Quarterly Report

April – June 2015

Summary

In line with its constitutional mandate, the monetary policy conducted by Banco de México seeks to procure stability of the national currency's purchasing power, while observing at all times that this happens at the lowest cost to society in terms of economic activity. As a result of the Central Institute's effort during the last years to curb inflation, during the present year convergence of inflation to its permanent 3 percent target has been achieved. In the quarter subject of this Report, inflation even reached historical minimum levels and it remains below the referred target, where it is estimated to remain during the rest of the year.

The outcomes in terms of inflation control have been achieved in a particularly complex environment, given the circumstances the Central Institute has been facing with respect to the conduct of monetary policy in Mexico. On the one hand, in the domestic environment, given the low growth rate of economic activity, conditions of slack prevail in the economy. Thus, no widespread demand-driven inflation pressures on prices have been observed. In this environment, inflation has shown a favorable evolution, to which reductions in input prices, such as energy prices, commodity prices and telecommunication service prices have also contributed, both directly and indirectly. On the other hand, in the external environment, although an increase in the federal funds rate as a response to the improved economic outlook in the U.S. will tend to favor the world economy and Mexico in particular, uncertainty regarding the imminent beginning of the normalization of U.S. monetary policy, together with the economic situation in Greece, the problems in Chinese financial markets and the commodity price decline, especially crude oil, contributed to increased volatility in international financial markets. This, coupled with reduced oil production in Mexico, led the Mexican peso to depreciate considerably against the U.S. dollar. Still, the pass-through of the currency depreciation onto prices has been limited, mainly affecting durable goods' prices, without generating second round effects. In light of this, the Central Institute has remained alert in order to prevent the relative prices adjustment caused by this depreciation from contaminating inflation expectations. Indeed, long-term inflation expectations have remained well-anchored, while those for the end of 2015 and for 2016 have decreased. Taking into account all these elements, in the period covered by the present Report, the Board of Governors maintained the Overnight Interbank Interest Rate target at 3 percent by virtue of the fact that it estimated this monetary policy stance to be conducive to the consolidation of the convergence of inflation to its permanent 3 percent target.

Economic activity in Mexico kept presenting a slow growth pace. In particular, external demand maintained a weak performance, while different domestic demand indicators registered moderate growth trends. In this context, conditions of slack persist in the economy, thus no pressures on prices in main input markets or external accounts are anticipated.

The global economy experienced in the quarter subject of this Report a moderate recovery with respect to the weakness observed in the previous quarter. This was due to the strengthening of advanced economies' domestic demand, supported by the ongoing highly accommodative monetary policies. In the particular case of the U.S., the recovery of economic activity was favored by an improvement in consumption. However, as in the first quarter, industrial production kept showing signs of weakness. Meanwhile, world inflation and inflation expectations remained below most central banks' targets.

International financial markets experienced increased volatility due to the factors mentioned before, which contributed to the appreciation of the U.S. dollar against basically all currencies, both of advanced and emerging economies, to less capital inflows to the latter ones and to less favorable financial conditions. From here on, the process of monetary policy normalization in the U.S. in response to a better U.S. economic outlook is expected to favor the dynamism of global economic activity, including that of emerging economies and that of Mexico in particular due to its close trade relations with the U.S. economy. However, given the uncertainty regarding the possible effects of the beginning of the referred normalization process on the reallocation of international portfolios and the outlook of commodity prices remaining at low levels, emerging economies are expected to face less accessible financing conditions.

Thus, the persistence of elevated volatility levels in external financial markets was reflected in domestic markets. Although no net capital outflows were observed, investors' portfolio adjustment to risk exposure increased the demand for foreign exchange risk hedges in derivative markets, contributing to a depreciation of the Mexican peso against the U.S. dollar. In this regard, it should be mentioned that the nominal exchange rate depreciation, in a context of well-anchored inflation expectations and a low pass-through of exchange rate movements onto prices, has caused the real exchange rate depreciation (associated among other factors with expected higher interest rates in the U.S and with last year's oil price and oil production reductions) to take place efficiently, thereby illustrating the strength of Mexico's macroeconomic framework. This was evidenced in the debt market, where interest rates of Mexican government bonds maintained a positive correlation with U.S. bonds, leading to a slight increase in medium and long-term interest rates.

Considering the possibility of persisting or even increasing volatility in external financial markets, it is fundamental to strengthen Mexico's macroeconomic framework. Therefore, it would be necessary to consolidate recent efforts in the fiscal environment and to adjust the monetary policy stance in a timely manner. This would contribute to maintaining confidence in the Mexican economy and, consequently, to hold the risk premia of interest rates at low levels, which would be crucial given an external environment of more stringent financial conditions.

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

GDP Growth: For 2015, the forecast for Mexico's GDP growth is revised from an interval of between 2.0 and 3.0 percent to one from 1.7 to 2.5 percent. For 2016, GDP growth is expected to be between 2.5 and 3.5 percent, the same interval as in the previous Report (Chart 1a). This forecast is based, on the one hand, on the fact that economic activity in Mexico in the first semester of 2015 was lower than expected, reflecting the weak performance of industrial activity and the moderate growth registered by domestic demand. On the other hand, from here on, Mexico's economic activity is expected to improve in the second half of the year, although at a lower rate than that anticipated in the previous Report. Domestic demand growth is expected to remain moderate, so the recovery would be mainly associated with higher manufacturing production in Mexico, reflecting increased exports of this sector due to an improvement of U.S. industrial activity and the real depreciation of the Mexican peso against the U.S. dollar.

For 2016, the implementation of structural reforms is anticipated to gradually be reflected in a greater dynamism of investment, which would complement the moderate recovery presented so far by consumption. Additionally, U.S. industrial activity and, as a consequence, Mexican exports are expected to further recover.

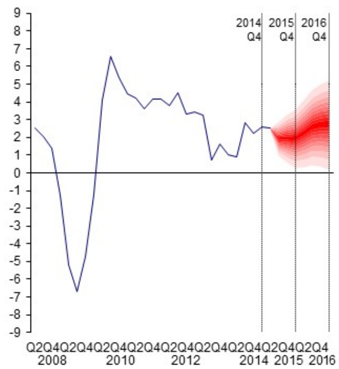
Employment: In line with the adjustment of the economic growth outlook for 2015, the forecast of the increase in the number of IMSS-insured jobs is also revised downwards for this year to between 560 and 660 thousand jobs (increase of between 580 and 680 thousand in the previous Report). For 2016, an increase of between 600 and 700 thousand IMSS-insured jobs is expected, the same interval as in the previous Report.

Current Account: For 2015, trade balance and current account deficits of USD 6.0 billion and USD 30.6 billion are expected, respectively (0.5 and 2.6 percent of GDP, in that same order). For 2016, the expected deficits are USD 6.3 billion and USD 31.8 billion, respectively (0.5 and 2.5 percent of GDP, in that order).

Given the described forecasts, no aggregate demand-related pressures on inflation or external accounts are expected. In particular, the GDP gap is anticipated to remain negative in the forecast horizon, although trending towards gradually closing (Chart 1b).

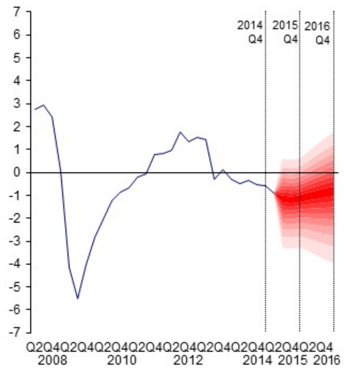
Fan Charts 1

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



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

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



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

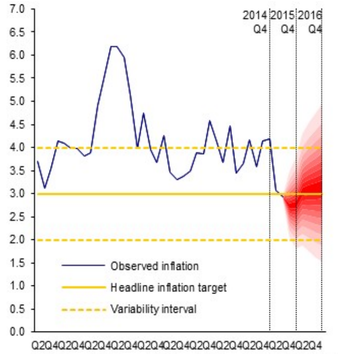
The GDP growth scenario is subject to diverse risks. Among the downward risks are: i) that manufacturing exports continue to register a low dynamism if the U.S. industrial sector keeps showing a weak performance; ii) a deterioration in investors' outlook due to the lack of favorable results with regard to the implementation of the energy reform and/or in face of an additional weakening of the perception of the rule of law; iii) that Mexican oil production recovery is delayed, affecting the dynamism of the country's industrial sector; and iv) an additional increase in international financial markets volatility that deteriorates access conditions to external financing for the Mexican economy.

Among the upward risks for the growth scenario the following stand out: i) greater dynamism of the export sector in case of a greater than expected recovery of external demand; and ii) better progress in the implementation of structural reforms and/or in the strengthening of the rule of law.

Inflation: Taking into consideration the lack of aggregate demand-driven inflationary pressures on prices, as well as its latest unfolding, inflation is foreseen to further show a favorable evolution during the rest of the year and during 2016. It is anticipated that both headline and core inflation will remain below 3 percent during the rest of 2015. For 2016, headline as well as core inflation are estimated to remain at levels close to 3 percent (Chart 2a and Chart 2b). The forecast for the inflation trajectory could be affected by some risks among which stand out the following. Upward risks: that the depreciation of the peso continues to a greater extent and that it passes through onto non-tradable goods prices, which could contaminate inflation expectations. Downward risks: i) a still lower than expected dynamism of economic activity; and ii) additional decreases of energy and/or telecommunication services prices.

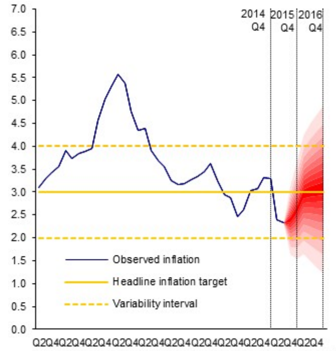
Fan Charts 2

a) Annual Headline Inflation [1/]
Percent



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

b) Annual Core Inflation [1/]
Percent



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

Considering the facts presented in this Report, in the future Banco de México's Board of Governors will continue to monitor the performance of all inflation determinants and its medium- and long-term expectations, in particular, the exchange rate performance, the monetary policy stance of Mexico relative to the U.S., as well as the evolution of the degree of slackness in the economy. All this in order to be able to take the necessary decisions in a flexible manner and whenever conditions demand it in order to consolidate the convergence of inflation to the 3 percent target.

In the face of the complex international environment and the expectations that it will persist in the future, it is fundamental to strengthen the macroeconomic framework that contributes to maintain confidence in the Mexican economy. Therefore, in addition to the timely adjustment of the monetary policy stance, the structural strengthening of public finances is required, gaining more relevance in light of the important decrease of oil prices and oil production. Particularly, it is necessary that the public debt to GDP ratio stabilizes at levels which are sustainable in the medium and long run. Thus, it is fundamental to meet the fiscal consolidation target announced by the Federal Government, as well as to back ongoing efforts to maintain sound public finances.

On the other hand, confidence in the Mexican economy should also be strengthened by means of higher growth rates in a sustainable manner. Hence, the country's productivity should expand at a greater rate, which in turn requires reaching clear progress in the implementation of structural reforms. Indeed, the correct implementation of educational, economic competition, telecommunication, energy and financial reforms is expected to lead to an incentive scheme which leads to productivity gains that are reflected in greater welfare for society in general. For instance, the competition policy, whose application to specific markets could generate lower prices, could have an important effect on households' welfare and, in particular, on low-income persons and/or those living in conditions of poverty.

Finally, international evidence and in particular the recent development of the political and economic crisis in Greece and the Euro zone have demonstrated that the strength of institutions is crucial in order to back the economy's sound functioning. Thus, Mexico should step up its efforts aimed at strengthening institutions and the rule of law, since, for example, the lack of public security has negative effects on confidence, inhibits an efficient allocation of resources in the economy and hinders the growth of economic activity. To the extent that Mexico moves in this direction, it will be possible to trigger the potential of the Mexican economy to achieve faster economic growth in an environment of low inflation and financial stability.