

The Future of Mexican Monetary Policy

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BANCO DE MÉXICO

*/ The views expressed herein are strictly personal.

- ❑ Monetary policy in Mexico has been implemented in recent months under a difficult macroeconomic environment: potential or actual inflationary pressures and a deceleration of economic activity.
- ❑ In accordance with its mandate, the Banco de México has focused on achieving a low and stable inflation rate, at the lowest possible cost in terms of economic activity.
- ❑ In this context, the reference rate has been increased on seven occasions since December 2015, to a level of 6.25 percent.

The Mexican economy continues to face a difficult external environment, although with some mixed features:

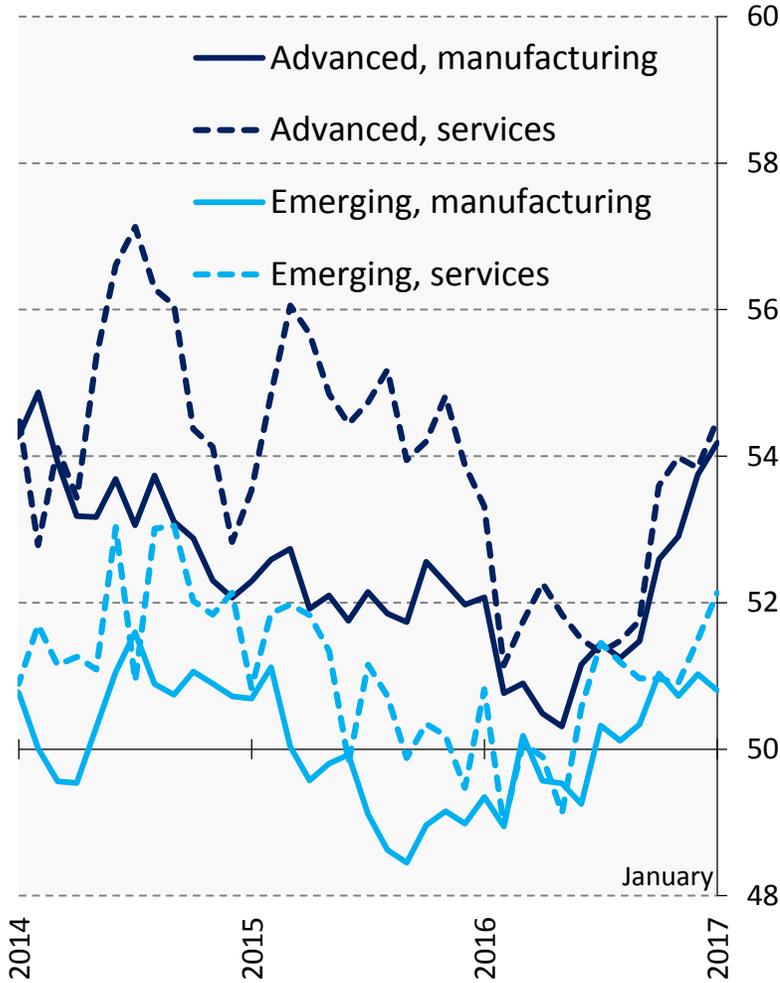
- ❑ GDP growth in the United States proceeds at a moderate pace, and some indicators point to an upturn of world economic activity and trade.
- ❑ At the same time, energy and other commodity prices have shown a moderate recovery.

However, the world economy faces numerous uncertainties as a result among other factors of:

- ❑ The economic policy to be implemented by the new administration in the US and its repercussions on that country and the rest of the world.
- ❑ The normalization of monetary policy in the US.
- ❑ UK exit from the European Union.
- ❑ Electoral processes in Europe.
- ❑ Economic vulnerabilities in China and other emerging market economies.
- ❑ The possibility of geopolitical problems in several countries or regions.

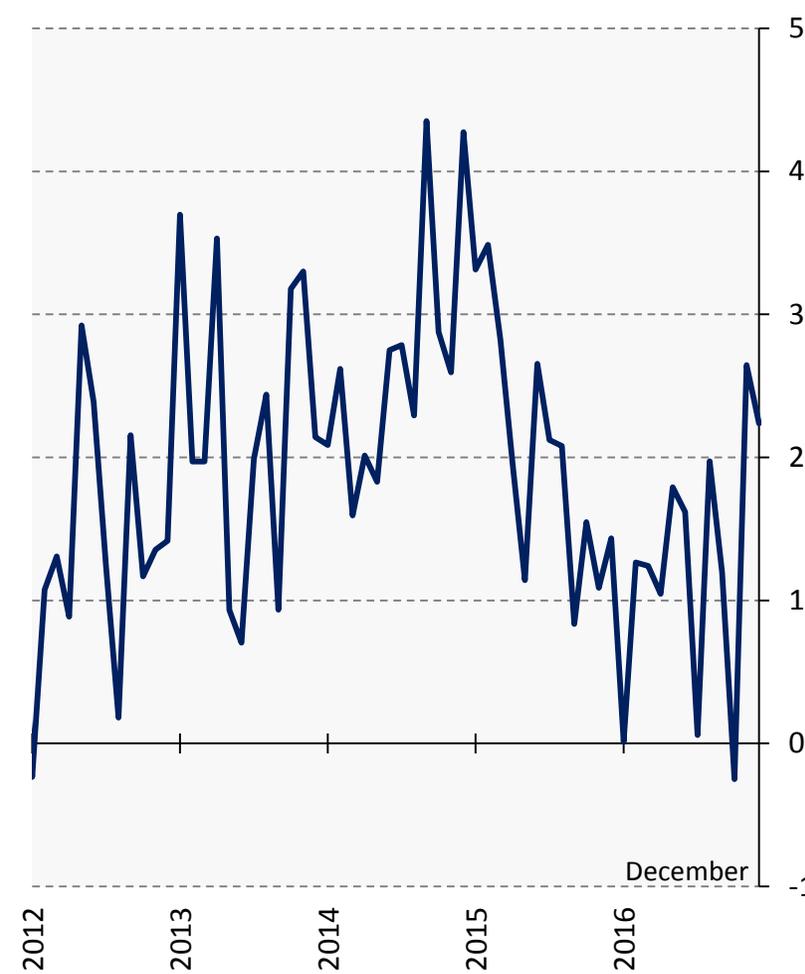
World economic activity and trade seem to be strengthening, while commodity prices are increasing.

Global Purchasing Managers' Index
Diffusion Index, s.a.



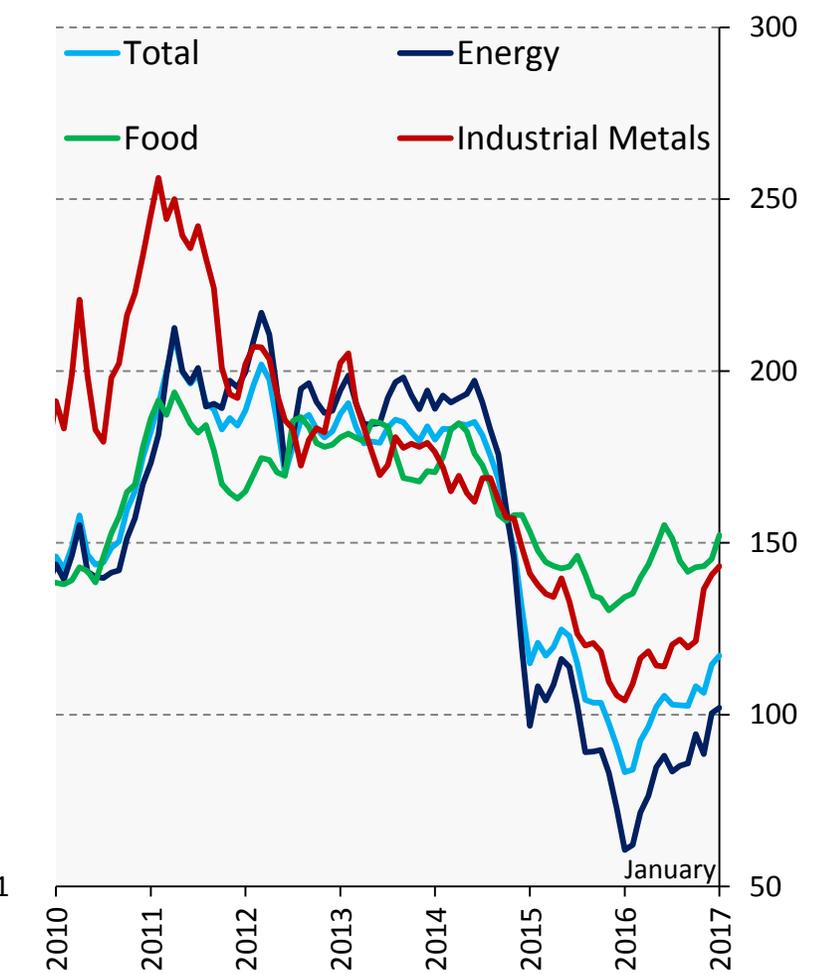
s.a. / Seasonally adjusted data.
Source: Markit.

World Trade Volume of Goods
Annual % Change, s.a.



s.a. / Seasonally adjusted data.
Source: CPB Netherlands.

Commodity Prices
Index 2005 = 100



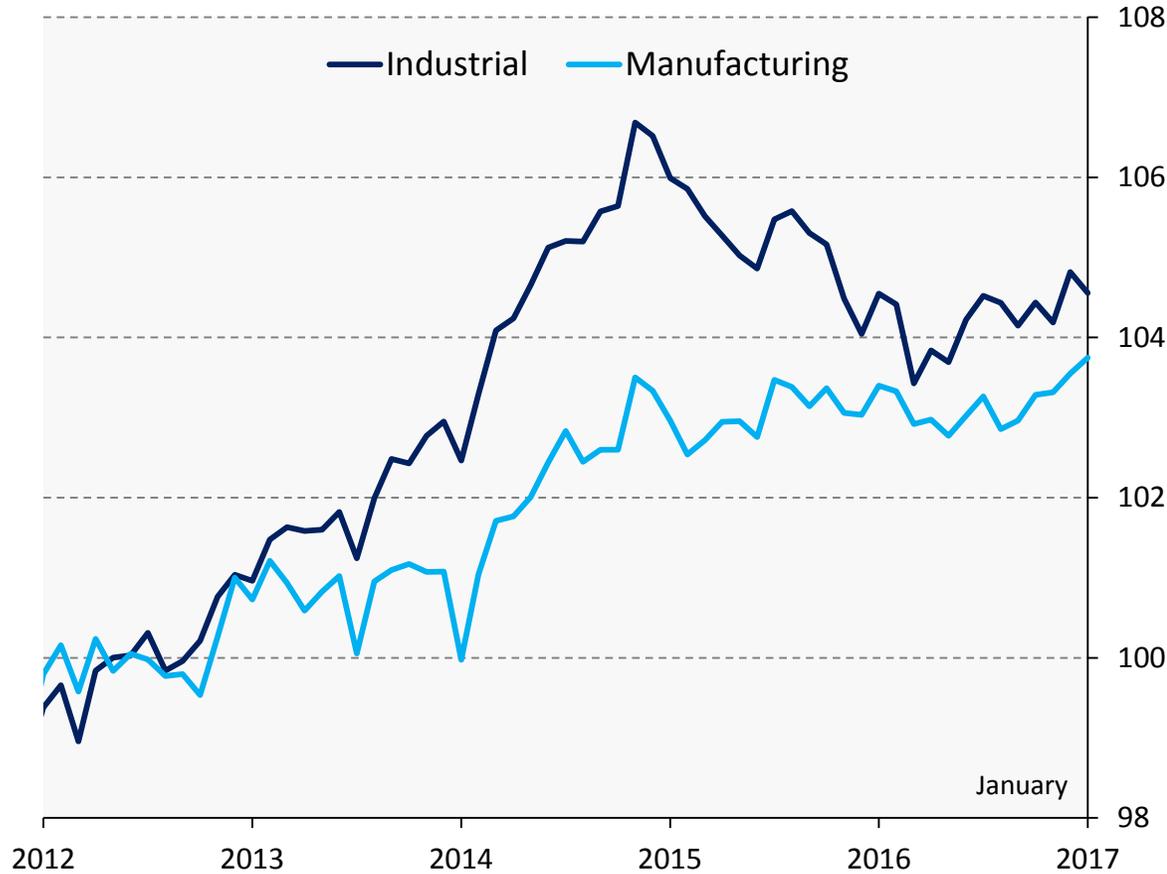
Source: IMF.

In the US, industrial output and foreign trade remain weak, but some upturn is observed...

United States

Industrial and Manufacturing Output

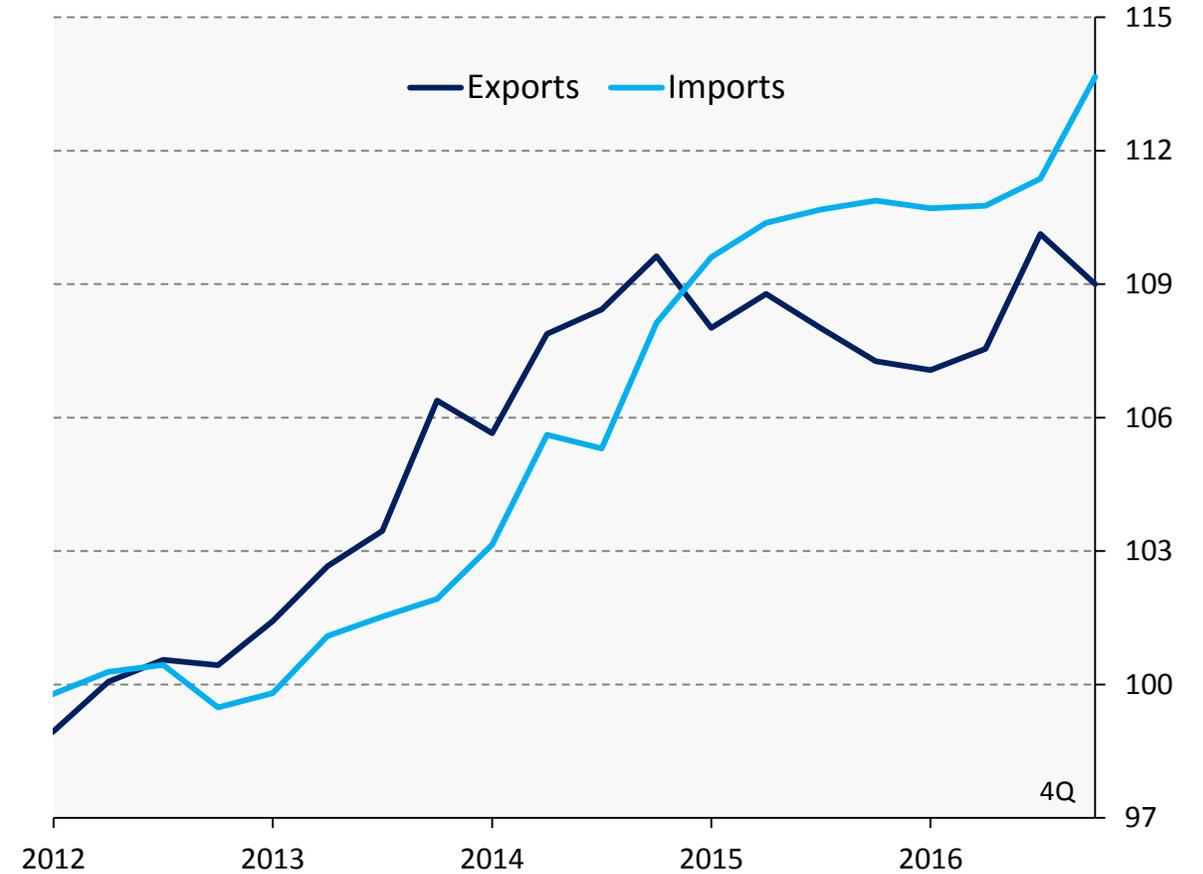
Index 2012 = 100, s.a.



s.a. / Seasonally adjusted data.
Source: Federal Reserve.

Real Exports and Imports of Goods and Services

Index 2012 = 100, s.a.

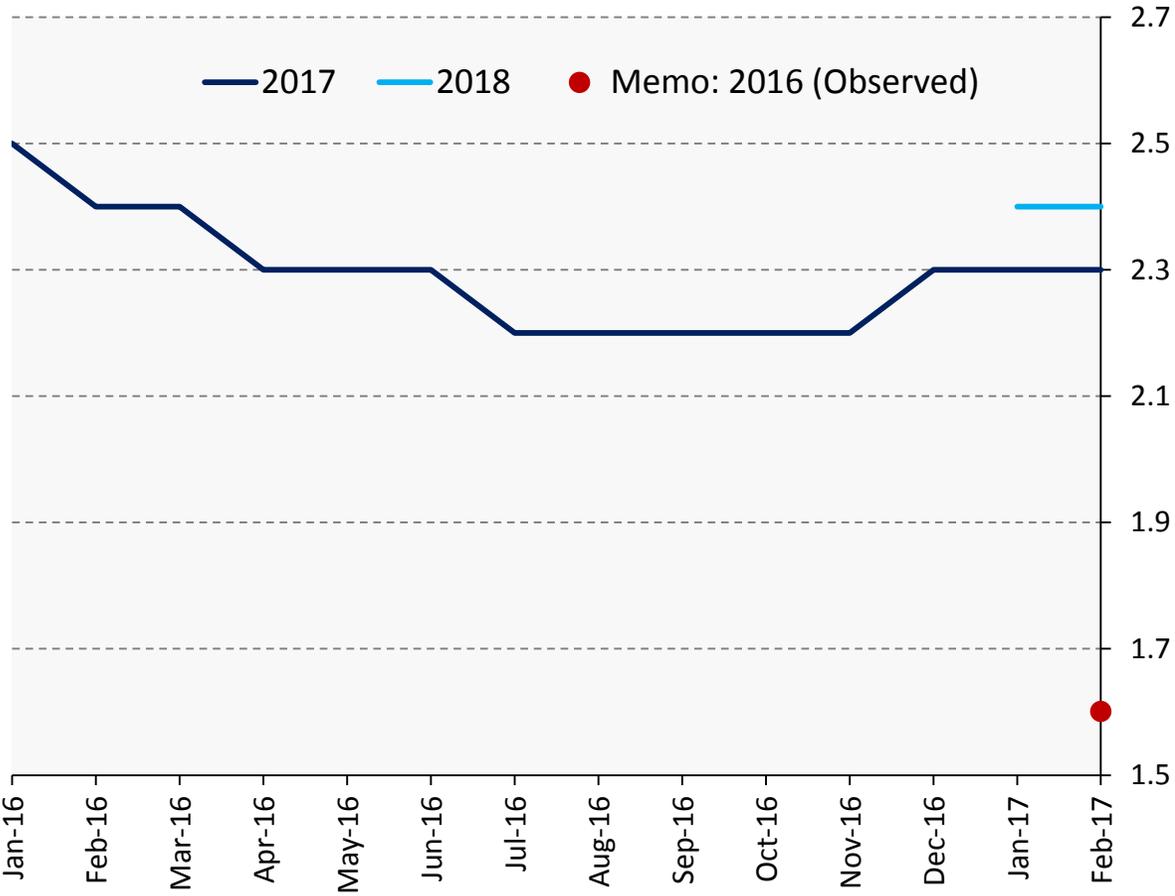


s.a. / Seasonally adjusted data.
Source: Bureau of Economic Analysis.

... and both GDP growth and industrial production are expected to recover in the next two years.

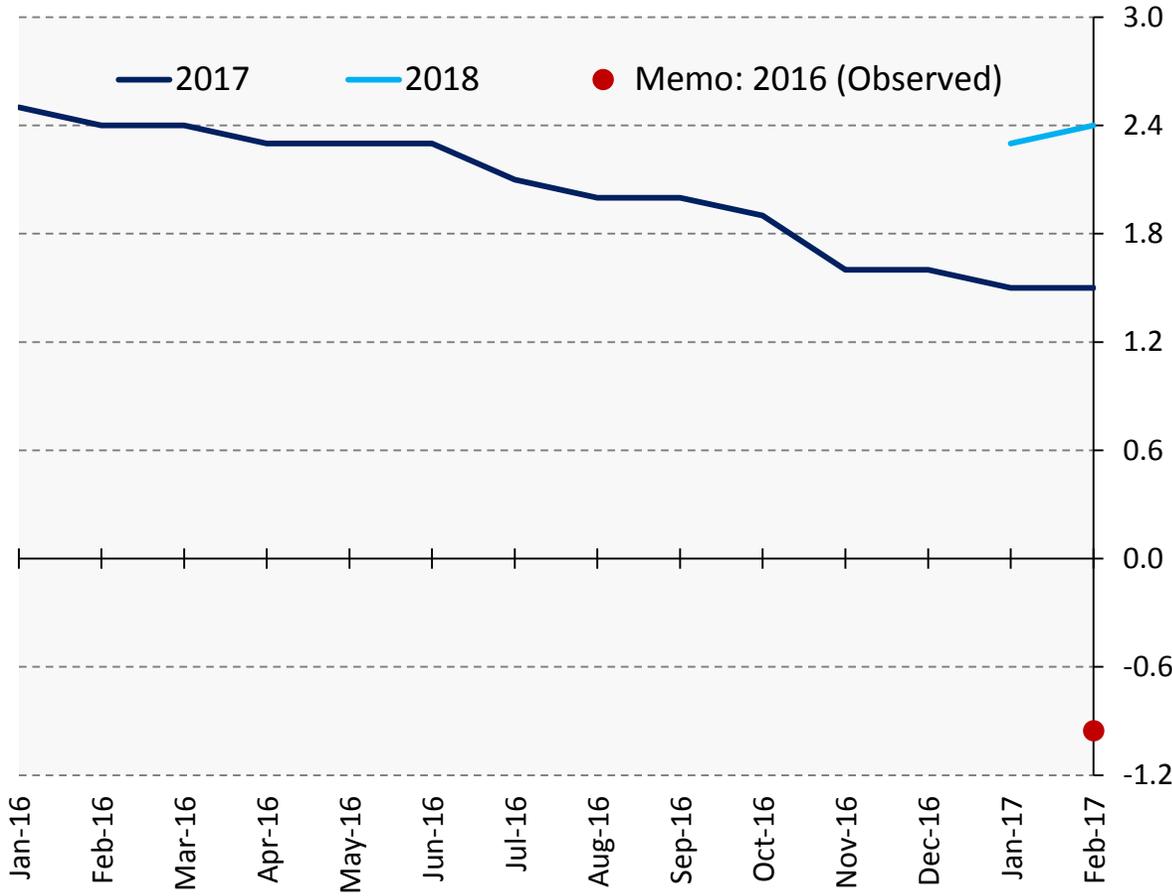
United States: Expected Real GDP and Industrial Production
Annual % Change

Real GDP



Source: BEA and Blue Chip Economic Indicators.

Industrial Production

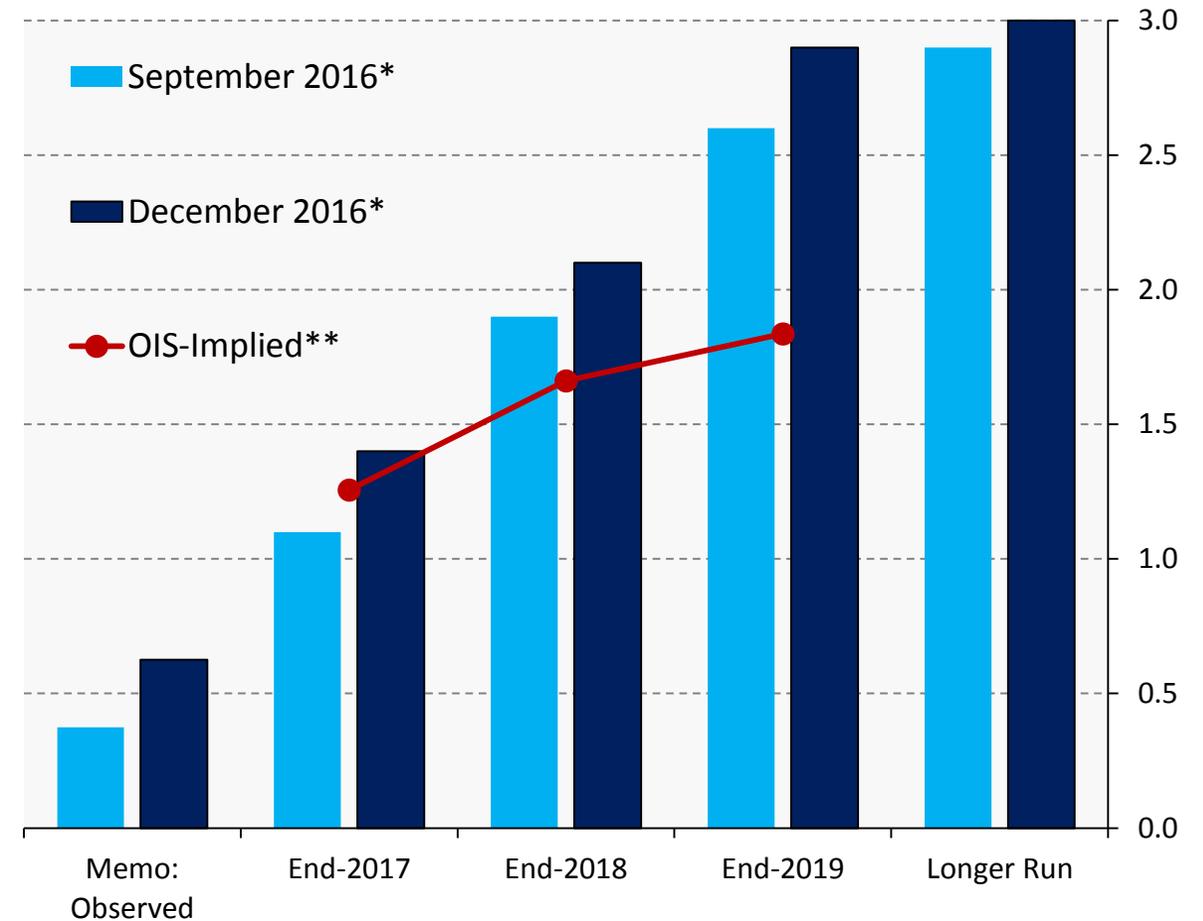


Source: Federal Reserve and Blue Chip Economic Indicators.

However, the main external risks for the Mexican economy originate from potential developments in the US.

- ❑ Fiscal reform.
- ❑ Barriers to foreign trade.
- ❑ NAFTA negotiations.
- ❑ Actions focused on foreign workers' remittances .
- ❑ Immigration policy.

United States: Expected Trajectory for the Federal Funds Rate
%



*/ Median expectation of FOMC participants for the midpoint of the appropriate target range for the FFR.

**/ OIS (Overnight Index Swap) curve as of 1 March 2017.

Source: Federal Reserve and Banco de México with information from Bloomberg.

- ❑ The Mexican economy recorded during 2016 a moderate rate of growth, slower than in 2015.

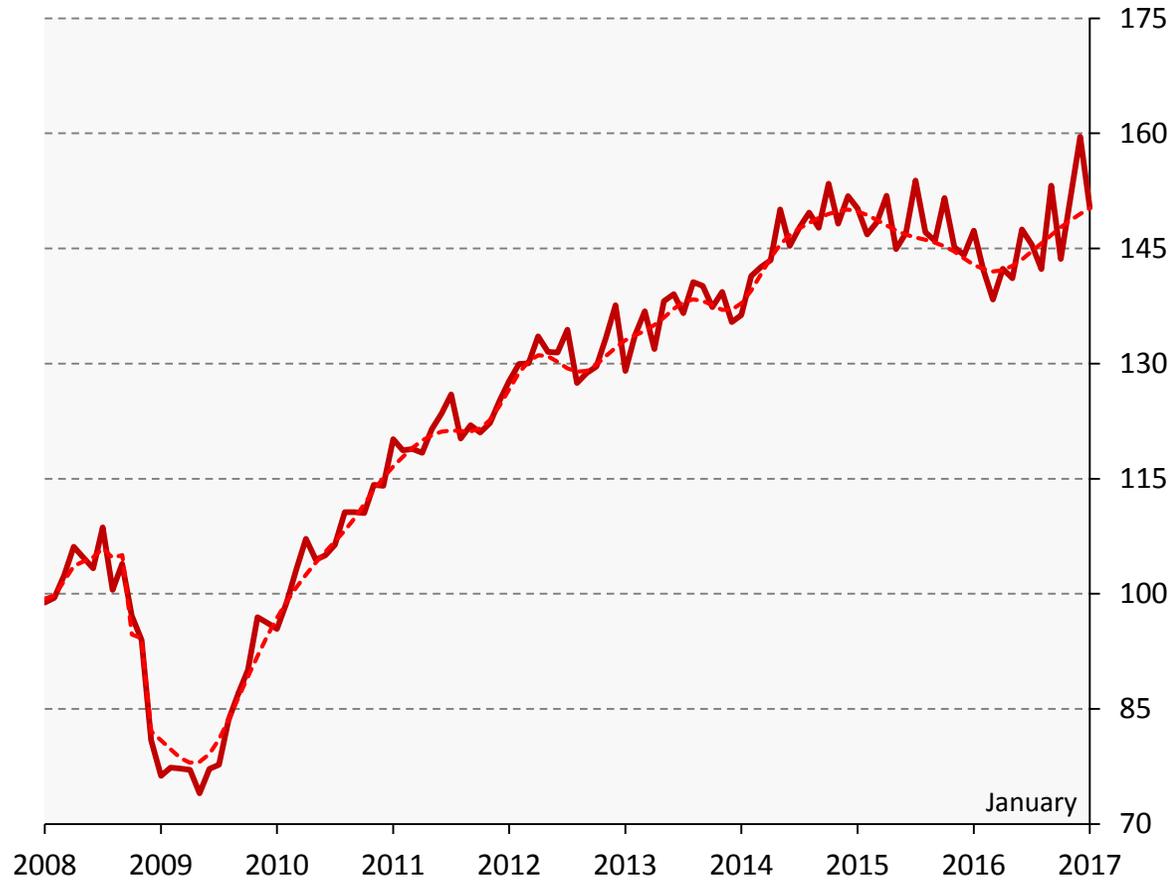
- ❑ On the demand side, the situation is characterized by:
 - ✓ A dynamic expansion of private consumption, although with signs of deceleration.
 - ✓ Low rates of growth of private investment.
 - ✓ Weak public expenditure.
 - ✓ An upturn of exports.

Both exports to the US and to the rest of the world are beginning to recover.

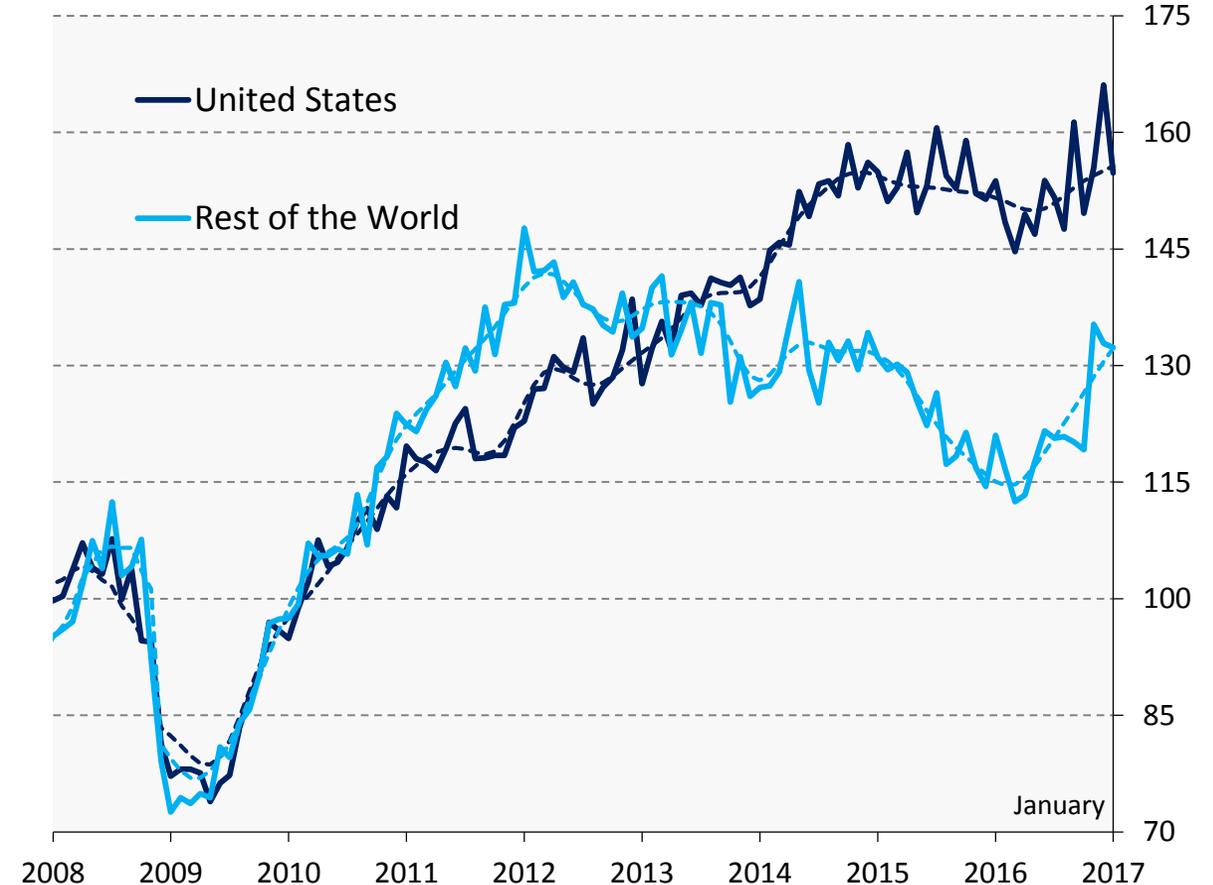
Manufacturing Exports

Index 2008 = 100; s.a.

Total



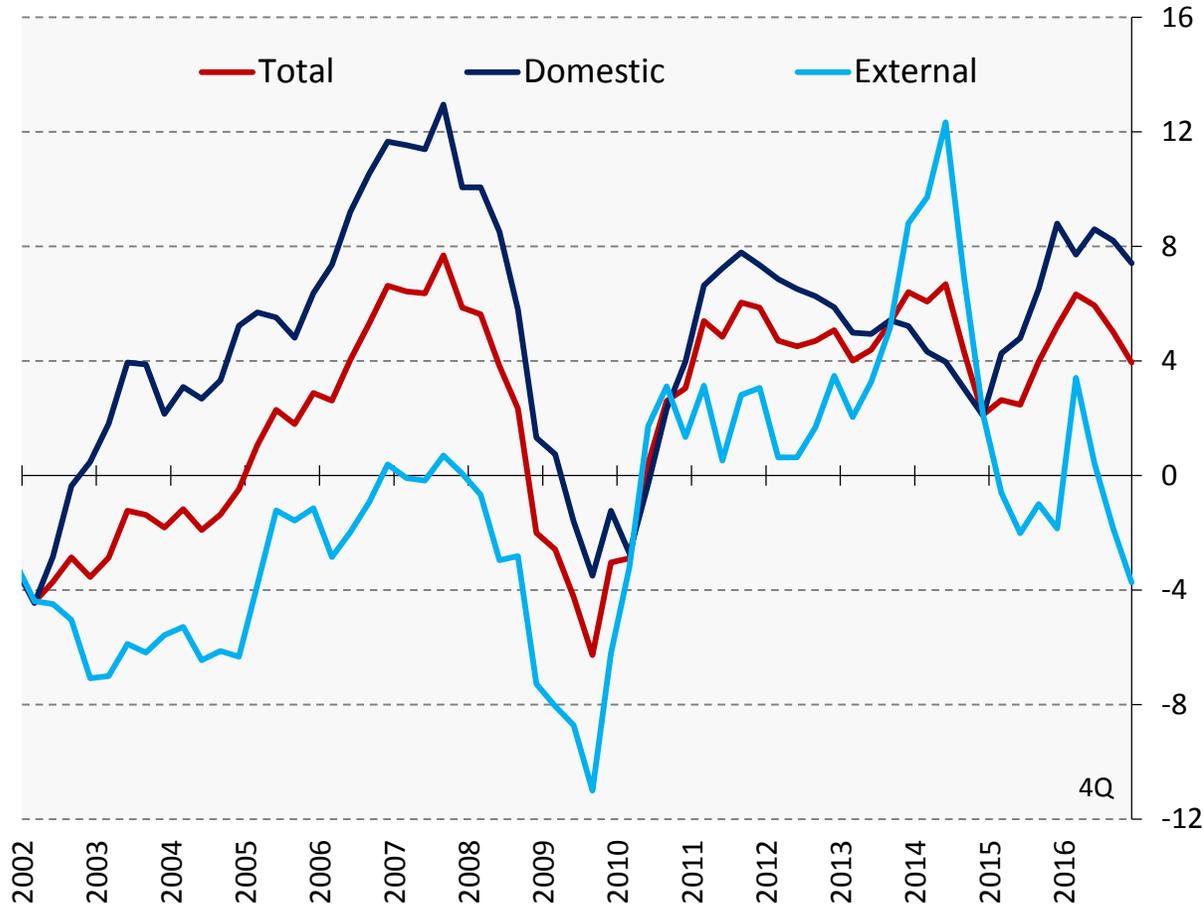
By Destination



s.a. / Seasonally adjusted data.
Source: Banco de México, INEGI, SAT and SE.

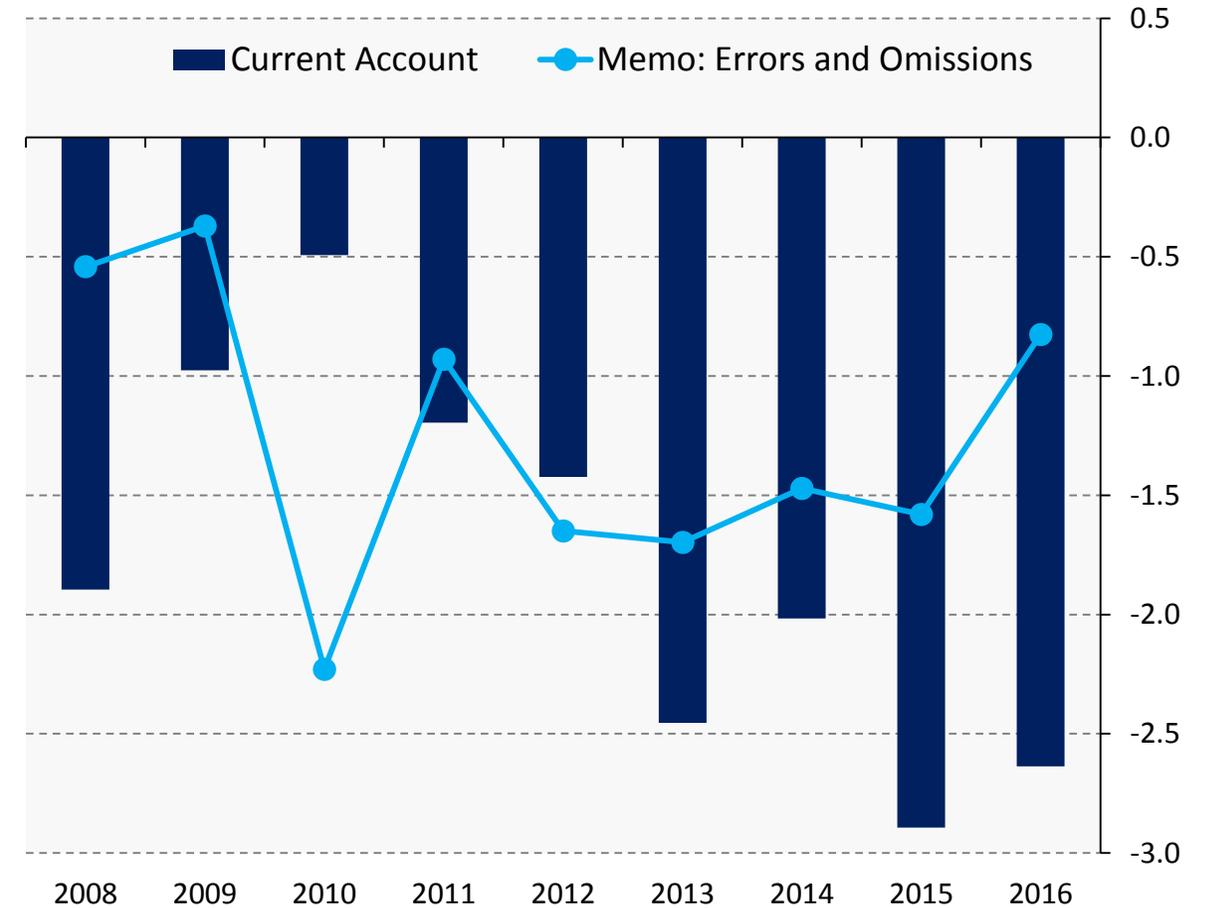
The deceleration of economic activity, lower rates of growth of total financing and the decline in the current account deficit, among other factors, suggest that there are no demand pressures on the economy.

Real Financing to the Non-Financial Private Sector^{1/}
Annual % Change



1 / Based on balances adjusted for exchange rate variations.
Source: Banco de México.

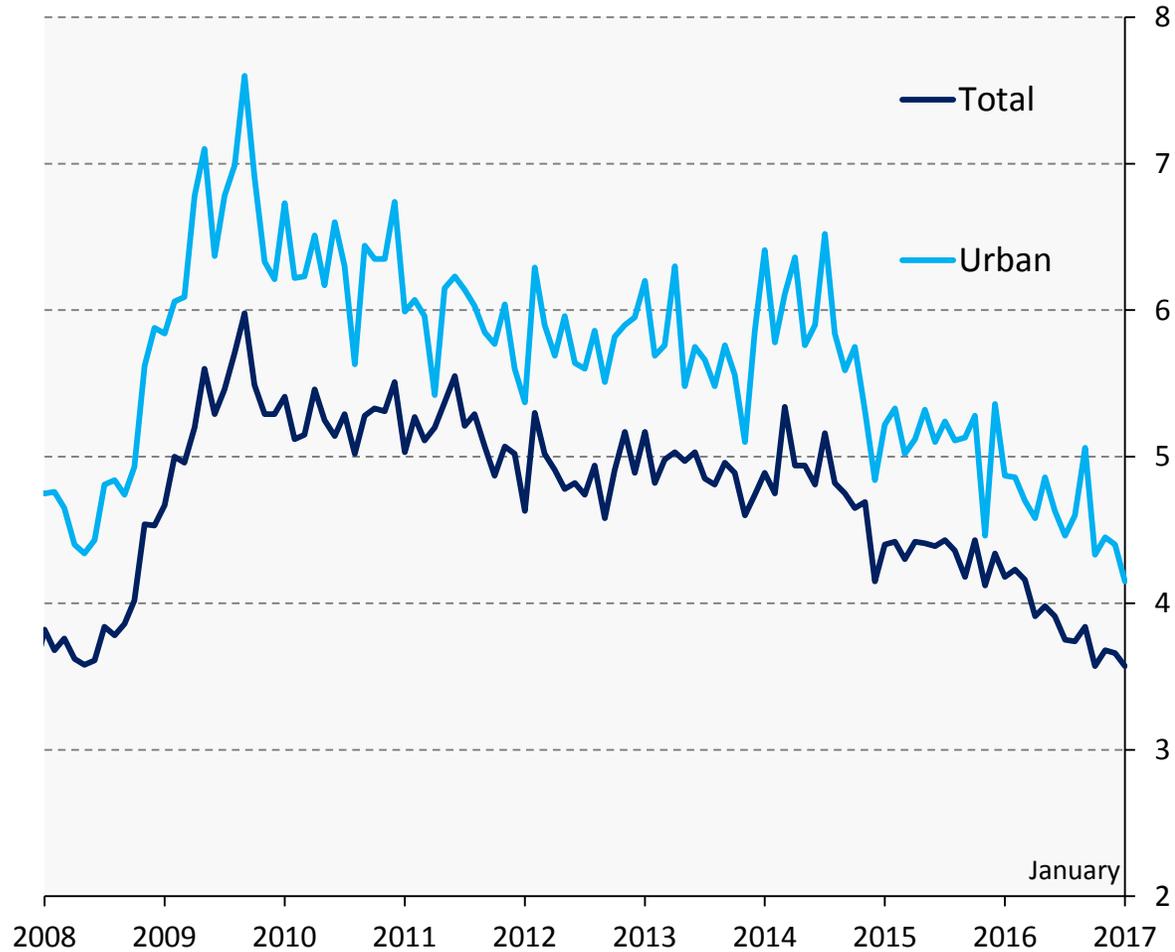
Current Account Balance
% of GDP



Source: Banco de México and INEGI.

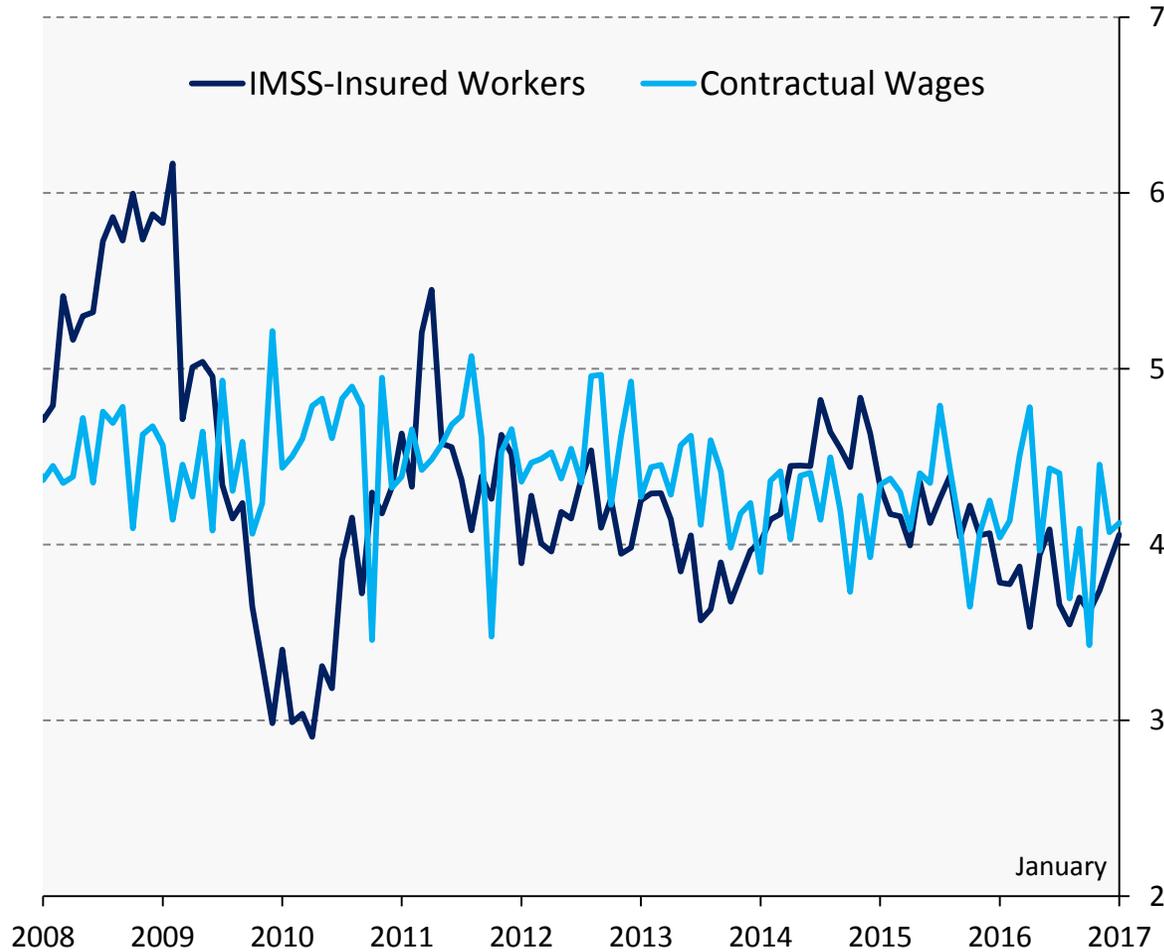
The unemployment rate has declined to levels similar to those observed prior to the global financial crisis, but in the absence of excessive wage demands.

Unemployment Rate
%, s.a.



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

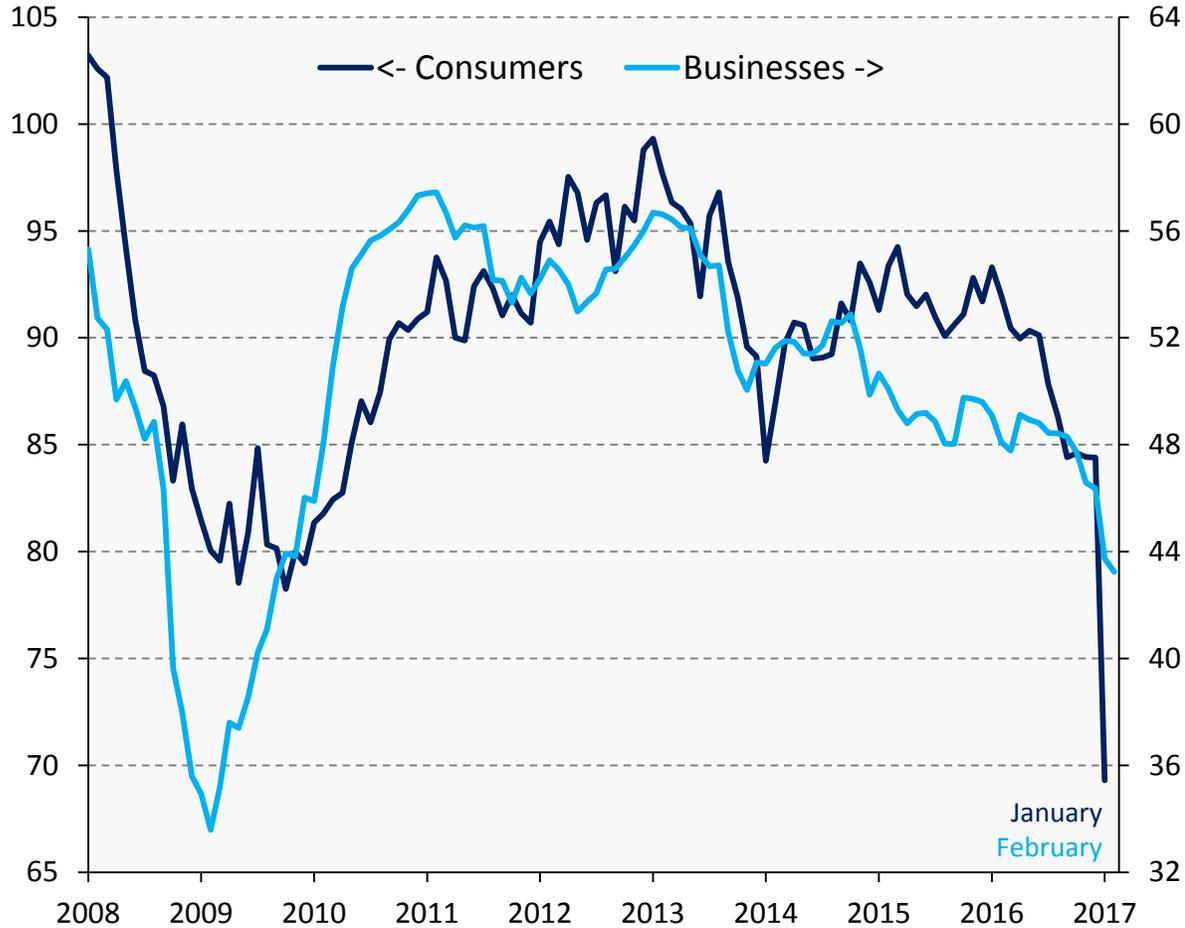
Nominal Wages
Annual % Change



Source: IMSS and STPS.

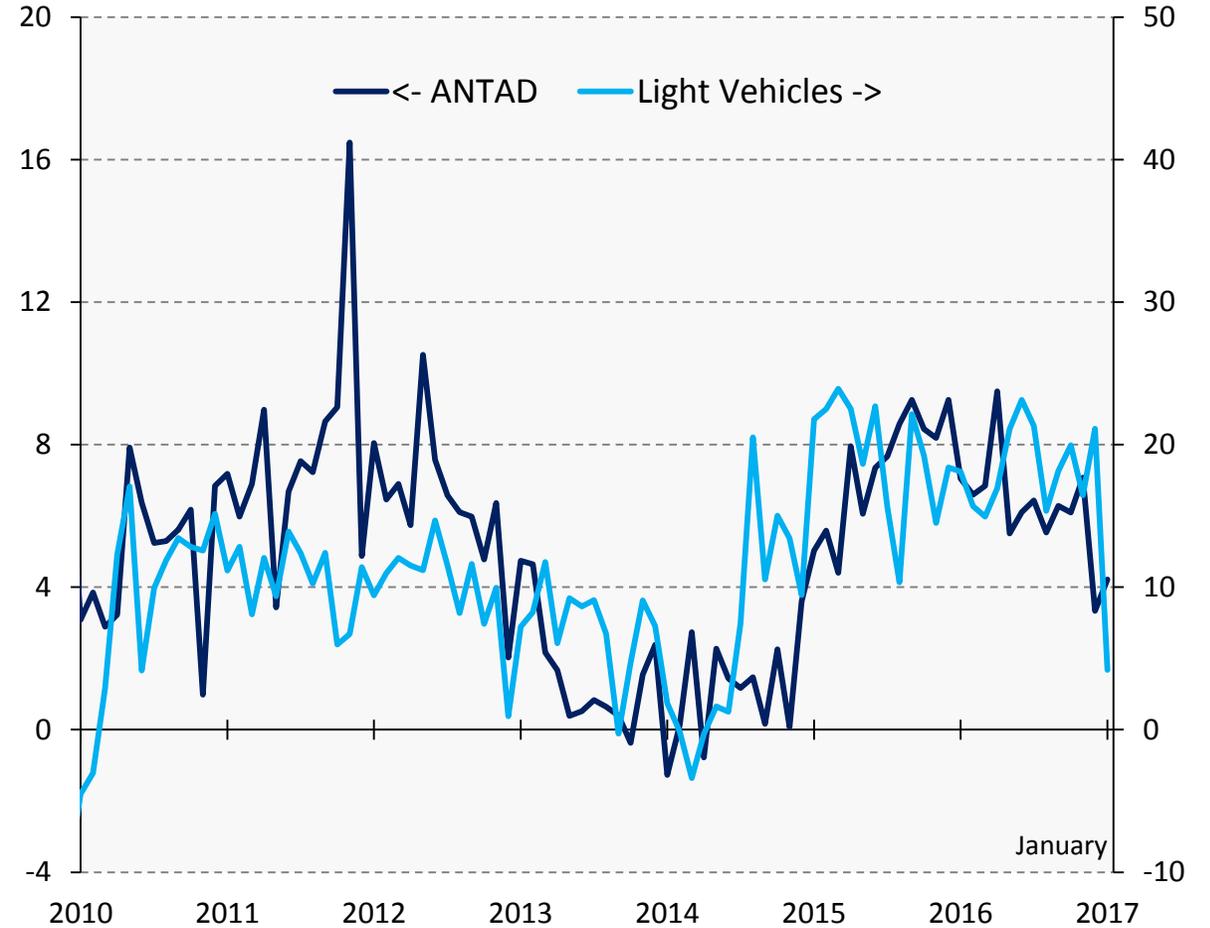
Some indicators point to a lower rate of economic growth during the first quarter.

Consumer and Business Confidence^{1/}
 Index Jan-2003 = 100 and Diffusion Index, s.a.



^{1/} Business confidence in the manufacturing sector.
 s.a. / Seasonally adjusted data.
 Source: Banco de México and INEGI.

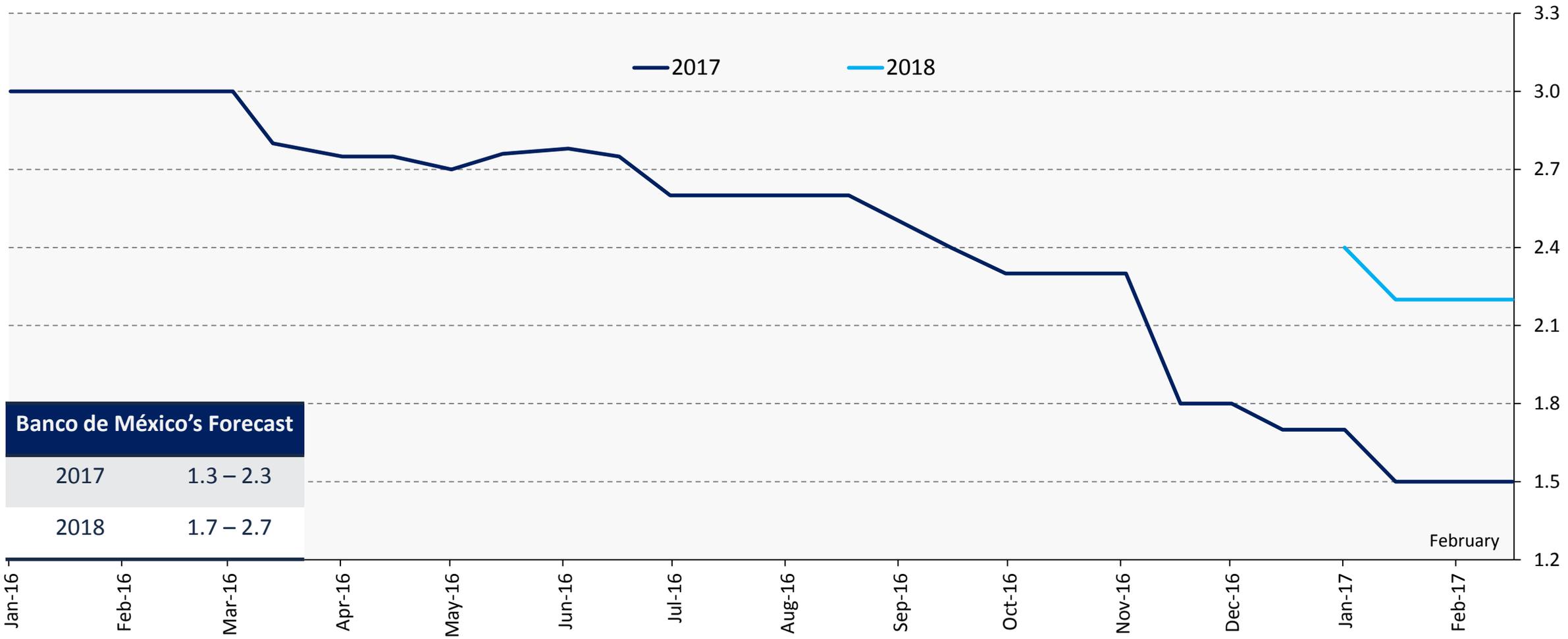
Total ANTAD and Light Vehicle Sales
 Annual % Change, s.a.



s.a. / Seasonally adjusted data.
 Source: Banco de México, ANTAD and AMIA.

In this context, projections for GDP growth in 2017 have been adjusted downwards.

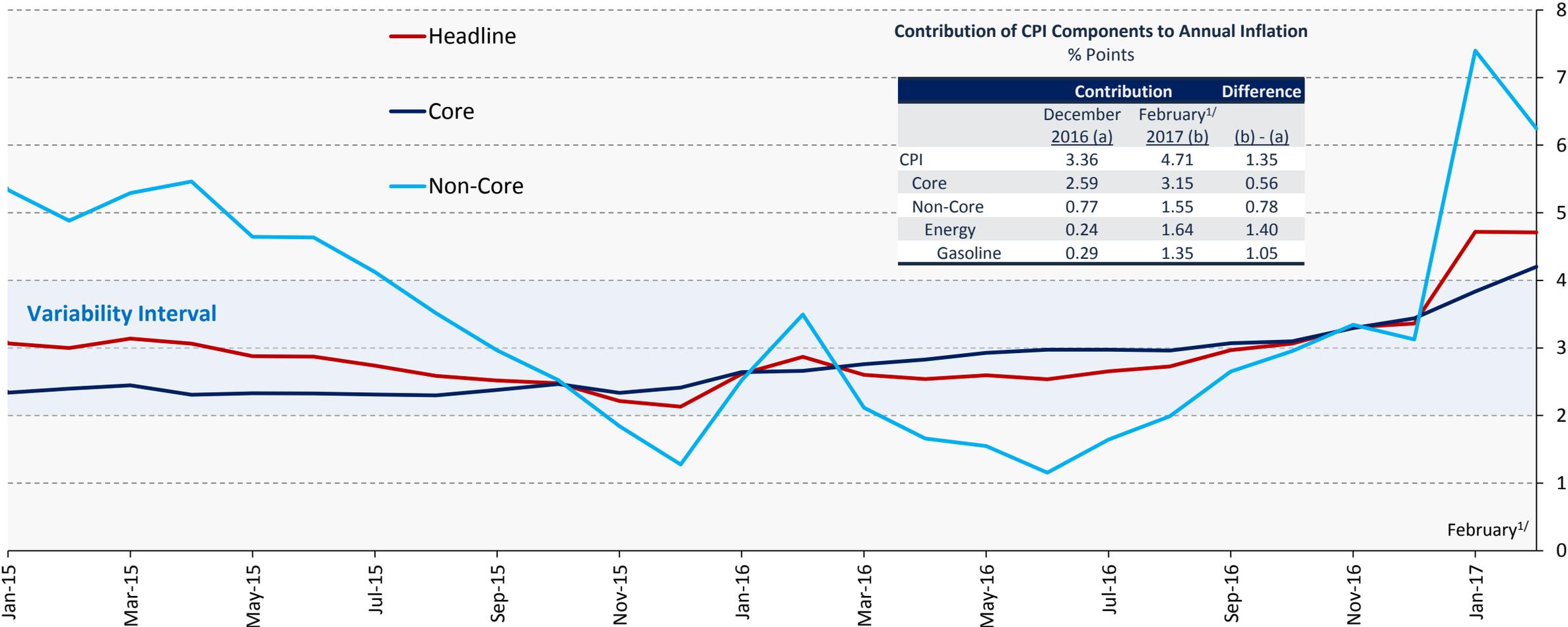
Real GDP Growth Projections
Annual %



Source: Banco de México and Citibanamex.

Inflation has increased, mainly as a result of the depreciation of the peso, the adjustment of gasoline prices and the liberalization of gas prices.

CPI Inflation
Annual %

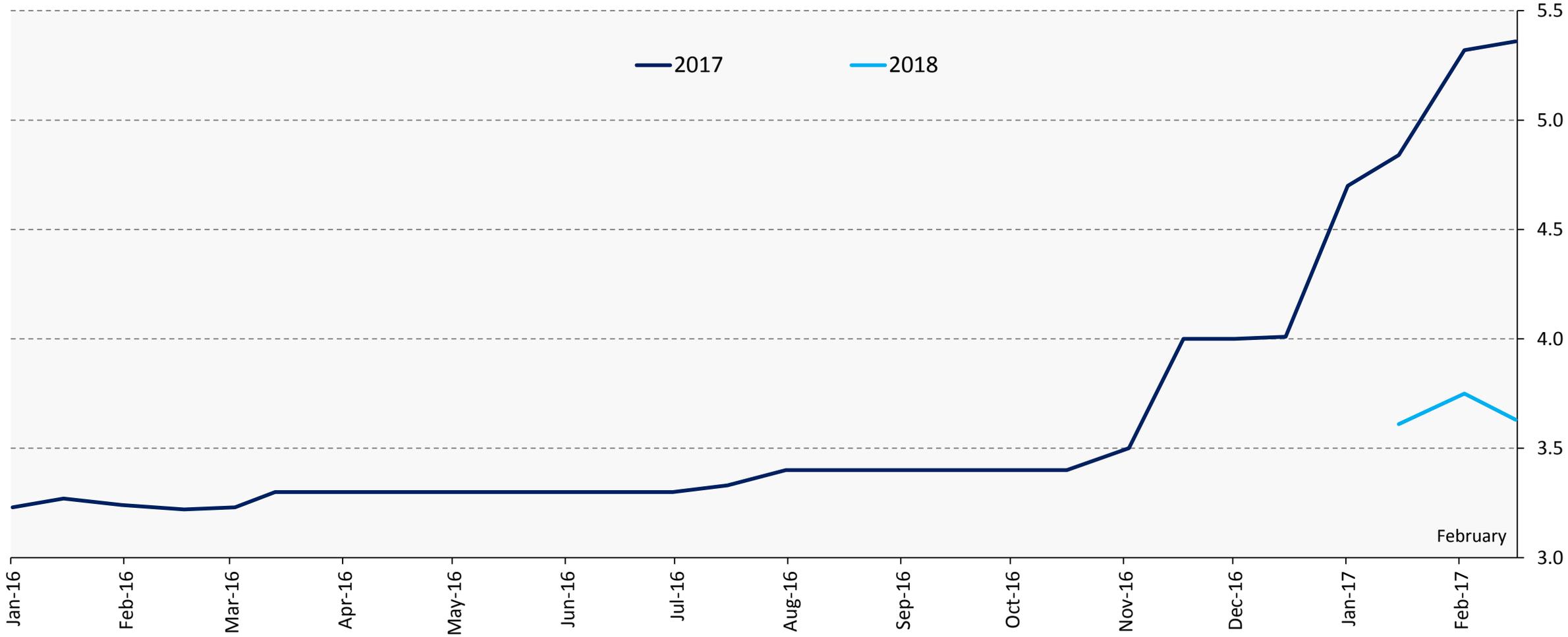


1/ Data through the first fortnight of February.
Source: INEGI.

- ❑ The supply shocks observed at the beginning of the year, coupled with the increase in the minimum wage, should reflect in the evolution of inflation in coming months.
- ❑ Thus, inflation is expected to show figures above the variability range around the inflation target throughout the year.
- ❑ However, in view of the nature of these shocks and the seasonal behavior of gasoline prices, inflation should decline in the second half of 2017 to fall again within the variability interval in 2018.

Short-term inflation expectations are consistent with this scenario...

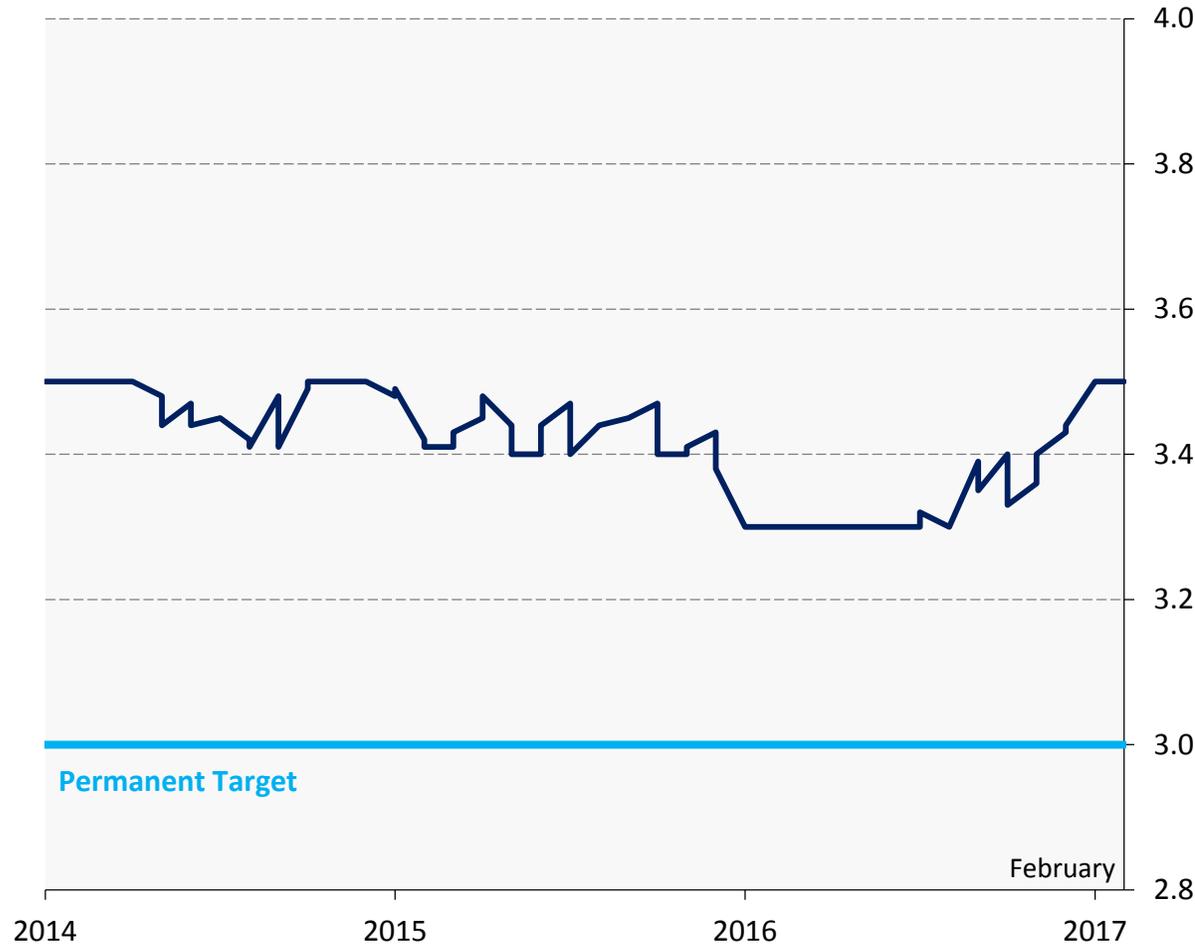
Short-Term Inflation Expectations Annual %



Source: Citibanamex.

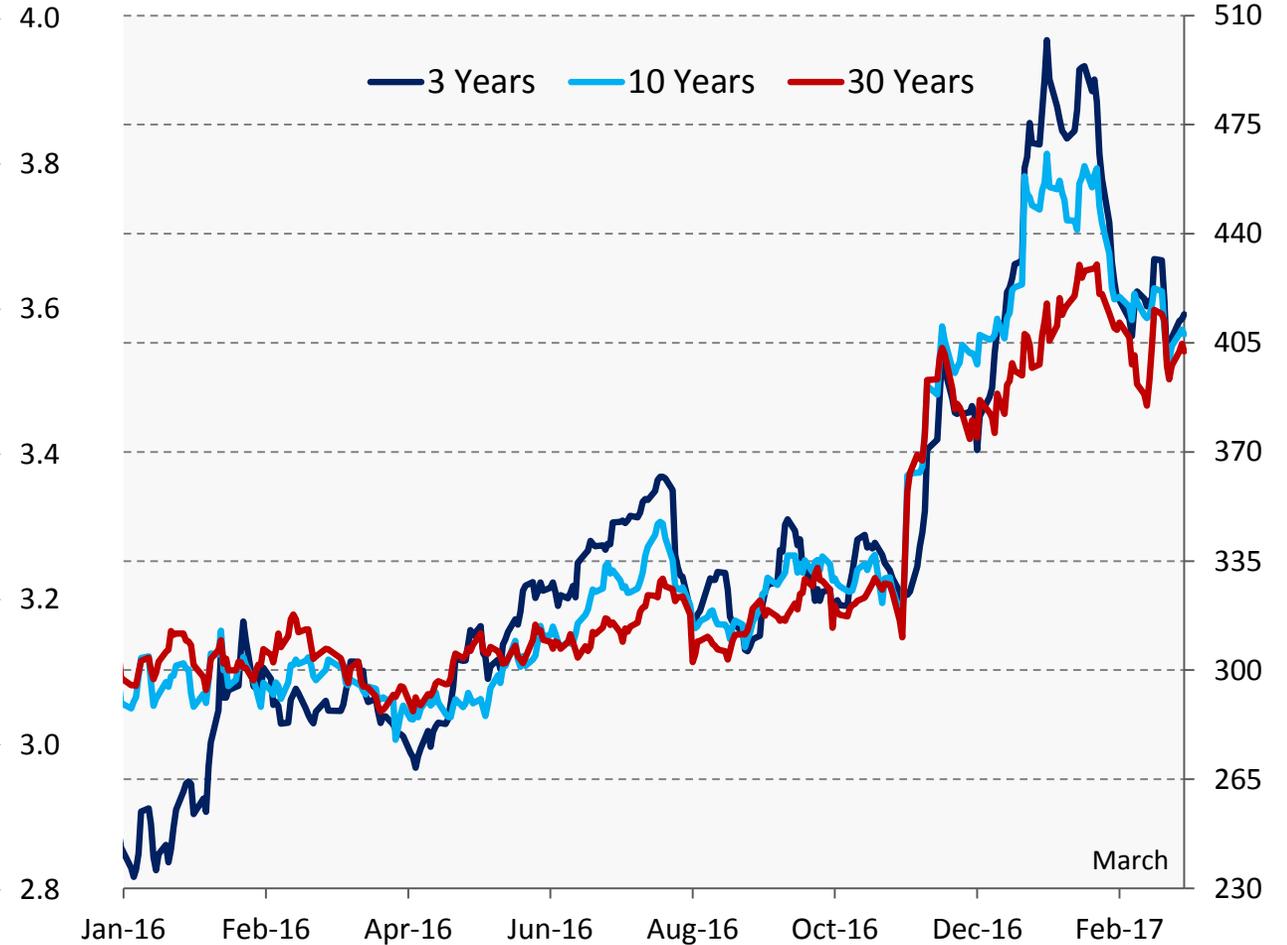
... although long-term inflation expectations based on surveys have increased somewhat and breakevens suggest concern about inflation in the long term.

Long-Term Inflation Expectations^{1/}
Annual %



1/ Median inflation expectation for the next 2-6 years.
Source: Citibanamex.

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 information from PiP.

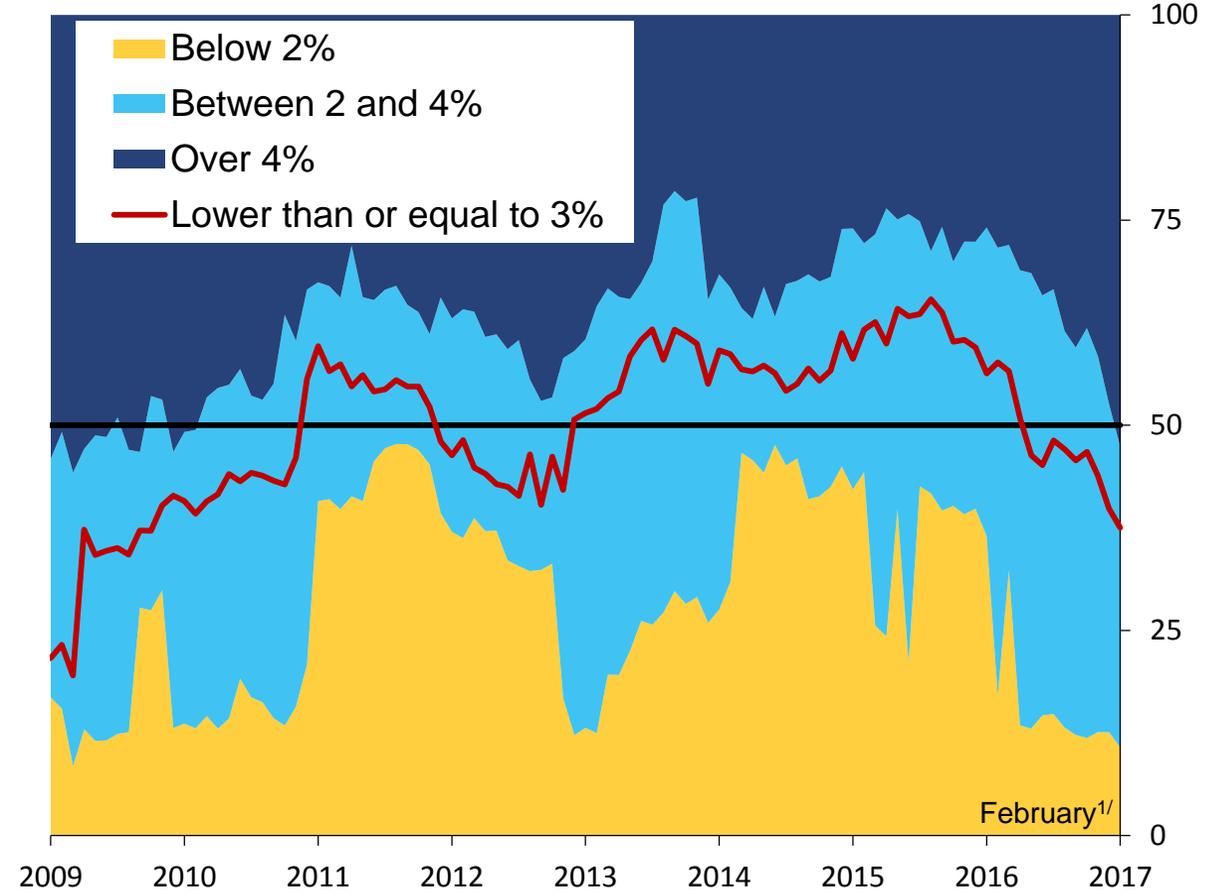
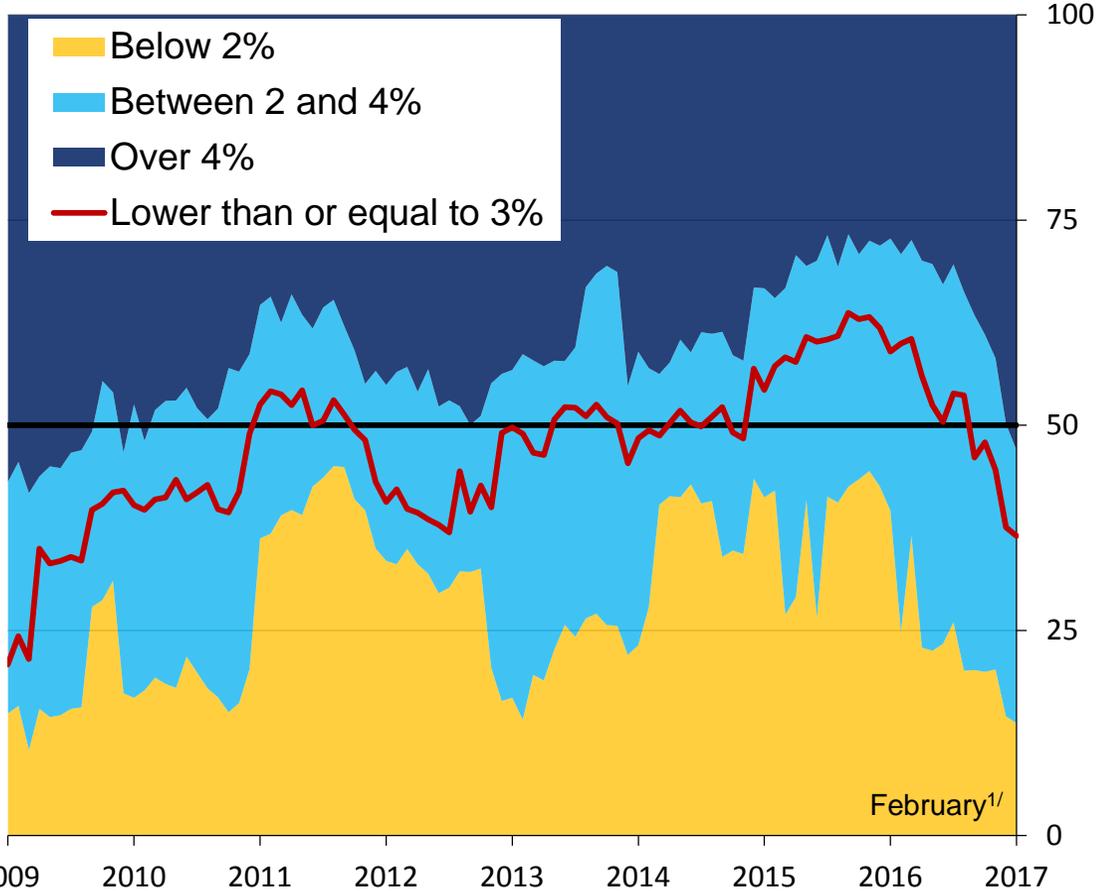
While the indirect impact of recent supply shocks on prices has been contained thus far, the possibility of second round effects represents one of the main risks for inflation in coming months.

Percentage of CPI Basket according to Intervals of Annual Increments

%

Headline

Core



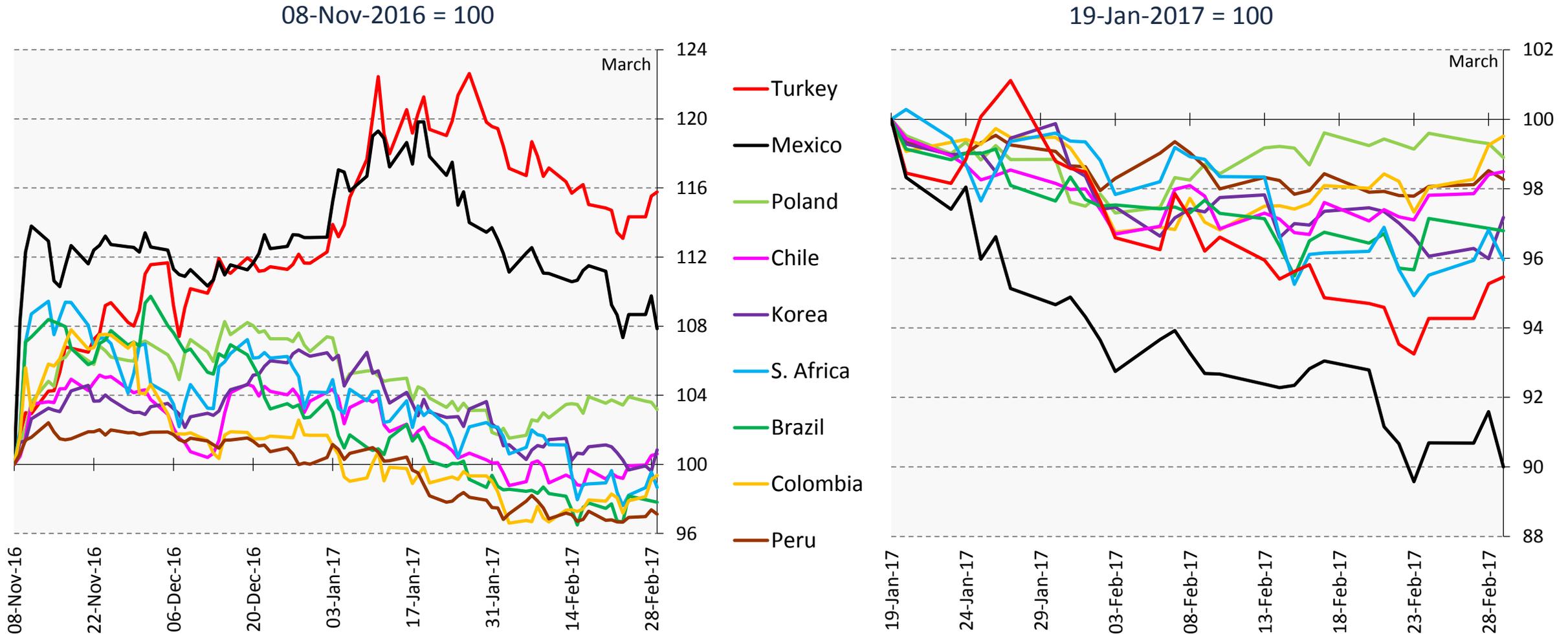
1/ Data through the first fortnight of February.
Source: Banco de México and INEGI.

In addition, inflation may be affected by:

- ❑ A higher pass-through from the exchange rate to prices.
 - ✓ Additional depreciation of the peso.
 - ✓ Worsened inflation dynamics.
- ❑ The transitory impact of an upturn of agricultural prices.

Following the pressures observed after the electoral process in the US, the peso has appreciated.

Emerging Market Economies: Nominal Exchange Rate with Respect to the US Dollar Index



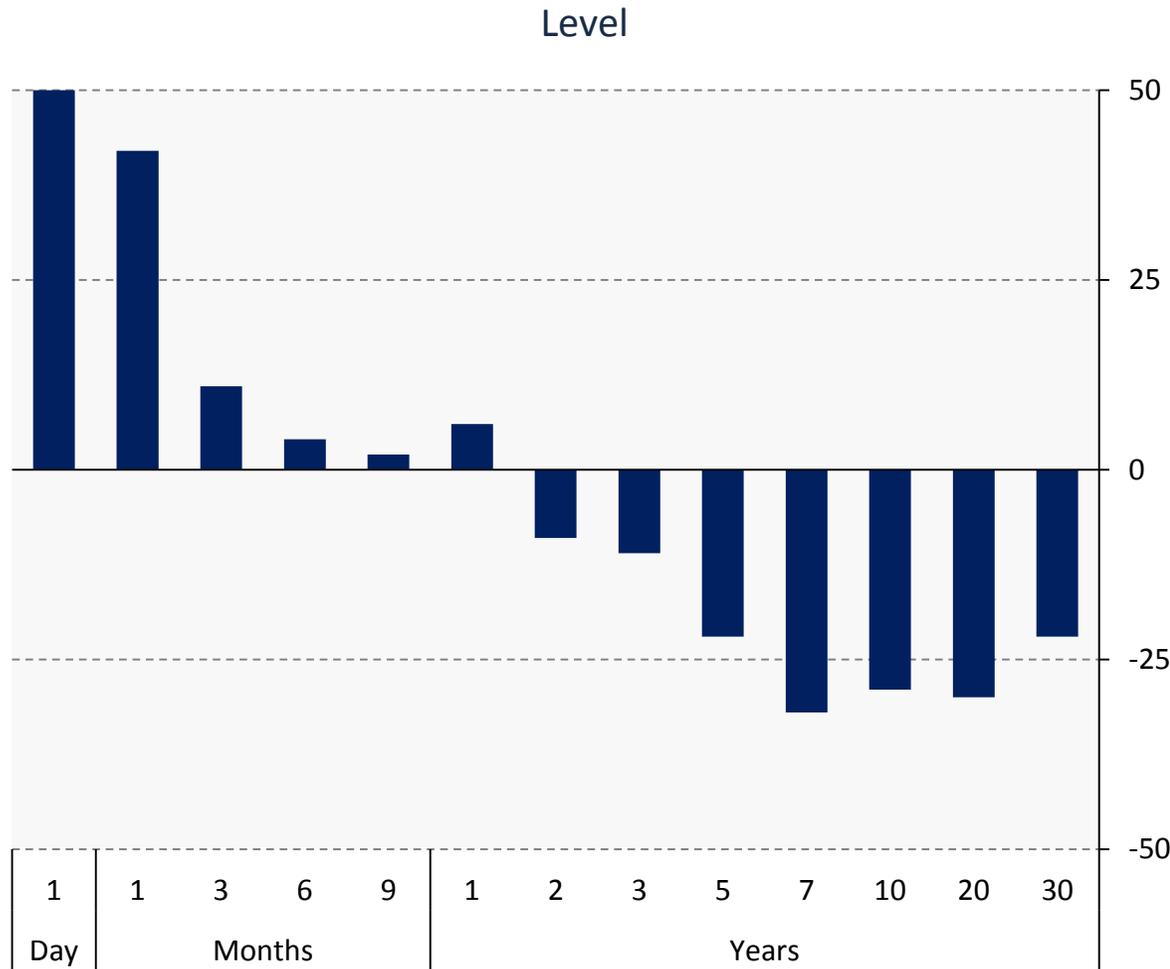
Source: Bloomberg.

These trends have been reinforced by the introduction of hedging mechanisms for the protection against exchange rate risk.

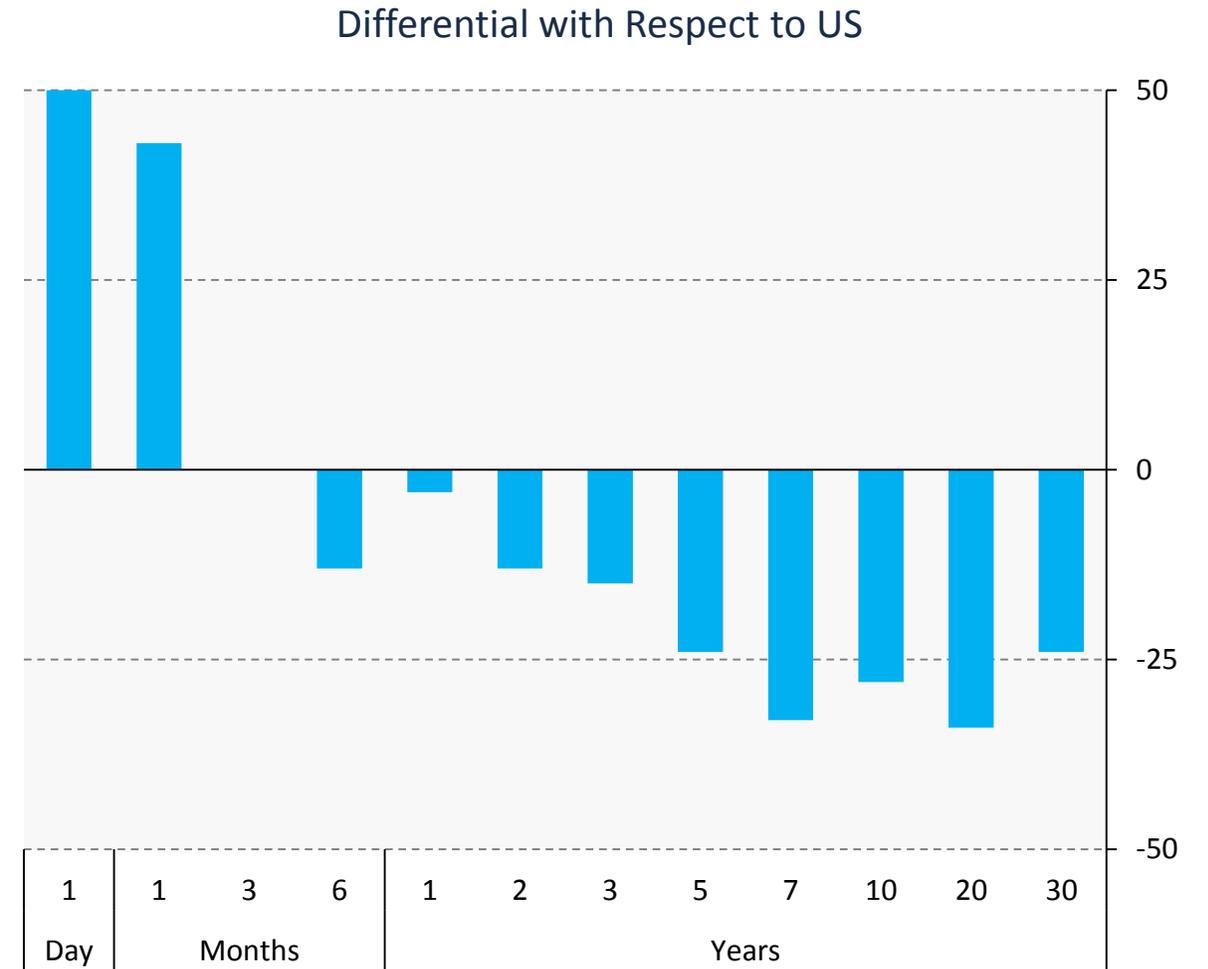
- ❑ To foster an orderly functioning of the foreign exchange market, Mexico's Foreign Exchange Commission announced on 21 February 2017 the decision to offer FX hedges to market participants.
- ❑ This measure does not involve the direct use of Banco de México's FX reserves, and it is capped at USD 20 billion.
- ❑ The first auction for these instruments is scheduled to take place on 6 March 2017, for an amount of up to USD 1 billion.
- ❑ The FX Commission does not rule out the possibility to implement additional measures should they be deemed necessary, and has reiterated that the exchange rate will be supported mainly by sound economic fundamentals.

In addition, interest rates have declined.

Change in Domestic Interest Rates since 19 January 2017 Basis Points



Source: Banco de México and PiP.



Source: Banco de México, PiP and US Department of the Treasury.

- In view of:
 - ✓ The upturn of inflation at the beginning of 2017.
 - ✓ An increase, though modest, in long-term inflation expectations based on surveys.
 - ✓ Concern regarding long-term inflation derived from market instruments.
 - ✓ The possibility of additional pressures on the peso under a situation of higher-than-usual uncertainty.
- A strong monetary policy stance is needed to avoid second round effects from the recent supply shocks and the unanchoring of long-term inflation expectations.

- ❑ The above should not be detrimental for economic activity.
- ❑ An alternative of higher inflation or an episode of macroeconomic instability would have far more serious implications for economic growth.

- In view of the economy's cyclical position and its anticipated evolution, it is unlikely to see demand pressures on prices in coming months.

- Therefore, although it is essential to continue to monitor all determinants of inflation, it is probable that decisions will be closely linked to the implications of:
 - ✓ The recent supply shocks.

 - ✓ The pass-through of the exchange rate to prices.

 - ✓ The normalization of monetary policy in the United States.

Concluding remarks

- ❑ The implementation of monetary policy in Mexico in coming months will continue to face an environment of uncertainty, to a significant extent as a result of the risks derived from potential policy measures to be implemented in the United States and the evolution of interest rates in that country.
- ❑ In addition, the economy will continue to show the effects of the depreciation of the exchange rate, the increase in energy prices and other recent shocks on inflation.
- ❑ Therefore, the main challenge for monetary policy will be to avoid second round effects from these shocks and in general the unanchoring of long-term inflation expectations.
- ❑ The fundamentally preventive increases in the monetary policy interest rate since late 2015 have been instrumental to contain the adverse impact of the recent price adjustments on medium- and long-term inflation expectations, and the Banco de México will be ready to further modify the stance of monetary policy as needed.
- ❑ On the other hand, a balanced macroeconomic policy approach is required to ensure an efficient adjustment of the economy. This underlines the importance of the fiscal targets announced by the government for this and subsequent years.
- ❑ The measures disclosed recently by the Exchange Commission to foster a more orderly evolution of the foreign exchange markets may also contribute to a more balanced policy approach.



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