

Mexico in an unfriendly world economy
Manuel Sánchez
2016 Mexico Opportunities Conference: Harvesting Growth
J.P. Morgan, Mexico City, June 21 2016



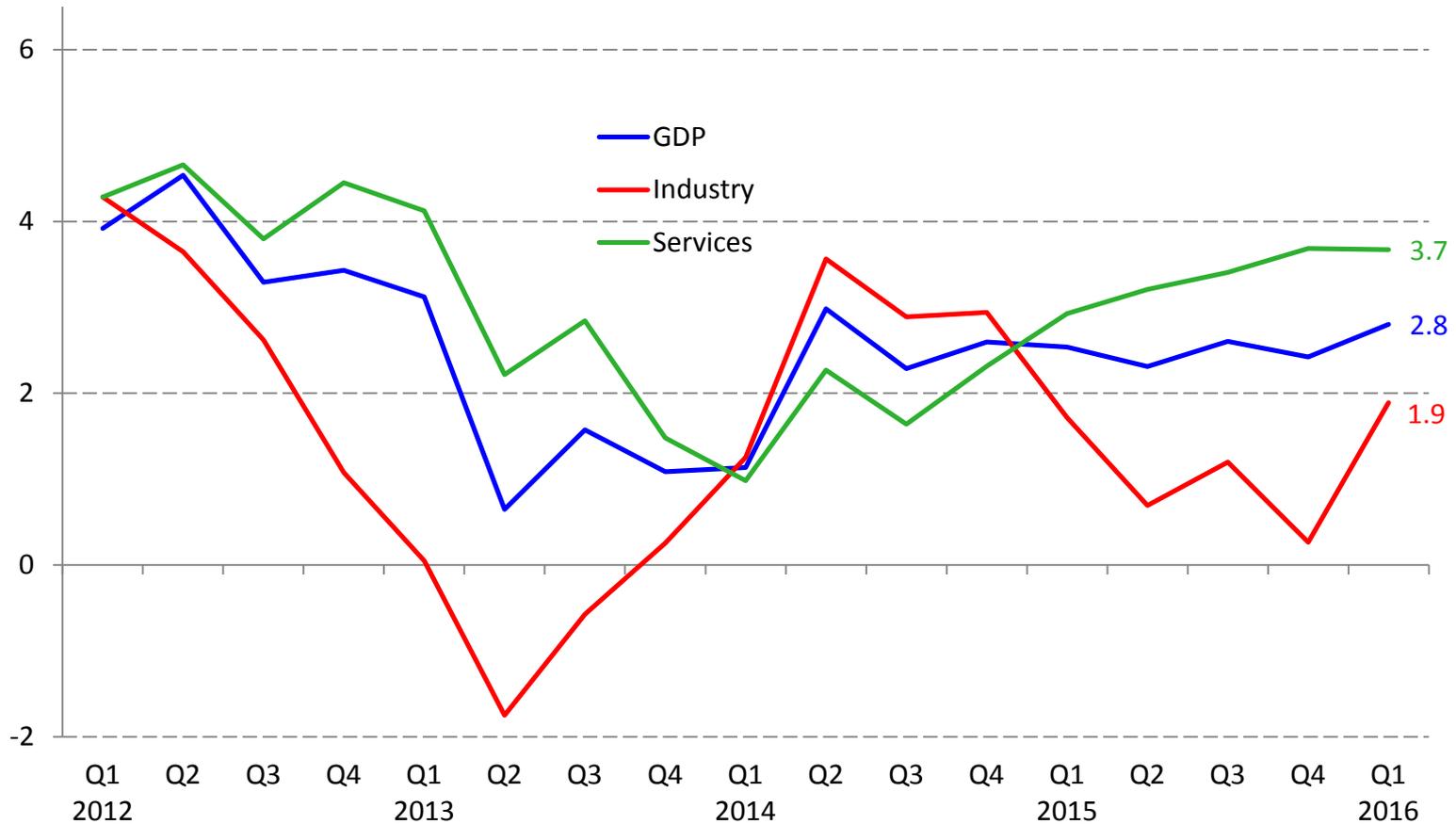
BANCO DE MÉXICO

During the last two years, international economic conditions have deteriorated

- Advanced nations are stuck in a slow recovery, emerging economies are decelerating, and global trade is stagnant
- Doubts and concerns on monetary policy stances and divergence among developed countries are present
- Worries over China persist, while uncertainty is rising on geopolitical issues
- The medium-term outlook is for low commodity prices
- Heightened risk aversion is hitting emerging economies especially hard

In this difficult environment, Mexico has maintained moderate growth driven by an expanding services sector

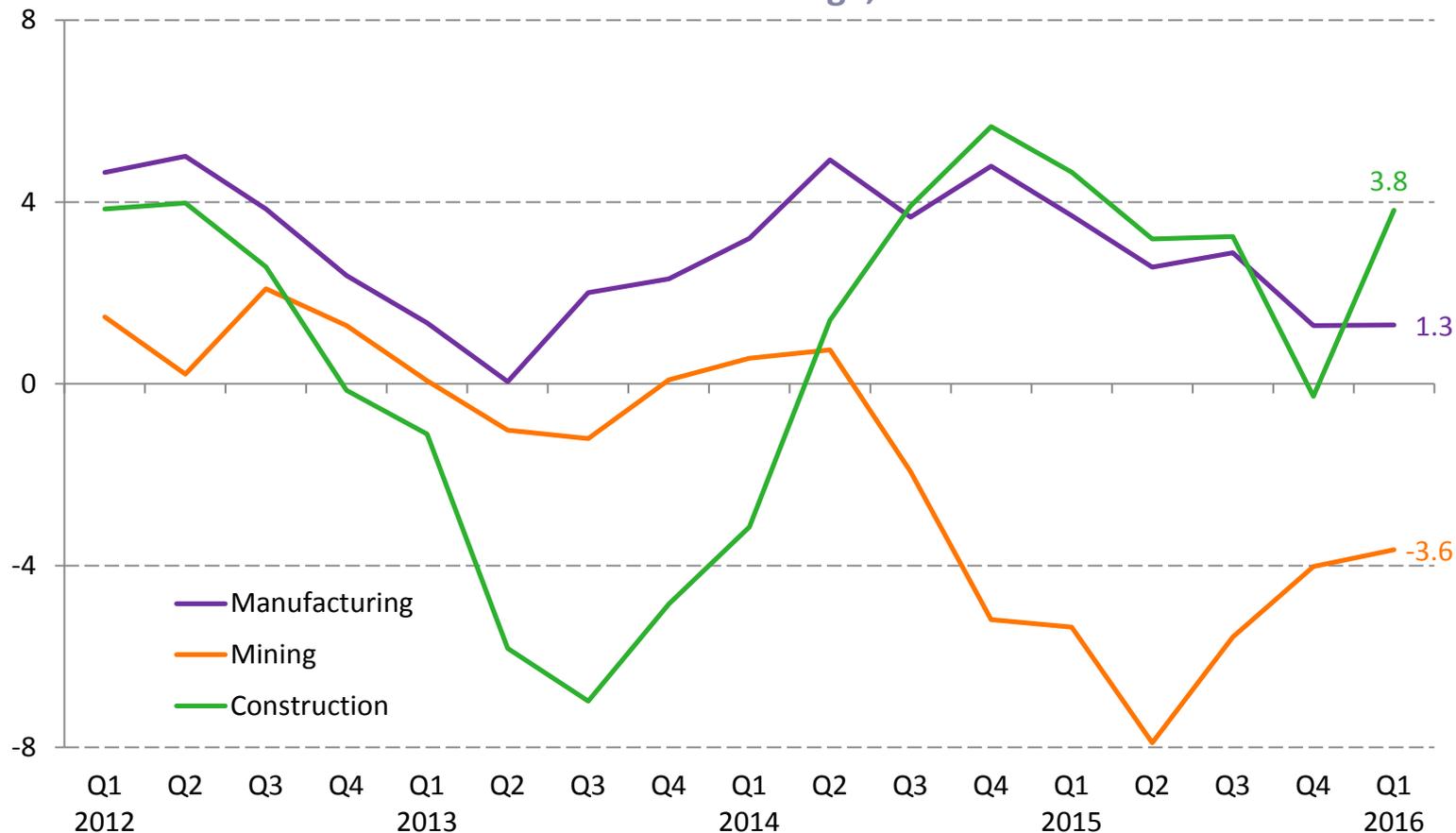
Mexico: GDP
Annual % change, s.a.



s.a. / Seasonally adjusted
Source: INEGI

Industrial production has restrained output due mainly to declining oil extraction

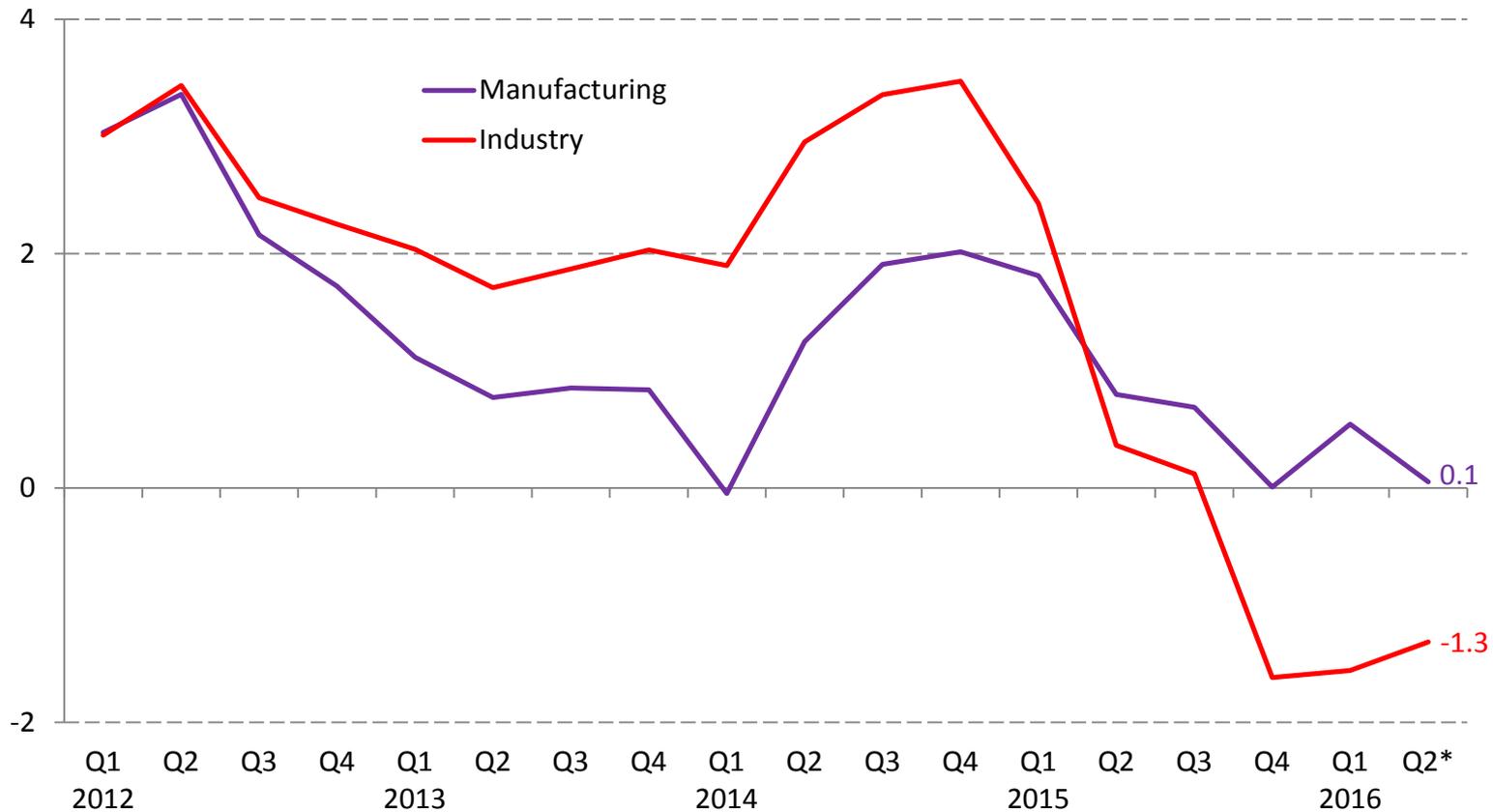
Mexico: Industrial GDP
Annual % change, s.a.



s.a. / Seasonally adjusted
Source: INEGI

... as well as less dynamic manufacturing stemming from falling U.S. industrial production

United States: Production
Annual % change, s.a.



s.a. / Seasonally adjusted

*/ April-May

Source: U.S. Federal Reserve

Mexico's manufacturing exports have dropped despite significant real peso depreciation

Mexico: Manufacturing exports
Annual % change, s.a.



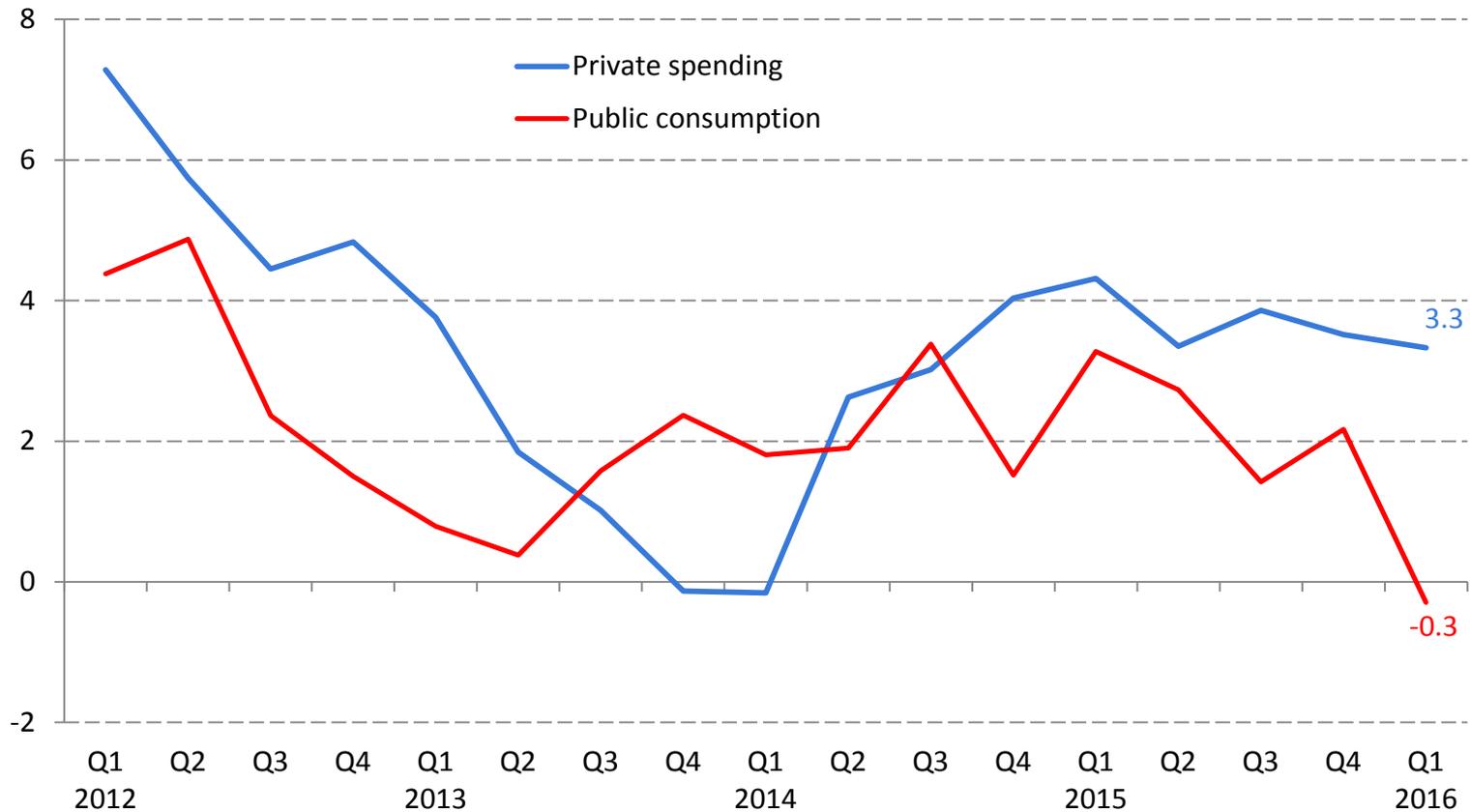
s.a. / Seasonally adjusted

*/ Only April

Source: Banco de México

The main engine of GDP growth has been private spending, while public consumption has recently dropped

Mexico: Expenditures
Annual % change, s.a.



s.a. / Seasonally adjusted
Source: INEGI

As with other countries, Mexico's economic outlook has continued to be revised downward

GDP outlook Annual % change

	2016		2017	
Forecast date	January 2016	Most recent ¹	January 2016	Most recent ¹
World	2.7	2.4	3.0	2.8
United States	2.4	1.9	2.5	2.3
Latin America ²	0.0	-0.6	2.2	2.0
Mexico	2.7	2.4	3.1	2.8

1/ World and U.S. forecasts correspond to June, while those for Latin America and Mexico correspond to May

2/ Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Rep., Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela

Source: Consensus Forecasts and Latin American Consensus Forecasts

The scenario of measured improvement is subject to downside risks

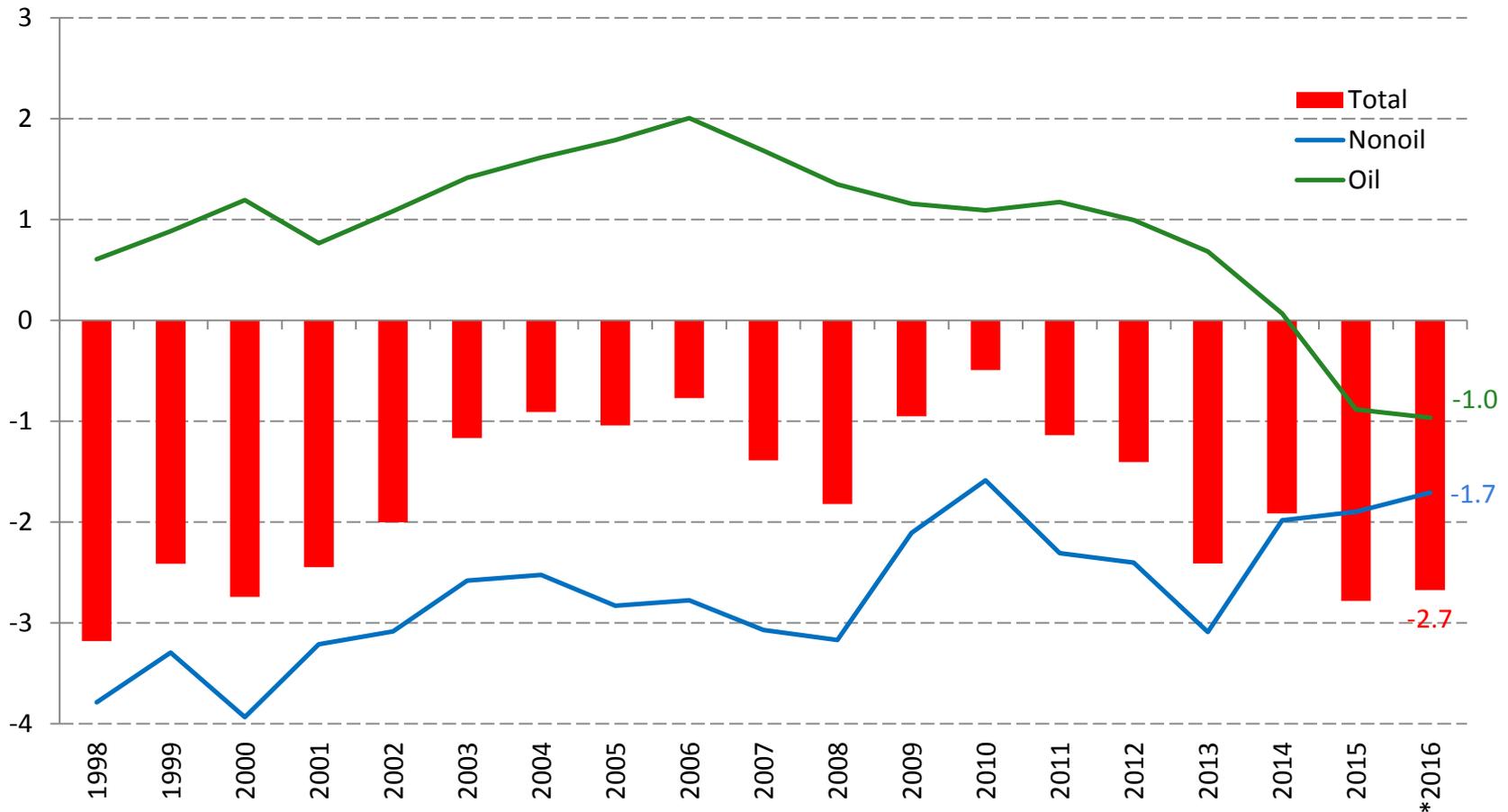
- Further slowdown in U.S. imports and industrial production, with adverse effects on Mexican manufacturing and spillovers on services and private investment
- Deterioration of producer and consumer sentiment due to less favorable international financial developments
- A larger-than-foreseen fall in Mexican oil extraction
- On the upside, recent structural reforms could start to yield greater-than-expected benefits

Emerging markets have been hit by less favorable international conditions

- The consequences of extraordinarily lax monetary policy in advanced nations are impossible to foresee
- Portfolios have been adjusted away from emerging markets, with lower capital inflows and even outflows
- Asset prices, including EME bonds and currencies, have seen downward pressure
- Spikes in financial volatility have occurred amid geopolitical jitters
- All of this is testing the strength of emerging market fundamentals, including those of Mexico

In Mexico, the unprecedented shrinkage of the oil balance has resulted in a slightly larger current account deficit

Mexico: Current account
% of GDP

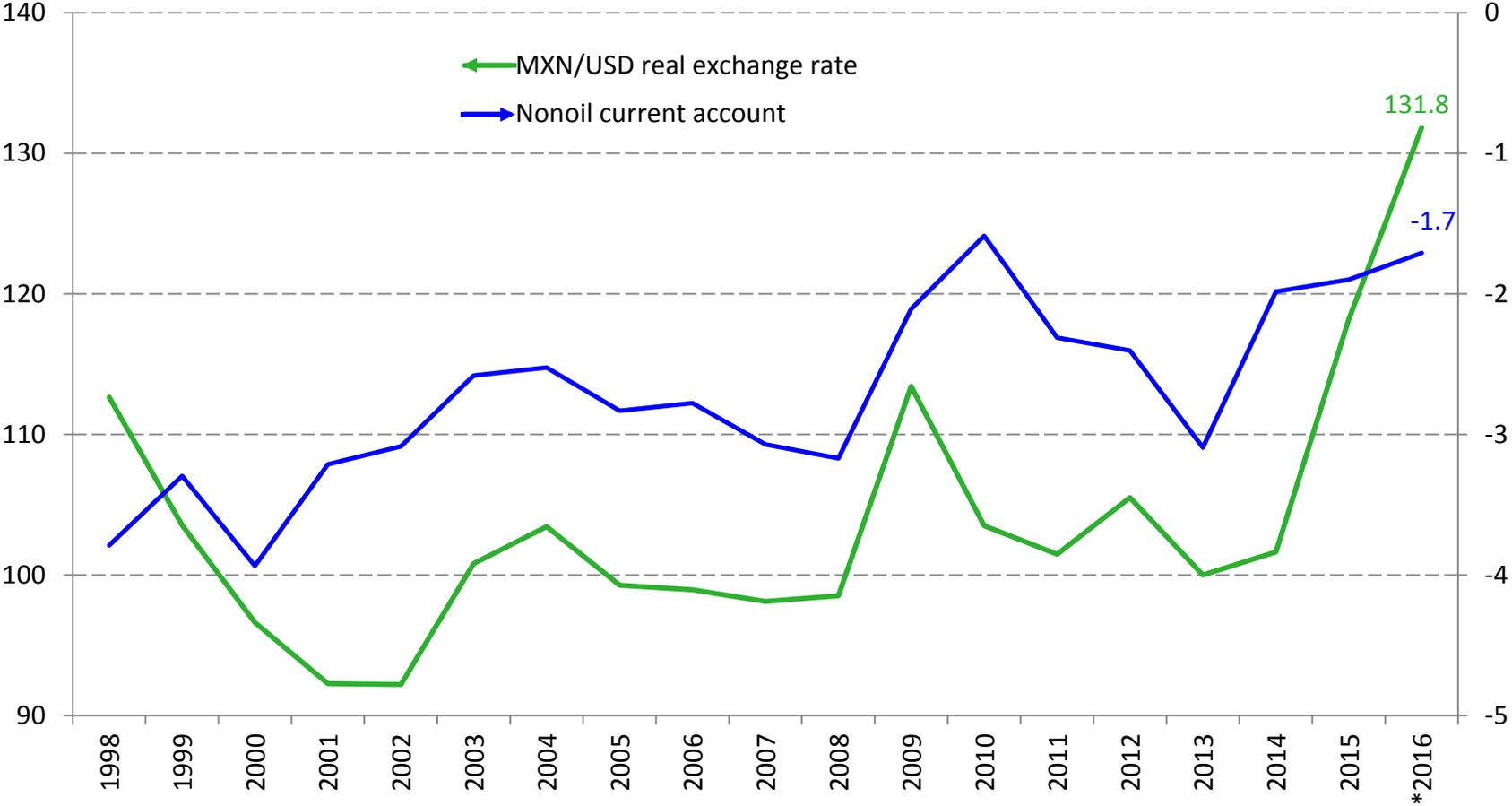


*/ First quarter

Source: Own calculations with data from Banco de México and Haver Analytics

The closing of the nonoil current account gap, aided by real peso depreciation, has not offset the deteriorating oil balance

Mexico: RER and nonoil current account
2013=100 and % of GDP

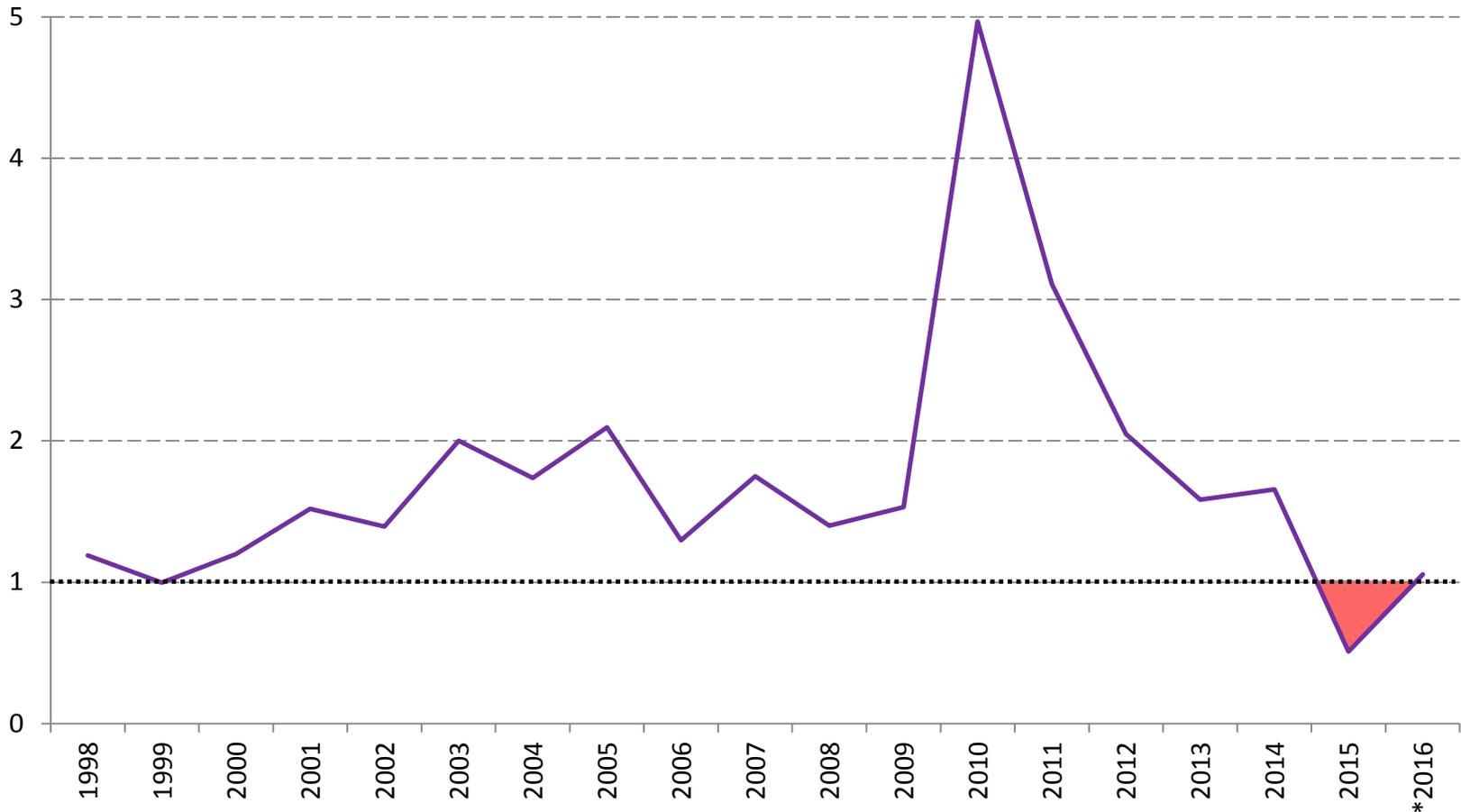


*/ First quarter

Source: Own calculations with data from Banco de México and Haver Analytics

Mexico's oil situation fully explains recent balance-of-payments developments

Mexico: Financial account surplus plus errors and omissions
Times current account deficit

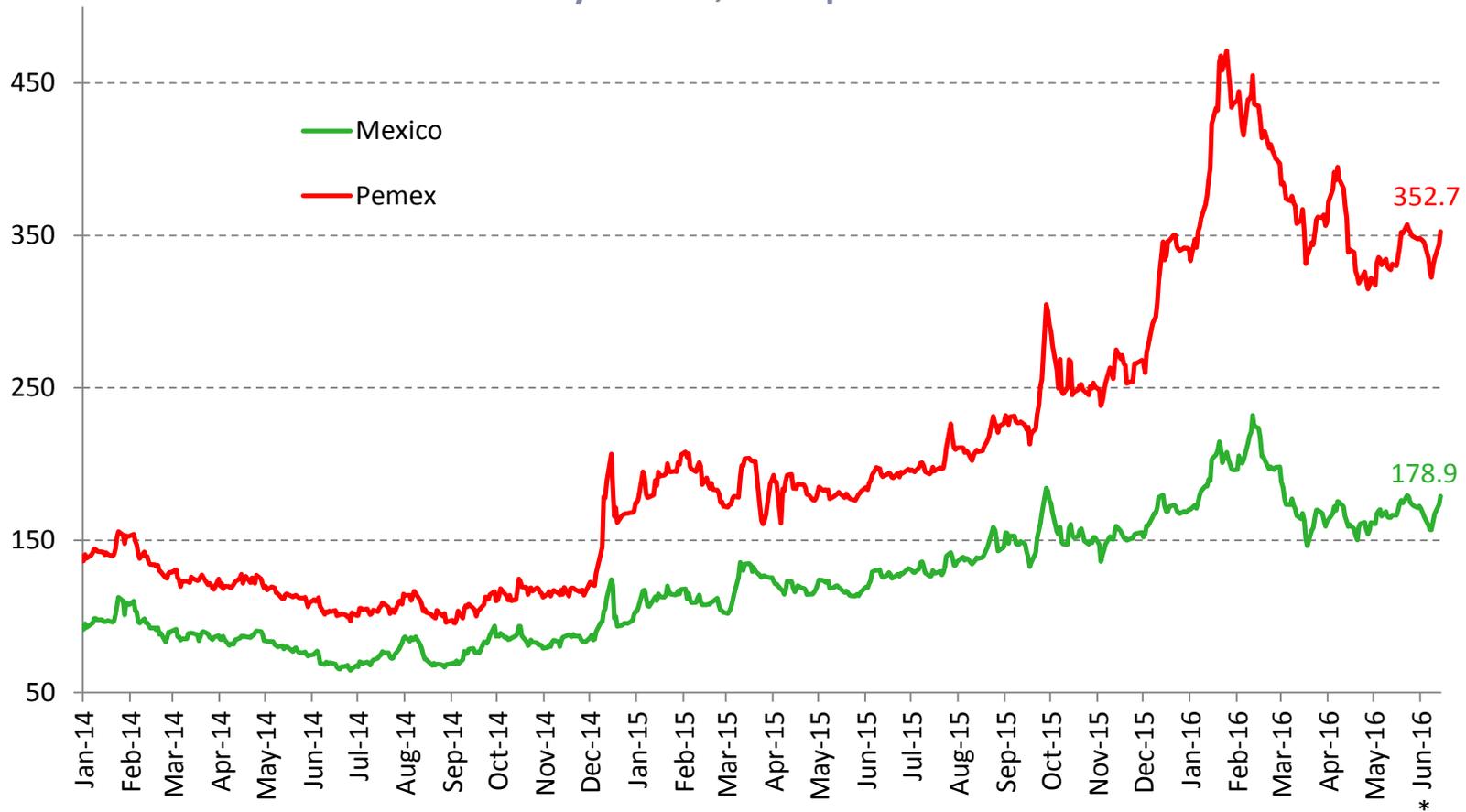


*/ First quarter

Source: Own calculations with data from Banco de México

Pemex financial weakness has affected sovereign risk perception

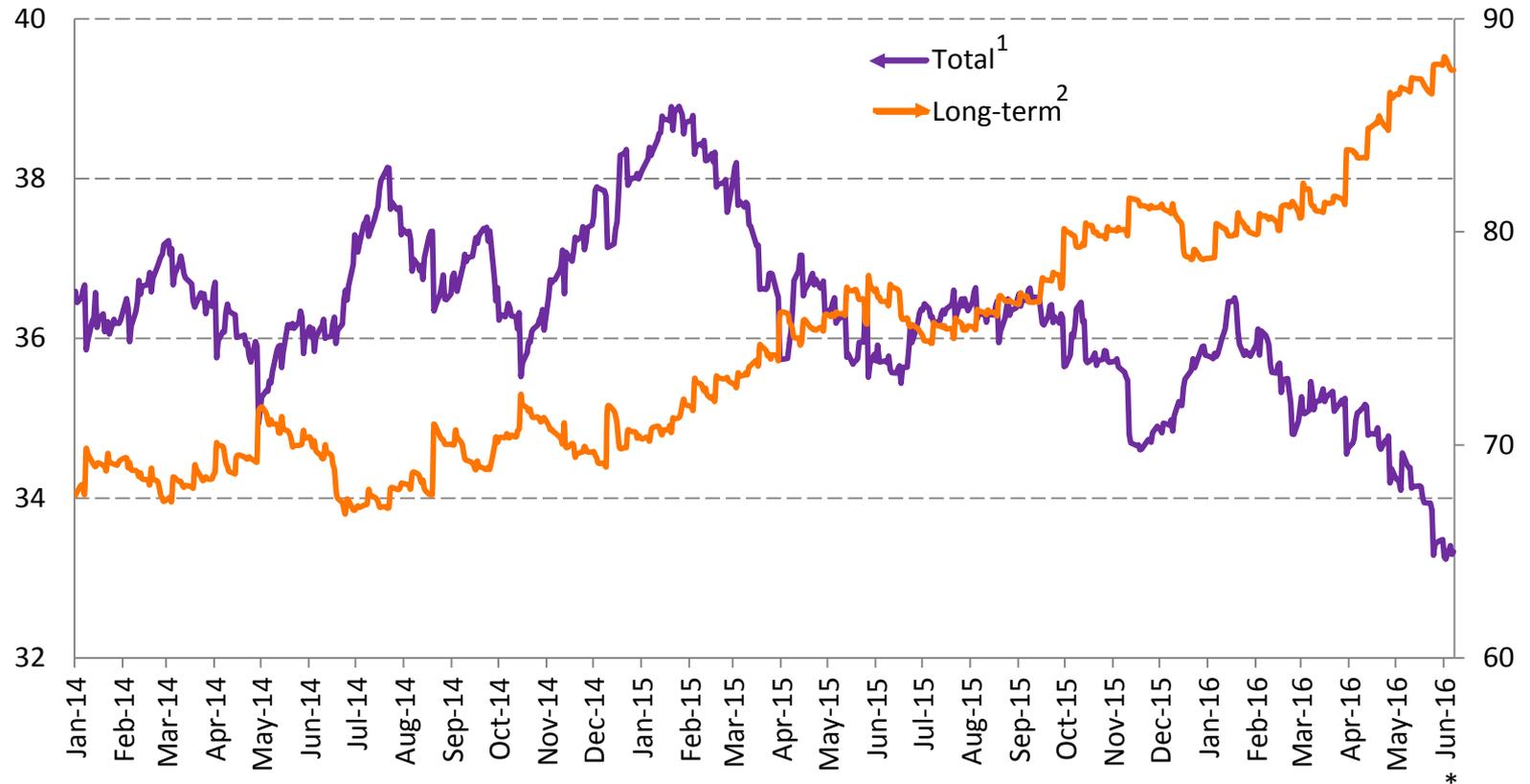
Mexico: Sovereign and Pemex credit risk premium
5-year CDS, basis points



*/ To June 14
Source: Bloomberg

NR holdings of peso government securities have dropped moderately, with displacement toward long-term bonds

Mexico: Nonresident holdings of peso-denominated government securities
% of total outstanding and % of NR holdings



1/ Cetes, Bondes D, Bonos M and Udibonos

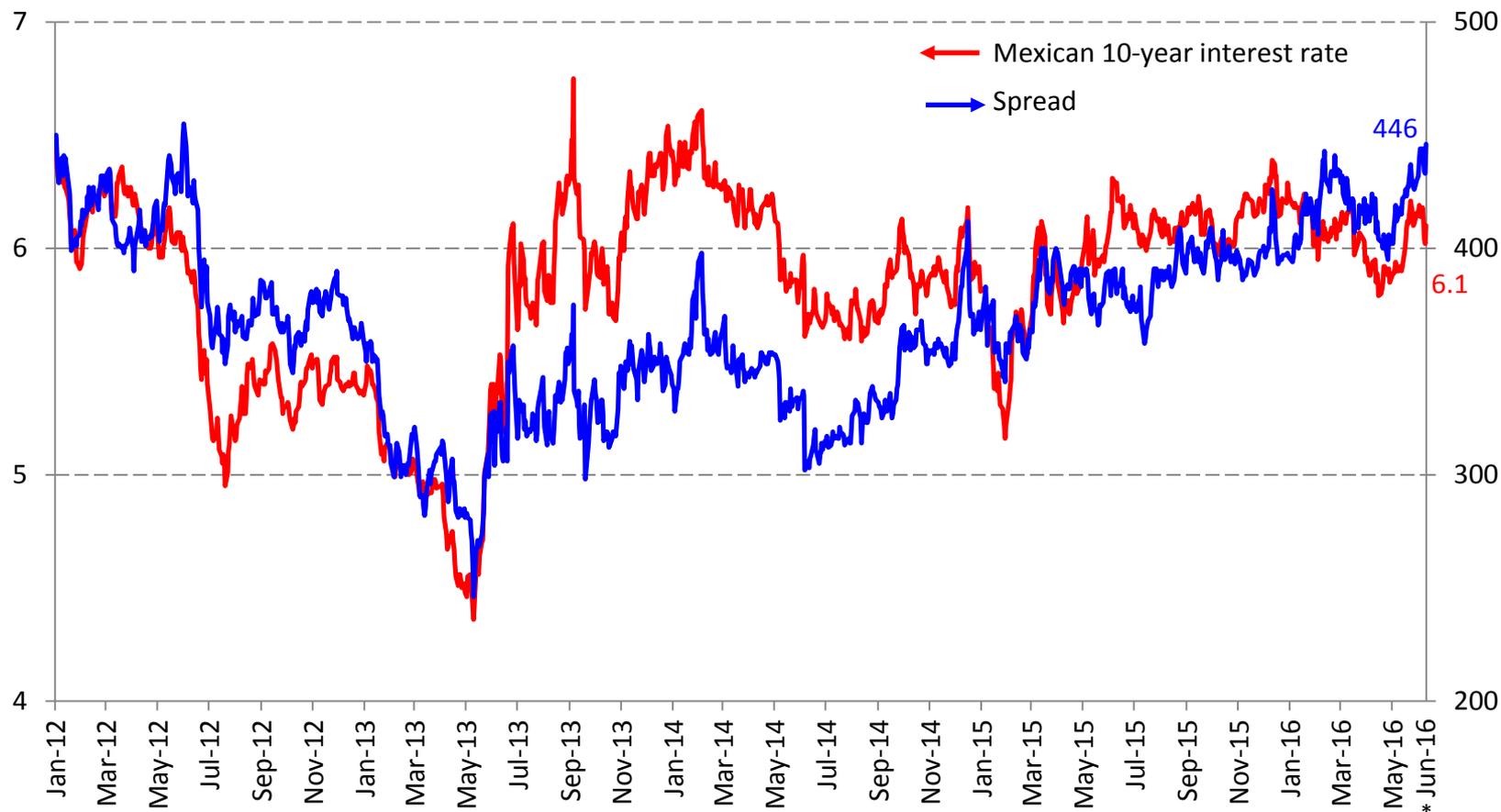
2/ Cetes not included

*/ To June 8

Source: Banco de México

As in other EMEs, heightened risk aversion since the taper tantrum has widened interest-rate spreads

Mexico and the United States: Mexican 10-year interest rate and spread between 10-year government bonds
% and basis points

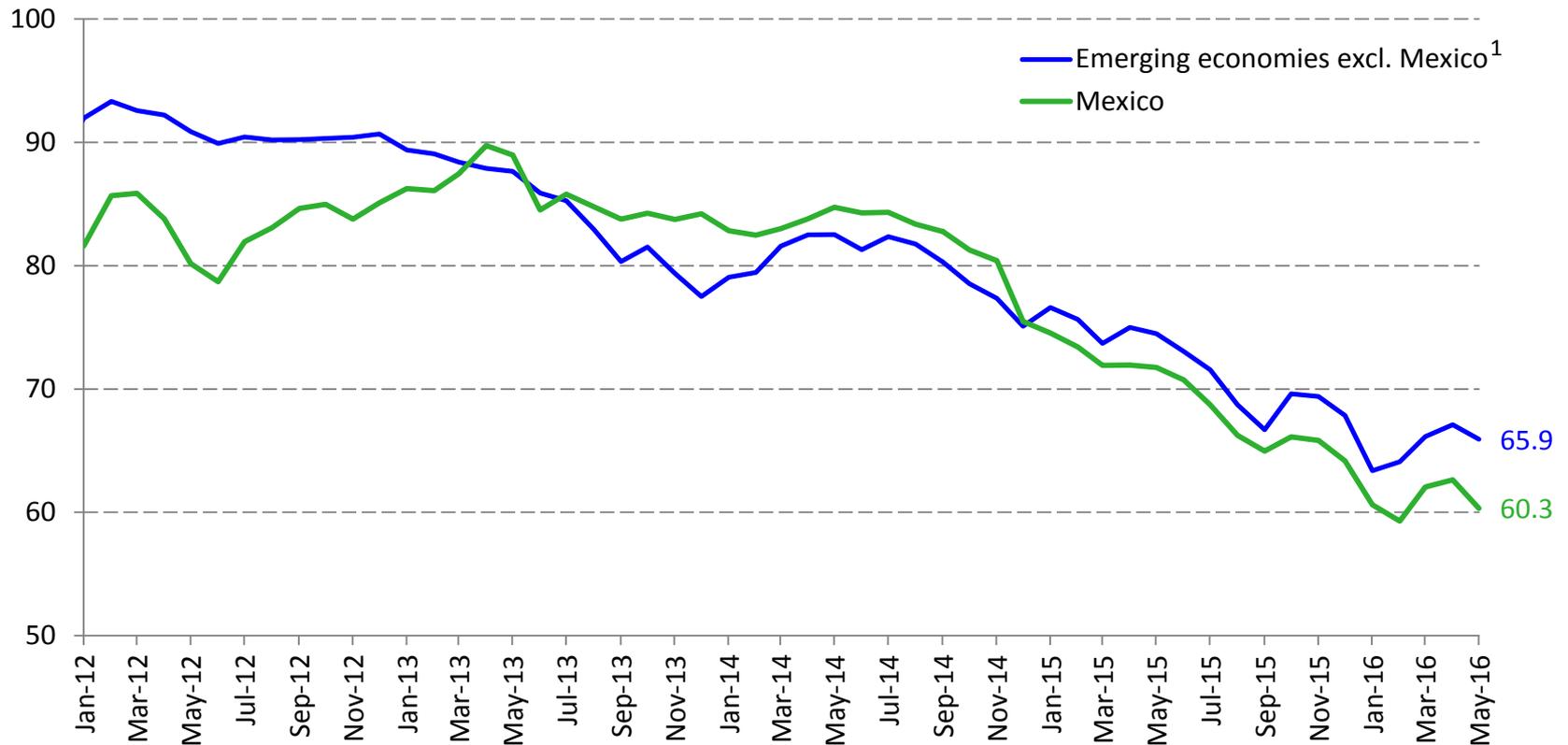


*/ To June 10

Source: Banco de México and Bloomberg

The Mexican peso has been the main adjustment vehicle, recently hit more than other EME currencies

Emerging economies and Mexico: Exchange rate
January 2007=100, local currencies in terms of U.S. dollars



1/ Trade-weighted average of values against the U.S. dollar of the following currencies: the Chinese yuan, Russian ruble, Turkish lira, Korean won, South African rand, Brazilian real, Indian rupee, Polish zloty, Hungarian florin, Malaysian ringgit, Thai baht, Chilean peso, Indonesian rupee, Philippine peso, Colombian peso, and Peruvian sol

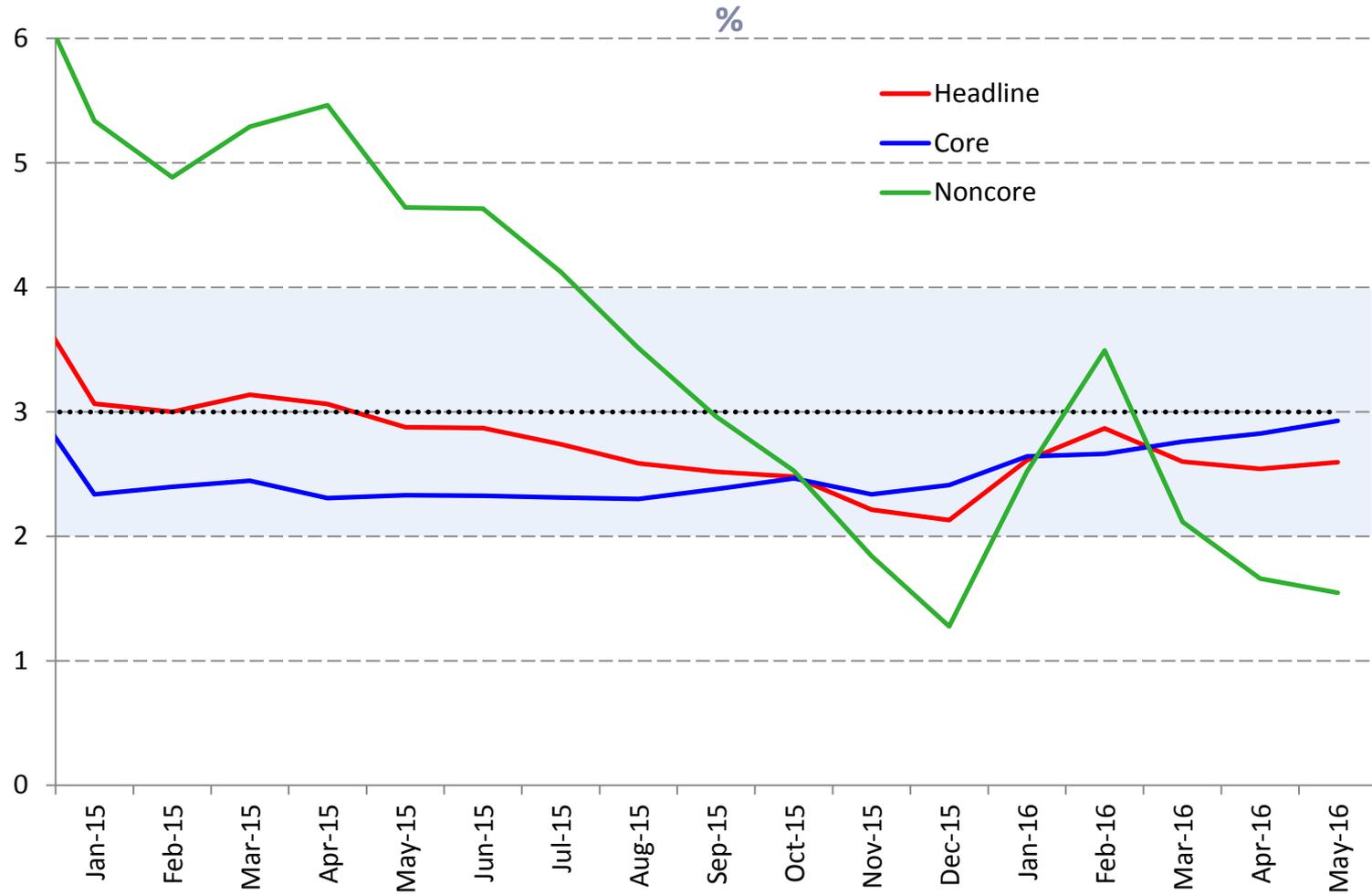
Source: Own calculations with data from Bloomberg

Strengthening of the fiscal stance is a welcome development in the face of external headwinds

- Financial and business restructuring in Pemex is in progress
- Cuts of total 2016 budgeted public expenditures are underway
- An initiative has been made for a positive primary balance in 2017
- Stabilization and decline in the total balance of public-sector borrowing requirements to GDP are foreseen

Finally, annual inflation has continued to be contained, below the permanent target

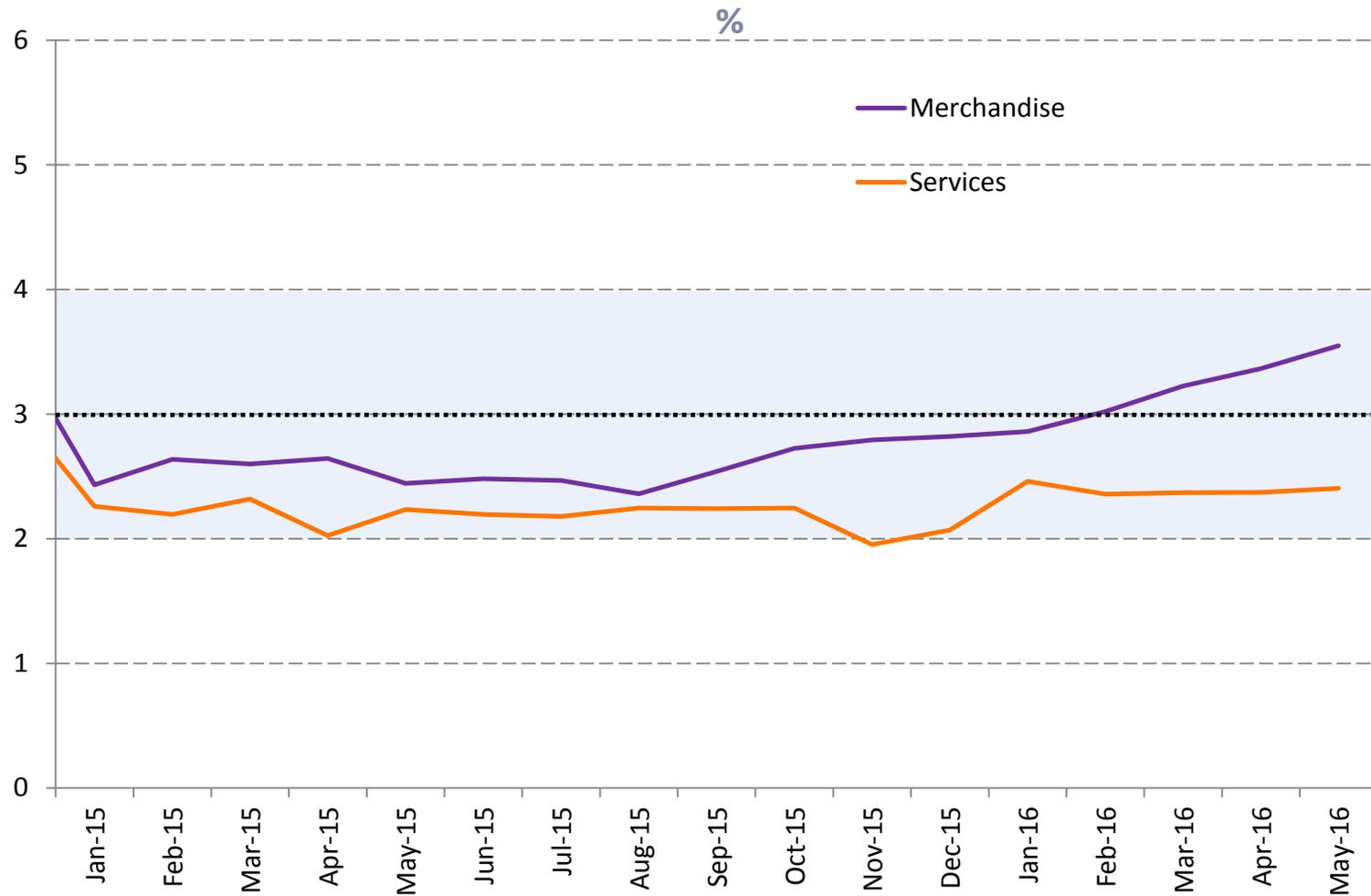
Mexico: Annual inflation



Source: INEGI

A surge in merchandise inflation reflects the effect of peso depreciation on tradable goods prices

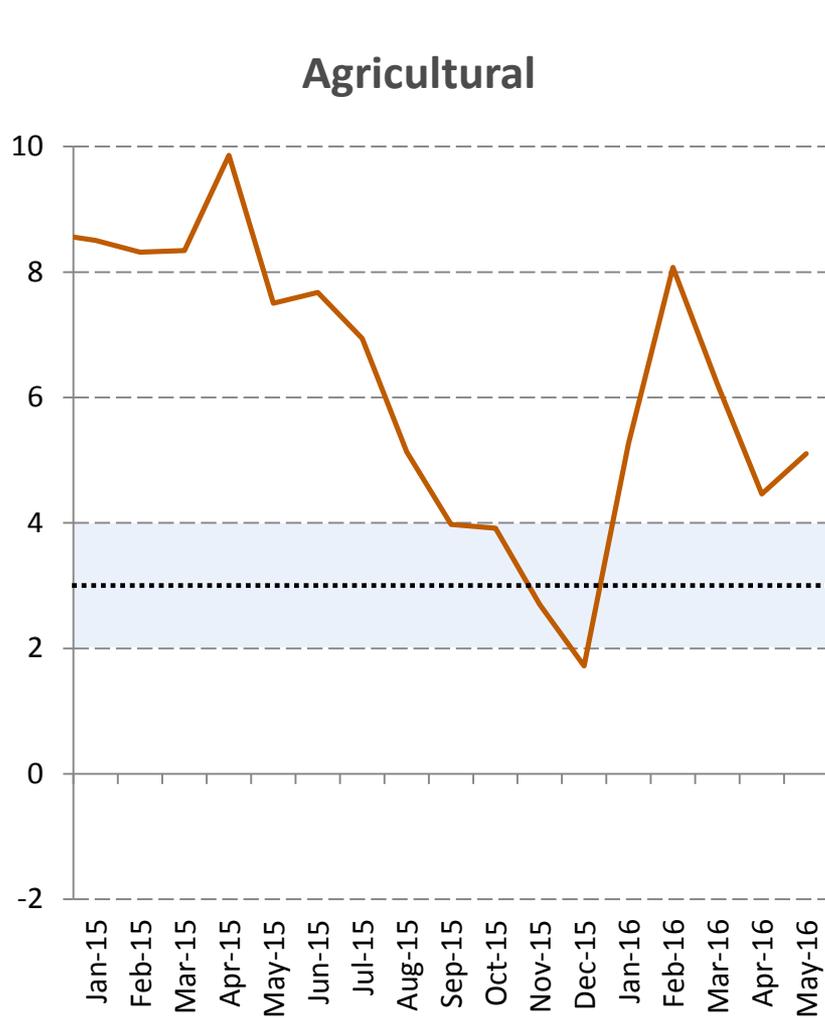
Mexico: Annual core inflation



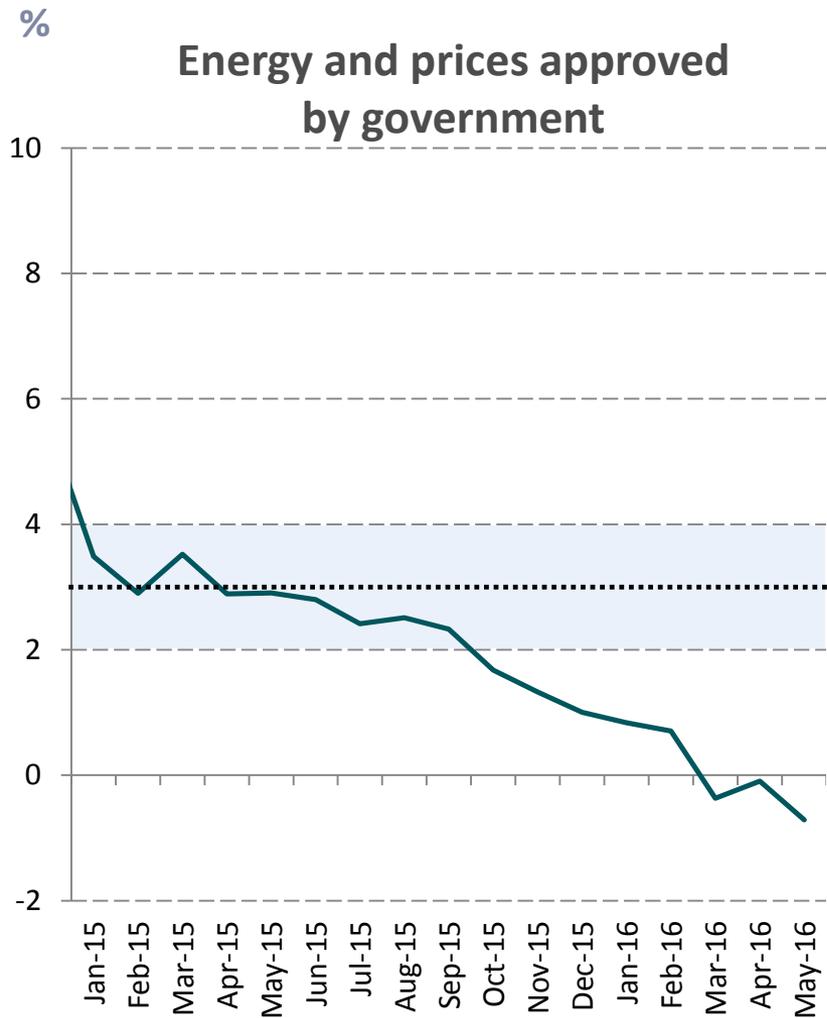
Source: INEGI

Low inflation has been supported significantly by declining noncore price increases

Mexico: Annual noncore inflation



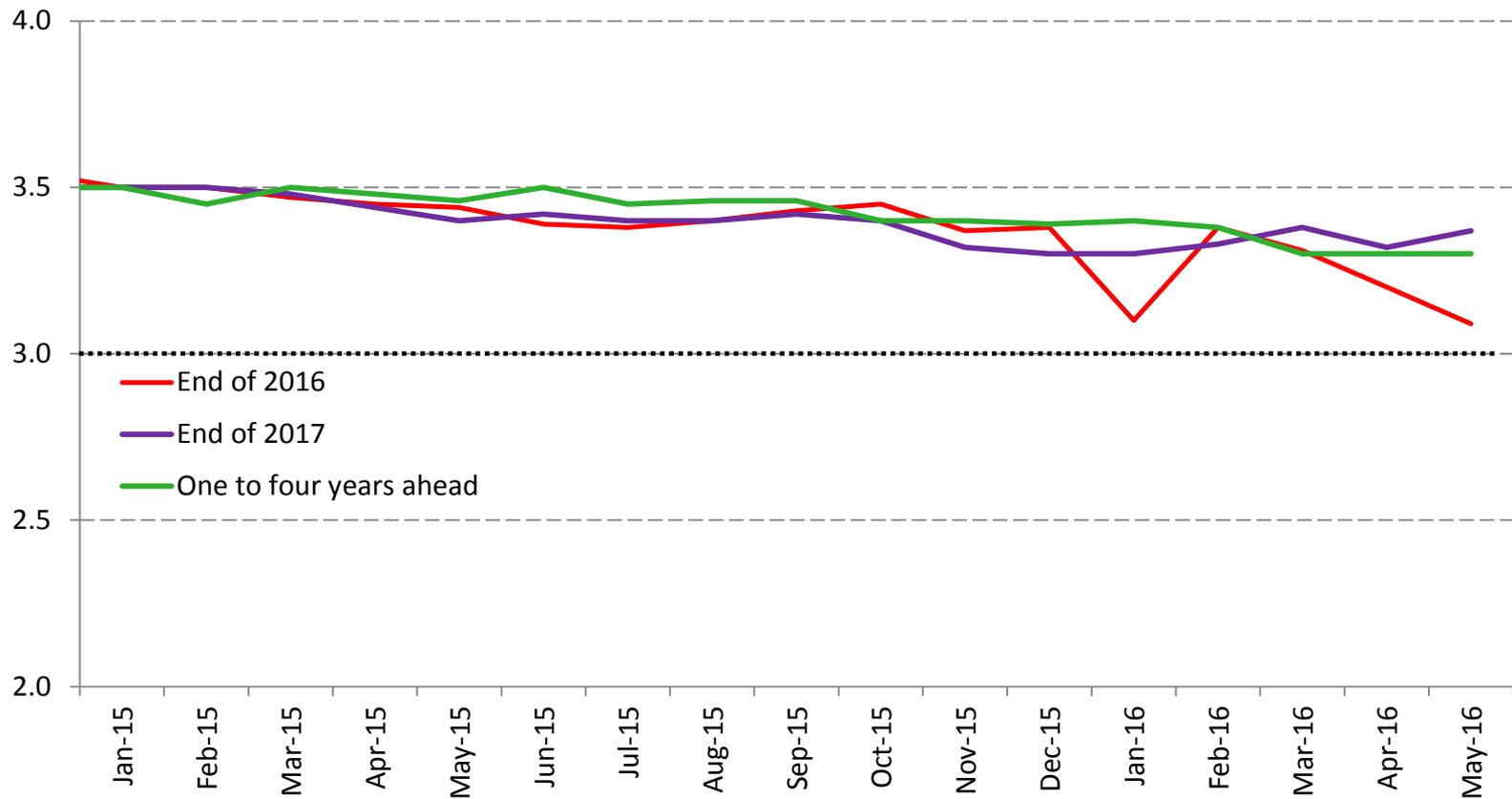
Source: INEGI



Source: INEGI

Survey-based measures of inflation expectations are gradually moving towards the target

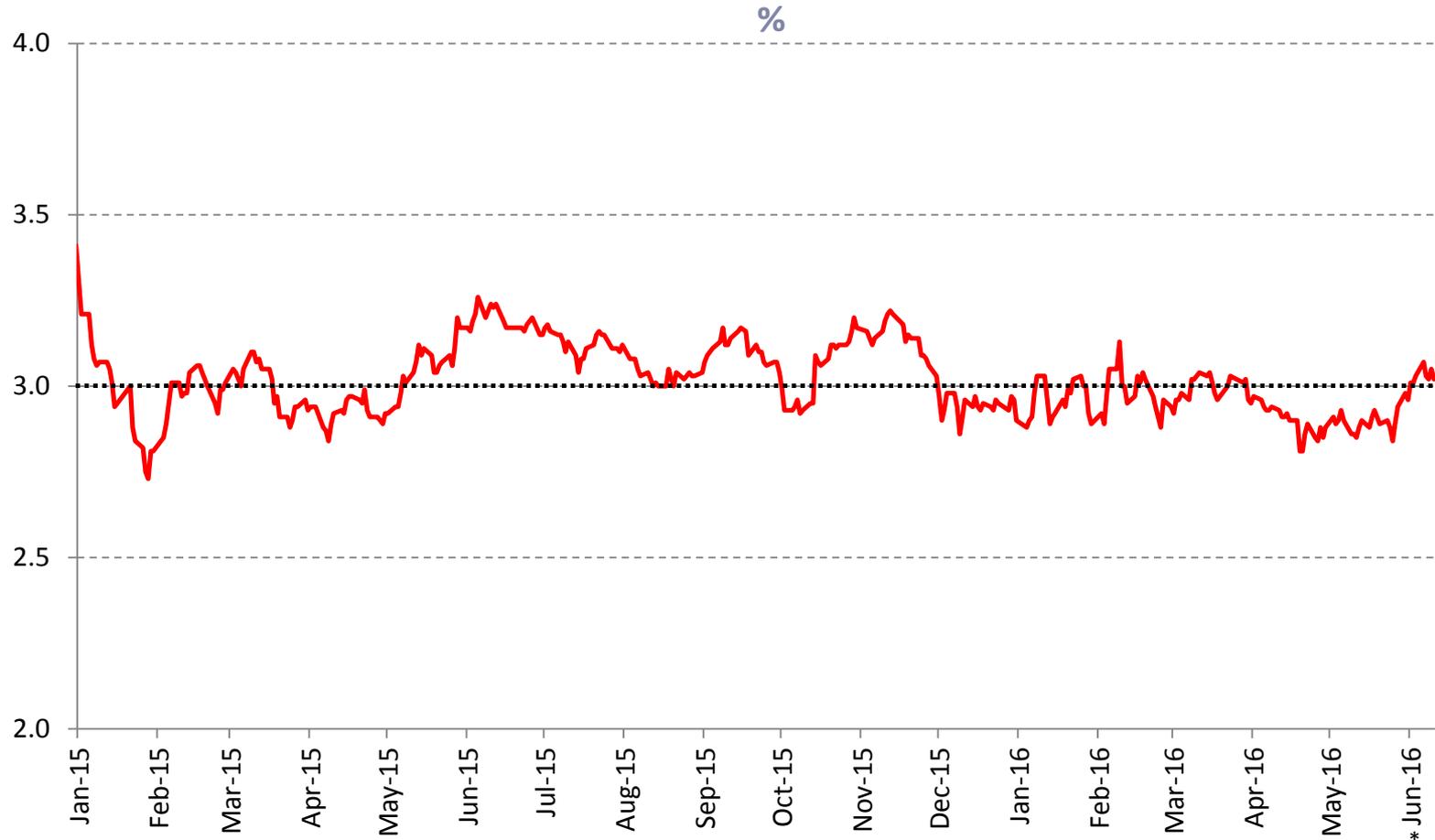
Mexico: Annual inflation expectations
Median, %



Source: Banco de México, *Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado*

... while those extracted from market instruments seem to have converged to the target

Mexico: 10-year breakeven inflation



*/ To June 10

Source: Banco de México with Valmer data

Some risks to the consolidation of inflation convergence to the target prevail

- Upward risks are especially significant given the relatively short time inflation has remained anchored on the target
- The most significant danger may come from additional peso weakness that may result in greater pass-through, yielding misalignment of inflation expectations
- Another risk could emerge in the form of aggregate demand pressures, since total absorption has increased
- Agricultural price rises may pick up, reverting to the medium-term average, with second-round price effects

Monetary policy must avoid complacency, remaining on guard to consolidate inflation convergence

- Results, while recently positive, carry no future guarantee
- Exchange rate considerations should be viewed from the perspective of the price stability mandate
- For time consistency, the relative monetary stance vis-à-vis the United States should continue to be a factor
- However, threats to price stability may arise regardless of what the U.S. Federal Reserve does. Hence, monetary policy adjustments can be independent of the Fed
- In any case, the Bank of Mexico will continue to act in a timely and decisive way to consolidate price stability

Conclusions

- Mexico's economic fundamentals are being tested
- Structural reforms, as well as an improved rule of law and security, could fuel more rapid growth
- Given the weak financial state of Pemex and contamination risks to the Mexican sovereign, adjustment of the fiscal stance is a welcome development
- Good inflation performance is not guaranteed, and thus complacency cannot be allowed to seep into monetary policy, which must continue to pursue permanent convergence
- The task of fortifying economic fundamentals is still an ongoing challenge for policy makers



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