Outline

1. External Conditions
   2. Evolution of the Mexican Economy
   3. Inflation and its Determinants
   4. Monetary and Exchange Rate Policies
   5. Final Remarks
International financial markets were affected by an episode of turmoil at the beginning of 2016.

Although uncertainty declined subsequently, as evidenced by recent bouts of market turbulence, the global economic and financial situation remain fragile. This is explained, among other factors, by:

- A weak recovery in advanced economies.
- Subdued global trade growth.
- Expectations of an increase in interest rates in the United States.
- The perception of a reduced effectiveness of monetary policy in advanced economies.
- Geopolitical risks.
- Persistent economic challenges in China.
- Low growth and a vulnerable situation in many emerging market economies.
World economic and trade growth remain below their long-term averages.

The Mexican Economy in the Global Economic Juncture

World Economy: Real GDP and Trade Volume
Annual % change

* Trade volume of goods and services.
Source: IMF (World Economic Outlook, April 2016).
The US economy has shown resilience to international developments, as GDP growth in this country has exceeded that observed in other advanced economies. However, its industrial production remains feeble.

United States: Industrial Production

**Level and Expected Growth**
Index 2012 = 100 and %

**Quarterly Growth**
Annualized %

Source: Federal Reserve and Blue Chip Economic Indicators.
After recording at the beginning of this year its lowest levels since early 2002, the price of the Mexican oil basket has increased. Futures markets continue to anticipate a gradual recovery of oil prices.
Notwithstanding the difficult external environment, the Mexican economy has continued to expand at a moderate pace...

Mexico: Total Output
Index 2Q-2009 = 100, s.a.

s.a. / Seasonally adjusted.
*/ Monthly GDP proxy.
Source: INEGI.
... and has kept a stable growth rate despite falling growth in global economic activity.

LAC: Latin America and the Caribbean.
Source: INEGI, IMF (World Economic Outlook, April 2016) and Bureau of Economic Analysis.
In fact, Mexico is one of the few emerging market economies that has managed to maintain a stable rate of economic growth, before and after the global financial crisis.

Change in the Growth Rate of Real GDP
2000-2007 vs 2011-2015, % points

Source: IMF (World Economic Outlook, April 2016) and INEGI.
In the face of stagnation of US industrial production and a situation of weakness in the global economy, non-oil exports have been sluggish. Thus, economic activity has been supported by domestic demand.

Exports
Index 2008 = 100, s. a.

Consumption and Investment
Index 2008 = 100, s. a.

s. a./Seasonally adjusted.
Source: SAT, Secretaría de Economía, Banco de México and INEGI.

s. a./Seasonally adjusted.
Source: INEGI.
As for the external sector, the current account deficit has widened mainly as a result of the deterioration of the oil trade balance.

Mexico: Current Account and Trade Balance

% of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Current Account (% of GDP)</th>
<th>Trade Balance (% of GDP)</th>
<th>Oil (% of GDP)</th>
<th>Non-Oil (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>-0.8</td>
<td>-0.6</td>
<td>2.0</td>
<td>-2.6</td>
</tr>
<tr>
<td>2015</td>
<td>-2.8</td>
<td>-1.3</td>
<td>-0.9</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

*Data for 2016 corresponds to the first quarter. Source: Banco de México and INEGI.*
It is expected that the Mexican economy will continue to display a gradual recovery in coming months, in part as a result of the anticipated rebound of industrial output in the US.

As evidenced by the fact that Mexican exports have continued to gain share in the US market, these have remained very competitive.

This would allow a more balanced growth of the various components of aggregate demand.
Nonetheless, the output gap could remain negative throughout 2017 and downside risks persist.

### Output Gap Estimates and Projections

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banco de México</td>
<td>2.0 – 3.0</td>
<td>2.3 – 3.3</td>
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<tr>
<td>Banamex Survey</td>
<td>2.30</td>
<td>2.76</td>
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<tr>
<td>Banco de México Survey</td>
<td>2.45</td>
<td>2.80</td>
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</table>

**Real GDP Growth Projections**

<table>
<thead>
<tr>
<th>Year</th>
<th>2015 Q4</th>
<th>2016 Q4</th>
<th>2017 Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>2.0</td>
<td>2.3</td>
<td>2.6</td>
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<tr>
<td>2009</td>
<td>2.0</td>
<td>2.3</td>
<td>2.6</td>
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<tr>
<td>2010</td>
<td>2.0</td>
<td>2.3</td>
<td>2.6</td>
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<td>2011</td>
<td>2.0</td>
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<td>2.6</td>
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<tr>
<td>2017</td>
<td>2.0</td>
<td>2.3</td>
<td>2.6</td>
</tr>
</tbody>
</table>

s.a. / Seasonally adjusted.
2/ Median projection of the 20 May 2016 release.
3/ Median projection of the May 2016 survey, released 1 June 2016.
Source: Banco de México, Banamex and INEGI
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In spite of the significant depreciation of the peso exchange rate, inflation recorded in 2015 historical minima for 8 consecutive months, and currently stands at 2.5 percent, below the 3 percent target.

Headline CPI and USD/MXN Exchange Rate
Index September 2014 = 100

Source: Banco de México and INEGI.
Survey-based long-term inflation expectations have decreased and show greater convergence to the target, although they are still slightly above it.

Inflation Expectations
Annual %

Source: Banco de México and Banamex.
These achievements are the result of a combination of factors.

- Chief among them is the implementation of prudent macroeconomic policies over several years.
  - In particular, monetary policy set by an independent central bank and in the context of an inflation targeting regime has allowed to strengthen the credibility of the authorities’ commitment with price stability.

- The structural reforms set in motion over the last years have resulted in declines in the prices of several key goods in the economy, telecommunications and electricity among them.

- Inflation has also been contained by lower international prices for several inputs and the absence of demand pressures on prices.
Inflation is projected to fluctuate around 3 percent during the rest of this year and the next.

- This is explained to a great extent by the expected behavior of gasoline prices.
  
  Starting in January this year, the Finance Ministry (SHCP) changed the mechanism for the determination of these prices, temporarily introducing a fluctuation band based on international prices, as way of transition towards their full liberalization in January 2018.

- Thus, inflation in Mexico will be affected this year and next, by both the seasonality in the international prices of this product and the formula used by the Finance Ministry to set its domestic prices.

- A trajectory of inflation characterized by fluctuations around 3 percent would be both normal and consistent with achievement of the target.
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Notwithstanding a situation characterized by a negative output gap, low inflation and firmly anchored inflation expectations, the reference interest rate has been increased twice recently.

<table>
<thead>
<tr>
<th>Date</th>
<th>Rate Change</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 17, 2015</td>
<td>25 bps increase to 3.25%</td>
<td>Following the 25 bps increase in the target range for the federal funds rate by the U.S. Federal Reserve.</td>
</tr>
<tr>
<td>February 17, 2016 Extraordinary Meeting</td>
<td>50 bps increase to 3.75%</td>
<td>As part of a coordinated policy response to the increase in volatility in international financial markets, the deterioration of the external environment, and risks for inflation and its expectations deriving from the sharp adjustment of the exchange rate.</td>
</tr>
</tbody>
</table>

The reference rate has been kept unchanged subsequently, as inflation is expected to display a trajectory consistent with the target.
In implementing monetary policy, the Board of Governors of the Banco de México has sought the convergence of inflation to the target at the lowest possible cost in terms of economic activity.

Notwithstanding the above-mentioned interest rate hikes, monetary conditions have remained very relaxed as a result of the exchange rate depreciation.

The incidence of the higher monetary policy rate has been concentrated on short-term interest rates.

In any event, the achievement of low and stable inflation represents the best contribution that the Banco de México can make to economic growth.
The Board will remain vigilant of all determinants of inflation and its expectations, especially:

- The exchange rate and its possible pass-through to domestic prices.
- 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 and at the moment that conditions require it, in order to consolidate the efficient convergence of inflation to the 3 percent target.

Therefore, the reference rate in Mexico can increase irrespective of the pace of normalization of monetary policy in the United States.
Although the Mexican peso has continued to be subject to pressures, the peso-U.S. dollar rate stands below the levels reached in mid-February...

USD/MXN Exchange Rate
Pesos per Dollar

Source: Banco de México.
Within the context of a more liquid foreign exchange market, lower volatility of the exchange rate...
...and in general improved operating conditions.

The index is calculated based on the volatility, skewness, and kurtosis implicit in 6-month options for the USD/MXN, taking the performance during 2007-2015 as the benchmark. Source: Banco de México with data from Bloomberg.
Mexico’s Foreign Exchange Commission, integrated by officials from the Ministry of Finance and the Banco de México, has made it clear that:

- It does not rule out the possibility of discretionary interventions in the foreign exchange market should extraordinary conditions arise.
- The nominal anchoring of the currency will continue to be sought through the preservation of solid economic fundamentals.
The macroeconomic framework has also been supported by the ongoing strengthening of public finances. In addition, the resilience of the Mexican economy will be enhanced by the recent renewal and increase of the Flexible Credit Line with the IMF.

Source: Banco de México and IMF.
It should also be noted that solvency indicators for Mexico are favorably placed within the emerging market world.

Emerging Market Economies: Credit Default Swaps
Basis points

Source: Bloomberg.
In spite of the difficult external conditions, the Mexican economy has continued to display stable growth rates and low inflation.

However, the importance of strengthening the country’s economic fundamentals as well as the domestic sources of growth has increased. This requires coordinated actions in different areas.

- In addition to the efforts on the monetary policy front, it will be fundamental to continue with fiscal consolidation, so as to ensure the achievement of the targets set for the PSBR and public debt in coming years.

- It will also be necessary to preserve financial stability, and to ensure an adequate implementation of the actions of structural reform and institutional change set in motion to increase the country’s economic growth potential.

- Finally, the authorities must be ready to implement any additional actions required to ensure macroeconomic and financial stability, as well as a more solid foundations to propel the economy’s growth.