Monetary Policy in Mexico in the Face of a More Accommodative Stance in Advanced Economies

Javier Guzmán Calafell, Deputy Governor, Banco de México*

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* The opinions and views expressed in this document are the sole responsibility of the author and do not necessarily represent the institutional position of the Banco de México or of its Board of Governors as a whole.
Global economic activity has lost speed, with weakness evident in global trade and manufacturing output. The recovery in 2020 is projected to be led by EMEs.

Global Growth
Annual %

- Emerging Market and Developing Economies
- World
- Advanced Economies

Global Economic Activity Indicators
Annual % change of the 3-month moving average and deviations from 50 (for PMI)

- Manufacturing PMI: New Orders
- Industrial Production
- World Trade Volumes

Source: IMF.

Source: Markit and CPB Netherlands.
Although a generalized deceleration has been observed, the cyclical position varies among economies. In particular, US GDP is expected to grow above potential this year and close to this figure in 2020. Paradoxically, the probability of a recession in this economy has increased.

The model is estimated with a Probit equation: $R_{t+12} = F(\alpha + \beta spr_{t})$, where $spr_{t}$ is the term spread, $\alpha$ and $\beta$ are constants and $F$ is the standard normal cumulative distribution function.

Note: The blue area represents the recession periods as established by the NBER, the green area includes forecasts for one year ahead.

Source: Federal Reserve Bank of Cleveland and Federal Reserve Bank of New York.
Labor markets in AEs maintain a solid performance, with the unemployment rate recording additional declines and nominal wage growth still showing a positive trend.

Advanced Economies

**Unemployment Rate**

- United States
- United Kingdom
- Eurozone
- Japan

**Nominal Wages**

- United States
- Eurozone
- United Kingdom
- Japan

s.a. / Seasonally adjusted series.
Source: Haver Analytics.

s.a. / Seasonally adjusted series.
Source: BLS, BCE, Bloomberg and ONS.
Nevertheless, inflation in these countries remains subdued.

Advanced Economies: Headline Inflation
Annual %

- United States 1/
- Eurozone
- Japan
- United Kingdom
- Inflation Target
- Canada

Advanced Economies: Core Inflation
Annual %

- United States 1/
- Eurozone
- Japan 2/
- United Kingdom
- Inflation Target
- Canada 3/

1/ Refers to the Personal Consumption Expenditure (PCE) Price Index.
2/ Excludes fresh food and the consumption tax that was implemented in 2014.
3/ Excludes fresh food and energy.
Source: Haver Analytics.

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In this context, monetary policy in the US and other AEs is expected to be more accommodative than previously foreseen.

Reference Rates and Implicit Trajectories in OIS Curves

Federal Funds Rate: Projections and Forecasts

1/ OIS: Fixed-for-floating swap where the fixed interest rate is the reference rate. **/ Refers to the midpoint of the Federal Funds target range.

Source: Bloomberg and Federal Reserve.

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Thus far, international financial markets have responded positively to these and other developments, and capital inflows to EMEs appear to have resumed.

However, the implications of a more gradual monetary policy normalization in AEs call for caution, as such development:

- Is indicative of a more subdued economic expansion going forward.
- Poses challenges for financial stability derived from persistently low interest rates.
- Lowers the margins of response for monetary policy in case the foreseen deceleration accentuates.

On the other hand, should there be a surprise in the opposite direction, the potential for turbulence would be higher.
Furthermore, important risks for global economic activity and financial stability remain:

- Steeper-than-expected deceleration of economic activity, mainly in AEs.
- Concerns surrounding the exit of the UK from the EU.
- Uncertainty related to trade negotiations between the United States and China.
- An increase of protectionism.
- Adverse economic developments in EMEs, particularly China.
- Other political and geopolitical risks.
Economic activity in Mexico has continued to weaken in the first months of this year, although showing positive rates of growth.

The deceleration has become more widespread:

- On the supply side, industrial output continues to fall, and the rate of growth of the services sector has also slowed down.
- On the demand side, exports show an upward trend, private consumption is losing strength, and investment has declined.
Given the current economic context, an accurate evaluation of the cyclical position of the Mexican economy is complex.

First, economic activity in early 2019 has been affected by short-term disruptions:

- Gasoline shortages in some cities.
- Blockades to railways that connect different regions and seaports.
- Labor strikes on the northern border.
- Economic weakness in the US due to the temporary government shutdown.
Second, the estimation of the output gap could prove more difficult in light of a possible decline in potential growth owing to unfavorable investment and productivity trends.

Total Factor Productivity
Index 1990 = 100

Labor Productivity and Investment Rate
Index 2013 = 100 and % of GDP, s.a.

1/ Based on hours worked.
Note: Investment is defined as gross fixed asset formation.
Source: INEGI.
Third, notwithstanding some recent upticks, the unemployment rate remains below levels estimated neutral in the long run.

Unemployment Rate

% \text{s.a.}

Labor Market Gap: Unemployment Rate\(^1/\)

Percentage points, s.a.

s.a. / Seasonally adjusted series.
The NAIRU estimation is based on the national unemployment rate.
Source: Banco de México with data from INEGI.

s.a. / Seasonally adjusted series.
1/ Shadows represent confidence bands. The interval corresponds to two average standard deviations among all estimates.
Source: Estimated by Banco de México with data from INEGI.
In any event, considering growth projections for this year and the next, a negative output gap is to be expected during this period.

In addition, the balance of risks for growth is tilted to the downside as a result, among others, of:

- Uncertainty related to the future orientation of some public policies.
- The ratification of the trade agreement with the United States and Canada.
- The evolution of oil output.
- External factors.
Headline inflation has declined over the course of 2019. A temporary increase in inflation is anticipated for coming months, due to base effects and an increase in energy prices.

**Headline CPI Inflation**

Annual %

**CPI Index**

**Gasoline Prices: Spot and Futures**

Cents of dollar per gallon

Note: The spot price corresponds to the RBOB87PM Index.

Source: Bloomberg.
However, core inflation has been resilient, and projections for its evolution subject to frequent upward revisions.

CPI: Core Inflation
Annual %

Core Inflation Forecasts by Banco de México
Annual %

Note: -0.1596 is the difference in percentage points from April 2018 to March 2019.
Source: INEGI.

Source: Banco de México.
In addition, inflation expectations surpass Central Bank’s projections, and inflation breakevens, though below recent peaks, remain high.

### Inflation Expectations by Analysts and Banco de México Forecasts

**Annual %**

<table>
<thead>
<tr>
<th>Source: PiP.</th>
</tr>
</thead>
</table>

### Inflation Breakevens

**Basis points**

<table>
<thead>
<tr>
<th>Basis</th>
<th>3 Years</th>
<th>10 Years</th>
<th>30 Years</th>
</tr>
</thead>
</table>

- **Headline (Banco de México Forecasts)**
- **Core (Banco de México Forecasts)**

- **Headline (End-of-Year Expectations)**
- **Core (End-of-Year Expectations)**

- **Headline (Long-Term Expectation)**
- **Core (Long-Term Expectation)**

Source: Banco de México and Citibanamex.

Source: PiP.
Moreover:

- Long-term core inflation expectations show the highest figures since records exist and have narrowed the gap with those for headline inflation.

- Convergence of long-term core to headline inflation expectations, if persistent, can imply more deeply embedded expectations above the target.

- The balance of risks for inflation continues to be tilted to the upside.
In the financial markets, yields on government securities have decreased and bond holdings by foreigners display a positive trend.

Mexico: Yield Curve of Government Securities

Government Securities: Non-Residents' Holdings

Source: PiP.

1/ Includes all government securities in circulation: CETES, Udibonos, bonds, Bondes D and Bondes.

Source: Banco de México.
The expectation of a more gradual normalization of monetary policy in AEs has contributed to alleviate uncertainty, but its final impact is uncertain.
In light of this, and the challenges the Mexican economy is facing, as reflected in the prevailing concern among rating agencies and other market participants, it is of the utmost importance to improve its fundamentals and tackle the main risks.

The recent announcements on fiscal policy for the remainder of this year and 2020 are a major step in this direction.

However, additional actions are required, in particular to:

- Strengthen the financial situation of PEMEX. To guarantee its long-term financial viability, PEMEX must adopt a business model that ensures a sustained recovery of oil production capacity, without affecting the long-term soundness of public finances.

- Enhance confidence, and deepen structural and institutional measures to increase the economy’s growth potential.
Analysts anticipate a relaxation of monetary policy later in the year, but in a context of short- and long-term inflation expectations above the 3 percent target. This suggests inconsistency in their estimates between the expected interest rate path and convergence to the target, and a credibility problem with the target. The information derived from market instruments leads to similar conclusions.

**Overnight Interest Rate: Target, Expectations and Implicit Rate**

### Inflation Expectations by Private Analysts

<table>
<thead>
<tr>
<th>Date</th>
<th>Source</th>
<th>End-2019</th>
<th>End-2020</th>
<th>Long Run</th>
</tr>
</thead>
<tbody>
<tr>
<td>05-apr-19</td>
<td>Citibanamex Survey</td>
<td>3.69</td>
<td>3.65</td>
<td>3.5*</td>
</tr>
<tr>
<td>01-apr-19</td>
<td>Banco de México Survey</td>
<td>3.60</td>
<td>3.57</td>
<td>3.5**</td>
</tr>
</tbody>
</table>

* Average annual inflation in 2021-2025
** Average annual inflation in 2024-2027

1/ Overnight interbank funding rate implied in interest rate swap contracts on the 28-day TIIE (equilibrium interbank interest rate). Source: Banco de México and Citibanamex.
Faced with current high levels of uncertainty and risks for inflation skewed to the upside, and consistent with Banco de México’s mandate, monetary policy must proceed with caution and focus on achieving the inflation target within the announced time frame, with priority attached to enhancing the credibility of the Central Bank.

A more gradual normalization of monetary policy in the United States alleviates risks for monetary policy in Mexico, but it neither eliminates them nor changes significantly the inflation outlook.

Therefore, under the macroeconomic outlook envisaged at present, achievement of the inflation target implies a firm monetary policy stance over a still-prolonged period.

Naturally, a careful monitoring of inflation and its determinants will continue to be of the essence, so that monetary policy can be timely adjusted should it be required.