# Quarterly Report

## *January – March 2017*

# *Summary*

During the first months of 2017, the Mexican economy continued facing different shocks, which generated significant and highly persistent, albeit transitory, impacts on inflation. In fact, since July 2016 an upward trend of inflation has prevailed for over 10 consecutive months, which resulted from increments in both core and non-core inflation. Thus, headline inflation attained levels close to 5 percent in the first quarter of 2017, and accelerated to 6.17 percent in the first fortnight of May. The effects of the accumulated depreciation of the national currency since the end of 2014, and the consequences of higher energy prices (in particular gasoline and LP gas prices), which were registered since the onset of 2017, are noteworthy. Furthermore, the increase in the minimum wage at the beginning of the year also contributed to the increment of annual headline inflation. The first of these shocks has considerably affected the trajectory of core inflation, as revealed through a gradual adjustment in relative prices of merchandise with respect to those of services. Meanwhile, higher energy prices affected non-core inflation directly and its core component indirectly, by raising production costs of different goods and of some services, mainly food-related services, that use the referred energy products as inputs. More recently, in April annual inflation was further affected by increments in some agricultural products' prices and in government approved fares, especially in passenger transport services.

It should be noted that despite the significant impact on inflation and its short-term expectations produced by the simultaneity and the magnitude of these shocks, the monetary policy implemented in a timely manner by Banco de México contributed to maintain medium- and long-term inflation expectations relatively stable. Indeed, to prevent contamination to the price formation process in the economy, to anchor inflation expectations and to reinforce the contribution of the monetary policy to the inflation convergence to its target, in the period covered by this Report, Banco de México's Board of Governors raised the target for the Overnight Interbank Interest Rate by 100 basis points, to a level of 6.75 percent.

This occurred in a context in which the world economy kept recovering in early 2017, reflecting an upturn in investment, industrial production and global trade. Nevertheless, the expected outlook of a moderate global growth in 2017 and 2018 is still subject to downward risks due to high uncertainty regarding the course of advanced countries' economic policies, of vulnerabilities in the Chinese economy that seem to have heightened, of the possible consequences of the U.K. exit from the European Union and increased geopolitical risks across various regions of the world. Meanwhile, inflation kept growing in the main advanced economies during the first quarter of the year, among other factors, reflecting higher energy prices during most of 2016. Still, in most of the said advanced economies this indicator persists below the target set by the respective central banks and inflation expectations are still low. Thus, the monetary stance of the main central banks in advanced economies remained accommodative, despite the persisting divergences across the countries, which reflect the differences in their relative positions in the economic cycle.

The economic activity in emerging economies recovered during the first quarter, even though the said recovery began from low levels. The recent boost to the world trade, which derived from a greater activity in advanced economies, and a certain rebound in international commodity prices during 2016 contributed to that. However, vulnerabilities in the Chinese economy and the recent political crisis in Brazil could impact the growth of these economies over the next quarters.

Despite the persisting uncertainty regarding economic policy and growing geopolitical risks, volatility levels declined dramatically in international financial markets, and asset prices went up with respect to the last quarter of 2016. The markets' favorable performance seems to respond to a greater degree to the estimated outlook characterized by sustained growth, backed by favorable credit conditions, the recovery of business profits, stronger demand and global trade, rather than to high levels of political and economic uncertainty. Still, markets do not rule out extreme or tail risks, which can be perceived in higher risk hedging costs. On the other hand, domestic financial markets were considerably affected at the beginning of the year, especially by uncertainty over the possible implementation of trade and migration policies by the incoming U.S. administration, which could negatively impact the Mexican economy. Thus, the Mexican peso observed a significant depreciation and high volatility, while interest rates for all terms went up. However, given the monetary policy actions put in place by Banco de México, the measures set forth by the Foreign Exchange Commission and some constructive comments by the members of the U.S. government relative to the future U.S. – Mexico bilateral relation, the afore mentioned depreciation of the national currency was reversed as of the second half of January, and long-term interest rates declined.

Regarding the domestic economy, in the first quarter of 2017 productive activity expanded at a rate similar to that in the previous one. This fundamentally reflected the persistent growth of private consumption and of external demand. In contrast, weakness of investment became more pronounced, as the negative trend in public investment has been recently accompanied by a slowdown in the private component. In this context, no significant aggregate demand-related pressures on prices have been observed yet, although the labor market slack has been depleting, which, in turn, has been reflected in an upward trajectory in unit labor costs, although starting from low levels.

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

**GDP Growth Rate:** Growth in the first quarter of 2017 was slightly higher than anticipated in the previous Report. Hence, a greater expansion of GDP is estimated for 2017 as a whole. In particular, the forecast interval for this year is adjusted from between 1.3 and 2.3 percent to between 1.5 to 2.5 percent (Chart 1a). Despite the relatively favorable performance of economic activity in early 2017, more recent figures point to a possible slowdown in productive activity over the next quarters, which, as indicated in the previous Report, appears to be partially related to the effects of the uncertainty over the future of the Mexico – U.S. economic relationship on investment and consumption decisions, even though these effects have somewhat attenuated. For 2018, the forecast interval of GDP growth is not modified with respect to the last Report and remains between 1.7 and 2.7 percent, so a greater expansion rate of the economy is still expected as compared to 2017, reflecting the estimated higher dynamism of the U.S. industrial production that year, along with the more noticeable positive effects of the structural reforms on investment conditions in 2018. It should be stated that these expectations assume that there is no major disruption in the Mexico – U.S. economic relationship and that adjustments in financial markets remain orderly. These expectations do not point to aggregate demand-related pressures onto prices in the forecast horizon, since the anticipated deceleration would lead to a widening of the negative output gap over the next quarters (Chart 1b).

**Employment:** Over the first four months of the year, the number of IMSS-affiliated jobs kept presenting a higher-than-anticipated dynamism, reason why the forecast for this indicator is adjusted upwards with respect to the previous Report. For 2017, the number of IMSS-affiliated jobs is estimated to increase between 650 and 750 thousand (an increment of between 580 and 680 thousand jobs, in the previous Report). On the other hand, in 2018 an increase of between

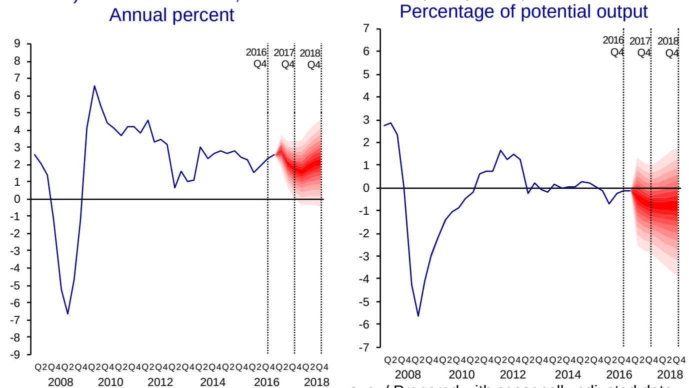
640 and 740 thousand jobs is expected (between 620 and 720 thousand jobs, in the last Report).

**Current Account:** For 2017, deficits in the trade balance and the current account of USD 12.8 and 24.7 billion are expected, respectively (1.2 and 2.3 percent of GDP, in the same order). For 2018, deficits in the trade balance and the current account are estimated to amount to USD 12.1 and 25.8 billion, respectively (1.1 and 2.3 percent of GDP, in the same order). It should be noted that these expectations were prepared based on the new balance of payment figures that follow the methodology of the sixth edition of the Balance of Payments of the IMF.

**Fan Charts 1**

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

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



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

s. a. / Prepared with seasonally adjusted data.
Source: Banco de México.

The balance of risks is still biased to the downside in the forecast horizon. Among the downward risks, the following stand out: i) that different enterprises decide to postpone their investment plans in Mexico in light of uncertainty regarding certain NAFTA-related policies that may be implemented by the U.S. government; ii) that protectionist policies are indeed put into effect in the U.S., generating lower-than-anticipated Mexican exports to the U.S.; iii) that workers' remittances to Mexico are lower than expected; iv) the possibility of new episodes of high volatility in international financial markets. Among the upward risks, the following are noteworthy: i) that the forthcoming negotiation of the NAFTA is a success and allows the countries in the region to exploit new areas of opportunity; ii) that the ongoing implementation of the structural reforms renders better-than-expected results; iii) that consumption shows a higher-than-anticipated dynamism; iv) that workers' remittances to Mexico are higher than estimated.

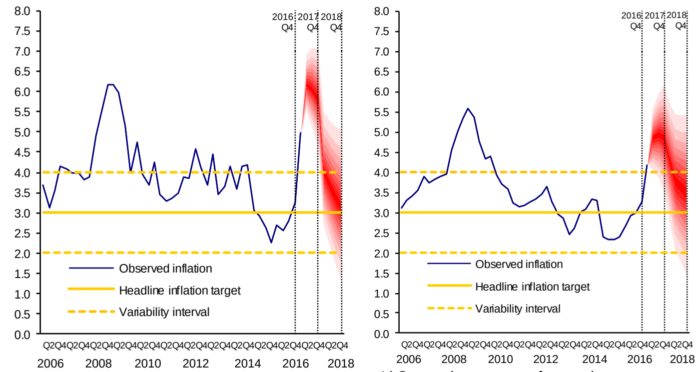
**Inflation:** Over the following months, annual headline inflation is expected to remain temporarily affected by the increment in passenger transport services' and in some agricultural products' prices, as well as by a number of shocks specified in the first paragraph of this Summary. Thus, in 2017 inflation is estimated to considerably exceed the upper limit of the variability interval set by Banco de México, even though during the last months of 2017 and during 2018 it is anticipated to resume the convergence trend to its 3 percent target and to achieve it by the end of the forecast horizon. In line with this estimation, in 2017 annual core inflation will also persist above the referred interval, but significantly below the trajectory of annual headline inflation, and in late 2017 and in early 2018 it is expected to resume the convergence trend towards the inflation target set by this Central Institute. These trajectories would be the result of a number of factors, among which the following are noteworthy: the fading of the shocks described above, the reversal of the exchange rate over the last months, the expected widening of the negative output gap, and significant adjustments in the monetary policy that have been put into place since December 2015, as well as those that may be required in the future (Charts 2a and 2b).

These forecasts are subject to risks. Among upward risks, the following should be mentioned: i) that the number and the magnitude of shocks that have recently occurred may increase the probability of second round effects onto inflation; ii) that inflation expectations may rise even further, as a consequence of its performance, or if the national currency depreciates abruptly, starting from current levels; iii) increments in agricultural products' prices, even though their impact on inflation would tend to be transitory; iv) that the upward trend in unit labor costs could start to be reflected in inflation. Among downward risks, these should be listed: i) that the recently observed appreciation of the national currency may consolidate and deepen; ii) that energy prices may go down insofar as there are decreases in their international counterparts; iii) that the structural reforms may lead to reductions in different prices of the economy; iv) that the Mexican economic activity may grow less than expected, lowering the possibility of aggregate demand-related pressures and pressures in the labor market.

**Fan Charts 2**

a) Annual Headline Inflation [1/]
Percent

b) Annual Core Inflation [1/]
Percent




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

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

In this context, in the future the Board of Governors will closely monitor the evolution of all inflation determinants and its medium- and long-term expectations, especially the possible pass-through of exchange rate adjustments and higher energy prices onto the rest of prices. Likewise, it will be watchful of the evolution of the monetary position of Mexico relative to the U.S., and the evolution of the output gap. This will be done in order to continue taking the necessary measures to attain the efficient convergence of inflation to its 3.0 percent target.

In an international environment in which the aftermath of the 2008 global financial crisis has given way to a fragile and slow recovery of the global economy and world trade, and has caused a number of volatility episodes in international financial markets, the Mexican economy has been resilient and has continued to expand, although at a moderate rate. From a longer-term perspective, this performance can be contributed, in part, to the authorities' commitment to maintain a solid macroeconomic framework, which has been complemented by the approval of a package of structural reforms seeking to push ahead with the modernization process of Mexico. As a result, a greater dynamism has been registered in the domestic market, and the Mexican export sector keeps taking advantage of its close integration in the global value chains. However, Mexico should strengthen the fundamentals that have allowed its economy to expand in spite of the adverse international conditions. In the same vein, it should move forward in approving and implementing policies that allow to address the shortcomings of the economy in order to attain a faster and more sustained growth. In particular, doing so would offset the weakness in investment that has been observed since the onset of the global financial crisis and would achieve a more balanced growth, less dependent on the dynamism of consumption, thus helping to reach a greater potential growth, increased competitiveness, and a faster, more sustainable growth of employment and wages. Specifically, it is important to continue implementing monetary policy in a timely manner and to introduce measures that contribute to the sound functioning of financial markets, thus enhancing the effectiveness of the aforementioned policy. Likewise, it is essential to ensure the implementation of the fiscal consolidation process, while, at the same time, encouraging the proper enforcement of structural reforms. Besides, in order to prevent insecurity and corruption from impeding economic growth, as has been mentioned in previous Reports, it is indispensable to strengthen the rule of law and to guarantee legal certainty for all economic agents.