BANCO DE MÉXICO

Quarterly Report

July – September 2015

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QUARTERLY REPORT

This report analyzes the development of inflation, the economic activity and different economic indicators in Mexico, as well as the monetary policy implementation in the quarter July – September 2015 and, in general, the activities of Banco de México over the referred period, in the context of the Mexican and international economic environment, in compliance with Article 51, section II of Banco de México's Law.

FOREWARNING

This text is provided for reader's convenience only. Discrepancies may possibly arise between the original document and its translation to English. The original and unabridged Quarterly Report in Spanish is the only official document.

Unless otherwise stated, this document has been prepared using data available as of November 3, 2015. Figures are preliminary and subject to changes.

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1. Introduction

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 an environment of low and stable inflation 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 have 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 taken place in a difficult economic juncture. Domestically, economic activity kept growing at a moderate pace, due to which an environment of slack prevailed in the economy and consequently, no aggregate demand-related pressures on prices were present. Meanwhile, the adjustment in relative prices, 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 was reflected in declines in the prices of financial assets globally, especially in emerging economies' currencies and stock indices worldwide. In the Mexican case, the MXN/USD exchange rate absorbed most 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 pace. In particular, 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, slack conditions persisted in the economy and thus no pressures on prices in the main input markets nor in the 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 face 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 observed. 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 participants 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 about the effects of its economic policy also contributed to this environment of high instability, which negatively affected commodity prices. In response, during the reported quarter drops in the prices of financial assets 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 for different terms, although with certain volatility as well. In this sense and given that additional episodes of turmoil in financial markets cannot be ruled out, it is fundamental to preserve a solid macroeconomic framework in Mexico in order to maintain confidence in the Mexican economy, such that the country risk component in the interest rates keeps at low levels, which will be crucial in face of an external environment with more stringent financial conditions.

It is expected that in the rest of 2015, the Mexican economy will continue showing a moderate dynamism, given the expectation of low growth of U.S. industrial activity, a modest expansion of domestic demand and that the effects of structural reforms will only gradually be reflected in greater competitiveness. Specifically, GDP in Mexico in 2015 is anticipated to grow between 1.9 and 2.4 percent, narrower interval as compared to the one of 1.7 to 2.5 percent in the previous Report, reflecting more information available regarding the performance of the economy in the present year. For 2016, a recovery of economic activity is further anticipated in light of the expected improvement of U.S. industrial production for that year, such that the forecast interval for the GDP growth rate in Mexico is maintained unchanged as compared to the previous Report, between 2.5 and 3.5 percent. For

2017, a more significant improvement in the U.S. industrial sector and a great boost to economic activity derived from the structural reforms' implementation in the country is expected. Thus, a GDP growth of between 3.0 and 4.0 percent is expected. Given that, conditions of slack are expected to prevail in the economy in the coming years, although gradually decreasing.

Regarding inflation, the slack prevailing in the economy and the absence of aggregate demand-related pressures on prices are expected to continue being factors that contribute to its good performance. In particular, annual headline and 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. However, 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.

The 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.

2. Recent Development of Inflation

2.1. Inflation

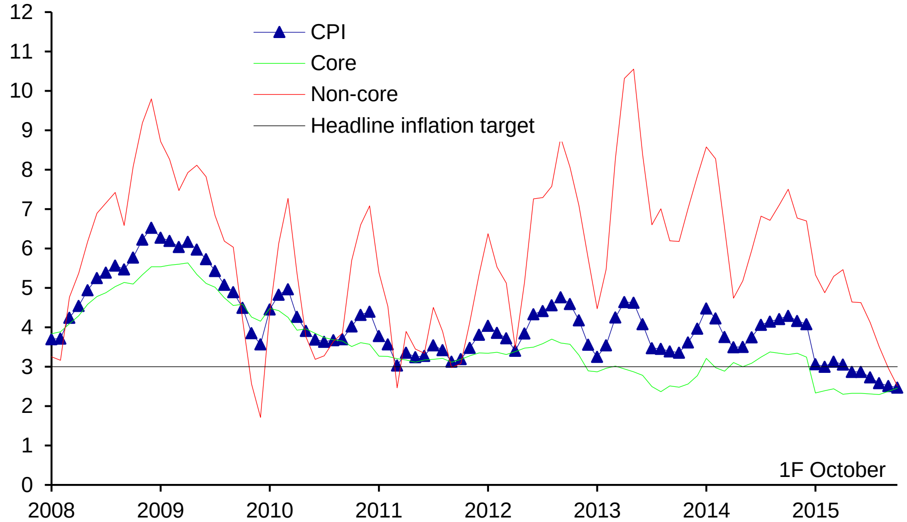
In the third quarter of 2015, annual headline inflation exhibited further reductions in addition to those observed in the previous quarter, locating below 3 percent and reaching new historical minimum levels. To the favorable performance of inflation contributed the monetary policy stance, which has been conducive to efficiently reach the 3 percent target, the prevailing slack in the economy and price reductions of widely used inputs, such as energy products, certain commodities and telecommunication services. The drop in some telecommunication services and energy prices is associated with the structural reforms. These reductions have directly influenced the recent evolution of inflation by lower increases of consumer prices, and indirectly, by contributing to lower costs for firms. In this context, the effect of the exchange rate depreciation on prices has been limited, and has been mainly reflected reflected in durable goods, which continued increasing slowly, without showing evidence of second round effects on the price formation process in the economy so far. To date, relative price changes due to the exchange rate depreciation occurred in an orderly and gradual manner (Table 1 and Chart 1).

Table 1
Consumer Price Index, Main Components and Trimmed Mean Indicators
Annual change in percent

	2014				2015			
	I	II	III	IV	I	II	III	1F October
CPI	**4.16**	**3.59**	**4.15**	**4.18**	**3.07**	**2.94**	**2.61**	**2.47**
Core	**3.03**	**3.07**	**3.32**	**3.30**	**2.39**	**2.32**	**2.33**	**2.46**
Merchandise	**2.91**	**3.10**	**3.46**	**3.57**	**2.56**	**2.52**	**2.46**	**2.71**
Food, beverages and tobacco	4.65	4.81	5.32	5.35	3.15	2.56	2.20	2.32
Non-food merchandise	1.51	1.72	1.96	2.13	2.07	2.49	2.67	3.04
Services	**3.14**	**3.04**	**3.21**	**3.08**	**2.26**	**2.15**	**2.22**	**2.24**
Housing	2.24	2.20	2.11	2.14	2.10	2.09	2.06	1.98
Education (tuitions)	4.36	4.42	4.29	4.30	4.36	4.35	4.37	4.28
Other services	3.73	3.54	4.06	3.72	1.80	1.57	1.75	1.90
Non-core	**7.79**	**5.29**	**6.89**	**6.99**	**5.17**	**4.92**	**3.53**	**2.52**
Agriculture	**4.33**	**0.94**	**6.53**	**8.04**	**8.39**	**8.34**	**5.33**	**3.83**
Fruit and vegetables	4.54	-6.86	1.48	-0.73	-1.39	7.43	7.91	6.78
Livestock	4.12	5.49	9.33	13.43	14.15	8.81	4.00	2.30
Energy and government approved fares	**9.99**	**8.09**	**7.11**	**6.35**	**3.30**	**2.87**	**2.42**	**1.72**
Energy	9.87	8.92	7.92	7.12	3.82	3.21	2.43	1.07
Government approved fares	10.23	6.64	5.71	4.93	2.32	2.26	2.39	2.91
Trimmed Mean Indicator [1/]								
CPI	3.64	3.63	3.75	3.83	3.13	2.86	2.67	2.51
Core	2.92	3.05	3.15	3.21	2.83	2.76	2.73	2.76

1/ Prepared by Banco de México with data from INEGI.
Source: Banco de México and INEGI.

Chart 1
Consumer Price Index
Annual change in percent

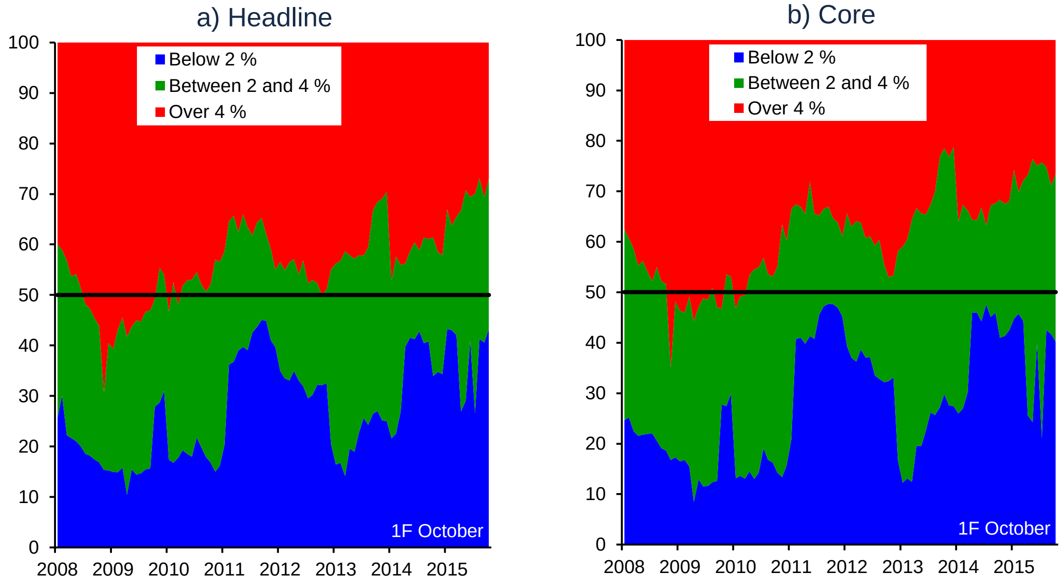


Source: Banco de México and INEGI.

Between the second and third quarter of 2015, annual headline inflation decreased from an average of 2.94 to 2.61 percent, reaching 2.47 percent in the first fortnight of October. Meanwhile, average annual core inflation remained stable in the mentioned quarters, registering levels of 2.32 and 2.33 percent, respectively, while in the first fortnight of October it was 2.46 percent. In the referred quarters, the average annual change rate of the non-core component decreased from 4.92 to 3.53 percent, locating at 2.52 percent in the first fortnight of October. It is noteworthy that, since September, headline inflation as well as core and non-core inflation lied for the first time below 3 percent.

The downward trajectory of annual headline inflation was not just due to less price increments of a small number of goods and services, but because of the favorable evolution of the great majority of them. This is shown by the stability of different trend measures of these indicators. One indicator is obtained by calculating the share of the Consumer Price Index (CPI) basket that presents annual price changes within different intervals. In order to do so, each month the generic items, which compose the basket of the headline and core index, are grouped into three categories according to their annual price change. Specifically, three groups are defined: i) items with an annual price change below 2 percent, ii) between 2 and 4 percent, and iii) over 4 percent. By calculating the percentage of the CPI basket in the referred intervals, it turns out that a high percentage presents price increments of less than 4 percent (blue and green areas, Chart 2). In particular, the share of goods and services of the CPI basket with increases below 4 percent was on average close to 70 percent in the third quarter of 2015, figure comparable to the previous quarter (Chart 2a). With respect to the core component, the share with increases below 4 percent was around 75 percent in both quarters (Chart 2b).

Chart 2
Percentage of the CPI Basket according to Intervals of Annual Increments
Percent

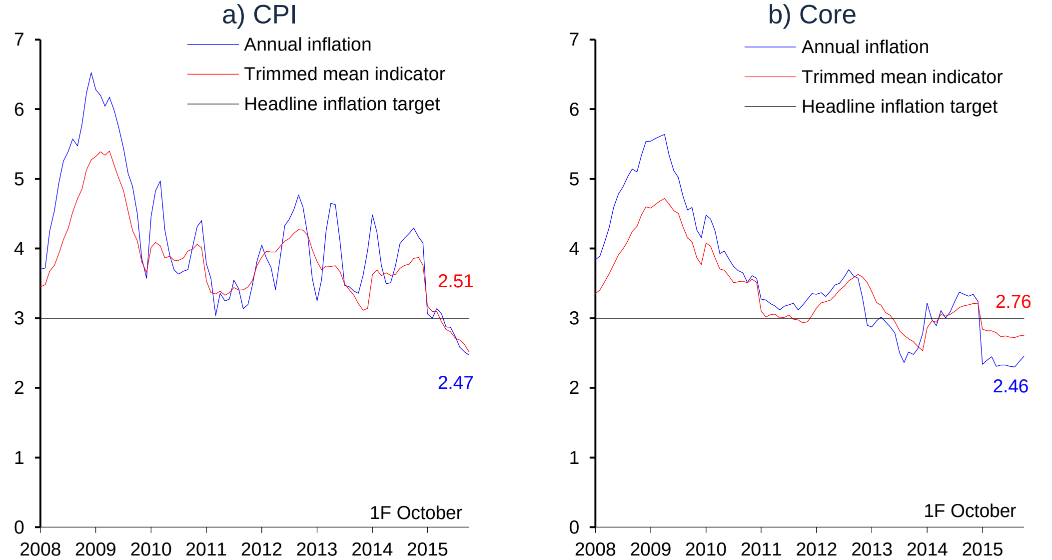


Source: Banco de México and INEGI.

One of the measures used in previous Reports to analyze the medium term inflation trend is the Trimmed Mean Indicator. This indicator provides information about the evolution of headline and core inflation in the low frequency, excluding extreme (high and low) price changes in each period. Thus, this indicator is usually not affected by relative price changes of a few goods and services, which have only transitory effects on inflation. The recent evolution of this indicator, both for headline and core inflation, shows that lower inflation observed in the reference quarter has been the result of a generalized drop in the price growth rate (Chart 3 and Table 1). In particular, in the first fortnight of October 2015, these indicators were 2.51 and 2.76 percent, respectively.

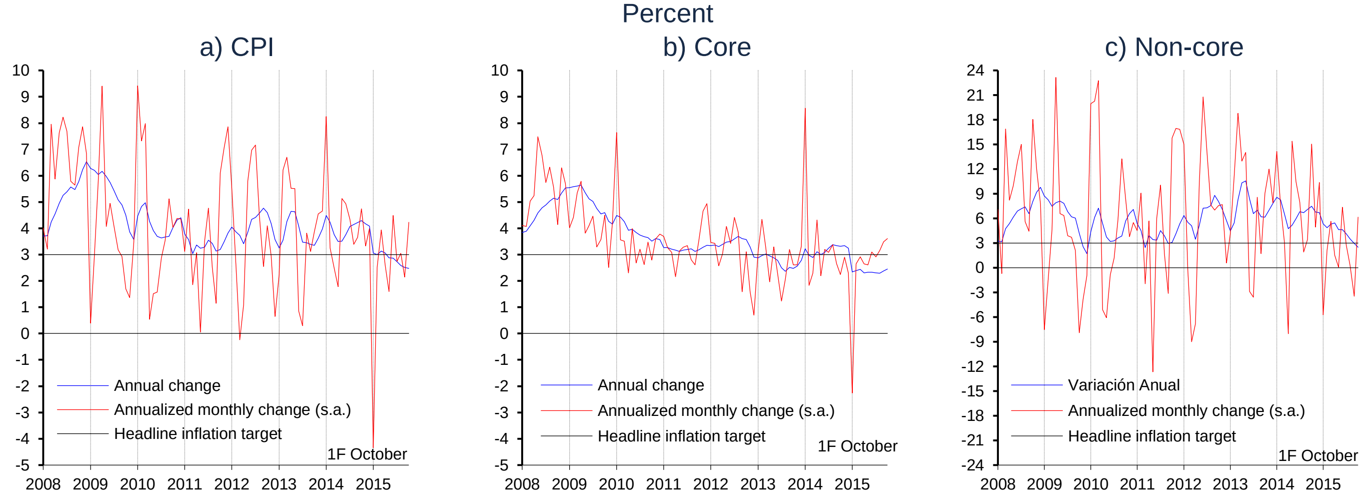
Another indicator that provides information on price dynamics is the annualized monthly (seasonally adjusted) inflation. This indicator, estimated for both headline and core inflation, remains at low levels, around 3 percent. However, towards the end of the period covered by this Report, both measures show an increase (Chart 4). In the case of headline inflation, this increment is partly explained by a higher monthly (seasonally adjusted) non-core inflation, due to recently observed increases in public transport prices in some cities. With respect to this, it should be mentioned that the non-core component tends to show high volatility and does not present an upward trend so far. In the case of core inflation, the increase in the referred indicator has been more moderate, although with a slight upward trend, reflecting the change in the price of merchandise relative to services, mainly induced by the exchange rate depreciation.

Chart 3
Price Indices and Trimmed Mean Indicators [1/]
Annual change in percent



1/ The Trimmed Mean Indicator excludes the contribution of extreme variations in the prices of some generic items from the inflation of a price index. To eliminate the effect of these changes, the following is done: i) the monthly seasonally adjusted changes of the generic items of the price index are arranged from the smallest to the largest value; ii) generic items with the biggest and the smallest variation are excluded, considering in each distribution tail up to 10 percent of the price index basket, respectively; and iii) using the remaining generic items, which by construction lie in the center of the distribution, the Trimmed Mean Indicator is calculated.
Source: Prepared by Banco de México with own data and data from INEGI.

Chart 4
Annual Change and Annualized Seasonally Adjusted Monthly Change
Percent



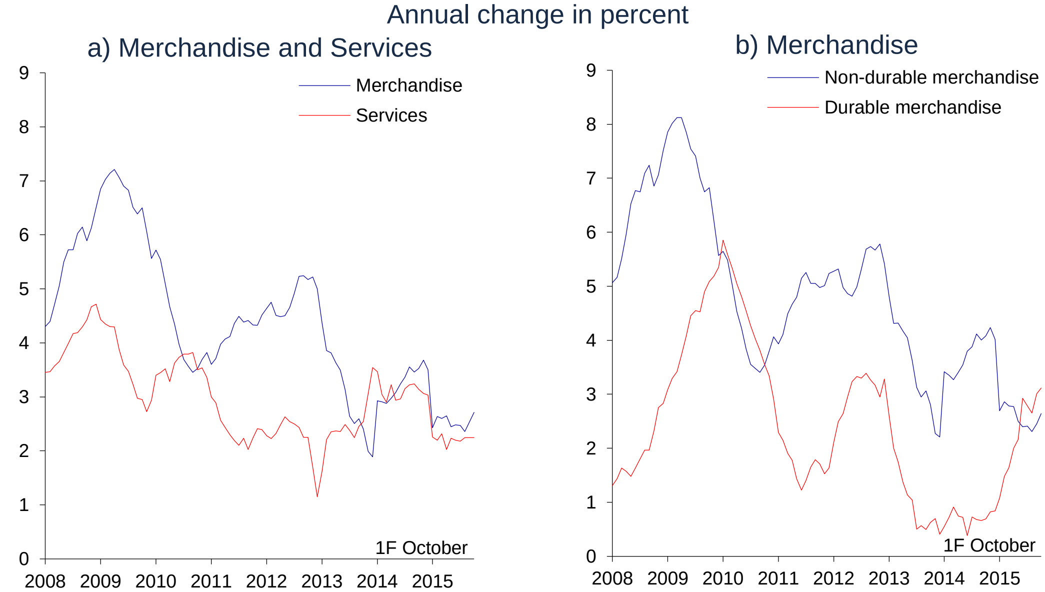
s. a. / Seasonally adjusted data.
Source: Seasonal adjustment prepared by Banco de México with own data and data from INEGI.

The referred relative price adjustment has implied increases in the annual growth rate of merchandise prices, mainly in those of durable goods, while service prices have been characterized by registering low and stable annual change rates (Chart 5 and Table 1).

- The merchandise price subindex reduced its average annual change from 2.52 percent in the second quarter of 2015 to 2.46 percent in the reference quarter, locating at 2.71 percent in the first fortnight of October. On the one hand, the average annual price change of the non-food merchandise group increased from 2.49 percent to 2.67 percent between the referred quarters and by 3.04 percent in the first fortnight of October. In particular, the average annual change of durable goods' prices, as subgroup of the non-food merchandise, went from 2.36 percent to 2.81 percent from the second to the third quarter of the year and located at 3.11 percent in the first fortnight of October (Chart 5b). Consequently, although these changes remain at low levels, it has been mainly in this category where the effects of the depreciation of the Mexican peso have been manifested. On the other hand, after having decreased its growth pace as registering average annual price changes of 2.56 percent and 2.20 percent in the referred quarters, some food items also presented slight increases in the annual price change rates towards the end of the quarter and in October, due to which their annual growth rate located at 2.32 percent in the first fortnight of October (Chart 5).

- Average annual changes of the services price subindex remain stable at low levels, reporting figures of 2.15 percent in the second quarter of 2015 and 2.22 percent in the third quarter. In the first fortnight of October, the annual price change of services was 2.24 percent. Reductions in telecommunication services prices, as well as moderate price increases in most of the other services have contributed to maintain this moderate price dynamic (Chart 5a and Table 1).

Chart 5
Core Price Index
Annual change in percent

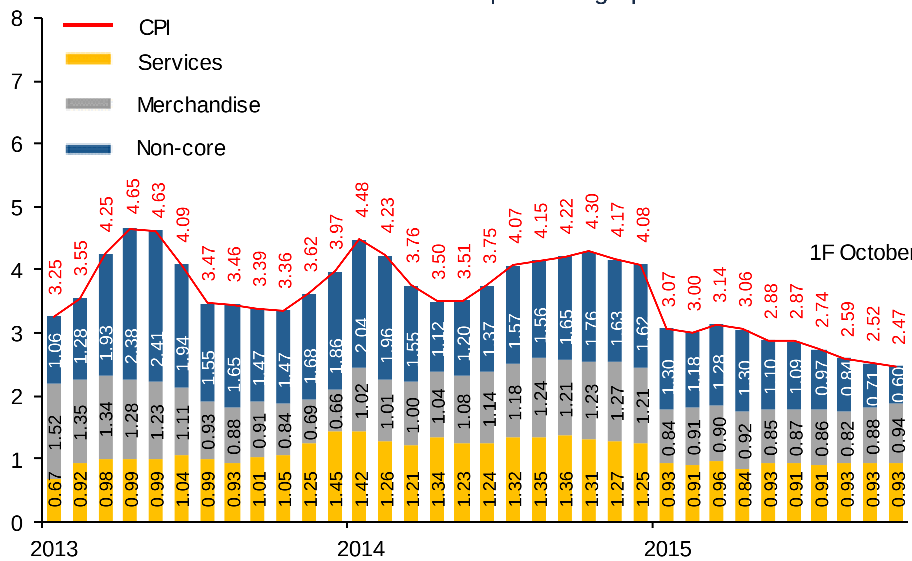


Source: Banco de México and INEGI.

The non-core price index kept decelerating its average annual growth rate (Chart 6 and Table 1).

- Agricultural products prices reduced their average annual growth between the second and third quarter of 2015, passing from 8.34 percent to 5.33 percent and later locating at 3.83 percent in the first fortnight of October. This result was mainly due to a lower annual growth rate of livestock products prices, which reduced from 8.81 percent to 4 percent between these quarter (2.30 percent in the first fortnight of October), while the average annual growth rate of the fruits and vegetables price subindex increased from 7.43 percent to 7.91 percent in the same period, later decreasing to 6.78 percent in the first fortnight of October.

Chart 6
Consumer Price Index
Annual contribution in percentage points 1/



1/ In some cases, the sum of respective components can differ due to rounding.
Source: Prepared by Banco de México with data from INEGI.

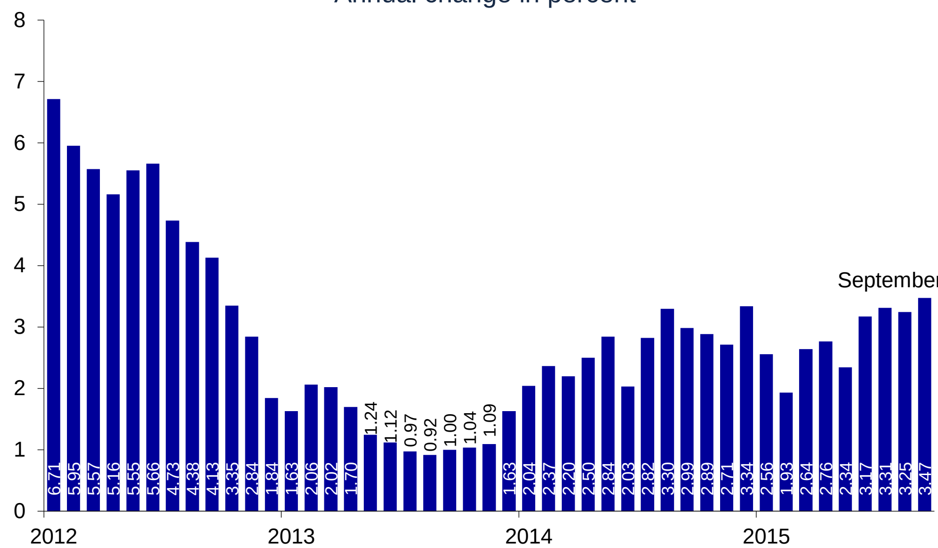
- The average annual changes of energy and government-approved fares price subindex decreased from 2.87 percent in the second quarter of 2015 to 2.42 percent in the third quarter and located at 1.72 percent in the first fortnight of October. The group of energy products reduced the average annual price change from 3.21 percent to 2.43 percent in the mentioned quarters and later reached a level of 1.07 percent in the first fortnight of October, with the drops in electricity fares standing out, which passed from -2.09 percent to -3.08 percent in the second and third quarter of 2015. It is noteworthy that the progress made regarding the implementation of the energy reform has favorably contributed to the dynamics of these fares, by promoting the adoption of new technologies that use cheaper and less polluting fuels. Additionally, the average annual change rate of gasoline prices decreased from 5.09 percent to 3.98 percent in the referred quarters, while that of domestic gas went from 3.51 percent to 3.33 percent. On the other hand, the group of government-approved fares registered average annual changes of 2.26 percent and

2.39 percent in the mentioned periods and 2.91 percent in the first fortnight of October, this last increase is attributable to the increment in public transport fares in some cities.

2.2. Producer Price Index

The Producer Price Index (PPI) of total production, excluding oil, registered an average annual change rate of 3.34 percent in the third quarter of 2015, while in the previous quarter it was 2.76 percent. In September, this indicator's annual change rate was 3.47 percent (Chart 7). This increase was mainly due to the increment in Mexican peso-nominated prices of export merchandise goods, among which are computers, electronic appliances, trucks and automobiles, which was reflected in the final merchandise and services index. On the other hand, intermediate use goods and services registered lower annual change rates than those of final merchandise and services prices, with industrial and commercial electricity fares standing out, and those of oil-derived products.

Chart 7
Producer Price Index [1/]
Annual change in percent



1/ Total Producer Price Index, excluding crude oil.
Source: Banco de México and INEGI.

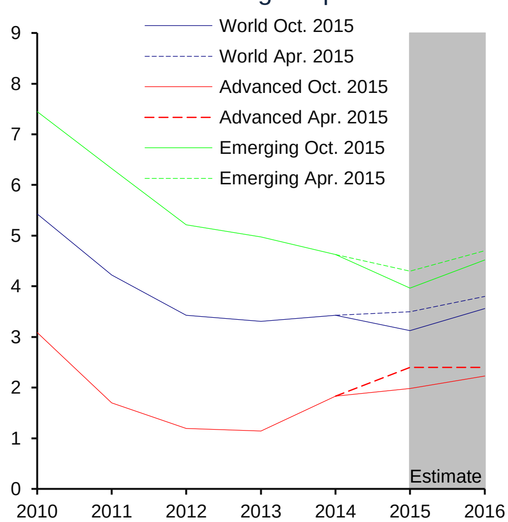
3. Economic and Financial Environment

3.1. External Conditions

The international environment has been characterized by continued weakness of economic activity, which was reflected in a reduction of the international trade volume (Chart 8). The gradual recovery of advanced economies was less than expected, while the slowdown of emerging economies intensified. The case of China stands out in that, besides having important vulnerabilities in the financial system, it faces significant challenges to rebalance and increase the sustainability of its sources of growth. Besides, commodity prices remain at extremely low levels. Therefore, the downward risks to the global growth outlook have increased. All this contributed to higher volatility in international financial markets, in particular in the exchange rate against the U.S. dollar of the currencies of commodity-exporting countries, in addition to the uncertainty regarding the normalization of U.S. monetary policy. Thus, the external scenario got substantially more complicated.

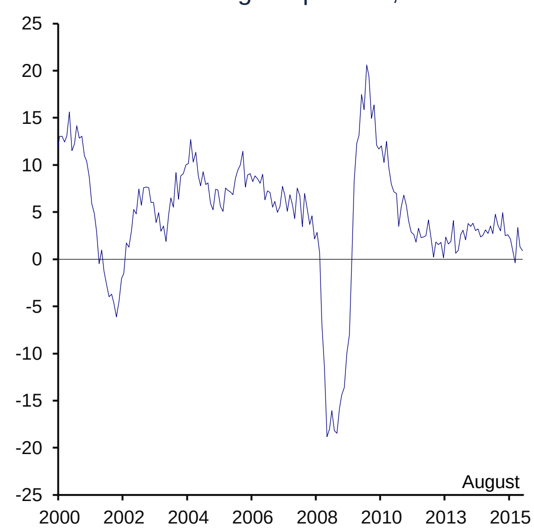
Chart 8
World Economic Activity

a) Global GDP Growth Forecast
Annual change in percent



Source: International Monetary Fund, World Economic Outlook April and October 2015.

b) World Trade Volume
Annual change in percent, s. a.



s. a. / Seasonally adjusted figures.
Source: CPB Netherlands.

3.1.1. World Economic Activity

In the U.S., the economy registered moderate growth during the third quarter. GDP grew 1.5 percent at an annualized quarterly rate, compared to 3.9 percent in the previous quarter.[1] To this, the main contribution came from a continued solidity of domestic demand, which offset the strong disaccumulation of inventories that with 1.4 percentage points negatively contributed to the GDP (Chart 9a). In particular, private consumption maintained a solid expansion at an annualized quarterly rate of 3.2 percent, supported by high consumer confidence, a larger increase in personal disposable income and an extremely low level of interest rates, which stimulated household spending and residential investment. Additionally, the

[1] According to the GDP Advance Estimate of the U.S. government Bureau of Economic Analysis (BEA).

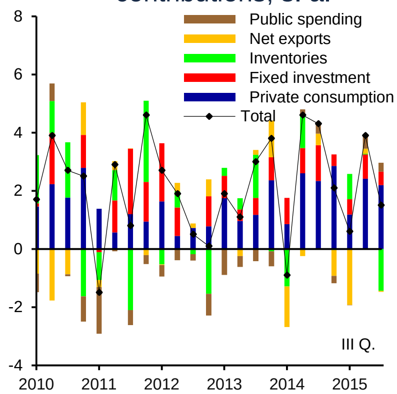
favorable performance of new house construction starts and the recovery of firms' spending in equipment were reflected in a modest increase in fixed investment. Finally, net exports contributed slightly negatively to GDP growth.

On the other hand, industrial production continued exhibiting weak growth, reflecting the effects of a generalized U.S. dollar appreciation and weaker global demand, the drop in oil exploration and production and the high inventory level. Indeed, after the contraction of 2.4 percent at an annualized quarterly rate in the second quarter, industrial production only increased 1.8 percent in the third quarter. This figure partly reflected the moderate recovery of manufacturing which, in turn, it is explained by greater dynamism of the automotive sector (Chart 9b).

In this context, the labor market further improved during the third quarter, although at a more moderate rate than in the previous quarter. Thus, non-farm payroll expanded on average 167 thousand jobs per month, below the 231 thousand jobs last quarter. At the same time, the unemployment rate dropped from 5.3 percent in June to 5.1 percent in September, level close to that considered as long term rate by the Federal Reserve. However, other labor market indicators, such as the labor participation rate and the percentage of persons working part time for economic reasons continue suggesting certain slackness in this market. This, plus the absence of significant wage pressures, intensified the debate with respect to the strength of the relationship between the unemployment rate and inflation, and it has complicated the interpretation of the signs arisen from different labor market indicators with respect to the future evolution of inflation (Chart 9c).

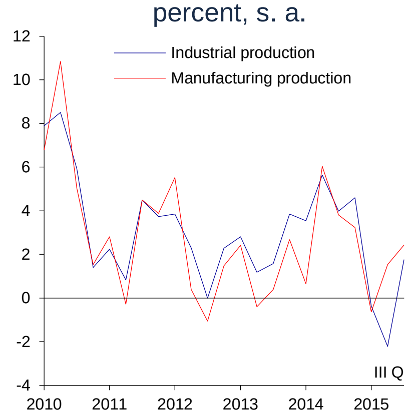
Chart 9
U.S. Economic Activity

a) Real GDP and Components
Annualized quarterly change in percent and percentage point contributions, s. a.



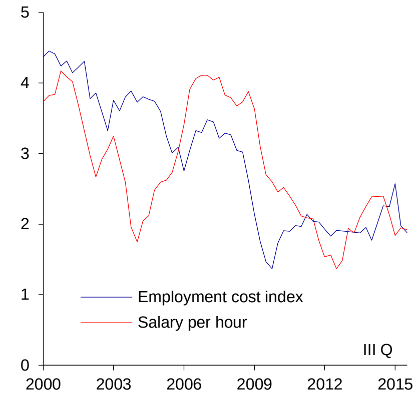
s. a. / Seasonally adjusted data.
Source: BEA.

b) Industrial and Manufacturing Production
Annualized quarterly change in percent, s. a.



s. a. / Seasonally adjusted data.
Source: Federal Reserve.

c) Wage Indicators
Annual change in percent

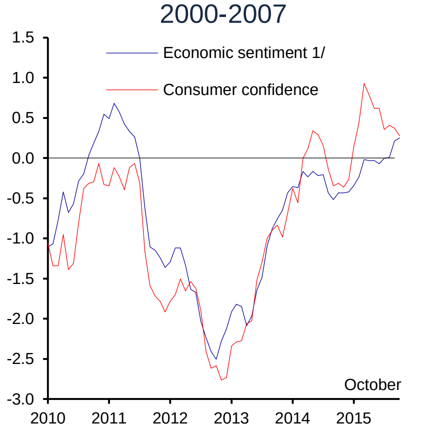


Source: BLS, Haver Analytics.

In the Euro zone, economic recovery remained weak and at a slower pace than expected, with a lot of heterogeneity among member countries. Consumption remains the main source of growth, supported by factors like the gradual improvement of labor market conditions, consumer confidence and low financing costs (Chart 10a). However, industrial production weakened from July to August (Chart 10b). With respect to this, the recent Euro appreciation and lower external demand from emerging economies, in particular from China, are having a negative impact on the region's exports (Chart 10c), due to which the European Central Bank (ECB) revised the GDP growth outlook for the next years downwards.

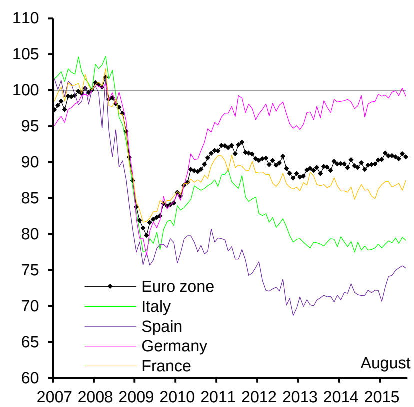
Chart 10
Economic Activity in the Euro zone

a) Economic Sentiment Indicator and Consumer Confidence
Standardized data for the period 2000-2007



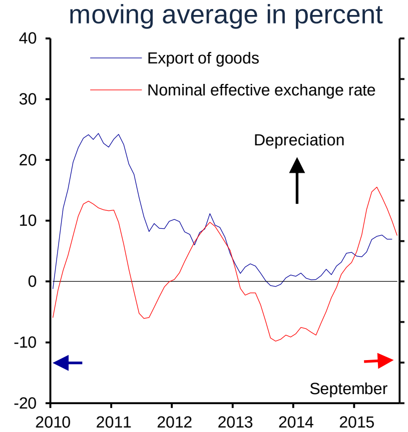
1/ Composite indicator, made up of five sectorial confidence indicators: industry, services, retail, construction and consumption.
Source: Haver Analytics.

b) Industrial Production 1/
Index December 2007=100, s. a.



s. a. / Seasonally adjusted data.
1/ Excludes construction industry.
Source: Eurostat.

c) Exchange Rate and Exports of Goods
Annual change of the 3-month moving average in percent



Source: Haver Analytics, BIS.

In Japan, the economy continued showing weakness in the third quarter of the year, after shrinking 1.2 percent at an annualized quarterly rate in the second quarter. In particular, households' income increase and high firms' revenues have not led to an increased private sector spending, suggesting caution of consumers and firms. On the other hand, capital goods' orders and business surveys point to investment having lost dynamism during the quarter. Finally, lower demand from China was reflected in an additional decrease in industrial production in the period covered by this Report.

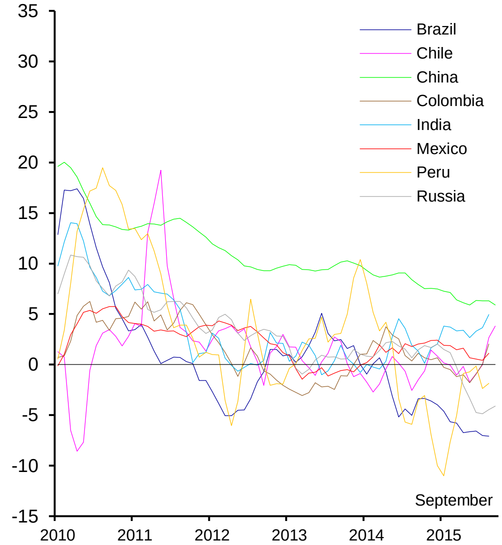
Activity in emerging economies continued slowing down, as reflected in low industrial production and export growth (Chart 11a and Chart 11b). Moreover, macroeconomic vulnerabilities of some countries accentuated, particularly in those economies, which did not made the necessary economic policy adjustments during the first years of this decade, in light of the important capital inflows due to globally low interest rates and high commodity prices. This exacerbated domestic and external imbalances. Thus, on the one hand, the drop in the terms of trade of commodity exporters contributed to a deterioration of external and fiscal accounts. On the other hand, tightening financial conditions provoked a worsening of firms' balances in light of the significant accumulation of corporate debt in the last years (Chart 11c). Among the countries most affected by these phenomenon can be mentioned Russia, Brazil, Turkey and Indonesia. Additionally, downward risks for this group of economies have intensified, among other reasons, due to the challenges faced by China in its transformation towards a mainly consumption-based economy, in a context of high levels of indebtedness and excess capacity in some industries.

Going into detail about China's evolution, the growth pace of its economy kept moderating to 6.9 percent in the third quarter (Chart 11d). Although the service sector and consumption maintained a relatively solid growth, investment and industry continued slowing down. Government's fiscal and monetary stimuli, including incentives for infrastructure spending, have been insufficient to offset the lower dynamism of residential construction and that of manufacturing sector investment. This greater weakness of industrial activity was reflected in a significant reduction in the demand for commodities, like oil and metals. Finally, the reform to the exchange rate fixing mechanism created uncertainty about the effects of the economic policy adjustments of this country on the global economy.[2]

[2] China's central bank announced on August 11 a modification of the determination mechanism for the opening exchange rate, on which each day a 2 percent interval is fixed. From this date on, the opening exchange rate refers to the closing quote of the interbank market of the previous day. In contrast, previously this level was determined by the authorities. According to the central bank, this modification has the objective to get each time closer to a market-based exchange rate determination mechanism.

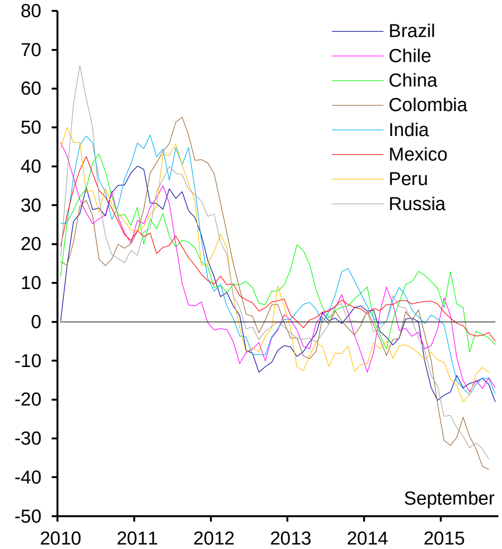
Chart 11
Economic Indicators of Emerging Economies
Annual change of the 3-month moving average in percent

a) Industrial Production

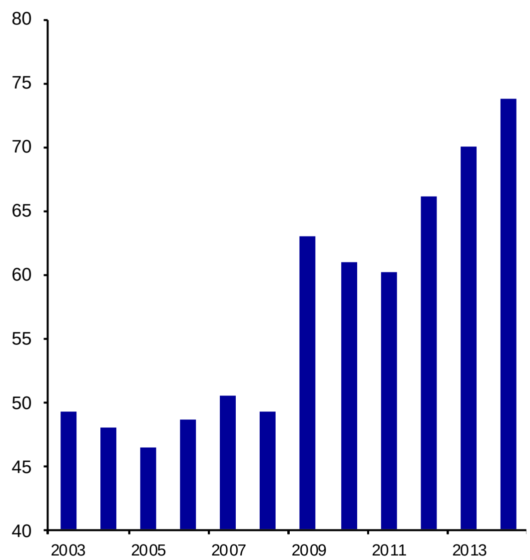


Source: Haver Analytics.

b) Exports

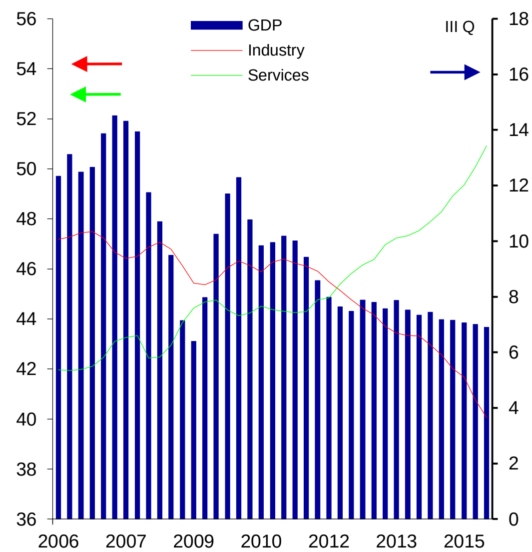


c) Corporate Debt
Percent of GDP



Note: The debt includes bank credits and bond issuance.
Source: International Monetary Fund, Global Financial Stability Report, October 2015.

d) China: GDP by Sectors
Annual change in percent and in percent of GDP

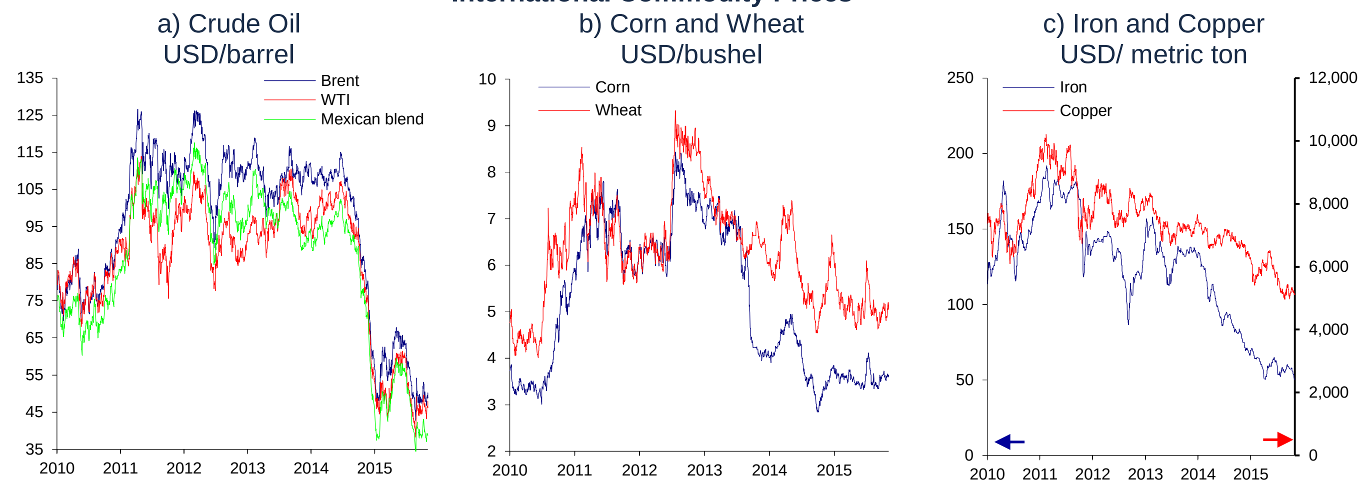


Source: Haver Analytics.

3.1.2. Commodity Prices

Commodity prices decreased during most of the third quarter of 2015, mainly due to excess supply and a lower global demand, although they showed some signs of recovery in October. Oil prices dropped in light of high production and inventory levels, the expectation regarding an increase in the exports of Iran, Libya and Iraq, and worries about the weakening of global demand. However, crude oil prices registered a slight rebound at the beginning of October, given increasing tensions in the Middle East (Chart 12a). On the other hand, cereal prices decreased due to the favorable U.S. production outlook and the expectation of less demand worldwide (Chart 12b). Finally, metal prices maintained their downward trend, as result of substantial increases in the supply of most metals and, as shown, of the slowdown of Chinese demand (Chart 12c).

Chart 12
International Commodity Prices [1/]



1/ Spot market.
Source: Bloomberg.

3.1.3. Inflation Trends Abroad

Inflation in the main advanced economies declined during the period covered in this Report, mainly due to the additional drop in oil prices and, in some cases, due to the currency appreciation (Chart 13a). Meanwhile, slower than expected convergence of inflation to the medium-term targets led to a reduction in inflation expectations, particularly those derived from financial instruments. These factors, together with the downward revision of the growth outlook, could contribute to inflation levels remaining at low levels for a prolonged period.

In the U.S., the annual change of the consumption deflator persistently maintained levels close to zero, locating at 0.2 percent in September, well below the inflation target of 2.0 percent. The weakness of this indicator is mainly due to low energy prices and the generalized U.S. dollar appreciation. In fact, the change of the core component remained low at 1.3 percent at an annual rate in September, precisely due to the USD appreciation effect on non-energy import prices.

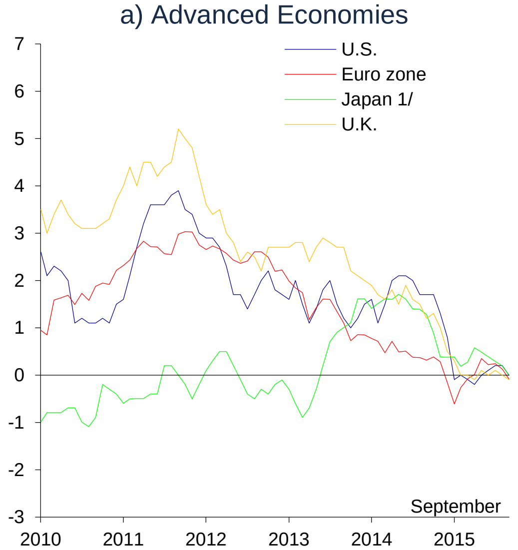
In the Euro zone, headline inflation returned to negative levels at the end of the quarter, mainly driven by low energy prices. Thus, it dropped from 0.2 percent in June to -0.1 percent in September. On the other hand, in the same period the core indicator slightly increased from 0.8 percent to 0.9 percent. In this environment, the ECB continued anticipating that inflation will stay low in the next months and will begin to increase gradually at the end of year, given the pass-through of the past Euro depreciation onto prices and the recovery of domestic demand. However, the ECB estimated that this rebound will be slower than previously expected, due to the drop in commodity prices, the recent Euro appreciation and the downward revision of the growth outlook of the Euro zone.

Inflation in Japan also decreased during the quarter, passing from 0.4 percent in June to 0.0 percent in September. This happened, because the energy price drop offset the increase of prices, mainly food, derived from the Yen depreciation.

Emerging economies continue with a mixed inflationary scenario, with most countries registering low inflation rates in an environment of weak domestic and external demand. In contrast, in some countries, like Brazil, Chile, Colombia and Peru, inflation was above the respective central bank target, partly reflecting the strong depreciation of their currencies, in combination with some macroeconomic imbalances (Chart 13b). Additionally, an increase in inflation expectations was also observed, which reduced the degrees of freedom of these countries' monetary policy. Meanwhile, in the case of Mexico, despite the MXN depreciation, no increase in inflation and its expectations was registered (see Box 1).

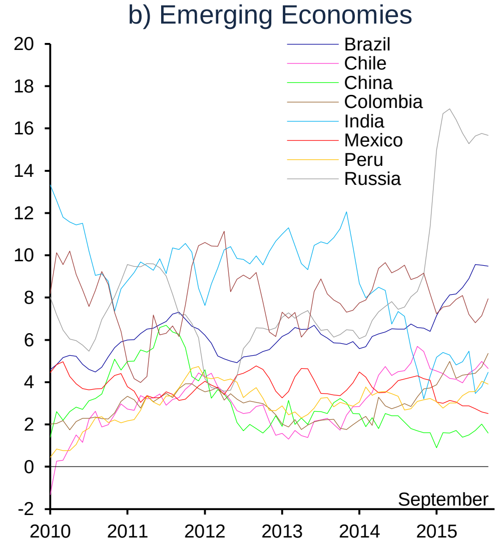
Chart 13
Annual Headline Inflation in Advanced and Emerging Economies
In percent

a) Advanced Economies



1/ It excludes the direct effect of the increment in the consumption tax.
Source: BLS, Eurostat and Statistics Bureau of Japan.

b) Emerging Economies



Source: National Statistics Bureaus and Central Banks.

Box 1
Pass-through of Exchange Rate Movements onto Prices in Latin-American Economies

1. Introduction

Uncertainty about the beginning of the normalization of the U.S. monetary policy, together with problems in financial markets in China, the drop in commodity prices worldwide, in particular of crude oil, and the feedback between these developments and the global environment of low growth have contributed to increasing volatility in international financial markets, mainly putting pressure on the exchange rates in emerging economies. Indeed, the currencies of the main emerging economies registered a generalized depreciation against the U.S. dollar of 25 percent on average since October 2014.[1] In Latin America, this depreciation has been on average around 30 percent.

In this context, besides the important decline observed in commodity prices and the weakening of economic activity, both headline as well as core inflation have been increasing in countries like Brazil, Chile, Colombia and Peru. In most of these countries, these indicators are even above the upper range bound of the variability interval defined around their respective inflation targets. With respect to this, at least part of this inflation increase has been attributed to the effect of the exchange rate depreciation on prices.

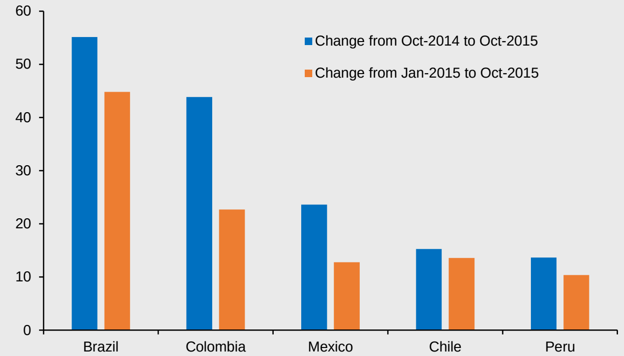
In this Box a measure of pass-through of exchange rate movements onto consumer prices is estimated for the main Latin-American economies with inflation targeting regimes: Brazil, Chile, Colombia, Mexico and Peru. Results show that for the Mexican economy the pass-through is low in comparison with that estimated for other countries.

2. Depreciation and inflation in the region

The observed currency depreciation in the main Latin-American economies from October 2014 until present has been substantial, although not homogeneous. In Brazil, the depreciation has been 55 percent, in Chile 15 percent, in Colombia 44 percent and in Peru 14 percent, while in Mexico it was 24 percent (Chart 1).

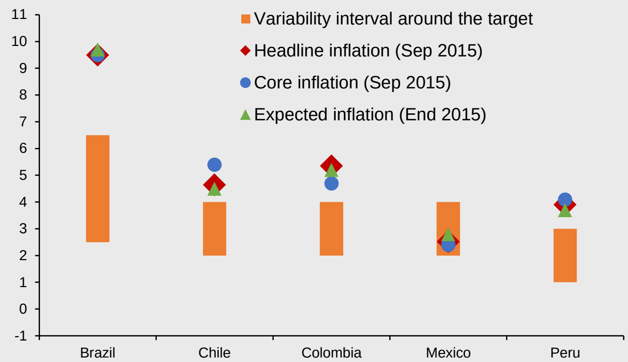
In light of the observed depreciation, in most cases, headline and core inflation have been increasing, even locating, as shown, above the upper bound of the variability interval of their corresponding inflation targets (Chart 2). Besides the observed increase in inflation, it stands out that even inflation expectations for the end of 2015 increased in most analyzed economies.

Chart 1
Exchange Rate Depreciation in Latin-American Economies
Percent



Source: Bloomberg.

Chart 2
Inflation Target and Observed and Expected Inflation
Percent



Note: Data as of September 2015.
Source: Central bank of each country, INEGI and Haver Analytics.

Given the aforementioned, it is clear that even though the currencies' depreciation has been generalized in the region, the behavior of inflation has been mixed. In the case of Mexico, inflation has shown a downward trend and even reached historical minimum levels. This, despite the fact that the MXN depreciation has been even higher than the observed in other countries of the region.

This suggests that the heterogeneous behavior of inflation in Latin America cannot exclusively be attributed to differences in the magnitude of adjustment in the observed exchange rate in each country, but rather to other factors, being one of them the degree of exchange rate pass-through onto prices. Taking this into consideration, in the following an econometric exercise is presented, based on which a measure of exchange rate pass-through onto prices for each country is estimated.

---
[1] The countries considered are: Brazil, Chile, Colombia, Korea, India, Hungary, Peru, Poland, Czech Republic, Russia, Thailand and Turkey.

3. Estimation of the Exchange Rate Pass-through onto Prices

Following the methodology of Albagli et al. (2015), in this section an estimation of the pass-through of exchange rate movements onto prices is presented for Brazil, Chile, Colombia, Mexico and Peru. For that purpose, a VAR model was estimated for each country. The periodicity of data is monthly and the sample comprises from January 2000 to June 2015. The variables included in the model are those commonly used to analyze small and open economies.[2] The endogenous variables vector includes: an economic activity indicator, the nominal exchange rate against the USD, the consumer price index and the monetary policy rate. The previous exogeneity order is used for the Choleski decomposition. As exogenous variables the first two principal components of the following variables are included: world and U.S. industrial production indices, U.S. federal funds rate, oil prices, international food prices, and a country-specific export price index.

As a measure of pass-through it is considered, the response of the consumer price index, accumulated in the first 12 months, after a 1 percent shock to the nominal exchange rate. Thus, in Table 1 it is presented the impact of a 1 percent depreciation of each analyzed country's exchange rate against the U.S. dollar on annual inflation, measured in basis points.

Table 1
12-month accumulated Effect on Inflation of a 1 percent Depreciation
Basis points

Country	Effect
Brazil	26.8
Chile	17.5
Peru	9.4
Colombia	4.6
Mexico	3.8

Source: Estimated by Banco de México.

As can be observed, the level of exchange rate pass-through onto prices is higher in Brazil and considerably lower in Mexico, which helps to explain why inflation has located at historical minimum levels in Mexico in the last months, despite the significant exchange rate depreciation.[3] Thus, the results show that, given the magnitude of depreciation suffered by these currencies, the countries with a greater pass-through coefficient are those that presented higher levels of inflation recently.

[2] All variables are expressed in logarithmic differences, except the monetary policy rate, which is included as difference in percentage points.

4. Final Considerations

The information presented in this Box shows that in several Latin-American countries, the exchange rate depreciation has had a significant impact on inflation. Additionally, an increase in inflation expectations for the end of 2015 has also been observed in some of these countries. In light of these developments, central banks of several of these economies have taken measures in order to increase their monetary policy rates.

In this context the case of Mexico stands out, whose inflation has remained below the 3 percent target, despite the exchange rate depreciation. This favorable behavior can mainly be explained by the strengthening of the macroeconomic framework in the last decade. A monetary policy focused on price stability together with fiscal discipline have contributed to controlling the inflationary phenomenon and to creating an environment of low and stable inflation. Among the structural achievements in controlling inflation, that have been documented by the Central Institute in the last year, stand out:

i. The reduction in the level, volatility and persistence of inflation (Banco de México, 2010);
ii. A price formation process that is similar to the way prices are determined in economies with a large history of price stability (Banco de México, 2011b, 2013b);
iii. A stronger anchoring of inflation expectations (Banco de México, 2011c and 2013a); and,
iv. A gradual reduction in inflation compensation and the inflationary risk premium (Banco de México, 2013c).

All this has contributed to the decrease in the pass-through of exchange rate fluctuations onto prices, which has also allowed the favorable evolution of inflation in the last months, despite the observed depreciation. In addition to this, as shown in this Report, slack conditions prevailing in the economy as well as input price reductions have also supported the favorable performance of inflation in the current year.

[3] These results are in line with the previous estimations of the exchange rate pass-through onto prices. In the Technical Chapter of the Inflation Report January - March 2011, results showed that for the period June 2001 – December 2010, the elasticity of the pass-through on prices was 0.02 percentage points one year after a shock. Updating this exercise in the Box "Estimation of the Effect of the Exchange Rate Adjustment on Inflation", "published in the Inflation Report July - September 2012, with information until August 2012, an pass-through elasticity of 0.03 percentage points, 12 months after the shock was estimated.

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Banco de México (2013a) Box 3 "Anchoring of Medium- and Long-term Inflation Expectations in face of Adverse Supply Shocks", Inflation Report January - March 2013.

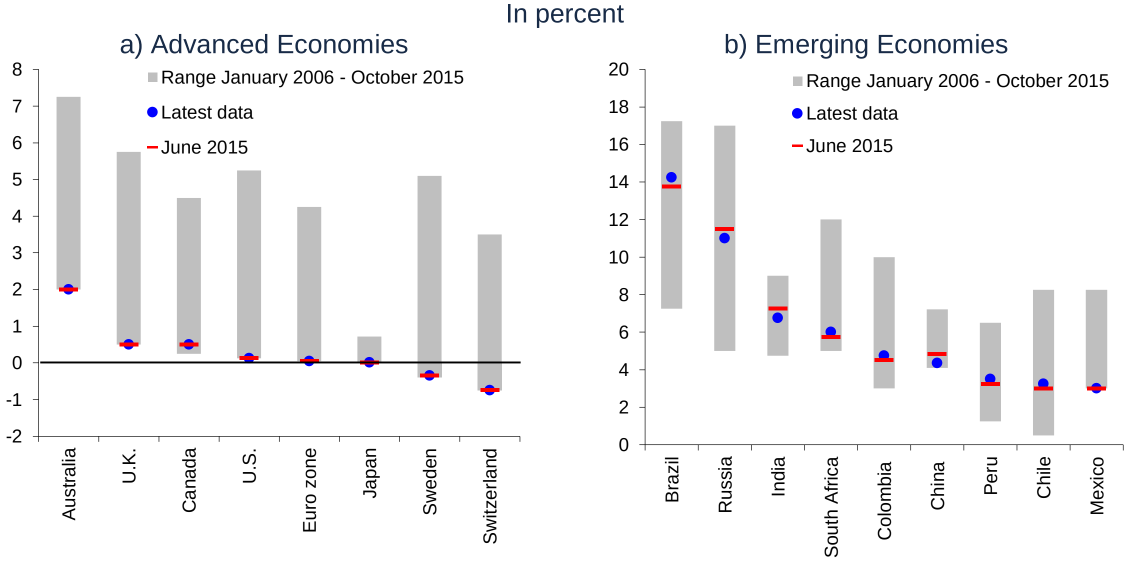
Banco de México (2013b) Box 1 "Relative Price Changes and Convergence of Inflation to the 3 percent Target", Inflation Report April - June 2013.

Banco de México (2013c) Box 1 "Inflation Decomposition and Inflation Risk", Quarterly Report October - December 2013.

3.1.4. International Monetary Policy and Financial Markets

In this environment of low growth and reduced inflation in main advanced economies, highly accommodative monetary conditions are anticipated to persist for a longer time and in some cases monetary stimulus may even be expanded (Chart 14a). On the other hand, some emerging economies, which, possibly due to macroeconomic vulnerabilities, have been characterized by a greater exchange rate pass-through onto inflation, increased their reference interest rates despite less economic dynamism (Chart 14b).

Chart 14
Monetary Policy Rates of Advanced and Emerging Economies
In percent



Source: Haver Analytics.

In its October meeting, the Federal Reserve maintained its reference rate unchanged, but explicitly pointed out that in the next meeting it will determine whether or not it is appropriate to increase the target range of the federal funds rate. This decision will depend on the evolution of economic activity, the labor market and inflation, reaffirming that it expects the pace of monetary policy normalization to be gradual. In its announcement, it evaluated more favorably the strength of domestic demand and stressed that the labor market continued improving. This latter besides the decline in the growth pace of employment and the recent stability of the unemployment rate. Furthermore, it reiterated its expectation that inflation will gradually increase towards the medium-term target, to the extent to which the labor market improves and temporary effects on inflation, caused by energy and import price drops, vanish. Finally, the Federal Reserve affirmed that it is monitoring the global economic and financial events, although eliminated the references made in the last announcement with regard to the possible negative effects of the uncertain international scenario on U.S. growth and inflation.

Meanwhile, the Bank of England in its October meeting decided to maintain the reference rate unchanged at 0.5 percent, as well as the balance of its security purchase program at GBP 375 billion. In its announcement, although it mentioned the deterioration of the global environment, it pointed out that domestic demand has remained solid and that there is evidence of pressures on the capacity of some sectors in the economy, although progress in productivity contributed to limit this effect on inflation. At the same time, it reiterated its expectations that once it determines the first increase in its reference rate, the pace of subsequent increments will be gradual.

In its October meeting, the ECB decided to maintain its monetary policy interest rates unchanged and reiterated its intention to continue implementing its security purchase program for EUR 60 billion monthly at least until September 2016 and, in any event, until a change in the inflation trend consistent with the achievement of the medium-term target is perceived. The ECB stressed that downward risks to the growth and inflation outlook in the Euro zone tightened, in light of the concern about the growth outlook in emerging economies and the possible repercussions for the region, derived from the recent development in financial markets and of commodities. In this context, it pointed out that the degree of monetary policy easing should be revised in the next meeting in December, once the new macroeconomic forecasts are available, and it reiterated its disposal to take action, if necessary, using all instruments available in its mandate to maintain an appropriate degree of monetary easing.

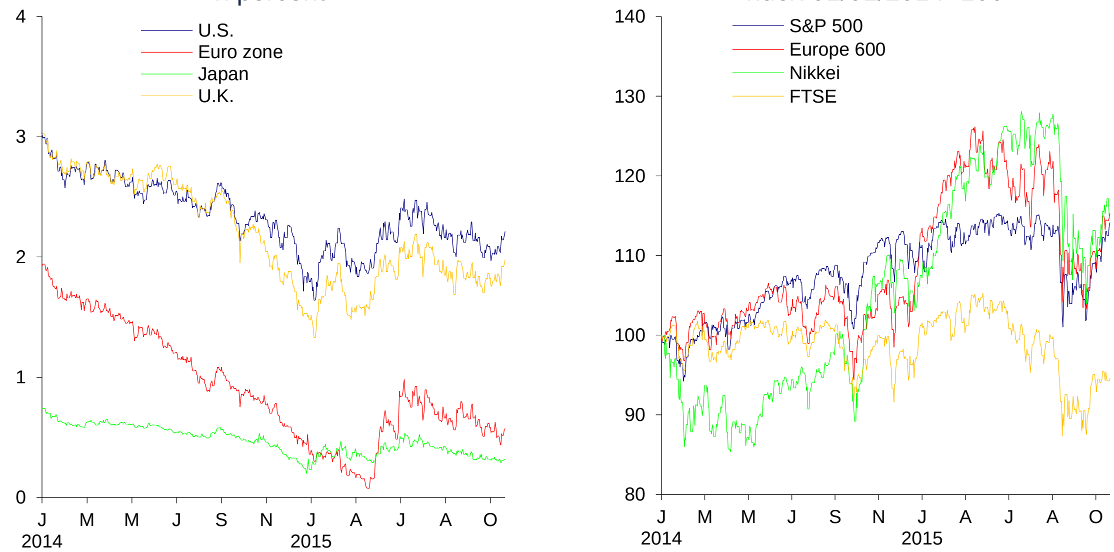
In its meeting in October, the Bank of Japan ratified that it will continue with its lax monetary program in order to reach the 2 percent inflation target, considering that the implemented quantitative and qualitative stimulus measures are having the expected effects. In this way, it maintained the objective to increase the monetary base at an annual rate close to JPY 80 trillion, and its decision to continue buying government bonds and other instruments. Besides, it pointed out that, although long-term inflation expectations further recovered, annual inflation will probably remain close to 0 percent for some months, due to the impact of the drop of energy prices, while it anticipates the Japanese economy to continue growing at a low rate.

As mentioned before, volatility in international financial markets kept high in the period covered by this Report. This was the result of uncertainty with respect to the normalization process of the U.S. monetary policy, the concerns regarding the Chinese growth outlook and its possible repercussions for the global financial and economic situation, as well as the perception of higher vulnerability of emerging economies. Thus, advanced economies registered certain tightening of financial conditions, given the downturn in their stock markets and a real interest rate increase due to lower inflation expectations (Chart 15).

Chart 15
Financial Indicators of Selected Advanced Economies

a) 10-year Bond Yield
In percent

b) Stock Markets
Index 01/01/2014=100

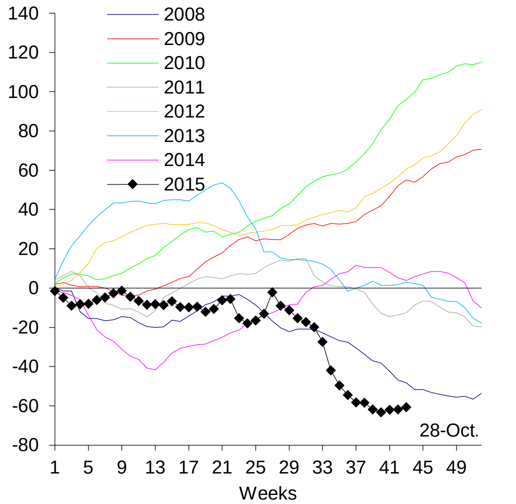


Source: Bloomberg.

The perception of greater divergence in the cyclical position between emerging economies and the U.S. economy, in addition to the drop in terms of trade, provoked a restructuring of portfolios towards less risky assets. This was reflected in a reduction in capital flows towards emerging economies, leading to a reduction in their financial asset prices and a greater depreciation of their currencies (Chart 16). On the other hand, sovereign risk premia indicators showed increases, mainly in those economies with greater macroeconomic challenges. Finally, the uncertain global environment exacerbated the risks that some emerging economies with weak fundamentals, like Brazil and Turkey, faced a disordered process of economic and financial adjustment. This, in turn, points to potential risks of contagion to other economies.

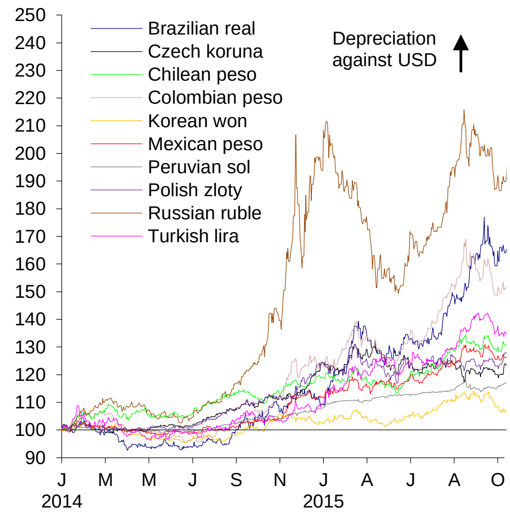
Chart 16
Financial Indicators of Emerging Economies

a) Total Capital Flows to Emerging Economies (Debt and Stocks) 1/



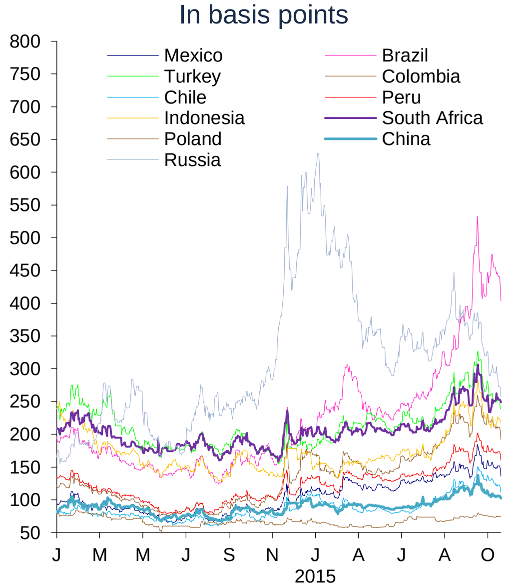
1/ The sample includes funds used for emerging economies' stock and bonds transactions, registered in advanced economies. The flows exclude the performance of the portfolio and exchange rate movements.
Source: Emerging Portfolio Fund Research.

b) Exchange Rate
Index 01/01/2014=100

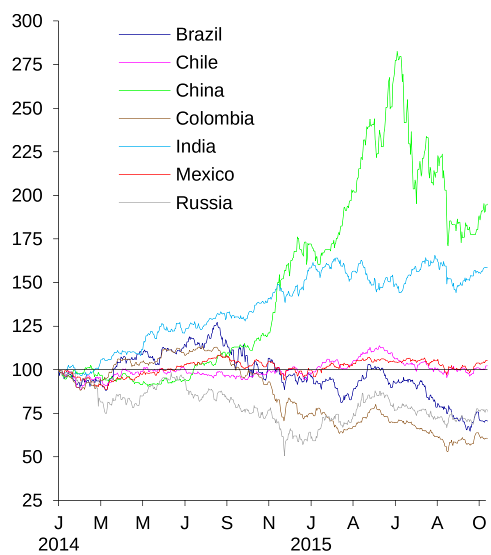


Source: Bloomberg.

c) Sovereign Credit Risk Measuring Market Indicators (CDS)
In basis points



d) Stock Markets
Index 01/01/2014=100



Source: Bloomberg.

Since October, volatility in international financial markets started showing certain decline, to a great extent, due to greater risk appetite of institutional investors. This, in light of the prevailing expectations of a possible delay in the start of the normalization process of the U.S. monetary policy and the measures adopted by Chinese authorities to stabilize their financial market and boost growth. This was reflected in an improvement of global stock markets, in a slight appreciation of emerging economies' exchange rates and certain decline in these countries' sovereign risk indicators. Additionally, long-term interest rates experienced a reduction at the end of the quarter, mainly reflecting the decision of the Federal Reserve not to increase the reference rate in its September meeting, as well as the increased expectations that emerging economies weakness, especially China, could lead advanced economies' monetary policy to remain lax for a prolonged time period.

However, a new rebound of volatility in international financial markets cannot be ruled out, in particular in the case that the first increase in the federal funds rate might be unexpected for most of the market, that the expectation of the subsequent trajectory of increments might be more pronounced than foreseen, or in the case of negative news regarding the economic and financial evolution of China. In this context, the position of higher vulnerability of some emerging economies stands out, in the face of significant deterioration in their macroeconomic situation in general, which requires important policy adjustments.

3.2. Evolution of the Mexican Economy

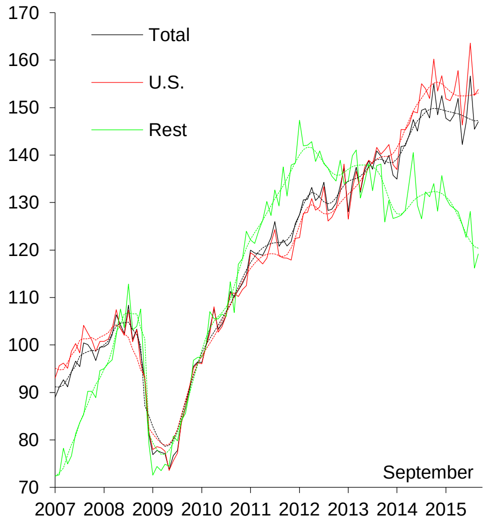
3.2.1. Economic Activity

In the third quarter of the present year, economic activity in Mexico maintained the moderate growth pace registered since the beginning of 2015. In particular, net exports continued presenting a low dynamism, while some domestic demand components showed certain improvement.

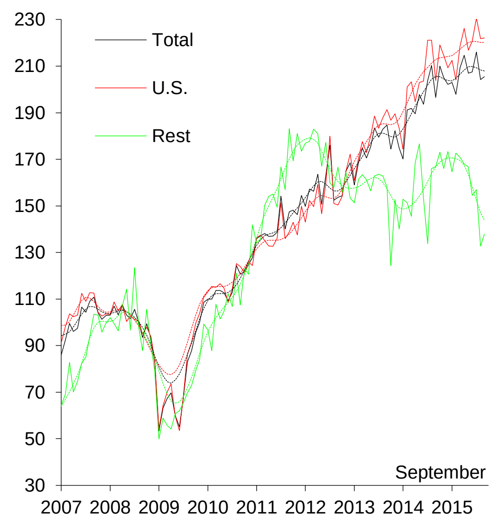
With respect to the external sector, manufacturing exports kept exhibiting a relative stagnation in the July - September 2015 period, despite the significant real MXN/USD exchange rate depreciation (Chart 17a). However, U.S. industrial production only grew 1.8 percent at an annualized seasonally adjusted quarterly rate, after having contracted 0.3 and 2.4 percent in the first two quarters of the year. To the extent to which the income effect of a weak external demand dominated the favorable price effect derived from the real exchange rate depreciation, both automotive and non-automotive exports to the northern neighbor country registered low growth. Additionally, in line with the weakness that demand from countries other than the U.S. has been presenting since several quarters, in the July - September 2015 period, exports to these countries continued exhibiting a negative trend, in particular those directed to Asia and Europe (Chart 17b and Chart 17c). Meanwhile, oil exports maintained the unfavorable performance shown since the beginning of 2012 (Chart 17d). In particular, in the reference period, shrinking of oil exports reflected a new decline in the oil price, since the export platform even presented a slight increase.

Chart 17
Export Indicators
Index 2008=100, s. a.

a) Manufacturing Exports
Total

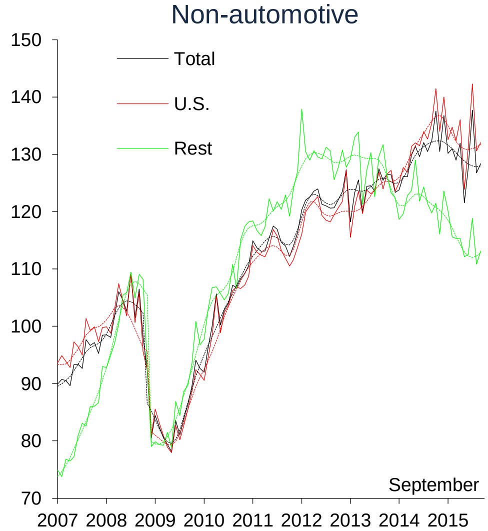


b) Manufacturing Exports
Automotive



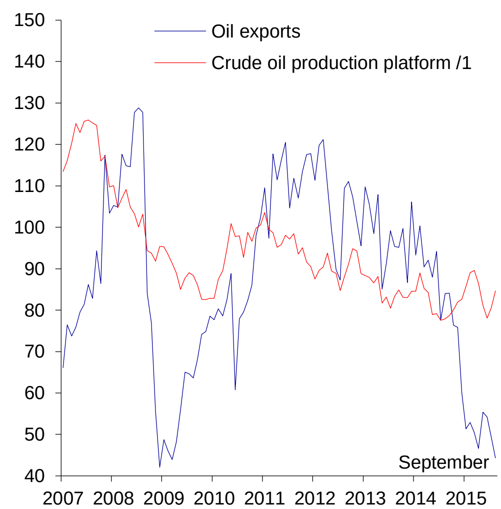
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Banco de México with data from Ministry of Finance (SAT), Ministry of Economy (SE), Banco de México, INEGI. Merchandise Trade Balance. SNIEG. Information of National Interest.

c) Manufacturing Exports
Non-automotive



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Banco de México with data from Ministry of Finance (SAT), Ministry of Economy (SE), Banco de México, INEGI. Merchandise Trade Balance. SNIEG. Information of National Interest.

d) Oil Exports and Crude Oil Export Platform



s. a. / Seasonally adjusted data.
1/ 3-month moving average of daily barrels.
Source: Ministry of Finance (SAT), Ministry of Economy (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.*

With respect to domestic spending, some of the private consumption indicators registered higher growth rates than last quarter, supported by the evolution of the labor market, low inflation and the rebound in income from workers' remittances.

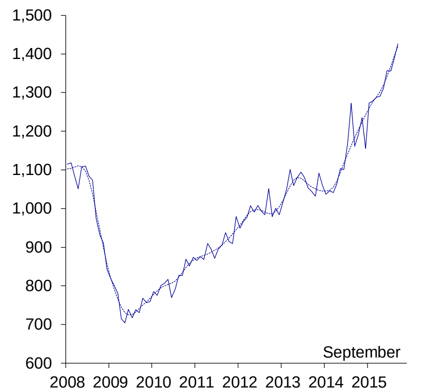
i. In the reported period, domestic light vehicle sales and commercial establishment revenues presented higher growth than that observed in the previous quarter, while ANTAD sales expanded at a similar rate, thus further exhibiting high dynamism (Chart 18a and Chart 18b). Meanwhile, the monthly indicator of domestic private consumption, which is a broader measure of private consumption, maintained its moderate growth pace at the beginning of the quarter (Chart 18c).

ii. In this context, some consumption determinants have gradually shown an improvement. In particular, in the first semester of 2015, workers' wage bill exhibited an increment, although starting from very low levels (Chart 19a). Income from remittances, both in constant USD and MXN, registered an increase in the period July – September as compared to the second quarter (Chart 19b). On the other hand, in the third quarter of the current year, bank credit for consumption presented an increase in its growth rate in relation to the one observed in the previous quarter (see Section 3.2.3). In contrast, the consumer confidence indicator maintained certain downward trajectory in the reported quarter, although it stands out that the component that measures the perception about the possibility of buying durable goods continued recovering (Chart 19c).

According to the latest data, gross fixed investment showed moderate dynamism at the beginning of the quarter subject of this Report (Chart 20a). In particular, growth observed in machinery and equipment, due to a greater dynamism of capital goods' imports (Chart 20b), was partially offset by the weakness that continued presenting investment spending in the construction sector, especially non-residential (Chart 20c). In this context, capital goods' imports have been boosted by a favorable outlook in the automotive, telecommunication sectors and the energy sector, as refers to electricity production and distribution.

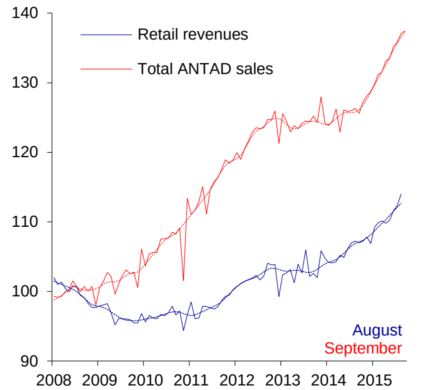
Chart 18
Consumption Indicators

a) Domestic Light Vehicle Retail Sales
Thousands of units, annualized, s. a.



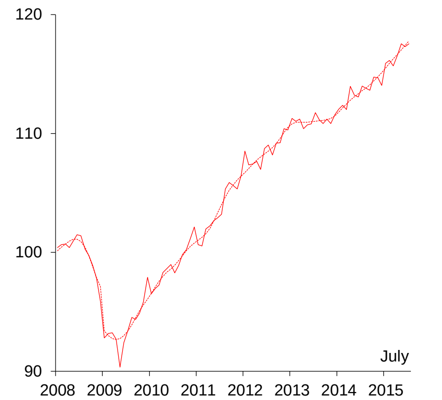
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Prepared by Banco de México with data from the Mexican Automotive Industry Association (AMIA).

b) Commercial Retail Business Revenues and ANTAD Sales
Index 2008=100, s. a.



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Monthly Business Survey, INEGI; and prepared by Banco de México with data from ANTAD.

c) Domestic Market Private Consumption Indicator
Index 2008=100, s. a.



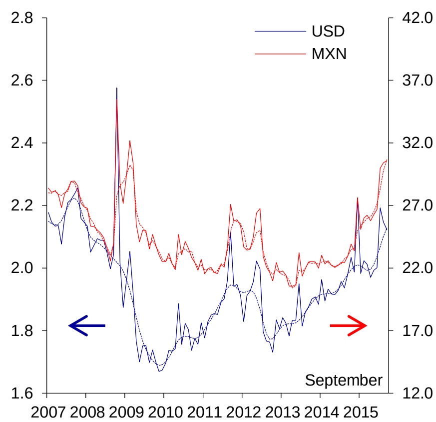
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: INEGI.

Chart 19
Consumption Determinants

a) Total Real Wage Bill
Index I-2008=100, s. a.

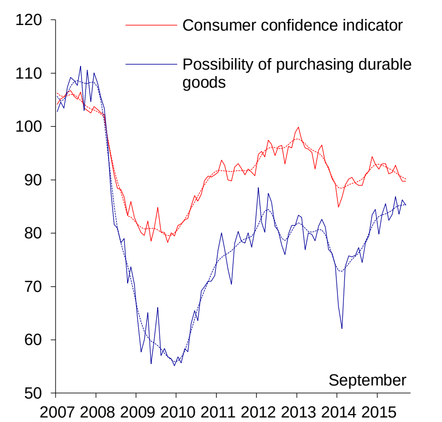
s. a. / Seasonally adjusted data.
Source: Prepared by Banco de México with data from the National Employment Survey (ENOE), INEGI.

b) Workers' Remittances
Billion, constant USD and MXN, 1/ s. a.



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
1/ Prices as of the second fortnight of December 2010.
Source: Banco de México.

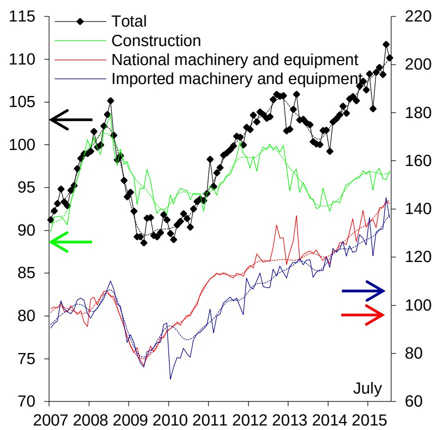
c) Consumer Confidence
Index January 2003=100, s. a.



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: National Consumer Confidence Survey (ENCO), INEGI and Banco de México.

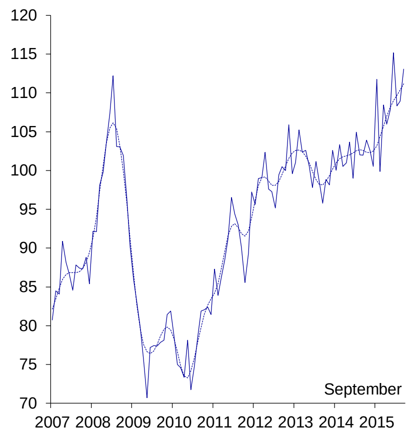
Chart 20
Investment Indicators
Index 2008=100, s. a.

a) Investment and its Components



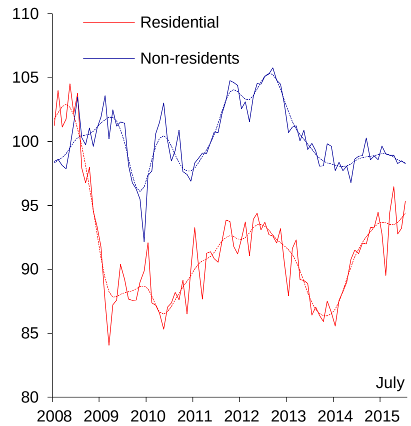
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Mexico's National Accounts System, INEGI.

b) Capital Goods' Imports



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Ministry of Finance (SAT), Ministry of Economy (SE), Banco de México, INEGI. Merchandise Trade Balance. SNIEG. Information of National Interest.

c) Investment in Residential and Non-residential Construction



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Mexico's National Accounts System, INEGI.

As regards to economic activity from the production side, in the first two months of the third quarter the industrial sector showed a slow growth pace, while services exhibited a positive trend (Chart 21a).

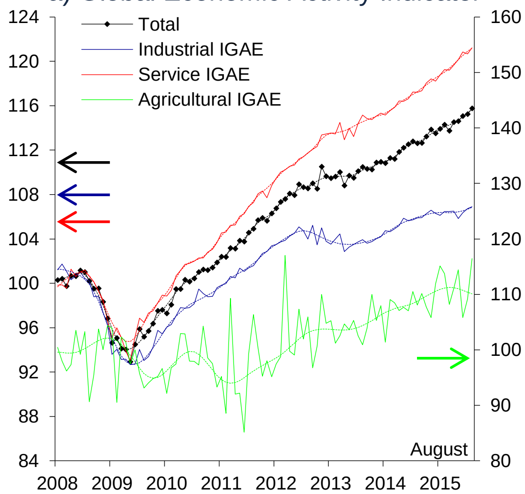
i. As to industrial production, in the two months of July – August of the ongoing year, the manufacturing sector kept presenting a positive trajectory, although it lost certain dynamism. In contrast, the construction sector maintained a weak performance (Chart 21b) and that of mining continued registering a negative trend, mainly reflecting the low level of oil production and the unfavorable performance of services associated with that sector (Chart 21c).

ii. Meanwhile, services kept showing a favorable evolution (Chart 21d). In the two months of July – August, the main sectors sustaining this upward trajectory were domestic trade, transport services and mass media information services, as well as temporary accommodation services and food and drink preparation services. The positive performance of these aggregates would seem to have been the result of the dynamism observed in consumption, the impact of the election process, the improvement of the telecommunication sector and the stimulus from tourist activities. In contrast, some sectors of the tertiary activities showed a less favorable evolution, with the case of financial and insurance services, corporative and educational services standing out.

iii. At the beginning of the third quarter of the current year, primary activities showed a positive growth rate, derived from an increase in crop planting in spring-summer cycle and a better harvest of the autumn – winter cycle and of some perennial crops.

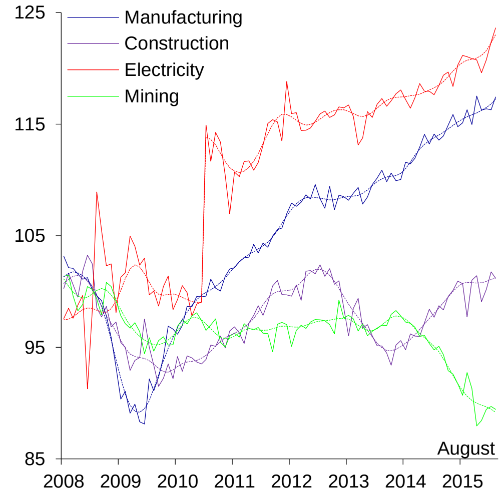
Chart 21
Production Indicators
Index 2008=100, s. a.

a) Global Economic Activity Indicator



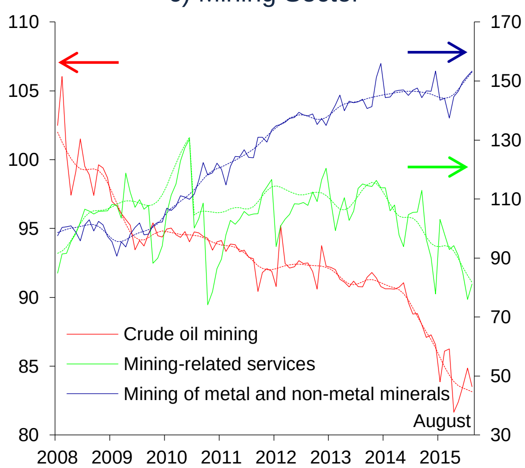
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Mexico's National Accounts System, INEGI.

b) Industrial Activity



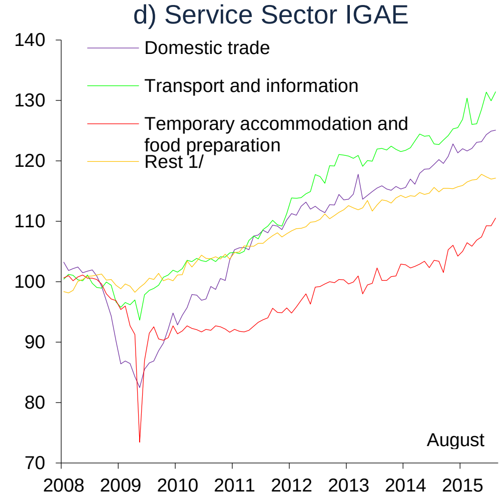
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Monthly Industrial Activity Indicator, Mexico's National Accounts System, INEGI.

c) Mining Sector



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: Monthly Industrial Activity Indicator, Mexico's National Accounts System, INEGI.

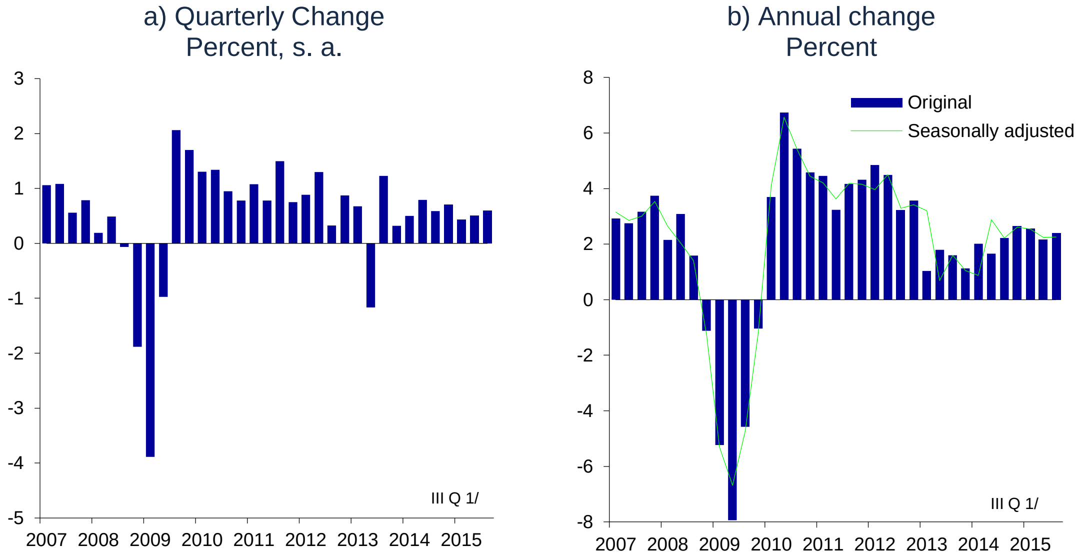
d) Service Sector IGAE



s. a. / Seasonally adjusted data.
1/ Includes the rest of the service sectors.
Source: Prepared by Banco de México with data from Mexico's National Accounts System.

In this context, in the third quarter of 2015, according to the latest quarterly GDP advanced estimate published by INEGI, economic activity showed a seasonally adjusted quarterly growth of 0.6 percent, figure compared to the growth rate of 0.5 percent observed in the previous quarter (Chart 22a). At an annual seasonally adjusted rate, according to the latest GDP advanced estimate, the Mexican economy presented an annual increase of 2.3 percent in the reference quarter, compared to 2.2 percent registered in the previous quarter. Data without seasonal adjustment show that the annual change, according to the latest GDP advanced estimate, was 2.4 percent in the third quarter of the present year, compared to 2.2 percent reported for the second quarter (Chart 22b).

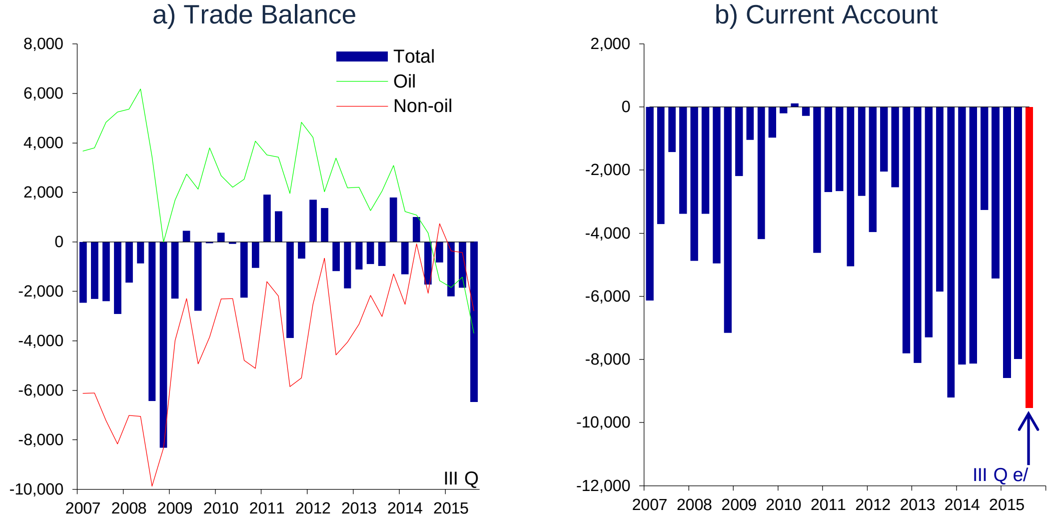
Chart 22
Gross Domestic Product



s. a. / Seasonally adjusted data.
1/ Data corresponding to the third quarter of 2015 refers to the quarterly GDP advanced estimate published by INEGI.
Source: Mexico's National Accounts System, INEGI.

Finally, in the third quarter of 2015, Mexico's trade balance showed a deficit of USD 6,469 million, composed of deficits of USD 2,783 million in the non-oil trade balance and USD 3,686 million in the one for oil (Chart 23a). Thus, the balance of the oil trade balance kept deteriorating and showed a deficit for the fourth consecutive quarter, after having presented surplus since 2009. On the other hand, latest data suggest that the current account will have registered a moderate deficit in the third quarter of 2015 and that it continued receiving resources through the financial account that allowed the financing of this deficit (Chart 23b). In particular, it is foreseen that, as reflection of the favorable outlook in face of the new investment possibilities opened up by structural reforms, further resources are captured in the direct investment and portfolio accounts. With respect to the latter, in the third quarter, a slight inflow of resources from non-resident investors to the stock market and government bond market was observed (see Section 3.2.3).

Chart 23
Trade Balance and Current Account
USD million



Source: Ministry of Finance (SAT), Ministry of Economy (SE), Merchandise Trade Balance. SNIEG. Information of National Interest.

e/ Banco de México estimate.
Source: Banco de México.

3.2.2. Labor Market

In light of the moderate economic growth, in the third quarter of 2015 conditions of slack persisted in the labor market.

i. Indeed, in the third quarter of 2015, national and urban unemployment rates registered levels similar to those last quarter and continued above pre-crisis levels (Chart 24a). In particular, in July – September of the current year, the national unemployment rate presented an average level of 4.3 percent in seasonally adjusted terms, figure similar to that reported in the second quarter of 4.4 percent, while the urban unemployment rate remained at 5.2 percent.

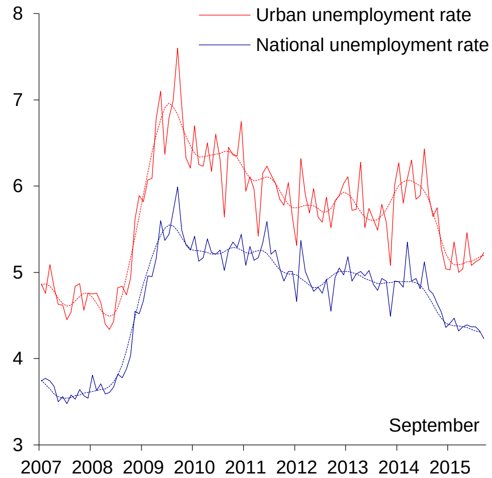
ii. The labor participation rate exhibited an increase with respect to the average of the second quarter (Chart 24b).

iii. In line with that, the number of IMSS-insured workers kept showing a favorable increase (Chart 24c).

iv. However, the growth pace of informal sector employment exceeded that of formal employment, so that the informality indicators continued without improvement (Chart 24d).

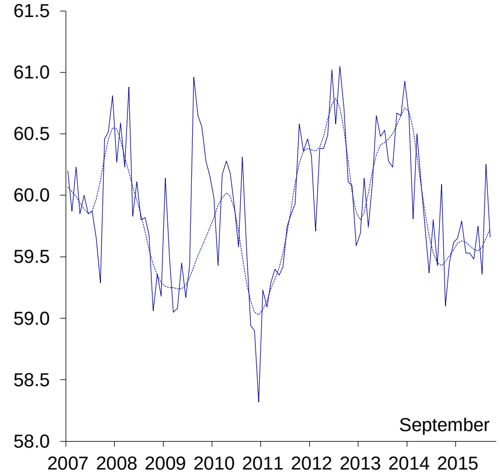
Chart 24
Labor Market Indicators

a) National and Urban Unemployment Rates
Percent, s. a.



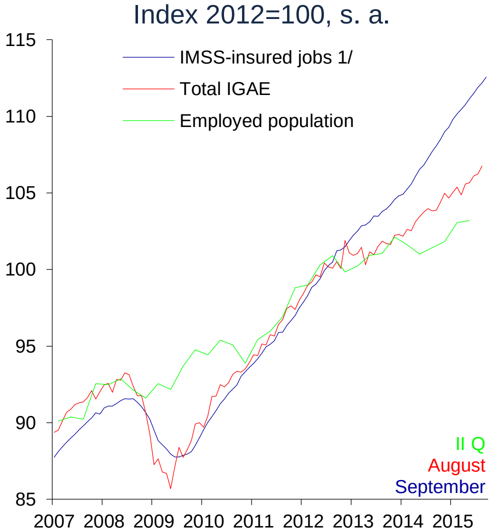
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
Source: National Survey on Occupation and Employment (ENOE), INEGI.

b) Labor Participation Rate [1/]
Percent, s. a.



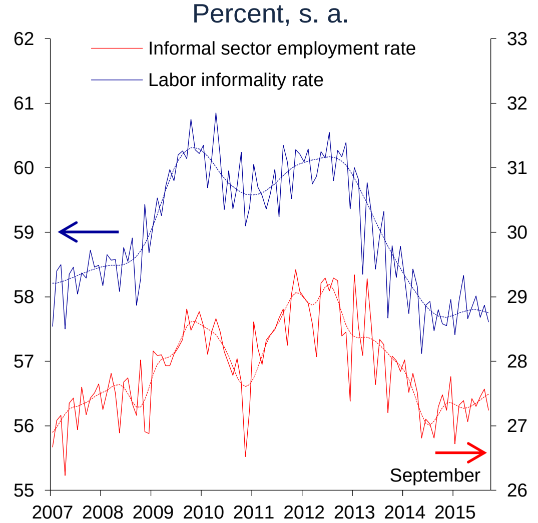
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
1/ Percentage of economically active population (EAP) with respect to the population of 15 years old and older.
Source: National Survey on Occupation and Employment (ENOE), INEGI.

c) IMSS-insured Workers, Total IGAE and Working Population
Index 2012=100, s. a.



s. a. / Seasonally adjusted data.
1/ Permanent and temporary jobs in urban areas. Seasonal adjustment by Banco de México.
Source: Prepared by Banco de México with data from IMSS and INEGI (SCNM and ENOE).

d) Informal Sector Employment[1/] and Labor Informality [2/]
Percent, s. a.



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line, the latter by a dotted line.
1/ It refers to individuals working in non-agricultural economic units, operating with no accounting records and with households' resources.
2/ It includes workers who, besides being employed in the informal sector, work without social security protection and whose services are used by registered economic units, and workers self-employed in subsistence agriculture.
Source: National Survey on Occupation and Employment (ENOE), INEGI.

In this context of slackness in the labor market, growth rates of the main wage indicators in the economy observed in the third quarter of the current year continued being moderate. In particular, no significant changes with respect to the changes reported in the previous quarters were presented.

i. In the third quarter of 2015, the reference wage of IMSS-insured jobs increased 4.3 percent annually, same figure as that registered in the previous two quarters (Chart 25a).

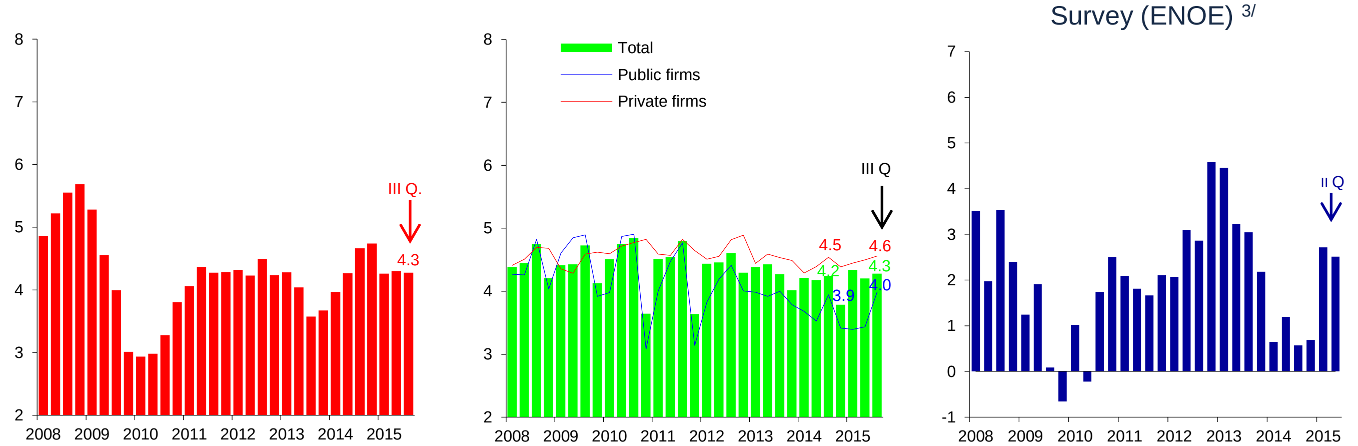
ii. Meanwhile, in the period July – September of this year, contractual wages negotiated by firms under federal jurisdiction presented a growth rate of 4.3 percent, as compared to 4.2 percent observed in the same quarter of 2014 (Chart 25b). This result reflected the fact that both private and public firms' negotiations led to average increases close to those in the third quarter of 2014. In particular, public firms' negotiations in the third quarter of 2015 led to an average raise of 4.0 percent, data similar to the average of 3.9 percent in the same period of the previous year, while private firms' negotiations resulted in an average wage increase of 4.6 percent, level comparable to that of 4.5 percent registered in the third quarter of 2014.

iii. In the second quarter of 2015, the average wage growth rate of total salaried workers in the economy (of 2.5 percent) maintained levels close to that of the previous quarter and located below the levels reported in 2012 (Chart 25c).

iv. From October 1st, 2015, the Council of Representatives of the National Minimum Wage Commission (CONASAMI) determined to homologate the minimum wage valid in economic zone 'B' with that of economic zone 'A'. This led to an increase of the average general minimum wage from MXN 69.26 daily to MXN 70.10 daily.

Chart 25
Wage Indicators
Annual change in percent

a) IMSS Reference Wage [1/] | b) Contractual Wage [2/] | c) Average Wage of Salaried according to National Employment Survey (ENOE) [3/]



1/ During the third quarter of 2015, on average 18.0 million workers registered at IMSS.
2/ The contractual wage increase is an average weighted by the number of involved workers. The number of workers in firms under federal jurisdiction that annually report their wage increases to the Secretary of Labor and Social Welfare (STPS) equals approximately 2 million.
3/ To calculate the average monthly nominal wages, the lowest 1 percent and the highest 1 percent in the wage distribution were excluded. Individuals with zero income or those who did not report are excluded.
Source: Calculated by Banco de México with data from IMSS, STPS and INEGI (ENOE).

3.2.3. Financial Saving and Financing in Mexico

In the third quarter of 2015, the sources of financial resources in the economy increased at a lower rate than in the previous quarter. This performance was the result of a moderation in the growth rate of both domestic and external sources of resources, the latter in a context characterized by a reduction in capital flows to emerging economies.

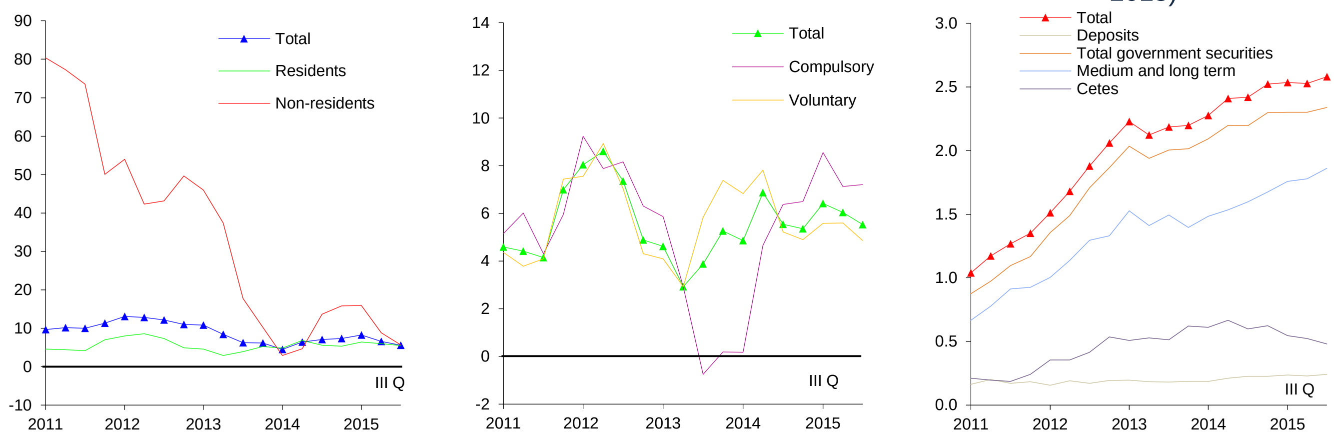
With respect to the domestic sources of financial resources, the stock of domestic financial saving –defined as the monetary aggregate M4 held by residents minus the stock of currency held by the public– grew less than last quarter (Chart 26a). This behavior was mainly explained by a moderation in the growth of the stock of voluntary financial saving, while the stock of the compulsory financial saving registered a real annual change close to that observed in the previous quarter (Chart 26b). On the other hand, although the growth rate of the monetary base was similar to that registered in the previous quarter, it continues at high levels. This is to a great extent due to the temporary effect of the elections that took place in Mexico on money demand, as well as some remaining effects of the fiscal reform and other changes in the use of payment methods, whose impacts on the annual growth rates should be vanishing over time.

Chart 26
Financial Saving Indicators

a) Total Financial Saving [1/] Quarterly average of real annual growth rates in percent

b) Resident Financial Saving Quarterly average of real annual growth rates in percent

c) Non-resident Financial Saving Stock at the end of the quarter in MXN trillion (MXN of September 2015)



1/ Defined as the monetary aggregate M4 minus the stock of currency held by the public.
Source: Banco de México.

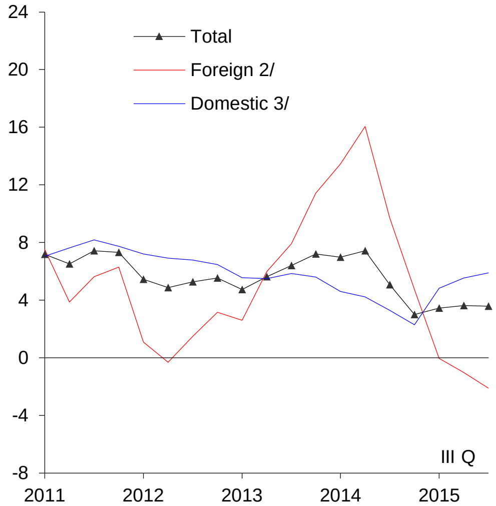
As refers to the external sources of resources, the growth pace of the stock of non-resident financial saving slowed down in the third quarter as compared to the previous one. This was mainly the result of a moderation in the expansion rate of the short-term government securities' holdings by foreign investors (Chart 26c). Meanwhile, external sources channeled to the financing of non-financial private firms kept moderating their growth pace, in an environment characterized by less liquidity in international financial markets.

In line with the above, the growth rate of the use of financial resources in the economy registered a reduction with respect to the previous quarter. The decrease in international reserves, as result of the measures adopted by the Foreign Exchange Commission to support the good functioning of the exchange market, in a context of a moderation in the growth rate of the sources of financial resources, allowed to provide resources for the financing of the private sector (see Section 4). Public Sector Borrowing Requirements (PSBR) were lower than those observed in the past quarter, while financing for the states and municipalities was similar to that registered in the second quarter of 2015. Finally, financing flows to the non-financial private sector remained unchanged with respect to those registered in the previous quarter.

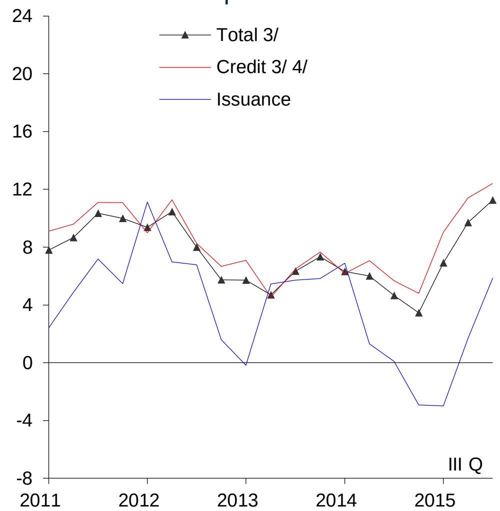
Going into details, total financing to non-financial private firms maintained during the third quarter a growth rate similar to that registered in the previous quarter, derived from a higher growth of domestic financing, offsetting the slowdown of external financing (Chart 27). Regarding the latter, as mentioned in previous Reports, there has been a slow pace of private debt placements in international markets, while external credit also has been showing less dynamism. In contrast, in the domestic market, credit granted by commercial banks to non-financial private firms kept increasing its growth rate, registering an average real annual change of 11.4 percent in the third quarter, above the 9.2 percent in the previous quarter (Chart 28a). It is worth mentioning that part of this increase is due to a currency depreciation effect, since a relatively small portion of the credit portfolio corresponds to USD-denominated credits, which are registered at market value in MXN. Also some firms decided to reduce their foreign debt in USD and substitute it with domestic financing in MXN, in light of the uncertainty prevailing in international financial markets (Chart 27). Likewise, direct credit by development banks continued accelerating its growth pace. All the before mentioned, in a context where interest and delinquency rates, in general, remained at relatively low levels, although in the reference quarter a slight increase in the interest rates of commercial bank credit is noted, as well as a certain improvement in the quality of their credit portfolio (Chart 28b and Chart 28c).

Chart 27
Financing to the Non-financial Private Sector

a) Total Financing to the Non-financial Private Sector [1/]
Real annual growth rates in percent



b) Domestic Financing to Non-financial Private Firms
Quarterly average of real annual growth rates in percent



1/ Data adjusted for exchange rate effects.
2/ Data of foreign financing for the third quarter of 2015 are preliminary.
3/ These data can be affected by the disappearance of some non-bank financial intermediaries and their conversion to non-regulated multiple purpose financial corporations (Sofom ENR).
4/ It refers to the performing and non-performing credit portfolio, and includes credit from commercial and development banks, as well as other non-bank financial intermediaries.
Source: Banco de México.

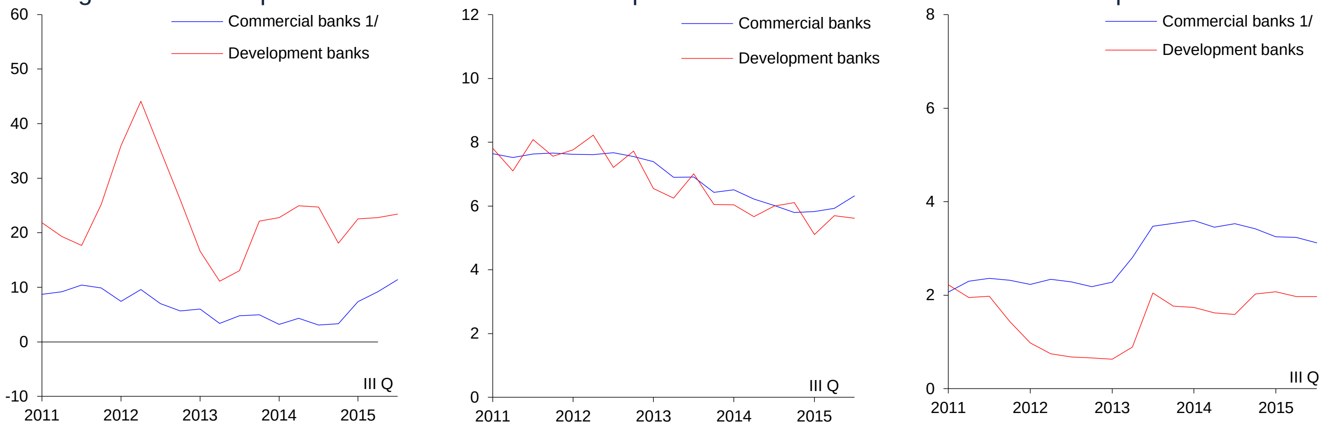
In the domestic debt market, placement of securities by non-financial private firms kept showing high dynamism in the third quarter of this year. In particular, net placement of medium- and long-term debt instruments was MXN 20.7 billion, constituting the highest quarterly amount on record (Chart 29a). This was the result of gross placements of MXN 25.8 billion, while gross amortizations –scheduled redemptions and prepayments– were MXN 5.2 billion. Meanwhile, both the average interest rate of short-term debt placements, as well as the corresponding to medium- and long-term securities, increased with respect to the previous quarter (Chart 29b).

Chart 28
Bank Credit to Non-Financial Private Firms

a) Performing Credit
Quarterly average of real annual growth rates in percent

b) Interest Rates of New Credits [2/]
Quarterly average of annual rates in percent

c) Delinquency Rates of Credit [3/]
Quarterly average of monthly rates in percent

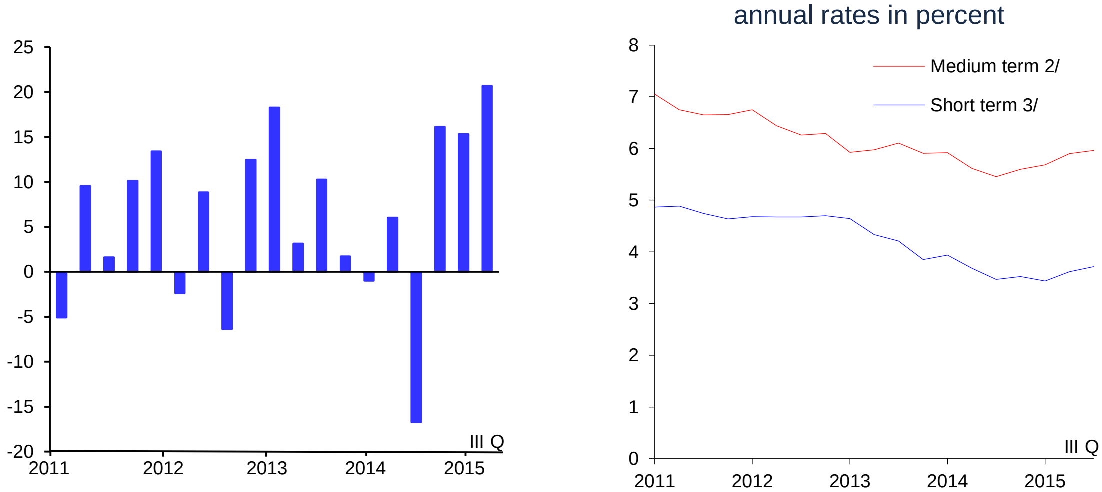


1/ Includes the Sofomes ER subsidiaries of bank institutions and financial groups.
2/ It refers to the interest rate of new bank credits to non-financial private firms, weighted by the associated stock of the performing credit and for all credit terms requested.
3/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.
Source: Banco de México.

Chart 29
Securities of Non-financial Private Firms in the Domestic Market

a) Net Placement of Medium-term Securities [1/]
MXN billion

b) Annual Interest Rates
Quarterly average of annual rates in percent



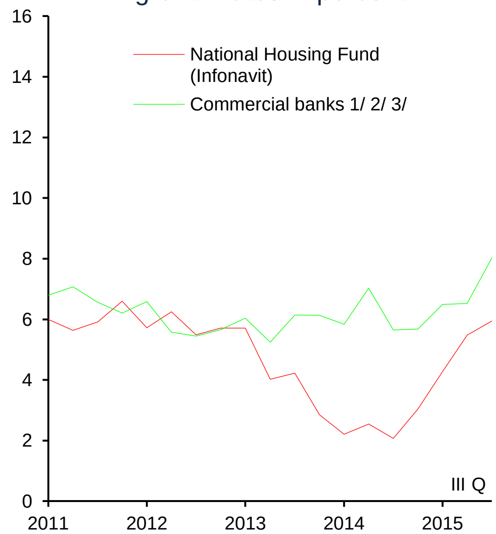
1/ Placements excluding amortizations in the quarter (scheduled redemptions and prepayments).
2/ Placements of more than one year.
3/ Placements of up to one year.
Source: Banco de México, with data from Valmer and Indeval.

Regarding credit to households, during the third quarter of 2015, its expansion was greater than that observed in the second quarter. This is mainly explained by the dynamism still shown by mortgage credit. Indeed, commercial banks' mortgage loans portfolio increased in the third quarter at an average real annual rate of 8.1

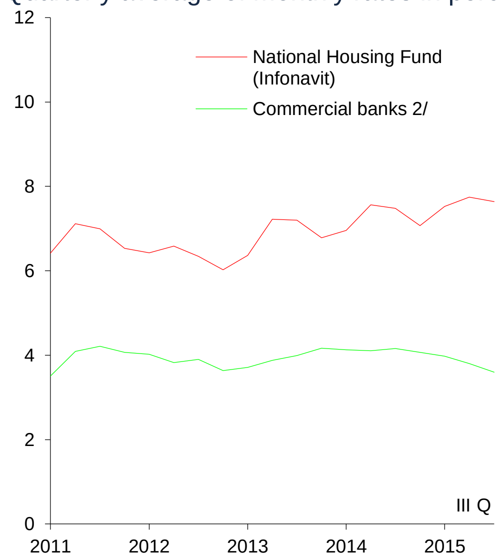
percent, which was above the rate of 6.5 percent registered in the previous period.[3] Likewise, mortgage loans granted by Infonavit increased its growth rate, passing from 5.5 percent in the second quarter of 2015 to 6.0 percent in the third quarter of the year (Chart 30a). In this environment, interest rates remained stable, while the delinquency rate of commercial banks' mortgage credit diminished. On the other hand, although the delinquency rate of the Infonavit credit portfolio did not observe significant changes in the period covered by this Report, it remains at relatively high levels (Chart 30b).

Chart 30
Housing Credit

a) Performing Credit
Quarterly average of real annual growth rates in percent



b) Delinquency Rates [4/]
Quarterly average of monthly rates in percent

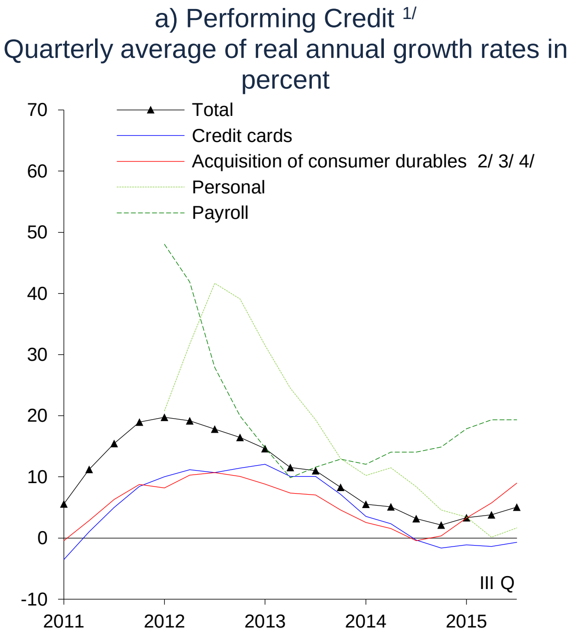


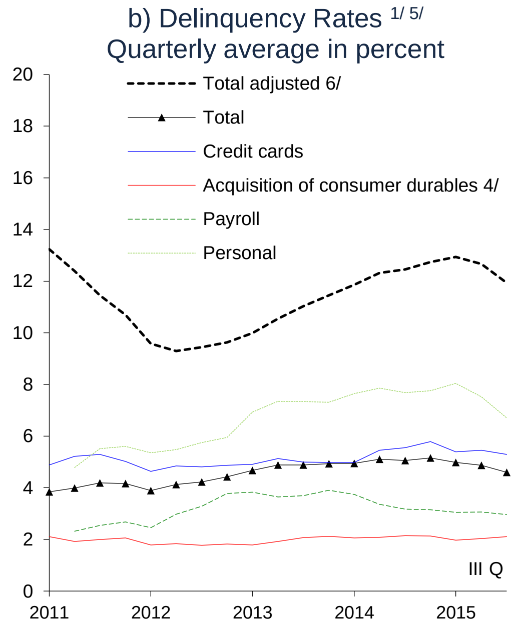
1/ Figures are adjusted in order to avoid distortions by the transfer from the UDIS trust portfolio to the commercial banks' balance sheet and by the reclassification of direct credit portfolio to ADES program.
2/ It includes sofomes owned by commercial banks.
3/ Figures are adjusted to avoid distortions due to the inclusion of some regulated sofomes to the bank credit statistics.
4/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.
Source: Banco de México.

Consumer credit granted by commercial banks observed an increase in its growth rate in the third quarter of 2015 with respect to the previous quarter. The average real annual growth rate of consumer credit was 5.1 percent in the period, compared to 3.8 percent registered in the previous quarter (Chart 31a). This was due to the dynamism that continues to be observed in the segment of payroll credit and an increase in the growth rate of credit for the acquisition of consumer durables. In contrast, personal and credit card loans kept showing a practically zero growth. Interest rates remained unchanged with respect to the previous quarter, while the quality of the portfolio improved, particularly in the personal loan segment. The latter reflected the evolution of delinquency rates, which, although continue at high levels, registered a decrease in the reference period (Chart 31b).

[3] Commercial banks' housing credit includes that for acquisition of new and used housing, remodeling, payment of mortgage liabilities, credit for liquidity, acquisition of land, and construction and own housing.

Chart 31
Commercial Banks' Consumer Credit





1/ Includes the Sofomes ER subsidiaries of bank institutions and financial groups.
2/ Between June 2010 and May 2011, figures are adjusted in order to avoid distortions due to the purchase of one banking institution's automobile loan portfolio.
3/ 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.
4/ It includes credit for movable property acquisition and auto loans.
5/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.
6/ It is defined as non-performing portfolio plus debt write-offs accumulated over the last 12 months divided by the total portfolio plus debt write-offs accumulated over the last 12 months.
Source: Banco de México.

In sum, financing to the non-financial private sector developed in line with the performance of economic activity. From here on, to the extent to which the recovery of productive activity consolidates, a gradual increase in the private sector's demand of financing resources would be expected. In this context, it is relevant to elaborate a forecast exercise of the sources and uses of financing resources of the economy that illustrates the factors that could support or limit financing to the private sector towards the end of 2015 and in 2016 (Table 2). In particular:

i. Taking into consideration the observed evolution of the sources of financing resources until the third quarter of 2015, for the end of 2015 they are estimated to be equivalent to 7.0 percent of GDP, figure below the 10.2 percent observed in 2014. This, mainly as result of the slowdown of external sources, as reflection of less resources from abroad channeled to emerging economies. Referring to the use of financing resources, the annual flow of financing to the private sector is estimated to be 2.6 percent of GDP, slightly above the 2.4 percent registered in 2014. This was due to the fact that, despite the mentioned reduction in sources, the expected decrease in international reserves will have provided resources for the private sector, to which would also contribute the lower use of resources by the public sector. With respect to this, resources for the public sector –the sum of PSBR and state and municipality financing– are expected to register a reduction with respect to the end of 2014, passing from 4.8 to 4.4 percent of GDP in 2015.

ii. For 2016, more sources of financing resources are anticipated, as compared to the end of 2015, increasing their annual flow to 8.1 percent of GDP. This would reflect an increase in domestic sources, while foreign sources would continue to present a reduced flow. This latter, in line with the uncertainty expected to prevail in international financial markets given the environment described in this Report. In relation to the use of financial resources, based on the forecasts presented by the Ministry of Finance *(Secretaría de Hacienda y Crédito Público*) in the General Criteria of Economic Policy 2016, financing to the private sector is anticipated to drop from 4.4 percent to 3.8 percent of GDP, what would allow channeling financing resources to the private sector equivalent to 2.8 percent of GDP, slightly above the flow of 2.6 percent anticipated for 2015. This, even considering a slight accumulation of international reserves.

The results of the previous exercise show that, in a context of tighter financial conditions –particularly of foreign financial markets- , it is of fundamental importance for Mexico to continue with the fiscal consolidation process. This, in addition to guaranteeing the sustainability of public debt, will avoid pressuring the loanable funds market in Mexico. In particular, strengthening of public finances would contribute to the reduction in risk premia, partly attenuating the interest rate increase that could be observed derived from an international environment with prevailing uncertainty and more restrictive monetary policies in some advanced countries, like the U.S. and the U.K.

Table 2
Total Funding of the Mexican Economy (Sources and Uses)
Percentage of GDP

	Annual flows						
	2010	2011	2012	2013	2014	2015 e/	2016 e/
Total sources	**9.4**	**10.1**	**9.8**	**8.5**	**10.2**	**7.0**	**8.1**
Domestic sources	4.1	5.7	4.4	4.7	5.8	5.3	6.1
Voluntary M4	2.6	4.2	3.0	4.1	4.2	3.9	4.7
Compulsory M4	1.5	1.5	1.4	0.7	1.7	1.4	1.4
Foreign sources	5.3	4.4	5.5	3.7	4.3	1.7	2.0
Non-residents M4	2.9	3.0	4.5	1.3	2.3	0.1	0.3
Foreign securities and credit 1/	2.4	1.4	1.0	2.4	2.0	1.6	1.7
Total uses	**9.4**	**10.1**	**9.8**	**8.5**	**10.2**	**7.0**	**8.1**
International reserves 2/	2.2	2.4	1.8	1.0	1.3	-1.4	0.5
Public sector financing	4.3	3.7	4.2	4.1	4.8	4.4	3.8
Public Sector Borrowing Requirements (PSBR) 3/	3.9	3.4	3.8	3.7	4.6	4.1	3.5
States and municipalities	0.4	0.3	0.5	0.4	0.2	0.3	0.3
Private sector financing	2.7	3.6	3.0	3.9	2.4	2.6	2.8
Foreign	0.7	0.8	0.6	1.5	0.7	0.2	0.3
Domestic 4/	2.0	2.8	2.4	2.4	1.7	2.4	2.5
Other concepts 5/	0.3	0.4	0.8	-0.6	1.7	1.5	1.0

Note: Figures may not add up due to rounding. Figures expressed in percent of nominal average annual GDP. The information on (revalued) flows is stripped from the effect of exchange rate fluctuations.

e/ Estimated figures, expressed in percent of nominal average annual GDP estimated by Banco de México.

1/ Includes external debt of the federal government, public entities and firms, and external PIDIREGAS, external liabilities from commercial banks and financing to the non-financial private sector.

2/ As defined by Banco de México's Law.

3/ From 2010 to 2014, Public Sector Borrowing Requirements (PSBR) corresponds to the data published by the Ministry of Finance (SHCP). Data for 2015 and 2016 correspond to those published in the General Criteria of Economic Policy 2016.

4/ Total portfolio of financial intermediaries, of the National Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores, Infonavit*), and of the ISSSTE Housing Fund (*Fondo de la Vivienda del ISSSTE, Fovissste*), as well as the issuance of domestic debt.

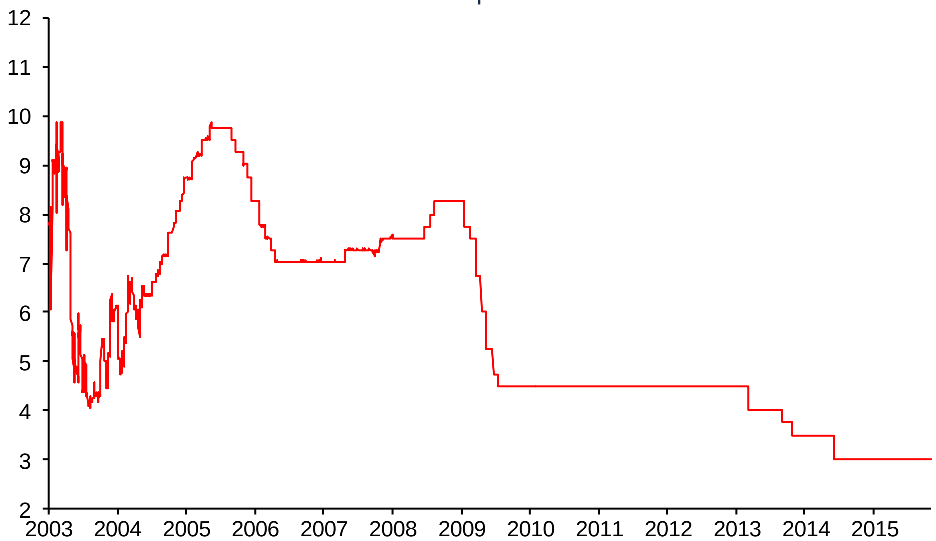
5/ It includes capital accounts and results and other assets and liabilities of commercial and development banks, Banco de México, non-bank financial intermediaries and INFONAVIT, non-monetary liabilities from the Institute for the Protection of Bank Savings (*Instituto de Protección del Ahorro Bancario, IPAB*), the effect of the change in the valuation of public debt instruments, as well as non-recurring revenues of the public sector derived from the net acquisition of financial assets and liabilities, among other concepts.

Source: Banco de México.

4. Monetary Policy and Inflation Determinants

During the period covered by this Report, the Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate at 3 percent, by virtue of the fact that it considered this monetary policy stance was conducive to support the convergence of inflation to its 3 percent target (Chart 32). With respect to this, it is noteworthy that, in face of an extremely difficult economic situation, the monetary policy conduction in Mexico required that the Central Institute weighs domestic and external factors in order to define the appropriate monetary policy stance.

Chart 32
Overnight Interbank Interest Rate Target 1/
Annual percent



1/ The Overnight Interbank Interest Rate is shown until January 20, 2008.
Source: Banco de México.

Among the elements, which were taken into consideration to support the monetary policy decisions, the following stand out. With respect to domestic factors:

a) Already being below 3 percent, inflation experienced further decreases and continued registering new historical minimum levels, and is anticipated to continue below 3 percent during the rest of 2015 and close to that level in 2016 and 2017.

b) Given that economic activity in Mexico has continued presenting a moderate growth pace, conditions of slackness persist in the labor market and in the economy in general, thus no generalized aggregate demand-related or input market-related pressures on prices are anticipated.

c) Until now, the pass-through of the exchange rate depreciation has mainly been reflected in a price increase of durable goods, without generating second round effects on the price formation process in the economy.

d) Inflation expectations for the end of this year continue declining, with its mean locating below 3 percent, while those corresponding to the end of 2016 and longer-term horizons remain anchored.

With respect to external factors:

e) The Mexican peso, like other emerging economies' currencies, further depreciated, in light of the possible interest rate increase by the Federal Reserve. This implied a risk due to the effect that this could have had on prices and inflation expectations, thus Banco de México remained alert to avoid this from happening.

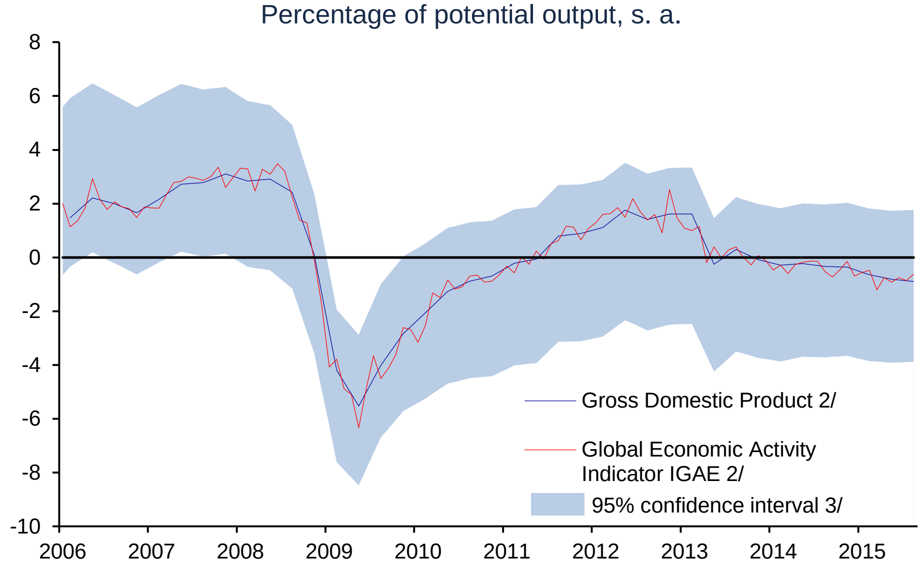
f) High volatility of oil prices, with potential of affecting the external accounts, public finances and the exchange rate.

Going into the details of inflation determinants, economic activity has continued registering slack conditions. In particular:

i. The output gap continues being negative and is expected to remain that way in the near future (Chart 33 and Chart 41b).

ii. In the labor market slack conditions persist, such that moderate increments presented by main wage indicators during the period covered by this Report, together with the upward trend exhibited by labor productivity, contributed to the fact that unit labor costs for the economy in general remained at low levels (Chart 34).

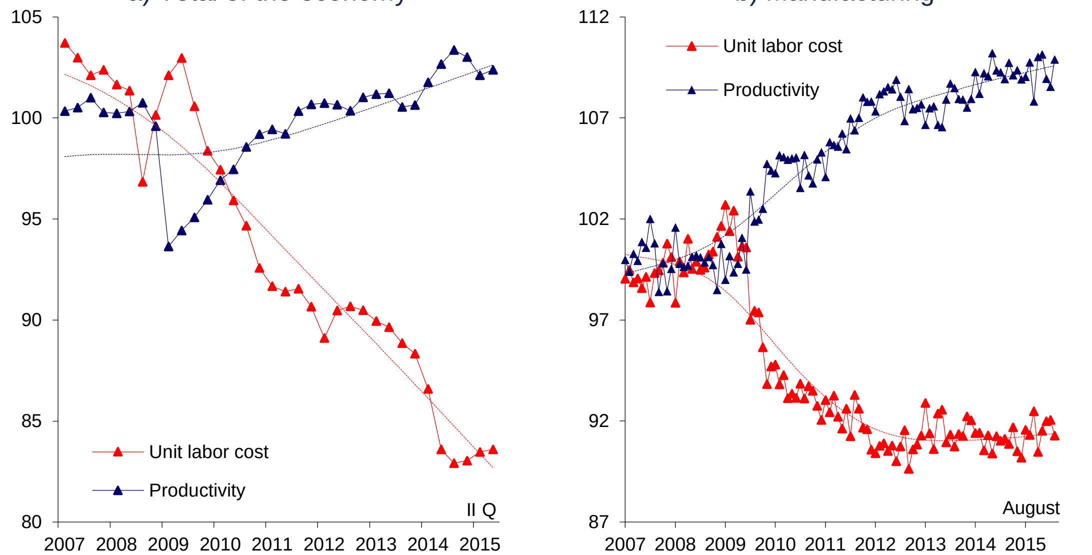
Chart 33
Output Gap Estimate 1/
Percentage of potential output, s. a.



s. a. / Prepared with seasonally adjusted data.
1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction; see Banco de México Inflation Report, April – June 2009, p. 69.
2/ GDP figures as of the third quarter of 2015 refers to the quarterly GDP advanced estimate published by INEGI. IGAE figures as of August 2015.
3/ Confidence interval of the output gap calculated with an unobserved components' method.
Source: Prepared by Banco de México with data from INEGI.

Chart 34
Productivity and Unit Labor Cost
Index 2008=100, s. a.

a) Total of the economy b) Manufacturing



s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line. Trends estimated by Banco de México.
Source: Unit cost prepared by Banco de México with data from INEGI. The Global Index of Labor Productivity in the Economy (IGPLE) published by INEGI.

s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
Source: Prepared by Banco de México with seasonally adjusted data from the Monthly Manufacturing Business Survey and the monthly indicator of industrial activity from Mexico's System of National Accounts, INEGI.

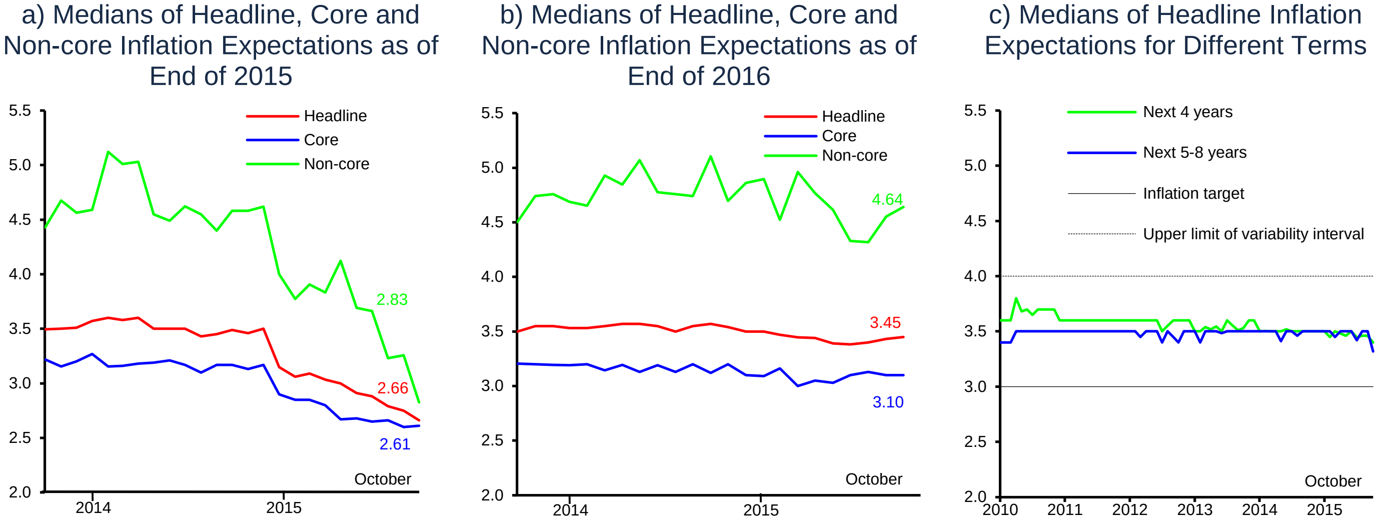
Regarding the behavior of inflation expectations, derived from Banco de México's survey to private sector specialists, the median of those for the end of 2015 continued decreasing, passing from 3.0 to 2.7 percent between May and October 2015 surveys.[4] In particular, within this forecast, both the median of core inflation expectations, as well as that corresponding to implicit non-core inflation reduced from 2.7 to 2.6 percent and from 4.1 to 2.8 percent, respectively (Chart 35a). On the other hand, the median of headline inflation expectations for the end of 2016 remained around 3.4 percent in the same period.[5] In particular, the median of those for the core component continued at 3.1 percent, while implicit non-core inflation expectations slightly dropped from 4.7 to 4.6 percent (Chart 35b). Finally, those corresponding to longer-term horizons decreased from 3.5 to 3.4 percent between the referred surveys (Chart 35c).[6]

[4] According to Banamex Survey of Financial Market Analysts' Expectations, the median of headline inflation expectation for the end of 2015 registered a similar behavior, as declining from 3.0 to 2.7 percent between the surveys from May 20, 2015 and October 20, 2015.

[5] Likewise, the median of headline inflation expectation for the end of 2016, according to the Banamex Survey, maintained around 3.4 percent between the surveys from May 20, 2015 and October 20, 2015.

[6] With respect to the median of long-term inflation expectations in the Banamex survey (corresponding to the period 2017- 2021), it remained on average around 3.5 percent between the surveys from May 20, 2015 and October 20, 2015.

Chart 35
Inflation Expectations
Percent



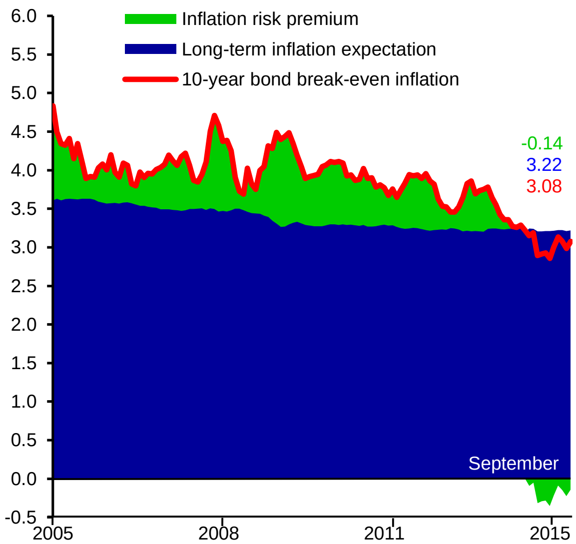
Source: Banco de México's survey.

Regarding the evolution of inflation expectations implicit in 10-year market instruments, they kept around 3.2 percent between May and September 2015, while the inflationary risk premium adjusted from approximately -20 to -15 basis points (Chart 36a).[7] In this way, although break-even inflation (the difference between long-term nominal and real interest rates) increased approximately 5 basis points during the reference period, it is still at low levels, close to its historic minimum level (Chart 36b), reflecting that the holders of nominal interest rate-indexed instruments keep demanding a relatively low compensation for inflation and inflationary risk related to Mexican government bonds.

[7] For a description of the estimation of long-term inflation expectations, see the Box "Decomposition of Break-even Inflation" in the Quarterly Report, October-December 2013.

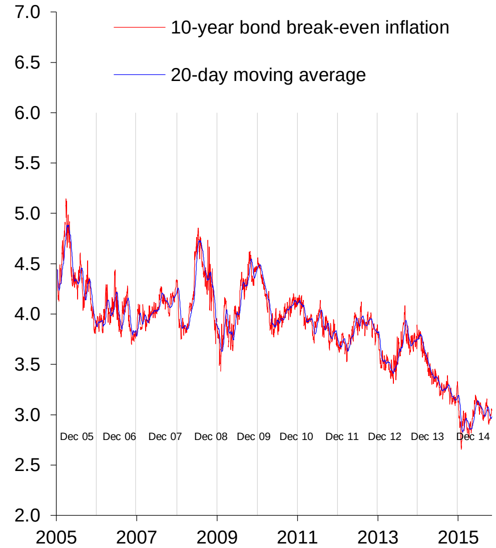
Chart 36
Inflation Expectations
Percent

a) Decomposition of Break-even Inflation and Inflation Risk



Source: Estimated by Banco de México.

b) 10-year Bond Break-even Inflation



Source: Estimated by Banco de México with data from Valmer and Bloomberg.

As result of the high volatility levels registered in international financial markets, during the third quarter of the year a generalized appreciation of the U.S. dollar against most currencies was observed, as well as important commodity price reductions and practically worldwide losses in stock markets. However, in October part of these adjustments reverted. In this environment, although national markets were affected, they continued functioning in an orderly manner.

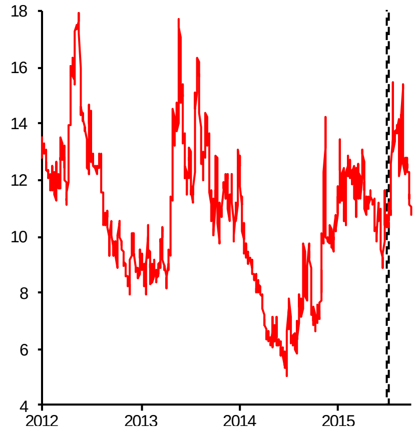
The Mexican peso, like other emerging economies' currencies, registered in the third quarter an additional depreciation against the U.S. dollar, reaching levels above 17 MXN/USD. Later, in October part of this depreciation reverted in order to locate around 16.50 MXN/USD, although with certain volatility. Thus, between June and early November 2015, the national currency registered a depreciation of 5.8 percent, passing from around 15.6 to 16.5 MXN/USD (Chart 37a).

Chart 37
Exchange Rate and Implied Volatility and Volume of FX Market Operations

a) Nominal Exchange Rate and Exchange Rate Expectations for the End of 2015 and 2016 1/
MXN/USD

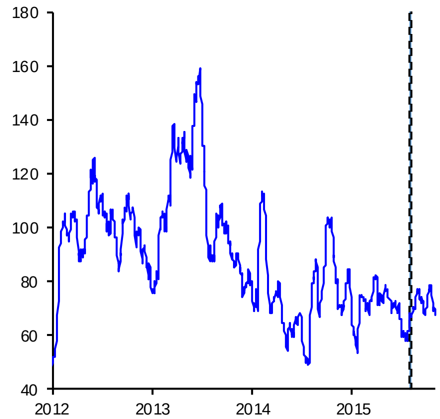
1/ The observed exchange rate is the daily quote of the FIX exchange rate. The latest quote of the observed exchange rate corresponds to November 3, 2015.
Source: Banco de México.

b) Currency Option Implied Volatility 1/
Percent



1/ Currency option implied volatility refers to one-month options.
Note: The black line corresponds to the announcement of the Foreign Exchange Commission on July 30, 2015.
Source: Bloomberg.

c) Volume of FX Market Operations
Index 02-Jul-08=100,
20-day moving average



Note: The black line corresponds to the announcement of the Foreign Exchange Commission on July 30, 2015.
Source: Banco de México and Reuters.

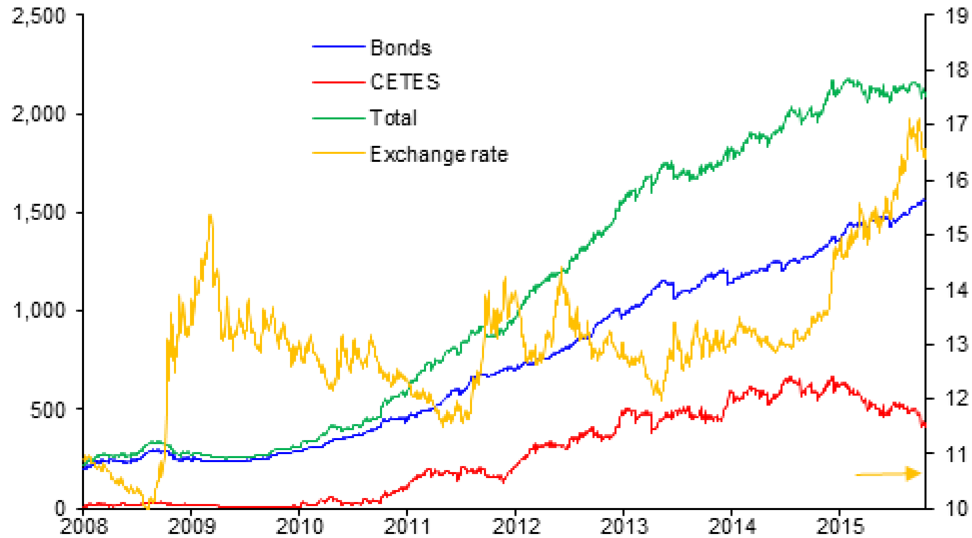
In this context, and despite the volatility registered in financial markets, government securities' holdings by non-residents remained relatively stable and no net reductions in holdings of Federal Government titles by institutional investors were observed. With respect to this, it is noteworthy that the investors' holdings of short-term instruments decreased, while those of medium- and long-term instruments continued increasing (Chart 38). However, the adjustment of risk exposure of the portfolio of investors and of Mexican firms led to a greater demand for exchange rate hedges, which contributed to the depreciation of the national currency.

In virtue of the volatility observed in international financial markets, the Foreign Exchange Commission decided on July 30, 2015 to strengthen the mechanisms to provide liquidity to the national exchange market in order to reduce the probability of additional pressures disturbing its orderly functioning.[8] Specifically, it increased the amount to be offered in the without minimum-price daily auctions from USD 52 million to USD 200 million and decreased the minimum price in the corresponding USD auctions (from one equivalent to an exchange rate 1.5 percent higher than the FIX exchange rate determined the previous day to one equivalent to a 1 percent higher exchange rate). On September 28, it extended the validity of these auctions until November 30, 2015 and expressed that it will continue monitoring the operating conditions in the exchange market in order to adjust the mentioned mechanisms if necessary. Regarding this, it should be noted that since its reintroduction on December 9, 2014, the USD auction mechanism with minimum price has been activated on fifteen occasions, implying an assigned total amount of USD 2,709 million. While the amount assigned through the USD auction without minimum price amounts USD 18,296 million (from March 11, 2015 to present). These mechanisms contributed to stabilize the conditions in the national exchange market. This, in

[8] See the press releases from the Foreign Exchange Commission from July 30 and September 28, 2015.

combination with other factors, contributed to a better performance of volatility indicators, which stopped increasing, and to the fact that the operations volume stopped declining (Chart 37b and Chart 37c), besides interrupting the trend of MXN depreciation.

Chart 38
Government Securities' Holdings by Foreign Investors and Exchange Rate
MXN billion and MXN/USD

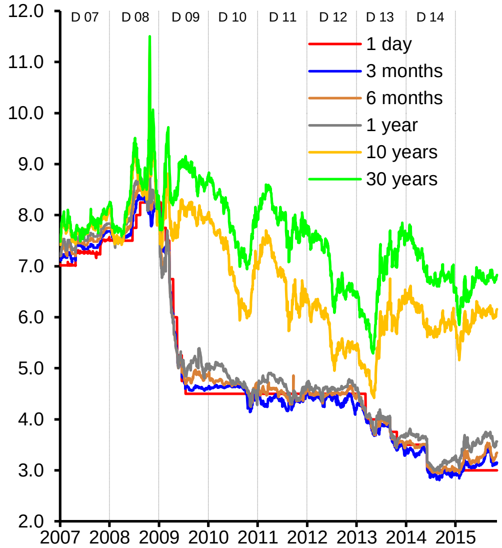


Source: Banco de México.

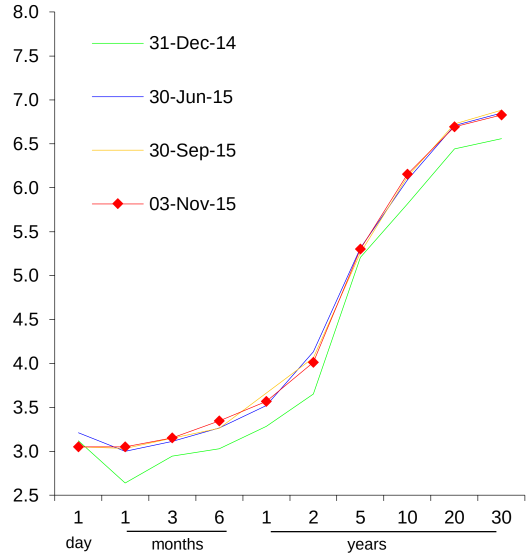
Interest rates in Mexico declined, although with certain volatility. On the one hand, those for short- and medium-term horizons registered, during the first part of the third quarter generalized increases and later reductions to the same or even lower levels than those observed at the beginning of the period covered by this Report. These changes were associated with the changes of economic agents' perspective regarding the possible adjustment of the monetary policy stance in Mexico and the U.S. Thus, after increasing around 40 basis points during the reference period, the 3-month sovereign bonds rate increased from 3.1 to 3.5 percent between June and September, returning to 3.1 percent in early November. On the other hand, interest rates for longer-term horizons showed more stability and even slightly decreased during this period. Specifically, the 10-year bond interest rates decreased close to 10 basis points, passing from 6.2 percent at the end of June to 6.1 percent at the beginning of November 2015 (Chart 39a). In this way, the slope of the yield curve (the difference between 10-year and 3-month rate) registered a decline of approximately 10 basis points, moving from 310 to 300 basis points in the same period (Chart 39b).

Chart 39
Interest Rates in Mexico
Percent

a) Government Bond Interest Rates 1/



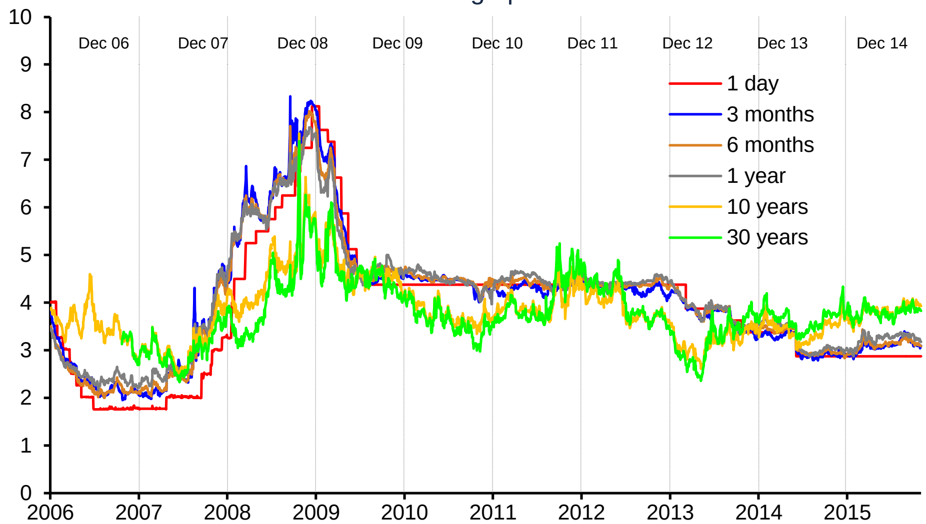
b) Yield Curve



1/ Since January 21, 2008, the one-day (overnight) interest rate corresponds to the target for the Overnight Interbank Interest Rate.
Source: Proveedor Integral de Precios (PiP).

The spreads between Mexican and U.S. interest rates registered a mixed behavior. In particular, while those corresponding to short- and medium-term horizons registered levels similar to those observed at the beginning of the reference period or even declined after having increased significantly, those for long-term horizons presented an increase, given that the decline in U.S. interest rates was higher. In this way, the 10-year interest rate spread increased from around 375 to 395 basis points in the period covered by this Report (Chart 40).

Chart 40
Spreads between Mexican and U.S. Interest Rates 1/
Percentage points



1/ For the U.S. target rate, an average interval considered by the Federal Reserve is considered.
Source: Proveedor Integral de Precios (PiP) and U.S. Department of the Treasury.

Looking forward, it is possible that the volatility in international markets continues. Consequently, it is fundamental to maintain a solid macroeconomic framework in Mexico, therefore it is necessary to concretize the recently proposed efforts in the fiscal area, adjust the monetary policy stance if necessary and continue implementing structural reforms in an adequate and timely manner. This will contribute to maintain confidence in the Mexican economy, distinguishing it from other emerging economies, such that the country risk component of interest rates in general remains at low levels, which will be crucial in an external environment of increasingly stringent financial conditions.

5. Inflation Forecasts and Balance of Risks

This chapter presents the macroeconomic scenario foreseen for the Mexican economy for the rest of 2015, 2016 and 2017, derived from the analysis presented in this Report for the external environment and evolution of the Mexican economic activity.

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 41a).

These forecasts take into account that in 2015 growth of economic activity in Mexico has been low and that it continues expanding at a moderate pace in the rest of the year. In particular, the evolution of external demand is anticipated to be modest due to the low dynamism expected for U.S. industrial production.[9] Additionally, domestic demand is foreseen to maintain moderate growth rates.

For 2016, U.S. industrial activity is still anticipated to register higher growth than in the current year and, consequently, it will be an impulse for manufacturing exports from Mexico. This recovery of U.S. industrial production is expected to be supported by the vanishing of the effect of the recent U.S. dollar appreciation and by the fact that no contraction, like the one in early 2015 in the energy sector, caused by the oil price drop, is to be expected. Furthermore, it is foreseen that the recovery of the external sector supports domestic demand growth in Mexico, to which could also contribute a positive effect of structural reforms. It should also be noted that this forecast considers that the oil production platform will practically remain unchanged with respect to the present year.[10]

For 2017, a more remarkable improvement of U.S. industrial activity is foreseen and that subsequent progress in the implementation of structural reforms will be reflected in a greater impulse 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

[9] Expectations for the U.S. economy are based on the consensus of analysts surveyed by Blue Chip in October 2015. For industrial production in 2015, these are adjusted from an annual growth of 1.9 percent in the previous Report to 1.6 percent in the present Report. For 2016, the growth of this indicator is adjusted from 2.7 percent reported in the last Report to 2.3 percent in the present Report. For 2017, growth of 2.8 percent is foreseen for this indicator.

[10] This forecast about the oil production platform is based on the General Criteria of Economic Policy (CGPE 2016), according to which it is anticipated to reach 2,262 thousand barrels per day in 2015, 2,247 thousand barrels daily in 2016 and 2,250 thousand barrels daily in 2017.

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.

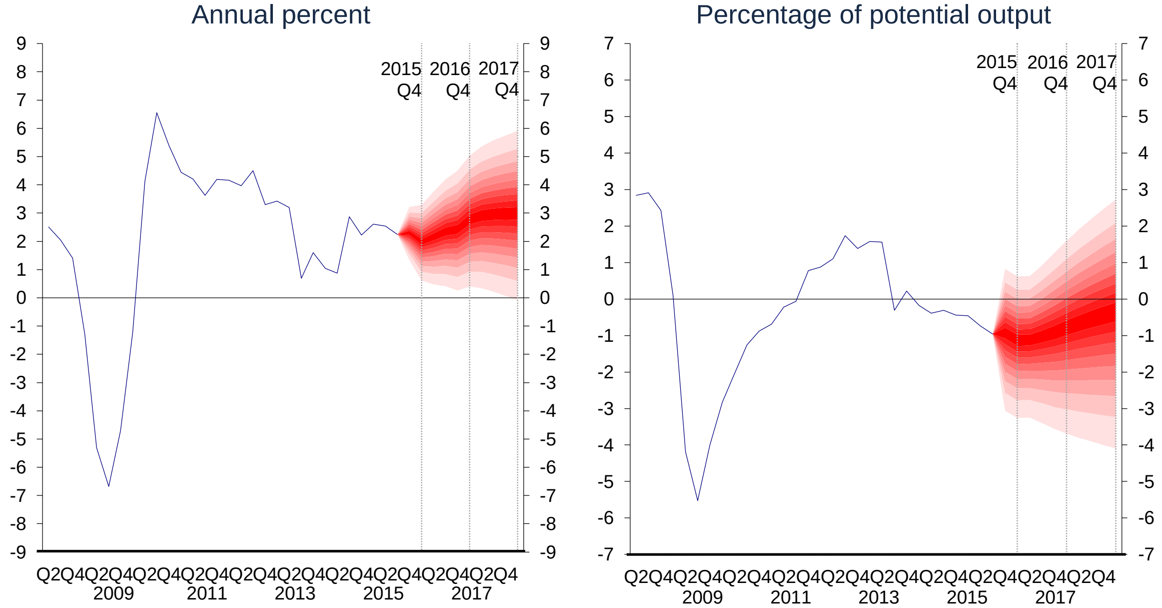
Current Account: With respect to external accounts, for 2015 trade balance and current account deficits of USD 9.4 billion and of USD 30.3 billion are expected, respectively (0.8 and 2.6 percent of GDP, in that same order). For 2016, trade balance and current account deficits of USD 6.6 billion and USD 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).

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 41b).

Chart 41
Fan Chart: GDP Growth and Output Gap

a) GDP Growth, 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. / Prepared with seasonally adjusted data.
Source: Banco de México.

Mexico's GDP growth scenario, presented in this Report, is subject to different risks. Among the downward risks are the following

i. A delay in the recovery of the U.S. industrial sector, either due to lower dynamism of the global economy or due to an additional USD appreciation.

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, in turn, affecting their balance.

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.

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. That the progress in the implementation of the structural reforms has a favorable effect on investors' expectations, faster than expected.

ii. A better 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 42 and Chart 43).

The forecast for the inflation trajectory might be affected by some risks, among which stand out the following.

Upward risks:

i. That, in face of a new deterioration of international financial markets 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.

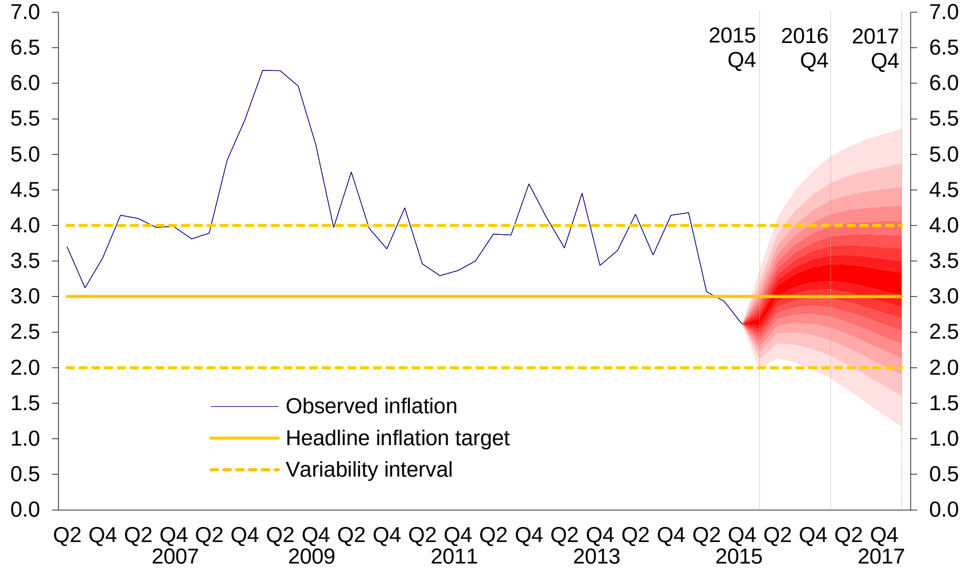
Downward risks:

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.

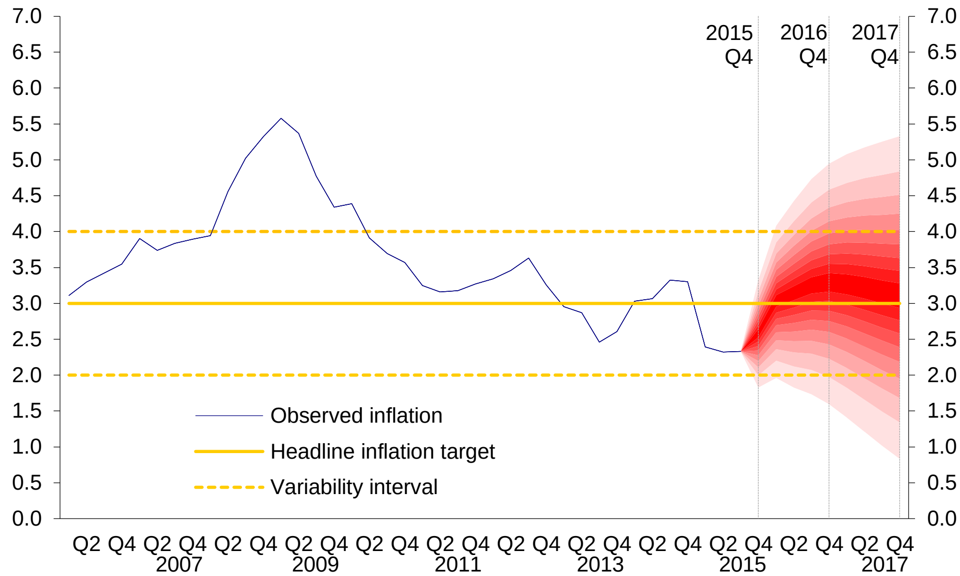
iii. That the national currency reverts part of the depreciation accumulated in the previous months.

Chart 42
Fan Chart: Annual Core Inflation 1/
Percent



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

Chart 43
Fan Chart: Annual Core Inflation 1/
Percent



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

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.

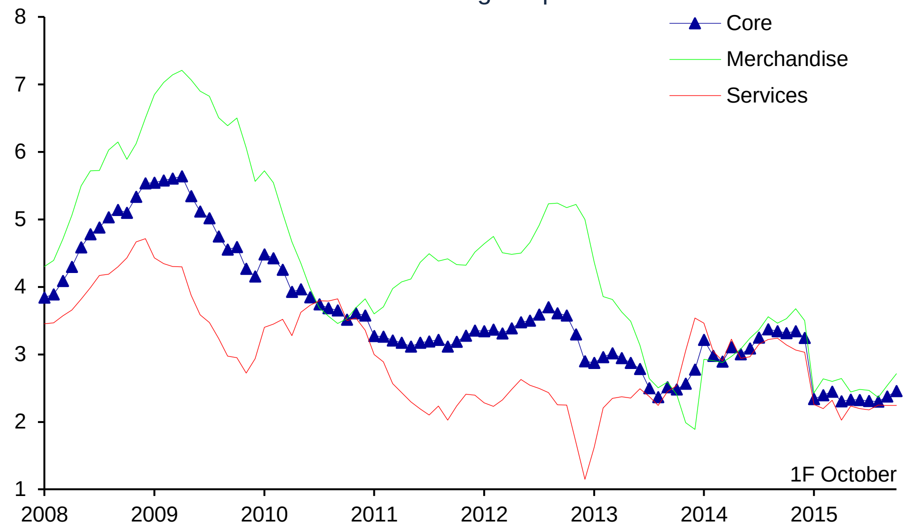
Considering the complex international environment and the expectations that it will persist in the future, it is fundamental to maintain a solid macroeconomic framework in Mexico. Therefore, it is necessary, in addition to the timely adjustment of the monetary policy stance, to concretize the recently 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 run, 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 run. 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 greater economic growth that leads to increased welfare for the entire population.

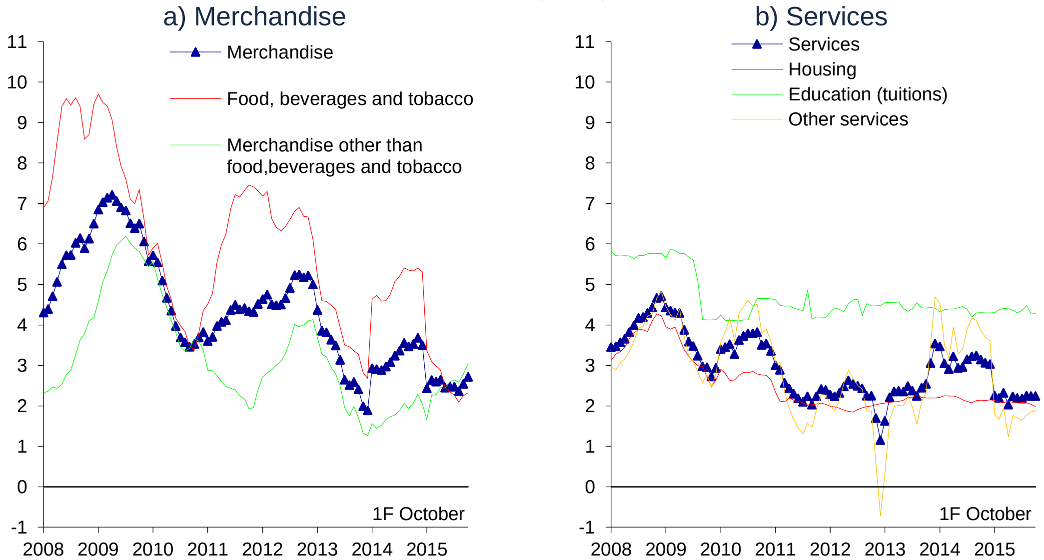
Annex 1: Complementary Charts of the Recent Development of Inflation

Chart A1
Core Price Index
Annual change in percent



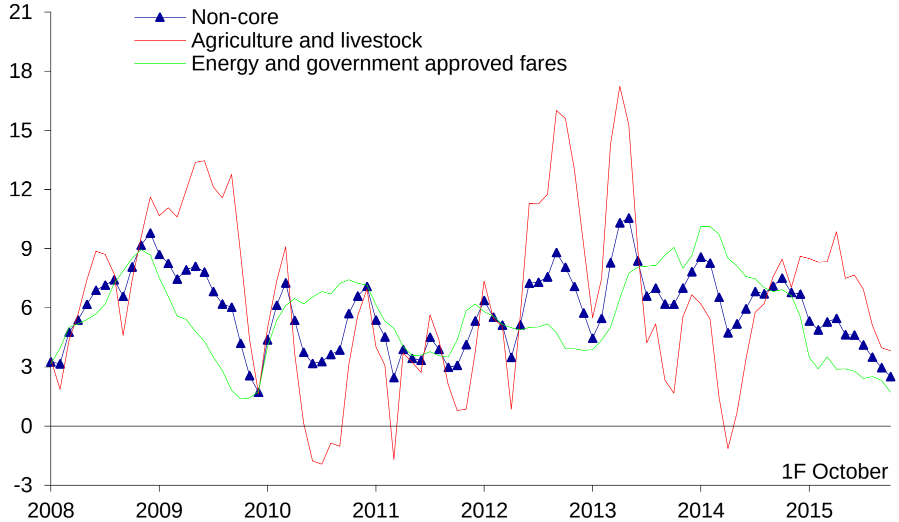
Source: Banco de México and INEGI.

Chart A2
Core Price Index: Merchandise and Services
Annual change in percent



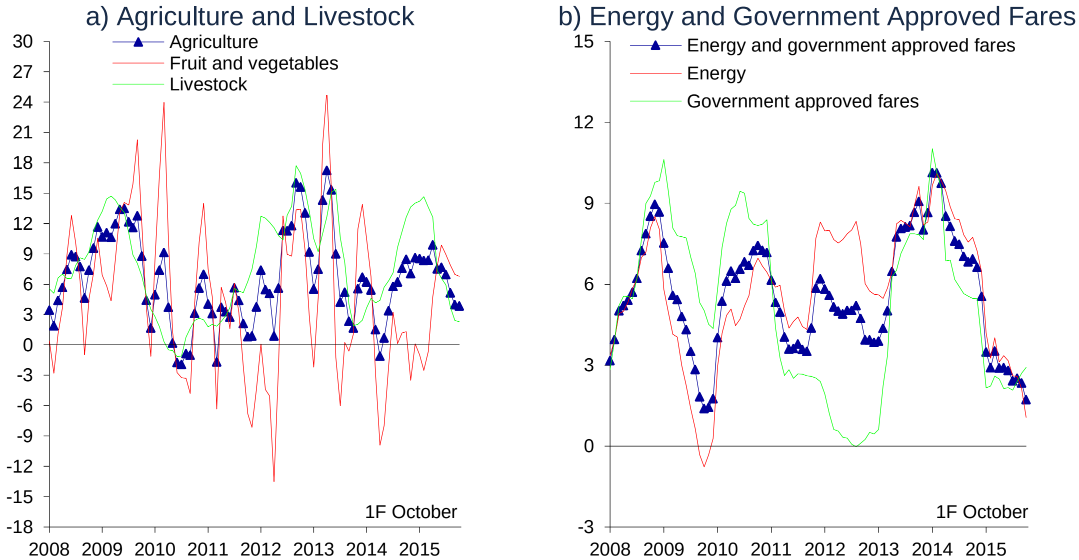
Source: Banco de México and INEGI.

Chart A3
Non-core Price Index
Annual change in percent



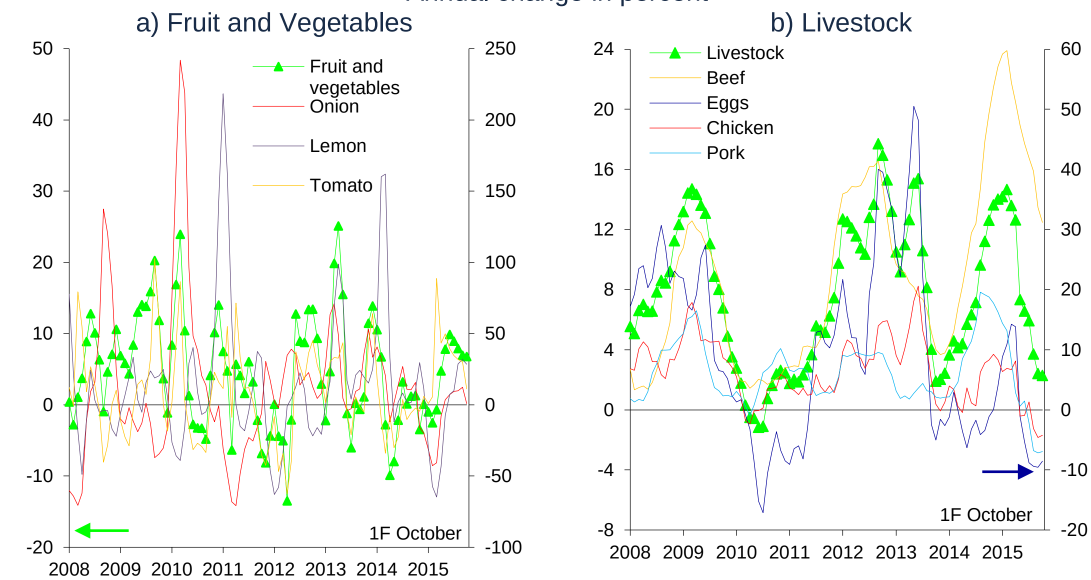
Source: Banco de México and INEGI.

Chart A4
Non-core Price Index
Annual change in percent



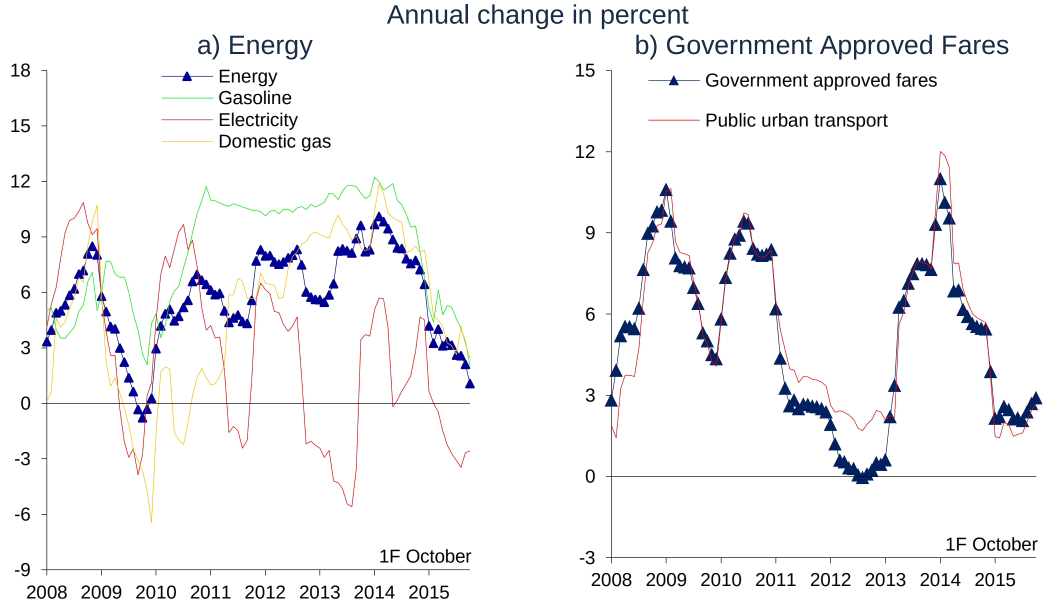
Source: Banco de México and INEGI.

Chart A5
Agriculture and Livestock Price Index
Annual change in percent



Source: Banco de México and INEGI.

Chart A6
Energy and Government approved Fares Price Index
Annual change in percent



Source: Banco de México and INEGI.

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November 2015

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