BANCO DE MÉXICO

Quarterly Report

July – September 2014

BOARD OF GOVERNORS

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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 July – September 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 November 17, 2014. Figures are preliminary and subject to changes.

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1. Introduction

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

In the third quarter of 2014, annual headline inflation exceeded 4 percent, reflecting mainly the fading of a high comparison base effect in the subindex of fruit and vegetables, as well as the increase in the relative prices of livestock products. Considering the transitory nature of this shock on inflation, that inflation expectations are well-anchored, and that a significant decrease in inflation is anticipated by the end of 2014 and early 2015, over the period covered by this Report the Board of Governors considered that, given the performance of all inflation determinants, the monetary policy stance was conducive to an inflation convergence towards the 3 percent target in 2015, reason for which it maintained the target for the Overnight Interbank Interest Rate at 3 percent.

In the third quarter of 2014, economic activity in Mexico kept recovering, although at a more moderate pace as compared to the previous quarter. This performance reflects the dynamism of external demand, mainly stemming from the U.S., as well as a slow reactivation of domestic demand. In line with the abovesaid, in the quarter analyzed in this Report, slack conditions persisted in the economy, even though they are estimated to continue declining over the next quarters. Consistent with the above, no pressures on labor and credit markets have been perceived.

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

Significant adjustments in international financial markets were reflected in the Mexican markets. So far, the referred adjustments have taken place in an orderly manner and under appropriate liquidity conditions. In particular, in the period analyzed by this Report, the Mexican peso depreciated, the Mexican Stock Market index presented volatility and interest rates for different terms increased marginally, although the year to date interest rates have declined. In fact, adjustments in financial variables in Mexico were smaller when compared to most emerging economies. Still, possible additional adjustments in the national financial markets cannot be ruled out and, thus, the need to remain alert to any event that could affect the stability of the national economy persists. In order to avoid risks to macroeconomic and financial stability, caution must be maintained when conducting the economic policies and, in particular, the fiscal, the monetary and the financial ones. This takes on greater relevance in a context where the possible persistent fall in the oil prices can constitute an additional risk to the external accounts and to the country's public finances.

The reactivation of the Mexican economy is expected to persist, supported mainly by the impulse of external demand, as well as by a gradual improvement of domestic expenditure. The GDP growth rate in Mexico is anticipated to locate in 2014 between 2.0 and 2.5 percent, as compared to an interval of 2.0 to 2.8 percent in the previous Report. For 2015, the GDP growth rate is forecast to lie between 3.0 and 4.0 percent, while for 2016 this interval is from 3.2 to 4.2 percent, sustained by the expectation of a proper implementation of the recently approved structural reforms. Based on these prospects, it is estimated that in the future slack conditions in the economy will continue to gradually diminish.

Annual headline inflation is forecast to drop in late 2014, to conclude the year around 4 percent and to converge to its 3 percent target in 2015. In particular, given the fading of the effects of changes in relative prices derived from the fiscal measures in early 2014, as well as the elimination of long-distance national phone charges and a lower annual growth rate of gasoline prices, annual headline inflation is anticipated to decrease considerably in early 2015 and to lie around 3 percent from mid-2015. In this regard, it should be noted that the decrease in the growth rate of gasoline prices represents a very important change in the price determination process of the economy. The reason for this is that over the last 4 years the annual change of gasoline prices was above 10 percent while the target for headline inflation was 3 percent. This difference clearly implied upward pressures onto inflation and its expectations in recent years. Thus, the estimated variation in the annual change rate of gasoline prices is estimated to directly contribute to a lower headline inflation and that, besides, inflation expectations and other prices in the economy will adjust in line with the 3 percent target. Annual core inflation is expected to persist at levels close to 3 percent over the rest of 2014 and below this level in 2015. Finally, for 2016 both headline and core inflation are estimated to lie at levels close to 3 percent.

Considering all of the above, the Board of Governors estimates that currently the monetary policy stance is congruent with the efficient convergence of inflation to its 3 percent target. 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 evolution of the degree of slack in the economy in light of the foreseen recovery, including the possible effects of structural reforms on the potential output of the economy and on the aggregate demand. Likewise, it will continue monitoring the monetary policy stance of Mexico relative to that of the U.S., all this in order to achieve the above referred inflation target.

2. Recent Development of Inflation

2.1. Inflation

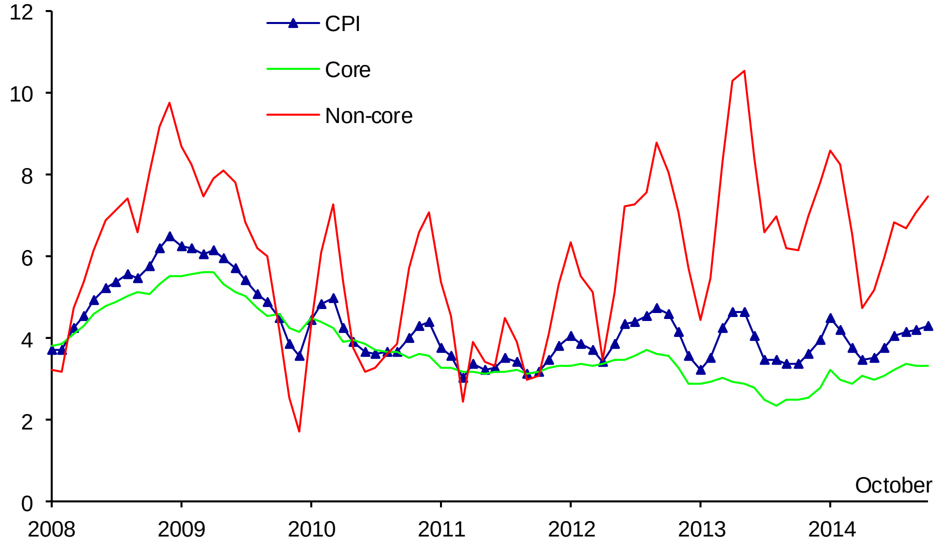
At the end of the second quarter and at the beginning of the third one, inflation rebounded, which was mainly related to the fading of a high comparison base effect in the non-core subindex (Table 1 and Chart 1). Furthermore, the referred increment was also contributed to by higher prices of meat products and some of their derivatives, as a reflection of supply shocks from the U.S. onto these products. Hence, average annual headline inflation shifted from 3.59 percent in the second quarter of 2014 to 4.15 percent in the third one. In October, annual headline inflation was 4.30 percent.

Table 1
Consumer Price Index and Components
Annual change in percent

	Annual change							Average	
	April 2014	May 2014	June 2014	July 2014	August 2014	September 2014	October 2014	Q II 2014	Q III 2014
CPI	**3.50**	**3.51**	**3.75**	**4.07**	**4.15**	**4.22**	**4.30**	**3.59**	**4.15**
Core	**3.11**	**3.00**	**3.09**	**3.25**	**3.37**	**3.34**	**3.32**	**3.07**	**3.32**
Merchandise	**2.97**	**3.08**	**3.24**	**3.37**	**3.56**	**3.46**	**3.53**	**3.10**	**3.46**
Food, beverages and tobacco	4.60	4.76	5.06	5.20	5.41	5.36	5.33	4.81	5.32
Cold cuts	4.89	7.21	7.91	8.64	9.49	10.05	10.90	6.67	9.39
Sweet bread	9.91	10.60	10.81	11.24	11.39	11.34	11.25	10.44	11.32
Canned soft-drinks	16.82	16.25	16.16	16.15	15.76	15.70	15.50	16.41	15.87
Non-food merchandise	1.67	1.73	1.78	1.88	2.06	1.94	2.07	1.72	1.96
Services	**3.23**	**2.94**	**2.96**	**3.15**	**3.22**	**3.24**	**3.14**	**3.04**	**3.21**
Housing	2.24	2.21	2.15	2.11	2.07	2.13	2.14	2.20	2.11
Education (tuitions)	4.39	4.42	4.46	4.38	4.19	4.30	4.31	4.42	4.29
Other services	3.94	3.28	3.40	3.90	4.17	4.12	3.86	3.54	4.06
Mobile phone services	-3.73	-6.77	-5.67	-3.15	-1.60	-4.11	-8.99	-5.39	-2.95
Air transport	1.89	-4.43	0.87	12.36	16.63	20.14	16.72	-0.53	16.15
Non-core	**4.75**	**5.19**	**5.96**	**6.83**	**6.72**	**7.11**	**7.51**	**5.29**	**6.89**
Agriculture	**-1.13**	**0.67**	**3.37**	**5.78**	**6.22**	**7.57**	**8.46**	**0.94**	**6.53**
Fruit and vegetables	-9.90	-7.97	-2.15	3.22	0.13	1.20	1.31	-6.86	1.48
Green tomato	-68.85	-63.07	-19.95	14.64	34.79	3.57	-21.93	-58.97	16.19
Tomato	-7.34	-30.06	-22.73	3.77	-10.39	-5.54	-2.22	-20.46	-4.52
Serrano pepper	-11.26	-19.48	11.00	32.78	44.43	39.73	24.67	-8.48	38.99
Livestock	4.39	5.70	6.34	7.14	9.64	11.22	12.62	5.49	9.33
Beef	8.23	9.92	11.78	12.38	14.71	17.85	19.73	9.98	14.99
Pork	8.48	10.01	11.43	14.37	19.58	19.16	18.78	9.98	17.70
Energy and government approved fares	**8.52**	**8.14**	**7.59**	**7.47**	**7.03**	**6.82**	**6.93**	**8.09**	**7.11**
Energy	9.45	8.86	8.42	8.38	7.83	7.56	7.74	8.92	7.92
Gasoline	11.69	11.89	10.97	10.74	10.22	9.53	9.59	11.51	10.16
Electricity	4.11	-0.19	0.17	0.66	1.07	1.49	2.81	1.57	1.07
Domestic gas	10.30	10.05	9.91	9.80	8.17	8.25	8.49	10.08	8.74
Government aproved fares	6.86	6.89	6.18	5.92	5.65	5.55	5.48	6.64	5.71
Public transport	6.16	5.79	4.40	3.59	2.74	2.53	2.48	5.44	2.95

Source: Banco de México and INEGI.

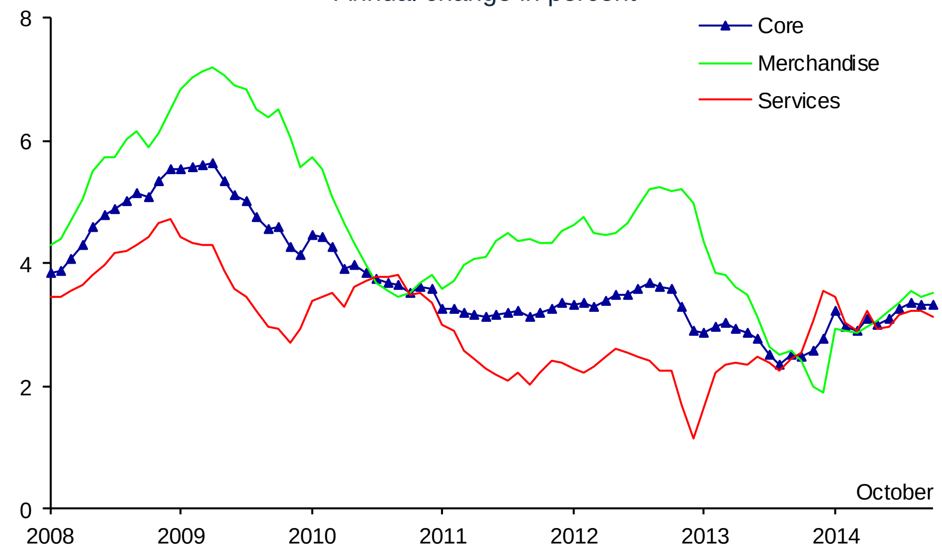
Chart 1
Consumer Price Index
Annual change in percent



Source: Banco de México and INEGI.

Average annual core inflation went up from 3.07 to 3.32 percent between the second and the third quarters, lying at 3.32 percent in October (Table 1 and Chart 2). Average annual inflation of the merchandise price subindex was 3.10 percent in the second quarter of 2014, while in the third one it was 3.46 percent. In October this subindex variation was 3.53 percent. The said increment was largely due to the performance of the food merchandise group, given that some goods derived from livestock products, such as cold cuts, increased their prices. Therefore, the referred group increased its average annual change from 4.81 to 5.32 percent between the indicated quarters, registering 5.33 percent in October. The average annual change of the non-food merchandise group rose slightly, from 1.72 to 1.96 percent over the same time period and to 2.07 percent in October (Table 1, Chart 2 and Chart 3a).

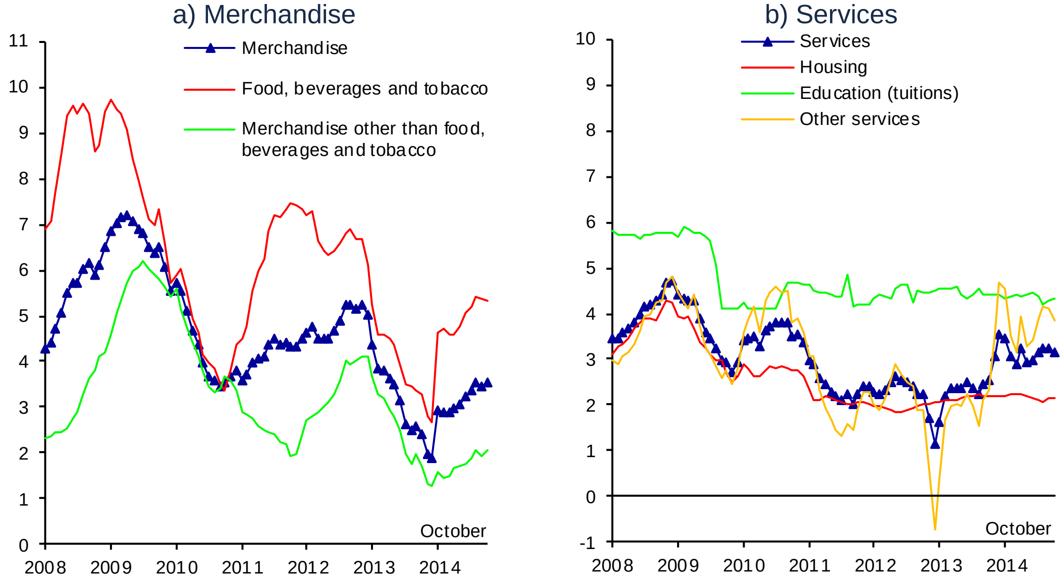
Chart 2
Core Price Index
Annual change in percent



Source: Banco de México and INEGI.

Chart 3
Core Price Index: Merchandise and Services
Annual change in percent

a) Merchandise
b) Services

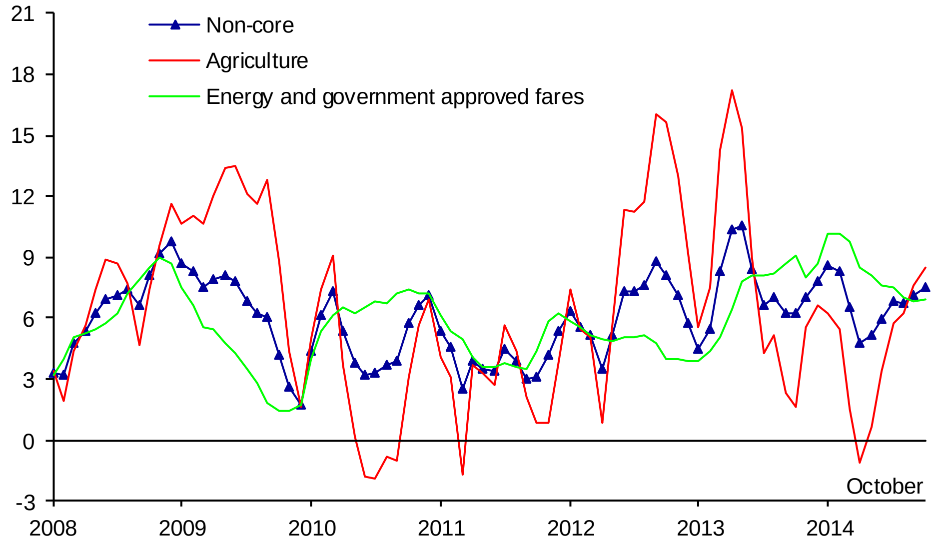


Source: Banco de México and INEGI.

Between the second and the third quarters of 2014, average annual inflation of the services subindex went up from 3.04 to 3.21 percent and subsequently decreased to 3.14 percent in October. The said increment was related to the performance of the group of services other than education and housing, in particular other than air transportation, given that greater increases in these fares were observed as compared to the same period of 2013, due to higher demand for this service. Thus, the average annual change of the group of services other than education and housing shifted from 3.54 to 4.06 percent between the referred quarters. Afterwards, the said indicator lied at 3.86 percent in October. This reduction mainly reflected the introduction of new plans and special offers by some mobile phone companies (Table 1 and Chart 3b).

The fading of a high comparison base effect in the subindex of fruit and vegetables, as well as unfavorable supply conditions that drove the prices of some meat products upwards, generated an increase in the average annual change rate of the non-core subindex from 5.29 to 6.89 percent between the second and the third quarter. Subsequently, in October annual inflation of this component lied at 7.51 percent (Table 1, Chart 4 and Chart 5).

Chart 4
Non-core Price Index
Annual change in percent



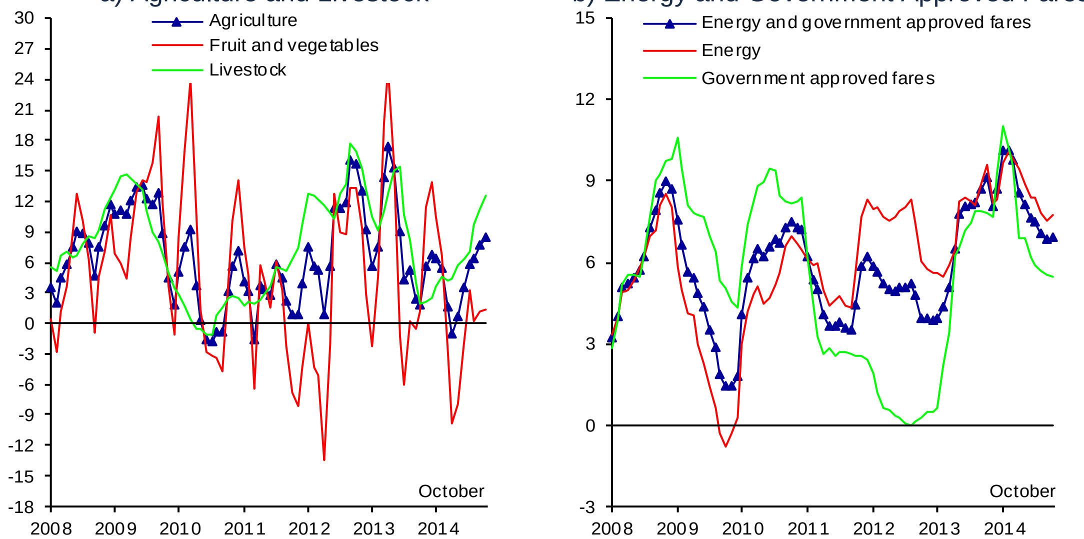
Source: Banco de México and INEGI.

Between the second and the third quarters of 2014, the average annual change of the subindex of agricultural prices soared from 0.94 to 6.53 percent, reaching 8.46 percent in October (Table 1, Chart 5a and Chart 6). The average annual change of the group of fruit and vegetables shifted from -6.86 to 1.48 percent between the referred quarters. This increment reflects the fading of a high comparison base effect and recent increases in the price of serrano pepper and tomato, although in the latter case the annual change rate was still negative. Subsequently, in October this indicator located at 1.31 percent, driven mostly by lower prices of some vegetables, such as green tomato. Meanwhile, the group of livestock products accelerated significantly its average annual change in the referred time period, spiking from 5.49 to 9.33 percent, registering 12.62 percent in October. As mentioned above, this increment was due to the negative supply conditions in the U.S., as a result of which beef and pork prices went up.

The average annual change rate of the subindex of energy prices and government approved fares dropped from 8.09 to 7.11 percent between the second and the third quarters, locating at 6.93 percent in October (Table 1, Chart 5b and Chart 7). The group of energy prices reduced its average annual change in the referred quarters from 8.92 to 7.92 percent and to 7.74 percent in October, due to lower gasoline prices in the Northern border region and due to smaller increments of domestic gas prices. The group of government approved fares changed from an average annual change of 6.64 to 5.71 percent over the same time period, registering 5.48 percent in October. This outcome is largely accounted for by upward adjustments in the public transport fares in different cities that were not as intense as last year.

Chart 5
Non-core Price Index
Annual change in percent

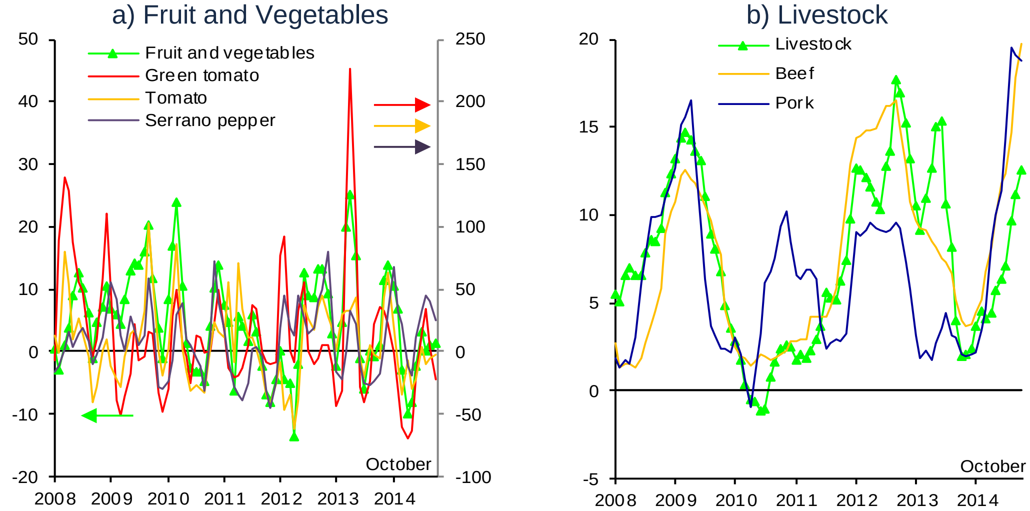
a) Agriculture and Livestock
b) Energy and Government Approved Fares



Source: Banco de México and INEGI.

Chart 6
Agricultural Price Index
Annual change in percent

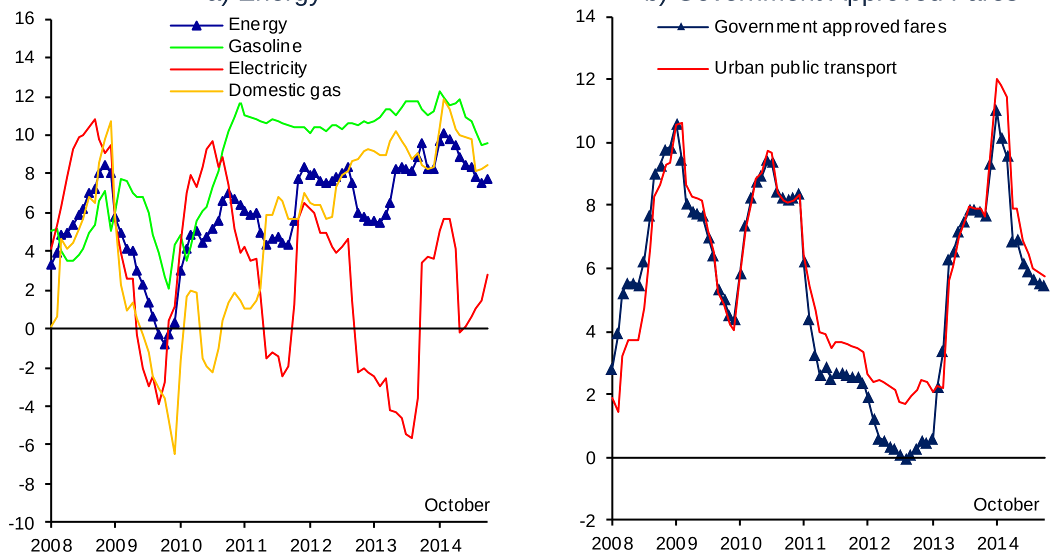
a) Fruit and Vegetables
b) Livestock



Source: Banco de México and INEGI.

Chart 7
Non-core Price Index
Annual change in percent

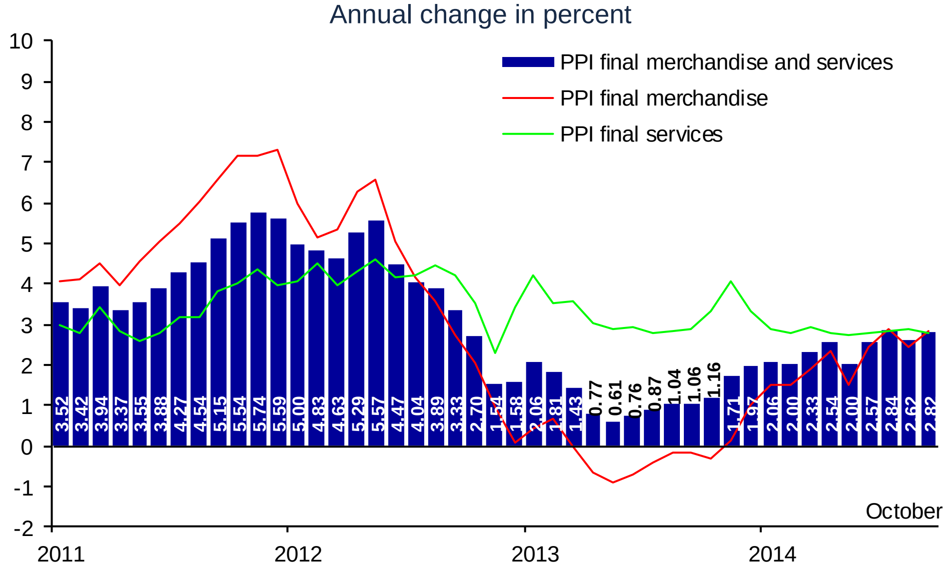
a) Energy b) Government Approved Fares



Source: Banco de México and INEGI.

In the third quarter of 2015, the Producer Price Index (PPI) of finished merchandise and services, excluding crude oil, registered an average annual change rate of 2.68 percent, while in the previous quarter it was 2.29 percent (Chart 8). This behavior was largely due to the price increments of agricultural products, some processed foods and goods related to the construction industry. In October 2014, the annual change of the referred indicator was 2.82 percent.

Chart 8
Producer Price Index
Annual change in percent



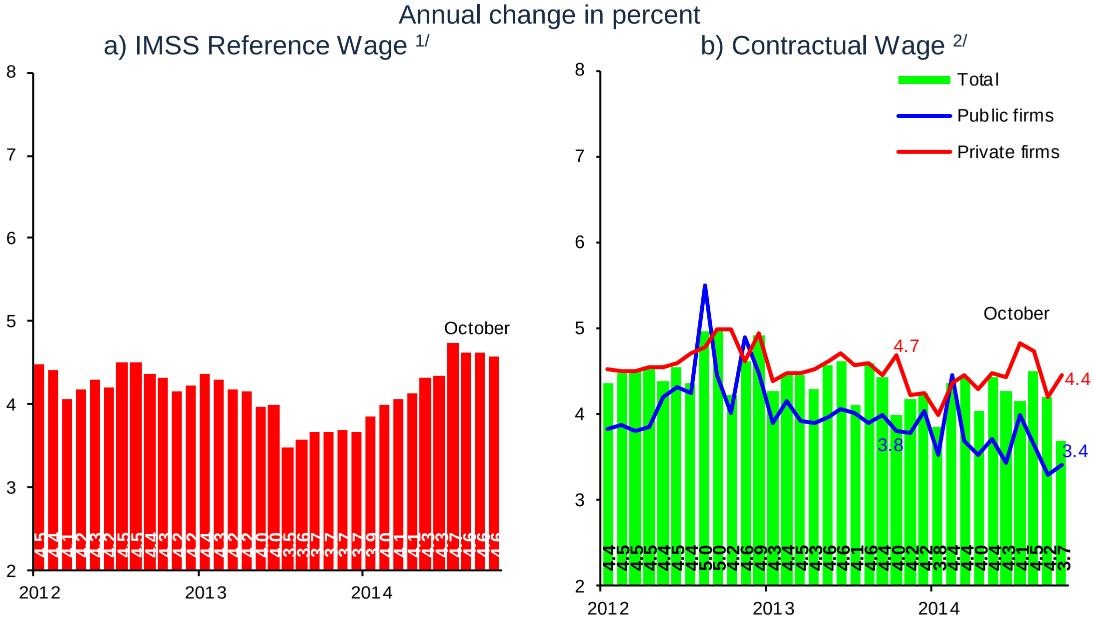
Source: Banco de México and INEGI.

2.2. Wages

During the third quarter of 2014, the main wage indicators increased in line with the recent evolution of inflation. The reference wage of IMSS-insured workers went up 4.7 percent in July 2014 as compared to the same period of last year. Subsequently, this indicator went down to 4.6 percent in August and September. Still, in the analyzed quarter the average annual change of the reference wage was 4.7 percent (4.3 percent in the last quarter). In October, the annual change of the reference wage remained at 4.6 percent (Chart 9a).

The average increment in the contractual wage negotiated by firms under federal jurisdiction was 4.2 percent over the third quarter of 2014, which was slightly lower than the figure registered in the same quarter of the previous year (4.3 percent). This difference derived from lower changes in contractual wages of public firms. In particular, public firms negotiated an increase of 3.9 percent (4.0 percent in the same quarter of 2013). Private firms negotiated an average increase of 4.5 percent from July to September 2014, a figure equivalent to that of the third quarter of 2013. Subsequently, in line with the persisting slack conditions of the economy, in October 2014 the change rate of the average contractual wage decreased with respect to the same month of the previous year, locating at 3.7 percent (4.0 percent in the same month of last year). Thus, in October increments in contractual wages were smaller for public and private firms, observing rates of 3.4 and 4.4 percent, respectively (3.8 and 4.7 percent in October 2013, Chart 9b).

Chart 9
Wage Indicators
Annual change in percent



1/ During the third quarter of 2014 an average of 17.1 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

World economy showed additional signs of weakening and lower inflation levels were registered in the third quarter. The differences among advanced economies, as well as those between these and the emerging ones intensified. In particular, while the economies of the U.S. and the U.K. kept expanding, albeit with certain uncertainty regarding the sustainability of their recovery, the economies of the Euro zone and Japan remained weak. In China, the rate of economic activity stabilized, although at a lower rate than that of last year, while other large emerging economies, such as Brazil and Russia slowed down considerably. This led to greater uncertainty regarding the direction of the world economic activity, inflation and the economic policy, in particular the monetary policy in the main advanced economies. This, as well as intensified geopolitical risks and alert triggered by the epidemic of Ebola virus disease was reflected in a strongly increased volatility of international financial markets. In this regard, it should be noted that there is a risk that structural problems, such as the low productivity growth and demographic factors, would limit the capacity for growth in the main advanced economies and some emerging ones from a long-term perspective.

3.1.1. World Economic Activity

In the U.S., the economic activity recovery continued consolidating, following a strong expansion in the second quarter. In accordance with the initial estimate, GDP grew at an annualized quarterly rate of 3.5 percent in the third quarter, after the 4.6 percent registered in the last quarter. Nonetheless, the recent weakness of global economic activity and the USD appreciation could be factors that limit growth in this country.

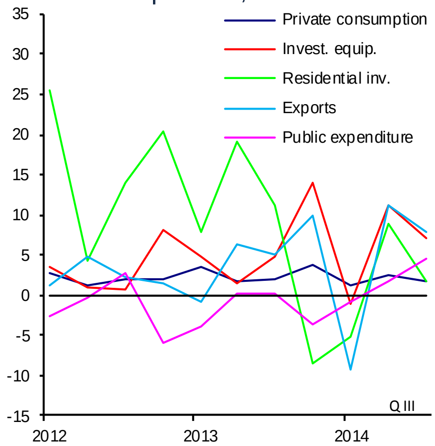
Over the referred period, both expenditure on investment in equipment and private consumption grew moderately (Chart 10a). Residential investment continued recovering slightly, although it maintained the lag with respect to the components of private domestic demand. Net exports contributed substantially to the GDP growth, more than offsetting the strong fall in the rate of inventory accumulation.

Labor market conditions kept strengthening gradually over the third quarter, even though different indicators suggest that slack conditions still prevail in this market. In October, non-farm payroll expanded by 214 thousand jobs, leading to the monthly employment growth of over 200 thousand jobs in the last nine months. Likewise, the unemployment rate dropped from 6.1 percent of labor force in June to 5.8 percent in October, its lowest level since mid-2008 (Chart 10b).[1] However, other indicators, such as the number of people working part-time for economic reasons, as well as the rate of recruitments and the rate of resignations, suggest certain slackness in this market.

[1] In September, the Federal Reserve estimated the central trend of the long-term unemployment rate between 5.2 and 5.5 percent.

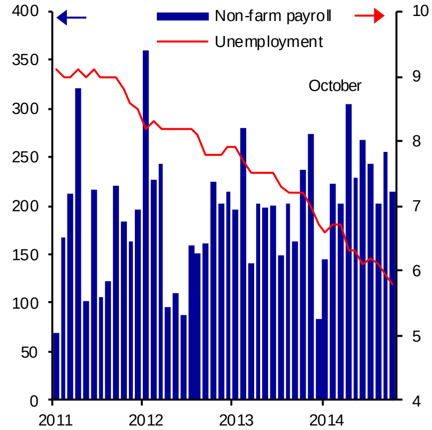
Chart 10
U.S. Economic Activity

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



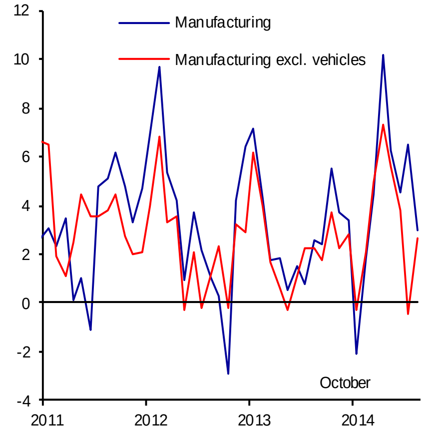
s. a. / Seasonally adjusted figures.
Source: BEA.

b) 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
Annualized quarterly change in percent, s. a.



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

Manufacturing production maintained a positive trend in the reference quarter. In particular, although the annualized growth of the sector moderated from 7.0 percent in the second quarter to 3.9 percent, mainly due to the automobile component (Chart 10c), in this economic cycle the sector's installed capacity utilization reached its maximum during the quarter. The leading indicators, such as the manufacturing sector's Purchasing Managers' Index, point to a continuous expansion of the sector in the next months.

In the Euro zone, economic activity remained weak in the third quarter of the year (Chart 11a), growing only 0.7 percent at an annualized quarterly rate, thus contributing to the ample slackness in the labor market and to the persisting contraction of credit. Likewise, geopolitical tensions derived from the crisis between Russia and Ukraine adversely affected the economic activity. During this period, private consumption kept growing modestly, limited by decreased consumer's confidence, households' over-indebtedness and high unemployment rates (Chart 11b). After a strong contraction in the previous quarter, private investment remained depressed in the third quarter, mainly due to decreased financing to firms (Chart 11c). Furthermore, insufficient structural reforms also contributed to the weak dynamics of investment, employment and slow growth of productivity.

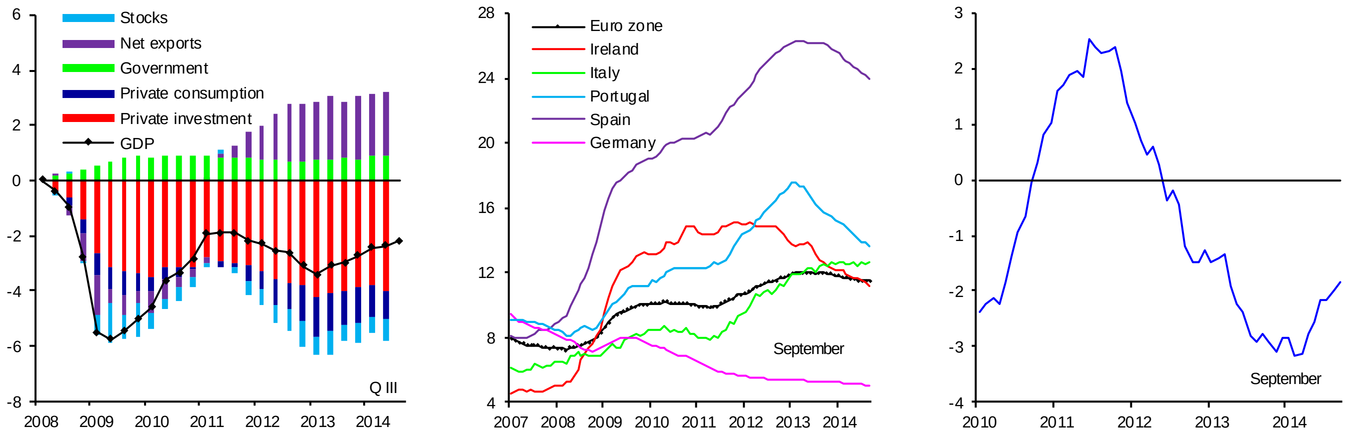
As part of its strategy to support the recovery of bank credit in the region, in late October the European Central Bank (ECB) announced the results of the comprehensive evaluation among 130 European banks, showing significant progress in their capitalization process and a relative strength in light of an adverse scenario. The goal of this evaluation, that included stress tests and a revision of asset quality, was to strengthen banks' balances, to enhance transparency and confidence in the sector, and to lay the foundations for the beginning of the Single Supervisory Mechanism (SSM) in November 2014.[2]

Chart 11
Euro Zone Economic Activity

a) Real GDP and Contributions of its Components with respect to the Recent Crest (2008-1Q=0)
In percent and percentage points, s. a.

b) Unemployment Rate
In percent of labor force, s. a.

c) Credit to Non-financial Corporations
Annual change in percent, s. a.



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

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

s. a. / Seasonally adjusted figures.
Source: European Central Bank.

The U.K. economy continued with a sustained growth, although it went down from 3.9 percent at an annualized quarterly rate in the second quarter to 2.7 percent in the reference quarter, particularly as a result of a lower dynamism of the services' sector. Demand in the housing market weakened incipiently given a low level of mortgage approvals and smaller than expected increments in the housing prices.

Economic activity in Japan kept contracting in the third quarter of the year. GDP decreased at an annualized quarterly rate of 1.6 percent, following a plunge of 7.3 percent in the previous quarter. The negative effect on domestic demand caused by the VAT increment in April has been more prolonged than anticipated, with a moderate growth of consumption, despite the improvement in the labor market and the persistent weakness of private investment. Even though in the third quarter the economy was supported by exports, lower economic growth in Asia and in the Euro zone represents a downward risk for Japan.

The growth outlook in emerging economies in general has deteriorated, although it has varied across countries and regions, given the persistent weakness of their domestic demand and exports (Chart 12). The latter has derived not only from lower world expansion, but also from a reduction related to commodity prices. Furthermore, in some of these economies, downward risks have intensified in light of an increased indebtedness of the private sector, and in some cases of the public sector. The above occurred in a context of a limited degree of freedom to conduct the fiscal and monetary policies in some of these economies.

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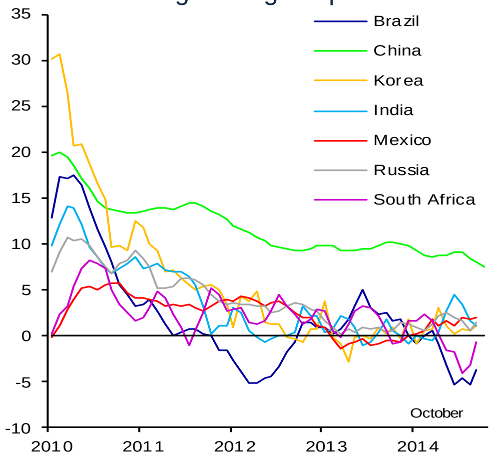
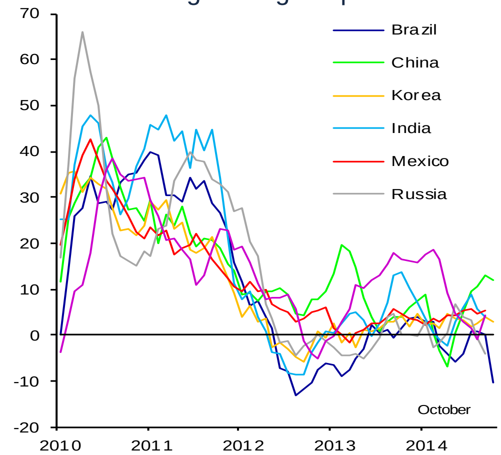
[2] The results indicated that 25 banks registered a capital deficit of EUR 25 billion, out of which 12 banks covered the gap with the anticipated capitalization measures. The remaining 13 banks, which lack EUR 9.5 billion of net capital, will have 9 months to eliminate this deficit.

Chart 12
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



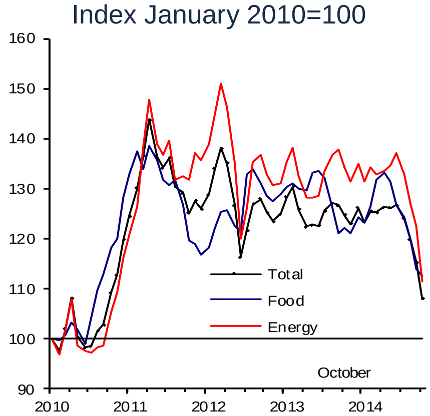
Source: Haver Analytics.

3.1.2. Commodity Prices

International commodity prices declined during the period covered by this Report (Chart 13a). This drop was a reflection of weak global demand, the supply-related factors and the USD appreciation. Despite geopolitical risks in the Middle East and Ukraine, the crude oil price went down due to a reduced demand, increased production in some countries and minor distribution problems in the U.S. (Chart 13b). Grain prices decreased given a favorable outlook for their supply, even though certain recovery was registered in the last days (Chart 13c).

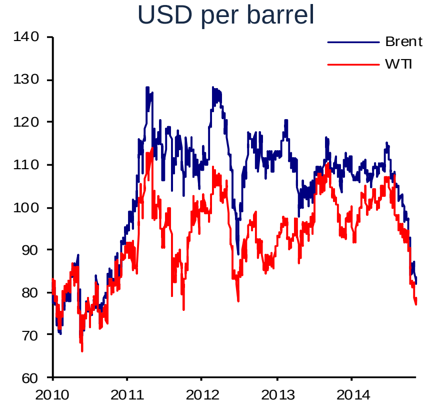
Chart 13
International Commodity Prices

a) Commodities
Index January 2010=100



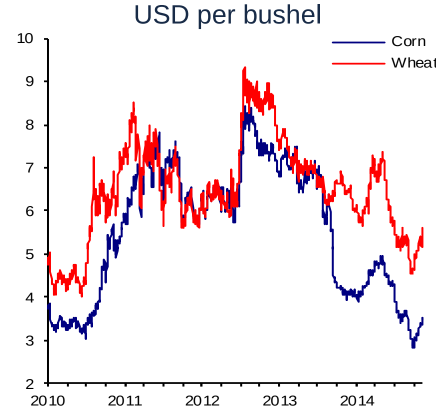
Source: International Monetary Fund.

b) Crude Oil [1/]
USD per barrel



1/ Spot.
Fuente: Bloomberg.

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



1/ Mercado Spot.
Fuente: Bloomberg.

3.1.3. Inflation Trends Abroad

In the third quarter, global inflation decreased (Chart 14), due to lower international prices of energy and food, and due to the prevailing slack conditions, particularly in advanced economies. In this context, fear has emerged regarding a possibility of very low and/or negative inflations in some economies.

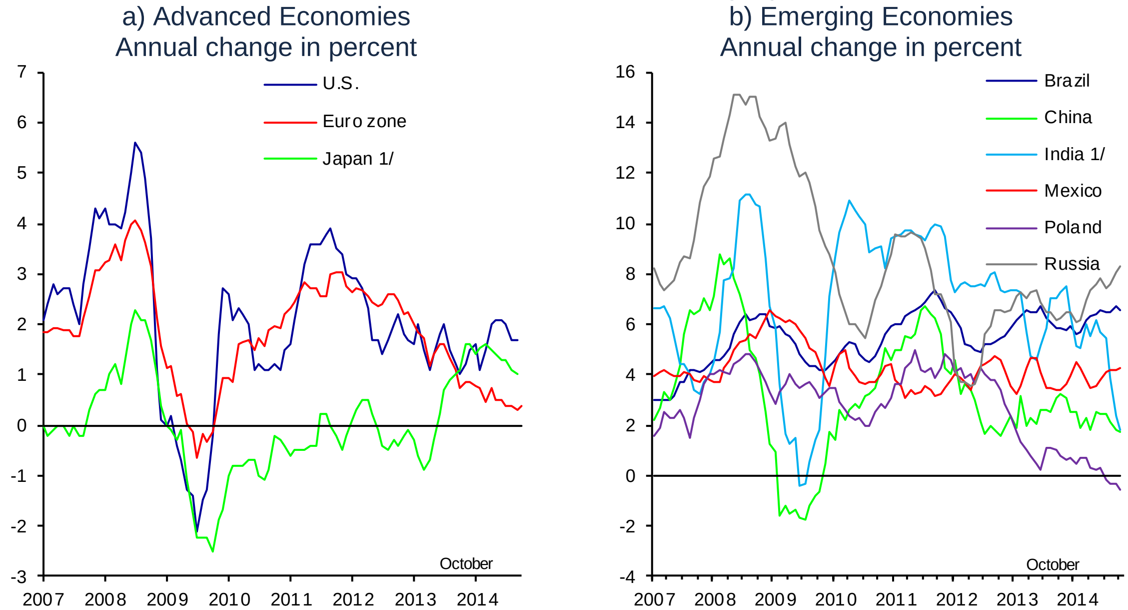
In the U.S., inflation and its expectations decreased slightly during the third quarter, especially due to the strength of the USD and lower gasoline prices, even though it is anticipated that once these effects fade, and the economic recovery consolidates, inflation will gradually increase to the 2 percent target. Thus, annual headline and core inflations lied at 1.7 percent in September. On the other hand, the annual change of the personal consumption expenditure (PCE) deflator was 1.4 percent in September and the core PCE was 1.5 percent.

In the Euro zone, deflation risks intensified, due to a continuous weakness of aggregate demand and the drop in commodity prices, which resulted in an additional reduction of medium- and long-term inflation. Thus, annual headline inflation lied at 0.4 percent in October, while core inflation was 0.7 percent in the same month, well below the ECB target of a figure below but close to 2 percent. In accordance with the ECB, it came as a surprise that inflation dynamics were downward and they are expected to remain at reduced levels over the next months, before starting to increase gradually in 2015 and 2016.

In the U.K., in September annual headline inflation dropped to its lowest level in five years, reaching 1.2 percent, while core inflation lied at 1.5 percent. This downward trend in inflation is accounted for, partly, by the low wage increase, as well as a lower inflation of imported goods, as a result of lower prices of commodities and a lower global inflation. On the other hand, inflation in Japan went down over the quarter. Headline inflation, excluding the effect derived from the increment in the consumption tax, located at 1.0 percent in September, while the component that excludes food and energy has stabilized at 0.6 percent since June.

Most emerging economies did not register considerable inflationary pressures, in an environment of moderate growth and lower prices of food and energy. Among the main ones, price increases in China and India decelerated significantly during the period, while in Brazil and Russia inflation went up slightly as compared to June, locating above the respective inflation targets of these countries.

Chart 14
Headline Inflation in Advanced and Emerging Economies



1/ Excluding the effect of the increment in the consumption tax.
Source: BLS, Eurostat and Japan Statistics Bureau, JP Morgan.

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

3.1.4. International Financial Markets

Considering the environment of weak growth and low global inflation, the monetary stance in most economies is expected to remain accommodative over the following quarters. However, derived from the cyclical phase the economies are going through, increasing differences are anticipated, particularly among the main advanced economies.

In the U.S., in September the Federal Reserve announced its new plans of the normalization process in its balance, stressing that these would not imply a modification in its monetary policy stance. Just as prior to the crisis, the monetary policy adjustment would be carried out by means of the measures affecting the federal fund rate and not through an active management of the Central Bank's balance. Subsequently, in its October meeting the Federal Reserve decided to conclude its asset purchase program, upon considering that the labor market outlook has improved substantially since its introduction and that the economy is strong enough to achieve its goal of full employment in a context of stable prices. Besides, it confirmed that it will probably maintain the current range of the federal fund rate for a considerable time period once the asset purchase program is concluded, especially if the forecast inflation persists below the long-term target of 2 percent and inflation expectations remain well-anchored. The Federal Reserve stressed that if data point to a more rapid than expected progress in achieving its goals, it will increase the target range of the federal funds rate ahead of time. In contrast, if the referred progress is lower than anticipated, increments in the target range will likely be postponed. On the other hand, the change in the Federal Reserve's message regarding the labor market conditions from a scenario in which significant slack conditions would prevail to a scenario in which the underuse of labor resources has reduced gradually prompted the analysts not to postpone, but rather to anticipate the expected date of the first increment in the monetary policy rate, although it would not be inferred from the data in financial instruments.

In its September meeting, the European Central Bank announced additional monetary stimulus measures in order to boost credit and to face weak inflation and economic activity outlook. Hence, the ECB reduced its monetary policy interest rates by 10 basis points, while it indicated the beginning of the purchase of asset-backed securities of the non-financial private sector, as well as a third purchase program of covered bonds issued by financial institutions. Besides, it stressed that it could use additional unconventional instruments to face the risk of an extended period of low inflation. These programs will complement the measures announced in June and will strengthen new long-term financing terms channeled to certain sectors (TLTROs), with a considerable impact on the ECB balance. Finally, in its October and November meetings, the ECB maintained unchanged its monetary policy rates and arranged the operational details of the programs announced in September to purchase assets, such as the date of the beginning, duration and eligibility conditions.

In its monetary policy meetings during the period covered by this Report the Bank of England maintained its reference rate at 0.5 percent, it did not modify the stock of its asset purchase program and kept unchanged the forward guidance for its reference rate. In the minutes of October, most members of the Monetary Policy Committee noted that there is not enough evidence of inflationary pressures to justify an increment in interest rates, emphasizing that when the referred increment takes place, it will be gradual.

In its October meeting the Bank of Japan expanded its program of quantitative and qualitative monetary easing to achieve its price stability target of 2 percent. This Central Institute decided to accelerate the annual growth rate of the monetary base from about JPY 60-70 trillion to JPY 80 trillion. Furthermore, it raised its government bond-buying target from JPY 50 to 80 trillion, and announced its intention to extend the average duration of bonds it holds by 3 years, to a range of 7-10 years. Likewise, the Central Bank tripled the annual purchases of exchange-traded funds and Japanese real-estate investment trusts to JPY 3 trillion and JPY 90 billion, respectively.

Differences in the monetary policy conduction continued in emerging economies. In some economies, such as Brazil, Russia and South Africa, the increment in inflationary and exchange rate pressures led to central banks increasing their reference interest rate. In contrast, the central banks of Chile, Korea, Hungary, Peru, Poland and Romania reduced their interest rates given an environment of low inflation and lower than expected growth.

International financial markets registered a spike in volatility in the analyzed period, which translated in significant exchange rate adjustments in stock markets worldwide and in a lower demand for higher-risk financial assets. High volatility is attributed to the deterioration of the world economic outlook, given a lower than expected growth in various economies, particularly in the Euro zone, geopolitical risks and fear of the Ebola epidemic, as well as the observed and expected differences in the monetary policy evolution in main advanced economies.

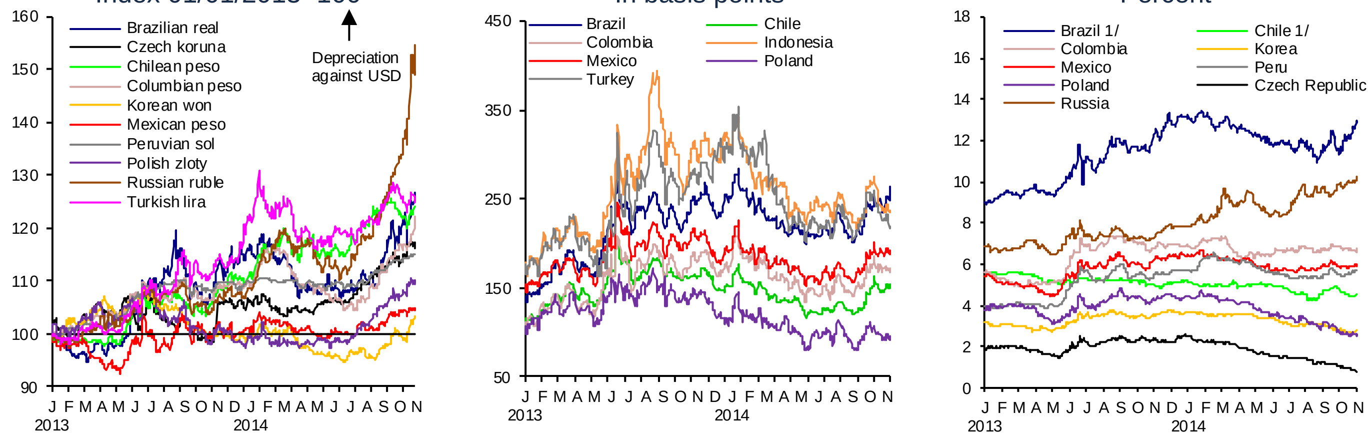
Thus, the U.S. dollar appreciated significantly against the main currencies, while the Euro and the Yen depreciated. The exchange rate of emerging economies' currencies generally depreciated against the U.S. dollar. Additionally, sovereign risk margins of this group of economies increased given a greater risk aversion in the markets, especially in September and October. On the other hand, long-term interest rates in these economies also observed a differentiated evolution, in some cases affected by lower inflation expectations, but also by different growth prospects and unequal macroeconomic fundamentals (Chart 15). Finally, capital flows to emerging economies grew until early September, with subsequent continuous outflows.

Chart 15
Financial Indicators of Emerging Economies

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

b) Sovereign Spreads
In basis points

c) 10-year Bond Yield
Percent



Source: Bloomberg.

Source: Bloomberg.

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

Considering the abovesaid, it should be noted that a possibility of the lower than expected growth of the world economy, as well as uncertainty regarding the speed at which the Federal Reserve will normalize its monetary policy would intensify volatility in international financial markets, in particular in those of emerging economies, with less solid macroeconomic fundamentals.

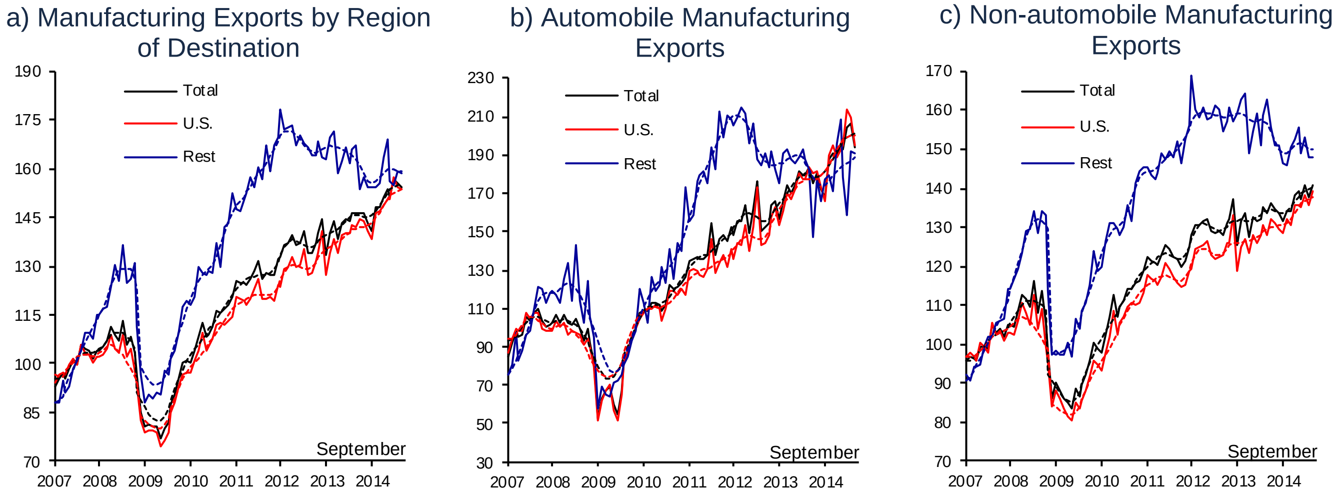
3.2. Development of the Mexican Economy

3.2.1. Economic Activity

According to the latest information, the reactivation of productive activity of the country which was observed in the second quarter of 2014 persisted in the third one, albeit at a more moderate rate. This performance mainly derived from the dynamism of external demand and a weak improvement in domestic demand.

In the third quarter of 2014, manufacturing exports continued to show the increase in dynamism that had begun in the first quarter. This performance was principally the reflection of the impulse of exports to the U.S., while the exports to the rest of the world stagnated (Chart 16a). Meanwhile, the rebound in manufacturing exports to the U.S. reflected increments of both the automobile sector exports and the rest of manufacturing (Chart 16b and Chart 16c).

Chart 16
Indicators of Manufacturing Exports
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.

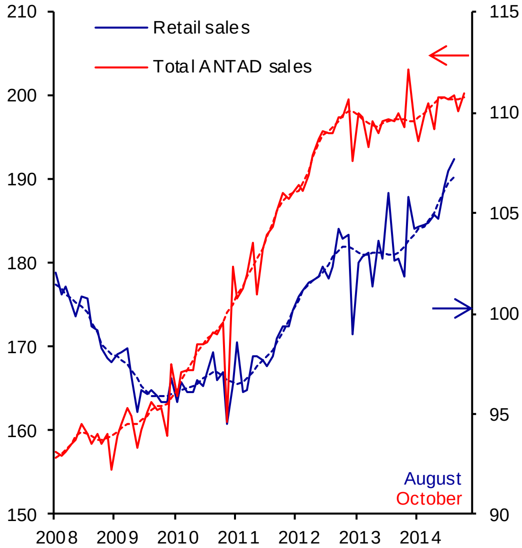
Some indicators of private consumption and gross fixed investment suggest that in the third quarter of 2014 these components of domestic spending continued reactivating, although at a relatively weaker pace as compared to the previous quarter.

i. As for private consumption, despite two consecutive quarterly seasonally adjusted increments in ANTAD sales, in the third quarter of 2014 this expansion was more moderate. On the other hand, in the period of July-August the revenues of commercial retail establishments obtained from marketing activities and services' provision showed a certain reactivation (Chart 17a).[3] Likewise, by the end of the second quarter and the beginning of the third one, monthly private domestic consumption registered a recovery trend (Chart 17b).

[3] Based on data from August 2014, INEGI released the results of the Monthly Survey of Commercial Firms, substituting those from the Monthly Survey of Commercial Establishments. Based on this new survey, INEGI reports the indices of revenues from the supply of goods and services of commercial retail and wholesale firms, instead of the indices of revenues from sales of goods in commercial retail and wholesale establishments that were obtained in the previous survey.

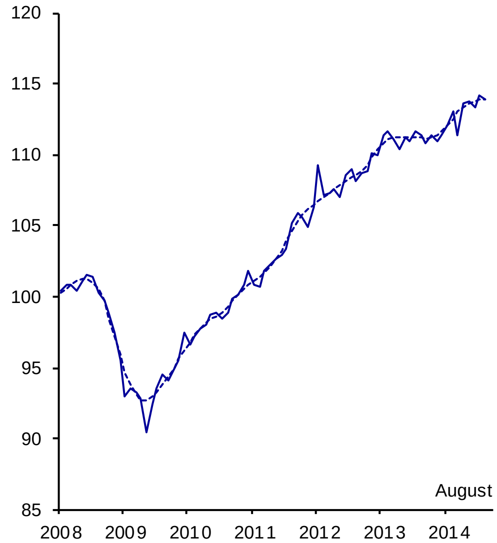
Chart 17
Consumption Indicators

a) Revenues of Commercial Retail Establishments and Total ANTAD Sales to Stores 1/
Indices 2003 and 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/ Revenues from the retail supply of goods and services has 2008=100 Base and Total ANTAD Sales have 2003=100 Base.
Source: Prepared by Banco de México with ANTAD data and the Monthly Survey of Commercial Establishments, INEGI.

b) 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: INEGI.

ii. Despite the abovesaid, some determinants of consumption remain somewhat weak. In particular, although in the third quarter workers' remittances improved as compared to the second one (Chart 18a), the wage bill of all workers is still affected by the low levels of the real average income of the employed population. Likewise, the consumer confidence index is still below the levels reached in early 2013 (Chart 18b). As indicated further below in this Report, consumer credit continued decelerating (see Section 3.2.2).

iii. In the first two months of the third quarter of 2014, gross fixed investment kept increasing (Chart 19a). This has resulted from the dynamism of investment in the national machinery and equipment, as well as a higher level of imports of capital goods (Chart 19b). Likewise, the recovery of private investment in housing has persisted, while the rest of private construction maintains an upward trend (Chart 19c) (see Box 1).

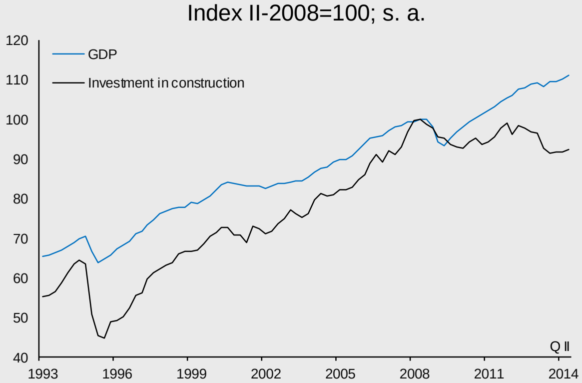
Box 1
Investment in the Construction Sector and Economic Activity in Mexico

1. Introduction

The construction sector in Mexico has registered a weak performance in recent years. Even in the environment of the general economic slowdown observed since mid-2012, the construction sector has presented a relatively unfavorable evolution for idiosyncratic reasons (Chart 1). However, certain reactivation has been observed in 2014 so far, reflecting the fact that some of the shocks that had affected the sector began to revert.

This Box briefly describes the major setbacks experienced by private construction, especially housing construction, and the recent signs of reactivation. Moreover, it states that public construction has also slowed down since 2012. Additionally, although public investment, as reported by the Ministry of Finance (SHCP), reactivated, public expenditure may not have affected the productive activity yet. Finally, more timely indicators point to a certain recovery of investment in construction and a strengthening is anticipated in the following quarters as a result of the National Infrastructure Plan and the recent approval of structural reforms.

Chart 1
Investment in Construction and GDP
Index II-2008=100; s. a.

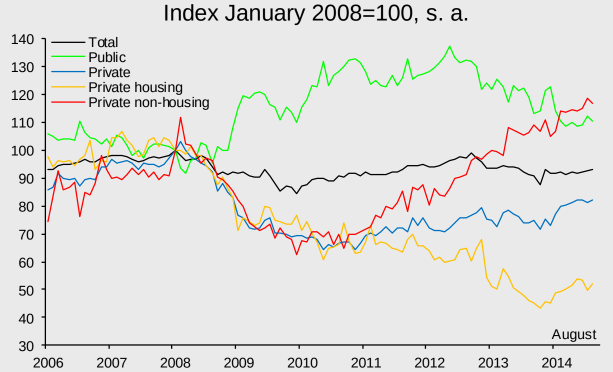


s. a. / Seasonally adjusted data.
Source: INEGI. For the case of investment in construction, the seasonal adjustment was prepared by Banco de México.

2. Investment in Private Sector Construction

The private construction sector has had a differentiated behavior as compared to the two subsectors it is composed of: the residential and the non-residential construction (Chart 2). Investment in residential construction did not recover after the international financial crisis, even though the rest of the economy had already been showing signs of recovery. In fact, it did not recover until early 2014 and it has been far from the high levels achieved in 2008. In that regard, it should be pointed out that the sector of private housing has faced significant setbacks, even since the world economic crisis. Although these setbacks are complex, in sum it should be noted that real estate development companies seem to have built more housings than required to meet demand. It is possible that prior to the crisis the sector operated under lax financial standards, in an environment of ample availability of resources and high demand, which could have induced excessive and unsustainable growth. The crisis hampered the resources' inflow to this sector and made the structural problems evident. Thus, once the Mexican economy entered the recovery phase after the crisis, the housing production did not recover and even the main real estate development companies went bankrupt.

Chart 2
Real Value of Production in Construction by the Hiring Institutional Sector
Index January 2008=100, s. a.

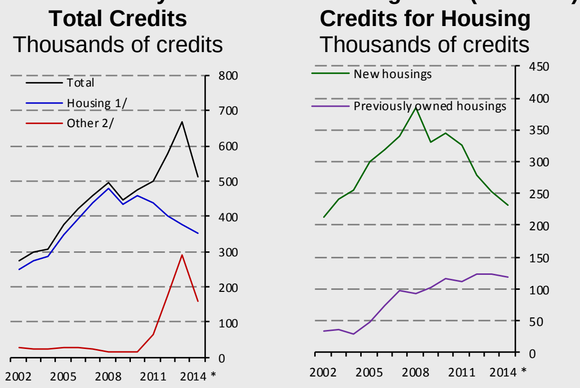


s. a. / Seasonally adjusted data. For the case of public and private construction, the seasonal adjustment was prepared by Banco de México with data from INEGI.
Source: INEGI, National Survey of Construction Companies (ENEC).

This was exacerbated by some events that affected the performance of the housing market, such as the shift in demand from new housings in favor of used housings.

The reactivation of Infonavit housing credits in 2012, which is an indicator of total demand for housing, was due to the increment of those granted for used housings (Chart 3). This could have hindered the recovery of the residential construction sector, despite the fact that total demand for housing slightly recovered in congruence with the economic cycle. This may have reflected that previously owned housings have better characteristics in terms of location and size. Besides, access to credit destined for used housings' purchase may have been facilitated. On the other hand, a series of supply shocks related to increments in construction commodity prices, particularly in 2011 and 2012 (Chart 4), seem to have interfered with a greater downward adjustment in the prices of new housings and have made them more attractive.

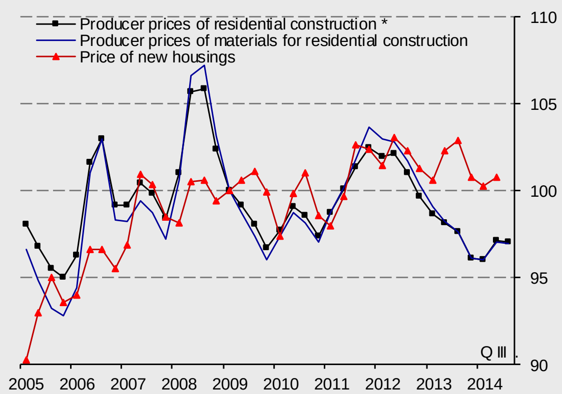
Chart 3
Credits Granted by the National Housing Fund (Infonavit)



1/ Includes new and previously owned housings.
2/ From 2011, credits granted by the program "Renew your Home" are included. This program grants credit to improve the housing one resides in (painting, waterproofing, changing the kitchen or bathroom furniture, etc.).
*/ Annual figures as of September 2014.
Source: Housing Policy and Information Directorate, Mexico's National Housing Commission, CONAVI.

More recently, the new administration announced it would publish the rules regarding the required characteristics of housings for the possible buyers to be eligible to receive subsidies. Nonetheless, the release of these rules was not immediate, which may have forced construction firms to cease their activities. It is possible that the release of the National Housing Plan in February 2013 and of the rules to grant subsidies in July of the same year contributed to the recently observed reactivation by resolving uncertainty regarding the rules governing the sector.

Chart 4
Housing Prices and Production Costs
Index I-2009=100

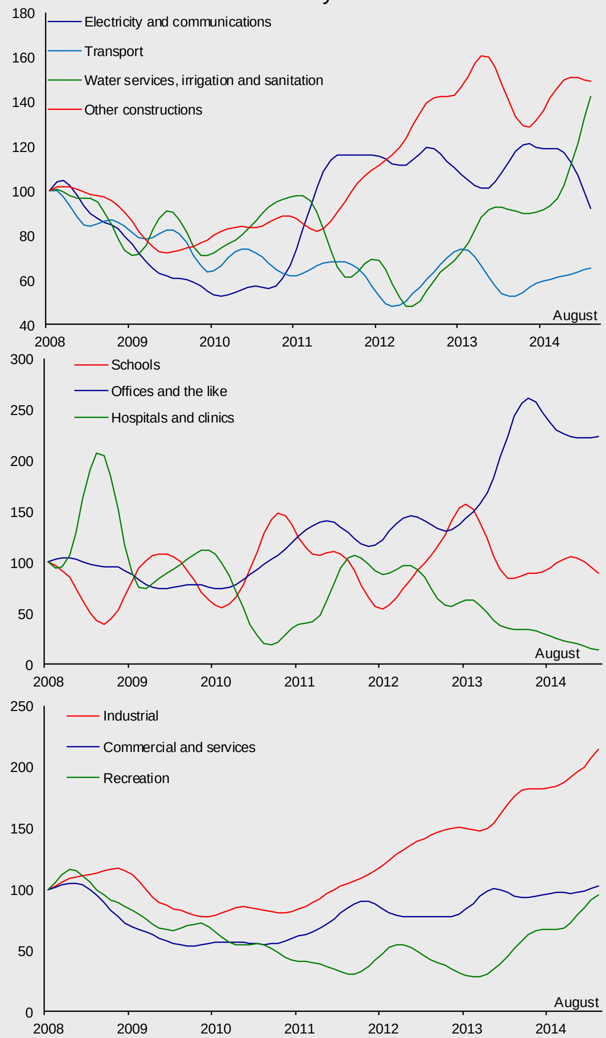


Source: SHF and INEGI.
*/ The Index of Producer Price for Residential Production, besides the subindex of building materials' prices, also includes the corresponding subindices of the machinery and equipment rental prices, as well as the prices of labor, whose levels have not increased significantly. The indices are reported in relative terms with respect to consumer prices.

In contrast with the abovesaid, non-residential private construction performed more in congruence with the economic cycle. Despite a strong deterioration between the early 2008 and mid-2010, the recovery registered by the end of that year led to higher than pre-crisis levels by mid-2013 and in 2014 so far.

The reactivation of non-residential private construction over the last four years has been relatively widespread inside its different segments. This seems to be consequent on the greater dynamism of aggregate demand observed over these years (Chart 5). Indeed, based on the data from the National Survey of Construction Companies by INEGI, there has been a considerable reactivation of private construction works in industrial plants, commercial and services buildings, office buildings and works in the electricity and communications sectors, and irrigation and sanitation sectors. Moreover, construction of buildings destined for recreation and entertainment has also slightly recovered. The only exceptions to this renewed dynamism seem to be transport works and construction of schools and hospitals, where there is still no notorious reactivation. It should be stressed, however, that these items represent a more reduced share of private construction as compared to most previously mentioned types of work

Chart 5
Non-residential Private Construction
Indices January 2008 =100*



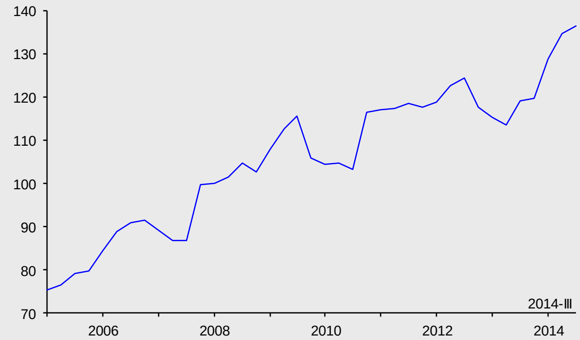
* Trend series.
Source: Prepared by Banco de México with data from INEGI, ENEC.

3. Investment in Public Sector Construction

Using the data from the National Survey of Construction Companies, Chart 2 shows that public construction was at high levels in 2010 and has stagnated since then. Additionally, according to these findings, the trend has been negative since 2012 but seems to have stopped declining in recent months.

It should be noted that public investment has recovered in recent months, according to the data reported by the Ministry of Finance (SHCP, Chart 6). However, this recovery has not been reflected in the National Accounts yet. Indeed, given the calculation methodology employed by the Ministry of Finance, National Accounts do not necessarily reflect the real activity generated by the public sector.

Chart 6
Investment Encouraged by Public Sector SHCP
Index I-2008 = 100 in constant Mexican pesos*



Source: Prepared by Banco de México with data from SHCP and INEGI.
*/ Quarterly flows of encouraged investment as reported by the Ministry of Finance (SHCP) in constant Mexican pesos were deflated with the CPI of INEGI. Figures are reported considering the moving averages of the four quarters.

In this regard, the main differences between the calculation of encouraged investment as reported by the SHCP and that of investment in construction from the National Accounts published by INEGI should be detailed.

a) As established by the Federal Income Law 2010 to 2015, expenditure on projects of Pemex infrastructure is considered as investment in construction. This information is not to be incorporated by INEGI as such, but rather as an intermediate consumption of production.[1,2]

b) The Ministry of Finance' source includes expenditures on the analysis of preinvestment in construction, while according to the Mexico's System of National Accounts it excludes activities dedicated exclusively to rendering of professional services, such as technical assistance and drafting projects related to the studies of preinvestment.

c) Although both sources of information include the federal public sector (the federal government, Pemex, the Federal Electricity Commission (CFE), the Mexican Social Security Institute (IMSS) and the Institute for Social Security and

[1] The Federal Income Law, approved on October 30, establishes that: "maintenance and operating costs of comprehensive infrastructure projects of *Petroleos Mexicanos* (Pemex) […] will be registered as investment".

[2] As regards aggregate demand, Mexico's System of National Accounts would indirectly classify it as private or government consumption, or exports depending on the final consumer of the good produced by Pemex (crude oil, gasoline, etc.).

Workers (ISSSTE)), apart from that INEGI includes investment of state and municipal governments.[3]

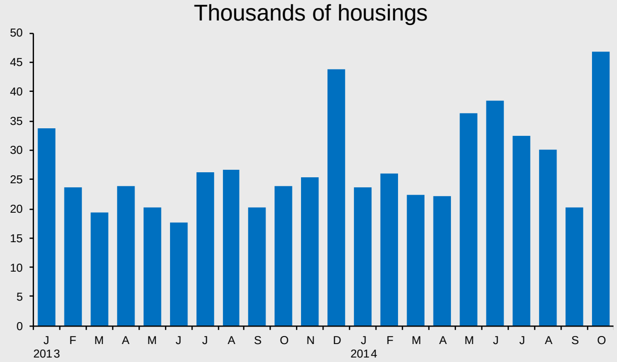
d) Public finance statistics of the Ministry of Finance (SHCP) are reported in cash flows, while public construction of INEGI is registered in accrued terms.

e) The Ministry of Finance uses public sector expenditure records as a source of information, while the National Accounts use surveys, in which the surveyed firms report their production value and the sector (private or public) they were hired by to carry out the project.

4. Recent Reactivation of the Construction Sector

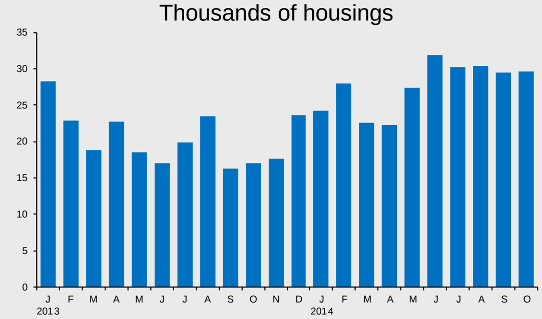
As mentioned above and can be observed in Chart 2, the construction sector has registered certain reactivation in recent months. Indeed, the positive trend of the non-residential private construction was complemented by the rebound in the residential one, despite a negative trend still presented by public construction. Additionally, more timely data indicate that this recovery could continue over the next months. Indeed, since May 2014 the indicators of new housing registers and starts have increased as compared to those observed last year (Chart 7 and Chart 8). Likewise, besides the reactivated provision of subsidies, the ones related to new housings have increased proportionally greater than those of previously owned housings. This fact also points to a greater activity in the construction sector.

Chart 7
Register of Housings
Thousands of housings



Source: Mexico's National Housing Registry.

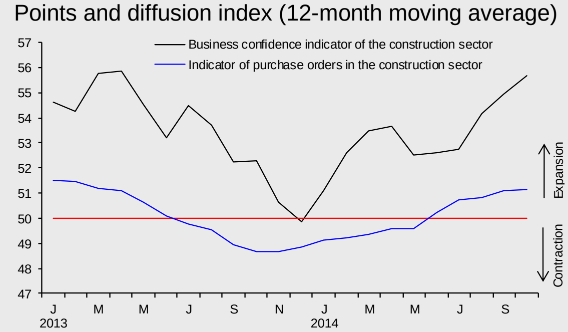
Chart 8
Housing Starts
Thousands of housings



Source: Mexico's National Housing Registry.

It should also be stressed that the construction business confidence indicator has lied above the expansion threshold since January 2014. In the same line, purchase orders in the construction sector, following a contraction for various months, have recently presented a sign of recovery (Chart 9). Furthermore, a survey among business directors of the construction sector carried out by Banco de México indicates that most of them (59 percent) anticipate a greater dynamism of the sector's activity in the second half of 2014.

Chart 9
Indicators of Business Opinion in the Construction Sector: Indicator of Business Confidence and of Purchase Orders
Points and diffusion index (12-month moving average)



Source: Prepared by Banco de México with data from the Monthly Survey of Business Opinion (EMOE) realized by INEGI, as well as the Regional Monthly Survey of Economic Activity in Non-manufacturing Sectors carried out by Banco de México.

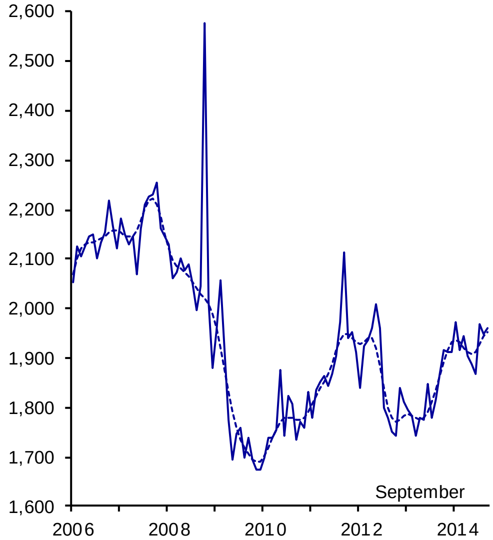
5. Outlook and Conclusions

The fact that the National Infrastructure Plan 2014-2018 considers various works of great magnitude also implies an encouraging picture for the sector of investment in construction. In particular, the expected construction of a new Mexico City airport stands out. Moreover, the energy reform approval also points to greater private sector investment in the oil sector, the natural gas sector and the electricity sector. Nonetheless, it should be noted that in order to achieve the expected investment in new projects, it is necessary to maintain a macroeconomic environment that favors economic growth and to strengthen the institutional framework.

[3] The statistics of public finances of the federal public sector released by the Ministry of Finance (SHCP) consider the investment realized by states and municipalities principally funded by means of contributions and agreements of decentralization. Likewise, it excludes investment realized by these government levels funded with own resources (interests, local taxes and indebtedness), which would indeed be reflected in the National Accounts.

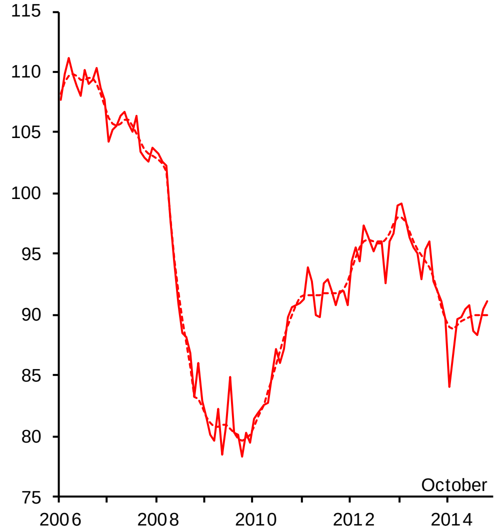
Chart 18
Consumption Determinants

a) 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.

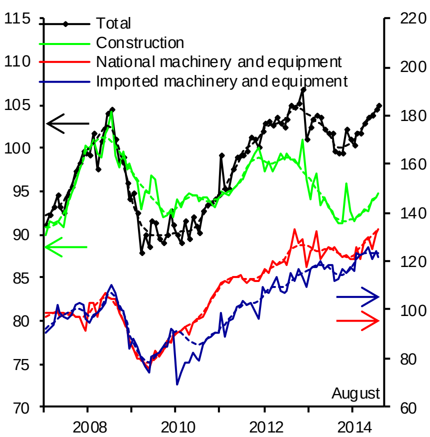
b) Consumer Confidence Index
Index Jan 2003=100, s. a.



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.

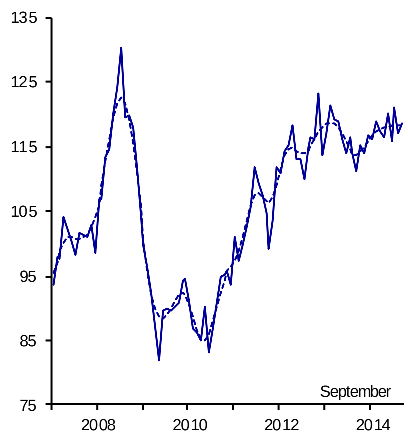
Chart 19
Investment Indicators

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



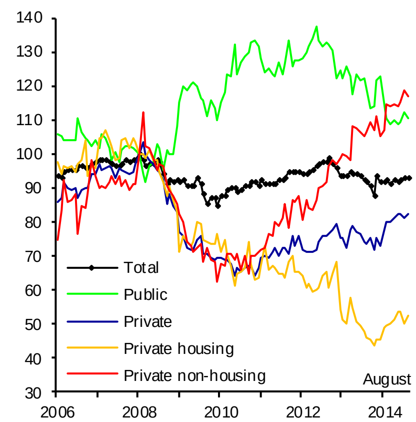
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Mexico's System of National Accounts, INEGI.

b) 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.

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



s. a. / Seasonally adjusted figures. 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.

As a result of the impulse of external demand, as well as the recovery of domestic demand, in the third quarter of 2014 productive activity continued expanding, although at a more moderate rate (Chart 20a). In particular:

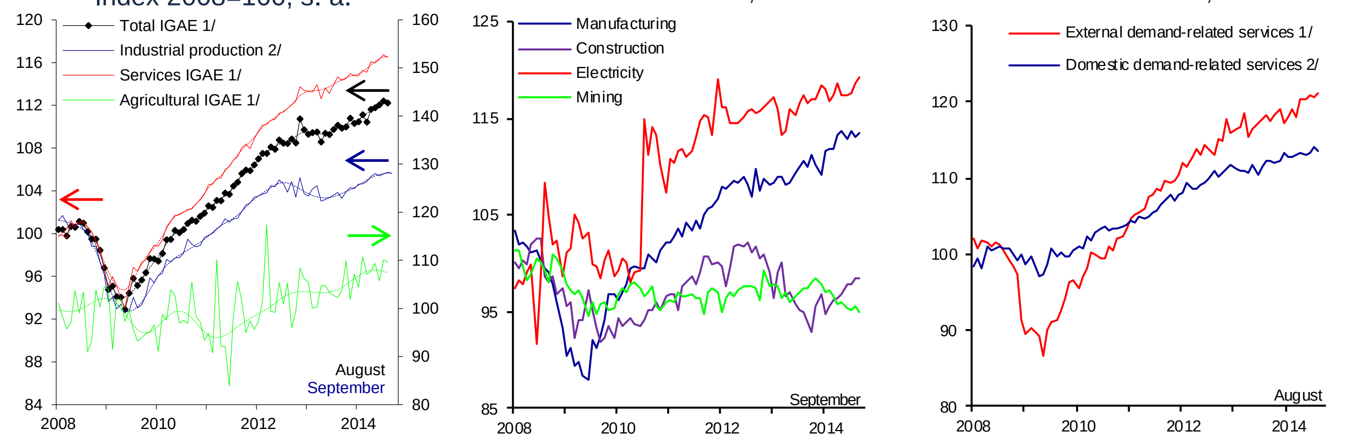
- In the third quarter of 2014, industrial production maintained a positive trend that had started in early 2014, although at a slower pace as compared to the second quarter. This trend mainly reflected the performance of the manufacturing industry, the rebound in the construction sector and an improvement in the electricity sector. On the other hand, the mining industry kept observing a negative trend (Chart 20b).
- Despite a decrease in the services sector in August 2014, a positive trend is expected to prevail in the third quarter. This trend derived from an increment in the external demand-related trade services and a weak rebound in the services related to domestic demand, such as government activities, domestic trade, and recreation and other services (Chart 20c).
- In the first two months of the third quarter of 2014, primary sector activities registered a positive performance, which was largely a reflection of a favorable climate for sowing and harvesting of the autumn-winter cycle, particularly of sorghum. Likewise, the volumes of production of perennial crops generally increased.

Chart 20
Indicators of Production

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

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

c) IGAE of the Services Sector
Index 2008=100, s. a.



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

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

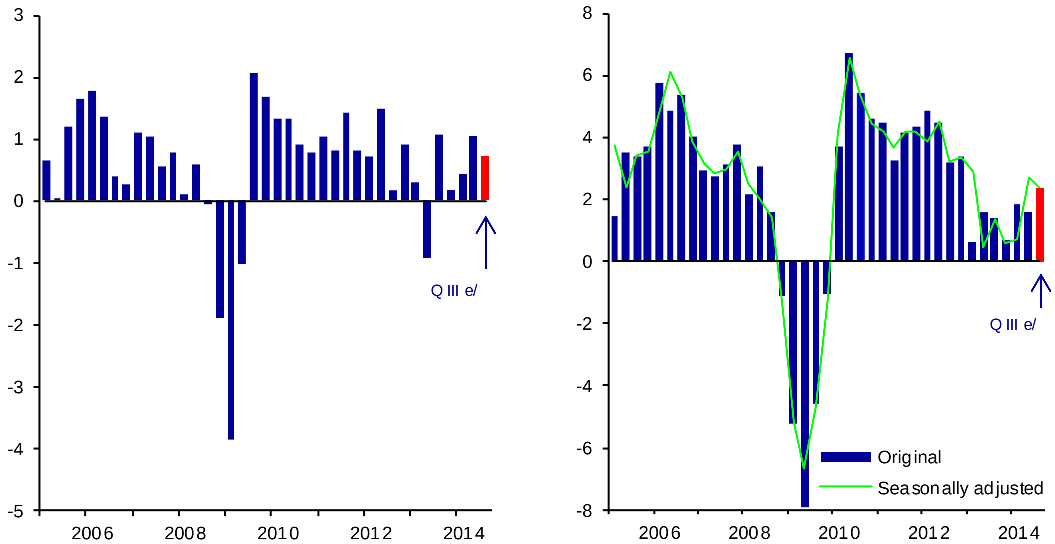
s. a. / Seasonally adjusted data.
1/ It includes commerce, transport, mail and warehousing, and mass media services.
2/ It includes the remaining sectors of tertiary activities.
Source: Prepared by Banco de México with data from Mexico's System of National Accounts, INEGI.

As a result of the abovesaid, for the third quarter of 2014 Mexico's GDP is expected to increase at a quarterly seasonally adjusted rate of around 0.6 percent, as compared to increments of 0.17, 0.44 and 1.04 percent in the previous three quarters, in chronological order (Chart 21a). In annual seasonally adjusted terms, GDP growth is estimated to be around 2.2 percent for the third quarter of this year, compared to 0.6, 0.7 and 2.7 percent in the previous three quarters. Based on data without seasonal adjustment, the annual change of GDP is estimated at 2.2 percent in the third quarter, figure that is compared to 0.7, 1.9 and 1.6 percent in the previous three quarters (Chart 21b).

Chart 21
Gross Domestic Product

a) Quarterly Change
Percent, s. a.

b) Annual Change
Percent



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

Despite the gradual recovery of economic activity, the most recent data suggest that in the third quarter of 2014 slack conditions persisted in the labor market, even though these seem to be decreasing. In particular:

i. The number of IMSS-insured workers presented a growing trend, even more dynamic as compared to that of total employment of the economy (Chart 22a).

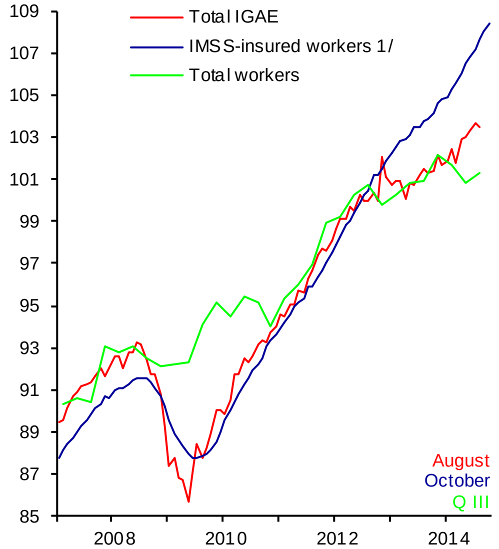
ii. As a consequence, a recomposition of employment in favor of the formal sector has been observed, which has resulted in a negative trend in informality rates since mid-2012 (Chart 22b).

iii. In turn, national and urban unemployment rates still report high levels and even levels higher than those registered in late 2013, despite a decrease in August and September 2014. It should be mentioned that, in part, the persistence of high unemployment rates in Mexico could be affected by the fact that, given the conditions prevailing in the U.S. and in its labor market, the migration of Mexicans to the referred country has reduced, which, in turn, raised labor supply in the Mexican labor market (Chart 22c).

iv. As a reflection of the above, a negative trend in average real wages of employed population is still observed. As a result, the wage bill showed a downward trend, and it suggests that so far no labor cost-related pressures on inflation have been observed (Chart 22d).

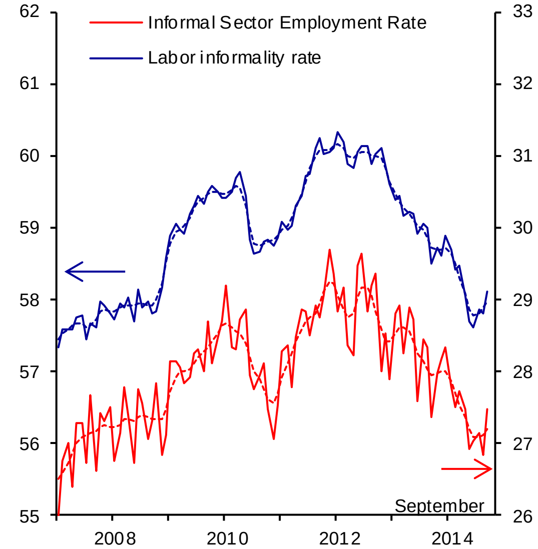
Chart 22
Labor Market Indicators

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



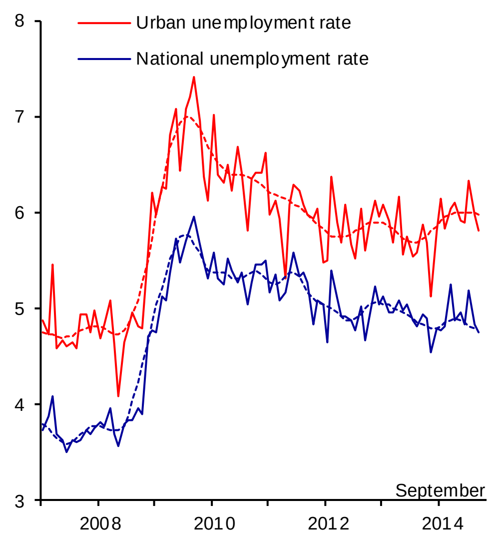
s. a. / Seasonally adjusted data.
1/ Permanent and temporary workers in urban areas. Seasonal adjustment by Banco de México.
Source: Prepared by Banco de México with data from IMSS and INEGI (SCNM and ENOE).

b) Labor Informality Rate
Percent, s. a.



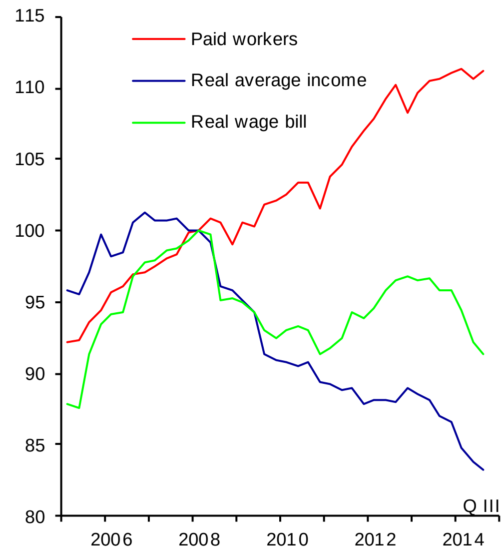
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
Source: Prepared and seasonally adjusted by Banco de México with information from the National Employment Survey (ENOE), INEGI.

c) 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.

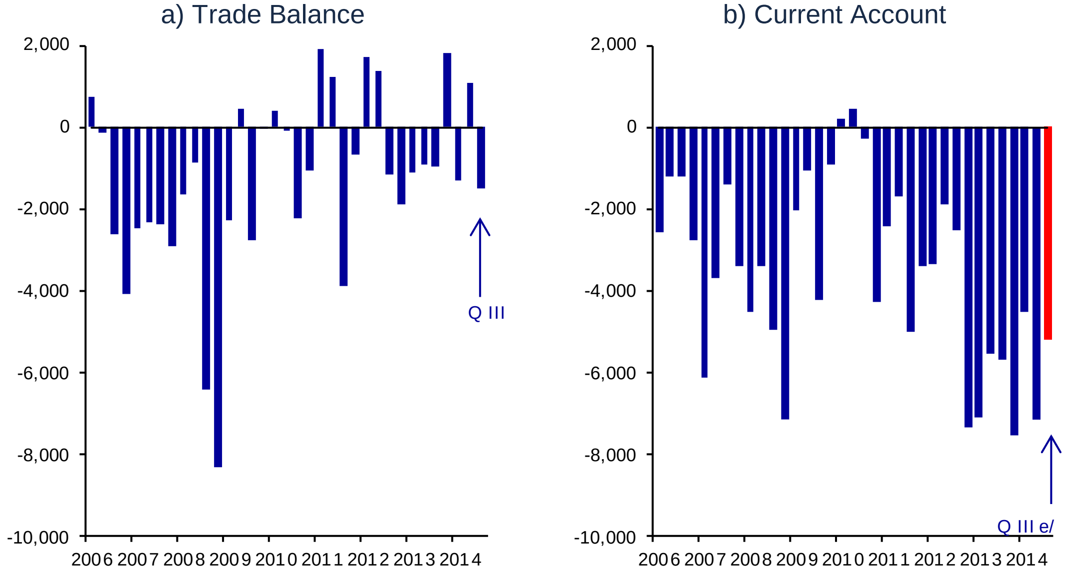
d) Real Total Wage Bill
Index I-2008=100, s. a.



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

Finally, in the third quarter of 2014, the trade balance registered a deficit of USD 1,513 million (Chart 23a). In turn, available data suggest that in the same period the current account observed a moderate deficit and that the country continued receiving capital inflows via the financial account sufficient to allow an easy financing of this deficit (Chart 23b).

Chart 23
Trade Balance and Current Account
USD million



Source: Banco de México.

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

3.2.2. Financial Saving and Financing in Mexico

In the third quarter of 2014, the sources of financial resources of the economy moderated their growth rate with respect to the previous quarter. On the one hand, it derived from a lower dynamism of domestic sources –following the recovery in the first half of the year-, and, on the other hand, from a lower growth of external sources, given higher volatility in international financial markets.

With respect to domestic sources, the stock of domestic financial saving –defined as the monetary aggregate M4 held by residents minus the stock of currency held by the public- registered a lower growth rate as compared the previous quarter, which was a result of lower growth rates of both the voluntary and the compulsory savings component (Chart 24). This partly resulted from a lower valuation of medium- and long-term instruments comprising this retirement funds' portfolio, as a consequence of the increment of these instruments' interest rates during the quarter prior to the environment of volatility in international financial markets. In turn, in the reference quarter the monetary base kept expanding with a similar dynamism to that in the previous quarter, in an environment of recovering economic activity and low interest rates.[4]

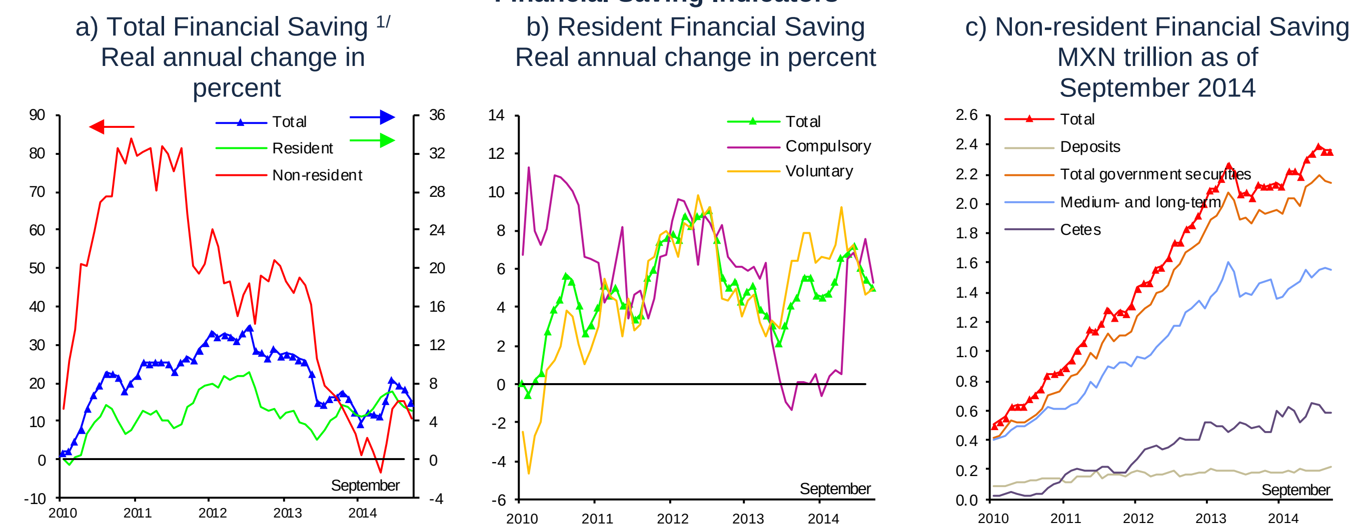
As regards external sources of financial resources, their growth rate also moderated as compared to the last quarter. On the one hand, the stock of non-resident financial saving remained practically unchanged with respect to late June (Chart 24). It should be noted that assets held by this sector were rearranged, when short-term government securities' holdings (Cetes) reduced, while medium- and long-term

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

ones increased. The increment in longer-term instruments' holdings took place even though the referred instruments were affected by the valuation as a result of the said increase in interest rates. On the other hand, the moderation in the growth rate of external sources was also contributed to by a lower inflow of foreign sources of financing channeled to non-financial private firms.

As regards the use of financial resources in the economy, financing to the non-financial private sector moderated its growth rate as compared to the previous quarter. In the third quarter of 2014, financing to non-financial private firms observed a lower growth rate with respect to the period of April-June 2014. This moderation was largely due to a decrease in the growth rate of foreign financing principally associated to the base effect, due to an unusually high amount of placements of external debt in the third quarter of 2013. Domestic financing to the business sector presented lower dynamism in the reference quarter, particularly derived from lower commercial banks' credit flows (Chart 25).

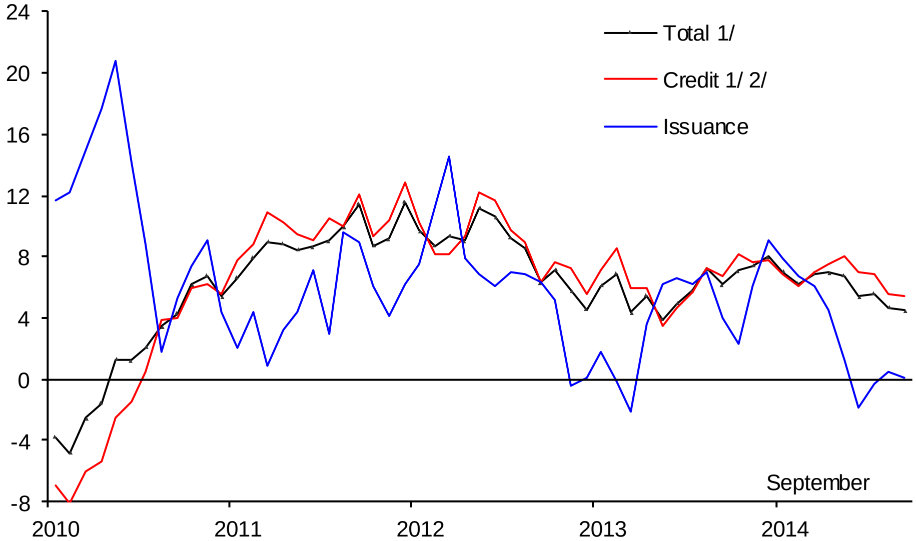
Chart 24
Financial Saving Indicators



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

Taking a closer look at the above, commercial banks' credit to firms had a real annual growth rate of 3.3 percent in the third quarter of 2014, figure lower than 4.4 percent of the second quarter of 2014. This derived from a lower dynamism of the growth rate of credit to large firms, while the credit portfolio to small and medium firms kept growing at relatively high rates. Direct credit of development banks kept expanding at rates similar to those observed in the period of April-June 2014 (Chart 26a). In this environment, interest rates and delinquency rates of banks' credit to firms still did not modify significantly in the reported period (Chart 26b and Chart 26c).

Chart 25
Domestic Financing to Non-financial Private Firms
Real annual change in percent



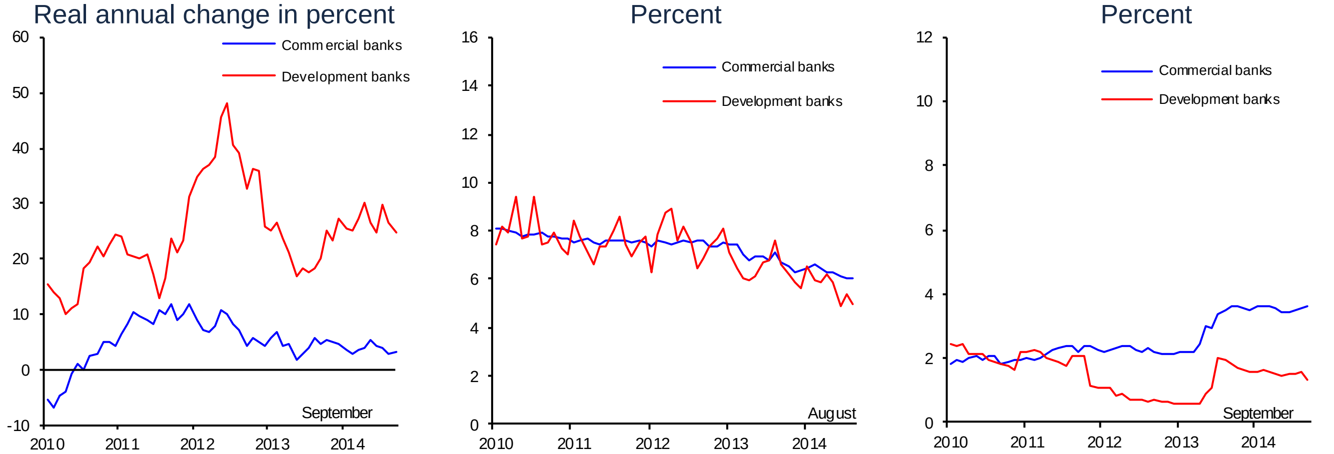
1/ These figures are affected by the disappearance of some non-banking financial intermediaries and their conversion to non-regulated Sofom.
2/ It refers to the performing and non-performing portfolio, and includes credit from commercial and development banks, as well as nonbank financial intermediaries.
Source: Banco de México.

Chart 26
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/
Percent

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



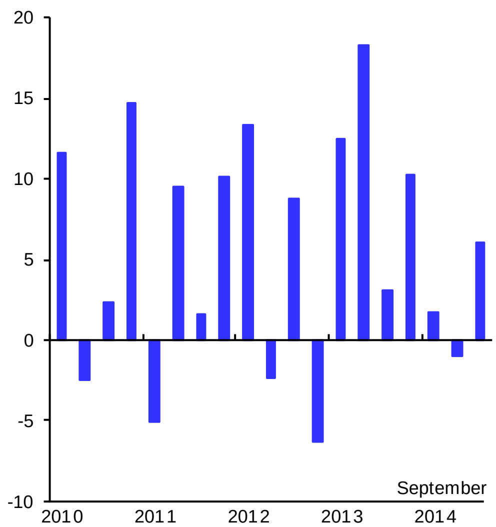
1/ It refers to the interest rates of new bank credits to non-financial private firms, weighted by the associated stock of the performing credit and for all credit terms requested.
2/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.
Source: Banco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

In the domestic debt market, the net placement of medium- and long-term securities by non-financial private firms in the third quarter of 2014 was greater as compared to the previous one (Chart 27a). In particular, the total amount issued in the domestic market, excluding amortizations was MXN 6.0 billion in July-September 2014 (which resulted from gross placements of MXN 18.9 billion and gross amortizations of MXN 12.9 billion), which was higher as compared to the net placement of MXN -1.0 billion in the previous quarter. In this context, a trend of lower interest rates of private domestic debt persisted, both for medium- and short-term placements (Chart 27b).

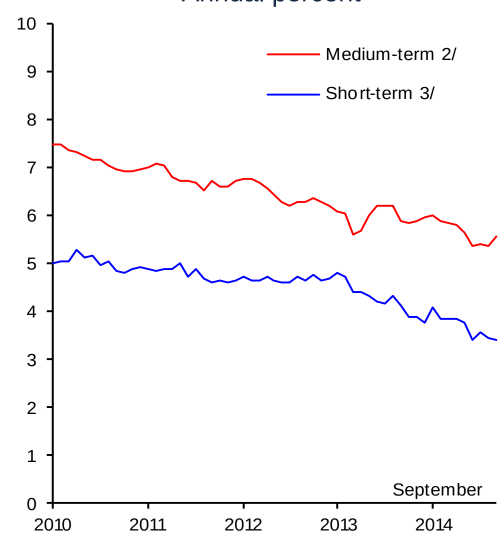
Segments comprising credit to households registered a mixed performance in the third quarter of 2014. On the one hand, the mortgage loan portfolio of commercial banks and sofomes expanded at an average real annual rate of 5.6 percent, maintaining a similar dynamism to that observed over the previous quarters (Chart 28a). This occurred in an environment, in which interest rates and delinquency rates did not present any substantial changes (Chart 28b). Still, the performing portfolio of the National Housing Fund kept expanding at relatively low rates (Chart 28a). As regards the quality of the National Housing Fund's portfolio, following a deterioration in the previous quarters, the delinquency rate remained relatively stable in the third quarter of the year (Chart 28b).

Chart 27
Securities of Non-financial Private Firms in the Domestic Market

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



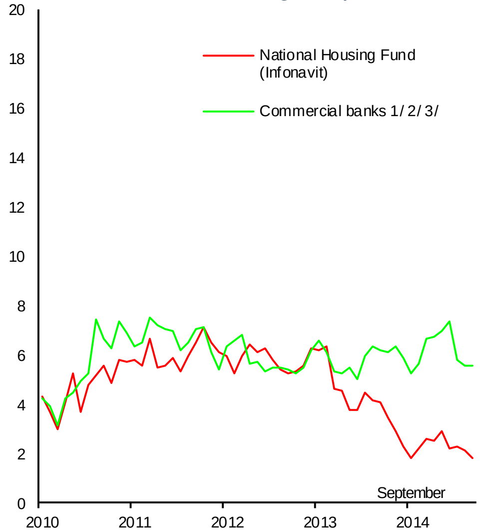
b) Interest Rates of Securities Issued by Non-financial Private Firms
Annual percent



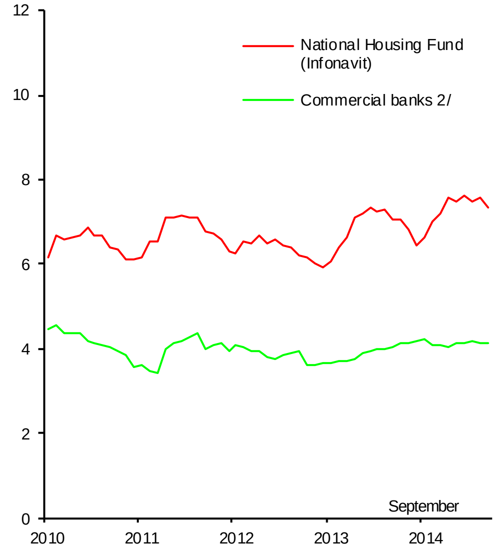
1/ Placements excluding amortizations in each month (securities and prepayments).
2/ Placements of more than one year.
3/ Placements of up to one year.
Source: Banco de México, with data from Valmer and Indeval.

Chart 28
Housing Credit

a) Performing Housing Credit
Real annual change in percent



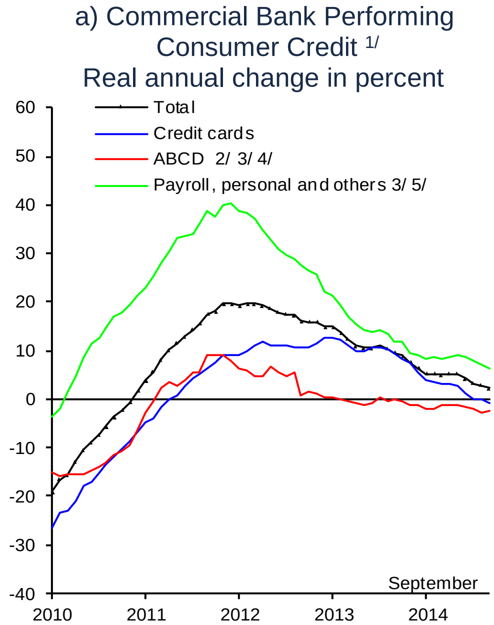
b) Delinquency Rates of Housing Credit 4/
Percent

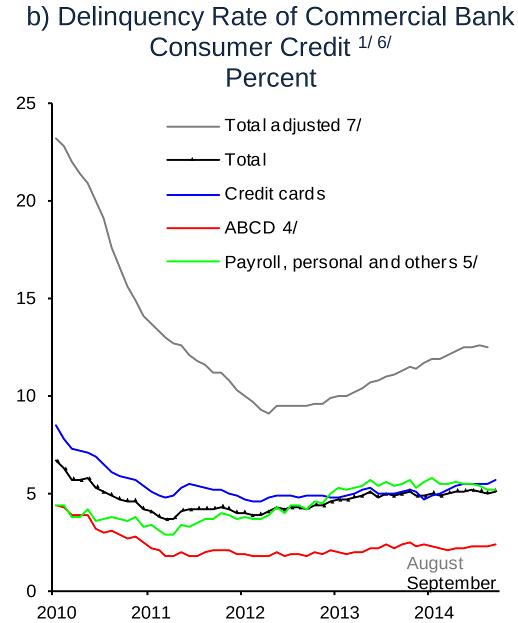


1/ Figures are adjusted in order to avoid distortions by the pass-through effect of UDIS trust portfolio to the balance sheet of commercial banks and by the reclassification of credit in direct portfolio to ADES.
2/ It includes sofomes of commercial banks.
3/ Figures are adjusted to avoid distortions 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 of commercial banks kept decelerating its growth rate during the third quarter of 2014 especially that granted through credit cards (Chart 29a). In particular, the performing consumer credit portfolio of commercial banks expanded in the period of July-September at an annual real rate of 2.8 percent, figure below 4.9 percent observed in the period of April-June 2014. In this context, the corresponding interest rates and delinquency rates did not present significant adjustments. As regards the latter, it stands out that the adjusted delinquency rate –which takes into account bad debt write-offs accumulated in the last twelve months– remained at levels similar to those observed in the second quarter of 2014, thus interrupting the upward trend registered in the previous quarters (Chart 29b). Although this dynamics of the delinquency rate is congruent with the reactivation of economic activity that started in the last quarter, it is important to remain alert so that the credit portfolio does not deteriorate further over the following quarters.

Chart 29
Commercial Bank 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 durable goods (ABCD) to other consumer credits by one banking institution.
4/ It includes credit for property acquisition and automobile credit.
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 punishments accumulated over the last 12 months divided by total portfolio plus punishments accumulated over the last 12 months.
Source: Banco de México.

In sum, financing to the non-financial private sector presented an evolution congruent with the performance of economic activity. In the future, insofar as the expectation of greater growth of productive activity is realized, a gradual increment in demand for financial resources by the non-financial private sector is expected. Therefore, considering that the public sector financial requirements will remain high next year, a less favorable external environment could imply reduced availability of resources for the private sector. In particular:

i. Taking into account the observed evolution of sources of financial resources until the third quarter of 2014, for the end of 2014 they are expected to lie at 9.0 percent of GDP, figure slightly above 8.6 percent registered in 2013 (Table 2). This resulted from an increment in domestic sources of resources from 4.8 to 5.4 percentage points of GDP. External sources are estimated to decrease with respect to last year from 3.8 to 3.6 percent of GDP, as a result of lower capital flows to emerging economies. Regarding the use of financial resources, the flow of financing to the private sector is expected to locate at 2.9 percentage points of GDP, lower than 3.9 percent of GDP observed in 2013. In contrast, resources destined to the public sector –that include the Public Sector Financial Requirements (PSFR) and financing to states and municipalities– are estimated to go up from 3.4 to 4.5 percent of GDP.

ii. For 2015, lower funding sources are anticipated. This principally results from the contraction of expected availability of foreign funding resources –which would shift from 3.6 percent of GDP in 2014 to 2.3 percent in 2015- as a result of the expected monetary stimulus withdrawal in the U.S. (Table 2). Financing to the public sector, in line with the General Criteria of Economic Policy 2015, will reduce from 4.5 to 4.3 percentage points of GDP.[5] Thus, a decrease in the financial resources directed to the private sector from 2.9 to 2.5 percent of GDP would be expected.

iii. For 2016, a similar outlook to that of 2015 is anticipated, in terms of flows of domestic and external sources of financial resources (Table 2). As regards the use of resources, public sector financial requirements will decrease to 3.8 percent of GDP, in line with above referred General Criteria of Economic Policy 2015, thus generating greater availability of resources to finance private sector, which will increase to 3.1 percent of GDP.

The above exercise stresses the importance of continuing with the fiscal consolidation in the following years, given that it will allow channeling greater resources to the private sector, besides guaranteeing the sustainability of public debt.

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

	Annual flows							
	2009	**2010**	**2011**	**2012**	**2013**	**2014 e/**	**2015 e/**	**2016 e/**
Total sources	**4.0**	**9.3**	**10.0**	**10.0**	**8.6**	**9.0**	**7.9**	**7.9**
Domestic sources	3.4	4.1	5.7	4.4	4.8	5.4	5.6	5.6
Voluntary M4	1.7	2.6	4.2	3.0	4.1	4.0	4.2	4.2
Compulsory M4 1/	1.7	1.5	1.5	1.4	0.7	1.4	1.4	1.4
Foreign sources	0.6	5.2	4.3	5.6	3.8	3.6	2.3	2.3
Non-resident M4	0.5	2.9	3.0	4.5	1.3	1.4	0.5	0.6
Securities and foreign credit 2/	0.2	2.3	1.3	1.1	2.5	2.2	1.8	1.7
Total uses	**4.0**	**9.3**	**10.0**	**10.0**	**8.6**	**9.0**	**7.9**	**7.9**
International reserves 3/	0.5	2.2	2.4	1.8	1.0	1.4	1.1	1.1
Public sector financing	3.4	3.8	2.9	3.7	3.4	4.5	4.3	3.8
Public Sector Borrowing Requirements 4/	2.6	3.4	2.7	3.2	3.0	4.2	4.0	3.5
States and municipalities	0.8	0.4	0.3	0.5	0.4	0.3	0.3	0.3
Private sector financing	0.0	2.5	3.5	3.1	3.9	2.9	2.5	3.1
Foreign	-0.4	0.5	0.7	0.8	1.6	0.9	0.7	0.7
Domestic 5/	0.4	2.0	2.8	2.4	2.4	2.0	1.8	2.4
Other 6/	0.2	0.8	1.1	1.4	0.2	0.2	-0.1	-0.1

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.
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 from M4.
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 2008 to 2013, 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). From 2014 to 2016, the PSBR as a percentage of the GDP are obtained from the General Criteria of Economic Policy 2015. Figures of revalued flows exclude the impact of the reform to the ISSSTE Law on PSBR.
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, as well as non-monetary liabilities from IPAB, among others.
Source: Banco de México.

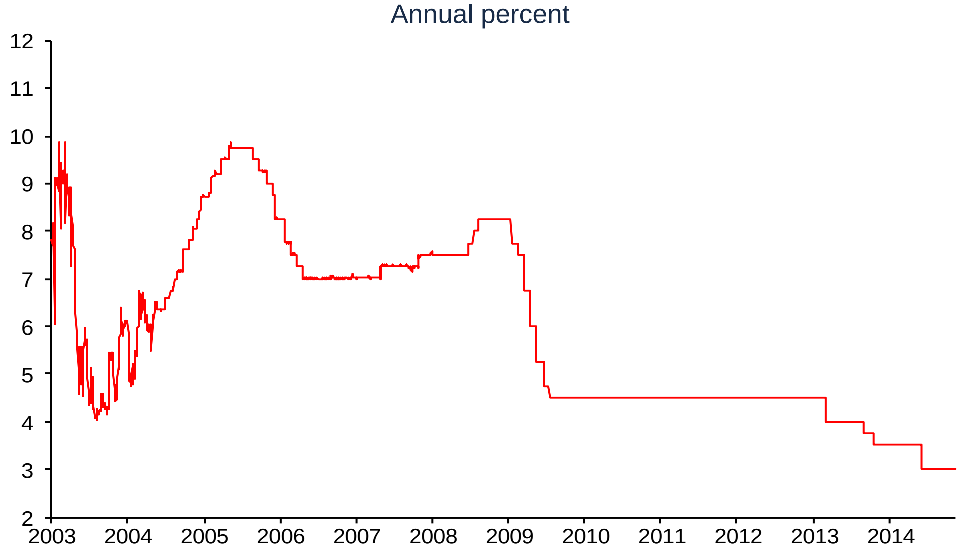
5 In congruence with the public balance in the Federal Income Law for 2015, passed on October 30.

4. Monetary Policy and Inflation Determinants

The conduction of the monetary policy has been oriented to achieve the permanent inflation target. Structural progress in curbing inflation, among which the reduction of its level, volatility and persistence, the decrease in the pass-through of relative price adjustments and changes in the exchange rate onto consumer prices, the anchoring of inflation expectations and a lower inflation risk premia are noteworthy, has given the Central Institute a greater leeway to achieve the inflation target at a lower cost to society in terms of economic activity. With that in mind, in March 2013 Banco de México's Board of Governors reduced the reference interest rate by 50 basis points. Subsequently, given a favorable evolution of inflation and its expectations and slack conditions in the economy, the greater leeway mentioned above allowed this Central Institute to lower the reference interest rate on three additional occasions, thus accumulating another 100 basis points and, therefore, supporting the economic recovery without compromising the process of convergence to the 3 percent inflation target.

During the period covered by this Report, inflation expectations remained well-anchored, despite the fact that, as mentioned before, the increase in the price of some livestock products increased inflation above 4 percent. In this regard, considering the transitory nature of this shock on inflation, the expectation of economic agents of a considerable decrease of inflation in late 2014 and early 2015 and a high probability of inflation converging to 3 percent in mid-2015, at its last monetary policy meeting the Board of Governors of this Central Institute decided to maintain the target for the Overnight Interbank Interest Rate at 3 percent (Chart 30).

Chart 30
Overnight Interbank Interest Rate [1/]
Annual percent



1/ The target for the Overnight Interbank Interest Rate is shown since January 21, 2008.
Source: Banco de México.

Among the elements considered for the conduction of the monetary policy during this period, the following stand out:

a) That the fading of the effects of recent shocks in relative prices, the absence of fiscal measures that could impact the general level of prices in 2015, the elimination of long-distance national phone charges and the reduction in the annual change rate of gasoline prices in 2015, allow anticipating annual headline inflation to finish 2014 around 4 percent, to reduce considerably in early 2015 and to reach levels close to 3 percent from mid-2015 onwards. Likewise, derived from the abovementioned, core inflation is estimated to lie below 3 percent in 2015.

b) Inflation expectations implicit in medium- and long-term market instruments persisted around 3 percent, while survey-derived medium- and long-term inflation expectations remained stable at 3.5 percent. Additionally, even though those corresponding to the end of 2014 increased, lying close to 4 percent, the ones referring to the end of 2015 remained stable.

c) Although the output gap is expected to continue closing, no aggregate demand-related pressures on inflation are anticipated during the following quarters.

d) The expectation that Mexico's financial markets will continue operating in an orderly manner and the pass-through of exchange rate adjustments onto prices will be low, even if high volatility episodes persist in international financial markets, with their consequent effect on the Mexican peso exchange rate. It should be noted that Banco de México will remain alert to the uncertain international environment, in order to timely react to any event that, by means of its effects on domestic markets, could interfere with the convergence of inflation to its permanent 3 percent target.

Regarding the evolution of the degree of slack in the economy, these slack conditions are expected to continue reducing gradually over the next quarters, given the foreseen recovery of the dynamism of productive activity. Still, despite the degree of uncertainty related to the estimation of potential output, no increases of unit labor costs are expected in the referred period. In particular:

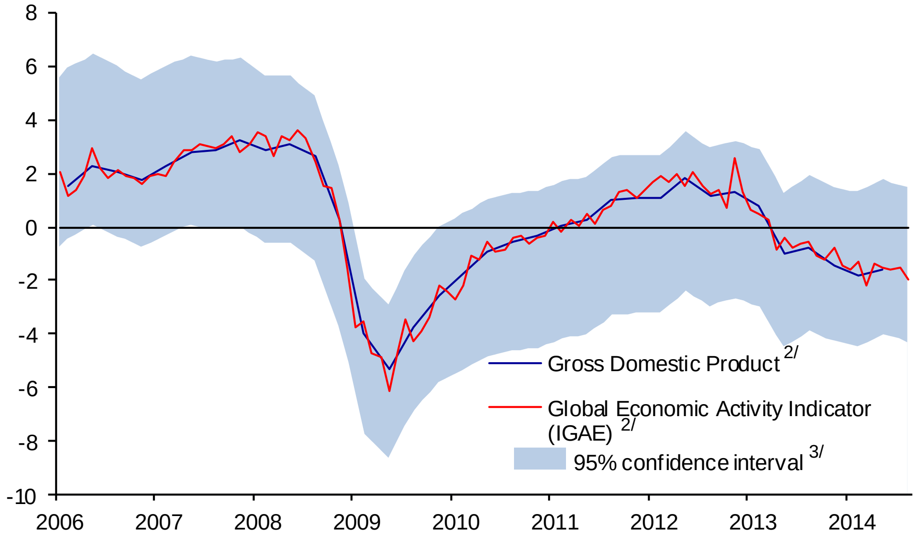
a) The output gap is estimated to remain negative, although it is expected to be closing over the next quarters (Chart 31).[6]

b) As mentioned above, slack conditions persist in the labor market (see Section 3.2.1).

c) Despite the recent increments in the annual growth rate of the IMSS reference wage, the drop in the real average income of Mexico's employed population, together with the increasing trend of labor productivity, led to a decrease in unit labor costs for the economy as a whole (Chart 32).

[6] 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.

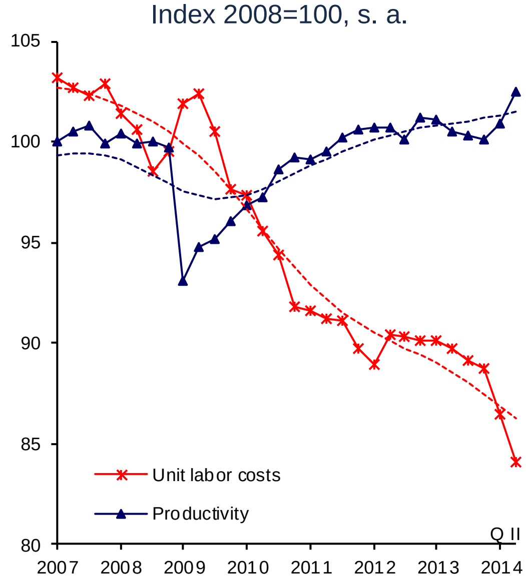
Chart 31
Output Gap Estimation [1/]
Percentage of potential output, s. a.



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

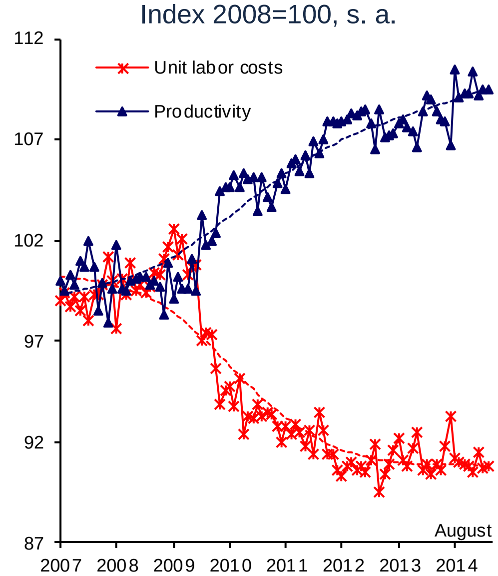
Chart 32
Productivity [1/] and Unit Labor Cost

a) In the Economy
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.

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

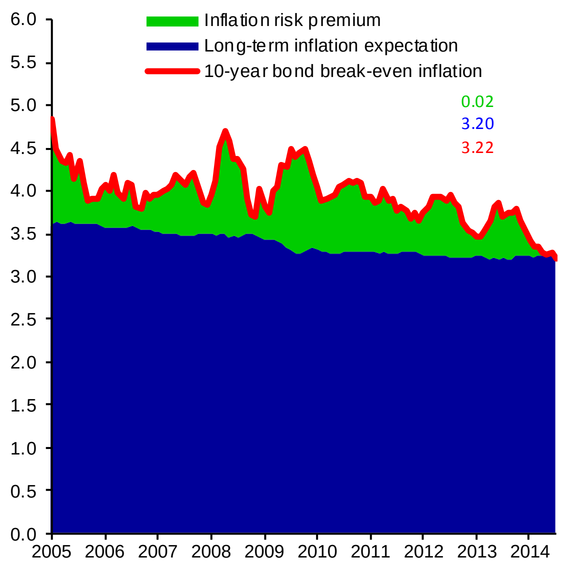


s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
1/ Productivity based on the number of hours worked.
Source: Prepared by Banco de México with seasonally adjusted data from the Monthly Manufacturing Business Survey and the monthly indicator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

Notably, inflation expectations implicit in long-term market instruments persist at levels close to 3 percent.[7] Thus, this indicator of inflation expectations, estimated from 10-year market instruments, remained stable around 3.2 percent between June and October 2014, while the associated inflation risk premium reduced from approximately 12 to 2 basis points in the same period (Chart 33a). Thus, break-even inflation (the difference between long-term nominal and real interest rates) shifted from an average level of 3.4 percent to 3.3 percent between the second and the third quarters of the year, reaching historic lows (Chart 33b). In sum, the continued reduction of this indicator reflects that the holders of nominal rate-indexed instruments have been requesting less coverage for future inflation.

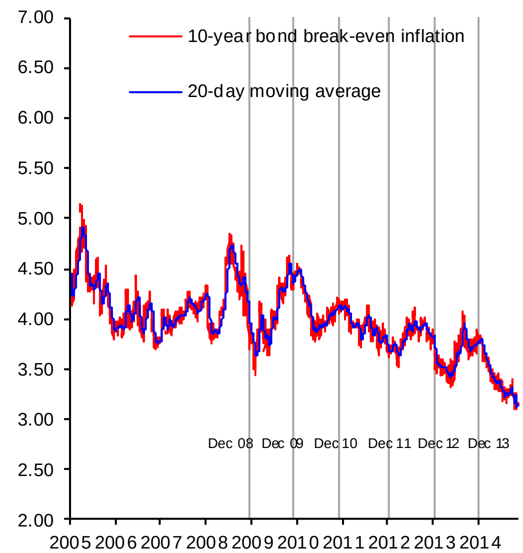
Chart 33
Inflation Expectations

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



1/ Last data available: October 2014.
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 close to 4 percent, shifting from 3.8 percent in June 2014 to 3.99 percent in October, given the spike in inflation observed over the recent months.[8] The expectation for core inflation for the end of 2014 persisted around 3.4 percent in the same period, while non-core inflation expectation, implicit in the previous median estimates increased from 5.16 to 5.93 percent (Chart 34a). It should be noted that despite the indicated performance, inflation expectations for each one of the subsequent months remained stable (Chart 34b).

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[7] 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.
[8] 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 3.88 percent in the survey of June 20, 2014 and increasing to 3.97 percent in the survey of November 5, 2014.

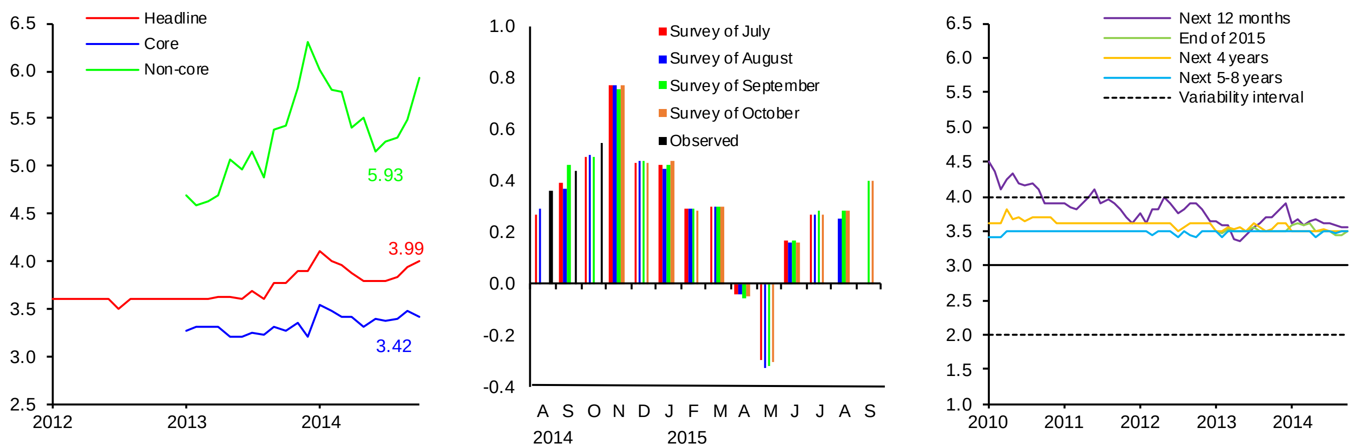
For 2015, the median of headline inflation expectations for the end of the year prevailed around 3.5 percent between June and October. In this respect, the median of core inflation expectations decreased slightly from 3.21 to 3.17 percent, while the implicit non-core inflation expectation went from 4.49 to 4.58 percent in the referred period. Finally, longer-term expectations remained stable at a level of around 3.5 percent (Chart 34c).[9]

Chart 34
Inflation Expectations

a) Medians of Headline, Core and Non-core Inflation Expectations as of End of 2014 1/
Percent

b) Monthly Inflation Expectations
Percent

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



1/ Last data available: October 2014.
Source: Banco de México's survey.

Source: Banco de México's survey.

2/ Last data available: October 2014.
Source: Banco de México's survey.

Following low volatility levels in financial markets in July 2014, volatility increased considerably in subsequent months, which resulted in an unfavorable performance of some financial asset prices. Among the factors that encouraged the said higher volatility are the following:

i. A worse outlook for the world economic growth, despite the economic recovery in the U.S.

ii. Uncertainty over when the Federal Reserve will begin increasing its reference interest rate.

iii. Divergence in expectations regarding the main advanced economies' monetary policy stances.

iv. The appreciation of the U.S. dollar.

v. Geopolitical risks.

vi. Fear of the epidemic of Ebola virus disease.

In this environment, there were adjustments in Mexican financial markets, although they were orderly and under adequate liquidity conditions. Thus, the index of prices and quotations of the Mexican Stock Exchange, which observed an upward trend since the second quarter of 2014, presented high volatility, dropping 5 percent

[9] The median of long-term inflation expectations (period 2016-2010) based on the Banamex survey also persisted around 3.5 percent between the surveys of June 20 and November 5.

between the beginning of September and mid-October. However, it has recently recovered, reason for which in the quarter as a whole this index' growth rate was 4 percent (Chart 35a).

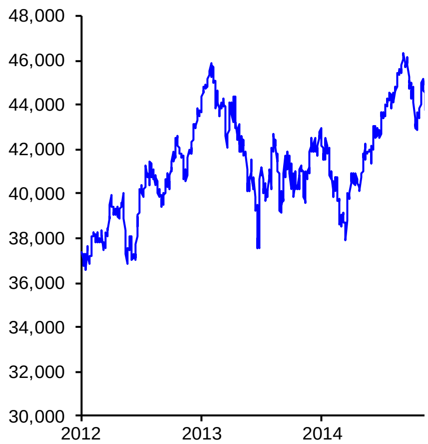
The Mexican peso exchange rate against the U.S. dollar went up from approximately MXN/USD 13 to 13.6 between late June and early November, depreciating around 4.5 percent, while during the year as a whole it was 4 percent, in a context of high volatility (Chart 35b and Chart 35c). It should be pointed out that the Mexican exchange market has preserved ample liquidity conditions, emerging economies' currencies having the highest trading volume (Chart 36a and Chart 36b). Moreover, a wide derivatives market allows economic agents to efficiently hedge against the exchange risks. In this context, the Mexican peso has been one of the currencies least affected by the recent volatility episode, once a group of emerging economies' currencies has depreciated against the U.S. dollar by approximately 10 percent in the same period of time.[10]

In this sense, even though it cannot be ruled out that new episodes of high volatility will persist in international financial markets, that would affect the Mexican peso exchange rate, it should be pointed out that the flexible exchange rate regime has allowed this variable to absorb external shocks. Furthermore, mainly due to the reduced pass-through of exchange rate fluctuations onto prices in recent years, the increment in the exchange rate volatility does not necessarily represent an important risk to inflation. The above has been possible because Banco de México has not monetized these shocks, given that this Central Institute has remained alert and did not allow exchange rate adjustments to be reflected in the dynamics of the price formation process.

[10] 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.

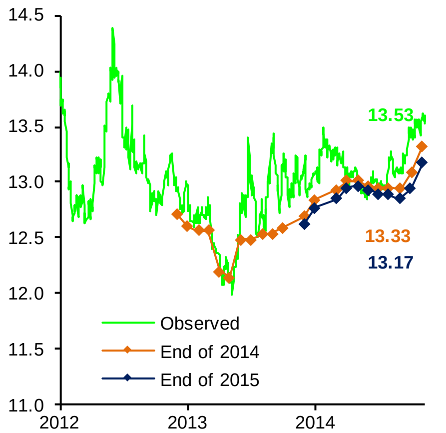
Chart 35
Index of Prices and Quotations of the Mexican Stock Exchange, Exchange Rate and Currency Option Implied Volatility

a) Index of Prices and Quotations of the Mexican Stock Exchange
Index



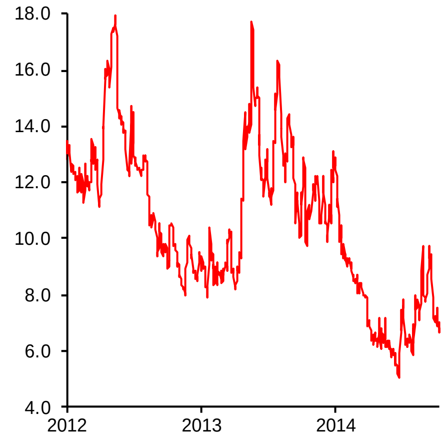
Source: Bloomberg.

b) Nominal Exchange Rate and Exchange Rate Expectations for the End of 2014 and 2015 1/
MXN/USD



1/ The observed exchange rate is the daily quote of the FIX exchange rate. The latest quote of the observed exchange rate corresponds to November 14, 2014. For its expectations, the latest quote corresponds to the survey of October 2014.
Source: Banco de México and Banco de México's survey.

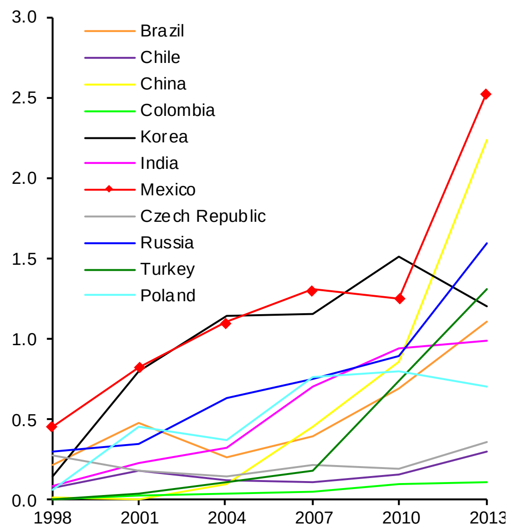
c) Currency Option Implied Volatility 2/
Percent



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

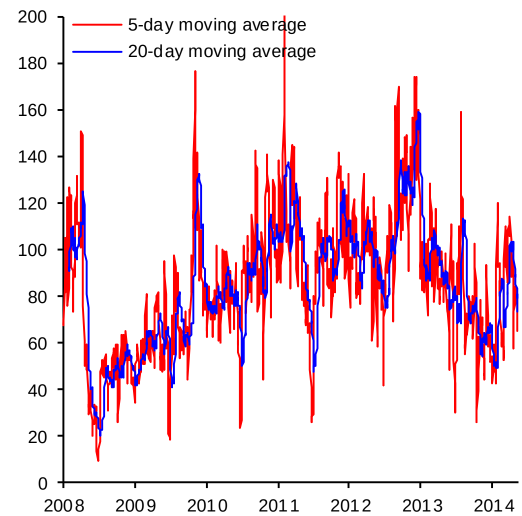
Chart 36
Trading Volume in the Exchange Market

a) Volume Traded in the Global Exchange Market 1/
Distribution % of traded volume 2/



1/ Given that two currencies are involved in each transaction, the total of percentages amounts to 200% rather than 100%.
2/ Data of April of each year.
Source: BIS triennial survey.

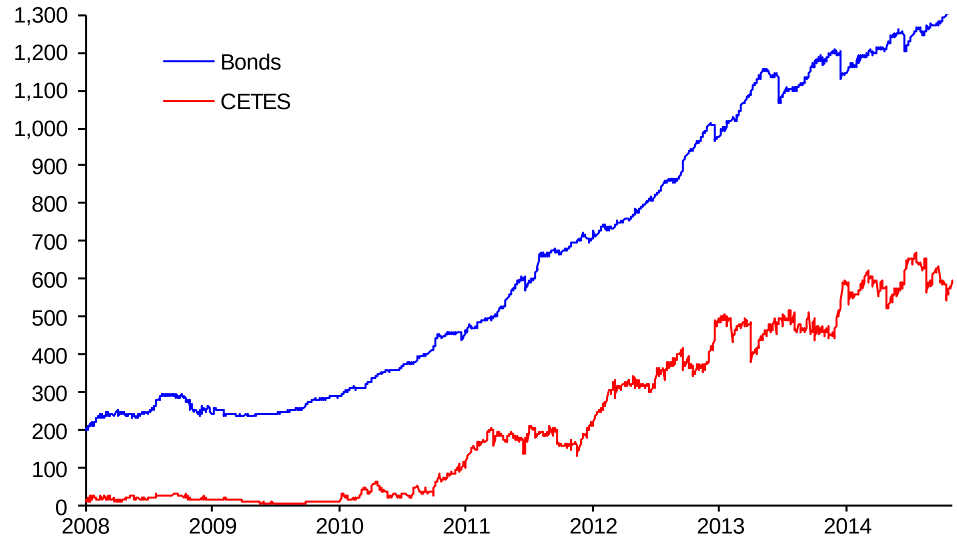
b) Volume Traded in the Exchange Market
Index 02-Jul-2008=100



Source: Banco de México and Reuters.

Despite greater volatility in financial markets, Mexico continued to attract foreign resources aimed at the acquisition of financial instruments in national currency. Thus, although investors' holdings of short-term government instruments decreased in the third quarter of 2014, those of medium- and long-term government instruments continued with their upward trend and remained at high levels (Chart 37).

Chart 37
Government Securities' Holdings by Foreign Investors
MXN billion

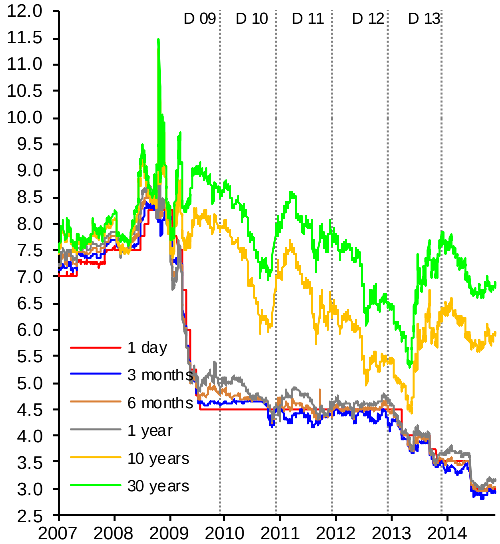


Source: Banco de México.

With regard to interest rates in national currency, they marginally increased for all maturities. In particular, the interest rate of 3-month government securities remained around 2.9 percent from late June 2014 to early November. Long-term interest rates presented high volatility. From late June to early October the 10-year bonds shifted from 5.7 to 6.0 percent, to decrease at the beginning of November to levels around 5.9 percent (Chart 38a). In this context, the slope of the yield curve (the difference between 10-year and 3-month rate) increased slightly from 280 to 300 basis points in the period from late June 2014 to early November (Chart 38b).

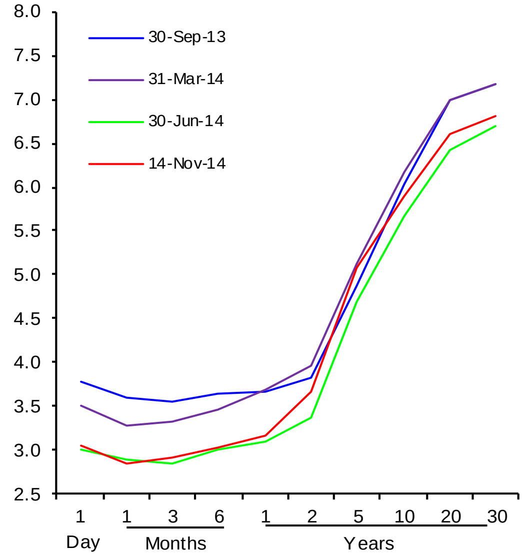
Chart 38
Interest Rates in Mexico

a) Government Securities Interest Rates [1/]
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).

b) Yield Curve
Percent



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

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

1. The target for the Overnight Interbank Interest Rate remained at 3 percent in the analyzed period.
2. Expected short-term interest rates remained unchanged. 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 persisted at 3 percent in the surveys from June to October. A similar evolution is inferred from the expectations implicit in market instruments' interest rates.
3. Finally, the evolution of different risk premia in Mexico was differentiated. Thus:
   i. Market indicators that measure sovereign credit risk for Mexico, after having reached historic lows in the second quarter of the year, increased slightly in the third one, although to a lesser degree as compared to other emerging economies, resuming levels shown in late 2013 (see Section 3.1.4).[11]
   ii. Inflation risk premium kept registering a decreasing trend in the analyzed period. In particular, during the third quarter of 2014, it dropped by approximately 10 basis points with respect to the previous quarter (Chart 33).

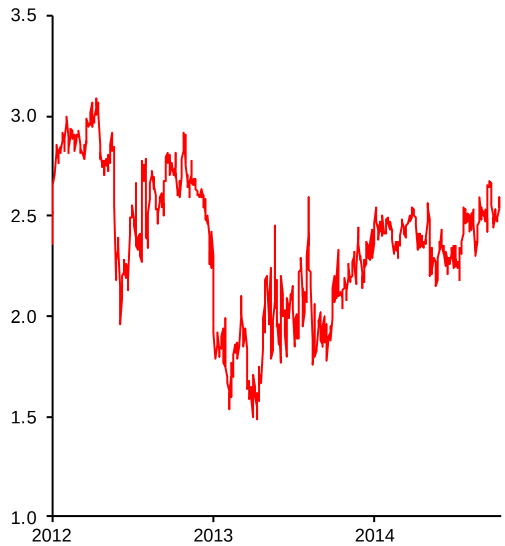
[11] It refers to 5-year Credit Default Swap.

iii. As to 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 the same term issued in the USD, it increased given the higher volatility registered in the exchange market (Chart 39a).

iv. Finally, the term premium (estimated as the difference between the 10-year and 2-year interest rates) slightly decreased from approximately 230 to 224 basis points from late June to the beginning of November (Chart 39b).

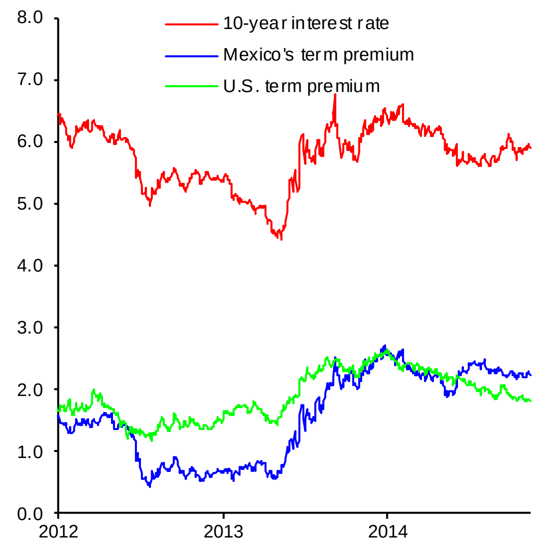
Chart 39
Risk Premia

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



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

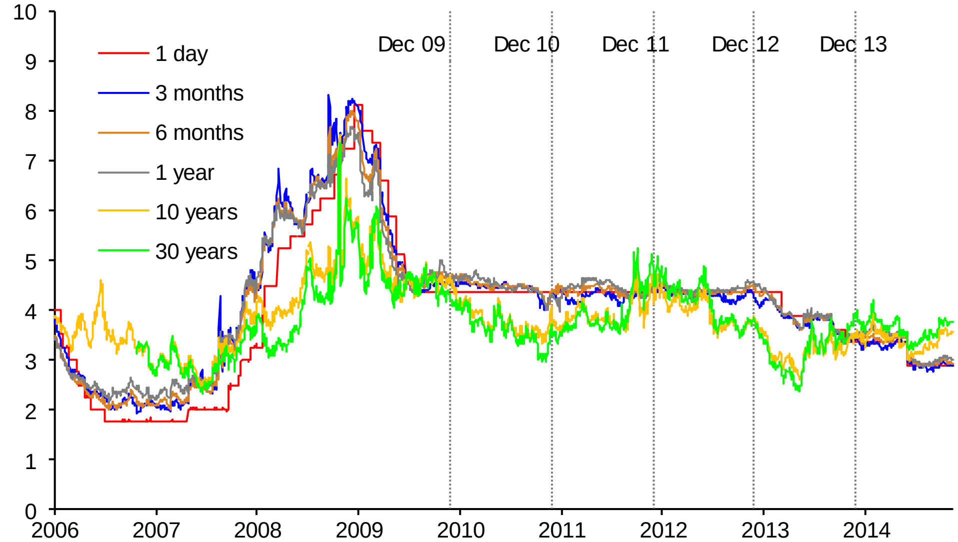
b) Mexico's 10-year Government Bond Interest Rate and the Term Premium [1/]
Percentage points, percent



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.

In accordance with the evolution of government bonds' interest rates in Mexico and the widespread decrease in interest rates in the U.S., the spreads of interest rates between both economies went up in the period. In particular, the 10-year interest rate spread increased from around 310 basis points in late June to 355 basis points in early November (Chart 40).

Chart 40
Interest Rate Spreads between Mexico and the U.S. [1/]
Percentage points



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

Despite the described environment, as mentioned above, the external sources of financing continued growing, although at a more moderate rate. Thus, foreign holdings of government debt instruments in the Mexican peso continued reflecting investors' confidence in the macroeconomic framework of the country and in the strategy of growth sustained on structural reforms. In this regard, the importance of maintaining the strength of the referred framework to facilitate an orderly adjustment of the Mexican economy to a less favorable external environment should be stressed. The above is crucial, given that volatility in international financial markets will probably persist over the following months, while it does not seem probable that the factors behind the referred volatility will dissipate in the near future.

5. Inflation Forecast and Balance of Risks

The expectations regarding the U.S. economic activity that are used for the construction of Mexico's macroeconomic framework are the following:[12]

a) The expected GDP growth in the U.S. in 2014 is adjusted, with respect to the previous Quarterly Report, from 2.1 to 2.2 percent, while that corresponding to 2015 remains at 3.0 percent. For 2016, the expectation for this indicator's growth is located at 2.9 percent.

b) The forecast for industrial production growth in the U.S. in 2014 remains unchanged at 4.0 percent, as compared to the previous Report. For 2015, this indicator is anticipated to expand 3.6 percent, a figure that is compared to the expectation of 3.7 percent in the last Quarterly Report. For 2016, an increment of 3.3 percent is expected.

GDP Growth Rate: The reactivation of the Mexican economy that had been observed in the second quarter persisted in the third one, although moderately. This dynamism is expected to prevail in the future, mainly supported by the impulse of the external demand, as well as by the gradual recovery of domestic expenditure. Thus, in 2014 the GDP growth rate is anticipated to lie between 2.0 and 2.5 percent, which compares to the interval of 2.0 to 2.8 percent published in the last Quarterly Report (Chart 41a). The expected lower dynamism in 2014 together with the estimation that the boost of the external demand and the reactivation of the domestic demand will persist suggests that in 2015 the GDP growth rate could be between 3.0 and 4.0 percent. However, it is expected that, if the structural reforms are adequately implemented, they will generate a gradual positive impact on the economic growth of Mexico, which could lead to a higher growth rates' interval for 2016. In this sense, for 2016 the forecast interval lies between 3.2 and 4.2 percent.

Employment: Considering the fact that the dynamism of the number of IMSS-insured workers continued to exceed that of the economic activity, the growth forecast for formal employment in 2014 is adjusted from an interval of 570 to 670 thousand workers to an interval of 640 to 710 thousand workers. For 2015, an increment of 620 to 720 thousand workers is still anticipated. For 2016, partly as a reflection of the implementation of the structural reforms, the number of IMSS-insured workers is estimated to perform more favorably, reason for which an interval of 640 to 740 thousand workers is expected.

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

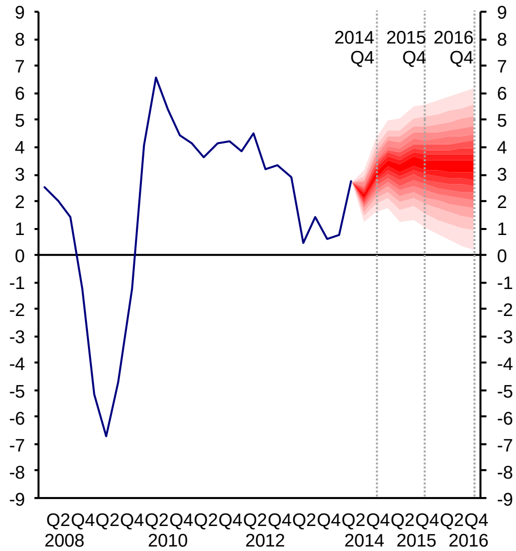
[12] Expectations for the U.S. economy for 2014 and 2015 are based on the consensus of analysts surveyed by Blue Chip in November 2014, while those for 2016 are based on the data release of Blue Chip in October 2014, as these are the most recent available forecasts for the given year.

in the economy and by the expectation of lower oil prices and exports' platform as compared to the previous forecast.

Even though it is anticipated that, due to a sharp deceleration of productive activity in late 2013 and early 2014, slack conditions will persist in the economy, it is also estimated that these will continue decreasing over the forecast horizon, given the anticipated dynamism for the economic activity (Chart 41b). Despite the above said, no aggregate demand-related pressures on inflation are expected, although due to uncertainty that naturally arises around the estimation of the potential growth of the economy, the evolution of slack conditions will have to be carefully watched.

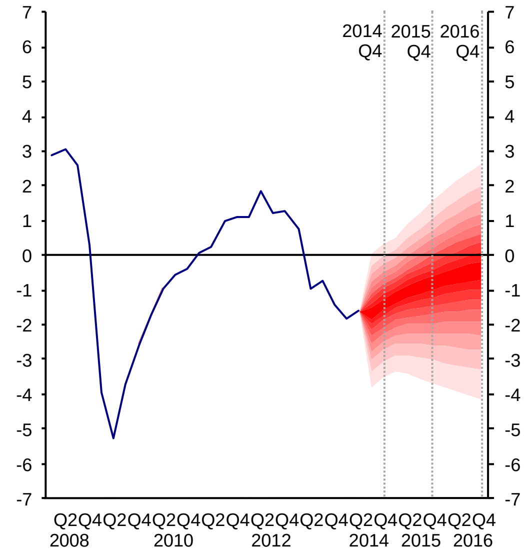
Chart 41
Fan Charts: GDP Growth and Output Gap

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



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

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



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

Among downward risks to the GDP growth outlook, the following stand out:

i. Lower than estimated world economic growth, particularly in the U.S.

ii. An additional reduction in the international oil price or in the production platform that could affect the external accounts and public finances of Mexico, requiring an adjustment in public expenditure in 2015.

iii. Increased uncertainty in international financial markets.

iv. Uncertainty generated by recent social events that could influence economic activity.

The growth outlook is also subject to upward risks, among which the following are notable:

i. A more vigorous than anticipated recovery of the U.S. economy.

ii. The rapid implementation of the first stages of structural reforms, in particular the energy reform, may contribute to a higher than expected investment.

Inflation: Given that the effect of recent supply shocks on inflation is expected to be transitory and that no second round effects have taken place so far, annual headline inflation is anticipated to decrease in December and to conclude the year around 4 percent. In early 2015, annual headline inflation is expected to decline considerably, once the arithmetic effect related to changes in relative prices derived from fiscal adjustments in early 2014 fades, and once long-distance national phone charges are eliminated, which together with a smaller increment in the gasoline price, locates the annual headline inflation forecast around 3 percent from the middle of the year onwards (Chart 42). For 2014, annual core inflation is estimated to persist close to 3 percent and below this level in 2015 (Chart 43). For 2016, both headline and core inflations are expected to lie at levels close to 3 percent.

It should be noted that the decrease in the growth rate of gasoline prices is a key element in the price determination process of the economy and it is fundamental for the inflation convergence to its permanent target and the anchoring of medium- and long-term inflation expectations. This derived from the fact that over the last four years the annual change of gasoline prices was above 10 percent, which, as a consequence, generated an upward pressure on headline inflation, by means of the non-core component.[13] Thus, although in the last 24 months annual core inflation of the CPI has been on average close to 2.9 percent, headline inflation lied on average at 3.9 percent, partly due to the impact of gasoline prices. This, in turn, has been reflected in longer-term headline inflation expectations (an average of the next 5-8 years) of economic analysts, which persisted around 3.5 percent, while core inflation expectations lie at 3.1 percent.

Hence, in the absence of gasoline price increases significantly greater than the inflation target, it is possible that besides the direct arithmetic effect on headline inflation, it will generate a more moderate increment in some prices of the economy and bring out a reduction in longer-term inflation expectations, thus consolidating the inflation anchoring around the permanent 3 percent target.

The above described forecast for the inflation outlook is subject to different risks, among which the following stand out:

Downward:

i. The possibility that the recovery of economic activity in Mexico will turn out lower than anticipated.

ii. Greater decreases in the prices of telecommunication services.

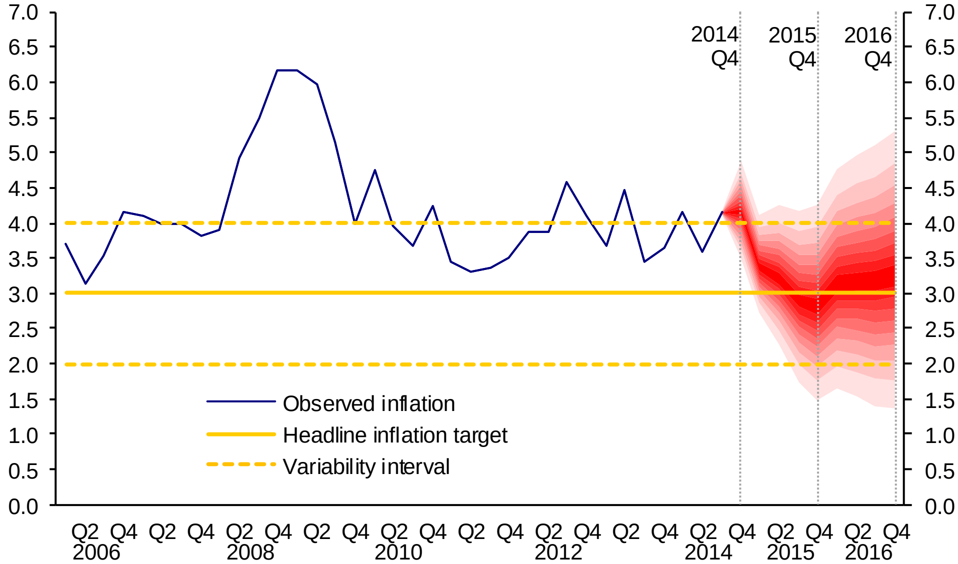
Upward:

i. Episodes of greater volatility in international financial markets that would imply exchange rate fluctuations with their consequent effect on inflation. Still, in the event that it happens, a moderate and transitory impact on inflation would be expected, given the low pass-through of exchange rate variations onto inflation.

ii. Possible considerable increases in the minimum wages higher than the expected inflation and the increment in productivity.

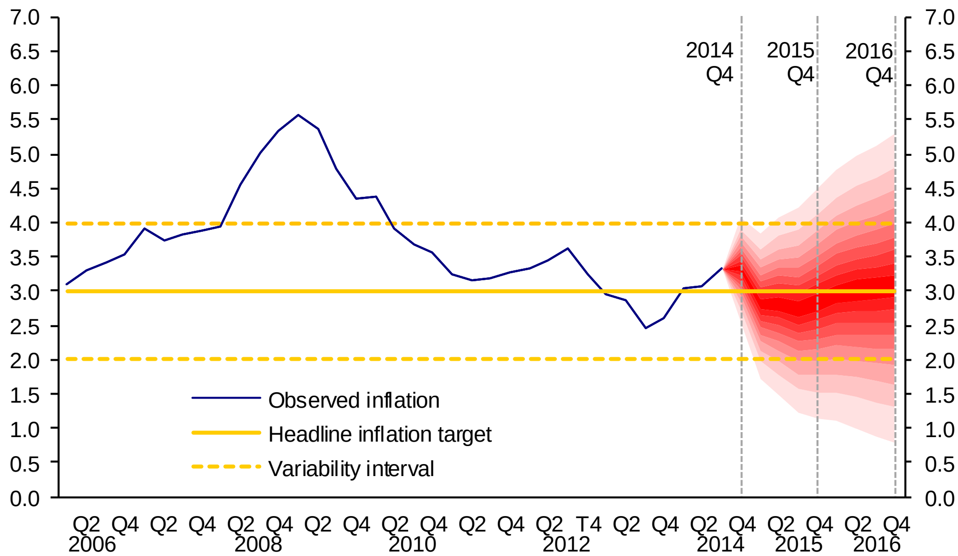
[13] A detailed analysis of this effect was presented in the Box “The Policy of Gasoline Price Adjustments and Inflation Expectations” in the Inflation Report July - September 2013.

Chart 42
Fan Chart: Annual Headline Inflation [1/]
Percent



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

Chart 43
Fan Chart: Annual Core Inflation [1/]
Percent



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

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

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

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

Annex

Calendar of Monetary Policy Decision Announcements, Minutes of the Board of Governors' Meetings regarding Monetary Policy Decisions and Quarterly Reports in 2015

Table 1 of this annex presents the calendar for the year 2015 of the monetary policy announcements, as well as the publication of the Minutes of the Board of Governors' meetings regarding the monetary policy decisions and the Quarterly Reports. It should be noted that from 2015 onwards the monetary policy decisions will be announced on Thursdays at 13:00, while so far these announcements were released on Fridays at 9:00.

Table 1
Calendar for 2015

Month	Announcements of Monetary Policy Decisions	Minutes of the Board of Governors' Meetings regarding Monetary Policy Decisions	Quarterly Reports [1/]
January	29		
February		12	18
March	26		
April	30	9	
May		14	19
June	4	18	
July	23		
August		6	12
September	3	17	
October	15	29	
November			4
December	3	17	

1/ The Quarterly Report that will be published on February 18, 2015 corresponds to the fourth quarter of 2014, the one to be released on May 19, 2015, to the first quarter of 2015, the one of August 12, 2015, to the second quarter of 2015, and finally the one to be presented on November 4, 2015, to the third quarter of 2015.

The calendar considers 8 dates for the announcement of monetary policy decisions in 2015. Two weeks after each announcement, on Thursdays, the corresponding Minutes will be published. Nonetheless, as in previous years, Banco de México reserves the right to announce changes in the monetary policy stance at dates different from those previously scheduled, in the case of extraordinary events that may require the Central Bank's intervention.

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