



Quarterly Report

April – June 2017

August 30th, 2017



BANCO DE MÉXICO

Outline

1 Monetary Policy and Inflation

2 External Conditions

3 Evolution of the Mexican Economy

4 Forecasts and Final Remarks

Conduction of Monetary Policy

- In recent years, the Mexican economy, and in particular **inflation**, have experienced a number of **shocks of considerable magnitude**, that has caused inflation to reach levels above 6.0 percent in annual terms, after having reached a historic low level in late 2015:
 - ✓ *The **depreciation** that the national currency has accumulated since late 2014.*
 - ✓ *The effects of the **liberalization process of some energy products' prices**.*
 - ✓ *The increase in the **minimum wage** last January.*
 - ✓ *In recent months, increments in **public transport fares** in some cities, and, more recently, in the **prices of some agricultural products**.*

In this context, Banco de México has implemented a **timely strategy**, taking the necessary measures for the **adjustments in relative prices** (derived from the abovementioned sequence of shocks) to take place in an **orderly manner**; this is, that medium- and long-term inflation expectations **remain anchored** and, in this way, provide conditions for the inflation to return to its 3.0 percent target.

In the period analyzed in this Report, Banco de México's Board of Governors raised the reference rate to a level of 7.0 percent in June.

These decisions were aimed to:

25bp increase to 6.75 percent.

May 2017

25bp increase to 7.0 percent.

June 2017

- Reinforce the actions implemented by Banco de México since 2015 in order to anchor inflation expectations.
- Create conditions for the inflation to converge to its 3 percent target by the end of 2018.

Unchanged at 7.0 percent.

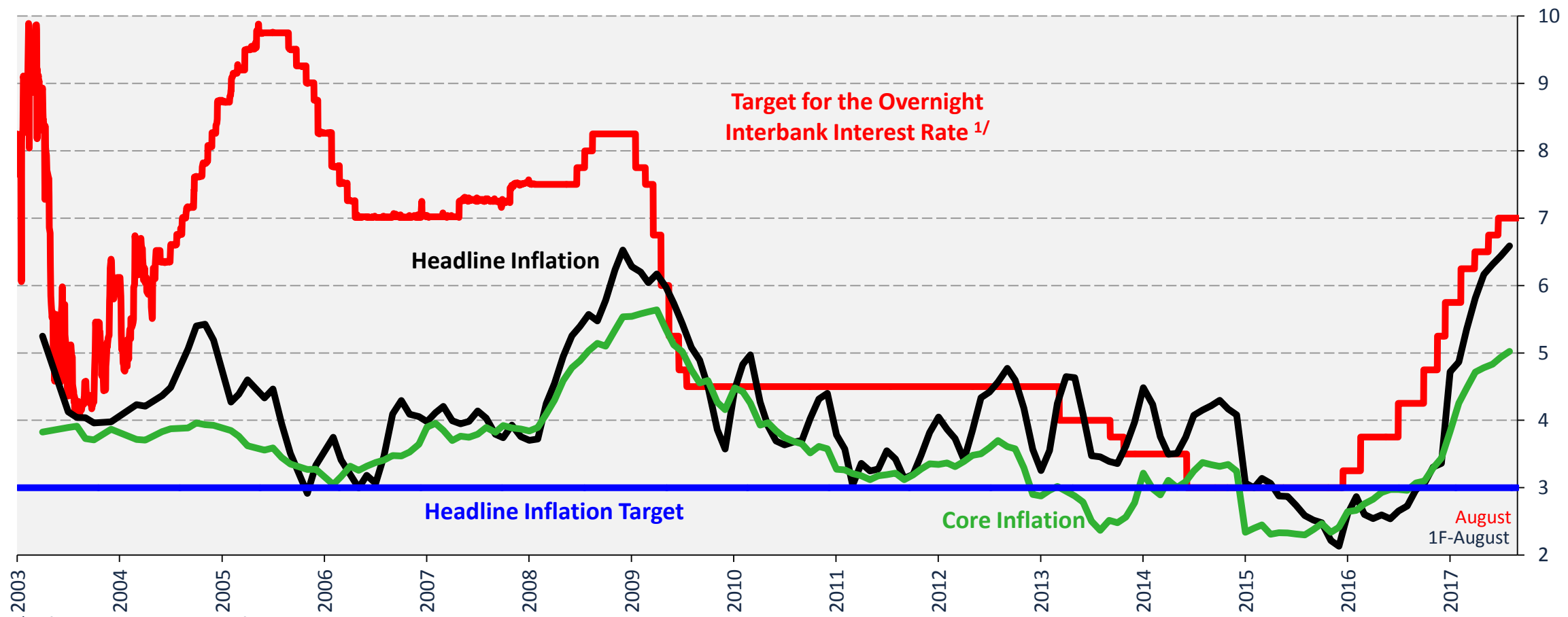
August 2017

- Despite the persisting upward trend in inflation, its growth rate had started to slow down.
- That, based on the information available at that moment, the level of the reference rate achieved at the previous decision appeared to be **congruent with the headline inflation convergence to its 3.0 percent target in late 2018.**

→ These decisions considered that monetary policy actions affect inflation with a considerable lag.

Thus, since December 2015, this Central Institute has increased the target for the overnight interbank interest rate by 400 basis points. With this, Banco de México has been one of the central banks that have tightened their monetary policy stance the most in recent years.

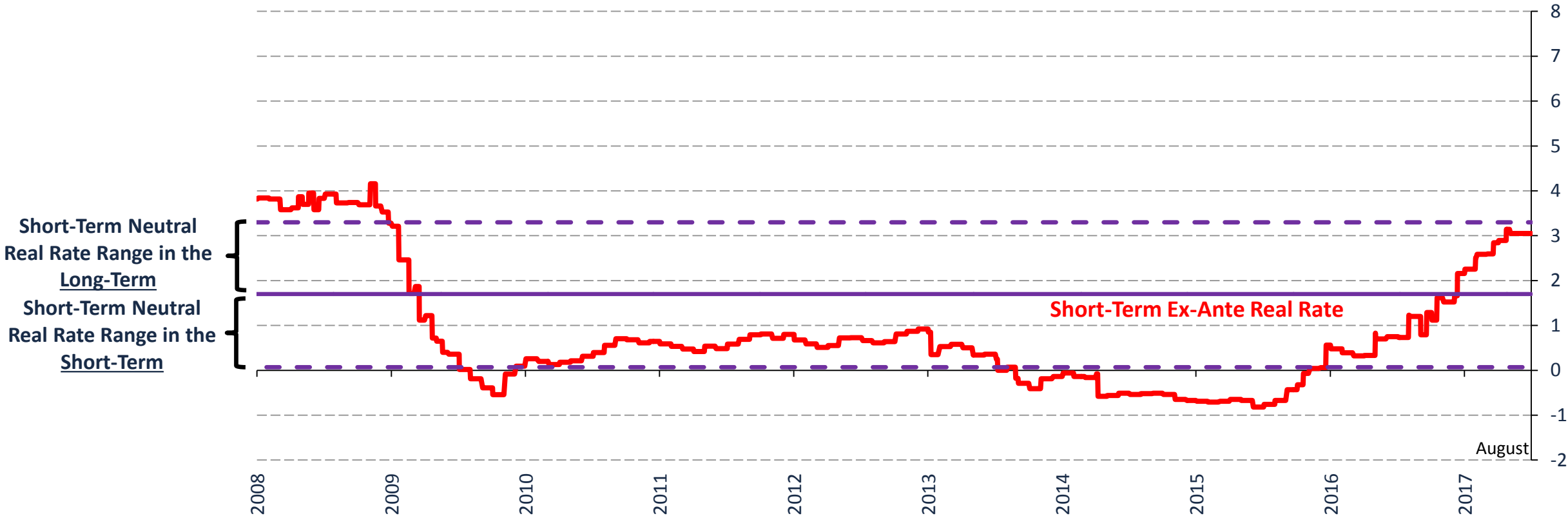
Monetary Policy Rate and Consumer Price Index
% and annual % change



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

This fundamentally constitutes a withdrawal of the monetary stimulus that prevailed during the previous period, as the current short-term ex-ante real rate appears to be close to the neutral level that is expected to be observed in the long term.

Short-Term Ex-Ante Real Rate and Estimated Ranges for the Short-Term Neutral Real Rate
in the Short and Long Terms ^{1/}
%



^{1/} It is constructed using the Target for the Overnight Interbank Interest Rate and 12-month inflation expectations from Banco de México Survey.
Source: Banco de México.

Conduction of Monetary Policy

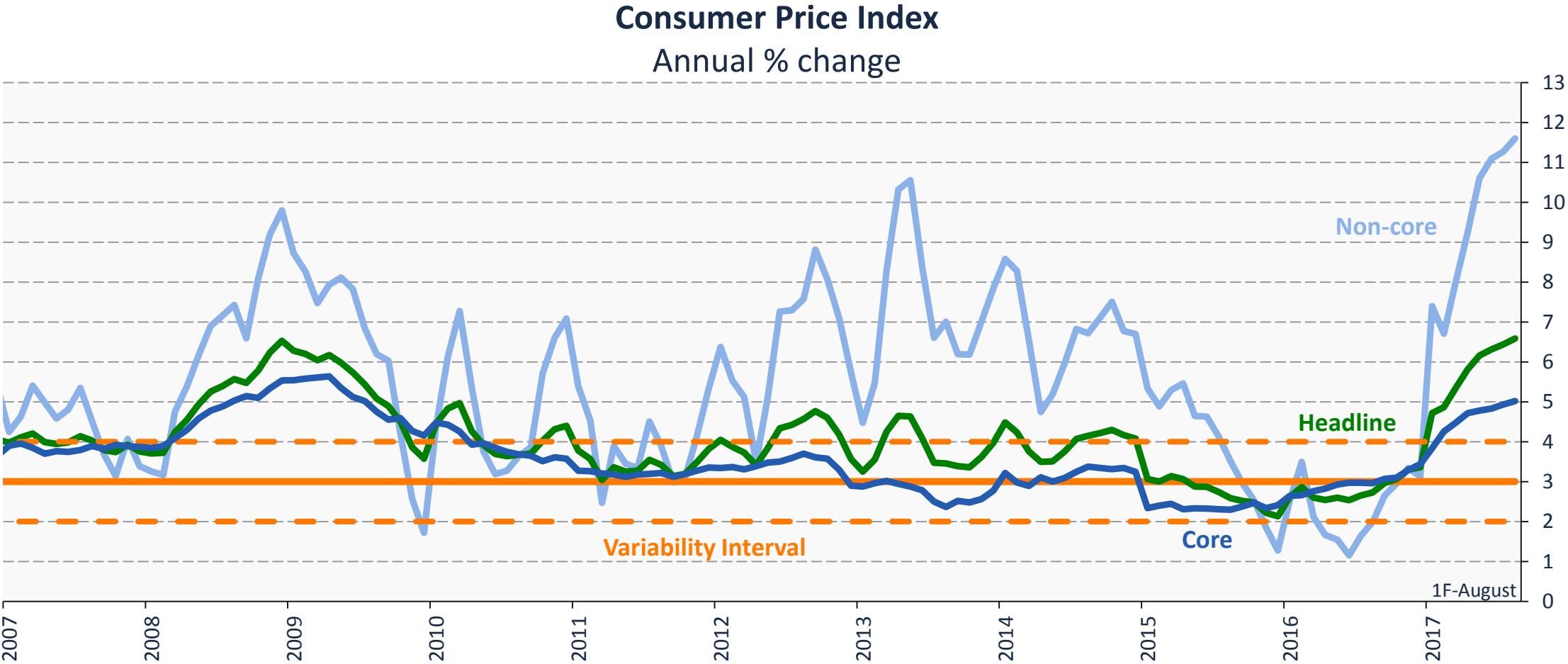
Considering that adjustments in the monetary policy have a lagged effect on inflation, **the monetary policy actions that have been implemented, have started to be reflected in different indicators and components of inflation**, which have recently lowered their growth rate and, even, in some cases, presented a certain reversion in their trend.

- ✓ In this sense, it stands out that the items affected by the initial shocks already present a **change in trend**: most energy prices decreased and non-food merchandise have started to stabilize.

On the other hand, expectations remain congruent with a **transitory increase** in inflation.

Considerable appreciation of the national currency against the U.S. dollar over the last months should be highlighted, as it is **one of the most important** monetary policy transmission channels.

Thus, albeit headline and core inflation kept presenting an upward trend, their growth rate has started to slow down.

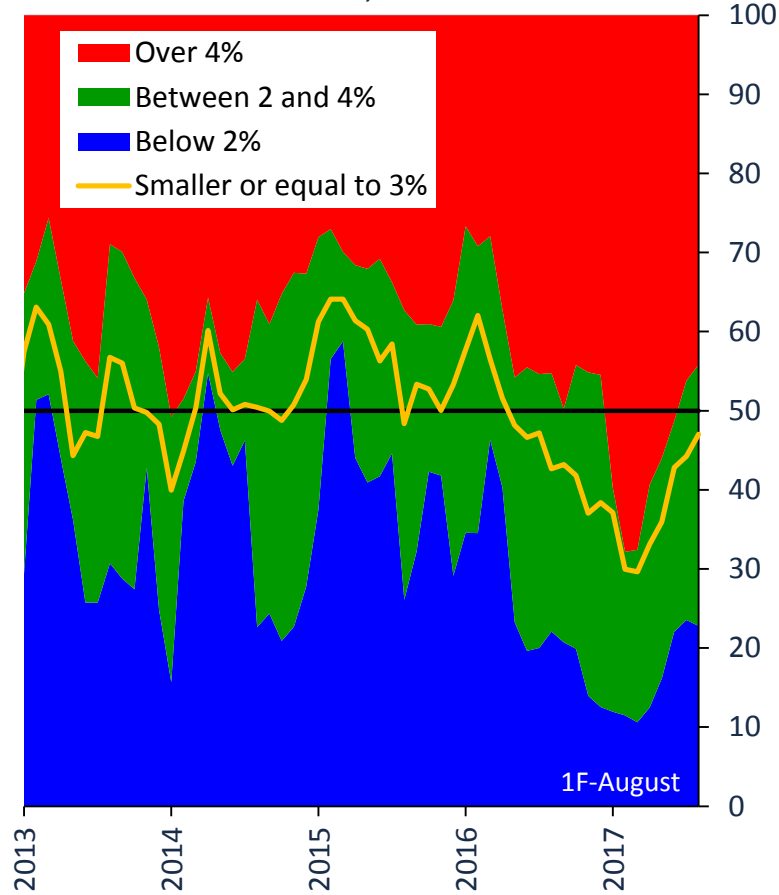


Source: Banco de México and INEGI.

In this sense, different CPI indicators already suggest an improvement in the inflationary process.

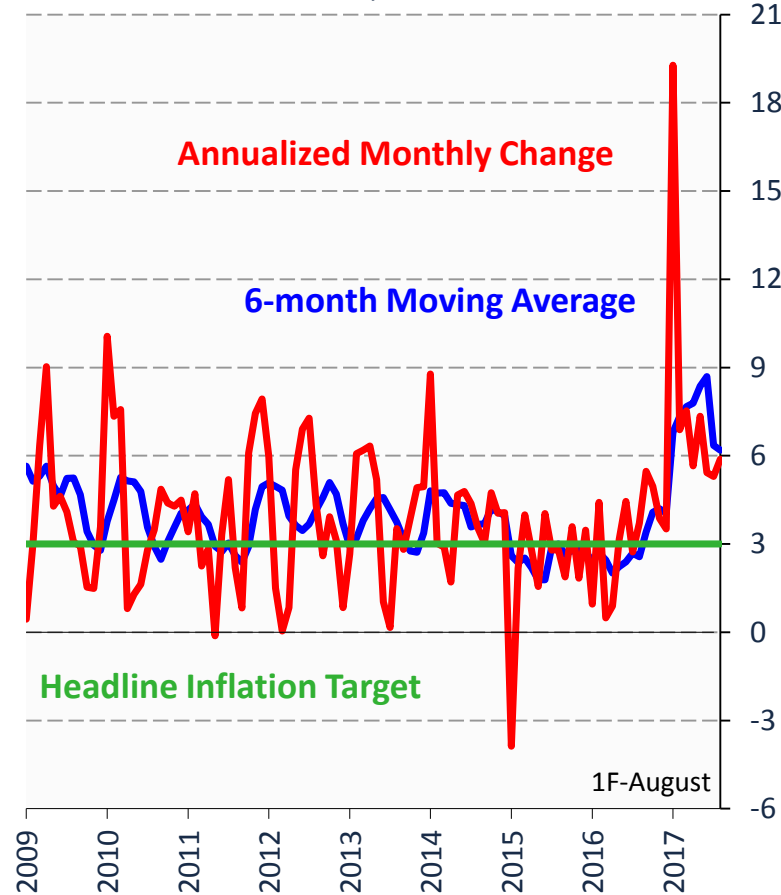
Headline Inflation

Percentage of CPI Basket According to Intervals of Annualized Monthly Increments ^{1/}
%, s. a.



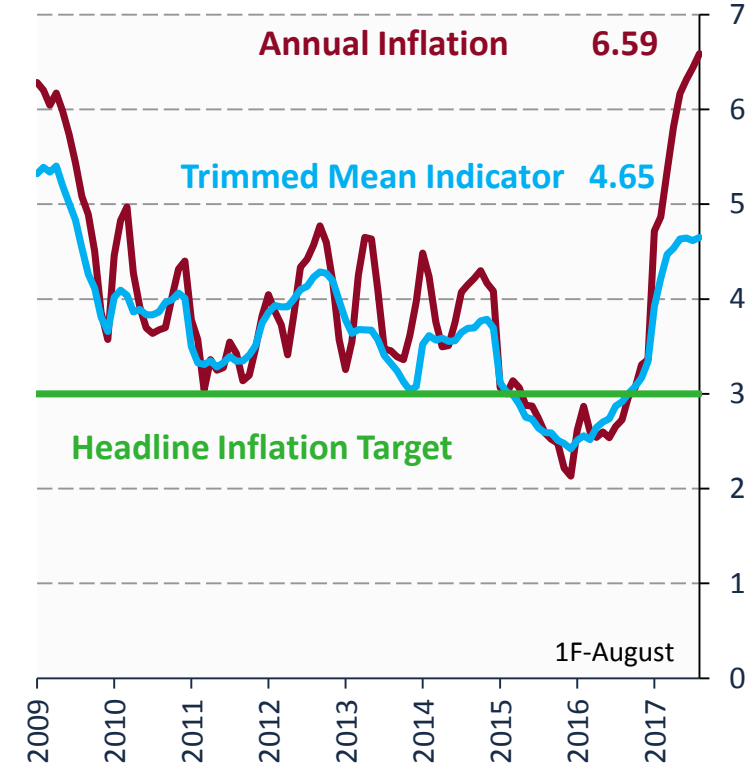
s. a. / Seasonally adjusted data.
1/ 3-month moving average.
Source: Banco de México and INEGI.

Seasonally Adjusted Annualized Monthly Change and Trend
%, s. a.



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

CPI and Trimmed Mean Indicator ^{2/}
Annual % change

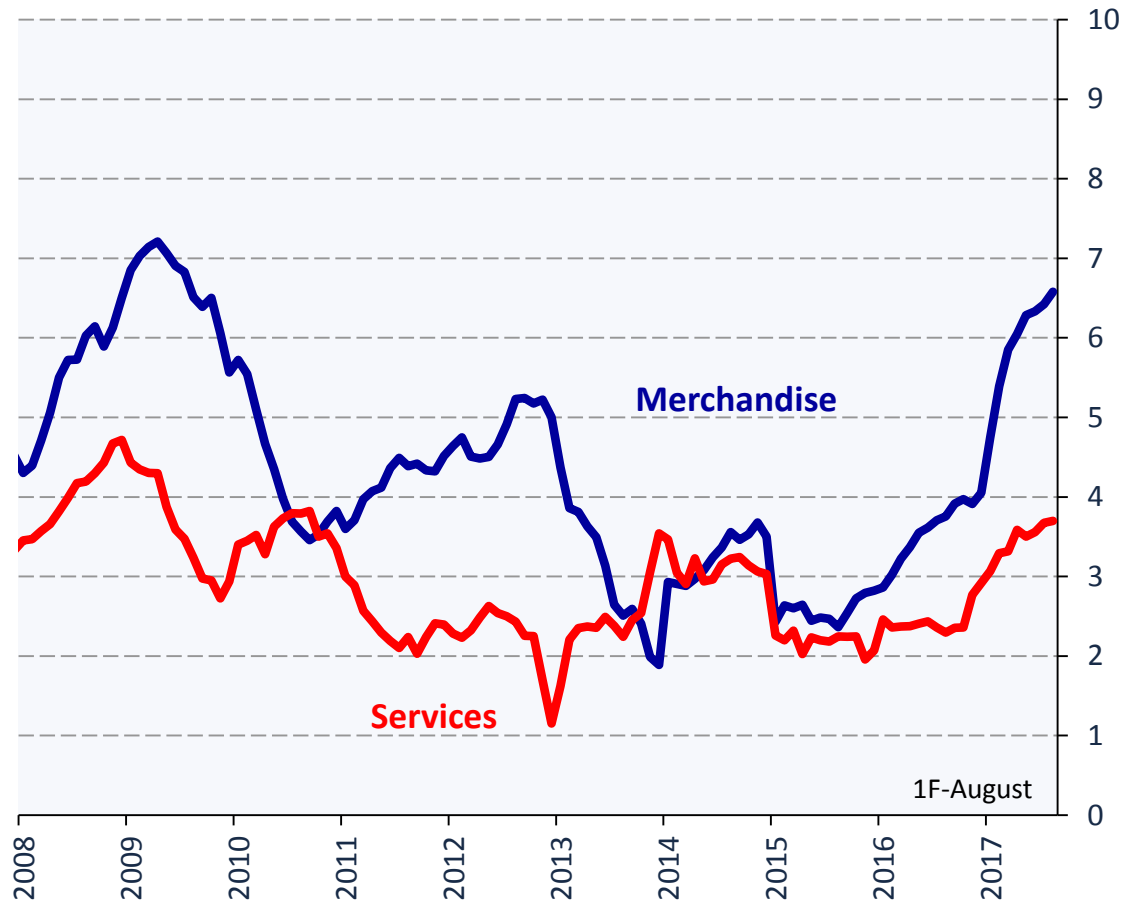


2/ The Trimmed Mean Indicator excludes the contribution of extreme variations in the prices of some generic items from the inflation of a price index. To eliminate the effect of these changes, we conduct the following procedure: i) monthly seasonally adjusted changes of the generic items of the price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

Although core inflation maintains an upward trend, its growth rate starts to moderate, as a result of a certain deceleration in the annual changes of merchandise prices. In particular, the growth rates of non-food merchandise have started to stabilize.

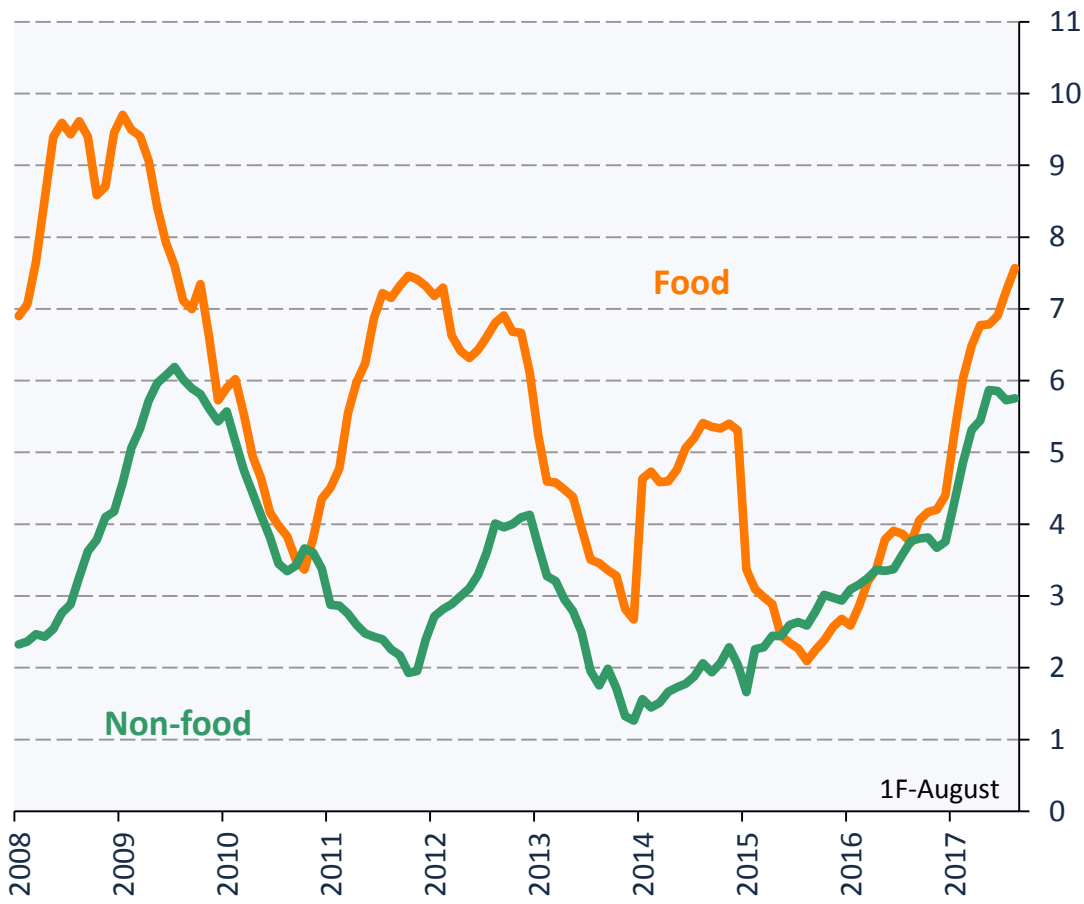
Core Price Index
Annual % change

Merchandise and Services



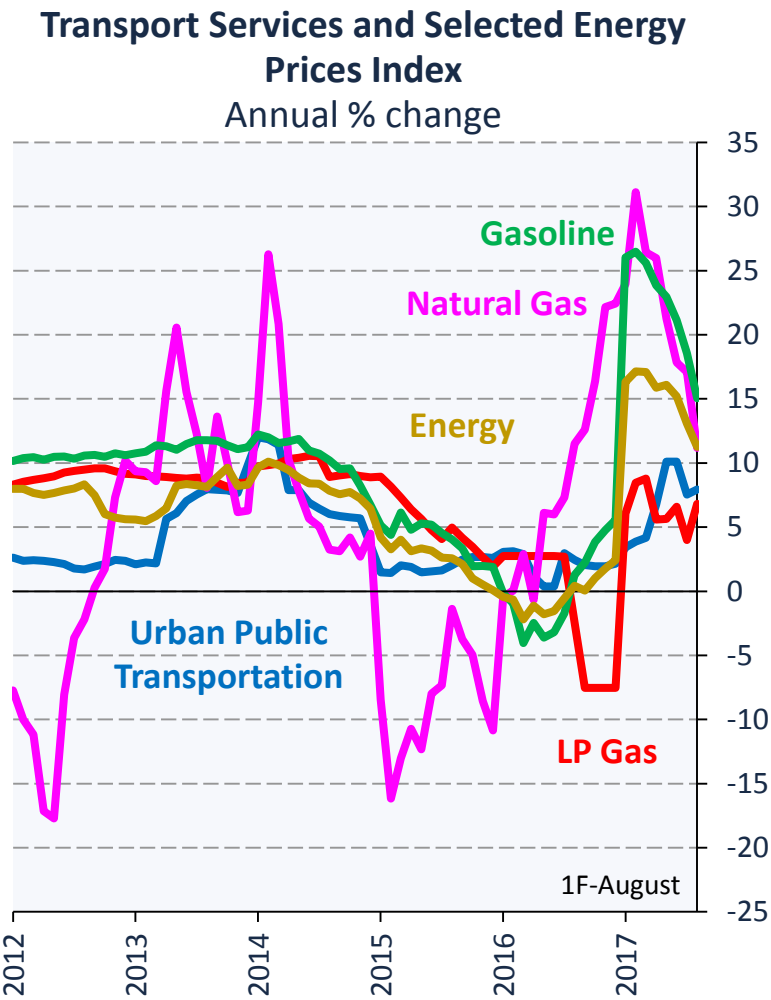
Source: Banco de México and INEGI.

Merchandise

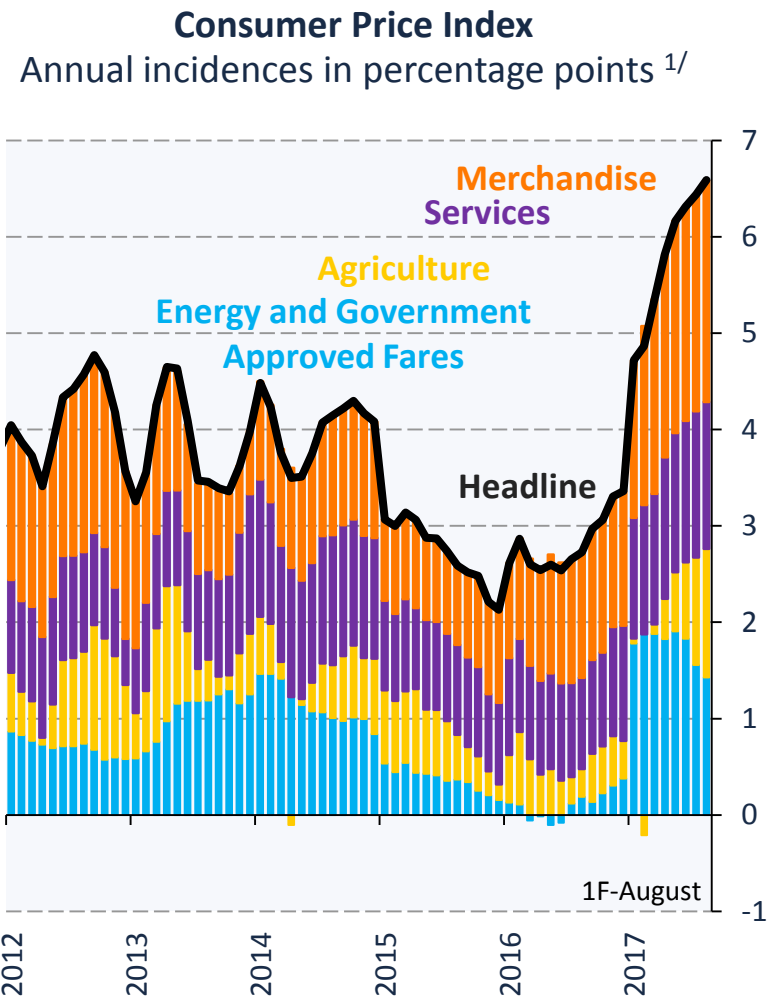


Source: Banco de México and INEGI.

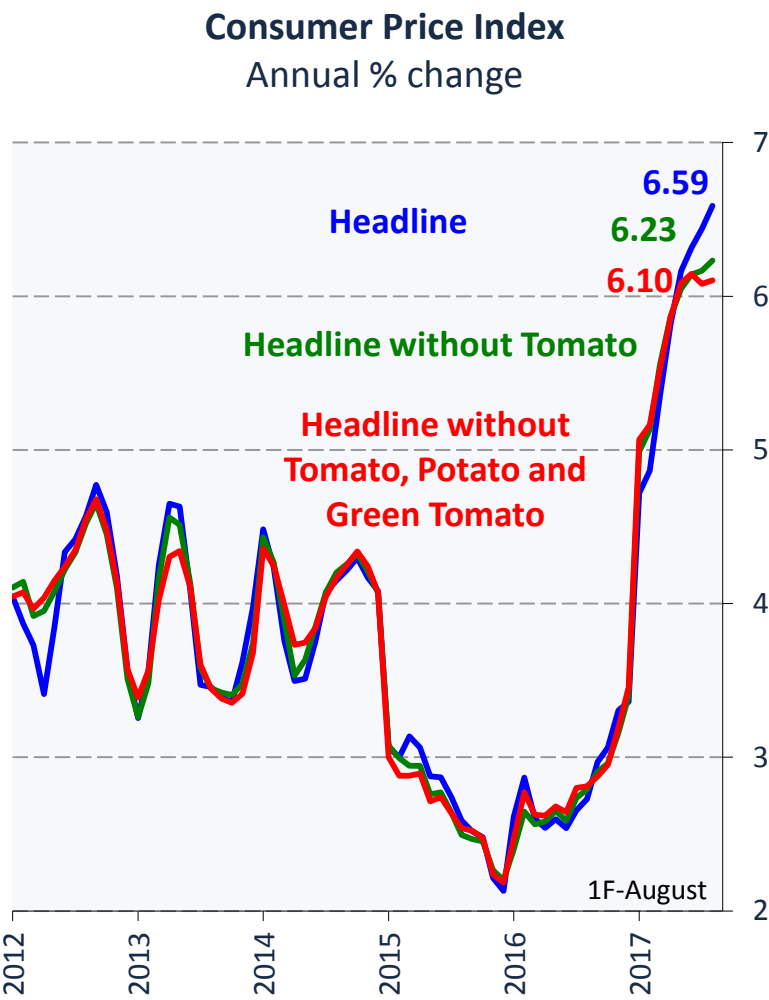
Non-core inflation received a further boost, as a consequence of the recent price increments in agricultural products and increases in public transport fares in some cities. If the items of tomato, potatoes and green tomato were excluded from the CPI, annual headline inflation would be 6.10 percent in the first fortnight of August.



Source: Banco de México and INEGI.



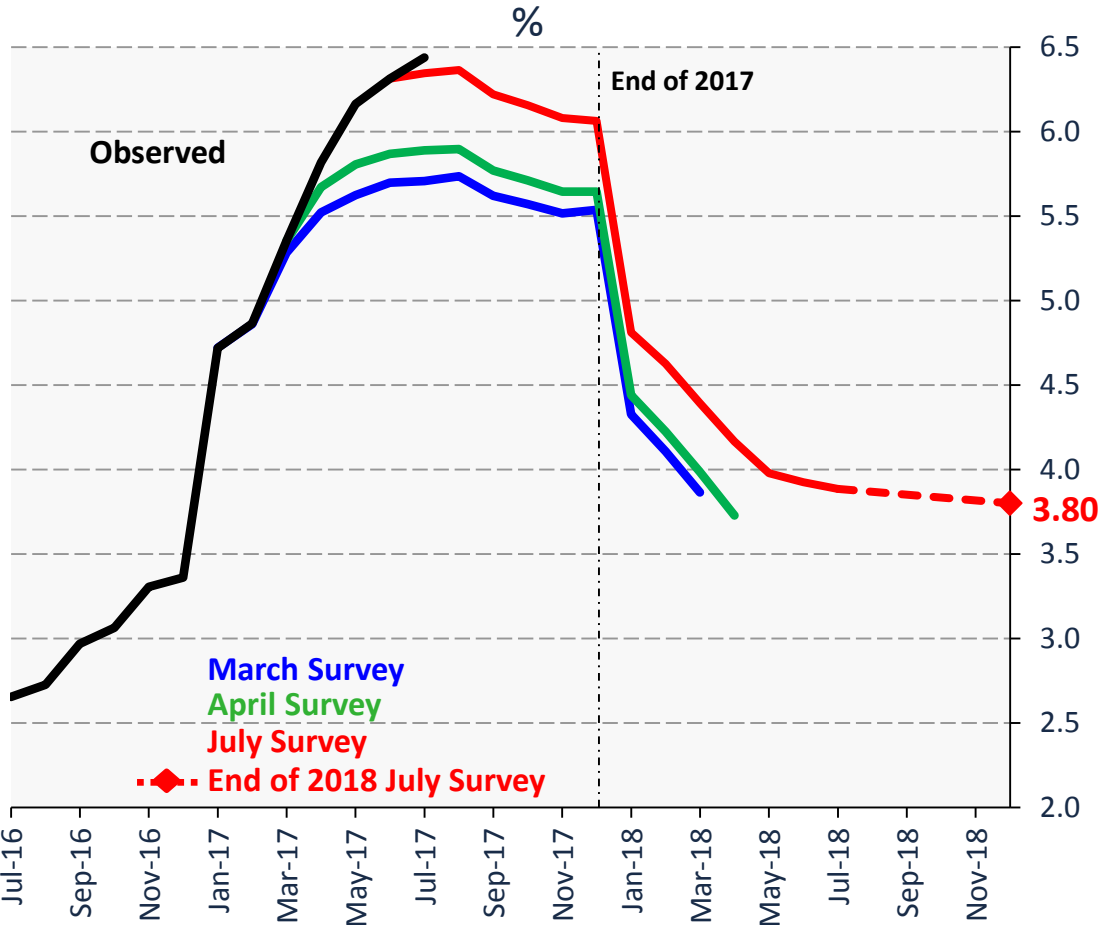
1/ In some cases the sum of the respective components may have some discrepancy due to rounding effects.
Source: Elaborated by Banco de México with data from INEGI.



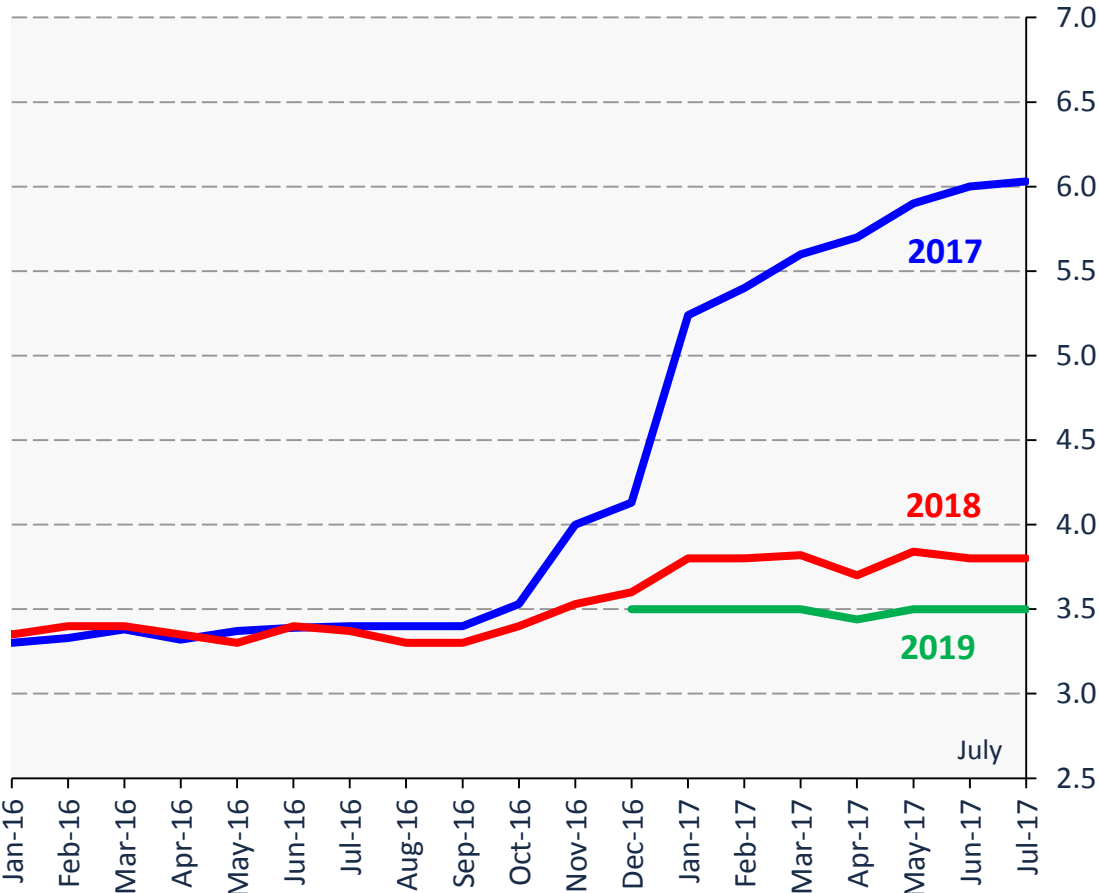
Source: Banco de México and INEGI.

Even though inflation expectations for the end of 2017 derived from surveys kept observing upward adjustments, those corresponding to 2018 and 2019 have remained stable, which is still congruent with a transitory increase in inflation.

Annual Headline Inflation Implicit in Monthly Inflation Expectations



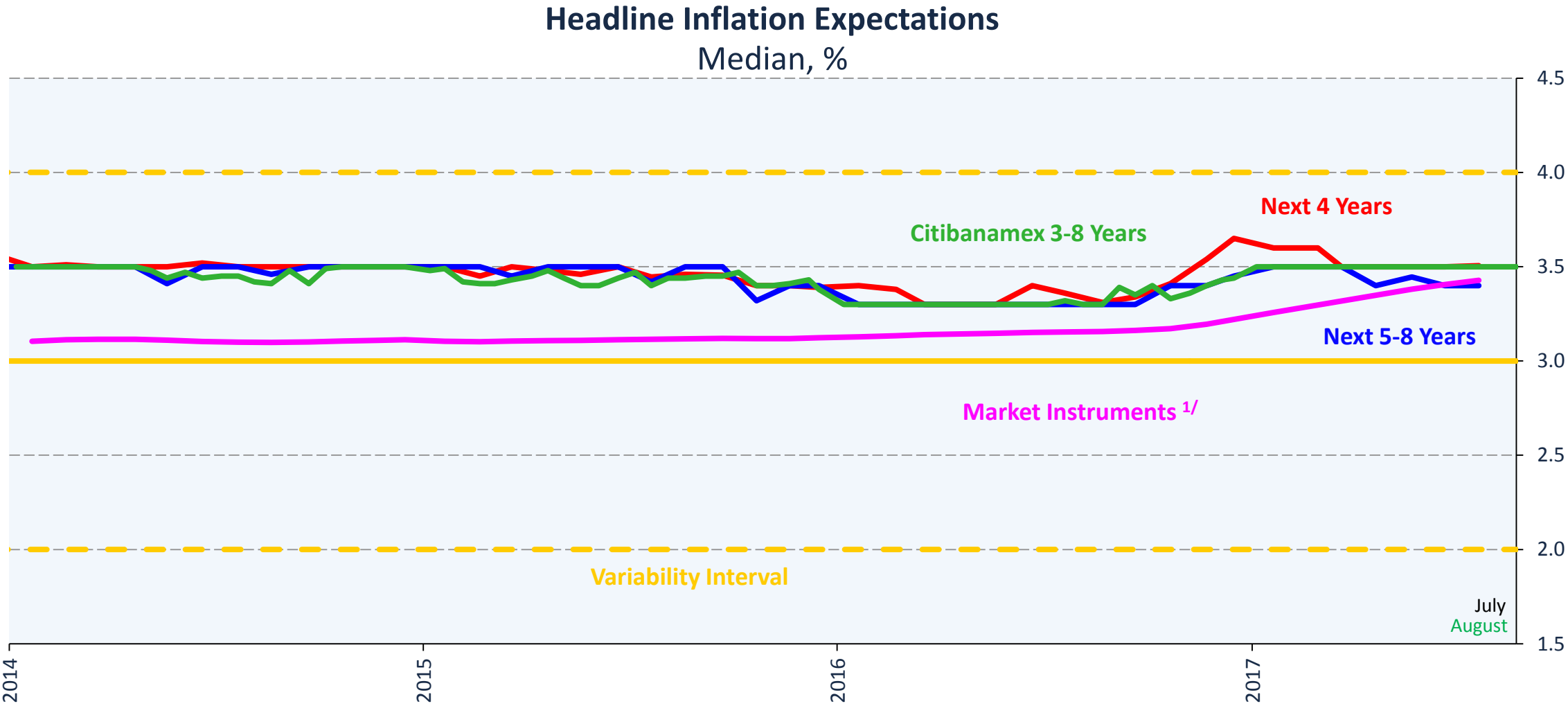
Annual Headline Inflation Expectations
Median, %



Source: Banco de México Survey, INEGI.

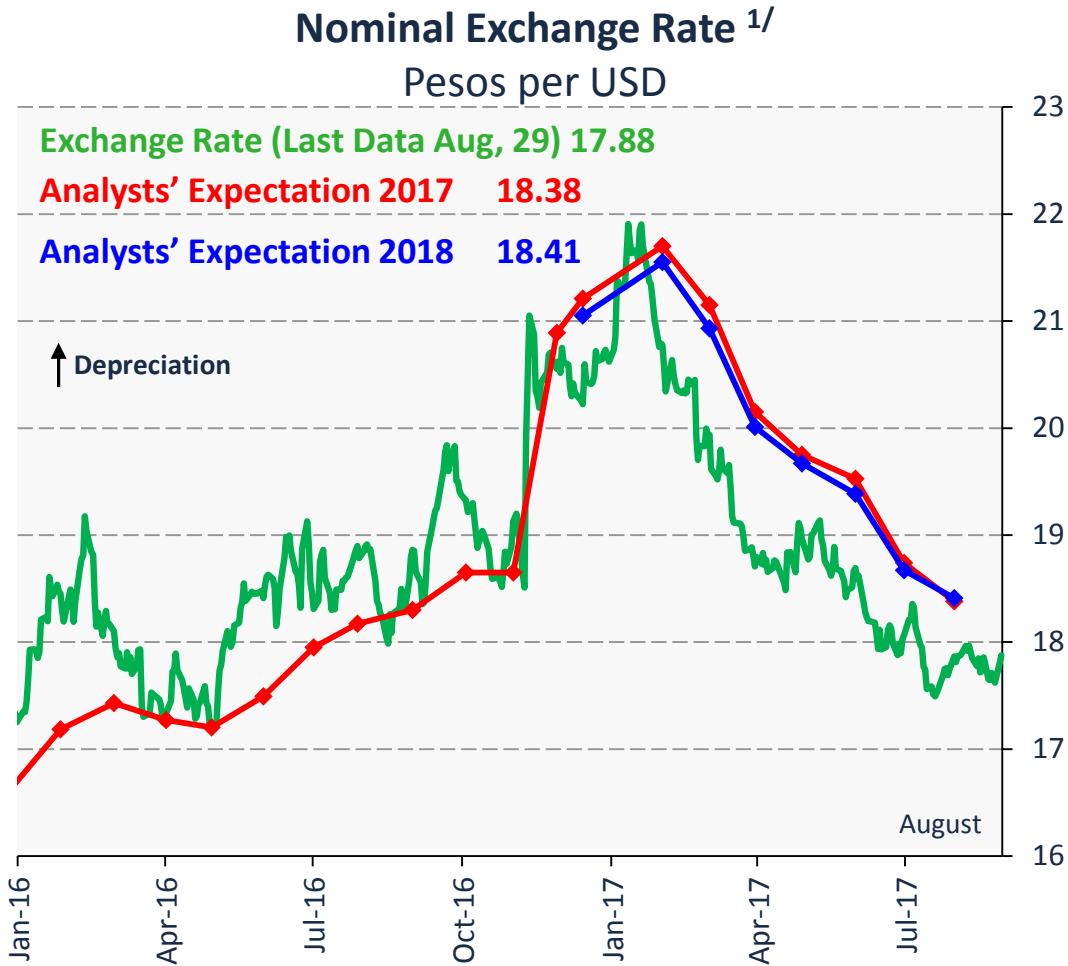
Source: Banco de México Survey.

Meanwhile, longer-term expectations remained anchored.

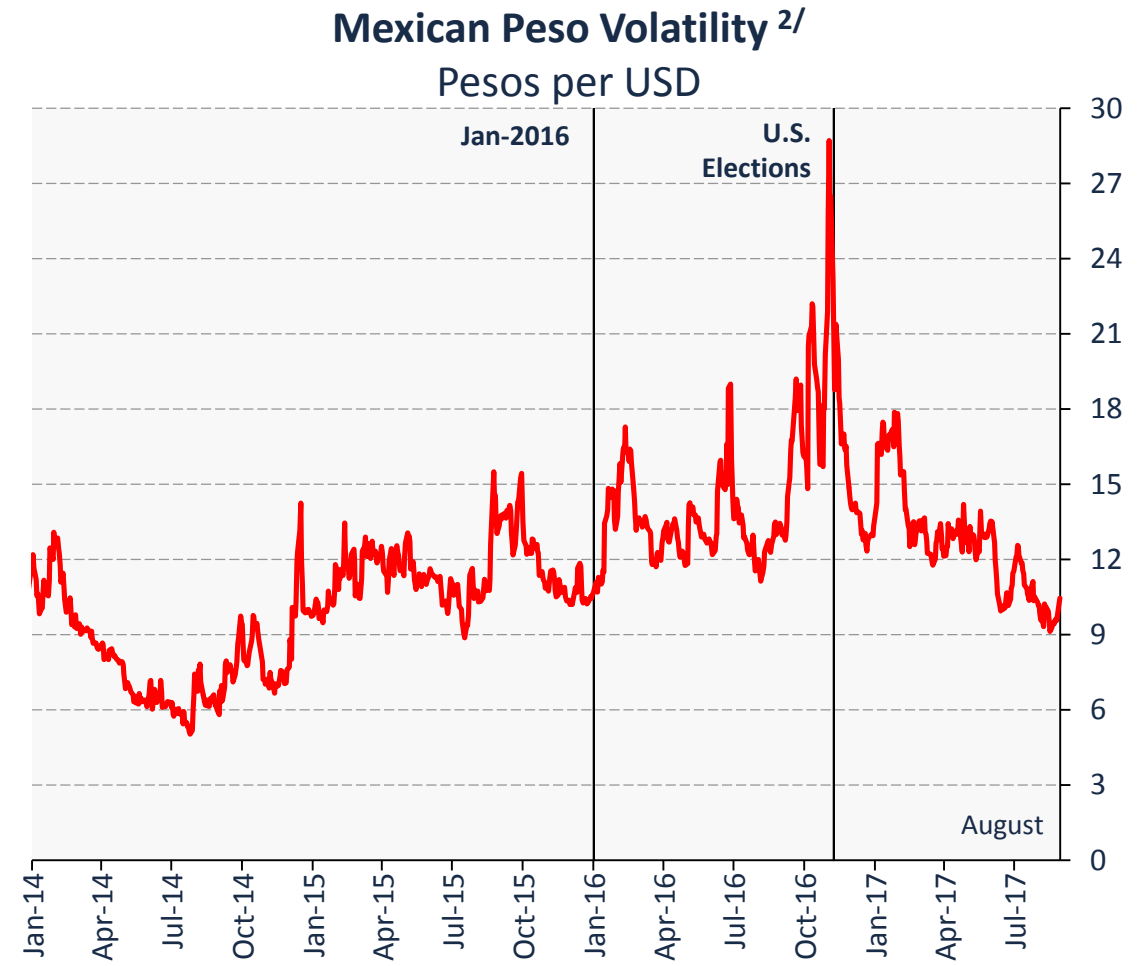


1/ For a description of the estimation of log-term inflation expectations, see the Box “Decomposition of Break-even Inflation” in the Quarterly Report, October – December 2013.
Source: Banco de México Survey (monthly periodicity) and Citibanamex Survey (biweekly periodicity).

The Mexican peso reduced its volatility and registered an additional appreciation. This was largely a reflection of the monetary policy actions, as well as of the improved perception of the bilateral Mexico-U.S. relationship and a more favorable international financial environment. Likewise, the actions implemented by the Foreign Exchange Commission contributed to improve the operating conditions in this market.

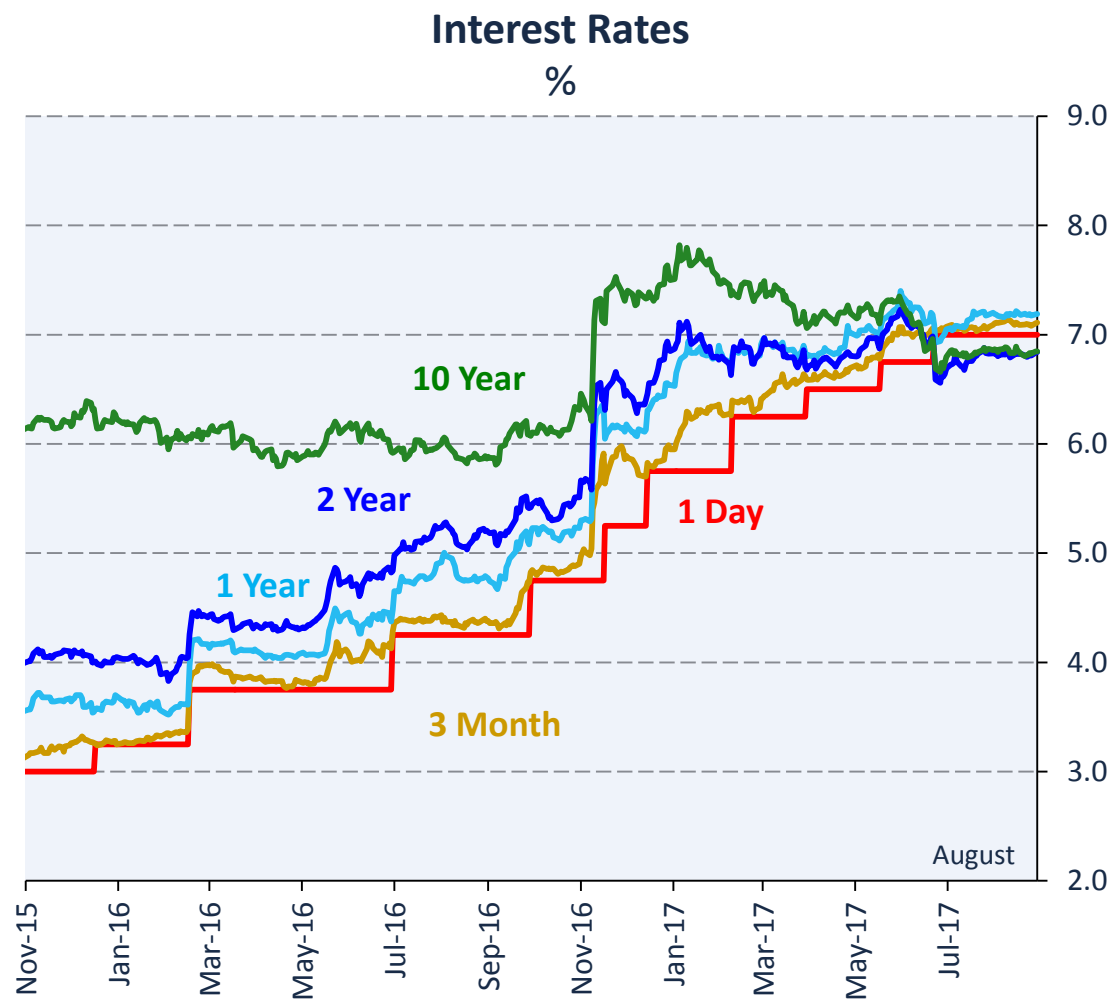


1/ Observed exchange rate refers to the daily FIX Exchange Rate. Expectations refer to the average of Banco de México Survey from July.
Source: Banco de México.

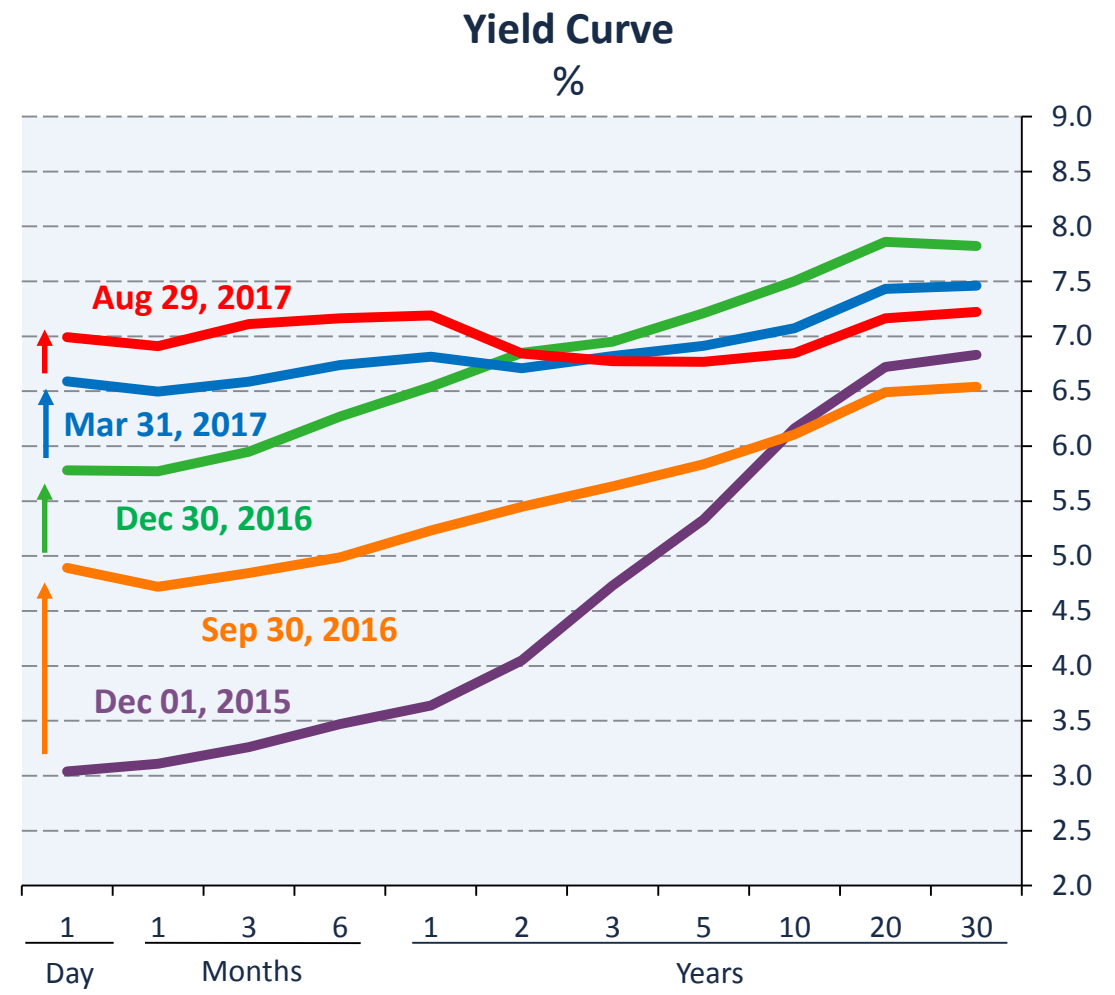


Note: The black lines correspond to January 1st, 2016 and November 8, 2016.
2/ It refers to implied volatility in one-month options.
Source: Banco de México.

Short-term interest rates increased, reflecting increments in the reference rate, while longer-term ones declined in view of the anchoring of medium- and long-term inflation expectations in Mexico, the reduction in the inflation risk premium, the decrease in long-term U.S. rates and an environment of greater appetite for risk.



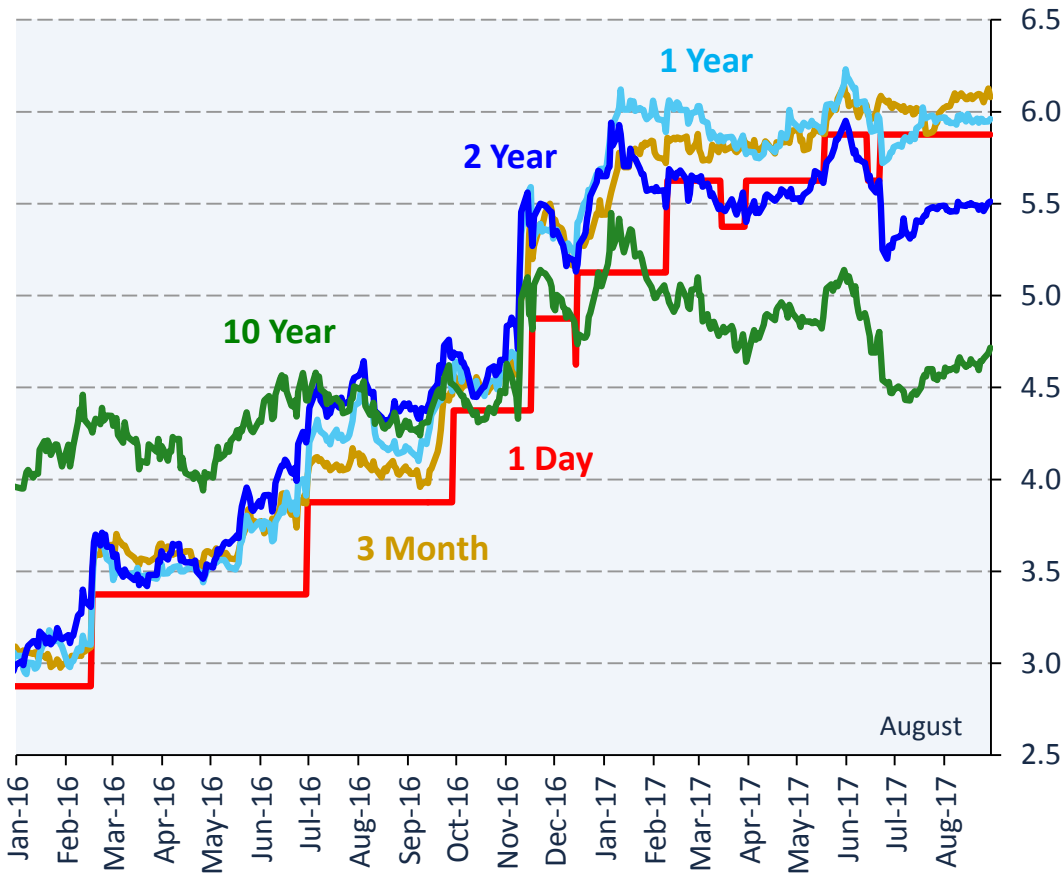
Source: Banco de México and Proveedor Integral de Precios (PiP).



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

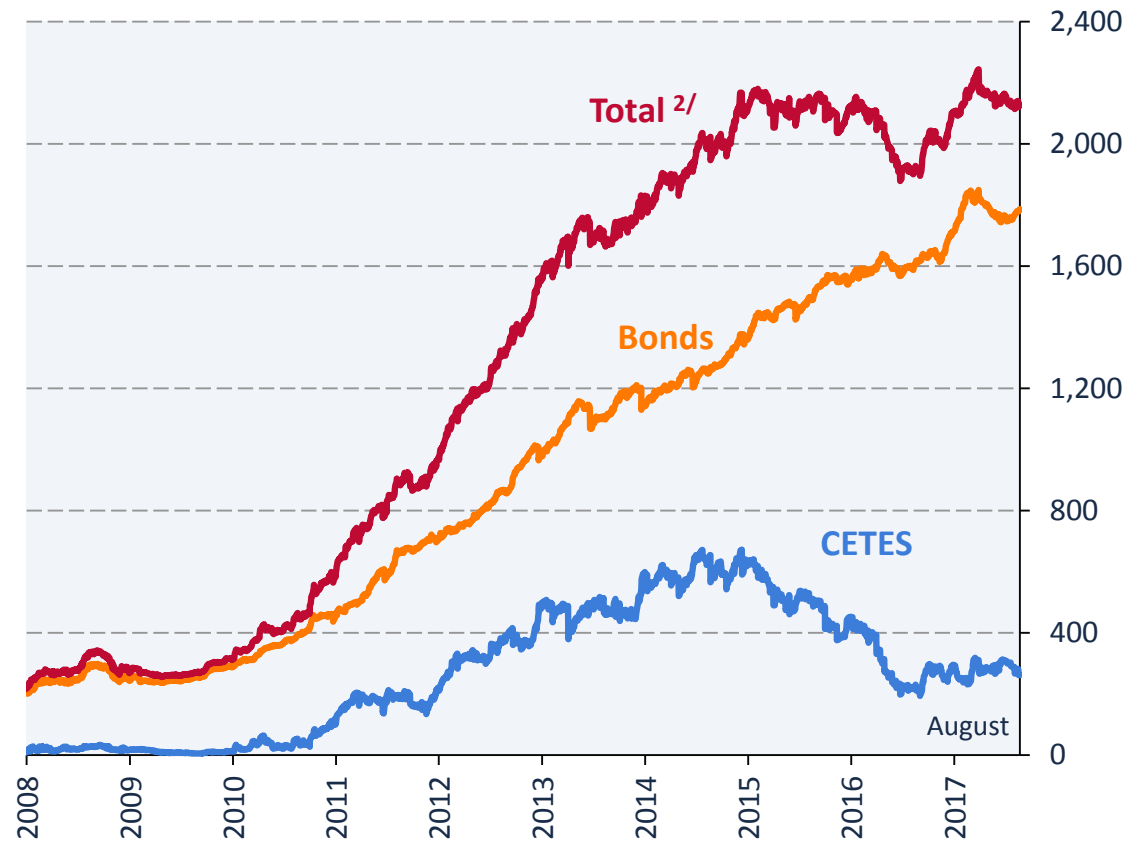
Mexico and U.S. interest rate spreads increased in their short-term horizons and slightly declined in the medium and long terms. In this context, bonds' holdings by foreign investors remain in high levels.

Mexico and United States Interest Rate Spreads ^{1/}
%



1/ The United States objective rate is the average of the interval considered by the Federal Reserve.
Source: Banco de México, Proveedor Integral de Precios (PiP), and U.S. Treasury Department.

Mexico: Government Securities' Holdings by Foreign Investors
MXN billion



2/ The total includes CETES, bonds, udibonos, bondes and bondes D.
Source: Banco de México.

Outline

1 Monetary Policy and Inflation

2 External Conditions

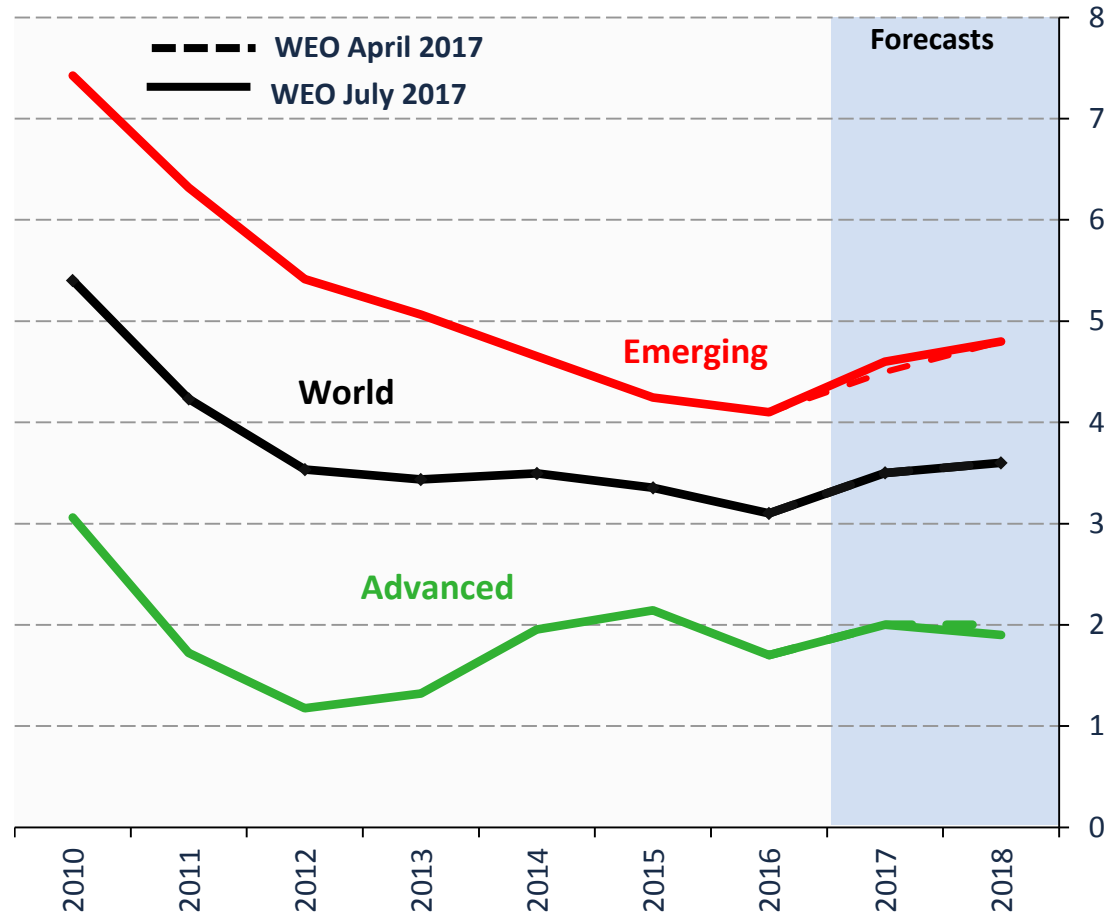
3 Evolution of the Mexican Economy

4 Forecasts and Final Remarks

World economic activity kept expanding at a moderate rate across countries and regions. This performance has been reflected in the favorable evolution of some indicators, such as international trade.

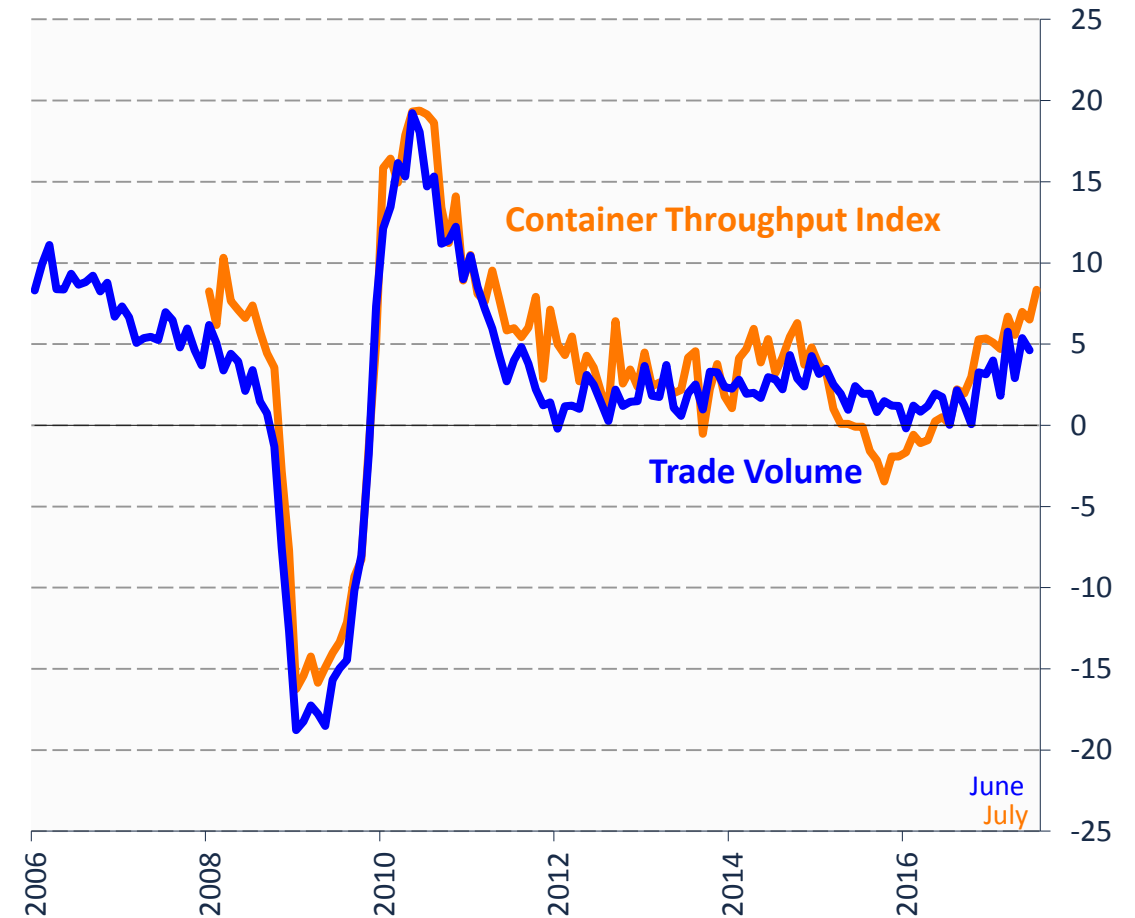
World Economy

GDP Growth Forecasts
Annual % change



Source: FMI, WEO April and July 2017.

Trade of Goods ^{1/}
Annual % change, s. a.

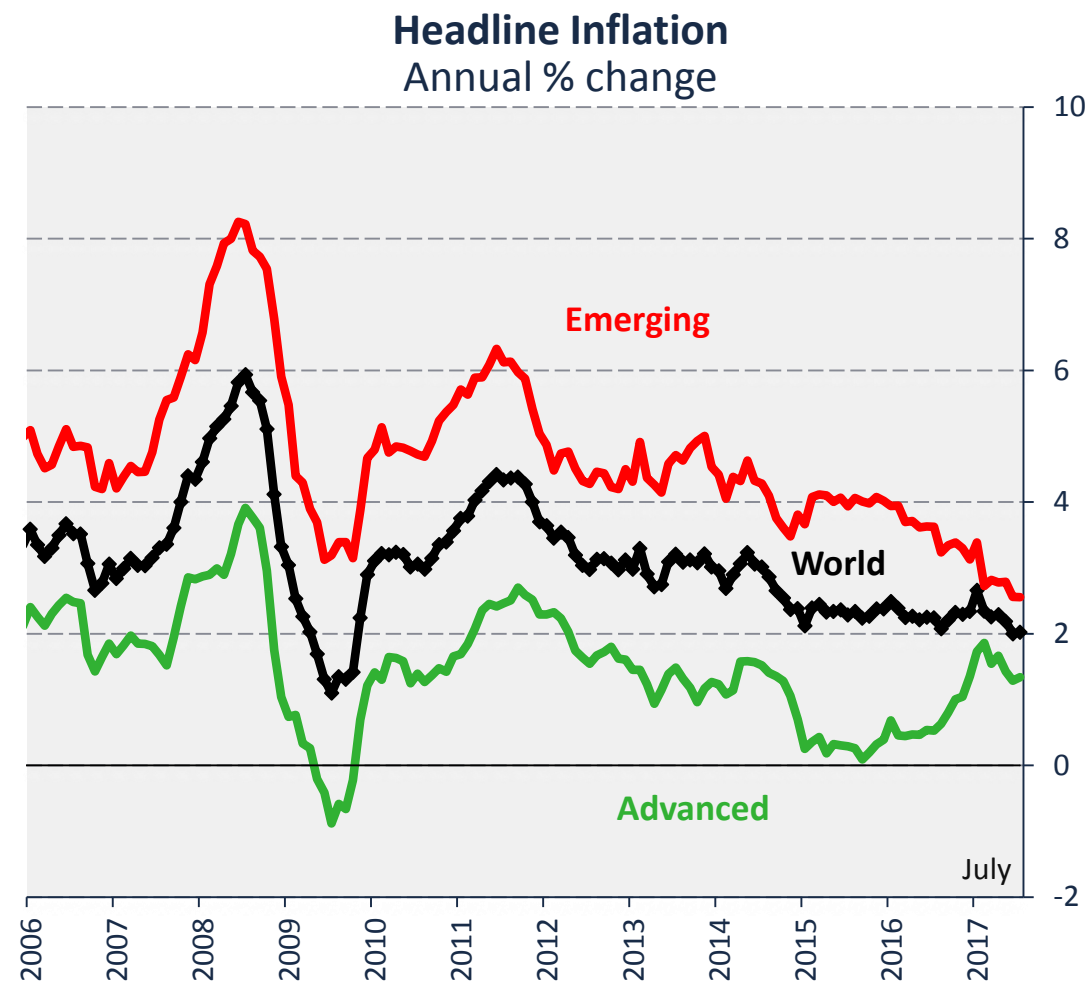


s. a. / Seasonally adjusted data.

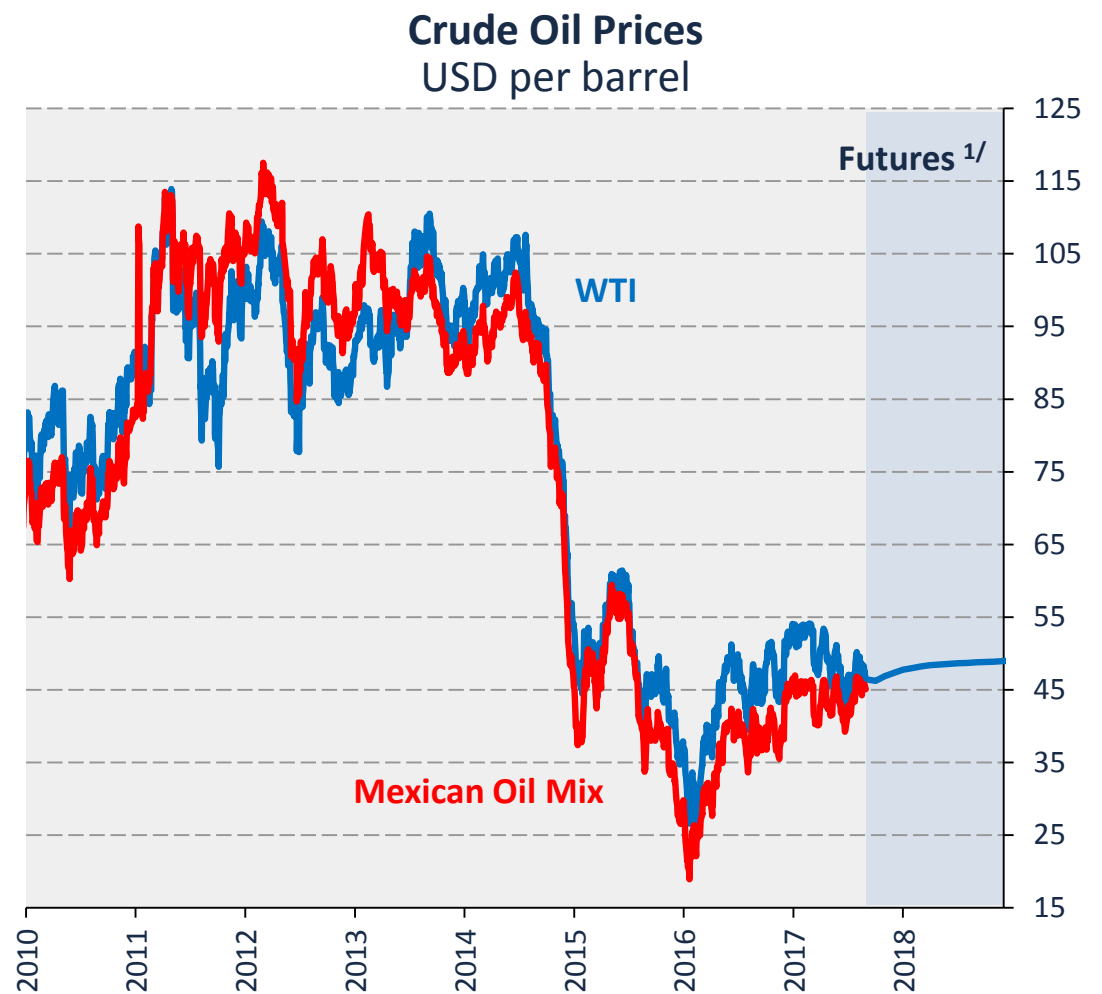
^{1/} It refers to the sum of imports and exports.

Source: Institute of Shipping Economics and Logistics, and CPB Netherlands.

Meanwhile, global inflation has remained low in recent months. In most advanced economies, it persisted below their targets, due to lower energy prices, absence of wage-related pressures and, in some cases, decreases in some prices whose effects are considered transitory.



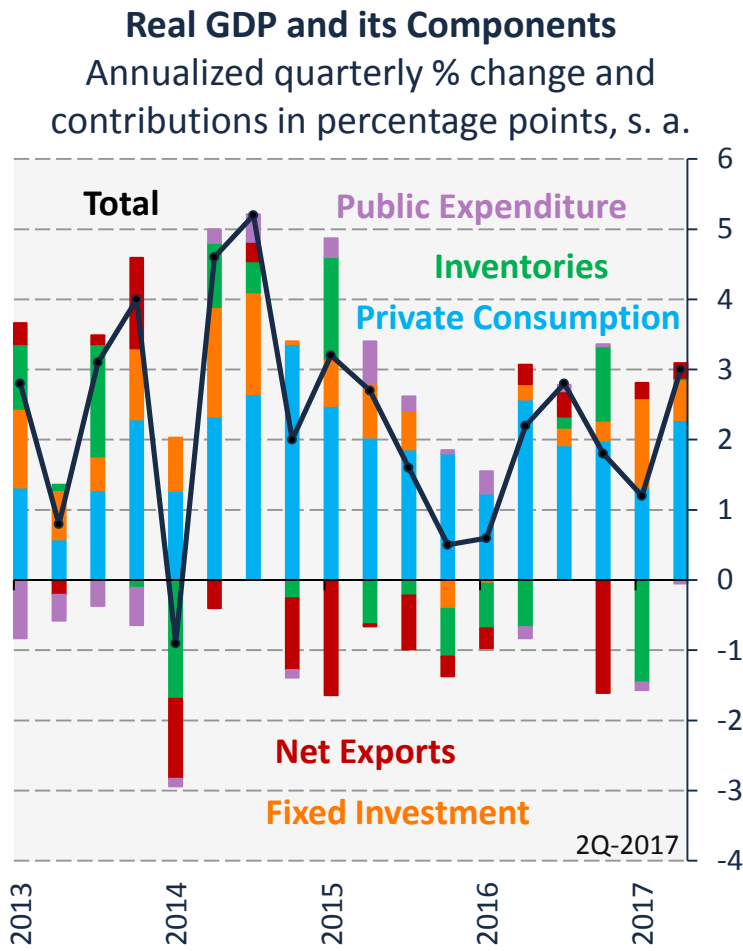
Note: The sample of countries used for the calculation represents the 83.2% of world GDP, measured by the purchasing power parity.
Source: Elaborated by Banco de México with data from Haver Analytics and IMF.



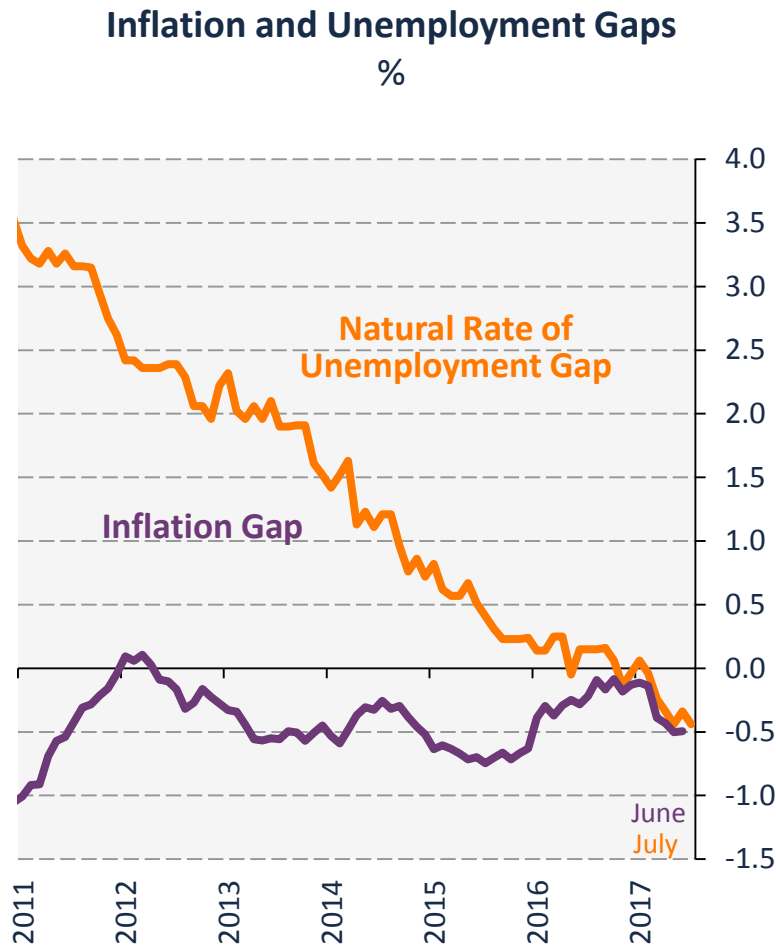
1/ Data up to August 29, 2017.
Source: Bloomberg.

U.S. GDP showed greater dynamism and its labor market kept strengthening. On the other hand, the consumption expenditures price index decreased, although this weakness could be transitory.

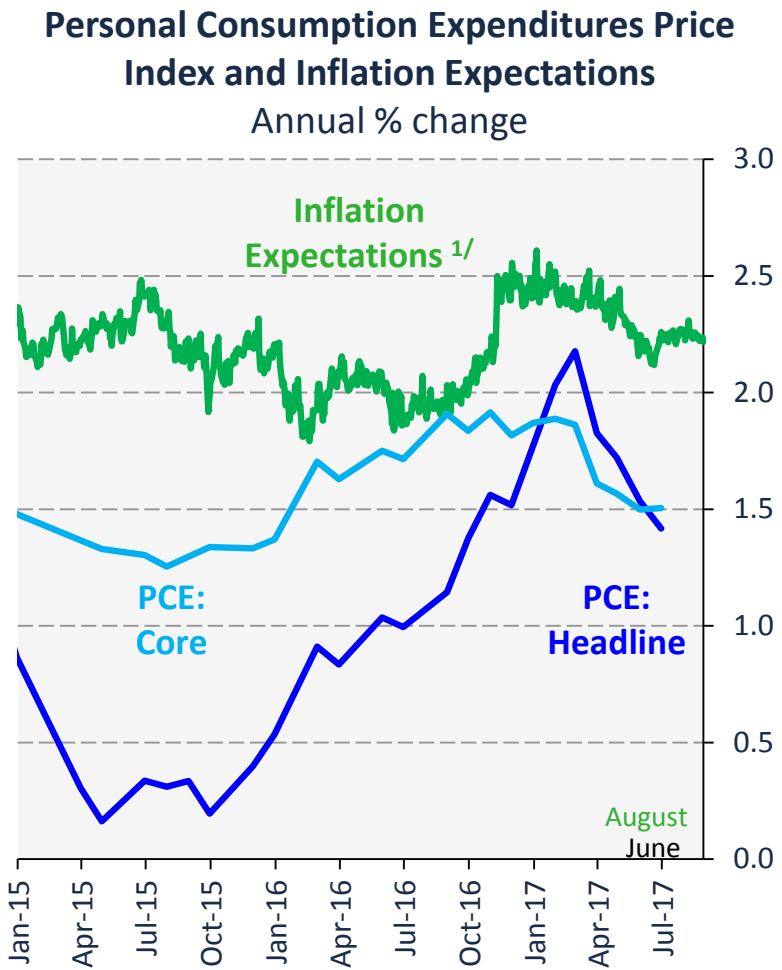
United States



s. a. / Seasonally adjusted data.
Source: Bureau of Economic Analysis.



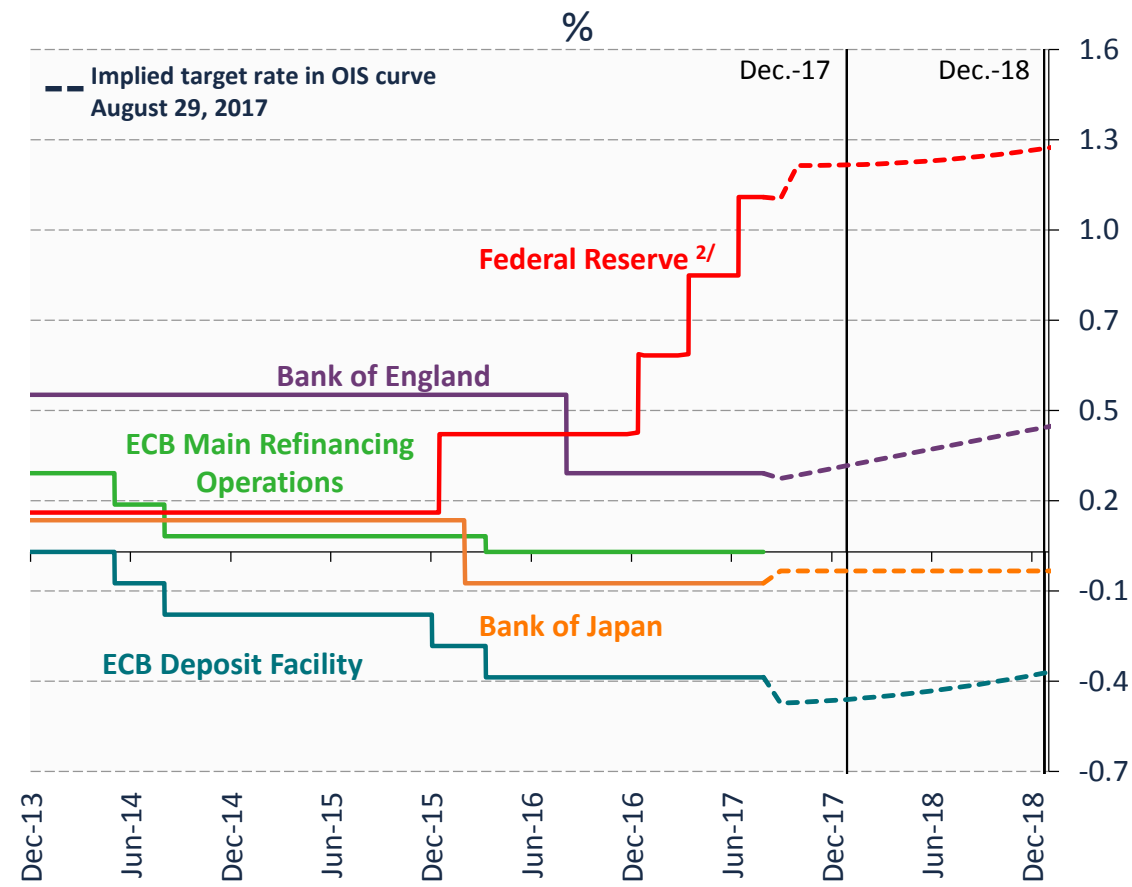
Note: Inflation gap refers to the PCE core component and is relative to the Federal Reserve 2% objective. Unemployment gap is relative to the natural rate of unemployment estimated by the CBO.
Source: U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office (CBO).



1/ Expected inflation over the five-year period that begins five years from today. Obtained from swap contracts in which one counterparty agrees to pay a fixed rate in exchange for receiving a referenced payment at an inflation rate over a specified period.
Source: Bloomberg and Bureau of Economic Analysis.

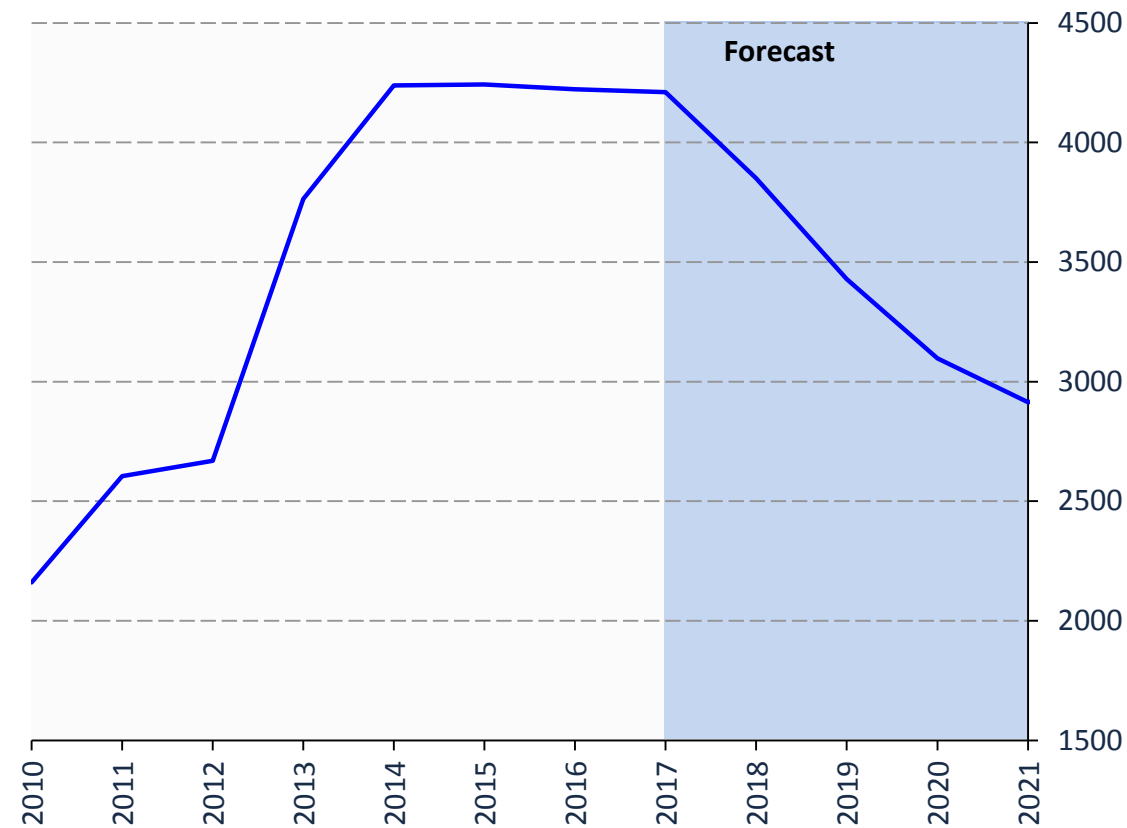
In this environment of persisting weakness of inflation and its expectations in advanced economies, it is expected a gradual withdrawal of the extraordinary monetary stimulus and then, slowly reach a more neutral stance.

Advanced Economies: Expected Monetary Policy Rates Implicit in OIS Curve ^{1/}



1/ OIS: Fixed-For-Floating swap where the fixed interest rate is the reference rate.
2/ Data for the observed federal funds rate corresponds to the average between the lower and upper bounds of the range (1.00% - 1.25%).
Source: Banco de México with data from Bloomberg.

Federal Reserve: Balance Sheet ^{3/}
USD Billions



3/ The forecasts are based on the median expected terminal value of the liabilities in the Federal Reserve balance sheet, which come from the Survey of Primary Dealers released in June 2017, assuming that the unwinding of the balance sheet starts in October 2017.
Source: Federal Reserve Bank of New York and Survey of Primary Dealers.

Outline

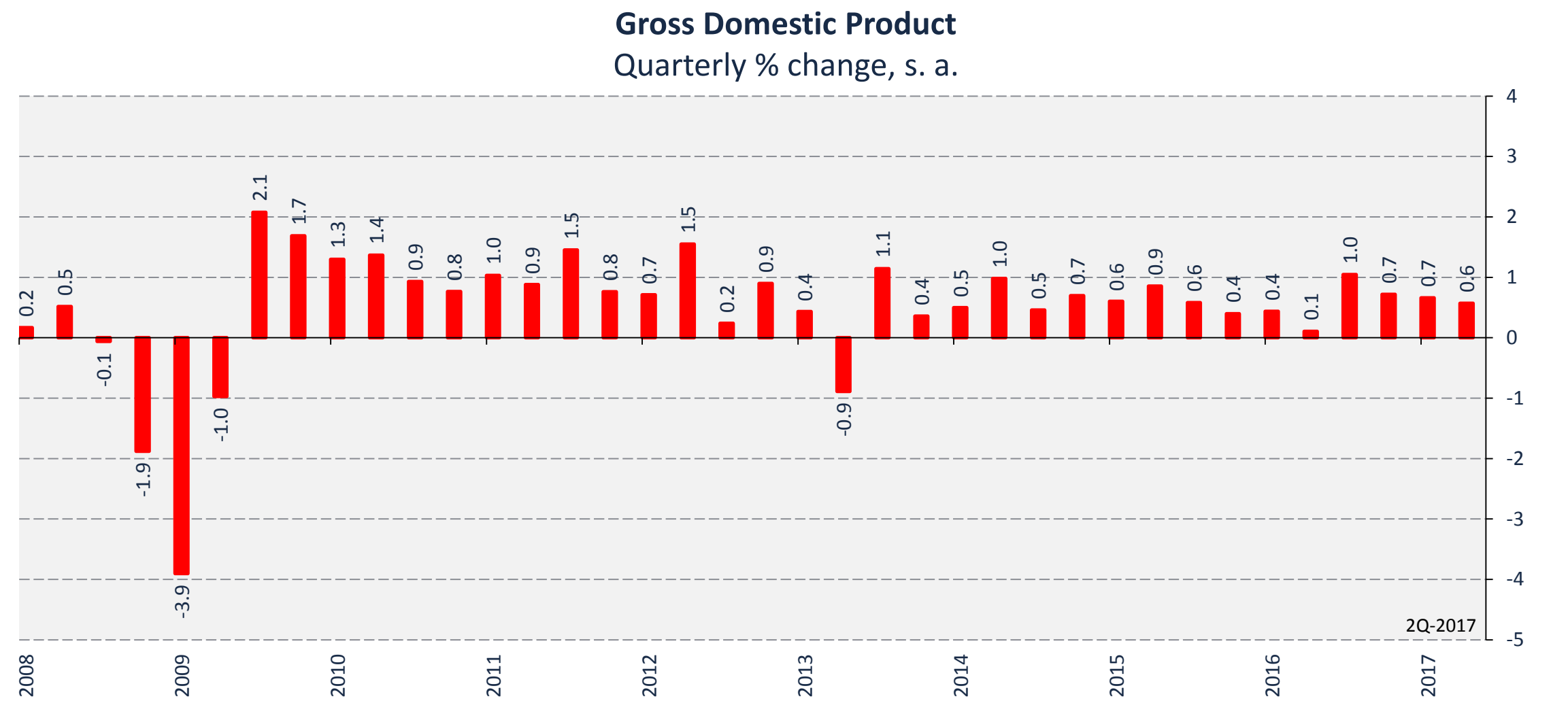
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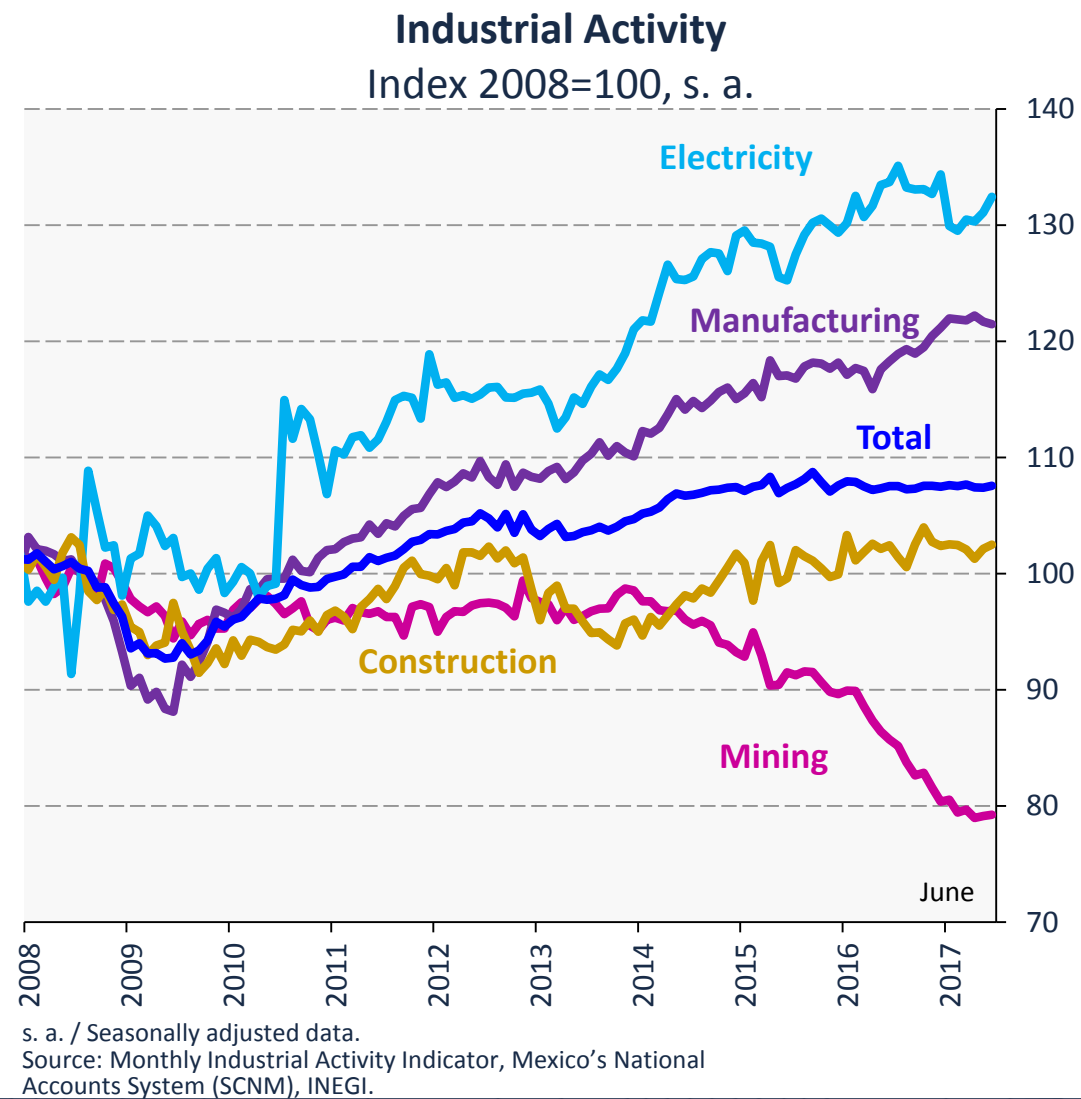
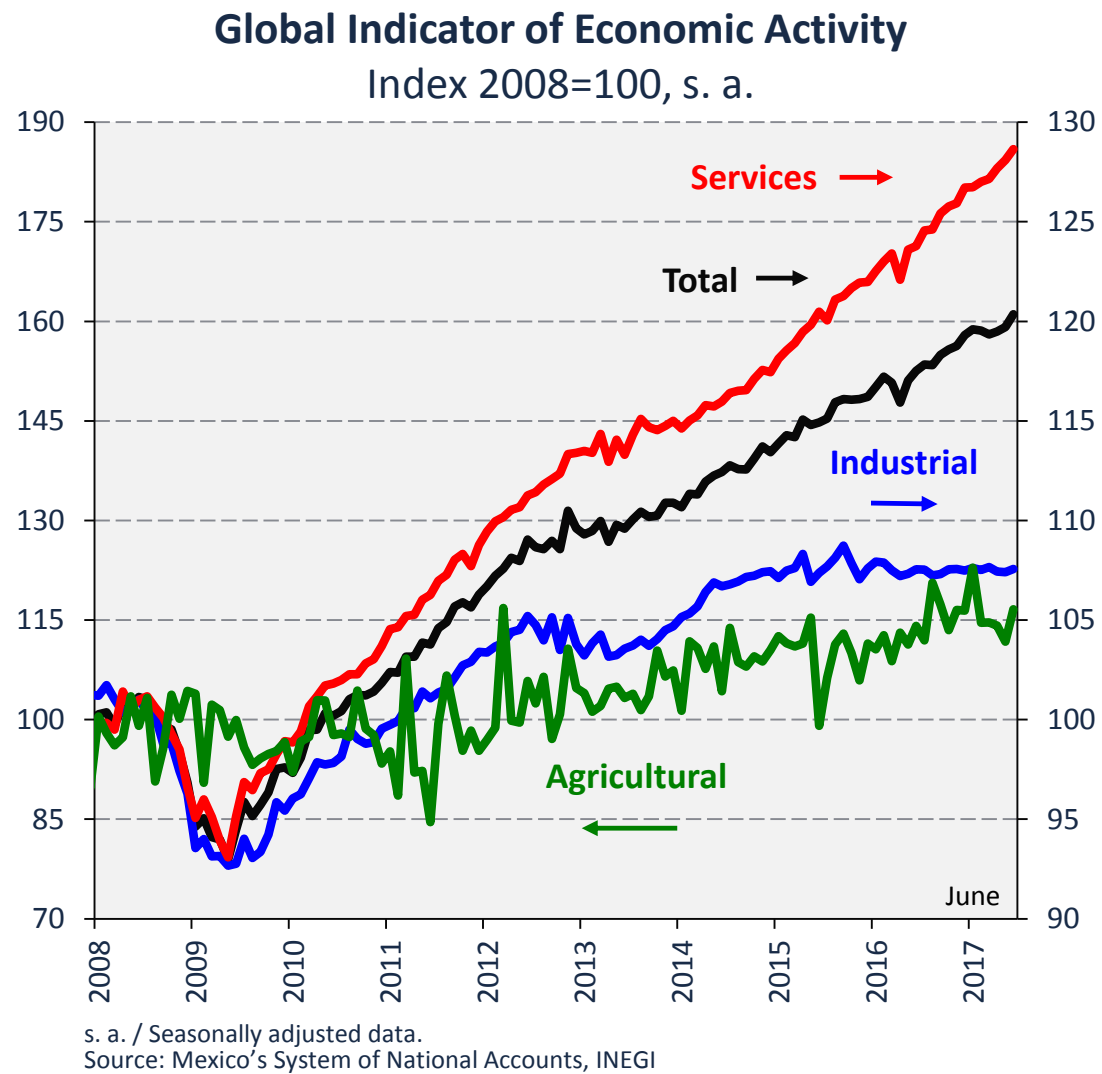
4 Forecasts and Final Remarks

In 2Q 2017, the Mexican economy kept expanding, even though at a slightly lower growth rate as compared to 1Q 2017.



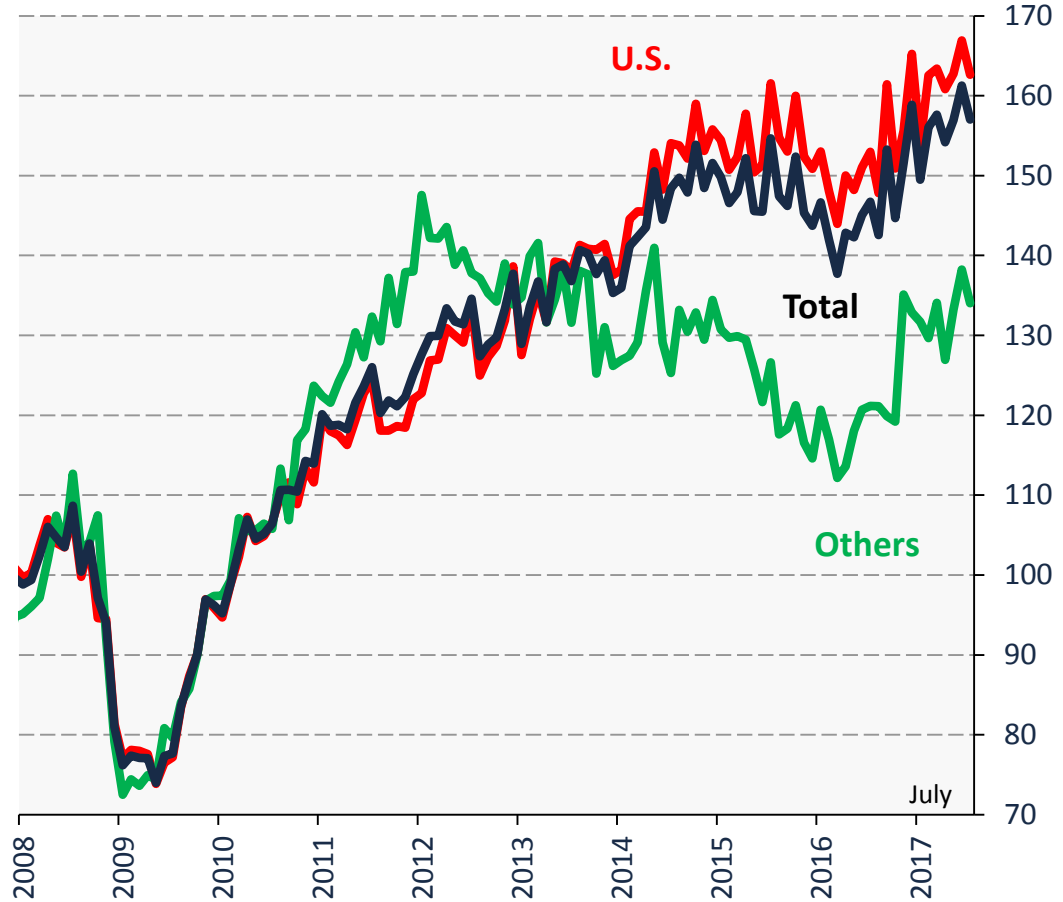
s. a. / Seasonally adjusted data.
Source: Mexico's System of National Accounts, INEGI

Growth of the economic activity in 2Q 2017 kept reflecting the dynamism of the tertiary activities, while the stagnation that the industrial activity had been registering, persisted.



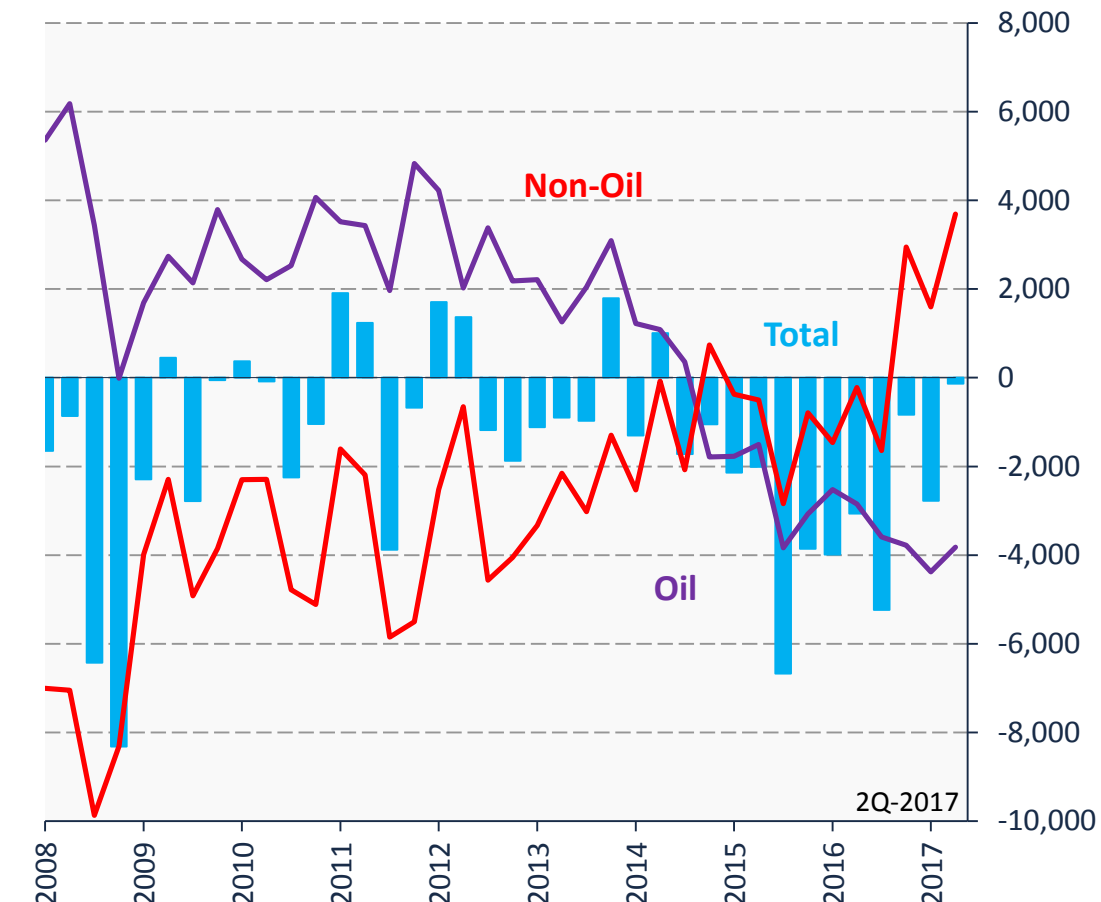
Manufacturing exports kept recovering, as a result of a gradual strengthening of the global activity and the accumulated depreciation of the real exchange rate. Meanwhile, the increment in the non-oil trade balance has substantially contributed to the reduction in the current account deficit.

Manufacturing Exports
Index 2008=100, s. a.



s. a. / Seasonally adjusted data based on information in nominal dollars
Source: Banco de México with data from SAT, SE, Banco de México, INEGI. Merchandise Trade Balance, SNIEG. Information of National Interest.

Trade Balance
USD millions

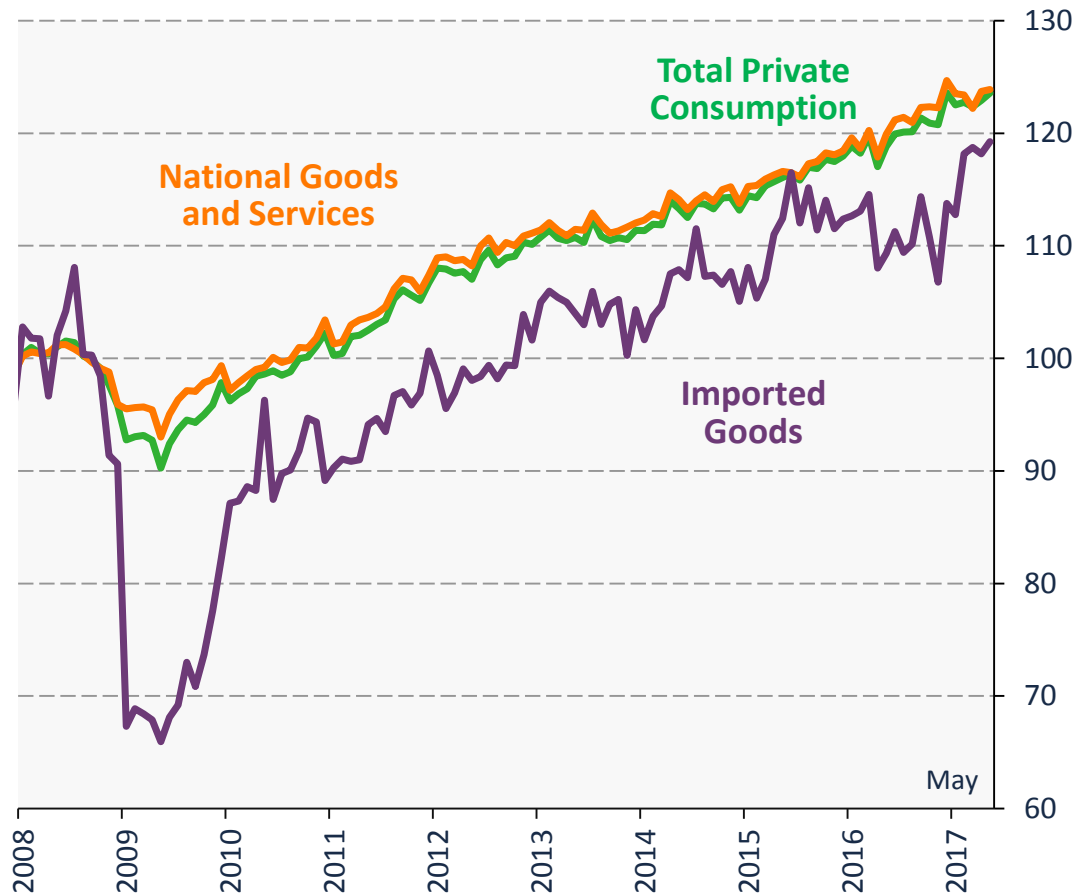


Source: SAT, SE, Banco de México, INEGI. Merchandise Trade Balance, SNIEG. Information of National Interest.

Private consumption kept registering a positive trend, even though it recently showed a certain slowdown. On the other hand, weakness of investment persisted.

Domestic Private Consumption

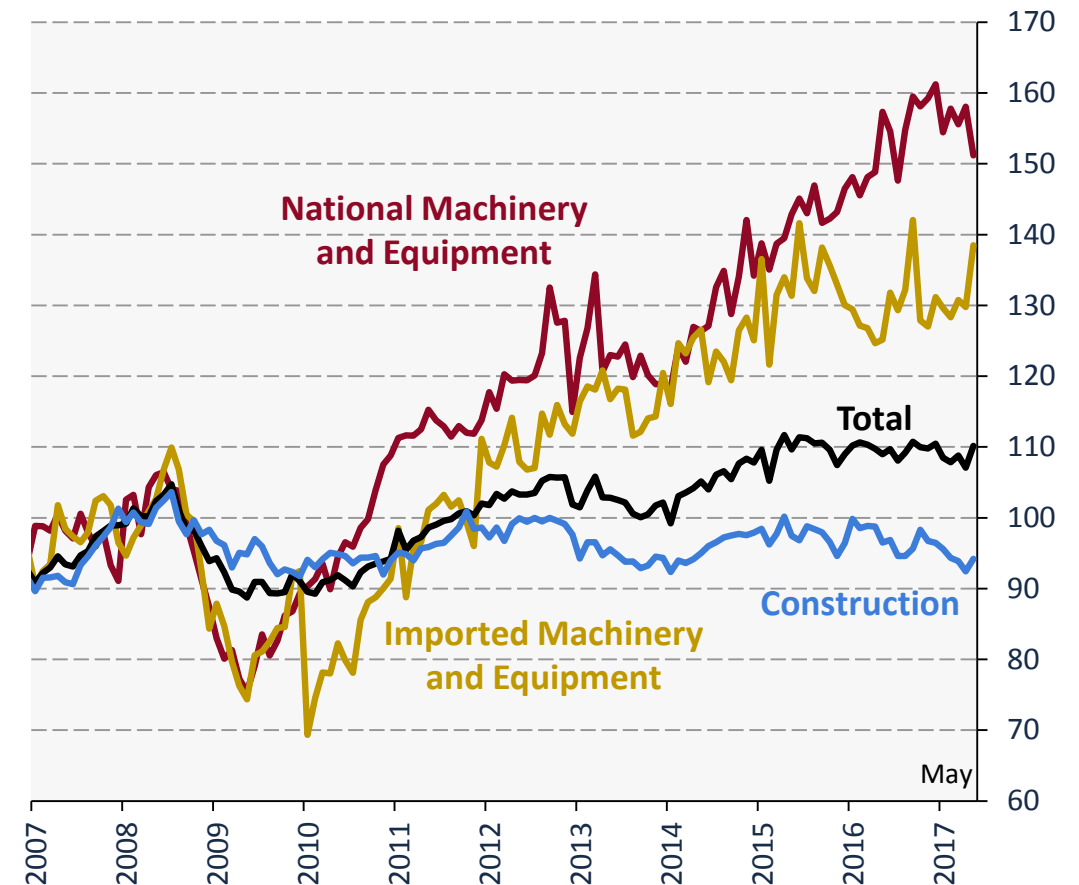
Index 2008=100, s. a.



s. a. / Seasonally adjusted data
Source: Mexico's System of National Accounts, INEGI.

Investment and its Components

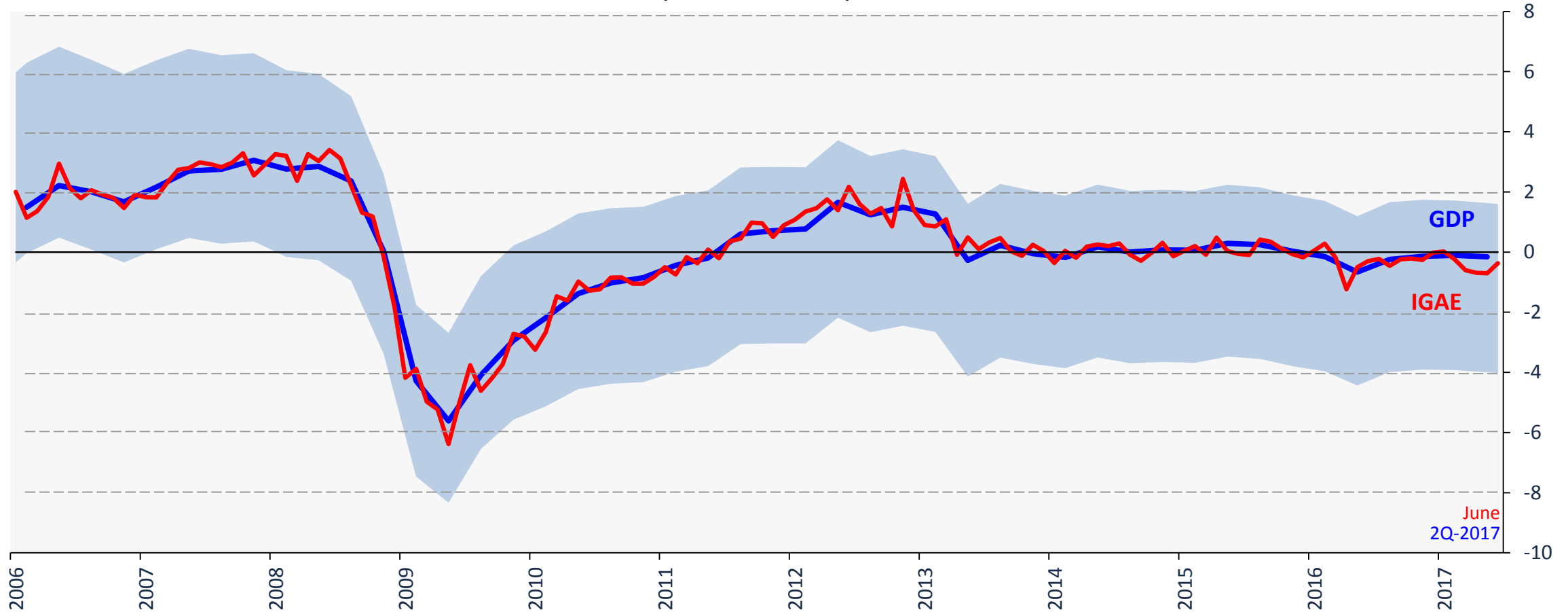
Index 2008=100, s. a.



s. a. / Seasonally adjusted data
Source: Mexico's System of National Accounts, INEGI.

In this environment, no significant aggregate demand-related pressures onto prices have been observed yet.

Output Gap ^{1/}
% of potential output, s. a.



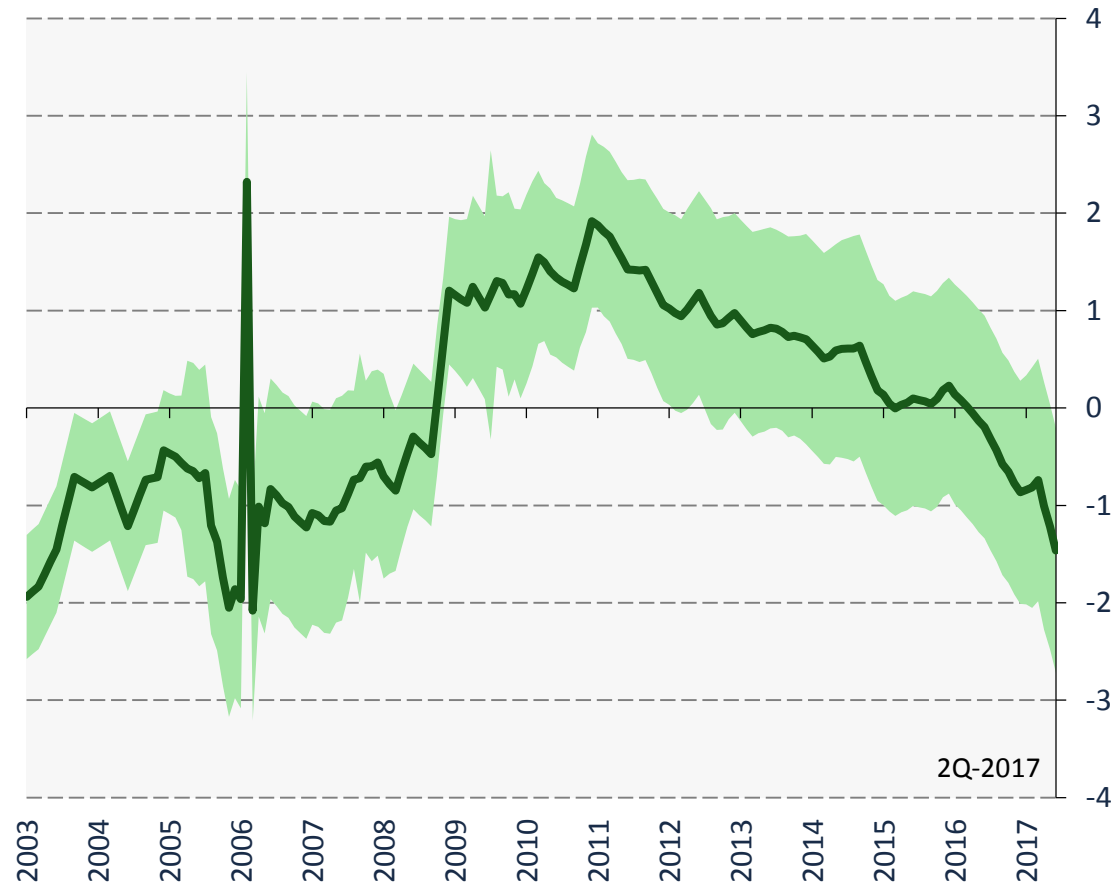
s. a. / Calculated with seasonally adjusted data

^{1/} Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p. 69. The shaded area is the 95% confidence interval of the output gap, calculated with an unobserved components method.

Source: Calculated by Banco de México with data from INEGI.

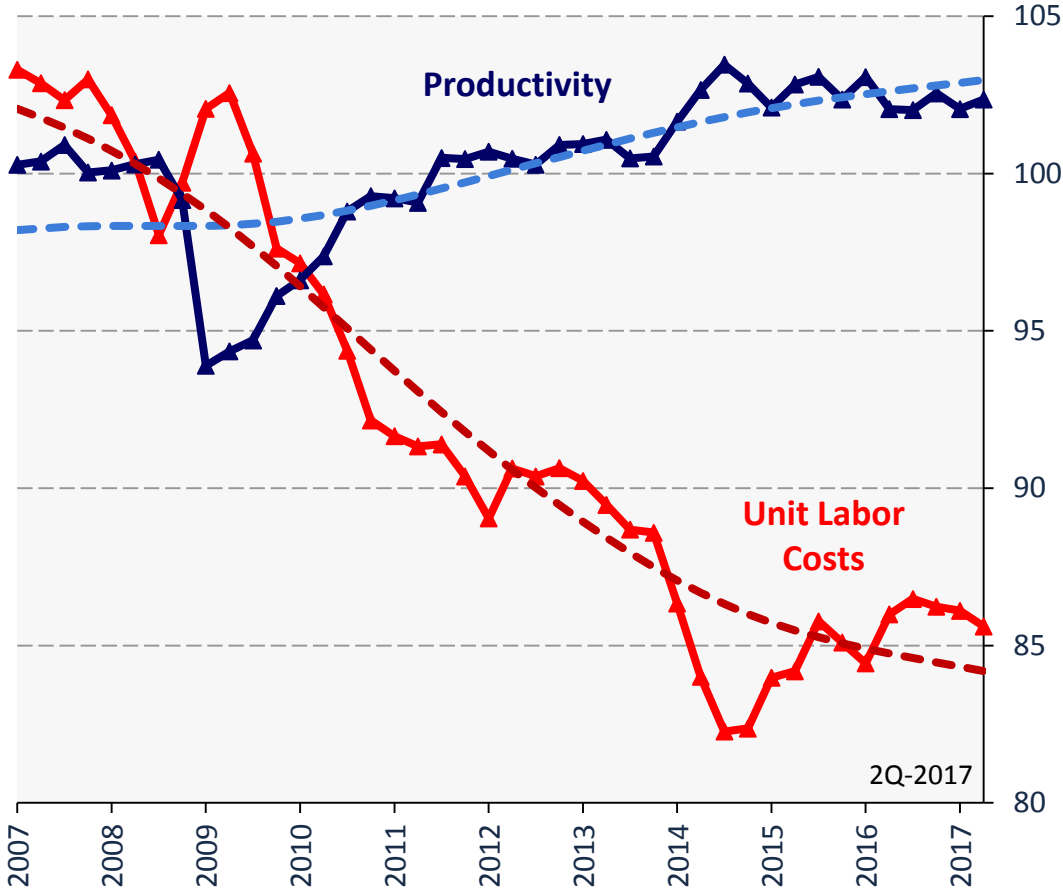
The labor market seems to have no slack, even though this has not been reflected in wage pressures that could affect the inflationary process.

Employment Gap and Informal Salaried Workers ^{1/}
Percentage points, s. a.



s. a./ Calculated with seasonally adjusted data.
1/ The shaded area represents the confidence interval, which corresponds to two average standard deviations among all estimates; see Banco de México (2017), "Quarterly Report, October-December 2016", pág.47.
Source: Banco de México.

Productivity and Unit Labor Cost ^{2/}
Index 2008=100, s. a.



Note: Data for 2Q-2017 estimated by Banco de México
s. a./ Seasonally adjusted and trend series. The former is represented with a solid line, the latter, with a dotted line.
Trends estimated by Banco de México.
2/ Productivity based on worked hours.
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.

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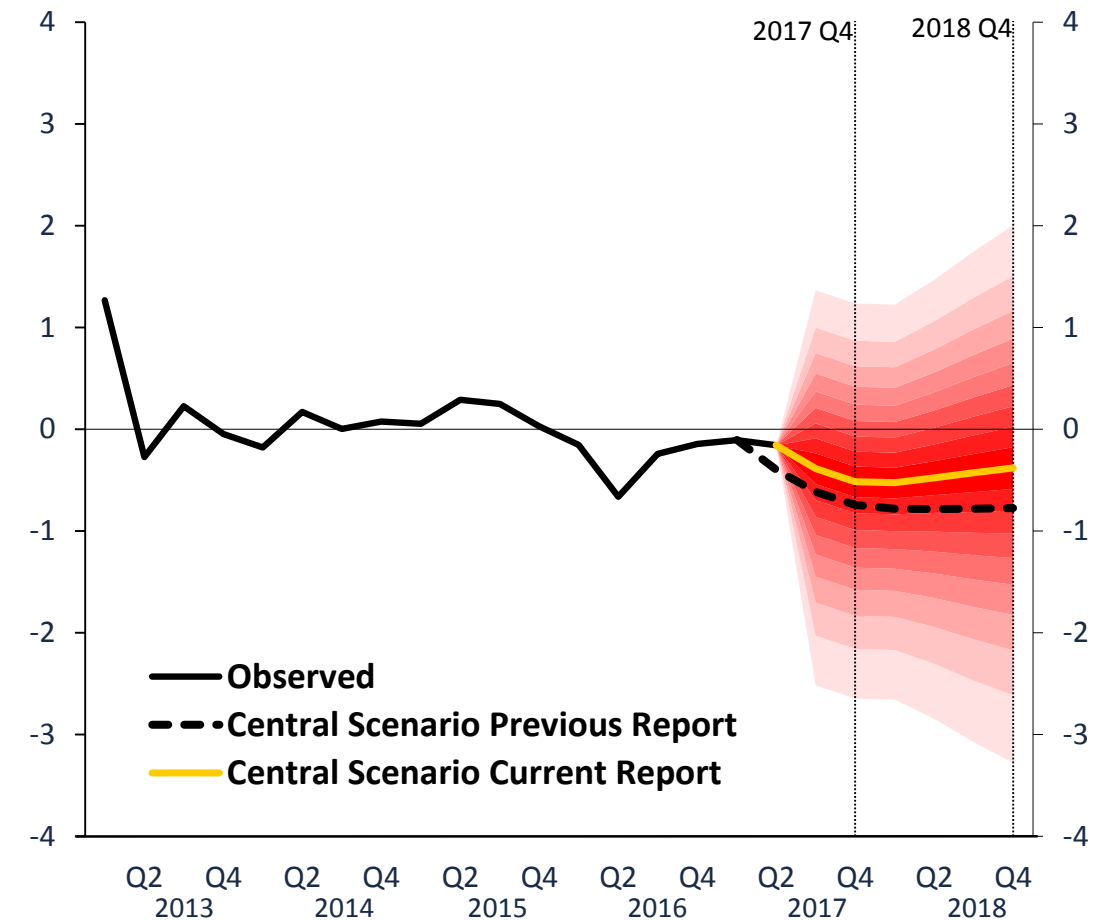
Economic Activity Outlook

GDP Growth (%)		
Report	Previous	Revised
2017	1.5 – 2.5	2.0 – 2.5
2018	1.7 – 2.7	2.0 – 3.0

Increase in the Number of IMSS-insured jobs (Thousands)		
Report	Previous	Revised
2017	650 – 750	660 – 760
2018	640 – 740	670 – 770

Current Account Deficit (% of GDP)		
Report	Previous	Revised
2017	2.3	2.2
2018	2.3	2.2

Fan Chart: Output Gap
% of potential output, s. a.



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

Risks to Growth Outlook

The balance has improved and has become neutral.

Upward



That a successful renegotiation of the NAFTA triggers investment in areas of opportunity, which have not been previously considered by the Agreement.



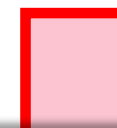
That the implementation of structural reforms renders greater-than-estimated results.



That the oil production platform shows a more favorable performance.



Downward



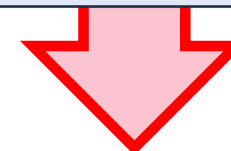
That the NAFTA renegotiation does not render favorable results.



That higher volatility in international financial markets and the upcoming electoral process in Mexico reduce the sources of financing, affecting private spending.



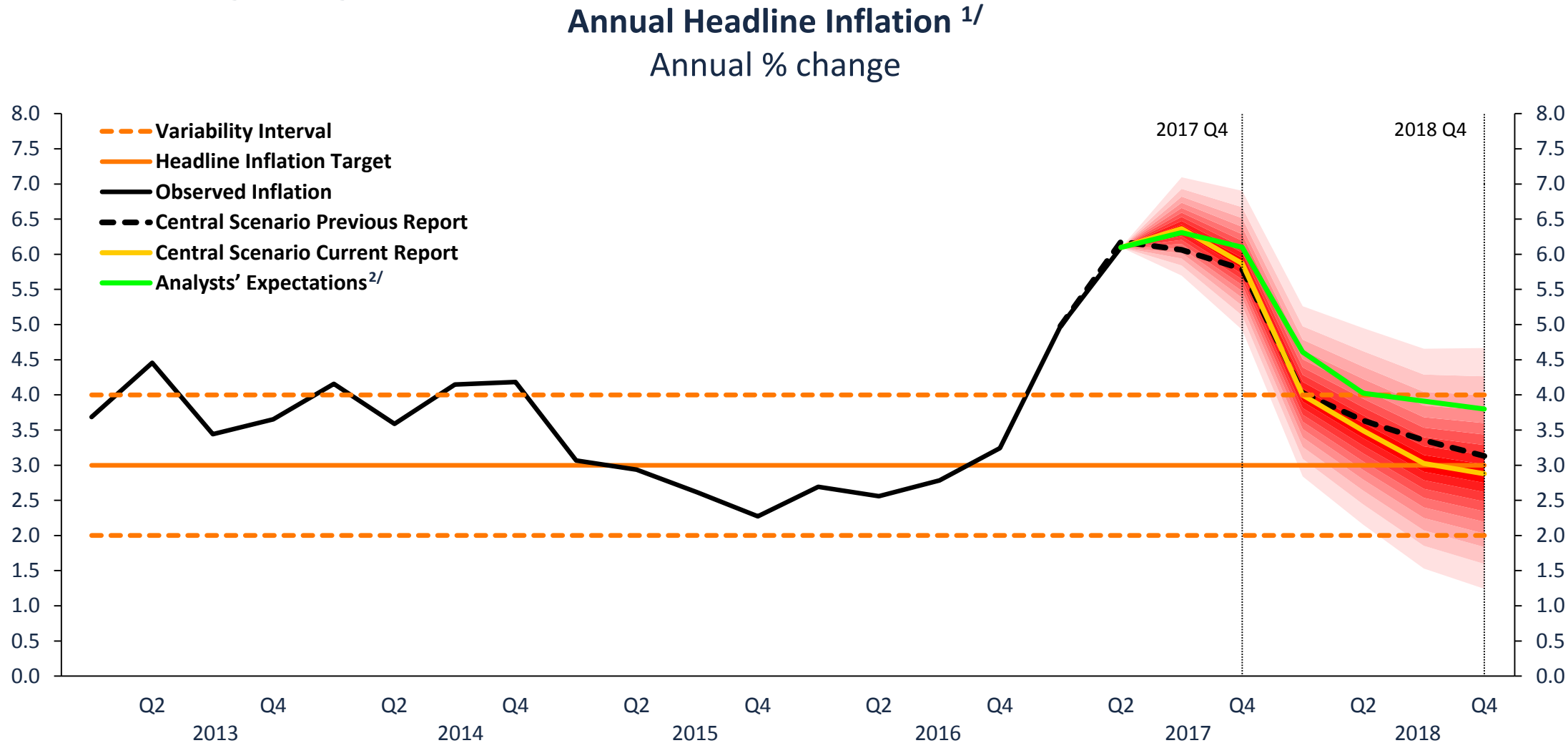
That the increase in public insecurity further affects productive activity.



Central Scenario for Inflation

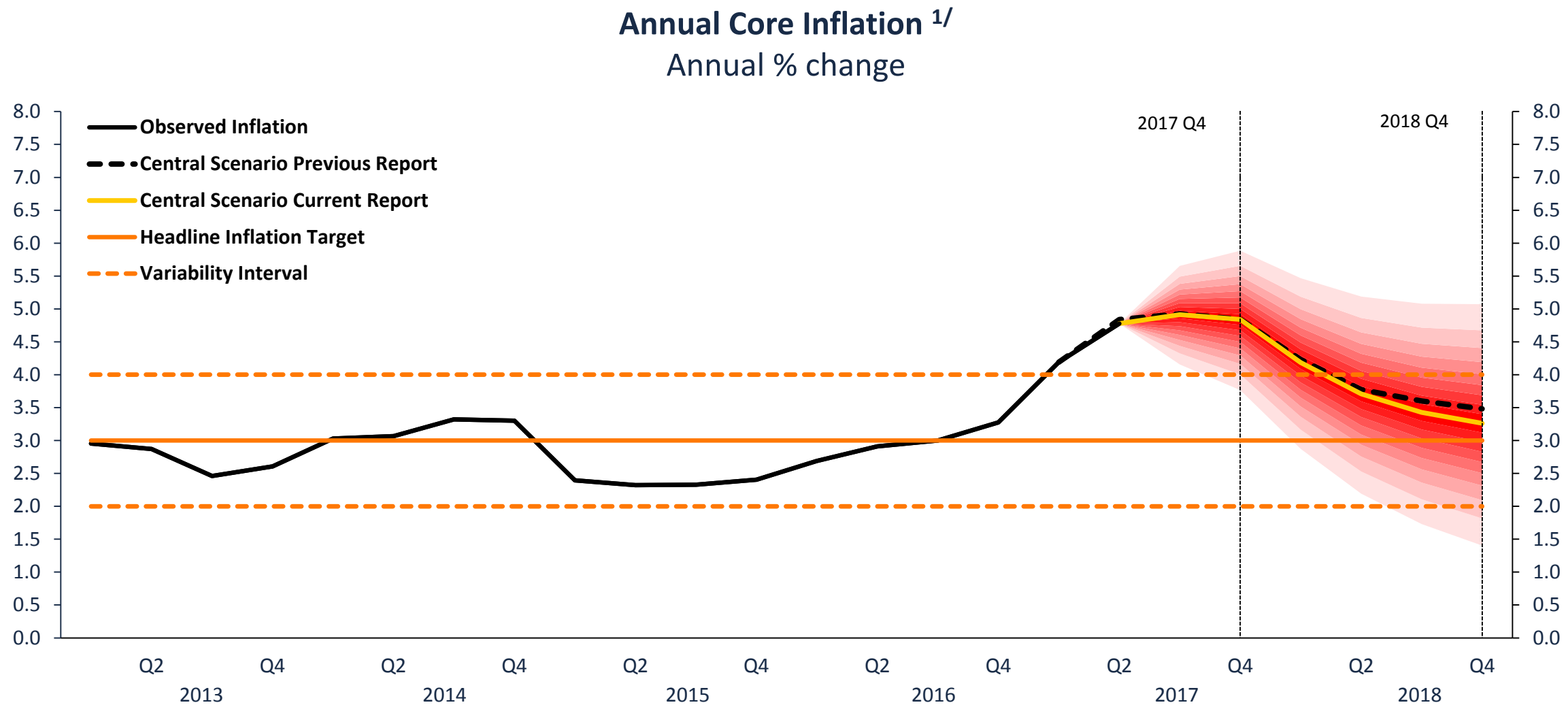
	Headline Inflation	Core Inflation
2017	<ul style="list-style-type: none">It is expected to resume a downward trend in the last months of this year.	<ul style="list-style-type: none">It is anticipated to remain above 4.0 percent and at the end of the year to resume the trajectory of convergence to its target.
2018	<ul style="list-style-type: none">It is expected to decline considerably over the first months of 2018 and that it will accentuate its convergence to the 3.0 percent target.	<ul style="list-style-type: none">At the end of 2018, it is estimated to reach levels close to 3.0 percent.

The central forecast considers the monetary policy adjustments that have been implemented since December 2015, and the vanishing of the base effect prompted by higher prices of various energy products at the beginning of 2017.



1/ Quarterly average of annual headline inflation.
2/ It refers to the median of monthly inflation expectations from the Survey of Private-sector Economic Analysts' Expectations from Banco de México.
Source: Banco de México and INEGI.

It is expected that, in late 2017 and at the beginning of 2018, core inflation will resume its trajectory of convergence to the inflation target.

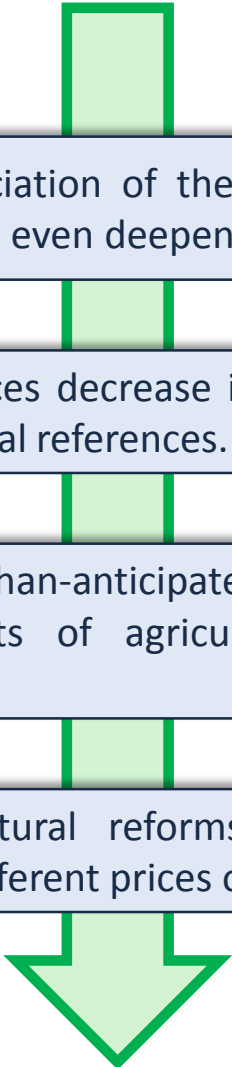


1/ Quarterly average of annual core inflation.
Source: Banco de México and INEGI.

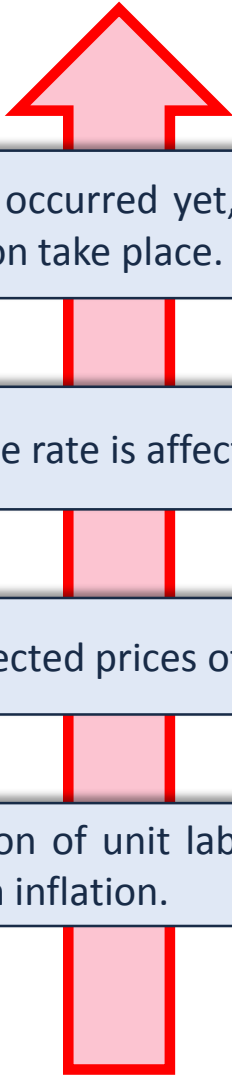
Risks to the Inflation Outlook

The balance is neutral.

Downward

- 
- ✓ That the appreciation of the national currency consolidates and even deepens.
 - ✓ That energy prices decrease in accordance with their international references.
 - ✓ That a greater-than-anticipated reversion in the price increments of agricultural products is observed.
 - ✓ That the structural reforms lead to further reductions in different prices of the economy.

Upward

- 
- ✓ Albeit it has not occurred yet, that second round effects on inflation take place.
 - ✓ That the exchange rate is affected by some shock.
 - ✓ Higher-than-expected prices of agricultural goods.
 - ✓ That the evolution of unit labor costs could start to be reflected in inflation.

Monetary Policy Stance

- In this context, going forward the Board of Governors will closely monitor the evolution of all inflation determinants and its medium- and long-term expectations, especially:

- ✓ The possible pass-through of exchange rate adjustments onto prices.

- ✓ The evolution of the output gap.

- ✓ The monetary position of Mexico relative to the U.S.

- In any event, in light of different prevailing risks, the Board of Governors will be watchful to ensure that the **monetary stance remains prudent**, so that the anchoring of medium- and long-term inflation expectations is strengthened, and its **convergence to the inflation target is achieved**.
- Banco de México's Board of Governors considers that currently the monetary policy stance is congruent with the convergence of headline inflation to its 3.0 percent target by the end of 2018.

Strengthening Confidence in the Mexican Economy

- It is important to keep in mind that the economy could face a highly complex environment, in particular, due to the possible tightening of global financial conditions, the evolution of the NAFTA negotiations and the upcoming electoral process in 2018.
- In this context, it is especially relevant to persevere in **maintaining strong macroeconomic fundamentals**. In particular, to ensure that fiscal and monetary policies keep contributing to propitiate an orderly adjustment in the economy and in financial markets.
 - ✓ *In the future, it is essential to ensure that the **fiscal consolidation** process attempts to structurally strengthen public finances, so that they are sustainable in the medium term.*

Strengthening Confidence in the Mexican Economy

- It is also necessary to **strengthen the country's institutions** at all levels so that they fulfill their social purpose under the principles of transparency and with zero tolerance on corruption.
- In this sense, legal certainty and a **strengthened rule of law** will ensure the timely and correct implementation of the structural reforms and will correct the deficiencies that prevent the country from achieving a **greater potential growth** and higher competitiveness.
- In this way, Mexico will be in a **better position** both to face the challenges it will have to cope with in the future, given the complex external and domestic environments, and to seize the opportunities that may arise.



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