



Quarterly Report

July - September 2016

November 23, 2016



BANCO DE MÉXICO

Outline

1 Monetary Policy

2 External Conditions

3 Evolution of the Mexican Economy

4 Inflation and its Determinants

5 Forecasts and Final Remarks

Conduction of Monetary Policy

- The Mexican economy is one of the most integrated with the global economy, and, in particular, with that of the U.S. Even if this has yielded considerable benefits, the domestic economy and financial markets have become more vulnerable to external events.
- During the period covered by this Report, the Mexican economy **faced a complex juncture**. The outlook for the world economy became more challenging as a consequence of the electoral process in the U.S. and its outcome, among other factors.
 - National financial markets were particularly hit by this events, registering **a fall in asset prices and high volatility**.

So far, the preemptive measures that Banco de México has adopted along this year have prevented headline inflation and its expectations from being affected by the referred factors.

- 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.

- The Mexican authorities will continue to act cautiously and keeping a medium and longer term perspective.
- In the short run, they will continue to carefully monitor the evolution of national financial markets, so as to take the **necessary measures** to maintain its sound functioning, in a coordinated manner.

- Mexico is in a **strong position** to face this new environment, as a result of:

- ✓ Actual and expected achievements in terms of **public finance consolidation**.

- ✓ Implementation of **preemptive monetary policy measures** during the year.

- ✓ A **well-capitalized, solvent, and adequately liquid financial system**.

- ✓ An unprecedented **structural reform** process.

- Nonetheless, it is inevitable to continue handling actual and emerging risks by further strengthening the macroeconomic fundamentals of the country.

Banco de México continued acting with full flexibility, and at the moment and extent required by the prevailing conditions, in order to offset inflationary pressures and to maintain inflation expectations anchored.

August 11, 2016

Rate unchanged at 4.25 percent.

September 29, 2016

50 bp increment to 4.75 percent.

- As volatility in financial markets in Mexico spiked, negatively affecting the dynamics of the national currency and, thus, endangering the anchoring of inflation expectations.

November 17, 2016

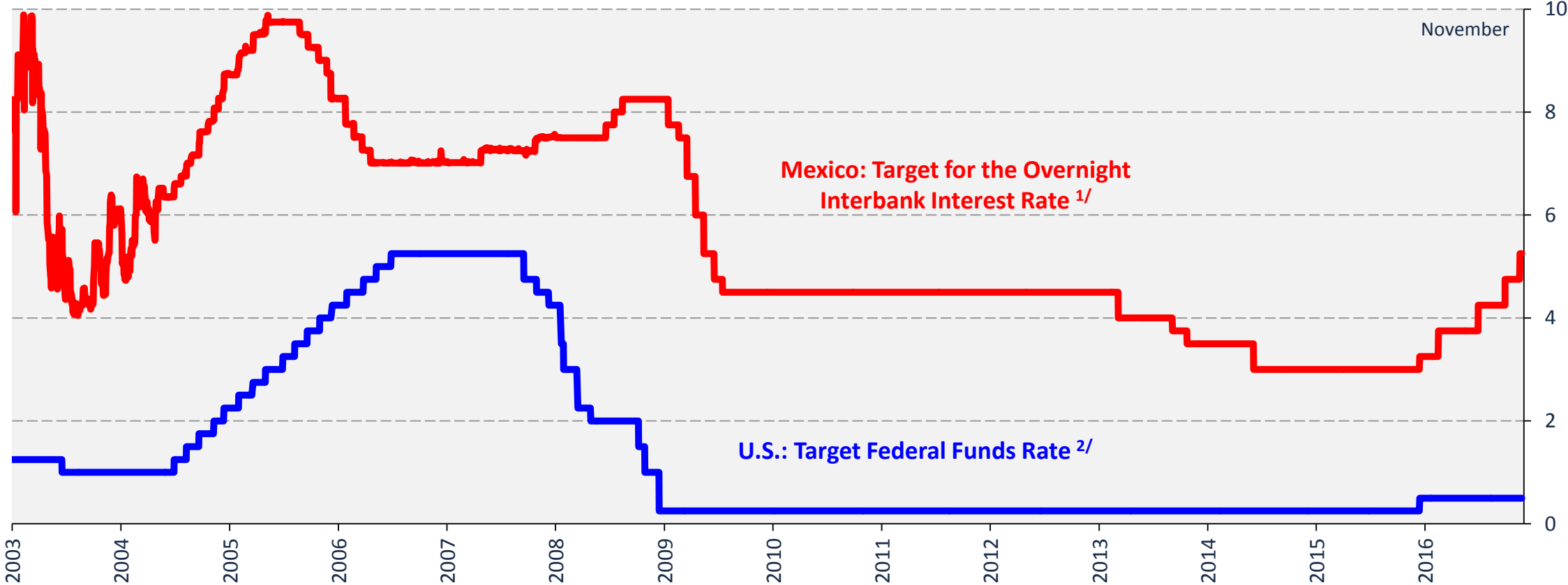
50 bp increment to 5.25 percent.

- As the national economy faces an environment characterized by increased uncertainty and a possibly permanent real shock, as well as to the deterioration of the balance of risks for inflation.

So far, in 2016 Banco de México has preemptively increased the Overnight Interbank Interest Rate by 200 basis points, in view of an increasingly adverse external environment.

Monetary Policies Rates

%



1/ Before January 20, 2008 it refers to the observed Overnight Interbank Interest Rate.

2/ The upper limit of the target range is shown.

Source: Federal Reserve and Banco de México.

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External Conditions

- The outlook for the world economy became **more complex** as a consequence of **the electoral process in the U.S.** and its outcome, among other factors.

➤ This led to increased financial market **volatility** in all regions.

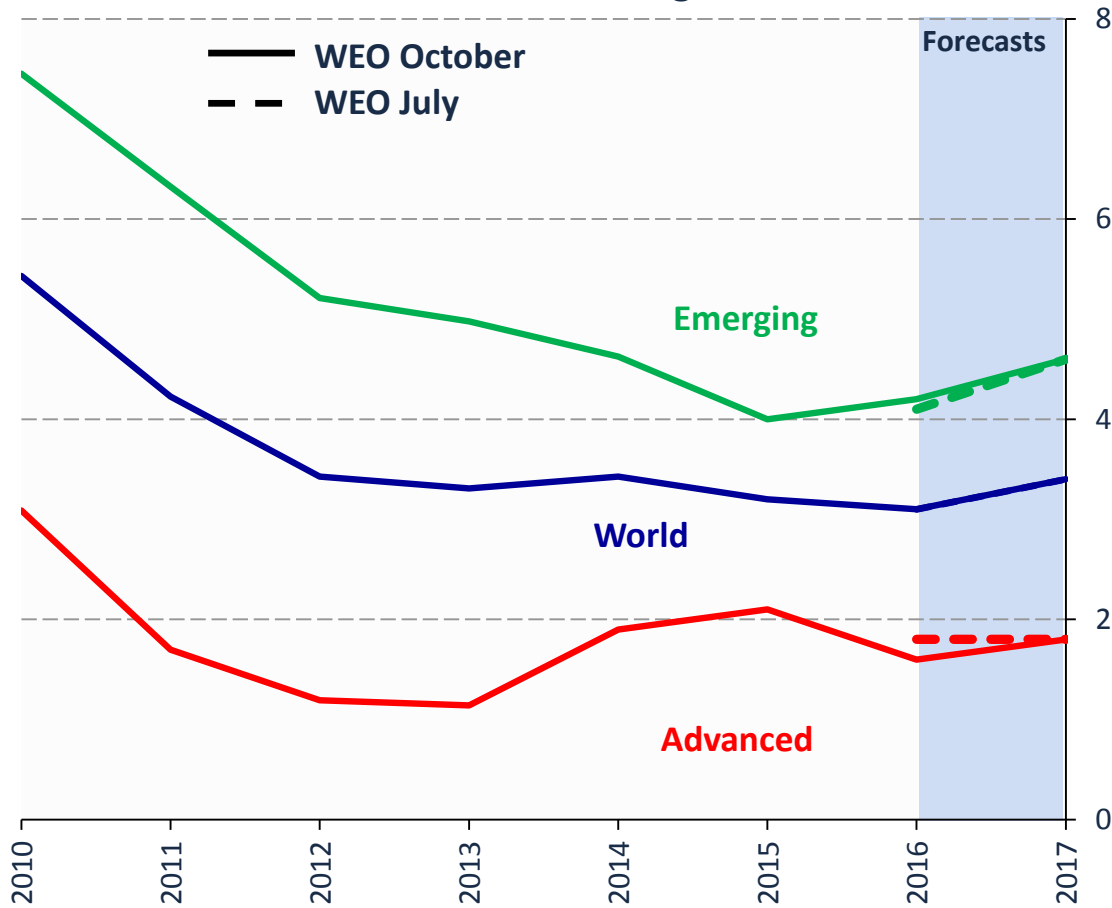
- ✓ Capital inflows to emerging economies started to revert.
- ✓ Interest rates exhibited an upward trend, **both in advanced and emerging economies.**

- Despite some signs of a moderate recovery of the world economy in Q3 2016, the possible implementation of measures that could hamper foreign trade and foreign investment led to **a deterioration in the balance of risks** for the global growth.

In Q3 2016, world economic activity recovered moderately, supported by greater growth in the U.S. and other advanced economies, as well as by a continuous expansion of some of the main emerging economies.

World Economy

GDP Growth Forecasts
Annual % change



Source: IMF, WEO July and October, 2016.

Trade of Goods ^{1/}
Annual % change, s. a.

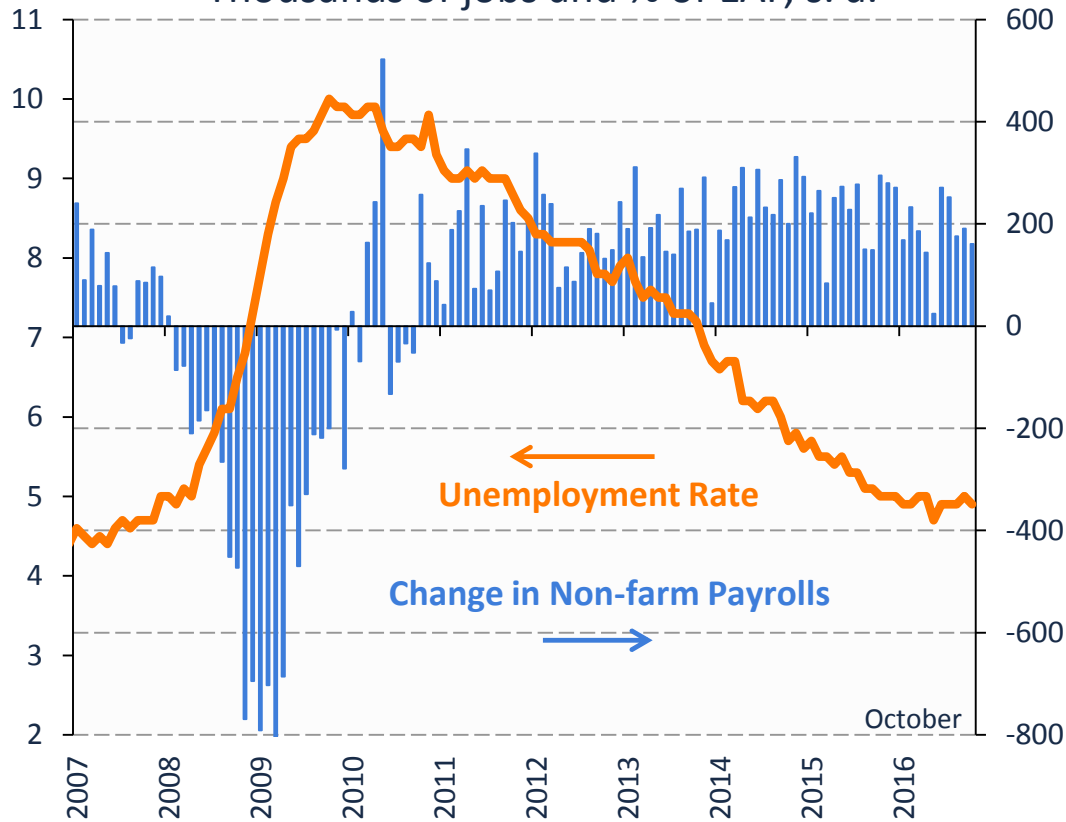


1/ Refers to the sum of imports and exports.
s. a. / Seasonally adjusted data.
Source: CPB Netherlands.

In the U.S., economic activity rebounded in Q3 2016. Although inflation remains low, inflation expectations spiked, largely in response to the expectation of an expansionary fiscal policy that would be, in principle, carried out by the incoming administration of the U.S.

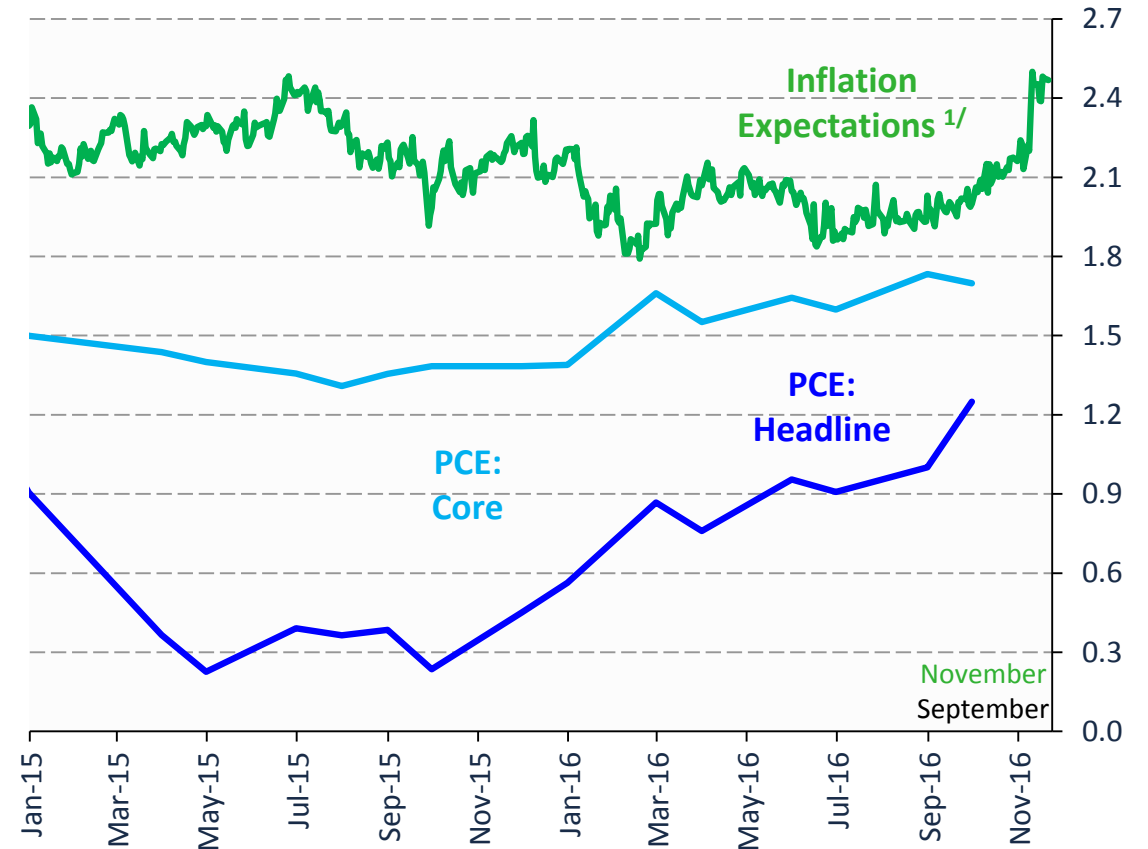
United States

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).

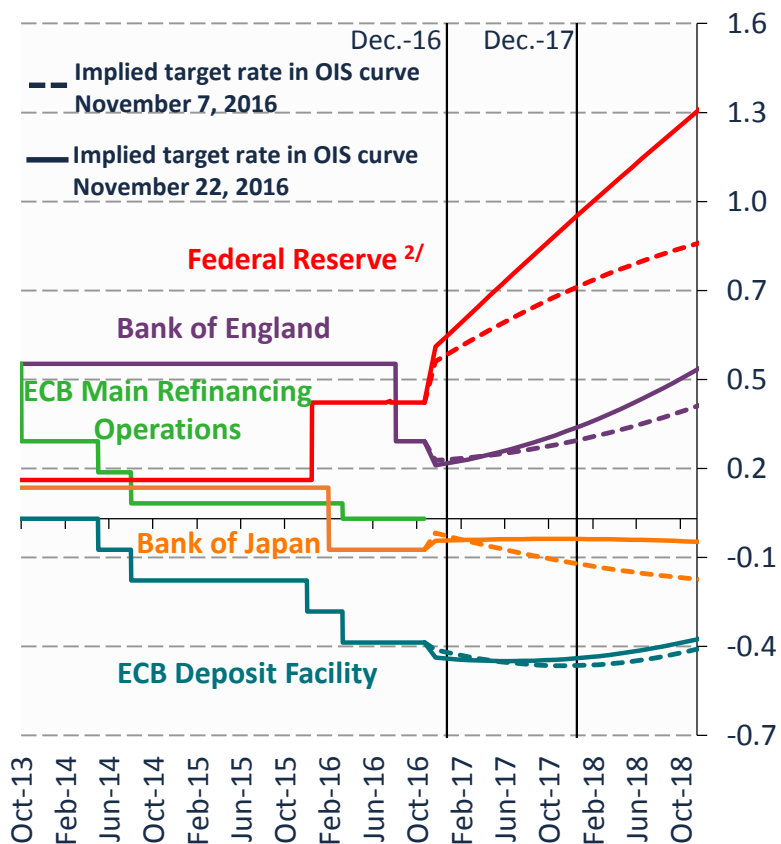
Personal Consumption Expenditures Price Index and Inflation Expectations
Annual % change



1/ Expected inflation over the five-year period that begins five years from today. Obtained from swap contracts in which one counterparty agrees to pay a fixed rate in exchange for receiving a referenced payment at an inflation rate over a specified period.
Source: JP Morgan.

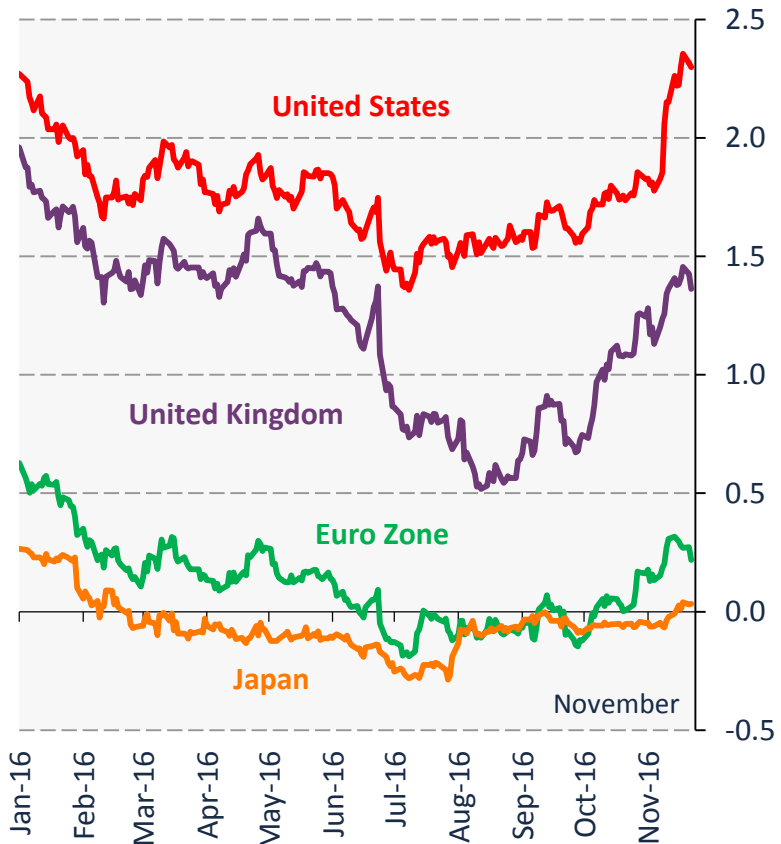
In light of a higher expected inflation in the U.S., the markets' perspective points to relatively faster and greater increments in the federal funds rate. Meanwhile, interest rates in the main advanced economies went up as of October.

Advanced Economies: Expected Monetary Policy Rates ^{1/}
%



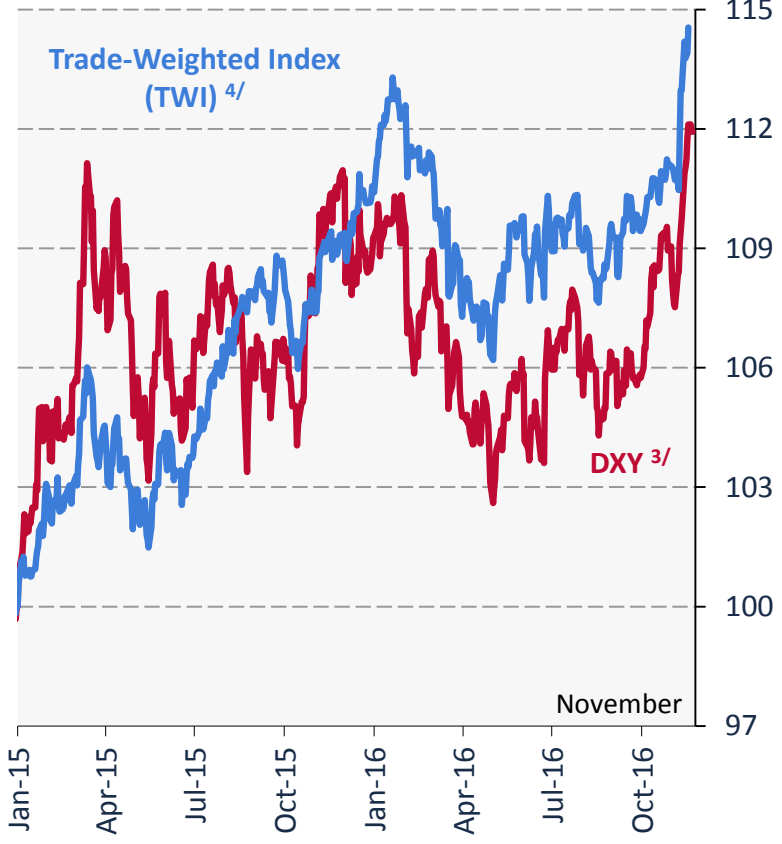
1/ OIS: Fixed-For-Floating swap where the fixed interest rate is the reference rate.
2/ Data for the observed federal funds rate corresponds to the average between the lower and upper bounds of the range (0.25% - 0.5%).
Source: Banco de México with data from Bloomberg.

Advanced Economies: 10-Year Government Bond Interest Rates
%



Source: Bloomberg.

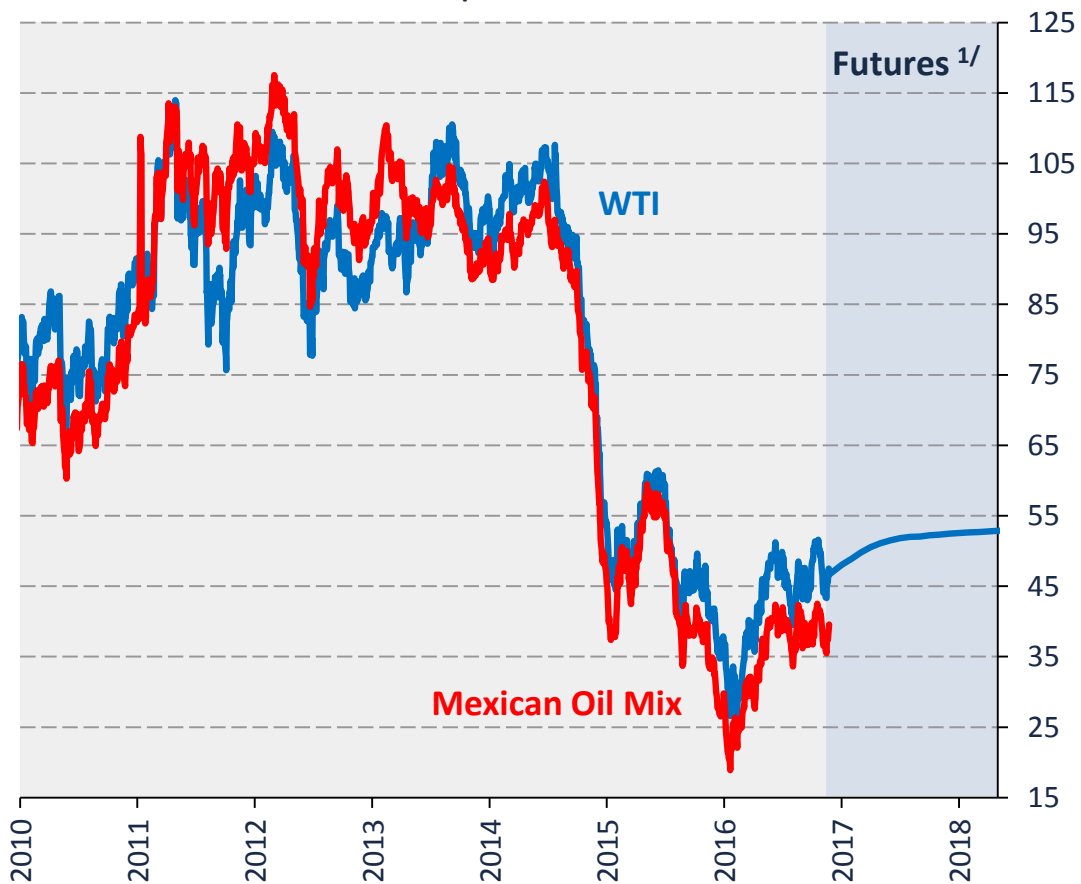
United States: DXY and Trade-Weighted US Dollar Index
Index 01-Jan-2015 = 100



3/ 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%. Base=100. 4/ Trade-Weighted Index of the Federal Reserve; main trade partners: China (21.3%), Euro Zone (16.38%), Canada (12.7%), Mexico (11.9%), Japan (6.9%), South Korea (3.9%), United Kingdom (3.35%).
Source: Bloomberg.

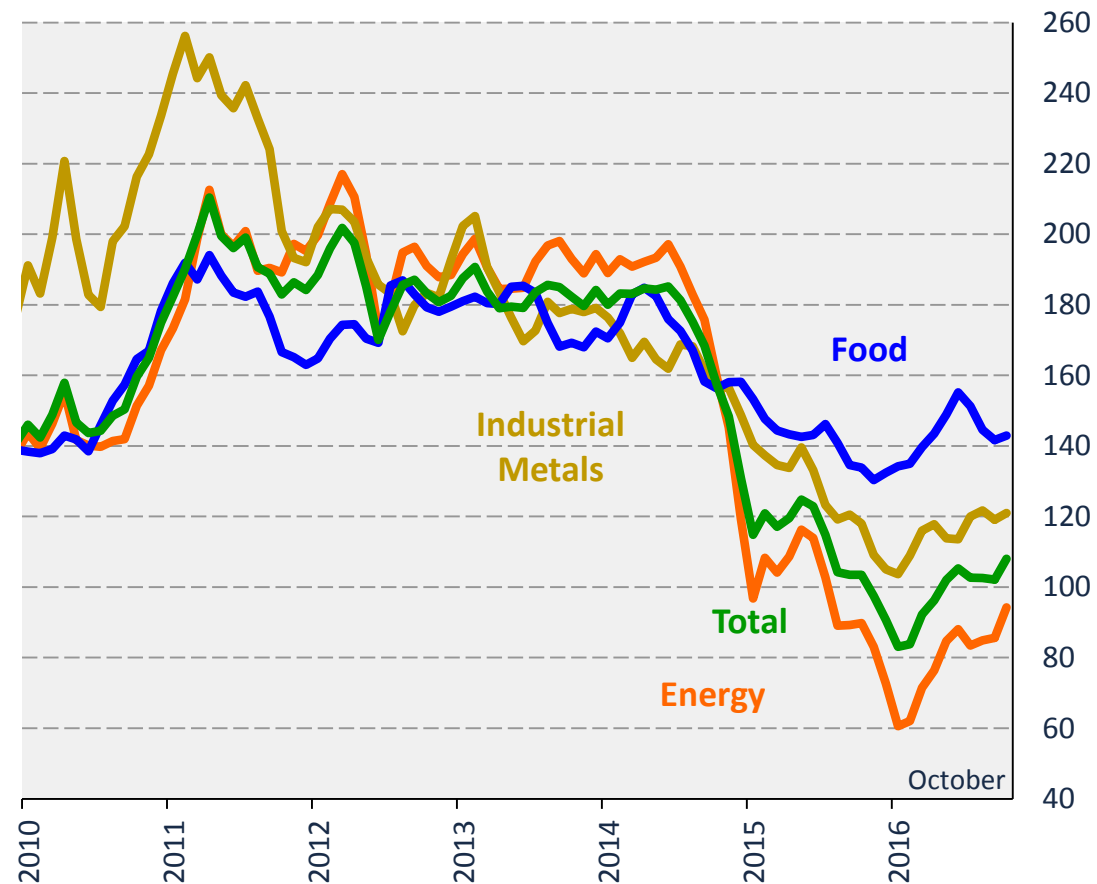
International commodity prices presented a mixed performance during the period analyzed in this Report.

Crude Oil Prices USD per barrel



1/ Data up to November 22, 2016.
Source: Bloomberg.

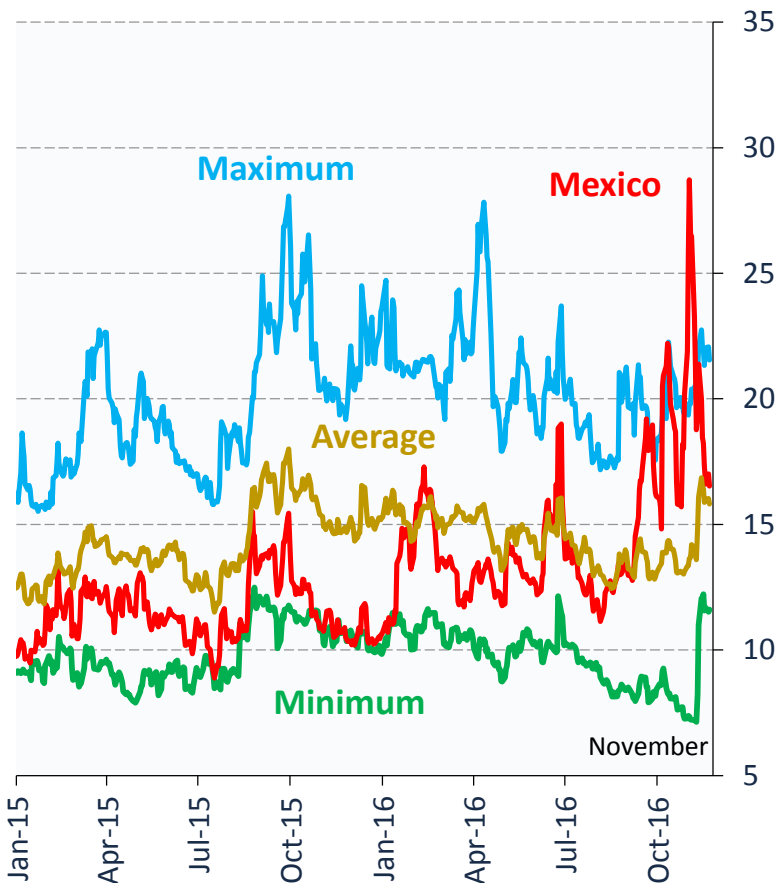
Commodity Prices Index 2005=100



Source: International Monetary Fund.

Volatility in international financial markets rebounded in all regions, mainly as a reflection of events related to the electoral process in the U.S. Thus, capital inflows to emerging economies started to revert as of November and their currencies depreciated.

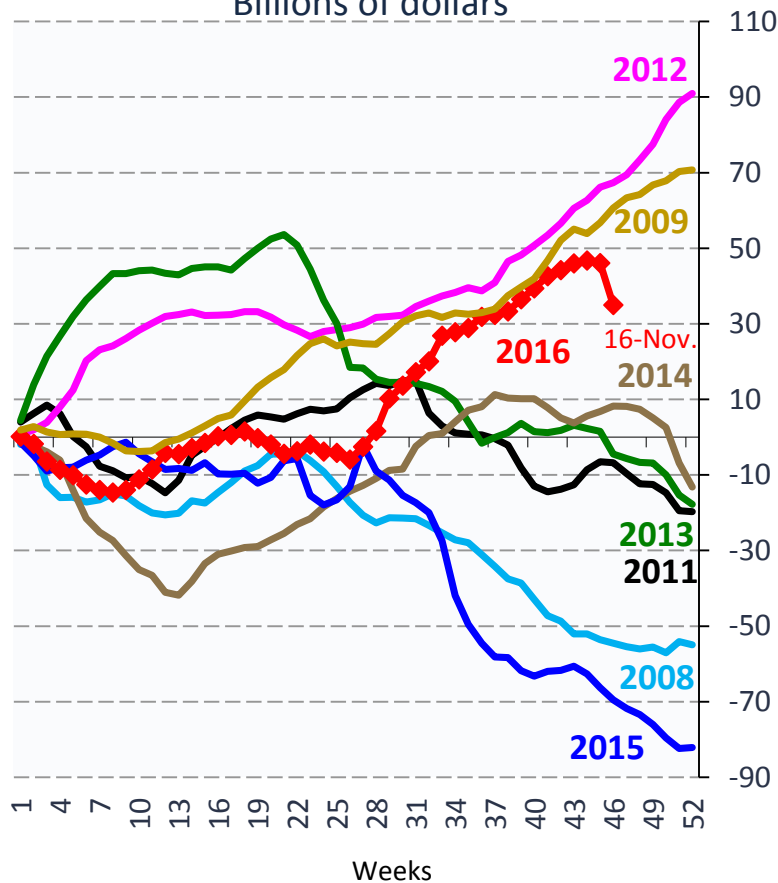
Currency Option Implied Volatility ^{1/}
%



1/ The minimum (maximum) value represents the lowest (highest) value in the volatility of a sample with currencies from Brazil, Chile, Colombia, Turkey, South Africa, South Korea and Indonesia.
Source: Bloomberg.

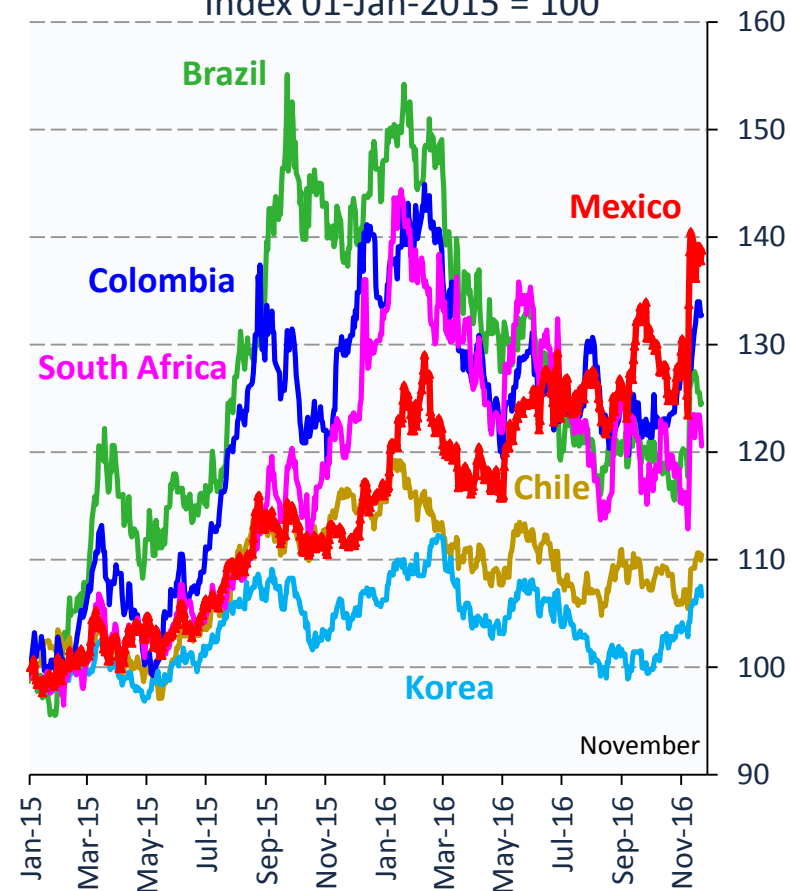
Emerging Markets

**Accumulated Capital Flows
(Debt and Equity) ^{2/}**
Billions of dollars



2/ 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-2015 = 100



Source: Bloomberg.

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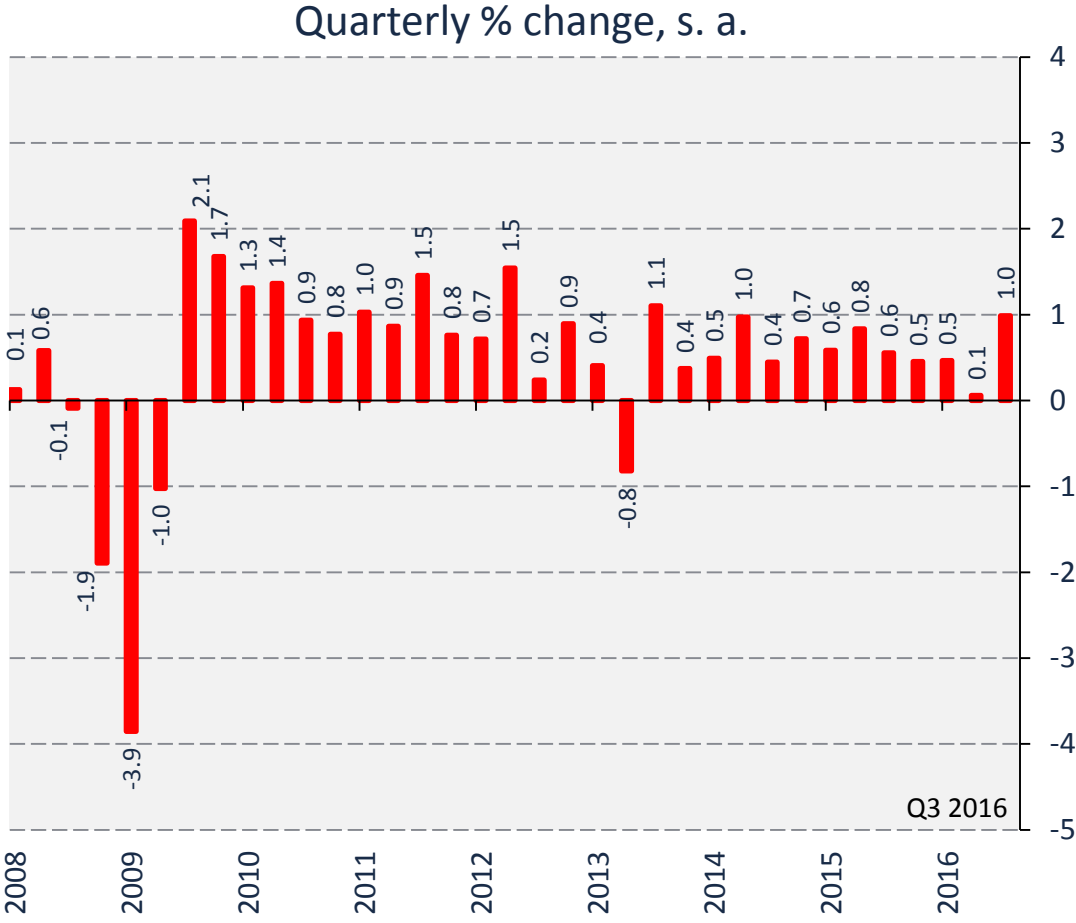
Inflation and its Determinants

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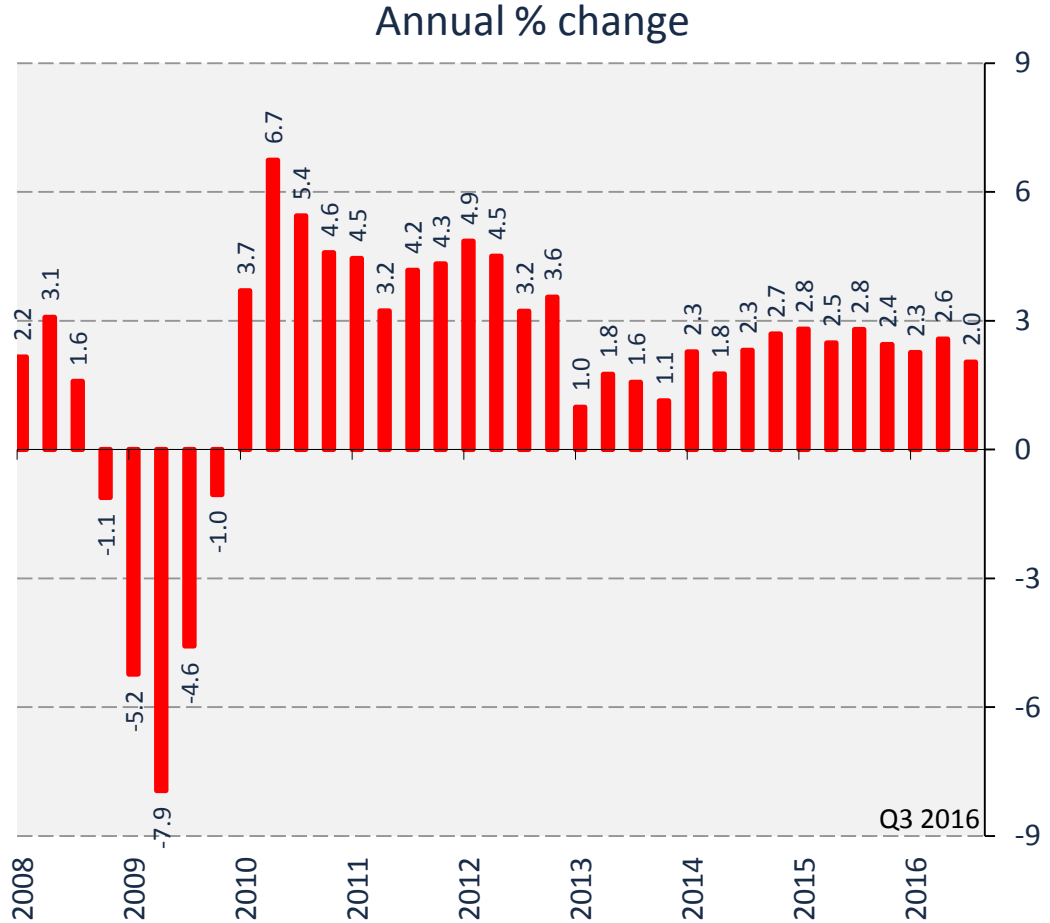
Forecasts and Final Remarks

In Q3 2016, the Mexican economy recovered moderately.

Gross Domestic Product

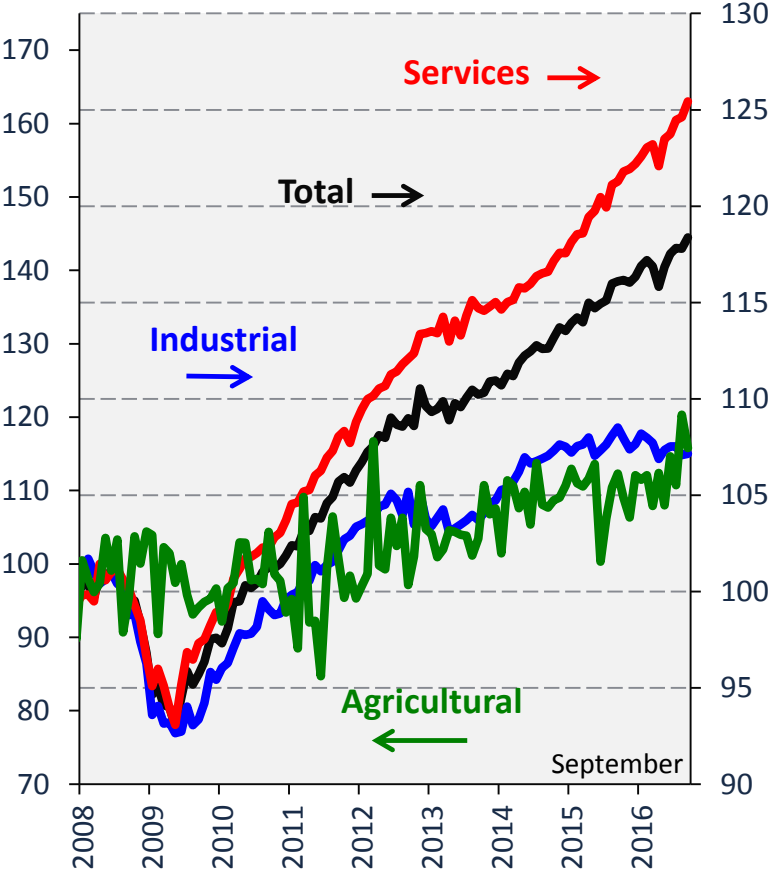


s. a. / Seasonally adjusted data.
Source: Mexico's System of National Accounts, INEGI.



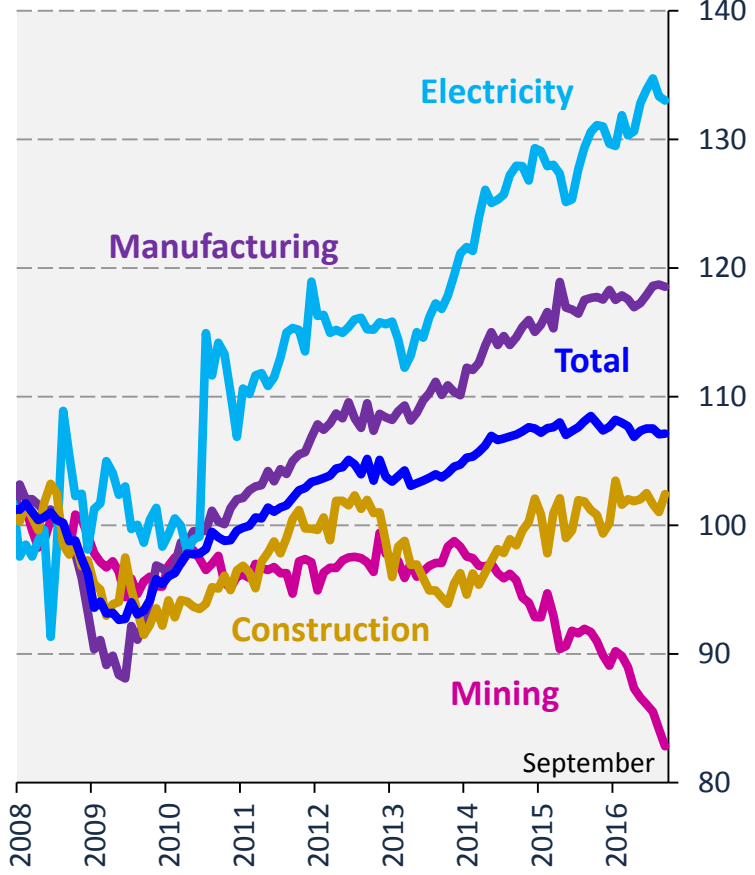
This recovery reflected the reactivation shown by the services' sector, while industrial production, overall, remained stagnant.

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



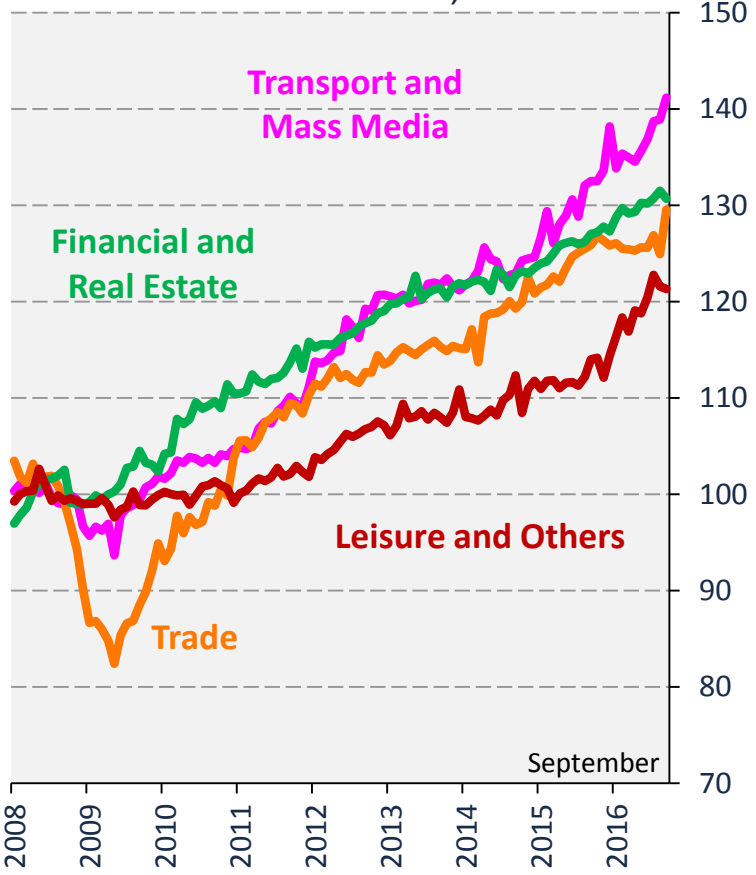
s. a. / Seasonally adjusted data.
Source: Mexico's System of National Accounts, INEGI.

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.

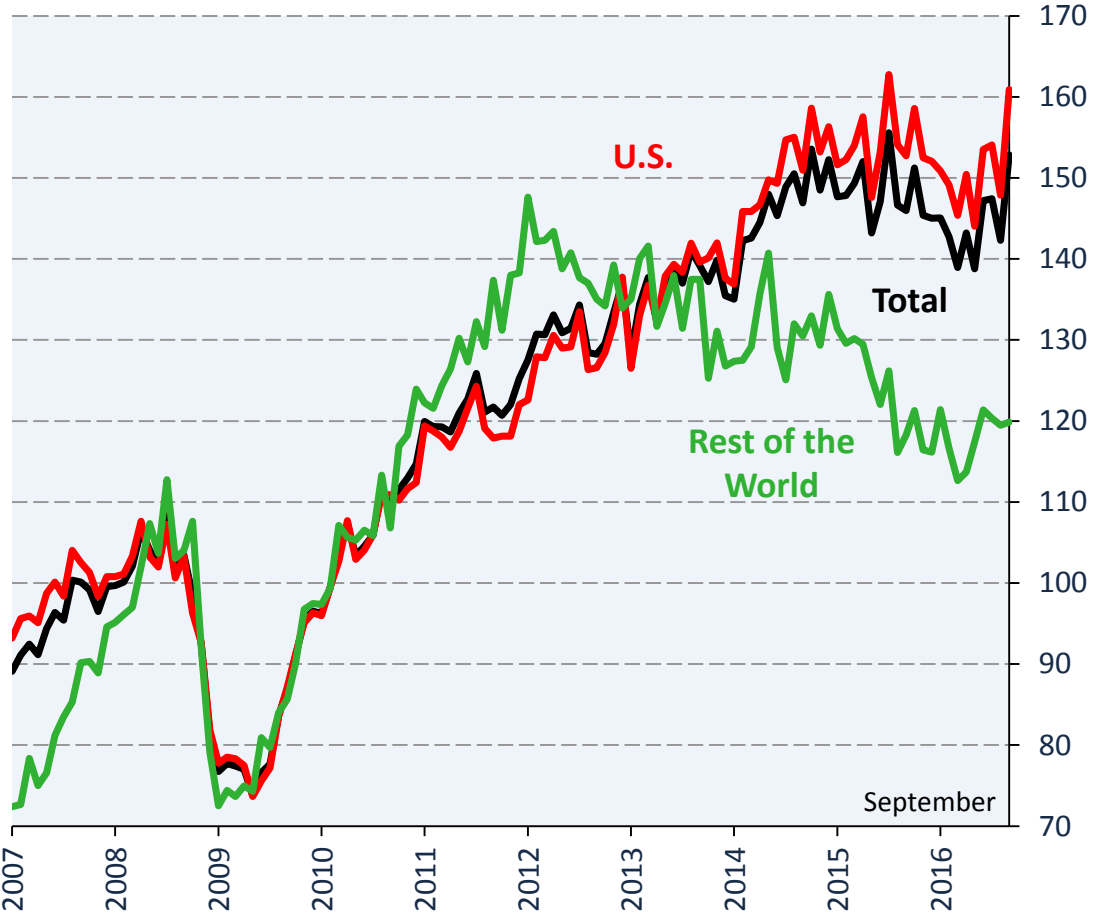
Global Indicator of Economic Activity: Services
Index 2008=100, s. a.



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

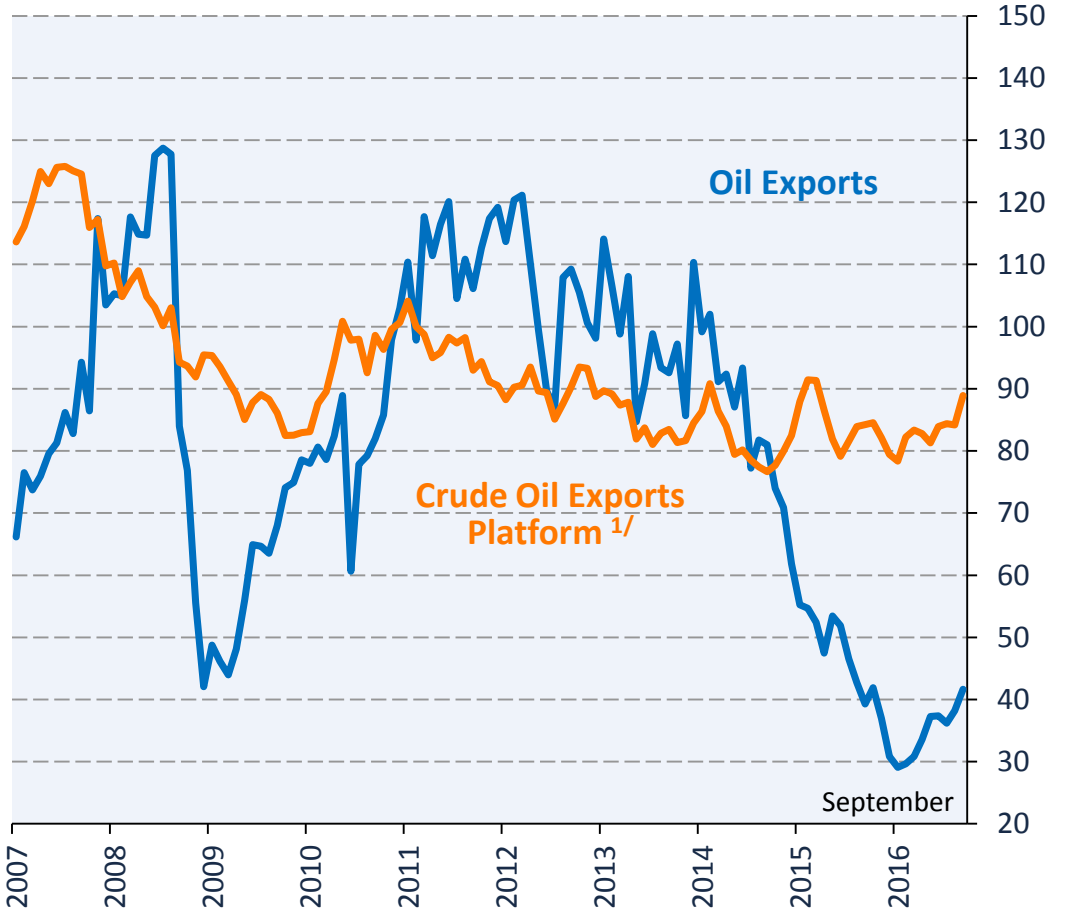
In Q3 2016, manufacturing exports in Mexico recovered, after showing a negative trend throughout 2015 and early 2016. Crude oil exports also increased.

Manufacturing Exports
Index 2008=100, s. a.



s. a. / Seasonally adjusted data based on information in nominal dollars.
Source: Banco de México with data from SAT, SE, Banco de México, INEGI. Merchandise Trade Balance, SNIEG. Information of National Interest.

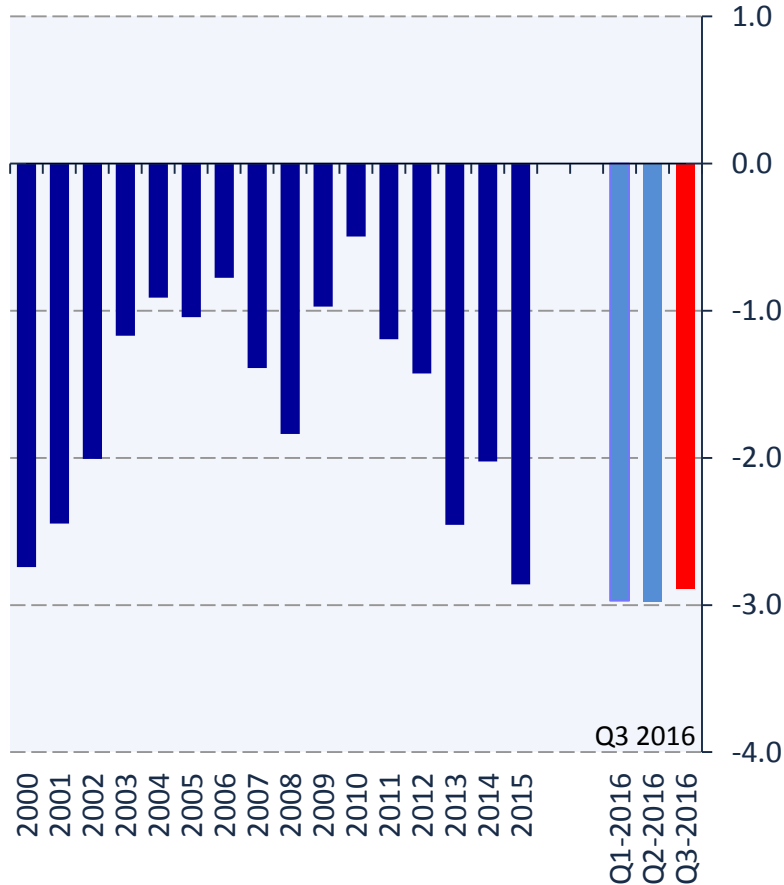
Oil Exports and Crude Oil Export Platform
Index 2008=100, s. a.



s. a. / Seasonally adjusted data based on information in nominal dollars.
1/ 3-month moving average of daily barrels of the seasonally adjusted series.
Source: SAT, SE, Banco de México, INEGI. Merchandise Trade Balance, SNIEG. Information of National Interest, and Banco de México with data from PMI Comercio Internacional, S.A. de C.V.

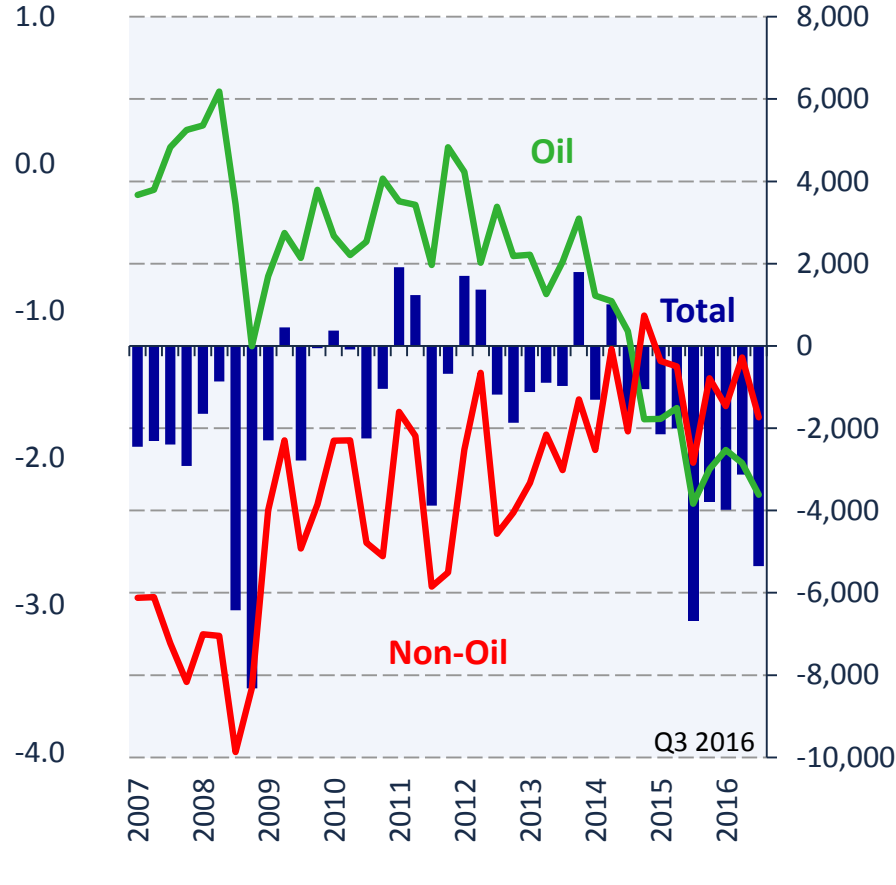
The current account seems to have stabilized, reflecting, in part, that the non-oil trade balance has apparently started to improve, after its deficit expanded from 2014 to 2015. Indeed, the accumulated deficit of this balance over the first three quarters of 2016, has been the lowest since 1996.

Current Account ^{1/}
% of GDP



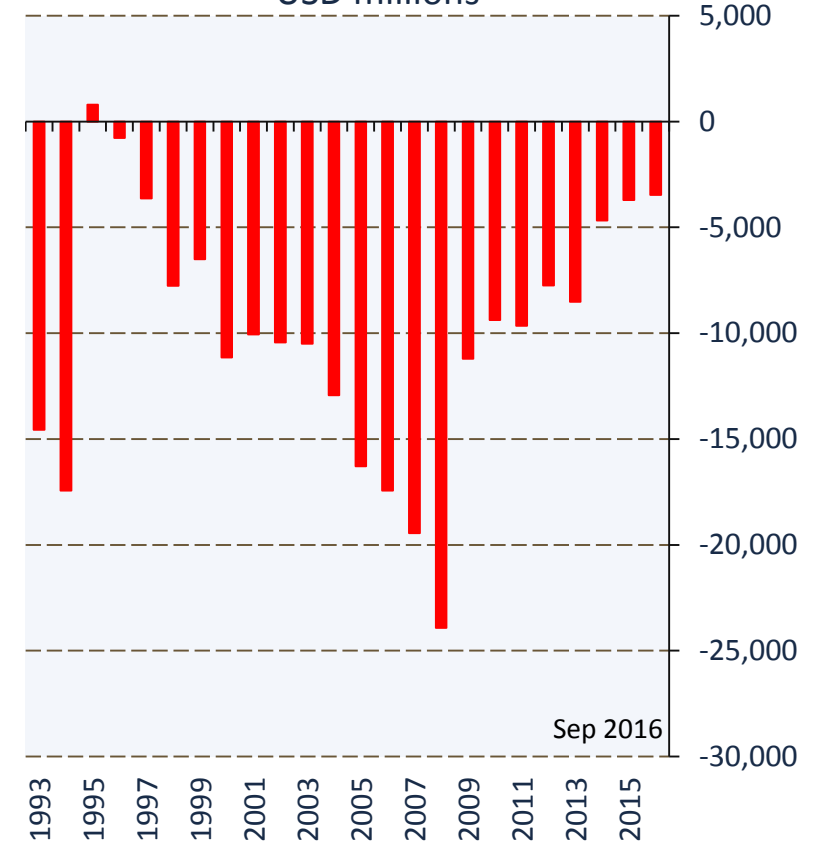
1/ Data for Q3 2016 correspond to Banco de México's estimate.
Source: Banco de México and INEGI.

Trade Balance
USD millions



Source: SAT, SE, Banco de México, INEGI. Merchandise Trade Balance, SNIEG. Information of National Interest.

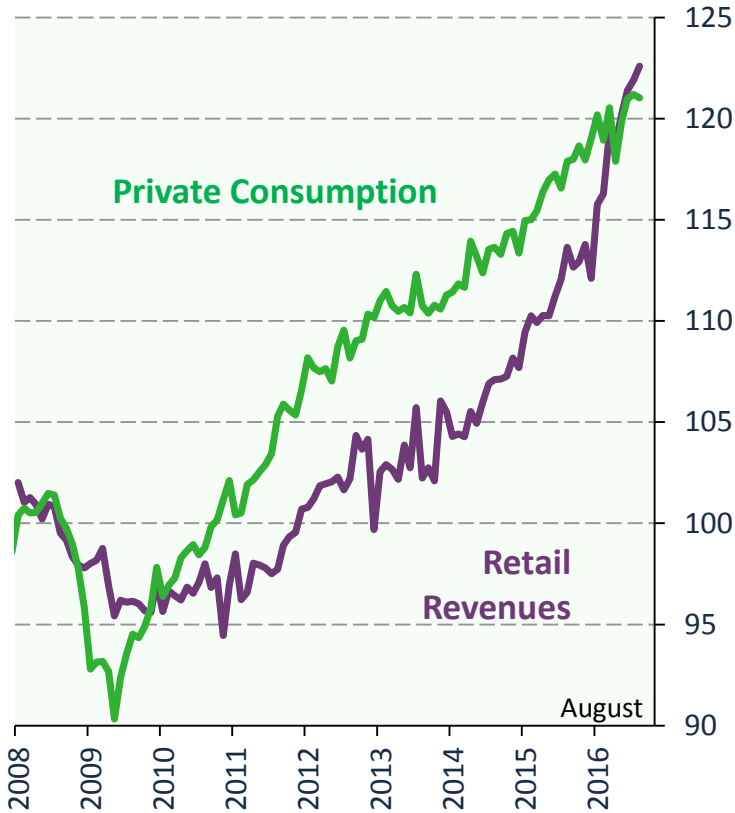
Non-oil Trade Balance
January-September of each year,
USD millions



Source: SAT, SE, Banco de México, INEGI. Merchandise Trade Balance, SNIEG. Information of National Interest.

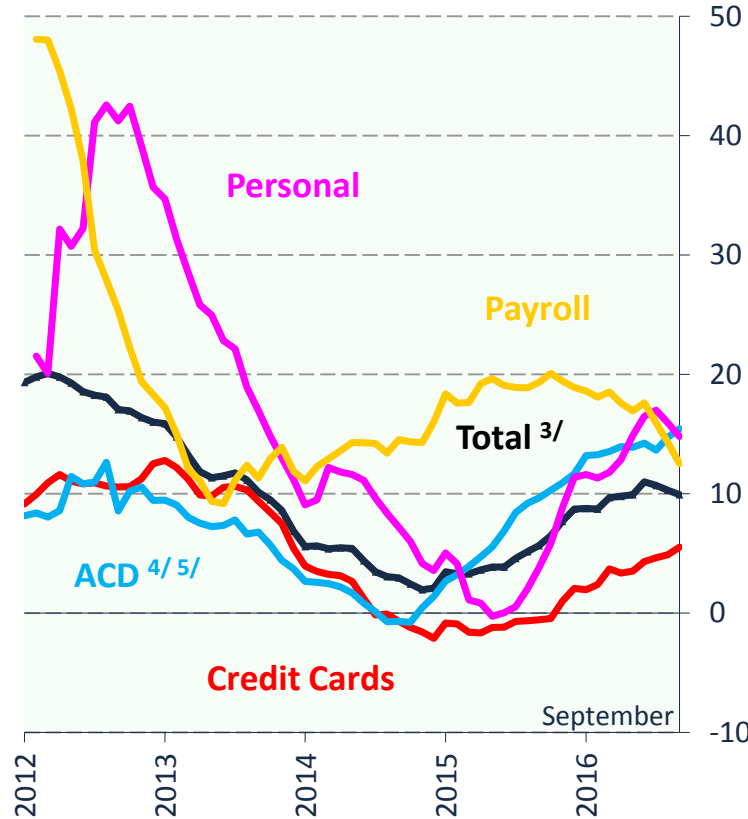
Private consumption resumed its upward trajectory, consistent with the improvement in the real wage bill. It also benefitted from the continued and rapid expansion of consumer credit, as well as from higher flows of remittances.

Domestic Private Consumption ^{1/} and Commercial Retail Business Revenues
Index 2008=100; s. a.



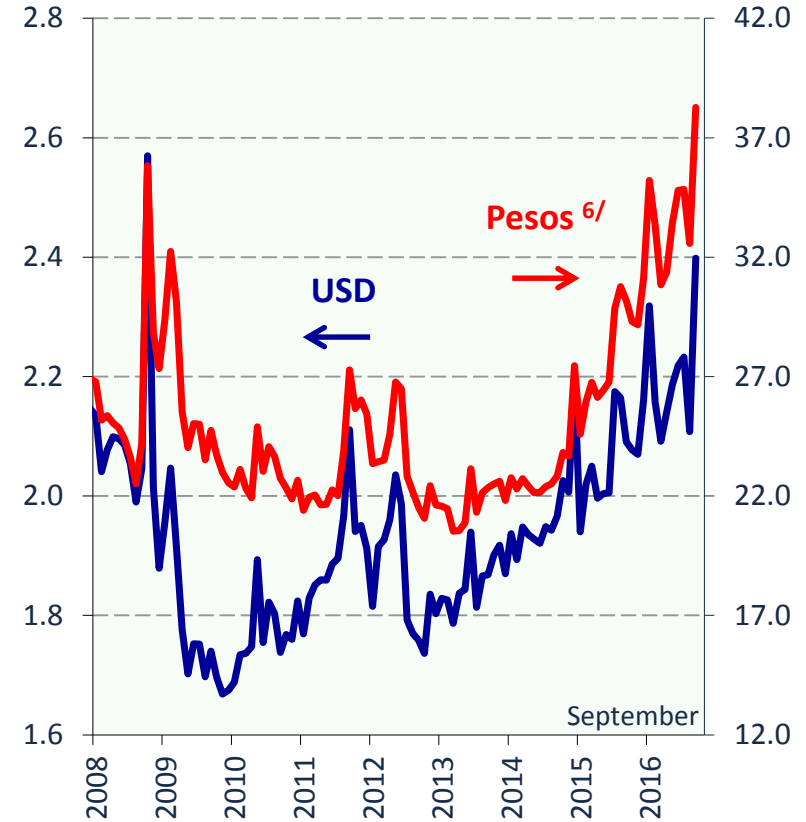
s. a. / Seasonally adjusted data.
1/ The Monthly Indicator of Private Consumption measures the performance of spending by resident households in the country on consumer goods and services of national and external origin. It does not include net purchases in foreign markets and imported services.
Source: EMEC and SCNM, INEGI.

Commercial Banks' Consumer Performing Credit ^{2/}
Real annual % change



2/ It includes Sofomes ER subsidiaries of bank institutions and financial groups.
3/ It includes credit for payable leasing operations and other consumer credits.
4/ From July 2011 onwards, figures are adjusted in order to avoid distortions due to the reclassification from acquisition of consumer durables to other consumer credits by one banking institution.
5/ It includes credit for movable property acquisition and auto loans.
Source: Banco de México.

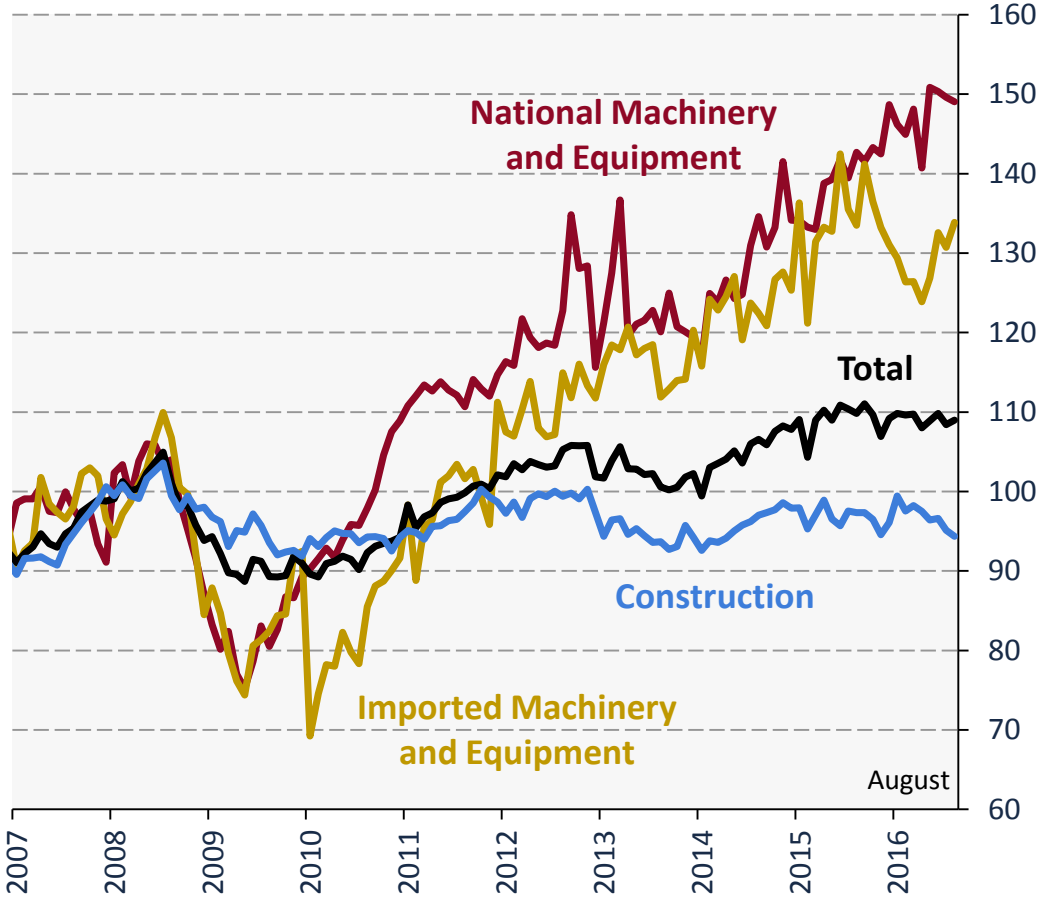
Workers' Remittances
USD billions and constant MXN billions; s. a.



s. a. / Seasonally adjusted data.
6/ Prices as of the second fortnight of December 2010.
Source: Banco de México.

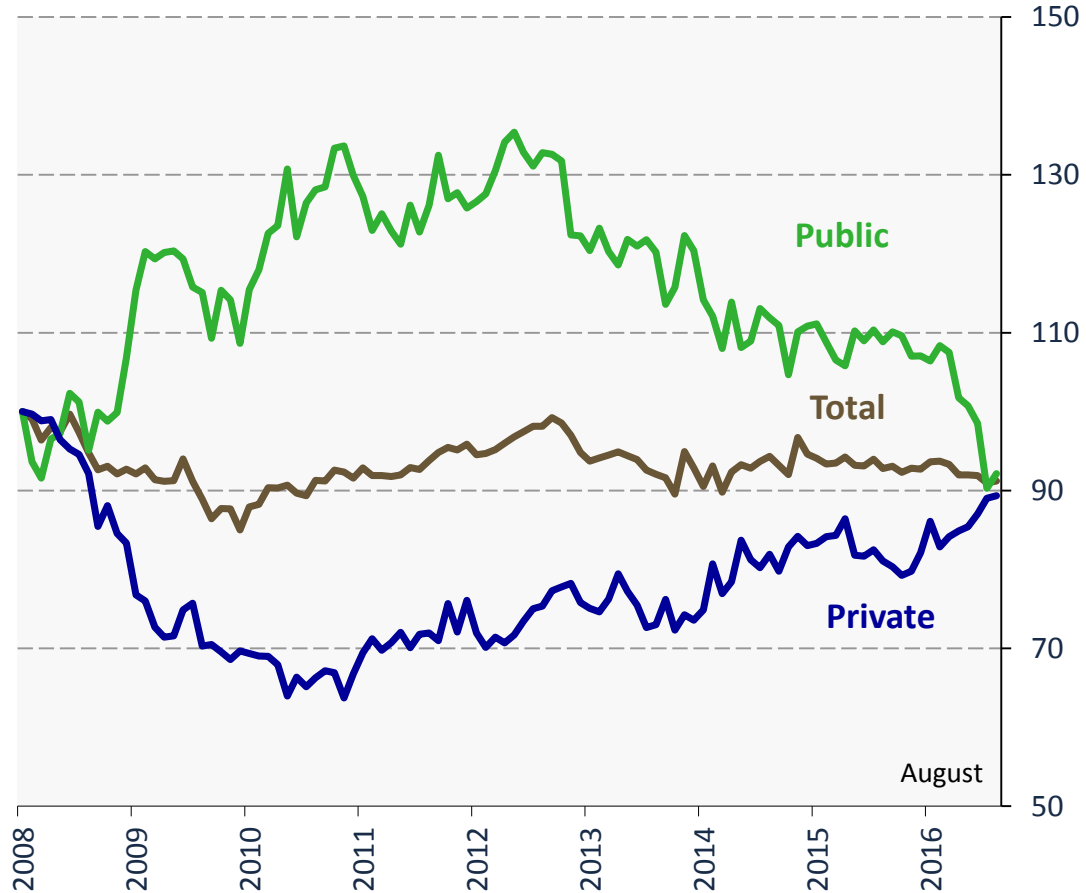
During the reported quarter, weakness in gross fixed investment persisted.

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



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

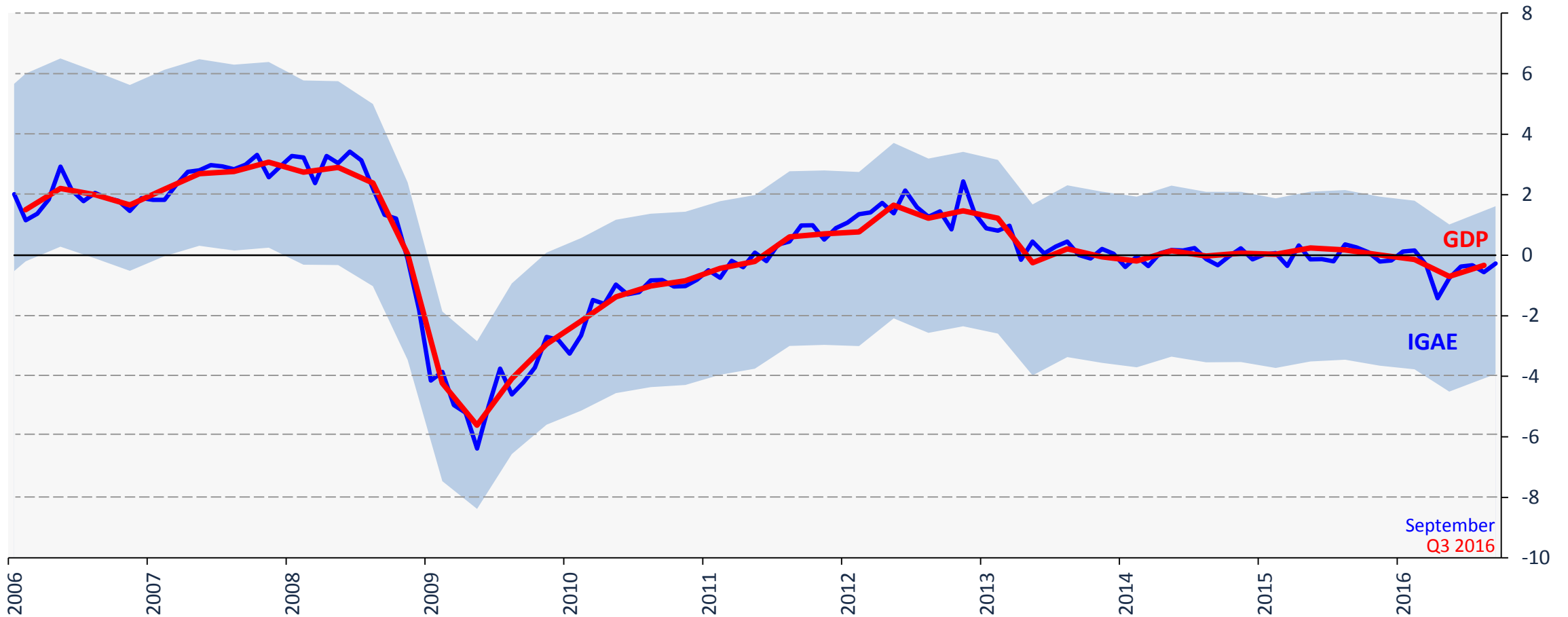
Real Value of Production in the Construction Industry by Contracting Institutional Sector ^{1/}
Index January 2008=100, s. a.



s. a./ Seasonally adjusted data.
^{1/} Seasonally adjusted by Banco de México, except the total.
Source: Calculated by Banco de México with data from ENEC, INEGI.

No significant price pressures coming from aggregate demand were observed.

Output Gap ^{1/}
% of potential output; s. a.



s. a. / Calculated with seasonally adjusted data.

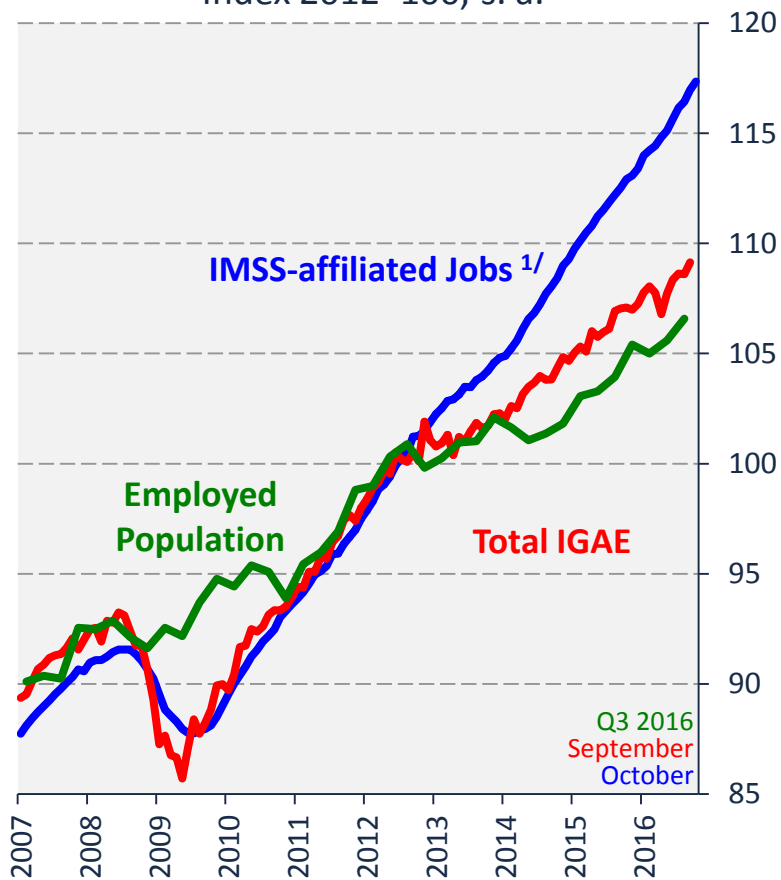
^{1/} Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p. 69. The shaded area is the 95% confidence interval of the output gap, calculated with an unobserved components method.

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

In Q3 2016, overall labor market conditions seemed to have continued gradually improving.

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.



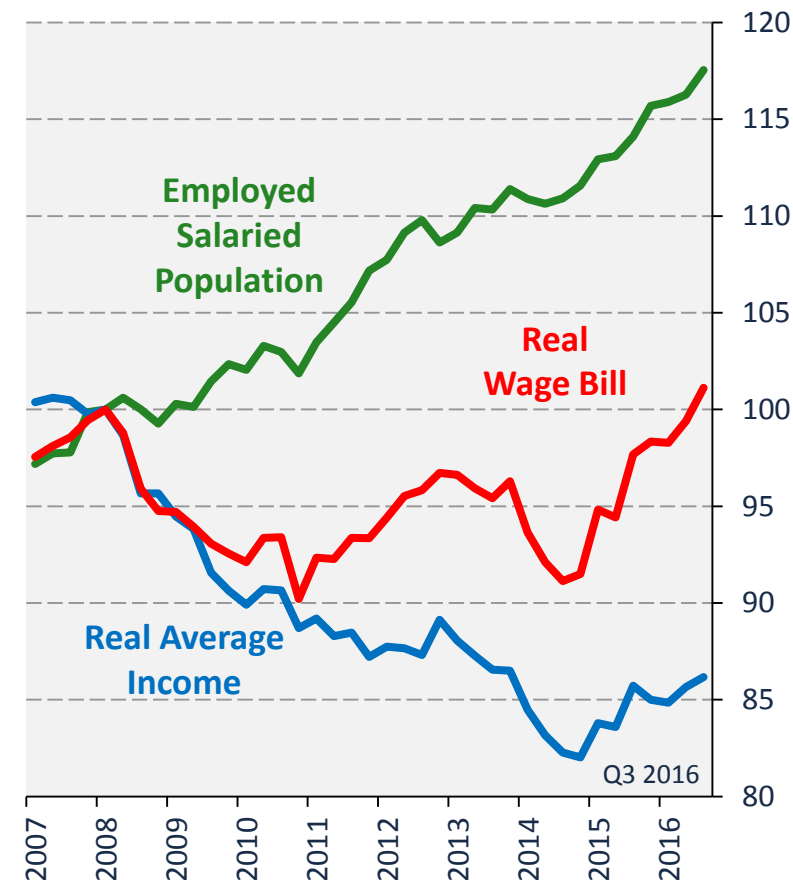
EAP/ Economically Active Population.

s. a. / Seasonally adjusted data.

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

Real Total Wage Bill

Index Q1-2008 =100, s. a.



s. a. / Seasonally adjusted data.

Source: Elaborated by Banco de México with data from National Employment Survey (*Encuesta Nacional de Ocupación y Empleo*), INEGI.

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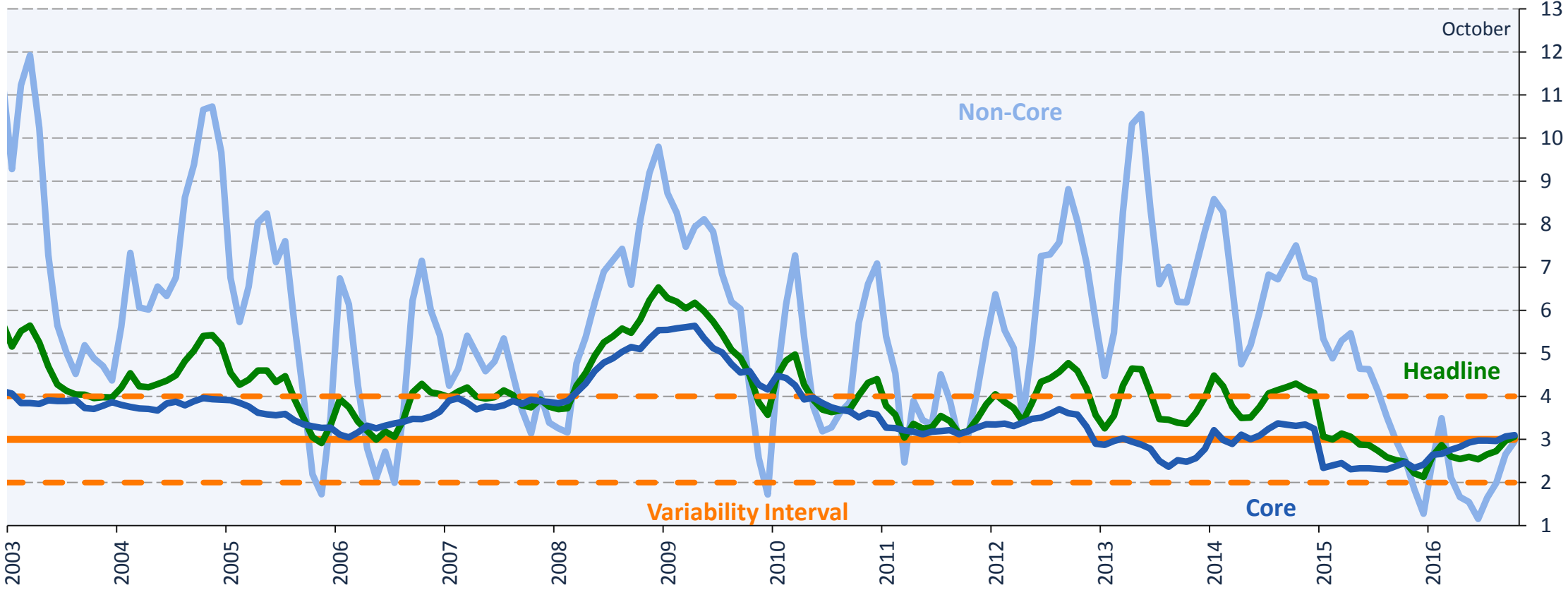
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Forecasts and Final Remarks

As of September 2016, annual headline inflation registered 17 consecutive months at levels under 3 percent, although in October it lied slightly above this figure.

Consumer Price Index Annual % change

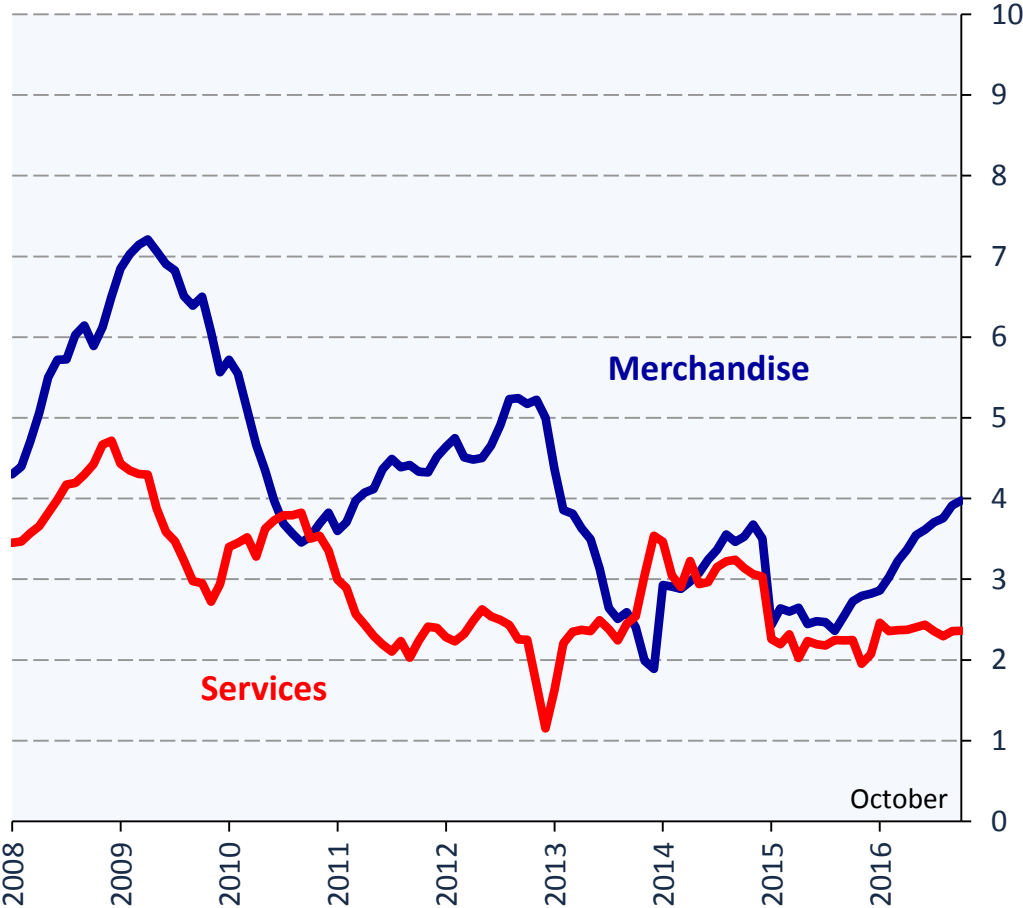


Source: Banco de México and INEGI.

The performance of core inflation is mainly explained by the evolution of the merchandise price sub-index, which responded to the depreciation of the national currency.

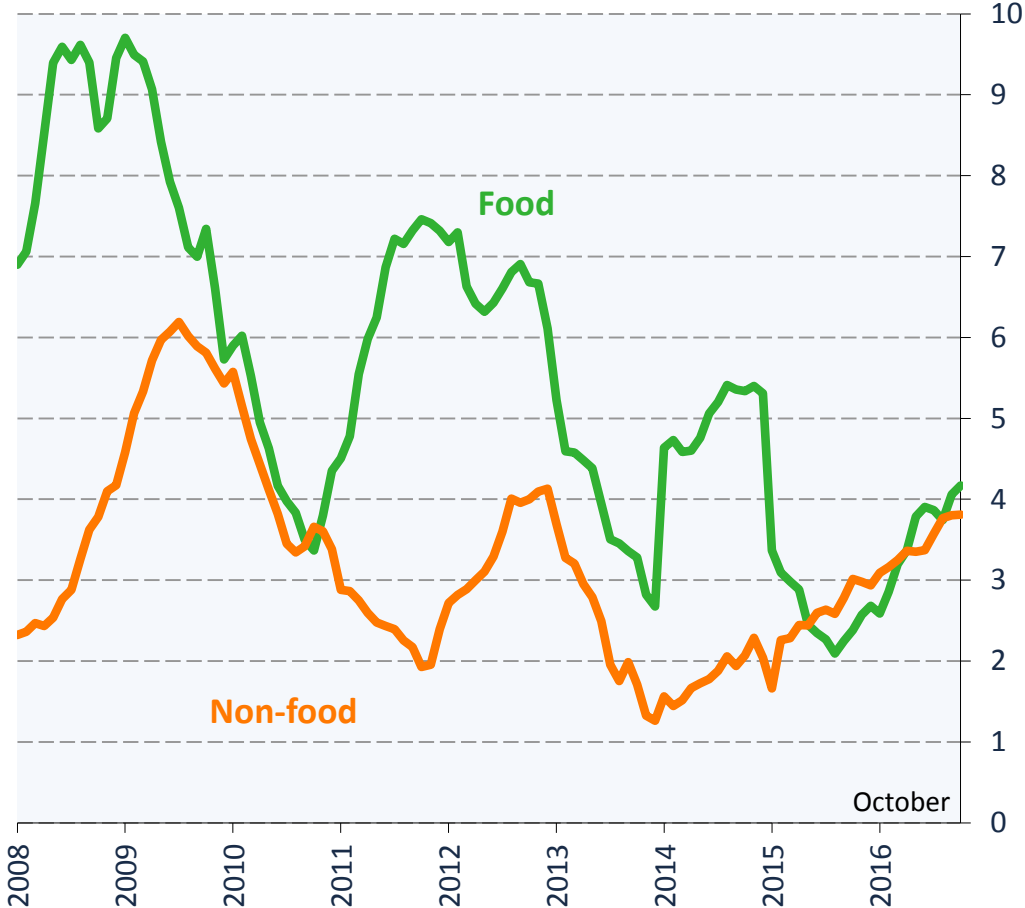
Core Price Index
Annual % change

Merchandise and Services



Source: Banco de México and INEGI.

Merchandise

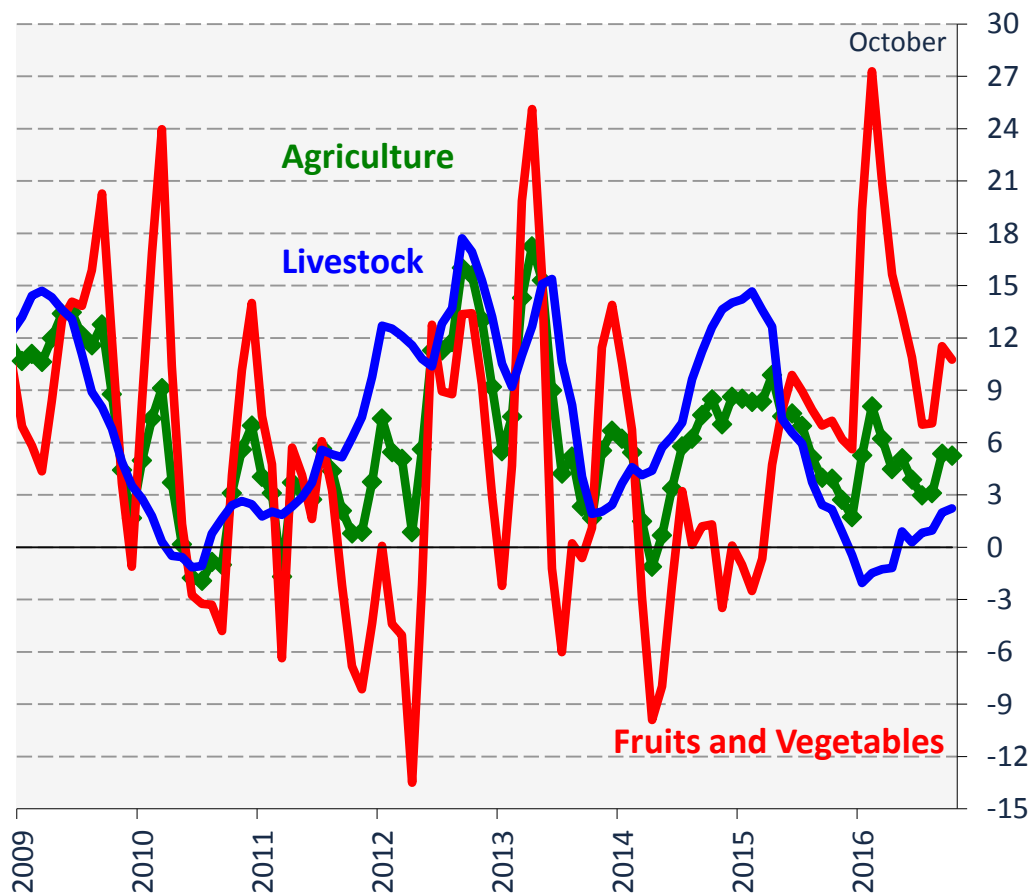


Source: Banco de México and INEGI.

Higher non-core inflation largely derived from increments in gasoline prices, which were partially offset by drops in the L.P. gas prices.

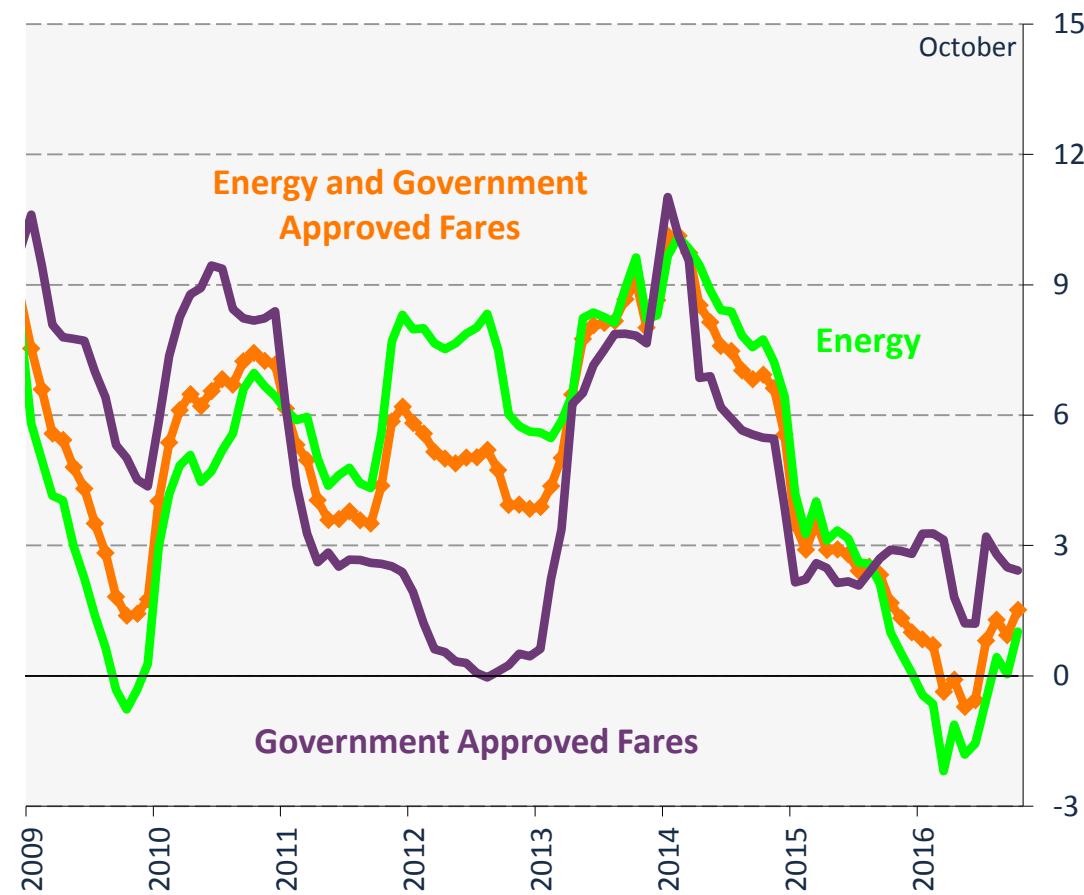
Non-Core Index Annual % change

Agriculture



Source: Banco de México and INEGI.

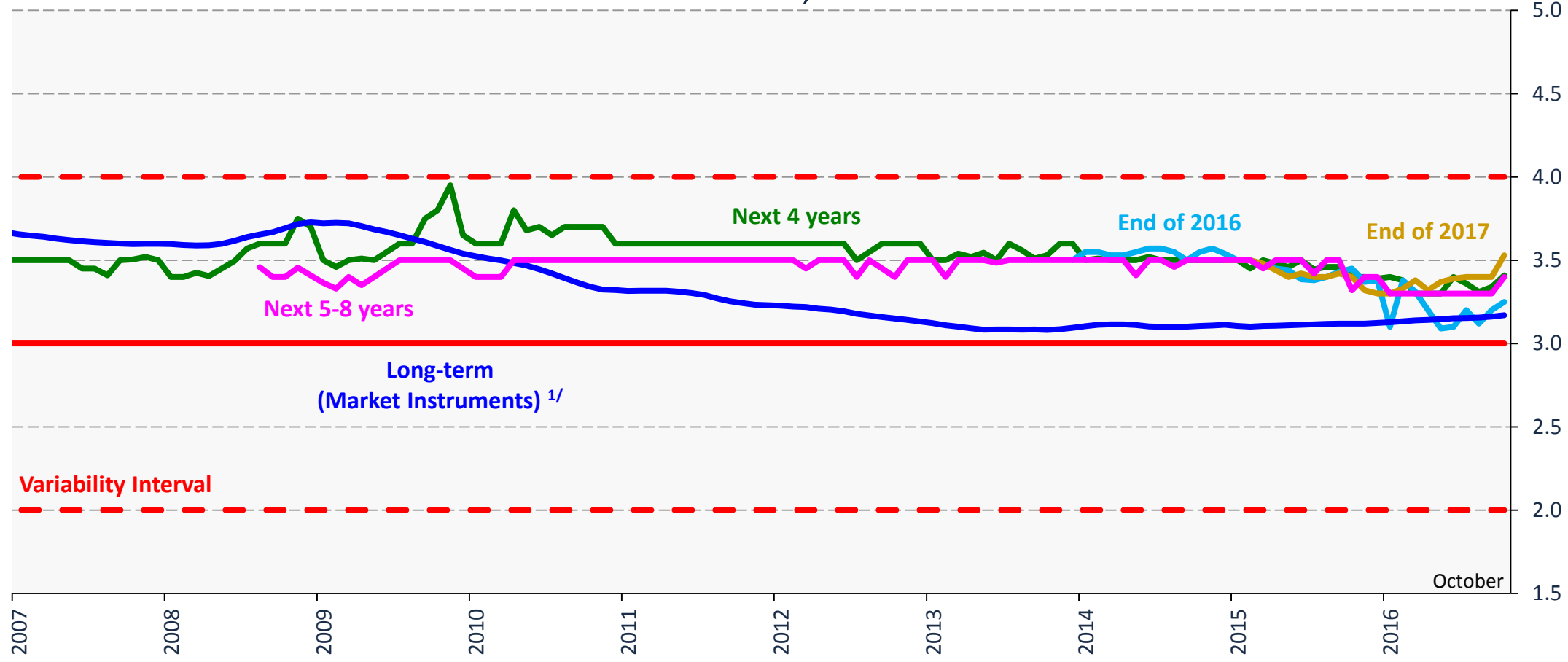
Energy and Government Approved Fares



Source: Banco de México and INEGI.

Long-term inflation expectations derived from surveys and from market instruments remain around 3 percent.

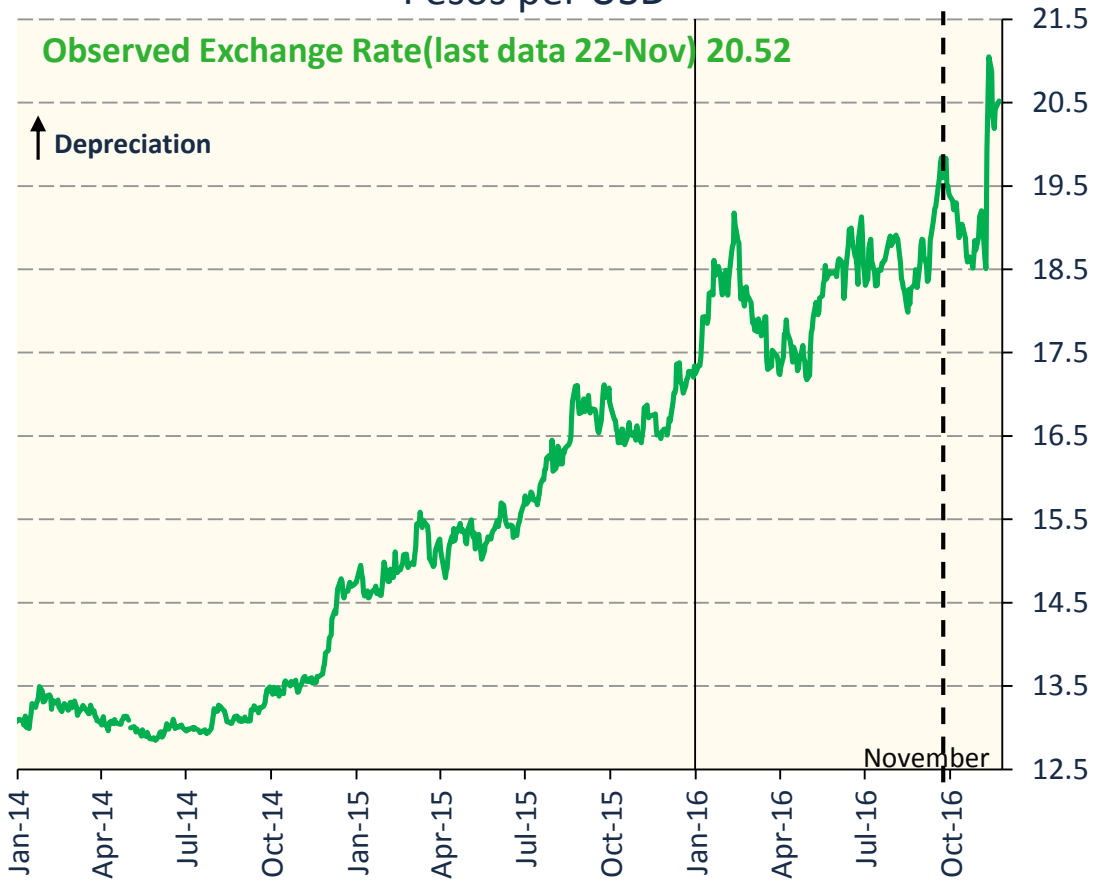
Headline Inflation Expectations for Different Terms Median, %



1/ For a description of the estimation of log-term inflation expectations, see the Box “Decomposition of Break-even Inflation” in the Quarterly Report, October – December 2013. For the current Report, the estimate was updated by including data as of December 2015.
Source: Banco de México.

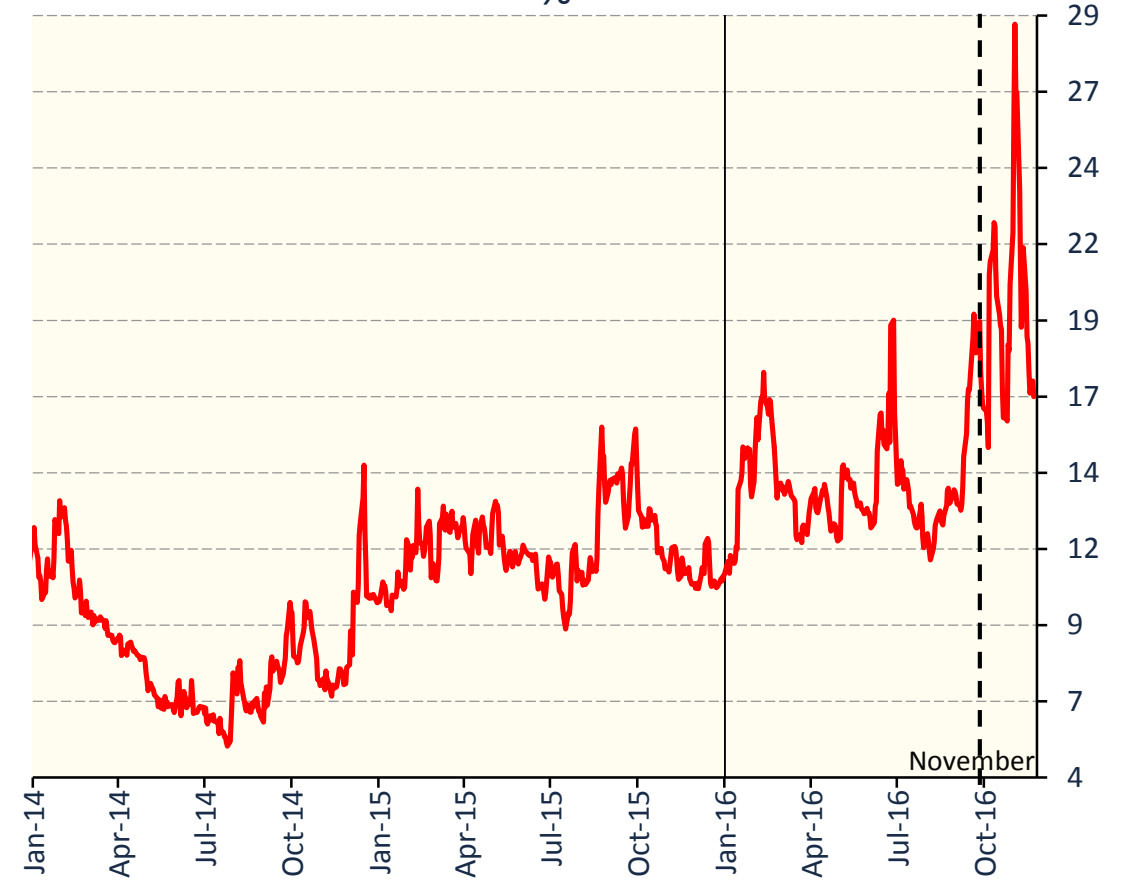
Episodes of high volatility in financial markets, mainly related to the electoral process in the U.S., led to high volatility and a considerable depreciation of the national currency.

Nominal Exchange Rate ^{1/}
Pesos per USD



1/ Refers to FIX Exchange rate. The black vertical line indicates January 1, 2016 and the dotted line indicates September 29, 2016.
Source: Banco de México.

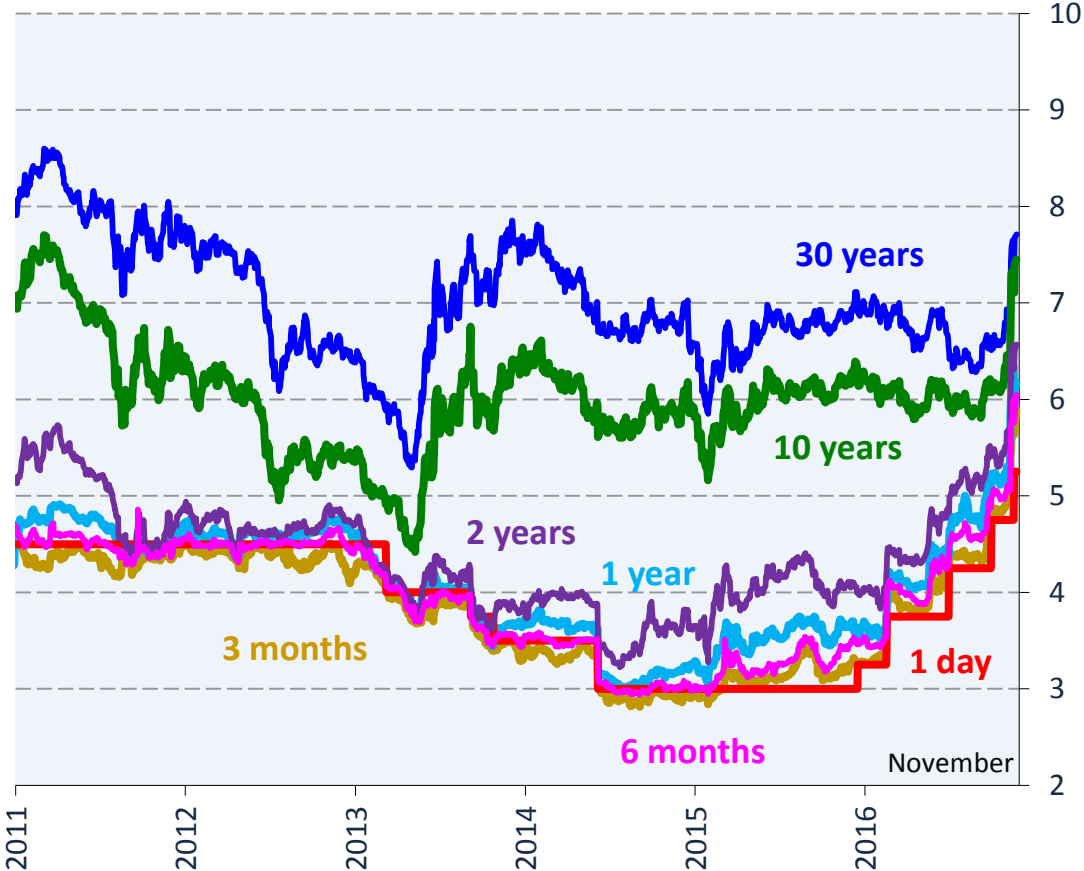
Currency Option Implied Volatility ^{2/}
%



2/ Currency option implied volatility refers to one-month options. The black vertical line indicates January 1, 2016 and the dotted line indicates September 29, 2016.
Source: Bloomberg.

Regarding the bond market performance, following the announcement of the results in the U.S. elections, the upward trend in interest rates sharply strengthened, especially along the longer end of the yield curve.

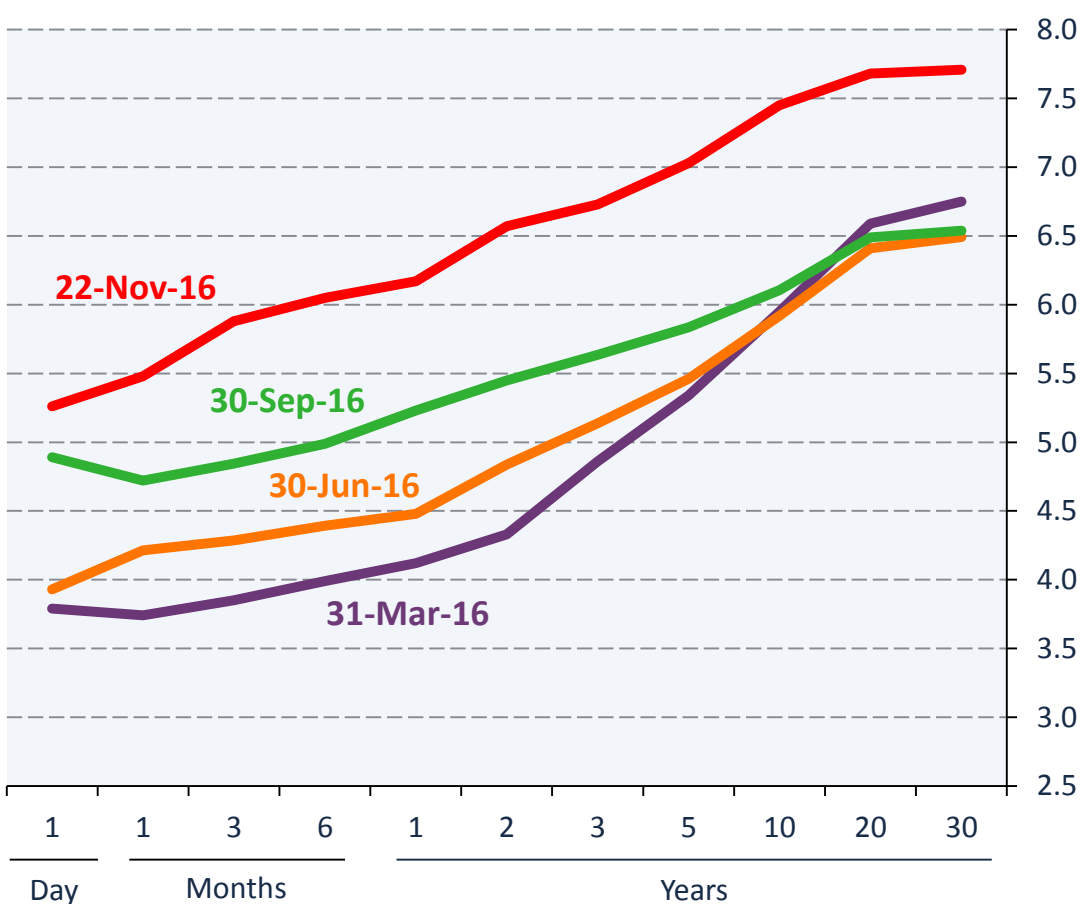
Government Bond Interest rates ^{1/}
%



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

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

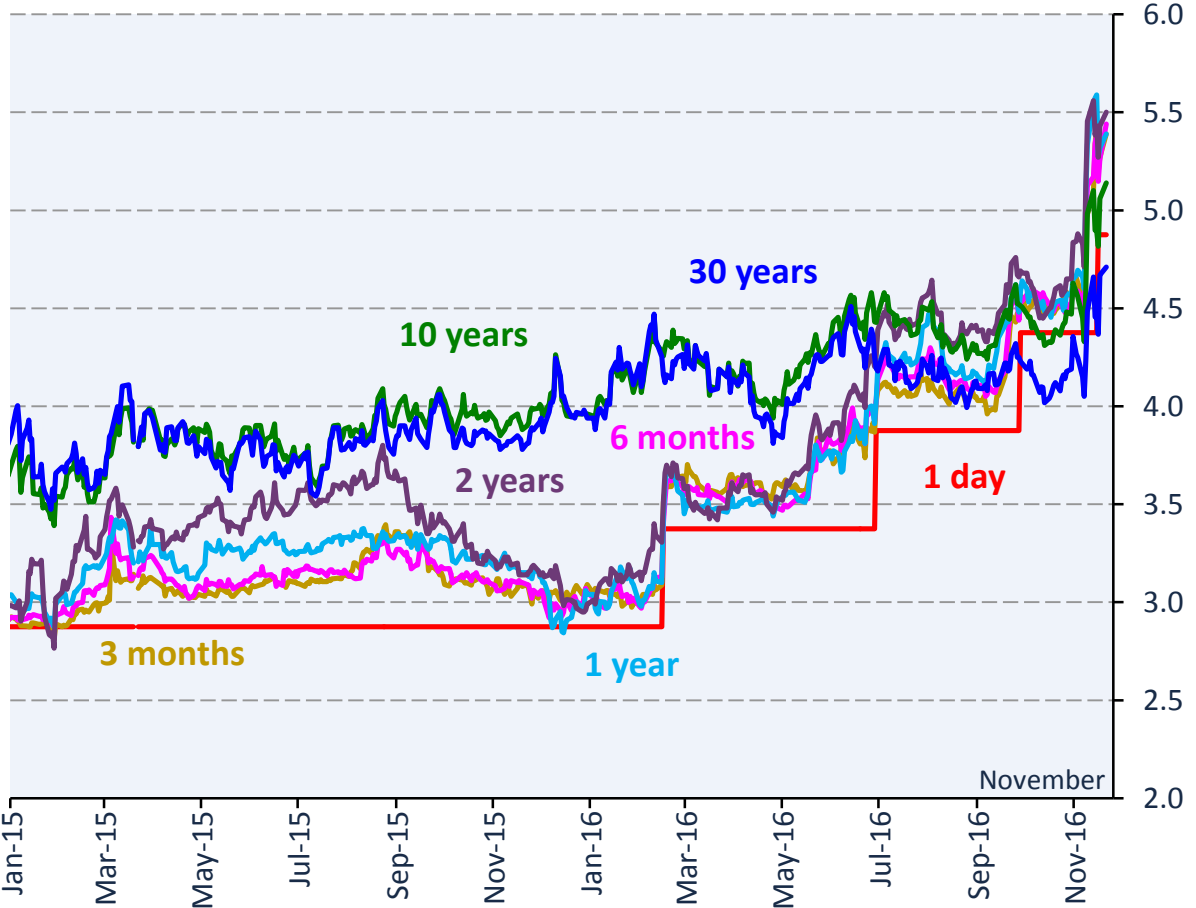
Yield Curve
%



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

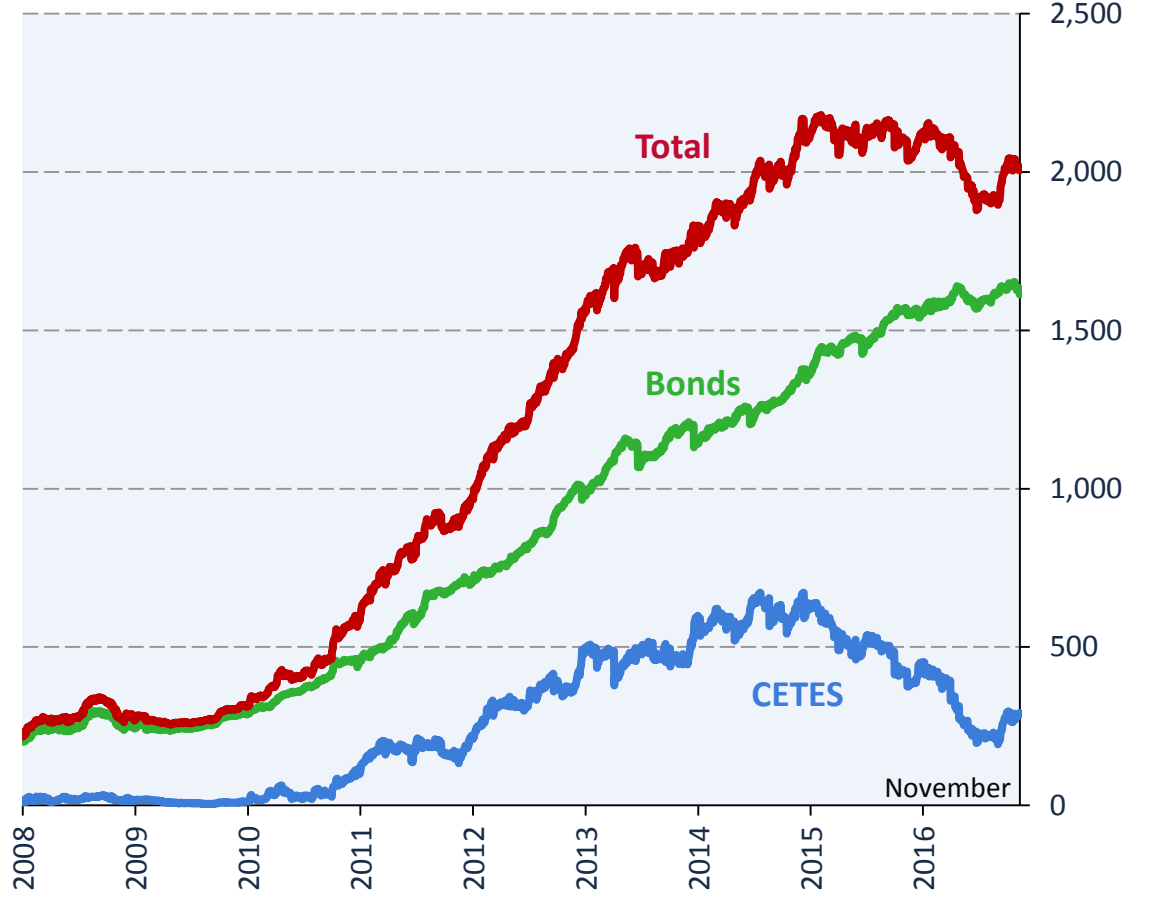
Even though the operating conditions in the national bond markets deteriorated recently, government securities' holdings by non-residents remained stable at levels close to historic maximums.

Mexico and United States Interest Rate Spreads ^{1/}
Percentage points



1/ The United States objective rate is the average of the interval considered by the Federal Reserve. Source: Proveedor Integral de Precios (PiP) and U.S. Treasury Department.

Government Securities' Holdings by Foreign Investors ^{2/}
MXN billion



2/ The total includes CETES, bonds, udibonos, bondes and bondes D. Source: Banco de México.

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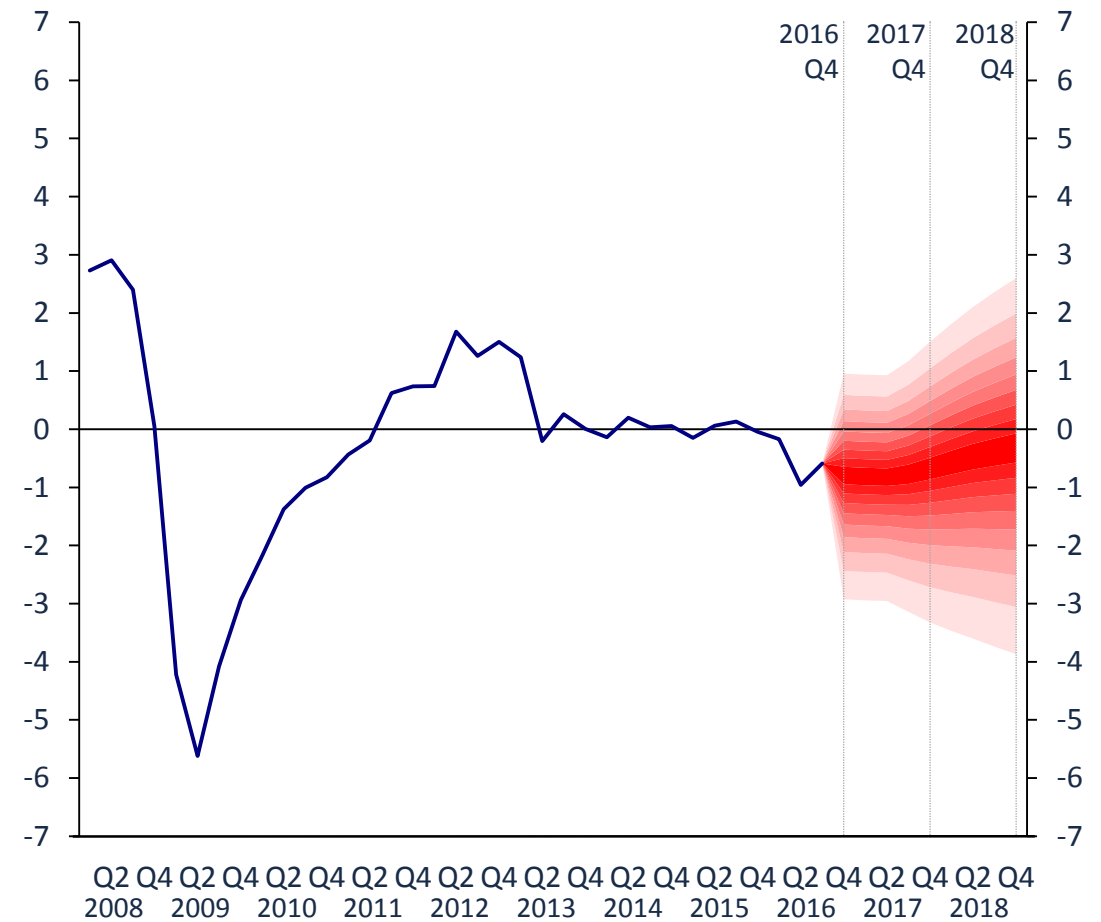
Economic Activity Outlook

GDP Growth (%)		
Report	Previous	Revised
2016	1.7 - 2.5	1.8 - 2.3
2017	2.0 - 3.0	1.5 - 2.5
2018	--	2.2 - 3.2

Increase in the number of IMSS-insured jobs (Thousands)		
Report	Previous	Revised
2016	590 - 690	640 - 710
2017	610 - 710	600 - 700
2018	--	650 - 750

Current Account Deficit (% of GDP)		
Report	Previous	Revised
2016	3.1	3.0
2017	3.2	3.0
2018	--	3.0

Fan Chart: Output Gap
% of potential output, s. a.



s. a. / Seasonally adjusted data.

Source: Banco de México.

Risks to the Growth Outlook

Upward:

- ✓ That the implementation of structural reforms would have a more positive impact on the economic growth and will be faster than anticipated.
- ✓ That, in view of the recent depreciation of the exchange rate, non-oil exports would exhibit a more noticeable and lasting recovery, which would further boost industrial production.

Downward:

- ✓ That the new administration of the U.S. would indeed implement policies that could hamper the functioning of shared production chains between Mexico and the U.S.
- ✓ Persisting episodes of high volatility in international financial markets, which would reduce the sources of financing or foreign investment to Mexico.
- ✓ That the deterioration that had been observed in consumers' and investors' confidence levels would persist, affecting private consumption and investment.

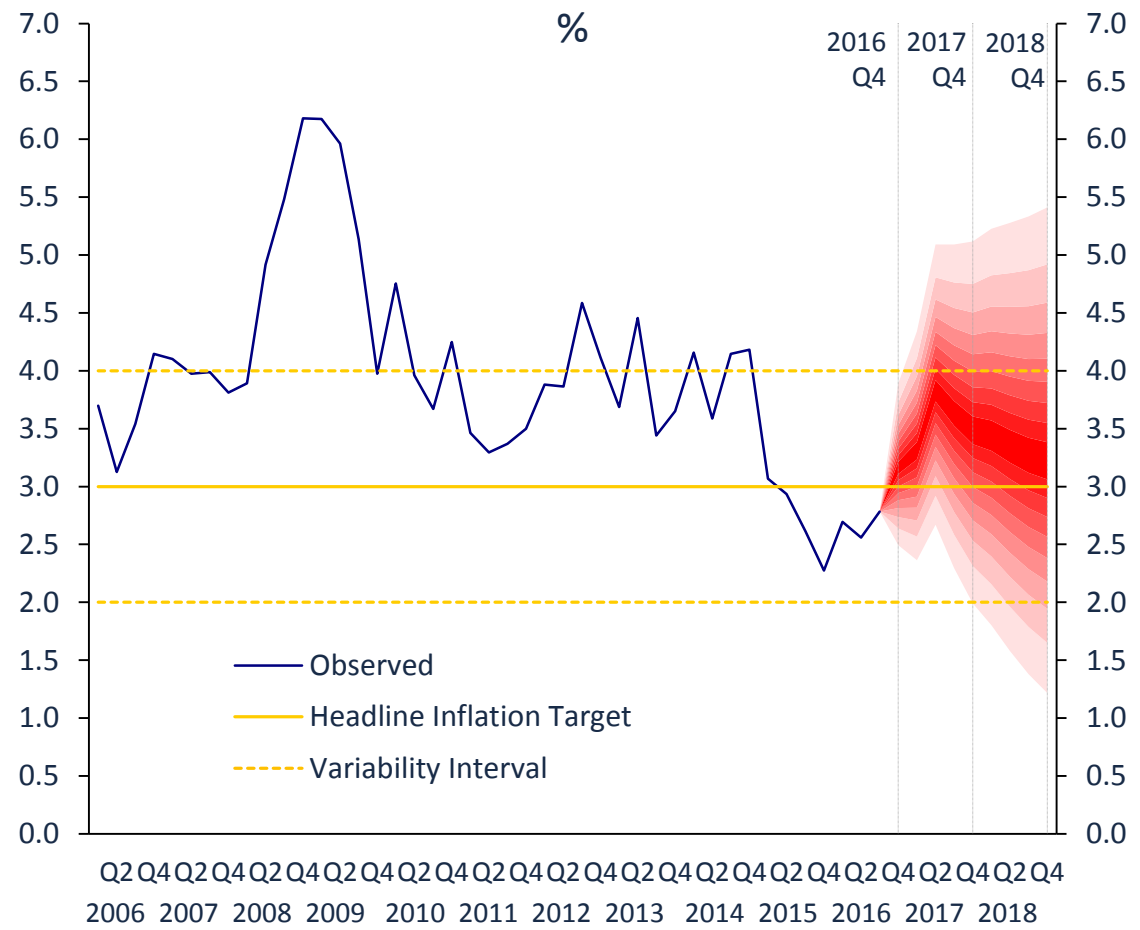
Inflation Outlook

	Headline inflation	Core inflation
2016	<ul style="list-style-type: none">• It will gradually increase and will lie slightly above 3 percent by the end of the year.	<ul style="list-style-type: none">• It is forecast to close the year moderately above 3 percent.
2017	<ul style="list-style-type: none">• It will be above the inflation target, although within the variability interval.	
2018	<ul style="list-style-type: none">• It will be close to levels around 3 percent by the end of the year.	

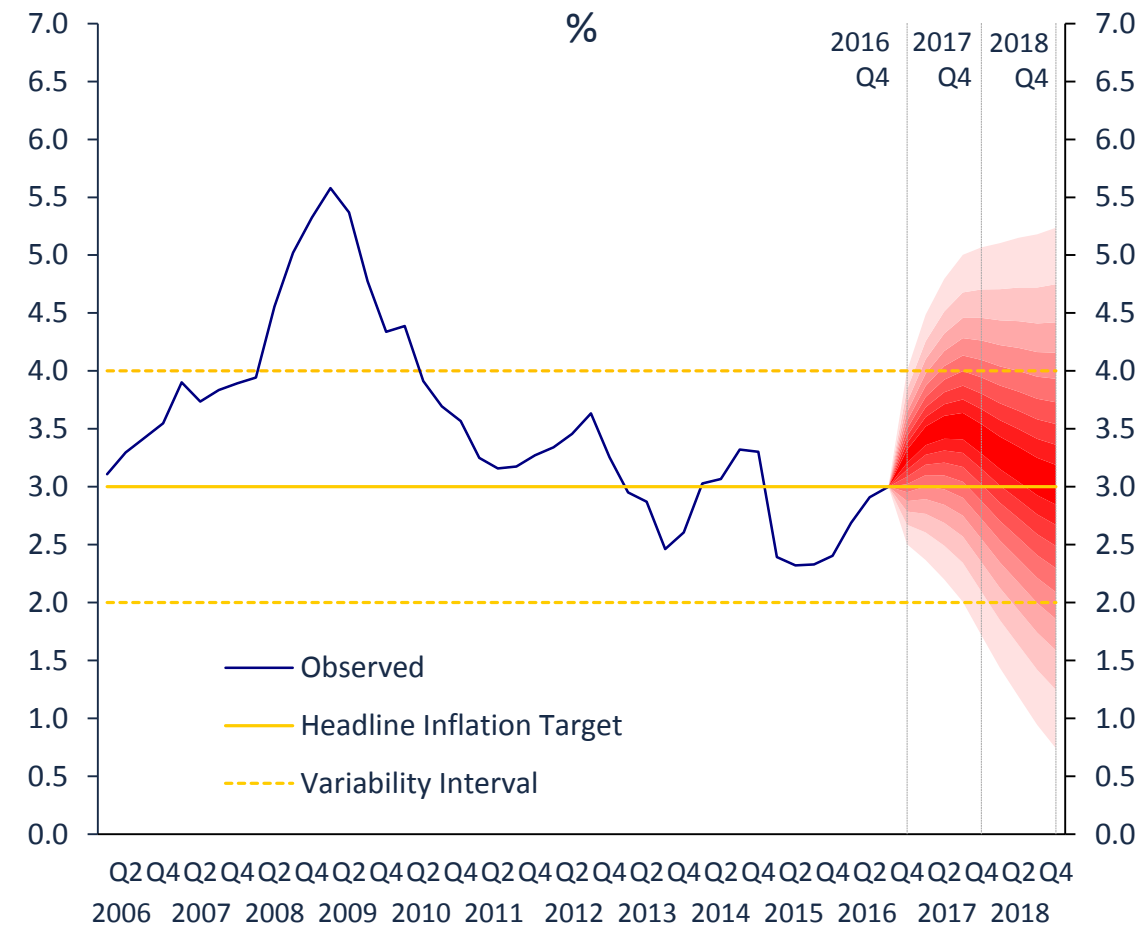
Annual inflation is forecast to lie slightly over 3 percent by the end of the year. For 2017, it is anticipated to be above the inflation target, although below the upper limit of the variability interval, getting close to levels around 3 percent by the end of 2018.

Fan Charts

Annual Headline Inflation ^{1/}



Annual Core Inflation ^{2/}

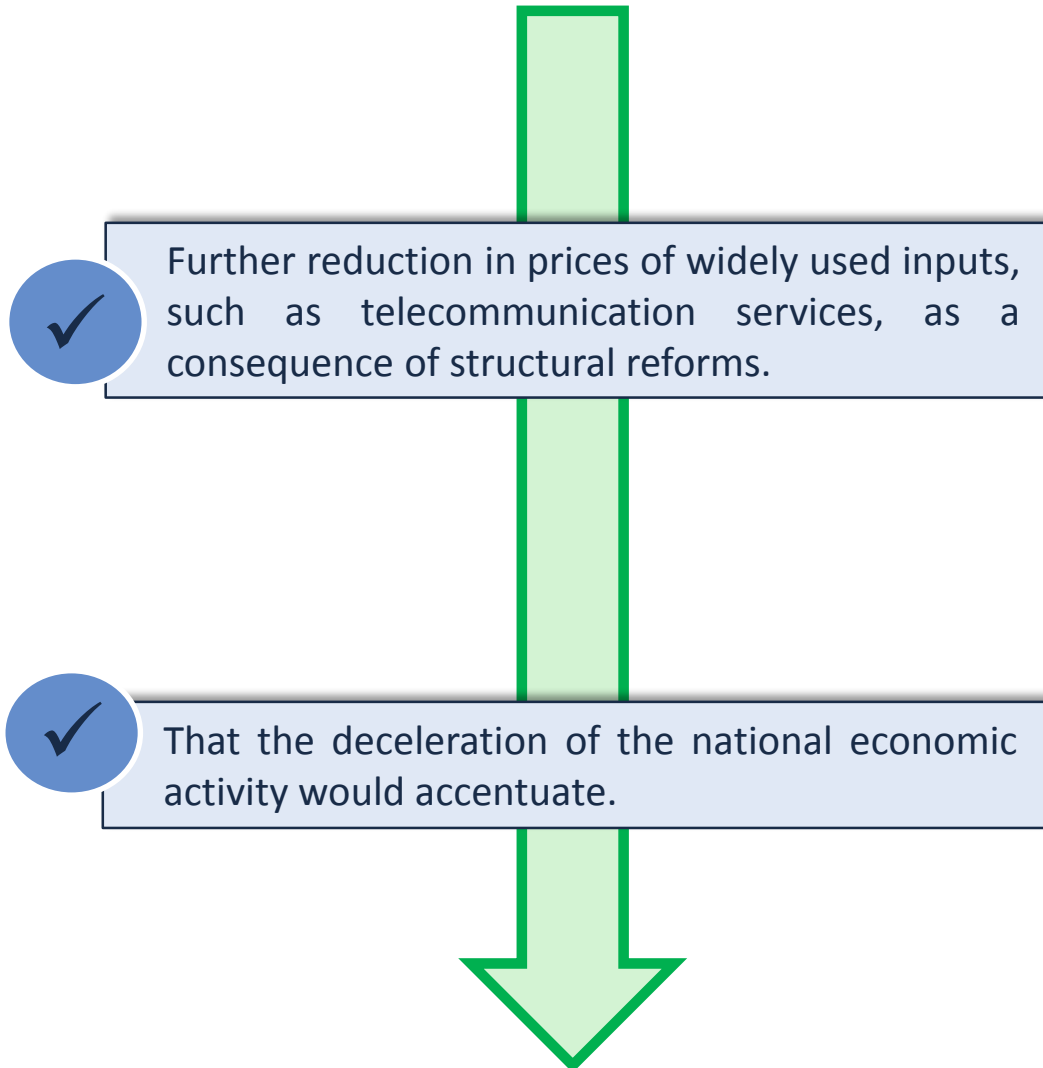


1/ Quarterly average of annual headline inflation.
Source: Banco de México and INEGI.

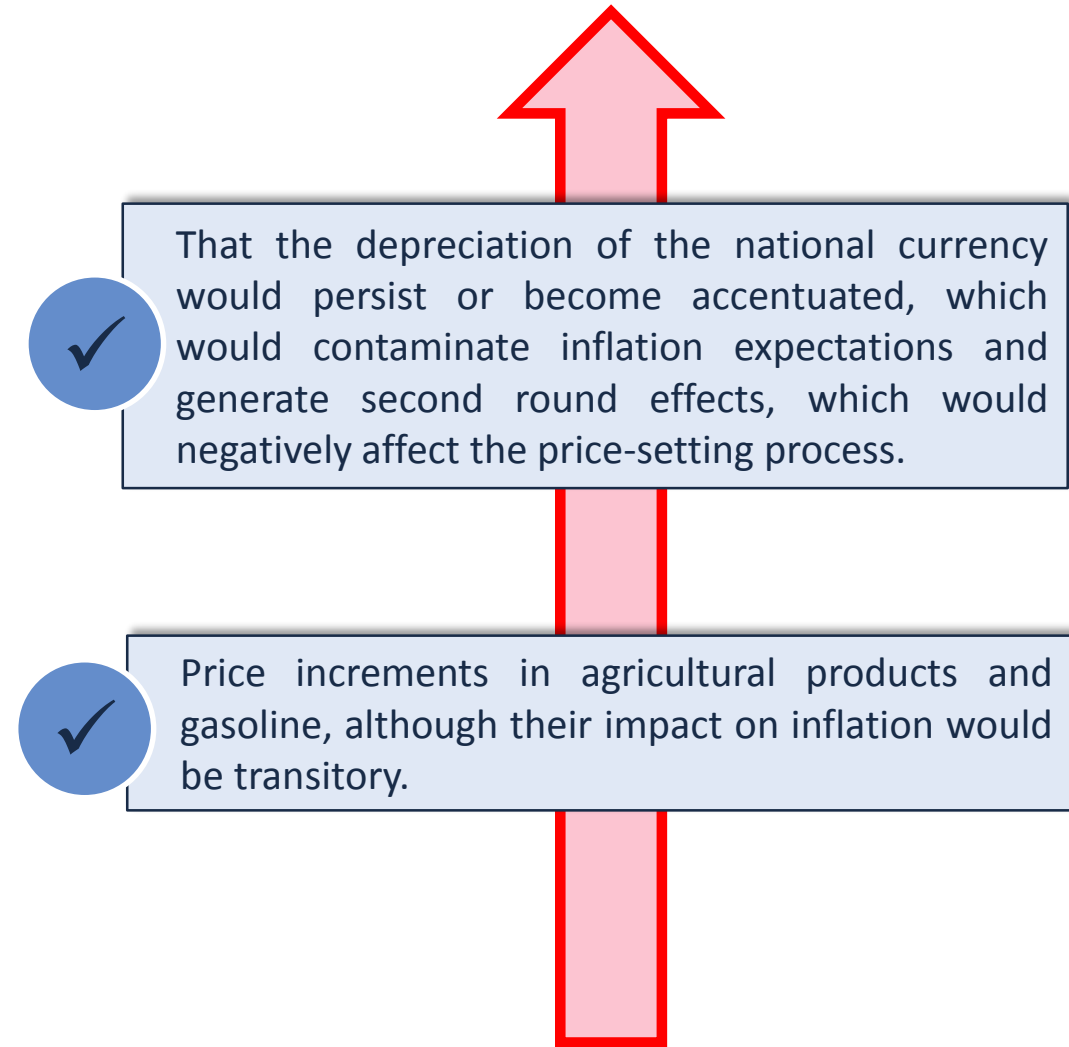
2/ Quarterly average of annual core inflation.
Source: Banco de México and INEGI.

Risks to the Inflation Outlook

Downward



Upward



Monetary Policy Stance

- Recent international events could impact the structural links between Mexico and its main trade partner. In this context, it is both natural and necessary to observe a depreciation of the real exchange rate, being **the most efficient adjustment mechanism and shock absorber**.
- The **main contribution of Banco de México** during this adjustment process, given its mandate, is to ensure that changes in relative prices take place in an orderly fashion, in order **to prevent inflation expectations from being contaminated, and to avoid second round effects**, which would negatively impact the price-setting process of the economy.

Monetary Policy Stance

- 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 any preset or desired level for the exchange rate.

- ✓ The monetary position of Mexico relative to that of 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 percent target**, with full flexibility and to the extent that the prevailing conditions may demand.

Strengthening Confidence in the Mexican Economy

- It is indispensable to continue **implementing structural reforms adequately and promptly**, as they would boost the country's productivity and would allow a better resource allocation.
- In addition, structural reforms will allow fostering greater **sustained growth in the domestic market**, which will contribute to offset the effects of the deeply adverse external environment faced by the Mexican economy.
- Current risks to the trade relation between Mexico and the U.S. highlight the importance of **diversifying Mexican exports' destinations**.



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