BANCO DE MÉXICO

Quarterly Report

October – December 2013

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QUARTERLY REPORT

This report analyzes the development of inflation, the economy and different economic indicators in Mexico, as well as the monetary policy implementation in the quarter October - December 2013 and, in general, the activities of Banco de México over the referred period, in the context of the Mexican and international economic environment, in compliance with Article 51, section II of Banco de México's Law.

FOREWARNING

This text is provided for reader's convenience only. Discrepancies may possibly arise between the original document and its translation to English. The original and unabridged Quarterly Report in Spanish is the only official document.

Unless otherwise stated, this document has been prepared using data available as of February 10, 2014. Figures are preliminary and subject to changes.

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1. Introduction

The conduction of the monetary policy by Banco de México has sought an efficient inflation convergence towards its 3 percent permanent target, i.e., at the minimum cost to society in terms of economic activity. The structural progress in curbing inflation over the last decade contributed to an environment of higher credibility regarding this target. This provided the Central Institute with more room for maneuver in the monetary policy conduction during 2013.

Recognizing the medium-term progress in the abatement of inflation and an environment of greater certainty regarding the Mexican economy, in March 2013 Banco de México's Board of Governors decided to reduce by 50 basis points the reference interest rate. Afterwards, in its September and October meetings, given the weakening of the economic activity in the first half of 2013, it lowered by 25 basis points the target for the Overnight Interbank Interest Rate in each of the referred meetings. The implementation of a countercyclical monetary policy, without jeopardizing the convergence of inflation to the above referred target, despite uncertainty in international financial markets, was possible thanks to the progress in anchoring inflation expectations in Mexico.

In the fourth quarter of 2013, Mexico's economic activity continued the upward trend that had started in the third quarter, although at a slower pace, following the contraction in the first half of the year. The economic recovery experienced since the third quarter of 2013 derived from a greater dynamism of external demand, and from an incipient recovery of some domestic demand components in the fourth quarter. In particular, private consumption and public expenditure have tended to uptick, although investment has not yet presented any clear signs of improvement. Even considering this recovery, slack conditions prevail in the economy.

Annual headline inflation remained within the interval of plus/minus one percentage point around the 3 percent target in the fourth quarter of 2013, while core inflation remained under 3 percent, close to its minimum historical levels. Despite this, annual headline inflation rebounded in November and December, mainly as a result of greater price increments of the non-core component. This increase was determined by two fully identified factors: i) unexpected increments in public transport fares in some cities in Mexico; and ii) higher prices of a reduced number of agricultural products, caused by weather conditions that delayed their production over the previous months.

With the onset of 2014, new fiscal measures and a series of increments in public prices came into force, resulting in higher annual headline inflation. It should be pointed out that this recent inflation increase has thus far been in line with this Central Institute's forecasts and that it has been concentrated in goods and services affected by the referred fiscal measures and public prices. It should be stressed that, based on the evidence available so far, no second round effects derived from the aforementioned adjustments in relative prices have been observed.

This evolution of economic activity and inflation in Mexico occurred in an environment in which global economic activity continued to recover in the fourth quarter, derived from a better performance of advanced economies, principally the U.S., and the stabilization of growth rates in emerging economies. In particular, the U.S. economy recovered, as a result of a greater dynamism in private spending, higher export growth, the fading effects of the fiscal consolidation in the first months of the year and an improvement in the labor market. In light of this, the Federal Reserve started to reduce the pace of its asset purchases in January, while it stressed that its reference interest rate would remain at low levels for a considerable period. Nonetheless, despite a low inflation level in the U.S., there is still uncertainty over the future monetary policy actions, and, therefore, regarding the level that the long-term interest rates could reach in the U.S.

Various emerging economies are facing a challenging environment, as the accumulation of macroeconomic imbalances in the past aggravated the impact of the uncertainty in international financial markets on their financial asset prices, particularly, their currencies. Additionally, a risk exists that the process of normalization of U.S. monetary policy could generate tighter conditions of access to external financing, which stresses the importance of maintaining fiscal discipline in these countries.

Capital flows to Mexico, and in general to emerging economies, remained highly volatile in the fourth quarter of 2013 and particularly over the first weeks of 2014. It should be noted that in light of the December announcement by the Federal Reserve, adjustments in domestic financial markets, particularly fixed-income and exchange rate markets, took place in an orderly manner. This orderly adjustment was also contributed to by the relative improvement in the perception of Mexico's sovereign risk, derived from the significant progress in the implementation of structural reforms in the country, in particular, the energy, financial, telecommunication, economic competition, labor market and education reforms, which led to the credit rating upgrade of Mexico's sovereign debt. The above was also contributed to by the fiscal reform. The main adjustments included the equalization of VAT in the border region to the rate prevailing in the rest of the country, new tax rates set on flavored drinks and high-calorie density food, as well as an ecological tax on automotive fuels and a lower monthly adjustment of their prices. The income tax (ISR) special regimes were limited or eliminated, higher tax rates to individuals with higher income were introduced, as well as a tax on dividends and capital gains. In the same manner, the Flat Rate Business Tax (IETU) and the Cash Deposit Tax (IDE) were repealed. In particular, the reform establishes the Public Sector Borrowing Requirements (a broad measure of the public deficit) as a fiscal anchor and limits the growth of current expenditure for it to be in line with the potential GDP growth (to be defined). In this context, the public deficit excluding Pemex investment will expand from 0.3 percent of GDP in 2013 to 1.5 percent in 2014, and the current proposal contemplates reducing it in subsequent years until it reaches equilibrium by 2017. In all, although it is clear that the tax measures and those of public prices will affect inflation in the short term, insofar as this reform consolidates stability of public finances in the medium term, it will contribute to the convergence of inflation to its 3 percent permanent target.

Despite the headline inflation rebound, mentioned above, and despite the moderate increment in inflation expectations for 2014, as a result of the expected impact of fiscal measures on some prices, the price formation process in the economy has not been contaminated. Thus, medium- and long-run inflation expectations have remained stable.

In the economic environment described above, headline inflation is forecast to locate above 4 percent over the first months of the year and to fall below this level in the second quarter, concluding the year within the variability interval of plus/minus one percentage point around the 3 percent target. For 2015, a significant downward adjustment of inflation is anticipated from January onwards, and it is expected to remain at levels slightly above 3 percent for the rest of the year. Even considering the effects of the referred tax measures, annual core inflation is anticipated to lie at levels close to 3 percent during 2014 and below this level in 2015. This evolution is caused by the fading effects of the aforesaid changes in relative prices, by the expected reduction in gasoline price increases from next year onwards in line with the recently approved Revenue Law and the expectation of no demand-related inflationary pressures, given that, although decreasing gradually, slack in the economy is anticipated to persist.

It is noteworthy that, even though the recent inflation increase is expected to be transitory, the risk of possible second round effects generated by adjustments in the above referred relative prices, which could generate increments in inflation expectations in the medium term, cannot be ruled out, especially in a context of an anticipated gradual reduction of slack conditions in the economy in the horizon at which the monetary policy operates. Additionally, there is a possibility that, in light of a new episode of high volatility in international financial markets, an exchange rate adjustment could occur, potentially affecting inflation and generating second round effects. Nonetheless, for the second round effects to become permanent, Banco de México would have to validate them through their monetization, which would not happen as it goes against this Central Institute’s mandate.

Considering the international environment, as well as the recent performance of the Mexican economy, GDP in Mexico for 2013 as a whole is anticipated to have grown around 1.2 percent. In line with the previous Quarterly Report, the GDP growth rate is forecast to locate between 3.0 and 4.0 percent in 2014, and between 3.2 and 4.2 percent in 2015. This forecast considers that in 2014 aggregate demand will be supported by a more dynamic external demand and by the fiscal stimulus. In this regard, it should be noted that the balance of risks for economic growth has improved, in particular, due to the progress in the process of the recently approved structural reforms. However, even taking this into consideration, based on the current data, slack in the economy is forecast to continue decreasing gradually, and the output gap is estimated to remain negative throughout 2014 and converging to zero towards the end of 2015. Thus, no aggregate demand-related pressures on either inflation or the external accounts are anticipated in the forecast horizon.

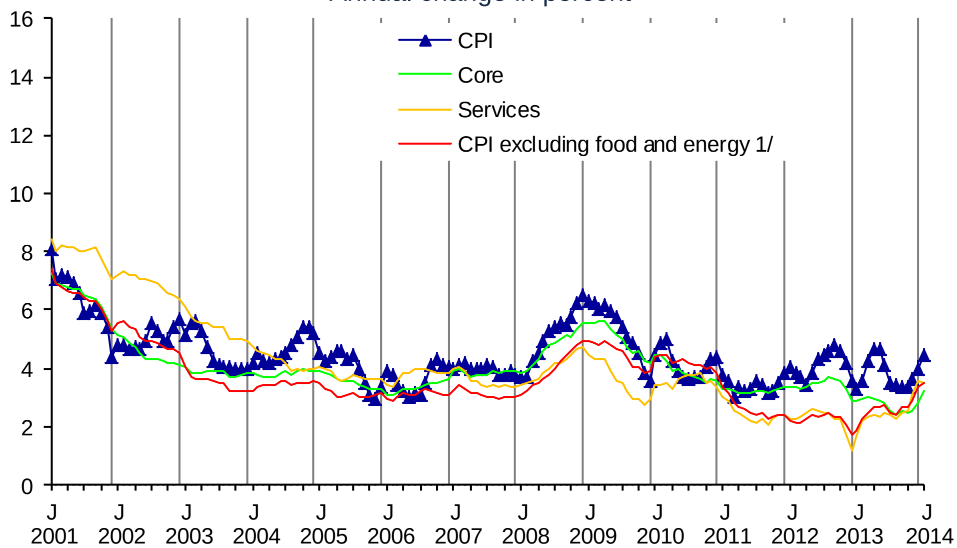
Considering all of the above, following the reduction in the target for the Overnight Interbank Interest Rate implemented last October, the Board of Governors decided to maintain this target at 3.50 percent in its meetings of December 2013 and January 2014. This, by virtue of the fact that it estimates the monetary policy as congruent with the efficient convergence of inflation to its 3 percent target. Nonetheless, given the recent reading of inflation and considering the risks indicated in this Quarterly Report, the Board will monitor all pressures that could affect inflation and its expectations in the medium- and long term. Likewise, it will monitor the implications of the economic activity evolution and the monetary stance of Mexico relative to the U.S., among other factors, onto the inflation outlook, so as to reach the abovesaid inflation target.

2. Recent Developments of Inflation

2.1. Inflation

Since more than a decade ago, inflation has presented a general downward trend converging to its 3 percent permanent target. During 2013, this trend was evident in the performance of core inflation, whose annual change was the lowest on record. Despite the above, the downward trend of annual headline inflation over most of 2013 was interrupted in the fourth quarter, due to adjustments in relative prices of a few goods and services of the non-core index (Table 1 and Chart 1). Afterwards, the fiscal measures and adjustments in public prices, in force since 2014, generated an increase in headline inflation. In this regard, it should be pointed out that the referred increment has been concentrated in goods and services affected by the above described measures and by the changes in public prices, and that, thus far, there is still no evidence of second round effects on the price formation process.

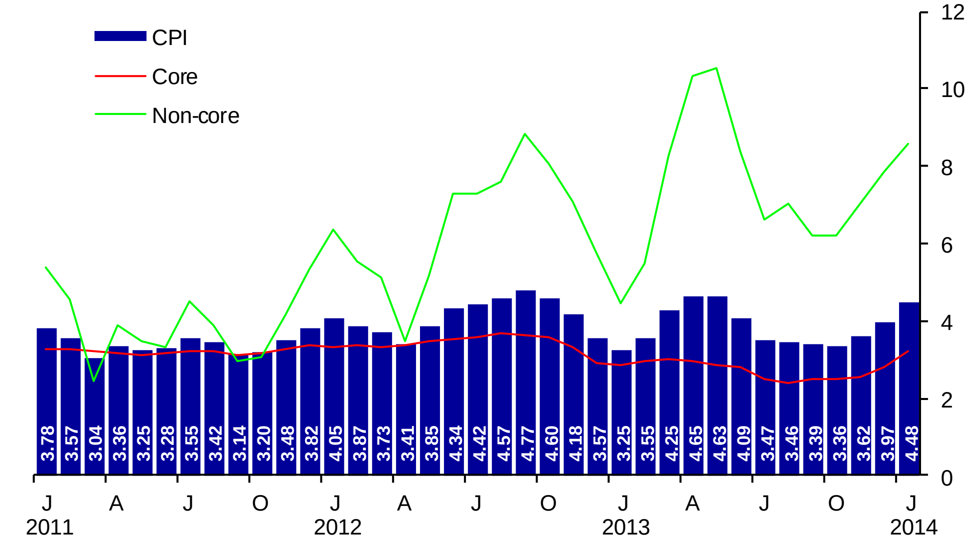
Chart 1
Consumer Price Index
Annual change in percent



1/ Excludes food at home (processed food, non-alcoholic beverages and livestock products), food away from home and energy products.
Source: Banco de México and INEGI.

In the fourth quarter of 2013, annual headline inflation lied at an average level of 3.65 percent, within the variability interval of plus/minus one percentage point around the 3 percent target, while in the previous quarter the corresponding figure was 3.44 percent. By the end of the year, this indicator reached 3.97 percent (Table 1 and Chart 2).

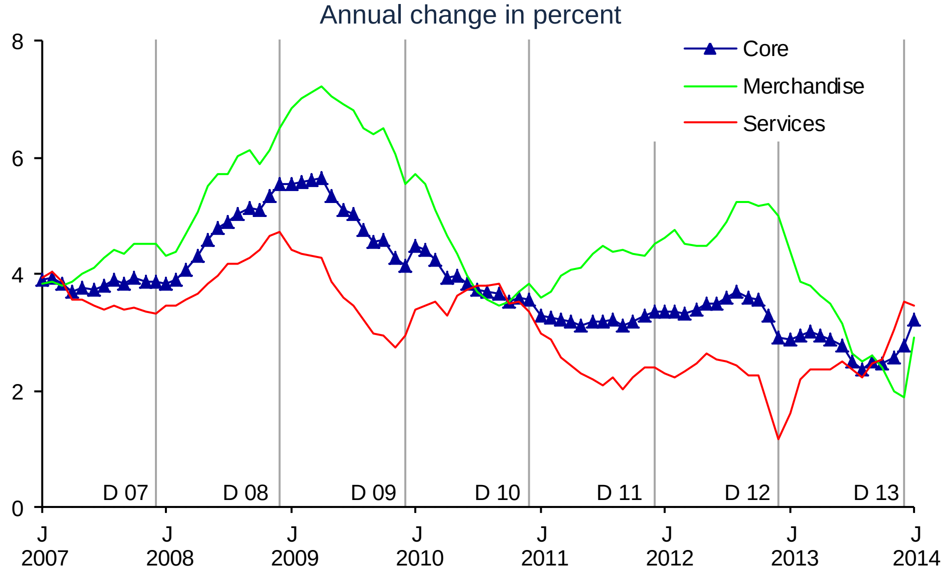
Chart 2
Consumer Price Index
Annual change in percent



Source: Banco de México and INEGI.

As anticipated, annual core inflation increased in the fourth quarter of 2013, due to the arithmetic effect coming from a low comparison base, reaching an average level of 2.61 percent, while in the third quarter it was 2.46 percent. In December 2013, the annual change of this price index was 2.78 percent. During the reference quarter, the components within this subindex registered opposite trajectories (Table 1 and Chart 3).

Chart 3
Core Price Index
Annual change in percent



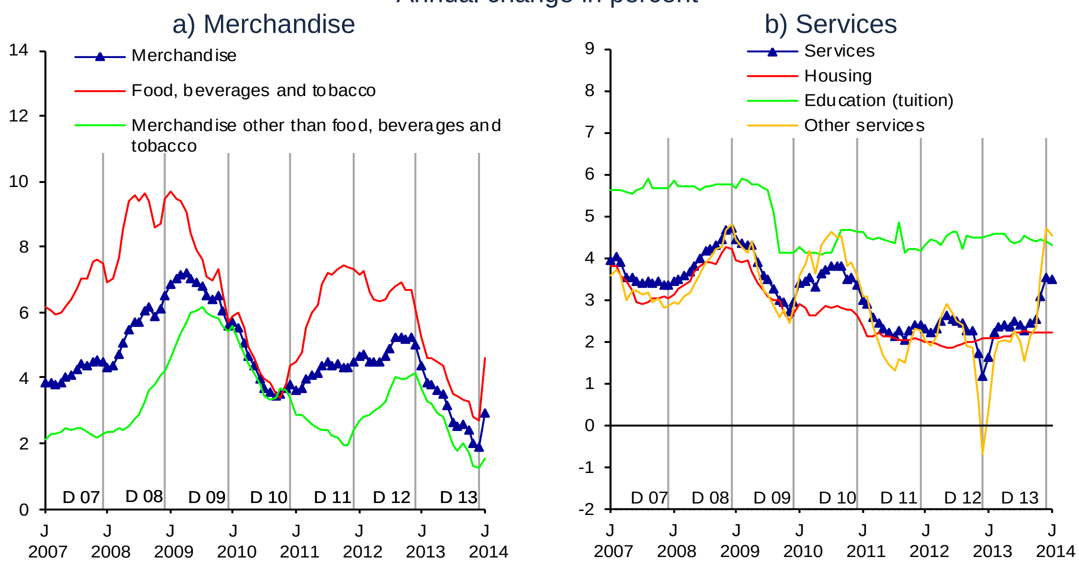
Source: Banco de México and INEGI.

In turn, annual inflation of the merchandise core subindex maintained a downward trend, observing levels below 2 percent at the end of the fourth quarter. In this way, the average annual change of this indicator in the reference quarter lied at

2.09 percent, while in the previous one it was 2.58 percent. This result was contributed to by the fading effects of the increments in international commodity prices, which had put pressure on some food merchandise' prices in the previous year. Thus, the average annual change of food merchandise in the last quarter of 2013 was 2.92 percent, as compared to 3.44 percent in the previous one, which was mainly consequent on a lower contribution of the prices of corn-, wheat- and soy-derived goods. Meanwhile, the average annual change rate of non-food merchandise shifted from 1.90 percent in the third quarter of 2013 to 1.43 percent in the quarter covered by this Report, which was related to the strong competition among the main retail chains (Table 1 and Chart 4a).

The annual average change of the services' core subindex was 3.04 percent in the fourth quarter of 2013, as compared to 2.36 percent in the previous one. This was mainly due to the performance of the group of services other than education and housing, which registered an average annual change of 3.52 percent in the fourth quarter of 2013, while in the previous one the respective figure was 1.87 percent. This is accounted for by the cellular phone services item, in which some operating companies' sales were not as intense as last year, resulting in a low comparison base, which led to a higher annual change rate in the last quarter of 2013 (Table 1 and Chart 4b).

Chart 4
Core Price Index: Merchandise and Services
Annual change in percent



Source: Banco de México and INEGI.

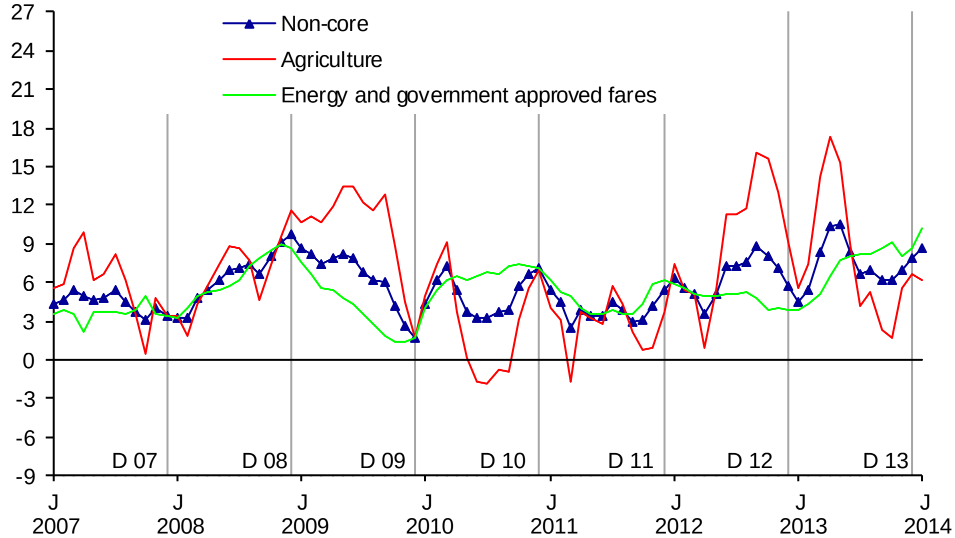
Table 1
Consumer Price Index and Components
Annual change in percent

	Annual change							Average percent	
	July 2013	August 2013	September 2013	October 2013	November 2013	December 2013	January 2014	QIII 2013	QIV 2013
CPI	**3.47**	**3.46**	**3.39**	**3.36**	**3.62**	**3.97**	**4.48**	**3.44**	**3.65**
Core	**2.50**	**2.37**	**2.52**	**2.48**	**2.56**	**2.78**	**3.21**	**2.46**	**2.61**
Merchandise	**2.64**	**2.51**	**2.59**	**2.41**	**1.99**	**1.89**	**2.93**	**2.58**	**2.09**
Food, beverages and tobacco	3.50	3.46	3.36	3.28	2.82	2.67	4.64	3.44	2.92
Non-food merchandise	1.96	1.75	1.98	1.71	1.33	1.26	1.56	1.90	1.43
Services	**2.38**	**2.24**	**2.45**	**2.54**	**3.06**	**3.54**	**3.47**	**2.36**	**3.04**
Housing	2.21	2.26	2.21	2.19	2.20	2.19	2.21	2.23	2.19
Education (tuitions)	4.41	4.55	4.42	4.42	4.43	4.42	4.32	4.46	4.42
Other services	1.97	1.55	2.10	2.34	3.54	4.69	4.53	1.87	3.52
Food stands, refreshment stands, sandwich stalls and taco bars	4.72	4.18	3.87	3.77	3.61	3.33	4.29	4.26	3.57
Restaurants and similar establishments	4.22	4.11	3.84	3.59	3.71	3.74	4.79	4.06	3.68
Cellular phone service	-7.35	-9.10	-7.33	-0.98	23.56	50.91	27.42	-7.93	20.84
Non-core	**6.60**	**7.01**	**6.20**	**6.18**	**7.02**	**7.84**	**8.58**	**6.60**	**7.02**
Agriculture	**4.22**	**5.19**	**2.33**	**1.67**	**5.53**	**6.67**	**6.21**	**3.90**	**4.62**
Fruit and vegetables	-6.01	0.22	-0.63	1.10	11.46	13.89	10.54	-2.14	8.77
Tomato	-21.19	5.64	-1.57	-5.02	43.00	63.89	18.36	-6.10	32.37
Livestock	10.60	8.15	4.04	1.92	2.03	2.43	3.65	7.53	2.13
Energy and government approved fares	**8.12**	**8.16**	**8.66**	**9.07**	**8.01**	**8.65**	**10.13**	**8.32**	**8.57**
Energy	8.26	8.13	8.91	9.62	8.20	8.30	9.67	8.43	8.69
Gasoline	11.77	11.79	11.72	11.37	11.08	11.23	12.24	11.76	11.23
Electricity	-5.43	-5.59	-3.53	3.45	3.72	3.63	5.07	-4.86	3.61
Domestic gas	9.38	8.81	9.07	8.41	8.25	8.37	10.41	9.09	8.34
Government approved fares	7.50	7.87	7.87	7.83	7.65	9.32	11.02	7.75	8.27
Public transport fares	11.39	12.24	12.21	12.05	11.81	12.21	12.52	11.95	12.02
Subway or electric transportation	0.79	0.79	0.79	0.79	0.79	30.97	51.20	0.79	10.85
CPI excluding food (at home and away from home) and energy [1/]	**2.49**	**2.41**	**2.68**	**2.68**	**2.89**	**3.35**	**3.53**	**2.53**	**2.97**

1/ Excludes food at home (processed food, non-alcoholic beverages and agricultural and livestock products), food away from home and energy products.
Source: Banco de México and INEGI.

In the fourth quarter of 2013, the average annual change of the non-core price index lied at 7.02 percent, as compared to 6.60 percent in the previous one. In December 2013, the annual change of this indicator was 7.84 percent. In this regard, the two components of this price index increased their change rates, as a result of higher prices of a reduced number of agricultural products and higher government approved fares (Table 1 and Chart 5).

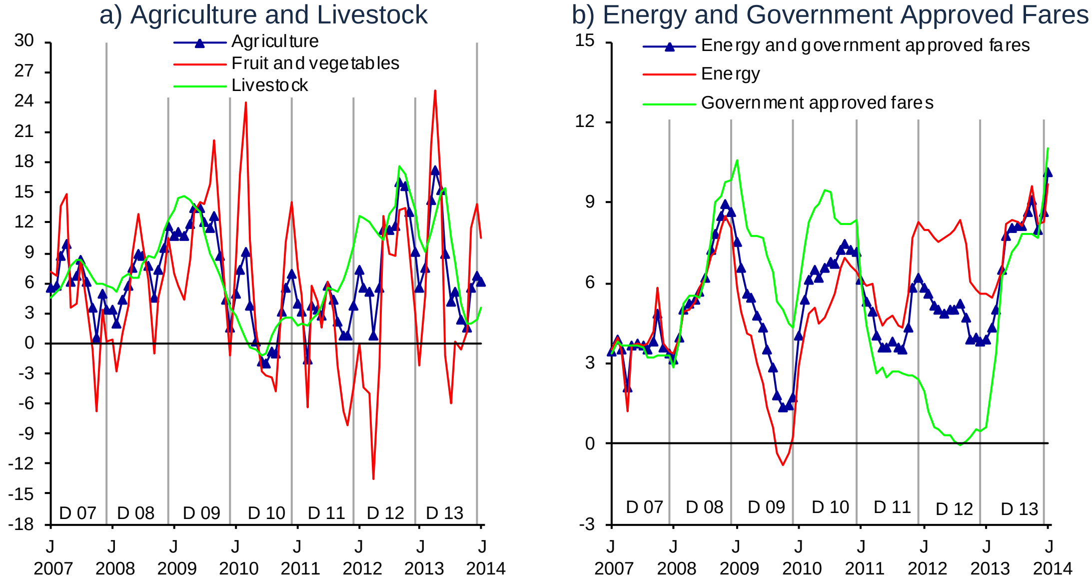
Chart 5
Non-core Price Index
Annual change in percent



Source: Banco de México and INEGI.

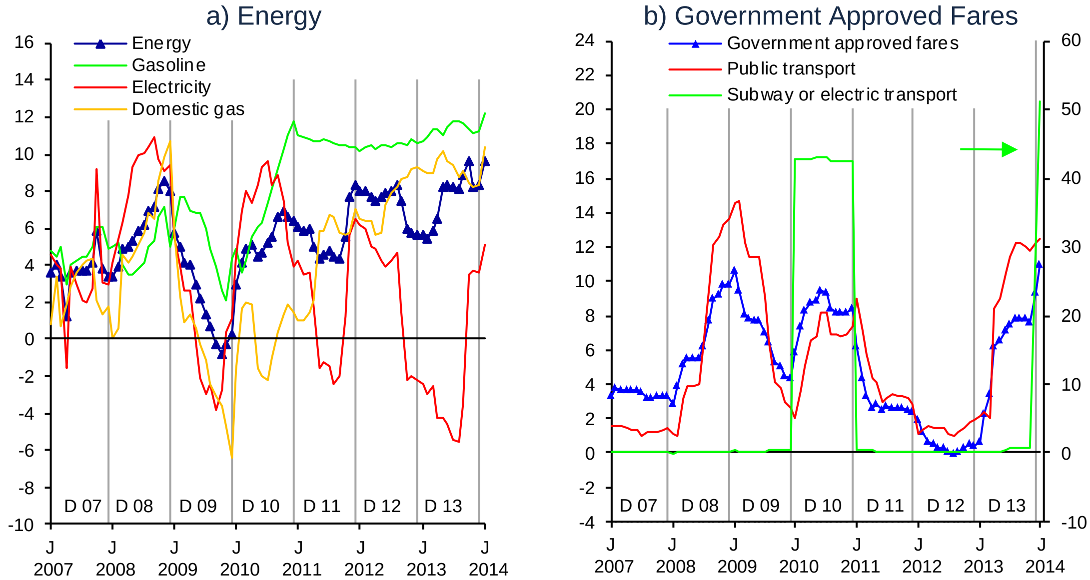
In the last quarter of 2013, the average annual change of the subindex of energy prices and government approved fares was 8.57 percent, while in the previous one it was 8.32 percent. The unanticipated upward adjustments of public transport fares in different cities, with the case of the subway in Mexico City standing out, were noteworthy in this regard, which contributed to the fact that the average annual growth rate of government approved fares reached 8.27 percent in the last quarter of 2013, as compared to 7.75 percent in the previous one. In turn, greater increments in the prices of gasoline and LP gas, with respect to the same period of last year, resulted in an average annual change of the energy price subindex of 8.69 percent in the reference quarter, as compared to 8.43 percent in the previous one (Table 1, Chart 6b and Chart 7). It should be pointed out that in 2013 as a whole the gasoline price went up by 11.23 percent, which makes it 4 years over which this CPI component has risen at least twice above the inflation target.

Chart 6
Non-core Price Index
Annual change in percent



Source: Banco de México and INEGI.

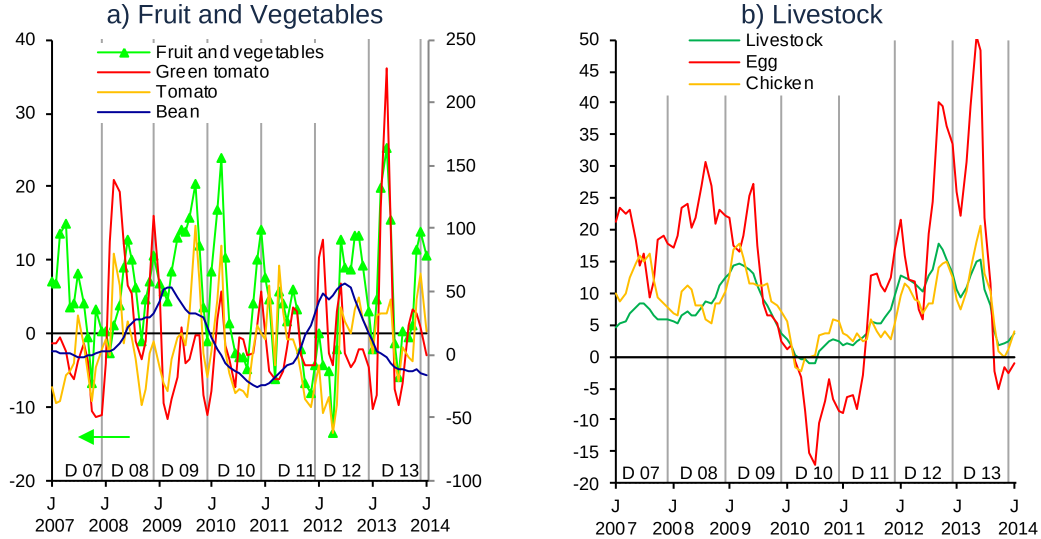
Chart 7
Non-core Price Index
Annual change in percent



Source: Banco de México and INEGI.

The subindex of agricultural products' prices shifted from an average annual growth rate of 3.90 percent in the third quarter of 2013 to 4.62 percent in the fourth one. This is accounted for by adjustments in relative prices of a few agricultural products, brought about by adverse weather conditions that delayed their production, with the case of tomato standing out. Thus, the average annual change of the fruit and vegetables' group soared from -2.14 percent in the third quarter of 2013 to 8.77 percent in the fourth one (Table 1, Chart 6a and Chart 8).

Chart 8
Agricultural Price Index
Annual change in percent



Source: Banco de México and INEGI.

Subsequently, in January 2014, annual headline inflation reached 4.48 percent, mostly driven by the policy of public prices and by the entry into force of various fiscal measures, which included, as mentioned above, the new Special Tax on Production and Services (IEPS) on a group of high-calorie density foods, flavored drinks among them, and the equalization of VAT in the border region. In this regard, it should be noted that annual headline inflation in the first fortnight of January was 4.63 percent (a fortnightly change of 0.68 percent); while in the second fortnight of the same month it was 4.34 percent (a fortnightly change of 0.12 percent).

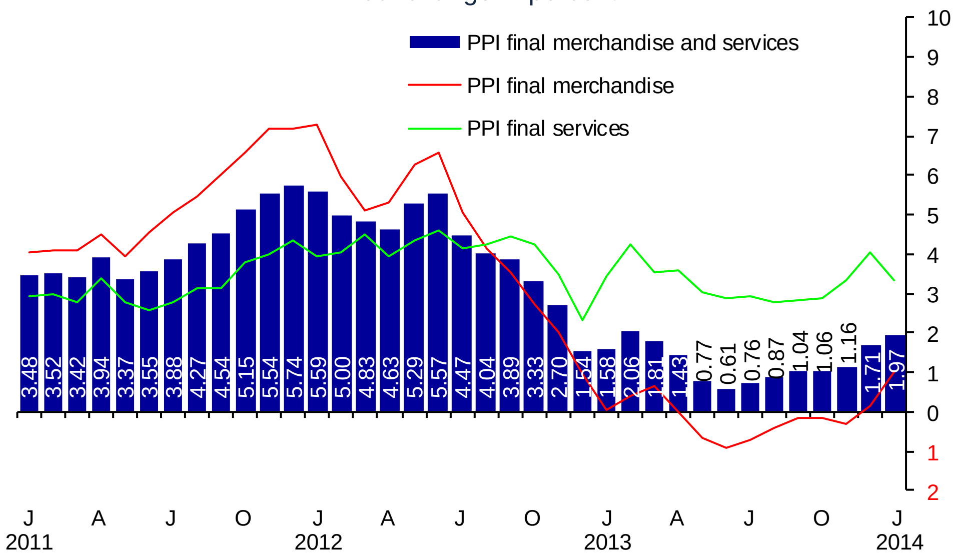
The above indicates that the impact of the fiscal measures on inflation was concentrated in the first fortnight of January and that in the second fortnight of the same month price increments began to diminish. Indeed, the referred dynamics of the inflationary impact generated by the fiscal measures primarily reflected the pattern of the core component. While its annual change in the first fortnight of January was 3.33 percent (a fortnightly change of 0.69 percent), in the second fortnight of the same month it was 3.10 percent (a fortnightly change of 0.24 percent). Thus, annual core inflation located at 3.21 percent for the month as a whole.

In the referred month, annual changes of the merchandise and services' subindices registered levels of 2.93 and 3.47 percent, respectively. In particular, within the group of food merchandise, adjustments in the prices of soft drinks stood out because of their contribution, while the subindex of non-food merchandise was affected by the equalization of VAT in the border region. The increment in the subindex of services' prices is accounted for by the dynamics of the group of services other than housing and education, where higher prices of food services have been recorded. These increases have been of similar magnitudes to those in previous years, although with a higher concentration in the first fortnight of the month, which can indirectly derive from the coming into force of the fiscal reform.

The annual change rate of the non-core price index located at 8.58 percent in January. In turn, the subindex of prices of agricultural products, energy prices and government approved fares reached 6.21 and 10.13 percent, respectively, in the same month. This upward adjustment mainly derived from the modifications in fossil fuel prices, the equalization of the VAT in the electricity fees in the border region, and higher public transport fares in some cities, with the weight of Monterrey and Guadalajara standing out.

The Producer Price Index (PPI) of finished merchandise and services, excluding crude oil, increased its average annual change from 0.89 percent, on average, in the third quarter of 2013 to 1.31 percent in the fourth one (Chart 9). This was mainly due to the increment in the average annual change rate of the services prices, which shifted from 2.85 percent in the third quarter to 3.42 percent in the fourth quarter of 2013, especially due to the evolution of the annual change rate of the cellular phone services prices. In January 2014, the annual change rate of the PPI located at 1.97 percent, which is mainly due to a greater contribution of the price indices of the construction sector.

Chart 9
Producer Price Index
Annual change in percent



Source: Banco de México and INEGI.

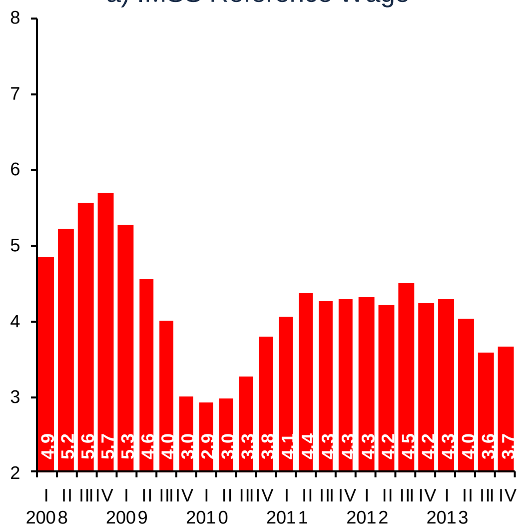
2.2. Wages

The evolution of the main wage indicators in the fourth quarter of 2013 suggests that labor costs still do not generate inflationary pressures. The reference wage of IMSS-insured workers increased 3.7 percent in the last quarter of 2013, similar to the previous quarter and lower than the figures observed over the last year (Chart 10a).

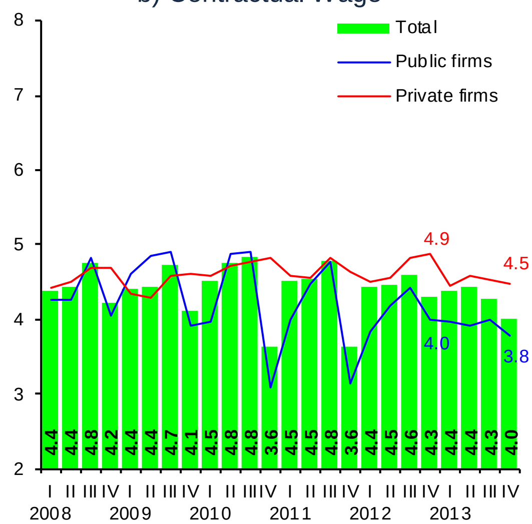
The increment in the contractual wage negotiated by firms under federal jurisdiction was 4.0 percent in the fourth quarter of 2013, which was lower than the figure of 4.3 percent registered in the same quarter of last year. This difference derived from lower changes in contractual wages of both public and private firms. In particular, public firms negotiated an increase of 3.8 percent (4.0 percent in the same quarter of 2012). In this group, the wage increase granted by IMSS to its workers stood out (3.8 percent in 2013 with respect to 4.0 percent in 2012). Private firms negotiated an increase of 4.5 percent in the period from October to December 2013 (4.9 percent in the fourth quarter of 2012, Chart 10b).

Chart 10
Wage Indicators
Annual change in percent

a) IMSS Reference Wage [1/]



b) Contractual Wage [2/]



Source: Calculated by Banco de México with data from IMSS and STPS.
1/ During the fourth quarter of 2013 an average of 16.6 million contributors were registered in IMSS.
2/ The contractual wage increase is an average weighted by the number of involved workers. The number of workers in firms under federal jurisdiction that annually report their wage increases to the Secretary of Labor and Social Welfare (*Secretaría del Trabajo y Previsión Social*, STPS) equals approximately 2 million.

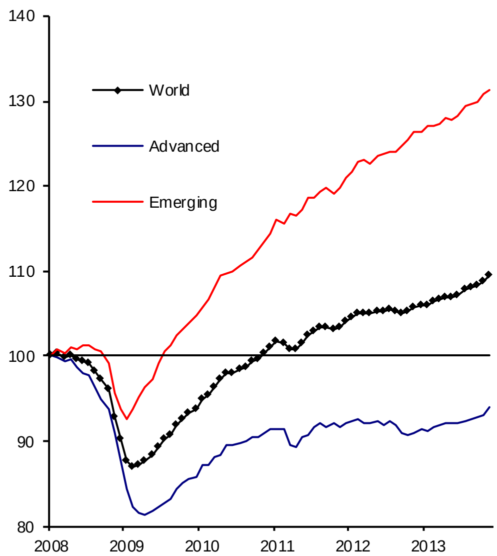
3. Economic and Financial Environment

3.1. International Environment

The world economy continued recovering in the fourth quarter of 2013, supported by greater dynamism in advanced economies, particularly, in the U.S. Available indicators of emerging economies point to a differentiated performance, following the slowdown in the previous quarters. Some economies, e.g. China, registered lower growth, while others recovered. In this context, both industrial production and exports worldwide improved (Chart 11). Volatility in international financial markets remained high during the last quarter of 2013 and increased significantly in early 2014. The latter derived from intensified difficulties in various emerging economies, in an environment of great nervousness in light of uncertainty over the effects that the U.S. monetary policy normalization process could generate on the level of long-term interest rates of that country and on capital flows to emerging economies. The impact was more strongly reflected in some of the economies with considerable macroeconomic imbalances. In sum, the growth outlook of the world economy has improved, although important risks prevail.

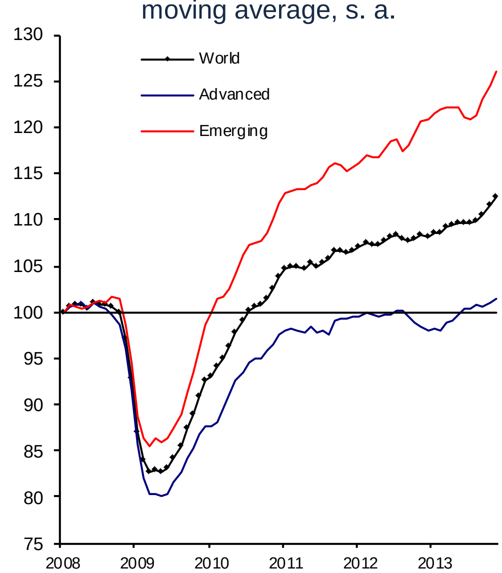
Chart 11
World Economic Activity

a) World Industrial Production
Index January 2008=100, s. a.



s. a. / Seasonally adjusted figures.
Source: CPB Netherlands.

b) Export Volume
Index January 2008=100 of the 3-month moving average, s. a.



s. a. / Seasonally adjusted figures.
Source: CPB Netherlands.

3.1.1. World Economic Activity

The U.S. economy improved gradually in the last quarter of 2013, backed by a strengthening of domestic and external demand. Even though risks and vulnerabilities still prevail, different factors indicate a sustained strengthening of the U.S. economic activity.[1] Among them the following are noteworthy: labor

[1] According to the Bureau of Economic Analysis, U.S. GDP expanded at an annualized quarterly rate of 3.2 percent in the fourth quarter of 2013, a figure lower than the 4.1 percent recorded in the third quarter.

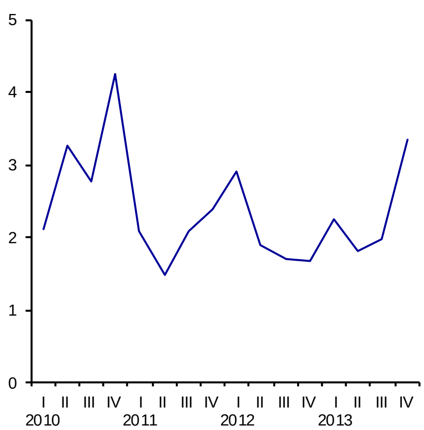
market recovery, improved confidence of households and firms, strengthening in households' balance, ample liquidity in firms and a gradual fading of fiscal consolidation effects.

Expenditure on private consumption in the U.S. expanded considerably in the fourth quarter of 2013, registering the highest annualized quarterly growth rate observed in the last three years (Chart 12a). Likewise, investment in equipment strengthened, following slow growth over the previous quarters. Net exports significantly contributed to the GDP growth, supported by higher external demand. In contrast, the construction sector showed certain weakness, with a contraction in investment in structures and residential construction, the latter reflecting the effects of higher mortgage interest rates. Public expenditure also adversely contributed to GDP growth, partly due to the temporary shutdown of the U.S. Federal Government last October.

In general, labor market kept improving in the fourth quarter of 2013, registering an increment in the non-farm payroll and a reduction in the unemployment rate, even though some indicators still presented certain weakness. Thus, the average monthly expansion of the non-farm payroll was 195 thousand jobs in the last quarter of 2013, a figure higher than the 172 thousand jobs recorded in the previous quarter. However, job creation decelerated in early 2014, registering an expansion of 113 thousand jobs in January. In turn, the unemployment rate dropped from 7.2 percent in September to 6.7 percent in December, partly due to a continuous fall in the labor participation rate (Chart 12b).[2] This downward trend in the unemployment rate persisted in January, with the rate locating at 6.6 percent.

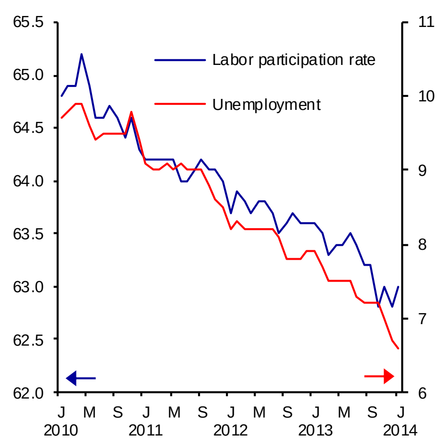
Chart 12
U.S. Economic Activity

a) Real Personal Consumption Expenditure
Annualized quarterly change in percent, s. a.



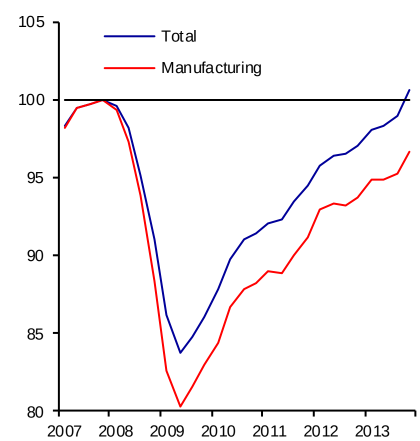
s. a. / Seasonally adjusted figures.
Source: BEA.

b) Unemployment Rate and Labor Participation Rate
In percent of labor force and of civilian population, s. a.



s. a. / Seasonally adjusted figures.
Source: BLS.

c) Industrial and Manufacturing Production
Index IV 2007=100, s. a.



s. a. / Seasonally adjusted figures.
Source: Federal Reserve.

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[2] The participation rate shifted from 63.2 to 62.8 percent of the working age population, over the same period.

U.S. industrial production rebounded in the fourth quarter, following the low growth observed in the last two quarters. Thus, this indicator finally exceeded the levels prevailing at the beginning of the recession. Likewise, manufacturing production registered a good performance, particularly that of durable consumption goods (Chart 12c).

In mid-December 2013, the U.S. Congress reached an agreement on the expenditure levels for the fiscal years 2014 and 2015, which reduces automatic cuts, decreed by the previous legislation, by USD 63 billion.[3] Afterwards, in mid-January the Congress approved the Consolidated Appropriations Act, 2014, which authorized higher expenditure levels and its allocations for the rest of the current fiscal year. This budgetary agreement, which is the first one achieved since 2009, will ease the previously foreseen fiscal restraint and will reduce uncertainty over the lack of fiscal agreements in the U.S. In this way, a reduced fiscal restraint with respect to the previous year is expected.[4]

In this environment, last December the Federal Reserve announced the beginning of a moderate reduction of the amount of its asset purchases from January 2014 onwards, while it stressed that it would probably be appropriate to maintain the policy rate at low levels for an extended period, even after the unemployment rate reaches the 6.5 percent threshold level, and while the expected inflation remains below the long-term target of 2.0 percent.[5] Subsequently in January 2014, the Federal Reserve announced an additional reduction of the amount of its asset purchases, starting from February.

As a result of the further evidence of a more solid recovery of the U.S. economic activity, together with the above mentioned announcement of the Federal Reserve, U.S. long-term interest rates maintained an upward trend, as a reflection of the decompression process of risk premia, particularly the term premium, which began in mid-2013. A widespread appreciation of the dollar against other currencies was also observed.

In the Euro zone, available indicators point to a moderate expansion of economic activity in the region in the last quarter of 2013, although from low levels.[6] Industrial production presented an almost widespread rebound, in line with the evolution of the area's prospective indicators (Chart 13a). Besides, private consumption is expected to expand slightly over the period, mostly driven by car sales, given the weakness in the rest of retail sales (Chart 13b). In turn, the unemployment rate stabilized in the last quarter of the year, although it still remains high and with considerable divergences among the member states (Chart 13c). Thus, the economic growth remains limited by the persisting high

[3] According to the preliminary estimates of the Congressional Budget Office (CBO), the aforementioned agreement will result in an increase in discretionary spending by USD 26 and 22 billion in 2014 and 2015, respectively, as compared to the previous forecast.

[4] A pending issue refers to the end of the temporary suspension of the debt limit, agreed upon in October 2013. According to the estimates of the Department of the Treasury, once the temporary suspension of the debt limit is concluded on February 7, 2014, the extraordinary resources of the U.S. Federal Government available to meet its financial obligations could be depleted at the end of the same month.

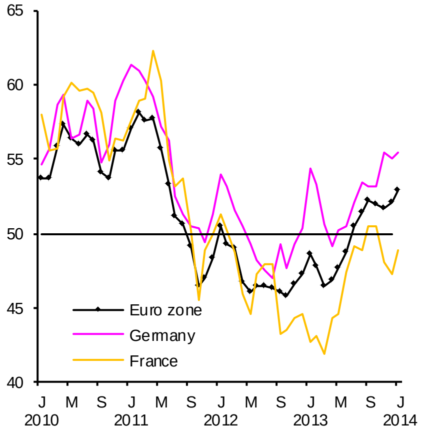
[5] The Federal Reserve also reiterated its expectation that the target range for its federal funds' rate will remain between 0 and 0.25 percent, at least as long as the unemployment rate persists above 6.5 percent, medium-term inflation is not expected to exceed 2.5 percent and inflation expectations remain well-anchored.

[6] Germany, Belgium, Spain and Lithuania recorded a positive GDP growth in the fourth quarter of 2013, according to the initial estimates of their statistics bureaus.

unemployment, the process of fiscal consolidation in some countries, significant indebtedness of the private sector, particularly in the countries of the periphery, and fragility of the European banking system.

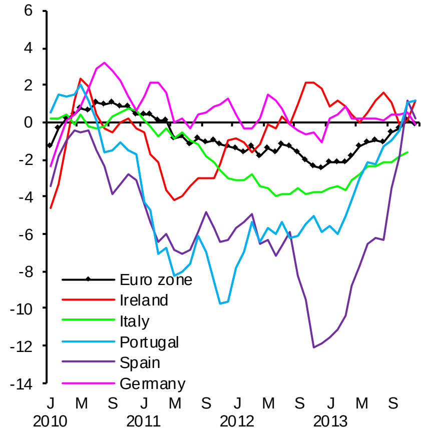
Chart 13
Euro Area Economic Indicators

a) Purchasing Managers' Composite Index
Index, s. a.



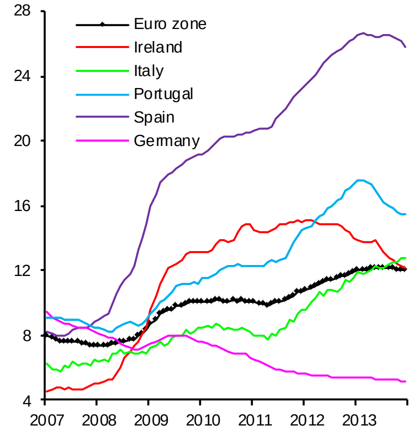
s. a. / Seasonally adjusted figures.
Source: Markit.

b) Retail Sales [1/]
Annual change of the 3-month moving average in percent, s. a.



s. a. / Seasonally adjusted figures.
1/ Excluding car sales.
Source: Eurostat.

c) Unemployment Rate
In percent of economically active population, s. a.



s. a. / Seasonally adjusted figures.
Source: Eurostat.

In the analyzed period, there was progress in forming a fiscal and banking union in Europe. In October, for the first time, the European Commission assessed draft budgetary plans for 2014 of its member states. On the other hand, on December 18, the Council of the European Union announced a proposal for the Single Resolution Mechanism (SRM), whose goal would be a prompt restructuring of distressed banks.[7] These measures, together with the results of the comprehensive assessment of the banking system by the European Central Bank (ECB)[8] and by national competent authorities, as well as an adequate implementation of other structural reforms, will be essential to support the economic recovery of the Euro zone.

In Japan, the accommodative monetary policy kept supporting a gradual strengthening of domestic demand in the fourth quarter of 2013, while external demand also rebounded. Private consumption remained solid due to the improved employment and income, despite the expected increase in the tax on consumption in April 2014. Public and private investment continued expanding, the latter with a

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7 It includes the creation of a Single Resolution Board and a Single Resolution Fund. The latter will be initially constituted by national funds, which will be financed by banks' contributions. Likewise, a resolution for the financing of these funds during its initial phase was adopted, which includes interim funding from other national sources or from the European Stability Mechanism (ESM). The SRM is expected to come in force in 2015 and it will constitute, together with the Single Supervisory Mechanism, one of the key elements of a banking union.

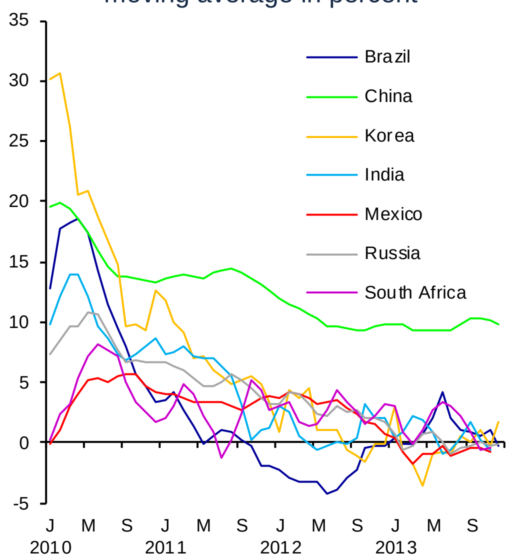
8 In early February 2014, the ECB together with the European Banking Authority (EBA) released the parameters for the next stress test. The capital threshold for the baseline scenario will be 8% of common equity tier 1 (CET1), and 5.5% CET1 for the adverse scenario. The stress test will incorporate the results of the asset quality analysis, whose methodology will be published in the first quarter of this year. For further information on the comprehensive assessment of banks, see Inflation Report July-September 2013.

favorable outlook reflected in the strength of business confidence indices. However, there are downward risks to the economic growth, derived from the expected moderate progress of structural reforms and the fiscal adjustment from the second quarter of 2014 onwards.

In the last quarter of 2013, exports of most emerging economies increased, as a result of the expansion of demand of advanced economies (Chart 14). Nevertheless, there is a significant divergence in the evolution of emerging economies, due to the persistence of external imbalances, weakness of domestic demand and slow progress in the implementation of structural reforms in some countries. It should be noted that the expectation and the subsequent announcement of the beginning of the process of monetary policy normalization in the U.S. exacerbated volatility in the exchange rate, bond and stock markets of emerging economies, even though the magnitude of volatility depended on the fiscal strength and the current account balance of each country. Thus, the countries that suffered most from portfolio adjustments were Argentina, Brazil, India, Indonesia, Russia, South Africa, Thailand, Turkey and Ukraine. In general, this situation indicates a lower risk appetite of institutional investors of emerging economies' assets.

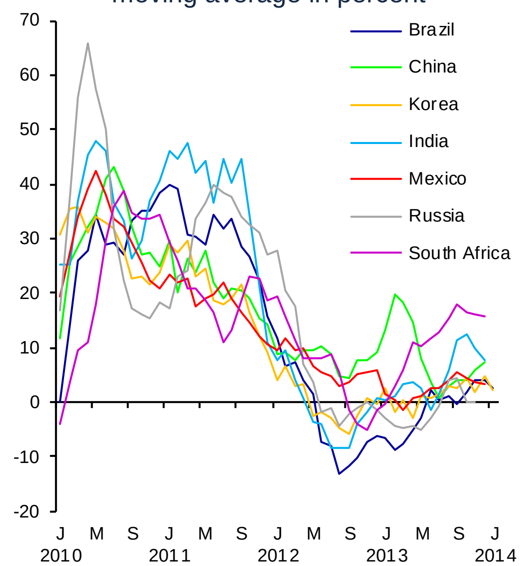
Chart 14
Economic Activity in Emerging Economies

a) Industrial Production
Annual change of the 3-month moving average in percent



Source: Bloomberg and Haver Analytics.

b) Exports
Annual change of the 3-month moving average in percent



Source: Bloomberg.

3.1.2. Commodity Prices

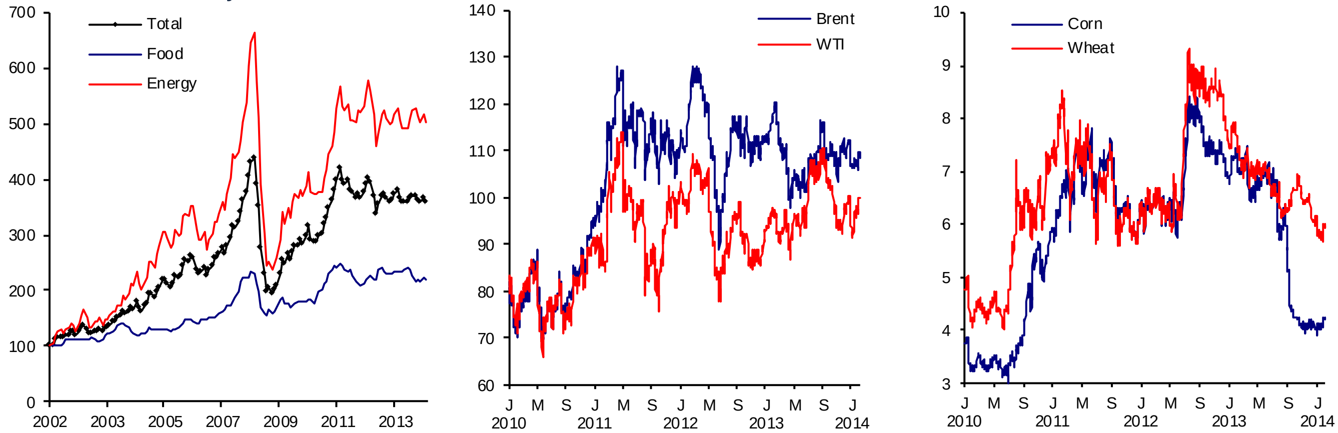
International commodity prices recorded a slowdown in the fourth quarter of 2013 (Chart 15a). Crude oil prices dropped in the quarter due to a higher production in the U.S., Canada and the North Sea, and due to some reduction in geopolitical risks in the Middle East (Chart 15b). In turn, grain prices dropped as a result of a greater supply of the main corn and wheat exporters, given that favorable weather conditions compensated for emerging economies' higher demand, particularly for corn (Chart 15c).

Chart 15
International Commodity Prices

a) Total Commodities, Food and Energy
Index January 2002=100

b) Crude Oil [1/]
USD per barrel

c) Corn and Wheat [1/]
USD per bushel



Note: Monthly figures as of January 2014.
Source: International Monetary Fund.

1/ Spot prices.
Source: Bloomberg.

1/ Spot prices.
Source: Bloomberg.

3.1.3. World Inflation Trends

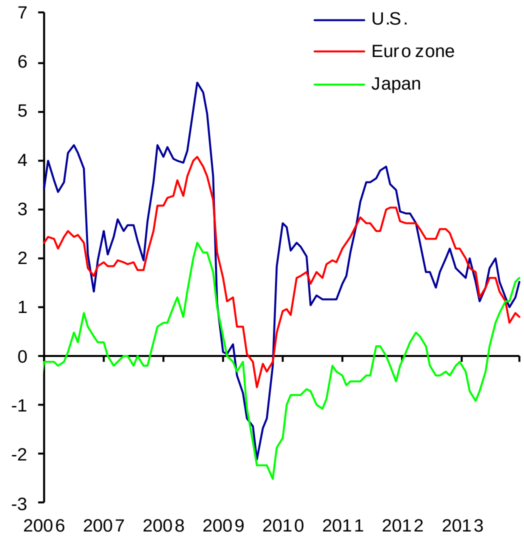
In general, global inflationary pressures attenuated in the fourth quarter of 2013. Inflation decreased in most advanced economies and part of the emerging ones in the period, and it is expected to remain at low levels over the following quarters (Chart 16). In advanced economies –with the exception of Japan, where the expansionary monetary policy has led to higher inflation and its expectations– slack in the labor market and lower energy prices contributed to a lower inflation rate, with its notable low levels in the Euro zone. In turn, in most emerging economies, moderate growth of economic activity and lower grain prices contributed to maintaining an environment of relatively low inflation. However, in some emerging economies with less solid macroeconomic fundamentals, their currencies' depreciation and structural problems generated greater inflationary pressures.

In the U.S., annual headline inflation was 1.5 percent in December, below the Federal Reserve long-term target of 2 percent, while core inflation was 1.7 percent. In turn, the annual change of the personal consumption expenditure deflator was 1.0 percent.

In the Euro zone, annual headline inflation maintained a downside trend in the fourth quarter of 2013, locating at 0.8 percent in December. Thus, inflation shifted further away from the European Central Bank's target of a figure below but close to 2 percent in the medium term. In turn, core inflation reached a historical minimum of 0.7 percent in the same month. The persisting low inflation levels and the expectation that they will remain so over the following years increased the risk of a deflationary period in the Euro zone. So far, only some countries on the European periphery, such as Greece and Cyprus, register deflation, although a slower than expected recovery of the region's economic activity could increase the probability that this phenomenon will spread.

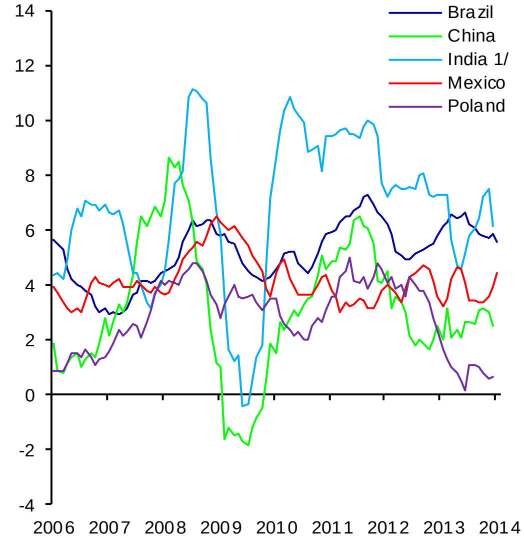
Chart 16
Headline Inflation in Advanced and Emerging Economies

a) Advanced Economies
Annual change in percent



Source: BLS, Eurostat and Japan Statistics Bureau.

b) Emerging Economies
Annual change in percent



1/ It refers to inflation of wholesale prices.
Source: National Statistics Bureaus.

3.1.4. International Financial Markets

In an environment of an expected moderate recovery of world economic activity and low inflation, the monetary policy stance is anticipated to remain relatively lax in most advanced economies, while in some emerging ones it has become tighter, as a result of higher volatility in their financial markets.

As stated above, in 2014 the Federal Reserve began the process of its monetary policy normalization. In its December meeting, it announced a reduction of its monthly asset purchases from USD 85 to 75 billion, from January onwards. Afterwards, in its January meeting, it decided to reduce its purchases even further, from USD 75 to 65 billion, starting from February.[9] According to the Federal Reserve, the reasons behind this decision were the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions. Additionally, it mentioned that, if this tendency persists and if inflation remains below its longer-term objective, similar reductions in the pace of monthly asset purchases are likely to be announced in the next monetary policy meetings. Still, it also noted that the asset purchases are not on a present course and the decisions regarding their pace will remain contingent on the outlook of the Federal Open Market Committee (FOMC) for the labor market and inflation, as well as the cost-benefit analysis of proceeding with these purchases. Additionally, the Federal Reserve maintained unchanged its target range for the federal funds' rate between 0 and 0.25 percent, and, as mentioned above, indicated that it would remain so for a certain period of time, even if the unemployment rate is below the 6.5 percent threshold, and while the projected inflation continues to run below the longer-term inflation target of 2 percent.

[9] The announcements consider USD 5 billion reductions in longer-term Treasury securities and USD 5 billion in mortgage-backed securities.

The European Central Bank (ECB) adopted a more accommodative monetary policy stance in its November monetary policy meeting, when it decreased its monetary policy interest rates, while in its December, January and February meetings it decided to maintain these rates unchanged. Additionally, in its January meeting the ECB strengthened the forward guidance for the benchmark interest rates announced last July, when it stressed emphatically that it would maintain an accommodative monetary policy for as long as necessary and that it expects its interest rates to remain at current levels, or below them, for an extended time period, given the estimated low inflation rates over the following years. Besides, the ECB left open the possibility of using all available instruments to stimulate recovery of the Euro zone and outlined possible scenarios that would prompt the Central bank’s response.

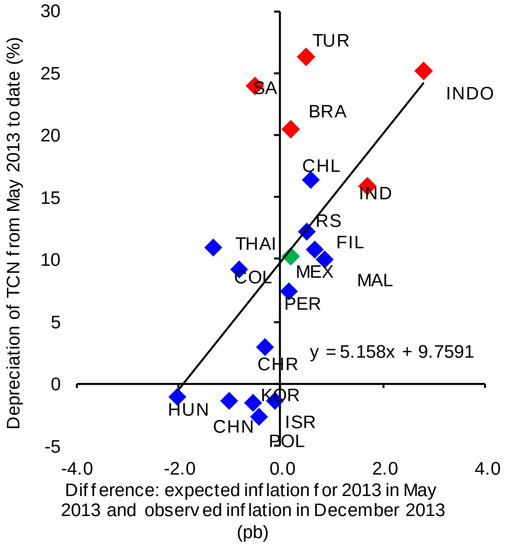
In its monetary policy meetings of December and January, the Bank of Japan (BJ) maintained unchanged the programmed level of asset purchases, in order to reach the inflation target of 2 percent (announced last April), within approximately two years. In its press releases, the BJ reiterated its favorable assessment of the economic conditions and showed greater confidence that inflation would be congruent with its target.

Emerging economies presented important differences in the monetary policy direction during the fourth quarter of 2013 and in early 2014. On the one hand, despite the slow performance of the economy, emerging countries with high current account deficits, greater dependence on portfolio investment and inflationary pressures increased their policy rates and, in some cases, e.g. Brazil, Indonesia, South Africa and Turkey, they intervened in the foreign exchange market to moderate their currencies’ depreciation (Chart 17a and Chart 17b). On the other hand, countries characterized by solid macroeconomic fundamentals and well-anchored inflation expectations managed to relax their monetary policies in order to support the economic activity.

In this environment, capital outflows from emerging economies persisted in the fourth quarter of 2013, leading to an upward trend in their long-term interest rates (Chart 18a). Likewise, over the first weeks of 2014, volatility in emerging economies’ financial markets exacerbated, registering additional falls in the stock markets, currencies’ depreciation and higher levels of sovereign credit risk premia of these economies (Chart 18b). The magnitude of these adjustments largely depended, as mentioned above, on the macroeconomic fundamentals of each country.

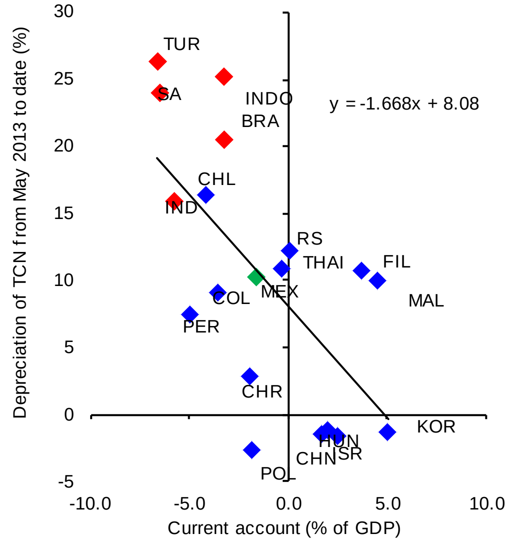
Chart 17
Inflation, Exchange Rates and Current Account Balance in Emerging Economies

a) Inflation and Exchange Rate
Percent



Source: Haver Analytics, Bloomberg and Consensus Forecasts.

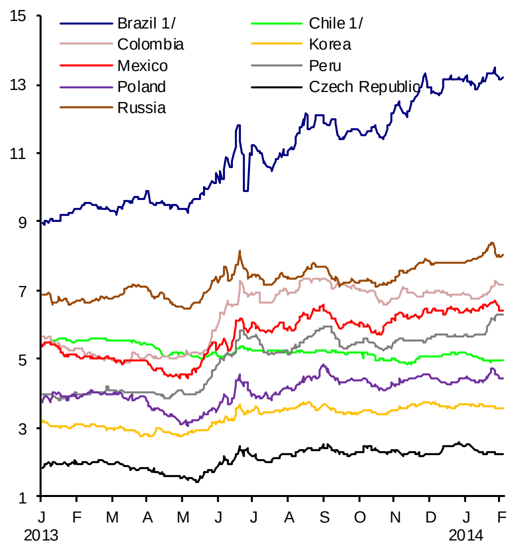
b) Current Account and Exchange Rate
Percent



Note: The current account is calculated as the average from the third quarter of 2012 to the third quarter of 2013, except for Mexico, in which case the data of the current account expected for the end of 2013, which is published in this Quarterly Report, is considered.
Source: Haver Analytics, Bloomberg and Consensus Forecasts.

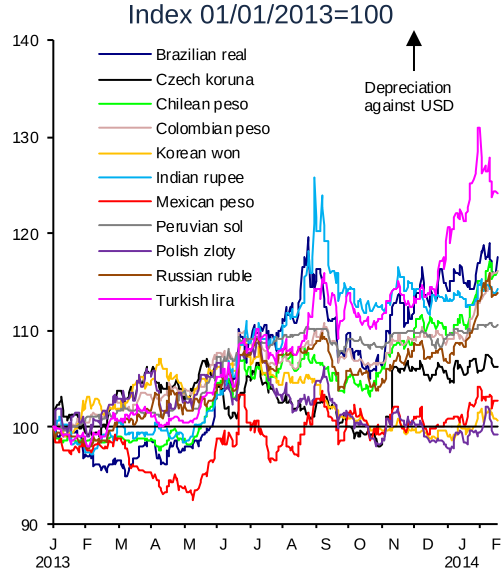
Chart 18
Financial Indicators of Emerging Economies

a) 10-year Bond Rates
Percent



1/ It refers to 9-year bonds.
Source: Bloomberg.

b) Exchange Rate
Index 01/01/2013=100



Source: Bloomberg.

As indicated above, financial markets have shown greater volatility, mainly in emerging economies, in light of the reduction of asset purchases of the Federal

Reserve. Additionally, there is uncertainty by virtue of the process of the U.S. monetary policy normalization. This could lead to tighter conditions of access to external financing, in particular in emerging economies with considerable macroeconomic imbalances. Therefore, new episodes of volatility in international financial markets cannot be ruled out. In this sense, for emerging economies, it is important to stress the need to implement macroeconomic policies that would ensure robust growth with stable prices, in particular, to maintain a fiscal discipline that would reduce external financial requirements and to implement structural reforms that would increase their potential GDP.

3.2. Developments of the Mexican Economy

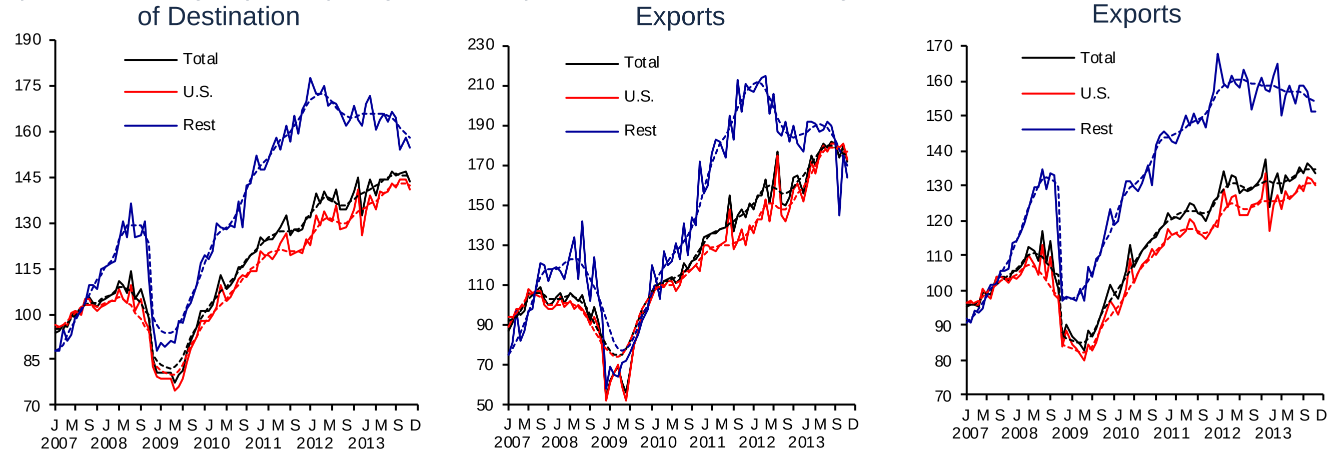
3.2.1. Economic Activity

In the fourth quarter of 2013, the Mexican economy kept recovering its activity levels, after the slowdown in the second half of 2012 and the contraction in the first half of 2013. The economic recovery in the second half of the year reflected the expansion of external demand, as well as an incipient rebound in some domestic demand indicators in the fourth quarter, in particular those related to private consumption and public expenditure, given that investment still does not present clear signs of improvement.

In the analyzed quarter, non-automobile manufacturing exports to the U.S. maintained a positive trend. As a consequence, despite the downward trend in non-automobile exports to the rest of the world and the fall in the sales of automobile products' abroad in December, largely caused by temporary factors, total manufacturing exports remained at high levels (Chart 19).[10]

Chart 19
Indicators of Manufacturing Exports
Index 2007=100, s. a.

a) Manufacturing Exports by Region of Destination | b) Automobile Manufacturing Exports | c) Non-automobile Manufacturing Exports



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

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

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

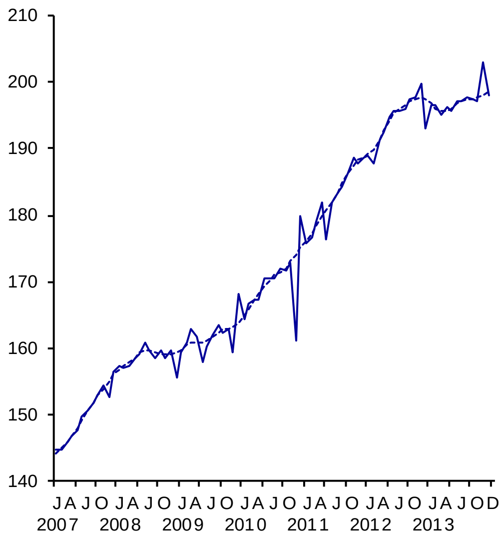
[10] In particular, in December 2013 automobile production and export levels were adversely affected, partly, by a temporary shutdown of some assembly plants in the same month in order to carry out repairs and modifications of production lines.

As regards domestic demand, even though public expenditure accelerated in the fourth quarter and some indicators of private consumption improved incipiently, gross fixed investment maintains an unfavorable performance. In particular:

i. In line with available data, private consumption rebounded in the fourth quarter of 2013. This uptick was partly a result of special offers of the program "*El Buen Fin*" (Mexico's equivalent to Black Friday). Indeed, both ANTAD sales and commercial establishments' retail sales registered a considerable expansion in November, which is calculated not to have been completely offset by a fall in December. Thus, in the period of November-December, consumer goods' retail sales are estimated to have slightly increased their growth rate (Chart 20a and Chart 20b).

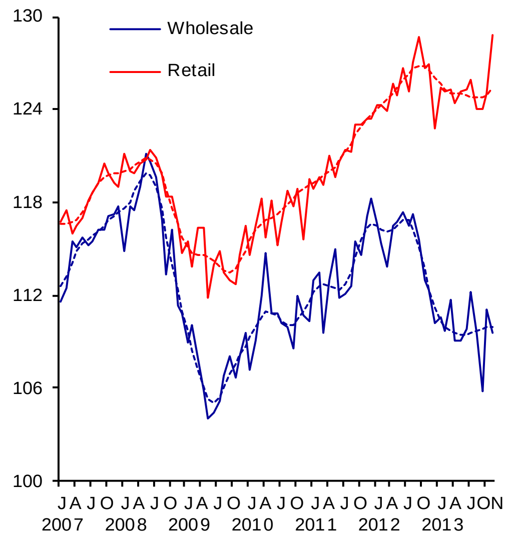
Chart 20
Consumption Indicators

a) Total ANTAD Sales
Index 2003=100, s. a.



s. a. / Seasonally adjusted and trend data.
Source: Prepared by Banco de México with ANTAD data.

b) Commercial Establishments' Sales
Index 2003=100, s. a.

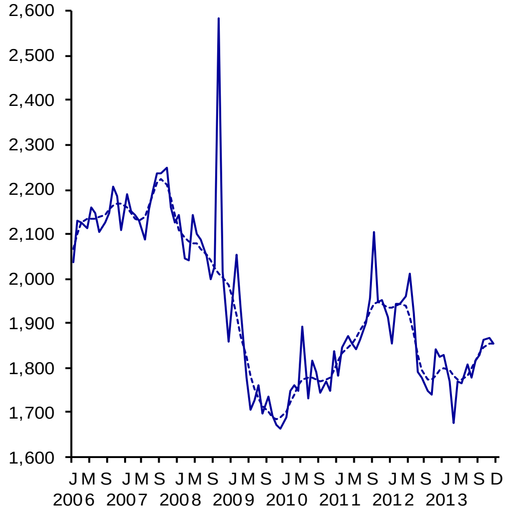


s. a. / Seasonally adjusted and trend data.
Source: Monthly Survey of Commercial Establishments, INEGI.

ii. In line with the above, some consumption determinants presented a favorable performance, as is the case of workers' remittances, which expanded in the analyzed quarter (Chart 21a). Nonetheless, other indicators, such as the consumer confidence index, maintained a negative trend (Chart 21b).

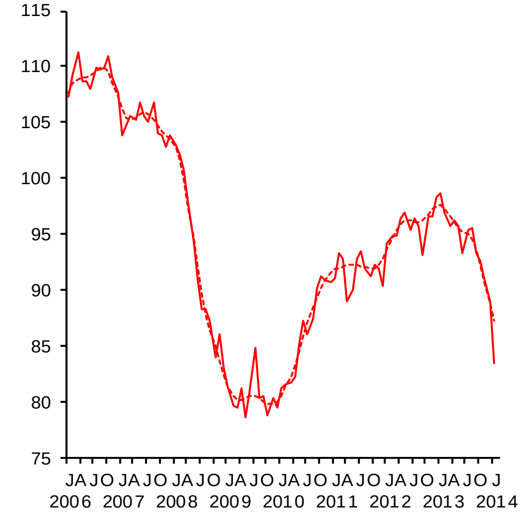
Chart 21
Consumption Determinants

a) Workers' Remittances
USD million, s. a.



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

b) Consumer Confidence Index
Index Jan 2003=100, s. a.



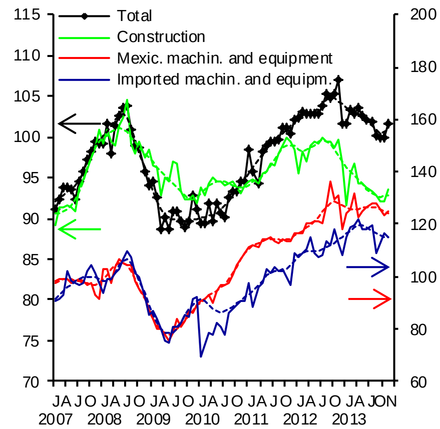
s. a. / Seasonally adjusted and trend data.
Source: National Consumer Confidence Survey, INEGI and Banco de México.

iii. Gross fixed investment, which has been contracting since the last quarter of 2012, did not present any clear change of trend, although in November an uptick in its component of investment in construction was registered. The performance of gross fixed investment mainly reflects weak imports of capital goods and the negative trend of the construction sector activity, in particular the one related to investment in housing (Chart 22).

iv. As regards public expenditure, this component of aggregate demand accelerated in the second half and, particularly, in the last quarter of the year, thus reverting the lack of expenditure observed at the beginning of the year.

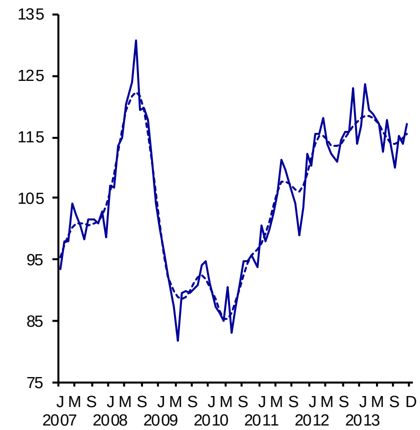
Chart 22
Indicators of Investment

a) Investment and its Components
Index 2008=100, s. a.



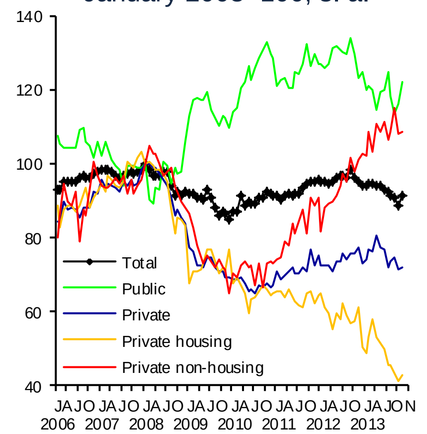
s. a. / Seasonally adjusted and trend data.
Source: Mexico's System of National Accounts, INEGI.

b) Imports of Capital Goods
Index 2007=100, s. a.



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

c) Real Value of Production in the Construction Sector by Contracting Institutional Sector
January 2008=100, s. a.



s. a. / Seasonally adjusted figures. For public and private construction (housing and total private non-housing), the seasonal adjustment was prepared by Banco de México with data from INEGI.
Source: INEGI.

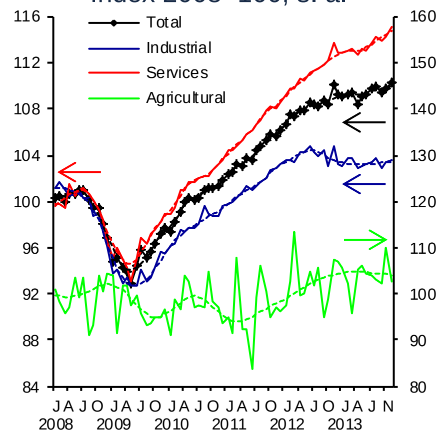
As a result of the described evolution of external and domestic demand, the expansion of the economic activity continued in the last quarter of the year, although at a more moderate pace as compared to the one registered in the third quarter. In particular, a slight positive trend observed in industrial production in the period of October-November tended to reflect the moderate dynamism in the mining sector, given that the manufacturing sector presented certain stagnation and the construction industry maintained a downward trajectory, despite a rebound registered in November in this sector (Chart 23a and Chart 23b).

The services sector continued to expand, mainly as a result of a growing number of activities more related to external demand, such as commerce and transport, mail and warehousing. Meanwhile, even though the services more related to domestic demand showed an increase, it was lower than the one in the services mentioned above (Chart 23c).

In the reported quarter, the agricultural activity tended to present a more favorable performance as compared to the third quarter, when it was affected by the hurricanes "Ingrid" and "Manuel" (Chart 23a). In this sense, in the period of October-November 2013, higher production of sesame seed, forage maize, forage oats, beans, apple, barley, forage sorghum, copra, potato, soy, tomato, avocado, lemon, rice and banana stands out. Likewise, higher production of egg for consumption, cow's milk and pork meat were also registered.

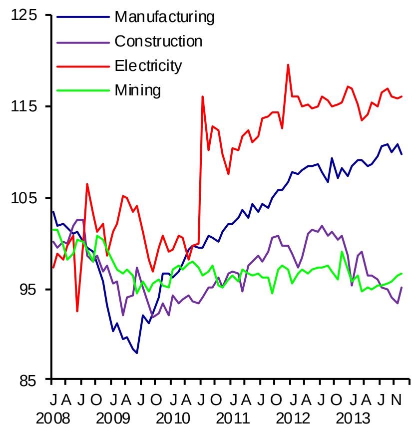
Chart 23
Indicators of Production

a) Global Economic Activity Indicator (IGAE)
Index 2008=100, s. a.



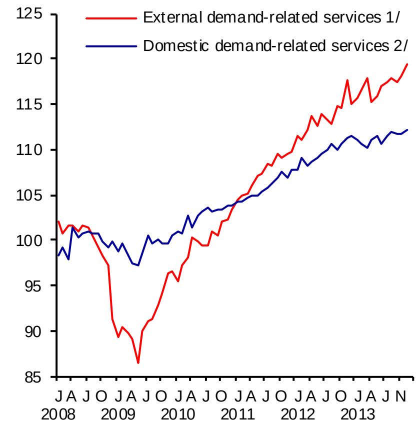
s. a. / Seasonally adjusted and trend data.
Source: Mexico's System of National Accounts, INEGI.

b) Industrial Activity
Index 2008=100, s. a.



s. a. / Seasonally adjusted data.
Source: Mexico's System of National Accounts, INEGI.

c) Services Sector IGAE
Index 2008=100, s. a.

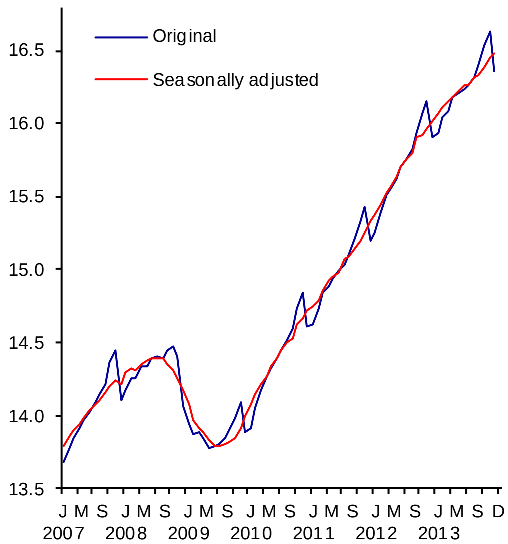


1/ It includes commerce, transport, mail and warehousing sectors, and mass media services.
2/ It comprises professional, scientific and technical services; corporations management; health care services; government activities, recreation services, financial and insurance services; real estate and renting services; business support services; educational services, temporary accommodation and food preparation services, and other services.
s. a. / Seasonally adjusted data.
Source: Prepared by Banco de México with data from Mexico's System of National Accounts, INEGI.

Given the growth of the economy, a positive trend in the main labor market indicators persisted. In particular, the number of IMSS-insured workers continued with an upward trend (Chart 24a), which contributed to the reduction of the national and urban unemployment rates to the minimum levels since the crisis outbreak. Indeed, from December 2012 to December 2013, the number of IMSS-insured permanent workers and temporary workers in urban areas increased by 453,719 persons. In turn, in seasonally adjusted terms, the national unemployment rate on average shifted from 4.9 percent in the third quarter to 4.7 percent in the last quarter of 2013, while the urban unemployment rate changed from 5.6 to 5.5 percent, in the same comparison. Meanwhile, the informal employment rate went from 58.9 percent in the period of July-September 2013 to 58.8 percent in the fourth quarter of that year (Chart 24b). However, these rates still remain above the pre-crisis levels, which suggests that slack conditions prevail in the labor market. In this environment, as stated above, in the period October-December 2013 the main wage indicators of the economy changed moderately, as was the case of the reference wage of the IMSS-insured workers (see Section 2.2).

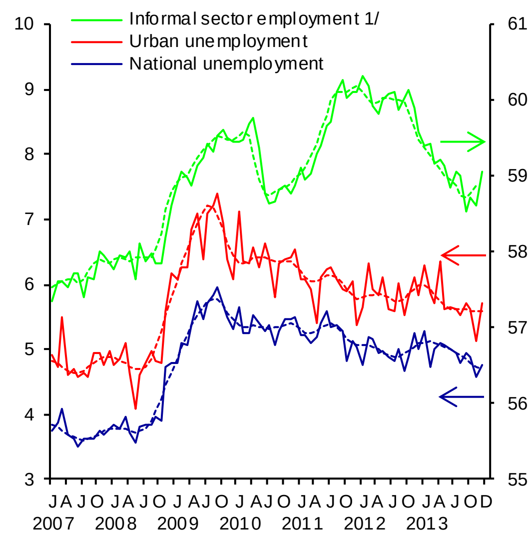
Chart 24
Labor Market Indicators

a) IMSS-insured Workers [1/]
Millions of persons



1/ Permanent workers and temporary workers in urban areas.
Source: IMSS. Seasonal adjustment by Banco de México.

b) National and Urban Unemployment Rates and Labor Informality Rate
Percent, s. a.



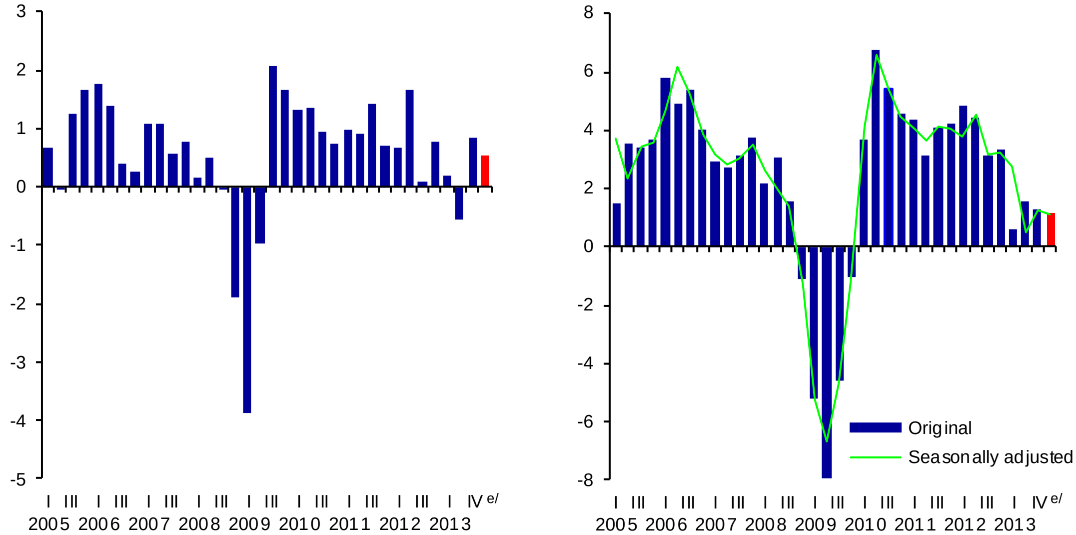
1/ Seasonal adjustment by Banco de México.
s. a. / Seasonally adjusted and trend data.
Source: National Employment Survey, INEGI.

Thus, for the fourth quarter of 2013, a quarterly seasonally adjusted GDP growth of approximately 0.5 percent is estimated, as compared to the figures of 0.20, -0.55 and 0.84 percent, registered in the first three quarters of the year, respectively (Chart 25a). An annual seasonally adjusted GDP growth of about 1.1 percent is estimated for the last quarter of 2013, compared to 2.8, 0.5 and 1.3 percent observed over the first three quarters of the year, respectively. Based on data without seasonal adjustment, an annual GDP growth of 1.2 percent is anticipated in the analyzed quarter (Chart 25b). Therefore, for 2013 as a whole a growth rate of approximately 1.2 percent is expected.

Chart 25
Gross Domestic Product

a) Quarterly Change
Percent, s. a.

b) Annual Change
Percent



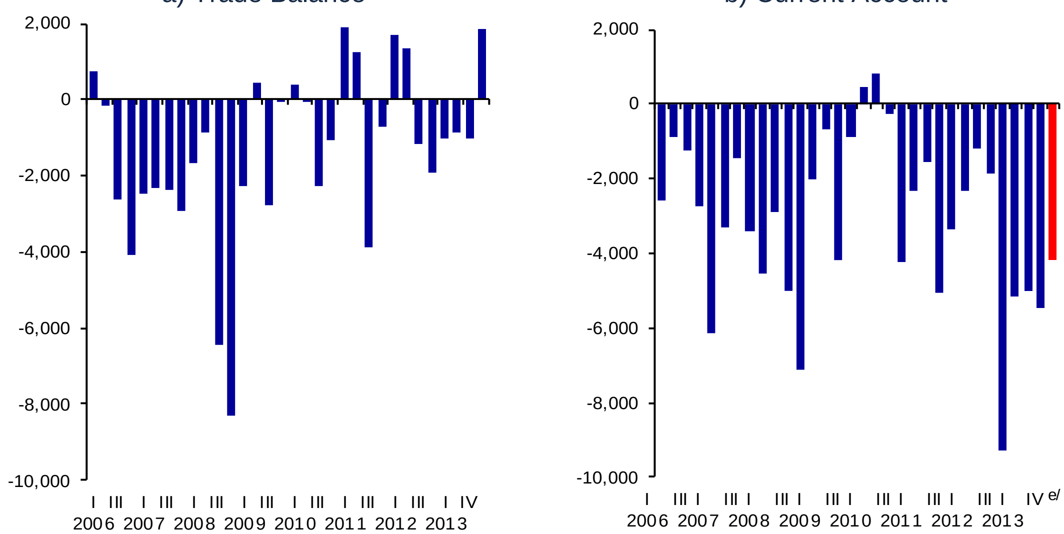
s. a. / Seasonally adjusted data.
e/ Estimated by Banco de México.
Source: Mexico's System of National Accounts, INEGI. Seasonal adjustment up to the fourth quarter of 2013 by Banco de México.

Finally, available data suggest that in the last quarter of 2013 the current account will have presented a moderate deficit and that the country continued receiving capital flows via the financial account, sufficient to allow an easy financing of the referred deficit (Chart 26a and Chart 26b).

Chart 26
Trade Balance and Current Account
USD million

a) Trade Balance

b) Current Account



Source: Banco de México.

e/ Estimated by Banco de México.
Source: Banco de México.

3.2.2. Financial Saving and Financing in Mexico

In the fourth quarter of 2013, the sources of financial resources of the economy continued to display the recovery observed in the previous quarter, following a moderation in the second quarter. This was mainly the result of faster growth of the domestic sources of funding. On the other hand, although the external sources showed less dynamism in comparison with the previous quarter, they continued to register positive flows.

With respect to the domestic sources of financial resources, the monetary base rebounded by the end of December 2013, recording an annual nominal rate of change of 8.5 percent, which was higher than the 5.7 percent rate observed in September of that year.[11] The higher growth was due to a recovery of economic activity in Mexico, as well as the fading out of the comparison base effect associated to the higher demand for currency that occurred around the period of the 2012 federal elections.

Financial saving –defined as the monetary aggregate M4 minus the stock of currency held by the public– maintained its growth rate in the fourth quarter of 2013, mainly due to the expansion of the stock of resident financial saving (Chart 27a). In particular, the growth rate of resident financial saving was higher than in the previous quarter, which was mainly accounted for by a recovery in the growth rate of the stock of voluntary financial saving (Chart 27a and Chart 27b). In contrast, the stock of compulsory financial saving continued to show a weak expansion rate, as a result of the lower valuation of its debt securities portfolio, which was in turn due to the increase in medium- and long-term interest rates.

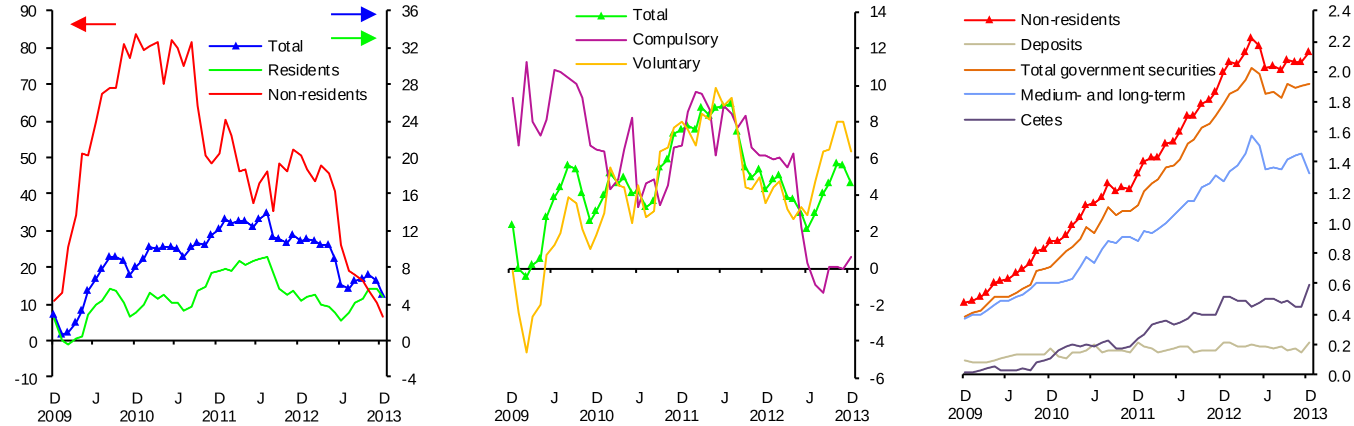
Meanwhile, non-resident financial saving continued to exhibit positive flows, albeit lower than those observed in the first months of 2013 (Chart 27c). In this regard, it should be stressed that, despite the environment of uncertainty in international financial markets, Mexico continued to receive resources from abroad that were directed towards the acquisition of financial instruments, which contrasts with the situation in other emerging economies. This largely reflects investors' perception of macroeconomic stability and their favorable views with respect to the process of structural reforms. Thus, in 2013, the stock of non-resident holdings of government debt securities increased by MXN 259.7 billion, which implied a real annual change of 12.1 percent with respect to the end of 2012.

The stock of non-resident financial saving increased slightly in the fourth quarter of 2013 with respect to the previous quarter (Chart 27c). It is important to mention that, as expected, a semiannual fixed rate bond expired on December 19, which implied –similarly to what has been observed in previous due dates of this type of instruments– a decrease in medium- and long-term non-resident government securities' holdings, which was in turn offset by corresponding increases of Cetes holdings and of the stock of deposits.

[11] The monetary base is defined as the sum of currency in circulation plus the bank deposits in Banco de México.

Chart 27
Financial Saving Indicators

a) Total Financial Saving 1/ Real annual change in percent | b) Resident Financial Saving 1/ Real annual change in percent | c) Non-resident Financial Saving MXN trillion as of December 2013



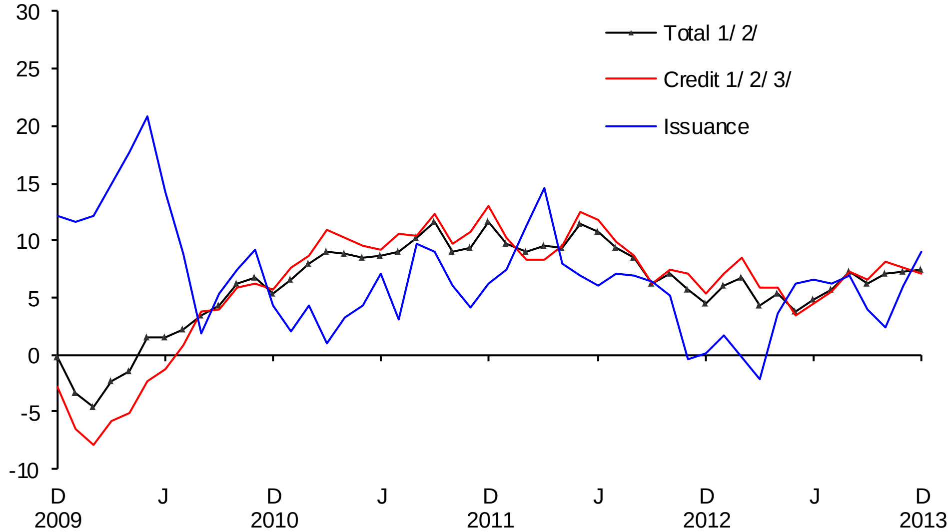
Source: Banco de México.
1/ Defined as the monetary aggregate M4 minus the stock of currency held by the public.

Regarding the use of financial resources in the economy, the use of resources by the public sector was greater during the last quarter of 2013, both at the federal level as well as at the states and municipalities level, while resources directed towards the accumulation of international reserves were lower than in the previous quarter.[12] Meanwhile, resources destined to the financing of the non-financial private sector maintained a positive flow, although of a smaller scale than in the previous quarter.

With respect to the last point, financing to non-financial private firms grew at a higher real annual rate in the fourth quarter of 2013 than in the previous one. This expansion was observed both in domestic credit and debt markets (Chart 28). Foreign financing also continued to display dynamism, particularly in what concerns the issuance of debt abroad.

[12] In the fourth quarter of 2013, the international reserve accumulation was USD 4,428.1 billion, below the change observed in the previous quarter of USD 5,563.3 billion.

Chart 28
Domestic Financing to Non-financial Private Firms
Real annual change in percent



Source: Banco de México.
1/ These figures are affected by the disappearance of some non-banking financial intermediaries and their conversion to non-regulated Sofom.
2/ From February 2009 onwards, figures are affected by the reclassification of credit granted to small- and medium-size firms (PyMES, for its acronym in Spanish) from consumer credit to credit granted to non-financial firms..
3/ It refers to the performing and non-performing portfolio, and includes credit from commercial and development banks, as well as nonbank financial intermediaries.

Regarding domestic credit markets, commercial bank credit to non-financial private firms expanded at a rate similar to that registered in the third quarter of 2013 (Chart 29a). Both large and smaller firms continued to receive resources through bank credit. Interest rates dropped, partly as a consequence of reductions in the target for the Overnight Interbank Interest Rate in September and October (Chart 29b). Delinquency rates of this portfolio did not change significantly in this period, in contrast with the deterioration that took place in the previous quarter due to the problems faced by a reduced number of firms in the housing construction sector (Chart 29c).

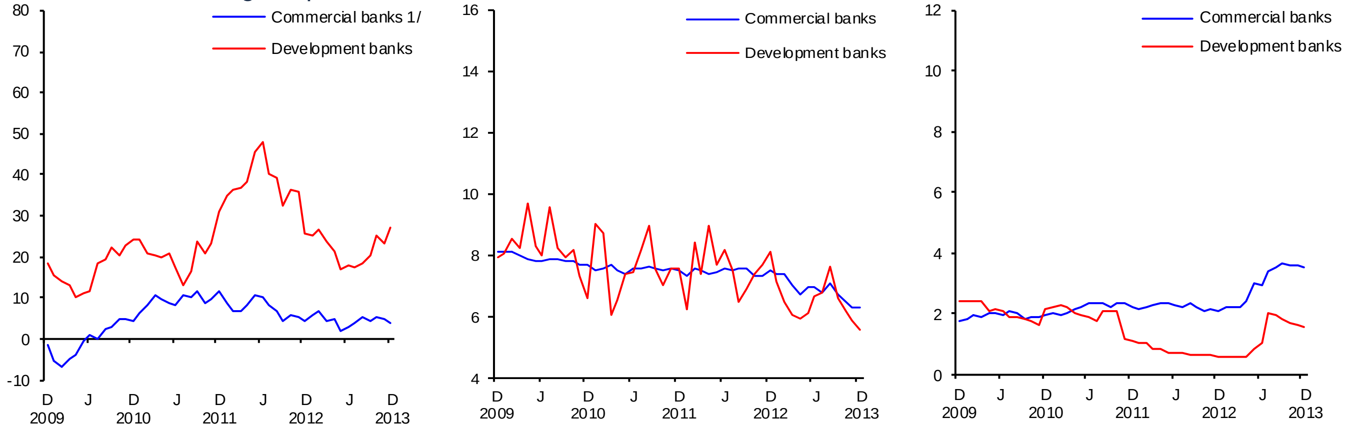
Development bank credit to non-financial private firms grew at a higher rate than in the previous quarter (Chart 29a). In the context of portfolio expansion, the corresponding interest rates evolved favorably, although this indicator typically shows some volatility (Chart 29b). Meanwhile, delinquency rates improved after the deterioration that was observed in the previous quarter derived from the problems faced by the same firms in the housing construction sector as discussed above (Chart 29c).

Chart 29
Bank Credit to Non-financial Private Firms

a) Performing Credit to Non-financial Private Firms
Real annual change in percent

b) Interest Rates of New Credits to Non-financial Private Firms 2/
Percent

c) Delinquency Rates of Credit to Non-financial Private Firms 3/
Percent



Source: Banco de México.

1/ From February 2009 onwards, figures are affected by the reclassification of credit granted to small- and medium-size firms (PyMES, for its acronym in Spanish) from consumer credit to credit granted to non-financial firms.

2/ It refers to the interest rates of new bank credits to non-financial private firms, weighted by the associated stock of the performing credit and for all credit terms requested.

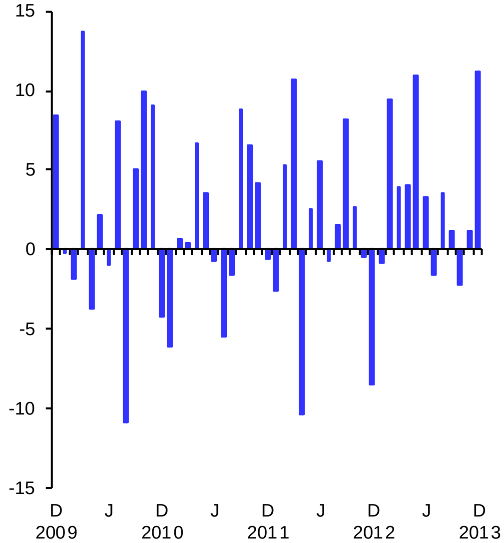
3/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.

In debt markets, non-financial private firms continued to issue securities in international markets, thus extending the dynamism that was observed in the sector throughout the year, particularly in the third quarter, when a relatively high external debt issuance was recorded. Meanwhile, the domestic debt market registered a rebound with respect to the previous quarter, as a result of an increase in the number of placements of medium-term securities by non-financial private firms that occurred amidst favorable conditions in terms of maturities and interest rates. Thus, in the fourth quarter of 2013, the net issuance of medium-term domestic debt amounted to MXN 10.2 billion, a figure higher than that in the previous quarter by MXN 7.1 billion (Chart 30a). The average maturity of medium-term securities issued by private firms was 8 years in the period of October-December 2013. Interest rates of short-term securities issued by private firms decreased as a result of the abovementioned reduction in the monetary policy reference rate. Likewise, interest rates of medium-term securities issued by private firms were lower than in the previous quarter, thus extending the long-term downward trend that they have been exhibiting (Chart 30b).

Credit to households expanded in the fourth quarter of the year, albeit at a more moderate growth rate. This portfolio grew at a rate of 4.1 percent in real annual terms during the period, while in the third quarter of 2013 it grew at a rate of 5.1 percent (Chart 31).

Chart 30
Securities of Non-financial Private Firms

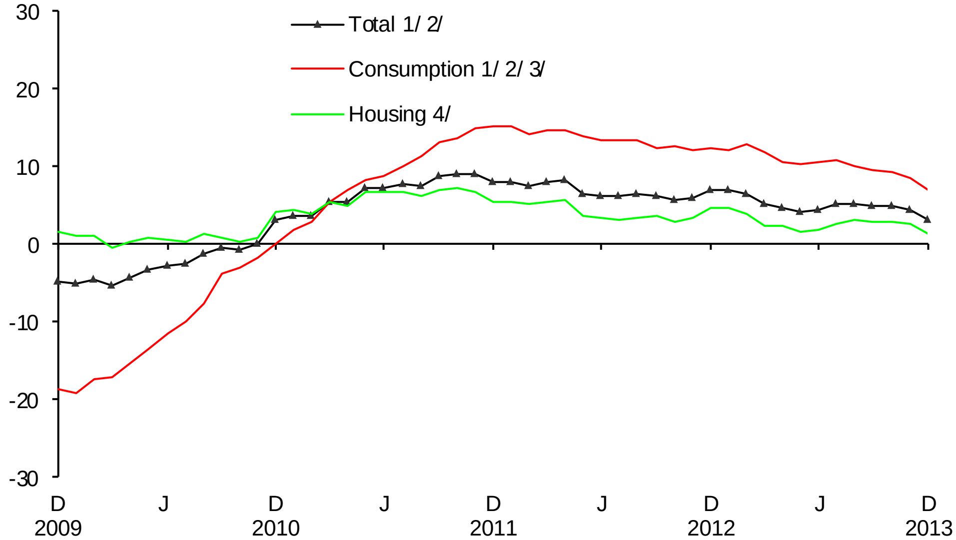
a) Net Placement of Medium-term Securities Issued by Non-financial Private Firms 1/
MXN billion



b) Interest Rates of Securities Issued by Non-financial Private Firms
Annual percent

Source: Banco de México, with data from Valmer and Indeval.
1/ Placements excluding amortizations in each month (securities and prepayments).
2/ Placements of more than one year.
3/ Placements of up to one year.

Chart 31
Credit to Households
Real annual change in percent



Source: Banco de México.

1/ From February 2009 onwards, figures are affected by the reclassification of credit granted to small- and medium-size firms (PyMES, for its acronym in Spanish) from consumer credit to credit granted to non-financial firms.

2/ It includes loans by credit-card regulated sofomes: Tarjetas Banamex, Santander Consumo, Ixe Tarjetas and Sociedad Financiera Inbursa. From February 2009 onwards, figures are affected by the reclassification of credit granted to small- and medium-size firms (PyMES) from consumer credit to credit granted to non-financial firms.

3/ It refers to the performing and non-performing portfolio, and includes credit from commercial and development banks, as well as non-bank financial intermediaries.

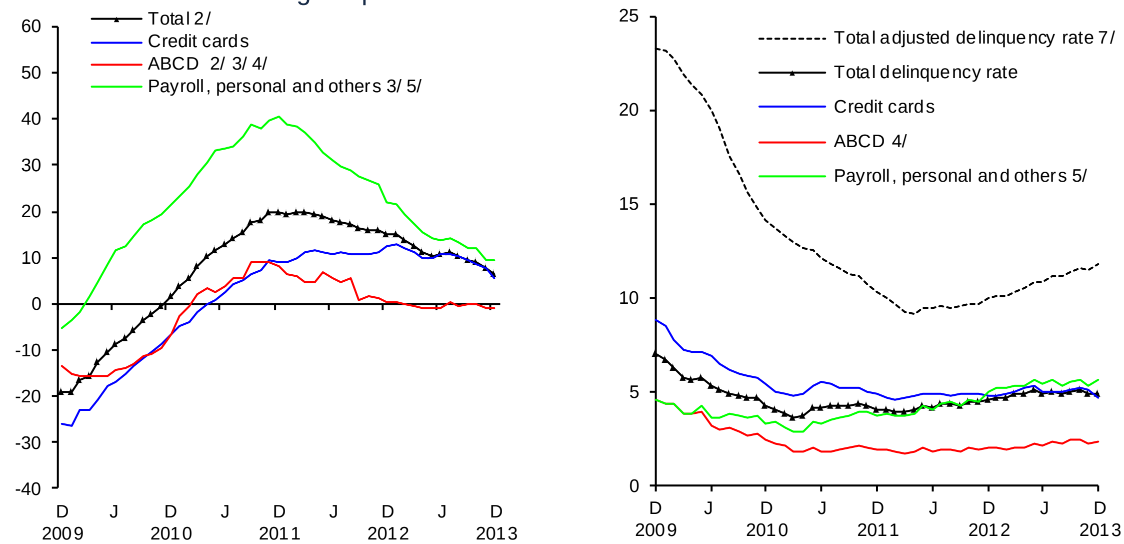
4/ It refers to the performing and non-performing portfolio, and includes credit from commercial and development banks, the National Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores*, Infonavit), the ISSSTE Housing Fund (*Fondo de la Vivienda del ISSSTE*, Fovissste) and other non-bank financial intermediaries.

Even though commercial bank consumer credit kept growing in the last quarter of 2013, this expansion took place at a slower rate as compared to the previous quarter (Chart 32a). Commercial bank performing consumer credit expanded in the period of October-December at an average annual real rate of 7.6 percent, lower than the growth rate of 10.3 percent recorded in the third quarter of the year. This was a result of the moderation in the rates of expansion of the payroll, personal and other credit portfolio, as well as the credit card portfolio. Interest rates did not show any significant changes during the period. Meanwhile, delinquency rates have remained stable in recent months, even though the adjusted delinquency rate—which takes into account bad debt write-offs accumulated in the last twelve months—has increased. Nonetheless, data as of the end of the fourth quarter of 2013 suggest that the deterioration observed in this indicator has stabilized (Chart 32b).

Chart 32
Commercial Bank Consumer Credit

a) Commercial Bank Performing Consumer Credit [1/]
Real annual change in percent

b) Delinquency Rate of Commercial Bank Consumer Credit [1/ 6/]
Percent

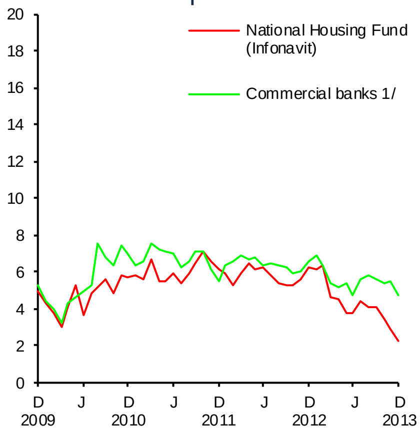


Source: Banco de México.
1/ It includes loans by credit card-regulated sofomes: Tarjetas Banamex, Santander Consumo, Ixe Tarjetas and Sociedad Financiera Inbursa. From February 2009 onwards, figures are affected by the reclassification of credit granted to small- and medium-size firms (PyMES) from consumer credit to credit granted to non-financial firms.
2/ Between June 2010 and May 2011, figures are adjusted in order to avoid distortions due to the purchase of one banking institution's automobile loan portfolio.
3/ From July 2011 onwards, figures are adjusted in order to avoid distortions due to the reclassification from durable goods (ABCD) to other consumer credits by one banking institution.
4/ It includes credit for property acquisition and automobile credit.
5/ "Others" refers to credit for payable leasing operations and other consumer credits.
6/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.
7/ It is defined as a non-performing portfolio plus punishments accumulated over the last 12 months divided by total portfolio plus punishments accumulated over the last 12 months.

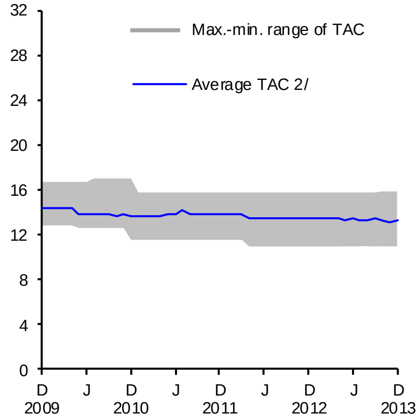
Mortgage loans continued expanding in the reference quarter, although with a lower dynamism than in the previous one. This was largely the result of a slowdown in mortgage loans granted by the National Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores*, Infonavit) observed in recent months. Meanwhile, commercial bank mortgage loans also decelerated (Chart 33a). Thus, commercial bank performing housing credit expanded at an average annual real rate of 5.2 percent in the fourth quarter of 2013, while the National Housing Fund increased its portfolio by 2.9 percent over the same period. Both figures are low compared to the previous quarter, when these portfolios grew at rates of 5.6 and 4.2 percent, respectively. The costs of commercial bank housing credit, which registered a gradual fall throughout the year, continued to display a favorable evolution, while the corresponding delinquency rates remained at low levels (Chart 33b and Chart 33c).

Chart 33
Housing Credit

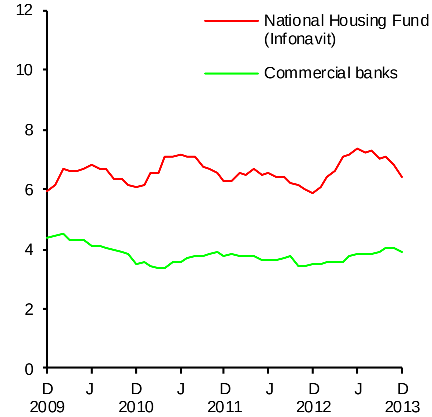
a) Performing Housing Credit
Real annual change
in percent



b) Costs of Commercial Bank
Housing Credit
Percent



c) Delinquency Rates of
Housing Credit 3/
Percent



Source: Banco de México.
1/ Figures are adjusted in order to avoid distortions by the pass-through effect of UDIS trust portfolio to the balance sheet of commercial banks and by the reclassification of credit in direct portfolio to ADES.
2/ Indicator's simple average resuming the total annual cost (TAC) for a standard mortgage product.
3/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.

Thus, considering the year as a whole, the analysis of the sources and uses of financial resources in 2013 suggests a lower dynamism with respect to the previous year, reflecting the moderation in the growth rate of economic activity[13] In the future, while an expansion of economy activity could generate higher growth in the domestic sources of financing, greater financial requirements of the public sector could exert pressure on the availability of resources for the private sector if the inflow of resources from abroad decelerates. In this regard, the greater financial deepening that could result from an appropriate implementation of the financial reform could have a favorable impact on the availability of domestic resources.

With respect to this last point, Table 2 presents the evolution of the sources and uses of resources in 2013, as well as their estimation based on a financial programming exercise for 2014 and 2015. This exercise enables us to analyze the possible pressures to the financing of different sectors of the economy, taking into account the macroeconomic outlook and the international environment presented in this Quarterly Report. In particular, the figures by year-end 2013 shown in the July-September Quarterly Report have been updated. The results indicate a more favorable scenario by the end of 2013 for the sources of financial resources than previously expected. This reflects both higher domestic sources and an increase in external sources towards the end of the year, which were mainly the result of the greater issuance of securities in international markets by non-financial private firms. Despite this upward revision, the total sources for 2013 were lower than in previous years.

[13] The information on annual flows of sources and uses of financial resources is estimated with preliminary data as of the fourth quarter of 2013.

For 2014, lower annual flows of the sources of financial resources of the economy are estimated, particularly of external sources, as well as an increase from 3.4 to 4.4 percent of GDP of those resources destined to the financing of the public sector, in line with the economic package approved for 2014 and with the forecast for financing to states and municipalities. The above would imply a lower flow of financing to the private sector, which would lie at 2.3 percent of GDP, lower than the flow of 3.5 percent registered in 2013.

For 2015, with respect to domestic sources of resources, the forecast considers a similar situation to that of 2014. In contrast, external sources are estimated to be lower than in 2014, as a result of the process of monetary policy normalization among the main advanced economies, principally the U.S. With respect to the use of financial funds, public sector borrowing requirements will remain high, although lower than in 2014 (3.9 percent of GDP), which implies that resources to the private sector would amount to 2.6 percent of GDP.

In this context, insofar as the sources of financial resources to the economy continues to expand dynamically, the probability that higher funding requirements demanded by the public sector over the following years could generate pressures on the loanable funds market—which would in turn affect financing to the private sector—will be lower. Thus, because the use of financial resources by the public sector will be relatively high, it is fundamental that the trajectory of public deficits proposed by the Federal Government is fulfilled, which contemplates reductions from 2015 onwards until reaching a public deficit excluding Pemex investment of zero by 2017. Besides ensuring the sustainability of the public debt, this would translate into proportionally higher resources to the private sector. Additionally, given the higher financial requirements of the public sector over the next years, it will be also highly important to continue attracting resources from abroad.

Table 2
Total Funding for the Mexican Economy (Sources and Uses)
Percentage of GDP

	Annual flows							
	2008	2009	2010	2011	2012	2013 p/	2014 e/	2015 e/
Total sources	**5.9**	**4.0**	**9.3**	**10.0**	**10.0**	**8.3**	**8.0**	**7.6**
Domestic sources	5.5	3.4	4.1	5.7	4.4	4.8	4.9	5.2
Voluntary M4	4.2	1.7	2.6	4.2	3.0	4.1	3.6	3.9
Compulsory M4 1/	1.3	1.7	1.5	1.5	1.4	0.7	1.3	1.3
Foreign sources	0.5	0.6	5.2	4.3	5.6	3.5	3.1	2.4
Non-residents' M4	0.5	0.5	2.9	3.0	4.5	1.3	1.7	1.1
Securities and credit abroad 2/	0.0	0.2	2.3	1.3	1.1	2.2	1.5	1.3
Total uses	**5.9**	**4.0**	**9.3**	**10.0**	**10.0**	**8.3**	**8.0**	**7.6**
International reserves 3/	0.7	0.5	2.2	2.4	1.8	1.0	1.4	1.2
Public sector financing	1.8	3.4	3.8	2.9	3.7	3.4	4.4	3.9
Public Sector Borrowing Requirements (PSBR) 4/	1.6	2.6	3.4	2.7	3.2	3.0	4.1	3.6
States and municipalities	0.2	0.8	0.4	0.3	0.5	0.4	0.3	0.3
Financing to firms	2.0	0.0	2.5	3.5	3.1	3.5	2.3	2.6
Foreign	0.0	-0.4	0.5	0.7	0.8	1.3	0.7	0.7
Domestic 5/	2.0	0.4	2.0	2.8	2.4	2.2	1.6	1.9
Other 6/	1.4	0.2	0.8	1.1	1.4	0.3	-0.1	-0.1

Source: Banco de México.

Note: Figures may not add up due to rounding. Figures expressed in percent of nominal annual average GDP. The information on (revalued) flows is stripped from the effect of exchange rate fluctuations.

p/ Preliminary data, expressed in percent of nominal annual average GDP, estimated by Banco de México.

e/ Estimated data, expressed in percent of nominal annual average GDP, estimated by Banco de México.

1/ Annual revalued flows exclude the effect of the reform to the ISSSTE Law.

2/ It includes foreign financing for the federal government, public institutions and entities, and foreign financed investment projects (PIDIREGAS), commercial banks' foreign liabilities and financing to the non-financial private sector.

3/ As defined by Banco de México's Law.

4/ From 2008 to 2013, Public Sector Borrowing Requirements (*Requerimientos Financieros del Sector Público*, RFSP or PSBR, for its acronym in English) correspond to data reported by the Ministry of Finance (SHCP). For 2014 and 2015, the PSBR as a percentage of the GDP are obtained from the Economic Package 2014. Figures of revalued flows exclude the impact of the reform to the ISSSTE Law on PSBR.

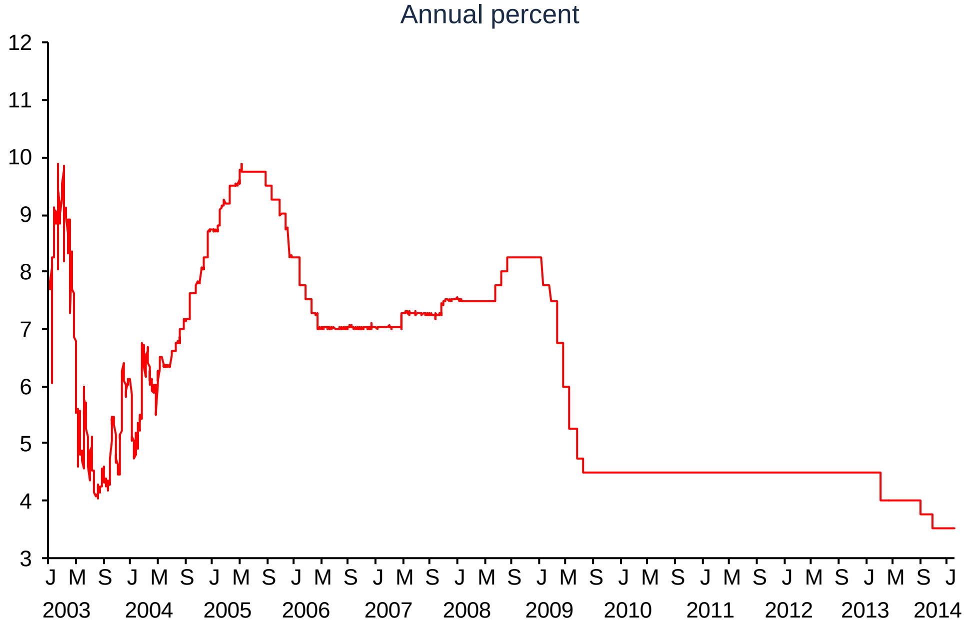
5/ Total portfolio of financial intermediaries, of the National Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores*, Infonavit), and of the ISSSTE Housing Fund (*Fondo de la Vivienda del ISSSTE*, Fovissste). It includes debt-restructuring programs.

6/ It includes capital accounts and results and other assets and liabilities of commercial and development banks, Banco de México, non-bank financial intermediaries and INFONAVIT, as well as non-monetary liabilities from IPAB, among others.

4. Monetary Policy and Inflation Determinants

As a result of adopting policies congruent with the stable macroeconomic environment, in 2013 it became clear that Banco de México has more room for maneuver in conducting the monetary policy. Thus, recognizing the progress in the abatement of inflation in recent years, as mentioned in previous Quarterly Reports, in March 2013 Banco de México's Board of Governors decided to reduce by 50 basis points the target for the Overnight Interbank Interest Rate. The financial markets reacted favorably to this adjustment and interest rates even presented similar drops along the yield curve. This was possible thanks to the anchoring of medium- and long-term inflation expectations. Afterwards, considering the weakening of the economic activity in the first half of the year, the Central Bank implemented a downward adjustment of 25 basis points in the reference rate in September and October, without jeopardizing the control of inflation. It is important to stress that these adjustments in the monetary policy stance principally derived from domestic factors and were implemented despite the uncertainty prevailing in international financial markets. Finally, last December and January, the Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate unchanged at 3.50 percent (Chart 34).

Chart 34
Overnight Interbank Interest Rate [1/]
Annual percent



1/ The target for the Overnight Interbank Interest Rate is shown since January 21, 2008.
Source: Banco de México.

Among the elements taken into account for the monetary policy conduction over the period covered in this Quarterly Report, the following stand out:

a) That, despite the incipient rebound of the economic activity, a considerable slack prevails in the labor market and in the economy as a whole.

b) That, even though headline inflation increased in November and December, as a result of unanticipated increases in the price of a few goods and services, core inflation remained close to its historical minimum levels, below 3 percent.

c) That the observed increment in inflation in January 2014, caused by the fiscal measures in force as of this year, has been in line with Banco de México's forecast.

d) That, although inflation expectations for the end of 2014 increased, as a result of the expected impact of the fiscal measures, medium- and long-term inflation expectations remained stable reflecting that no second round effects are anticipated.

e) That the adjustment in domestic financial markets, given a global environment of high volatility took place in an orderly manner, thanks to the strength of the macroeconomic framework in Mexico.

As regards inflation determinants, in line with the available data on the evolution of various indicators related to the use of productive resources, in the reference quarter no pressures on the prices of main input markets, or the external accounts were observed. In particular:

a) Despite the moderate recovery of the economic activity in the second half of 2013, given the contraction in the first half of the year, the output gap remained negative (Chart 35).[14]

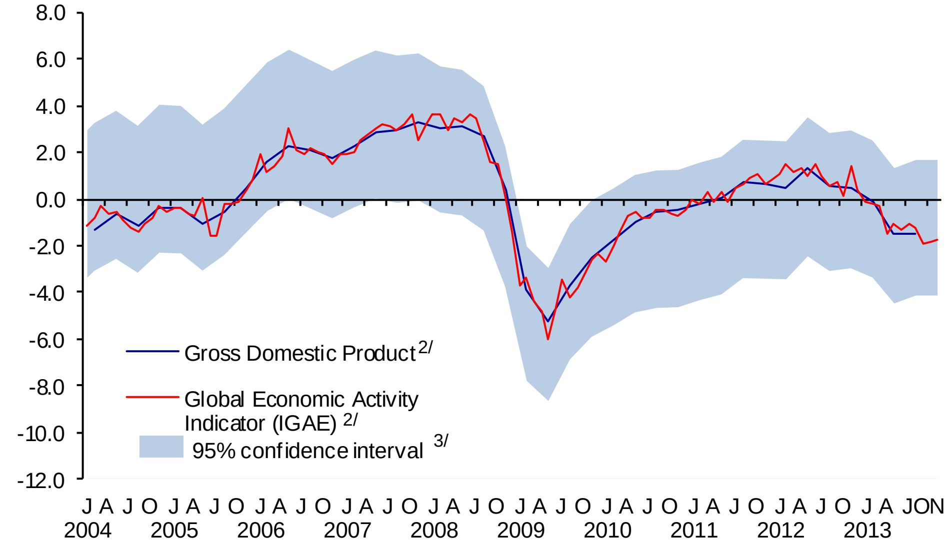
b) As stated before, slack conditions prevail in the labor market, even though they tended to diminish with respect to previous quarters.

c) As a result of the moderate changes in the main wage indicators of the economy and the tendency of the average labor productivity, the unit labor costs kept going down (Chart 36).

d) The recent evolution of various indicators in the debt market and the market of credit to the non-financial private sector continue pointing to the absence of signs of pressures in these markets.

[14] Considering that this indicator's estimation is subject to a certain degree of uncertainty, it should be carefully interpreted, given that, from a statistical point of view, it does not register levels significantly different from zero.

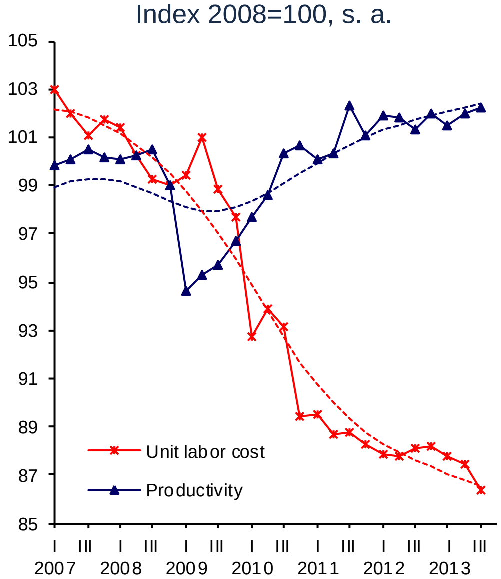
Chart 35
Output Gap Estimation [1/]
Percentage of potential output, s. a.



1/ Estimated using the Hodrick-Prescott (HP) filter with tail corrections; see Banco de México (2009), "Inflation Report, April - June 2009", p.69.
2/ GDP figures up to the third quarter of 2013, IGAE figures up to November 2013.
3/ Confidence interval for the output gap calculated with an unobserved components' method.
s. a. / Prepared with seasonally adjusted figures.
Source: Prepared by Banco de México with data from INEGI.

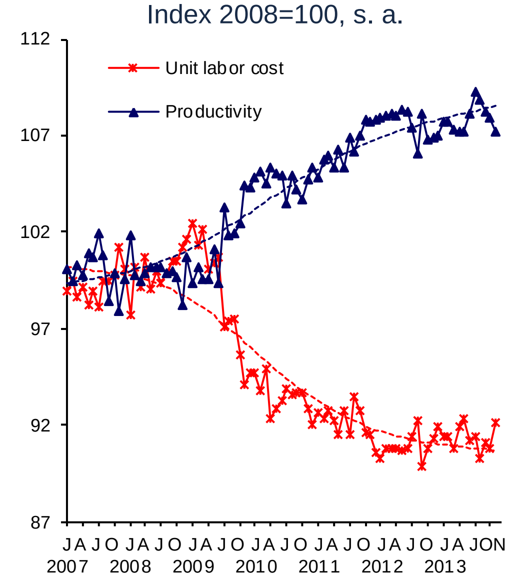
Chart 36
Productivity [1/] and Unit Labor Cost

a) In the Economy
Index 2008=100, s. a.



s. a. / Seasonally adjusted data. Trends estimated by Banco de México.
1/ Productivity based on the amount of hours worked.
Source: Unit cost prepared by Banco de México based on data from INEGI. The Global Index of Labor Productivity in the Economy (IGPLE), as released by INEGI.

b) In the Manufacturing Sector
Index 2008=100, s. a.



s. a. / Seasonally adjusted and trend data.
1/ Productivity based on the amount of hours worked.
Source: Prepared by Banco de México with seasonally adjusted data from the Monthly Manufacturing Business Survey and the monthly indicator of the Mexico's System of National Accounts, INEGI.

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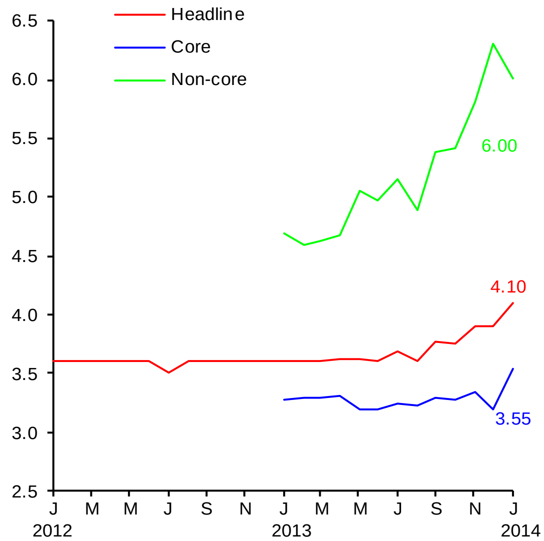
In line with Banco de México's expectation survey among private sector analysts, the median of short-term inflation expectations for the end of 2014 increased with respect to its September level, derived from adjustments in the anticipated impact of fiscal measures, in force as of this year. In particular, the median of headline inflation expectations for the end of 2014 went up from 3.77 to 4.10 percent between the surveys of September 2013 and January 2014. In turn, the median of core inflation for the end of the same year grew from 3.30 to 3.55 percent between September and January, while non-core inflation expectation implicit in the referred medians shifted from 5.38 to 6.0 percent over the same time frame.[15] In contrast, longer-term expectations maintained stable around 3.5 percent.[16]

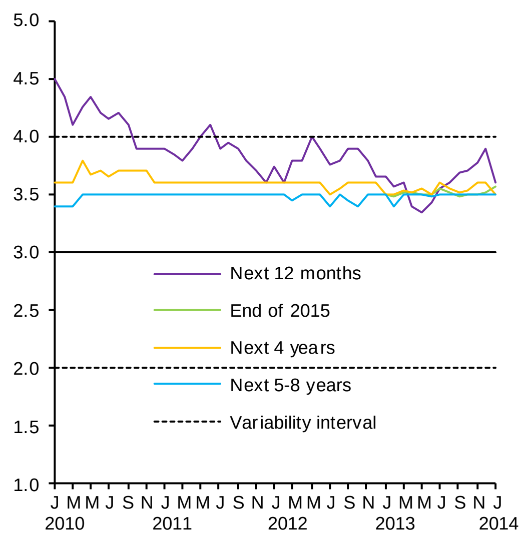
Chart 37
Inflation Expectations

a) Medians of Headline, Core and Non-core Inflation Expectations as of End of 2014
Percent



Source: Banco de México's survey.

b) Medians of Headline Inflation Expectations across Different Terms[1/]
Percent



1/ Latest available data: January 2014.
Source: Banco de México's survey.

Inflation expectations derived from market-based instruments also indicate a stable performance. In this respect, the evolution of break-even inflation and inflationary risk (the difference between long-term nominal and real interest rates), which has been decreasing in recent years from an average of 4.3 percent in 2005 to around 3.8 percent during last month is noteworthy. It should be noted that the decrease in this break-even inflation resulted from the fact that these instruments' holders demanded coverage of lower future inflation and with a reduced risk. In accordance with recent studies, the components of this break-

[15] According to Banamex Survey of Financial Market Analysts' Expectations, the median of headline inflation expectations for the end of 2014 increased from 3.75 to 3.94 percent between the surveys of September 20, 2013 and February 5, 2014. This was a result of an increment in medians of core inflation expectations for the same horizon from 3.20 to 3.51 percent, while the expectation of non-core inflation implicit in the abovesaid medians dropped from 5.64 to 5.42 percent.

[16] It should be pointed out that this figure coincides with the results of the survey conducted by Banamex among financial market analysts, whose median of long-term inflation expectations was 3.50 percent both in the survey of January 7 and in that of February 5, 2014. From this year onwards, this survey includes the expected average annual inflation with a long-term horizon (period 2016-2020).

even inflation, both the long-term inflation expectation and the inflation risk premium have exhibited a downward trend in recent years. In particular, the referred expectations dropped from a level around 3.6 percent in 2005 to one of approximately 3.2 percent in 2013, thus reaching historical minimum levels. In turn, despite high volatility, the inflation risk premium also reduced in recent years from levels around 75 basis points in 2005 to 40 basis points in 2013. It is noteworthy that an environment of higher certainty regarding inflation is reflected in a lower dispersion of inflation expectations, which, in turn, is related to a smaller inflation risk premium. Thus, insofar as business agents can more accurately forecast future inflation, the risk of it being different from expected inflation decreases, and, therefore, the related break-even inflation, which would be demanded by a holder of a financial instrument denoted in nominal terms also decreases. All these results point to a better anchoring of inflation expectations and economic agents' greater credibility for the Central Bank's inflation target (see Box 1).

In total, the evolution of medium- and long-term inflation expectations allows maintaining the forecast that the recent inflation increase will be transitory and will not affect the price formation process in the economy. Indeed, the drop in the CPI growth rate, registered between the first and the second fortnight of January, from 4.63 to 4.34 percent, is congruent with this forecast.

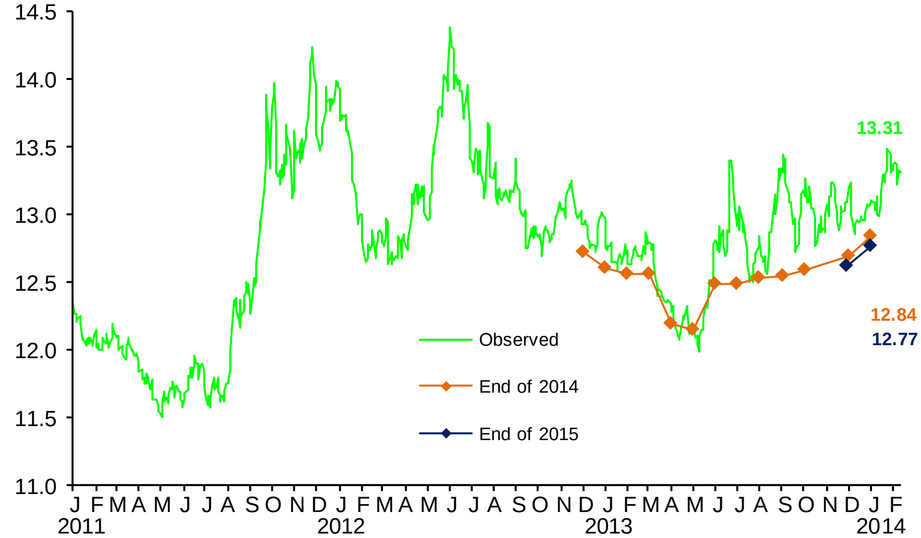
Due to the 2008-2009 financial crisis, financial markets observed high volatility. During 2013, uncertainty in these markets increased in the second quarter of the year, as a result of the Federal Reserve announcement that it could begin reducing the pace of its asset purchases. This gave rise to the decompression process of some risk premia in international financial markets, with its corresponding effect on longer-term interest rates, which generated abrupt movements in capital flows. The flexible exchange rate regime in Mexico has served as a shock buffer, which allowed attenuating part of the effects of the referred adverse external shocks. Various elements have strengthened the role of the exchange rate as a buffer of these shocks. First, the reduction in the pass-through of exchange rate fluctuations onto the domestic prices, which has been observed in recent years. Second, the existence of a well-developed derivatives market in Mexico, which allows economic agents to cover their exchange rate risks. Hence, due to its stabilizing properties, the flexible exchange rate regime is an important element for the monetary policy conduction in Mexico.

Thus, despite lower capital inflows to emerging economies, including Mexico, from May 2013 onwards, adjustments in domestic financial markets, in particular exchange rate and fixed-income markets, have been orderly. It should be mentioned that both markets have maintained an adequate functioning and high liquidity levels. In the case of the exchange rate market, in 2013 the national currency registered a depreciation of 0.9 percent against the dollar, even though with high volatility, which still has been recently recorded (Chart 38). However, driven by the strength of the Mexican economy, the MXN registered an average appreciation rate of 8.2 percent against other emerging countries' currencies (see Section 3.1.4).[17] Recently, in light of the renewed volatility in international financial markets, mentioned above, a depreciation of approximately 1.75 percent of the national currency against the dollar has been registered. This evolution of the

[17] Currencies of Brazil, Chile, Colombia, Czech Republic, India, Peru, Russia, Thailand and Turkey.

national currency contrasts with that of other emerging economies characterized by less solid macroeconomic fundamentals, whose currencies have depreciated significantly, due to the uncertainty prevailing in international financial markets.

Chart 38
Nominal Exchange Rate and Exchange Rate Expectations as of End of 2014 and 2015 1/
MXN/USD



1/ The observed exchange rate is the daily datum of the FIX exchange rate. The latest datum of the observed exchange rate corresponds to February 10, 2014. For its expectations, the latest datum corresponds to the survey of January 2014.
Source: Banco de México and Banco de México's Survey.

As a result of the decompression process of risk premia in international markets, long-term interest rates in Mexico, just like in most emerging economies, increased during 2013. In particular, the interest rate of 10-year government bonds went up from an average level of around 5.9 percent in late September to 6.5 percent in early February 2014, as a reflection of an increment in the term premium in the U.S. In turn, the interest rate of 3-month government securities diminished slightly from 3.5 to 3.4 percent over the same period (Chart 39).

Box 1
Decomposition of the Break-even Inflation

1. Introduction

The dynamics of inflation and its expectations have changed considerably over the last decade. Several structural improvements achieved in the abatement of inflation have been documented by Banco de México in different studies and boxes of Quarterly Reports.[1] As a complement to the referred analyses, this Box studies the evolution of the break-even inflation implicit in financial instruments, which, as mentioned in previous Reports, diminished over the last years. In particular, the dynamics of the components of the referred break-even inflation, i.e., the long-term inflation expectation and the inflation risk premium are analyzed, and it is shown that they reduced significantly from 2005 to 2013.[2]

There are two main sources of information regarding economic agents' inflation expectations. The first one corresponds to data obtained directly from agents via surveys. Thus, Banco de México conducts and follows up on surveys in which it collects expectations for inflation and other economic variables for over 13 years.[3] The second one derives from the information implicit in the prices of some financial instruments, in particular of some government bonds. In this regard, it should be mentioned that, given the degree of development of Mexico's financial markets, the information that can be extracted from these instruments is reliable and, therefore, relevant.

Specifically, an indicator that contains information regarding the long-term inflation outlook and that stems from the second source is the break-even inflation, i.e. the compensation demanded by investors, to hold medium- and long-term peso-denominated debt instruments. This break-even inflation is calculated as the difference between the yields derived from nominal bonds and inflation-indexed bonds.

The fact that the above referred compensation has been decreasing in recent years indicates that nominal bond holders demand less coverage for future inflation (inflation expectation) and for inflation-related uncertainty (inflation risk premium). Even though the evolution of the compensation provides information regarding the markets' perception of inflation expectations, for their more accurate follow-up it is necessary to analyze separately the part corresponding to the inflation risk premium, on the one hand, and the referred expectations, on the other hand.

2. Break-even Inflation

One of the advantages of splitting the break-even inflation into its two components, using the data derived from financial instruments, instead of that from surveys, is that this approach allows obtaining an indicator of inflation expectations that considers the perception of a broader group of people, longer-term horizons and that reflects the portfolio positions of economic agents as a whole.[4] Thus, this indicator can be considered to more accurately reflect the inflation expectations of financial markets' participants. This contrasts with the indicator derived from surveys, which usually corresponds to a specific group of agents and that are not necessarily backed by financial positions.

In this context, considering the Fisher equation that relates nominal interest rates and real interest rates with the expected inflation, the break-even inflation for any term *n*, in period *t*, is given according to the following relation:

$$\begin{aligned} BEI_t^n &= i_t^{nom,n} - i_t^{real,n} \\ &= E_t\left(\pi_{t+1,t+n}\right) + \varphi_t^n + \varepsilon_t \quad (1) \end{aligned}$$

where BEI_t^n is the break-even inflation in the *n* term; $i_t^{nom,n}$ and $i_t^{real,n}$ correspond to a nominal bond yield and to the yield of an inflation-indexed debt instrument, respectively, both with a maturity of *n* periods; $E_t\left(\pi_{t+1,t+n}\right)$ is the average inflation expectation between *t*+1 and *t*+*n*; φ_t^n is the inflation risk premium in *n* and, ε_t is a convexity adjustment that, according to literature, is assumed to be zero.[5]

Based on the abovesaid, the long-term break-even inflation is obtained by subtracting from the nominal 10-year bond yield the real yield associated to inflation-indexed bonds (Udibonos) of the same term. Chart 1 presents the dynamics of these rates between 2005 and 2013. In turn, Chart 2 shows the evolution of

[1] For more details regarding the achieved structural progress in curbing inflation, see: Ramos-Francia and Torres (2005); Chiquiar et. al. (2007); García-Verdú (2012); Cortés (2013); Aguilar et. al. (2013).

[2] For more details regarding this analysis, see Aguilar et. al. (2014) forthcoming in Banco de México Working Papers series.

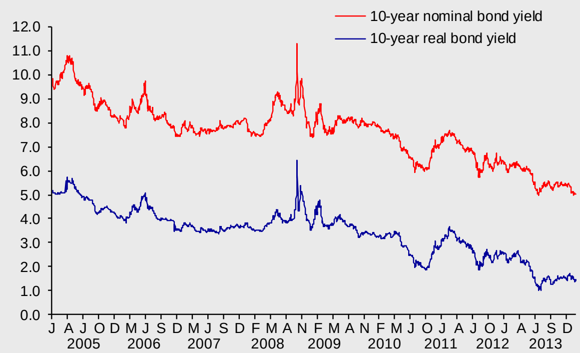
[3] Among these, there is "*Encuesta sobre las Expectativas de los Especialistas en la Economía del Sector Privado*", realized by Banco de México.

[4] The longer-term inflation expectation currently provided by available surveys is the one corresponding to the next 5-8 years.

[5] The convexity of a bond measures the sensitivity to changes in its price. Assuming a convexity adjustment equal to zero implies considering that both nominal and inflation-indexed bonds with maturity *n* have the same convexity.

the break-even inflation over the same period. It can be observed that not only the long-term nominal and real bond yields registered a downward trend in recent years, but also that the difference between these (i.e., the break-even inflation) has been diminishing, reflecting a lower demanded coverage for future inflation and associated risk, as mentioned above. It is important to highlight that, despite the recent process of decompression of some risk premia, which increased long-term interest rates in international financial markets, including the Mexican market, the above referred compensation has not changed significantly.[6]

Chart 1
Nominal and Real Bond Yields
Percent



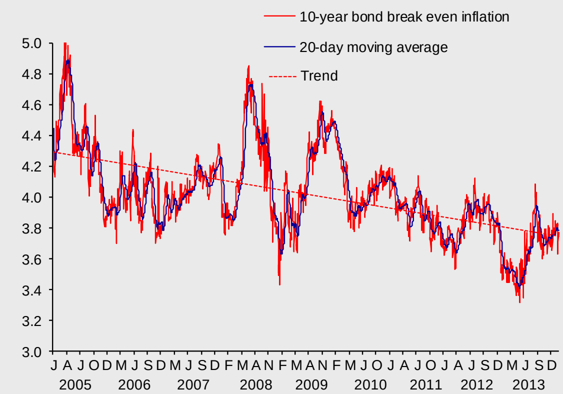
Source: *Proveedor Integral de Precios* (PiP) and Valmer.

The decomposition of the break-even inflation is calculated in two steps. First, the average inflation expectation is estimated for the next 10-year horizon, $E_t(\pi_{t+1,t+10years})$. Once a long-term inflation forecast is obtained, in the second step, the inflation risk premium is calculated as the difference between the break-even inflation extracted from nominal and inflation-indexed bonds and this expectation:

$$\varphi_t^{10years} = BEI_t^{10years} - E_t(\pi_{t+1,t+10years}) \quad (2)$$

[6] For an analysis of the process of decompression of some risk premia, see the Box "Process of Risk Premia Decompression and its Effect on Longer-term Interest Rates in the U.S. and the Rest of the World" in the Inflation Report April-June 2013.

Chart 2
Break-even Inflation
Percent



Source: Estimated by Banco de México with data from PiP and Valmer.

2.1 Step 1: Estimating the Long-term Inflation Expectation

The estimation of this expectation is done by means of an affine term structure model, which is standard in the financial literature.[7] Specifically, the affine model estimated in this analysis is represented by the following system of equations:

$$X_t = \mu + \phi X_{t-1} + \Sigma \eta_t$$
$$i_t = A + BX_t + \varepsilon_t$$

The first expression corresponds to the transition equation, which describes the dynamics of a vector of state variables, X_t, which follows a first-order autoregressive stochastic process (VAR (1)). This vector includes inflation and two unobservable variables (latent factors).[8] The second expression corresponds to the measurement equation that relates X_t with the performance of interest rates i_t which, in this case, is a vector composed of yields of nominal and inflation-indexed government bonds, the observed inflation and the inflation expectation for the next 12 months from Banco de México's survey. In turn, μ and A are vectors, while ϕ, Σ and B are coefficient matrices. Finally, $\eta_t \sim N(0,I)$ and $\varepsilon_t \sim N(0,H)$ are uncorrelated errors.[9]

Once the previous model is estimated, the average inflation expectation for the next 10-year horizon is obtained, as the inflation forecast derived from the dynamics of the transition equation. Specifically, the

[7] See, for example, Adrian and Wu (2010); García and Werner (2010) and Melo and Granados (2010).
[8] The unobservable variables in the estimation can be interpreted as the level and the slope of the yield curve (see Cortés et. al. (2008)).
[9] The data used in the estimation are at monthly frequency. For further details on the model and its estimation, see Aguilar et. al. (2014).

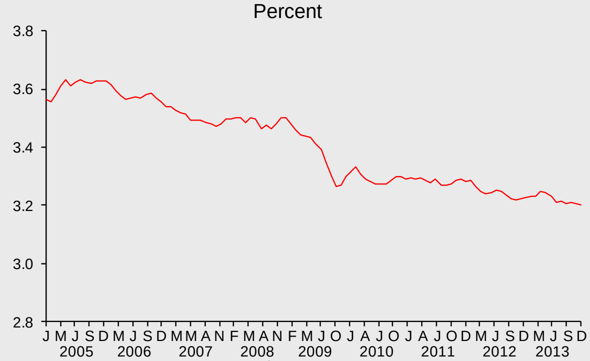
third element of the vector, which corresponds to inflation, is considered:

$$E_{t|model}^{10years}\left(\pi_{t+1,t+10years}\right)$$
$$= e_3^{'}(I-\phi^{10})(I-\phi)^{-1}\mu + e_3^{'}\phi^{10}X_t \quad (3)$$

where $e_3^{'} = (0,0,1)$.

Chart 3 shows the trajectory of this expectation.[10] In particular, it is observed to have reduced from an average level of 3.6 percent in 2005 to one of 3.2 percent in 2013. This reduction contrasts with the evolution of the long-term inflation expectation, obtained from survey data, which remained stable around 3.5 percent over the last years. Furthermore, it should be pointed out that, despite the increase in the yield of nominal and real bods in recent months, as a result of the decompression process of some risk premia in the international financial markets (Chart 1), the break-even inflation, as well as the average long-term inflation expectations remained stable.

Chart 3
Long-term Inflation Expectations
Percent



Source: Estimated by Banco de México.

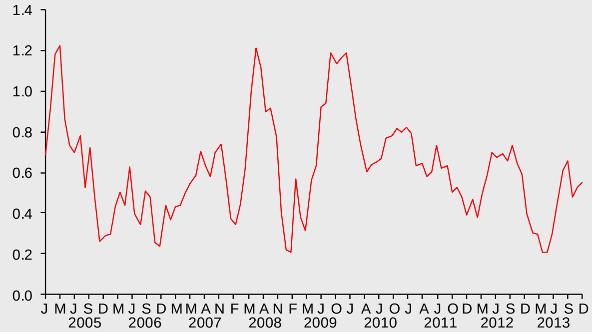
2.2 Step 2: Estimating the Inflation Risk Premium

Once the long-term inflation forecast is obtained, it is possible to estimate the inflation risk premium, based on equation (2). In Chart 4 it can be observed that the referred premium, despite its high volatility, has been decreasing over the last years. In particular, it has exhibited a downward trend in recent years, dropping from levels around 75 basis points in 2005 to 40 basis points in 2013.

Chart 5 summarizes the above described analysis, by presenting both the break-even inflation and their two components.

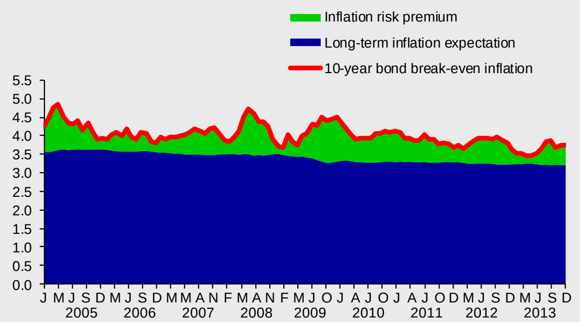
[10] It should be stressed that, like in any econometric exercise, the results of this estimation are subject to a certain degree of uncertainty, reason for which they should be interpreted with caution.

Chart 4
Inflation Risk Premium
Percent



Source: Estimated by Banco de México.

Chart 5
Decomposition of the Break-even Inflation
Percent



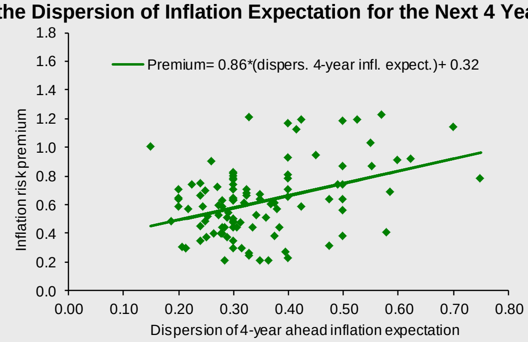
Source: Estimated by Banco de México.

In general, a lower dispersion of inflation expectations is associated to a lower inflation risk premium, due to the fact that a lower dispersion of inflation expectations reflects an environment of greater certainty. Thus, insofar as the agents are able to forecast future inflation more precisely, the risk that it is different from expected inflation decreases, so as the compensation associated to this risk that would be demanded by a holder of a financial instrument in nominal terms. Hence, both variables are expected to be positively correlated. In Mexico, as documented before, the dispersion of inflation expectations has been reducing in recent years.[11] In light of this, it is relevant to analyze the relation between the dispersion of inflation expectations and the inflation risk premium estimated here. In particular, the relation between the 10-year inflation risk premium and the dispersion of inflation expectations for the next 4 years is analyzed, obtained from Banco de México's survey by means of

[11] See García-Verdú (2012).

estimating a linear regression.[12] As observed in Chart 6, this relation is indeed positive.

Chart 6
Relation between the 10-year Inflationary Risk Premium and the Dispersion of Inflation Expectation for the Next 4 Years



Source: Estimated by Banco de México.

3. Final Remarks

Complementing the analysis carried out by Banco de México regarding the achieved progress in the process of structural changes aimed at the abatement of inflation, this Box presents an estimation of the decomposition of the break-even inflation implicit in government bonds' interest rates. In doing so, an average inflation expectation for a 10-year horizon is estimated, by means of an affine term structure model. This expectation is then subtracted from the referred break-even inflation to obtain the inflation risk premium. The results of the analysis suggest that both the long-term inflation expectation and the inflation risk premium decreased in the period 2005-2013.

References

[1] Adrian T. and H. Wu, (2010). "The Term Structure of Inflation Expectations". Federal Reserve Bank of New York Staff Reports No. 362.

[2] Aguilar A., G. Cuadra, C. Ramírez and D. Sámano, (2013). "El Anclaje de las Expectativas de Inflación ante Choques de Oferta". Forthcoming in the series of Banco de México's Working Papers.

[3] Aguilar A., R. Elizondo and J. Roldán-Peña, (2014). "Descomposición de la Compensación por Inflación y Prima por Riesgo Inflacionario". Forthcoming in the series of Banco de México's Working Papers.

[4] Chiquiar D., A. Noriega and M. Ramos-Francia, (2007). "Un Enfoque de Series de Tiempo para Probar un Cambio en Persistencia de la Inflación: la Experiencia de México". Banco de México. Working Paper No. 2007-01.

[5] Cortés J., M. Ramos-Francia and A. Torres, (2008). "Un Análisis Empírico de la Estructura Temporal de Tasas de Interés en México". Banco de México. Working Paper No. 2008-07.

[6] Cortés J., (2013). "Estimación del Traspaso de las Variaciones en el Tipo de Cambio a los Precios en México". Banco de México. Working Paper No. 2013-02.

[7] García J. and T. Werner, (2010). "Inflation Risk and Inflation Risk Premia". European Central Bank Working Paper No. 1162.

[8] García-Verdú S., (2012). "Evolución de las Expectativas de Inflación en México". Banco de México. Working Paper No. 2012-06.

[9] Melo L. and V. Granados, (2010). "Expectativas y Prima por Riesgo Inflacionario bajo una Medida de Compensación a la Inflación". Banco de la República Colombia, Borradores de Economía No. 589.

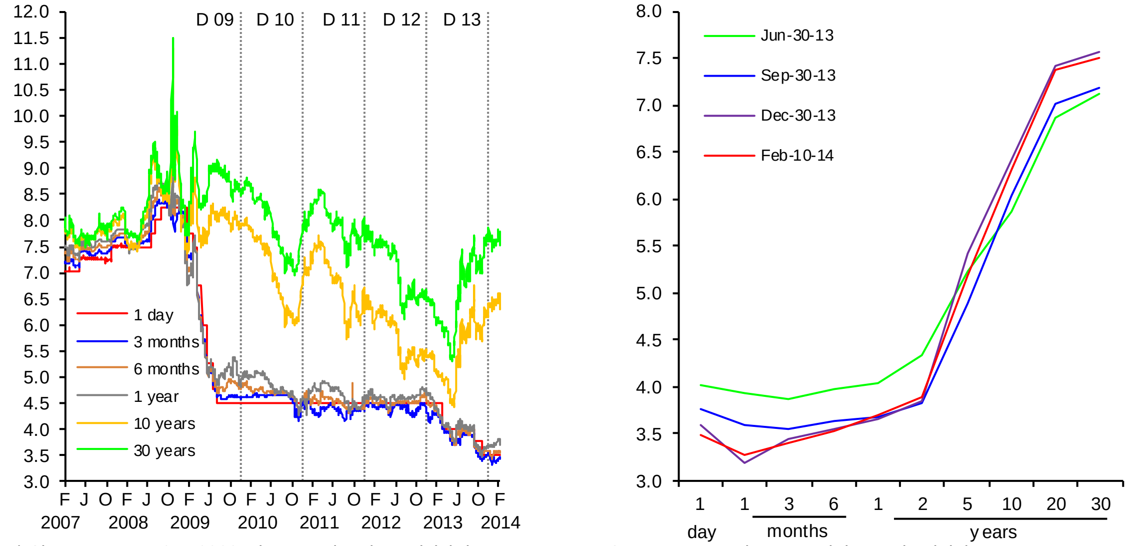
[10] Ramos-Francia M. and A. Torres, (2005). "Reducción de la Inflación a Través de un Esquema de Objetivos de Inflación: La Experiencia Mexicana". Banco de México. Working Paper No. 2005-01.

[12] The dispersion is estimated as the difference between the 75th and the 25th percentile of the sample. The 4-year inflation expectation is used, given that it represents the long-term expectation with most historical information available (that corresponding to the next 5-8 years is only available from 2008 onwards).

Chart 39
Interest Rates in Mexico

a) Government Securities Interest Rates [1/]
Percent

b) Yield Curve
Percent



1/ Since January 21, 2008, the one-day (overnight) interest rate corresponds to the target for the Overnight Interbank Interest Rate.
Source: *Proveedor Integral de Precios* (PiP).

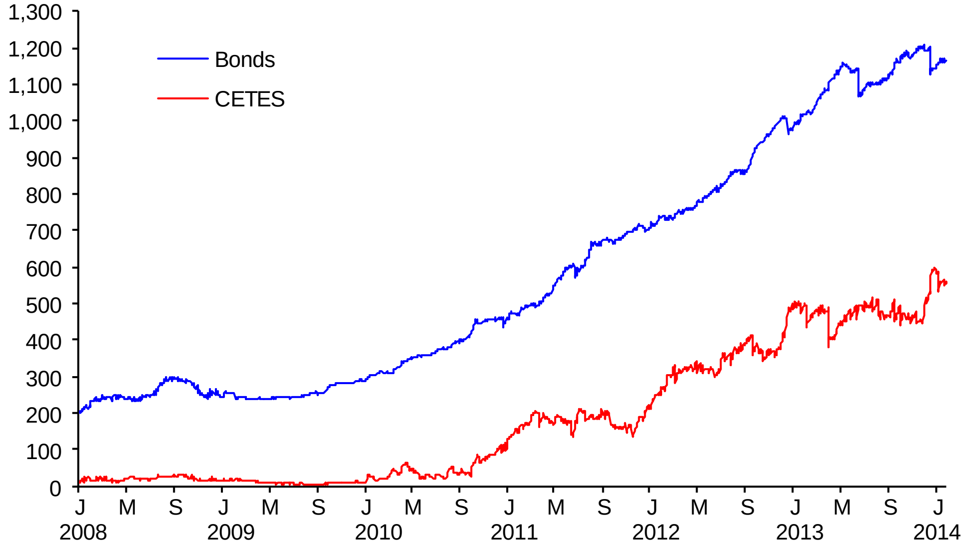
Source: *Proveedor Integral de Precios* (PiP).

As mentioned in Section 3.2.2, in the last quarter of 2013, despite uncertainty in international financial markets and unlike other emerging economies, Mexico continued receiving resources from abroad, channeled to financial instruments' acquisition. Thus, non-resident financial savings kept registering positive flows, although of a lower magnitude as compared to those observed in the first months of 2013. Regarding this, the recent change in the portfolio composition of this type of investors stands out, who increased their short-term government securities holdings, which has remained at high levels in recent weeks (Chart 40).

As a result of the above, in 2013 medium- and long-term interest rates in Mexico increased more than those in the U.S., reason for which long-term interest rate spreads between the two countries went up, close to the levels observed in mid-2012 (Chart 41).

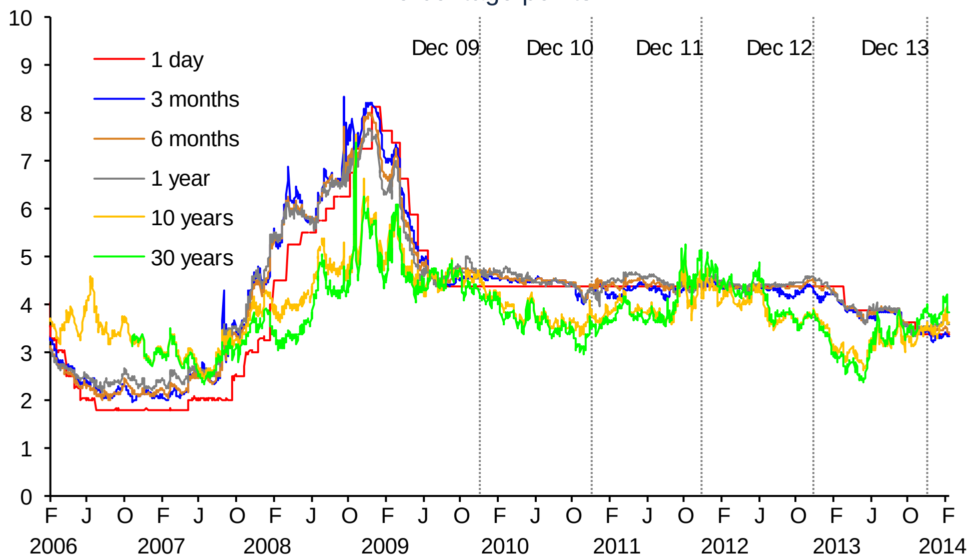
Complementing the abovesaid, the evolution of long-term nominal interest rates in Mexico is analyzed below, by means of the evolution of each of their components: i) the short-term interest rate (the reference interest rate); ii) the expected short-term interest rates, which consider medium- and long-term inflation expectations; and iii) risk premia.

Chart 40
Government Securities' Holdings by Foreign Investors
MXN billion



Source: Banco de México.

Chart 41
Interest Rate Spreads between Mexico and the U.S. [1/]
Percentage points



1/ For the U.S. target rate, the average of the interval considered by the U.S. Federal Reserve is considered.
Source: *Proveedor Integral de Precios* (PiP) and U.S. Department of the Treasury.

In general, for the case of Mexico it stands out that:

a) With respect to the observed short-term interest rate, as stated above, the reference interest rate dropped by 100 basis points in 2013. It should be noted that at that moment, these reductions were reflected in lower medium- and long-term interest rates.

b) The expected short-term interest rates have remained relatively stable in light of the expectation of economic analysts and, in general, of financial market agents that the monetary policy would remain unchanged in an environment of the prevailing slack in the economy and in which longer-term inflation expectations remain anchored. In particular, in line with Banco de México's survey among private sector analysts, the median of the expectations for the 28-day Cetes interest rate as of end of 2014 is 3.5 percent. Similarly, the interest rates of government securities of up to one year locate around 3.5 percent.

c) In general, as a reflection of the macroeconomic stability and of progress in the process of structural reforms, the risk premia in Mexico have been diminishing:

   i. During 2013, various indicators of sovereign risk premium for Mexico decreased slightly. This contrasted to the vast majority of emerging economies that registered increments in their sovereign risk premia in the same time frame, especially those vulnerable to an adverse external environment (Chart 42a). Additionally, in January and in the first days of February, the indicators of sovereign risk premia of emerging economies registered widespread increments, brought about by the considerable uncertainty persisting in international financial markets. However, in the case of Mexico, the increment has been of a lower magnitude, as a reflection of solid macroeconomic fundamentals and of progress in the approval of structural reforms that led to a rating upgrade of Mexico's sovereign debt by two rating agencies in December and February.

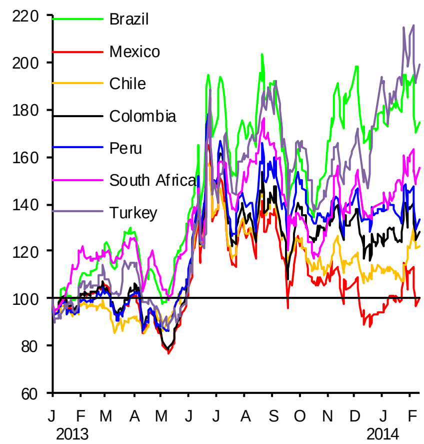
   ii. As indicated above, the Central Bank's effort to reduce inflation generated a downward trend in the inflation risk premium. Just in 2013, this premium fell by around 15 basis points with respect to the previous year.

   iii. As regards the exchange risk premium, the spread between the interest rate of the 10-year government bond issued in pesos and the government bond of the same term issued in dollars observed high volatility in 2013, in line with the environment prevailing in international financial markets. Nonetheless, this spread decreased from late 2012 to the end of January 2014 (Chart 42b).

   iv. As a result of a high degree of monetary lassitude in the U.S. in recent years, the term premium in international financial markets remained at minimum historical levels. In the case of Mexico, this reduction was reflected by lower long-term interest rates. Nevertheless, in 2013, given the abovementioned process of the risk premia decompression in the U.S., higher term premium in this country also generated an increment in term premium in Mexico (measured as the difference between the 10-year interest rate and the 2-year interest rate), which soared from 70 basis points in early May 2013 to approximately 250 basis points in early February 2014. Thus, it comes as no surprise that the recent increase in long-term interest rates in Mexico, to a large extent, stemmed from the decompression process of the term premium in the U.S. (Chart 42c).

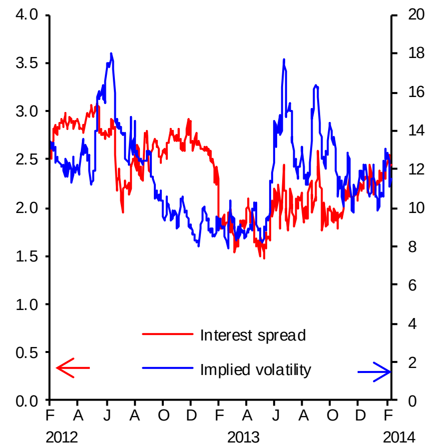
Chart 42
Risk Premia

a) Credit Default Swaps [1/]
Index 01-Jan-13=100



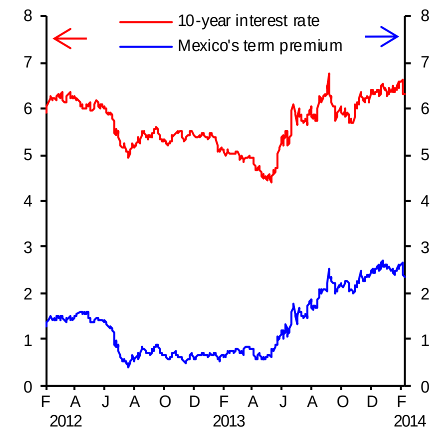
1/ It refers to 5-year *Credit Default Swaps*.
Source: Bloomberg.

b) Spread between the 10-year Bond Rate in Pesos and in Dollars, and Volatility Implied in Exchange Rate Options [2/]
Percentage points, percent



2/ Volatility implied in exchange rate options refers to options with a monthly term.
Source: Bloomberg, *Proveedor Integral de Precios* and Valmer.

c) Interest Rate in Mexico of the 10-year Government Bond and the Term Premium [3/]
Percent, percentage points



3/ The term premium refers to the difference between the 10-year and the 2-year interest rate.
Source: *Proveedor Integral de Precios*.

5. Inflation Forecasts and Balance of Risks

As detailed above, in the second half of 2013 the Mexican economy resumed a positive trend. This performance, together with the expectations of a greater dynamism of the U.S. economy and of a continuous recovery of domestic spending, both private and public, suggest an evolution of the economic growth in Mexico over the next two years similar to that anticipated in the previous Report.

The expectations regarding the U.S. economic activity, which represent the basis for Mexico's macroeconomic framework, are the following:[18]

a) The U.S. GDP grew at a rate of 1.9 percent in 2013, figure that compares to the expectation of 1.6 percent reported in the previous Quarterly Report. For 2014 and 2015, the U.S. GDP growth is expected to amount to 2.9 and 3.0 percent, respectively, as compared to the figures of 2.6 and 2.9 percent, in the same order, indicated in the previous Report.

b) U.S. industrial production registered a growth rate of 2.6 percent in 2013, figure that compares to the expectation of 2.3 percent reported in the previous Report. For 2014 and 2015, this indicator is estimated to grow 3.6 and 3.5 percent, respectively, above the figures indicated in the previous Report of 2.9 and 3.4 percent, in the same order.

Growth of the Mexican Economy: As mentioned above, in 2013 GDP in Mexico is forecast to have grown at an annual rate of approximately 1.2 percent. Given a more dynamic performance of the U.S. economy in 2014 with respect to 2013, and with respect to that expected in the previous Report, the GDP growth rate in Mexico is forecast to increase in 2014 with respect to 2013, although it is still expected to lie between 3.0 and 4.0 percent, in line with the last Report. For 2015, in line with the previous Report, the GDP growth rate is still estimated to lie between 3.2 and 4.2 percent (Chart 43a).

Employment: The expected increase in the number of IMSS-insured workers (permanent workers and urban temporary workers) in 2014 and 2015 remains unchanged with respect to the previous Report. In particular, for 2014 an increase of 620 to 720 thousand IMSS-insured workers is estimated. For 2015, an increment similar to that of 2014 is anticipated.

Current Account: In 2013, the deficit in the trade balance amounted to USD 1.0 billion (0.1 percent of GDP), while the deficit in the current account is estimated to have reached USD 19.8 billion (1.6 percent of GDP). For 2014, deficits in the trade balance and the current account of USD 5.8 and 25.4 billion are estimated, respectively (0.4 and 1.9 percent of GDP, in the same order). For 2015, deficits in

[18] Expectations for the U.S. economy are based on the consensus of analysts surveyed by Blue Chip in February 2014.

the trade balance and the current account are expected to amount to USD 7.2 and 27.9 billion, respectively (0.5 and 1.9 percent of GDP, in the same order).

The balance of risks for the growth of the economic activity has improved as compared to the previous Quarterly Report:

i. In the short run, a more favorable outlook for the U.S. economy could imply a greater dynamism of external demand.

ii. This year will be characterized by a significant fiscal stimulus.

iii. In the medium term, an effective achievement and implementation of structural reforms could improve investment prospects in Mexico, with a consequent effect on aggregate demand and on the potential growth of the economy, which could accelerate economic growth without generating inflationary pressures.

In spite of the above, the following downward risks prevail:

i. The possibility that the normalization process of the U.S. monetary policy may propitiate a significant adjustment in capital flows to emerging economies cannot be ruled out, which might affect the available sources of resources for the economy.

ii. The recovery of consumption could be more moderate than anticipated or the delay in the recovery of investment levels could persist, particularly, insofar as the housing sector does not pick up.

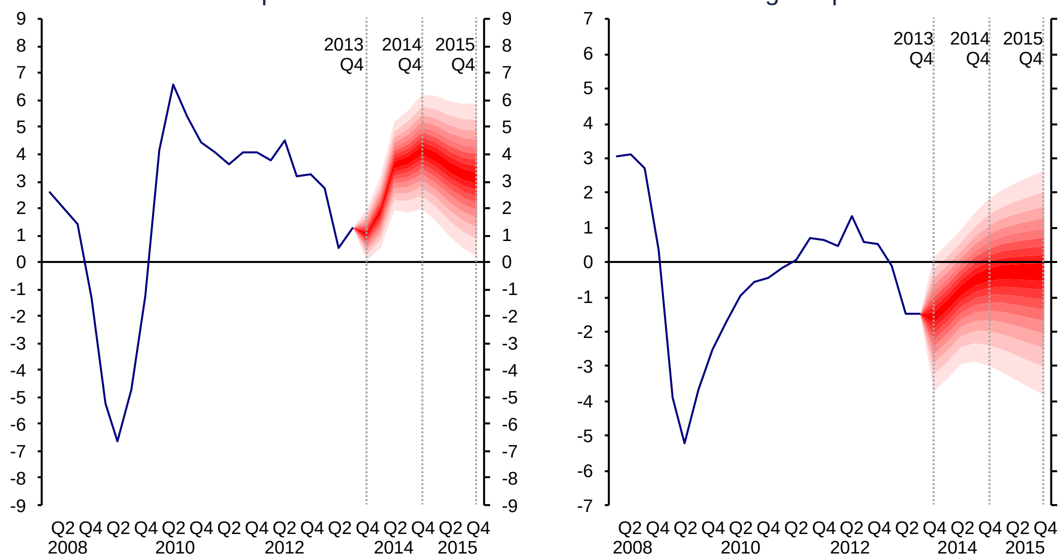
Even considering possible upward risks to the growth outlook, based on the current data, slack in the economy is expected to gradually decrease and the output gap is estimated to remain negative throughout 2014 and to converge to zero by late 2015 (Chart 43b). Thus, no aggregate demand-related pressures on either inflation or the external accounts are anticipated in the forecast horizon.

Inflation: Inflation is forecast to lie above 4 percent in the first months of 2014 as a result of: i) an unanticipated uptick in non-core inflation in late 2013, even though its impact on headline inflation will fade in the course of the year; and ii) the impact of the changes in relative prices as a result of the fiscal measures, which are estimated to be moderate, are expected not to generate second round effects and to only have a transitory effect on inflation. Thus, in the second quarter, headline inflation is anticipated to fall below the 4 percent level. In the second half of the year, due to the arithmetic effect coming from a low comparison base, as well as the volatility of the non-core component, headline inflation could locate above 4 percent in some months, although it is expected to conclude the year within the variability interval of plus/minus one percentage point around the 3 percent target. This expectation stems from the rebound of headline inflation at the end of 2013, as mentioned above, and considers an impact generated by the fiscal measures of approximately 40 basis points on annual headline inflation as of December 2014. For 2015, a significant downward adjustment is anticipated from January onwards and it is expected to remain at levels slightly above 3 percent for the rest of the year (Chart 44). Even considering the effects of the referred measures, annual core inflation is anticipated to lie at levels close to 3 percent during 2014 and below this level in 2015 (Chart 45). This evolution is caused by the fading effects of the aforesaid changes in relative prices, by the expected reduction in gasoline price increments from the next year onwards in line with the recently approved Revenue Law and the expectation of no demand-related inflationary pressures.

Chart 43
Fan Charts: GDP Growth and Output Gap

a) GDP Growth, s. a.
Annual percent

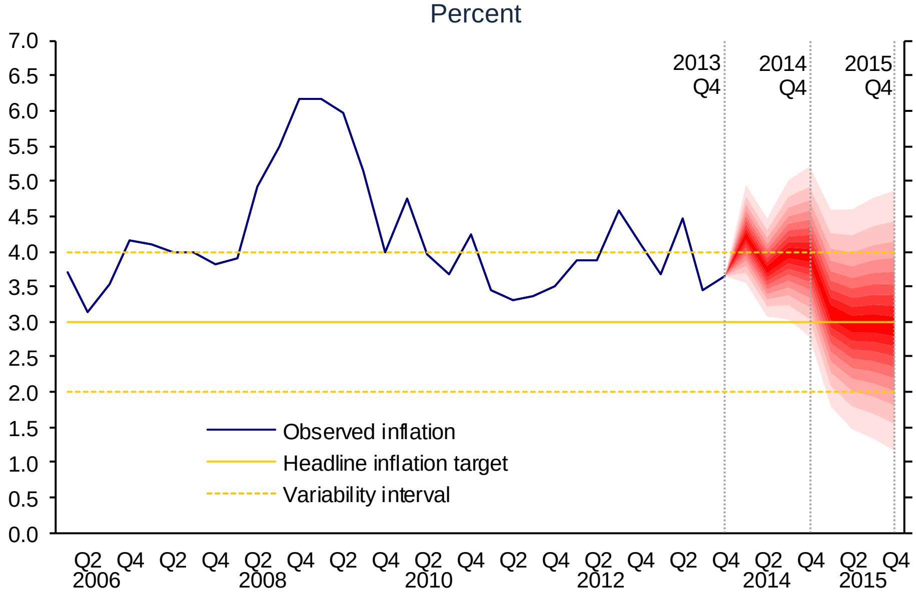
b) Output Gap Estimate, s. a.
Percentage of potential GDP



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

s. a. / Based on seasonally adjusted figures.
Source: Banco de México.

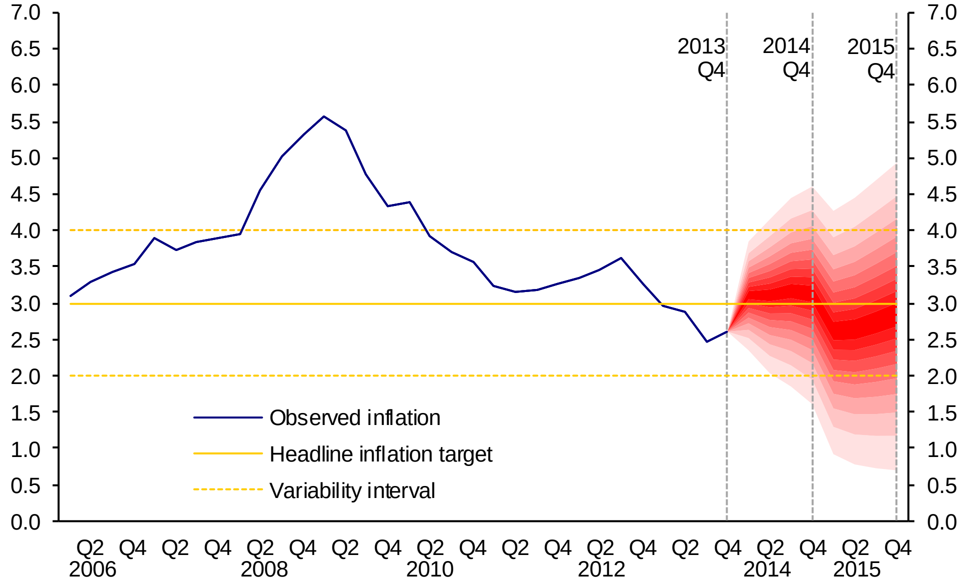
Chart 44
Fan Chart: Annual Headline Inflation [1/]
Percent



1/ Quarterly average of annual headline inflation.

Source: INEGI and Banco de México.

Chart 45
Fan Chart: Annual Core Inflation [1/]
Percent



1/ Quarterly average of annual core inflation.
Source: INEGI and Banco de México.

Among the risks to the outlook of annual headline inflation, the following stand out:

i. An upward risk of possible second round effects generated by adjustments in relative prices, as a result of the fiscal measures and their possible impact on other prices, as well as longer-term inflation expectations, cannot be ruled out, especially when a gradual reduction in slack conditions in the economy is anticipated.

ii. New episodes of high volatility in international financial markets could generate an exchange rate adjustment, with a potential impact on inflation. However, if such an adjustment takes place, its effect would be expected to be transitory and moderate, given the low pass-through of exchange rate variations onto inflation, which has been observed in the past.

iii. As a downward risk, the possibility remains that the recovery of the economic activity in the country might turn out lower than anticipated.

In sum, the balance of risks for inflation has deteriorated with respect to the previous Report.

Taking into consideration the above, Banco de México's Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate at 3.50 percent in its Monetary Policy meetings of December 2013 and January 2014, following the reduction implemented in October 2013. Indeed, the Board of Governors considers that the monetary policy is congruent with the efficient convergence of inflation to the 3 percent target. Nonetheless, given the recent inflation prints and considering the risks indicated in this Quarterly Report, the Board will monitor all pressures that could affect inflation and its expectations in the medium- and long term. Likewise, it will monitor the implications of the economic activity evolution and the monetary stance of Mexico relative to the U.S., among other factors, onto the inflation outlook, so as to reach the abovesaid inflation target.

In the future, given the expected global environment of less favorable conditions in the financial markets, it is fundamental to continue strengthening the domestic sources of growth and the framework for the macroeconomic policy conduction in Mexico. In this context, it should be pointed out that a significant progress in the process of structural reforms aimed at boosting productivity in Mexico has been recently made. It is relevant to improve the institutional framework to strengthen the domestic sources of growth from a microeconomic perspective. Thus, the need to allow for a flexible resource allocation to their more productive uses, to boost market competition, particularly in input markets, and to achieve an incentive structure conducive to higher productivity should be emphasized. The recently approved structural reforms represent great progress in this direction. Indeed, the labor market, telecommunication, economic competition, financial, energy and education reforms will contribute to increasing competitiveness and the potential GDP of Mexico. It is encouraging that deficiencies in such a broad number of key markets are addressed. Still, for these reforms to reach their potential and to effectively lead to higher economic growth, both an appropriate secondary legislation and an adequate implementation are indispensable.

It is anticipated that the referred structural reforms will not only derive in a more vigorous growth of the economy, but will also lead to an environment of low and stable inflation. Increased competition could result in lower prices, with the associated enhanced welfare of the population, while greater productivity would allow aggregate demand to reach higher growth rates without generating inflationary pressures. Thus, it is important to continue improving the institutional framework and to provide greater security and legal certainty to economic agents.

Annex Modifications to the Calendar of Monetary Policy Decision Announcements, Minutes of the Board of Governors' Meetings regarding Monetary Policy Decisions and Quarterly Reports in 2014

Table 1 of this annex presents the new calendar for the year 2014 of the monetary policy announcements, as well as the publication of the Minutes of the Board of Governors' meetings regarding monetary policy decisions and quarterly reports. With respect to the calendar released in the previous Inflation Report, the release date of the Quarterly Report January-March 2014 is modified form May 14 to May 21, 2014, and the date of the Quarterly Report July-September 2014 is shifted from November 12 to November 19, 2014.

Table 1
Calendar for 2014

Month	Announcements of Monetary Policy Decisions	Minutes of the Board of Governors' Meetings regarding Monetary Policy Decisions	Quarterly Reports 1/
January	31		
February		14	12
March	21		
April	25	4	
May		9	21
June	6	20	
July	11	25	
August			13
September	5	19	
October	31		
November		14	19
December	5	19	

1/ The Quarterly Report that will be published on February 12, 2014 corresponds to the fourth quarter of 2013, the one to be released on May 21, 2014, to the first quarter of 2014, the one of August 13, 2014, to the second quarter of 2014, and, finally, the one to be presented on November 19, 2014, to the third quarter of 2014.

The calendar considers 8 dates for the announcement of monetary policy decisions in 2014. Two weeks after each announcement the corresponding Minutes will be published. Nevertheless, as in previous years, Banco de México reserves the right to announce changes in the monetary policy stance at dates different from those previously scheduled, in the case of extraordinary events that may require the Central Bank's intervention.

BANCO DE MÉXICO

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