

Quarterly Report
January – March 2017
May 31, 2017



Outline

1 Monetary Policy and Inflation

2 Economic Activity and Financial Markets

3 Forecasts and Final Remarks

As established in the Constitution, the primary goal of Banco de México is to ensure the stability of the national currency's purchasing power.

To fulfill this goal, in 2001 Banco de México adopted an **inflation targeting regime**, as its framework to conduct monetary policy:



- Institutional **commitment** with price stability.
- A **quantitative target** for inflation.
- **Improving transparency and communication** with the public.

Ensuring the fulfillment of this constitutional mandate represents **the best contribution by Banco de México to social welfare**, as it allows to generate an environment of price stability, and to prevent economic and social costs associated to a high and volatile inflation.

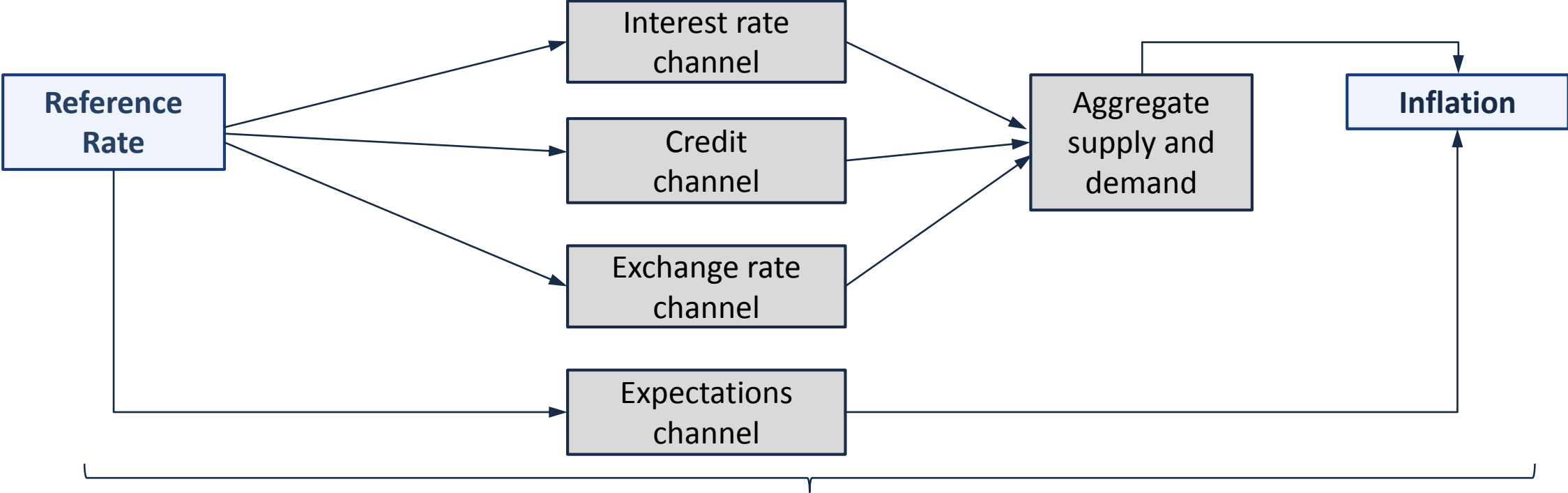
Conduction of Monetary Policy

Under the inflation targeting regime, monetary policy actions will lead to:



If monetary policy **is not credible**, medium- and long-term inflation expectations deanchor, and second round effects arise.

In order to implement its monetary policy, the central bank adjusts its overnight interest rate target, known as the reference rate. This affects the economy via the transmission channels of monetary policy.



It takes certain time for these channels to operate.

Thus, the central bank must take into account that monetary policy actions affect the economy with a certain lag, especially regarding the evolution of prices.

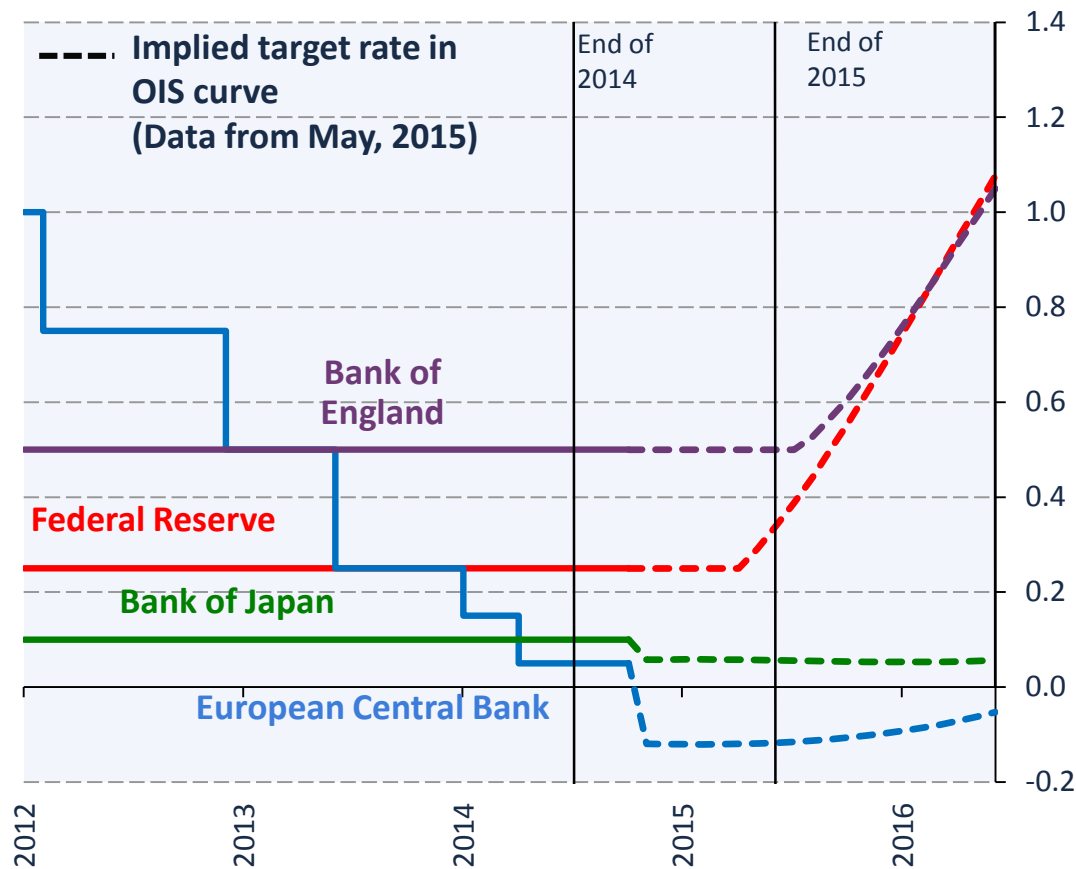
- Therefore, the monetary authority should take decisions after a thorough **assessment of the inflation outlook**, among other factors.
- It is essential that the central bank's actions are **timely and decisive**, considering both the lags at which the monetary policy operates, and **the nature of the shocks** (whether these merely impact relative prices or generate widespread inflationary pressures).
- Through these actions, it prevents shocks in relative prices from turning into generalized inflationary pressures.

- Since 2014, the Mexican economy has faced **a number of shocks** that could considerably affect **inflation**.

	Shocks	Effects of the Shocks	Inflation in Mexico
I Jul. 2014 – Dec. 2015	Prospects for the normalization of the monetary stance in the U.S. and U.S. dollar appreciation. Drops in oil prices .	Exchange rate depreciation and increased volatility.	<ul style="list-style-type: none"> The beginning of the adjustment in relative prices. Fading effects of fiscal adjustments in 2014. Lower prices of telecommunication services and energy products. End of 2015: 2.13 percent (historic low).
II Jan. 2016 – Oct. 2016	Oil prices remain low. The process and the outcome of the U.S. presidential election.	Further exchange rate depreciation and high volatility.	<ul style="list-style-type: none"> An upward trend in core inflation starting from low levels. No more arithmetic favorable effect from the fading of shocks during the previous year. Lower reductions in telecommunication services' prices. End of 2016: 3.36 percent.
III Nov. 2016 – 2017	Uncertain Mexico – U.S. relation. Higher domestic energy prices . An increment in the minimum wage . Higher agricultural products' prices and public transport fares .	Exchange rate depreciation and higher volatility . Direct and indirect effects of energy prices. A moderate impact of a minimum wage increase .	<ul style="list-style-type: none"> Upward trend: over 10 consecutive months. 1F May 2017: 6.17 percent.

The prospects for the monetary policy normalization process of the Federal Reserve and the divergence in the expected monetary policy stance among the main advanced economies were reflected in a widespread U.S. dollar appreciation.

Expected Monetary Policy Rates Implicit in OIS Curve ^{1/}
%



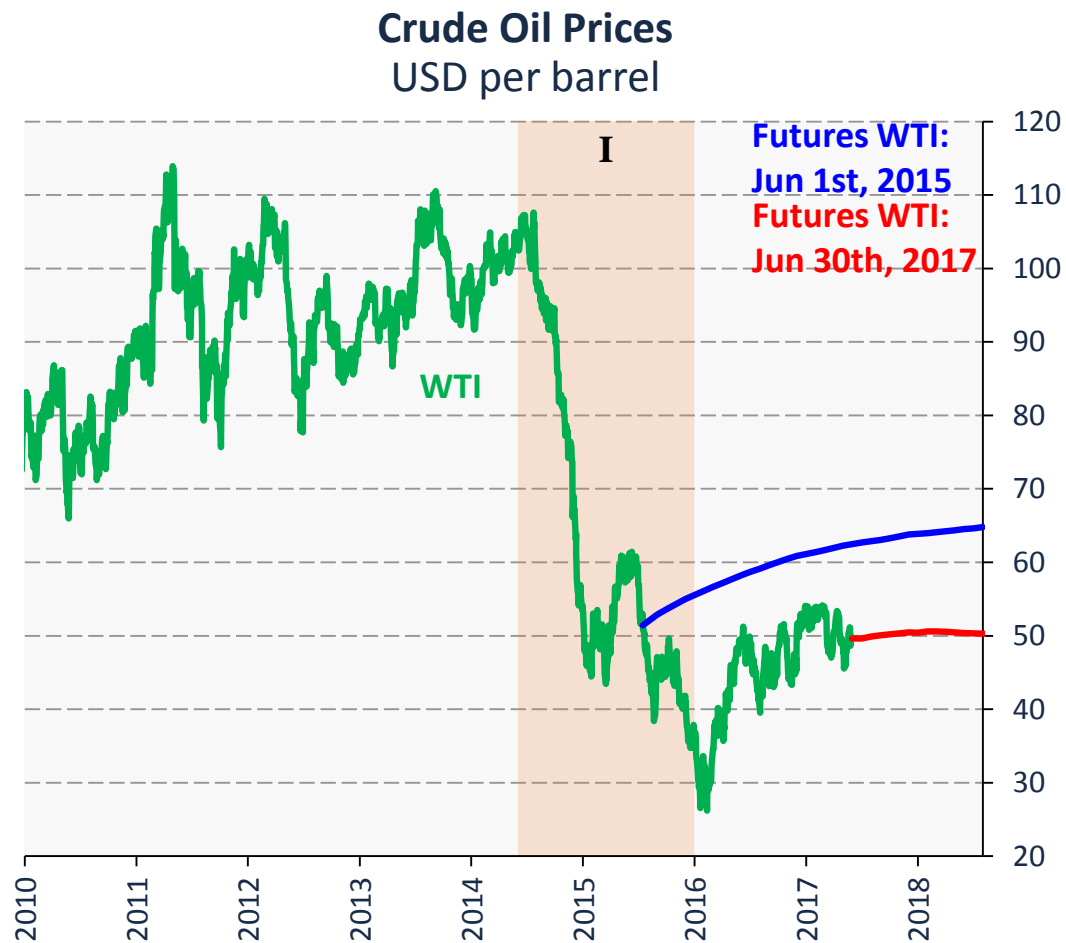
^{1/} OIS: Overnight Index Swap.
Source: Banco de México with data from Bloomberg.

U.S. Dollar Index (DXY) ^{2/}
Index 1-Jan-2013=100

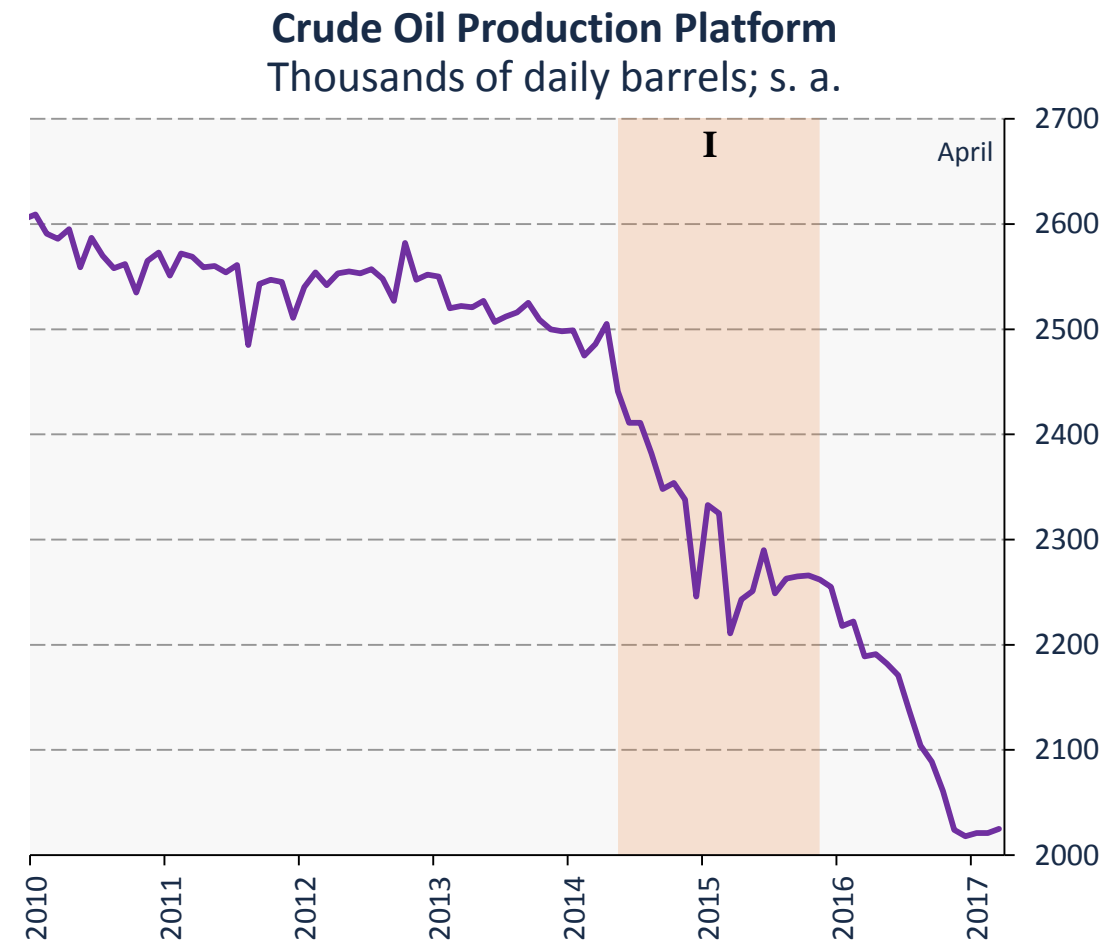


^{2/} DXY index is estimated by the Intercontinental Exchange (ICE) based on the weighted geometric mean of the dollar's value compared with a basket of 6 other major currencies which are: EUR: 57.6%, JPY: 13.6%, GBP: 11.9%, CAD: 9.1%, SEK: 4.2% and CHF: 3.6%. Base=100.
Source: Bloomberg.

The plunge in oil prices since 2014 caused a deterioration in the terms of trade. In addition, there was a decline in crude oil production.



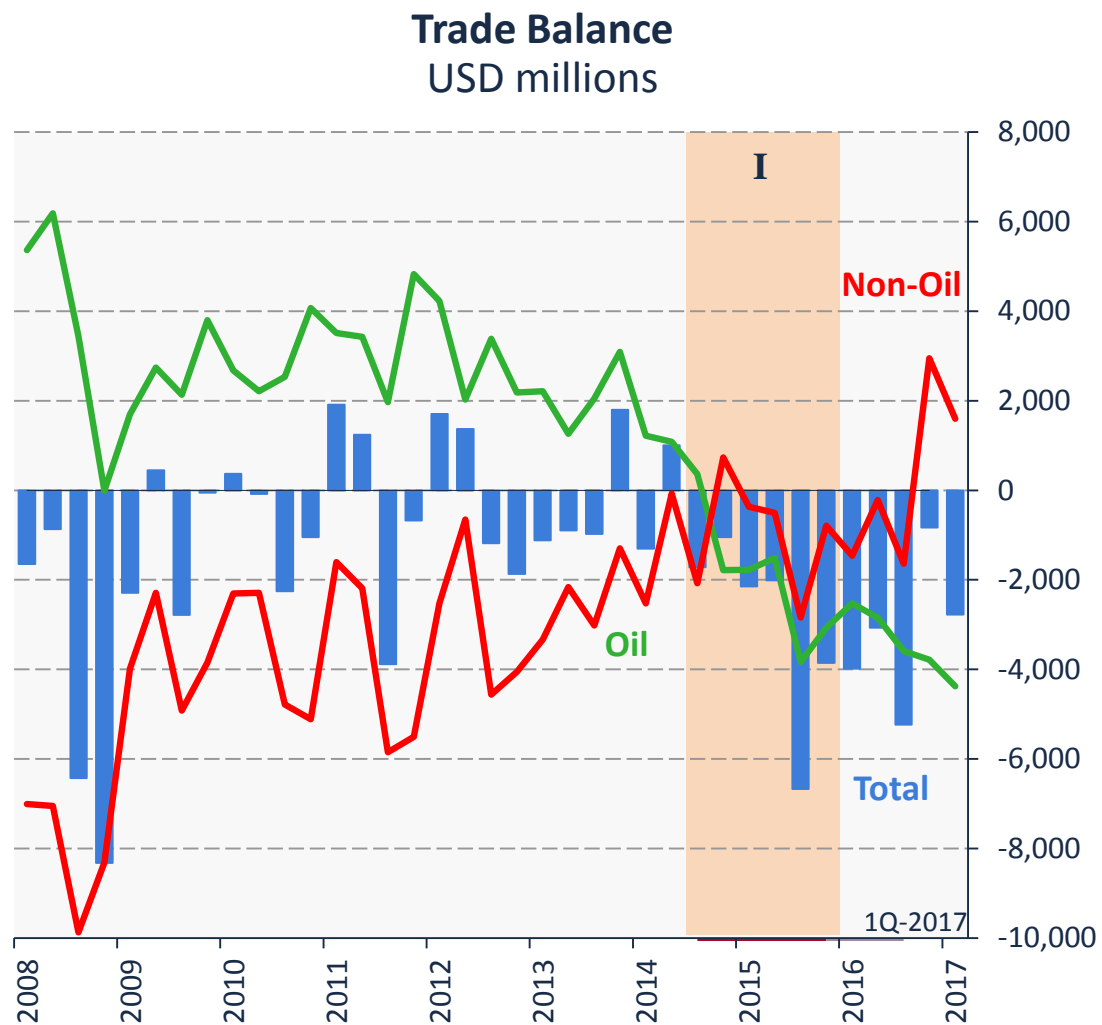
Source: Bloomberg and Banco de México.



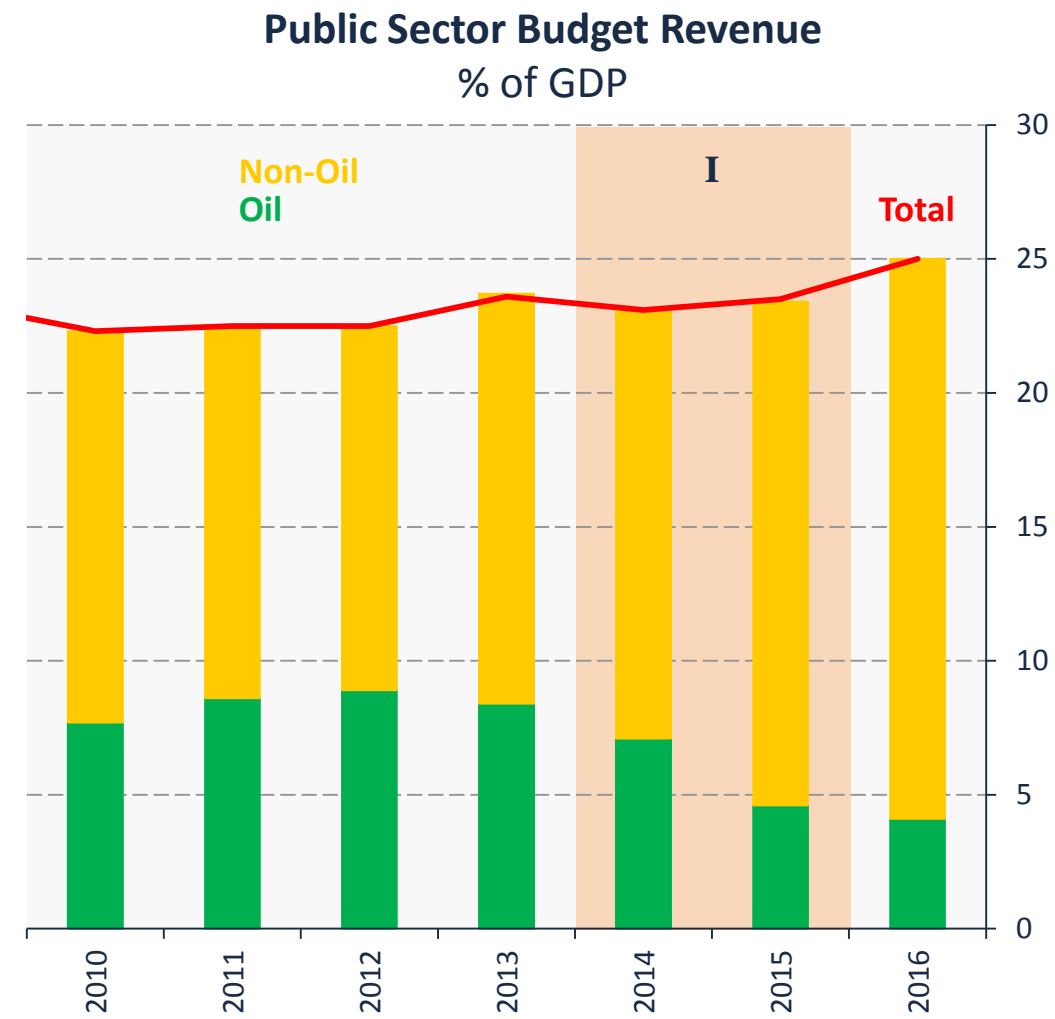
s. a./ Seasonally adjusted data.

Source: Seasonally adjusted by Banco de México with data from PEMEX.

Such shocks caused a deterioration in the external accounts, mainly in the oil trade balance. Meanwhile, there was a decline in public sector's oil revenues.



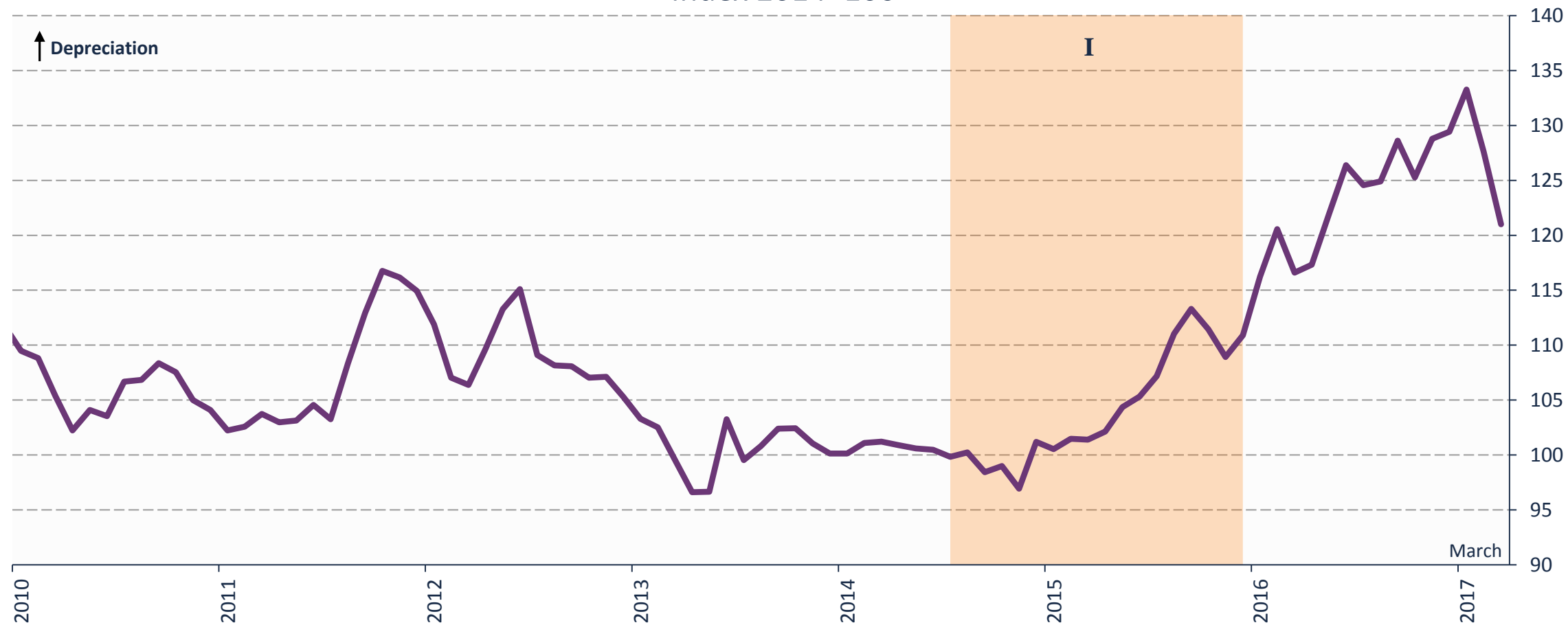
Source: SAT, SE, Banco de México, INEGI. Merchandise Trade Balance, SNIEG. Information of National Interest.



Source: Ministry of Finance (SHCP).

Thus, the real exchange rate depreciated considerably.

Multilateral Real Exchange Rate Index 2014=100



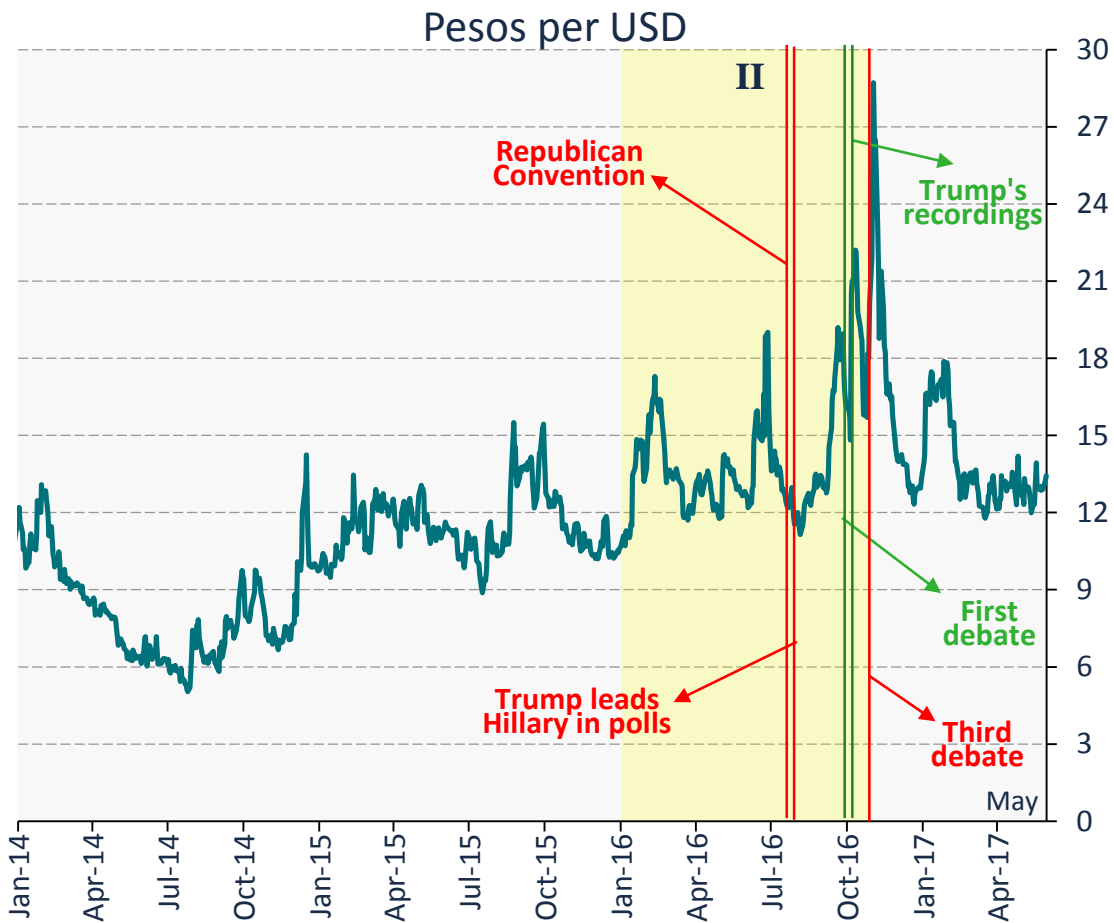
Source: Banco de México.

- Since 2014, the Mexican economy has faced **a number of shocks** that could considerably affect **inflation**.

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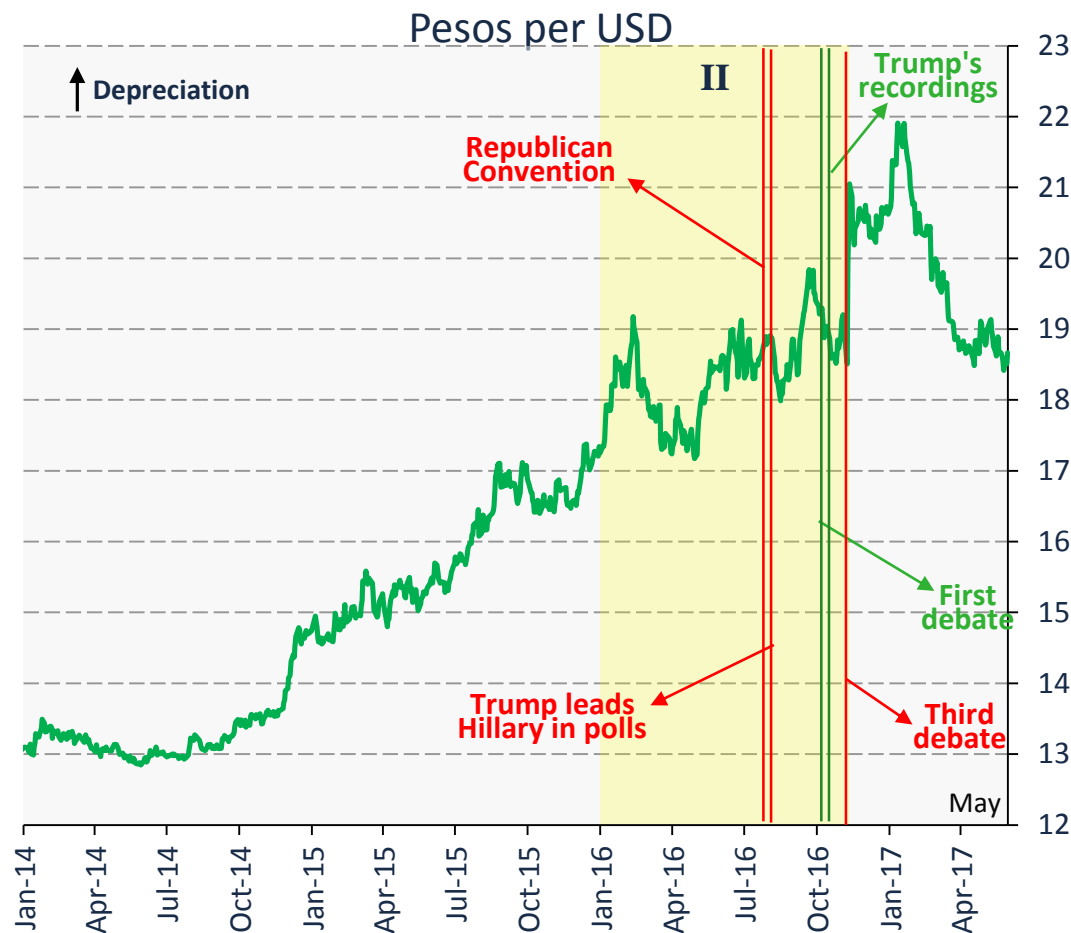
In addition to the depreciation of the Mexican peso, resulting from the decrease in oil prices, a further drop of in the level of the national currency during the U.S. elections was observed. Likewise, during this process this variable presented high volatility.

Mexican Peso Volatility ^{1/}



1/ Refers to implied volatility in one-month options.
Source: Banco de México.

Nominal Exchange Rate ^{2/}



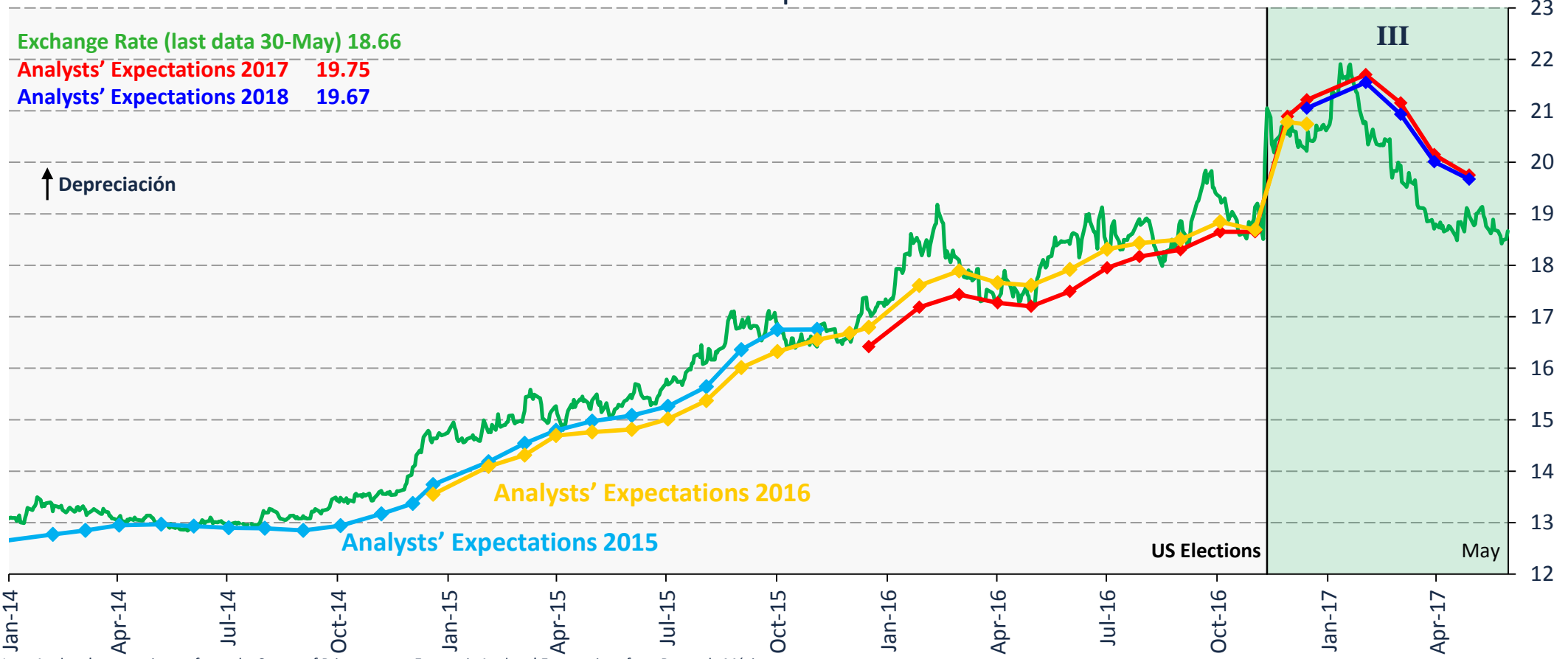
2/ Refers to FIX Exchange Rate.
Source: Banco de México.

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In light of the outcome of the U.S. elections, the national currency further depreciated in addition to the accumulated depreciation that had been observed since mid-2014. However, as of the second half of January it appreciated considerably. Nevertheless, economic analysts' expectations have been adjusting with lags.

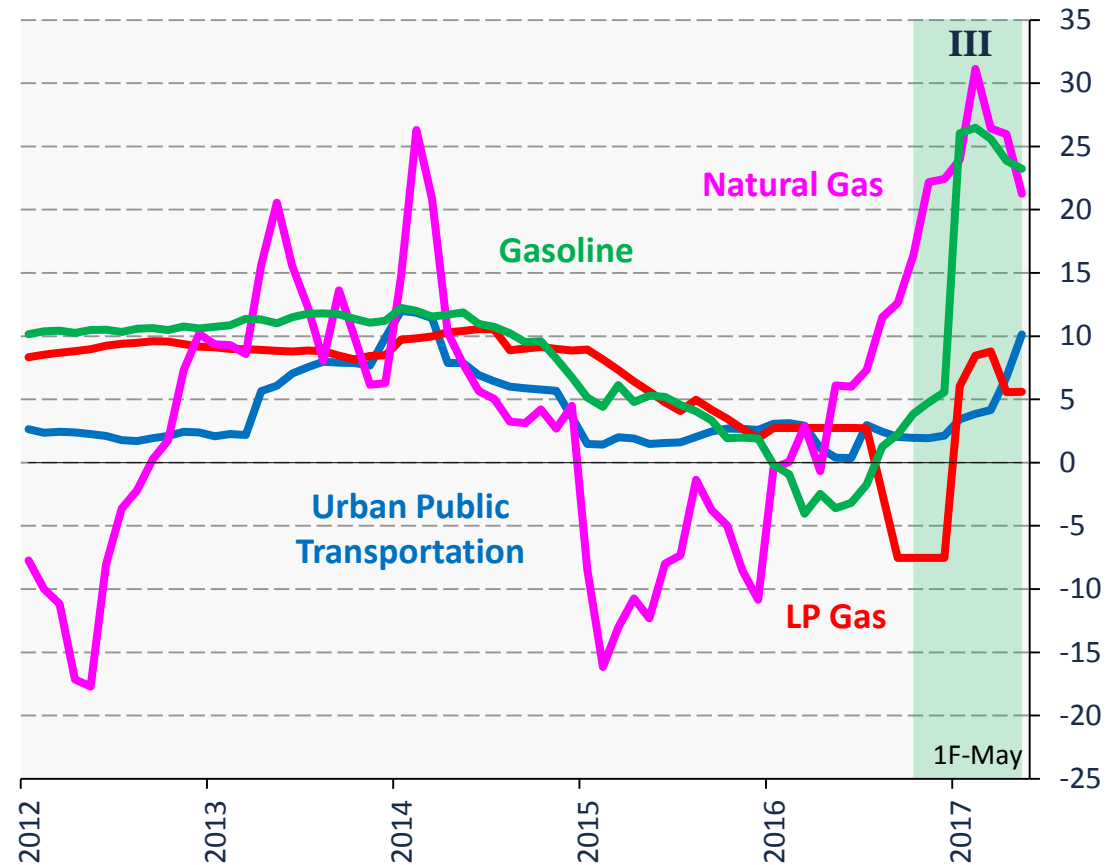
Nominal Exchange Rate ^{1/} Pesos per USD



Note: Analysts' expectations refer to the Survey of Private-sector Economic Analysts' Expectations from Banco de México.
1/ Refers to FIX Exchange Rate.
Source: Banco de México.

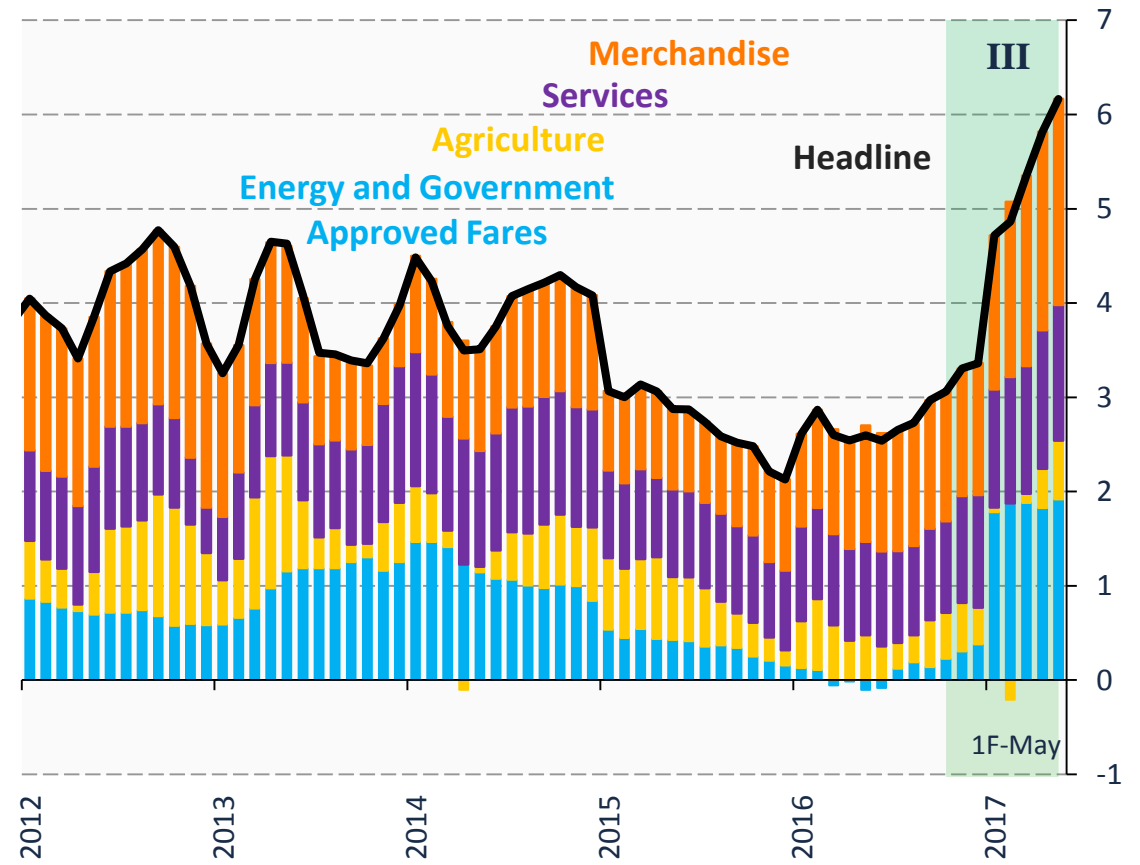
In late 2016 and early 2017, simultaneous shocks of considerable magnitude were observed: 1) the Mexican peso further depreciated in the wake of the U.S. elections, 2) the liberalization process of some energy products' prices, 3) a minimum wage increase; 4) more recently, increases in public transport fares and some agricultural products' prices.

Transport Services and Selected Energy Prices Index
Annual % change



Source: Banco de México and INEGI.

Consumer Price Index
Annual incidences in percentage points^{1/}

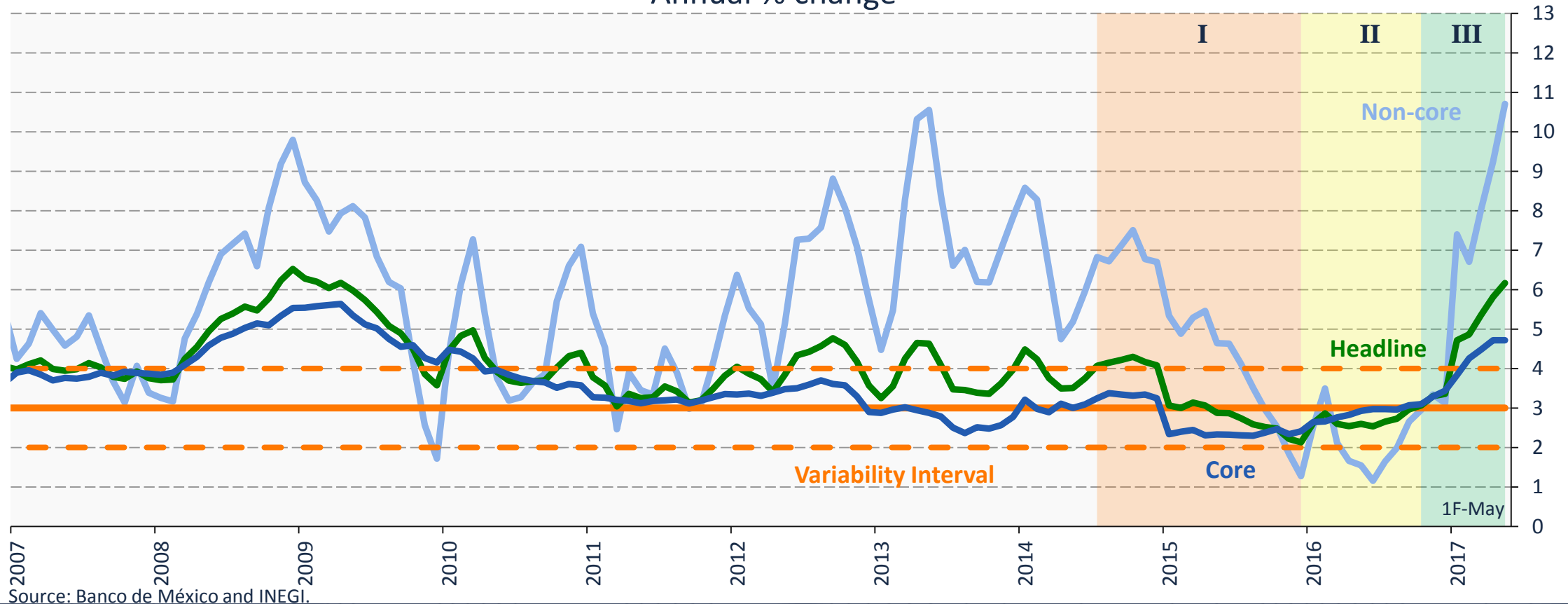


^{1/} Incidence refers to the contribution of each component of the CPI on percentage points to the general inflation. In some cases the sum of the respective components may have some discrepancy due to rounding effects.
Source: Elaborated by Banco de México with data from INEGI.

Inflation in Mexico

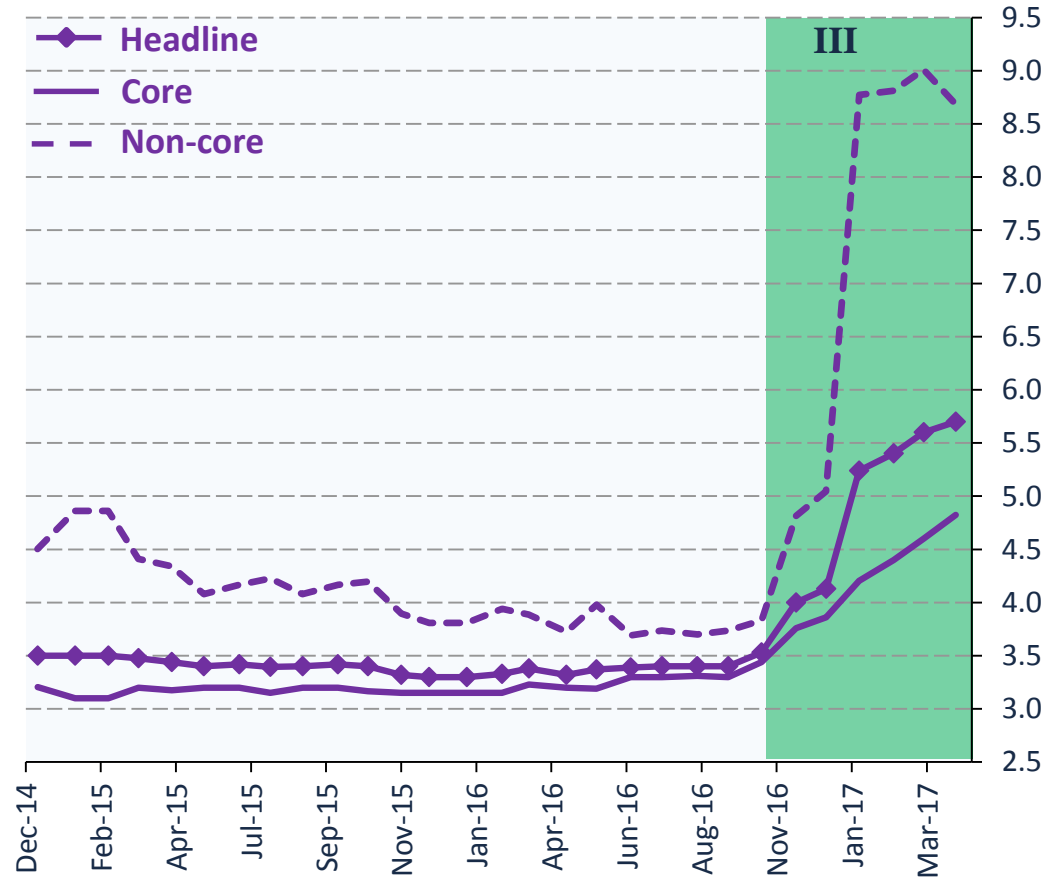
The inflation trajectory has been affected by different shocks. Thus, inflation has recently maintained an upward trend for over 10 consecutive months, as a result of the effects of the above mentioned shocks, which are expected to be transitory.

Consumer Price Index
Annual % change

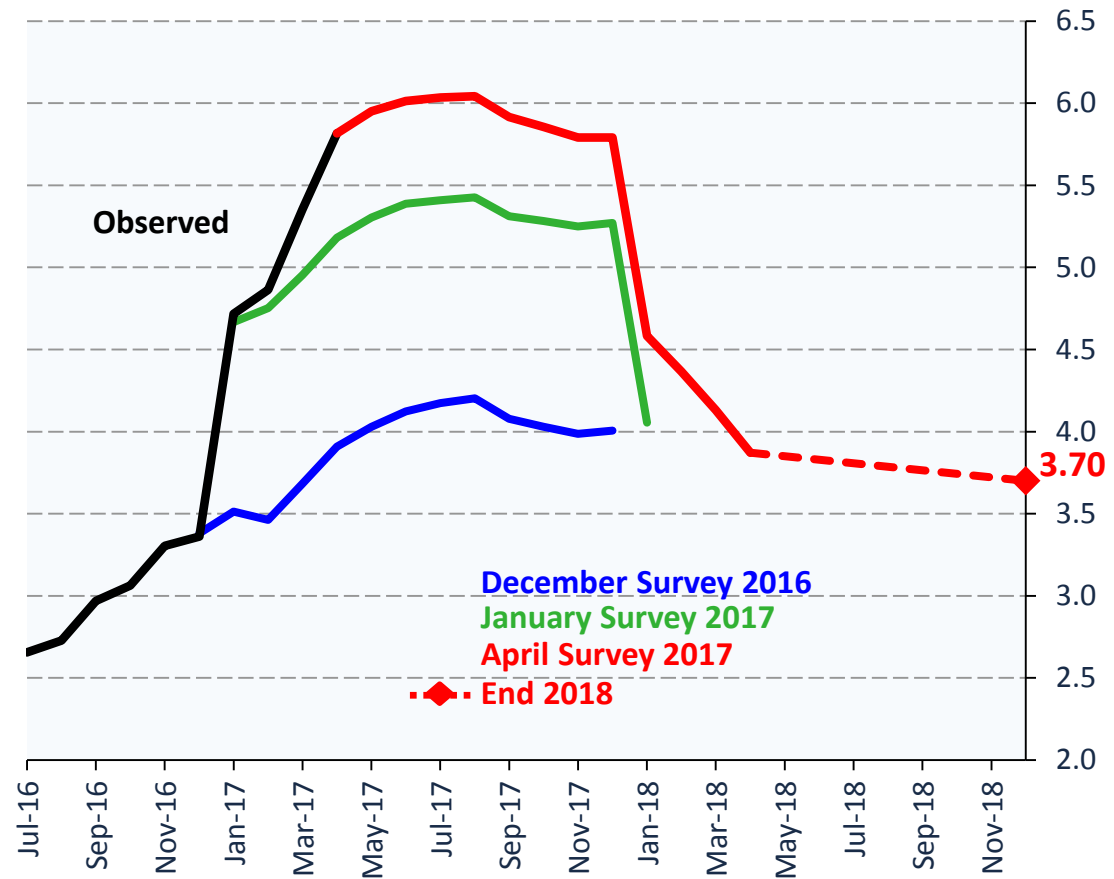


Despite a spike in short-term inflation expectations, these are anticipated to decrease in late 2017, and to adjust downwards significantly in January 2018 and in subsequent months.

Inflation Expectations End of 2017
Median, %



Annual Inflation Expectations
%



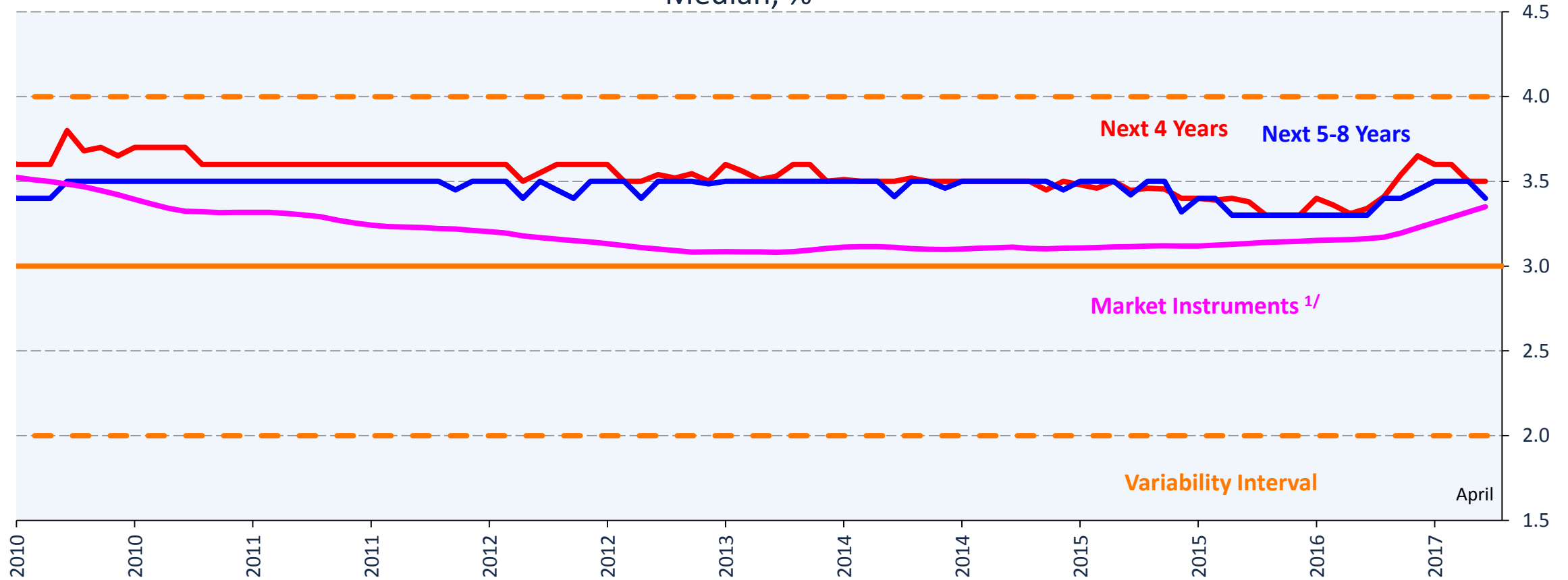
Source: Banco de México Survey (monthly periodicity).

Source: Banco de México and INEGI.

Long-Term Inflation Expectations

Despite the increment in short-term inflation expectations, long-term ones remained stable, reflecting the anticipation that the rise in inflation will be transitory.

Long-Term Inflation Expectations: Headline Inflation Median, %

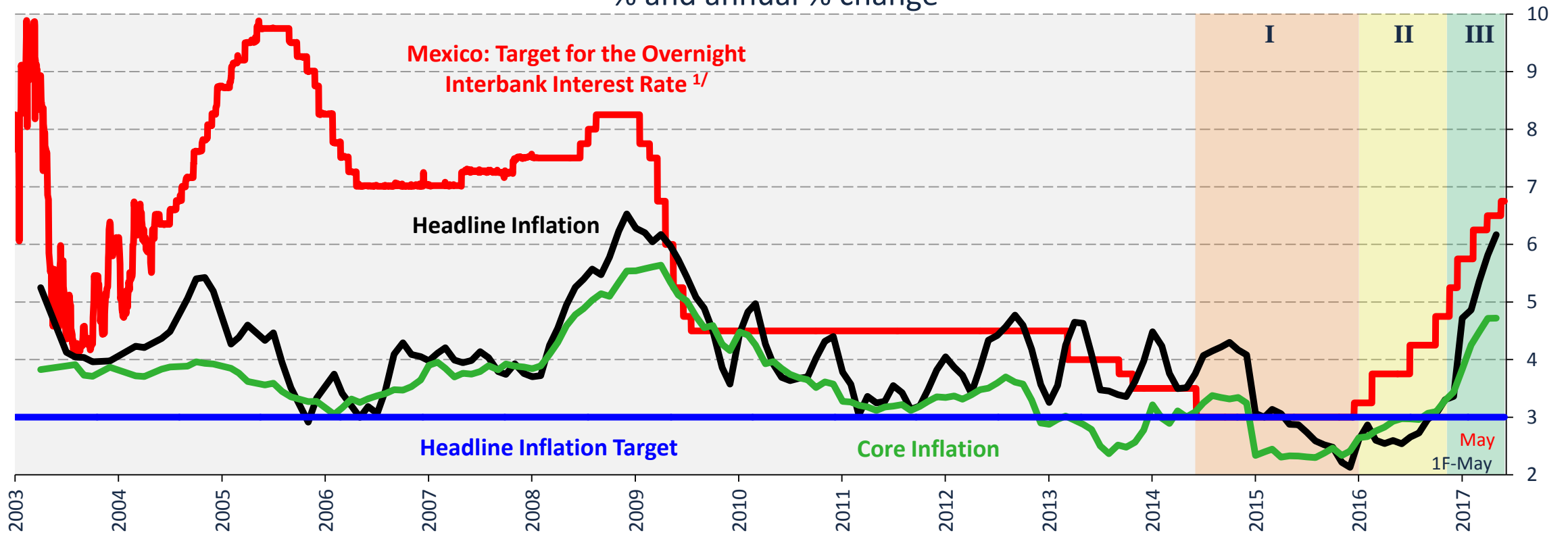


1/ For a description of the estimation of long-term inflation expectations, see the Box "Decomposition of Break-even Inflation" in the Quarterly Report, October – December 2013. For the current Report, the estimate was updated by including data as of December 2015.
Source: Banco de México Survey (monthly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

Considering all of the above, between December 2015 and May 2017, Banco de México has increased the target for the Overnight Interbank Interest Rate from 3.00 to 6.75 percent.

Monetary Policy Rate and Consumer Price Index

% and annual % change

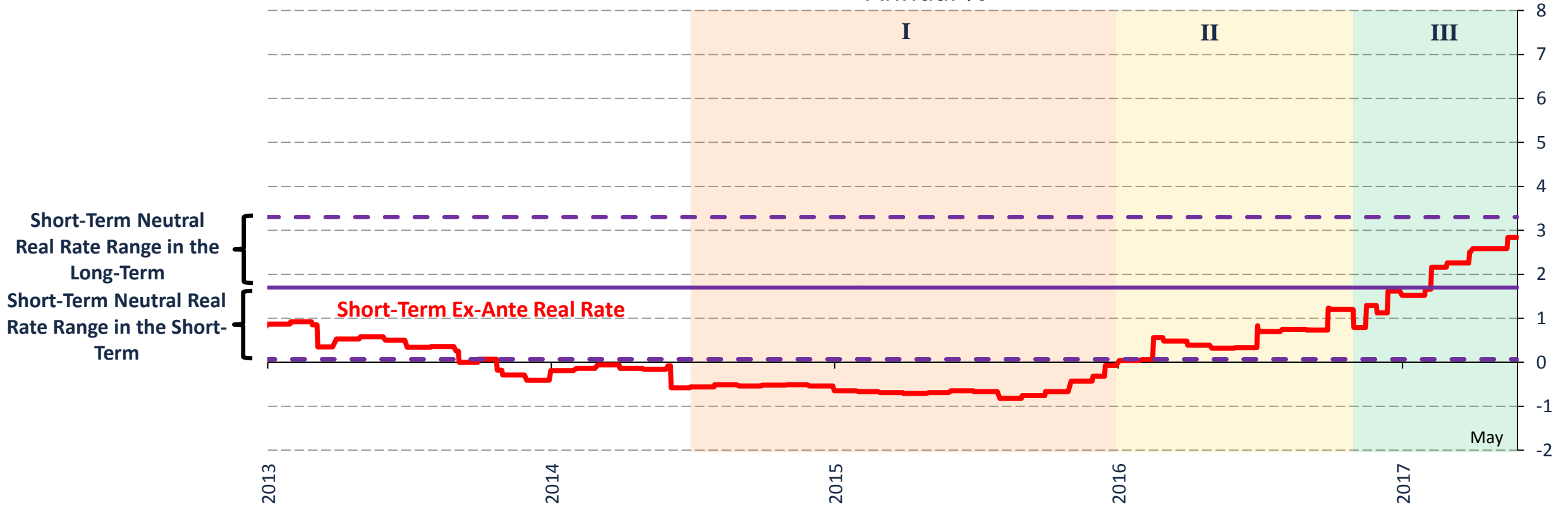


1/ Before January 20, 2008 it refers to the observed Overnight Interbank Interest Rate.

Source: INEGI and Banco de México.

The 375-basis-point increment fundamentally constitutes the withdrawal from the monetary stimulus that had prevailed over the previous period, as the current short-term ex-ante real rate seems to be close to the neutral level that is expected to be observed in the long term.

Short-Term Ex-Ante Real Rate and Estimated Ranges for the Short-Term Neutral Real Rate in the Short and Long Terms ^{1/}
Annual %



^{1/} For its construction is used the Target for the Overnight Interbank Interest Rate and 12-month inflation expectations from Banco de México Survey.
Source: Banco de México.

In particular, in 2017 so far:

February 2017

50 bp increment to 6.25 percent

March 2017

25 bp increment to 6.50 percent

May 2017

25 bp increment to 6.75 percent

The above decisions took into account:

- ✓ Mainly, the **inflation trend** in light of the transitory shocks in relative prices.
- ✓ The outlook of **no expected aggregate demand-related pressures**.
- ✓ **Increments in the monetary policy rate** carried out since 2015.
- ✓ The **25 bp increment** in the target range for the U.S. Federal Reserve reference rate in its March meeting.

Regarding the decisions of March 30, 2017 and May 18, 2017, the Board of Governors agreed that, given the conditions prevailing at that moment, the expectation of **no aggregate demand-related pressures** on inflation, as well as the **increments** in the monetary policy rate **carried out since 2015**, the **required adjustment amounted to 25 basis points**.

Outline

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2 Economic Activity and Financial Markets

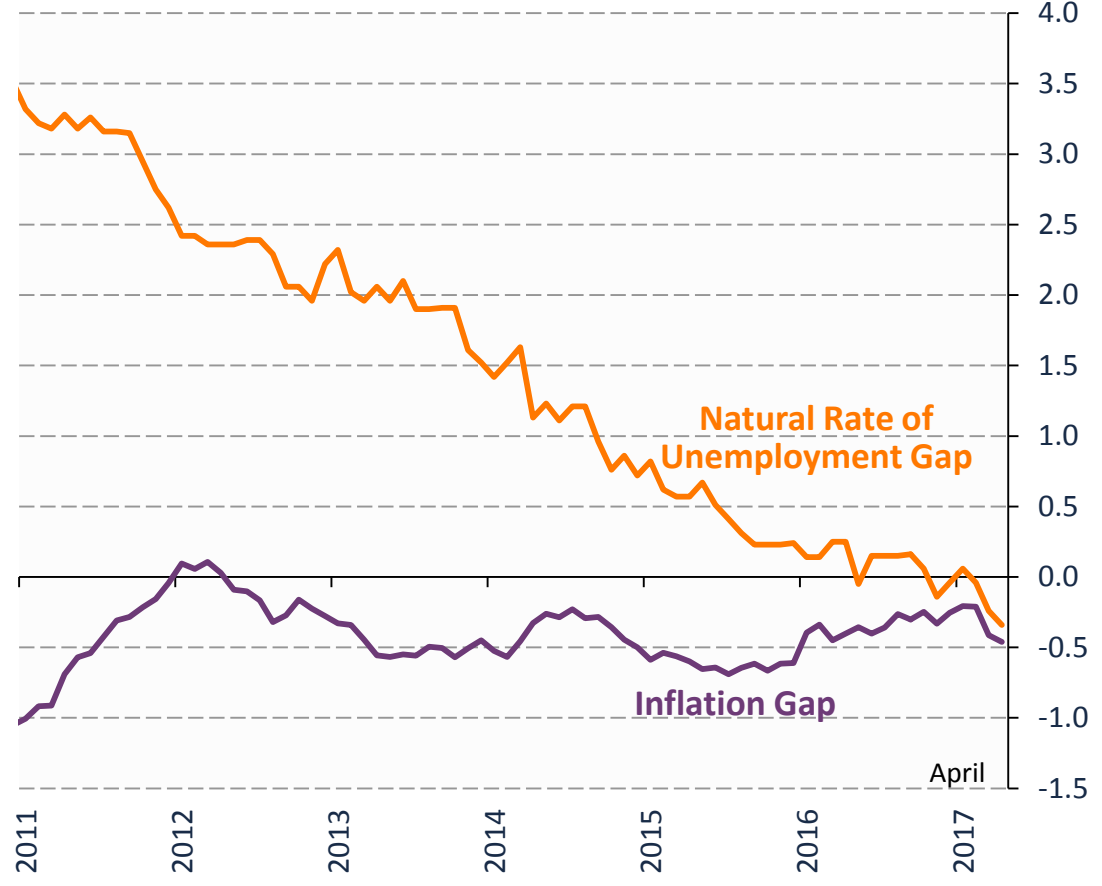
3 Forecasts and Final Remarks

The U.S. economy decelerated during 1Q 2017, even though it was due to transitory factors. The labor market continued strengthening and inflation slowed down as a result of temporary factors, and so it is expected to converge to its target in the future.

United States

Inflation and Unemployment Gaps

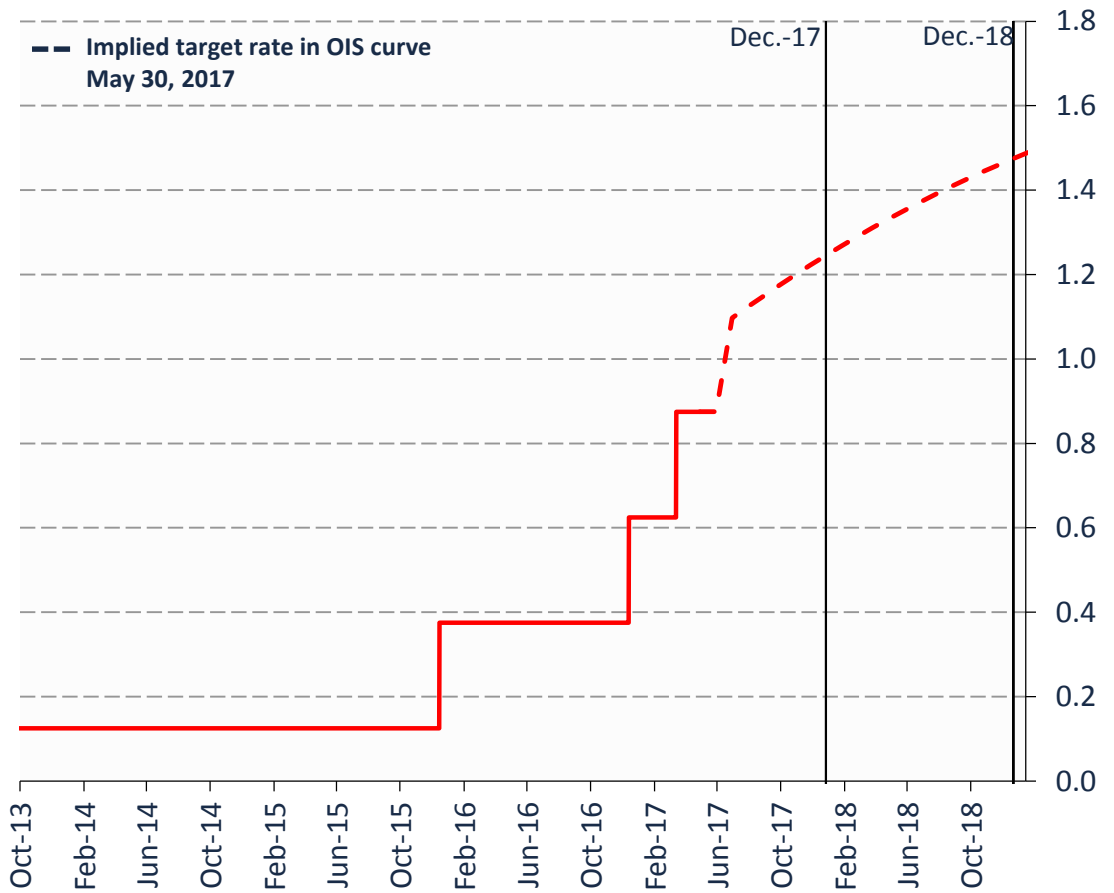
%



Note: Inflation gap is relative to the Federal Reserve 2% objective. Unemployment gap is relative to the natural rate of unemployment estimated by the CBO.
Source: U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office (CBO).

Expected Federal Funds Rate Implicit in OIS Curve ^{1/}

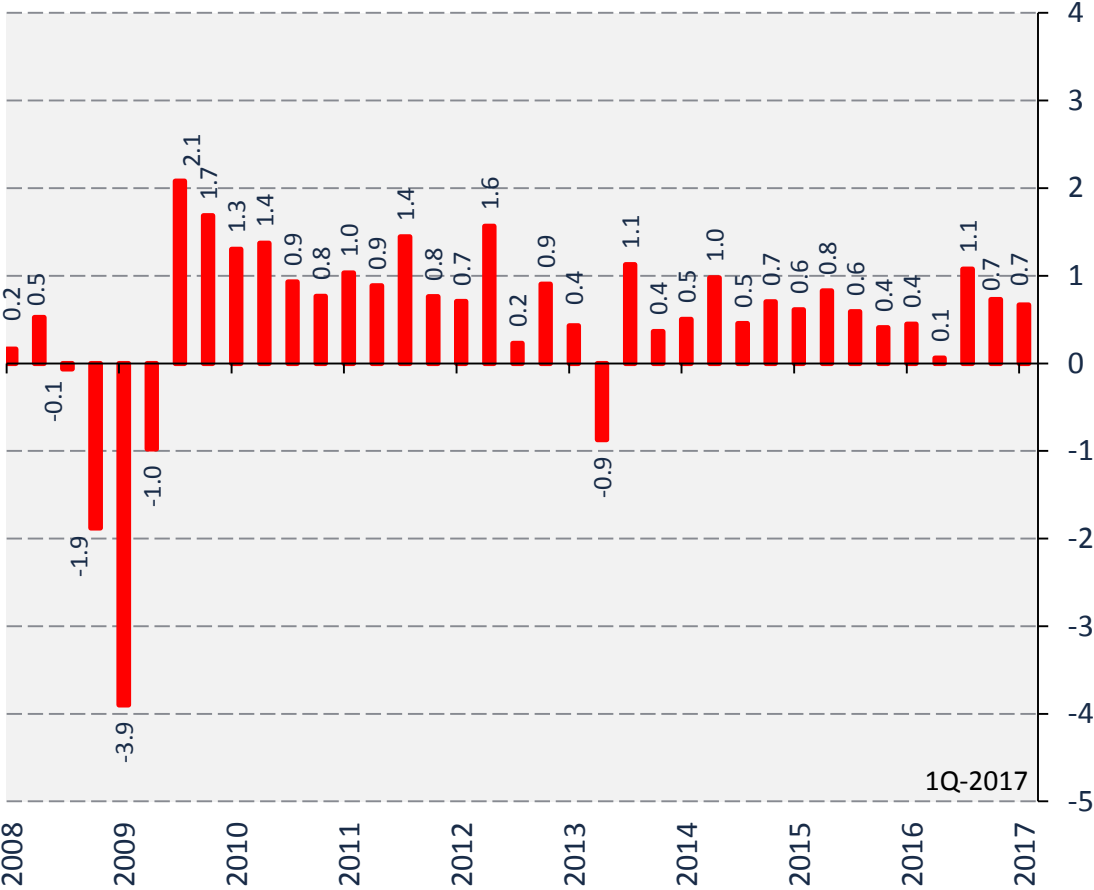
%



^{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 (0.75% - 1.00%).
Source: Banco de México with data from Bloomberg.

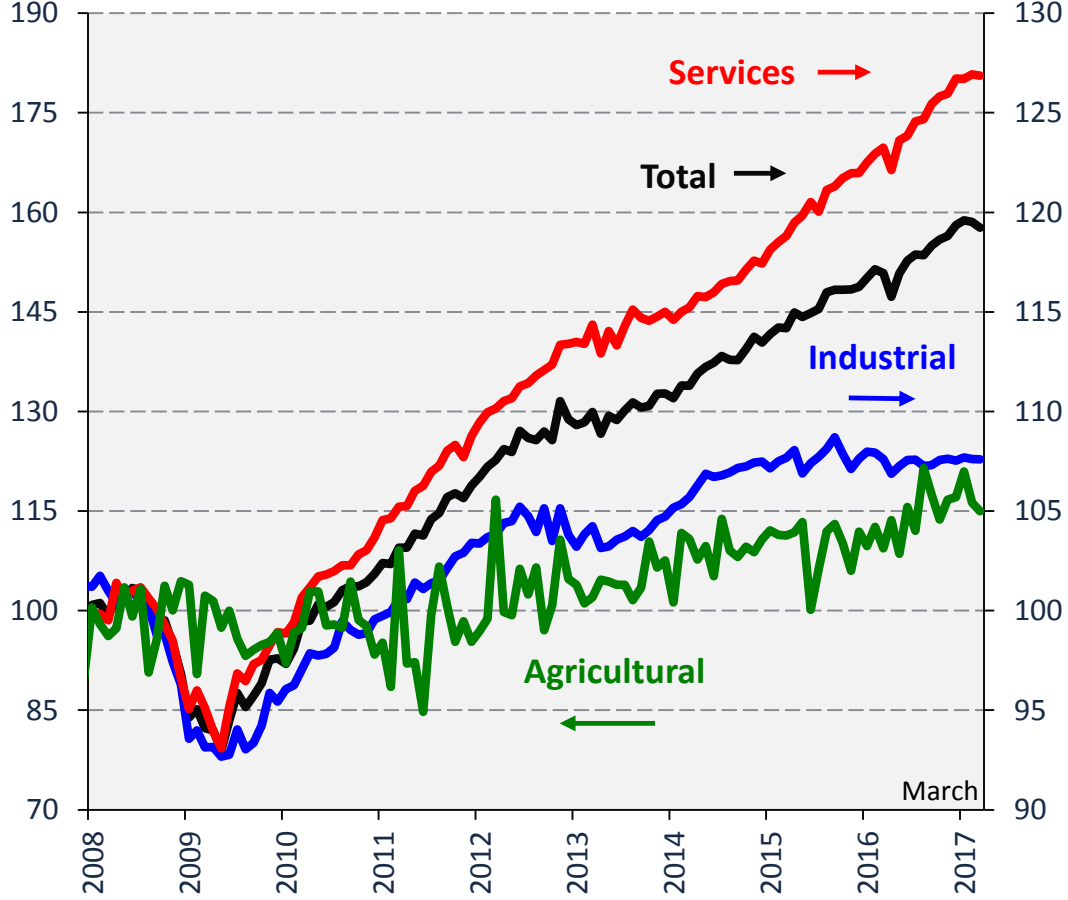
In 1Q 2017, the Mexican economy registered a similar growth rate to that observed in 4Q 2016, largely reflecting the dynamism in services.

Gross Domestic Product
Quarterly % change, s. a.



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

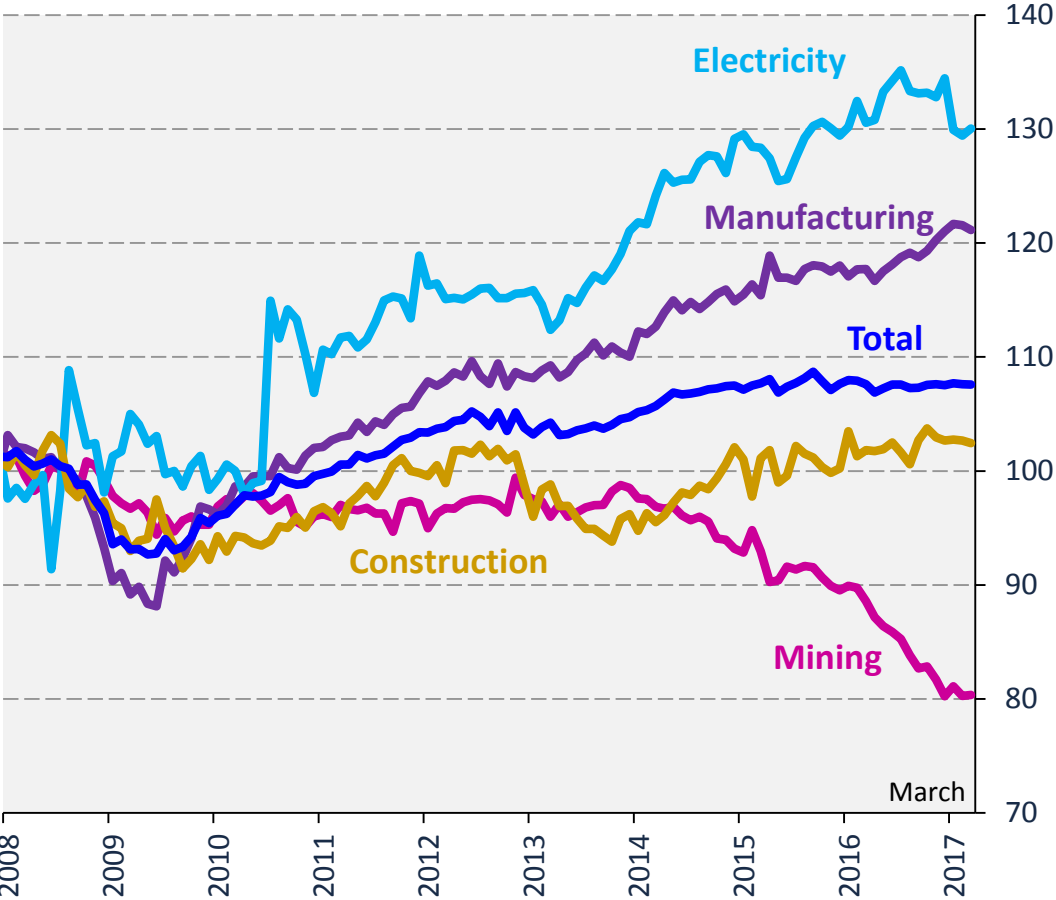
Global Indicator of Economic Activity
Index 2008=100, s. a.



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

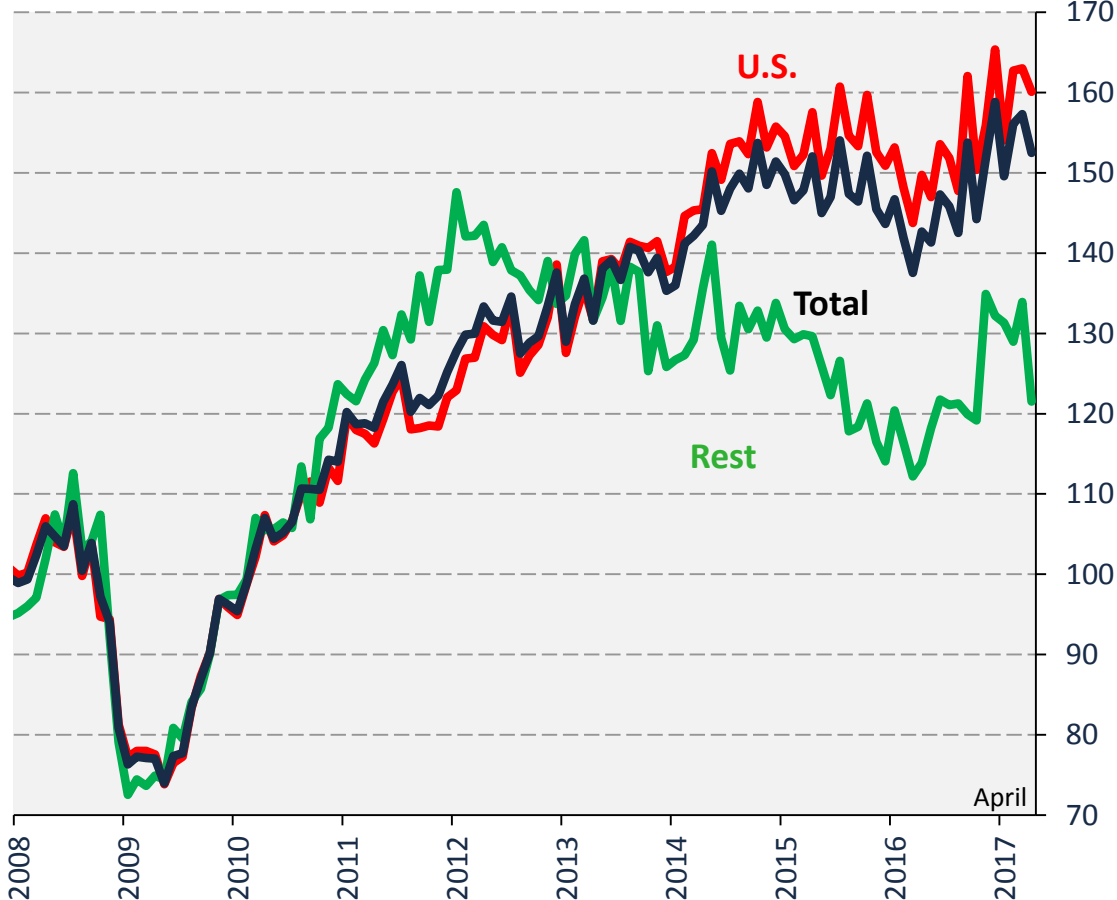
Manufacturing production kept expanding. Meanwhile, manufacturing exports continued to recover, encouraged by the depreciation of the real exchange rate and the gradual strengthening of global economic activity.

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.

Manufacturing Exports
Index 2008=100, s. a.

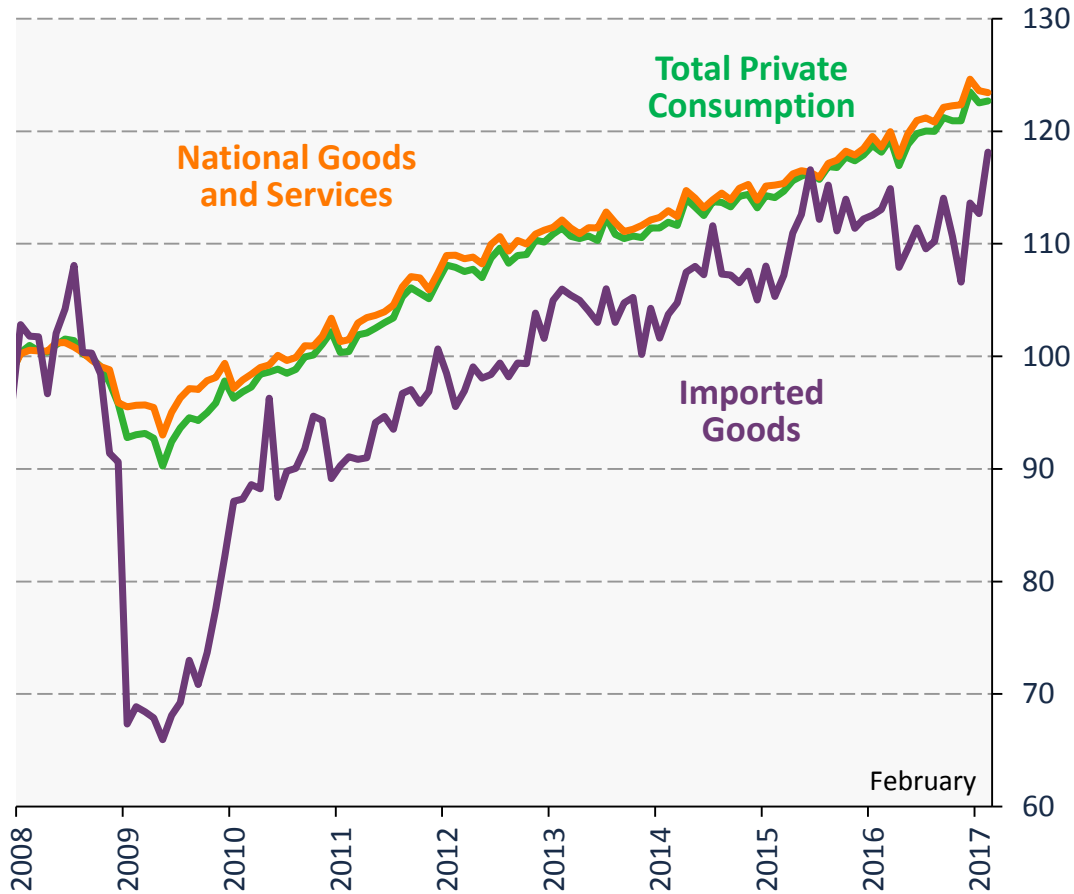


s. a. / Seasonally adjusted data based on information in nominal dollars.
Source: Banco de México with data from SAT, SE, Banco de México, INEGI. Merchandise Trade Balance, SNIEG. Information of National Interest.

During the first two months of 2017, the monthly indicator of domestic private consumption kept a positive trend, even though recent data point to a certain slowdown. In turn, weakness in investment accentuated.

Domestic Private Consumption

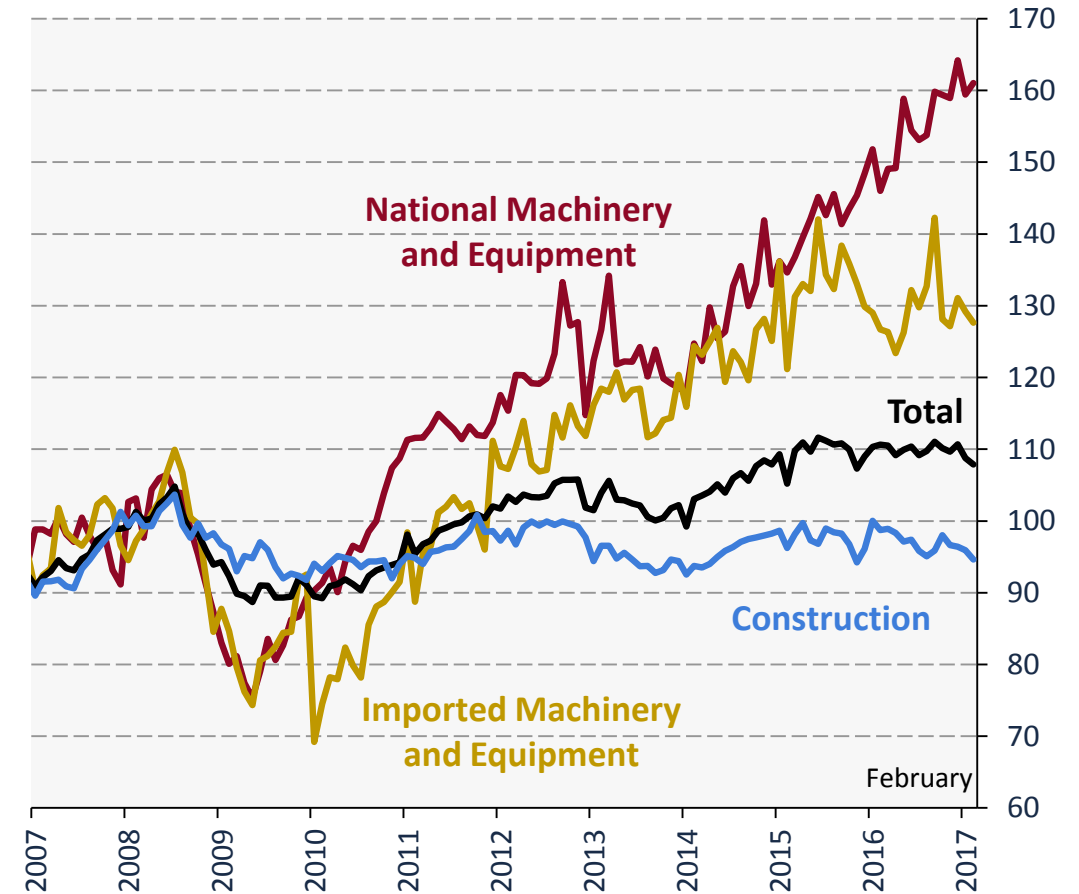
Index 2008=100; s. a.



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

Investment and its Components

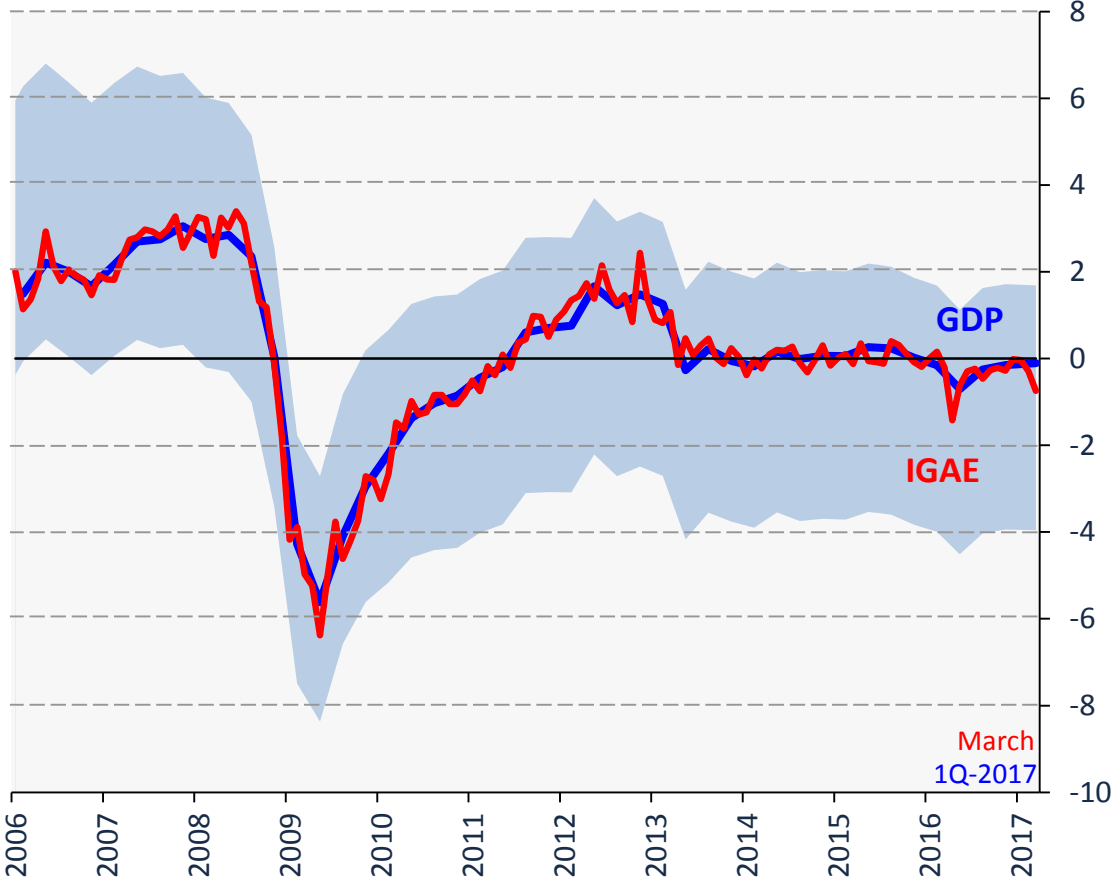
Index 2008=100, s. a.



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

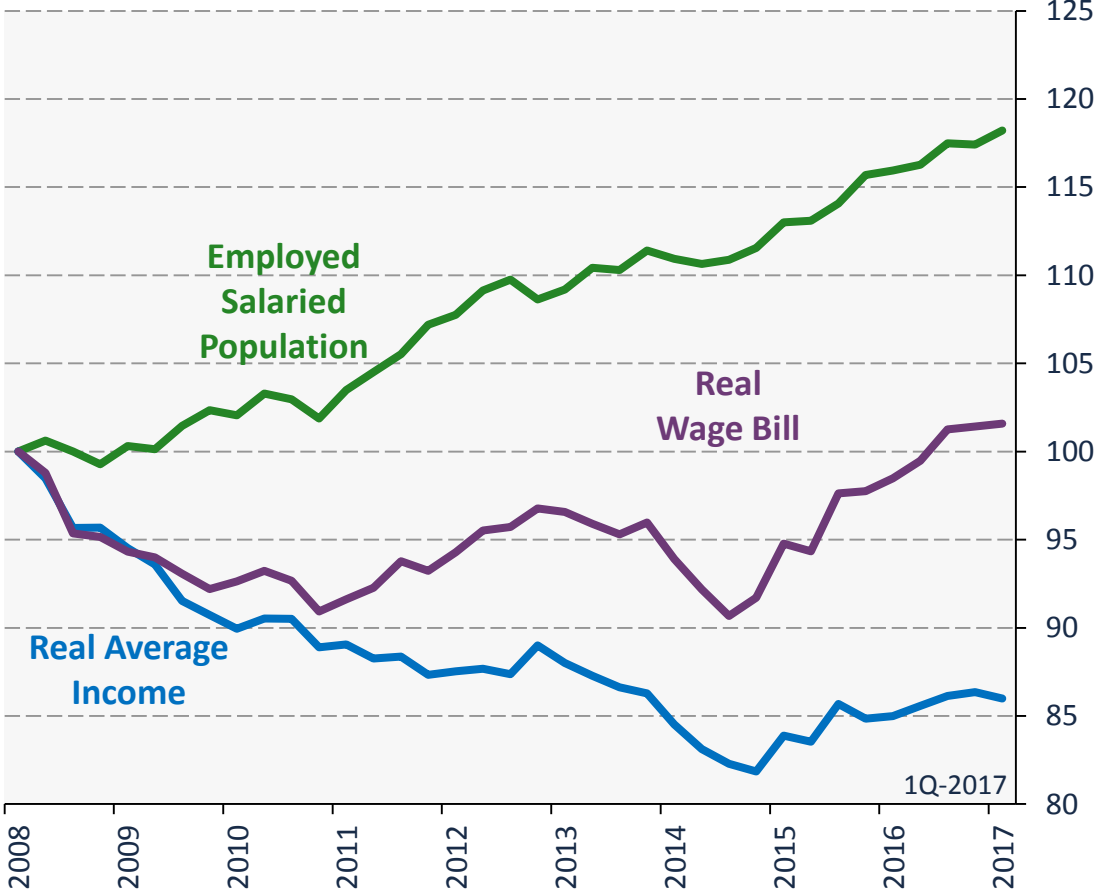
Following the recent evolution of the economic activity, no significant aggregate demand-related pressures onto prices have been observed yet. On the other hand, labor market kept recovering.

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.

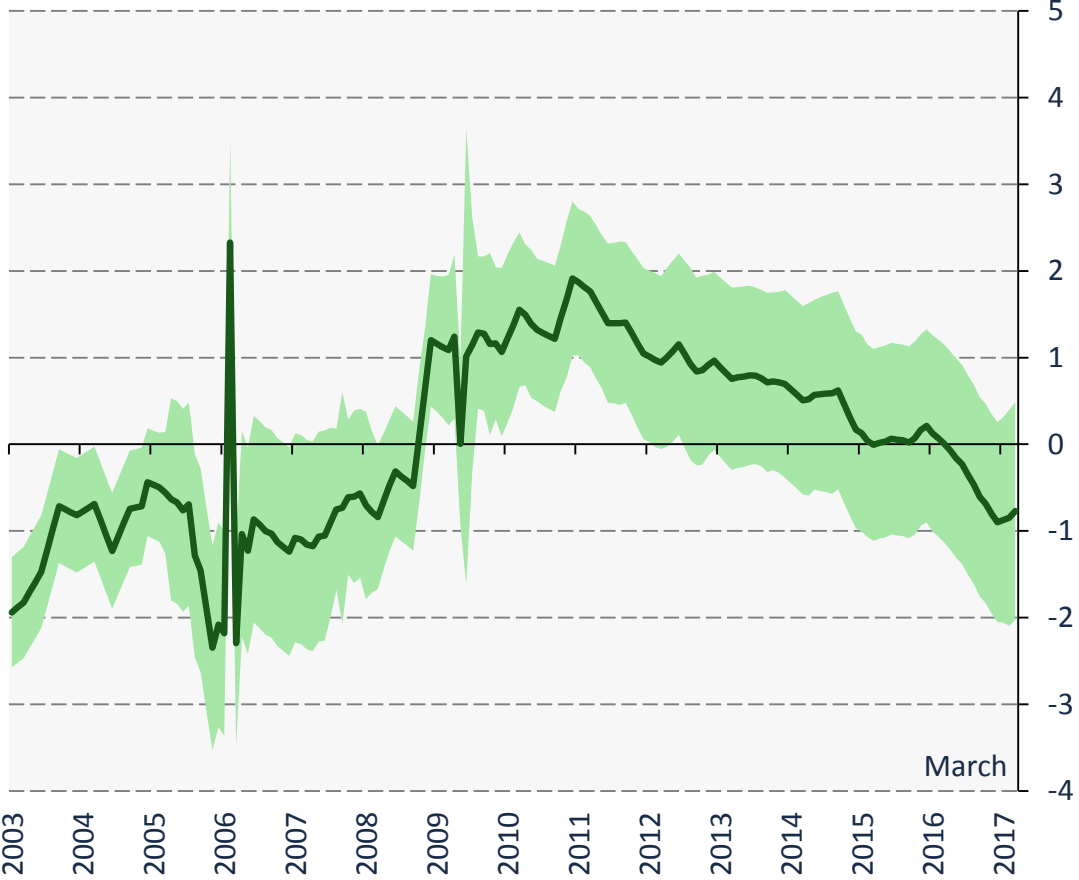
Real Total Wage Bill
Index 1Q-2008 =100, s. a.



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

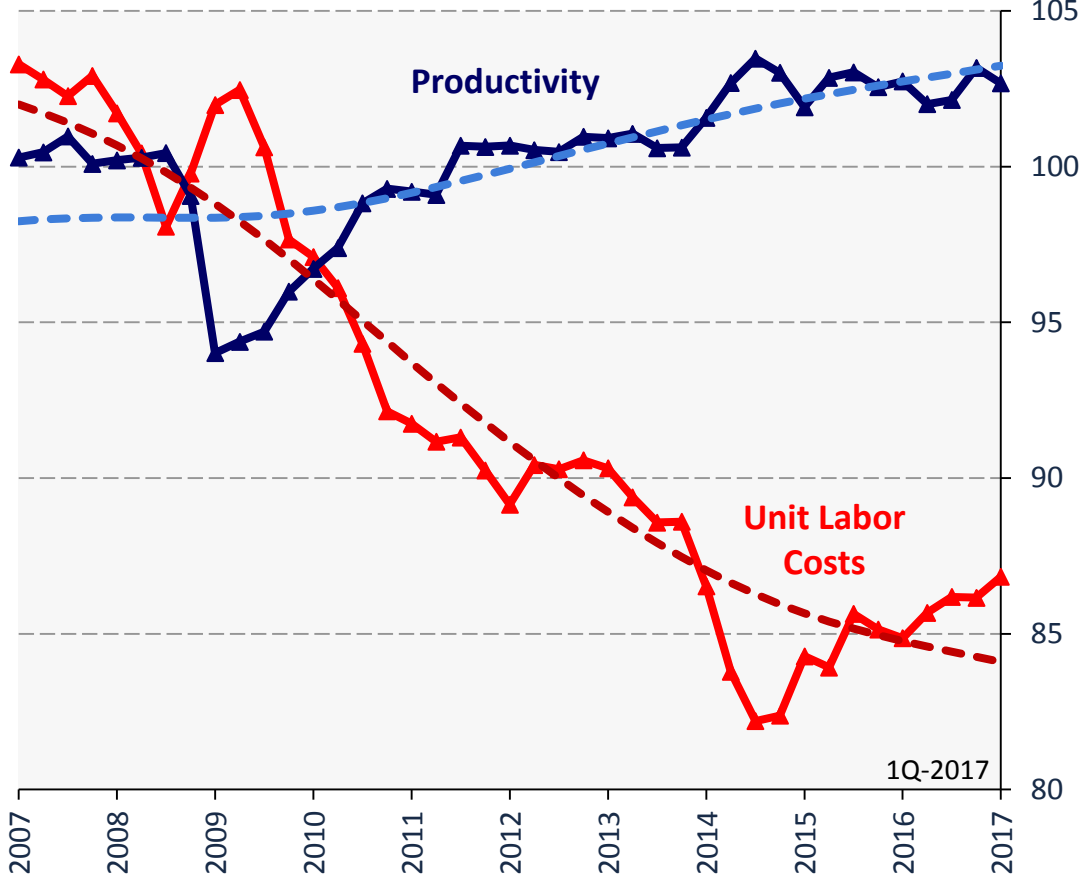
Thus, slackness in the labor market has been diminishing. In this context, an upward trend is still observed in unit labor costs, even though starting from low levels, so that they have not resulted in wage pressures.

Employment Gap and Informal Salaried Workers ^{1/}
Percentage points; s. a.



s. a. / Calculated with seasonally adjusted data.
 1/ The shaded area represents the confidence interval, which corresponds to two average standard deviations among all estimates; see Banco de México (2017), "Quarterly Report, October-December 2016", pág.47.
 Source: Banco de México.

Productivity and Unit Labor Cost
Index 2008=100, s. a. ^{2/}

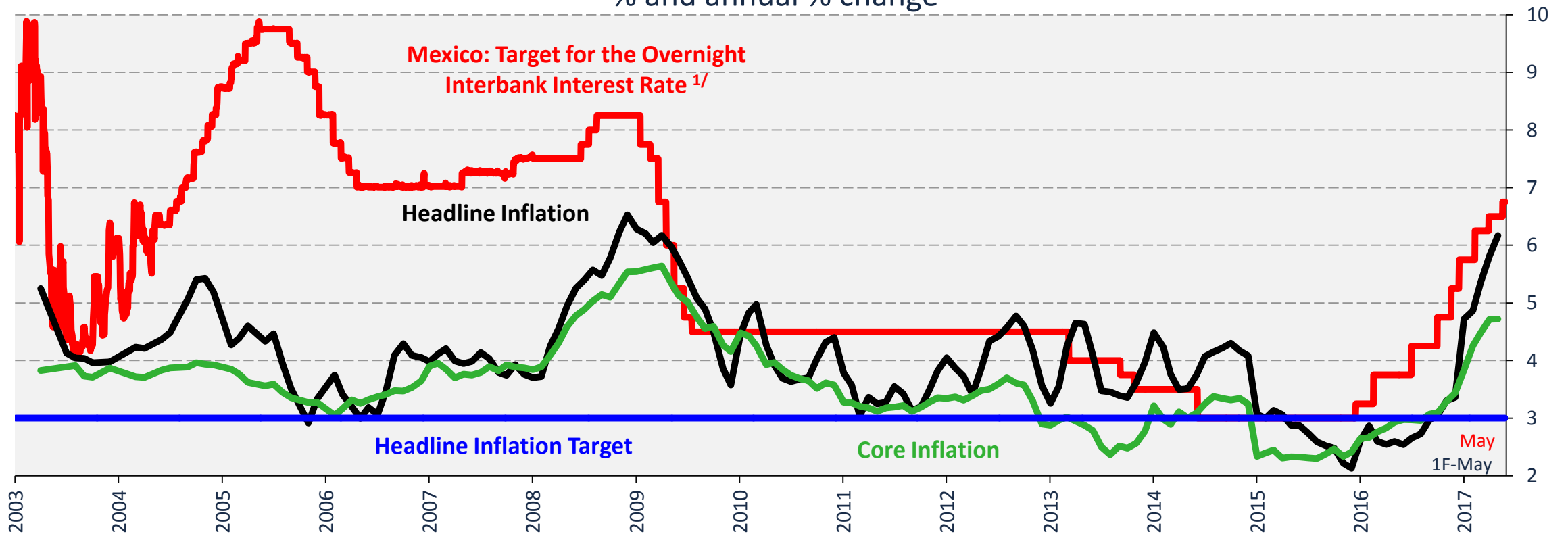


Note: Data for 1Q-2017 estimated by Banco de México.
 s. a. / Seasonally adjusted and trend series. The former is represented with a solid line, the latter, with a dotted line.
 Trends estimated by Banco de México.
 2/ Productivity based on worked hours.
 Source: Unit cost prepared by Banco de México based on data from INEGI. The Global Index of Labor Productivity in the Economy (IGPLE), as released by INEGI.

The evolution of the economic activity and of the external sector has not generated inflation pressures. However, in order to prevent a contamination to the price formation process in the economy, to anchor inflation expectations and to strengthen the contribution of the monetary policy to the inflation convergence to its target, the reference rate has been adjusting.

Monetary Policy Rate and Consumer Price Index

% and annual % change

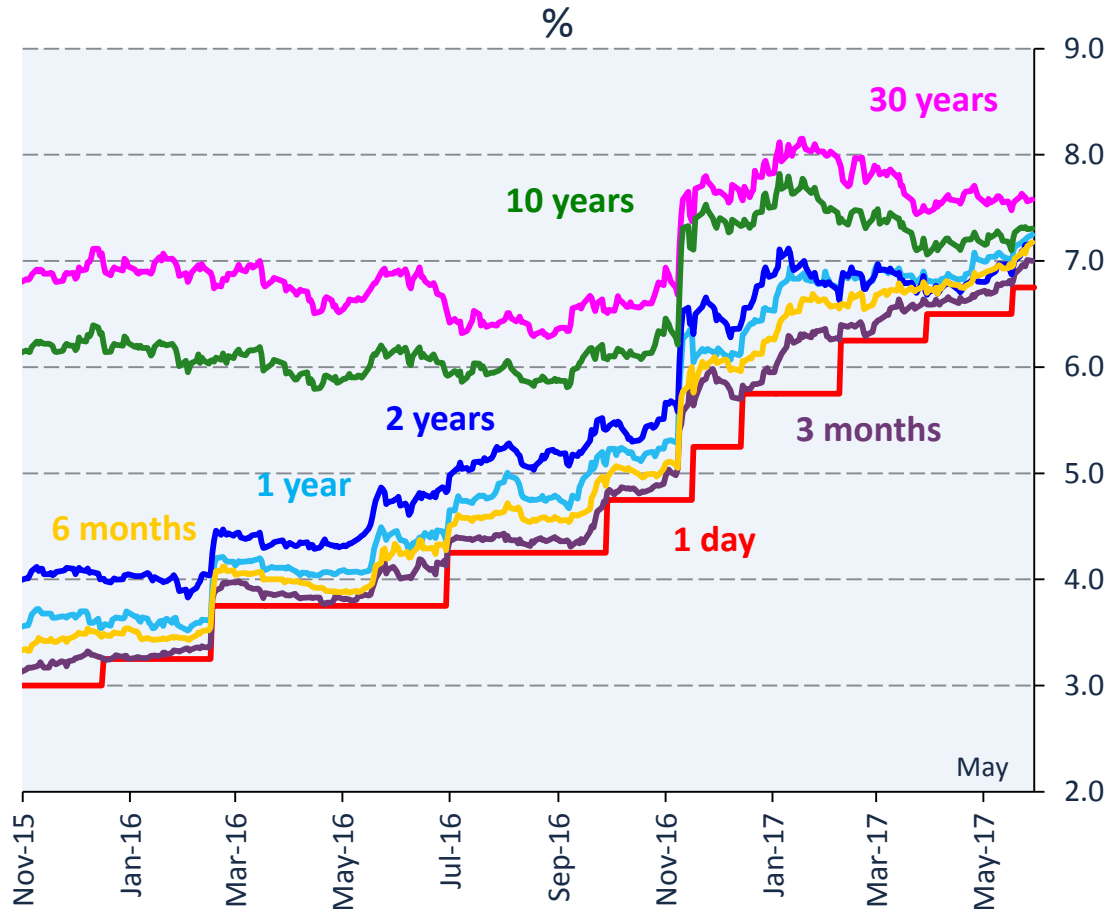


1/ Before January 20, 2008 it refers to the observed Overnight Interbank Interest Rate.

Source: INEGI and Banco de México.

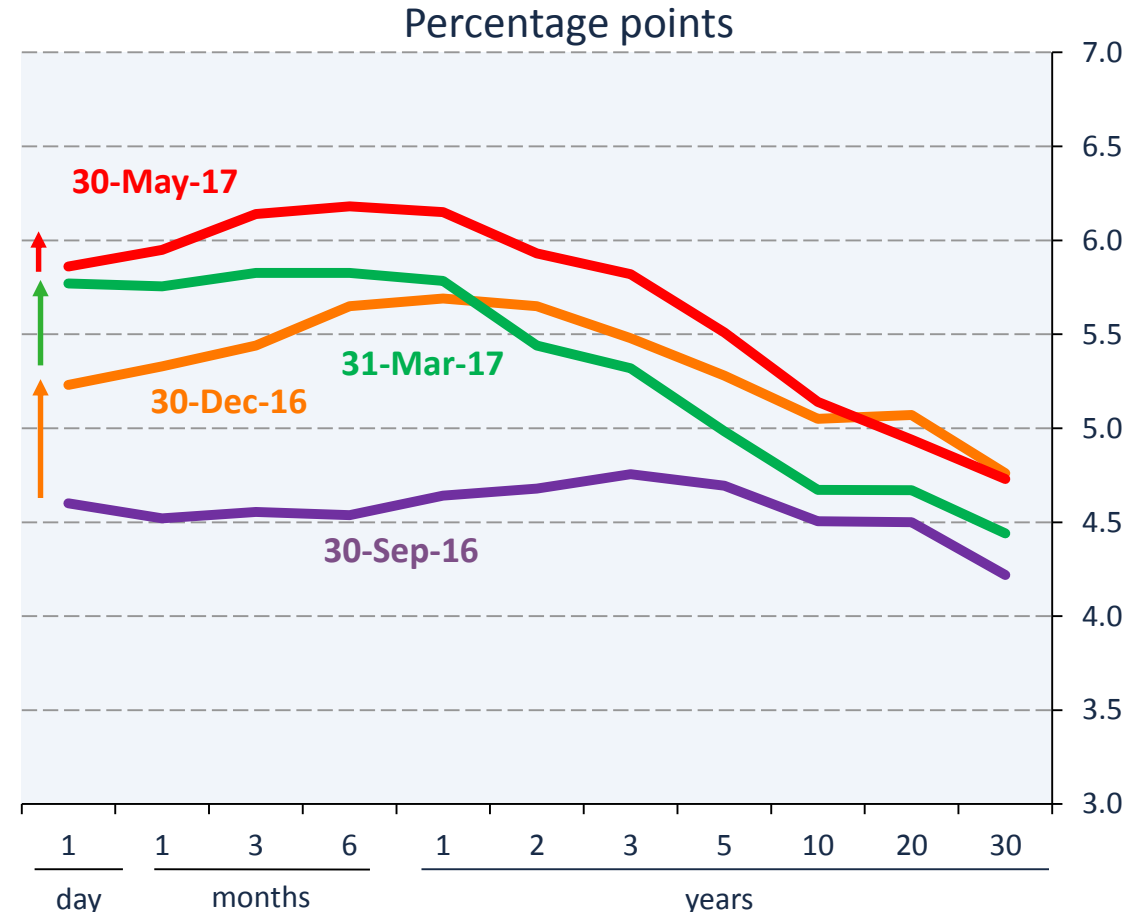
Short-term interest rates went up, reflecting the increments in the reference rate, while longer-term rates diminished. Thus, the yield curve has flattened, as a result of the measures set forth by Banco de México and those that it could implement. On the other hand, Mexico and U.S. interest rate spreads increased in their short-term horizons and remained stable in long-term ones.

Mexico Interest Rates



Fuente: Proveedor Integral de Precios (PiP).

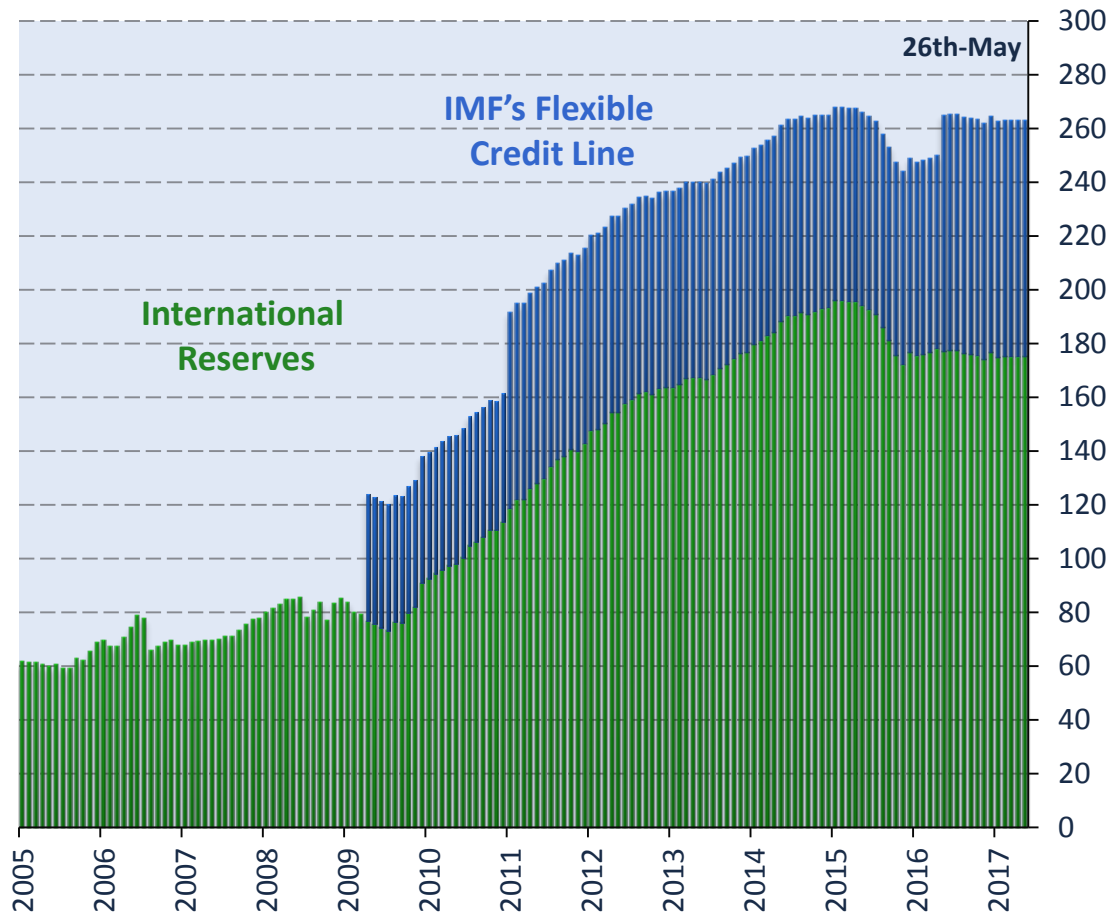
Mexico and United States Interest Rate Spreads ^{1/}



^{1/} The United States objective rate is the average of the interval considered by the Federal Reserve.
Source: Proveedor Integral de Precios (PiP) and U.S. Treasury Department.

To propitiate a more orderly functioning in the foreign exchange market, the Foreign Exchange Commission instructed Banco de México to implement a foreign exchange hedging program, in a context where Mexico has a high level of international reserves.

International Reserves
USD billions



Source: Banco de México and International Monetary Fund.

Foreign Exchange Commission: Foreign Exchange Hedging Program

- ✓ Allows to offer up to **USD 20 billion** in currency hedges, without using international reserves.
- ✓ The Foreign Exchange Commission:
 - Reaffirmed its commitment to monitor the operating conditions in the foreign exchange market.
 - **Does not rule out the possibility of taking additional actions if necessary.**

IMF: Flexible Credit Line

- ✓ Ratified for **USD 86 billion**.
- ✓ The IMF recognizes the Mexican authorities' commitment to maintain strong economic fundamentals and to ensure financial stability.

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Economic Activity Outlook

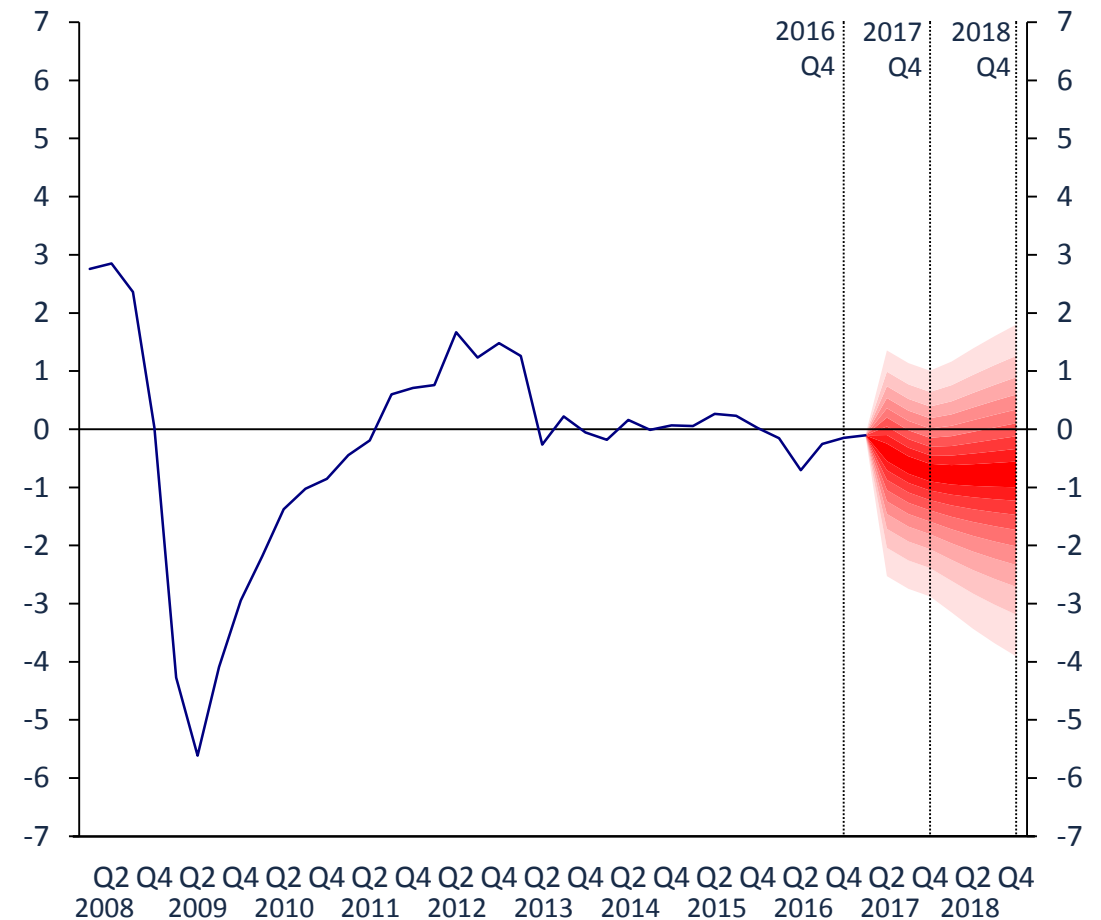
GDP Growth (%)		
Report	Previous	Revised
2017	1.3 – 2.3	1.5 – 2.5
2018	1.7 – 2.7	1.7 – 2.7

Increase in the Number of IMSS-insured jobs (Thousands)		
Report	Previous	Revised
2017	580 – 680	650 – 750
2018	620 – 720	640 – 740

Current Account Deficit ^{1/} (% of GDP)	
Report	Actual
2017	2.3
2018	2.3

1/ The forecasts for the current account deficit in the actual Report were elaborated considering the new balance of payments figures that follow the methodology of the sixth edition of the Manual of the International Monetary Fund.

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



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

Risks to Growth Outlook

The balance is still biased to the downside:

Upward

- ✓ Successful renegotiation of the NAFTA.
- ✓ Timely implementation of structural reforms.
- ✓ Consumption keeping its growing dynamism.
- ✓ Higher-than-expected worker remittances.

Downward

- ✓ Postponing investment, in view of the NAFTA-related uncertainty.
- ✓ Implementation of protectionist policies in the U.S.
- ✓ Lower-than-expected worker remittances.
- ✓ New episodes of turbulence in international financial markets.

Inflation Outlook

Headline inflation

- In 2017, it is expected to significantly exceed the upper limit of the variability interval, even though it is estimated that during the last months of 2017 and during 2018 it will resume its convergence trend to the 3 percent target and will attain such level at the end of that year.

Core inflation

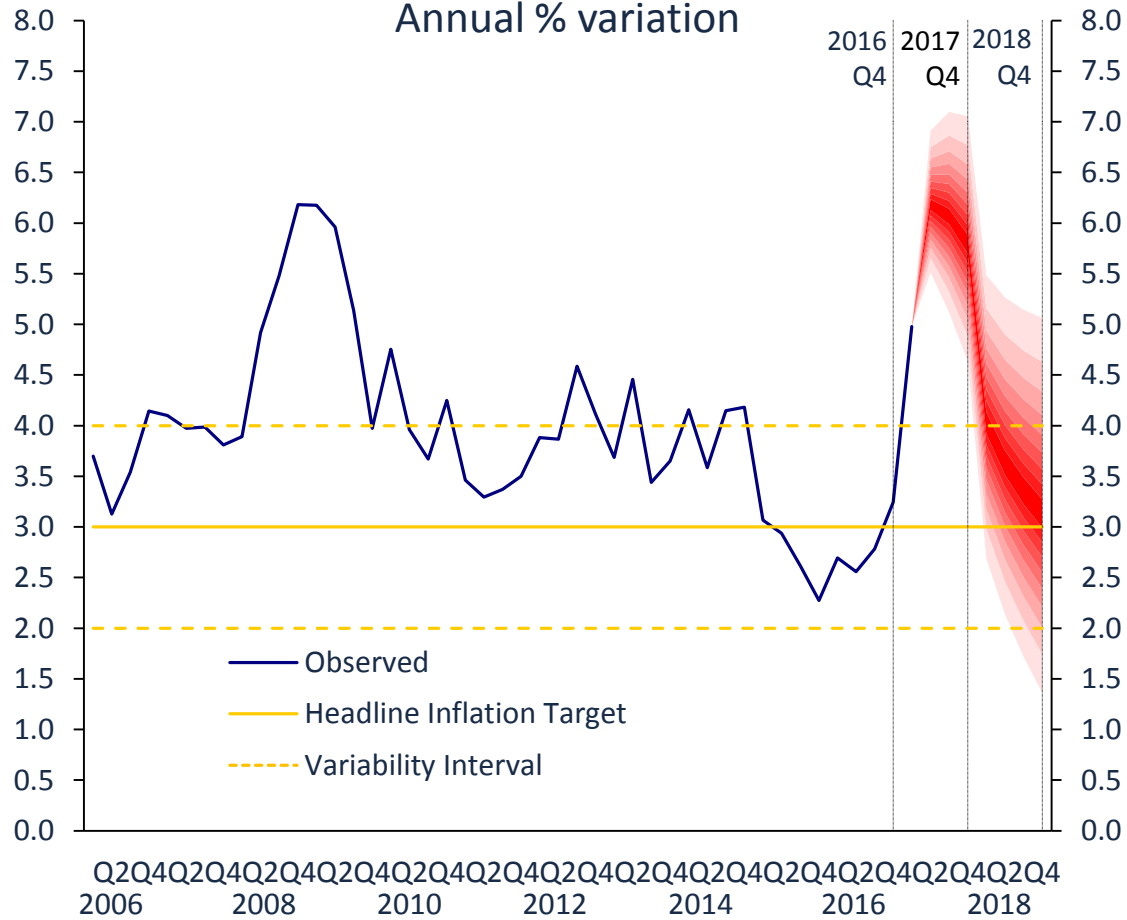
- In 2017, it is expected to persist above the variability interval, although considerably below the headline inflation trajectory, and at the end of 2017 and in early 2018 it is forecast to resume the convergence trend to its target.

- The expected trajectories will be the result of a number of factors:
 - ✓ *The fading of the shocks that affected inflation.*
 - ✓ *The reversal that the exchange rate has shown over the last months.*
 - ✓ *The expected widening of the output gap into negative territory.*
 - ✓ *The monetary policy stance.*

Over the next months, inflation is expected to remain temporarily affected by the described shocks.

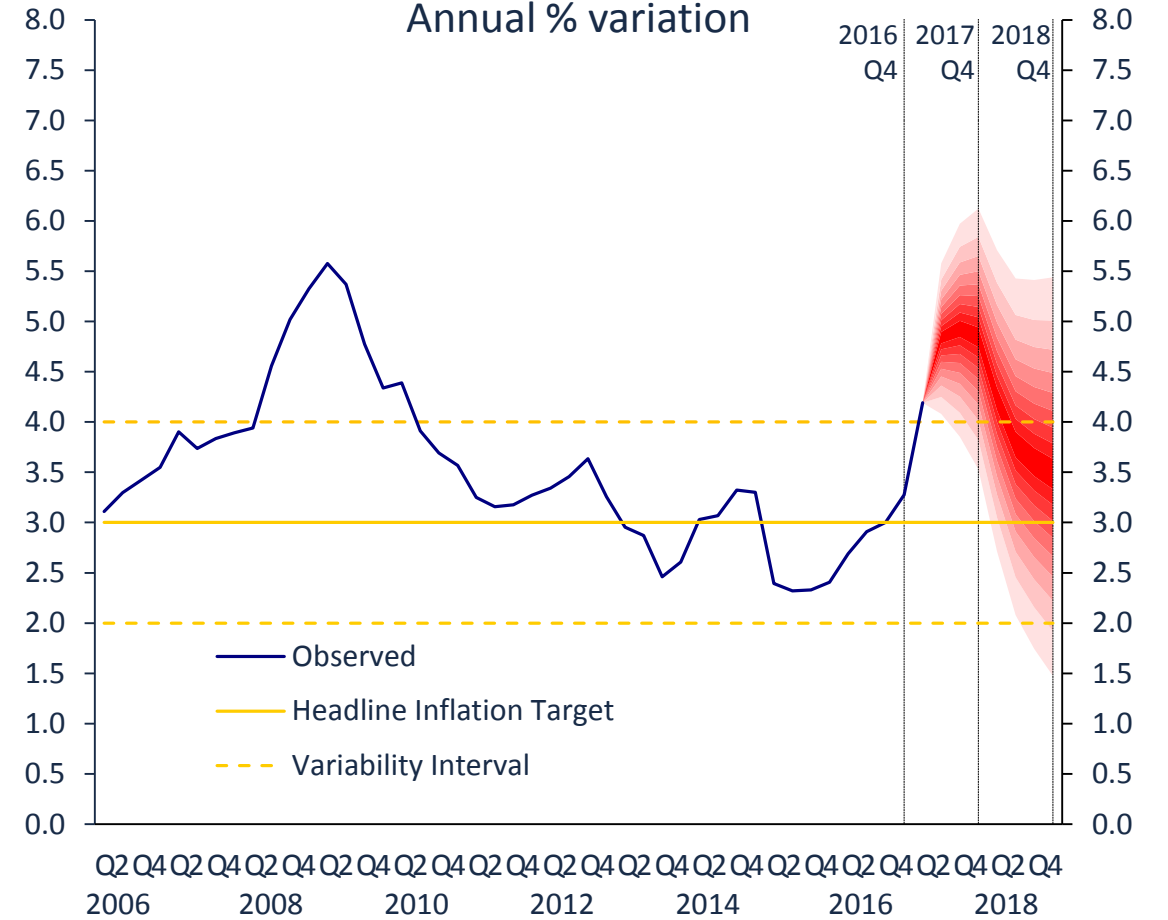
Fan Charts

Annual Headline Inflation 1/
Annual % variation



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

Annual Core Inflation 2/
Annual % variation



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

Risks to the Inflation Outlook

Downward

- ✓ A consolidation and deepening of the appreciation of the national currency over the recent months.
- ✓ A decrease in energy prices, as a result of price drops in their international price references.
- ✓ Reductions in a number of prices of the economy, as a consequence of structural reforms.
- ✓ A less dynamic-than-expected progress in domestic economic activity.

Upward

- ✓ An increase in the probability of second round effects, in view of the number and the magnitude of recent shocks.
- ✓ A further increase in inflation expectations.
- ✓ Increments in agricultural products' prices, even if the nature of their impact onto inflation is only transitory.
- ✓ An upward trend in unit labor costs that was reflected in inflation.

Monetary Policy Stance

■ In this context, in the future, the Board of Governors will closely monitor the evolution of all inflation determinants and its medium- and long-term expectations:

✓ Especially, the potential pass-through of exchange rate adjustments and of energy price increments on the rest of prices.

✓ The evolution of the monetary position of Mexico relative to the U.S.

✓ The evolution of the output gap.

→ This will be done in order to continue taking the necessary measures to **consolidate the efficient convergence of inflation to its 3.0 percent target.**

Strengthening Confidence in the Mexican Economy

- In an environment in which the world economy recovered in a fragile and slow manner, the Mexican economy was resilient and grew continuously, although at a moderate rate.
- In the future, it is essential for Mexico to **strengthen the fundamentals** that have allowed the country to expand regardless of adverse international conditions, and to move forward in approving and implementing policies that would help to attain a faster and more sustained growth.
 - ✓ *It is important to **keep conducting monetary policy in a timely manner**, along with **measures aimed to a healthy functioning of financial markets**, which would, in turn, enhance the effectiveness of monetary policy.*
 - ✓ *It is **essential for the authorities to comply with the fiscal consolidation process**, while encouraging the adequate **implementation of structural reforms**.*
- In order to prevent insecurity and corruption from hampering economic growth, it is indispensable to **strengthen the rule of law** and to guarantee legal certainty.



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