REMARKS BY MR. JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, ON "MONETARY POLICY IMPLEMENTATION IN A COMPLEX ENVIRONMENT", AT THE ABERDEEN NYC EMD POLICY MAKER POWER LUNCH. New York City, October 11, 2016. [1]

My sincere thanks to Aberdeen Asset Management for the invitation to participate in this event.

The primary mandate of the Banco de México, enshrined in the country's Constitution, is to aim at low and stable inflation. To this end, monetary policy is conducted within a framework supported by two main pillars: an independent central bank and an inflation targeting regime with a 3 percent objective for the annual rate of growth of consumer prices. In this context, the Banco de México seeks an efficient convergence of inflation to the target, that is to say, at the lowest possible cost in terms of economic activity.

At present, monetary policy in Mexico is implemented in a rather complex environment. On the one hand, the level of output is below the estimated potential, and the available forecasts suggest that this gap will remain in negative territory through end-2017. In addition, consumer price inflation displays a favorable behavior and has been persistently below the 3 percent target. However, on the other hand, the Mexican peso has recorded an important depreciation over the last couple of years, and continues to be subject to significant pressures. Naturally, this raises question marks about the accompanying risks to inflation.

[1] The views expressed in this document are strictly personal.

Let me elaborate on the macroeconomic situation under which monetary policy is carried out at present.

After the decline observed in the second quarter of the year, economic activity has resumed a moderate rate of expansion, fueled by private consumption and services, on the demand and supply fronts, respectively. An accurate assessment of the economy's position during the first half of this year is challenging, among other reasons since national account figures are distorted by seasonal factors which are difficult to correct. However, there are grounds to believe that economic activity has begun a phase of deceleration.

The most recent information suggests a lower growth trend for both private consumption and services, and the remaining components of aggregate demand and supply remain stagnant. Although labor market indicators provide mixed signals, they are generally consistent with a gradual deceleration of economic growth. The overall rate of unemployment has continued to fall, approaching levels observed prior to the crisis, but the pace of employment growth has lost some momentum and nominal wage increases remain contained. In this context, a negative output gap is observed.

It is reasonable to expect that the expansion of economic activity will continue during the remainder of this year and in 2017. In fact, the anticipated upturn of industrial output in the United States, if materialized, would contribute to a more balanced economic recovery in Mexico through its impact on manufacturing output and exports. In this respect, it is worth noting that there are some early signs of a revival of production in the manufacturing industry, and that this sector's external sales, though still sluggish, seem to have stopped declining. On the other hand, the expansion of GDP is likely to remain below potential and downside risks persist.

It is true that economic growth in Mexico has been low vis-à-vis the population's needs. However, the shocks which have affected the economy have to be taken into consideration for an objective assessment of its performance. In particular, it is important to take into account that the industrial sector in the United States has been in recession since early 2015, and that GDP annual growth in that country has decelerated continuously since the second quarter of that year. Notwithstanding the close long-term correlation between these two aggregates and economic activity in Mexico, the latter has shown resilience to this shock. The efforts of structural reform carried out in Mexico in recent years are clearly an important factor behind this result.

As noted previously, general inflation has shown a favorable performance. It stands at 2.97 percent as of September of this year, thus accumulating 17 months below the 3 percent target, including 8 consecutive historical minima in 2015. The importance of these results is underlined when it is taken into consideration that since early September 2014 the peso has depreciated by some 45 percent with respect to the U.S. dollar. Although depreciation of the exchange rate has had some effect on inflation, so far, the pass-through has been concentrated on the prices of merchandise, with no second round effects.

General inflation is projected to increase gradually during the rest of this year towards levels slightly above 3 percent, and to fluctuate around this figure in 2017, but it should be noted that the latter is subject to some uncertainty, since the proposal to liberalize gasoline prices starting in 2017, which may affect the evolution of inflation, is still under consideration by Congress. Going further forward into the medium to long terms, survey-based inflation expectations remain well anchored, although still a tad above the target.

While demand pressures on prices are likely to remain subdued given the expectation of a negative output gap throughout next year, the outlook for inflation presents, in my opinion, risks tilted to the upside. The possibility of a rebound in the prices of agriculture and livestock, present for some time given below-trend increases, is already materializing. However, recent experience suggests that its effects on overall inflation should be transitory. Therefore, the evolution of the exchange rate continues to represent the main risk for inflation. The possibility of a higher pass-through to prices has increased as a result of the additional peso depreciation in recent weeks and the potential for further pressures on the peso in the short term, especially in view of the upcoming presidential election in the United States.

Depreciation of the peso is explained by a combination of external and domestic factors. Naturally, the anticipated normalization of monetary policy in the United States has been a source of apprehension. In addition, as already noted, uncertainty regarding the outcome of the electoral process in that country has been reflected in the behavior of the peso, in view of the potential implications for Mexico's economy. The situation has been further complicated by weak oil prices, a generalized situation of uncertainty in international financial markets, and the use of the peso as a hedging instrument against risks in other emerging market economies and for speculative purposes. On the domestic front, distress is mainly related to the evolution of public finances and, to a lesser extent, the widening of the current account deficit.

In a situation characterized by a negative output gap, low inflation and well anchored inflation expectations, on the one hand, but higher risks for inflation, on the other, the target for the overnight inter-bank interest rate has been increased four times since late 2015 to date.

The first increase, of 25 basis points, took place as a response to a corresponding adjustment in the target range for the federal funds rate in the US. The reasons are straightforward. In view of close links between the Mexican and US economies, an environment of widespread nervousness in international financial markets, a very open capital account in Mexico and high peso-dollar exchange rate levels, a narrowing of the interest rate differential between the US and Mexico could have resulted in disorderly capital outflows, and risks for inflation and financial stability.

Subsequent increases in the monetary policy interest rate in Mexico of 50 basis points each in February, June and September are explained by a number of common factors: the expectation of an upward trend for inflation even in the absence of further shocks; risks for inflation and its expectations deriving from a sharp depreciation of the exchange rate; the possibility of a higher than anticipated level for the peso-dollar rate for a significant period; potential non-linear effects of the exchange rate on prices; and the adverse signaling that could result from the absence of decisive action in the face of evident perils for inflation. Naturally, adjustment of the monetary policy stance has been considered fundamental to fulfill the constitutional mandate of the Banco de México, based on the premise that maintaining a low and stable inflation rate represents the best contribution of the Central Bank to economic growth.

In spite of the accumulated tightening of the monetary policy stance in Mexico since late last year, the impact of the higher target for the reference rate on domestic economic activity has been alleviated by a flattening of the yield curve. Interest rate increases have been concentrated on the short end of the curve, while rates for longer maturities have actually declined.

Looking forward, it is difficult to evaluate the possible trend of the monetary policy rate in Mexico in the very short term, especially in view that some of the factors that have recently affected the most the peso-dollar rate, and particularly the electoral process in the United States, could dissipate or accentuate in coming weeks. Looking beyond this special period, against the background of an output gap that is expected to remain negative throughout next year, interest rates in Mexico are likely to be significantly affected by the evolution of interest rates in the United States.

Markets continue to anticipate a further tightening of the monetary policy stance in that country, although at a very gradual pace. To the extent that it responds to the need to contain inflation and maximize employment, this should be good news for the world and Mexico's economies. Furthermore, as the experience with the increase of the federal funds rate in late 2015 shows, if well communicated, it need not be a source of disruption in international financial markets. However, for the reasons I underlined above, should conditions similar to those prevailing at present persist, an increase in the federal funds rate without a monetary policy response in Mexico would give rise to major risks.

More generally, in accordance with the Central Bank's mandate, monetary policy in Mexico will continue to focus on the attainment of the inflation target. This implies a careful monitoring of all determinants of inflation and its medium- to long-term expectations. However, special attention will be paid to the exchange rate in light of its potential pass-through to consumer prices, without implying an objective for the exchange rate, and to the relative monetary policy stance between Mexico and the US. In addition, considering the uncertainties related to estimates of the output gap, a careful assessment of demand pressures on prices will also be carried out. In any event, the Banco de México will adjust its monetary policy stance with all due flexibility, at the moment and in the magnitude that conditions require it, to consolidate the efficient convergence of inflation to the 3 percent target.

Obviously, efforts on the monetary policy front alone would be insufficient to preserve macroeconomic stability. Action is also fundamental on the fiscal side, especially in view of the concern surrounding the current situation and outlook for public finances.

The economic program for 2017 presented to Congress by the Ministry of Finance envisages a surplus in the primary balance for the first time since 2008. Accordingly, the Public Sector Borrowing Requirements (PSBR), the most comprehensive measure of the deficit, should display next year a reduction equivalent to 1.2 percent of GDP with respect to 2015 (and 1.7 percent with respect to 2014). As a result of these measures, the historical balance of the PSBR as a share of GDP is projected to peak this year and to follow a downward trend subsequently. It will be essential to adhere strictly to these commitments and to be ready to take additional measures if needed.

The implementation of the above fiscal actions should also alleviate concerns deriving from the increase in the current account deficit. Even though part of the needed adjustment has taken place through depreciation of the real exchange rate, macroeconomic policy support is required to ensure an orderly performance of the economy. Indeed, since the increased external deficit is explained mostly by the decline in public revenues, in turn the result of the fall in both prices and output of oil, fiscal policy represents the most adequate instrument to tackle this imbalance. In addition to this, and from a medium- to long-term perspective, structural reform is essential to increase oil output and exports, which should in turn make the rebalancing efforts more sustainable. Action on the monetary policy front should only be considered if the current account deficit poses risks to the accomplishment of the inflation target through its effects on the exchange rate.

Intervention in the foreign exchange market can also play a role in coping with the challenges deriving from exchange rate volatility. The Foreign Exchange Commission, integrated by representatives of the Ministry of Finance and the Banco de México, has made clear that anchoring of the Mexican peso will be sought through the preservation of strong economic fundamentals. However, it has also been underlined that discretionary intervention in the foreign exchange market cannot be discarded should exceptional circumstances arise.

To conclude, I just want to note that while Mexico's economy has performed relatively well in a rather difficult environment, as evidenced by the resilience of economic activity and the low rate of inflation, the need to strengthen its economic fundamentals has increased. This implies action on several fronts: adherence to a monetary policy approach emphasizing prudence, a strengthening of public finances that ensures a sustained decline in the share of public debt in GDP, the implementation of any policies required to ensure the preservation of financial stability, and continued strengthening of the domestic sources of growth.