# Quarterly Report

## April – June 2016

# Summary

The primary goal of this Central Institute is to procure the stability of the general price level, which represents the best contribution Banco de México can make to promote economic growth. In recent years, the conduct of monetary policy under an inflation targeting regime, along with some important results of the structural reforms, have contributed to achieve an environment of low and stable inflation, to anchor inflation expectations at levels congruent with Banco de México's target, to lower risk premia, particularly the inflation risk premium and to reduce the pass-through of exchange rate fluctuations onto goods and services' prices, all of which have positively affected the economy as a whole. However, this progress cannot be taken for granted, especially given the complex international environment currently faced by Mexico and the expectations that this context could prevail in the future. Indeed, future external and/or domestic adverse events that could affect the economy and inflation cannot be ruled out, whereby it is crucial to underpin the strength of the macroeconomic framework of the country by means of appropriate monetary and fiscal policies.

Considering this, in the period covered by this Report, Banco de México responded with total flexibility and at the moment the conditions demanded so, in order to consolidate the efficient convergence of inflation to the 3 percent target, and, thus, contribute to maintain an adequate macroeconomic framework. Thus, even though in the monetary policy decision of May the Board of Governors maintained the target for the Overnight Interbank Interest Rate unchanged, in its decision of June it increased this rate by 50 basis points to 4.25 percent. This was fundamentally because the external conditions were deteriorating, leading to a considerable depreciation of the exchange rate that could jeopardize the anchoring of inflation expectations in Mexico and, eventually, negatively affect its performance. Given that, with the referred adjustment to the monetary policy stance, the balance of risks to inflation was deemed neutral, in its decision of August 2016 the Central Institute maintained the reference interest rate unchanged at 4.25 percent.

During the reported period, the Mexican economy continued coping with an adverse international environment, characterized by an even lower outlook for world economic growth and by diverse events that generated episodes of high financial volatility. The downward revision of world economic prospects resulted from the expected negative effect on the United Kingdom derived from its decision to leave the European Union, as well as by a lower than estimated growth of other advanced economies. The global economy is also facing structural challenges, such as: i) low growth of productivity and the labor force; ii) the contraction of international trade, which could intensify, given the risks of a broader implementation of protectionist measures in different countries, and further negatively affect global production chains, investment and productivity; and iii) insufficient levels of investment, in a context of greater global savings, chiefly in advanced economies, in response to demographic factors, among others.

Meanwhile, volatility in international financial markets spiked in late June, as an immediate consequence of the referendum outcome in the U.K. Nevertheless, financial stability was restored thanks to the prompt response of the Bank of England and other advanced economies' central banks that provided liquidity, the perception that the U.K. exit from the European Union would mainly affect that country, as well as the expectation of a gradual normalization process of the U.S. monetary policy and the adoption of greater monetary stimuli by other advanced economies. Nonetheless, looking ahead, new volatility episodes cannot be ruled out, given the persisting risks related to different economic and geopolitical factors. The negative impact of the deterioration in the external environment on the Mexican financial markets not only was perceived on the exchange rate evolution, but also on the performance of government securities' interest rates, which increased for most terms. In view of the monetary policy adjustment carried out in the decision of June, a flattening of the yield curve was expected, as this measure would induce an increment in the cost of money in the short term, while maintaining inflation expectations well-anchored. This is exactly what happened.

In this environment, after the growth observed in the previous quarter, the Mexican economy contracted in the second quarter of the year. Indeed, different indicators suggest that private consumption decelerated, while the external demand and investment weakened. This performance contributed to the fact that stagnation that had already been perceived in the industrial sector since early 2015 was joined by a slower dynamism of the services. In this context, the output gap seemed to have remained negative. Nonetheless, in 2016 so far the current account deficit in terms of GDP increased with respect to 2014 and 2015.

In the analyzed period, inflation remained at levels below the permanent 3 percent target, as of the first fortnight of August accumulating 15 consecutive months below this figure. This was due to the conduct of monetary policy, and the absence of aggregate demand-related pressures on prices. The favorable evolution of inflation was contributed to by the good performance of both its core and non-core components. Although the former, just as expected, exhibited a gradual upward trend, reflecting the effect of the exchange rate depreciation on the relative prices of merchandise with respect to services, as of the first fortnight of August it remained under 3 percent. So far, no second round effects on the price-setting process of the economy have been observed. In the same fortnight, non-core inflation lied at levels close to 2 percent, mainly consequent on the moderate growth of agricultural products' prices and lower prices of some energy products, which were registered at the beginning of the year, although in July and August gasoline prices went up.

To address external risks, different economic policy measures have been implemented, adjusting the fiscal and monetary stances so as to bolster the macroeconomic framework of the country. Furthermore, the IMF Board approved the petition by the Foreign Exchange Commission to renew in advance and to increase the Flexible Credit Line for Mexico. In addition to contingent resources it grants, this contributes to strengthen the macroeconomic stability, as it generates significant incentives to maintain the sound fundamentals of the economy, which is a requirement to preserve the access to the said credit line.

The macroeconomic scenario expected by Banco de México considers the following:

**GDP Growth Rate:** The Mexican economy has kept facing a complex external environment, which has turned more adverse. Indeed, besides a continued stagnation of world trade and the weakness of the U.S. industrial sector, various geopolitical developments have accentuated uncertainty regarding the world economic outlook. In this context, although the recovery of the U.S. industrial production is still anticipated, which would contribute to foster Mexican exports over the next quarters, this boost is projected to be lower than the estimate presented in the previous Report.

Additionally, although an economic slowdown in the second quarter of the year was already anticipated in the previous Report, it turned out more pronounced than previously estimated. In this way, the intervals of the economic activity growth forecasts for 2016 and 2017 are revised downwards, given the persistence of an adverse external environment and the effects of the GDP drop in the second quarter on the average level registered by this aggregate during the year. Thus, the Mexican GDP is forecast to grow between 1.7 and 2.5 percent in 2016. This interval compares to that of 2.0 and 3.0 percent published in the previous Report and is narrower, given that more information is now available. The forecast interval for 2017 is revised from a growth of 2.3 to 3.3 percent published in the previous Report to that of 2.0 to 3.0 percent (Chart 1a). In this respect, it should be noted that the structural reforms are expected to contribute to the recovery of the private domestic expenditure and to gradually generate a more favorable environment for expansion that would lead to higher growth rates of consumption and investment.

**Employment:** Despite the downward revision of the GDP growth forecasts for 2016, the strong dynamism observed in the number of IMSS-affiliated jobs in recent months implies that there will be no adjustment of this indicator's forecast interval for that year with respect to the last Report. Thus, for 2016 an increment between 590 and 690 thousand IMSS-affiliated employments is still anticipated. Still, the lower economic growth foreseen for 2017 does imply a downward revision in growth expectations for the number of IMSS-insured jobs for that year, in line with which the forecast interval is revised from 630 to 730 thousand jobs to 610 to 710 thousand employments, relative to that estimated in the previous Report.

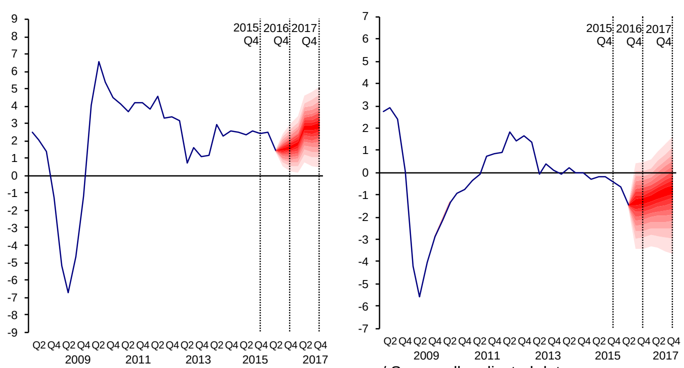
Considering the described growth expectations, the output gap is still estimated to remain negative in the forecast horizon, and, in this context, no aggregate demand-related pressures on prices are expected (Chart 1b).

**Current Account:** For 2016, deficits in the trade balance and the current account of USD 16.0 and 32.4 billion are anticipated, respectively (1.5 and 3.1 percent of GDP, in the same order). For 2017, deficits in the trade balance and the current account are estimated to be USD 16.0 and 35.6 billion, respectively (1.4 and 3.2 percent of GDP, in the same order).

**Fan Charts 1**

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

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




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

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Source: Banco de México.

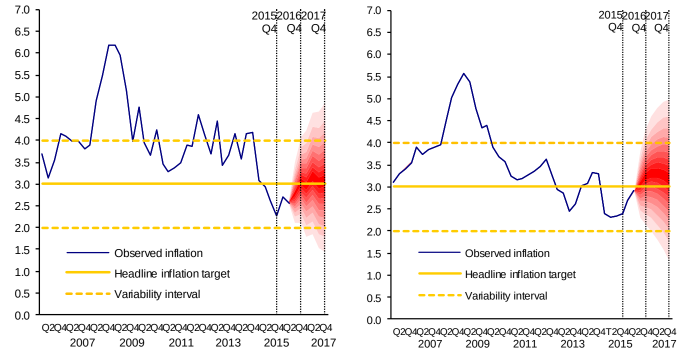
Among downward risks associated to the growth forecast, the following stand out: i) the possibility that slack conditions for the Mexican exports may persist; and, ii) that the political and economic landscape prevailing in the U.S. could affect the growth of the Mexican economy, by reducing investment in our country. Among upward risks to growth, the next should be listed: i) the possibility that the structural reforms may affect economic growth favorably and faster than anticipated; and, ii) that consumption will register a more pronounced and lasting sustained reactivation.

**Inflation:** Over the following months, annual headline inflation is estimated to gradually go up, locating very close to 3 percent at the end of 2016 and with an average below this figure for the year as a whole. This forecast contemplates the formula used by the Ministry of Finance to set maximum gasoline prices, as well as the evolution of this fuel's international references. The effect of the above is partially offset by the favorable impact on inflation by the reduction in the L.P. gas prices announced by the same Ministry on August 14, 2016. Meanwhile, annual core inflation is expected to increase gradually throughout 2016, closing the year at levels near 3 percent. For 2017, both headline and core inflation are anticipated to lie around the permanent inflation target (Chart 2a and Chart 2b). Among upward risks to inflation, the following should be pointed out: i) that derived from uncertainty related to the outcome of the U.S. electoral process and its implications, the possibility of weaker oil prices, a deterioration of the current account deficit, and the resumed normalization of the Federal Reserve monetary stance, the national currency may further depreciate, which, in turn, could impact inflation expectations and its performance; and, ii) increments in agricultural products' prices. Among downward risks, the next should be listed: i) further reductions in prices of some widely used inputs, such as telecommunication services, as a consequence of the structural reforms; and, ii) that the dynamism of the national economy will remain lower than anticipated.

**Fan Charts 2**

a) Annual Headline Inflation [1/]
Percent

b) Annual Core Inflation [1/]
Percent




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

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In this context, and considering the data presented in this Report, in the future the Board of Governors will closely monitor the evolution of all inflation determinants and its medium- and long-term expectations, especially the exchange rate and its possible pass-through onto consumer prices. Likewise, it will be watchful of the monetary position of Mexico relative to the U.S., without overlooking the evolution of the output gap. This will be done in order to be able to continue taking the necessary measures to consolidate the efficient convergence of inflation to the 3 percent target, in a flexible manner, and whenever and to the extent that conditions may demand so.

In view of the complex international environment, in which some risks have already materialized, the world economic activity could further deteriorate, due to the consequences of these adverse events or due to new geopolitical developments, among which the possible outcome of the U.S. electoral process stands out. In this context, measures to strengthen and to make macroeconomic fundamentals sounder should continue to be taken. Thus, the measures announced by the Federal Government regarding the public finances are imperative, as their comprehensive implementation would not only allow having sound public finances, but would also lessen pressures on the external accounts. Likewise, even though the adoption of measures that in the medium and long terms would strengthen the domestic sources of growth is a permanent obligation in order to improve the welfare of the population, their promotion is indispensable given the challenges from abroad faced by Mexico. In this sense, it is crucial to continue correctly implementing the structural reforms, fostering greater productivity and competitiveness of the country.

Furthermore, as stated in previous Reports, it is also fundamental to have a solid rule of law and to guarantee legal certainty. Modifying the institutional framework in this direction will not only promote an environment of greater certainty that should encourage more investment in Mexico and allow the structural reforms to achieve their full potential, but will also amend the incentives economic agents face so as to reduce rent-seeking behavior and boost value-creating activities.