



Quarterly Report

October – December 2014

February 18, 2015



BANCO DE MÉXICO

Outline

1 Monetary Policy

2 External Conditions

3 Economic Activity in Mexico

4 Inflation Determinants

5 Forecasts and Balance of Risks

Recent Evolution of Inflation

In 2014, the evolution of headline inflation in Mexico was in line with the forecast of Banco de México.

✓ *As a result of fiscal adjustments and other transitory shocks, inflation located above the upper bound of the variability interval during most of the year.*

✓ *However, from November onwards, it started to present a **clear downward trend** and closed 2014 at 4.08 percent.*

In January 2015, it further reduced to 3.07 percent, derived from:

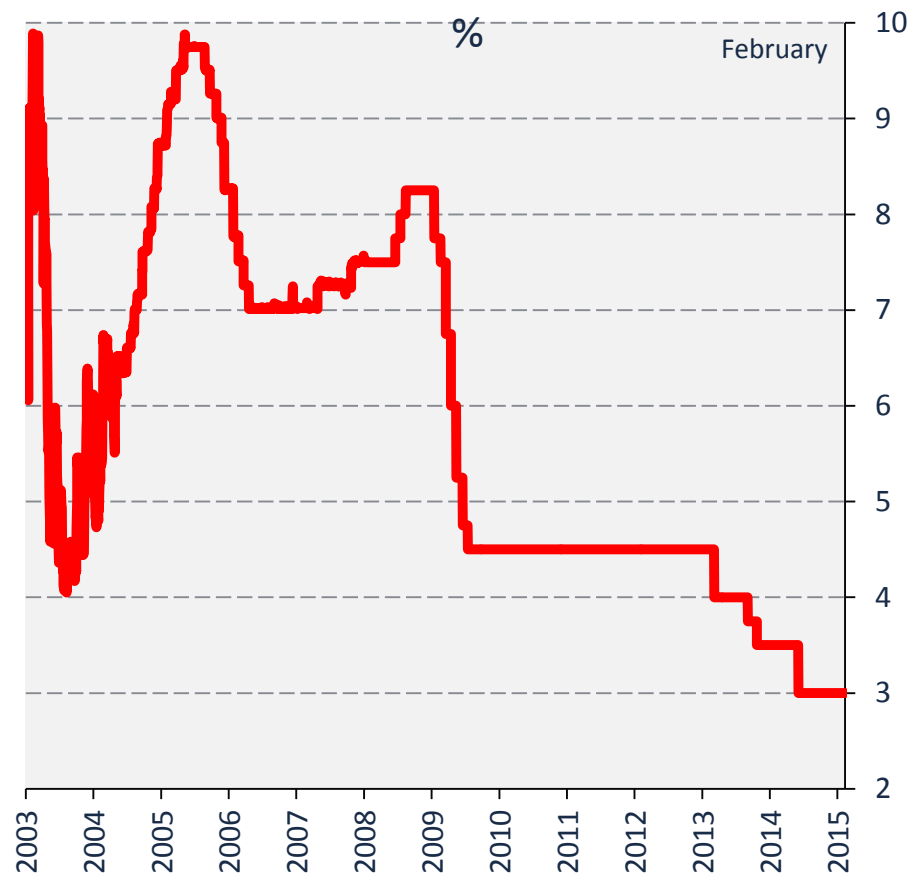
- ✓ *The fading of the effects of the above referred shocks.*
- ✓ *Downward adjustments in telecommunication services' prices and some energy prices.*
- ✓ *Lower increments with respect to last year in the prices of merchandise and services in general.*
- ✓ *The monetary policy conduction.*

From October 2014 up-to-date (the period analyzed by this Report) Banco de México's Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate at 3 percent.

The above, considering that:

- No aggregate demand-related pressures on prices were anticipated.
- Inflation expectations remained well-anchored.
- The pass-through of exchange rate adjustments onto prices was expected to be low.
- A considerable drop of inflation in early 2015 and the convergence to the 3 percent target from mid-2015 were expected.

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



1/ Before January 20, 2008 it refers to the observed Overnight Interbank Interest Rate. Source: Banco de México.

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External Conditions

During 4Q 2014, the international environment dramatically deteriorated as a result of two shocks:

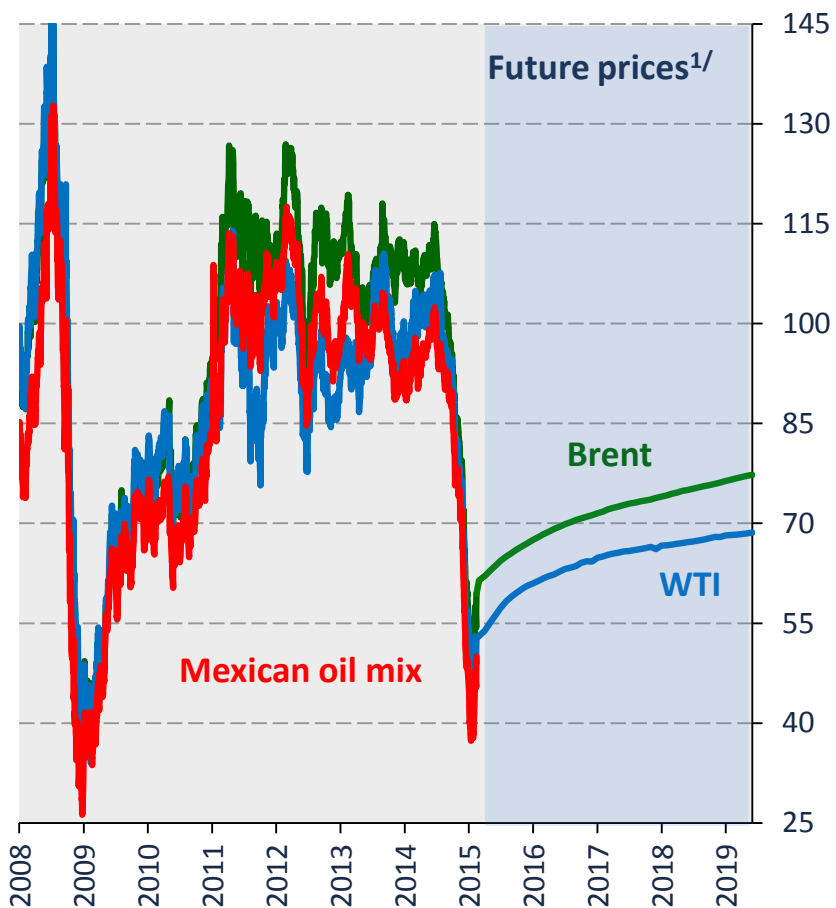
① *International oil prices* dropped significantly and it is anticipated to remain at low levels for an extended period of time.

② A *widespread appreciation of the USD*, as a result of the differences in the growth rate and in the expectations of the U.S. monetary stance with respect to the main advanced economies and most emerging ones.

➤ The above, as well as the slowdown of the world economy, led to **higher volatility in international financial markets**.

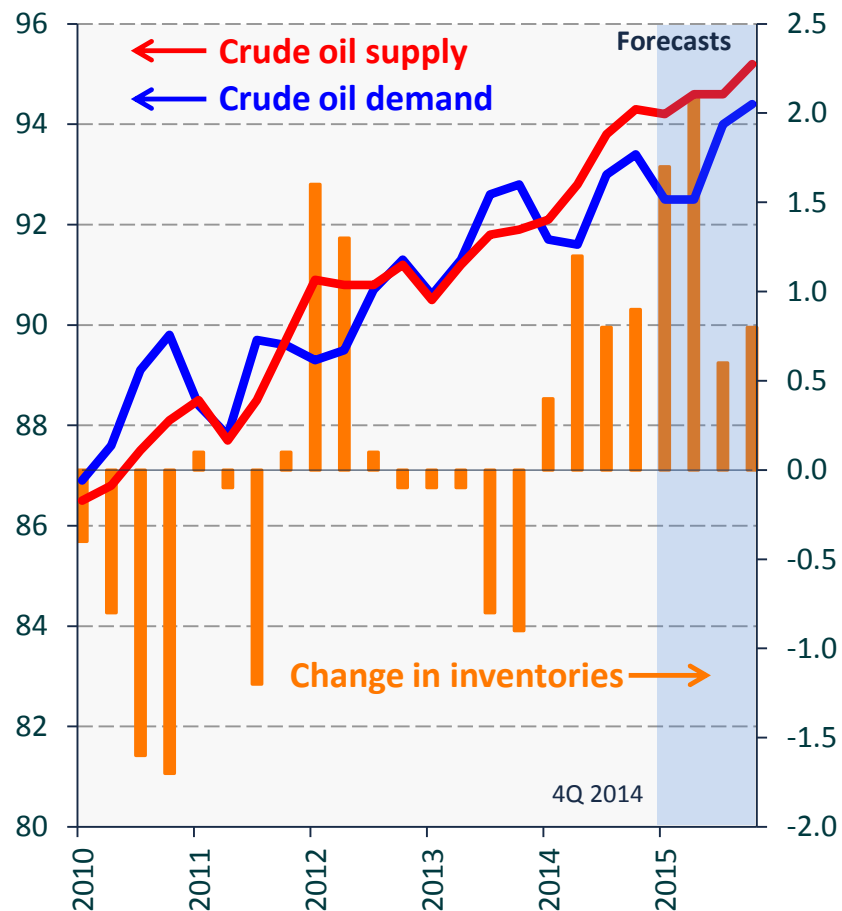
Lower oil prices are mainly attributed to supply factors, although lower demand has also contributed to the above.

Crude Oil Prices
USD per barrel



1/ Data up to February 16, 2015.
Source: Bloomberg.

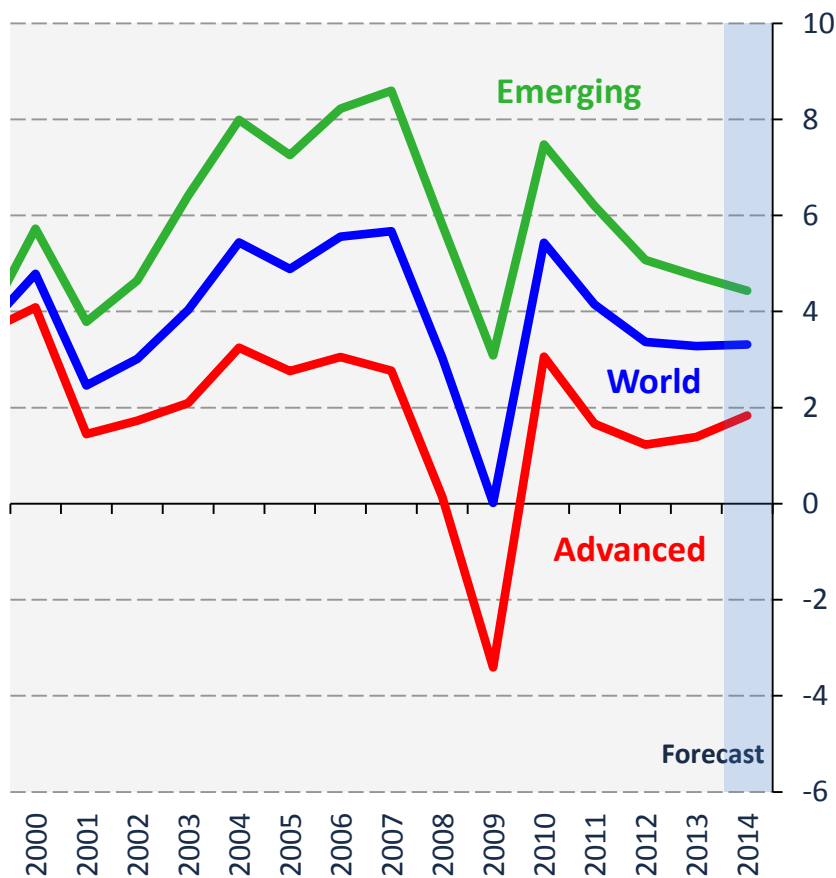
World Supply and Demand for Crude Oil 2/
Millions of daily barrels



2/ For 2015, it is assumed that the OPEP will keep unchanged its production levels. Source: International Energy Agency.

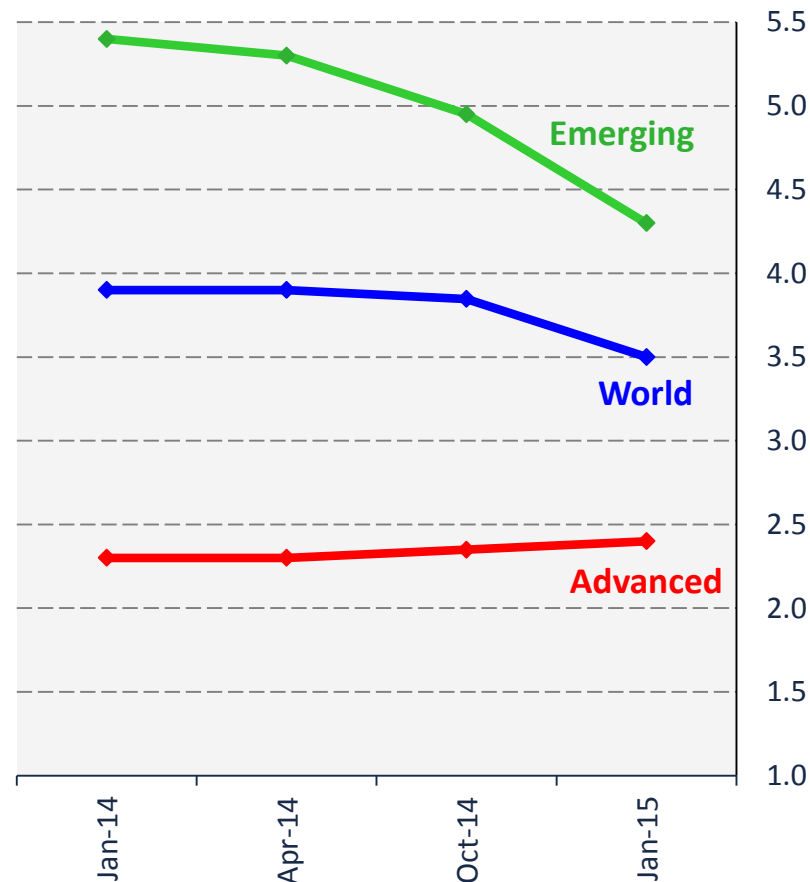
World economy remained weak in 4Q 2014, which translated into a downward adjustment of the global growth outlook.

World GDP Growth
Annual % change



Source: World Economic Outlook, October 2014 and January 2015, International Monetary Fund.

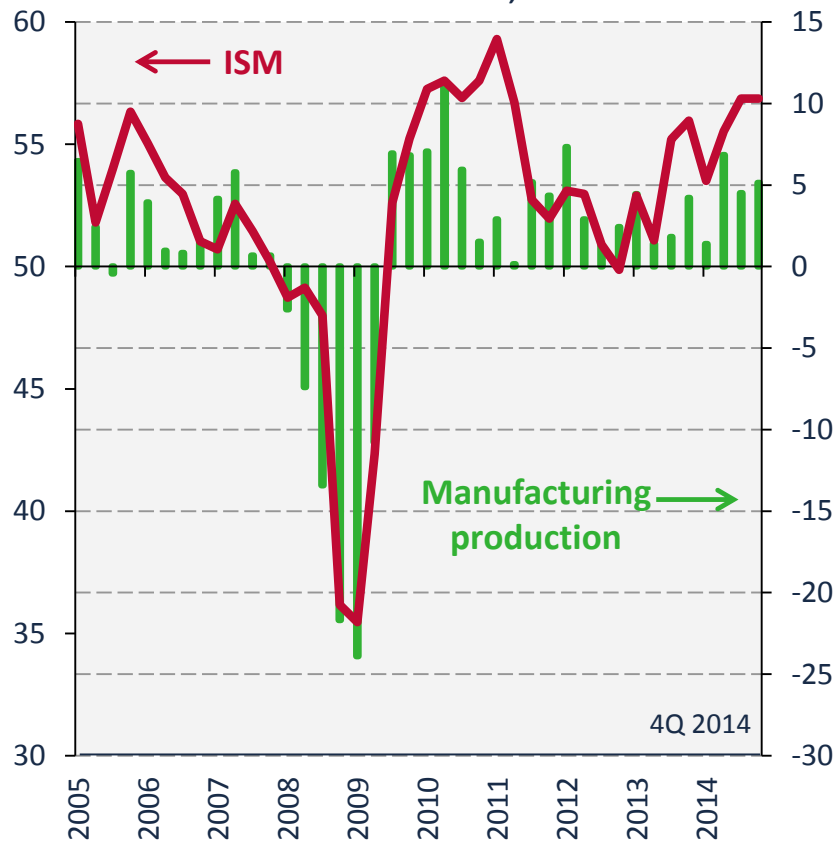
Evolution of IMF's GDP Growth Forecast for 2015
Percent



Source: World Economic Outlook, January, April, October 2014 and January 2015, International Monetary Fund.

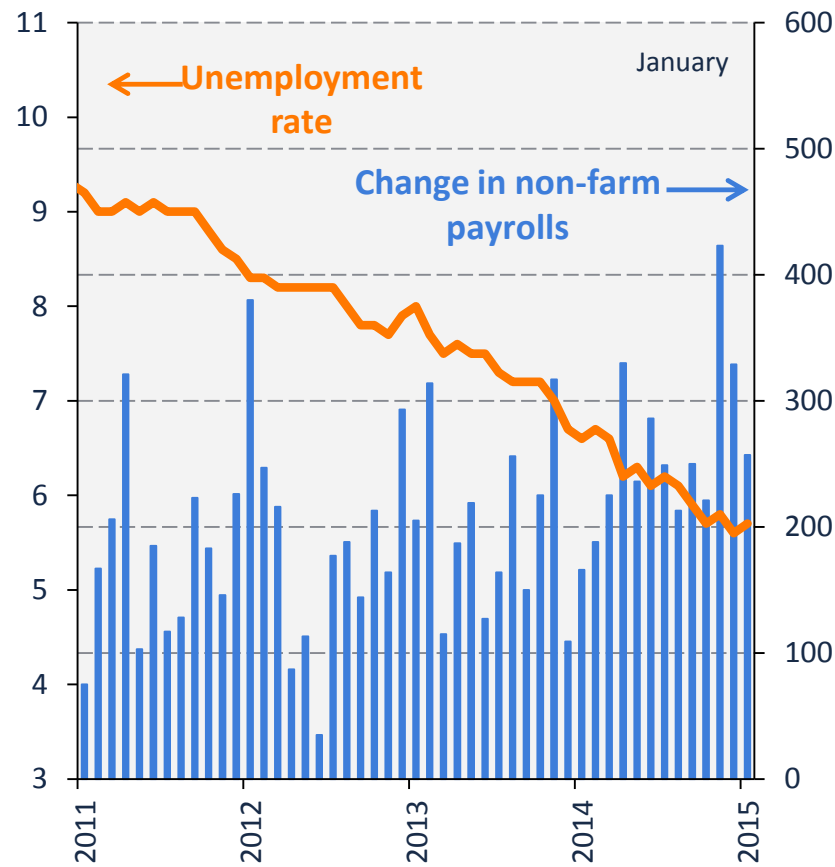
However, the U.S. economic recovery kept strengthening.

Manufacturing Production and Purchasing Managers Index (ISM)
 Quarterly % change at annual rate and diffusion index, s. a.



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

Change in Non-farm Payrolls and Unemployment Rate
 Thousands of jobs and % of EAP, s. a.

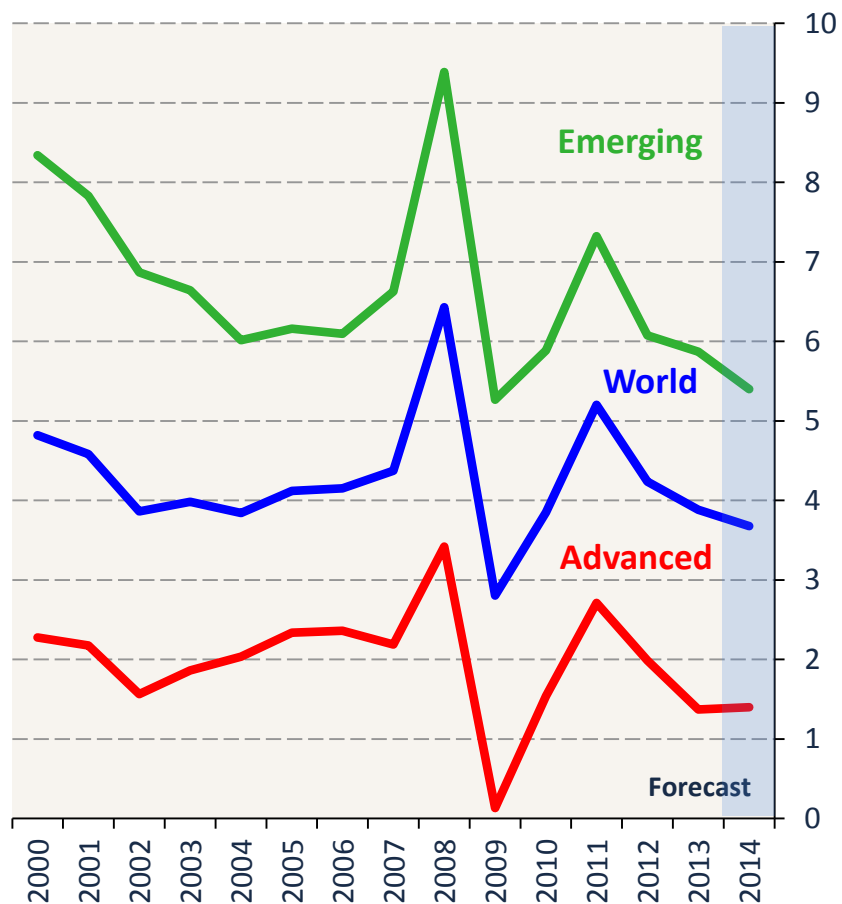


EAP/ Economically Active Population.
 s. a./ Seasonally adjusted data.
 Source: Bureau of Labor Statistics.

Inflation continued to decrease worldwide, as a considerable drop in energy prices was added to the ample slack conditions still prevailing in some advanced economies and to the weak domestic demand in the emerging ones.

World Annual Headline Inflation

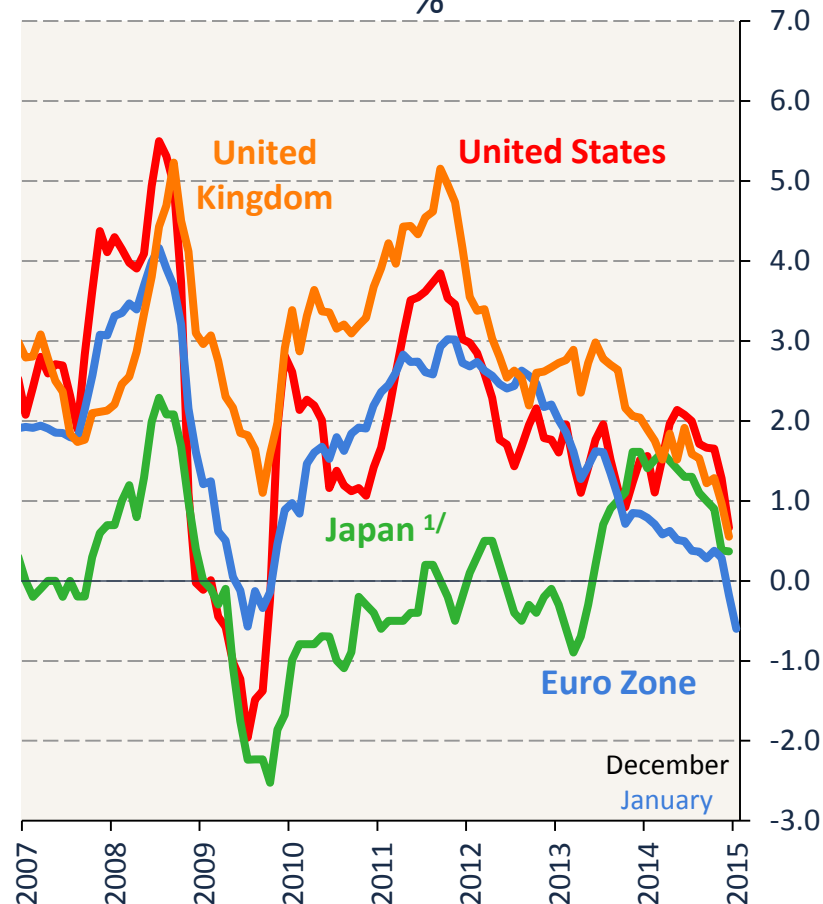
%



Source: World Economic Outlook, October 2014 and January 2015, International Monetary Fund.

Advanced Economies: Annual Headline Inflation

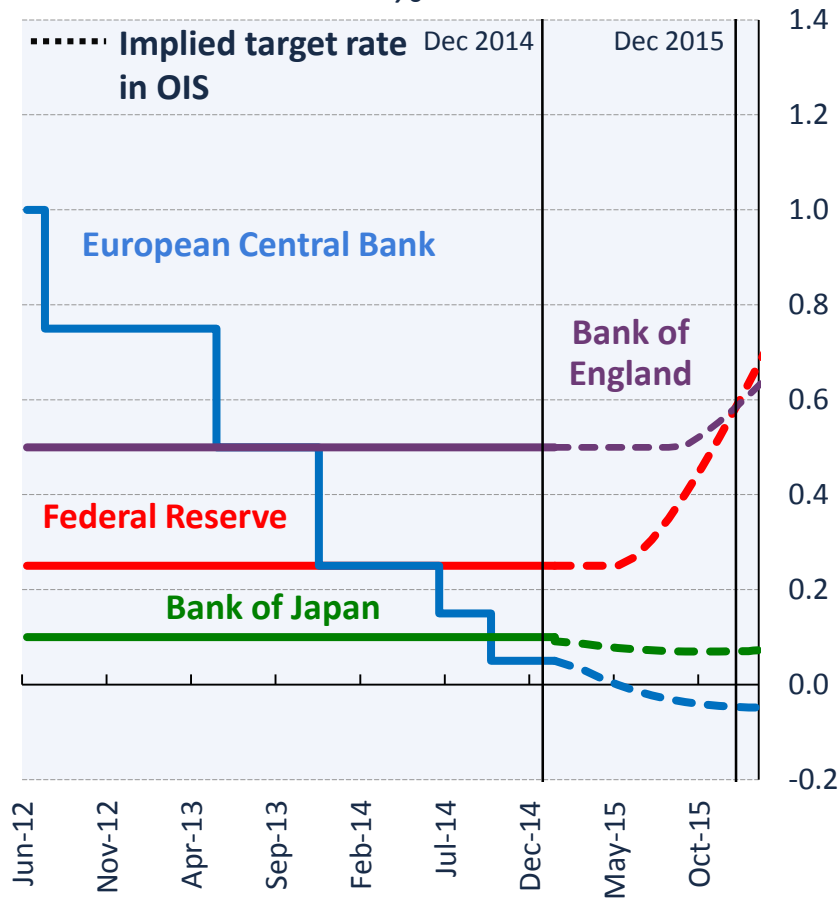
%



1/ Excluding the effects of the consumption tax rise.
Source: BLS, Eurostat and Japan Statistics Bureau.

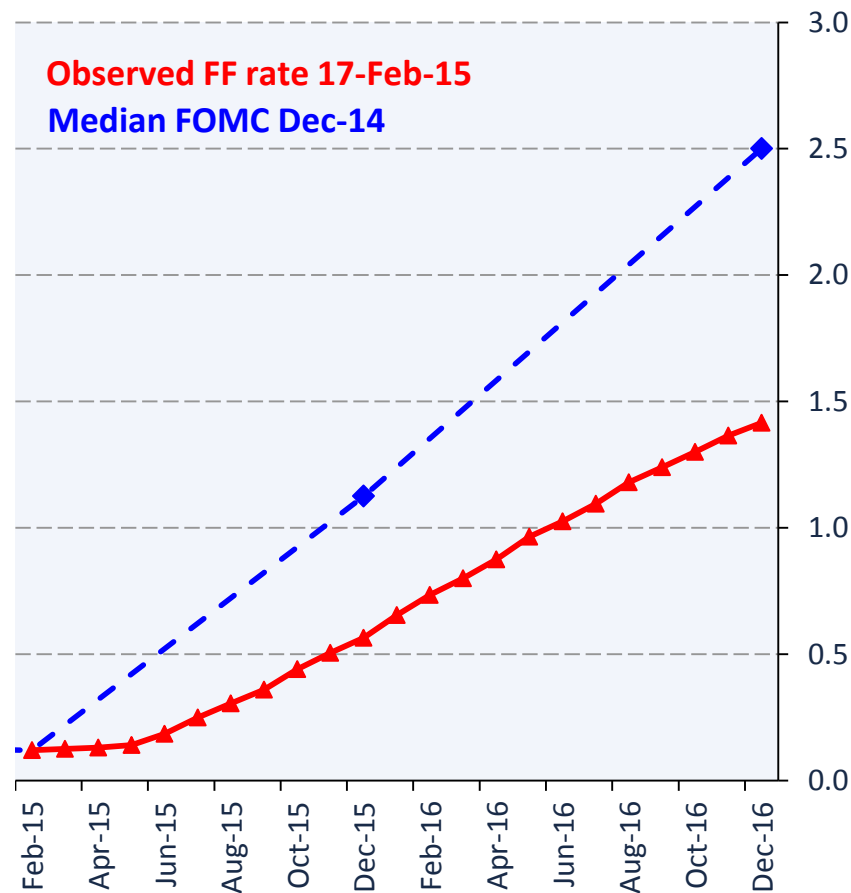
The monetary policy stance in the main economies remained accommodative and in some cases additional monetary easing measures were adopted.

**Advanced Economies:
Implied Monetary Policy Rates
in OIS Curves^{1/}**
%



1/ OIS: Overnight Index Swap.
Source: Bloomberg with estimates from Banco de México.

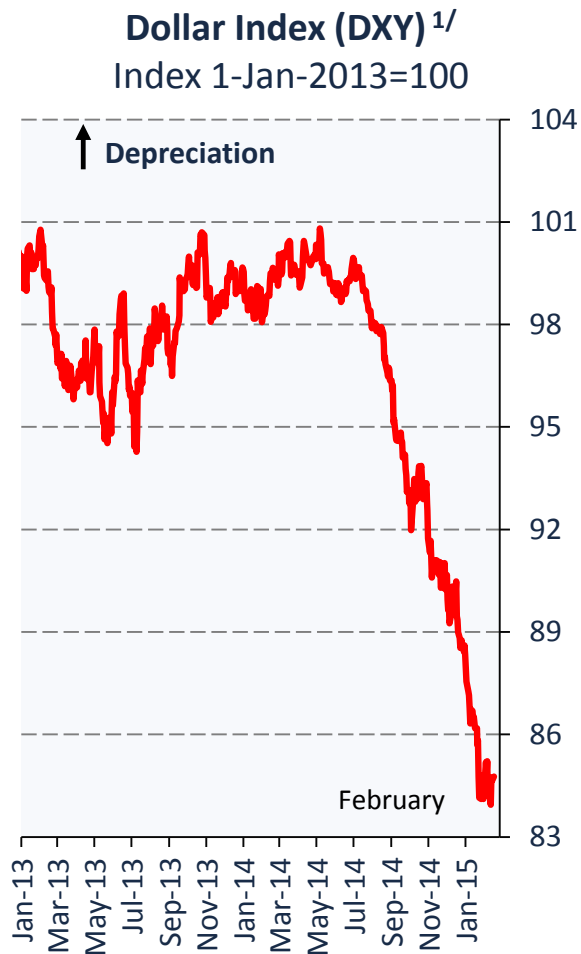
U.S.: Expected Federal Funds Rate
%



Source: Bloomberg and projections from members of the FOMC, Federal Reserve.

An important increase in volatility in international financial markets was observed. The USD strengthened against most advanced and emerging economies' currencies.

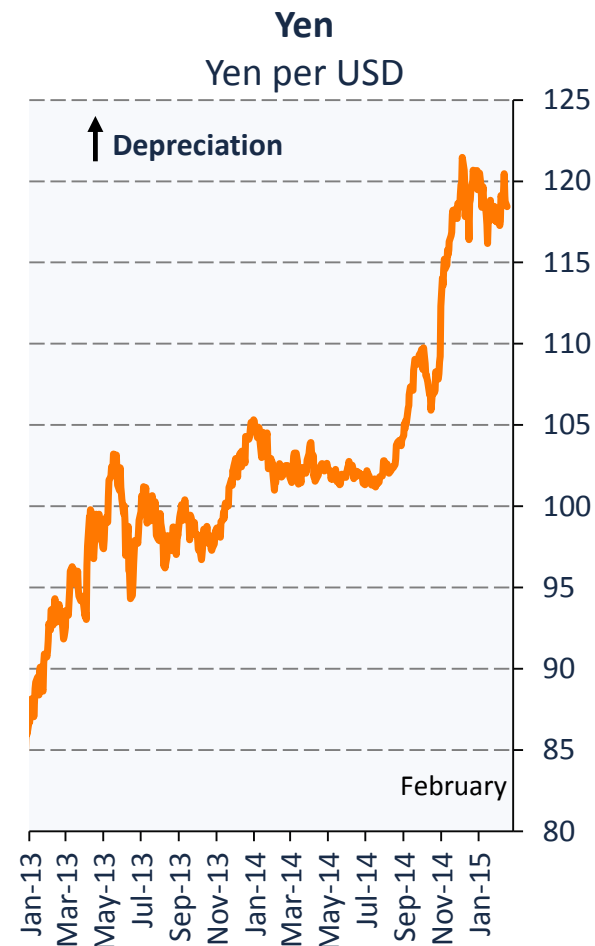
Advanced Economies: Nominal Exchange Rates



^{1/} 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.



Source: Bloomberg.

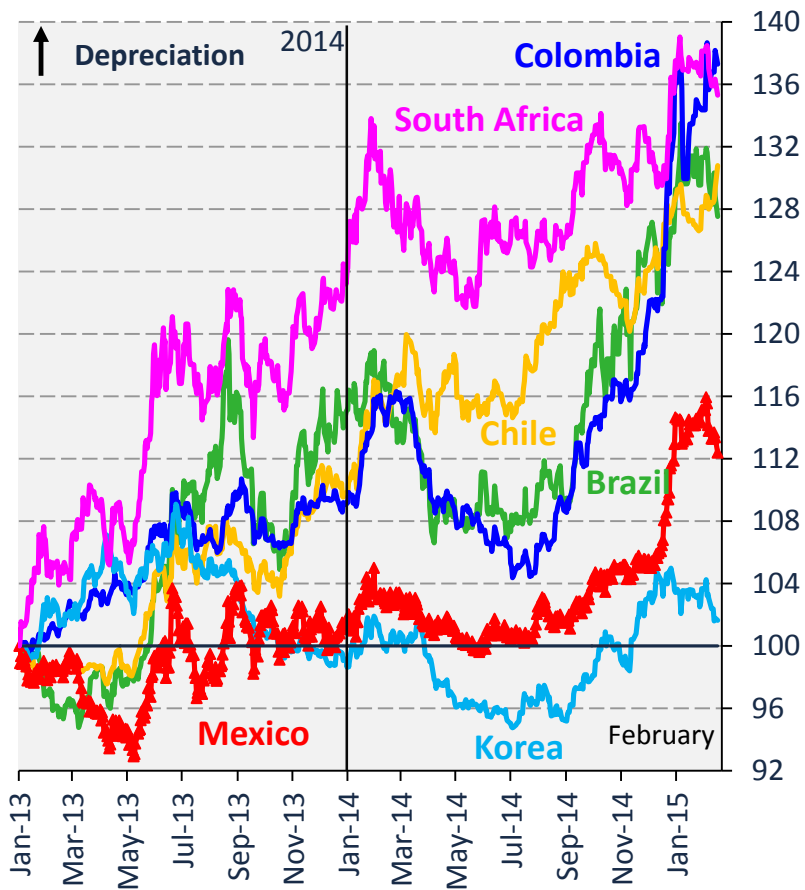


Source: Bloomberg.

Emerging economies' currencies depreciated. In Mexico, a relationship between the fall of oil prices and the Mexican peso depreciation was observed.

Emerging Economies: Nominal Exchange Rate against USD

Index 01-Jan-2013 = 100



Source: Bloomberg.

Mexican Oil Mix Price and Nominal Exchange Rate

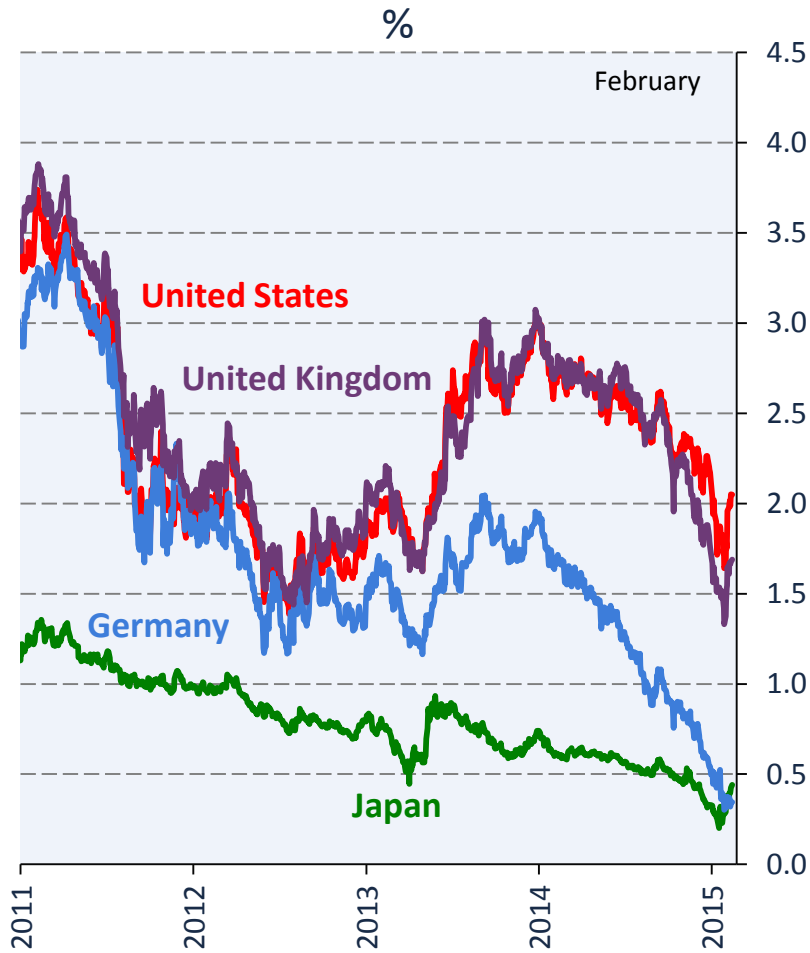
USD per barrel, pesos per USD



Source: Banco de México and Bloomberg.

Government bond interest rates decreased in most countries, including Mexico.

Advanced Economies: 10-Year Interest Rates



Source: Bloomberg.

Mexico: Interest Rates of Government Securities



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

Outline

1 **Monetary Policy**

2 **External Conditions**

3 **Economic Activity in Mexico**

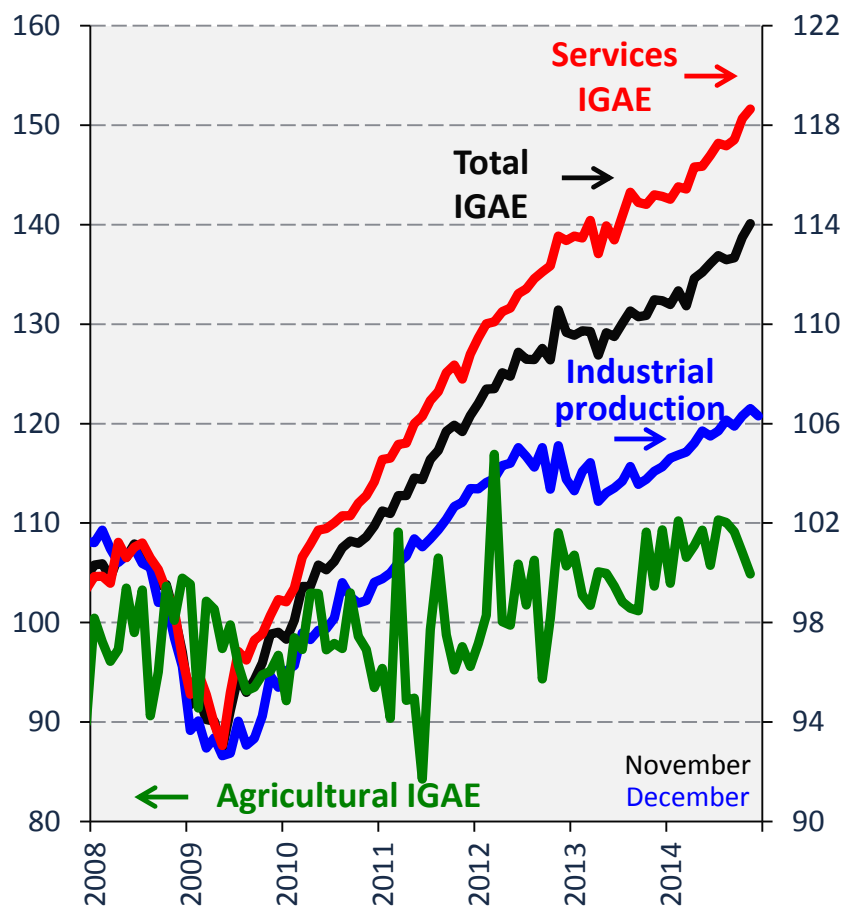
4 **Inflation Determinants**

5 **Forecasts and Balance of Risks**

In 4Q 2014 the Mexican economy continued with the moderate recovery that had started in 2Q 2014.

Economic Activity Indicators

Index 2008 = 100, s. a.

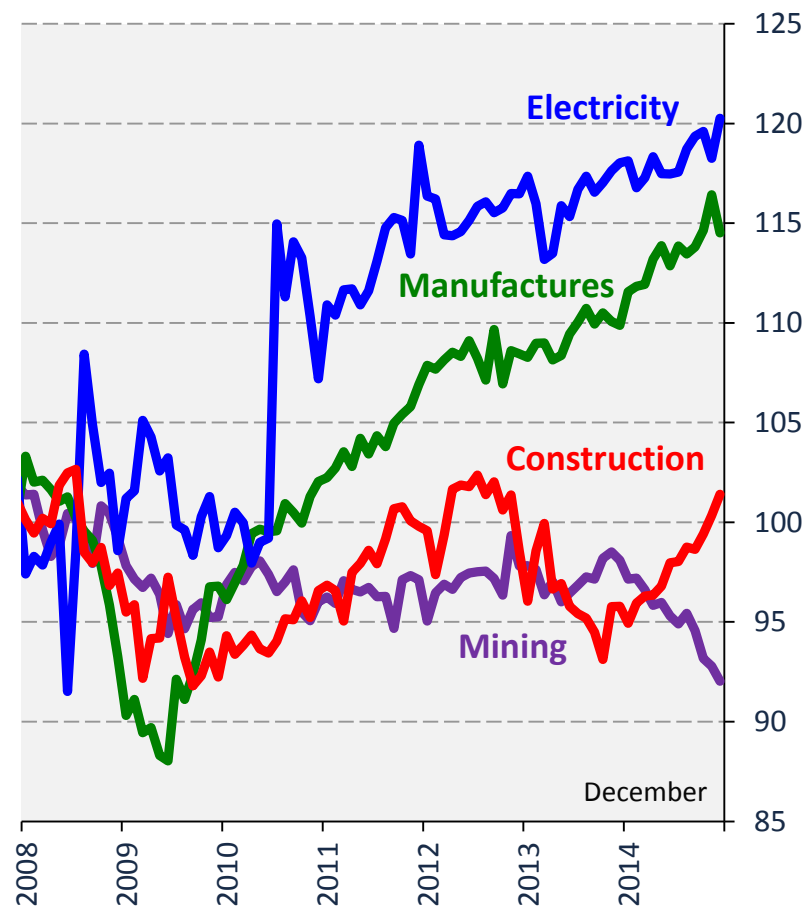


s. a./ Seasonally adjusted data.

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

Industrial Activity

Index 2008 = 100, s. a.

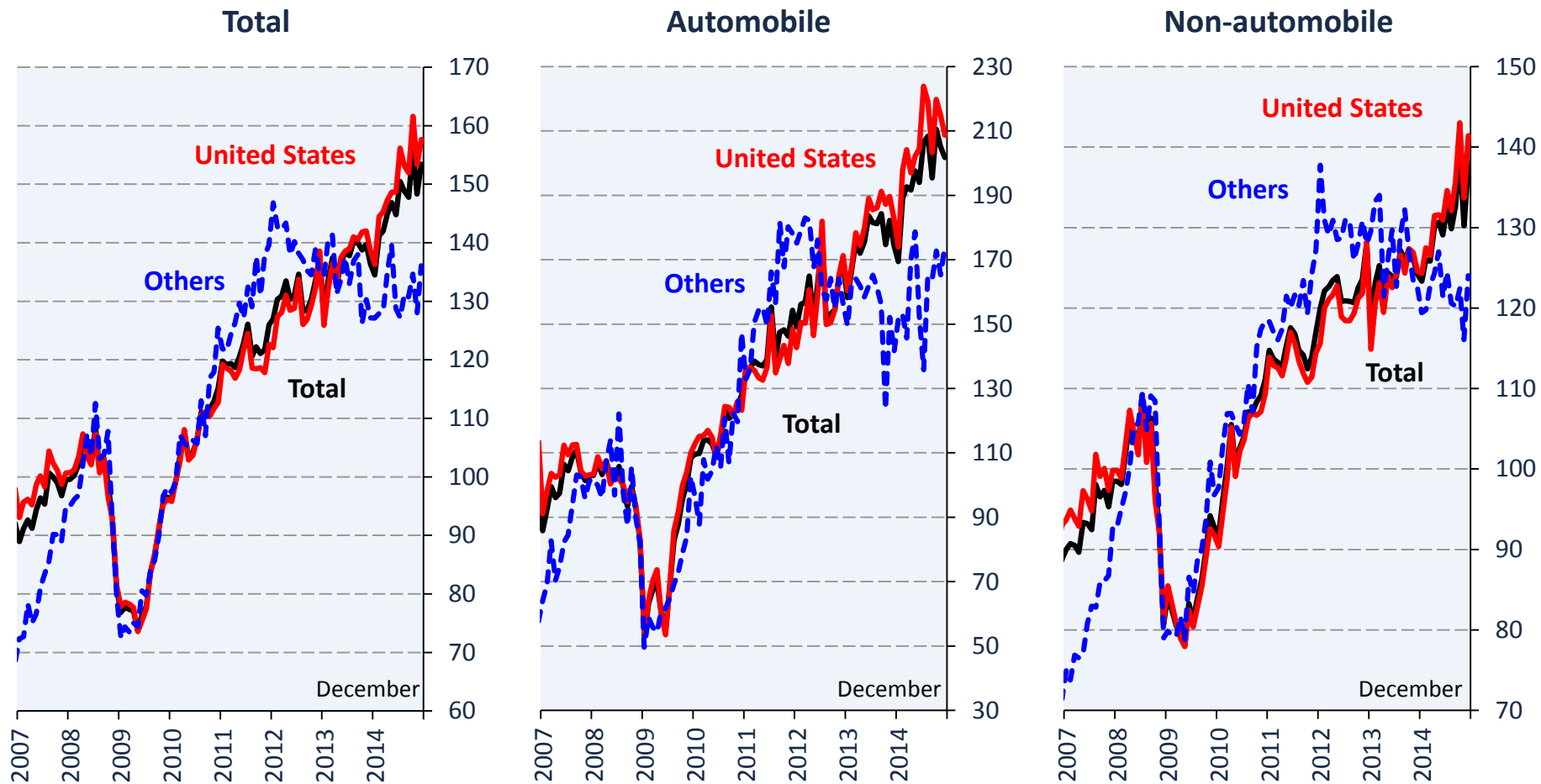


s. a./ Seasonally adjusted data.

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

Manufacturing exports maintained the growing trend that had been observed since late 1Q 2014.

Manufacturing Exports Index 2008=100, s. a.



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

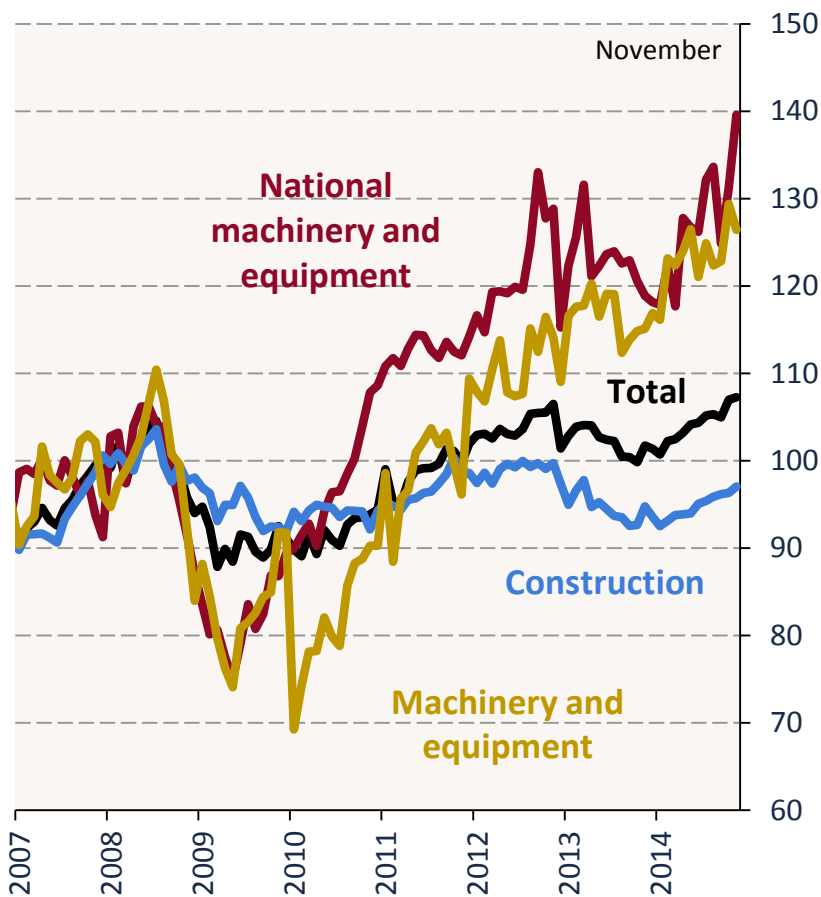
s.a./ Seasonally adjusted data.
Source: Banco de México.

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

Investment maintained a positive trend in 4Q 2014.

Investment and its Components

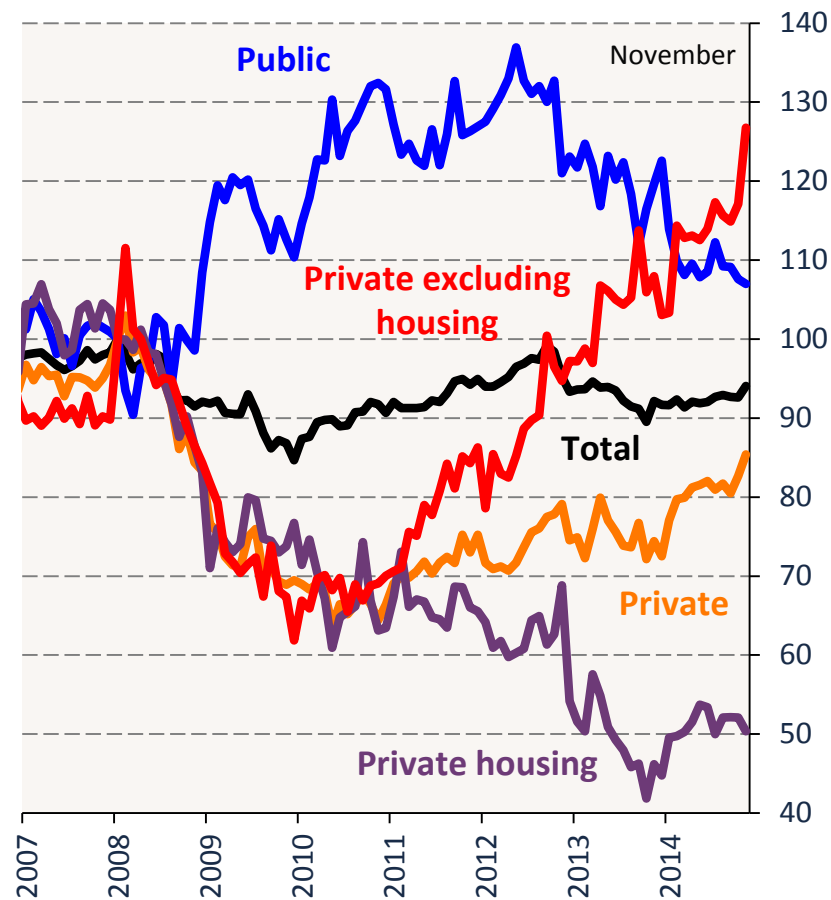
Index 2008=100, s. a.



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

Real Value of Production in Construction

Index Jan-2008=100, s. a.

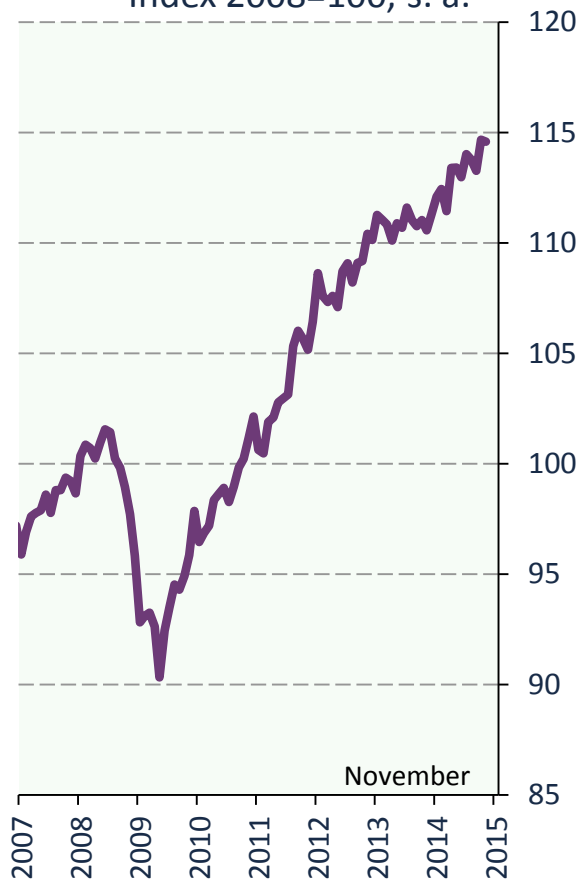


s.a./ Seasonally adjusted data.
Source: INEGI and seasonally adjusted by Banco de México in the case of public and private construction (private housing and private excluding housing).

However, private consumption still did not show clear signs of solid reactivation.

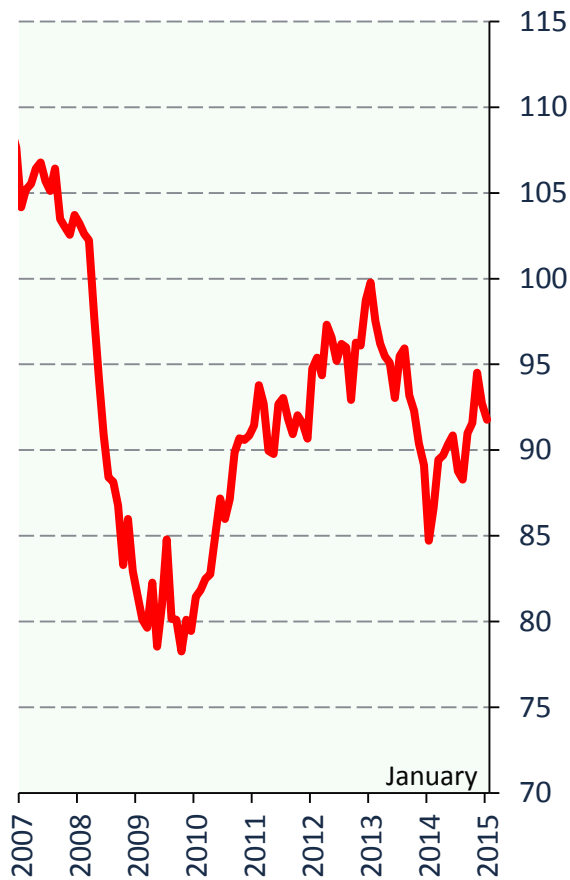
Monthly Indicator of Private Consumption in the Domestic Market

Index 2008=100, s. a.



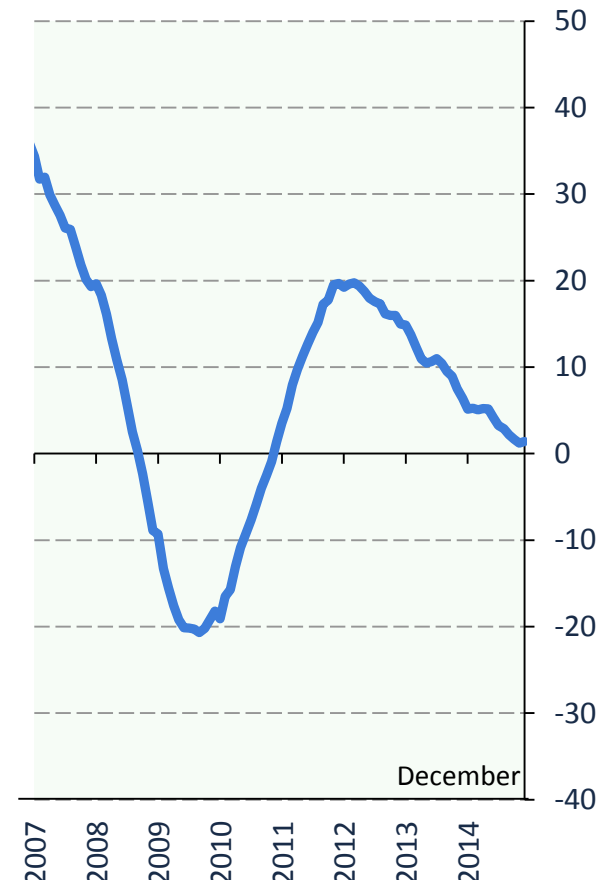
s. a./ Seasonally adjusted data.
Source: INEGI.

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



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

Commercial Bank Performing Consumer Credit^{1/}
Real annual % change



1/ It includes loans by credit card-regulated sofomes.
Source: Banco de México.

Timely data indicate that a gradual improvement in the labor market was still observed in 4Q 2014 .

IMSS-Affiliated Jobs and Employed Population

Index 2012=100, s. a.



s. a./ Seasonally adjusted.

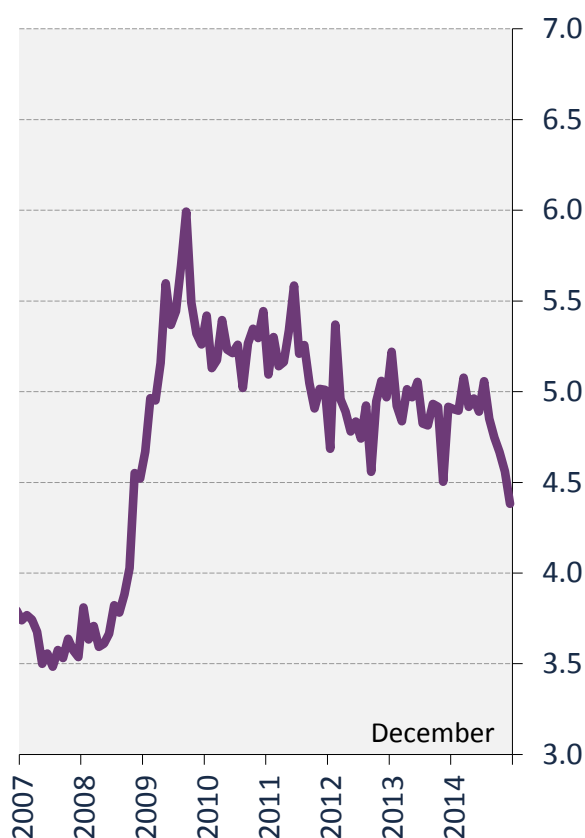
1/ Permanent and temporary workers in urban areas. Seasonally adjusted by Banco de México.

2/ Calculated by Banco de México with data from INEGI.

Source: IMSS and INEGI (ENOE).

National Unemployment Rate

% of EAP, s. a.



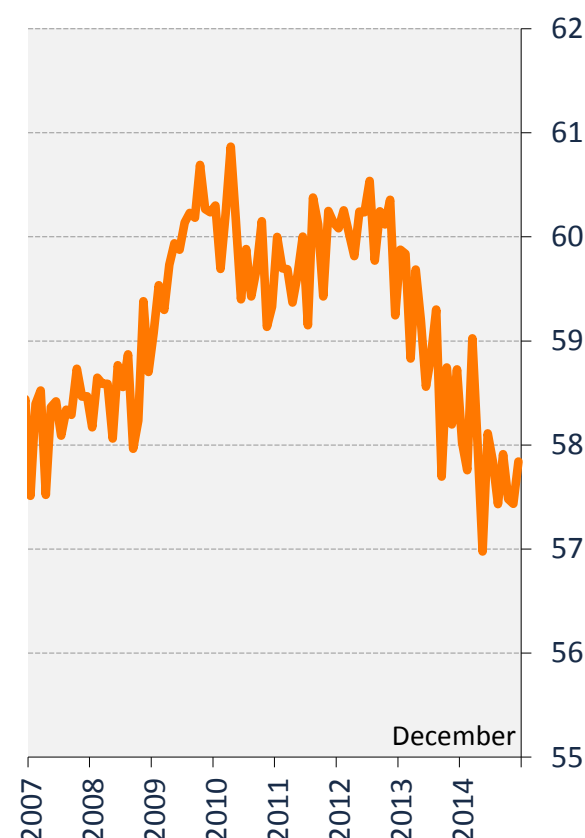
EAP/ Economically Active Population.

s. a./ Seasonally adjusted.

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

Labor Informality Rate

% of employed population, s. a.



s. a./ Seasonally adjusted.

Source: Seasonally adjusted by Banco de México with data from the National Employment Survey (*Encuesta Nacional de Ocupación y Empleo*), INEGI.

Given a less favorable external environment, strengthening the macroeconomic policy framework by means of adopting a monetary stance in accordance with the new international situation has become indispensable.

- As a preemptive measure, the Federal Government decided to **adjust the fiscal policy through a significant reduction in public expenditure in 2015.**
- This adjustment in the federal public sector expenditure contributes to:
 - ✓ *Facilitating an orderly depreciation of the real exchange rate in light of the oil price decrease.*
 - ✓ *Reducing upward pressures on interest rates.*

➤ **The fiscal adjustment along with a monetary policy stance congruent with the convergence of inflation to its target, strengthen the fundamentals of the Mexican economy and will contribute to generating an environment conducive to higher growth with low inflation.**

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Since the beginning of the last decade, the conduction of the monetary policy has contributed to the convergence of annual headline inflation to the 3 percent target.

■ Although the downward inflation trend has been exposed to different supply shocks, it has not generated second round effects.

✓ *Economic agents' inflationary expectations have not been affected.*

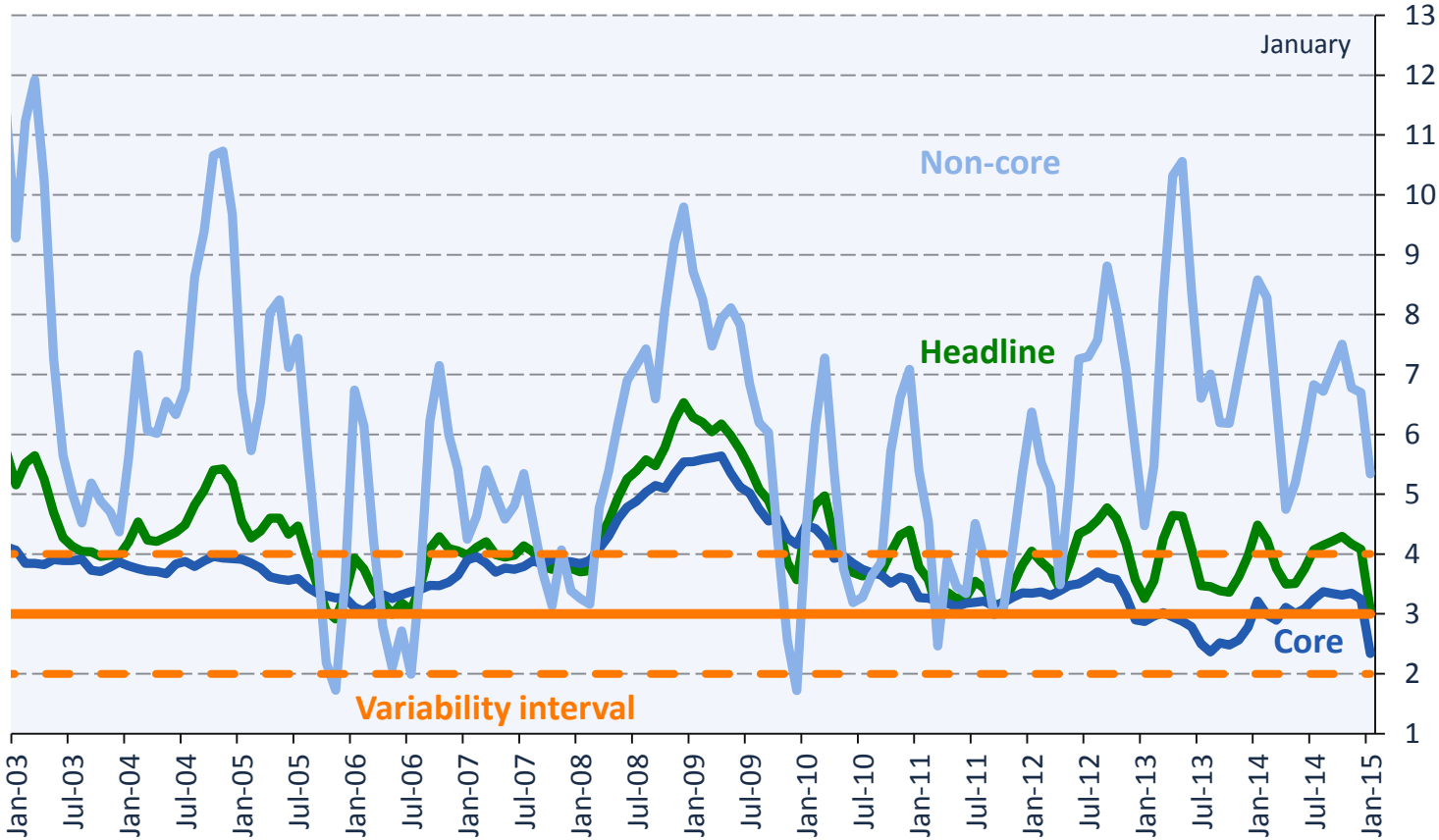
■ Core inflation, which better responds to the monetary stance and is more closely associated to the economic cycle:

✓ *Has shown a downward trend since several years ago, fluctuating over the past 5 years around 3 percent.*

✓ *In 2014, even considering the fiscal modifications, it remained at levels close to 3 percent, and, once these effects faded, it resumed levels below 3 percent.*

After locating at 4.08 percent at the end of 2014, headline inflation dropped considerably to 3.07 percent in January 2015. Thus, once the different shocks that affected inflation during 2014 were absorbed, it resumed its downward trend.

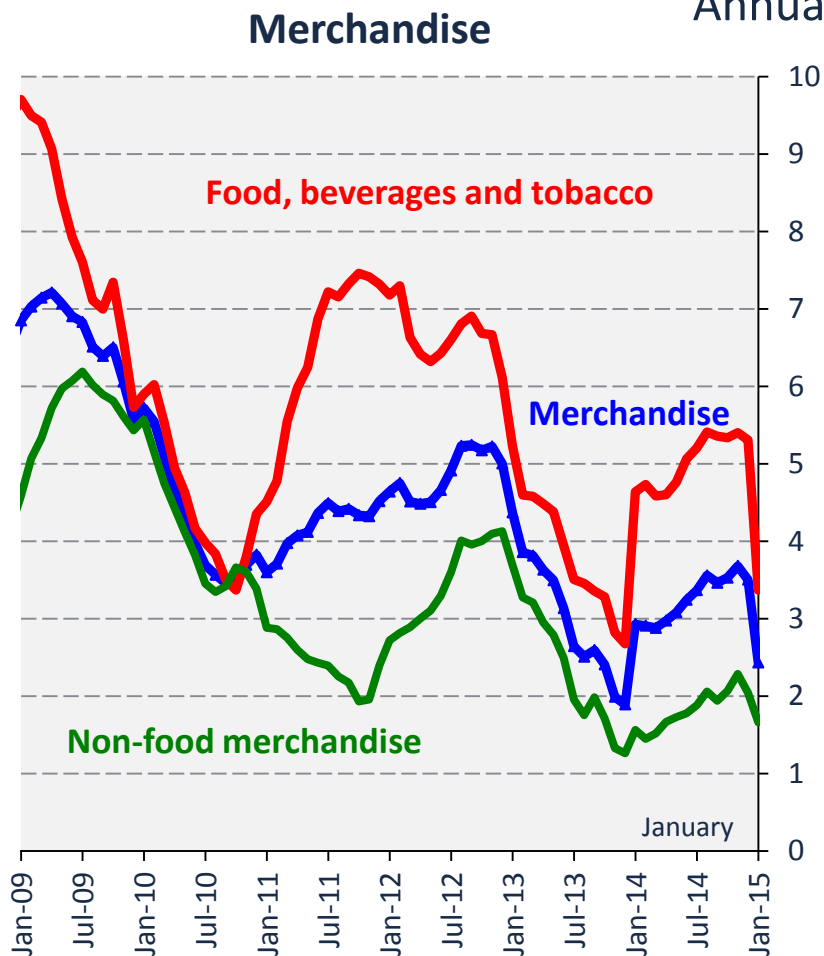
Consumer Price Index Annual % change



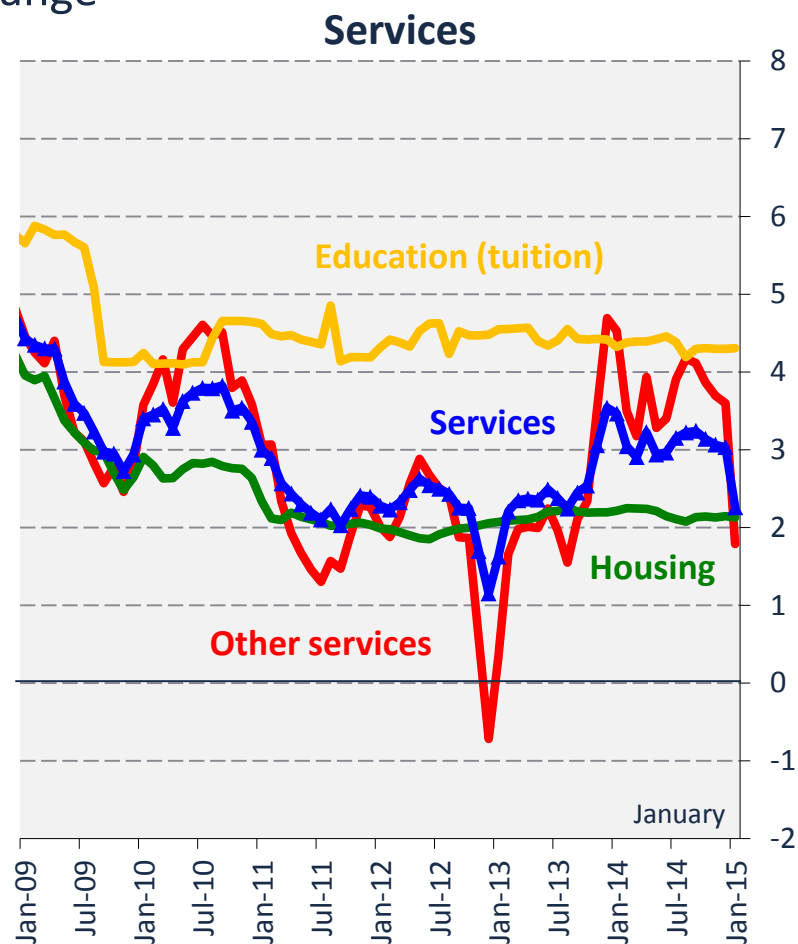
Source: Banco de México and INEGI.

The annual change of the merchandise and services' price subindexes dropped, as a result of the fading of the effects of the fiscal changes and due to lower prices of other services, respectively.

Core Price Index Annual % change



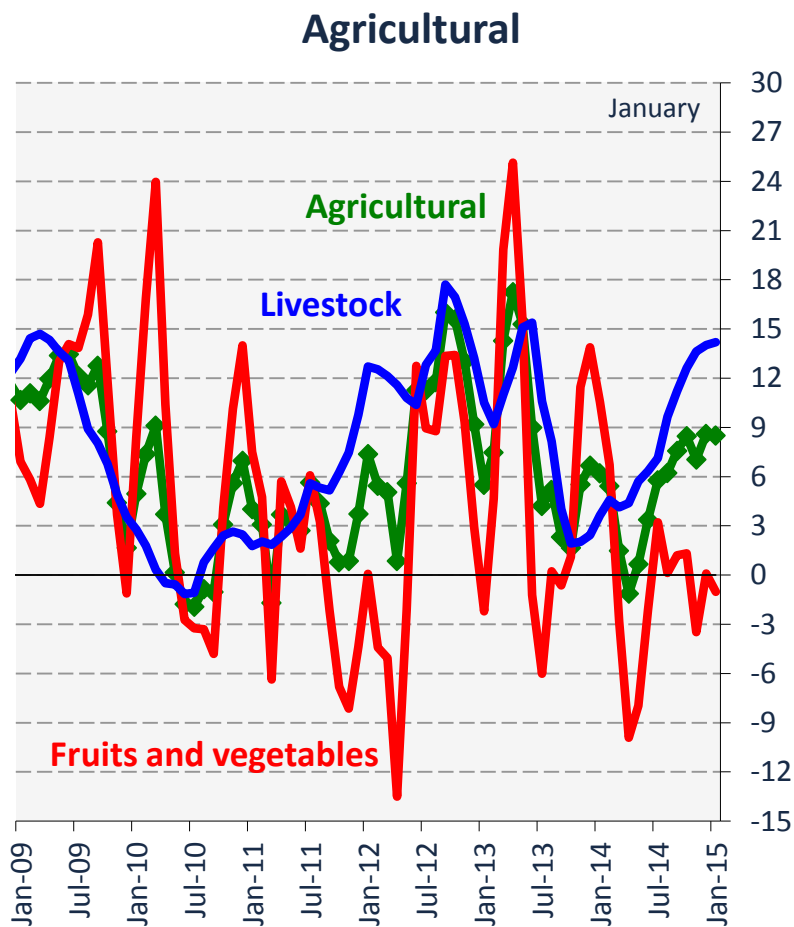
Source: Banco de México and INEGI.



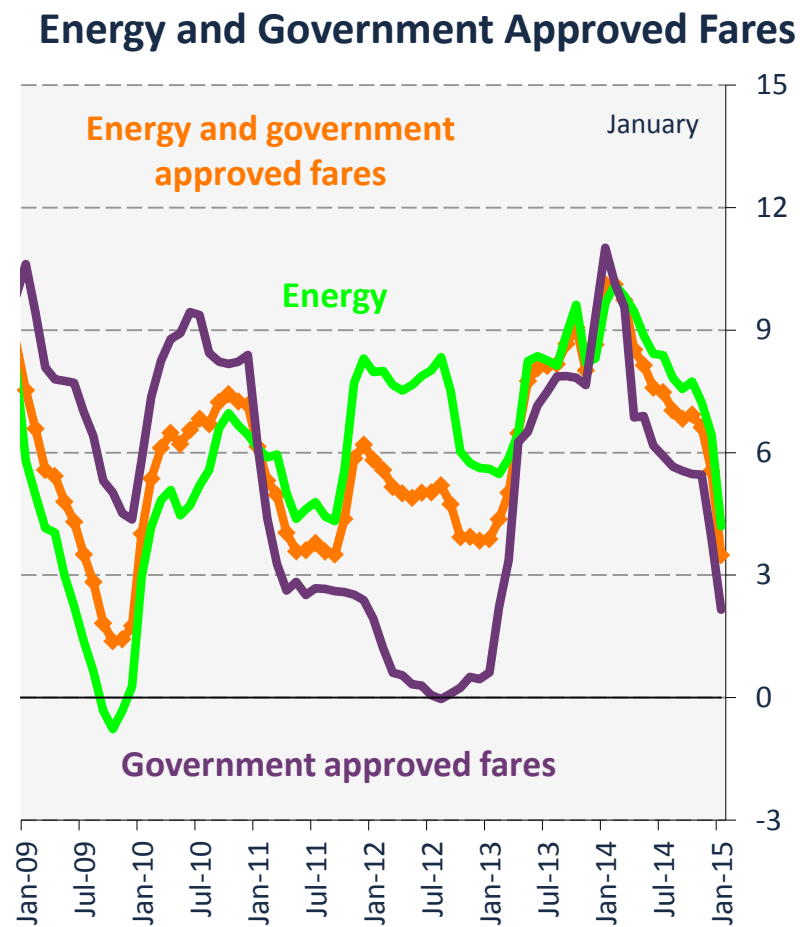
Source: Banco de México and INEGI.

Non-core inflation experienced upward pressures as a result of the performance of agricultural products' prices, which was offset by a lower annual change of energy prices and government approved fares.

Non-core Index Annual % change

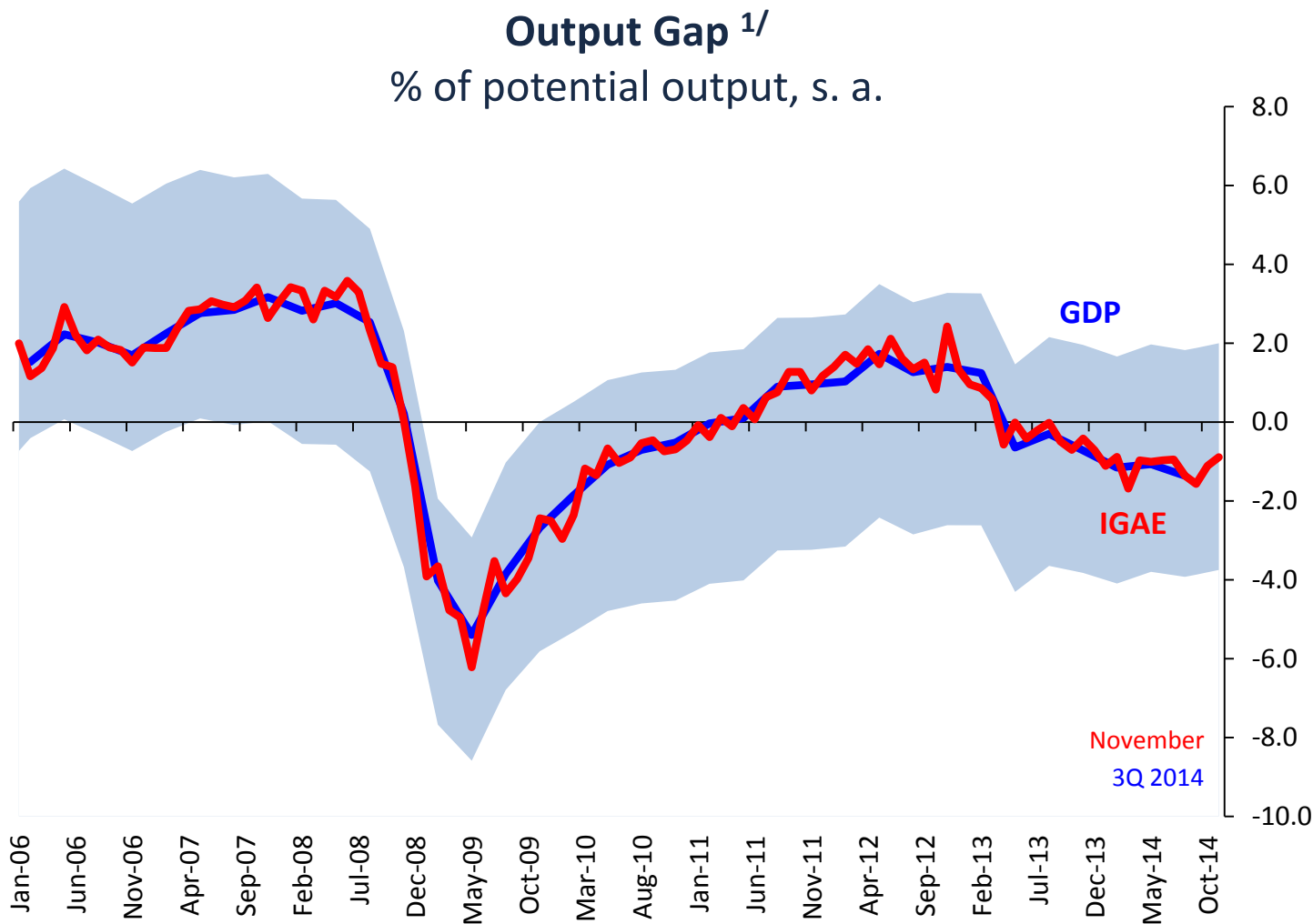


Source: Banco de México and INEGI.



Source: Banco de México and INEGI.

The output gap remains negative, even though it is expected to continue gradually closing.



s. a./ Calculated with seasonally adjusted data.

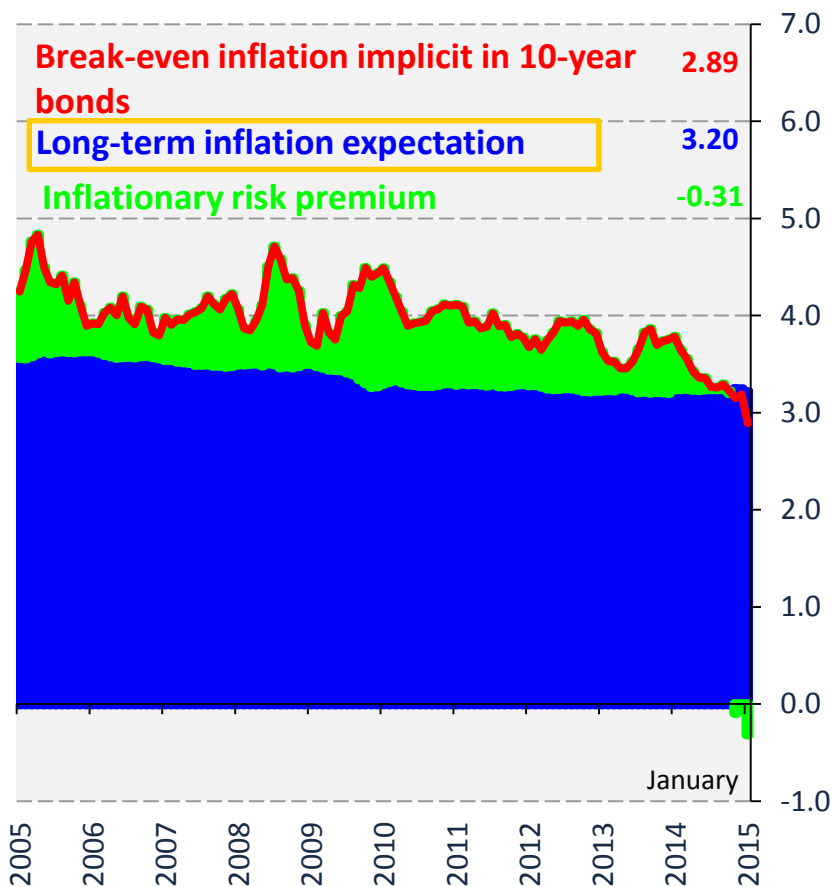
1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p.69.

The shaded area is the 95% confidence interval of the output gap, calculated with an unobserved components method.

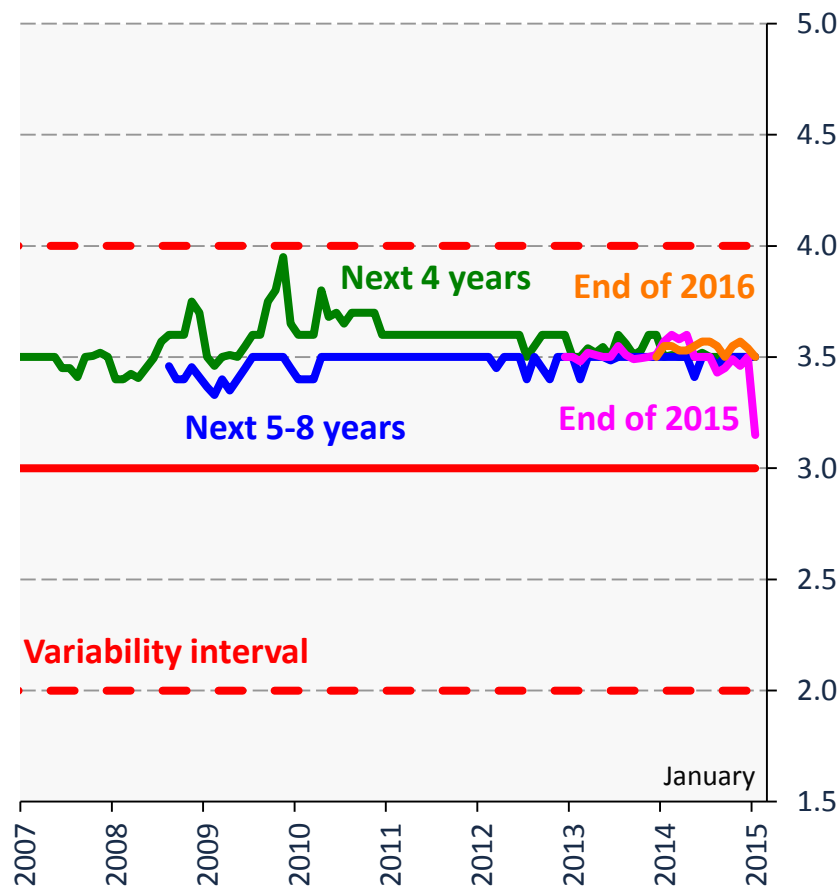
Source: Calculated by Banco de México with data from INEGI.

Inflation expectations remained well-anchored during 2014, which suggested that the price determination process was not contaminated by the above said supply shocks.

Break-even Inflation Decomposition ^{1/} %



Annual Headline Inflation Expectations Median, %

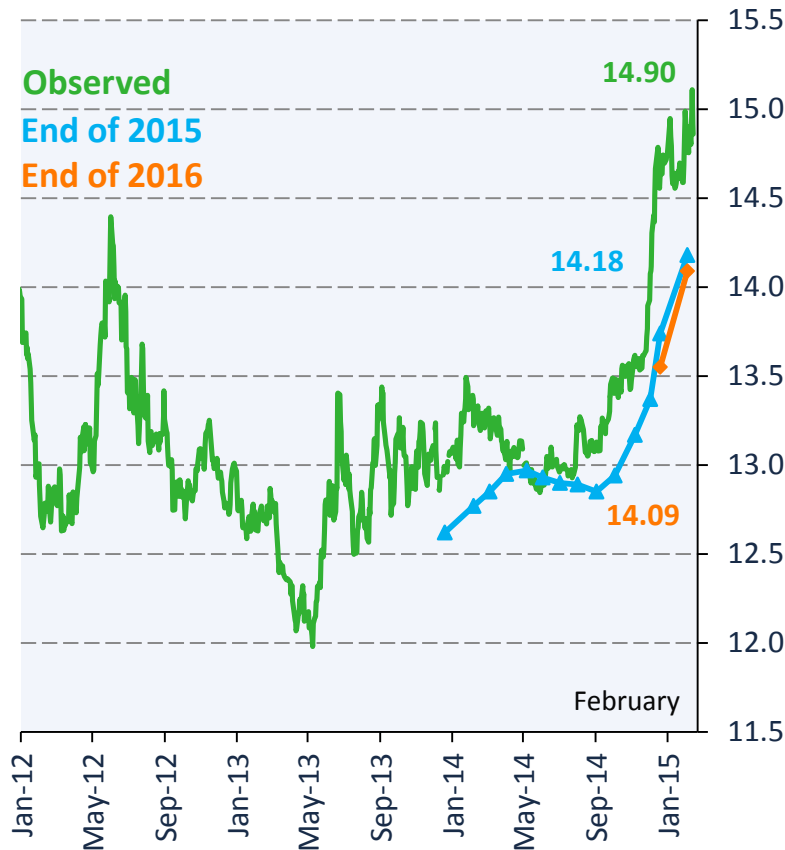


1/ The inflation risk premium is calculated with data from Valmer and Bloomberg, based on the methodology described in Box 1 "Decomposition of the Break-even Inflation" of the Quarterly Report October-December 2013.

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

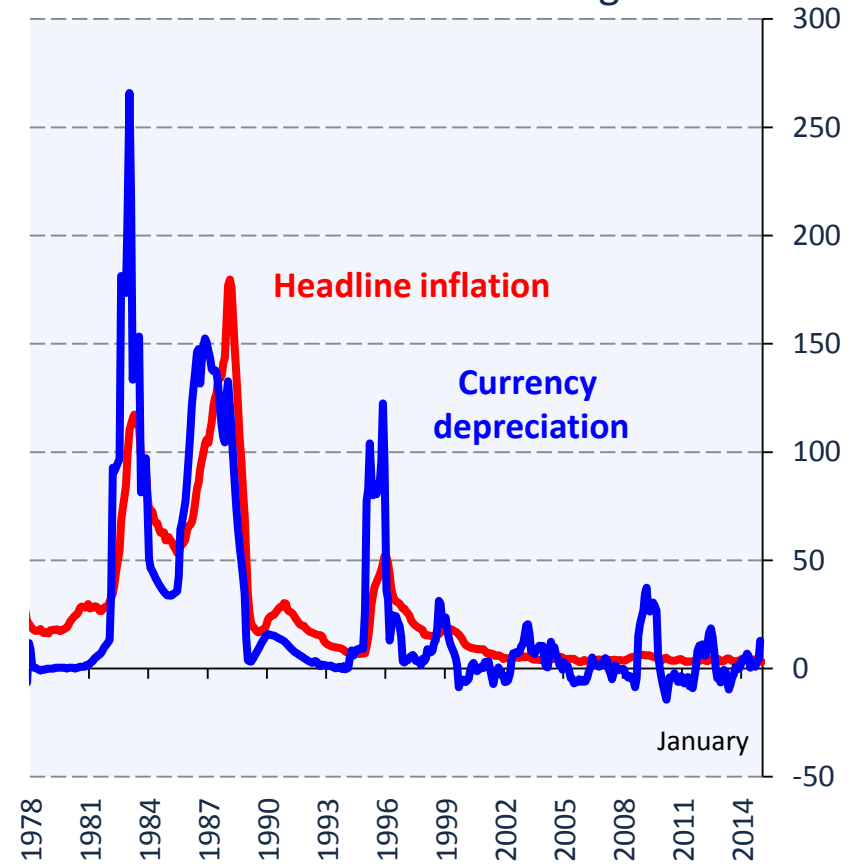
Considering the shocks to the international financial environment, adjustments in the national markets were relatively orderly. It should be noted that in recent years there has been a low pass-through of FX depreciation onto prices.

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 February 16, 2015, and the foreign exchange rate forecasts is January 2015. Source: Survey of private sector economic analysts' expectations, Banco de México.

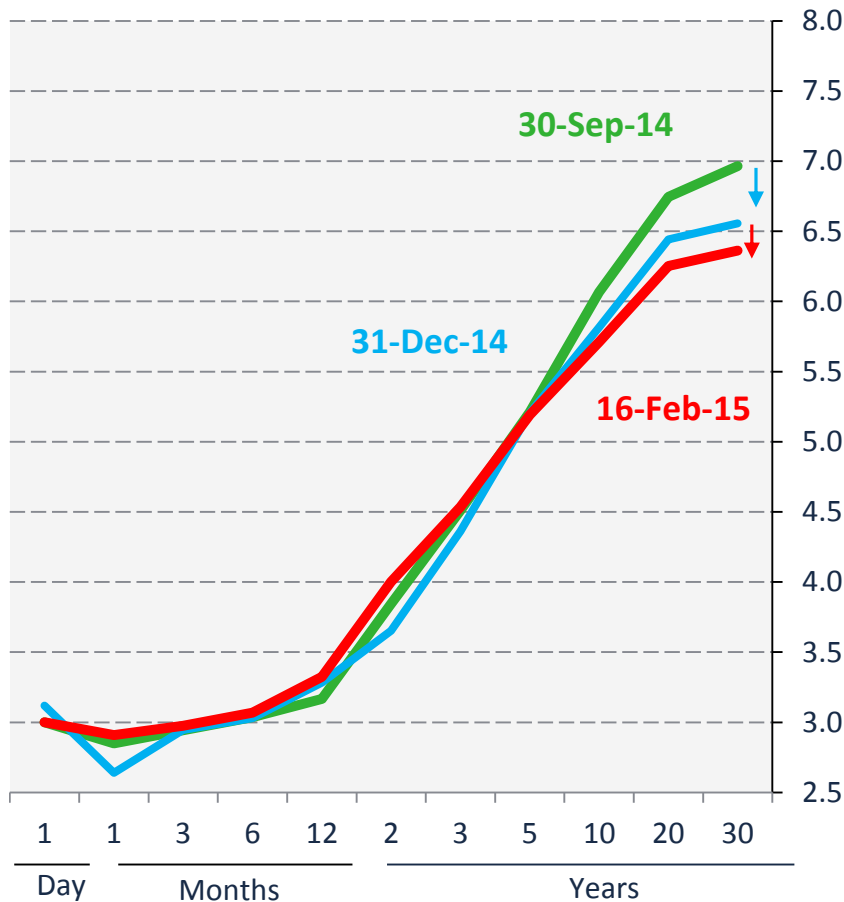
Headline Inflation and Nominal Exchange Rate Change
% and annual % change



Source: Banco de México and INEGI.

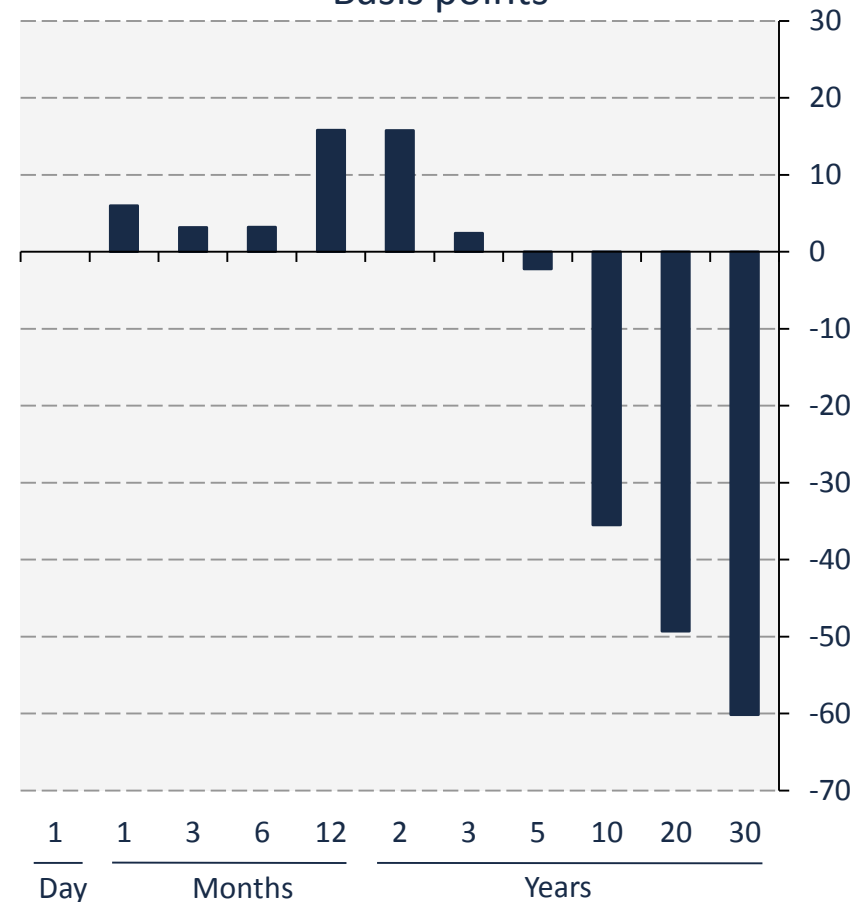
Longer-term interest rates in Mexico decreased in the reference period.

Government Securities Yield Curve %



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

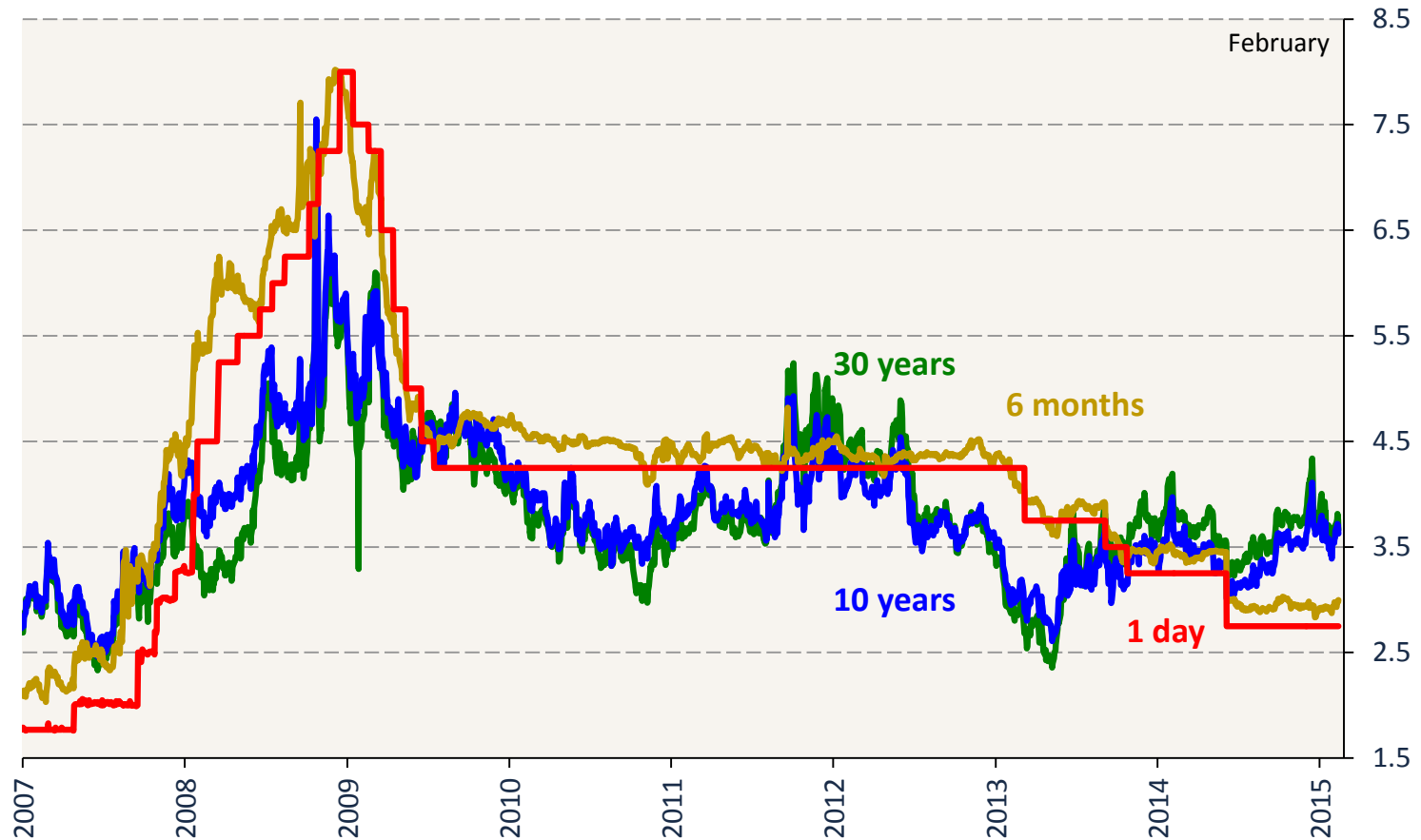
Change in Interest Rates from September 30, 2014 to February 16, 2015 Basis points



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

Spreads between Mexico and U.S. interest rates increased.

Spreads between Mexico and U.S. Interest Rates Percentage points



Source: Banco de México, *Proveedor Integral de Precios (PiP)* and U.S. Department of the Treasury.

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Expected Macroeconomic Environment

■ For 2015 and 2016, growth is anticipated to be higher than in 2014, due to:

- ✓ *A gradual effect of structural reforms on the economy.*
- ✓ *Dynamism of the economic activity in the U.S.*
- ✓ *The prevision that activities that started to recover in 2014 still represent support to productive activity.*

■ Despite the abovesaid, the foreseen macroeconomic environment is less favorable than that considered in the last Report, reason for which the forecast intervals for the GDP growth in 2015 and 2016 are revised downwards. In particular, due to the following:

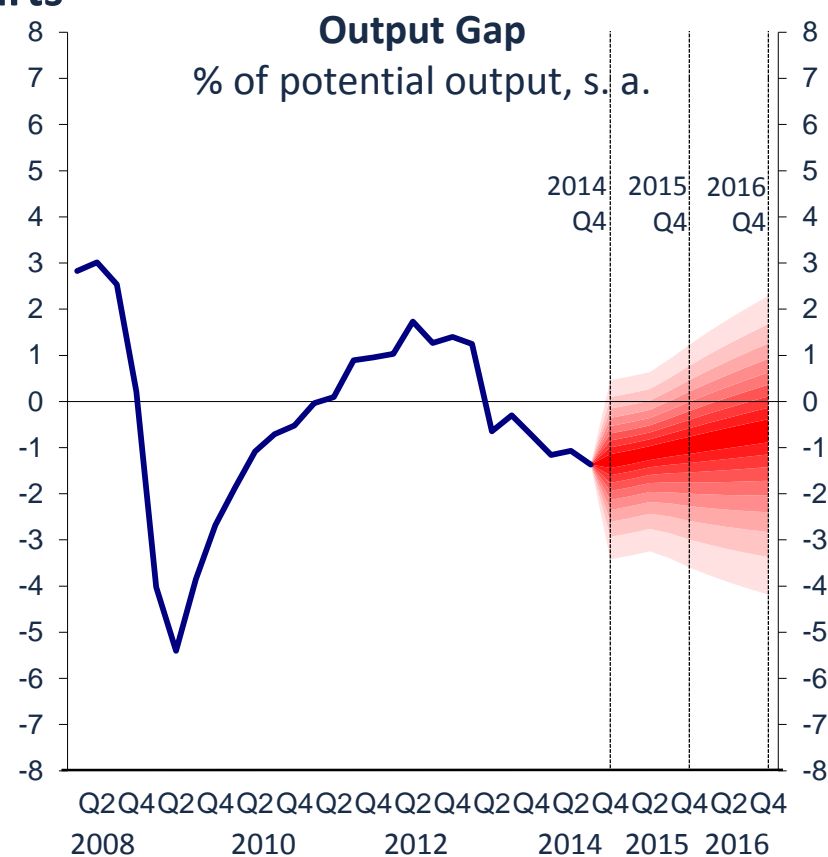
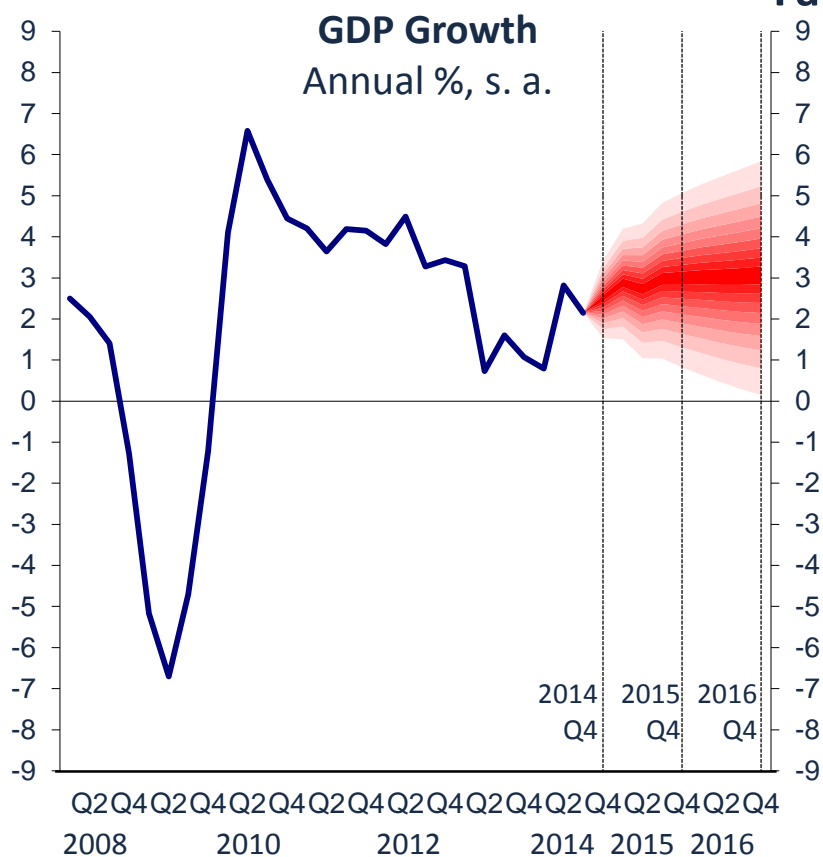
- ✓ *Oil price at low levels.*
- ✓ *A downward trend of the oil production platform.*
- ✓ *Private consumption still does not give clear signs that it could resume a strong dynamism in the short term.*

In line with the evolution of the balance of risks presented in the monetary policy releases published in the period analyzed in this Report, the economic activity forecasts are revised as follows:

GDP Growth	
2014	Around 2.1%
2015	Between 2.5 and 3.5%
2016	Between 2.9 and 3.9%

Increase in the number of IMSS-insured workers	
2015	Between 600 and 700 thousand
2016	Between 620 and 720 thousand

Fan Charts



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

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

Risks for Economic Growth:

Upward:

- ✓ Higher dynamism of the U.S. economy, given the lower energy costs.
- ✓ Faster than expected improvement in the investors' prospects, that could derive from progress in the implementation of structural reforms.

Downward:

- ✓ Lower than estimated growth of the world economy.
- ✓ Intensified volatility and uncertainty in international financial markets.
- ✓ A further decrease in the oil price and/or its production platform, that would affect external accounts and public finances.
- ✓ That social unrest in recent months would significantly affect expenditure decisions of the economic agents in the country.

Inflation Forecasts

Headline Inflation

Core Inflation

2015

Will continue at levels close to **3 percent** and will close the year slightly below the referred level.

Will lie **below 3 percent** throughout 2015.

2016

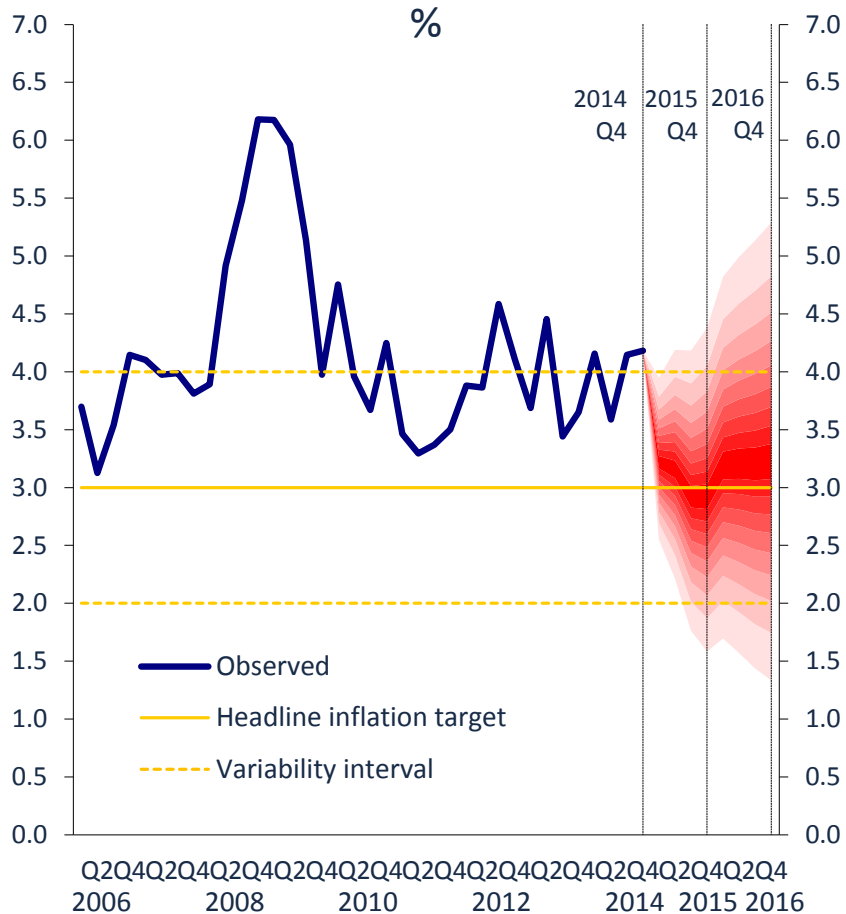
Will persist at **levels close to 3 percent**.

Will remain at **levels close to 3 percent**.

In 2015 inflation is expected to converge to the 3 percent permanent target and in 2016 it is estimated to consolidate around it.

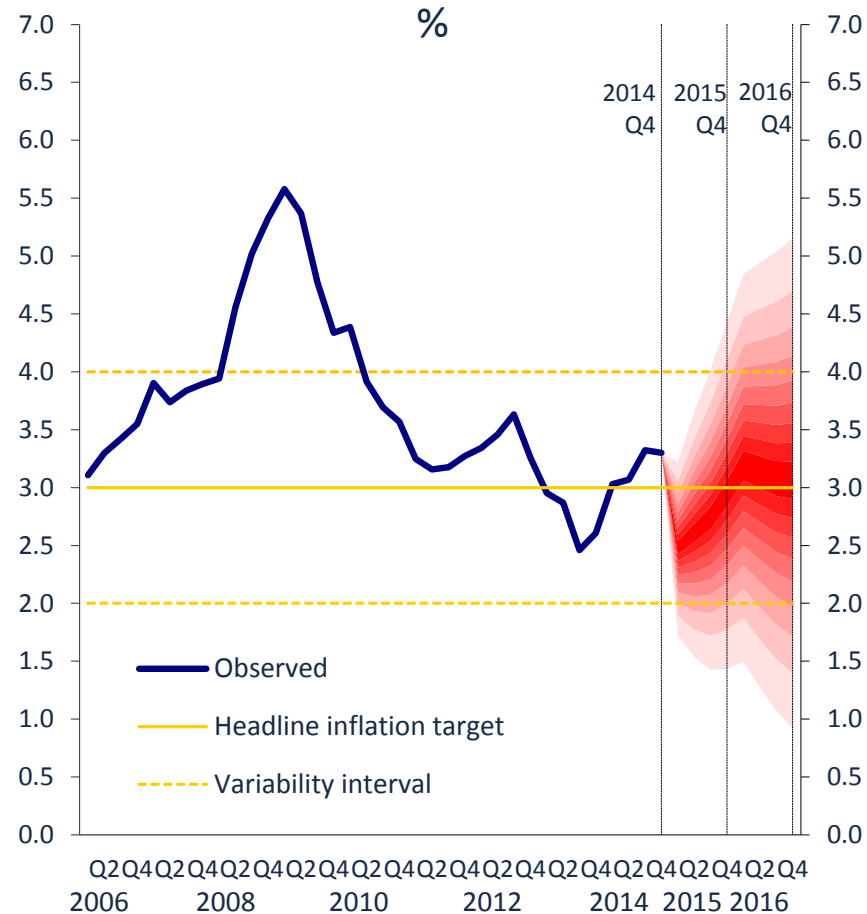
Fan Charts

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 inflation trend could be affected by different risks:

Downward

✓ That economic activity in the country have lower than expected dynamism.

✓ Further decreases in energy prices and in telecommunication services' prices.

✓ Exchange rate appreciation.

Upward

✓ That the exchange rate remains at current levels for an extended period of time and that the Mexican peso depreciates even further.

✓ Supply shocks that could affect the inflation evolution.

✓ That given the foreseen gradual recovery of the economic activity, the space to absorb the effect of new changes in relative prices could reduce.

Monetary Policy Stance

- In the future, the Board of Governors will remain alert to the evolution of inflation determinants and its expectations for medium- and long-term horizons. In particular, it will monitor:
 - ✓ *The monetary stance of Mexico relative to the U.S.*
 - ✓ *The performance of the exchange rate and its possible impact on inflation.*
 - ✓ *The evolution of the degree of slack in the economy.*

➤ **All this in order to take the necessary measures to ensure the convergence of inflation to the 3 percent target and to consolidate it.**

Importance of Institutional Strength

- The strength of the macroeconomic framework has resulted from the efforts of the society over many years and its benefits have been evident.
- In order to face a complex environment, **preserving macroeconomic stability** is indispensable. This largely depends on:
 - ✓ *Ensuring the sustainability of public finances.*
 - ✓ *Consolidating an environment of low inflation and stability of the financial system.*
- The federal authorities' commitment, recently emphasized, to maintain sound public finances is highly relevant.
- Additionally, to improve the welfare of the society as a whole:
 - ✓ *Proper implementation of **structural reforms** is important to boost productivity and competitiveness of the country.*
 - ✓ *Work in the **transformation of the country's institutional structure** is indispensable, in order to achieve a stronger rule of law and to grant greater legal certainty to the society.*



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