



The Mexican Economy: Some Old and New Issues

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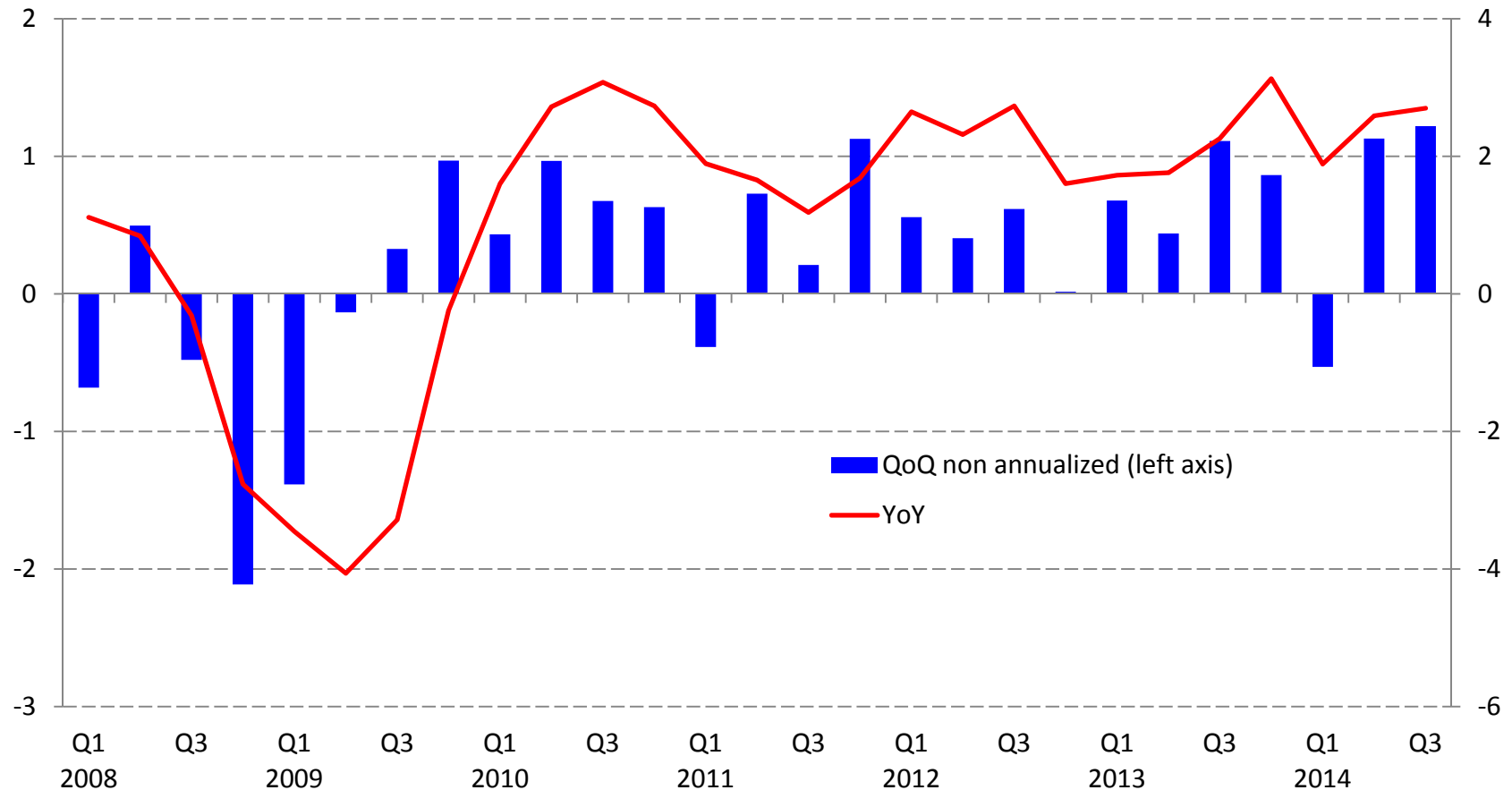
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Outline

- The U.S. economic recovery solidifies
- Oil prices take a dive
- The Federal Reserve is close to increasing rates
- Mexico's economic rebound is weak
- Domestic financial markets show resilience
- Inflation turns upward

The U.S. economic recovery continues to gain momentum

The United States: GDP growth
% change, s.a.

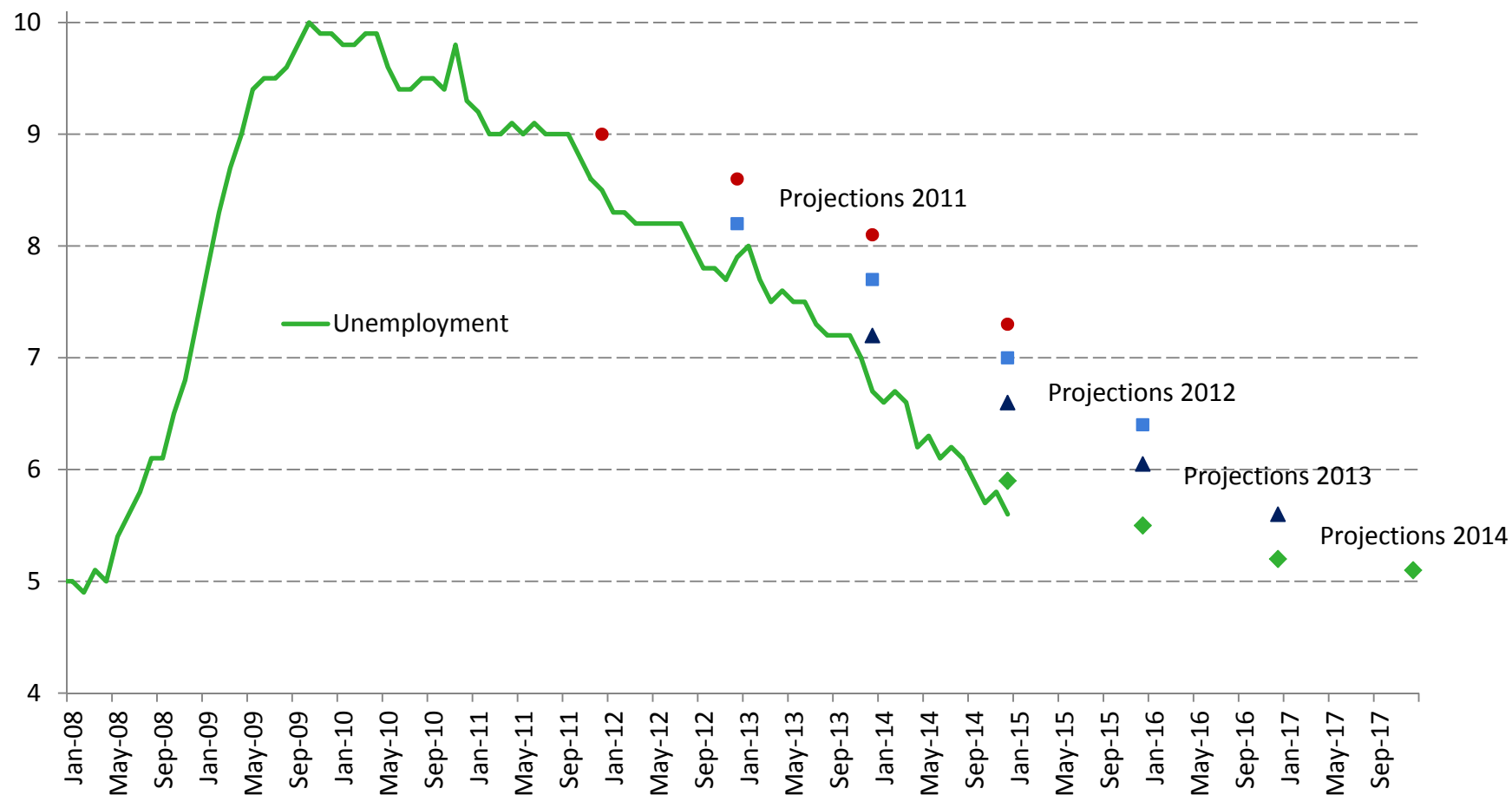


s. a. / Seasonally adjusted

Source: The U.S. Bureau of Economic Analysis

Unemployment has been dropping significantly, surpassing the Fed's successive projections

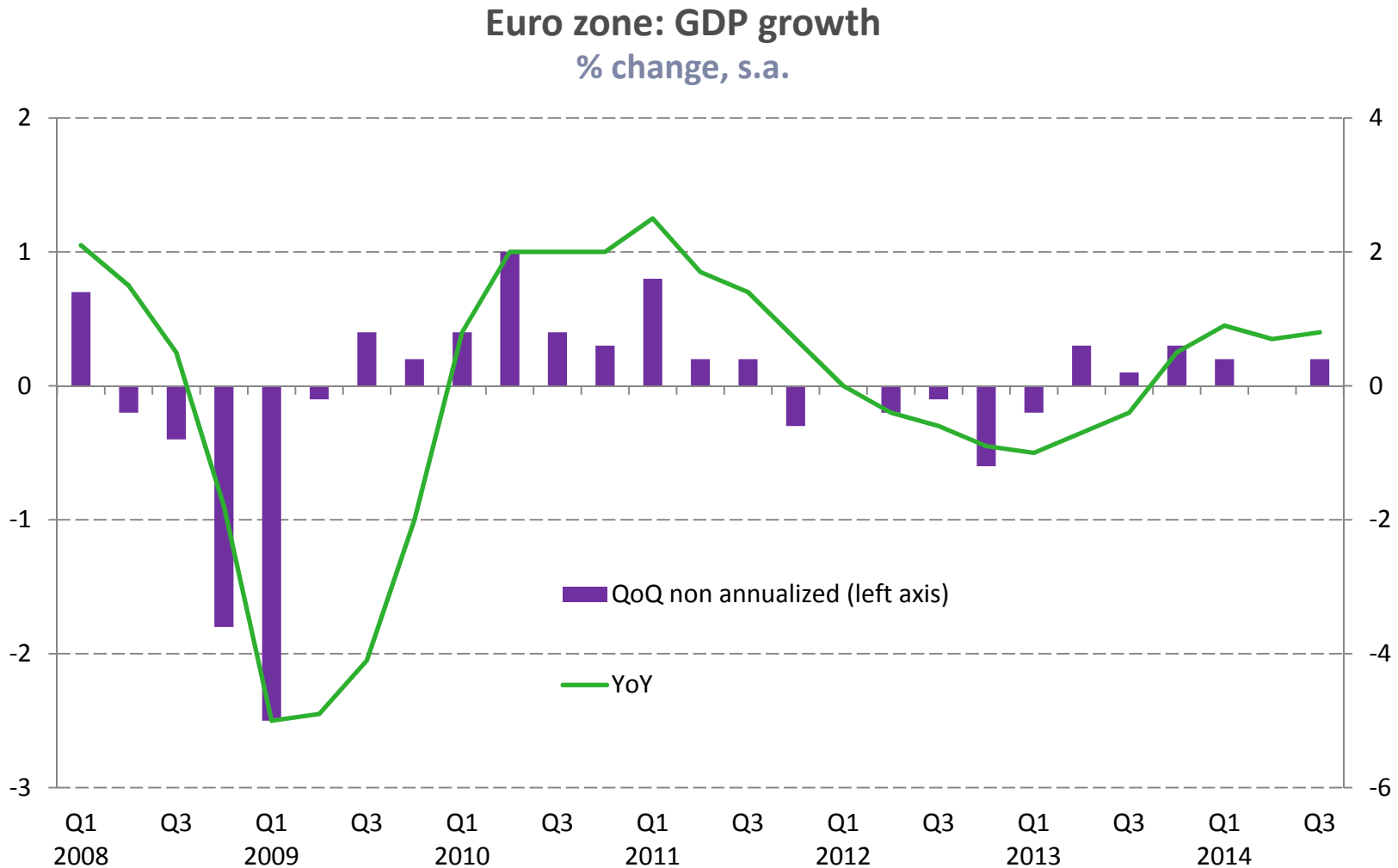
The United States: Unemployment and Fed's unemployment projections¹



1/ Seasonally adjusted unemployment; median of projections contained in the FOMC Minutes of September of each year, except for 2011 which corresponds to November

Source: The U.S. Bureau of Labor Statistics and the Federal Reserve

In contrast, growth in the euro zone has stalled at low rates

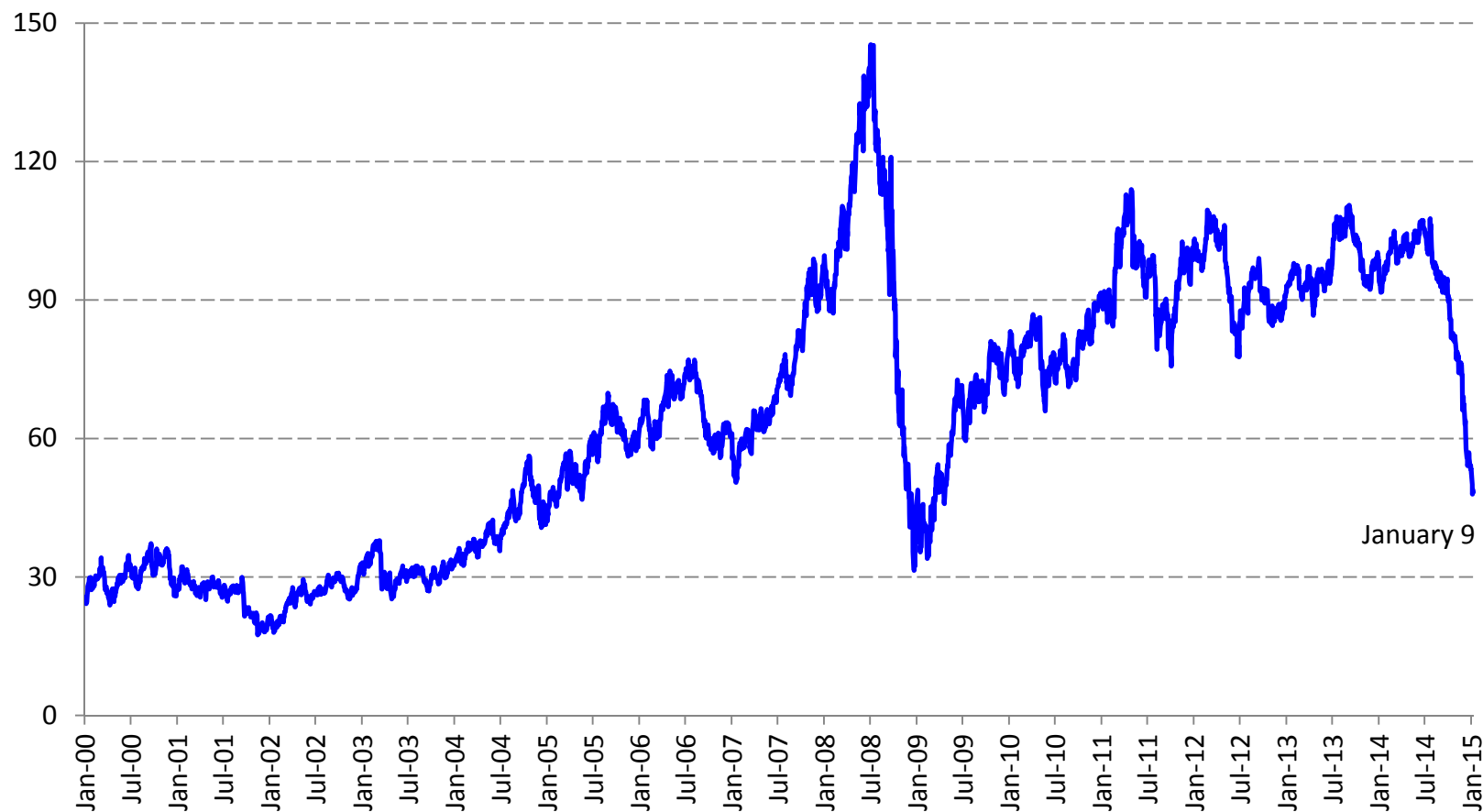


s. a. / Seasonally adjusted

Source: Haver Analytics

Oil prices have fallen to levels not seen in more than five years

WTI oil prices
U.S. dollars per barrel



Source: Bloomberg

The drop in oil prices, driven mainly by an abundant supply, should enhance U.S. economic recovery

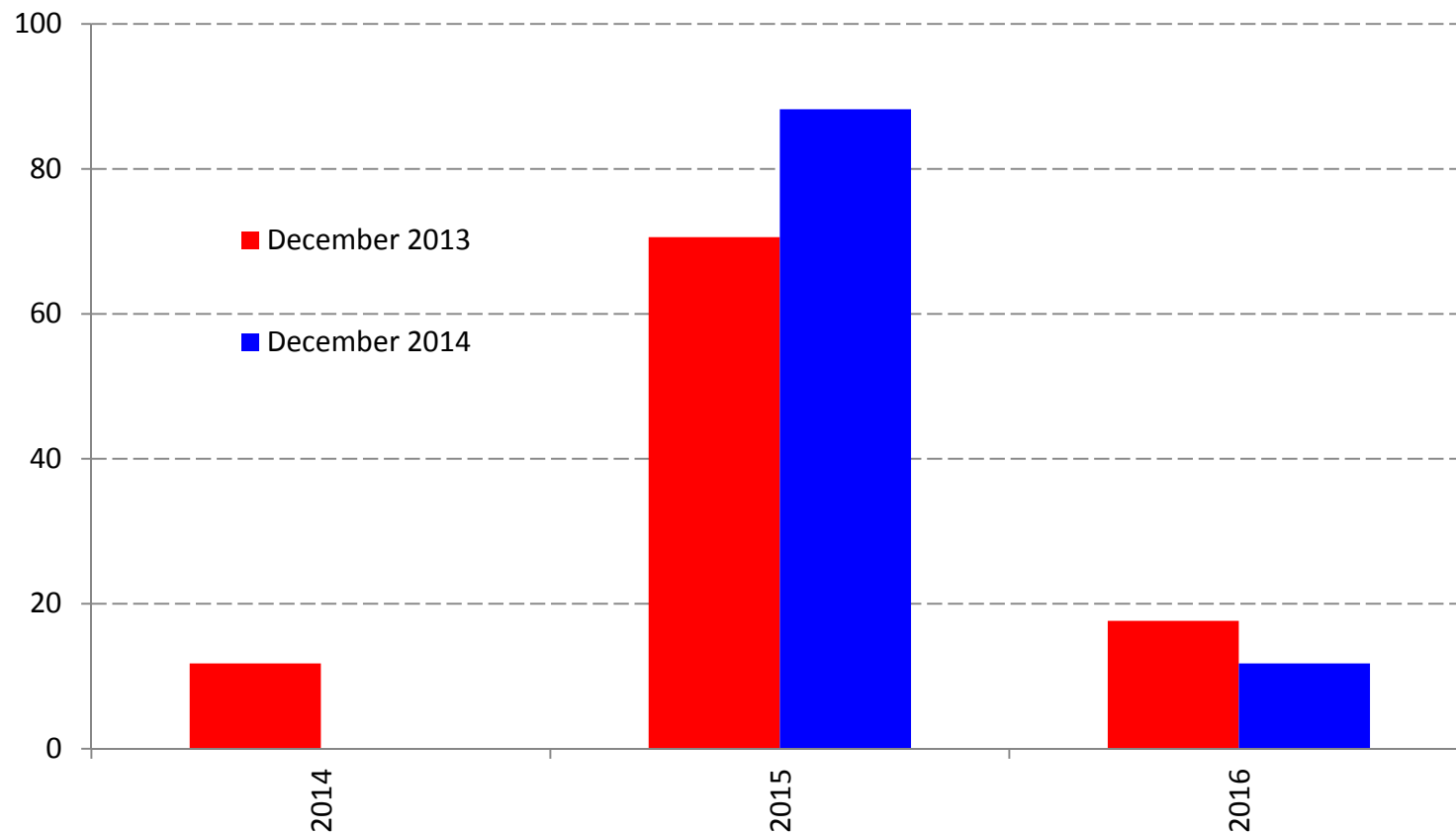
- An oil production boom started in the U.S. in 2008
- Increased competition has triggered the price drop since the middle of 2014
- Slower global economic growth precedes the oil price fall
- Lower fuel prices should stimulate consumption in the U.S.

The recent FOMC statement suggests that gradual monetary normalization in the U.S. is close

- Economic activity is expanding at a moderate pace and is expected to continue this path
- Decisions on hikes will be data dependent
- The FOMC can be “patient” in beginning to normalize the stance of monetary policy
- Even after attaining its dual mandate, the federal funds rate may stay, for some time, below long-run normal levels

The majority of FOMC members expect the first Fed funds rate hike in 2015

First Fed funds rate hike expected by FOMC participants
% of FOMC participants

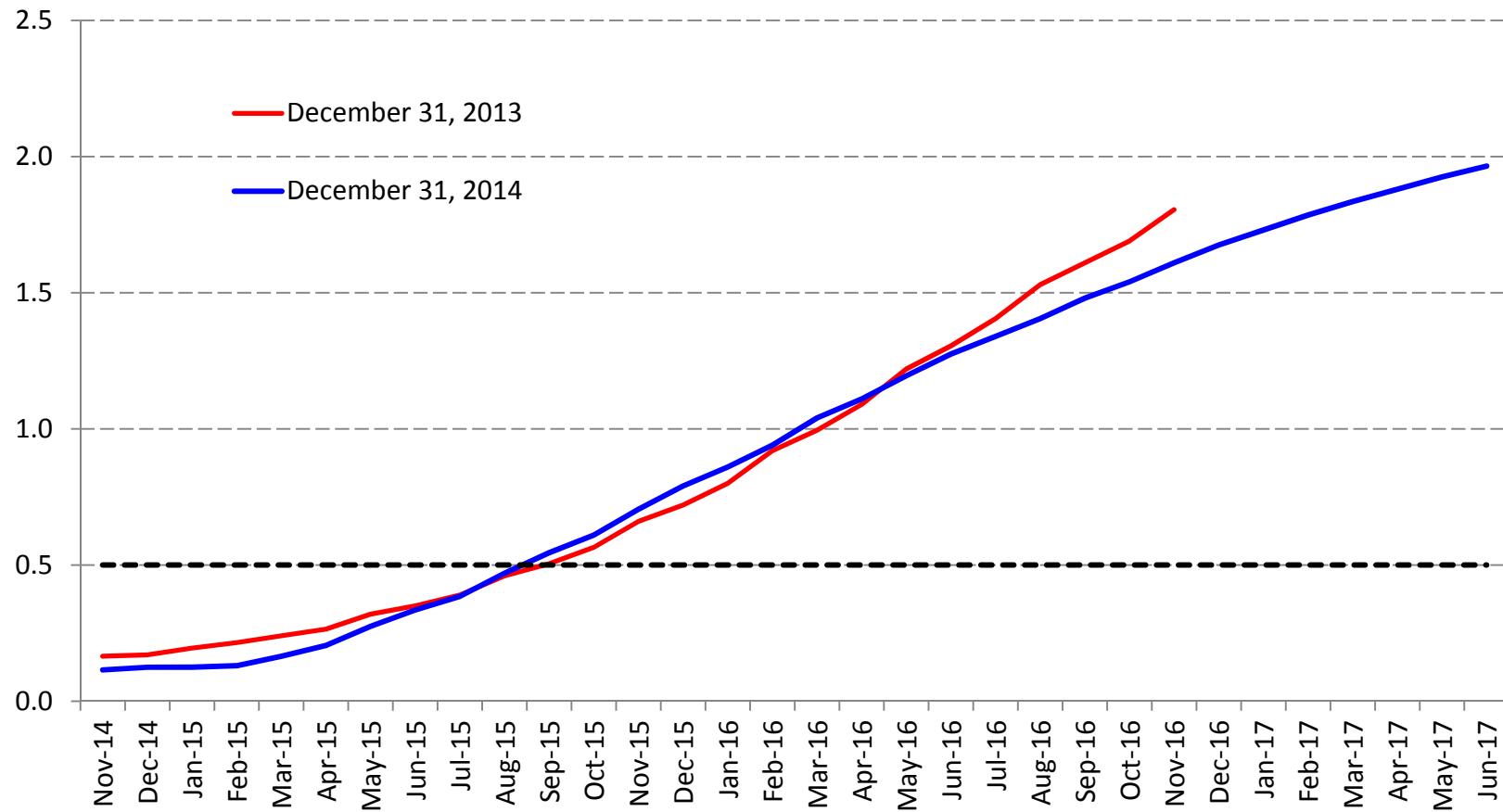


Source: The Federal Reserve

Although with significant volatility, futures markets have tended to anticipate the first hike in 2015

Yield curve for Fed funds rate futures contracts

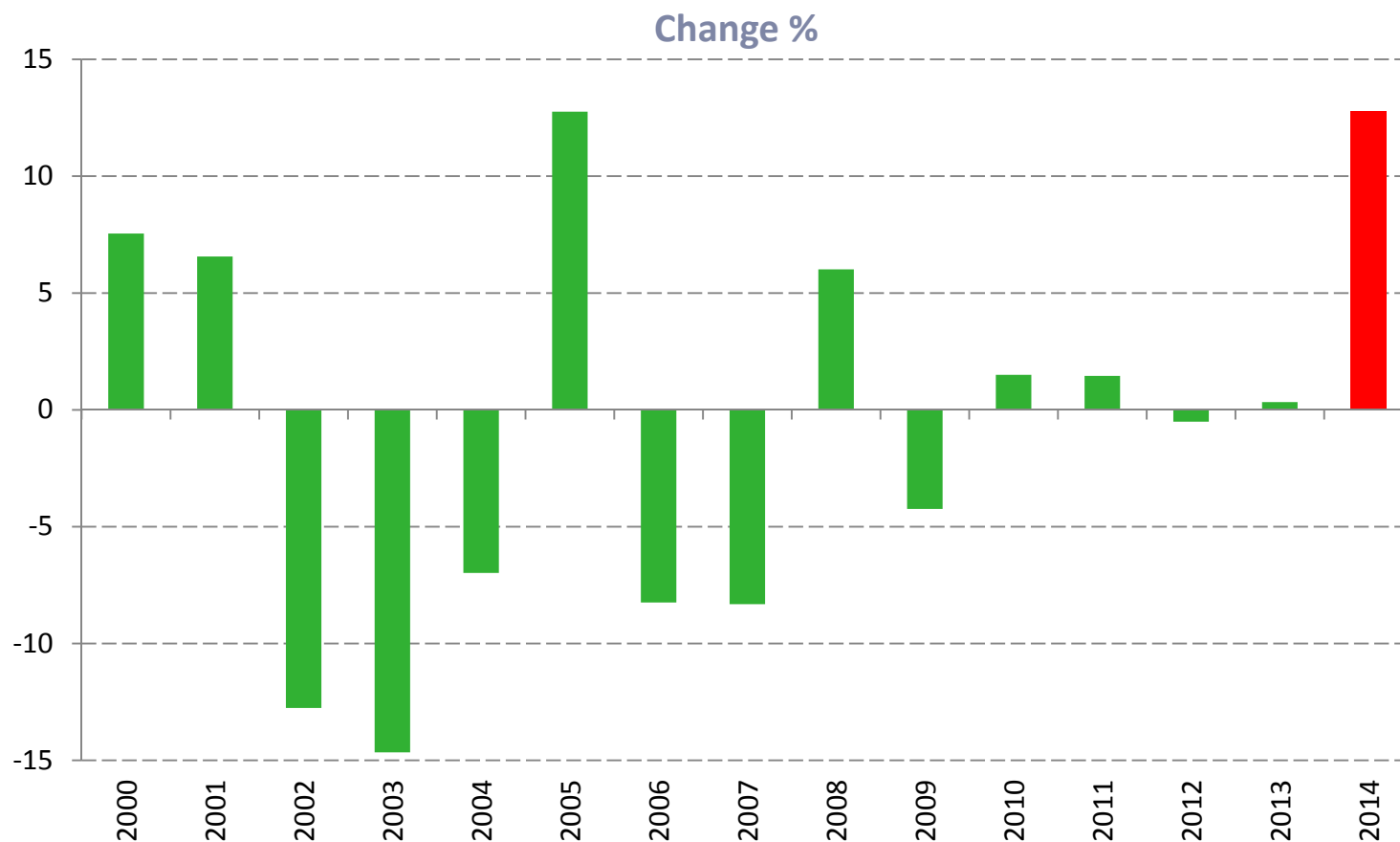
%



Source: Bloomberg

Superior U.S. economic performance and expected monetary tightening may have contributed to dollar strength

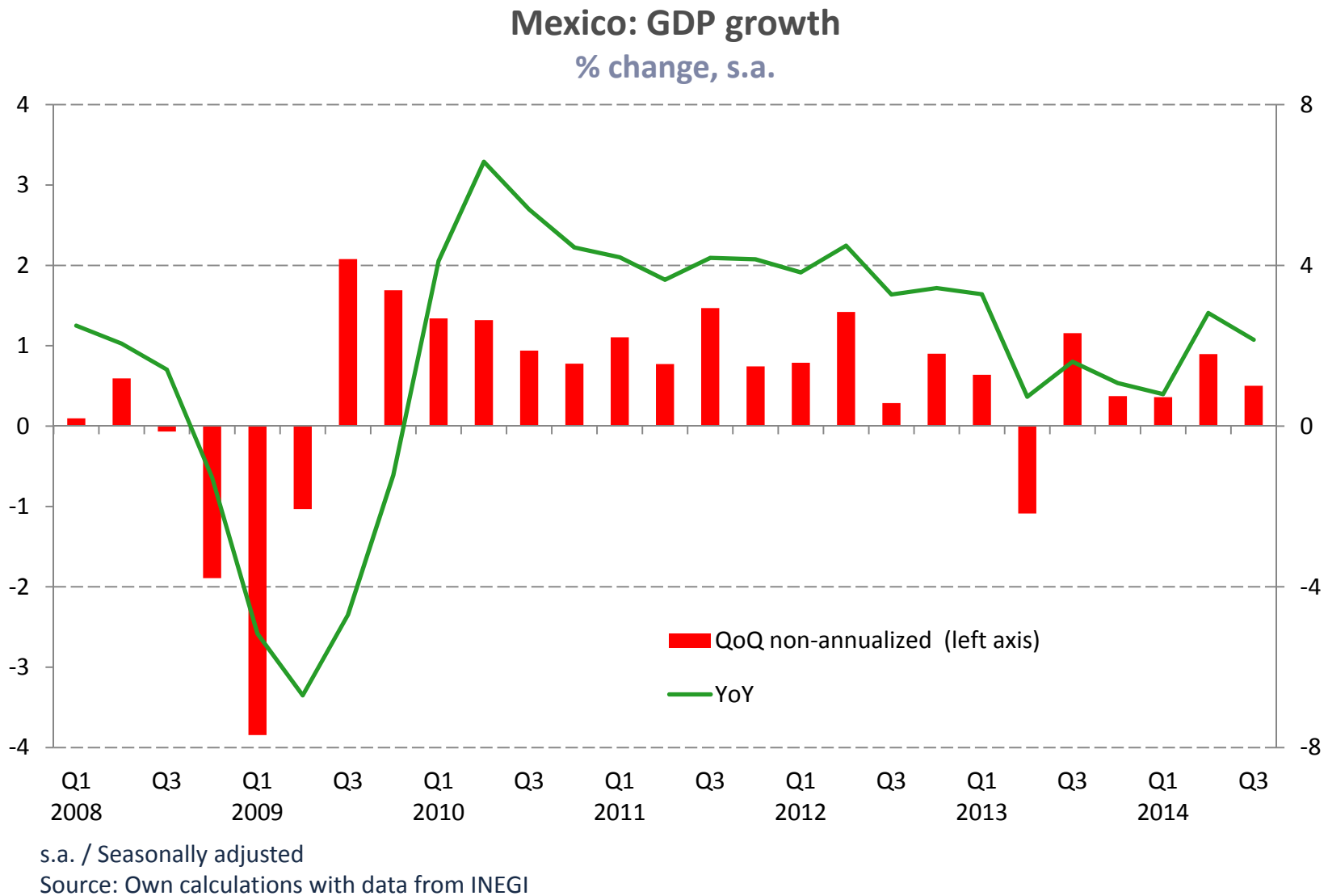
U.S. dollar versus six key currencies (DXY)¹



1/ DXY is a weighted average of the dollar's value relative to the euro (57.6%), Japanese yen (13.6%), pound sterling (11.9%), Canadian dollar (9.1%), Swedish krona (4.2%), and Swiss franc (3.6%)

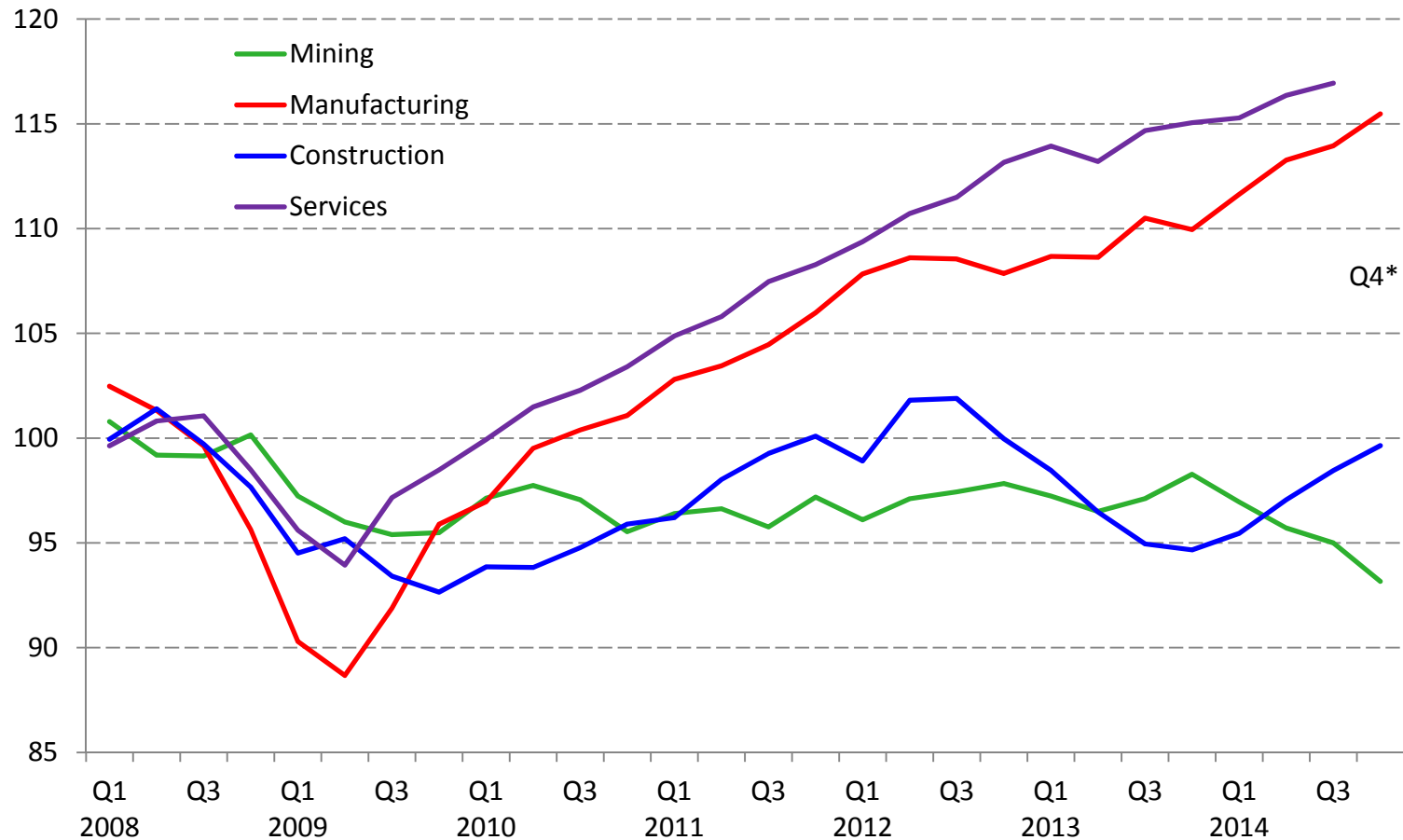
Source: Bloomberg

In Mexico, economic rebound has not consolidated



In 3Q14, most sectors decelerated

Key real GDP components
2008 = 100; s.a.



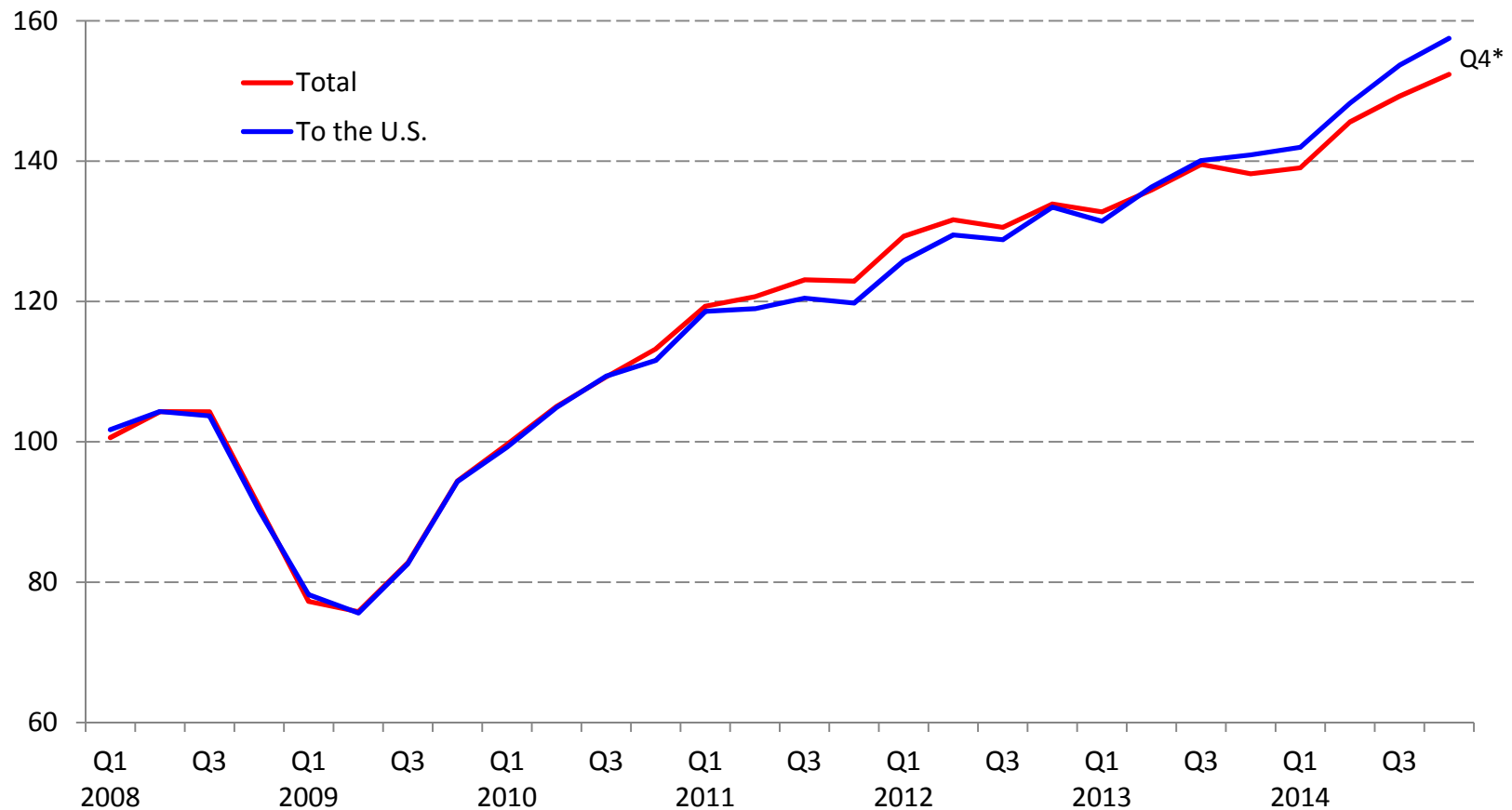
s.a. / Seasonally adjusted

*/ Estimation based on October-November industrial production

Source: INEGI

Although strong external demand, mainly from the U.S., continued to support manufacturing exports

Manufacturing exports
U.S. dollar value; 2008 = 100; s.a.

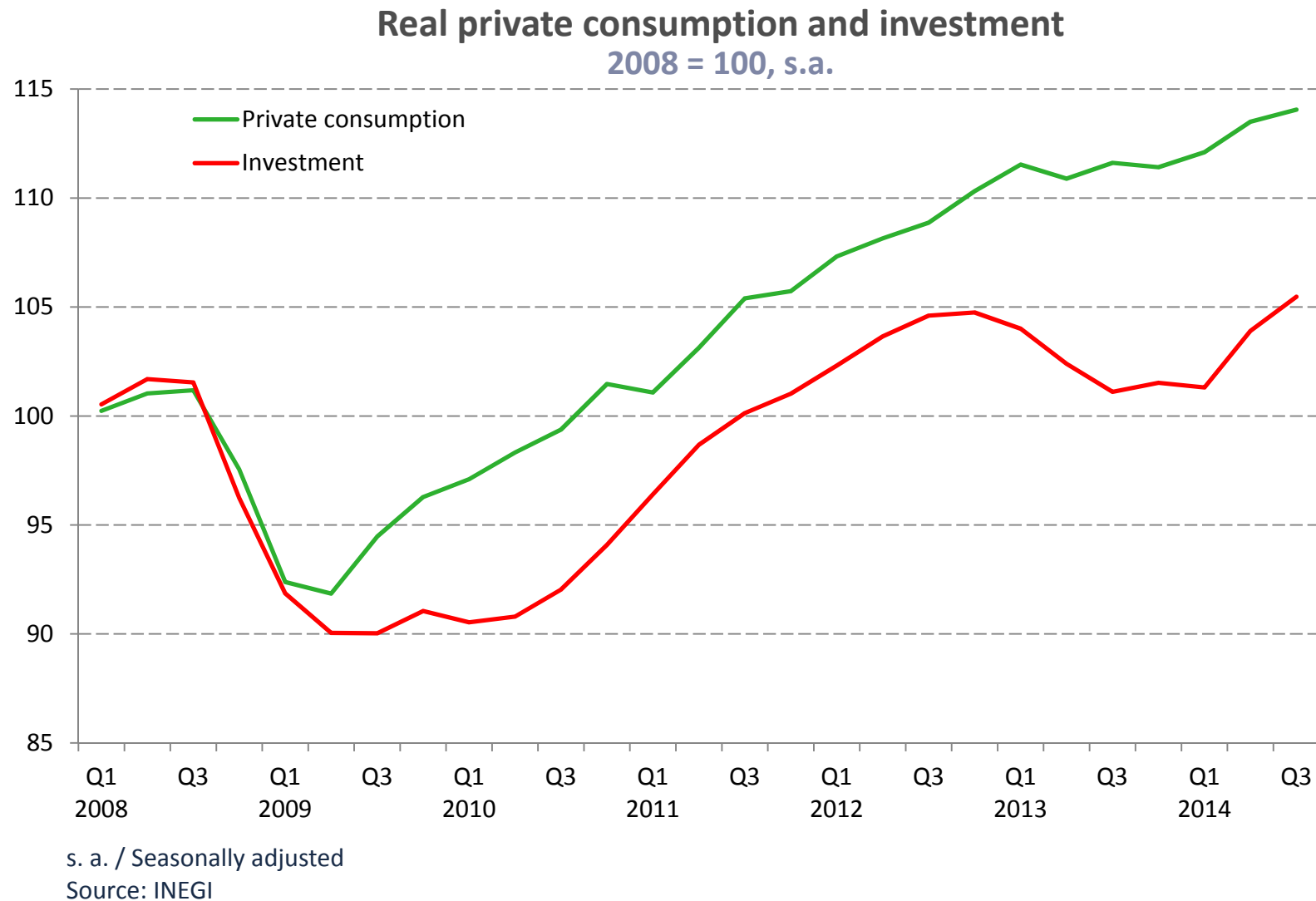


s.a. / Seasonally adjusted

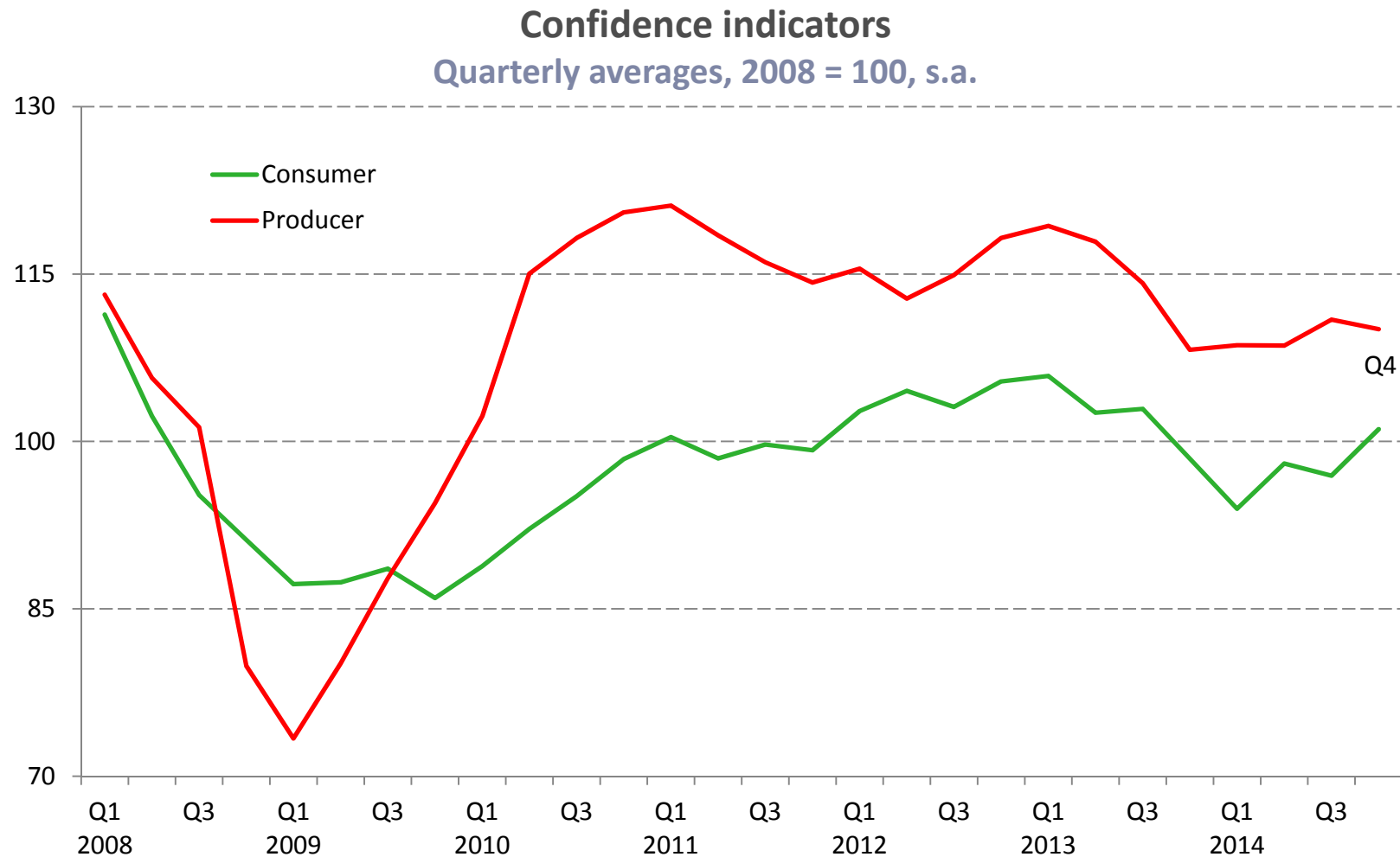
*/ Estimation based on October-November

Source: Banco de México

.... growth in domestic spending, especially in private consumption, has softened

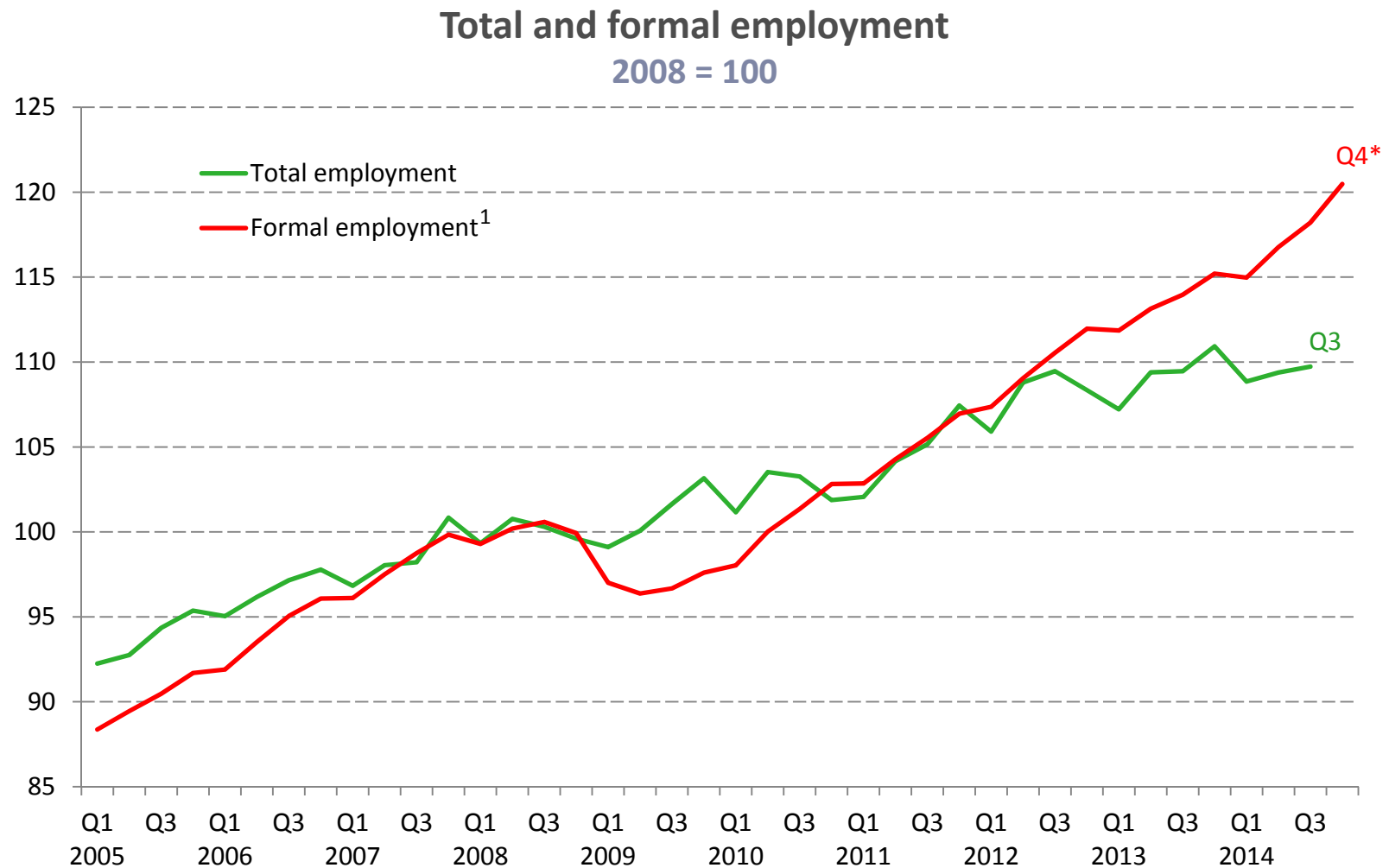


Despite some improvement, consumer and producer confidence remain relatively weak



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

Labor market yardsticks imply that informality is on a slight decline

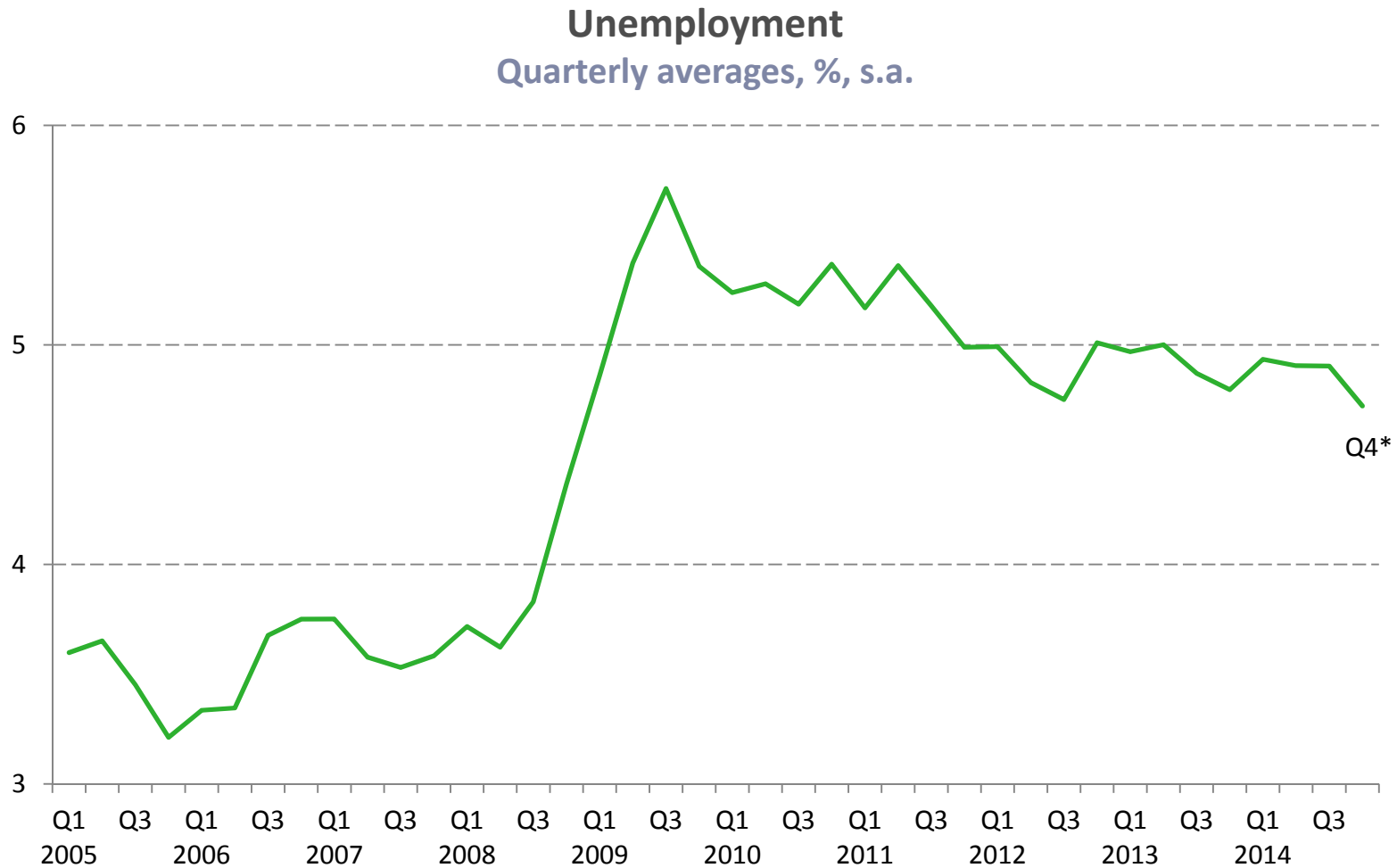


1/ Quarterly averages

* / October-November

Source: Banco de México with data from IMSS and INEGI

However, unemployment is falling rather slowly



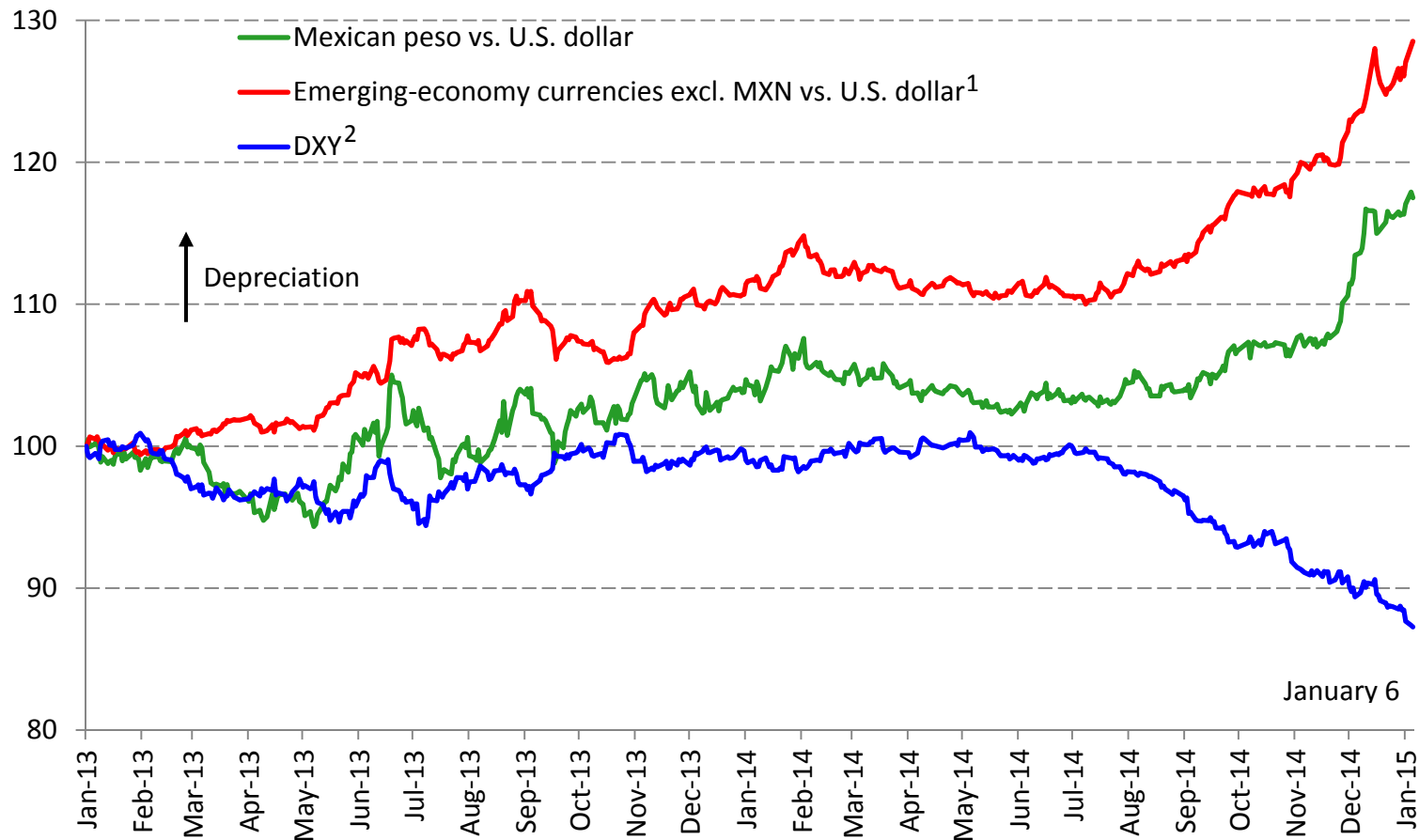
s.a. / Seasonally adjusted

*/ October-November

Source: INEGI

The weakening of the Mexican peso largely reflects global factors such as the U.S. economy and oil prices

Exchange rates
January 2 2013=100



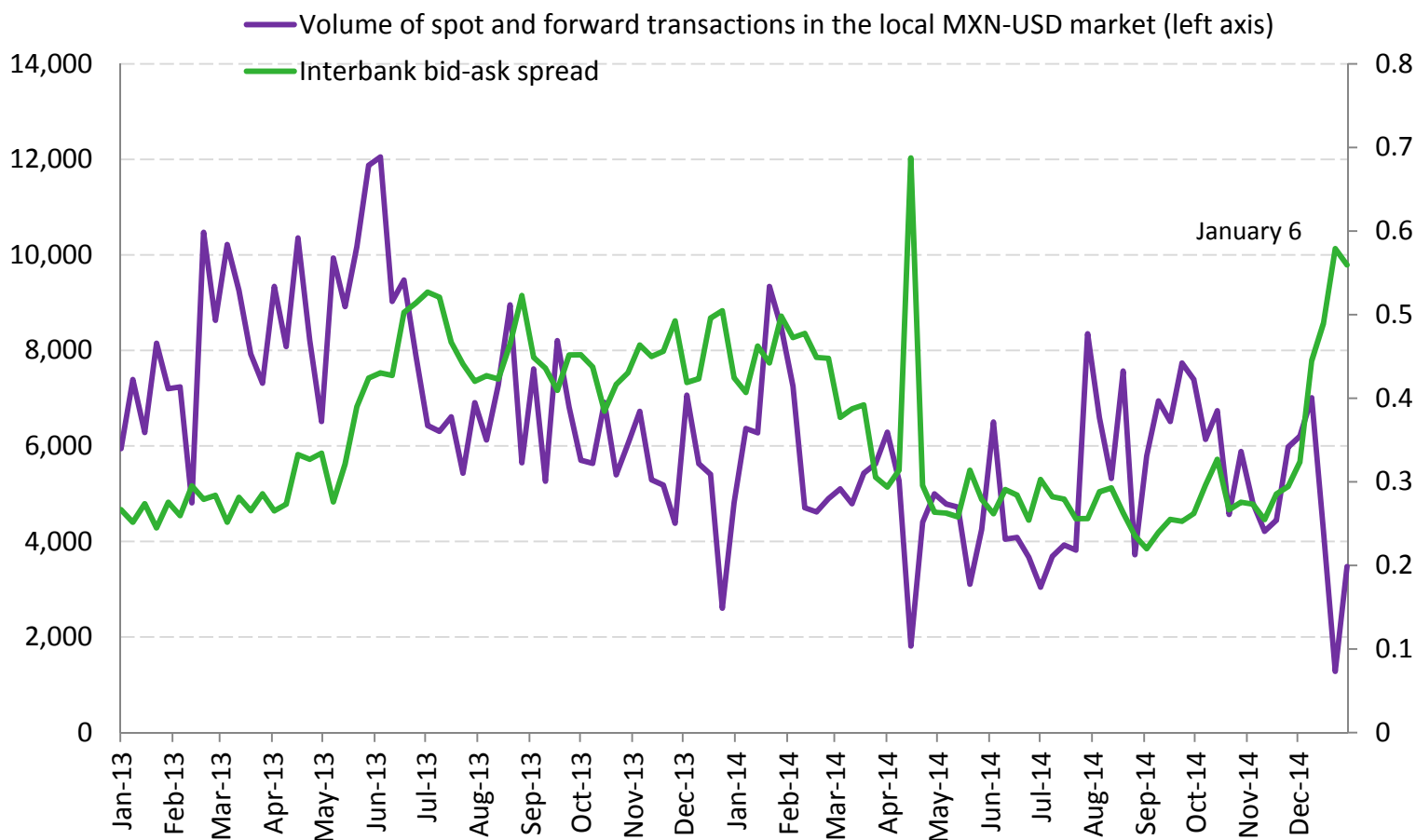
1/ Brazil, Chile, Colombia, Poland, Czech Rep., Turkey, Russia, India, South Korea, Indonesia, and Thailand

2/ DXY is a weighted average of the dollar's value relative to the euro (57.6%), Japanese yen (13.6%), pound sterling (11.9%), Canadian dollar (9.1%), Swedish krona (4.2%), and Swiss franc (3.6%)

Source: Bloomberg

The FX adjustment has been orderly with highly liquid markets

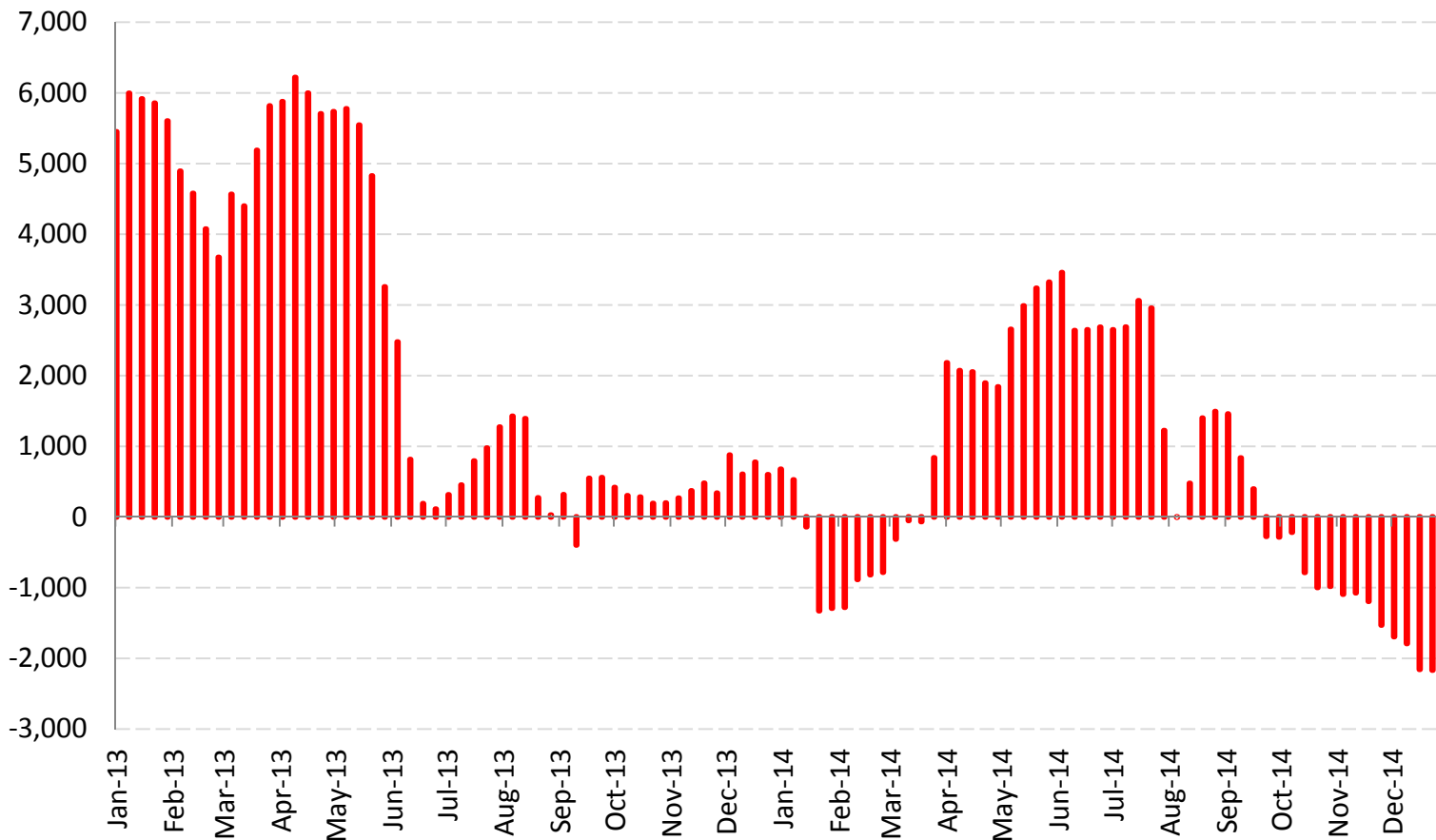
Peso-Dollar trade volume and spreads Millions of dollars and MXN cents



Source: Reuters and Banco de México

The derivative markets have allowed investors to hedge FX risks

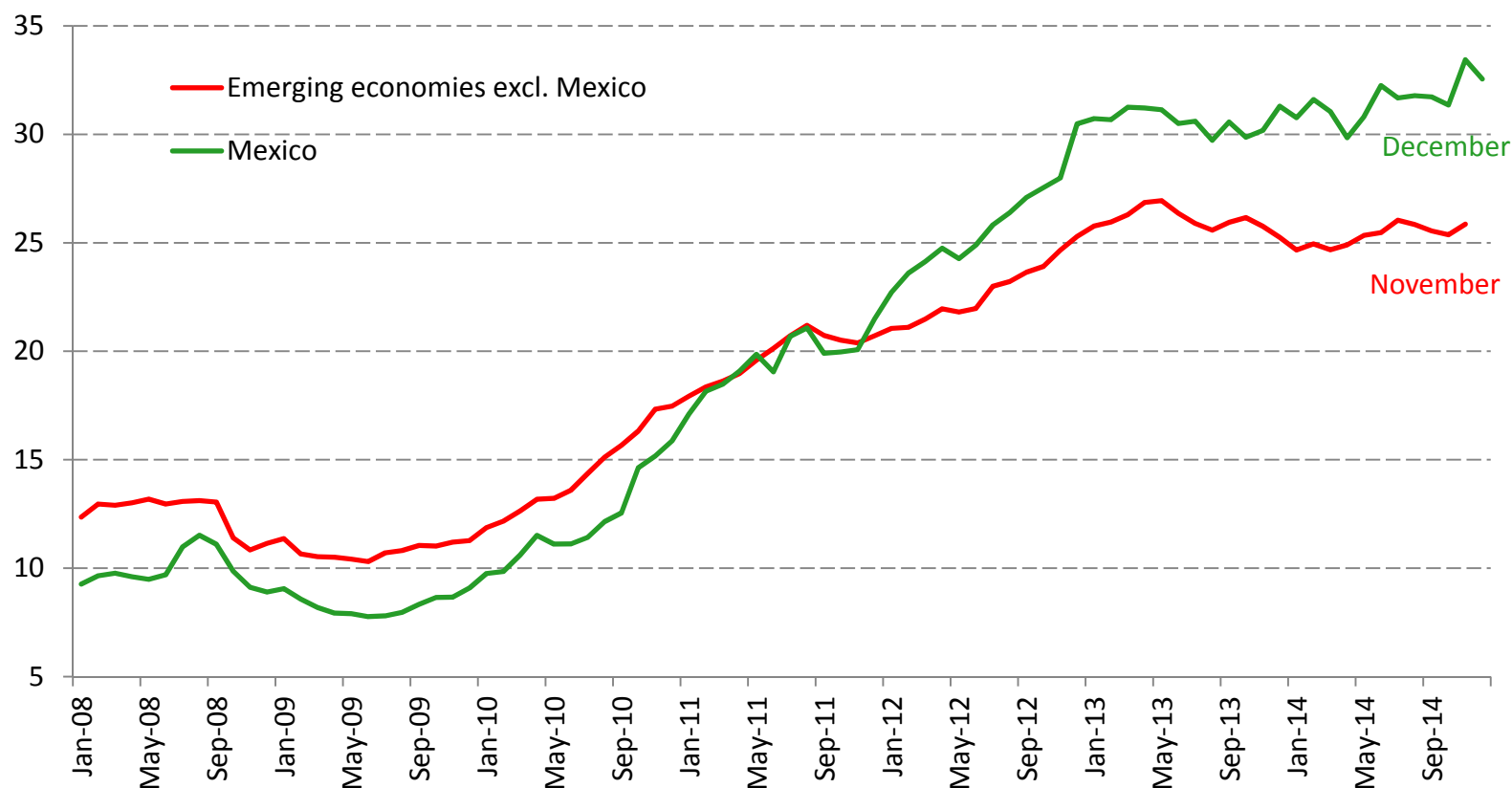
Speculative position in the peso-dollar IMM futures market
Millions of U.S. dollars



Source: Banco de México and Chicago Mercantile Exchange

The share of peso-denominated government bond holdings by nonresidents has recently risen

Emerging economies: Foreign holdings of local government bonds¹
Share in total local-currency government debt outstanding, %

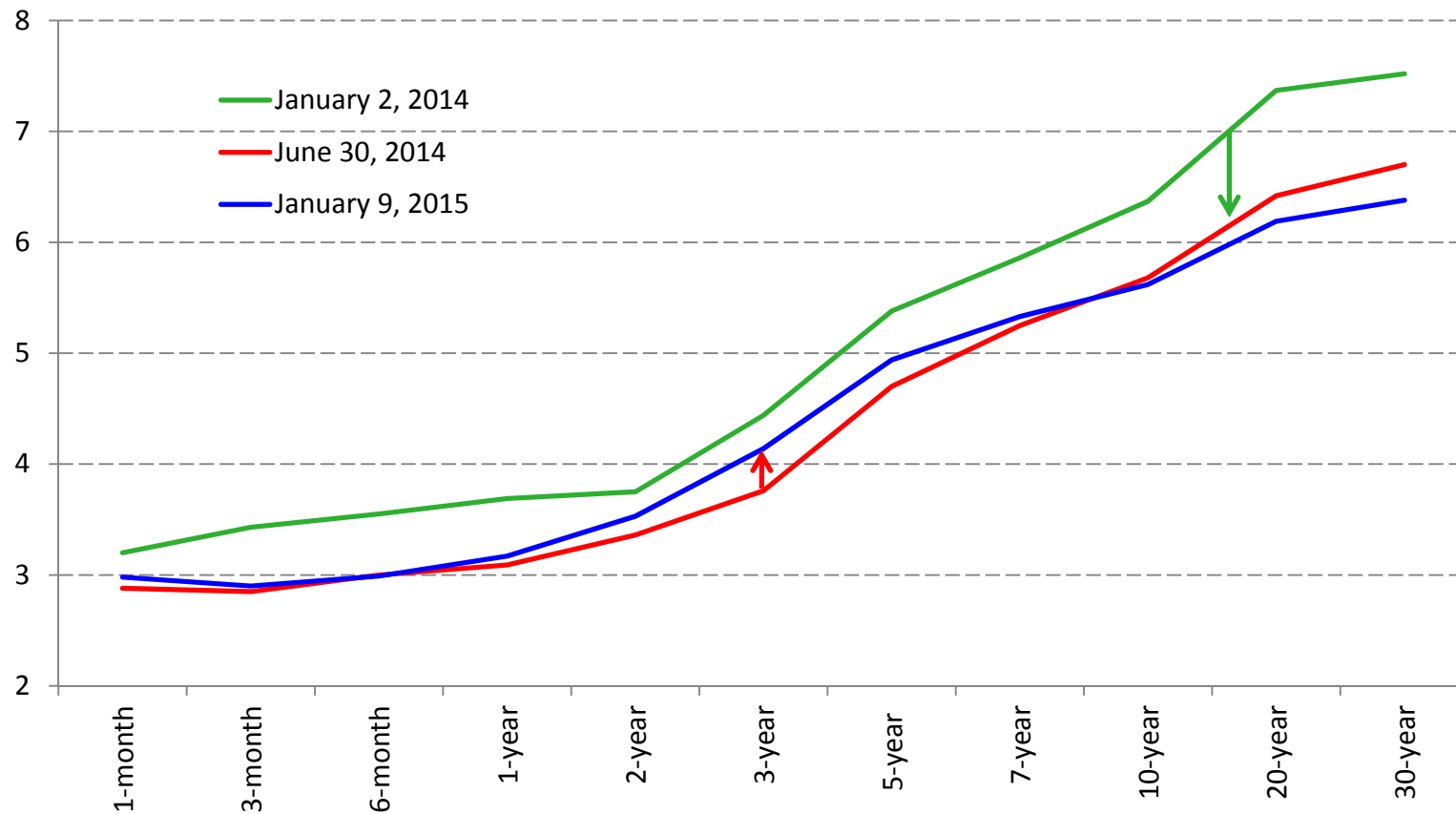


1/ Federal government debt issued in the domestic market, in local currency. Emerging markets excluding Mexico include Brazil, Colombia, Hungary, Indonesia, Malaysia, Peru, Poland, Russia, Thailand, Turkey, Israel, and South Africa

Source: Selected countries' central banks and finance ministries

Investors' preference for peso-denominated bonds has contributed to a flattening of the yield curve

Mexico: Government securities yield curve
%

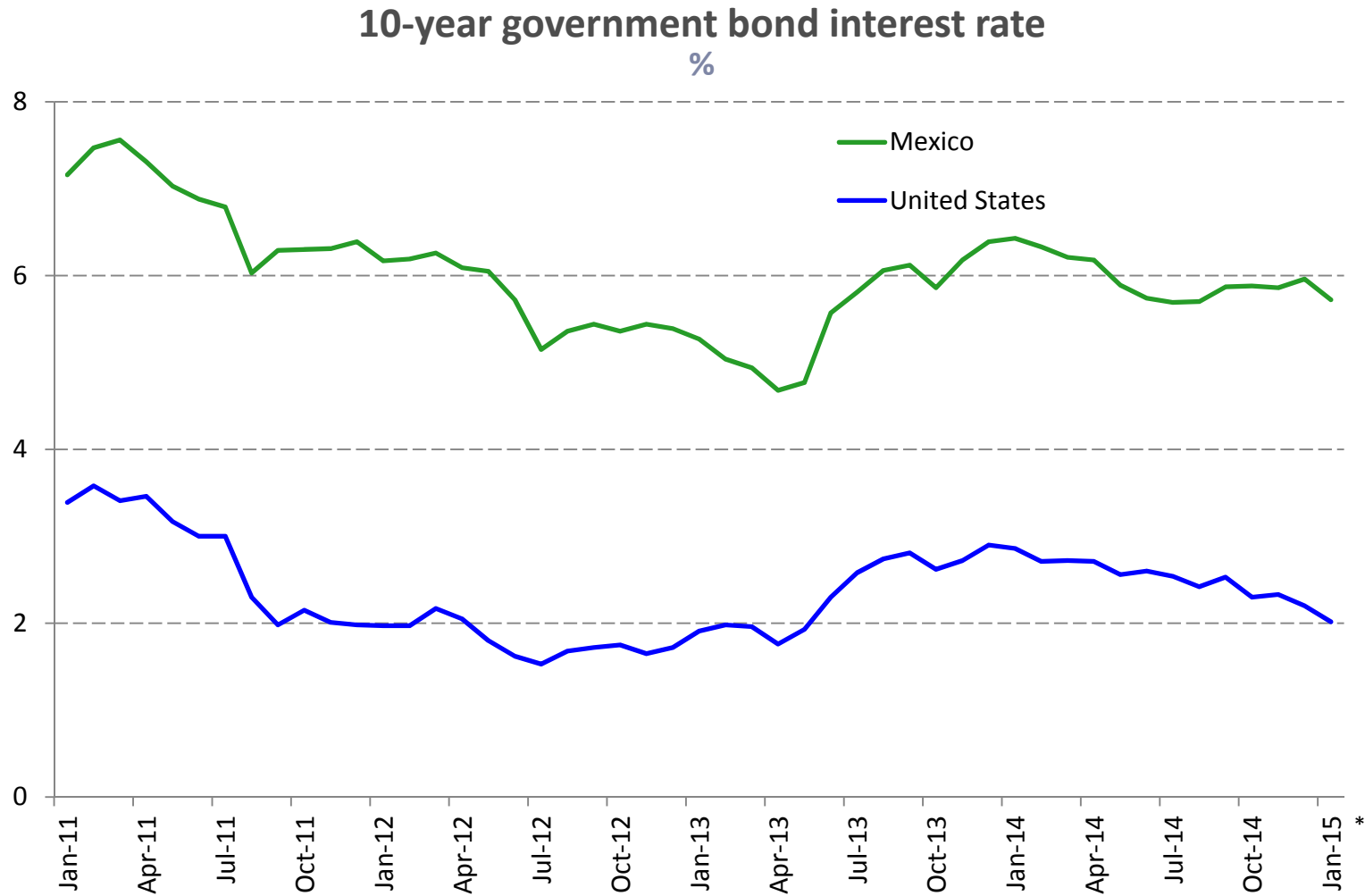


Source: Banco de México

However, adverse spillovers from factors unassociated with fundamentals continue to pose risk for Mexico

- Uncertainty on the pace of U.S. monetary normalization still looms
- How markets will react to policy news is unpredictable
- Long positions in fixed-income assets are bound to result in losses for investors as yields in advanced economies normalize
- Authorities must remain alert to domestic financial risks

Eventually, higher U.S. rates will most probably affect Mexican interest rates



* Average up to January 9

Source: Proveedor Integral de Precios (PiP) and the Federal Reserve

Mexico, along with the U.S., should see a gradual economic recovery this and next year

GDP growth forecasts YoY % change

	2014	2015	2016
U.S. Blue Chip	2.3	3.2	2.9
Mexico Blue Chip	2.3	3.3	3.9
Mexico Banxico	2.0 – 2.5	3.0 – 4.0	3.2 – 4.2

Source: *Blue Chip Economic Indicators*, December 2014 and January 2015, and Banco de México (2014), *Quarterly Report, July-September 2014, Summary*, November

There are significant downward risks to this growth scenario

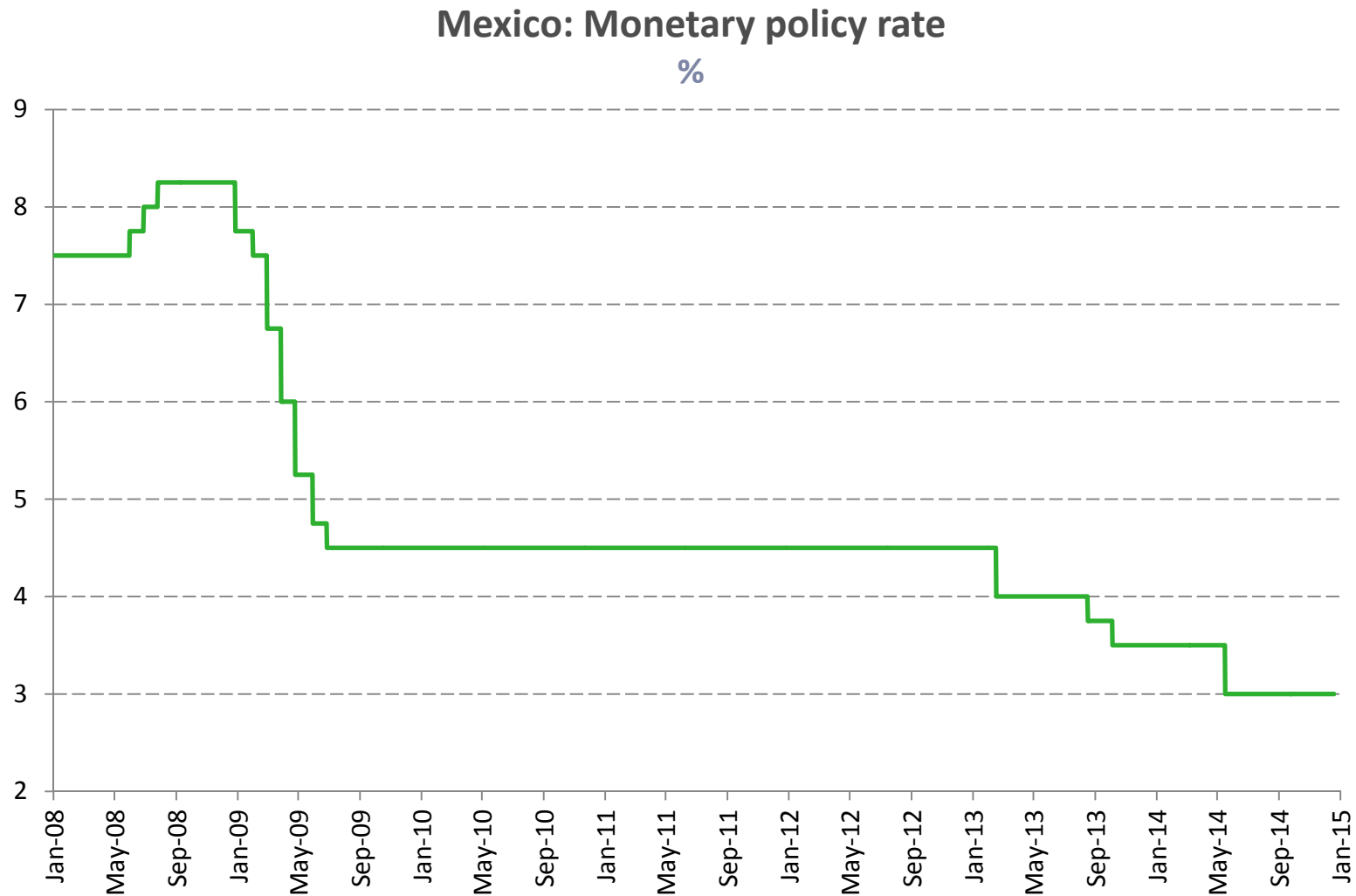
■ Upside

- ✓ Stronger U.S. economic recovery
- ✓ Higher-than-expected results from structural reforms

■ Downside

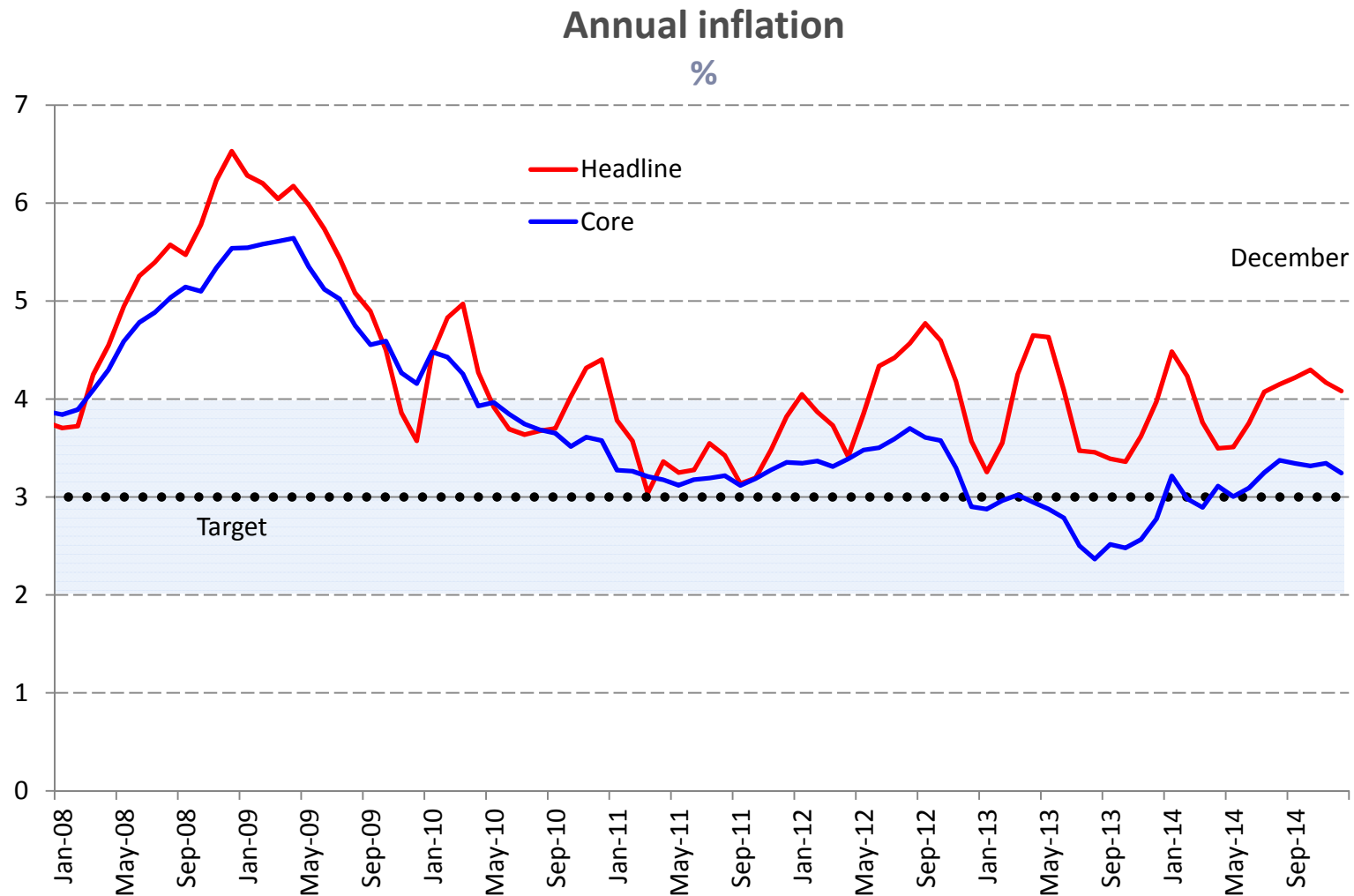
- ✓ Consumer and producer confidence may remain stagnant
- ✓ Social unrest may have a negative impact on economic activity
- ✓ Oil production and prices could continue declining

In the context of weak economic activity, monetary accommodation has increased



Source: Banco de México

Inflationary pressures have recently arisen from core and noncore components

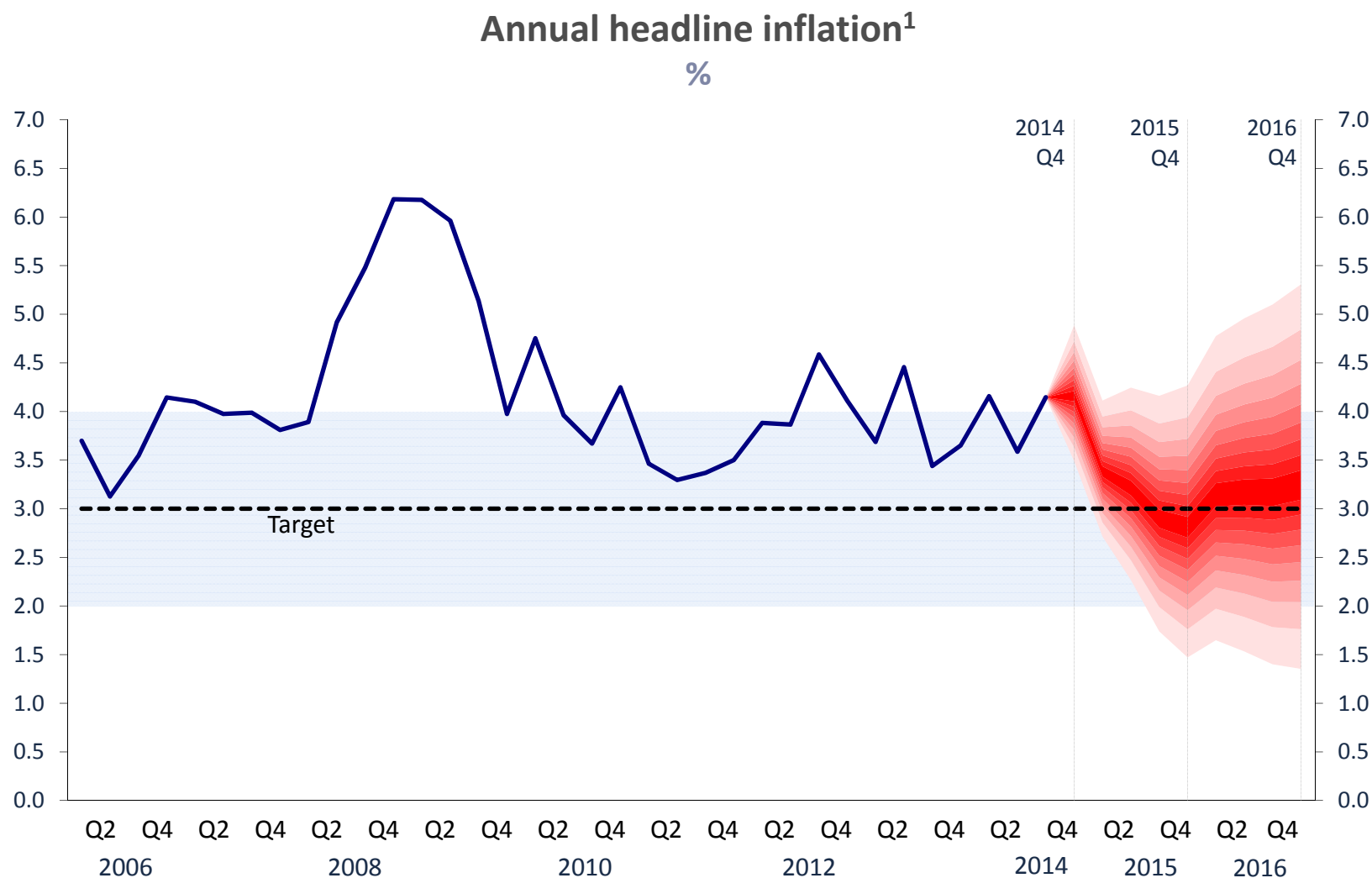


Source: INEGI

Several factors will likely lower annual inflation in the short term

- Favorable base tax effects
- Lower gasoline price adjustment
- Elimination of national long-distance phone charges

The Bank of Mexico expects inflation in 2015 to approach the 3 percent permanent target



1/ Quarterly average, annual headline inflation

Source: Banco de México (2014), *Quarterly Report*, July-September 2014, Summary, November

Inflation risks should be carefully monitored to attain convergence to the permanent target

- Weaker peso for a prolonged period of time
- ✓ Despite low pass-through in recent years, significant currency depreciation may have an impact on inflation
- Renewed substantial rises in noncore price components
- Eventual aggregate demand pressures

Concluding remarks

- The U.S. economic recovery has continued to gain momentum, which could be enhanced by low oil prices
- International financial volatility may continue
- Mexico should face external uncertainty by strengthening its economic fundamentals
- A gradual recovery is forecast for the Mexican economy
- Inflation risks should be carefully monitored to channel inflation to its permanent target



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