BBVA | RESEARCH

Mexico Economic Outlook

Second Quarter 2014
Economic Analysis

- After the slow start of the year, we expect economic activity to pick up over the following quarters as a result of an improvement in the US and the public expenditure
- The energy reform, among other positive aspects, would help to reduce the proportion of workers in the informal economy
- The effect of the fiscal reform on prices has been transitory, contributing to maintain inflation under control

BBVA Bancomer

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Closing Date: May 27, 2014

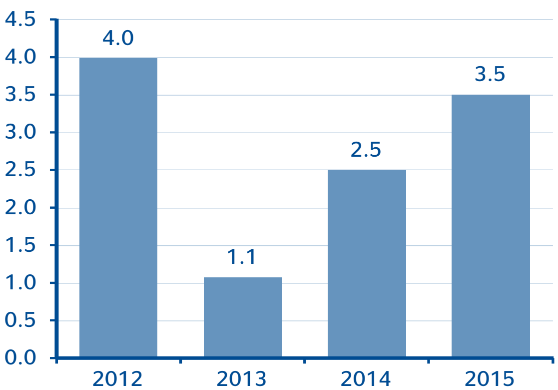
1. Summary

Given the lower-than-expected first quarter GDP growth, we revised our 2014 economic growth scenario down to 2.5% from the previously estimated annual rate of 3.4%. The low growth rate in the year's first quarter resulted from a weak performance of the US economy caused by weather issues, which had an effect on both consumption and investment greater than that expected from the tax increase, and from other domestic factors such as the slow recovery in construction and the drop in oil production. Nevertheless, the worst seems to have passed. The economy should pick up over the coming quarters, as a result of the improvement in the US economy and a greater amount of, and efficiency in, public sector spending. These factors are expected to continue over the course of 2015, which is also when the structural reforms could begin to provide their initial (albeit still modest) results, leading to an annual growth rate of around 3.5% for that year.

In our opinion, the investment that an efficient energy reform implementation could generate would foster the creation of formal employment. Over the medium term, it would cut the proportion of informal labour in the underground economy, from the 27% of the economically active population currently observed to between 24% and 26%.[1] A sustained annual GDP growth of 5.0%, however, would enable the creation of 700,000 jobs on an annual average, although such a growth level is ambitious. This would mean that virtually all of the people who enter the labour market every year would find employment in the formal sector.

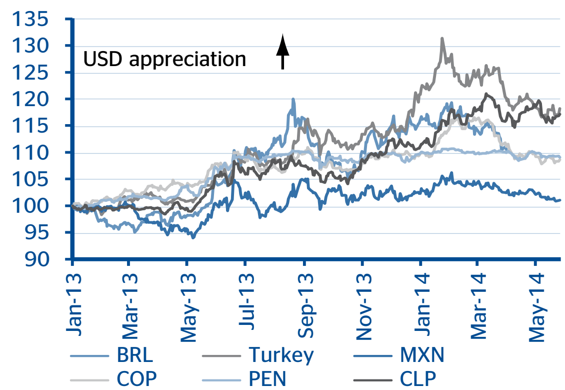
The legislative process of the current administration's extensive reforms agenda continues. The debate on and adoption of the bylaws should move forward over the coming months, followed by the subsequent implementation of the reforms. For the Mexican economy to achieve a sustained growth rate of over 4.0%, the bylaws that are ultimately enacted must promote an effective meeting of the reforms agenda goals, and must be efficiently implemented.

Chart 1
Mexico GDP (YoY % change)



Source: BBVA Research

Chart 2
Emerging countries exchange rates (local currency vs. USD, index Jan. 2013=100)



Source: BBVA Research with Bloomberg data

[1] 27% of the EAP corresponds to employees working in informal companies. However, in the broadest definition of informality it reaches 58% of the EAP.

As expected, the new fiscal measures that came into force in January had only a temporary effect on inflation. Furthermore, the rises in the prices of farm products observed over the last months of 2013 faded over the first quarter of this year. This, together with the moderate economic growth, led to a lower monthly inflation from February to April than the average of the last five years, which contributed to the current annual inflation rate of around 3.5%. We expect that short-term signs of economic recovery will start manifesting in a moderate pickup in prices toward the second half of the year, with inflation closing around 3.7% in December.

Within this environment of inflation under control and ample slack in the economy, we expect that monetary policy will remain on pause for an extended period. The central bank's statement was along those lines, when noting that this year's growth will be lower than previously expected and that the output gap will not close until 2015.

The behaviour of Mexico's financial markets was mainly influenced by the Fed's statement and US economic activity data, both of which had rather more effect than any geopolitical tensions.

Recently and transitorily, two factors that generate a favourable environment for higher-risk asset demand have coincided. To begin with, the Fed used a relaxed tone in its statement, to reaffirm that low rates will be maintained for an extended period notwithstanding the scheduled conclusion of its asset purchase programme at the end of the year, which the market takes to mean that liquidity will still be maintained for a lengthy period. In contrast with what is usually the case, this occurred while US data and economic activity outlooks were improving. Economic activity improvements are usually accompanied by an outlook of greater monetary restraint. In the case of the exchange rate, both the outlook for extended liquidity and the improvements in the US economic cycle favour its appreciation, and motivate the current rate of under 12.9 pesos per dollar. Worth noting is that exchange rate volatility has dropped to its lowest level since 2009. The peso has also maintained its positive differentiation with respect to other emerging economy currencies. The economic stability, the outlook for the implementation of reforms and the tight relationship between the Mexican economy and the US economic cycle contribute favourably to that differentiation.

Once the Fed ends its asset purchase programme, presumably at the end of the year, markets are expected to begin focusing their attention on the potential start of the cycle of Federal Fund Rate increases. When this occurs, as in the case of past rate increase cycles, we expect the exchange rate to move to the upside. We nevertheless believe that the depreciation will be moderate, around levels of 13.30 pesos per dollar towards the end of 2014. It should be mentioned that an environment of rising US interest rates would also indicate an improvement in the US economic cycle, which stands as a favourable factor for the Mexican peso, one that would assist in keeping it anchored.

Regarding interest rates on government debt, we expect that a scenario of cyclical strengthening and a gradual rise in US inflation will tend to exert upward pressure on interest rates for the remainder of 2014 and during 2015. However, given the surprises of low first quarter inflation and the Fed statement noting that current lax monetary policy conditions are still required, we do not expect major interest rates movements over the second quarter. Considering the expectation that the Fed will end its quantitative easing programme in October, we believe that long-term interest rates will start adopting a gradually upward trend in the third quarter of this year. We expect that trend to reach levels of close to 3.4% on the 10-Year US Treasury Note at the close of 2014, and close to 6.9% for the Mexican M-Bond of the same maturity.

2. The deceleration in China and the Fed's tighter monetary policy will define the global scenario

The global recovery continues, but the improvement is being hampered by the deceleration in the EMs. China and the Fed's tighter monetary policy will determine the global scenario

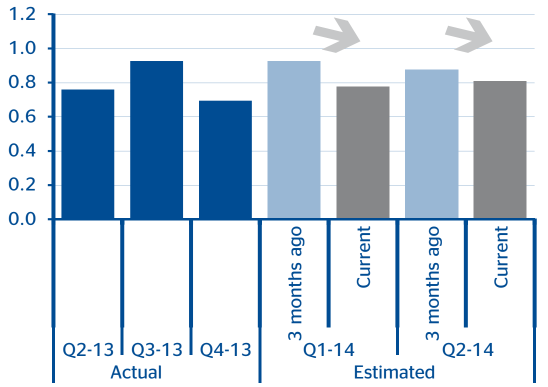
The global economic cycle remains robust at the start of 2014. According to our estimates, in the first quarter of 2014 global GDP has accelerated very slightly to around 0.8% QoQ and, according to our global activity indicator (BBVA-GAIN), we expect this pace to be maintained for the first part of the year (Chart 3). In the wake of this sustained global recovery is the cyclical improvement in the DMs, which has offset the deceleration in some EMs in Asia and Latin America. Meanwhile, in the last few months the financial markets have performed very differently in the two regions (Chart 4), and with more differentiation between the EMs. Capital flows, asset prices, interest rates and financial tension indicators have fundamentally performed in line with the outlook for rate hikes in the UK, but have also been affected to a greater or lesser extent by geopolitical risk events in Eastern Europe and China's slowdown expectations. Altogether, tightening financial conditions have differed in each economy as a function of the degree of external vulnerability and financial integration. This is all related to higher deficits on current account, dollar-linked liabilities and flexible exchange rates.

The global scenario is a result of a combination of the policies introduced domestically but having cross-border implications, not only in terms of more or less demand for goods and services (international trade), but also in the extent to which they help to alter global risk-aversion, which is reflected in the volatility of capital flows and/or the prices of financial assets and raw materials.

On the one hand, the cyclical recovery is gathering pace in the DMs on the back of less restrictive fiscal consolidation, fewer concerns about the sustainability of debt levels (thanks to contained financial costs) and progress on the implementation of banking union in the EMU. However, the normalisation of US monetary policy via quantitative measures and interest-rate expectations is resulting in a rebalancing of financial portfolios at a global level, which is having a relevant impact on funding conditions and asset prices in the EMs. This contagion is nothing new, but has raised its head again in a new environment: with more financial integration in the EMs and an extraordinarily lax monetary policy in the US (Chart 5). Symmetrically, the exit from this exceptional period will also have an impact on the financial variables (Chart 6).

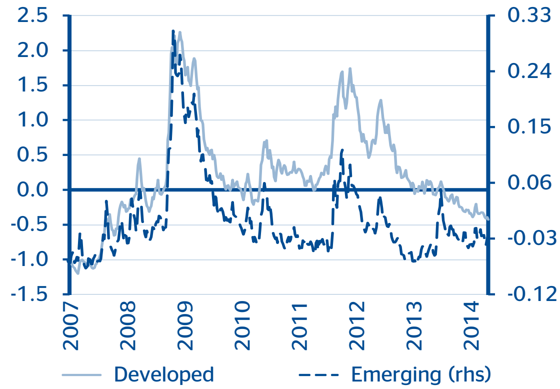
In this latter group, we are also starting to see concerns about the economic slowdown in China since the Chinese New Year, given the increased emphasis that the authorities are now placing on reducing vulnerabilities – via medium-term macro-prudential policies – rather than in sustaining growth in the short term.

Chart 3
Global growth (%, QoQ) based on BBVA-GAIN



Source: BBVA Research with IMF data

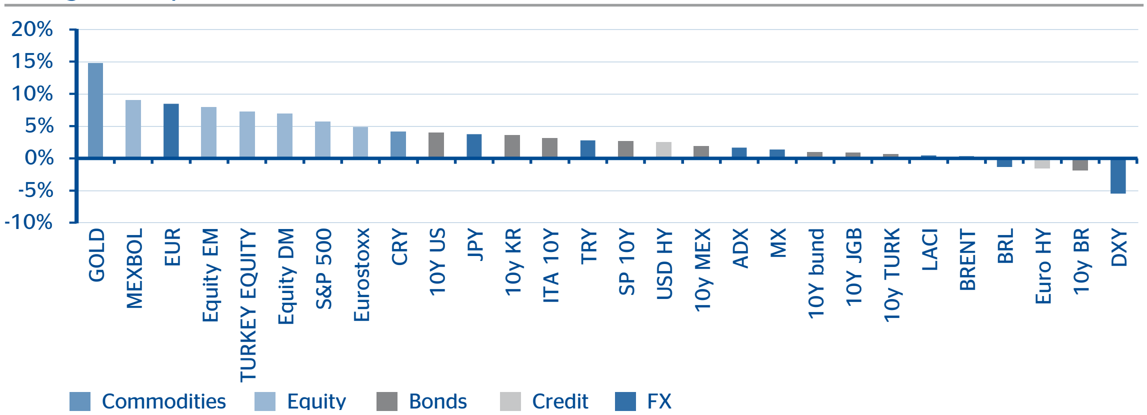
Chart 4
BBVA Research Financial Tensions Index in DMs and EMs



Source: BBVA Research

To sum up, our assessment of the global scenario has a downward bias compared with our valuation three months ago, which is reflected in the adjustments to our forecasts. After growing at 3.0% in 2013, global GDP will start to accelerate again in 2014 and 2015 at around 3.4% and 3.8% respectively, figures that demonstrate both the variations in growth expectations in diverse regions and the increased, although slight, contribution to global growth by the developed economies. Although there have been no significant changes in either the US or the eurozone, the downward pressures in our forecasts are above all visible in the EMs in 2014 and 2015, in both Asia and Latin America. In this context, there are still short- and medium-term downside risks to our forecast. Some factors with a global impact could make themselves felt more intensely than expected in the base scenario on a short-term time horizon, such as a tighter monetary policy on the part of the Fed, reduced growth of the global demand stemming from economic slowdown in China or geopolitical risks derived from Eastern Europe.

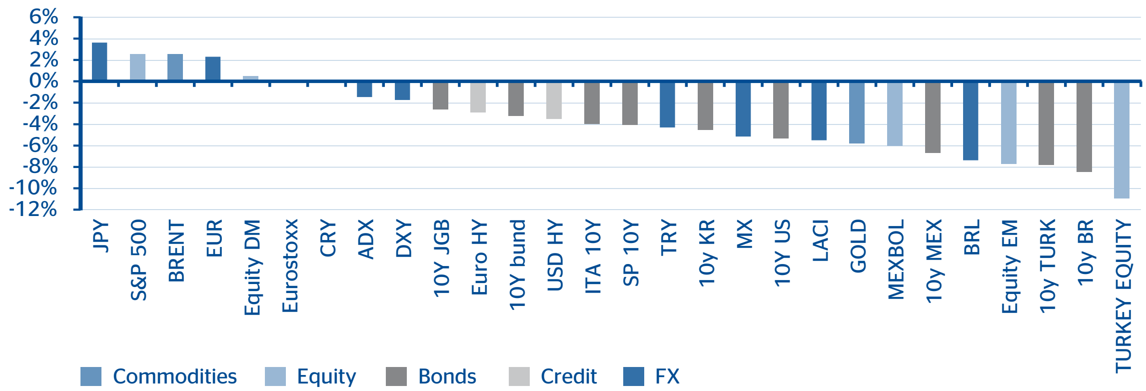
Chart 5
Change in the price of financial assets on the arrival of the Fed's Q1, Q2 and Q3*



* The periods analysed are: Q1: 3 Nov 08- 2 Jan 09; Q2:27 Aug 10-10 Nov 10; Q3: 1 Aug 12-17 Sept 12
Source: BBVA Research with EPFR data

Chart 6

Change in the price of financial assets on the tapering announcement in May 2013



Source: BBVA Research with IMF data

In the developed economies, the US overcomes the impact of an unusually cold winter and the perspectives for an improvement in the eurozone have increased

US GDP has been affected by the impact of unusually adverse weather conditions. In the labour market, employment has increased by an average of 178,000 jobs in 1Q14, in line with the print in 4Q13, and the unemployment rate has fallen to 6.7% of the labour force, a smaller than expected fall because the increase of the population available to work. As a result, the Fed has pressed ahead with the announced moderation in its balance-sheet expansion. In this context, we are expecting the Fed to complete its exit from the asset-purchase programme towards the end of the year, and the market to focus on a possible change in inflation trends as it anticipates the start of interest-rate hikes in a scenario of a gradual acceleration in GDP growth. Growth in 1Q14 reached -1.0% SAAR. The leading indicators point to a slightly more robust start to the second quarter than to the first. Altogether, we are maintaining our forecast for US growth at 2.5% in 2014, and the same in 2015.

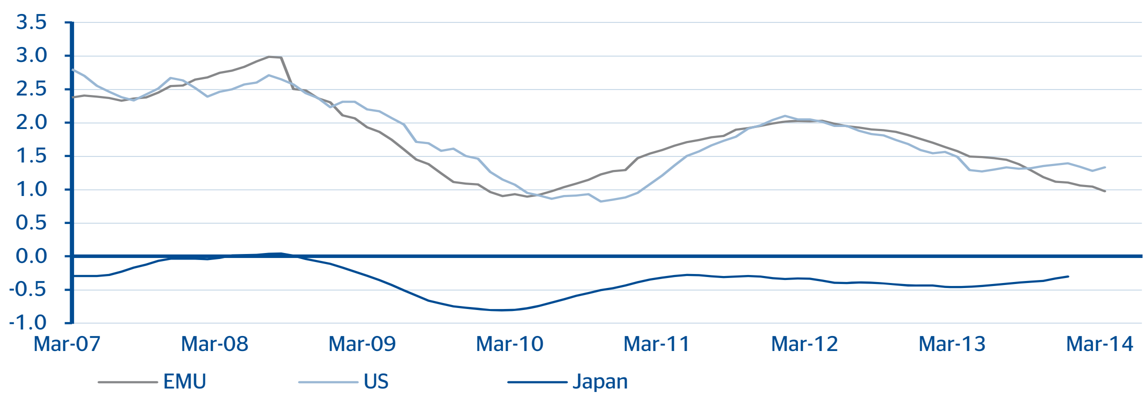
On the European side, growth in the eurozone in the latter part of 2013 was driven by the recovery in exports, which has also favoured the improvement in investment. Looking at the first quarter of 2014, our short-term models point to an acceleration of around 0.5% QoQ, although the boost from the external sector could moderate in the coming months due to: i) euro appreciation, with a slight impact on growth but clearly differentiated by country; ii) the reduced demand from China, also with diverging direct effects; and iii) geopolitical risks in the East if the crisis in Ukraine continues.

Altogether, we maintain our forecasts for the eurozone in 2014 at 1.1%, and 1.9% in 2015, in a scenario of contained financial tensions and fiscal and monetary policies that do not put a brake on growth. In this gradual recovery, domestic demand will play a growing part, with accelerating investment and enhanced consumption, in line with the steadiness of the labour market in 2014 and then job-creation in 2015. As already established, this scenario requires progress on the achievement of an effective banking union, starting with the maximum transparency of bank balance sheets through asset quality reviews under common regulations and stress tests under common adverse scenarios.

Finally, of the developed economies, there is slightly more uncertainty about the growth outlook for Japan, which has had a QE programme underway since January 2013, together with fiscal stimuli to return to having inflation and favouring consumption and investment. The recent tax increases on consumption to control the public deficit could put the recovery in private demand at risk, although there are still some offsetting measures to take to offset this, including an even more intense monetary expansion. Altogether, we have revised downwards our outlook for growth in 2014 by four basis points to 1.1%, and we are maintaining our estimate for 2015 at 1.3%.

In the developed economies, the period of low inflation or disinflation continues, as evidenced by various optimised indicators[1] (Chart 7). While in Japan the inflationary tensions indicator is rising – although still in negative territory – as a result of the above-mentioned policies and it remains anchored in the US, in the eurozone it is still falling and is now around 1%. According to our base scenario, it is likely close to its lows and the perspective of an increase is sound. Nonetheless, although we are not expecting deflation, the vulnerability to negative shocks, global or domestic, with an impact on prices[2] is comparatively high. The vulnerability comes not only from the level and the downward trend of inflationary tensions, but also from the financial situation of the private sector, with very high levels of debt in at least some of the economies in the region and a banking sector that is in the process of reinforcing its capacity to lend, as described above. A negative shock that could result in a change in inflationary expectations would increase the probability that the ECB would take additional measures, from providing long-term liquidity to the banking sector with no restrictions, to lowering reference rates or making selective purchases of high-quality private-sector debt assets.

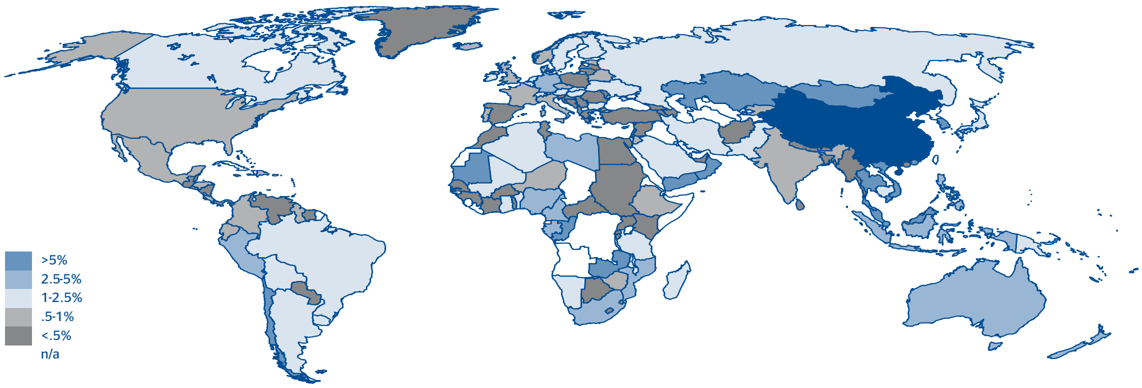
Chart 7
Inflationary tensions indicators in developed economies*



* Trimmed means from baskets of personal consumption prices in the US and from CPI in Japan and the eurozone
Source: BBVA Research with Dallas Fed data

[1] For more information about trimmed means see, for example, Spain Economic Outlook from February 2014, available at: http://www.bbvaresearch.com/KETD/fbin/mult/1402_Spain_Economic_Outlook_tcm348-426396.pdf?ts=2942014
[2] Falls in import inflation either as a result of additional strength of the euro or lower raw material prices, resurgence of global risk aversion in financial markets. Note our downwards correction of inflation forecasts for China, around 0.5pp in 2014 and somewhat less in 2015, to 2.7% and 3.3% respectively.

Chart 8
Exports to China in 2012 (% GDP)



Source: BBVA Research with World Bank and UN Comtrade data

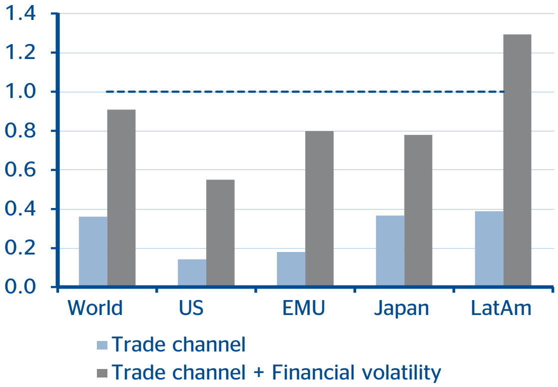
In China, the deceleration that began at the Chinese New Year is here to stay, in an environment of lower than expected inflation

In line with our forecasts in our last quarterly report, uncertainties about the cyclical strength of the Chinese economy have materialised, with a deceleration in activity during the first quarter of 2014. The latest data from indicators on both domestic and foreign demand show the loss of momentum in the cycle, more so in investment than in consumption, in an environment of lower than expected inflation. At the same time, the authorities are starting to introduce measures to deal with the weaknesses arising from economic policy decisions taken in the last few years to support growth in the short term. This has involved postponing the deleveraging of local governments and companies, and continuing to approve infrastructure projects and excess installed capacity which are unlikely to be profitable while families, who are financing the process, are receiving negative real interest rates on their savings. This is an inefficient allocation of resources, which also encourages the development of financial systems in parallel with the more regulated one and which may be a source of problems in the future. To this end, regulations on the non-banking financial sector, shadow banking and environmental protection are all being toughened.

In view of this, we have revised Chinese growth downwards to 7.2% and 7.0%, in 2014 and 2015 respectively, nearly half a point less than previously expected.

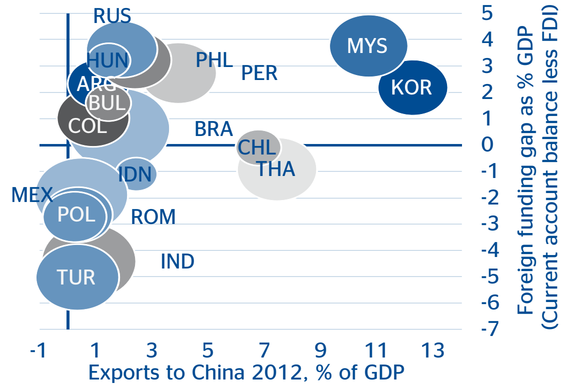
The increasing importance of China as a source of world demand in the last few years is undeniable (Chart 8). But the differentiation between areas is unchanged, with higher exposures in Southeast Asia, some South American and African countries and, among developed economies, Germany. According to our estimates, the impact on world growth of each point of Chinese growth lost is around 4pp, principally as a result of lower demand from China itself. Note also that the expected adjustment in the local scenario is limited, and clearly not enough to unleash episodes of global financial uncertainty, something which, should it occur, would raise the impact above the forecast (Chart 9).

Chart 9
GDP growth, impact of 1pp adjustment in China's growth (pp)



Source: BBVA Research

Chart 10
Exposure of emerging markets to Chinese slowdown and foreign borrowing needs (%)



Note: The size of the circles is proportional to their exchange rate volatility during the Fed tapering episode.
Source: BBVA Research with Haver Analytics data

In summary, there are two factors with a global impact on the forecast horizon: the tightening of the Fed's monetary policy, and lower growth of Chinese demand, with macro-economic repercussions that are clearly differentiated between economies. As outlined above, the sudden perception by the market that the tightening by the Federal Reserve of the monetary cycle was imminent with the withdrawal of quantitative easing, raised financial volatility in emerging economies. There was a clear differentiation between different areas, however, with greater volatility in those exchange rates whose exposure to foreign funding is greater. On the other hand, also among emerging economies, it is the Asian economies which are most exposed to a reduction in Chinese demand, with the further addition to the list of a few raw materials exporters, such as Chile. All these factors, as illustrated in Chart 10, can be shown in a map of vulnerabilities where differentiation is a vital factor.

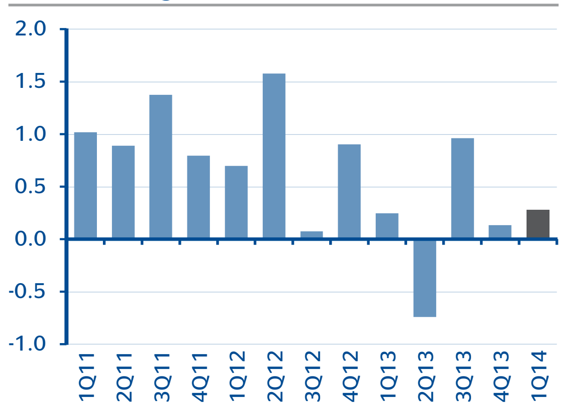
3 The economy's moderate recovery begins to materialise

3.1 After the slow start to the year, economic activity will pick up over the next quarters

Signs of a slow recovery in economic activity have been observed since the fourth quarter of 2013, while growth was expected to resume in the first quarter of 2014. However, the seasonally-adjusted (sa) GDP growth rate for the first quarter of 2014 (1Q14) with respect to the previous quarter (QoQ) was 0.3%, equivalent to an annual growth (YoY) of barely 0.6%, below both our and the markets' expectations (BBVA Research: 0.6% QoQ; consensus: 0.6% QoQ).[1] The low growth rate in 1Q14 resulted from a weak performance by the US economy caused by weather issues, which had an effect on both consumption and investment greater than that expected from the tax increases, and from other domestic factors such as the slow recovery in construction and lower oil production (see Chart 11).

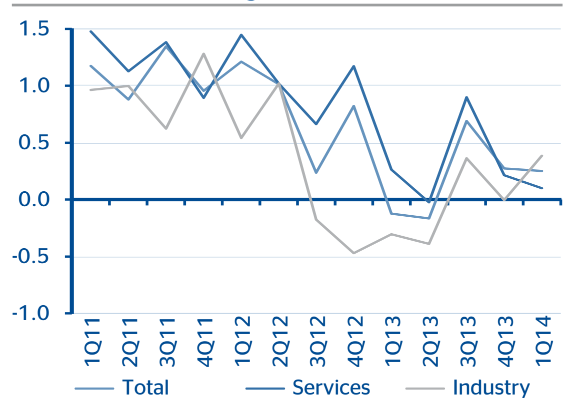
The slowdown was reflected in the monthly evolution of the Global Economic Activity Indicator (IGAE). The indicator's deseasonalised monthly growth rates for January and February were 0.1 and 0.7% respectively, which would suggest a limited expansion of GDP for the year's first quarter. However, the IGAE's monthly growth figure for March (-0.8%) was much worse than expected, due to the decline in its three components. Industrial production fell 0.1% MoM, the service sector dropped 0.3% MoM and agriculture declined 3.8% MoM, all rates seasonally adjusted. This led to very limited quarterly growth rates. For example, agriculture barely rose 0.9% QoQ in 1Q14, followed by industrial production with a rise of 0.4% QoQ sa, while the service sector grew 0.1% QoQ sa (see Chart 12).

Chart 11
Gross Domestic Product, 2011-14 (QoQ % change, sa)



sa=Seasonally Adjusted
Source: BBVA Research with INEGI (National Institute of Statistics and Geography) data

Chart 12
Global Economic Activity Indicator, Components, 2011-14 (QoQ % change, sa)



sa=Seasonally Adjusted
Source: BBVA Research with INEGI data

[1] See Weekly Flash of 16 May 2014. Available at: http://www.bbvaresearch.com/KETD/fbin/mult/140516_SemanalMexico_447_tcm346-451027.pdf?ts=2352014

Given the negative surprise to first quarter GDP growth, we have lowered our economic growth scenario for 2014 to 2.5%, from the annual 3.4% previously estimated. This forecast is based on the following factors: a 2014 US GDP growth of 2.5% and an appropriate and efficient flow of higher public sector spending, supported by the approved fiscal deficit of 1.5% of GDP. This means that the quarterly growth rates for the year's remaining three quarters should be high, with a seasonally-adjusted average of 1.2%. The foregoing is exclusive of the effects of the reforms enacted in 2013, given that their start-up and still-modest initial effects will become apparent in 2015.

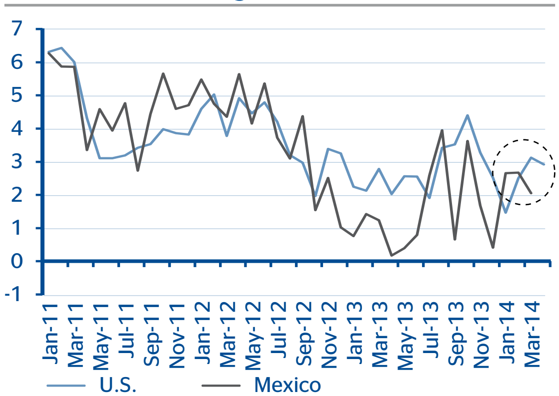
3.1.1 Production activity: an improvement associated with foreign demand; the domestic market remains weak

The dynamism of economic activity in the first quarter of 2014 was very moderate, due to the stagnation of the domestic market, with little revenue given the limited number of jobs created, and to the negative impact of the fiscal reform. Furthermore, foreign demand was moderate over the first two months of the year, due to the adverse weather effects in the US. Other adverse factors that manifested over the first quarter of 2014 were the decline in oil production, the deterioration of the construction sector and the limited rise in household purchases of consumer goods.

The lower GDP growth rate can also be seen by looking at the main sectors of economic activity. For example, the annual growth rate in the agricultural sector for the first quarter of 2014 was 4.9%, but this figure had a very limited impact on total GDP growth, given that the GDP of this primary activity only accounted for 2.8% of total GDP. For its part, the industrial, or secondary, sector recorded an annual growth rate of 1.6% over the same period. With respect to industrial sector components, the manufacturing sector registered a high annual growth rate of 4.3%, which contrasts with the 1.4% rate of the electricity, gas and water sector, with the 0.0% rate of the mining sector and the negative 2.8% rate of the construction sector. The services, or tertiary, sector recorded an annual growth rate of 1.8% in the first quarter of 2014. In other words, over the first quarter of 2014 and with the exception of the agricultural sector, which has a lower relative weight in the economy, the industrial and service sectors also showed a lower growth rate.

Chart 13

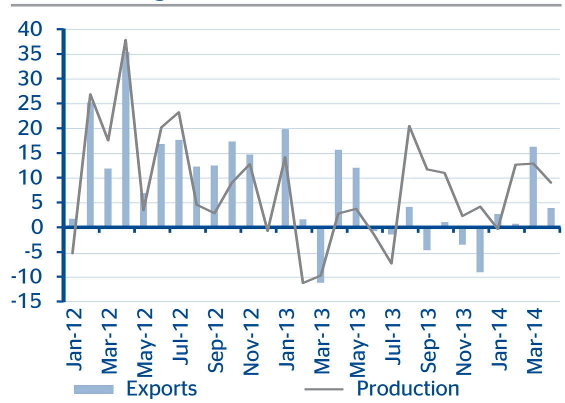
US and Mexico manufacturing production, 2011-14 (YoY % change, sa)



sa=Seasonally Adjusted.
Source: BBVA Research with INEGI data.

Chart 14

Automotive production and exports, 2012-14 (YoY % change)



Source: BBVA Research with INEGI data.

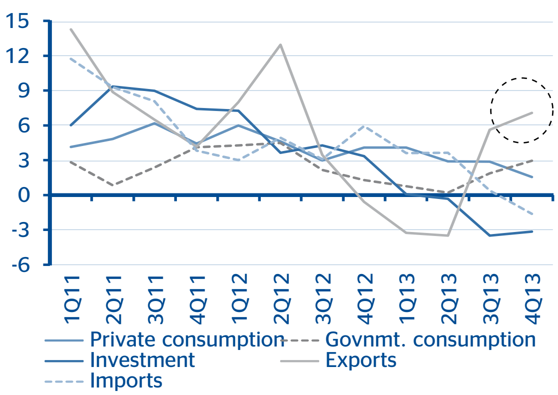
To a large extent, the performance of Mexican manufacturers was related to higher foreign demand. One of the sectors with the highest demand for Mexican products is US industry, which registered an annual growth rate of over 3.0% sa over the first four months of 2014 (3.0% in January, 3.4% in February, 3.9% in March and 3.5% in April, sa). One of the components with a greater weight within industrial production, and with a greater demand for Mexican products, is the manufacturing sector, which recorded a growth of 2.9% YoY sa in April (see Chart 13).

The automotive industry, which is closely linked to exports, performed well in the first quarter of the year, even though its domestic demand remained weak. Specifically, this industry produced a total of 1,022,672 automobiles over the first four months of 2014, representing an annual increase of 5.8% over production for the same period of 2013. It exported 808,532 units, which accounted for an annual growth of 8.7%. In the domestic market, however, only 327,989 vehicles were sold, which equates to a 0.8% drop in annual terms (see Chart 14).

In 2013, the country's aggregate demand components registered a very moderate performance and investment was even negative. Only exports displayed a considerable recovery over the last two quarters of the year (see Chart 15). Imports declined from a rate of 6.0% in the fourth quarter of 2012 to -1.6% in the fourth quarter of 2013. The information available for 2014 indicates that consumption has continued to register a moderate performance, due to insufficient job creation and the meagre variation in real wages. For example, private consumption grew just 0.5% and 1.1% YoY sa in January and February of 2014, versus the 2.0% and 3.9% YoY sa for the same months of 2013. To a certain extent, this could be related to the negative effect of the fiscal reform on Mexican household incomes. For their part, retail sales dropped steadily over the first three months of the year, by 0.4%, 1.6% and 0.6% YoY sa respectively, which demonstrates the weakness of domestic demand (see Chart 16).

Chart 15

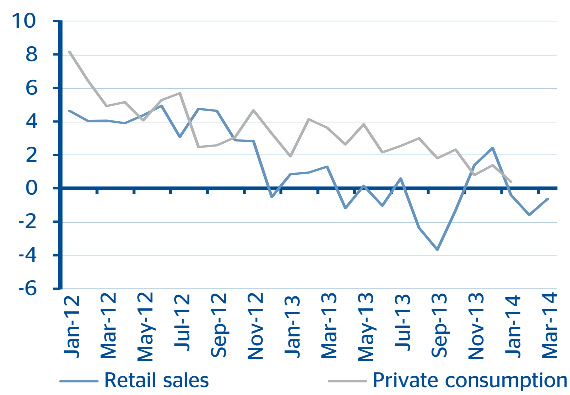
Aggregate demand: components, 2011-13 (YoY % change, sa)



sa=Seasonally Adjusted
Source: BBVA Research with INEGI data

Chart 16

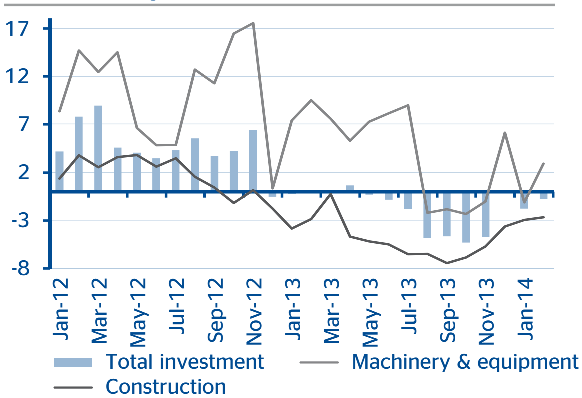
Retail sales and private consumption, 2012-14 (YoY % change, sa)



sa=Seasonally Adjusted
Source: BBVA Research with INEGI data

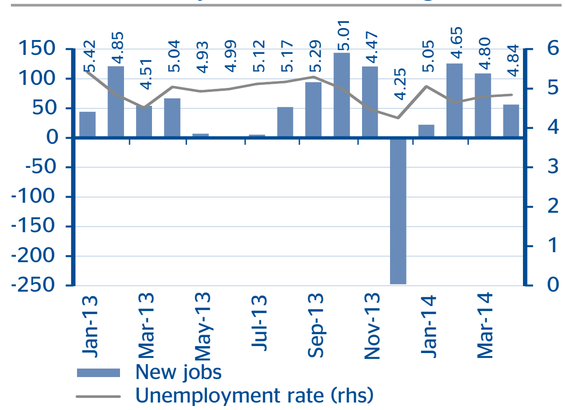
At the end of 2013, total Gross Fixed Investment and its components gave signs of experiencing an honest recovery, although the improvement was interrupted in January with a significant decline in the machinery and equipment component of 1.6% YoY sa. Nevertheless, this indicator recovered in February by rising at an annual rate of 2.9%. However, this was not enough to offset the annual drop in total investment, which came in at 0.8% in February (see Chart 17). In other words, the available indicators reveal that total investment in the first quarter of 2014 continued to display an unfavourable performance. However, we believe that the public investment component within total investment will start to grow at higher rates from the second to the third quarter of 2014, which will assist in reversing the negative trend of total investment. The latter point is in line with the larger budget for 2014 approved by the Congress, and the start-up of additional infrastructure works, scheduled in the 2014-18 National Infrastructure Programme.

Chart 17
Investment: Components, 2011-14 (YoY % change, sa)



sa=Seasonally Adjusted
Source: BBVA Research with INEGI data

Chart 18
Monthly job creation and unemployment rates, 2013-14 ('000s of jobs and YoY % change)



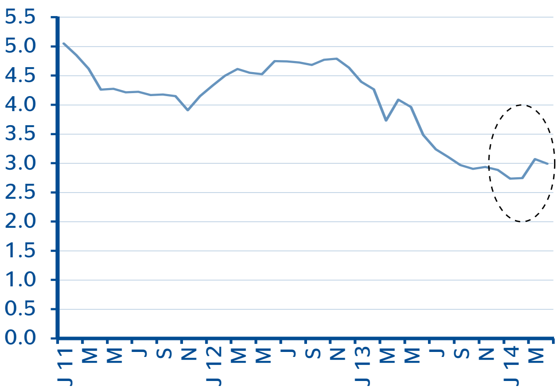
Source: BBVA Research with INEGI and STPS (Secretariat of Labour and Social Welfare) data.

3.1.2 Employment: formal job creation improved over the first quarter of 2014 versus the same period for 2013

An improvement was observed in the creation of private formal employment over the first four months of 2014. A total of 21,979 new workers registered with the Mexican Social Security Institute (IMSS) in January. New jobs created totalled 125,559 in February, 108,726 in March and 56,042 in April. Cumulative job creation from January to April 2014 thus totalled 312,306, which compares positively against the 285,930 created in the same period for 2013, and equates to an annual rise of 9.2% in the number of jobs created at the start of this year. The annual growth rate in the number of IMSS-registered workers in 2014 was 2.6% in January, 2.7% in February, 3.1% in March and 3.0% in April. For its part, the unemployment rate rose to 4.84% in April from 4.65% in February, with original series (see Chart 18), which means that formal IMSS job creation was not enough to offset the rise in the unemployment rate caused by the number of people who have joined the labour market.

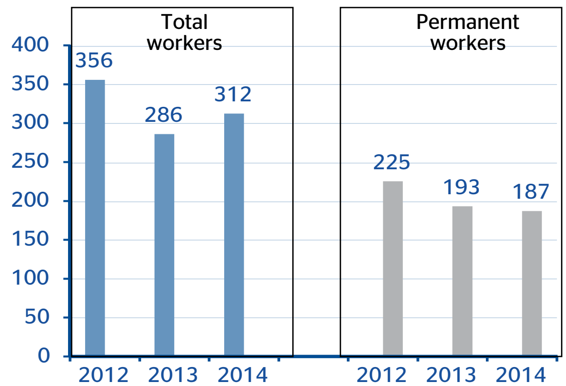
However, the total number of IMSS-registered workers includes both those with permanent and those with temporary employment contracts. In April 2014, 85.7% of total IMSS-registered workers were permanent, while the remaining 14.3% were casual. The annual growth rate in each of these two worker categories differed in April 2014: 2.8% for permanent workers and 4.0% for casual. Thus there were no more permanent jobs created in the first quarter of this year than in the same period last year (see Charts 19 and 20).

Chart 19
Number of IMSS-registered workers, 2011-14 (YoY % change)



Source: BBVA Research with INEGI and STPS data.

Chart 20
Cumulative number of new IMSS-registered workers as at April of each year, 2012-14 (thousands of workers, total and permanent)

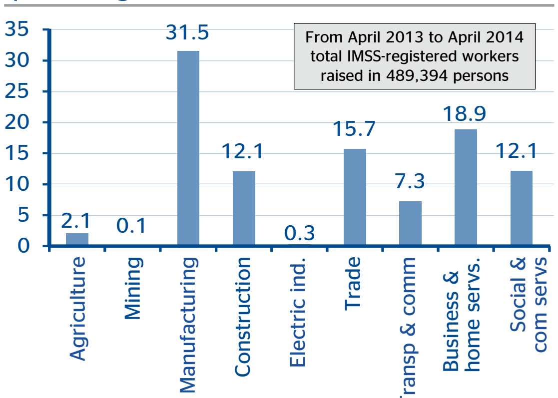


Source: BBVA Research with INEGI and STPS data.

Over the last 12 months (April 2013-April 2014), the number of new workers registered with the IMSS was 489,394. Over that period, the economic activity sector that created the highest number of jobs was the intermediate goods industries (31.5%), followed by the company and household service sectors (18.9%), retail (15.7%) and construction (12.1%).

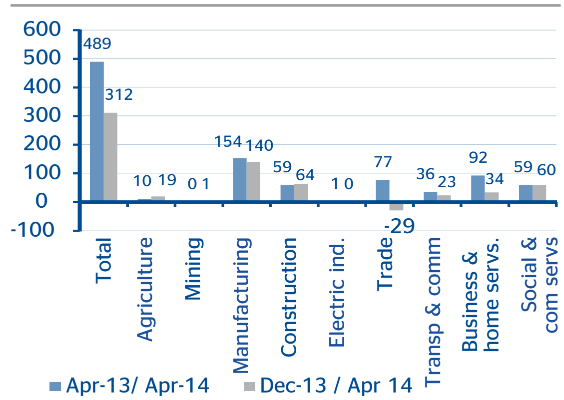
The 312,306 formal jobs created over the first four months of the year account for 63.8% of the jobs generated over the last 12 months. The recent job creation was particularly important in the case of the processing and construction industries. The rises in the numbers of workers in these two sectors over the first four months of 2014 respectively accounted for 90.9% and 107.1% of the increases in these activities over the last 12 months. These figures suggest a recent improvement in the performance of the intermediate goods and construction industries. To the degree that the improvement in formal employment continues, we would expect a boost to domestic demand (see Charts 21 and 22).

Chart 21
Rise in total number of IMSS-registered workers, April 2013-April 2014 (percentage structure)



Source: BBVA Research with INEGI and STPS data.

Chart 22
Rise in total number of IMSS-registered workers (thousands)



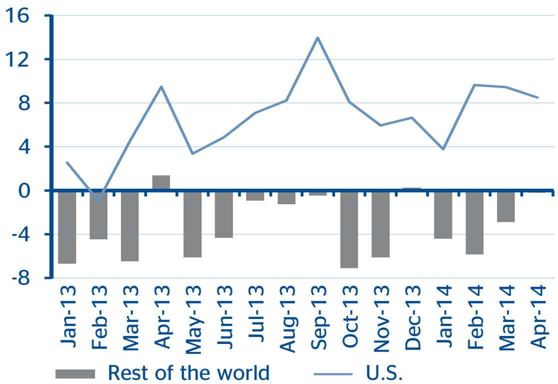
Source: BBVA Research with IMSS data.

3.1.3 Foreign sector: strong dynamism for the Mexican economy

One of the factors to have driven the country's growth, and which we expect will be more vigorous over the next months, is foreign demand. It must be noted that Mexico's share of US imports of manufactured durable goods has maintained a steady rate over recent years. Non-oil exports to the US rose from an annual 3.8% in January to 9.6% in February and 9.5% in March. However, demand from the rest of the world remained weak, shrinking 2.9% in March (see Chart 23).

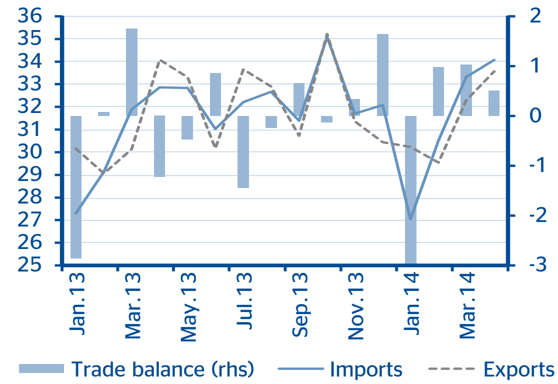
Over the first four months of 2014, the country's goods trade balance recorded a deficit of almost USD683mn, 69.6% less than the USD2.25bn registered for the same period in 2013. The rise in the deficit, which in quantitative terms was relatively limited, resulted from a respective annual pace of growth in goods imports and exports of 1.8% and 3.1% over the referenced period (see Chart 24).

Chart 23
Total Mexico exports by geographic area, 2013-14 (YoY % change)



Source: BBVA Research with INEGI data.

Chart 24
Balance of trade, 2013-14 (USDbn)



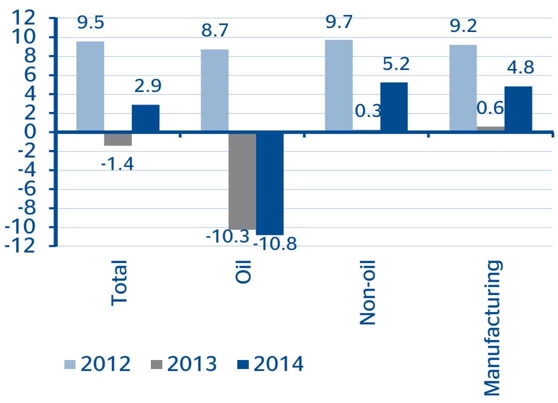
Source: BBVA Research with INEGI data.

The performance of total goods exports over the first quarter of 2014 was higher than for the same period in 2013, with an annual growth rate of 2.8% for the period, while the rate for the same months of 2013 was -1.4%. Exports are classified as oil and non-oil. Oil exports recorded a negative annual growth rate of 10.7%, a higher absolute number than the 9.9% contraction seen over the same period in 2013. On the other hand, over the first quarter of 2014, non-oil exports displayed a favourable performance, with an annual growth rate for the period of 5.1%, which contrasts with the 0.2% rate for the first three months of 2013.

The 2.9 percentage point (pp) contribution of total exports to growth in the first quarter of 2014 is itemised as follows: oil, -1.6pp given its negative growth; agricultural, 0.3pp; extractive, 0.2pp; manufacturing 3.9pp (2.4pp in automotive and 1.5pp in non-automotive manufacturers). In other words, manufacturing exports were the main growth driver of goods exports, with automotive exports also playing a major role therein. Manufacturing and motor vehicles account for 81% and 27% respectively of the country's total exports (see Charts 25 and 26).

Chart 25

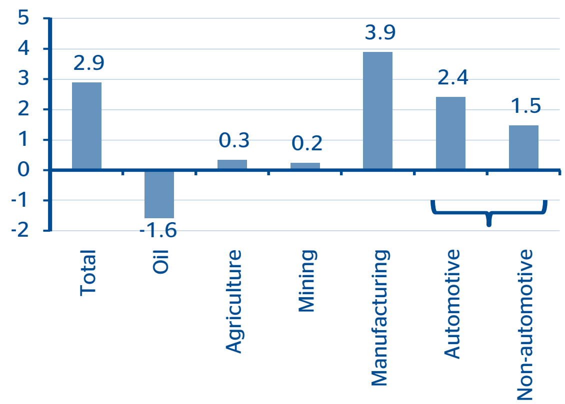
Goods exports as at first quarter of year, 2012-14 (YoY % change)



Source: BBVA Research with INEGI data.

Chart 26

Total goods exports, 1Q14 (percentage points)

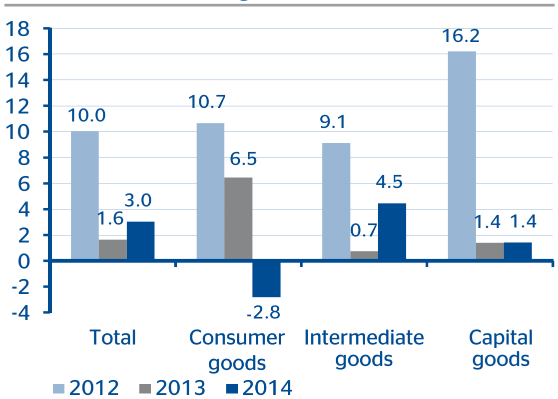


Source: BBVA Research with INEGI data.

The annual growth rate in total goods imports for the first quarter of 2014 was 3.0%, higher than the 1.9% seen in the same period of 2013. The growth in the import components for that period was as follows: intermediate goods, 4.5%; capital goods, 1.4%; and consumer goods, -2.8%. The pace of growth in goods imports would suggest a certain reactivation in the activity level of the productive base, given the rise in imports of intermediate goods used to produce other intermediate or final goods over the first quarter. The latter may also be related to the greater dynamism in exports of manufactured goods, which require imported inputs. On the other hand, the limited growth in capital goods imports seen over the first quarter of 2014 could be indicating that the production sector is somewhat wary of increasing installed production capacity. For its part, the negative growth in consumer goods imports seems to be another manifestation of the weakness in the country's private consumption (see Charts 27 and 28).

Chart 27

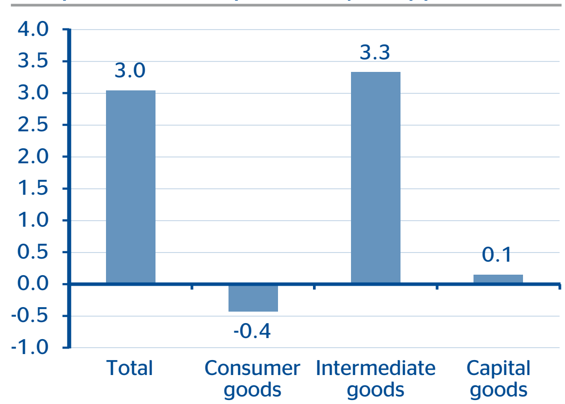
Goods imports as at first quarter of year, 2012-14 (YoY % change)



Source: BBVA Research with INEGI data.

Chart 28

Goods imports: contribution to growth by component in first quarter of year (pp)



Source: BBVA Research with INEGI data.

Over the first quarter of 2014, the performance of inward remittances received by the country's households recorded an annual growth rate of 10.4%. This is favourable behaviour for this line item of the country's current account, given that in the first quarter of 2013 this item registered a negative annual growth rate of 10.5%. Furthermore, if the US economy manages to increase its pace of growth in a sustained manner over the remainder of 2014, the inward household remittances line item might also rise. The improved performance of remittances will help to raise the available income of the households that receive these revenues, thus supporting their consumption.

The balance of tourism for the first quarter of 2014 registered a surplus of almost USD2.5bn, 26.9% higher than the figure for the same period of 2013. This improvement in the balance of tourism was due to the 14.8% growth in income in this line item, which was significantly higher than the 2.7% growth in tourism expenditure recorded over that period.

In the first quarter of 2014, the current account deficit was USD4.5bn, lower than the USD7.1bn deficit recorded for the same period of 2013. The improved position of this account was due to the enhanced performance of the balance of tourism and household remittances, and to the lower expenditure on payments for factoring services, mainly related to remitted and reinvested profits. To the extent that the year's first quarter current account performance prevails over the rest of 2014, the deficit of this line item could be somewhat lower in 2014 than 2013.

3.1.4 Fiscal position: essential that public investment is exercised efficiently

Budget revenues for the first quarter of 2014 rose 3.8% in real terms over the figure observed for the same period of 2013. Over the first three months of the year, the oil revenues component registered a negative real growth rate of 0.7%, while the non-oil revenues component grew at a real 5.9% over the period.

The decline in oil revenues in the first quarter of 2014 was due to the 2.1% drop in the country's crude oil production versus the figure for the same period of 2013. Furthermore, the average price of a barrel of crude oil for export also fell, by 10.4%. For its part, the rise in revenues from domestic sales of oil and petrochemical products was not enough to make up for the lower revenues generated by oil exports.

To a large extent, the 5.9% growth in public sector non-oil revenues as at March 2014 was due to the 10.7% rise in federal government tax revenues (see Chart 19). It should be mentioned that the year's first quarter value-added tax (VAT) revenues revealed an annual real growth rate of 17.1%, while revenues from income taxes displayed a real rate of 18.2%. In other words, the evolution of these two categories of taxes, which are highly related to economic activity, was very favourable from a collections and public finances point of view.

Furthermore, net budget expenditure for the first quarter of 2014 recorded a real growth rate of 13.2% over the rate for the same period of 2013. To be noted within this expenditure aggregate is the growth in programmable expenditure, given that the latter's real growth rate was 15.2%. Real growth in the portion of programmable expenditure pertaining to current expenditure was 9.0%, while real growth in capital expenditure was much greater, at 40.2% (see Chart 20).

The diverse dynamism recorded in the public sector's income and expenditure line items in the first quarter of 2014 was reflected in the public sector balance. Thus, over the first three months of 2014, the public sector's primary balance registered a deficit of MXN10.7bn, which contrasts with the MXN67.2bn surplus recorded in that account for the same period in 2013. It is worth mentioning that the public sector balance, which includes the Pemex investment, registered a deficit of MXN61.9bn in the first quarter of 2014, which contrasts significantly with the surplus of MXN40.2bn recorded for the same period of 2013 (see Chart 21).

Given this year's approval of a public sector deficit of 1.5% of GDP in addition to the financial requirements of the Pemex investment of 2.0% of GDP, we believe that the public finance figures for the first quarter of the year suggest that the goal of achieving a deficit of 3.5% of GDP will be met.

Table 1
Public sector budget revenues (MXN bn)

	January-March 2014		
	Amount	Real % chge.	% struc.
Total	**963.2**	**3.8**	**100.0**
Oil	289.7	-0.7	30.1
Non-oil	672.7	5.9	69.8
Federal Gvnment.	529.8	6.4	55.0
Taxes	487.1	10.7	50.6
Non-tax	42.7	-26.7	4.4
Companies	143.8	4.4	14.9

Source: BBVA Research with SHCP (Secretariat of Finance and Public Credit) data.

Table 2
Public sector budget expenditure (MXN bn)

	January-March 2014		
	Amount	Real % chge.	% struc.
Total	**1,023.7**	**13.2**	**100.0**
Primary Expendit.	982.9	13.7	96.0
Programmable	801.1	15.2	78.3
Current	608.2	9.0	59.4
Capital	193.0	40.2	18.9
Non-Programmable	181.8	7.9	17.8
Borrowing costs	40.8	1.4	4.0

Source: BBVA Research with SHCP data.

Table 3
Public sector fiscal position (MXN bn, January-March 2014)

	2013	2014	Real % change
Public Balance	40.2	-61.9	ns
Public balance excluding Pemex investment	98.7	35.6	-63.9
Budget balance	22.4	-60.5	ns
Budget revenues	890.6	963.2	8.2
Net budget expenditures	868.2	1,023.7	17.9
Balance of entities under indirect budget control	17.8	-1.4	ns
Primary balance	67.2	-10.7	ns

Source: BBVA Research with SHCP data.

3.1.5 Economic outlooks: foreign demand and the pickup in public spending will drive the economic recovery in 2014

The economic slowdown in 2013 (1.1% growth) continued over the first quarter of 2014. To begin with, the poor weather conditions in the US affected the latter's demand for Mexican products. Additionally, private consumption and investment still remain weak, probably due in part to a greater-than-expected effect from the fiscal reform. The reactivation of the country's economic activity will hinge upon the pickup in US economic growth, and upon the efficient and productive use of a greater amount of public spending in Mexico. As a result of these two factors and the expectation of an acceleration over the coming quarters, we expect a growth rate of 2.5% for 2014.

These factors are expected to continue over the course of next year, which is also when the structural reforms could begin to provide their initial (albeit still modest) results, leading to an annual growth rate of around 3.5% for that year (see Charts 29 and 30).

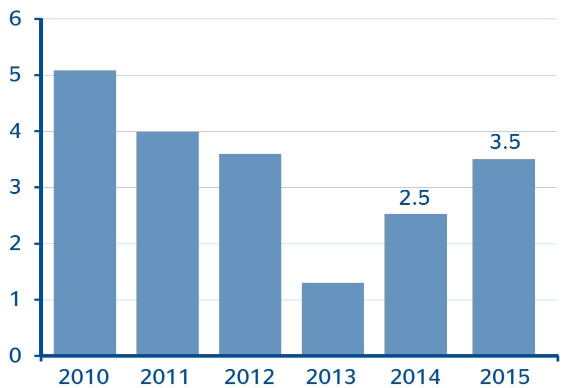
Thus, to the extent that the economic and structural reforms mature over time, we expect the Mexican economy to boast a more dynamic growth that will enable greater development and supply of public goods and services, such as security, education and health. The achievement of a growth rate of over 4.0% will hinge upon the successful start-up of the reforms, and upon the co-ordinated efforts of the political class, private initiative and Mexican society at large, which could lead to better living conditions for all strata of Mexican society.

3.1.6 Economic reforms: a window of opportunity to overcome structural deficiencies

The approval of the fiscal, energy, labour, telecommunications and educational reforms, and the increased investment in infrastructure, should lead to greater and improved levels of capital and efficiency in the use of production factors. In February 2014, Moody´s Investors Service raised Mexico's sovereign debt credit rating from Baa1 to A3 with a stable outlook, due to the approval of structural reforms, the strengthening of public finances with higher government savings and its placing on a par with other countries with a similar credit profile. To a large extent, and thanks to the reforms and the country's economic stability, Mexico has stood out favourably among the emerging markets. However, Mexico still faces major challenges to improve the living conditions of its population.

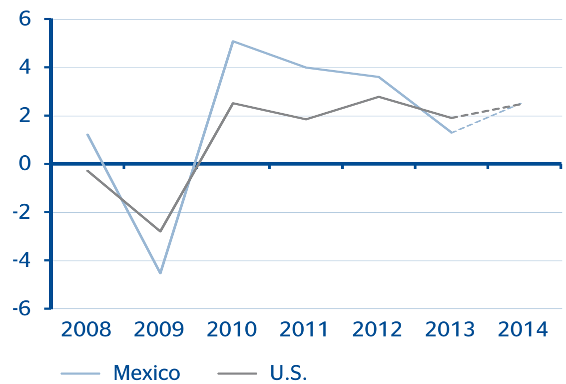
For example, informal labour is one of the main factors limiting Mexico's growth and economic development. According to INEGI data and depending on the definition used, the informal labour employment rate currently ranges between 27% and 59% of the country's Economically Active Population (EAP). It thus represents a considerable problem, given the salient distinguishing features of Mexico's informal labour sector that must be noted, such as scarce formal education, low productivity and insufficient levels of income. One would expect the investment created by the energy reform to lead to a gradual reduction in informal labour, via the generation of more well-paid formal jobs (see Section 4).

Chart 29
Mexico annual GDP growth, 2010-14 (YoY % change, sa)



sa=Seasonally Adjusted.
Source: BBVA Research with INEGI data.

Chart 30
Mexico and US GDP, 2008-14 (YoY % change, sa)



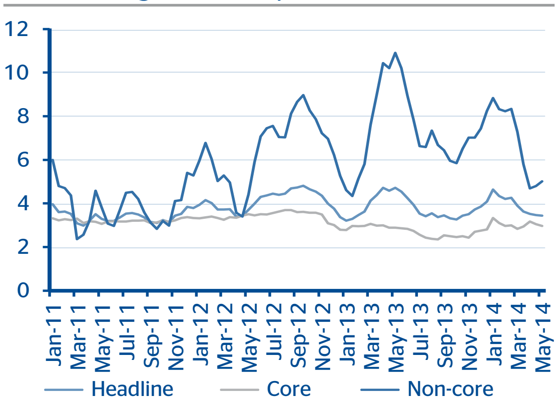
sa=Seasonally Adjusted.
Source: BBVA Research with INEGI and BEA data.

3.2 As the supply shocks at the turn of 2013-14 began to fade, inflation resumed its downward trend, meeting our expectations

As a result of the variation in relative prices, mostly caused by supply-side shocks in agricultural markets and some rate changes authorised by the government (e.g., an increase in the metro fare), inflation rose considerably at the end of 2013, from 3.36% in October to 3.97% in December. The new fiscal measures that came into force in January 2014 caused an additional pickup in inflation, to our expected levels of close to 4.5%. Subsequently, and as we expected, inflation resumed a downward trend as the effects of these shocks started to fade. Our belief that there would be no second-order effects on the price formation process was confirmed and, as we expected, inflation returned to the central bank's tolerance range of 3.0% +/- 1pp in March 2014, by coming in at 3.76%. The downward trend continued up to the first half of May, with inflation at levels of 3.44%, assisted by the very favourable behaviour of the non-core component and the slack in the economy, which has enabled core inflation to remain at subdued levels. We expect the annual inflation rate to remain around 3.5% in May, to rise gradually toward 4.0-4.1% over the following months, and then to decline towards 3.7% at the end of the year. Inflation will come in over 4.0% during the July-October period, due to the calculational effect of a low basis of comparison. Inflation should drop considerably in January 2015, given that further fiscal changes are not expected, and considering that the increase in gasoline prices will be determined as a function of expected inflation from that month forward.

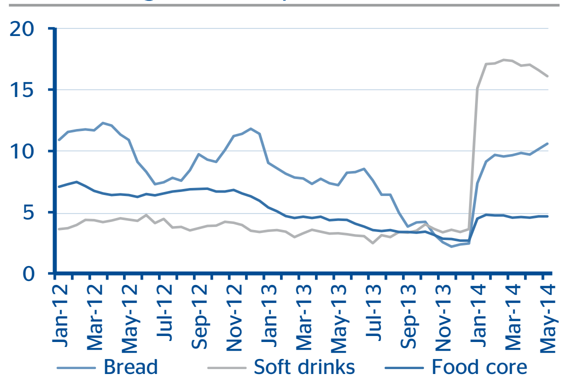
Inflation has behaved as we expected this year, with the annual rate temporarily rising to 4.5% in January, and returning to levels below 4.0% in March. Likewise, core inflation returned to levels of around 3.0% in February, after having risen temporarily to 3.2% in January. Thus, after the upward trend in 4Q13 and January 2014 resulting from some shocks to relative prices, inflation resumed its downward trend in February of this year, once those shocks began to fade (see Chart 31). Two main factors explain this downward trend: a) the failure of the new taxes to cause second-order effects on price formation; and b) the waning of the supply shocks over the course of this year that had affected produce prices in 4Q13.

Chart 31
Headline Inflation and components
YoY % change, bi-weekly series



Source: BBVA Research with INEGI (National Institute of Statistics and Geography) data

Chart 32
Food Core Inflation
YoY % change, bi-weekly series



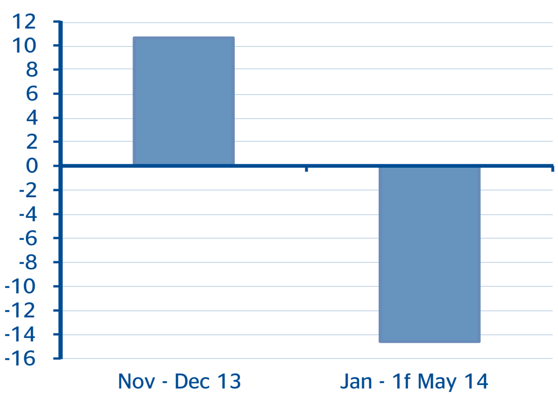
Source: BBVA Research with INEGI data

Given the outlook for a gradual recovery of the economy, we do not expect price pressures

As observed on Chart 32, the new taxes on sweetened beverages and high-calorie foods caused their prices to rise significantly, affecting the food component of core inflation. Nevertheless and as anticipated, the rise in the relative prices of these products did not have any second-order effects on price formation and failed to cause a widespread increase in core food component prices. The annual inflation in this component stabilised after the one-off spike seen in January of this year. Furthermore, the considerable rise in produce prices over the last two months of 2013 was followed by significant declines so far this year (see Chart 33). Thus, the fact that the variation in some relative prices due to the taxation changes failed to affect the price formation process, and that the supply shocks seen in produce prices in 4Q13 ultimately faded, to a large extent explains the downward trend of headline inflation observed to date.

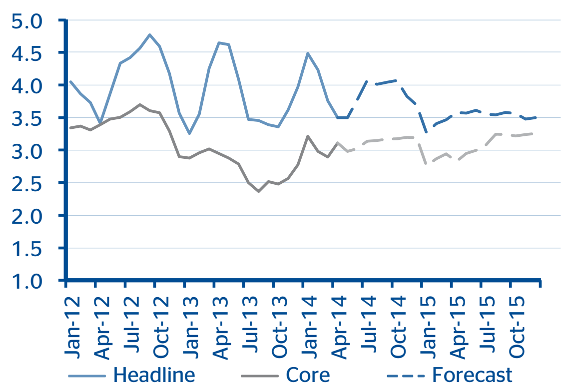
When considering core inflation, the best indicator of medium-term inflation behaviour, the recent course of inflation has been favourable, notwithstanding the fiscal shock observed in January of this year. Inflation trended down over the first three quarters of 2013, assisted by the weakness in the economic cycle and the consequent slack, which translated into a lack of demand pressure on prices. Core inflation averaged under 3.0% in all of last year's quarters: 2.95% in 1Q13, 2.87% in 2Q13, 2.46% in 3Q13 and 2.61% in 4Q13, with the yearly close (2.78%), annual average (2.72%) and August bottom (2.37%) all setting historical lows. The fiscal changes implemented in January of this year temporarily interrupted this trend, and the annual rate climbed to 3.2%. Nevertheless, it once again registered an average level just shy of 3.0% (2.99%) from February to April 2014. The persistent economic weakness this year over the first quarter and the start of the second continues to restrain rises in the selling prices received by companies, favouring low core inflation. This can be observed in the April Producer Price Index, which came in at a mere 2.3%.

Chart 33
Produce Inflation
Cumulative % change



Source: BBVA Research with INEGI data

Chart 34
Inflation Outlooks
YoY % change



Source: BBVA Research with INEGI data

We expect core inflation to remain low, within a context of a lack of demand pressures. Furthermore, we do not expect any financial stresses that would materially depreciate the peso, nor a global pickup significant enough to cause a considerable acceleration in commodity prices. However, while core inflation will remain moderate for a longer period, the gradual improvement in the economic cycle should lead this variable to pick up moderately over the rest of the year. This scenario will translate into higher average annual core inflation levels over this year. We anticipate an average of 3.1% in 2014 as opposed to the 2.7% average seen in 2013.

The favourable behaviour of the non-core component resulting from the drop in produce prices, and the positive performance of core inflation due to economic weakness persisting beyond our expectations, lead us to revise our year-end headline and core inflation forecasts slightly to the downside. We now expect headline inflation to come in at 3.7% at year close (vs. prior 3.9%), and core inflation to close 2014 at 3.2% (vs. prior 3.4%). Regarding the scenario for the rest of the year, we anticipate that the calculational effects of a low basis of comparison will cause a gradual rise in the annual rate of headline inflation starting in June. After maintaining a level slightly above 4.0% from July to October, we expect the annual rate to resume its downward trend in November and to close the year at around 3.7%. This scenario will translate into slightly higher average annual inflation levels than those seen in 2013: 3.9% for 2014, versus the 3.8% average observed for last year. Inflation should drop considerably in January 2015, given that further fiscal changes are not expected, and considering also that the increase in gasoline prices will be determined as a function of expected inflation from that month forward (see Chart 34).

3.3 The monetary pause will continue for an extended period, within an environment of inflation under control and a slack in the economy

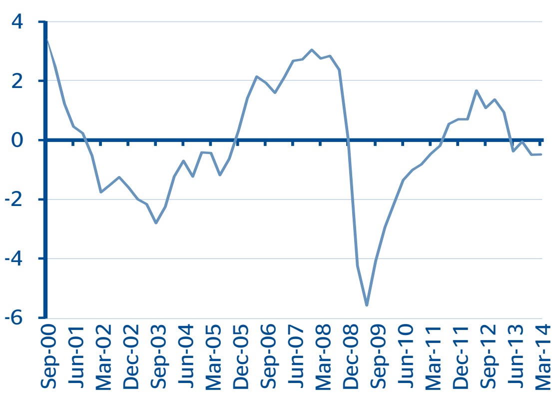
The risks of the short-term economic activity and inflation scenario have changed significantly over the first months of the year. The new tax regulations that became effective in January failed to materialise the risks of a rise in inflation expectations and of second-round effects on prices. What is more, inflation registered a greater-than-expected drop and is now clearly below 4.0%, at the top of the range around the central bank's target. To a large extent, this was due to an unexpected moderation in economic activity at the start of the year which, in turn, can be explained by the effects of the intensive snowfall on US industrial production and consumption.

In response to these changes in the economic environment, central bank statements have also changed. To begin with, concerns over domestic activity have once again come to the fore in central bank communiqués, the March statement noting that several components of domestic demand revealed no clear signs of recovery. In fact, the central bank cut its 2014 growth forecast from 3.0-4.0% to 2.3-3.3%. The weak behaviour of domestic demand notwithstanding, the greater dynamism in economic activity and employment recently displayed by the US economy contributed to a somewhat less relaxed tone in the April statement on the monetary policy decision. The fact is that although GDP growth durign the first quarter was less than expected, the outlook remains unchanged: once the effect of the winter storms has passed, US demand will be the Mexican economy's main growth driver. Furthermore, the central bank noted the improvement in the inflation risk balance, as evidenced by the drop in annual inflation from 4.48% in January to 3.50% in April, which dispelled the upside risks to inflation sooner than expected. Consequently, the mildly restrictive tone that the Bank of Mexico displayed early this year, possibly intended to anchor inflation expectations, was gone in a couple of months. This evolution of the economic environment led the market to once again expect the next monetary policy rate hike in the second half of 2015.

Going forward, we stand by our outlook for an extended monetary pause, as a result of the following factors. First, we agree with the expectation of higher growth over the coming quarters, basically driven by exports and public spending. Second, we believe the lack of demand pressures on prices will continue, leading inflation to close the year within a range around the central bank's target.

Chart 35

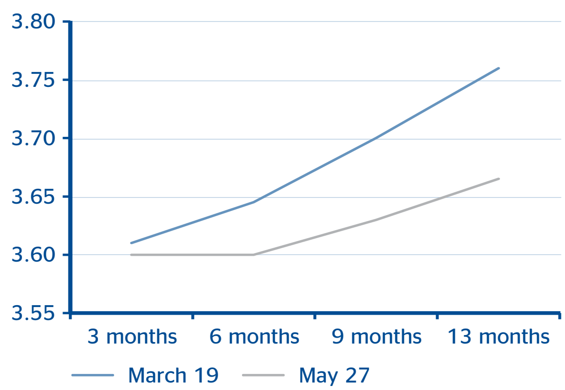
Output gap (% with respect to potential output)



Source: BBVA Research

Chart 36

Estimated implicit Monetary Policy Rate on the interest rate swap curve (%)

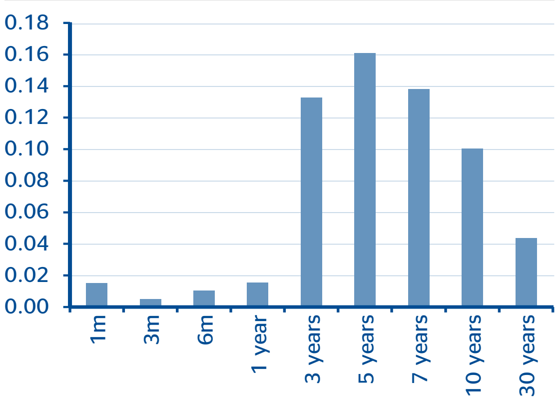


Source: BBVA Research with Valmer data

3.4 The foreign environment remains key to financial markets' performance

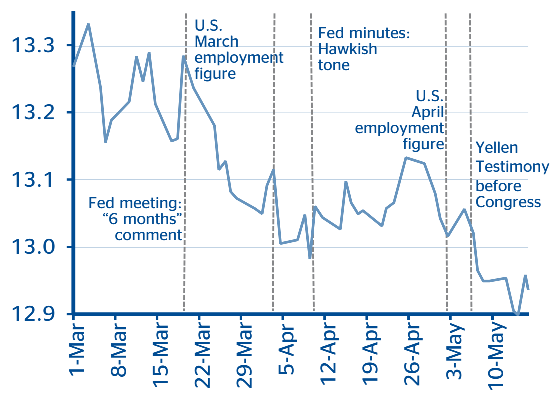
Fed statements and US economic activity data have prevailed over geopolitical tensions in Mexico's financial market movements. With markets to a large extent already discounting the effect of the Fed's tapering of asset purchases, attention centres on the economic recovery and, consequently, on the start date of the cycle of Federal Funds Rate increases. This was evidenced last March, when the economic projections of FOMC members and the Fed Chair's press conference favoured significant increases in US interest rates. Specifically, the projections noted a rise in the average expectations for the Federal Funds Rate at the end of 2015 of 0.75 to 1.0%, while the Fed Chair suggested the press that there could be a period of six months between the end of the asset purchase policy and the start of the interest rate tightening cycle. In spite of Fed statements having emphasised that monetary policy may remain accommodative even with inflation and employment close to levels consistent with their mandate, concerns over an earlier-than-expected start of interest rate increases generated market movements similar to those seen during a bout of risk aversion. In particular, after the aforementioned statements and publication of projections of March 2014, US medium- and long-term interest rates rose 9bp. The VIX index, which measures global risk aversion, rose 60bp. In Mexico, the peso depreciated against the US dollar by 0.95% to reach a level of MXNUSD 13.28, while the yield to maturity on the 10-year government bond rose by 11bp to close at 6.26% on 19 March. What follows is an in-depth description of the recent behaviour of government bond rates in Mexico.

Chart 37
Changes in US yield curve 19 March 2014 (%)



Source: BBVA Research with Bloomberg data

Chart 38
USD/MXN exchange rate (ppd)



Source: BBVA Research with Bloomberg data

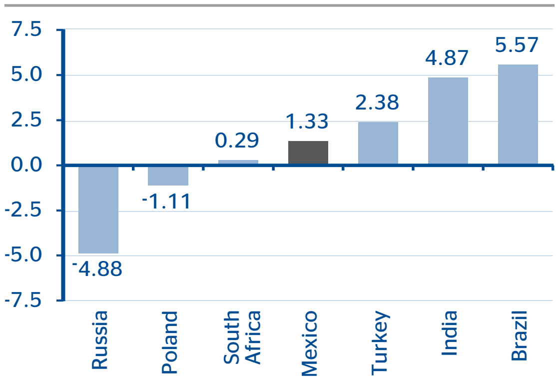
Fed members' statements and speeches since April have made it clear that the changes to their economic projections do not reflect a more restrictive stance, and that members agree that the extraordinarily lax monetary policy conditions are still required, and will continue to be so for some time. This clear tone of forward-looking relaxation, combined with the improvement seen in the data and the outlooks for US economic activity, generated a favourable atmosphere for higher-risk asset demand. In particular, the average increase in non-farm payrolls of more than 200,000 jobs over the last three months, and the average 3.4% YoY growth in Industrial Production from January to March, were reflected in the exchange rate of the peso, which has been holding below 13 pesos per dollar (ppd) for the third week in a row after appreciating 2.6% from its low on 19 March. Worth noting is that implied exchange rate volatility has dropped to 6.2%, the lowest level since 2008.

Notwithstanding an environment with expectations of extraordinarily low rate levels and expected improvements in US economic activity, geopolitical problems have fostered sporadic rises in risk aversion. In particular, developments in the conflict in the Ukraine are keeping investors on edge as to the magnitude of the sanctions and the risk of an escalation of military action. Up to now, the most marked effects have been observed in the area of commodities and in the financial assets of the countries within the conflict region. The rouble, for example, is the emerging country currency with the second highest depreciation this year, having dropped 4.9% (Chart 39). Nevertheless, in the event of a further deterioration of the situation, geopolitical generation of emerging country volatility cannot be ruled out.

In this context, no sudden outflows of foreign investments from fixed income instruments in Mexico have been observed, although the pace of their inflows has dwindled by comparison with past years. Foreign holdings of M-Bonds rose by about USD7.6bn in 2014[1], a slow start to the year when compared with 2013, although slightly higher than what was seen in 2010 on the announcement of the inclusion of Mexican bonds in the WGBI index. The rise of over USD2bn in CETES (Mexican Federal Treasury Certificates) holdings in early May represented the first increase in foreign holdings after two back-to-back months of significant reductions (Chart 40). On an aggregate basis and in 2014, foreign holdings of nominal fixed income instruments rose at the slowest pace of the last four years. All of these movements were influenced by the process of normalisation of risk premiums in the rates of industrialised countries, and the reduction of risk levels in the European periphery.

Chart 39

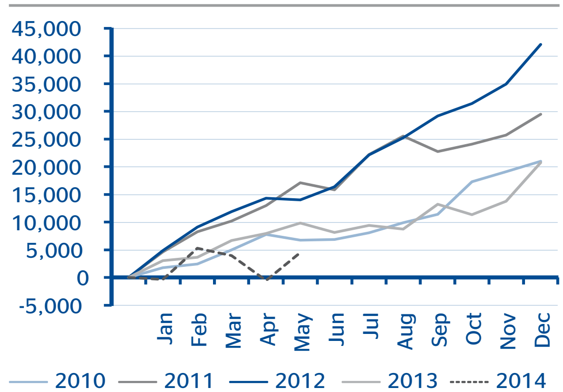
2014 appreciation/depreciation (%)



Source: BBVA Research with Bloomberg data

Chart 40

Aggregate change in foreign holdings of M-Bonds and CETES (USD mn)



Source: BBVA Research with Central Bank of Mexico data

Going forward, we expect the peso to depreciate as the end of the Fed's asset purchases approaches, and markets focus their full attention on the start of Fed's tightening cycle, although we believe that the move to the upside will be moderate. In particular, and as a result of the evolution expected in the aforementioned variables, we expect the peso to trade at around USDMXN 13.30 toward the end of 2014.

[1] Information as at 14 May 2014.

Mexico's long-term interest rates have moved in step with the markets' perception over the eventual normalisation of monetary policy

Over the last 12 months, the markets' interpretation of Fed statements[2] and the perception of US cyclical strength were the main determinants of US and Mexican long-term interest rate movements (see Chart 41). Over this timeframe, the only interruption in the synchronisation of these movements occurred in the first two months of 2014, a period in which Mexico's long-term interest rates temporarily responded to domestic factors, which are summarised in monetary policy expectations (see Chart 42). The synchronisation in the interest rate movements of the US 10-Year Treasury Note (10YTN) and the 10-Year Mexican Bond (M10) resumed in March of this year. The synchronisation can be expected to continue in the future. We thus anticipate that movements in M10 yields will mainly continue to respond to the movements in the 10YTN yield for the remainder of the year. Beginning in 2015, they will also increasingly respond to expectations on the Banco de México's cycle of rate increases, which we expect will start in the second half of the year, although we also believe that the synchronisation with US rates will continue, as we anticipate that the cycle of US and Mexican benchmark interest rate increases will be synchronised.

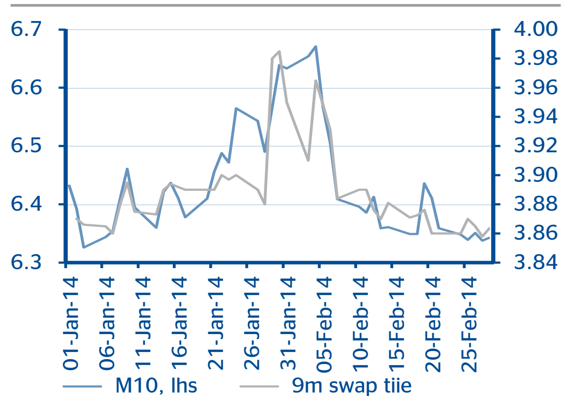
Chart 41

Long-term interest rates: 10-Year Bond/Note in Mexico and US (%)

Source: BBVA Research with Bloomberg data

Chart 42

Long-term interest rate and 9-month tiie swap in Mexico (%)



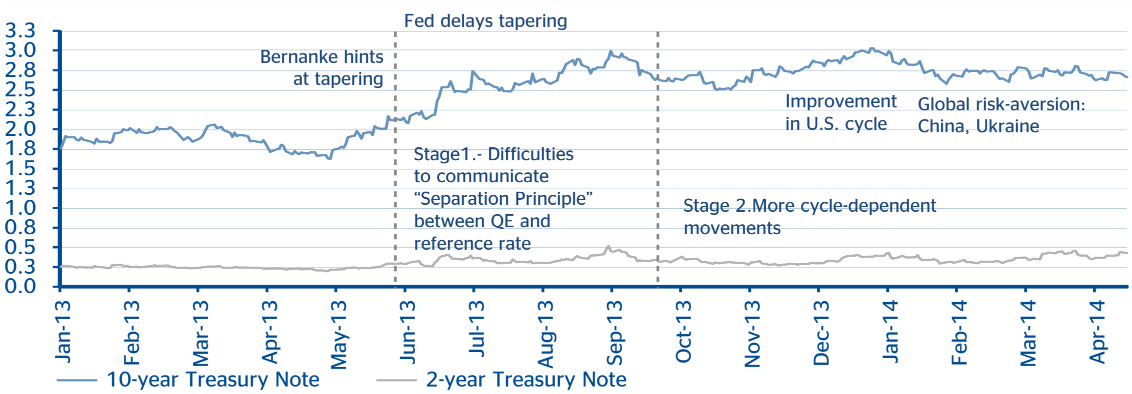
Source: BBVA Research with Bloomberg data

To explain long-term interest rate movements, it is useful to split them into two large stages (Chart 43). The first stage, which runs from early May to mid-September 2013, is characterised by an upward trend in US (and Mexican) long-term interest rates, in response to the Fed statement regarding the imminent start of its exit strategy, that is, with respect to the gradual withdrawal of unconventional monetary policies via a gradual reduction in the pace of asset purchases. The second stage runs from mid-September 2013 to date, and is characterised by less persistent trends in the movements of long-term interest rates, with fluctuations within tighter ranges (from 2.5 to 3.0% on the 10YTN and from 5.7 to 6.7% on the M10). During this stage, it is clear to the markets that the withdrawal of the Fed's unconventional monetary policies does not imply the imminent start of monetary interest rate increases, but rather that the need for rates to stay at extraordinarily low levels for a still extended period remains. Consequently, the perception of the relative strength or weakness of the US economic cycle has been an important factor in explaining the trend changes during this second stage.

[2] On its future intentions with respect to the gradual withdrawal of non-conventional monetary policies (i.e., quantitative easing) and the eventual normalisation of conventional monetary policy (i.e., the eventual start of the cycle of Federal Funds Rate increases).

The first signals that some board members sent in early May 2013, suggesting that the Fed could begin its exit strategy in the short-term, mark the beginning of the first stage. Once sent, those signals caused a pick-up in US long-term interest rates, and generated an uncertainty that affected the price of emerging market bonds, including Mexico's. This trend gained traction after the statements before Congress by then Fed Chairman Ben Bernanke on 22 May 2013. Thus, the yield on the 10-Year bond displayed a strong upward trend, which took it to a level of 5.6% on June 10, 120bp above the lows registered one month before. The trend was boosted by Ben Bernanke's 19 June press conference on the Fed's most recent monetary policy decision, when his statements were taken as confirmation that the withdrawal from unconventional monetary policy was close, and that the start of the tightening cycle was now less distant than previously expected. The interest rate on the M10 thus continued to rise quickly to a high of 6.2% at the end of June, in step with the movements of the 10YTN. Up until then, the major factor behind these movements was the uncertainty over the Fed's difficulty in explaining the "separation principle," which refers to the gap between the decisions that would be made on unconventional monetary stimulus and those regarding the future start of the normalisation of conventional monetary policy (i.e. the tightening cycle), which was still far off, more distant than the markets anticipated at the time (they had brought forward the expected date for the start of the tightening cycle).

Chart 43
US Treasury note (%)



Source: BBVA Research and Bloomberg

Little by little, the Fed began to shed light on the "separation principle" with its statements, and gradually managed to shape market expectations, clarifying that any movement would be contingent upon the favourable progress of economic indicators, particularly employment, and that, at any rate, the start of the tightening cycle was still far off and would not be brought forward, due to the initiation of the gradual reduction in the pace of Fed asset purchases. If we had to choose a date that marks the start of the second stage, it would be 18 September 2013, when the FOMC decided to delay the start of the reduction in the pace of asset purchases. The markets reacted and interest rates on the 10YTN, which had reached 3.0% barely a few days before, adopted a downward trend (which adjusted the previously observed overreaction) to 2.5% at the end of October 2013. The M10 interest rate accompanied those movements, dropping to 5.7% after reaching a high of 6.5% at the beginning of September. From that point forward, long-term interest rate movements begin to rely more on the economic cycle, and increasingly to respond to the relevant indicators. Since early November 2013, those indicators have started to surprise to the upside on a consistent basis, and have begun to show a cyclical strengthening of the US economy. Consequently, long-term interest rates resumed their upward trend.

At the start of this year, 10YTN yields, which had reached a high of 3.03% at the close of 2013, dropped close to 40bp in slightly more than a month, in response to several factors: the slowdown suggested by the relevant indicators (which seemed, and was later confirmed, to be associated with the harsh winter weather), concerns over emerging markets, geopolitical tensions in the Ukraine and worries over the slowdown in China. These factors caused a flight to quality, leading the interest rate on the 10YTN to fall. This is the period in which M10 and 10YTN interest rate movements went their own way. How is this sudden divergence in movements explained? By monetary policy expectations in Mexico (see Chart 42). Thus, the M10 interest rate not only failed to fall, but was increasing and even exceeded the highs seen in September 2013, to reach a level of 6.67% at the beginning of February 2014. These movements, set against those of the 10YTN, responded mainly to changes in monetary policy expectations. As seen in Chart 42, even the shorter-term (e.g. nine-month) TIIE (Equilibrium Interbank Interest Rate) swaps were rising, as they began to anticipate a potential increase in the monetary policy rate within the current year. The overreaction was caused by the inflationary fears at the time over the effect of the recently enacted fiscal changes on prices. Nevertheless, this upward trend in swap and M10 rates started to revert after the release of the January inflation data, which began to dispel fears of a stronger-than-expected pickup in inflation, and of the potential of the fiscal supply shock to inflation to cause second round effects. February inflation finished off those concerns and monetary policy expectations normalised. M10 interest rate movements consequently re-established their association with those of the yield on the 10YTN. Since then, long-term interest rates have moved within narrower ranges, rather sideways and without clear direction, as they have in the US.

What can we expect going forward? A scenario of cyclical strength and gradually declining labour market slack in the US, and a gradual rise in inflation, will tend to exert upward pressure on the country's interest rates for the remainder of 2014 and during2015. However, given the surprises to the downside in first quarter inflation, and the Fed signalling that current lax monetary policy conditions are still required, we do not expect major movements over the second quarter. The fact is that, considering the expectation that the Fed will end its quantitative easing programme in October this year, it will be increasingly difficult for bond yields to remain at depressed levels. Therefore, beginning in 3Q14, we expect the country's long-term interest rates to readopt a gradual upward trend. We expect that trend to reach levels of close to 3.4% on the 10YTN at the close of 2014, and of close to 6.9% for the M10. The gradual upward trend should continue over the course of 2015, until the yields on the aforementioned US and Mexican bonds reach respective levels of around 3.8 and 7.5% at the close of 2015.

4. Potential effects of the structural reforms on Mexico's labour market

I. Recent evolution of the labour market in Mexico

Economically Active Population, formal employment and economic growth

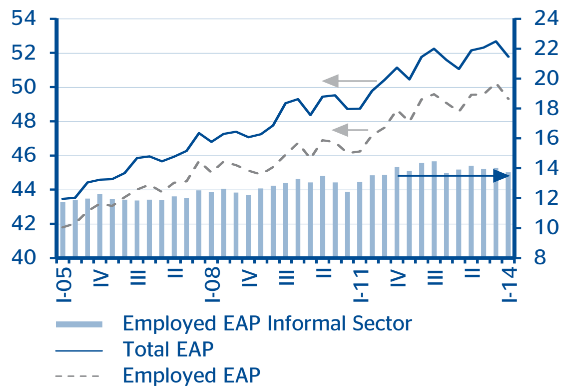
The country's Economically Active Population (EAP) totalled 43.5 million in the first quarter of 2005. As seen in Table 1, that figure has risen by 8.3 million over nine years to 51.8 million as at the first quarter of 2014. In other words, over the nine years of the reference period, the average annual rise in the EAP was 922,000.

Table 4
Economically Active Population (EAP) in Mexico (mn)

	Total	Employed*	Unemployed	PEIS
I-2005	43.5	41.8	1.7	11.7
I-2010	48.4	45.8	2.6	13.1
I-2011	48.7	46.2	2.5	13.1
I-2012	50.4	48.0	2.5	13.8
I-2013	51.1	48.6	2.5	13.9
I-2014	51.8	49.3	2.5	13.7
EAP, Percentage Structure, %				
I-2005	100.0	96.2	3.8	27.0
I-2010	100.0	94.7	5.3	27.0
I-2011	100.0	94.9	5.1	26.8
I-2012	100.0	95.1	4.9	27.4
I-2013	100.0	95.1	4.9	27.3
I-2014	100.0	95.2	4.8	26.5

* Formal and informal sector. PEIS: People Employed in Informal Sector
Source: BBVA Research with INEGI data.

Chart 44
EAP: total, employed and employed in the informal sector (mn)



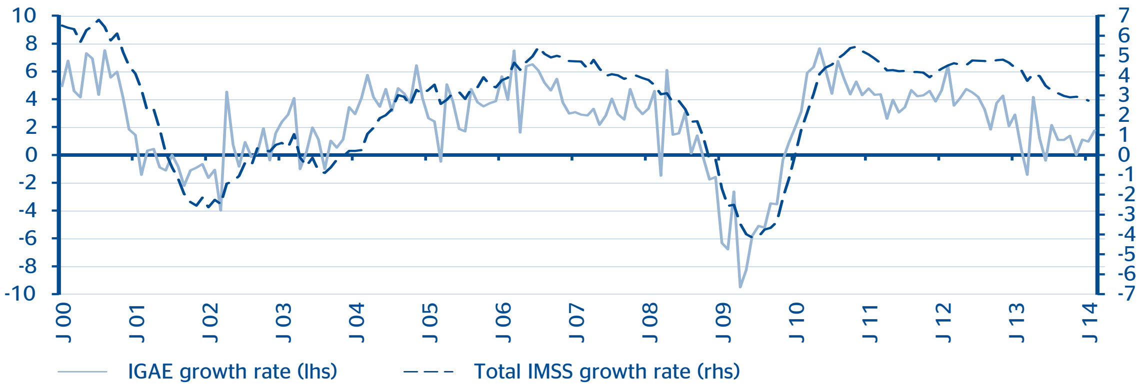
Source: BBVA Research with INEGI data.

The considerable annual increase in the number of people seeking employment represents a major challenge for the country, given that it creates a need for the economy and the productive base to grow to increase job supply. This challenge is linked to the process and pace of the country's economic growth, as greater GDP growth leads to higher levels of employment. To illustrate the latter point, Chart 45 shows the annual growth rate for both the Global Economic Activity Indicator (IGAE), a trustworthy monthly indicator of the country's GDP behaviour, and the total number of workers registered with the Mexican Social Security Institute (IMSS). It should be mentioned that the statistics of IMSS-registered workers relate to the behaviour of formal sector employment within private sector companies.

The correlation ratio between economic activity growth rates and employment from January 2000 to December 2013 was 0.78. On the other hand, the ratio rises to 0.84 when considering the more recent period from January 2005 to December 2013.

The high positive association between the expansion of economic activity and the expansion of formal employment reveals that the higher the sustained growth rate of GDP, the faster the creation of formal jobs and, therefore, the greater the population's well-being. Furthermore, economic activity expansion or contraction processes pass through to formal employment in a matter of a few months, as also observed on Chart 45. What is more, the fact that activity growth picks up first and is subsequently followed by rising employment has been observed. Worth mentioning is that the country's recent economic performance has been determined, to a large extent, by foreign demand. This is due to the tight relationship between Mexican and US economic cycles and, to the degree that US economic growth drives Mexican economic growth, our country will experience a positive job impact.

Chart 45
IGAE and total number of IMSS-registered workers (% annual growth rate)



Source: BBVA Research with INEGI data.

Employment in the informal sector

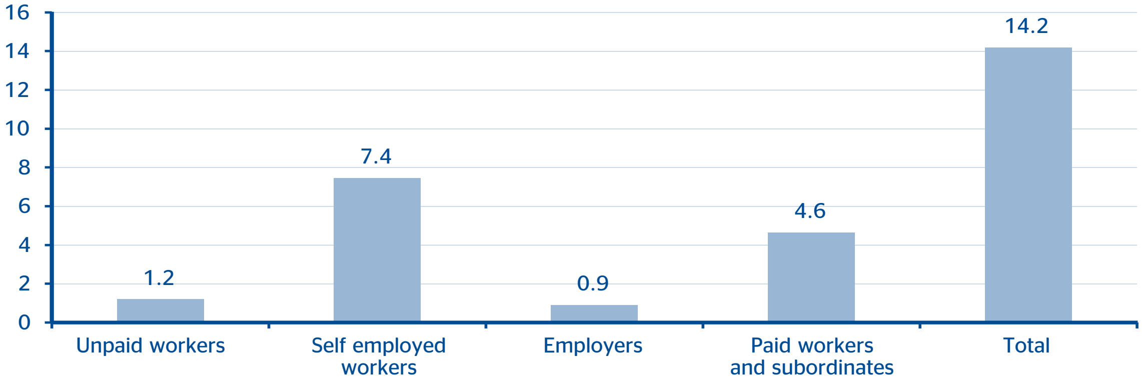
Employment in the economy's informal sector is substantial in Mexico. While the determinants of the size of the informal economy are complex, institutional factors and formal sector weakness are recognised as the key elements that have fostered its development.

While there are different ways to define informality, a widely-used concept (applied by INEGI, among other entities) refers to people who work at companies or household businesses that keep no accounting records, in other words, those who work at production units that are themselves deemed to be informal. This is the concept that will be referenced in this chapter. Thus, in the first quarter of 2014, a total of 13.7 million individuals were employed in the economy's informal sector, accounting for 27% of the EAP. However, when applying the wider definition, informality rises to 58% of the EAP.[1]

Chart 46 itemises the categories that INEGI considers in the informal sector employment concept, as follows: i) unwaged workers (8.4% of total); ii) self-employed workers (52.5%); iii) employers (6.4%); and iv) subordinate workers [employees] and waged workers (32.7%).

[1] The INEGI document entitled Mexico: New Labour Informality Statistics notes that the broad concept of labour informality refers to employed people who have no social security. According to INEGI, there was an EAP of 49.5 million in the second quarter, 29.3 million of whom were people who had an informal job. This last figure included the 14.2 million people who work at informal sector companies. The groups of people with no formal job and who did not work at informal companies in the second quarter of 2013 were as follows: waged domestic workers, 2.1 million; agricultural sector, 6.1 million; companies, government and institutions, 6.9 million. INEGI's recently-announced informality classification broadens the classification of informality following OECD criteria. Previously, a worker was classified as informal based on whether the economic unit where they worked was informal. On the other hand, the new methodology also recognises informal workers at formal companies. That is, the traditional classification of informality includes people employed at non-agricultural units operated with no accounting records, and who function based on the resources of the household or person heading the activity, without incorporating as a company. On the other hand, the wider definition also includes subordinate workers [employees] who are not registered with social security, even when working at formal companies. This definition expands upon the first, and includes workers who are vulnerable from a labour perspective. It includes subsistence agriculture and workers without social security, in other words, workers who are classified as informal due to some vulnerability.

Chart 46
Number of Workers in the Informal Sector
in mn - second quarter of 2013



Source: BBVA Research with INEGI data.

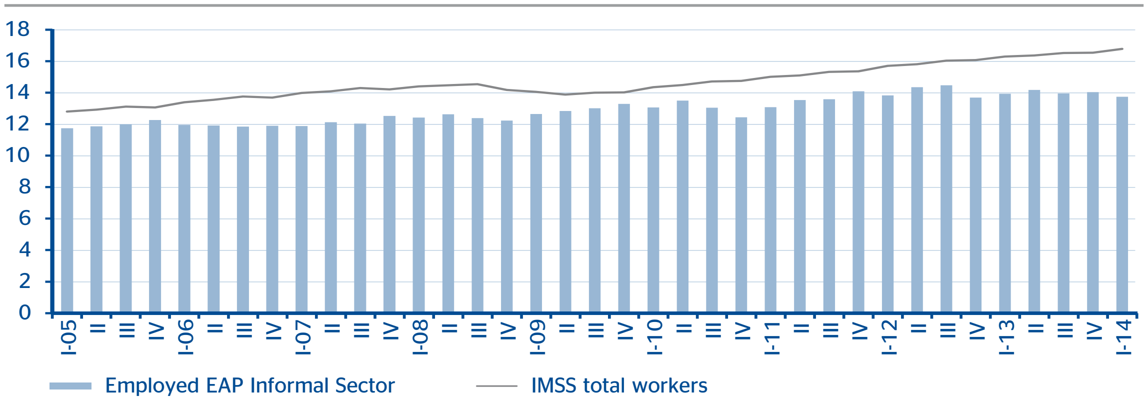
As shown in Table 1, the number of workers in the economy's informal sector rose from 11.7 million in the first quarter of 2005 to 13.7 million in the first quarter of 2014. Thus, over the nine years considered, the number of people who work in the economy's informal sector rose by nearly two million, that is, the economy's informal sector accommodated an annual average of 222,000 jobs. This figure represented a 24% rise in the EAP over the nine-year period.

Employment in the formal private sector

The evolution of formal private employment in the country is analysed based on the number of IMSS-registered workers, given that they are the people who work at private sector companies that have social security. At the end of the first quarter of 2005, the total number of IMSS-registered workers was nearly 12.8 million. Of this total, 11.5 million (89.6%) had a permanent job, and 1.3 million (10.4%) had a temporary job.

By the end of the first quarter of 2014, the total number of IMSS-registered workers had risen to nearly 16.8 million (85.7% permanent and 14.3% temporary). In other words, over the referenced period, formal IMSS employment rose by 2.9 million permanent and 1.1 million temporary jobs, for a total of 4 million.

Chart 47
Total number of IMSS-registered workers and EAP working in the informal sector (millions)



Source: BBVA Research with INEGI data.

The foregoing figures reveal that, over the nine years considered from 2005 to 2014, the number of jobs held by IMSS-registered workers rose by a total annual average of almost 443,000, of which nearly 324,000 held a permanent job and 119,000 a temporary job.

Thus, from the first quarter of 2005 to the same period of 2014, the accommodation of new IMSS-registered workers, in terms of their share with respect to the average annual rise in the EAP of 922,000, was 34.9% for those with a permanent job and 12.8% for those with a temporary ob. Overall, the rise in IMSS-registered workers with both permanent and temporary employment accounted for 47.8% of the average annual rise in the EAP for the period.

The moderate rise in formal employment generated by private sector companies, together with the rise in informal sector employment, reveals that the pace of formal job creation to date has proved insufficient to accommodate all of the people who enter the EAP. Thus, a considerable share of the annual number of job-seekers finds work in the informal sector. The other side of the coin is that, according to INEGI data, average informal sector wages represent 72% of average formal sector wages.

As mentioned, a higher GDP growth rate leads to a higher pace of job growth in the economy's formal sector. The challenge the country thus faces is to be capable of generating a higher rate of sustained GDP growth than the historical average, consequently creating more formal jobs.

In this regard, the average figure of 900,000 people who join the labour market each year can be a useful benchmark parameter to target, if the goal is to make the economy's formal sector capable of accommodating the new labour market participants. This would thus contain the expansion of informal sector employment.

II. Effects of the structural reforms on Mexico's labour market

Energy reform

Mexico has approved an extensive agenda of structural reforms intended to generate higher rates of GDP growth than in the past. To be noted is the energy reform, due to the major expectations of the level of investment it could generate. The energy reform was enacted by the government on 20 December 2013 and published in the Official Journal of the Federation on the following day.

The secondary laws that will support it and will set forth the details of the participation of private initiative in the sector are pending. This reform is expected to have several positive effects on the economy, such as a rise in domestic and foreign investment and in energy production, higher levels of oil exports, and greater productivity in the country's energy production sector. These aspects should be reflected in a higher rate of GDP growth and, therefore, in more and better-paid formal sector jobs.

Considering that one of the biggest challenges the economy faces is that of reducing the size of the informal economy, it is useful to assess the potential effect of the energy reform on that variable. To do this, we created different scenarios by applying diverse methodologies. Specifically, we used a quarterly macroeconomic model of GDP demand components, which allowed us to generate scenarios with different assumptions for the 2014 to 2025 period. The second model estimates the determinants of employment in the economy's informal sector.[2] Finally, we used a growth model for two sectors, the formal and informal, calibrated to the Mexican economy.[3] These models were estimated by including

[2] The Ordinary Least Squares (OLS) method is used to estimate an equation that summarises the determinants of the informality rate, which include their lag, to measure the persistence of that variable, the growth rate of economic activity, and average wages computed for benefits at the IMSS, among other variables. The estimate's reference period runs from the first quarter of 2001 to the fourth quarter of 2013. The equation is estimated in logarithms. The model's results are used to calculate a counterfactual scenario or an alternative scenario for the case in which the economy experiences an energy reform that generates investment inflows of between USD5BN and USD25bn to 2020. The results also assume that, per federal government estimates, the energy reform will contribute to the economy's growth by 0.3, 0.4, 0.7, 1.0 and 1.1 percentage points each year until 2020.

[3] We consider a Solow-type economic growth model expanded to two sectors, one representing the formal and the other, the informal (based on López-Marmolejo, 2007). The baseline component of the formal sector is created with a Cobb-Douglas-type production function that uses labour, capital and exogenous technology. The baseline component of the informal sector only uses labour. Consumers maximise consumption and leisure time, and determine the amount of time they will work in either of the two sectors and provide their capital to formal companies. The model is calibrated to replicate the Mexican economy and allows us to determine the current size of the informal economy, in addition to other features of the Mexican economy. This exercise consists of estimating a counterfactual or alternative scenario for the case in which the economy experiences an energy reform that generates investment inflows of between USD5bn and USD25bn until 2020. In this model, the investment generated by the energy reform would lead to the creation of more formal work, which in turn requires higher compensation, resulting in a reduction of the size of the informal economy.

assumptions on the effects that the energy reform could have in terms of investment. The results of these models estimate counterfactuals of the share of informal employment the economy could have in the presence of an energy reform that would generate higher levels of investment. The higher investment levels considered range from USD5bn to USD25bn annually to 2020, which would be additional to the investment that would take place in the event of the country having no energy reform.

The results in terms of the participation of formal employment in the EAP are summarised in Table 5.

Table 5
Effect of energy reform on share of informal employment (% of EAP)

No reform	With reform		
	Model 1	Model 2	Model 3
27	25	26	24

Notes:
Model 1: macroeconomic model by GDP components.
Model 2: model of informality determinants.
Model 3: Solow-type economic growth model with two sectors, formal and informal.
The reduction of the share of informal employment with respect to the EAP assumes that the economy achieves an investment of between USD5bn and USD25bn.
Source: BBVA Research

One finding is that an appropriate implementation of the energy reform, one which would allow a significant rise in investment, could reduce the informal economy by one to three percentage points of the EAP. In other words, employment in the economy's informal sector could drop from 27% of the EAP to between 24 and 26%, when the expected rise in investment materialises in a sustained manner.

The foregoing scenarios do not include the potential for improved economic performance due to lower energy costs, for example, which could lead to an additional reduction in the share of informal employment. Nor do they include any downward bias to the creation of new jobs, considering that the economic expansion achieved arises from technologies that are more capital- than labour-intensive, in comparison with how employment expanded in the recent past.

Prima facie, these reductions in the share of people who work in the economy's informal sector seem small, although in absolute values they are not. For example, the entry of workers into the informal economy must be considerably reduced, by around 100,000 per year, and the creation of formal employment must rise above the historical creation levels by around 200,000 per year. Furthermore, the employment created would come from a sector characterised by being highly-specialised and requiring high qualifications. This is different with the characteristics and skills of most of the informal labour force.

The results presented in this article are consistent with the findings of other studies such as those by Esquivel and Ordaz (2008) and Perry et al. (2007), which suggest that informality is a persistent phenomenon and that sustained economic growth can assist in reducing its rate over the long-term.

Overall structural reforms

The foregoing notwithstanding, it is important to bear in mind that the reform agenda does not only include energy reform, but that other significant reforms were also approved. Consequently, an effective implementation of the whole of this important reform agenda should also lead to a significant rise in GDP growth rates, and in the creation of formal employment.

According to different estimates, we believe that an effective implementation of the overall structural reforms approved could generate an average annual growth of around 5.0% over the medium term, from 2015 to 2025. Our estimates reveal that a 5.0% growth rate would enable the creation of nearly 700,000 formal private sector jobs per year, as can be seen in Table 6. While this number of formal jobs is lower than the 900,000 or thereabouts who join the labour market each year, one must consider that there are other factors that could reduce the search for employment in the informal sector, which means that almost all of the people who join the labour market each year could be accommodated by the formal sector, were the sustained 5.0% growth to be achieved.

Table 6

Results of GDP growth and formal IMSS employment simulation exercise under different structural reforms Impact assumptions 2015 - 25

	Base Case Scenario	Oil Reform	Oil Reform and Other Reforms
GDP, average growth rate	3.0	4.1	5.0
Formal private employment, thousands	530	630	690

Source: BBVA Research based on a macroeconomic model estimate of GDP by demand components, according to INEGI quarterly data, which also includes formal employment data (total number of IMSS-registered workers).

What follows are some of the factors that could reduce the search for employment in the informal sector. First is the retirement of formal sector workers, whose jobs would be taken by people joining the labour market. IMSS data indicate that it issued an average of 98,000 pensions per year from 2006 to 2013. Second, the creation of formal employment in the public sector would accommodate a share of the new labour market participants. Figures for this type of formal worker were not considered in the analysis, due to the lack of a series. Finally, given the population dynamics, one must entertain the possibility that the annual number of people who join the labour market may drop below the aforementioned 900,000 in the future. These three situations could have a favourable effect on reducing the share of people who must seek employment in the economy's informal sector. However, in spite of these mitigating factors, the challenge that the country's economy faces, in achieving sustained high growth rates and thus increasing the number of formal jobs, remains.

III. Conclusions

The most significant conclusions reached from the results of this analysis are as follows:

i) Growth in the country's economy and in formal sector wages has positive effects on informality. This suggests that economic activity must be driven by supporting new and existing formal companies with financing and support programmes for their development, and with greater conditions of security to generate a favourable business atmosphere. Furthermore, on-going improvement in labour market conditions is required, such as wage increases in accordance with economic sector productivity, to incentivise the incorporation of more workers into the formal sector;

ii) Greater increases in the persistent phenomenon of informality will make it harder to reduce over time. Therefore, now is the time to take advantage of the recently-approved economic reforms to begin its containment and, if possible, a gradual reduction;

iii) The effort required to achieve a sustained growth rate of 5.0% in the medium-term is significant in terms of investment and exports. This means that the approved structural reforms must be successfully implemented and have a substantial impact, and that their results must have a long-lasting effect so that they can enable the economy to grow at significantly higher rates than in the past, and

iv) Informality in Mexico has a structural and persistent component, and only sustained and robust growth in the Mexican economy will reduce the informal sector over the medium-term. The energy reform, and the rest of the approved structural reforms, can assist in this process by enabling the economy to grow at higher rates. However, the reforms' expected effects will be realised if their implementation is thorough and effective.

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5. Indicators and forecasts

Table 7

Macroeconomic forecasts: Gross Domestic Product

(YoY growth rate)	2011	2012	2013	2014	2015
United States	1.8	2.8	1.9	**2.5**	**2.5**
EMU	1.6	-0.6	-0.4	**1.1**	**1.9**
Germany	3.4	0.9	0.5	**1.8**	**2.0**
France	2.0	0.0	0.3	**0.9**	**1.5**
Italy	0.6	-2.4	-1.8	**0.7**	**1.4**
Spain	0.1	-1.6	-1.2	**1.1**	**1.9**
UK	1.1	0.3	1.7	**2.8**	**2.4**
Latin America *	4.1	2.6	2.3	**2.3**	**2.5**
Mexico	4.0	3.7	1.3	**2.5**	**3.5**
Brazil	2.7	1.0	2.3	**2.0**	**1.6**
EAGLES **	6.7	5.0	5.3	**5.3**	**5.6**
Turkey	8.5	2.4	4.0	**1.5**	**5.1**
Asia-Pacific	6.1	5.2	5.2	**5.0**	**5.2**
Japón	-0.5	1.5	1.5	**1.1**	**1.3**
China	9.3	7.7	7.7	**7.2**	**7.0**
Asia (exc. China)	3.8	3.5	3.3	**3.5**	**3.9**
World	4.0	3.2	3.0	**3.4**	**3.8**

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Corea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Closing date: April 30, 2014
Source: BBVA Research

Table 8

Macroeconomic Forecasts: inflation (Average)

(YoY growth rate)	2011	2012	2013	2014	2015
United States	3.2	2.1	1.5	**1.8**	**2.2**
EMU	2.7	2.5	1.4	**0.9**	**1.3**
Germany	2.5	2.1	1.6	**1.3**	**1.6**
France	2.3	2.2	1.0	**1.1**	**1.2**
Italy	2.9	3.3	1.3	**0.7**	**1.2**
Spain	3.2	2.4	1.4	**0.3**	**0.9**
UK	4.5	2.8	2.6	**1.9**	**2.0**
Latin America *	8.0	7.6	8.9	**11.8**	**10.8**
Mexico	3.4	4.1	3.8	**3.9**	**3.5**
Brazil	6.6	5.4	6.2	**6.4**	**5.8**
EAGLES **	6.5	4.8	5.1	**4.8**	**4.7**
Turkey	6.2	8.7	7.6	**8.2**	**5.3**
Asia-Pacific	4.9	3.4	3.5	**3.6**	**3.8**
Japón	-0.3	0.0	0.4	**2.2**	**1.5**
China	5.4	2.6	2.6	**2.6**	**3.3**
Asia (exc. China)	4.6	4.0	4.2	**4.4**	**4.1**
World	5.1	4.2	3.8	**3.9**	**4.0**

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Corea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Closing date: April 30, 2014
Source: BBVA Research

Table 9

United States indicators and forecasts

	2012	2013	2014	2015	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14
Macroeconomic Indicators												
GDP (real % change)	2.8	1.9	**2.5**	**2.5**	1.1	2.5	4.1	2.6	-1.0	**4.7**	**3.7**	**3.5**
Personal consumption (real % change)	2.2	2.0	**2.5**	**1.7**	2.3	1.8	2.0	3.3	3.0	**2.2**	**2.0**	**1.4**
Gov. consumption (real % change)	-1.0	-2.2	**-1.0**	**0.0**	-4.2	-0.4	0.4	-5.2	-0.5	**0.4**	**0.0**	**0.0**
Gross fixed investment (real % change)	8.3	4.5	**4.0**	**7.1**	-1.5	6.5	5.9	2.8	-2.8	**9.7**	**7.2**	**6.9**
Construction	3.4	3.1	**3.8**	**5.5**	3.8	-1.5	5.7	4.0	1.5	**6.1**	**4.1**	**6.1**
Industrial prod. (real annual % change)	3.8	2.9	**4.0**	**3.9**	3.0	2.5	2.7	3.3	3.4	**4.2**	**4.4**	**4.0**
Current account balance (% of GDP)	-2.7	-2.3	**-2.8**	**-2.4**	-2.5	-2.3	-2.3	-1.9	-3.1	**-2.7**	**-2.7**	**-2.7**
Final annual inflation	1.7	1.5	**2.3**	**2.2**	1.5	1.8	1.2	1.5	1.5	**1.7**	**2.1**	**2.3**
Average annual inflation	2.1	1.5	**1.8**	**2.2**	1.7	1.4	1.6	1.2	1.4	**1.6**	**1.9**	**2.2**
Primary fiscal balance (% of GDP)	-6.8	-4.1	**-3.0**	**-2.7**				-4.1				**-3.0**

Note: **Bold** figures are forecast
Source: BBVA Research

Table 10

Mexico Indicators and Forecasts

	2012	2013	2014	2015	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	3.7	1.3	2.5	**3.5**	2.9	0.5	1.4	0.6	0.6	**2.4**	**2.8**	**4.1**
Per inhabitant (US dollars)	10,095	10,606	10,698	**11,370**	10,734	10,575	10,504	10,606	10,441	**10,690**	**10,713**	**10,947**
US$ billions	1,181.7	1,255.7	1,280.7	**1,375.8**	1,270.9	1,252.0	1,243.6	1,255.7	1,249.9	**1,279.8**	**1,282.5**	**1,310.6**
Inflation (average, %)												
Headline	4.1	3.8	3.9	**3.5**	3.7	4.5	3.4	3.7	4.2	**3.6**	**4.0**	**3.9**
Core	3.4	2.7	3.1	**3.1**	3.0	2.9	2.5	2.6	3.0	**3.0**	**3.2**	**3.2**
Financial Markets (eop, %)												
Interest rates												
Bank funding	4.5	**3.5**	**3.5**	**3.8**	4.0	4.0	3.8	3.5	3.5	**3.5**	**3.5**	**3.5**
28-day Cetes	3.9	3.2	3.5	**4.0**	4.2	3.9	3.5	3.2	3.3	**3.6**	**3.5**	**3.5**
28-day TIIE	4.8	3.8	3.9	**4.2**	4.4	4.3	4.0	3.8	3.8	**3.9**	**3.9**	**3.9**
10-year Bond (%, average)	5.7	5.7	6.5	**7.3**	5.1	5.3	6.2	6.2	6.3	**6.2**	**6.6**	**6.8**
Exchange rate (average)												
Pesos per dollar	12.9	13.0	13.3	**13.2**	12.3	12.9	13.1	13.0	13.2	**13.1**	**13.3**	**13.3**
Public Finances												
*FRPS (% of GDP)	-3.1	-2.3	-3.5	**-3.0**	-	-	-	-2.3	-	-	-	**-3.5**
External Sector[3]												
Trade balance (US$ billions)	0.0	-1.0	-1.3	**-3.5**	-1.0	-0.8	-1.0	1.9	-1.2	**0.5**	**-1.5**	**0.8**
Current account (US$ billions)	-14.8	-22.3	-16.6	**-17.2**	-6.5	-5.5	-5.6	-4.7	-4.4	**-5.1**	**-3.3**	**-3.8**
Current account (% of GDP)	-1.2	**-1.8**	**-1.4**	**-1.4**	-2.1	-1.8	-1.8	**-1.5**	**-1.4**	**-1.6**	**-1.0**	**-1.2**
Oil (Mexican mix, dpb, eop)	102.0	98.6	98.4	**98.8**	103.0	98.6	100.5	92.1	92.3	**100.1**	**101.0**	**100.2**
Employment												
Formal Private (annual % change)	4.6	3.5	2.9	**3.4**	4.1	3.8	3.1	2.9	2.9	**2.7**	**3.3**	**2.9**
Open Unemployment Rate (% active pop.)	5.0	4.9	4.9	**4.9**	5.0	5.0	4.9	4.7	4.9	**4.9**	**5.0**	**4.9**

Source: BBVA Research with Federal Reserve, Bureau of Labor Statistics, Banco de Mexico, INEGI and SHCP data

DISCLAIMER

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