BANCO DE MÉXICO

Quarterly Report

April – June 2014

BOARD OF GOVERNORS

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QUARTERLY REPORT

This report analyzes the development of inflation, the economy and different economic indicators in Mexico, as well as the monetary policy implementation in the quarter April - June 2014 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 August 11, 2014. Figures are preliminary and subject to changes.

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1. Introduction

The monetary policy implemented by Banco de México has focused on reaching an efficient inflation convergence towards its 3 percent target, that is, at the minimum cost to society in terms of economic activity. This has been possible, in part, due to the credibility of the Bank's commitment to price stability. Thus, there has been a positive feedback between the conduction of monetary policy, the environment of low and stable inflation and the anchoring of inflation expectations.

Therefore, the conduction of monetary policy, among other factors, contributed to inflation evolving as expected during the first two quarters of the current year, while inflation expectations for end of 2014 and 2015 diminished. Meanwhile, during the first quarter economic activity registered a lower performance than initially anticipated; contributing to a higher degree of slack in the economy than that foreseen a few months ago. In this context, considering the favorable evolution of inflation, the prevision that it will stay at levels close to 3 percent from early 2015 onwards and the weak economic activity, the Board of Governors decided to decrease the target for the Overnight Interbank Interest Rate from 3.5 to 3.0 percent in June. However, it considered that, given the expected recovery of the economy and the monetary policy stance of Mexico relative to the U.S., a further reduction in this target was not recommendable, thus it remained unchanged in July.

Economic activity in Mexico showed an improvement during the second quarter of the current year in relation to the weak behavior observed in the previous two quarters. This evolution has been mainly due to the dynamism of the external sector, since the recovery of the domestic demand is not yet very strong. Despite the mentioned recovery, the prevailing degree of slack in the economy is greater than the one anticipated in the previous Report.

During the second quarter, the international environment was characterized by a recovery of the world economy. In advanced economies, the effects of a lower fiscal consolidation and a very accommodative monetary policy contributed to boosting economic activity, while in emerging economies weak conditions prevailed. The expansion of the world economy was supported by the fading of transitory factors that led to lower than expected growth in the first quarter, mainly in the U.S. In this context, the Federal Reserve reaffirmed that it anticipates a gradual normalization of its monetary policy stance. Meanwhile, the European Central Bank announced major measures of monetary easing. Thus, the expectation that the considerable monetary stimulus in advanced economies will prevail for an extended period of time contributed to a low volatility in financial markets and a recovery of capital flows to emerging economies. However, even if most market participants expect monetary policies in advanced economies to normalize in an orderly manner, new episodes of volatility cannot be ruled out, as was the case at the end of July and the beginning of August. This since the normalization process may turn out more complicated than expected, especially in the U.S.

Despite the greater dynamism of the Mexican economy in the second quarter and the expectation of a stronger recovery in the second half of the year, the fact that its performance was lower than anticipated in the first quarter, together with the perception of a more modest than previously expected growth of domestic demand, lead to a downward revision of the GDP growth forecast for 2014. In particular, the forecast interval for Mexico's GDP growth in 2014 is revised from 2.3 to 3.3 percent in the previous Report to 2.0 to 2.8 percent. For 2015, the forecast interval is maintained between 3.2 to 4.2 percent. Although the output gap is anticipated to close gradually, it is likely to remain in negative levels until the end of 2015. In sum, aggregate-demand related pressures on inflation are not expected during the next 18 months.

The outlook for annual headline inflation continued being positive. As in the previous Report, inflation is expected to converge to the 3 percent target in 2015. As foreseen, it is expected to remain close to 4 percent during the second half of 2014, although due to the high volatility that characterizes the prices of agricultural products it may exceed that level at some point, as in fact happened in July. However, it is expected that towards the end of this year, headline inflation will be below 4 percent, given the fading effect of changes in relative prices that took place in November and December of 2013. For 2015, annual headline inflation is anticipated to rapidly decrease to levels close to 3 percent, as the arithmetic effect derived from the fiscal measures, which came into force in early 2014, vanishes, and the increases in gasoline prices from 2015 onwards are consistent with expected inflation, as established by the Federal Income Law 2014. The annual core inflation forecasts indicate that it will remain around 3 percent for the rest of 2014 and below this level in 2015.

In this context, the Board of Governors considers that the monetary policy stance is consistent with the efficient convergence of inflation towards its 3 percent target. However, the Board will closely monitor the performance of all determinants of inflation and inflation expectations for medium- and long-term horizons, including the expected recovery of the economy and the monetary policy stance of Mexico relative to the U.S., in order to be able to reach the target of 3 percent for headline inflation.

2. Recent Development of Inflation

2.1. Inflation

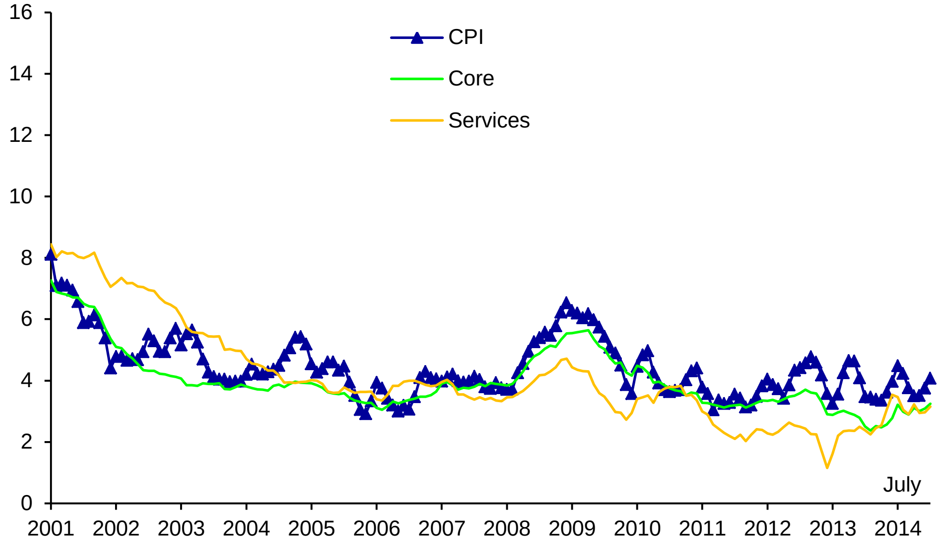
The conduction of monetary policy, among other factors, contributed to the decrease in annual headline inflation in the second quarter. This indicator's average went from 4.16 to 3.59 percent between the first and second quarter of the year, proving the absence of second round effects on the price formation process derived from diverse fiscal changes that came into force in early 2014 (Table 1 and Chart 1). Later, as expected, annual headline inflation rebounded, mainly due to the arithmetic effect of a low comparison base in the non-core component, namely the agricultural price subindex, and the increase in air transport and tourism package prices, which are expected to revert in the next months. Thus, annual headline inflation was 4.07 percent in July (Table 1 and Chart 2).

Table 1
Consumer Price Index and Components
Annual change in percent

	Annual change							Average percent	
	January 2014	February 2014	March 2014	April 2014	May 2014	June 2014	July 2014	QI 2014	QII 2014
CPI	**4.48**	**4.23**	**3.76**	**3.50**	**3.51**	**3.75**	**4.07**	**4.16**	**3.59**
Core	**3.21**	**2.98**	**2.89**	**3.11**	**3.00**	**3.09**	**3.25**	**3.03**	**3.07**
Merchandise	**2.93**	**2.91**	**2.88**	**2.97**	**3.08**	**3.24**	**3.37**	**2.91**	**3.10**
Food, beverages and tobacco	4.64	4.73	4.58	4.60	4.76	5.06	5.20	4.65	4.81
Non-food merchandise	1.56	1.45	1.52	1.67	1.73	1.78	1.88	1.51	1.72
Services	**3.47**	**3.05**	**2.90**	**3.23**	**2.94**	**2.96**	**3.15**	**3.14**	**3.04**
Housing	2.21	2.25	2.24	2.24	2.21	2.15	2.11	2.24	2.20
Education (tuitions)	4.32	4.38	4.39	4.39	4.42	4.46	4.38	4.36	4.42
Other services	4.53	3.50	3.17	3.94	3.28	3.40	3.90	3.73	3.54
Mobile phone services	27.42	1.34	-1.79	-3.73	-6.77	-5.67	-3.15	7.44	-5.39
Tourism packages	2.39	2.78	-2.37	13.02	4.34	1.95	5.02	0.85	6.42
Air transport	-9.29	-14.09	-12.01	1.89	-4.43	0.87	12.36	-11.84	-0.53
Non-core	**8.58**	**8.28**	**6.54**	**4.75**	**5.19**	**5.96**	**6.83**	**7.79**	**5.29**
Agriculture	**6.21**	**5.43**	**1.49**	**-1.13**	**0.67**	**3.37**	**5.78**	**4.33**	**0.94**
Fruit and vegetables	10.54	6.73	-2.81	-9.90	-7.97	-2.15	3.22	4.54	-6.86
Lemon	56.55	160.18	161.98	32.89	-11.85	1.92	8.22	130.71	10.45
Onion	40.73	32.26	20.36	-11.97	1.51	13.99	26.82	30.54	-1.03
Green tomato	-0.95	-29.57	-60.29	-68.85	-63.07	-19.95	14.64	-38.50	-58.97
Tomato	18.36	-9.89	-33.89	-7.34	-30.06	-22.73	3.77	-8.63	-20.46
Zucchini	0.84	-22.19	-50.93	-48.75	-10.92	10.85	2.84	-28.94	-23.45
Livestock	3.65	4.58	4.14	4.39	5.70	6.34	7.14	4.12	5.49
Energy and government approved fares	**10.13**	**10.12**	**9.73**	**8.52**	**8.14**	**7.59**	**7.47**	**9.99**	**8.09**
Energy	9.67	10.10	9.83	9.45	8.86	8.42	8.38	9.87	8.92
Gasoline	12.24	12.00	11.54	11.69	11.89	10.97	10.74	11.92	11.51
Electricity	5.06	5.69	5.66	4.11	-0.19	0.17	0.66	5.47	1.57
Domestic gas	10.41	11.88	11.34	10.30	10.05	9.91	9.80	11.21	10.08
Government approved fares	11.02	10.14	9.55	6.86	6.89	6.18	5.92	10.23	6.64
Public transport	12.52	12.40	12.48	6.16	5.79	4.40	3.59	12.47	5.44
Vehicle procedure fees	68.11	45.56	11.54	2.76	2.79	2.82	2.82	37.66	2.79
City buses	8.10	7.76	5.89	5.74	6.21	5.48	5.44	7.25	5.81

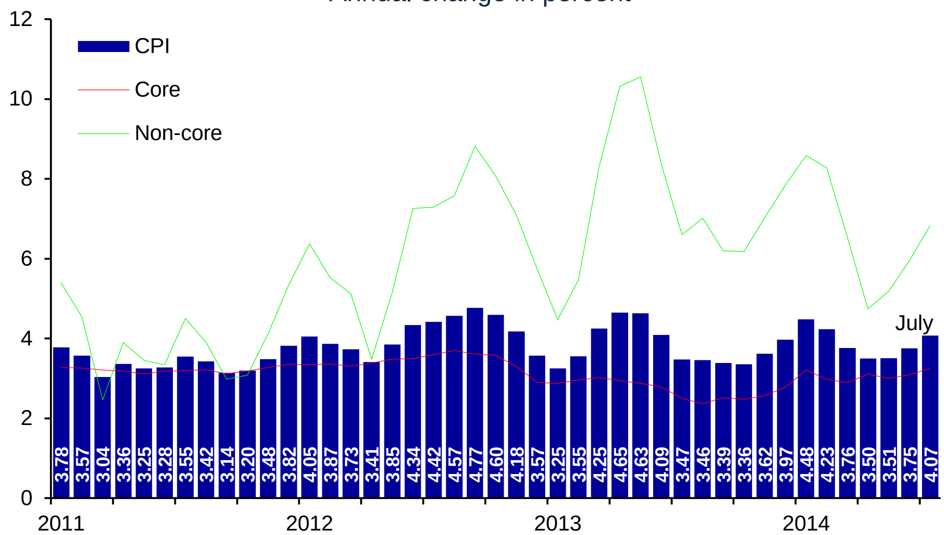
Source: Banco de México and INEGI.

Chart 1
Consumer Price Index
Annual change in percent



Source: Banco de México and INEGI.

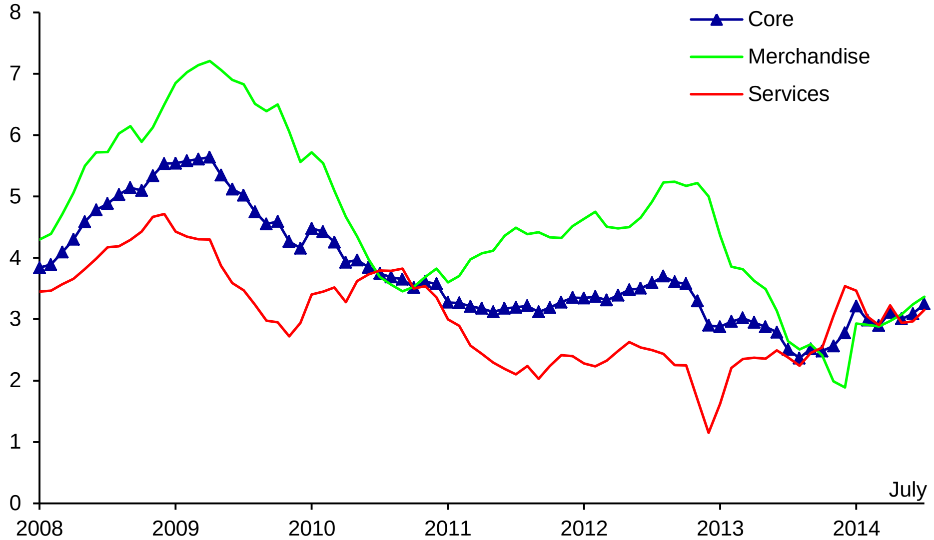
Chart 2
Consumer Price Index
Annual change in percent



Source: Banco de México and INEGI.

Although an important number of the referred tax changes affected the core price index, in particular diverse food items, this indicator's annual change maintained at levels close to 3 percent. Thus, in the first quarter of the year average annual core inflation was 3.03 percent and in the second quarter it was 3.07 percent. In July the annual change was 3.25 percent (Table 1, Chart 3 and Chart 4a).

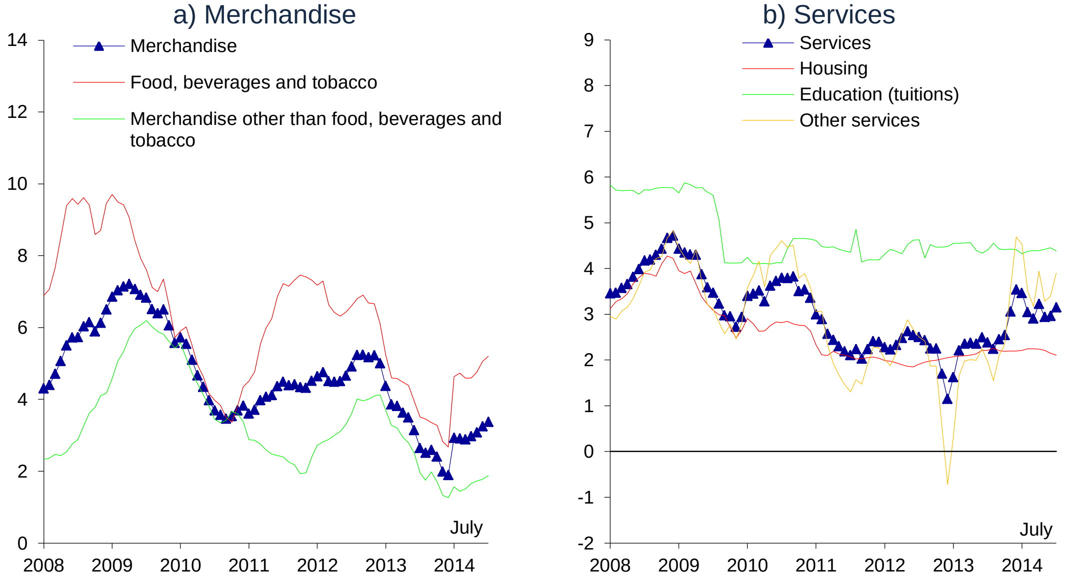
Chart 3
Core Price Index
Annual change in percent



Source: Banco de México and INEGI.

The merchandise price subindex went from an average annual change of 2.91 percent in the first quarter of 2014 to one of 3.10 percent in the second quarter, registering a variation of 3.37 percent in July. This was mainly due to the behavior of the food items' group, which still reflects the arithmetic effect of fiscal changes at the beginning of the year, as its average annual change rate increased from 4.65 in the first quarter of the year to 4.81 percent in the second one. During July this group recorded an annual change of 5.20 percent, with high growth rates of beer and some cold cuts prices standing out. Meanwhile, the non-food merchandise group partly compensated the referred increments in the food merchandise subindex, by maintaining annual growth rates below 2 percent, changing from an average of 1.51 to 1.72 percent in the mentioned quarters (1.88 percent in July) (Table 1, Chart 3 and Chart 4a).

Chart 4
Core Price Index: Merchandise and Services
Annual change in percent

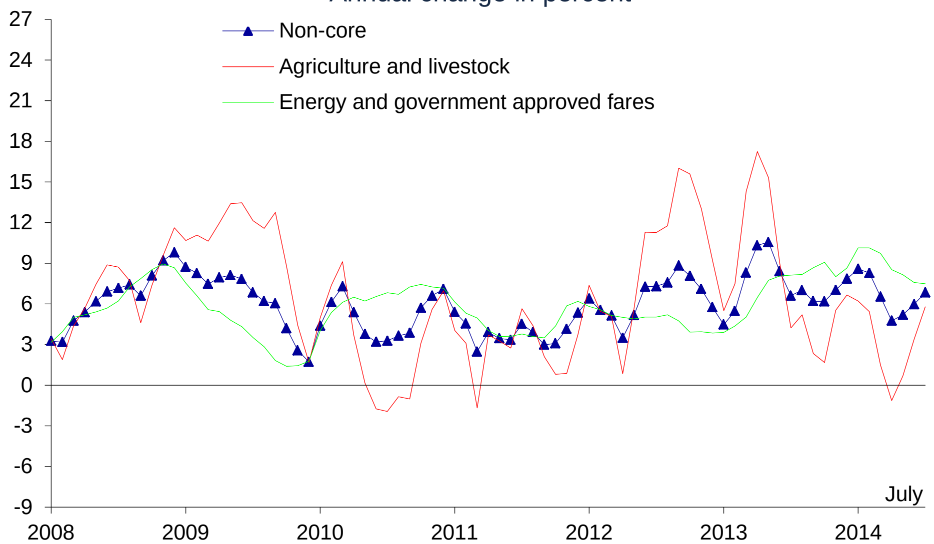


Source: Banco de México and INEGI.

The average annual change of the service price subindex decreased from 3.14 percent in the first quarter of 2014 to 3.04 percent in the second quarter, while in July it was 3.15 percent. This evolution can be mainly explained by the trajectory of prices of the services other than education and housing group. This happened, despite the seasonal effect of Easter holiday registered in the tourism service prices, whose annual change rates increased between the first and second quarter, given that the referred vacations took place in April this year, while in 2013 it was in March. On the other hand, the rest of this group's components showed a favorable trajectory, in particular, declines were registered in the mobile phone service charges. In this way, the average annual change of the group of services other than education and housing went from 3.73 percent in the first quarter to 3.54 percent in the second quarter of the year. Later, in July it was 3.90 percent, due to the transitory increments of tourism service prices, derived from the beginning of the summer holidays, which have been higher than those observed during the same period of the previous year, possibly associated with the modified school calendar that implied that vacations started later than last year and lasted less (Table 1 and Chart 4b).

During the period covered in this Report, annual non-core inflation presented lower levels than those observed at the beginning of the year, as effects of some vegetable price shocks from the previous quarters continued vanishing. Additionally, in the second quarter some energy prices decreased and public transport fares increased less than last year. Therefore, average annual non-core inflation dropped from 7.79 percent in the first quarter of 2014 to 5.29 percent in the second quarter. It stands out that towards the end of the quarter, the annual change rate of the agricultural price subindex, as expected by the Central Institute, increased as reflection of the arithmetic effect of a lower comparison base, besides the transitory price increments of some fruit and vegetables, caused by harvest problems after heavy rains, leading to an annual non-core inflation of 6.83 percent in July (Table 1, Chart 5 and Chart 6).

Chart 5
Non-core Price Index
Annual change in percent



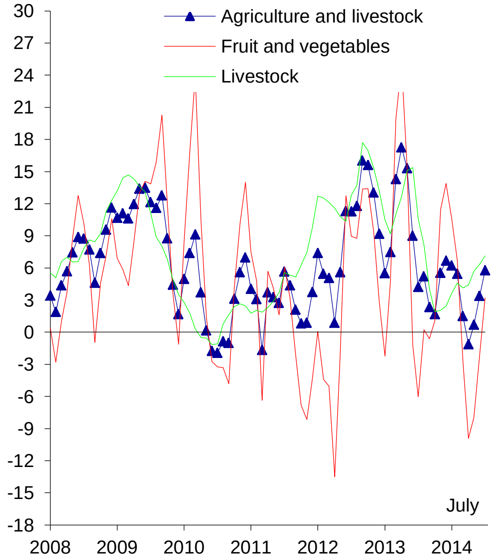
Source: Banco de México and INEGI.

The subindex of agricultural and livestock product prices reduced its average annual change from 4.33 percent in the first quarter of 2014 to 0.94 percent in the second quarter. As anticipated, this result was due to an arithmetic effect of a high comparison base, given the climate and sanitary effects during the same period last year, which significantly increased prices of some agricultural products, especially onion, tomato and zucchini. However, since June and as expected, the mentioned arithmetic effect diluted, and the annual change of the agricultural product price subindex went from 3.37 percent in June to 5.78 percent in July. It should be remembered that last year the prices of some vegetables, like green tomato and zucchini, reported important declines, as supply recovered after frost having affected production in the second quarter of 2013. Thus, the group of fruit and vegetables went from an annual change of -2.15 percent in June to 3.22 percent in July. Likewise, in the group of livestock products, the recent egg price decreases were less than those presented last year, when production re-established after being affected by the avian flu at the end of the first quarter of 2013. In this way, the annual change of livestock products increased from 6.34 percent in June to 7.14 percent in July (Table 1, Chart 6a and Chart 7).

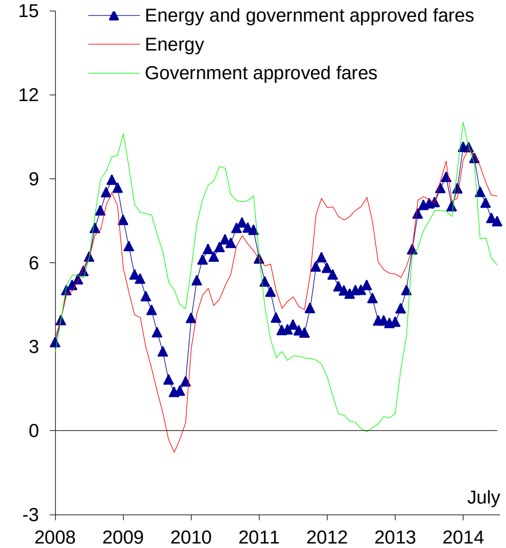
In the subindex of energy prices and government approved fares, high annual change rates still prevail, which went from an average of 9.99 percent in the first quarter of 2014 to 8.09 percent in the second quarter, registering a level of 7.47 percent in July. The group of energy products exhibited a slower growth pace, as the price of natural gas for domestic use reduced and gas prices in the border region, in general, increased less pronounced, as compared to last year. As to the fares approved by different government levels, lower growth rates are mainly due to less intense increases in public transport fares, as compared to last year (Table 1, Chart 6b and Chart 8).

Chart 6
Non-core Price Index
Annual change in percent

a) Agriculture and Livestock



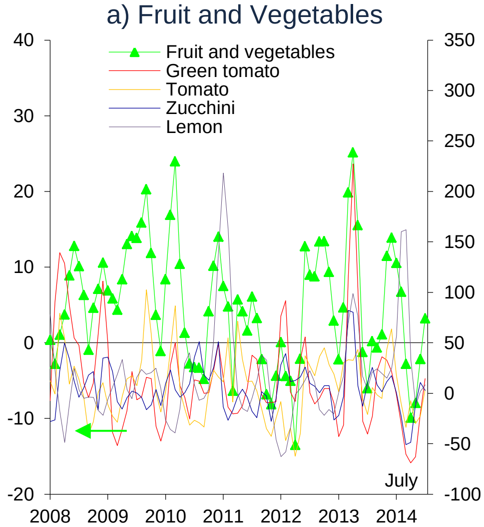
b) Energy and Government Approved Fares



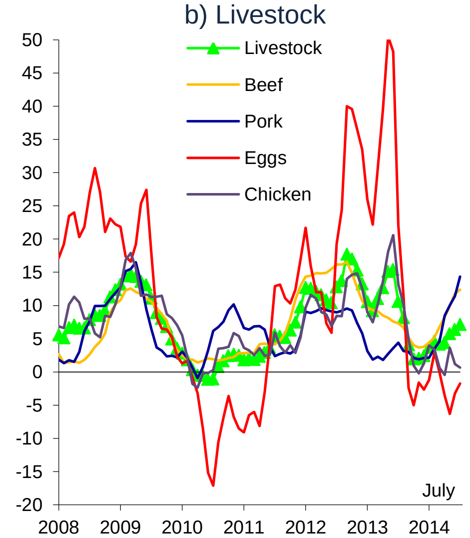
Source: Banco de México and INEGI.

Chart 7
Agricultural Price Index
Annual change in percent

a) Fruit and Vegetables

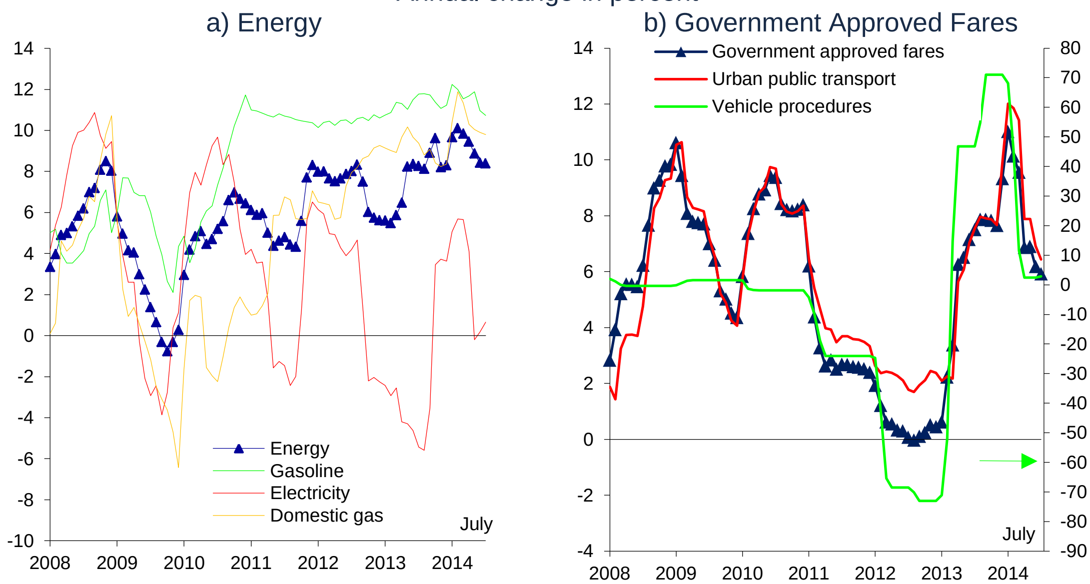


b) Livestock



Source: Banco de México and INEGI.

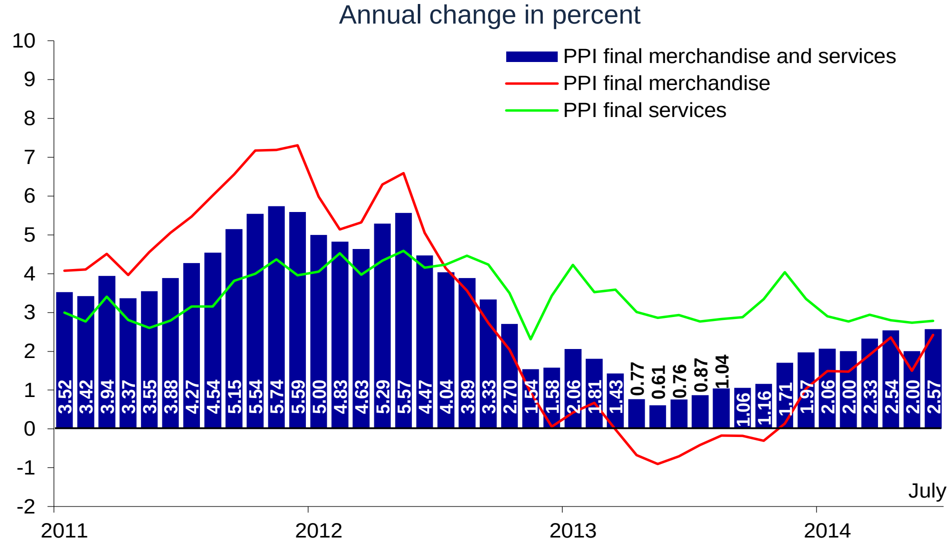
Chart 8
Non-core Price Index
Annual change in percent



Source: Banco de México and INEGI.

In the second quarter of 2014, the Producer Price Index (PPI) of finished merchandise and services, excluding crude oil, registered an average annual change rate of 2.29 percent, while in the first quarter it was 2.01 percent (Chart 9). This behavior was due to the fact that price reductions observed for most PPI finished merchandise groups, among which transport equipment and machinery and equipment stand out, were mainly offset by the rebound of construction sector prices (concrete, asphalt and other chemicals, and rod), basic metal export industries, and some processed foods (sugar, meat and lard, gold coffee). In July 2014, the annual change of the referred indicator was 2.57 percent.

Chart 9
Producer Price Index
Annual change in percent



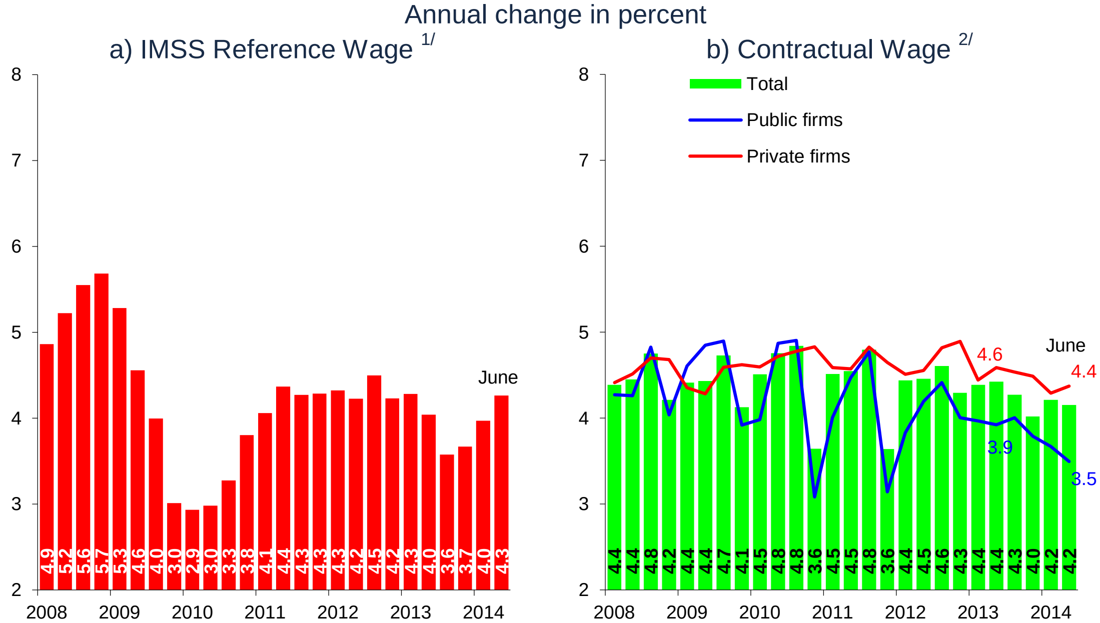
Source: Banco de México and INEGI.

2.2. Wages

The evolution of the main wage indicators in the second quarter of 2014 suggests that labor costs did not generate inflationary pressures. The reference wage of IMSS-insured workers increased 4.3 percent during the second quarter of 2014, while in the previous quarter this figure was 4.0 percent (Chart 10a). Thereby, this indicator returned to levels registered at the beginning of the previous year.

The increment in the contractual wage negotiated by firms under federal jurisdiction was 4.2 percent in the second quarter of 2014, which was lower than the figure of 4.4 percent registered in the same quarter last year. This difference derived from lower changes in contractual wages of both public and private firms. In particular, public firms negotiated an increase of 3.5 percent (3.9 percent in the same quarter of 2013). Private firms negotiated an increment of 4.4 percent in the period from April to June 2014 (4.6 percent in the second quarter of 2013, Chart 10b).

Chart 10
Wage Indicators
Annual change in percent



1/ During the second quarter of 2014 an average of 16.9 million contributors were registered in 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 (*Secretaría del Trabajo y Previsión Social*, STPS) equals approximately 2 million.
Source: Calculated by Banco de México with data from IMSS and STPS.

3. Economic and Financial Environment

3.1. International Environment

The growth of the world economy showed a greater dynamism during the second quarter, after a weaker than expected onset of the year. This was due to the recovery of advanced economies, while in the emerging ones weak conditions prevailed. Leading indicators suggest the recovery of the world growth pace to continue in the next months, although there are downward risks. International financial markets registered very low volatility levels, since monetary conditions in advanced economies are expected to remain accommodative for an extended period. However, by the end of July and early August, these conditions in international financial markets have been affected by a more favorable evolution of the U.S. economy during the second quarter of the year, arousing expectations about an anticipated adjustment of this country's monetary conditions.

3.1.1. World Economic Activity

In the U.S., after a significant contraction in the first quarter, mainly caused by temporary factors, among which severe climate conditions stand out, economic activity resumed its growth in the second quarter. According to preliminary information, GDP expanded 4.0 percent in this quarter, after having contracted 2.1 percent in the previous quarter. Likewise, leading indicators suggest that the recovery will continue in the second half of the year, supported by a lesser fiscal restriction, an accommodative monetary policy, additional gains in households' net wealth, favorable credit conditions and an increase in employment. Despite the aforementioned, and mainly due to the slowdown in the first quarter, the growth forecast for the entire year 2014 has been revised downwards, as compared to the forecast in the previous Report.

In the second quarter, the main U.S. aggregate demand components recovered. Private consumption grew at a moderate rate, partly due to improved household confidence (Chart 11a). On the other hand, although residential investment grew for the first time since the third quarter last year, in part as a result of normalizing weather conditions, its recovery is still weak. After contracting in the previous quarter, fixed investment in equipment grew slightly during the quarter, and it maintains a favorable outlook. Finally, net exports contracted in the referred period, although to a lesser extent than in the previous quarter.

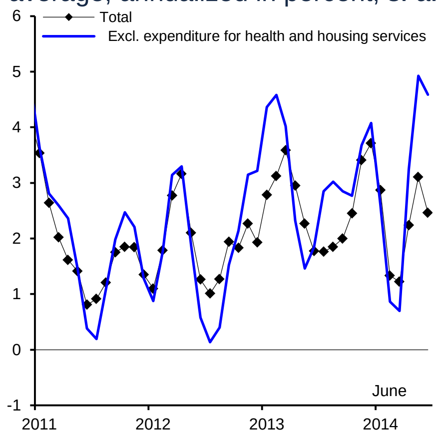
Conditions in the U.S. labor market further improved. In the second quarter, the non-farm payroll grew on average 277 thousand jobs per month, its fastest growth pace since the first quarter of 2006. In July, this recovery continued with a monthly job creation of more than 200 000 jobs for the sixth consecutive time (209 thousand jobs). Likewise, the unemployment rate fell from 6.7 percent in March to 6.2 percent in July, although it remains above the long-term level estimated by the U.S. Federal Reserve (Chart 11b).[1] However, there is uncertainty as to the extent to which a decline in that rate represents a reduction in the degree of slack in the labor market. Although the drop in the unemployment rate was partly due to a lower labor participation rate, which was driven by demographic factors and the

[1] In June, the Federal Reserve estimated the central trend of the long-term unemployment rate between 5.2 and 5.8 percent.

effects of an extended period of high unemployment, it is also likely to reflect demoralized individuals that abandoned the labor force because of economic reasons, but who could rejoin once the recovery consolidates.

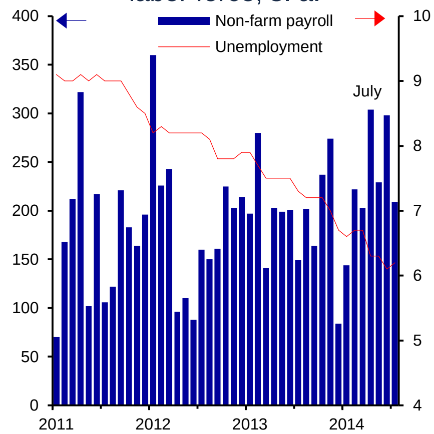
Chart 11
U.S. Economic Activity

a) Personal Consumption Expenditure
Quarterly change of 3-month moving average, annualized in percent, s. a.



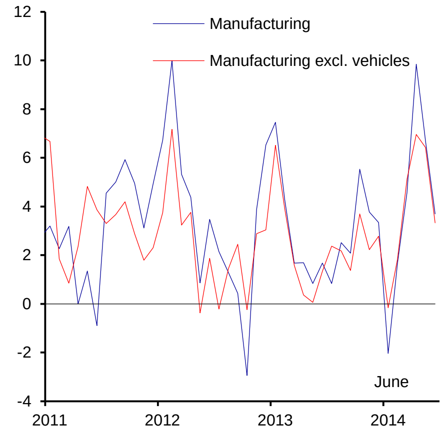
s. a. / Seasonally adjusted figures.
Source: BEA.

b) Monthly Change of Non-farm Payroll and Unemployment Rate
In thousands of jobs and percent of labor force, s. a.



s. a. / Seasonally adjusted figures.
Source: BLS.

c) Manufacturing Production
Annualized quarterly change in percent, s. a.



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

Manufacturing production presented solid growth during the period, widespread across different industries, with the automobile industry standing out (Chart 11c). Leading indicators, such as the manufacturing sector's Purchasing Managers' Index, are recording the highest levels in more than three years and point to a further strengthening of the sector in the second half of the year.

In this environment, the Federal Reserve, as will be explained in detail below, expects inflation to increase towards its 2 percent target, in line with the expectation of a further improvement of the labor market and persisting well-anchored long-term inflation expectations. Additionally, this Institution reaffirmed its anticipation of a gradual normalization of its monetary policy, depending on the performance of the relevant indicators. The recent, better than expected, information, led some market participants to expect an earlier normalization process.

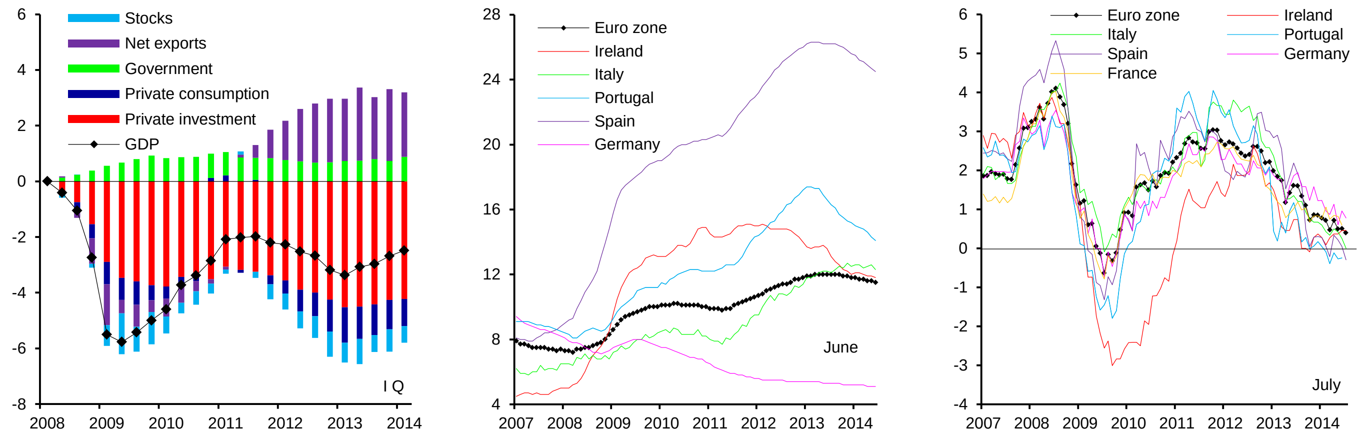
In the Euro zone, economic recovery remained weak and heterogeneous, with GDP still below pre-crisis levels, due to a low growth of investment and consumption, being reflected in still very high unemployment levels (Chart 12a and Chart 12b). This lack of momentum of domestic private demand was partly due to less dynamic bank credit, principally that granted to small enterprises. The region's economic activity outlook is mixed, given the relative dynamism of Germany and Spain and the stagnation of France and Italy. The inflation rate remained at levels significantly below the European Central Bank's (ECB) target (Chart 12c).

Chart 12
Euro Zone Economic Activity

a) Real GDP and Contribution of Components (2008-1Q=0)
In percent and percentage points, s. a.

b) Unemployment Rate
In percent of economically active population, s. a.

c) Inflation Rate
Annual change in percent



s. a. / Seasonally adjusted figures.
Source: Eurostat and Haver Analytics.

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

Source: Eurostat.

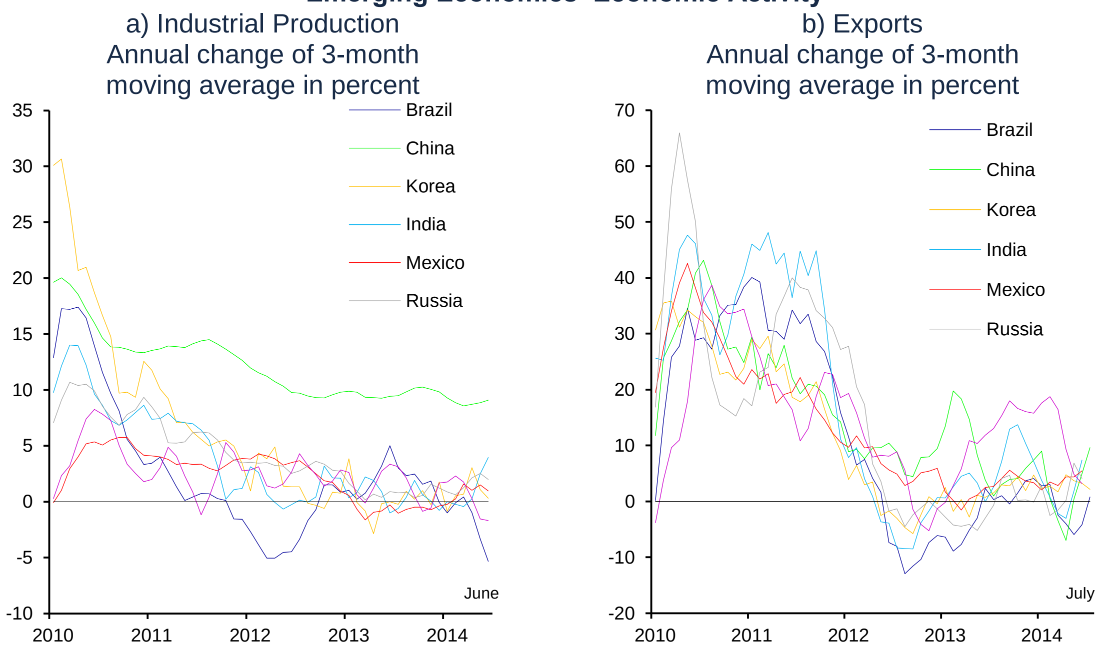
In response to the aforementioned, in June the ECB announced important measures to support the reactivation of the credit channel in the Euro zone. These measures are expected to contribute to greater easing of credit conditions and expansion for financing, particularly to small and medium enterprises in periphery countries. However, the reactivation of private sector financing also depends on the successful completion of the asset quality review and stress tests applied to banks by monitoring authorities, whose results will be published in October. The ECB informed in July that banks facing a capital shortfall have to submit capital plans in November. These plans will be evaluated and closely monitored by the ECB-led Joint Supervisory Teams and responsible national authorities.

The U.K. registered an annualized quarterly GDP growth rate of 3.2 percent in the second quarter, similar to that of the last quarter, driven by the expansion of investment and private consumption, and accompanied by strong job creation. The Bank of England (BI) has noted the presence of certain risks in the financial system, due to which it implemented macroprudential measures in order to limit the increase in housing prices and to prevent households' over-indebtedness.

With respect to Japan, economic activity is estimated to contract during the second quarter, mainly due to the negative effect of the consumption tax raise in April on domestic demand and the weakness of exports. Available indicators point to a sharp decline in personal consumption spending and private investment, especially at the beginning of the quarter. Real exports contracted towards the end of the referred period. However, GDP is expected to resume its modest growth pace in the next quarters, given the improvement observed in the labor market and the announcement of new structural reforms, aimed at increasing productivity, particularly in the non-manufacturing sector, and improving the business environment.

In emerging economies, conditions of relative weakness prevailed during the second quarter, especially as concerns domestic demand. The growth of retail sales has remained stable so far, although at relatively low rates. In contrast, in line with the improvement in advanced economies, emerging countries' exports performed better and are expected to boost industrial activity in the next quarters (Chart 13). Nevertheless, there are risks to financial stability in some of these economies, derived from high credit growth in previous years and the increase in external debt issuance by the corporate sector.

Chart 13
Emerging Economies' Economic Activity



Source: Haver Analytics.

3.1.2. Commodity Prices

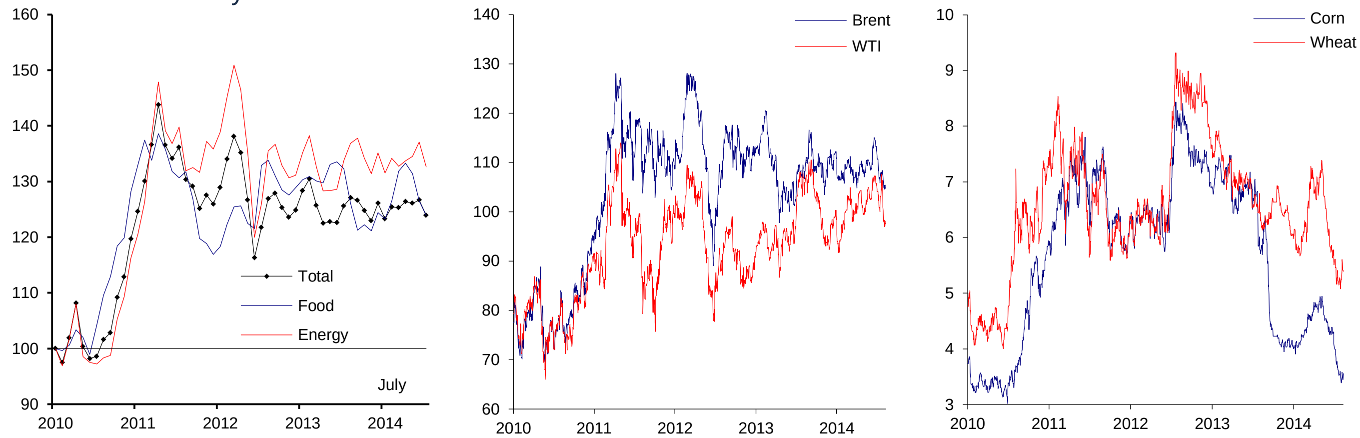
International commodity prices registered a mixed performance during the period covered by this Report (Chart 14a). Crude oil prices displayed high volatility as a response to changes in geopolitical risks in the Middle East (Chart 14b). Meanwhile, grain prices dropped during the referred period, in face of the expectation that global wheat and corn harvests for the 2014-2015 season will be close to record levels (Chart 14c).

Chart 14
International Commodity Prices

a) Total Commodities, Food and Energy
Index January 2010=100

b) Crude Oil [1/]
USD per barrel

c) Corn and Wheat [1/]
USD per bushel



Source: IMF.

1/ Spot prices.
Source: Bloomberg.

1/ Spot prices.
Source: Bloomberg.

3.1.3. World Inflation Trends

In general, global inflation remained at low levels during the second quarter. The case of the Euro zone stands out, as deflation risks prevail. On the contrary, inflation in the U.S. increased in the referred quarter, although it locates below the Federal Reserve's 2 percent target and medium-term inflation expectations remain stable (Chart 15). Meanwhile, in many emerging economies, inflationary pressures decreased due to weak domestic demand and lower grain prices, although in several of these economies relatively high inflation rates persist.

In the U.S., annual headline inflation was 2.1 percent in June, while core inflation was 1.9 percent. The annual change of the personal consumption expenditure (PCE) deflator was 1.6 percent in June and the core PCE, 1.5 percent.

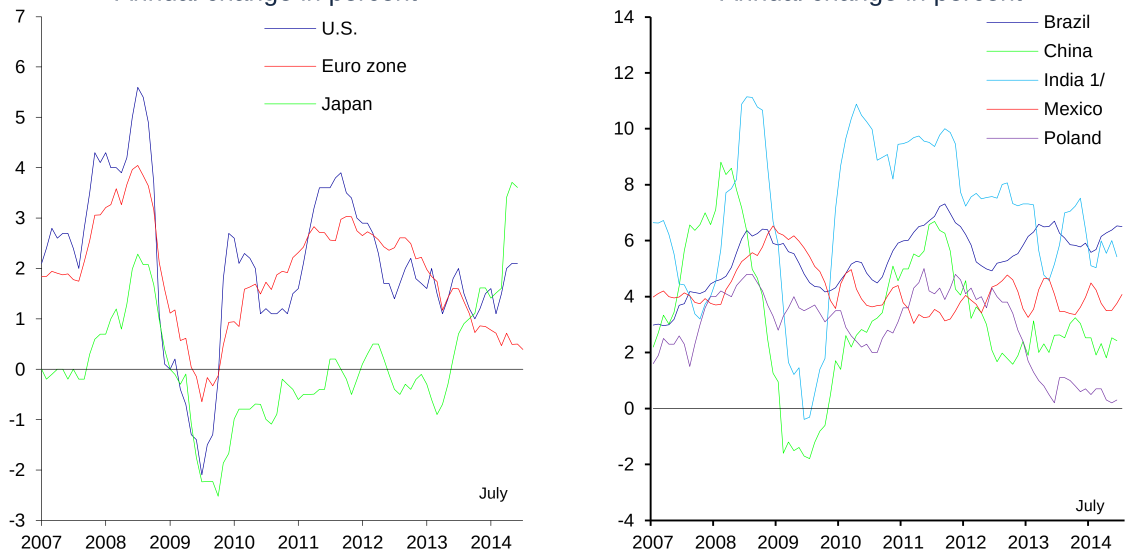
In the Euro zone, inflation continued a decreasing trend in the second quarter of the year, even with negative annual rates in some countries of the region. Annual headline inflation was 0.4 percent in July, while core inflation was 0.8 percent in the same month, considerably below the European Central Bank's (ECB) medium-run target of inflation below, but close to 2 percent. According to the ECB, inflation will remain at low levels in the next months, before gradually increasing during 2015 and 2016. It also considers that the appreciation of the Euro since mid-2012 contributed to the price dynamics, and that in the current context its appreciation trend jeopardizes reaching the inflation target. Indeed, modifying this trend is one of the objectives pursued by the ECB by means of the monetary easing last June.

In the U.K., headline inflation was 1.9 percent in June (2.0 percent in the case of core inflation). This represents an increase as compared to May, mainly due to volatile components. Thus, inflation is expected to slightly decrease as the effect of the mentioned components fades, although the economy also strengthened more than expected. In Japan, inflation rebounded significantly during the quarter, reaching 3.6 percent in June, while core inflation (excluding food and energy) ended the reference period with 2.3 percent, as compared to 0.6 percent in March. This increase was to a great extent due to the raise in the consumption tax from 5 to 8 percent in April.

Chart 15
Headline Inflation in Advanced and Emerging Economies

a) Advanced Economies
Annual change in percent

b) Emerging Economies
Annual change in percent



Source: BLS, Eurostat and Japan Statistics Bureau.

1/ It refers to inflation of wholesale prices.
Source: National Statistics Bureaus.

3.1.4. International Financial Markets

Considering the current environment of global growth and inflation, the monetary policy stance in most economies is expected to stay accommodative in the next quarters. However, given the different stages of the economic cycle advanced economies are going through, the withdrawal of the accommodative measures is also anticipated to be differentiated.

In the case of the U.S., the Federal Reserve reaffirmed in its June and July meetings its strategy of gradually withdrawing the monetary stimulus. In particular, it reiterated that the recent range of the federal funds rate will most likely be maintained for a considerable time period after the asset purchase program finishes, especially if projected inflation continues below the 2 percent target and inflation expectations remain well-anchored. However, in its July meeting, it pointed out that inflation has been approaching this target and is less likely to persistently stay below it. With respect to the labor market, the Federal Reserve considered that several indicators suggest that a significant underuse of labor resources remains, although the unemployment rate was no longer considered as high. Furthermore, it also decided to further reduce the amount of asset purchases from August onwards from USD 35 to 25 billion each month and anticipated that this program could end in October of this year. However, it stressed that the future trajectory of the federal fund rate will depend on the evolution of the economy. The tone of the Federal Open Market Committee

(FOMC) statement reflects a more cautious stance of the Federal Reserve with respect to the future behavior of economic activity.

The Bank of England, in its monetary policy meetings during the period covered by this Report, maintained the reference rate at 0.5 percent, and did not change the balance of its asset purchase program or the forward guidance on the reference rate. However, in the minutes of the June and July meeting and in recent interventions of Monetary Policy's Committee members, the increasing possibility of a tightening of monetary policy towards the end of this year was emphasized, given the favorable performance of economic activity. As already mentioned before, the Financial Policy Committee (FPC) established in June new macroprudential measures, as a response to indirect risks to financial stability, derived from substantial increases in residential real estate prices, which, in turn, have been accompanied by over-indebtedness of households.[2]

On the contrary, in the Euro zone, the ECB announced in its June meeting important monetary stimulus and private sector financing measures in order to improve the functioning of the monetary policy transmission mechanism. Among these measures the following stand out: the decrease of the main interest rates, including a negative rate for commercial bank deposits in the Central Bank; the introduction of new targeted longer-term refinancing operations (TLTRO);[3] preparatory work related to outright purchases of asset-backed securities; and the prolongation of the fixed rate, full allotment tender procedures until the end of 2016. Later, in its July and August meetings, the ECB maintained the interest rates and forward guidance unchanged. It also mentioned that the monetary operations in the next months will continue increasing monetary stimulus and will help inflation to return to levels close to, but below 2 percent, emphasizing its intention to safeguard the anchoring of inflation expectations over the medium term.

The Bank of Japan (BJ), in its meetings during the period April-August, maintained the programmed level of asset purchases unchanged at an annual amount of between JPY 60 to 70 trillion, aimed at reaching the 2 percent inflation target in a two-year horizon. BJ mentioned that the monetary easing had the expected effects, and hence the Institution will continue this program as long as necessary in order to maintain target inflation stable.

It is noteworthy that the U.S. and U.K. economies are in an advanced stage of the economic cycle, as compared to the Euro zone and Japan. In this way, the outlook points to a divergence in advanced economies' monetary policy stances. While in the former, the gradual liftoff of monetary stimulus is about to start, in the latter the monetary policy is expected to still remain very accommodative for an extended period, in order to boost the slow recovery of their economies. This

[2] The FPC set a limit for new mortgage lenders of 15 percent of their total number of new residential mortgages at loan to income ratios at or greater than 4.5 and established stricter tests of affordability, assessing whether borrowers could confront a 300 basis point increase in the rate in the first five years of the loan.

[3] These operations will provide financing to banks in the next 4 years at low cost (main refinancing rate (MRO) plus 10 basis point spread), for a total amount of up to EUR 1 trillion, depending on the credits that banks granted to the non-financial private sector. The initial amount of these operations amounts to EUR 400 billion (7 percent of performing loans to non-financial firms and households, excluding house purchase loans), to be conducted in September and December this year. The remaining amount will be assigned quarterly, depending on new financing provided as compared to a benchmark, in the next two years.

discrepancy between monetary policy stances could increase exchange rate volatility, with possible repercussions on economic activity and the international financial system.

Emerging economies kept showing differences in the conduction of the monetary policy. In some cases, like Brazil, Malaysia, Russia and South Africa, the increase in inflationary pressures led their central banks to raise their reference interest rate. In contrast, central banks of Chile, Hungary and Peru decreased their interest rates in face of the outlook of lower growth and absence of inflationary pressures.

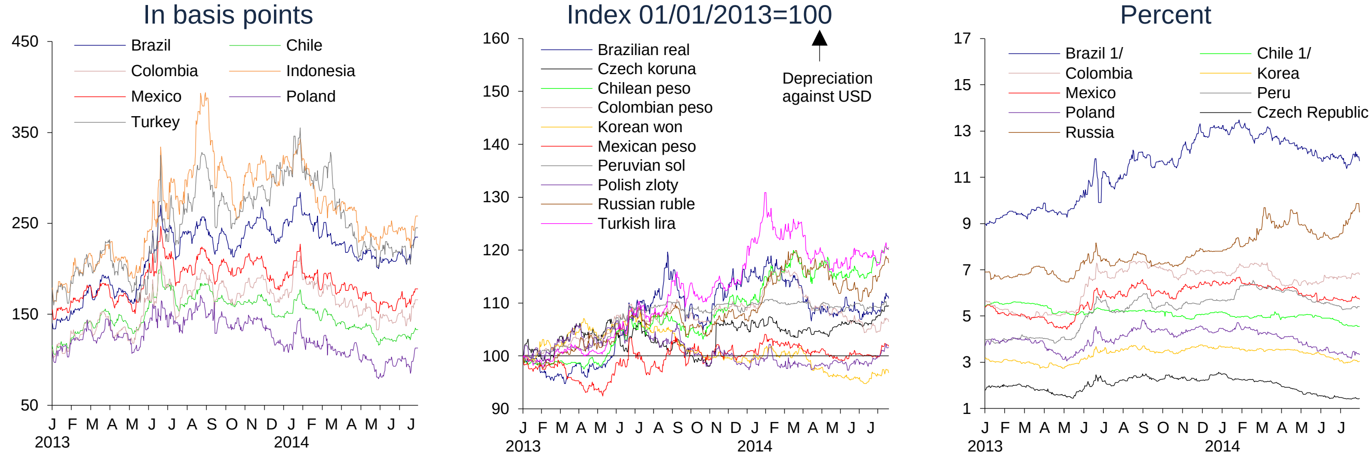
During the period covered by this Report, low volatility was registered in most financial markets, since the monetary policy stance in the main advanced economies was expected to remain accommodative. In this context, with respect to the first quarter of the year, long-term interest rates in advanced economies dropped, partly reflecting the expected lower reference rates in the medium term. This perception intensified investors' search for yield, which led to a recovery of capital flows to emerging economies, a drop in sovereign bond yields, progress in stock markets and an appreciation of most currencies against the USD, despite weak economic conditions prevailing in some of these economies (Chart 16).

Chart 16
Financial Indicators of Emerging Economies

a) Sovereign Spreads
In basis points

b) Exchange Rate
Index 01/01/2013=100

c) 10-year Bond Yield
Percent



Source: Bloomberg.

Source: Bloomberg.

1/ It refers to 9-year bonds.
Source: Bloomberg.

Derived from the aforesaid, it should be noted that there is a risk that changes in the perception of the monetary policy normalization process in main advanced economies could provoke a sudden reversal of capital flows, in favor of safer assets. In particular, although the central scenario of many market participants regarding the normalization of the U.S. monetary policy is that of a gradual increase in interest rates from the second half of 2015 onwards, there is uncertainty about this process, and therefore, episodes of volatility that affect emerging markets, cannot be ruled out. After FOMC's July meeting, this type of behavior was observed in the markets, although apparently to a limited extent. Mexican authorities exhorted national financial institutions and firms to strengthen their risk control and management processes. Thus, some possible scenarios of U.S. interest rate increases and implications for the stability of the financial system have been analyzed. In particular, each year stress tests for the Mexican financial system have been carried out. The most recent results show, in general, important strengths in terms of the market position, as well as the portfolio or funding concentration.[4] On the other hand, it cannot be ruled out that some of the geopolitical conflicts, which have intensified during the recent months, can become factors of volatility.

3.2. Development of the Mexican Economy

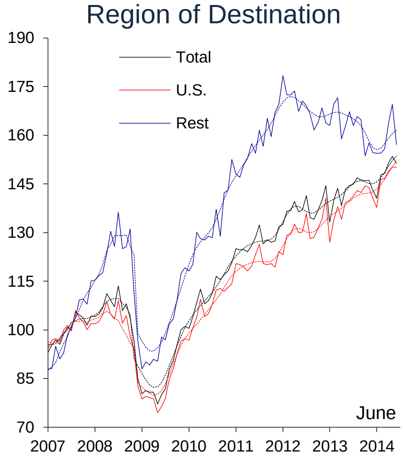
3.2.1. Economic Activity

During the second quarter of 2014, economic activity in Mexico registered a greater dynamism than in the previous two quarters. This evolution was mainly the result of the dynamism of external demand, since the recovery of domestic demand is still not very strong.

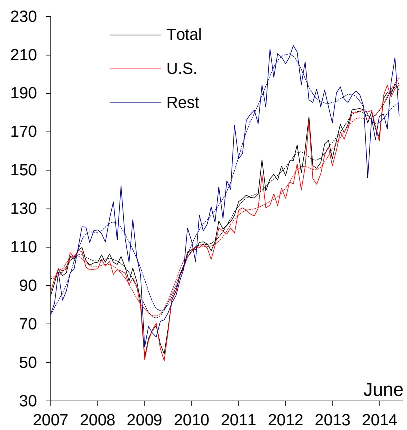
Available indicators of the performance of foreign trade show that, after the drop observed in December 2013 and January 2014, manufacturing exports displayed a widespread improvement in their growth rate at the end of the first quarter of this year, which continued in the second quarter. In fact, higher growth was registered for both manufacturing exports to the U.S. and to the rest of the world (Chart 17a). Further, this rebound of manufacturing exports has been present in the automobile, as well as in other manufacturing sectors (Chart 17b and Chart 17c).

Chart 17
Indicators of Manufacturing Exports
Index 2007=100, s. a.

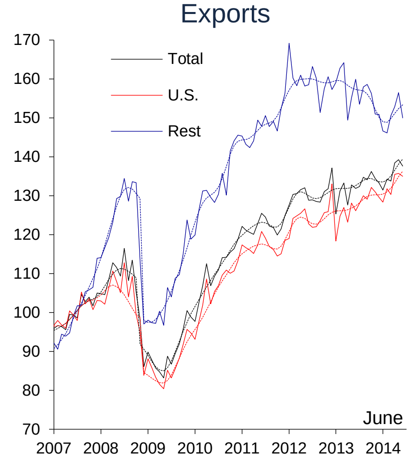
a) Manufacturing Exports by Region of Destination



b) Automobile Manufacturing Exports



c) Non-automobile Manufacturing Exports



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.

Regarding domestic spending, private consumption and gross fixed investment indicators showed certain improvement in the second quarter, as compared to the previous one.

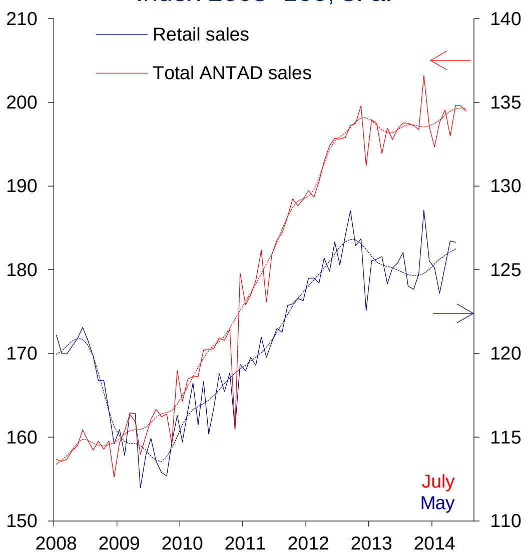
i. As for private consumption, some of its indicators showed a change in their trend. In particular, in the second quarter of 2014, ANTAD sales

[4] See Annual Report for information about Mexico's Financial Systems Stability and the activities undertaken by the Financial System Stability Council, March 2014.

rebounded, after having dropped in the previous quarter. Commercial establishment retail sales reached a higher level in the months of April and May, as compared to the first quarter average (Chart 18a). While the expansion in April of monthly private domestic consumption, which also includes services, suggests a certain recovery of consumption at the beginning of the second quarter (Chart 18b).

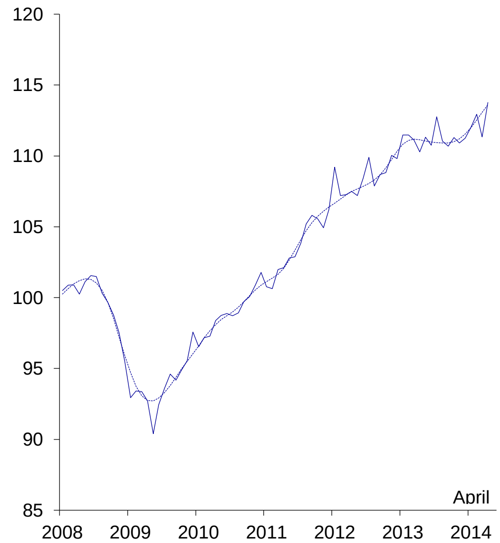
Chart 18
Consumption Indicators

a) Total ANTAD Sales and Commercial Establishments' Retail Sales
Index 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: Prepared by Banco de México with ANTAD data and Monthly Survey of Commercial Establishments, INEGI.

b) Monthly Indicator of Private Consumption in the Internal Market
Index 2008=100, s. a.

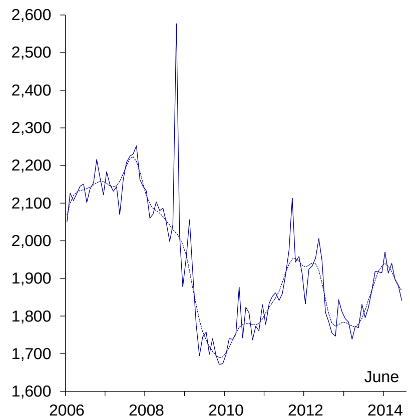


s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
Source: INEGI.

ii. Despite the abovementioned, various determinants of private consumption continue showing signs of weakness. In fact, in the last months, workers' remittances levels contracted, while the real wage bill of all workers maintained still low levels (Chart 19a and Chart 19b). As to the consumer confidence index, although it kept improving in the second quarter of 2014, it is still below the levels of early 2013 (Chart 19c).

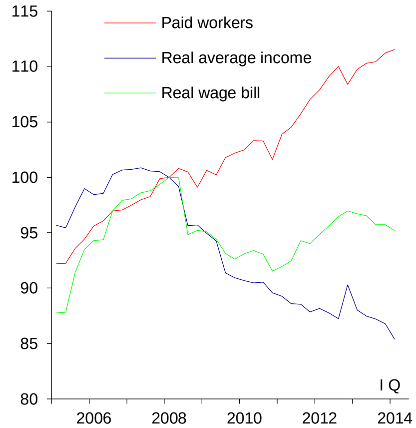
Chart 19
Consumption Determinants

a) Workers' Remittances
USD million, s. a.



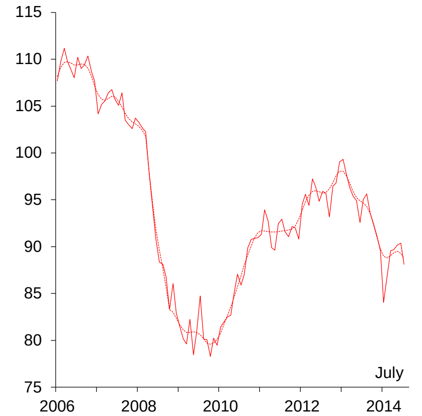
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
Source: Banco de México.

b) Real Total Wage Bill 1/
Index I-2008=100, s. a.



s. a. / Seasonally adjusted figures.
1/ Figures adjusted according to CONAPO demographic projections 2010-2050.
Source: Prepared by Banco de México with data from the National Employment Survey, INEGI.

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

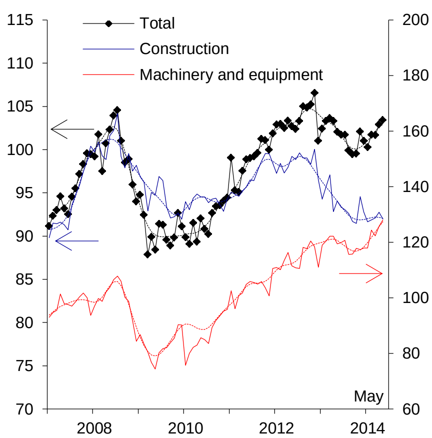


s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
Source: National Consumer Confidence Survey, INEGI and Banco de México.

iii. Even though gross fixed investment remains at relatively low levels, its recent evolution seems to indicate a gradual improvement, after the weak performance shown during most of 2013 and early 2014 (Chart 20a). In particular, investment in machinery and equipment presented an upward trend, while investment in housing construction registered a certain rebound (Chart 20b and Chart 20c).

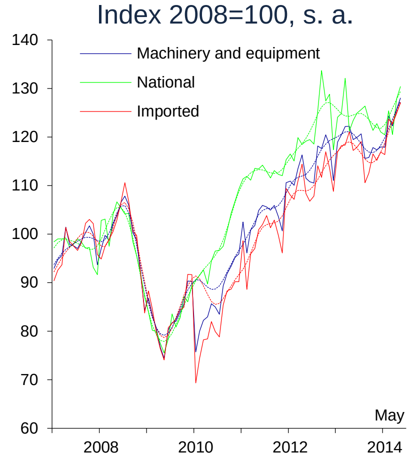
Chart 20
Investment Indicators

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



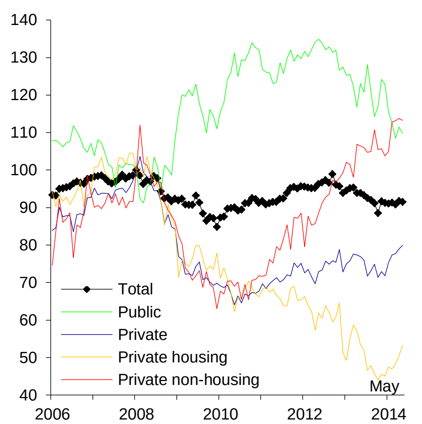
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
Source: Mexico's System of National Accounts, INEGI.

b) Investment in Machinery and Equipment
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: Mexico's System of National Accounts, INEGI.

c) Real Value of Production in the Construction Sector
Index January 2008=100, s. a.



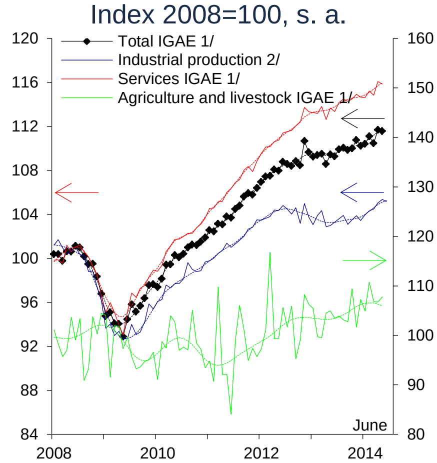
s. a. / Seasonally adjusted figures. For public and private construction (housing and total private non-housing), the seasonal adjustment was prepared by Banco de México with data from INEGI.
Source: INEGI.

The described performance of both external and domestic demand was reflected in an increase in dynamism of production during the second quarter of 2014, as compared to the previous two quarters (Chart 21a). In particular:

- The positive trend exhibited by industrial production in the first quarter of 2014, after having contracted at the end of the previous year, continued in the second quarter. This recovery can be mainly explained by the rebound in both, the manufacturing and construction industry, since the improvement of the electricity sector is still weak and the mining sector continues registering a negative trend (Chart 21b).
- At the beginning of the second quarter 2014, the growth pace of the services sector also recovered, after having stagnated in late 2013 and early 2014. This reflects, in line with the dynamism observed in the export sector, a rebound in external demand-related services, although those more related to domestic demand also improved at the margin (Chart 21c).
- Primary sector activities developed positively in the first months of the second quarter of the year, in part as a response to greater availability of water, which favored seeding in the spring-summer season. Likewise, perennial crops and livestock products performed favorably.

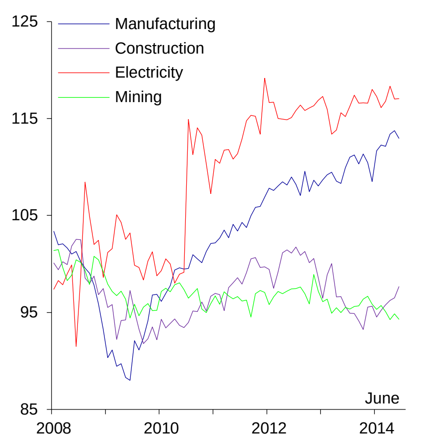
Chart 21
Production Indicators

a) Economic Activity Indicators
Index 2008=100, s. a.



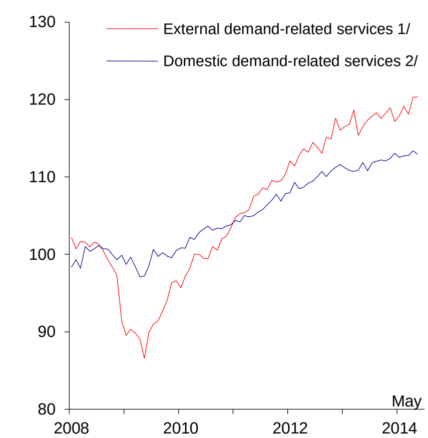
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
1/ Figures as of May 2014.
2/ Figures as of June 2014.
Source: Mexico's System of National Accounts, INEGI.

b) Industrial Activity
Index 2008=100, s. a.



s. a. / Seasonally adjusted figures.
Source: Industrial Activity Indicators (SCNM), INEGI.

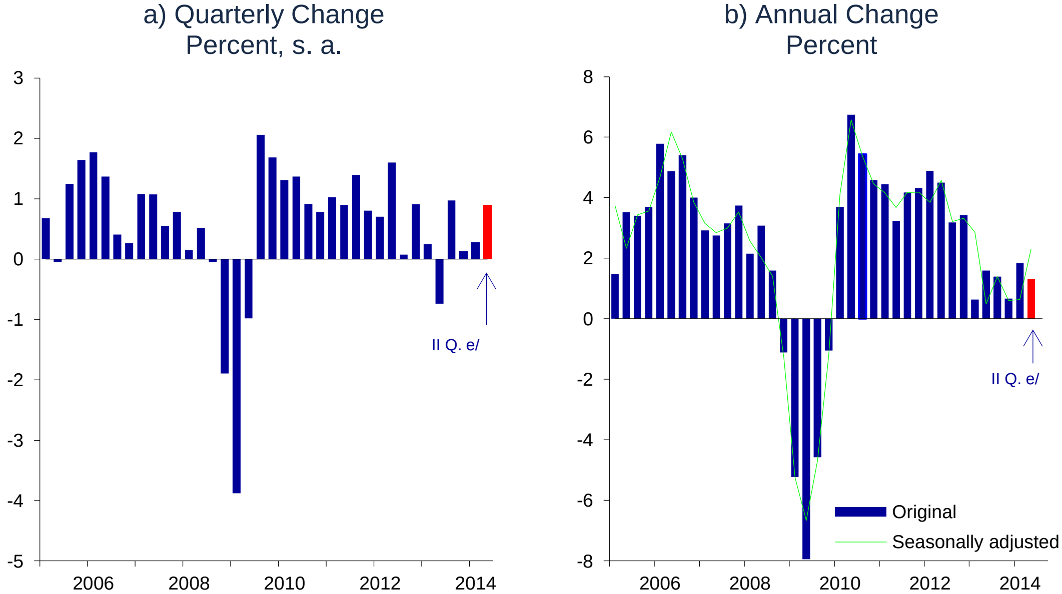
c) Services Sector IGAE
Index 2008=100, s. a.



s. a. / Seasonally adjusted figures.
1/ It includes commerce, transport, mail and warehousing sectors, and mass media services.
2/ It includes the rest of the sectors of tertiary activities.
Source: Prepared by Banco de México with data from Mexico's System of National Accounts, INEGI.

As a result of the above mentioned, for the second quarter of 2014, Mexico's GDP is expected to increase at a quarterly seasonally adjusted rate of around 0.9 percent, as compared to increases of 0.97, 0.13 and 0.28 percent in the previous three quarters, in chronological order (Chart 22a). In annual seasonally adjusted terms, GDP growth is estimated to be around 2.5 percent for the second quarter of this year, compared to 1.4, 0.6 and 0.6 percent in the previous three quarters. Based on data without seasonal adjustment, the annual change of GDP is estimated at 1.3 percent in the second quarter, figure biased downwards since this year Easter holiday took place in April, while in 2013 it was in March (Chart 22b).

Chart 22
Gross Domestic Product

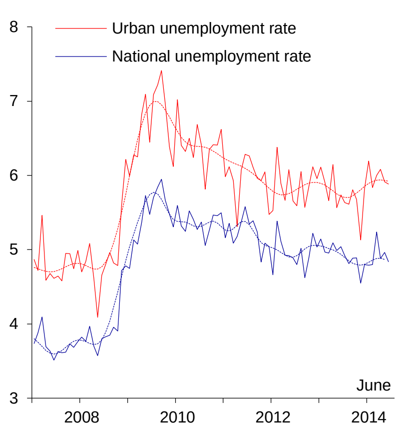


s. a. / Seasonally adjusted data.
e/ Estimated by Banco de México.
Source: Mexico's System of National Accounts, INEGI. Seasonal adjustment of the second quarter of 2014 realized by Banco de México.

Despite the greater dynamism of economic activity, latest data suggest that during the second quarter of 2014 slack conditions persisted in the labor market. In fact, national and urban area unemployment rates continued above those reported in late 2013, and close to those of the first quarter of 2014 (Chart 23a). It is worth noting, however, that since mid-2012, despite the deceleration of economic activity, the number of IMSS-insured workers maintained a high dynamism, above that of production. In contrast, the growth pace of total economy's employment slowed down, in line with lower economic growth (Chart 23b). Thus, the greater dynamism of formal employment in relation to informal employment seems to indicate a recomposition of employment, as reflected in the negative trend of the labor informality rate presented since mid-2012 (Chart 23c).

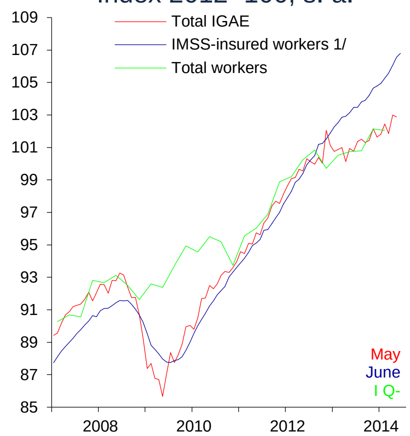
Chart 23
Labor Market Indicators

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



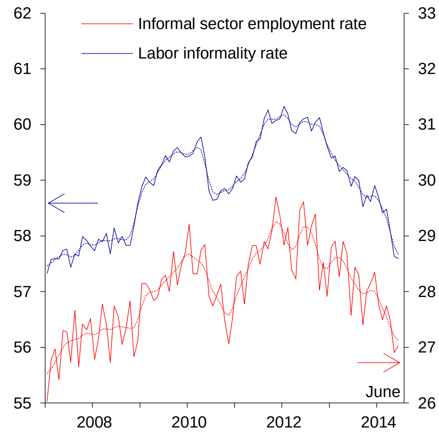
s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
Source: National Employment Survey (ENOE), INEGI.

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



s. a. / Seasonally adjusted data.
1/ Permanent and temporary workers in urban areas.
Source: IMSS and INEGI (SCNM and ENOE). Seasonal adjustment realized by Banco de México, except for IGAE.

c) Labor Informality Rate
Percent, s. a.

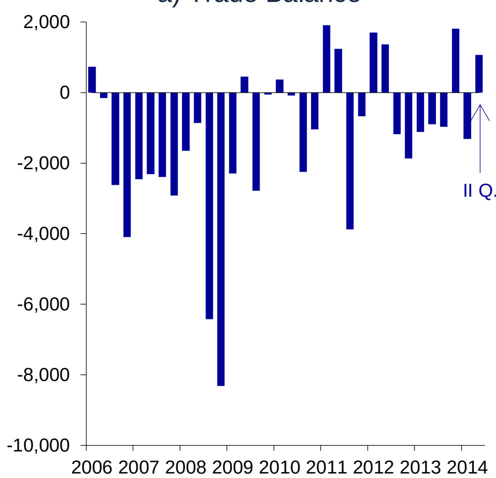


s. a. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line.
Source: Seasonal adjustment realized by Banco de México with information from the National Employment Survey (ENOE), INEGI.

In the second quarter of 2014, the trade balance registered a surplus of USD 1,065 million (Chart 24a). In turn, available data suggest that the current account will have presented a moderate deficit in the same period and that the country continued receiving capital inflows via the financial account sufficient to allow an easy financing of this deficit (Chart 24b).

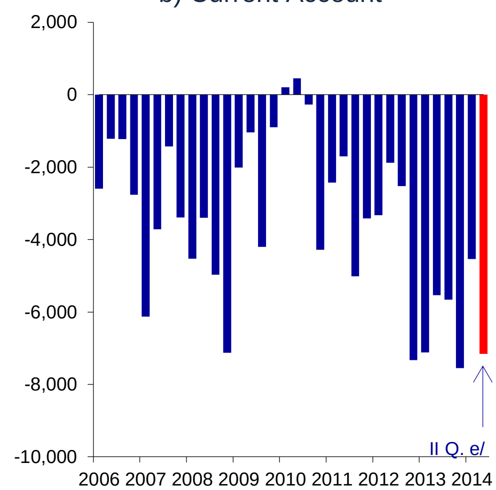
Chart 24
Trade Balance and Current Account
USD million

a) Trade Balance



Source: Banco de México.

b) Current Account



e/ Estimated by Banco de México.
Source: Banco de México.

3.2.2. Financial Saving and Financing in Mexico

In the period April-June 2014, the sources of financial resources of the economy expanded at a greater pace than in the previous quarter, which was reflected in an increased annual flow of resources at the end of this quarter, as compared to the previous one (Table 2). This was mainly the result of the dynamism of domestic sources, while external sources recovered from their sluggish performance in 2013 when uncertainty prevailed in international financial markets.

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

	Annual flows						Stock 2014 II e/	
	2013 I	2013 II	2013 III	2013 IV	2014 I	2014 II e/	% GDP	Est. %
Total sources	**10.2**	**7.2**	**7.9**	**8.5**	**8.7**	**12.0**	**95.4**	**100.0**
Domestic sources 1/	4.4	3.3	4.3	4.8	5.1	6.4	60.8	63.8
Foreign sources 2/	5.8	3.9	3.7	3.7	3.6	5.6	34.5	36.2
Total Uses	**10.2**	**7.2**	**7.9**	**8.5**	**8.7**	**12.0**	**95.4**	**100.0**
Public sector financing	3.1	3.3	3.6	3.4	3.9	4.2	44.3	46.4
Public Sector Borrowing Requirements (PSBR) 3/	2.7	2.9	3.3	3.0	3.6	3.9	41.2	43.2
States and municipalities	0.4	0.4	0.4	0.4	0.3	0.3	3.1	3.2
International reserves 4/	1.4	0.8	0.8	1.0	1.3	1.9	14.9	15.7
Private sector financing	2.9	3.0	3.2	3.9	3.9	4.0	36.3	38.0
Households	1.3	1.2	1.2	1.1	1.2	1.1	14.9	15.7
Consumption	0.6	0.6	0.6	0.5	0.4	0.4	4.8	5.0
Housing 5/	0.6	0.6	0.6	0.6	0.7	0.7	10.2	10.7
Firms	1.7	1.8	2.1	2.8	2.7	2.9	21.3	22.3
Domestic 6/	1.0	1.0	1.0	1.3	1.1	1.0	12.1	12.7
Foreign	0.7	0.8	1.1	1.5	1.6	1.9	9.2	9.6
Commercial banks' foreign assets 7/	0.0	0.0	-0.3	0.0	-0.1	0.2	1.3	1.4
Other 8/	2.8	0.1	0.5	0.2	-0.3	1.7	-1.4	-1.5

Note: Figures may not add up due to rounding. Figures expressed in percent of nominal annual average GDP. The information on (revalued) flows is stripped from the effect of exchange rate fluctuations.
e/ Data estimated based on data of the second quarter of 2014.
1/ It includes the monetary aggregate M4 held by residents. Annual revalued flows of domestic sources exclude the effect of the reform to the ISSSTE Law on the monetary aggregate M4. Information on the stock of domestic sources includes the effect of this reform.
2/ It includes the monetary aggregate M4 held by non-residents, foreign financing for the federal government, public institutions and entities, and foreign financed investment projects (PIDIREGAS), commercial banks' foreign liabilities and financing to the non-financial private sector.
3/ Public Sector Borrowing Requirements *(Requerimientos Financieros del Sector Público*, RFSP or PSBR, for its acronym in English) and historical stock of Public Sector Borrowing Requirements (HSPSBR or SHRFSP, for its acronym in Spanish) as reported by the Ministry of Finance (SHCP). Figures of revalued flows exclude the impact of the reform to the ISSSTE Law on PSBR. Information on HSPSBR does include the effect of this reform on the public debt.
4/ As defined by Banco de México's Law.
5/ Total portfolio of financial intermediaries and 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). It includes debt-restructuring programs.
6/ Total portfolio of financial intermediaries. It includes debt-restructuring programs.
7/ It includes assets from abroad and foreign financing.
8/ 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, as well as non-monetary liabilities from IPAB, among others.

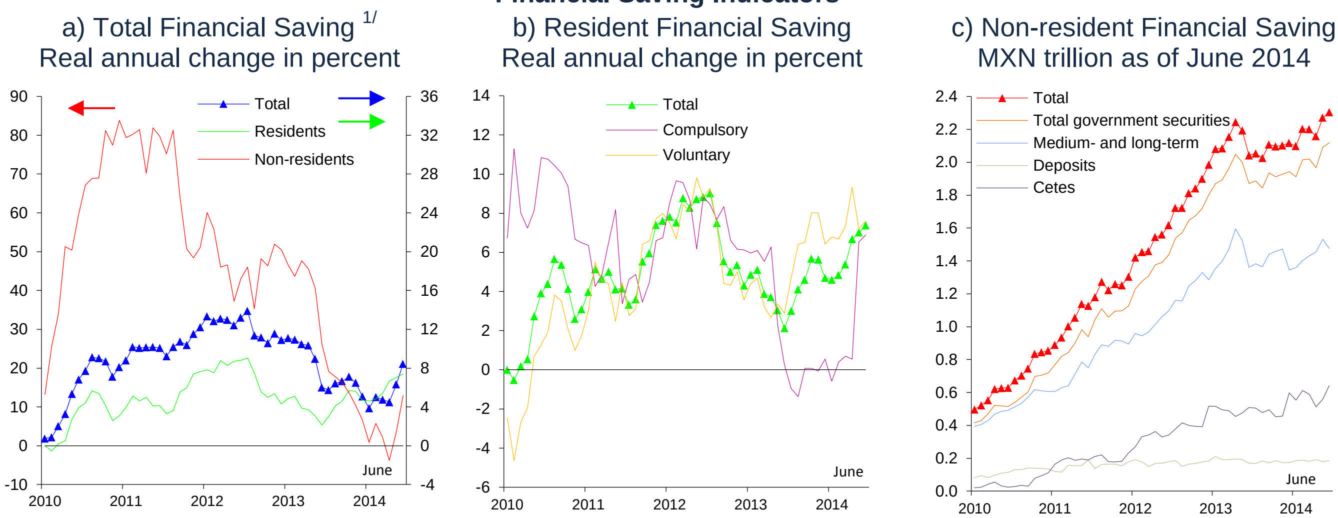
With respect to domestic sources, in line with the improvement of economic activity in Mexico, the monetary base grew at an average annual rate of 13.2 percent, figure above the 9.6 percent rate observed in the first quarter of the year.[5] The stock of domestic financial saving -defined as the monetary aggregate M4 minus the stock of currency held by the public- increased at a faster rate,

5 The monetary base is defined as the sum of currency in circulation plus bank deposits in Banco de México.

mainly due to the expansion of the compulsory saving component, particularly pension funds administered by Siefores (Chart 25). This resulted, on the one hand, from a higher valuation of medium- and long-term securities comprising these portfolios, associated with the reduction of these instruments' interest rates during the second quarter of 2014, and on the other hand, from a base effect given the decrease in the market value of these instruments in May and June of last year. Meanwhile, the indicator of the stock of resident voluntary financial saving kept increasing at a rate similar to that in the previous quarter.

As regards the external sources of financial resources, the stock of non-resident financial saving expanded more than in the first quarter (Chart 25). This was the result of inflows directed towards the acquisition of short-, medium- and long-term government bonds, as well as of the increase in the valuation of these instruments in face of the generalized decline in interest rates. This, in turn, was a consequence of the reduced volatility in international financial markets and the strengthening of investors' appetite for emerging countries' financial assets, as the monetary policy stance in advanced economies may continue being accommodative in the next quarters.

Chart 25
Financial Saving Indicators



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

In line with the above, the use of the economy's financial resources increased in the second quarter, as compared to the previous quarter. As anticipated in the Economic Package 2014, Public Sector Borrowing Requirements (PSBR) have been increasing vis-à-vis last year, which has implied an increase in the annual flow of financing to the public sector in the second quarter in comparison to the first quarter (Table 2). As concerns financing to the states and municipalities, the annual flows at the end of the second quarter were similar to those observed at the end of the first quarter of the year. Meanwhile, in annual flow terms, the accumulation of international reserves was higher in June than in March 2014. Finally, the annual flow of financing to the non-financial private sector at the end of the second quarter was similar to that in the previous quarter (Table 2 and Chart 26).

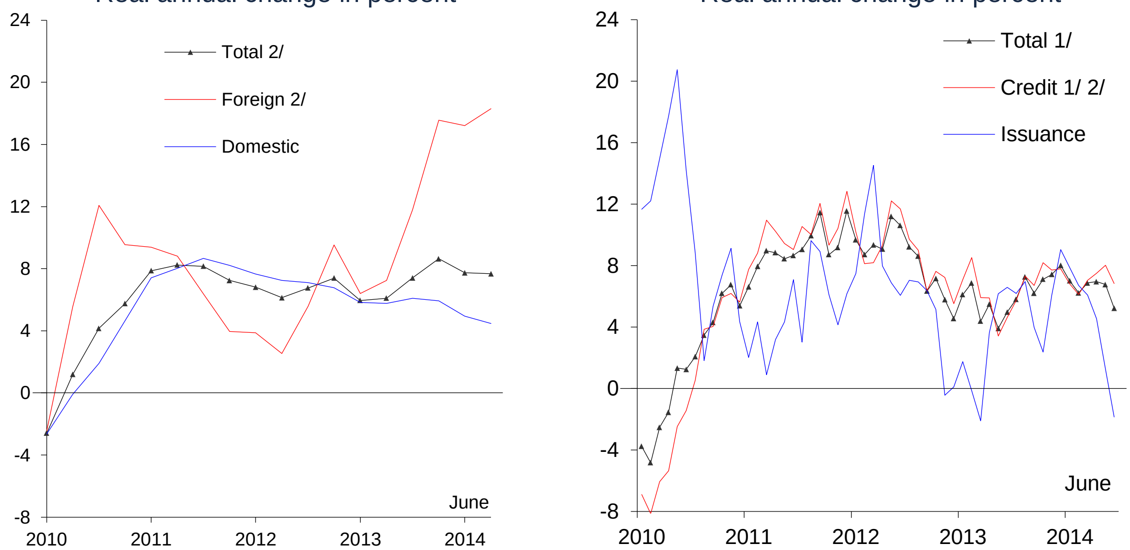
Delving into this last point, in the period April-June, the expansion of financing to non-financial private firms was stable, albeit its components showed a mixed evolution. On the one hand, external financing presented a greater dynamism during the second quarter of 2014 due to an increase in the issuance of corporate debt in international markets. On the other hand, domestic financing expanded at a more moderate rate than in the previous quarter, as a result of a reduction in the net placement of private debt, although bank credit granted to firms continued evolving favorably (Chart 26).

With respect to the latter, commercial bank credit to firms grew faster than in the first quarter of the year (Chart 27a). Within this portfolio, loans to small and medium enterprises continued exhibiting the greatest dynamism. In this context, interest rates and delinquency rates of commercial banks' credit to firms remained basically unchanged (Chart 27b and Chart 27c). As refers to the credit portfolio of development banks, its growth rate in April-June was higher than in the period January-March 2014, while the corresponding interest rates and delinquency indices remained stable.

Chart 26
Total Financing to the Non-financial Private Sector

a) Total Financing to the Non-financial Private Sector 1/
Real annual change in percent

b) Domestic Financing to Non-financial Private Firms
Real annual change in percent



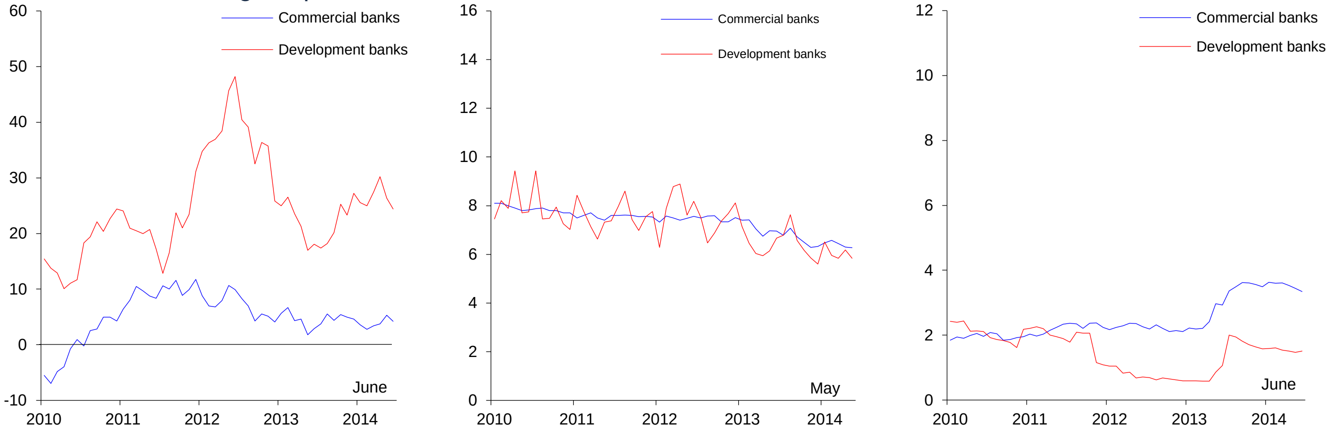
1/ Figures adjusted for exchange rate changes.
2/ Data for external financing corresponding to the second quarter of 2014 are preliminary.
3/ These figures are affected by the disappearance of some non-banking financial intermediaries and their conversion to non-regulated sofomes.
4/ It refers to the performing and non-performing portfolio, and includes credit from commercial and development banks, as well as non-bank financial intermediaries.
Source: Banco de México.

Chart 27
Bank Credit to Non-financial Private Firms

a) Performing Credit to Non-financial Private Firms
Real annual change in percent

b) Interest Rates of New Credits to Non-financial Private Firms 1/
Percent

c) Delinquency Rates of Credit to Non-financial Private Firms 2/
Percent



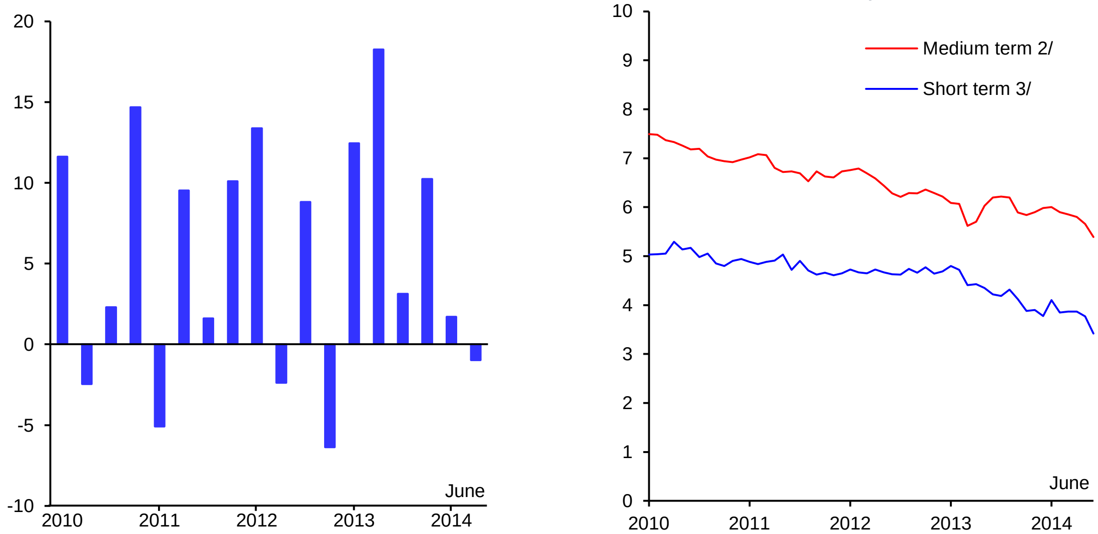
1/ It refers to the interest rates of new bank credits to non-financial private firms, weighted by the associated stock of the performing credit and for all credit terms requested.
2/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.
Source: Banco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

In the domestic debt market, firms kept funding their operations through the placement of securities, albeit a relatively high amount of amortizations led to a lower net placement than in the previous quarter. It is also evident that large Mexican firms have taken advantage of the high degree of liquidity in international markets, issuing debt at very attractive terms and interest rates, at the expense of domestic bond issuance. Net placement of medium- and long-term securities by non-financial private firms was MXN -1.0 billion (which resulted from gross placements of MXN 11.2 billion and gross amortizations of MXN 12.2 billion), as compared to MXN 1.7 billion in the first three months of the year (Chart 28a). Interest rates of private securities showed a generalized decrease at all maturities, in response to the 50 basis-point reduction of the Overnight Interbank Interest Rate, by Banco de México that took place in June (Chart 28b).

Chart 28
Securities of Non-financial Private Firms

a) Net Placement of Medium-term Securities Issued by Non-financial Private Firms 1/
MXN billion

b) Interest Rates of Securities Issued by Non-financial Private Firms
Annual percent

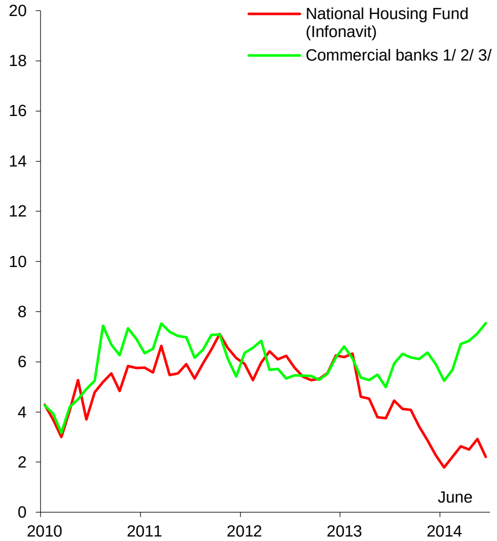


1/ Placements excluding amortizations in each month (securities and prepayments).
2/ Placements of more than one year.
3/ Placements of up to one year.
Source: Banco de México, with data from Valmer and Indeval.

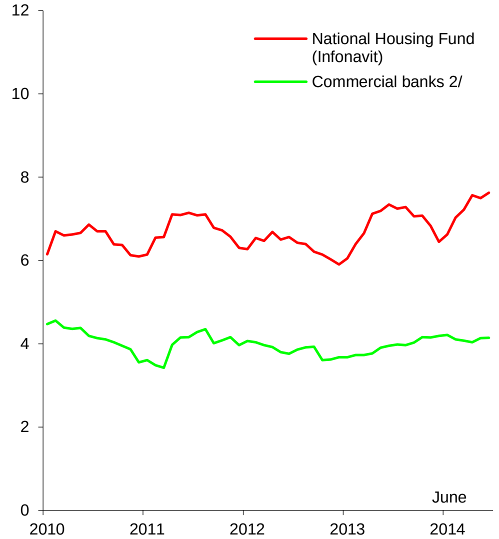
Credit to households grew at a faster rate in the second quarter than in the previous quarter, as a result of the greater dynamism of commercial bank mortgage loans (Chart 29a). Indeed, in April-June the performing mortgage loan portfolio of commercial banks and sofomes expanded at an average annual rate of 7.2 percent, a figure above the 5.9 percent rate recorded in January-March 2014. This took place in an environment, in which interest rates and delinquency rates did not show significant changes (Chart 29b). Meanwhile, the performing portfolio of the National Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores*, Infonavit) maintained its low dynamism, registering real average annual growth rates of 2.5 percent in the period April-June (2.2 percent in the first quarter) (Chart 29a). In terms of the delinquency rate of this portfolio, its increase in recent months has been more moderate relative to the first months of the year (Chart 29b). Insofar as economic activity in Mexico continues strengthening, this indicator is expected to stabilize and even to start declining.

Chart 29
Housing Credit

a) Performing Housing Credit
Real annual change in percent



b) Delinquency Rates of Housing Credit [4/]
Percent

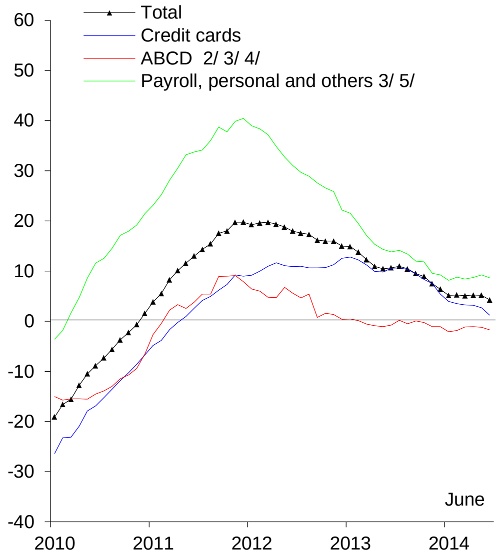


1/ Figures are adjusted in order to avoid distortions by the pass-through effect of UDIS trust portfolio to the balance sheet of commercial banks and by the reclassification of credit in direct portfolio to ADES.
2/ It includes sofomes of commercial bank.
3/ Figures are adjusted to avoid distortions 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.

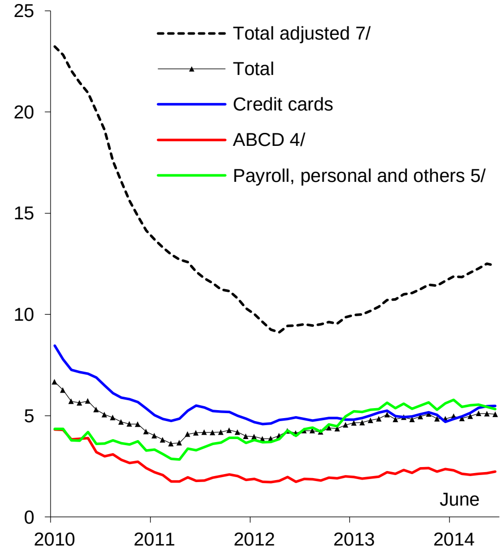
Consumer credit in its different segments expanded at a slightly lower rate than in the previous quarter (Chart 30a). The performing consumer credit portfolio of commercial banks increased during April-June at a real average annual rate of 4.9 percent, while in January-March 2014 it grew at 5.1 percent. The credit cards segment kept decelerating, while the growth of credit for durable consumption goods (ABCD, for its Spanish acronym) remained stable. In contrast, the payroll and personal credit portfolio, which had shown a gradual deceleration since 2012, expanded more vigorously than in the previous quarters. In this environment, interest rates did not present significant changes. With regard to delinquency rates, the adjusted rate —which takes into account bad debt write-offs accumulated in the last twelve months— continued increasing, in line with the deceleration of the economy's growth pace in the previous year (Chart 30b). However, the accumulation of such write-offs has moderated in recent months.

Chart 30
Commercial Bank Consumer Credit

a) Commercial Bank Performing Consumer Credit 1/
Real annual change in percent



b) Delinquency Rate of Commercial Bank Consumer Credit 1/ 6/
Percent

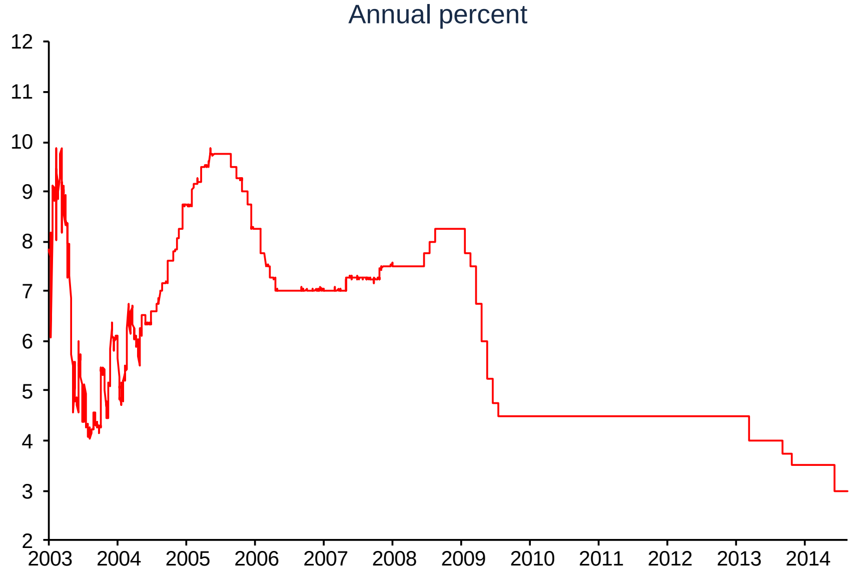


1/ It includes loans by credit card-regulated sofomes: Tarjetas Banamex, Santander Consumo, Ixe Tarjetas and Sociedad Financiera Inbursa.
2/ Between June 2010 and May 2011, figures are adjusted in order to avoid distortions due to the purchase of one banking institution's automobile loan portfolio.
3/ From July 2011 onwards, figures are adjusted in order to avoid distortions due to the reclassification from durable goods (ABCD) to other consumer credits by one banking institution.
4/ It includes credit for property acquisition and automobile credit.
5/ "Others" refers to credit for payable leasing operations and other consumer credits.
6/ The delinquency rate is defined as the stock of non-performing loans divided by the stock of total loans.
7/ It is defined as a non-performing portfolio plus punishments accumulated over the last 12 months divided by total portfolio plus punishments accumulated over the last 12 months.
Source: Banco de México.

4. Monetary Policy and Inflation Determinants

The evolution of inflation and inflation expectations was favorable during the first half of the year. To this contributed, besides the monetary policy, the increase of slack conditions in the economy, mainly because dynamism of economic activity was lower than expected in the first months of the year. On the other hand, inflation expectations for 2014 are below 4.0 percent and inflation is anticipated to converge to the 3.0 percent target in early 2015. Considering all this, Banco de México's Board of Governors decided in June to reduce the Overnight Interbank Interest Rate by 50 basis points, from 3.5 to 3.0 percent, after leaving it unchanged in April. Taking into account the foreseen recovery of the economy and the monetary policy stance of Mexico relative to the U.S., the Board further announced that additional reductions of the reference rate were not recommendable. Accordingly, the referred target remained unchanged in July (Chart 31).

Chart 31
Overnight Interbank Interest Rate [1/]
Annual percent



1/ The target for the Overnight Interbank Interest Rate is shown since January 21, 2008.
Source: Banco de México.

To be more specific, among the elements considered for the conduction of the monetary policy during the period analyzed in this Report, stand out:

a) That the evolution of inflation and inflation expectations confirmed the absence of second round effects on the price formation process in the economy, derived from the relative price changes in late 2013 and early 2014, including those associated with fiscal modifications.

b) That annual headline inflation is estimated to decrease to levels close to 3 percent in early 2015, with core inflation below this level.

c) That inflation expectations derived from market instruments for the medium- and long-term have shown a downward trend, currently locating very close to 3 percent, while expectations derived from surveys for long-term horizons have remained stable and those corresponding to the end of 2014 have declined below 4 percent.

d) That, derived from the evolution of economic activity in the first quarter, the output gap widened and, despite the foreseen recovery of the economy, it will probably remain at negative levels until the end of 2015. Thus, no aggregate demand-related pressures on inflation are anticipated in the horizon where monetary policy has an effect.

e) That in an environment of less uncertainty and low levels of volatility in international financial markets, induced by the central banks of main advanced economies announced intention of maintaining an accommodative monetary policy stance for an extended period, the functioning of financial markets in Mexico has been orderly. This does not imply that episodes of high volatility, which could lead to currency depreciations, can be ruled out, as observed in late July and early August. However, experience has shown that, in general, the pass-through of exchange rate variations to prices is low, especially if there is a high degree of slackness in the economy.

Due to the deceleration of the Mexican economy since mid-2012, despite the greater dynamism exhibited in the first months of the second quarter of 2014, there were no demand-related pressures on inflation or external accounts in the analyzed period. In particular:

a) The output gap remained at negative levels, even below those estimated in the previous Report (Chart 32).[6]

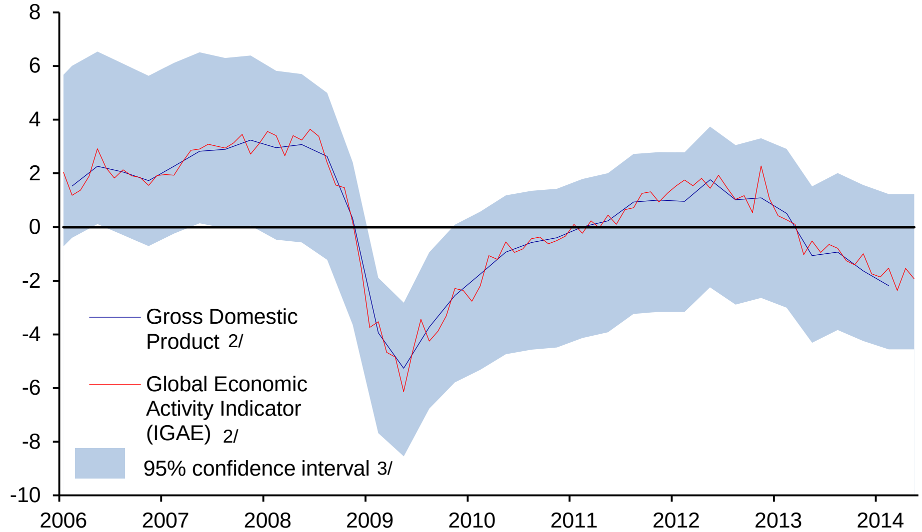
b) As mentioned, slack conditions persisted in the labor market (see Section 3.2.1).

c) The increments in the main wage indicators registered during the second quarter of 2014 continue being moderate. This, together with the trend of average labor productivity, contributed to the fact that unit costs remained at significantly low levels (Chart 33).

d) The reactivation of domestic financing to the non-financial private sector has been moderate, and interest rates and delinquency rates, in general, have remained stable.

[6] Considering that this indicator's estimation is subject to a certain degree of uncertainty, it should be carefully interpreted, given that, from a statistical point of view, it does not register levels significantly different from zero.

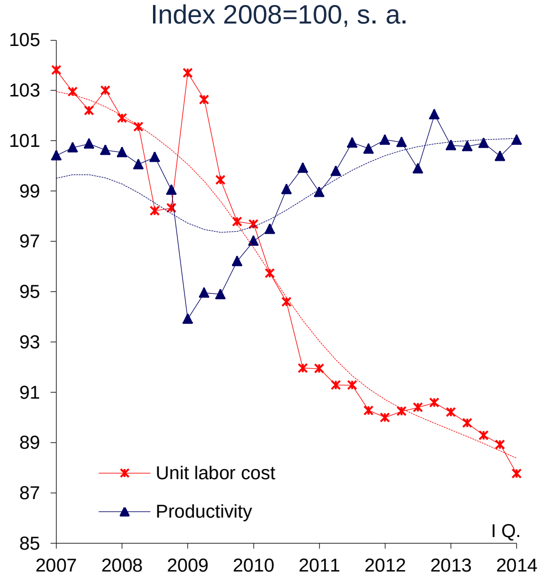
Chart 32
Output Gap Estimation [1/]
Percentage of potential output, s. a.



s. a. / Prepared with seasonally adjusted figures.
1/ Estimated using the Hodrick-Prescott (HP) filter with tail corrections; see Banco de México (2009), "Inflation Report, April - June 2009", p.69.
2/ GDP figures as of the first quarter of 2014, IGAE figures as of May 2014.
3/ Confidence interval for the output gap calculated with an unobserved components' method.
s. a. / Prepared with seasonally adjusted figures.
Source: Prepared by Banco de México with data from INEGI.

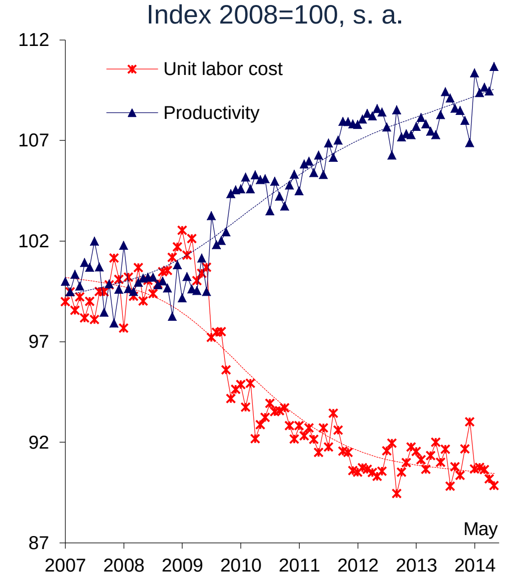
Chart 33
Productivity [1/] and Unit Labor Cost

a) In the Economy
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. Trend estimated by Banco de México.
1/ Productivity based on the amount of hours worked.
Source: Unit cost prepared by Banco de México based on data from INEGI. The Global Index of Labor Productivity in the Economy (IGPLE), as released by INEGI.

b) In the Manufacturing Sector
Index 2008=100, s. a.

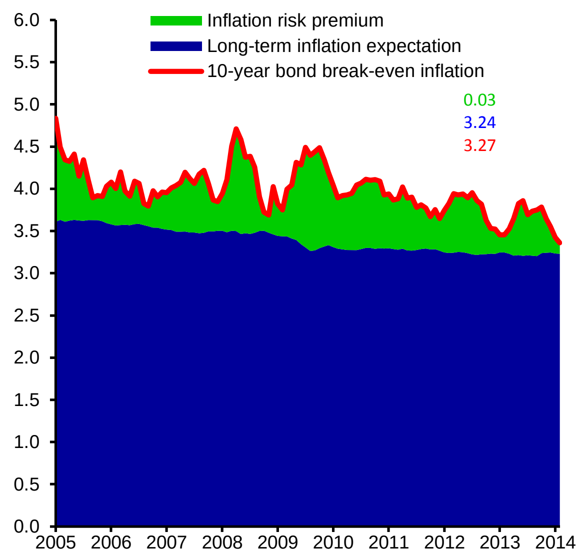


a. e. / Seasonally adjusted and trend data. The former is represented by a solid line; the latter by a dotted line. Trend estimated by Banco de México.
1/ Productivity based on the amount of hours worked.
Source: Prepared by Banco de México with seasonally adjusted data from the Monthly Manufacturing Business Survey and the monthly indicator of the Mexico's System of National Accounts, INEGI.

Regarding inflation expectations, it is noteworthy that those implicit in long-term market instruments have been gradually declining in the last years, currently reaching levels close to 3 percent. It should be noted that these inflation expectations are not directly observed, but are estimated with diverse econometric methods.[7] It is important to point out that, since they are based on daily financial data, they incorporate information more rapidly than those obtained through surveys to analysts, and reflect positions of a wide range of investors. Thus, in the period analyzed in this Report, the indicator of inflation expectations estimated from 10-year bonds remained stable around 3.2 percent. The associated inflationary risk premium reduced from approximately 31 to 3 basis points from March to July 2014 (Chart 34a). As a reflection of the aforesaid, break-even inflation (the difference between long-term nominal and real interest rates), decreased from an average level of 3.55 percent to 3.27 percent during the same period, registering record lows (Chart 34b). The reduction of this indicator implies that holders of nominal rate-indexed instruments have been requesting less coverage for future inflation, possibly due to the less inherent risk perceived.

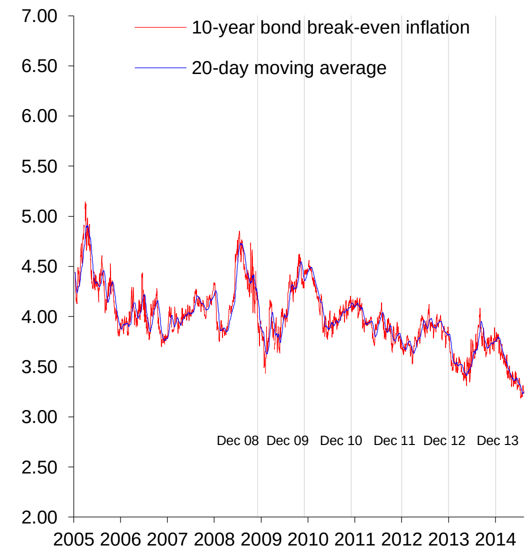
Chart 34
Inflation Expectations

a) Decomposition of Break-even Inflation and Inflation Risk 1/
Percent



1/ Last data available: July 2014.
Source: Estimated by Banco de México.

b) Break-even Inflation
Percent



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

Regarding inflation expectations obtained through Banco de México's surveys to private sector analysts, it stands out that in the period covered in this Report, the median for end 2014 remained below 4 percent and continued decreasing from 3.95 percent in March to 3.80 percent in July.[8] The expectation for core inflation

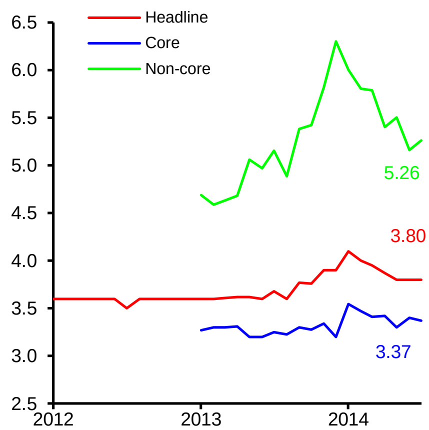
[7] For a description of the estimation of long-term inflation expectations, see Box "Decomposition of the Break-even Inflation" in the Quarterly Report October-December 2013.
[8] According to Banamex Survey of Financial Market Analysts' Expectations, the median of headline inflation expectations for the end of 2014 registered a similar behavior, locating at 3.96 percent in the survey of March 20, 2014, decreasing gradually afterwards to 3.87 percent in the survey of August 5, 2014.

for end 2014 showed a stable performance, remaining around 3.40 percent between March and July 2014, while non-core inflation expectation, implicit in previous median estimates, declined from 5.79 to 5.26 percent (Chart 35a). It should be noted that not only the median of the responses of inflation expectations for the end of 2014 has been declining, but also its associated dispersion (Chart 35b).

On the other hand, the median of headline inflation for 2015 reduced slightly, shifting from 3.60 to 3.50 percent in the period March-July. The median of core inflation expectations remained stable at 3.2 percent, while the implicit non-core inflation expectation went from 5.0 to 4.6 percent. Finally, longer-term expectations remained at a stable level of around 3.50 percent (Chart 35c).[9]

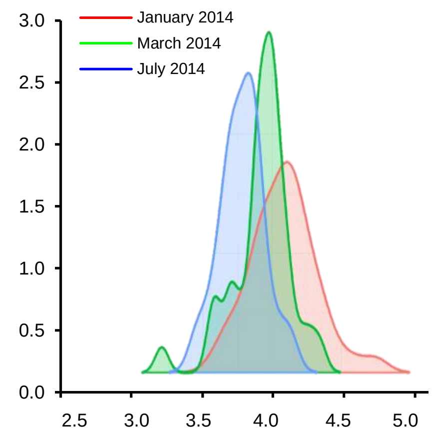
Chart 35
Inflation Expectations

a) Medians of Headline, Core and Non-core Inflation Expectations for the End of 2014 [1/]
Percent



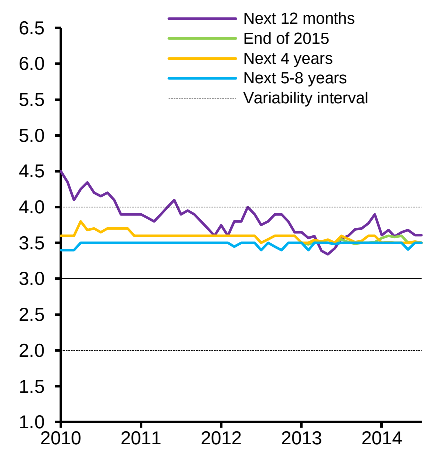
1/ Latest available data: July 2014.
Source: Banco de México survey.

b) Distribution of Headline Inflation Expectations for the End of 2014
Percent



Source: Estimated with data from Banco de México surveys.

c) Medians of Headline Inflation Expectations for Different Terms [1/]
Percent



1/ Latest available data: July 2014.
Source: Banco de México survey.

It should be mentioned that expectations for 2015 do not seem to fully incorporate two factors, which alone should produce a convergence of headline inflation to 3.0 percent at the beginning of that year: i) the elimination of the numeric impact caused by tax measures implemented in early 2014, and ii) the Federal Government's commitment to reduce in 2015 the adjustment of gasoline prices to expected inflation, as stipulated in the Federal Income Law for 2014.

The reaction of national financial markets to the target interest rate cut last June 6, 2014 was favorable. Specifically:

a) An important pass-through of the reference rate reduction to medium- and long-term-market interest rates was registered, shifting the entire yield curve downwards.

[9] This figure matches the results of the Banamex survey, given that the median of longer-term expectations (period 2016-2020) is around 3.5 percent in the March 20 survey and decreased slightly to 3.4 percent in the August 5, 2014 survey.

b) The trajectory of the market-implicit and survey-derived short-term interest rates adjusted downwards after the reference interest rate cut. As a result, expectations of this rate for end 2014 and 2015 were lower than those prevailing before the adjustment.

c) The foreign exchange market maintained an orderly functioning and its volatility remained at record lows.

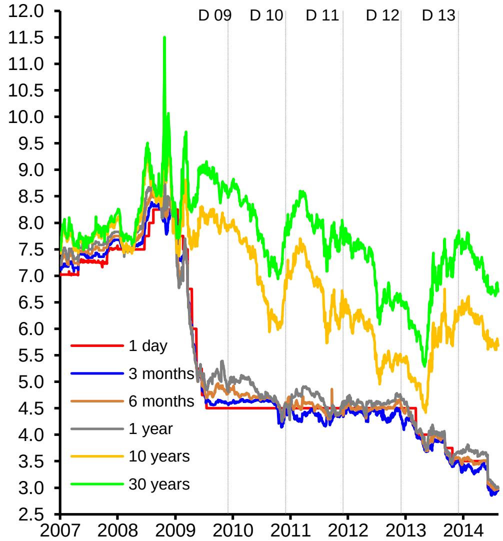
d) Short- and long-term inflation expectations remained stable after that movement.

Derived from the abovementioned, ex-ante real interest rates for different terms, that is, those obtained from the difference between nominal interest rates and inflation expectations, of the same terms respectively, presented a decline. In particular, the ex-ante real interest rate associated with the nominal reference rate and Banco de México's 12-month inflation forecast, which, as will be shown below, locates inflation very close to 3 percent from the beginning of 2015 onwards, is at levels close to zero. In the future, this ex-ante real interest rate is estimated to gradually increase, in accordance with the additional decrease foreseen for inflation in the second half of 2015. This is congruent with the cyclic recovery of economic activity in the next quarters.

As to the behavior of interest rates for different terms in Mexico, in face of the previously mentioned important pass-through of the reference rate cut to the short-, medium- and long-term interest rates, the entire yield curve shifted downwards during the period analyzed in this Report. In particular, the interest rate of 3-month government bonds went from 3.30 percent at the end of March 2014 to 2.85 percent at the end of June, recently locating at 2.90 percent. The 10-year bonds rate declined from around 6.20 percent in late March to 5.70 percent in late June, ranging at a level close to 5.75 percent in the last days, although with certain volatility. It should be noted that even though this interest rate had declined by around 20 basis point from late March to early June, after the downward adjustment of the reference rate on June 6, this interest rate presented further reductions of around 30 basis points. Given the development of these interest rates, the slope of the yield curve (difference between 10-year and 3-month rate) remained relatively stable, shifting from around 290 basis points at the end of March to 285 basis points at the end of June, remaining close to this level since then (Chart 36). In this way, both monetary and financial conditions supported the economy, given the current phase of the economic cycle.

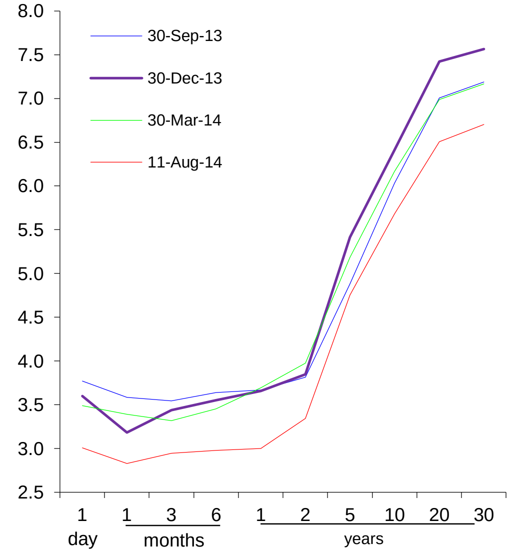
Chart 36
Interest Rates in Mexico

a) Government Securities Interest Rates [1/]
Percent



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).

b) Yield Curve
Percent



Source: *Proveedor Integral de Precios* (PiP).

In the following, the dynamics of long-term interest rates in Mexico are analyzed in more detail, particularly, through the evolution of its components: a) short-term interest rate (reference rate); b) the expected short-term interest rates that consider the medium- and long-term inflation expectation; and c) the risk premia. In general, stands out that:

a) As mentioned before, the Overnight Interbank Interest Rate, which is the reference rate for the monetary policy, was reduced from 3.5 to 3.0 percent during the period analyzed in this Report.

b) Given the reference interest rate cut, together with the slack prevailing in the economy, and the fact that medium- and long-term inflation expectations remained stable, expected short-term interest rates declined. In particular, according to Banco de México's survey to private sector analysts, the median of the expectations for the interbank interest rate at the end of 2014 reduced from 3.5 percent in the March survey to 3.0 percent in the July survey.

c) Finally, the evolution of different risk premia in Mexico was heterogeneous. Thus:

   i. Diverse indicators of the sovereign risk premium for Mexico decreased during the period analyzed in this Report. In particular, market indicators that measure the sovereign credit risk registered a 15 basis point reduction from end of March 2014 to end of June, locating close to record lows.[10]

ii. Regarding the inflation risk premium, it continued its downward trend in the period covered in this Report, as the evolution of inflation and inflation expectations confirmed the prospect that the increase of inflation in early 2014 was transitory and that there were no second round effects. In particular, during the second quarter of 2014, this premium dropped around 20 basis points compared to the previous quarter (Chart 34b).

iii. As to the performance of exchange risk premium, the spread between the interest rate of the 10-year government bond issued in MXN and the government bond of the same term issued in USD, it stayed relatively stable around 2.4 percentage points, level close to that observed at the end of 2013 (Chart 37a).

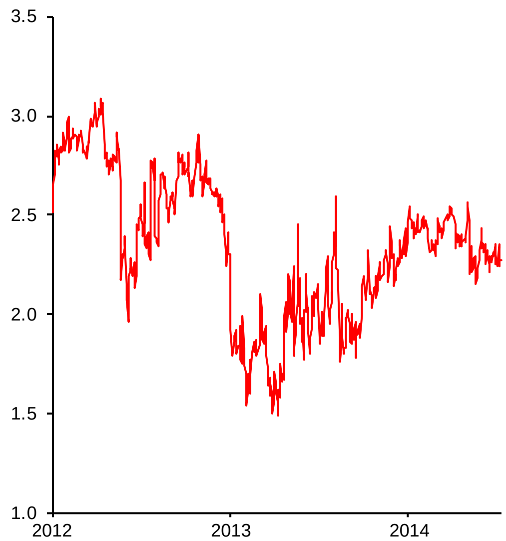
iv. As mentioned in previous Reports, given the process of risk premia decompression since May 2013 in the U.S., the term premium (estimated as the difference between the 10-year and 2-year interest rates) in this country increased, leading to an increase in the term premium in Mexico. In this way, the rise registered in Mexico's long-term interest rate since that date and until the end of January 2014 was mainly due to the evolution of the term premium in the U.S. Later, in the first months of 2014, this indicator presented an important decline until reaching levels below 200 basis points, and later, driven by the reference rate cut, corrected to levels close to 235 basis points (Chart 37b).

In addition to the abovementioned, it is noteworthy that the spread between U.S. and Mexican long-term interest rates remained stable during April and May, and decreased after the reference rate adjustment in June. In particular, the 10-year interest rate spread dropped from 340 to 310 basis points approximately from end of March to end of June. In the last weeks, this spread hovered around 320 basis points (Chart 38).

[10] It refers to 5-year Credit Default Swap.

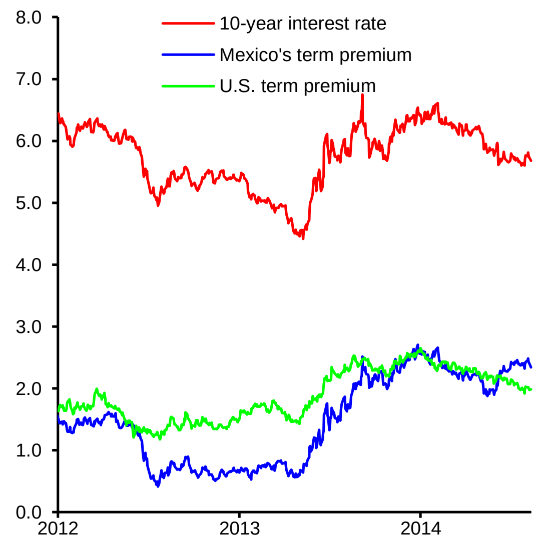
Chart 37
Risk Premia

a) Spread between MXN- and USD-indexed 10-year Bond Rate
Percentage points



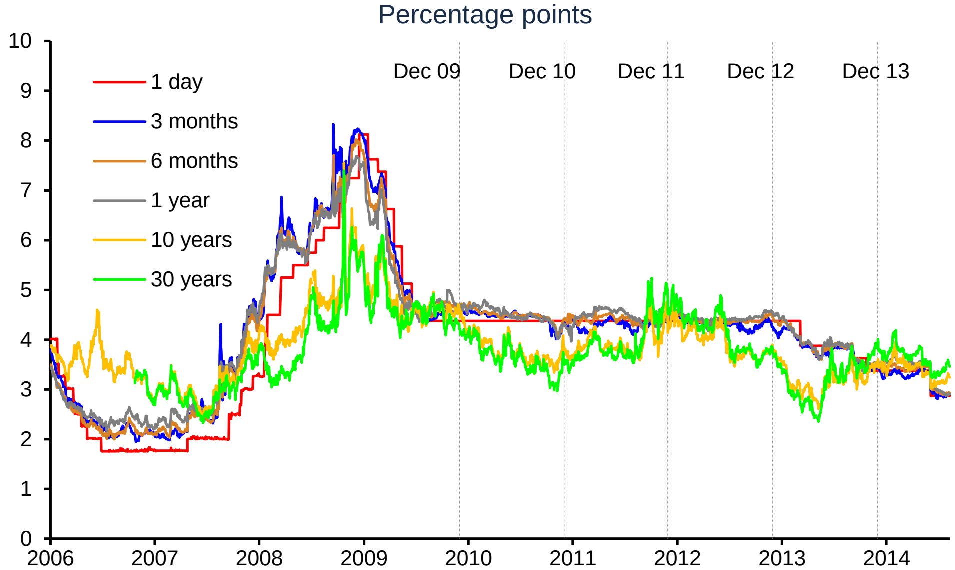
Source: Bloomberg, *Proveedor Integral de Precios* (PiP) and Valmer.

b) Mexico's 10-year Government Bond Interest Rate and the Term Premium [1/]
Percentage points, percent



1/ The term premium refers to the difference between the 10-year and the 2-year interest rate.
Source: Banco de México, Proveedor Integral de Precios (PiP) and Bloomberg.

Chart 38
Interest Rate Spreads between Mexico and the U.S. [1/]
Percentage points



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

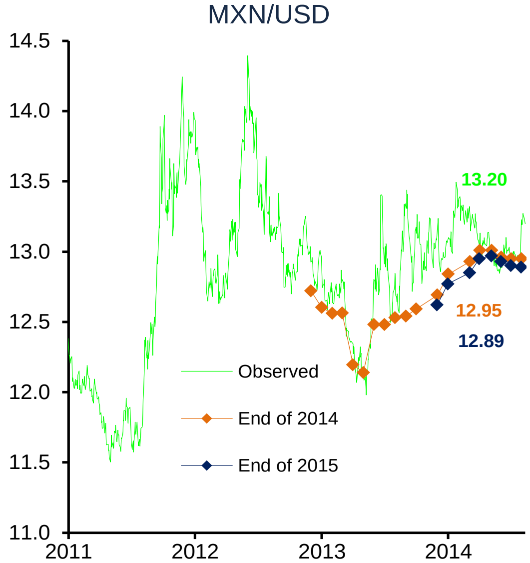
In the environment of low volatility prevailing in international financial markets until mid-July, international financial conditions were affected by investors' intensified search for yield process. In this context, the evolution of the national currency's exchange rate continued showing low volatility and remained relatively stable, changing from an average level of 13.20 MXN/USD in March 2014 to an average of 13.00 MXN/USD in June and July (Chart 39a). Despite that, at the end of July, the exchange rate depreciated to levels close to 13.25 MXN/USD. This, in light of the increased volatility in international financial markets, which was registered as a response to some better than expected figures of the U.S. economy, and the fact that the last announcement of the U.S. Federal Reserve seems to indicate that the conditions that might determine a reference rate adjustment could be anticipating, among other factors, as mentioned in Section 3.1.4 (Chart 39b).

It stands out that the flexible exchange rate regimen that characterizes the Mexican peso, has allowed this variable to function as a buffer for external shocks. Thus, an increase in exchange rate volatility would not necessarily represent an important risk to inflation and the entire economy, due to various factors, among which stand out: first, the fact that the pass-through of exchange rate fluctuations to prices reduced in last years; second, that a wide derivatives market has developed in Mexico, allowing economic agents to hedge against currency risks; and, third, that the national currency market operates under conditions of ample liquidity, as it is the currency with the highest trading volume among emerging economies.

The mentioned environment has also been reflected in the recovery of capital flows to emerging economies, including Mexico. In particular, as described in Section 3.2.2, during the first quarter of 2014, Mexico continued receiving resources from abroad aimed at the acquisition of financial instruments. With respect to this, it stands out that short-term government bond holdings recovered during the second quarter of 2014, while those corresponding to the medium and long term maintained high levels (Chart 40).

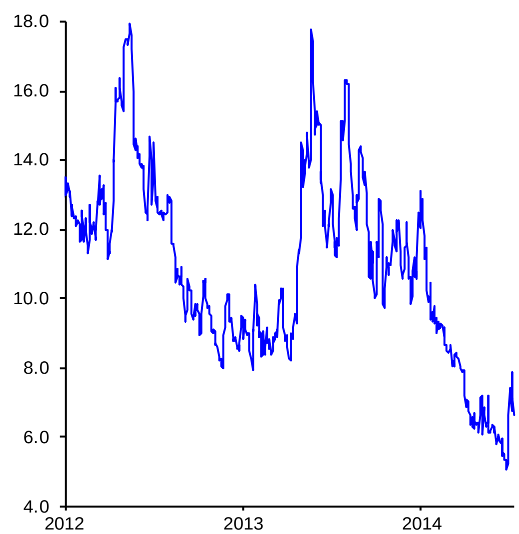
Chart 39
Exchange Rate

a) Nominal Exchange Rate and Exchange Rate Expectations for the End of 2014 and 2015 1/
MXN/USD



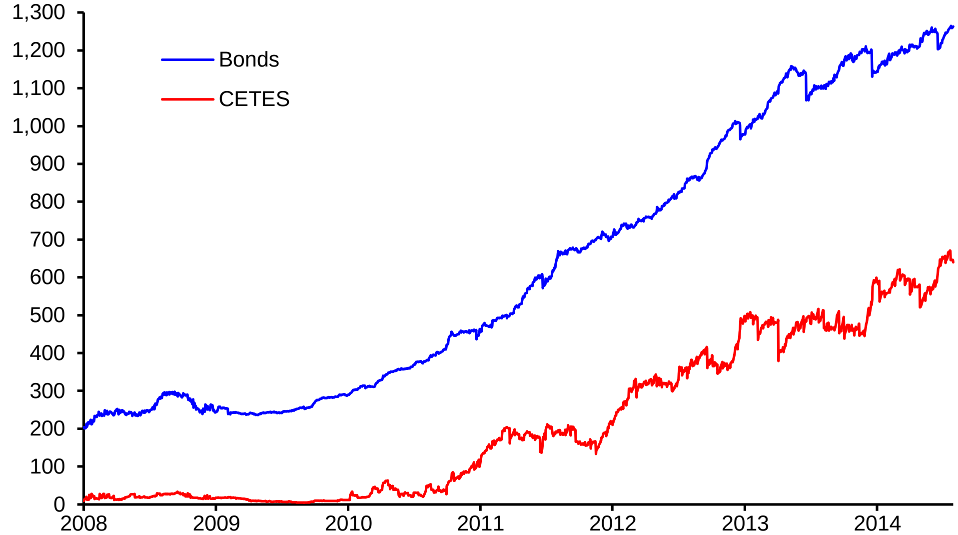
1/ The observed exchange rate is the daily quote of the FIX exchange rate. The latest quote of the observed exchange rate corresponds to August 11, 2014. For its expectations, the latest quote corresponds to the survey of July 2014.
Source: Banco de México and Banco de México's Survey.

b) Currency Option Implied Volatility 2/
Percent



2/ It refers to one-month options.
Source: Bloomberg.

Chart 40
Government Securities' Holdings by Foreign Investors
MXN billion



Source: Banco de México.

Furthermore, the framework for the conduction of the macroeconomic policy in Mexico is expected to continue supporting the stable functioning of the national financial markets. In particular, the orderly implementation of public finances, as well as the conclusion of the legislative stage of the recent structural reform process that could increase total factor productivity and ultimately, potential GDP, are expected to contribute to a further reduction in the risk premia with the subsequent effect on longer-term interest rates in Mexico.

5. Inflation Forecast and Balance of Risks

The expectations regarding the U.S. economic activity that are used for the construction of Mexico's macroeconomic framework are the following:[11]

a) Expected U.S. GDP growth is revised downwards from 2.4 percent in the previous Quarterly Report to 2.1 percent in the present one. This adjustment is mainly due to the revision of the U.S. GDP growth in the first quarter, which contracted more than previously expected. For 2015, GDP growth expectation remains at 3.0 percent.

b) U.S. industrial production is anticipated to grow 4.0 and 3.7 percent in 2014 and 2015, respectively. These figures are compared to the forecasts of 3.7 and 3.6 percent for 2014 and 2015, in the same order, published in the previous Report.

Growth of the Mexican Economy: During the first quarter of 2014, Mexico's GDP recorded a quarterly seasonally adjusted growth of 0.28 percent (lower than the 0.6 percent anticipated in the previous Report). In fact, as shown in this Report, although the aforementioned manufacturing exports rebounded, after having stagnated, in the previous quarter, domestic demand components continued showing weakness. Likewise, even though a more dynamic evolution is expected for the second quarter, this expectation mainly reflects a more noticeable rebound in foreign demand since the recovery of domestic demand is not yet very strong.

In this context, although a strengthening of economic activity in the second half of the year is still expected, the fact that its performance was lower than anticipated at the beginning of the year implies the need to revise downwards the growth estimate for the entire year of 2014. Additionally, the fact that the recovery of domestic demand has been more moderate than what was considered in the previous Report also suggests that the dynamism of the economy for the rest of 2014 could be lower than previously expected.

These elements lead to a downward revision of the GDP growth forecast for 2014 and the forecast for 2015 remains unchanged. Particular, the forecast interval for Mexico's GDP growth in 2014 is revised from 2.3 to 3.3 percent in the previous Report to 2.0 to 2.8 percent in the present one (Chart 41a). For 2015, the forecast interval remains between 3.2 and 4.2 percent. It is worth mentioning that the interval for GDP growth in 2014 in the present Inflation Report is narrower than the interval presented in the previous Report. In fact, the information presented in the present Report for the first quarter and that available so far for the second quarter suggests that it is possible to reduce the range of the interval. With regard to the aforementioned, it should be noted that in last years' Quarterly Reports the forecast interval of the GDP growth rate of the current year had a width of one percentage point in the Reports of the first two quarters, half percentage point in

[11] Expectations for the U.S. economy are based on the consensus of analysts surveyed by Blue Chip in August 2014.

the third quarter Report and a point estimate in the fourth quarter Report. From here onwards, in the second quarter Report the forecast range for the current year will be reduced to 0.8 percentage points, as in the present Report, since more information is available.

It is worth mentioning that the described forecasts involve a gradual strengthening of the domestic demand in the second half of 2014 and in 2015, which is derived from both a stronger impact of the rebound in the external demand on the domestic market and the effects that recent developments in the structural reform process could have on consumer and producer confidence. However, as shown in previous Reports, it should be recognized that the favorable effects of this process on economy's growth will materialize gradually and will be more notorious in the medium term.

Employment: Regarding employment levels, it stands out that despite the weakness of economic activity in 2013 and early 2014, the number of IMSS-insured workers continued to show a positive trend. In fact, as noted above, the growth of formal employment in the economy exceeded that of informal employment. Thus, the previsions of the previous Report for the variation in the number of IMSS-insured workers remain unchanged, considering the following aspects. On the one hand, during the first quarter of this year this indicator showed a good performance, despite the weakness of economic activity in that period. On the other hand, during the second quarter it continued showing a positive trajectory. Additionally, this growing trend is still anticipated to prevail, given the expected recovery of the economy. In particular, an increase of between 570 to 670 thousand workers (permanent and urban temporary) in 2014, and between 620 to 720 thousand workers in 2015 is expected.

Current Account: For 2014, trade balance and current account deficits of USD 3.9 and 26.7 billion respectively are expected (0.3 and 2.0 percent of GDP, in the same order). For 2015, these deficits are estimated to amount to USD 5.7 and 28.9 billion, respectively (0.4 and 2.0 percent of GDP, in the same order).

Due to the sharp slowdown of economic activity in late 2013 and early 2014, the level of slack in the economy is greater than anticipated in the previous Report and the output gap remains in negative levels. Moreover, despite the expected recovery for the rest of 2014 and 2015, the output gap is expected to remain in negative levels by the end of 2015, but it will be gradually closing. Thus, no-aggregate demand-related pressures on inflation or external accounts are perceived in the horizon in which monetary policy has an effect (Chart 41b).

The prevailing weakness of some indicators suggests downward risks to the growth scenario for Mexico. In particular:

i. Economic agents' confidence might recover more slowly than anticipated, which would delay a full recovery of domestic demand.

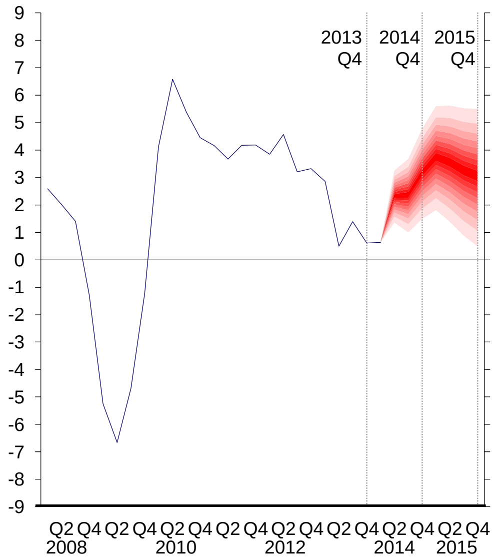
However, this scenario could be positively affected by the following upward risks:

ii. The possibility of a more vigorous than expected U.S. economic recovery.

iii. The possibility of a better than expected implementation of structural reforms, with its consequent impact on investors' and economic agents' expectations.

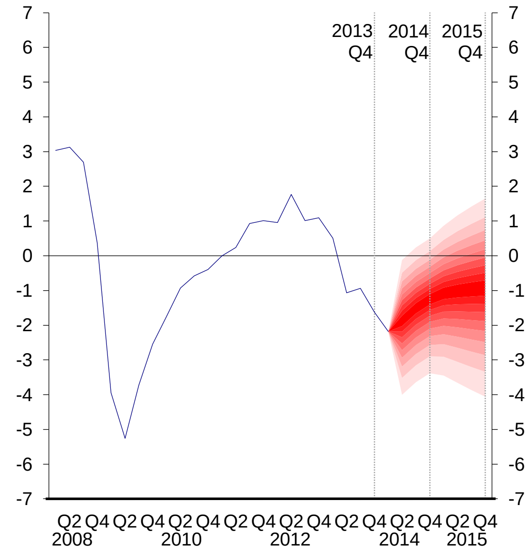
Chart 41
Fan Charts: GDP Growth and Output Gap

a) GDP Growth, s. a.
Annual percent



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

b) Output Gap Estimation, s. a.
Percentage of potential GDP



s. a. / Based on seasonally adjusted figures.
Source: Banco de México.

Inflation: Taking into consideration the degree of slack prevailing in the economy and the absence of second round effects derived from changes in relative prices that occurred in late 2013 and early 2014, which include those derived from fiscal measures, it is anticipated that annual headline inflation will remain close to 4 percent during the second half of 2014, although due to the high volatility that characterizes the prices of agricultural products it may exceed that level at some point, as in fact happened in July (Chart 42). This path for headline inflation is consistent with the forecasts of Banco de México released in the previous Report. As mentioned, its level in the second half of 2014 would mainly be reflecting the arithmetic effect coming from a low comparison base. In particular, low change rates of some agricultural product prices were observed during several months of the second half of 2013, once their production re-established after being affected by climate and sanitary events during most of the first half of the previous year. However, it is expected that towards the end of the current year, headline inflation will be below 4 percent given the fading effect of changes in relative prices that took place in November and December of 2013.

Furthermore, annual headline inflation is expected to decrease to levels close to 3 percent from early 2015 onwards and to remain near that level during the rest of the year (Chart 42). Factors favoring this evolution, besides the monetary policy stance, are the vanishing of the effects of the aforementioned changes in relative prices, and according to the Federal Income Law 2014, the increases in gasoline prices in 2015 consistent with expected inflation.

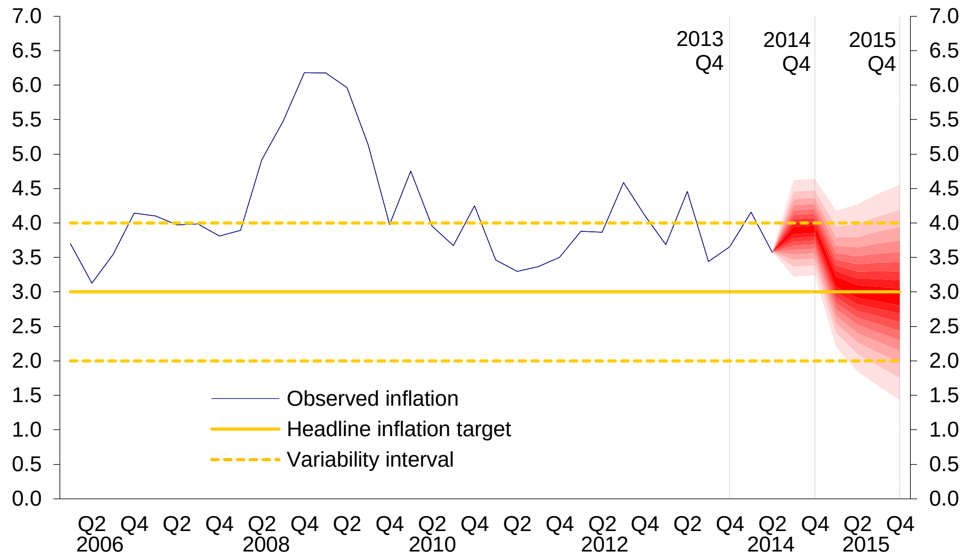
The annual core inflation forecasts for 2014 indicate that it will remain around 3 percent for the rest of 2014 and below this level in 2015 (Chart 43).

The foreseen path for inflation may be affected by certain risks, among which stand out:

i. Downward, the possibility that economic activity in the country recovers less than anticipated.

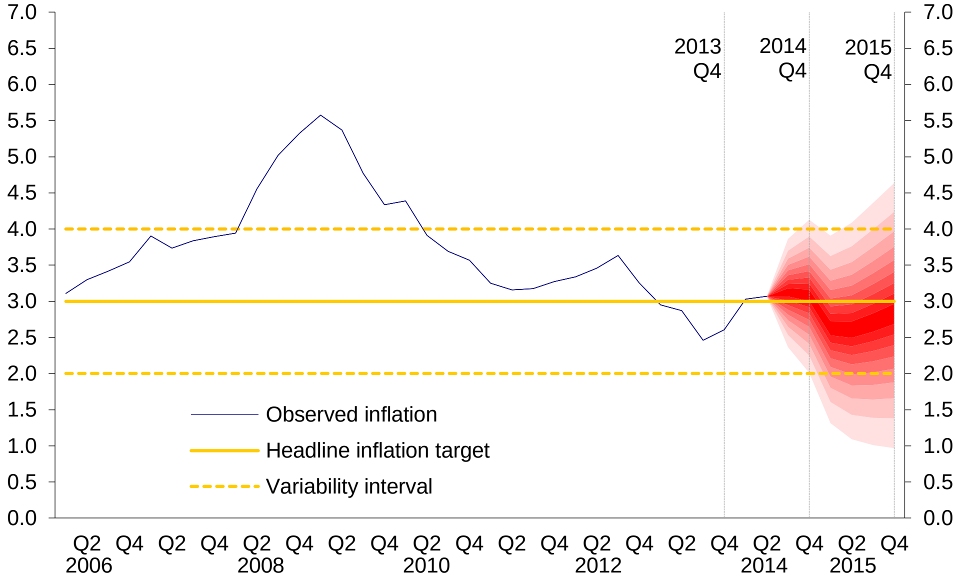
ii. Upward, new episodes of volatility in international financial markets that imply adjustments to the exchange rate with their consequent effect on inflation. However, in this case, only a moderate and transitory effect on inflation would be expected, because of the low pass-through of exchange rate variations to prices and the degree of slack that prevails in the economy.

Chart 42
Fan Chart: Annual Headline Inflation [1/]
Percent



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

Chart 43
Fan Chart: Annual Core Inflation 1/
Percent



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

The credibility of the Central Bank's commitment to ensure the national currency's purchasing power stability has increased the degrees of freedom to conduct the monetary policy in Mexico. In this environment, after having maintained unchanged the Overnight Interbank Interest Rate in April, Banco de Mexico's Board of Governors decided to reduce this target rate by 50 basis points, from 3.5 to 3.0 percent, in June, aimed at inflation converging to its 3 percent target in early 2015, precisely at lower interest rate levels. In the future, the Board will closely monitor the performance of all inflation determinants and inflation expectations for medium- and long-term horizons, including the expected recovery of the economy and the monetary policy stance of Mexico relative to the U.S., in order to be able to reach the target of 3 percent for headline inflation.

6. Structural Reforms and Final Considerations

It is encouraging that the legislative stage of the recently discussed structural reforms, aimed at increasing the country's productivity, has successfully concluded. The approval of the pending secondary legislation of the reforms on economic competition, telecommunications and broadcasting and energy is an indispensable step in the right direction. It is anticipated that these structural changes to the institutional framework of the country will have a positive impact on its potential growth and on the investment climate, so that the low rate of expansion that Mexico has exhibited from a long-term perspective could be reverted. Indeed, it is foreseeable that these modifications will boost the competitiveness of the economy and promote a more efficient allocation of resources to their most productive uses by means of removing entry barriers and of increasing competition in the markets, particularly in those referred to inputs.

It is appropriate to present a recapitulation about the reforms that have been achieved, and their main features, simply to visualize their scope. The focus is on the reforms that implied modifications of the Constitution: the education, economic competition, telecommunications and broadcasting and energy reforms. In the following, main aspects of each reform are described, highlighting the mechanisms through which they are expected to increase the country’s productivity and thus to generate higher growth rates.

Among the constitutional reforms, the education reform was the first to be enacted on February 25, 2013. The corresponding secondary laws were enacted on September 10, 2013. This reform is expected to increase the quality of education and, thus, to increase the country’s human capital, although its effects could take several years to be notorious. More human capital does not only directly increase productivity, but it also facilitates innovation and the introduction of new technologies. In this sense, it allows the country to produce goods of higher value added. Additionally, the increase in human capital is also anticipated to lead directly to an increase in the population’s income.

Evaluation is one of the main tools used by the education reform to achieve the increase in educational quality. In particular, the reform introduces the Professional Teaching Service *(Servicio Profesional Docente),* establishing the base for hiring, promotion and retention of teachers through evaluation and competition processes. The National Institute for the Evaluation of Education (*Instituto Nacional para la Evaluación de la Educación* (INEE)), body with constitutional autonomy, is in charge of the National Evaluation System, which, among others, has the task of providing better coordination among different government bodies and of promoting the adoption of best practices in terms of education. In this context, INEE conducted, in collaboration with INEGI, the Census of Schools, Teachers and Students of Basic and Special Education *(Censo de Escuelas, Maestros y Alumnos de Educación Básica y Especial),* during the year 2013. More information about the education system will allow taking better decisions about how to improve education quality, while evaluation could also generate incentives for students, teachers and schools to address their commitments with greater effort.

The constitutional reform on economic competition, telecommunications and broadcasting promulgated on June 10, 2013 (and whose secondary laws were enacted on May 22 and July 14, 2014, respectively) pursues the main objective of reaching greater economic efficiency in the markets in general, and in the area of telecommunications and broadcasting in particular, given the importance of this sector. Therefore, two constitutional autonomous entities, with legal personality, own patrimony and greater competency were founded: Federal Economic Competition Commission (*Comisión Federal de Competencia Económica* (COFECE)) and the Federal Telecommunications Institute *(Instituto Federal de Telecomunicaciones* (IFT)). Their rules and acts can only be challenged by an indirect *amparo* trial and they will not be subject to suspension.[12] Only the severe cases of fines or the divestiture of assets imposed by COFECE will be executed after resolving the *amparo* trial, if promoted. Additionally, special courts expert in economic competition, broadcasting and telecommunications have been established, which will facilitate the adequate and timely implementation of the new legal regulations. Thereby, a solid institutional framework has been consolidated in order to implement an effective antitrust policy, as well as to promote practices that favor greater market competition. Greater strength of the authority allows implementing necessary measures that avoid rent seeking and allow an efficient resource allocation.

One of the new instruments COFECE and IFT will be provided with to fulfill their functions is the possibility to mandate structural measures, in particular the divestiture of assets, rights, social share or stocks of economic agents in the proportions necessary to avoid anti-competitive effects. In this context, they should verify that all measures taken to determine access to essential inputs or elimination of competition barriers increase market efficiency. The catalogue of criminal sanctions for absolute anticompetitive practices, which are particularly harmful, has been updated.

These measures will allow for increased market competition, thus directly benefiting households through lower prices, and through higher quality and diversity of products. Moreover, from a long-term perspective, it is also anticipated that a more competitive environment will encourage the adoption of improved technologies and induce a better organization of work, which will necessarily translate into increases in productivity and, therefore, in higher economic growth.

In this context, it is noteworthy that information recently collected by Banco de México provides an insight into the challenge faced by the antitrust policy. In particular, information on the perception of competition in Mexico has been obtained through surveys to different economic agents. The results manifest the need to intensify competition in several sectors of the economy, as well as to attain greater efficiency of the antitrust policy (see Box 1). This represents a challenge and, at the same time, an opportunity for the new regulatory entities,

[12] The aspect of indirect *amparo* trial is relevant, given that these recently created entities' resolutions can only be challenged through this constitutional control measure, unlike what happened in the case of the former entities Federal Competition Commission *(Comisión Federal de Competencia)* and the Federal Communications Commission *(Comisión Federal de Telecomunicaciones),* whose resolutions could also be challenged through litigation administrative procedures.

which by means of the new instruments provided through the recent reforms, will be in position to promote greater economic competition.

With respect to telecommunications, it should be mentioned that they are a fundamental input for economic development in any country. For instance, broadband allows high-speed data transfer, reducing transaction costs and providing greater flexibility to firms. Likewise, the use of telecommunications by households also generates important positive externalities, given the advantages of information transmission through internet use. The changes introduced by this sector’s reform are aimed at reaching greater penetration of telecommunications and broadcasting, with the corresponding benefits. In particular, a new fundamental right was created: the right of access to information and communication technologies and to telecommunication and broadcasting services. The new law mandates the creation of a backbone network with national broadband coverage for wholesale services, thus facilitating the fulfillment of this fundamental right. Additionally, the reform is anticipated to impulse greater penetration, mainly by increasing the competition between providers of these services. In fact, among the changes directed at reaching this goal is the possibility of greater participation of foreign investment in the sector and the reallocation of the radiocommunication spectrum to more valuable uses, once the digital transition concludes. Further, the IFT, which is qualified to regulate, promote and monitor the access to essential inputs, as well as to impose asymmetric regulation for preponderant economic agents with substantial power, has already issued pro-competition provisions according to its mandate. Among them stand out the definition of preponderant economic agents, the elimination of roaming charges by the preponderant mobile phone operator and the establishment of general guidelines about *must-carry* and *must-offer.* Besides, IFT published a call for tender for two new national TV broadcast networks.

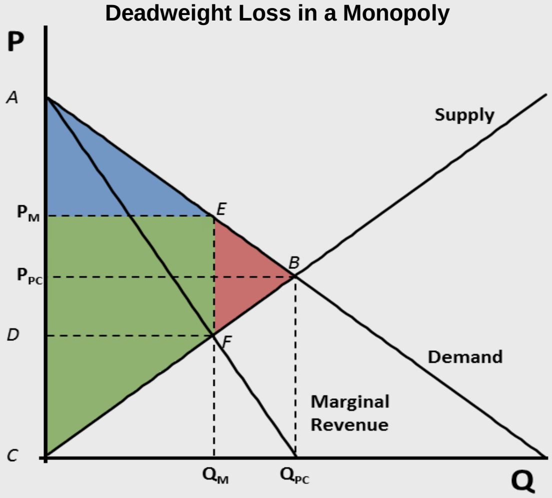
Box 1
Perception of Economic Competition in National Markets Obtained through Banco de México Surveys

1. Introduction

The constitutional reform on telecommunications, broadcasting and economic competition and the approval of the secondary legislation represent an important progress in order to boost greater competition in Mexican markets, which leads to a better resource allocation and an increase in the productivity of the national economy.

Market equilibrium in the case of one single producer leads to an allocation with less quantity and higher price, as compared to one in which different producers compete with each other. The functioning of the market under economic competition generates higher producer and consumer surpluses (social welfare) than in the case of monopolistic conditions. This is due to the fact that in the second case, quantities of those goods, whose value to consumers is higher than their production costs, are no longer produced and consumed. To illustrate this, Figure 1 presents a market with equilibrium quantities and prices under perfect competition (Q_{PC} and P_{PC}) and under monopolistic competition (Q_M and P_M). The triangle EBF measures the deadweight loss (difference in social welfare under competition (triangle ABC) and a monopoly (area AEFC)).

Figure 1
Deadweight Loss in a Monopoly



Thus, since April 2014, Banco de México, with the aim of evaluating the conditions of economic competition in the national markets before the approval of the previously mentioned secondary legislation, started consulting economic specialists, financial managers of non-financial firms, business agents, and representatives of firms of the manufacturing and non-manufacturing sectors about three fundamental aspects of economic competition in Mexico.

The topics of the survey were: first, the perception about the intensity of competition in national goods and inputs markets; second, the economic consequences of the lack of competition in the markets; and third, the perception of the efficiency of antitrust policies in the country before the reforms (Table 1).

Table 1
Aspects of Competition and Sources of Information

Topics	Sources	Private sector economic specialists[1]	Financial managers[2]	Business leaders[3]	Firms' represen-tatives[4]
Intensity of competition	Domestic market	✓	✓		
	Input market				✓
	Own product's market				✓
	Sectors with competition problems	✓	✓	✓	
Consequences of the lack of competition	Prices, quality of goods and services			✓	
	Obstacle to doing business	✓	✓		
	Obstacle to economic growth	✓	✓		
Effectiveness of antitrust policy[5]	Percepction of antitrust policy	✓	✓	✓	

1/ It refers to the specialists consulted in the Survey on Expectations of Private Sector Economic Specialists of July; 30 specialists answered the survey.
2/ It refers to the managers consulted in the Credit Market Evaluation Survey from July and early August, with answers from around 480 managers.
3/ It refers to the business agents from Banco de Mexico's regional contact network, surveyed between March 18 and April 16. Around 500 managers answered the survey.
4/ It refers to the firms' representatives interviewed in the Regional Economic Activity Survey of April; around 1500 representatives responded.
5/ It refers to the policy in place before the reforms.

This Box summarizes the results obtained from the conducted surveys.

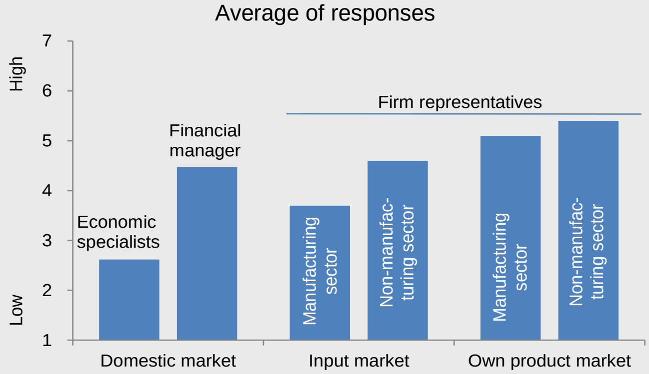
2. Results

2.1 Intensity of Competition

On the one hand, economic specialists consider that the intensity of competition in the domestic market is low. On the other hand, non-financial firms' financial managers and manufacturing and non-manufacturing sector business representatives perceive higher intensity. In particular, the latter pointed out that competition in input markets is moderate, while competition faced in the market of their main product or service is intense (Chart 1).

The differences in the perception of intensity of competition in the domestic market between economic specialists and firms' financial managers and firms' representatives can be associated with their perspective of the economy: the specialists' aggregate perspective of less competitive markets, and the specific perspective of market participants (firms' financial managers and representatives) of higher competition.

Chart 1
Intensity of Competition in Domestic Markets [1/]
Average of responses

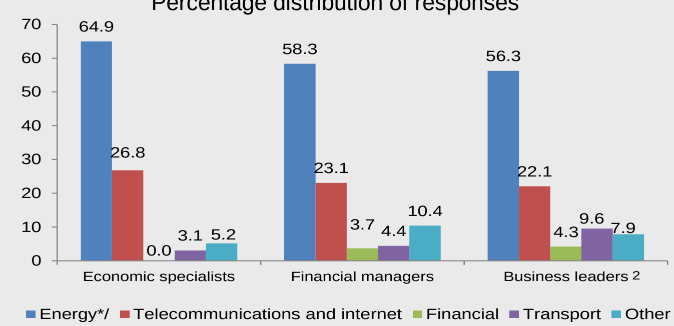


1/ Survey question: How would you assess the intensity of competition in Mexican markets? (1 = low in most markets; 7 = high in most markets).
Source: Banco de México.

2.2 Sectors Perceived as Problematic in Terms of Competition

The results of the surveys and interviews agree that the sectors with most competition problems are those related to oil and derived products, electricity, telecommunications and internet. Although some economic agents indicate that financial and transportation sectors present competition problems, the percentage of answers in these cases was considerably lower (Chart 2).

Chart 2
Sectors with Low Level of Competition in Mexico
Percentage distribution of responses [1/]



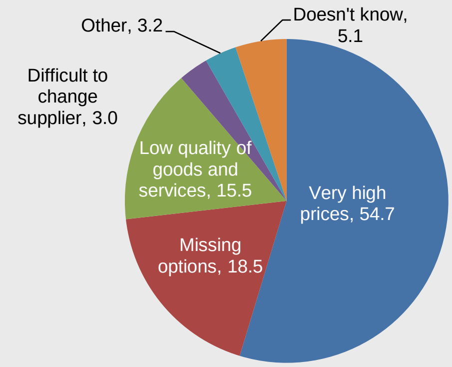
1/ Distribution with respect to total answers of specialists/financial managers, who could name up to three sectors, which they consider face competition problems. Survey question: In your opinion, which sectors have a lack or low level of competition?
2/ In the realized interviews, the business agents exclusively stated which sector with competition problems they considered the most important.
*/ The energy sector includes oil, petrol, gas and electricity.
Source: Banco de México.

2.3 Consequences of the Lack of Competition

High Prices

Interviewed business agents state that the main consequence of the lack of competition in the mentioned sectors is the high price of goods and services provided. Further repercussions of the absence of competition are missing options and low quality of goods and services provided (Chart 3).

Chart 3
Main Consequences of the Lack of Competition, according to Business Agents [1/]
Percentage distribution of responses



1/ Interview question: Which is the main consequence of the lack of competition in the sector you mentioned before?
Source: Banco de México.

Obstacles to Economic Growth

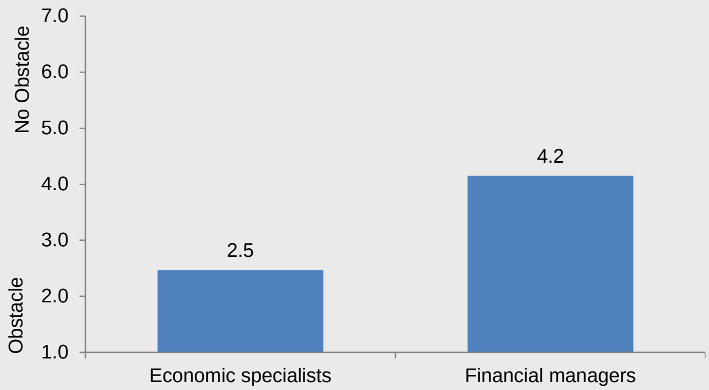
The opinion of consulted specialists and financial managers suggests that the existence of dominant firms, or the lack of competition, is a limiting factor for doing business in Mexico (Table 2). Furthermore, they consider that prevailing competition conditions hinder economic growth, although financial managers' perception of that impact is moderate as compared to that of specialists (Chart 4).

Table 2
Main Obstacles to Doing Business in Mexico
Percentage distribution of responses [1/]

Percentage distribution of responses	Economic specialists	Financial managers
Corruption	30.9	23.7
Bureaucracy	17.5	17.8
Access to financing	12.4	3.1
Crime	9.3	12.9
Dominance of existing firms/ Lack of competition	8.2	3.7
Legal status/ secure property rights	6.2	4.1
Taxes	6.2	22.1
Others	9.3	12.7

1/ Distribution with respect to total answers of surveyed persons, who could name up to three obstacles. Survey question: In your opinion, what are the main obstacles faced by business agents to doing business in Mexico?
Source: Banco de México.

Chart 4
Competition Conditions in Mexico as Obstacle to Economic Growth [1/]
Average of responses

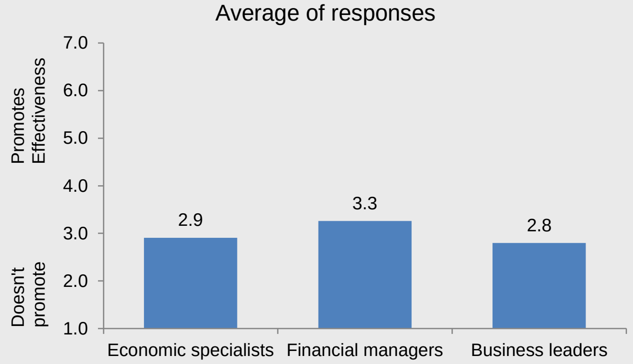


1/ Survey question: In your opinion, are the competition conditions prevailing in Mexican markets an obstacle to economic growth? (1 = severe obstacle; 7 = no obstacle to economic growth at all).
Source: Banco de México.

2.4 Effectiveness of Antitrust Policy

According to the interviewees' opinion, the effectiveness of antitrust policies in promoting competition is low (Chart 5).

Chart 5
Effectiveness of Antitrust Policy in Promoting Economic Competition [1/]
Average of responses



1/ Survey and interview question: In your opinion, how effective is the antitrust policy in Mexico? (1 = it does not promote competition; 7 = promotes competition effectively).
Source: Banco de México.

It stands out that, given the approval of the constitutional reform on telecommunications, broadcasting and economic competition and of their secondary legislation, this opinion reflects the perception of consulted sources based on their experience of previous years, before the recent legislative changes. Thus, these results could be considered as a benchmark for future evaluations of the progress of competition policy.

3. Final Considerations

The analysis of the surveys and interviews showed, on the one hand, that the perception of the intensity of competition in the country's markets is low in the case of economic specialists and higher among market participants; and, on the other hand, that there is a widespread opinion regarding the following three aspects: first, that the energy, telecommunications and internet sectors are those with the lowest level of competition; second, that the absence of competition leads to higher product and service prices, as well as hurts economic growth; and third, that the effectiveness of the antitrust policy in promoting competition, in the period before the approval of the recent reforms, is low.

The approval of the constitutional reform on telecommunications, broadcasting and economic competition and of the energy reform, as well as their secondary legislation, provides an opportunity to promote greater competition in the referred markets, which would result in a more efficient resource allocation and hence, in productivity gains, greater economic growth and lower prices.

Thus, it is necessary to monitor the correct implementation of the approved reforms, such that, with the new instruments assigned to both the Federal Telecommunications Institute (IFT) and the Federal Economic Competition Commission (COFECE) greater economic competition could be effectively promoted in the mentioned key sectors, which, eventually, would favorably impact the price formation process and economic growth in Mexico. This would support Banco de Mexico's task of inflation convergence to the permanent 3.0 percent target.

The constitutional reform on energy, enacted on December 20, 2013, whose secondary legislation was promulgated on August 11, 2014, provides the sector with a completely new institutional arrangement, by opening it to the private sector basically at all stages of the production chain of the electricity, oil and gas sectors. This reform takes on special relevance given that Mexico has not taken full advantage of its comparative advantage in the energy sector. In this sector the market structure and technological, financial and operational capacity of Pemex *(Petróleos Mexicanos)* and the Federal Electricity Commission (CFE) is insufficient to cover the big investments and technologies necessary to exploit unconventional, currently not exploited, resources, where Mexico has a great potential such as, for instance, in deep water and shale fields (shale oil y shale gas).

Among the main modifications to the oil and gas sectors stand out the opening of the production chain to private investment, including exploration and extraction, refining processes and petrochemical development, as well as transport, storage and distribution. The Nation maintains the inalienable and imprescriptible property of underground oil and hydrocarbons and oil revenues, but contracts with private parties for exploration and extraction will be allowed. It is noteworthy, that the reform is not only expected to increase oil and gas production, with its subsequent direct impact on GDP, but also to generate efficiency and productivity gains due to the environment of economic competition at different stages of the production chain.

With respect to the electricity sector, the private sector will be allowed to participate in the generation and commercialization of electricity and the State could conclude contracts with private parties to expand and strengthen transport and distribution networks. As a result of the reform, not only are energy prices expected to decrease, but also quality is expected to improve. This will lower both firms' direct and indirect costs and thus, increase productivity given the particular importance of electricity as input.

The new institutional framework clarifies the qualifications of the entities participating in the energy sector, ensuring a more effective level of coordination. Further, the institutional structure has been changed in order to control the operations associated with the different links in the production chains of oil, gas and electricity. In this context, Pemex and CFE become productive state enterprises and will be able to participate and compete alongside private participants. Thus, the strengthening of institutions will allow the good functioning of the sector, yielding higher production and efficiency gains. Further, the Mexican Oil Fund for Stabilization and Development *(Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo)* will be created, a trust managed by Banco de Mexico as trustee.

The recent process of structural change involved, besides the reforms mentioned above, modifications to the labor and financial legislation, which did not represent constitutional changes. With respect to the labor reform, enacted on November 29, 2012, the main changes are aimed at reaching higher flexibility in this market by introducing new contractual forms and greater transparency of labor unions.

Regarding the financial reform promulgated on January 9, 2014, the four pursued objectives can be summarized as follows: i) increase competition in the financial sector; ii) promote credit through the development bank, redefining its mandate to grant credit to priority areas of national interest, promote financing to small and medium firms, and support export firms; iii) boost the amount of credit extended by private financial institutions by improving the system and by establishing incentives to expand credit supply and to reduce interest rates; and iv) ensure the soundness and prudence of the financial sector. In this way, this reform will reaffirm the strength of the Mexican financial system. Additionally, in the context of the structural change process, it is expected to facilitate availability of resources that might be necessary for the financing of projects that could arise from the introduction of the remaining reforms mentioned before. Thereby, a more active and solid financial system, together with an impulse to productivity from a microeconomic perspective derived from the approval of a broad set of structural reforms, puts Mexico into a unique position to stand out among emerging economies. This fact is especially relevant given the recent, particularly difficult, international economic environment.

Besides the fact that, as described before, each reform by itself represents progress in the improvement of the institutional framework that will allow increasing country's productivity, it is also possible that synergies arise among them, thereby further stimulating employment, wages and economic growth. The structural reforms will not only result in a more vigorous expansion of the economy, but will also favor an environment of low and stable inflation. Indeed, higher productivity will allow reaching higher aggregate demand and supply growth rates without generating inflationary pressures. This will be more likely given that the mentioned reforms were achieved in an environment of macroeconomic stability. Along these lines, as firms become more productive they will have more degrees of freedom to face uncertain scenarios without having to increase their prices.

In addition to the important progress reached, as is evident from the previous description, this structural change process cannot be considered as fulfilled, since it is still imperative to implement the recently approved reforms adequately. It is important that this challenge is resolved effectively, so that the potential of the reforms to boost growth in the Mexican economy is achieved.

Finally, it should be mentioned that the improvement of the institutional framework should be a permanent objective, always seeking to align economic agents' incentives towards the creation of higher value. In this sense, it is crucial to identify the main causes of inefficient resource allocations that generate lower economic growth. Of course, in addition to the aforementioned, the strengthening of the framework for the conduction of macroeconomic policy should continue. On this regard, it stands out that the benefits of the efforts undertaken in the past years in that direction have been evident in face of recent episodes of uncertainty in international financial markets.

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