Quarterly Report

July – September 2017

Summary

Since late 2014, the Mexican economy has experienced a number of different shocks, which strongly affected inflation. In particular, over the last months of 2014 and during 2015, a drop in oil prices, among other factors, caused a significant depreciation of the real exchange rate. Additionally, during 2016 a complex external environment prevailed, which was principally related to the U.S. elections, which led to higher volatility in domestic financial markets and further depreciation of the currency, generating an environment of uncertainty over the bilateral Mexico – U.S. relation. This resulted in an adjustment of relative prices, which spurred inflation above its 3.0 percent target at the end of 2016. Subsequently, in January 2017, the upward trend of headline inflation was aggravated mainly by the effect of the price liberalization on some energy products, as well as by additional shocks of diverse nature on non-core inflation over the next months. In this juncture, since late 2015 Banco de Mexico has implemented measures so that the adjustments in relative prices derived from this sequence of shocks take place in an orderly manner, preventing second round effects on the price formation process in the economy. During the decision-making process, the Board of Governors has taken into consideration the fact that monetary policy measures affect the evolution of inflation with a lag, via a number of transmission channels. These channels have been in operation during 2017. The monetary policy actions contributed to anchoring inflation expectations, to moderating credit demand and to a considerable appreciation of the Mexican peso against the U.S. dollar from mid-January and until late September 2017, even though this has recently been partially reversed.

Hence, derived from the adopted monetary policy stance, annual headline inflation attained a maximum of 6.66 percent in August 2017, later lowered to 6.35 percent in September, and marked 6.37 percent in October, this last adjustment fundamentally reflecting the evolution of non-core inflation. Meanwhile, annual core inflation decreased in September and October and marked 4.80 and 4.77 percent, respectively, in the referred periods, after having recorded 5.00 percent in August. The change in the inflation trend has been mainly a result of two factors. First, the partial fading of adjustments in relative prices, derived from the sequence of shocks on inflation, which have temporarily diverted it from its permanent 3.0 percent target in late 2016. Secondly, the effect of increments in the reference interest rate, which this Central Bank began to implement in December 2015 and which, in view of the lag of the said adjustments onto inflation, has started to be perceived recently at lower levels both of headline and core inflation.

After having announced increments in the reference rate, which accumulated 400 basis points since December 2015, in the period covered in this Report the Board of Governors of Banco de México considered that, despite the increase of some risks, the monetary policy stance adopted based on these actions remained congruent with the convergence of headline inflation to the 3.00 percent target in late 2018, reason why the Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate unchanged at 7.00 percent. It is noteworthy, however, that due to the persisting risks, Banco de México will remain on alert to ensure that a prudent monetary policy prevails.

The above occurred in an environment of expanding world economic activity, reflecting a more widespread growth rate both in advanced and emerging economies. This expansion kept reflecting the rebound in international trade, industrial production and investment in businesses. For the remainder of 2017 and 2018, the world economy is forecast to continue expanding moderately. In turn, despite a smaller slack in the use of resources, inflation remained low in the main advanced economies.

In this scenario of greater global economic recovery, where monetary conditions remain accommodative and there are expectation of possible fiscal stimuli, financial asset prices kept growing across most advanced economies and in some emerging ones. However, new volatility episodes cannot be ruled out.

In a context of the normalization of the U.S. monetary policy, a possible approval of the expansionary fiscal plan in the U.S., and uncertainty relative to the process of NAFTA renegotiation, the Mexican peso depreciated against the U.S. dollar and its volatility increased as of the end of September. In addition, operating conditions in the foreign exchange market somewhat deteriorated. Based on the above, to procure a more orderly functioning in the said market, on October 25 the Foreign Exchange Commission announced the increase in non-deliverable forward (NDF’s) auctions that would be settled in Mexican pesos for an amount of USD 4 billion, which would be carried out on a weekly basis in accordance with the pre-established calendar. Meanwhile, interest rates increased in a differentiated manner: short-term ones (one year or less) went up slightly, while medium- and long-term ones (two years or more) increased more. In this way, the slope of the yield curve steepened slightly, which would have been steeper but for the monetary policy actions implemented by Banco de México. Similarly, spreads between Mexican and U.S. interest rates went up.

In the third quarter of 2017, Mexican economic activity contracted, which was in contrast with the dynamism observed in the first half of the year. This performance reflected the deceleration of some aggregate demand components, the transitory effects of the earthquakes that occurred in September and the reduction of crude oil production in that month.

The macroeconomic scenario expected by Banco de México considers the following:

GDP Growth Rate: The forecast interval for GDP growth for 2017 has been adjusted from one between 2.0 and 2.5 percent in the last Report to one between 1.8 and 2.3 percent in the current one. This adjustment responds to the fact that in the third quarter productive activity decelerated more than anticipated in the previous Report, largely due to the effects of the earthquakes that occurred in September and the marked contraction in the crude oil platform in that month. The consequences of the earthquakes on economic activity seem to have been moderate and transitory. Hence, the growth forecast for 2018 is not modified with respect to the previous Report, so that GDP growth is still estimated to lie between 2.0 and 3.0 percent in 2018, while for 2019 an expansion rate of between 2.2 and 3.2 percent is anticipated (Chart 1a).

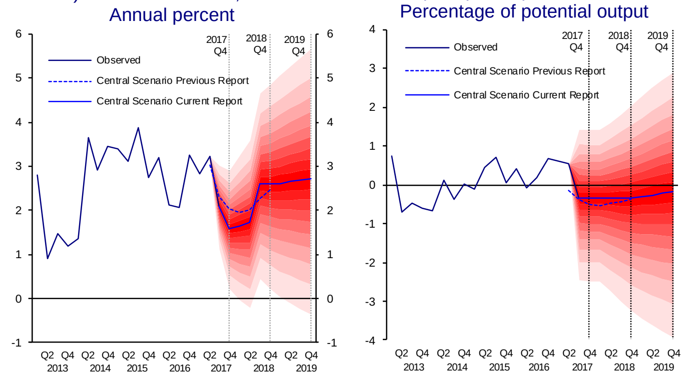
In accordance with the new information on economic activity stemming from the change of the base year to 2013, in some of the previous quarters the output gap estimate has been slightly positive. Nevertheless, the contraction of economic activity in the third quarter of 2017 implied that it decreased to negative levels close to zero once again. Over the forecast horizon the output gap estimate persists at levels slightly below zero, although above the estimates presented in the last Report, as a consequence of data revision. In this way, the growth forecasts do not point to aggregate demand-related pressures onto prices (Chart 1b).

Employment: The performance of the number of IMSS-affiliated jobs has continued to show the dynamism that is greater than that suggested by economic growth and greater than previously anticipated, reasons why the forecasts for this indicator are adjusted upwards with respect to the last Report. For 2017, the number of IMSS-affiliated jobs is forecast to grow between 720 and 790 thousand jobs (between 660 and 760 thousand jobs in the previous Report). For 2018, an increase of between 680 and 780 thousand jobs is anticipated (between 670 and 770 thousand jobs in the last Report). For 2019, the number of IMSS-affiliated jobs is estimated to expand by between 690 and 790 thousand jobs.

Fan Charts 1

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

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



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

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

Current Account: For 2017, deficits in the trade balance and the current account are expected to amount to USD 11.0 and 19.4 billion (0.9 and 1.7 percent of GDP, respectively). For 2018, deficits in the trade balance and the current account are estimated to be USD 13.1 and 25.9 billion (1.0 and 2.1 percent of GDP, in the same order). For 2019, deficits in the trade balance and the current account are expected to be USD 14.5 and 30.6 billion, respectively (1.1 and 2.3 percent of GDP, in the same order).

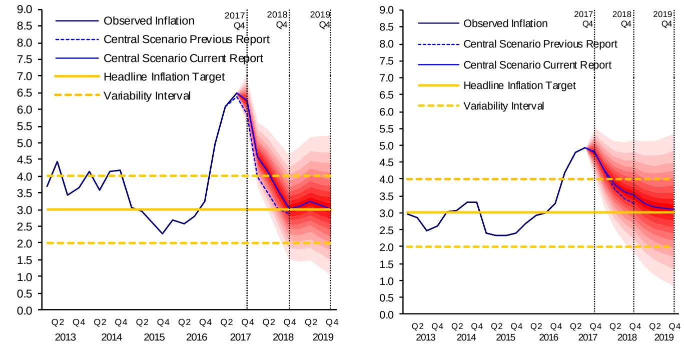
The balance of risks for growth has deteriorated and is biased to the downside. Among the downward risks, the following stand out: i) that the NAFTA renegotiation is not favorable for the Mexican productive sector or that it even results in its cancellation; ii) that due to uncertainty over the NAFTA renegotiation, different enterprises decide to postpone their investment plans in Mexico even more or that consumers lower their spending as a precautionary measure; iii) that episodes of high volatility in international financial markets are observed, derived from the U.S. monetary policy normalization process or from geopolitical events that may reduce the sources of financing to Mexico; iv) that the upcoming electoral process in Mexico causes volatility in domestic financial markets, negatively affecting the evolution of private spending; v) that public insecurity becomes a more relevant factor for productive activity. Among the upward risks, the next are noteworthy: i) that the renegotiation of NAFTA triggers investment in new areas of opportunity and in those previously considered by the Agreement; ii) that the implementation of structural reforms renders greater-than-expected results; iii) that the reconstruction effort following the natural disasters in Mexico and the U.S. has a greater-than-estimated impact on economic activity.

Inflation: According to the forecast presented in the last Report, the current scenario considers that non-core inflation will decrease less than anticipated in the remainder of 2017 and over most of 2018. This is accounted for by recent price increments in some agricultural goods and, in particular, in energy products. As regards core inflation, for the rest of 2017 a slightly more marked decrease is anticipated with respect to the previous estimate, derived from a better-than-expected evolution of merchandise prices. Nonetheless, for 2018 the forecast for the core inflation performance is slightly higher than previously considered, reflecting the impact of the recent exchange rate reversal onto the merchandise prices. As a result of the above, by the end of 2017 annual headline inflation is forecast to continue exhibiting a downward trend, which is expected to accentuate during next year, so that it attains the convergence to its 3.0 percent target in the last quarter of 2018, rather than in the third one, as it has been previously considered. In 2019, annual headline inflation is expected to fluctuate around the said target (Chart 2a and 2b). It should be noted that although the increase in the minimum wage starting in December 2017 could adjust the closing of annual headline inflation slightly upwards in 2017, the expected trajectory of its convergence to the 3.0 percent target at the end of 2018 is not anticipated to be significantly modified. The previous estimates are subject to risks. The main upward risks are: i) that the national currency further depreciates; ii) that prices of some agricultural goods increase, even though their impact onto inflation would be transitory; iii) that considerable upward pressures onto the prices of some energy products, especially LP gas, continue; iv) considering that conditions in the labor market have been tightening, the evolution of unit labor costs could be reflected in inflation. Among downward risks, these should be listed: i) that a more favorable environment related to the outcome of the NAFTA negotiations leads to the appreciation of the national currency; ii) that the structural reforms contribute to further reductions in different prices; iii) that economic activity observes a lower-than-anticipated dynamism. Given that some upward risks have been gaining relevance, the balance of risks related to the inflation trajectory expected by this Central Institute has deteriorated and exhibits an upward bias in the horizon in which monetary policy operates.

Fan Charts 2

a) Annual Headline Inflation [1/]
Percent

b) Annual Core Inflation [1/]
Percent



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

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Considering the data presented in this Report, in the future the Board of Governors will closely monitor the evolution of all inflation determinants and its medium- and long-term expectations, especially considering the above described balance of risks, the future changes in the monetary position of Mexico relative to the U.S., the potential pass-through of exchange rate adjustments onto prices and the evolution of the output gap, as well as the performance of potential wage pressures. In any event, in light of different prevailing risks, the Board of Governors will be watchful to ensure that the monetary stance remains prudent, so that the anchoring of medium- and long-term inflation expectations is strengthened, and the convergence of inflation to its target is achieved.

Derived from the structural reforms that are being implemented, and the economic policy seeking to maintain a sound macroeconomic environment, the Mexican economy has shown resilience in the face of the negative shocks mentioned above, allowing it to maintain an upward trajectory. This has been the case even considering that far-reaching reforms, such as those that have been adopted, require a long implementation period and that its full impact on economic growth and on the welfare of the population should be assessed from a long-term perspective. However, an environment of public insecurity and of a lack of full observance of the rule of law prevents necessary, but not sufficient, conditions for economic growth (such as macroeconomic stability or a better functioning of certain markets) from being reflected in greater investment and greater productivity. Productivity growth is ultimately the only way to obtain a sustainable greater expansion of the economy, and, therefore, to increase labor incomes and population welfare without generating inflation pressures, unemployment or greater informality. Thus, the country should implement more profound reforms to provide legal certainty, enhance the rule of law, strengthen the institutions and modify the incentives' system faced by economic agents, so that it favors value-creating activities. Progress in this direction becomes even more pressing given the current uncertainty faced by Mexico regarding its economic relation with the U.S., which highlights the importance for the country to diversify and strengthen the different engines of growth that it has at its disposal.