

Quarterly Report

July-September 2015

November 04, 2015



BANCO DE MÉXICO

Outline

1

Monetary Policy

2

External Conditions

3

Economic Activity in Mexico

4

Inflation Determinants

5

Forecasts and Balance of Risks

Monetary Policy Conduction

■ After having converged to the permanent 3 percent target, headline inflation decreased further since May 2015 and registered new historical minimum levels. To this contributed:

1. The monetary policy stance.

2. A negative output gap.

3. Effects of price reductions of widely used inputs, as well as goods and services whose prices decreased as a result of the implementation of structural reforms.

The favorable evolution of inflation has been achieved in a difficult economic environment.

Domestic Environment:

✓ Moderate growth of economic activity.

✓ The relative price adjustment, associated with national currency's depreciation, has mainly been reflected in durable goods' prices.

✓ Well-anchored inflation expectations.

External Environment:

✓ Uncertainty with respect to the normalization process of the U.S. monetary policy continues.

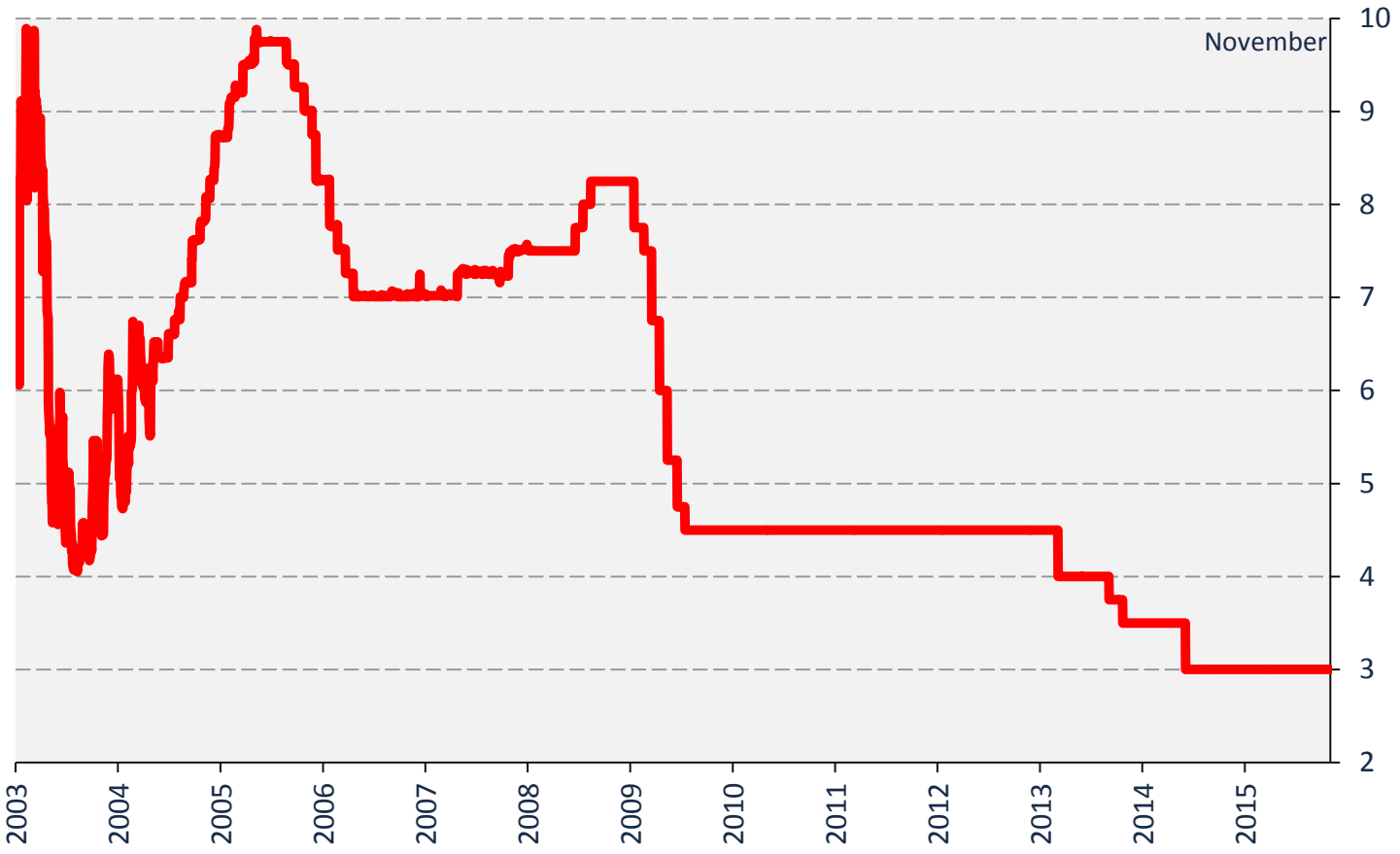
✓ Global growth remains at very low levels.

✓ Greater concern regarding the depth of China's and other emerging economies' deceleration.

→ All this has been reflected in financial assets' price drops at the global level.

Taking these elements into account, the Board of Governors decided to maintain the Overnight Interbank Interest Rate target at 3 percent, by virtue of the fact that it considered the monetary policy stance to be conducive to the consolidation of the convergence of inflation to the permanent 3 percent target.

Target for the Overnight Interbank Interest Rate ^{1/}
%



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

Outline

1 **Monetary Policy**

2 **External Conditions**

3 **Economic Activity in Mexico**

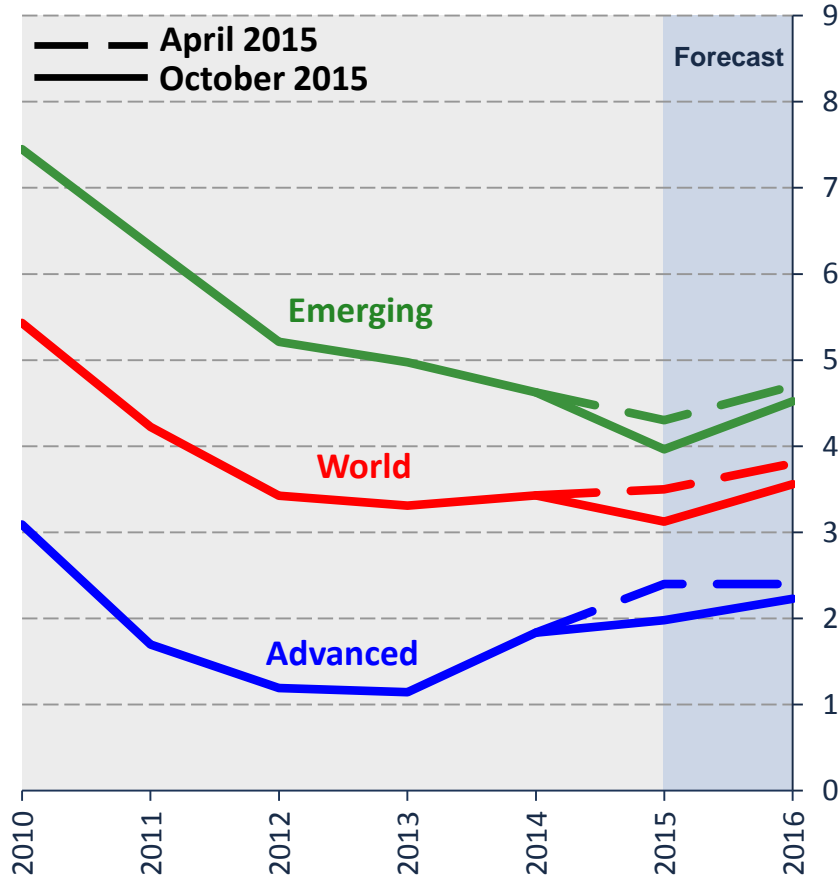
4 **Inflation Determinants**

5 **Forecasts and Balance of Risks**

World economic activity continued weakening.

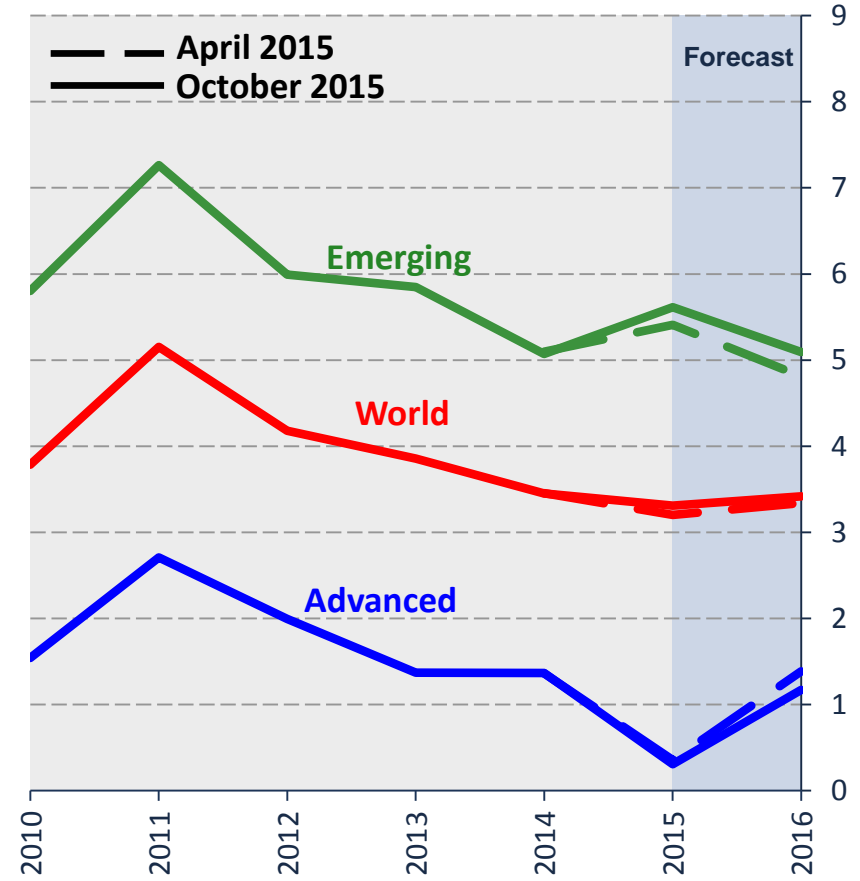
World Economy

GDP Growth
Annual % change



Source: IMF, WEO April and October 2015.

Headline Annual Inflation
Annual % change

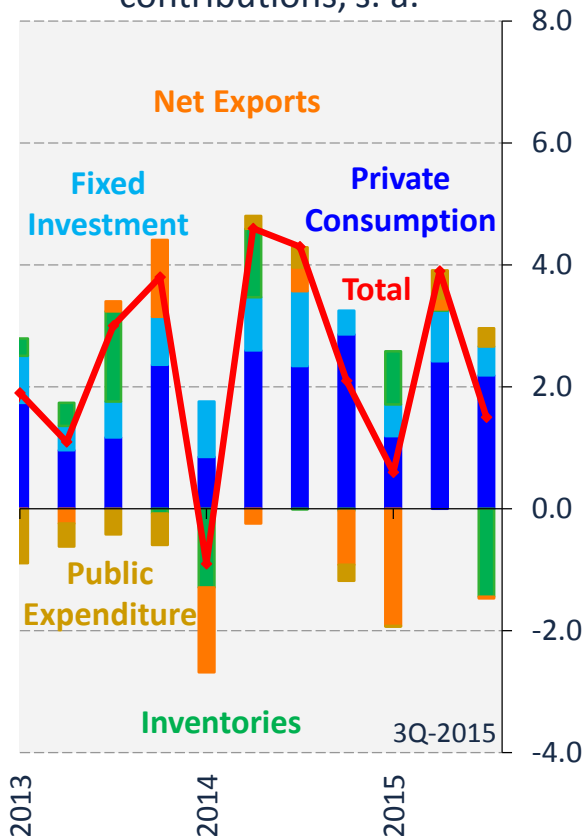


Source: IMF, WEO April and October 2015.

The U.S. economy grew moderately in the third quarter. To this contributed the solid domestic demand, which offset the strong disaccumulation of inventories.

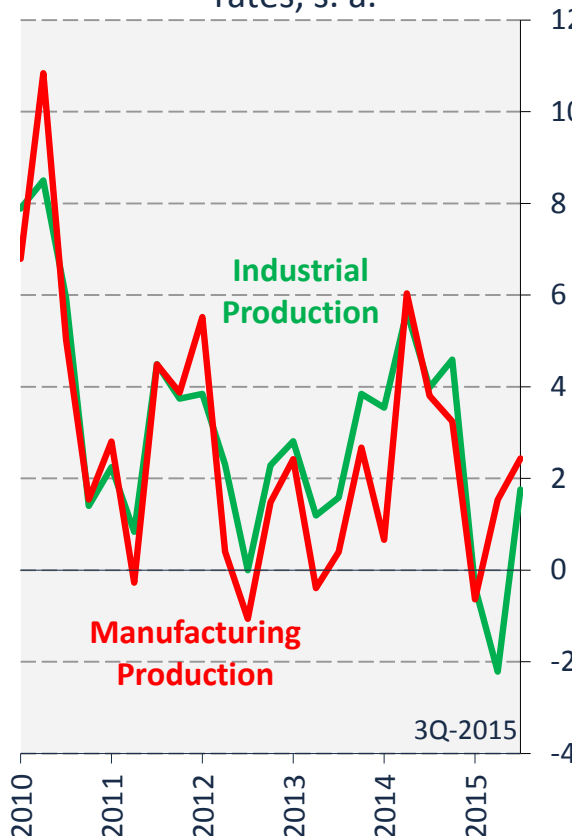
United States

Real GDP and Components
Quarterly % change at annual rate and percentage points contributions, s. a.



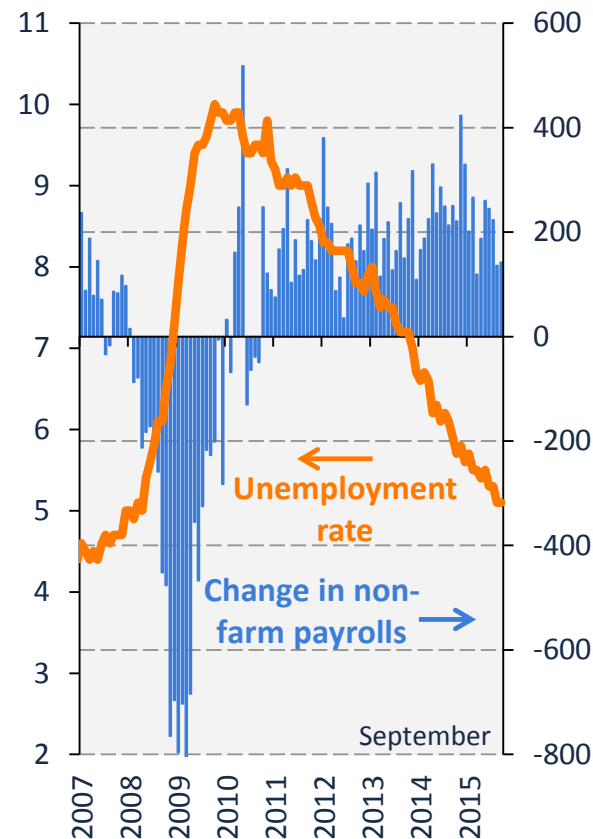
s. a. / Seasonally adjusted data.
Source: Bureau of Economic Analysis (BEA).

Industrial and Manufacturing Production
Quarterly % change at annual rates, s. a.



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

Change in Non-farm Payrolls and Unemployment Rate
Thousands of jobs and % of EAP, s. a.



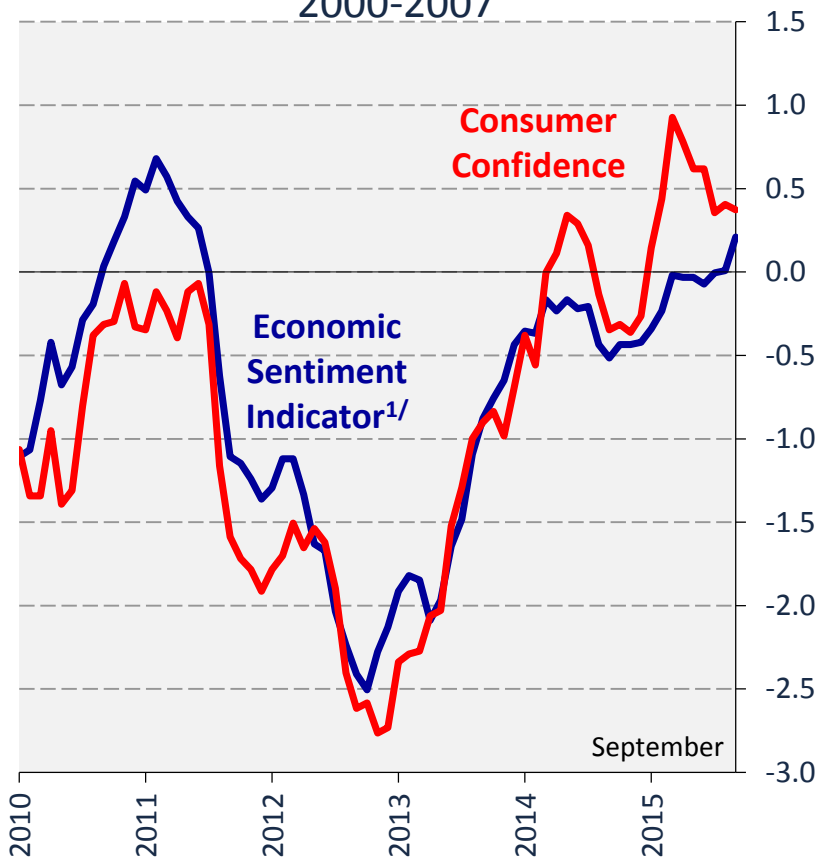
EAP/ Economically Active Population.
s. a. / Seasonally adjusted data.
Source: Bureau of Labor Statistics (BLS).

In the Euro zone, economic recovery continued, although at a lower rate than expected, with large heterogeneity among the member countries.

Euro Zone

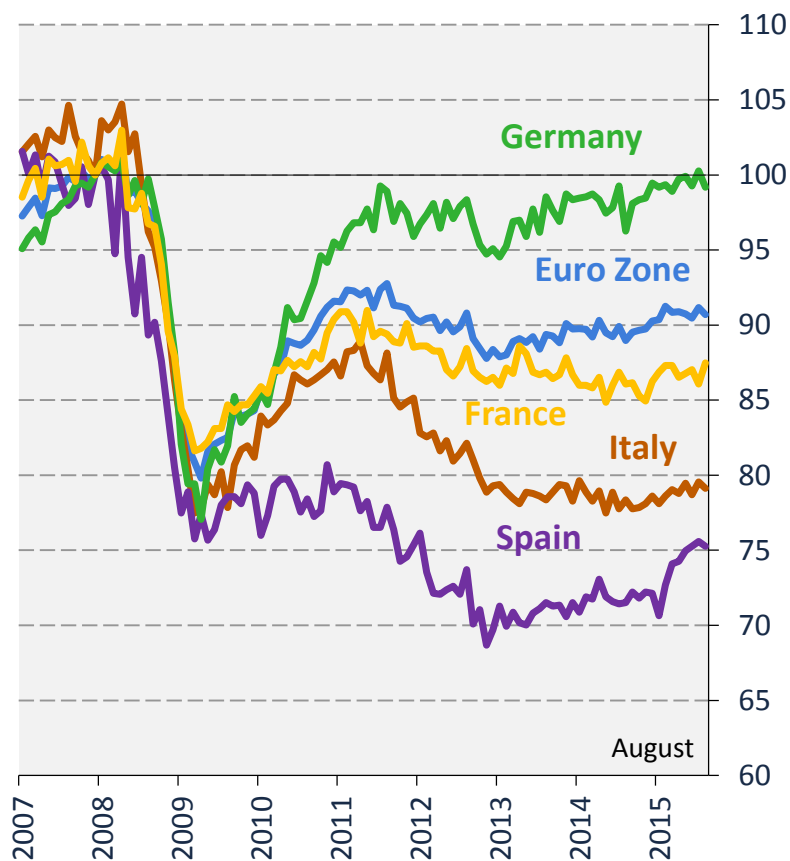
Economic Sentiment Indicator and Consumer Confidence

Standardized data from period 2000-2007



1/ Composite indicator, which summarizes five sectorial confidence indicators: industry, services, retail, construction and consumption
Source: Haver Analytics.

Industrial Production ^{2/} Index Dec-2007=100, s. a.



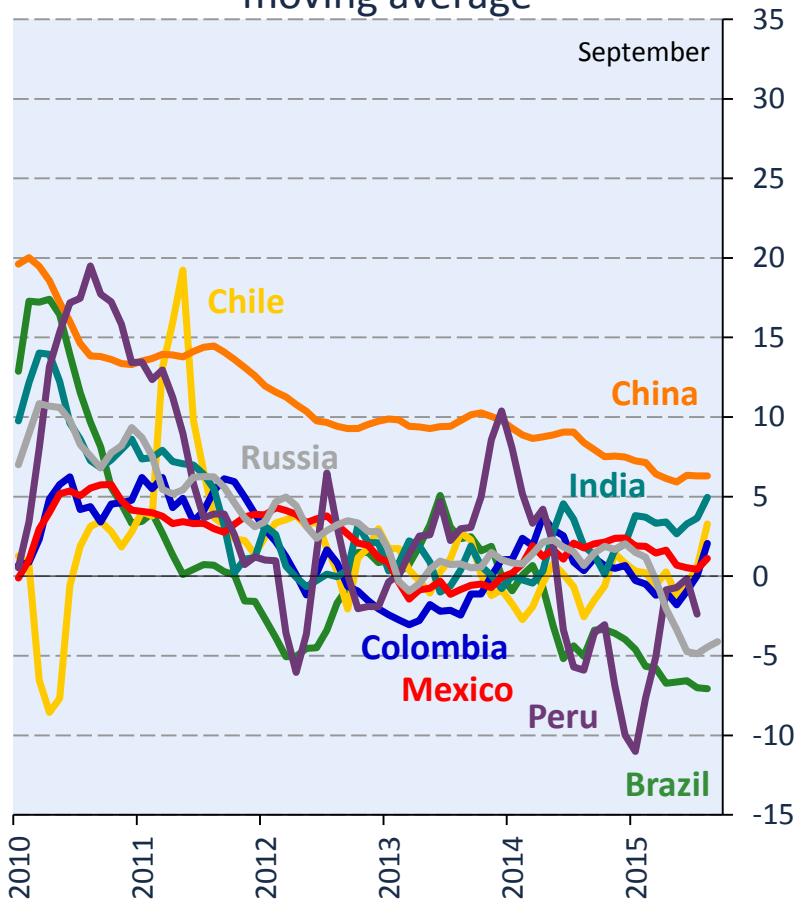
s. a. / Seasonally adjusted data.
2/ Excluding construction industry.
Source: Eurostat.

Economic activity in emerging economies keeps slowing down.

Emerging Economies

Industrial Production

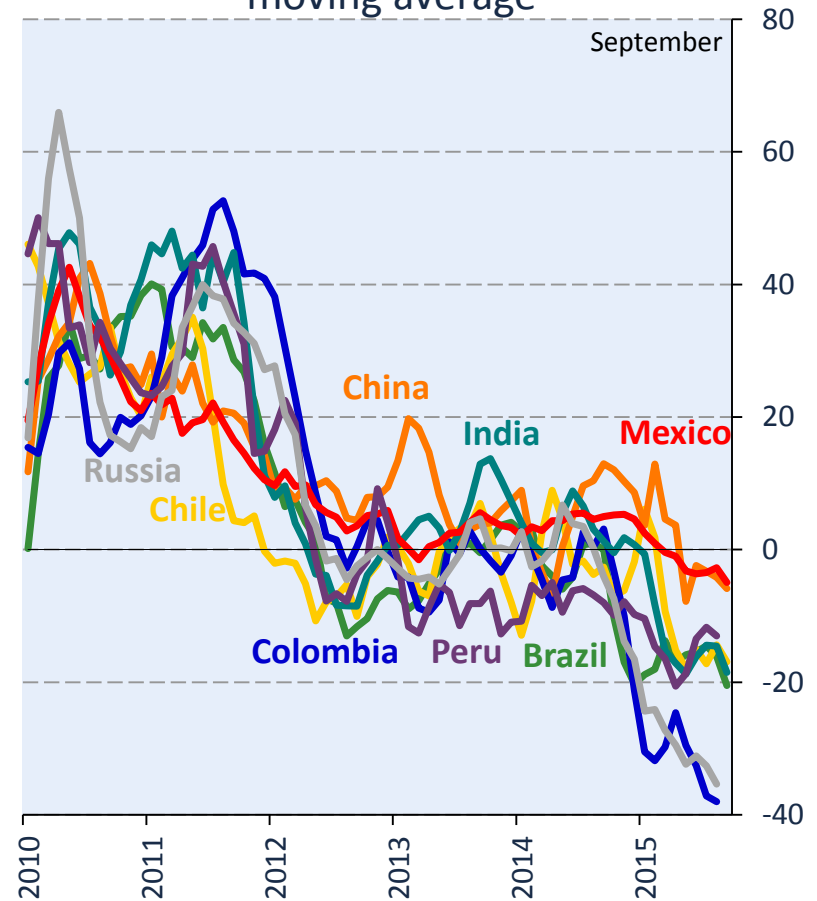
Annual % change of 3-month moving average



Source: Haver Analytics and INEGI.

Exports

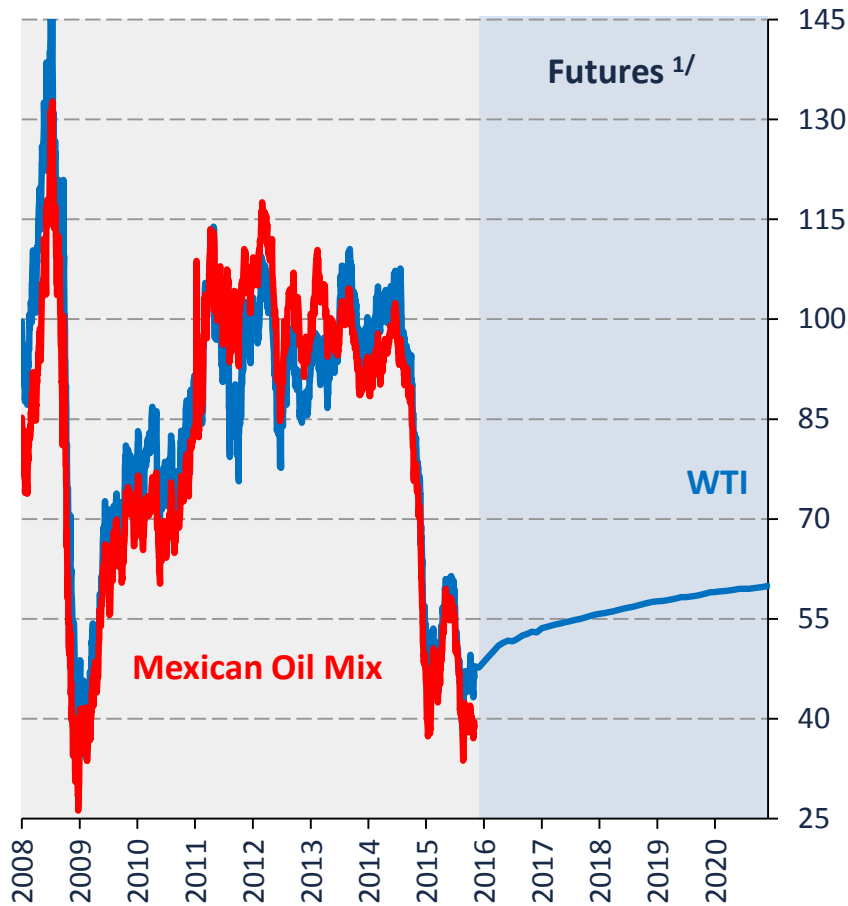
Annual % change of 3-month moving average



Source: Haver Analytics and INEGI.

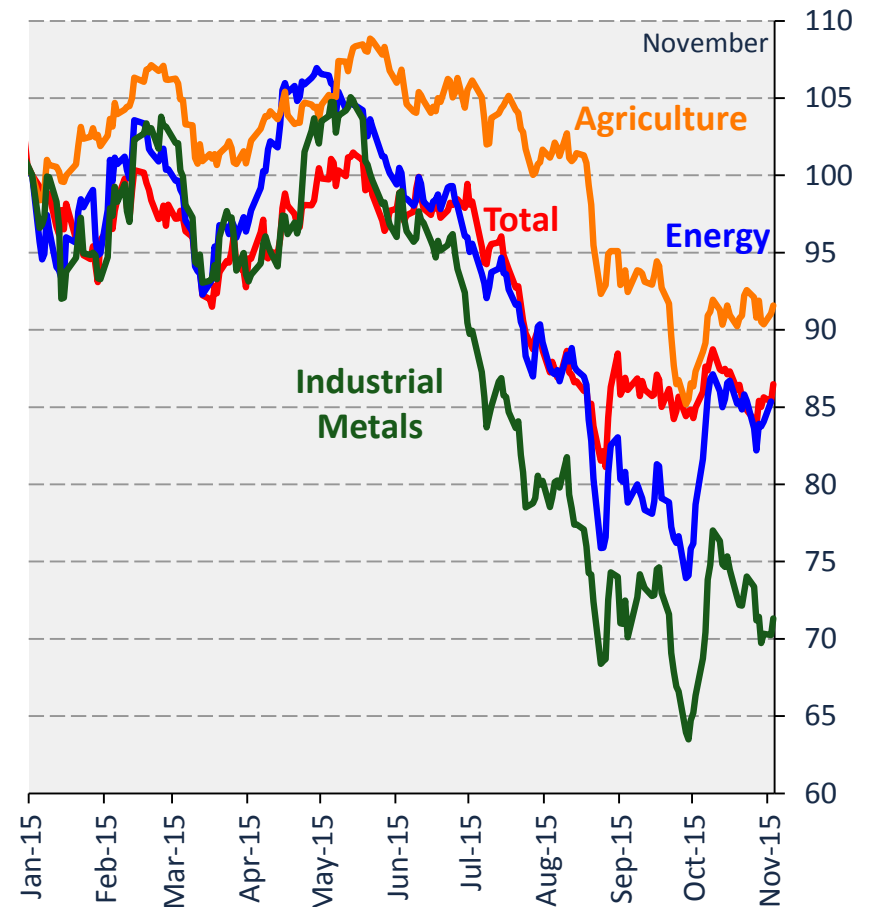
Commodity prices decreased during most of the third quarter of 2015, although they showed certain recovery in October.

Crude Oil Prices
USD per barrel



1/ Data up to November 03, 2015.
Source: Bloomberg.

Commodities Prices ^{2/}
Index Jan-2005=100

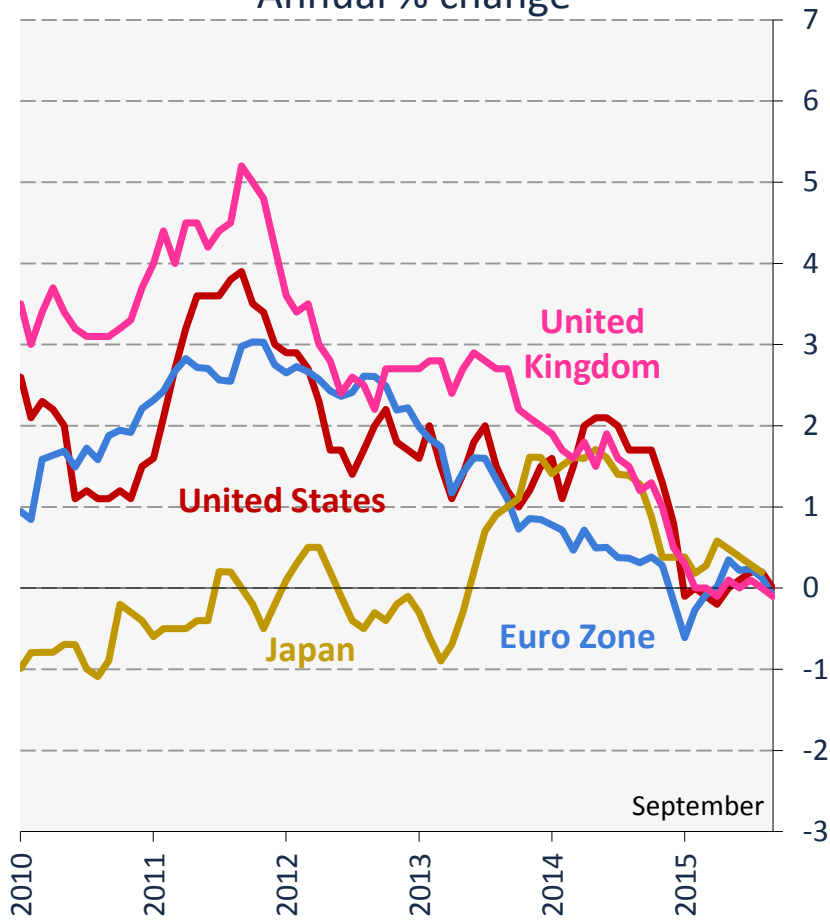


2/ It refers to the Thomson Reuters' CRB index composed by 19 raw materials divided in 4 groups: energy (39%), agriculture (41%), precious metals (7%) and industrial metals (13%).
Source: Bloomberg.

Inflation in the main advanced economies decreased during the period covered by this Report. Emerging economies presented a mixed inflationary performance.

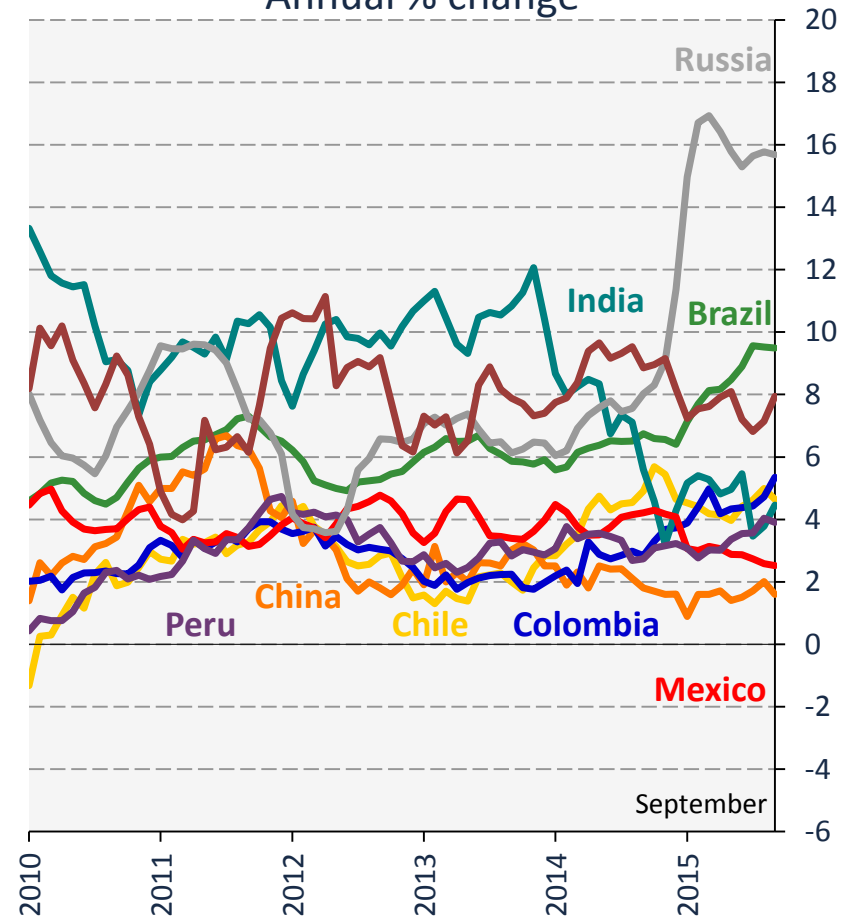
Headline Inflation

Advanced Economies
Annual % change



Source: Haver Analytics.

Emerging Economies
Annual % change

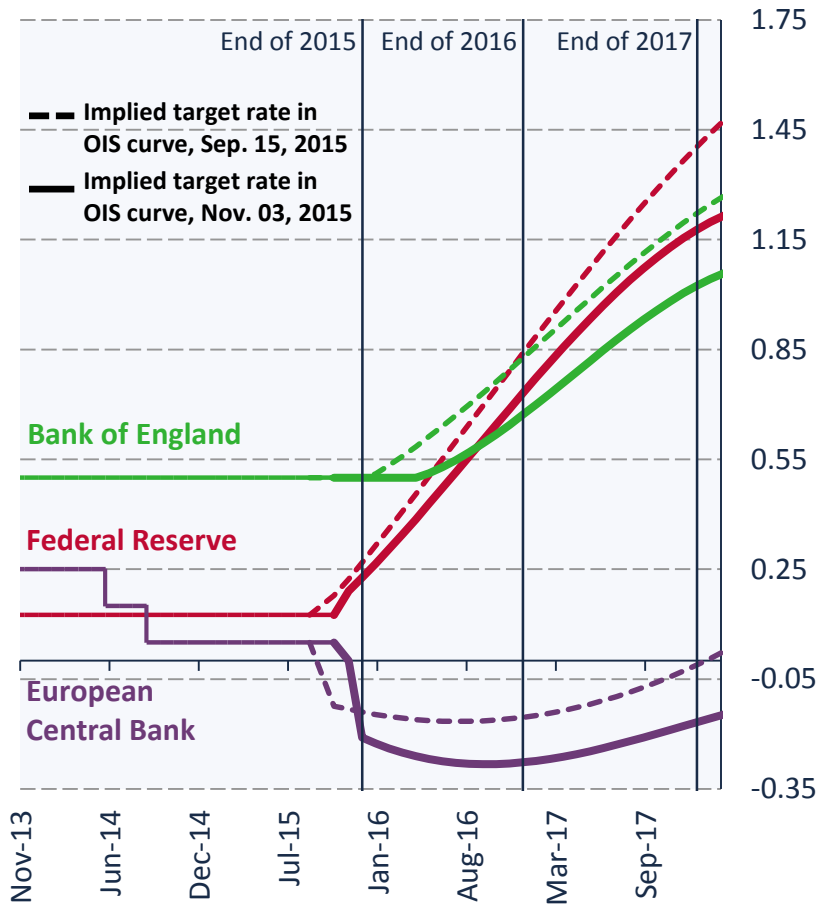


Source: Haver Analytics and INEGI.

In international financial markets, uncertainty regarding the normalization process of the U.S. monetary policy continues.

Expected Monetary Policy Rates ^{1/}

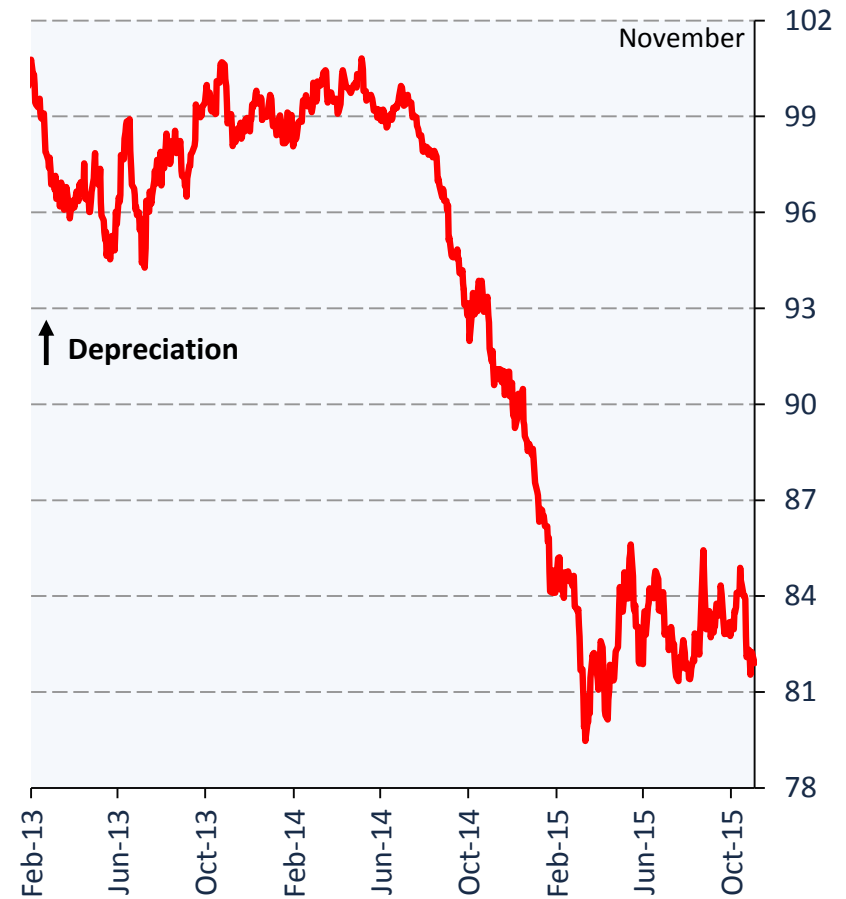
%



^{1/} The expected rates are the trajectories implicit in OIS Curves (Overnight Index Swap).
Source: Bloomberg with estimates from Banco de México.

U.S. Dollar Index (DXY) ^{2/}

Index 1-Jan-2013=100

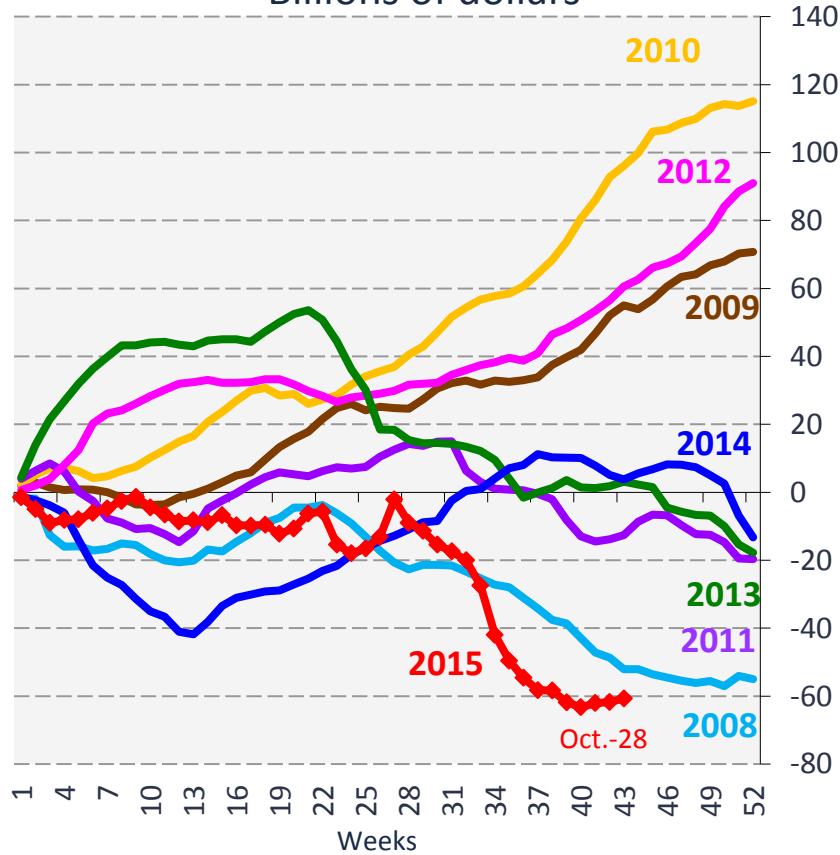


^{2/} DXY index is estimated by the Intercontinental Exchange (ICE) based on the weighted geometric mean of the dollar's value compared with a basket of 6 other major currencies which are: EUR: 57.6%, JPY: 13.6%, GBP: 11.9%, CAD: 9.1%, SEK: 4.2%, and CHF: 3.6%. Source: Bloomberg.

The aforementioned was reflected in a drop in capital flows to emerging economies, with its consequent effect on their exchange rates.

Emerging Economies

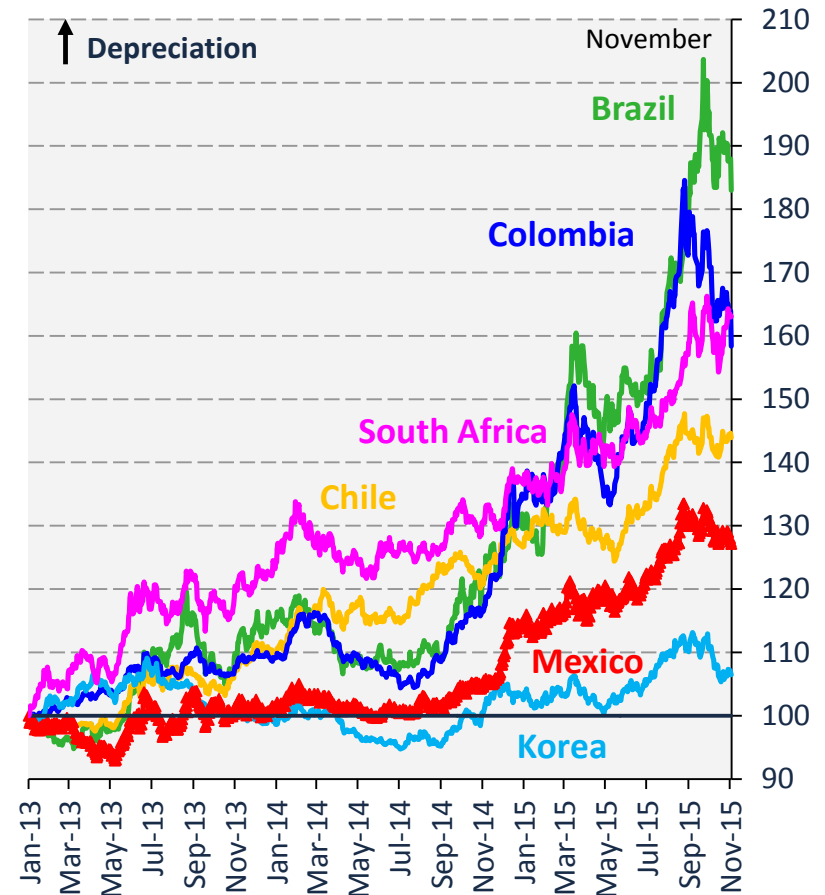
**Accumulated Capital Flows
(Debt and Equity) ^{1/}**
Billions of dollars



1/ The sample covers funds used for the buying-selling of stocks and bonds from emerging countries, recorded in advanced countries. Flows exclude portfolio performance and changes in the exchange rate.

Source: Emerging Portfolio Fund Research.

Nominal Exchange Rate against USD
Index 01-Jan-2013 = 100



Source: Bloomberg.

Outline

1 **Monetary Policy**

2 **External Conditions**

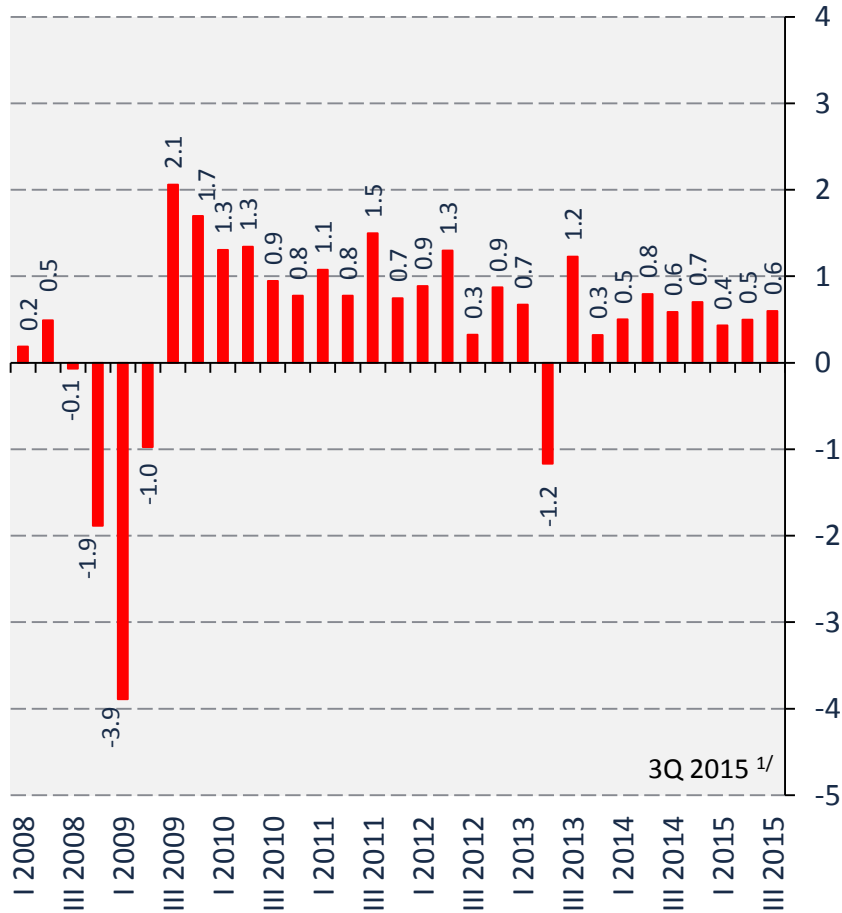
3 **Economic Activity in Mexico**

4 **Inflation Determinants**

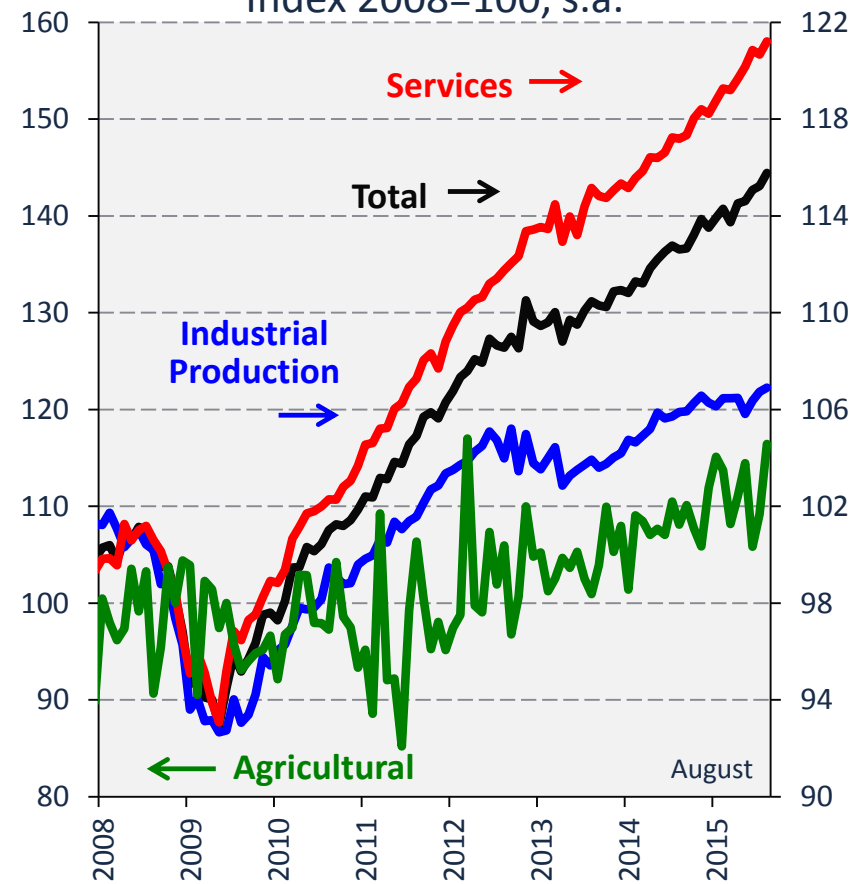
5 **Forecasts and Balance of Risks**

In the third quarter of the present year, economic activity in Mexico maintained the moderate growth pace registered since the beginning of 2015.

Gross Domestic Product
Quarterly % change, s.a.



Global Indicator of Economic Activity
Index 2008=100, s.a.

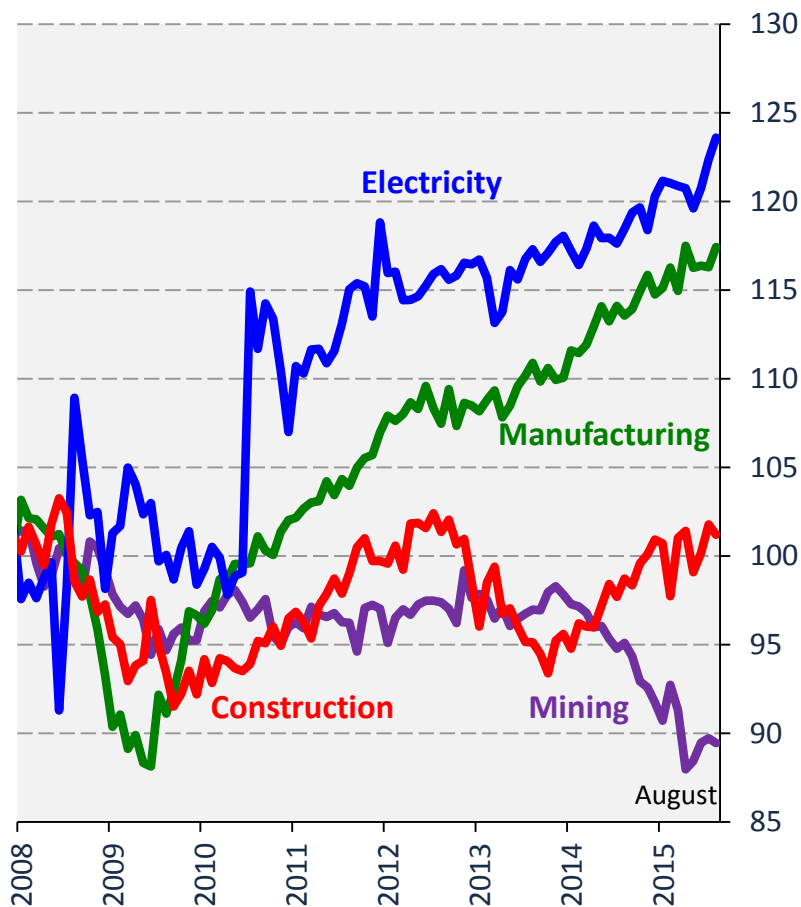


s.a. / Seasonally adjusted data.
1/ The GDP data for the third quarter of 2015 corresponds to preliminary estimates published by the INEGI.
Source: Mexico's System of National Accounts, INEGI.

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

As regards to economic activity from the production side, the industrial sector showed a slow growth pace.

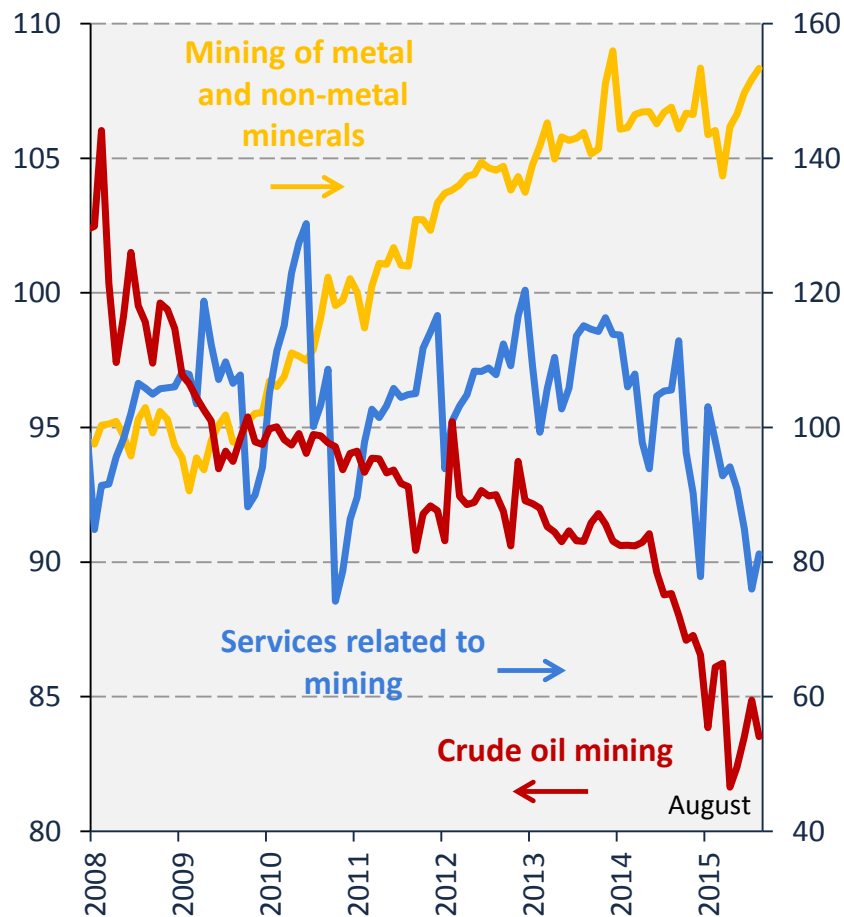
Industrial Activity
Index 2008=100, s.a.



s. a. / Seasonally adjusted data.

Source: Monthly Indicator of Industrial Activity, Mexico's System of National Accounts, INEGI.

Mining Sector
Index 2008=100, s.a.



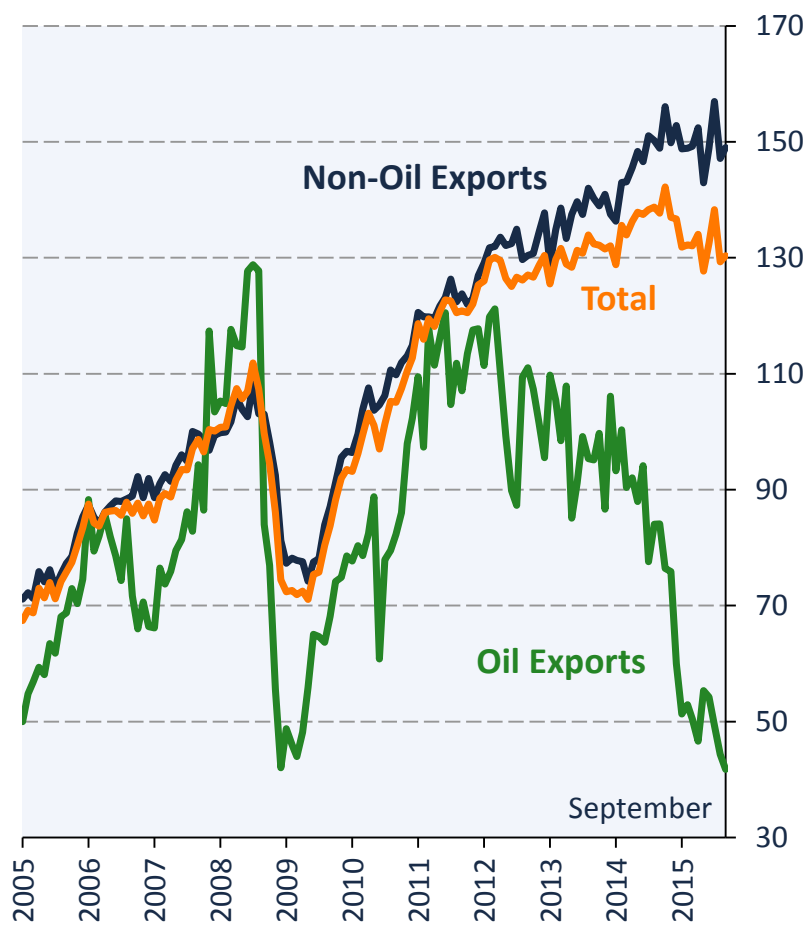
s. a. / Seasonally adjusted data.

Source: Monthly Indicator of Industrial Activity, Mexico's System of National Accounts, INEGI.

Exports kept exhibiting a relative stagnation.

Total, Oil and Non-Oil Exports

Index 2008=100, s.a.

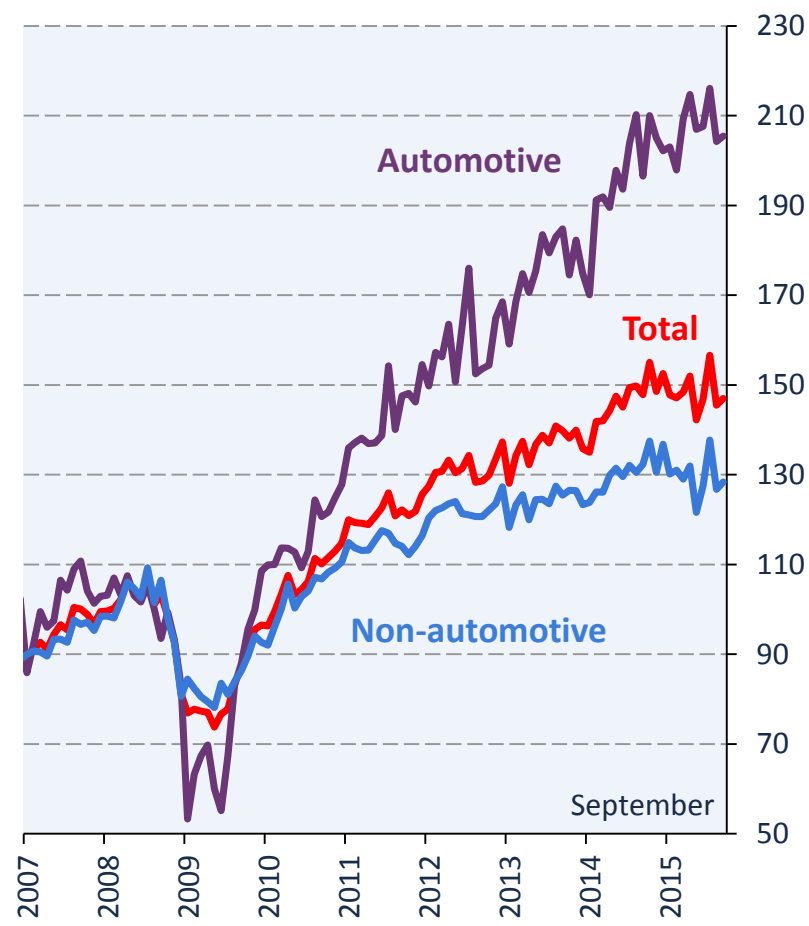


s. a. / Seasonally adjusted data.

Source: SAT, Secretaría de Economía, Banco de México, INEGI. México's Goods Trade Balance. SNIEG. National Interest Information.

Manufacturing Exports

Index 2008=100, s.a.

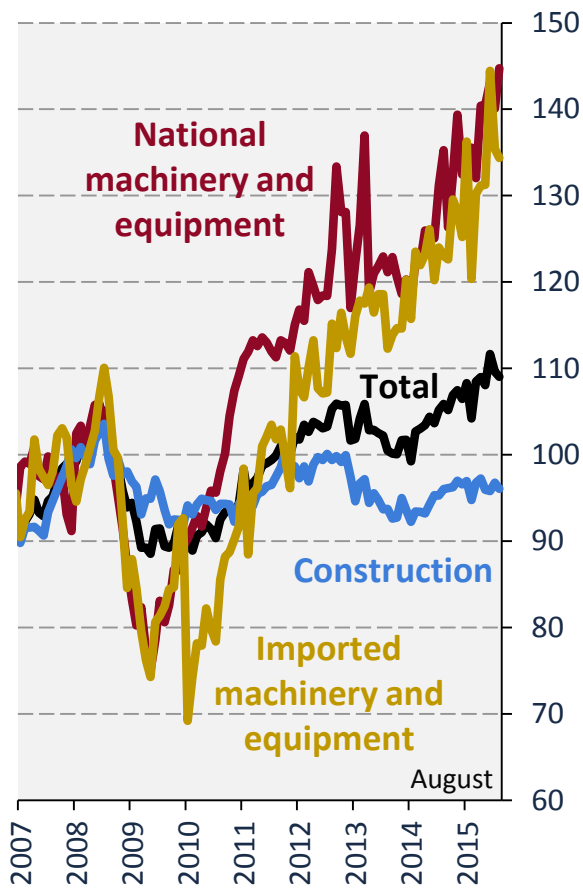


s. a. / Seasonally adjusted data.

Source: SAT, Secretaría de Economía, Banco de México, INEGI. México's Goods Trade Balance. SNIEG. National Interest Information.

Gross fixed investment continued showing a moderate dynamism at the beginning of the quarter subject of this Report.

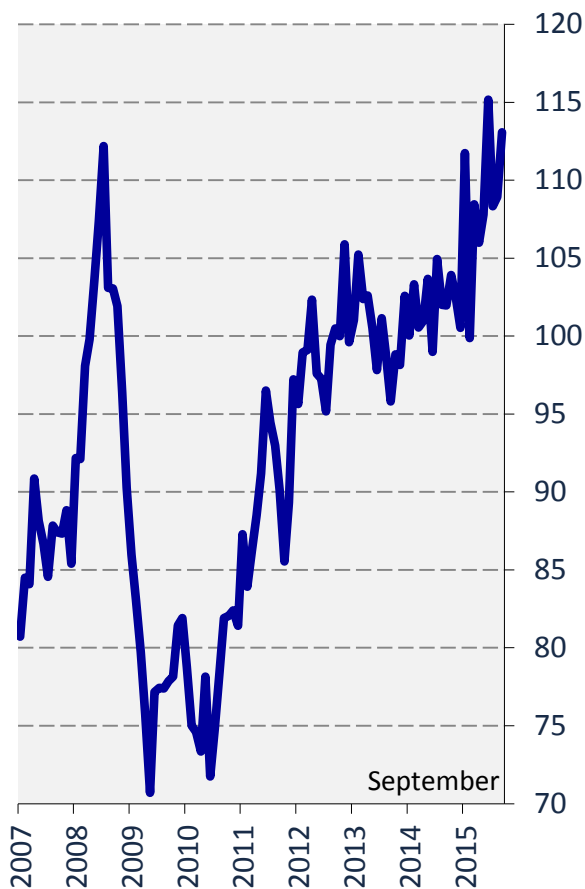
Investment and its Components
Index 2008=100, s.a.



s. a. / Seasonally adjusted data.

Source: Mexico's System of National Accounts, INEGI.

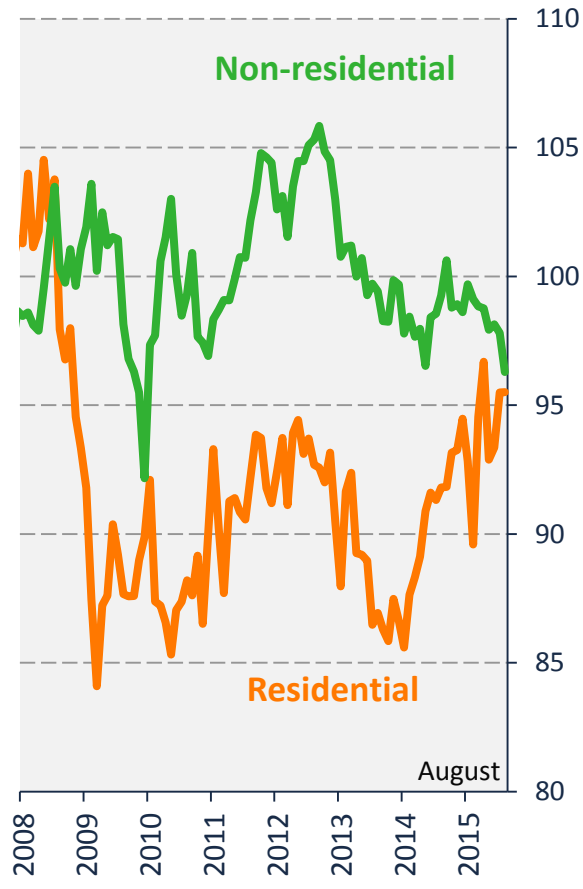
Imports of Capital Goods
Index 2008=100, s.a.



s. a. / Seasonally adjusted data.

Source: SAT, Secretaría de Economía, Banco de México, INEGI. México's Goods Trade Balance. SNIIEG. National Interest Information.

Residential and Non-Residential Construction Investment
Index 2008=100, s.a.

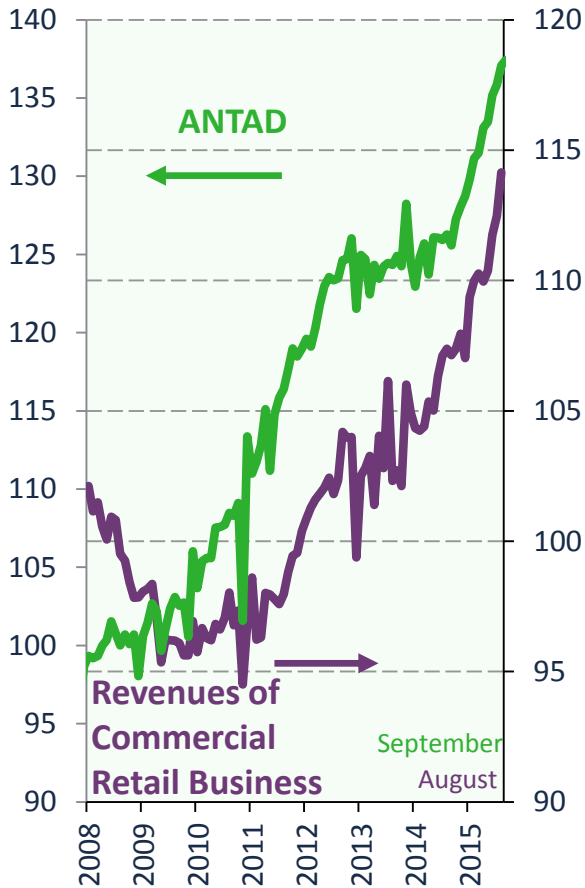


s. a. / Seasonally adjusted data.

Source: Mexico's System of National Accounts, INEGI.

Some of the private consumption indicators registered higher growth rates as compared to the previous quarter.

Revenues of Commercial Retail Business and Total ANTAD Sales
Index 2008=100, s.a.



s.a./ Seasonally adjusted data.

Source: INEGI and elaborated by Banco de México with data from ANTAD.

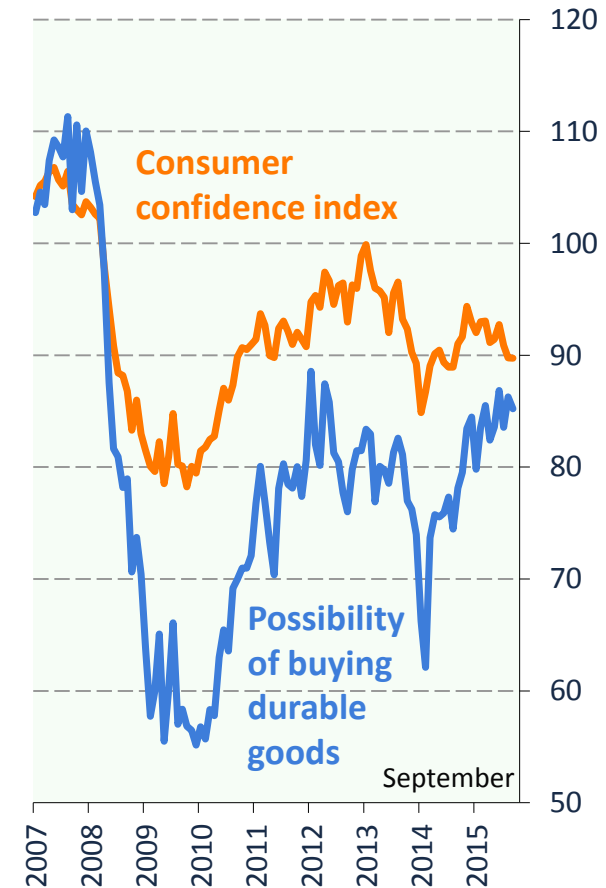
Workers' Remittances
Billion, constant
USD and MXN ^{1/}, s. a.



s.a./ Seasonally adjusted data.

1/ At prices of the second fortnight of December, 2010.
Source: Banco de México.

Consumer Confidence
Index Jan-2003=100, s.a.

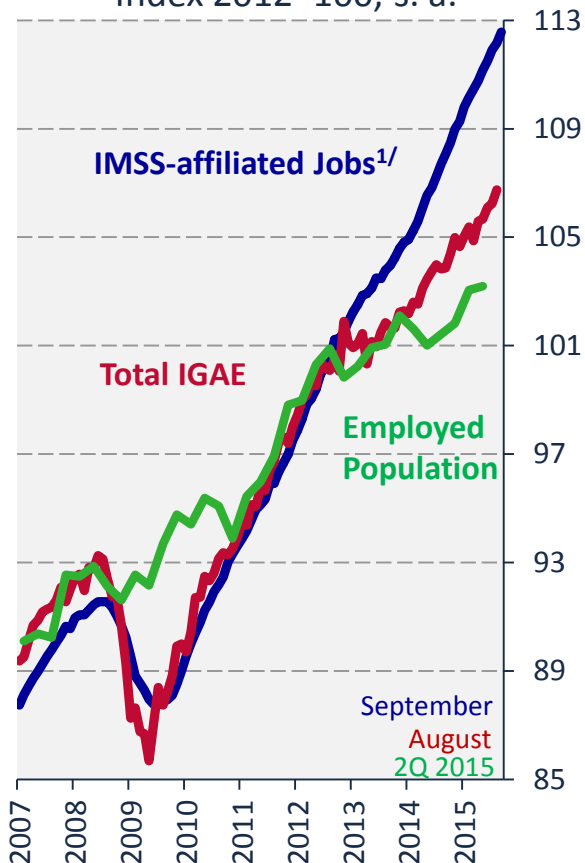


s.a./ Seasonally adjusted data.

Source: INEGI and Banco de México.

In face of the moderate economic growth, in the third quarter of 2015 slack conditions persisted in the labor market.

IMSS-Insured Jobs, Employed Population and Total IGAE
Index 2012=100, s. a.

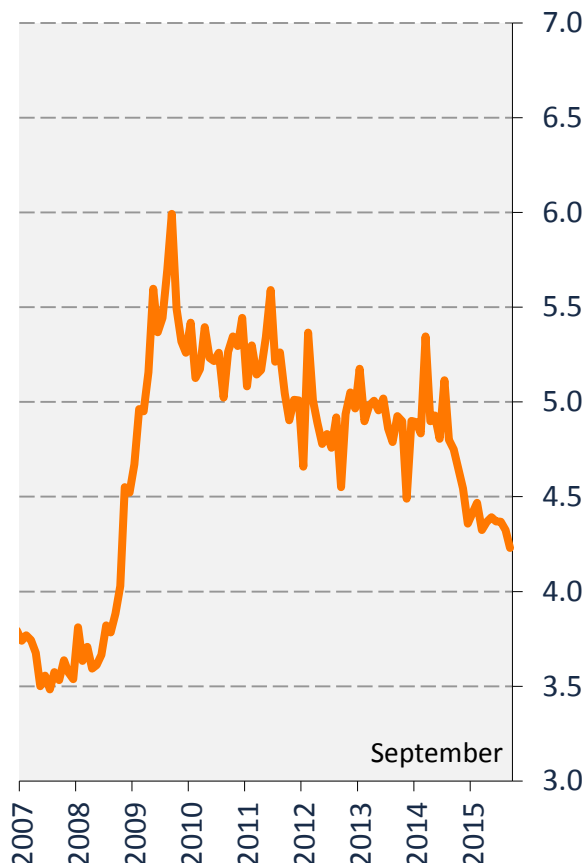


s. a. / Seasonally adjusted data.

1/ Permanent and temporary workers in urban areas. Seasonally adjusted by Banco de México.

Source: Calculated by Banco de México with data from IMSS and INEGI (SCNM and ENOE).

National Unemployment Rate
% of EAP, s. a.

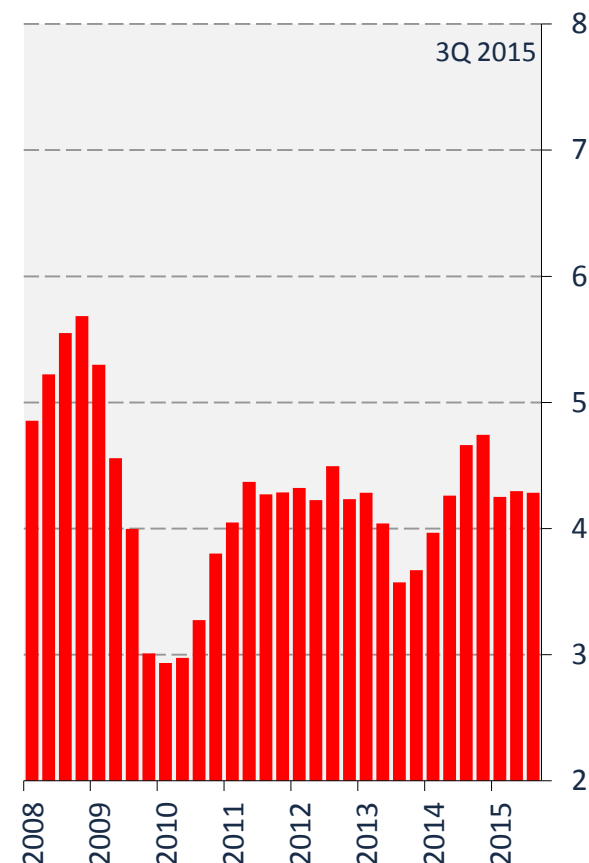


EAP/ Economically active population.

s. a. / Seasonally adjusted data.

Source: National Employment Survey (*Encuesta Nacional de Ocupación y Empleo*), INEGI.

IMSS Reference Wage ^{2/}
Annual % change



2/ During the third quarter of 2015, on average 17.7 million of contributors were registered to IMSS.

Source: Calculated by Banco de México with data from IMSS.

Outline

1 **Monetary Policy**

2 **External Conditions**

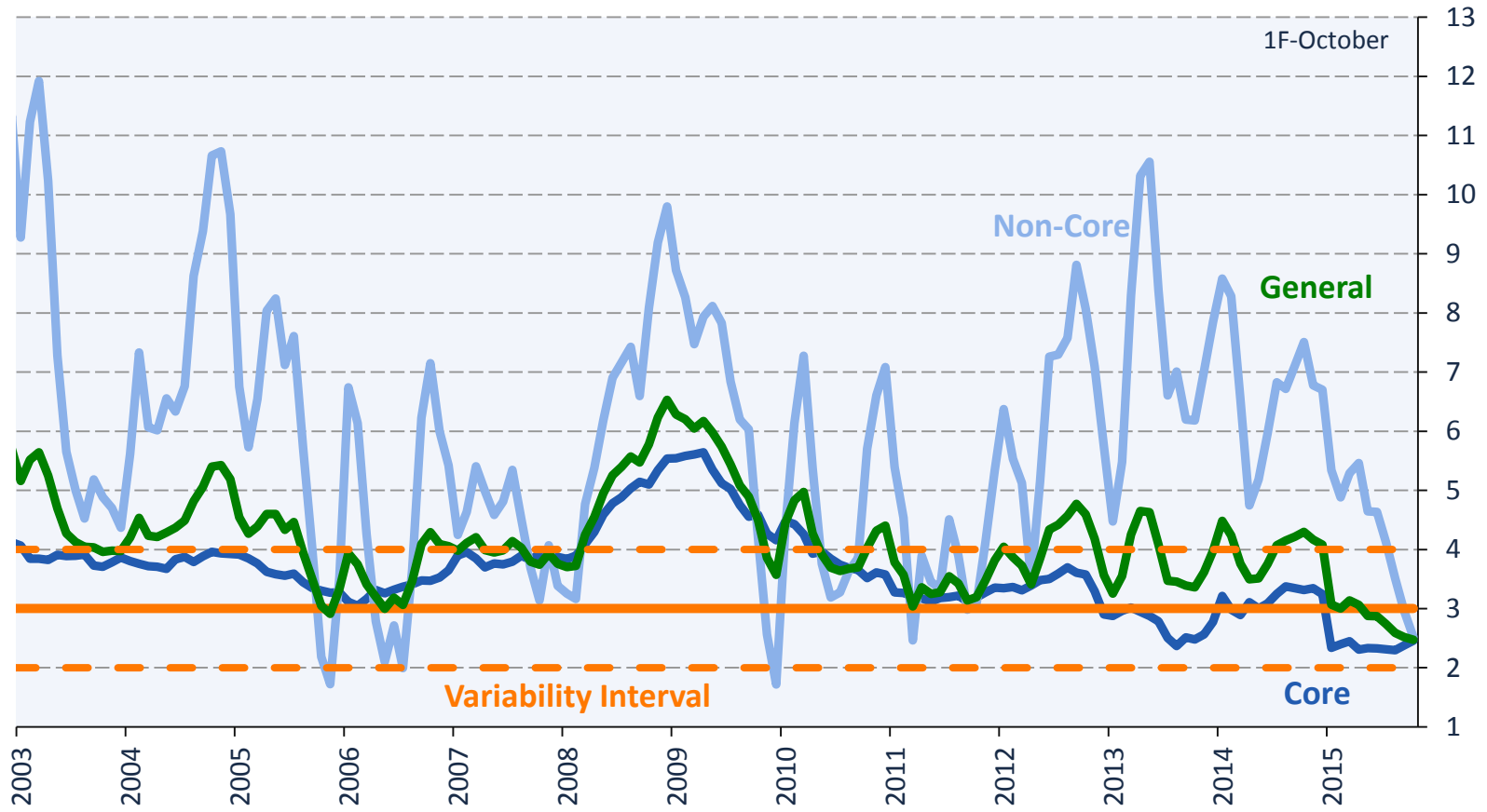
3 **Economic Activity in Mexico**

4 **Inflation Determinants**

5 **Forecasts and Balance of Risks**

In the third quarter of 2015, annual headline inflation exhibited further decreases in addition to those observed in the previous quarter, locating below 3 percent and reaching new historical minimum levels.

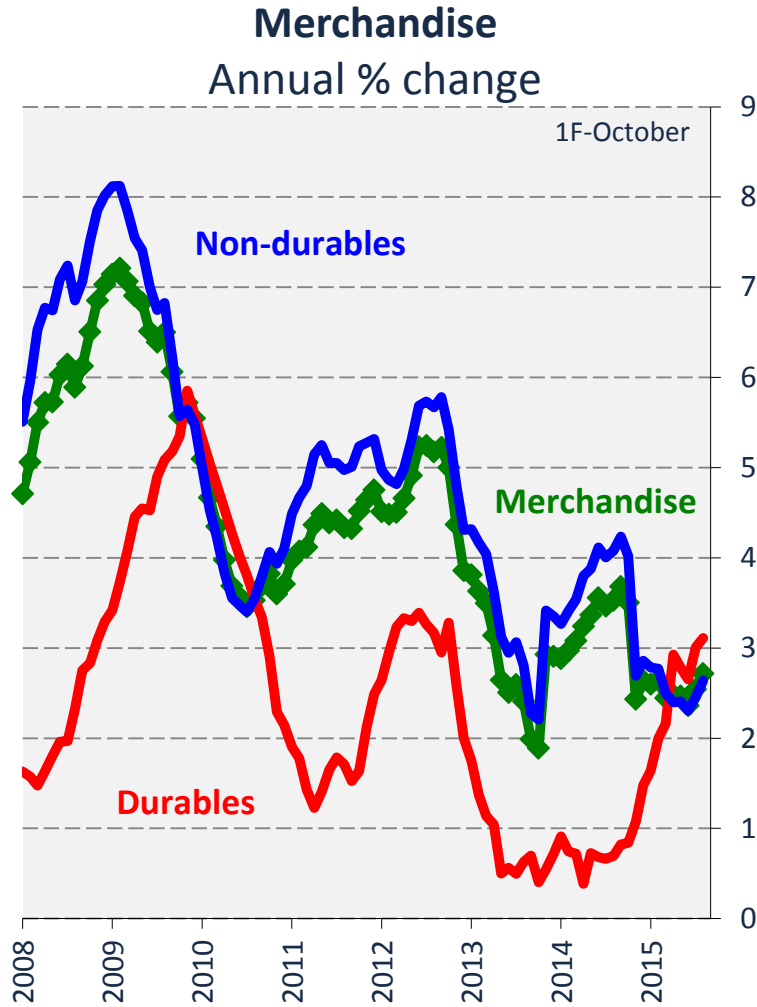
Consumer Price Index Annual % change



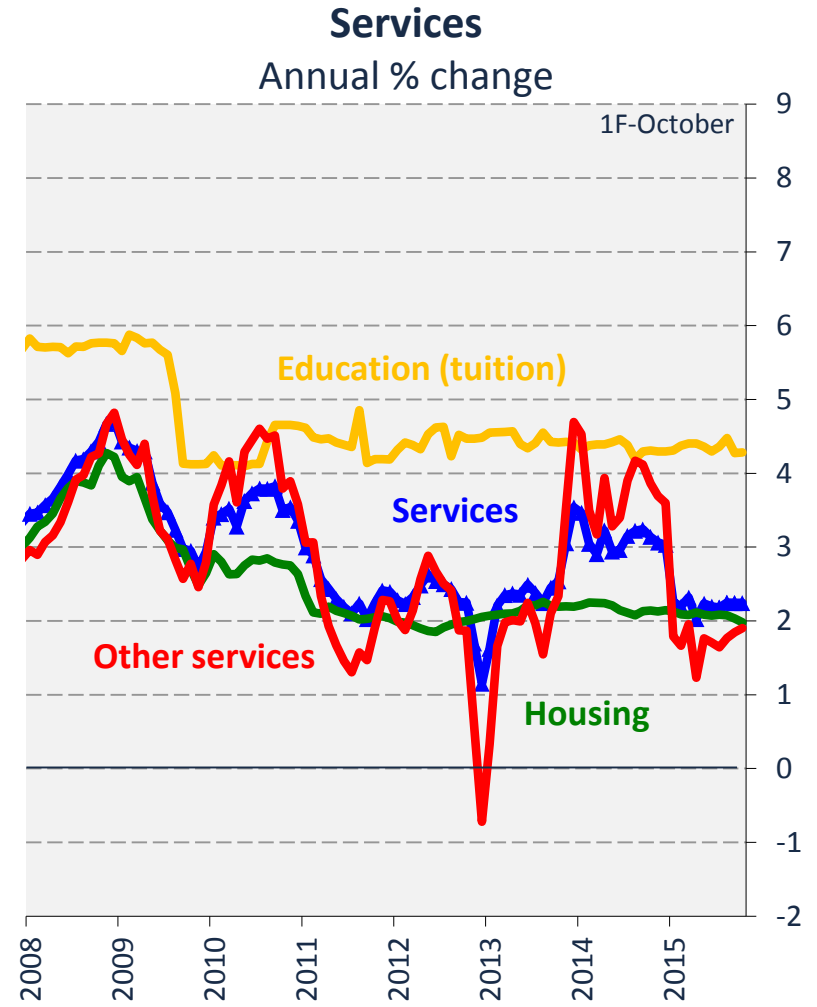
Source: Banco de México and INEGI.

The effect of the exchange rate depreciation on prices was limited, mainly affecting durable merchandise, without generating second round effects so far.

Core Price Index



Source: Banco de México and INEGI.

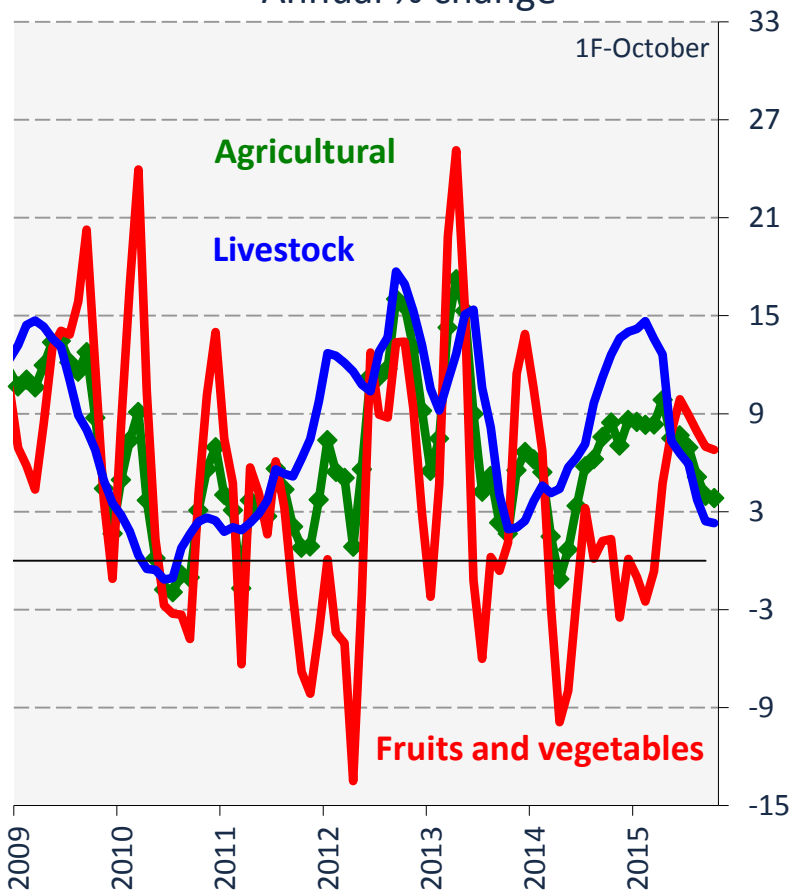


Source: Banco de México and INEGI.

The average annual growth rate of the non-core price index continued slowing down.

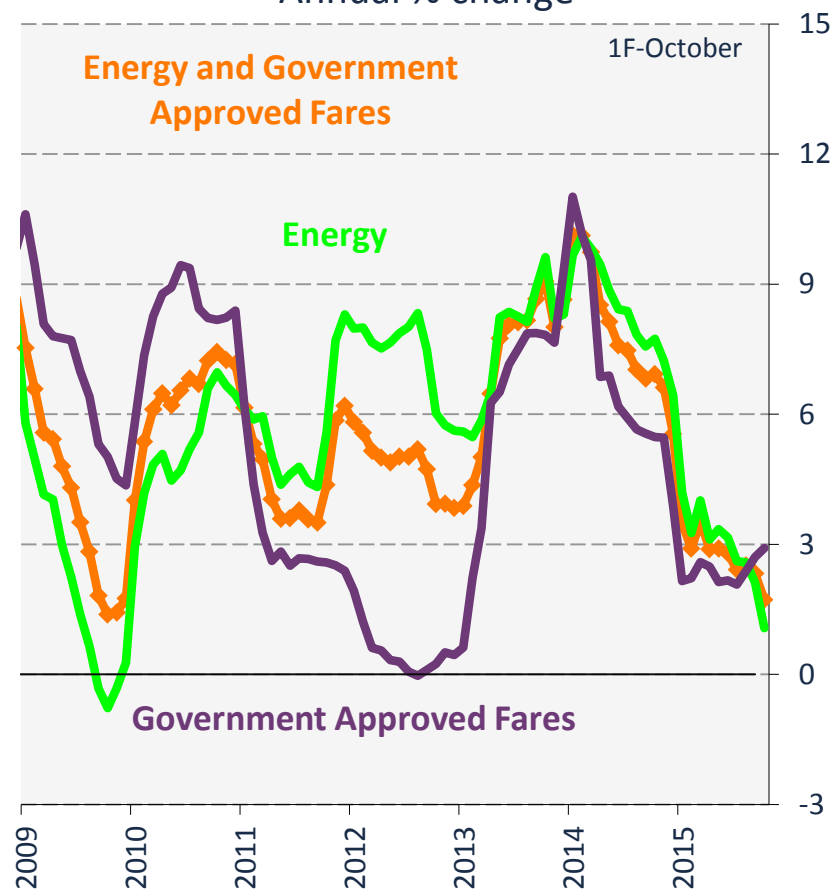
Non-Core Index

Agricultural
Annual % change



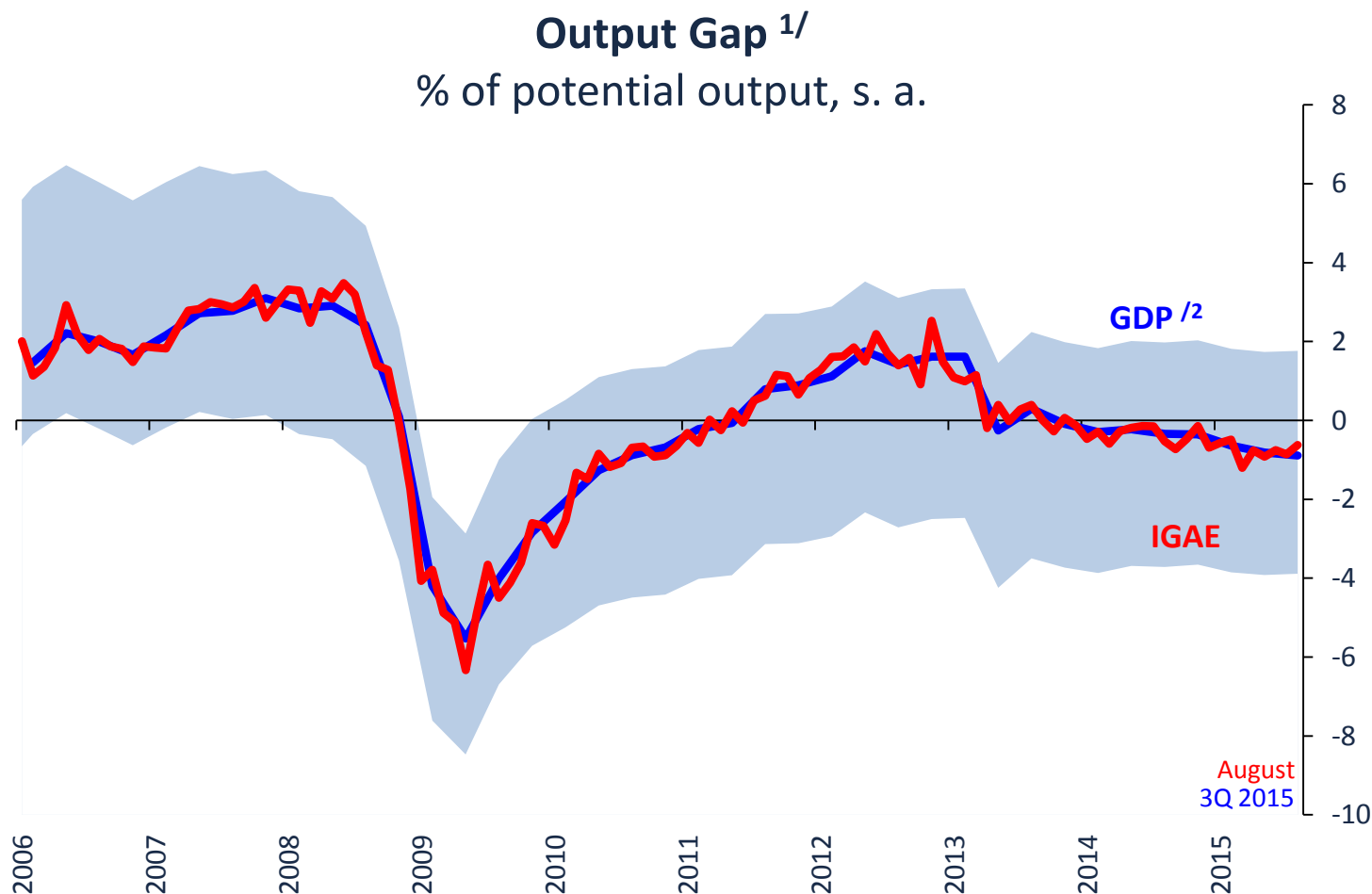
Source: Banco de México and INEGI.

Energy and Government Approved Fares
Annual % change



Source: Banco de México e INEGI.

In light of the abovesaid, slack conditions are expected to persist in the economy in the coming years, although gradually declining.



s.a. / Calculated with seasonally adjusted data.

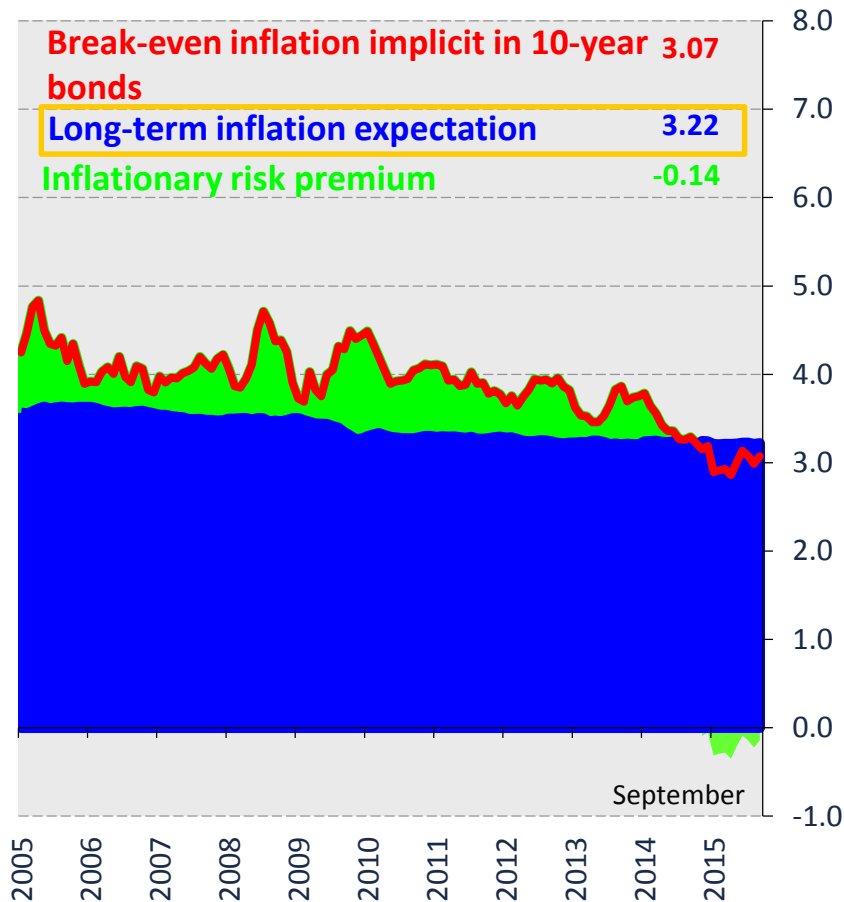
1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p.69. The shaded area is the 95% confidence interval of the output gap, calculated with an unobserved components method.

2/ The GDP data for the third quarter of 2015 corresponds to preliminary estimates published by the INEGI.

Source: Calculated by Banco de México with data from INEGI.

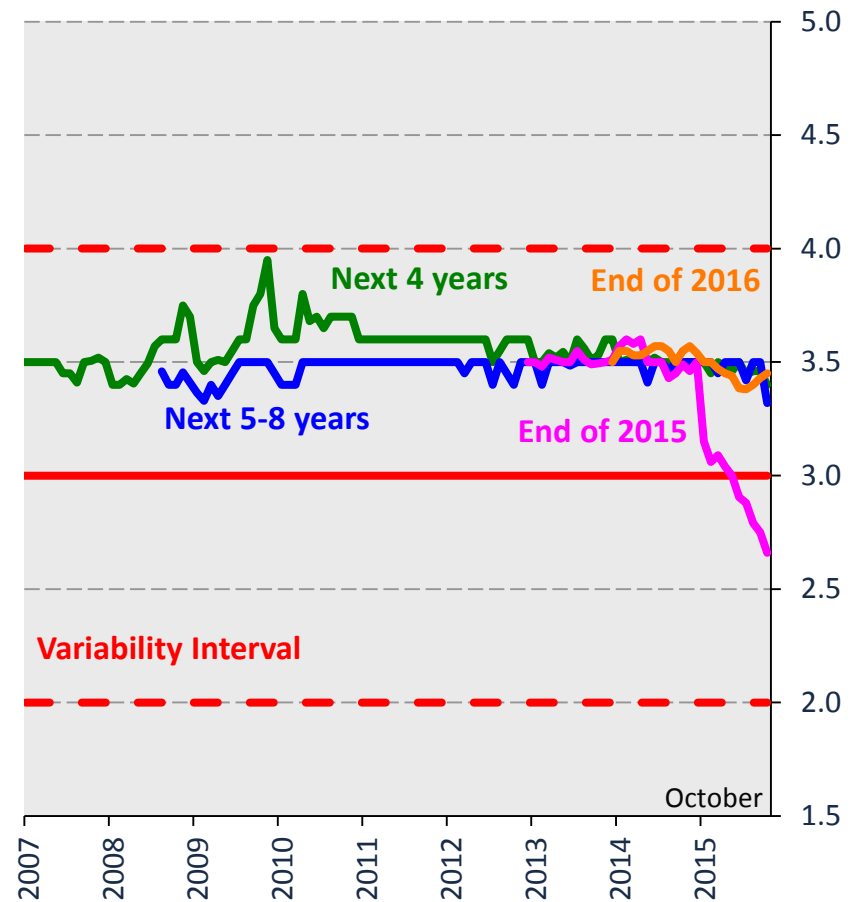
Inflation expectations implicit in long-term market instruments remained stable, while survey-based ones for the end of 2015 kept decreasing.

Break-even Inflation Decomposition ^{1/} %



^{1/}The inflation risk Premium is calculated with data from Valmer and Bloomberg, based on the methodology described in Box 1 "Decomposition of the Break-even Inflation" of the Quarterly Report October-December 2013.

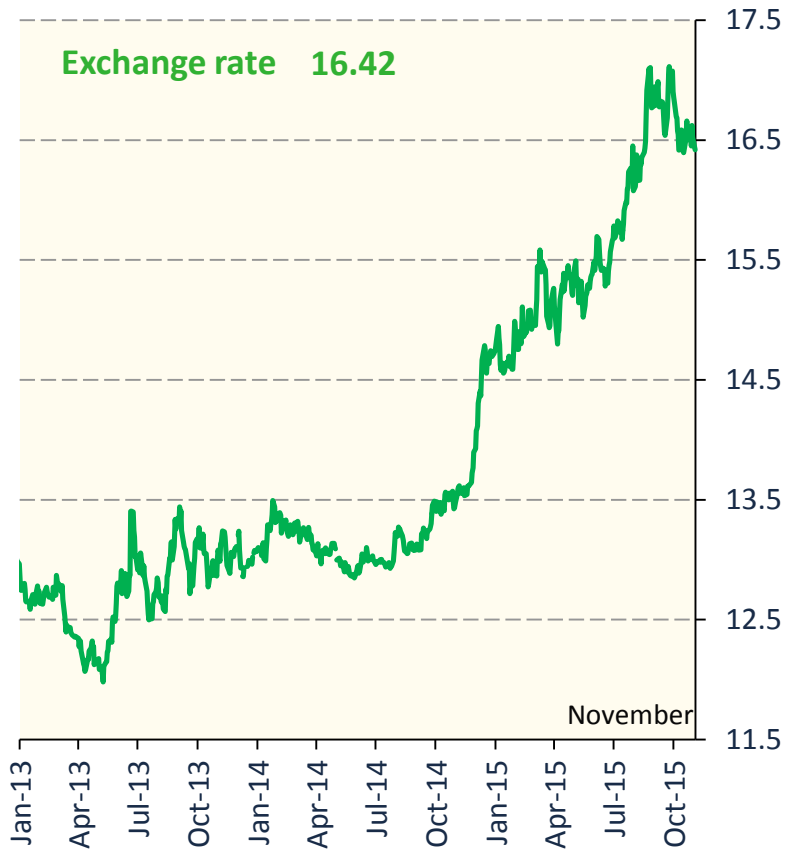
Annual Headline Inflation Expectations Median, %



Source: Survey of private sector economic analysts' expectations, Banco de México.

The Mexican peso, just like other emerging economies' currencies, registered an additional depreciation in the third quarter of 2015. Part of this depreciation reverted in October.

Exchange Rate ^{1/}
Pesos per USD



1/ The latest data for the observed exchange rate is November 03, 2015.
Source: Banco de México.

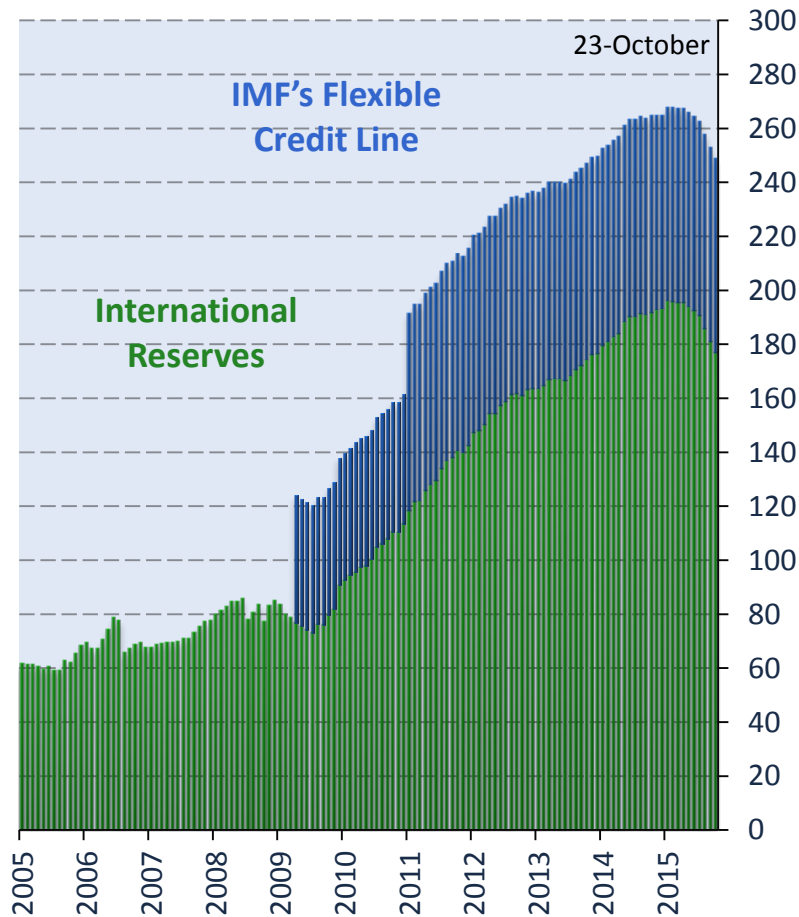
Implied Volatility in Foreign
Exchange Rate Options ^{2/}
%



2/ Refers to implied volatility in one-month options.
Source: Bloomberg.

The reduction in international reserves during the third quarter was due to the continuation of the USD auction mechanisms, determined by the Foreign Exchange Commission.

International Reserves USD billion



Source: Banco de México and International Monetary Fund.

Foreign Exchange Commission Preemptive Steps to Provide Liquidity to the FX Market:

- ✓ **December 2014:** Daily auctions of dollars of up to USD 200 million at a minimum price.
- ✓ **March 2015:** Daily auctions of USD 52 millions without a minimum price.
- ✓ **May 2015:** The extension until September 29, 2015 of the auction period of USD 52 millions without a minimum price.
- ✓ **July 2015:** The increment in the amount of auctions without a minimum price from USD 52 to 200 million, and the decrease of the threshold from 1.5% to 1.0%, to activate the auctions with a minimum price, both mechanisms until September 30, 2015.
- ✓ **September 2015:** The extension until November 30, 2015 of both mechanisms.

Interest rates in Mexico showed declines for different terms and trading conditions in the debt market have improved.

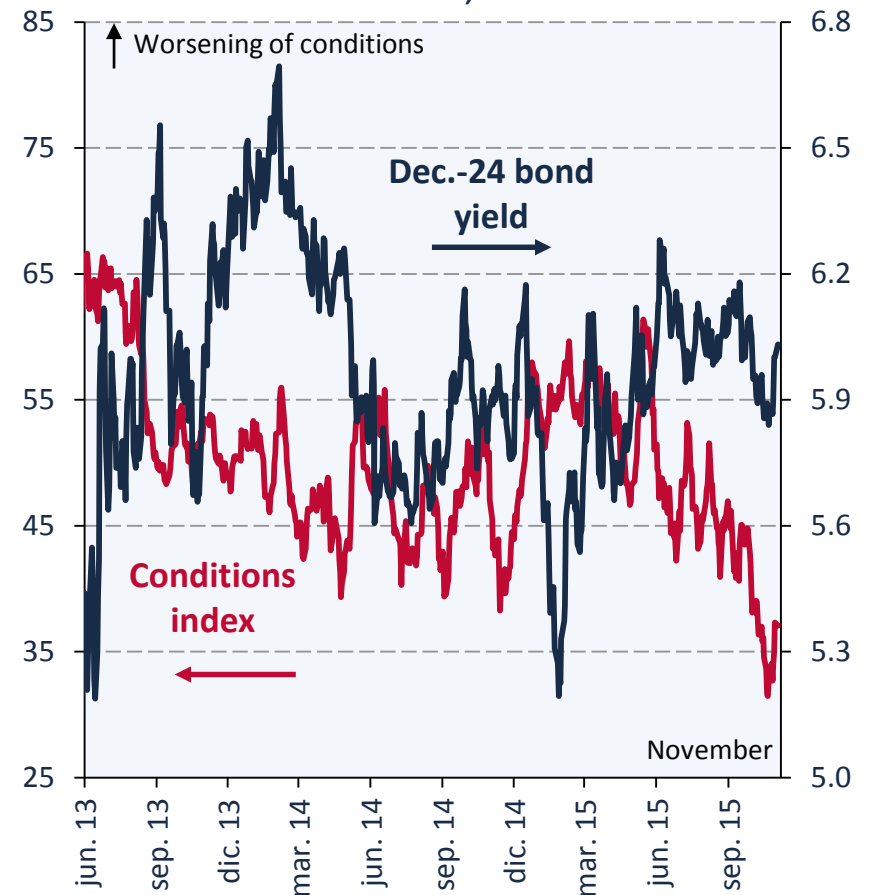
Government Securities' Interest Rates ^{1/} %



^{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).

Trading Conditions Index in Debt Market Index, %

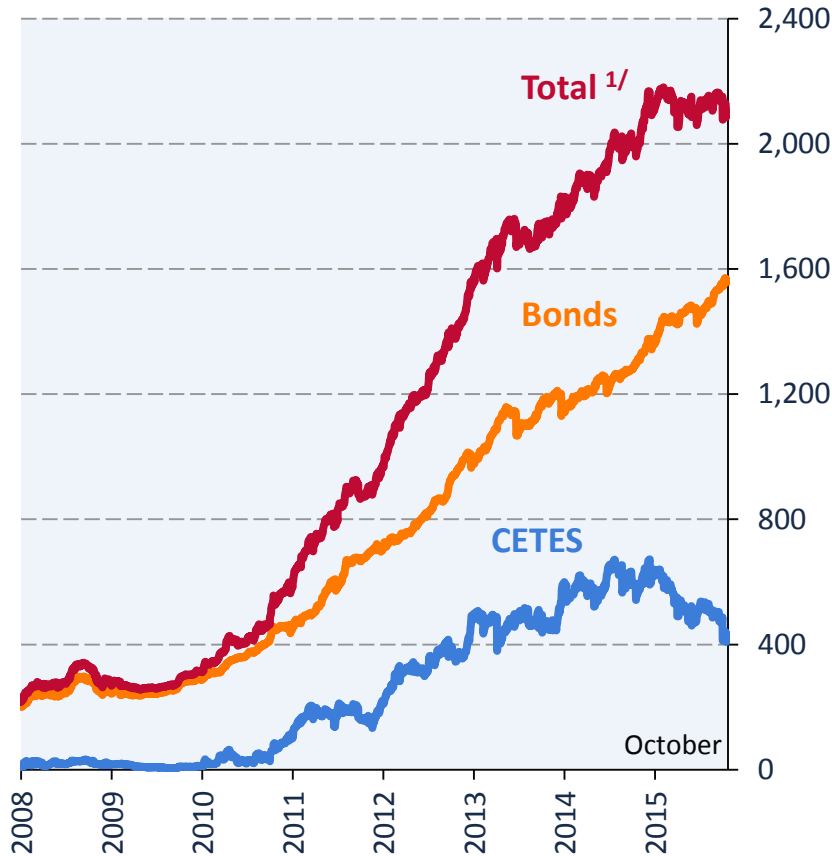


Note: The index is calculated based on the average volatility bias, kurtosis, buying and selling differential, all these intraday operation of Dec- 24 Bond, and daily trading volume. From them, the percentiles are calculated in the period 2013-2015 and the average of the six percentiles for each day is taken.

Source: Brokers Interbancarios with calculations of Banco de México.

Total government securities' holdings by foreign investors remained relatively stable and spreads between Mexican and U.S. interest rates behaved differentiated.

**Government Securities' Holdings
by Foreign Investors**
MXN billion



1/ Includes: Bondes, Bondes D, Bonos, Cetes and Udibonos.
Source: Banco de México.

**Mexico and United States
Interest Rate Spreads**
Percentage points



Source: PiP, Banco de México and U.S. Treasury Department.

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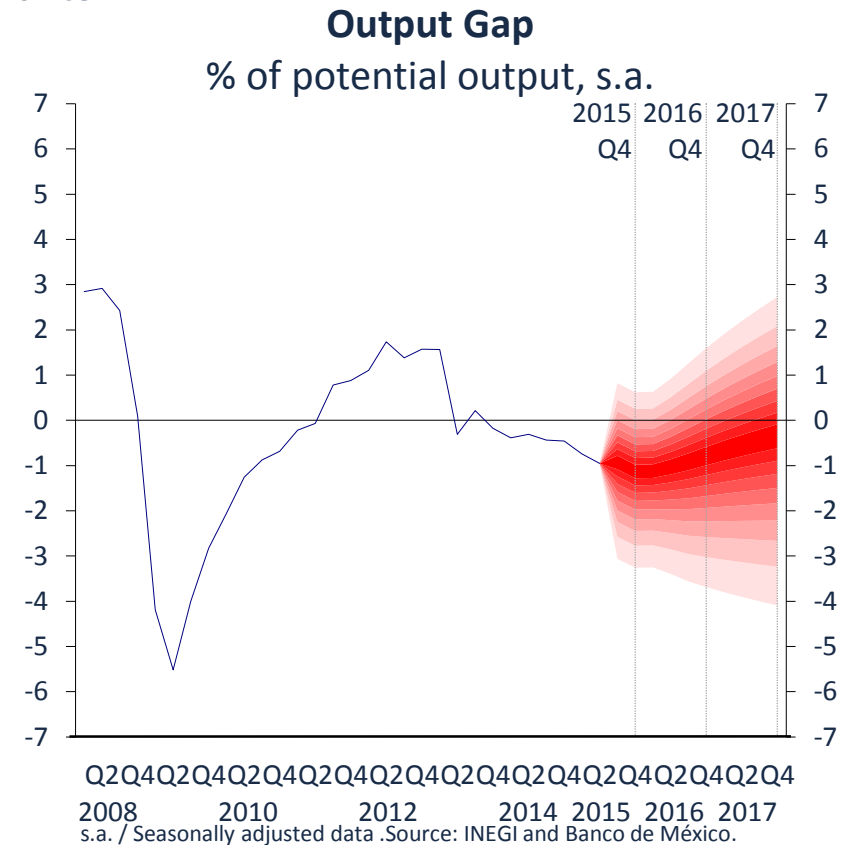
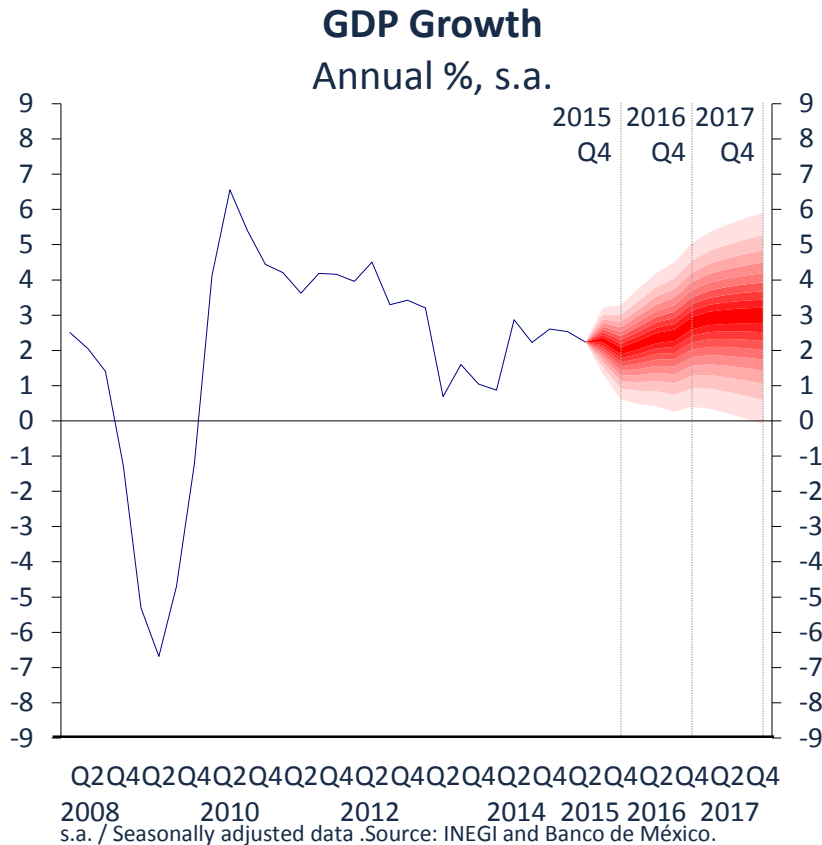
5 **Forecasts and Balance of Risks**

Economic Activity Outlook

GDP Growth (%)		
Report	Previous	Current
2015	1.7 - 2.5	1.9 - 2.4
2016	2.5 - 3.5	2.5 - 3.5
2017	--	3.0 - 4.0

Increase in the number of IMSS-insured jobs (Thousands)		
Report	Previous	Current
2015	560 - 660	640 - 710
2016	600 - 700	630 - 730
2017	--	660 - 760

Fan Charts



Risks to the Growth Outlook:

Upward:



Further progress in the implementation of structural reforms.



A faster than expected U.S. recovery.

Downward:



A new drop in Mexico's oil production and/or its price.



A deterioration in international financial market conditions, propitiating an increase in firms' financial costs.



An additional deterioration in economic agents' confidence in light of the persistence of a weak economy and/or the absence of progress in the strengthening of the rule of law.



Less dynamism of the automotive sector, given the problems that some of the sector's participants have experienced at the global level.



A delay in the recovery of the U.S. industrial sector.

Inflation Outlook

**Headline
Inflation**

**Core
Inflation**

2015

Below 3 percent during the rest of the year.

2016

At levels close to 3 percent.

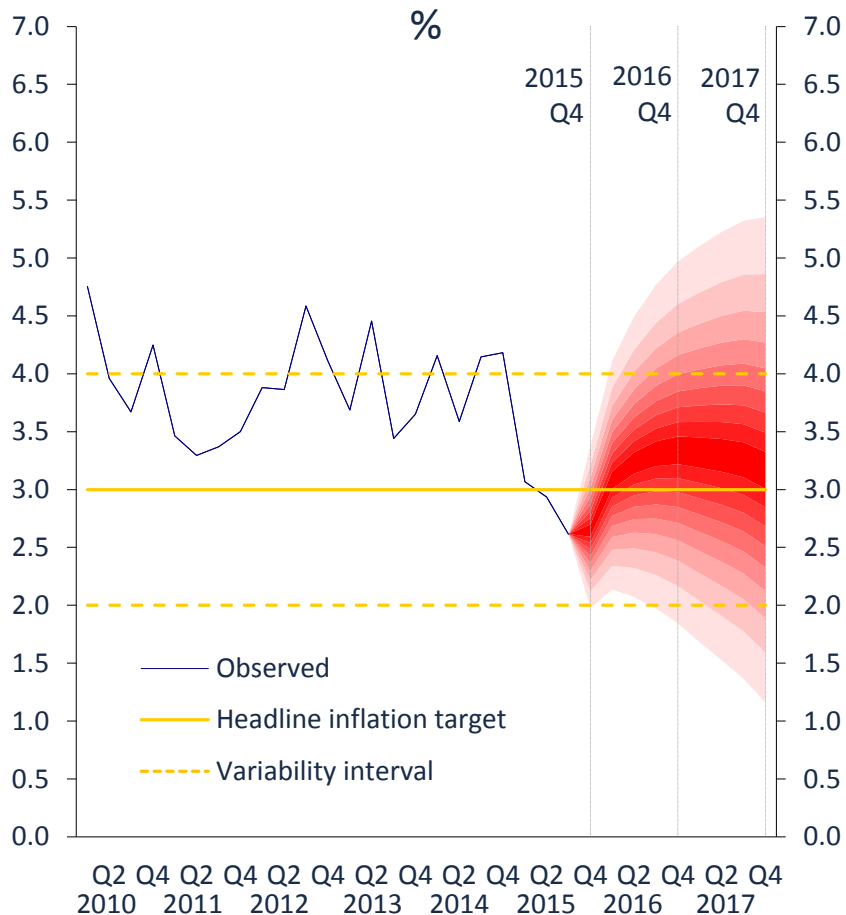
2017

Moderate downward trend, locating at levels closer to 3 percent at the end of the year.

Inflation is anticipated to remain below 3 percent during the rest of 2015, close to that level in 2016 and with a slight downward trend in 2017, being closer to 3 percent by the end of that year.

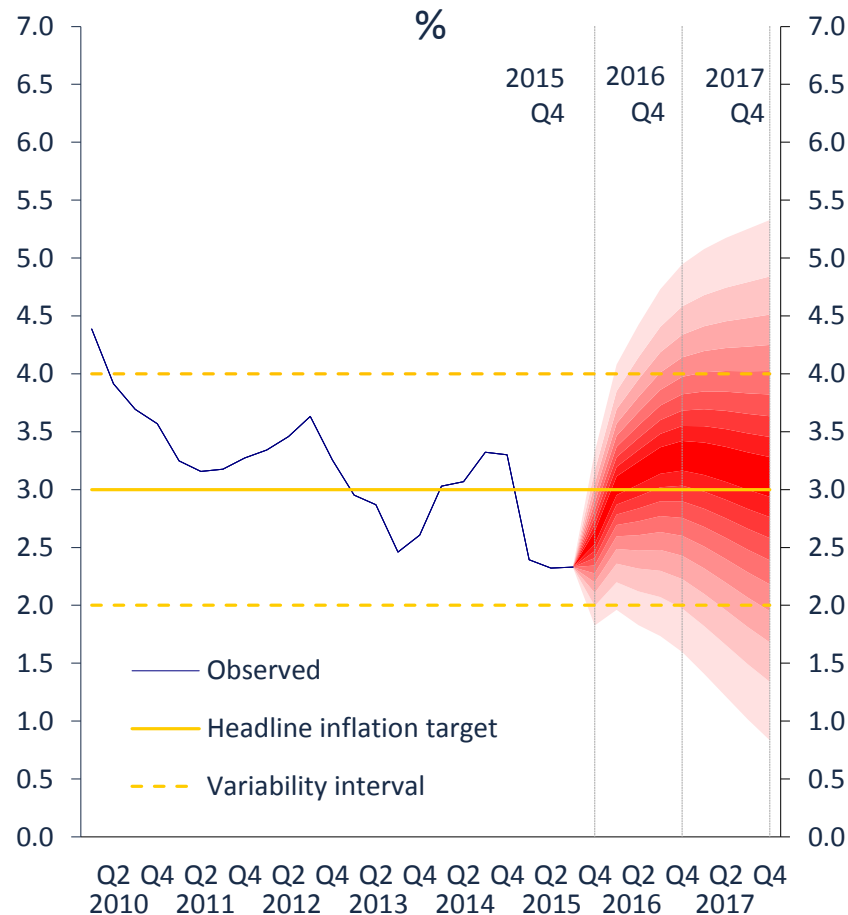
Fan Charts

Annual Headline Inflation ^{1/}



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

Annual Core Inflation ^{2/}



^{2/} Quarterly average of annual headline inflation.
Source: INEGI and Banco de México.

Risks to the Inflation Forecast:

Downward

✓ A lower than expected dynamism of economic activity.

✓ That some goods and widely used inputs continue exhibiting price decreases, in some cases as a result of the implementation of structural reforms.

✓ That the gasoline price increases less than 3 percent next year.

✓ That the national currency reverts part of the depreciation accumulated in the previous months.

Upward

✓ That the depreciation propitiates price increases for a broad set of goods and services, and contaminates inflation expectations. As in the past, Banco de México will be alert to avoid this from happening.

Monetary Policy Stance

- Considering the facts presented in this Report, Banco de México's Board of Governors will continue to monitor the performance of all inflation determinants and its medium- and long-term expectations, in particular:
 - ✓ *The monetary stance of Mexico relative to the U.S.*
 - ✓ *The pass-through of exchange rate movements onto consumer prices.*
 - ✓ *The evolution of the degree of slackness in the economy.*

➤ **All this in order to be able to take the necessary measures in a flexible manner and whenever conditions demand it in order to consolidate the convergence of inflation to the permanent 3 percent target.**

Challenges to Strengthen Confidence in the Mexican Economy

- Considering the complex international environment and the expectations that it will persist in the future, it is fundamental to **maintain a solid macroeconomic framework** in Mexico. Therefore, in addition to the timely adjustment of the monetary policy stance, it is necessary to:
 - ✓ Concretize the recently proposed efforts in the fiscal front.
 - ✓ Continue implementing structural reforms in an adequate and timely manner.
- This will contribute to **preserve an environment of confidence** towards the Mexican economy, distinguishing it from other emerging economies, such that the country risk component implicit in interest rates remains at low levels.
- Finally, as mentioned on previous occasions, it is also necessary to **strengthen institutions and the rule of law**, clearly implying an appropriate legal framework, but especially, its enforcement and full compliance.



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