Quarterly Report

July – September 2016

Summary

The Mexican economy is one of the most integrated with the global economy, and, in particular, with the U.S. Its trade and financial integration has offered considerable benefits, allowing to seize increased opportunities of shared trade and production, a wider diversity in terms of sources of financing for its growth and a greater development of its financial system. However, as a consequence, the national economy and financial markets have become more vulnerable to external events. In this context, during the period covered by this Report, the Mexican economy faced a complex juncture. Indeed, the outlook for the world economy has become more challenging, among other factors, as a consequence of the electoral process in the U.S. and its outcome. The events related to the aforementioned process led to higher volatility in all regional financial markets, very strongly affecting the national ones, in light of the relevance represented by the outcome of the said process for Mexico. In particular, the national currency depreciated significantly and interest rates observed increments for all terms. In this context, the preemptive measures that Banco de México adopted during the year, acting with total flexibility and in line with the conditions that demanded so, prevented headline inflation and its expectations from being affected. Thus, despite the challenges implied by the current juncture and its consequences for the exchange rate, the low pass-through of exchange rate fluctuations onto domestic prices has allowed to maintain an environment of low inflation and relatively stable inflation expectations. The referred low pass-through is precisely one of the fundamental consequences of the conduct of monetary policy, which has focused on anchoring inflation expectations, and preventing second round effects in view of adjustments in relative prices.

In this context, as pointed out by the national authorities, it is worth acknowledging that it is still difficult to identify the elements that will define the economic policy stance of the U.S. regarding its bilateral relation with Mexico starting from 2017. Thus, as previously announced, the Mexican authorities will continue to exercise caution, analyzing the policy announcements by the next administration of the U.S., making their decisions based on the received solid information and, at all times, keeping a vision of what is more convenient for Mexico in the medium and long terms.

Even though Mexico is in a position of strength to face this new environment, as a result of achievements reached and foreseen in terms of consolidation of public finances; of applying preemptive monetary policy measures that have been adopted this year; of a well-capitalized financial system, that is solvent and with no liquidity problems; of an unprecedented process of structural reforms, it is inevitable to continue dealing with both existing and emerging risks, by further strengthening the macroeconomic fundamentals of the country. Accordingly, Banco de México continued to respond with total flexibility and at the moment and magnitude required by conditions, in order to counteract inflation pressures and to maintain inflation expectations anchored. Thus, even though in its monetary policy decision of August the Board of Governors kept the target for the Overnight Interbank Interest Rate unchanged, in its decisions of September and November it was increased by 50 basis points in each occasion, reaching a level of 5.25 percent. This was done in order to counteract inflation pressures and to maintain inflation expectations anchored.

Aside from the volatility experienced by financial markets, in the third quarter of the year, world economic activity recovered moderately, supported by a greater growth of the U.S. and other advanced economies, and a continuous expansion of some of the main emerging ones. In this environment, derived from a possible implementation of a highly expansionary fiscal policy in the U.S., there was a spike in inflation expectations in the markets. Hence, even though the Federal Reserve is still anticipated to increase the federal funds' rate in December and to continue with the process of its monetary stance normalization at a gradual rate, in view of the recent events in financial markets, this rate is now estimated to be faster and possibly of a greater magnitude than previously anticipated. In turn, other central banks are expected to maintain an accommodative monetary policy stance for an extended period.

The incipient growth in global activity contributed to the moderate recovery of the Mexican economy in the third quarter of 2016, following the contraction in the second one. Indeed, Mexico's external demand improved, after a negative trend in exports during 2015 and in early 2016, while private consumption displayed a greater dynamism. In contrast, the weakness of gross fixed investment, which had been registered since mid-2015, prevailed. In this context, economic activity has somewhat decelerated and no significant aggregate demand-related pressures onto the prices of the economy have been observed.

The annual headline inflation registered until September 2016 seventeen consecutive months below 3 percent, even though in October it lied slightly above this figure, as a result of the gradual upward trend maintained by core inflation as well as the impact generated by the increment in gasoline prices at the Northern border. The performance of core inflation is mainly accounted for by the evolution of the merchandise price subindex, which has been responding to the depreciation of the national currency. The persisting low inflation during the reported period stemmed from the conduct of monetary policy, from the absence of significant aggregate demand-related pressures onto prices, from the low level of international prices of most commodities and from reductions in prices of some widely used inputs, which derived, in part, from the efforts of the structural reforms.

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

GDP Growth Rate: Even though the global economy is expected to recover, the outlook for world growth and trade has continued to be revised downwards. Furthermore, the result of the U.S. electoral process increased the risk of the implementation of policies that could hamper foreign trade and foreign investment in Mexico. Domestically, the forecast for crude oil production was adjusted downwards. This suggests that GDP growth in Mexico over the following quarters could be lower than estimated in the previous Report. Still, it should be noted that the central scenario for economic growth presented in this Report assumes that, by and large, trade relations between Mexico and the U.S. remain sound, and that the adjustment in financial markets continues to be carried out in a relatively orderly fashion. Hence, it is forecast that for 2016, as a whole, Mexican GDP will grow between 1.8 and 2.3 percent (between 1.7 and 2.5 percent in the last Report). The forecast interval for GDP growth in 2017 is adjusted to between 1.5 and 2.5 percent (between 2.0 and 3.0 percent in the previous Report). However, for that and the following years, the structural reforms are expected to contribute to the economic growth, and the efforts undertaken by the authorities to strengthen the stability of the macroeconomic framework will also foster a more favorable environment for economic activity. For 2018, a more evident recovery of U.S. industrial activity is anticipated. As a result, Mexican GDP growth rate is estimated to lie between 2.2 and 3.2 percent for that year (Chart 1a). Note that these forecasts should be taken with caution, as insofar as there is more available information regarding the economic policies of the incoming U.S. administration, growth previsions will be adjusted to incorporate their possible adverse effects.

Employment: For 2016, an increment between 640 and 710 thousand jobs in IMSS-affiliated employment is expected, while for 2017, the anticipated increase is between 600 and 700 thousand jobs. Likewise, it is estimated that in 2018, between 650 and 750 IMSS-affiliated jobs will be added.

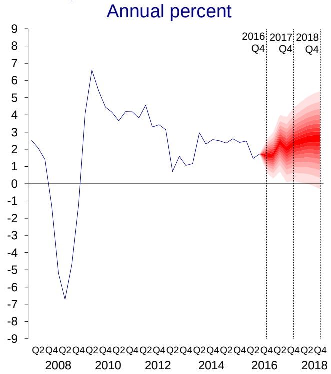
Considering these forecasts, aggregate-demand related pressures onto prices are not to be expected (Chart 1b).

Current Account: For 2016, deficits in the trade balance and the current account of USD 15.2 and 31.5 billion are anticipated,

respectively (1.5 and 3.0 percent of GDP, in the same order). For 2017, deficits in the trade balance and the current account are estimated to amount to USD 12.6 and 30.9 billion, respectively (1.2 and 3.0 percent of GDP, in the same order). For 2018, deficits in the trade balance and the current account are expected to be USD 12.3 and 33.9 billion, respectively (1.1 and 3.0 percent of GDP, in the same order).

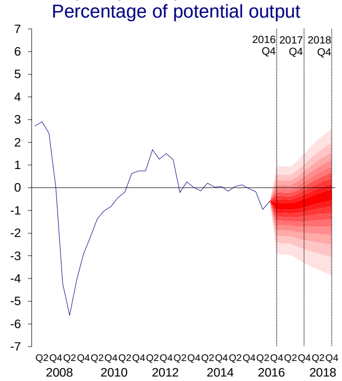
Fan Charts 1

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



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

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



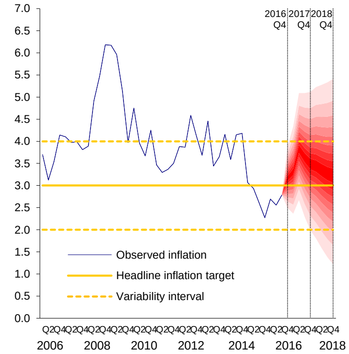
s. a. / Seasonally adjusted data.
Source: Banco de México.

The balance of risks for the growth scenario in Mexico is biased to the downside. Among downward risks, the following stand out: i) that the new administration of the U.S. indeed implements policies, which could hamper the functioning of shared production chains between Mexico and the U.S., and/or policies that would lower the flow of wage remittances to Mexico; ii) the possibility of persisting episodes of high volatility in international financial markets; and, iii) that in this environment, the deterioration that had been observed in consumers' and investors' confidence persists. Among upward risks to growth, these stand out: i) that the implementation of structural reforms has a more positive effect on economic activity and in a shorter time-frame than anticipated; and, ii) that in view of the recent depreciation of the exchange rate, non-oil exports exhibit a more noticeable and lasting reactivation.

Inflation: Annual headline inflation is expected to continue increasing gradually, to reach levels slightly above 3 percent by the end of the year. Core inflation is also forecast to close the year moderately above the aforementioned level. For 2017, both headline and core inflations are anticipated to lie above the inflation target, but below the upper limit of the variability interval, both of these indicators registering levels close to 3 percent by the end of 2018 (Chart 2a and Chart 2b). Among upward risks, the following should be mentioned: i) that considering the uncertainty prevailing in the international environment, the depreciation of the national currency may persist or become accentuated, and, thus, may contaminate inflation expectations and generate second round effects that would negatively impact the price-setting process; ii) price increases of agricultural goods and gasoline, although their impact onto inflation would tend to be transitory. Among downward risks, these should be listed: i) further reductions in prices of some widely used inputs, such as telecommunication services, as a result of structural reforms; ii) that the deceleration of the national economic activity would be accentuated, which would reduce the possibility of aggregate demand-related inflation pressures.

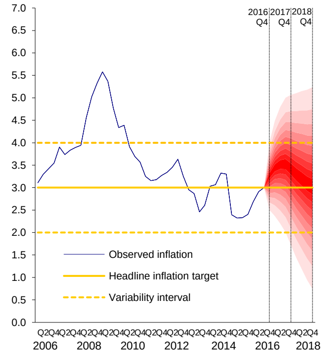
Fan Charts 2

a) Annual Headline Inflation [1/]
Percent



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

b) Annual Core Inflation [1/]
Percent



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

It is important to reiterate that Mexico is characterized by a solid macroeconomic stability that has been achieved through many years of exercising responsible, prudent and timely fiscal and monetary policies. This, along with the unprecedented process of implementing structural reforms that are currently underway, place the Mexican economy in a privileged position to successfully compete in the world markets and to reach solid economic growth. Furthermore, the Mexican government has announced that it will continue to further strengthen the fundamentals of the economy and will keep implementing structural reforms in a timely and adequate manner to further boost economic growth and the welfare of the population. In the short run, the Mexican authorities will pay particular attention to the evolution and the sound functioning of financial markets. The Federal Government and Banco de México will take the necessary measures in a coordinated manner, using all tools within their reach, in the scope of their powers and in line with their respective mandates, to maintain the orderly functioning of the markets.

Recent international events can possibly affect the structural relation of Mexico with its main trade partner. In this context, it is both natural and necessary to observe a real exchange rate depreciation, as it is the most efficient adjustment mechanism and shock absorber. The principal contribution of Banco de México during this adjustment process is to make the change in relative prices more orderly, to prevent inflation expectations from being contaminated, as it would negatively affect the price formation process of the economy.

In this context, and considering what has been presented in this Report, in the future the Board of Governors will closely monitor the evolution of all inflation determinants and its medium- and long-term expectations, especially the possible pass-through of exchange rate adjustments onto prices, without implying that it is established as a goal. Likewise, it will be watchful of the monetary position of Mexico relative to the U.S., without overlooking the evolution of the output gap. This will be done in order to be able to continue taking the necessary measures to consolidate the efficient convergence of inflation to its 3.0 percent target, with total flexibility, whenever and to the extent that conditions may demand so.

Even though the close trade and financial relations that Mexico has established with the U.S. in recent decades has generally been beneficial for our country, it has made Mexico especially sensitive to the economic performance and the economic policy decisions of the U.S. To achieve a greater diversification and, more importantly, to reach an accelerated and sustained economic growth, Mexico needs to continue improving its infrastructure, its communications and transportation systems, and other elements that could encourage investments. In the same vein, it is indispensable to continue the adequate and prompt implementation of structural reforms, as they will boost the country's productivity and will allow a better allocation of resources. These reforms will foster greater sustained growth of the domestic market, thus offsetting the effects of the adverse external environment currently faced by the Mexican economy.