Quarterly Report

January – March 2015

Summary

The monetary policy implemented by Banco de México seeks to ensure stability of the national currency's purchasing power and has been conducive to achieving an environment of low and stable inflation in Mexico. Inflation practically reached the 3 percent target during the period covered in this Report.

This achievement has come despite a complex environment faced by the monetary policy in recent months, where both domestic and external factors that could affect inflation had to be properly weighed. On the one hand, regarding domestic factors, inflation in Mexico has converged to its permanent 3 percent target, it is expected to persist around it and inflation expectations are well-anchored. Furthermore, no aggregate demand-related pressures onto it are anticipated, as slack conditions prevail in the economy as a result of weaker than expected growth in economic activity. On the other hand, the national currency depreciated in response to external factors. The drop in the crude oil price suggests that a significant part of the aforementioned exchange rate adjustment is accounted for by real factors. Moreover, the prospect of the normalization of the U.S. monetary policy and the uncertainty associated with this process were reflected in international financial markets, generating high volatility and widespread depreciations of a vast majority of currencies against the U.S. dollar. So far, inflation has not been affected by the exchange rate adjustment more than estimated by the Central Institute, and it has been several years since exchange rate pass-through onto prices in Mexico has been low and there have been no second round effects. Still, a risk to inflation as a consequence of depreciation cannot be overlooked. Taking all these elements into consideration, in the period analyzed by this Report, the Board of Governors kept the target for the Overnight Interbank Interest Rate at 3 percent by virtue of the fact that the monetary policy was deemed to be conducive to secure the convergence of inflation to the permanent target.

Annual headline inflation went down considerably in early 2015. The adopted monetary policy contributed to this decrease by correctly anticipating the fading out of the effects on prices generated by the fiscal modifications implemented last year, as well as other shocks, while monitoring that inflation expectations were not affected. Drops in telecommunication services' prices and in some energy prices also contributed, both directly and indirectly. It is noteworthy that this took place even considering the depreciation of the national currency that occurred since mid-2014, whose effects were concentrated in the prices of some durable merchandise. In general, the latter did not affect the price formation dynamics in the economy and inflation expectations remained well-anchored.

In the first quarter of 2015, certain weakness in the performance of economic activity prevailed in Mexico. Indeed, external demand lost dynamism, mainly as a response to the slowdown of the U.S. economy, while domestic demand improved slightly. In this environment, slack conditions persisted in the economy, reason for which no pressures on either prices in the main inputs' markets or on the external accounts were perceived.

World economic activity remained weak in the first months of the current year, while global inflation presented a downward trend, as a consequence of low oil prices, among other factors. Thus, various central banks, both in emerging and advanced economies, adopted more accommodative monetary policies. In this context, uncertainty regarding the onset and the subsequent speed of U.S. monetary policy normalization, combined with a highly lax monetary policy in other advanced economies -which led to a generalized appreciation of the USD- the performance of basic commodity prices, particularly crude oil prices, and the economic situation in Greece led to an environment in which international financial markets kept exhibiting high volatility in the period analyzed by this Report.

The referred volatility affected the performance of domestic financial markets. Particularly, in the first quarter of 2015, the exchange rate depreciated in an environment of high volatility, even when the functioning of the foreign exchange market was orderly and at adequate operating and liquidity levels. Although from April onwards conditions in financial markets improved slightly, a further increment in volatility in international markets, which could further impact the national currency's exchange rate, cannot be ruled out. In light of this possibility, it is important to continue strengthening the macroeconomic framework in Mexico. In particular, consolidation of the adjustment in public expenditure announced by the Federal Government is required in order to stabilize the public debt to GDP ratio and to begin to decrease it as soon as possible, so that public finances do not become a source of vulnerability and facilitate the adjustment to tighter conditions in international financial markets.

The macroeconomic scenario foreseen by Banco de México is as follows:

GDP Growth Rate: Some of the downward risks to the economic growth in Mexico, indicated in the last Quarterly Report, have been materializing. In particular, oil production kept decreasing and there is great uncertainty regarding its future evolution. Likewise, U.S. economic activity was adversely affected in the first quarter of the year, partly by transitory factors. Furthermore, in a context of USD appreciation, the U.S. economic growth forecast was revised downwards for the year as a whole. As a consequence, Mexico's external demand lost dynamism, while growth in the first quarter is expected to be lower than previously anticipated. Additionally, even though domestic expenditure in Mexico kept recovering gradually, there are still no clear signs that it could present a greater dynamism in the future. Considering the factors described above, the forecast for Mexico's economic growth in 2015 and 2016 is adjusted downwards. For 2015, the forecast interval for GDP growth lowered from 2.5 to 3.5 percent to a range of 2.0 to 3.0 percent. For 2016, the forecast interval for the GDP growth is modified from a range of 2.9 to 3.9 percent to a range of 2.5 to 3.5 percent (Chart 1a).

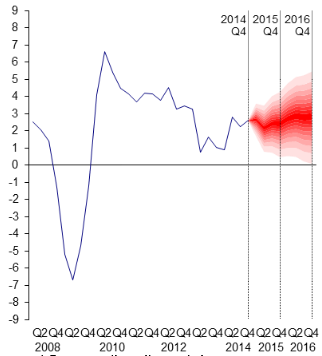
Employment: In line with the adjustment in the economic growth outlook, the forecast for growth in the number of IMSS-affiliated jobs is also revised downwards. For 2015, an increase of 580 to 680 thousand IMSS-insured jobs is estimated, compared to the expectation of an increment of 600 to 700 thousand jobs in the previous Report. For 2016, the growth interval is adjusted from 620 to 720 thousand jobs in the last Report to an interval of 600 to 700 thousand jobs.

Current Account: For 2015, respective trade balance and current account deficits of 5.2 and 27.7 billion USD are anticipated (0.4 and 2.3 percent of GDP, in the same order). For 2016, deficits in the trade balance and the current account of 6.9 and 29.7 billion USD are estimated, respectively (0.5 and 2.3 percent of GDP, correspondingly).

Given the described forecasts, no aggregate demand-related pressures are expected on either inflation or the external accounts. In particular, the output gap is estimated to remain negative, although it would gradually close in the forecast horizon (Chart 1b).

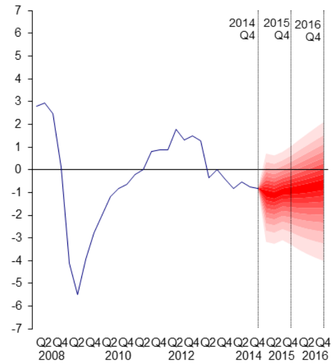
Fan Charts 1

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



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

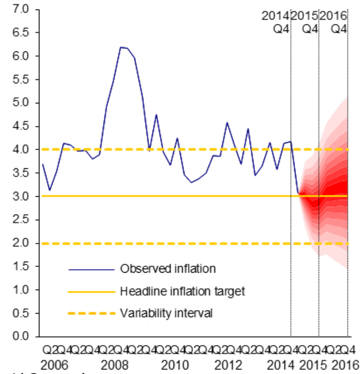
b) Output Gap Estimate, s. a.
Percentage of potential output



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

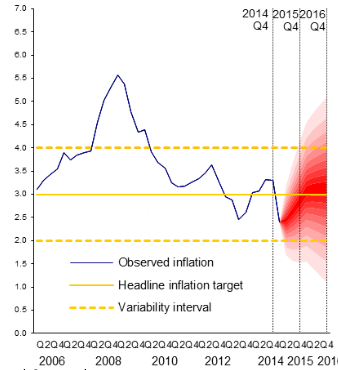
Fan Charts 2

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.

The GDP growth outlook is subject to different risks. Among downward ones, the following can be noted:

i. A further weakening of U.S. economic activity.

ii. New volatility episodes in international financial markets.

iii. A further decrease in oil production that would affect external accounts and public finances.

iv. That weakness in consumers' and businesses' confidence indicators, among other reasons due to public safety conditions, would limit the recovery of expenditure in the country.

Among upward risks to growth, these are noteworthy:

i. A greater dynamism of the U.S. economy given low energy costs.

ii. An improvement in investors' prospects given a favorable result in the first stages of the implementation of the energy reform.

Inflation: The forecast for annual inflation remains unchanged with respect to that presented in the previous Report. Thus, for 2015, annual headline inflation is estimated to persist close to 3 percent over the following months and in the second half of the year it is expected to lie slightly below that level (Chart 2a). Core inflation is anticipated to remain below 3 percent all year long (Chart 2b). For 2016, both headline and core inflation are estimated to prevail at levels close to 3 percent. The inflation forecast trajectory could be affected by some risks. Among upward risks, the following stand out:

i. The exchange rate of the national currency against the USD could continue with a depreciation trend.

ii. Considering the expected gradual reduction of slack conditions in the economy during the forecast horizon, new changes in relative prices could contaminate inflation expectations.

Among downward risks, the next should be mentioned:

i. Further reductions in telecommunication services' prices.

ii. That the reduction in energy costs could contribute to the fact that increments in prices will be generally lower than expected.

iii. A lower than estimated dynamism of economic activity.

iv. An appreciation of the national currency against the USD due to the recovery in the crude oil price and a more favorable than expected response of international financial markets to the onset of the U.S. monetary policy normalization process, given that asset prices will probably have already partially discounted the adjustment.

Currently, economic recovery is weak, headline inflation practically lies at its target, core inflation (both merchandise and services subindices) is below 3 percent and inflation expectations remain anchored. On the other hand, since the Mexican economy is highly integrated to the global one, in particular to the U.S., U.S. monetary policy actions could affect the exchange rate, inflation expectations, and, through these, price dynamics in Mexico. Accordingly, the Board of Governors of this Central Institute will remain alert to the evolution of all inflation determinants and its medium and long-term expectations: particularly, it will monitor the monetary policy stance of Mexico relative to the U.S., as well as the behavior of the exchange rate. Besides, it will also be watchful of the evolution of the degree of slackness in the economy. All of the above will be done in order to take the necessary measures to ensure the convergence of inflation to the 3 percent target in 2015 and to consolidate it.

In light of a complex international environment, it is of great importance that Mexico boosts its domestic sources of growth and maintains solid macroeconomic fundamentals. As mentioned in previous reports, the approval of structural reforms aimed at raising the productivity of the country is an important step for Mexico to achieve greater growth rates in a sustainable manner. In this sense, it should be recalled that the correct and timely implementation of these reforms is a necessary condition for them to reach their potential. Additionally, improving the rule of law and security, including legal security, is indispensable to generate a favorable environment for growth.

Finally, it is important to reiterate that sound public finances are required in order to continue ensuring a solid macroeconomic framework, and, in particular, the public debt to GDP ratio needs to stabilize and resume a downward trend. Although the Federal Government is taking action to this end, not only is the achievement of the current objectives necessary, but also a permanent monitoring of the fiscal stance, particularly in an uncertain environment, which will likely be characterized by tighter financing conditions. Therefore, the importance of the effort aimed at fiscal consolidation should be reiterated. In this regard, due to its implications for long-term economic growth, the relevance of the comprehensive revision of the public expenditure structure for the fiscal year 2016 with the purpose of designing it from a "zero base" perspective stands out (see Box "Fiscal Responsibility Measures" in the Quarterly Report October – December 2014). Even when this revision of expenditure is required to eliminate duplication, to improve efficiency and to facilitate the fiscal consolidation process mentioned above, it is fundamental that this exercise should favor expenditure on investment and on programs with high social returns, in order to help boost the sustained economic growth of the country, maintain an environment of low inflation and, as an overall goal, ensure greater welfare for society.