Monetary Policy in Mexico

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The implementation of monetary policy in Mexico rests on four main pillars:

2. An inflation targeting regime pursuing inflation of 3%.
3. An efficient convergence of inflation to the target.
4. Transparency and accountability.
Monetary policy and the strengthening of public finances have allowed the reduction of inflation to levels around the target...

Overnight Interest Rate and Headline Inflation
Annual %

1/ Target for the overnight interbank interest rate adopted on 21 January 2008.
2/ Data through the first fortnight of April.
3/ Data through 5 May 2015.
...and other important accomplishments:

- A decline in the volatility of inflation.
- A sharp reduction in the pass through of the exchange rate to prices.
- A substantial decline in the persistence of inflation.
- A lower dispersion of inflation expectations.
Thus, the impact of the recent depreciation of the peso on domestic prices has been modest.

Foreign Exchange and Consumer Prices
Annual %

Source: Banco de México.
1/ Data through the first fortnight of April.
2/ Data through 5 May 2015.
Similarly, the increase in prices derived from the 2014 tax reform and other supply shocks proved to be transitory.

**Deviation from 3% Target in Headline Inflation**

Percent points

![Graph showing deviation from 3% target in headline inflation](image-url)

Source: Banco de México.

1/ Data through the first fortnight of April.
Looking ahead, the main challenge for monetary policy is to consolidate the progress made in the reduction of inflation. Although economic activity is expected to strengthen gradually, no demand pressures on inflation are foreseen for this year.
In addition, supply shocks, though frequent, have only a temporary impact on prices.

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**Inflation Expectations and Inflation Shocks**

**Annual %**

Sources: Banco de México and INEGI.

1/ Inflation data through the first fortnight of April.
Therefore, the main risk for inflation (and financial stability) in coming months will probably derive from the implications of normalization of monetary policy in the US.

Federal Funds Rate
Annual %

Sources: FOMC, Bloomberg and Blue Chip.
These challenges are heightened by Mexico’s financial openness...

Financial Openness
Chinn-Ito Index\(^1/\), 2012

\(^*/\) Average for the major advanced economies: Canada, France, Germany, Italy, Japan, United Kingdom, and United States.
\(^1/\) Measures a country’s degree of de jure financial account openness (0-1 scale), based on the IMF’s Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER).
... and the relatively high participation of non-residents in the domestic government securities market...

Non-residents Share of Holdings
% of total outstanding local currency government bonds

* / Average of Brazil, Hungary, Indonesia, Malaysia, Mexico, Poland, Russia, South Africa, Thailand and Turkey, weighted by non-residents’ dollar-value of holdings.

1/ Data for Mexico through March 2015.

Source: Banco de México and Credit Suisse.
...although it is important to note the long-term nature of these flows in Mexico’s case, since a sizable portion originates from institutional investors.

Non-residents Holdings of Mexican Peso-denominated Bonds

Percent\(^1\/

- NORGES BANK INVESTMENT MANAGEMENT: 47.9%
- FRANKLIN RESOURCES: 14.7%
- PIMCO ADVISORS: 14.3%
- LOOMIS SAYLES: 13.9%
- STANDARD LIFE INVESTMENTS: 13.9%
- LEGG MASON: 13.9%
- STONE HARBOR INVESTMENT PART: 13.9%
- BLACKROCK: 13.9%
- Japan Ministry of Finance: 13.9%
- Japan Pension Funds: 13.9%
- Toushin Funds (Japan): 13.9%
- Other US based funds: 13.9%
- Not identified: 13.9%

1/ As of 31 March 2015. Total outstanding nominal value of bonds held by non-residents: MXN 1,423 billion.
Sources: Bloomberg, SEC, Toushin Funds, Ministry of Finance Japan, Norges Bank.
The implementation of market-based mechanisms for the provision of liquidity has contributed to curb volatility of the exchange rate.

### Foreign Exchange
MXN per USD

<table>
<thead>
<tr>
<th>Date</th>
<th>Value</th>
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<tbody>
<tr>
<td>11-Dec-14</td>
<td>USD 200 mn allocated</td>
</tr>
<tr>
<td>6-Mar-15</td>
<td>USD 200 mn allocated</td>
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<tr>
<td>11-Mar-15</td>
<td>USD 52 mn daily</td>
</tr>
</tbody>
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Source: Banco de México.

### Implied Volatility in 1-month USD/MXN Options
Percent

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Source: Banco de México.
However, the stance of monetary policy in Mexico will need to be adjusted at some stage. The timing is subject to a number of uncertainties:

- The date of the first adjustment of the reference interest rate in the US, as well as the pace of subsequent increases.
- The impact of normalization of monetary policy in the US on the peso-dollar rate, domestic interest rates, and other financial variables.
- The moment when monetary policy actions in the US will be reflected in these variables (e.g. will markets anticipate?).
- In view of these uncertainties, monetary policy must be ready to respond in a timely and flexible way as needed.
Mexico is well prepared to face the challenges posed by the normalization of monetary policy in the US.

1. Prudent monetary and fiscal policies (expenditure adjustments of 0.7 percent of GDP announced for both 2015 and 2016 to meet the fiscal targets in the face of lower oil prices and output).

2. A moderate current account deficit.

3. A well functioning floating exchange regime.

4. International reserves around record levels and a 66.2 billion US dollar FCL with the IMF.

5. A sound financial system.

Furthermore, the economy’s growth potential should be substantially strengthened by the major structural reform efforts underway.
The decline of inflation is a necessary, but not sufficient, condition to achieve adequate rates of economic growth.

Headline Inflation and Real GDP Growth

Annual %

* Information through the first fortnight of April.
Source: Banco de México and INEGI.
However, there are good reasons to expect a major change of trend in coming years. The economy’s potential is already evident in the evolution of exports...

Source: Direction of Trade Statistics, IMF.
...and particularly in sectors such as the automobile industry.

Light Vehicle Production and Installed Capacity

Thousand annualized units

* Seasonally adjusted data.
Source: Banco de México with data from AMIA. Estimation of installed capacity based on manufacturers’ press releases and newspapers’ reports.
And very importantly, a major process of structural reform has been launched to increase the economy’s growth potential.

**Economic Reform Responsiveness**
Share of OECD reform recommendations with significant action taken during 2013-2014

Economic growth should also be supported by favorable demographics.

**Labor Force¹/ Growth**

Annual %

1/ Economically active population aged 15-64. Source: International Labour Organization.
It is also worth noting that the external environment is expected to be less unfavorable to Mexico relative to other EMEs in coming years, given the projected evolution of the major economies...

Real GDP Growth in Major Economies
Annual %

Source: IMF (WEO, April 2015).
...and a low share a commodities in total exports.

Commodities Exports\(^1\)

% of total merchandise exports, 2013

* The figure for Mexico corresponds to 2014.
1/ Includes: Agricultural commodities, food, fuels and metals.

Source: Banco de México and World Bank (World Development Indicators).
- Implementation of the structural reform measures has begun.

- Accordingly, some results are already evident.

- Furthermore, important efforts have been made to improve the institutional framework.

- However, this is just the beginning of a long process.

- Continuous efforts are required to ensure macroeconomic and financial stability.

- In addition, the efficient implementation of reforms is a major challenge, and measures in other areas will likely be needed.