



Recent Economic Developments and Monetary Policy in Mexico

Javier Guzmán Calafell, Deputy Governor, Banco de México*

United States-Mexico Chamber of Commerce, Northeast Chapter

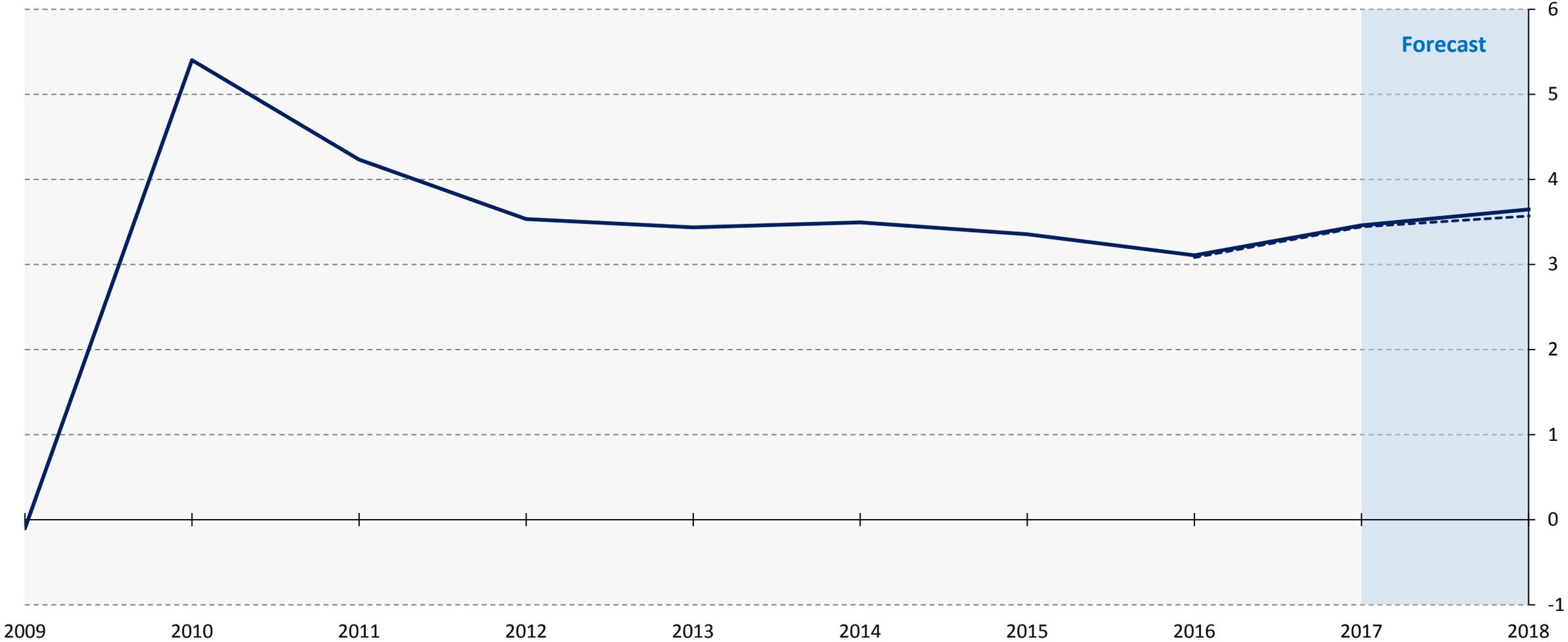
New York City, 2 June 2017



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The most recent projections foresee a gradual upturn in world GDP growth starting this year.

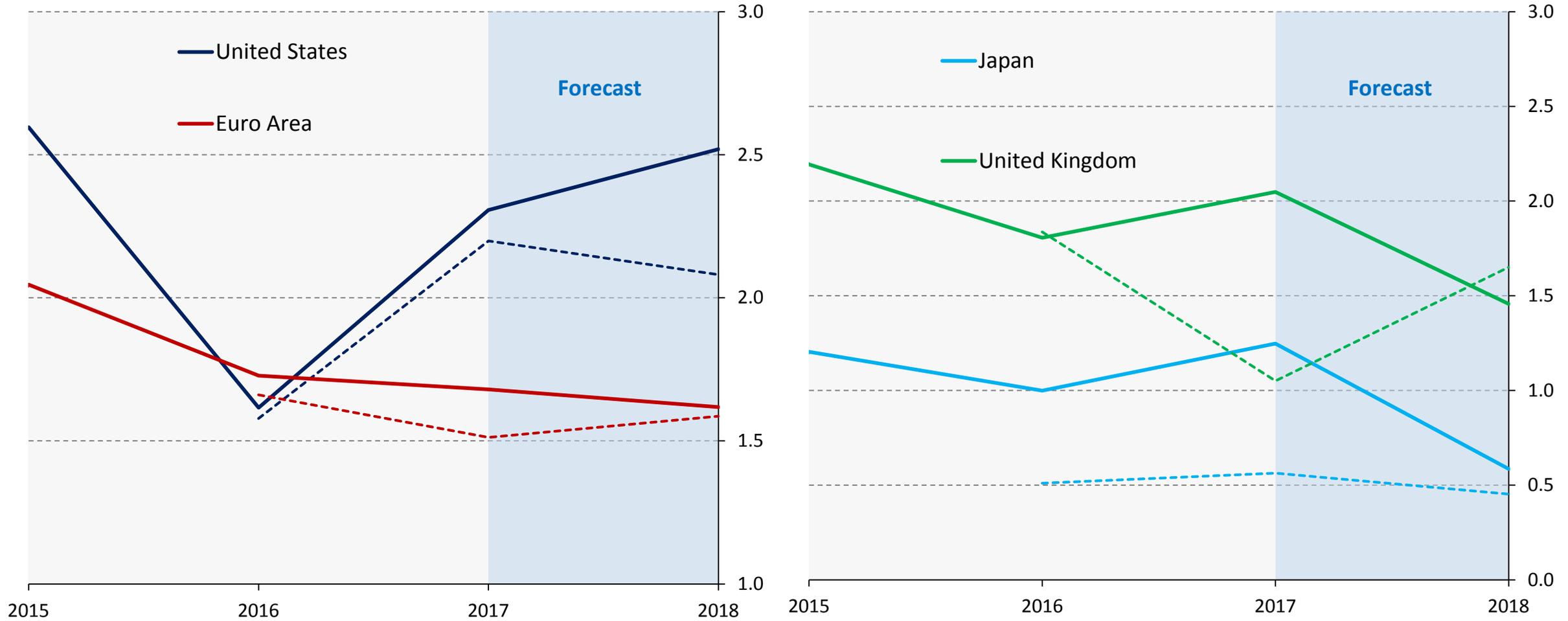
World GDP Growth
Annual %



Source: IMF, WEO October 2016 (dashed line) and April 2017 (solid line).

Particularly noteworthy are the improved prospects for the advanced economies...

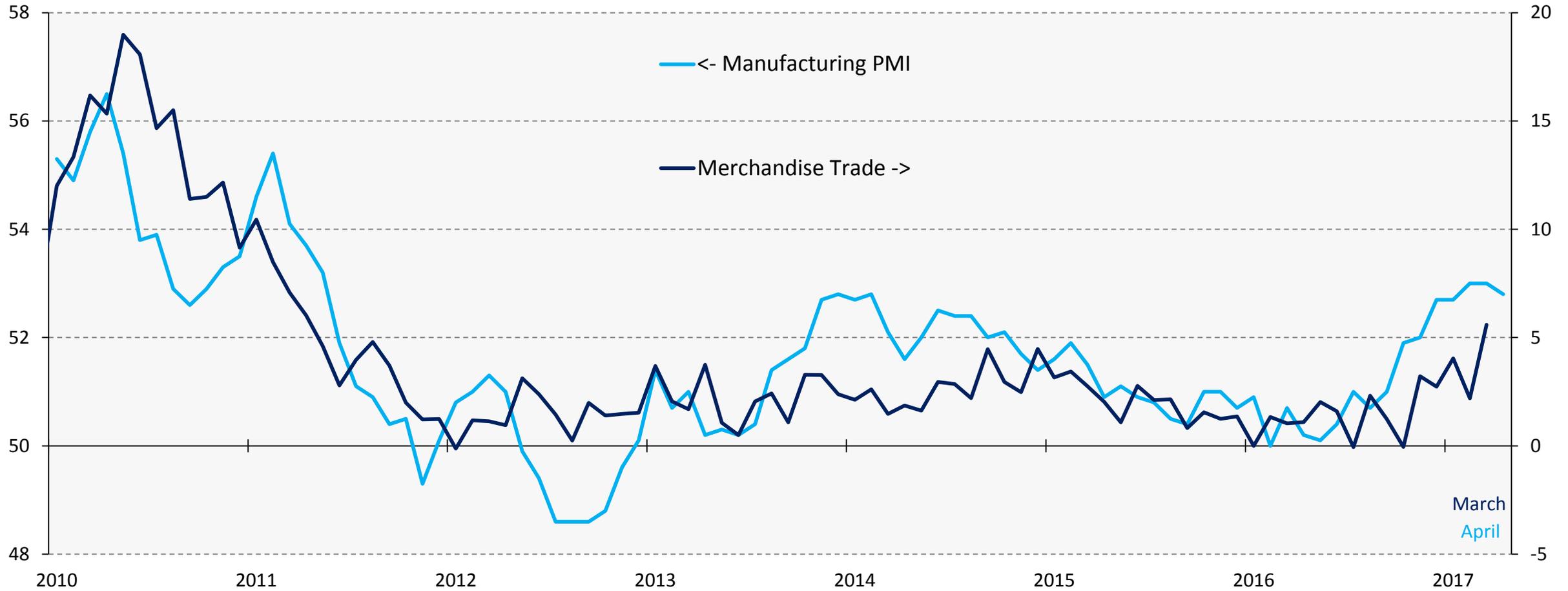
Advanced Economies' GDP Growth Annual %



Source: IMF, WEO October 2016 (dashed line) and April 2017 (solid line).

... and the upturn in global industrial production and international trade.

Global Manufacturing PMI^{1/} and Merchandise Trade Volume^{2/}
Diffusion Index and Annual % Change, s.a.

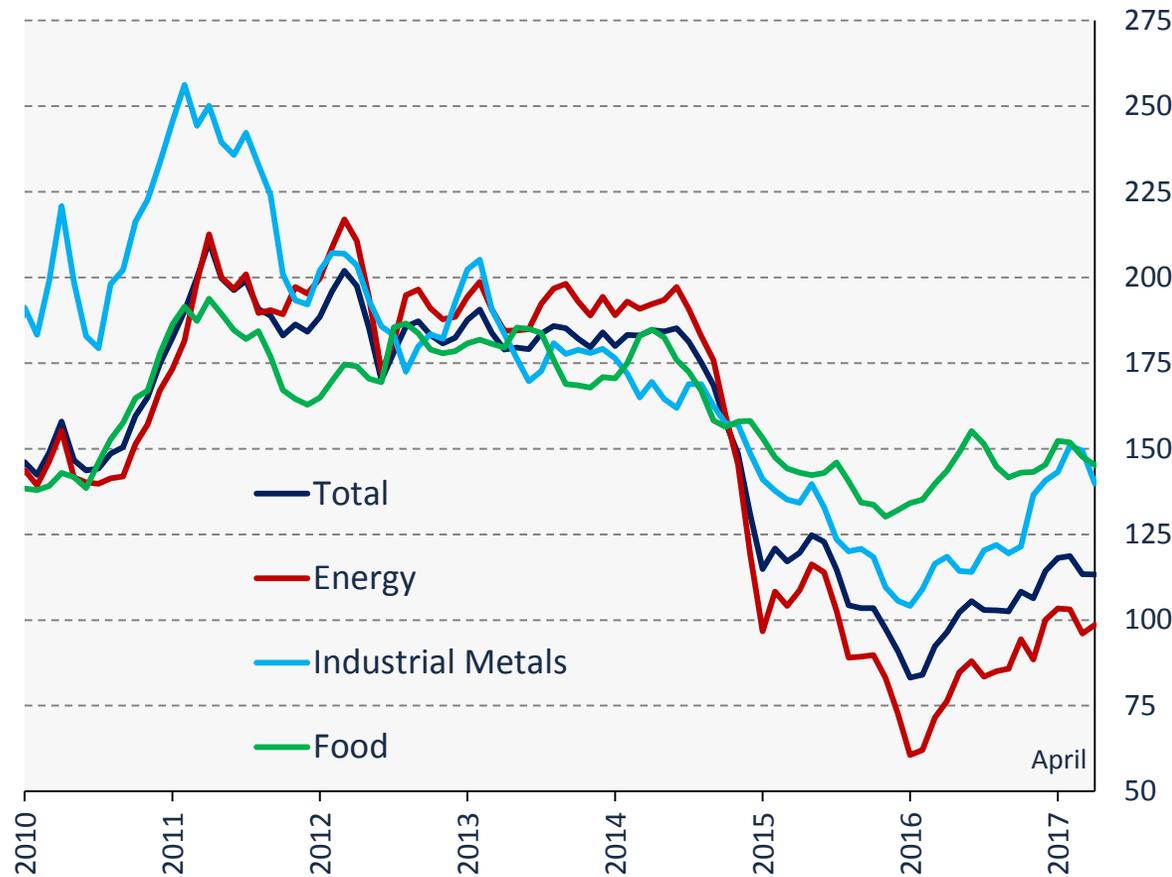


s.a./ Seasonally adjusted data.
1/ Purchasing Managers' Index.
2/ Sum of exports and imports.
Source: Markit and CPB Netherlands.

Meanwhile, commodity prices have displayed a moderate recovery.

Commodity Prices

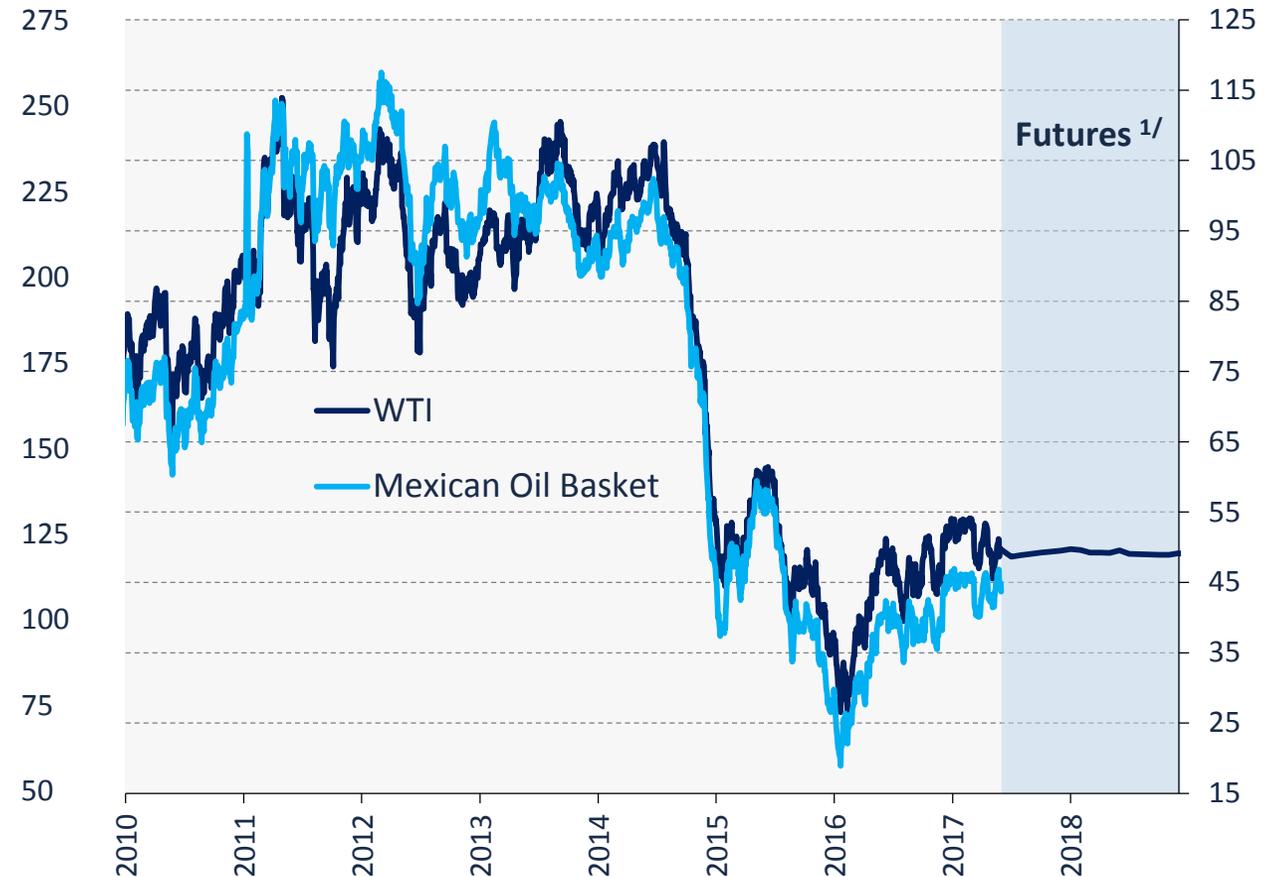
Index 2005 = 100



Source: IMF.

Oil Prices

US Dollars per Barrel

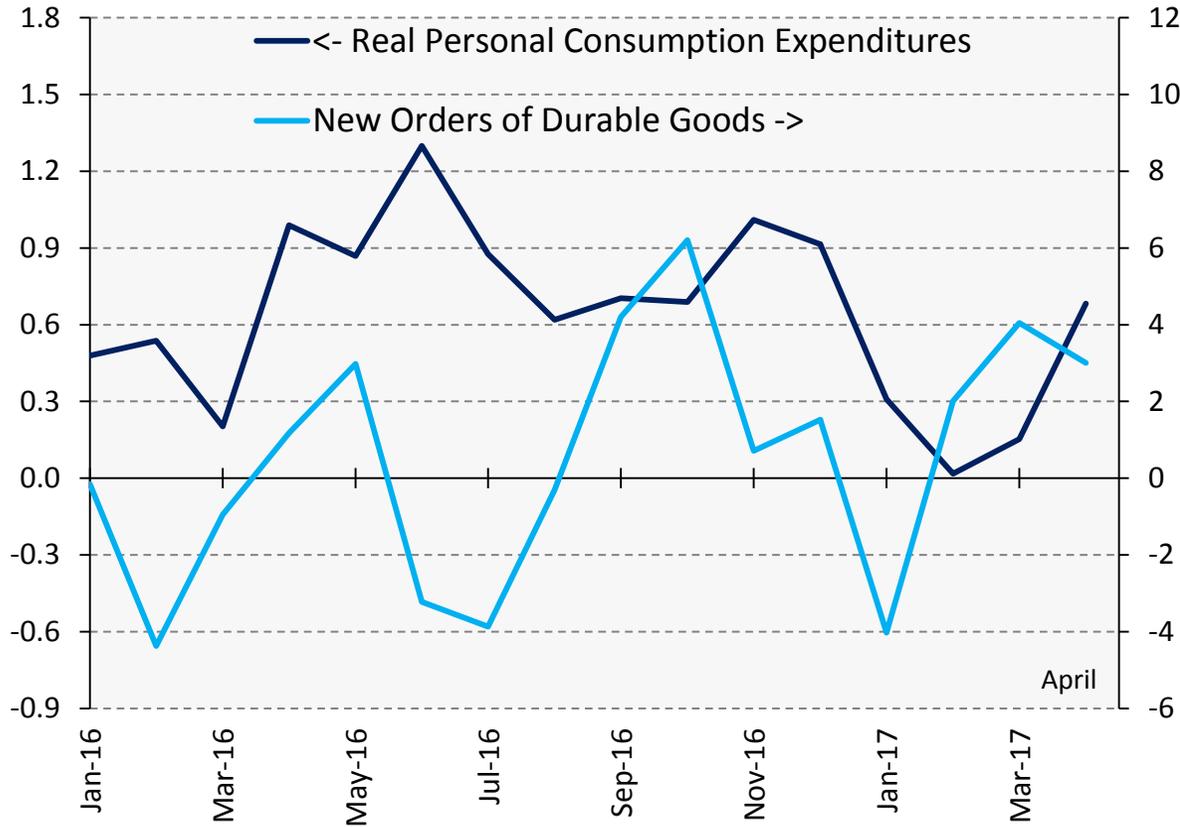


1/ As of 31 May 2017.
Source: Bloomberg.

In the US, after having decelerated in early 2017, GDP growth appears to be strengthening, in a trend that is expected to continue over coming quarters.

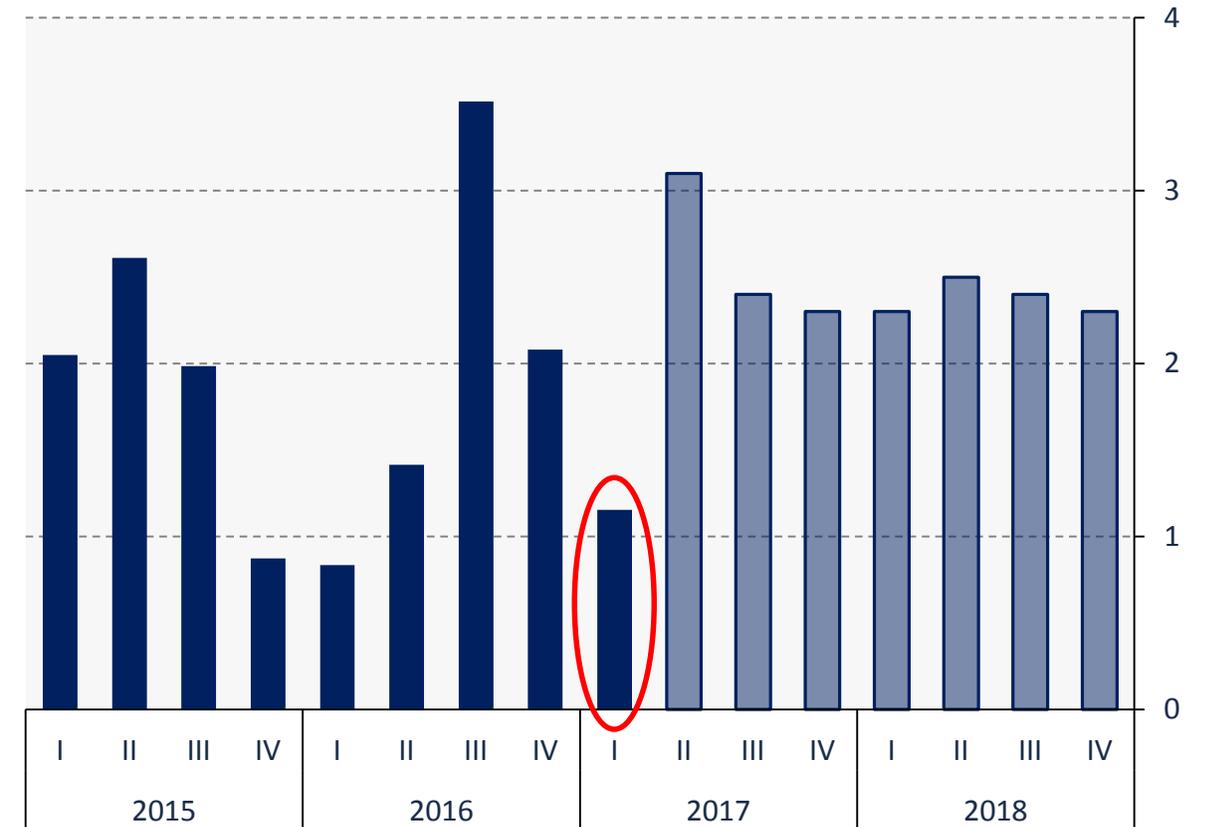
United States

Real Personal Consumption Expenditures and New Orders of Durable Goods
3-Month % Change, s.a.



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

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

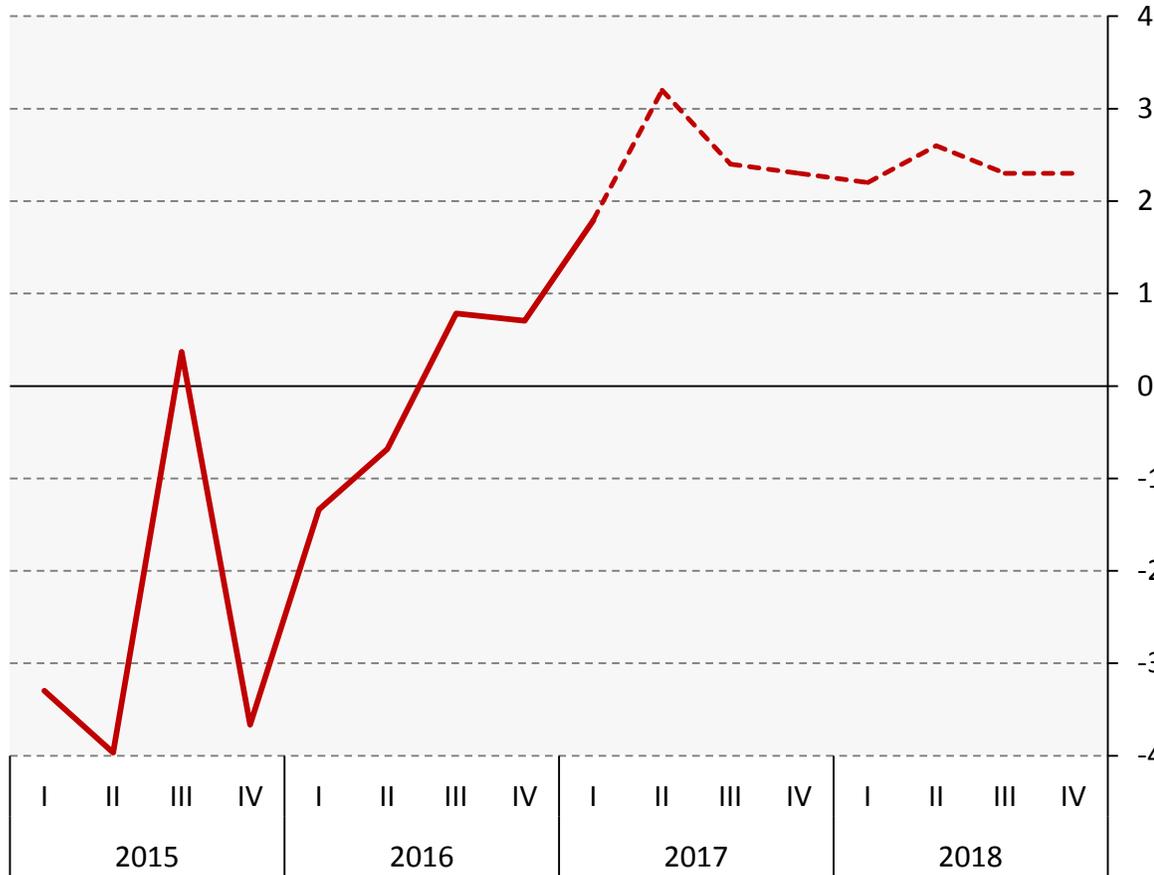


s.a./ Seasonally adjusted data.
Source: Bureau of Economic Analysis and Blue Chip.

Industrial production in the US is expected to resume a positive rate of growth this year, in the context of a more dynamic external sector.

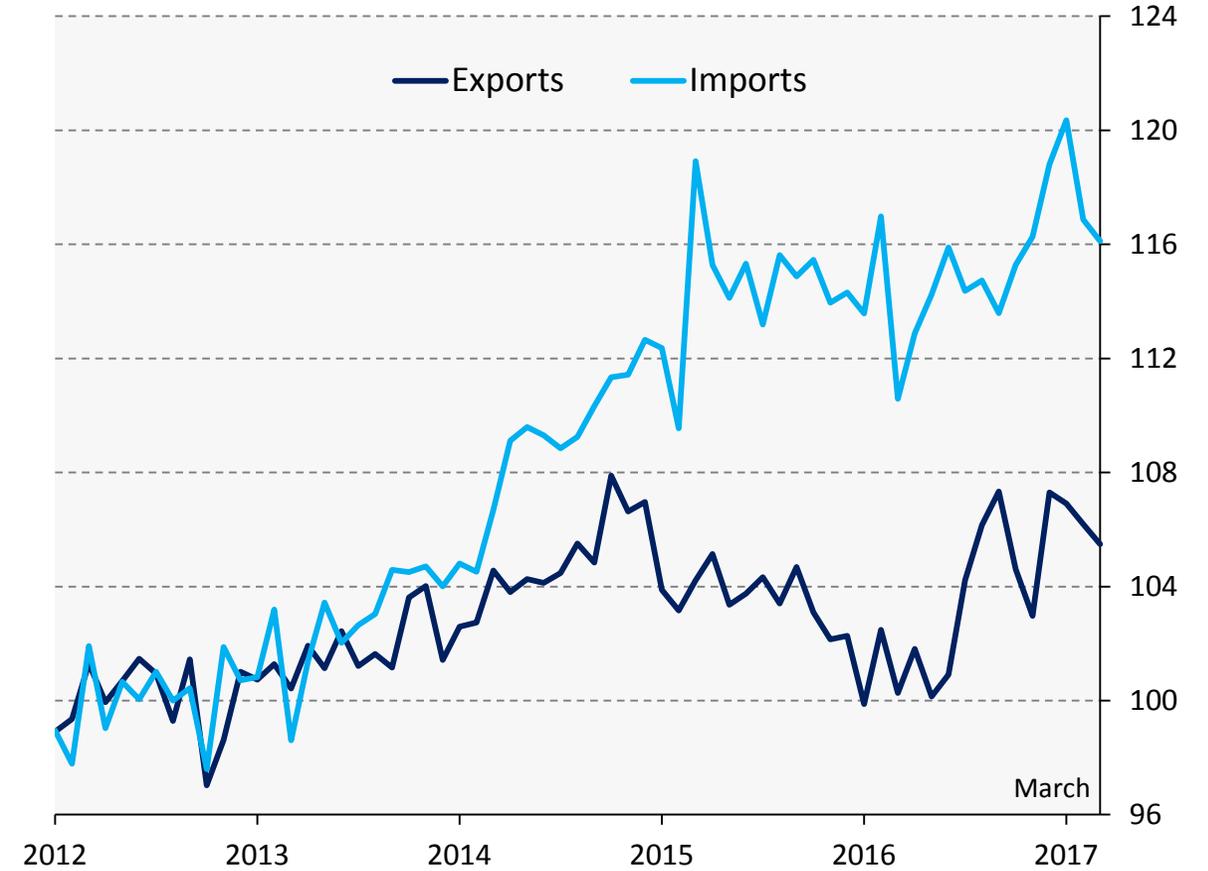
United States

Industrial Production
Annualized Quarterly % Change, s.a.



s.a. / Seasonally adjusted data.
Source: Federal Reserve and Blue Chip.

Real Exports and Imports of Non-Petroleum Goods
Index 2012 = 100, s.a.



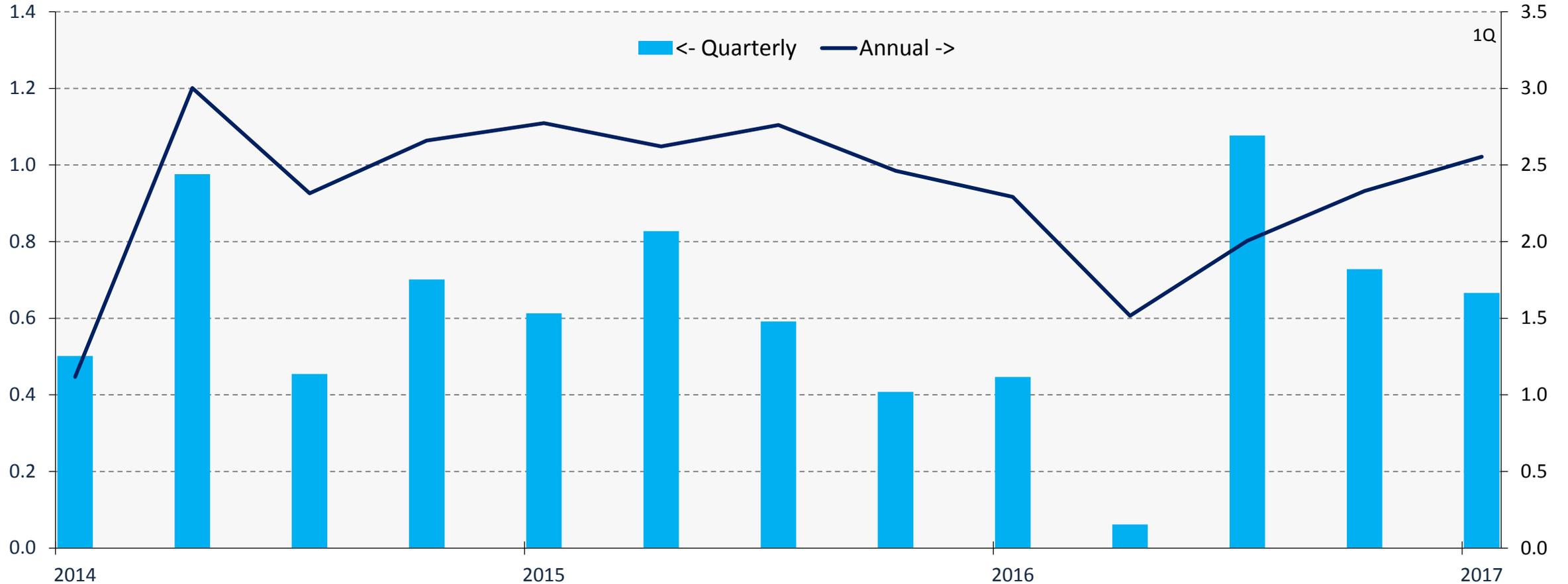
s.a. / Seasonally adjusted data.
Source: Census Bureau.

In spite of a number of positive developments, a high level of uncertainty regarding the future evolution of the world economy persists, as a result of a number of factors.

- Globally, the main concerns gravitate around:
 - UK exit from the European Union.
 - Potential strengthening of protectionist and anti-globalization trends.
 - Macroeconomic and financial vulnerabilities in China and other emerging economies.
 - Latent likelihood of conflicts and difficulties of a geopolitical nature in some regions.
- In the US, the main sources of uncertainty arise from:
 - Insufficient clarity in relation to future actions from the part of that country's administration in several areas, notwithstanding the improvement observed recently.
 - The normalization of monetary policy by the Federal Reserve.

Economic activity in Mexico during the first quarter of 2017 was stronger than anticipated.

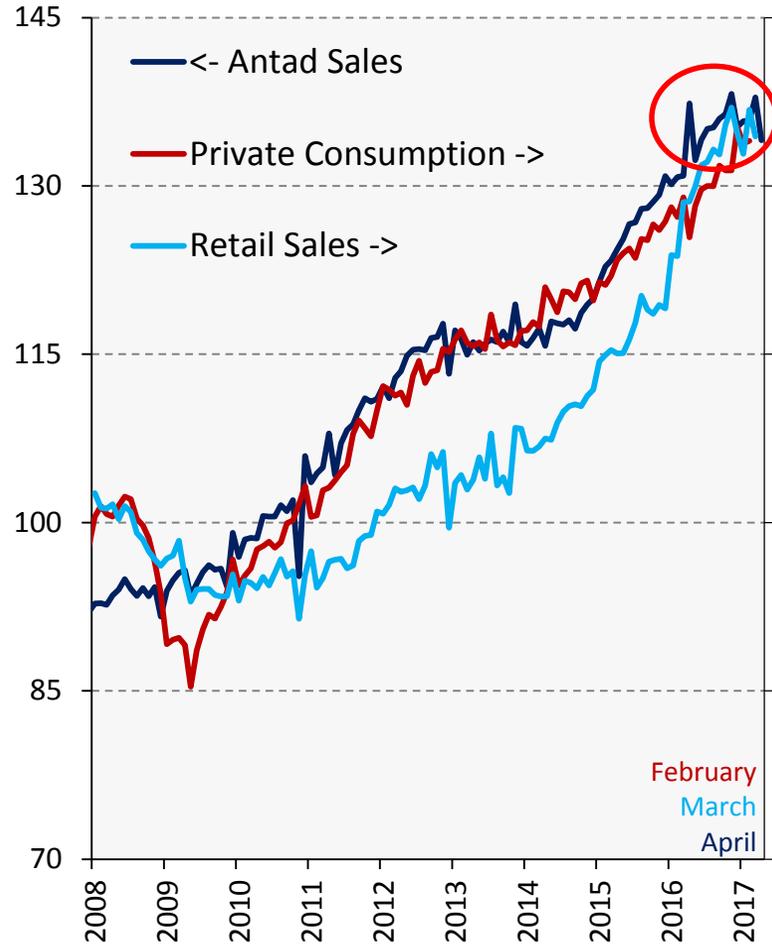
Mexico: Gross Domestic Product
% Change, s.a.



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

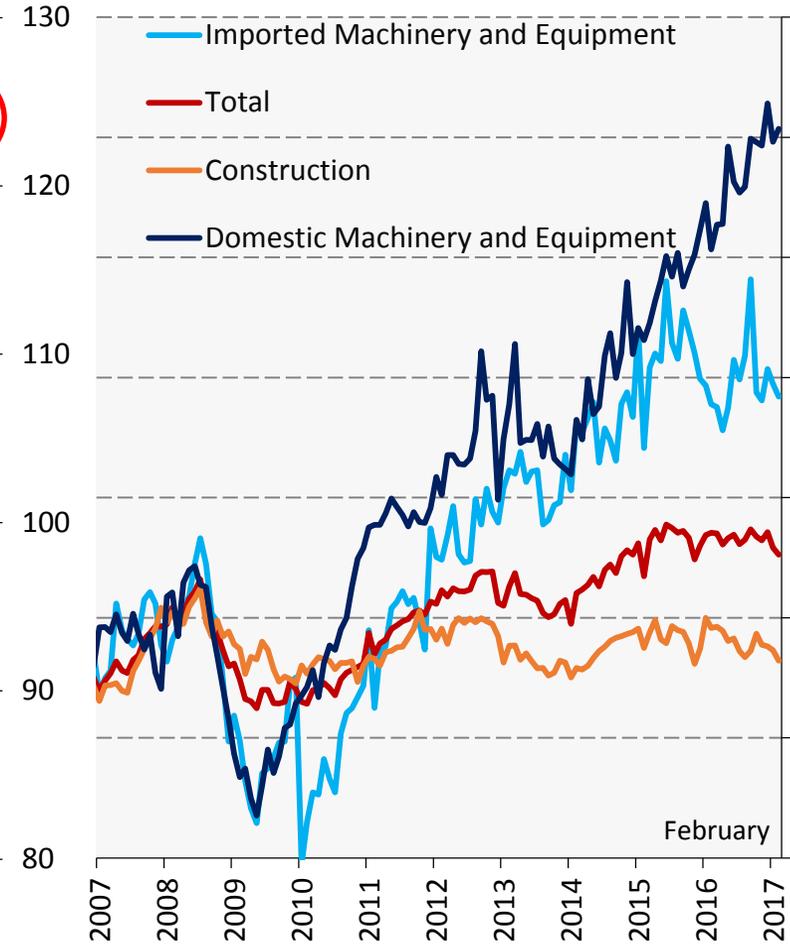
On the demand side, consumption keeps showing a significant year-over-year expansion, although decelerating at the margin, while investment expenditure has weakened further and exports continued to display an upturn.

Domestic Consumption
Index 2008=100; s.a.



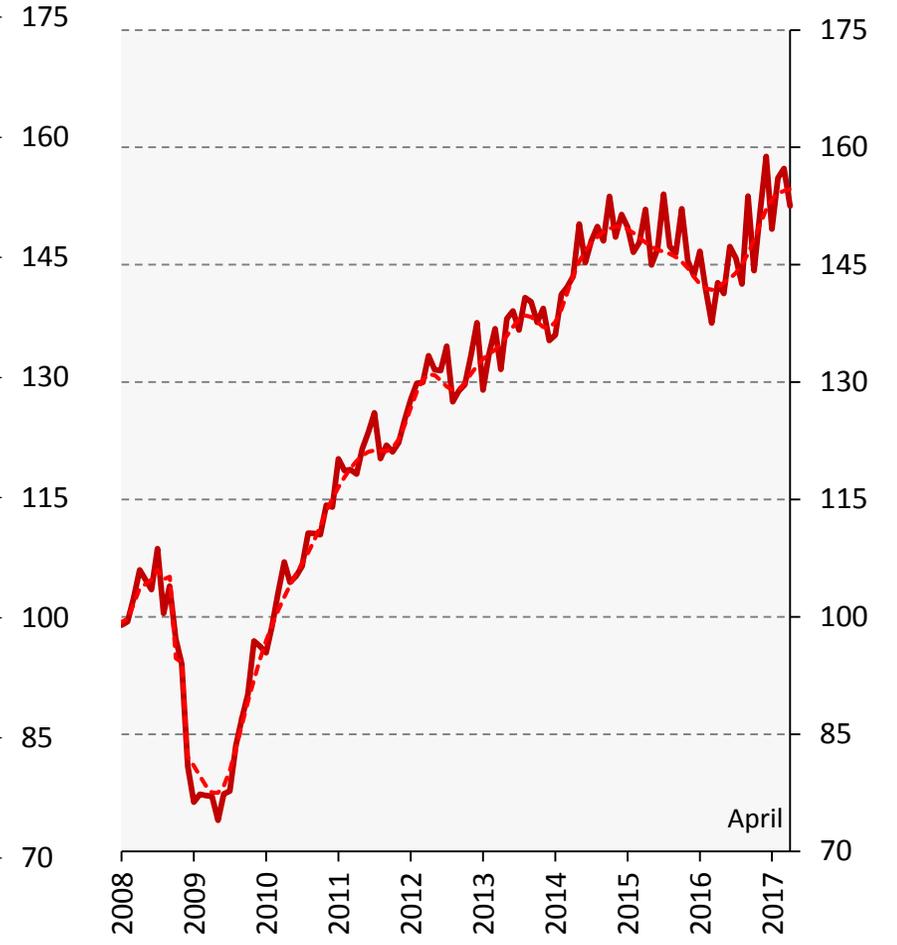
s.a. / Seasonally adjusted data.
Source: INEGI and ANTAD.

Gross Fixed Investment
Index 2008=100, s.a.



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

Manufacturing Exports
Index 2008 = 100; s.a.

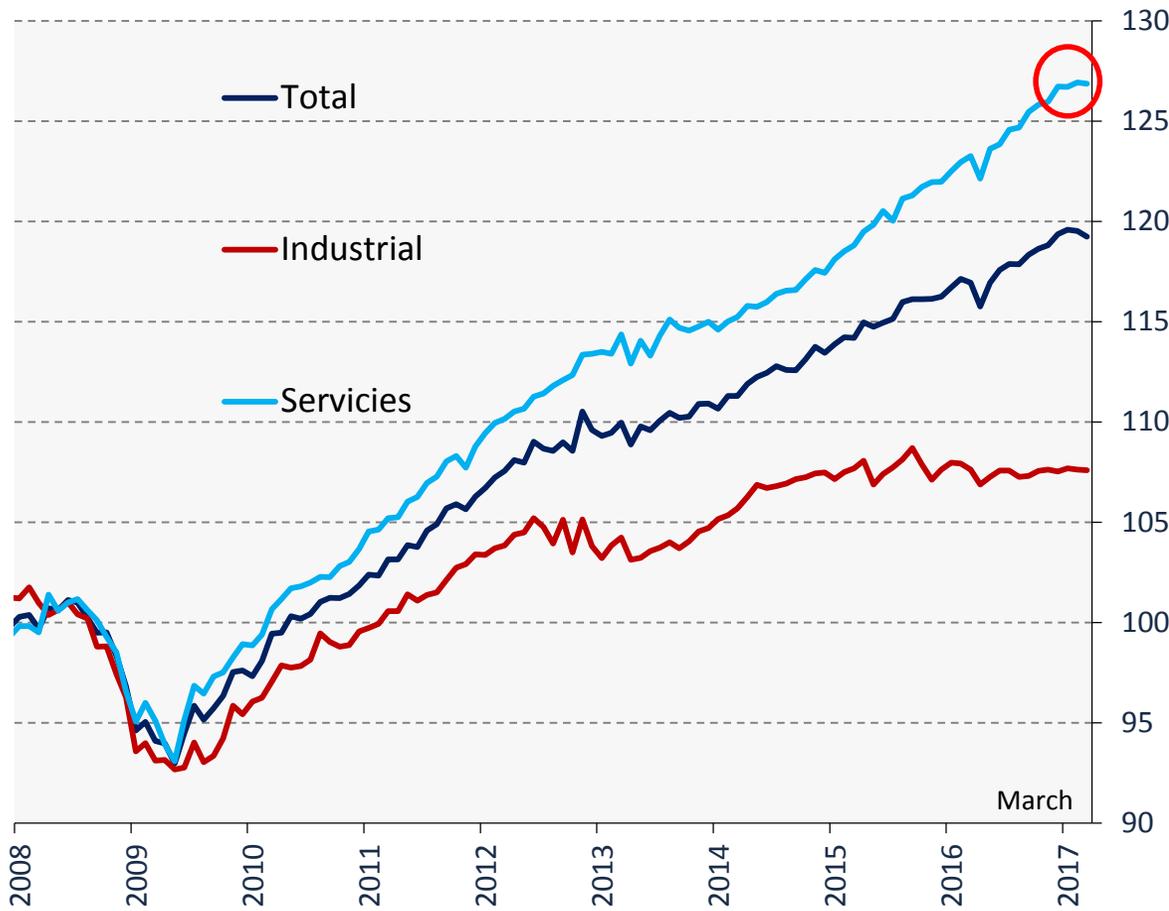


s.a. / Seasonally adjusted data.
Source: Banco de México, INEGI, SAT and SE.

An equivalent pattern is observed among the components of aggregate supply, as illustrated by the expansion of the services sector, with a recent deceleration, and the stagnation of industrial activity, although with an upward trend in manufacturing.

Global Indicator of Economic Activity (IGAE)

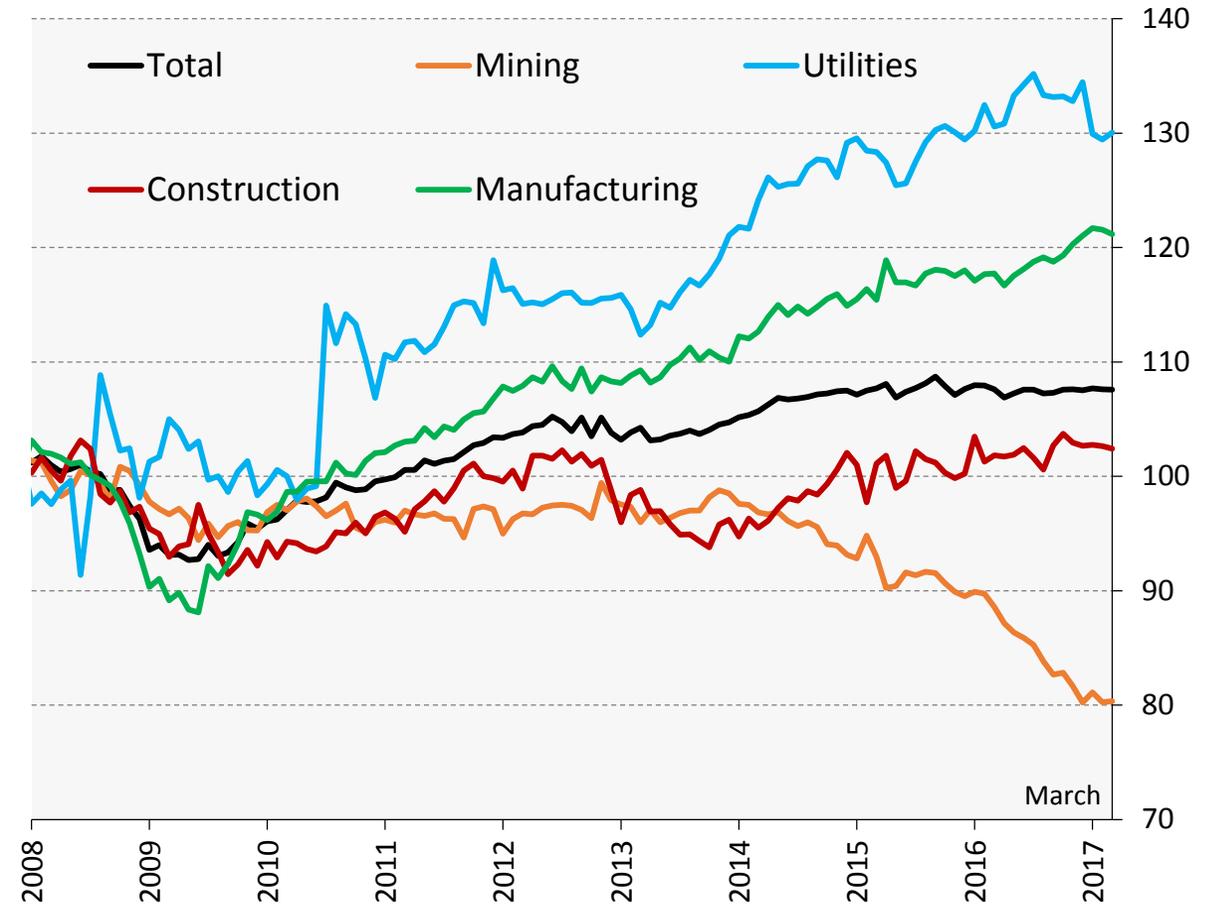
Index 2008=100, s.a.



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

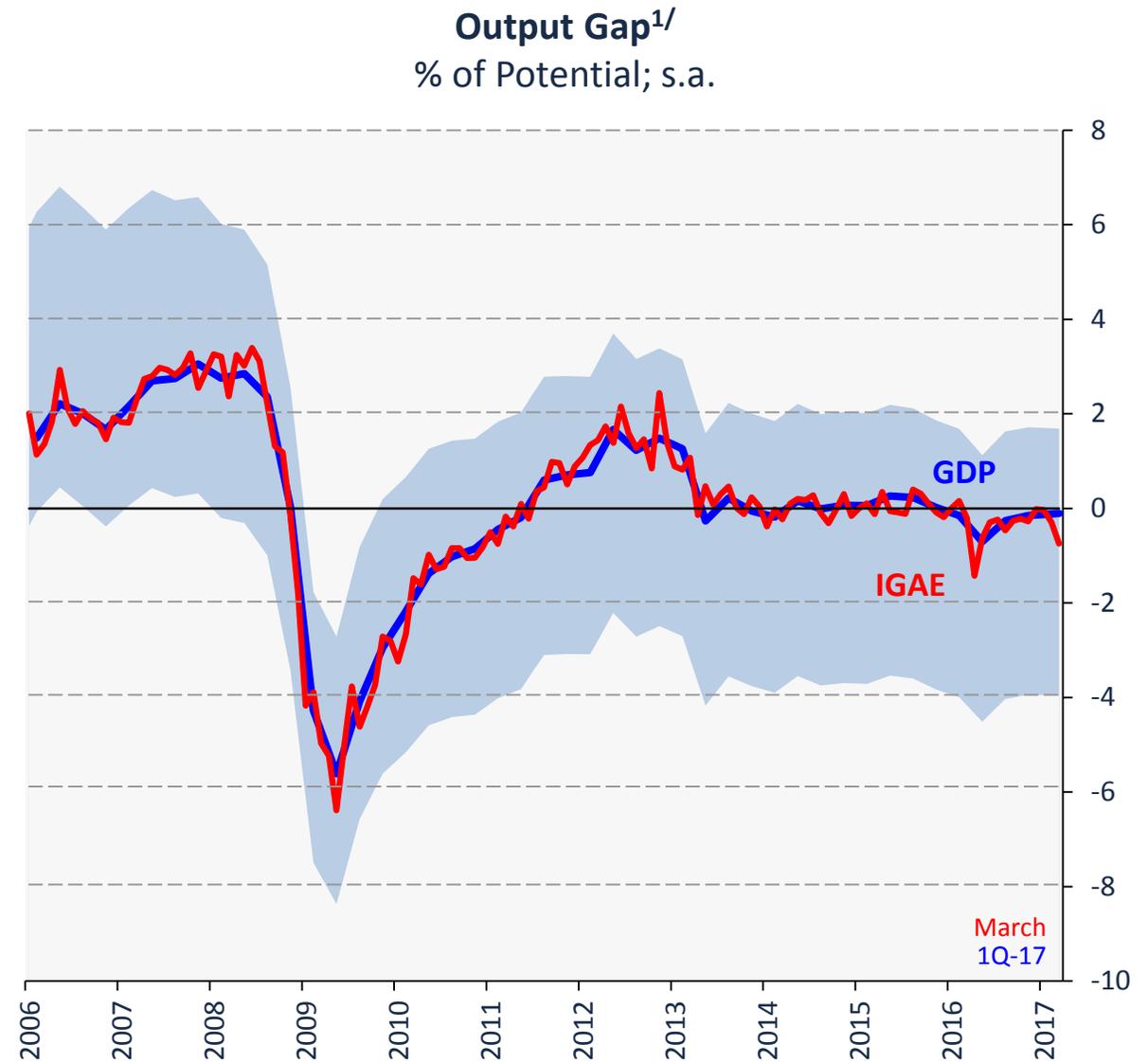
Industrial Activity

Index 2008=100, s.a.



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

- Notwithstanding a better than expected performance during the first quarter, GDP growth is anticipated to decelerate during the rest of the year.
- Slack in the economy seems to have virtually disappeared.
- However, the weakening of economic activity should limit the emergence of demand pressures in coming months.



s.a. / Seasonally adjusted data.

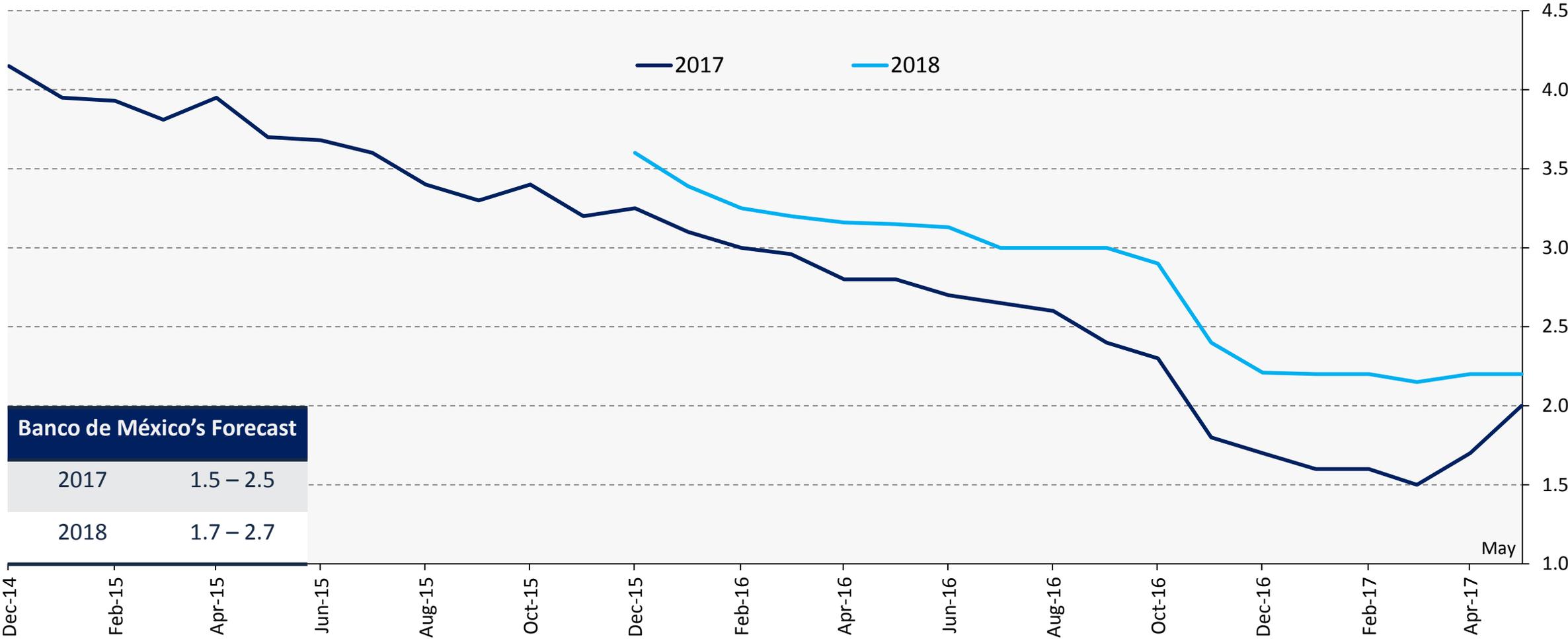
1/ The shaded area indicates the 95% confidence interval.

Source: Banco de México with data from INEGI.

- ❑ A number of factors play a role in the economy's deceleration:
 - The impact on private consumption of the decline in real wages and low levels of consumer confidence.
 - Uncertainty may continue weighing down on confidence of the corporate sector, with adverse implications for investment.
- ❑ On the other hand, given the expectation of a further strengthening of industrial production, including manufacturing, in the US, Mexican exports should continue to recover.

Projections for economic growth in 2017 and 2018 have been adjusted downwards, although with a recent improvement in the case of the former.

Real GDP Growth Forecasts
Annual %

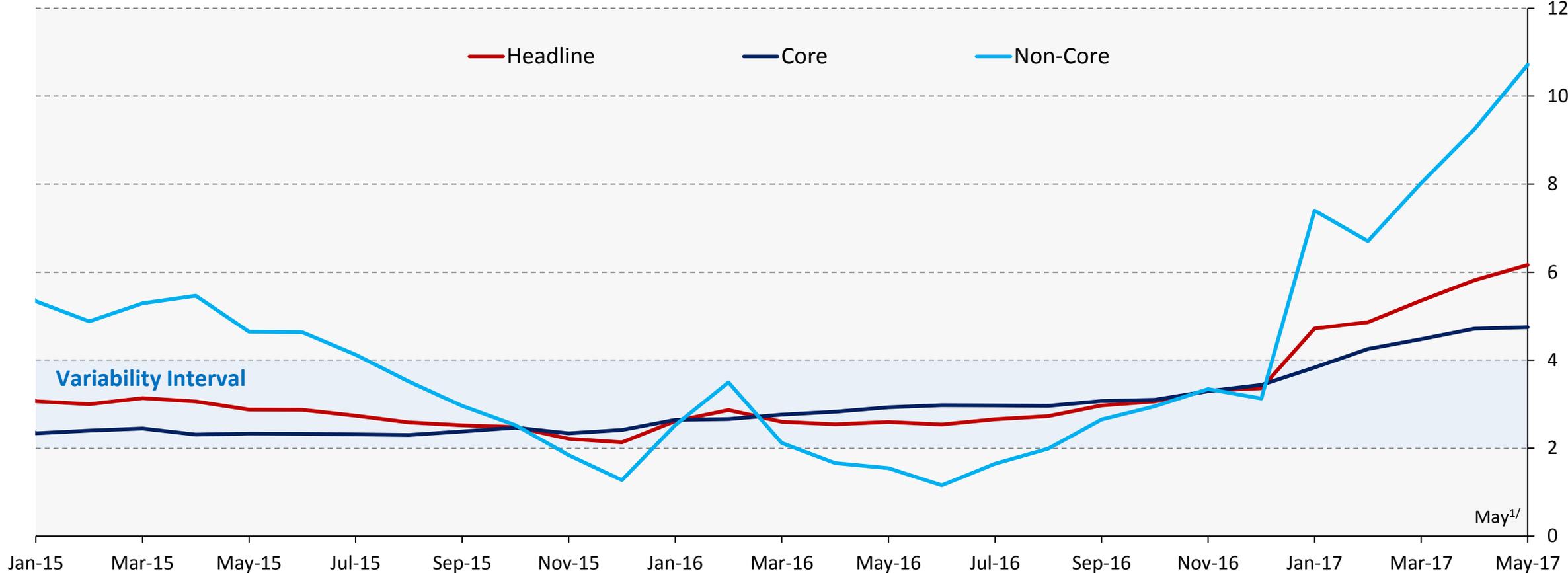


Banco de México's Forecast	
2017	1.5 – 2.5
2018	1.7 – 2.7

Source: Banco de México.

Price growth has increased significantly during 2017. Both headline and core inflation have trended upwards, recording higher-than-expected levels.

CPI Inflation
Annual %



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

Over the course of this year, headline inflation has been well above the upper limit of the variability interval around the permanent target of 3 percent.

- This, mainly as a result of the combined impact of a number of factors:
 - The adjustment of energy prices
 - A more evident pass-through from the exchange rate to prices.
 - Higher agricultural prices.
 - The increase in the minimum wage.
 - Rises in public transport fares.

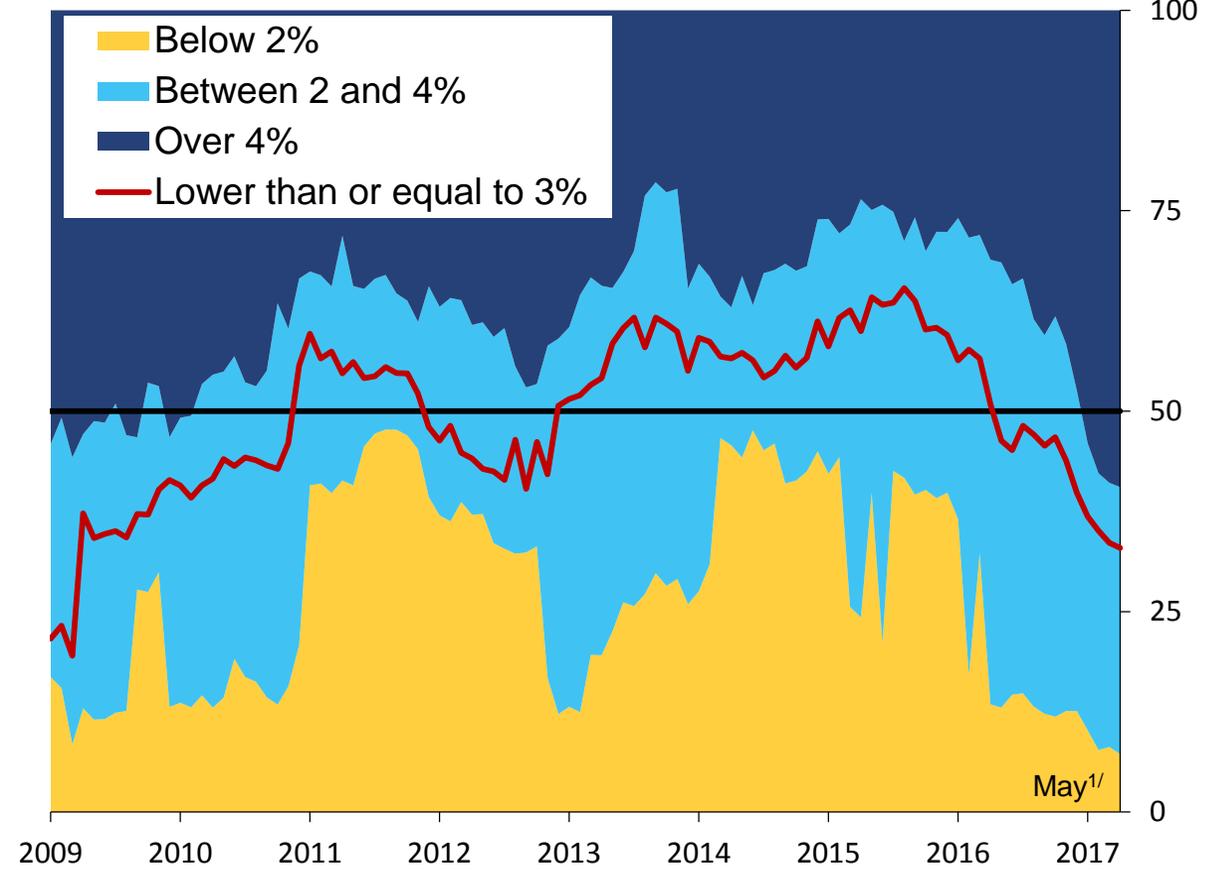
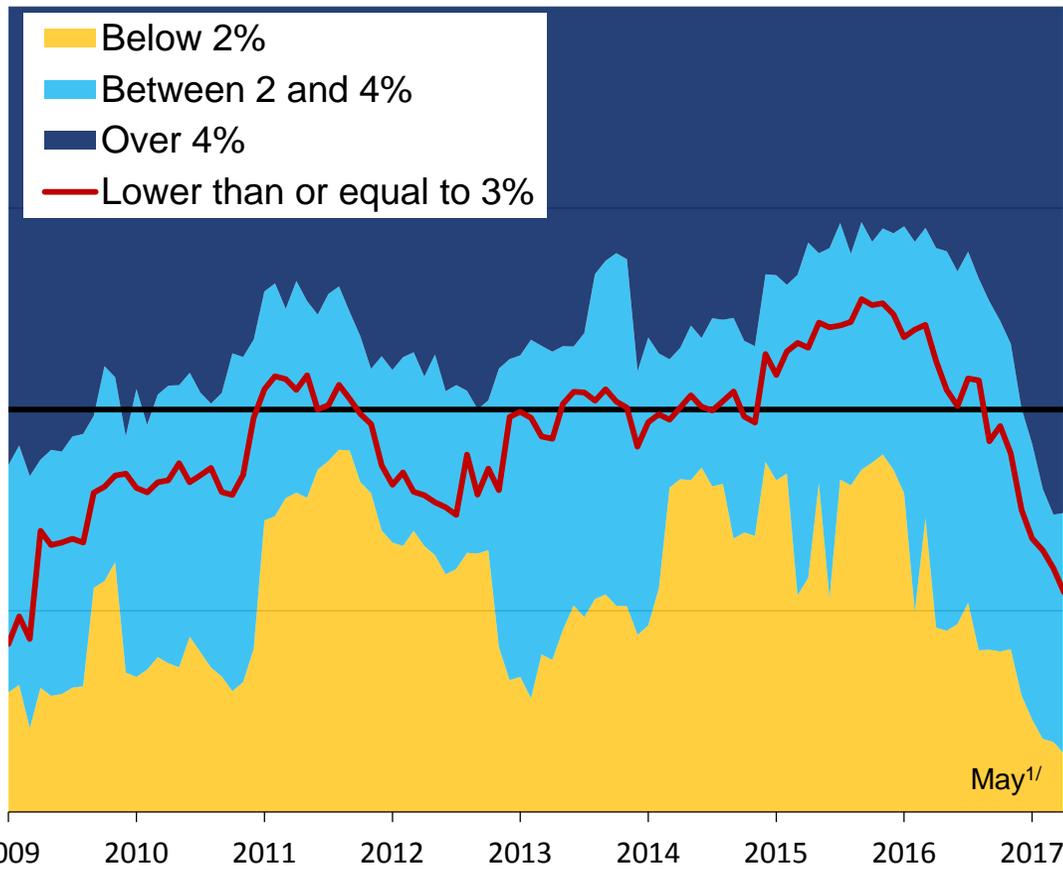
The share of CPI items recording annual price growth above 4 percent has continued to increase, reaching around 60 percent through the first fortnight of May.

Percentage of CPI Basket according to Intervals of Annual Increments

%

Headline

Core



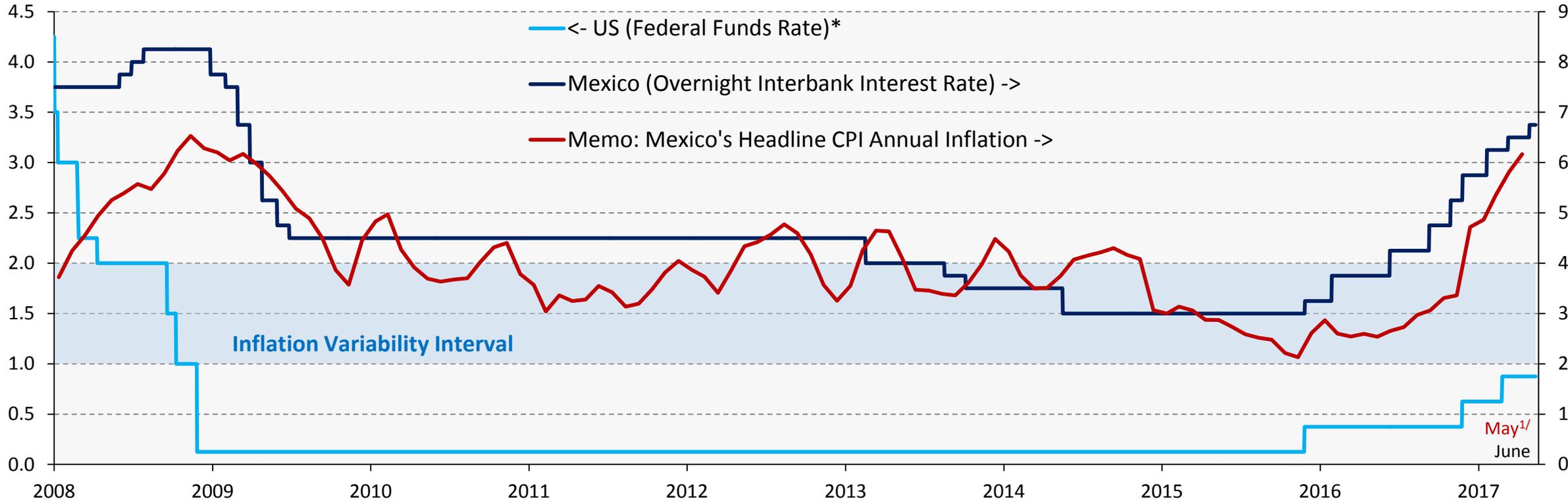
1/ Data through the first fortnight of May.

Source: Banco de México and INEGI.

Inflation is expected to continue rising in the near future, before starting to decline in the second semester of this year, and at a faster pace in 2018. This, mainly as a result of the monetary policy adjustments implemented since late 2015, which have yielded an accumulated 375 basis-point increase in the reference interest rate.

Monetary Policy Rates

%

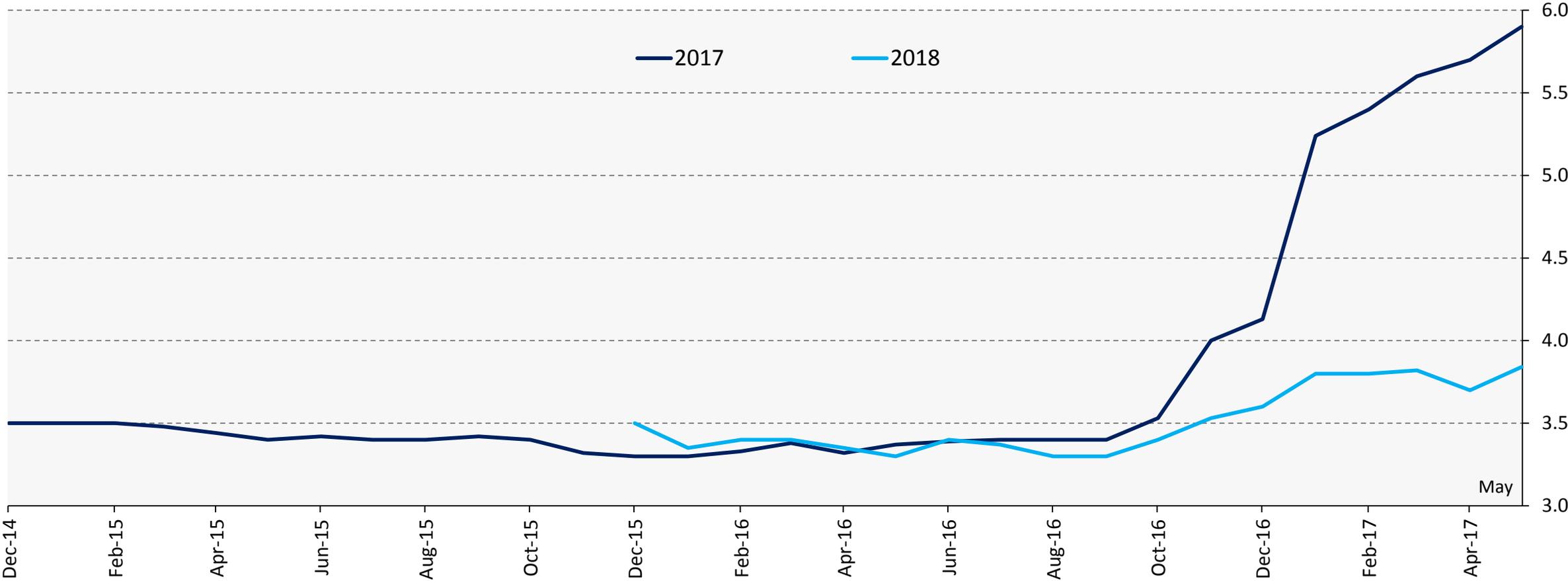


1/ Data through the first fortnight of May.
 */ Mid-point of the target range from 16 December 2008 onwards.
 Source: Banco de México, INEGI and Federal Reserve.

- In addition, the decline in inflation will be influenced by:
 - The gradual fading of the shocks that have affected price growth.
 - The deceleration of economic activity.
 - The recent appreciation of the peso.
 - Base effects.

Survey-based inflation expectations display a pattern consistent with this trajectory. Nonetheless, inflation expectations for 2017 have increased significantly, while those for end-2018 remain at levels above the target.

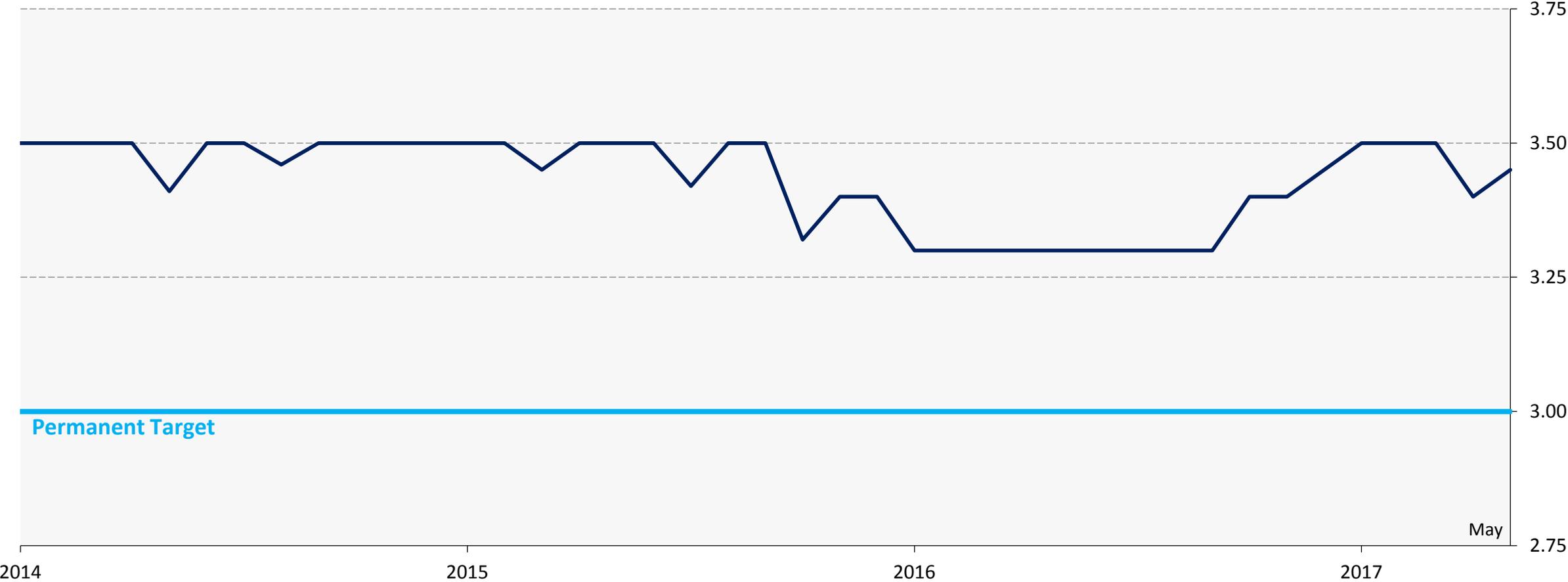
Short-Term Inflation Expectations
Annual %



Source: Banco de México.

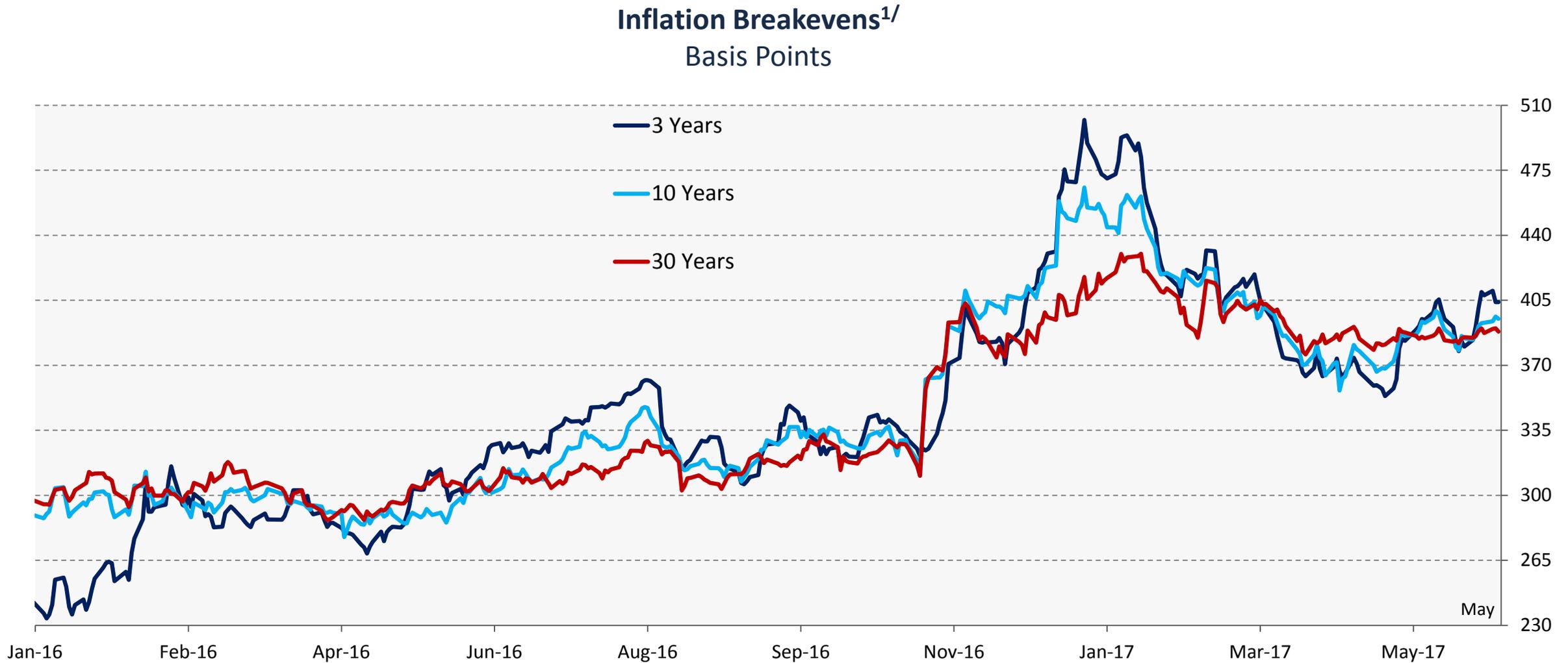
Survey-based inflation expectations for the long term have remained stable around 3.5 percent.

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



1/ Median expectation for the next 4-8 years.
Source: Banco de México.

Inflation breakevens have displayed a volatile behavior throughout the year, remaining at relatively high levels.



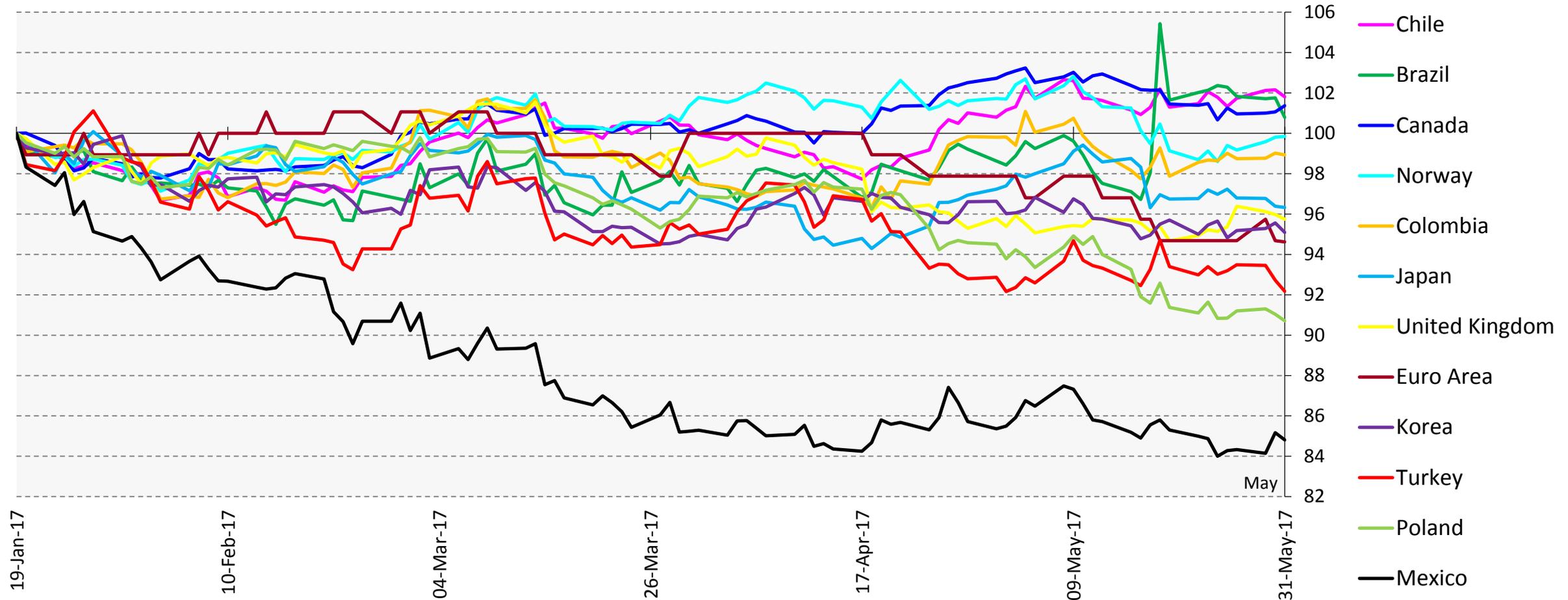
^{1/} Difference between yields on nominal and real (inflation-protected) bonds. In addition to expected inflation, this measure includes other (e.g. inflationary, liquidity and term) risk premia.
Source: Banco de México with information from PiP.

The balance of risks for inflation during this and next year remains tilted to the upside.

- ❑ So far, there is no evidence of second round effects on inflation.
 - Long-term inflation expectations remain stable.
 - Even though services inflation has increased, this responds mainly to cost effects derived from higher energy prices, a slower decline in telecommunications prices, and seasonal factors.
- ❑ Nonetheless, in light of the adverse inflation results and the multiplicity of shocks that have contributed to this outcome, the risk of second round effects has increased.
- ❑ To this, one may add the possibility of:
 - Further pressures on the exchange rate.
 - A higher pass-through coefficient.

The exchange rate of the peso vis-à-vis the US dollar has displayed a favorable behavior during 2017, and particularly since mid-January.

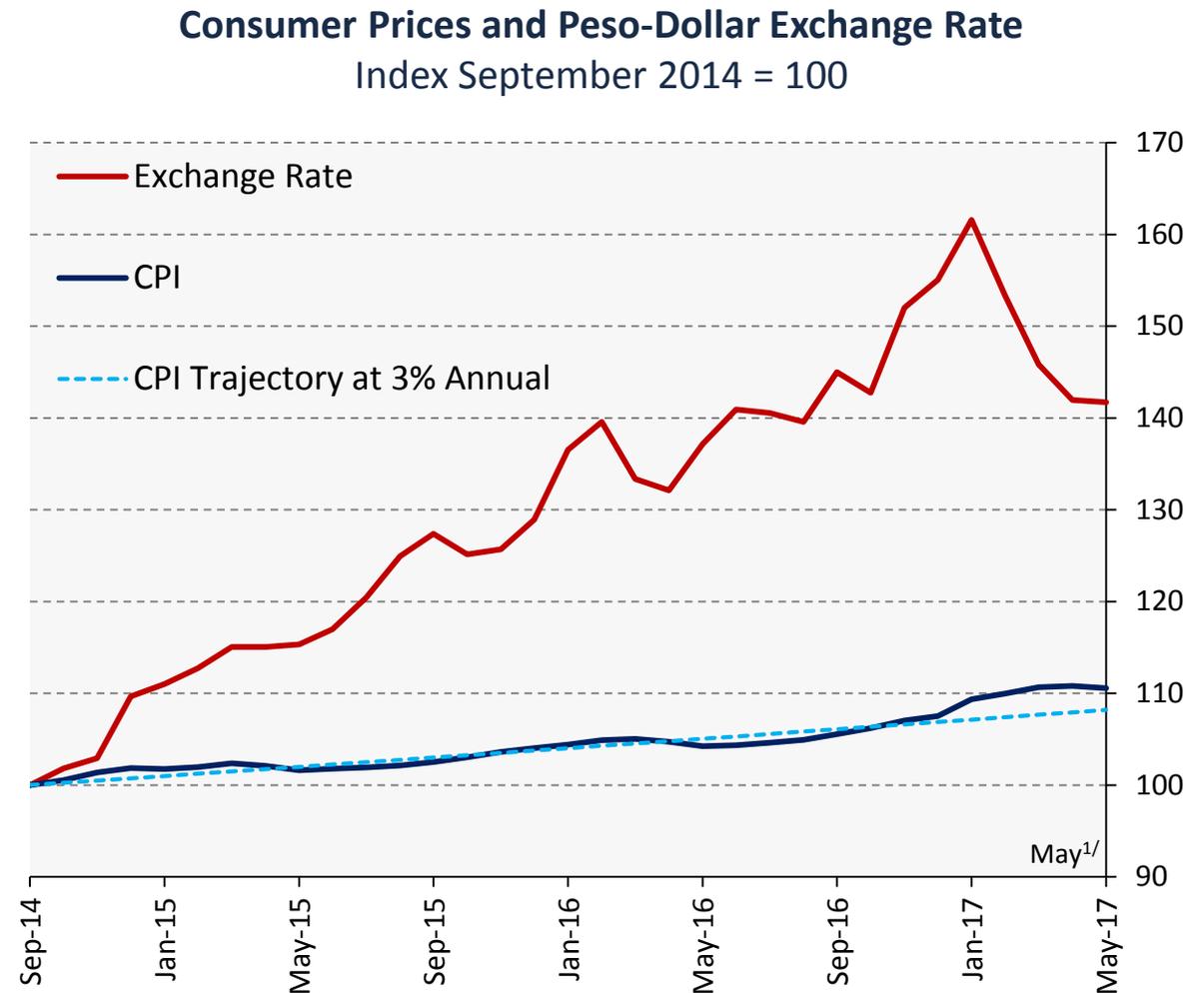
Nominal Exchange Rate with Respect to the US Dollar
Index 19-Jan-2017 = 100



Source: Bloomberg.

However, the peso-dollar rate remains highly sensitive to developments in a number of fronts, and especially to the likely evolution of the Mexico-US economic relationship.

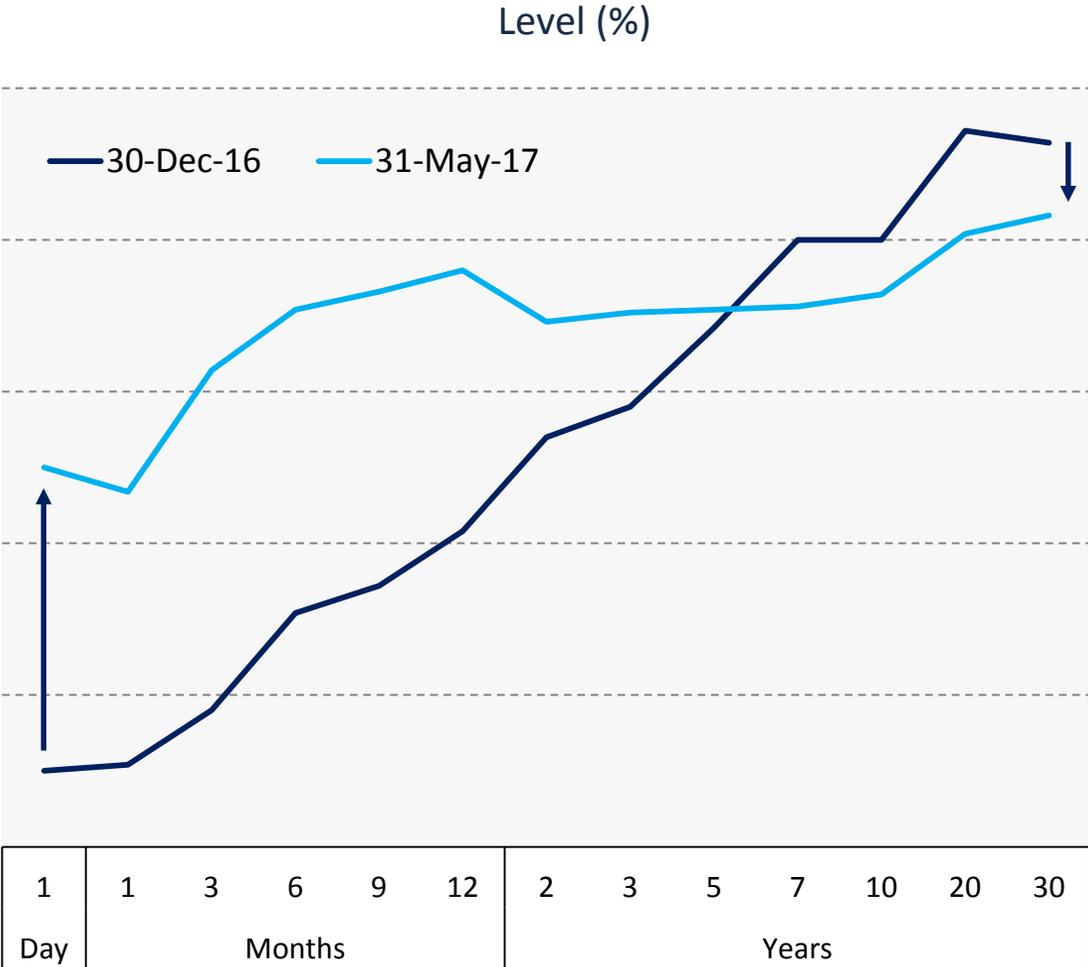
- In light of the above, and in presence of other risk factors, both domestic and external, the potential for sharp swings in the peso exchange rate in coming months remains.
- It is also important to take into account that in view of the accumulated depreciation of the peso since September 2014, the possibility of lagged effects on prices cannot be ruled out.



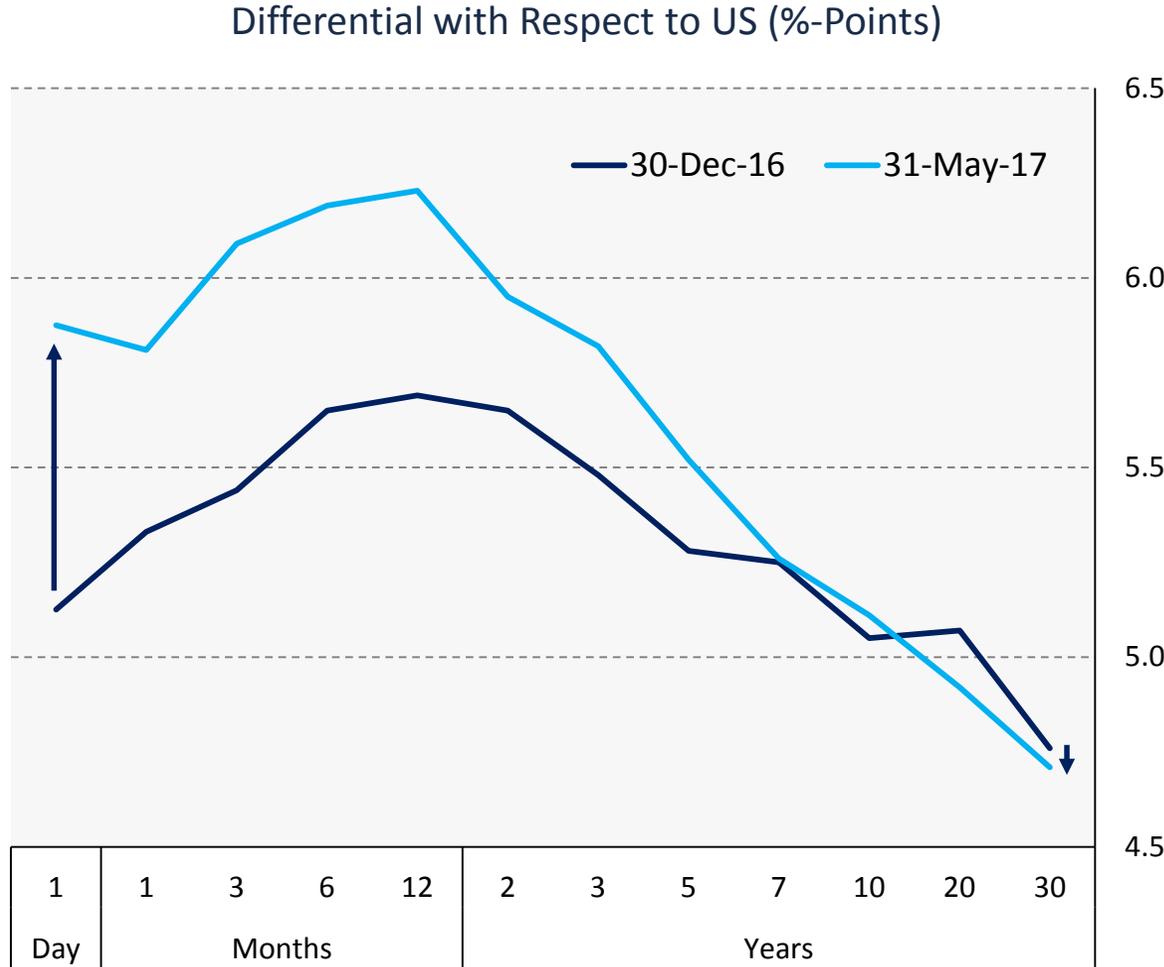
1/ CPI data through the first fortnight of May.
Source: INEGI and Banco de México.

Domestic medium- to long-term interest rates, as well as their differential with respect to those in the US, have declined during the course of 2017.

Domestic Interest Rates



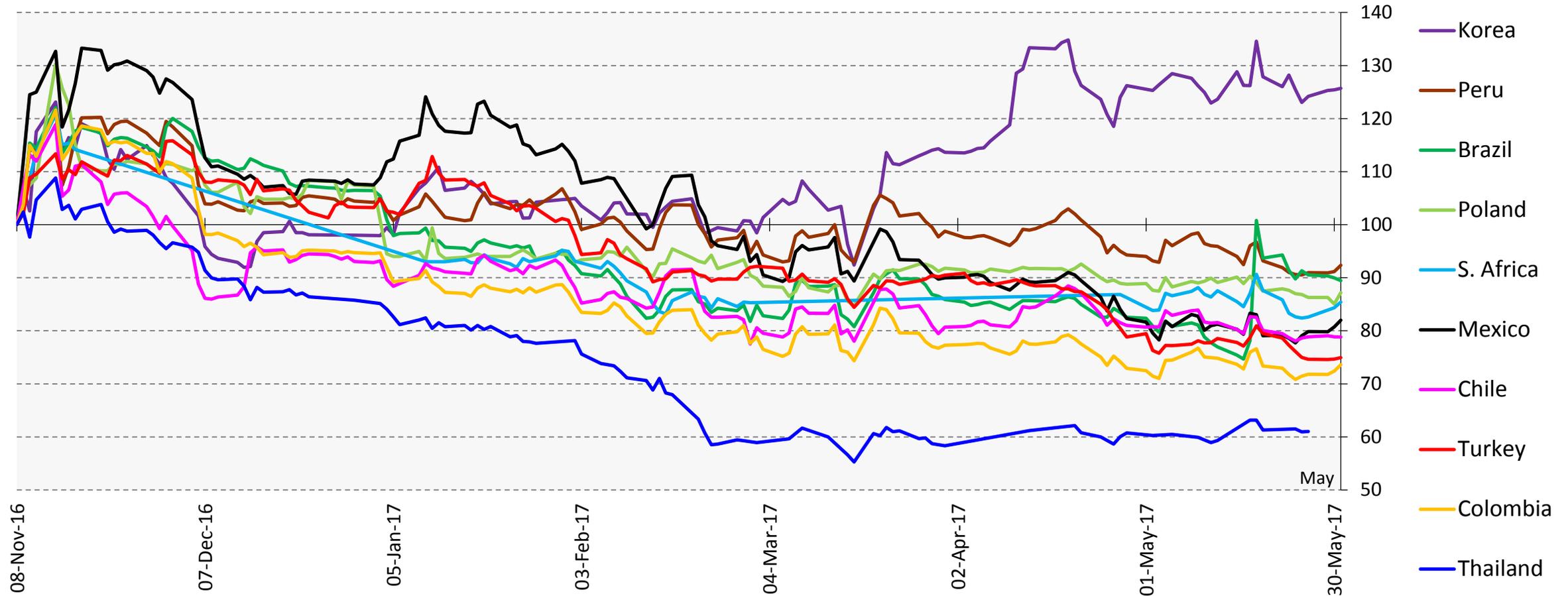
Source: Banco de México and PiP.



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

Mexico's credit default swaps have more than reverted their increase following the end of last year's electoral process in the US, although they remain above those of other economies with similar credit ratings.

Emerging Market Economies: Credit Default Swaps^{1/}
Index 08-Nov-2016 = 100



^{1/} 5-year CDS.
Source: Bloomberg.

□ Therefore, monetary policy in Mexico faces a scenario with mixed features:

- Indications that economic activity is decelerating.
- Low likelihood of demand pressures on prices.
- Stable long-term inflation expectations.

But at the same time:

- Inflation performance above expectations.
- A generalization of pressures on prices.
- A probably higher pass-through from the exchange rate to prices.
- Increased upside risks.

- Furthermore, the most likely setting for coming months includes:
 - An inflation rate significantly above the upper limit of the variability interval around Banco de México's target for the rest of the year.
 - New hikes in the US federal funds rate.
 - An environment of high uncertainty, with potential implications for the exchange rate and prices.

- ❑ Under these circumstances, a cautious monetary policy stance is needed, since otherwise second round effects on prices may emerge, with the credibility of monetary policy affected.
- ❑ This points to the probability of higher interest rates in Mexico in coming months.
- ❑ The margins of maneuver for monetary policy should widen as convergence of inflation towards the target becomes evident.
- ❑ The latter should be reinforced by continuous consolidation of the fiscal effort underway.



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