MEXICO’S MONETARY POLICY AND ECONOMIC OUTLOOK

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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 Governing Board.
The situation of the world economy continues to be determined fundamentally by the COVID-19 pandemic and the policies implemented as a response.

Global economic activity fell in the first quarter of this year and is expected to show an even sharper decline during the period April-June.

The IMF estimates a contraction of world economic activity of 3 percent during 2020, followed by a moderate recovery in 2021.

However, projections continue to be adjusted downwards and many risks prevail.
In the United States, a relatively rapid recovery of GDP and industrial output is anticipated, although with a balance of risks tilted to the downside.

United States

Real Gross Domestic Product and Industrial Production
Quarterly annualized % change, 3-month/3-month annualized % change, s.a.

Blue Chip Consensus Forecasts
Quarterly annualized % change

s.a. / Seasonally adjusted series.

*/Actual.
The crisis has given rise to a contraction of world trade, a decline in commodity prices...

World Trade Volume
Index 2010=100, s.a.

Crude Oil Price and Global Commodity Price Index
Dollars per barrel and index

s.a./ Seasonally adjusted series.
Source: CPB Netherlands.

Source: Bloomberg and IMF.
...a major increase in risk aversion, a tightening of global financial conditions and capital outflows from emerging market economies larger than those observed during the Global Financial Crisis.

Global Risk Appetite Index

Human-to-Human Transmission of COVID-19 Confirmed (January 20, 2020)

Note: The value of the index corresponds to the estimated coefficient from a regression of volatility as a function of the daily yields of 64 assets. The index takes into account that, in periods of greater appetite for risky assets, those assets register elevated yields while safe assets show negative yields.

Source: Credit Suisse.

Total Accumulated Capital Flows to EMEs1/

Billions of US dollars

Note: 1/ Includes fixed income and equity flows.

Source: EPFR.

Mexico’s Monetary Policy and Economic Outlook
In addition to public health actions, aggressive fiscal and monetary policy measures have been implemented in many countries in response to the pandemic.

These policies have allowed some improvement in sentiment in financial markets and a gradual restart of economic activity in some countries.

However, risks prevail:
- Persistent uncertainty among firms and individuals.
- A new outbreak of contagion.
- Tensions between USA and China.
- USA presidential election.
- Political or geopolitical conflicts in other regions.
- The emergence or increase of financial vulnerabilities.
As in other countries, the pandemic affects Mexico’s economy through several shocks:

- Demand
- Supply
- Financial

Challenges for the Mexican economy are accentuated given:

- The openness of the economy to trade and capital flows, and
- The importance of remittances and tourism.
Recent economic indicators reflect the effects of the pandemic on Mexico’s economy. The contraction of economic activity is expected to accentuate during the second quarter.
A weakening economy has affected employment severely, with underemployment increasing sharply and the impact of the decline in formal employment falling mainly on low-wage earners.
With the anticipated restart of activities in coming weeks, the economy should begin to recover. However, the strength and durability of the upturn is unclear:

- Gradual opening of sectors.
- Potential for new episodes of contagion.
- Cautious attitudes by consumers and investors.
- Unbalanced policy response.
- Deterioration of climate for private investment.
Consequently, considerable uncertainty persists about the evolution of GDP in 2020 and 2021.

**GDP Growth Projections by Banco de México**

Index 4Q-2019=100, s.a.

- V-Shaped Scenario
- Deep U-Shaped Scenario
- Deep V-Shaped Scenario
- Central Scenario from Previous Report
- Actual

**GDP Growth Expectations by Economic Specialists**

Median, annual % change

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s.a./ Seasonally adjusted series.

Source: INEGI and Banco de México.
Inflation shows a mixed picture.

Data through the first fortnight of the month.
Source: Banco de México and INEGI.

Variability Interval

* / Data through the first fortnight of the month.
Source: Banco de México and INEGI.

Gasoline Prices During 2020 (Annual % change)

<table>
<thead>
<tr>
<th>February</th>
<th>March</th>
<th>April</th>
<th>May*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.11</td>
<td>-8.61</td>
<td>-23.63</td>
<td>-20.27</td>
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Mexico’s Monetary Policy and Economic Outlook
Inflation is expected to follow an upward trend in coming months, in part due to:
- Increase in energy prices,
- Arithmetic effects,
- Effect of peso depreciation, and
- Supply shocks.

This could lead to figures above the target during the second half of 2020 and the first of 2021.

However, monetary policy must focus on the behavior of prices during its period of influence.

Given the expected evolution of economic activity and the consequent wide negative output gap both in 2020 and 2021, inflation should converge to the target in the second half of next year.

This is likely to take place in a context of pressures in both directions and therefore of high uncertainty.
The scenarios prepared by the Central Bank point in this direction.

Inflation Forecast by Banco de México
Annual % change

1/ Data corresponding to May 2020 refers to the midpoint of the range resulting from the three scenarios for economic activity. Source: Banco de México.
The Banco de México has responded to the crisis with a significant reduction of the monetary policy rate...

Mexico: Reference Interest Rate

Reference Interest Rate

Start of the COVID-19 Pandemic

Source: Banco de México.
... and with a number of measures aimed at:

- Ensuring adequate levels of liquidity in the economy.
- Restoring orderly conditions in the financial markets.
- Fostering the expansion of domestic credit.
- Strengthening the capability to respond to excessive volatility in the foreign exchange market.
  - Adjustments to the NDF program.
  - USD 60 billion swap line with the US Federal Reserve.
These measures, coupled with improved global sentiment, have ameliorated conditions in domestic financial markets...

**Exchange Rate**
Mexican pesos per dollar

Source: Banco de México.

**M-Bond Interest Rates**
%

Source: PiP.
... and helped to contain capital outflows.

Weekly Capital Flows to Mexico
Millions USD dollars

Total Accumulated Capital Flows to Emerging Economies Since
February 19, 2020 1/
Millions USD dollars

Source: EPFR.

1/ Accumulated flows through June 3, 2020, includes fixed income and equity flows. Source: EPFR.
However, as shown by market indicators and recent decisions by credit rating agencies, risks are elevated.

**Mexico: Sovereign Credit Rating**

**Foreign Currency Long Term Issuer Default Rating**

![Diagram showing credit ratings for Mexico (Moody's), Mexico (Fitch), and Mexico (S&P)]

**Note:** Dotted lines represent the investment grade rating. Source: Moody’s, Fitch Ratings and Standard and Poor’s.

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**5-Year Credit Default Swaps by S&P Sovereign Credit Rating**

**Basis points**

![Graph showing 5-year credit default swaps for various ratings: Average BB-, Average BBB-, Average BBB, Average BBB+, and Mexico (BBB)]

1/ The average includes CDS data for Brazil and South Africa.
2/ The average includes CDS data for Colombia, India, and Russia (through April 28, 2020).
3/ The average includes CDS data for Indonesia, and Hungary.
4/ The average includes CDS data for Peru, Philippines, Panama and Thailand.

Source: Banco de México with data from Bloomberg and S&P.
The evolution of inflation determinants is likely to allow a further relaxation of monetary policy.

However, it would be imprudent and probably misleading to provide forward guidance beyond this:

- Unusually high uncertainty regarding the future evolution of the main macroeconomic aggregates, financial markets and the external environment.

In addition, with shocks of a global nature and a substantial increase in risk aversion worldwide, the signals derived from normally important points of reference for monetary policy are blurred:

- Less clarity on the impact of interest rate differentials with other economies.
- Effects in opposite directions on the short-term neutral rate (e.g. high uncertainty and a tightening of global financial conditions, combined with a possible decline in potential growth), which complicate even more the usual difficulties to make a reasonable assessment of its level.

Thus, under present conditions monetary policy must continue to proceed with caution.

A more aggressive monetary response to try to stimulate economic activity would be accompanied by high risks in exchange for, at best, a modest impact on growth for well-known and documented reasons.
To overcome the challenges derived from the pandemic and foster long-term growth, a balanced policy approach is required. In addition to previous and future actions on the monetary and financial areas as needed, efforts should focus on:

- Additional fiscal support in response to the crisis in a context of sustainable public finances.
- Strengthened bonds with the private sector to foster a more friendly environment for investment.
- Adequate response to the institutional and public policy issues repeatedly pointed as major obstacles for economic growth.
- Implementation of additional measures to increase productivity.

This is essential to avoid a more severe deterioration of economic conditions and a continued decline in potential growth from already low levels.