



Quarterly Report

January – March 2014

May 21, 2014



BANCO DE MÉXICO

Outline

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Monetary Policy

2

External Conditions

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Economic Activity in Mexico

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Inflation Determinants

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Forecasts and Balance of Risks

Recent Inflation Developments

The conduction of the monetary policy in Mexico has been oriented towards achieving an efficient inflation convergence towards its 3 percent permanent target, i.e. at the minimum cost to society in terms of economic activity.

In late 2013 and early 2014, in light of the occurrence of some supply shocks and once new fiscal measures came into force in 2014, inflation in Mexico increased.

Subsequently, as anticipated, it resumed its downward trend, when the effects of some of these shocks began to dissipate.


Meanwhile, medium- and long-term inflation expectations remained stable, and the price formation process of the economy has not been contaminated.

Monetary Policy Conduction

Banco de México has indicated that supply shocks, in a context of well-anchored inflation expectations, only propitiate temporary inflation increments.

→ Therefore, the referred shocks do not justify upward adjustments in the reference interest rate.

- *It would imply an unnecessary tightening of the monetary policy stance.*



In view of the above, the monetary policy stance was not modified over the period covered by this Report, even though the Central Institute remained alert, so that no second round effects are generated in the price system of the economy.

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External Conditions

Global Outlook in 1Q 2014

Growth

- ✓ *The economic activity expanded at a moderate pace:*
 - ➔ **An improvement in some advanced economies.**
 - ➔ **Emerging economies' growth rate diminished.**

Inflation

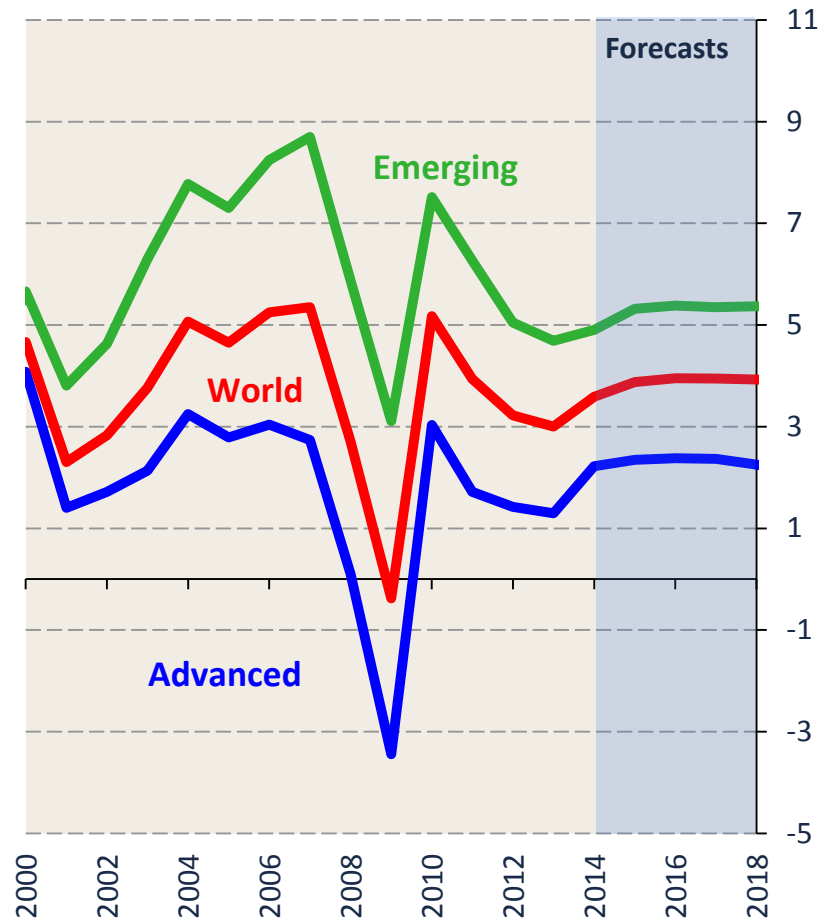
- ✓ *At low levels, in light of slack conditions in advanced economies and the slowdown of various emerging ones.*

Monetary Policy

- ✓ *Is forecast to remain accommodative for an extended period of time.*
- ✓ *In the medium term, it is expected to begin to normalize, as it has been gradually happening in the U.S.*

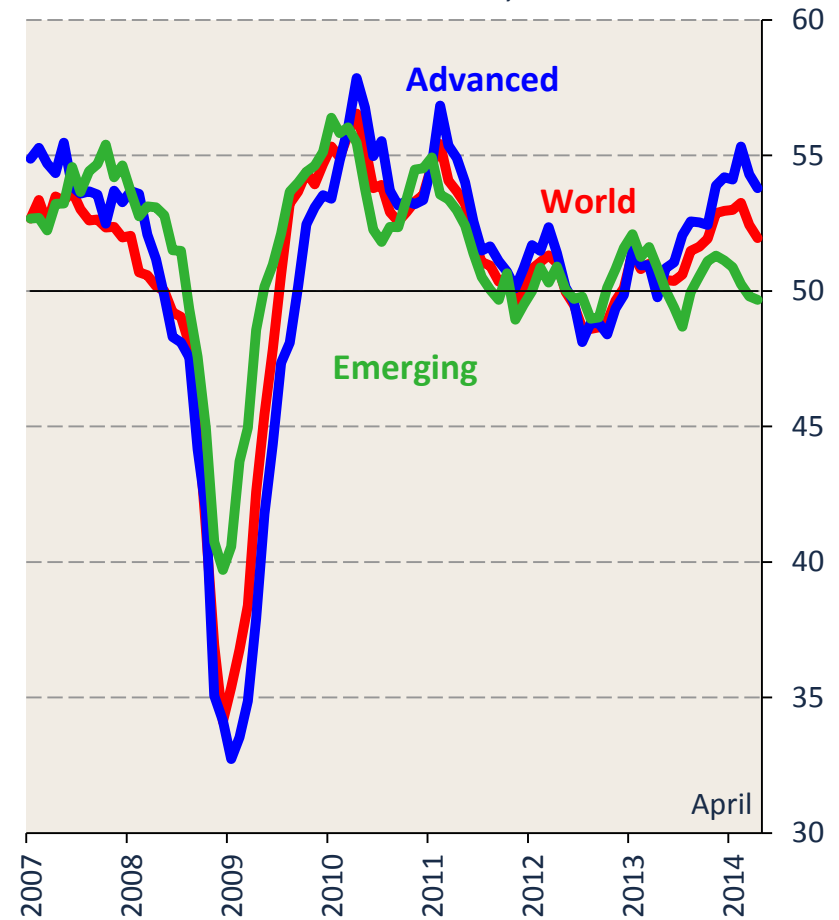
World economy continued recovering moderately, mainly driven by some advanced economies.

GDP Growth
%



Source: WEO, April 2014, IMF.

**Manufacturing Purchasing
Managers' Index**
Diffusion index, s.a.



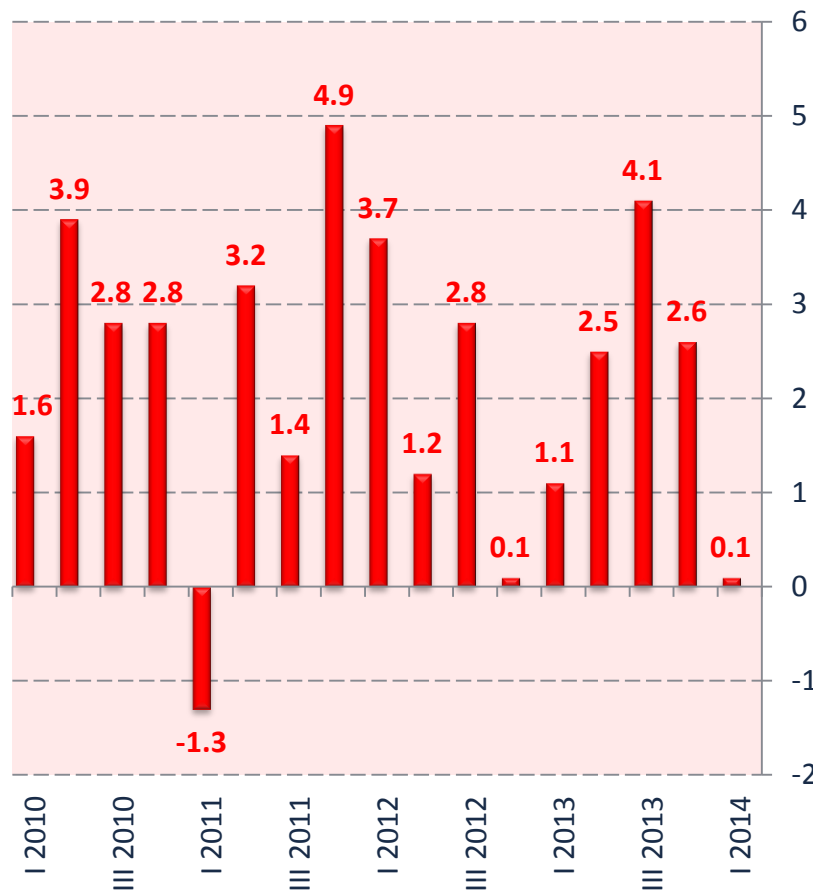
s. a./ Seasonally adjusted.

Source: Elaborated by Banco de México with data from IMF, ISM and Markit.

U.S. economic activity expanded less than expected, mainly as a result of adverse weather conditions, even though by the end of 1Q 2014 it resumed greater dynamism.

Gross Domestic Product

Quarterly % change at annual rates, s. a.

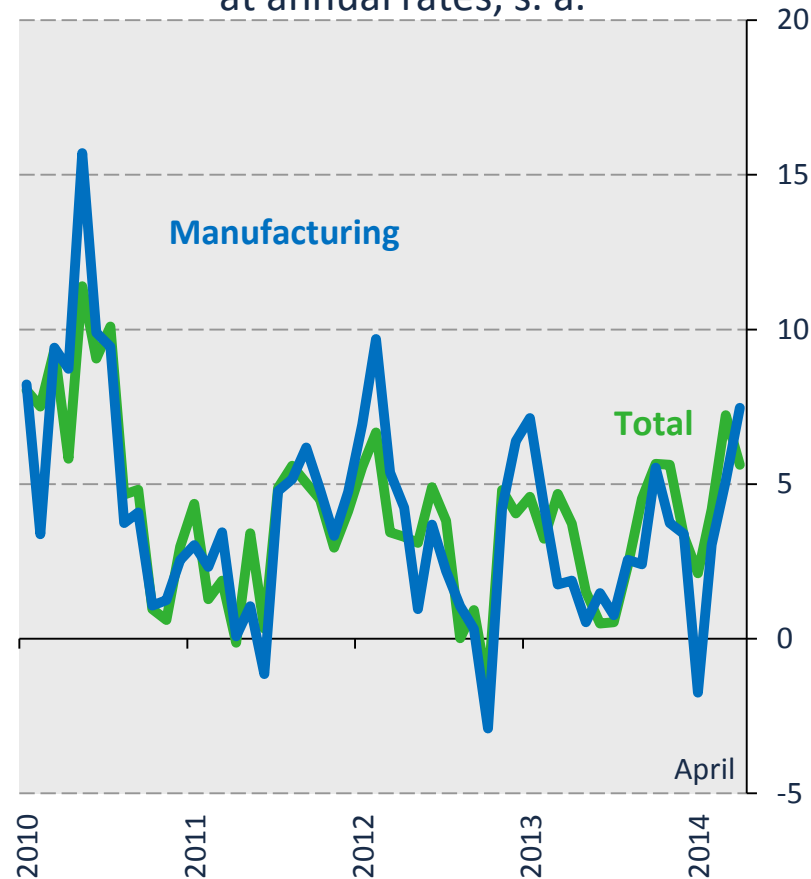


s.a./ Seasonally adjusted data.

Source: Bureau of Economic Analysis.

Industrial Production

3-month percentage change at annual rates, s. a.

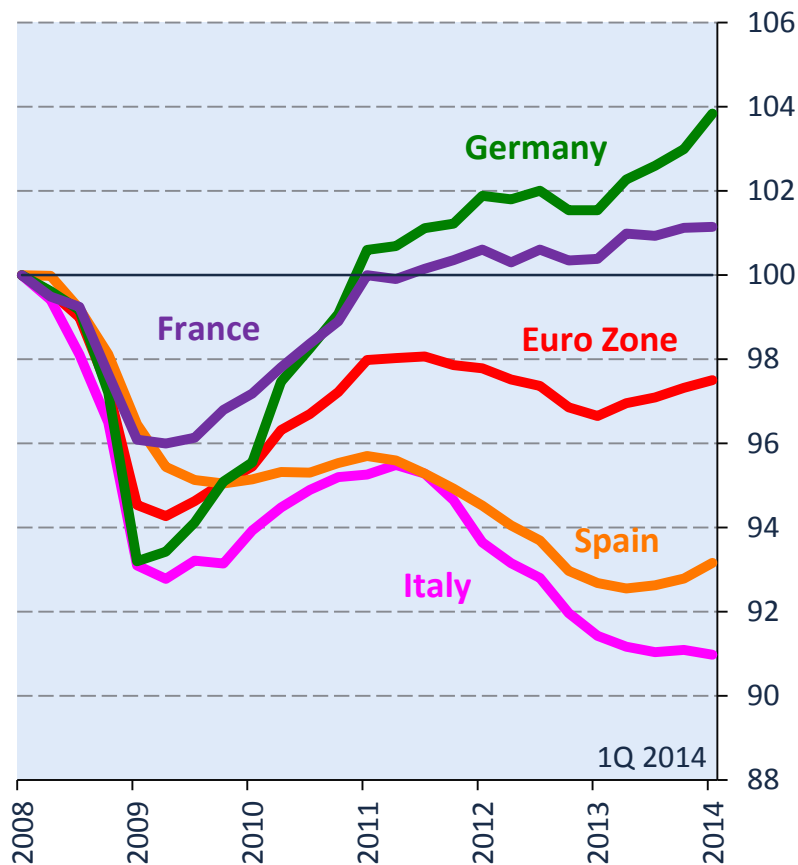


s.a./ Seasonally adjusted data.

Source: Federal Reserve.

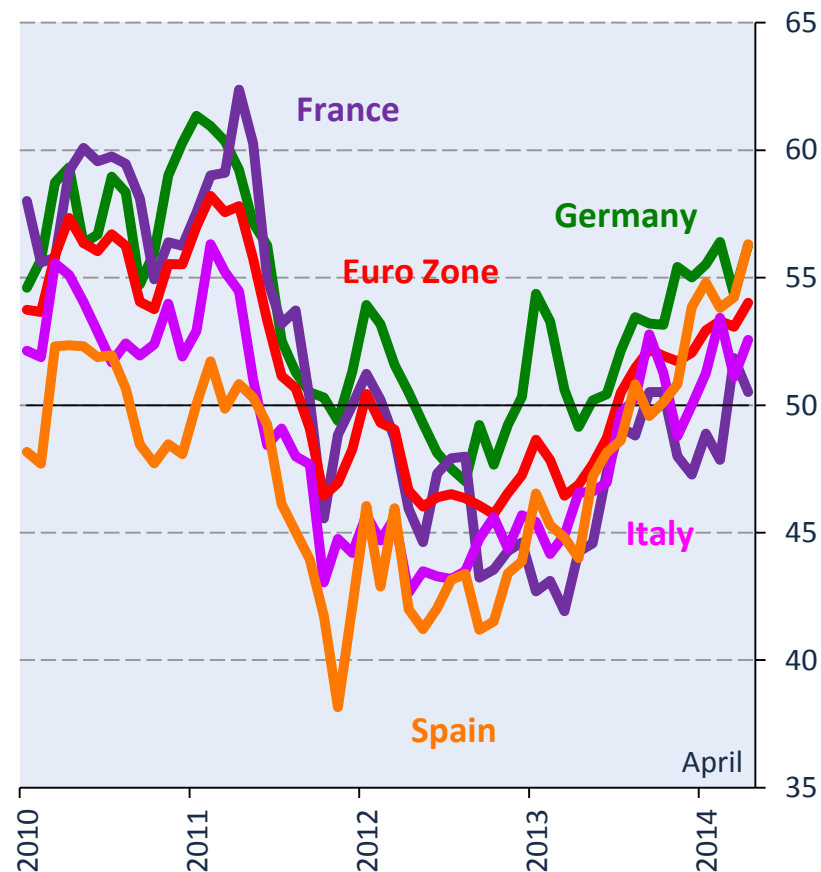
Growth of the economic activity in the Euro zone in 1Q 2014 was similar to that of 4Q 2013, although this recovery remains weak.

Gross Domestic Product
Index I-2008=100, s. a.



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

Manufacturing and Services Purchasing Managers' Index
Index, s.a.



s. a./ Seasonally adjusted.
Source: Markit.

In some of the main advanced economies, risks related to very low inflation levels have arisen, despite an accommodative monetary policy.

U.S.: Personal Consumption Expenditures

Price Index

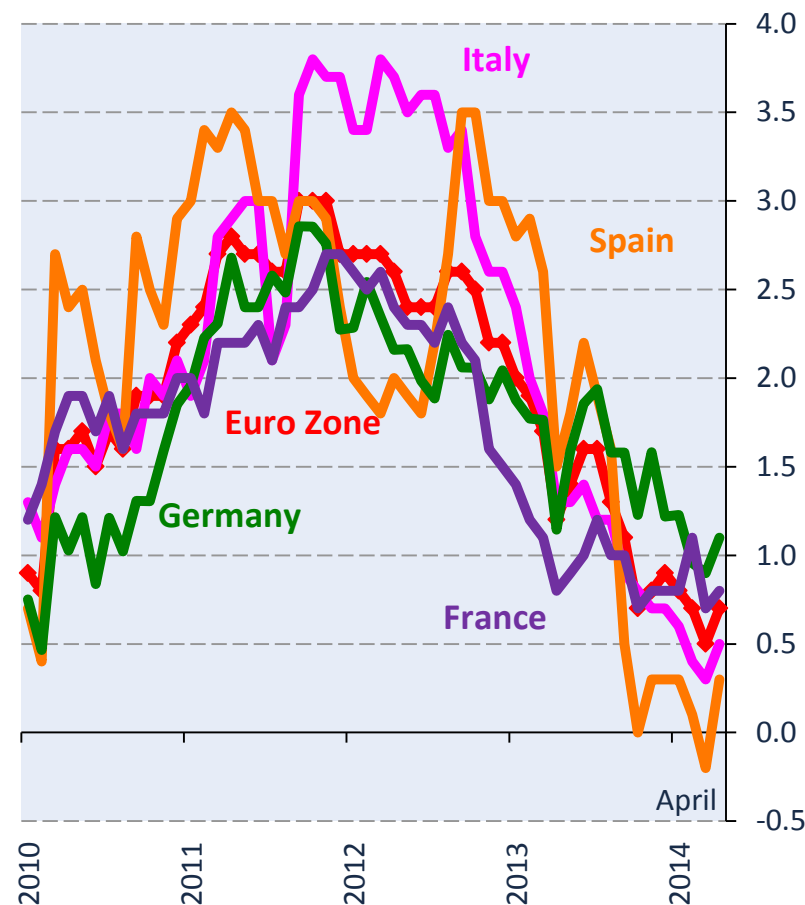
Annual % change



Source: Bureau of Labor Statistics and Bureau of Economic Analysis.

Euro Zone: Consumer Prices Index

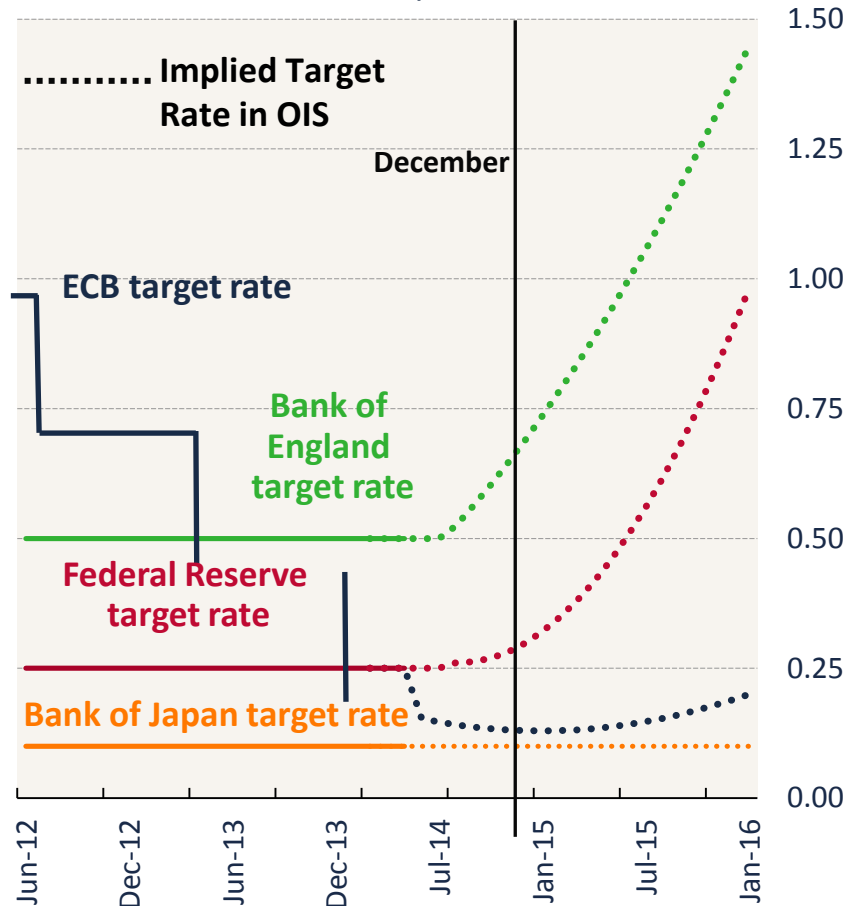
Annual % change



Source: Eurostat.

Monetary policy in most advanced economies is anticipated to remain accommodative, although in the medium term it is expected that it may begin to normalize.

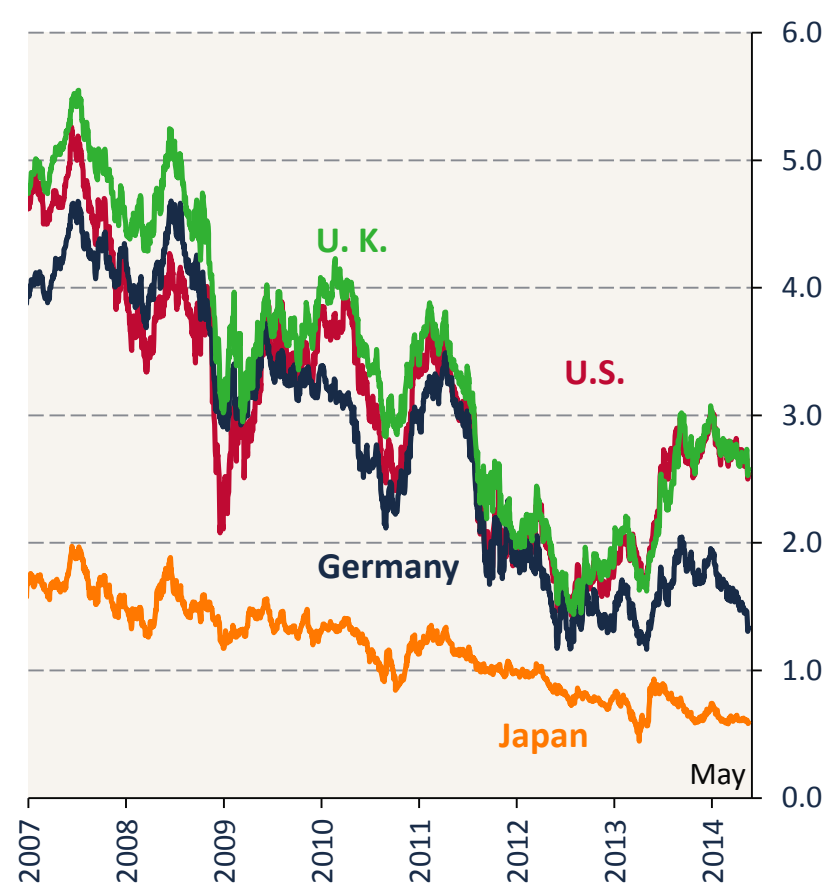
Implied Monetary Policy Rates in
OIS Curves ^{1/}
%



1/ OIS: Overnight Index Swap.

Source: Bloomberg with estimates of Banco de México.

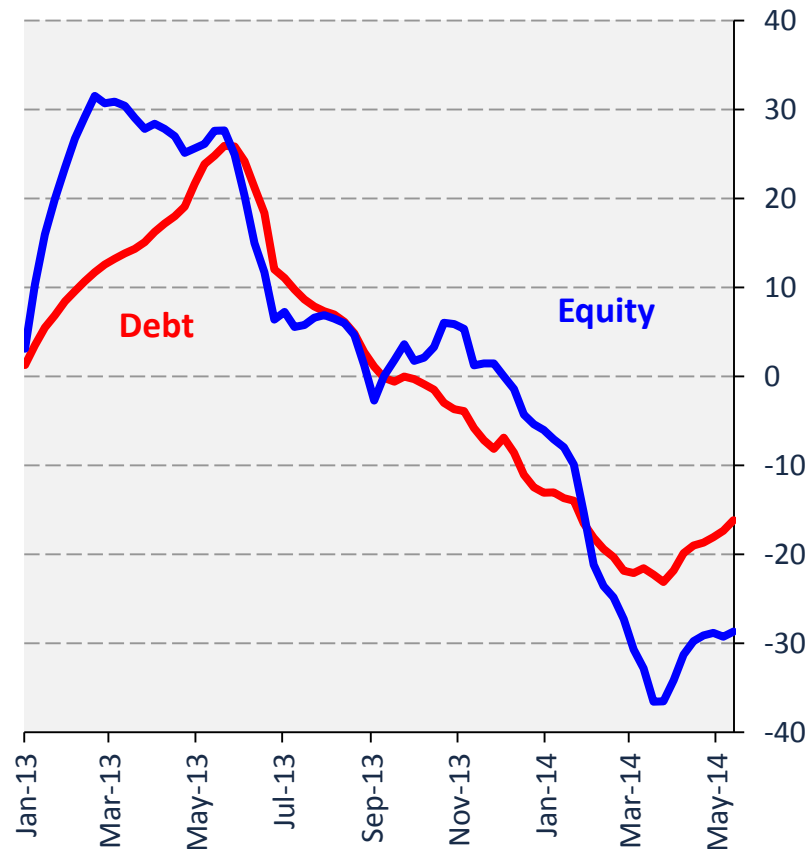
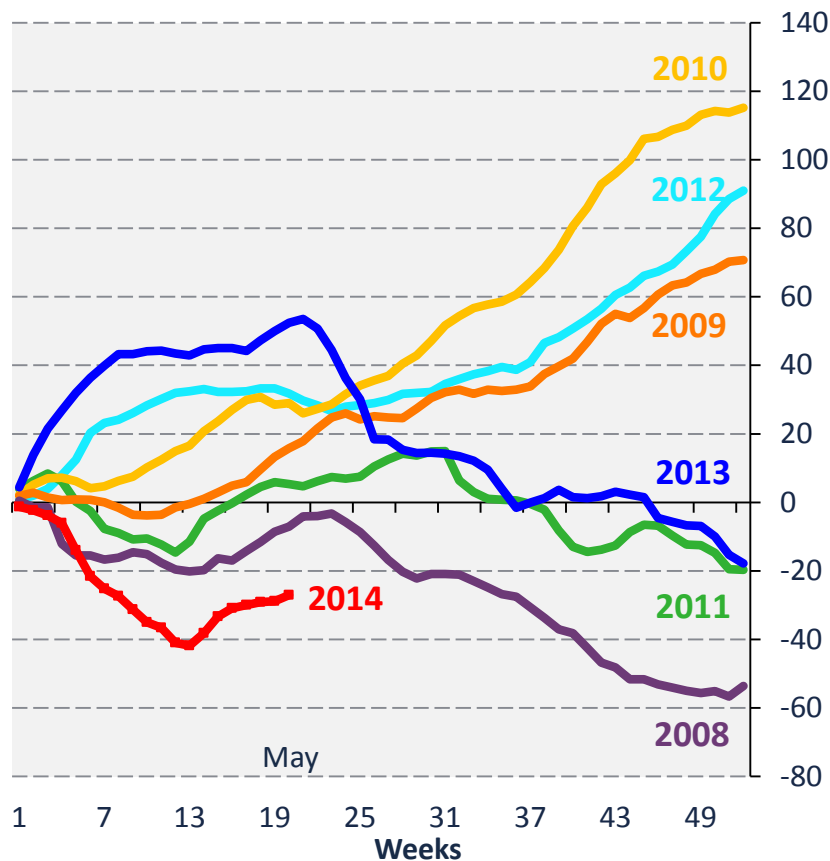
10-Year Interest Rates
%



Source: Bloomberg and U.S. Treasury Department.

Since February, greater stability in international financial markets has been recorded, which was reflected by resumed capital flows to emerging markets.

Accumulated Capital Flows to Emerging Markets (Debt and Equity) ^{1/} USD billion



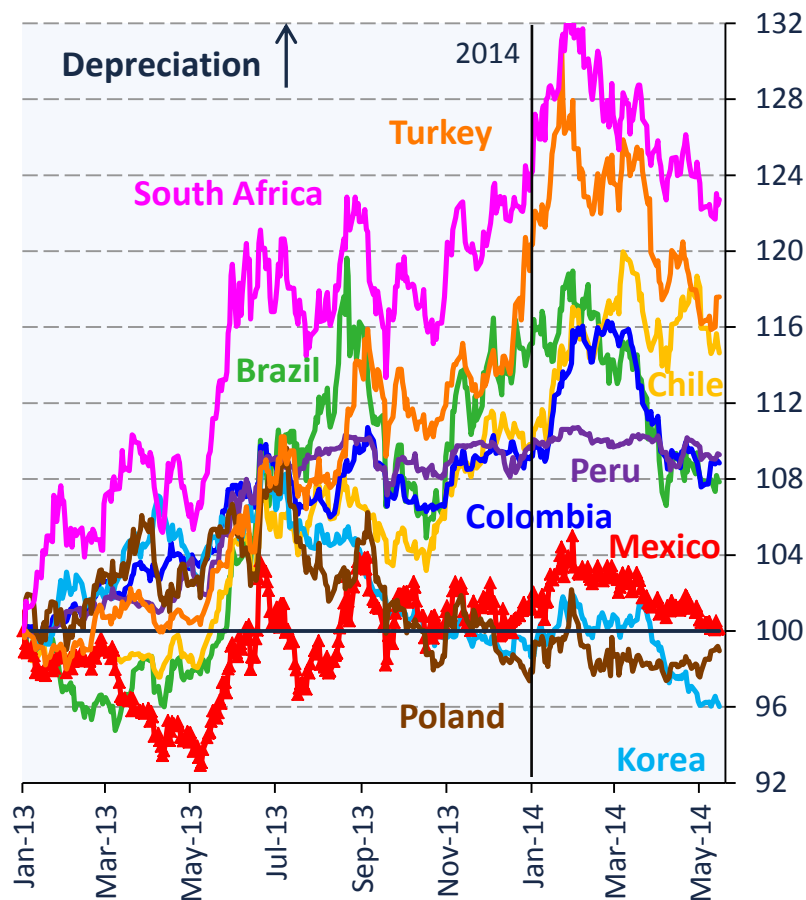
^{1/} The sample includes funds used to sell or buy equity and bonds from emerging markets registered in advanced economies. Flows exclude changes in market value of portfolios and changes in foreign exchange rates.

Source: Emerging Portfolio Fund Research.

Improved conditions were also reflected in a recovery of financial asset prices in emerging economies, as well as a significant decrease of their volatility.

Nominal Exchange Rate against USD

Index 01-Jan-2013 = 100



Source: Bloomberg.

Exchange Market Volatility^{1/}

Percent



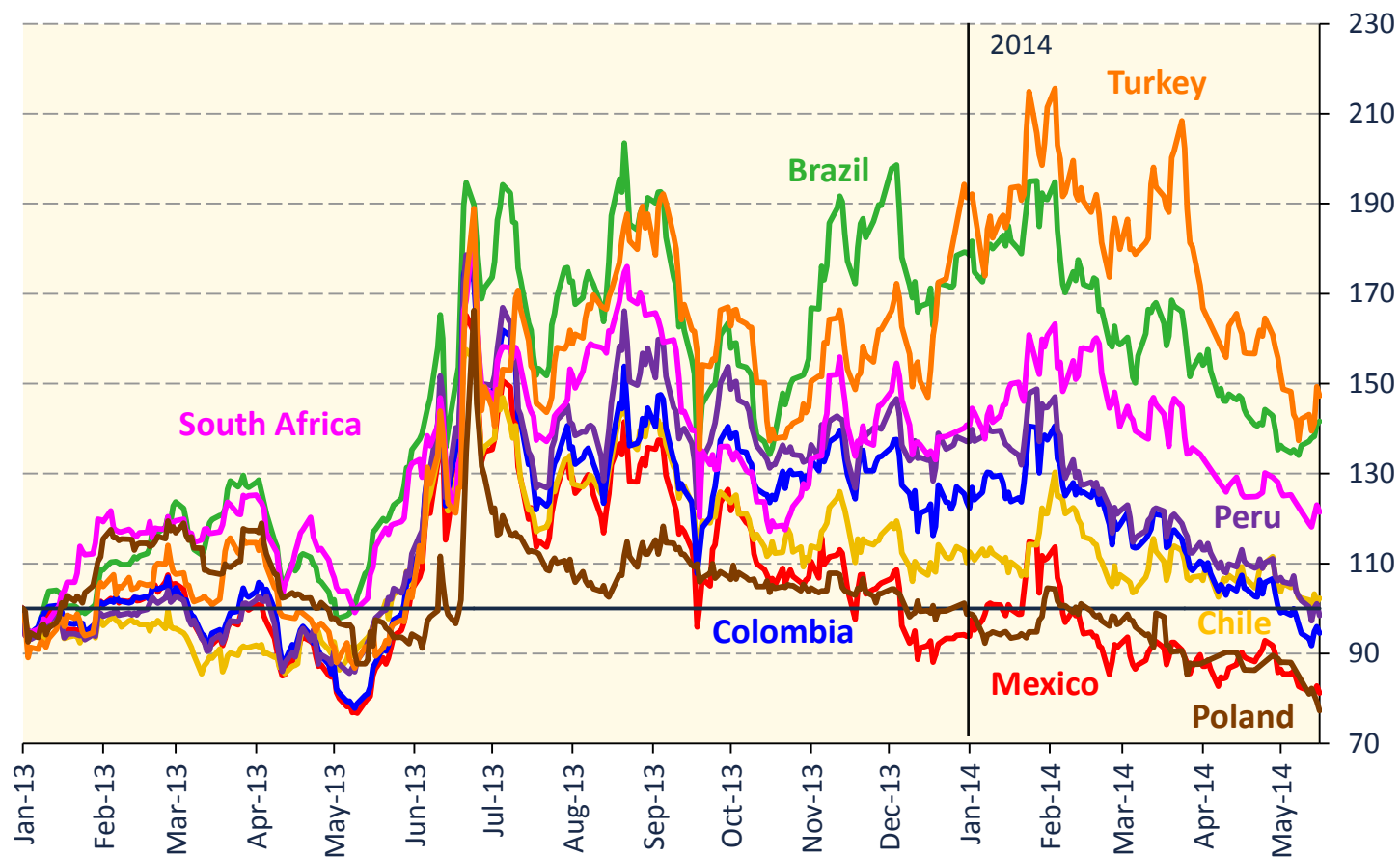
1/ Implied volatility of one month exchange rate options.

2/ Refers to the simple average for: Brazil, Chile, Korea, India, Mexico, Peru, Poland, South Africa and Turkey.

Source: Bloomberg.

In this context, Mexico stands out for being one of the economies, whose risk indicators were less affected during volatility episodes.

Credit Default Swaps ^{1/}
Index 01-Jan-2013=100



1/ 5-year CDS.
Source: Bloomberg.

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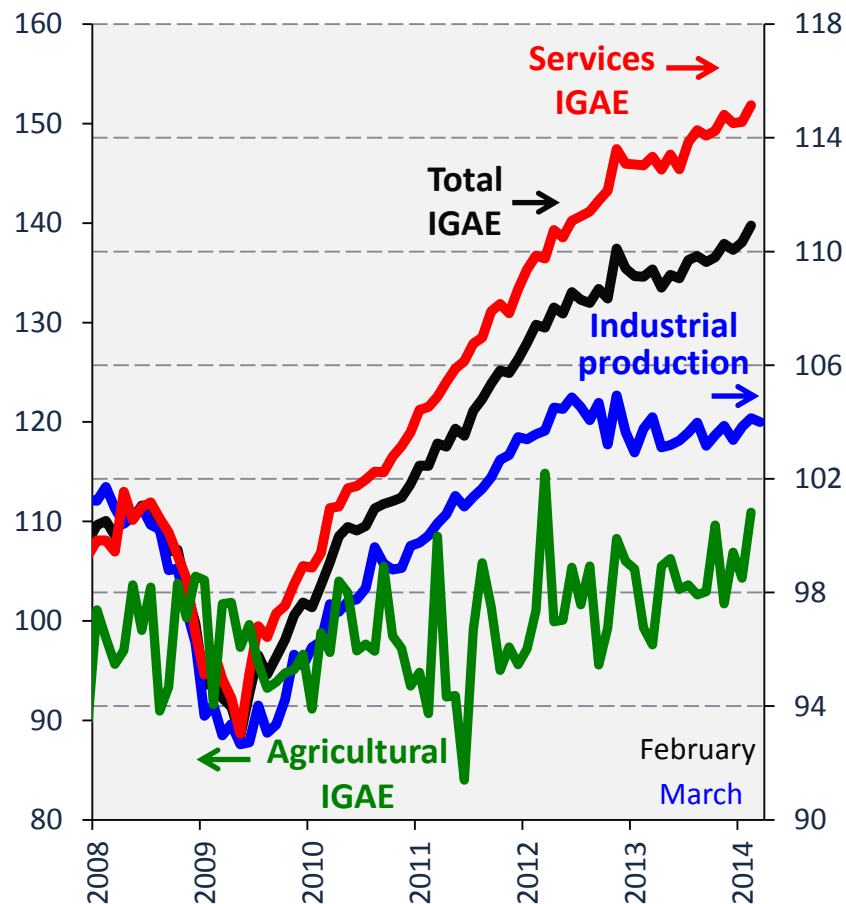
5

Forecasts and Balance of Risks

At the beginning of the 1Q of 2014, the weakness that the economic activity in Mexico registered in the 4Q of 2013 persisted, even though by the end of the quarter different indicators began performing more favorably.

Economic Activity Indicators ^{1/}

Index 2008 = 100, s.a.

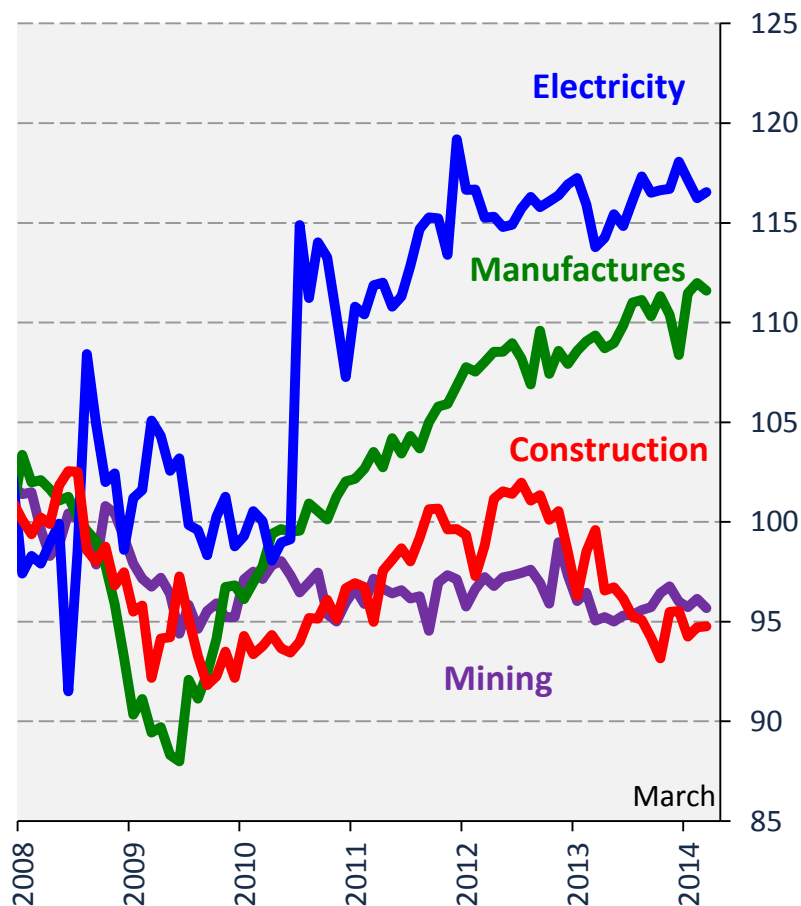


s.a./ Seasonally adjusted data.

1/ Industrial production up to March 2014. Total IGAE, services and agricultural up to February 2014. Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

Industrial Activity

Index 2008 = 100, s.a.

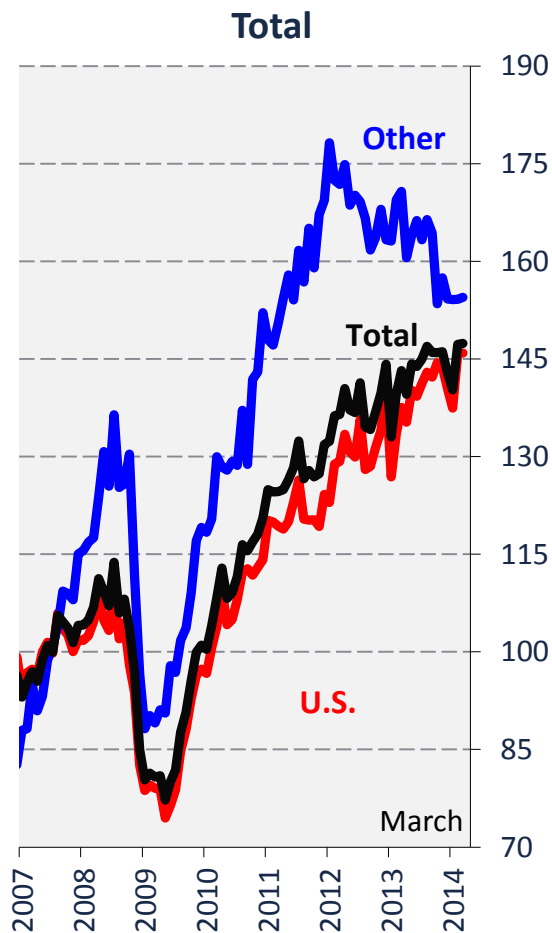


s.a./ Seasonally adjusted data.

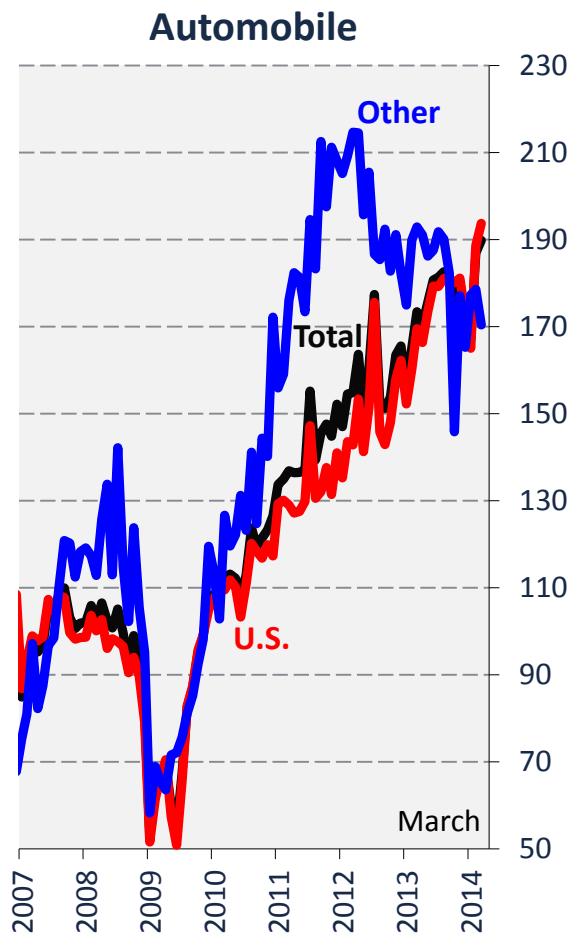
Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

The recovery of the manufacturing exports reflects, above all, higher dynamism of U.S. exports, especially automobile exports.

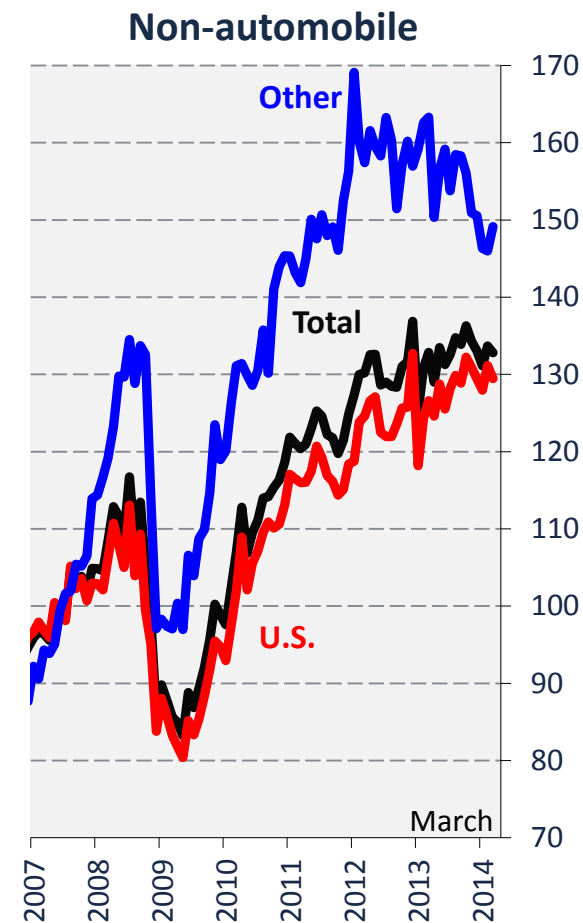
Manufacturing Exports Index 2007=100, s.a.



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



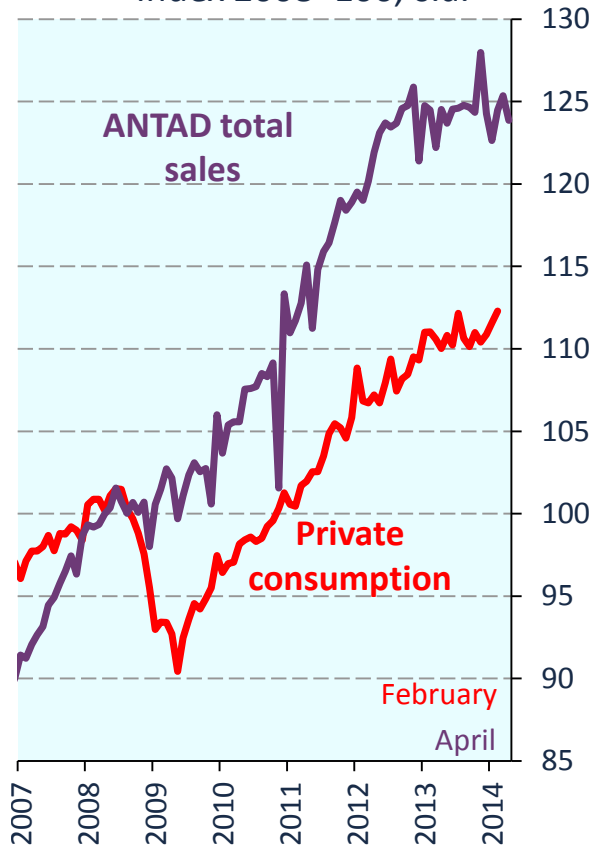
s.a./ Seasonally adjusted data.
Source: Banco de México.



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

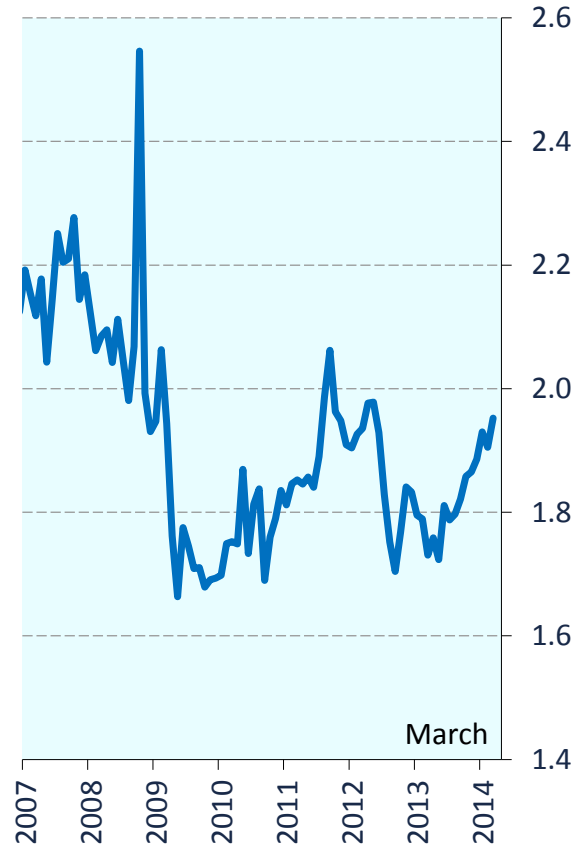
Some consumption-related indicators moderately improved their performance in recent months.

Monthly Indicator of Private Consumption in the Domestic Market and ANTAD Total Sales ^{1/}
Index 2008=100, s.a.



s.a./ Seasonally adjusted data. 1/ ANTAD data up to April 2014. Monthly Indicator of Private Consumption in the Domestic Market up to February 2014.
Source: Estimated by Banco de México with data from INEGI and ANTAD.

Workers' Remittances
USD billion, s.a.



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

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

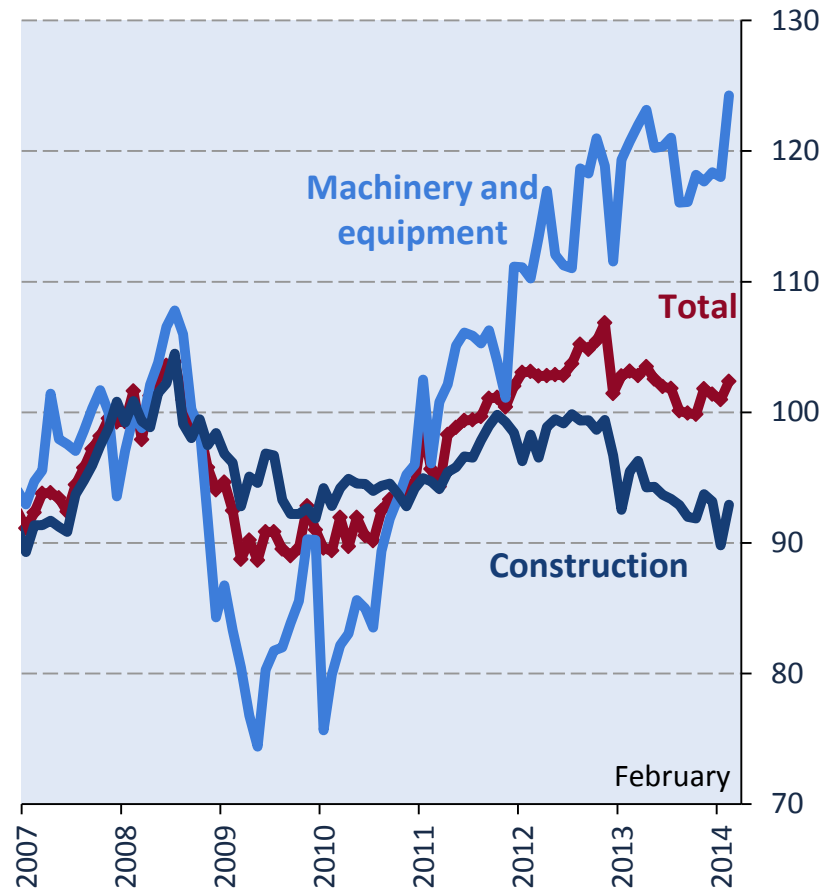


s.a./ Seasonally adjusted data.
Source: Banco de México and INEGI.

Some indicators related to gross fixed investment started to show an incipient favorable change of trend.

Investment and its Components

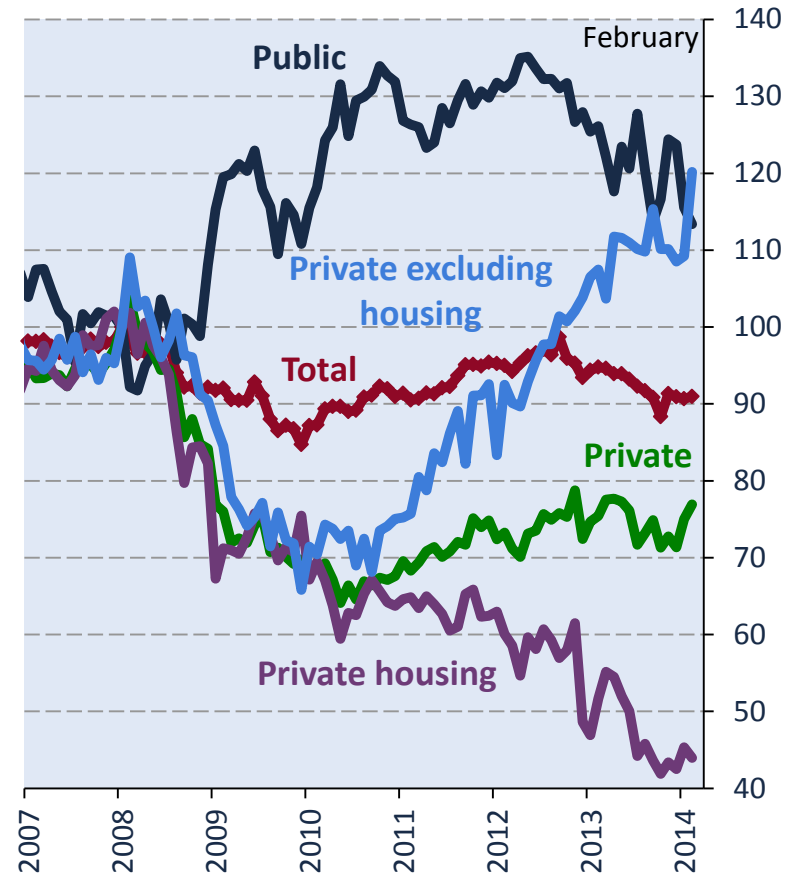
Index 2008=100; s.a.



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

Real Value of Production in Construction

Index Jan-2008=100; s.a.



s.a./ Seasonally adjusted data.
Source: INEGI and seasonally adjusted by Banco de México in the case of public and private construction (private housing and private excluding housing).

In this context, the latest data indicate that broad slack conditions persist in the labor market.

IMSS-insured Workers ^{1/}
Million workers



1/ Permanent and temporary workers in urban areas.
Source: IMSS and seasonally adjusted by Banco de México.

National Unemployment Rate
% of EAP; s.a.



EAP/ Economically Active Population.
s.a./ Seasonally adjusted.
Source: National Employment Survey (*Encuesta Nacional de Ocupación y Empleo*), INEGI.

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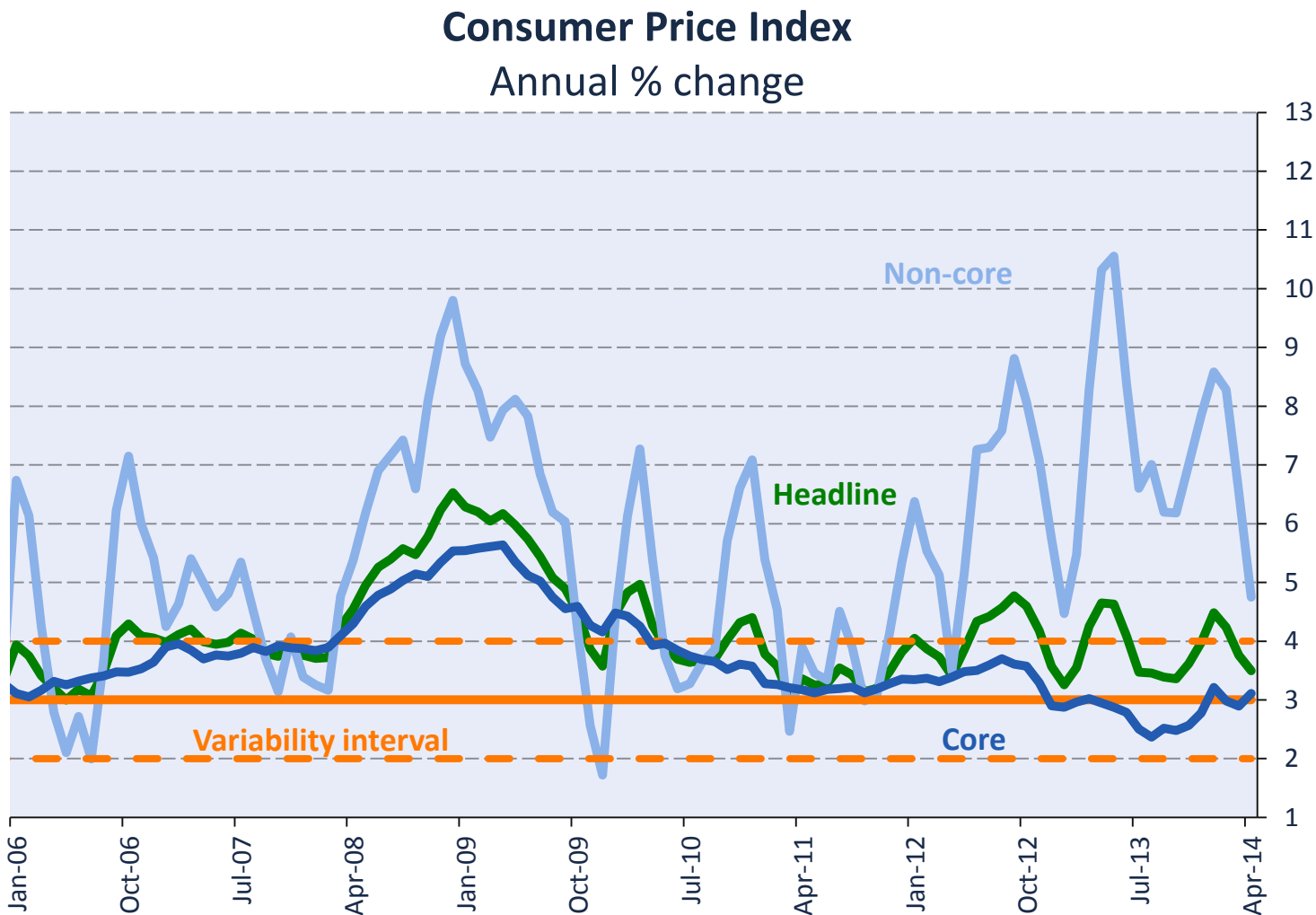
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Forecasts and Balance of Risks

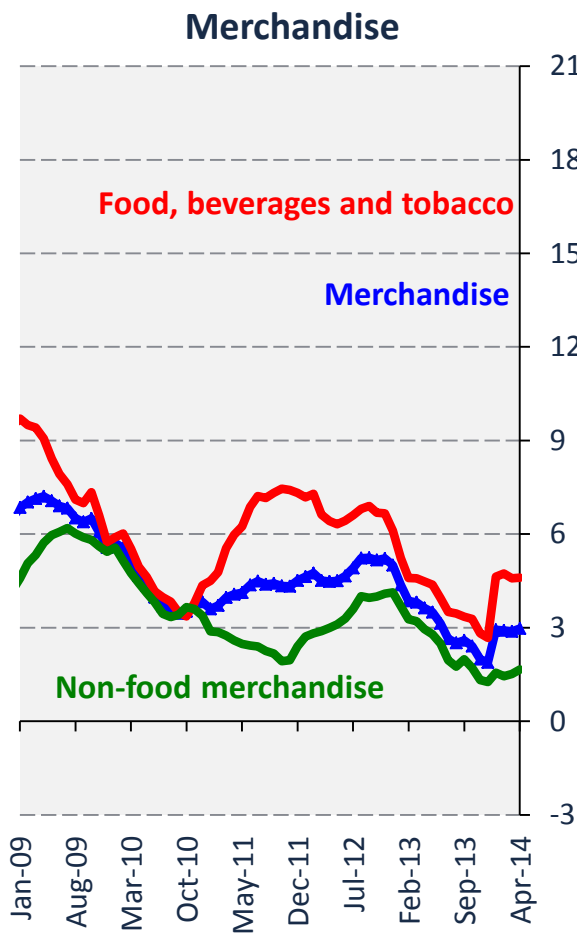
Despite the fact that some shocks in relative prices propitiated an inflation increase in late 2013 and in early 2014, it resumed its downward trend, insofar as the effects of the referred shocks started to dissipate, as expected.



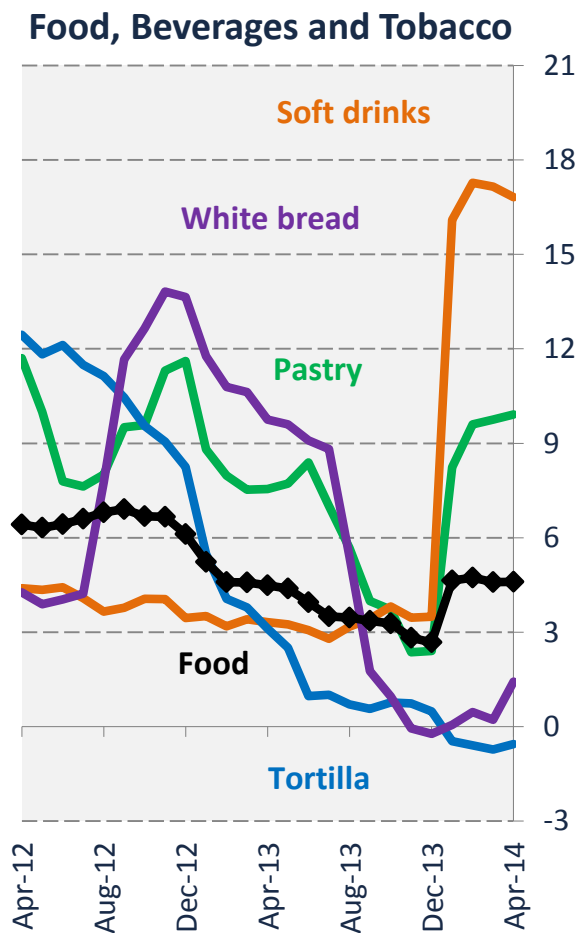
Source: Banco de México and INEGI.

The increase in inflation was concentrated in the group of goods and services affected by fiscal adjustments, without generating second round effects on the price formation process.

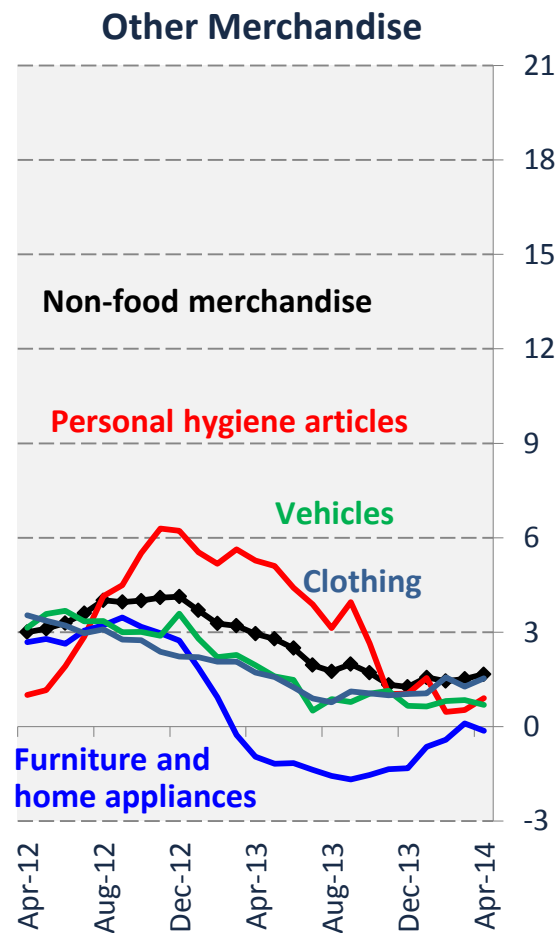
Core Price Index Annual % change



Source: Banco de México and INEGI.



Source: INEGI.

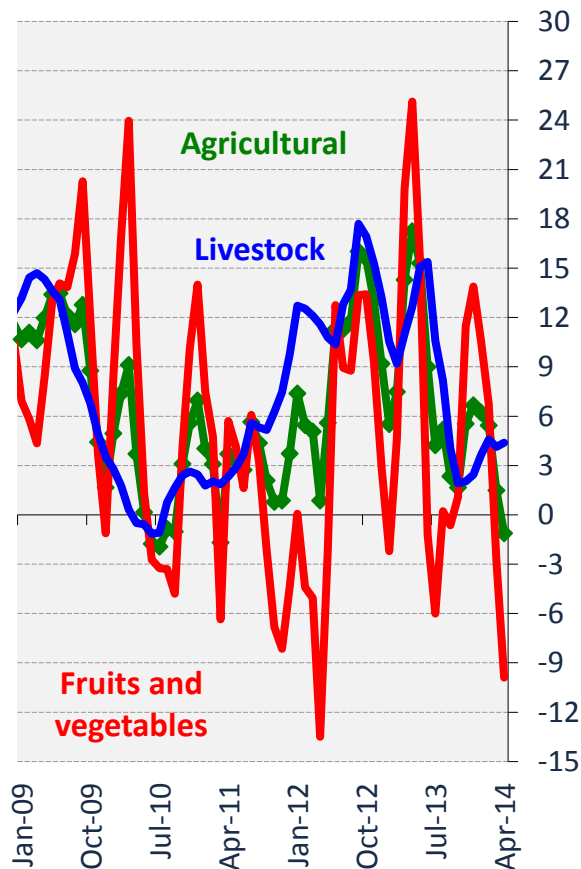


Source: INEGI.

Lower inflation in the subindex of agricultural goods offset high rates observed in the energy component and government approved fares.

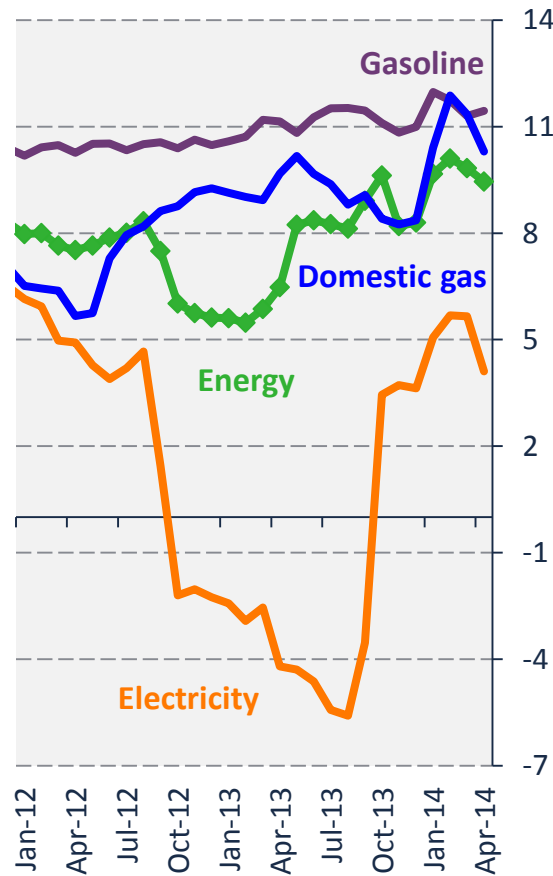
Non-core Price Index Annual % change

Agricultural



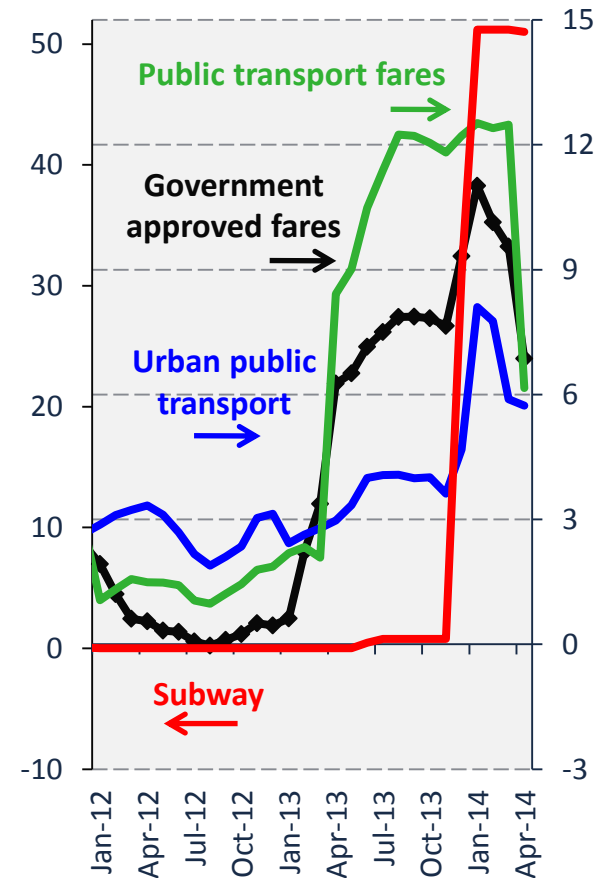
Source: Banco de México and INEGI.

Energy



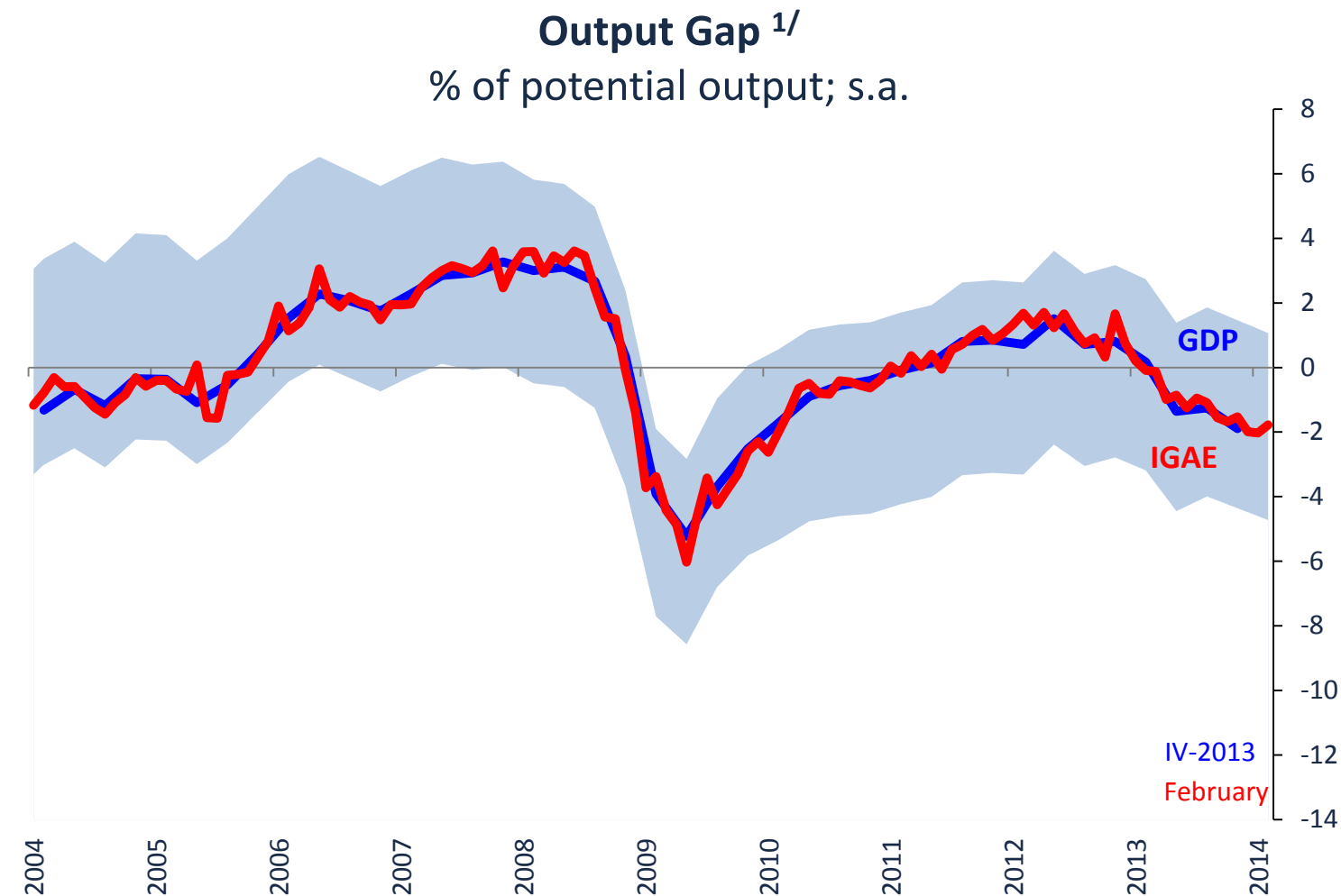
Source: INEGI.

Government Approved Fares



Source: INEGI.

Consequent on the recent economic evolution, the output gap remained negative and even widened with respect to 4Q 2013.

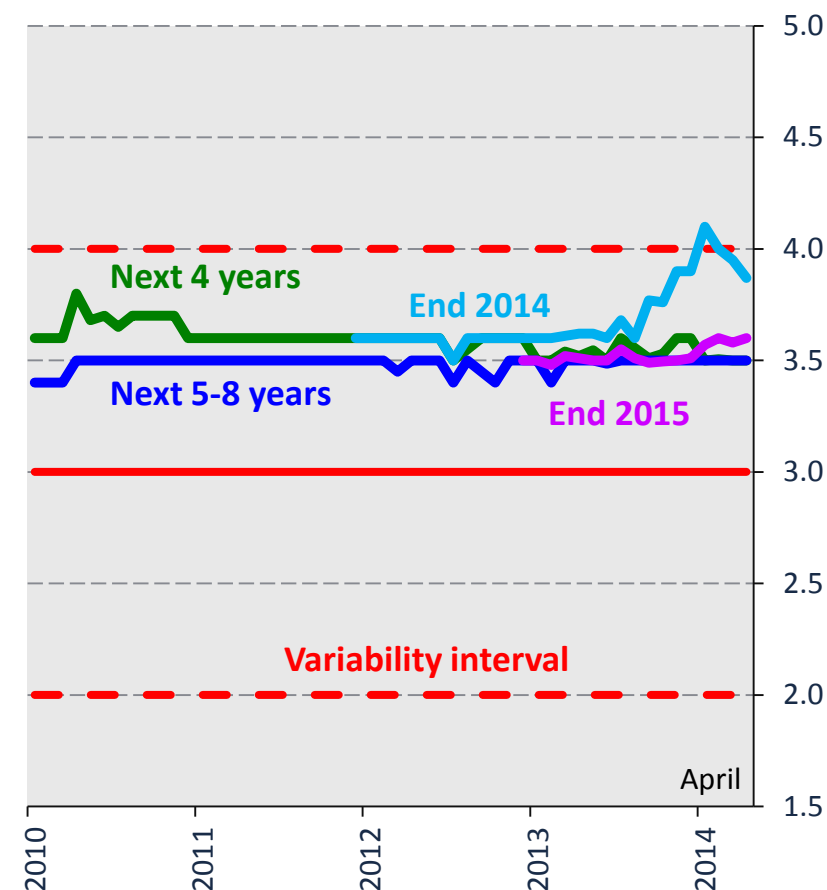


s.a./ Calculated with seasonally adjusted data.

1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p.69. The shaded area is the 95% confidence interval of the output gap, calculated with an unobserved components method. GDP figures up to 4Q 2013; IGAE up to February 2014. Source: Calculated by Banco de México with data from INEGI.

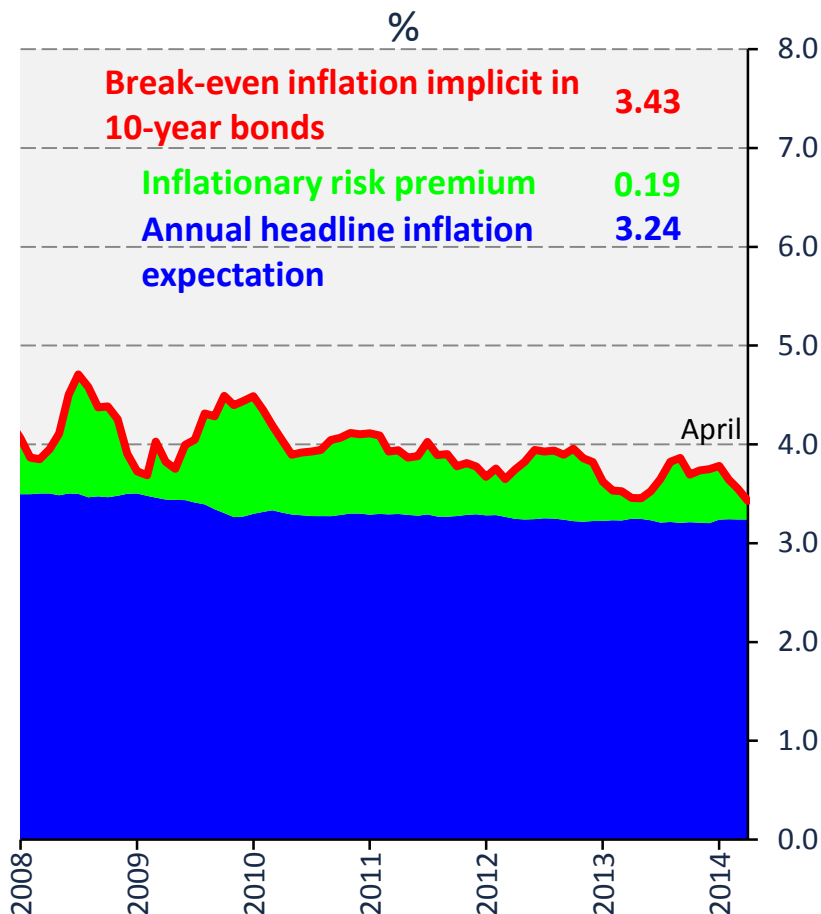
Short-term inflation expectations were revised downwards and medium- and long-term ones remained stable, while those implicit in long-term market instruments have been diminishing over the recent years.

Annual Headline Inflation Expectations Median, %



Source: Banco de México's Survey.

Break-even Inflation and Inflationary Risk and its Components ^{1/}



^{1/} The inflation risk premium is calculated with an affine model as described in Aguilar, Elizondo and Roldán (2013) with data from Valmer and Bloomberg.

Following a widespread increment in long-term interest rates, derived from the process of risk premia decompression, these have decreased from February on.

Interest Rates of Government Securities ^{1/} %



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

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

Mexico and U.S. Term Premium Approximation ^{2/} Percentage points



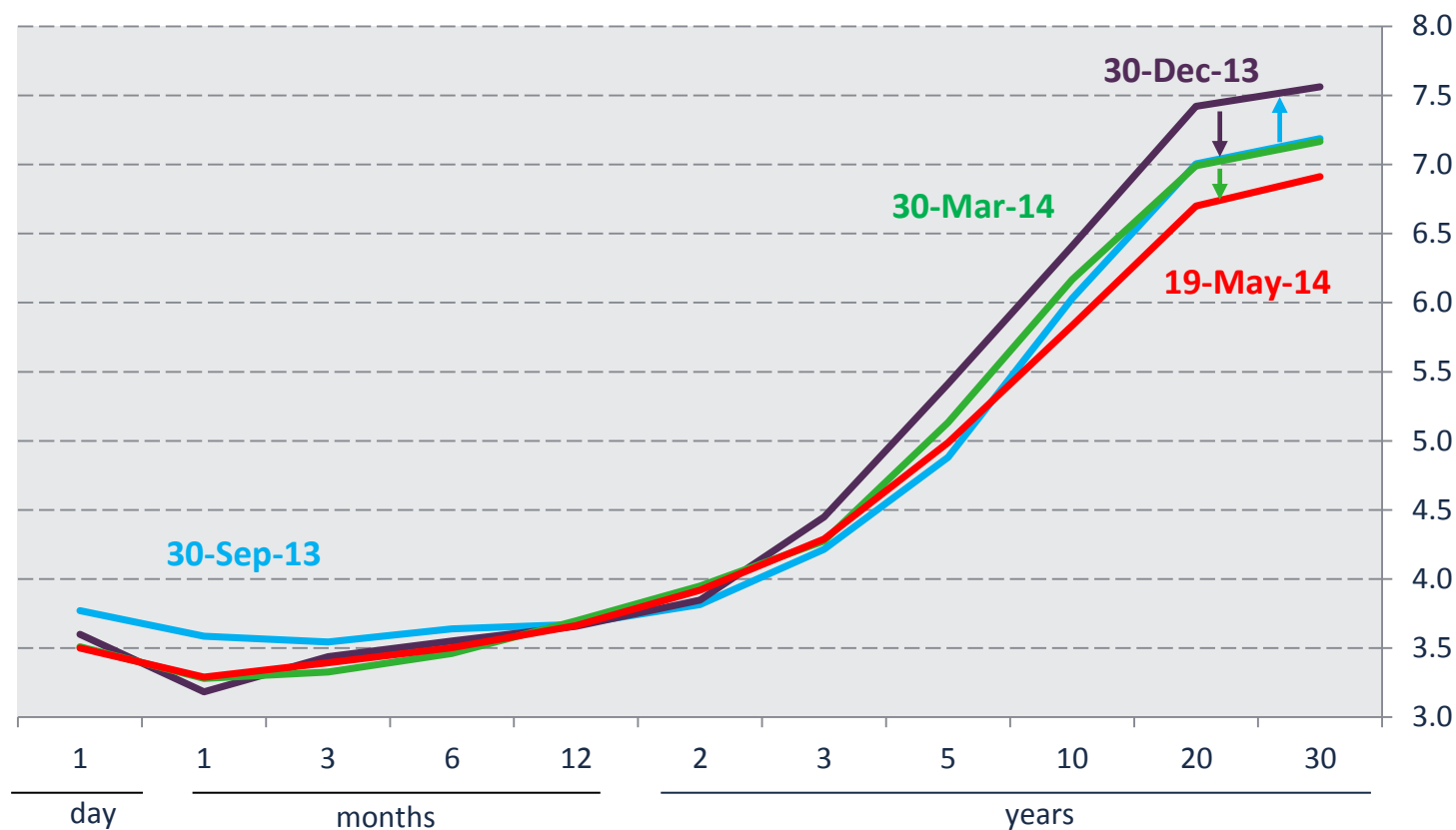
2/ The term premium approximation is calculated as the difference between the 10-year rate and 2-year rate.

Source: *Proveedor Integral de Precios* (PiP) and Federal Reserve.

In this environment, both monetary and financial conditions supported the economy, given the phase of the business cycle the economy is going through.

Government Bond Yield Curve

%



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

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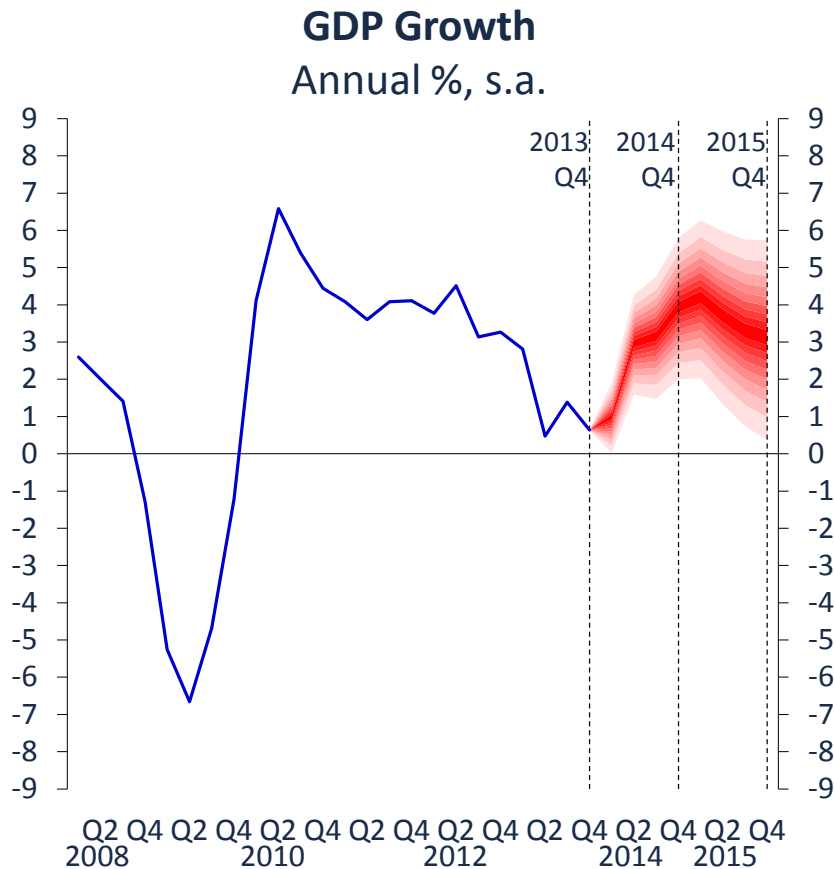
Forecasts and Balance of Risks

Economic Activity Outlook

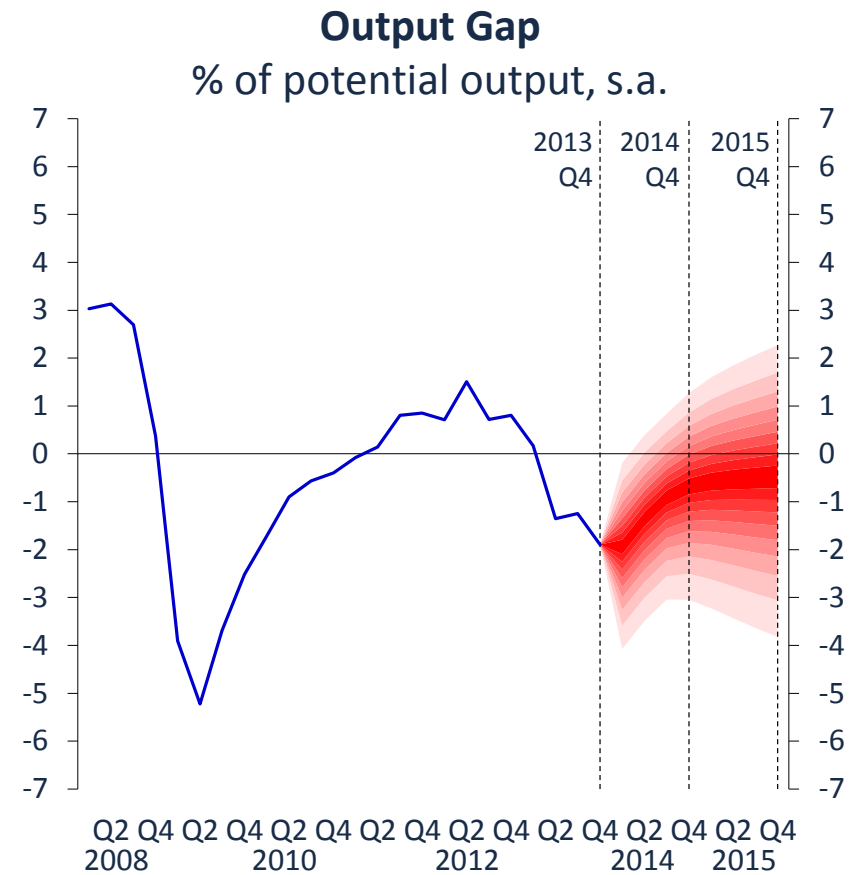
GDP Growth	
2014	Between 2.3 and 3.3%
2015	Between 3.2 and 4.2%

Increase in the number of IMSS-insured workers	
2014	Between 570 and 670 thousand
2015	Between 620 and 720 thousand

Fan Charts




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



s.a./ Elaborated with seasonally adjusted data.
Source: Banco de México.


Risks to the Growth Outlook:

Upward




The possibility that the recovery of the U.S. economic activity accelerates.

Downward:



That consumer and producer confidence does not improve fast enough, and, therefore, that private sector expenditure does not recover at the expected rate.



That the process of the U.S. monetary policy normalization is not orderly.

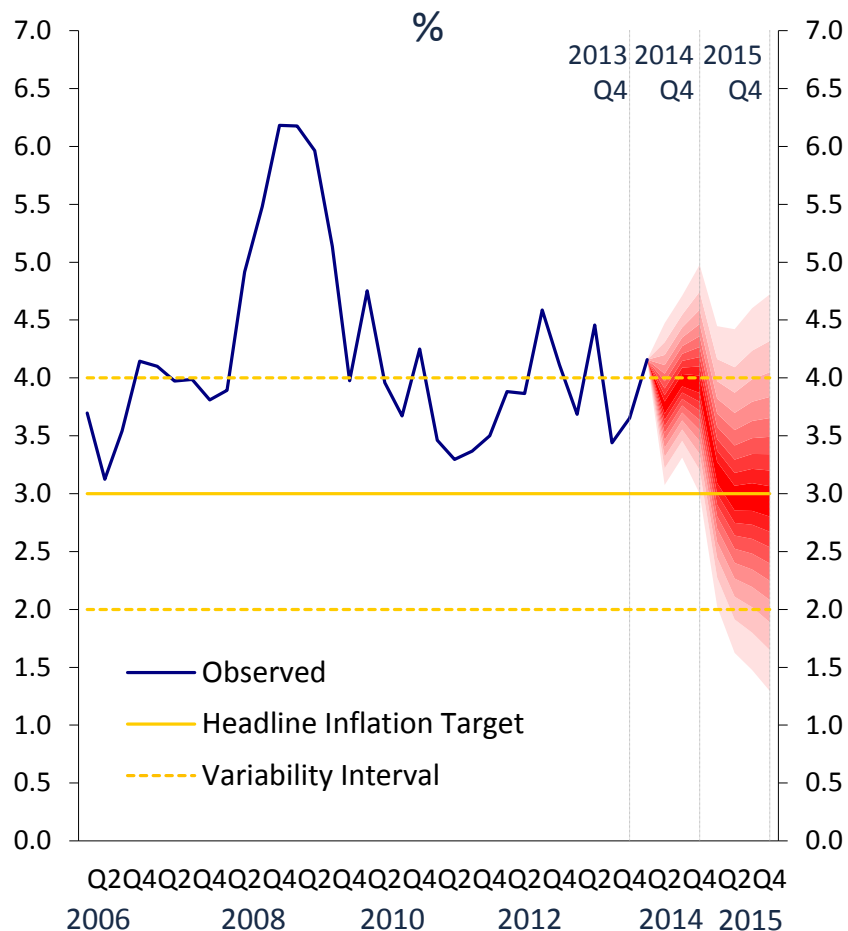
Inflation Forecasts

	Headline inflation	Core inflation
2014	2Q: is expected to remain under 4 percent.	
	2H: due to the arithmetic effect coming from a low comparison base, as well as the volatility of the non-core component, headline inflation could locate above 4 percent in some months, although it is expected to conclude the year below this level.	Will persist around 3 percent.
<hr/>		
2015	From <u>January</u> onwards, is anticipated to show an important reduction and to remain at levels slightly above 3 percent for the <u>rest of the year</u> .	Lies below 3 percent.

The expected inflation performance considers that for 2015 no fiscal adjustments are observed and that the change in gasoline prices is determined based on the expected inflation.

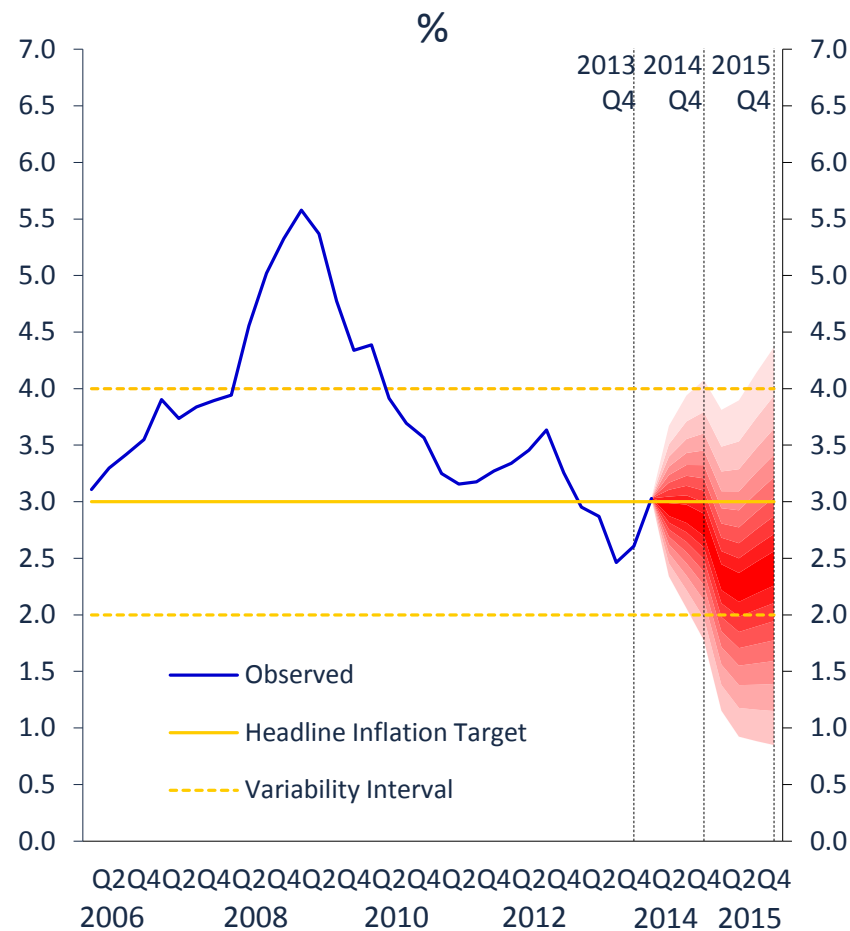
Fan Charts

Annual Headline Inflation ^{1/}



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

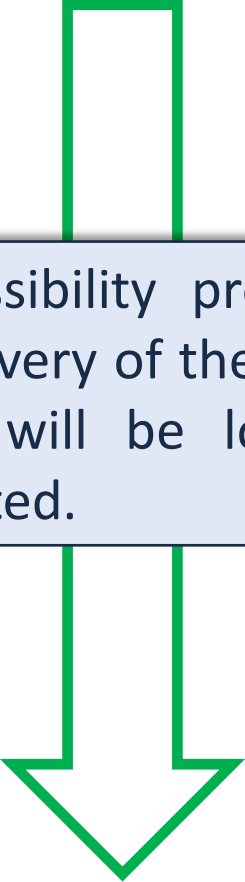
Annual Core Inflation ^{2/}



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

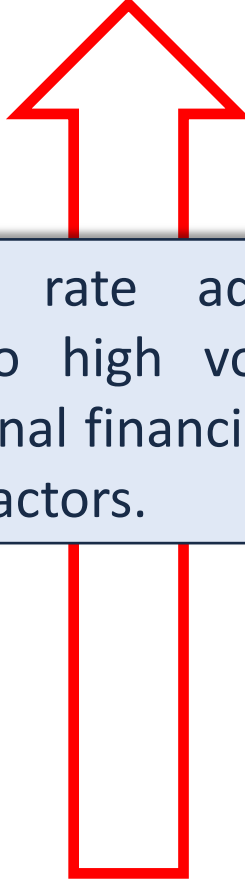
Inflation outlook is not risk-free:

Downward



The possibility prevails that the recovery of the economic activity will be lower than anticipated.

Upward



Exchange rate adjustments related to high volatility in international financial markets or other factors.

Monetary Policy Stance

- Banco de México's Board of Governors has estimated that the current monetary policy stance has so far been congruent with the efficient convergence of inflation to the 3 percent target.
- Still, in the future, it will monitor all factors that could affect inflation and its expectations in the medium- and long term, particularly the evolution of the degree of slack in the economy.
- Likewise, it will monitor the implications of the monetary policy stance of Mexico relative to the U.S. onto the inflation outlook, so as to reach the abovesaid inflation target.

The juncture that the Mexican economy is going through is propitious to make a reflection on the importance of strengthening the domestic sources of growth over the coming years.

- One of the main reasons behind the reduced growth that Mexico has been presenting for decades is the low rate of productivity expansion.

➔ Achieving higher productivity and stronger potential growth in Mexico represents a considerable challenge.

- In this context, it is encouraging that structural reforms aimed at increasing productivity are being carried out. Nevertheless:
 - ✓ *It is imperative that this progress should be backed by **secondary legislation** that preserves the spirit of constitutional amendments.*
 - ✓ *For the reforms to unlock their full potential onto the economic activity and welfare, it is also necessary to ensure that they are **properly implemented** in the following years.*



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