Quarterly Report

October – December 2015

Summary

In line with its constitutional mandate, the monetary policy conducted by Banco de México aims at procuring the stability of the national currency's purchasing power, seeking to achieve this mandate at the lowest cost to society in terms of economic activity. The efforts undertaken by this Central Institute to attain an environment of low and stable inflation in Mexico contributed to the convergence of headline inflation to the permanent 3 percent target in the first months of 2015, and since May 2015 it located below the referred target, closing 2015 at 2.13 percent, a historic low since the CPI has been measured. Other factors that also contributed to this low inflation rate is the environment of slack conditions prevailing in the economy, as well as the direct and indirect effects on inflation generated by reductions in the prices of widely used inputs, such as commodities, energy products and telecommunication services, the latter two largely as a result of the implementation of structural reforms. The favorable evolution of inflation observed in 2015 occurred despite the depreciation of the national currency, which so far has only been reflected in the prices of some merchandise, which increased pausefully and gradually, without generating second round effects on the price formation process in the economy.

During 2015 and in early 2016, the domestic economy predominantly kept growing at a moderate pace, without registering aggregate demand-related pressures on prices and with inflation expectations that were well-anchored. Still, the international environment faced by the Mexican economy has been characterized by a noticeably weak expansion rate of the world economy for several years, generating continuous downward adjustments in growth expectations. Likewise, in 2015 recurrent episodes of volatility in financial markets were registered, a persistent downward trend in oil prices was observed, as well as a high degree of uncertainty regarding the moment and the pace at which the U.S. monetary policy stance will normalize. This was in contrast to the expectations of a greater monetary stimulus from most of the rest of advanced economies. The referred adverse environment further intensified over the first weeks of 2016. Indeed, despite the first adjustment to the target for the federal funds rate in December 2015, which temporarily dissipated an element of uncertainty in financial markets, in early 2016 the downward trend in the international oil price strengthened, while at the same time there were clear signs of doubt regarding the growth outlook and the efficiency of the economic policies adopted in China. Likewise, the expectation of a pronounced divergence among advanced economies' monetary policy stances prevailed, despite the anticipation that the U.S. monetary policy normalization process would be more gradual, which kept raising the value of the U.S. dollar against other currencies, especially those of emerging economies.

All of the above further increased the levels of risk aversion and volatility in international financial markets, leading to generalized depreciations of emerging economies' currencies, as well as a deterioration in their sovereign risk indicators. The latter, in part, reflected signs of vulnerability of some important emerging economies, such as China, Brazil and Russia. The referred volatility soared in the first half of February, while the international environment faced by the Mexican economy kept deteriorating. In this context, the national currency continued depreciating, not only as a response to factors triggering the depreciation of the real exchange rate, such as the drop in oil prices, but also as a result of the presence of operating mechanisms in financial markets that tended to amplify the negative response of the national currency to the prevailing environment. Thus, in the first weeks of 2016 the Mexican peso depreciated considerably as compared to the depreciation that had already been registered in the fourth quarter of 2015, despite the fact that the Federal Reserve maintained the federal funds rate unchanged in its January meeting.

In this context, in each monetary policy decision the Board of Governors procured to carefully weigh the possible influence of both internal and external factors on inflation and its expectations, so as to prevent the previously mentioned events from jeopardizing the attainment of the Central Bank target. Thus, during much of 2015 Banco de México maintained the monetary policy reference rate unchanged at 3 percent, its historic low. However, following the first increment in the federal funds rate by the Federal Reserve, in its December monetary policy meeting Banco de México's Board of Governors decided to make an upward adjustment of 25 basis points to the target for the reference interest rate. Thus, considering the integration and openness of the commercial and financial sectors in Mexico to its foreign partners, particularly, the U.S., the Central Institute sought to prevent the risk-adjusted spread of U.S. interest rates from compressing. In turn, in its meeting on February 4, 2016, just like the Federal Reserve and considering that the central scenario of the inflation evolution in the short and medium term would remain congruent with the convergence of inflation to its permanent target, it decided to maintain this target unchanged. Still, following this monetary policy meeting, volatility in international financial markets aggravated and the international environment faced by the Mexican economy kept deteriorating. This further adversely affected the quote of the national currency, thus increasing the probability of inflation expectations deviating from the consolidation path to the permanent 3 percent target. In view of that, in an extraordinary meeting, on February 17, 2016 the Board of Governors decided to increase by 50 basis points the target for the reference interest rate to the level of 3.75 percent. This adjustment was part of a series of measures announced in coordination with the Ministry of Finance and the Foreign Exchange Commission seeking to contribute to strengthening the country's economic fundamentals and to help anchor the value of the national currency. In particular, the Foreign Exchange Commission decided to suspend the daily auctions of the foreign currency, at the same time announcing that in exceptional cases it may discretionally intervene in the exchange market, ratifying that the key factor to procure the anchoring of the national currency would be upholding sound macroeconomic fundamentals. It is in this context that the increase in the reference interest rate target and the spending cuts of MXN 132.3 billion announced by the Ministry of Finance should be evaluated.

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

GDP Growth: In 2015, the performance of the Mexican economy was slightly better than what it could be previously appreciated. Thus, GDP of 2015 as a whole expanded 2.5 percent, slightly above the upper limit of the forecast interval published in the last Quarterly Report. Nonetheless, for 2016 and 2017 a more complex external environment is expected as compared to the previous Report. In particular, a lower dynamism of external demand is anticipated with respect to the previous estimation, mainly because of the downward adjustment in the forecast for the U.S. industrial activity and the slowdown in the world economy. Thus, for 2016 the forecast interval for GDP growth in Mexico is reduced with respect to the previous Report, from one between 2.5 to 3.5 percent, to one between 2.0 to 3.0 percent (Chart 1a). Similarly, for 2017 GDP growth outlook is estimated to be between 2.5 and 3.5 percent as compared to the interval of 3.0 to 4.0 percent in the last Quarterly Report.

The abovementioned forecast considers that the adjustments announced on February 17 will strengthen the country's economic fundamentals. In particular, these adjustments will enhance investors' confidence regarding Mexico's commitment to preserving a solid macroeconomic framework, as well as its ability to act timely given the complex external environment.

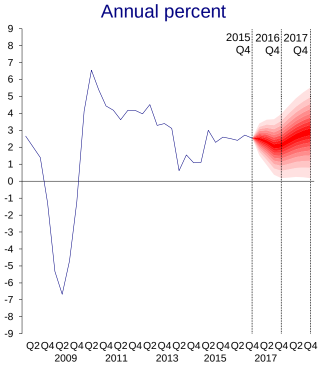
Employment: In accordance with the adjustment in the economic outlook, the expectation of an increase in the number of IMSS-affiliated jobs is revised downwards. For 2016, an increment of between 610 and 710 thousand IMSS-insured jobs is expected (an increase of between 630 and 730 thousand jobs in the previous Quarterly Report). For 2017, an increment of between 650 to 750 thousand IMSS-affiliated jobs is estimated (an interval of 660 to 760 thousand jobs in the last Report).

Current Account: In 2015, the trade balance registered a deficit of USD 14.5 billion (1.3 percent of GDP). The current account deficit amounted to USD 32.4 billion (2.8 percent of GDP), as compared to USD 24.8 billion (1.9 percent of GDP) in 2014. This change in the current account balance between 2014 and 2015 is mainly accounted for by the deterioration in the oil production balance (the current account excluding the oil production balance presented a deficit of 2.0 percent of GDP in 2014, figure similar to that observed in 2015). For 2016, trade balance and current account deficits of USD 12.0 and 30.3 billion are expected, respectively (1.2 and 2.9 percent of GDP, in the same order). For 2017, trade balance and current account deficits of USD 13.1 and 33.5 billion, respectively, are projected (1.2 and 2.9 percent, in the same order).

In line with the economic growth forecast, no aggregate demand-related pressures on inflation or external account are anticipated. Thus, the output gap is expected to remain negative in the forecast horizon (Chart 1b).

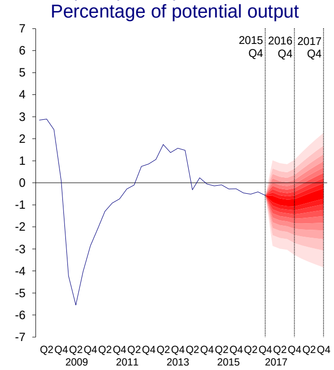
Fan Charts 1

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



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

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



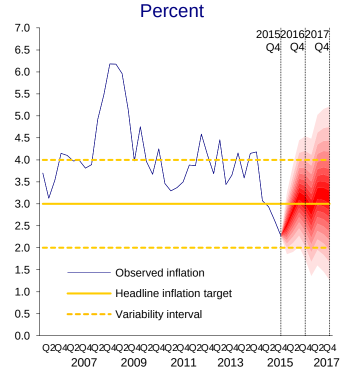
s. a. / Seasonally adjusted data.
Source: Banco de México

The GDP growth outlook for Mexico is subject to different risks. Among the most important downward risks to this outlook the following are noteworthy: i) an even lower than expected dynamism of the U.S. industrial activity; ii) that oil prices will not recover; and iii) that volatility in international financial markets will further intensify. Among upward risks the next stand out: i) A better than expected U.S. industrial activity, which, together with a more orderly adjustment of the real exchange rate, may lead to a considerable increase in Mexican non-oil exports; and, ii) that the implementation of structural reforms may produce more favorable and faster effects on investment.

Inflation: Annual headline inflation is anticipated to increase in 2016 and to temporarily reach levels slightly above 3 percent in the second and the third quarters, to later conclude the year around this level. This projected inflation path considers the fading of favorable supply shocks that occurred in early 2015, adjustments in relative prices derived from the exchange rate depreciation, as well as the change in the gasoline pricing mechanism, and, as a consequence, the change in its seasonal nature, which would imply higher gasoline prices in the second and third quarters, and lower gasoline prices in the first and the fourth quarters of the year. Annual core inflation is expected to gradually go up throughout the year, as a result of the mentioned adjustment in relative prices, to also conclude 2016 at levels close to 3 percent. For 2017, both annual and core inflation are estimated to stabilize around the permanent inflation target. It should be noted that this outlook does not imply a generalized deterioration in the price formation process, but rather reflects the anticipated effect produced by the above mentioned factors onto inflation (Chart 2a and Chart 2b). The forecast of the inflation trajectory could be affected by certain risks, among which the following should be specified. Upward risks: i) that the depreciation of the national currency returns, which could contaminate inflation expectations and generate higher prices of non-tradable goods; and, ii) a greater than anticipated dynamism of economic activity, which could lead to a faster than expected closing of the output gap. Still, it is estimated that this risk would take place gradually. Downward risks: i) that as a result of structural reforms, prices of some widely used inputs, such as telecommunication services and energy products, would further diminish; and, ii) that at least a part of the recent depreciation of the national currency may revert, as it has been happening already.

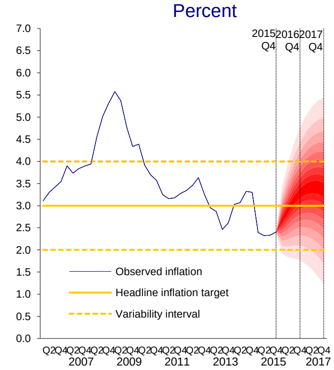
Fan Charts 2

a) Annual Headline Inflation [1/]
Percent



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

b) Annual Core Inflation [1/]
Percent



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

Considering the facts stated in this Report, on February 17, the Board of Governors clarified that, although its latest monetary policy decision does not initiate the cycle of monetary tightening, in the future it will remain alert to the performance of all inflation determinants and its expectations for the medium and long term, especially the exchange rate and its possible pass-through onto consumer prices. Likewise, it maintained that it would continue monitoring the monetary stance of Mexico relative to the U.S., without overlooking the evolution of the output gap. All this in order to be able to take measures in a flexible manner and whenever conditions demand it, so as to consolidate the efficient convergence of inflation to the 3 percent target.

In view of increased volatility in international financial markets and the deterioration in the external environment faced by the Mexican economy, on February 17, 2016 the Mexican authorities acted in a timely and coordinated manner, so as to implement a series of adjustment measures mentioned above that would contribute to strengthening the country's macroeconomic fundamentals. The fast reaction of authorities in light of more unfavorable conditions and the coordinated action among different institutions of the Mexican state will allow the measures to be more effective so as to simultaneously guarantee the country's financial stability and generate a more favorable environment for greater economic growth.

Furthermore, the importance of having domestic sources of growth is underlined, particularly in a context of a weak world economy and a low volume of world trade. If the structural reforms are adequately implemented, apart from directly benefitting the welfare of the Mexican population, they would allow to distinguish the Mexican economy among other emerging countries even more and to consolidate a greater growth rate in the medium term. In connection with the above, and as stated in previous Quarterly Reports, it is necessary to strengthen the rule of law and guarantee legal certainty. This would allow to enhance the effect of structural reforms onto the economic growth, besides directly attracting greater investment to the country.