



# Mexico's Macroeconomic Outlook and Monetary Policy

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XP Securities

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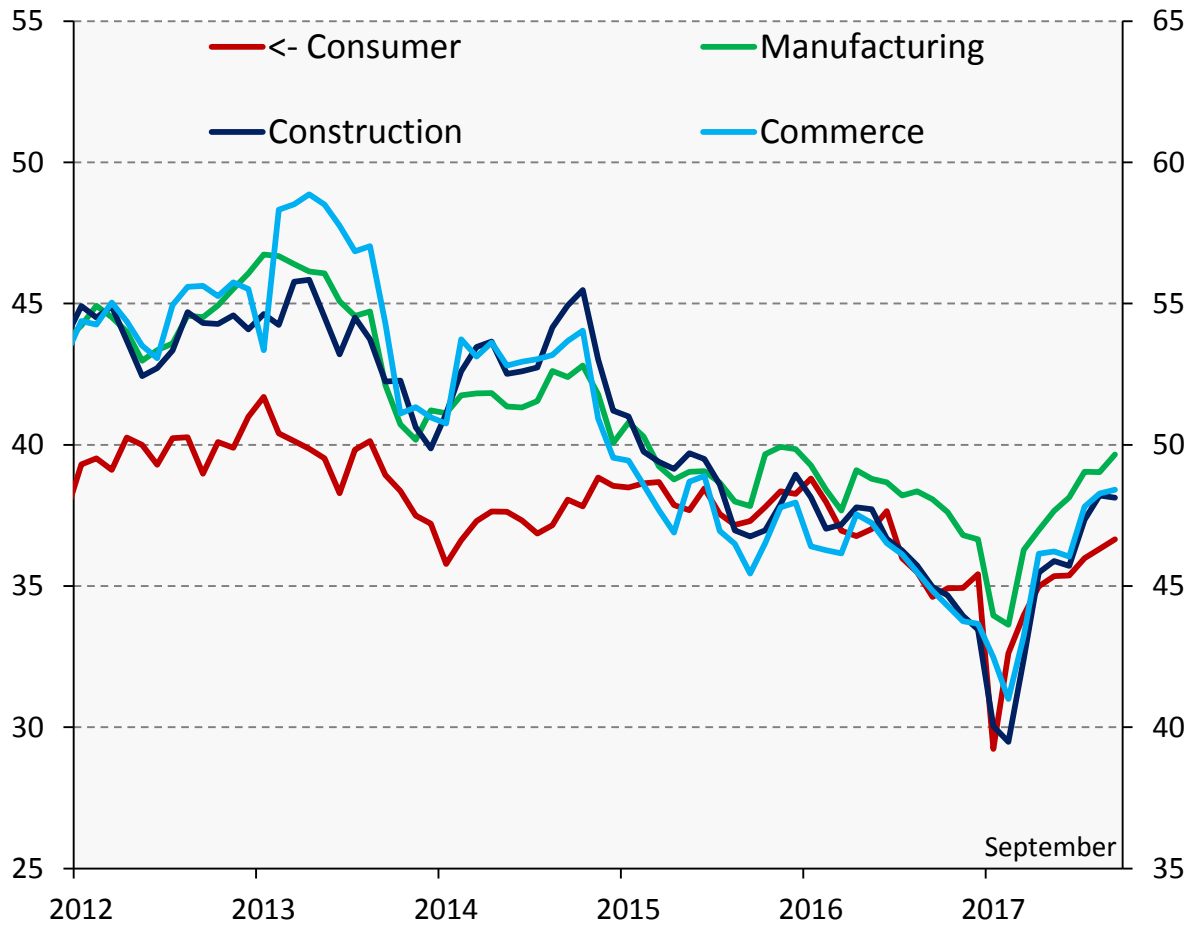
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- The global economic recovery seems set to continue on a firmer footing and on a broader base:
  - The US economy maintains a moderate rate of growth, while its perspective remains in general favorable as the recent climate-related disruptions are expected to have only transitory effects.
  - The higher-than-expected dynamism in other advanced economies (AEs), including the euro area, Japan and Canada, make for a more generalized upturn in the economies of this group.
  - Emerging market economies (EMEs) are projected to show stronger growth both in 2017 and 2018.
  - The relative stability in international financial markets has continued to support capital inflows and a favorable performance of asset prices in EMEs.
  - Continued upward trend in world trade volumes.
  - Sustained dynamism of global industrial production.

- However, the outlook continues to display important risks:
  - Uncertainty related to the future course of economic policy in the United States.
  - Possibility of surprises in the normalization of monetary policy in that country.
  - Persistent vulnerabilities in a number of large EMEs, including China.
  - Possible overvaluation of financial assets in several advanced and emerging market economies.
  - The potential implications of lingering anti-globalization sentiment
  - Heightened geopolitical tensions.

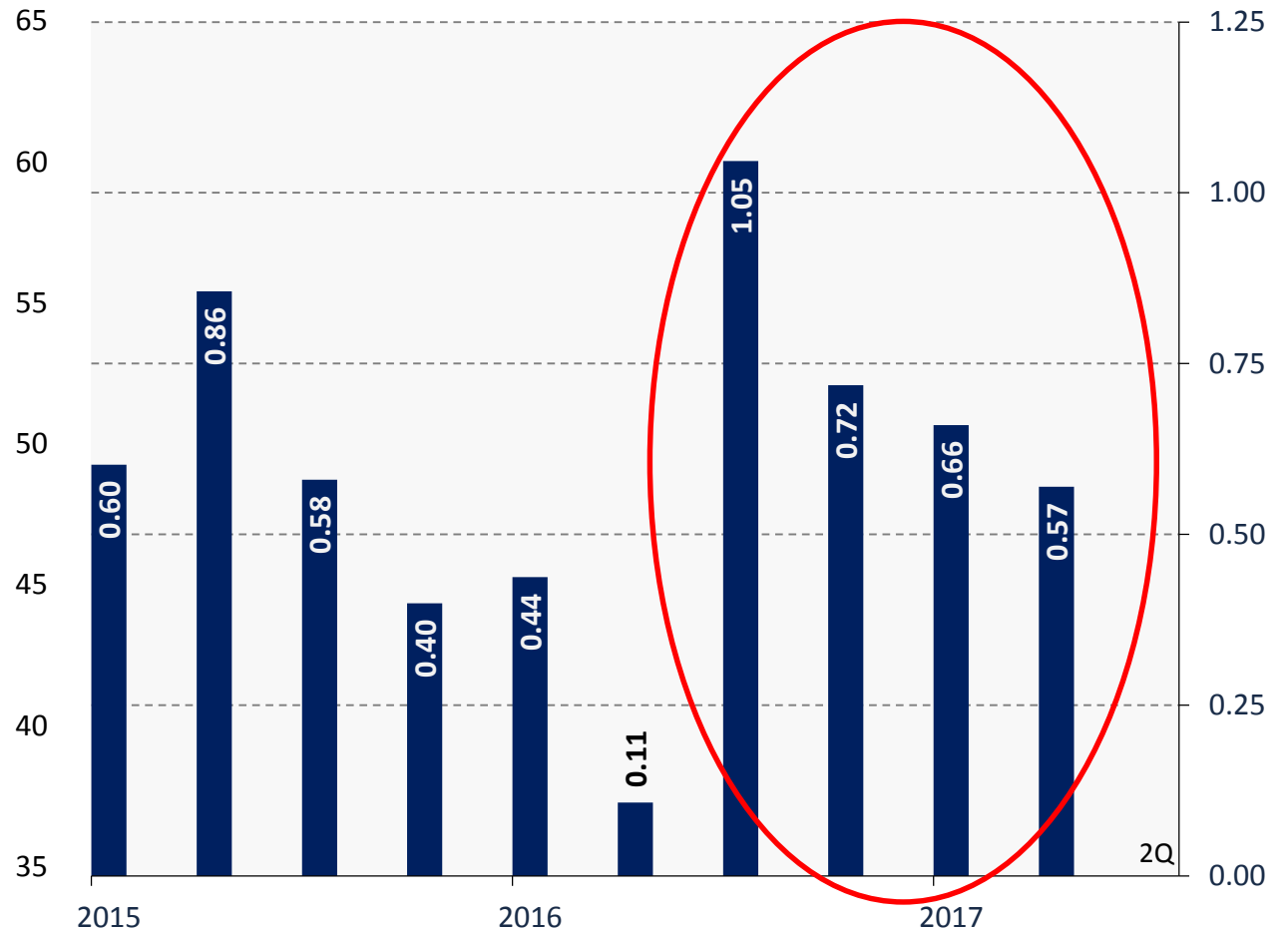
In this context, the Mexican economy has been affected by several external shocks, including the electoral process in the US. However, the adjustment has been gradual and during 2017 economic activity has performed better than expected.

**Business and Consumer Confidence**  
Level, s.a.



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

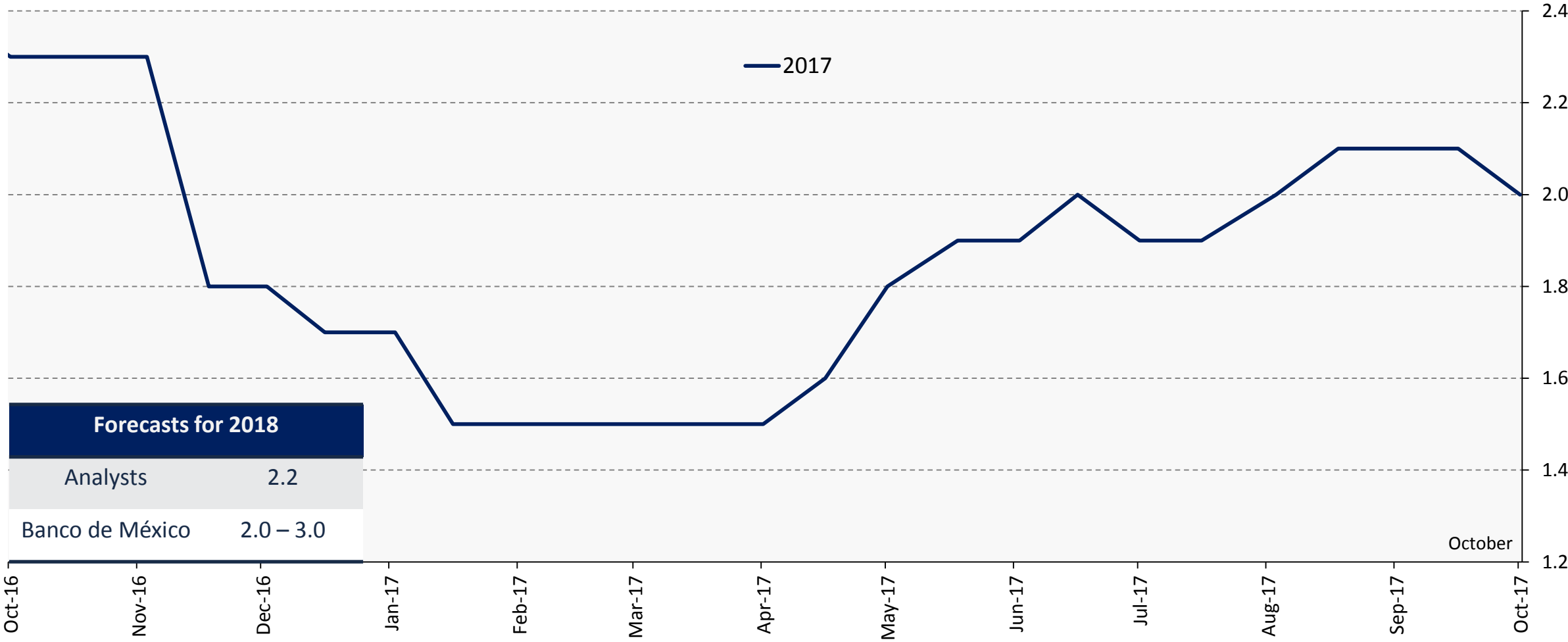
**Gross Domestic Product**  
Quarterly % Change, s.a.



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

Thus, in recent months GDP growth expectations for this year have been adjusted upwards.

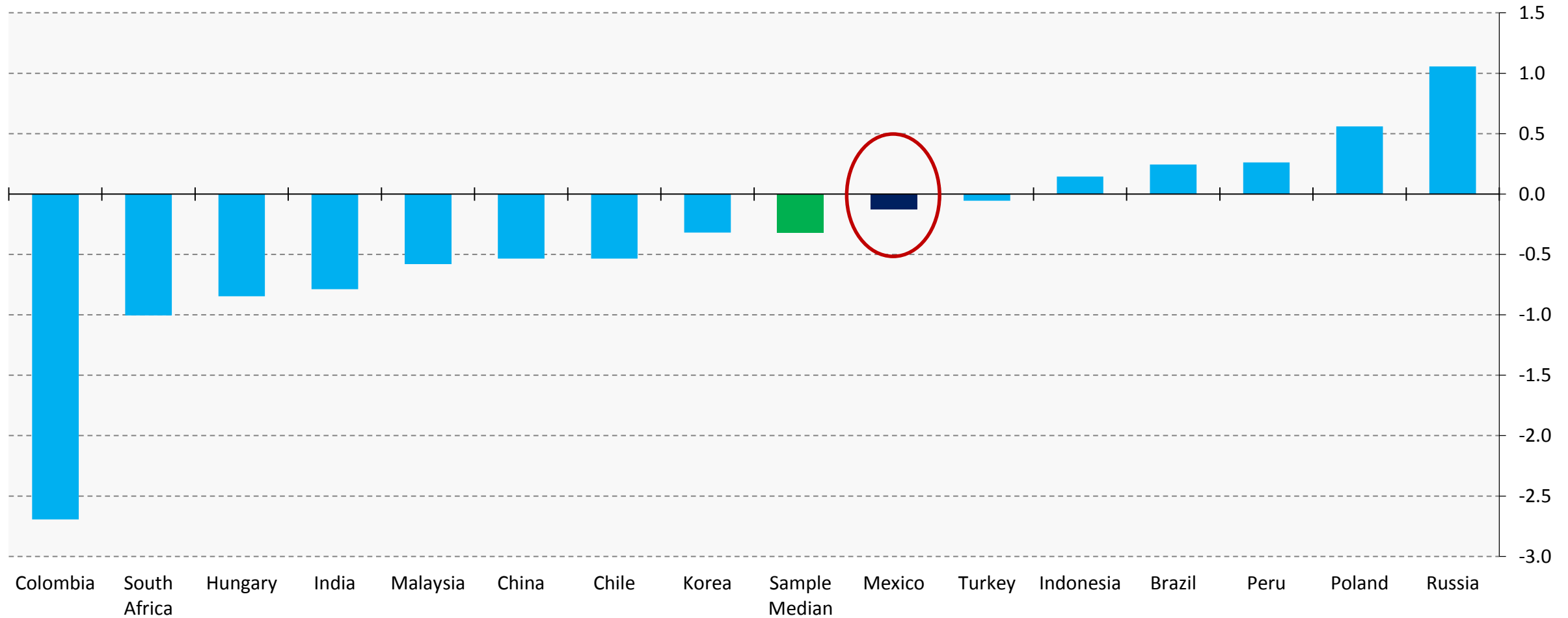
Real GDP Growth Expectations  
Annual %



Source: Banco de México and Citibanamex.

# In fact, economic activity in Mexico has decelerated only modestly during the last years.

Emerging Market Economies: Change in GDP Growth Rates between 2014 and 2017  
% Points



Source: IMF (World Economic Outlook, October 2017).

- ❑ The earthquakes and other natural disasters that have recently hit Mexico are expected to have a transitory effect on economic activity:
  - Generally, this type of phenomena have a negative short-term incidence in GDP growth, to subsequently begin a recovery process as the damage repair efforts are initiated.
  - Although it is still too early for an accurate assessment of their impact, GDP growth is likely to record a slight downward adjustment in the short term vis-à-vis previous projections, and to display afterwards a rebound of similar proportions.
  - As result, the economy's macroeconomic perspectives should not be significantly affected.

- The balance of risks for economic activity continues to be tilted downwards, mainly as a result of:
  - Renegotiation of NAFTA.
  - Presidential elections in 2018.
  - Potential for new episodes of turbulence in international financial markets.

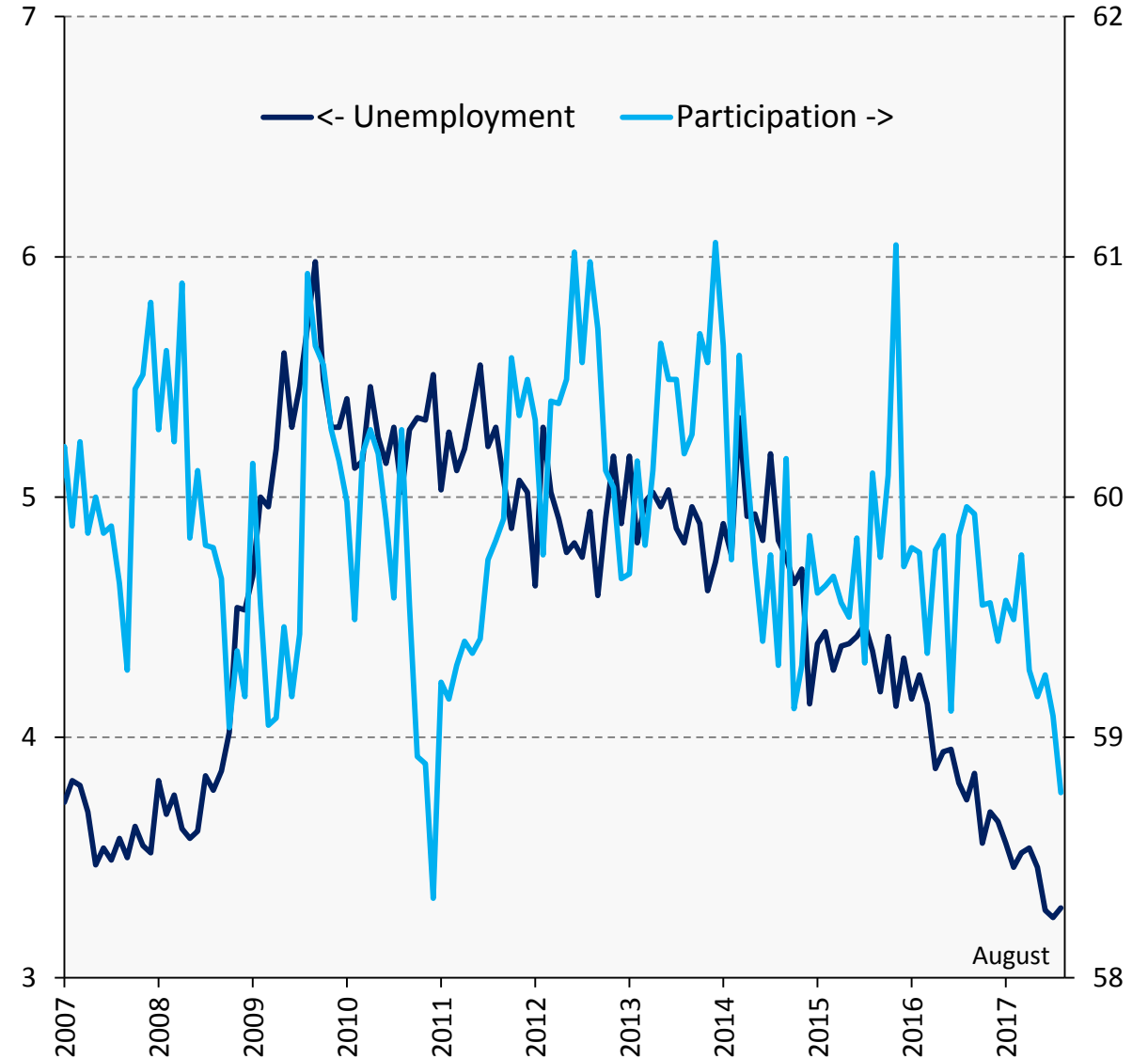


□ However, it will be important to continue monitoring the evolution of aggregate demand, in light of:

- The resilience the economy has displayed to a number of shocks;
- The possibility of a lower-than-expected effect of the above-mentioned events; and
- The marked decline in labor market slack, although in a context of a relatively low participation rate.

## Unemployment and Participation Rates

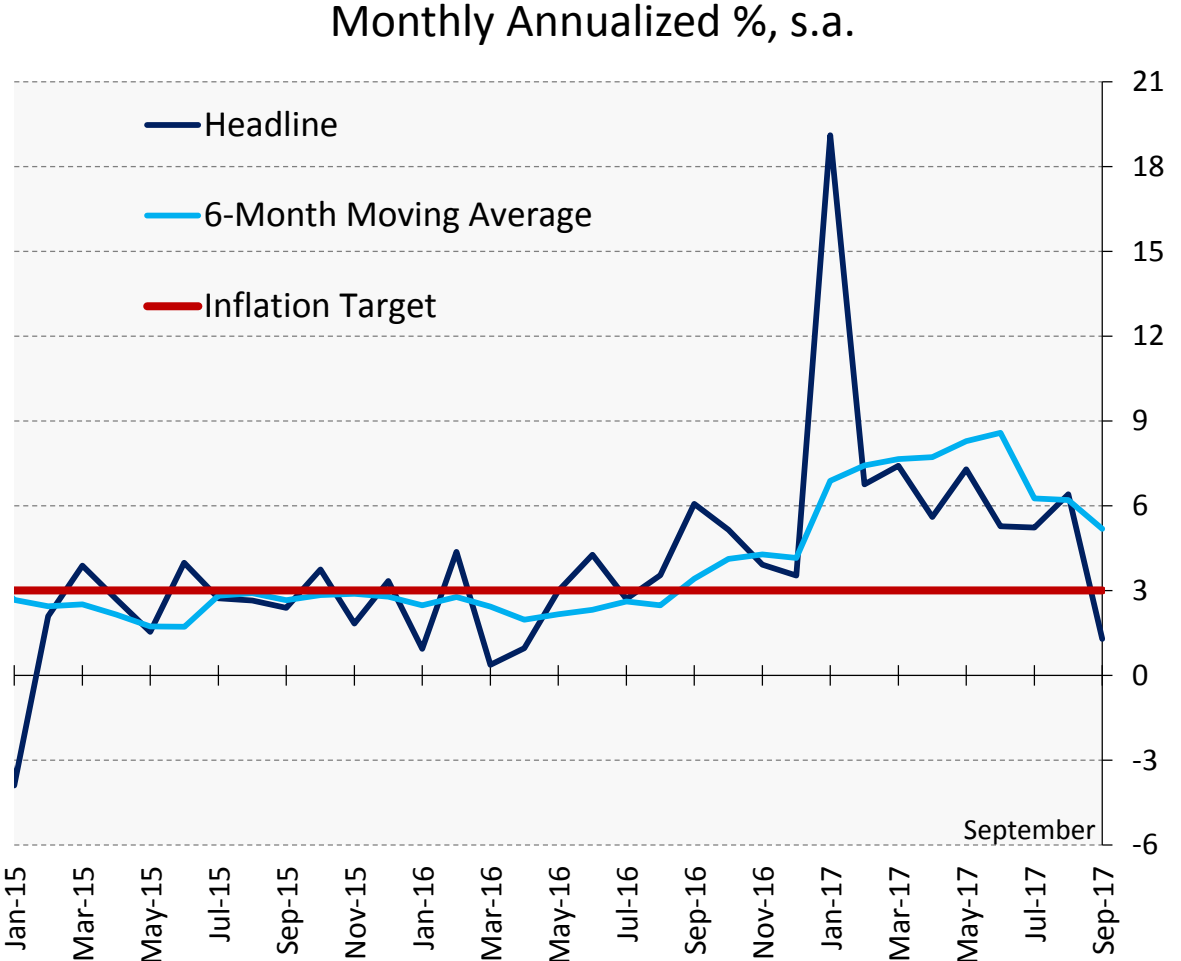
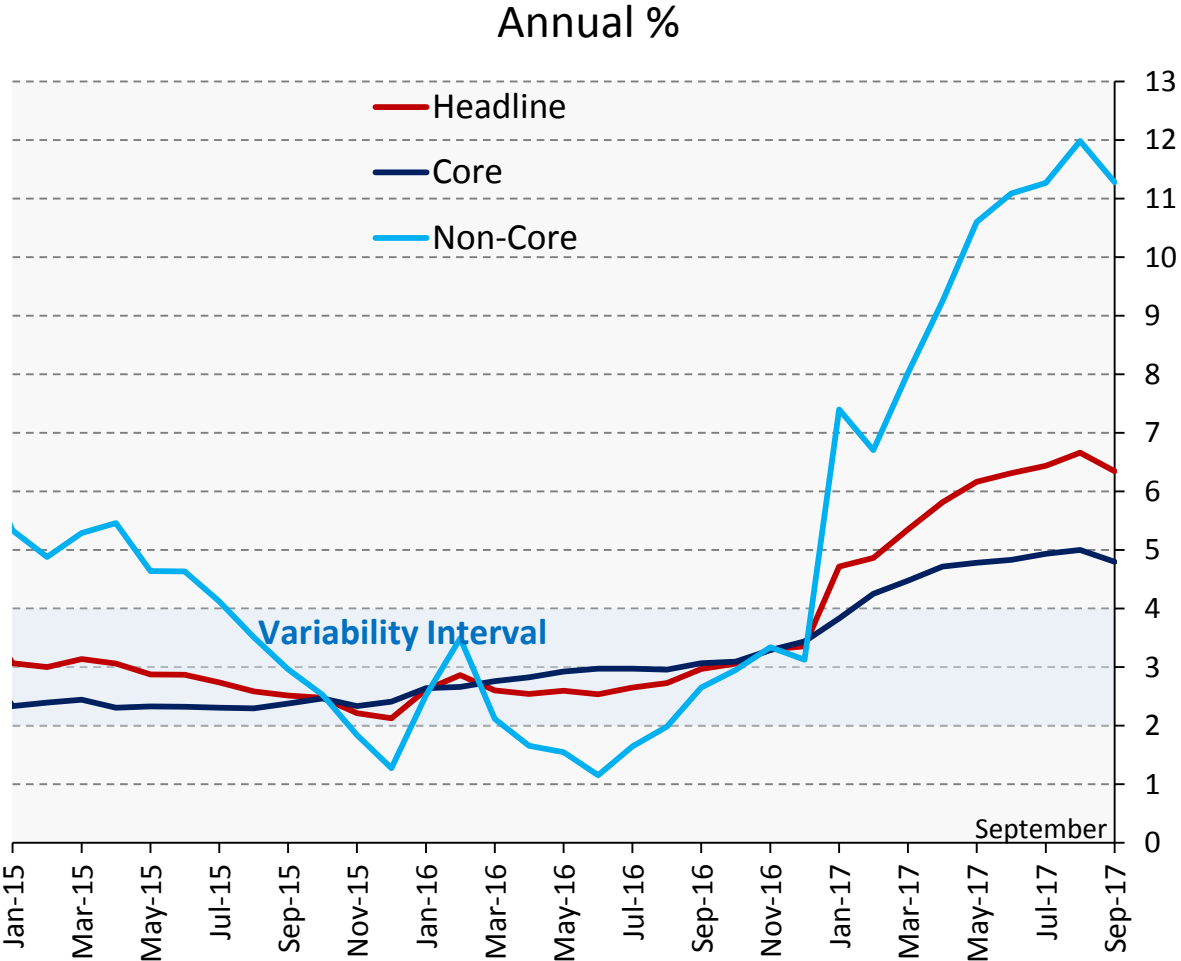
%, s.a.



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

Inflation in Mexico has continued to be affected by both the cumulative depreciation of the peso since late 2014, as well as by the supply shocks that have taken place throughout 2017. However, a downward trend seems to be already under way.

CPI Inflation

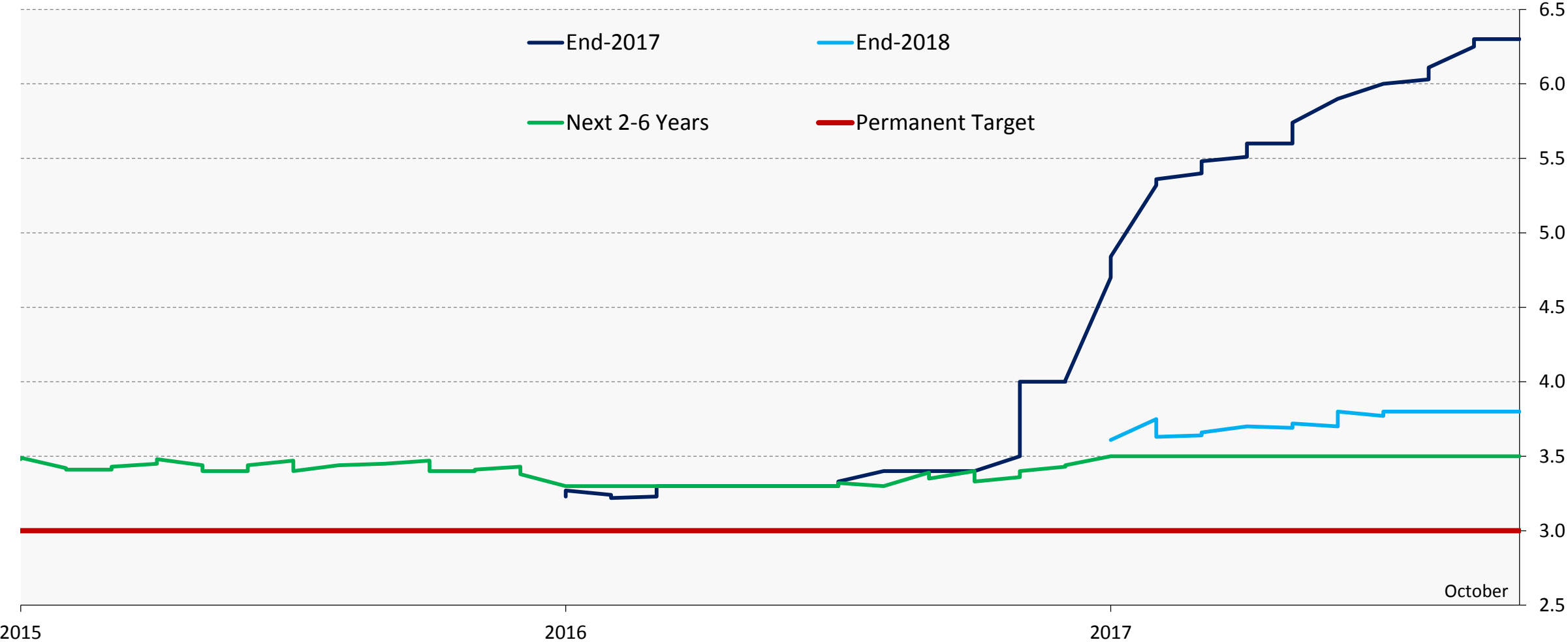


s.a. / Seasonally adjusted series.  
Source: INEGI and Banco de México.

- The recent earthquakes and other natural disasters in Mexico are not expected to significantly affect a baseline scenario in which:
  - Inflation begins to trend downwards after having peaked in August at 6.66 percent.
  - The downward trend accelerates starting next year, as result of:
    - The monetary policy actions that have been implemented.
    - The appreciation of the exchange rate.
    - Base effects.

Short- and long-term inflation expectations are consistent with this scenario. However, they remain above the 3 percent target.

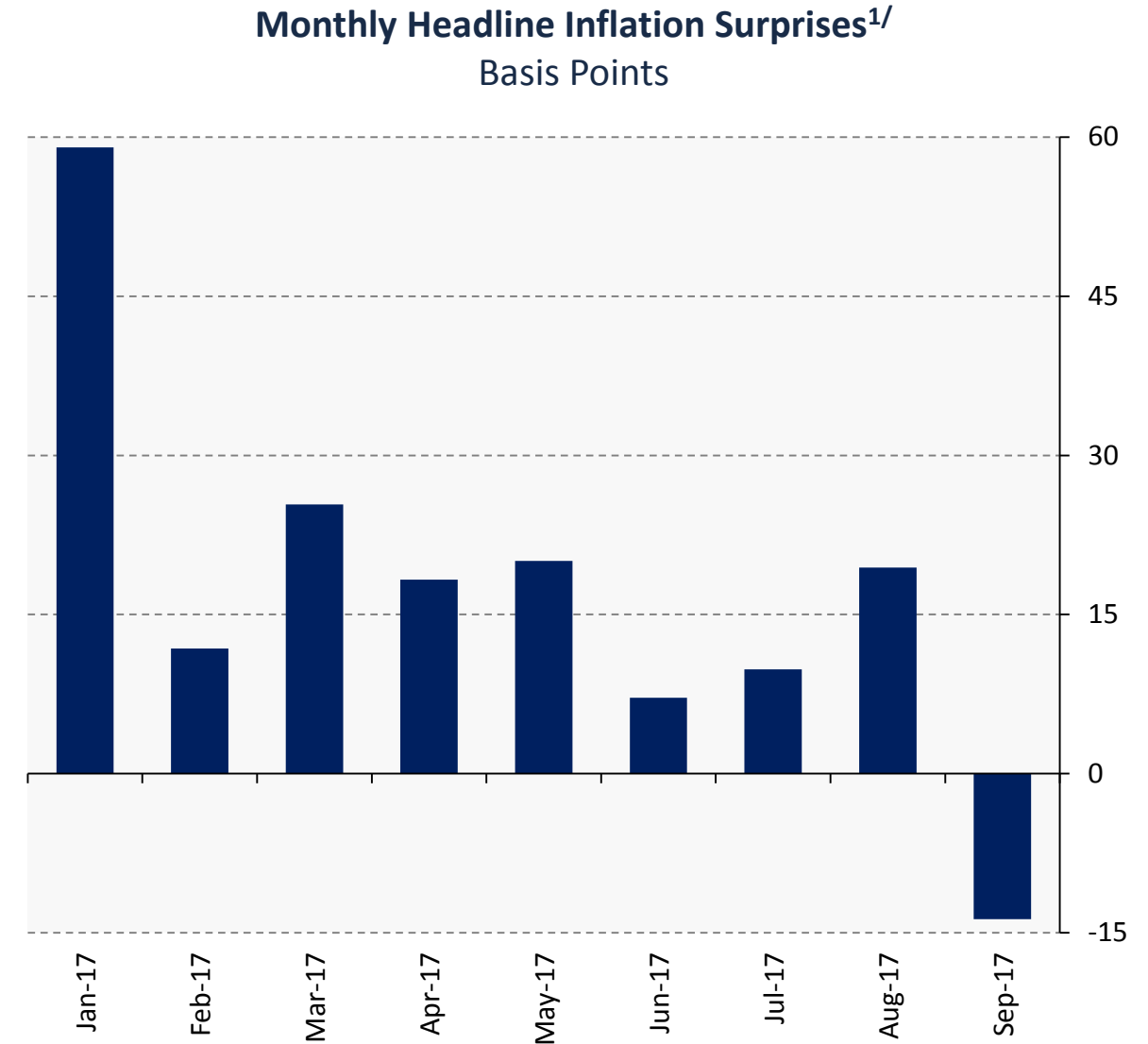
Short- and Long-Term Inflation Expectations  
Annual %



Source: Citibanamex.

□ Also:

- Prior to September, actual inflation had systematically surprised to the upside throughout 2017.
- Expectations for core inflation as of end-2018 also remain above the 3 percent permanent target.



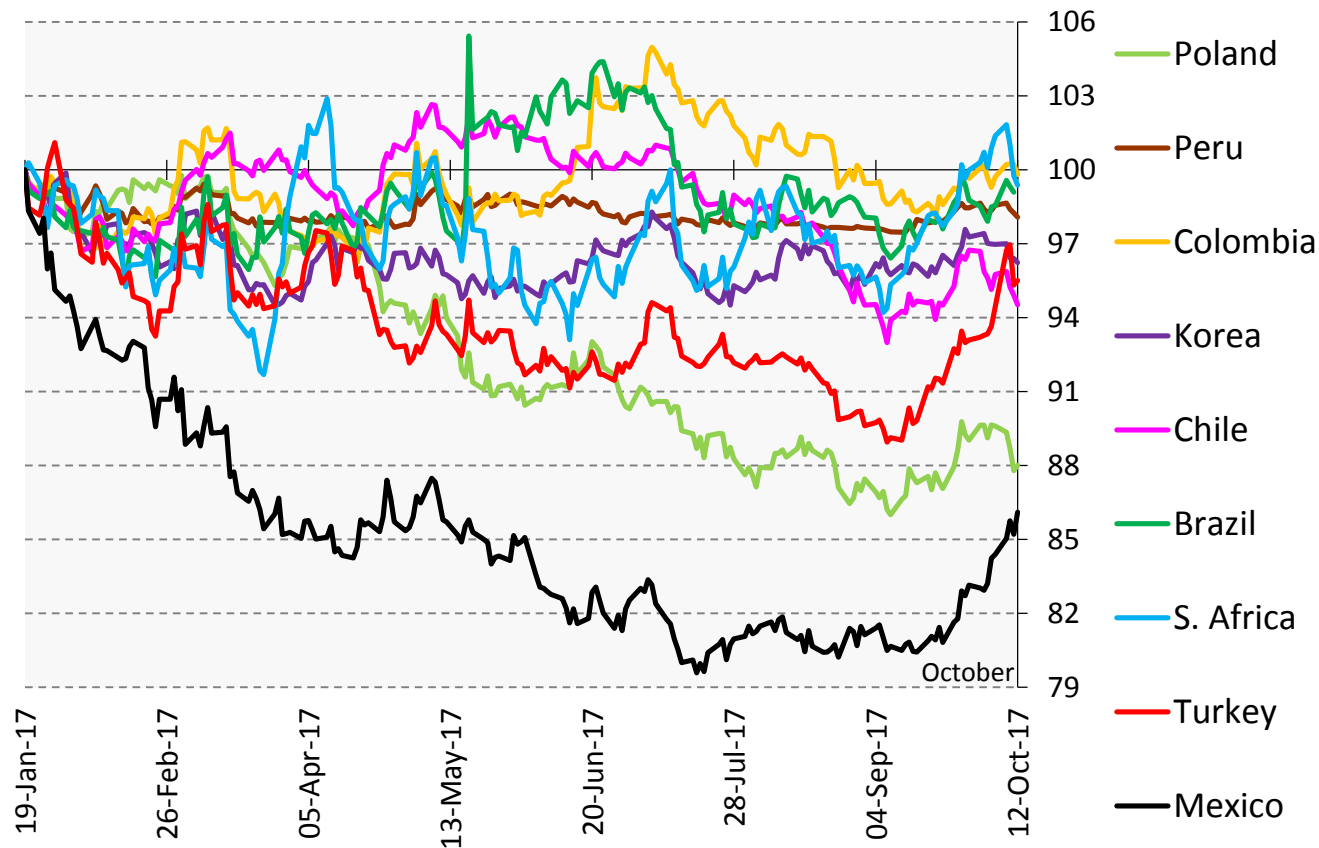
1/ Difference between actual monthly headline inflation and the corresponding 1-month ahead expectations.  
Source: INEGI and Citibanamex.

- The balance of risks for inflation continues to be skewed to the upside:
  - Although, thus far, the shocks that have affected inflation throughout 2017 have not given rise to second-order effects on prices, the possibility of this occurring has not fully dissipated.
  - Potential of new bouts of volatility in the foreign exchange market, arising from:
    - Monetary policy normalization in the US;
    - NAFTA renegotiation; and
    - Mexico's elections in 2018.
  - Minimum wage adjustments inconsistent with the evolution of productivity.
  - Sharp fluctuations in the prices of non-core items.

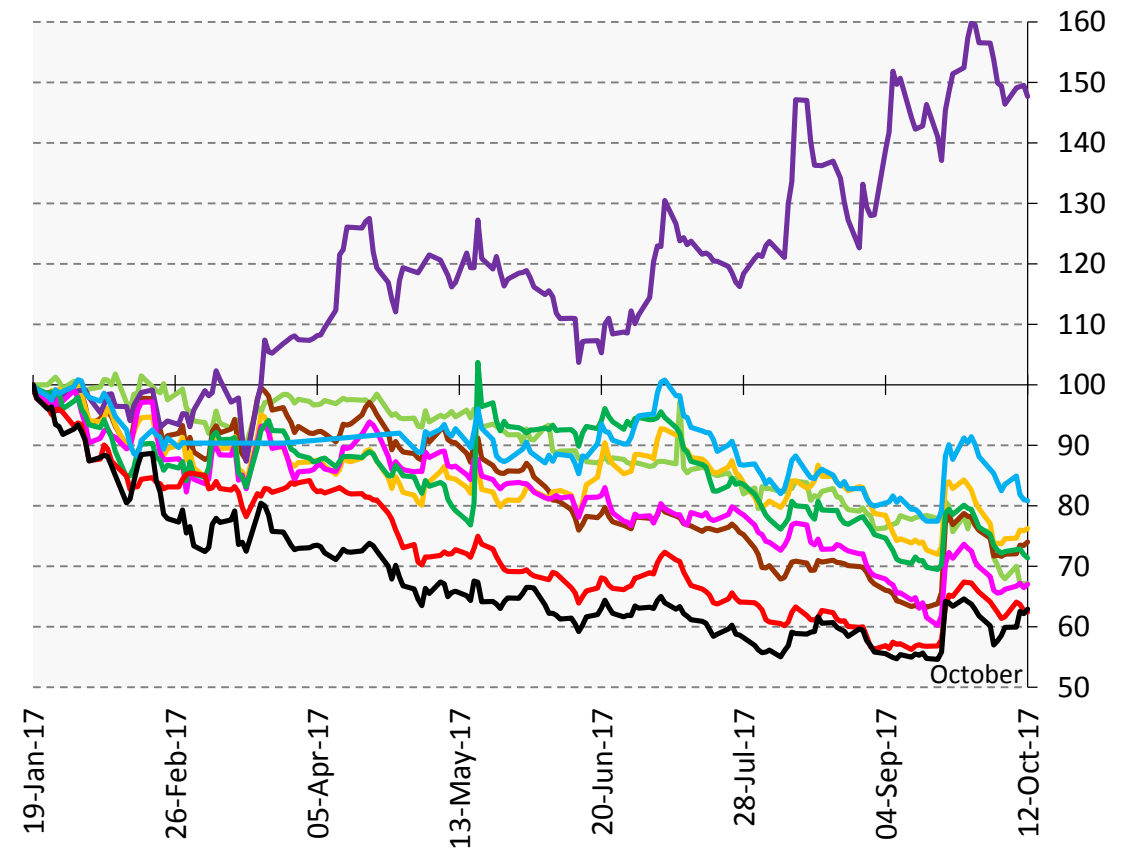
The peso has appreciated significantly during 2017. Although this is in part explained by external factors, the increased strength of the country's macroeconomic fundamentals resulting from monetary policy management and improved public finances, is also noteworthy.

Emerging Market Economies: Exchange Rates and Sovereign Default Risk  
 Index 19-Jan-2017 = 100

Exchange Rates with Respect to the USD



Credit Default Swaps

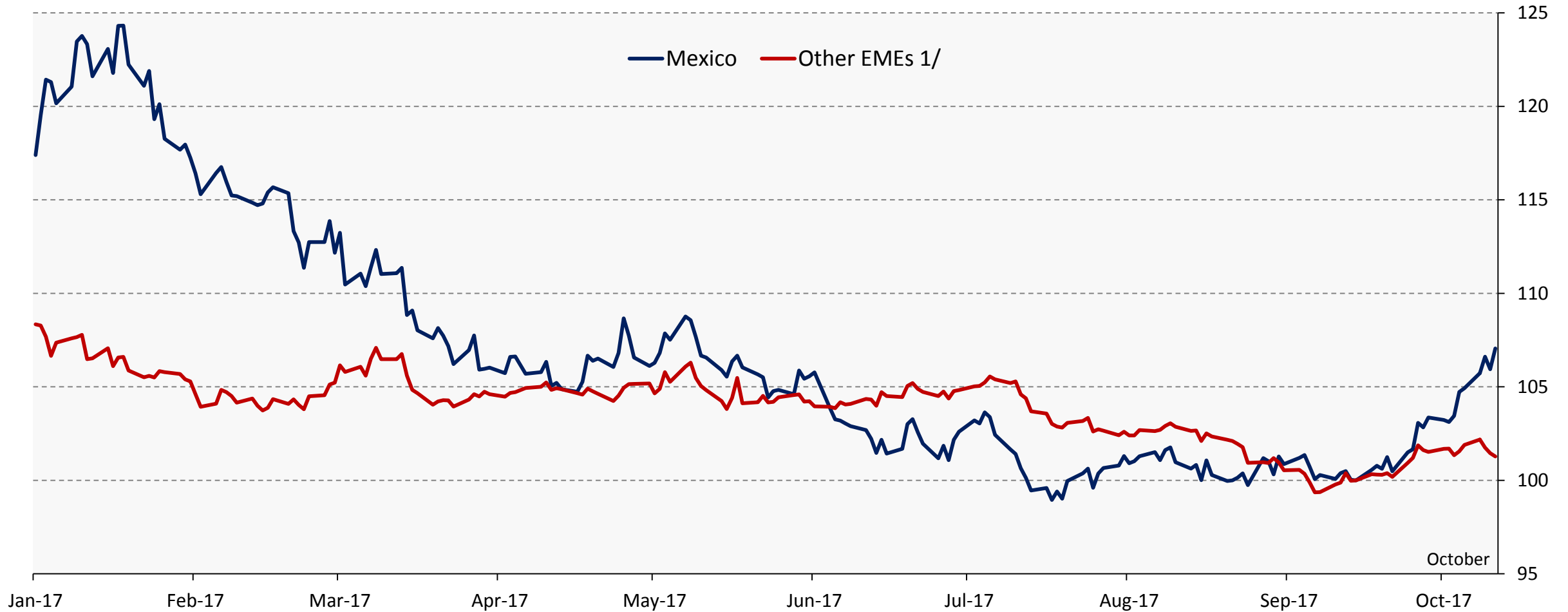


Source: Bloomberg.

More recently, mainly as a result of external factors, the peso has depreciated against the US dollar and other currencies.

### Emerging Market Economies: Exchange Rates with Respect to the USD

Index 15-Sep-2017 = 100



1/ Median for Brazil, Chile, Colombia, Korea, Peru, Poland, South Africa and Turkey.  
Source: Bloomberg.



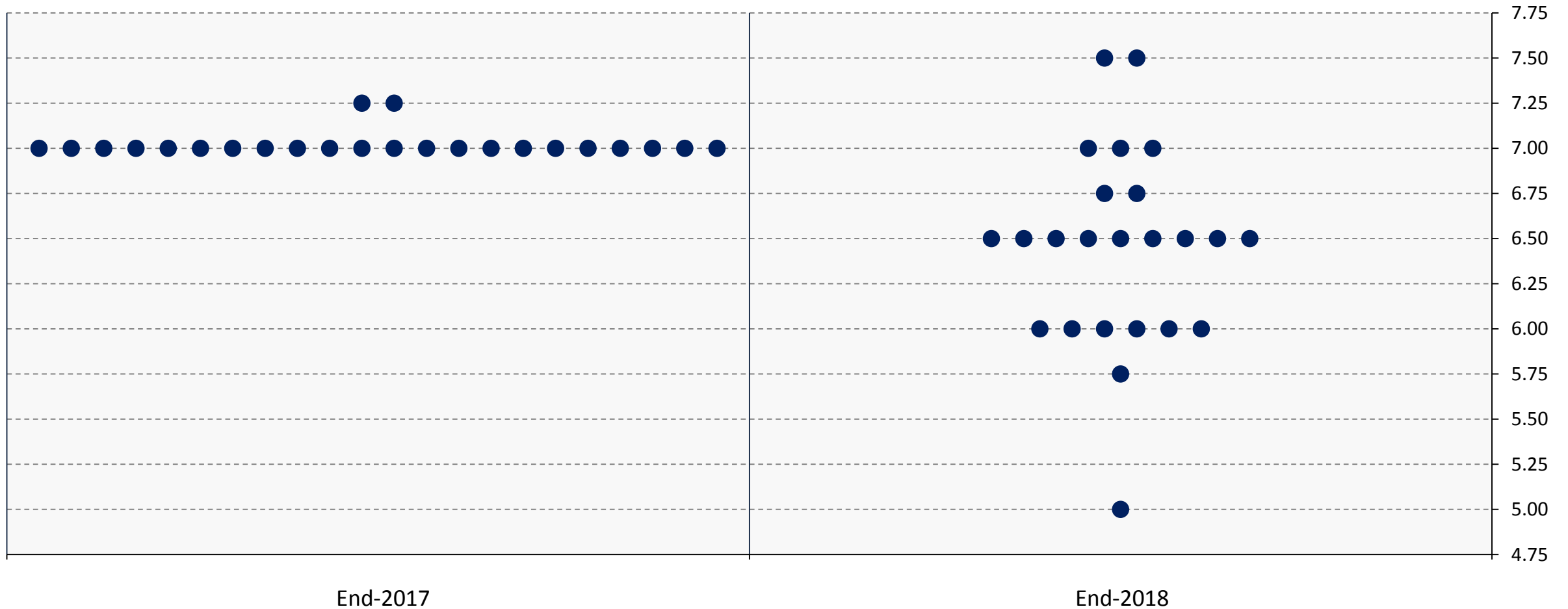
- Monetary policy in Mexico faces and economic outlook which is difficult to assess accurately.
  - Under a baseline scenario in which:
    - Demand pressures on prices remain subdued;
    - The exchange rate behaves in an orderly manner; and
    - There are no shocks that significantly affect the evolution of prices.
  - Inflation is expected to converge to the 3 percent target towards end-2018.
  - However, the risk that one or several of the above assumptions will not materialize is significant.

- Alternative scenarios are also subject to a high level of uncertainty.
  - In particular, the exchange rate has the potential to move in either direction as a result of outcomes regarding:
    - The normalization of monetary policy in the United States;
    - The renegotiation of NAFTA; and
    - Mexico's elections in 2018.
  - Even though this may give rise to opposing risks for inflation, the possibility of adverse shocks arising from any, and even all, of these events, cannot be discarded.
  - This entails scenarios of potentially elevated costs.

# Uncertainty is reflected in the wide dispersion of analysts' expectations on the evolution of the reference rate in 2018.

Mexico: Analysts' Expectations for the Monetary Policy Rate<sup>1/</sup>

%



<sup>1/</sup> As of 5 October 2017.  
Source: Citibanamex.

- Faced with these circumstances, monetary policy must proceed with caution.
- This implies not overlooking any possible scenario and, therefore, acknowledging that increases in the policy rate cannot be ruled out.
- More generally, the monetary authority must be ready to implement any actions needed to ensure the convergence of inflation to the target, at the lowest possible cost for economic activity.

- ❑ To sum up, Mexico's macroeconomic situation is characterized at present by:
  - A gradual deceleration of economic activity combined with a substantial decline in slack in the labor market.
  - A high rate of inflation, with indications that a downward trend has already begun but with upside risks.
  - A situation of higher than usual uncertainty.
- ❑ Given the risks involved, an emphasis on prudence in the implementation of monetary policy is warranted. Naturally, this also applies for fiscal policy.
- ❑ In addition, the efforts to enhance the growth potential must continue and even deepen in a number of areas.



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