The Mexican Economy: Dealing with a More Complex Environment

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Outline

1. Introduction
2. Economic Activity and Inflation
3. Outlook
As in the case of other EME’s, the Mexican economy has been hit by a combination of external shocks in recent months. The first one is a decline in oil prices...

Crude Oil Prices
USD per barrel

Terms of Trade
Index, 1980 = 100

Share of oil in:
2014
Exports 10.8%
GDP 4.7%
Public revenues 30.6%

Source: Banco de México, SHCP and INEGI.
The second external shock relates to the volatility in international financial markets deriving from expectations of interest rate increases in the US and divergent monetary conditions in the main advanced economies, among other factors.

Benchmark Rates and Implied OIS¹/²
Forward Rates
Percent

Accumulated Capital Flows to Emerging Market Economies (Debt and Equity) ¹/
USD billion

1/ OIS: Overnight Index Swap
Source: Banco de México with data from Bloomberg.

1/ The sample includes funds used to sell or buy equity and bonds from emerging markets registered in advanced economies. Flows exclude changes in market value of portfolios and in foreign exchange rates.
Source: Emerging Portfolio Fund Research, with data through 8 April 2015.
The slow growth of the world economy has affected Mexico to a lesser extent, given its trade links with the US. This is expected to continue in coming years.

Source: IMF (WEO, April 2015).

Note: Figures in parentheses indicate the share of Mexican exports destined to that market in 2014.

Source: IMF and INEGI.
In addition to these external shocks, Mexico’s economy has been affected by a decline in oil output.

Crude Oil Output, 2000-2016
Thousand Barrels per Day

<table>
<thead>
<tr>
<th>Year</th>
<th>Output (Thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>3,012</td>
</tr>
<tr>
<td>2001</td>
<td>3,127</td>
</tr>
<tr>
<td>2002</td>
<td>3,177</td>
</tr>
<tr>
<td>2003</td>
<td>3,371</td>
</tr>
<tr>
<td>2004</td>
<td>3,333</td>
</tr>
<tr>
<td>2005</td>
<td>3,256</td>
</tr>
<tr>
<td>2006</td>
<td>3,076</td>
</tr>
<tr>
<td>2007</td>
<td>2,792</td>
</tr>
<tr>
<td>2008</td>
<td>2,601</td>
</tr>
<tr>
<td>2009</td>
<td>2,577</td>
</tr>
<tr>
<td>2010</td>
<td>2,553</td>
</tr>
<tr>
<td>2011</td>
<td>2,548</td>
</tr>
<tr>
<td>2012</td>
<td>2,522</td>
</tr>
<tr>
<td>2013</td>
<td>2,429</td>
</tr>
<tr>
<td>2014</td>
<td>2,288</td>
</tr>
<tr>
<td>2015</td>
<td>2,400</td>
</tr>
<tr>
<td>2016^e</td>
<td>2,300</td>
</tr>
</tbody>
</table>

*^e/ Expected.
Source: Pemex and SHCP.*

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The policy response to these developments has been a tightening of fiscal policy...

- Faced with a sharp decline in oil revenues, the Federal Government decided to preventively tighten the fiscal stance through a reduction in public spending in 2015 (0.7% of GDP).

- With the perspective that oil prices will remain low, an additional fiscal adjustment (0.7% of GDP) has been announced for 2016, supported by a comprehensive revision of the structure of public spending.

- These measures will allow a gradual adjustment of the fiscal position and an evolution of public finances in 2015-16 consistent with the previously committed strengthening.
...the implementation of a monetary policy focused on the efficient convergence of inflation to the 3 percent target...

Overnight Interest Rate and Headline Inflation
Annual %

Headline inflation
Target for the overnight interbank interest rate\(^1\)

Source: Banco de México.
1/ Target for the overnight interbank interest rate adopted on 21 January 2008.
With the objective to preserve the orderly functioning of the domestic market, the Foreign Exchange Commission decided to implement the following measures:

- The daily auctioning, starting 9 December 2014, of USD 200 million at a minimum exchange rate equal to that of the previous day plus 1.5%. To date USD 400 million have been allocated under this mechanism.

- The daily auctioning, between 11 March and 8 June 2015, of USD 52 million without a minimum exchange rate. This amounts to a 25% reduction in the pace of the expected net reserve accumulation over the 12-month period starting 11 March 2015.
In this context, the exchange rate has depreciated significantly, but in an orderly fashion...

**Exchange Rate**
MXN per USD

Source: Banco de México.

**Implicit Volatility in FX Options of Selected Emerging Markets**
Percent

Maximum

Mexico

Minimum

Note: The minimum (maximum) value represents the lowest (highest) value in the implicit volatility from the following countries: Russia, Indonesia, South Korea, South Africa, Turkey, Colombia, Chile, Brazil and Mexico.

Source: Bloomberg.
...and domestic interest rates have increased moderately.

Source: Banco de México and Proveedor Integral de Precios (PiP).

Source: PiP and US Department of the Treasury.
Overall, the performance of the exchange rate and solvency indicators has been in general favorable relative to that observed in other emerging market economies.
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Economic activity has shown a gradual recovery...

Gross Domestic Product
Annual % change, s.a.

s.a. / Seasonally adjusted.
Source: INEGI.
...stimulated to a significant extent by the external sector, as shown by indicators on the supply...

**Services IGAE**
Index 2008 = 100, s.a.

**Industrial Production**
Index 2008 = 100, s.a.

s.a./ Seasonally adjusted.
Source: Banco de México with information from INEGI.

s.a./ Seasonally adjusted.
Source: INEGI.
...and demand sides...

Exports of Goods and Services
Million 2008 Pesos, s.a.

Private Consumption and Investment
Million 2008 Pesos, s.a.

s.a. / Seasonally adjusted.
Source: INEGI.
...with recent signs of an upturn in domestic consumption and investment.

Domestic Private Consumption
Index, 2008 = 100, s.a.

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

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

s.a./ Seasonally adjusted.
Source: INEGI.
However, a negative output gap is still observed.

Output Gap
Percent of potential, s.a.

s.a./ Seasonally adjusted.
Source: Banco de México with data from INEGI.
At the same time, inflation has fallen to around target levels...

**Consumer Price Index**
Annual % change

Source: INEGI.
...and there is still no evidence of a significant pass through of the exchange rate to prices.

Merchandise Consumer Price Index
Annual % change

Source: INEGI.
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The balance of risks for growth has deteriorated, but economic activity is expected to continue to recover...

### Real GDP Growth Forecast (Banco de México)

<table>
<thead>
<tr>
<th>Year</th>
<th>Forecast Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>Between 2.5 and 3.5%</td>
</tr>
<tr>
<td>2016</td>
<td>Between 2.9 and 3.9%</td>
</tr>
</tbody>
</table>

### Real GDP Growth Expectations of Private Sector Analysts

**Median, %**

[Graph showing Real GDP growth expectations from January 2013 to March 2015, with median values indicated for each year.]
...with inflation expected to show a favorable performance, although subject to risks.

### Headline Inflation Forecast (Banco de México)

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>Continue at levels close to 3 percent in coming months, and close the year slightly below this level.</td>
</tr>
<tr>
<td>2016</td>
<td>Continue at levels around 3 percent.</td>
</tr>
</tbody>
</table>

### Headline CPI Inflation Expectations of Private Sector Analysts

**Median, %**

- **Next 4 Years**
- **Next 5-8 Years**
- **Variability Interval**

Source: Banco de México Survey.

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Monetary Policy Stance

- In view of the negative output gap, no demand pressures on inflation are observed.
- In addition, the experience of recent years shows that supply shocks tend to have only a temporary impact on domestic prices.
- However, since the Mexican economy is highly integrated to the global economy, the evolution of the exchange rate could have effects on inflation expectations and the dynamics of price formation.
- Therefore, the Banco de México will continue to monitor carefully all determinants of inflation, with particular attention to the relative monetary position between the United States and Mexico, and the evolution of the exchange rate. Naturally, the degree of slack in the economy will also be followed closely.
- In this context, any measures required to ensure the convergence of inflation to the target and its consolidation will be implemented.
With strong macroeconomic policies and fundamentals, a well functioning floating exchange regime, ample availability of external resources and financial stability, Mexico is well prepared to face the potential turbulence in international financial markets in coming months.

Furthermore, the economy’s growth potential should be substantially strengthened by the major structural reform efforts underway.

The importance of these reforms, and the consequent strengthening of the domestic sources of growth, has been enhanced by the deterioration of the external environment.
In fact, notwithstanding the more difficult external conditions, private sector analysts expect a significant increase in long-term GDP growth.

**Long-term Real GDP Growth: Observed and Expected**

- **Average over the Next 10 Years**
- **Average over 1980-2014: 2.45%**

Source: Banco de México Survey and INEGI.
However, to ensure the success of these efforts it will be necessary:

- To preserve macroeconomic and financial stability.
- An efficient implementation of the approved structural reforms.
- The implementation of any other reforms required to tackle other major obstacles to the efficient functioning of the economy.