

# Quarterly Report

April - June 2014

## Summary

The monetary policy implemented by Banco de México has focus on reaching an efficient inflation convergence towards its 3 percent target, that is, at the minimum cost to society in terms of economic activity. This has been possible, in part, due to the credibility of the Bank's commitment to price stability. Thus, there has been a positive feedback between the conduction of monetary policy, the environment of low and stable inflation and the anchoring of inflation expectations.

Accordingly, the conduction of monetary policy, among other factors, contributed to inflation evolving as expected during the first two quarters of the current year, while inflation expectations for end of 2014 and 2015 diminished. Meanwhile, the economic activity registered during the first quarter a lower performance than initially anticipated; contributing to a higher degree of slackness in the economy than that foreseen a few months ago. In this context, considering the favorable performance of inflation, the prevision that it will stay at levels close to 3 percent from early 2015 and the weak economic activity, the Board of Governors decided to decrease the Overnight Interbank Interest Rate from 3.5 to 3.0 percent in June. However, it considered that, given the expected recovery of the economy and the monetary policy stance of Mexico relative to the U.S., a further reduction in this target was not recommendable, thus it remained unchanged in July.

Economic activity in Mexico showed an improvement during the second quarter of the current year in relation to the weak behavior observed in the previous two quarters. This evolution has been mainly due to the dynamism of the external sector, since the recovery of domestic demand is not yet very strong. Despite the mentioned recovery, the prevailing degree of slackness in the economy is greater than the one anticipated in the previous Report.

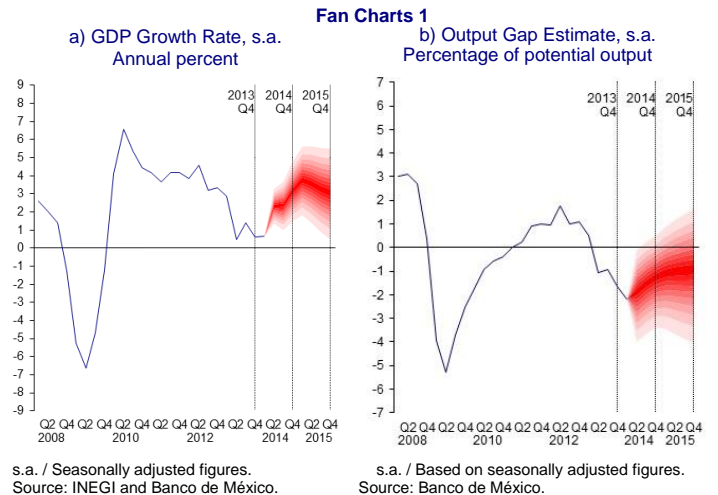
During the second quarter, the international environment was characterized by a recovery of the world economy. In advanced economies, the effects of a lower fiscal consolidation and a very accommodative monetary policy contributed to boost economic activity, while in emerging economies weak conditions prevailed. The expansion of the world economy was supported by the fading of transitory factors that led to lower growth than expected in the first quarter, mainly in the U.S. In this context, the Federal Reserve reaffirmed that it anticipates a gradual normalization of its monetary policy stance. Meanwhile, the European Central Bank announced major measures of monetary easing. Thus, the expectation that the considerable monetary stimulus in advanced economies will prevail for an extended period of time contributed to low volatility in financial markets and a recovery in capital flows to emerging economies. However, even if most market participants expect the advanced economies' monetary policies to normalize in an orderly manner, new episodes of volatility cannot be ruled out. This given that then normalization process may turn out more complicated than expected, especially in the U.S., as was the case at the end of July and the beginning of August.

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

**GDP Growth Rate:** Taking into account that in the first quarter of 2014 Mexico's GDP recorded a quarterly seasonally-adjusted growth of 0.28 percent (lower than anticipated in the previous Report of 0.6 percent), for the second quarter it is expected to show a stronger dynamism than in the first one, derived from a more noticeable rebound in foreign demand. In this context, although a strengthening of economic activity in the second half of the year is still expected, the fact that its performance was lower than anticipated at the beginning of the year, and that domestic demand has been more modest than what was considered in the previous Report, suggests that the dynamism of the economy for the rest of 2014 could be lower than previously expected. This leads to a downward revision of GDP growth forecast for 2014. In particular, the forecast interval for Mexico's GDP growth in 2014 is revised from 2.3 to 3.3 percent in the previous Report to 2.0 to 2.8

percent (Chart 1a). For 2015, the forecast interval is maintained between 3.2 to 4.2 percent.

It is worth mentioning that the described previsions involve a gradual strengthening of domestic demand in the second half of 2014 and 2015, which is derived from both a stronger impact of the rebound in external demand on the domestic market and the effects that recent developments in the structural reform process could have on consumer and producer confidence.



**Employment:** The previsions of the previous Report for the variation in the number of IMSS-insured workers are unchanged, considering that: i) during the first quarter of this year this indicator showed a good performance, despite the weak economic activity in that period; ii) during the second quarter it continued to show a positive trajectory; and, iii) a growing trend is still anticipated to prevail, given the expected recovery of the economy. Therefore, it is anticipated an increase of between 570 to 670 thousand workers (urban permanent and temporary) in 2014, and between 620 to 720 thousand workers in 2015.

**Current Account:** For 2014, trade balance and current account deficits of 3.9 and 26.7 billion USD respectively are expected, (0.3 and 2.0 percent of GDP, in the same order). For 2015, these deficits are estimated to amount 5.7 and 28.9 billion USD, respectively (0.4 and 2.0 percent of GDP, in the same order).

The sharp slowdown in economic activity in late 2013 and early 2014 led to a level of slackness in the economy greater than that anticipated in the previous Report and the output gap to remain in negative levels. Moreover, despite the expected recovery for the rest of 2014 and 2015, it is expected that the output gap will remain in negative levels until the end of 2015, but will be gradually closing. Thus, there are not perceived pressures on inflation nor on the external accounts derived from the expected behavior of aggregate demand in the horizon in which monetary policy has an effect (Chart 1b).

The prevailing weakness of some indicators suggests downward risks to the growth scenario in Mexico. In particular, economic agents' confidence might recover more slowly than anticipated, which would delay a full recovery of domestic demand. However, this scenario could be positively affected by some upward risks, among which are: i) the possibility of a more vigorous than expected U.S. economic recovery; and ii) the possibility of a structural reforms better than expected implementation, with its consequent impact on investors' and economic agents' expectations.

**Inflation:** Taking into consideration the degree of slackness prevailing in the economy and the absence of second-order effects derived from changes in relative prices that occurred in late 2013 and early 2014, which include those derived from fiscal measures, it is anticipated that

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the annual headline inflation will remain close to 4 percent during the second half of 2014, although due to the high volatility that characterizes the prices of agricultural products it may exceed that level at some point, as in fact happened in July (Figure 2a). This path for headline inflation is consistent with the provisions of Banco de México released in the previous Report. As mentioned, its level in the second half of 2014 would mainly be reflecting the arithmetic effect coming from a low comparison base. However, it is expected that towards the end of this year, headline inflation will be below 4 percent given the fading effect of changes in relative prices that took place in November and December of 2013.

Furthermore, it is expected that annual headline inflation decreases to levels close to 3 percent from early 2015 and remains near that level during the rest of the year (Chart 2a). Factors favoring this evolution are the monetary policy stance, the vanishing of the mentioned relative price change effects, and according to the Federal Income Law 2014, the increases in gasoline prices in 2015 consistent with expected inflation.

The annual core inflation forecasts for 2014 indicate that it will remain around 3 percent the rest of 2014 and below this level in 2015 (Chart 2b).

The foreseen path for inflation may be affected by certain risks:

- i. Downward, the possibility that the recovery of economic activity in the country is lower than anticipated.
- ii. Upward, new episodes of volatility in international financial markets that involve adjustments to the exchange rate with their consequent effect on inflation. However, in this case, one would expect only a moderate and transitory effect on inflation because of the low pass-through of exchange rate variations to prices and the degree of slack that prevails in the economy.

In this environment, the Board of Governors considers that the monetary policy stance is consistent with achieving inflation convergence towards the 3 percent target efficiently. In the future, the Board will closely monitor the performance of all determinants of inflation and inflation expectations for medium and long-term horizons, including the expected recovery of the economy and the monetary policy stance of Mexico relative to the U.S., in order to be able to reach the target of 3 percent for headline inflation.

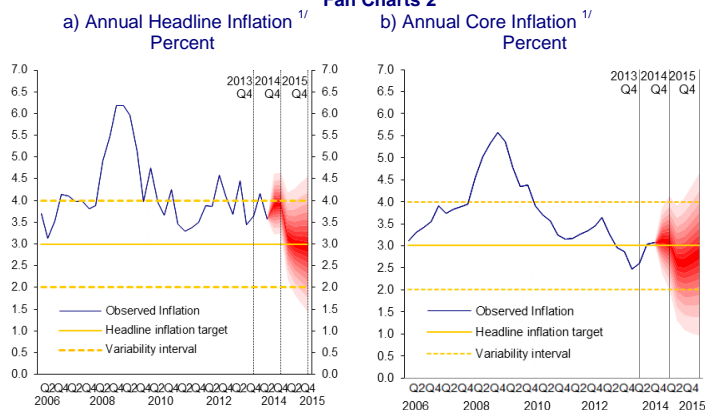
product diversity. Moreover, from a long-term perspective, it is also anticipated that a more competitive environment will encourage the adoption of improved technologies and to impulse for a better organization of work, which will necessarily translate into increases in productivity and, therefore, in higher economic growth.

The structural reforms will not only result in a more vigorous expansion of the economy, but will also favor an environment of low and stable inflation. Indeed, higher productivity will allow reaching higher aggregate demand and supply growth rates without generating inflationary pressures. The latter will be more likely given that the mentioned reforms were achieved in an environment of macroeconomic stability. In this sense, as firms become more productive they will have more degrees of freedom to face uncertain scenarios without having to increase their prices.

Besides the important progress reached, this structural change process cannot be considered as fulfilled, since it is still imperative to implement the recently approved reforms adequately. It is important that this challenge is resolved effectively, thereby reaching the potential of the reforms in order to boost growth of the Mexican economy.

Finally, it should be mentioned that the improvement of the institutional framework should be a permanent objective, aligning economic agents' incentives towards a higher value creation. In this sense, it is crucial to identify main causes of inefficient resource allocations, which generate lower economic growth. Of course, in addition to the aforementioned, the framework for the conduction of macroeconomic policy should be further strengthened. On this regard, it stands out that the benefits of the efforts undertaken in the past years in that direction have been evident in face of recent episodes of uncertainty in international financial markets.

Fan Charts 2



1/ Quarterly average.

Source: INEGI and Banco de México.

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On the other hand, it is encouraging that the legislative stage of structural reforms aimed at increasing the country's productivity has concluded. In particular, the approval of the pending secondary legislation related to economic competition, telecommunications and broadcasting and the energy reforms are an indispensable step in the right direction. It is anticipated that these structural changes to the institutional framework of the country will have a positive impact on potential growth and investment climate, so that the low rate of expansion that Mexico has exhibited from a long-term perspective could be reverted. Indeed, it is foreseeable that these modifications will boost the competitiveness of the economy and promote a more efficient allocation of resources to their most productive uses by means of removing barriers to entry and increase competition in the markets, particularly in those referred to inputs. Increased competition, in turn, will benefit households directly through lower prices and higher quality and