

# Quarterly Report

July - September 2014

## Summary

**B**y constitutional mandate, the monetary policy in Mexico seeks to ensure the stability of the national currency's purchasing power. As a consequence, in recent years, significant progress in curbing inflation has been made; in particular, the following has been achieved: a reduction of the inflation's level and volatility, an absence of second round effects derived from changes in relative prices, better-anchored inflation expectations and a decrease in the inflation risk premium. The referred progress has enhanced the effectiveness of the monetary policy. In this regard, over the last two years, given a favorable inflation environment, characterized by a trend of inflation convergence towards its permanent target, stable medium and long-term inflation expectations and slack conditions in the economy, the Board of Governors took advantage of the circumstances to adjust the monetary policy stance and to support the recovery of the economic activity. Thus, between March 2013 and June 2014 the Board reduced the reference interest rate by 150 basis points, acting, at all times, in accordance with its primary mandate and without compromising the process of inflation convergence towards its 3 percent target.

In the third quarter of 2014, annual headline inflation exceeded 4 percent, reflecting mainly the fading of a high comparison base effect in the subindex of fruit and vegetables, as well as the increase in the relative prices of livestock products. The economic activity in Mexico kept recovering, although at a more moderate rate as compared to the previous quarter. This performance reflects the dynamism of the external demand, mainly stemming from the U.S., as well as a slow reactivation of the domestic demand. In line with the abovesaid, in the reported quarter, slack conditions persisted in the economy, even though they are estimated to continue declining over the next quarters. Consistent with the above, no pressures on labor and credit markets have been perceived.

The current international environment has turned especially complex and uncertain, which implies the need of more precaution in conducting the country's macroeconomic policy. First, the world economy kept showing signs of weakness in the third quarter, while inflation decreased at the global level. In Japan and the Euro area, economic activity remained weak, while in the U.S. and the U.K. it continued expanding. Hence, the expectations for the monetary policy stance in main advanced economies took opposite directions during the period covered by this Report. The Federal Reserve confirmed its strategy of a gradual withdrawal of the monetary stimulus, while the European Central Bank and the Bank of Japan announced additional monetary easing measures. Likewise, some of the main emerging economies, especially Brazil, China and Russia, registered lower dynamism of economic activity. Second, concerns over the world economic outlook, uncertainty regarding a possible response of monetary policy in the main advanced economies, geopolitical risks and the alert triggered by the epidemic of Ebola virus disease caused a sharp increase in international financial markets' volatility over the referred period. This situation generated adverse implications for asset prices and currencies in emerging economies. In this respect, greater concern is notable regarding the possibility that the weakness of the global growth, which has been lower than expected in recent years, might be a reflection of structural problems in the world economy rather than a reflection of cyclical factors. Finally, it is also noteworthy that this environment led to lower international prices of different basic goods, oil among them.

Significant adjustments in international financial markets were reflected in the Mexican markets. So far, the referred adjustments have taken place in an orderly manner and under appropriate liquidity conditions. In particular, in the period analyzed by this Report, the Mexican peso depreciated, the Mexican Stock Market index presented volatility and interest rates for different terms increased marginally, although over the year as a whole rates have fallen. In fact, adjustments in financial variables in Mexico were smaller when

compared to most emerging economies. Still, possible additional adjustments in the national financial markets cannot be ruled out and, thus, the need to remain alert to any event that could affect the stability of the national economy persists. In order to avoid risks to macroeconomic and financial stability, caution must be maintained when conducting the economic policies and, in particular, the fiscal, the monetary and the financial ones. This takes on greater relevance in a context where the possible persistent fall in the oil prices can constitute an additional risk to the external accounts and to the country's public finances.

The macroeconomic scenario foreseen by Banco de México is the following:

**GDP Growth Rate:** The reactivation of the Mexican economy observed in the second quarter persisted in the third one, although moderately. This dynamism is expected to persist in the future, mainly supported by the impulse of the external demand, as well as by the gradual recovery of the domestic expenditure. Thus, in 2014 the GDP growth rate is anticipated to lie between 2.0 and 2.5 percent, which compares to the interval of 2.0 to 2.8 percent published in the last Quarterly Report (Chart 1a). The expected lower dynamism in 2014 together with the estimation that the boost of the external demand and the reactivation of the domestic demand will persist suggests that in 2015 the GDP growth rate could be between 3.0 and 4.0 percent. However, it is expected that, if the structural reforms are adequately implemented, they will generate a gradual positive impact on economic growth, which could lead to an interval of higher growth rates for 2016. In this sense, for 2016 the forecast interval lies between 3.2 and 4.2 percent.

**Employment:** Considering the fact that the dynamism of the number of IMSS-insured workers has continued to exceed that of the economic activity, the growth forecast for formal employment in 2014 is adjusted to an interval of 640 to 710 thousand workers. For 2015, an increment of 620 to 720 thousand workers is still anticipated. For 2016, partly as a reflection of the implementation of the structural reforms, the number of IMSS-insured workers is estimated to perform more favorably, reason for which an interval of 640 to 740 thousand workers is expected.

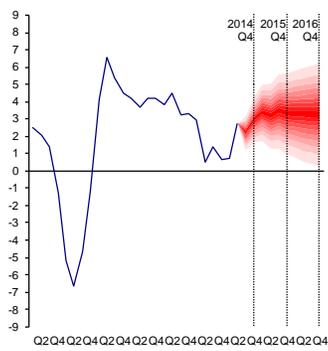
**Current Account:** For 2014, trade balance and current account deficits of 4.0 and 26.0 billion USD are anticipated, respectively (0.3 and 2.0 percent of GDP, respectively). For 2015, these deficits are estimated to amount to 11.5 and 34.4 billion USD, respectively (0.8 and 2.5 percent of GDP, in the same order). For 2016, deficits in the trade balance and the current account of 15.5 and 38.8 billion USD, respectively, are expected (1.0 and 2.6 percent of GDP, in the same order).

Even though it is anticipated that, due to a sharp deceleration of the productive activity in late 2013 and early 2014, slack conditions will persist in the economy, it is also estimated that these will continue decreasing over the forecast horizon, given the dynamism anticipated for the economic activity (Chart 1b). Despite that, no aggregate demand-related pressures on inflation are expected.

Among downward risks to the GDP growth outlook, the following stand out: i) lower than expected growth of the world economy, particularly in the U.S.; ii) an additional reduction in the international oil price or in the production platform that could affect the external accounts and public finances of Mexico, requiring an adjustment in public expenditure in 2015; iii) increased uncertainty in international financial markets, and iv) uncertainty generated by recent social events that could influence economic activity.

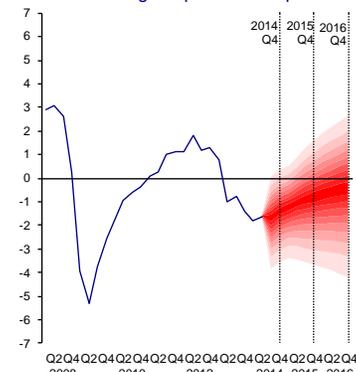
Fan Charts 1

a) GDP Growth Rate, s.a. Annual percent



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

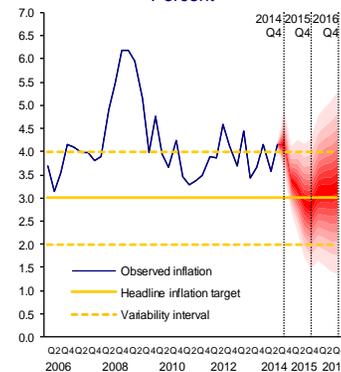
b) Output Gap Estimate, s.a. Percentage of potential output



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

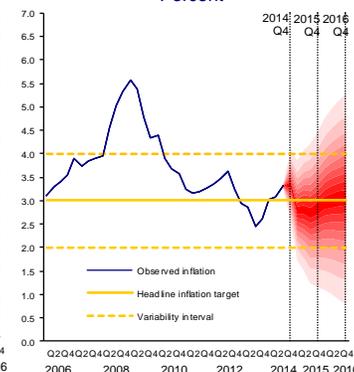
Fan Charts 2

a) Annual Headline Inflation 1/ Percent



1/ Quarterly average.  
Source: INEGI and Banco de México.

b) Annual Core Inflation 1/ Percent



1/ Quarterly average.  
Source: INEGI and Banco de México.

The growth outlook is also subject to upward risks, among which the following are notable: i) a more vigorous than anticipated recovery of the U.S. economy; and ii) the rapid implementation of the first stages of structural reforms, in particular the energy reform, may contribute to a higher than expected investment.

**Inflation:** Given that the effect of recent supply shocks on inflation is expected to be transitory and that no second round effects have taken place so far, annual headline inflation is anticipated to decrease in December and to conclude the year around 4 percent. In early 2015, annual headline inflation is expected to decline considerably, once the arithmetic effect related to changes in relative prices derived from fiscal adjustments in early 2014 fades, and once long-distance national phone charges are eliminated, which together with a smaller increment in gasoline price, locates the annual headline inflation forecast close to 3 percent from the middle of the year onwards (Chart 2a). For 2014, annual core inflation is estimated to persist close to 3 percent and below this level in 2015 (Chart 2b). For 2016, both headline and core inflations are expected to lie at levels close to 3 percent.

It should be noted that the decrease in the growth rate of gasoline prices is a key element in the price determination process of the economy and it is fundamental for the inflation convergence to its permanent target and the anchoring of medium- and long-term inflation expectations.

The above described forecast for the inflation outlook is subject to different risks. Among the downward risks, the following stand out: i) the possibility that the recovery of economic activity in Mexico will turn out lower than anticipated, and ii) greater decreases in the prices of telecommunication services.

Among the upward risks, the following can be listed: i) episodes of greater volatility in international financial markets that would imply exchange rate fluctuations with their consequent effects on inflation. Still, in the event that it happens, a moderate and transitory impact on inflation would be expected, given the low pass-through of exchange rate variations onto inflation; and ii) possible considerable increases in the minimum wages, higher than the expected inflation and the increment in productivity.

In view of the above, over the period covered by this Report, the Board of Governors maintained the target for the Overnight Interbank Interest Rate at 3.0 percent, by virtue of the fact that it estimated the monetary stance to be congruent with the efficient inflation convergence to its 3 percent target. In the future, the Board will monitor the performance of all determinants of inflation and its expectations for the medium- and long-term horizons. In particular, it will monitor the evolution of the degree of slack in the economy in light of the expected recovery, including the possible effects of the implementation of structural reforms on aggregate supply and demand of the national economy. Likewise, the Board will monitor the monetary policy stance of Mexico relative to that of the U.S., all of the above to reach the referred inflation target.

As pointed out in the previous Report, it is encouraging that the legislative stage of the recent process of structural reforms aimed at boosting productivity of the country has concluded, since these reforms are expected to positively influence the potential growth of Mexico. Their impacts are anticipated to emerge gradually and become more evident in the medium term, although it should be recalled that for the reforms to reach their full potential, their proper implementation should be guaranteed. It should also be reiterated that the process of improvement of the institutional framework should continue, as well as the strengthening of macroeconomic fundamentals, so that the country can achieve higher growth rates, better jobs and greater welfare for the society. The latter becomes especially important given that the international environment is expected to remain quite uncertain. In that regard, it should be recalled that the benefits of the efforts made in recent years were evident during the recent episodes of volatility in international financial markets, which were absorbed by the Mexican economy without any major repercussions.

Finally, the significance of improving the institutional framework of Mexico should be reiterated, because it is highly relevant to enhance the efficiency of the economy and to strengthen the beneficial effects of the structural reforms on potential growth, employment and the welfare of the population. Indeed, an institutional transformation that improves the rule of law, legal certainty and, generally, the strength of the institutions that govern the society as a whole and economic agents, in particular, will result not only in a better economic performance and greater social harmony, but will also translate in a more appropriate use of the benefits derived from structural reforms and a better distribution of the above said benefits in the Mexican society.