



# Quarterly Report

April – June 2014

August 13, 2014



BANCO DE MÉXICO

# Outline

**1**

**Monetary Policy**

**2**

**External Conditions**

**3**

**Economic Activity in Mexico**

**4**

**Inflation Determinants**

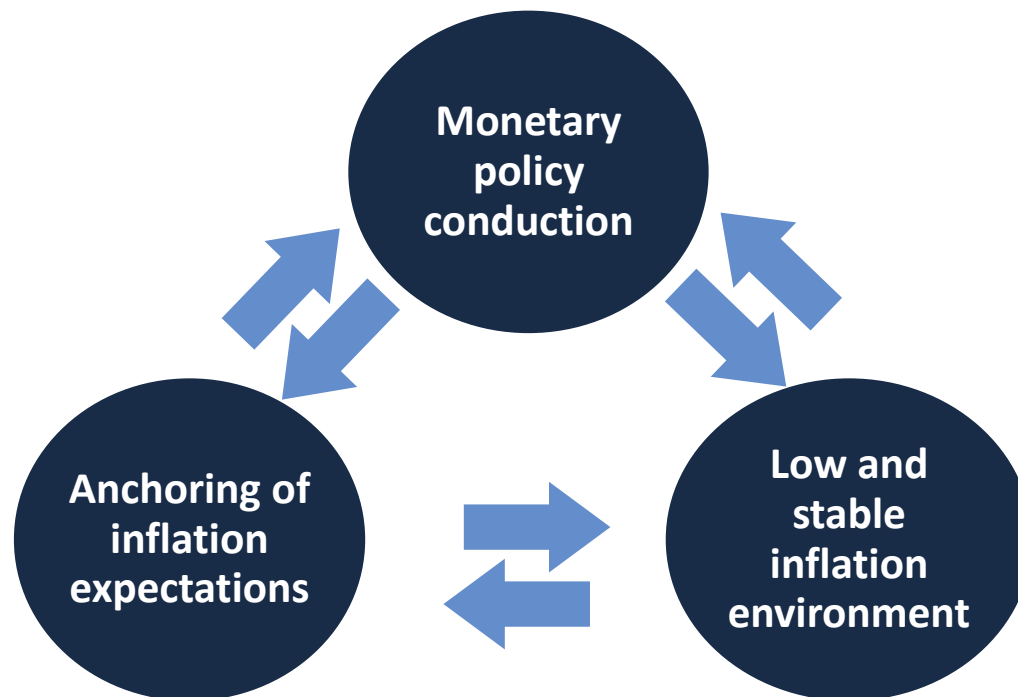
**5**

**Forecasts and Balance of Risks**

# Monetary Policy Conduction

Monetary policy has focused on reaching an **efficient convergence** towards the 3 percent inflation target, i.e. **at the lowest cost to economic activity**.

- *The process of anchoring inflation expectations has been one of the key factors for this convergence.*




# Monetary Policy Conduction

**Inflation:** developed as expected in the first half of the year, while inflation expectations for the end of 2014 and 2015 declined.

**Economic activity:** was less dynamic than expected in the first months of the year, resulting in a **higher degree of slackness** in the economy.

**In this context, considering:**

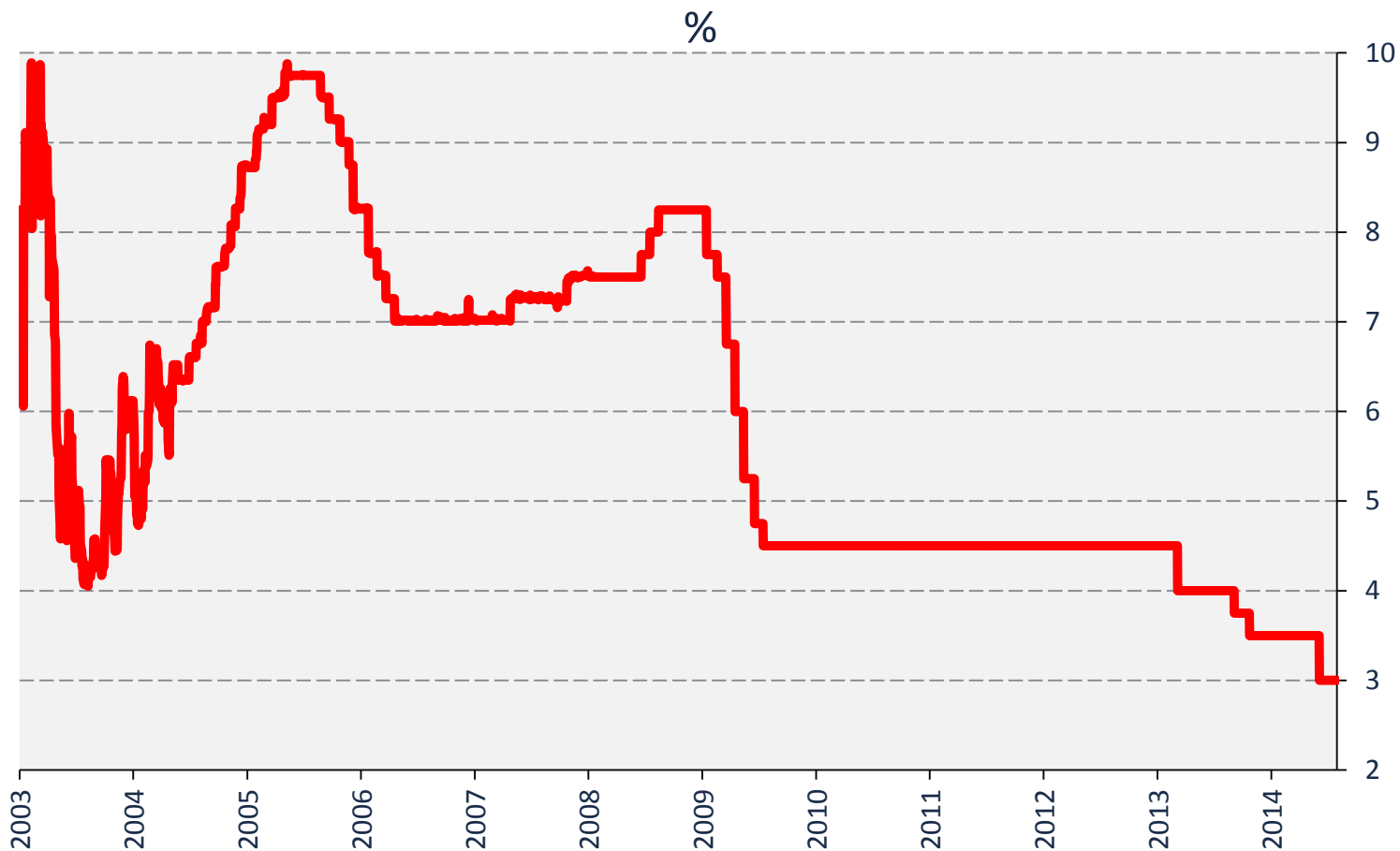
- The favorable performance of inflation.
- The outlook that inflation will be close to 3 percent from the beginning of 2015 onwards.
- Anchored inflation expectations.
- The weakness of economic activity.



**The Board of Governors decided in June to decrease the Overnight Interbank Interest Rate from 3.5 to 3.0 percent.**

The Board of Governors also estimated that, considering the foreseen recovery of the economy and the monetary stance of Mexico relative to the U.S., a further reduction of the interest rate target was not recommendable.

### Overnight Interbank Interest Rate <sup>1/</sup>



1/ Since January 21, 2008, the Overnight Interbank Interest Rate is shown.

Source: Banco de México.

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# External Conditions

## Global Outlook in 2Q 2014

### Growth

- ✓ *Recovery of the world economy:*
  - ➔ **Advanced economies:** the effects of a lower fiscal consolidation and a very accommodative monetary policy supported the recovery.
  - ➔ **Emerging economies:** relatively weak conditions persisted.

### Inflation

- ✓ *In general, remained at low levels.*

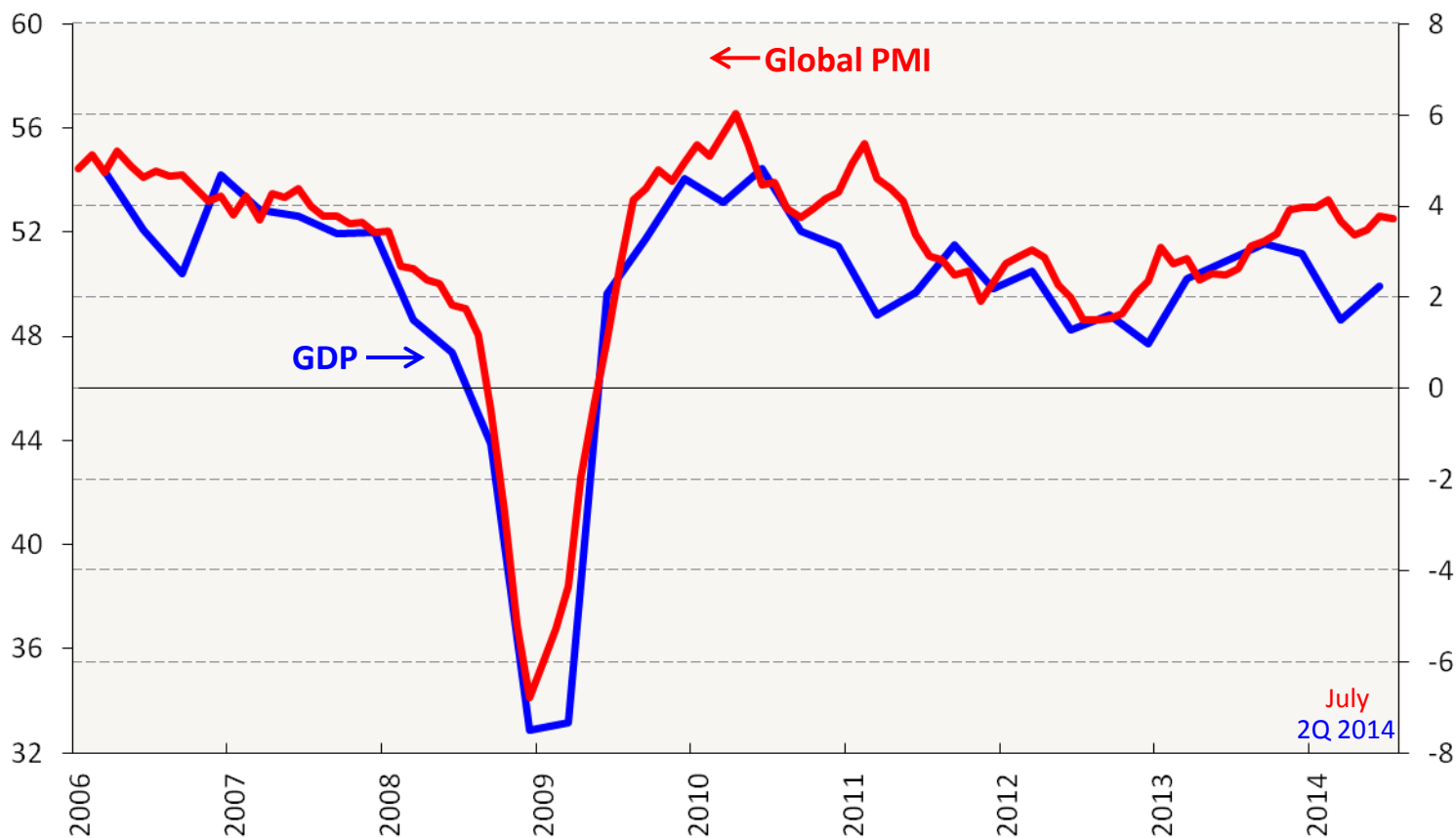
### Monetary Policy

- ✓ *Expectation that monetary stimulus in advanced economies prevails for a prolonged period.*
- ✓ *In particular, the U.S. Federal Reserve reaffirmed, conditional on the performance of the economy, its expectation of a gradual normalization of its monetary policy.*

**Growth of the world economy increased moderately during 2Q 2014, after a weaker than expected onset of the year.**

## World GDP Growth and Manufacturing Purchasing Managers' Index (PMI)

Quarterly % change at annual rate and diffusion index, s.a.



s.a./ Seasonally adjusted data.

Note: The sample of countries used for the calculation represents 86.1% of global GDP measured by purchasing power parity.

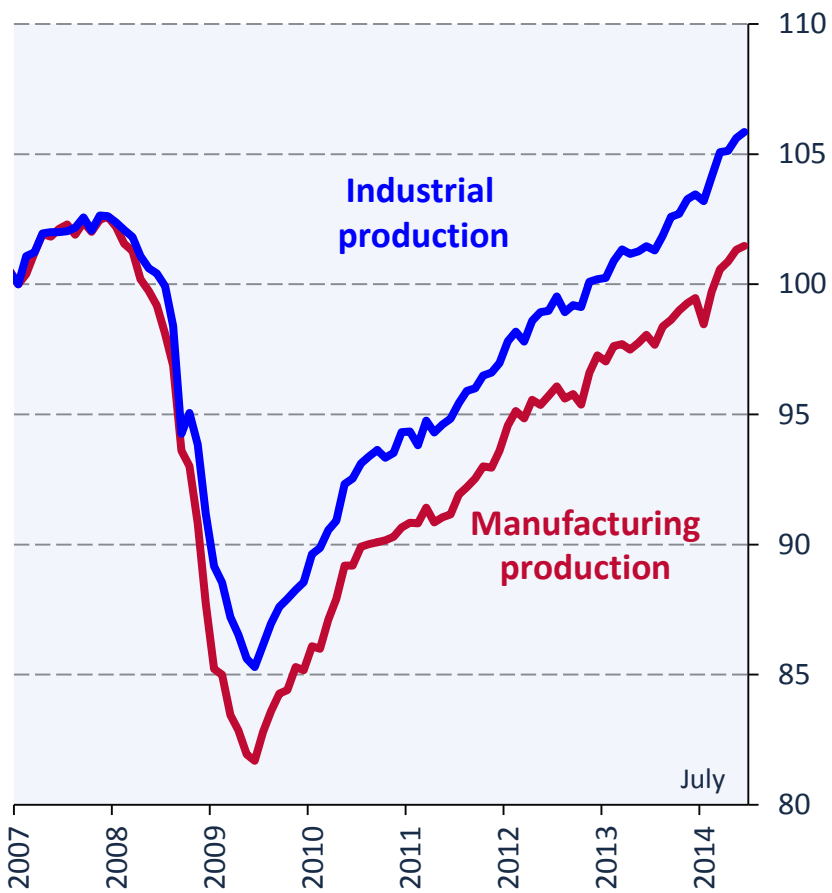
Source: Estimated by Banco de México with data from Haver Analytics, JPMorgan and Markit.



# In the U.S., manufacturing production presented a solid growth and labor market conditions further improved.

## Industrial and Manufacturing Production

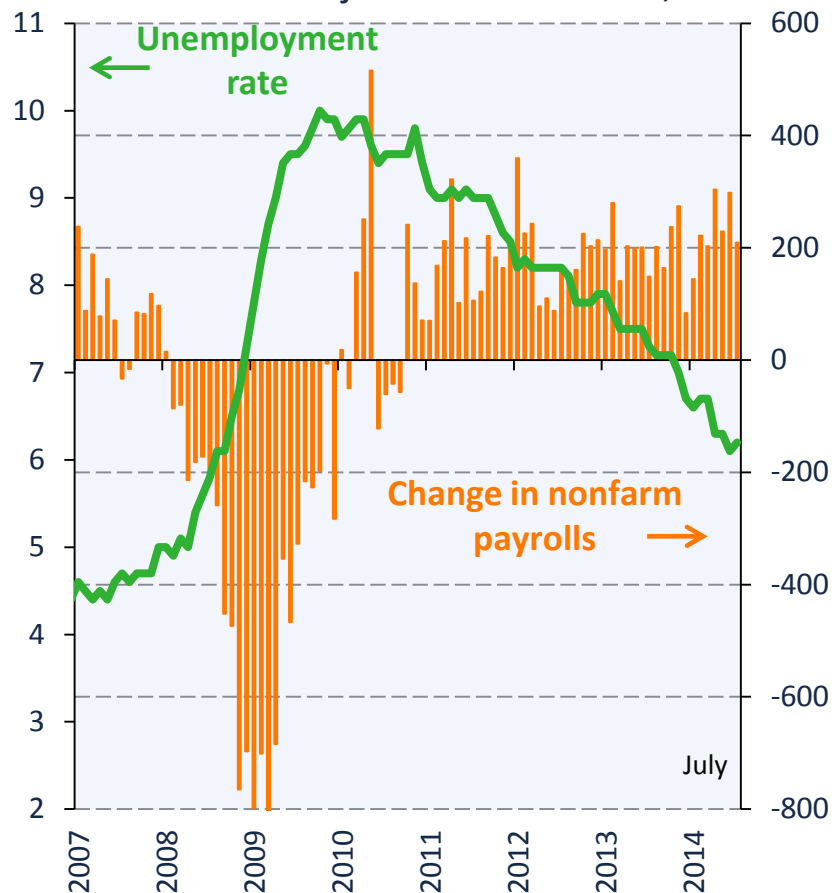
Index 2007=100, s.a.



s.a./ Seasonally adjusted data.  
Source: Federal Reserve.

## Change in Nonfarm Payrolls and Unemployment Rate

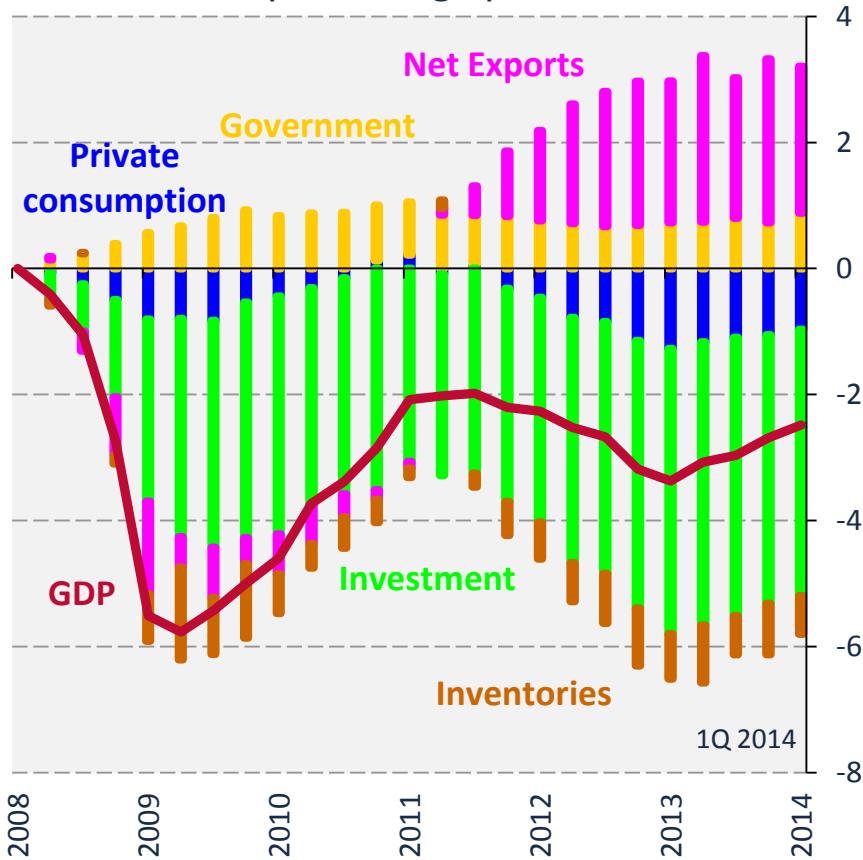
Thousands of jobs and % of EAP, s.a.



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

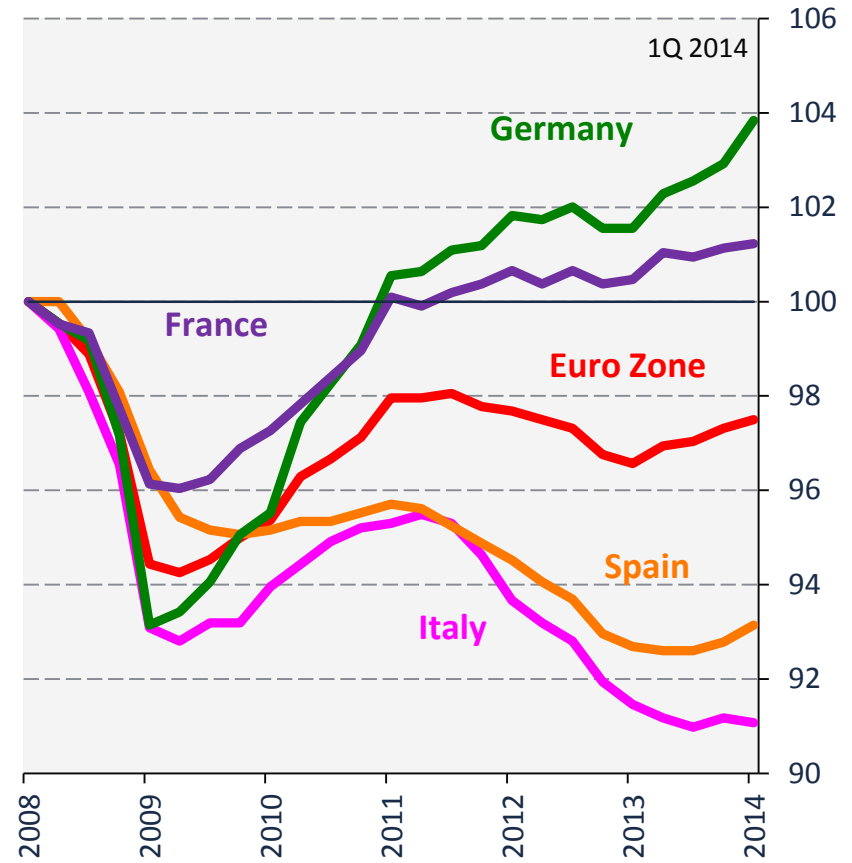
# In the Euro zone, economic recovery remained weak and heterogeneous, with GDP still below pre-crisis levels.

**GDP Growth and Contributions of its Components as Compared with its Recent Peak**  
% and percentage points, s. a.



s.a./ Seasonally adjusted data.  
Source: Eurostat and Haver Analytics.

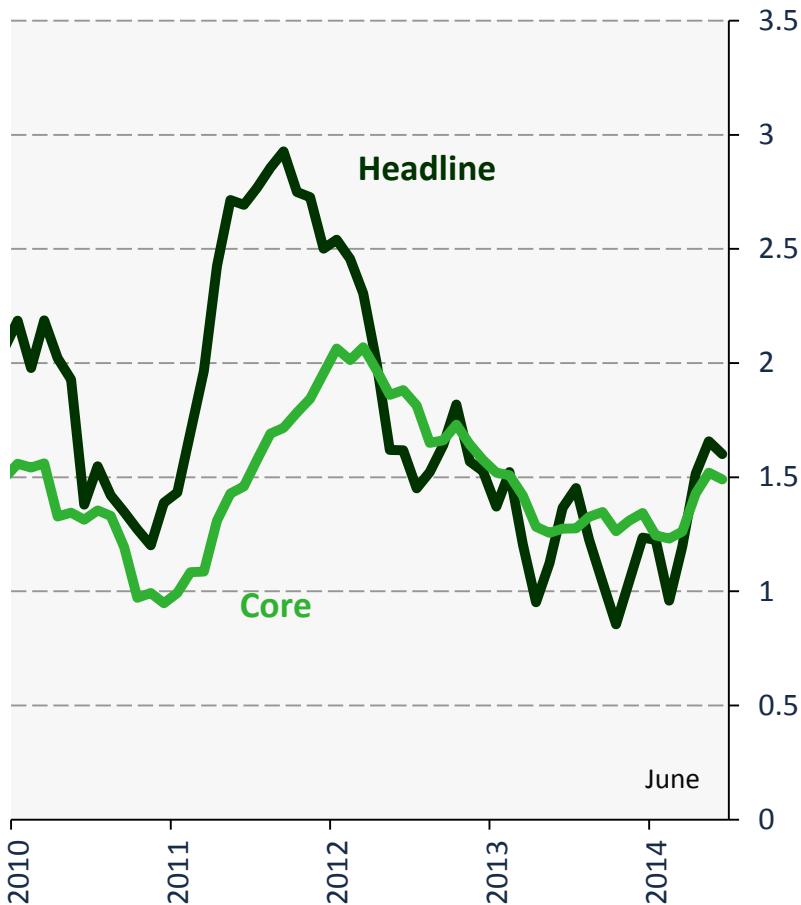
**Gross Domestic Product**  
Index I-2008=100, s.a.



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

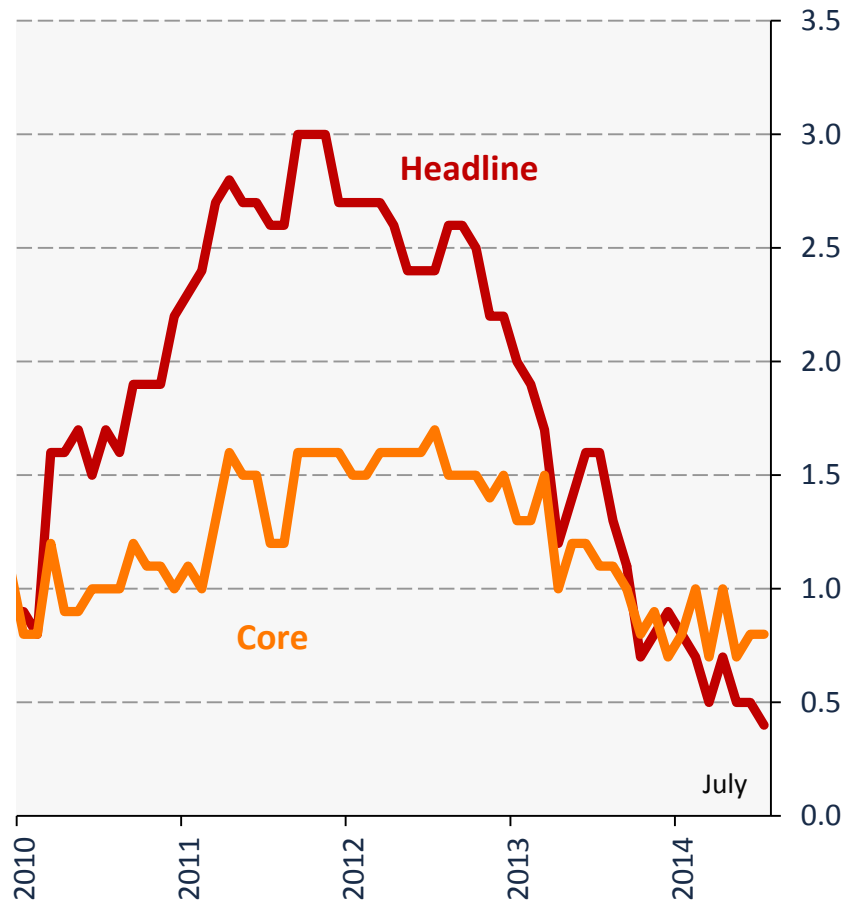
In the U.S., inflation increased, although it remains below the Federal Reserve's 2 percent target. Meanwhile, in the Euro zone deflation risks persist.

**U.S.: Personal Consumption Expenditures  
Price Index  
Annual % change**



Source: Bureau of Economic Analysis.

**Euro Zone: Consumer Prices Index  
Annual % change**

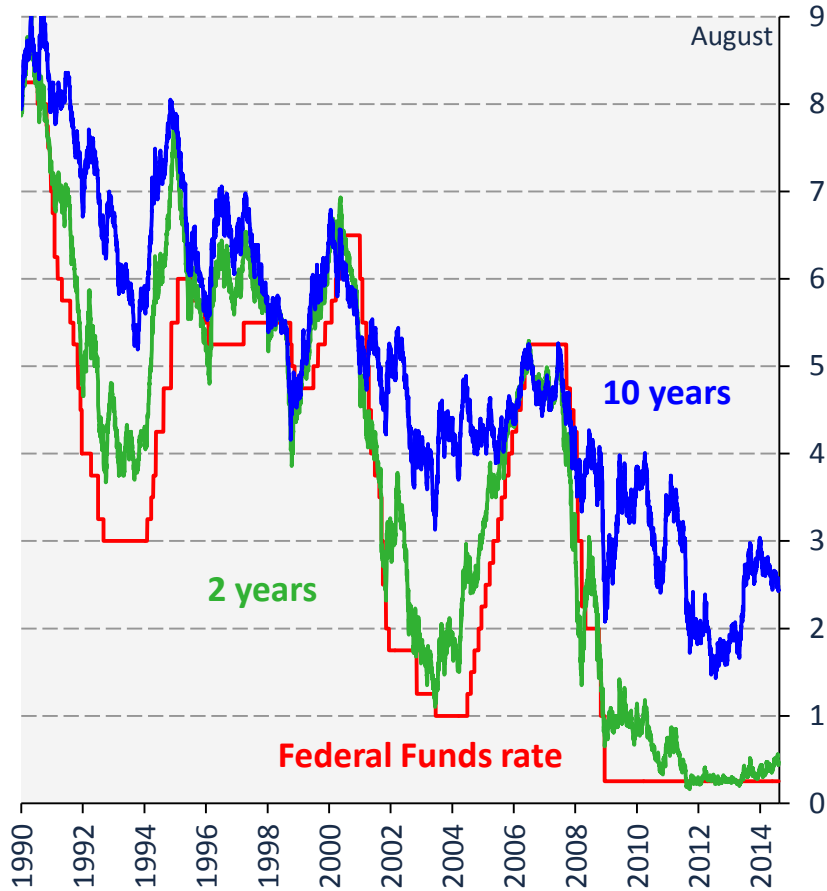


Source: Eurostat.

The U.S. Federal Reserve reaffirmed its strategy of gradually withdrawing the monetary stimulus. However, recent U.S. data have raised expectations among some market participants of an anticipated adjustment of monetary conditions in that country.

### Interest Rates of Government Securities

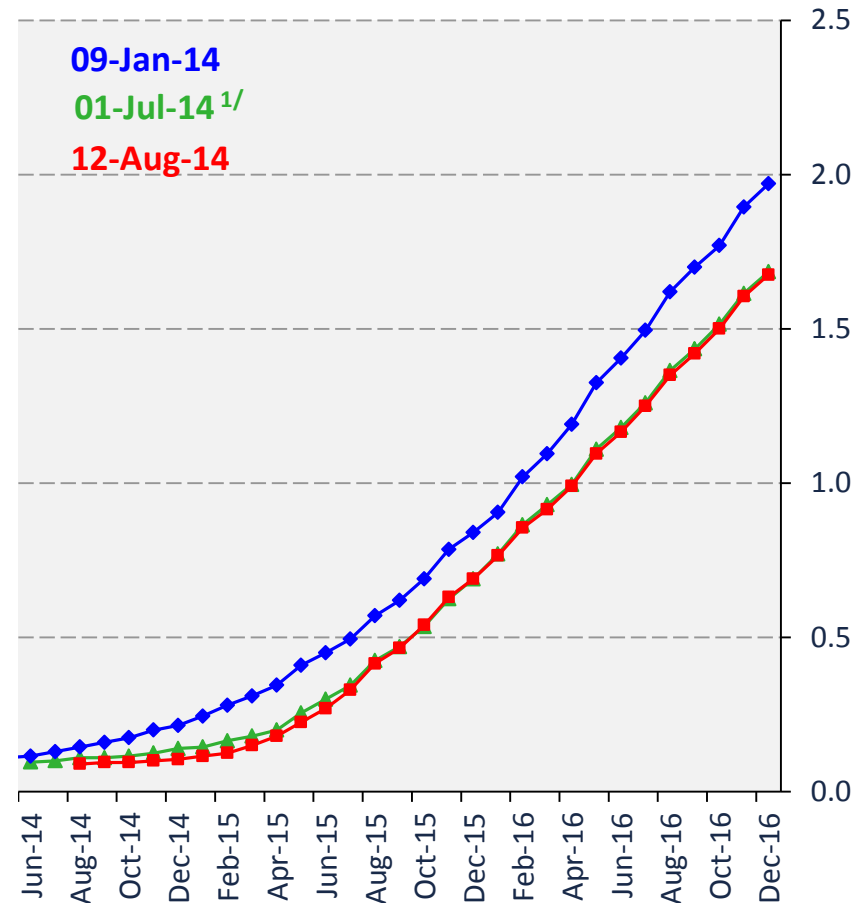
%



Source: U.S. Department of the Treasury.

### Federal Funds Rate Futures

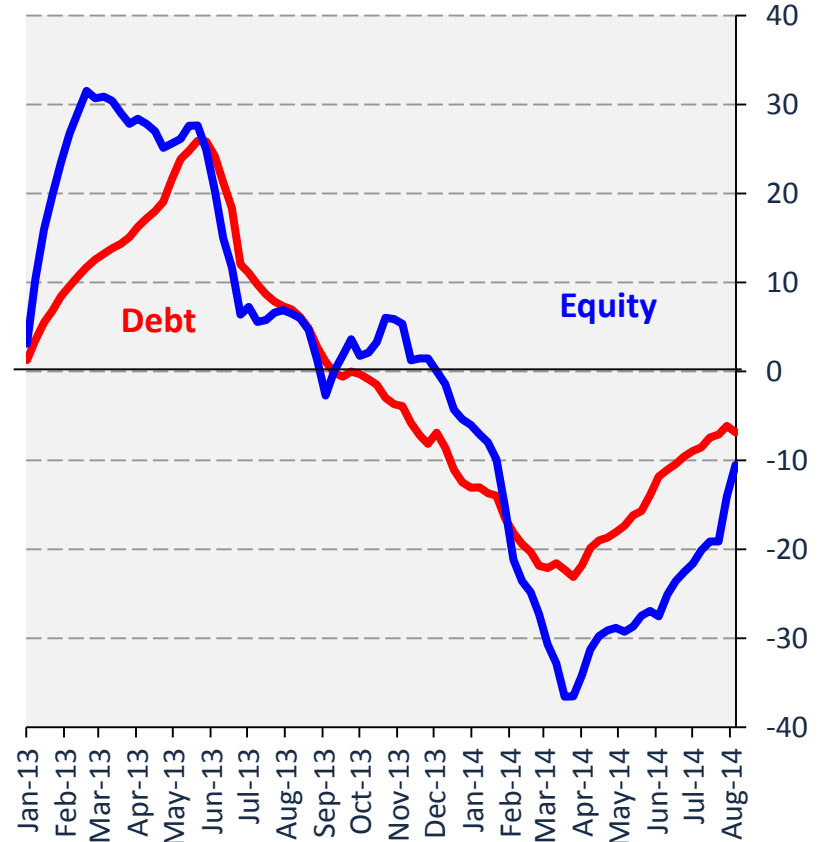
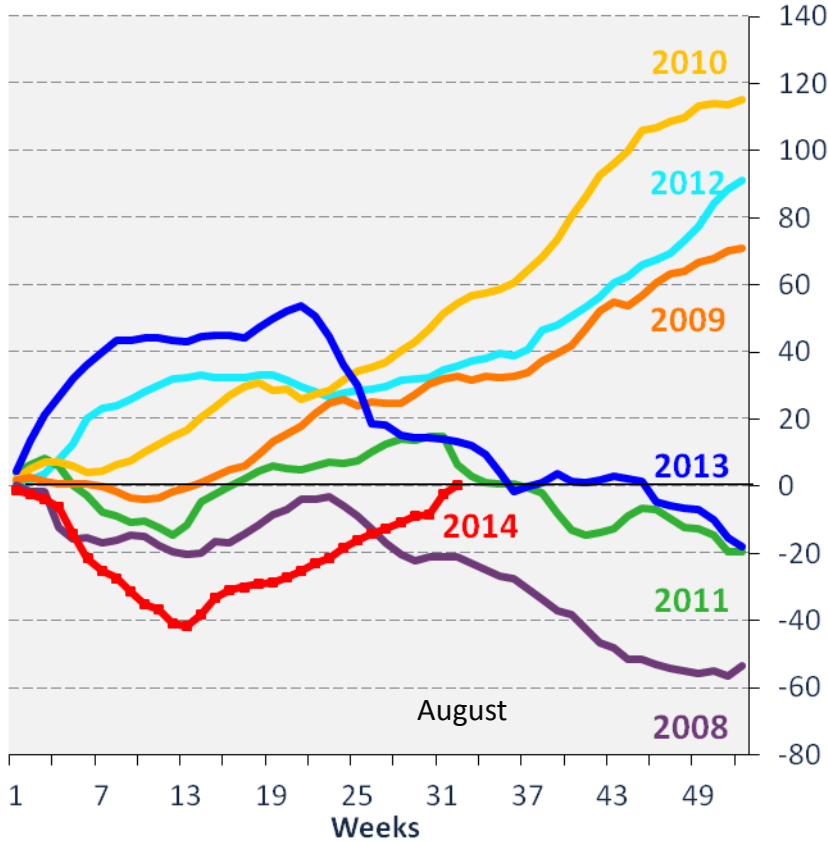
%



1/ Date prior to the publication of favorable economic activity data and the FOMC's July statement. Source: Bloomberg.

The expectation of a prevailing accommodative monetary policy intensified the search for yield process in 2Q 2014, leading to a recovery of capital flows to emerging economies.

### Accumulated Capital Flows to Emerging Markets (Debt and Equity) <sup>1/</sup> USD billion

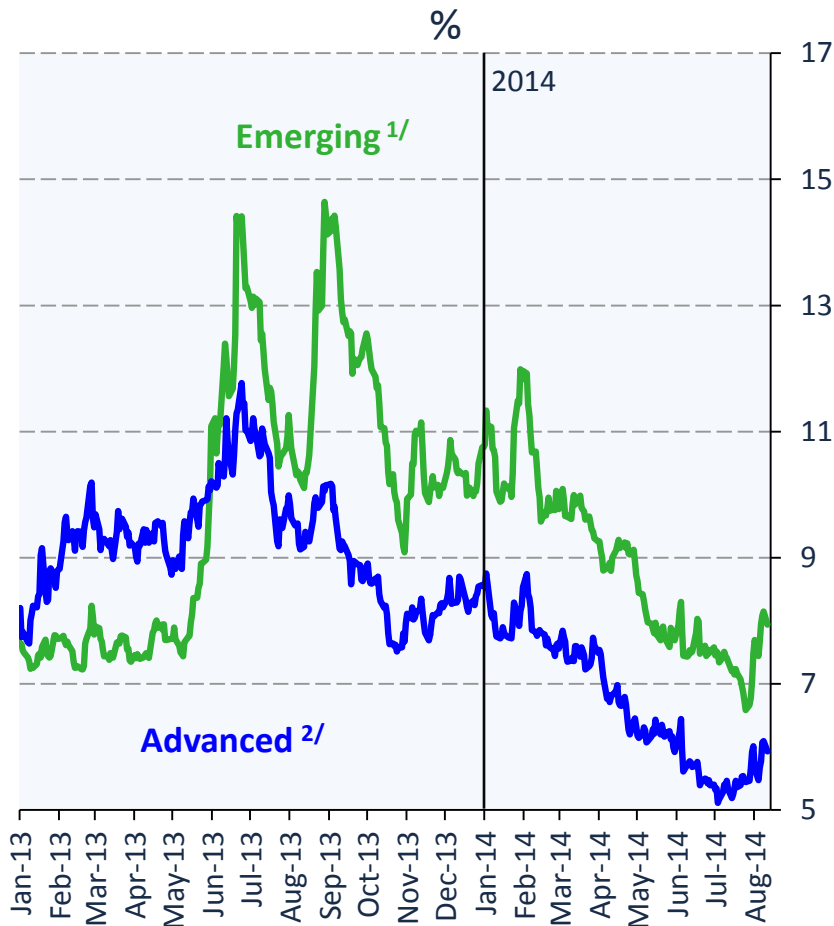


<sup>1/</sup> The sample includes funds used to sell or buy equity and bonds from emerging markets registered in advanced economies. Flows exclude changes in market value of portfolios and changes in foreign exchange rates.

Source: Emerging Portfolio Fund Research.

Given the aforementioned, low volatility was registered in financial markets. However, due to more favorable than expected U.S. economic data, volatility increased recently.

### Volatility in FX Markets

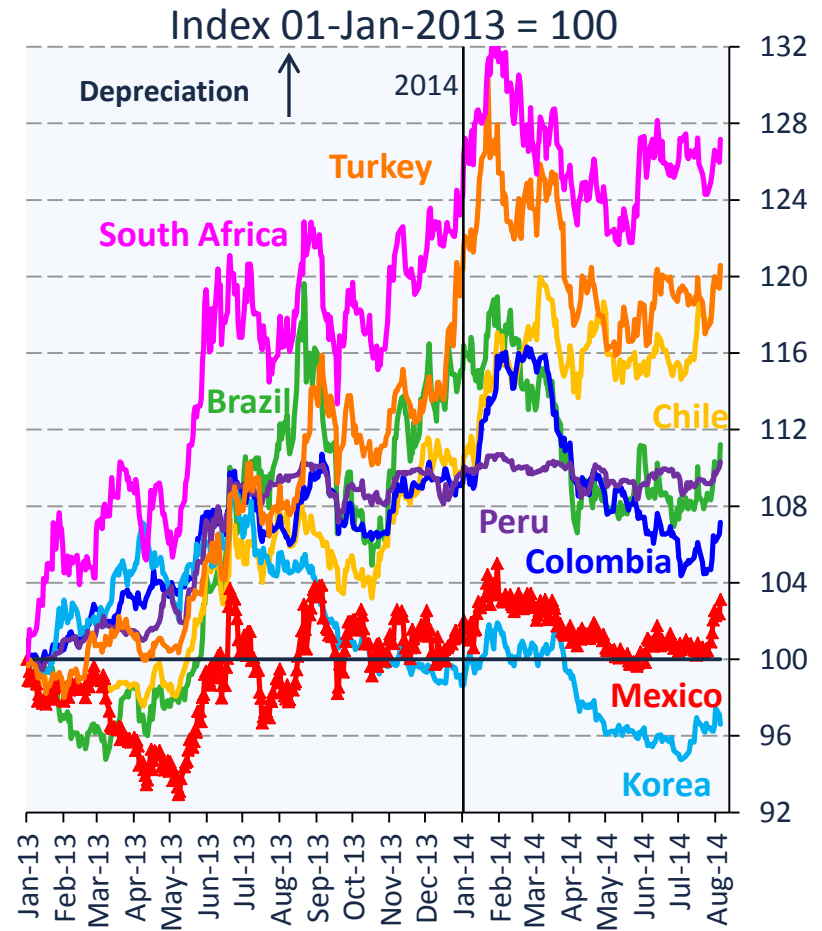


1/ Simple average of the implied volatility of one month exchange rate put options for: Brazil, Chile, Korea, India, Mexico, Peru, Poland, South Africa and Turkey.

2/ JP Morgan's FX implied volatility index for G7 countries (Canada, France, Germany, Italy, Japan, U.K. and U.S.).

Source: Bloomberg.

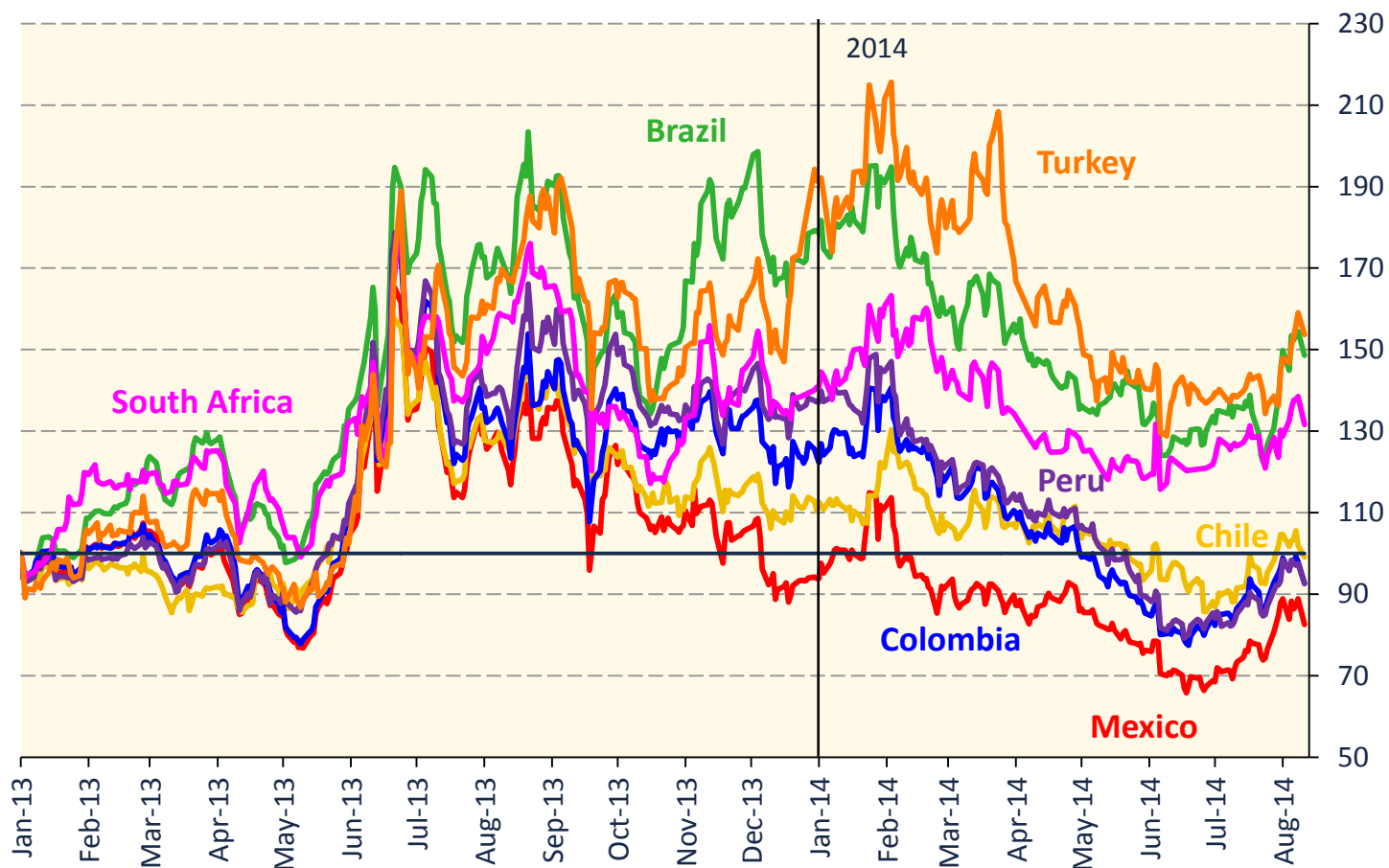
### Nominal Exchange Rate against USD



Source: Bloomberg.

In this context, Mexico stood out for being one of the economies whose risk indicators have been less affected during recent episodes of volatility.

### Credit Default Swaps <sup>1/</sup> Index 01-Jan-2013=100



1/ 5-year CDS.  
Source: Bloomberg.

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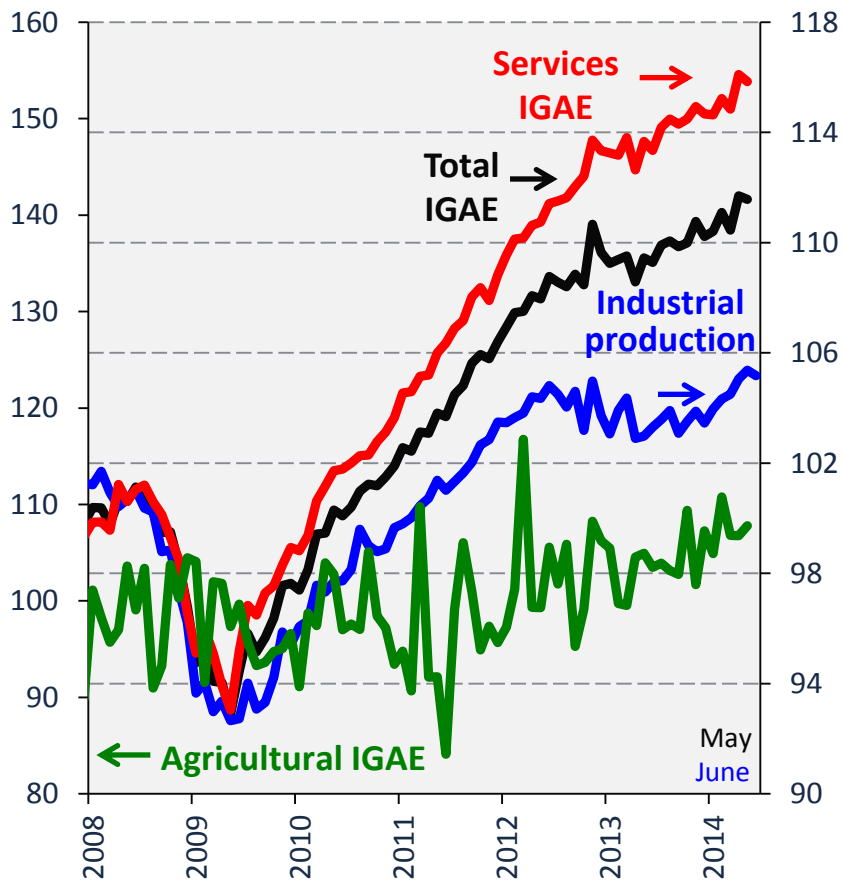
**5** **Forecasts and Balance of Risks**



# Economic activity in Mexico improved during 2Q 2014, as compared to the weakness observed in the previous two quarters.

## Economic Activity Indicators

Index 2008 = 100, s.a.

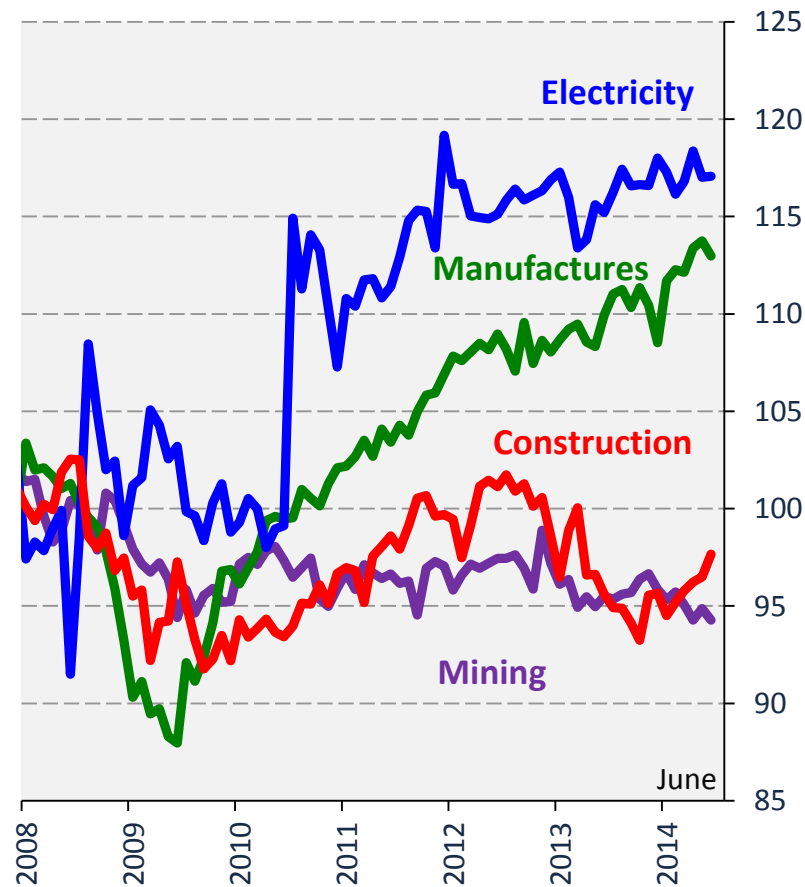


s.a./ Seasonally adjusted data.

Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

## Industrial Activity

Index 2008 = 100, s.a.

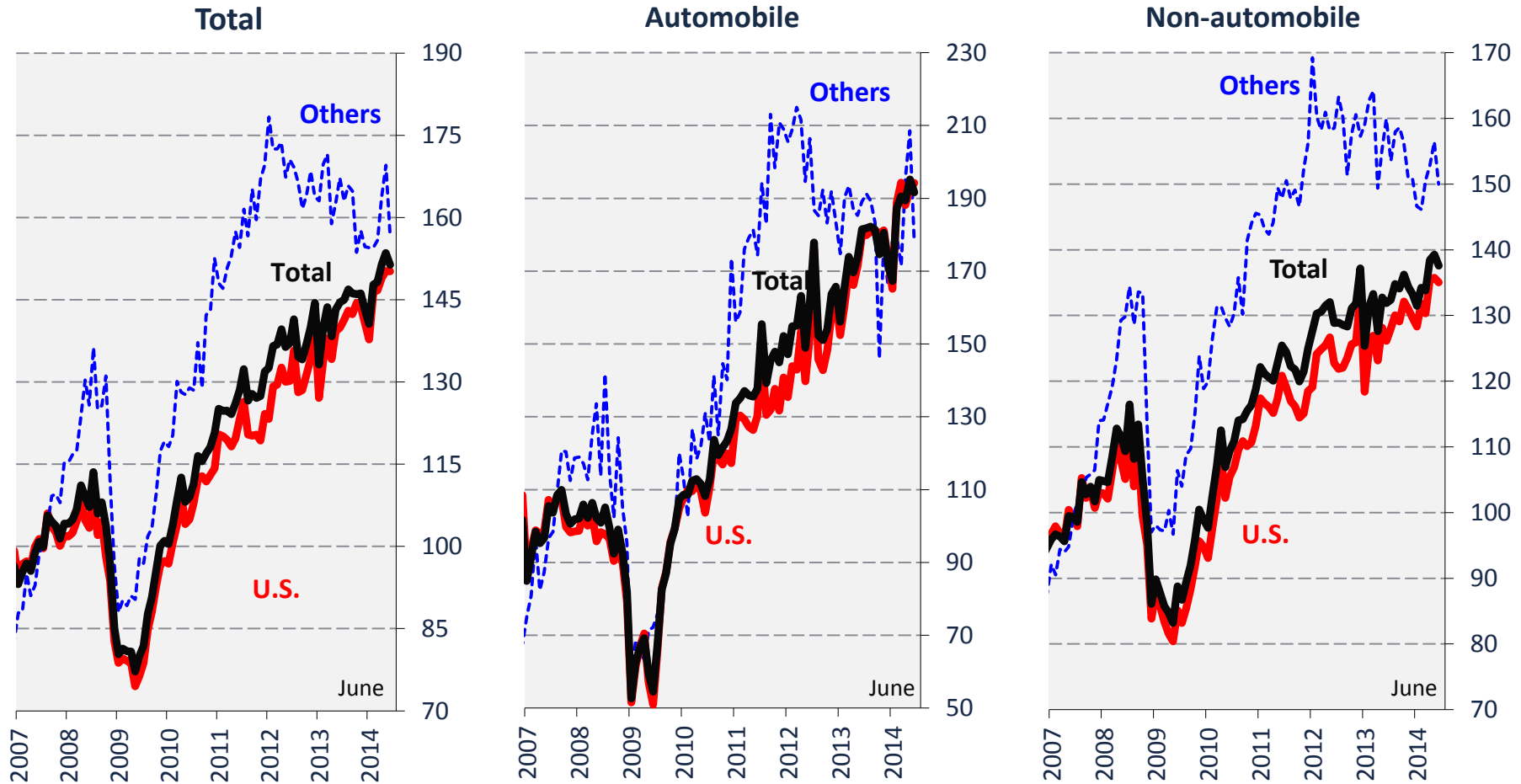


s.a./ Seasonally adjusted data.

Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

# More dynamic economic activity was mainly driven by external demand.

## Manufacturing Exports Index 2007=100, s.a.



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

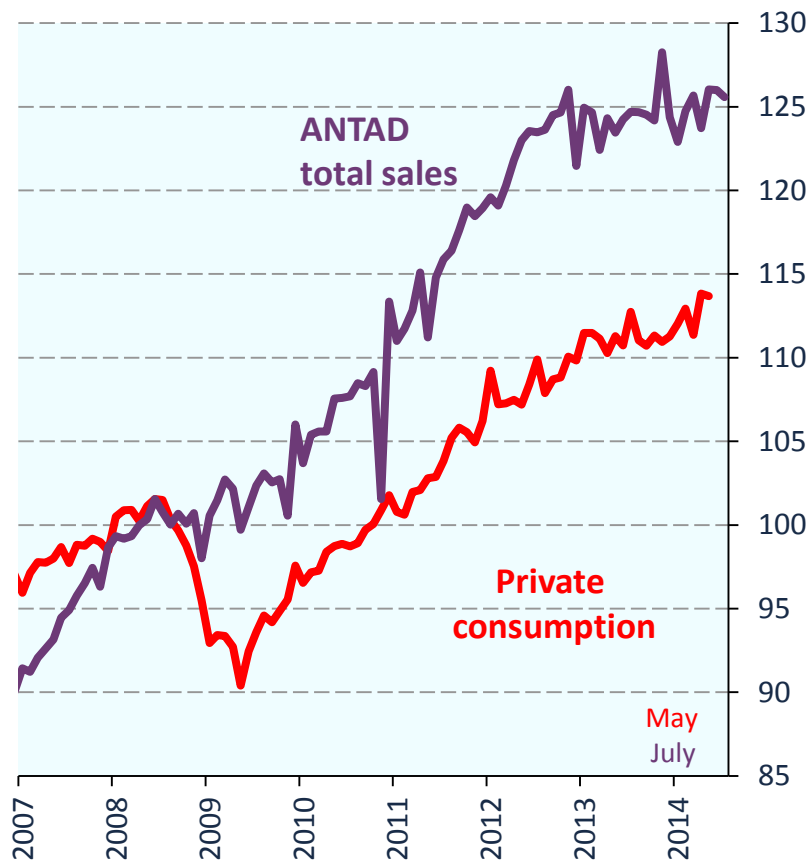
s.a./ Seasonally adjusted data.  
Source: Banco de México.

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

# Some consumption indicators changed their trend, although some of their determinants continue showing signs of weakness.

## Monthly Indicator of Private Consumption in the Domestic Market and ANTAD Total Sales

Index 2008=100, s.a.

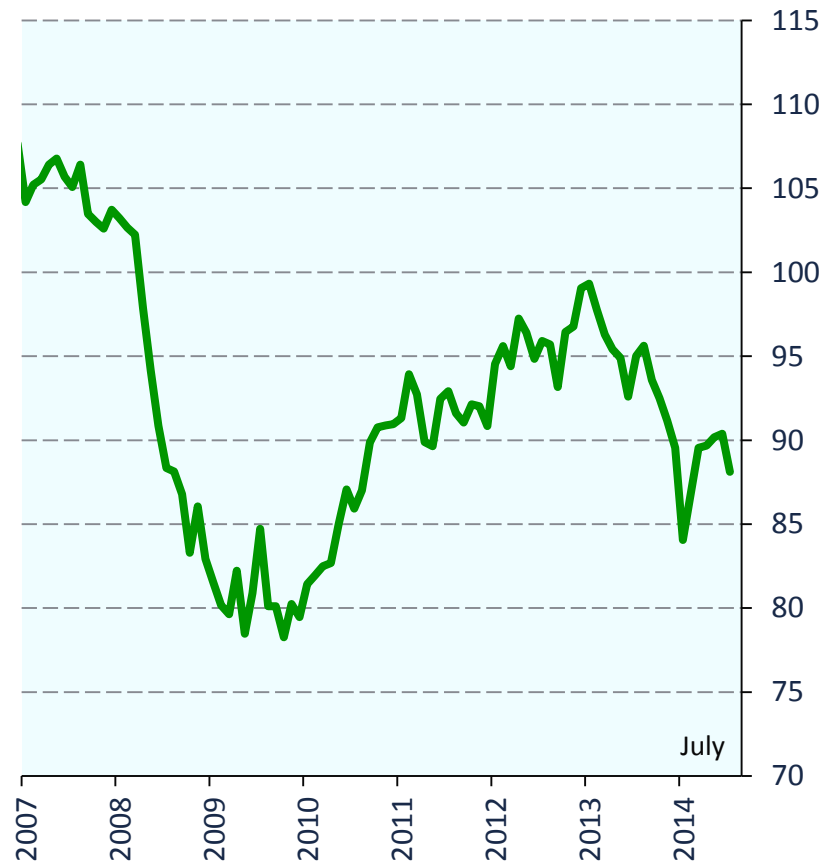


s.a./ Seasonally adjusted data.

Source: Estimated by Banco de México with data from INEGI and ANTAD.

## Consumer Confidence

Index Jan-2003=100, s.a.



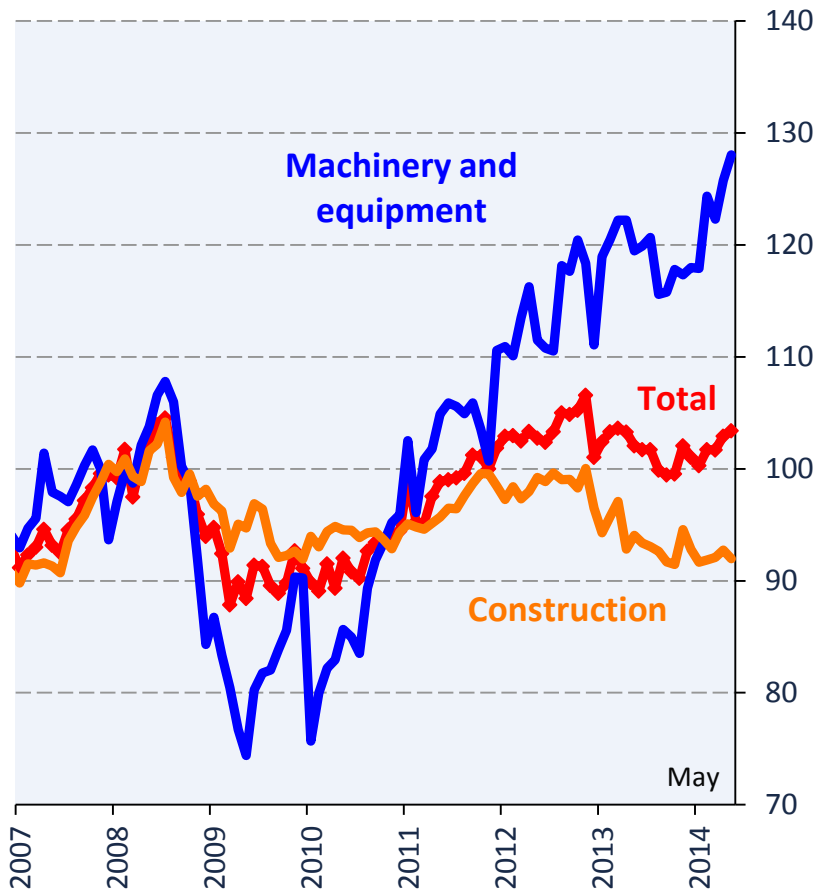
s.a./ Seasonally adjusted data.

Source: Banco de México and INEGI.

# Gross fixed investment indicators gradually improved in 2Q 2014.

## Investment and its Components

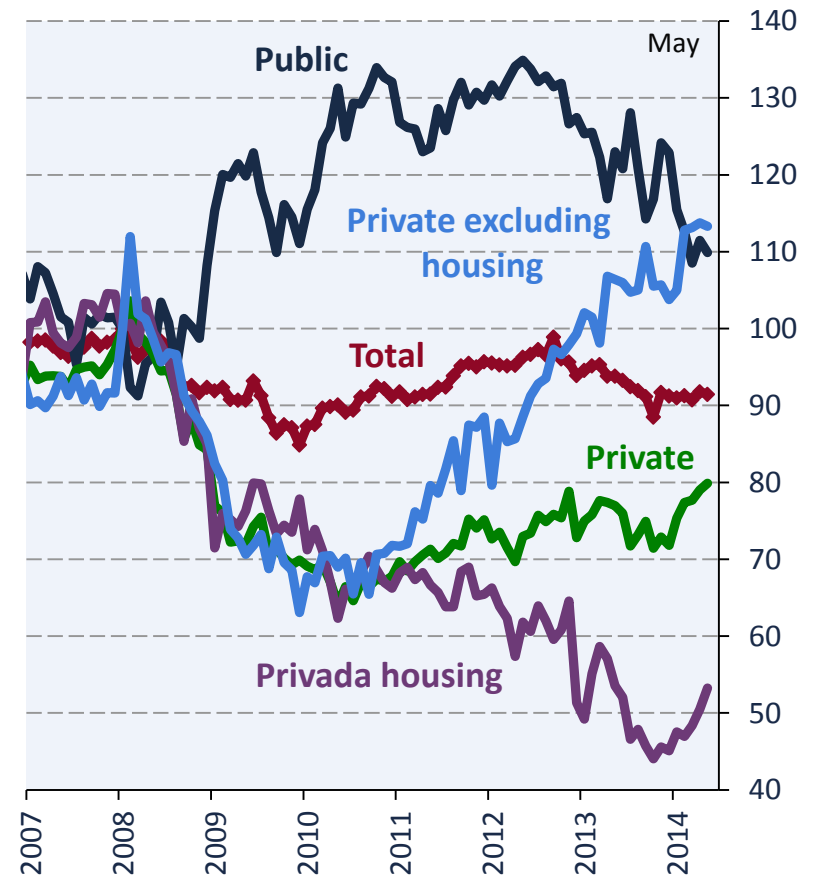
Index 2008=100, s.a.



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

## Real Value of Production in Construction

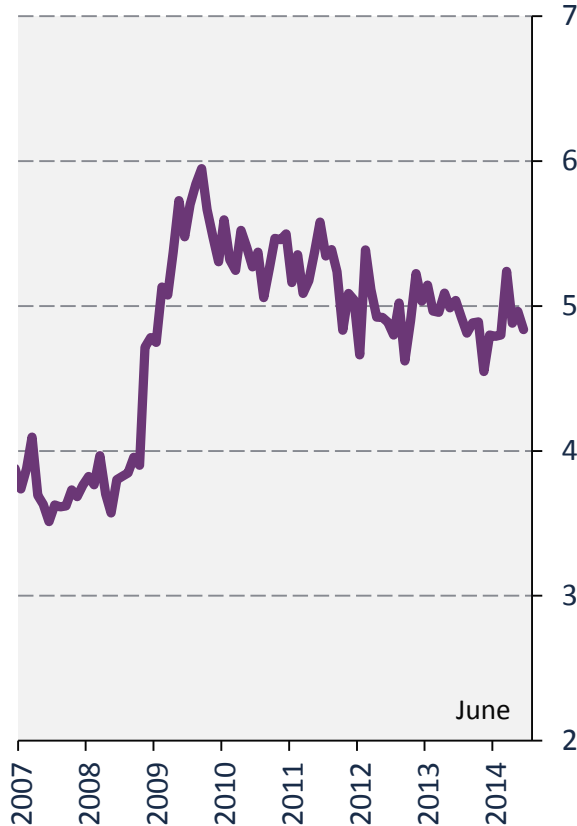
Index Jan-2008=100, s.a.



s.a./ Seasonally adjusted data.  
Source: INEGI and seasonally adjusted by Banco de México in the case of public and private construction (private housing and private excluding housing).

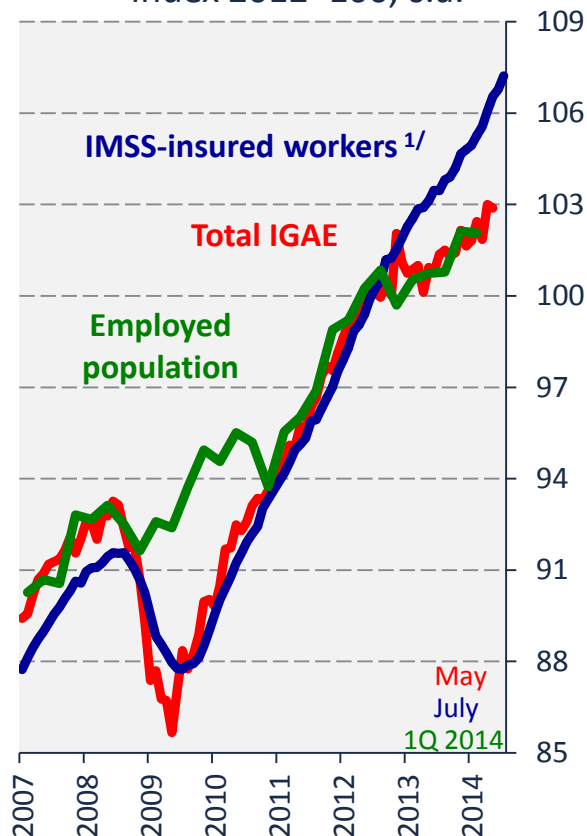
# Despite the more dynamic economic activity, during 2Q 2014 slack conditions persisted in the labor market.

**National Unemployment Rate**  
% of EAP, s.a.



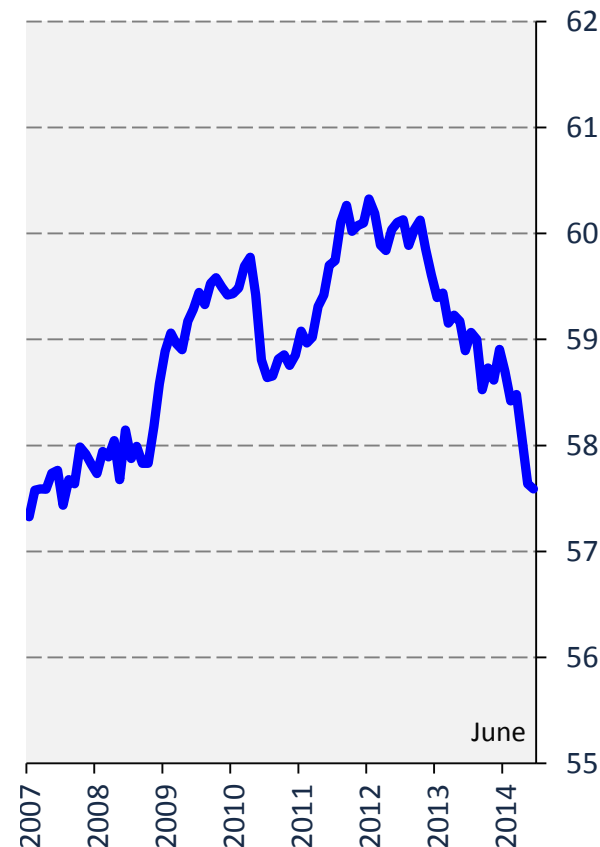
EAP/ Economically Active Population.  
s.a./ Seasonally adjusted.  
Source: National Employment Survey (*Encuesta Nacional de Ocupación y Empleo*), INEGI.

**Total IGAE, IMSS-insured Workers and Employed Population**  
Index 2012=100, s.a.



a.e./ Cifras con ajuste estacional.  
1/ Permanent and temporary workers in urban areas.  
Source: IMSS and INEGI (*SCNM* and *ENOE*).  
Seasonally adjusted by Banco de México except for IGAE.

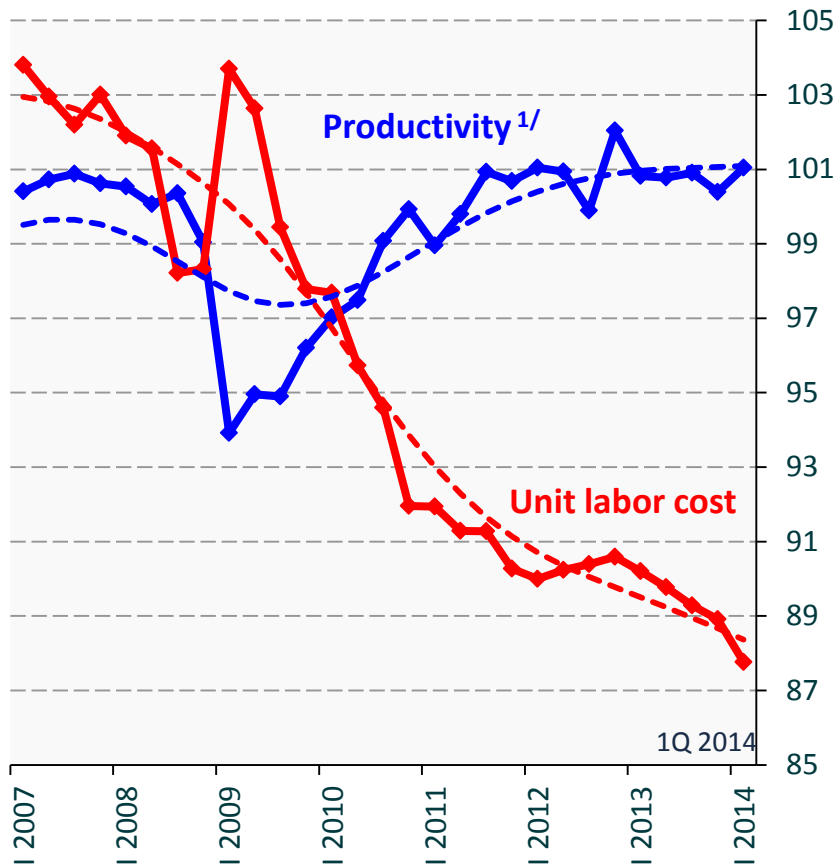
**Labor Informality Rate**  
% of employed population, s.a.



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

Although labor productivity in the manufacturing sector continued its upward trend, the one corresponding to the whole economy has remained stable in the last years.

**Productivity and Unit Labor Cost in the Economy**  
Index 2008=100, s. a.

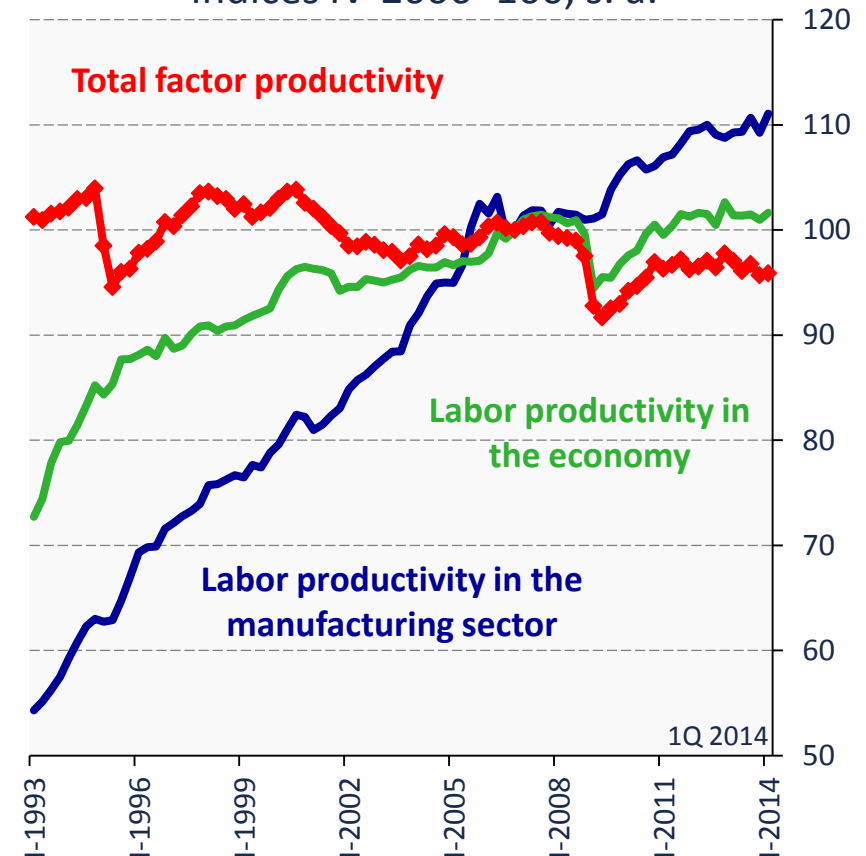


s.a./ Seasonally adjusted and trend data.

1/ Productivity based on the amount of hours worked.

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.

**Total Factor Productivity and Labor Productivity in the Economy and in the Manufacturing Sector<sup>2/</sup>**  
Indices IV-2006=100, s. a.



s.a./ Seasonally adjusted and trend data.

2/ The total factor productivity was estimated as the Solow residual of a regression in logs of GDP versus labor and capital stock. Labor productivity is based on the amount of hours worked. Source: Prepared by Banco de México with data from IGPLE, EMIM and industrial activity data from Mexico's System of National Accounts (Sistema de Cuentas Nacionales), INEGI.

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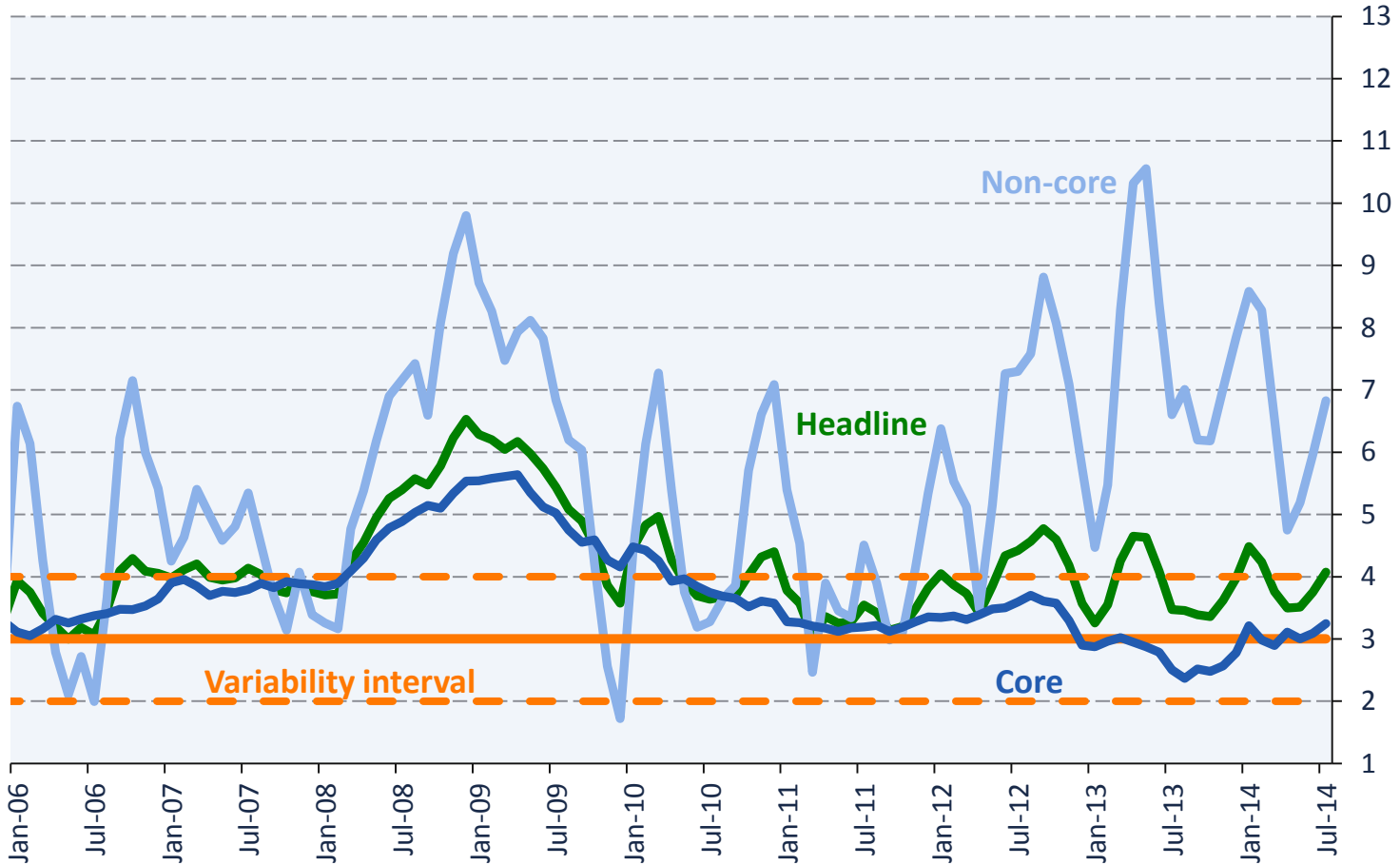
**3** **Economic Activity in Mexico**

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**5** **Forecasts and Balance of Risks**

The conduction of monetary policy, among other factors, contributed to the decrease in annual headline inflation in 2Q 2014. Later, as expected, an increase was observed, mainly due to a low base of comparison.

### Consumer Price Index Annual % change

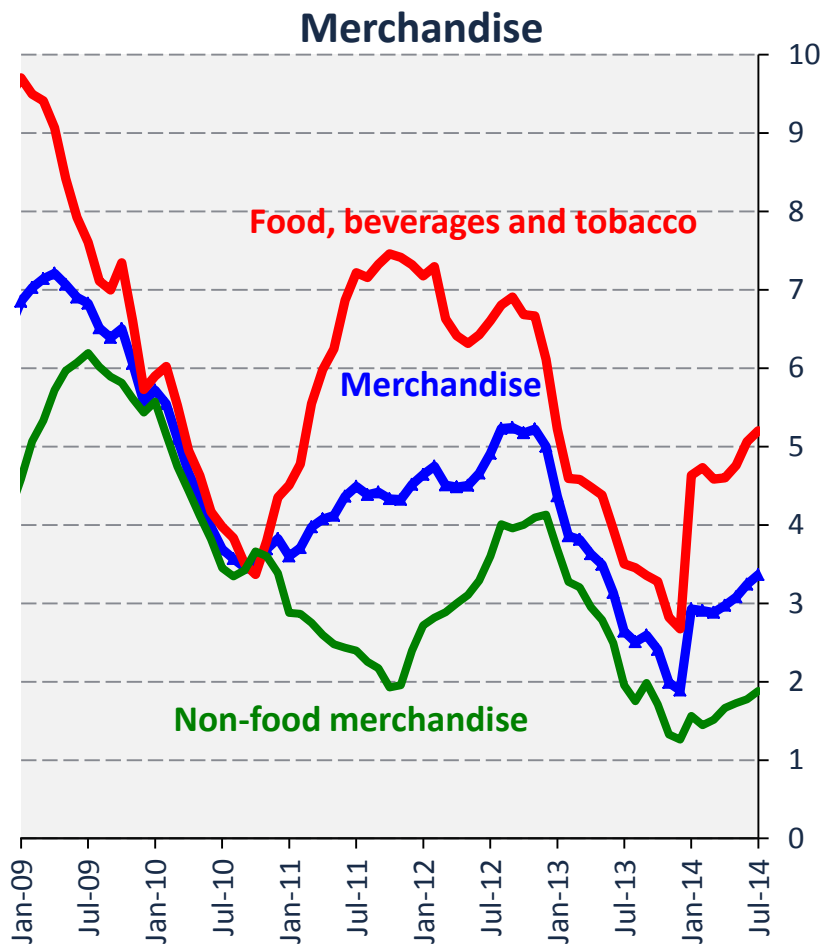


Source: Banco de México and INEGI.

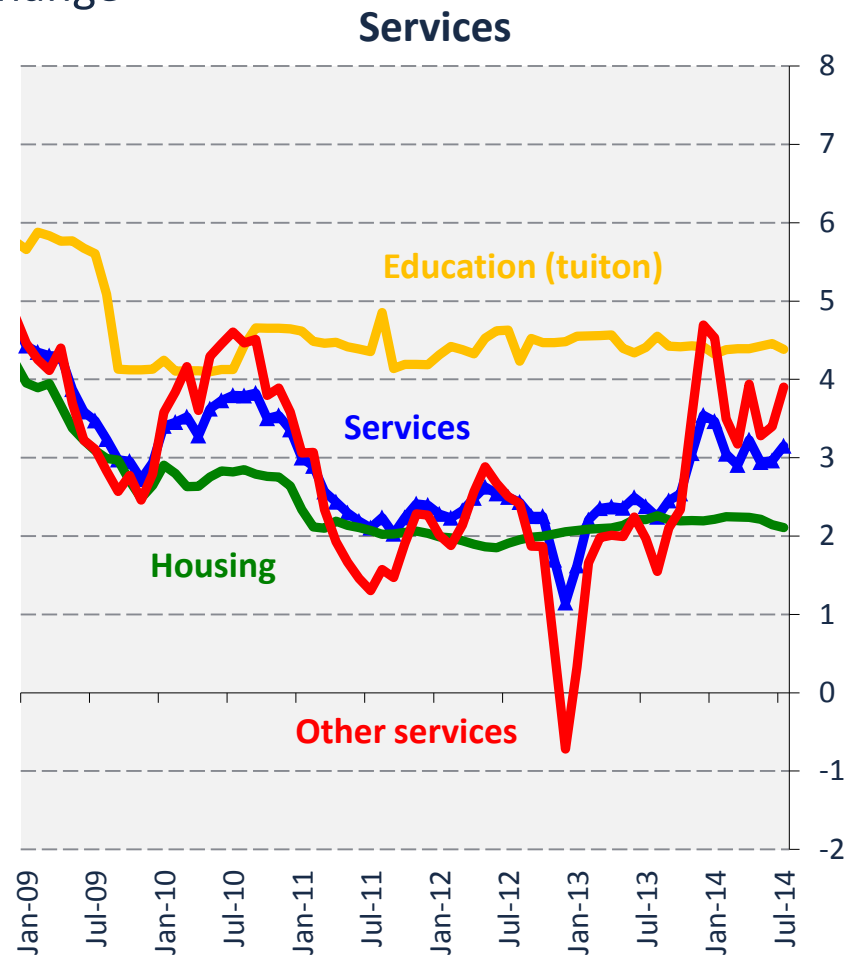


Although an important number of fiscal modifications that came into force in 2014 affected the core price index, its annual change kept close to 3 percent.

### Core Price Index Annual % change



Source: Banco de México and INEGI.

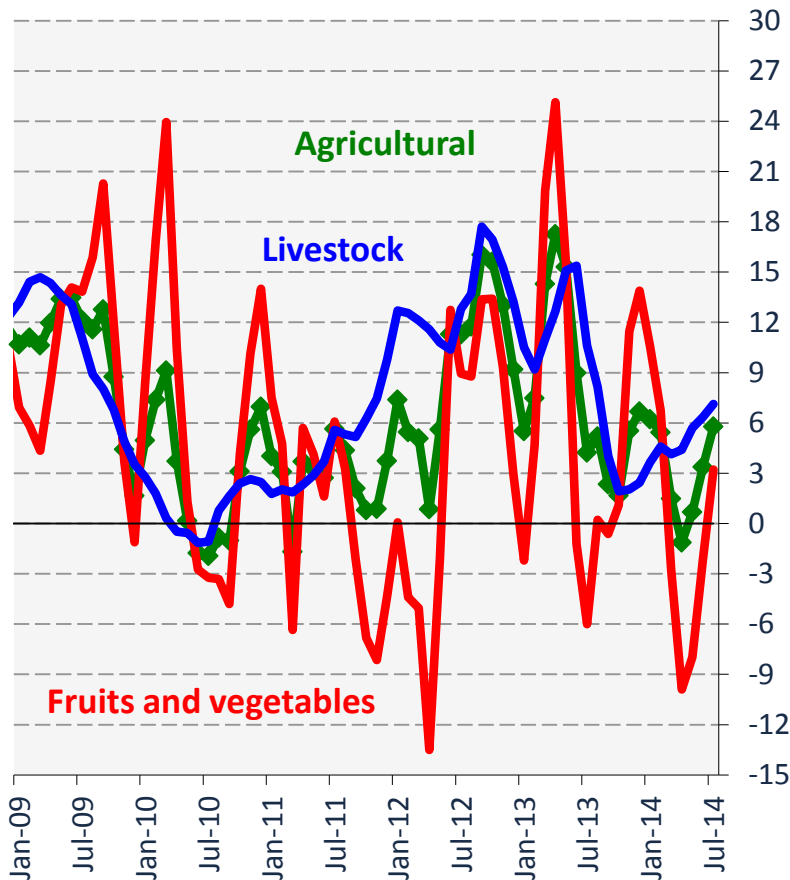


Source: Banco de México and INEGI.

In 2Q 2014, non-core inflation was lower than at the beginning of the year, although it increased recently due to arithmetic effects of a low base of comparison in the agricultural price subindex.

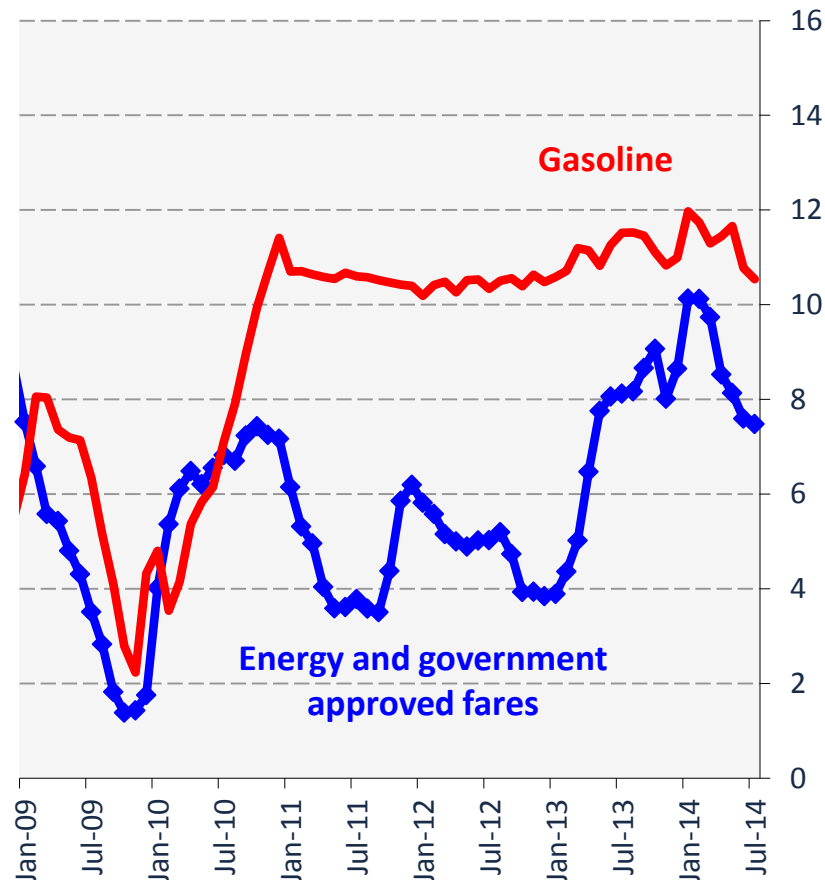
### Non-core Price Index Annual % change

#### Agricultural



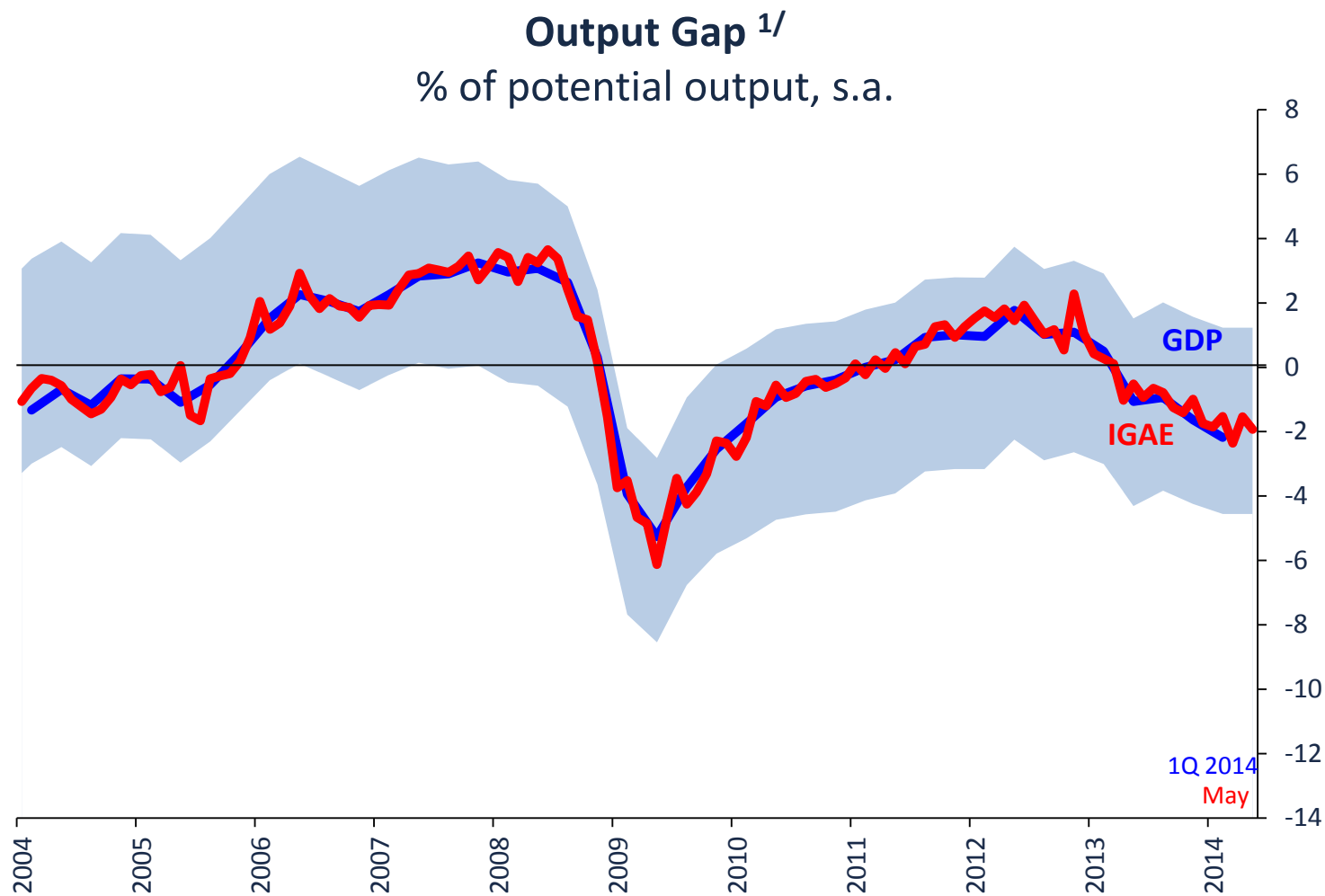
Source: Banco de México and INEGI.

#### Energy and Government Approved Fares



Source: Banco de México and INEGI.

Due to the evolution of economic activity in 1Q 2014, the output gap widened and, despite the foreseen recovery, it is expected to remain negative until the end of 2015.



s.a./ Calculated with seasonally adjusted data.

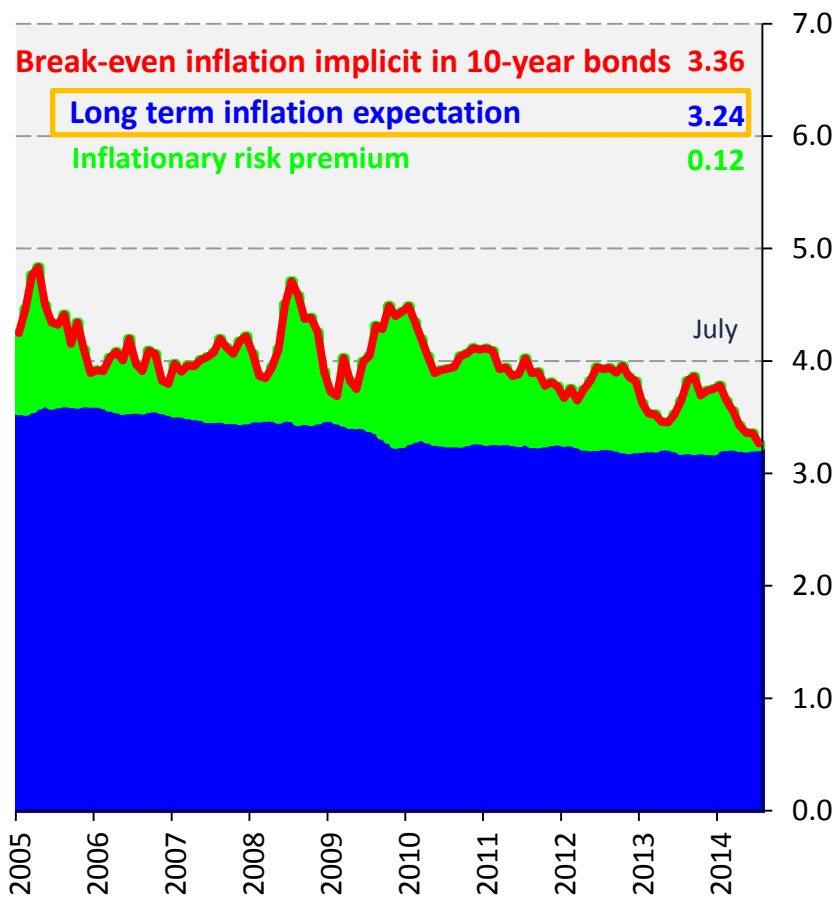
1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p.69.

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.

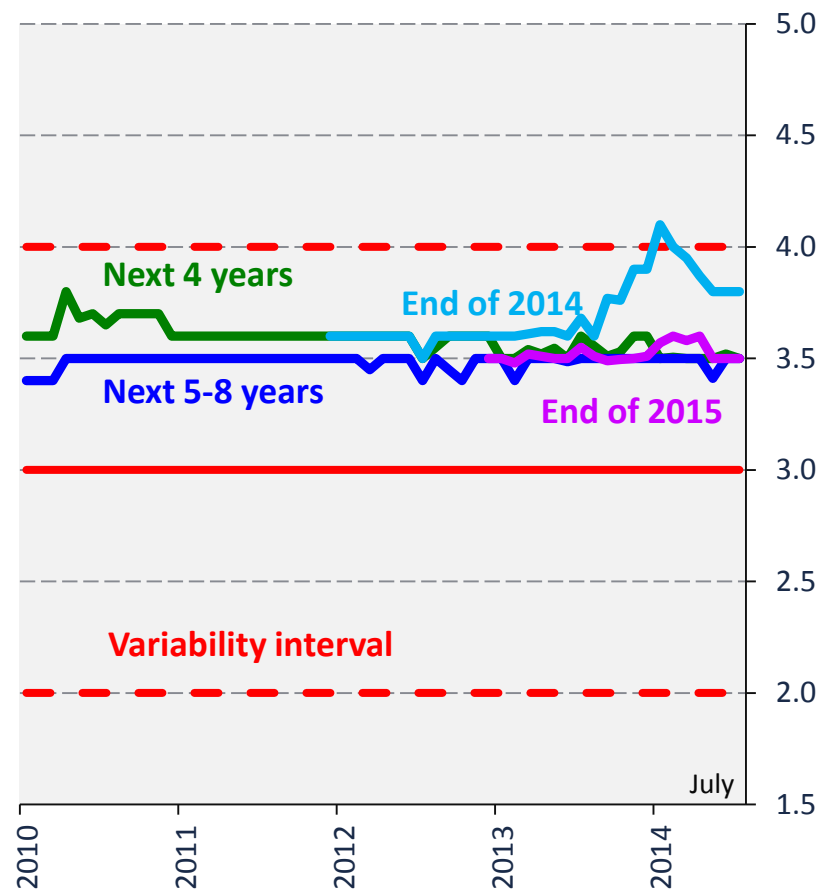
Long-term inflation expectations implicit in market instruments have gradually declined, while those obtained from surveys remain at 3.5 percent.

### Break-even Inflation Decomposition <sup>1/</sup> %



<sup>1/</sup> The inflation risk premium is calculated with an affine model as described in Aguilar, Elizondo and Roldán (2014) with data from Valmer and Bloomberg.

### Annual Headline Inflation Expectations Median, %



Source: Banco de Mexico's Survey.

# Reflecting the decrease in the reference interest rate, interest rates and spreads between U.S. and Mexican long-term interest rates decreased.

## Interest Rates of Government Securities <sup>1/</sup> %



<sup>1/</sup> Since January 21, 2008, the overnight interest rate corresponds to the target for the Overnight Interbank Interest Rate.

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

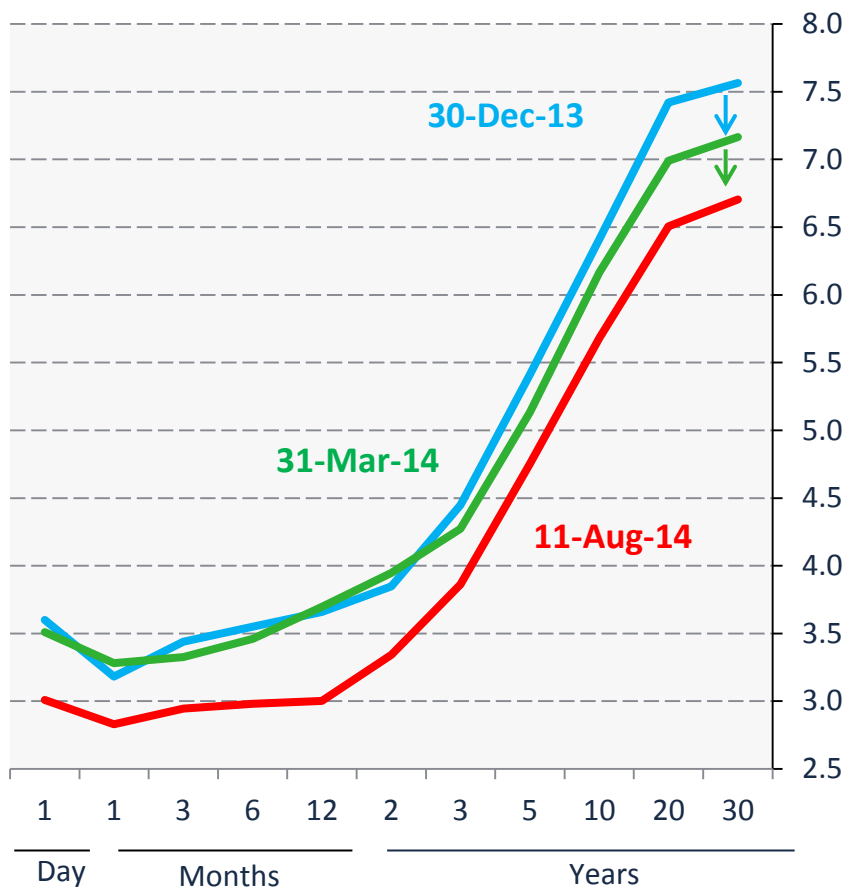
## Spread between Mexico and U.S. Interest Rates Percentage points



Source: Banco de México, *Proveedor Integral de Precios (PiP)* and U.S. Department of the Treasury.

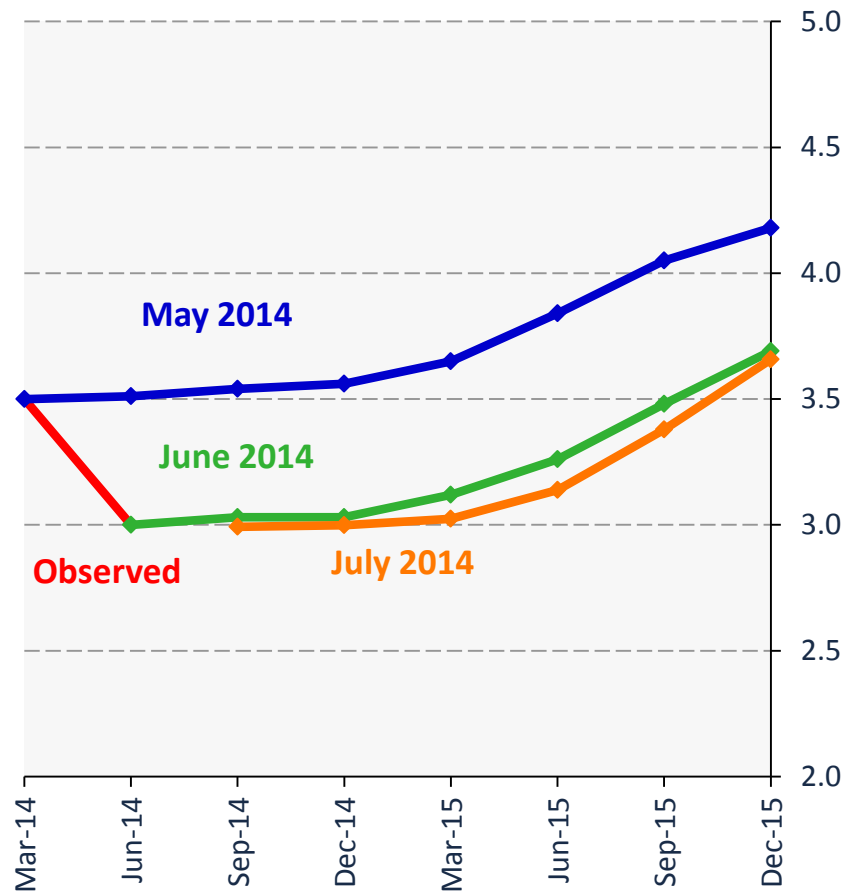
Thus, the yield curve shifted downwards and the expected short-term interest rates for 2014 and 2015 decreased.

**Government Bond Yield Curve**  
%



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

**Expectations for the Overnight Interbank Interest Rate**  
%



Source: Banco de México' survey.

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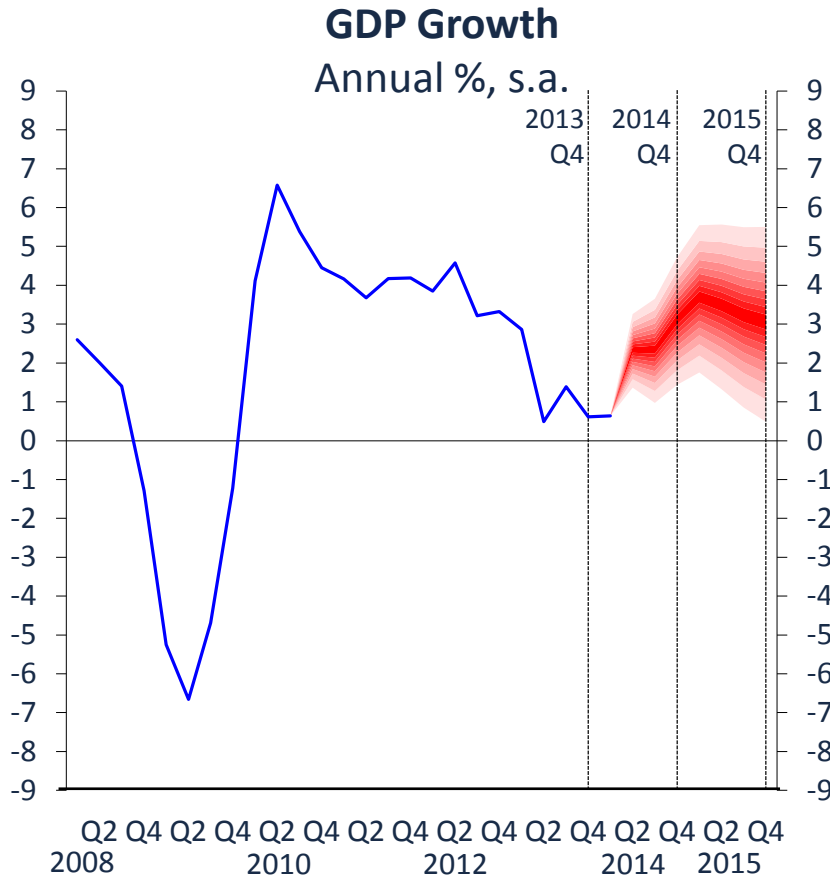
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# Economic Activity Outlook

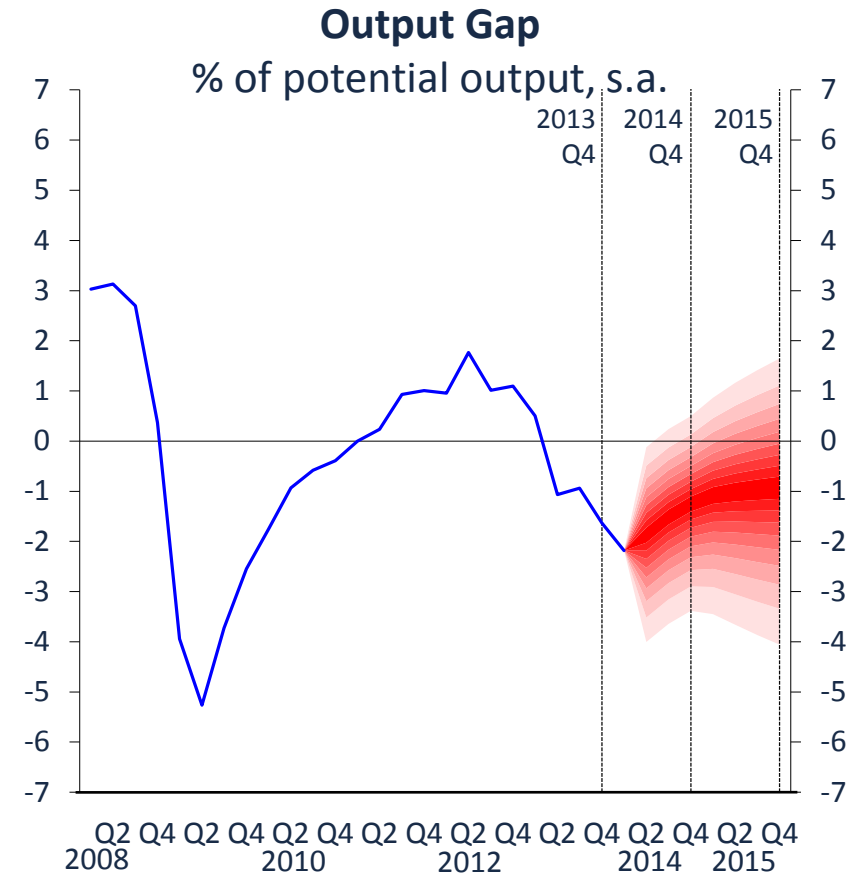
GDP Growth	
2014	Between 2.0 and 2.8%
2015	Between 3.2 and 4.2%

Increase in the number of IMSS-insured workers	
2014	Between 570 and 670 mil
2015	Between 620 and 720 mil

## Fan Charts



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



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



## Risks to the Growth Outlook:

### Upward:



The possibility of a better than expected implementation of structural reforms with its consequent impact on investors' and economic agents' expectations.



The possibility of a more vigorous than expected recovery of U.S. economic activity.

### Downward:



Economic agents' confidence might recover more slowly than anticipated, which would delay a full recovery of domestic demand.

# Inflation Forecasts

## Headline inflation

## Core inflation

2014

- **Second half of 2014:** it is expected to remain **close to 4 percent**, although it could exceed that level at some point, as happened in July.
- **End of 2014:** it is anticipated to lie **below 4 percent**, as the effects of relative price changes from November and December 2013 vanish.

It is anticipated to remain **close to 3 percent** in the rest of 2014.

2015

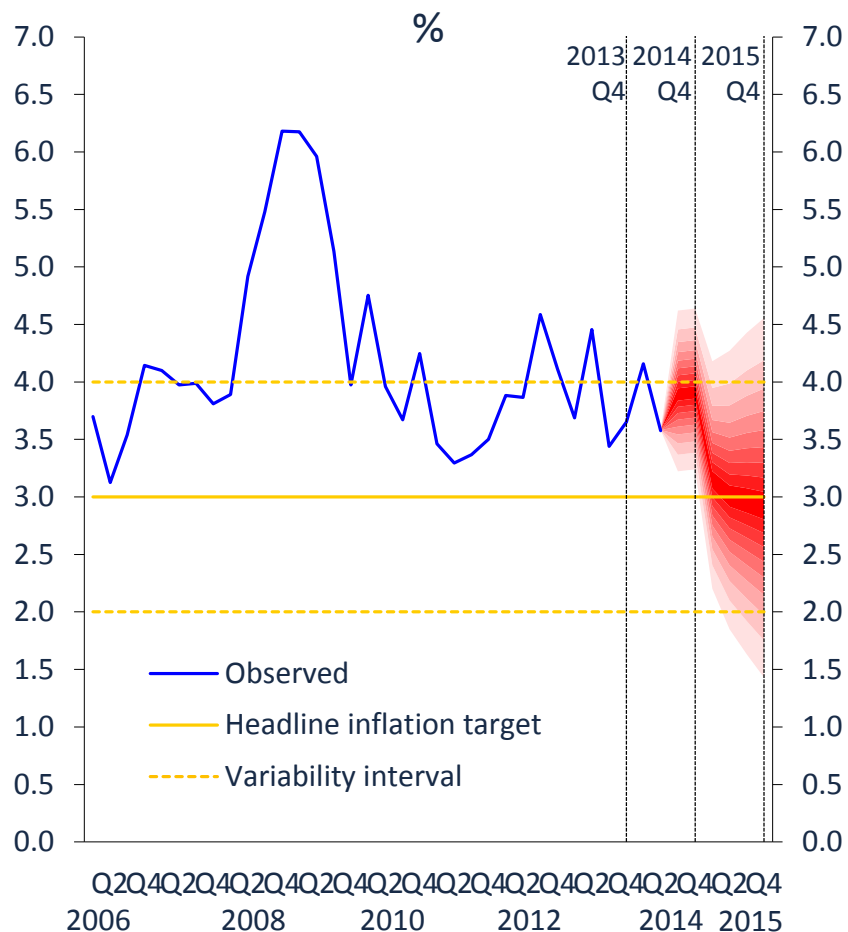
It is estimated to reduce to levels **close to 3 percent** at the beginning of 2015 and to stay around that level for the remaining of the year.

It is expected to be **below 3 percent** in 2015.

The fading of the effect of the relative price changes and the expectation that the increments in gasoline prices will be in line with expected inflation, will contribute to the decrease in inflation in 2015.

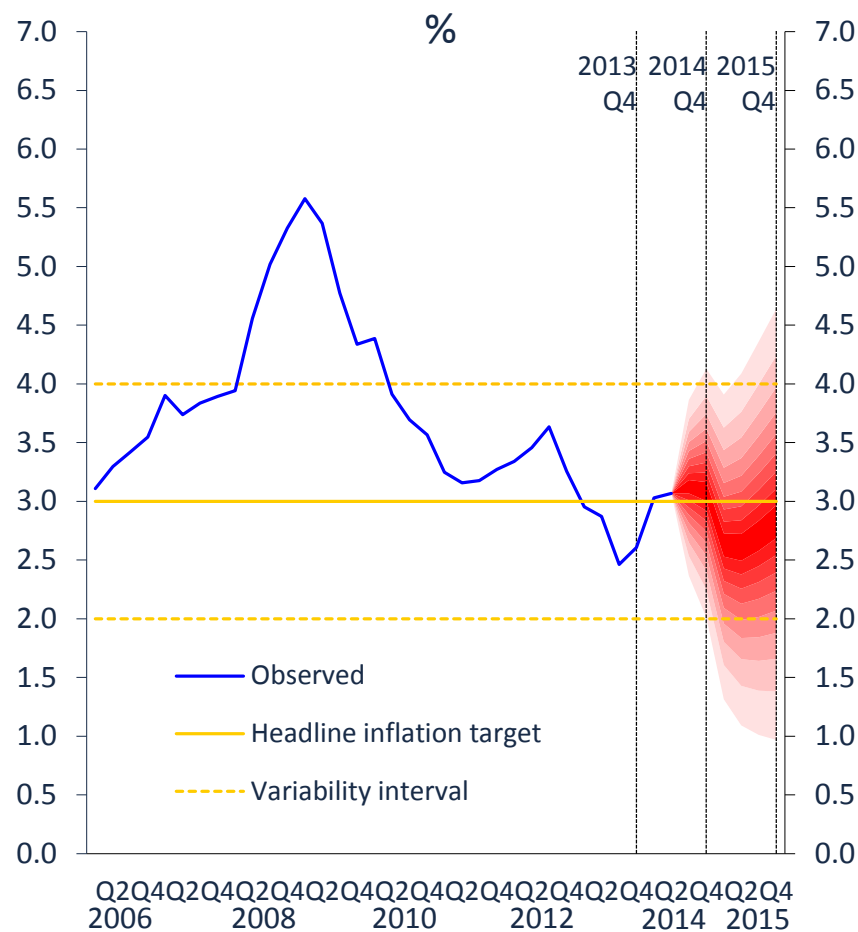
## Fan Charts

### Annual Headline Inflation <sup>1/</sup>



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

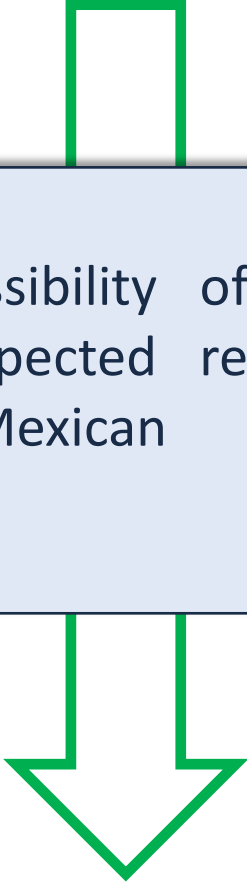
### Annual Core Inflation <sup>2/</sup>



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

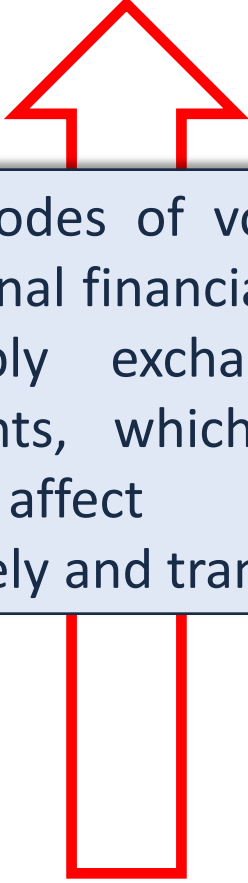
## The inflation outlook might be affected by certain risks:

### Downward



The possibility of a lower than expected recovery of the Mexican economic activity.

### Upward



New episodes of volatility in international financial markets that imply exchange rate adjustments, which in turn may affect inflation (moderately and transitorily).

# Monetary Policy Stance

- Banco de México's Board of Governors considers that the monetary policy is consistent with the efficient convergence of inflation to its 3 percent target.
- However, the Board will closely monitor the performance of the inflation determinants and the medium- and long-term inflation expectations, including the foreseen recovery of the economy and the monetary policy stance of Mexico relative to the U.S., in order to provide the necessary conditions to reach the 3 percent target of headline inflation.

The completion of the legislative stage of the structural reform process, aimed at increasing the country's productivity, is encouraging.

The recent approval of the secondary legislation of the economic competition, telecommunications and broadcasting and energy reforms is **an indispensable step in the right direction**. Thus, these reforms are expected to:

- ✓ Boost the **economy's competitiveness**.
- ✓ Have a **positive and sustainable impact on employment, wages, potential growth and investment climate**.

The increase in productivity would 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 the future, despite the great progress made, it is still imperative to encourage an **adequate implementation of the reforms**.



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