



The Mexican Economy: Coping with a Challenging Environment

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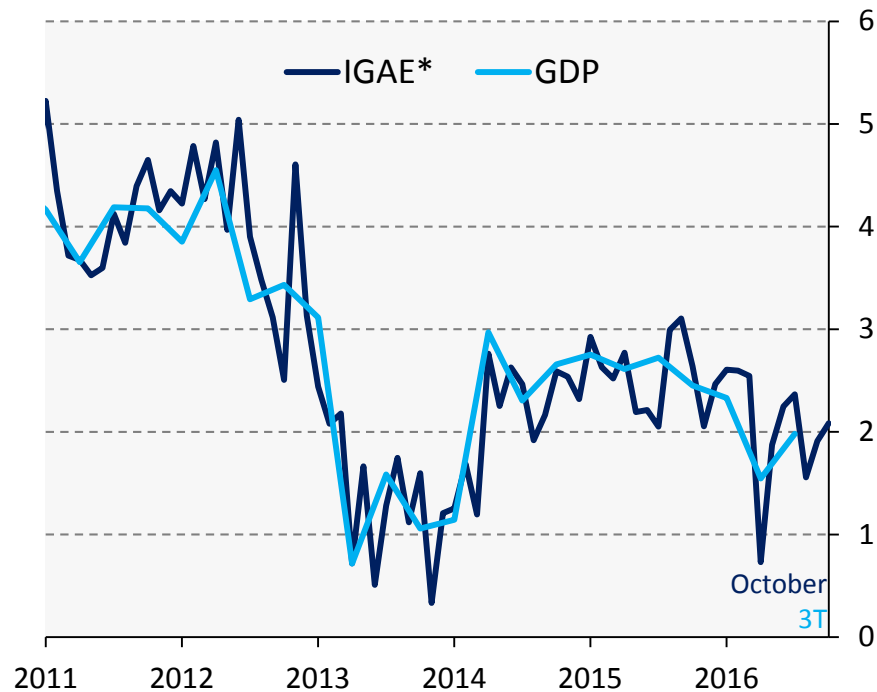


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- ❑ The Mexican economy faces a difficult external environment:
 - ✓ Modest growth of global economic activity and trade.
 - ✓ Weak exports and industrial production in the United States.
 - ✓ Low oil prices.
 - ✓ The normalization of monetary policy by the Federal Reserve.
 - ✓ A context of generalized uncertainty.
- ❑ The situation has been further complicated by the result of the electoral process in the US.
- ❑ In addition, a number of challenges of a domestic nature remain:
 - ✓ Decline in oil output.
 - ✓ Increase in the public-debt-to-GDP ratio.

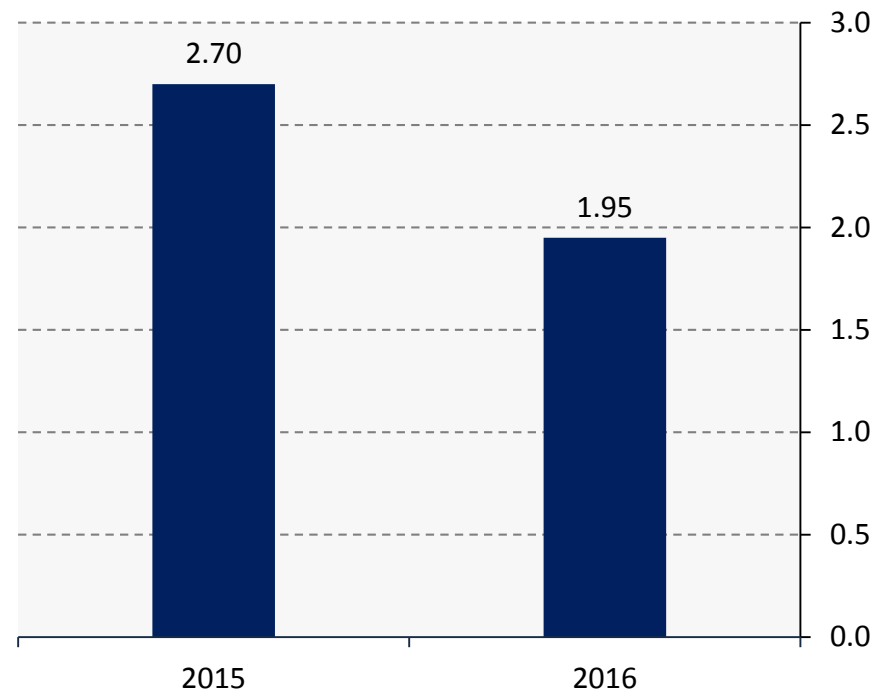
As a result of both domestic and external factors, Mexico's GDP shows a moderate rate of growth and signs of deceleration.

Mexico: Total Output
Annual % Change, s.a.



s.a./ Seasonally adjusted.
*/ Monthly GDP proxy.
Source: INEGI.

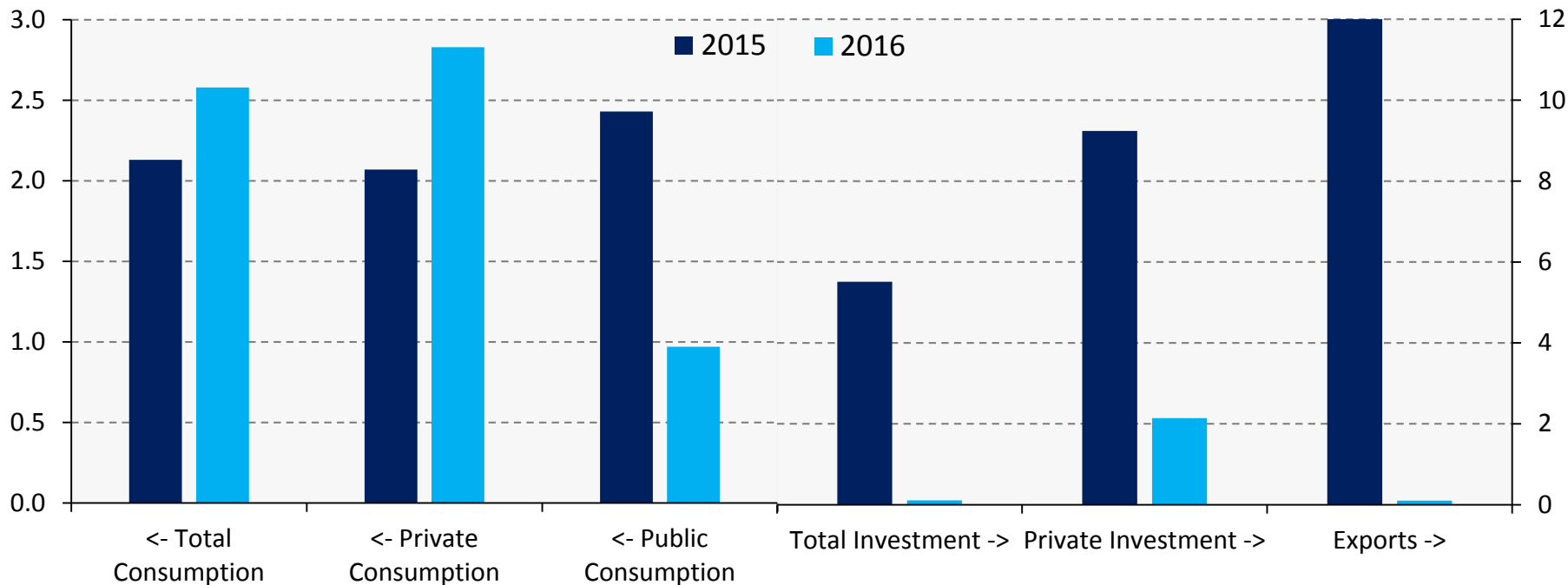
Mexico: Gross Domestic Product
Accumulated Annual % Change through 3Q, s.a.



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

On the demand side, this is explained by the combination of a dynamic private consumption and weak investment, exports and public spending.

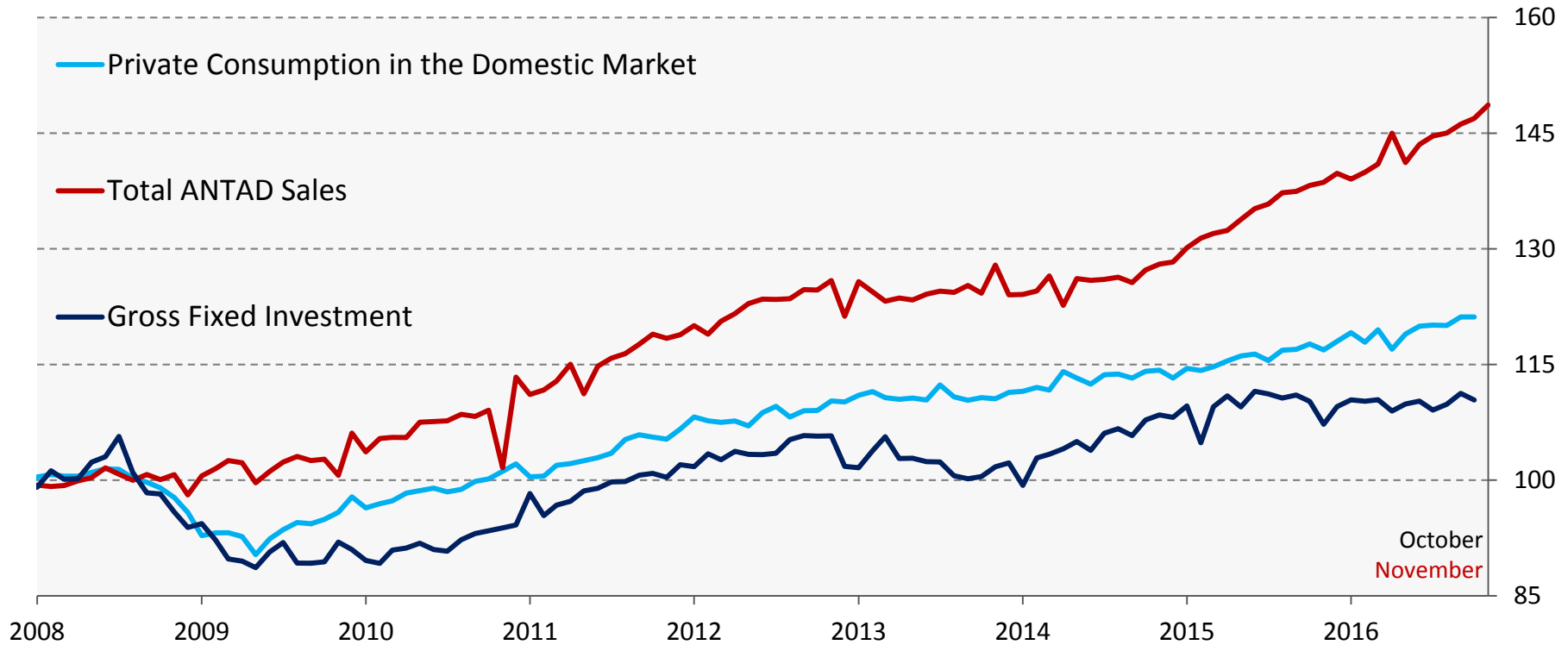
Mexico: Aggregate Demand Components
Accumulated Annual % Change through 3Q, s.a.



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

These trends in general continued during the fourth quarter of 2016...

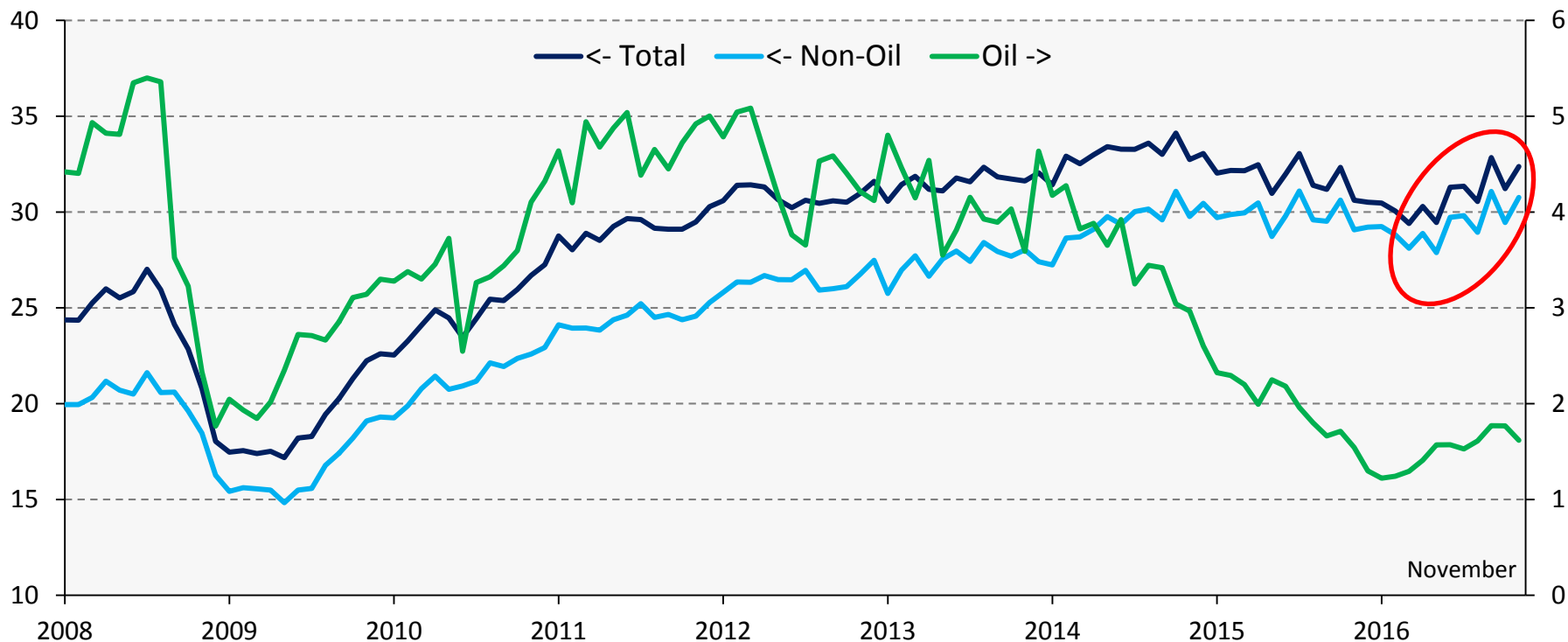
Mexico: Consumption and Investment
Index 2008 = 100, s.a.



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

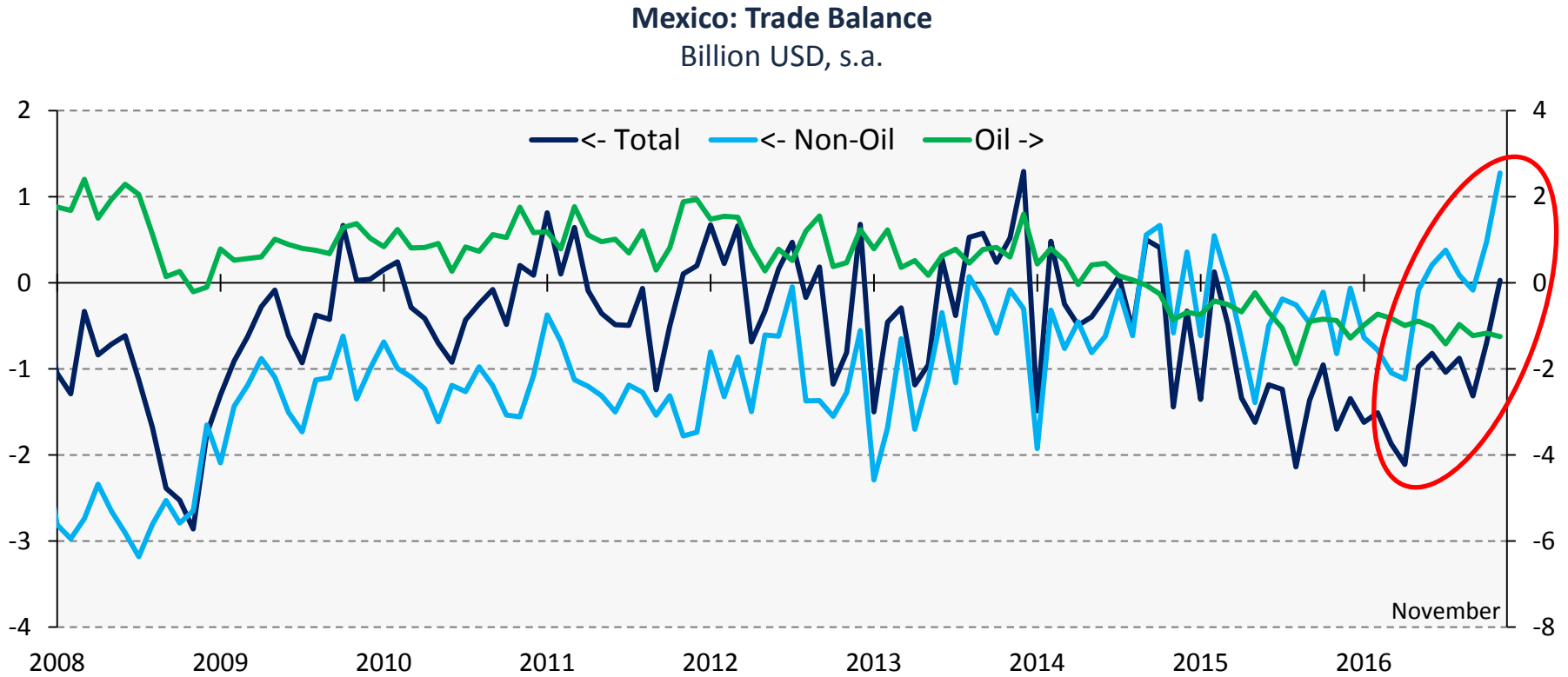
...but it is worth to note that exports have increased recently...

Mexico: Merchandise Exports
Billion USD, s.a.



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

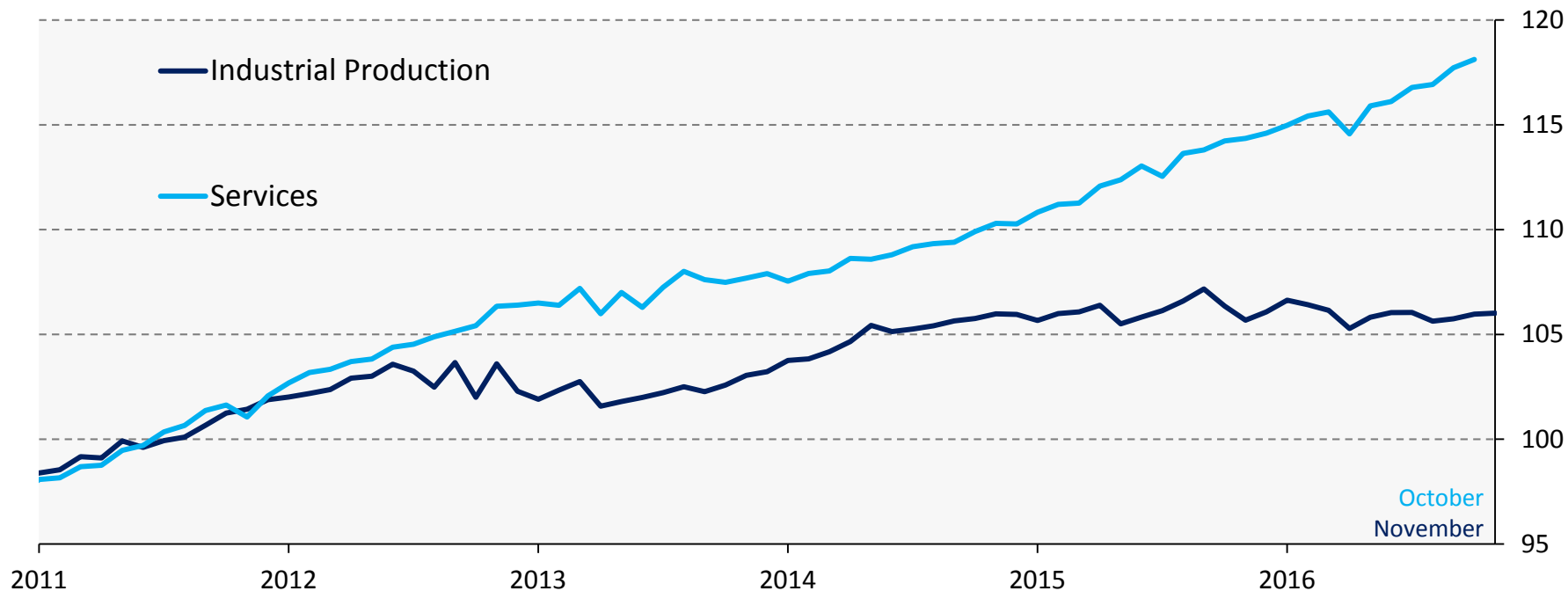
... which together with the adjustment of imports has improved the trade balance, and particularly its non-oil component.



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

On the supply side, the services sector continues to provide support to overall economic activity, but industrial production remains laggard.

Mexico: Industrial Production and Services Activity
Index 2011 = 100, s.a.

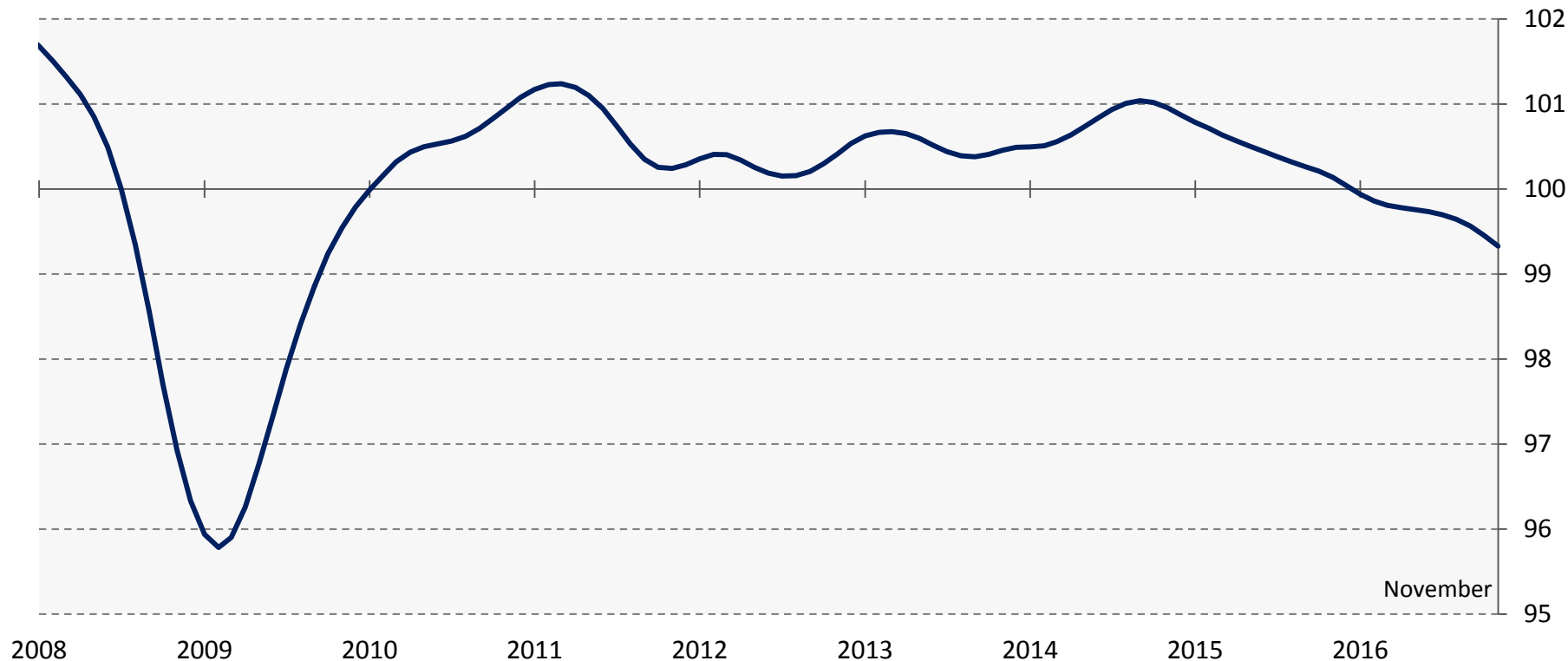


s.a./ Seasonally adjusted.
Source: INEGI.

Leading indicators suggest that the deceleration of economic activity may continue.

Mexico: Leading Indicator of the Economic Cycle

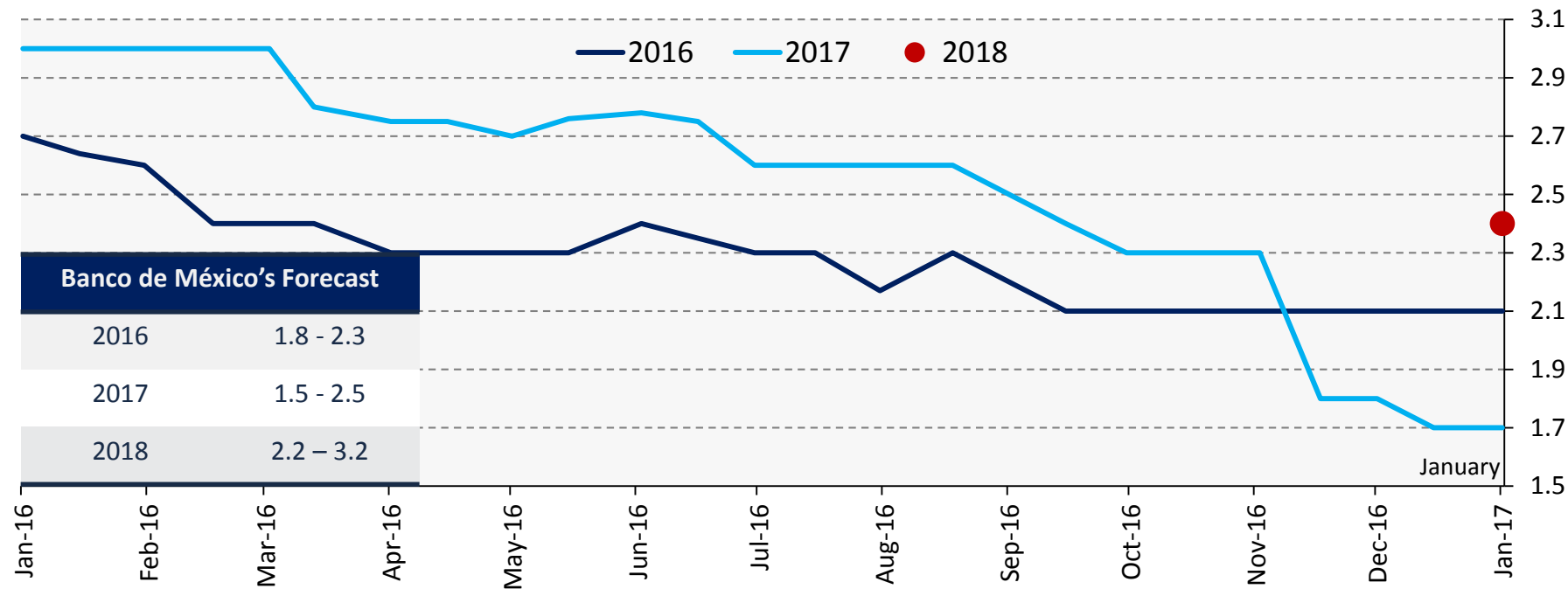
Index 2008 = 100, s.a.



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

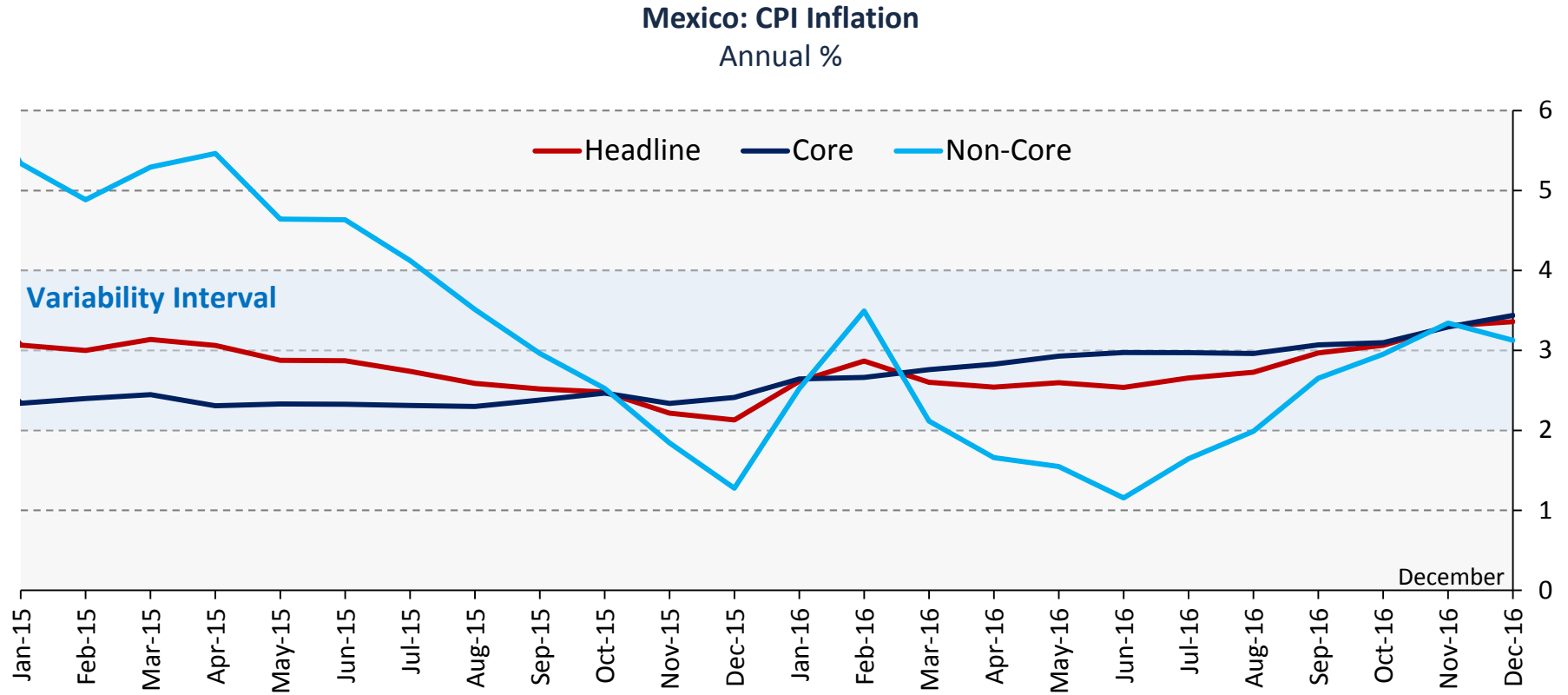
In this context, and in view of the prevailing uncertainty, growth projections for 2016-17 have been adjusted downwards, with an upturn expected in 2018.

Mexico: Real GDP Growth Projections
Annual %



Source: Banco de México and Citibanamex.

Inflation increased during 2016 due to an upward trend of both its core and non-core components.



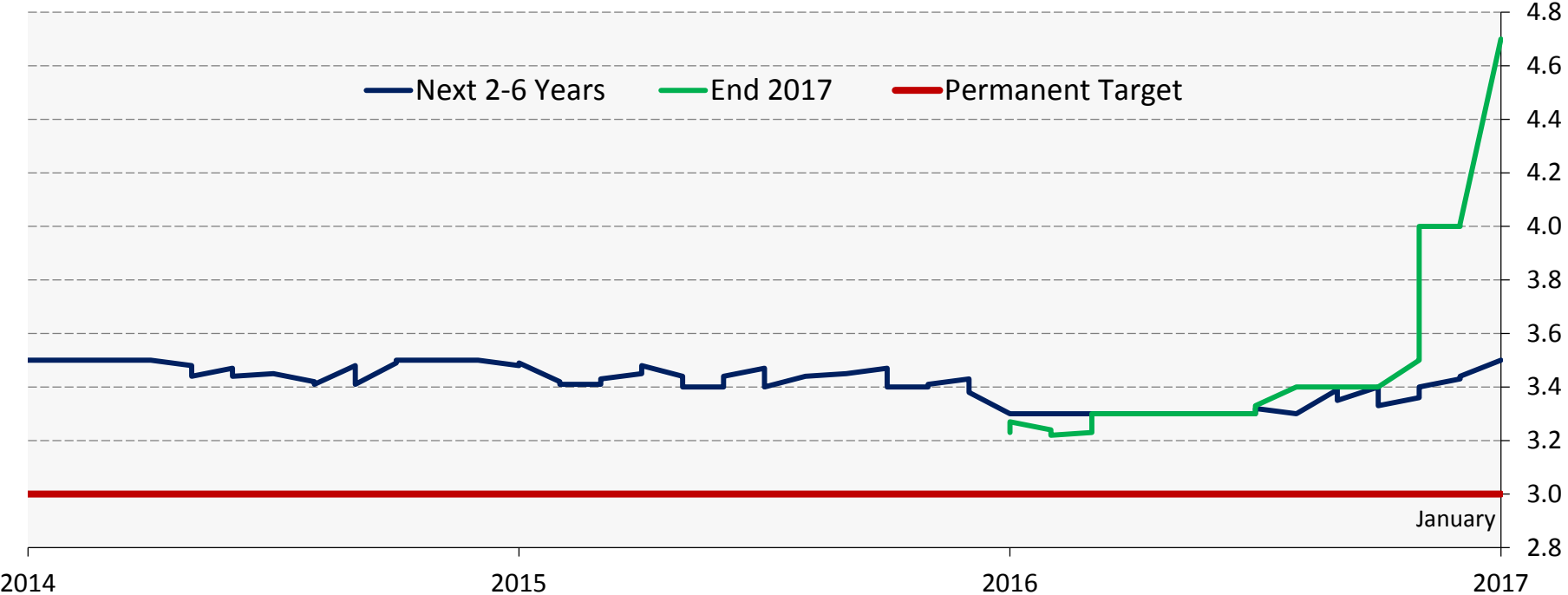
Source: INEGI.

- Inflationary pressures rose in early 2017 and are expected to accentuate during the year, due to a large extent to the increase in the prices of gasoline and their programmed liberalization over the course of 2017.
- ✓ Against the background of higher international prices and the depreciation of the peso, to avoid an adverse impact on public finances, gasoline and diesel maximum prices increased throughout the country by an average of 14.2-20.1% in January vs. December.
- ✓ The current schedule foresees a gradual liberalization process across regions, to allow prices to be fully determined by market mechanisms. This process should be completed by the end of the year.
- ✓ In the meantime, domestic fuel prices in the not-yet-liberalized regions will be adjusted on the basis of their international reference, while also taking into account logistic and other costs, such as applicable taxes and profit margins.

- ❑ In addition, inflation in 2017 may be affected, among others, by:
 - ✓ The liberalization of gas prices.
 - ✓ The increase in the minimum wage in early 2017.
 - ✓ The possibility of a more depreciated equilibrium real exchange rate in light of the results of the US presidential election.
 - ✓ The risk of further increases in the prices of agricultural goods and livestock.

Thus, survey-based inflation expectations have deteriorated, with the increase concentrated mostly in the short term.

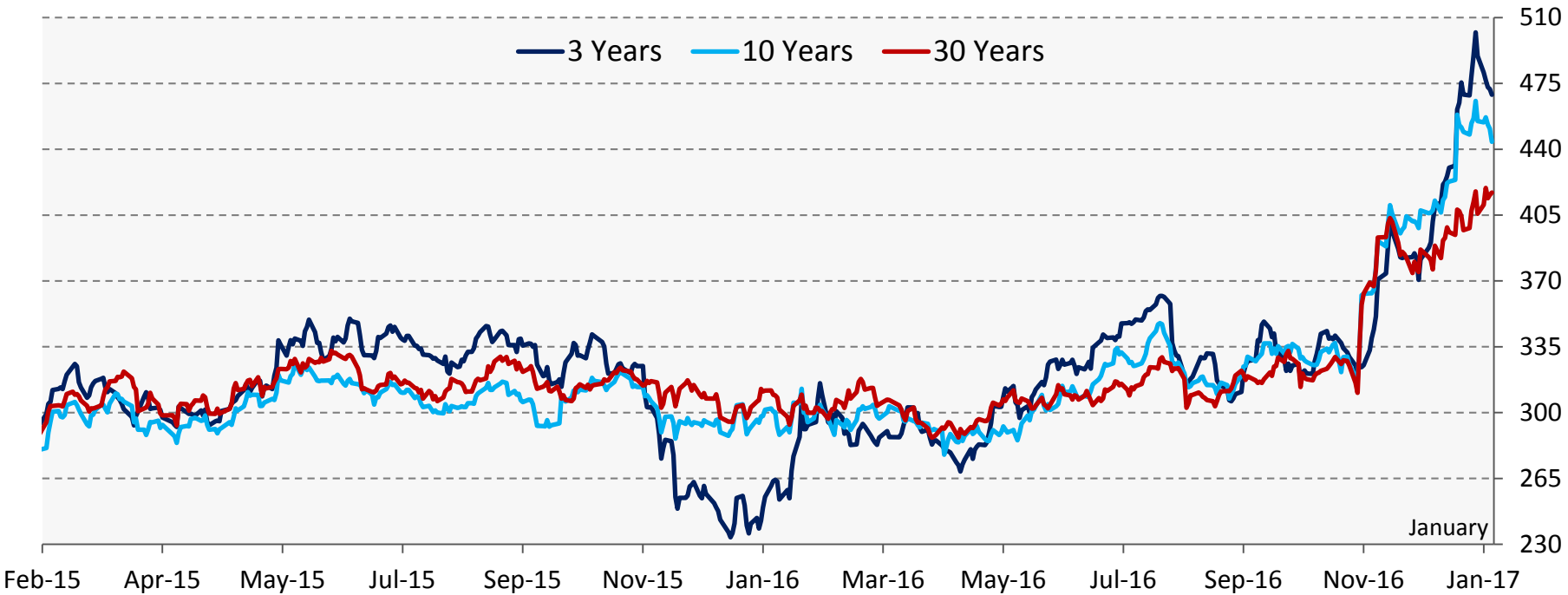
Mexico: Inflation Expectations^{1/}
Annual %



1/ Median expectation.
Source: Citibanamex.

On the other hand, the differential between nominal and real yields on government securities has increased significantly.

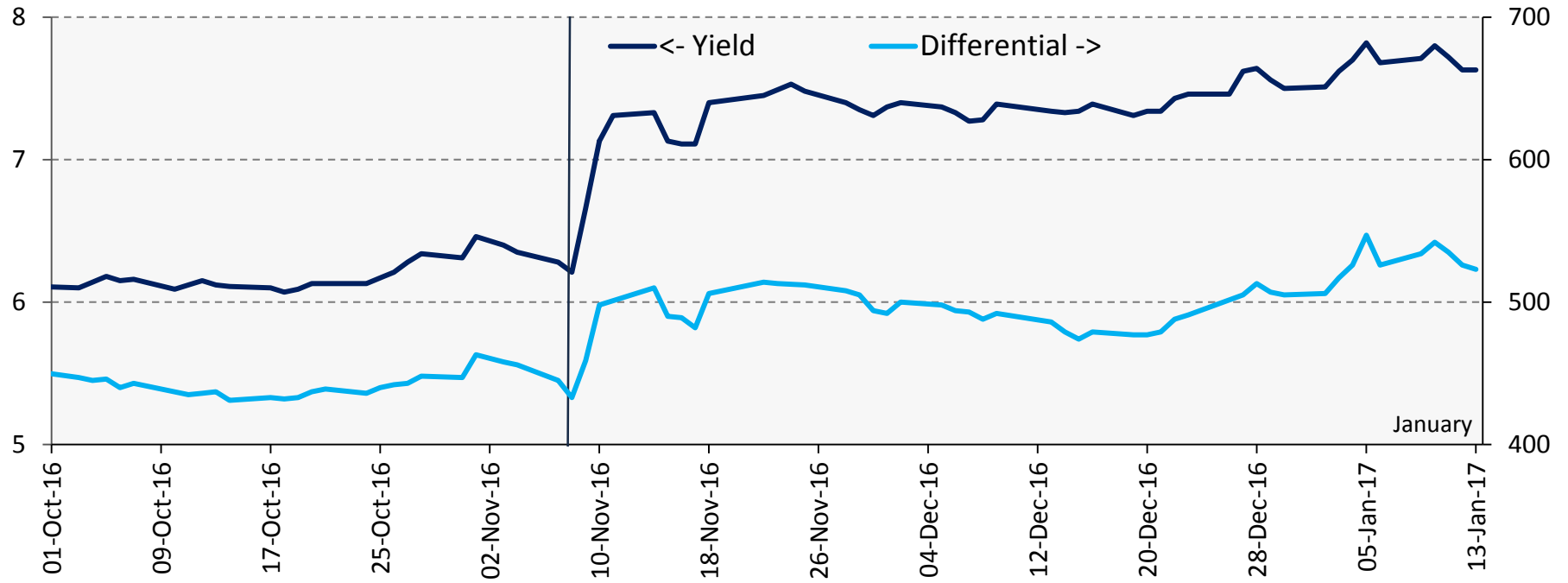
Mexico: Inflation Breakevens^{1/}
Basis Points



^{1/} Difference between yields of 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.

Domestic financial markets have been affected by the outcome of the US presidential election.

Mexico: 10-Year Government Bond Yields and Differential with Respect to US Treasury Note % and Basis Points

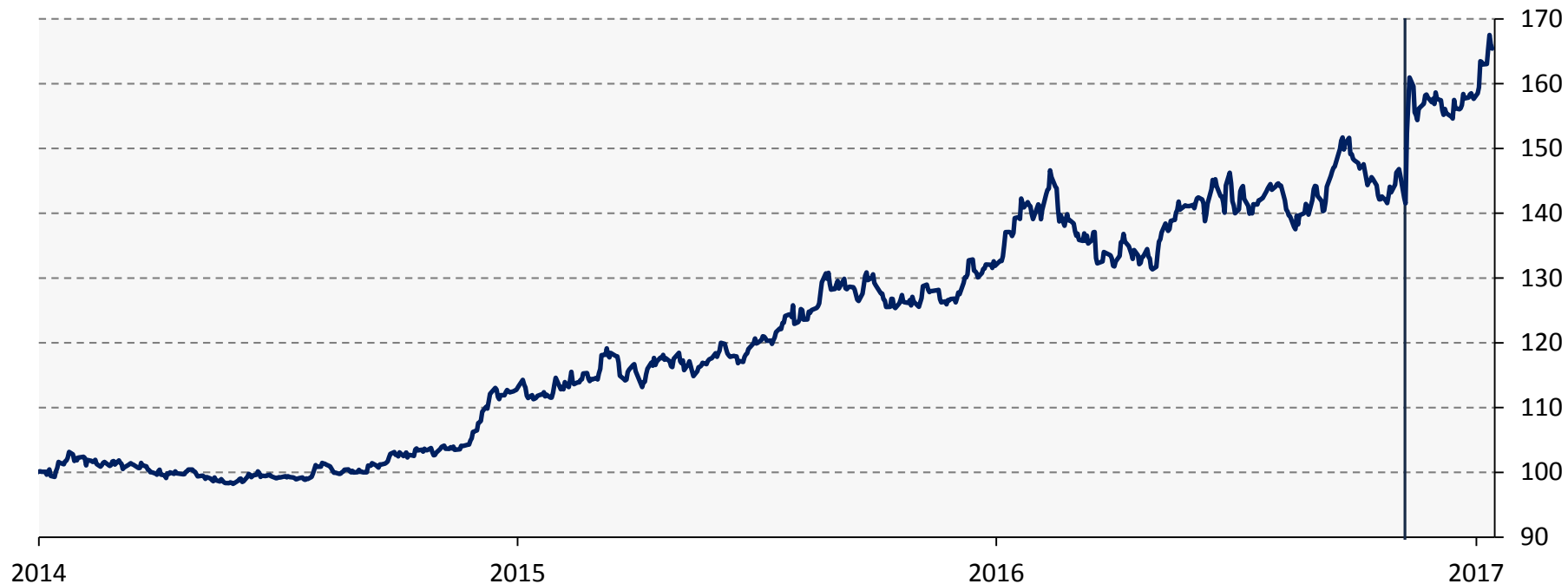


Note: Vertical line on 8 November 2016.
Source: PiP and US Department of the Treasury.

The Mexican peso has depreciated substantially since the second semester of 2014...

Mexico: Exchange Rate with Respect to the USD

Index 05-Sep-2014 = 100

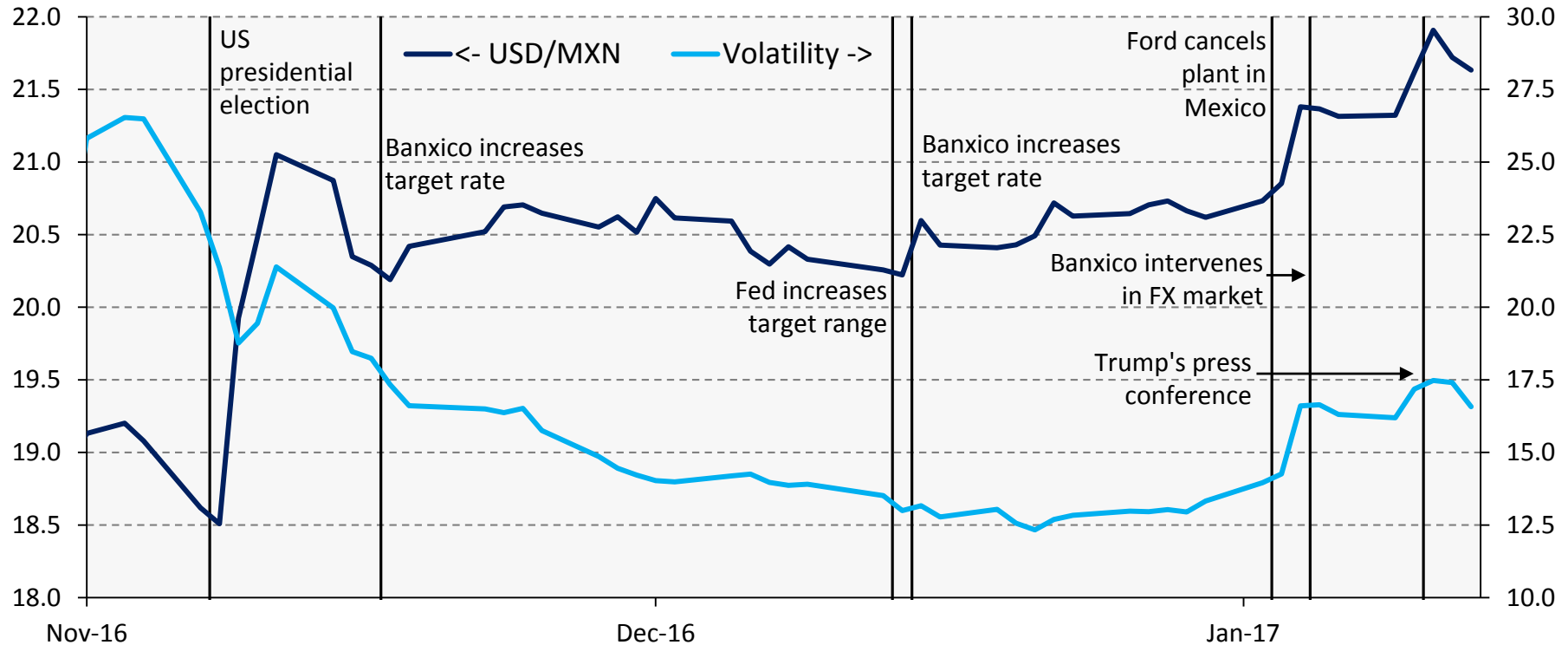


Note: Vertical line on 8 November 2016.

Source: Banco de México.

...with pressures increasing after the presidential election in the United States.

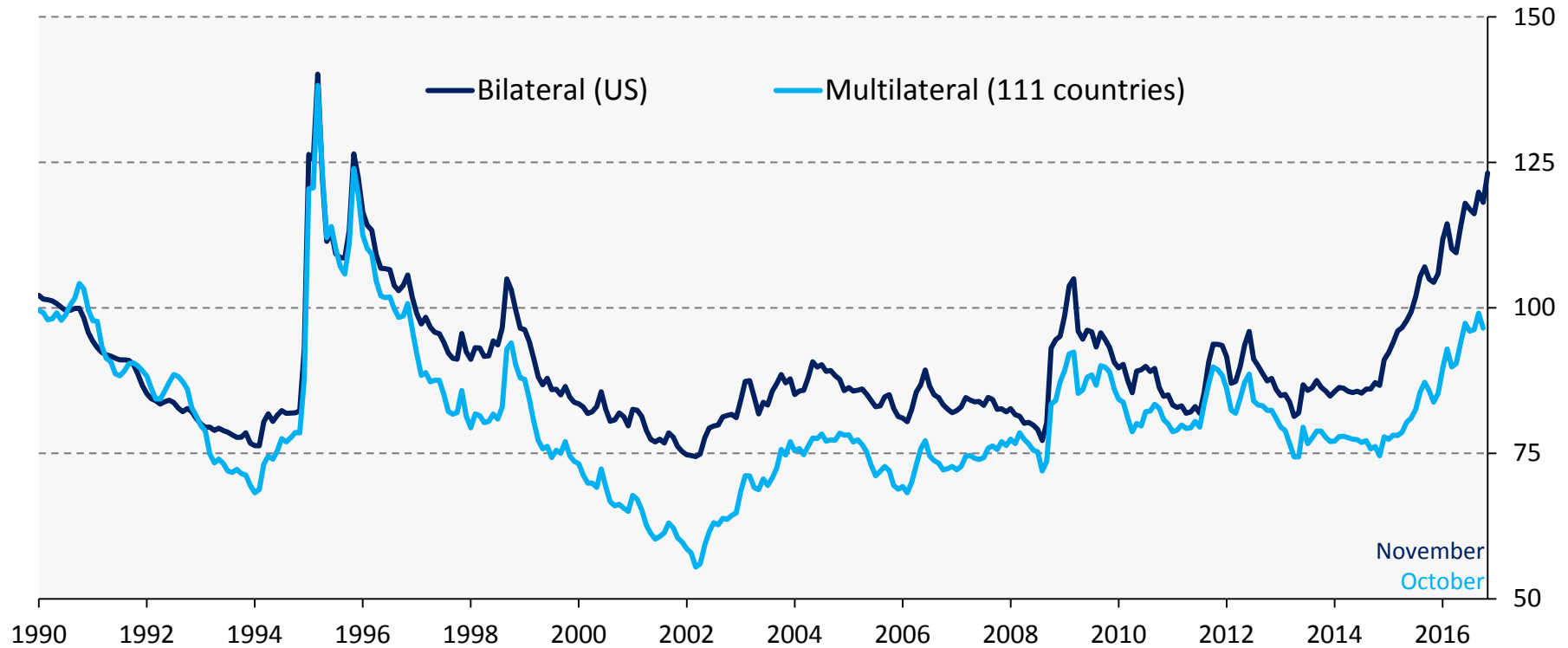
Mexico: Exchange Rate Level and Volatility^{1/}
MXN per USD and %



^{1/} Implicit volatility in 1-month USD/MXN options.
Source: Banco de México and Bloomberg.

Thus, the real exchange rate has shown a significant depreciation...

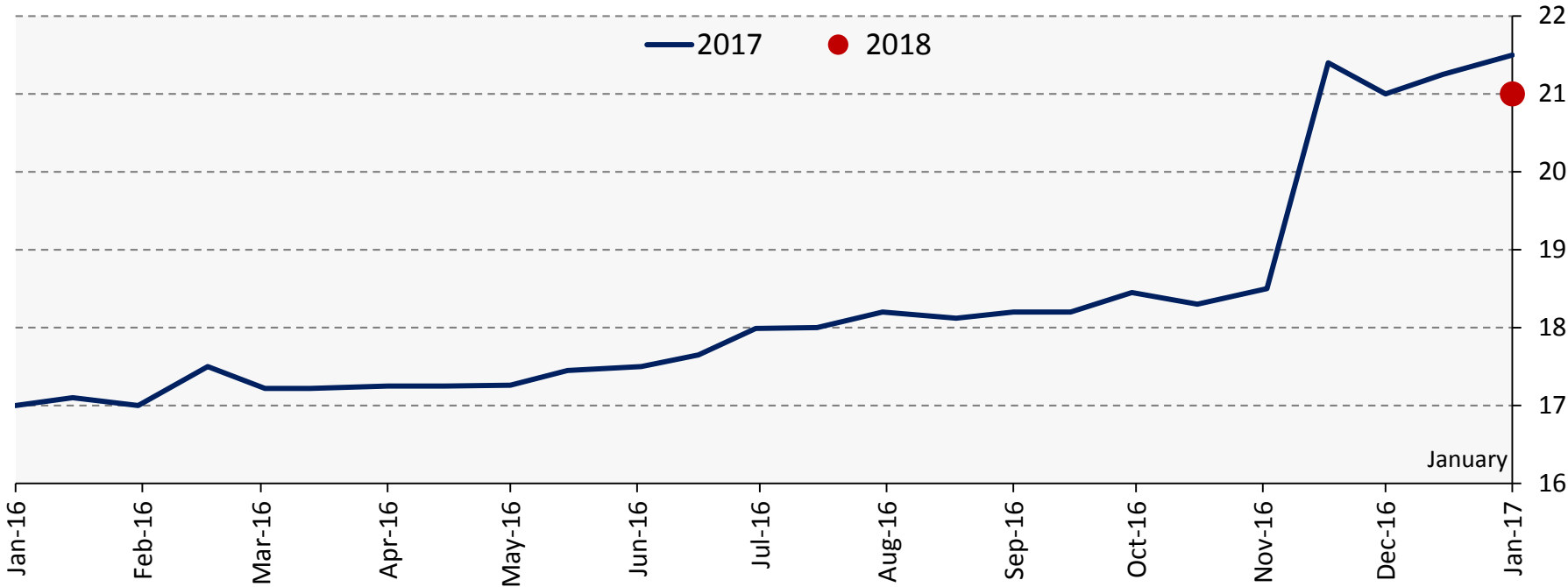
Mexico: Real Exchange Rate
Index 1990 = 100



Source: Banco de México.

...and the expected peso-dollar rate for end-2017 has increased, although an appreciation continues to be projected for December 2018.

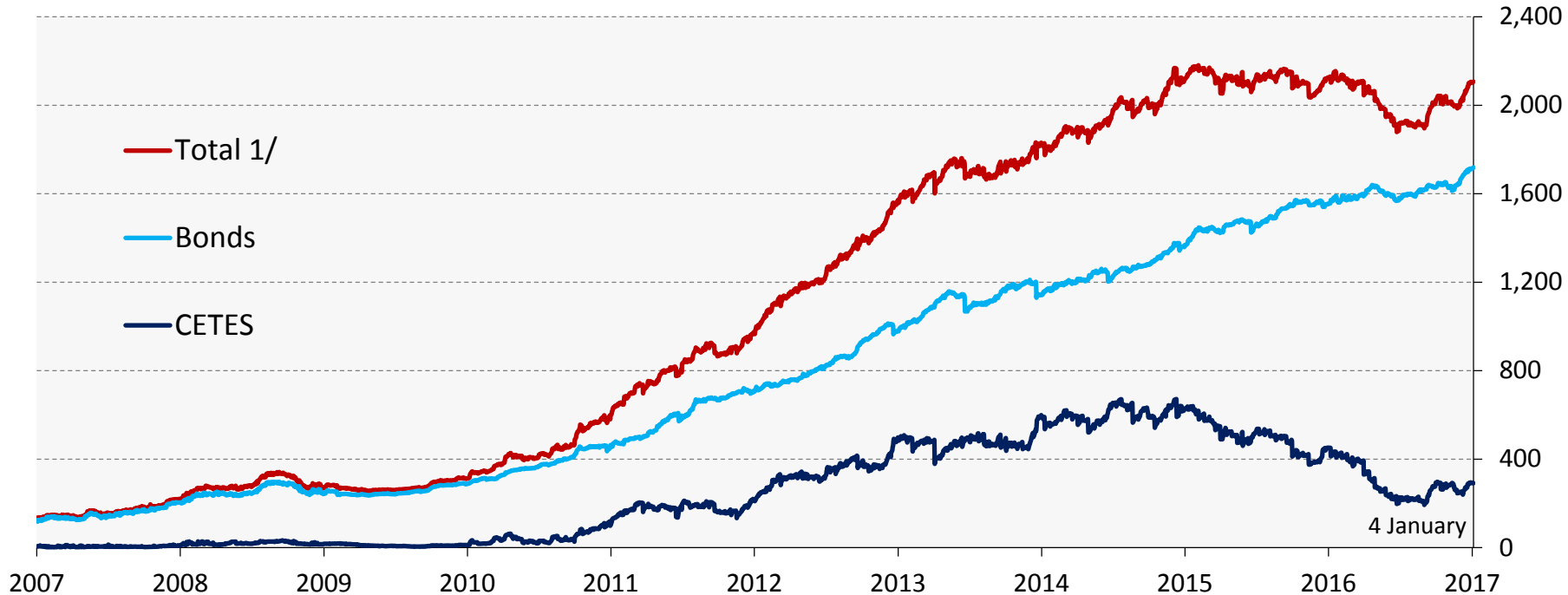
Mexico: Exchange Rate Expectations^{1/}
MXN per USD



^{1/} Median expectation.
Source: Citibanamex.

Notwithstanding the above trends, non-residents' appetite for government securities, and particularly long-term bonds, has remained robust.

Mexico: Non-Resident Holdings of Government Securities
Billion Pesos



1/ Total includes CETES, bonos, udibonos, bonos and bonos D.
Source: Banco de México.

- ❑ To sum up, monetary policy in Mexico faces a situation characterized by:
 - ✓ A deceleration of economic activity.
 - ✓ Significant upside risks for inflation.
 - ✓ Potential for a deterioration of medium- and long-term inflation expectations.

- ❑ This, within the context of:
 - ✓ Higher-than-usual uncertainty.
 - ✓ A normalization of monetary policy in the United States.

- ❑ Since late 2015, the Banco de México has increased the target for the overnight interbank interest rate on 6 occasions, for a total 275 basis points.
- ❑ This has responded partly to the tightening of monetary policy in the United States.
- ❑ Most of the increases have been of a preventive nature, with recent developments showing the merits of this approach.
- ❑ In December 2016, an adjustment to the monetary policy stance would have been justified even in the absence of an increase in the federal funds rate, given the deteriorated balance of risks for inflation.

- ❑ The decision to increase rates in the presence of a subdued outlook for economic activity may be subject to question marks.

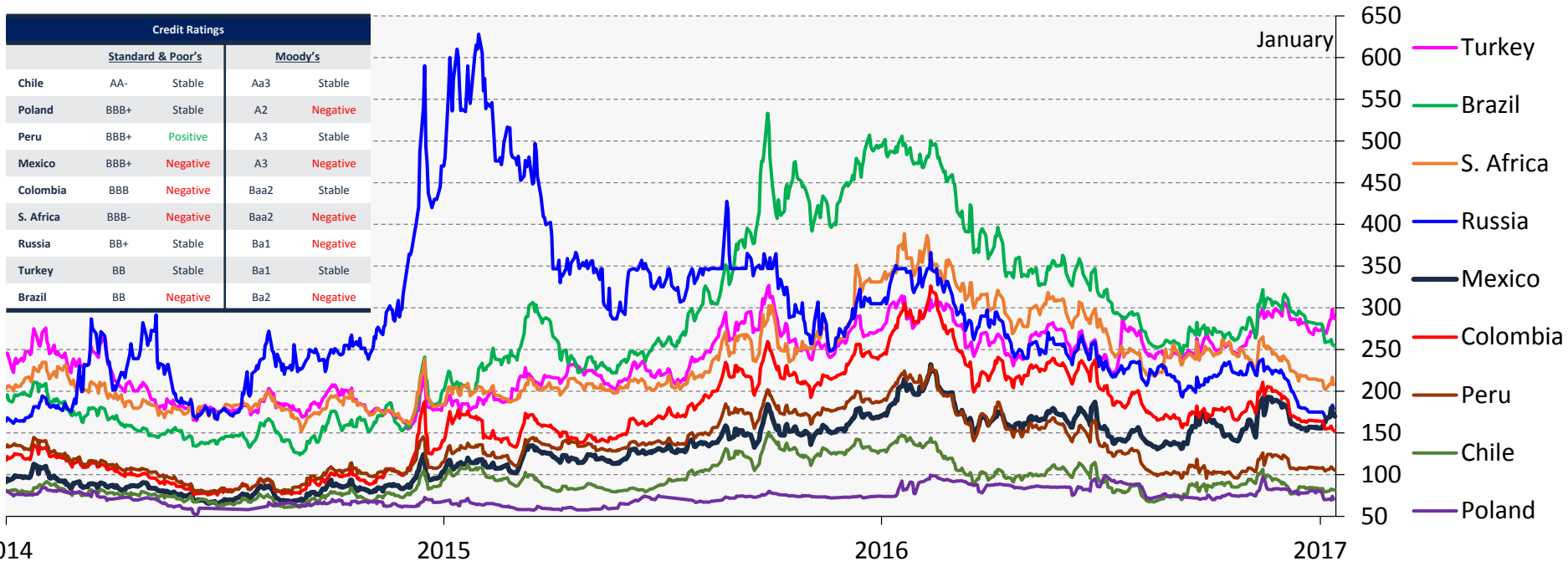
- ❑ However, it is important to bear in mind that the alternative would imply more pernicious and longer-lasting effects for the country's economic growth, given the risks of:
 - ✓ An unanchoring of medium- and long-term inflation expectations.
 - ✓ The erosion of the Banco de México's credibility.

- ❑ With the current cyclical position of the economy, the risk of demand pressures on prices has declined.
- ❑ Therefore, the implementation of monetary policy in Mexico in coming months is likely to be significantly influenced by the inflationary risks deriving from:
 - ✓ The potential of a higher pass-through from the exchange rate to prices arising from the recent evolution of the peso-dollar rate or from additional pressures on the peso.
 - ✓ The normalization of monetary policy in the United States.
 - ✓ The need to ensure that the recent adjustments in relative prices do not give rise to second-round effects and have only a temporary impact on inflation.
- ❑ In any event, the Banco de México's Board will continue to closely monitor the evolution of all determinants of inflation and its medium- and long-term expectations, and implement any necessary measures to consolidate the efficient convergence of inflation to the 3 percent target.

- ❑ Intervention in the foreign exchange market remains part of the toolkit to cope with exchange rate volatility.
- ❑ Strong economic fundamentals constitute the basis through which the anchoring of the peso will be sought.
- ❑ However, discretionary intervention in the foreign exchange market cannot be discarded, should exceptional circumstances arise.

While Mexico's sovereign rating remains several notches above investment grade and well positioned among emerging market economies, it has been placed under negative watch and the evolution of the country's CDS has recently underperformed that of other EMEs.

Emerging Market Economies: 5-Year Credit Default Swaps
Basis Points



Source: Bloomberg, Reuters, Moody's and Standard & Poor's.

- ❑ This situation, coupled with the challenges the economy may face in coming years, underlines the need to strengthen economic fundamentals.
- ❑ A monetary policy focused on attaining a low and stable inflation is central in this regard.
- ❑ Mexico's public finances represent a source of nervousness among market participants.
- ❑ Thus, the measures announced by the government to set the public-debt-to-GDP ratio on a declining trajectory are of utmost relevance.
- ❑ It will also be essential to preserve financial stability.
- ❑ Finally, enhancing the economy's competitiveness and the domestic sources of growth has taken on added importance. This implies the continuation of efforts of structural adjustment and reform of the institutional framework underway, and the implementation of actions in other areas as needed.



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