



Inflation Report

July – September 2013

November 6, 2013



BANCO DE MÉXICO

Outline

1

External Conditions

2

Economic Activity in Mexico

3

**Monetary Policy and Inflation
Determinants**

4

Forecasts and Balance of Risks

External Conditions

Global Situation in 3Q2013

Growth

- ✓ *Environment of weak growth of the world economy.*
 - ➔ *Mixed performance in advanced economies.*
 - ➔ *Lower than expected growth in main emerging economies.*

Inflation

- ✓ *Remained low in most economies and is expected to persist at reduced levels.*

Monetary Policy

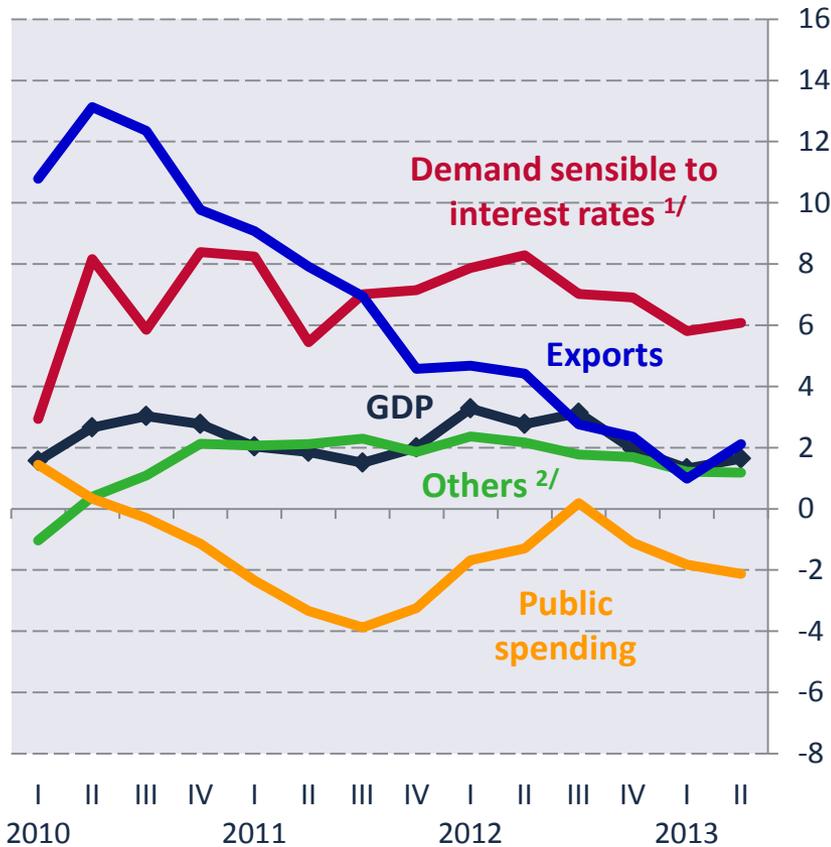
- ✓ *Given the moderate U.S. economic recovery and uncertainty over the impact of the fiscal debate, **the Federal Reserve maintained the pace of its asset purchases unchanged**, resulting in:*
 - *A slight decrease in long-term interest rates.*
 - *The recovery of international financial markets.*
- ✓ *However, the expectation of a reduction in asset purchases over the next months prevails.*

3

The recovery of the U.S. economic activity seems to have moderated in 3Q2013, due to a lower dynamism of private domestic demand.

GDP Growth Components

Annual % change

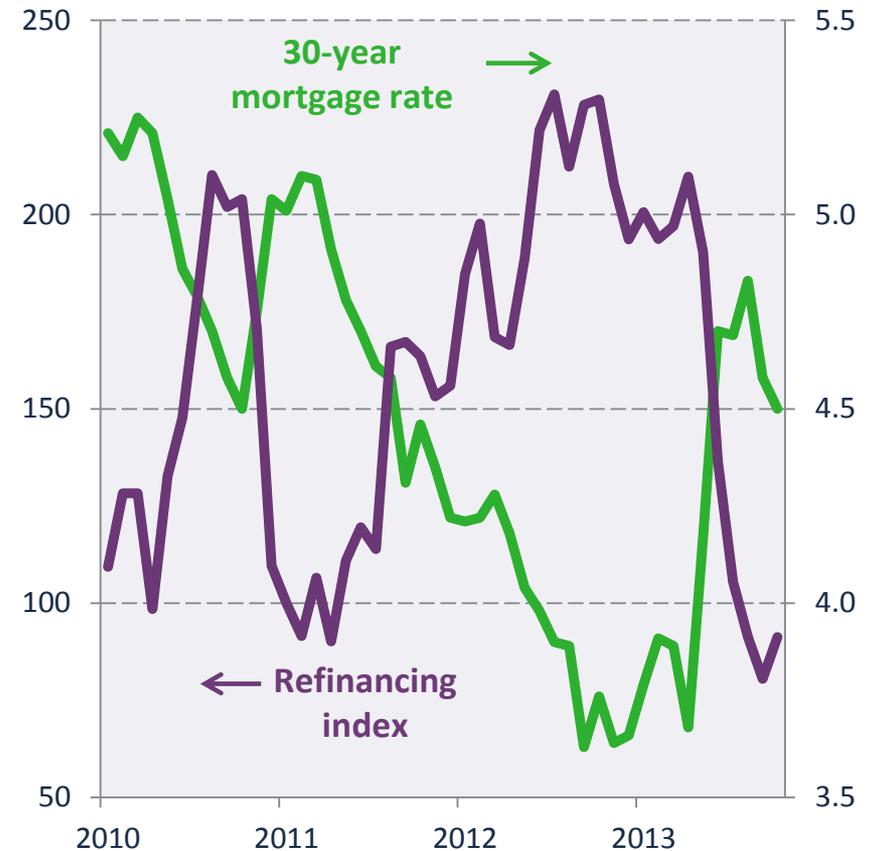


1/ Includes expenditures on durable goods, equipment and residential investment. 2/ Includes services, expenditures on non-durable goods and investment in structures.

Source: BEA.

Housing Market Indicators

Index Jan-2011=100 and %

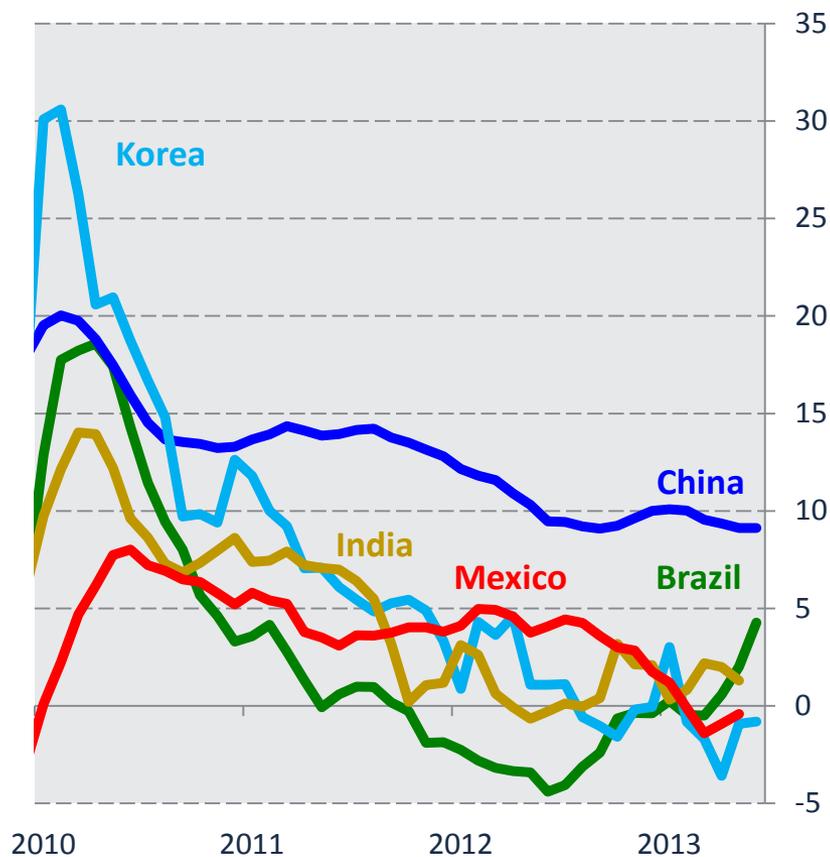


Source: MBA and Bloomberg.

In main emerging economies, the economic growth in 3Q2013 was generally lower than anticipated.

Industrial Production

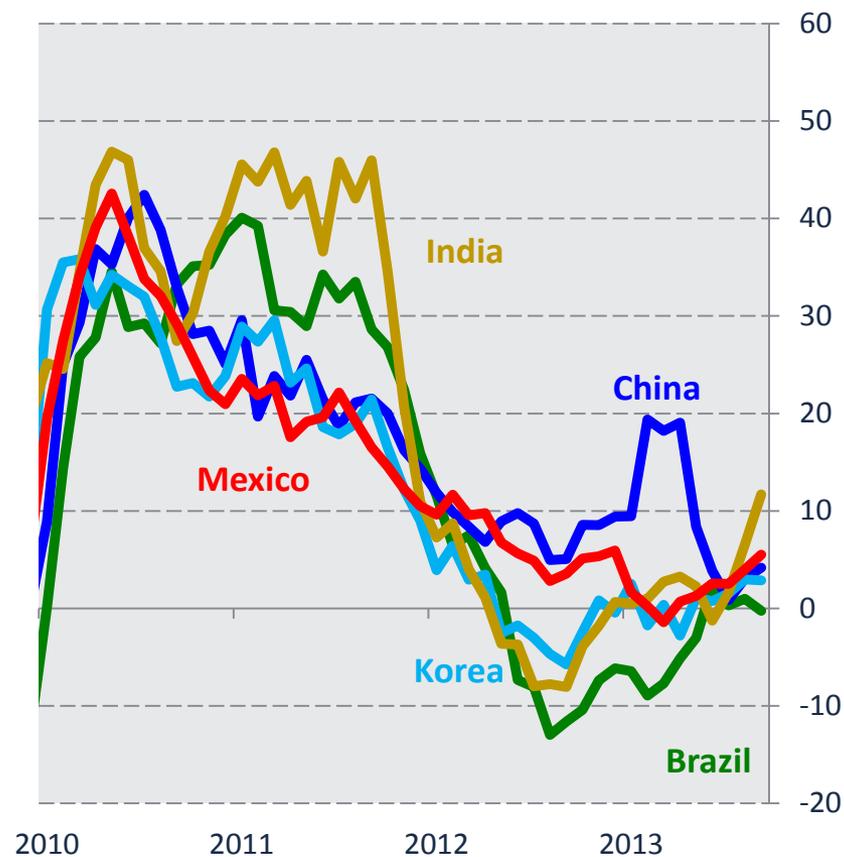
Annual % change of 3-month moving average



Source: INEGI and Haver Analytics.

Exports

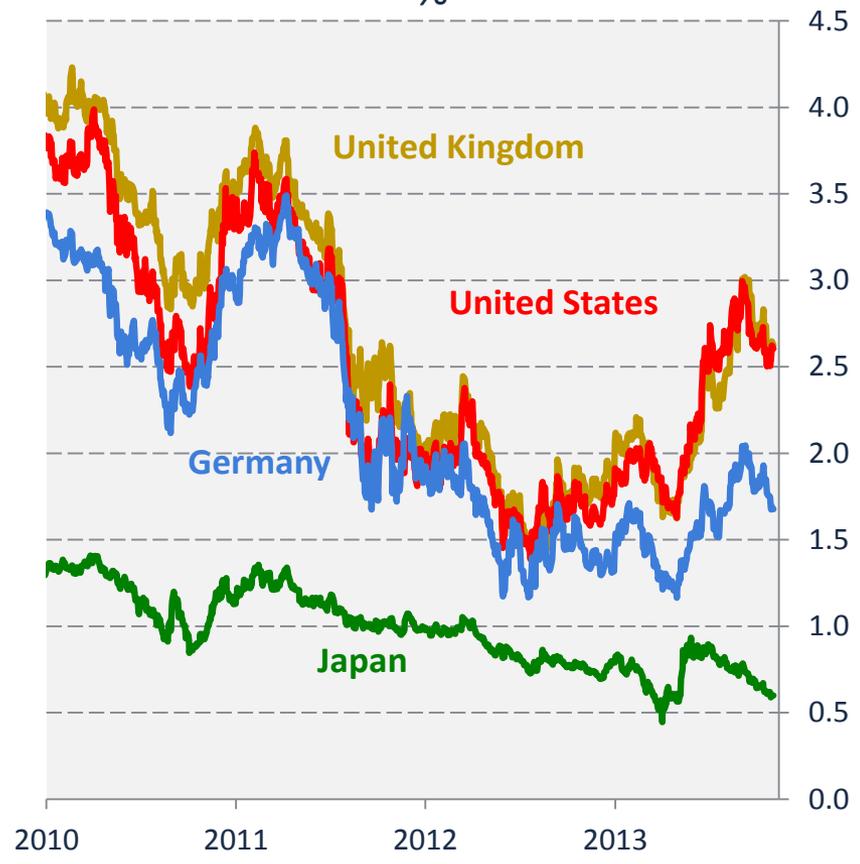
Annual % change of 3-month moving average



Source: INEGI and Haver Analytics.

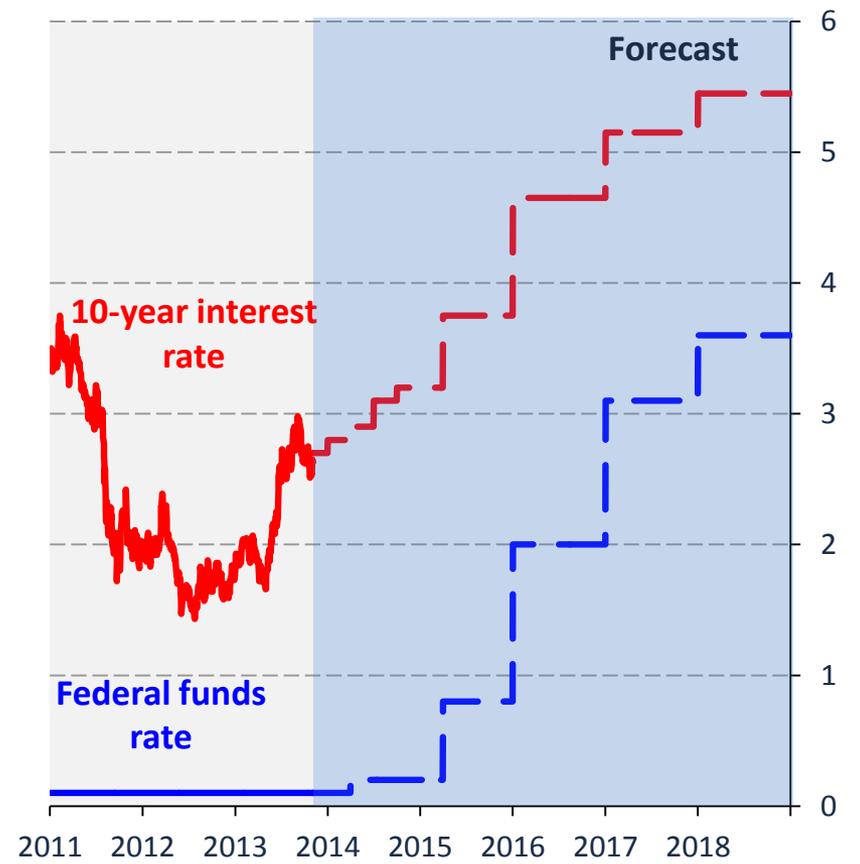
The Federal Reserve decision to maintain its monetary policy unchanged led to a recovery of the financial markets from late September onwards. Still, adjustments to this policy are expected in the near future.

**Advanced Economies:
10-Year Interest Rates**
%



Source: Bloomberg.

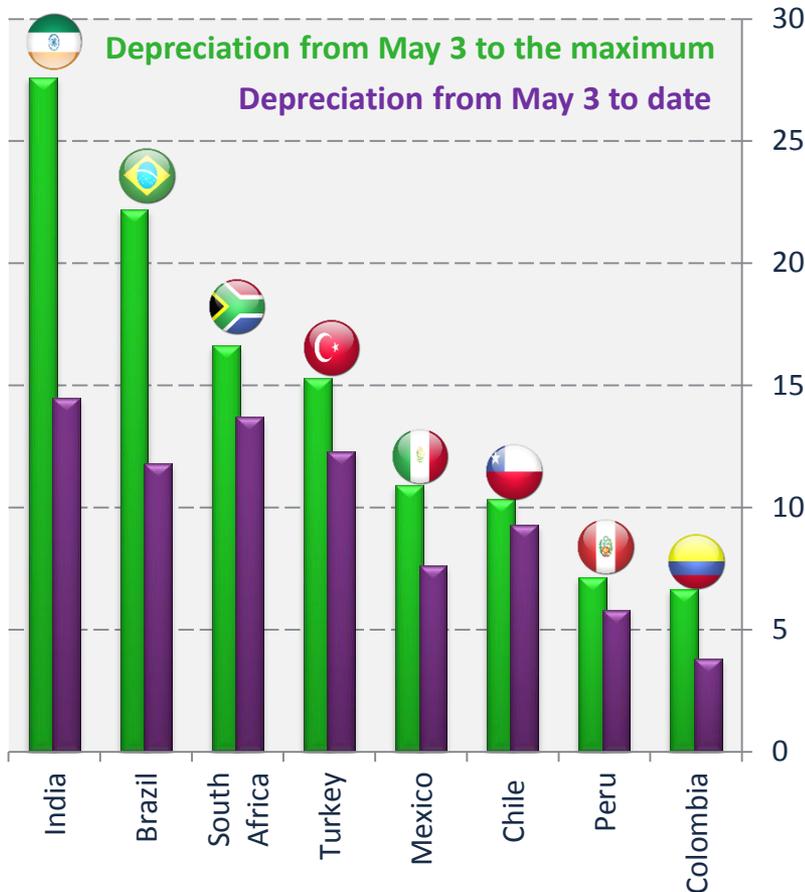
U.S.: Interest Rates Forecasts
%



Source: U.S. Department of the Treasury and Blue Chip.

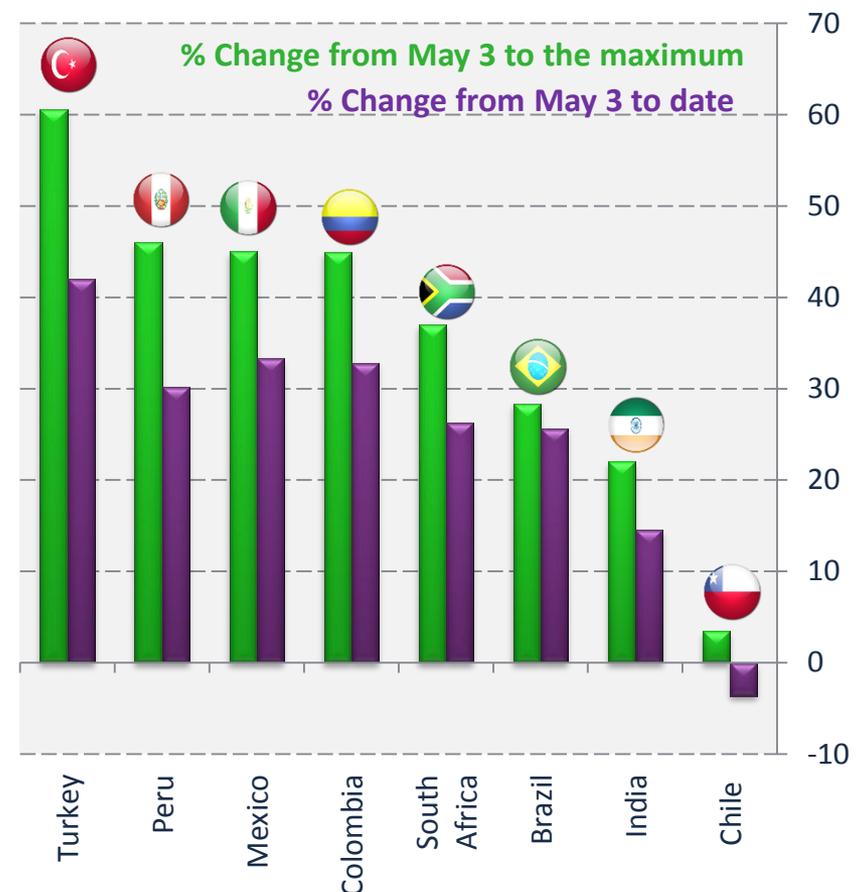
As a result of the above, emerging economies registered a partial correction in their asset prices.

Nominal Exchange Rate against USD ^{1/}
Change %



1/ A positive variation corresponds to an appreciation. May 3 is the date of the publication of April U.S. employment report.
Source: Bloomberg.

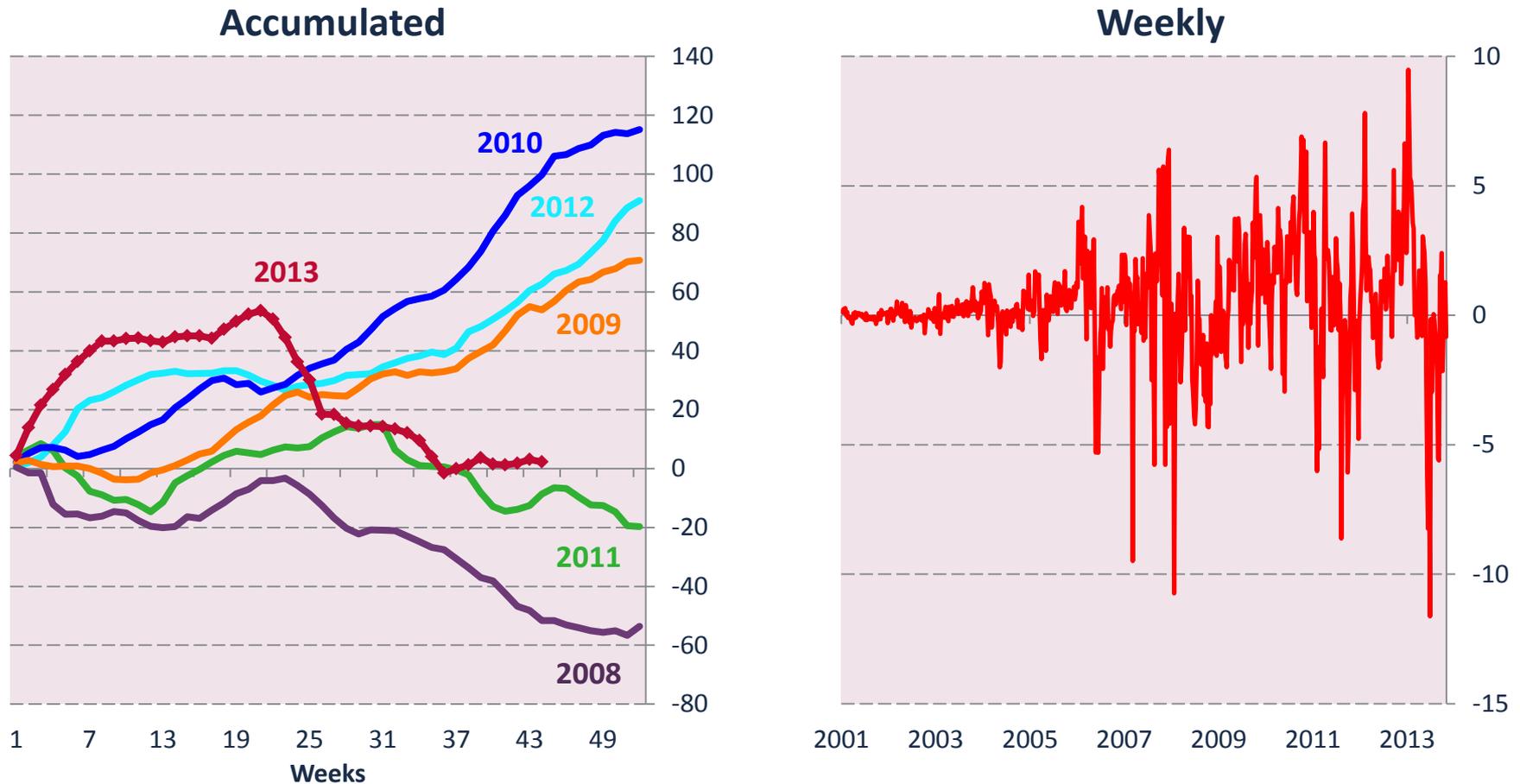
10-Year Interest Rates ^{2/}
Change %



2/ May 3 is the date of the publication of April U.S. employment report.
Source: Bloomberg.

However, as a reflection of the abovedescribed environment, volatility in capital flows to emerging economies has been observed in recent months.

Emerging Economies: Capital Flows (Debt and Equity) Billions of dollars

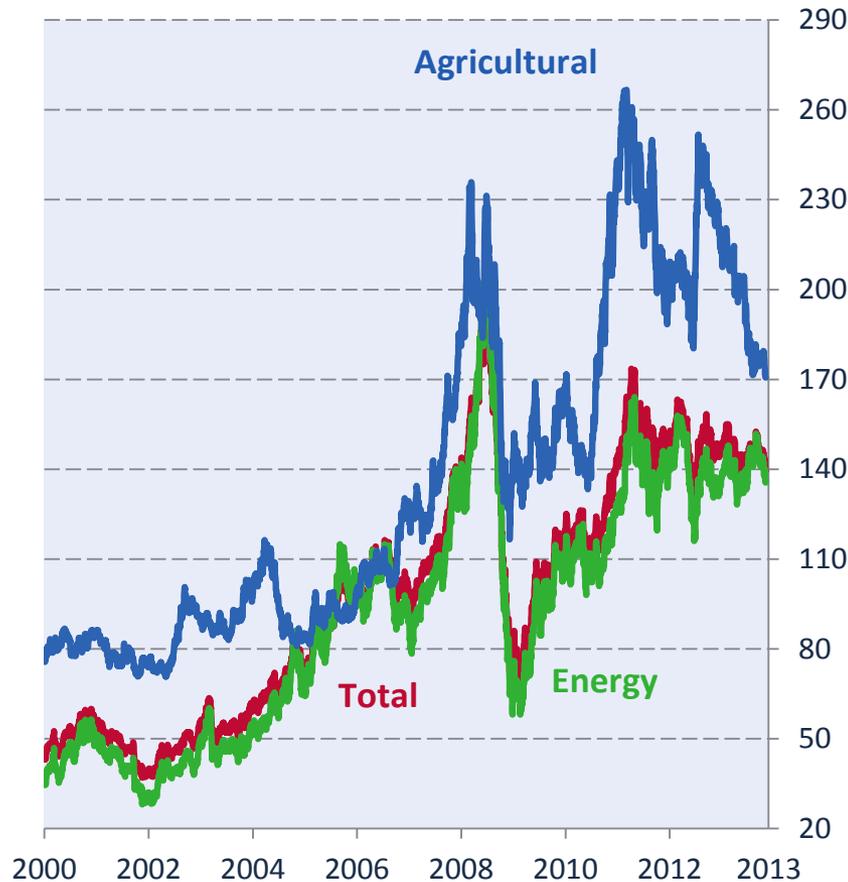


Source: Emerging Portfolio Fund Research.

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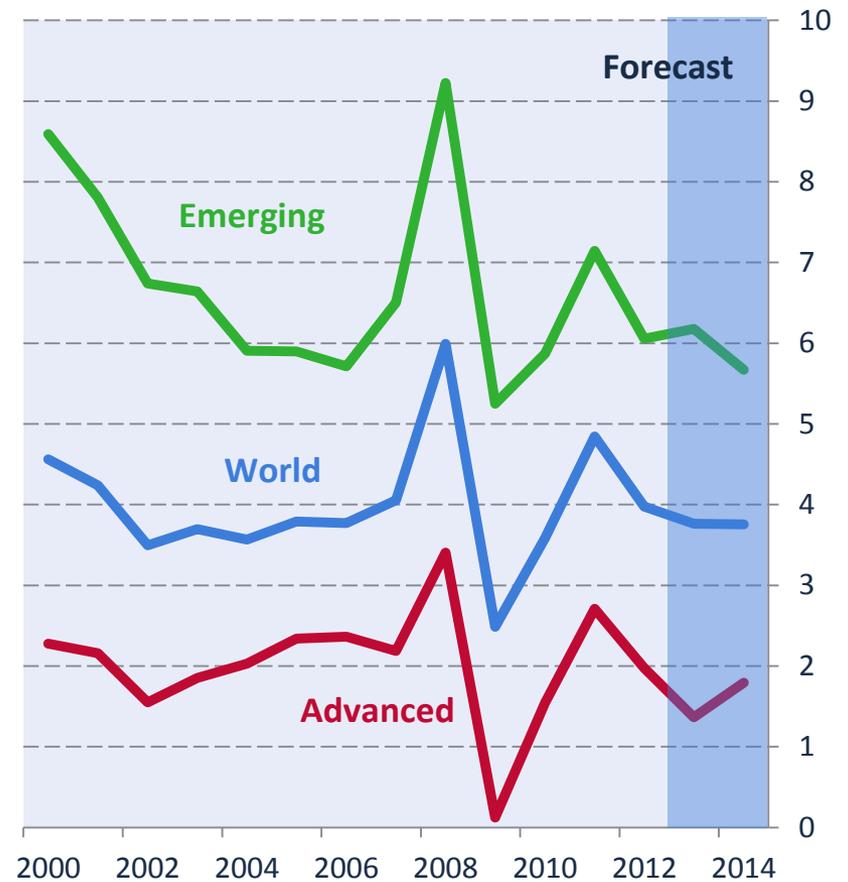
In general, inflation persisted at low levels in most advanced and emerging economies, and it is expected to remain at reduced levels over the following quarters.

Commodity Prices
Index 03-Jan-2006 = 100



Source: Standard & Poor's.

World Inflation
% Annual



Source: International Monetary Fund.

Outline

1 External Conditions

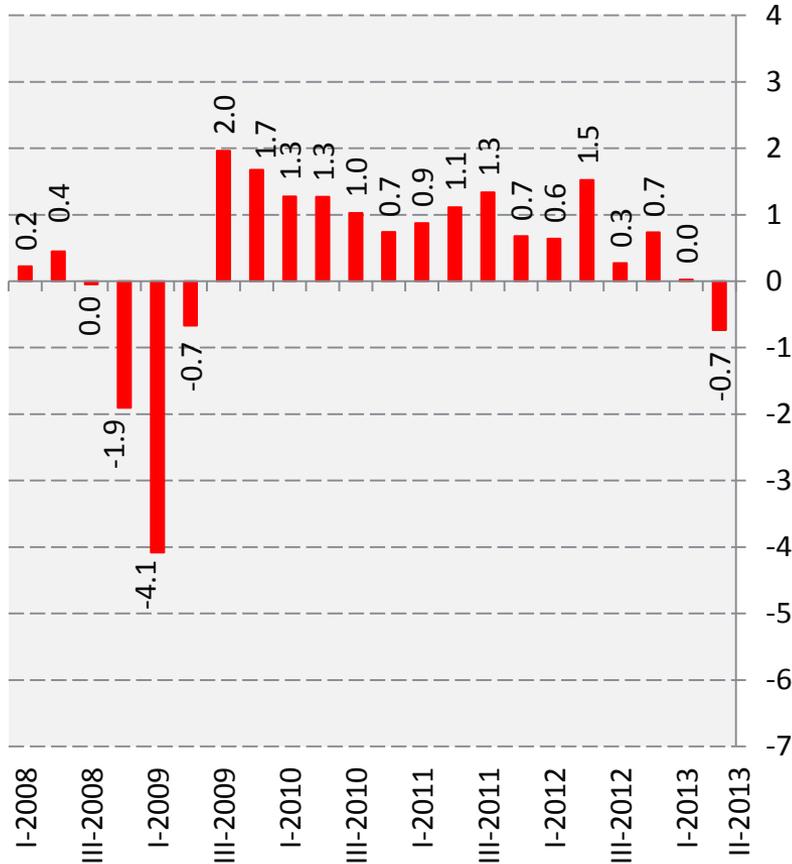
2 Economic Activity in Mexico

3 Monetary Policy and Inflation
Determinants

4 Forecasts and Balance of Risks

Following the deceleration of the Mexican economy since 2H2012, some indicators suggest that in 3Q2013 a positive trend may resume.

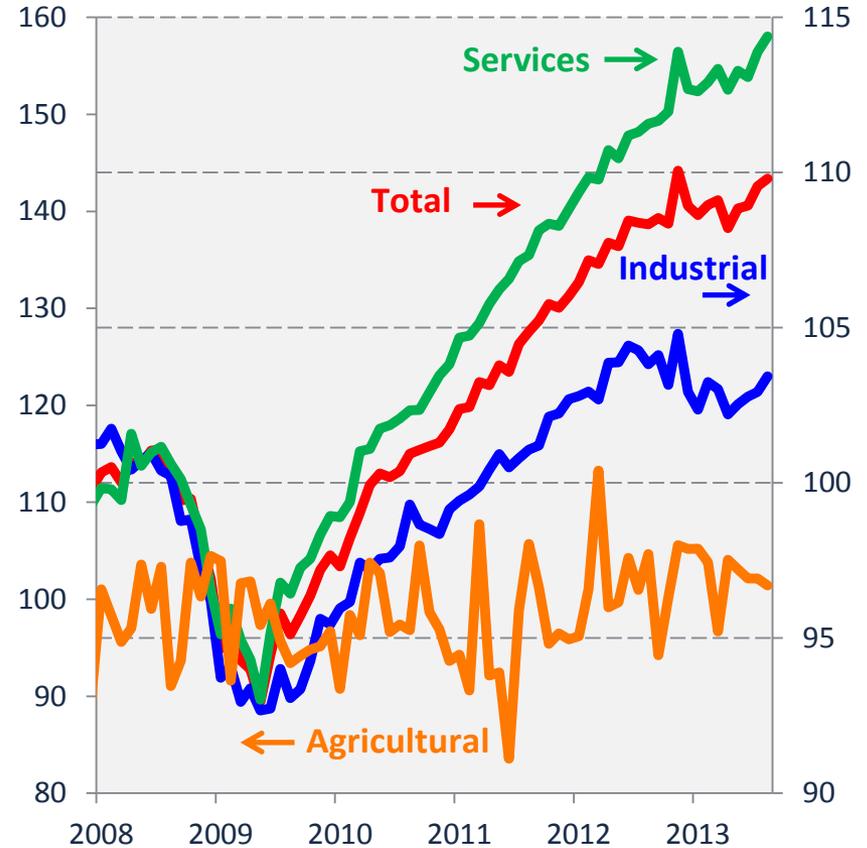
Gross Domestic Product
Quarterly growth rates %; s.a.



s.a./ Seasonally adjusted data.

Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

Global Indicator of Economic Activity (IGAE)
Index 2008=100; s.a.

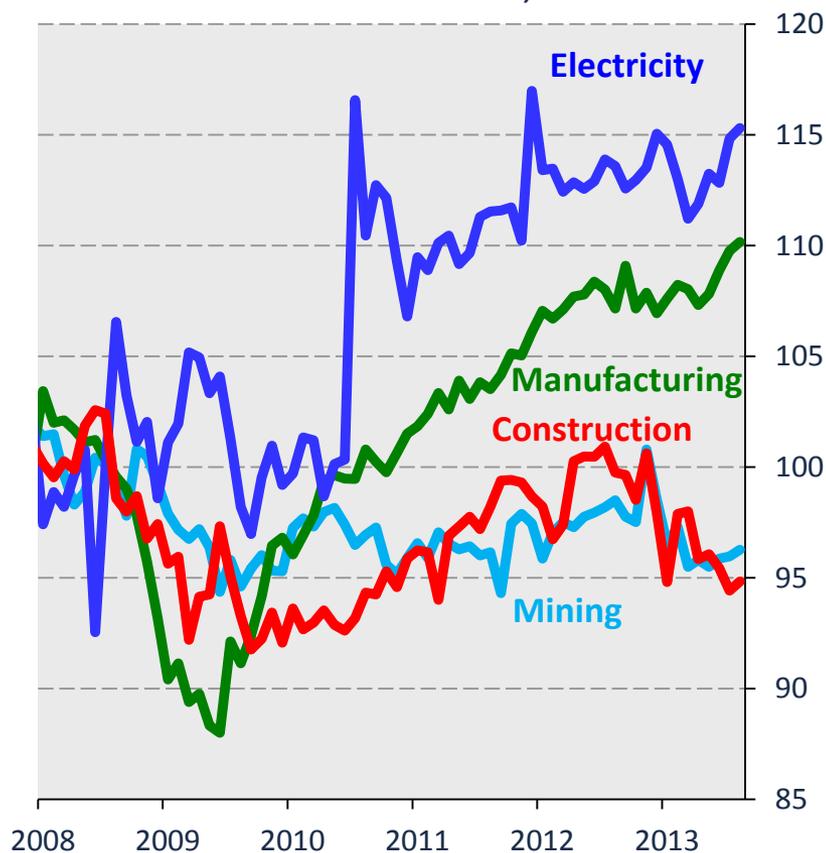


s.a./ Seasonally adjusted data.

Source: INEGI.

In particular, industrial production and the services sector exhibited a favorable evolution.

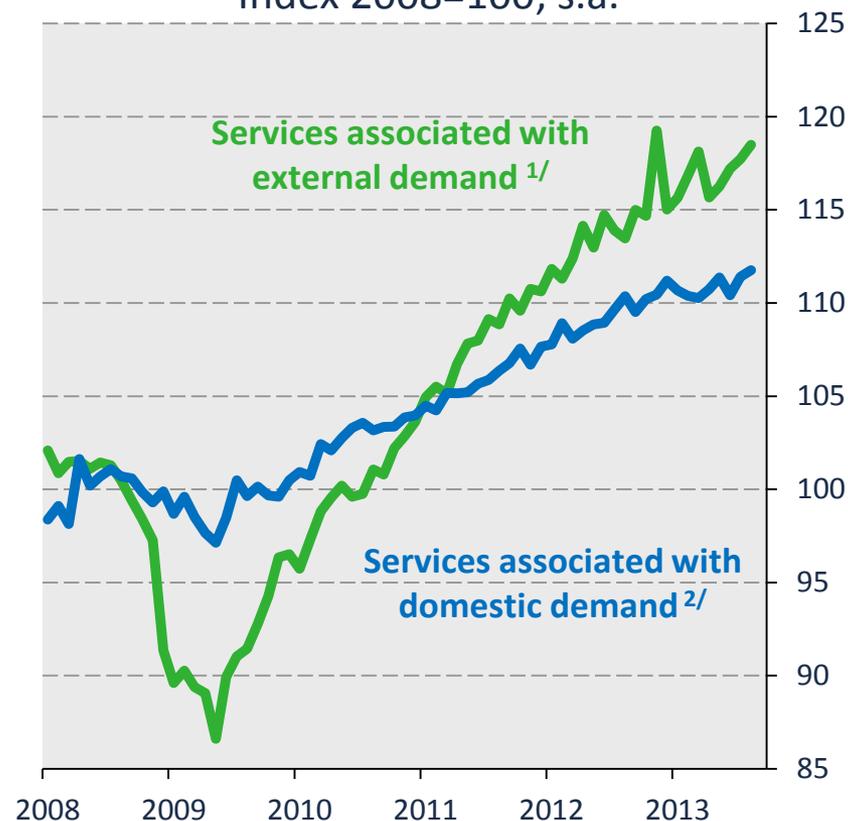
Industrial Activity
Index 2008=100; s.a.



s.a./ Seasonally adjusted data.

Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

Services Sector IGAE
Index 2008=100; s.a.



s.a./ Seasonally adjusted data.

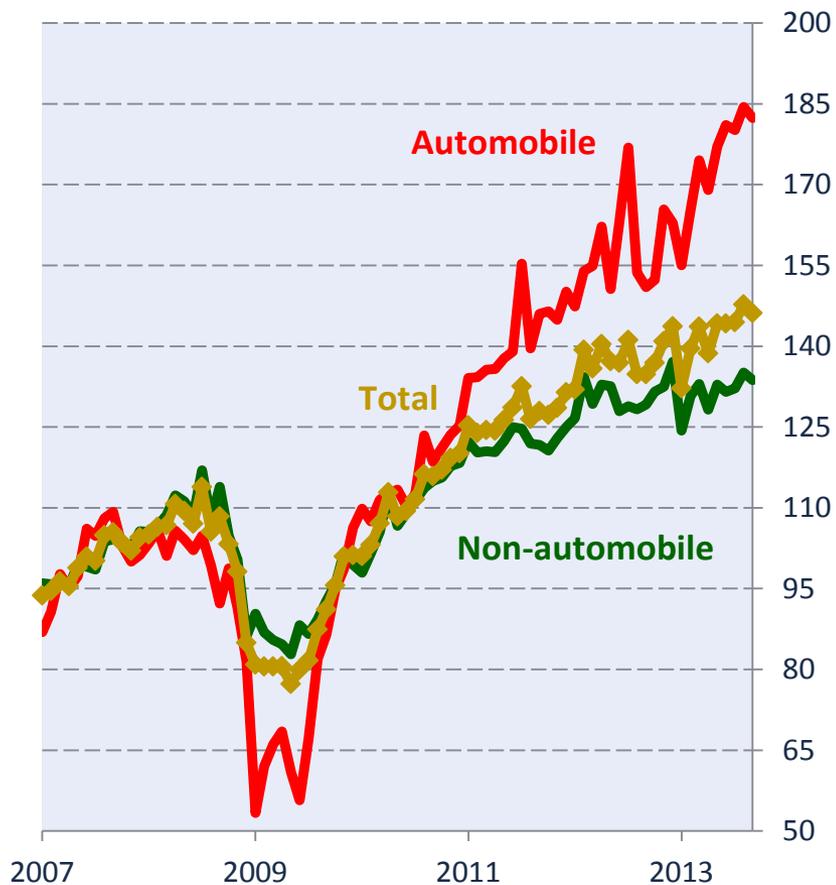
1/ Includes commerce, transportation, post and storage services, and media information.

2/ Corresponds to professional services, scientific and technical; corporate management, health services; government activities; leisure and recreational services; financial and insurance services; real estate services; support services to business, educational services, and temporary accommodation and food preparation services, and other services. Source: Elaborated and seasonally adjusted by Banco de México with data from Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

Manufacturing exports exhibited an upward trend, after a period of stagnation observed in the previous quarters.

Manufacturing Exports

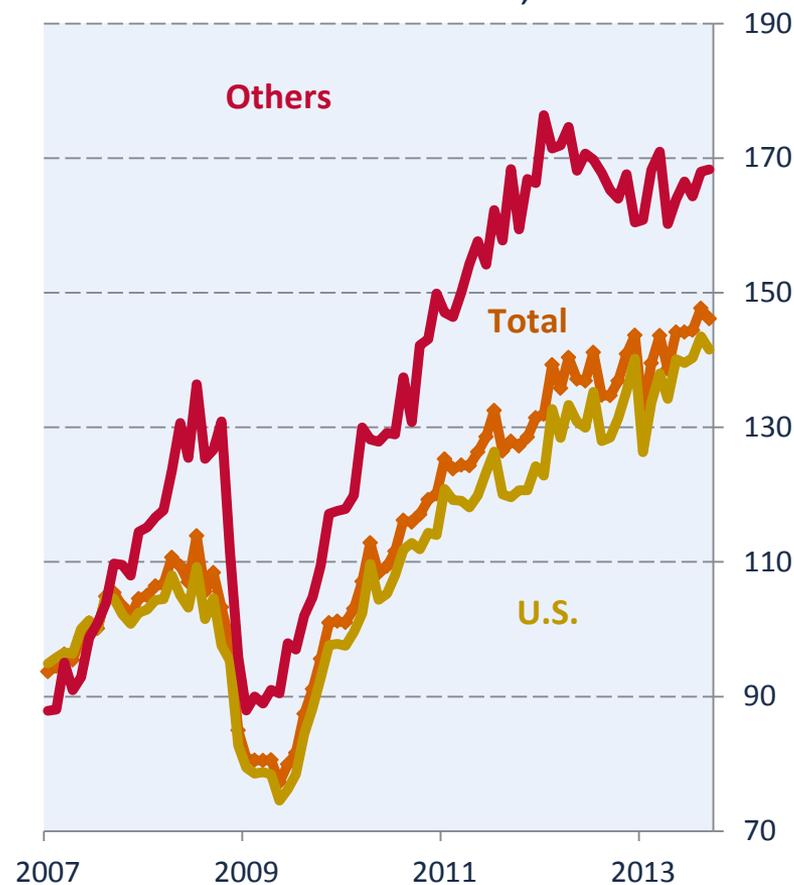
Index 2007=100; s.a.



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

Manufacturing Exports by Region of Destination

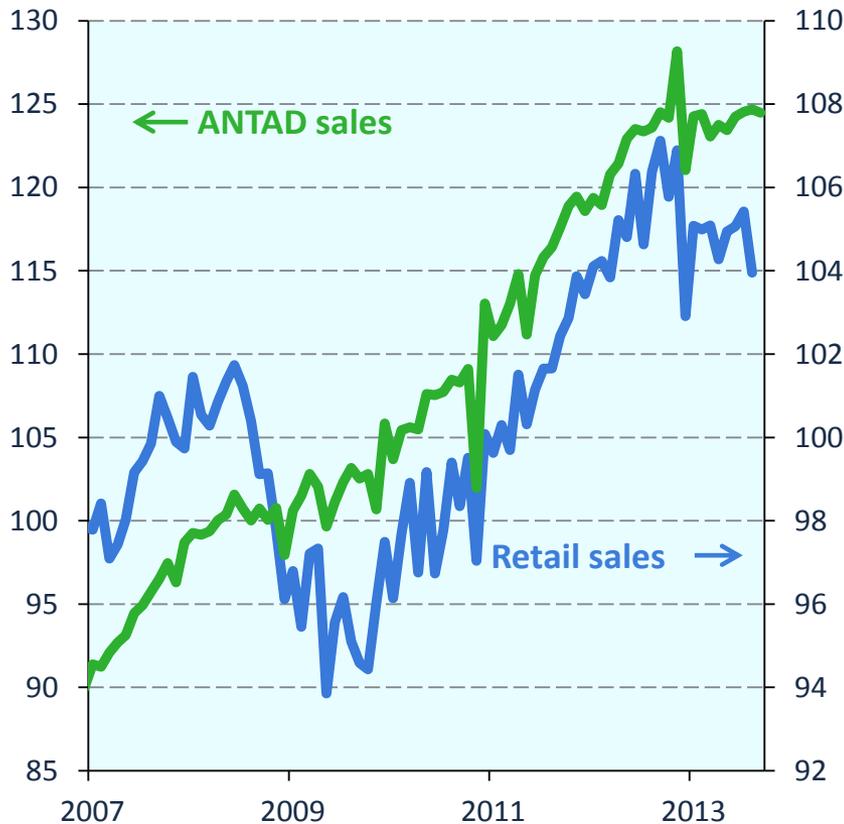
Index 2007=100; s.a.



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

Available data seem to suggest that the performance of private consumption has improved with respect to the previous quarter, despite the prevailing signs of weakness.

**Commercial Establishments' Retail and
ANTAD Sales ^{1/}**
Index 2008=100; s.a.



^{1/} ANTAD data up to September 2013. INEGI data up to August 2013. ANTAD sales refer to total store sales.
s.a./ Seasonally adjusted data. Source: Elaborated by Banco de México with data from INEGI and ANTAD.

**Consumer Confidence
Index Jan-2003=100; s.a.**

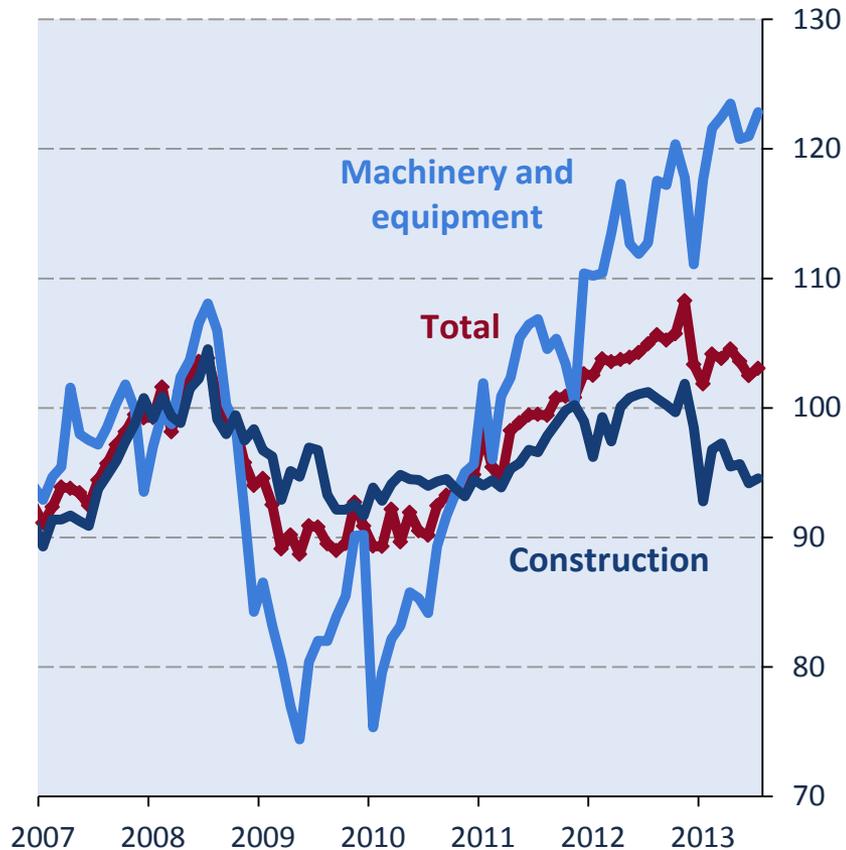


s.a./ Seasonally adjusted data.
Source: INEGI and Banco de México.

Gross fixed investment maintained a downside trend.

Investment and its Components

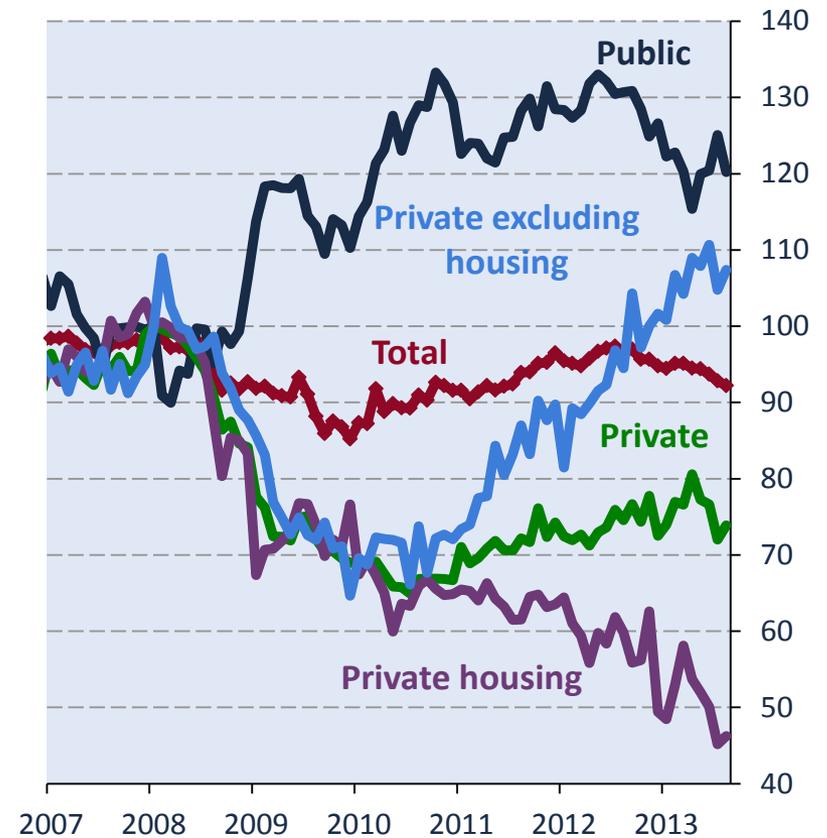
Index 2008=100; s.a.



s.a./ Seasonally adjusted data.
Source: INEGI.

Real Value of Production in Construction

Index Jan-2008=100; s.a.



s.a./ Seasonally adjusted data.
Source: INEGI and seasonally adjusted by Banco de México in the case of public and private construction (private housing and private excluding housing).

Outline

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2 Economic Activity in Mexico

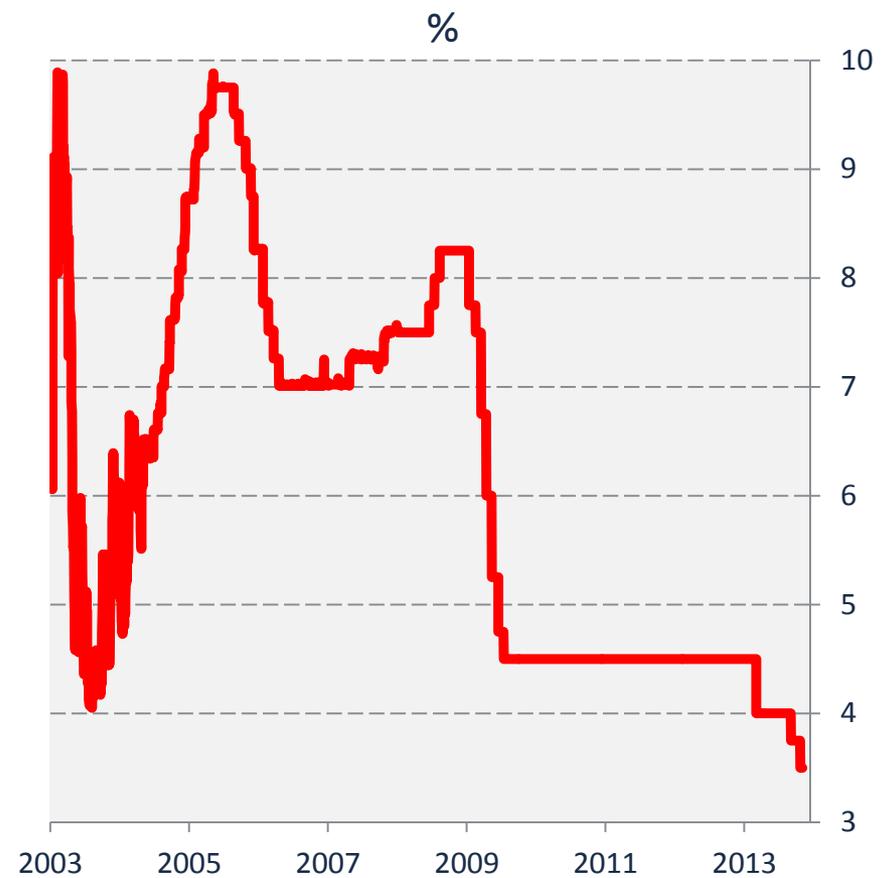
3 Monetary Policy and Inflation Determinants

4 Forecasts and Balance of Risks

The monetary policy in Mexico has been characterized by greater degrees of freedom to implement a countercyclical policy, without jeopardizing the process of inflation convergence to its target.

- Thus, in light of the weakened economic activity and an environment of low inflation, Banco de México carried out downward adjustments of 25 bp in the target for the reference rate in September and October, reducing it from 4.00 to 3.50 percent.
- These adjustments:
 - *Derived from both domestic and external factors.*
 - *Were implemented despite the uncertainty prevailing in international financial markets.*

Overnight Interbank Interest Rate ^{1/}

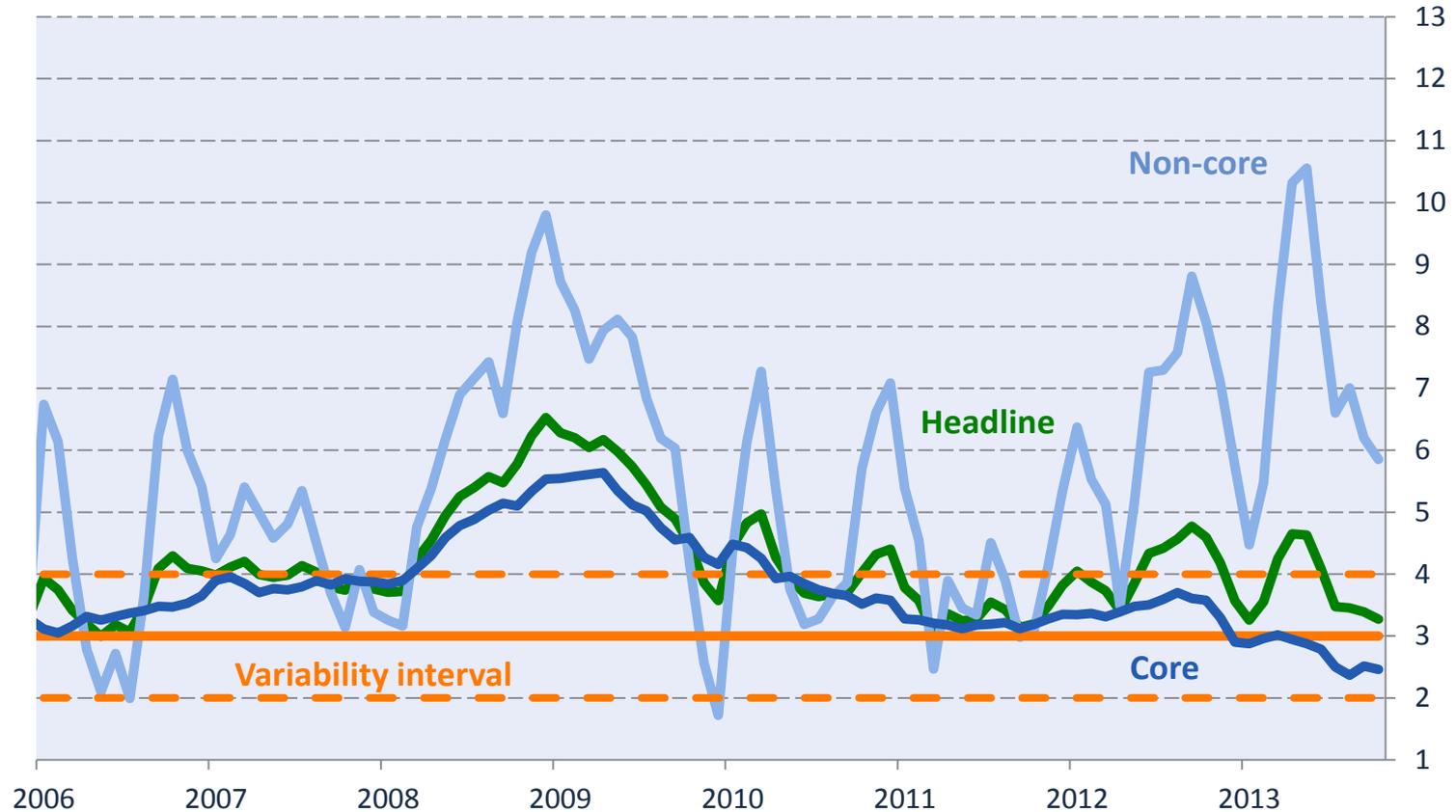


1/ Since January 21, 2008, the overnight interest rate corresponds to the target for the Overnight Interbank Interest Rate.

Source: Banco de México.

Headline inflation continued with a downward trend, which it had started in April 2013.

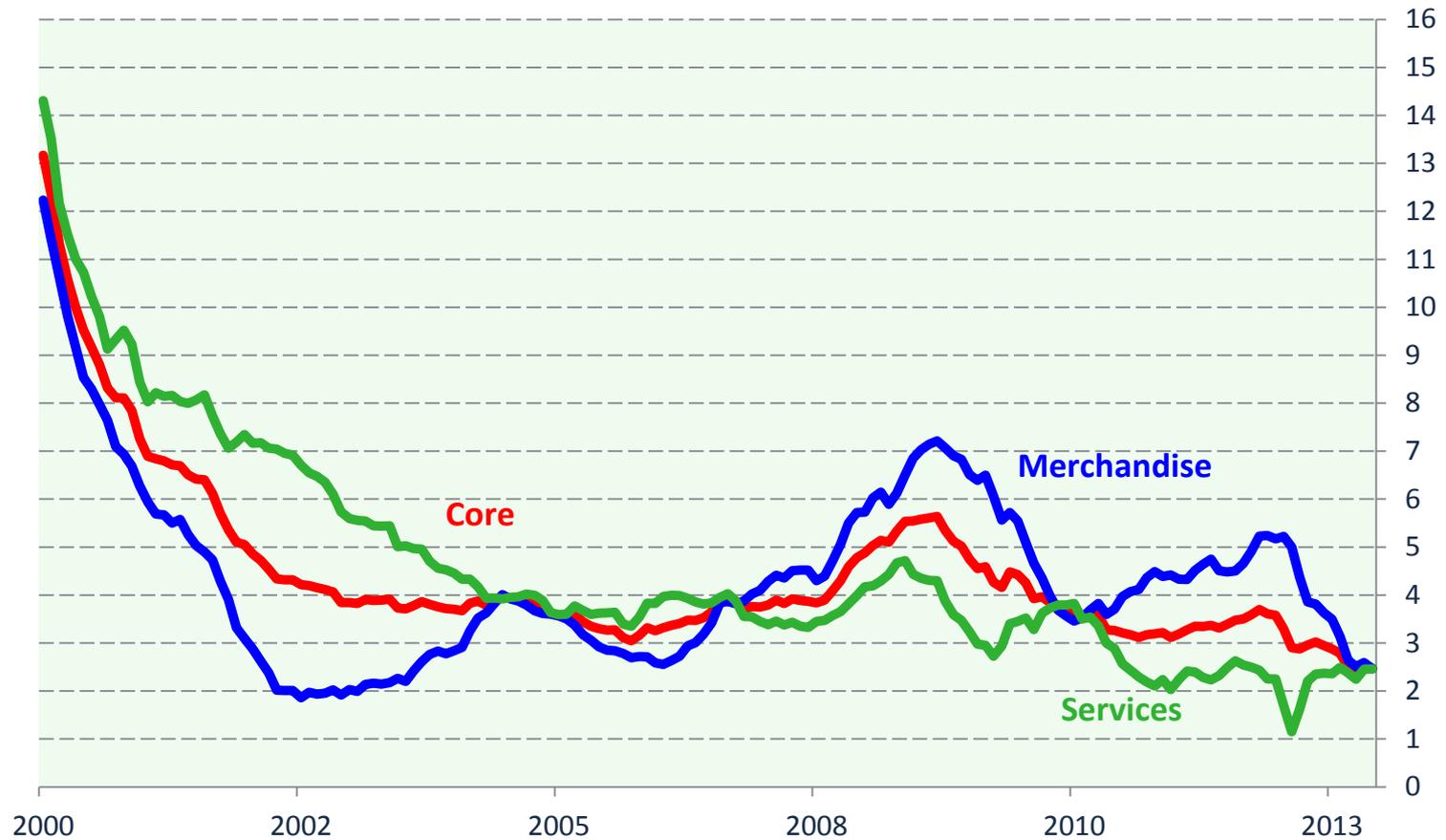
Headline, Core and Non-core Inflation ^{1/} %



1/ Data as of the first fortnight of October 2013.
Source: Banco de México and INEGI.

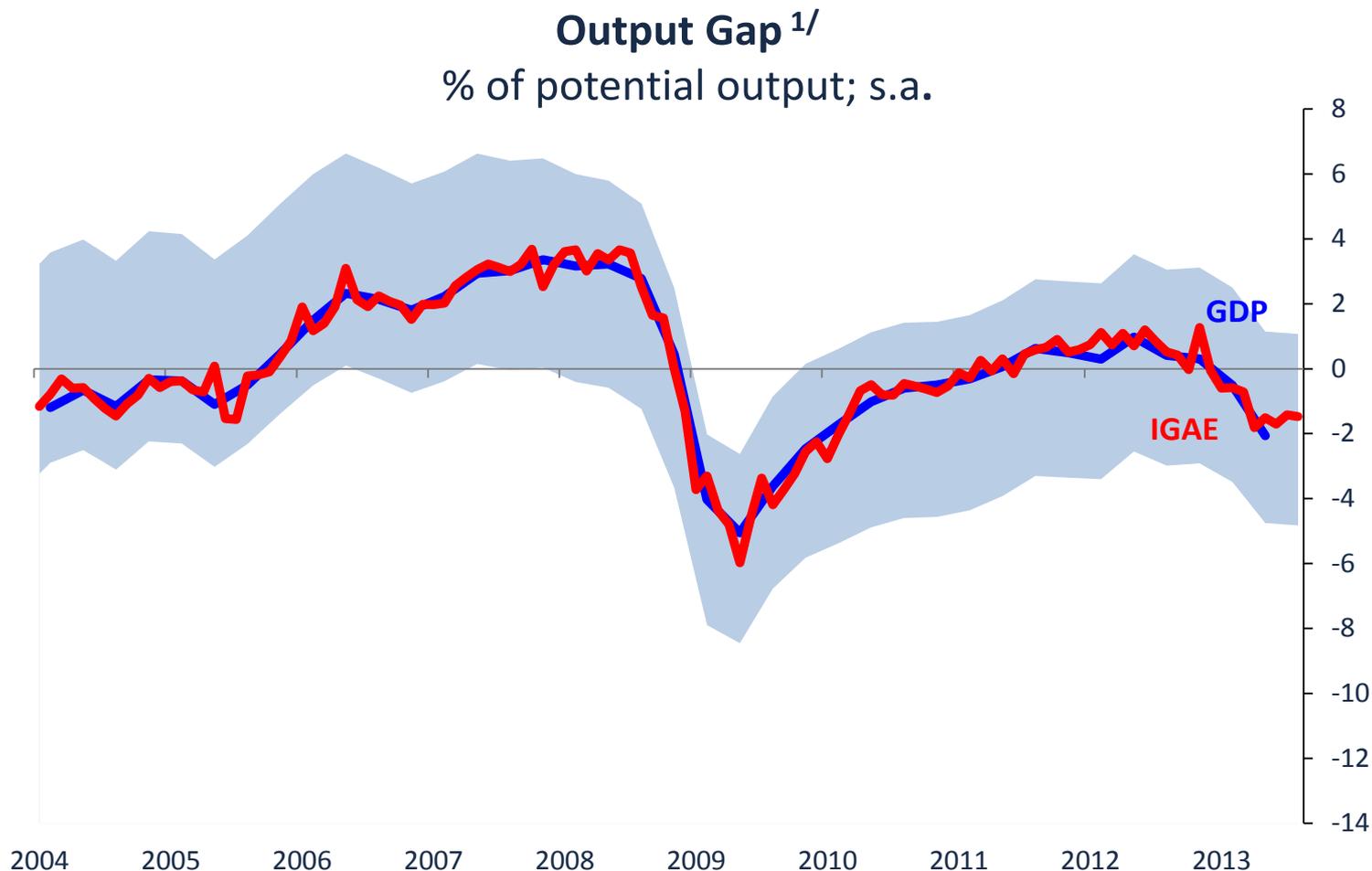
Annual core inflation kept exhibiting a downside trend, registering historical minimum levels in the period of analysis.

Core Inflation ^{1/}
%



1/ Data as of the first fortnight of October 2013.
Source: Banco de México and INEGI.

Given a profound deceleration since 2H2012, the output gap has become negative.



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. GDP figures up to 2Q 2013; IGAE up to August 2013. Source: Calculated by Banco de México with data from INEGI.

Fiscal adjustments proposed by the President and approved by the Congress in October will impact the Mexican economy by affecting:

1 Inflation

2 Economic activity

3 Use of financial resources

1

Regarding inflation, the total impact, considering direct and indirect effects, is estimated to be:

An additional increment in the CPI from December 2013 to December 2014: 40 basis points.

This impact is expected to be transitory and no second round effects on the price formation process in the economy are anticipated.

2

The net impact on the economic activity by the expansionary fiscal policy implicit in the economic package approved for 2014 will be:

GDP growth for 2014: 0.2 additional percentage points.

For 2014, a reduction in the flow of funds to the private sector is expected. This derives from an anticipated increment in the public sector borrowing requirements, in line with the economic package.

Sources and Uses of Financial Resources in the Economy

Annual flows in percent of GDP

	Flows			
	2012	2013 ^{e/}	2014 ^{e/}	2015 ^{e/}
Total Sources	10.0	7.1	8.0	7.6
Total Uses	10.0	7.1	8.0	7.6
International Reserves	1.8	1.1	1.4	1.2
Public Sector	3.7	3.2	4.4	3.9
Public Sector Borrowing Requeriments	3.2	2.9	4.1	3.6
States and municipalities	0.5	0.3	0.3	0.3
Private sector	3.2	2.7	2.3	2.6
Other	1.4	0.1	-0.1	-0.1

Note: Figures may not add up due to rounding. Figures expressed as a percentage of average GDP of the last four quarters.

e/ Estimated data.

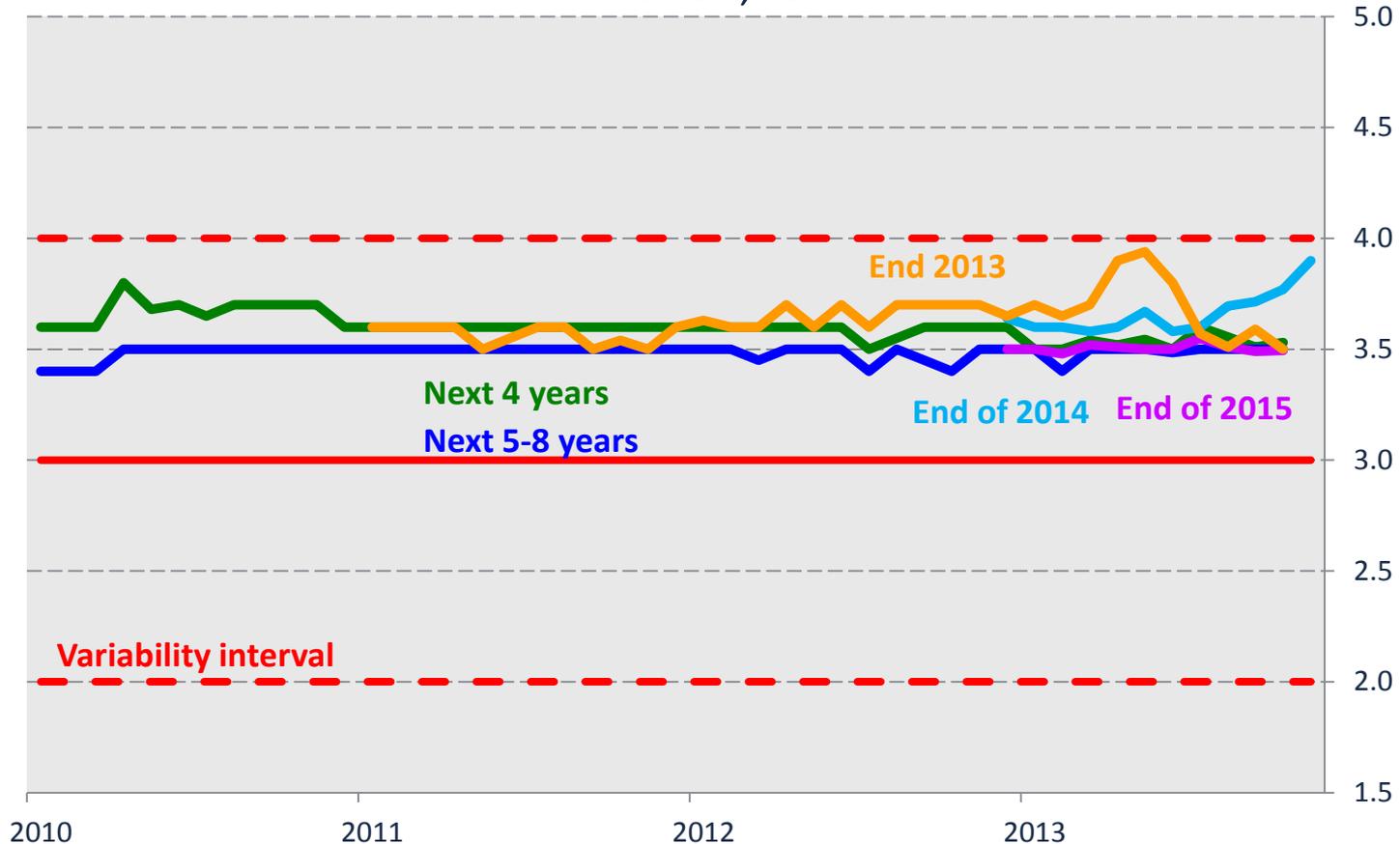
Source: Banco de México.

Thus, it is important to consolidate a downward trajectory of public deficits, which would guarantee the sustainability of the public debt and would allow more resources to be channeled to financing the private sector.

Despite the abovesaid, inflation expectations for 2014 remain below 4 percent, even taking into account the effect of the economic package. In turn, those corresponding to longer terms are stable, which emphasizes the anchoring of the inflationary process in Mexico.

Annual Headline Inflation Expectations for Different Terms

Median, %



Source: Banco de México's survey, except for the end of 2014 expectations, whose source is the *Encuesta de Expectativas de Analistas de Mercados Financieros Banamex*.

Derived from Banco de México's monetary policy decisions and given the deferred reduction of the pace of asset purchases by the Federal Reserve, longer-term interest rates dropped.

Yields of Government Securities ^{1/}

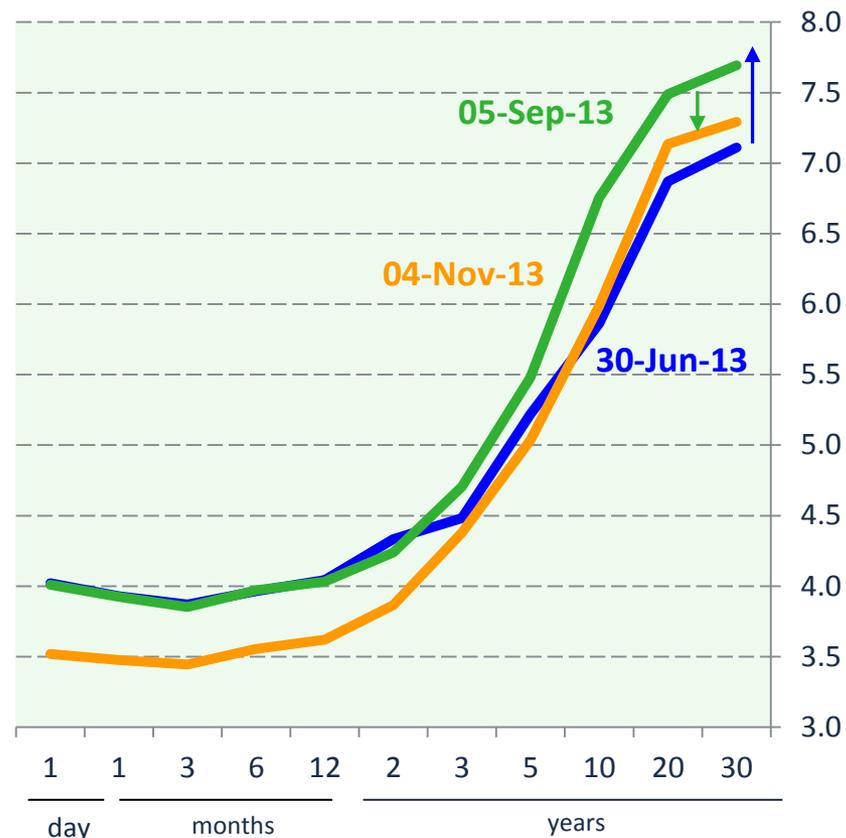
%



^{1/} Since January 21, 2008, the overnight interest rate corresponds to the target for the Overnight Interbank Interest Rate. Source: Banco de México and Proveedor Integral de Precios (PiP).

Government Bond Yield Curve

%



Source: Banco de México and Proveedor Integral de Precios (PiP).

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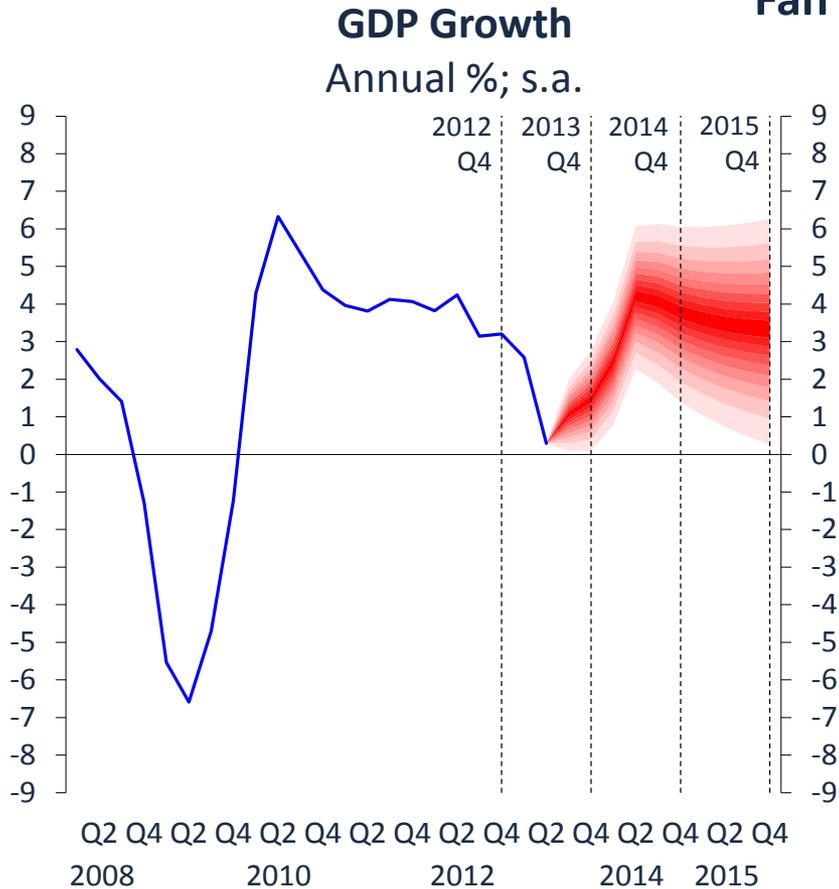
4 Forecasts and Balance of Risks

Economic activity outlook

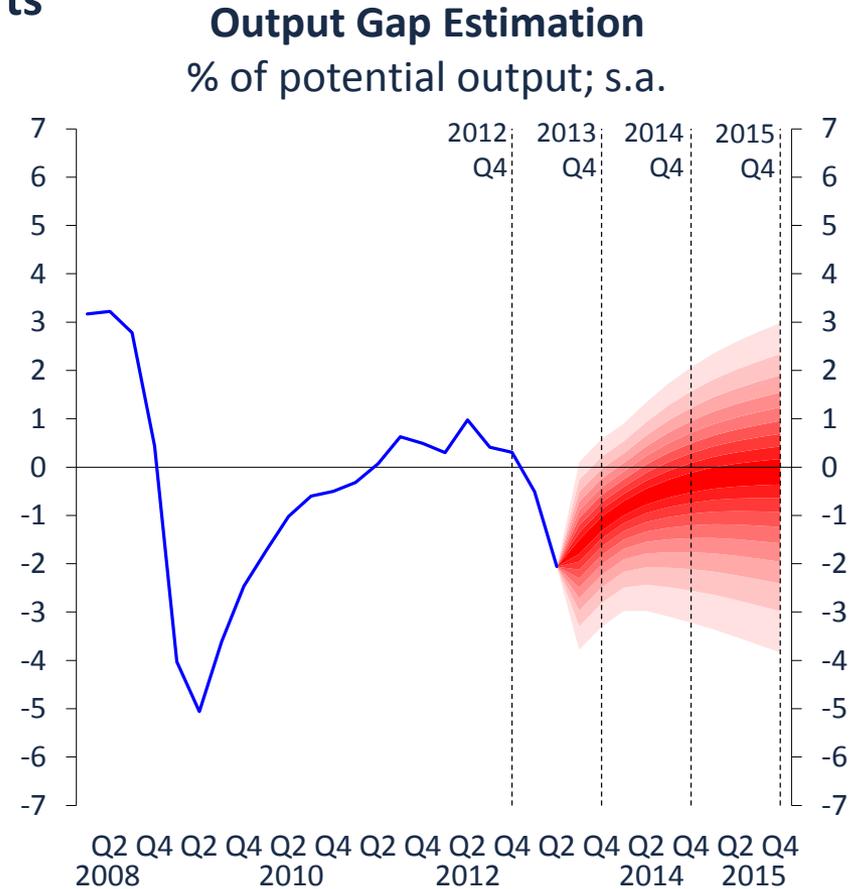
GDP Growth	
2013	Between 0.9 and 1.4%
2014	Between 3.0 and 4.0%
2015	Between 3.2 and 4.2%

Increase in the number of IMSS-insured workers:	
2013	Between 400 and 500 thousand
2014	Between 620 and 720 thousand
2015	Similar to 2014 levels

Fan Charts



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



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

Balance of Risks for the Economic Activity

Downward risks to the Mexican economic growth, although lower than in recent months, remained high.

I

Lower than expected growth of the U.S. economy.

II

Possible volatility episodes in international financial markets.

III

A less dynamic than anticipated evolution of public expenditure in Mexico.

IV

The possibility that the housing sector may remain an obstacle to the construction sector recovery.

V

The fact that the reforms under discussion in Congress will not be approved or will turn out of a lesser scope than estimated by the economic agents.

Inflation Forecasts

Given the abovementioned lower expectations of the economic growth, the corresponding ample slack in the economy, as well as the transitory impact of fiscal adjustments, the following is anticipated:

Headline
inflation

2013

Will remain at levels close to **3.5 percent in 4Q 2013.**

2014

Considering the possible impact of the fiscal changes (moderate and transitory), the most probable trajectory is estimated to fluctuate around **3.5 percent.**

2015

A downward trend to locate around the target of **3 percent.**

Core
inflation

2013

Will persist at levels below **3 percent.**

2014

Even considering the effects derived from the fiscal changes, it is expected to remain below **3 percent.**

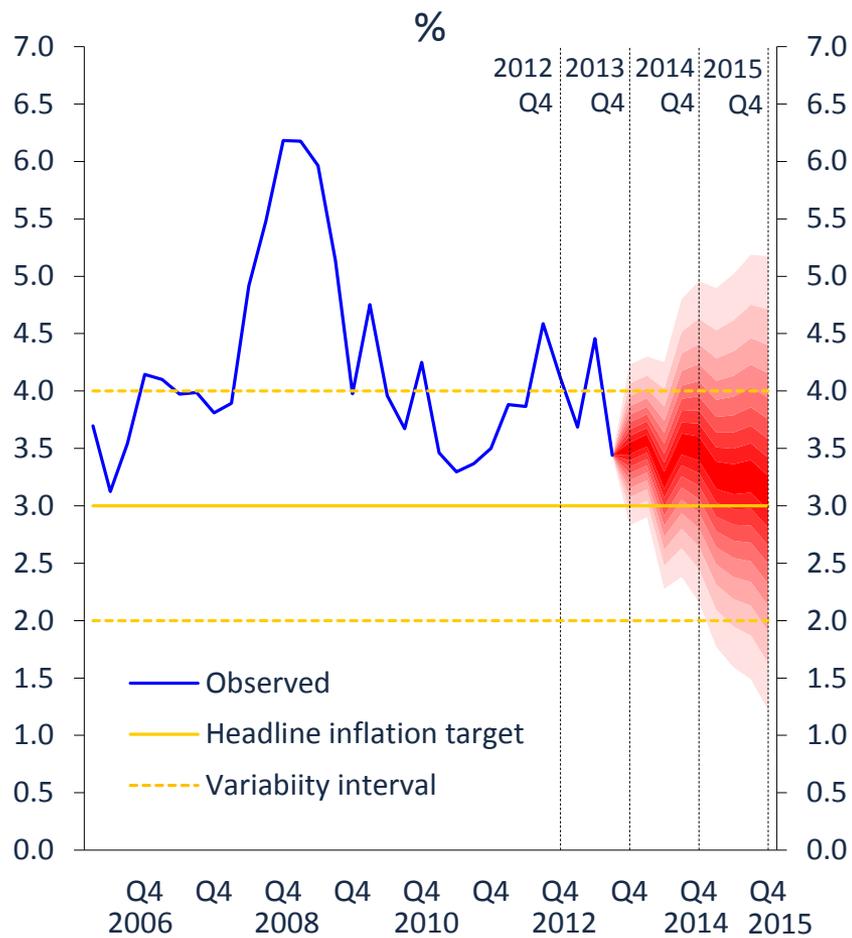
2015

Slightly lower levels as compared to the previous year.

Given the expected fiscal policy, the adjustments in the monetary policy in September and October are congruent with the inflation convergence to the 3 percent target.

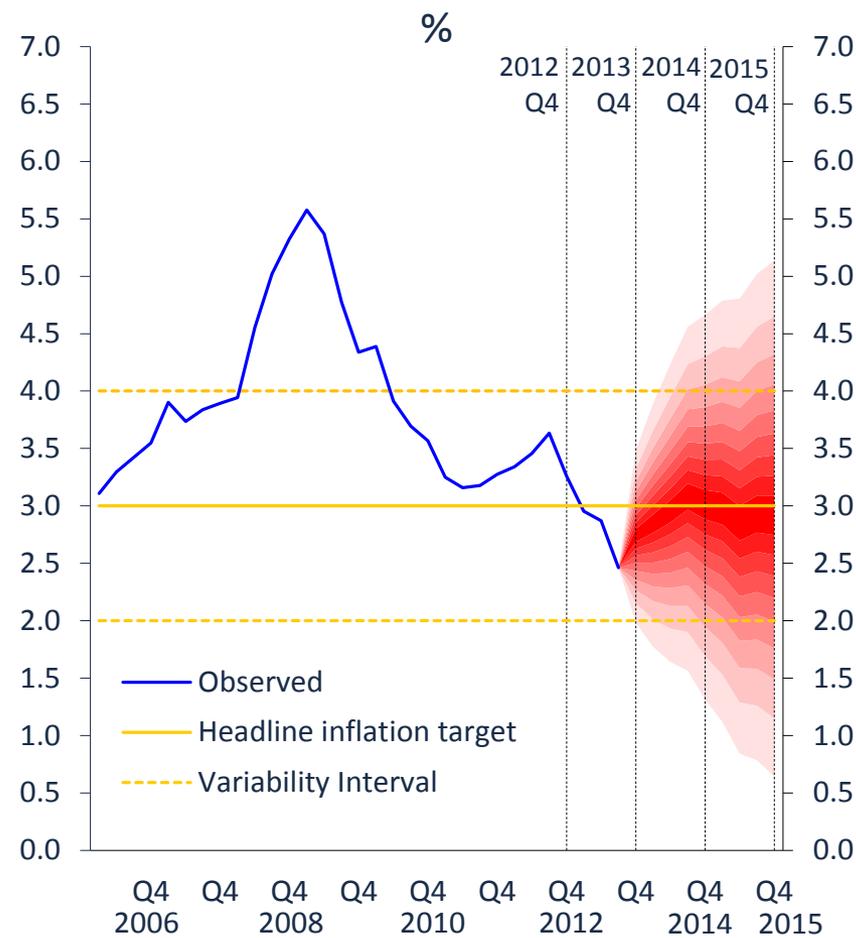
Fan Charts

Annual Headline Inflation ^{1/}



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

Annual Core Inflation ^{2/}

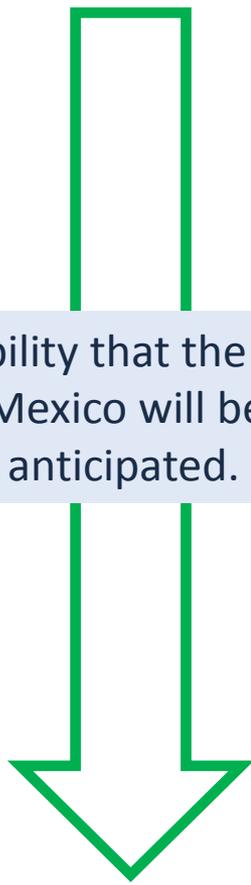


2/ Quarterly average of annual core inflation.
Source: INEGI and Banco de México.

Balance of Risks for Inflation

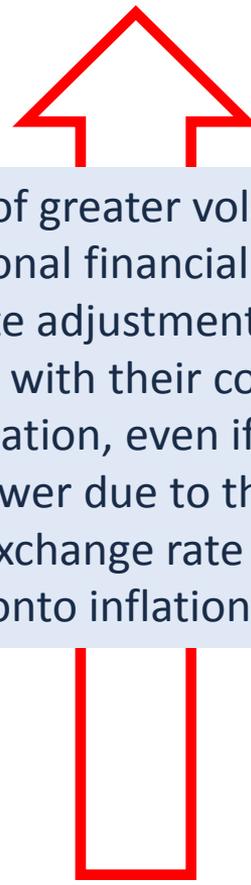
The balance of risks for inflation in the horizon in which the monetary policy operates is considered to have improved.

Downward



The possibility that the economic recovery in Mexico will be lower than anticipated.

Upward



In light of greater volatility in international financial markets, exchange rate adjustments can not be ruled out, with their consequent effect on inflation, even if this impact would be lower due to the low pass-through of exchange rate adjustments onto inflation.

Monetary Policy Stance

- The Board of Governors considers that no additional reductions in the target for the reference interest rate would be advisable in the foreseeable future. Given that:
 - ✓ *Even though the economy presents a considerable slack, it is anticipated to reduce in the horizon at which the monetary policy operates.*
 - ✓ *Considering the adjustments realized in September and October, the ex-ante short-term real interest rate locates at levels close to zero.*

- In any event, the Board of Governors:
 - ✓ *Will remain alert so that the relative price changes derived from the fiscal adjustments will not generate second round effects on inflation.*
 - ✓ *It will also monitor the implications of the evolution of the economic activity and the monetary stance of Mexico relative to the U.S., among other factors, onto the inflation outlook, so as to reach the abovesaid inflation target.*

It is necessary to foster the domestic sources of growth and to strengthen the framework for the macroeconomic policy conduction.

- There are two key elements in supporting the favorable evolution of the Mexican economy in the following years:
 - ✓ The structural reforms which would boost the economy's productivity and competitiveness.
 - ✓ Strengthening the framework for the conduction of the macroeconomic policy.
 - In this respect, the commitment of the Mexican Government to bringing the fiscal deficit to zero in 2017 at the latest and the strengthening of the Federal Law of Budget and Fiscal Responsibility are fundamental.



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