



Quarterly Report

January – March 2015

May 19, 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

Conduction of the Monetary Policy

- The monetary policy implemented by Banco de México seeks to ensure stability of the national currency's purchasing power and has conducted to achieving an environment of **low and stable inflation** in Mexico.
- ✓ As a result, **inflation practically reached the 3 percent target during the period covered by this Report.**
- This was attained despite a complex environment faced by monetary policy in recent months.

Monetary policy faces the challenge of properly weighing both domestic and external factors that could affect inflation.

Domestic Conditions:

✓ Inflation has converged to its permanent 3 percent target.

✓ Inflation expectations remain well-anchored.

✓ No aggregate demand-related pressures onto inflation are anticipated.

External Conditions:

✓ A drop in the crude oil price.

✓ Uncertainty regarding the normalization of the U.S. monetary policy.

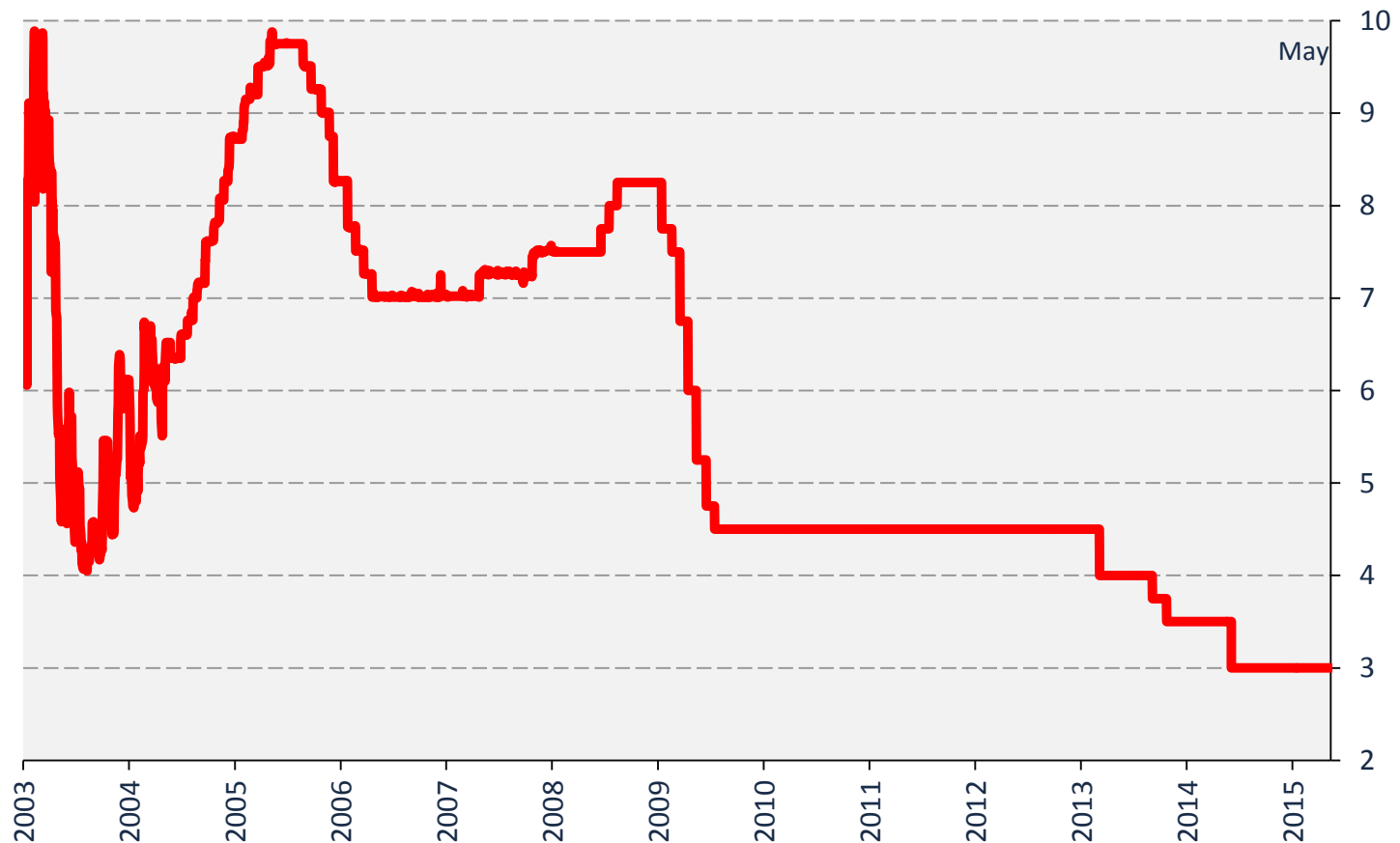
○ Volatility in financial markets and depreciations of most currencies against the USD, including the Mexican peso.

→ *Depreciation implies a risk to inflation that cannot be overlooked.*

During the reference period, the Board of Governors maintained the target for the Overnight Interbank Interest Rate at 3 percent, as the monetary stance was conducive to secure the inflation convergence to the permanent target.

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

%



1/ Before January 20, 2008 it refers to the observed Overnight Interbank Interest Rate. Source: Banco de México.

Outline

1 **Monetary Policy**

2 **External Conditions**

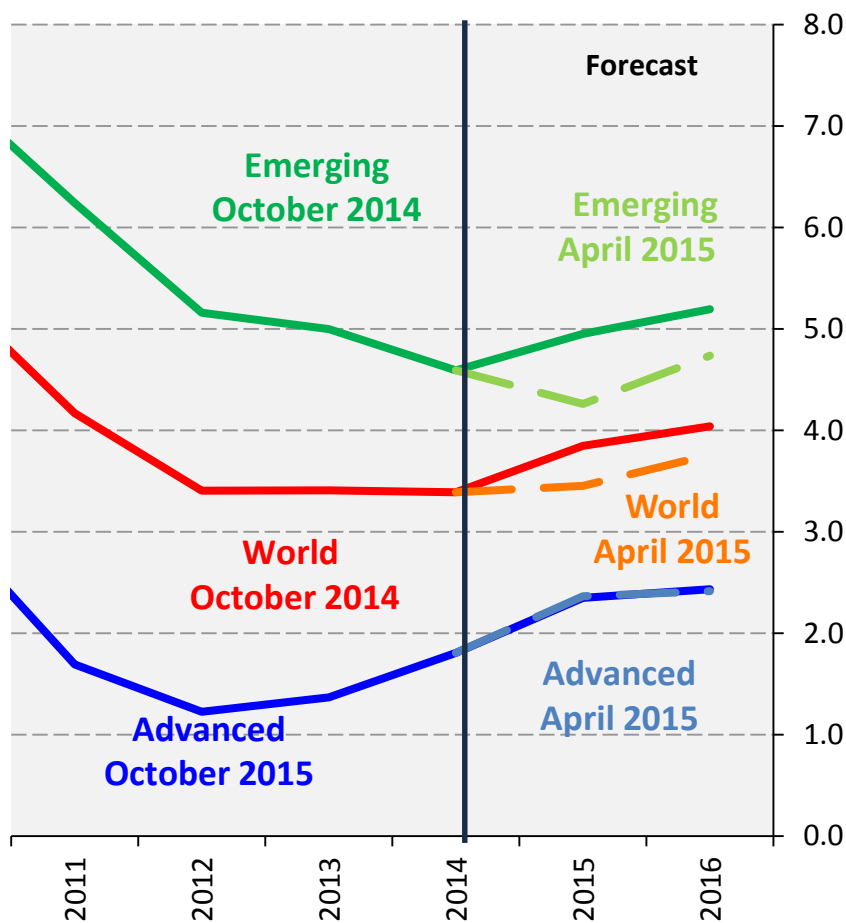
3 **Economic Activity in Mexico**

4 **Inflation Determinants**

5 **Forecasts and Balance of Risks**

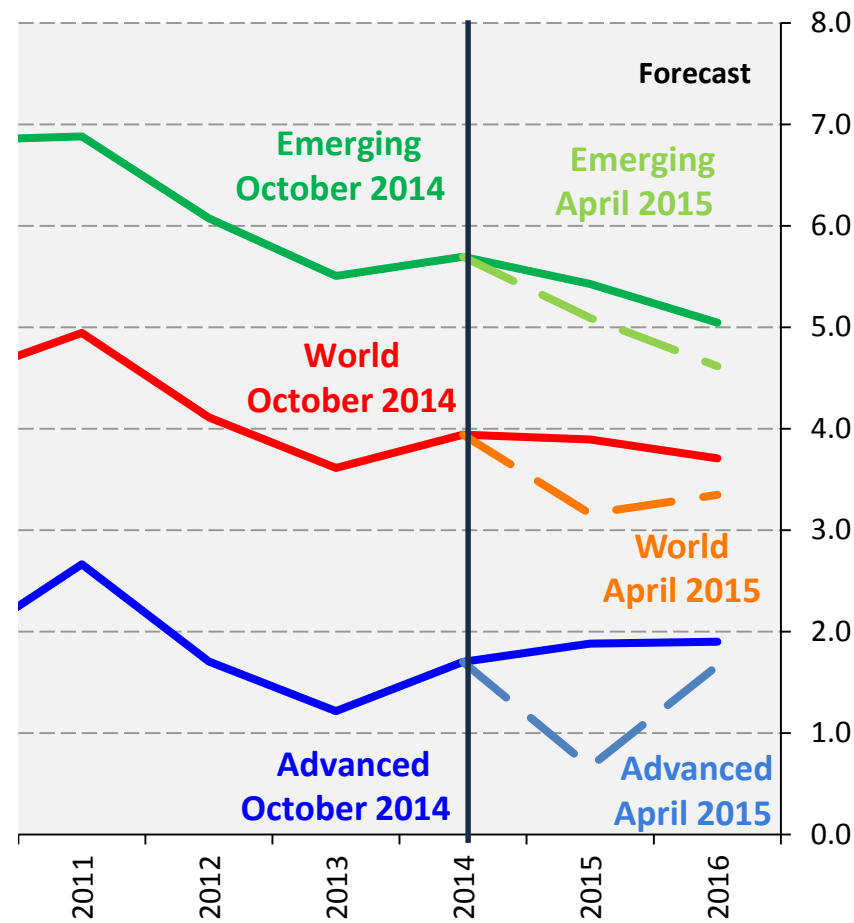
World economic activity remained weak in the first months of 2015, while global inflation showed a downward trend.

World GDP Growth
Annual % change



Source: IMF, WEO October 2014 and April 2015.

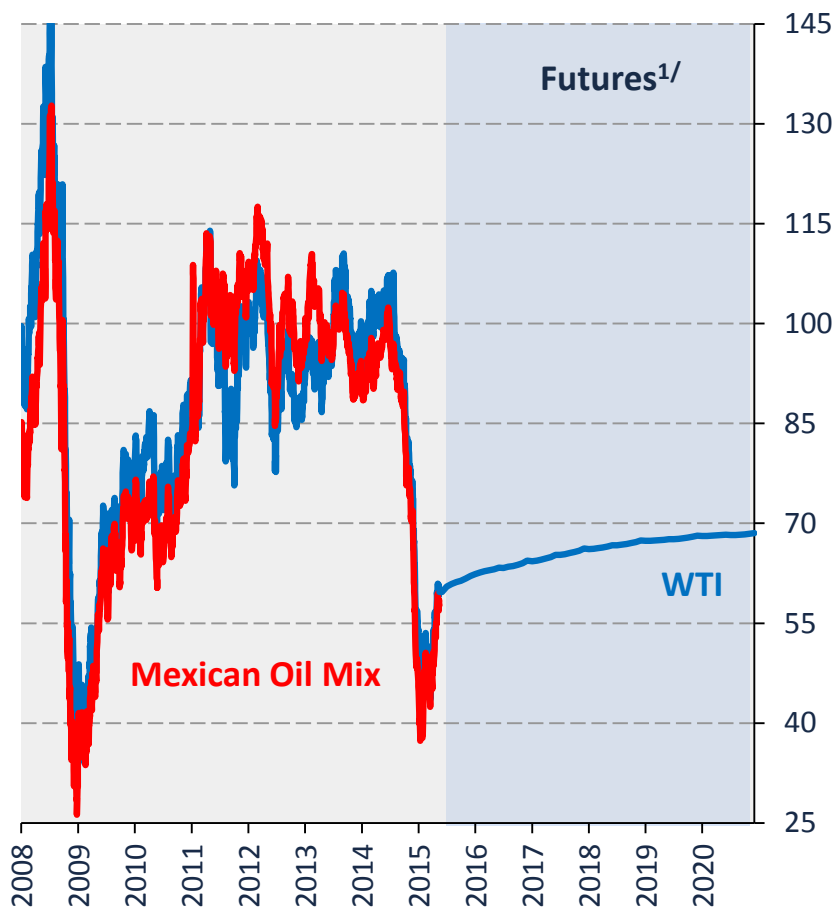
Headline Annual World Inflation
%



Source: IMF, WEO October 2014 and April 2015.

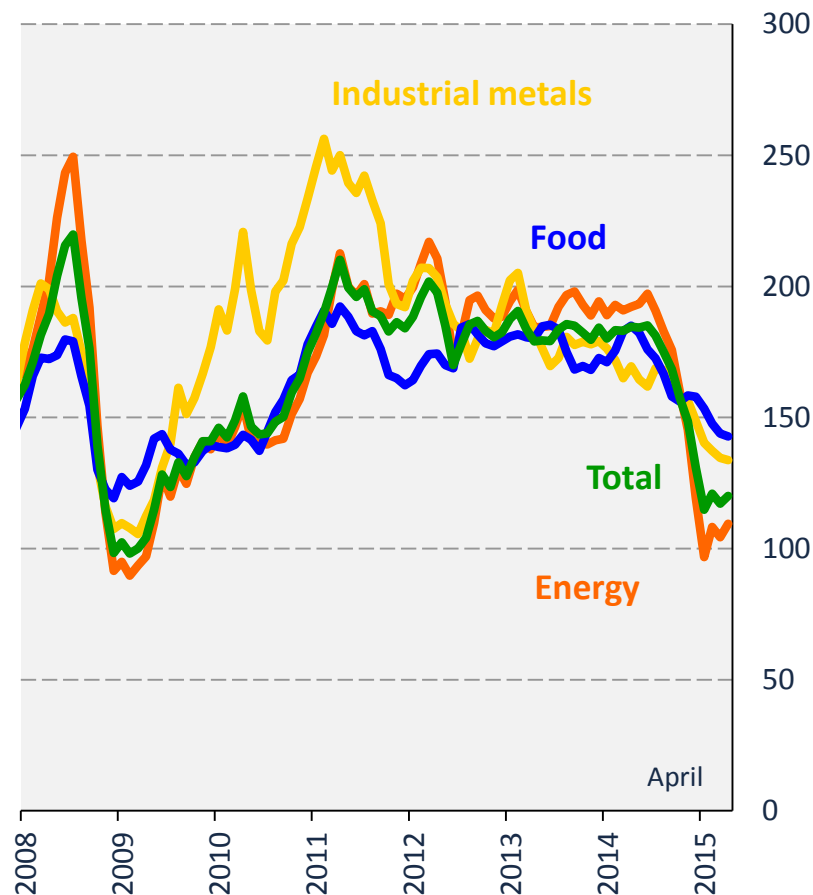
The downward trend of the world inflation derived from low crude oil prices, among other factors.

Crude Oil Prices
USD per barrel



1/ Data up to May 18, 2015.
Source: Bloomberg.

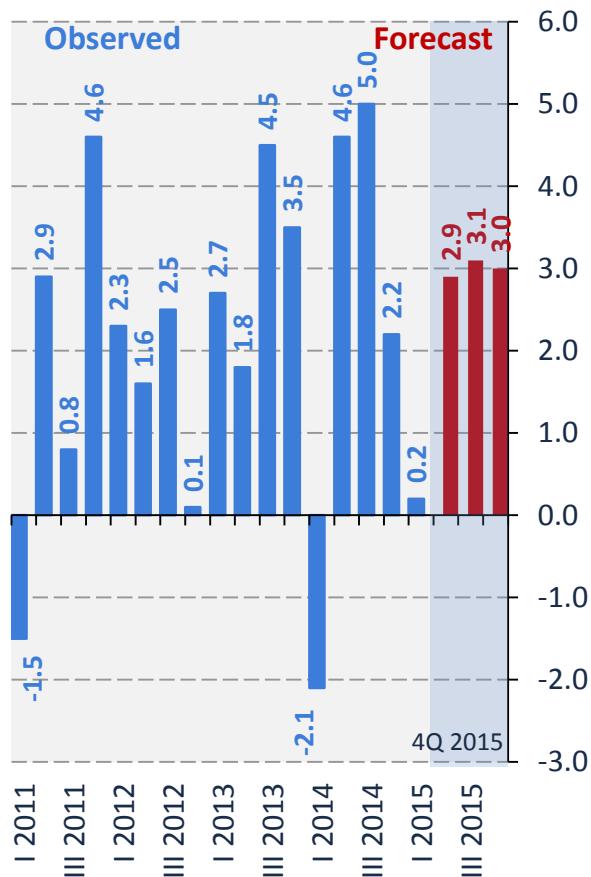
Commodities Prices
Index 2005=100



Source: International Monetary Fund.

In 1Q 2015, the U.S. economic growth decelerated more than anticipated by economic analysts due, in part, to transitory factors.

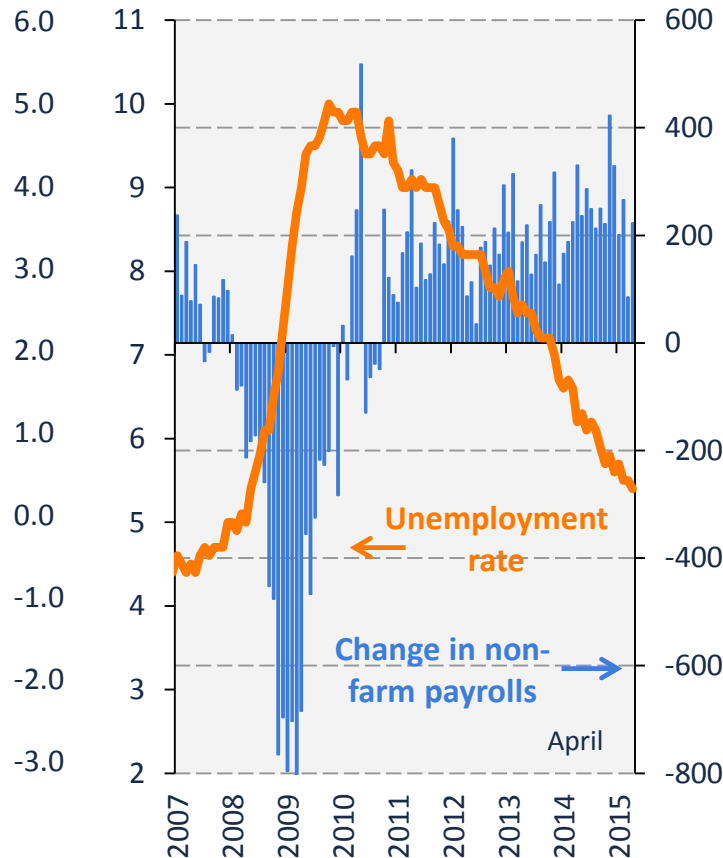
Gross Domestic Product
Quarterly % change at annual
rates, s. a.



s. a. / Seasonally adjusted data.

Source: Bureau of Economic Analysis (BEA) and Blue Chip.

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

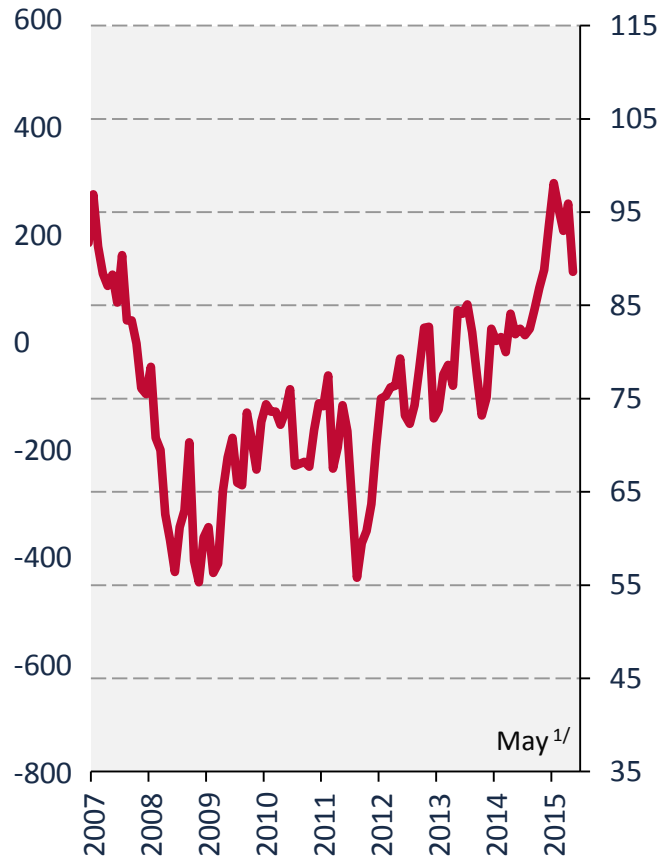


EAP/ Economically Active Population.

s. a. / Seasonally adjusted data.

Source: Bureau of Labor Statistics (BLS).

Consumer Confidence Index
Index 1966=100, s. a.



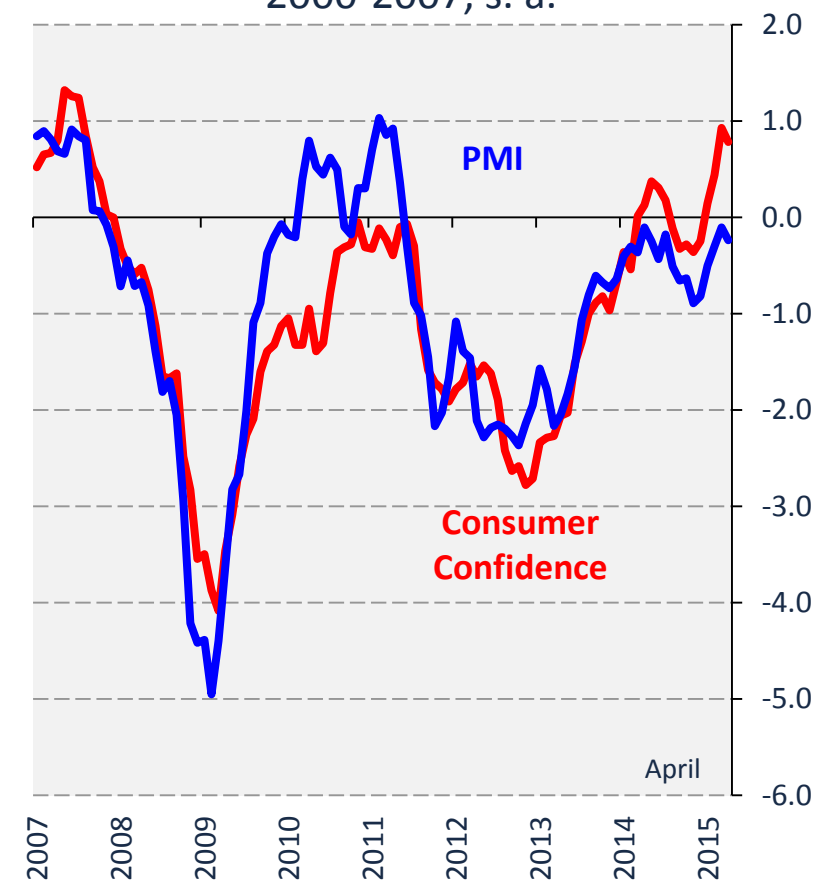
s. a. / Seasonally adjusted data.

1/ Preliminary data for May 2015.

Source: Michigan University.

Economic activity in the Euro zone registered a slight improvement, although starting from low levels.

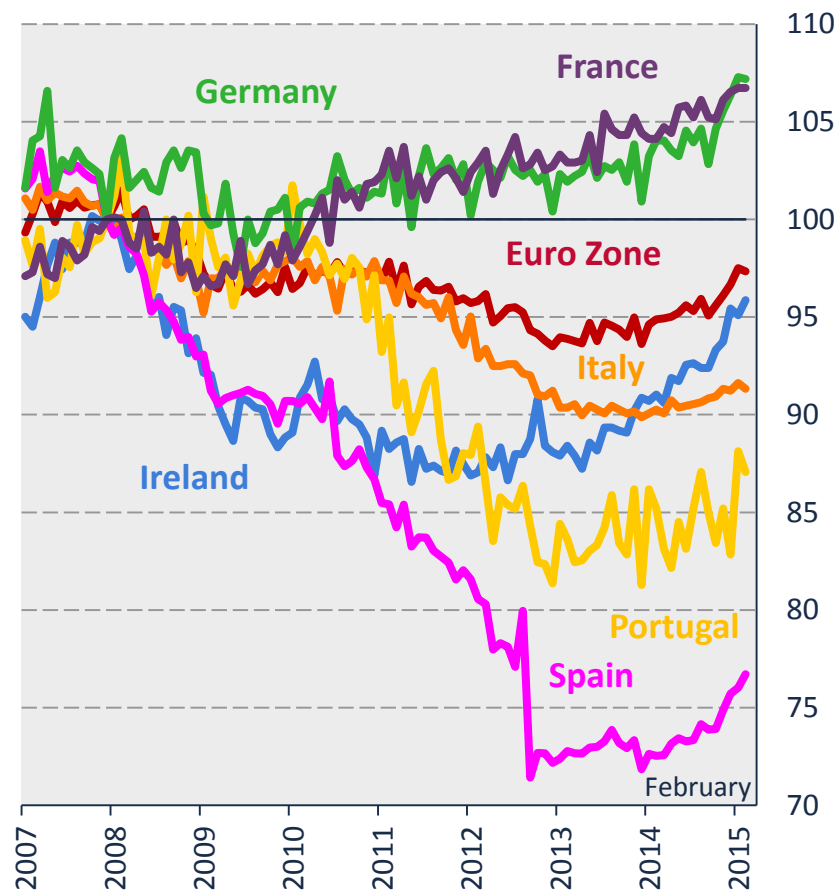
Consumer Confidence and Composite Purchasing Managers' Index
Standardized data from period 2000-2007, s. a.



s. a. /Seasonally adjusted data.

Source: Markit and European Commission.

Retail Sales ^{1/}
Index December 2007=100, s. a.

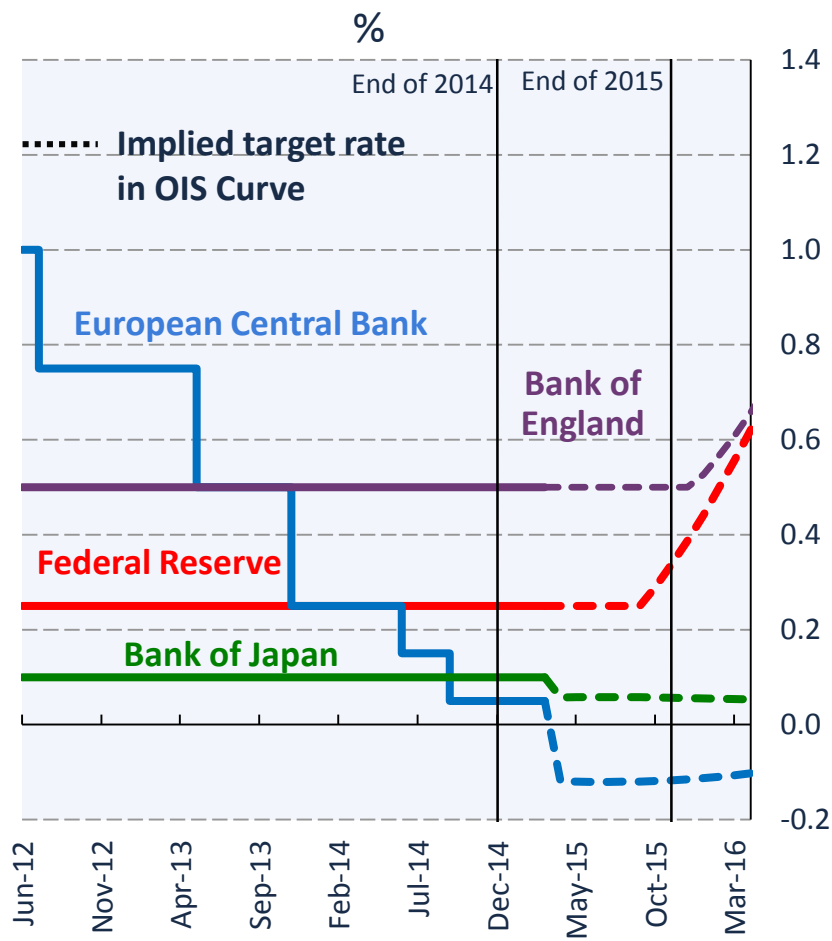


s. a. /Seasonally adjusted data.

1/ Excludes vehicles sales. Source: Eurostat.

It is still anticipated that the Federal Reserve will begin the process of its monetary policy normalization at some point of this year.

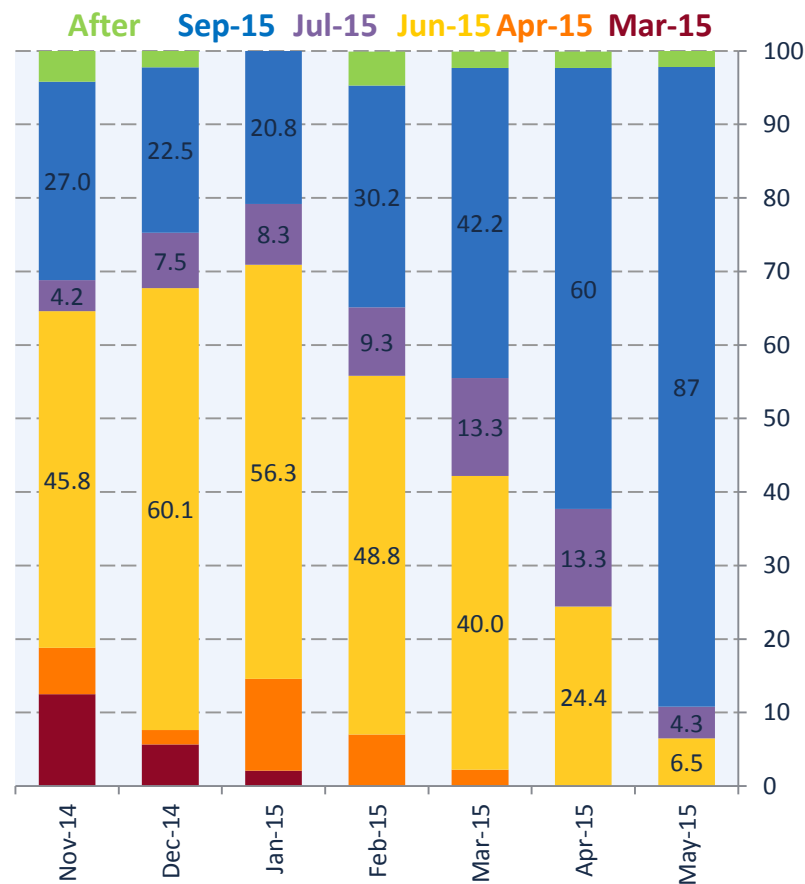
Advanced Economies: Expected Monetary Policy Rates ^{1/}



1/ The expected rates are the trajectories implicit in OIS Curves (Overnight Index Swap).

Source: Bloomberg with estimates from Banco de México.

United States: First Federal Funds Rate Hike Expectation ^{2/}



2/ The bars show the percentage of survey respondents from Blue Chip Financial Forecasts expecting the first increase in the federal funds rate at the appointed date. Source: Blue Chip Financial Forecasts.

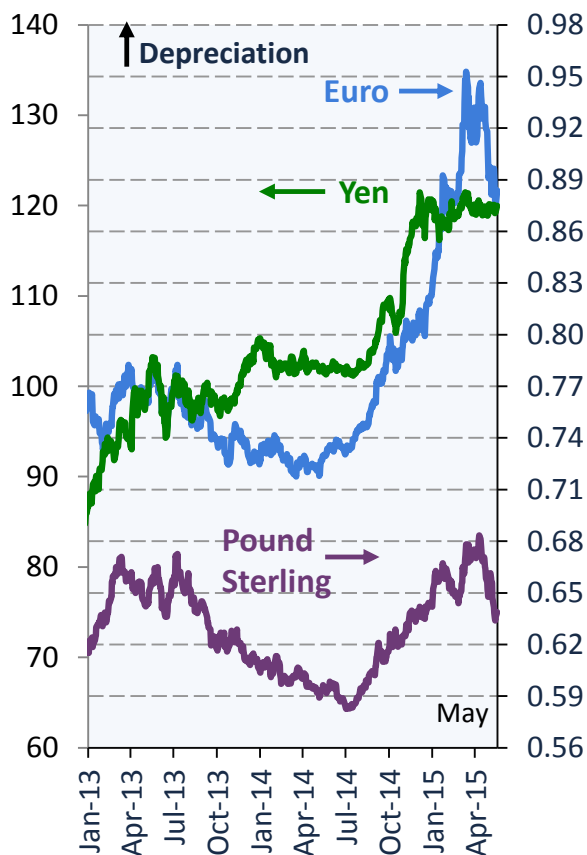
Differences in monetary policy stances resulted in a continued appreciation of the USD against most currencies for nearly all the 1Q 2015.

U.S. Dollar Index (DXY) ^{1/}
Index 1-Jan-2013=100



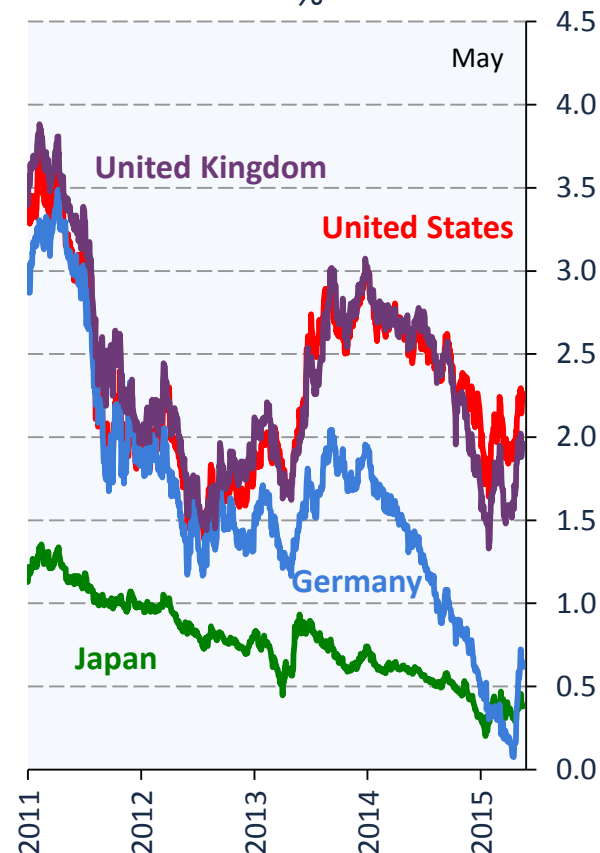
1/ DXY index is estimated by the Intercontinental Exchange (ICE) based on the weighted geometric mean of the dollar's value compared with a basket of 6 other major currencies which are: EUR: 57.6%, JPY: 13.6%, GBP: 11.9%, CAD: 9.1%, SEK: 4.2%, and CHF: 3.6%. Source: Bloomberg.

**Advanced Economies:
Nominal Exchange Rates**
Local currency per USD



Source: Bloomberg.

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

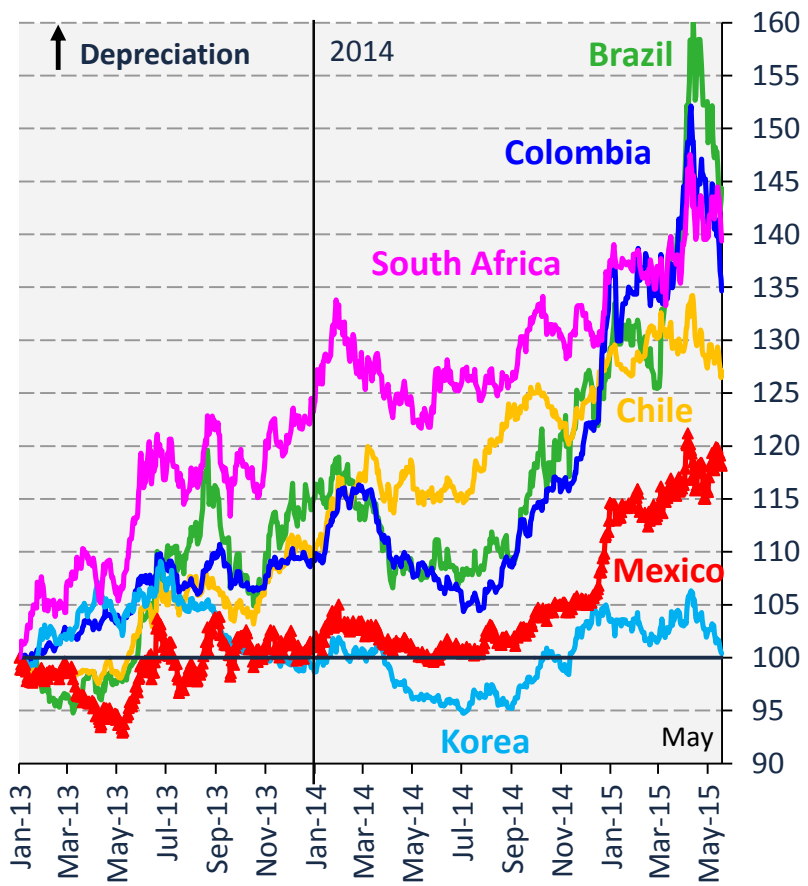


Source: Bloomberg.

The aforementioned has generated fears that, in case of abrupt changes in global portfolio allocations, considerable capital outflows in emerging economies may be observed.

Emerging Economies: Nominal Exchange Rate against USD

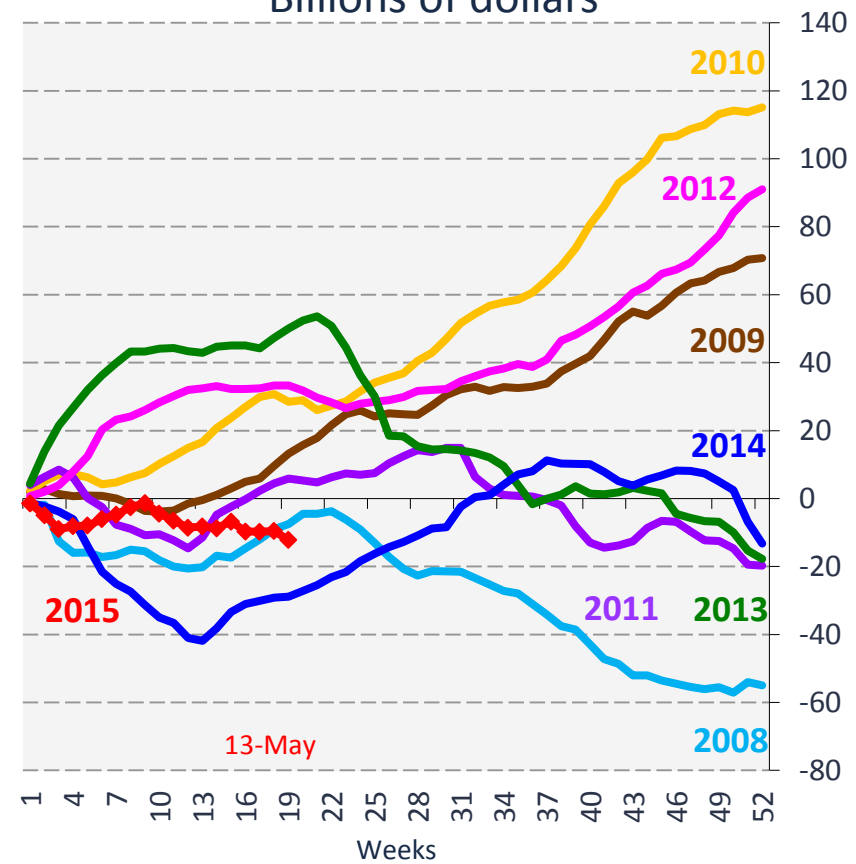
Index 01-Jan-2013 = 100



Source: Bloomberg.

Accumulated Capital Flows to Emerging Economies (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.

Outline

1 **Monetary Policy**

2 **External Conditions**

3 **Economic Activity in Mexico**

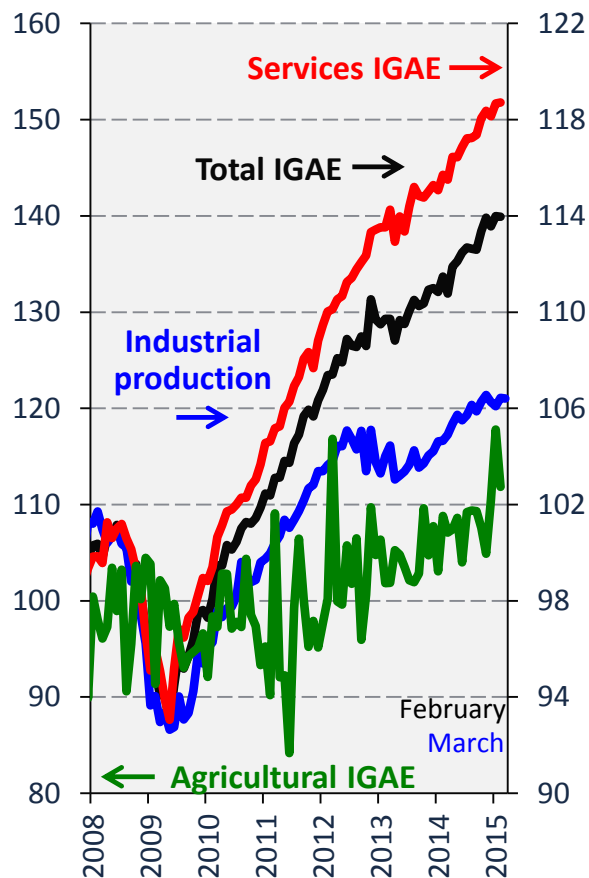
4 **Inflation Determinants**

5 **Forecasts and Balance of Risks**

In 1Q 2015, the Mexican economy continued showing a moderate growth rate.

Economic Activity Indicators

Index 2008 = 100, s. a.

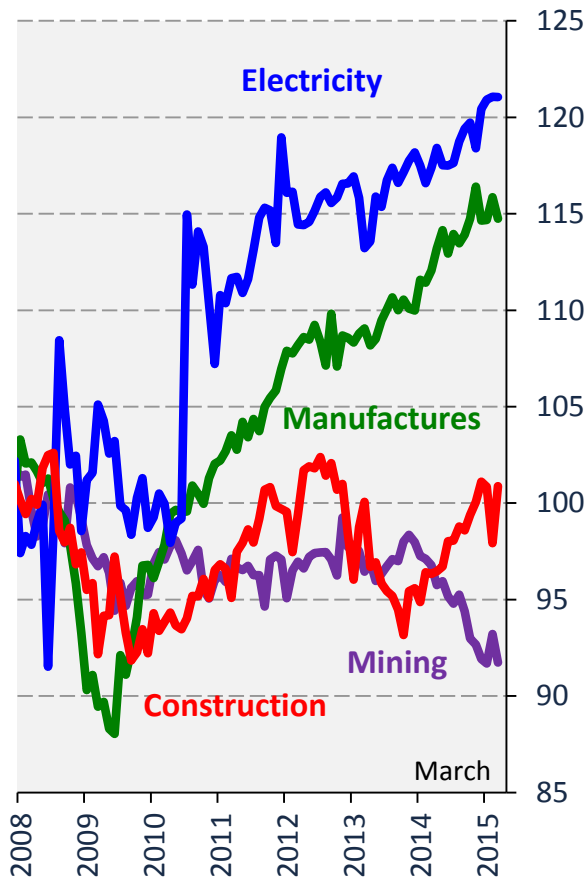


s. a. / Seasonally adjusted data.

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

Industrial Activity

Index 2008 = 100, s. a.

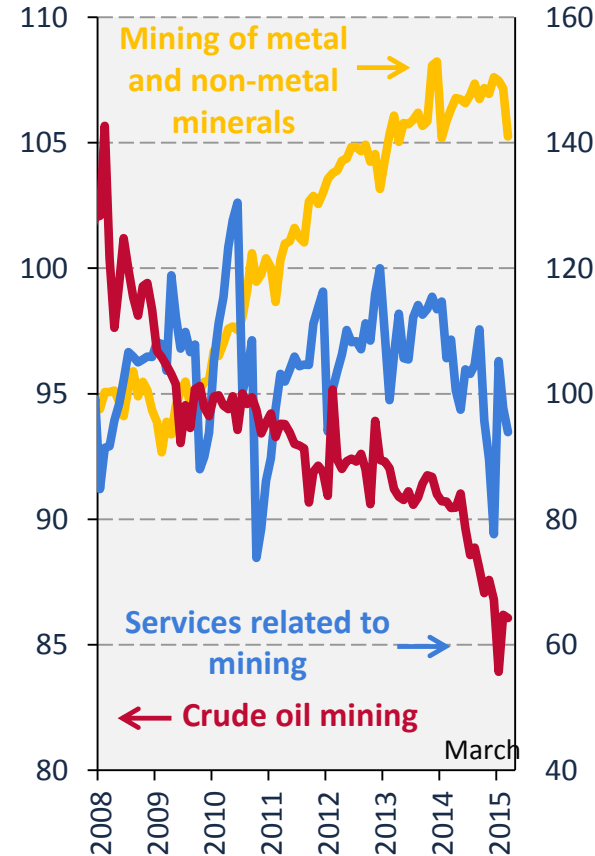


s. a. / Seasonally adjusted data.

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

Mining Sector

Index 2008=100, s. a.



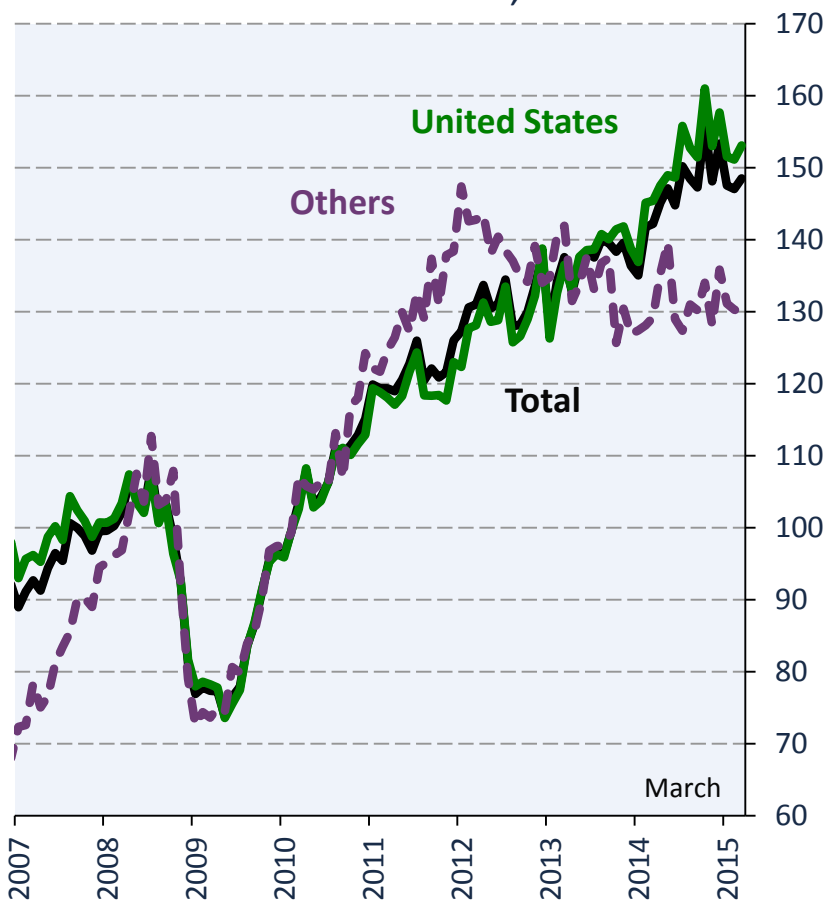
s. a. / Seasonally adjusted data.

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

Manufacturing exports lost dynamism, possibly as a result of the transitory factors that affected the U.S. economic activity.

Manufacturing Exports by Region of Destination

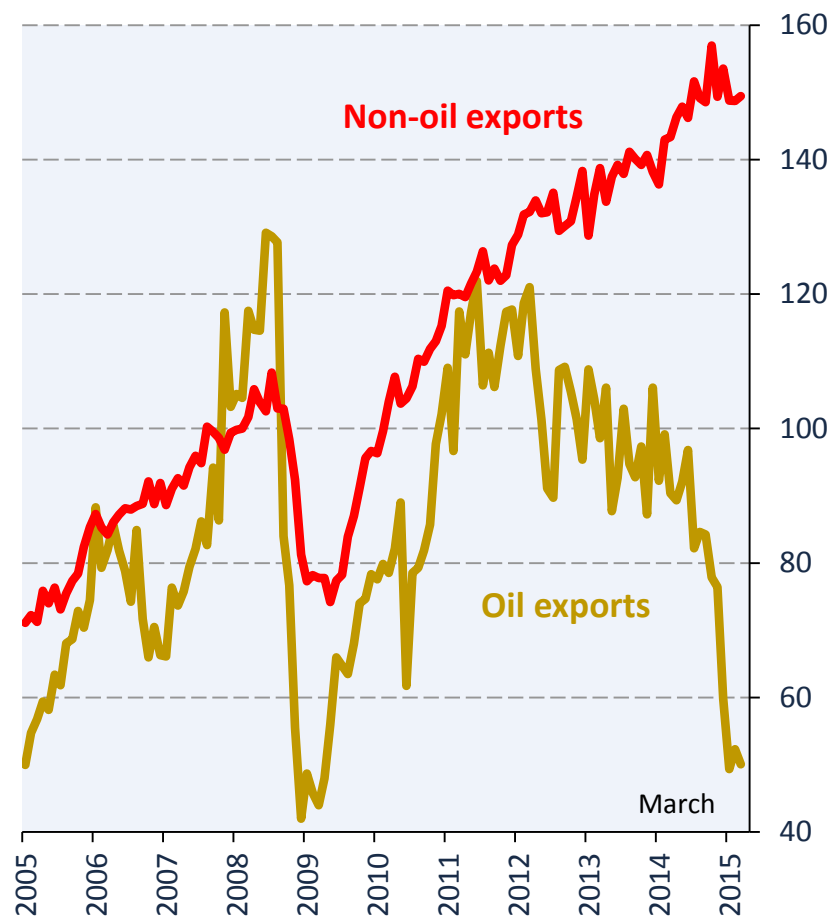
Index 2008=100, s. a.



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

Oil and Non-Oil Exports

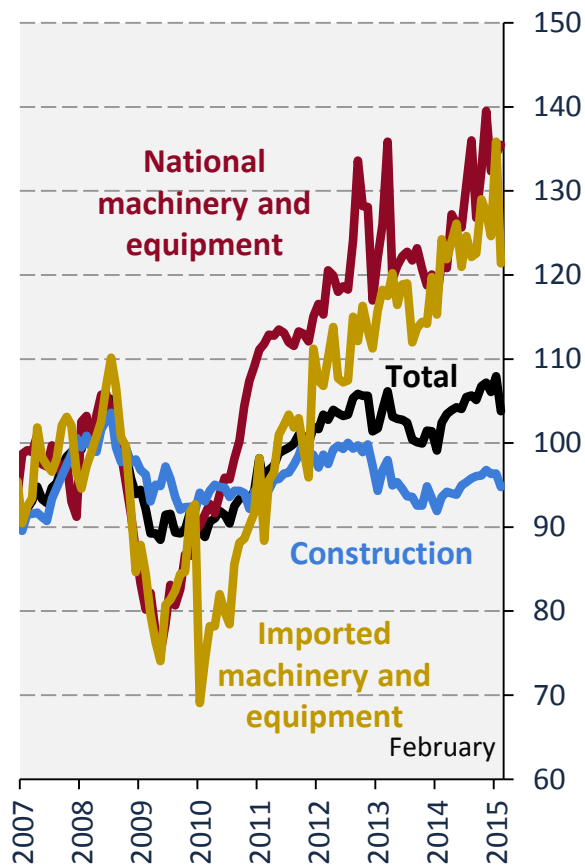
Index 2008=100, s. a.



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

In the first months of 2015, gross fixed investment lost dynamism as compared to the recovery that had been observed since 2Q 2014.

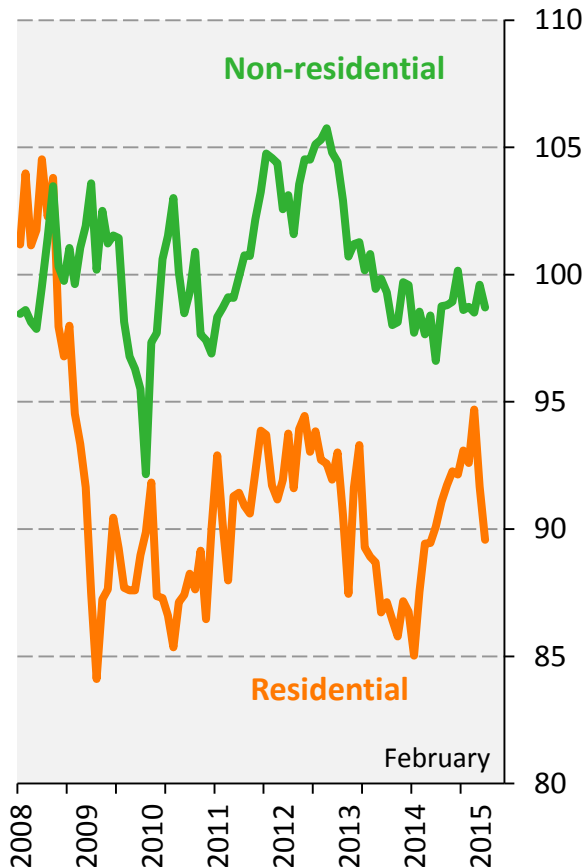
Investment and its Components
Index 2008=100, s. a.



s. a. / Seasonally adjusted data.

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

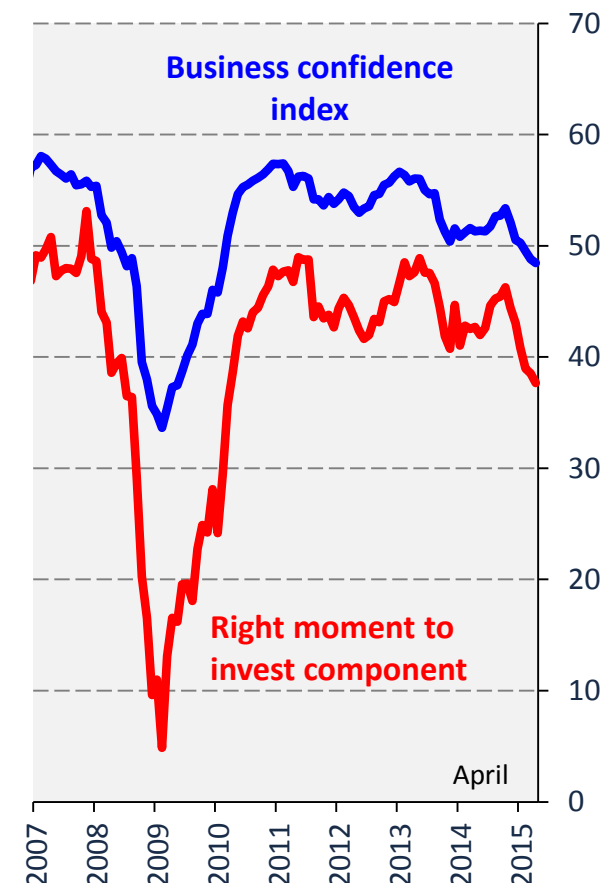
Residential and Non-Residential Construction Investment
Index 2008=100, s. a.



s. a. / Seasonally adjusted data.

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

Business Confidence Index
Index with respect to 50 points, s. a.

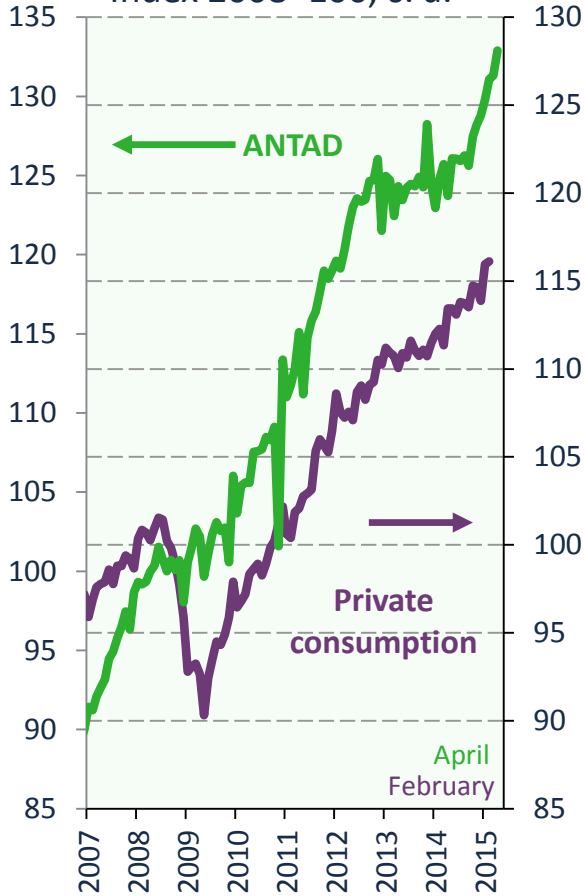


s. a. / Seasonally adjusted data.

Source: INEGI

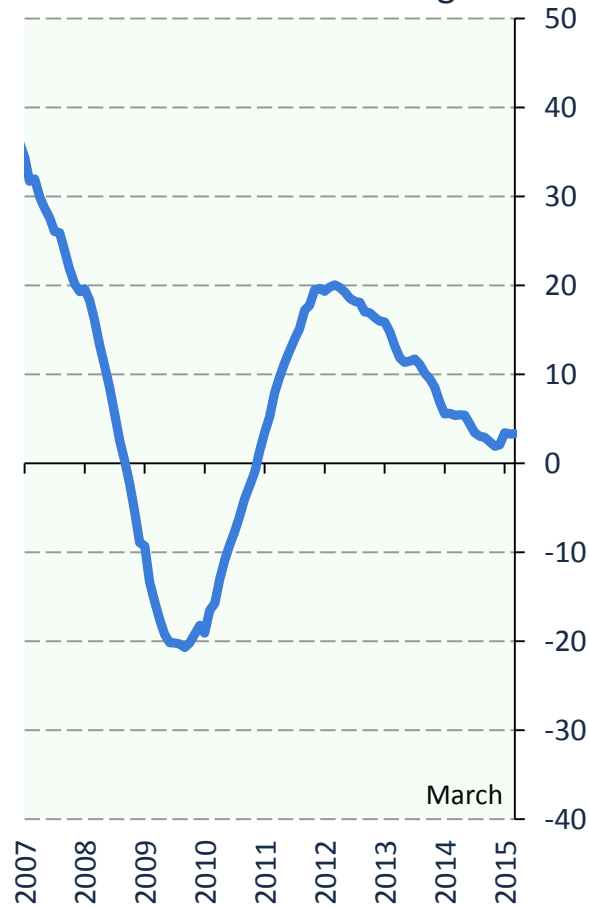
Some indicators suggest that in 1Q 2015 private consumption recovered moderately with respect to its performance in late 2014.

Monthly Indicator of Private Consumption in the Domestic Market and ANTAD Total Sales
Index 2008=100, s. a.



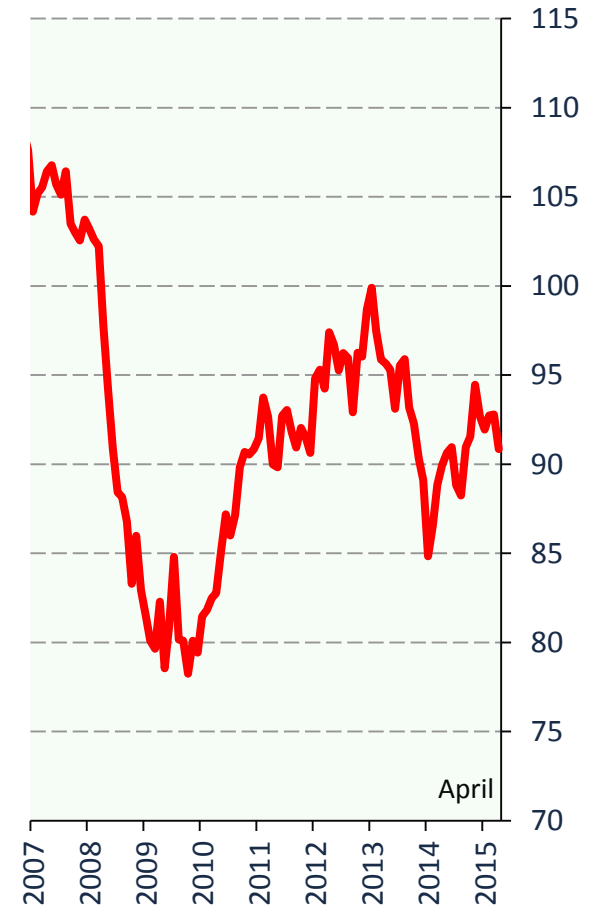
s. a. / Seasonally adjusted data.
Source: INEGI.

Commercial Bank Performing Credit to Consumption ^{1/}
Real annual % change



^{1/} It includes loans by credit card-regulated sofomes.
Source: Banco de México.

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

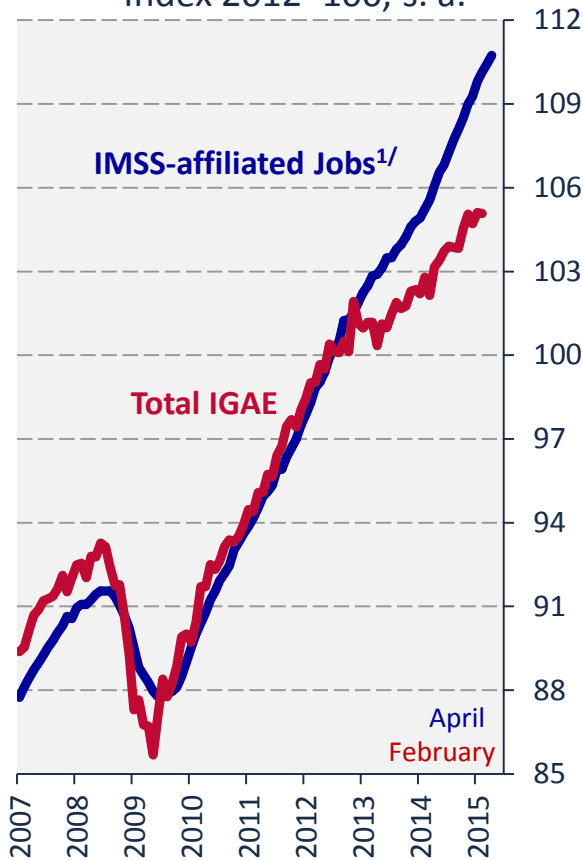


s. a. / Seasonally adjusted data.
Source: INEGI and Banco de México.

The timely information suggests that in the first months of 2015 a moderate improvement in the labor market persisted.

**IMSS-Affiliated Jobs and
Total IGAE**

Index 2012=100, s. a.

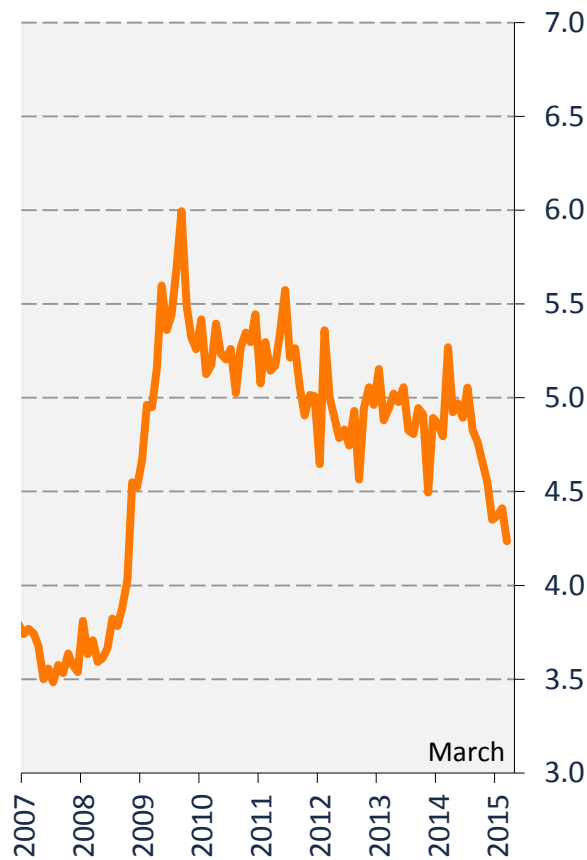


s. a. / Seasonally adjusted data.

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.

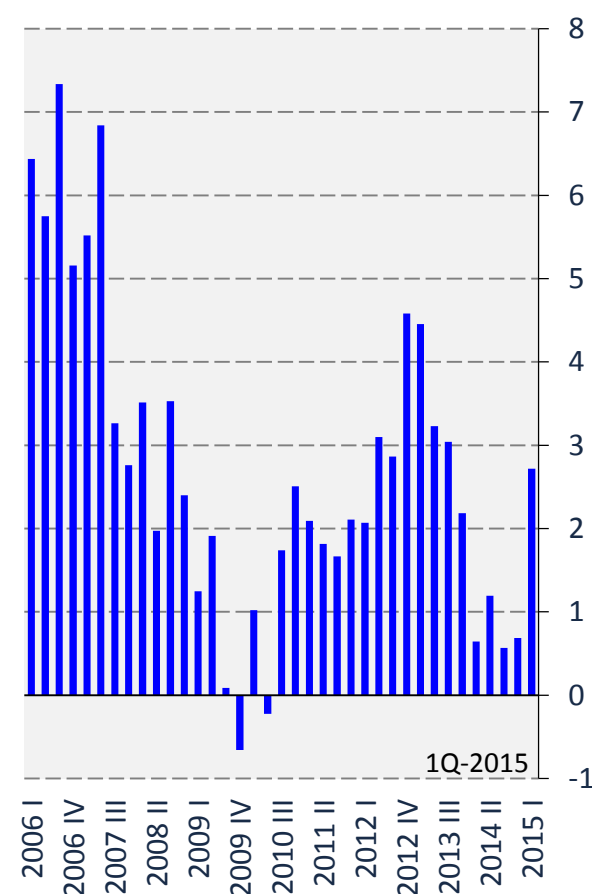


EAP/ Economically active population.

s. a. / Seasonally adjusted data.

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

ENOE's Average Wage^{2/}
Annual % Change



2/ To calculate average nominal wages, the lowest and the highest 1 percent of the distribution were trimmed. People with no income and people who didn't report it were excluded. Source: Calculated by Banco de México with data from INEGI.

Outline

1 **Monetary Policy**

2 **External Conditions**

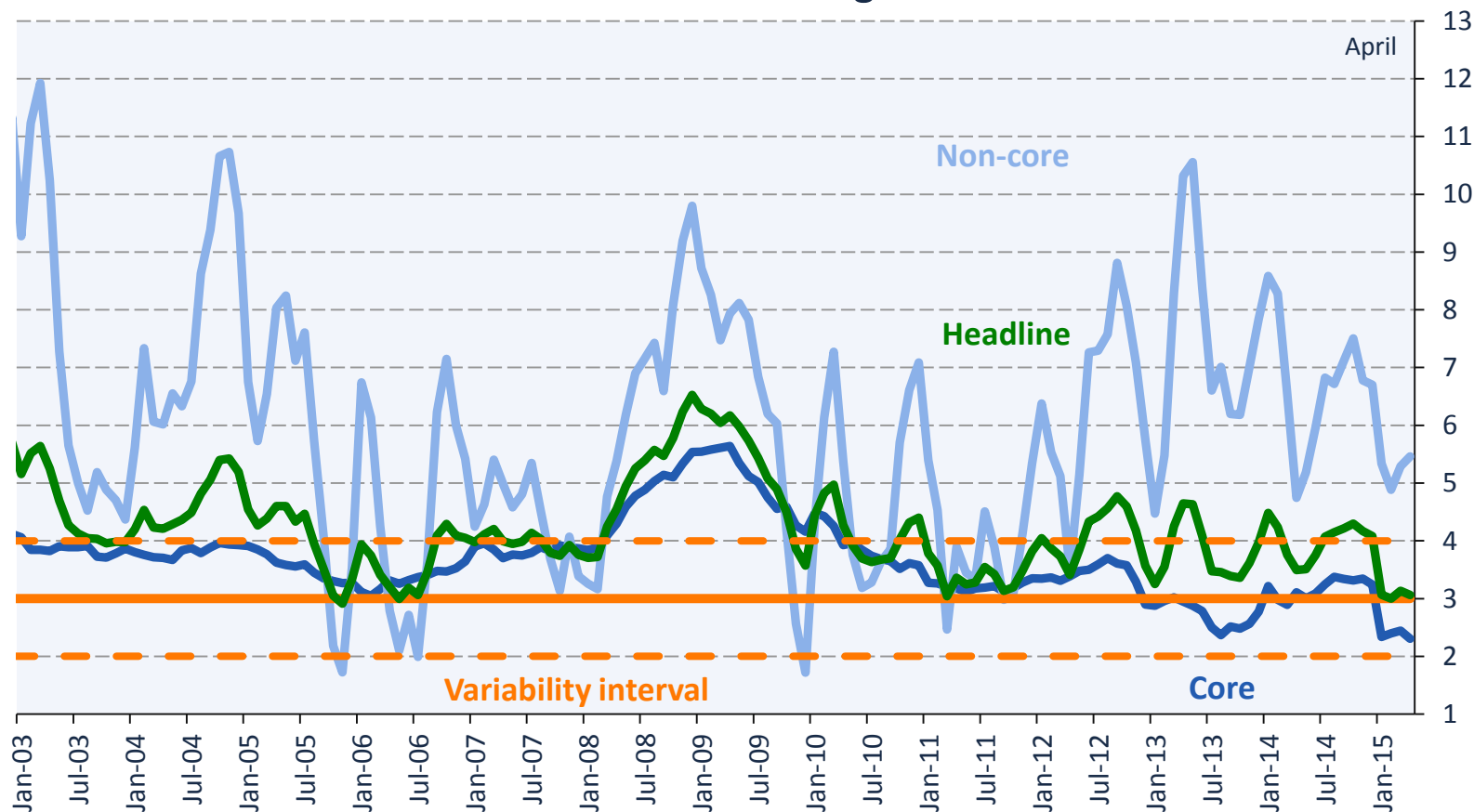
3 **Economic Activity in Mexico**

4 **Inflation Determinants**

5 **Forecasts and Balance of Risks**

As anticipated by Banco de México, annual headline inflation decreased considerably in early 2015 to reach the 3 percent target in 1Q 2015.

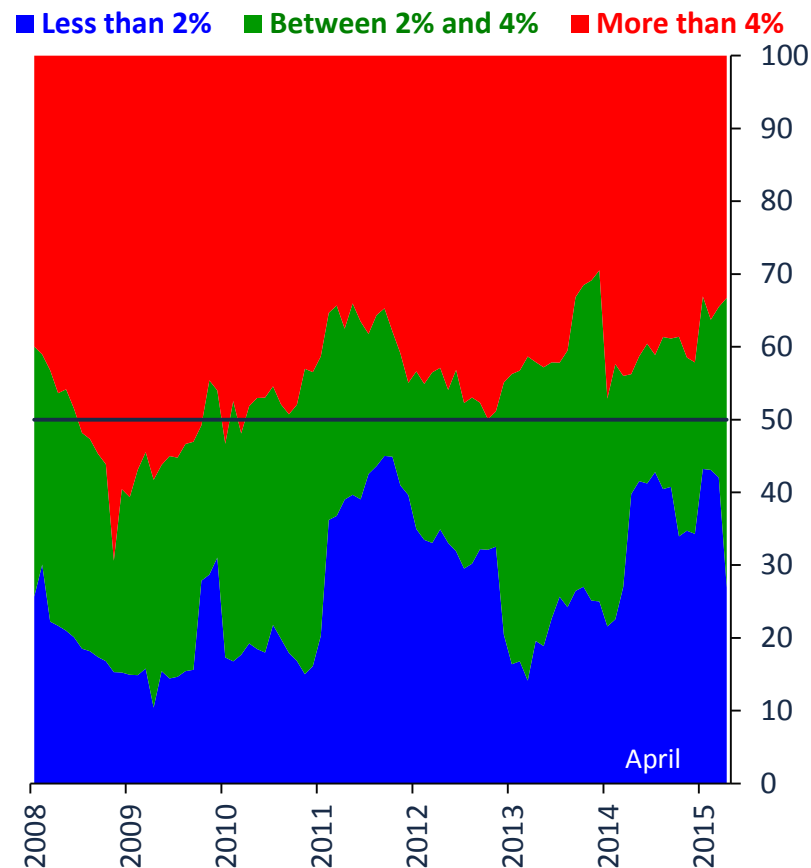
Consumer Price Index Annual % change



Source: Banco de México and INEGI.

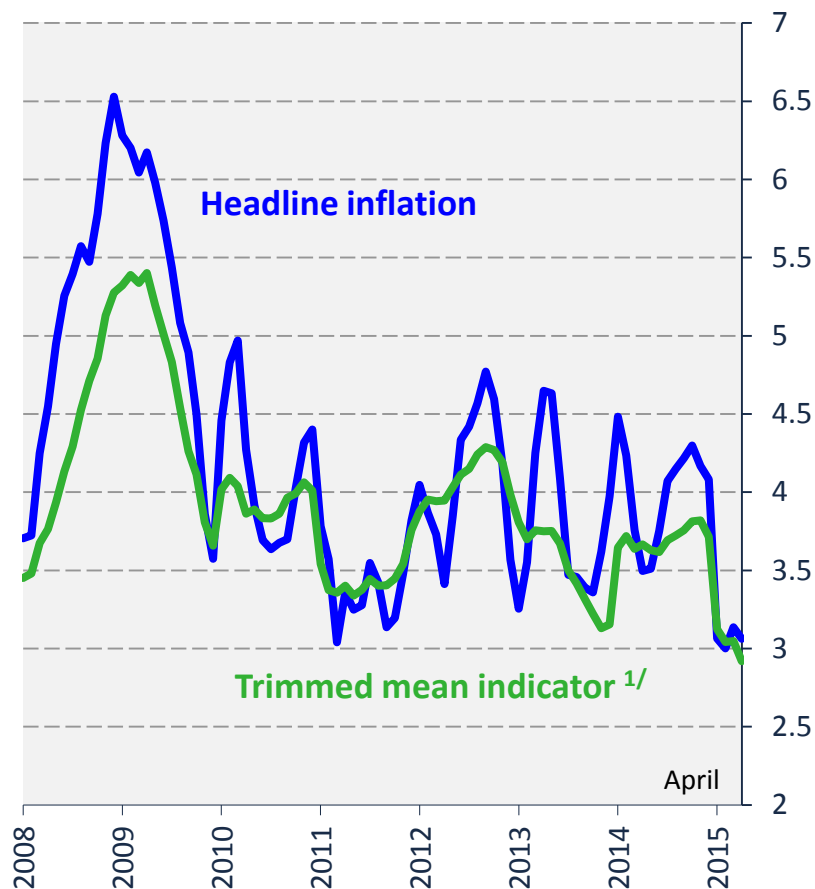
The lower growth rate of headline inflation was also reflected in the dynamics of some of its medium-term trend indicators.

Percentage of the CPI Basket according to Annual Increment Interval (%)



Source: Banco de México and INEGI.

Headline Consumer Price Index and Trimmed Mean Indicator Annual % change

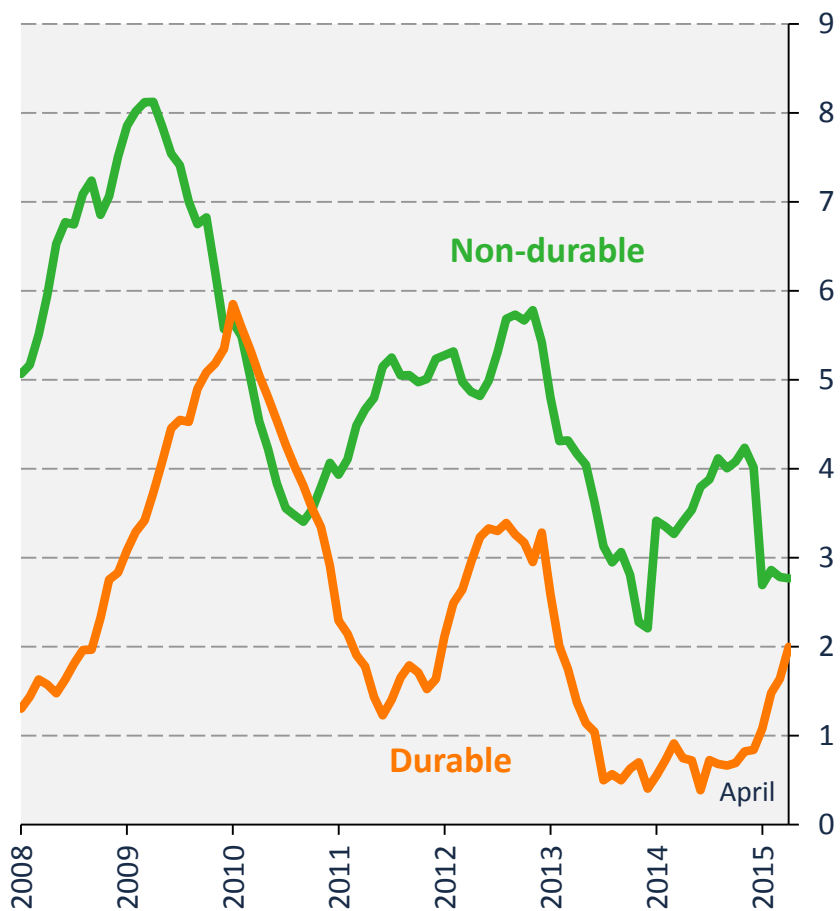


^{1/} The trimmed mean discards the contribution of extreme changes in the prices of some generics to the inflation of the price index. Source: Calculated with data from Banco de México and INEGI.

The above is due to a favorable evolution of most goods and services' prices.

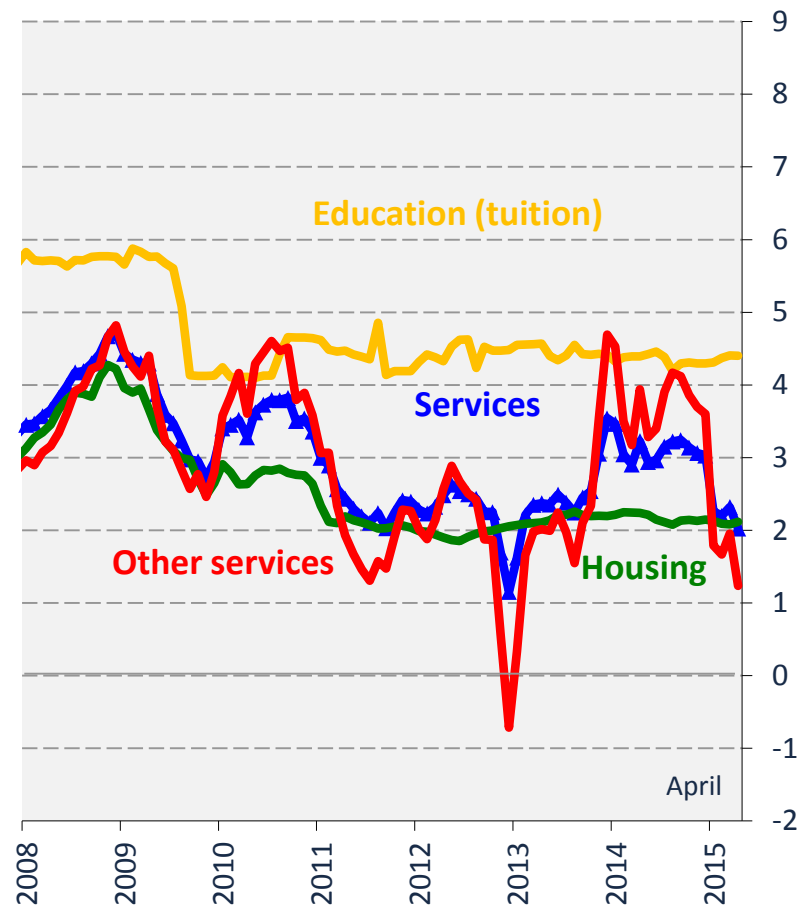
Core Price Index Annual % change

Merchandise



Source: Banco de México and INEGI.

Services

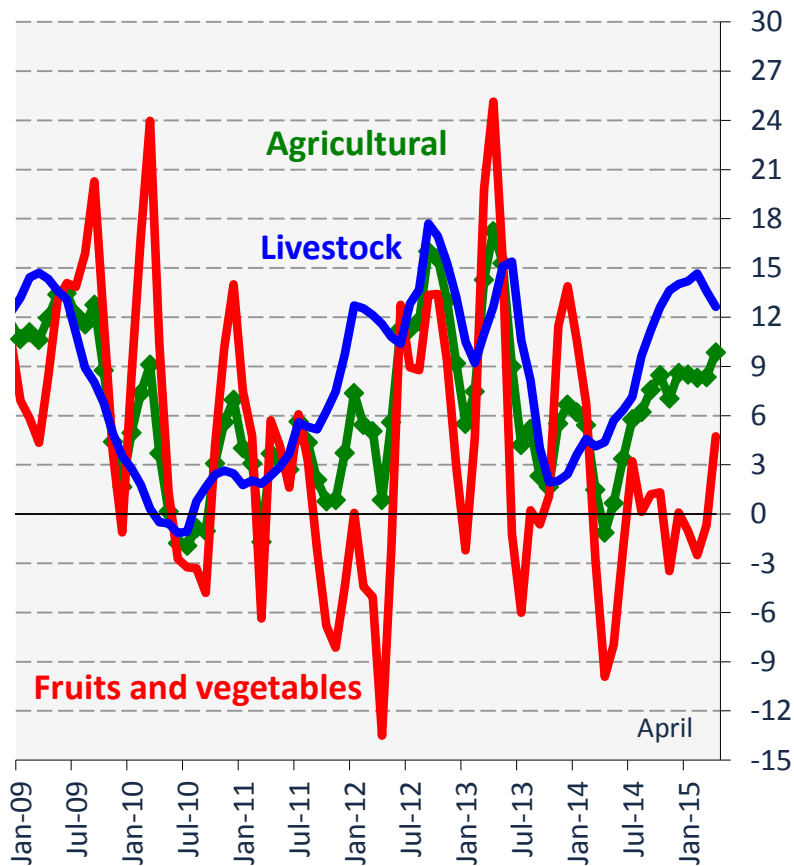


Source: Banco de México and INEGI.

The contribution of non-core inflation to headline inflation also decreased in recent months.

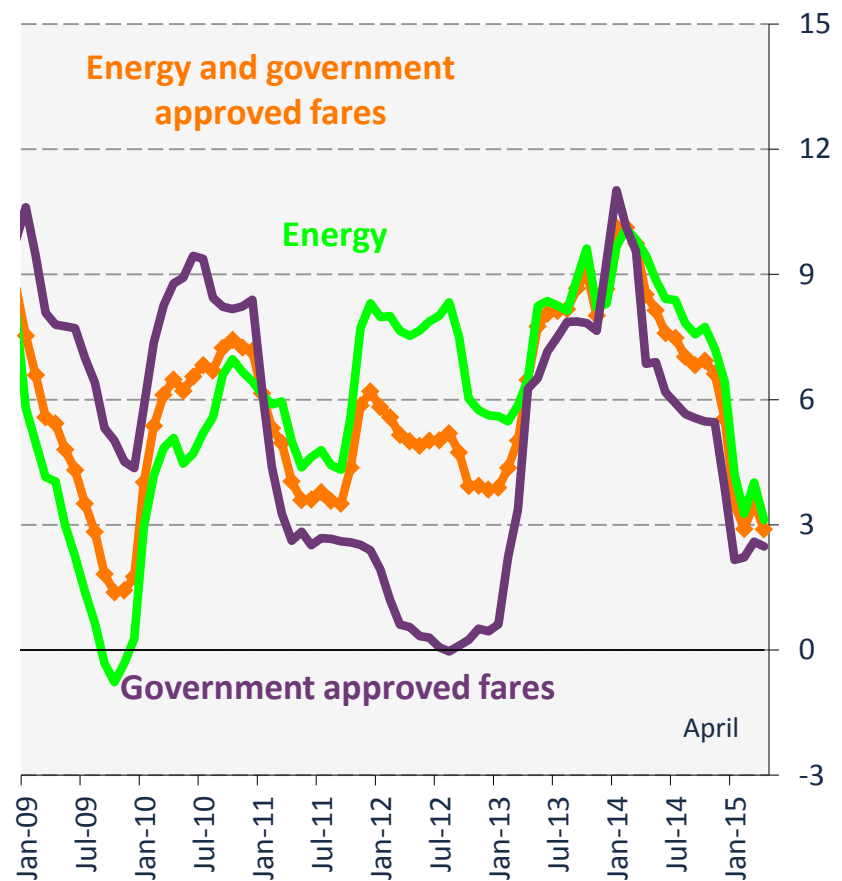
Non-Core index Annual % change

Agricultural



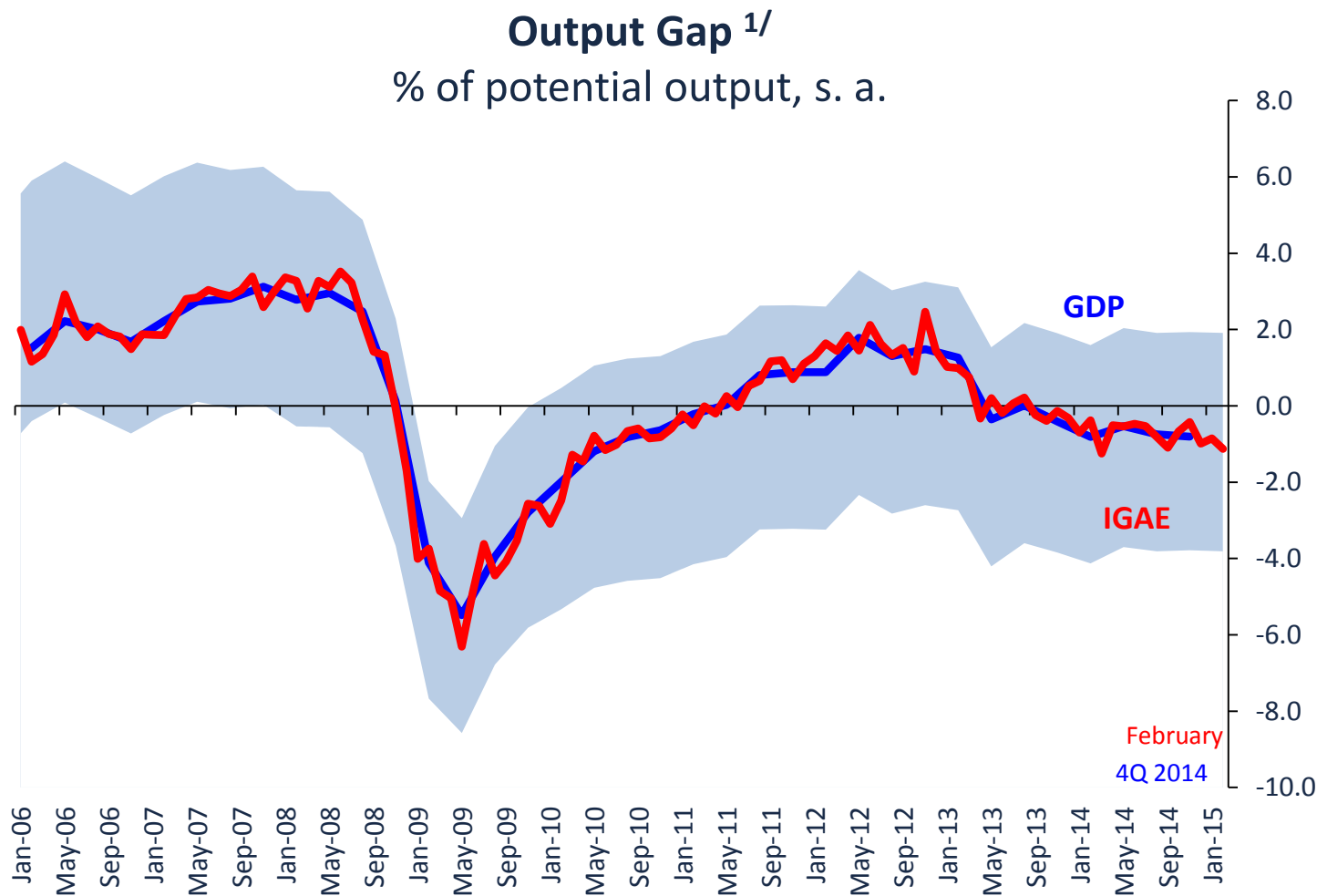
Source: Banco de México and INEGI.

Energy and Government Approved Fares



Source: Banco de México and INEGI.

The output gap remains negative. However, it is expected to continue closing gradually.



s. a. / Calculated with seasonally adjusted data.

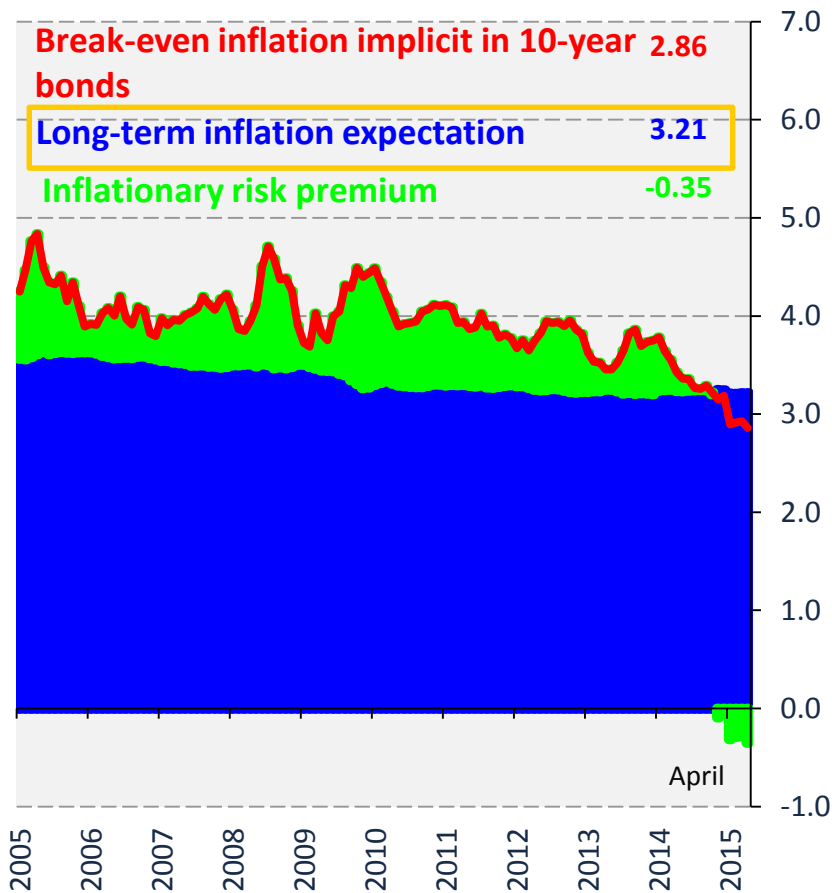
1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p.69.

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.

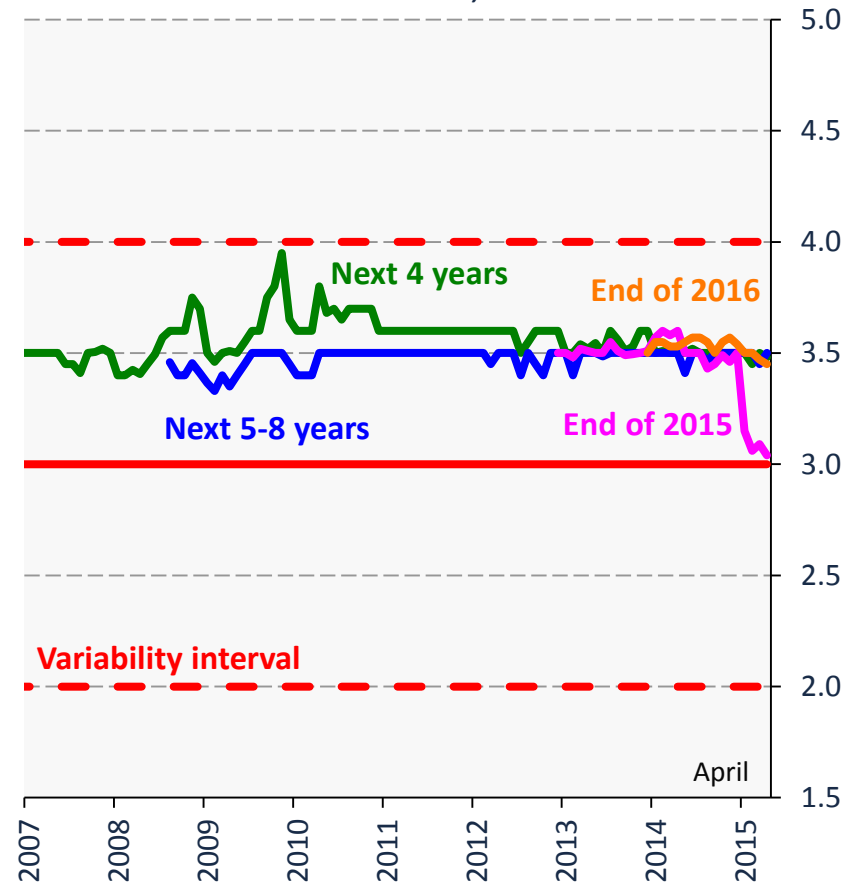
Inflation expectations, both implicit in market instruments and medium- and long-term survey-derived, remain stable.

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.

Just like other advanced and emerging economies' currencies, the Mexican peso kept showing high volatility and depreciated against the USD.

Exchange Rate and its Expectations for the End of 2015 and 2016 ^{1/}

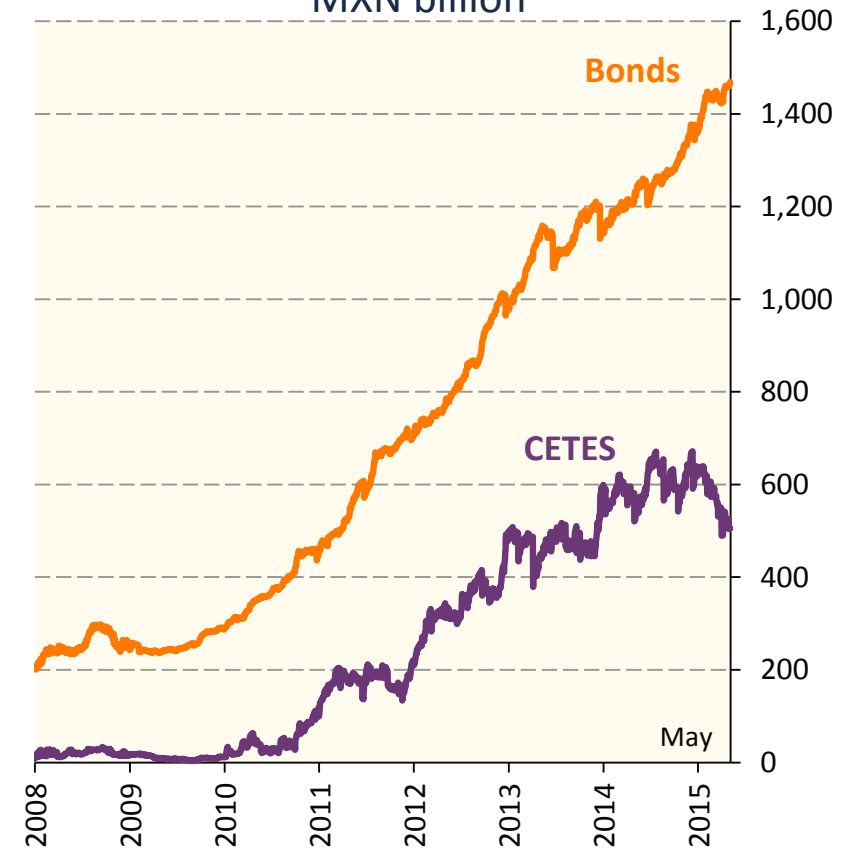


^{1/} The observed exchange rate is the daily FIX exchange rate. The latest data for the observed exchange rate is May 18, 2015, and the foreign exchange rate forecasts is May 5, 2015.

Source: Banco de México and Banamex survey.

Government Securities' Holdings by Foreign Investors

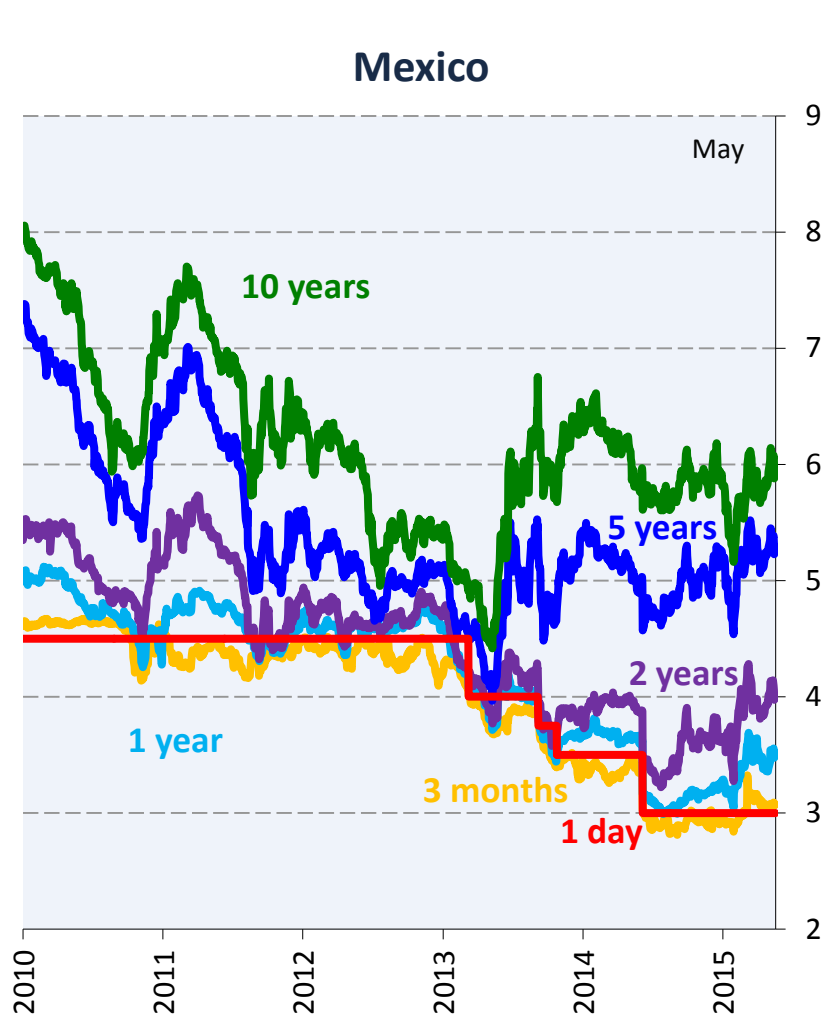
MXN billion



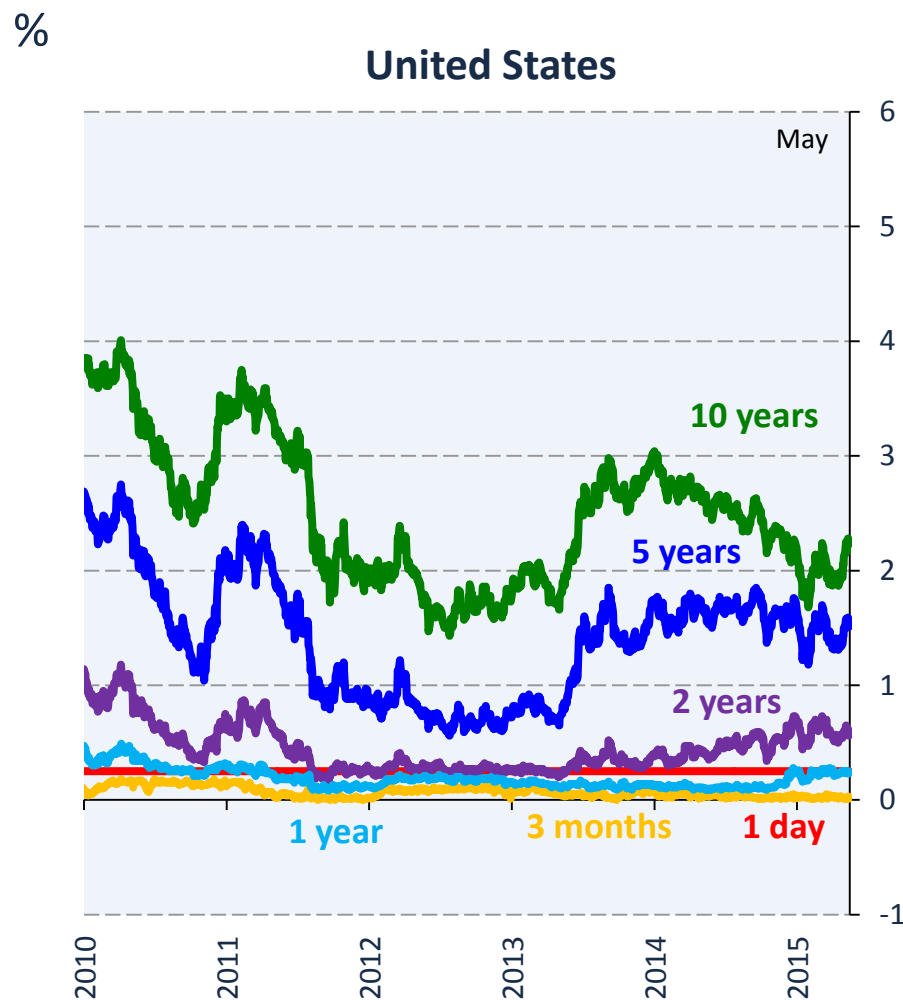
Source: Banco de México.

Long-term interest rates in Mexico increased in the period analyzed in the Report.

Government Securities' Interest Rates



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



Source: U.S. Department of the Treasury.

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Economic Activity Outlook

GDP Growth

2015	Between 2.0 and 3.0%
2016	Between 2.5 and 3.5%

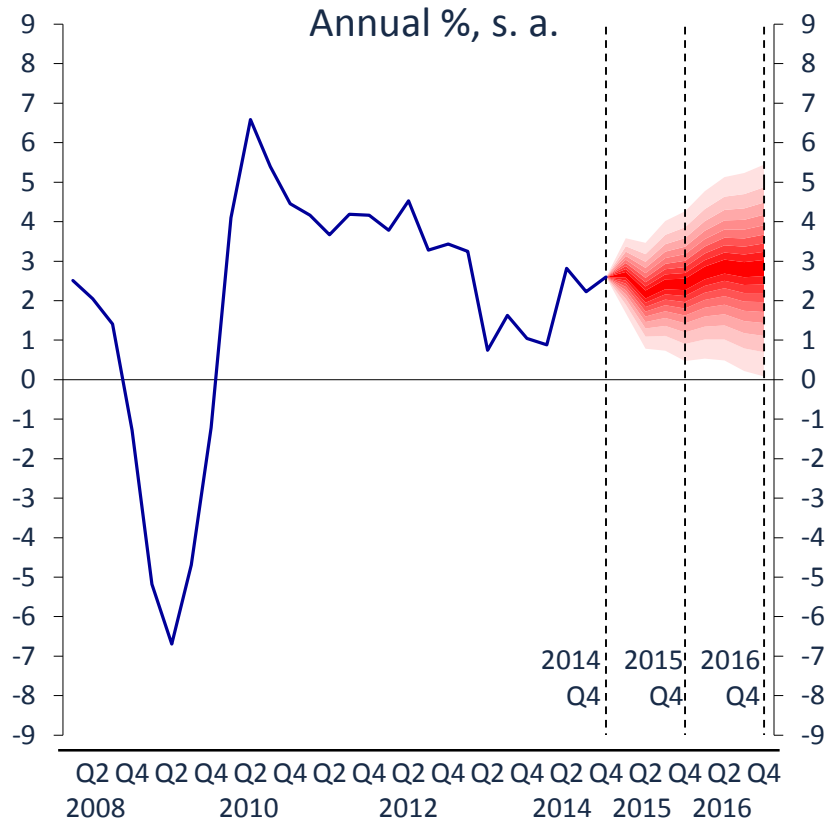
Increase in the number of IMSS-affiliated jobs

2015	Between 580 and 680 thousand
2016	Between 600 and 700 thousand

Fan Charts

GDP Growth

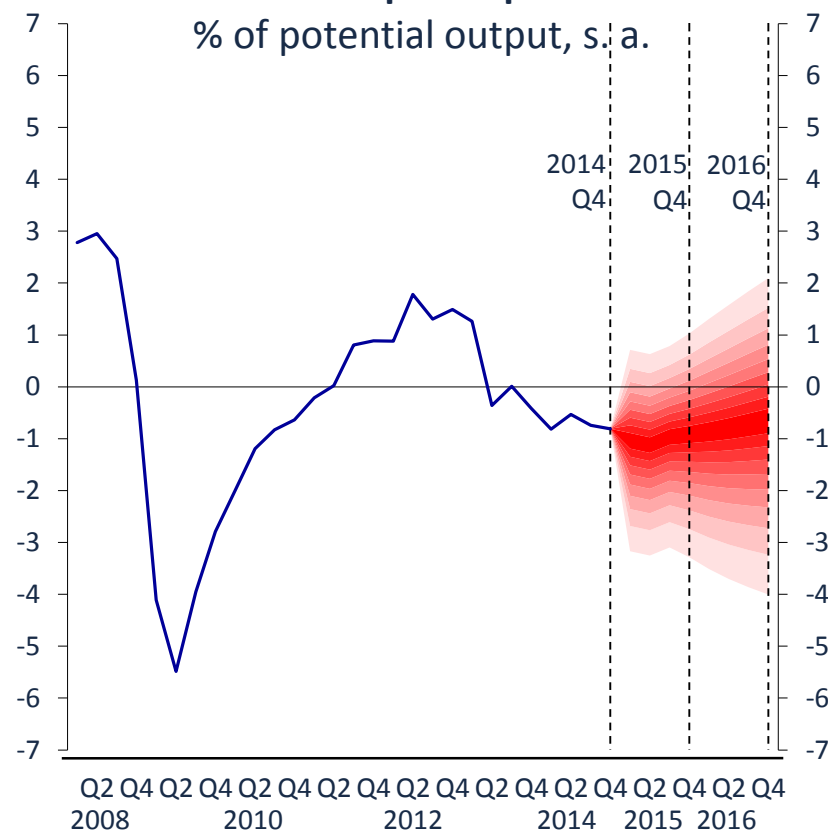
Annual %, s. a.



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

Output Gap

% of potential output, s. a.



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

Risks to Growth Scenario:

Upward:



A greater dynamism of the U.S. economy.



A better prospect of investors given the implementation of the energy reform.

Downward:



A further weakening of the U.S. economic activity.



Greater volatility in international financial markets.



A further decrease in the oil production platform.



Weakness in consumer and businesses' confidence.

Inflation Outlook

Headline Inflation

Core Inflation

2015

Close to 3 percent over the next months and in 2H 2015 slightly below that level.

Below 3 percent throughout the year.

2016

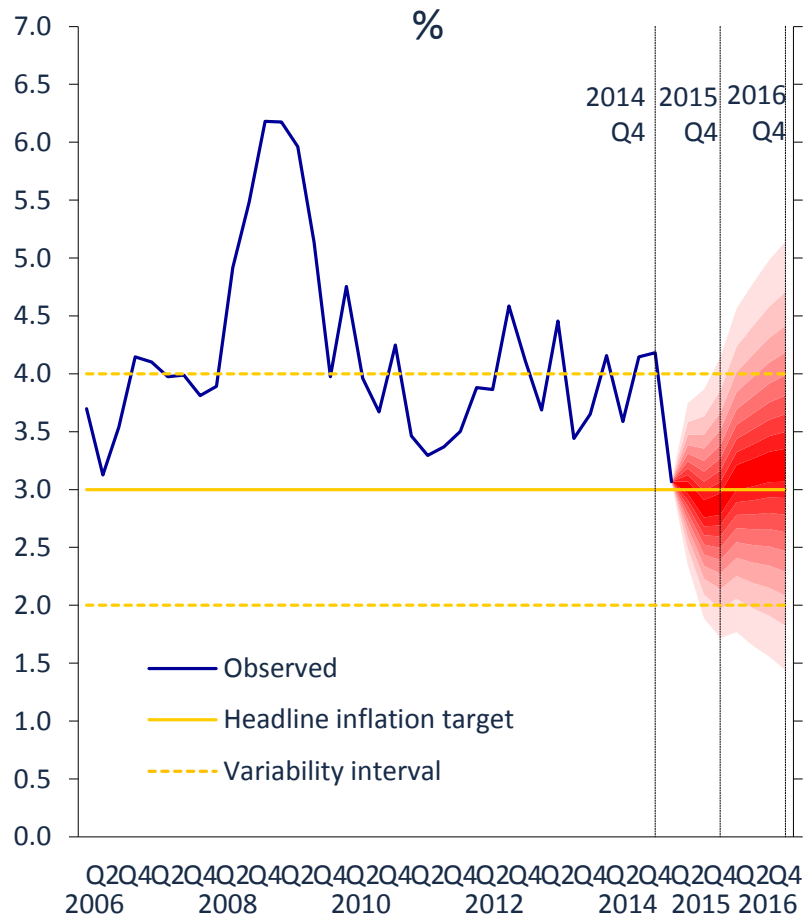
At levels close to 3 percent.

At levels close to 3 percent.

The monetary policy stance is expected to continue contributing to inflation remaining close to its target.

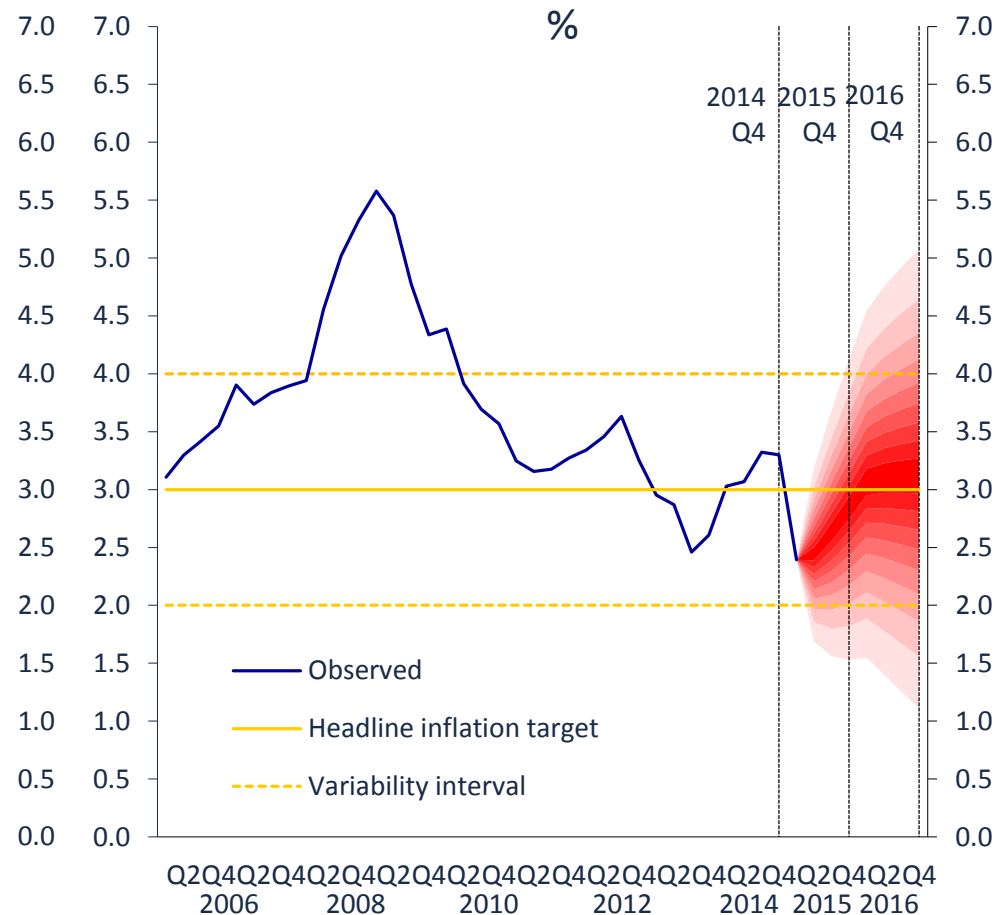
Fan Charts

Annual Headline Inflation ^{1/}



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

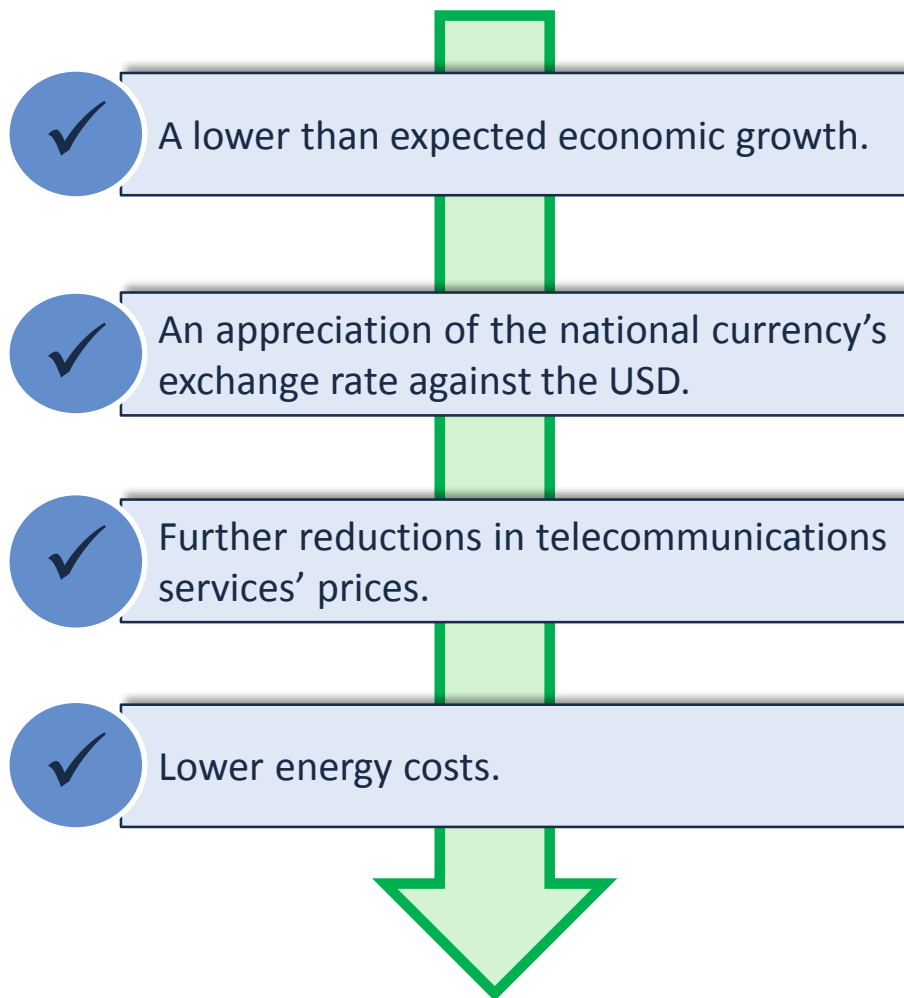
Annual Core Inflation ^{2/}



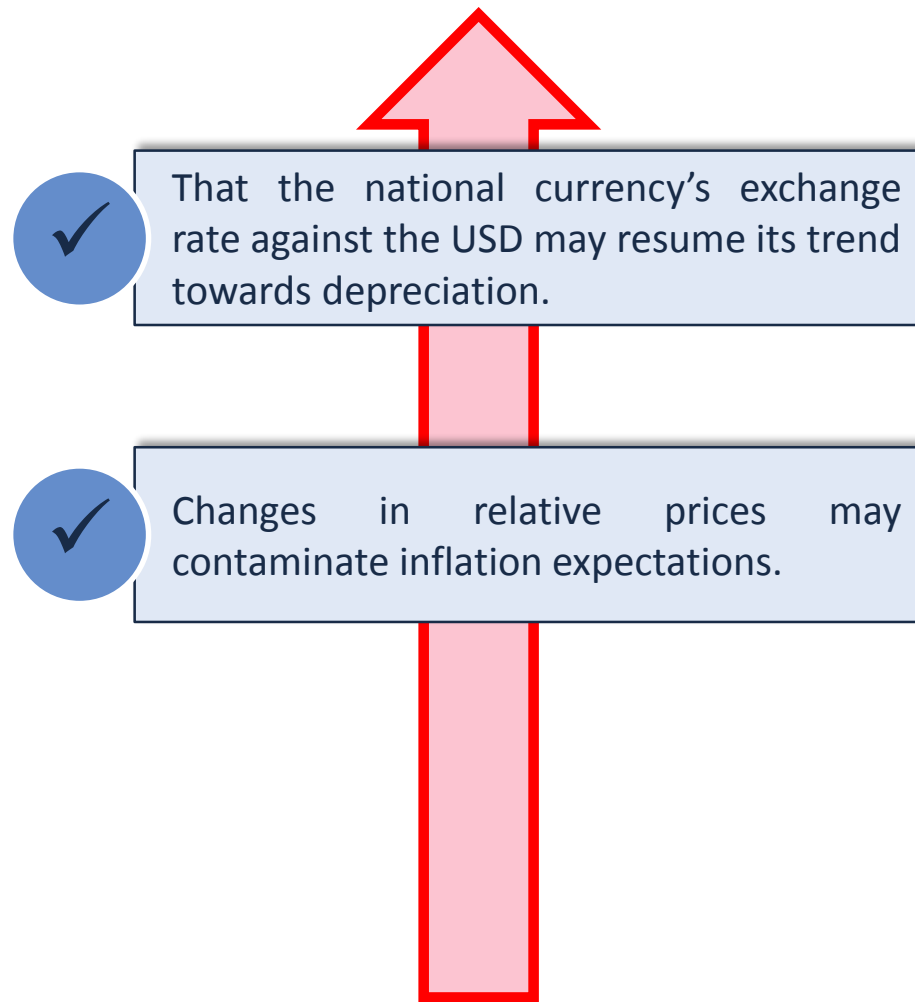
2/ Quarterly average of annual core inflation.
Source: INEGI and Banco de México.

Risks to Inflation Outlook:

Downward



Upward



Monetary Policy Stance

The monetary policy in Mexico faces a complex environment:

Domestic Conditions

The recovery of the economy shows weakness, headline inflation lies practically at the target, core inflation locates below 3 percent and inflation expectations remain anchored.

External Conditions

Monetary policy actions in the U.S. could affect the exchange rate, inflation expectations and, therefore, the price dynamics in Mexico.

- Hence, the Board of Governors will remain alert to the evolution of all inflation determinants and its expectations for medium and long horizons. In particular, it will monitor:
 - ✓ *The monetary stance of Mexico relative to the U.S.*
 - ✓ *Performance of the exchange rate trend.*
 - ✓ *Evolution of the degree of slack in the economy.*

➤ All of the above, in order to be able to take the necessary measures to ensure the convergence of inflation to the 3 percent target and to consolidate it.

Importance of Institutional Strength

- In light of a complex international environment, it is of great importance for Mexico to boost its **domestic sources of growth** and to maintain **solid macroeconomic fundamentals**.
 - ✓ *Timely and efficient implementation of structural reforms is required for an increment in contemporary and potential growth of the economy.*
 - ✓ *Improving the rule of law and security, as well as legal certainty, is necessary to generate a favorable environment for growth.*
- Finally, to preserve the solid macroeconomic framework **sound public finances** are required, in particular, the public debt to GDP ratio should stabilize and resume its downward trend.



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