BANCO DE MÉXICO

Quarterly Report

October – December 2014

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QUARTERLY REPORT

This report analyzes the development of inflation, the economic activity and different economic indicators in Mexico, as well as the monetary policy implementation in the quarter October – December 2014 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 16, 2015. Figures are preliminary and subject to changes.

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BOXES

1. Introduction

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 growth rates and the expected 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 in 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 closed 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 aforementioned 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, 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, and, consequently, 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 in 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 domestic 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. For this reason, as a preemptive measure, the Federal Government decided to adjust the fiscal policy by considerably diminishing public expenditure in 2015. This adjustment, together with 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.

Considering the abovesaid, greater expansion is still anticipated for 2015 and 2016, as compared to that expected to have taken place in 2014. Nonetheless, in light of a less favorable international environment, of the downward trend in the oil production platform and of the persisting weakness in some domestic demand components, the forecast of GDP growth in Mexico is revised downwards with respect to that presented in the previous Quarterly Report. In particular, the GDP growth rate for 2014 is estimated to have been approximately 2.1 percent. For 2015, the forecast interval for GDP growth is adjusted from 3.0 to 4.0 percent in the previous Report to 2.5 to 3.5 percent. For 2016, the forecast interval is revised from 3.2 to 4.2 percent to an interval of 2.9 to 3.9 percent. In this context, slack conditions are anticipated to prevail in the economy, although they will be closing and currently no widespread and sustained aggregate demand-related pressures on prices are estimated.

Inflation is anticipated to converge to 3 percent over the following months, considering that its evolution in 2014 was in line with the forecast and that the price determination process in the economy was neither contaminated by a transitory increment during the year nor by the recent depreciation of the national currency. In particular, following a considerable drop in annual headline inflation in January, it is estimated to remain close to 3 percent and to conclude the year slightly below that level. Core inflation is anticipated to lie below 3 percent throughout 2015. For 2016, both headline and core inflation are forecast to locate at levels close to 3 percent.

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 all 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.

2. Recent Development of Inflation

2.1. Inflation

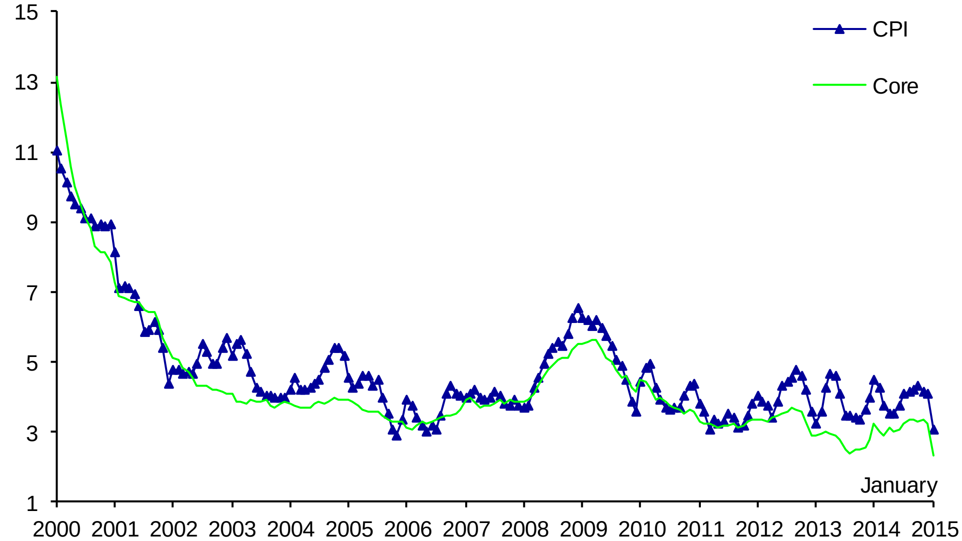
In an environment of economic policies seeking to strengthen the macroeconomic framework, the conduction of the monetary policy has contributed since the beginning of last decade to the convergence of inflation to the 3 percent target (Chart 1). Although the downward inflation trajectory has been exposed to different supply shocks, which affected some products' relative prices, no second round effects were generated. Thus, these shocks only produced a transitory effect on inflation, without affecting economic agents' inflation expectations.[1]

This has been evident from the dynamics of annual core inflation, which is an indicator of the medium-term trend of headline inflation. Once different items, whose prices have been affected by supply shocks or that are not determined by market conditions more directly, are excluded, this component better responds to the monetary stance and is more closely associated to the economic cycle. Thus, this indicator has been generally characterized by a downward trend since various years ago, fluctuating around 3 percent for the last 5 years. In particular, during almost all 2013, annual core inflation remained below this level, even registering historical minimum levels. Even considering the fiscal adjustments in force since 2014, it persisted at levels close to 3 percent, and, once the effects of the fiscal changes vanished, it resumed levels below 3 percent.

During the period covered by this Report, annual headline inflation shifted from 4.30 percent in October 2014 to 4.08 percent in December (Table 1 and Chart 1). Subsequently, in January 2015, the fading of the effect of the fiscal adjustments that came into force a year before, lower telecommunication services' prices, lower prices of some energy products and, in general, increments in the merchandise and services' prices lower than the year before, contributed to a considerable decrease in annual headline inflation, registering 3.07 percent in the referred month. In all, once the different shocks on inflation in 2014 were absorbed, it resumed its downward trend, reaching levels even lower than those registered in the second half of 2013 (Table 1 and Chart 2).

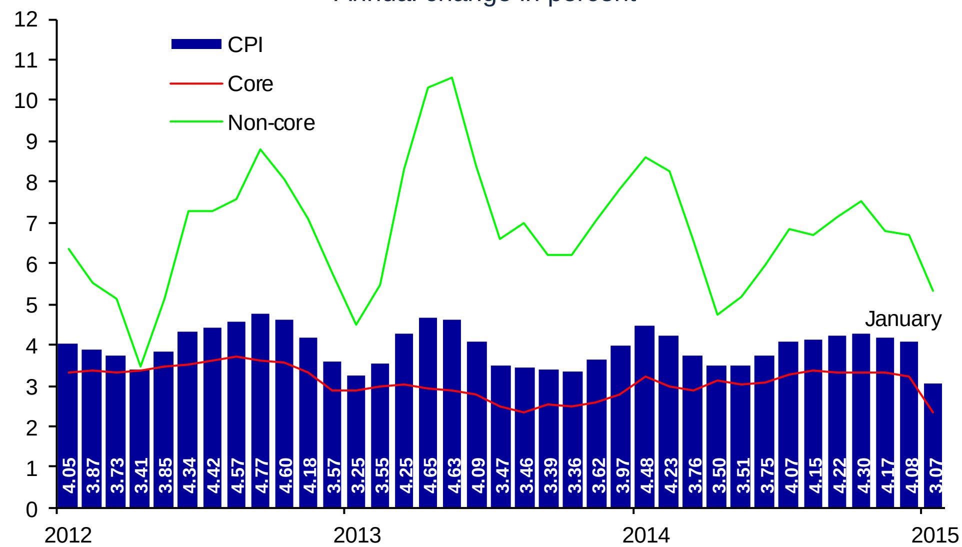
[1] See Box 3 "Anchoring of Medium- and Long-term Inflation Expectations in light of Adverse Supply Shocks", Inflation Report, January – March 2013. Also, see Box 1 "Relative Price Changes and Inflation Convergence towards the 3 Percent Target", Inflation Report April – June 2013.

Chart 1
Consumer Price Index
Annual change in percent



Source: Banco de México and INEGI.

Chart 2
Consumer Price Index
Annual change in percent



Source: INEGI.

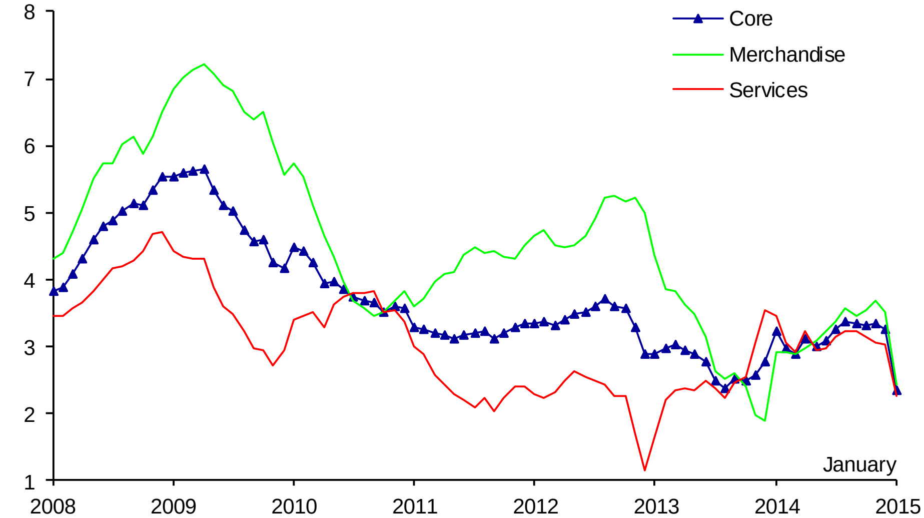
Table 1
Consumer Price Index and Components
Annual change in percent

	Annual change							Average	
	July 2014	August 2014	September 2014	October 2014	November 2014	December 2014	January 2015	Q III 2014	Q IV 2014
CPI	**4.07**	**4.15**	**4.22**	**4.30**	**4.17**	**4.08**	**3.07**	**4.15**	**4.18**
Core	**3.25**	**3.37**	**3.34**	**3.32**	**3.34**	**3.24**	**2.34**	**3.32**	**3.30**
Merchandise	**3.37**	**3.56**	**3.46**	**3.53**	**3.68**	**3.50**	**2.43**	**3.46**	**3.57**
Food, beverages and tobacco	5.20	5.41	5.36	5.33	5.40	5.31	3.37	5.32	5.35
Sweet bread	11.24	11.39	11.34	11.25	10.10	8.96	2.74	11.32	10.10
Canned soft drinks	16.15	15.76	15.70	15.50	15.16	15.35	3.53	15.87	15.34
Corn tortilla	-0.37	-0.07	-0.11	-0.12	-0.10	-0.08	-0.03	-0.18	-0.10
White bread	2.31	2.07	2.05	2.07	2.46	2.43	1.81	2.14	2.32
Non-food merchandise	1.88	2.06	1.94	2.07	2.29	2.04	1.66	1.96	2.13
Services	**3.15**	**3.22**	**3.24**	**3.14**	**3.06**	**3.03**	**2.26**	**3.21**	**3.08**
Housing	2.11	2.07	2.13	2.14	2.13	2.14	2.13	2.11	2.14
Education (tuitions)	4.38	4.19	4.30	4.31	4.30	4.30	4.31	4.29	4.30
Other services	3.90	4.17	4.12	3.86	3.69	3.60	1.79	4.06	3.72
Mobile phone service	-3.15	-1.60	-4.11	-8.99	-11.53	-14.48	-16.45	-2.95	-11.66
Local fixed telephone service	-0.17	-0.10	-0.06	-0.06	-0.07	-0.03	-16.45	-0.11	-0.05
National long distance service	0.61	0.61	0.61	0.61	0.61	0.61	-100.00	0.61	0.61
International long distance service	0.61	0.61	0.61	0.61	0.61	0.61	-40.69	0.61	0.61
Non-core	**6.83**	**6.72**	**7.11**	**7.51**	**6.78**	**6.70**	**5.34**	**6.89**	**6.99**
Agriculture	**5.78**	**6.22**	**7.57**	**8.46**	**7.04**	**8.61**	**8.50**	**6.53**	**8.04**
Fruit and vegetables	3.22	0.13	1.20	1.31	-3.48	0.10	-1.01	1.48	-0.73
Onion	26.82	10.92	10.52	15.62	-15.90	-19.70	-31.19	15.24	-7.71
Tomato	3.77	-10.39	-5.54	-2.22	-4.49	6.07	0.80	-4.52	0.46
Livestock	7.14	9.64	11.22	12.62	13.63	14.03	14.20	9.33	13.43
Beef	12.38	14.71	17.85	19.73	21.45	22.84	23.67	14.99	21.35
Egg	-1.73	-4.13	-3.43	-1.15	0.02	3.97	6.38	-3.10	0.96
Energy and government approved fares	**7.47**	**7.03**	**6.82**	**6.93**	**6.62**	**5.55**	**3.49**	**7.11**	**6.35**
Energy	8.38	7.83	7.56	7.74	7.23	6.43	4.20	7.92	7.12
Gasoline	10.74	10.22	9.53	9.59	8.23	6.73	5.14	10.16	8.18
Electricity	0.66	1.07	1.49	2.81	4.67	4.52	0.64	1.07	4.08
Domestic gas	9.80	8.17	8.25	8.49	8.18	8.30	6.63	8.74	8.32
Government approved fares	5.92	5.65	5.55	5.48	5.46	3.88	2.16	5.71	4.93
Subway and electric transportation	49.63	49.63	49.63	49.63	49.63	15.15	-0.26	49.63	36.05

Source: Banco de México and INEGI.

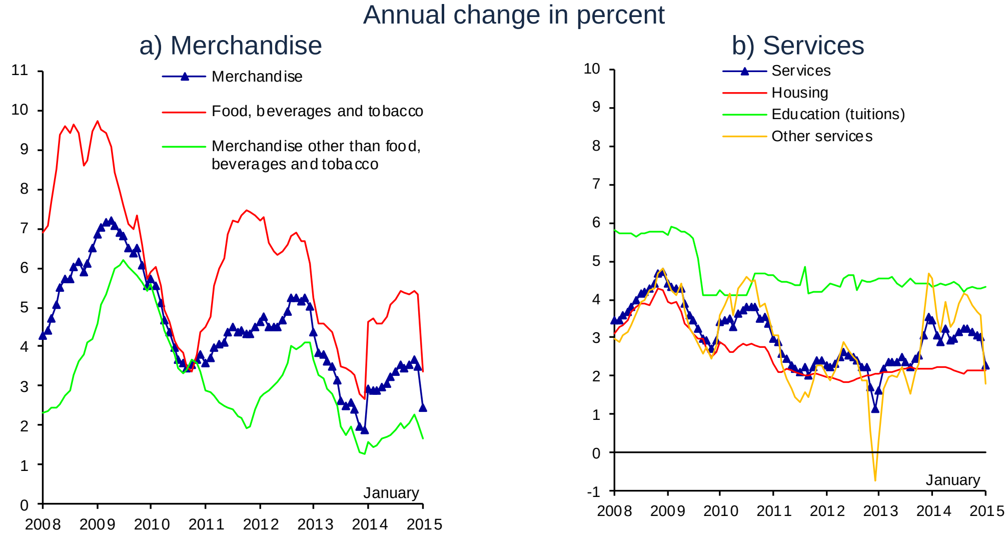
Over the period analyzed by this Report, annual core inflation persisted at levels close to 3 percent, shifting from 3.32 to 3.24 percent between October and December. Afterwards, in January 2015, this indicator dropped significantly to register 2.34 percent (Table 1 and Chart 3). In this respect, the annual change of the merchandise price subindex changed from 3.53 to 3.50 percent between October and December 2014, to later decrease to 2.43 percent in January 2015. This derived from the performance of both food and non-food merchandise, and was partly affected by the fading of the effects of the above said fiscal changes. Hence, the annual changes of food merchandise were 5.33 and 5.31 percent in October and December, decreasing to 3.37 percent in January. As to non-food merchandise, its annual changes in the referred months were 2.07 and 2.04 percent, registering 1.66 percent in January (Table 1, Chart 3 and Chart 4a). It should be noted that the growth rate of merchandise prices in January is the lowest for this month since 2003, which is in line with the forecast that once the shocks on inflation in 2014 are overcome, it will resume low levels.

Chart 3
Core Price Index
Annual change in percent



Source: Banco de México and INEGI.

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



Source: Banco de México and INEGI.

Likewise, the annual change rate of the services' price subindex went down from 3.14 to 3.03 percent between October and December 2014, to later register 2.26 percent in January 2015. This performance was largely determined by the evolution of services other than education and housing, the annual growth rate of which reduced from 3.86 to 3.60 percent between October and December 2014 and to 1.79 percent in January 2015. In this regard, drops in telecommunication services' prices were noteworthy, as was the case of the local fixed telephone services and the elimination of long-distance national phone charges, the fading of the effects of the fiscal changes that affected food services' prices at the beginning of last year and, in general, increments in services' prices lower than those of last year (Table 1, Chart 3 and Chart 4b).

Box 1
Recent Evolution of Telecommunication Services' Prices

1. Introduction

The goal of the constitutional reform and secondary regulation of the telecommunications' sector of 2013 and 2014 is to develop the sector by improving the regulatory framework, which would boost investment and competition. The purpose of this is to improve the quality of services, and services to be offered at competitive prices.

With this background, throughout 2014 various provisions were implemented, derived from the referred reform, which affected the recent price dynamics in the sector. This Box briefly describes some regulatory changes in force since recently, along with the evolution of the price indices of telecommunication services and their contribution to headline inflation.

2. Telecommunication Reform

As part of the referred reform, in 2013 the Federal Telecommunications Institute (IFT, for its acronym in Spanish) was established, as an independent agency with capacity as regulator of the sector, of granting licenses for the provision of telecommunications and broadcasting services and of declaring existence or absence of conditions for effective competition in the sector. Among some of the IFT's powers is the one to determine, if applicable, the presence or absence of predominant economic agents in the sector, as well as the measures to prevent this from affecting competition.

In this context, in March 2014, IFT declared businesses with greater share in the telecommunication and broadcasting markets as predominant economic agents, and imposed specific regulatory measures onto these firms. Additionally, in August 2014 the Federal Telecommunications and Broadcasting Law (LFTR, for its acronym in Spanish) entered into force, establishing further determinations, some of which apply to predominant economic agents and other to all service providers. There are some measures among those imposed onto the predominant agent in the telecommunications market that were reflected in lower retail prices in the sector: [1]

- The elimination of roaming fees as of April 6, 2014.

1 The LFTR establishes that any economic agent that, directly or indirectly, has the national share over 50 percent is considered a predominant economic agent in the telecommunications and broadcasting sectors.

From the date of entry into force of the LFTR, on August 13, 2014:

- The asymmetric interconnection regime, in which the preponderant agent cannot charge the remainder of providers for the interconnection of calls and messages that terminate on its network, while others can charge it to the preponderant agent.
- The obligation to charge mobile phone users the same tariff for the services provided within and outside its network; that is the price per minute of call and messages should be the same to contact the phone numbers of the company in question or other companies.
- The obligation to allow the resale of mobile services to other concessionaires, including virtual operators.
- The unbundling of the local network, which would allow other providers to offers services by means of the "last mile" access.

As regards the LFTR provisions that apply to all services' providers, which increment consumers' welfare, indirectly affecting the prices paid by users and boosting competition, the following can be named:

- For the prepaid scheme, the contractual term for unused balances was extended to a minimum of one year.
- Mobile phone equipment should be unblocked, that is, it should be available to be used with any provider, once acquired by a user.
- Telephone number portability should be free of charge for users, and should be resolved within 24 hours upon request, which could be done via electronic means.
- From January 2015 onwards, the elimination of national long distance fees both in fixed and mobile telephone services.

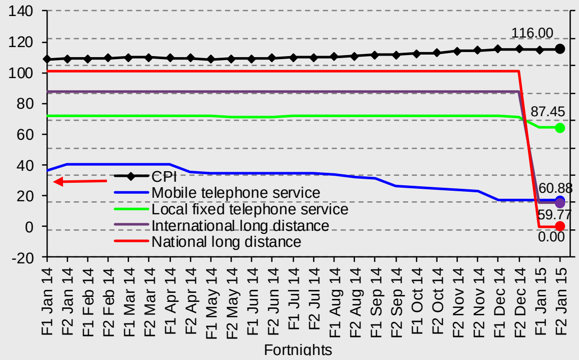
3. Recent Evolution in the Telecommunications' Market in Mexico

In the above described environment, during 2014 and in 2015 so far significant changes in the telecommunications services' supply and prices were observed, which made a downward contribution to headline inflation.

Chart 1 presents the evolution of telephone services' price indices, quoted in the CPI. As can be seen, mobile phone prices are the first ones to have started to decrease due to the entry into force of the referred reform.

As regards local and long-distance telephone services, both national and international, after remaining stable in recent years, the indices dropped significantly in January 2015.

Chart 1
CPI and Telephone Price Indices
Base 2nd Fortn. December 2010 = 100



Source: INEGI.

The observed dynamics is mainly accounted for by the following changes presented in its offered services:

Mobile Telephone Service

As mentioned above, the elimination of the national roaming fee charged by the predominant agent, as of April 6, 2014.

Lower fees of the predominant economic agent in calls outside the network (the effective fees charged by the predominant agent for the services outside the network, identical to those charged within the network, since the entry into force of the LFTR). This includes balance special offers in the prepayment scheme, additional minutes in the postpayment scheme, and frequent or free telephone numbers that are no longer exclusive to the services within own network since the above said date. So, they can also be used to contact other providers' telephone numbers.

The emergence of new mobile plans both prepayment and postpayment with the flat-rate scheme for the service with lower fees, as well as prepayment planes with packaged services, i.e., that for a specified amount a package of voice minutes, SMS messages and megabytes for browsing is acquired.

Fixed Telephone Service

An adjustment in the services' offer, granted by means of different packages of combined services of fixed telephone service, internet and cable TV. These increased significantly the amount of minutes for calls to cell phones and national and international long-distance calls that are offered, without a change in prices.

International Long Distance

The modification and emergence of different packages of combined telephone services, internet and cable TV, which recently started to include considerable number of minutes for long distance international calls, without a change in price.

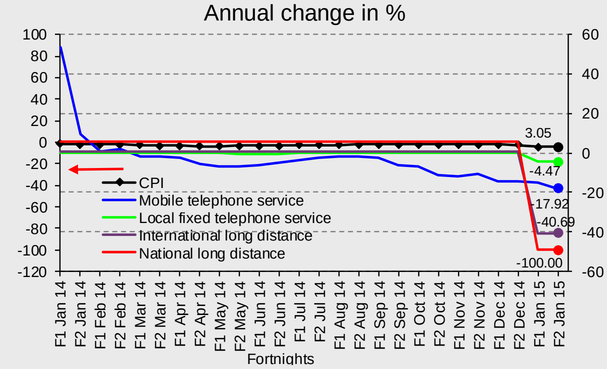
National Long Distance

The elimination of the fee for this services, both in fixed and mobile telephone services, in accordance with the LFTR, from 2015 onwards.

4. Effect of Telephone Services' Prices on Headline Inflation

As a consequence of the above described, in January 2015 the referred telecommunications services' prices that are part of the CPI, reflected negative annual changes (Chart 2).

Chart 2
CPI and Telephone Price Indices
Annual change in %



Source: INEGI.

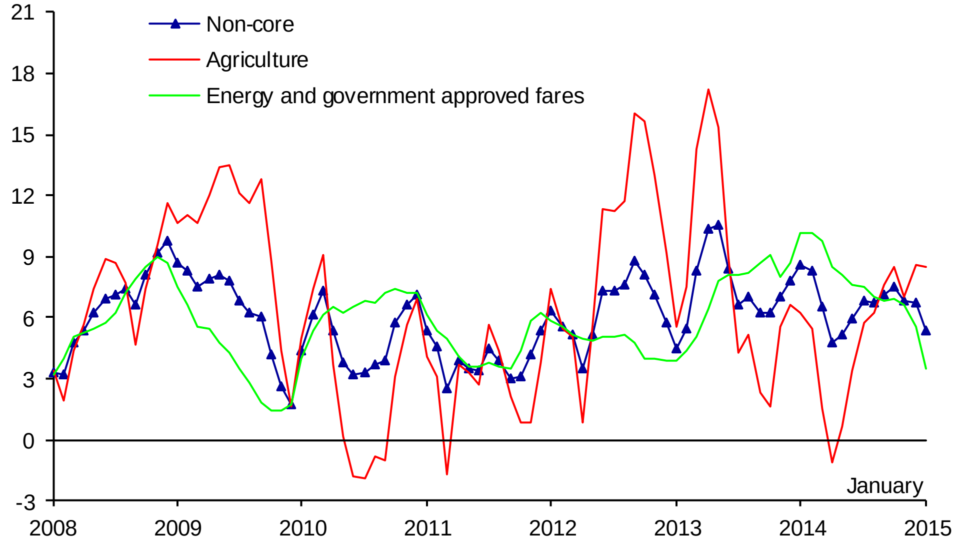
In this way, and given its share in the CPI, the group of telecommunication prices has a considerable contribution to the decrease in annual headline inflation in January 2015. In particular, the group of telephone services has an incidence of -38 basis points onto annual headline inflation of the referred month.

5. Final Remarks

The constitutional reform to the telecommunications' sector establishes an improvement to the regulatory framework, aimed at boosting competition and development in the sector. During the first months following its entry into force, various provisions were established, generating greater competition in the sector. This was reflected in the entry of new providers and innovative schemes with more attractive prices, which made a downward contribution to headline inflation, as long as a contribution to greater welfare of consumers.

In the last quarter of 2014, non-core inflation registered upward pressures as a result of the performance of agricultural products' group, mainly the increments in the prices of beef and tomato. However, the above was offset by the lower growth rate in the subindex of energy prices and government approved fares. Thus, the annual change of the non-core price index decreased from 7.51 to 6.70 percent between October and December 2014. The same factors continue contributing to the fact that this index has reduced its annual change to 5.34 percent in January (Table 1, Chart 5 and Chart 6).

Chart 5
Non-core Price Index
Annual change in percent



Source: Banco de México and INEGI.

The subindex of agricultural prices increased its annual change rate from 8.46 to 8.61 percent between October and December 2014. Nonetheless, in January 2015, the annual change of the referred subindex reduced to 8.50 percent, when lower prices of some fruit and vegetables, such as tomato and onion, were observed, which offset the still high growth rates of livestock prices. In particular, the annual change of the fruit and vegetables group shifted from 1.31 percent in October to 0.10 percent in December, and later to -1.01 percent in January. In turn, the annual change of the group of livestock products increased from 12.62 to 14.03 percent over the referred months, presenting 14.20 percent in January (Table 1, Chart 6a, and Chart 7).

In contrast, the annual change rates of the energy prices and government approved fares have been decreasing since October 2014 (Chart 6b). Specifically, the annual change of this subindex dropped from 6.93 to 5.55 percent between October and December 2014, to later decrease to 3.49 percent in January 2015. Lower increments in gasoline prices and domestic gas prices, as compared to last year, and lower prices of other energy products, such as electricity, have been particularly relevant for the abovesaid. Derived from this, the group of energy prices lowered its annual change rate from 7.74 percent in October to 6.43 percent in December, and to 4.20 percent in January.

In particular, the most relevant price changes of energy products were the following:

- From January 1, 2015 onwards, the gasoline price in the cities not located at the border region increased by 1.9 percent, which, in line with the Ministry of Finance, will be the only increment during the year. It contributed to the fact that in the first fortnight of January the change of the gasoline price in these cities was 1.9 percent, while in the cities in the Northern border region a decrease of 6.94 percent was registered. Hence, the average gasoline price increment was 0.87 percent in the referred fortnight. In the month as a whole, the monthly gasoline price change for non-border region cities was 2.07 percent, while in the Northern border region there was a decrease of 12.36 percent, resulting in a national increment of 0.28 percent during the month. That is in contrast with the average annual change of this fuel above 10 percent in 2014. It should be noted that in the cities in the Northern border region the adjustment of prices over the following months will depend on the evolution of prices in the U.S. cities they adjoin, which in turn follow the dynamics of the international oil price (Chart 9).

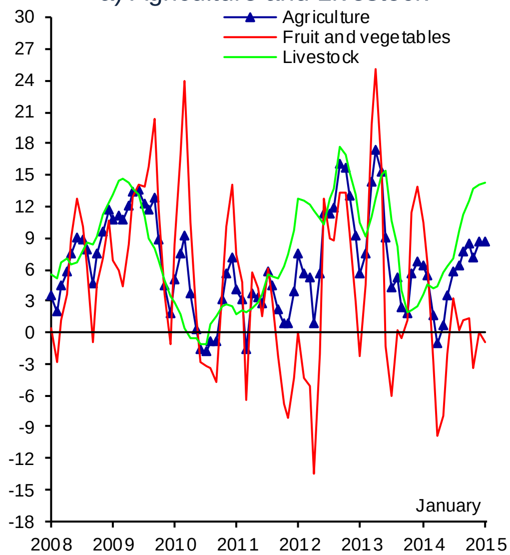
- The price of domestic gas, which in 2014 had an average annual increment of 9.68 percent, increased by 1.92 percent in January 2015 and is not expected to grow further in the remainder of the year.

- Electricity tariffs dropped by 2.04 percent in January 2015 and are anticipated to remain unchanged in the rest of the year, while in 2014 they went up by 3.30 percent, on average.

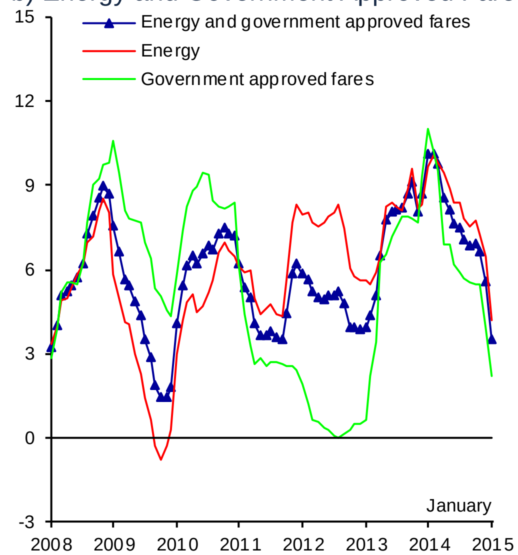
The group of government approved fares lowered their annual change from 5.48 to 3.88 percent between October and December 2014, and finally to 2.16 percent in January 2015, when some of the adjustments in public transport fares that had taken place last year did not occur again, as was the case of the Mexico City subway (Table 1, Chart 8).

Chart 6
Non-core Price Index
Annual change in percent

a) Agriculture and Livestock



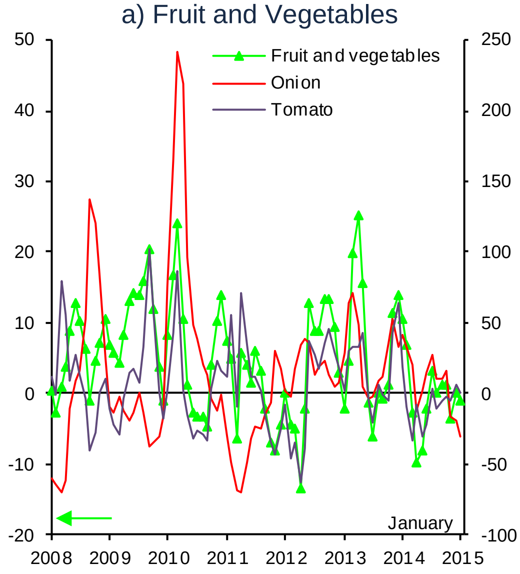
b) Energy and Government Approved Fares



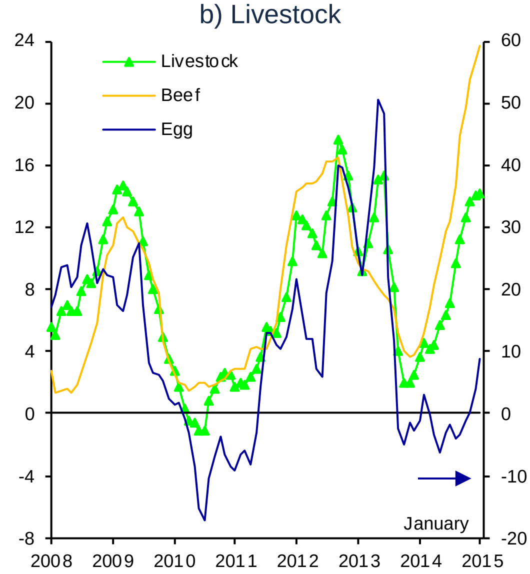
Source: Banco de México and INEGI.

Chart 7
Agricultural Price Index
Annual change in percent

a) Fruit and Vegetables

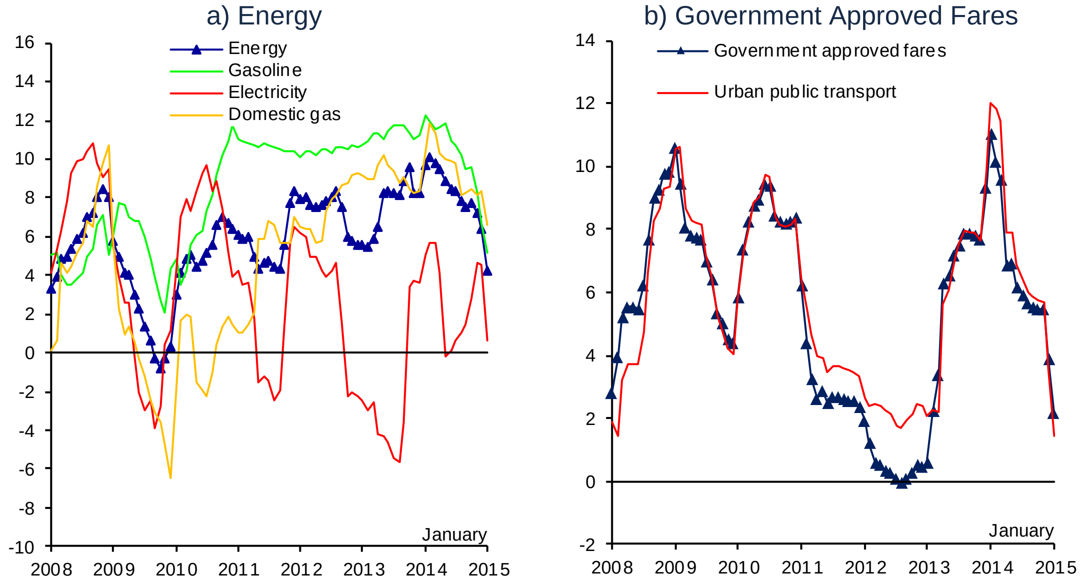


b) Livestock



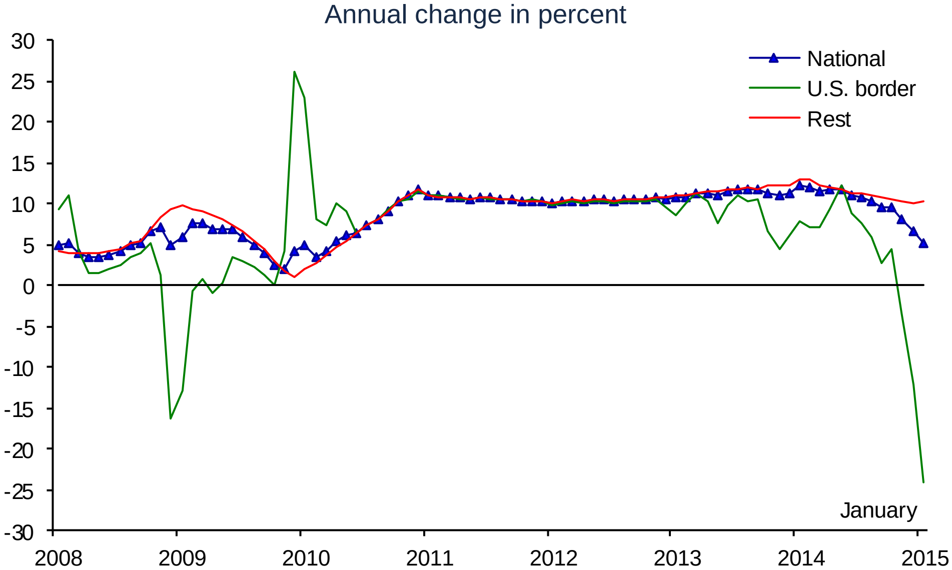
Source: Banco de México and INEGI.

Chart 8
Non-core Price Index
Annual change in percent



Source: Banco de México and INEGI.

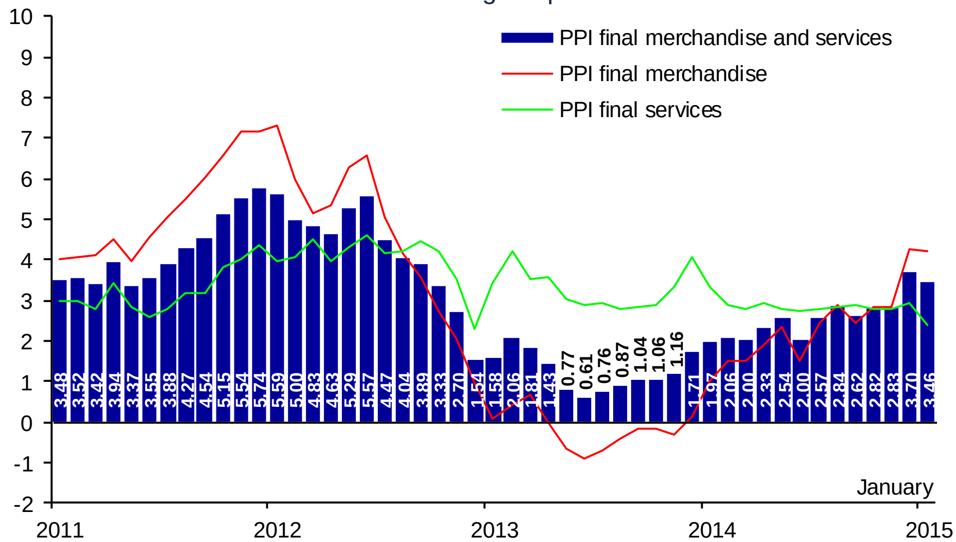
Chart 9
Gasoline Price Index
Annual change in percent



Source: Banco de México and INEGI.

In the last month of 2014, the Producer Price Index (PPI) of finished merchandise and services, excluding crude oil, registered an annual growth of 3.70 percent, while in October it was 2.82 percent (Chart 10). This performance was mainly due to a greater upward contribution in the prices of some manufacturing exports. Subsequently, in January 2015, the annual change of the referred indicator lied at 3.46 percent.

Chart 10
Producer Price Index
Annual change in percent



Source: Banco de México and INEGI.

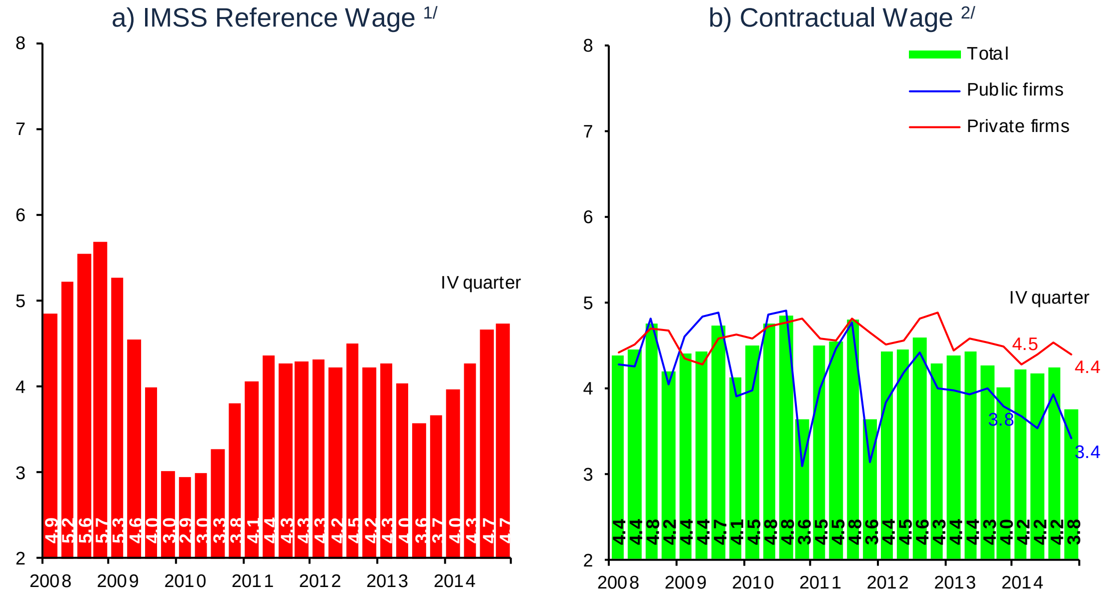
2.2. Wages

During the fourth quarter of 2014, the main wage indicators increased in line with the labor productivity growth, reason for which labor costs remained low and still did not generate inflation pressures (see Section 3.2.1 further below). In particular, the reference wage of IMSS-insured workers increased 4.7 percent in the last quarter of 2014, a figure similar to that observed in the previous quarter (Chart 11a). Afterwards, in January 2015 the annual change rate of the reference wage lied at 4.3 percent.

The increment in the contractual wage negotiated by firms under federal jurisdiction was 3.8 percent in the fourth quarter of 2014, which was lower than the figure registered in the same quarter of the previous year (4.0 percent). This difference mainly derived from lower changes in contractual wages of public firms. In particular, these firms negotiated an average increase of 3.4 percent (3.8 percent in the same quarter of 2013), while private firms' wages increased on average by 4.4 percent (4.5 percent in the same period of 2013, Chart 11b). Later, in January 2015 the average change rate of the contractual wage was 4.2 percent (in the same month of the previous year it was 3.8 percent). In particular, the average increment in contractual wages for public and private firms lied at 3.4 and 4.6 percent, respectively (3.5 and 4.0 percent in January 2014).

Furthermore, during the period analyzed in this Report, the Council of Representatives of the National Minimum Wage Commission agreed to raise the average general minimum wage by 4.2 percent, in force from January 1, 2015 (in 2014 it was 3.9 percent), with the possibility that over the following months the gap in minimum wages in the areas A and B could be reduced in half, which may represent a further increase to the average minimum wage of 1.3 percent.

Chart 11
Wage Indicators
Annual change in percent



1/ During the fourth quarter of 2014, an average of 17.4 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.
Source: Calculated by Banco de México with data from IMSS and STPS.

3. Economic and Financial Environment

3.1. International Environment

The world economy kept showing weakness during the last quarter of 2014, which translated into a downward adjustment of the growth outlook for the following years. In fact, the global economic activity faced two shocks: a drastic drop in crude oil prices, which are expected to persist at low levels for a considerable period of time and a USD appreciation against most currencies, which derived from a portfolio adjustment driven by the divergence in the growth rates and expectations for the main advanced economies' monetary policy stances. Lower hydrocarbon prices contributed to the reduction in inflation worldwide, in some cases, aggravating deflation risks. In this environment of a world economic slowdown, the drop in the crude oil price and the expectations of higher interest rates in the short term in the U.S. were reflected in the considerably higher volatility in international financial markets.

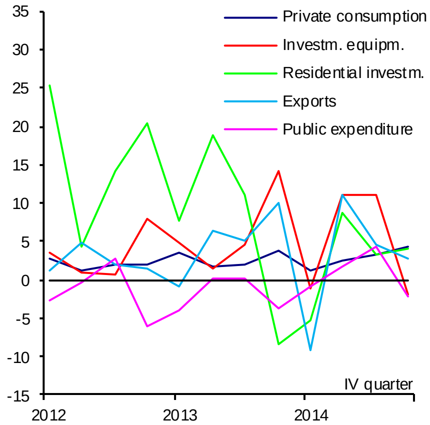
3.1.1. World Economic Activity

In the U.S., the economic recovery kept consolidating. GDP grew at an annualized quarterly rate of 2.6 percent in the fourth quarter of 2014, after the 5.0 and 4.6 percent registered in the second and the third quarters, respectively. In particular, it stands out that private consumption kept growing at a high rate, supported by an increment in personal income, driven by lower gasoline prices and by improved household confidence. In contrast, progress in private investment remained moderate, mainly as a reflection of weak expenditure on equipment and low growth in housing construction. Finally, net exports lost momentum, after being affected by lower external growth and the above referred USD appreciation (Chart 12a).

The dynamism of the U.S. economy translated into a considerable improvement in labor market conditions in the fourth quarter of 2014, reason for which slack conditions in the said market continued decreasing. In particular, employment kept increasing, registering an average monthly growth of non-farm payroll of 324 thousand jobs, as compared to 237 thousand jobs in the third quarter. The favorable performance of employment persisted in January 2015. In turn, the unemployment rate dropped faster than expected, despite greater stability in the labor participation rate, reaching a level of 5.7 percent in January 2015, after having lied at 5.9 percent in late third quarter (Chart 12b). Moreover, other labor market indicators improved. In particular, the employment-to-population ratio increased slightly in the quarter and the number of people working part time for economic reasons went down.

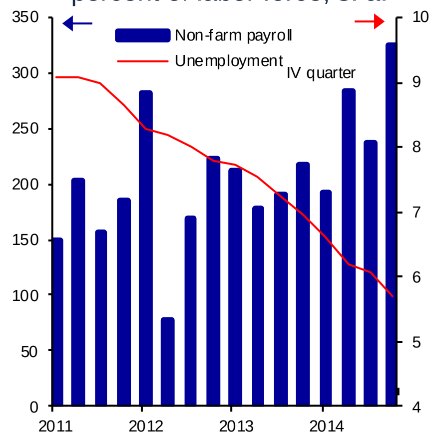
Chart 12
U.S. Economic Activity

a) Selected Components of Real GDP
Annualized quarterly change in percent, s. a.



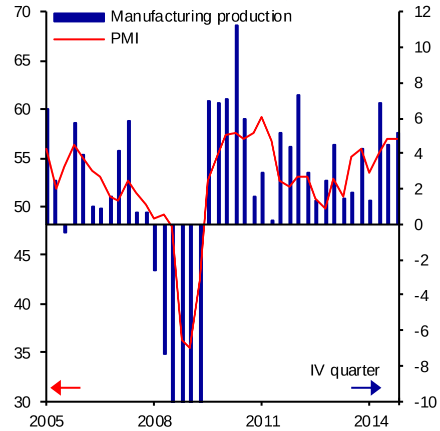
s. a. / Seasonally adjusted figures.
Source: BEA.

b) Average Monthly Change of Non-farm Payroll and Unemployment Rate
In thousands of jobs and percent of labor force, s. a.



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

c) Manufacturing Production and Manufacturing Sector's Purchasing Managers' Index (PMI)
Annualized quarterly change and diffusion index, s. a.



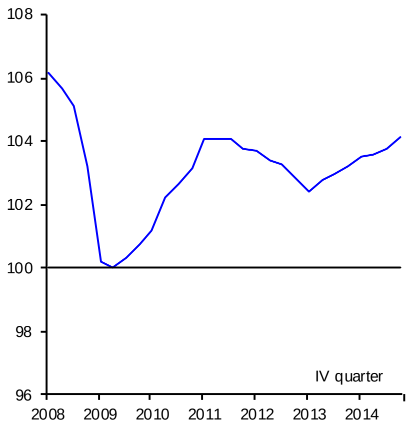
s. a. / Seasonally adjusted figures.
Source: Federal Reserve, PMI.

A positive trend in the U.S. industrial production prevailed during the fourth quarter of 2014, expanding at an annualized quarterly rate of 5.6 percent, figure above 4.1 percent observed in the third quarter. The greater rate of expansion of industrial activity was mainly due to manufacturing production, which increased at an annualized quarterly rate of 5.2 percent (Chart 12c), all of the above supported by lower energy prices.

In the Euro zone, economic growth remained weak in the analyzed quarter (Chart 13). GDP expanded at an annualized quarterly rate of 1.4 percent, as compared to 0.6 percent in the third quarter. Despite a certain improvement in private consumption and in exports, the recovery was still affected by the poor performance of private investment and by adjustments in the balances of the public and private sectors. Credit to households and non-financial corporations was also depressed, even though it progressed incipiently in late 2014, while new credits' interest rates kept going down. In this context, it is expected that additional monetary easing announced in January 2015 by the European Central Bank (ECB), the Euro depreciation, lower crude oil prices, and a fiscal monetary stance remaining unchanged will support the sustained expansion of economic activity over the next quarters. Still, there are considerable risks derived from the possibility of a deflationary process in the region, of the possible implications of the political and economic situation of Greece onto the financial markets, and of the lack of structural reforms necessary to enhance competitiveness of the region.

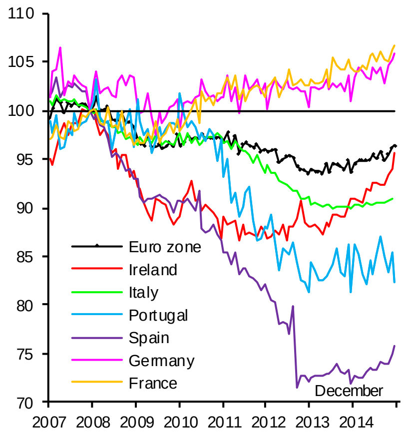
Chart 13
Euro Zone Economic Activity

a) Real Gross Domestic Product
Index 2S 2009=100, s. a.



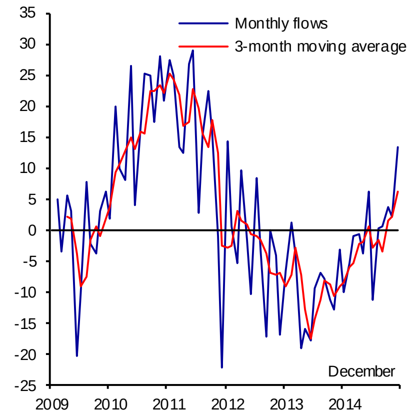
s. a. / Seasonally adjusted figures.
Source: Eurostat, Haver Analytics.

b) Retail Sales [1/]
Index December 2007=100, s. a.



s. a. / Seasonally adjusted figures.
1/ Car sales excluded.
Source: Eurostat.

c) Credit to Non-financial Private Sector
Monthly flows in EUR billions



Source: European Central Bank.

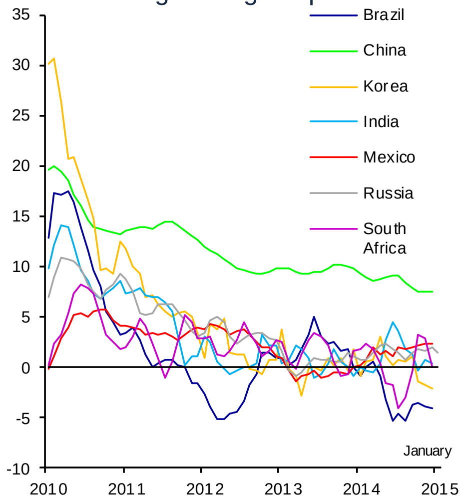
The economy of the U.K. expanded in the last quarter of 2014, at an annualized quarterly rate of 2.0 percent, as compared to 3.0 percent in the previous one. According to available indicators, this expansion was supported by strong consumption and improved net exports. In contrast, private investment moderated, in particular in the residential sector, as a result of a lower growth in housing prices and lower demand for housing credit.

The GDP of Japan expanded at an annualized quarterly rate of 2.2 percent in the last quarter of the year, following a contraction of 6.7 and 2.3 percent in the second and the third quarters, respectively. This expansion was contributed to by a greater growth of private consumption given a gradual increase in labor income and lower crude oil prices. Furthermore, the increment in exports as a result of the yen depreciation has been a positive factor for the recovery. Finally, business' fixed investment recovered slightly in light of the improvement in corporate profits.

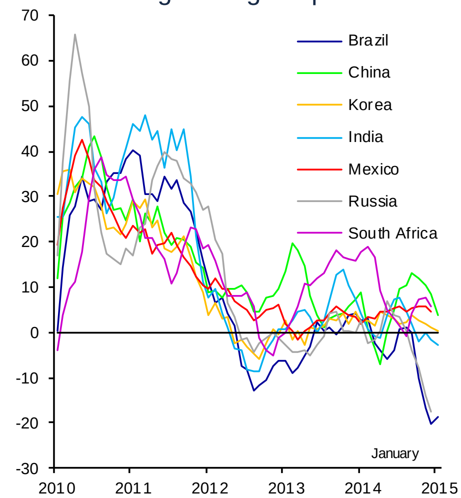
The growth outlook in most emerging economies has been adjusted downwards, given some cases of macroeconomic imbalances, weakness of domestic demand and lower commodity prices. In particular, the forecast indicates a lower dynamism in China, a still weaker outlook for Russia and downward adjustments in the expansion of commodity exporting countries. The timely indicators, such as the industrial production and exports, continued pointing to a slowdown, and in some cases even decreases, which indicates a lower dynamism of both domestic and external demand (Chart 14). Lower commodity prices, in particular crude oil prices, contributed to a deterioration in the current account and public finances in most countries exporting these goods, by means of a decrease in their terms of exchange and lower tax revenues. In some economies, the adoption of corrective measures was required to offset the non-sustainable expansionist policies applied in the past. For example, such countries as Brazil, Indonesia and Russia, introduced different fiscal measures, such as tax increases, lower subsidies on fuel prices and lower expenditure in order to improve their public finances.

Chart 14
Emerging Economies' Economic Activity

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



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



Source: Haver Analytics.

3.1.2. Commodity Prices

During the quarter analyzed in this Report, lower commodity prices were registered, particularly those of crude oil (Chart 15a). This drop in crude oil prices is largely attributed to supply factors, although smaller demand has also contributed. Regarding the supply factors, as a result of high crude oil prices persisting over the last years, and progress in oil extraction technologies, new unconventional sources of crude oil were incorporated, such as shale oil, especially in the U.S. Gradually, these new technologies more than offset the stagnated production of the OPEC (Organization of the Petroleum Exporting Countries) and decreased production in other oil producing countries. In this environment, the OPEC member states, in particular Saudi Arabia, functioned as regulatory bodies in the world oil market, preventing, by means of incrementing and lowering their production quota, considerable imbalanced between crude oil supply and demand at the global level. Still, lower participation in the market, which implied the sustained increase in the production of some OPEC non-member states, with greater marginal extraction costs, motivated an apparent adjustment in the OPEC strategy. Thus, the decrease in prices at the end of the year intensified, starting from the OPEC decision not to cut down on production, in light of a lower demand growth.

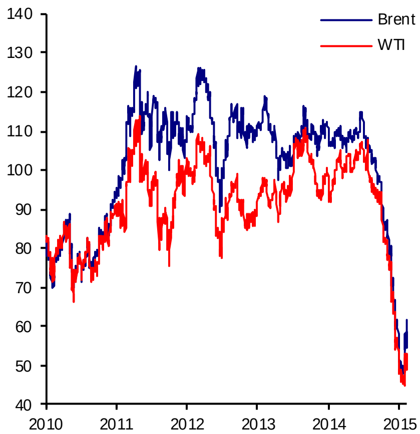
In fact, the lower growth of the world economy led to a downward adjustment in the estimations of crude oil demand, which also contributed to lower prices (Chart 15b). The observed slowdown in emerging economies' growth, in particular that of China, accounts for a great part of the downward revision in the estimations of demand for crude oil and its forecast for 2015.

Under a scenario in which the OPEC is assumed to sustain its production rate in 2015, the International Energy Agency (IEA) estimates that the world oil supply will be higher than its demand in the first half of the year, and, therefore, that inventory accumulation will be registered, which will have to go down insofar as the world economic activity rebounds in the second half of the year (Chart 15c). Thus, oil prices are likely to remain low for an extended time period, while investment and eventually supply with greater extraction costs do not decrease considerably.

Industrial metal prices also presented a downward trend, although to a lesser degree. In the particular case of iron ore, the fall was due to an expansion of production in Australia and Brazil, in a market with excess supply (Chart 16a). In turn, grain prices, such as corn and wheat remained low as favorable supply conditions persisted (Chart 16b).

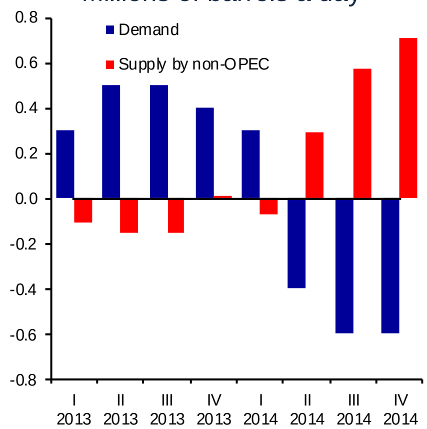
Chart 15
Supply and Demand in the Global Oil Market

a) Crude Oil [1/]
USD per barrel



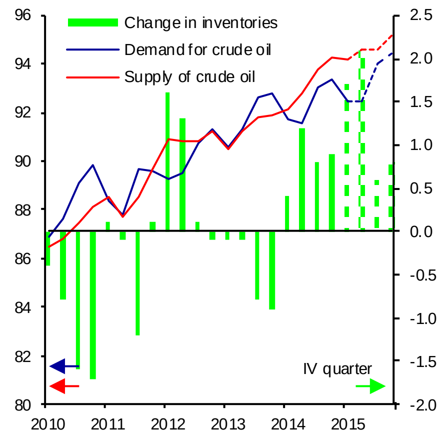
1/ Mercado Spot.
Source: Bloomberg.

b) Revisions of Estimations of World Oil Supply and Demand
Millions of barrels a day



Note: Revisions of the estimates from June 2014 to February 2015.
Source: International Energy Agency.

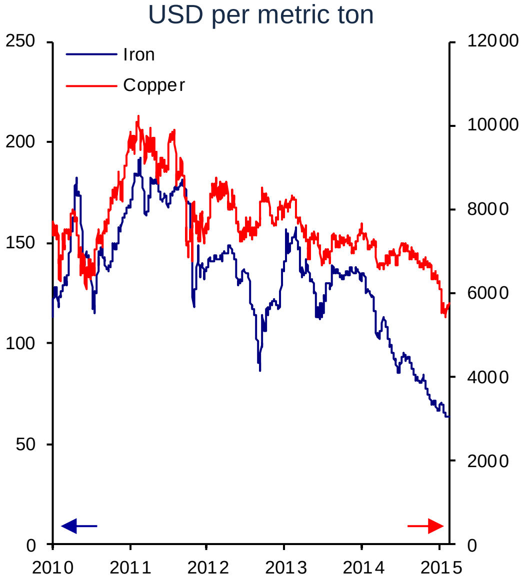
c) Supply and Demand of World Oil
Millions of barrels a day



Note: For 2015, it is a forecast and it is assumed to sustain the OPEC production rate.
Source: International Energy Agency.

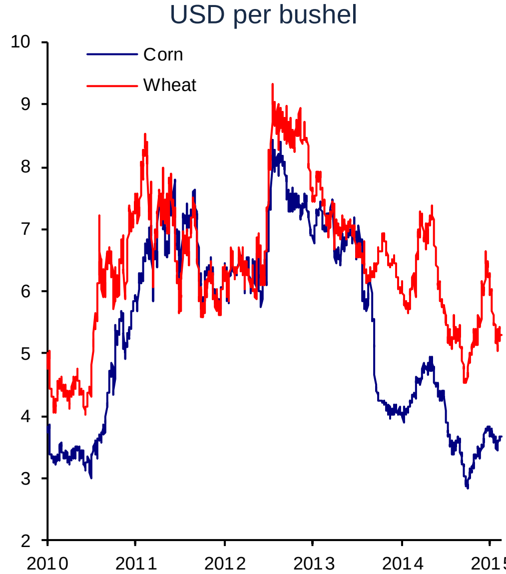
Chart 16
International Commodity Prices

a) Iron and Copper [1/]
USD per metric ton



1/ Mercado Spot.
Source: Bloomberg.

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



3.1.3. Inflation Trends Abroad

Global inflation continued decreasing in the fourth quarter of 2014, once the still persisting ample slack conditions in some advanced economies and weak domestic demand in the emerging ones were complemented by a considerable drop in commodity and energy prices (Chart 17). Hence, fear of the fact that very low and/or negative inflations might affect the anchoring of long-term inflation expectations in these economies, in particular in most advanced economies, maintained.

In the U.S. inflation and market inflation expectations decreased in the period analyzed by this Report, due to lower energy prices, to the effect generated by the USD depreciation on imports' prices and the absence of labor cost-related pressures. In December, headline inflation was 0.8 percent, its lowest reading in over five years, while the core inflation remained at 1.6 percent. On the other hand, the annual change of the personal consumption expenditure (PCE) deflator was 0.7 percent and the core PCE was 1.3 percent. Thus, inflation lies below the 2.0 percent target of the Federal Reserve.

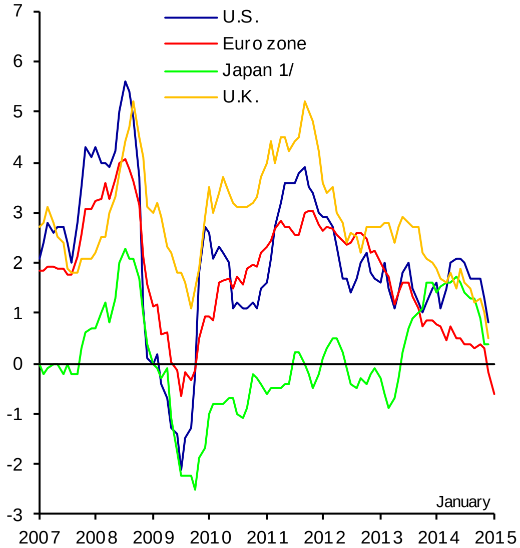
In the Euro zone, inflation turned negative (-0.6 percent at an annual rate in January), while its expectations kept lowering, thus increasing the deflation risks. This performance was mainly contributed to by the plunge in energy prices and low growth in food prices. In turn, the ample slack in the economy led to lower core inflation, which located at 0.6 percent. The historical low levels of inflation and its expectations generated concern in the ECB regarding the possibility of second round effects on wages and price setting.

In the U.K., in December annual headline inflation went down to 0.5 percent. This decrease was mainly attributed to lower fuel prices. Core inflation dropped to 1.2 percent in the same month, partly due to lower imports' prices, given the GBP appreciation. In Japan, headline inflation, excluding the upward effect in the consumption tax, also showed a downward trend with respect to the previous quarter, shifting from 1.3 to 0.4 percent between September and December. The above was a reflection of a significant drop in crude oil prices.

In emerging economies, the evolution of inflation was mixed. In most countries, among which China, Korea, Hungary, India, Poland and Thailand stand out, the downward inflation trend was due to the weakness of domestic demand, although by the end of the year the drop in the crude oil price contributed as well. Still, in other countries, such as Brazil, Indonesia and Russia, inflation rebounded or remained high, as a reflection of macroeconomic imbalances.

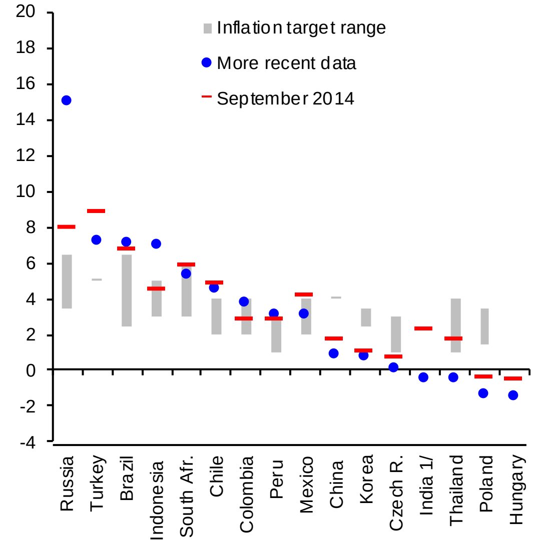
Chart 17
Annual Headline Inflation in Advanced and Emerging Economies

a) Advanced Economies
Percent



1/ It excludes the direct effect of the increment in the consumption tax.
Source: BLS, Eurostat and Statistics Bureaus of Japan and the U.K.

b) Emerging Economies
Percent



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

3.1.4. Monetary Policy and International Financial Markets

During the period covered by this Report, in general, the monetary policy stance in the main economies remained accommodative and in some cases additional monetary easing measures were taken. Accommodative monetary conditions are expected to prevail in the future, with the notable exception of the U.S. The strength of the economic activity in this country has generated an expectation of a first increment in the reference interest rate. However, there is great uncertainty regarding the moment it will take place and the speed at which this rate will adjust over the following months.

In its January meeting, the Federal Reserve evaluated the economic recovery and employment more positively as compared to December. Furthermore, it kept characterizing inflation, caused by lower fuel prices, as transitory, but informed that inflation will continue decreasing in the short term and will gradually resume its target in the medium term. As regards inflation expectations, it acknowledged a considerable reduction in those derived from financial instruments, but stressed that long-term ones, derived from surveys, remain stable. In this context, the Federal Reserve maintained its forward guidance of the interest rate announced last December, indicating that it could be patient about normalizing its monetary policy stance and emphasized that its actions will depend on the performance of the economy, and will consider the international events as well.

In contrast, given the weakness of the economy and greater deflation risks, in January 2015 the European Central Bank announced additional monetary easing, consisting in an expanded amplification of the program of the purchase of securities. Under this program, the Eurosystem will buy Euro-denominated investment-grade securities issued by Euro area governments, European agencies and institutions in the secondary market, which will amount to a monthly value of EUR 60 billion. These purchases, that will also include asset-backed securities and covered bonds, will start in March 2015 and will tentatively conclude in September 2016. However, the ECB notified that these operations could extend until a sustained increment of inflation towards its target is perceived. Additionally, it was decided to eliminate the 10 basis points' margin on the main refinancing rate, applicable to facilitate long-term financing (TLTROs), which are to take place between March 2015 and June 2016. According to the ECB, the main goal of these new measures is to effectively address the risks of a very extended period of low inflation, even preventing deflation.

The Bank of England maintained its reference rate at 0.5 percent and kept unchanged the forward guidance for its interest rate during the period analyzed in this Report. Additionally, it did not modify the stock of its asset purchase program, leaving it at GBP 375 billion and announced that it will reinvest GBP 4.35 billion, from the maturity of government bonds in January 2015. Still, in the Minutes of its January meeting, greater concern over the possible effects of an extended period of low inflation was present.

In its January meeting, the Bank of Japan ratified its quantitative and qualitative monetary easing program to achieve its 2 percent inflation target announced last October. Thus, it maintained its goal to increase the monetary base at an annual rate of JPY 80 trillion, as well as its decision to keep buying government bonds and exchange-traded funds at an annual rate of JPY 80 and 3 trillion, respectively. Likewise, it did not modify its decision to purchase real estate investment trusts of JPY 90 billion. Although the Bank of Japan made a downward revision of its inflation outlook, thus delaying the possibility to achieve its target this year, this revision was attributed to the temporary decrease in energy prices. Furthermore, it maintained unchanged its outlook for core inflation and slightly adjusted upwards its inflation forecast for 2016.

Differences in the conduction of the monetary policy persisted among emerging economies. On the one hand, a drop in inflation, accentuated in some cases by the fall of the energy price, and the accommodative stance in main advanced economies allowed the central banks of such countries as China, Korea, Hungary, India, Poland and Thailand to reduce their reference interest rates. Nonetheless, other countries such as Brazil, Indonesia and Russia, despite weakness of their economies, increased their interest rates, in order to reduce their high inflation levels, as well as to offset the effects of the strong depreciation of their exchange rates.

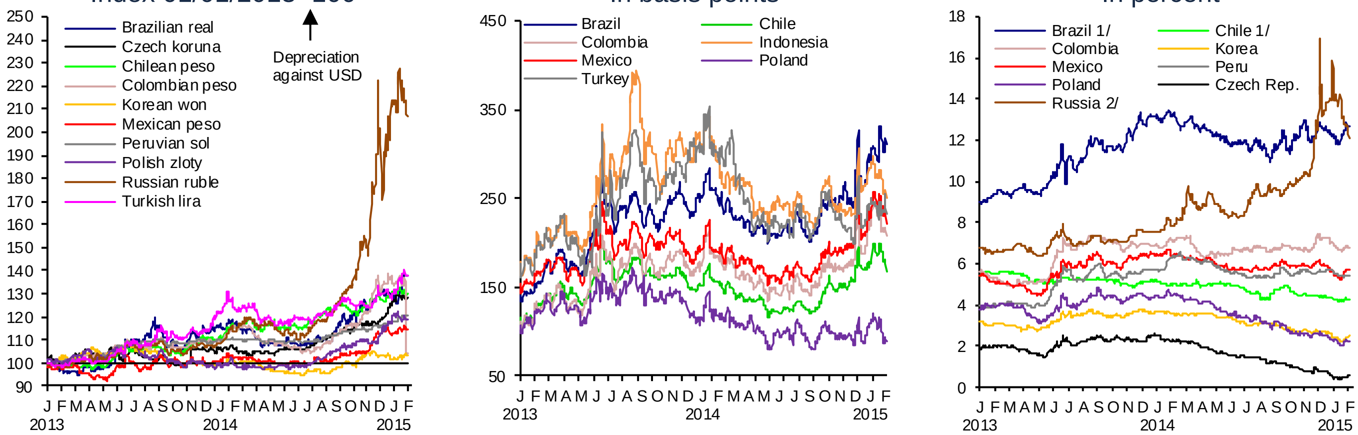
During the fourth quarter of 2014 and the first weeks of the current year, a considerable increment in volatility in international financial markets was observed. Among the main elements generating this volatility the following stand out: divergence in current and expected monetary policy stances of the main advanced economies, the drop in crude oil prices and the forecast that they will persist at low levels for an extended period, as well as economic implications and risks of contagion derived from the political situation in Greece. This was combined with uncertainty generated by geopolitical risks due to the conflict in Ukraine and by the sanctions imposed on Russia by the international community. Thus, greater risk to aversion was reflected in a marked upward trend of sovereign risk margins and a smaller capital inflow to emerging economies (Chart 18). In this environment, new episodes of volatility cannot be ruled out, which can translate into tighter conditions of access to financial markets for emerging countries. This, along with the recent depreciation of their currencies, could exacerbate financial vulnerabilities of economies with high levels of liabilities denominated in foreign currency and, in general, with weak economic fundamentals.

Chart 18
Financial Indicators of Emerging Economies

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

b) Sovereign Spreads
In basis points

c) 10-year Bond Yield
In percent



Source: Bloomberg.

Source: Bloomberg.

1/ It refers to 9-year bonds.
2/ It refers to 8-year bonds.
Source: Bloomberg.

3.2. Evolution of the Mexican Economy

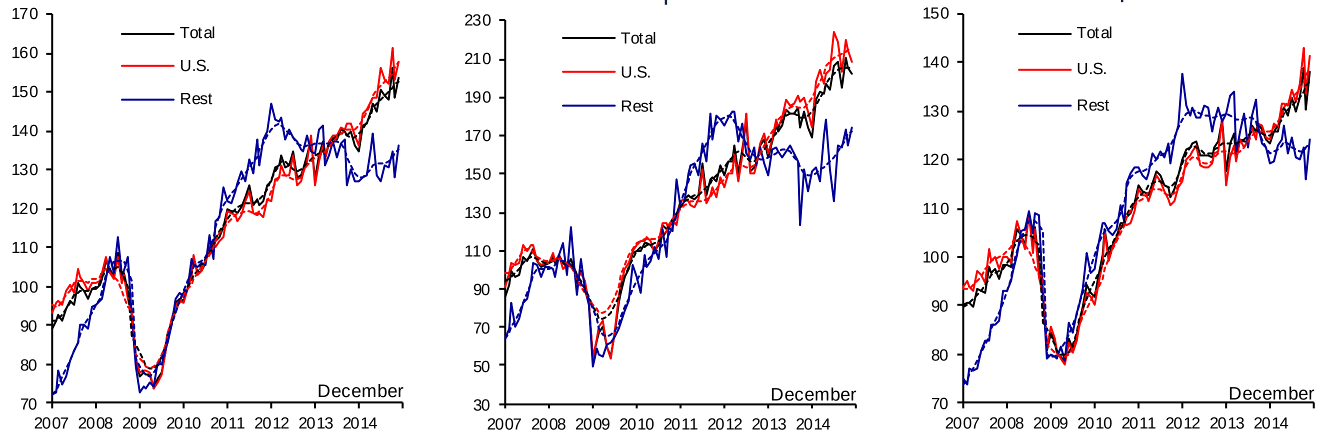
3.2.1. Economic Activity

In the fourth quarter of 2014, the Mexican economy continued with the moderate recovery, that had been registered since the second quarter of that year. This evolution principally derived from the dynamism of external demand, while domestic demand presented certain improvement.

In the analyzed quarter, manufacturing exports maintained the growing trend they had been showing since the end of the first quarter of 2014. Growth of manufacturing exports largely originated from the impulse of those to the U.S. (Chart 19a), in line with the growth of productive activity observed in that country. In turn, the dynamism of these exports reflected the increments of both the automobile sector exports and those in the rest of the manufacturing sector (Chart 19b and Chart 19c). For their part, exports to the rest of the world remained relatively stagnated.

Chart 19
Indicators of Manufacturing Exports
Index 2008=100, s. a.

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



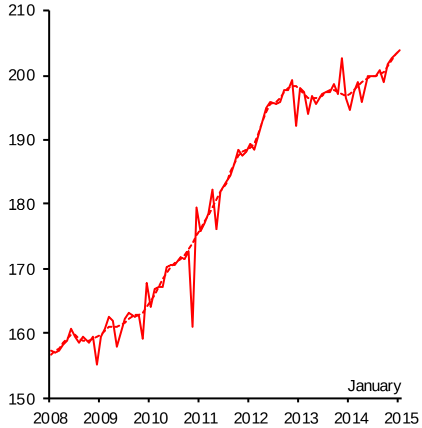
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Banco de México.

As regards domestic demand, while private consumption still did not present clear signs of a solid reactivation, some investment indicators suggested that it kept improving gradually, following weak performance in 2013 and early 2014.

i. As for private consumption, ANTAD sales presented progress in the fourth quarter (Chart 20a), while in the period of October-November 2014, revenues of commercial retail establishments obtained from goods and services' provision reported a seasonally adjusted level similar to that observed, on average, in the third quarter (Chart 20b). On the other hand, in the period of October-November, the monthly private domestic consumption indicator recovered incipiently (Chart 20c).

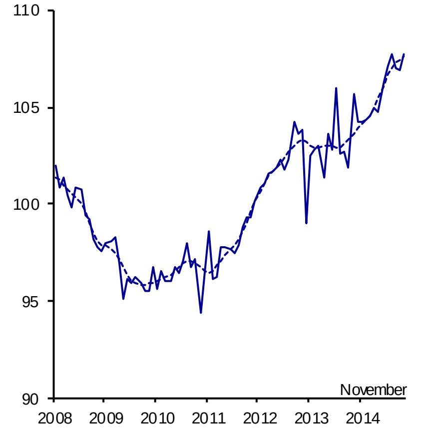
Chart 20
Consumption Indicators

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



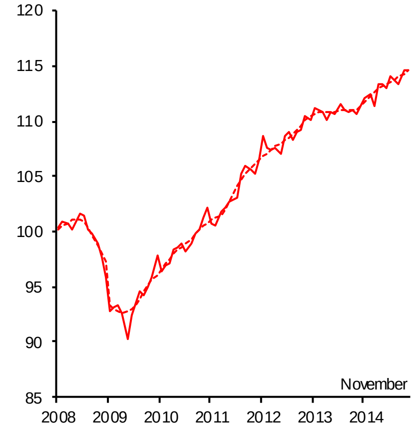
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Prepared by Banco de México with ANTAD data.

b) Revenues of Retail Businesses
Index 2008 =100, s. a.



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Monthly Survey of Commercial Establishments, INEGI.

c) Monthly Indicator of Private Consumption in the Internal Market
Index 2008=100, s. a.



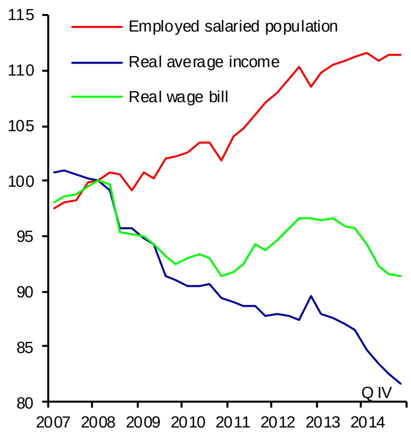
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Mexico's System of National Accounts, INEGI.

ii. The above derived from the fact that some consumption determinants kept registering certain weakness. In particular, workers' real wage bill remained affected by the drop in the real average income of employed population, and, consequently, kept showing decreases (Chart 21a). Although the consumer confidence index started to present an upward trend, in recent months it began going down again and still located below the levels observed in the first half of 2013 (Chart 21b). Meanwhile, as indicated further below in this Report, consumer credit kept decelerating (see Section 3.2.2). In contrast, in the fourth quarter of 2014, workers' remittances showed a greater growth rate as compared to the previous quarter (Chart 21c). Although part of this improvement could be due to the exchange rate depreciation, its impulse, to a certain degree, was also a reflection of greater employment dynamism in the U.S. construction sector.

iii. Gross fixed investment maintained a positive trend in the last quarter of 2014. This performance mainly derived from the recovery of investment in construction (Chart 22a). The said improvement originated from the reactivation of private investment in construction, given that the component of the public sector kept presenting a weak performance (Chart 22b). As regards the item of machinery and equipment, although in the fourth quarter of 2014 imports of capital goods stagnated (Chart 22c), expenditure on domestic machinery and equipment kept registering increments in its dynamism.

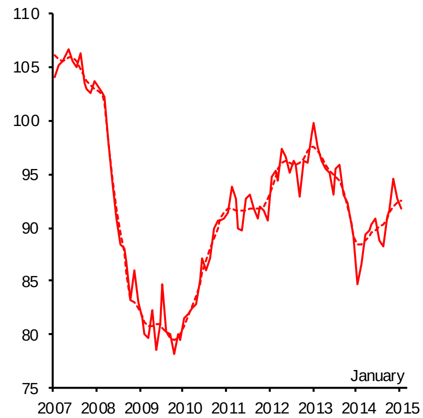
Chart 21
Consumption Determinants

a) Real Total Wage Bill
Index I-2008=100, s. a.



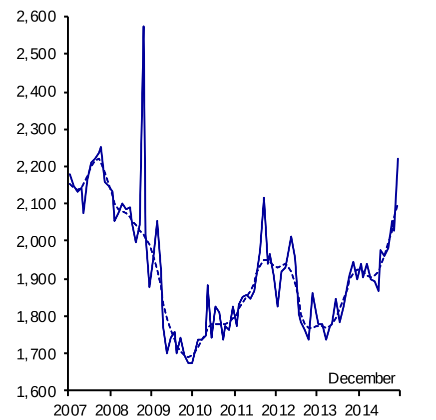
s. a. / Seasonally adjusted data.
Source: Prepared by Banco de México with information from the National Employment Survey (ENOE), INEGI.

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



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: National Consumer Confidence Survey (ENCO), INEGI and Banco de México.

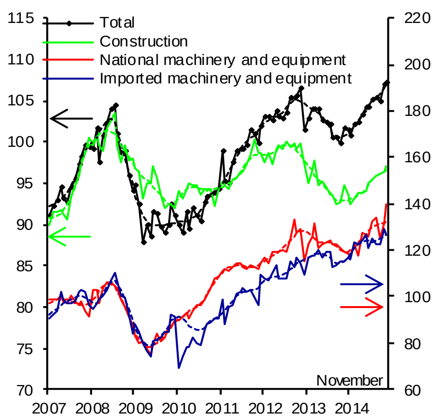
c) Workers' Remittances
USD million, s. a.



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Banco de México.

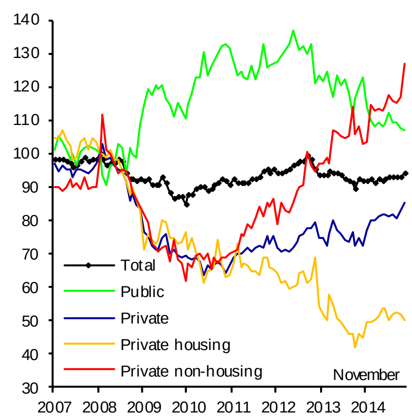
Chart 22
Investment Indicators

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



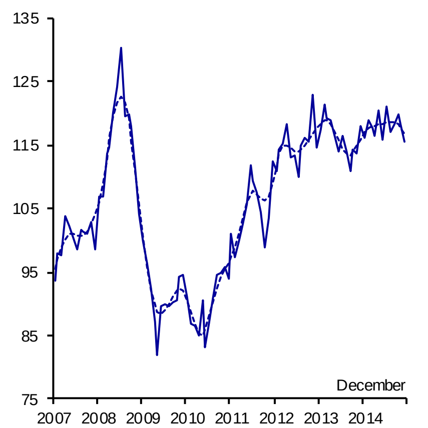
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Mexico's System of National Accounts, INEGI.

b) Real Value of Production in the Construction Sector by Contracting Institutional Sector
Index Jan 2008=100, s. a.



s. a. / Seasonally adjusted data. 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.

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



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Banco de México.

iv. In reference to public expenditure, available information of national accounts indicates that in the third quarter of last year the dynamism of public consumption had a greater contribution to aggregate demand than in previous quarters. However, public investment still did not register a clear recovery.

The performance of external and domestic demand reflected in a moderate recovery of economic activity in the period of October-December 2014, which derived from a positive evolution of both industrial production and the services' sector (Chart 23a). In particular:

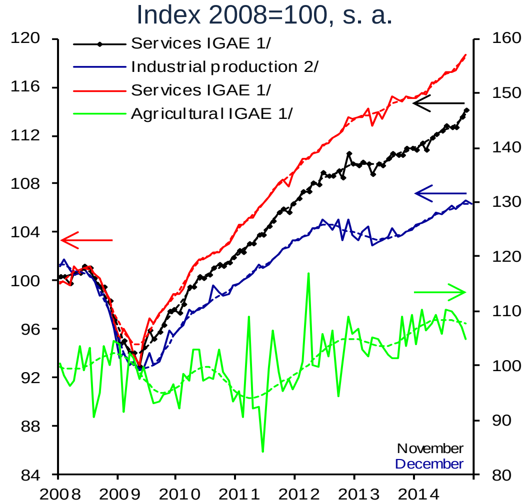
i. Within the industrial activity, the dynamism of manufacturing production and the reactivation of construction industry stand out, after the weak performance of the latter in the period between mid-2012 and early 2014 (Chart 23b). In contrast, the mining sector continued to observe a negative trend, which is due to the contraction in crude oil mining, which, in turn, is the reflection of the reduction in the crude oil production platform, as well as in the services related to oil extraction (Chart 23c).

ii. The expansion of the services' sector mainly responded to the dynamism of the external sector, that is the impulse of the services more related to external demand, such as commerce and transport linked to the external sector. On the other hand, even though the services more related to domestic demand, such as temporary accommodation and food preparation, mass media information, domestic trade and business support services improved as well, this improvement was lower than that observed in the services closer related to external demand (Chart 23d).

iii. In the first two months of the fourth quarter of 2014, primary sector activities decreased with respect to the average achieved in the previous quarter. This drop derived both from a smaller harvested area of the spring-summer cycle, and from a contraction in the production of some perennial crops.

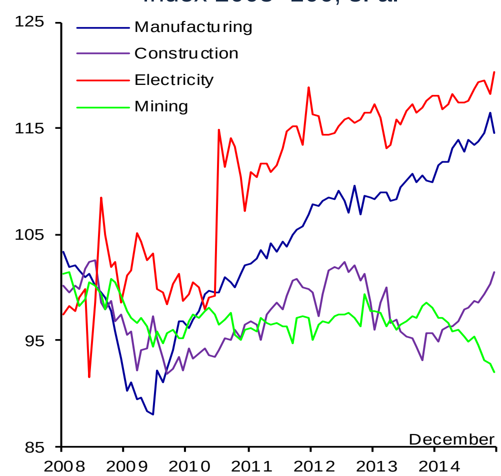
Chart 23
Indicators of Production

a) Economic Activity Indicators
Index 2008=100, s. a.

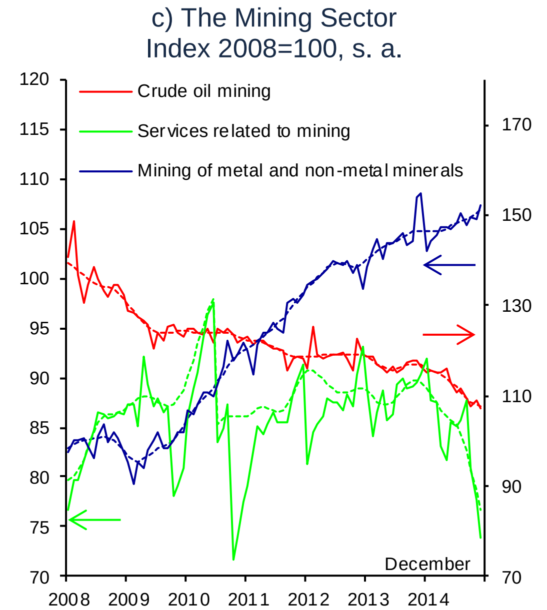


s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
1/ Data as of November 2014.
2/ Data as of December 2014 with information of the Monthly Indicator of Industrial Activity.
Source: Mexico's System of National Accounts, INEGI.

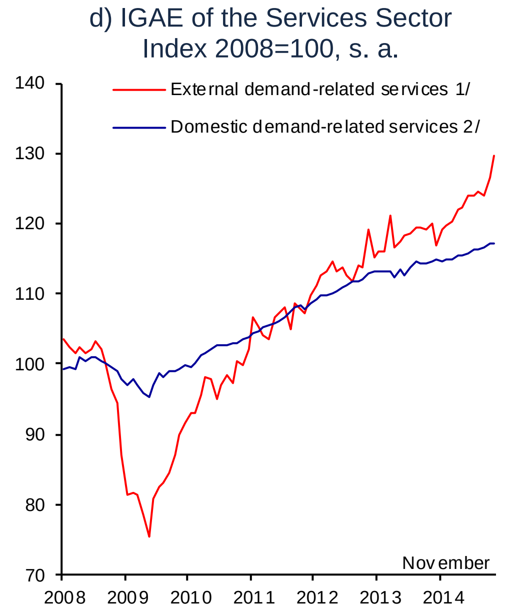
b) Industrial Activity
Index 2008=100, s. a.



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



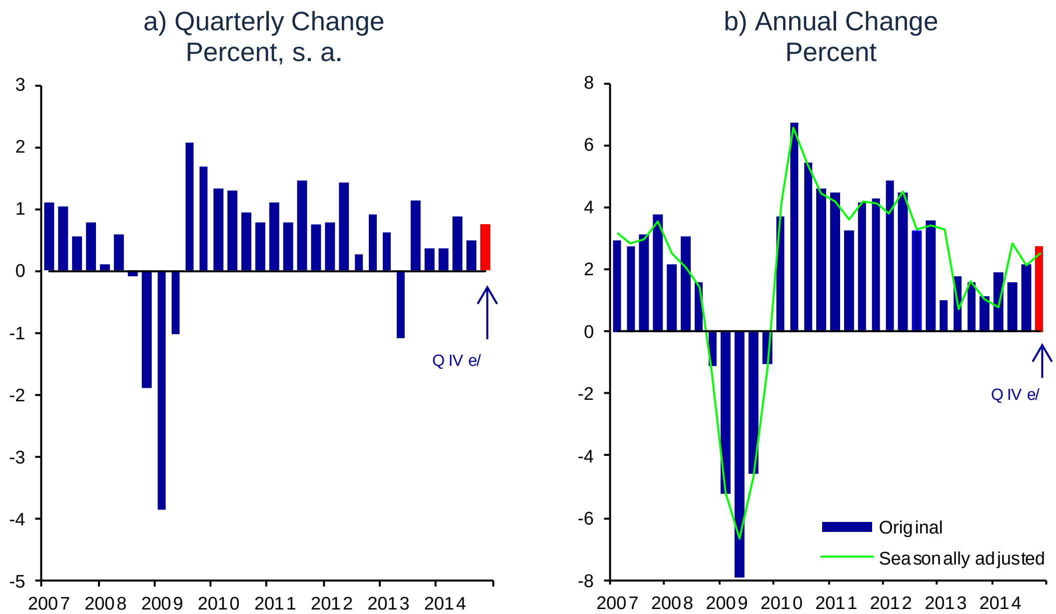
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Monthly Indicator of Industrial Activity, Mexico's System of National Accounts, INEGI.



s. a. / Seasonally adjusted data.
1/ It includes commerce and transport sectors related to external demand.
2/ It includes the remaining sectors of tertiary activities.
Source: Prepared by Banco de México with data from Mexico's System of National Accounts, INEGI.

As a result of the abovesaid, for the fourth quarter of 2014, GDP is expected to increase at a quarterly seasonally adjusted rate of around 0.7 percent, which compares to the increments of 0.36, 0.90 and 0.50 percent in the previous three quarters, respectively (Chart 24a). In annual seasonally adjusted terms, GDP growth is estimated to be around 2.6 percent for the last quarter of 2014, which compares to 0.8, 2.8 and 2.1 percent in the last three quarters. Based on data without seasonal adjustment, the annual change of GDP is estimated at 2.7 percent in the period October-December 2014, as compared to 1.9, 1.6 and 2.2 percent in the three previous quarters. Therefore, GDP growth rate in 2014 is expected to have been approximately 2.1 percent (Chart 24b).

Chart 24
Gross Domestic Product



s. a. / Seasonally adjusted data.
e/ Estimated by Banco de México.
Source: Mexico's System of National Accounts, INEGI. Seasonal adjustment of the fourth quarter of 2014 was prepared by Banco de México.

The most timely information indicates that in the last quarter of 2014, labor market gradually improved. Thus, although slack conditions persisted, they are decreasing. In particular:

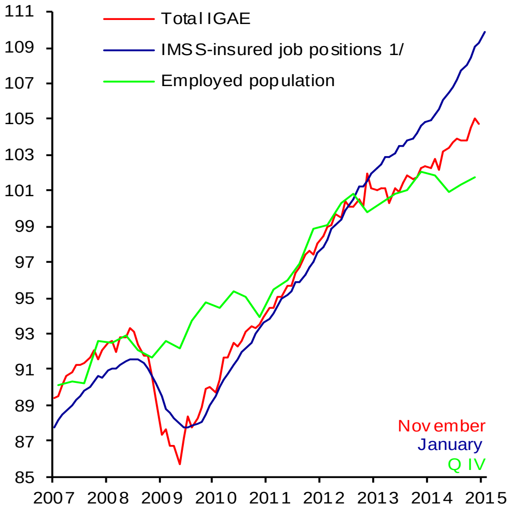
i. Even though the number of IMSS-insured workers kept showing a growing trend, partly as a reflection of greater supervision effort for businesses to formalize their workers, total employment in the economy still has not reactivated (Chart 25a).

ii. National and urban unemployment rates have considerably reduced in recent months (Chart 25b).

iii. In this context, no labor cost-related pressures on inflation have been perceived. Indeed, recent wage increments occurred simultaneously with increases in labor productivity, reason for which labor unit costs remained at low levels (see Section 4 further below).

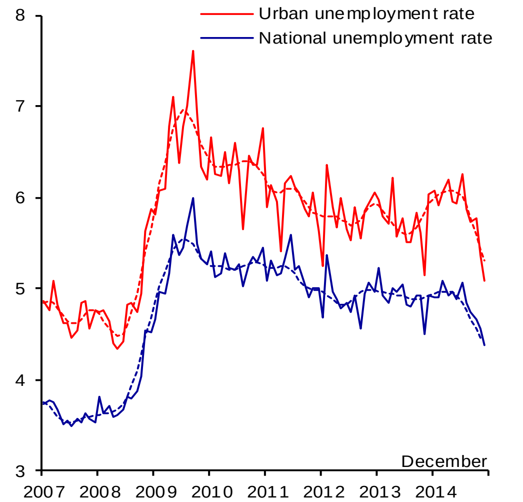
Chart 25
Labor Market Indicators

a) Total IGAE, IMSS-insured Workers and Employed Population
Index 2012=100, a. e.



s. a. / Seasonally adjusted data.
1/ Permanent and temporary workers in urban areas. Seasonal adjustment by Banco de México.
Source: Prepared by Banco de México with data from IMSS and INEGI (SCNM and ENOE).

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

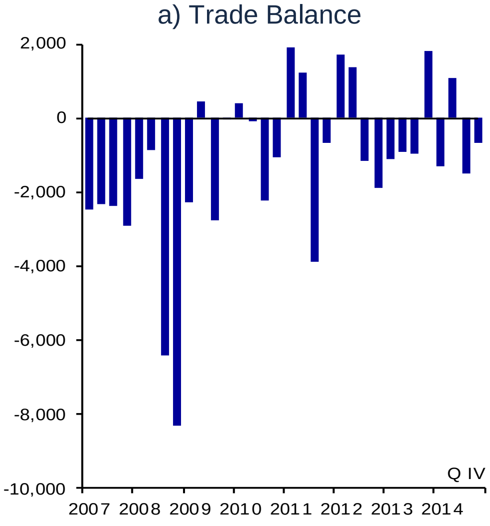


s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: The National Employment Survey (ENOE), INEGI.

In the last quarter of 2014, the trade balance registered a deficit of USD 680 million (Chart 26a). In turn, available data suggest that in the same period the current account observed a moderate deficit and the country continued receiving capital inflows via the financial account sufficient to allow an easy financing of this deficit (Chart 26b).

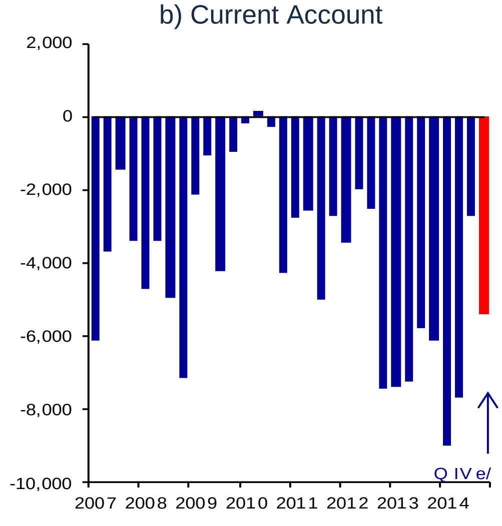
Chart 26
Trade Balance and Current Account
USD million

a) Trade Balance



Source: Banco de México.

b) Current Account



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

3.2.2. Financial Saving and Financing in Mexico

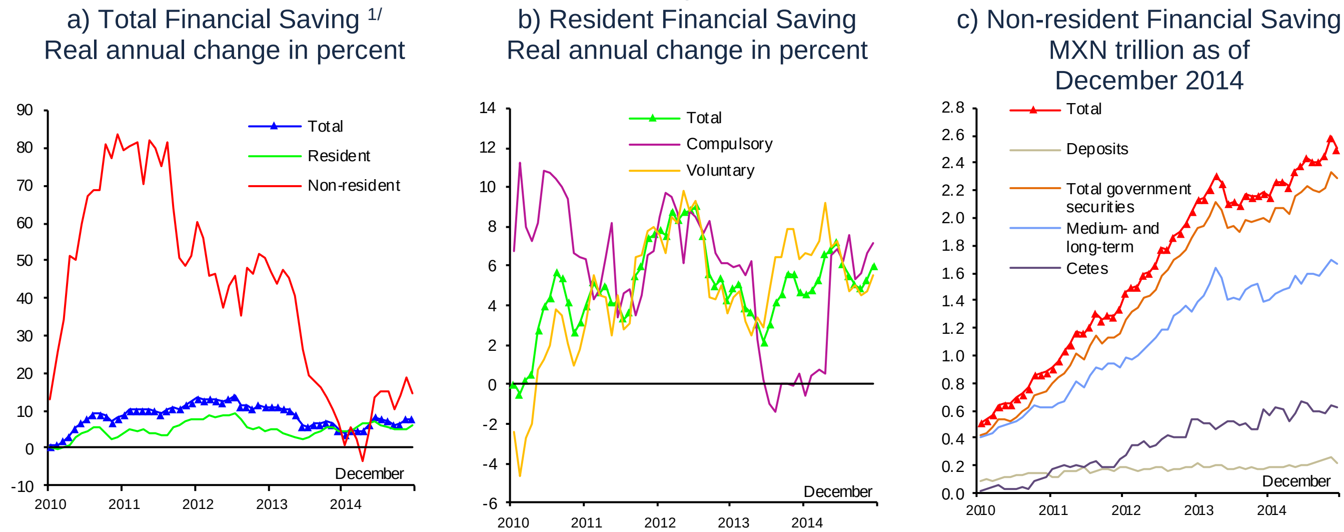
In the fourth quarter of 2014, the sources of financial resources of the economy expanded with a similar dynamism to that registered in the third quarter of the year. This performance was accounted for by the growth rate stability of both domestic and external sources, highlighting, in particular, the evolution of this last component despite higher volatility in international financial markets.

With respect to domestic sources, the stock of domestic financial saving –defined as the monetary aggregate M4 minus the stock of currency held by the public– registered a similar growth rate to that observed in the previous period. This performance was observed both in the voluntary and compulsory savings' component (Chart 27a and Chart 27b). In turn, the monetary base expanded more than in the third quarter, in a context of a moderate recovery of economic activity and low interest rates.[2]

External sources presented a similar growth to that in the previous quarter, despite a differentiated performance of its components. On the one hand, the stock of non-resident financial saving increased its growth rate, which reflected an increment in its holdings of government debt instruments in the reference quarter, in particular of medium- and long-term securities (Chart 27c). In this regard, it is important to highlight that even though in December there were pre-scheduled redemptions of fixed-rate government securities –in which non-residents had an important participation-, foreign investors' holdings of these debt instruments continued to increase, even in the context of high volatility in international financial markets. In contrast, foreign financing to non-financial private firms kept moderating its growth rate.

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

Chart 27
Financial Saving Indicators

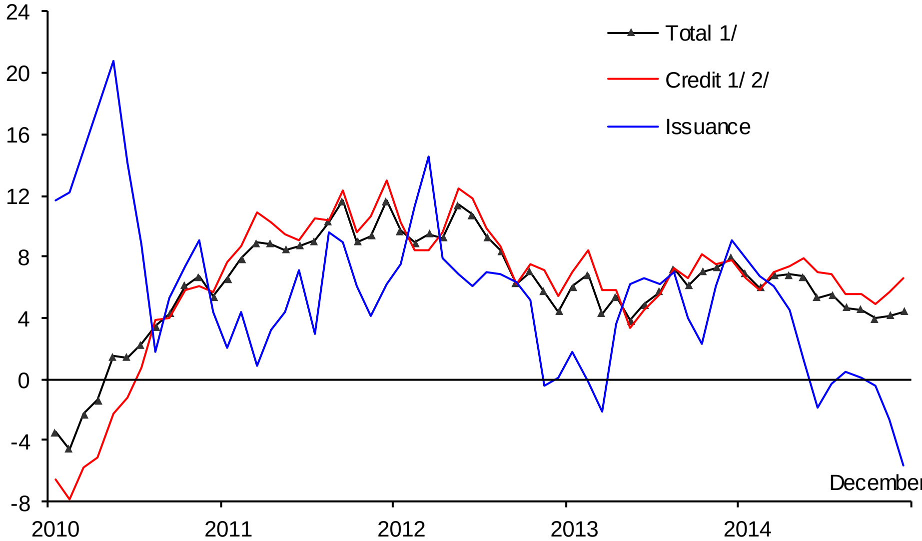


1/ Defined as the monetary aggregate M4 minus the stock of currency held by the public.
Source: Banco de México.

As regards the use of financial resources in the economy in the fourth quarter of 2014, even though Public Sector Borrowing Requirements (PSBR) were lower than in the third quarter –even showing a moderation with respect to what was previously anticipated by the 2015 General Criteria of Economic Policy (2015 CGPE)–, both financing to states and municipalities and the accumulation of international reserves were higher than in the previous quarter. In what concerns financing to the non-financial private sector, it grew at a lower rate during the analyzed quarter.

In particular, the growth rate of total financing to non-financial private firms decelerated, largely due to the above referred moderation of the growth rate of external financing. This was partly a consequence of a base effect due to an unusually high level of debt issuance in international markets in the fourth quarter of 2013. Domestic financing also showed a lower dynamism in the analyzed quarter, particularly as a result of a reduction in the net placement of private securities (Chart 28).

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



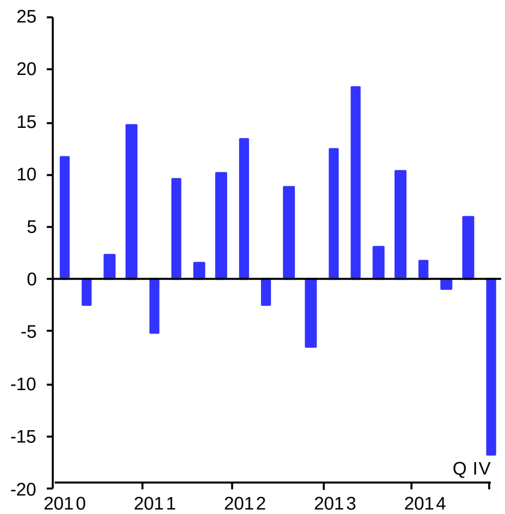
1/ The annual changes prior to January 2014 can be slightly affected downwards due to the conversion of some nonbank financial intermediaries to non-regulated multiple purpose financial corporations (Sofom ENR).
2/ It refers to the performing and non-performing portfolio, and includes credit from commercial and development banks, as well as other nonbank financial intermediaries.
Source: Banco de México.

With respect to this last point, even though firms continued to finance themselves through the issuance of medium-term domestic debt, net financing decreased due to the unusually high amortizations of debt that was not renewed. In the period of October-December 2014, gross placements of medium-term domestic debt amounted to MXN 13.2 billion, while gross amortizations –scheduled redemptions and prepayments– were MXN 29.9 billion, so that the net placement of non-financial private firms was MXN -16.7 billion (Chart 29a). The above, in an environment in which the interest rates of private debt securities, in general, remained relatively stable (Chart 29b).

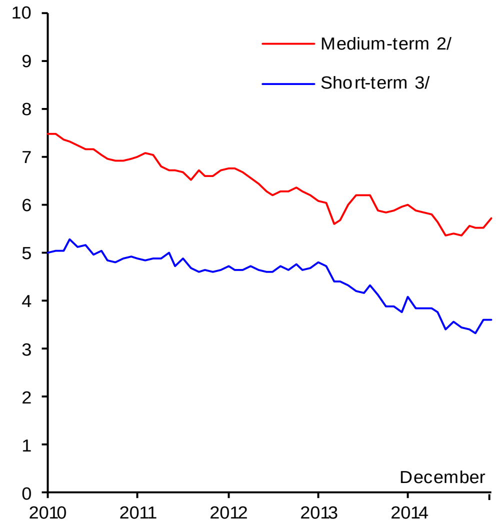
On the other hand, the growth rates of commercial banks' performing credit to firms remained relatively stable during the fourth quarter of 2014, while the growth rate of direct performing credit granted by development banks decreased, although it continues to grow at relatively high rates (Chart 30a). In this context, interest rates and delinquency rates of bank credit to firms showed no significant changes in the reported period (Chart 30b and Chart 30c).

Chart 29
Securities of Non-financial Private Firms in the Domestic Market

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



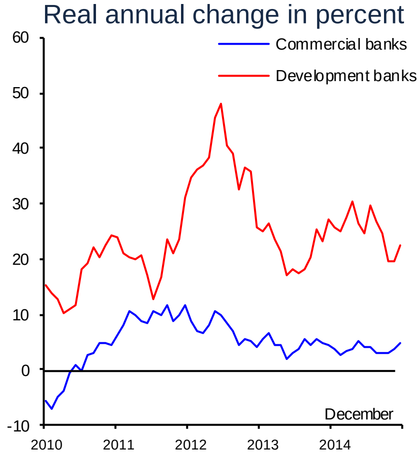
b) Interest Rates of Securities Issued by Non-financial Private Firms
Annual percent



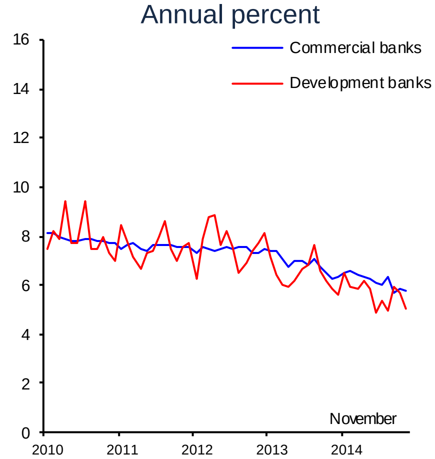
1/ Placements excluding amortizations in the quarter (maturities and prepayments).
2/ Placements of more than one year.
3/ Placements of up to one year.
Source: Banco de México, with data from Valmer and Indeval.

Chart 30
Bank Credit to Non-financial Private Firms

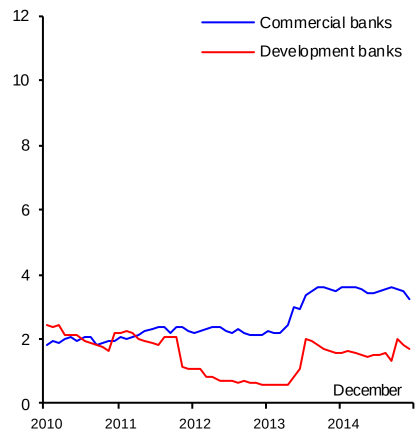
a) Performing Credit to Non-financial Private Firms
Real annual change in percent



b) Interest Rates of New Credits to Non-financial Private Firms [1/]
Annual percent



c) Delinquency Rates of Credit to Non-financial Private Firms [2/]
Percent



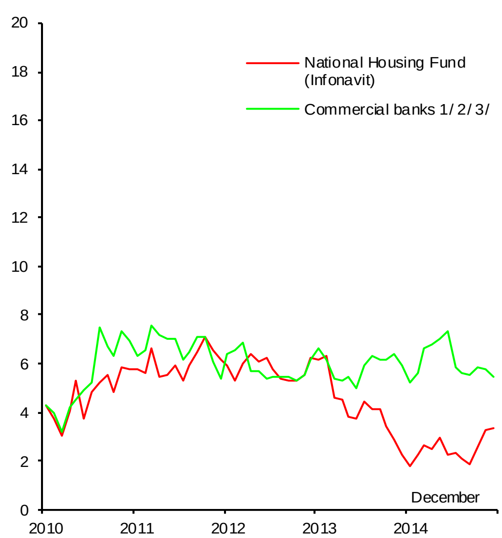
1/It refers to the interest rate of new bank credits to non-financial private firms, weighted by the associated stock of the performing credit and for all credit terms requested.
2/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.
Source: Banco de México.

Credit portfolio to households kept showing a mixed performance. On the one hand, the mortgage loan portfolio of commercial banks and their multiple purpose financial corporations (sofomes) kept expanding with dynamism, registering an average annual real growth rate of 5.7 percent, similar to the 5.6 percent rate observed in

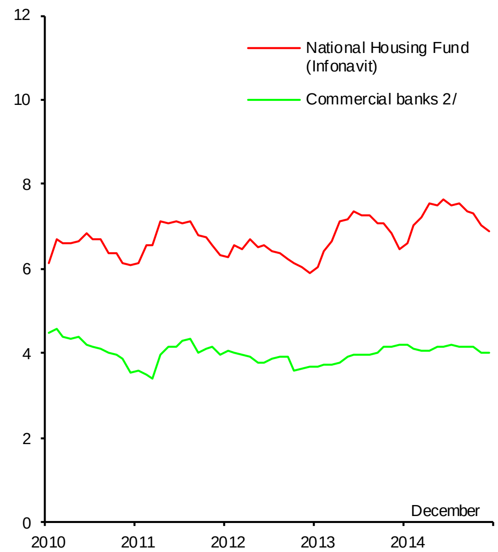
July-September 2014 (Chart 31a). This expansion occurred in an environment, in which interest and delinquency rate did not present any substantial changes (Chart 31b). On the other hand, the performing portfolio of the National Housing Fund registered an increase in its average growth rate during the fourth quarter of 2014, locating at 3.0 percent in real annual terms, although it still lies below the levels observed in previous years (Chart 31a). As regards the quality of the credit portfolio granted by the National Housing Fund, the delinquency rate of this institute's credit portfolio decreased as compared to the level observed in the third quarter (Chart 31b).

Chart 31
Housing Credit

a) Performing Housing Credit
Real annual change in percent



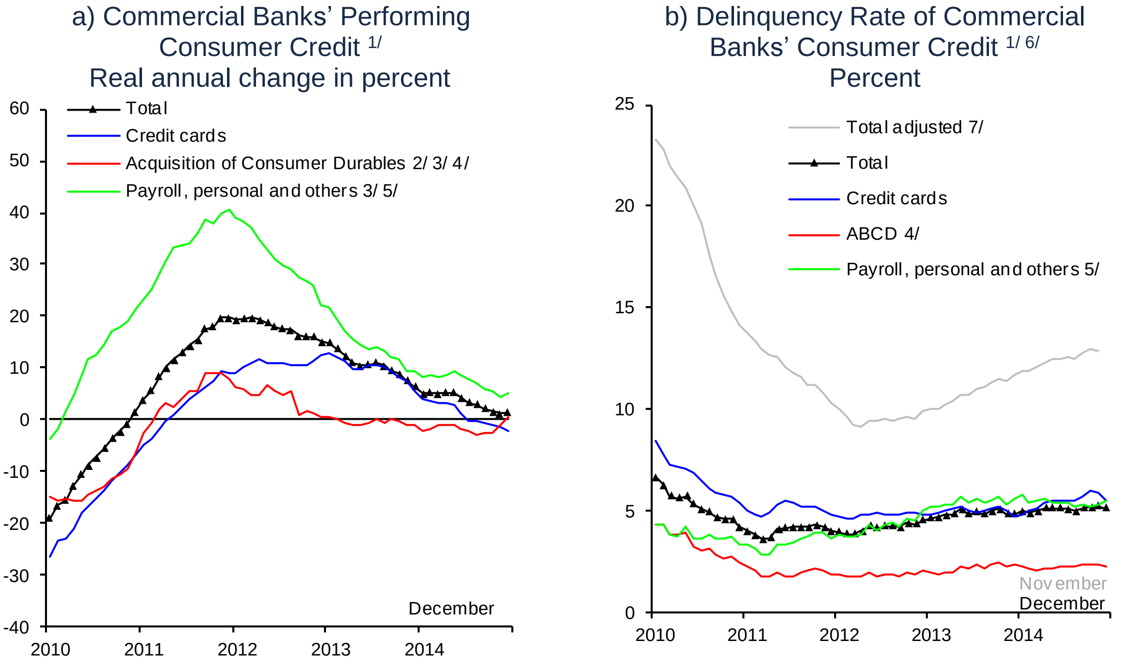
b) Delinquency Rates of Housing Credit [4/]
Percent



1/ Figures are adjusted in order to avoid distortions by the transfer from the UDIS trust portfolio to the commercial banks' balance sheet and by the reclassification of direct credit portfolio to ADES program.
2/ It includes sofomes owned by commercial banks.
3/Figures are adjusted to avoid distortions due to the inclusion of some regulated sofomes to the bank credit statistics.
4/The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.
Source: Banco de México.

Consumer credit moderated its growth rate, mainly reflecting the low dynamism that the credit card segment exhibited throughout the year (Chart 32a). In particular, during the period of October-December, the commercial banks' performing consumer credit portfolio expanded at an annual real rate of 1.4 percent, below the 2.8 percent rate observed in the period of July-September 2014. In this context, the corresponding interest rates and delinquency rates did not present significant changes (Chart 32b). However, the adjusted delinquency rate –which considers bad debt write-offs accumulated in the last twelve months– remains at high levels, which highlights the importance to remain alert to the evolution of this indicator in the following quarters.

Chart 32
Commercial Banks' Consumer Credit



1/ It includes loans by credit card-regulated sofomes: Tarjetas Banamex, Santander Consumo, Banorte-Ixe Tarjetas and Sociedad Financiera Inbursa.
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 acquisition of durable goods (ABCD) to other consumer credits by one banking institution.
4/ It includes credit for movable property acquisition and auto loans.
5/"Other" 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 debt write-offs accumulated over the last 12 months divided by total portfolio plus debt write-offs accumulated over the last 12 months.
Source: Banco de México.

Taking into account the recent changes in the macroeconomic environment –including tighter external financial conditions, low crude oil prices and adjustments to the fiscal policy announced by the Federal Government in January 2015– the results of a prospective exercise regarding the sources and uses of financial resources of the economy for the current year are presented below. This exercise shows the importance of maintaining the effort regarding the fiscal consolidation process, particularly given that it shows that the referred changes will be reflected in a more ample availability of resources to the private sector. In particular:

i. For the end of 2014, the annual flow of sources of financial resources is expected to increase to 9.8 percent of GDP, as compared to 8.6 percent observed in 2013 (Table 2). This was mainly a result of greater domestic sources, since it is estimated that the external sources will be similar to those registered last year.

Regarding the use of these resources, despite the increase in the sources, the flow of financing to the private sector is estimated to represent 2.5 percent of GDP, lower than the flow of 3.9 percent of GDP registered in 2013. The above, in the context of an increase of resources channeled to the public sector –including the PSBR and financing to states and municipalities- from 3.4 percent of GDP in 2013 to 4.2 percent in 2014, as well as greater resources channeled to finance the international reserve accumulation from 1.0 to 1.3 percent of GDP.

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

	Annual flows						
	2009	2010	2011	2012	2013	2014 p/	2015 e/
Total sources	**4.0**	**9.3**	**10.0**	**10.0**	**8.6**	**9.8**	**8.1**
Domestic sources	3.4	4.1	5.7	4.4	4.8	5.9	6.0
Voluntary M4	1.7	2.6	4.2	3.0	4.1	4.2	4.6
Compulsory M4 1/	1.7	1.5	1.5	1.4	0.7	1.7	1.4
Foreign sources	0.6	5.2	4.3	5.6	3.8	4.0	2.1
Non-resident M4	0.5	2.9	3.0	4.5	1.3	2.2	0.5
Securities and foreign credit 2/	0.2	2.3	1.3	1.1	2.5	1.8	1.7
Total uses	**4.0**	**9.3**	**10.0**	**10.0**	**8.6**	**9.8**	**8.1**
International reserves 3/	0.5	2.2	2.4	1.8	1.0	1.3	1.0
Public sector financing	3.4	3.8	2.9	3.7	3.4	4.2	3.6
Public Sector Borrowing Requirements (PSBR) 4/	2.6	3.4	2.7	3.2	3.0	4.0	3.3
States and municipalities	0.8	0.4	0.3	0.5	0.4	0.2	0.3
Private sector financing	0.0	2.5	3.5	3.1	3.9	2.5	2.8
Foreign	-0.4	0.5	0.7	0.8	1.6	0.7	0.4
Domestic 5/	0.4	2.0	2.8	2.4	2.4	1.8	2.4
Other 6/	0.2	0.8	1.1	1.4	0.2	1.8	0.5

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 2009 to 2014, 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).
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), as well as the domestic debt issuance.
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, non-monetary liabilities from IPAB, the effect of the change in the valuation of public debt instruments, as well as non-recurring revenues of the public sector derived from the net acquisition of financial assets and liabilities, among other concepts.
Source: Banco de México.

ii. For 2015, a possible reduction in the annual flow of sources of financial resources is expected; these flows are anticipated to represent 8.1 percent of GDP. This decrease would mainly reflect a lower availability of foreign resources –which would go down from 4.0 to 2.1 percent of GDP- in light of the expectation of increments in U.S. interest rates. In contrast, an expansion of domestic sources of financial resources from 5.9 to 6.0 percent of GDP is anticipated, in a context of higher economic growth, although this increase would not be sufficient to offset the fall in external sources (Table 2).

Given the expected reduction in external sources of financial resources, 2015 appears to be a year in which the private sector access to financing might be affected. However, the measures announced on January 30, 2015 by the Federal Government, aimed at lowering public expenditure, contribute to free up resources to the private sector in a less favorable external environment (see Box 2). Indeed, considering this adjustment to public expenditure and assuming that public revenues will remain unchanged in accordance with the 2015 Federal Income Law, this exercise considers that PSBR will reduce from 4.0 percent of GDP in this year, in line with the data in the 2015 CGPE, to 3.3 percent of GDP. Hence, the public sector's use of resources –including the PSBR and financing to states and municipalities- would shift from 4.2 percent of GDP to 3.6 percent in 2015. This would increase the availability of financial resources to the private sector, from 2.5 percent of GDP in 2014 to 2.8 percent in 2015, even given the expected decrease in total sources as mentioned above.

In sum, the above illustrates the relevance of the recently announced fiscal adjustment to facilitate the economy's transition to an external environment with less favorable financial market conditions. Likewise, it stresses the importance of continuing with the fiscal consolidation process in the next years, given that, besides guaranteeing the sustainability of public debt, it would allow the channeling of more resources to the private sector and would mitigate possible pressures in credit markets, in particular on interest rates. This is particularly relevant in light of the foreseen recovery of economic activity in the following years, given that it is anticipated that it would be associated with a gradual rise in the demand for financing by the private sector.

Box 2
Fiscal Responsibility Measures

1. Introduction

On January 30, 2015, the Federal Government announced a set of fiscal responsibility measures in order to strengthen the stance of public finances from an intertemporal perspective, in light of a less favorable external environment (including the crude oil market) for the following years. The referred measures include the next: i) a preemptive adjustment to the public sector programmable expenditure in 2015, which implies a reduction by MXN 124.3 billion, with respect to the level approved by the Congress, equivalent to 0.7 percent of GDP; and, ii) a comprehensive revision in the elaboration of the Federal Government's Expenditures Budget (PEF, for its acronym in Spanish) from 2016 onwards in order to eliminate duplication in functions and structures, and to prioritize investment projects with greater social and economic impact, thus generating greater efficiency in public expenditure.

This Box explains the background in which the recently announced fiscal responsibility measures take place. In particular, a reference is made to the macroeconomic stance in recent years and to the dependence of public revenues on crude oil revenues, to explain why, in light of the crude oil price drop, it was necessary to accelerate the fiscal consolidation process. Subsequently, a description of the announced fiscal measures is presented.

2. Economic Environment and Macroeconomic Policy Stance

In recent years, the macroeconomic stance in Mexico has been expansionary in an environment of high oil prices, which until recently were expected to remain at high levels for an extended time period, and an environment of low inflation, converging towards the set target.

In this context of high oil prices, the fiscal policy was expansionary, so that in recent years increments in public deficit were observed. Moreover, primary deficit balances were reached. Thus, the Public Sector Borrowing Requirements (PSBR) went up to 4.0 percent of GDP in 2014. As a consequence of the accumulation of fiscal deficits, the Historical Balance of PSBR (HBPSBR), which is the broadest indicator of public debt in Mexico, reached 41.0 percent of GDP in 2014.

However, as mentioned in this Report, the macroeconomic environment was modified drastically, following the recent fall in oil prices, which in the medium term are not expected to keep the levels observed in recent years. This makes necessary to modify the macroeconomic stance to make it consistent with the new environment.

Due to the fact that budget revenues are highly dependent on oil revenues, and considering the recent raise in public deficit and public debt, the fall in the Export Price of the Mexican Oil Mix (PMME, for its acronym in Spanish) highlighted the need to change the course and to adjust the fiscal stance to strengthen the macroeconomic framework.

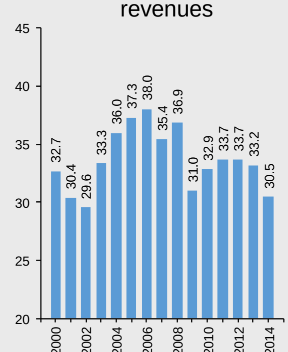
The adjustment in public finances introduced in the expenditure item is congruent with the fact that, given the persistent nature of the crude oil price fall, the adjustment also had to be persistent. That is, lower crude oil revenues could not have been funded with greater deficit without risking the long-term fiscal sustainability. Hence, the referred fiscal adjustment is an important step that maintains the expectation that fiscal deficit will follow a trend over the next years, in line with the projections of the 2015 General Criteria of Economic Policy (CGPE, for its acronym in Spanish), and strengthens the confidence in the fiscal policy conduction in the medium term.

3. Public Finances' Dependence on Oil Revenues

Over the last 15 years, oil revenues represented around one third of budgetary revenues of the public sector (Chart 1a). This share reached a maximum level of 38.0 percent in 2006, and since then it has diminished to 30.5 percent in 2014. This reduction since 2006 was due to two factors: i) the crude oil production decreased by 25.4 percent between 2006 and 2014, which was partially offset by the increment in PMME, which shifted from an annual average of USD 53.0 per barrel in 2006 to USD 86.0 per barrel in 2014, (Charts 1b and 2a); and, ii) that in the period of 2006-2014, various fiscal measures were implemented so as to increase fiscal revenues.

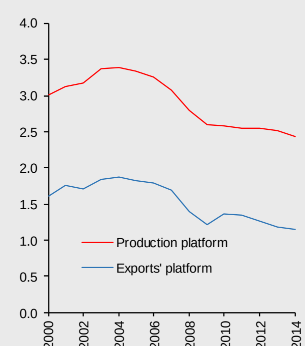
Chart 1

a) Public Sector Oil Revenues
Percent of budgetary revenues



Source: Ministry of Finance (SHCP).

b) Oil Production and Exports
Millions of barrels a day



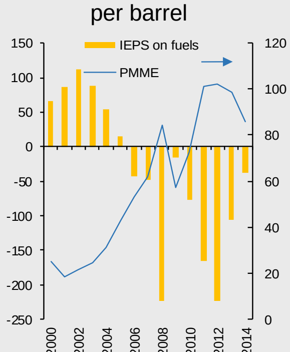
Source: SENER.

In light of a lower crude oil price, there are two mechanisms operating as automatic stabilizers that allow mitigating its effect on public finances:

- The first one refers to imports of oil derivatives, which, just like oil exports, vary due to the fluctuations of international oil prices. Thus, a lower oil price decreases the value of oil derivatives' imports, mitigating the negative impact on the value of crude oil exports.
- The second mechanism consists in the way in which the Excise Tax (IEPS) on gasoline and diesel is calculated. Given that the domestic prices of Magna and Premium gasoline and of diesel are administered by the Federal Government, the IEPS on fuels was designed as a shock-absorber in light of the changes in international oil prices. The IEPS on fuel section I equals the difference between the retail price minus the integrated price composed of the Pemex revenue price (the international reference price adjusted for fuel-quality parameters) plus shipping costs, concessionaires' profit margin and taxes. This difference can be positive, in which case it behaves as a tax, or negative, which generates a subsidy to consumers. Thus, when the crude oil price decreases, the international fuel prices and the integrated price follow, and the IEPS tends to behave as a Federal Government tax, that can be passed on to the final consumer, as it is currently happening with low crude oil prices. On the contrary, when the crude oil price increases, the IEPS could become a subsidy to consumers, as it happened between 2006 and 2014 (Chart 2a and Chart 2b).

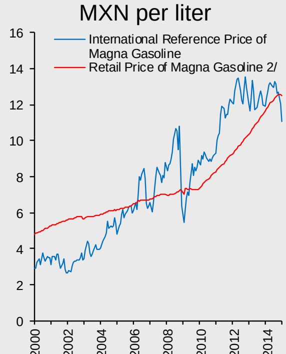
Chart 2

a) IEPS on Fuel and PMME[1/]
MXN and USD billions per barrel



1/ PMME= Export Price of the Mexican Oil Mix
Source: SHCP and SENER.

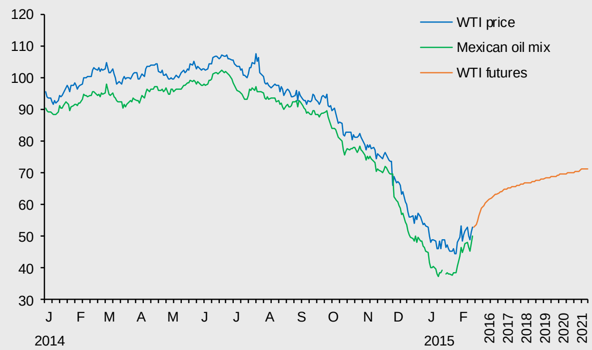
b) International Price and Retail Price of Magna Gasoline
MXN per liter



2/ Price excluding state funding.
Source: SENER.

Although these two mechanisms diminish the effect of lower oil prices on public finances, it should be recalled that Pemex is a net hydrocarbon exporter, reason for which oil revenues are expected to be lower, given the decrease in oil prices. In this sense, the plunge in oil prices and the expectation that it will not recover over an extended time period (Chart 3), along with the decline in the oil production platform in recent years, and high deficit levels, required a fiscal adjustment with a structural approach.

Chart 3
Prices and Oil Price Futures
USD per barrel



Source: Bloomberg.

4. Recently Announced Fiscal Responsibility Measures

On January 30, 2015, the Federal Government announced two fiscal adjustment measures: i) a preemptive adjustment of pubilc sector programmable expenditure of this year and ii) a comprehensive revision in the elaboration of the PEF for 2016.

Adjustment to Public Expenditure of 2015

The adjustment to the approved 2015 programmable expenditure, which will be implemented preemptively, given the risks faced by public finances, is of MXN 124.3 billion, which equals to 0.7 percent of GDP. This adjustment represents reductions of 2.6 percent of the originally approved total expenditure for 2015 and of 3.4 percent with respect to the programmable expenditure. This measure is additional to the already implemented strategy of oil hedges contracted by the Federal Government.

Specifically, the announced adjustment will consist in a reduction of MXN 52.3 billion in the expenditure channeled to the Federal Government ministries and entities; of MXN 62.0 billion in the Pemex expenditure, equivalent to 11.5 percent of its original programmable budget; and, of MXN 10.0 billion in the expenditure of the Federal Electricity Commission (CFE, for its acronym in Spanish) corresponding to 3.2 percent of its original programmable budget.[1] Among the reductions affecting the Federal Government offices stand out those applied to the Secretary of Communications and Transport (SCT) of MXN 11.8 billion, to the Secretary of Public Education (SEP) of MXN 7.8 billion, to the Secretary of Agriculture, Livestock and Rural Development, Fisheries and Food of Mexico (SAGARPA) of MXN 7.2 billion, and to the National Water Commission (CONAGUA) of MXN 6.4 billion, and to the Secretary of Social Development (SEDESOL) of MXN 3.8 billion and to the Secretary of Health of MXN 3.3 billion (equivalent to 9.4, 2.6, 7.8, 12.7, 3.3. and 2.5 percent of their original budget, respectively) (Table 1).

The reduction of expenditure of the federal public administration, excluding Pemex and CFE, will imply a decrease of MXN 34.1 billion in current spending (65 percent of total) and of MXN 18.1 billion (35 percent of total) in capital spending. The adjustment to the current expenditure considers a decrease of MXN 15.0 billion in subsidies, of MXN 12.3 billion in other operating expenses and of MXN 6.8 billion in the spending on personal services.

Table 1
Breakdown of Public Spending Adjustment in 2015

	Fiscal adjustment MXN billion	% with respect to approved budget
Total spending	**124.3**	**2.6**
Programmable spending	**124.3**	**3.4**
Pemex	62.0	11.5
CFE	10.0	3.2
SCT	11.8	9.4
SEP	7.8	2.6
SAGARPA	7.2	7.8
CONAGUA	6.4	12.7
SEDESOL	3.8	3.3
Healthcare	3.3	2.5
Other offices	12.0	2.1

Source: Ministry of Finance.

Expenditure cuts to the public sector will prevent a crowding out of the private sector spending, which could take place if the Federal Government decided to offset lower oil revenues, either by increasing deficit, thus generating the expectation of higher taxes in the future, or through an increase in taxes, through modifications to the fiscal framework. Similarly, if the deficit is reduced by means of a permanent adjustment to expenditure, the probability that an increment in sovereign risk premia takes place diminishes, in light of the signal of fiscal prudence given by the Federal Government.

Reengineering Expenditure for 2016

For the elaboration process of the 2016 PEF, a comprehensive revision of the public expenditure structure is expected, so that its planning will no longer be carried out intertially and in 2016 it will be designed from a “zero base” perspective. The “zero based” budgeting would consist in evaluating each of expenditure items, always starting from zero. That is, it would be drawn as if it were the first budget prepared by the government, and the amounts and needs of each items would have to be evaluated and justified.

Thus, the budget will be fundamentally based on the real spending needs for the following year, without using previous years’ references. This would imply a reengineering of public expenditure, given the inertial character of the PEF in recent years. Thus, this is an opportunity to correct this inertia, which has led to little flexibility in drafting a budget, given the high level of expenditure channeled to regularized expenditure, i.e. expenditure’s item that is implied as permanent and frequently with a growing trend in subsequent fiscal years. For example, personal services and operating expenses of public firms and entities. Thus, it will represent an effort to eliminate duplication of functions and structures, and to give priority to investment projects with the greatest social and economic impact to make the most efficient use of expenditures.

5. Final Remarks

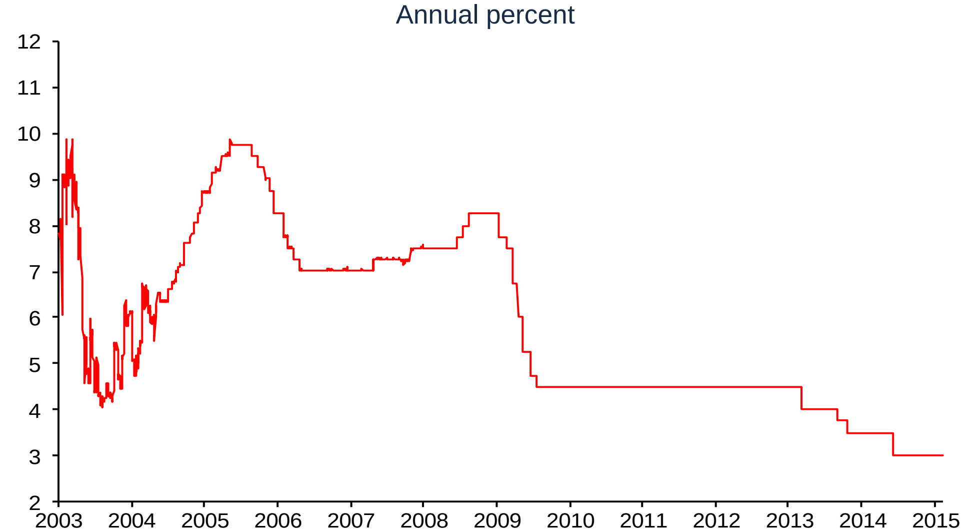
The expectation that low oil prices and oil production will persist implied the necessity to carry out an adjustment in public expenditure. This adjustment strengthens the fiscal position of the government and limits the crowding out effect on private sector financing in the economy. The above means a more solid macroeconomic framework and it is expected to strengthen confidence regarding the Mexican economy. Additionally, the conduction and the effectiveness of the monetary policy will also be favored by an intertemporal stance of sustainable public finances, given that sound public finances constitute a necessary condition for a low and stable inflation.

1 Pemex Board of Directors approved the plan of the budgetary adjustment of MXN 62.0 billion, on February 13, 2015. The CFE budget adjustment is still to be approved by the Board of Directors.

4. Monetary Policy and Inflation Determinants

The monetary policy implemented by Banco de México seeks to procure the stability of the national currency's purchasing power. This has been reflected in the evolution of headline inflation which, despite the different shocks it has been subject to, since various years ago has presented a gradual trend towards its 3 percent target and a favorable performance of its core component. As proof of this, despite the increment of inflation since early 2014, inflation expectations remained well-anchored during all year, suggesting that the price determination process was not contaminated by the said supply shocks. Indeed, as the effects of the shocks that affected inflation in 2014 started to reverse, it presented a considerable decrease from November onwards to achieve levels close to 3 percent in January 2015. In this context, after having reduced the Overnight Interbank Interest Rate by 50 basis points in June 2014, during the third quarter and the period covered by this Report, Banco de México's Board of Governors decided to maintain the target for this rate at 3 percent (Chart 33).

Chart 33
Overnight Interbank Interest Rate 1/
Annual percent



1/ The Overnight Interbank Interest Rate is shown until January 20, 2008.
Source: Banco de México.

Among the elements considered to justify the above referred monetary policy decisions, the following stand out:

a) The fact that, given the moderate performance of the economic activity in the second half of 2014, slack conditions still prevailed in the economy and no generalized and sustained aggregate demand-related pressures on prices were anticipated.

b) The evolution of inflation expectations implicit in market instruments' interest rates and survey-derived inflation expectations, which remained well-anchored.

c) The expectation that, despite the presence of volatility in international financial markets, markets in Mexico would continue operating in an orderly manner and the pass-through of exchange rate adjustments onto prices would be low.

d) Considering the above, it was anticipated that, although annual headline inflation would lie around 4 percent in late 2014, it would decrease considerably in early 2015 to converge to 3 percent from the middle of the year onwards.

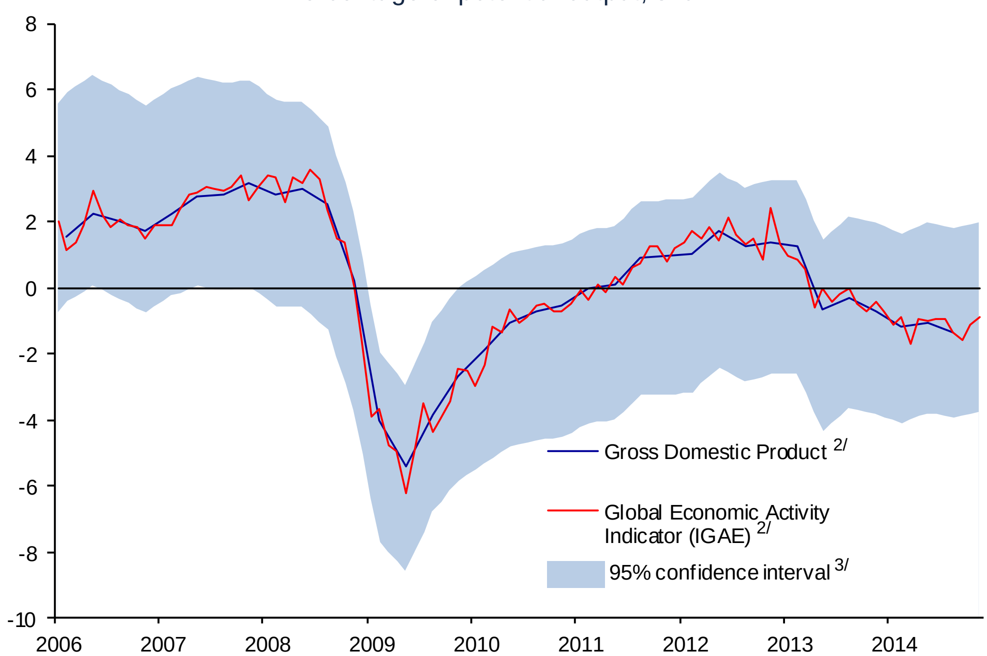
Analyzing more in depth the abovesaid, as a result of the deceleration of the economic activity in the second half of 2012 and early 2014, slack conditions persisted in the economy, despite the moderate recovery that economic activity had shown in the last quarters. Therefore, no aggregate demand-related pressures on prices of either the main input markets or external accounts were observed. In particular:

a) The output gap remained negative, although it is expected to continue closing gradually (Chart 34).[3]

b) As mentioned above, slack conditions persist in the labor market, although they seem to be decreasing.

c) Lower real average income of the employed population, along with the growing trend presented by labor productivity, contributed to the fact that unit labor costs for the economy as a whole continue at very low levels (Chart 35).

Chart 34
Output Gap Estimation 1/
Percentage of potential output, s. a.



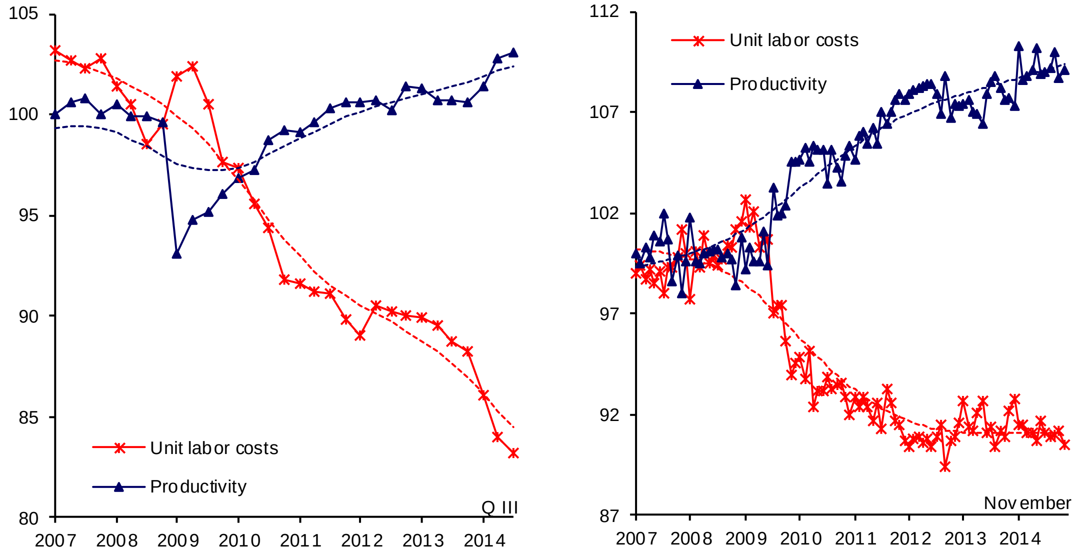
s. a. / Prepared with seasonally adjusted data.
1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction: see Banco de México Inflation Report, April-June 2009, p. 69.
2/ GDP figures as of the third quarter of 2014, IGAE figures as of November 2014.
3/ Confidence interval of the output gap calculated with an unobserved components' method.
Source: Prepared by Banco de México with data from INEGI.

3 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
Productivity 1/ and Unit Labor Cost

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

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



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line. Trends estimated by Banco de México.
1/ Productivity based on the number 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.

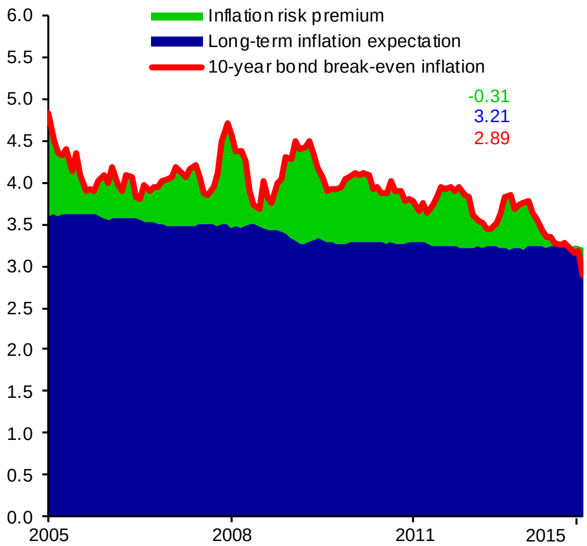
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
1/ Productivity based on the number of hours worked.
Source: Prepared by Banco de México wish seasonally adjusted data from the Monthly Manufacturing Business Survey and the monthly indicator of the Mexico's System of National Accounts, INEGI.

Inflation expectations implicit in long-term market instruments continue being at levels close to 3 percent. Thus, this indicator of inflation expectations, estimated from 10-year market instruments, remained stable around 3.2 percent between September 2014 and January 2015, while the associated inflation risk premium decreased during the same period (Chart 36a). Hence, break-even inflation (the difference between long-term nominal and real interest rates) has been registering historic lows. Moreover, in the analyzed period, it shifted from an average level of 3.3 percent to 2.9 percent (Chart 36b). This drop seems to be related to a reduced appetite for holdings of inflation-indexed instruments, which, in turn, could be increasing the liquidity premium demanded by investors to maintain the said instruments. This implies that the inflation risk premium, which reduced from 5 basis points to minus 30 basis points during the reference period, could also be affected by the said liquidity premium.[4] Additionally, in an environment in which financial markets register low risk-adjusted returns in their assets, risk premia demanded by investors may reduce or even become negative, due to the diversification benefits offered to their portfolios. In sum, the reduction still registered by this indicator suggests that holders of nominal rate-indexed instruments have been demanding less coverage for future inflation during last year.

[4] For a description of the estimation of long-term inflation expectations, see Box "Decomposition of the Break-even Inflation" in the Quarterly Report, October-December 2013.

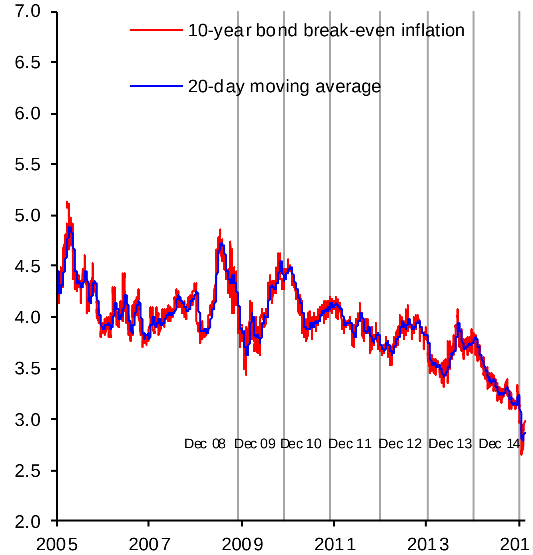
Chart 36
Inflation Expectations

a) Decomposition of Break-even Inflation and Inflation Risk 1/
Percent



1/ Last data available: January 2015.
Source: Estimated by Banco de México.

b) 10-year Bond Break-even Inflation
Percent



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

Regarding inflation expectations obtained through Banco de México's surveys among private sector specialists, the median for the end of 2014 located at levels slightly above 4 percent, shifting from 3.9 to 4.1 percent between the surveys of September and December. This occurred due to the increment in inflation in the third quarter and in October 2014.[5] On the other hand, the median of expectations for core inflation for the end of the same year decreased slightly from 3.5 to 3.4 percent between the referred surveys, while the non-core inflation expectation, implicit in the referred median estimates increased from 5.5 to 6.5 percent.

The median of headline inflation expectations for the end of 2015 reduced from 3.5 to 3.2 percent between the surveys of September and January, mainly following the reduction in inflation in January.[6] In particular, the median of core inflation expectations changed from 3.2 to 2.9 percent, while the implicit non-core inflation expectation reduced from 4.4 to 4.0 percent in the referred period. Finally, longer-term inflation expectations remained stable around 3.5 percent (Chart 37a and Chart 37b).[7]

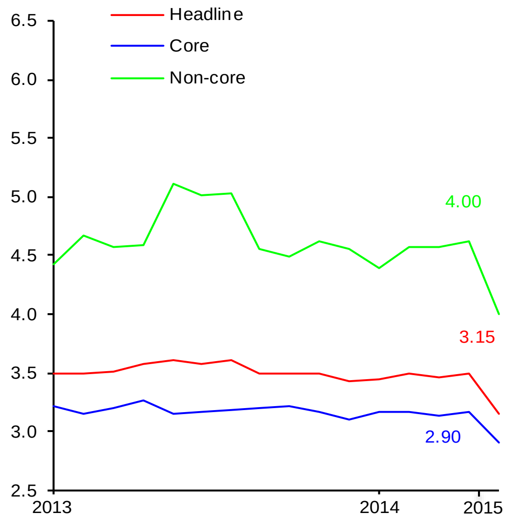
[5] According to Banamex Survey of Financial Market Analysts' Expectations, the median of headline inflation expectation for the end of 2014 registered a similar behavior, locating at 3.9 percent in the survey of September 22, 2014 and increasing to 4.1 percent in the survey of January 7, 2015.

[6] Similarly, the median of headline inflation expectation for the end of 2015, based on the Banamex survey, reduced from 3.4 percent in the survey of September 22, 2014 to 3.1 percent in the survey of February 5, 2015.

[7] The median of long-term inflation expectations in the Banamex survey (corresponding to the period 2016-2020 in the surveys of 2014 and to the period 2017-2021 in those of 2015) also persisted, on average, around 3.5 percent between the surveys of September 22, 2014 and February 5, 2015.

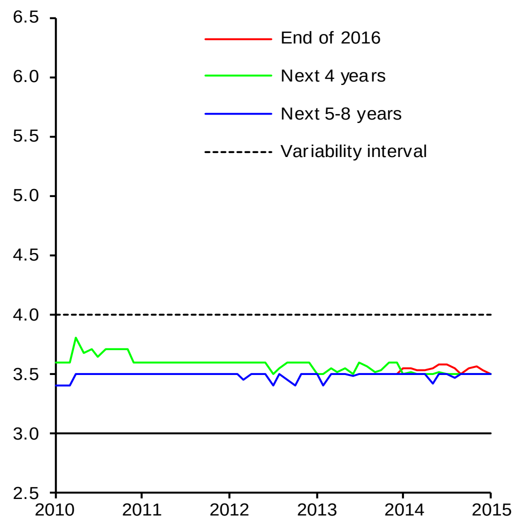
Chart 37
Inflation Expectations

a) Medians of Headline, Core and Non-core Inflation Expectations as of End of 2015 1/
Percent



1/ Last data available: January 2015.
Source: Banco de México's survey.

b) Medians of Headline Inflation Expectations of Different Terms 2/
Percent



2/ Last data available: January 2015.
Source: Banco de México's survey.

As mentioned above, during the period covered by this Report, two shocks in the international environment, which affected international financial markets and thus the performance of Mexico's financial markets, took place. In this regard, it should be noted that, in general terms, so far adjustments in the national markets took place in a relatively orderly manner.

In this context, the index of the Mexican Stock Exchange reversed the profits observed during the third quarter of 2014, registering a drop of around 5 percent from late September to early February. Likewise, just like other advanced and emerging economies' currencies, the Mexican peso observed an increase in its volatility and an important depreciation against the USD, shifting from an average level of MXN/USD 13.4 to 14.9 during the same period (Chart 38a and Chart 38b). Thus, in response to this environment of greater volatility and in order to procure an orderly functioning of the national exchange market, on December 8, 2014 the Foreign Exchange Commission decided to reactivate the daily auction of dollars' mechanism, by which USD 200 million a day are offered at a minimum price that is 1.5% above the previous day's exchange rate (FIX), set by the Central Bank. It is noteworthy that, since its reactivation and to date, the referred mechanism has generated sales on a single occasion. Specifically, on December 11, 2014, when USD 200 million were assigned.

As for the exchange rate evolution, it should be noted that the value of the national currency has been particularly sensitive to drops in crude oil prices and the possibility that they remain at low levels for an extended period of time, partly reflecting concerns regarding their fiscal and current account implications. This suggests that a part of the observed Mexican peso adjustment is due to real factors, which implies a more depreciated real exchange rate. However, it is noteworthy that the exchange market has preserved conditions of adequate liquidity, the Mexican peso being the emerging economies' currency with the highest trading volume

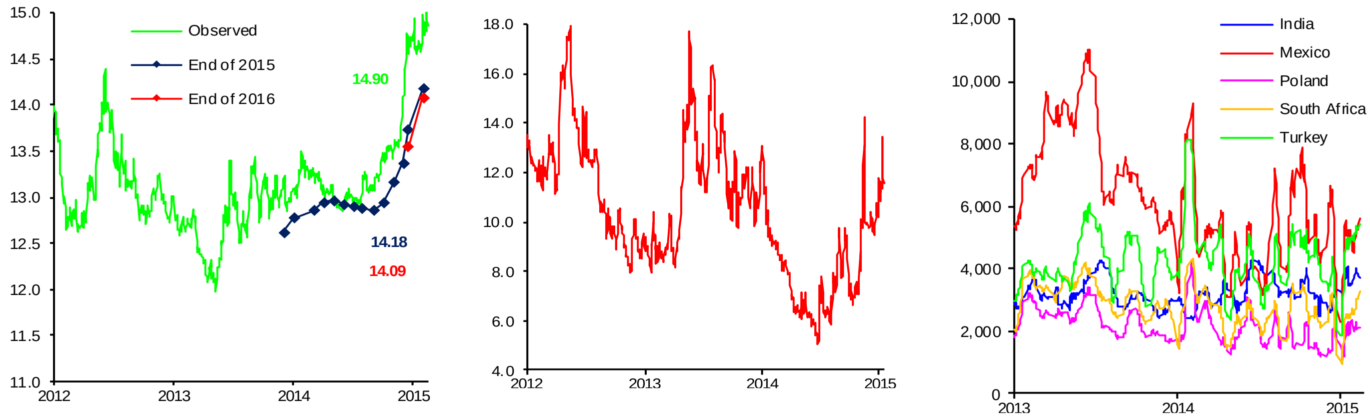
(Chart 38c), and that the existence of a wide derivatives market allows economic agents to efficiently hedge against exchange risks. Thus, a 13 percent depreciation of the Mexican peso against the U.S. dollar during 2014 contrasts with an average depreciation of approximately 18 percent, registered by a group of emerging economies' currencies during the same period.[8] It is also worth pointing out that the above mentioned fiscal adjustment will facilitate the required adjustment of the real exchange rate, while offsetting upward pressures onto interest rates.

Chart 38
Exchange Rate, Currency Option Implied Volatility and Trading Volume in the Exchange Market

a) Nominal Exchange Rate and Exchange Rate Expectations for End of 2015 and 2016 1/
MXN/USD

b) Currency Option Implied Volatility 2/
Percent

c) Daily Volume Traded of Emerging Economies' Currencies
USD million



1/ The observed exchange rate is the daily quote of the FIX exchange rate. The latest quote of the observed exchange rate corresponds to February 12, 2015. For its expectations, the latest quote corresponds to the survey of January 2015.
Source: Banco de México and Banco de México's Survey.

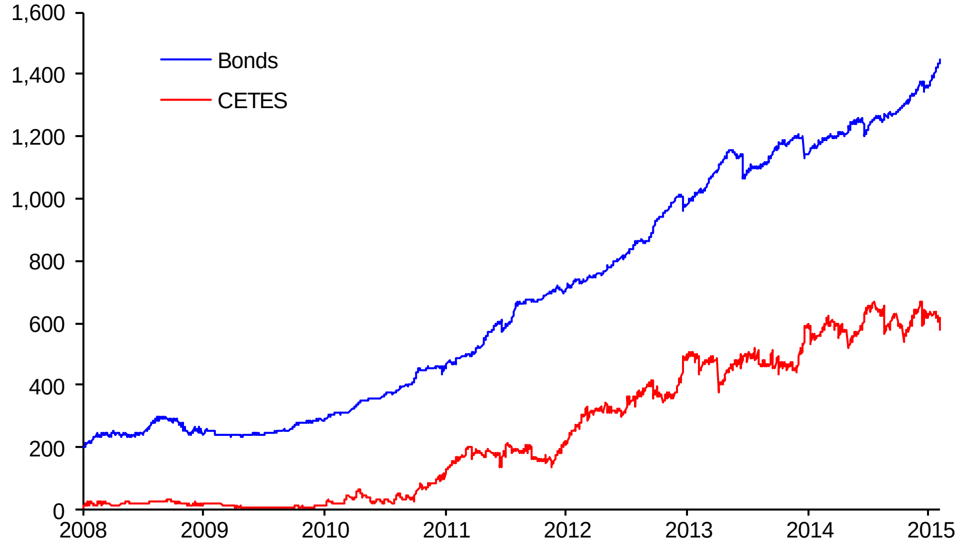
2/ Currency option implied volatility refers to one-month options.
Source: Bloomberg.

Source: Reuters.

Despite greater volatility in the financial markets, Mexico kept attracting foreign resources channeled to the acquisition of financial instruments in national currency. Thus, investors' holdings of short-term government instruments increased slightly in the fourth quarter of 2014, while those of medium- and long-term government instruments continued with their upward trend and remained at high levels (Chart 39).

[8] The depreciation of other emerging economies' currencies considers the average performance of the exchange rate of the currencies of Brazil, Chile, Colombia, Czech Republic, India, Peru, Russia, Thailand and Turkey against the U.S. dollar and is calculated with data from Bloomberg.

Chart 39
Government Securities' Holdings by Foreign Investors
MXN billion

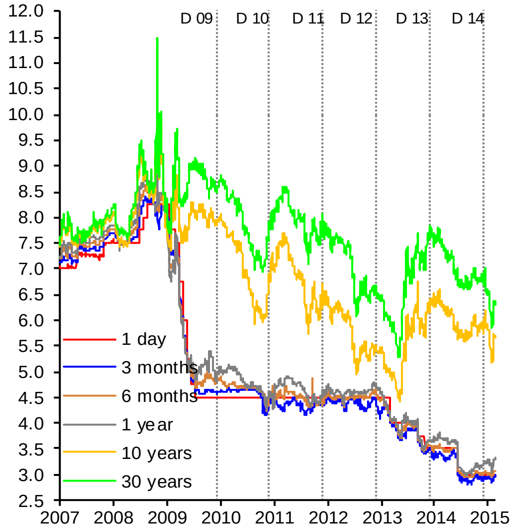


Source: Banco de México.

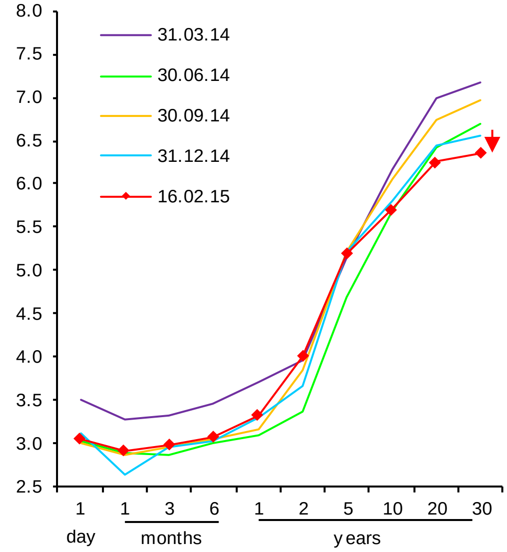
Regarding the evolution of longer-term interest rates in Mexico, it should be noted that, in line with the performance of long-term interest rates in the U.S. and given the recent increase observed in the correlation between these two variables, they have decreased. In particular, the 10-year government bonds interest rate reduced by approximately 40 basis points, shifting from 6.1 percent in late September to 5.7 percent in early February, although with a rebound in the first weeks of that month. In turn, shorter-term interest rates registered marginal upward adjustments during the same period. Thus, the 2-year interest rate increased from 3.8 to 3.9 percent, while the 3-month interest rate went up from 2.9 to 3.0 percent (Chart 40a). Accordingly, the slope of the yield curve (the difference between 10-year and 3-month rate) reduced from approximately 320 to 270 basis points from late September 2014 to early February 2015 (Chart 40b).

Chart 40
Interest Rates in Mexico

a) Government Securities' Interest Rates [1/]
Percent



b) Yield Curve
Percent

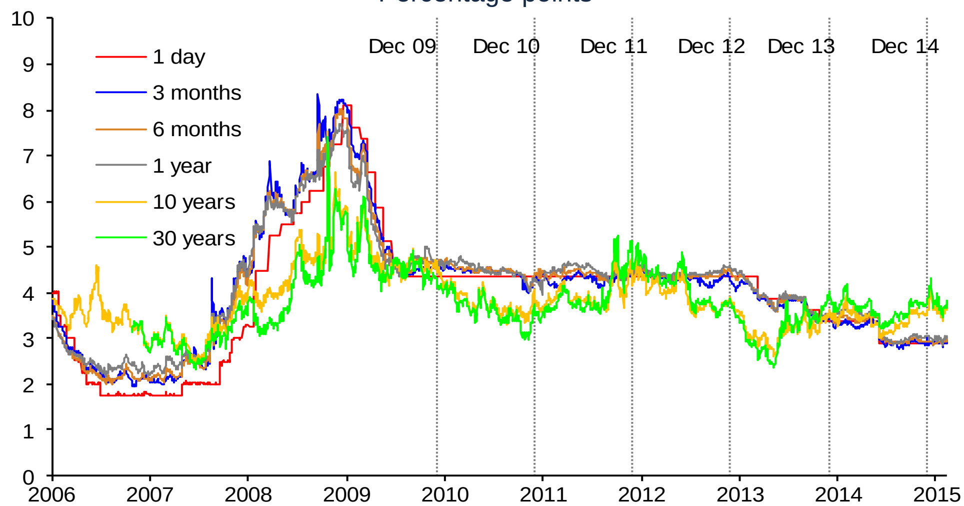


1/ Since January 21, 2008, the one-day (overnight) interest rate corresponds to the target for the Overnight Interbank Interest Rate.
Source: *Proveedor Integral de Precios* (PiP).

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

In line with the interest rate evolution of government securities in Mexico and due to the fact that those of the U.S. registered a greater decrease, the interest rate spreads between these two economies increased during the analyzed period. In particular, the 10-year interest rate spread went up from around 350 to 370 basis points (Chart 41).

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



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

To further examine the evolution of longer-term interest rates in Mexico, as on other occasions, the performance of their components should be analyzed: the short-term interest rate (reference rate); the implicit short-term interest rates that consider the medium- and long-term inflation expectation; and, the risk premia. In this regard, the following stands out:

a) The target for the Overnight Interbank Interest Rate remained at 3.0 percent in the analyzed period.

b) Expected short-term interest rates continued without change during the same period. In particular, according to Banco de México's survey among private sector specialists, the median of expectations for the interbank interest rate at the end of 2014 remained at 3.0 percent in the surveys from September to December. A similar evolution is inferred from the expectations implicit in market instruments' interest rates.

c) Finally, the evolution of different risk premia in Mexico was differentiated. Thus:

   i. Market indicators that measure sovereign credit risk increased by around 30 basis points from late September to early February.[9]

   ii. Inflation risk premium continued its downward trend in the analyzed period. In particular, it reduced by 25 basis points from September to date (Chart 36a).

   iii. As for the performance of the exchange risk premium, which is estimated by means of the spread between the interest rate of the 10-year government bond issued in MXN and that of the same term issued in the USD, it reduced between September and February (Chart 42a).

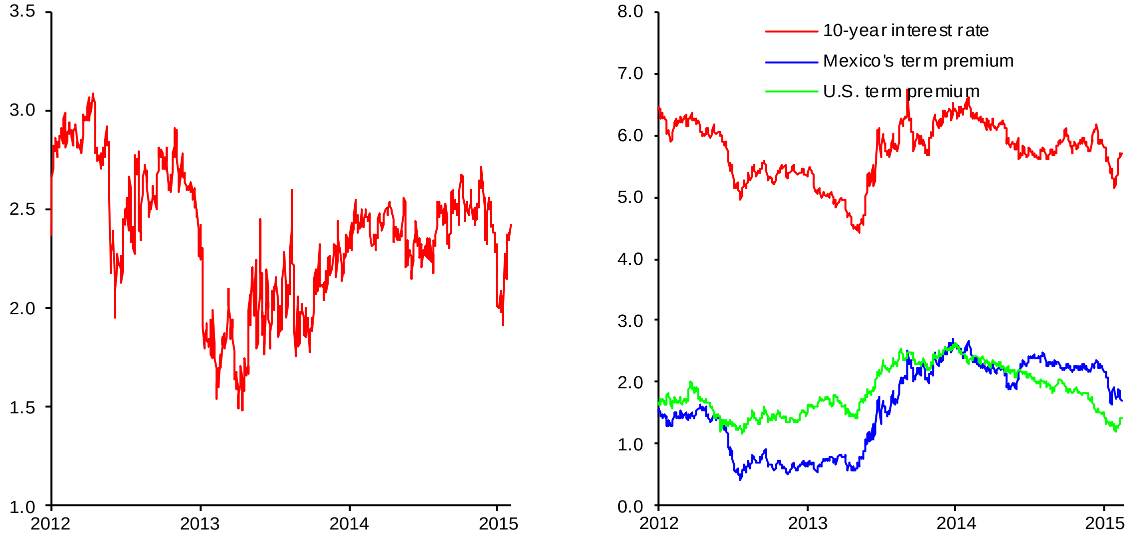
   iv. Finally, an indicator of the term premium (estimated as the difference between the 10-year and 2-year interest rates) decreased, shifting from levels of around 230 to 180 basis points from the end of September to the beginning of February (Chart 42b).

[9] It refers to 5-year Credit Default Swap.

Chart 42
Risk Premia

a) Spread between MXN- and USD-indexed 10-year Bond Rate
Percentage points

b) Mexico's 10-year Government Bond Interest Rate and the Term Premium 1/
Percentage points, percent



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

1/ The term premium refers to the difference between the 10-year and the 2-year interest rate.
Source: Banco de México, *Proveedor Integral de Precios* (PiP) and Bloomberg.

Considering the above described external environment, it should be noted that, in the future, the Mexican peso exchange rate against the U.S. dollar could be affected by the normalization process of the U.S. monetary policy, even though it is possible that part of the impact of this process has already been incorporated by market participants. Although it is expected that the Federal Reserve will carry out a gradual and orderly withdrawal of this stimulus, there is uncertainty regarding the time frame and the results of this process. Therefore, new episodes of high volatility in international financial markets cannot be ruled out, which may affect the national currency's exchange rate and, eventually, inflation. In this sense, despite the evidence of various years that the pass-through of the exchange rate movements onto prices is low and that its effect on inflation tends to be transitory, the national currency already depreciated considerably and could remain at current levels for an extended time period or even register further depreciations with a possible effect on inflation. Hence, the above should be considered among upward risks to inflation. For this reason, the Central Institute will remain alert to guarantee that indeed the pass-through of the exchange rate adjustment onto domestic prices will persist at low levels.

Following on the last idea, given a less favorable external environment faced by the Mexican economy, it was necessary to strengthen the macroeconomic policy framework, adopting a stance in line with the new international reality. In particular, it was necessary to adjust the aggregate demand to a context characterized by lower crude oil prices with a consequent effect on public revenues, and, as mentioned above, on the real exchange rate. In this sense, the fiscal responsibility measures announced by the Federal Government are anticipated to contribute to this adaptation. It should be noted that adjustments in the federal public expenditure contribute, on the one hand, to facilitating an orderly depreciation of the real exchange rate, and, on the other hand, to mitigating the impact of the adjustment in the macroeconomic policy stance on private expenditure. In this context, the announced measures constitute an appropriate policy response to the described external environment. Likewise, they help consolidate an environment of low inflation, while boosting investors' confidence in the sustainability of public debt and strengthening the anchoring of inflation expectations. This clearly increases the degrees of freedom of the monetary policy, which will adjust to strengthen the macroeconomic policy framework when appropriate.

5. Inflation Forecast and Balance of Risks

As mentioned in this Report, the external environment faced by Mexico has become less favorable. Indeed, it is expected that in 2015 and in 2016 crude oil prices will remain below those registered until mid-2014. Moreover, even though the forecast for the U.S. economic growth continues suggesting that the recovery will persist, uncertainty prevails over the date when the Federal Reserve will carry out its first increment in the federal funds rate and over the rate of subsequent adjustments. The situation in Greece and its possible impact on the rest of the Euro zone is also a reason for concern. Therefore, new episodes of volatility in international financial markets cannot be ruled out.

To facilitate the transition of the Mexican economy in this new environment, the macroeconomic policy adjustment to a less stimulative stance was required. In this context, as mentioned above, an important first step was the recent announcement of the Federal Government regarding the preemptive adjustment of public expenditure in 2015, and, particularly, regarding the comprehensive review of all items of public expenditure so as to achieve greater efficiency in allocating public resources from 2016 onwards. The strengthened public finances are expected to positively affect investors' confidence in the future. For that, it is estimated that this adjustment will help encourage a favorable environment for economic growth, while strengthening the macroeconomic fundamentals of the country. It should be also pointed out that the observed reduction of inflation of over one percentage point in January and the expectation that it will remain at around 3 percent for the rest of the year imply higher real interest rates, which also partly mitigates the expansive monetary policy.

In addition to the abovesaid, the macroeconomic scenario estimated for Mexico considers the following forecasts for the U.S. economic activity:[10]

a) U.S. GDP expanded 2.4 percent in 2014, which is compared to the 2.2 percent forecast in the previous Report. For 2015, this indicator is estimated to grow 3.2 percent, with respect to the 3.0 percent anticipated in the last Report. For 2016, the forecast remains unchanged at 2.9 percent.

b) Industrial production in the U.S. in 2014 registered a growth rate of 4.2 percent, which compares to the expectation of 4.0 percent in the previous Report. For 2015, the anticipated growth for this indicator is 3.9 percent (the expectation of 3.6 percent in the last Report). For 2016, just as in the previous Report, an increment of 3.3 percent is expected.

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 certain 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

[10] Expectations for the U.S. economy are based on the consensus of analysts surveyed by Blue Chip in February 2015.

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, the activities that started to recover in 2014, as is the case of the construction sector in Mexico, are estimated to continue supporting productive activity.

Despite the abovesaid, the expected 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 43a). 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.

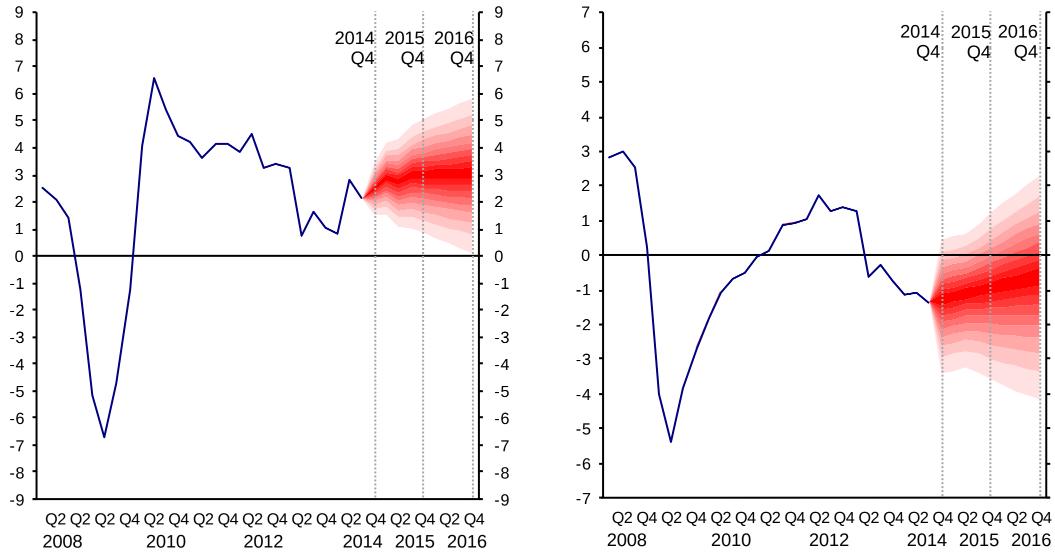
Current Account: In 2014, the trade balance registered a deficit of 2.4 billion USD (estimated 0.2 percent of GDP), reason for which the current account deficit is expected to have amounted to 26.5 billion USD (2.1 percent of GDP). For 2015, trade balance and current account deficits of 6.0 and 28.7 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 43b).

Chart 43
Fan Charts: GDP Growth and Output Gap

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

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



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

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

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. A 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 a somewhat higher one 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 44). Core inflation is estimated to lie below 3 percent throughout 2015 (Chart 45). 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 inflation dynamics.

Among downward risks the next are noteworthy:

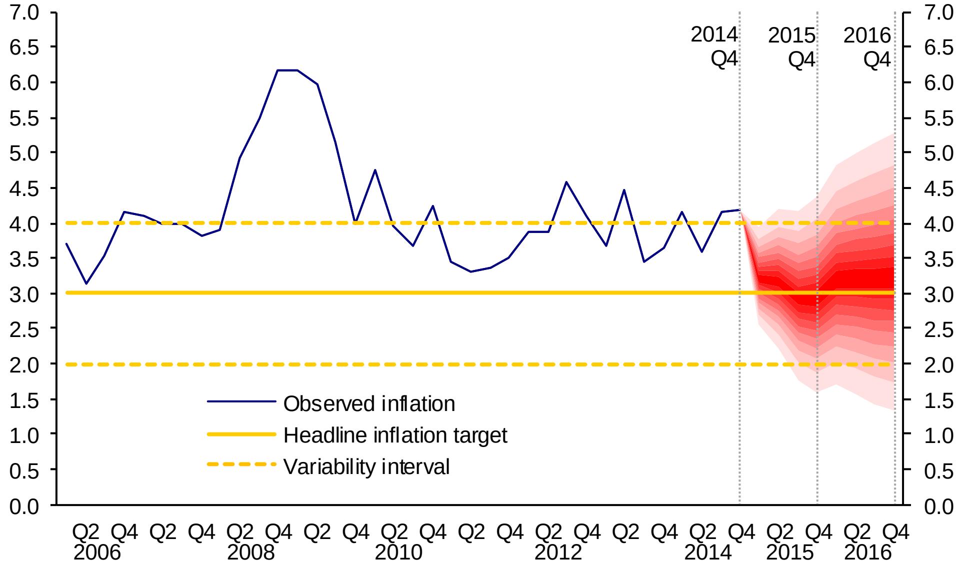
i. The possibility that the dynamism of the economic activity in the country may be lower than expected.

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.

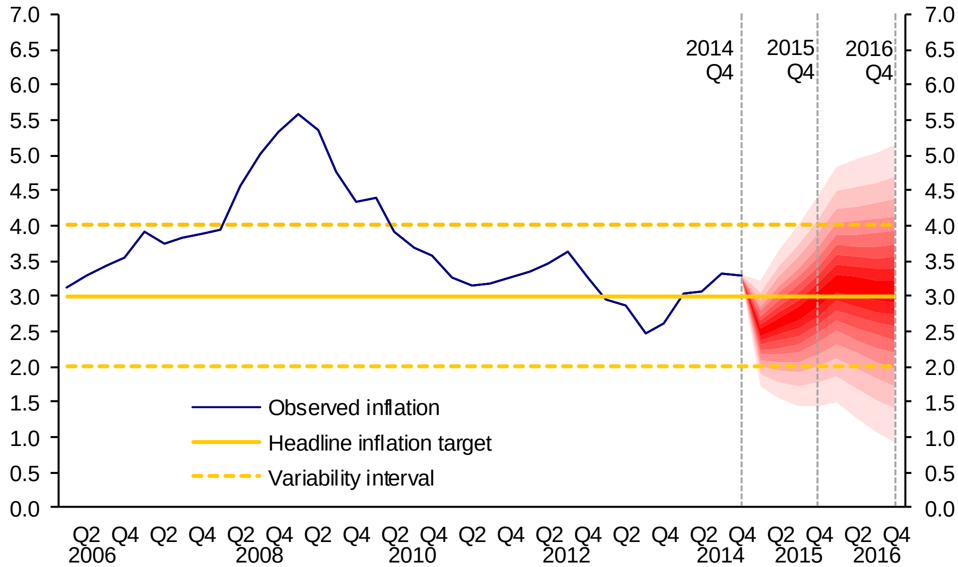
iv. An exchange rate appreciation, if the Federal Reserve delays or dilutes the measures aimed at normalizing its monetary policy stance and/or due to a better than expected performance in the crude oil price or in the effects of structural reforms on the potential growth of the country.

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



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

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



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

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 the financial system stability. 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 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.

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