Quarterly Report

October – December 2016

Summary

During 2016 as a whole, the Mexican economy faced a challenging external environment, which deteriorated throughout the year. In particular, high volatility persisted as a consequence, among other factors, of uncertainty related to the process of the monetary policy normalization in the U.S., as well as to the elections held at the end of the year in that country and their outcome. This has led to an adjustment in international financial markets' portfolios, which strongly affected the national markets and as a result of which asset prices dropped and high volatility was observed. The effect of this context on domestic financial markets was especially noticeable in the last quarter of 2016 and over the first weeks of January 2017, given the relevance that the outcome of the referred elections could represent for Mexico in light of the different elements of the possible economic policy implemented by the new U.S. administration. Thus, at the end of the year the national currency depreciated considerably and interest rates in Mexican pesos increased for all terms, while at the end of January and in February both the exchange rate and interest rates have registered a considerable reversion. As regards the exchange rate, this reversal was contributed to by the monetary policy actions undertaken by the Central Bank and the measures recently announced by the Foreign Exchange Commission. The impact of this environment on the performance of the exchange rate prompted an increase in core inflation, mainly its merchandise subindex, as a reflection of the gradual change in relative prices induced by the depreciation. As a result of this performance, and the increments in non-core inflation at the end of the year, as of October 2016 headline inflation slightly exceeded the 3 percent target, after persisting below this level for 17 consecutive months, and closed the year at 3.36 percent. Additionally, in January 2017 the upward trend in headline inflation was exacerbated by the impact of the adjustments in some energy prices, mainly gasoline, attaining an annual rate of 4.72 percent in that month and 4.71 percent in the first fortnight of February.

As a result of this environment, inflation expectations increased, especially short-term ones, while medium- and long-term expectations rose to a much lesser extent, fundamentally reflecting a temporary increase in inflation. Thus, in order to prevent contamination to the price formation process in the economy, to anchor inflation expectations and to strengthen the inflation convergence to its target, the Board of Governors decided to increase the target for the Overnight Interbank Interest Rate by 50 basis points in each of its decisions of November and December 2016, and in February 2017, thus reaching a level of 6.25 percent. These actions were taken while procuring that the adjustment in relative prices, which derived from the real exchange rate depreciation, and, in the case of the latter decision, also from other supply shocks, was orderly. It should be noted that the main challenge faced by the Board of Governors in the future is to prevent second round effects on inflation and to maintain medium- and long-term inflation expectations anchored.

During the fourth quarter of 2016 the world economic activity kept recovering. In particular, the U.S. economy continued expanding and the labor market kept strengthening. Meanwhile, despite still remaining below the Federal Reserve target, inflation went up. In this context, in its decision of February this Institute maintained the target range of the federal funds' rate unchanged. Nevertheless, it is anticipated that the process of the monetary stance normalization will be carried out at a faster rate as compared to that expected prior to the meeting of December, partly as a consequence of the new U.S. administration intention to undertake an ambitious fiscal expansion, as well as to implement a set of deregulation measures. In the Euro zone, the U.K. and Japan, a greater dynamism of the economic activity was observed and inflation rebounded, reason why deflationary concerns in these economies subsided, as a result of which less accommodative monetary policies may be adopted in the referred countries. On the other hand, emerging economies faced a highly uncertain environment, in particular given the fiscal, trade and migration policies contemplated by the new U.S. administration. This could cause lower trade and foreign direct investment at the global level, and, along with a faster-than-expected rate of the monetary policy normalization of the Federal Reserve, it could trigger a tightening of the global financial conditions.

As regards the domestic economy, in the fourth quarter of 2016, productive activity kept expanding, although at a lower rate with respect to the previous quarter. In particular, external demand continued recovering, and private consumption maintained a positive trend. However, investment performance remained weak. In this context, significant aggregate demand-related pressures onto prices have not been observed yet. Furthermore, a significant drop in the trade balance and current account deficits has been registered. Nevertheless, the improvement in the labor market has translated into higher labor unit costs, while they are persisting at low levels relative to those observed prior to the global financial crisis. In this juncture, for 2016 as a whole the Mexican economy grew 2.1 percent based on seasonally adjusted data (2.3 percent based on data without seasonal adjustment).

The environment of uncertainty currently faced by the national economy makes it especially relevant for the authorities to strengthen the macroeconomic fundamentals of the country, consolidating public finances and adjusting the monetary policy stance at a timely fashion, while at the same time promoting an adequate implementation of structural reforms. In this sense, the favorable results observed in the fourth call of Round One of public tenders in hydrocarbon exploration and extraction and in the first call to formalize partnerships of private sector with Pemex, as well as the liberalization of gasoline prices should be mentioned, as they represent progress in strengthening the macroeconomic framework of the country. In particular, the referred liberalization stands out due to reduced vulnerabilities it represents for public finances, as maintaining public prices that are misaligned in reference to their international counterparts is not sustainable. Furthermore, a solid fiscal stance is essential to strengthen the macroeconomic framework and it helps to reduce the perception of risk in the economy, creating an environment more conducive to growth and price stability in the medium and long terms. In this context, the Federal Government's goal to attain a primary surplus in public finances in 2017 plays a key role.

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

GDP Growth Rate: Global economic growth forecasts, and in particular those for the U.S. economy, still point to a gradual recovery over the coming years. However, these expectations do not seem to fully incorporate possible adverse effects on the global economic activity and trade, as a consequence of certain protectionist policies being pursued by the new U.S. government. Indeed, despite the still prevailing uncertainty regarding the specific measures, the economic policy proposals mentioned by the said government in reference to Mexico already tend to signal that, to a certain degree, it will take actions that would hinder the relations between the two countries. This environment has already affected consumers' and businesses' confidence, foreign direct investment and workers' remittances to Mexico. Therefore, the central growth scenario presented in this Report incorporates a certain deterioration in the expected trade flow between Mexico and the U.S. and a reduced foreign direct investment with respect to that previously expected. However, the negative effect of the above is estimated to be partially offset by the boost provided by the structural reforms and by an environment more conducive to growth, derived from the soundness of the macroeconomic framework. Thus, the GDP growth rate for 2017 is expected to lie between 1.3 and 2.3 percent (between 1.5 and 2.5 percent in the previous Report). For 2018, the forecast range has been adjusted downwards from between 2.2 and 3.2 percent to between 1.7 and 2.7 percent (Chart 1a).

Employment: For 2017 an increment of between 580 and 680 thousand jobs in IMSS-affiliated employment is expected, as compared to an increase of between 600 and 700 thousand jobs in the previous Report. Likewise, for 2018 the number of IMSS-affiliated jobs is expected to grow between 620 and 720 thousand jobs (an increment of between 650 and 750 thousand jobs, as published in the previous Report).

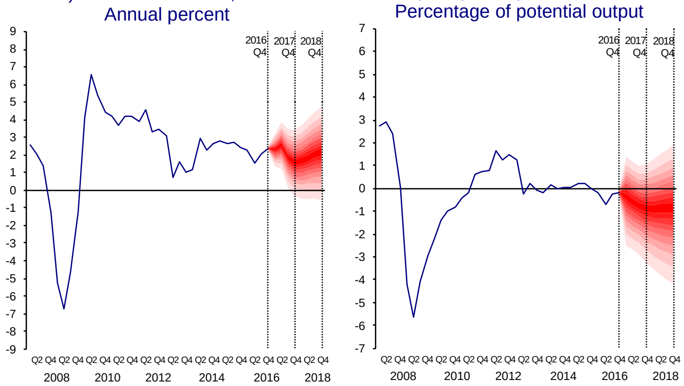
Current Account: For 2017, deficits in the trade balance and the current account of USD 10.1 and 26.5 billion are anticipated, respectively (1.0 and 2.7 percent of GDP, in the same order). For 2018, deficits in the trade balance and the current account are estimated to amount to USD 9.0 and 27.8 billion, respectively (0.9 and 2.7 percent of GDP, in the same order).

Considering these forecasts, no aggregate demand-related pressures onto prices are anticipated (Chart 1b).

Fan Charts 1

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

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



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

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

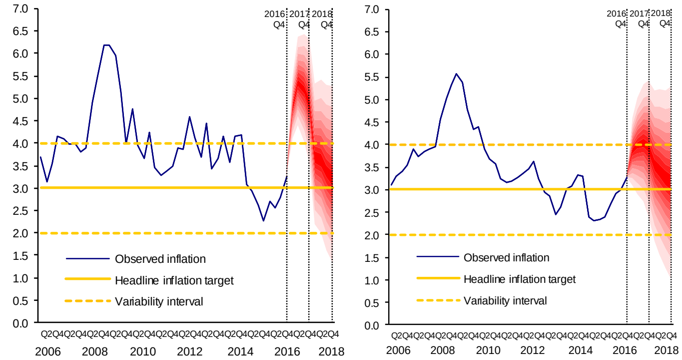
The balance of risks for the growth scenario in Mexico is still biased to the downside. Among downward risks, the following stand out: i) that different enterprises may decide to cancel or postpone their investment plans in light of the recent events in the U.S.; ii) that a highly protectionist trade or fiscal policy may be implemented in the U.S., affecting Mexican exports to the said country and leading to a further deterioration of consumers' and businesses' confidence; iii) that the rating agencies may reduce the credit rating of the country, thus affecting investment flows to Mexico; iv) that workers' remittances to Mexico may be lower than expected, possibly as a consequence of the policies impeding their transfers or of a smaller number of jobs for Mexicans in the U.S.; v) that episodes of high volatility in international financial markets may be observed, hence possibly reducing the sources of financing to Mexico. Among upward risks, the following are noteworthy: i) that the implementation of structural reforms may render higher-than-expected results; ii) that given the recent exchange rate depreciation, non-oil exports may observe a more notorious recovery; iii) that the implementation of the expansionary fiscal policy in the U.S. may have a net positive impact on the Mexican industrial production and the transfer of workers' remittances to the country; iv) that the forthcoming negotiations of the Free Trade Agreement with the U.S. may reach a favorable outcome.

Inflation: It is estimated that during 2017 headline inflation will exceed the upper limit of the variability interval of Banco de México's target, even though during the last months of that year it is expected to resume its trend of convergence towards the target and will lie close to 3 percent in late 2018. Thus, during this year inflation is anticipated to be temporarily affected by both the changes in relative prices of merchandise with respect of those of services, as a result of the depreciation of the real exchange rate, and the transitory impact of the liberalization of gasoline prices. Likewise, in 2017 core inflation is also estimated to remain at levels above the permanent 3 percent target and in late 2017 and in 2018 it is expected to resume its trend of converging to the permanent Banco de México's target. It is anticipated to occur once the effects of the afore mentioned shocks start dissipating and the monetary policy measures that have already been implemented, as well as those adopted in the remainder of 2017, take effect (Charts 2a and 2b).

Fan Charts 2

a) Annual Headline Inflation 1/
Percent

b) Annual Core Inflation 1/
Percent



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

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

The balance of risks for inflation is considered to have continued deteriorating. Among upward risks, the following should be mentioned: i) that the number of shocks that have occurred may increase the probability of second round effects onto inflation; ii) that inflation expectations may rise even further as a consequence of additional depreciations of the national currency, derived from uncertainty still prevailing in the external environment or that, given the national currency depreciation, its pass-through onto prices may increase; iii) higher prices of agricultural products, even though their impact onto inflation is expected to be transitory. Among downward risks, these should be listed: i) a possible appreciation of the national currency; ii) further reductions in different prices of the economy, as a consequence of the structural reforms; iii) that the future performance of the international references and a higher competition among gasoline and other fuels' suppliers in the country would lead to lower prices of these products; iv) that the national economy may decelerate more than estimated.

In this context, in the future the Board of Governors will closely monitor the evolution of all inflation determinants and its medium- and long-term expectations, especially the possible pass-through of exchange rate adjustments and gasoline prices onto the rest of prices. Likewise, it will be watchful of the monetary position of Mexico relative to the U.S., and the evolution of the output gap. This will be done in order to continue taking the necessary measures to consolidate the efficient convergence of inflation to its 3.0 percent target.

Regardless of any external developments, Mexico should continue boosting its competitiveness in the international arena and enhance its growth potential in the domestic market. In this sense, the commitment to implement the approved structural reforms in an adequate and timely manner and to persevere with the fiscal consolidation efforts should be a priority. The strengthening of both the microeconomic functioning of the economy and its macroeconomic soundness will allow Mexico to become a more attractive investment destination. Moreover, it is imperative to strengthen the rule of law and to guarantee legal certainty, so as to propitiate a more favorable environment for growth. This has gained even more relevance in view of the challenge faced by Mexico derived from the U.S.' intended economic agenda. In the same vein, even though the trade integration of North America has indeed benefitted all members of the block and that further deepening the economic relations could boost the competitiveness of the region, it is mandatory to maintain Mexico's trade openness and to seek greater diversification of destination markets for Mexican exports, as well as the sources of foreign direct investment and imports to the country.