



Monetary Policy under Fed Normalization and Other Challenges

Javier Guzmán Calafell, Deputy Governor, Banco de México*

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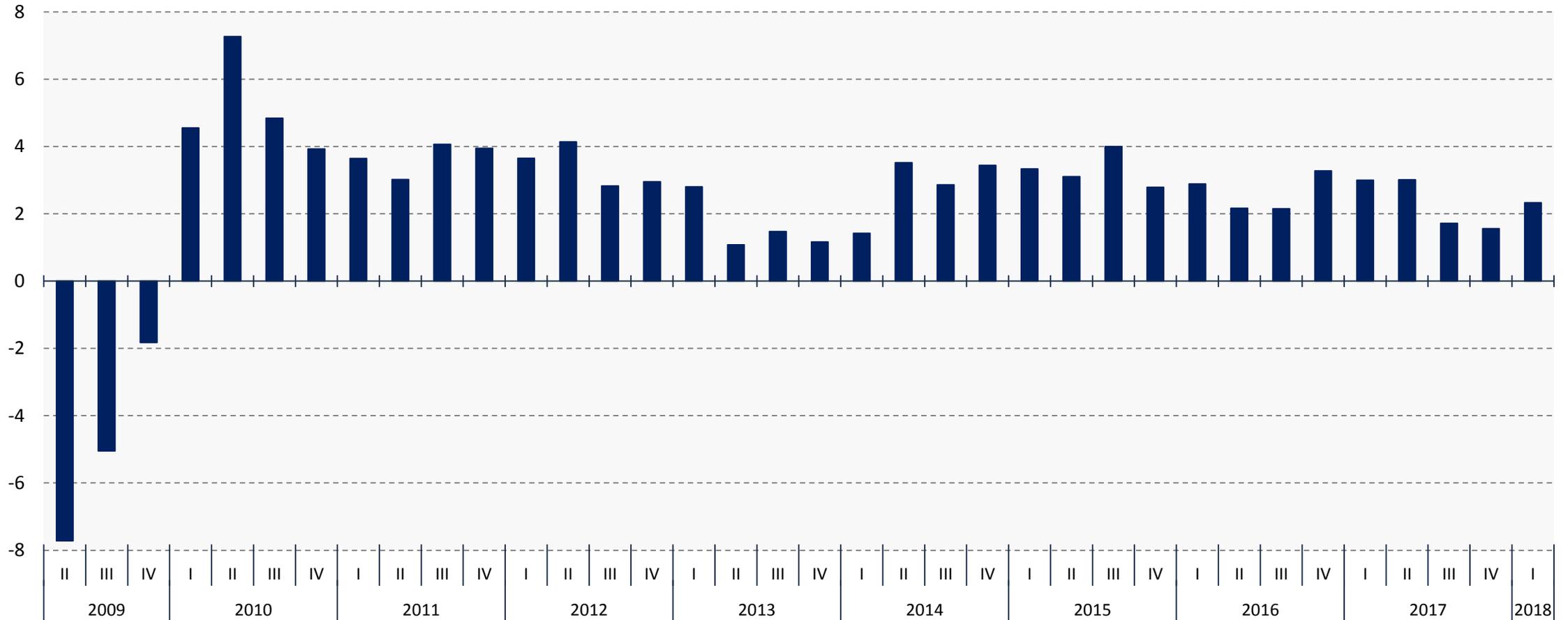


BANCO DE MÉXICO

- ❑ The favorable recent performance of the global economy supports the expectation of a further, albeit moderate, strengthening over the rest of this year and the next, with growth rates at levels above the estimated potential.
- ❑ However, downside risks for this scenario persist, and some of them have accentuated recently.
 - Potential for further restrictions to international flows of goods and services.
 - Possibility of a faster-than-anticipated normalization of monetary policy in the United States.
 - Risk of mounting geopolitical tensions in multiple regions, coupled with political and electoral developments in several countries.
- ❑ In this context, international financial markets have displayed in recent weeks increased volatility and diminished risk appetite.
- ❑ This has resulted in capital outflows from EMEs, with a negative impact on their asset prices.

The Mexican economy has shown resilience in a context of shocks, both domestic and external. Annual GDP growth has recorded positive figures for 33 consecutive quarters.

Mexico: Gross Domestic Product
Annual % change, s.a.

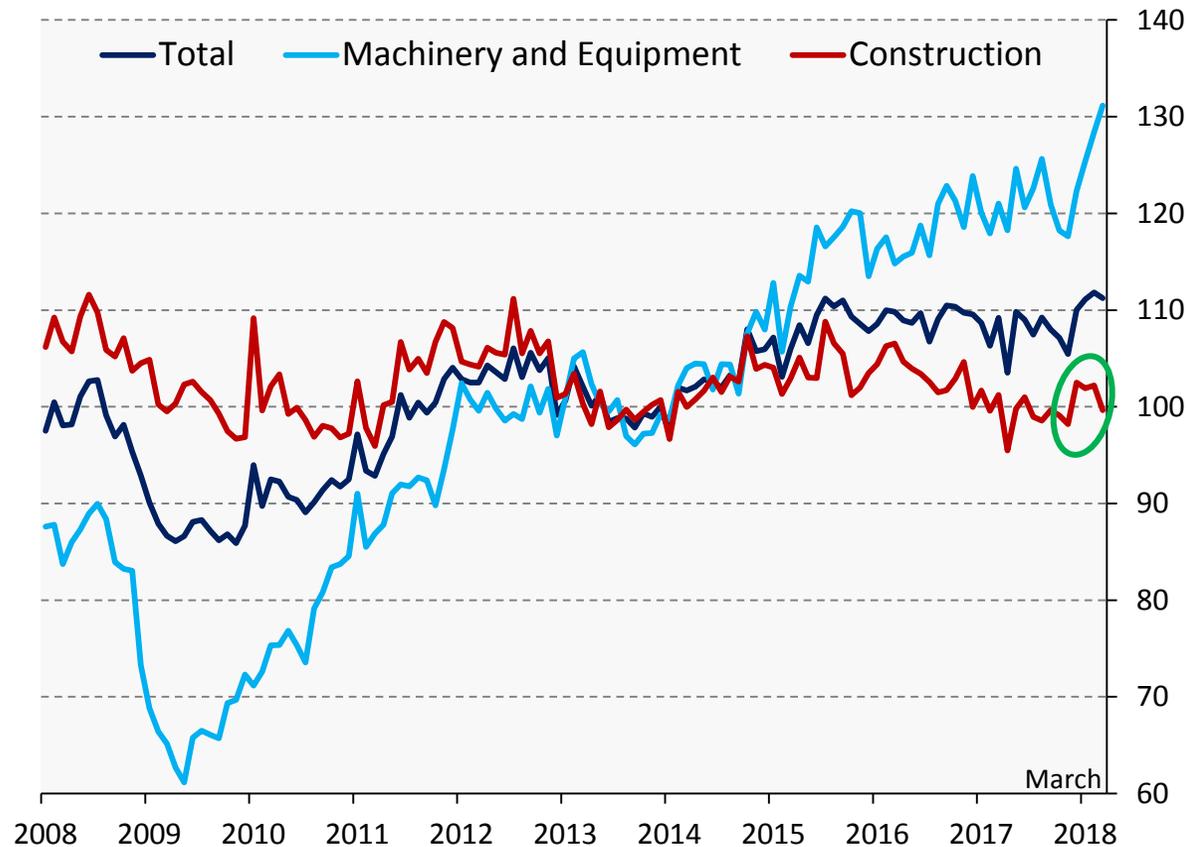


s.a./ Seasonally adjusted series.
Source: INEGI

- Economic activity strengthened significantly in the first quarter of 2018. This was explained by:
 - On the demand side: Growing exports and private consumption, in addition to an upturn in investment.
 - On the supply side: Sustained growth in the services sector, with a slight improvement in industrial activity.
- Thus, at the start of the year, GDP growth recorded the highest quarterly rate since July-September 2016.

Such high rates of growth, however, are unlikely to be sustained in coming quarters. The monthly indicator of economic activity fell in April and investment might not sustain its recent dynamism.

Gross Fixed Investment
Index 2013 = 100, s.a.



s.a. / Seasonally adjusted series.
Source: INEGI.

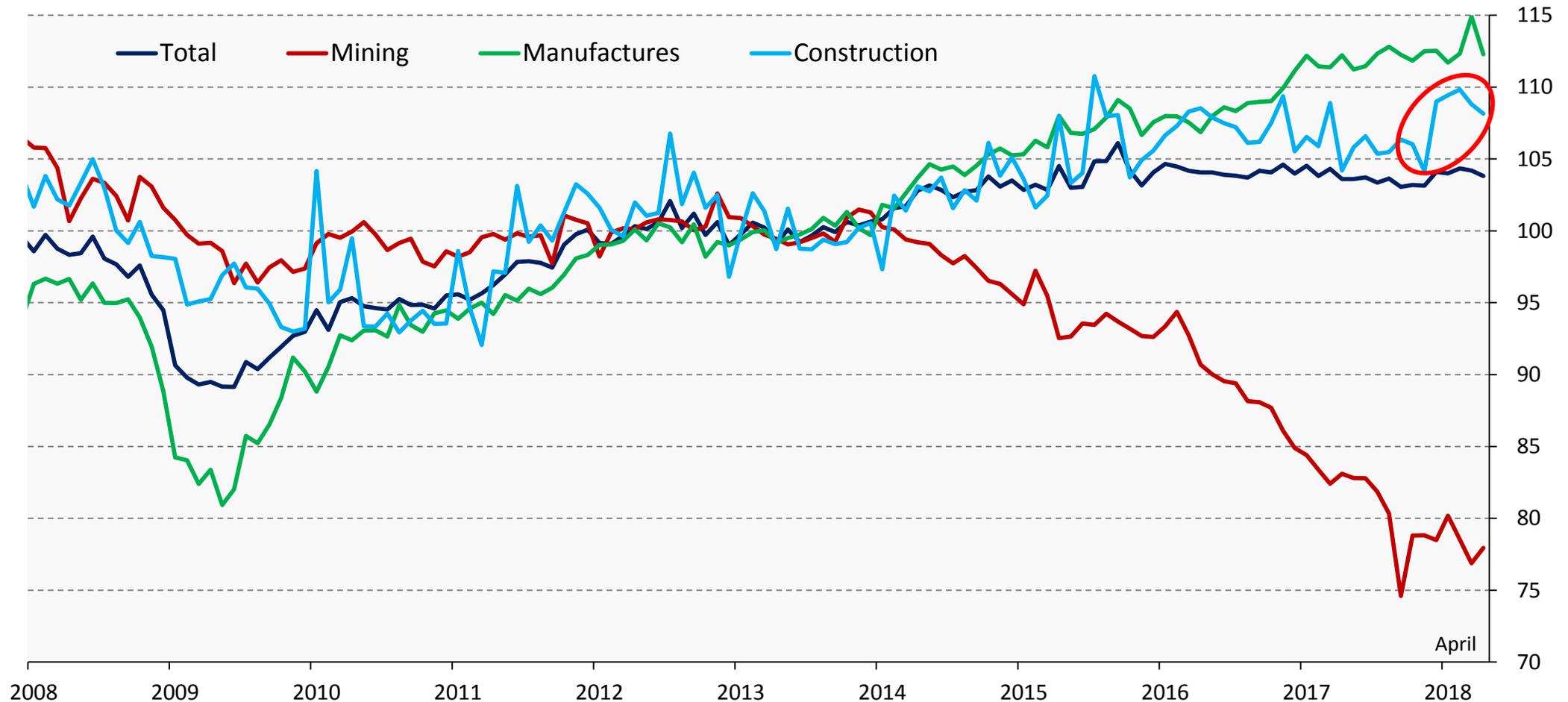
Monthly Indicator of Economic Activity (IGAE)
% change with respect to the previous period, s.a.

	Total
4Q 2017	0.88
1Q 2018	0.68
April 2018	-0.57

s.a. / Seasonally adjusted series.
Source: INEGI.

The recent evolution of industrial output also suggests that the impact of transitory factors is beginning to fade.

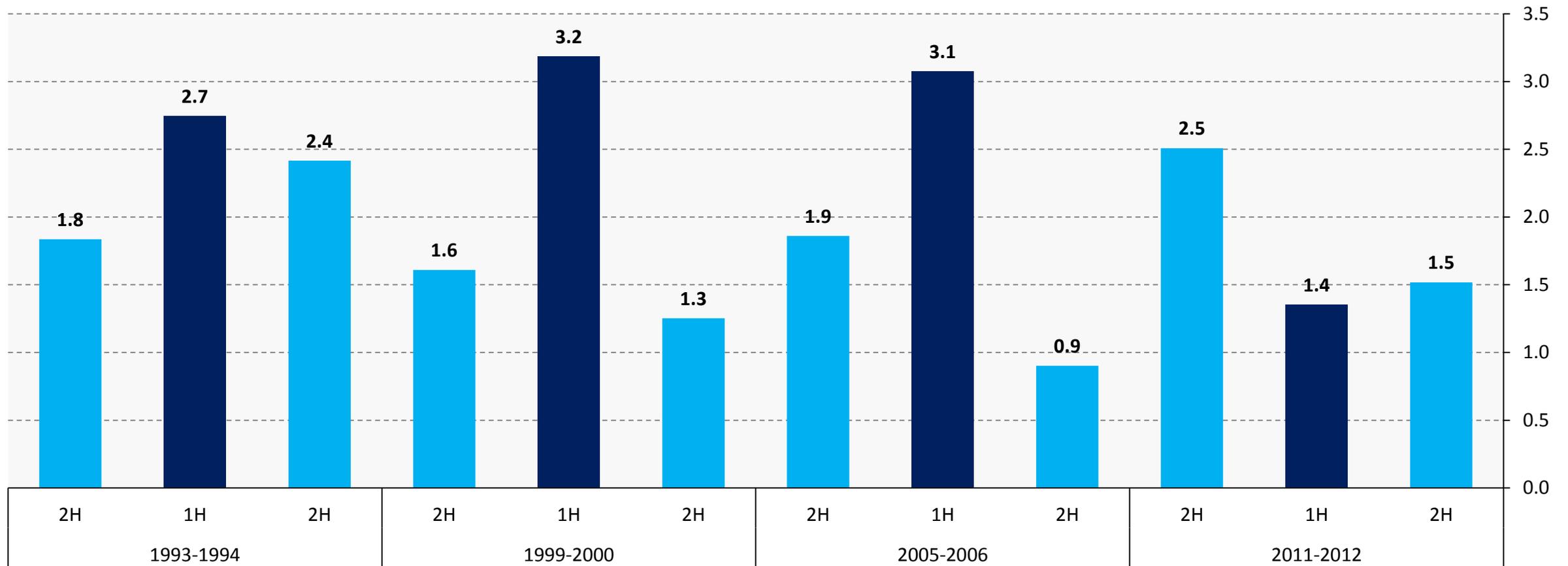
Industrial Production
Index 2013 = 100, s.a.



s.a. / Seasonally adjusted series.
Source: INEGI.

It is also important to take into account that, in previous electoral periods, it is frequent to observe upturns in economic activity during the first half of the year, which tend to revert, at least partially, over the second half.

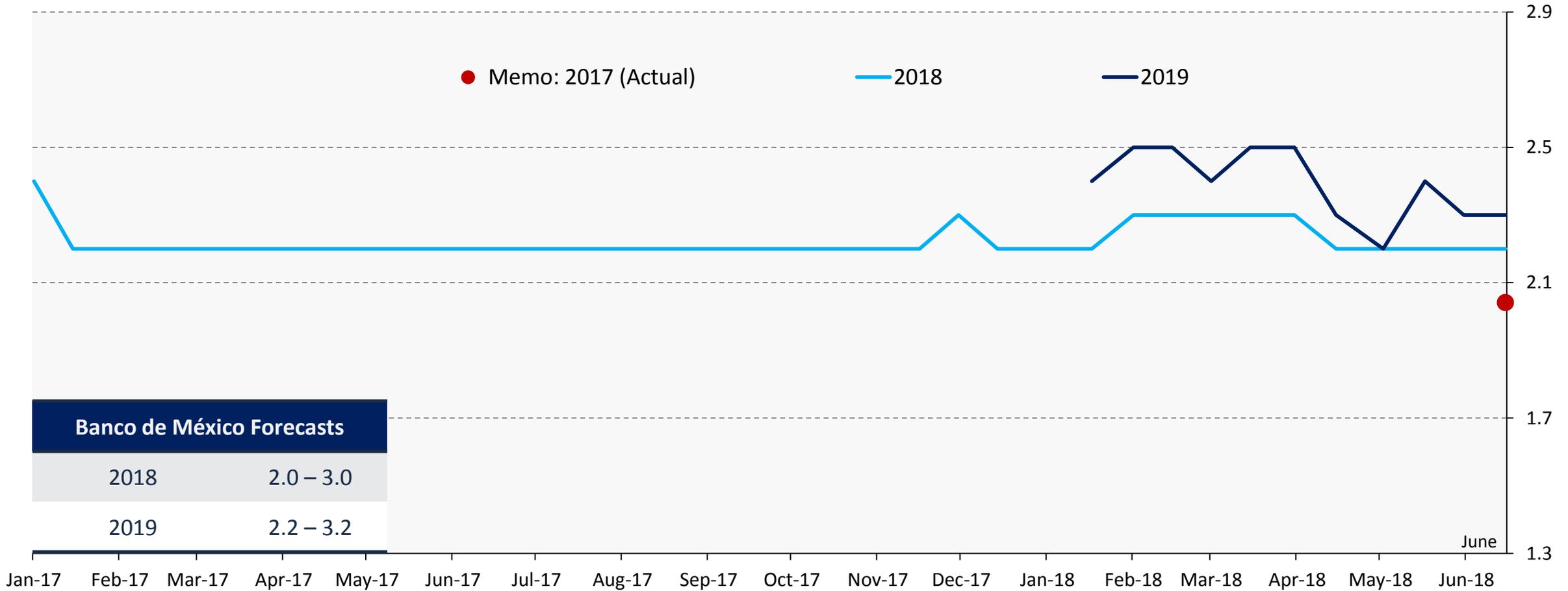
Gross Domestic Product
 % change with respect to the previous period, s.a.



s.a. / Seasonally adjusted series.
 Source: INEGI.

Although, in principle, a faster-than-expected expansion of GDP last quarter would give support to improved expectations for 2018 as a whole, the extent to which the fading of the above-noted factors affects economic activity going forward remains to be seen.

Real GDP Growth Expectations
Annual %

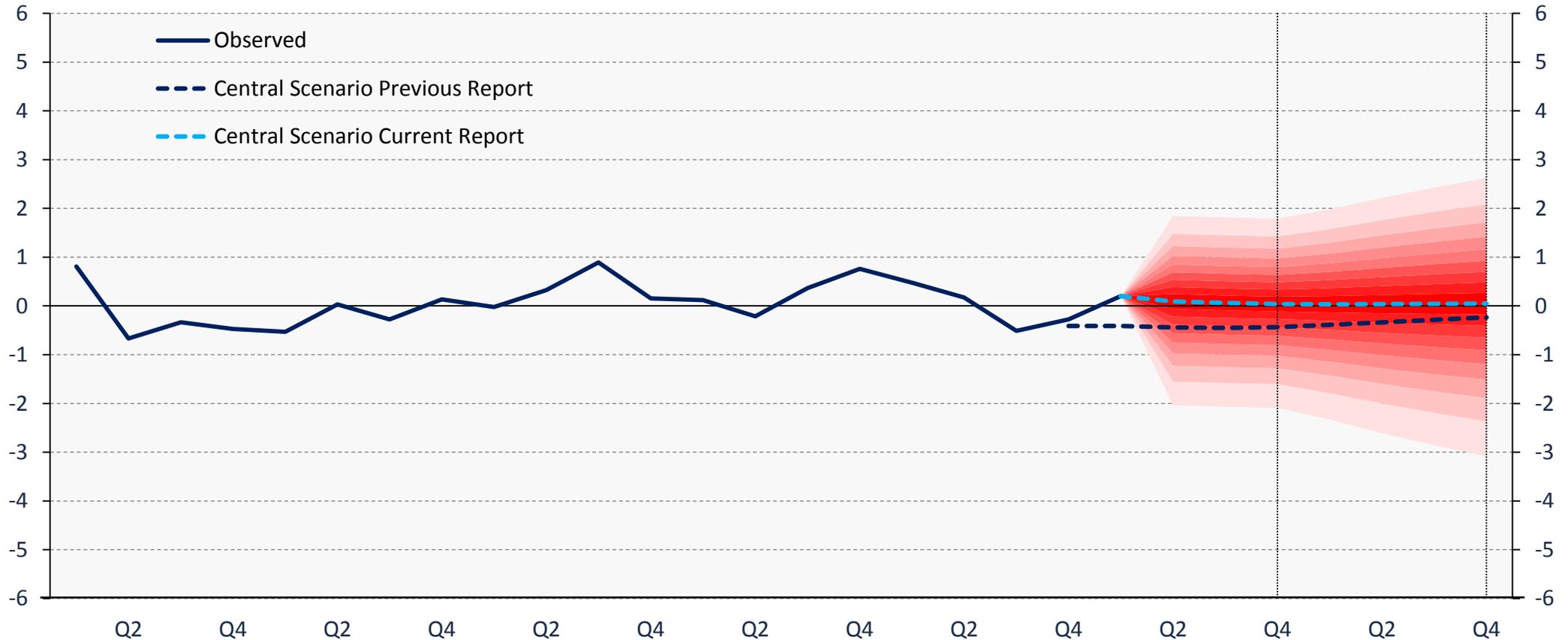


Source: Banco de México and Citibanamex.

- Economic performance in Mexico through 2018 has kept conditions in the labor market tight.
 - Current estimations suggest that the unemployment rate is significantly below long-term levels.
- This might not accurately reflect prevailing conditions in this market, especially in light of the absence of excessive wage pressures or those that could be expected from the demand side in a situation of this nature.
- The size of the informal sector adds to the difficulties involved in accurately assessing slack in the labor market.

The situation in the labor market seems more compatible with current estimations of the output gap, which place it at levels close to zero.

Output Gap Projections
% of potencial GDP, s.a.



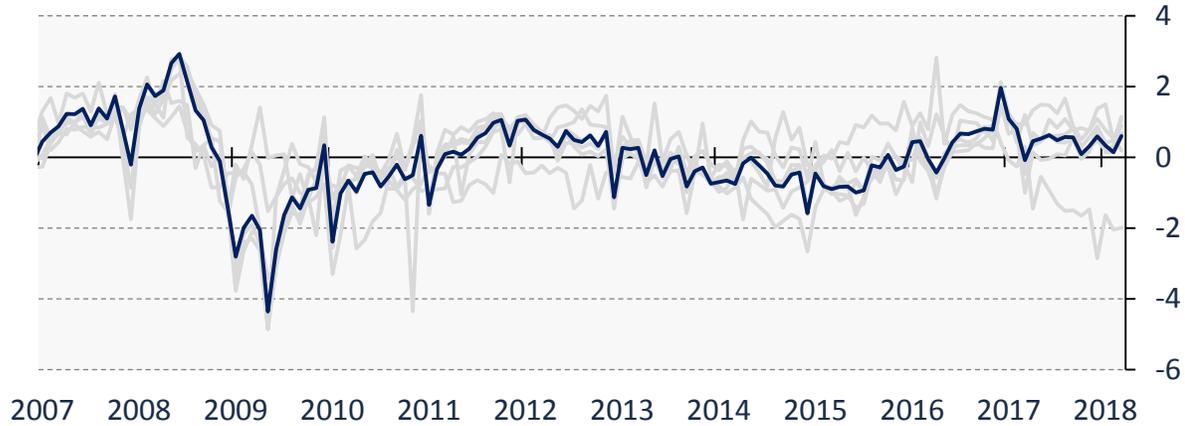
s.a. / Seasonally adjusted series.
Source: Banco de México.

The recent evolution of 3 out of the 4 sets of variables used by the Banco de México to estimate monthly indicators of slack in the economy also supports this conclusion.

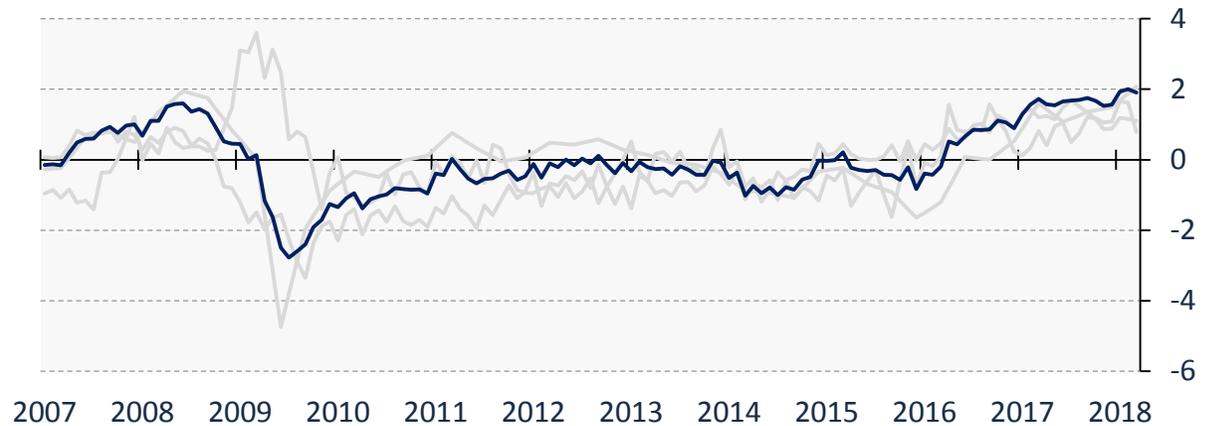
First Principal Components

Consumption

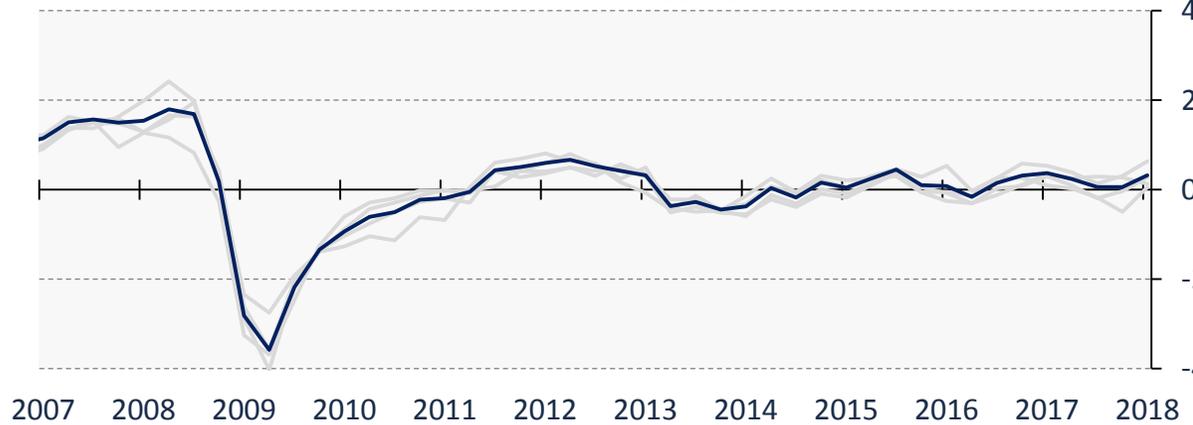
%



Labor Market



Economic Activity and Aggregate Demand



Demand Conditions in the Loanable Funds Market

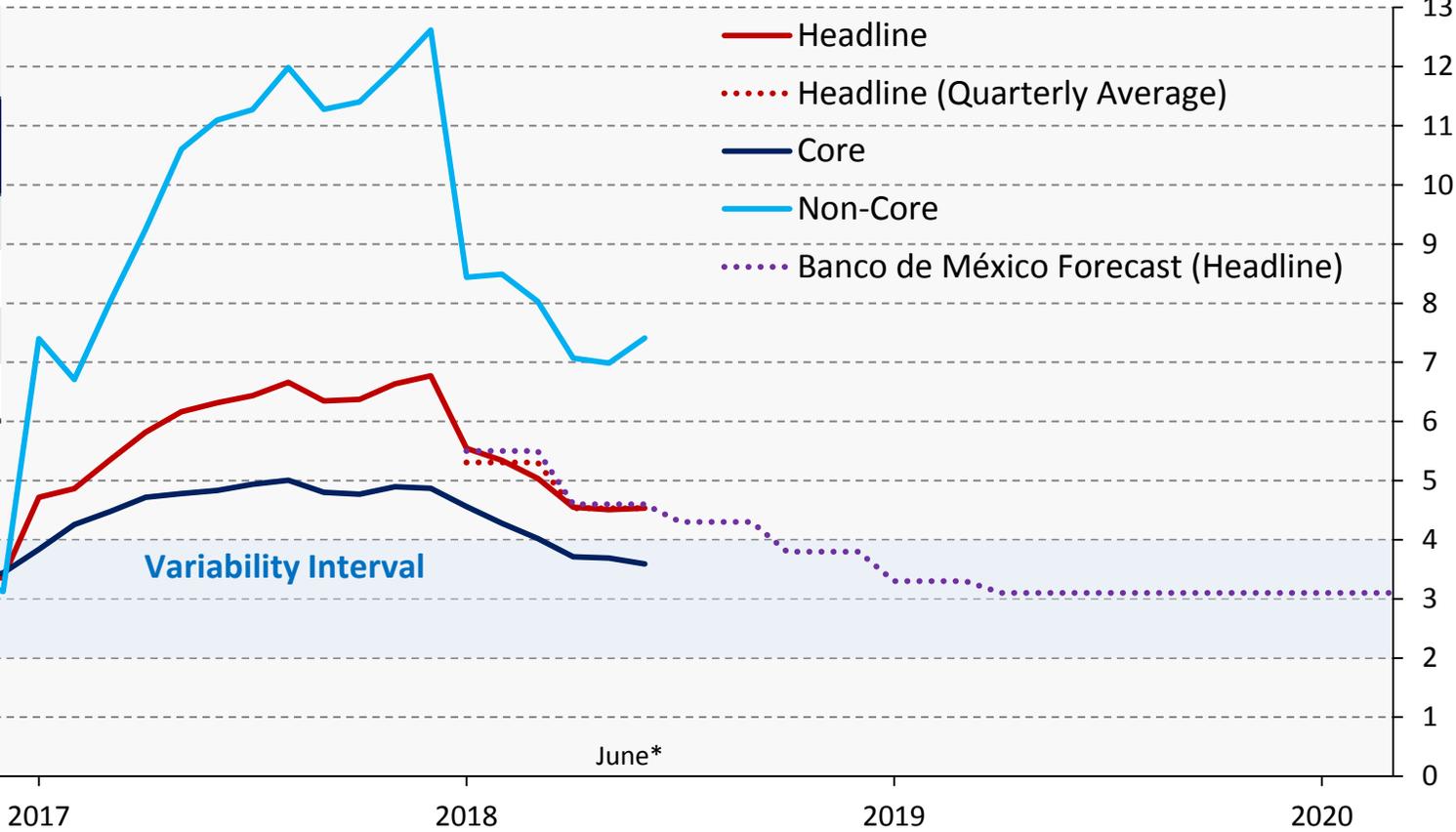


Source: Banco de México.

Inflation continues to display a downward trend which, although less pronounced than in the first months of the year, remains compatible with the trajectory foreseen by Banco de México.

CPI Inflation
Annual %

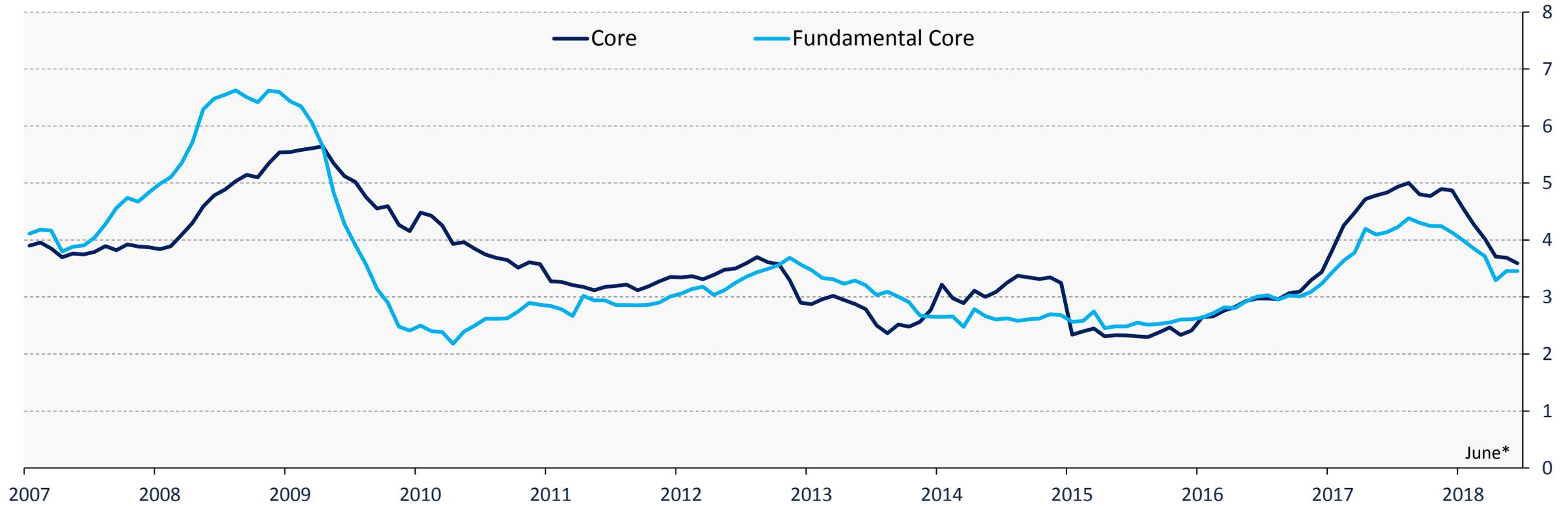
Contributions to CPI Inflation			
Annual %, %-points and %			
	December 2017	June* 2018	Difference
Headline CPI	6.77	4.54	-2.23
<u>Contributions (%):</u>			
Core	4.87	3.59	43.0
Non-Core	12.62	7.41	57.0



*/Data through the first fortnight of June 2018.
Source: Banco de México and INEGI.

In addition, core inflation has declined to levels below the upper limit of the variability interval around the target. Meanwhile, *fundamental* core inflation, which tends to be more closely associated with the economic cycle, has fallen during the year, and remains below core inflation.

Core and Fundamental Core Inflation
Annual % change



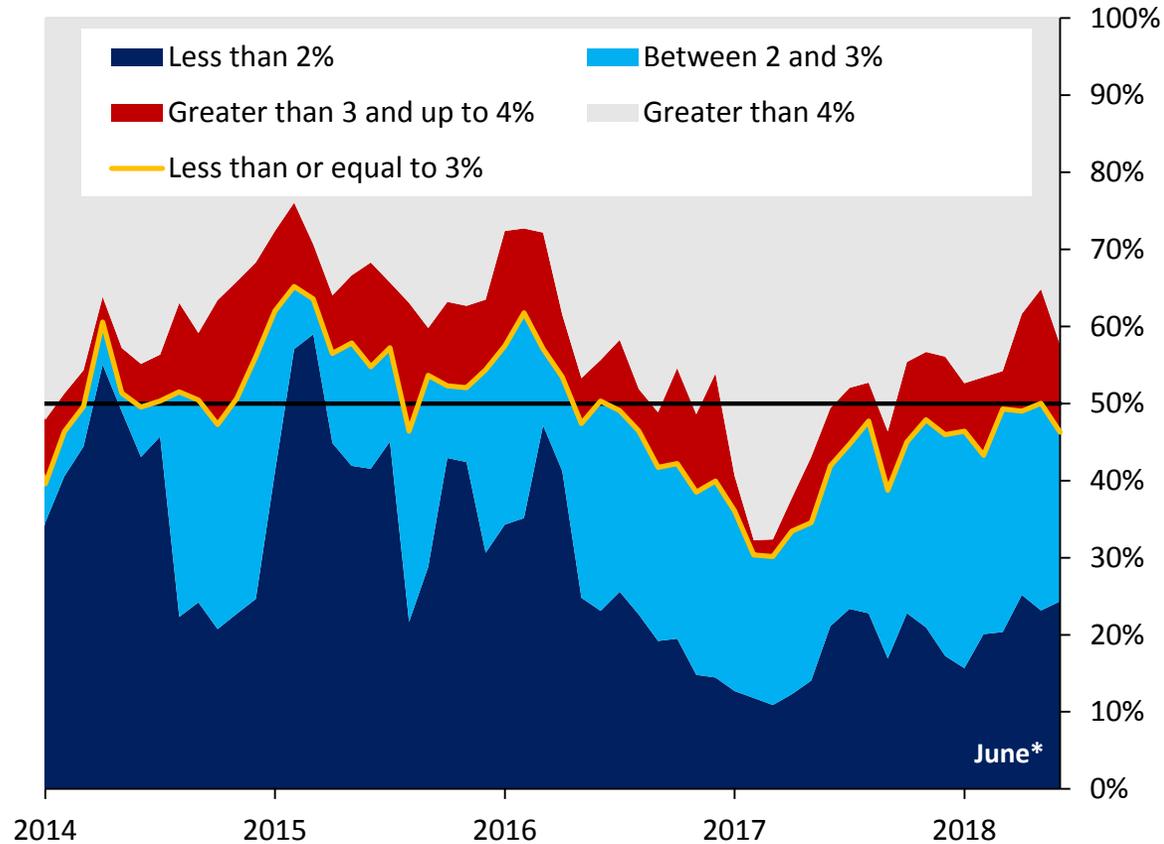
*/Data through the first fortnight of June 2018.
Source: Banco de México and INEGI.

Furthermore, nearly half of the CPI basket shows annualized growth under 3 percent as of the first fortnight of June this year.

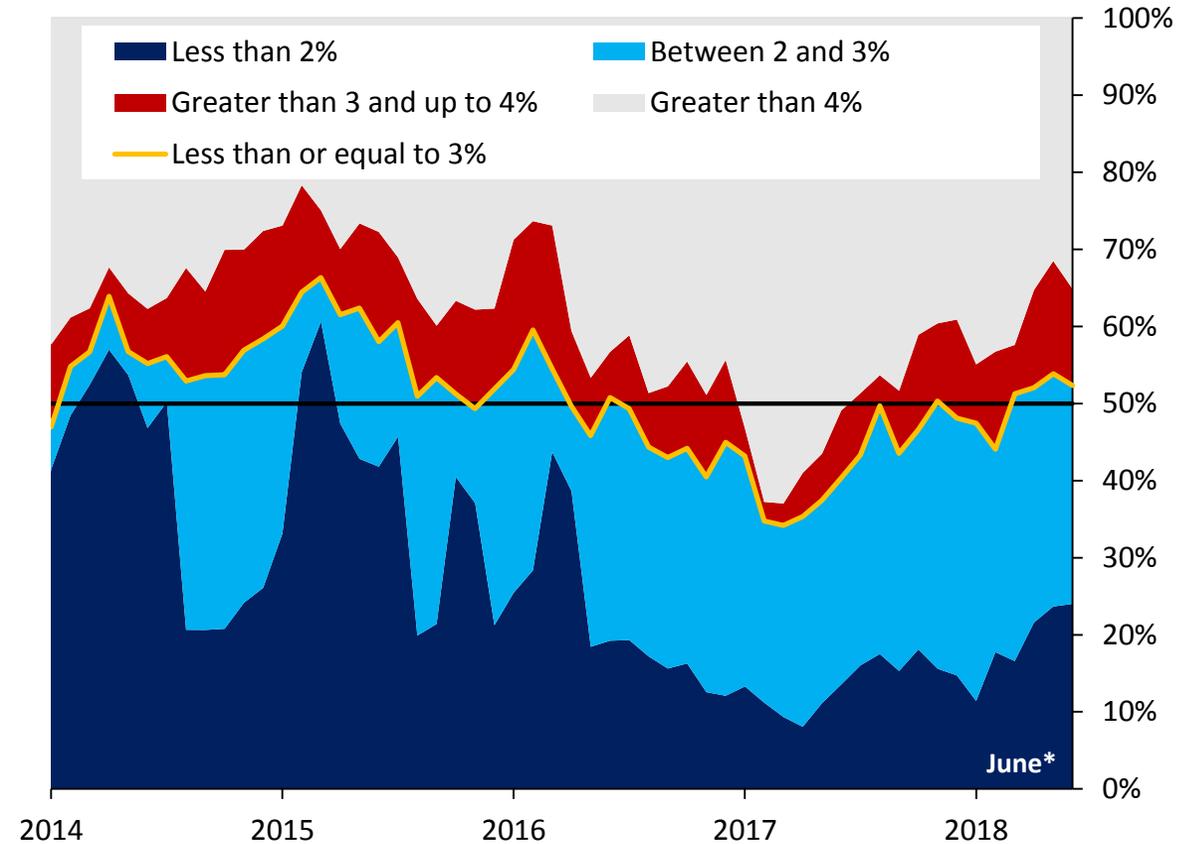
Percentage of the CPI Basket According to Intervals of Monthly Annualized Increment

%, s.a.

Headline



Core



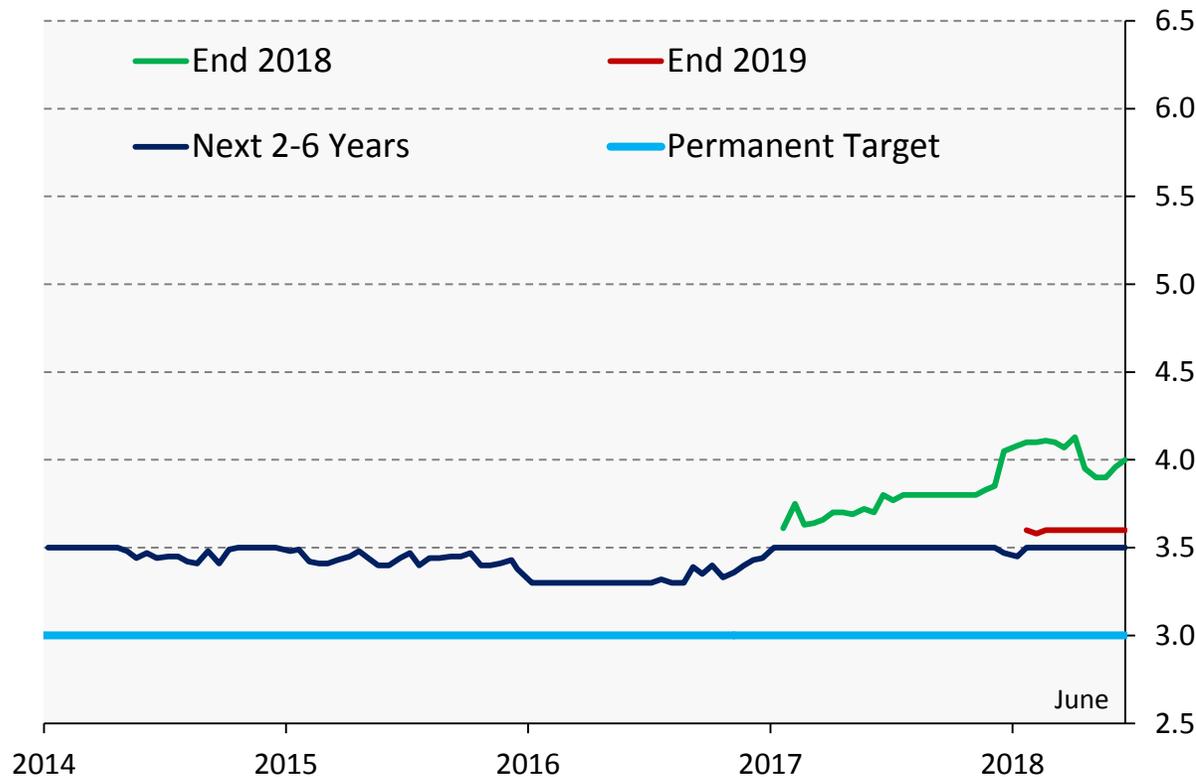
*/Data through the first fortnight of June 2018.
Source: Banco de México and INEGI.

*/Data through the first fortnight of June 2018.
Source: Banco de México and INEGI.

Survey-based inflation expectations at all horizons remain relatively stable. However, they are above both Banco de México's projections and the 3 percent target. In addition, inflation breakevens increased in recent weeks, which suggests more market concern about the trajectory of inflation in the medium to long terms.

Short- and Long-Term Inflation Expectations

Annual %



Inflation Breakevens^{1/}

Basis Points



^{1/} Difference between yields on nominal and real (inflation-protected) bonds. In addition to expected inflation, this measure includes other (e.g. inflationary, liquidity and term) risk premia.
Source: Banco de México with data from PiP.

Source: Citibanamex.

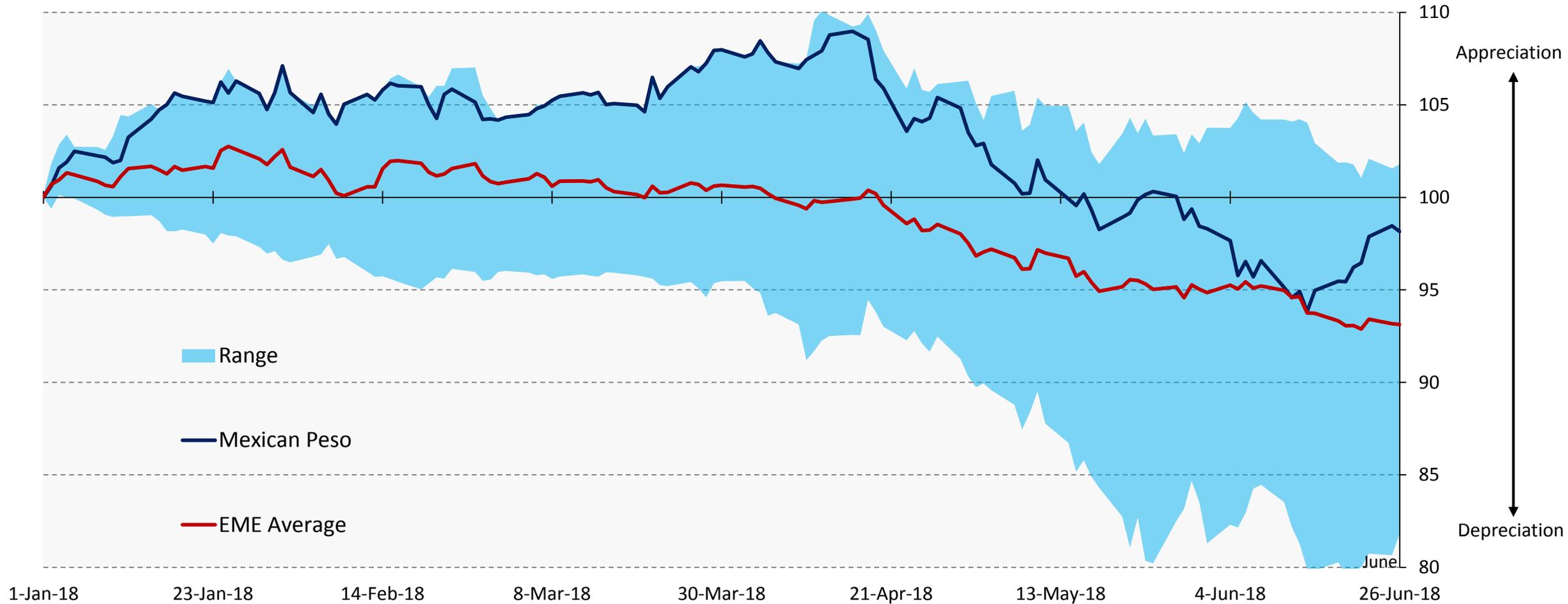
- ❑ A number of factors may adversely affect the foreseen trajectory for inflation in coming months.
 - The recent performance of the peso-dollar exchange rate, as well as the perspective of prolonged NAFTA negotiations, may imply a more depreciated exchange rate for the rest of the year.
 - Futures markets suggest additional pressures from the evolution of gasoline and domestic gas prices.
 - Recent tariffs to imports of some items from the United States will have an impact on prices.
- ❑ In view of the above, the convergence of inflation to the target may take longer than previously expected.

- Thus, the balance of risks for inflation is tilted to the upside.
 - As in recent months, the main risk comes from the exchange rate, as it can be affected, among other factors, by the negotiation of NAFTA, the electoral process in Mexico, and interest rate increases in the US.
 - In view of tight conditions prevailing in the labor market, demand pressures on prices cannot be disregarded.
 - Increases in the prices of non-core items can materialize, given their high volatility.
 - The likelihood of inflationary pressures from greater global protectionism has increased, especially in light of recent messages and actions from the part of the US government.

The peso has depreciated significantly since mid-April. This is partly explained by the appreciation of the dollar, but idiosyncratic factors are also behind this trend.

EME Currency Performance in 2018

Index 31-Dec-2017 = 100



Note: The countries included in the average for EMEs are Argentina, Brazil, Chile, Colombia, Hungary, Indonesia, Mexico, Peru, Philippines, Poland, Russia, South Africa, South Korea and Turkey.
Source: Banco de México with data from Bloomberg.

Operating conditions in the foreign exchange market have deteriorated, although they remain within adequate ranges.

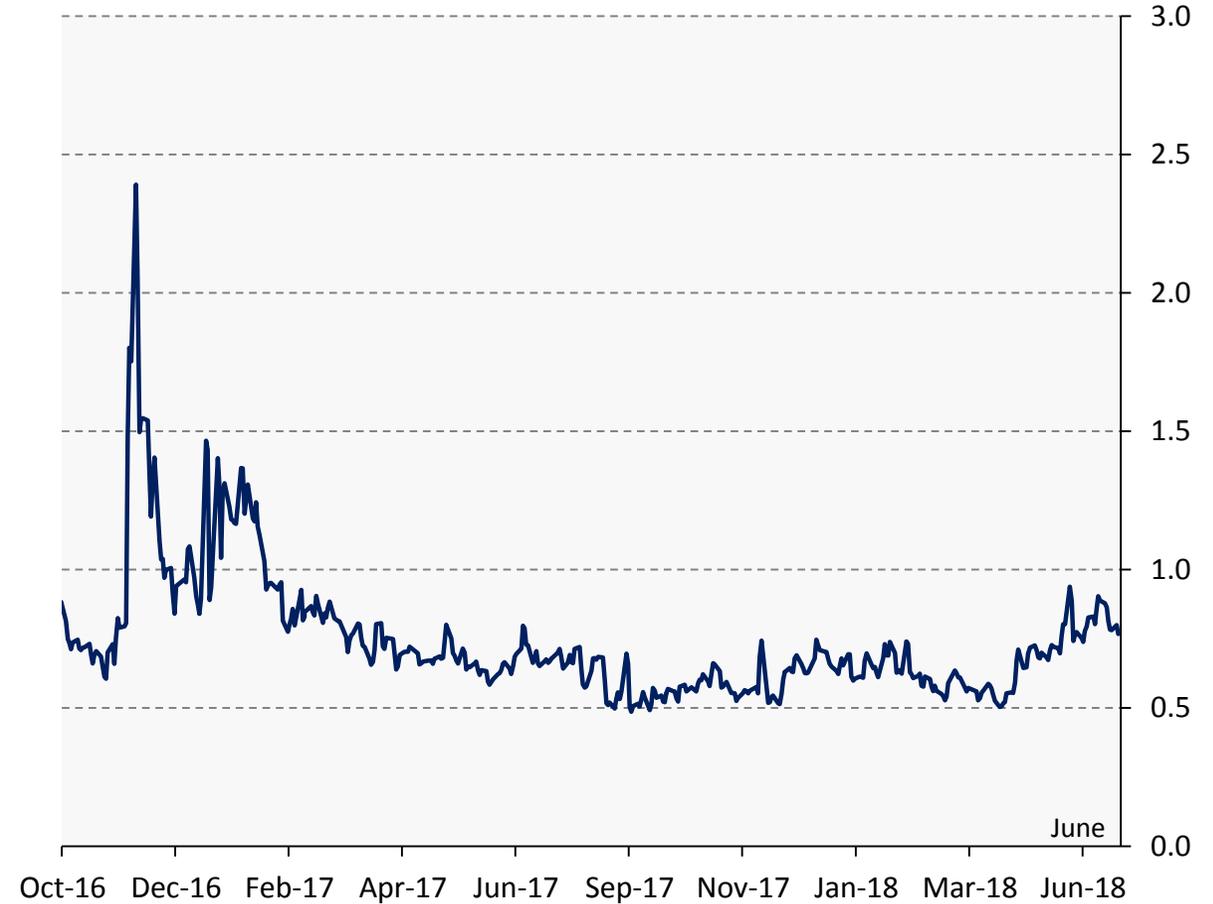
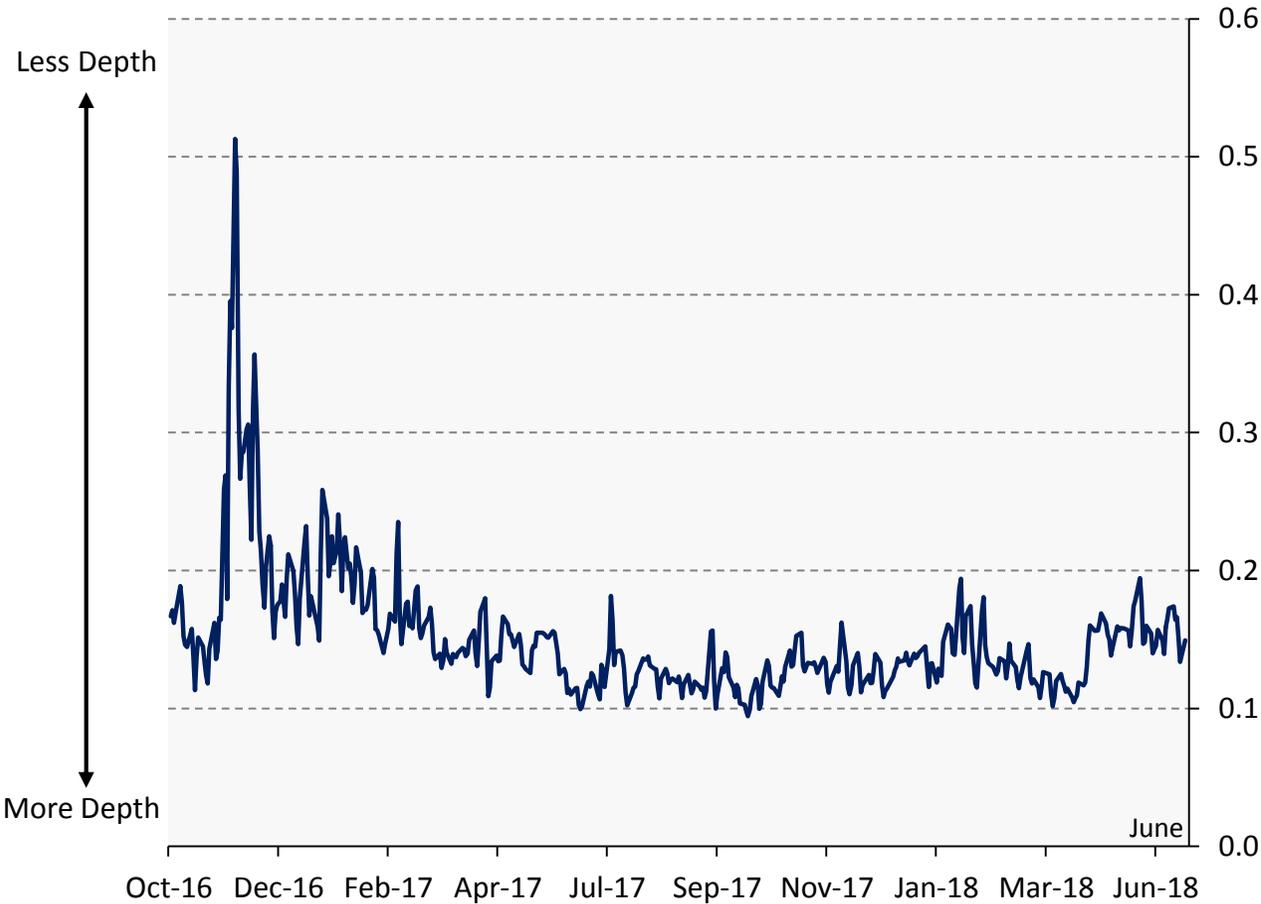
FX Market

Market Depth

Cents of Mexican Peso^{1/}

Bid-Ask Spread

Cents of Mexican Peso



^{1/} Change in the USD/MXN per USD million traded.
Source: Banco de México with data from Reuters

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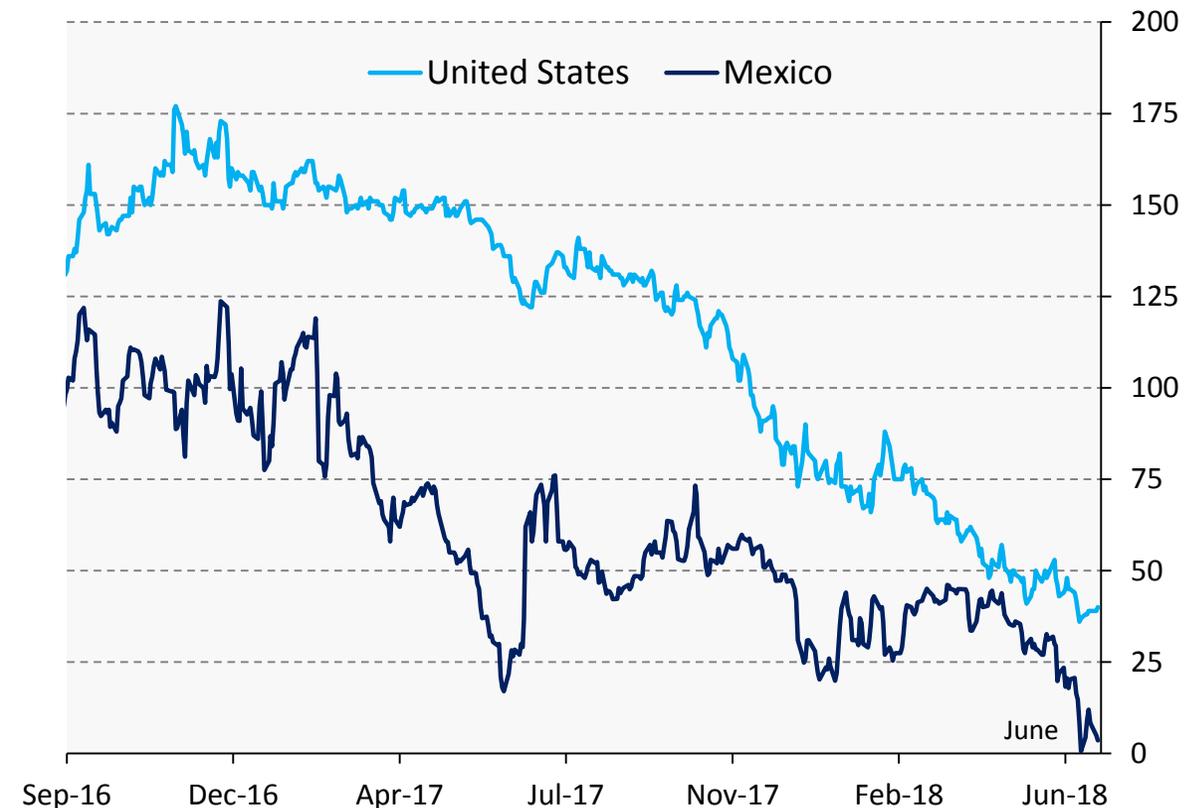
Naturally, interest rates in Mexico have also been affected by a combination of domestic and external factors. In this context, a further widening of differentials with respect to US rates and a flattening of the domestic yield curve have been observed.

Mexico-United States Interest Rate Spreads
Basis points



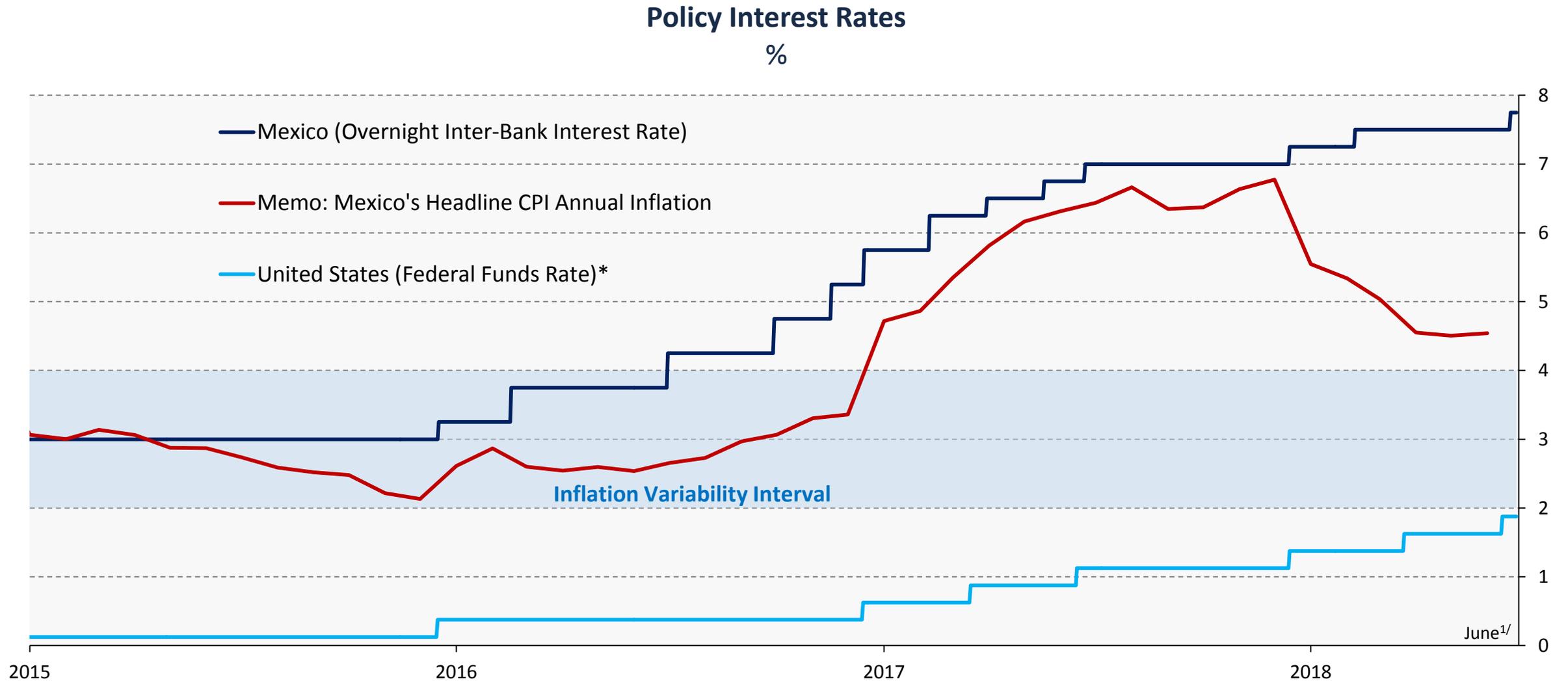
Source: Banco de México with data from Bloomberg.

Slope of the Yield Curve as Measured by the 30-3 Years Government Bond Interest Rate Spreads
Basis points



Notes: Nominal interest rates.
Source: PiP and Bloomberg.

Monetary policy has reacted decisively to actual or potential inflationary pressures since late-2015.



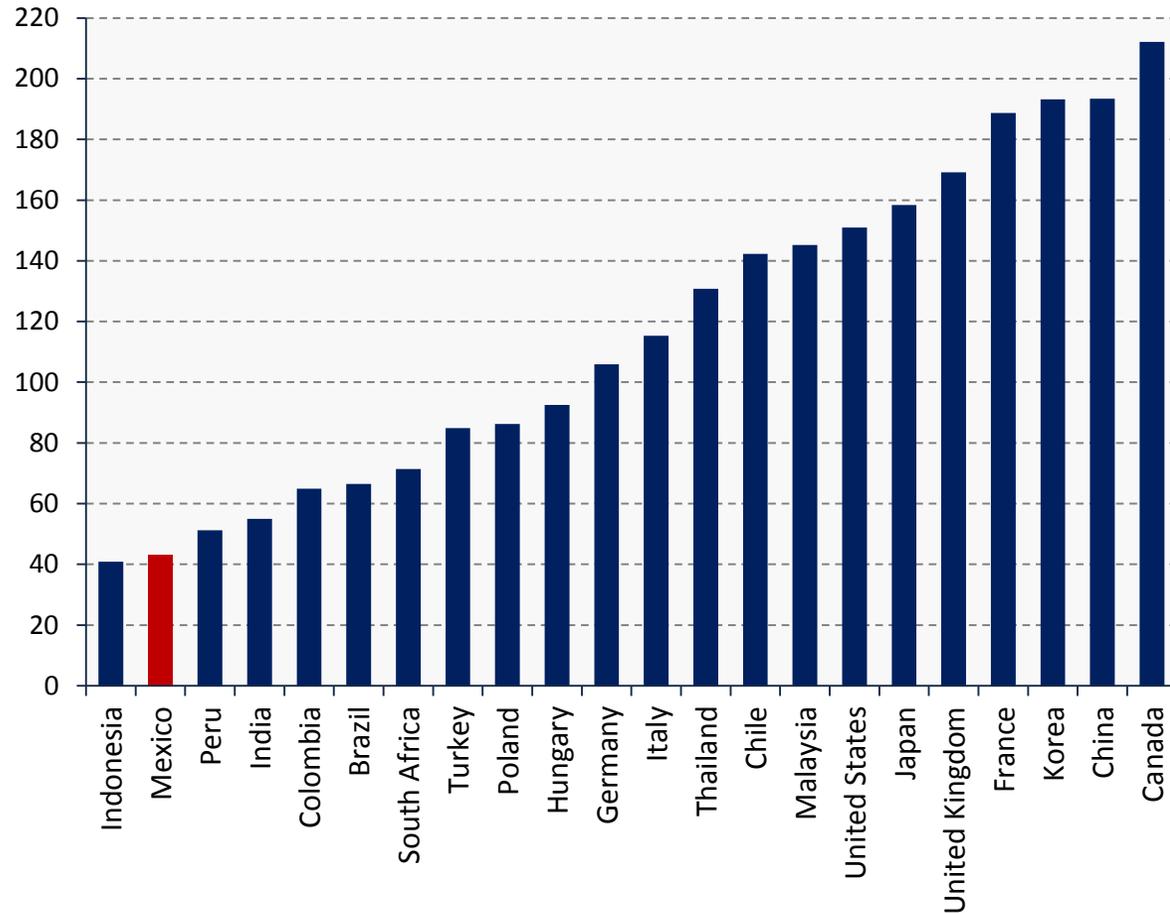
1/ Data for inflation through the first fortnight of June 2018.
*/ Mid-point of the target range.
Source: Banco de México, INEGI and Federal Reserve.

- ❑ Recent developments imply the materialization of some of the inflationary risks identified by the Banco de México several months ago.
- ❑ Some of them represent changes in relative prices, with a short-term impact on inflation but unlikely to affect long-term inflation expectations. However, in other cases the potential implications are not clear-cut.
- ❑ Since this is taking place in a context of shocks from several sources, a balance of risks for inflation tilted to the upside and above-normal uncertainty conditions, additional adjustments to the monetary policy stance have been needed.
- ❑ Given the prevailing conditions, the Banco de México must continue to adhere to a cautious monetary policy approach and be ready to respond according to emerging circumstances. Therefore, the possibility of additional adjustments to the reference rate cannot be excluded.

- ❑ Naturally, the breadth of the actions required goes beyond monetary policy.
- ❑ Overall, the Mexican economy has a firm basis to face shocks.
 - Fiscal consolidation efforts have turned the primary balance into a surplus since last year, yielding corresponding declines in the public sector's debt.
 - The current account deficit shows, and is expected to maintain, moderate levels.
 - International reserves are adequate by international standards, and emergency liquidity funding is available through a FCL with the IMF.
 - The banking system is well capitalized, profitable and has adequate levels of liquidity. In general, financial risks of a systemic nature appear absent.
 - Despite some increase in recent years, the debt of the private sector remains at moderate levels

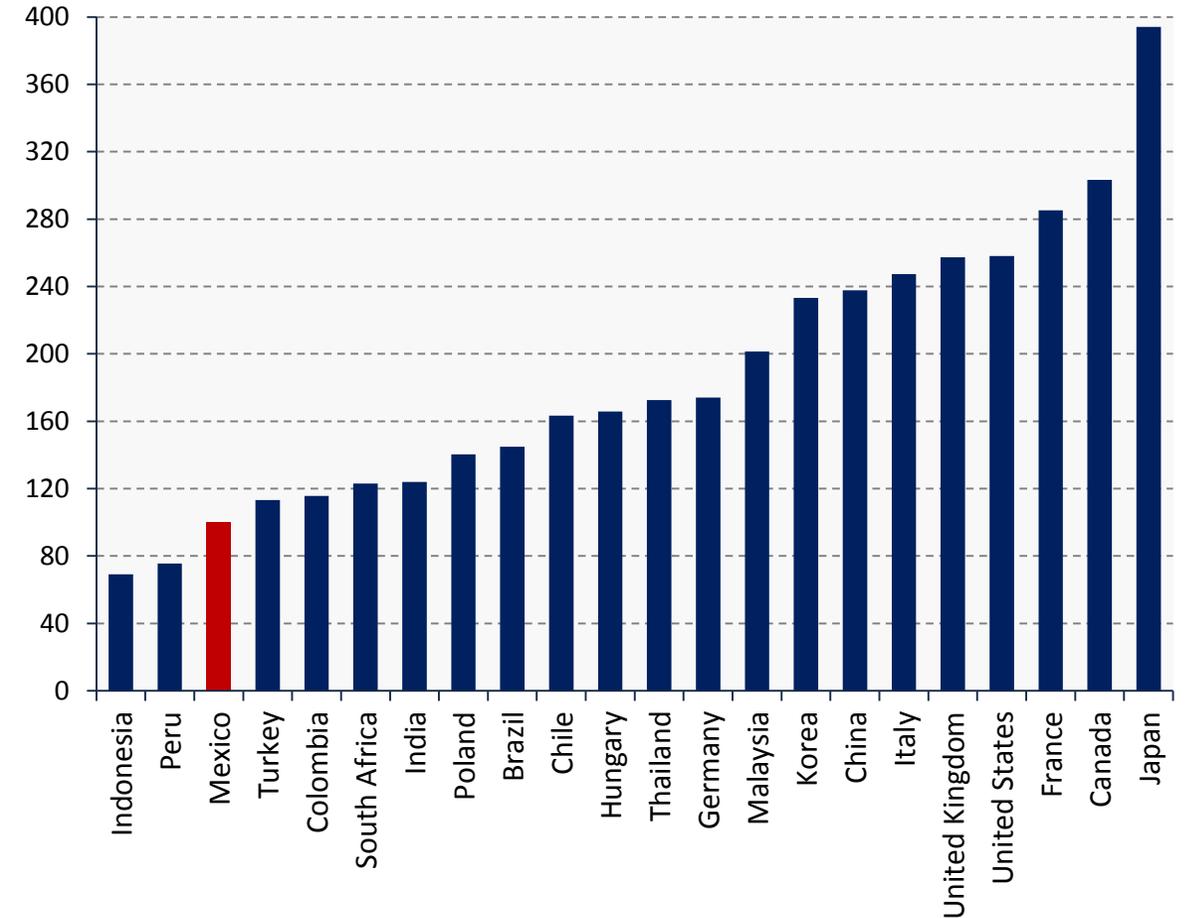
In fact, private and total indebtedness in Mexico compare well with other emerging and advanced economies.

Private Debt
% of GDP (2016)



Source: IMF.

Total Debt
% of GDP (2016)



Source: IMF.

- However, the magnitude of the challenges we face underscores the need of timely and adequate economic policy responses, as well as of strengthening the economy's fundamentals and the institutional framework.
- It is of the utmost importance to keep in mind that we may continue to face a situation of high uncertainty over a prolonged period.
- Even under a scenario in which some of the current risks dissipate, others, such as the tightening of external financial conditions, will in all likelihood be present for an extended time.
- In addition, an increase in the economy's growth potential is needed.

- ❑ It is also important to keep in mind that some, but not all, of the sources of uncertainty are outside the authorities' control.
- ❑ In particular, as soon as the electoral process is concluded, specific details will be required regarding the economic policy actions that the incoming administration intends to take, especially though not only, in the public finance front.
- ❑ In this process, it will be essential to keep in mind the risks derived from a very complex external environment and from the openness of the Mexican economy to foreign capital flows.



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