Mexico’s Monetary Policy and Economic Outlook

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The United States-Mexico Chamber of Commerce, Northeast Chapter

New York City, September 6th, 2019

* 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.
Global economic activity decelerated further during the first half of 2019, with weakness evident in the case of some of the main economies, both advanced and emerging.

Simultaneously, the pace of growth of global trade has declined sharply.

At the sectoral level, industrial output, and especially manufacturing, have been more severely affected by trade tensions.

In this context, forecasts for global growth for both 2019 and 2020 have been adjusted downwards, and the balance of risks remains biased to the downside.
In the United States, GDP continues to grow above potential under tight labor market conditions.

United States: Gross Domestic Product
Annual % change, s.a.

- Real Gross Domestic Product
- Real Potential Gross Domestic Product

United States: Unemployment Gap
Percentage points

Source: U.S. Congressional Budget Office and U.S. Bureau of Economic Analysis.
A deceleration is anticipated and the perceived possibility of a recession has increased.

United States: Gross Domestic Product Forecasts
Annual % change

United States: Probability of Recession
%
In this context, and in the absence of generalized inflationary pressures, a relaxation of monetary policy in many advanced and emerging market economies has been observed.

United States: Reference Rates and Implicit Trajectories in OIS Curves\(^1/\)

- Range of Analysts’ Forecasts (August)
- Median of Analysts’ Forecasts (August)
- Implicit Rate (September 4th, 2019)
- Implicit Rate (December 31st, 2019)
- Midpoint of the Target Range

Note: For each country, the deviation refers to the difference between the annual inflation observed the month before the monetary policy announcement and the inflation target. Countries included satisfy two criteria: they relaxed monetary policy and have an explicit inflation target. For those countries with no point target, but an interval, we use the midpoint.

Source: IMF and corresponding central banks’ websites.

Headline Inflation Deviation from Target

\(^1/\) OIS: Fixed-for-floating swap where the fixed interest rate is the reference rate. Source: Banco de México, Bloomberg and Federal Reserve.
While this should lead to an improvement in global financial conditions, the potential impact on capital flows to EMEs may be moderate, given difficult economic circumstances in a number of them and the complex global economic situation, as a result, among others, of:

- The trade conflict between the United States and China.
- The risk of a sharper deceleration of global economic activity.
- A potential deterioration of economic problems in important advanced or emerging market economies.
- The greater probability of a disorderly exit of the United Kingdom from the European Union.
- Political and geopolitical problems in several countries or regions.

Therefore, the possibility of turbulent market adjustments that restrict EMEs’ access to external financing remains.
In Mexico, economic activity has decelerated and a stagnation is observed in recent quarters.

Mexico: Gross Domestic Product
Quarterly annualized % change, s.a.

Mexico: Cyclical Indicators
Indexes referenced to 100 points

Note: The long-term trend of both coincident and leading indicators is represented by the 100 line. Source: INEGI.
Weakness is generalized among the different components of aggregate demand. However, exports have remained resilient. This has been supported by the composition of manufacturing growth in the US...
... and by a higher share of Mexican exports in the US market, probably influenced recently by the trade conflict between this country and China.
Economic growth in Mexico has been hindered by external and especially domestic factors, among which monetary policy is not attributed a major role.

Main Factors that Could Limit Growth of Economic Activity in Mexico

<table>
<thead>
<tr>
<th>Factor</th>
<th>Analysts</th>
<th>Businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>35%</td>
<td>25%</td>
</tr>
<tr>
<td>Domestic Economic Conditions</td>
<td>35%</td>
<td>30%</td>
</tr>
<tr>
<td>Public Finances</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>External Conditions</td>
<td>15%</td>
<td>20%</td>
</tr>
<tr>
<td>Monetary Policy</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Inflation</td>
<td>0%</td>
<td>5%</td>
</tr>
</tbody>
</table>

Perception of the Economic Environment: Investment in the Current Juncture

1/ Answers correspond to the following question: How do you consider the current juncture is for firms to invest?

Source: Survey about Expectations of Economic Analysts in the Private Sector by Banco de México.

Note: Data comes from two surveys: Survey about Expectations of Economic Analysts in the Private Sector corresponding to August 2019 and Monthly Survey of Regional Economic Activity corresponding to July 2019.
Source: Banco de México.
Although employment has weakened, labor costs are increasing faster than productivity.

**Labor Productivity and Unit Labor Costs for the Economy**

Index 2013 = 100, s.a.

- Labor Productivity
- Unit Labor Costs

s.a. / Seasonally adjusted series.
1/ Labor productivity based on worked hours.
2/ Preliminary data for 2Q 2019.
Source: Banco de México with data from INEGI.

**Labor Productivity and Unit Labor Costs for the Manufacturing Sector**

Index 2013 = 100, s.a.

s.a. / Seasonally adjusted series.
3/ Labor productivity based on worked hours.
Source: Banco de México with data from INEGI.
Projections for economic growth in 2019 and 2020 have been adjusted downwards. The Banco de México estimates rates of growth of 0.2-0.7% and 1.5-2.5% for these years, respectively.

As a result, a negative output gap is expected for this period, although this should be adjusted to take into consideration the possible decline in potential growth.

Such a deceleration is taking place in the context of a strong expansion of the US economy.

The potential consequences of the expected lower rates of growth in that country underline the need to correct the domestic factors that are affecting the performance of the Mexican economy.
Headline inflation has fallen significantly, from 6.77 percent in December 2017 to 3.29 percent as of the first fortnight of August of this year. Nearly 80 percent of this decline is explained by non-core inflation.

* Data through the first fortnight of the month.
Source: Banco de México and INEGI.
The latter shows very low levels at present, but is usually very volatile.

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*CPI: Non-Core Inflation*

Annual %

*Data through the first fortnight of August 2019. Source: INEGI.*

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*Core and Non-Core Inflation Volatility¹/

%*

*Data through the first fortnight of August 2019.
1/ As measured by the standard deviation of annual inflation in 12-month rolling windows. Source: Banco de México with data from INEGI.*
Therefore, a more accurate assessment of inflationary trends requires a simultaneous evaluation of the core component. Cumulative core inflation thus far this year is similar to that observed on average since 2003 and recent projections for its evolution have been frequently adjusted upwards.

**Cumulative Inflation**

<table>
<thead>
<tr>
<th>Year</th>
<th>Cumulative Inflation %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>0.5</td>
</tr>
<tr>
<td>2004</td>
<td>1.0</td>
</tr>
<tr>
<td>2005</td>
<td>1.5</td>
</tr>
<tr>
<td>2006</td>
<td>2.0</td>
</tr>
<tr>
<td>2007</td>
<td>2.5</td>
</tr>
<tr>
<td>2008</td>
<td>3.0</td>
</tr>
<tr>
<td>2009</td>
<td>3.5</td>
</tr>
<tr>
<td>2010</td>
<td>4.0</td>
</tr>
<tr>
<td>2011</td>
<td>4.5</td>
</tr>
<tr>
<td>2012</td>
<td>5.0</td>
</tr>
<tr>
<td>2013</td>
<td>5.5</td>
</tr>
<tr>
<td>2014</td>
<td>6.0</td>
</tr>
<tr>
<td>2015</td>
<td>6.5</td>
</tr>
<tr>
<td>2016</td>
<td>7.0</td>
</tr>
<tr>
<td>2017</td>
<td>7.5</td>
</tr>
<tr>
<td>2018</td>
<td>8.0</td>
</tr>
<tr>
<td>2019</td>
<td>8.5</td>
</tr>
</tbody>
</table>

1/ Through the first fortnight of August of each year.

Source: INEGI.

**Core Inflation Forecasts by Banco de México**

Source: Banco de México.
Some of the supply shocks that have affected core inflation have begun to dissipate.

Gasoline Prices: Domestic and International Markets
Annual % change

Food and Agricultural Prices: Domestic and International Markets
Annual % change

Note: Agriculture (Domestic CPI) includes fruits and vegetables CPI for Mexico. International Agriculture Price Index includes food and beverages and agriculture raw materials price indices. International Food Price Index includes cereal, vegetable oils, meat, seafood, sugar, and other food.

Source: INEGI and IMF.

*Data through the first fortnight of August 2019.
In view of the above, and in the presence of a negative output gap, core inflation is expected to decline in coming months.

It remains to be seen to what extent possible pressures from wages and the exchange rate obstruct the decline of this indicator.

Overall, achievement of the inflation target in the second half of 2020, in the context of a core component under control, is feasible.

However, the evolution of inflation will probably continue to be affected by pressures in opposing directions from its different determinants.
Notwithstanding the recent decline in survey-based expectations for headline inflation in 2019-2020, the corresponding readings for the core component show a different behavior. Market-based measures for the medium-to-long term continue to suggest upward risks for inflation, albeit improving in recent months.
The peso has depreciated significantly with respect to the dollar in recent weeks, by somewhat more than the average for other emerging market currencies, notwithstanding relatively high interest rates in Mexico.

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**Exchange Rate**
Mexican pesos per dollar

**Emerging Economies Exchange Rate**
Index 30-Jul-2019 = 100

Note: The average and the range include Brazil, Colombia, Chile, Malaysia, South Africa, Hungary, India, Indonesia, Peru, Poland, Turkey, and Thailand. Range covers from minimum to maximum. Source: Bloomberg.
The perception of country risk has increased, as shown by CDS and their evolution in recent months...

Emerging Economies Market Indicators of Domestic Sovereign Credit Risk

Basis points

Emerging Economies Market Indicators of Domestic Sovereign Credit Risk1/

Index 1-Oct-2018=100

Note: This refers to the arithmetic mean of the 5-year Credit Default Swaps and to the minimum rating reported among S&P Ratings, Fitch Ratings and Moody’s.
1/ Colombia, Hungary, India and Russia. 2/ Brazil and Turkey. 3/ Peru and Thailand.
Source: Bloomberg.

Note: The average and range includes Brazil, Colombia, Chile, Malaysia, South Africa, Hungary, India, Indonesia, Peru, Poland, Turkey, and Thailand. Range covers from minimum to maximum.
1/ This refers to the arithmetic mean of the 5-year Credit Default Swaps.
Source: Bloomberg.
… the fact that Mexico is included among the emerging market economies whose credit rating and/or outlook was downgraded by at least one rating agency in the last year…

Sovereign Credit Rating Changes for Main Emerging Economies
(September 4, 2019 vs. September 30, 2018)

Note: The classification of countries is based on whether S&P, Moody’s or Fitch changed the sovereign credit rating between September 30, 2018 and September 4, 2019. There were no cases in which credit rating agencies contradicted one another. If the rating by any of the three credit rating agencies increased (decreased) the country is classified as “better-off” (“worse-off”). Those countries with no credit rating actions are in the middle group. The color of the country name indicates the minimum credit rating outlook among S&P, Moody’s and Fitch as of September 4, 2019 as follows: red stands for negative outlook; green stands for positive outlook, and black means stable outlook.
... and the performance of the Mexican Stock Exchange.

Emerging Markets: Stock Exchange Index\(^1/\)
Index 1-Oct-2018=100

1/ Time series in local currency converted to dollars. The sample includes Argentina, Brazil, Chile, Czech Republic, Colombia, Hungary, India, Indonesia, Malaysia, South Africa, Philippines, Peru, Poland, Taiwan and Turkey.

Source: Bloomberg.
Interest rates have declined this year, especially at the long end of the curve. The slope of the yield curve has flattened, but the low term premium points to the risk of decompression.

**M-Bonds Interest Rates**

<table>
<thead>
<tr>
<th>Year</th>
<th>1 Month</th>
<th>3 Months</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
<th>20 Years</th>
<th>30 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>6.0</td>
<td>6.5</td>
<td>7.0</td>
<td>7.5</td>
<td>8.0</td>
<td>8.5</td>
<td>9.0</td>
<td>9.5</td>
</tr>
</tbody>
</table>

*Source: Banco de México with data from Bloomberg and PiP.*

**Yield Curve Slope**

- 30 Years - 3 Years
- 10 Years - 3 Years

*The slopes are calculated as the difference between the 30-year and the 3-year rates; and between the 10-year and the 3-year rates, respectively. Source: PiP.*

**10-year Term Premium**

*Source: Banco de México with data from Bloomberg and Valmet.*
The situation of PEMEX continues to be a major source of concern.

The business plan recently announced has not dissipated distress about the firm’s financial perspectives.

In particular, doubts have been expressed about the viability of reaching oil output and reserves’ replenishment targets considered in the plan.

Thus, markets seem to continue to discount an additional downgrade of PEMEX’ ratings.

Also, unease remains about the potential implications for public finances and the sovereign.
Monetary policy continues to be implemented in a context of high uncertainty.

The difficulties originating from a complex external environment have been accentuated by idiosyncratic factors.

As a result, a deceleration of economic activity has combined with a persistently high core inflation and pressures on the exchange rate, in the context of an increase in the perception of country risk.

Inflationary pressures should decline in coming months.

However, to the extent that uncertainty persists, especially related to domestic factors, the margins of maneuver for monetary policy are likely to remain constrained.

The level of interest rates is partly a reflection of country risk.

Under current conditions monetary policy must contribute to support confidence, with any future actions depending on incoming data and evolving circumstances.

The implementation of policies in other areas aimed at strengthening confidence would open margins of maneuver for monetary policy and in general support the recovery of economic activity.
FINAL REMARKS

- The Mexican economy continues to face a challenging situation.
- The external environment is likely to become more complex, thus enhancing the importance of domestic actions aimed at strengthening economic fundamentals.
- Under these circumstances, monetary policy should prioritize prudence.
- Monetary and in general macroeconomic policies face important limitations to stimulate economic activity.
- To reach this objective, efforts should concentrate on overcoming the fundamental causes of the current weakness.
- This implies ensuring sound public finances in the long term, implementing public policies conducive to an increase in productivity, fostering adequate conditions for an increase in private investment, and in general enhancing confidence in the economy’s outlook and the institutional framework.