



Quarterly Report

October – December 2013

February 12, 2014



BANCO DE MÉXICO

Outline

1 Monetary Policy

2 External Conditions

3 Economic Activity in Mexico

4 Inflation Determinants

5 Forecasts and Balance of Risks

The priority goal of Banco de México is procuring the purchasing power stability of the currency

Banco de México's actions have been oriented towards achieving an efficient convergence of inflation to the 3 percent permanent target, i.e. at the minimal cost to the society in terms of economic activity.

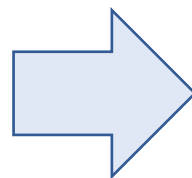
Structural progress in curbing inflation over the last decade

Adequate macroeconomic policy stance

More room for maneuver in the monetary policy conduction in 2013

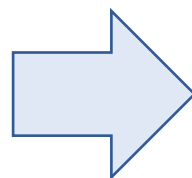
Monetary Policy Conduction in 2013

March 2013: reduction of the reference interest rate by 50 basis points



Recognizing the medium-term progress in curbing inflation

September and October 2013: two reductions of the reference interest rate by 25 basis points



Given the observed weakening of economic activity

Implementing a countercyclical monetary policy, without jeopardizing the inflation convergence to its target, despite uncertainty in international financial markets, was possible thanks to the progress in anchoring inflation expectations in Mexico.

During 2013 inflation showed a favorable evolution.

Headline Inflation: maintained a downward trend, converging to the 3 percent permanent target

Core Inflation: located at minimum historical levels

Despite the abovesaid:

4Q 2013



The downward inflation trend was interrupted by the changes in relative prices of a reduced number of goods and services of the non-core subindex

Early 2014



The implementation of the fiscal measures and adjustments in public prices has led to a temporary inflation increase

The recent inflation increase is expected to be transitory and to not affect the price formation process in the economy, due to the following:

→ It has been concentrated in goods and services affected by the fiscal measures and public prices

→ No second round effects have been observed, given that medium- and long-term inflation expectations have remained stable

✓ *If such effects occur, for them to become permanent Banco de México would have to ratify them by means of monetization, which would not be the case as it goes against its mandate*

→ Slack conditions prevail in the economy

→ Inflation dropped in the period from the first to the second fortnight of January

→ It has been in line with Banco de México's forecast

➔ *Thus, even though Banco de México is not comfortable with the current inflation level, it considers that the inflationary process is under control*

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External Conditions

Global Outlook in 4Q 2013

Economic Growth

- ✓ *World economic activity continued recovering*
 - ➔ *Better performance of advanced economies, mainly the U.S.*
 - ➔ *Stabilization of the growth rate of most emerging economies*

Inflation

- ✓ *In general, inflationary pressures diminished and in line with the expectations, inflation will remain at low levels*

Monetary Policy

- ✓ *The Federal Reserve started to reduce the pace of its asset purchases from January 2014, and stressed that its reference interest rate would remain at low levels for a considerable period of time*
- ✓ *However, uncertainty persists regarding:*
 - *The normalization process of the monetary policy*
 - *The levels that long-term interest rates could reach in this country*

In the U.S., different indicators show that economic activity is strengthening.

Industrial and Manufacturing Production

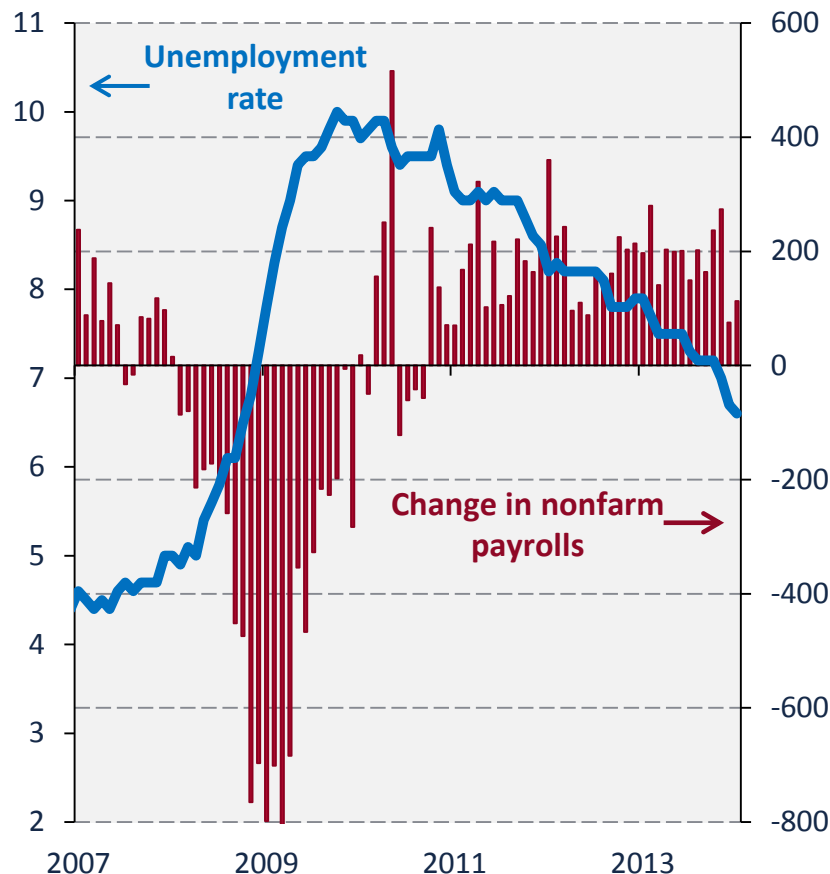
Index 2007=100, s.a.



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

Change in Nonfarm Payrolls and Unemployment Rate

Thousands of jobs and % of EAP, s.a.



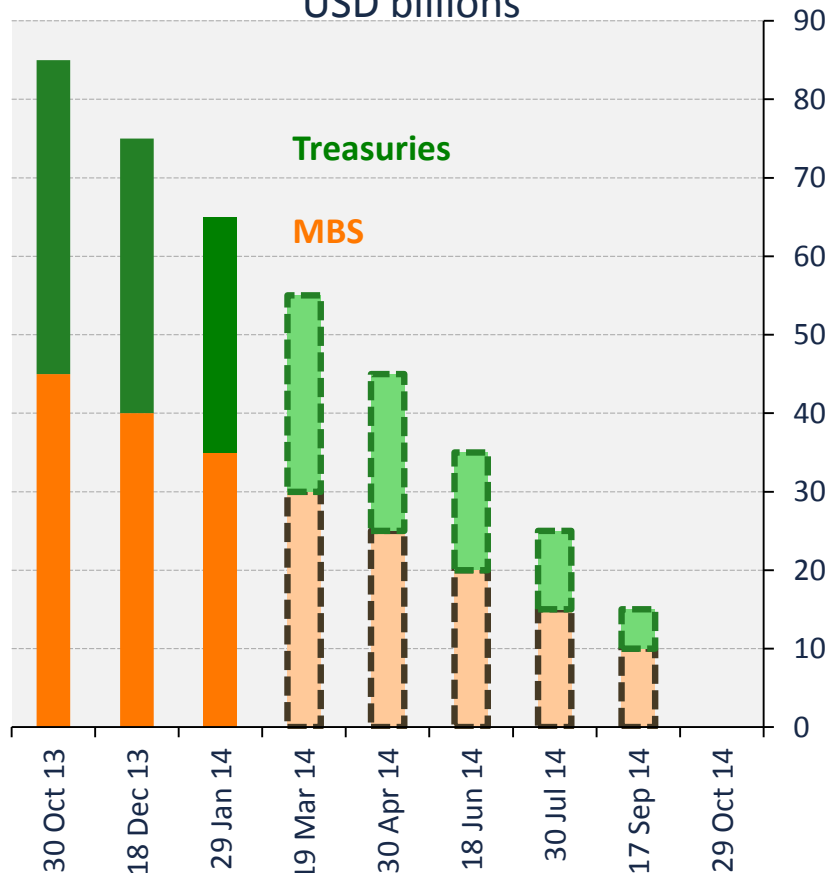
EAP/ Economic ally Active Population.
s.a./ Seasonally adjusted data.
Source: Bureau of Labor Statistics.

The Federal Reserve announced the beginning of a moderate reduction of its asset purchases and stressed that it would probably be appropriate to maintain the policy rate at low levels for a long period of time.

Expected Path for the Federal Reserve

Asset Purchase Program ^{1/}

Announcement of monthly purchases,
USD billions



^{1/} It is assumed that the Federal Reserve will reduce the pace of its monthly asset purchases by \$10 bn in each of its following meetings, so as to announce the end of the program on September 2014. After the program concludes, the Federal Reserve's balance sheet is assumed to shrink as the assets purchased mature.

Yields of Government Securities

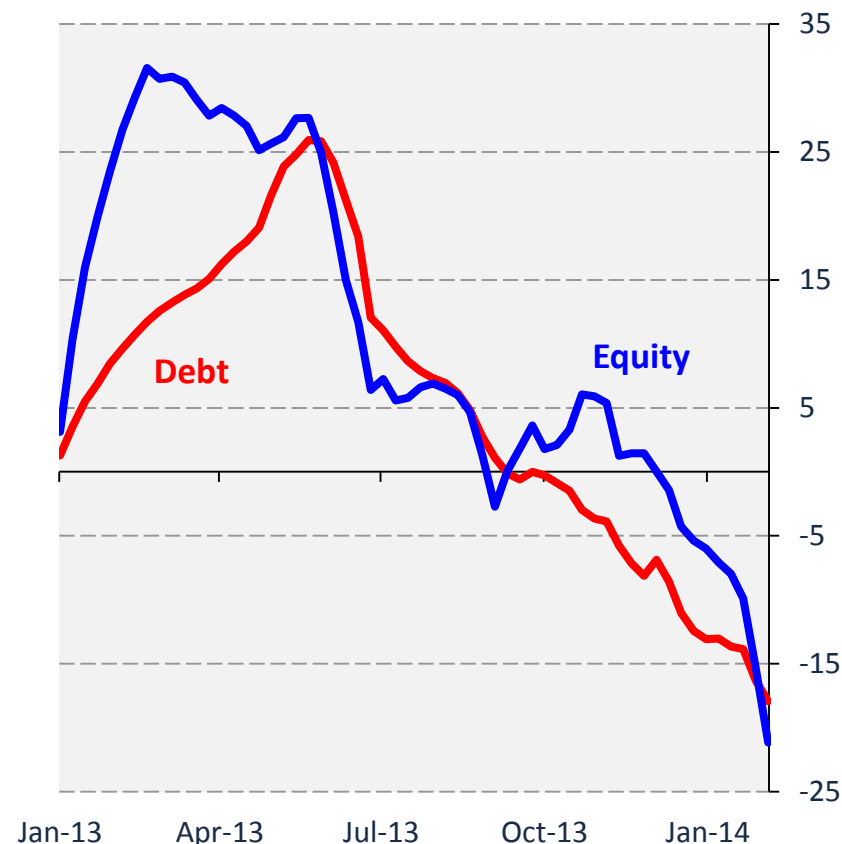
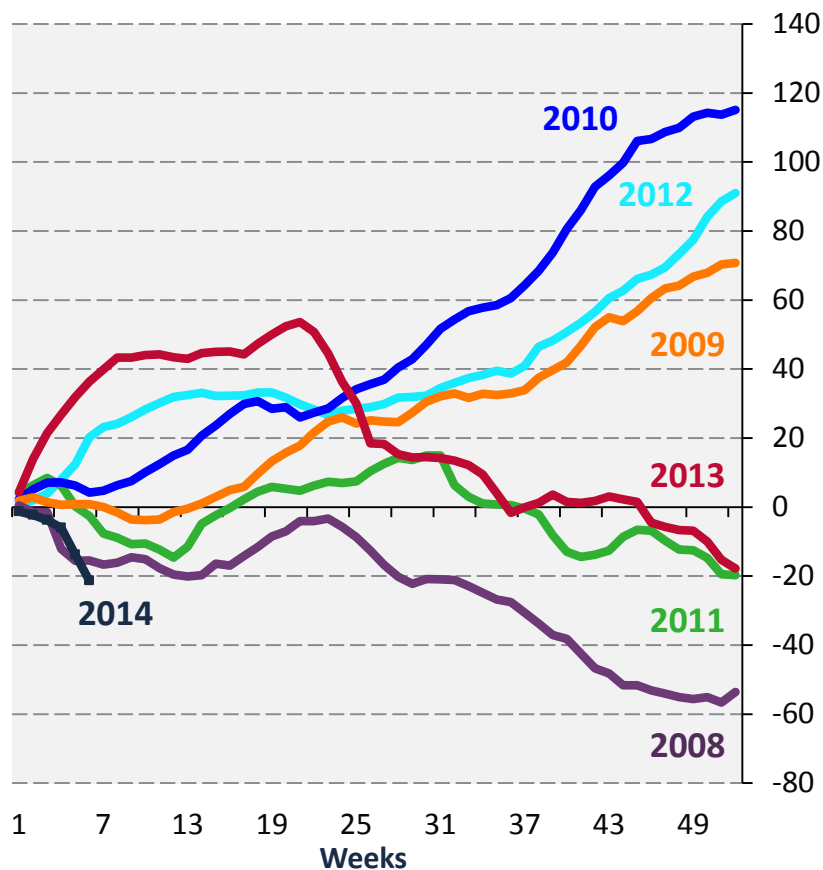
%



Source: U.S. Department of the Treasury.

In this environment of volatility, capital outflows in emerging economies have been registered.

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



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

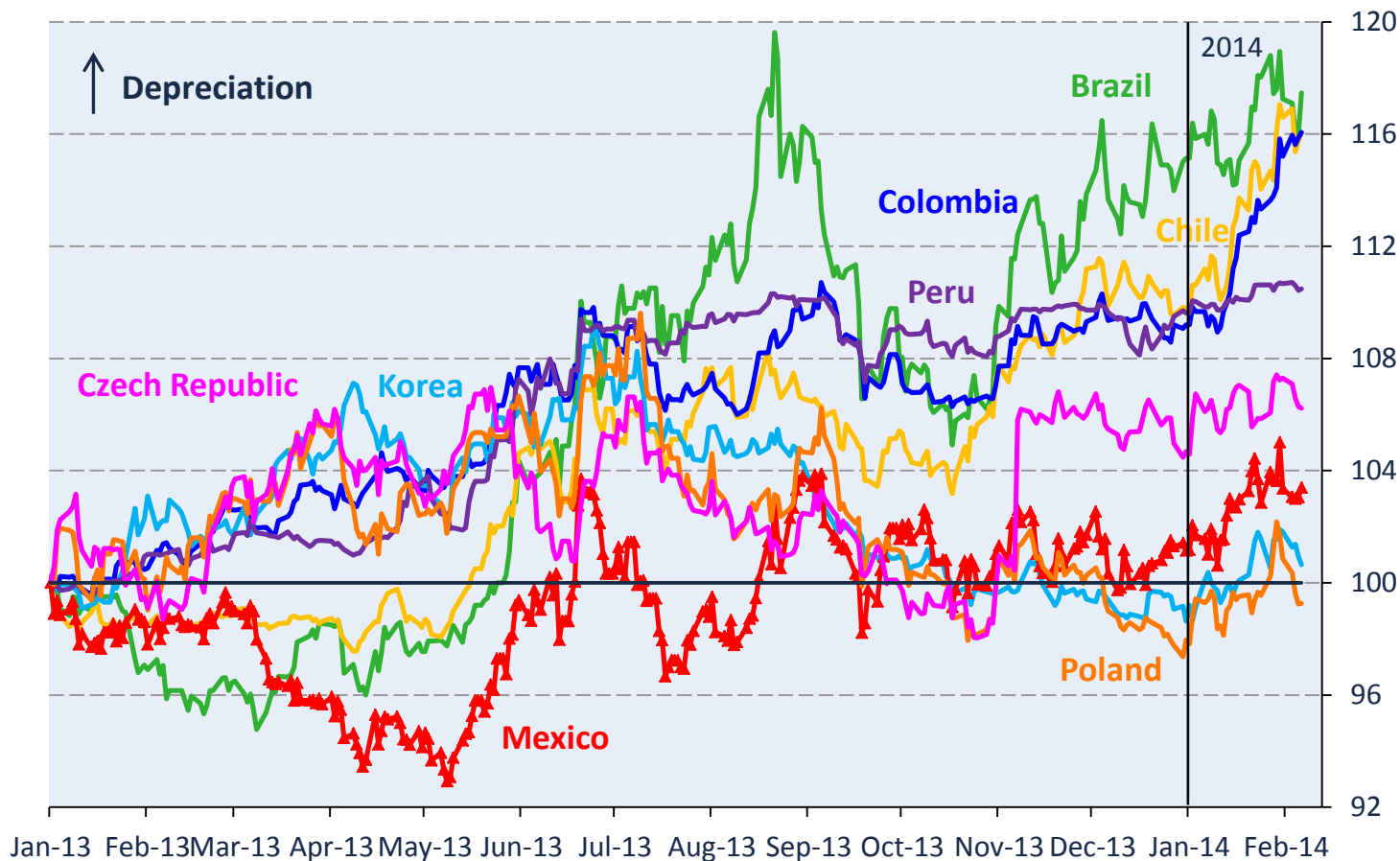
Source: Emerging Portfolio Fund Research.

Source: Emerging Portfolio Fund Research.

In the first weeks of 2014, volatility in emerging economies' financial markets exacerbated, registering depreciations of their currencies.

Nominal Exchange Rate against USD

Index 01-Jan-2013 = 100

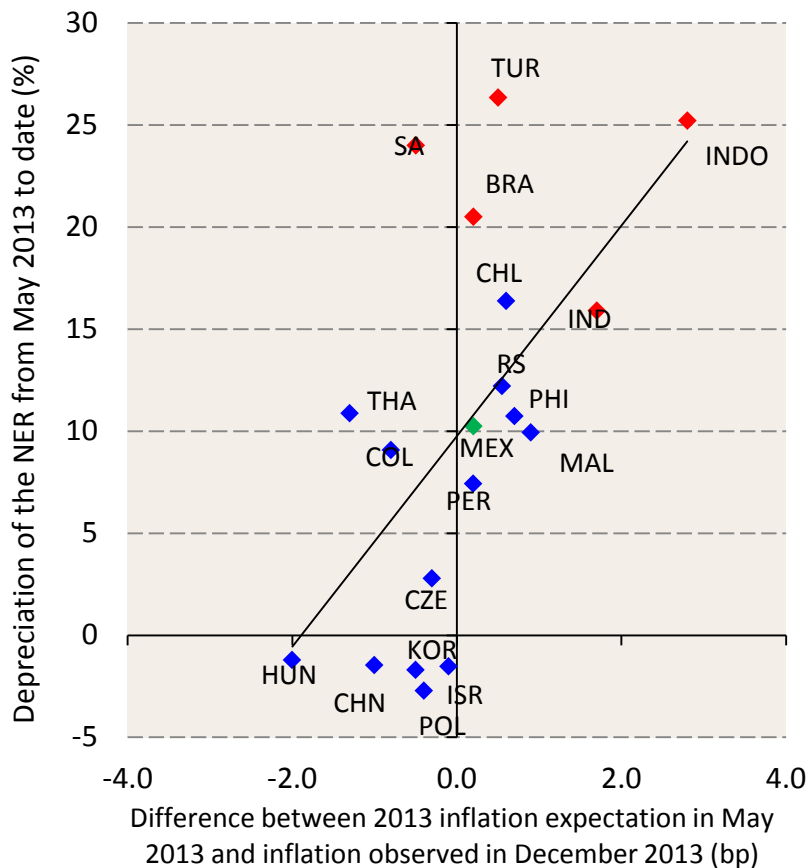


Source: Bloomberg.

The magnitude of these adjustments largely depended on the macroeconomic fundamentals of each country.

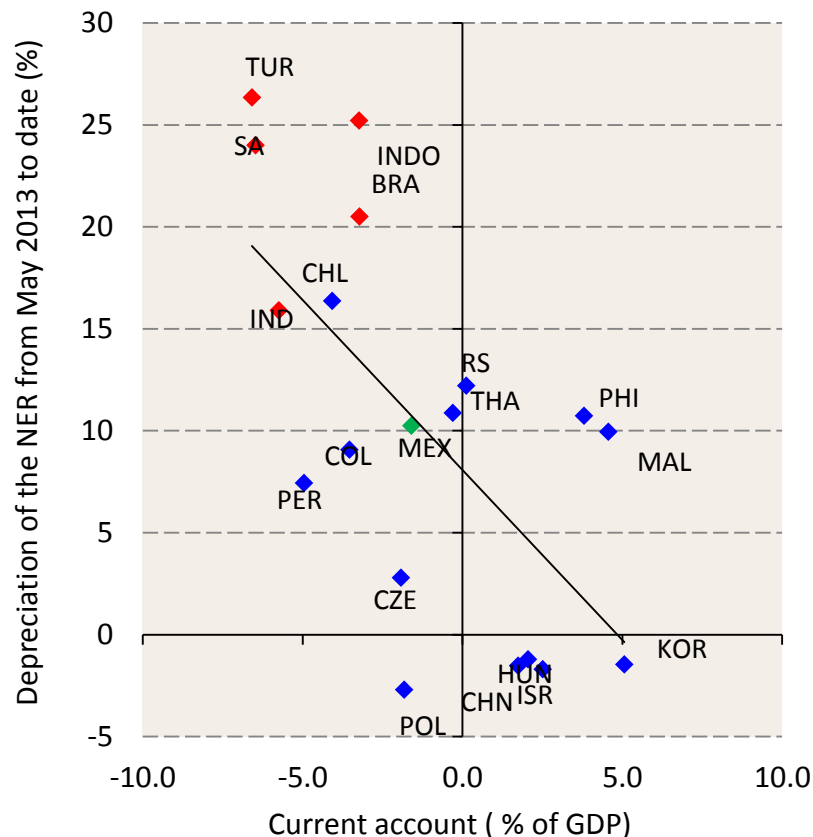
Inflation and Nominal Exchange Rate

%



Current Account and Nominal Exchange Rate

%



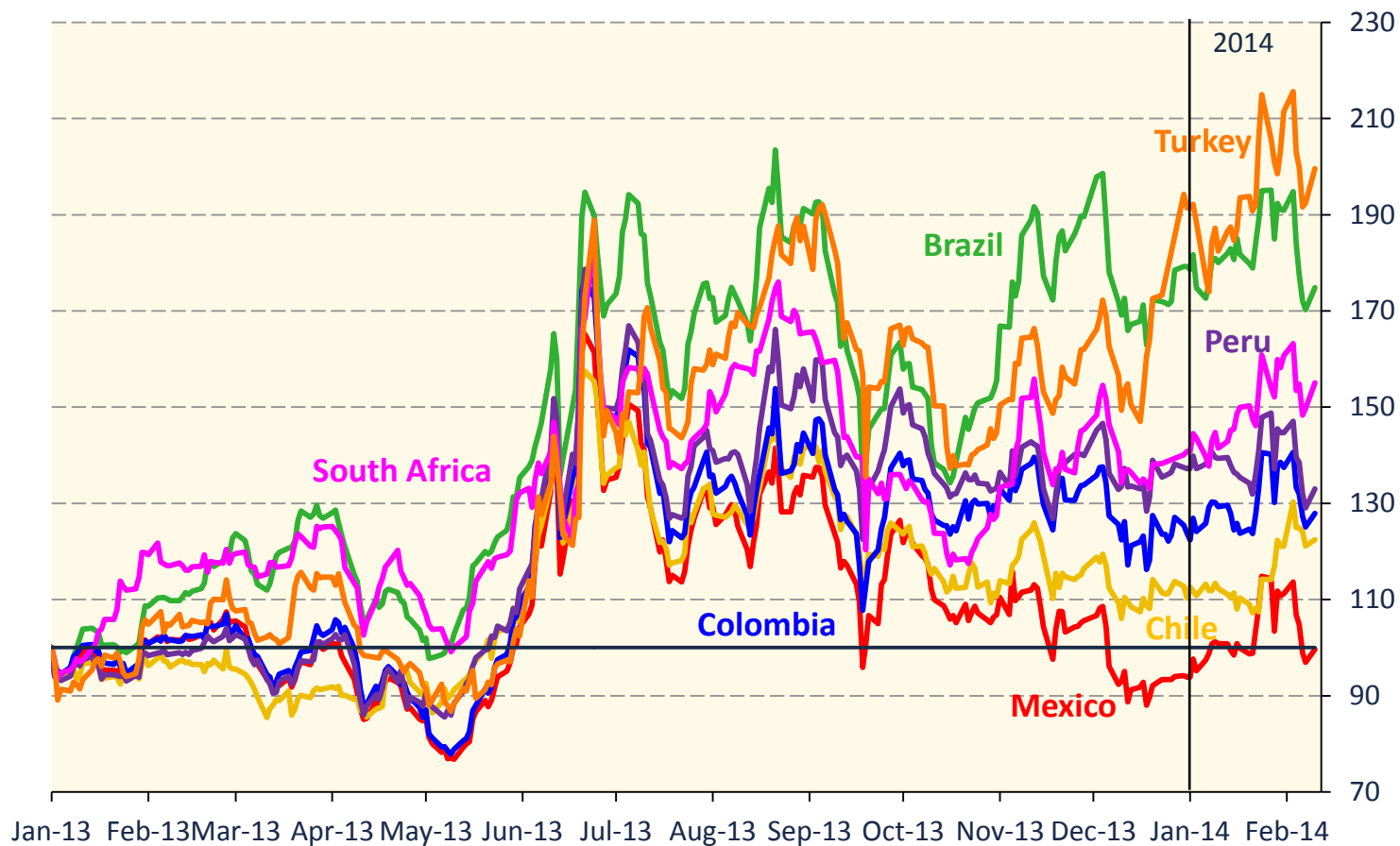
Source: Haver Analytics, Bloomberg and Consensus Forecasts.

1/ Current account refers to the average from the third quarter of 2012 to the third quarter of 2013, except for Mexico, in which case we consider the forecast for 2013 published in this Quarterly Report.

Source: Haver Analytics, Bloomberg and Banco de México.

In this context, Mexico has stood out as one of the economies whose risk indicators were less affected as compared to other emerging economies.

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



^{1/} 5-year CDS.
Source: Bloomberg.

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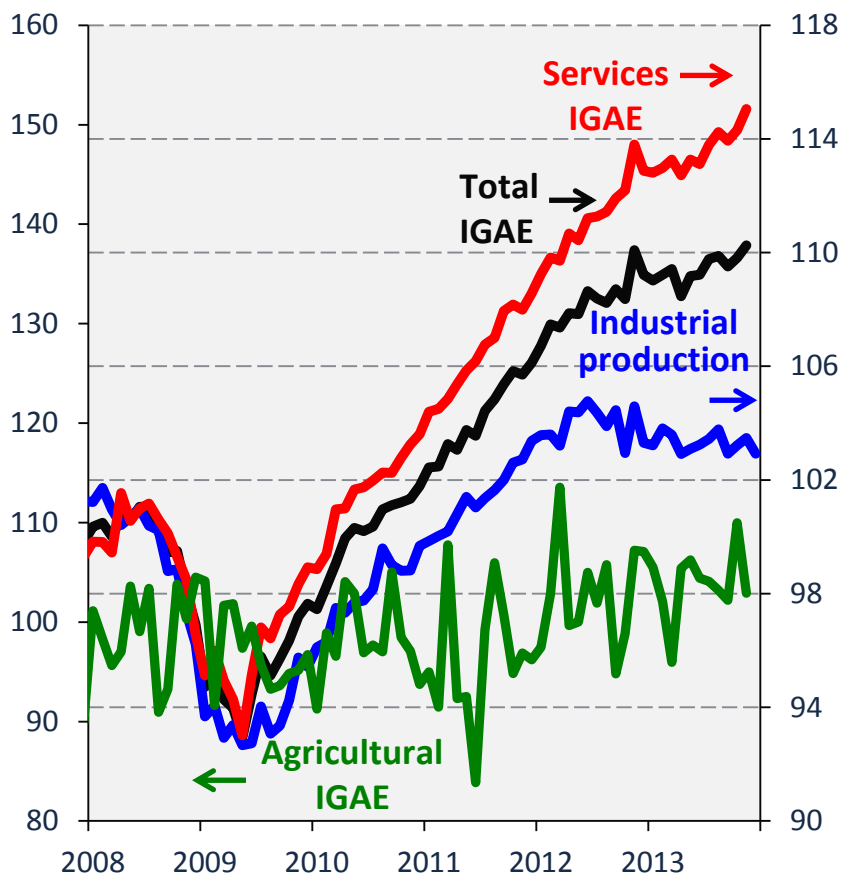
4 **Inflation Determinants**

5 **Forecasts and Balance of Risks**

In 4Q 2013, economic activity maintained an upward trend, which had started in 3Q 2013, although at a lower pace, following a contraction in 1H 2013.

Economic Activity Indicators ^{1/}

Index 2008 = 100, s.a.

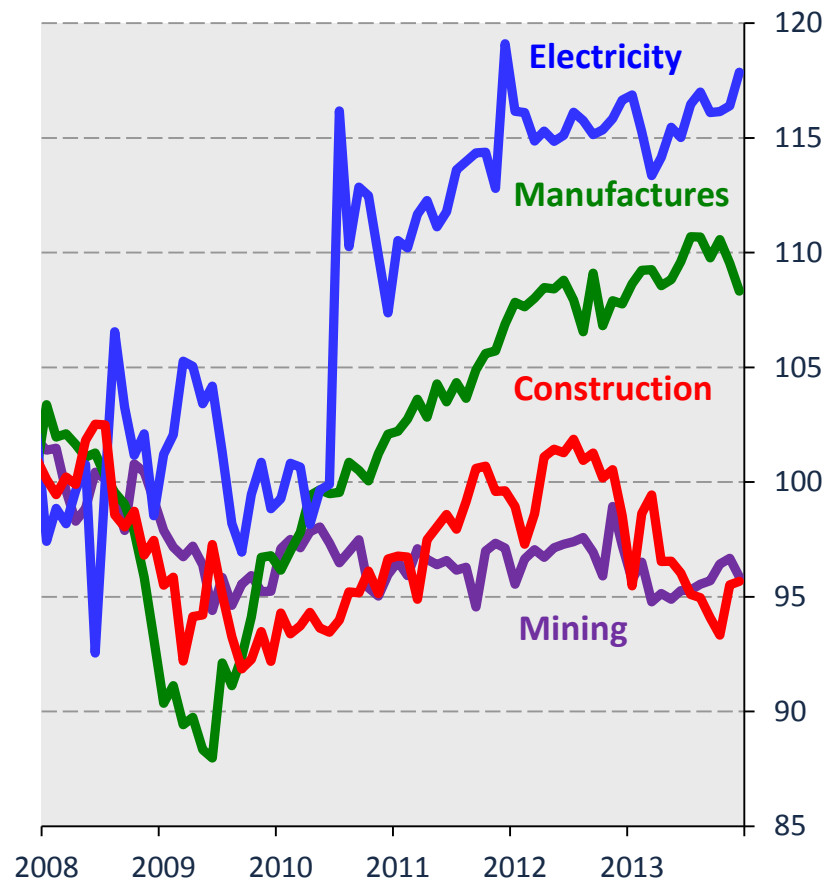


s.a./ Seasonally adjusted data.

^{1/} Industrial production up to December 2013. Total IGAE, services and agricultural up to November 2013. Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

Industrial Activity

Index 2008 = 100, s.a.

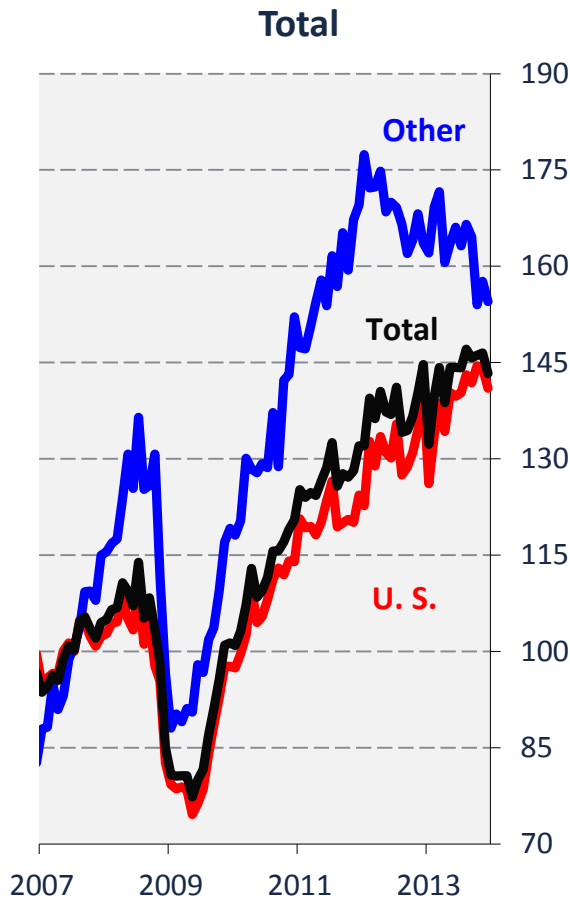


s.a./ Seasonally adjusted data.

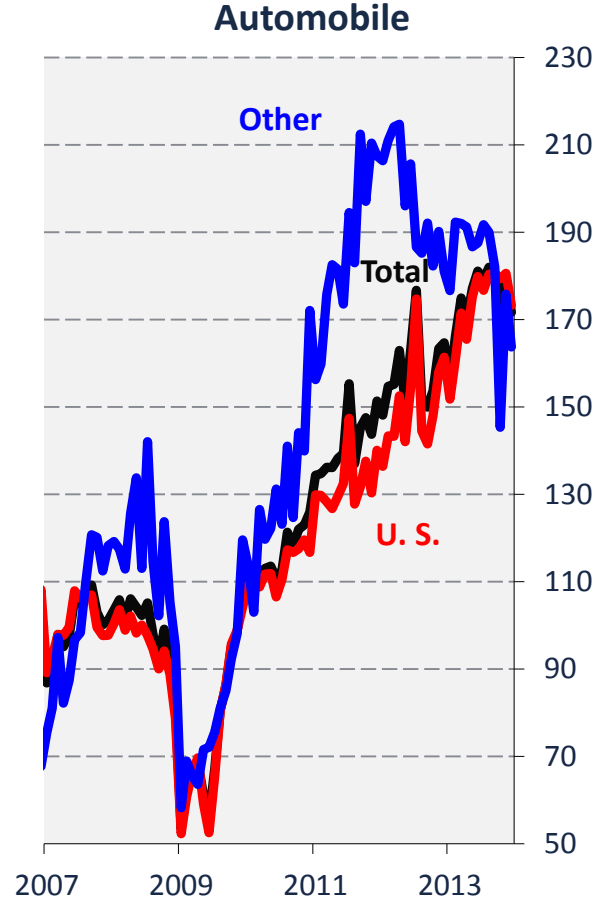
Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

The economic recovery in 2H 2013 was partly a reflection of the continuous expansion of external demand, particularly of the U.S.

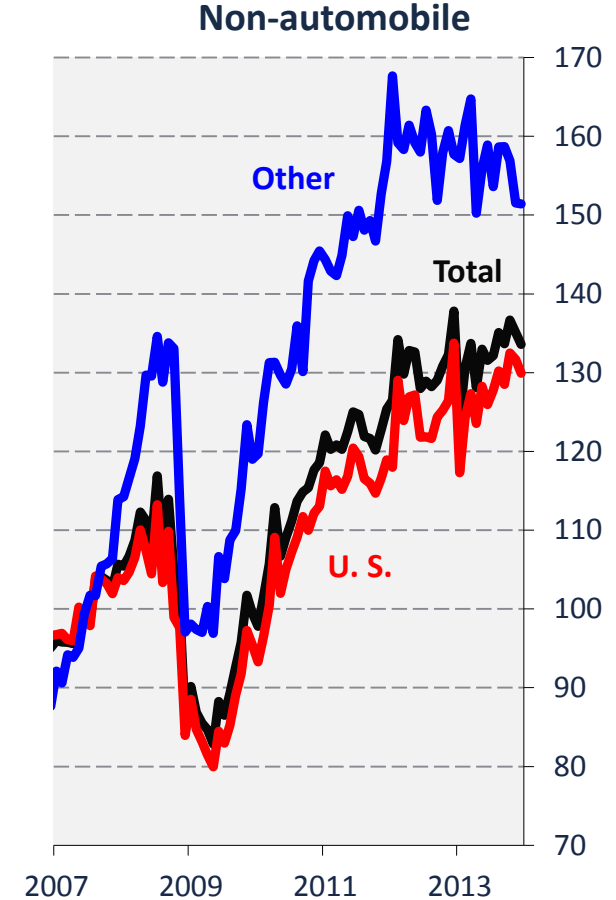
Manufacturing Exports Index 2007=100, s.a.



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



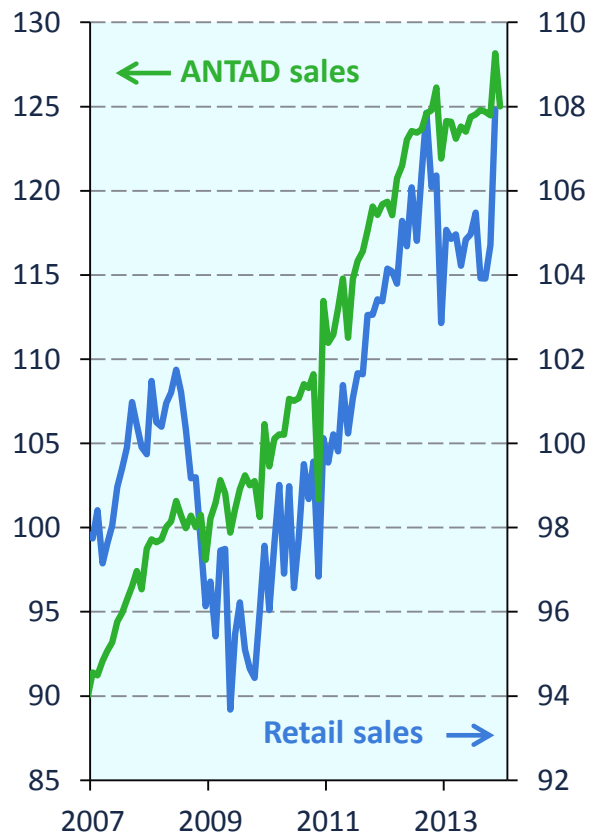
s.a./ Seasonally adjusted data.
Source: Banco de México.



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

The economic recovery also derived from an incipient improvement in private consumption and public expenditure.

Commercial Establishments' Retail and ANTAD Sales ^{1/}
Index 2008=100, s.a.



s.a./ Seasonally adjusted data.
^{1/} ANTAD data up to December 2013. INEGI data up to November 2013. ANTAD sales refer to total store sales.
 Source: Elaborated by Banco de México with data from INEGI and ANTAD.

Workers' Remittances
USD billion, s.a.



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

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

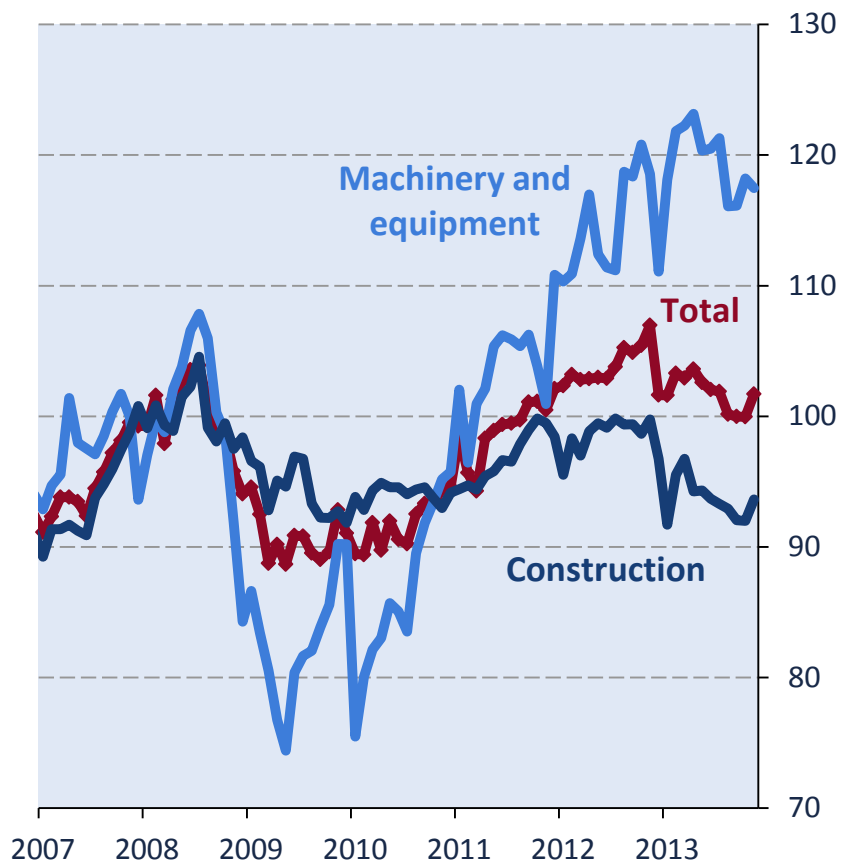


s.a./ Seasonally adjusted data.
 Source: Banco de México and INEGI.

However, gross fixed investment, which had been contracting since 4Q 2012, did not observe a clear change of trend.

Investment and its Components

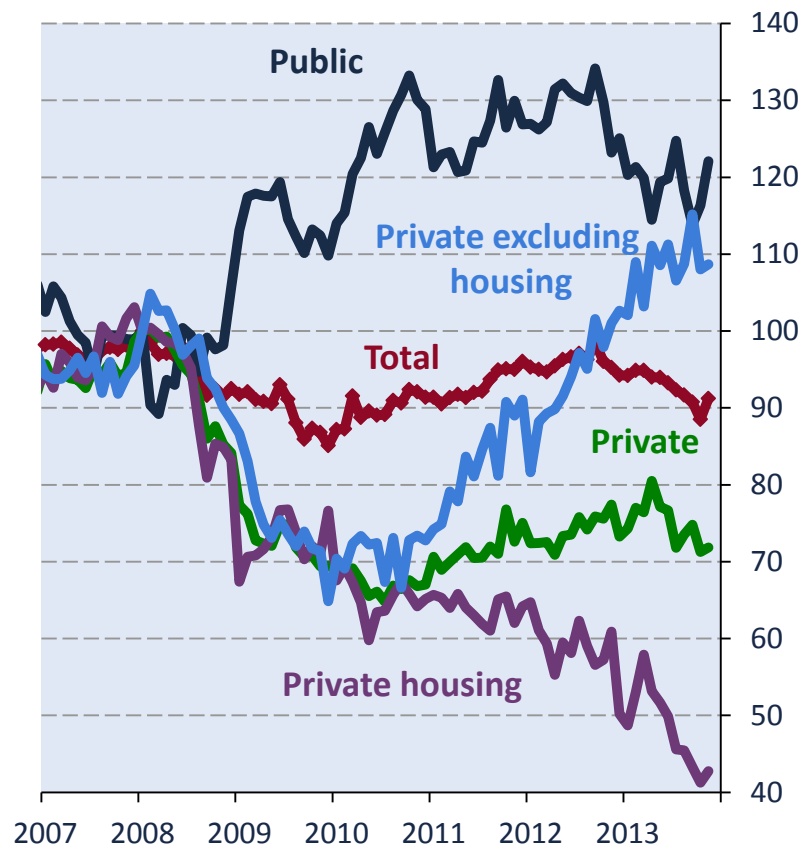
Index 2008=100; a.e.



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

Real Value of Production in Construction

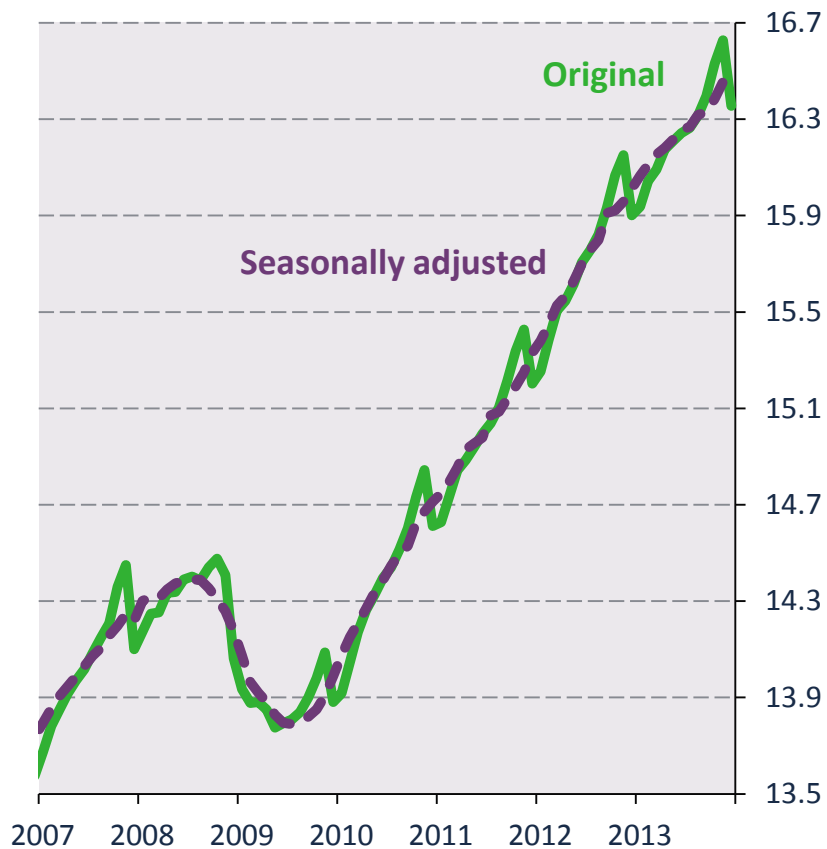
Index Jan-2008=100; s.a.



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

In light of economic growth, a favorable trend in the main labor market indicators persisted, although slack conditions prevail.

IMSS-insured Workers ^{1/}
Million workers



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

National Unemployment Rate
% of EAP; s.a.



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

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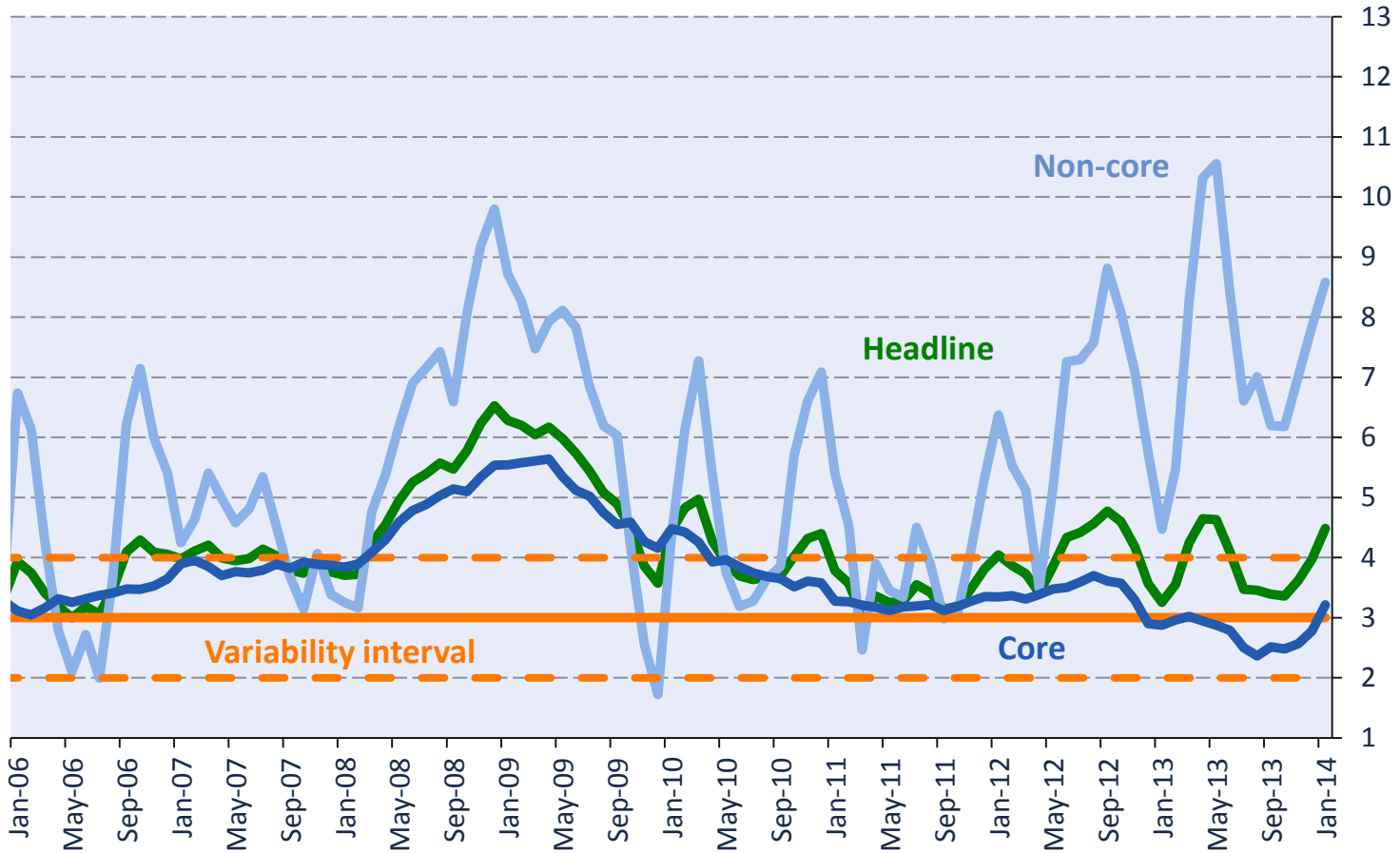
4 **Inflation Determinants**

5 **Forecasts and Balance of Risks**

Inflation rebounded in November and December 2013, as a result of higher prices in the non-core component. Afterwards, the fiscal measures and adjustments in public prices in force since 2014, further increased inflation.

Headline, Core and Non-core Inflation

%

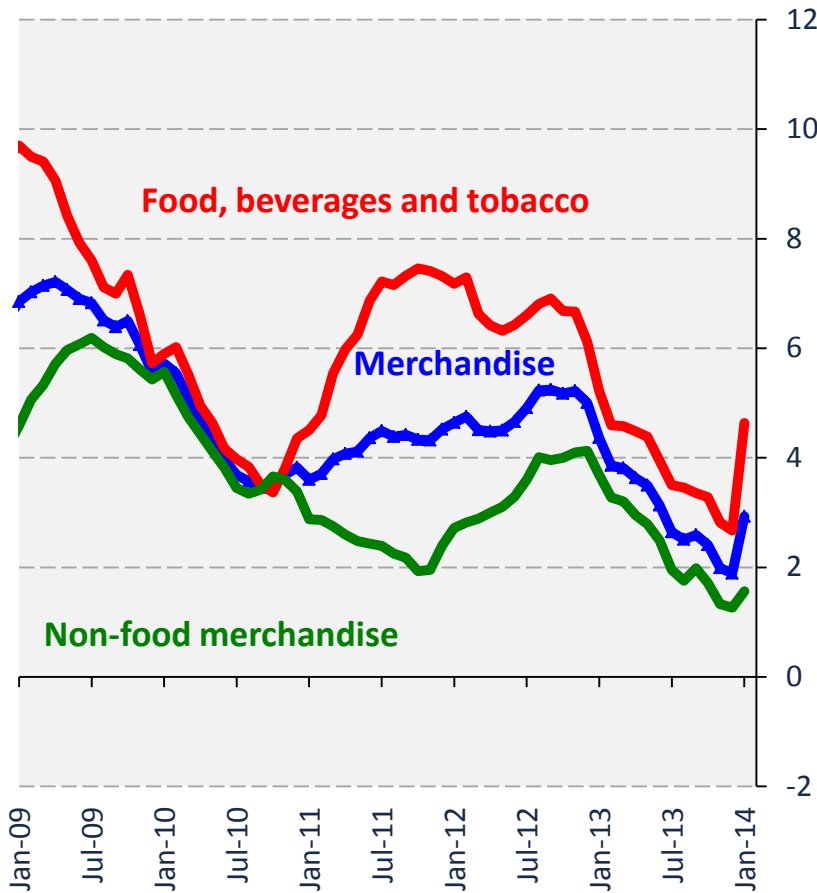


Source: Banco de México and INEGI.

It should be noted that inflation increase has been concentrated in goods and services affected by the fiscal measures.

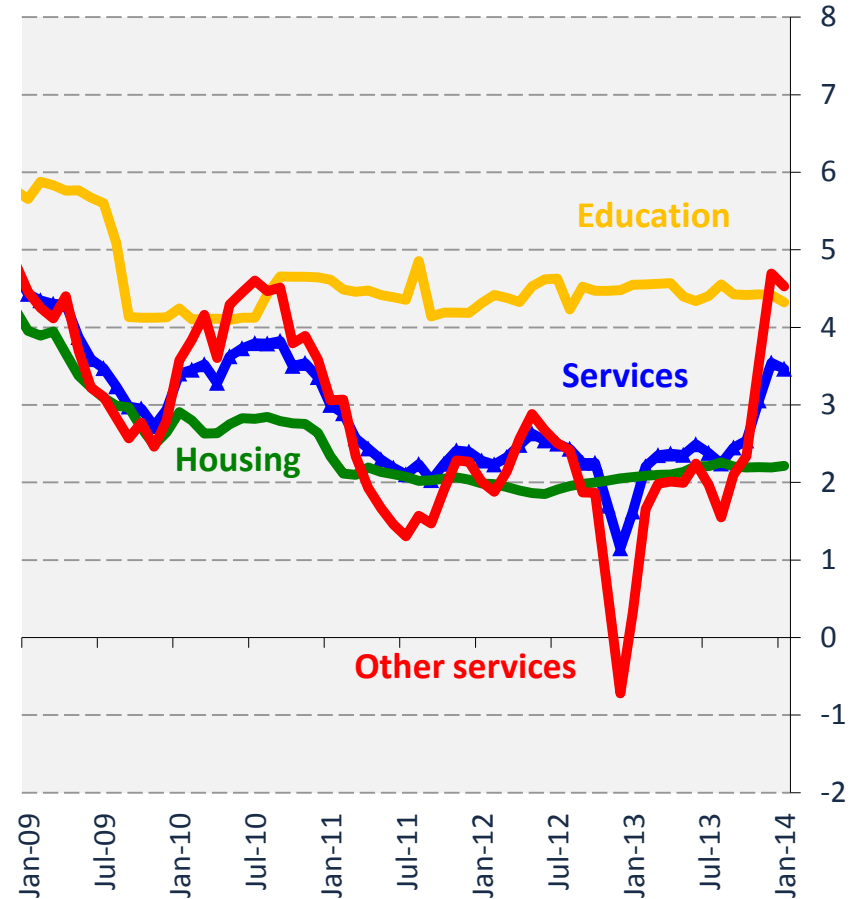
Core Inflation Annual % change

Merchandise



Source: Banco de México and INEGI.

Services

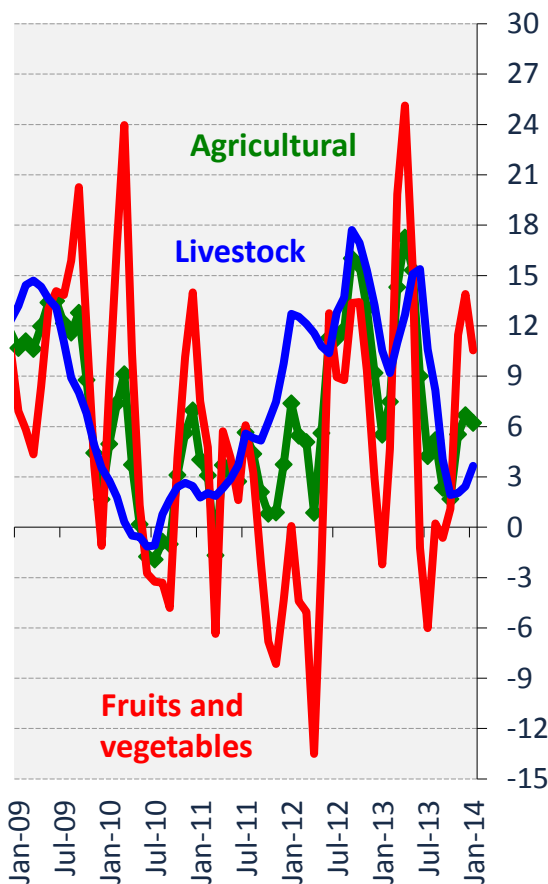


Source: Banco de México and INEGI.

Higher prices in a reduced number of agricultural goods, as well as changes in public prices, affected inflation.

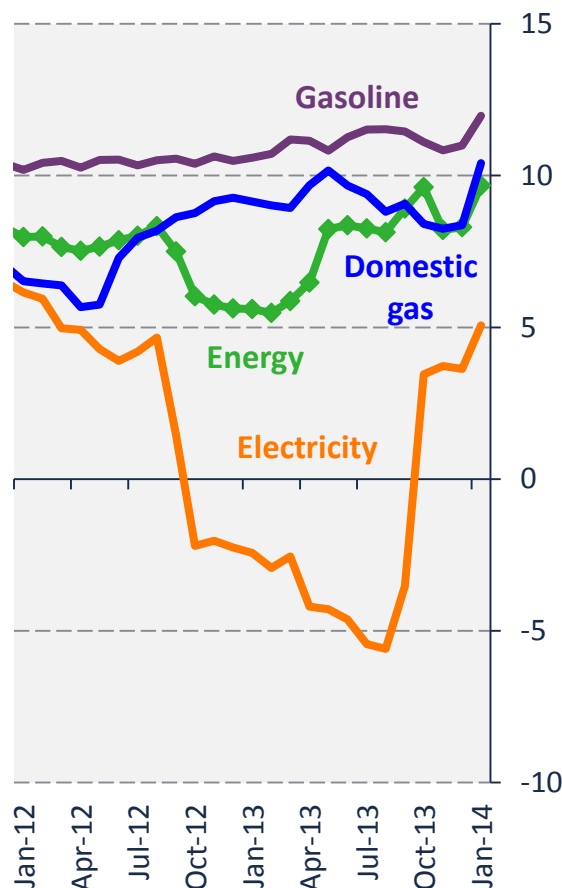
Non-core Inflation Annual % change

Agricultural



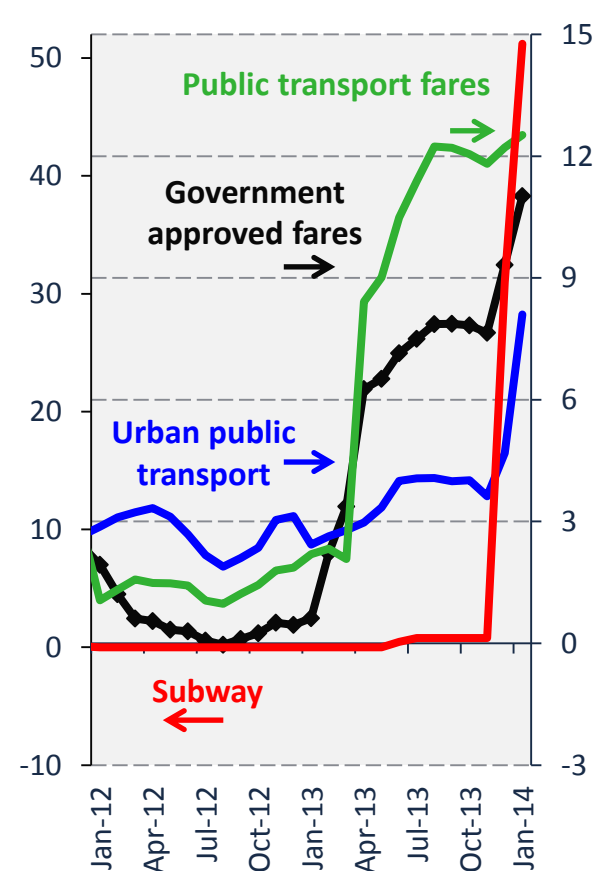
Source: Banco de México and INEGI.

Energy



Source: INEGI.

Government Approved Fares

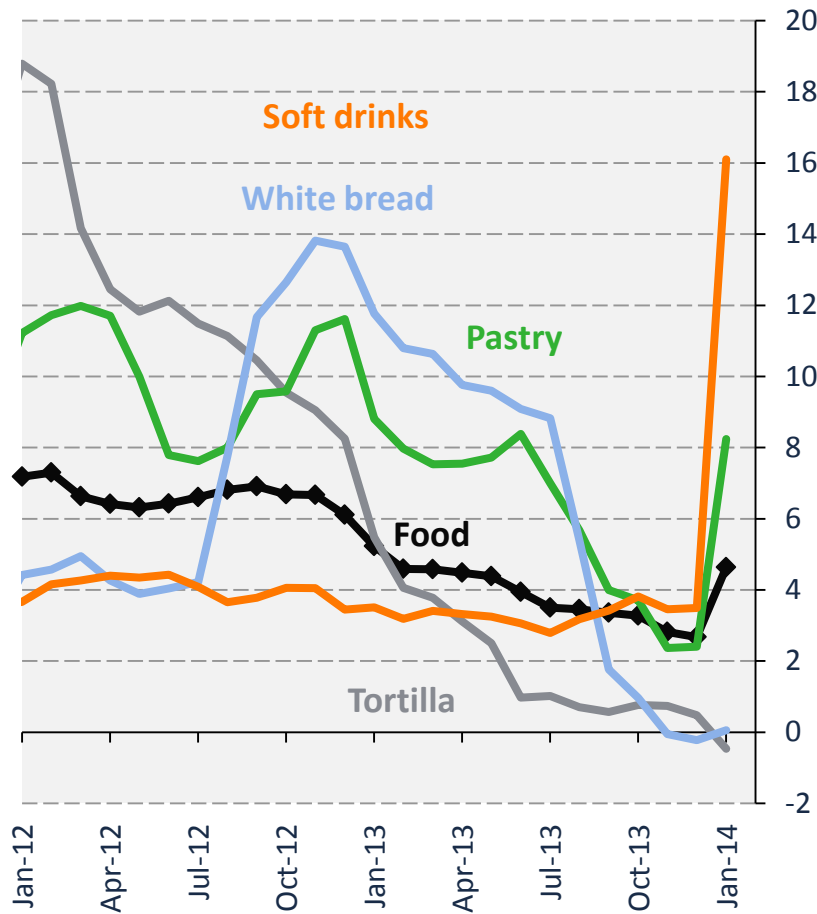


Source: INEGI.

The contribution to inflation of price increases in products such as soft drinks and pastries, derived from the fiscal measures, stand out.

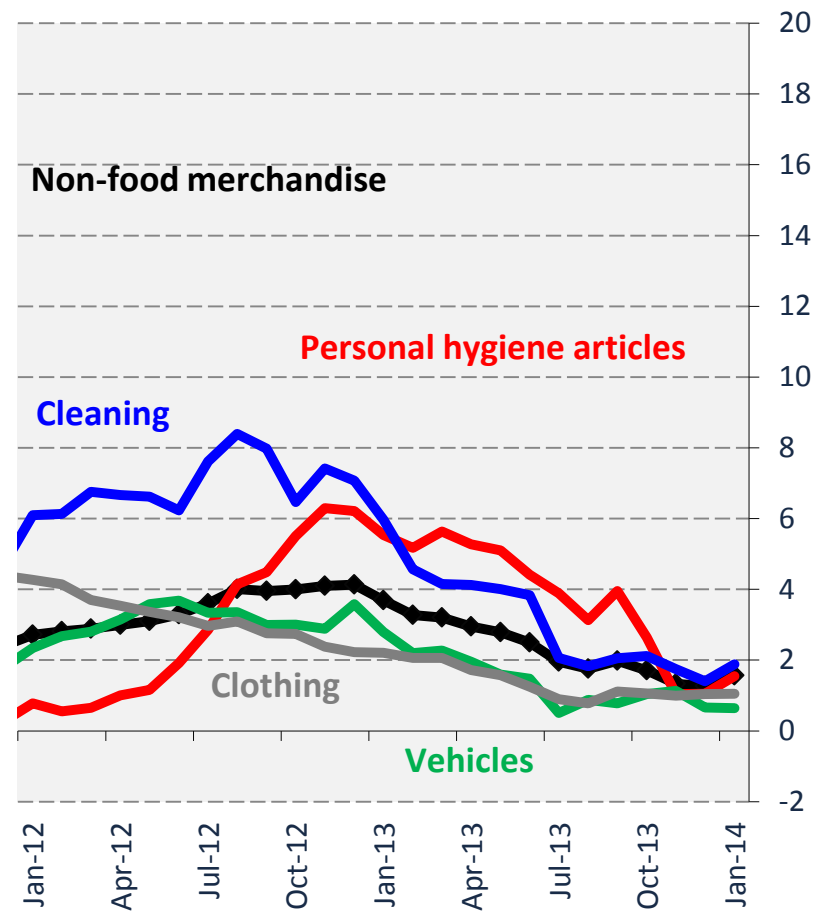
Core Inflation Annual % change

Food, Beverages and Tobacco



Source: INEGI.

Other Merchandise



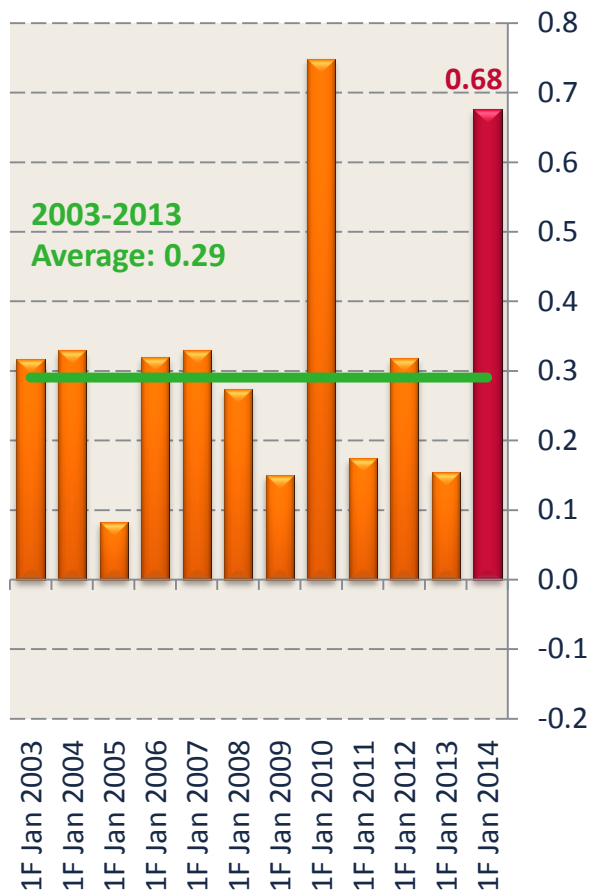
Source: INEGI.

Inflation dropped in the period from the first to the second fortnight of January.

Bi-weekly Inflation in the Month of January

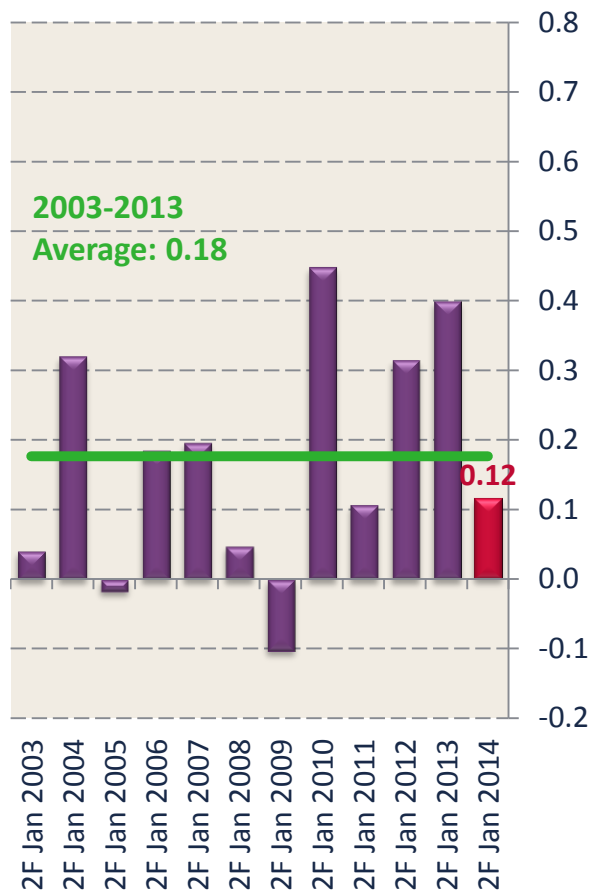
Bi-weekly % change

First Fortnights



Source: Banco de México and INEGI.

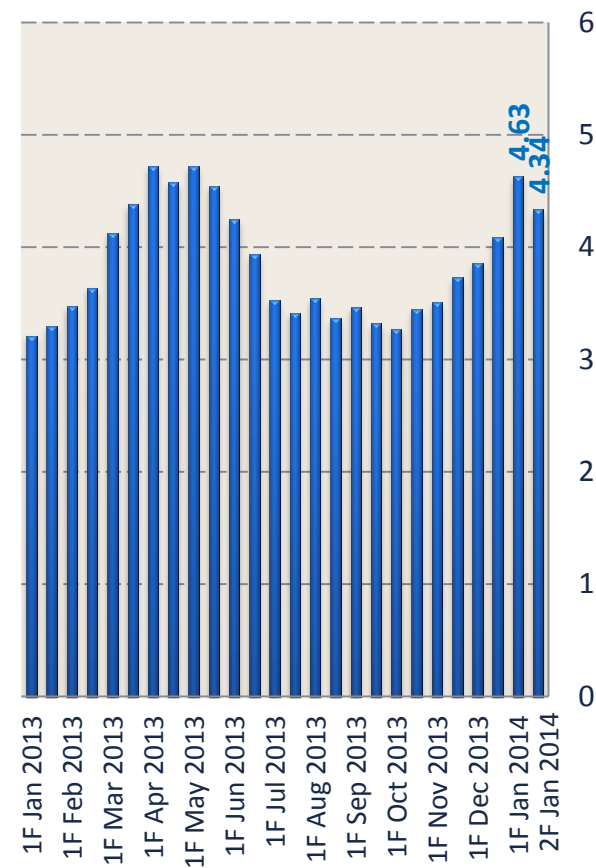
Second Fortnights



Source: Banco de México and INEGI.

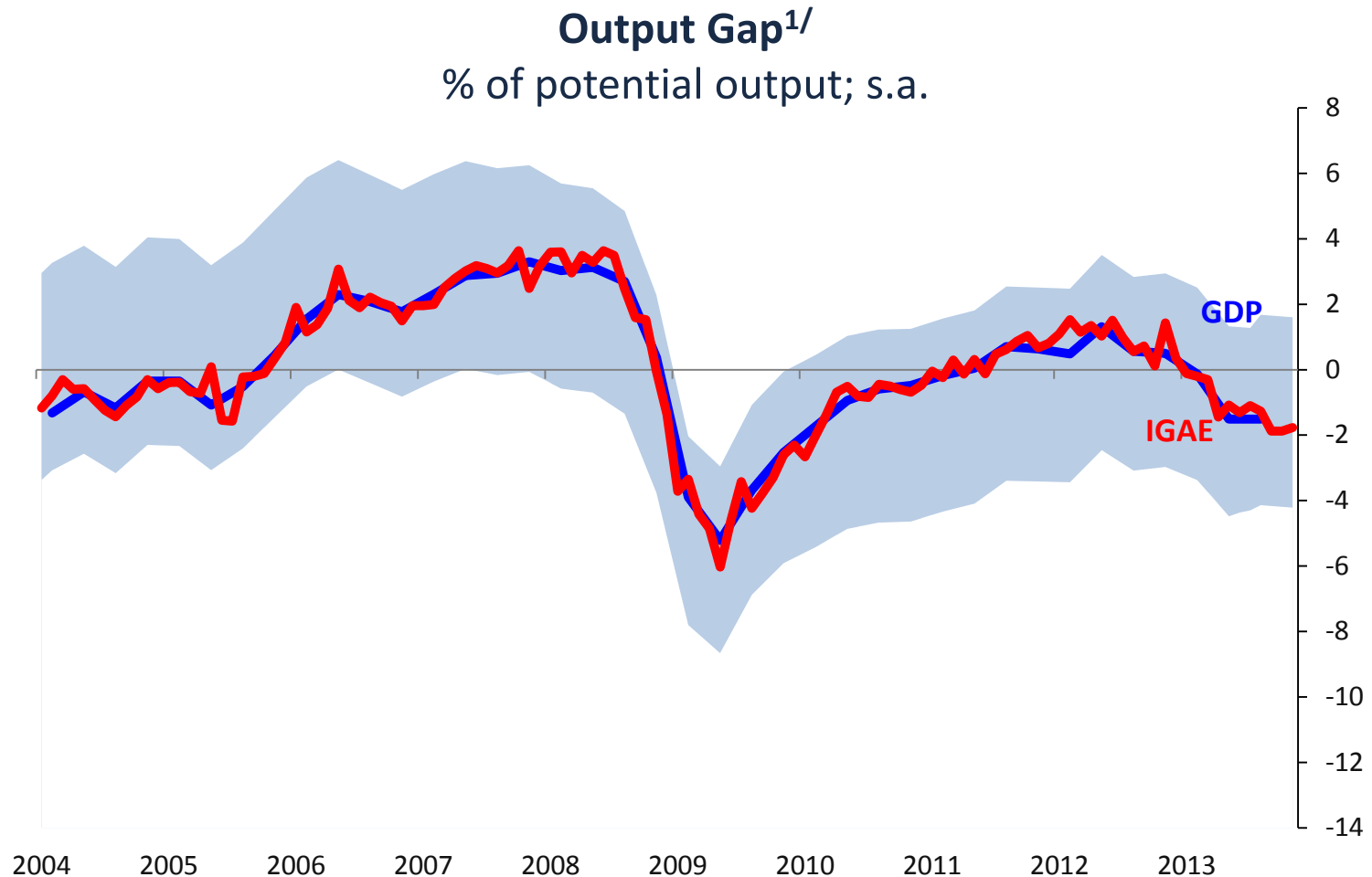
Bi-weekly Inflation

Annual % change



Source: INEGI.

Despite the moderate recovery of economic activity in 2H 2013, given the contraction in 1H 2013, the output gap remained negative.

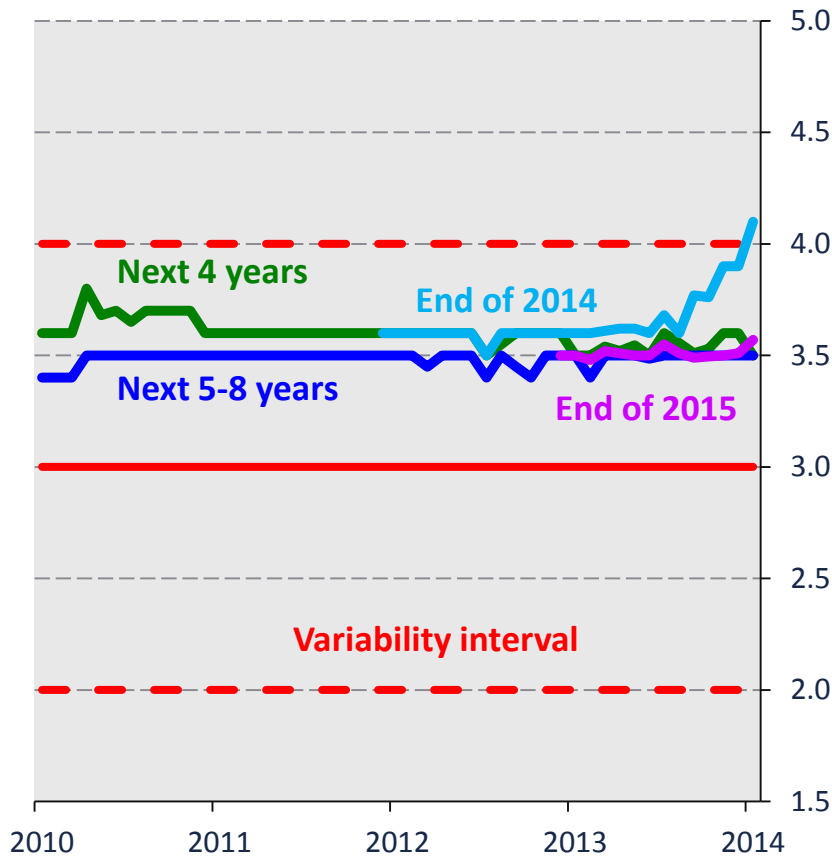


s.a./ Calculated with seasonally adjusted data.

1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p.69. The shaded area is the 95% confidence interval of the output gap, calculated with an unobserved components method. GDP figures up to 3Q 2013; IGAE up to November 2013. Source: Calculated by Banco de México with data from INEGI.

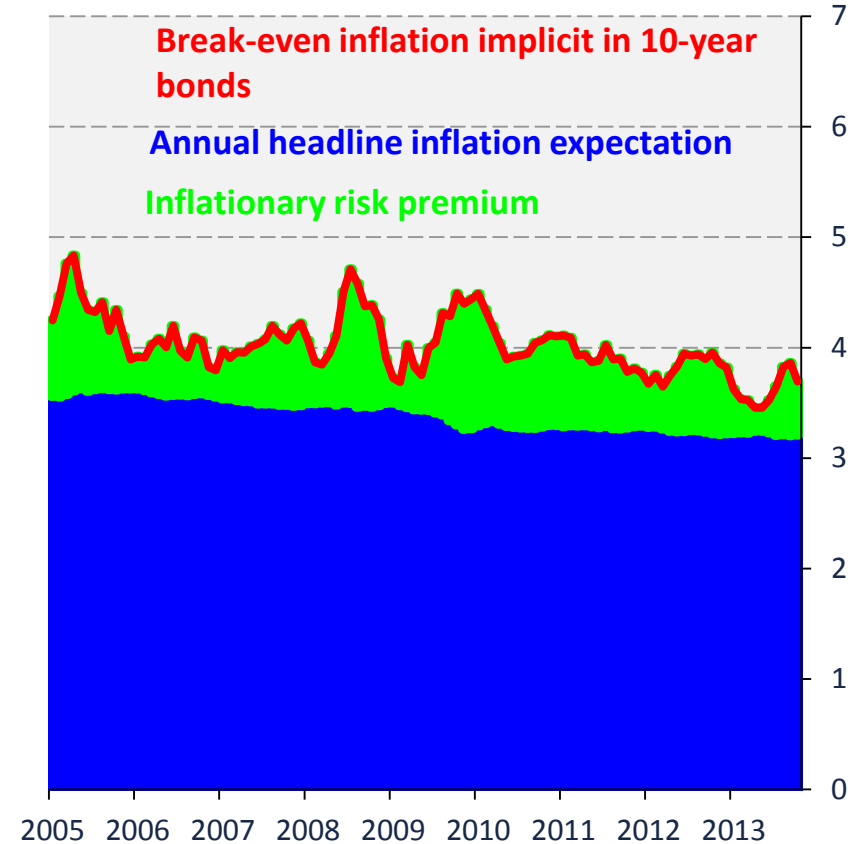
Longer-term inflation expectations remained stable.

Annual Headline Inflation Expectations Median, %



Source: Banco de México's Survey.

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



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

As a result of the decompression process of risk premia in international markets, long-term interest rates increased. It is noteworthy that the adjustment in domestic financial markets took place in an orderly manner.

Interest Rates of Government Securities ^{1/}

%



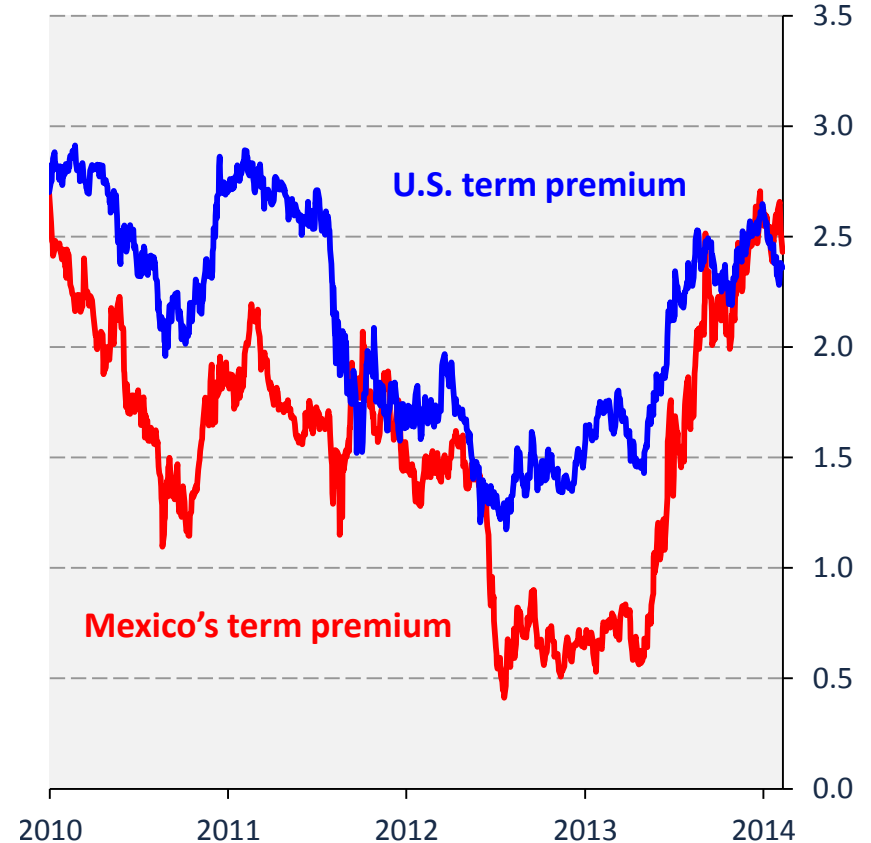
1/ Since January 21, 2008, the overnight interest rate corresponds to the target for the Overnight Interbank Interest Rate.

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

Mexico and U.S. Term Premium

Approximation ^{2/}

Percentage points



2/ The approximation consists of the difference between the 10-year rate and 2-year rate.

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

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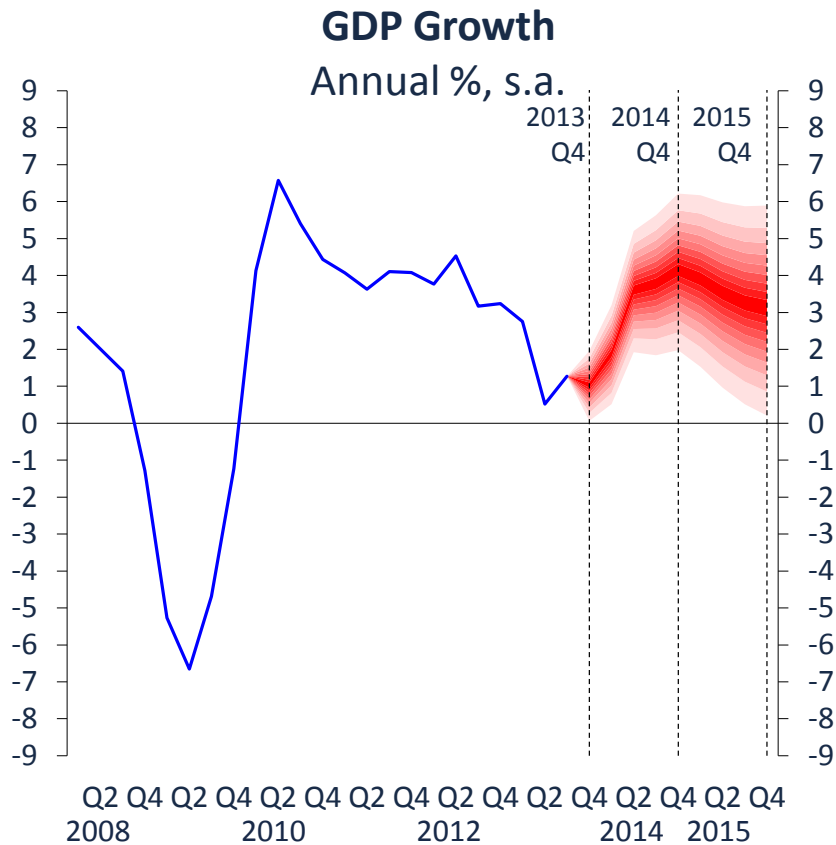
5 **Forecasts and Balance of Risks**

Economic activity outlook

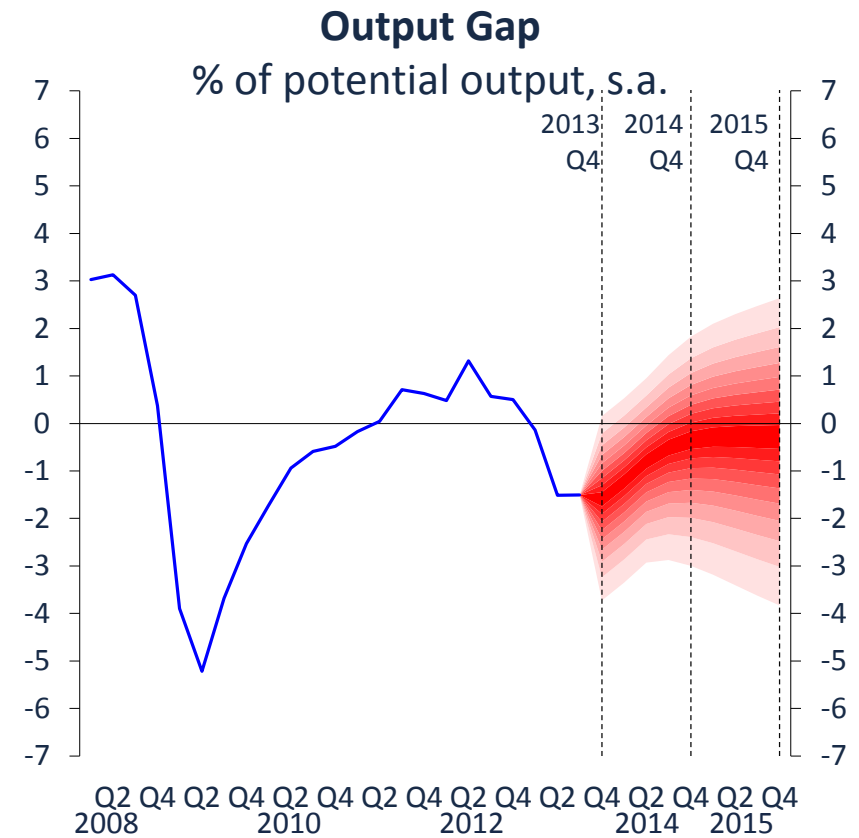
GDP Growth	
2013	Around 1.2%
2014	Between 3.0 y 4.0%
2015	Between 3.2 y 4.2%

Increase in the number of IMSS-insured workers:	
2014	Between 620 and 720 thousand
2015	Similar to levels in 2014

Fan Charts

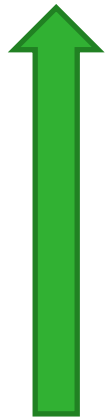


s.a./ Seasonally adjusted data.
Source: INEGI and Banco de México.



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

The balance of risks to the growth of economic activity has improved as compared to the previous Quarterly Report



I

In the short run, a more favorable outlook for the U.S. economy could imply greater dynamism of external demand

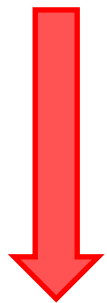
II

This year will be characterized by a significant fiscal stimulus

III

In the medium term, an effective achievement and implementation of structural reforms could improve prospects for investment

Despite the abovesaid, downward risks prevail:



I

The possibility that the normalization process of U.S. monetary policy may trigger a significant adjustment in capital flows to emerging economies

II

The recovery of consumption could turn out more moderate than anticipated or the delay in the recovery of investment levels could persist

Inflation Forecasts

Headline inflation

Core inflation

2014

First months: will lie above 4 percent due to:

- i. An unanticipated uptick of non-core inflation in late 2013
- ii. The impact of the changes in relative prices as a result of the fiscal measures

2Q: falls under 4 percent

2H: could locate in some months above 4 percent, and is expected to conclude the year within the interval around the target

Even considering the effects of the referred measures, it is anticipated to lie at levels close to 3 percent

2015

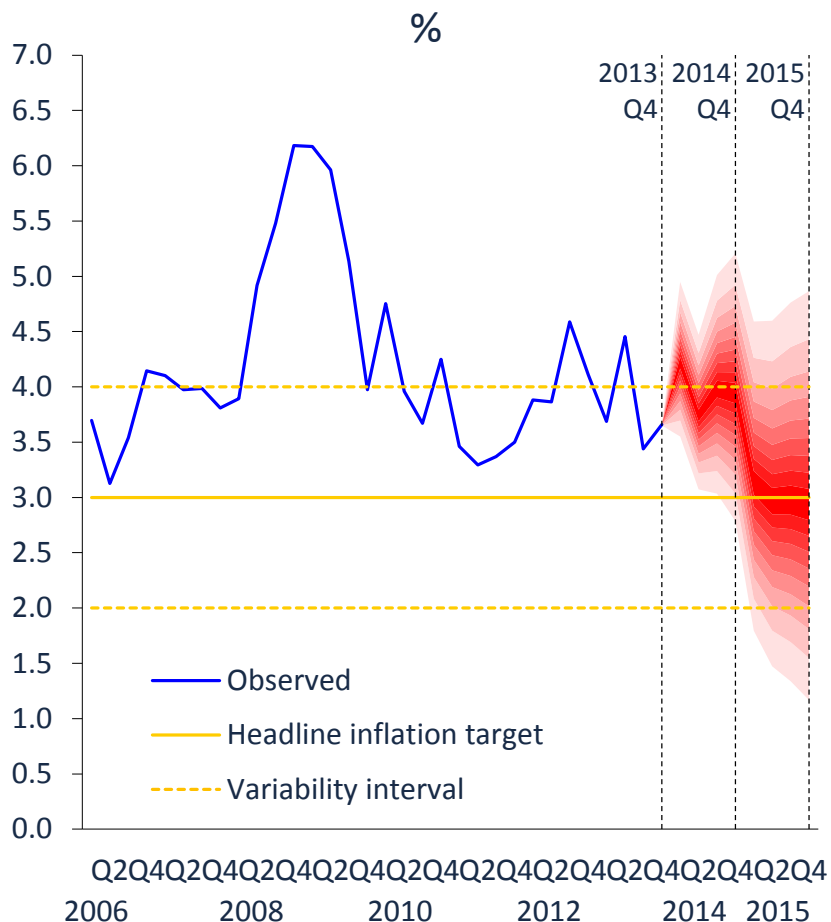
From January onwards: significant downward adjustment
Rest of the year: will remain at levels slightly above 3 percent

Will lie below 3 percent

The expected evolution of inflation considers the fading of the effects of the changes in relative prices, an expected reduction in gasoline price adjustments from 2015 onwards and no expected demand-related pressures on inflation.

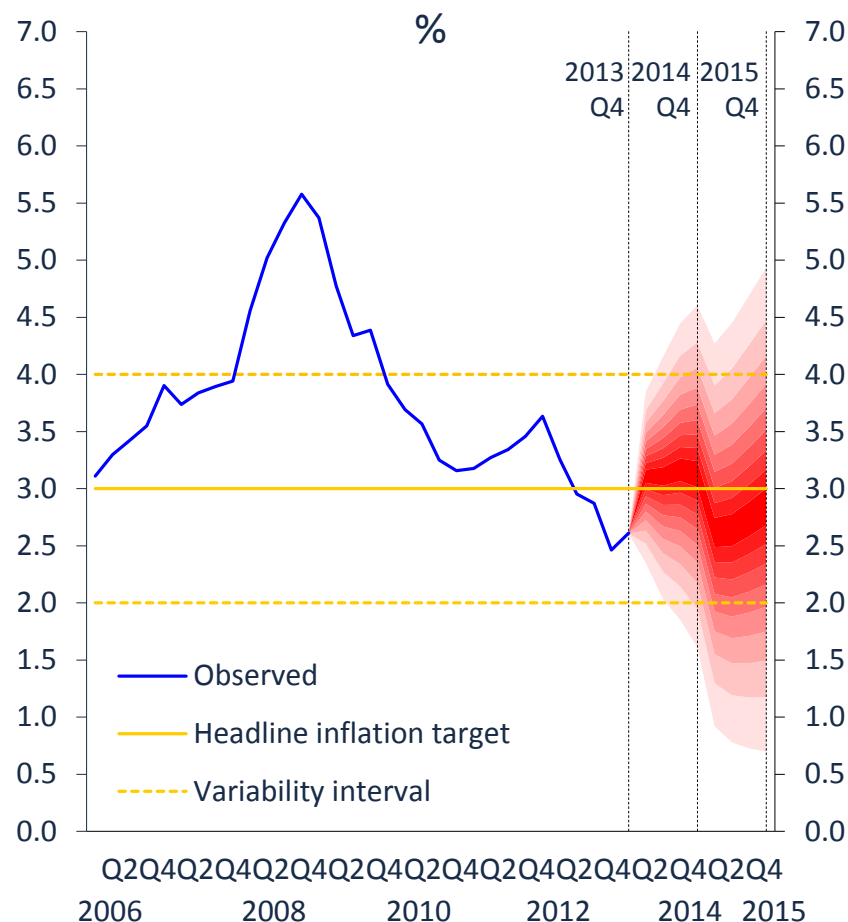
Fan Charts

Annual Headline Inflation ^{1/}



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

Annual Core Inflation ^{2/}



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

The balance of risks to inflation has deteriorated as compared to the last Quarterly Report

Upward



I A risk of possible second round effects generated by adjustments in relative prices, and their possible impact on other prices, as well as longer-term inflation expectations, especially when a gradual reduction in slack conditions in the economy is anticipated

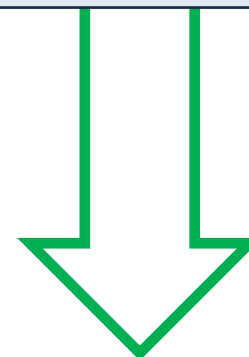
II New episodes of high volatility in international financial markets could generate an exchange rate adjustment, with a potential impact on inflation



Downward



I The possibility remains that the recovery of economic activity might turn out lower than anticipated



Monetary Policy Stance

- The Board of Governors considers the monetary policy stance congruent with the efficient convergence of inflation to the 3 percent target.
- However, given the recent reading of inflation and considering the risks mentioned in this Quarterly Report, the Board will monitor all pressures that could affect inflation and its expectations in the medium- and long term.
- Likewise, it will monitor the implications of the economic activity evolution and the monetary stance of Mexico relative to the U.S., among other factors, onto the inflation outlook, so as to reach the abovesaid inflation target.

In the future, the global environment characterized by less favorable conditions in financial markets is expected.

- Recently, there has been significant progress in the process of structural reforms aimed at boosting productivity of Mexico.

→ *This, together with the strength of the framework for the macroeconomic policy conduction, has led to an upgraded credit rating of Mexico's sovereign debt.*

- However, for these reforms to reach their potential and indeed result in greater economic growth, an appropriate secondary legislation and an adequate implementation are indispensable.



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