



Quarterly Report

April – June 2015

August 12, 2015



BANCO DE MÉXICO

Outline

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Monetary Policy

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External Conditions

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Economic Activity in Mexico

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Inflation Determinants

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Forecasts and Balance of Risks

Monetary Policy Conduction in Mexico

- The conduction of the monetary policy seeks to ensure the stability of the national currency's purchasing power.
 - ✓ This, ensuring that it is achieved at the lowest cost to society in terms of economic activity, at all times.
- As a result of Banco de Mexico's effort to curb inflation, during 2015 **convergence of inflation to its permanent 3 percent target has been achieved.**
 - ✓ Moreover, during 2Q 2015, it even reached its historic minimum levels and has recently remained below the target.
 - ✓ The above took place in a context in which the pass-through of the exchange rate depreciation onto prices has been limited, mainly reflected in the prices of durable goods, and without contaminating prices of non-tradable goods and services.

The convergence of inflation to its target has been achieved in a particularly complex environment, given the circumstances faced by the monetary policy.

Domestic Environment:

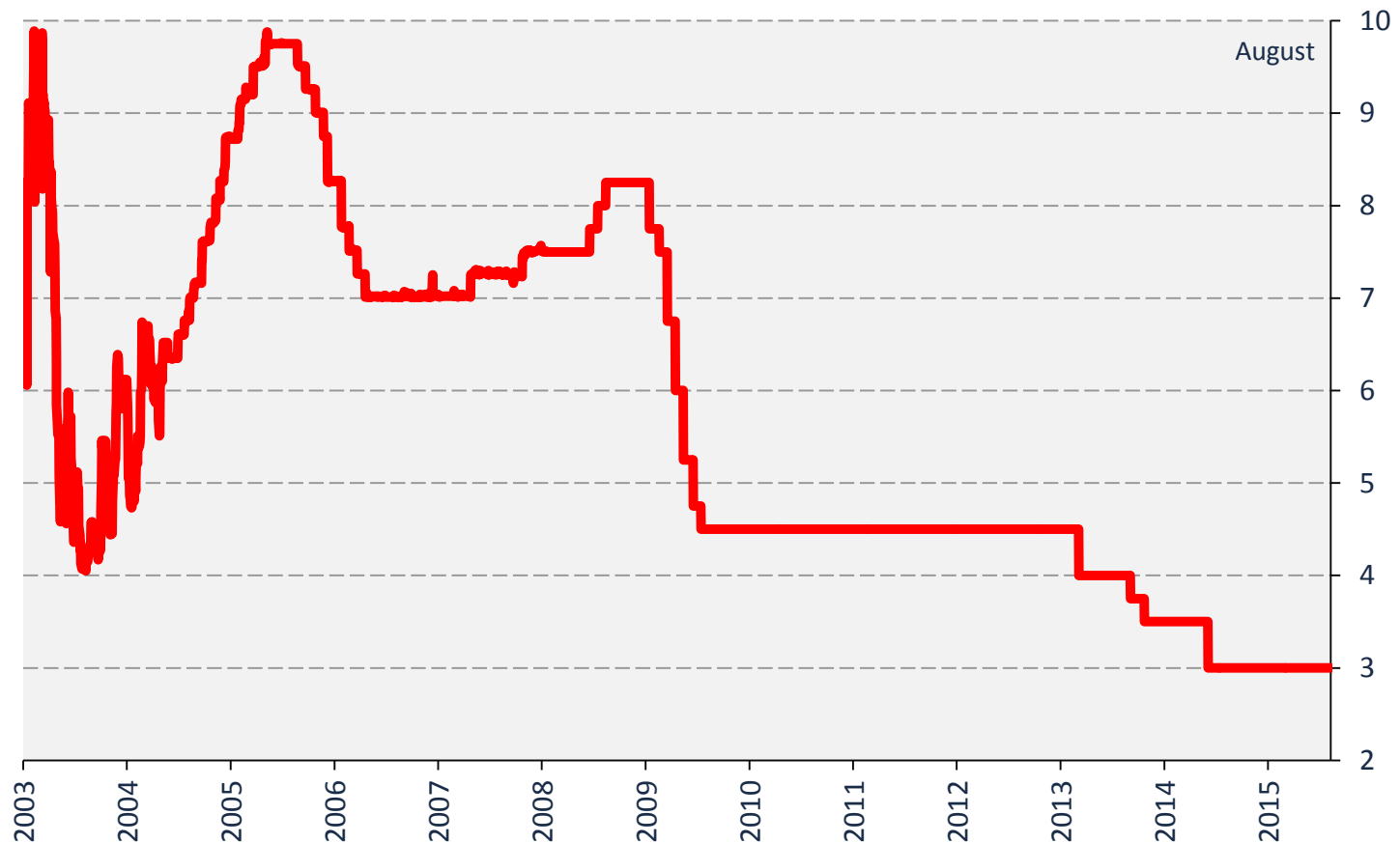
- ✓ Low growth rate of economic activity.
- ✓ Favorable inflation evolution.
- ✓ Well-anchored long-term inflation expectations and reductions in the short-term ones.

International Environment:

- ✓ High volatility in international financial markets.
 - The imminent beginning of the normalization of the U.S. monetary policy.
 - Lower commodity prices, in particular crude oil prices.
- *A considerable depreciation of the Mexican peso against the U.S. dollar.*

During the period covered by this Report, the Board of Governors maintained the target for the Overnight Interbank Interest rate unchanged at 3 percent, by virtue of the fact that it estimated the current monetary stance to be conducive to ensure the convergence of inflation to its 3 percent target.

Target for the Overnight Interbank Interest Rate^{1/}
%



1/ The Overnight Interbank Interest Rate is shown until January 20, 2008.

Source: Banco de México.

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1 **Monetary Policy**

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3 **Economic Activity in Mexico**

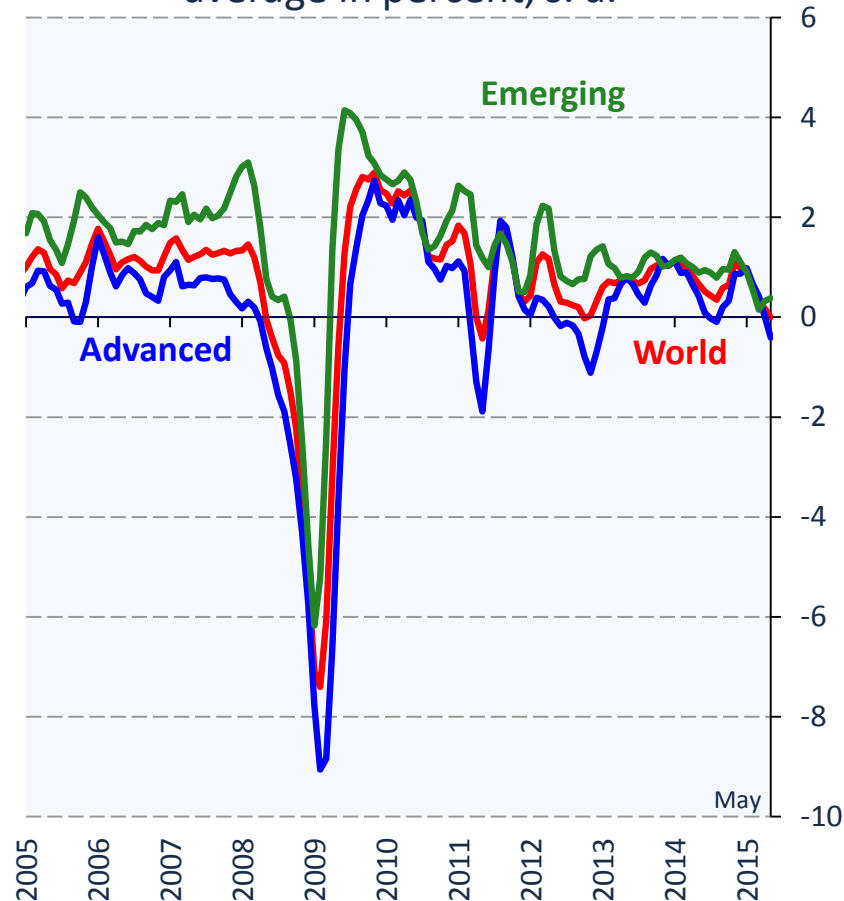
4 **Inflation Determinants**

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Although the world economic activity recovered moderately in 2Q 2015, global industrial production and the volume of international trade decreased.

Industrial Production

Quarterly change of 3-month moving average in percent, s. a.

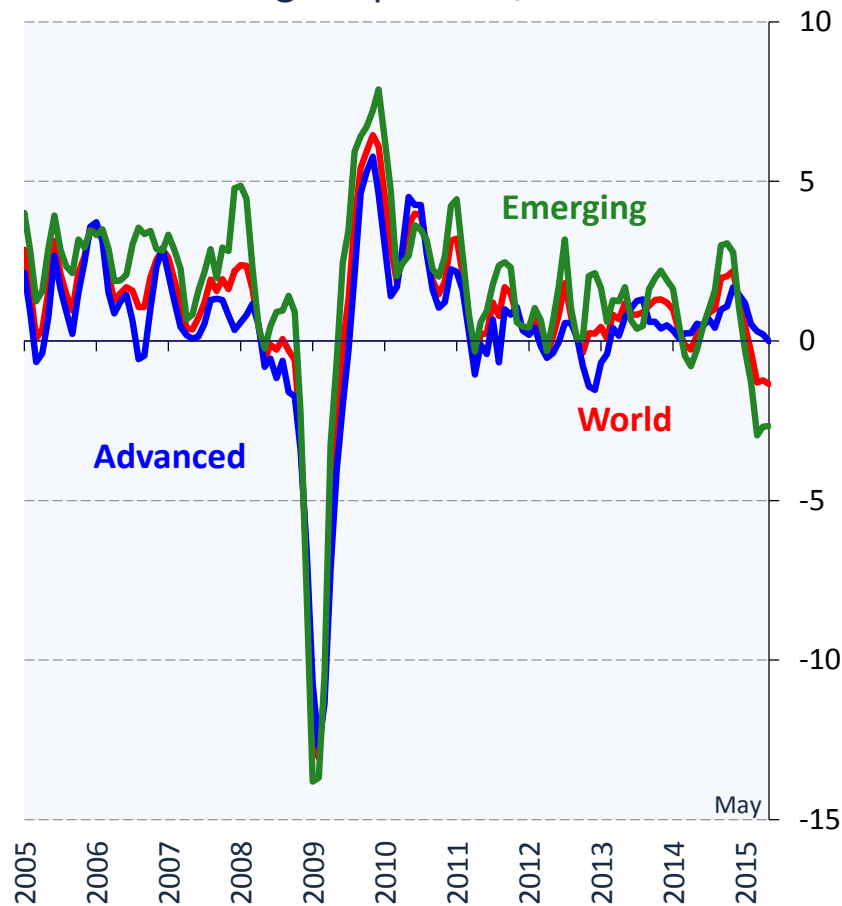


s. a./ Seasonally adjusted data.

Source: Haver Analytics.

Trade Volume

Quarterly change of 3-month moving average in percent, s. a.

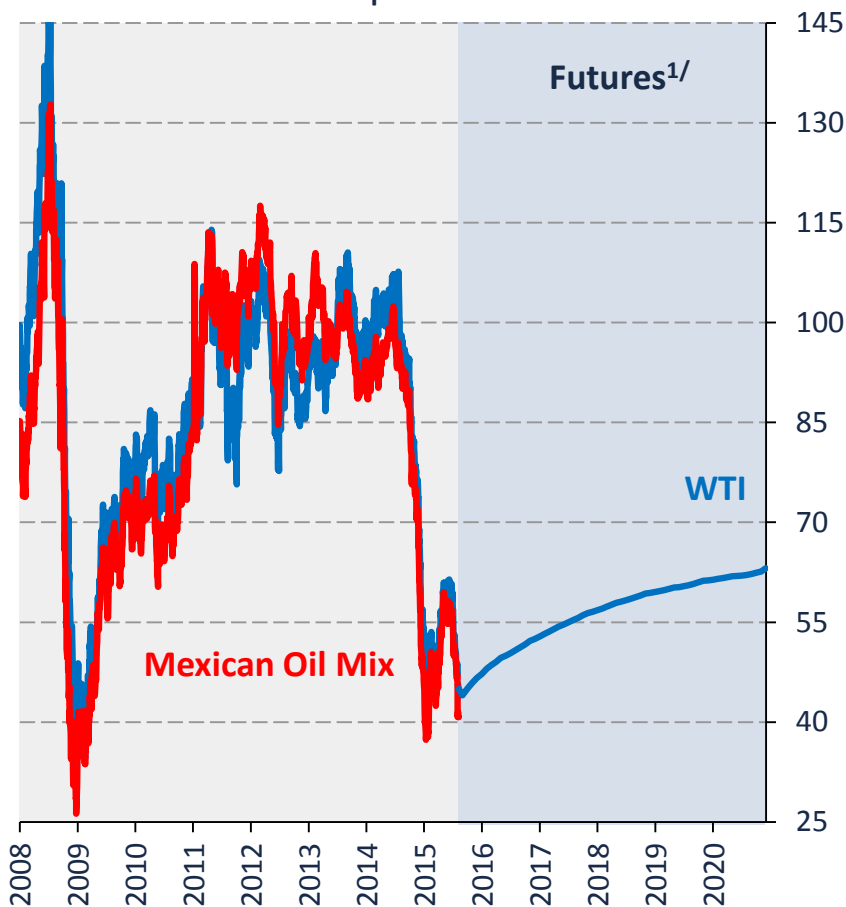


s. a./ Seasonally adjusted data.

Source: Haver Analytics.

Commodities prices exhibited high volatility in 2Q 2015, and by the end of the referred quarter they decreased again.

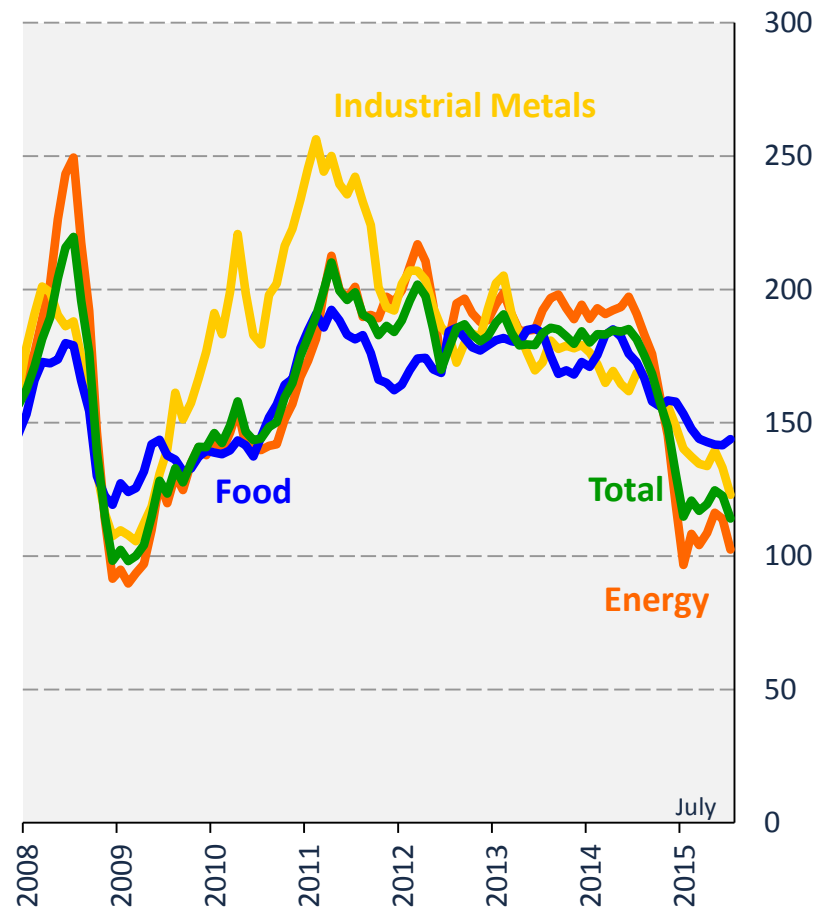
Crude Oil Prices
USD per barrel



1/ Data up to August 11, 2015.

Source: Bloomberg.

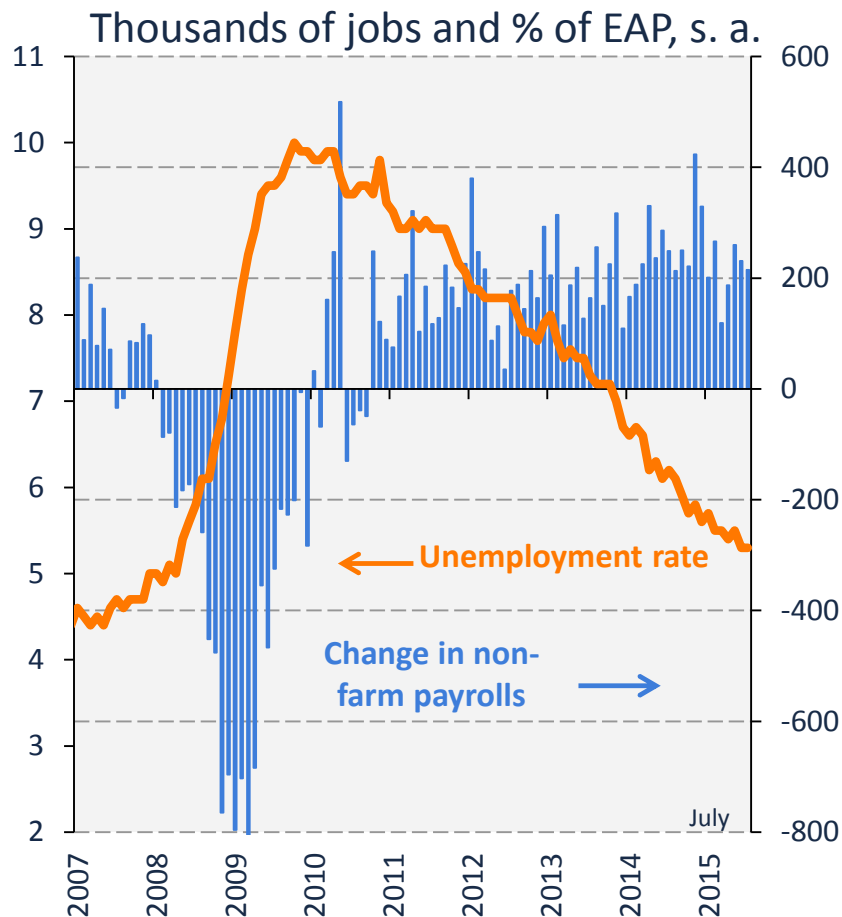
Commodities Prices
Index 2005=100



Source: International Monetary Fund.

U.S. economic activity maintained a moderate growth rate. Nevertheless, the industrial sector registered weakness.

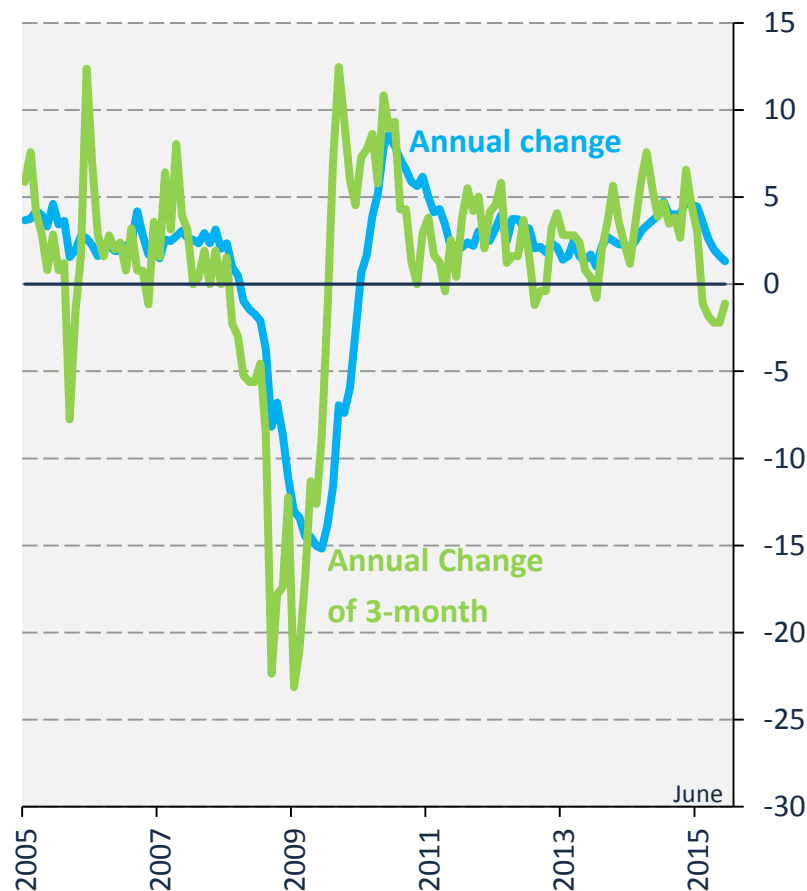
Change in Non-farm Payrolls and Unemployment Rate



EAP/ Economically Active Population.
s. a. / Seasonally adjusted data.
Source: Bureau of Labor Statistics (BLS).

Industrial Production

Percent change, s. a.

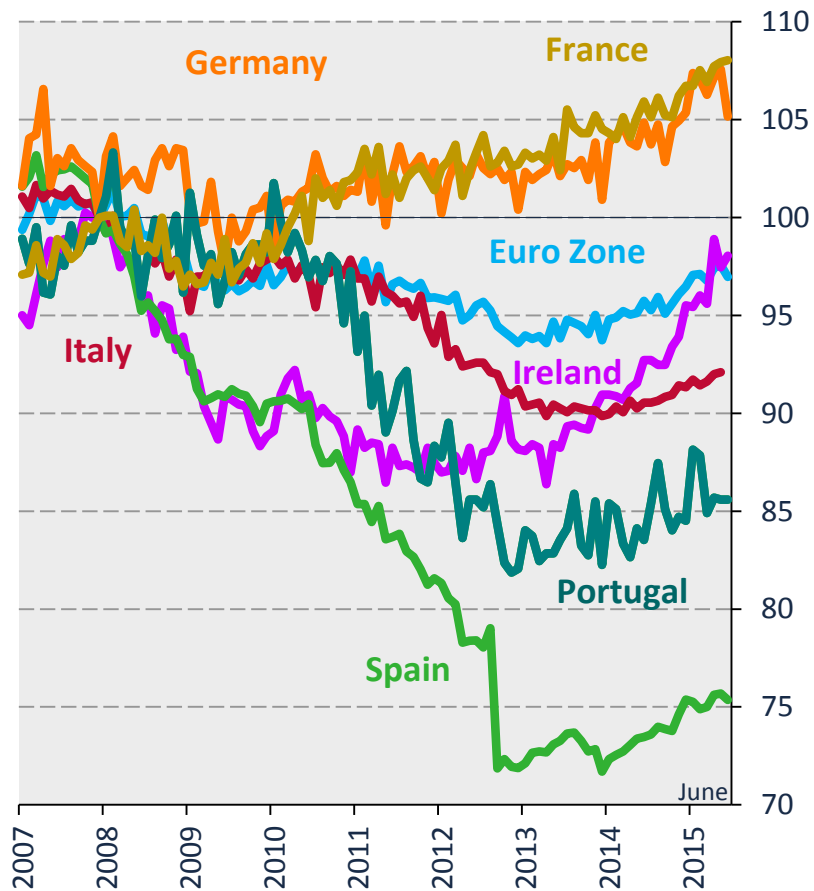


s. a. / Seasonally adjusted data.
Source: Haver Analytics.

In 2Q 2015, economic activity in the Euro zone kept recovering at a moderate pace, particularly as a reflection of an extremely loose monetary policy.

Retail Sales^{1/}

Index December 2007=100, s. a.



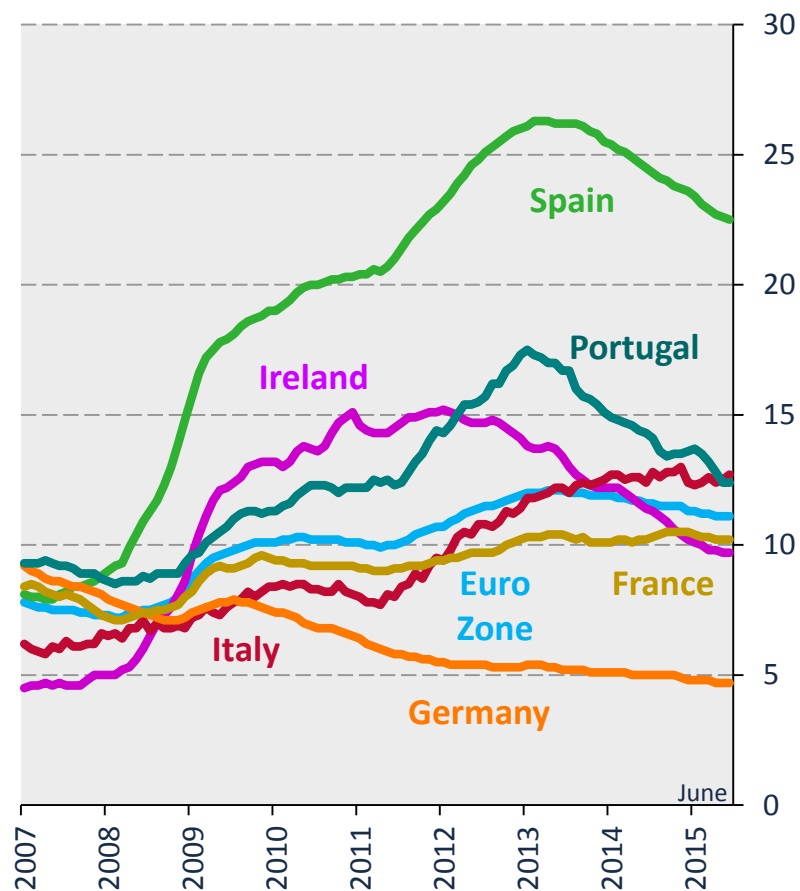
s. a. / Seasonally adjusted figures.

1/ Car sales excluded.

Source: Eurostat.

Unemployment Rate

Percentage of EAP, s. a.



s. a. / Seasonally adjusted figures.

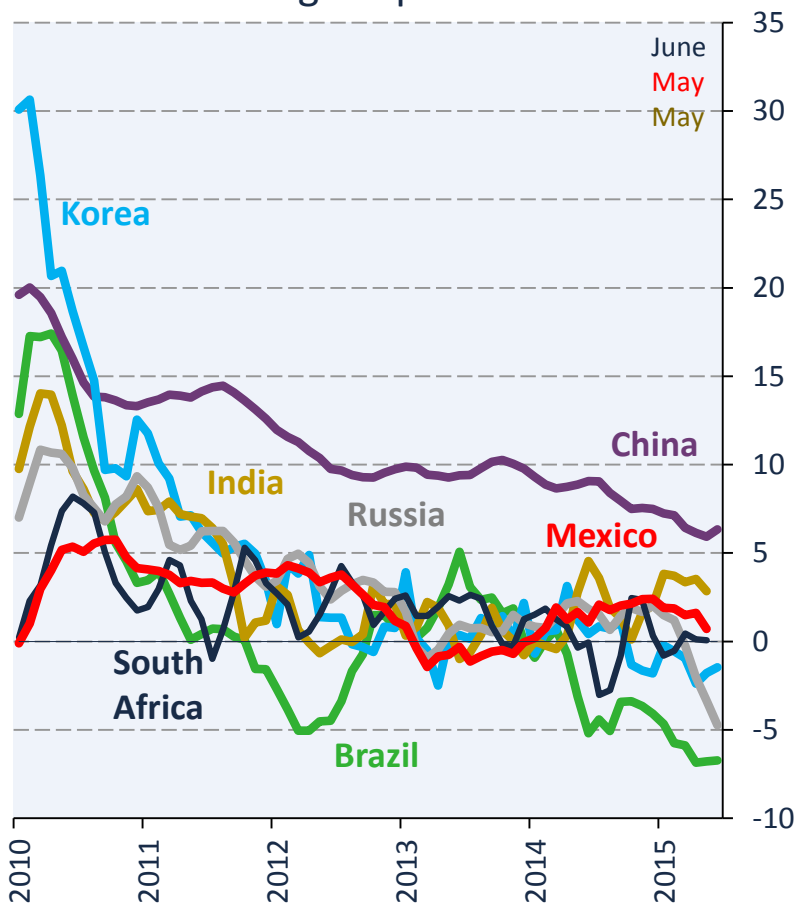
EAP/ Economically Active Population.

Source: Eurostat.

Given lower commodities prices, the activity in emerging economies continued weakening in 2Q 2015.

Industrial Production

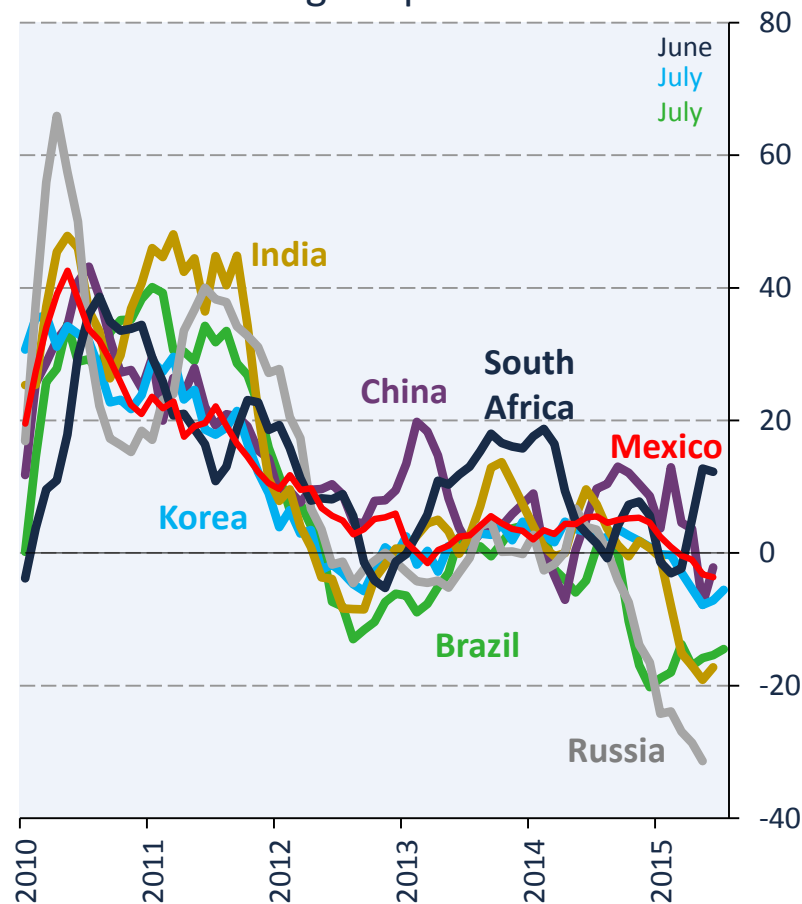
Annual change of 3-month moving average in percent



Source: Haver Analytics.

Exports

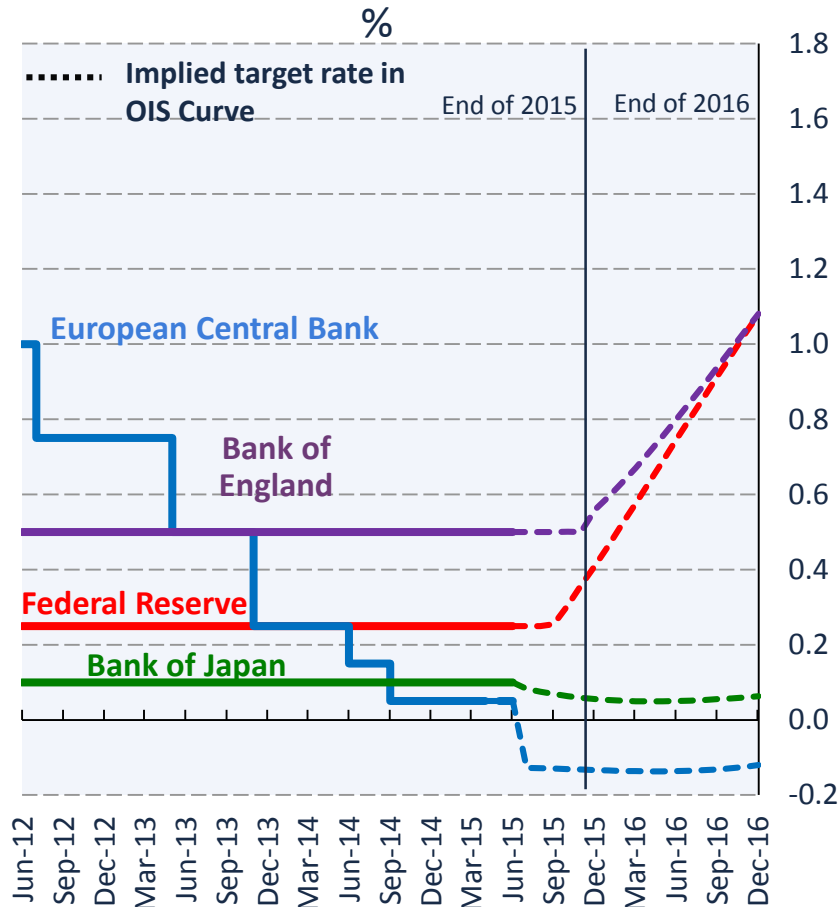
Annual change of 3-month moving average in percent



Source: Bloomberg and INEGI.

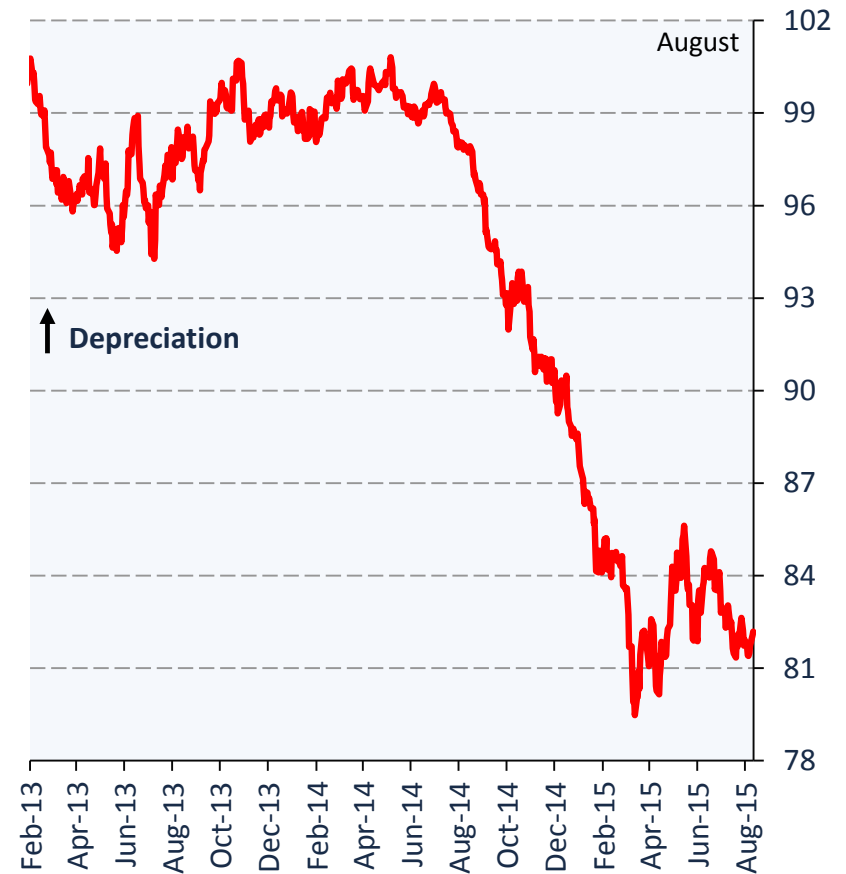
The Federal Reserve is expected to start the normalization process of its monetary policy before the year ends. In light of this, the U.S. dollar appreciated against practically all currencies.

Advanced Economies: Expected Monetary Policy Rates ^{1/}



1/ The expected rates are the trajectories implicit in OIS Curves (Overnight Index Swap). Source: Bloomberg with estimates from Banco de México.

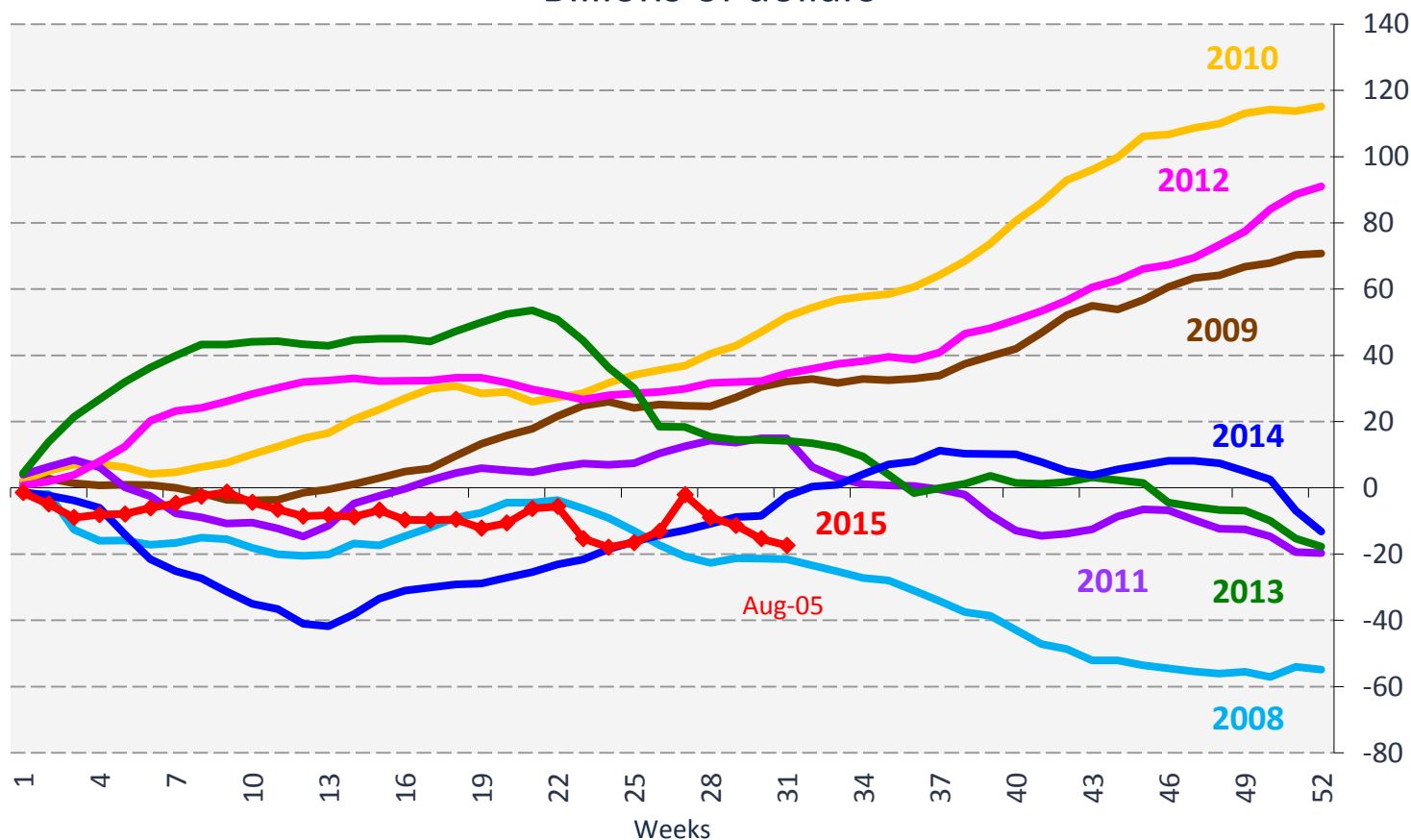
U.S. Dollar Index (DXY) ^{2/} Index 1-Jan-2013=100



2/ DXY index is estimated by the Intercontinental Exchange (ICE) based on the weighted geometric mean of the dollar's value compared with a basket of 6 other major currencies which are: EUR: 57.6%, JPY: 13.6%, GBP: 11.9%, CAD: 9.1%, SEK: 4.2%, and CHF: 3.6%. Source: Bloomberg.

In this setting, emerging economies registered lower capital inflows.

**Accumulated Capital Flows to Emerging Economies
(Debt and Equity) ^{1/}
Billions of dollars**

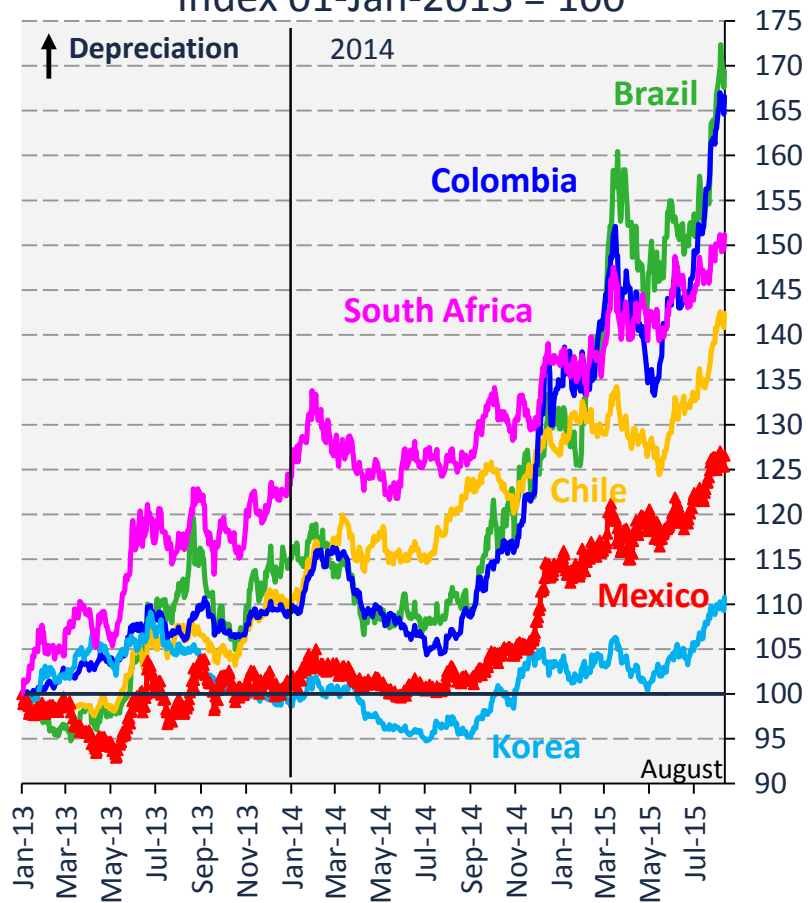


^{1/} The sample covers funds used for the buying-selling of stocks and bonds from emerging countries, recorded in advanced countries. Flows exclude portfolio performance and changes in the exchange rate.
Source: Emerging Portfolio Fund Research.

Emerging economies' currencies depreciated significantly.

Emerging Economies: Nominal Exchange Rate against USD

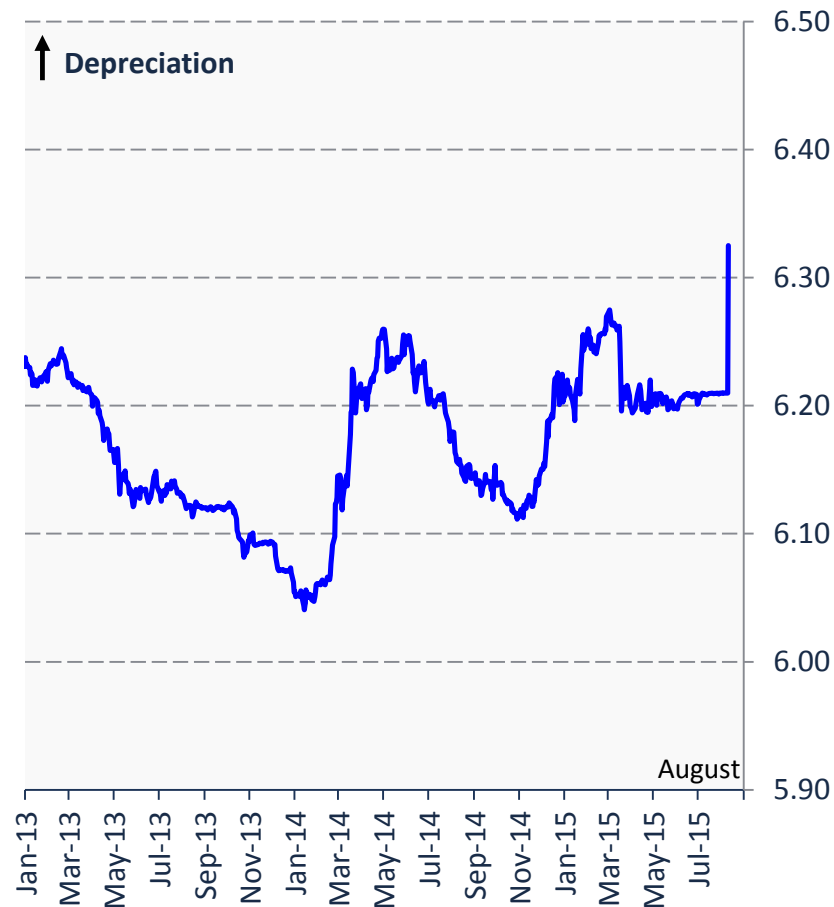
Index 01-Jan-2013 = 100



Source: Bloomberg.

China: Exchange Rate

Yuan per USD



Source: Bloomberg.

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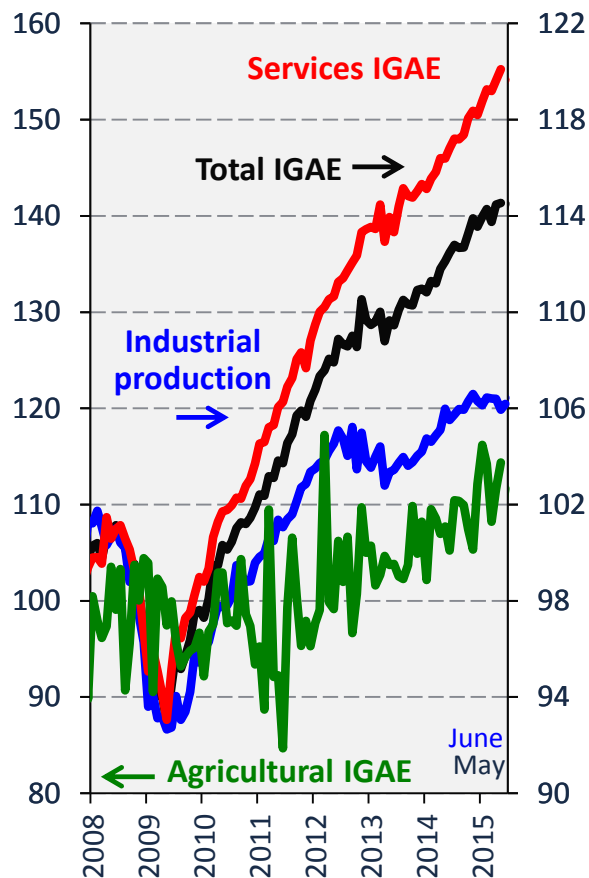
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Forecasts and Balance of Risks

In 2Q 2015, economic activity in Mexico continued exhibiting a low growth rate.

Economic Activity Indicators

Index 2008 = 100, s. a.

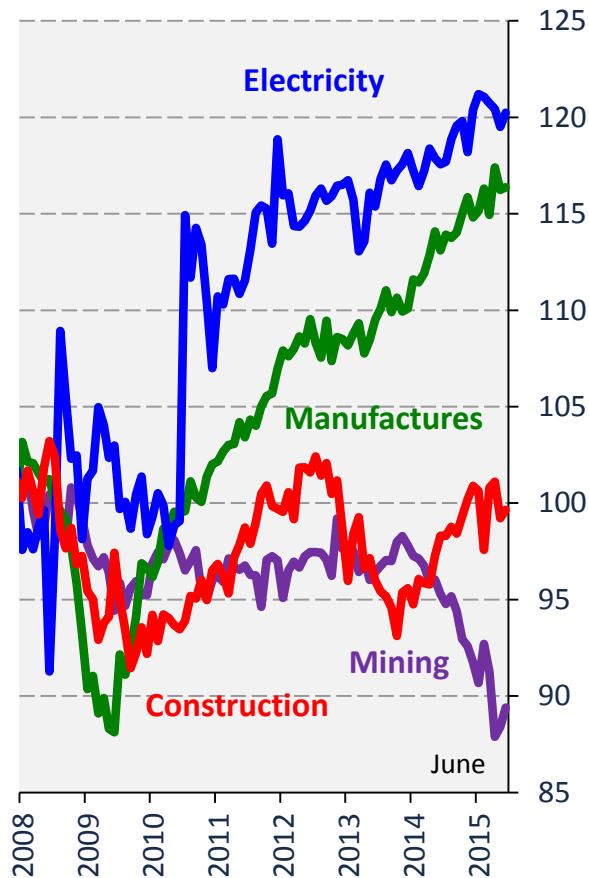


s. a. / Seasonally adjusted data.

Source: Mexico's System of National Accounts, INEGI.

Industrial Activity

Index 2008 = 100, s. a.

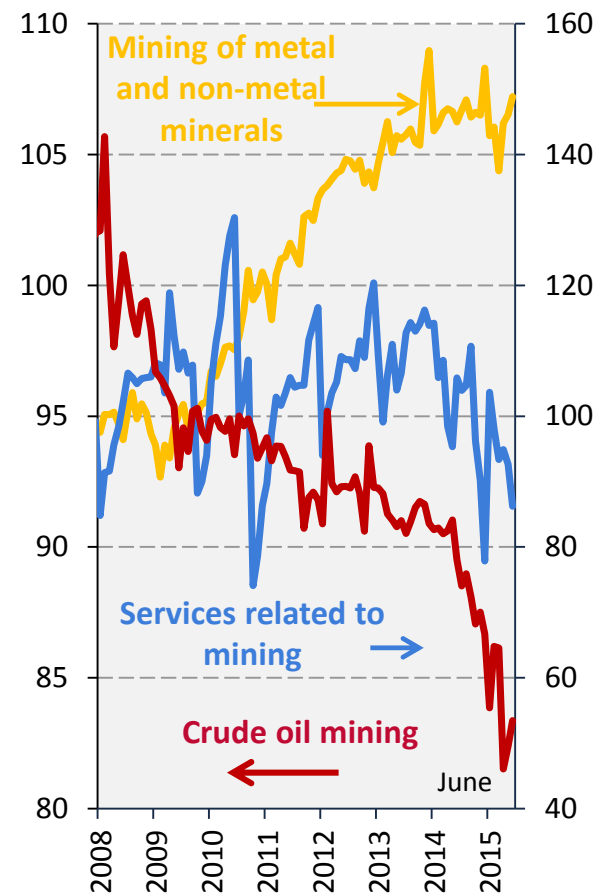


s. a. / Seasonally adjusted data.

Source: Mexico's System of National Accounts, INEGI.

Mining Sector

Index 2008=100, s. a.



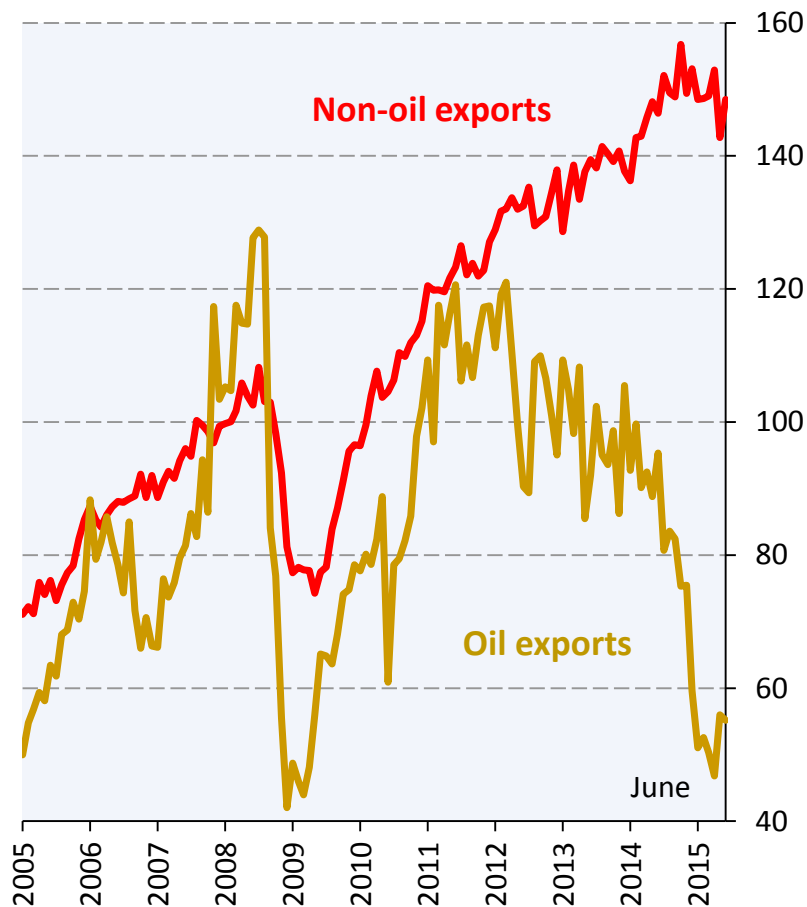
s. a. / Seasonally adjusted data.

Source: Monthly Indicator of Industrial Activity, Mexico's System of National Accounts, INEGI.

Exports registered a weak performance.

Oil and Non-Oil Exports

Index 2008=100, s. a.

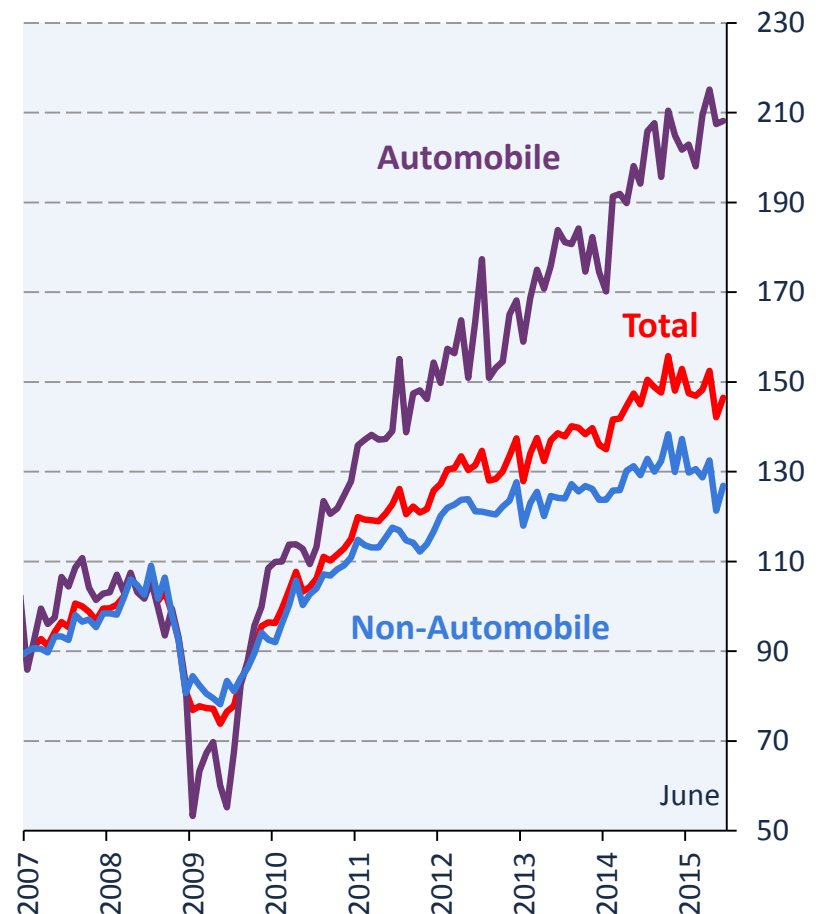


s. a. / Seasonally adjusted data.

Source: Banco de México.

Manufacturing Exports

Index 2008=100, s. a.



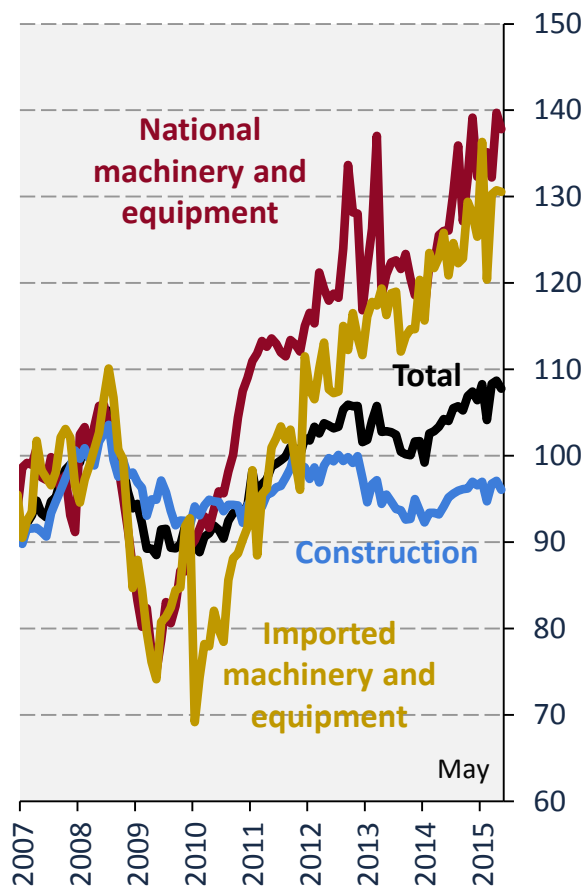
s. a./Seasonally adjusted data.

Source: Banco de México.

Investment presented a lower dynamism, as compared to that observed in previous quarters.

Investment and its Components

Index 2008=100, s. a.

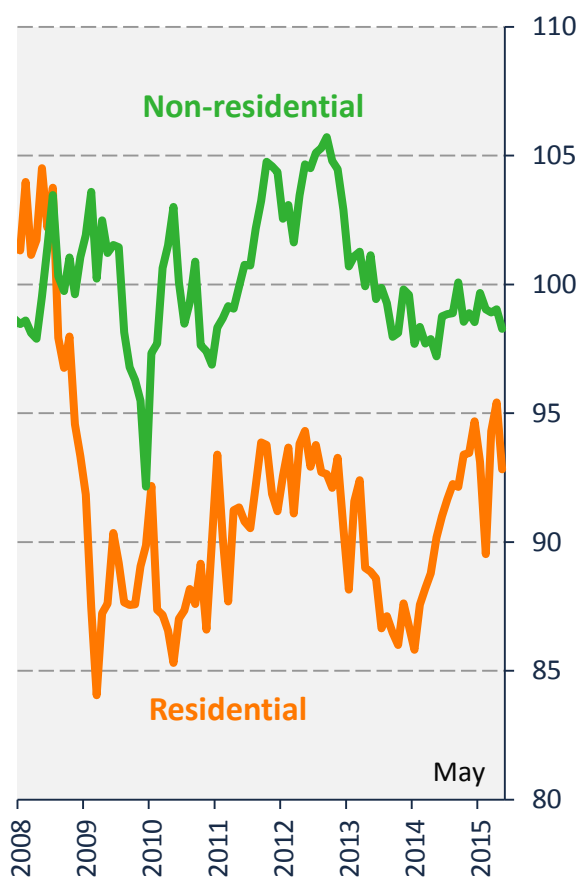


s. a. / Seasonally adjusted data.

Source: Mexico's System of National Accounts, INEGI.

Residential and Non-Residential Construction Investment

Index 2008=100, s. a.

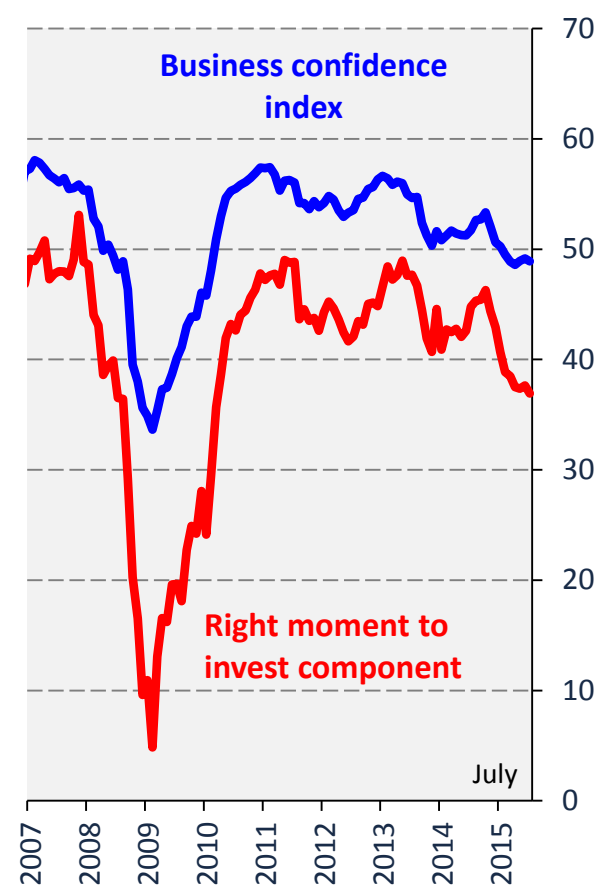


s. a. / Seasonally adjusted data.

Source: Mexico's System of National Accounts, INEGI.

Business Confidence Index

Index with respect to 50 points, s. a.



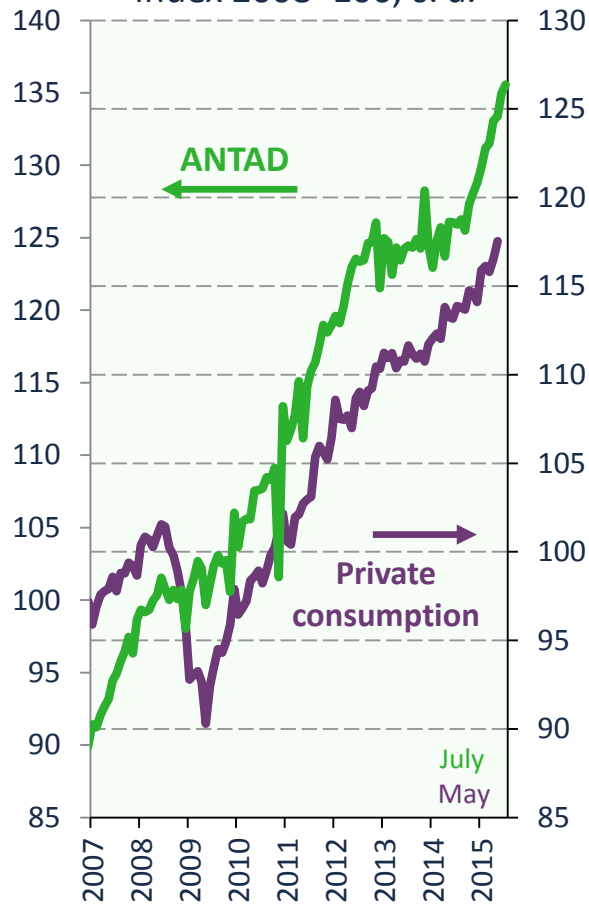
s. a. / Seasonally adjusted data.

Source: INEGI.

In turn, private consumption kept recovering at a moderate pace.

Monthly Indicator of Private Consumption in the Domestic Market and ANTAD Total Sales

Index 2008=100, s. a.

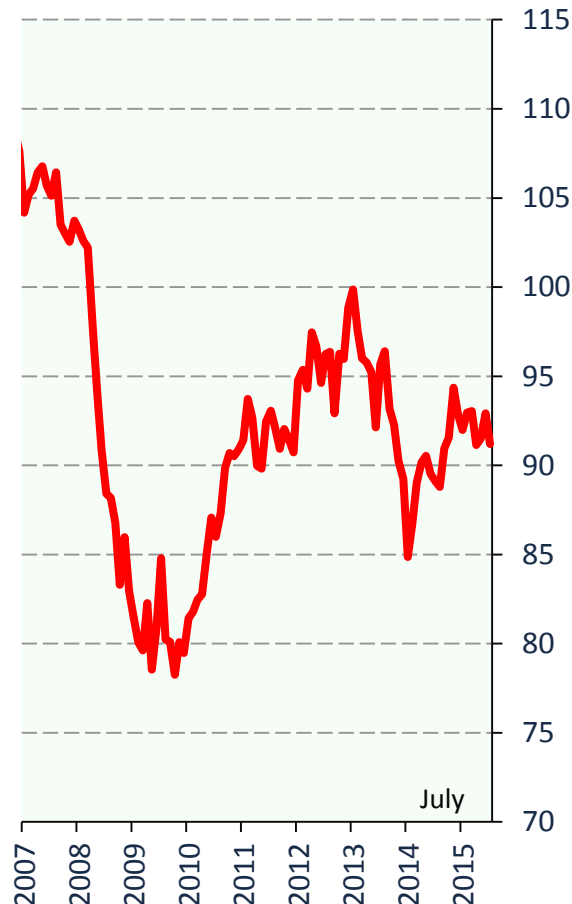


s. a. / Seasonally adjusted data.

Source: INEGI and prepared by Banco de México with ANTAD data.

Consumer Confidence

Index Jan-2003=100, s. a.

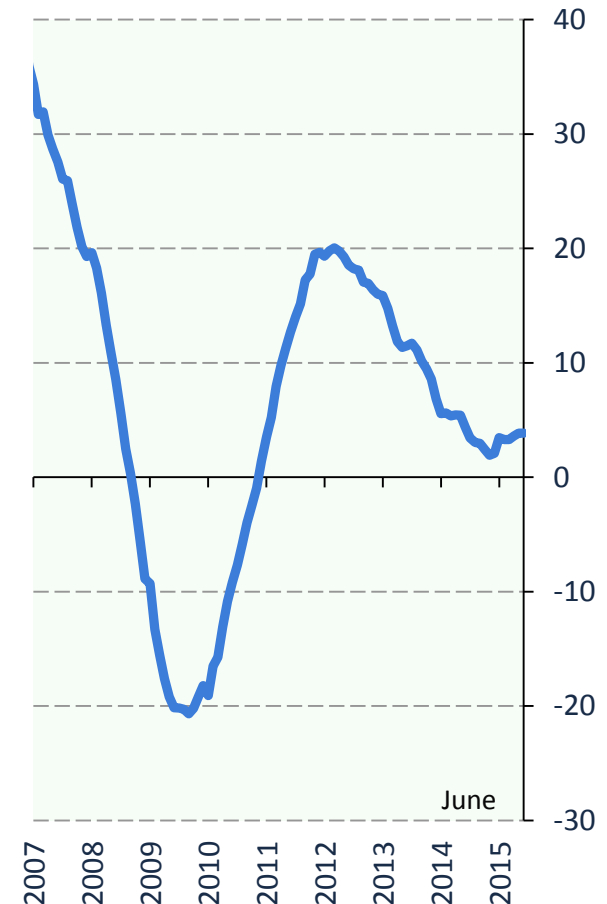


s. a. / Seasonally adjusted data.

Source: INEGI and Banco de México.

Commercial Bank Performing Credit to Consumption ^{1/}

Real annual % change

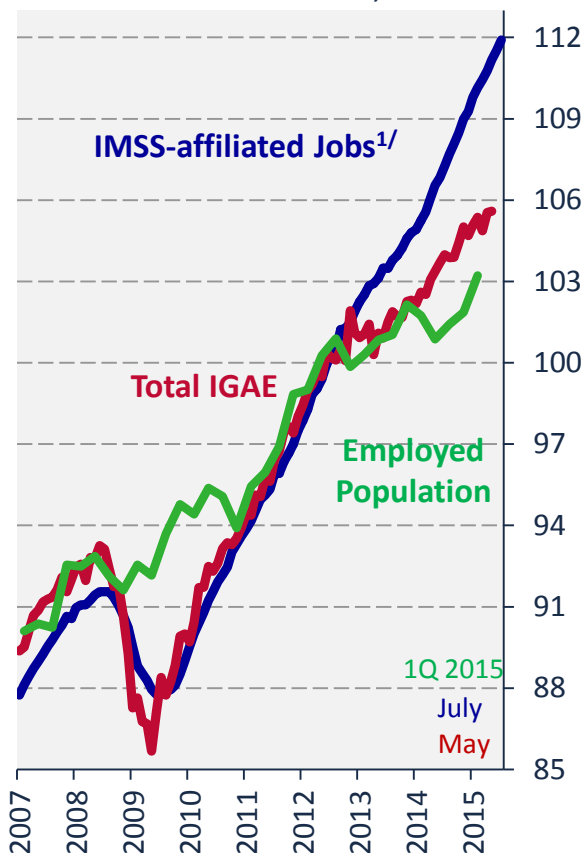


^{1/} It includes loans by credit card-regulated sofomes.

Source: Banco de México.

In 2Q 2015, slack conditions persisted in the labor market, in a context in which some indicators no longer showed the improvement they had been exhibiting since 2014.

IMSS-Affiliated Jobs, Employed Population and Total IGAE
Index 2012=100, s. a.

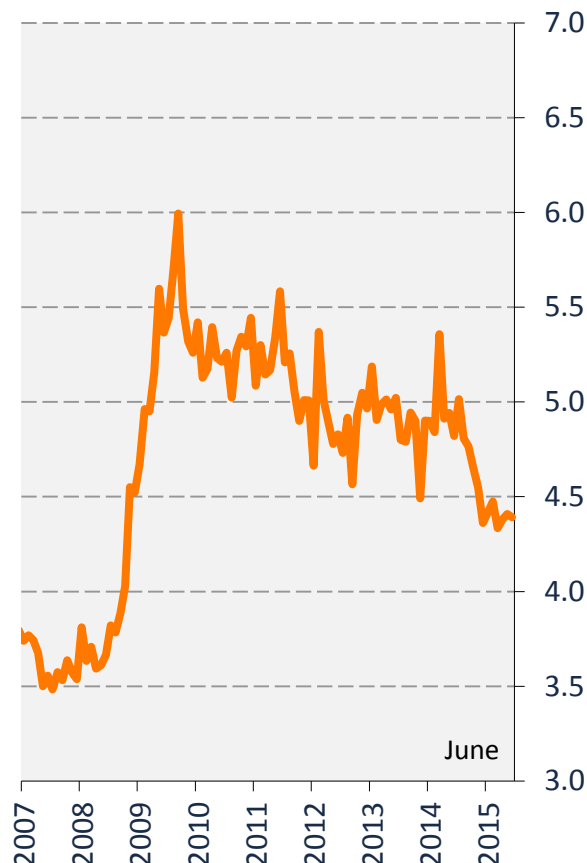


s. a. / Seasonally adjusted data.

^{1/} Permanent and temporary workers in urban areas. Seasonally adjusted by Banco de México.

Source: Calculated by Banco de México with data from IMSS and INEGI (SCNM and ENOE).

National Unemployment Rate
% of EAP, s. a.

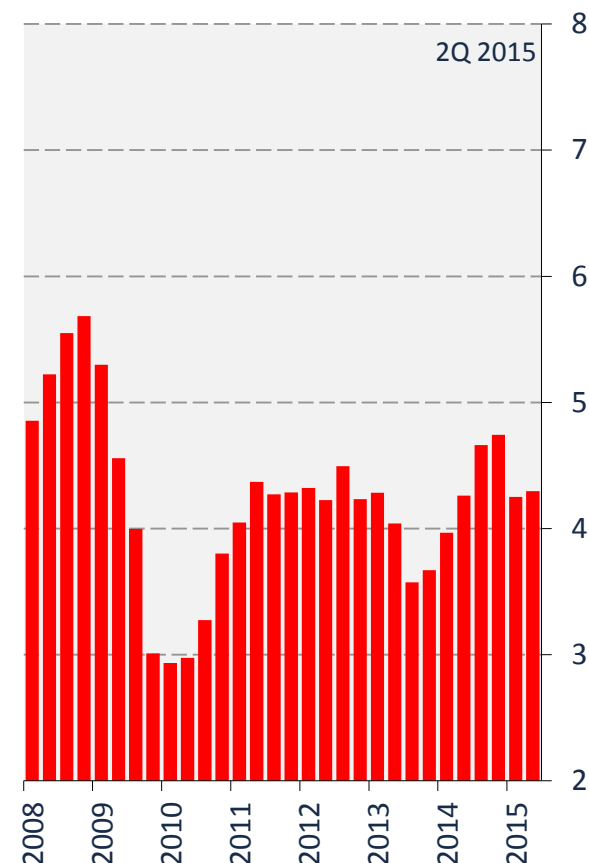


EAP/ Economically active population.

s. a. / Seasonally adjusted data.

Source: National Employment Survey (*Encuesta Nacional de Ocupación y Empleo*), INEGI.

IMSS Reference Wage ^{1/}
Annual % change



^{1/} During the second quarter of 2015, on average 17.7 million of contributors were registered to IMSS.

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

Outline

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2 **External Conditions**

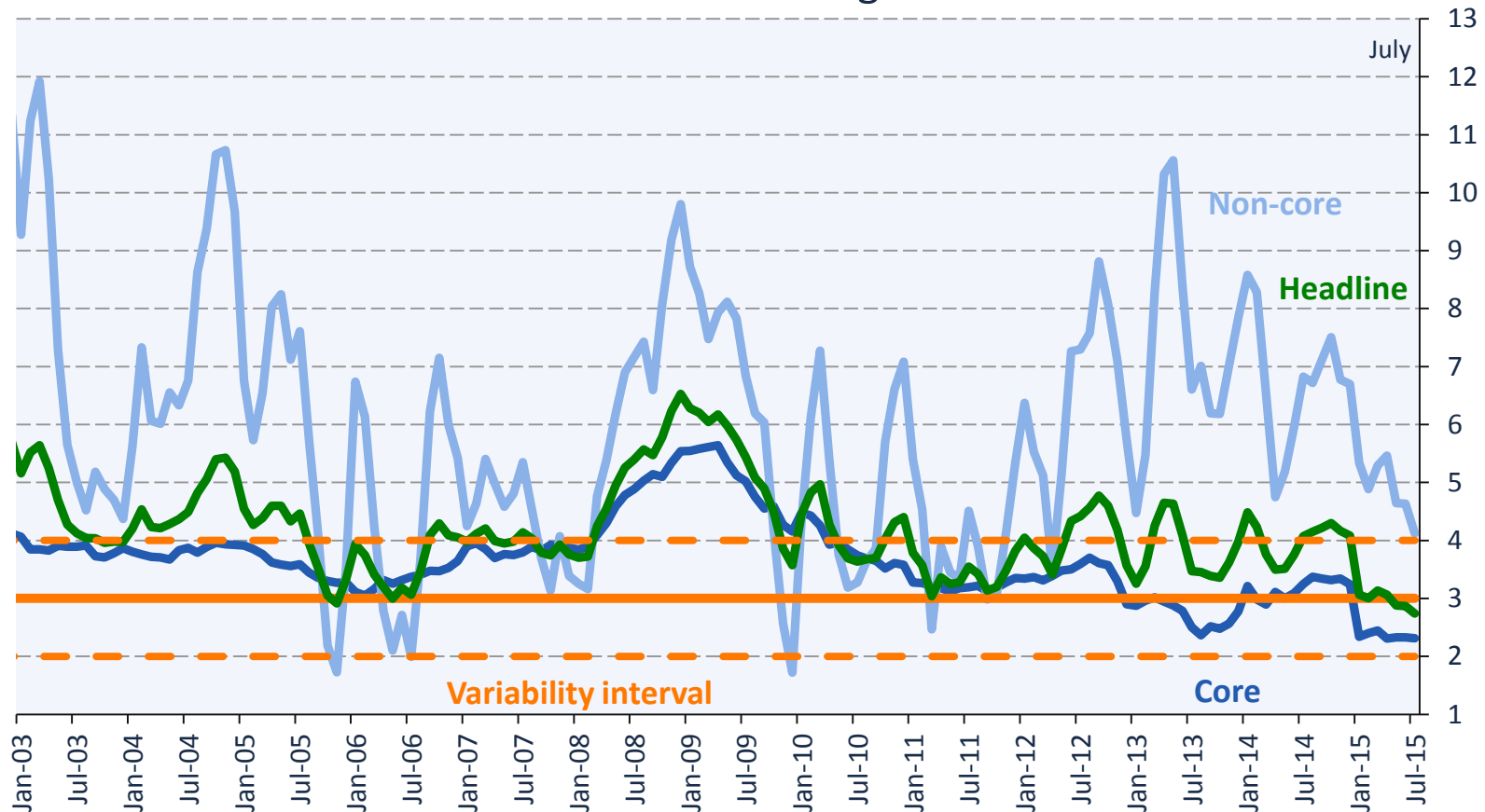
3 **Economic Activity in Mexico**

4 **Inflation Determinants**

5 **Forecasts and Balance of Risks**

In 2015, headline inflation converged to the permanent 3 percent target. Moreover, since May 2015 it has even lied below the target, reaching minimum historic levels.

Consumer Price Index Annual % change

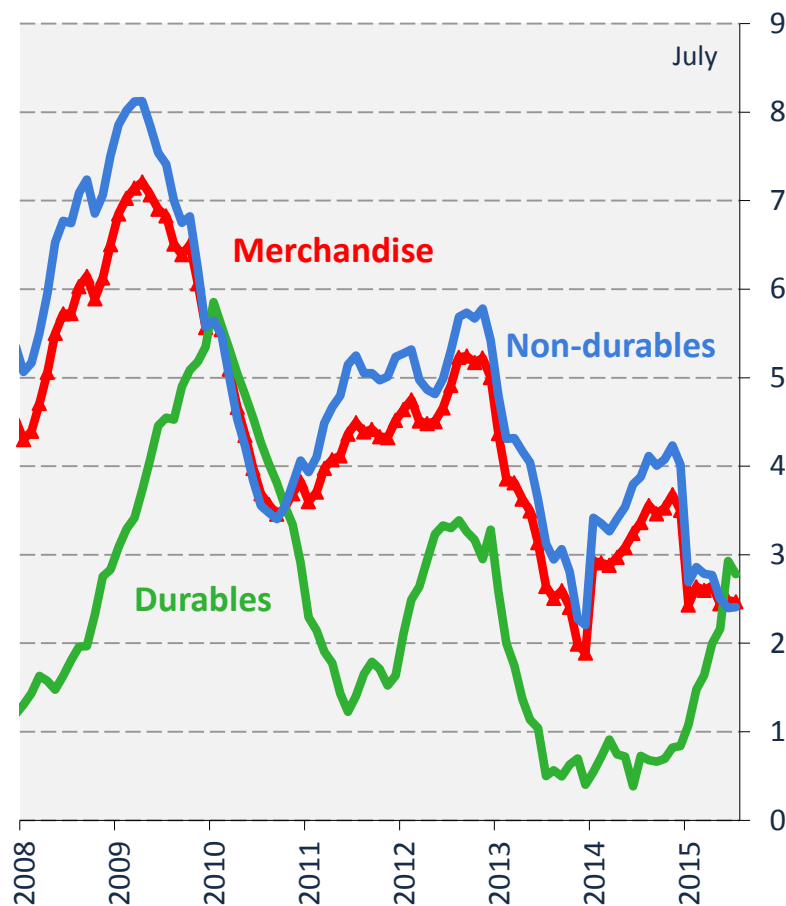


Source: Banco de México and INEGI.

The pass-through of the exchange rate depreciation onto prices has been limited, mainly reflecting in the prices of durable goods and without generating second round effects.

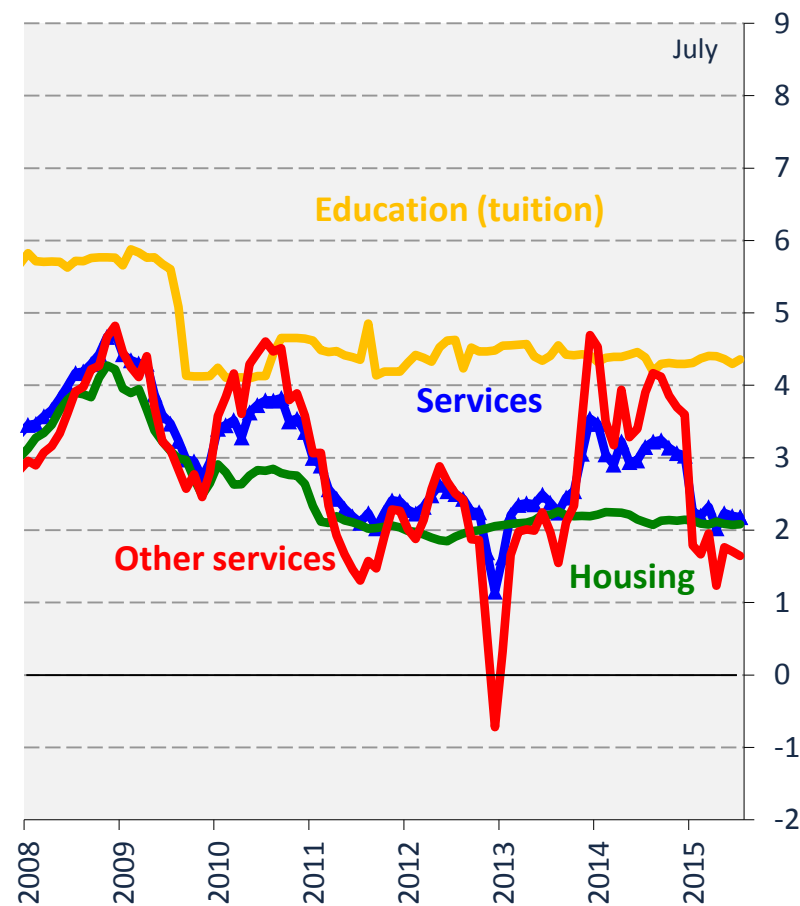
Core Price Index Annual % change

Merchandise



Source: Banco de México and INEGI.

Services

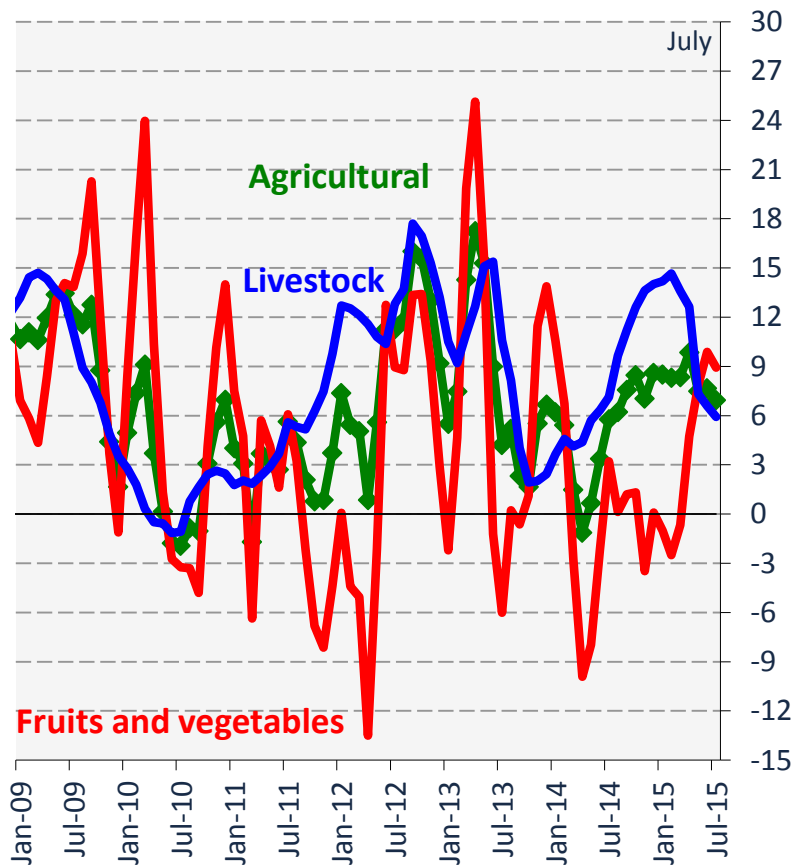


Source: Banco de México and INEGI.

The non-core price index reduced its average annual growth rate between 1Q and 2Q 2015.

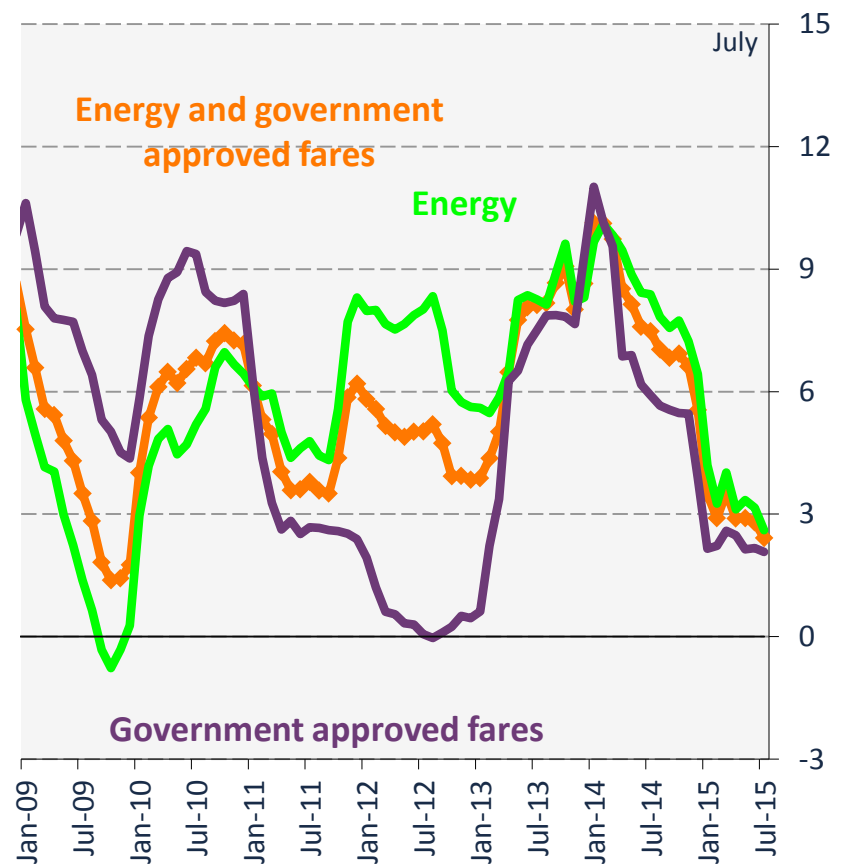
Non-Core index Annual % change

Agricultural



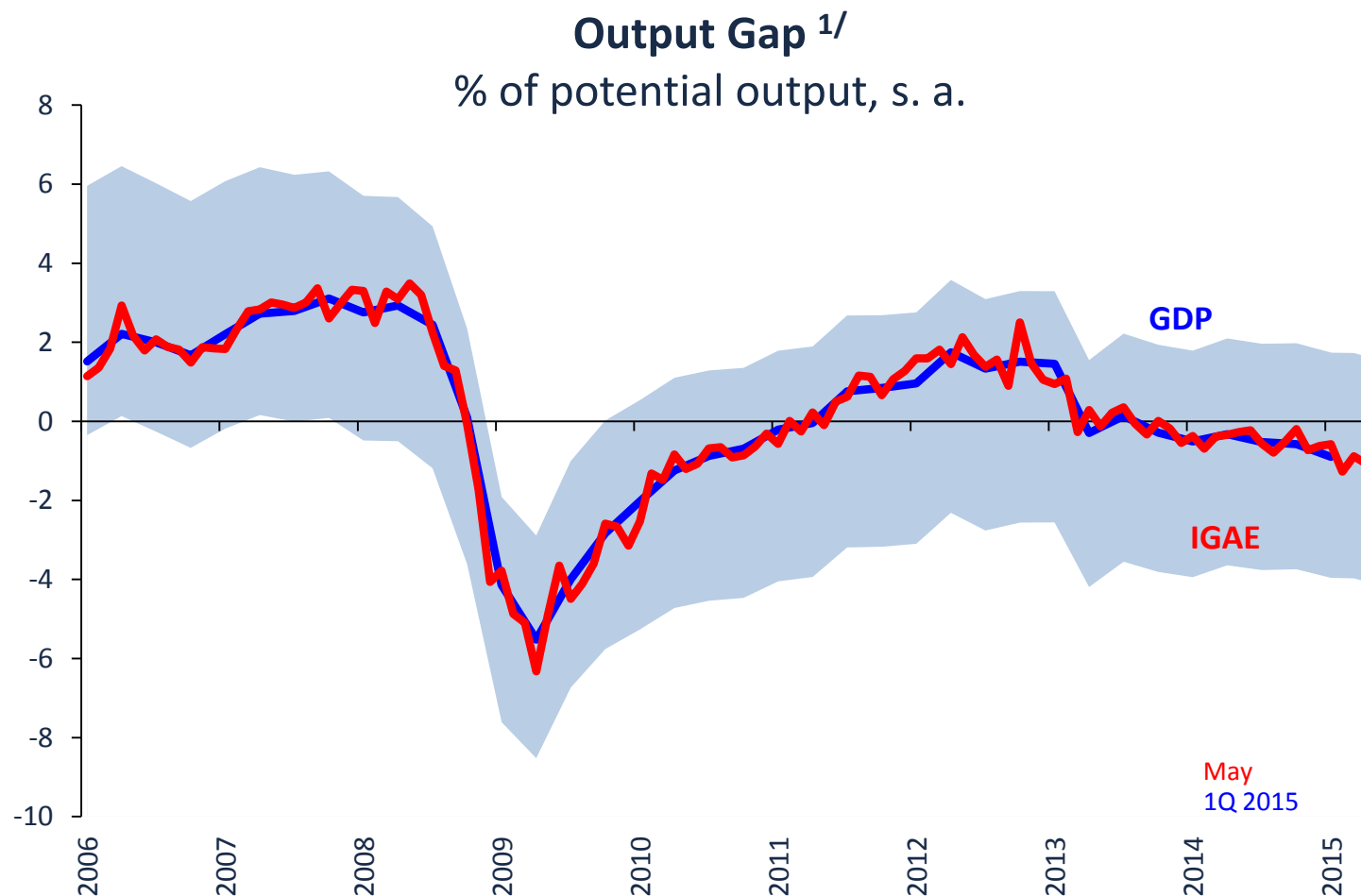
Source: Banco de México and INEGI.

Energy and Government Approved Fares



Source: Banco de México and INEGI.

In the described environment, the output gap is still at negative levels. However, if the economic activity registers greater dynamism, it will be gradually closing.



s. a. / Calculated with seasonally adjusted data.

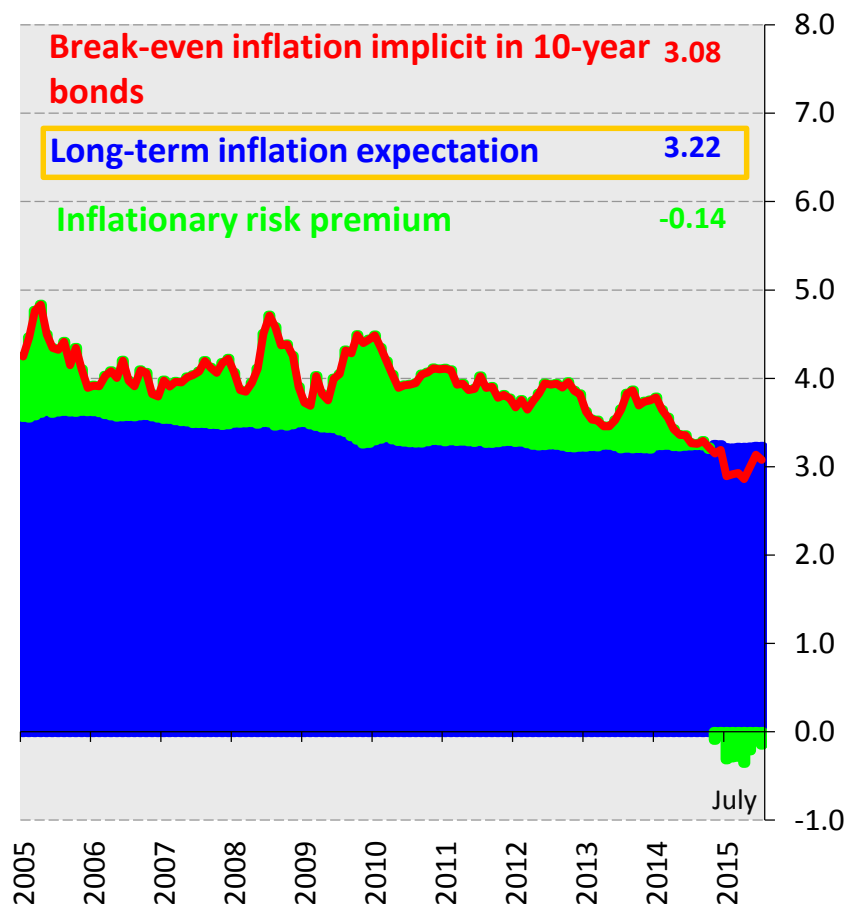
1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p.69.

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.

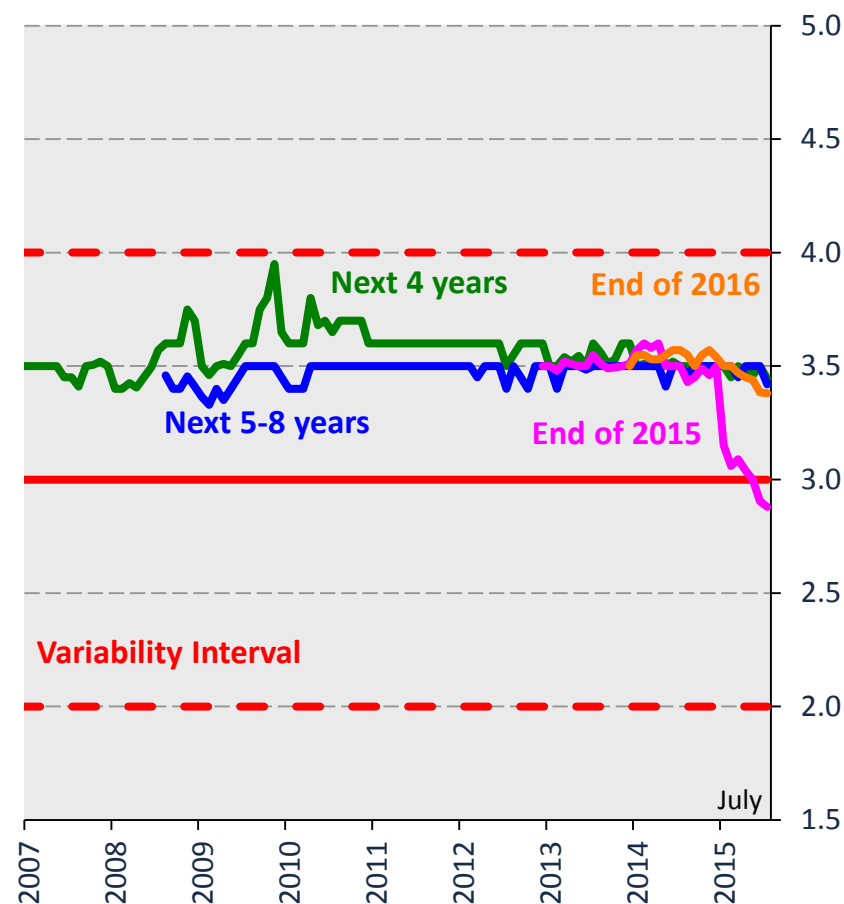
Long-term inflation expectations implicit in market instruments remained stable, while the survey-derived ones decreased for shorter terms.

Break-even Inflation Decomposition ^{1/} %



1/ The inflation risk premium is calculated with data from Valmer and Bloomberg, based on the methodology described in Box 1 "Decomposition of the Break-even Inflation" of the Quarterly Report October-December 2013.

Annual Headline Inflation Expectations Median, %



Source: Survey of private sector economic analysts' expectations, Banco de México.

The adjustment in real terms of the national currency's exchange rate facilitates the economy's adjustment to the new international environment.

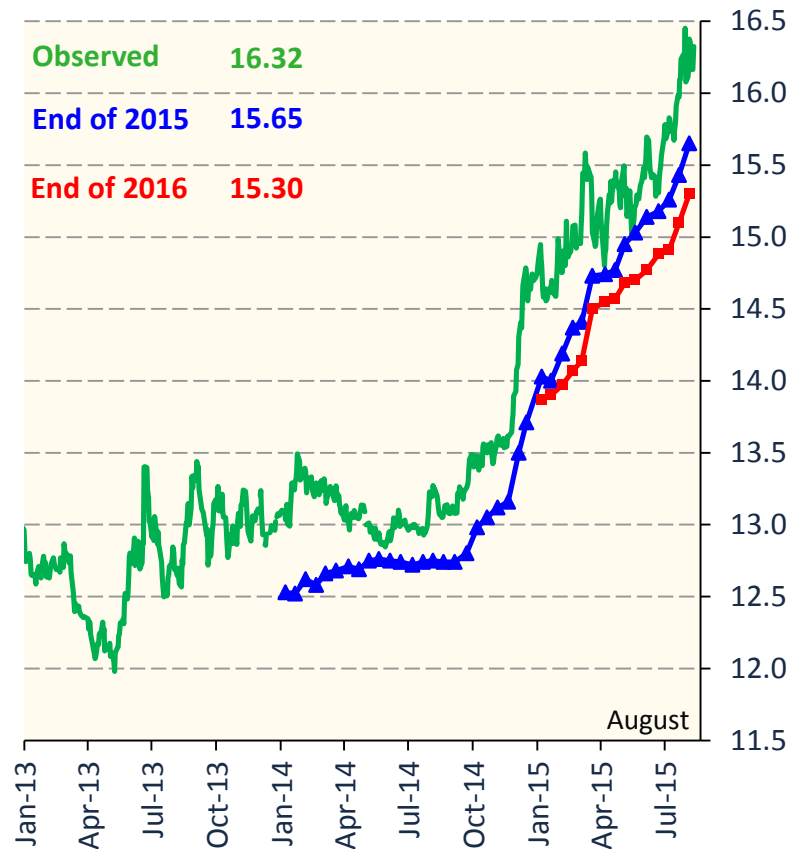
■ In a context of:

- ✓ *Well-anchored inflation expectations.*
- ✓ *A low pass-through of exchange rate adjustments onto prices.*
- ✓ *Efforts to ensure the fiscal consolidation.*

→ **The nominal exchange rate depreciation contributes to a more efficient real exchange depreciation.**

The nominal exchange rate adjustment of the Mexican peso against the U.S. dollar has been significant, although it occurred under orderly conditions in the FX market.

Exchange Rate and its Expectations for the
End of 2015 and 2016 ^{1/}
Pesos per USD



1/ The observed exchange rate is the daily FIX exchange rate. The latest data for the observed exchange rate is August 11, 2015, and the foreign exchange rate forecasts is August 05, 2015.

Source: Banco de México and Banamex survey.

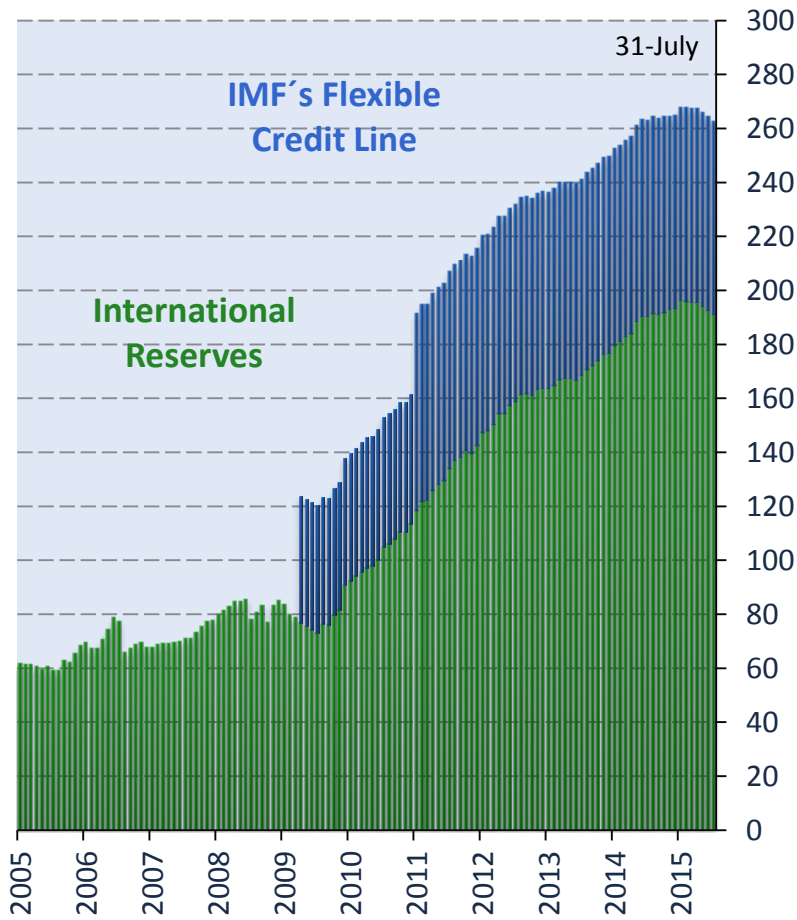
Implied Volatility in Foreign
Exchange Rate Options ^{2/}
%



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

To reduce the probability that potential pressures on the exchange rate could disrupt the proper functioning of this market in Mexico, the Foreign Exchange Commission took various measures during the reference period.

International Reserves USD billion



Source: Banco de México and International Monetary Fund.

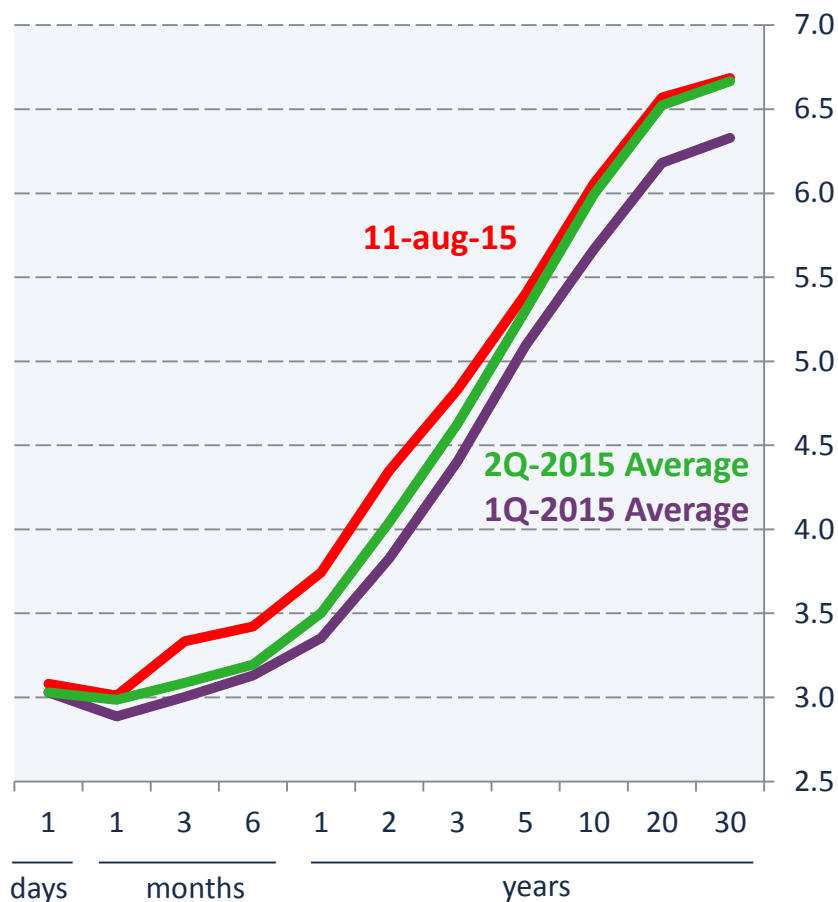
Foreign Exchange Commission Preemptive Steps to Provide Liquidity to the FX Market:

- ✓ **December 2014:** Auctions of dollars of up to USD 200 million at a minimum price.
- ✓ **March 2015:** Daily auctions of USD 52 million without a minimum price.
- ✓ **May 2015:** The extension until September 29, 2015 of the auction period of USD 52 million without a minimum price.
- ✓ **July 2015:** The increment in the amount of auctions without a minimum price from USD 52 to 200 million, and the decrease of the threshold from 1.5% to 1.0%, to activate the auctions with a minimum price. Both mechanisms are in force until September 30, 2015.

Interest rates increased for medium and long terms. However, government securities' holdings by foreign residents remained stable.

Government Bond Yield Curve

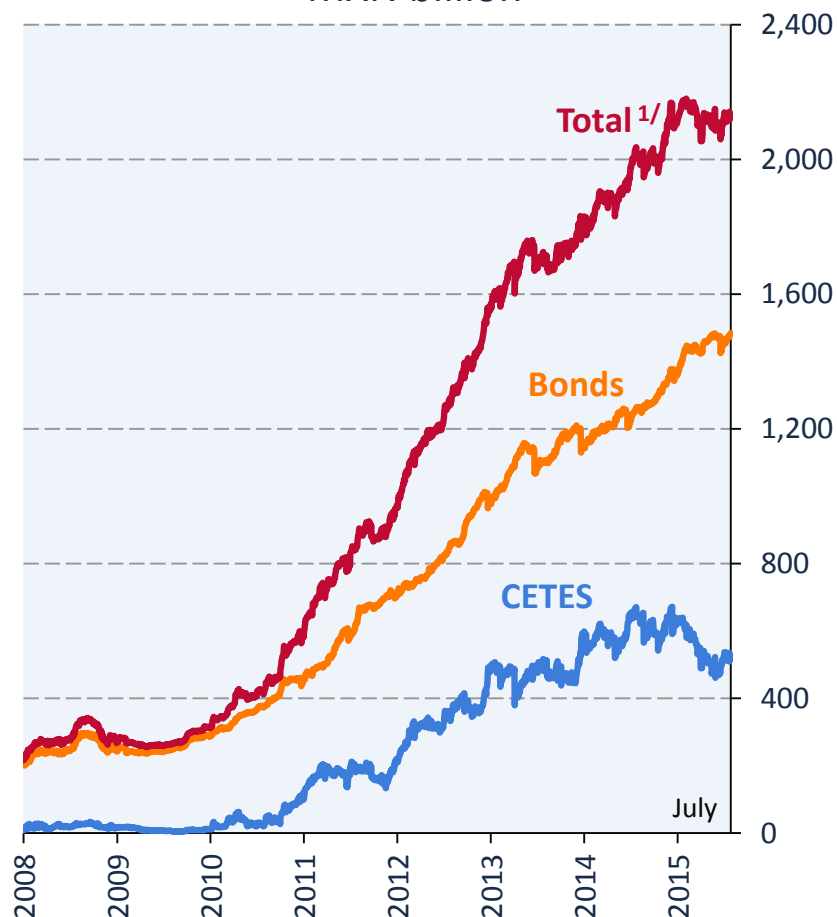
%



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

Government Securities' Holdings by Foreign Investors

MXN billion



1/Includes: Bondes, Bondes D, Bonos, Cetes and Udibonos.

Source: Banco de México.

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Economic Activity Outlook

GDP Growth

2015	Between 1.7 and 2.5
2016	Between 2.5 and 3.5

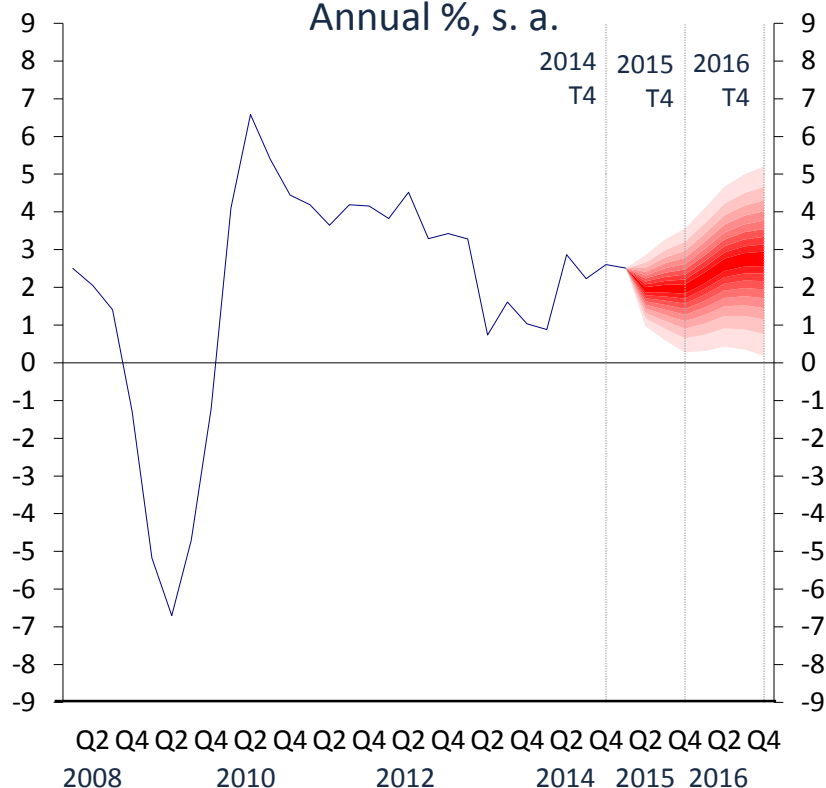
Increase in the Number of IMSS-affiliated Jobs

2015	Between 560 and 660 thousand
2016	Between 600 and 700 thousand

Fan Charts

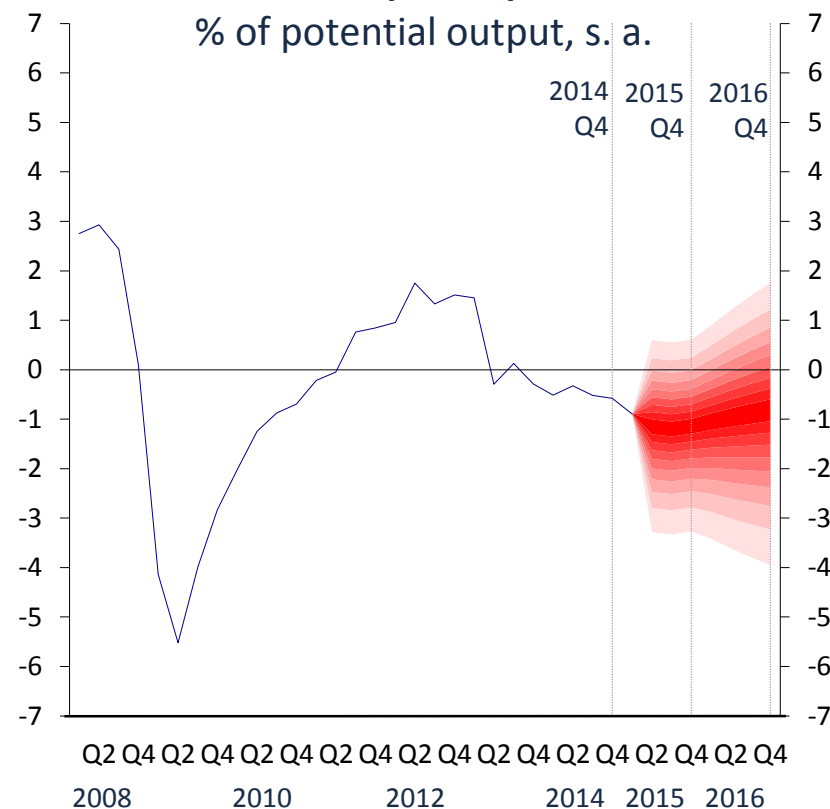
GDP Growth

Annual %, s. a.



Output Gap

% of potential output, s. a.



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

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

Risks to the Growth Outlook:

Upward:

- ✓ A greater dynamism of the exports' sector, given a greater than expected recovery of external demand and a real exchange rate depreciation.
- ✓ Rapid progress in the implementation of structural reforms and in the strengthening of the rule of law.

Downward:

- ✓ That manufacturing exports will keep registering a low dynamism, if the U.S. industrial sector maintains a weak performance.
- ✓ A deterioration in investors' outlook.
- ✓ That the recovery of the national oil production in Mexico will be delayed.
- ✓ A further increase in international financial markets volatility.

Inflation Outlook

Headline Inflation

Core Inflation

2015

Below 3 percent for the rest of the year.

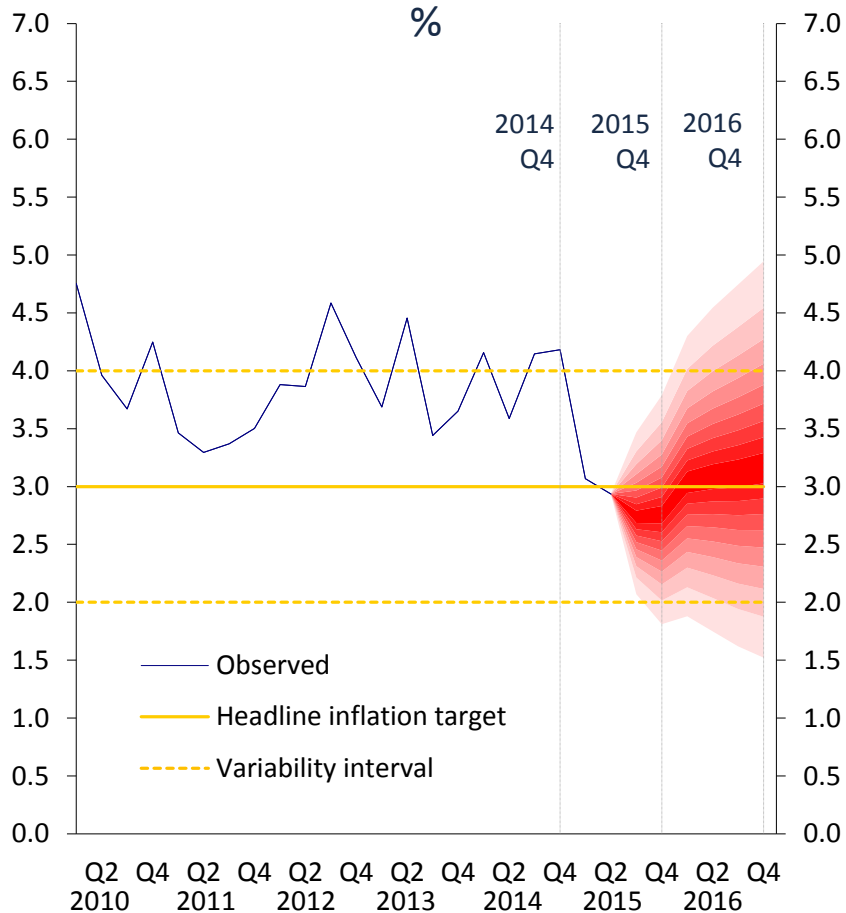
2016

At levels close to 3 percent.

Inflation is estimated to continue with a favorable evolution for the rest of the year and during 2016.

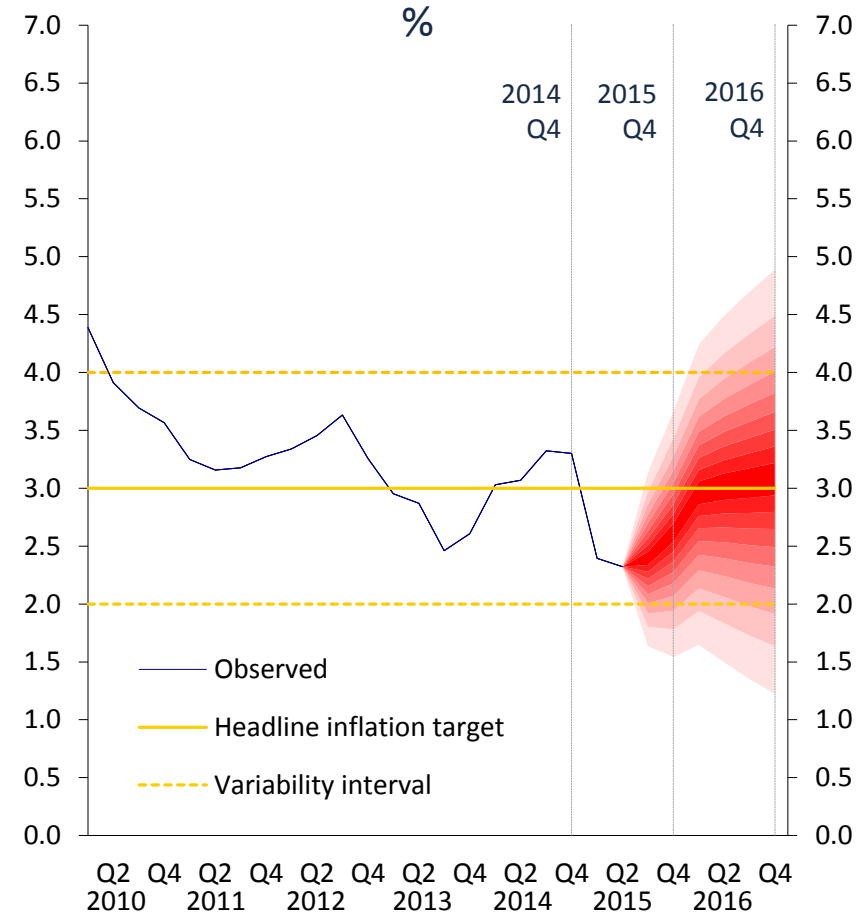
Fan Charts

Annual Headline Inflation ^{1/}



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

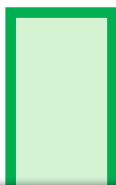
Annual Core Inflation ^{2/}



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

Risks to Inflation Forecast :

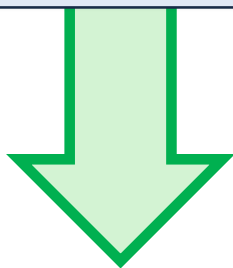
Downward



A still lower than expected dynamism of economic activity.



Further reductions in energy prices and/or in telecommunication services prices.



Upward



That the depreciation of the Mexican peso increases and affects non-tradable goods prices, which could contaminate inflation expectations.



Monetary Policy Stance

Domestic conditions

The cyclical conditions of the economy continue to show weakness, inflation has remained below 3 percent and inflation expectations are well-anchored.

External conditions

Federal Reserve possible monetary policy actions could have further repercussions on the exchange rate, inflation expectations, and, therefore, on the price dynamics in Mexico.

- Hence, Banco de México's Board of Governors will monitor the performance of all inflation determinants and its expectations in the medium and long term, in particular:
 - ✓ *The performance of the exchange rate.*
 - ✓ *The monetary policy stance of Mexico relative to the U.S.*
 - ✓ *The evolution of the degree of slack in the economy.*

➤ **All of the above, in order to be able to take the necessary measures, flexibly and when needed, to consolidate the convergence of inflation to the 3 percent target.**

Challenges to Strengthen Confidence in the Mexican Economy

- ① In light of a complex international environment and the expectation that it will persist in the future, it is of key to preserve a **solid macroeconomic framework**.
 - ✓ *The structural strengthening of public finances is required, which becomes more relevant given a significant decrease in crude oil prices and production. In particular, it is necessary that the public debt to GDP ratio stabilizes at sustainable levels in the medium and long term.*
- ② **Higher and sustainable growth rates**. In order to achieve this it is necessary to increase the productivity, which, in turn, requires clear progress in the implementation of structural reforms.
- ③ The strength of institutions is crucial to back a good functioning of the economy. For this reason Mexico should make an additional effort to strengthen **the institutions** and **the rule of law**.



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