REMARKS BY JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, ON "MEXICO'S MONETARY POLICY AND ECONOMIC OUTLOOK". THE UNITED STATES-MEXICO CHAMBER OF COMMERCE, NORTHEAST CHAPTER. February 15-16, 2018.[1]

First of all allow me to thank the US-Mexico Chamber of Commerce, and especially Alejandro Ramos, for the invitation to share with you some views on monetary policy and the economic outlook for Mexico in these challenging times.

World economic activity seems to be gaining steam at the beginning of 2018 and a number of timely indicators point to further strength in coming months. In addition, its generalization among different countries, from both advanced and emerging economies, continues. Not surprisingly, then, projections for global growth for this year and the next have been revised upwards. Given its relevance for the Mexican economy, it is important to highlight that, according to IMF figures,[2] within the advanced world it is the US economy that has seen one of the largest improvements in projections for GDP growth during the period 2018-2019.

The momentum shown by world economic expansion, combined with the stimulus resulting from the tax reform recently approved in the United States, has improved the balance of risks for global growth in the short term. However, when seen from a longer-term perspective, a number of clouds in the horizon continue to tilt this balance to the downside. In fact, recent

[1] The views and opinions expressed in this document are the sole responsibility of the author and do not necessarily represent the institutional position of the Banco de México or of its Board of Governors as a whole.
[2] International Monetary Fund, World Economic Outlook Update, January 2018.

developments represent a timely reminder of the nature of the challenges that we might be facing in the not-to-distant future.

One of the most important among them relates to the normalization of monetary policy in the United States. The Federal Open Market Committee has insisted once and again that it expects gradual adjustments in its monetary policy stance. However, it is clear that the possibility of surprises on this front has increased. Under a situation of limited, if any, slack in the US economy, a policy of fiscal stimulus as the one under way can lead to an acceleration of price growth, which, combined with its implications for public finances, could give rise to an increase in interest rates above current expectations.

Uncertainty in this respect is of course not limited to the United States. As is well known, a noticeable improvement in economic activity has been observed in other advanced economies, the euro area and Canada among them, that has also aroused concern about the possibility of a faster normalization of monetary policy in these countries.

Secondly, and closely linked to the above, the risk of sharp valuation adjustments in some financial assets, particularly among the high-risk segment, has increased. In fact, mostly as a result of the above-noted anxiety with the speed of normalization of monetary policy in advanced economies, and the possible overvaluation of some of those assets, barely a month and a half into 2018 we have already seen a significant increase in the yields of long-term bonds in many advanced economies and sharp downward corrections in their stock exchanges. Obviously, bearing in mind the magnitude of the potential market disruption, the possibility of disorderly adjustments in the future with adverse effects on global economic activity and financial stability cannot be discarded.

Thirdly, the functioning of world markets can also be affected by a number of other factors, including problems of a geopolitical nature and/or the proliferation of protectionist trends. For instance, notwithstanding progress on negotiations between the United Kingdom and the European Union, uncertainty regarding the possible final outcome has not dissipated. In addition, the potential for problems in other countries or regions, such as North Korea or the Middle East, lingers. And one must add to this the possibility of further actions aimed at obstructing trade flows, particularly in the United States.

In a context of strong risk appetite and a generally favorable economic outlook, emerging economies have continued to attract substantial capital flows. However, the materialization of the previously noted risks or others, such as more serious economic difficulties in China, would tighten external financial conditions for these economies and impact their asset prices, with more acute effects on those countries beset with more evident vulnerabilities.

Naturally, the recent evolution of the Mexican economy has been heavily influenced by the peculiarities of the external environment. In fact, as will be noted below, external factors have impinged on economic activity in divergent ways, while simultaneously being a source of anxiety for domestic financial markets.

Economic activity in Mexico showed wide fluctuations in the second half of 2017, as a result of the natural disasters that took place in the third quarter of the year. Thus, after a decline during the period July-September, GDP growth recorded a strong rebound in the following quarter, in response to the efforts of reconstruction and the recovery of oil output, which had been affected temporarily by the September earthquakes and other meteorological phenomena. Notwithstanding the above, the trend of deceleration that began in 2016 continued during this period, as the annual rate of economic growth fell from 3 percent in the first semester of the year to 1.6 percent in the second.

Economic activity in Mexico is expected to face winds in opposing directions in coming months. On the one hand, expectations of a favorable performance of the world economy and an additional stimulus to growth in the US from the recently approved fiscal reform in that country, combined with a competitive exchange rate, should continue to foster export growth.

On the other hand, a number of sources of uncertainty may restrain domestic demand. In particular, fears of an adverse result of the ongoing NAFTA renegotiation have lessened but not disappeared, and the possibility of a prolonged process, with a more persistent impact than previously thought on consumption and especially on investment, has increased. To this one must add the potential implications for these variables of the apprehension that may result from the electoral process that will take place in Mexico this year. In addition, as already noted, fiscal stimulus in the United States may lead to faster than anticipated increases in interest rates in that country, and the risks for Mexico resulting from lower corporate tax rates in the US should not be disregarded either. The advent of these risks would be troublesome, in view of early signs of deceleration of consumption and the weakness displayed by investment.

Projections by the Banco de México estimate that the combination of the above factors will lead to a moderate strengthening of economic activity in the next couple of years. In my opinion, the balance of risks is to the downside.

A crucial issue here relates to the economy's cyclical position today and in future months. Slack in the labor market has declined substantially in recent years and a detailed analysis of a set of other indicators provides mixed evidence in this regard. Given the evolution of a number of macroeconomic variables (the current account deficit, total financing, wages and the real wage bill, among them), I am inclined to believe that we are not facing a situation of excess demand in the economy. Technical estimates suggest that the output gap is at present not statistically different from zero and that no significant demand pressures are likely to emerge during the period 2018-2019. However, it is also true that the potential for risks from this source cannot be discarded.

Inflation declined sharply in January 2018, as a result of both an arithmetic effect deriving from the increase in energy prices in the same month of the previous year, and the lower rate of growth of core prices. Nevertheless, the decline in inflation did not match expectations prevailing only a few weeks ago, due to the behavior of non-core prices, since the core component in fact undershoot previous projections.

In this context, inflation expectations for the end of 2018 have increased, to levels slightly above the upper end of the variability interval around the 3 percent target. On the other hand, monetary policy has succeeded in avoiding second-round effects from the recent shocks, as suggested by the fact that long-term inflation expectations have remained relatively stable. While this is a laudable outcome, it is also important to take into consideration that we cannot be satisfied yet, since long-term inflation expectations based on surveys remain at around 3.5 percent, i.e. above the target, and the differential between nominal and real yields on government securities continue to point to upward risks for inflation in the medium and long terms.

It is difficult to define a baseline scenario for the behavior of inflation in coming months, in a context of unusually high uncertainty as the one prevailing today. However, in view of the recent behavior and the prospects for inflation, even assuming an orderly behavior of the exchange rate, no demand pressures on prices, and the absence of new supply shocks, a convergence of inflation to the 3 percent target by the end of this year appears to be unrealistic. In fact, under these assumptions, it is estimated that the target would be achieved during the first quarter of 2019.

In my opinion, the balance of risks for this scenario is clearly tilted to the upside. As I noted above, given the current cyclical position of the economy and the balance of risks for coming months, the emergence of demand pressures on prices does not seem to be the main source of concern. Non-core inflation should decline, but it is also true that its components tend to be highly volatile and therefore its behavior is subject to a high degree of uncertainty.

In any case, I am of the view that the main risks for inflation, especially during the first semester of the year, are related to the possibility of wide fluctuations of the exchange rate. For the reasons noted above, the potential for pressures on the peso related to the renegotiation of NAFTA seems to have declined, at least in the short term. At the same time, those deriving from the normalization of monetary policy in the United States have exacerbated, particularly with the recent approval of a fiscal reform in that country. In addition, experience shows that electoral periods like the one that will be taking place in Mexico this year, may prompt episodes of substantial volatility in the foreign exchange market.

The Mexican peso has shown a moderate appreciation vis-à-vis the US dollar in recent weeks, although in a context of wide fluctuations, with sentiment about the renegotiation of NAFTA as the main determinant. A combination of other factors has also influenced, in one direction or another, the evolution of the peso-dollar rate, including expectations related to the normalization of monetary policy in the United States, the perception of risk in international financial markets, and some concern about the electoral process in Mexico later in the year.

On the other hand, domestic interest rates have continued to follow an upward trend, a result both of monetary policy actions by the central bank and the behavior of external interest rates. It should be noted that Mexican financial markets have adjusted in an orderly way to the recent episodes of international turbulence. Consequently, with the recent increase in long-term interest rates in the United States, the corresponding differential for the long end of the curve has narrowed during the course of this year.

To sum up, monetary policy in Mexico is facing a scenario where attaining the inflation target by the end of 2018 seems no longer feasible. This is explained essentially by the pass-through from the exchange rate to prices, and by a recent and anticipated trajectory for non-core inflation which is above previous projections. Even though no evident demand pressures on inflation are neither observed nor envisaged, the mixed signals from different indicators and the uncertain future path for the economy, provide additional reasons for caution in the implementation of monetary policy.

In view of the nature of inflationary pressures and the adjustment to the monetary policy rate that would be required to reduce inflation to 3 percent by December of this year, with the costs for the real sector that this would imply, in my opinion monetary policy must focus on convergence to the target over a time frame that allows: 1. to preserve the credibility of the Central Bank; 2. to continue to avoid second-round effects of the observed and potential future shocks on inflation; and 3. to minimize costs for economic activity. Consequently, it is necessary to lengthen the period over which the target will be met. Under the assumptions noted above, this would be achieved in early 2019, although materialization of some of the previously mentioned risks may imply postponement of this objective for later in the year.

The increase in the monetary policy interest rate in early February was essential to move in this direction. At the same time, this adjustment should protect the Mexican economy from the risks derived from the expected increase in the federal funds rate in the United States in March of this year, since if similar adjustments finally take place in both countries, the differential between policy rates would remain constant. Irrespective of the above, the need for an additional change in the monetary policy stance in Mexico within that time frame, would need to be assessed on the basis of incoming information on inflation and its prospects. I am also of the view that in the face of major risks ahead, the possibility of additional upward movements of the monetary policy rate in Mexico in subsequent months persists.

Mostly for the reasons already explained, 2018 will probably be a challenging year for the Mexican economy. I wish to conclude by stressing that while the implementation of monetary policy is a fundamental piece in overcoming these challenges, this is only one component of a set of policy tools available to face them.

In this respect, it is important to note the following: the fiscal adjustment carried out over the last couple of years has allowed to record a primary surplus and to revert the upward trend of public debt as a share of GDP; the flexible exchange rate has worked efficiently as a shock absorber, with the support of a mechanism for the hedging of foreign exchange risks focused on dealing with difficulties of a temporary nature; international reserves can be considered as adequate under international standards, and a Flexible Credit Line with the IMF is available in case of need; the financial sector is well capitalized, profitable and liquid, with no evident risks of a systemic nature observed; and the ambitious efforts of structural reform set in motion a few years ago are already showing concrete results.

On the other hand, it is also true that, if we look beyond the challenges that we may be facing in the short term, we cannot be satisfied with the results achieved up to date. Indeed, much remains to be done. To this end, it will be essential to continue and build on the policies carried out so far, and to tackle those areas where progress is still insufficient.