for all IMSS-affiliated workers. Source: IMSS.
In this context, the output gap is projected to remain negative through end-2017.

Output Gap Estimates and Projections
% of potential, s.a.

s.a./ Seasonally adjusted.
Source: Banco de México.
GDP growth in Mexico has been restrained by the evolution of economic activity in the US. Yet, Mexico’s economy has shown resilience to this shock...
...with structural reform efforts as an important explanatory factor.

Emerging Market Economies: Change in Global Competitiveness Index Score between 2015 and 2016

Mexico: Global Competitiveness Index Score (1-7 scale) and Ranking

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Inflation has displayed a favorable behavior, and currently stands at 2.97 percent, slightly below the 3 percent target.
The core and more recently the non-core components show an upward trend, but they remain at moderate levels.

CPI Inflation: Core vs. Non-Core

Source: Banco de México and INEGI.
So far, the pass-through from the exchange rate depreciation has been concentrated on the prices of merchandise, which have increased relative to those of services.

Source: Banco de México and INEGI.
Inflation is projected to gradually increase towards year-end to slightly above 3 percent, and to fluctuate around this level in 2017. Survey-based long-term inflation expectations remain anchored, although still somewhat above the target.

Inflation Expectations\(^1\)/
Annual %

<table>
<thead>
<tr>
<th>Year</th>
<th>Next 2-6 Years (Banamex)</th>
<th>Next 5-8 Years (Banco de México)</th>
<th>Permanent Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>3.2</td>
<td>3.4</td>
<td>3.0</td>
</tr>
<tr>
<td>2011</td>
<td>3.1</td>
<td>3.3</td>
<td>3.0</td>
</tr>
<tr>
<td>2012</td>
<td>3.4</td>
<td>3.4</td>
<td>3.0</td>
</tr>
<tr>
<td>2013</td>
<td>3.2</td>
<td>3.3</td>
<td>3.0</td>
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<tr>
<td>2014</td>
<td>3.1</td>
<td>3.3</td>
<td>3.0</td>
</tr>
<tr>
<td>2015</td>
<td>3.0</td>
<td>3.3</td>
<td>3.0</td>
</tr>
<tr>
<td>2016</td>
<td>3.1</td>
<td>3.3</td>
<td>3.0</td>
</tr>
</tbody>
</table>

1/ Median expectation. Source: Banco de México and Banamex.
Demand pressures on prices are likely to remain subdued, given the expectation of a negative output gap throughout next year. The evolution of prices of agriculture and livestock represents an upward risk, although of a transitory nature.

CPI Inflation: Agriculture and Livestock

%}

Source: Banco de México and INEGI.
Therefore, the main risk for the inflation outlook arises from the evolution of the exchange rate of the peso.

USD/MXN: Level and Volatility

Pesos per dollar and %

<table>
<thead>
<tr>
<th>Date</th>
<th>Level</th>
<th>Volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sep-14</td>
<td>12</td>
<td>4</td>
</tr>
<tr>
<td>Dec-14</td>
<td>13</td>
<td>5</td>
</tr>
<tr>
<td>Mar-15</td>
<td>14</td>
<td>6</td>
</tr>
<tr>
<td>Jun-15</td>
<td>15</td>
<td>7</td>
</tr>
<tr>
<td>Sep-15</td>
<td>16</td>
<td>8</td>
</tr>
<tr>
<td>Dec-15</td>
<td>17</td>
<td>9</td>
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<tr>
<td>Mar-16</td>
<td>18</td>
<td>10</td>
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<tr>
<td>Jun-16</td>
<td>19</td>
<td>11</td>
</tr>
<tr>
<td>Sep-16</td>
<td>20</td>
<td>12</td>
</tr>
</tbody>
</table>

1/ Implicit volatility in 1-month USD/MXN options.

Note: Vertical lines indicate dates when the reference rate in Mexico was increased in 2015 (17 December) and 2016 (17 February, 30 June and 29 September).

Source: Banco de México and Bloomberg.
The steep depreciation of the Mexican peso over the last couple of years is explained by a combination of factors, including:

- Normalization of monetary policy in the United States.
- Uncertainty regarding the outcome of the US electoral process.
- An environment of generalized anxiety among international investors.
- The use of the peso as a hedging instrument against risks in other emerging markets and for speculative purposes.
- Weak oil prices.
- Deterioration of public sector finances.
- A higher current account deficit.
Notwithstanding a negative output gap, low inflation and well anchored inflation expectations, monetary policy has been tightened four times since late 2015.

- A response to an increase in the target range for the federal funds rate in the US, in view of:
  - Close links between the Mexican and US economies;
  - An environment of widespread nervousness in international financial markets;
  - A very open capital account in Mexico; and
  - High peso-dollar exchange rate levels;

- A narrowing of the interest rate differential between the US and Mexico could have resulted in disorderly capital outflows, and risks for inflation and financial stability.
Main explanatory factors:

- Expectation of an upward trend for inflation even in the absence of further shocks;
- Risks for inflation and its expectations from the depreciation of the exchange rate;
- Possibility of a higher than anticipated peso-dollar rate for a significant period;
- Potential non-linear effects of the exchange rate on prices; and
- Risk of adverse signaling in the absence of decisive action.

- Banco de México’s mandate.
The impact of a higher monetary policy rate on economic activity has been alleviated by a flattening of the yield curve.

Source: Banco de México and Proveedor Integral de Precios (PiP).
The Banco de México has noted that the latest increase in the monetary policy rate does not intend to begin a cycle of adjustments.

Considering the nature of some of the factors affecting the peso at present, and especially the electoral process in the United States, it is difficult to evaluate the possible trend of the monetary policy rate in Mexico in the very short term.

Beyond this special period, interest rates in Mexico are likely to be significantly affected by the evolution of interest rates in the United States.
Markets continue to anticipate a gradual tightening of monetary policy in the US.

The net effect should be beneficial for Mexico’s economy.

If adequately anticipated, it need not have a major impact on international financial markets.

However, under circumstances similar to those prevailing at present, the absence of a monetary policy response in Mexico would give rise to major risks.

US: Probability of a 25bp Increase in the Target for the Federal Funds Rate

1/ Based on market prices of futures for the Federal Funds Rate.
Source: Banco de México with data from Bloomberg.
Banco de México’s Board will closely monitor the evolution of all determinants of inflation and its medium- to long-term expectations, and especially:

- The exchange rate given its possible pass-through to consumer prices, without implying an objective for the exchange rate.
- The relative monetary policy stance between Mexico and the US.
- The evolution of the output gap.

The Banco de México will adjust the monetary policy stance with all due flexibility, at the moment and in the magnitude that conditions require it, to consolidate the efficient convergence of inflation to the 3 percent target.
Strong public finances are essential to preserve macroeconomic stability and strengthen confidence. The implementation of the announced program of fiscal adjustment in 2017 would alleviate risks from this source...

Source: SHCP.
... and from the current account which, although still within reasonable margins, has given rise to some nervousness.

Note: Data for 2016 corresponds to the first half. Source: Banco de México and INEGI.

Emerging Market Economies: Current Account
% of GDP

Source: IMF (World Economic Outlook, October 2016).
- Intervention in the foreign exchange market can also play a role in coping with exchange rate volatility.

- The Foreign Exchange Commission has emphasized that anchoring of the Mexican peso will be sought through the preservation of strong economic fundamentals.

- However, it has also been noted that discretionary intervention in the foreign exchange market cannot be discarded should exceptional circumstances arise.
Mexico’s economy has performed relatively well in a rather difficult environment, but the need to strengthen economic fundamentals has increased.

This implies:

- Adherence to a monetary policy approach emphasizing prudence.
- An adjustment of public finances leading to a sustained decline in the share of public debt in GDP.
- The implementation of any policies required to ensure the preservation of financial stability.
- Continued reinforcement of the domestic sources of growth.