Quarterly Report

January – March 2016

Summary

The monetary policy conduction of Banco de México has focused on procuring the stability of the national currency's purchasing power, so that it is achieved at the lowest cost to society in terms of economic activity. Through the inflation targeting regime, this Central Institute has set out to reach the annual inflation rate of 3 percent, with a variability interval of plus/minus one percentage point. Efforts undertaken in the field of monetary policy have yielded an important result: the consolidation of an environment of low and stable inflation in Mexico. Among the outcomes achieved through the above referred regime, the following stand out: i) a permanent reduction in the inflation levels, its volatility and persistence; ii) a decrease in risk premia, particularly inflation risk premium; iii) a solid anchoring of inflation expectations at levels close to the permanent target, as well as their smaller dispersion; and iv) a reduction in the pass-through of changes in relative prices and, particularly, of exchange rate fluctuations, to the prices of goods and services. These achievements have become evident in the current juncture. Indeed, recent exchange rate fluctuations have not affected the price formation process of the economy, while inflation has persisted below the permanent target for the last 12 months, and inflation expectations in the medium and long term remain well-anchored. Thus, the exchange rate has functioned as a shock absorber for the Mexican economy in light of a highly complex external environment, without generating disproportionate pressures on inflation. The consolidation of an environment of low and stable inflation has allowed, along with other factors, a recovery of the purchasing power of wages.

This favorable performance of inflation has taken place in an especially challenging environment, which compelled Banco de México to carefully weigh the possible effects of both domestic and external factors on the evolution of inflation and its expectations, in order to define the most appropriate monetary policy stance at each point of time. In the period analyzed in this Report, domestic economic environment was characterized by moderate growth, no aggregate demand-related pressures on prices and a solid anchoring of inflation expectations. This expansion of the Mexican economic activity was supported by the dynamism of consumption, which was favored by improvements in the labor market, low inflation, credit expansion and more favorable conditions to growth as a result of the structural reforms. By contrast, external demand performed unfavorably and gross fixed investment remained weak. Indeed, in the international environment, world economic growth expectations proceeded with the downward adjustment and world trade has stagnated, in a context in which most advanced and some large emerging economies expanded less than previously anticipated. Likewise, different episodes of volatility occurred in international financial markets, which noticeably pressured the national currency's value.

In its first decision on February 4, 2016, considering that the central scenario of the inflation evolution for the short and medium term at the time was congruent with the consolidation of its convergence to the permanent 3 percent target, the Board of Governors decided to maintain the level of the target for the Overnight Interbank Interest Rate unchanged at 3.25 percent. Despite this, a warning was issued about the risk to inflation and its expectations, arising from the possibility that the depreciation of the national currency may further persist or become more pronounced. In this context, following the surge in volatility in international financial markets, the deterioration of the external environment and strong exchange rate fluctuations that occurred in the weeks following the referred decision, the Board of Governors deemed it appropriate to hold an extraordinary session and on February 17, 2016 announced a 50-basis-point increment in the target for the Overnight Interbank Interest Rate, to 3.75 percent. In this regard, the Board of Governors clarified that the said increment would not initiate a cycle of monetary contraction.

It should be noted that this decision was part of a coordinated set of actions taken along with other authorities. In particular, together with the described monetary policy measure, the Ministry of Finance announced a preemptive adjustment to the expenditure of the Federal Public Administration for 2016, and the Foreign Exchange Commission decided to suspend the auction of dollars' mechanisms, leaving open the possibility to discretionally intervene in the exchange market if exceptional circumstances should occur.

The implemented measures produced the expected result. Indeed, at the moment of the announcement the national currency appreciated considerably, a tendency that persisted for several weeks. Likewise, short-term interest rates went up in line with the increase in the reference interest rate, while those corresponding to longer terms went down, resulting in a significant flattening of the yield curve, just as it was desired. These results, together with the fact that the balance of risks to inflation was considered neutral, and, in particular, that the central scenario of its performance was congruent with the 3 percent permanent target, taking into account the adjustment realized on February 17, 2016, resulted in the Board of Governors decisions, made at the monetary policy meetings of March 18 and May 5, to maintain unchanged the target for the Overnight Interbank Interest Rate.

The macroeconomic scenario expected by Banco de México considers the following:

GDP Growth: Just as it was forecast in the previous Quarterly Report, the complex external environment faced by the Mexican economy has persisted. Indeed, given the weak global economic activity, volatility in international financial markets and the reduction of the world trade, the U.S. industrial activity has not recovered. Hence, Mexican external demand is still expected to register a relatively low dynamism for the following years, although it is anticipated to gradually resume a greater expansion rate.

Despite the slack in global demand, domestic demand in Mexico continued to expand at a considerable rate and, in this context, it is anticipated to continue sustaining economic activity over the next quarters. Low inflation that led to a recovery in the real wage bill, the improvement in the labor market and the implementation of structural reforms are generating an environment more conducive to growth of domestic expenditure, which is expected to prevail during the next quarters.

Thus, domestic demand dynamism has managed to partially offset (and is expected to keep doing so) weakness of the external sector, so that a moderate growth rate is still expected in the country. Similarly, a greater dynamism of economic activity in the first quarter of 2016 implies a certain improvement in the growth outlook for this year, although an adjustment of the forecast interval remains unjustified. Thus, GDP in Mexico is still estimated to grow between 2.0 to 3.0 percent in 2016. For 2017, due to the adverse international environment, and in particular to the downward adjustment in the growth expectations for the U.S. industrial production, the interval for GDP growth is slightly revised from one of 2.5 to 3.5 percent in the last Report to one of 2.3 to 3.3 percent in the current one (Chart 1a).

Employment: Even though the number of IMSS-insured jobs maintained a positive trend, recently it has somewhat decelerated. Therefore, the outlook for this indicator's growth is slightly adjusted downwards. Thus, for 2016 an increment of 590 to 690 thousand employments is expected, as compared to 610 to 710 thousand employments published in the previous Report. For 2017, an increase of 630 to 730 thousand workers is estimated, which is less than the anticipated 650 to 750 thousand employments announced in the previous Report.

Current Account: For 2016, deficits in the trade balance and the current account of USD 15.4 and 34.4 billion are anticipated, respectively (1.4 and 3.1 percent of GDP, in the same order). For 2017, deficits in the trade balance and the current account are expected to amount to USD

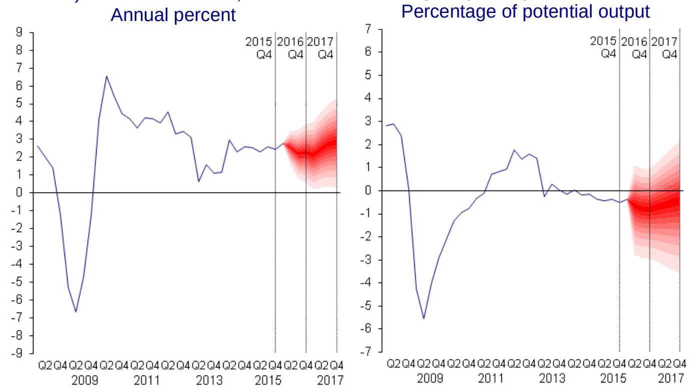
15.1 and 36.7 billion, respectively (1.3 and 3.1 percent of GDP, in the same order).

The economic growth outlook does not indicate the presence of any aggregate demand-related pressures on either inflation or external accounts. In particular, the output gap is anticipated to remain negative in the forecast horizon (Chart 1b).

Fan Charts 1

a) GDP Growth Rate, s. a.
Annual percent

b) Output Gap Estimate, s. a.
Percentage of potential output



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

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

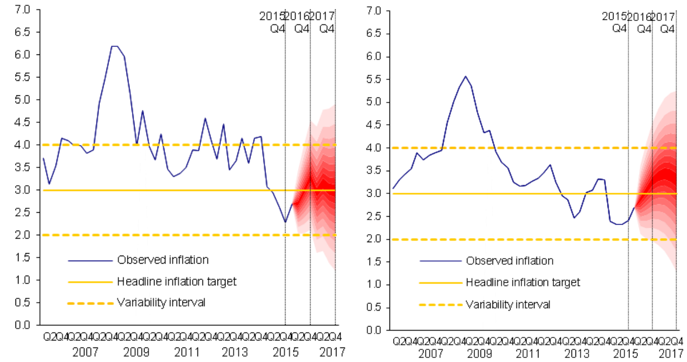
Among downward risks to growth of the Mexican economy related to the described scenario, the following are noteworthy: i) the possibility of a more pronounced slowdown of the world economic growth and, in particular, of U.S. industrial activity; and, ii) that, in light of a more complex international environment, financing conditions in the economy will be tighter, which could negatively affect investment plans and, consequently, economic growth. Among upward risks, the next should be listed: i) that the improvement in the labor market and the expansion in the amount and access of households to credit will lead to an even greater dynamism of private consumption over the next quarters; and, ii) that the implementation of structural reforms will produce more favorable and faster effects than anticipated. In particular, that a greater impulse in the investment in the energy sector will be observed, above all in view of the recent announcements regarding gasoline and gas imports, or that the dynamism generated by the Mexico's Telecom reform will persist.

Inflation: Inflationary conditions in the economy are anticipated to remain favorable, so that inflation will keep fluctuating around its permanent target and medium- and long-term inflation expectations will remain anchored to the said target over the rest of 2016 and in 2017. In particular, annual headline inflation is expected to persist under 3 percent over the next months, although in the last months of the year it is anticipated to temporarily exceed this figure. In any event, for the year as a whole, average annual inflation is forecast to be practically at 3 percent. This trajectory is mostly a consequence of the recent update in the formula used by the Ministry of Finance to set maximum gasoline prices and of the expected evolution of this fuel's international counterparts. The update attempts to partially cushion the effect of volatility in international gasoline prices on the national prices of this fuel, which, in turn, alters its seasonality. Core inflation is anticipated to gradually increase in annual terms, concluding 2016 at levels close to 3 percent. For 2017 both headline and core inflation are estimated to persist around the permanent inflation target (Chart 2a and Chart 2b). The indicated forecast of the inflation trajectory is not risk-free. Among upward risks to inflation, the following should be mentioned: i) that a possible deterioration in the international environment may generate a disorderly depreciation of the exchange rate, and that it may, to a greater degree, affect headline inflation; and, ii) additionally, increments in agricultural products' prices cannot be ruled out, although their impact on inflation would tend to be transitory. As to downward risks, the next should be listed: i) that as a result of structural reforms, prices of some generalized-use inputs will continue decreasing, such as the telecommunication services and energy prices; and, ii) that the Mexican and global economic activity may have a lower than expected dynamism, which would defer aggregate demand-related pressures on inflation.

Fan Charts 2

a) Annual Headline Inflation [1/]
Percent

b) Annual Core Inflation [1/]
Percent



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

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In this context, and considering the data presented in this Report, in the future the Board of Governors will continue closely monitoring the evolution of all inflation determinants and its medium- and long-term expectations, especially the exchange rate and its possible pass-through onto consumer prices. Moreover, it will monitor the monetary policy stance of Mexico relative to that of the U.S., without overlooking the evolution of the output gap. All this, in order to be able to take the necessary measures in a flexible manner and whenever conditions demand it, so as to consolidate the efficient convergence of inflation to the 3 percent target.

Finally, it should be kept in mind that the Mexican economy is still facing an adverse international environment. In this context, it should be noted that the Mexican authorities in a timely manner implemented a set of measures aimed at strengthening macroeconomic fundamentals. These actions contributed to guaranteeing the macroeconomic stability of the country and to generating an environment more conducive to growth. In particular, the adjustment of public expenditure, along with Banco de México's operational surplus to improve the Federal Government financial position and to decrease public indebtedness, by means of repurchasing the existing Federal Government debt and reducing the amount of placements in 2016, will contribute to sound public finances in the country. Nonetheless, it is necessary to continue encouraging domestic sources of growth, so that not only the slack in global demand is offset, but also so that higher economic growth rates are achieved in a sustained manner. On the one hand, it is necessary to proceed with the appropriate and prompt implementation of structural reforms, as they will contribute to boost productivity and generate greater economic competition, with a consequent favorable effect on the welfare of the population. On the other hand, the rule of law should be strengthened and legal certainty should be guaranteed. As stated in previous Reports, this would allow achieving greater economic growth, while broadening the scope of structural reforms and attracting greater investment to the country.