



Quarterly Report
January - March 2016
May 25, 2016



Outline

1 Monetary Policy

2 External Conditions

3 Inflation and its Determinants

4 Forecasts and Balance of Risks

Inflation has registered a favorable performance, despite a challenging environment.

Banco de México carefully weighed the possible effects of both domestic and external factors on the evolution of inflation and its expectations, seeking to **define the most appropriate monetary policy stance at each point of time.**

February 4, 2016

Rate unchanged at 3.25%.

- The Board alerted about the risk to inflation and its expectations, derived from the possibility that the depreciation of the national currency may further persist or become more pronounced.

**February 17, 2016
Extraordinary session**

50 bp increase to 3.75%.

- In response to a sudden surge in international financial market's volatility, a deterioration of the external environment and strong exchange rate fluctuations, all of which could affect inflation and its expectations.

The decision of February 17, 2016 was part of a coordinated measure taken together with the Ministry of Finance.

Banco de México

50 bp increment in the reference rate at an extraordinary session.

Ministry of Finance

Announced a preemptive adjustment to the expenditure of the Federal Public Administration, concentrated in PEMEX.

Foreign Exchange Commission

Decided to suspend the daily dollar auctions mechanisms, leaving open the possibility to discretionally intervene, in exceptional cases.

→ The authorities stressed that the key to ensure the anchoring of the national currency would be **preserving sound macroeconomic fundamentals**.

■ The implemented measures produced the expected result:

✓ **Considerable appreciation of the national currency**, a trend that persisted for several weeks.

✓ **Increments in short-term interest rates**, while longer-term rates went down.

○ *Significant flattening of the yield curve, as it was intended.*

Subsequent decisions:

- Central scenario for the future evolution of inflation congruent with the 3 percent target.
- Neutral balance of risks to inflation.

March 18, 2016

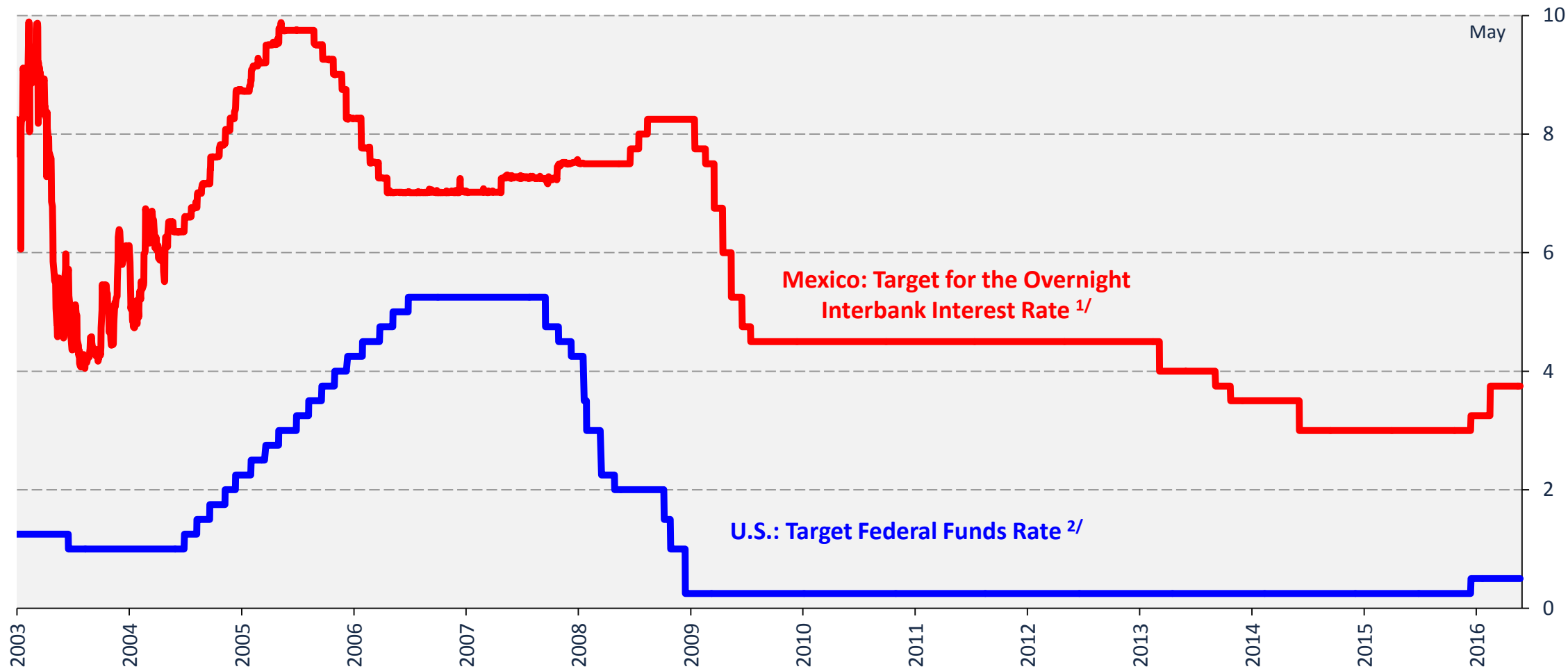
Rate unchanged at 3.75%.

May 5, 2016

Rate unchanged at 3.75%.

Monetary Policy Rates

%



1/ Before January 20, 2008 it refers to the observed Overnight Interbank Interest Rate.

2/ The upper limit of the target range is shown.

Source: Federal Reserve and Banco de México.

Outline

1 Monetary Policy

2 External Conditions

3 Inflation and its Determinants

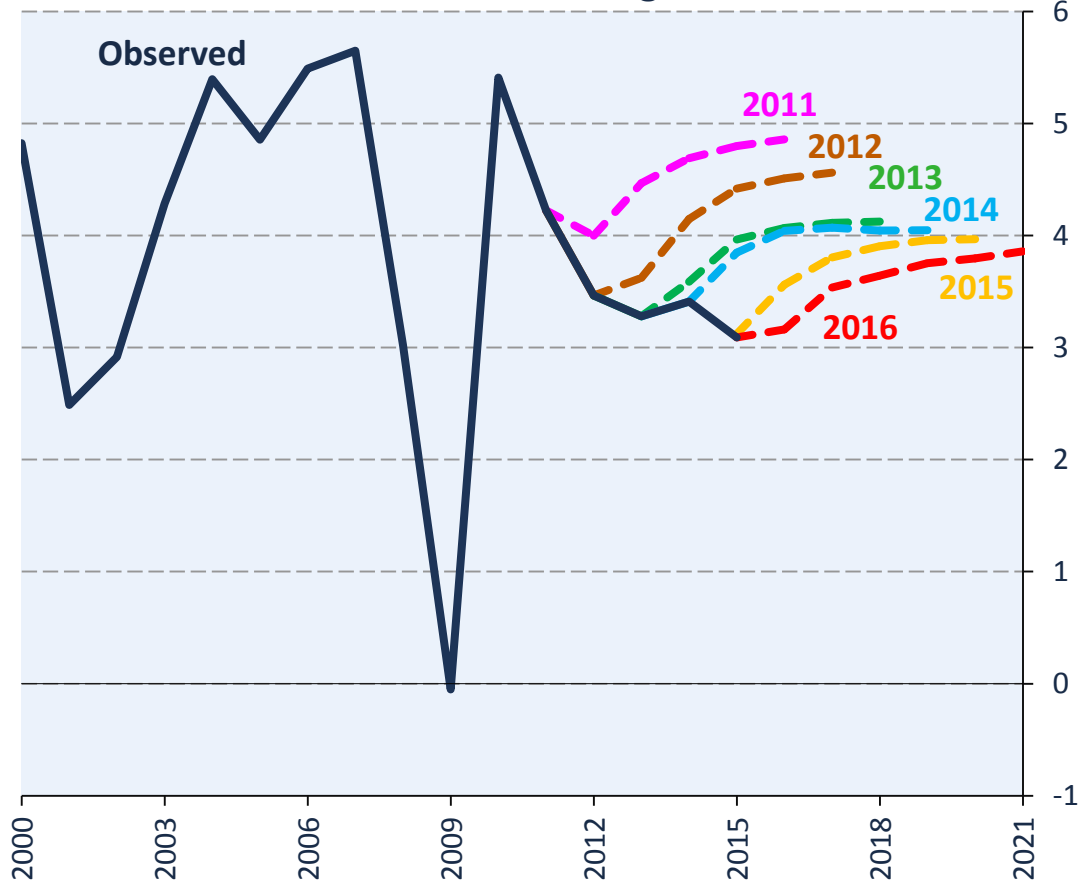
4 Forecasts and Balance of Risks

The downward adjustment of the world economic growth expectations continued and world trade remained stagnated.

World Economy

Evolution of GDP Growth Forecasts

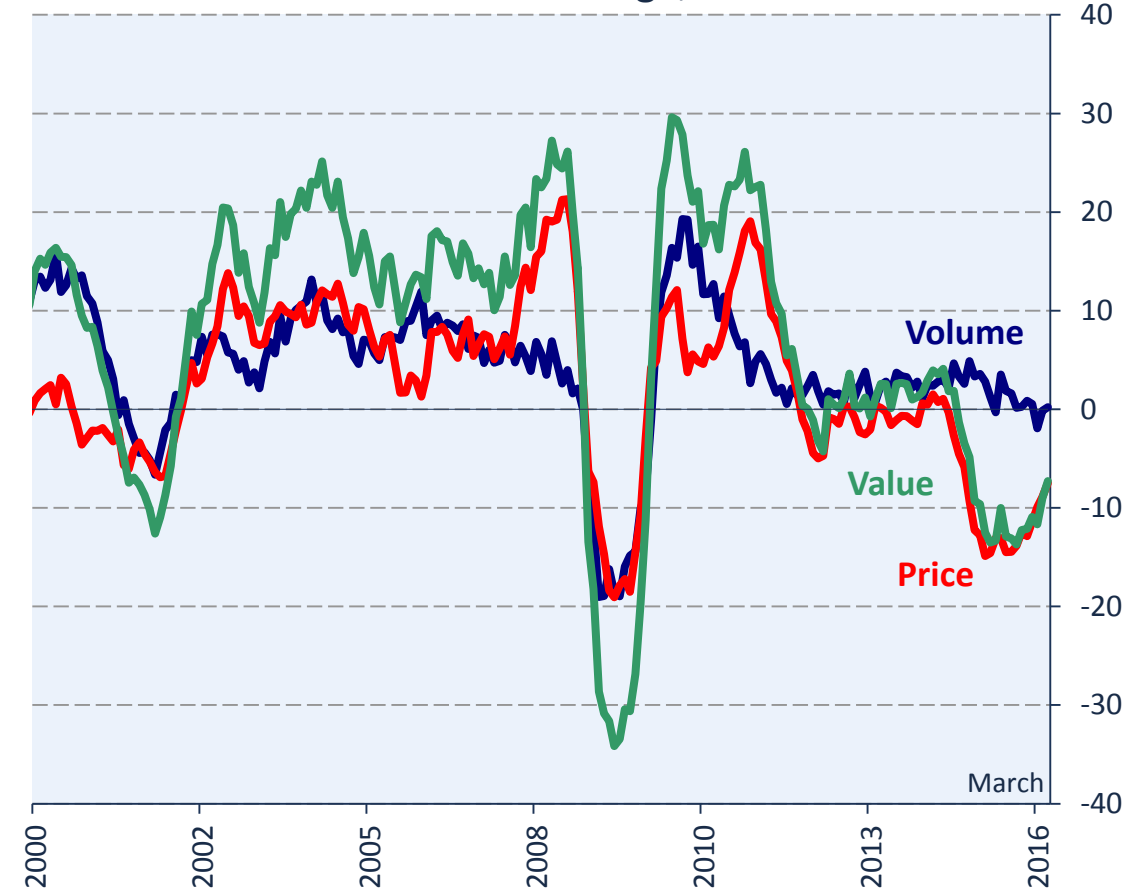
Annual % change



Source: IMF, WEO spring 2012-2016.

Trade of Goods ^{1/}

Annual % change, s. a.

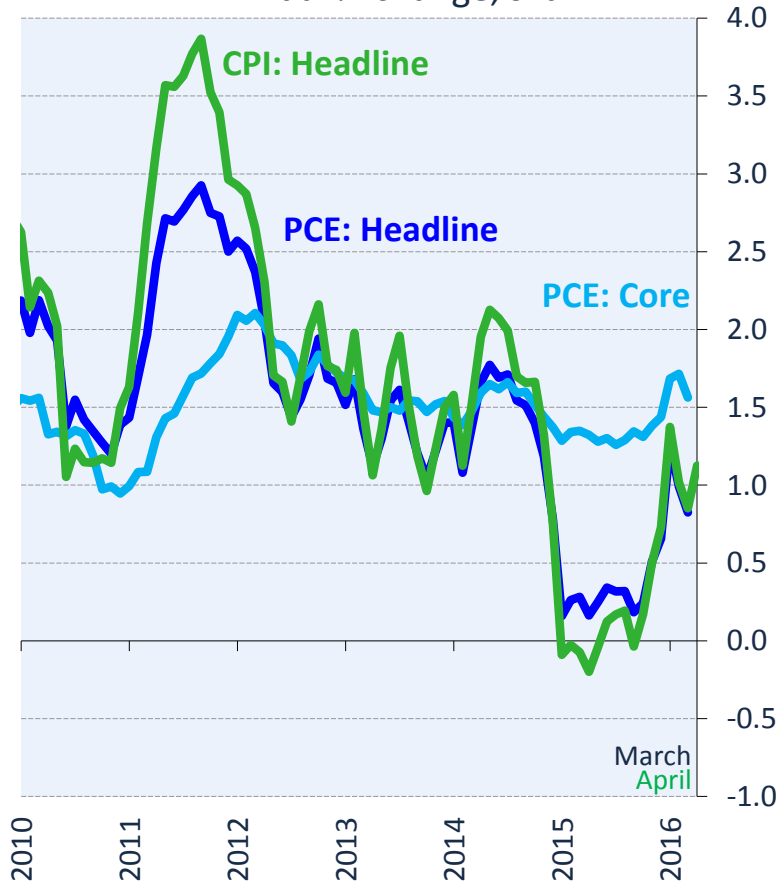


^{1/} Refers to the sum of imports and exports.
s. a. / Seasonally adjusted data.
Source: CPB Netherlands.

In the U.S., inflation remained below its 2 percent target and GDP growth significantly decelerated in 1Q 2016, while labor market conditions continued improving.

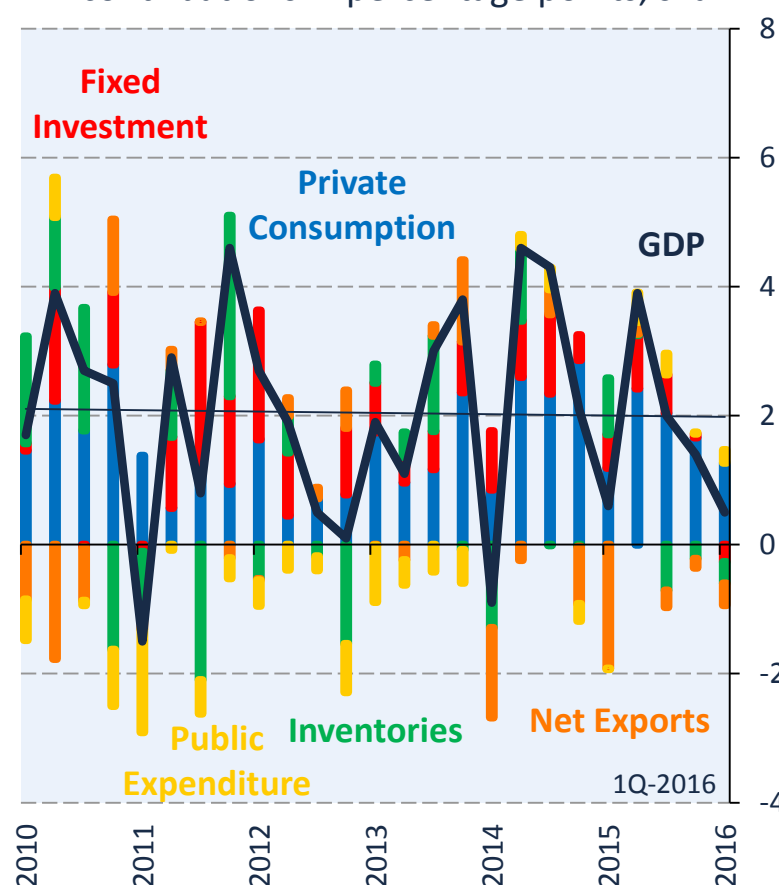
United States

Consumer Price Index and Personal Consumption Expenditures Deflator
Annual % change, s. a.



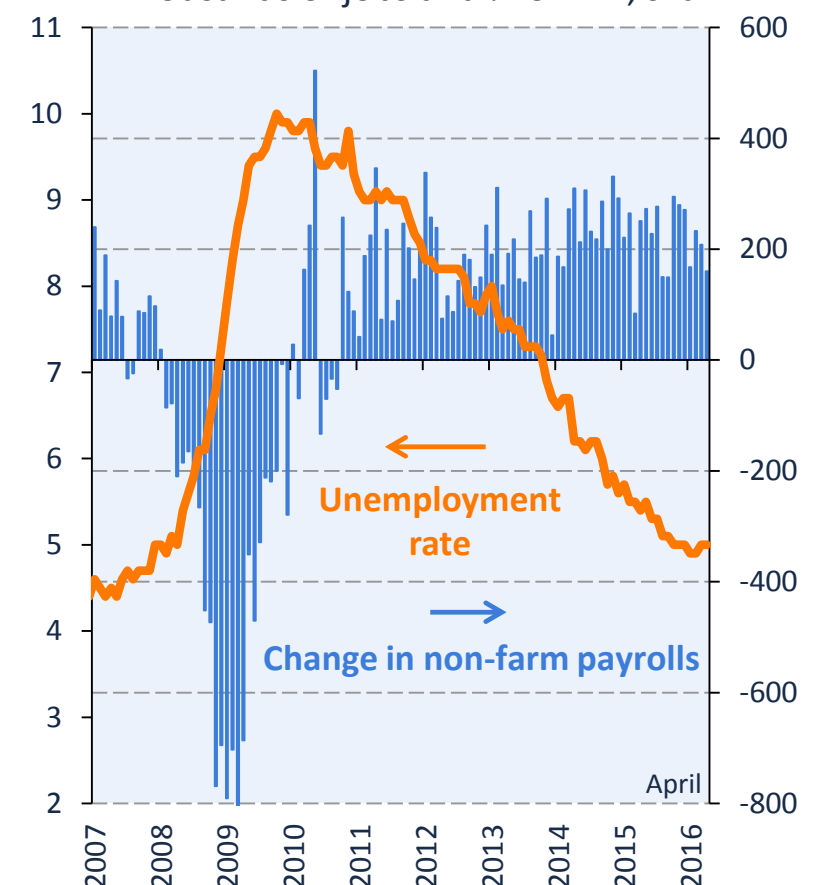
s. a. / Seasonally adjusted data.
Source: U.S. Department of Commerce and Bureau of Economic Analysis (BEA).

Real GDP and Components
Quarterly % change at annual rates, and contributions in percentage points, s. a.



s. a. / Seasonally adjusted data.
Source: Bureau of Economic Analysis (BEA).

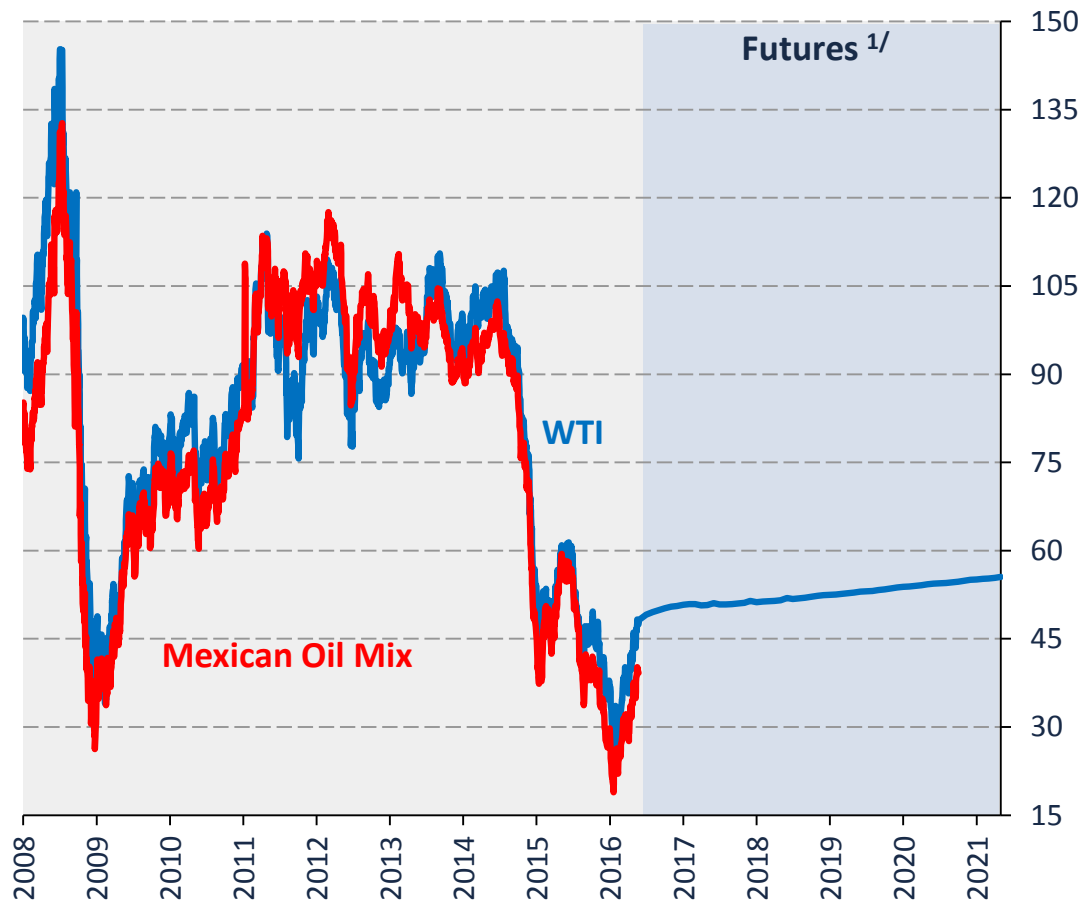
Change in Non-farm Payrolls and Unemployment Rate
Thousands of jobs and % of EAP, s. a.



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

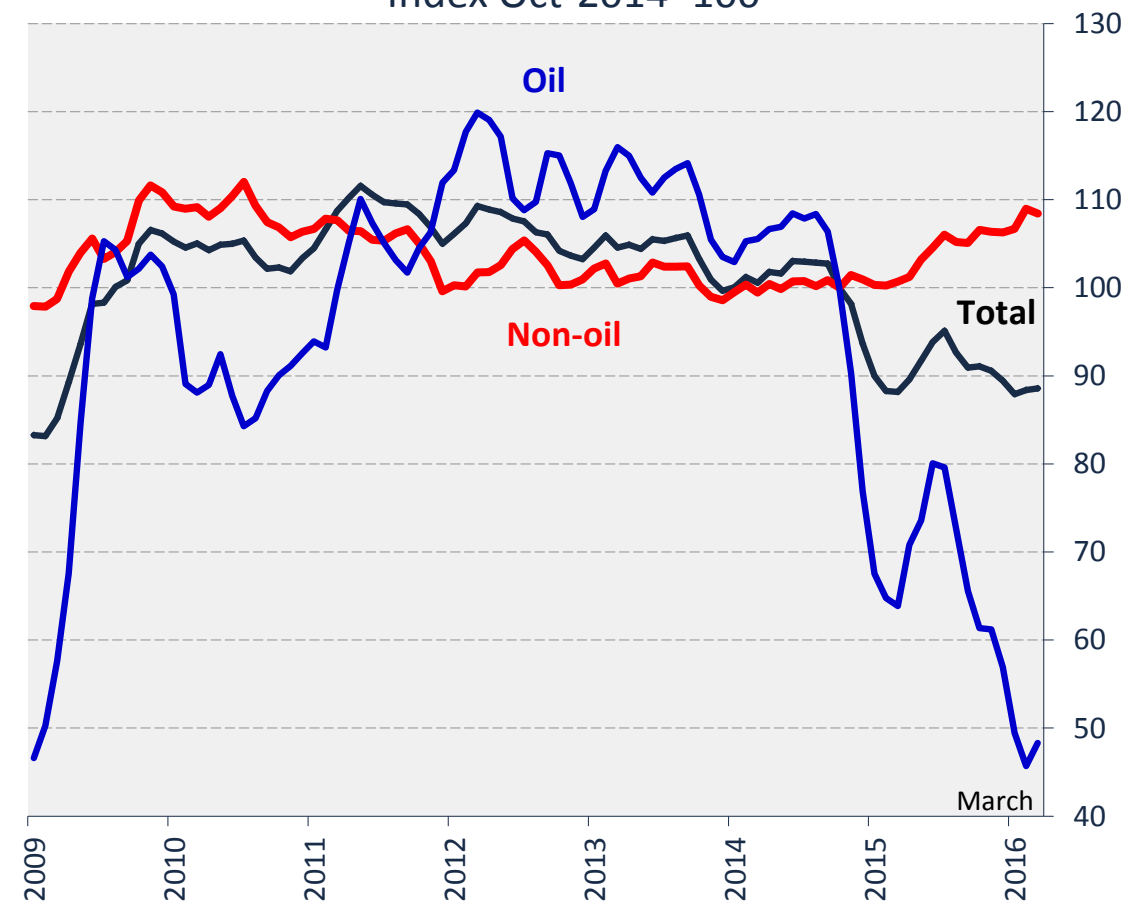
After the drop registered during the first weeks of 2016, commodity prices recovered slightly, although they still remain at low levels. Thus, the terms of trade deteriorated in Mexico.

Crude Oil Prices
USD per barrel



1/ Data up to May 24, 2016.
Source: Bloomberg.

Mexico: Terms of Trade
3-month moving average
Index Oct-2014=100

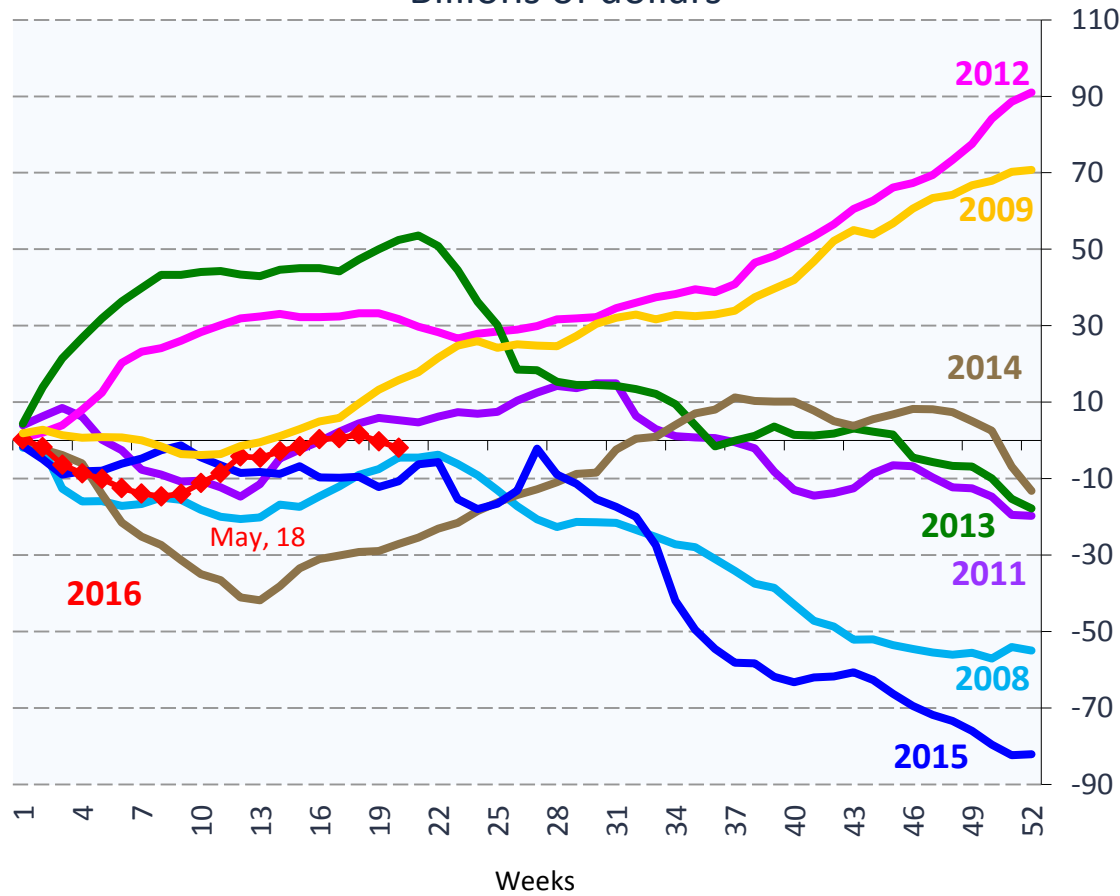


Source: Calculated by Banco de México with data from SAT, Ministry of Economy, Banco de México, INEGI. México's Goods Trade Balance. SNIEG. National Interest Information.

These factors have generated higher exchange rate volatility and lower capital flows to emerging economies.

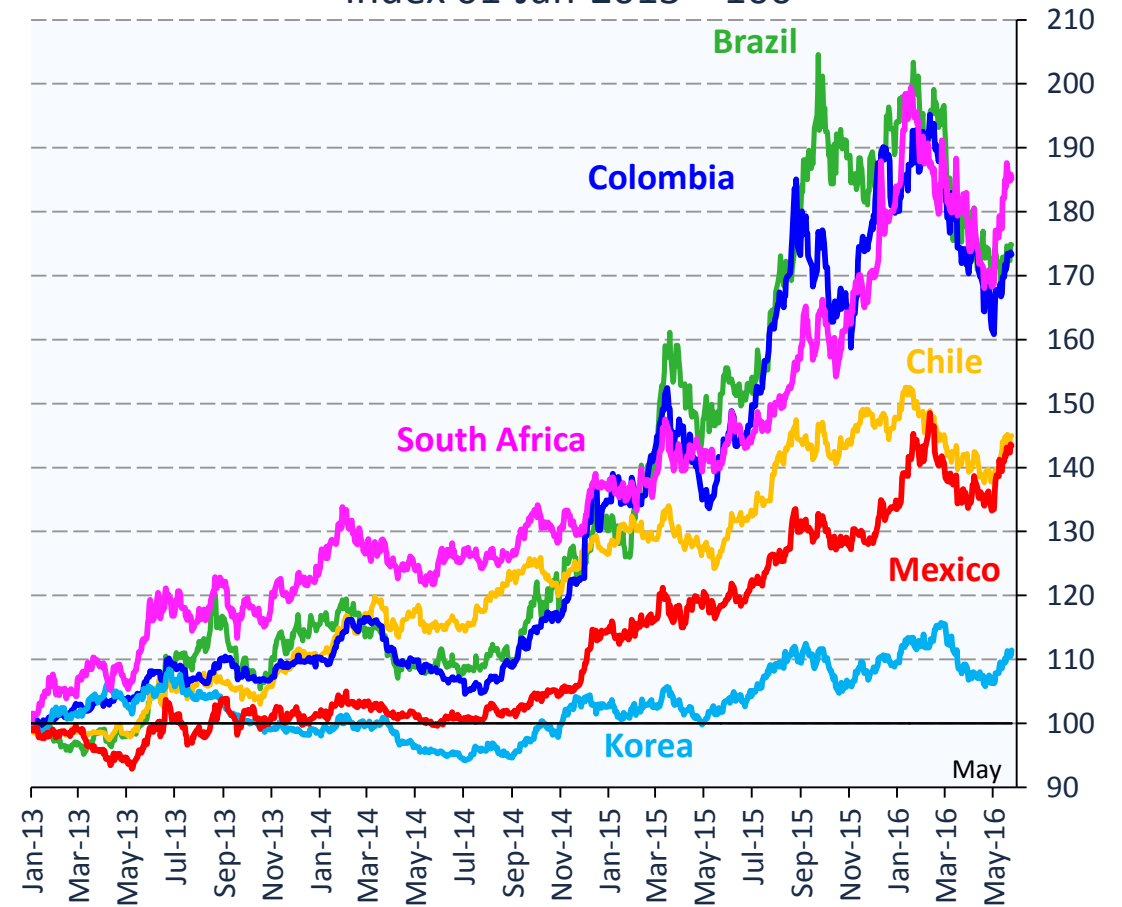
Emerging Markets

Accumulated Capital Flows (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.

Nominal Exchange Rate against USD
Index 01-Jan-2013 = 100



Source: Bloomberg.

The Mexican economy is facing different challenges

- Low world economic growth and stagnated global trade.
 - Unstable international crude oil prices.
 - The normalization process of the U.S. monetary policy.
- All of the above led to recurrent volatility episodes in international financial markets that passed through to Mexico's local markets.

Outline

1 **Monetary Policy**

2 **External Conditions**

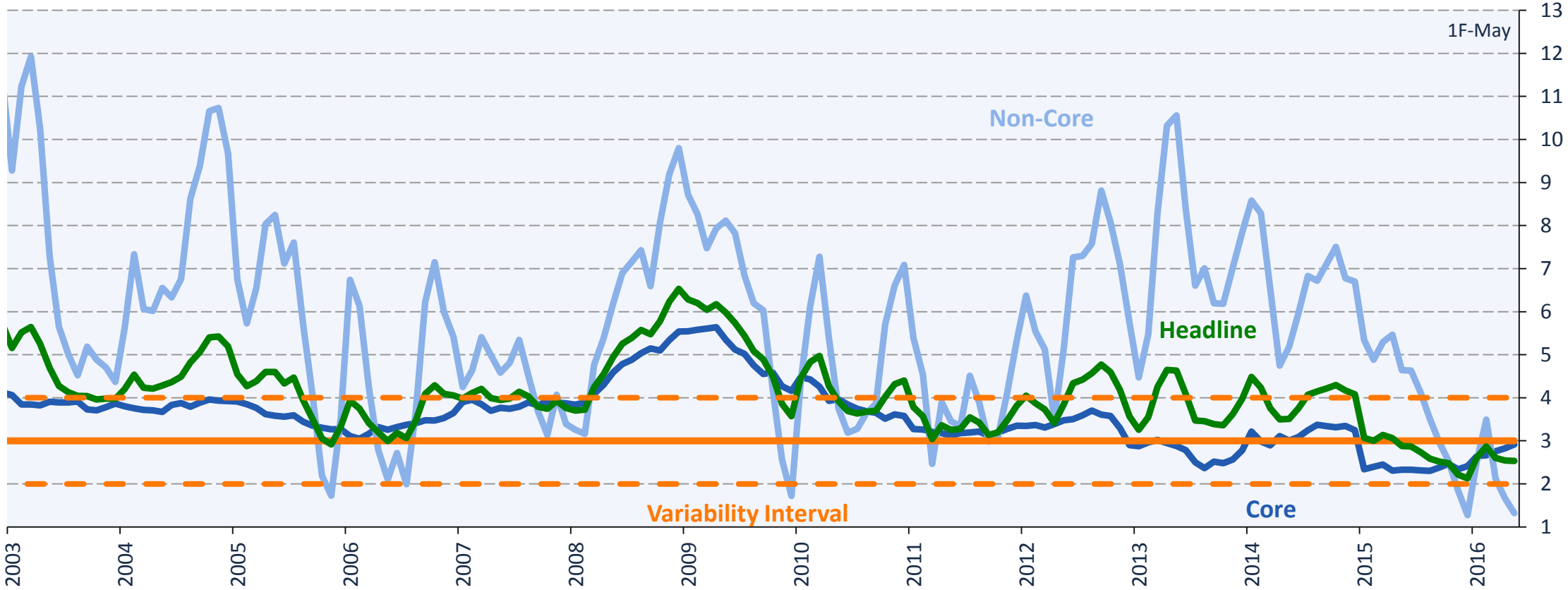
3 **Inflation and its Determinants**

4 **Forecasts and Balance of Risks**

Inflation performance has been favorable:

- 12 consecutive months **below the permanent target**.
- **A low pass-through** of exchange rate fluctuations onto prices.

Consumer Price Index Annual % change

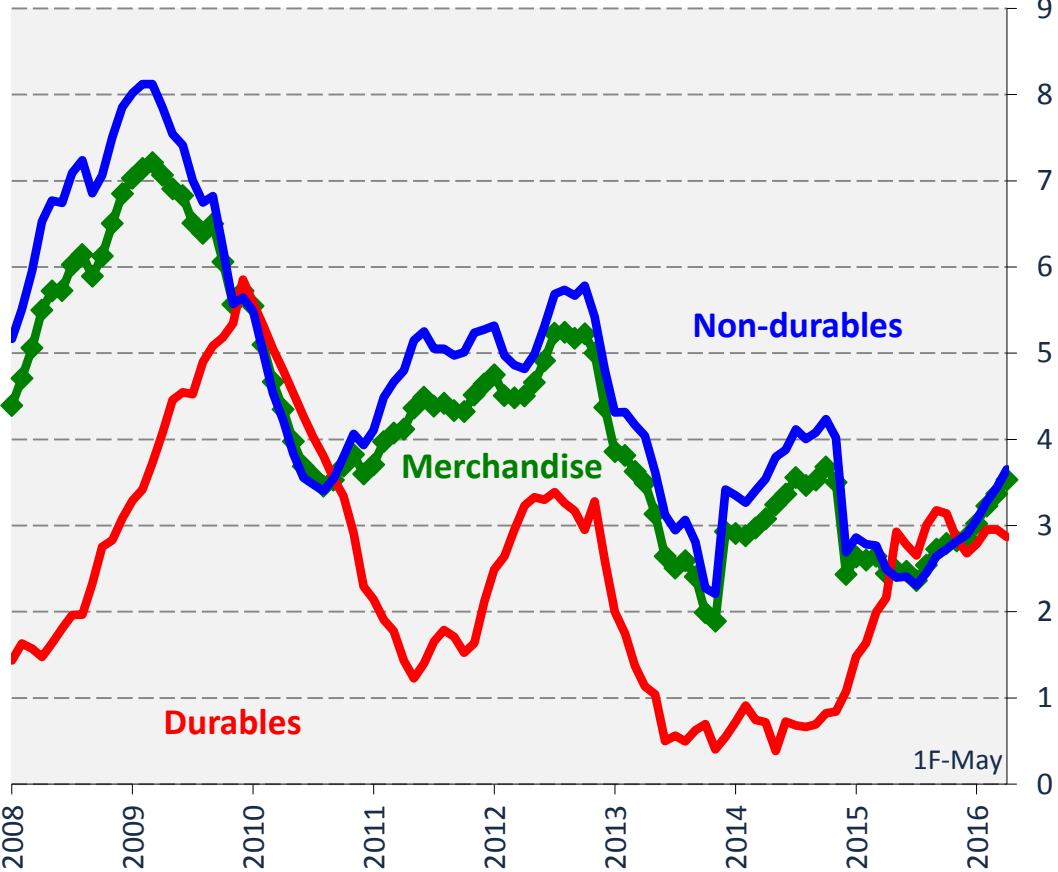


Source: Banco de México and INEGI.

Core inflation showed a moderate upward trend derived from the relative price adjustments between merchandise and services.

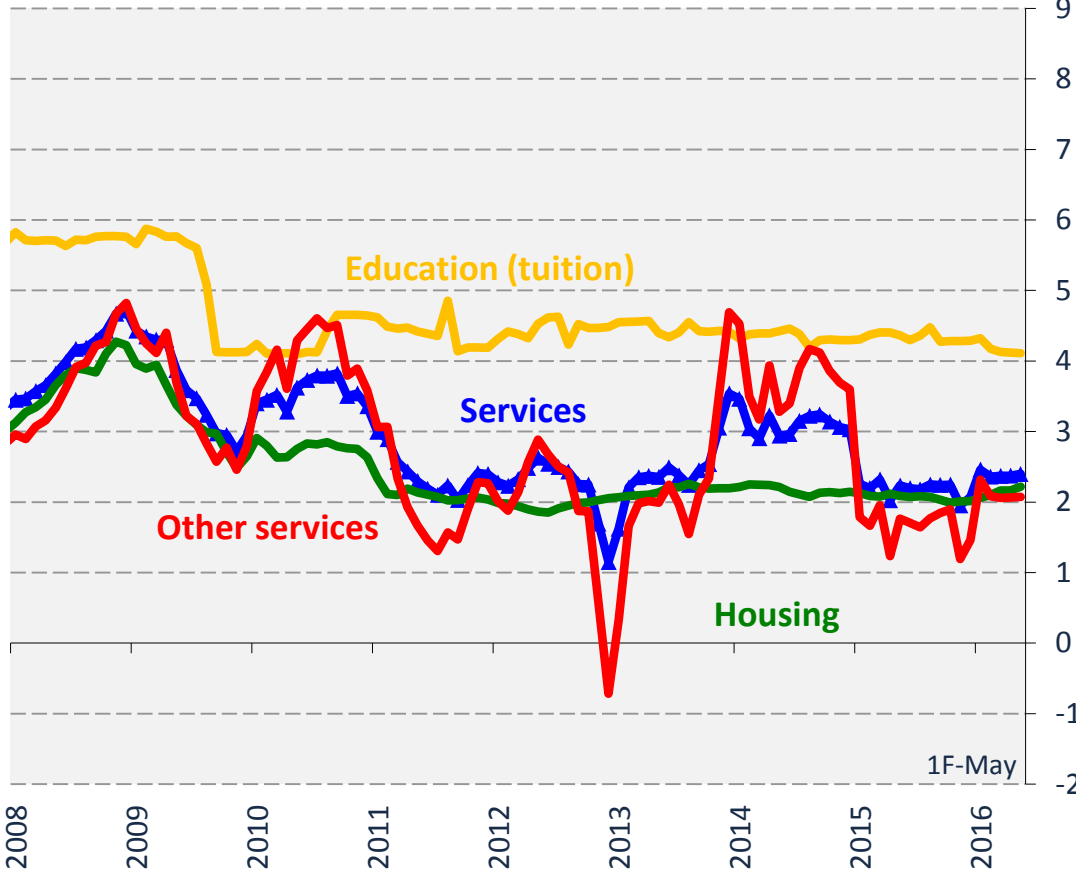
Core Price Index
Annual % change

Merchandise



Source: Banco de México and INEGI.

Services

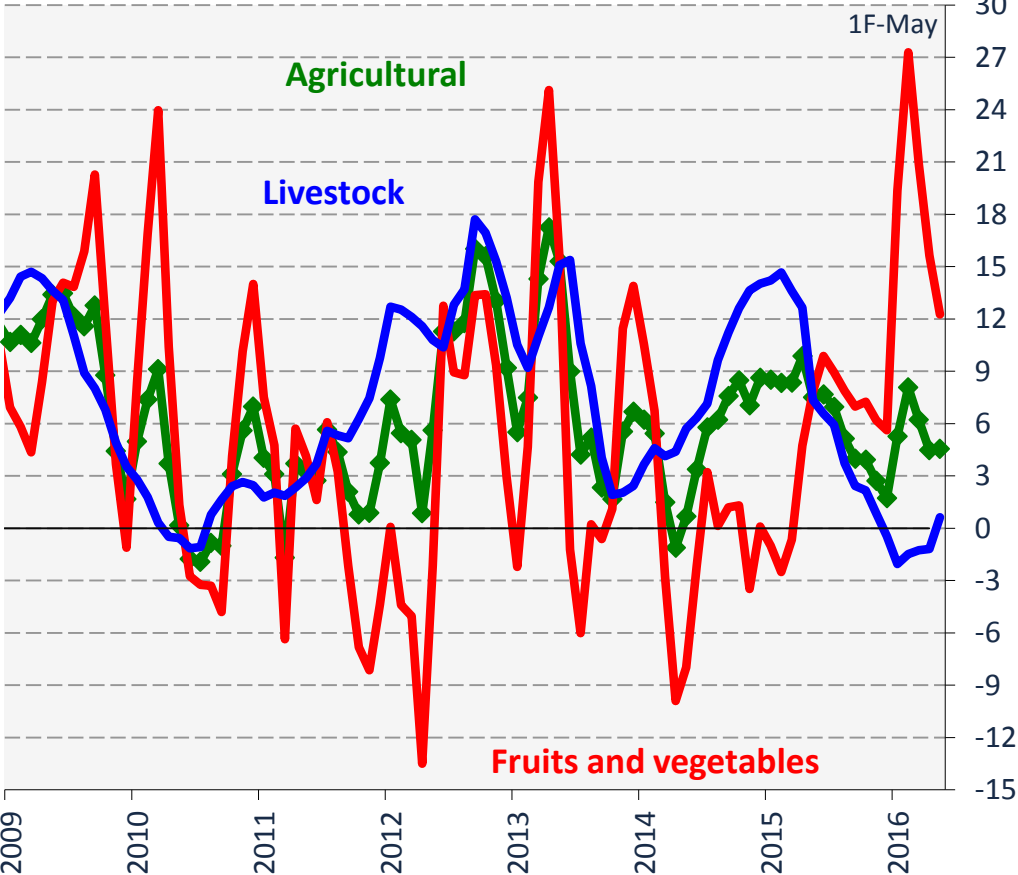


Source: Banco de México and INEGI.

A more favorable evolution of energy prices since 2015 continued decreasing the contribution of non-core inflation to headline inflation.

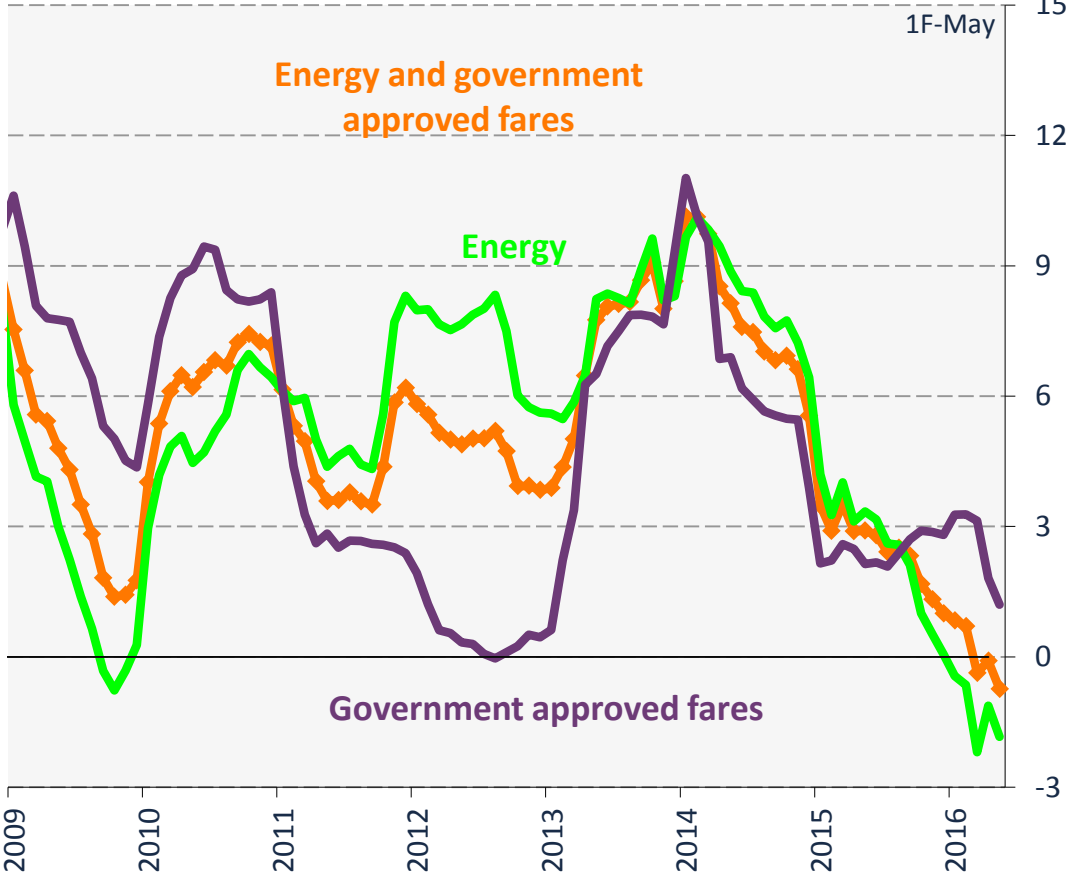
Non-Core Index
Annual % change

Agricultural



Source: Banco de México and INEGI.

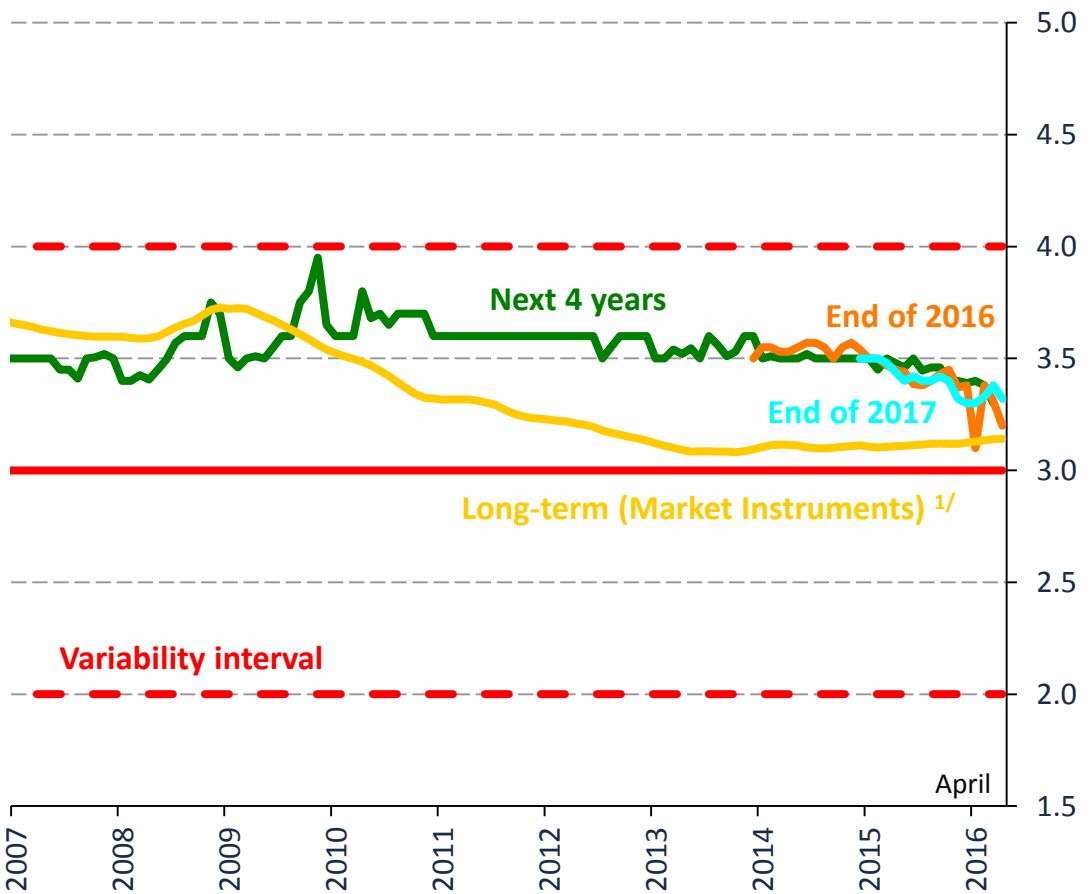
Energy and Government Approved Fares



Source: Banco de México and INEGI.

Inflation expectations implicit in long-term market instruments remain stable, while survey-based expectations kept decreasing, in a context in which the level, volatility and persistence of inflation have diminished since various years ago.

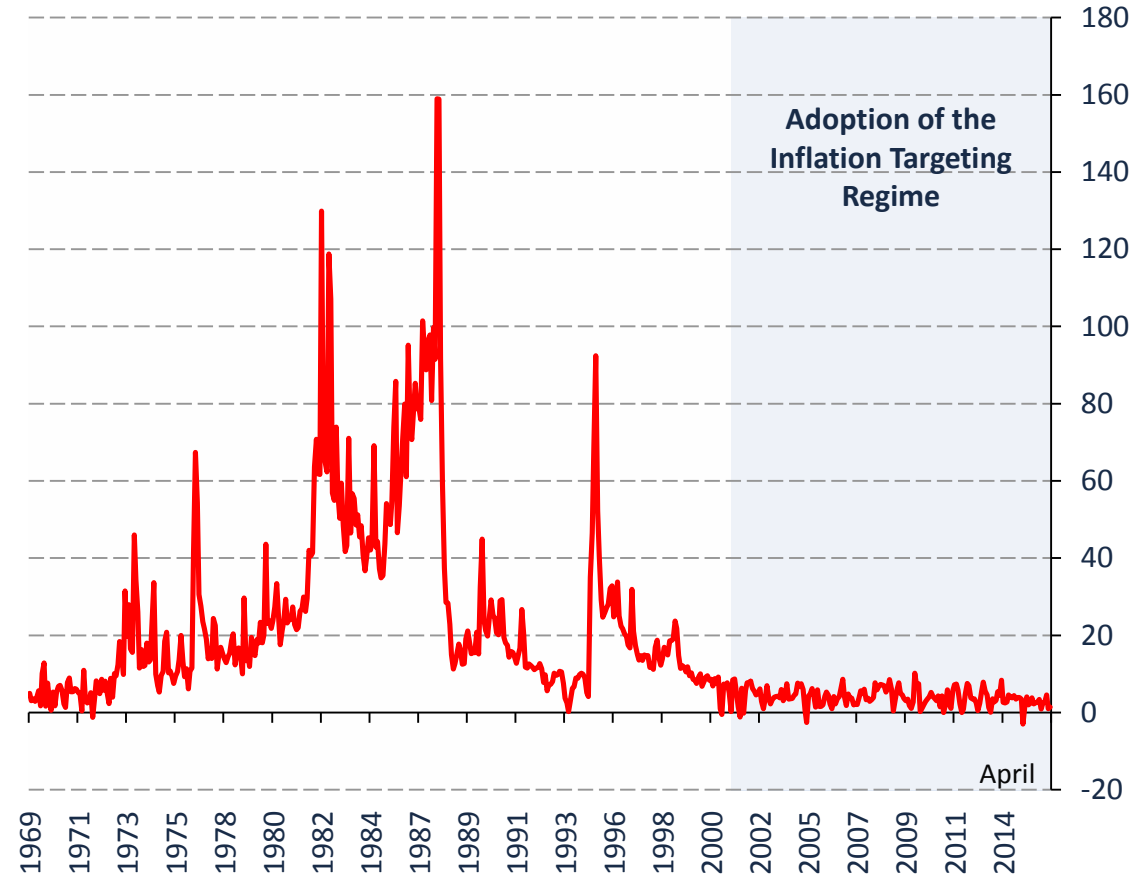
Headline Inflation Expectations
Median, %



1/ Based on the methodology described in Box 1 "Decomposition of the Break-even Inflation" of the Quarterly Report October-December 2013. For this report, the estimate was updated to include data up to December 2015.

Source: Banco de México.

Annualized Monthly Rate of Inflation ^{2/}
%, s. a.

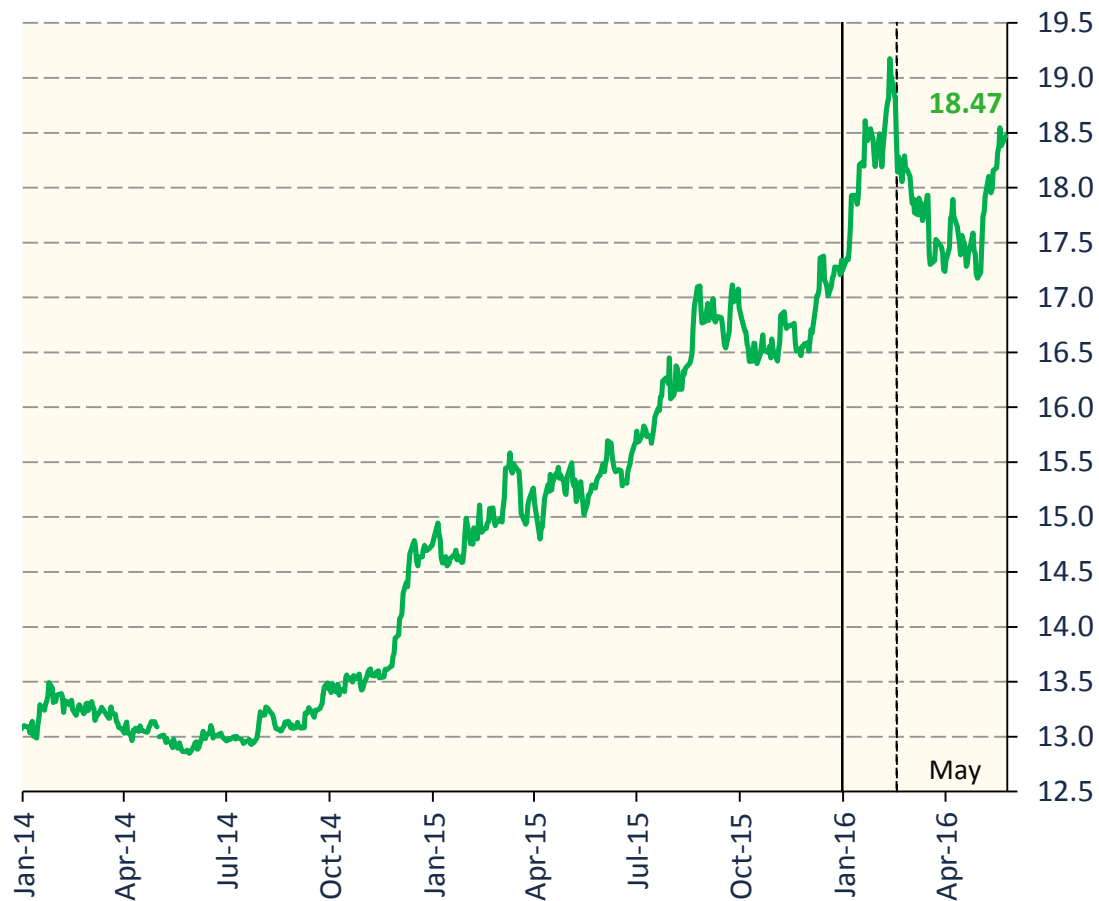


s. a. / Seasonally adjusted data.

2/ Technical Chapter from the Inflation Report October - December 2010: Change in the Nominal System of the Mexican Economy in the early 2000's. It is shown that from October 2001 inflation began a stationary process [I(0)]. Source: Banco de México.

The foreign exchange market kept functioning as the main absorber of external shocks.

Exchange Rate ^{1/} Pesos per USD



1/ Refers to FIX exchange rate. Data up to May 24th. The vertical black line refers to January 1st, while the dashed line indicates the February 17th.
Source: Banco de México.

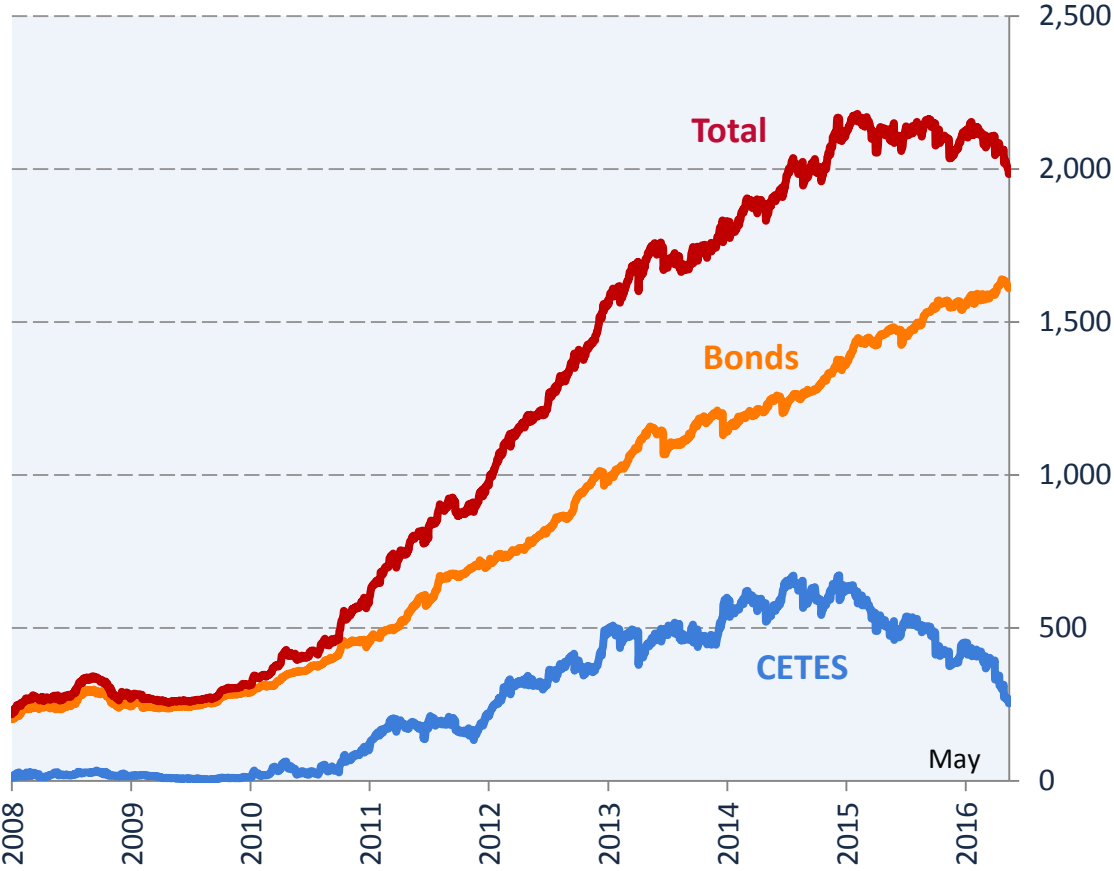
Implied Volatility in Exchange Rate Options ^{2/} %



2/ Refers to implied volatility in one-month options. The vertical black line refers to January 1st, while the dashed line indicates the February 17th.
Source: Bloomberg.

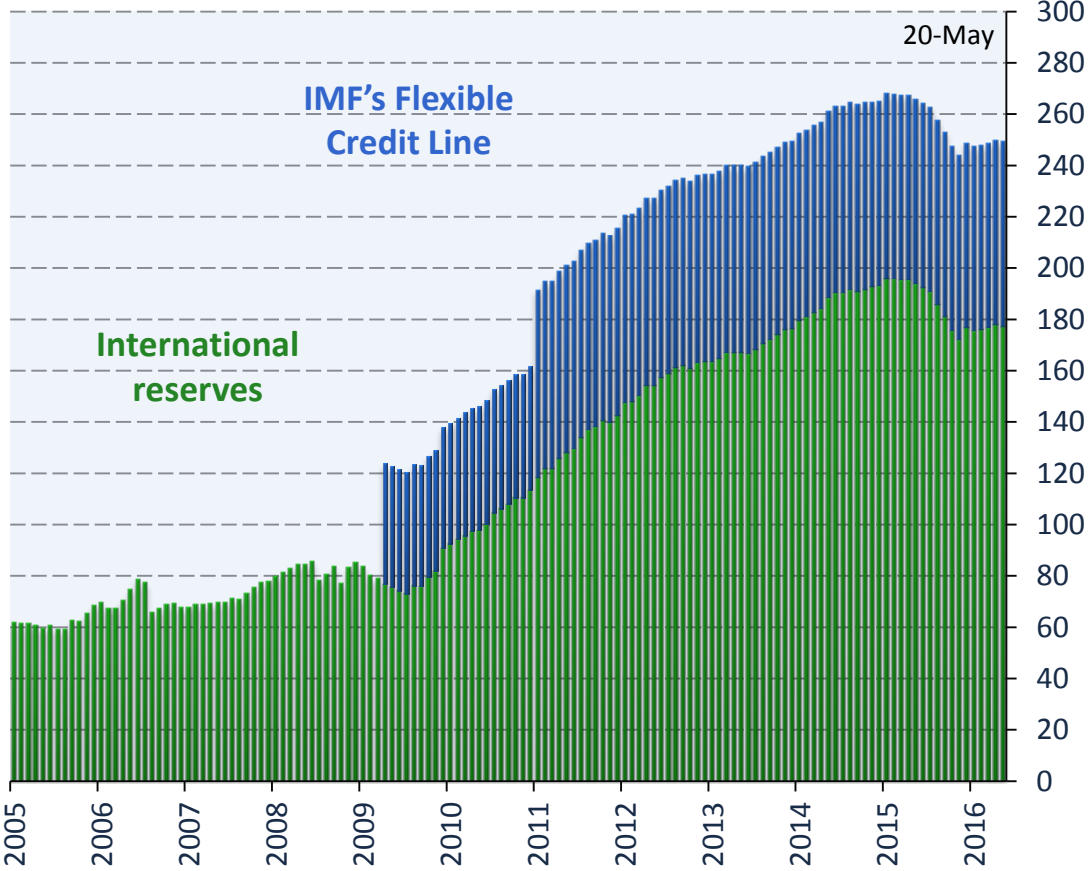
Non-resident government securities' holdings reduced slightly.

Government Securities' Holdings by Foreign Investors ^{1/}
 MXN billion



^{1/} Total includes CETES, bonos, udibonos, bondes and bondes D.
 Source: Banco de México.

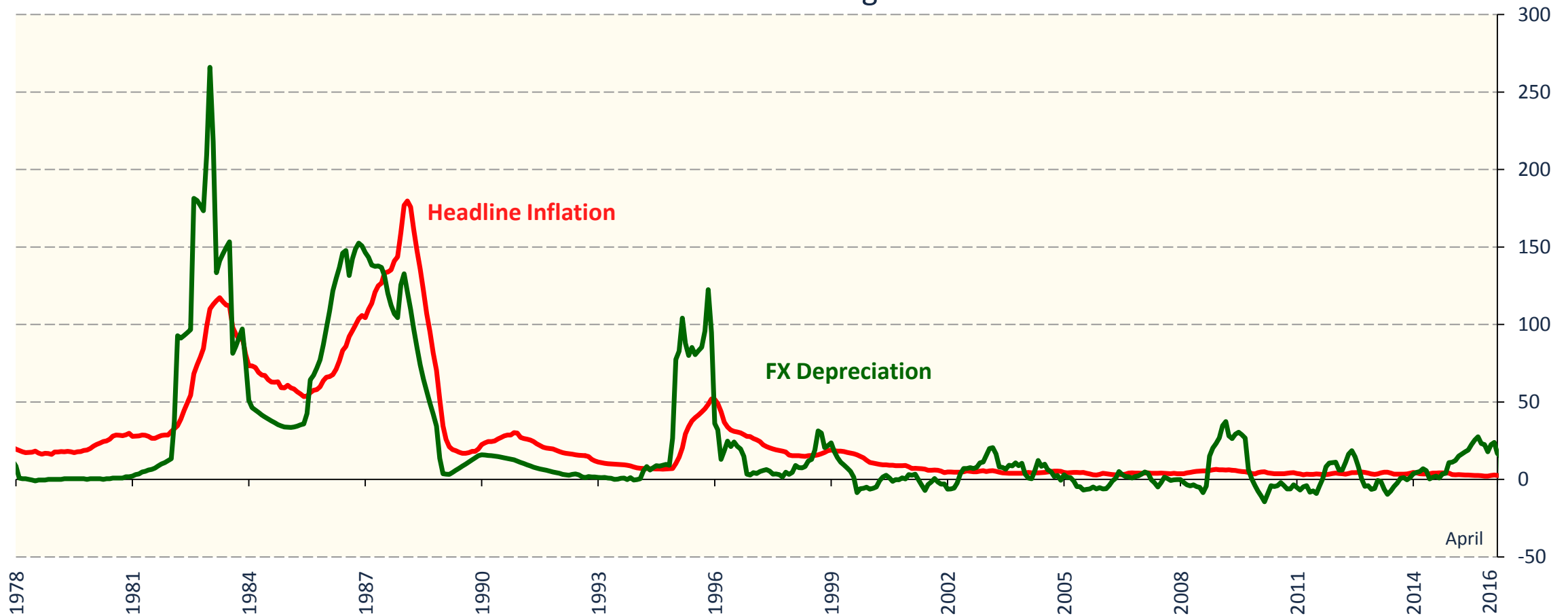
International Reserves
 USD billion



Source: Banco de México and International Monetary Fund.

Unlike in the past, recent exchange rate fluctuations have not affected the price formation process of the economy. Thus, inflation has stayed below the permanent target over the last 12 months, despite the exchange rate performance.

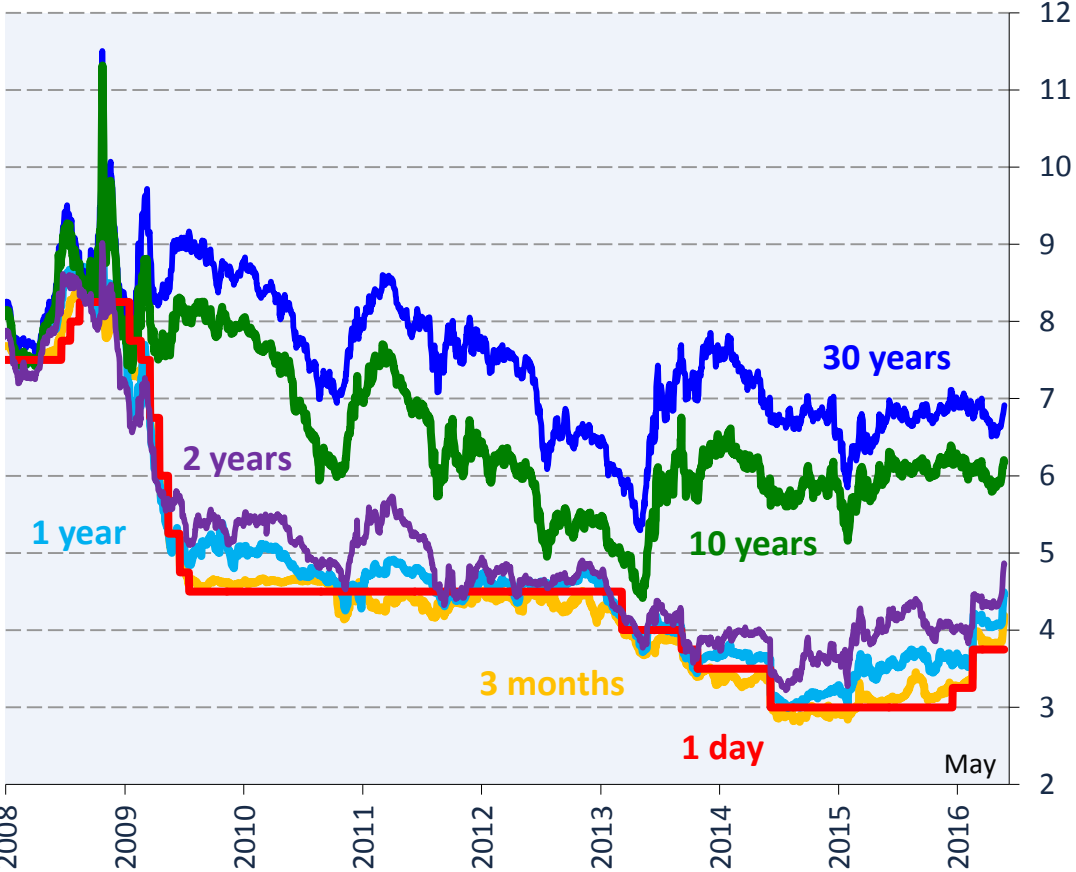
Headline Inflation and Nominal Depreciation Rate Annual % change



Source: Banco de México and NEGI.

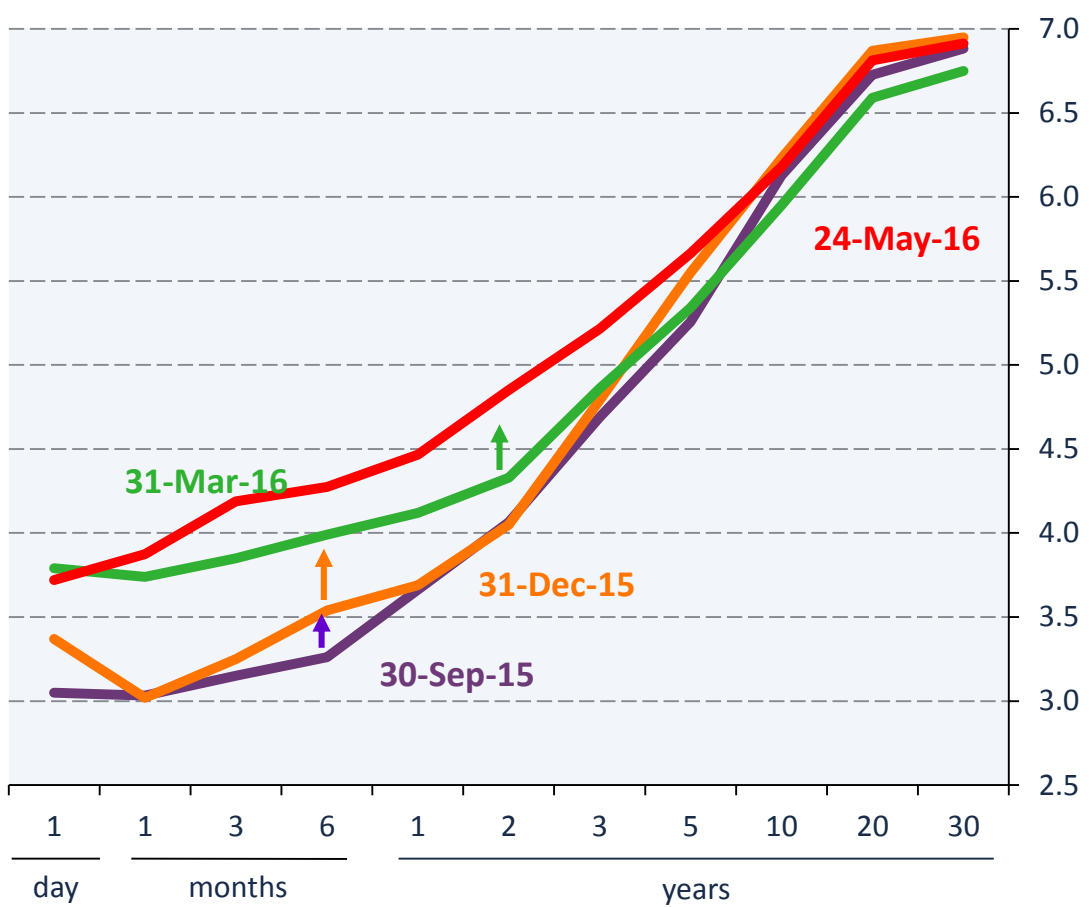
Short-term interest rates in Mexico reflected the increments in the reference interest rate that resulted from the monetary policy actions. In contrast and congruent with the anchoring of long-term inflation expectations, long-term interest rates remained relatively stable.

Government Securities' Interest Rates ^{1/}
%



^{1/} Since January 21, 2008, the one-day (overnight) interest rate corresponds to the target for the Overnight Interbank Interest Rate.
Source: Banco de México and Proveedor Integral de Precios (PIP).

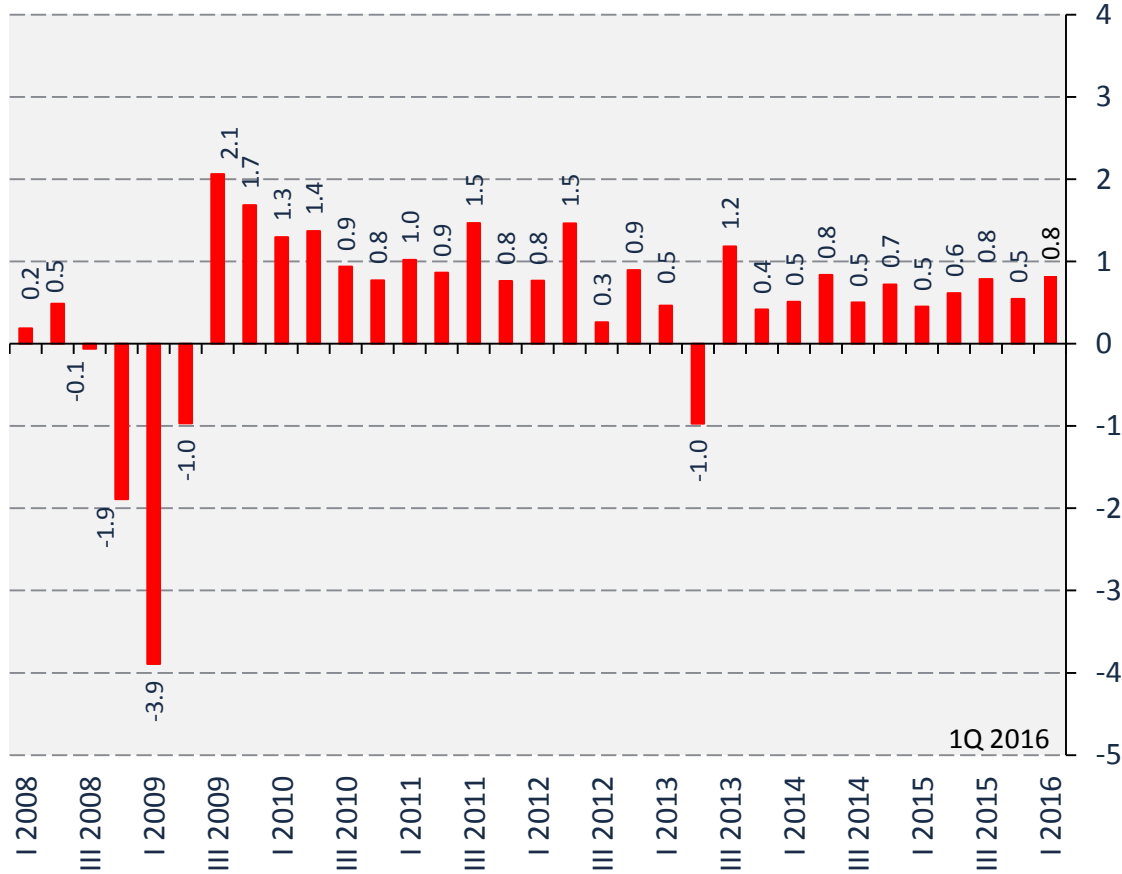
Government Bond Yield Curve
%



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

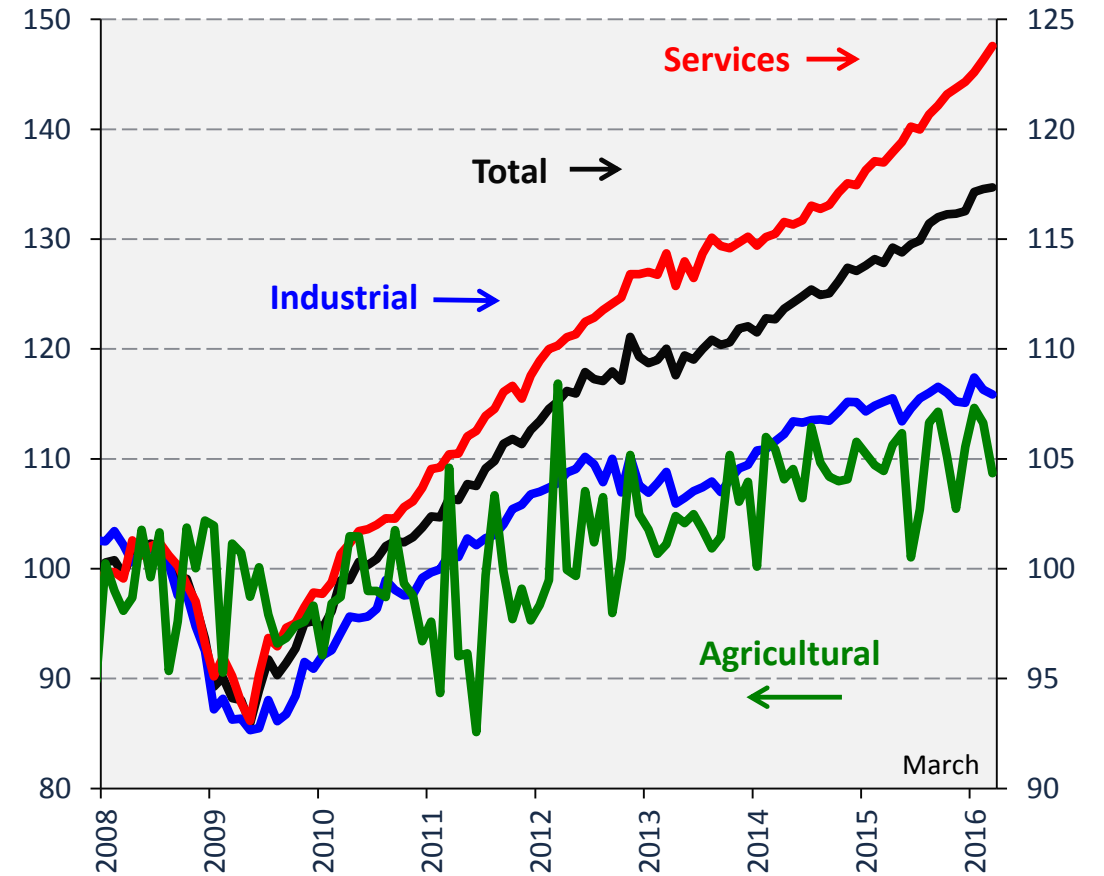
In 1Q 2016, the growth of the Mexican economy was greater than in the previous quarter.

Gross Domestic Product
Quarterly % change, s. a.



s. a. / Seasonally adjusted data.
Source: Mexico's System of National Accounts, INEGI.

Global Indicator of Economic Activity
Index 2008=100, s. a.

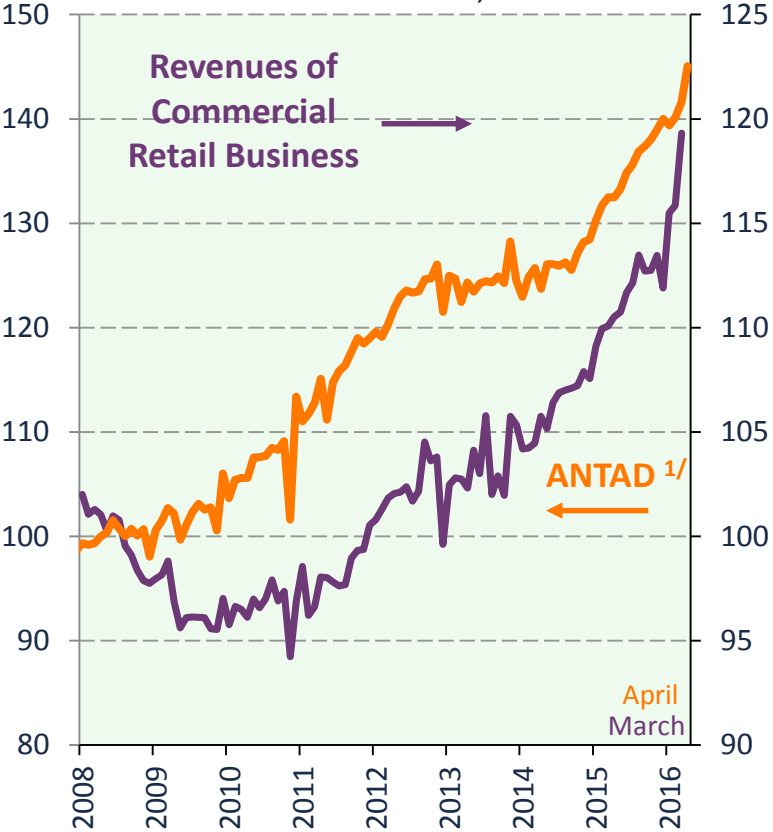


s. a. / Seasonally adjusted data.
Source: Mexico's System of National Accounts, INEGI.

Most private consumption indicators suggest that it continued registering a favorable trajectory in 1Q 2016.

Revenues of Commercial Retail Business and Total ANTAD Sales

Index 2008= 100, s. a.



s. a./ Seasonally adjusted data.
 1/ It refers to total sales.
 Source: INEGI and elaborated by Banco de México with data from ANTAD.

Domestic Light Vehicle Retail Sales

Thousands of units, annualized, s. a.



s. a./ Seasonally adjusted data.
 Source: Prepared by Banco de México with data from the Mexican Automotive Industry Association (AMIA).

Workers' Remittances

Billion, constant USD and MXN ^{2/}, s. a.

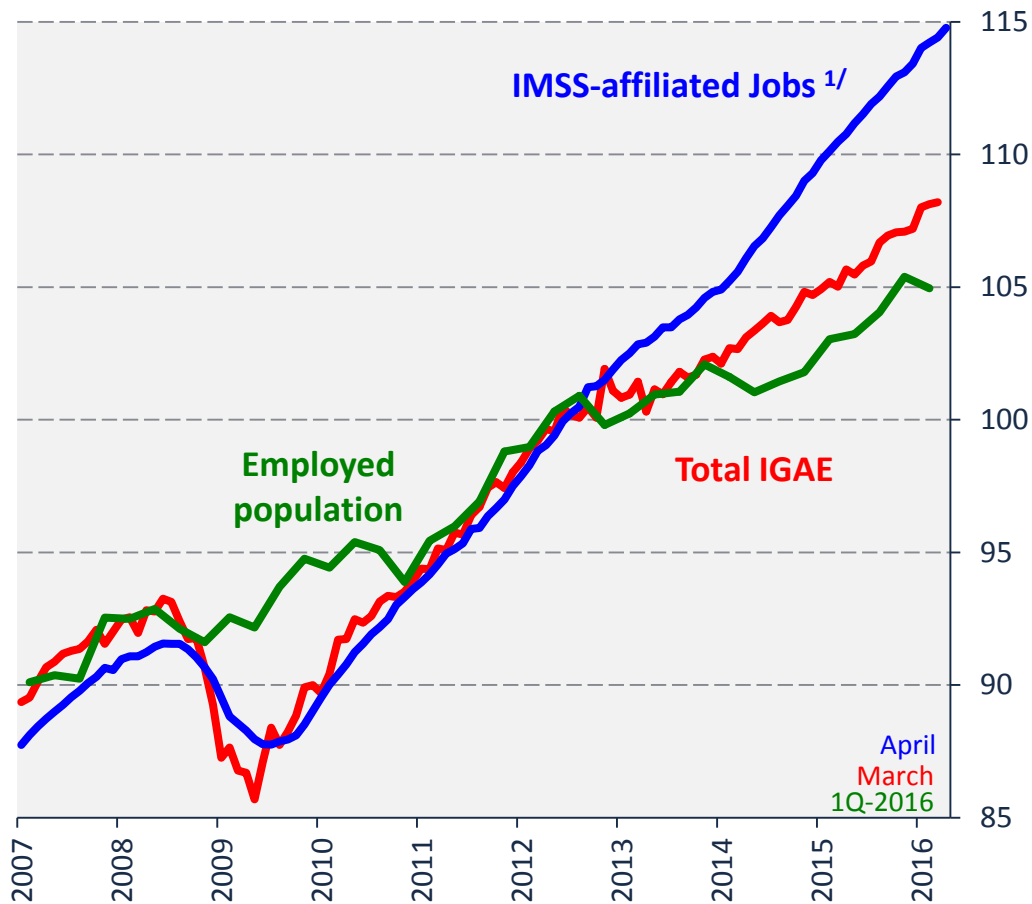


s. a./ Seasonally adjusted data.
 2/ Prices as of the second fortnight of December 2010.
 Source: Banco de México.

Although most labor market indicators showed an improvement, certain slack conditions still prevail.

IMSS-Insured 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.

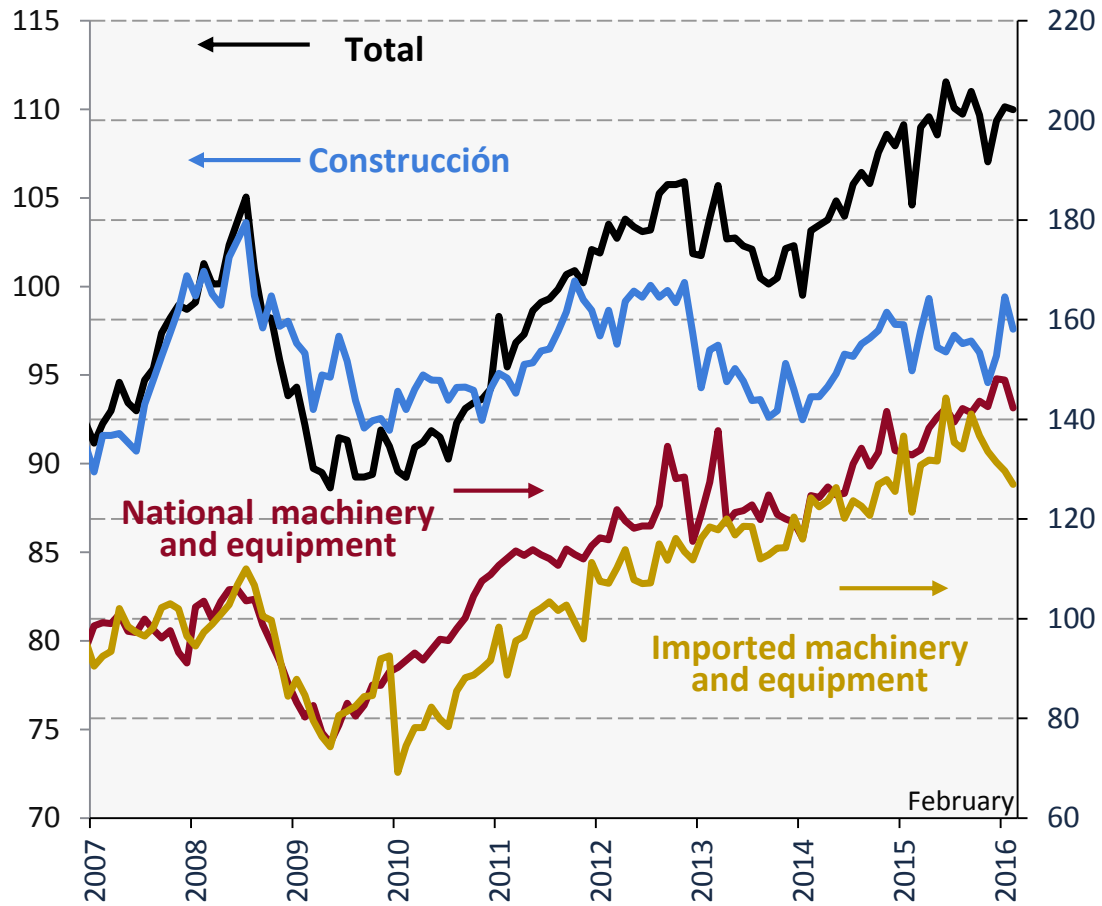
s. a. / Seasonally adjusted data.

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

Gross fixed investment continued showing a weak performance, although at the margin there was a rebound in construction.

Investment and its Components

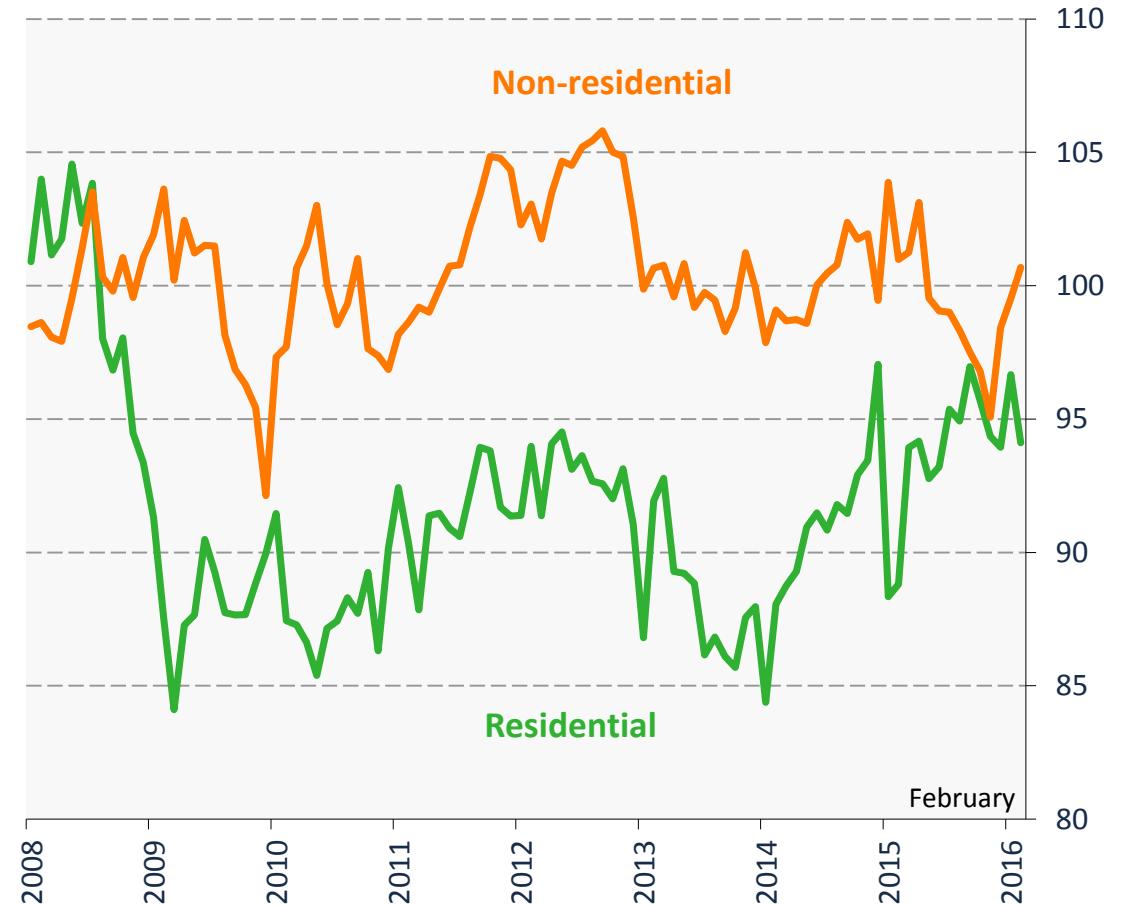
Index 2008=100, s. a.



s. a. / Seasonally adjusted data.
Source: Mexico's System of National Accounts, INEGI.

Investment in Residential and Non-residential Construction

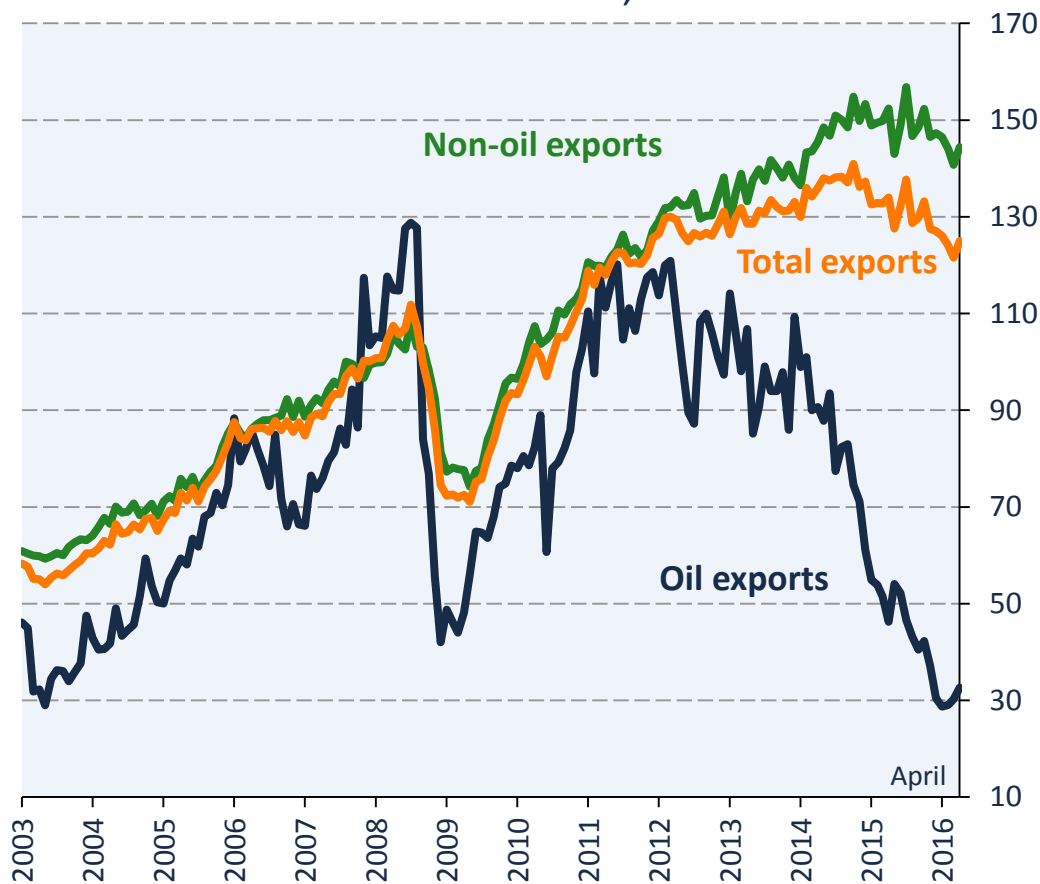
Index 2008=100, s. a.



s. a. / Seasonally adjusted data.
Source: Mexico's System of National Accounts, INEGI.

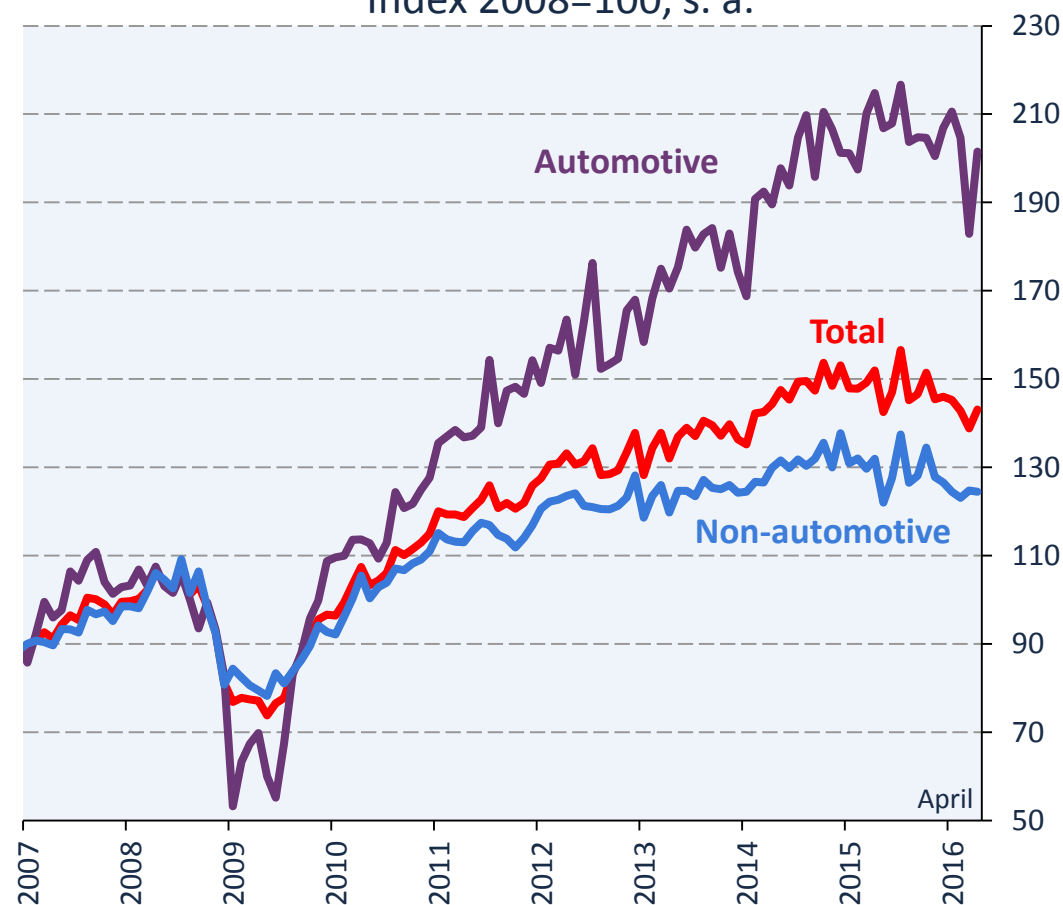
External demand continued exhibiting an unfavorable performance. Hence, both manufacturing and crude oil exports kept showing a negative trend.

Oil and Non-oil Exports
Index 2008=100, s. a.



s. a. / Seasonally adjusted data.
Source: SAT, Ministry of Economy, Banco de México, INEGI. México's Goods Trade Balance. SNIEG. National Interest Information, and Banco de México with data from PMI Comercio Internacional. S.A. de C.V.

Manufacturing Exports
Index 2008=100, s. a.



s. a. / Seasonally adjusted data.
Source: SAT, Ministry of Economy, Banco de México, INEGI. México's Goods Trade Balance. SNIEG. National Interest Information.

This occurred in a context of a widespread decrease in export activity in the main world economies.

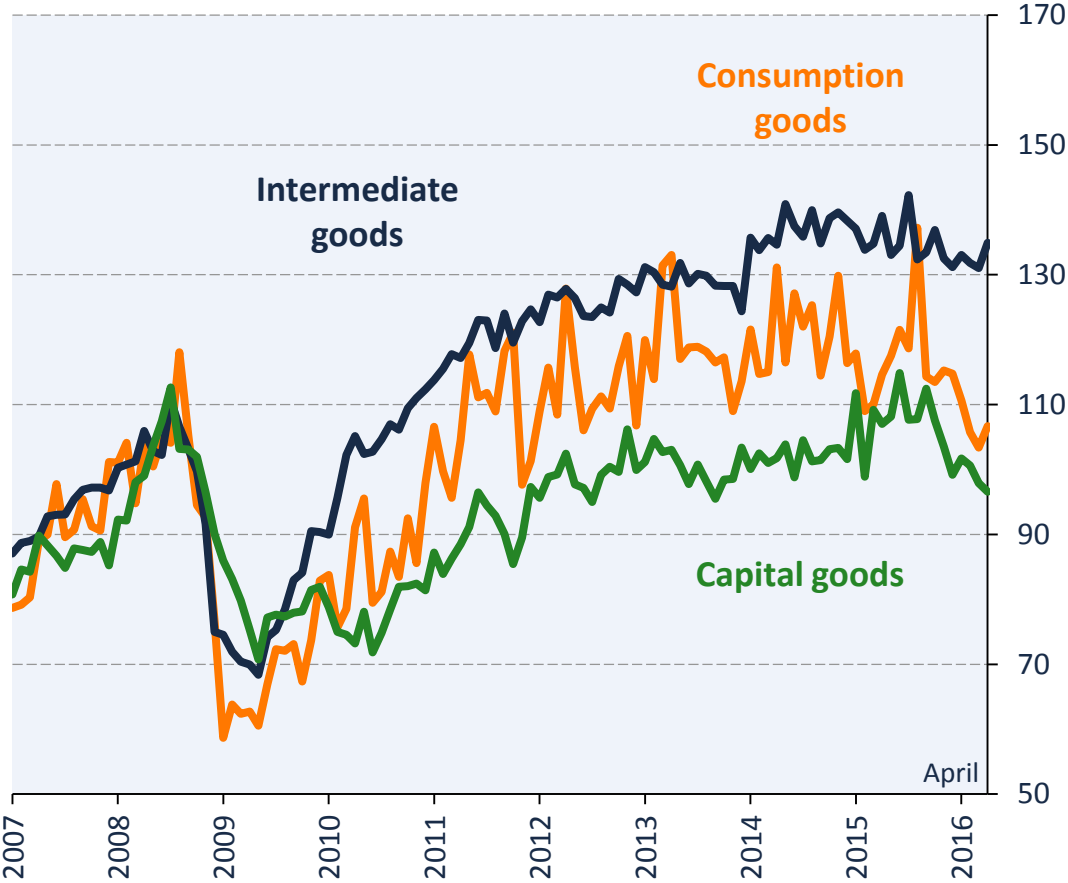
OECD Countries Exports Annual % change

	2013-I	2013-II	2013-III	2013-IV	2014-I	2014-II	2014-III	2014-IV	2015-I	2015-II	2015-III	2015-IV
Australia	-1.3	-2.9	-2.8	1.3	1.1	-4.1	-3.8	-12.5	-20.1	-23.3	-22.0	-21.6
Austria	1.8	3.8	4.5	8.1	6.0	7.6	1.0	-6.0	-15.4	-19.2	-12.7	-10.1
Belgium	0.1	2.5	9.4	9.6	4.2	7.3	1.2	-9.1	-17.3	-17.3	-16.6	-10.3
Canada	-0.1	0.7	0.7	0.9	-1.5	5.3	8.9	2.4	-8.0	-14.0	-15.7	-16.8
Chile	-4.9	1.5	5.8	-7.9	2.5	-2.0	-3.5	-4.5	-10.7	-19.0	-19.3	-19.2
Czech Republic	-4.1	1.0	5.5	10.4	13.8	13.6	5.6	-1.3	-12.3	-13.1	-7.8	-4.4
Denmark	2.0	0.0	7.7	6.6	4.4	7.4	-0.6	-8.6	-12.8	-16.9	-16.3	-12.0
Estonia	4.4	5.2	-4.8	1.8	-4.4	0.7	3.0	-5.1	-18.7	-20.1	-21.9	-17.9
Finland	-2.4	-0.5	1.5	6.9	0.4	7.7	1.3	-9.3	-19.5	-21.7	-20.4	-17.0
France	-0.5	2.0	2.5	4.6	2.0	3.6	0.1	-5.7	-14.8	-14.1	-12.5	-10.3
Germany	-0.0	0.8	3.9	7.1	5.4	7.6	4.4	-3.3	-11.6	-12.9	-11.1	-9.7
Greece	8.6	7.8	9.0	-9.8	2.3	-0.9	-4.0	-1.5	-20.9	-19.9	-24.3	-18.5
Hungary	-0.3	1.9	5.4	10.8	8.7	9.6	3.8	-5.6	-11.3	-13.3	-11.1	-6.4
Iceland	-0.7	-4.9	4.6	0.3	-2.6	1.1	5.0	0.4	3.0	7.3	-17.6	-13.5
Ireland	-7.3	0.3	-1.0	6.3	5.2	8.5	4.4	1.5	-0.1	-0.9	0.3	2.7
Israel	5.5	5.6	-3.2	14.0	8.6	-3.6	9.3	-8.3	-8.5	-5.9	-12.0	-2.2
Italy	1.1	1.5	4.6	5.0	5.1	6.8	1.7	-5.2	-14.2	-15.9	-14.0	-10.2
Japan	-12.4	-12.9	-10.4	-5.6	-4.1	-2.7	-1.7	-5.5	-5.1	-9.7	-12.5	-10.5
Korea	-0.3	1.3	3.1	4.3	1.2	3.5	3.7	0.7	-3.0	-7.1	-9.5	-12.0
Luxembourg	-18.1	-2.2	6.9	9.8	12.8	8.6	5.2	-8.8	-13.5	-9.8	-12.3	-6.8
Mexico	0.4	2.0	4.5	2.6	3.1	5.9	4.4	5.0	-0.6	-4.2	-4.0	-6.7
Netherlands	2.0	-0.1	5.1	2.8	1.5	6.3	1.0	-7.2	-17.1	-17.3	-15.6	-13.0
New Zealand	3.2	1.1	0.5	16.9	18.3	15.9	2.9	-11.4	-19.3	-17.8	-17.0	-16.4
Norway	-8.9	-3.9	2.2	-0.6	2.0	-4.8	-9.1	-17.0	-30.1	-25.0	-25.0	-27.2
Poland	7.4	10.3	12.5	11.9	13.3	13.8	3.7	-0.5	-11.0	-12.8	-9.8	-5.8
Portugal	2.5	7.7	10.8	11.3	5.2	5.0	1.5	-4.4	-13.5	-14.9	-14.0	-11.5
Slovak Republic	4.7	5.1	5.6	9.9	9.8	5.3	0.7	-9.8	-16.2	-16.9	-11.8	-6.5
Slovenia	3.0	2.1	7.7	9.6	8.3	9.0	5.9	-2.2	-12.2	-13.7	-12.6	-8.5
Spain	7.3	8.7	8.6	4.9	3.4	6.2	3.0	-4.7	-13.0	-15.6	-13.8	-8.7
Sweden	-4.3	-3.7	-3.0	-0.5	1.2	2.3	-2.0	-8.3	-18.7	-16.3	-15.1	-8.5
Switzerland	-2.0	2.3	2.8	2.8	9.6	6.8	5.1	-1.4	-7.7	-9.1	-9.6	-2.7
Turkey	5.5	-2.3	-5.4	0.2	7.0	5.0	3.0	-0.3	-7.7	-8.9	-11.9	-6.9
United Kingdom	-2.9	4.0	-1.8	1.8	5.0	1.4	0.7	-3.7	-12.1	-7.1	-9.9	-9.6
United States	1.6	1.0	1.5	4.3	2.1	3.5	4.3	0.8	-4.5	-5.8	-7.9	-10.3
Total OCDE	-0.6	0.4	2.1	4.0	3.3	4.7	2.4	-3.5	-10.7	-12.1	-11.9	-10.5

Source: Organization for Economic Cooperation and Development (OECD).

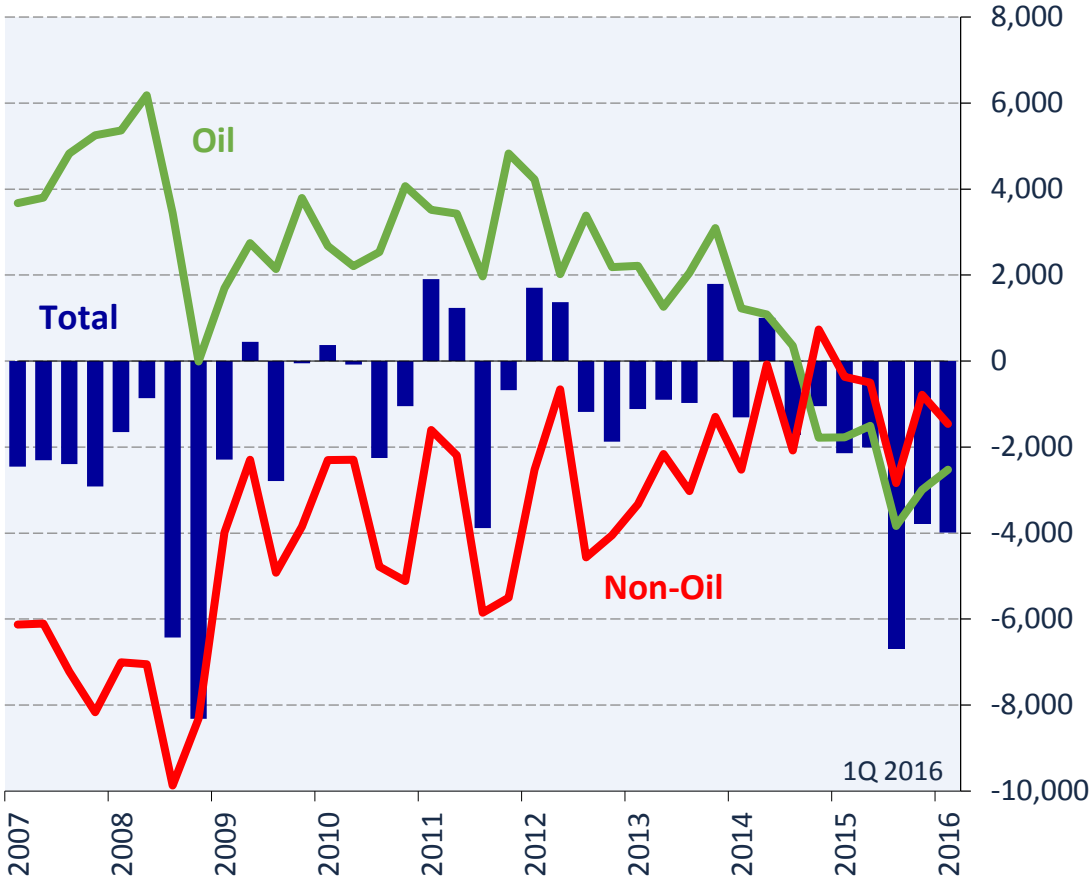
In an environment of weak global trade, imports in Mexico stagnated and the trade balance deficit increased, mainly as a consequence of the crude oil trade balance performance.

Imports by Type of Good
Index 2008=100, s. a.



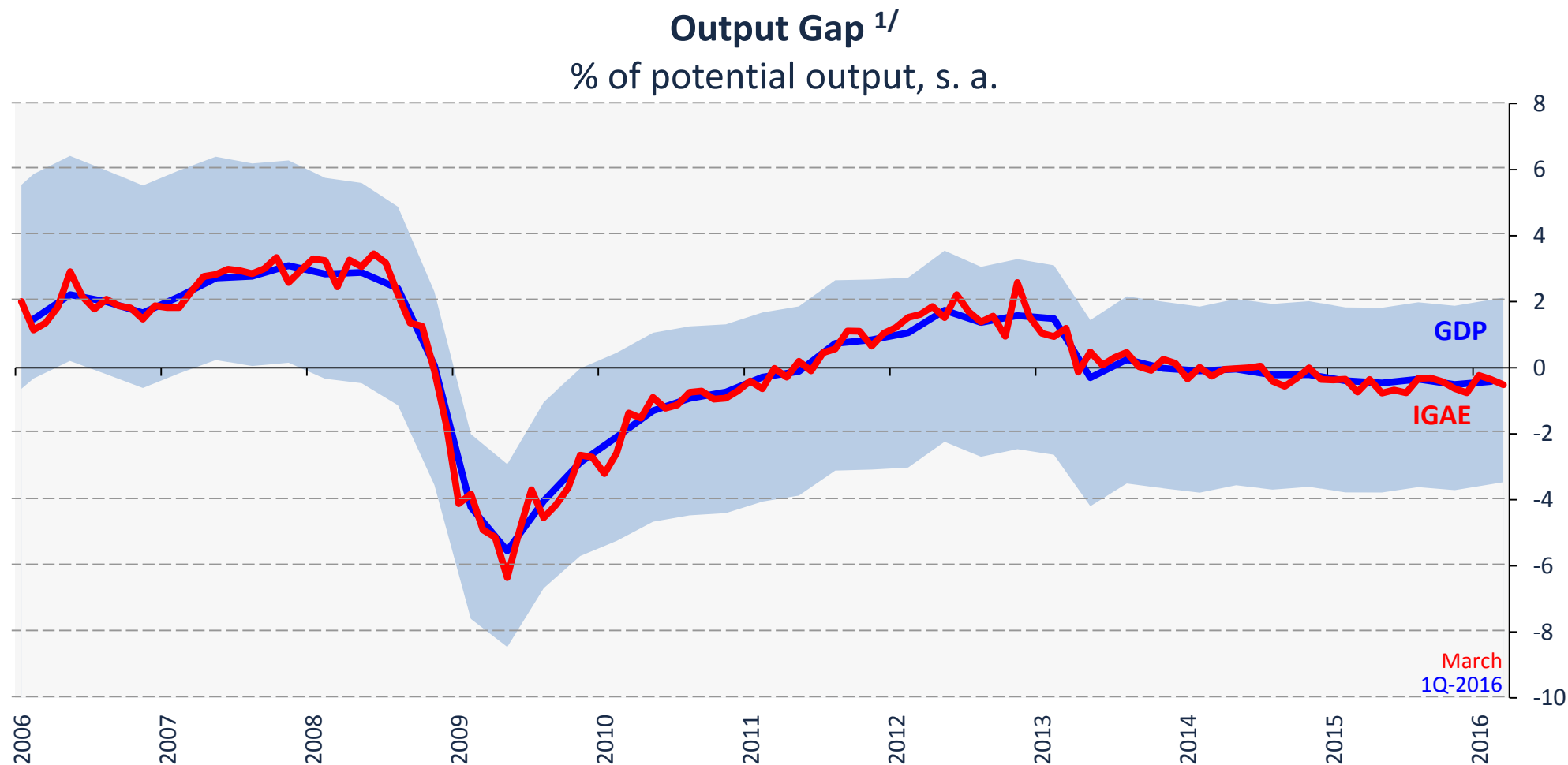
s. a./ Seasonally adjusted data.
Source: SAT, Ministry of Economy, Banco de México, INEGI. México's Goods Trade Balance. SNIEG. National Interest Information.

Trade Balance
Millions of dollars



Source: SAT, Ministry of Economy, Banco de México, INEGI. México's Goods Trade Balance. SNIEG. National Interest Information.

Thus, so far in 2016 slack conditions, even though decreasing, have prevailed in the economy.



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.

Outline

1 **Monetary Policy**

2 **External Conditions**

3 **Inflation and its Determinants**

4 **Forecasts and Balance of Risks**

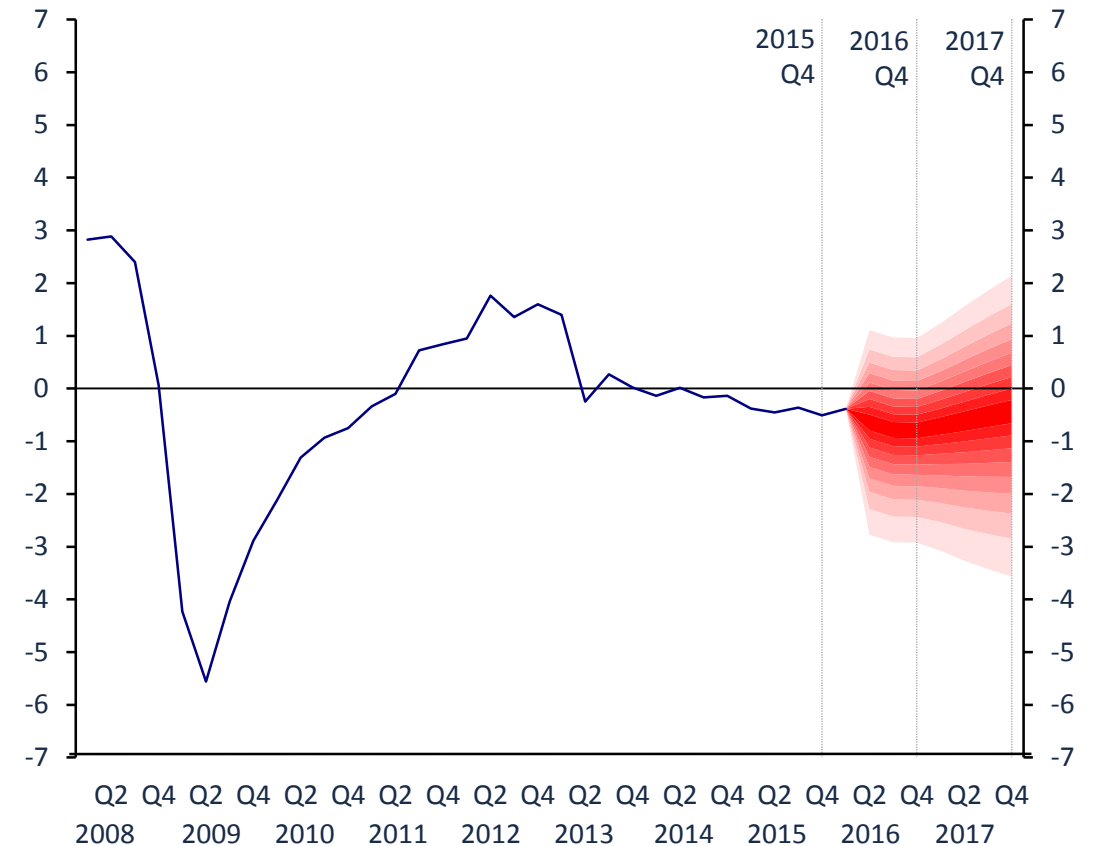
Economic Activity Outlook

GDP Growth (%)		
Report	Previous	Current
2016	2.0 – 3.0	2.0 – 3.0
2017	2.5 – 3.5	2.3 – 3.3

Increase in the number of IMSS-insured jobs (Thousands)		
Report	Previous	Current
2016	610 – 710	590 – 690
2017	650 – 750	630 – 730

Current Account Deficit (% of GDP)		
Report	Previous	Current
2016	2.9	3.1
2017	2.9	3.1

Fan Chart: Output Gap
% of potential output, s. a.



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

Risks to the Growth Outlook

Upward

- ✓ A greater dynamism of private consumption over the next quarters.
- ✓ That the implementation of structural reforms would produce more favorable and faster effects than anticipated by the market.

Downward

- ✓ The possibility of a more pronounced slowdown of the world economic growth and, in particular, of the U.S. industrial activity.
- ✓ That, in light of a more complex international environment, financing conditions would become tighter, which could affect investment plans.

Inflation Outlook

Headline inflation

Core inflation

2016

That over the next months it will remain under 3 percent and in the last months of the year it will temporarily exceed this figure. For the year as a whole, average annual inflation is expected to lie practically at 3 percent.

That it will gradually increase in annual terms, concluding 2016 at levels close to 3 percent.

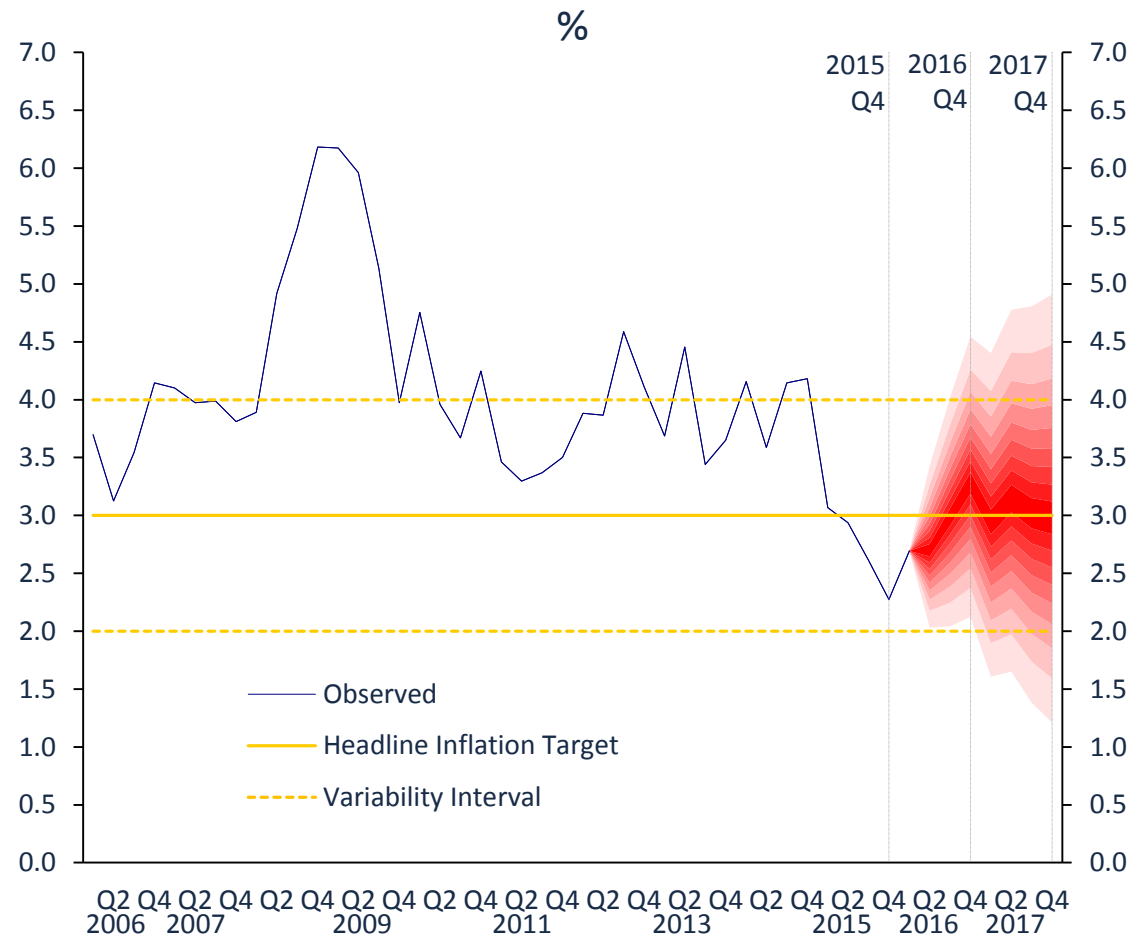
2017

That they will persist around the permanent inflation target.

Inflationary conditions in the economy are anticipated to remain favorable, so that inflation will continue fluctuating around its permanent target.

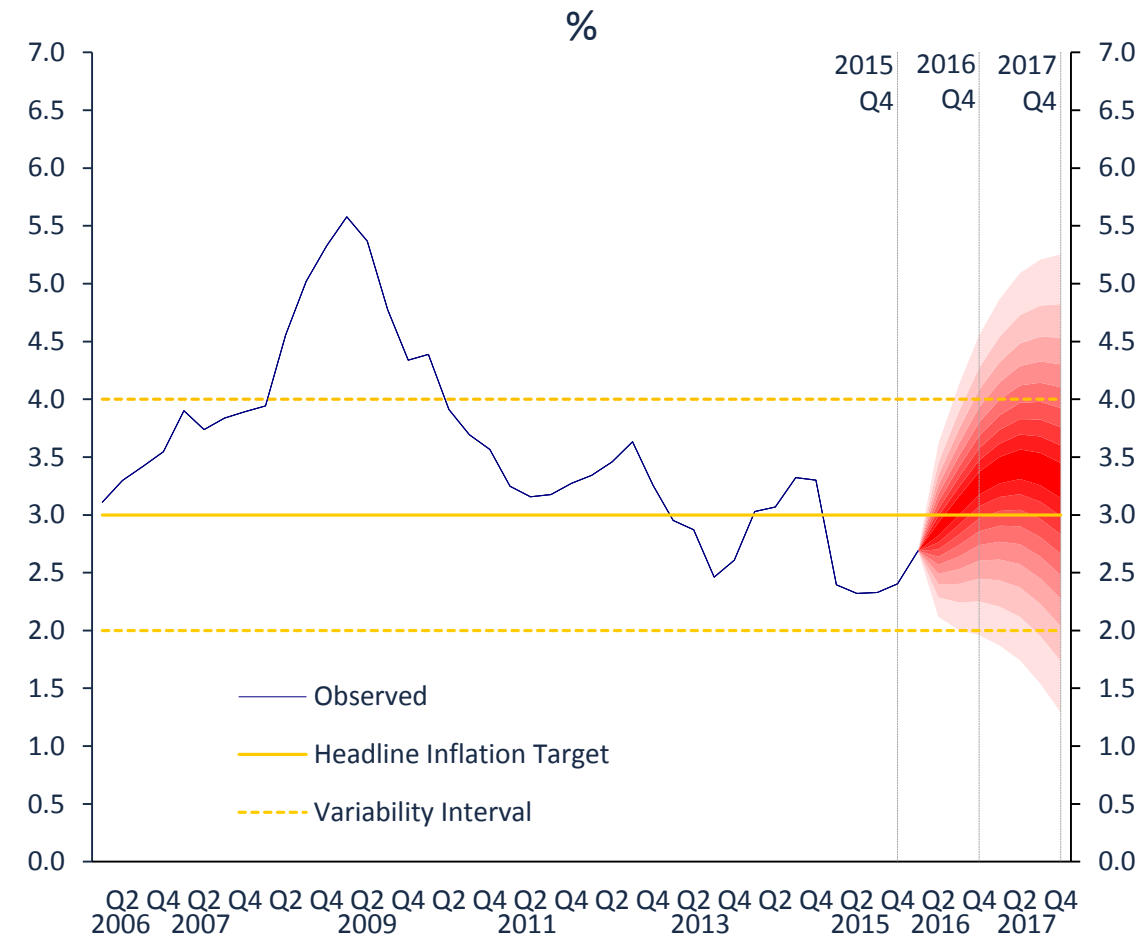
Fan Charts

Annual Headline Inflation ^{1/}



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

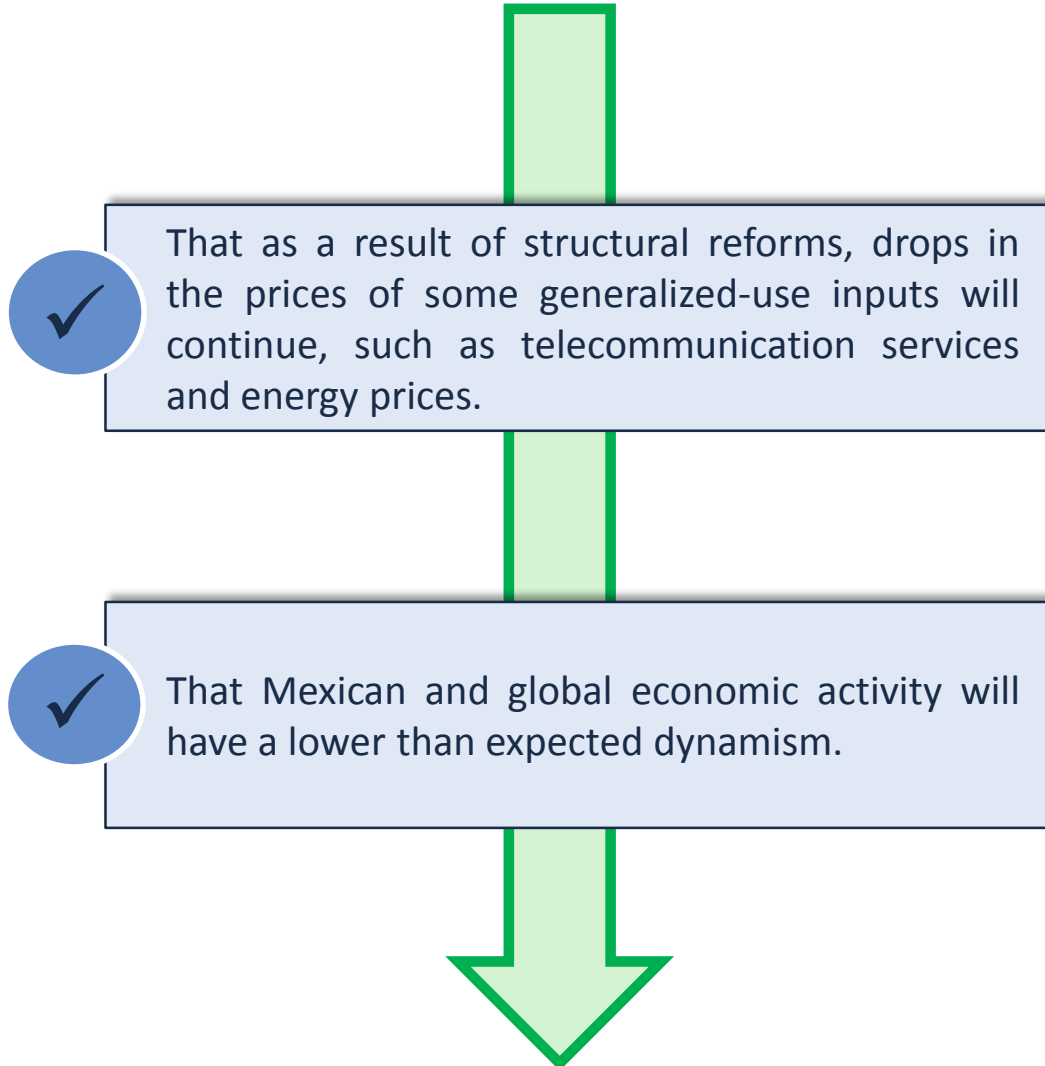
Annual Core Inflation ^{2/}



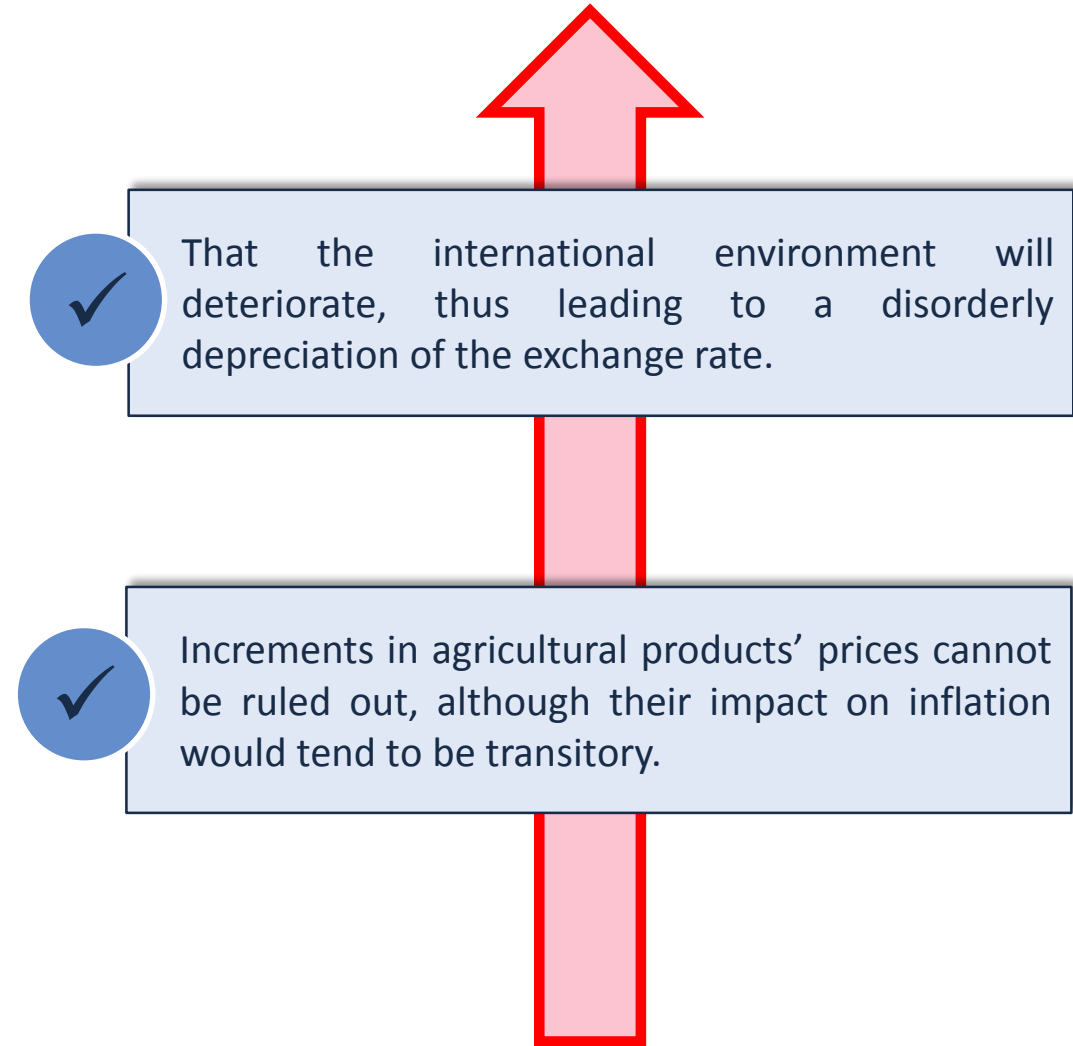
2/ Quarterly average of annual core inflation.
Source: INEGI and Banco de México.

Risks to Inflation Outlook

Downward



Upward



Monetary Policy Stance

- Considering the facts presented in this Report, the Board of Governors **will closely monitor the evolution of all inflation determinants and its medium- and long-term expectations**, especially:

- ✓ The exchange rate and its possible pass-through onto consumer prices.

- ✓ The monetary stance of Mexico relative to that of the U.S.

- ✓ The evolution of the output gap.

→ All this, in order to be able to take the necessary measures in a flexible manner and whenever conditions demand it, so as to **consolidate the efficient convergence of inflation to its 3 percent target**.

Strengthening Confidence in the Mexican Economy

- In the future, Mexico will be facing an adverse external environment that will represent a threat to economic growth and possible pressures on inflation.
- In this context, it is crucial to **preserve the macroeconomic strength**, adjusting in a timely manner the monetary and fiscal stances.
- Likewise, it is necessary to **continue encouraging domestic sources of growth**, so that not only the sluggishness of global demand is offset, but also so that higher economic growth rates are achieved in a sustained manner. The **efficient implementation of structural reforms** is of utmost importance.



BANCO DE MÉXICO

www.banxico.org.mx