

# Quarterly Report

July – September 2015

## Summary

In line with its constitutional mandate, the monetary policy conducted by Banco de México aims at procuring the stability of the purchasing power of the national currency. Furthermore, this Central Institute seeks to achieve its mandate at the lowest possible cost to society in terms of economic activity. In the last few years, there has been significant progress in the creation of a low and stable inflation environment in Mexico. Thereby, after having converged to the permanent 3 percent target and even locating below this target since May 2015, headline inflation decreased further and registered new historical minimum levels in the quarter subject of this Report. To this performance of inflation contributed the monetary policy stance, lower than expected economic growth and the direct and indirect effects on inflation of the price reductions of widely used inputs, such as energy products, commodities and telecommunication services. Several of these reductions resulted from the implementation of structural reforms. Looking forward, inflation is expected to continue locating below 3 percent for the rest of 2015.

The favorable evolution of inflation has been achieved in a difficult economic environment. Domestically, economic activity kept growing at a moderate pace, due to which slackness prevailed in the economy and consequently, no aggregate demand-related pressures on prices were present. Meanwhile, the relative prices adjustment, associated with the national currency's depreciation, in response to significant external shocks has mainly been reflected in durable goods' prices. In the external domain, uncertainty with respect to the normalization process of the U.S. monetary policy remains. Furthermore, global growth remains at low levels and there is greater concern regarding the depth of China's deceleration, all of which has further negatively affected commodity prices. This contributed to the fact that volatility in international financial markets continued being high and that investors' risk aversion increased during the reference quarter. This has been reflected in financial assets' price drops globally, especially in emerging economies' currencies and stock indices worldwide. In the Mexican case, the MXN/USD exchange rate absorbed great part of the adjustment, registering high volatility with a depreciatory trend in the third quarter, even though this trend partially reverted in October. In light of this, inflation expectations remained well-anchored and the exchange rate pass-through onto prices was very low. Taking these elements into account, in the period covered by this Report, the Board of Governors maintained 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 support the convergence of inflation to the permanent 3 percent target.

During the third quarter of 2015, the Mexican economy continued growing, but at a moderate rate. In particular, the external demand maintained a weak performance. As to domestic spending, at the beginning of this period investment showed less dynamism than in the second quarter. However, private consumption indicators exhibited a higher growth rate than in the previous quarter. In this context, conditions of slack persisted in the economy and thus, no pressures on prices in main input markets nor external accounts were perceived.

World economic activity continued weakening. The modest recovery in the advanced economies and the persistent deceleration in the emerging ones were reflected in the lower dynamism of international trade and financial markets. In front of this situation, a reduction in the growth outlook and an intensification of downward risks have been observed. Among these risks the possibility that a disorderly adjustment of the Chinese economy could have greater effects on the global economy stands out. Other reasons for concern have been the recession of Brazil, with extremely high inflation rates in the middle of a political crisis, and the problems that Turkey is undergoing. It should be pointed out that the deceleration of the emerging economies does not only respond to idiosyncratic factors, but also reflects the damage caused by a long period of below-potential growth in most of the advanced economies.

In this environment, a high volatility in international financial markets was registered. The possible impact of lower global growth, particularly in emerging economies, on the growth and inflation outlook of advanced economies, generated higher uncertainty regarding their possible economic policy actions. In particular, it stands out that market players anticipate a delay in the normalization process of the U.S. monetary policy and an increased easing in other advanced economies. In turn, the latent concern regarding the growth outlook of the Chinese economy and the doubts with respect to its economic policy also contributed to this environment of high instability, which negatively affected commodity prices. In response, during the reported quarter drops in financial assets' prices were observed globally, especially in the currencies of emerging economies and some commodity-exporting advanced economies, as well as in most countries' stock market indices. In fact, some emerging economies' central banks increased their reference interest rate due to a rebound of inflation, explained in some cases by the depreciation of their currencies in a context of macroeconomic vulnerability. However, global monetary conditions are expected to remain extraordinarily accommodative in the near future.

In light of the complicated global outlook, national financial markets were affected. Thus, the Mexican peso depreciated against the U.S. dollar, while government bonds' interest rates showed declines, although with certain volatility as well.

The macroeconomic scenario foreseen by Banco de México is:

**GDP Growth:** For 2015, considering the increased information regarding the evolution of the economy throughout the year, the width of the forecast interval for GDP growth in Mexico is reduced from one between 1.7 to 2.5 percent in the previous Report to one between 1.9 to 2.4 percent in the present Report. For 2016, GDP growth is expected to be between 2.5 and 3.5 percent, the same interval as in the previous Report. For 2017, the GDP growth rate is estimated to lie between 3.0 and 4.0 percent (Chart 1a).

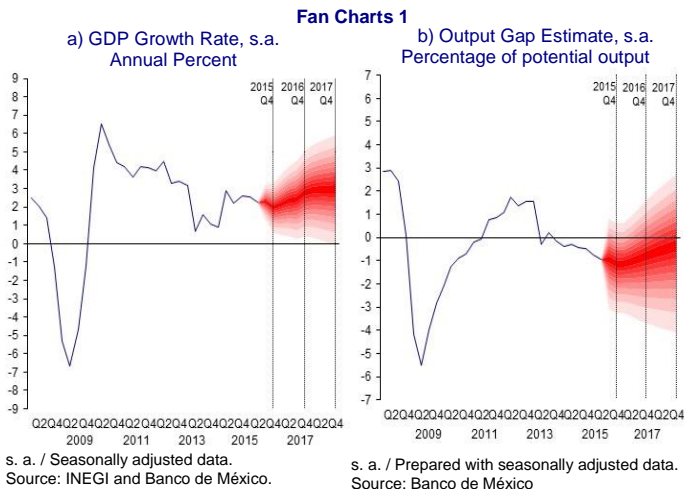
These forecasts of an upward trajectory of economic activity in the following years consider that U.S. industrial activity will register larger growth in 2016 as compared to the present year and an even more remarkable improvement in 2017. Likewise, subsequent progress in the implementation of structural reforms is considered to be reflected in a greater thrust for economic activity in Mexico.

**Employment:** For 2015, an increase of between 640 and 710 thousand IMSS-insured jobs is expected, compared to the expectation of an increase of between 560 and 660 thousand jobs in the previous Report, given the better than expected performance of this indicator so far this year and the fact that its recovery has been more vigorous than that of economic activity. For 2016, also considering this dynamism to be higher than that of the economy, the expected increase in the number of IMSS-affiliated jobs is revised upwards to between 630 and 730 thousand, compared the one foreseen in the previous Report of between 600 and 700 thousand. For 2017, an increase of between 660 and 760 thousand work posts is anticipated.

**Current Account:** For 2015, trade balance and current account deficits of USD 9.4 billion and of USD 30.3 billion are expected, respectively (0.8 and 2.6 percent of GDP, in that same order). For 2016, trade balance and current account deficits of USD 6.6 billion and USD 29.8 billion, respectively are foreseen (0.6 and 2.5 percent of GDP, in that order). For 2017, trade balance and current account deficits of USD 9.4 billion and USD 34.9 billion are expected, respectively (0.7 and 2.7 percent of GDP, in the same order).

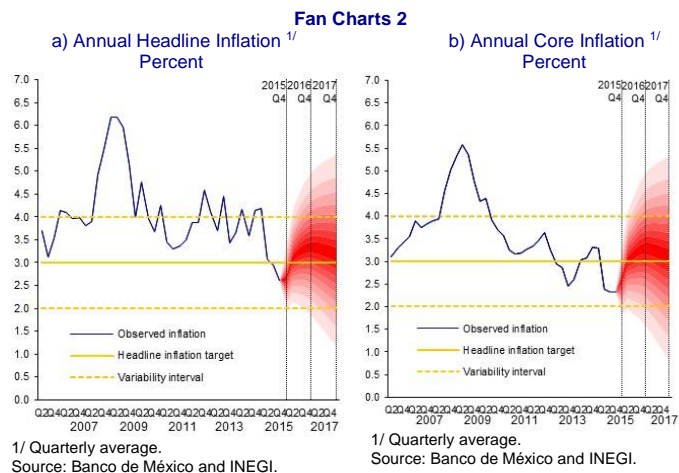
## Summary

In a context of moderate growth, no aggregate demand-related pressures on inflation or external accounts are expected. In particular, the output gap is anticipated to remain negative in the forecast horizon, although gradually closing (Chart 1b).



Mexico's GDP growth scenario is subject to different risks. Among the downward risks are the following: i) a delay in the recovery of the U.S. industrial sector; ii) a new drop in Mexico's oil production and/or its price; iii) a deterioration in international financial market conditions, propitiating an increase in firms' financial costs; iv) 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, and v) less dynamism of the automotive sector, given the problems that some of the sector's participants have experienced at the global level. Among the upward risks, the following stand out: i) a better progress in the implementation of the structural reforms, and ii) a faster than expected U.S. recovery.

**Inflation:** Considering the slack presented by the economy and the absence of demand-related pressures on prices, headline as well as core inflation are expected to remain below 3 percent in the rest of 2015. For 2016, both indicators are anticipated to observe an increase, locating at levels close to 3 percent. This would reflect the vanishing of the effect of favorable supply shocks that took place in 2015 and the impact of the exchange rate depreciation on some product prices, rather than a widespread deterioration of the price formation process. For 2017, these effects are anticipated to vanish and a moderate downward trend is expected, locating headline and core inflation at the end of that year closer to 3 percent (Chart 2a and Chart 2b). The forecast for the inflation trajectory might be affected by some risks, among which the following stand out. Among the upward risks, that, in face of a new deterioration of international financial market conditions, the Mexican peso returns to a depreciatory trend, propitiating price increases in a broad set of goods and services, derived from a contamination of inflation expectations. It is important to note that, just as in the past, Banco de México will be alert to avoid this from happening. Among the downward risks are i) a lower than expected dynamism of economic activity; ii) that some widely used inputs continue exhibiting price decreases, in some cases as a result of the implementation of structural reforms; and iii) that the national currency reverts part of the depreciation accumulated in the previous months.



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, as well as 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.

Considering the complex international environment and the expectations that it will persist in the future, it is fundamental to maintain a solid macroeconomic framework. Therefore, it is necessary, in addition to the timely adjustment of the monetary policy stance, to concretize the recently proposed efforts in the fiscal environment, as well as to 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 of interest rates remains at low levels. This will be fundamental in an external environment of increasingly stringent financial conditions. Thereby, it will be possible to make further progress in the consolidation of a more solid and resistant economy.

The outlook described in this Report stresses the importance of focusing on the generation of domestic sources of growth for Mexico. In this sense, the approval of the structural reforms was a step in the right direction. In the short term, these reforms can have a significant effect on investment, as it has already started to be observed, and that is expected to continue in the next years. However, their greater contribution is expected to occur in the long term. An adequate instrumentation would imply a profound change in the economy's functioning, modifying the incentives of economic agents and propitiating an environment of increased competition that balances the opportunities of market participation. Furthermore, these reforms, correctly implemented, could achieve an increase in human capital and would facilitate the adoption of new technologies. This, together with the also-to-be-expected improved resource allocation, would allow reaching a higher productivity growth. However, this process may take time. Thus, although their favorable effects may not be immediately evident, it is necessary to persist in their adequate implementation and to be vigilant towards the continuation of the change process.

Finally, as mentioned in previous occasions, it is necessary to strengthen institutions and the rule of law, which would clearly imply an appropriate legal framework, but especially, its enforcement and full compliance. It should be noted that this strengthening also requires constant effort from society for its results to be reflected in a greater economic growth that leads to increased welfare for the entire population.