

Quarterly Report

October - December 2014

Summary

During the fourth quarter of 2014, the international environment deteriorated dramatically as a result of two shocks. On the one hand, the international oil price dropped considerably and it is anticipated to remain at low levels for an extended period of time, primarily due to supply factors. On the other hand, a generalized appreciation of the USD has been observed, caused by a portfolio adjustment driven by differences in the growth rates and expectations regarding monetary policy stances of the main advanced economies. The above, as well as the slowdown of the world economy caused by the persisting weakness of most advanced and emerging economies, with the notable exception of the U.S., gave rise to higher volatility in international financial markets, which further increased financial vulnerabilities of some emerging economies.

In 2014, the evolution of inflation in Mexico was in line with the forecast of this Central Institute. Although, as a result of the fiscal changes in early 2014 and a series of transitory shocks onto the non-core inflation, annual headline inflation lied above the upper bound of the variability interval over most of the year, from November onwards it started to register a clear downward trend, and finished the year at 4.08 percent. Subsequently, in January 2015, it presented a further significant reduction to 3.07 percent, caused by the fading effect of the abovementioned shocks, downward adjustments in the telecommunication services' prices and some energy prices, as well as by smaller increments with respect to last year in the merchandise and services' prices, in general.

In the fourth quarter of 2014, the economic activity in Mexico continued to recover moderately. This performance reflected the favorable evolution of external demand, as well as a gradual improvement in private investment. Nevertheless, private consumption still did not present a solid reactivation. Therefore, slack conditions persisted in the economy, reason for which no generalized pressures on either prices in the main inputs' markets or on external accounts were perceived.

Given the increment in international financial volatility, markets in Mexico were also affected. In the quarter analyzed by this Report, the Mexican peso depreciated and the index of the Mexican Stock Exchange reversed the profits registered in the previous quarter. In this respect, it should be noted, that, although as of the release date of this Report the referred movements were orderly, additional adjustments in the Mexican financial markets cannot be ruled out.

The deterioration of the external environment, as well as the evolution of financial markets in Mexico made it clear that an eventual adjustment in the macroeconomic stance was required in the country. This was due to the fact that the said change would ease the transition of the Mexican economy to a new external circumstance and would help avoid the possible financial astringency derived from uncertainty regarding the sustainability of public debt and/or of external accounts. Hence, as a preemptive measure, the Federal Government decided to adjust the fiscal policy by considerably diminishing public expenditure in 2015. This adjustment, together with the other announced fiscal responsibility measures, will contribute to preventing a deterioration in the confidence of households, firms and investors, and will strengthen the conditions to face the referred external environment. Thus, the fiscal adjustment along with the monetary stance congruent with the convergence of inflation towards its target, strengthen the fundamentals of the Mexican economy and will contribute to generating an environment conducive to higher growth with low inflation.

The macroeconomic scenario foreseen by Banco de México is as follows:

GDP Growth Rate: In 2014, GDP is estimated to have registered a growth rate of around 2.1 percent, as a reflection of the impulse from

external demand and a gradual improvement in domestic demand with respect to last year.

For 2015 and 2016, a higher growth rate is still anticipated as compared to 2014. Indeed, the recently implemented structural reforms are expected to generate a gradual positive effect on economic activity, particularly in 2016. Likewise, the dynamism of the U.S. economy, especially of its industrial sector, is estimated to remain a source of growth for the Mexican export sector and the impulse from external demand is anticipated to pass through onto the domestic demand. Furthermore, it is estimated that the activities that started to recover in 2014, as is the case of the construction sector in Mexico, will continue supporting productive activity.

Despite the abovesaid, the estimated macroeconomic environment is less favorable than that considered in the previous Quarterly Report. In particular, the oil price is anticipated to register levels below those observed before mid-2014. Likewise, the downward trend of the oil production platform, which has recently accentuated, is expected to possibly limit the dynamism of productive activity, as long as it does not stabilize and starts to recover. Additionally, private consumption has not yet presented clear signs indicating that it could resume a strong dynamism in the short term despite a gradual improvement in recent months. Considering that, the forecast intervals for GDP growth in 2015 and 2016 are revised downwards. Taking into account the marginal impact of fiscal consolidation on the economic growth, the forecast interval of the GDP growth rate in Mexico in 2015 is adjusted from 3.0 to 4.0 percent in the previous Quarterly Report to a range of 2.5 to 3.5 percent (Chart 1a). For 2016, it is expected that some difficulties for the macroeconomic environment could persist to a certain degree, so that the GDP growth rate is anticipated to lie between 2.9 and 3.9 percent, interval that is compared to that of 3.2 to 4.2 percent in the previous Report.

Employment: In line with the adjustment in the economic growth outlook, the forecast for the growth of the number of IMSS-insured workers is revised downwards. In particular, for 2015 an increase of 600 to 700 thousand IMSS-insured workers is expected (permanent and temporary workers in urban areas), as compared to the expectation of an increment of 620 to 720 thousand workers in the previous Report. For 2016, the growth interval is adjusted from 640 to 740 thousand workers in the last Report to an interval of 620 to 720 thousand workers.

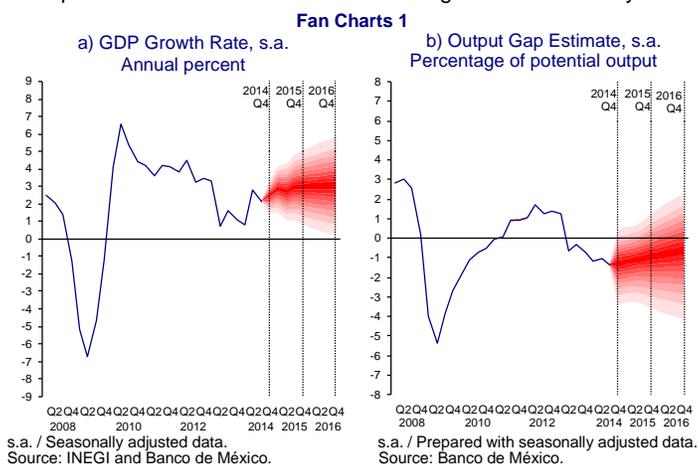
Current Account: In 2014, the trade balance registered a deficit of 2.4 billion USD (estimated 0.2 percent of GDP), reason for which the current account deficit is expected to have amounted to 26.5 billion USD (2.1 percent of GDP). For 2015, trade balance and current account deficits of 6.0 and 28.7 billion USD are anticipated, respectively (0.5 and 2.3 percent of GDP, in the same order). For 2016, deficits in the trade balance and the current account of 8.8 and 31.6 billion USD are estimated, respectively (0.6 and 2.3 percent of GDP, correspondingly).

Given the described forecasts, no aggregate demand-related pressures are expected on either inflation or the external accounts. In particular, the output gap is estimated to remain negative in the near future, although it will be gradually closing (Chart 1b).

Among downward risks to the GDP growth outlook, the following stand out:

- i. A lower than expected world economic expansion, in particular in the U.S.
- ii. Intensified volatility and uncertainty in international financial markets.
- iii. An further decrease in the oil price and/or in the production platform, that would affect the external accounts and public finances, requiring an adjustment in public expenditure greater than that recently announced.

iv. That social unrest in recent months considerably affects expenditure decisions of the economic agents in the country.



The growth outlook is also subject to upward risks, among which the following are notable:

- i. A greater dynamism of the U.S. economy, in light of lower energy costs.
- ii. A faster than expected improvement in investors' prospects, which could derive from progress in the implementation of structural reforms.

Inflation: In previous communications, Banco de México emphasized the outlook that shocks affecting inflation in 2014 will temporarily raise it and that in late 2014 and early 2015 inflation will considerably drop to later converge to the 3 percent target. Considering the recent evolution of inflation and its outlook, this Report confirms the forecast that inflation will reach 3 percent in 2015, and will remain around that level.

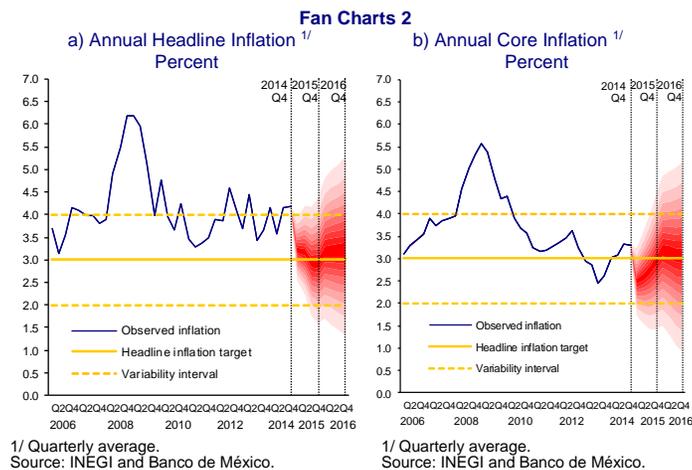
Indeed, the forecast for annual headline inflation is very similar to that presented in the last Quarterly Report. Nonetheless, its performance is slightly revised over the time horizon, with a lower trajectory in early 2015 and somewhat higher in the second semester of the year. This resulted from two groups of factors acting in opposite directions. On the one hand, a moderate upward impact of the Mexican peso depreciation, and, on the other hand, an unanticipated reduction in regular electricity rates, as well as higher than estimated decreases in telecommunication services' prices. Thus, after a considerable drop of headline inflation in January, it is expected to persist at levels close to 3 percent and to conclude the year slightly below this level (Chart 2a). Core inflation is estimated to lie below 3 percent throughout 2015 (Chart 2b). For 2016, both headline and core inflation are estimated to remain around 3 percent.

The indicated outlook for the inflation trajectory is not risk-free. Among upward risks the following stand out:

- i. The possibility that the exchange rate will prevail at current levels for an extended time period or that the Mexican peso will further depreciate.
- ii. Other supply shocks that could affect the evolution of inflation.
- iii. That given the foreseen recovery of the economic activity, the space to absorb the effect of new changes in relative prices may reduce and that it could contaminate the inflation dynamics.

Among downward risks the next are noteworthy:

- i. The possibility that the dynamism of the economic activity in the country may be lower than expected.
- ii. Additional decreases in energy prices, above all in gasoline prices in the border region.
- iii. Further reductions in the telecommunication services' prices, generated by an intensified competition in the sector.
- iv. An exchange rate appreciation, if the Federal Reserve delays or dilutes the measures aimed at normalizing its monetary policy stance and/or due to a better than expected performance in the crude oil price or in the effects of structural reforms on the potential growth of the country.



The monetary policy implemented by Banco de México seeks to ensure the stability of the national currency's purchasing power. This has contributed to the progress in converging to the permanent inflation target, as well as the anchoring of medium- and long-term inflation expectations in Mexico. Additionally, given the challenging international environment and considering its impact on the evolution of domestic financial markets, the importance of the continuous strengthening of Mexico's macroeconomic framework should be stressed. In this regard, it should be kept in mind that the current strength has resulted from the effort of the society as a whole over the course of many years and that the benefits of a stable macroeconomic environment have been evident, particularly, in recent years, in light of the difficulties experienced in other economies. Therefore, to face a complex external environment, macroeconomic stability should be preserved. This largely depends on ensuring the sustainability of public finances, consolidating the environment of low inflation and stability of the financial system. The recently stressed commitment of the federal authorities to maintaining sound public finances is of paramount importance.

Considering all of the above, the Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate at 3 percent during the period covered by this Report. In the future it will remain alert to the performance of inflation determinants and its expectations for the medium- and long-term horizons. In particular, it will monitor the monetary stance of Mexico relative to the U.S., the performance of the exchange rate and its possible impact onto inflation, as well as the evolution of the degree of slack in the economy given the foreseen recovery. All this in order to be able to take the necessary measures to ensure the convergence of inflation to the 3 percent target in 2015 and to consolidate it.

Finally, as it has been previously mentioned, to improve the welfare of the society as a whole, besides strengthening the macroeconomic framework, the adequate implementation of structural reforms is also indispensable, in order to boost productivity and competitiveness of the country, and, thus, to motivate the internal sources of growth. It is of the utmost importance to work on the transformation of the country's institutional structure, in order to achieve a stronger rule of law and to grant greater legal certainty to society. In this way, Mexico could achieve the higher objective of growing at faster rates and with price stability, for the benefit of all society.