Quarterly Report

April – June 2017

Summary

In recent years the Mexican economy, and in particular inflation, have experienced an array of shocks of considerable magnitude, as a result of which inflation accelerated and achieved levels above 6.0 percent in recent months, after having reached a historic low in late 2015. In this context, Banco de México has implemented a timely strategy which consisted in adopting the necessary measures for the adjustments in relative prices (which originated from the said sequence of shocks) to be orderly, namely that medium- and long-term inflation expectations remain anchored, and thereby provide conditions for inflation to return to its 3.0 percent target. Thus, since December 2015, this Central Institute has raised the target for the Overnight Interbank Interest Rate by 400 basis points, hence increasing it from 3.0 to 7.0 percent. Considering that revisions in the monetary policy have a lagged effect on headline inflation, the adopted monetary policy actions have also begun 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 reversal in their trend. 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.

High levels of annual headline inflation during this year reflect the impact of different shocks, such as the depreciation of the national currency that has been accumulated since late 2014, the effects of the price liberalization process of some energy products and the rise in the minimum wage last January. In recent months, headline inflation received an additional impetus, as a consequence of price increments across some core index items, such as the increases in passenger transport fares in Mexico City, as well as some other cities of the country, and, more recently, in the prices of some agricultural products. Despite the upward trend in headline and core inflation during the period analyzed in this Report, which marked 6.59 and 5.02 percent in the first fortnight of August 2017, respectively, its growth rate has started to slow down. Similarly, there has already been a change of trend in the items affected by the initial shocks, such as those corresponding to energy products and non-food merchandise.

Banco de México's Board of Governors increased the monetary policy rate by 25 basis points, both in its decision of May and of June, raising this rate to 7.0 percent. These decisions principally considered the inflation trend prompted by the referred shocks, no anticipated aggregate demand-related pressures onto inflation, and the 25-basis-point increase in the target range for the U.S. Federal Reserve reference rate. On the other hand, in its August meeting the Board decided to maintain the target for the Overnight Interbank Interest Rate, considering, based on the information available at the time, that the level of the reference rate achieved in the previous decision seemed to be congruent with the convergence of headline inflation to the 3.0 percent target at the end of 2018.

For the remainder of 2017 and for 2018, both advanced and emerging economies are still expected to recover slightly. Nevertheless, this outlook still has downward risks, including high uncertainty over the direction of the U.S. economic policies, growing geopolitical tensions across different regions, and a possible environment of greater protectionism in international trade.

Despite the persistent uncertainty regarding the economic policy and increased geopolitical risks, international financial markets showed a sharp decline in their volatility levels and an increase in the price of assets with respect to the first quarter of 2017. In other words, they benefitted from the greater global growth, an environment of ample liquidity and the prospect of interest rates remaining low, which has been reflected in a continuous search for higher yields, mainly by institutional investors. Despite the reduced probability of extreme or tail risks that could affect the performance of financial markets, during the second quarter, it remains high.

In the same vein, conditions in domestic financial markets kept improving in the reported period. The volatility of the quote of the Mexican peso against the U.S. dollar decreased and the national currency further appreciated, as it marked levels that had not been observed since May 2016. This largely reflects the monetary policy measures that have been adopted by Banco de México, along with a more positive international financial environment and a relative improvement in the perception of the future bilateral Mexico – U.S. relation. As regards the end of the previous quarter, short-term interest rates went up in accordance with the monetary policy actions, while medium- and long-term ones declined given the anchoring of medium- and long-term inflation expectations in Mexico, the corresponding reduction in the inflation risk premium, the decrease in long-term rates in the U.S. and the environment of higher appetite for risk.

With respect to the domestic economy, in the second quarter of 2017 productive activity kept expanding, even though its growth rate was slightly lower than that observed in the previous quarter. This reflected the positive trajectory of exports and private consumption, while the weakness of investment persisted. In this context, no significant aggregate demand-related pressures onto prices have been recorded. Furthermore, albeit labor market seems to lack slack, no wage pressures that could affect the inflation process have been perceived.

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

GDP Growth Rate: The outlook for economic growth in Mexico appears to have improved with respect to the perception that prevailed at the release of the previous Report. World economic activity and global trade have continued to recover, the domestic market has proven to be resilient, and businesses' and consumers' confidence has gradually increased. In the same vein, despite the persistent uncertainty over the future of the Mexico – U.S bilateral relation, more recent data point to a lower probability for scenarios that may strongly affect economic growth. Hence, the forecast interval for GDP growth in Mexico for 2017 has been adjusted from between 1.5 and 2.5 percent to between 2.0 and 2.5 percent. For 2018, the forecast interval is revised upwards from between 1.7 and 2.7 percent to between 2.0 and 3.0 percent. In this way, a greater growth rate of the economy is expected in 2018 relative to 2017. This trajectory is consistent with the estimation that the reactivation of U.S. industrial production will consolidate, as well as with the expectation that some structural reforms will generate even more noticeable effects on growth, and that strengthening of the macroeconomic framework, that has been carried out by both the fiscal and monetary authorities, will propitiate conditions that are more favorable for economic activity in Mexico (Chart 1a).

These growth expectations do not suggest the presence of aggregate demand-related pressures onto prices in the forecast horizon. In particular, the output gap is still anticipated to remain negative, although lying closer to zero, as compared to the previous Report (Chart 1b).

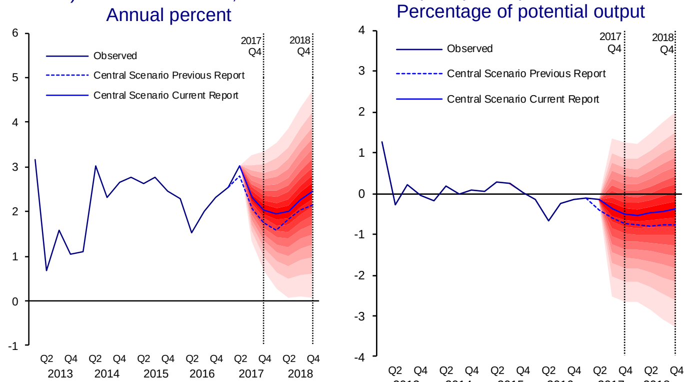
Employment: In line with the expected greater economic growth, in 2017 the number of IMSS-affiliated jobs is forecast to grow between 660 and 760 thousand jobs (between 650 and 750 thousand jobs in the previous Report). For 2018, an increase of between 670 and 770 thousand jobs is anticipated (between 640 and 740 thousand jobs in the last Report).

Current Account: For 2017, deficits in the trade balance and the current account are expected to amount to 1.2 and 2.2 percent of GDP (USD 13.2 and 25.0 billion, respectively). For 2018, deficits in the trade balance and the current account are estimated to be 1.0 and 2.2 percent of GDP (USD 12.5 and 27.1 billion, in the same order).

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. / Prepared with seasonally adjusted data.
Source: Banco de México

The balance of risks for growth has improved and has become neutral, derived from the perception that the probability that some of the most extreme downward risks may take place has diminished. Among the downward risks, the following stand out: i) that due to uncertainty over the NAFTA renegotiation, different enterprises decide to postpone their investment plans in Mexico; ii) that the NAFTA renegotiation is not favorable for the Mexican productive sector or that it even results in its cancellation; iii) that episodes of high volatility in international financial markets are observed; iv) that the upcoming electoral process in Mexico causes volatility in domestic financial markets, creating an environment of uncertainty that negatively affects the evolution of private spending; v) that the rise in public insecurity further affects productive activity. Among the upward risks, the following are noteworthy: i) that the renegotiation of NAFTA triggers investment in the areas of opportunity, which have not been previously considered by the Agreement; ii) that the implementation of structural reforms renders greater-than-estimated results; iii) that the performance of oil production improves.

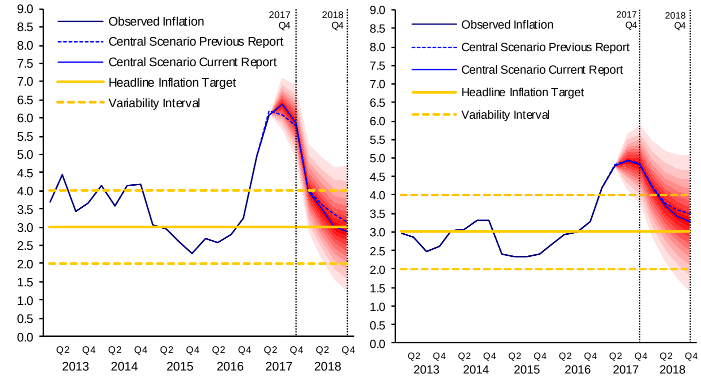
Inflation: According to the central scenario, annual headline inflation is estimated to persist above 6.0 percent over the next months. However, it appears to be approaching its ceiling. In line with that, during the last months of this year headline inflation is expected to resume its downward trend, which is anticipated to accentuate during the following year, leading to the inflation convergence to its 3.0 percent target around the third quarter of 2018. Under this scenario, in 2017 annual core inflation is estimated to remain above 4.0 percent, although significantly below the trajectory of annual headline inflation. Likewise, at the end of 2017 and in early 2018, it is expected to resume its convergence trajectory to the inflation target, attaining levels close to 3.0 percent in late 2018. The above estimations consider monetary policy adjustments that have been implemented since December 2015 up to date, and which will keep affecting the evolution of inflation over the next quarters. Similarly, it is considered that in January 2018 the vanishing of the base effect brought about by higher prices of various energy products in early 2017 will significantly impact annual inflation, which will present a downside trajectory during the subsequent months. This will take place in an environment, in which no aggregate demand-related pressures onto prices are expected (Chart 2a and Chart 2b). These forecasts assume that in an event of volatility in domestic financial markets, it would be transitory.

The above estimations are subject to risks. Among upward risks, the following should be mentioned: i) albeit it has not occurred yet, that second round effects on inflation take place; ii) that the exchange rate is affected by a shock; iii) higher-than-expected prices of agricultural goods; iv) that the evolution of unit labor costs will start to be reflected in inflation. Among downward risks, these should be listed: i) that the appreciation of the national currency consolidates and even deepens; ii) that energy prices go down in accordance with their international references; iii) that a greater-than-anticipated reversal in the price increments of agricultural products is observed; iv) that the structural reforms lead to further reductions in different prices of the economy. Given the current monetary policy stance, the balance of risks to inflation is considered to be neutral.

Fan Charts 2

a) Annual Headline Inflation 1/
Percent

b) Annual Core Inflation 1/
Percent



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

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

Considering the data presented in this Report, in the future 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 and the evolution of the output gap. It will also assess 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.

As a result of the sound macroeconomic framework of Mexico, despite the complex external environment faced by the Mexican economy throughout various years, the country continues growing and financial stability has prevailed, as the economy has been adjusting to the new environment in an orderly manner. Nonetheless, it is important to keep in mind that the economy is still facing serious challenges, reason why it is crucial to continue strengthening the macroeconomic fundamentals. This is contributed to by the monetary policy actions seeking to maintain anchored medium- and long-term inflation expectations and to attain the convergence of inflation to its target, as well as by the Federal Government commitment to implement the fiscal adjustment so that the public debt-to-GDP ratio declines. In particular, the fiscal authority has made a decision to attain a primary surplus of 0.4 percent of GDP in 2017 (excluding Banco de México's operational surplus), and a surplus of 1.0 percent of GDP for 2018, as published in the most recent document related to the Federal Budget and Fiscal Responsibility Law (*Pre-Criterios)*. Progress in the implementation of the structural reforms, in particular in the competition, telecommunications and energy ones, should be stressed. In recognition of the above factors, some rating agencies revised Mexico's sovereign debt credit outlook up to stable from negative.

The Board of Governors of Banco de México considers that the current monetary policy stance is congruent with the convergence of headline inflation to its 3.0 percent target by the end of 2018. It is worth highlighting that achieving the fiscal goals proposed by the Ministry of Finance for this year and the next one will reinforce the convergence process of inflation to its target and will help make it more efficient. This takes on greater relevance in light of the still prevailing uncertainty, related to the possible tightening of global financial conditions in the future, to the NAFTA renegotiation and to the upcoming electoral process in Mexico.

Banco de México's experience in curbing inflation, backed by its autonomy, testifies to the importance of Mexico's having the institutions that meet society's demands. In this sense, strengthening Mexico's institutions at all levels so that they comply with their social purpose under the principles of transparency and with zero tolerance for corruption should be an essential part of the effort to ratify the supremacy of the rule of law in Mexico. In a context in which public insecurity issues have increased, it becomes particularly relevant to adopt measures to prevent this factor from gaining greater importance as an obstacle to the economic development of the country.