

Quarterly Report

January - March 2014

Summary

The conduction of the monetary policy in Mexico has sought an efficient inflation convergence towards its 3 percent permanent target, i.e., at the minimum cost to society in terms of economic activity. In late 2013 and early 2014, in light of the occurrence of some supply shocks and once new fiscal measures came into force in 2014, inflation in Mexico went up. Subsequently, as anticipated, it resumed its downward trend, when the effects of some of these shocks began to dissipate. Meanwhile, medium- and long-term inflation expectations remained stable, and the price formation process of the economy has not been contaminated. Banco de México has repeatedly indicated that supply shocks or relative price shocks, in a context of well-anchored inflation expectations, only propitiate temporary inflation increments. Therefore, the referred shocks do not justify upward adjustments in the reference interest rate, since it would imply an unnecessary tightening of the monetary policy stance, as, by the moment the increase in the reference interest rate affects inflation, the transitory impact of this shock on inflation will have faded already. In view of the above, the monetary policy stance was not modified in the period covered by this Quarterly Report, even though this Central Institute remained alert, so that no second round effects are generated in the price system of the economy.

At the beginning of the first quarter of 2014, the weakness that the economic activity in Mexico registered in the last quarter of 2013 persisted, which points to an average growth during the analyzed quarter lower than anticipated some months ago. Although some aggregate demand components registered certain stagnation in early 2014, by the end of the first quarter different indicators related to them started to perform more favorably. In particular, given that some of the negative shocks that affected productive activity in the last few months of 2013 and in early 2014 seem to have been transitory and started to revert, more timely data indicate an incipient reactivation of the economy.

The referred events in Mexico unfolded in a context of moderate world economic growth in the first quarter of 2014. This expansion was mainly motivated by the dynamism observed in some advanced economies, given that the growth rate of emerging ones decreased in the first months of the year. Although the U.S. economic activity expanded less than anticipated, largely due to the impact of winter weather conditions, by the end of the quarter it resumed greater dynamism. In this context, the Federal Reserve continued with a gradual process of normalization of the U.S. monetary policy. As a result, following the episode of high uncertainty in international financial markets in January, the referred markets have performed better from February onwards. Also, capital flows to emerging markets were observed again, and those destined to the countries on the European periphery were accentuated. This was partly due to the economic policy response in some of emerging economies, but principally due to a perception of reduced uncertainty regarding the future conduction of the U.S. monetary policy. However, the possibility of new volatility episodes in international financial markets cannot be ruled out, given that this perception could present a sudden change.

It is expected that, once the effects of the temporary factors on productive activity fade, economic growth in Mexico will benefit from higher external demand and from the fiscal and monetary impulses that are underway. Still, the economic slowdown registered in late 2013 and in early 2014 inevitably implies a downward adjustment of the growth forecast for 2014 as a whole.

Thus, the macroeconomic scenario foreseen by Banco de México is the following:

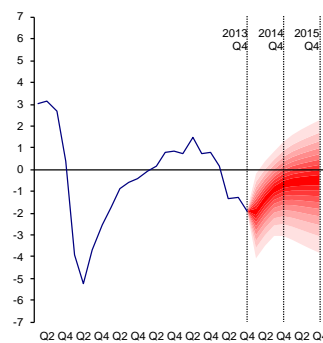
GDP Growth Rate: Considering the performance of GDP in Mexico in recent months, as well as the expectations of the determinants of economic growth, in particular growth expectations in the U.S., the forecast interval for the GDP growth rate of Mexico in 2014 is revised from 3.0 to 4.0 percent in the previous Report, to 2.3 to 3.3 percent (Chart 1a). For 2015, a GDP growth rate between 3.2 and 4.2 percent is still anticipated.

Employment: The expected increase in the number of IMSS-insured workers (permanent workers and temporary workers in urban areas) in 2014 is revised downwards, in accordance with the adjustment in the economic growth expectations. In particular, an increment of 570 to 670 thousand IMSS-insured workers is estimated for 2014, as compared to an expected increase of 620 to 720 thousand workers in the previous Report. For 2015, an increment of 620 to 720 thousand IMSS-insured workers is still anticipated.

Current Account: For 2014, deficits in the trade balance and the current account of USD 4.9 and 25.4 billion are estimated, respectively (0.4 and 2.0 percent of GDP, in the same order). For 2015, deficits in the trade balance and the current account are expected to amount to USD 6.9 and 28.5 billion, respectively (0.5 and 2.1 percent of GDP, in the same order).

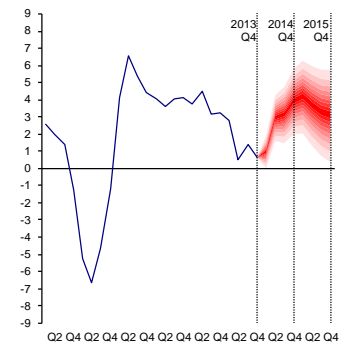
Fan Charts 1

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



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

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



s.a. / Based on seasonally adjusted figures.
Source: INEGI and Banco de México.

Given the recent performance of the Mexican economy, as well as the above referred estimates, no aggregate demand-related pressures on either inflation or the external accounts are anticipated. In particular, the output gap is estimated to remain negative in the forecast horizon, even though gradually narrowing over time (Chart 1b).

In this environment, there are risks to the growth scenario for 2014 and 2015. Among the main downward risks the following stand out:

- That consumer and producer confidence does not improve fast enough, and, therefore, that private sector expenditure does not recover at the rate foreseen in the central scenario.
- That the process of monetary policy normalization in the U.S. does not take place in an orderly manner.

Summary

Despite the abovesaid, it should be pointed out that, along with the improved world economic outlook, a reduction in the perceived vulnerability in most emerging economies has been observed, due to their stronger macroeconomic stances and, especially, due to lower uncertainty regarding the normalization of the U.S. monetary policy. Hence, considering that certain advanced economies have been consolidating their recovery and that the perception of vulnerability in some emerging ones has reduced, the forecast for the Mexican economy is also subject to upward risks. Particularly, the possibility that the recovery of the U.S. economic activity accelerates is noteworthy.

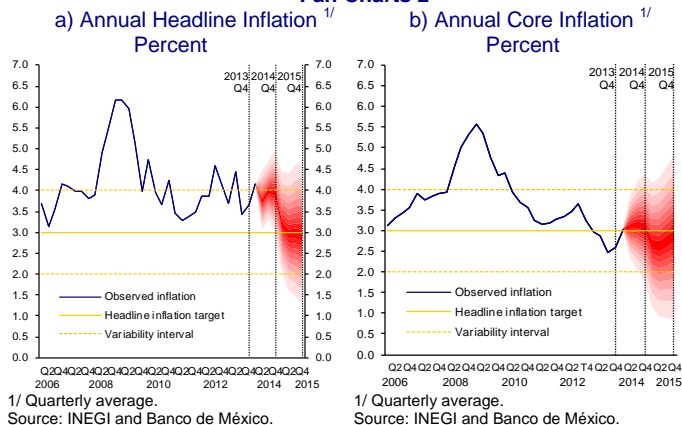
Inflation: With respect to annual headline inflation forecasts, as pointed out in the previous Quarterly Report, in the second quarter of 2014 it is expected to remain below the upper bound of the variability interval around the 3 percent target. For the second half of the year, due to the arithmetic effect coming from a low comparison base, as well as the volatility of the non-core component, headline inflation could locate above 4 percent in a few months, although it is expected to conclude the year below this level. From January 2015 onwards, annual headline inflation is estimated to significantly decrease and to remain at levels slightly above 3 percent for the rest of the year (Chart 2a). This expected inflation performance will be consequent on the fact that in 2015 no fiscal measures, that could impact prices as they did in 2014, are anticipated to be taken. Additionally, it was considered that the gasoline price adjustment will be determined from January 2015 onwards, based on the expected inflation, just as established by the Federal Income Law 2014.

According to the estimates of annual core inflation, it will remain at levels around 3 percent in 2014 and below this level in 2015 (Chart 2b). As regards non-core inflation, it is expected to plunge in early 2015, when gasoline prices are adjusted in accordance with the referred Federal Income Law, even though its other components could register volatility during the year.

The inflation outlook is not risk-free:

- i. An upward risk refers to exchange rate adjustments as a result of high volatility in international financial markets or other factors. However, in such case, the impact on inflation is anticipated to be transitory and moderate, given a low pass-through of exchange rate fluctuations onto prices, even more so if the output gap is considered to remain negative.
- ii. A downward risk that still prevails is a lower than anticipated economic activity recovery.

Fan Charts 2



Banco de México's Board of Governors has estimated that the monetary policy stance has so far been congruent with the efficient convergence of inflation to its 3 percent target. Therefore, it has maintained the Overnight Interbank Interest Rate at 3.5 percent in its Monetary Policy meetings of January, March and April 2014. Still, in the future it will monitor all factors that may affect inflation and its expectations in the medium- and long term, particularly the evolution of the degree of slack in the economy. Likewise, it will monitor the implications of the monetary policy stance of Mexico relative to the U.S. onto the inflation outlook, so as to reach the abovesaid inflation target.

Finally, the juncture the Mexican economy is going through is propitious to reflect on the importance of strengthening the domestic sources of growth over the coming years. In this regard, it is important to keep in mind that, from a long-run perspective, the economic growth of Mexico has been unsatisfactory. One of the main reasons behind the reduced growth that Mexico has been presenting for decades is the low growth rate of productivity. It should be noted that for a country to significantly increase its productivity, thus leading to persisting increments in its growth rates, a comprehensive transformation process of the national life is required, which can take a long period of time to be implemented, given that, in turn, this process generally requires deep changes in the institutions governing the economic activity. The historical evidence of numerous countries supports this statement. This suggests that achieving higher productivity and stronger potential growth in Mexico poses a considerable challenge. In this context, it is encouraging that structural reforms aimed at increasing productivity are being carried out. Indeed, among other reforms, the amendments to the Constitution, which have been approved recently in the areas of telecommunications, economic competition, energy and education, represent a crucial step in the process of structural change required by the country. Nevertheless, it is imperative that this progress is backed by secondary legislation that preserves the spirit of the constitutional amendments. Likewise, for the reforms to unlock their full potential onto productivity growth, and, therefore, on economic activity and welfare, it is also necessary to ensure that they are adequately put into practice in the course of the following years.