Since mid-2014, international risk aversion has risen, affecting emerging markets especially hard.

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**EMBI global**

Basis points

1/ JP Morgan’s index tracking total returns for traded external debt instruments in the emerging markets. It includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. */ To March 16

Source: JP Morgan
Portfolio capital flows to emerging economies has become negative

Total portfolio flows to emerging economies\(^1\)

Billions of U.S. dollars

1/ Net purchases by nonresidents of emerging-market shares and bonds posted to the balance of payments. Emerging economies are Argentina, Brazil, Bulgaria, Chile, China, Colombia, the Czech Republic, Ecuador, Egypt, Hungary, India, Indonesia, South Korea, Lebanon, Malaysia, Mexico, Morocco, Nigeria, Peru, the Philippines, Poland, Romania, Russia, Saudi Arabia, South Africa, Thailand, Turkey, Ukraine, the United Arab Emirates, and Venezuela. Source: IIF
... while prices for commodities and financial assets have continuously fallen

Prices for commodities, shares, and currencies in U.S.-dollar terms
June 2014 = 100

1/ Float-adjusted market capitalization index based on U.S. dollars for Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.
2/ Non-weighted average of dollar exchange rates for the Mexican peso, Chinese yuan, Russian ruble, Turkish lira, Korean won, South African rand, Brazilian real, Indian rupee, Polish zloty, Hungarian florin, Malaysian ringgit, Thai baht, Chilean peso, Indonesian rupee, Philippine peso, Colombian peso, and Peruvian sol

Source: Banco de México, Bloomberg, Haver Analytics and the IMF
Mexico’s exchange rate has recently been hit by volatility above that of other emerging-market currencies

Mexico and emerging economies: U.S. dollar exchange rate in local currency terms

June 2014 = 100

1/ Non-weighted average for the Chinese yuan, Russian ruble, Turkish lira, Korean won, South African rand, Brazilian real, Indian rupee, Polish zloty, Hungarian florin, Malaysian ringgit, Thai baht, Chilean peso, Indonesian rupee, Philippine peso, Colombian peso, and Peruvian sol

*/ To March 17

Source: Bloomberg
The correlation between the exchange rate and oil prices has strengthened.

Mexico: Oil price and exchange rate
U.S. dollars per barrel and pesos per U.S. dollar

* To March 17
Source: Banco de México and PMI
... which has coincided with the deterioration of Pemex’s credit risk premium, lately attenuated by improved oil prices.

Mexico: Sovereign and Pemex credit risk premium
5-year CDS, basis points

[Graph showing Mexico and Pemex CDS premiums from June 2014 to March 2016 with specific values for March 11, 2016: Mexico at 164.3 basis points, Pemex at 360.5 basis points.]

*/ To March 11
Source: Bloomberg
In contrast, market interest rates have remained relatively stable.

Mexico: Government bond interest rates

* To March 11

Source: Banco de México
Nonresident holdings of peso-denominated government securities have stayed roughly constant in peso terms since 2015.

Mexico: Nonresident holdings of peso-denominated government securities

June 2, 2014 = 100

1/ Cetes, Bondes D, Bonos M and Undibonos
*/ To March 10
Source: Banco de México
... while those holdings relative to the total outstanding have declined moderately

Emerging economies and Mexico: Nonresident holdings of local-currency-denominated government securities

% of total outstanding

1/ Unweighted average of ratios for Brazil, Colombia, Hungary, Indonesia, Israel, Malaysia, Peru, Poland, Russia, South Africa, South Korea, Thailand and Turkey. 2/ Total outstanding includes Bonos M, Cetes, Bondes D, Udibonos and BPA

Source: Finance ministries, central banks and other national authorities
So far, the most negative external impact on Mexico’s output stems from U.S. manufacturing.

Mexico and the United States: Manufacturing production

Annual % change, s.a.

s.a. / Seasonally adjusted
*/ Only January for Mexico and January-February for the United States
Source: INEGI and the U.S. Federal Reserve
Consequently, Mexico’s exports to the U.S. have slowed and even contracted.

Mexico: U.S. dollar value of manufacturing exports

Annual % change, s.a.

To the United States
To the rest of the world

s.a. / Seasonally adjusted
*/ Only January
Source: Banco de México
However, as in the U.S., mining has been the most significant drag on industrial production.
The key drivers of an ongoing upturn in the economy are services and private consumption.

Mexico: GDP
Annual % change, s.a.

- GDP
- Private consumption
- Services

s.a. / Seasonally adjusted
Source: INEGI
... while private investment has decelerated

Mexico: Investment
Annual % change, s.a.

s.a. / Seasonally adjusted
Source: INEGI
The Mexican economy is expected to recover gradually, along with U.S. industrial production.

The United States and Mexico: Growth forecasts

<table>
<thead>
<tr>
<th>Year</th>
<th>U.S. industrial production (Mean)</th>
<th>Mexican GDP (Mean)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>0.9</td>
<td>2.5</td>
</tr>
<tr>
<td>2017</td>
<td>2.4</td>
<td>2.9</td>
</tr>
</tbody>
</table>

Source: Blue Chip, March 2016
The economic growth scenario holds risks

- **To the downside**
  - ✔ Slower-than-expected recovery for U.S. industrial production
  - ✔ A sudden swoon in Chinese economic momentum
  - ✔ A drop in Mexican oil production beyond current forecasts

- **To the upside**
  - ✔ Greater-than-expected benefits from structural reforms
Mexico needs to confront an adverse international scenario by strengthening its economic fundamentals

- **Strong macroeconomic stance**
  - The finances of the public sector and Pemex adjusted to reflect lower oil prices
  - Convergence of inflation to the target safeguarded by monetary policy

- **Solid financial system maintained**

- **Structural reforms that stoke greater productivity adequately implemented**
After an unprecedented decline to an all-time low, inflation has slightly risen, approaching the target.

Mexico: Annual inflation
Benign inflation has been supported by positive relative price shocks

Mexico: Agricultural, energy and telecommunication services prices

Annual % change

Source: INEGI
Also, the impact from peso depreciation on inflation has been modest, confined to tradable goods.

**Mexico: Exchange rate and prices of some durable goods**

**Annual % change**

- Exchange rate
- Furniture
- Domestic accessories
- Domestic appliances
- Textile accessories for home use

Source: Banco de México and INEGI
To face adverse international conditions, monetary policy has been adjusted twice.

Mexico: Policy interest rate target
overnight funding rate, %

Source: Banco de México
These interest rate hikes have sought to safeguard price stability

- Maintain the relative monetary stance vis-à-vis that of the United States
- Prevent inflation expectations from getting out of line in the face of peso depreciation
- Buttress economic fundamentals, action taken in conjunction with the announcement of preventive public-sector spending cuts
Last year’s improvement in inflation expectations depended crucially on declines foreseen in the noncore component

Mexico: Inflation expectations
Median, %

Year-end 2016

Year-end 2017

1/ Implicit based on CPI weights
Source: Banco de México, Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado
Monetary policy will continue to be on guard for any obstacles that may hinder the consolidation of convergence of inflation to the target.

Some risks to watch:

- Amplified FX depreciation and greater pass-through to inflation, with second-round effects.
- Larger increases in noncore price components, with contamination to other prices.
- Aggregate demand pressures as the economy recovers, given uncertainty over measures of slack such as the output gap.
Conclusions

- The adverse international scenario has hurt the Mexican economy through lower oil prices and slower U.S. industrial production, making it necessary for Mexico to fortify its economic fundamentals

- Fiscal and monetary measures undertaken in February have been geared toward safeguarding price and financial stability in this difficult global environment

- Current benign inflation represents an unprecedented opportunity to consolidate convergence of inflation to the permanent target
Mejoran las perspectivas económicas mundiales