

Quarterly Report

April - June 2016

August 31, 2016



BANCO DE MÉXICO

Outline

1 Monetary Policy

2 External Conditions

3 Economic Activity in Mexico

4 Inflation and its Determinants

5 Forecasts and Balance of Risks

Monetary Policy Conduction

- The primary mandate of this Central Institute is **to procure low and stable inflation**.
- The monetary policy conduction **under the inflation targeting regime**, along with some important outcomes of **the structural reforms**, contributed to achieve the following:
 - ✓ Low and stable inflation.
 - ✓ Anchoring of inflation expectations.
 - ✓ Decrease in the risk premia, particularly inflationary risk premium.
 - ✓ Reduction in the pass-through of exchange rate fluctuations onto prices.
- Despite the aforementioned achievements, **this progress cannot be taken for granted**, especially in view of the complex international environment Mexico is currently facing, as well as the expectation that this context will prevail in the future.

In order to consolidate the efficient convergence of inflation to the 3 percent target, and thus, to help maintain an adequate macroeconomic framework, in the period covered by this Report, Banco de México acted with all flexibility, at the moment when conditions demanded so:

May 5, 2016

Rate unchanged at 3.75 percent.

June 30, 2016

50 bp increment to 4.25 percent.

- This was mainly due to the deteriorating external conditions, generating a considerable depreciation of the exchange rate, which could jeopardize the anchoring of inflation expectations in Mexico, and eventually could negatively affect the evolution of inflation.

August 11, 2016

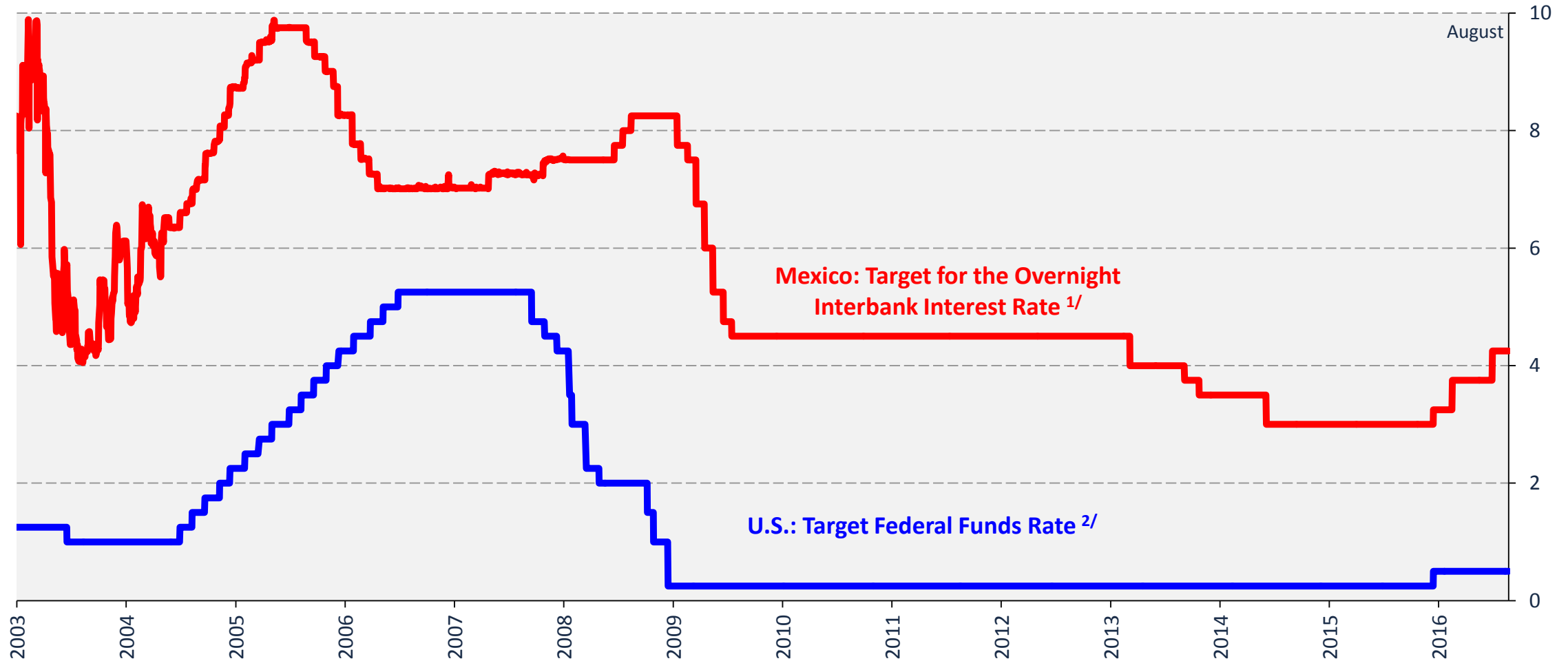
Rate unchanged at 4.25 percent.

- By virtue of the fact that it was considered that, **given the June adjustment**, the central scenario for inflation for the short and medium terms was still congruent with the permanent target and its balance of risks was deemed neutral.

Since December 2015, the target for the Overnight Interbank Interest Rate has gone up by 100 basis points, in addition to the increment in the U.S. reference interest rate.

Monetary Policies 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.

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Inflation and its Determinants

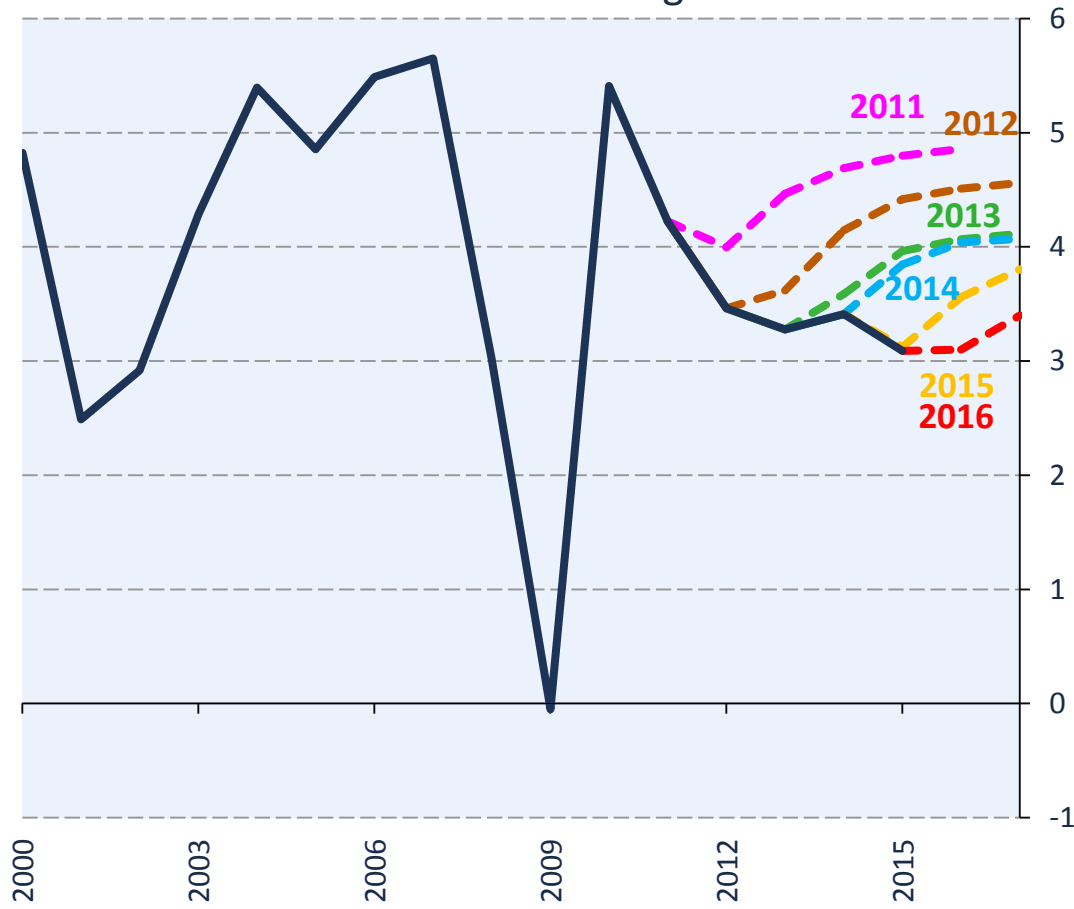
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Forecasts and Balance of Risks

Global economy kept exhibiting a weak growth rate during 2Q 2016, while its growth outlook continued adjusting downwards.

World Economy

Evolution of GDP Growth Forecast
Annual % change



Source: FMI, WEO from 2012 to 2016.

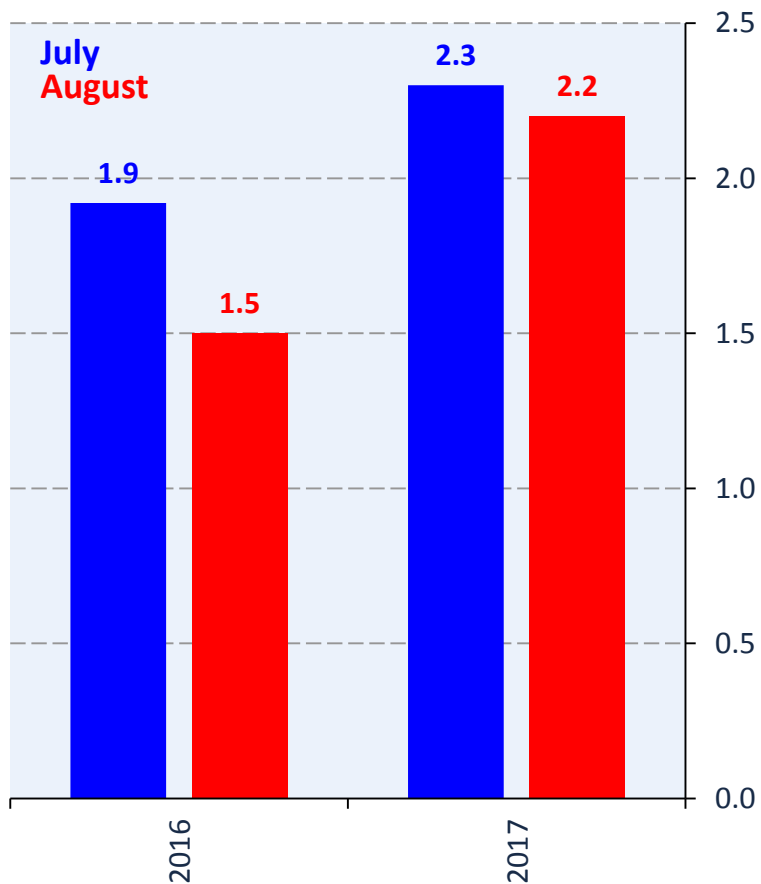
Trade of Goods ^{1/}
Annual % change, s. a.



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

In the U.S., GDP grew less than anticipated during 2Q 2016, while inflation somewhat stabilized at still low levels. Meanwhile, labor market performed very favorably.

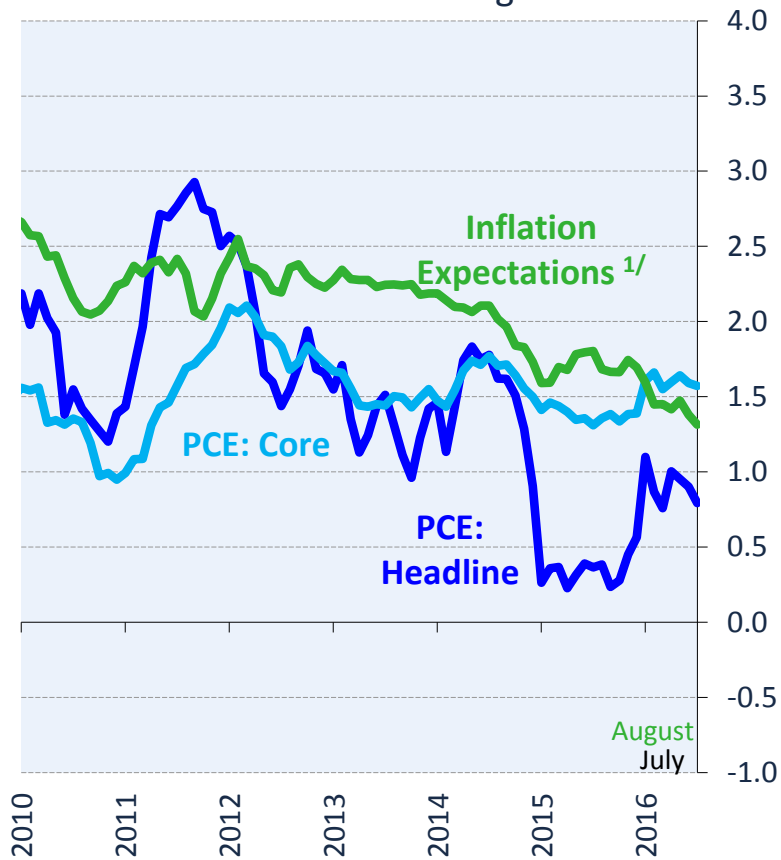
GDP Growth Expectations
Annual % change



Source: Blue Chip.

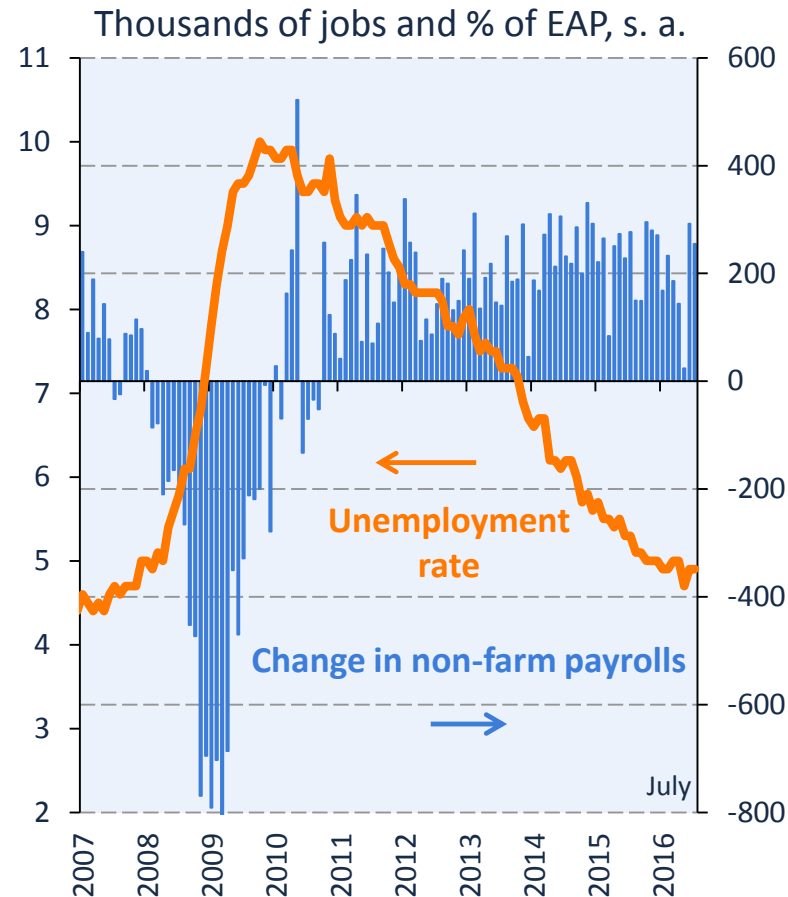
United States

Personal Consumption Expenditures Price Index and Inflation Expectations
Annual % change



1/ The data are monthly averages of a daily data, which are a measure of expected inflation over the five-year period that begins five years from today. Obtained from swap contracts in which one counterparty agrees to pay a fixed rate in exchange for receiving a referenced payment at an inflation rate over a specified period.
Source: JP Morgan.

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

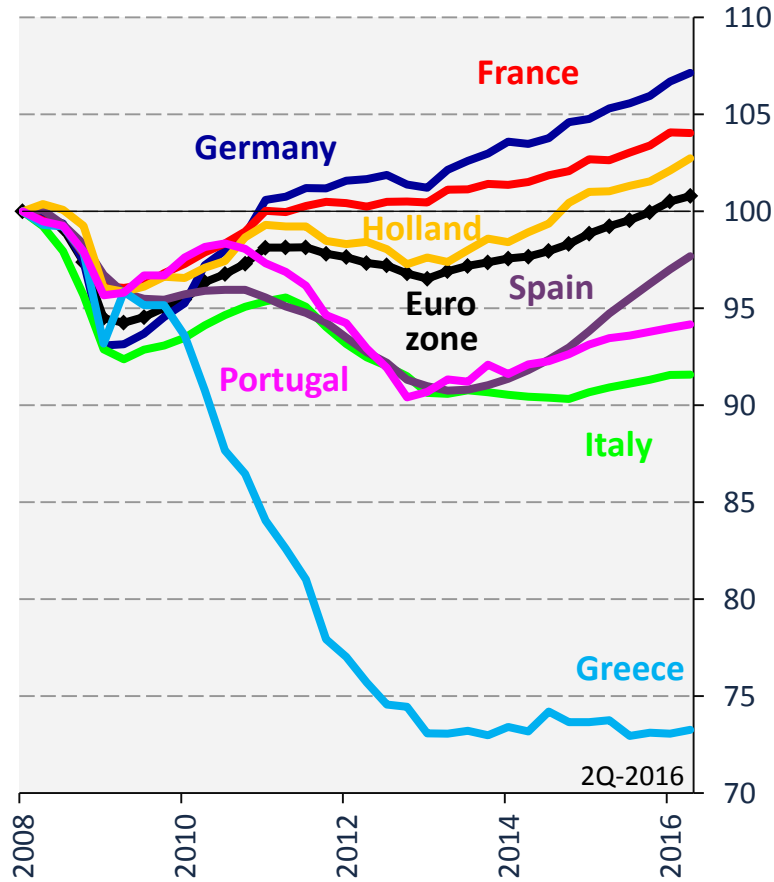


EAP/ Economically Active Population.
s. a. / Seasonally adjusted data.
Source: Bureau of Labor Statistics (BLS).

In the Euro zone, confidence indicators are still consistent with a modest growth. However, there is a concern that, in light of the United Kingdom exit from the European Union, vulnerabilities prevailing in the banking system of the region may worsen.

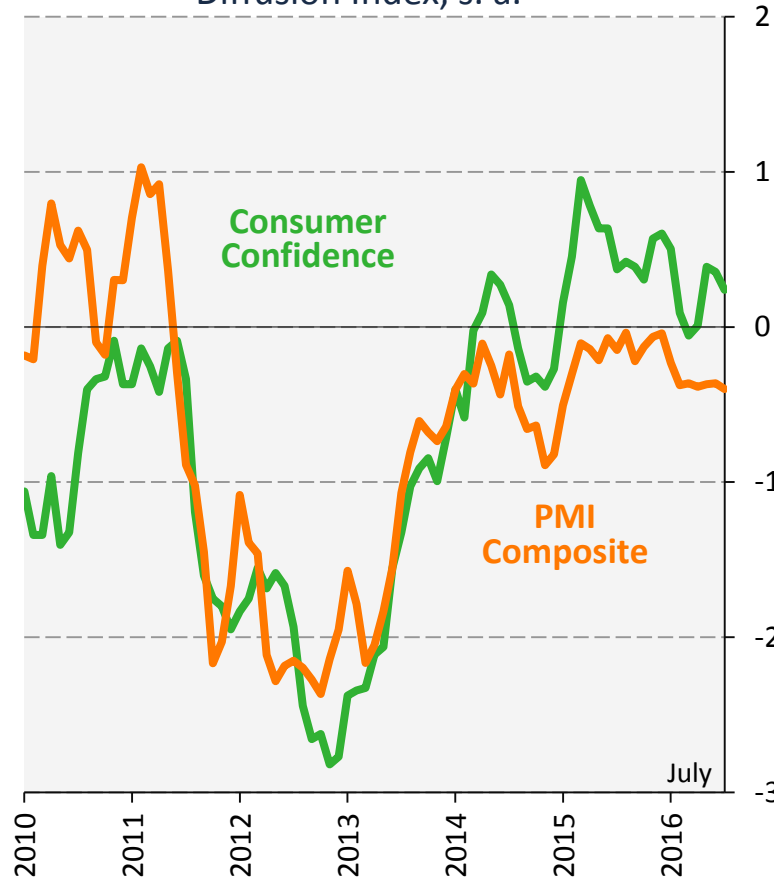
Euro Zone

Gross Domestic Product
Index 1Q-2008=100, s. a.



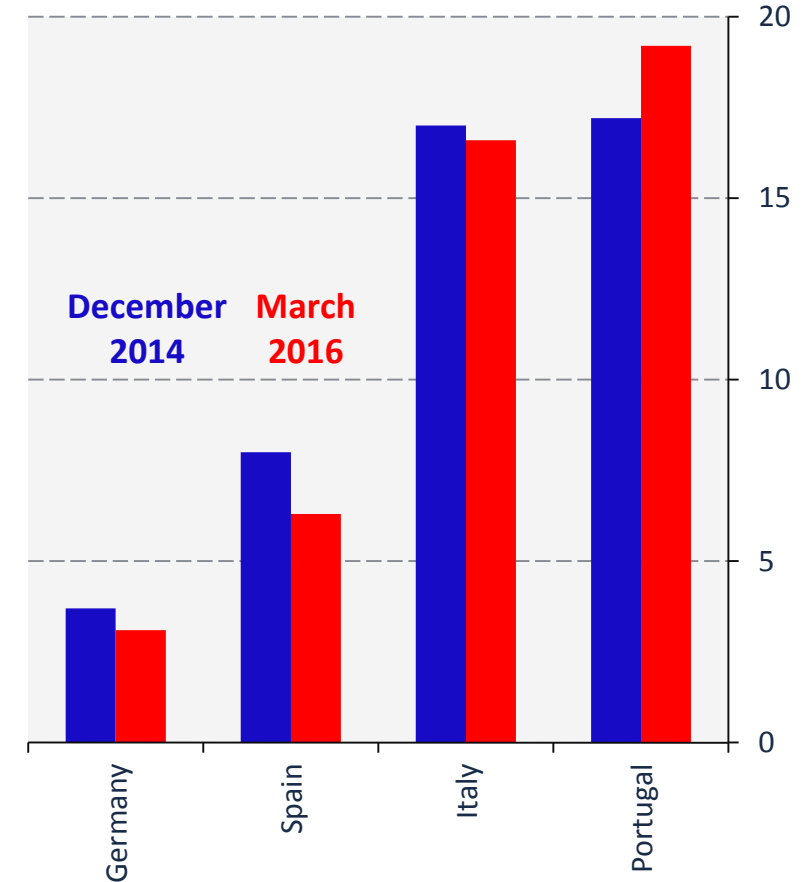
s. a. / Seasonally adjusted data.
Source: Eurostat.

Consumer Confidence and Purchasing Managers' Index 1/
Diffusion Index, s. a.



s. a. / Seasonally adjusted data.
1/ Standardized figures respect to the period 2000-2007.
Source: European Commission and Markit.

Banking System Non-Performing Loans
% of Bank loans

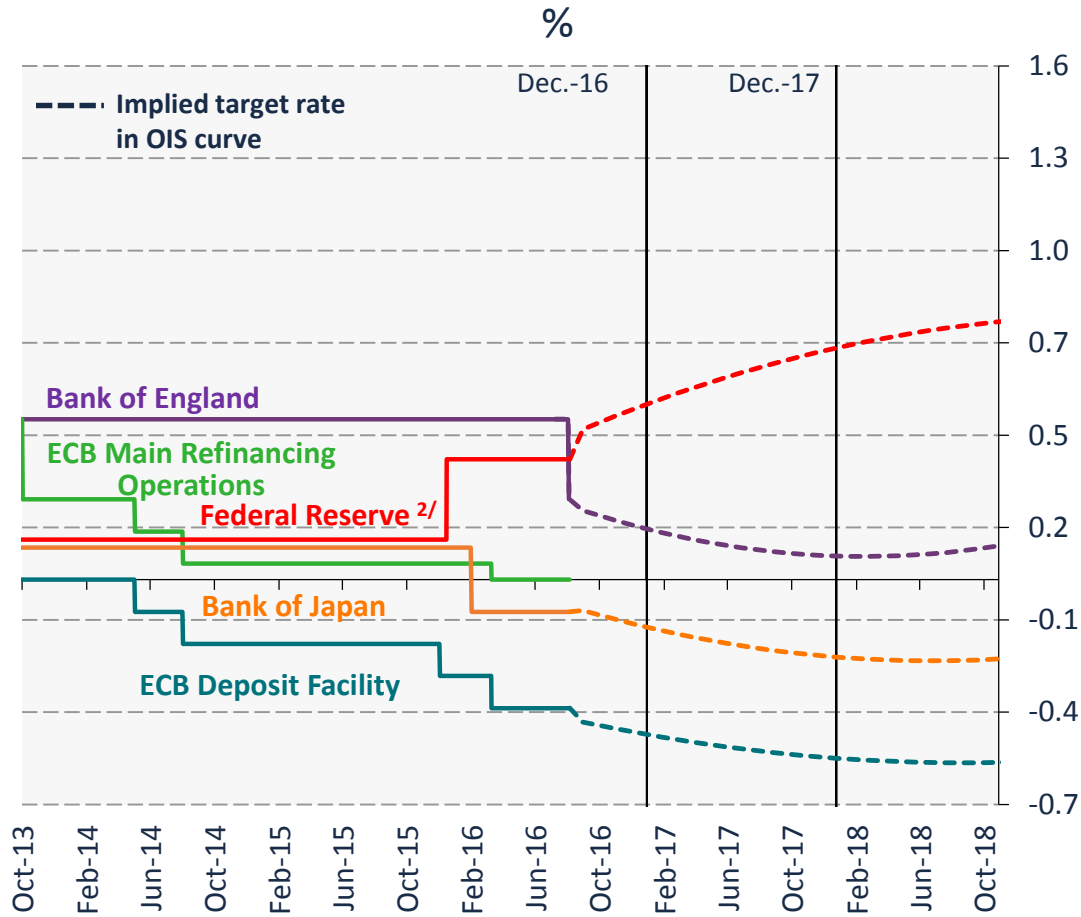


Source: European Banking Authority (EBA).

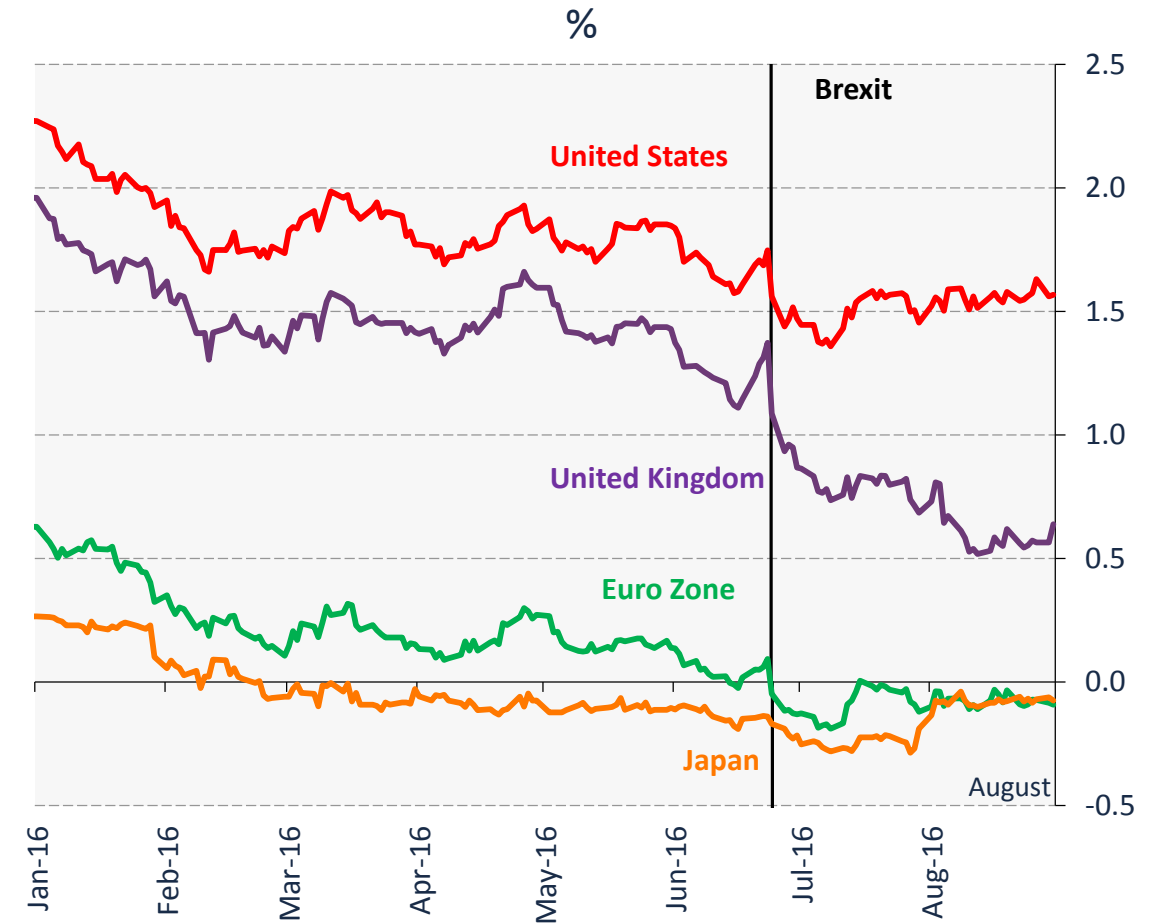
In this context, the monetary policy of the main advanced economies is expected to remain accommodative for a prolonged period. In turn, in light of some statements by Federal Reserve members, there is a higher probability that this Institution will increase its reference rate in September.

Advanced Economies

Expected Monetary Policy Rates^{1/}



10-Year Government Bond Interest Rates

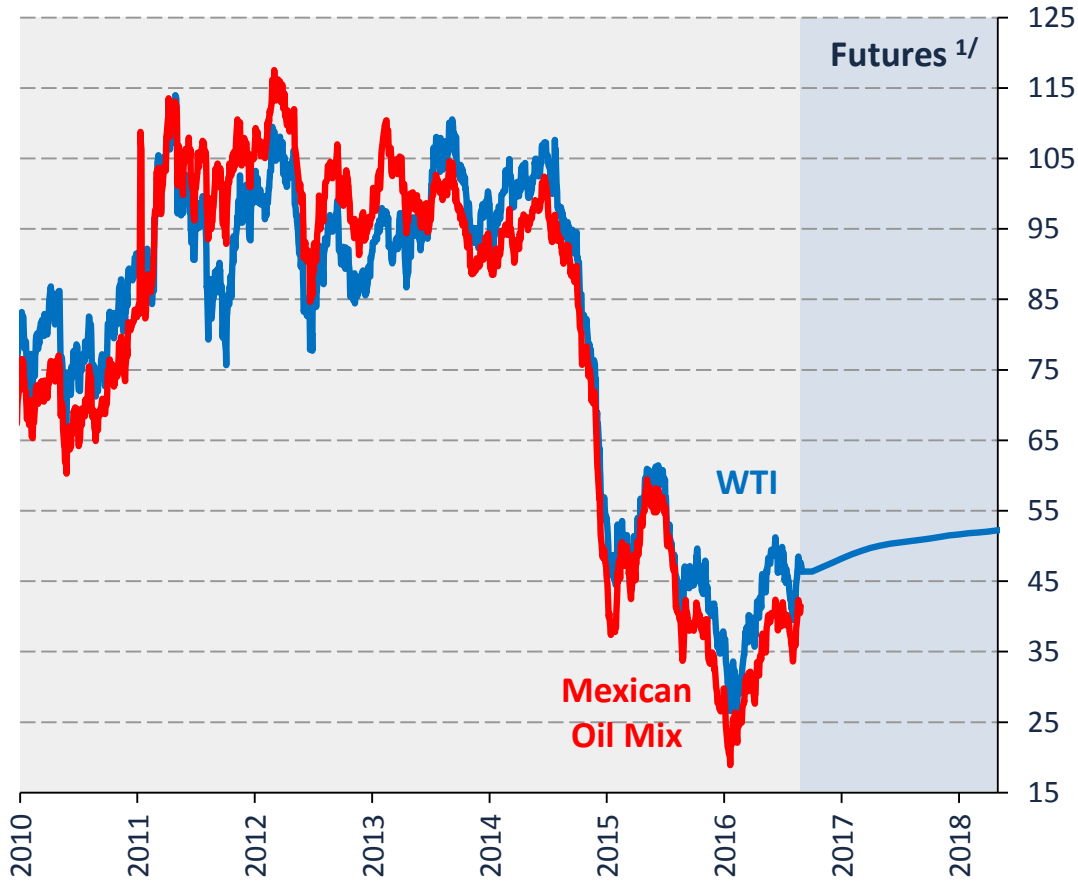


1/ OIS: Fixed-For-Floating swap where the fixed interest rate is the reference rate.
 2/ Data for the observed federal funds rate corresponds to the average between the lower and upper bounds of the range (0.5% 0.25%).
 Source: Banco de México with data from Bloomberg.

Source: Bloomberg.

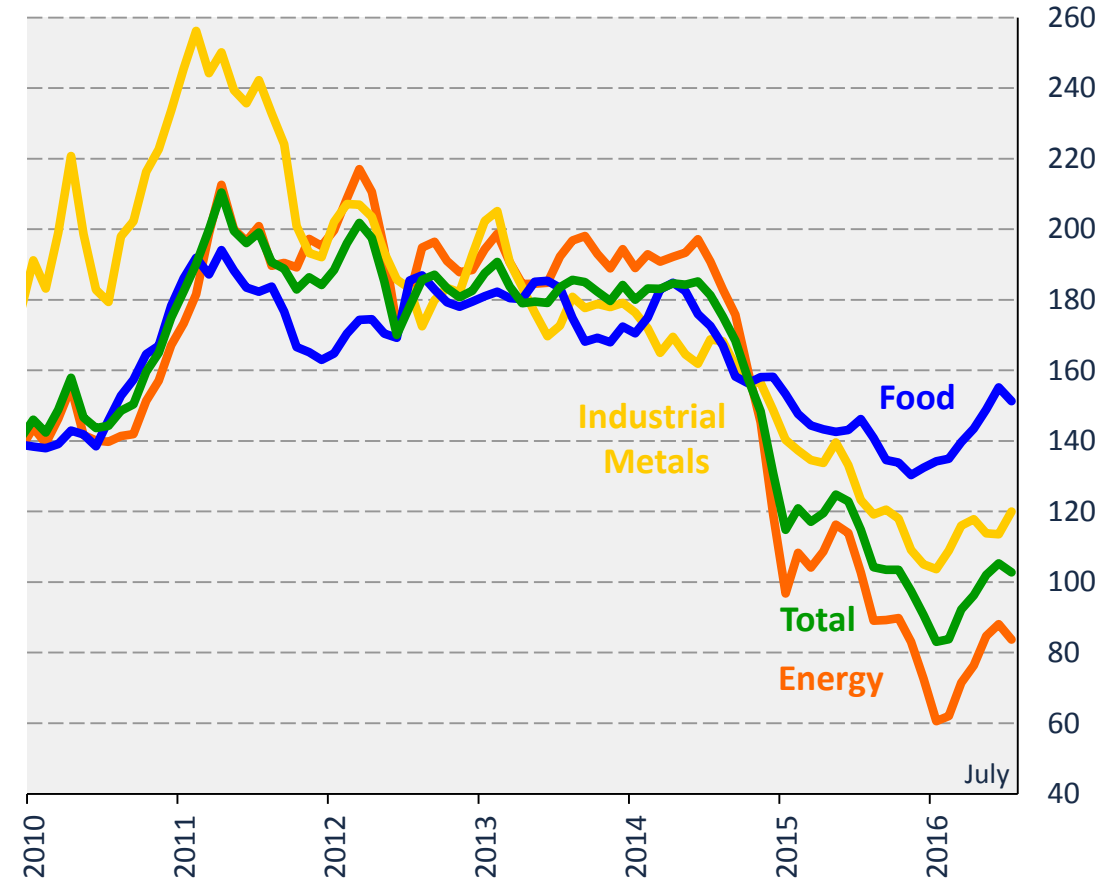
After the increments registered during most of 2Q 2016, international commodity prices decreased by the end of the reported period.

Crude Oil Prices
USD per barrel



1/ Data up to August 30, 2016.
Source: Bloomberg.

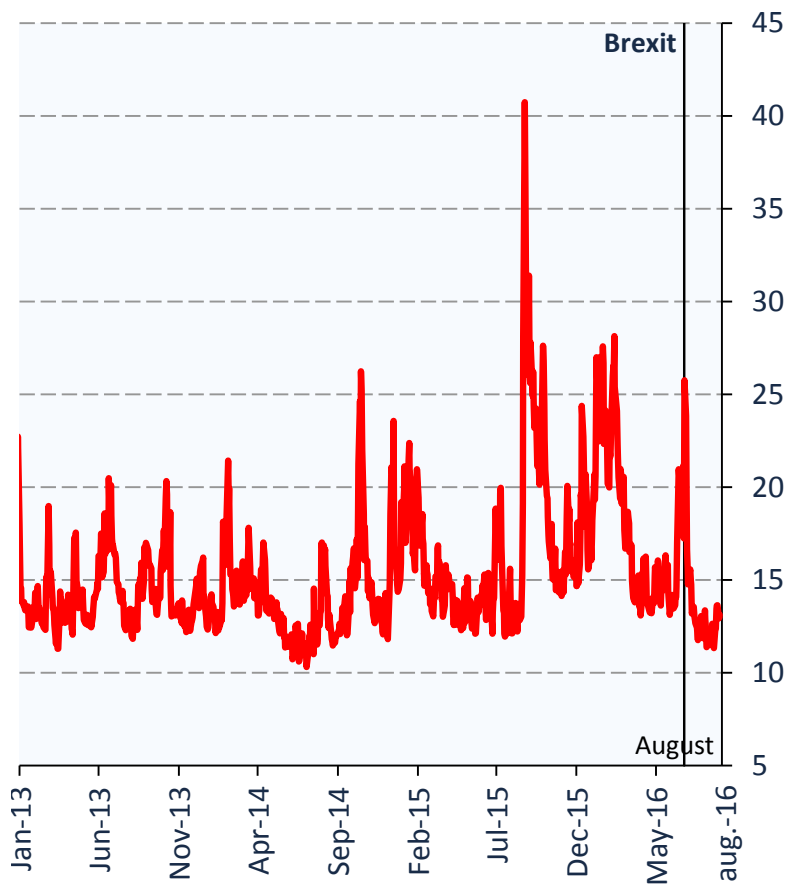
Commodities Prices
Index 2005=100



Source: International Monetary Fund.

Volatility spiked in international financial markets in late June, as an immediate consequence of the outcome of the U.K. referendum. Nonetheless, stability was quickly restored in the markets.

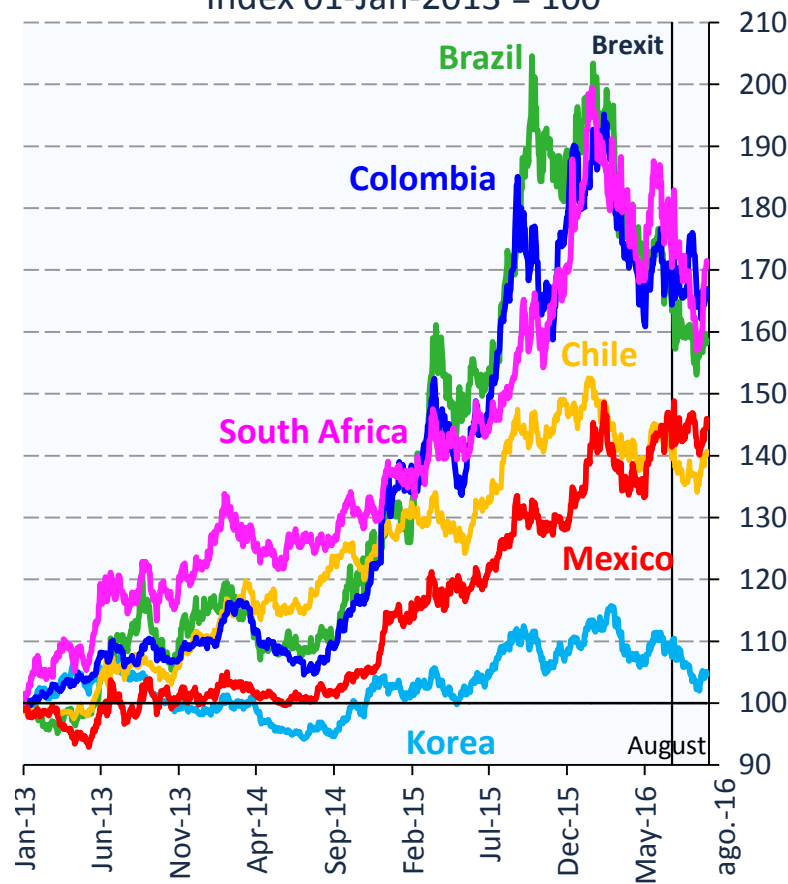
VIX Index



Source: Bloomberg.

Emerging Markets: Nominal Exchange Rate against USD

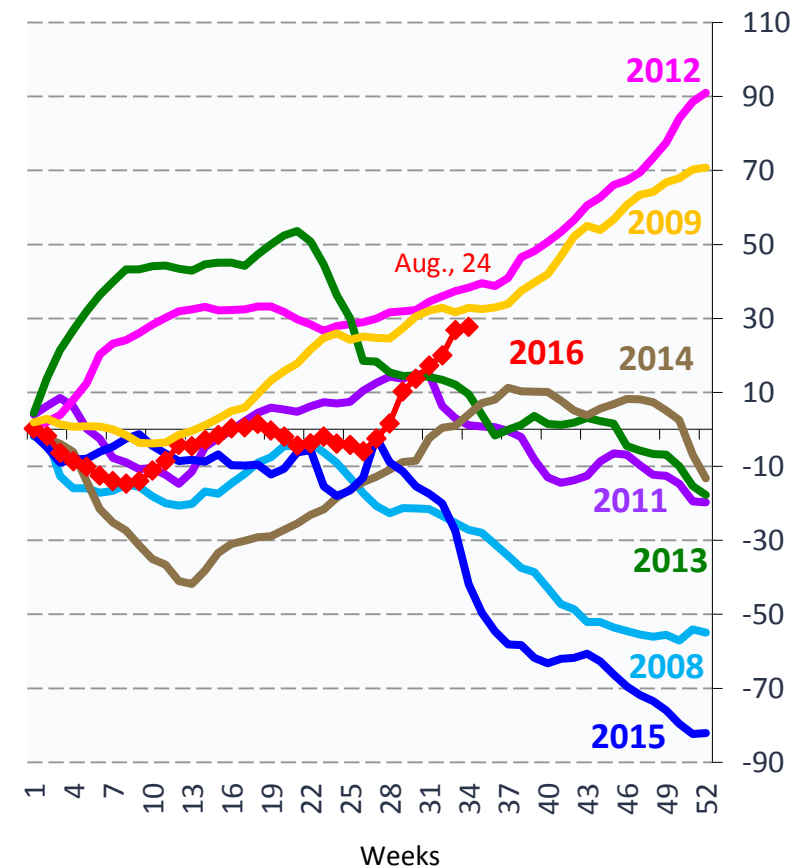
Index 01-Jan-2013 = 100



Source: Bloomberg.

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.

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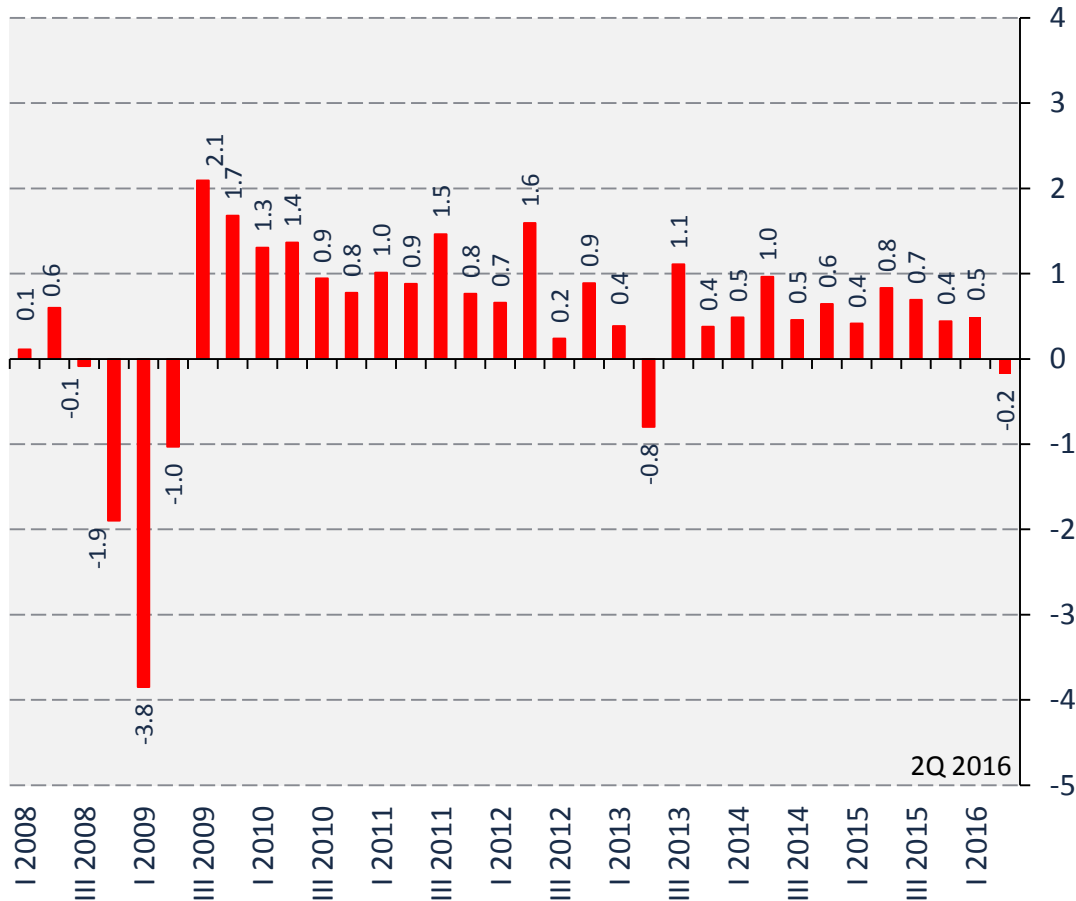
Inflation and its Determinants

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Forecasts and Balance of Risks

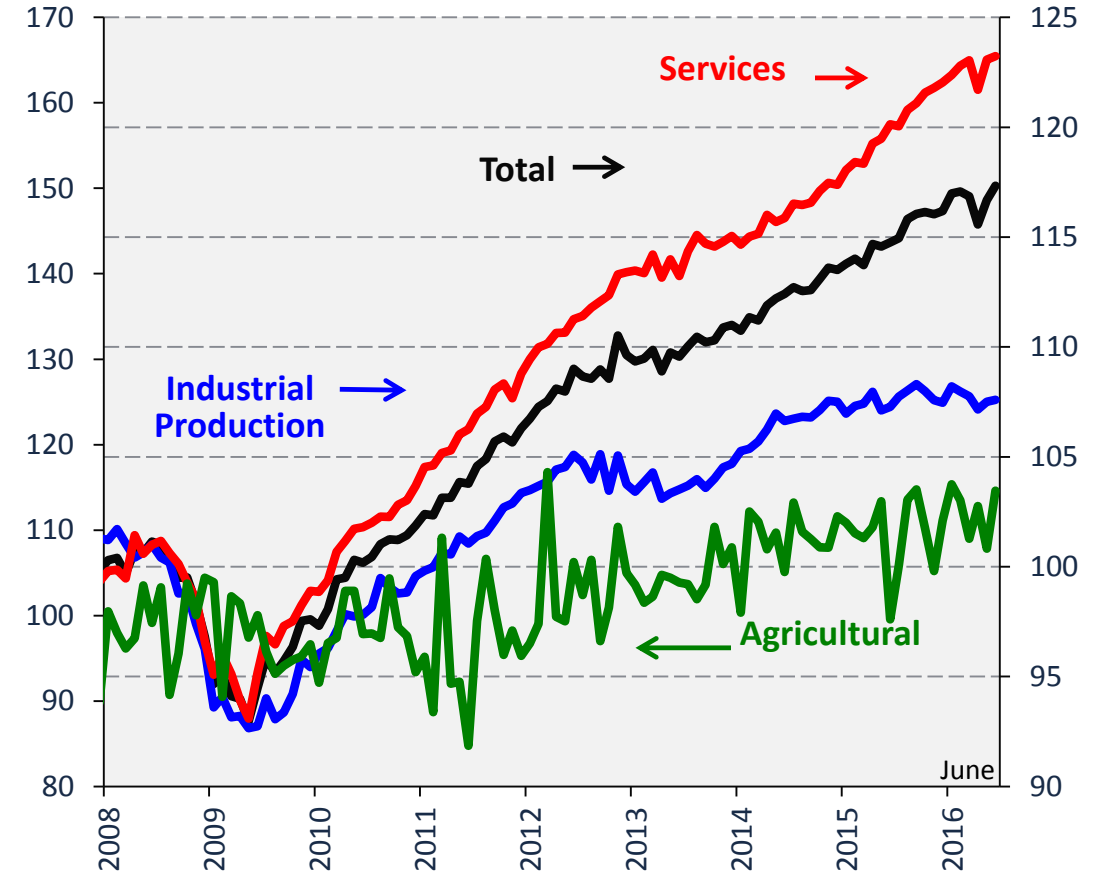
Following the expansion of the Mexican economy during 1Q 2016, it contracted in 2Q 2016.

Gross Domestic Product
Quarterly % change, s. a.



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

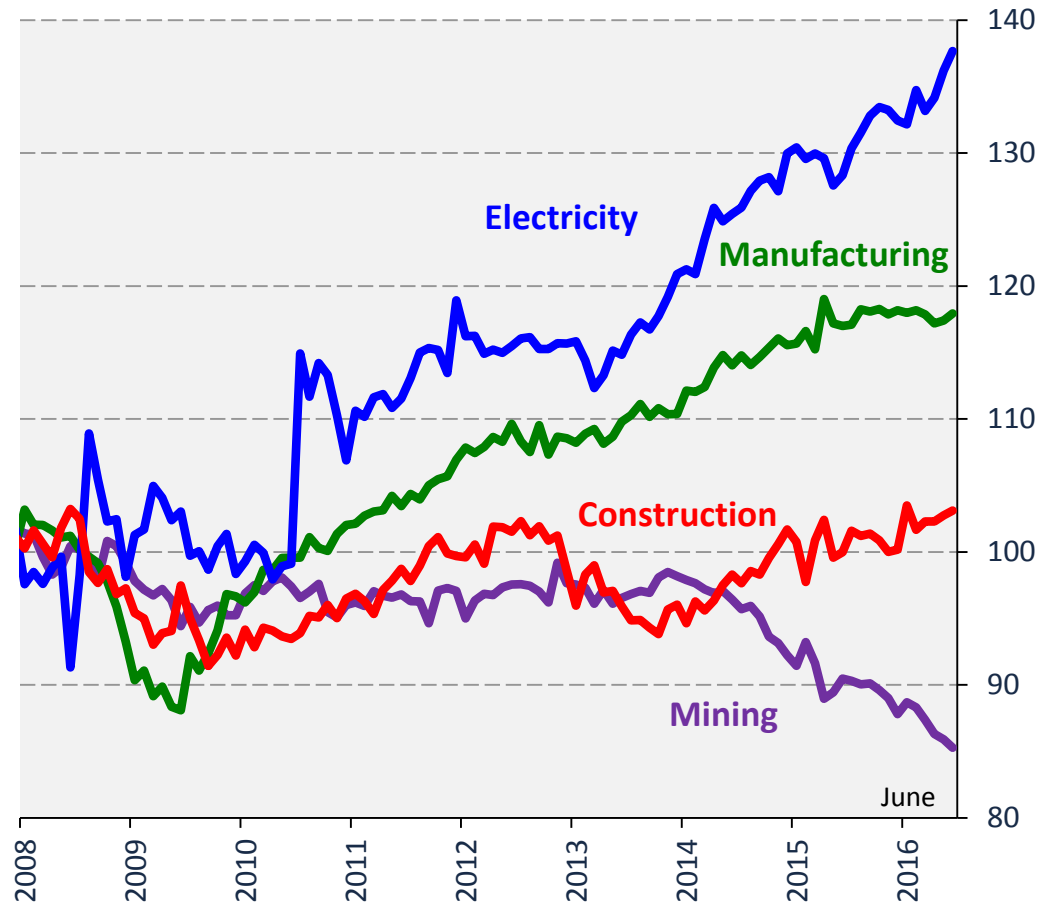
Global Indicator of Economic Activity
Index 2008=100, s. a.



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

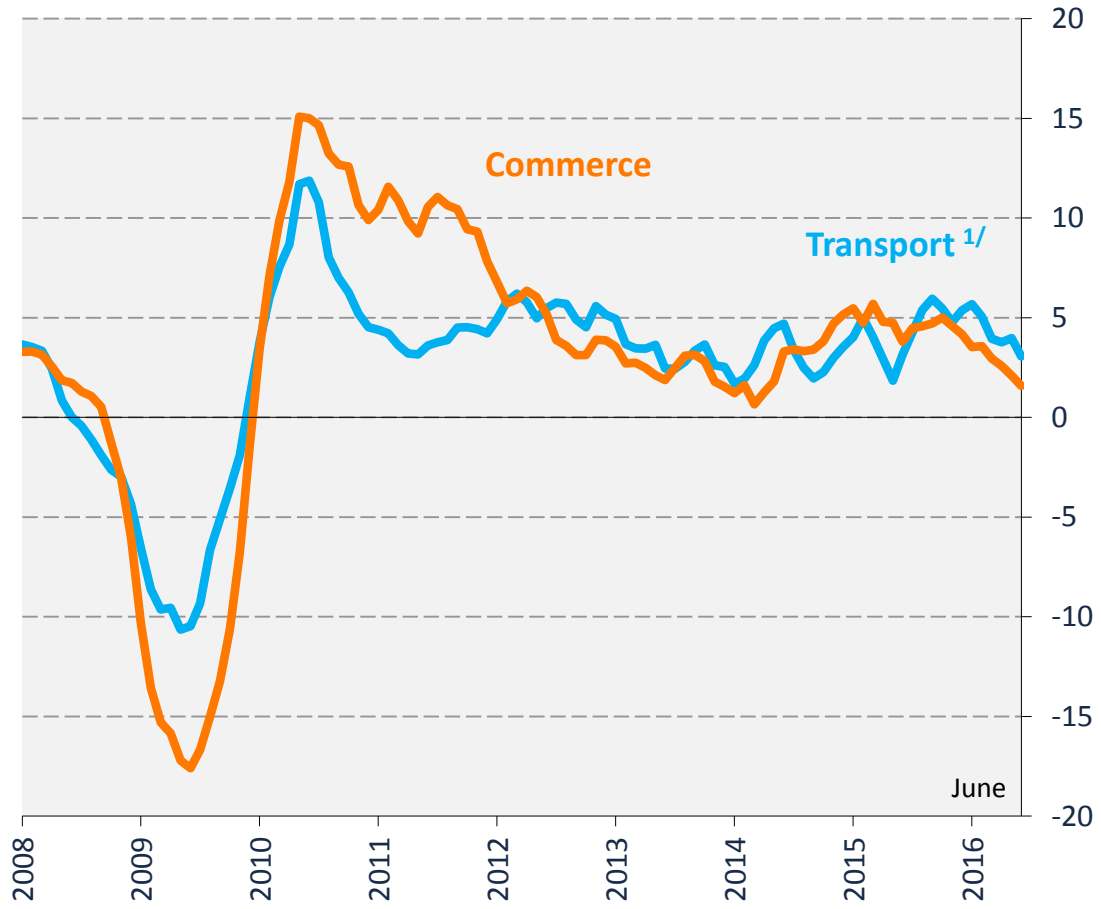
The industrial sector remained stagnated, situation that had been observed since mid-2014. On the other hand, the services stopped expanding in 2Q 2016.

Industrial Activity
Index 2008=100, s. a.



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

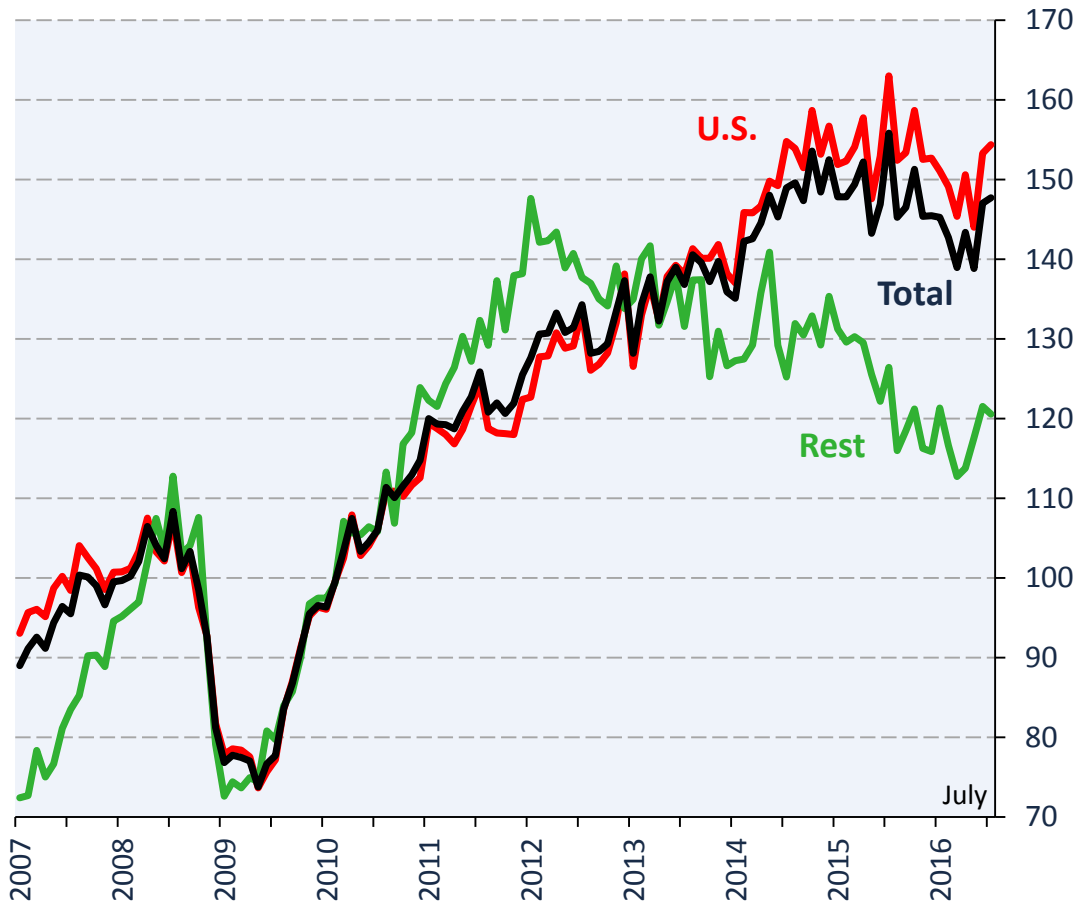
IGAE: Services Associated with the External Demand
Annual % change, s. a.



s. a. / 3-month moving average of seasonally adjusted data.
1/ Estimated by Banco de México with data from Mexico's System of National Accounts.
Source: Mexico's System of National Accounts, INEGI.

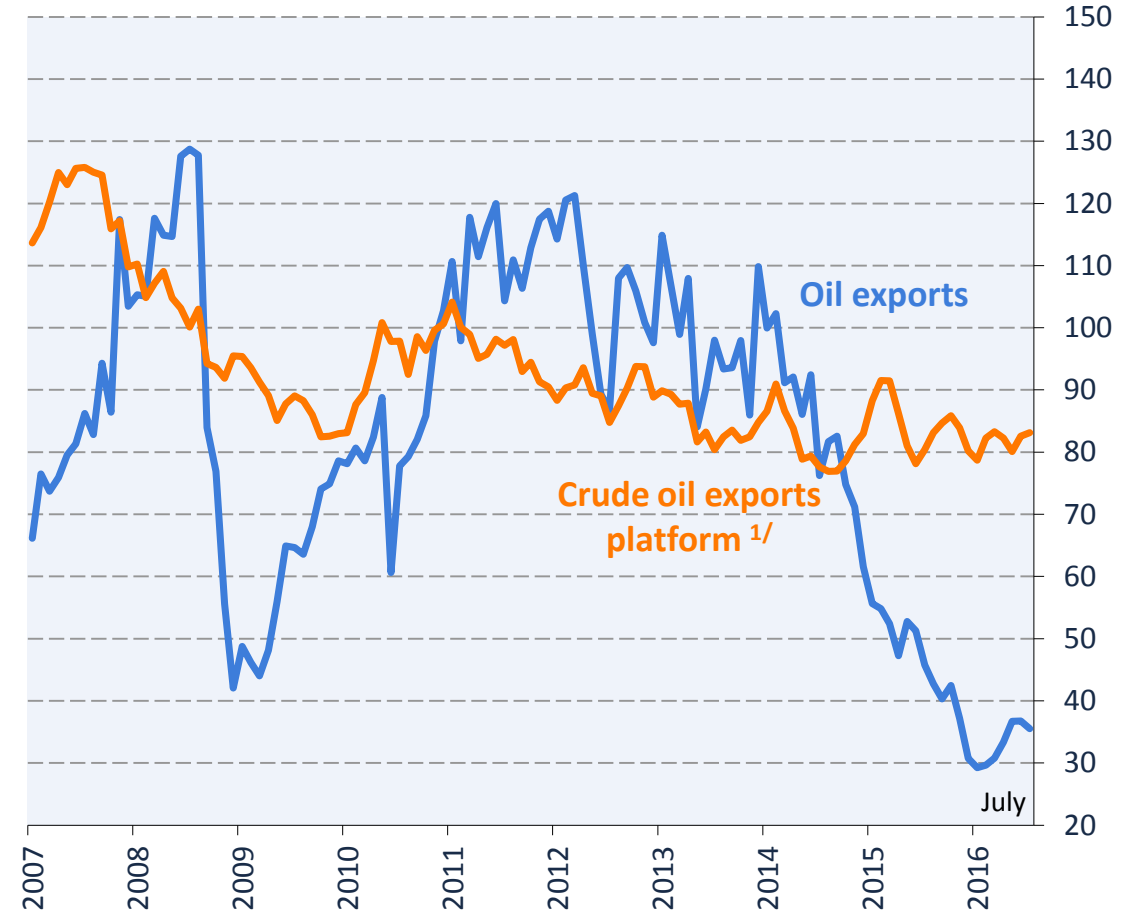
In the reported quarter, manufacturing exports kept performing poorly, while oil exports somewhat recovered, nevertheless they remain at low levels.

Manufacturing Exports
Index 2008=100, s. a.



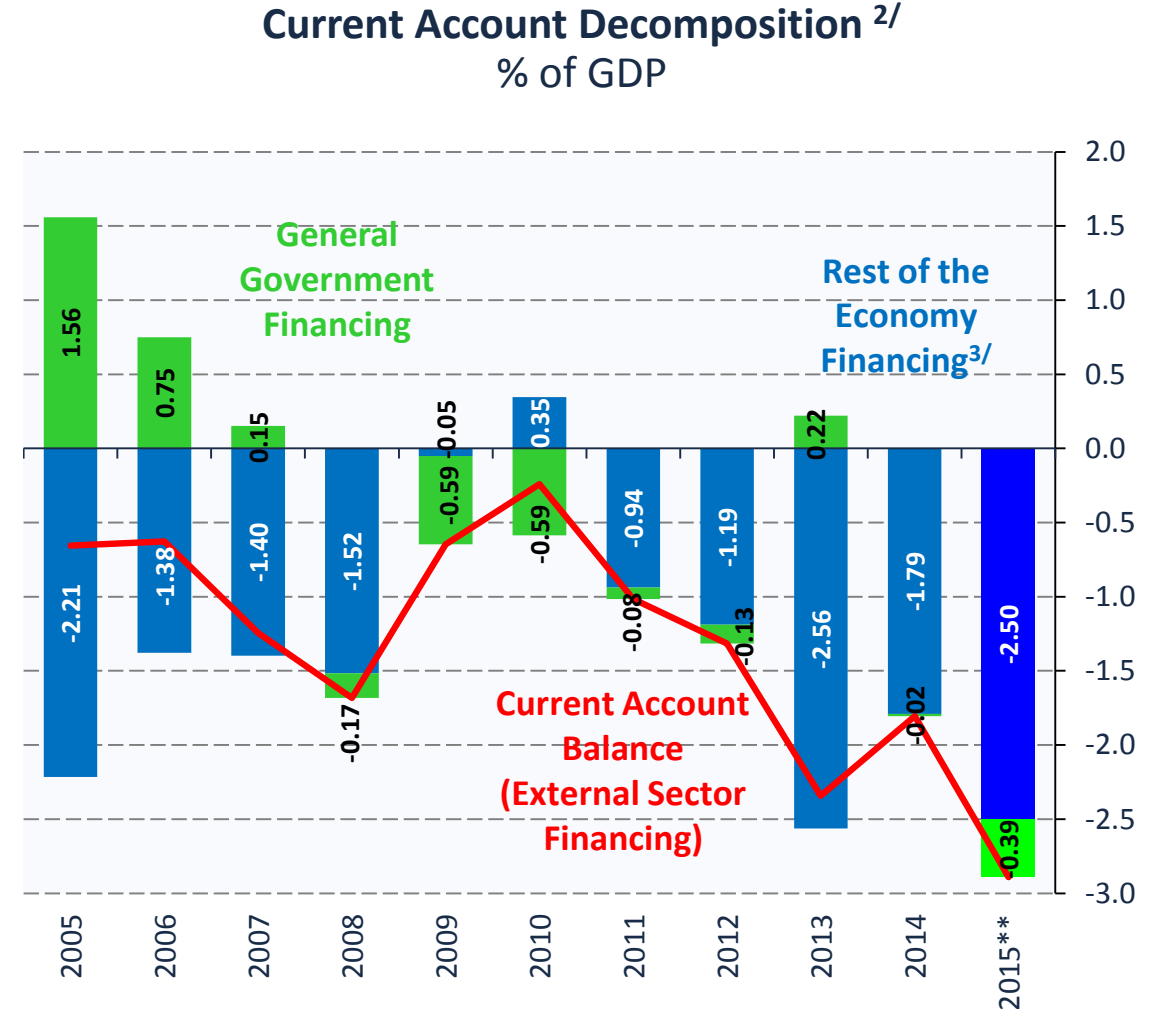
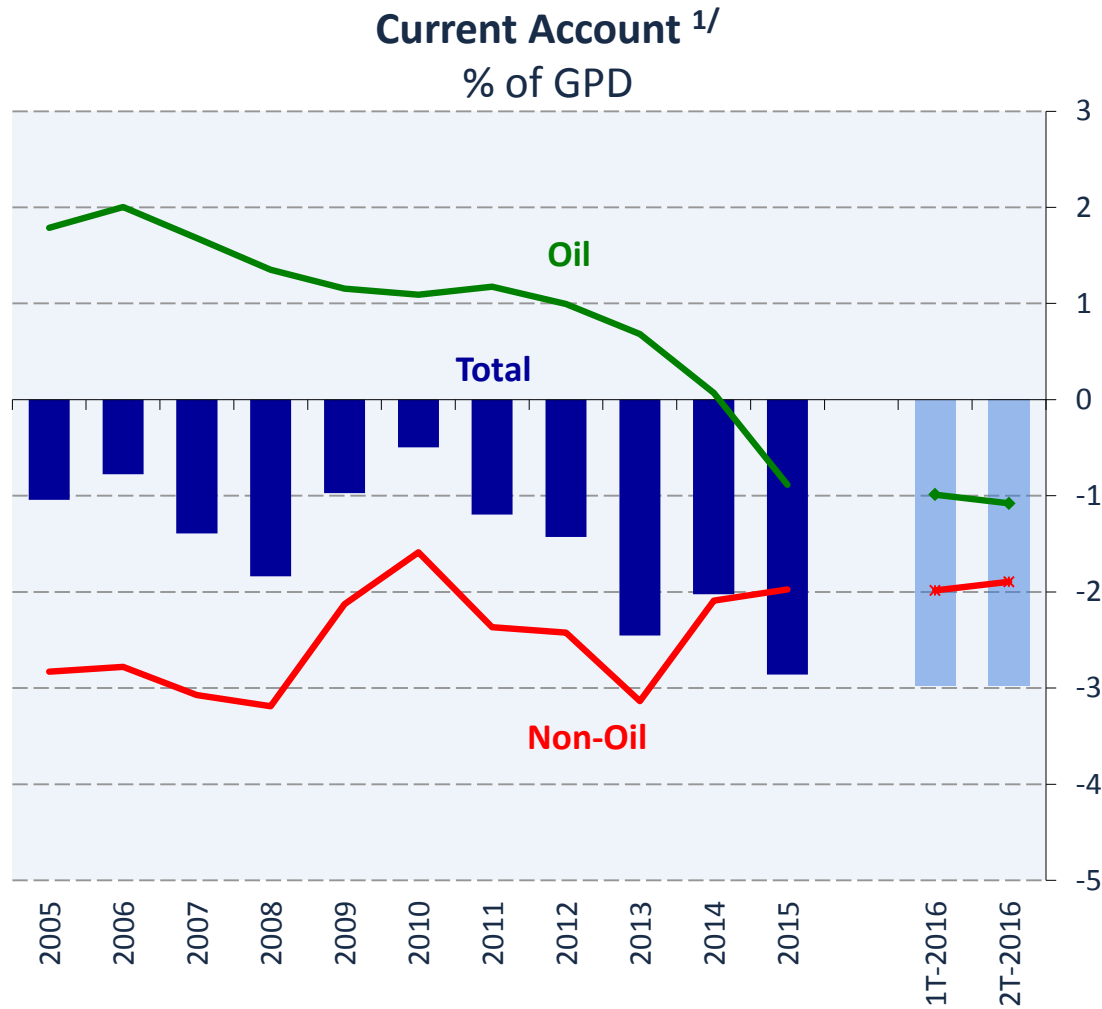
s. a. / Seasonally adjusted data based on information in nominal dollars.
Source: Banco de México with data from SAT, SE, Banco de México, INEGI. Merchandise Trade Balance, SNIEG. Information of National Interest.

Oil Exports and Crude Oil Export Platform
Index 2008=100, s. a.



s. a. / Seasonally adjusted data based on information in nominal dollars.
1/ 3-month moving average of daily barrels of the seasonally adjusted series.
Source: SAT, SE, Banco de México, INEGI. Merchandise Trade Balance SNIEG. Information of National Interest, and Banco de México with data from PMI Comercio Internacional, S.A. de C.V.

Given the nature of the shocks that generated a higher current account deficit, it would seem more efficient to contain it mainly through fiscal policy.

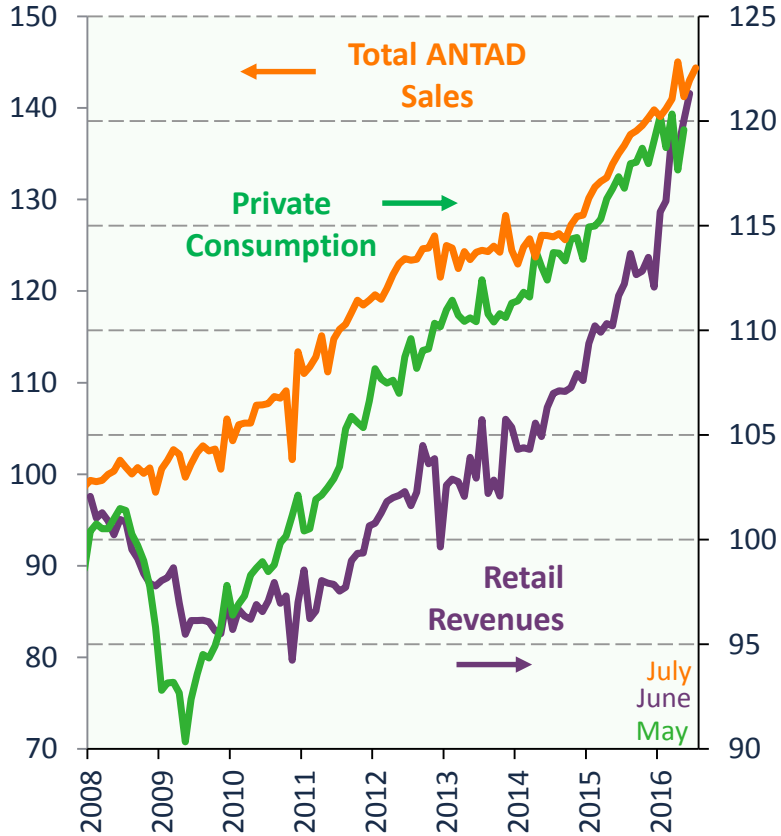


1/ For the oil current account the oil commercial balance is used, whereas the non-oil current account corresponds to the total current account excluding the oil commercial balance.
Source: Estimated by Banco de México with data from Banco de México and INEGI.

2/ Calculated with data from *Sistema de Cuentas por Sectores Institucionales*. A positive sign indicates that net loans were made, and a negative sign implicates net borrowing, except for the external financing for which signs are opposite.
3/ Includes financial and no financial public firms.
** Estimated data for 2015 based on the increase of the public balance deficit observed in that year.
Source: Elaborated by Banco de México with data from *Sistema de Cuentas Nacionales de México (SCNM)*, INEGI.

Some indicators suggest that private consumption decreased its growth rate in the analyzed period, after the dynamism exhibited in 2015 and in early 2016.

Domestic Private Consumption,^{1/} Commercial Retail Business Revenues and Total ANTAD Sales
Index 2008 = 100; s. a.

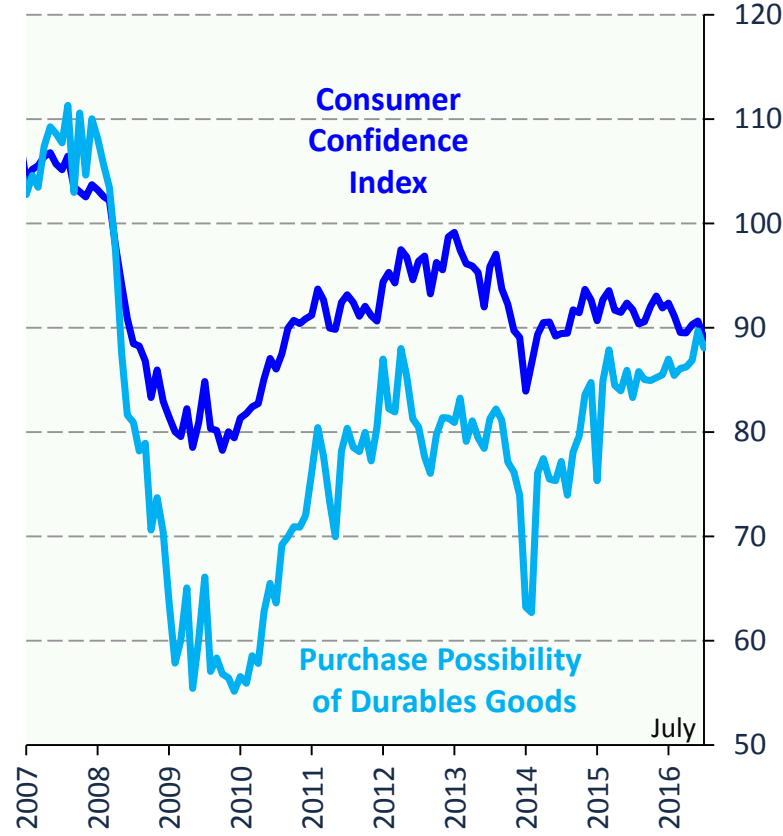


s. a. / Seasonally adjusted data.

1/ The Monthly Indicator of Private Consumption measures the performance of spending by resident households in the country on consumer goods and services of national and external origin. It does not include net purchases in foreign markets and imported services.

Source: Elaborated by Banco de México with data from ANTAD, EMEC and SCNM, INEGI.

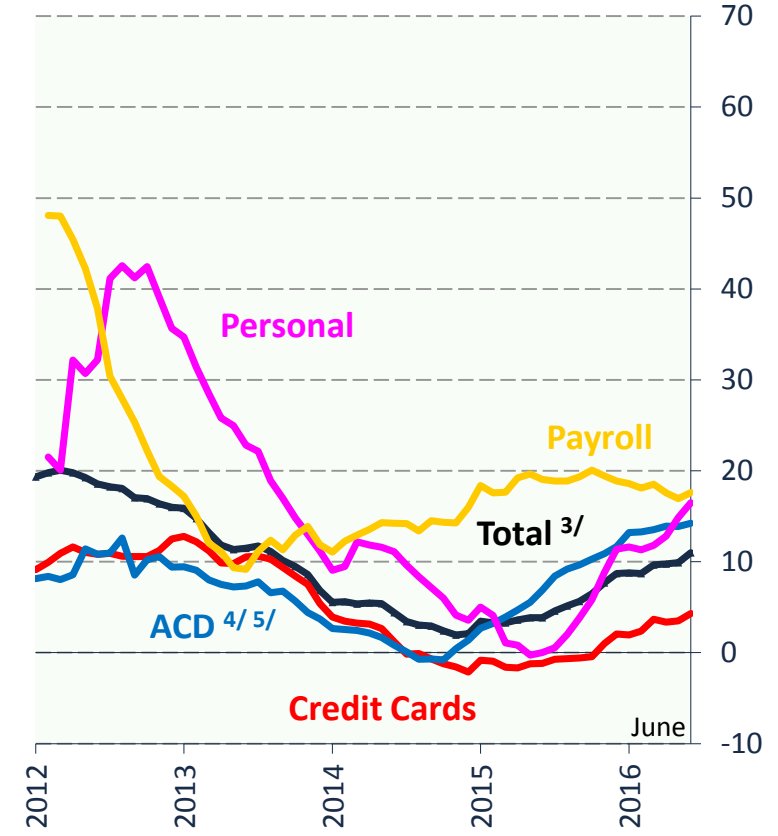
Consumer Confidence
Index Jan-2003 = 100; s. a.



s. a. / Seasonally adjusted data.

Source: National Consumer Confidence Survey (ENCO), INEGI and Banco de México.

Commercial Banks' Consumer Performing Credit ^{2/}
Real annual % change



2/ It includes the Sofomes ER subsidiaries of bank institutions and financial groups.

3/ It includes credit for payable leasing operations and other consumer credits.

4/ From July 2011 onwards, figures are adjusted in order to avoid distortions due to the reclassification from acquisition of consumer durables to other consumer credits by one banking institution.

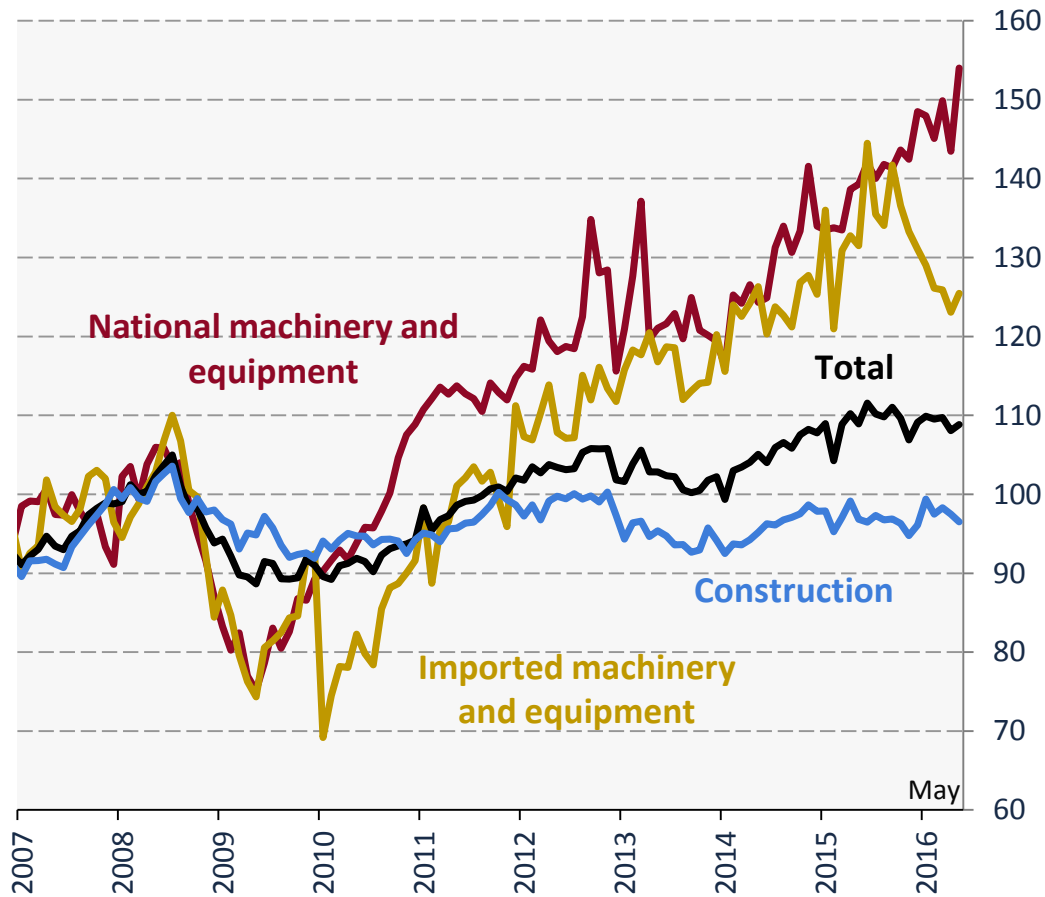
5/ It includes credit for movable property acquisition and auto loans.

Source: Banco de México.

In early 2Q 2016, gross fixed investment showed a certain downward trend.

Investment and its Components

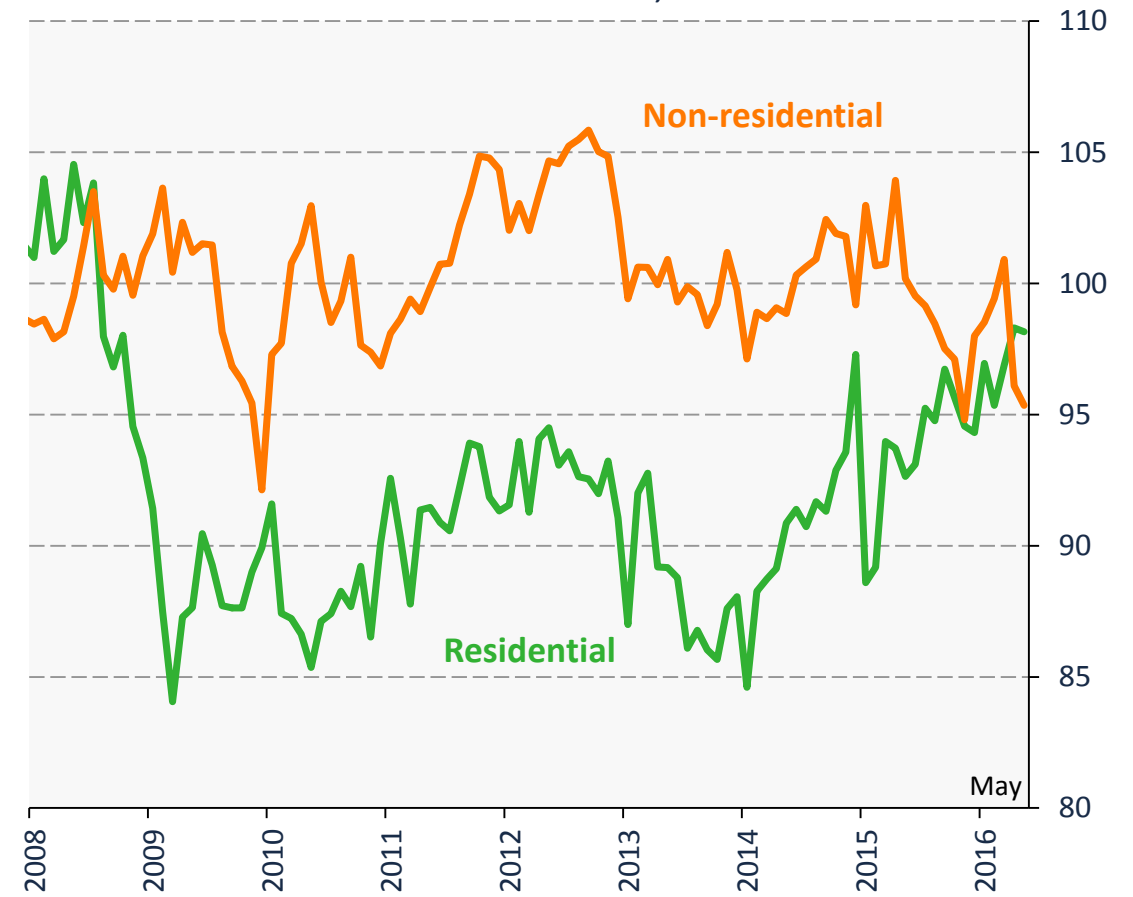
Index 2008=100, s. a.



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

Investment in Residential and Non-residential Construction

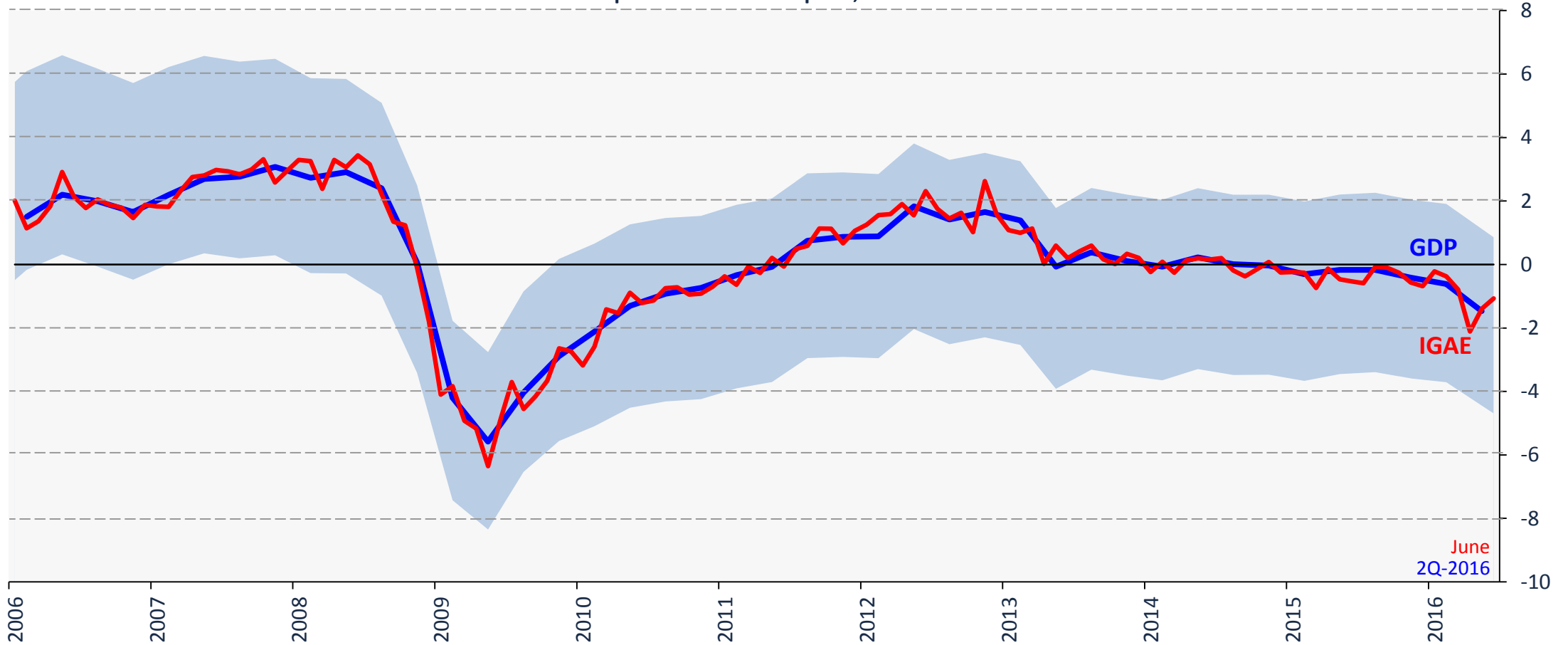
Index 2008=100, s. a.



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

In this context, the output gap seems to have remained negative.

Output Gap ^{1/}
% of potential output, s. a.



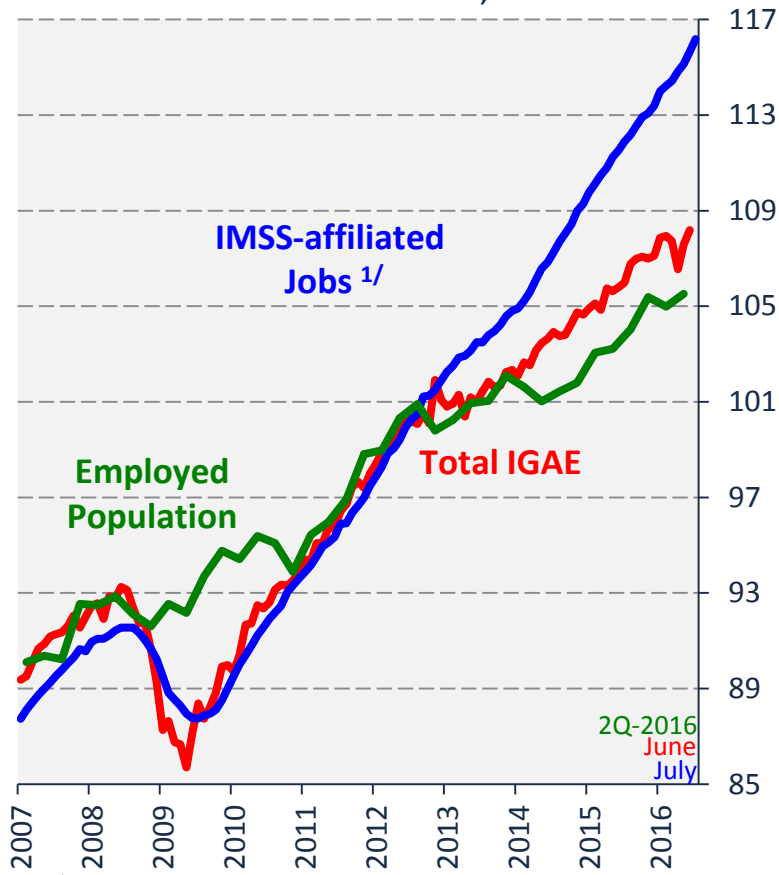
s. a. / Calculated with seasonally adjusted data.

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.

The main labor market indicators in 2Q 2016 send mixed signals regarding its evolution, although, in general, labor market's conditions seem to have continued improving gradually.

IMSS-Insured Jobs, Employed Population and Total IGAE
Index 2012=100, s. a.



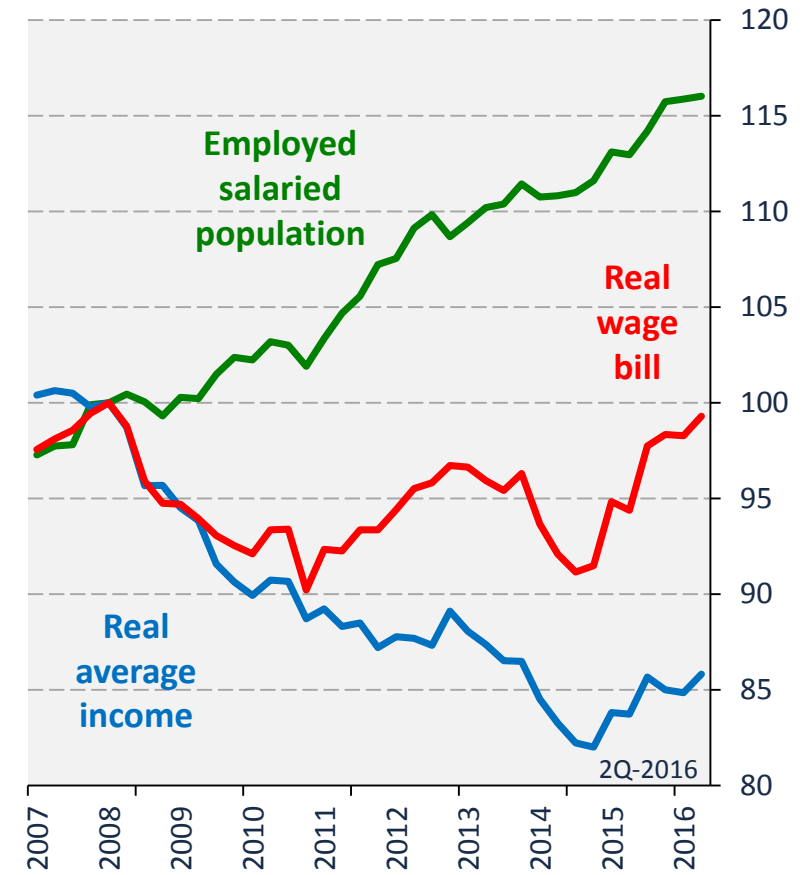
s. a. / Seasonally adjusted data.
1/ Permanent and temporary workers in urban areas. Seasonally adjusted by Banco de México.
Source: Calculated by Banco de México with data from IMSS and INEGI (SCNM and ENOE).

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.

Real Total Wage Bill
Index 1Q-2008 = 100, s. a.



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

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1 Monetary Policy

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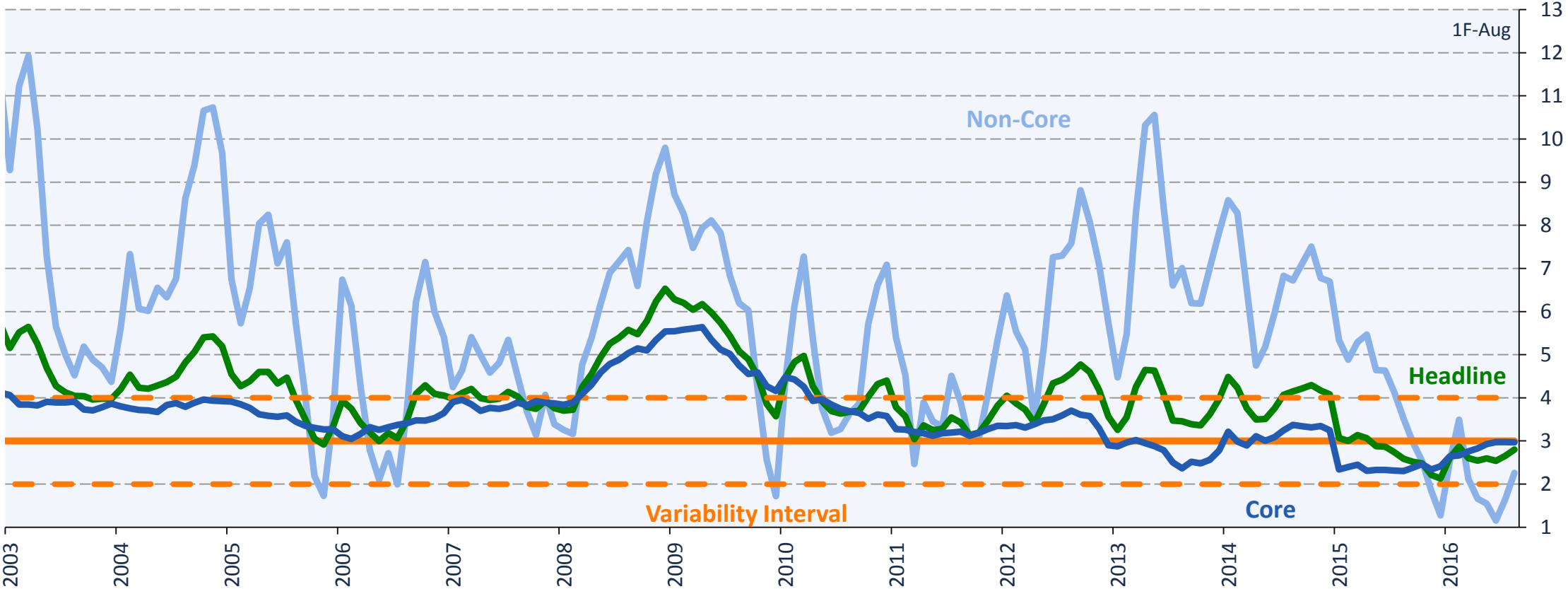
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Inflation persisted at levels below the permanent target, accumulating as of the 1st fortnight of August over 15 consecutive months under 3 percent. To this evolution contributed the good performance of both, its core and non-core components.

Consumer Price Index Annual % change

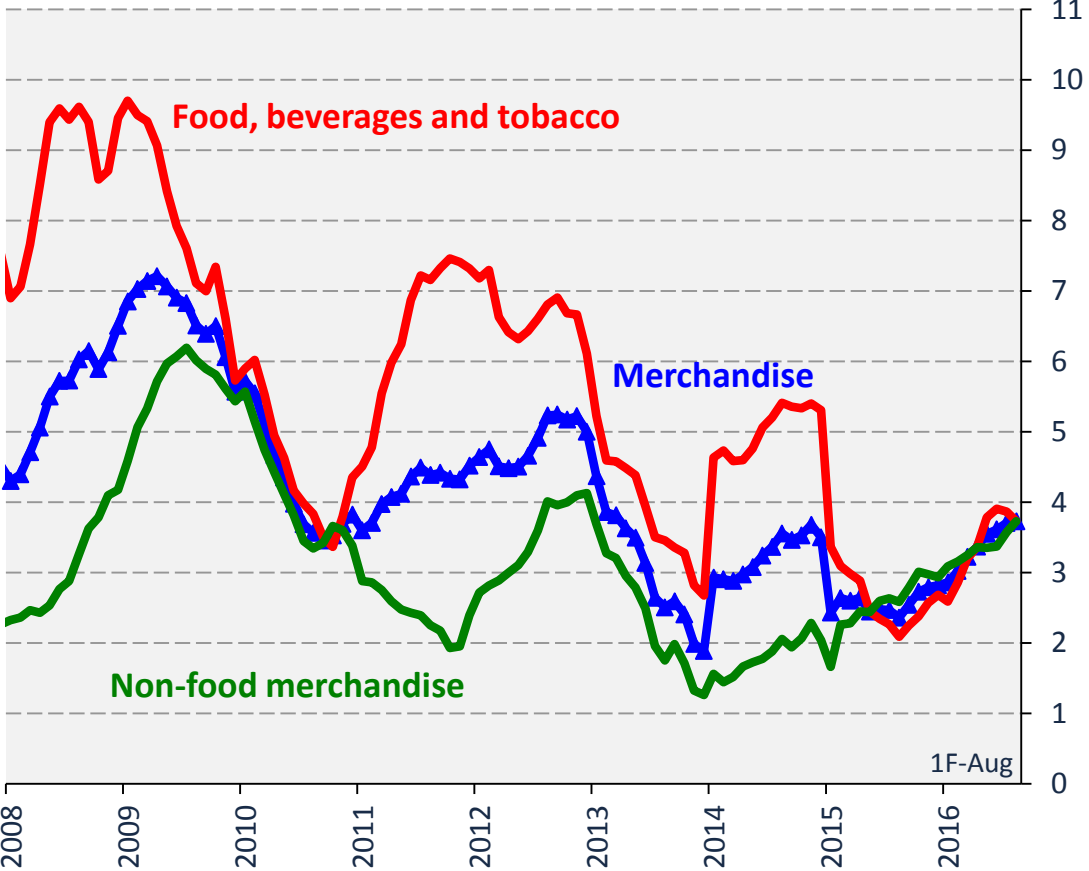


Source: Banco de México and INEGI.

The evolution of core inflation largely derived from an adjustment in the relative prices of merchandise with respect to those of services, reflecting the effect of the exchange rate depreciation.

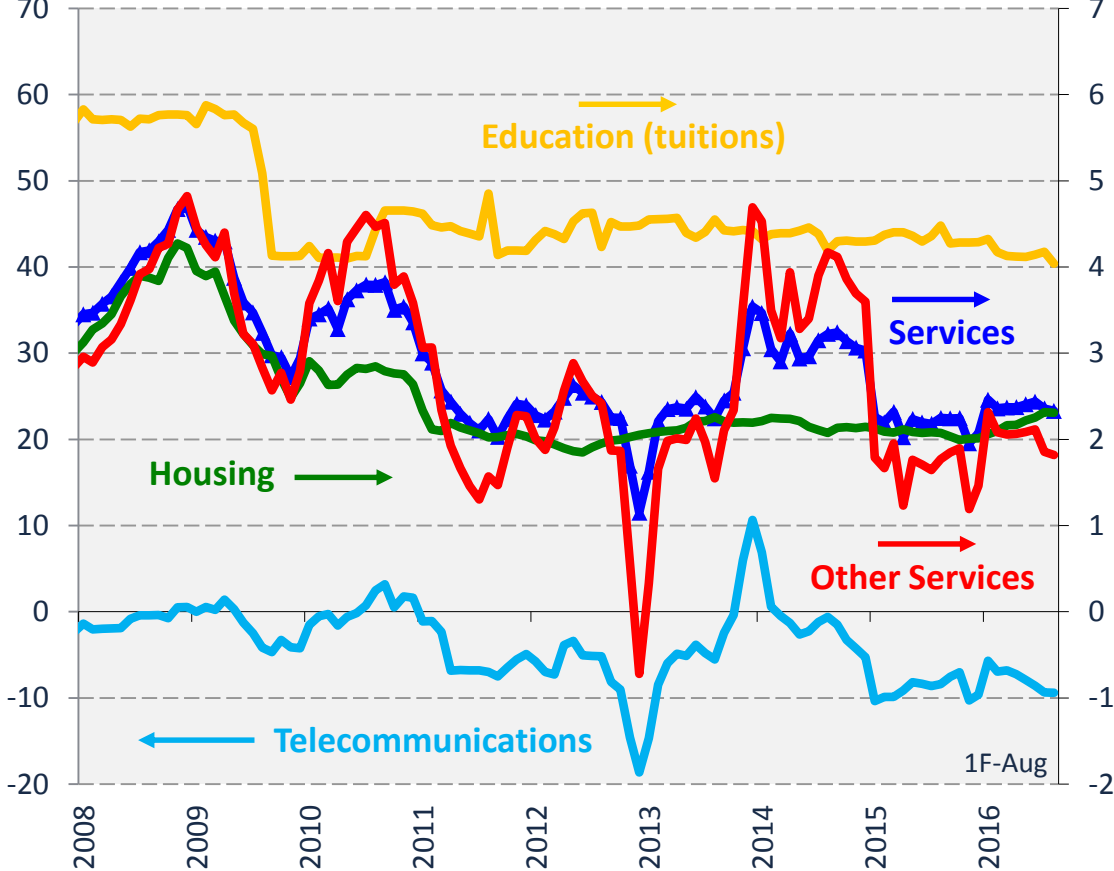
Core Price Index
Annual % change

Merchandise



Source: Banco de México and INEGI.

Services

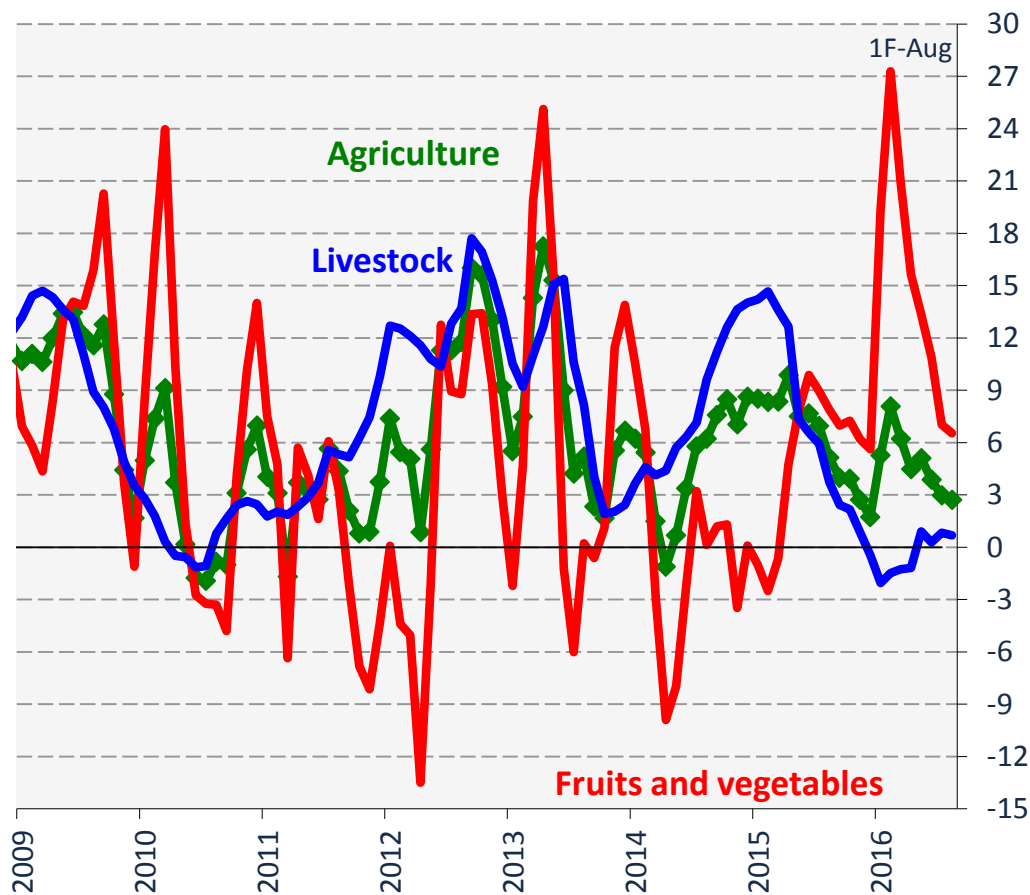


Source: Banco de México and INEGI.

The performance of the non-core component reflects the decrease in the growth rate of agricultural products' prices, while negative annual growth rates of the energy price subindex accentuated.

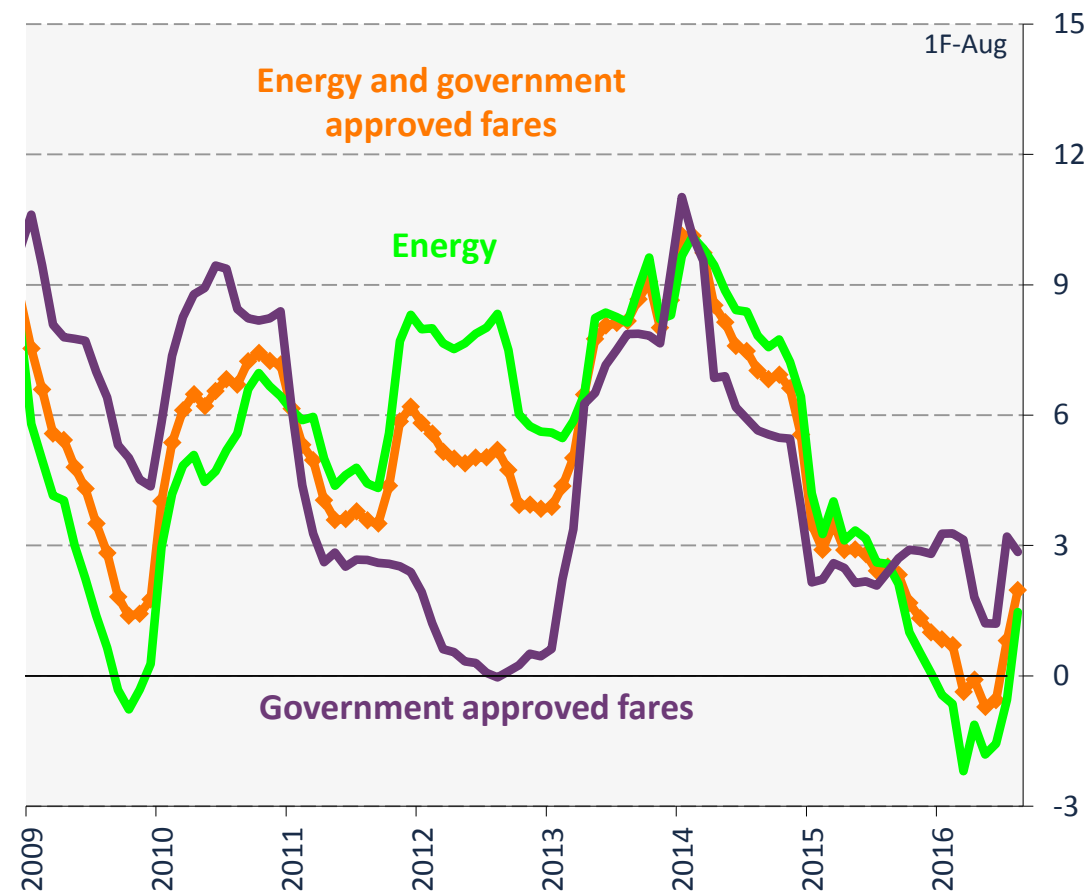
Non-Core Index
Annual % change

Agriculture



Source: Banco de México and INEGI.

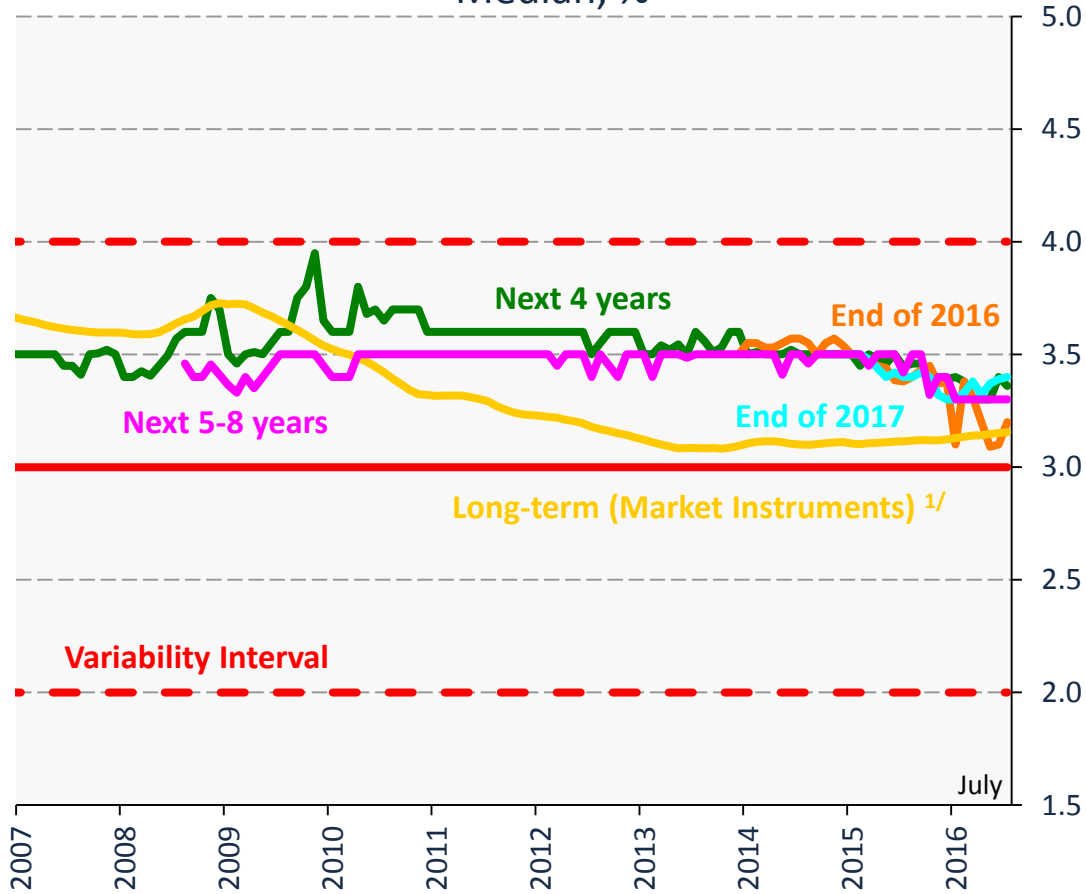
Energy and Government Approved Fares



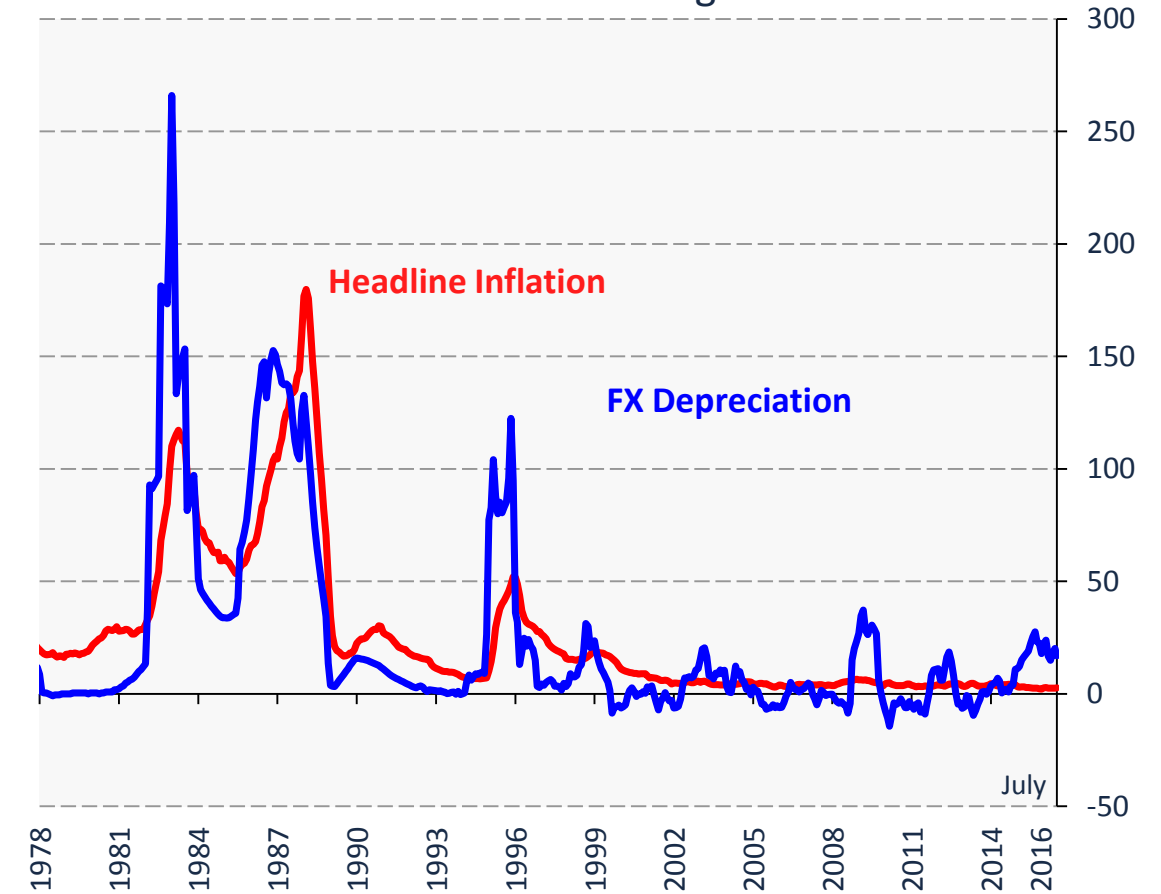
Source: Banco de México and INEGI.

Long-term inflation expectations remain stable, in a context in which no second-round effects on the price-setting process of the economy, derived from the impact of the exchange rate fluctuation, were observed.

Headline Inflation Expectations for Different Terms
Median, %



Headline Inflation and Nominal Depreciation Rate
Annual % change

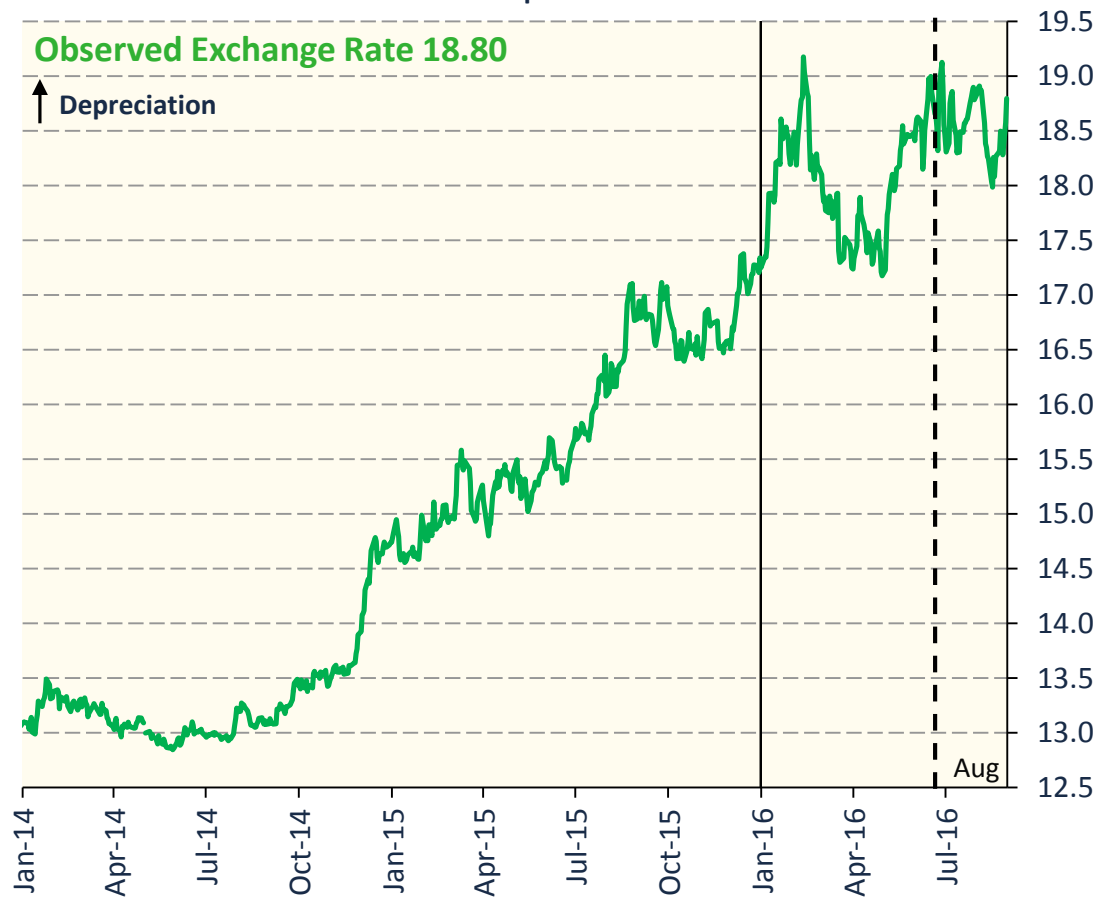


Source: Banco de México and INEGI.

1/ For a description of the estimation of log-term inflation expectations, see the Box "Decomposition of Break-even Inflation" in the Quarterly Report, October – December 2013. For the current Report, the estimate was updated by including data as of December 2015.
Source: Banco de México.

The national currency depreciated significantly, and its volatility increased in 2Q 2016.

Nominal Exchange Rate ^{1/} Pesos per USD



1/ Refers to FIX Exchange rate. Data up to August 30, 2016. The black vertical line indicates January 1, 2016 and the dotted line indicates June 30, 2016.
Source: Banco de México.

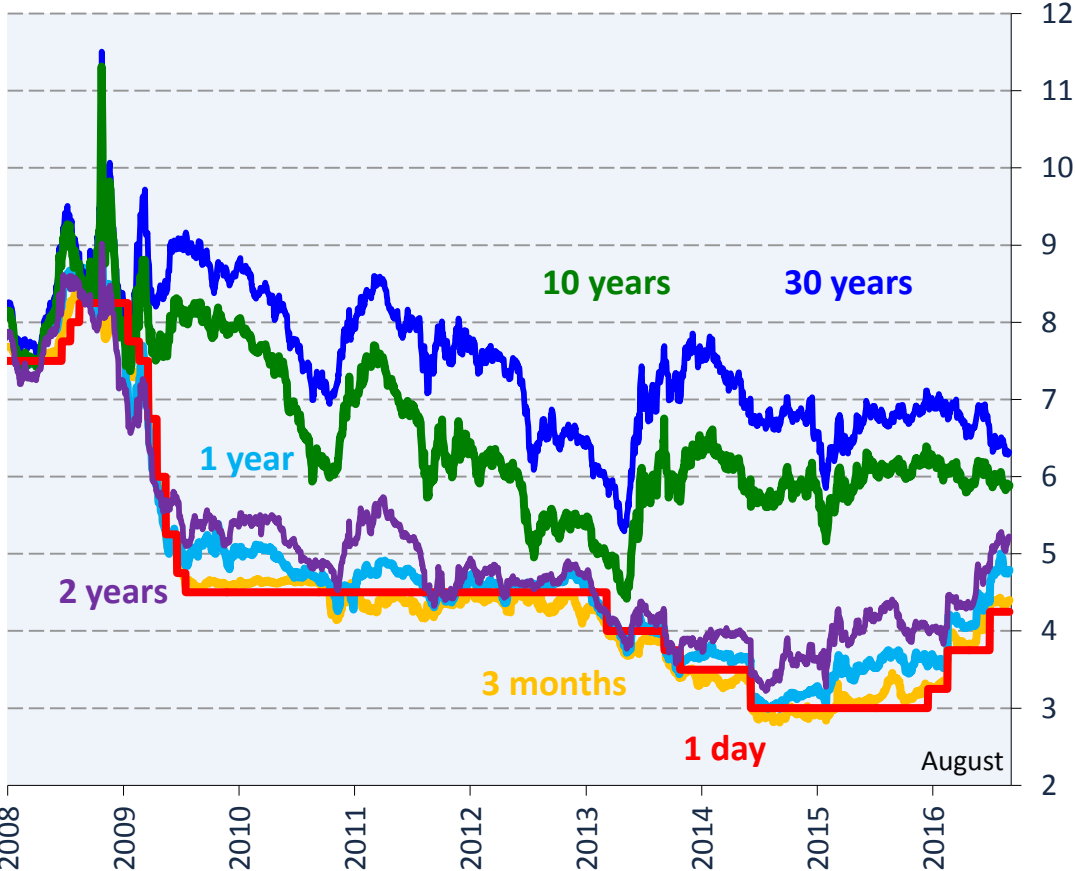
Currency Option Implied Volatility ^{2/} %



2/ Currency option implied volatility refers to one-month options. The black vertical line indicates January 1, 2016 and the dotted lines indicates June 30, 2016.
Source: Bloomberg.

In view of the June monetary policy adjustment, as expected a flattening of the yield curve was observed, as this action induced an increment in the cost of money in the short term, while inflation expectations remained well-anchored.

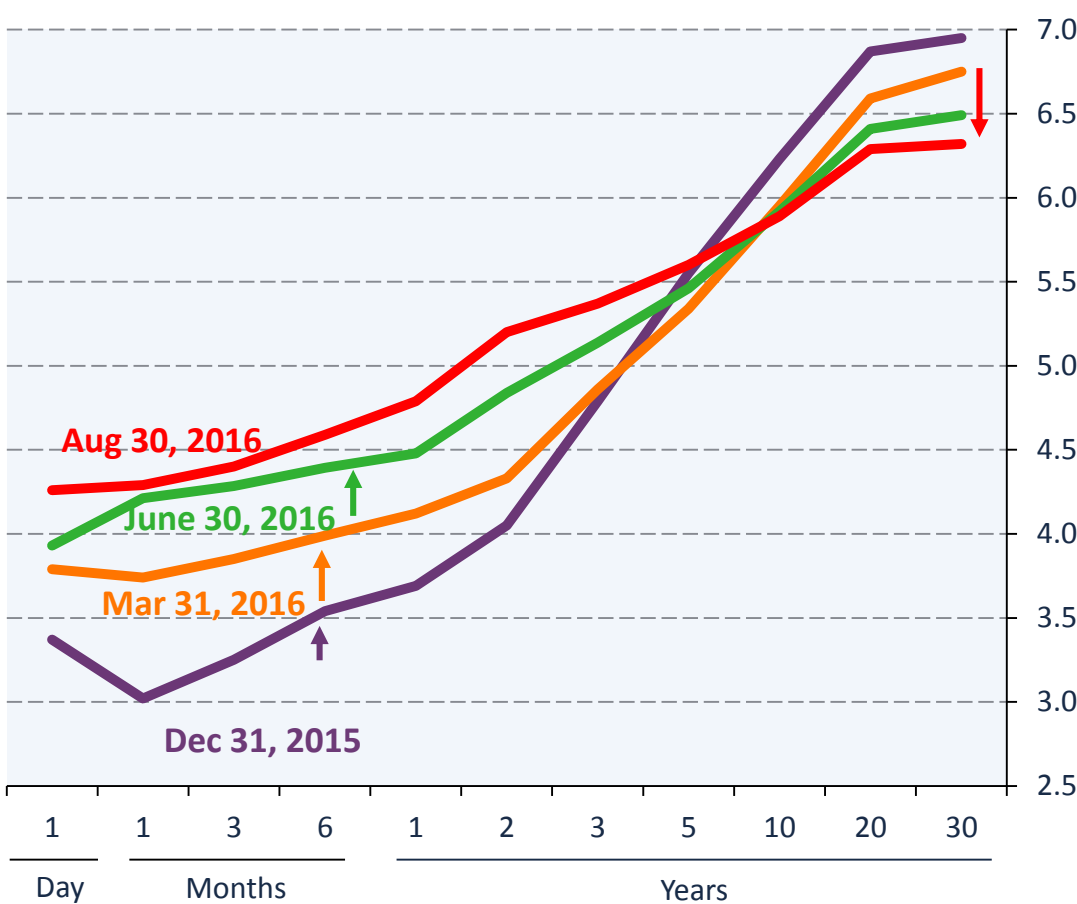
Government Bond Interest Rates ^{1/}
%



^{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).

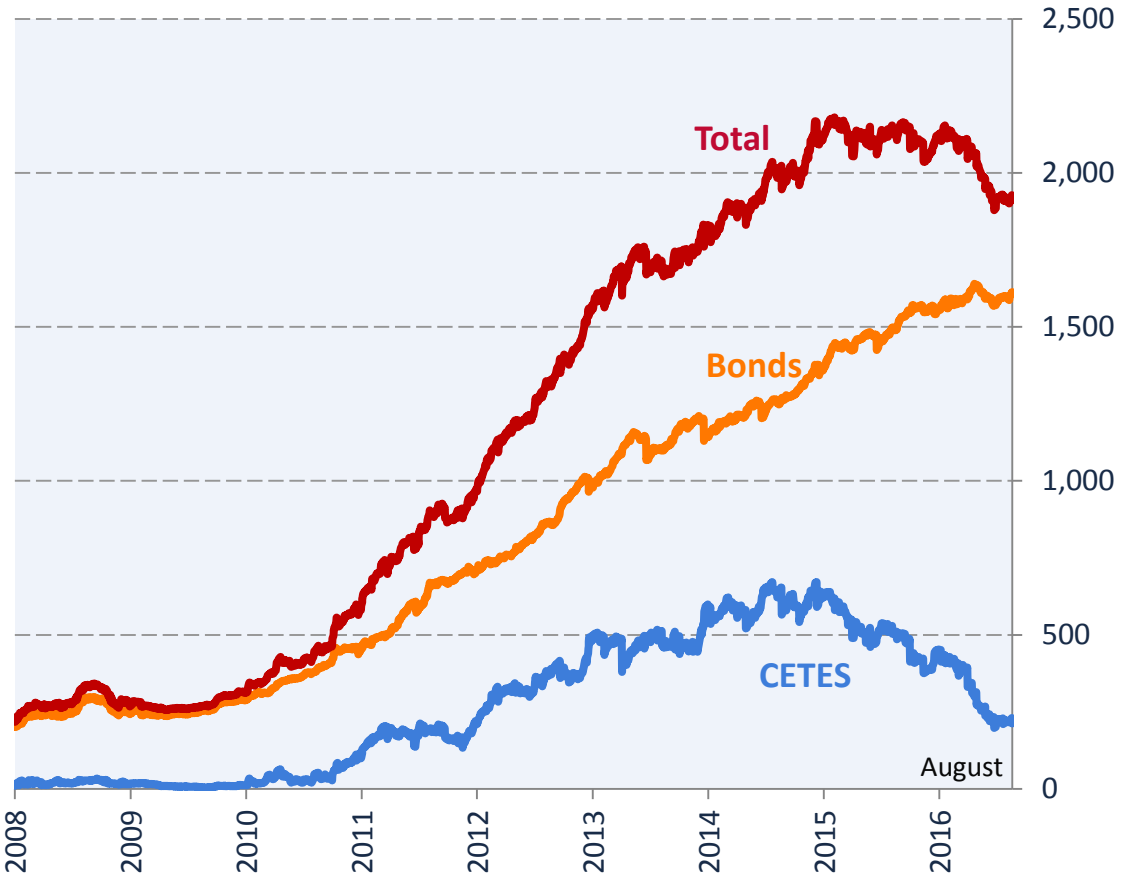
Yield Curve
%



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

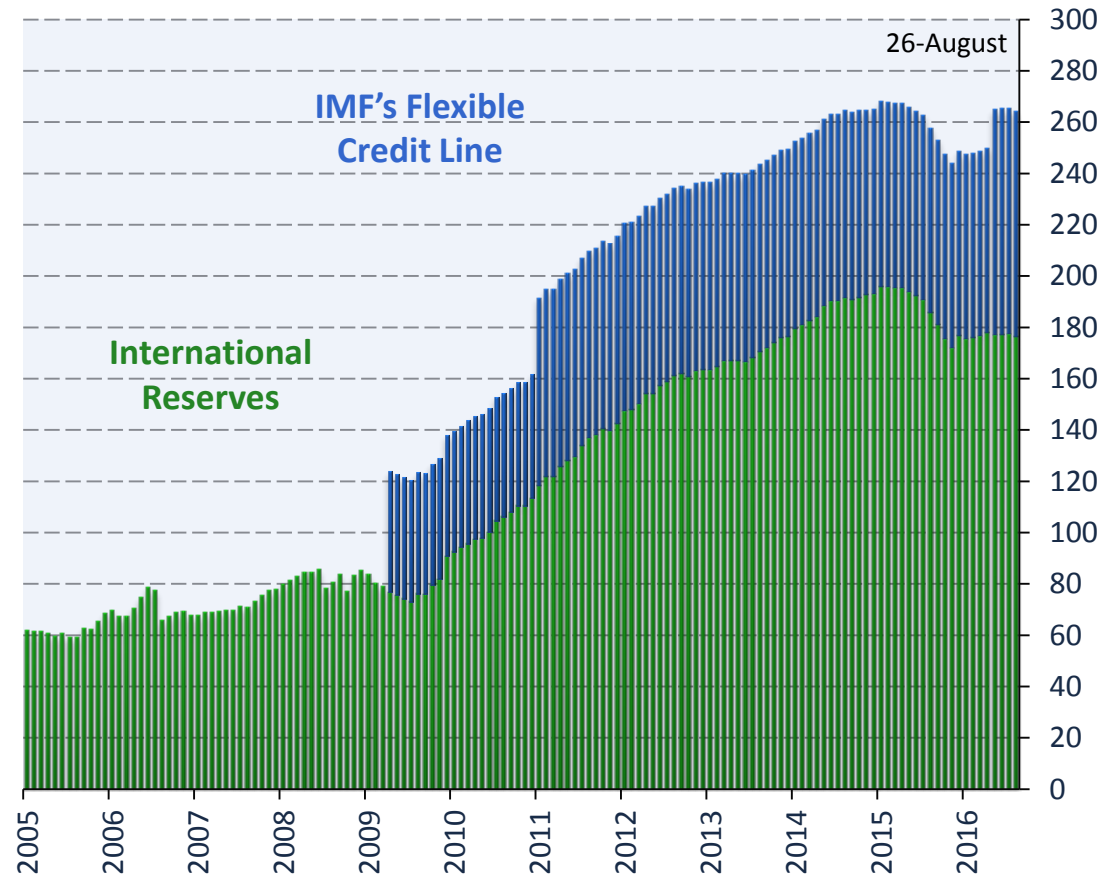
The environment prevailing in international financial markets led to a slowdown of external financing sources, as compared to the previous quarter.

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



^{1/} The total includes CETES, bonds, udibonos, bondes and bondes D.
Source: Banco de México.

International Reserves
USD billion



Source: Banco de México and International Monetary Fund.

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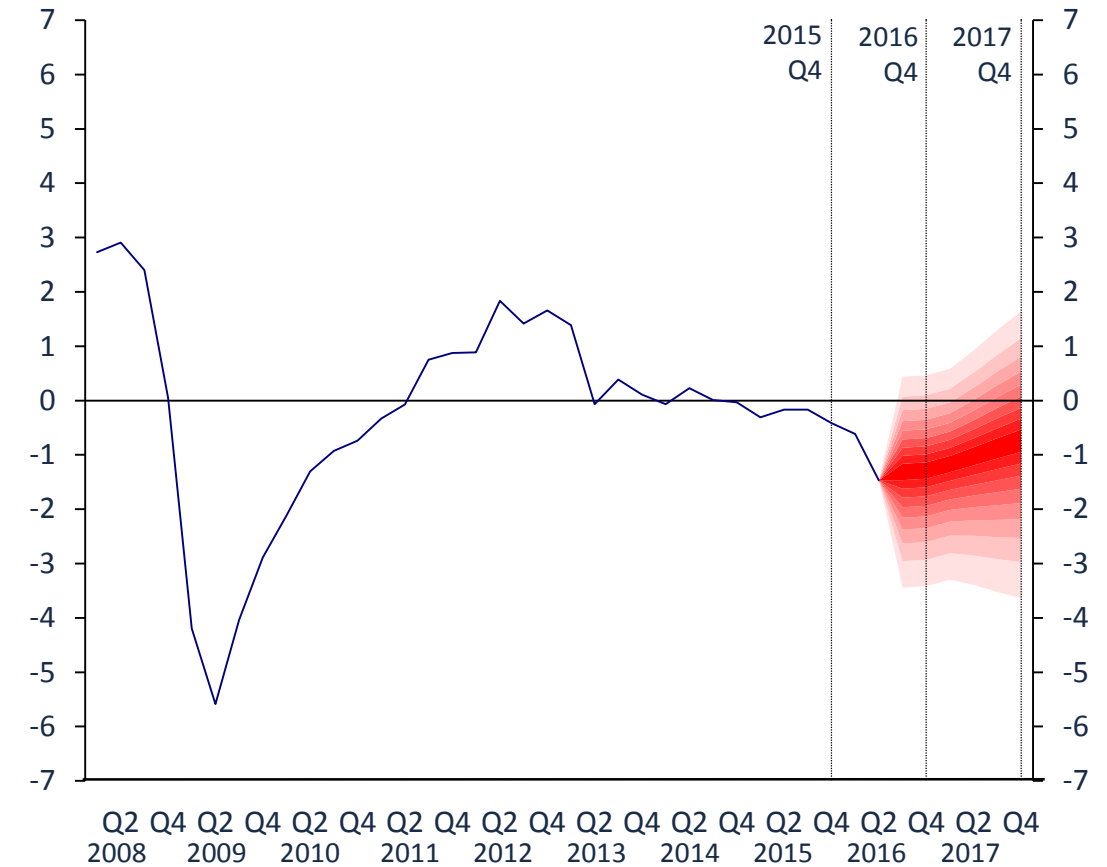
Economic Activity Outlook

GDP Growth (%)		
Report	Previous	Revised
2016	2.0 - 3.0	1.7 - 2.5
2017	2.3 - 3.3	2.0 - 3.0

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

Current Account Deficit (% of GDP)		
Report	Previous	Revised
2016	3.1	3.1
2017	3.1	3.2

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



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

Risks to the Growth Outlook

Upward:



The possibility that the structural reforms will impact the economic growth favorably and faster than anticipated.



That consumption will register a greater sustained recovery, a more noticeable improvement in the labor market, that the dynamism of workers' remittances will persist, and the recovery of higher consumer confidence levels.

Downward:



The possibility that weak performance of Mexican exports will persist:

- Given a lower than expected economic growth of both the world economy and/or the U.S. economy.
- Due to lower oil prices and/or a further reduction of the oil exports platform.



The political and economic outlook prevailing in the U.S. can also affect the growth of the Mexican economy by reducing investment in our country.

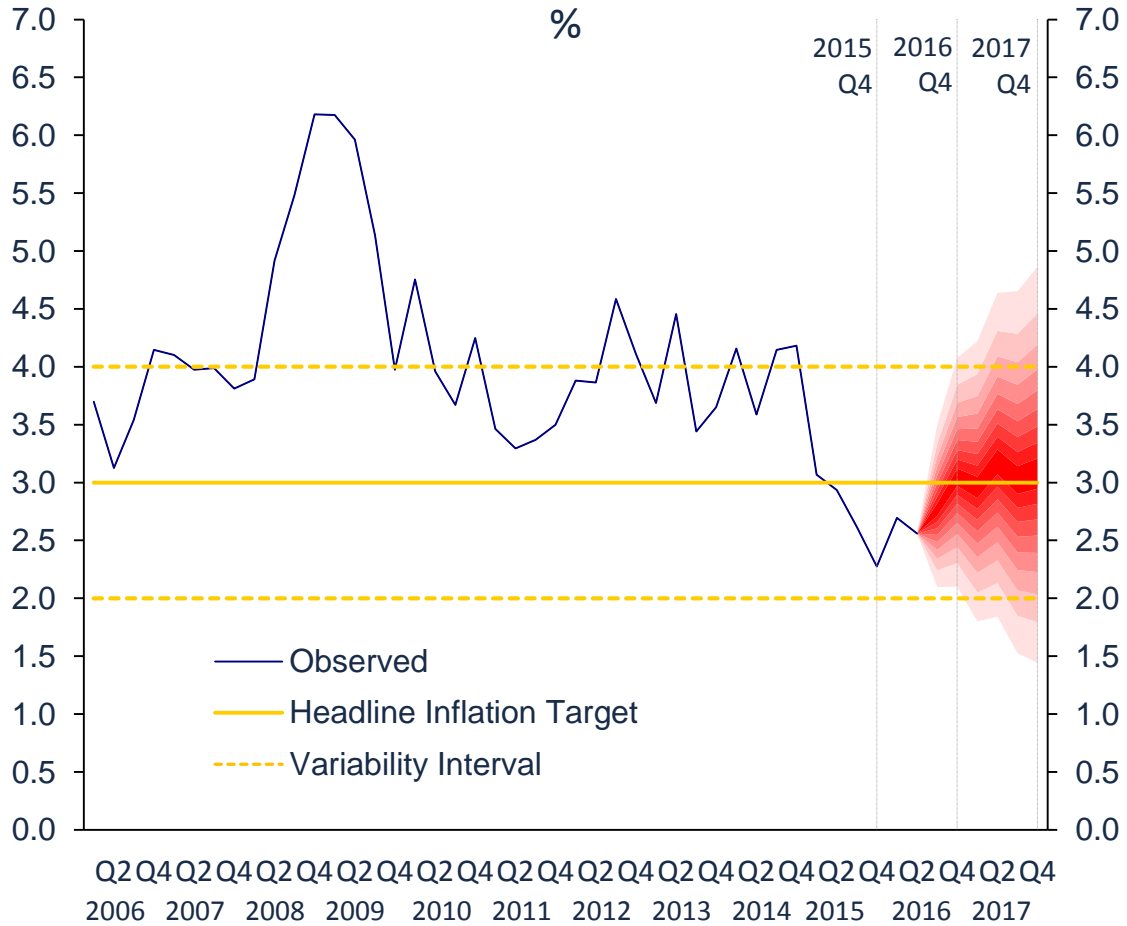
Inflation Outlook

	Headline inflation	Core inflation
2016	<ul style="list-style-type: none">• Gradual increment, locating close to 3 percent by the end of the year.• The annual average below the target.	<ul style="list-style-type: none">• Gradual increase, closing the year near 3 percent.
2017	<ul style="list-style-type: none">• Headline and core inflation will lie around the permanent inflation target.	

The expected performance considers the formula used to determine maximum gasoline prices, as well as the evolution of this fuel's international counterparts. Their effect will be partially offset by the impact of lower L.P. gas prices.

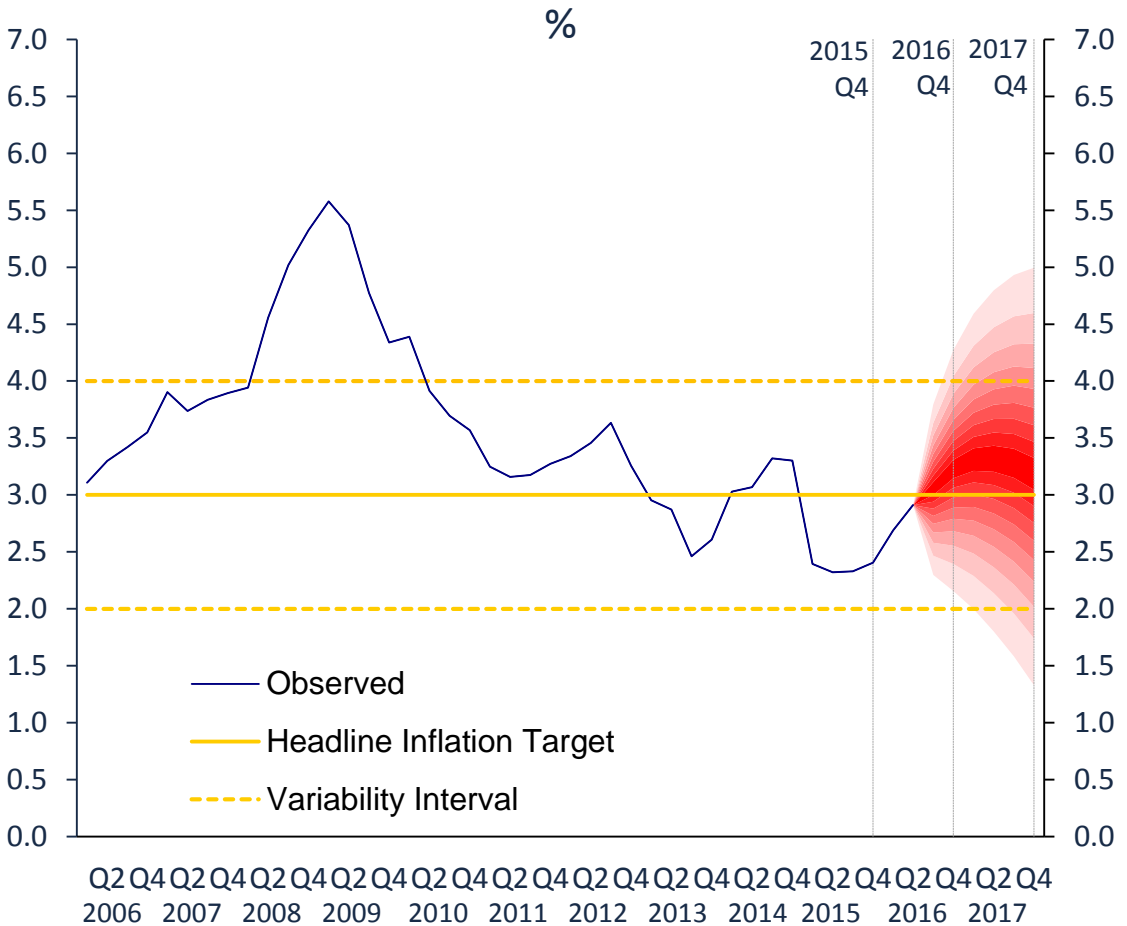
Fan Charts

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

✓ Further reductions in some prices, derived from the structural reforms.

✓ Lower inflationary pressures, as a result of a less dynamic aggregate demand.

Upward

✓ Pressures on the exchange rate derived from:

- Resumed normalization of the Federal Reserve monetary stance.
- Lower crude oil prices.
- A deterioration of the current account deficit, caused by domestic factors.
- Uncertainty related to the outcome of the U.S. electoral process.

✓ Possible increments in agricultural goods' prices.

Monetary Policy Stance

■ The Board of Governors will closely monitor the evolution of all inflation determinants and its medium and long-term expectations, particularly:

✓ 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.

→ In order to be able to continue taking the necessary measures **to consolidate the efficient convergence of inflation to the 3 percent target**, with all the flexibility and at the time and in the magnitude needed.

Strengthening Confidence in the Mexican Economy

- In view of the complex international environment, it is necessary to continue taking measures that would strengthen **the macroeconomic fundamentals of Mexico**.
 - ✓ *The measures outlined by the Federal Government for public finances in 2017 are **imperative**, as their comprehensive implementation will not only allow having sound public finances, but will also release pressures on external accounts.*
- It is crucial to proceed with **the correct implementation of the structural reforms**, since they will foster higher productivity and competitiveness of the country.
- Likewise, it is fundamental to have **a solid rule of law and to guarantee legal certainty**.



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