# Quarterly Report

## *October - December 2013*

# *Summary*

The conduction of the monetary policy by Banco de México has sought an efficient inflation convergence towards its 3 percent permanent target, i.e., at the minimum cost to society in terms of economic activity. The structural progress in curbing inflation over the last decade contributed to an environment of higher credibility regarding this target. This provided the Central Institute with more room for maneuver in the monetary policy conduction during 2013.

Recognizing the medium-term progress in the abatement of inflation and an environment of greater certainty regarding the Mexican economy, in March 2013 Banco de México's Board of Governors decided to reduce by 50 basis points the reference interest rate. Afterwards, in its September and October meetings, given the weakening of economic activity in the first half of 2013, it lowered by 25 basis points the target for the Overnight Interbank Interest Rate in each of the referred meetings. The implementation of a countercyclical monetary policy, without jeopardizing the convergence of inflation to the above referred target, despite uncertainty in international financial markets, was possible thanks to the progress in anchoring inflation expectations in Mexico.

In the fourth quarter of 2013, Mexico's economic activity continued the upward trend that had started in the third quarter, although at a slower pace, following the contraction in the first half of the year. The economic recovery experienced since the third quarter of 2013 derived from a greater dynamism of external demand, and from an incipient recovery of some domestic demand components in the fourth quarter. In particular, private consumption and public expenditure have tended to uptick, although investment has not yet presented any clear signs of improvement. Even considering this recovery, slack conditions prevail in the economy.

Annual headline inflation remained within the interval of plus/minus one percentage point around the 3 percent target in the fourth quarter of 2013, while core inflation remained under 3 percent, close to its minimum historical levels. Despite this, annual headline inflation rebounded in November and December, mainly as a result of greater price increments of the non-core component. This increase was determined by two fully identified factors: i) unexpected increments in public transport fares in some cities in Mexico; and ii) higher prices of a reduced number of agricultural products, caused by weather conditions that delayed their production over the previous months.

With the onset of 2014, new fiscal measures and a series of increments in public prices came into force, resulting in higher annual headline inflation. It should be pointed out that this recent inflation increase has thus far been in line with this Central Institute's forecasts and that it has been concentrated in goods and services affected by the referred fiscal measures and public prices. It should be stressed that based on the evidence available so far no second round effects derived from the aforementioned adjustments in relative prices have been observed. If such effects were to occur, they would only become permanent should Banco de México validate them through their monetization, which would not happen as it goes against this Central Institute's mandate.

This evolution of economic activity and inflation in Mexico occurred in an environment in which global economic activity continued to recover in the fourth quarter, derived from a better performance of advanced economies, principally the U.S., and the stabilization of growth rates in emerging markets. In particular, the U.S. economy recovered, as a result of a greater dynamism of private spending, higher export growth, the fading of the effects of the fiscal adjustment in the first months of the year and an improvement in the labor market. In light of this, the Federal Reserve started to reduce its asset purchases in January, while it stressed that its reference interest rate would remain at low levels for a considerable period. Nonetheless, despite a low inflation level in the U.S., there is still uncertainty over the future monetary policy actions, and, therefore, regarding the level that the long-term interest rates could reach in the U.S.

Various emerging economies are facing a complicated environment, as the accumulation of macroeconomic imbalances in the past aggravated the impact of the uncertainty in international financial markets on their financial asset prices, particularly, their currencies. Additionally, there is risk that the process of normalization of U.S. monetary policy could generate tighter conditions of access to foreign financing, which stresses the importance of maintaining fiscal discipline in these countries.

Capital flows to Mexico, and in general to emerging economies, remained highly volatile in the fourth quarter of 2013 and particularly over the first weeks of 2014. It should be noted, that in light of the December announcement by the Federal Reserve, adjustments in domestic financial markets, particularly fixed-income and exchange rate markets, took place in an orderly manner. This orderly adjustment was also contributed to by the relative improvement in the perception of Mexico's sovereign risk, derived from the significant progress in the implementation of structural reforms in the country, in particular, the energy, financial, telecommunication, economic competition, labor market and education reforms, which led to the credit rating upgrade of Mexico's sovereign debt. The above was also contributed to by the fiscal reform. The main adjustments included the equalization of VAT in the border region to the rate prevailing in the rest of the country, new tax rates set on flavored drinks and high-calorie density food, as well as an ecological tax on automotive fuels and a lower monthly adjustment of their prices. The income tax (ISR) special regimes were limited or eliminated, higher tax rates to individuals with higher income were introduced, as well as a tax on dividends and capital gains. In the same manner, the Flat Rate Business Tax (IETU) and the Cash Deposit Tax (IDE) were repealed. In particular, the reform establishes the Public Sector Borrowing Requirements (a broad measure of the public deficit) as a fiscal anchor and limits the growth of current expenditure for it to be in line with the potential GDP growth (to be defined). In this context, the public deficit excluding Pemex investment will expand from 0.3 percent of GDP in 2013 to 1.5 percent in 2014, and the current proposal contemplates reducing it in subsequent years until it reaches equilibrium by 2017. In all, although it is clear that the tax measures and those of public prices will affect inflation in the short term, insofar as this reform consolidates stability of public finances in the medium term, it will contribute to the convergence of inflation to its 3 percent permanent target.

Despite the headline inflation rebound, mentioned above, and despite the moderate increment in inflation expectations for 2014, as a result of the expected impact of fiscal measures on some prices, the price formation process in the economy has not been contaminated. Thus, medium- and long-run inflation expectations have remained stable.

The macroeconomic scenario foreseen by Banco de México is the following:

**Growth of the Mexican Economy:** In 2013 GDP in Mexico is forecast to have grown at an annual rate of approximately 1.2 percent. For 2014, the GDP growth rate in Mexico is expected to locate between 3.0 and 4.0 percent, as indicated in the previous Quarterly Report. For 2015, in line with the last Quarterly Report, the GDP growth rate is still estimated to lie between 3.2 and 4.2 percent (Chart 1a).

**Employment:** The expected increase in the number of IMSS-insured workers (permanent workers and temporary workers in urban areas) in 2014 and 2015 remains unchanged with respect to the previous Quarterly Report. In particular, for 2014 an increase of 620 to 720 thousand IMSS-insured workers is estimated. For 2015, an increment similar to that of 2014 is anticipated.

**Current Account:** In 2013, the deficit in the trade balance amounted to USD 1.0 billion (0.1 percent of GDP), while the deficit in the current account is estimated to have reached USD 19.8 billion (1.6 percent of GDP). For 2014, deficits in the trade balance and the current account of USD 5.8 and 25.4 billion are estimated, respectively (0.4 and 1.9 percent of GDP, in the same order). For 2015, deficits in the trade balance and the current account are expected to amount to USD 7.2 and 27.9 billion, respectively (0.5 and 1.9 percent of GDP, in the same order).

The balance of risks for 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 the external demand.

ii. This year will be characterized by a significant fiscal stimulus.

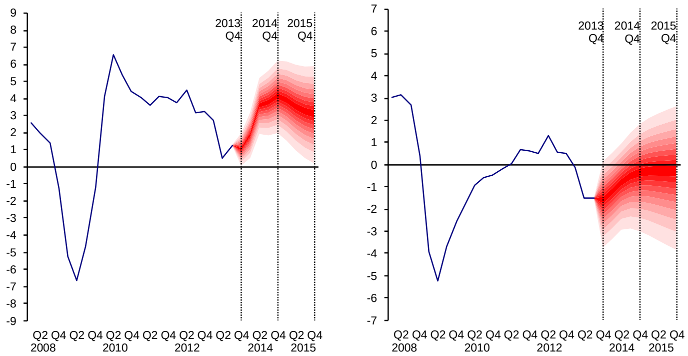
iii. In the medium term, an effective achievement and implementation of the structural reforms could improve prospects for investment in Mexico, with a consequent effect on aggregate demand and on the potential growth of

the economy, which would lead to higher growth without generating inflationary pressures.

**Fan Charts 1**

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

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




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

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

In spite of the above, the following downward risks prevail:

i. The possibility that the normalization process of the U.S. monetary policy may propitiate a significant adjustment in capital flows to emerging economies cannot be ruled out, which might affect the available sources of resources for the economy.

ii. The recovery of consumption could turn out to be more moderate than anticipated or the delay in the recovery of investment levels could persist, particularly, insofar as the housing sector does not pick up.

Even considering possible upward risks to the growth outlook, based on the current data, slack in the economy is expected to gradually decrease and the output gap is estimated to remain negative throughout 2014 and converge to zero by late 2015 (Chart 1b). Thus, no aggregate demand-related pressures on either inflation or the external accounts are anticipated in the forecast horizon.

**Inflation:** Inflation is forecast to lie above 4 percent in the first months of 2014 as a result of: i) an unanticipated uptick in non-core inflation in late 2013, even though its impact on headline inflation will fade in the course of the year; and ii) the impact of the changes in relative prices as a result of the fiscal measures, which are estimated to be moderate, are expected not to generate second round effects and to only have a transitory effect on inflation. Thus, in the second quarter, headline inflation is anticipated to fall below the 4 percent level. In the second half of the year, due to the arithmetic effect coming from a low comparison base, as well as the volatility of the non-core component, headline inflation could locate above 4 percent in several months, although it is expected to conclude the year within the variability interval of plus/minus one percentage point around the 3 percent target. This expectation stems from the rebound of headline inflation at the end of 2013, as mentioned above, and considers an impact generated by the fiscal measures of approximately 40 basis points on annual headline inflation as of December 2014. For 2015, a significant downward adjustment is anticipated from January onwards and it is expected to remain at levels slightly above 3 percent for the rest of the year (Chart 2a). Even considering the effects of the referred measures, annual core inflation is anticipated to lie at levels close to 3 percent during 2014 and below this level in 2015 (Chart 2b). This evolution is caused by the fading effects of the aforesaid changes in relative prices, by the expected reduction in gasoline price increases from next year onwards in line with the recently approved Revenue Law and the expectation of no demand-related inflationary pressures.

Among the risks to the outlook of annual headline inflation, the following stand out:

i. An upward risk of possible second round effects generated by adjustments in relative prices, as a result of the fiscal measures and their possible impact on other prices, as well as longer-term inflation expectations, cannot be ruled out, 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. However, if such an adjustment takes place, its effect would be expected to be transitory and moderate, given a low pass through of exchange rate variations onto inflation, which has been observed in the past.

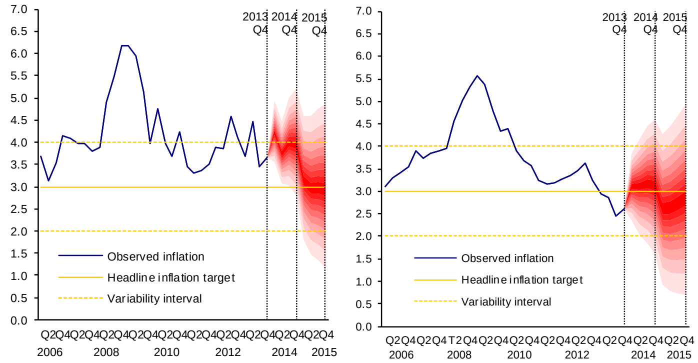
iii. As a downward risk, the possibility remains that the recovery of economic activity in the country might turn out lower than anticipated.

In sum, the balance of risks for inflation has deteriorated with respect to the previous Quarterly Report.

**Fan Charts 2**

a) Annual Headline Inflation [1/]
Percent

b) Annual Core Inflation [1/]
Percent




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

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Taking into consideration the above, Banco de México's Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate at 3.50 percent in its Monetary Policy meetings of December 2013 and January 2014, following a reduction of October 2013. Indeed, the Board of Governors considers the monetary policy congruent with the efficient convergence of inflation to the 3 percent target. Nonetheless, given the recent reading of inflation and considering the risks indicated 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, given the expected global environment of less favorable conditions in the financial markets, it is fundamental to continue strengthening the domestic sources of growth and of the framework for the macroeconomic policy conduction in Mexico. Thus, the need to allow for a flexible allocation of resources to their more productive uses, to boost market competition, particularly in input markets, and to achieve an incentive structure conducive to higher productivity should be emphasized. The recently approved structural reforms represent great progress in this direction, and will contribute to increasing competitiveness and the potential GDP of the country. Still, for these reforms to reach their potential and to effectively lead to higher economic growth, both an appropriate secondary legislation and an adequate implementation are indispensable.

It is anticipated that the referred structural reforms will not only derive in a more vigorous growth of the economy, but also lead to an environment of low and stable inflation. Increased competition could result in lower prices, with the associated enhanced welfare of the population, while greater productivity would allow the aggregate demand to reach higher growth rates without generating inflationary pressures. Thus, it is important to continue improving the institutional framework and to provide greater security and legal certainty to economic agents.