RESEARCH

Mexico Economic Outlook

Fourth Quarter 2014

Economic Analysis

- A better economic performance next year will come from increased growth in the United States and greater public expenditure
- The economic reforms could spur an increase in the growth rate of potential GDP up to the 4.0% level in the coming years
- Promoting investment, security and the rule of law is also important if greater productive activity and welfare among the population is to be achieved
- Inflation is under control and any perceived upside risks should have limited effects

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Closing Date: December 4, 2014

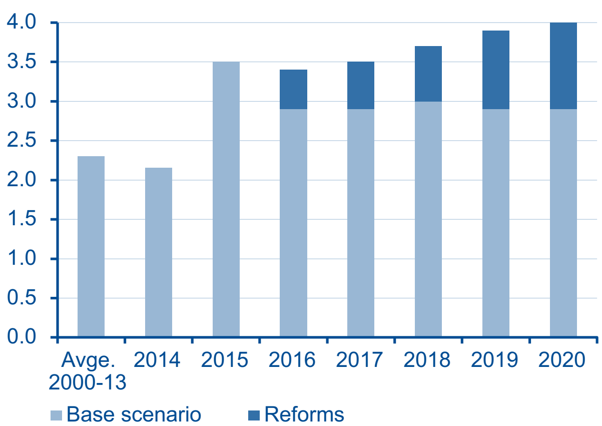
1. Summary

After the slowdown seen in 1Q14 the Mexican economy has shown an improvement thanks to the increase in external demand, although the upturn did not live up to expectations. On the one hand quarterly growth rates for Q1 and Q2 were revised downwards, while on the other hand Q3 growth was more modest than predicted. Among the factors accounting for this more subdued growth were the lower oil price and production levels, a delay in executing major public investment projects, and weak domestic demand, which crucially depends on formal job creation. As a result of the less robust economic performance in the first nine months of the year we are revising GDP growth for 2014 from 2.5% down to 2.1%. For 2015 the forecast for growth is 3.5%, assuming that external demand continues to perform well in a scenario in which the United States grows at 2.5% YoY, the price and production of oil both stop falling, and public expenditure on infrastructure projects picks up.

The process of structural reform being implemented in Mexico has continued to make headway. In specific terms, energy reform is expected to be one of the catalysts for greater economic growth, on the basis of the substantial investment anticipated in the sector and its invigorating knock-on effects on other productive sectors in Mexico. The authorities have estimated that this reform will steadily lift private investment in the sector to USD25bn in 2020. These funds will enhance infrastructure in the sector and will therefore reinforce the domestic energy supply, among other long-term benefits.

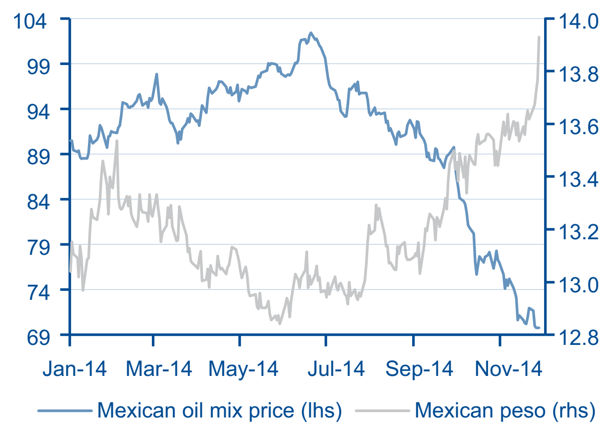
Assuming the previously described investment flows arising from the energy reform, as well as the fulfilment of other essential macroeconomic conditions, such as the provision of stout public investment on various infrastructure projects already announced and stable economic growth in the United States, the economic reforms recently enacted in Mexico should generate a higher growth rate of the country's potential GDP. This should then progressively rise from our estimate of 2.9% for the current growth rate of potential GDP to 4.0% in 2020.

Chart 1
GDP growth 2014-20 (YoY % change, sa)



YoY=% variation Year on Year, sa=seasonally adjusted
Source: BBVA Research with information from INEGI

Chart 2
MXN and Mexican oil mix price (USD/MXN, dollars per barrel)



Source: BBVA Research with information from Bloomberg.

With respect to the risk of a lower oil price, we estimate that for every 10 dollars' reduction in price, GDP would fall by around 0.2pp. It should be pointed out here that such a reduction could be offset to some extent by stronger growth in the USA. On the other hand, no material decrease is forecast in government revenues budgeted for 2015. This is because the government has bought oil hedges for most of the expected export platform, resources are available from the Mexican Petroleum Fund, and because of the lower prices that could be achieved for imported petrol. If the fall in the oil price persists beyond 2015, it is estimated that the State would obtain revenues below the originally budgeted figure of around 0.6% of GDP.

Inflation is back on its downward path, and is expected to end the year at about 4.0%. Annual inflation has eased to 4.16% from its high of 4.32% in October, while core inflation is holding steady at 3.3%, which suggests that there are no demand-side pressures. From January 2015, we expect inflation to fall to around the 3.6% level, due to the soaking up of base effects as the impact dwindles on the annual rate of January's tax changes and because of the lower telecom services prices following sector reform. An additional factor favouring annual inflation in 2015 will be the lower rise in the petrol price for the year compared to those leading up to it (3.0% vs. 11% on average in 2010-14). For the year as a whole, we are forecasting average inflation of 3.56%.

Expectations of an extended break from monetary policy rate moves remain, given the slack in the economy, a short-term sub-zero real rate, and the slight improvement in the economic cycle. The neutral tone of the recent statement from the central bank supports this scenario. In the medium term, as economic growth gathers speed the policy rate should begin to creep up slowly, in step with the monetary and economic cycle in the United States. The first policy rate hike is expected to take place in mid-2015.

Recent volatility in Mexican financial assets has intensified as a result of greater demand for US assets and the fall in the oil price. In a climate in which there is still little global risk aversion and the US economy is distinguishable in a positive sense from the eurozone and China thanks to higher than expected growth, the dollar has firmed and medium and long-term rates in the United States have come down in the face of the demand for its financial assets. Consequently, the currencies of emerging countries have weakened against the dollar, including the Mexican peso. Moreover, as concern about the strength of the global cycle has abated, the perception of risk has faded too, which has worked in favour of the bonds of emerging economies, and therefore Mexican government long bond yields have swung back into line with levels in the United States. On top of this, the recent drop in the oil price has been a factor in the softening of currencies in the oil-exporting countries. In the case of the peso, the depreciation has been less pronounced than it has been for those currencies where oil production accounts for a large slice of the economy's total output, and it has been similar to the average depreciation experienced in the Latam countries.

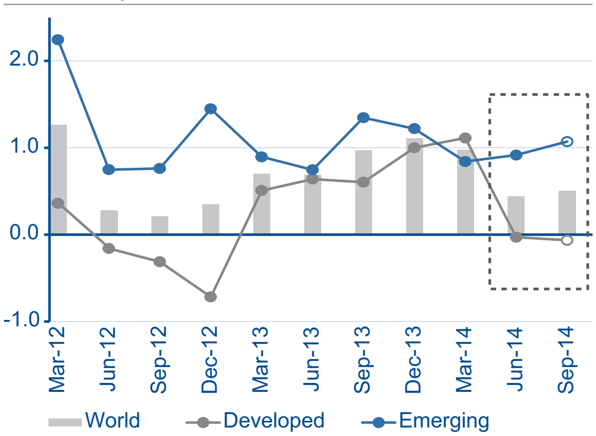
Looking ahead we foresee continued volatility in the FX market on dollar strength and the effect on currencies associated with the oil industry. With regard to long-term interest rates, their movements are likely to have a strong correlation with the course taken by US interest rates and they will probably climb only gradually, as is expected to happen in the United States, in a situation where the Federal Reserve's cycle of hikes will start next year.

2. Slow global recovery with downside risks in Europe

Global economic growth continued in 3Q14, as shown by the positive variations of world trade volumes for goods and industrial production up to August. However, their trend growth is very moderate, with a rising path in the case of trade and falling in the case of industry. In both cases the moderation in global trade and industrial production is greater in the more developed economies, and of these, more in Japan and the eurozone than in the US.

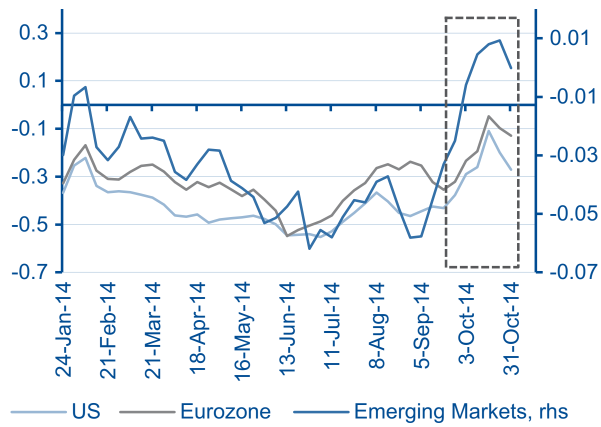
The confidence indicators for September remain consistent with the expansion of manufacturing activity, although it has been some months since they stopped improving in the key economic areas. An additional sign of the fragility of the present cyclical recovery is the uptick of the tension indicators (including our own) in the financial markets (volatility) since mid-September. In the case of the emerging economies (EMs), these have reached levels not seen since May 2013, when the market discounted a rapid withdrawal of Fed stimuli that actually never happened. At the same time, geopolitical risks are multiplying and negative surprises are building up on the consensus in the activity indicators, particularly in the eurozone and South America.

Chart 2.1
Industrial production ex-construction, % QoQ*



* 3Q14: year to August, variation June-August vs. March-May
Source: CPB and BBVA Research

Chart 2.2
BBVA Research Financial Tensions Index



Source: BBVA Research

Altogether, the most likely scenario is that global growth improved in 3Q14 vs. 2Q14. According to our calculations, global GDP expanded 0.6% QoQ in 2Q14 and the forecast based on our BBVA Research GAIN[1] indicator is +0.8% in 3Q14. However, there is downside risk to these figures given that the industrial activity indicators and world trade in September could still moderate, and the effects of the financial volatility on confidence could be more persistent than we expect. Also, there are the geopolitical risks associated with the situation in Syria and Iraq and the fragile agreement between Ukraine and Russia. It is worth noting that sanctions are already having an impact on activity in important sectors such as the Russian energy.

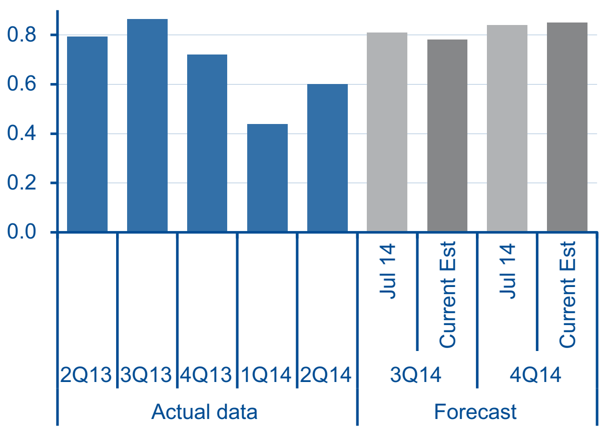
In this context, monetary policy will remain focused on supporting activity, while fiscal policy will be less restrictive in tone in 2014-15 in both the US and the eurozone than in the recent past. Even in China, together with the budget consolidation at the local and regional government level it is felt that additional measures to support growth could be implemented if necessary by the central government. In the case of the more developed economies, the tone of fiscal

[1] Details on the methodology of BBVA Research GAIN available at: http://bit.ly/1nl5RIn

policy is the result of both the discretionary decisions taken by the authorities, in some cases in Europe preoccupied by the short-term effects on growth of the rapid and intense fiscal consolidations, and by the room for manoeuvre afforded due to the more favourable funding conditions from sovereigns bonds. The latter is a direct consequence of central bank support, with their policies of anchoring expectations of interest rates and the provision of liquidity to the system, which is what has allowed the above-mentioned discretionary decisions to be taken by the authorities in countries with increasing primary public deficits and levels of indebtedness.

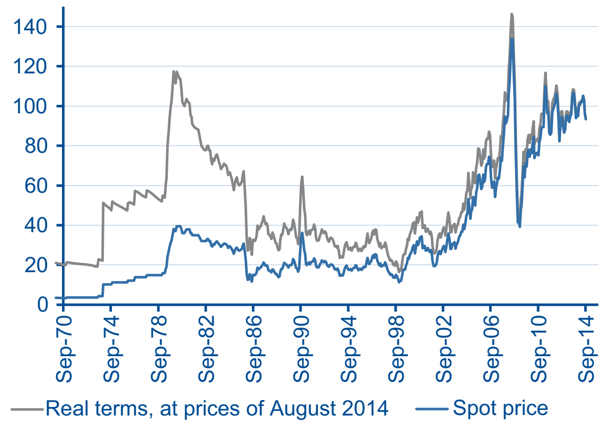
Finally, the fall in oil prices is a favourable factor for global growth expectations to the extent that this is the result of a positive supply shock, especially for the sustained increase in unconventional oil production.[2] The diminished transfer of income from importers to producers gives more scope for the former to attend to their spending, saving and investment decisions, which is a much more positive situation for the economic scenario. All increases in productive capacity of a limited and growing demand resource, even for a more efficient use, help to put a brake on prices that in real terms are at similar levels to those of the oil crisis at the end of the 1970s.

Chart 2.3
Global GDP, % QoQ
Forecasts based on BBVA GAIN



Source: BBVA Research

Chart 2.4
Oil price (West Texas, USD/barrel)



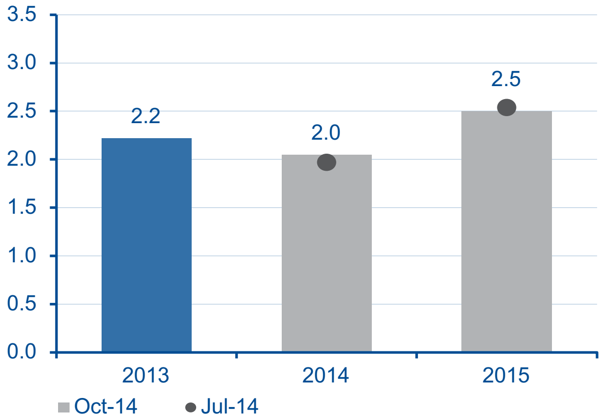
Source: BBVA Research, Haver Analytics

These income transfers to consumer countries have their flip side in the producer countries of oil and, in general, raw materials, where prices are also falling due to the moderation of demand from Asia. These countries are posting decelerating activity and downward adjustments to perspectives for growth in 2015 as well, which is doubtless affecting some South American economies where we are seeing a delay in expected productive investments.

US growth remains in line with our expectations, and could reach 2.5% in 2015. After the unexpected and transitory drop in activity in 1Q14, the activity, spending and employment indicators have recovered to the extent that the pace of GDP growth could well be above 2.5% in the second half of the year, and thus average 2% for 2014 as a whole. In fact, in the light of the first estimation of 3Q14 GDP growth this forecast has a positive bias of around 0.2 pp. However, the role of the Fed, which emphasises caution and patience before acting on the signs of improvement in the economy, continues to support our scenario of a cyclical recovery in the US underpinned by the solid creation of employment and the increase in household wealth. The Fed's scope for manoeuvre is favoured by the lack of inflationary tensions in a context of a stronger dollar and lower oil prices, together with moderate wage increases.

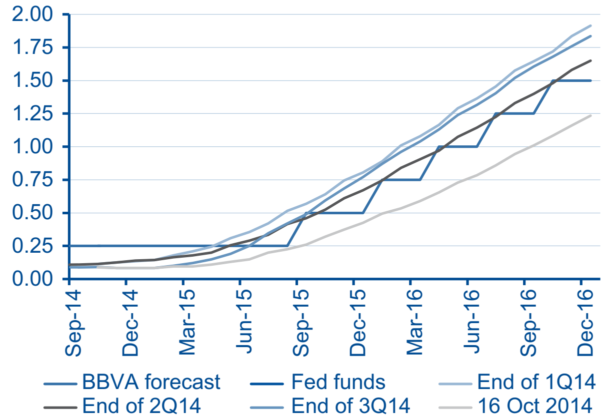
[2] The recent fall in oil prices reflects not only the increased supply, but also USD appreciation and a moderation in expectations of demand, in both DMs and EMs.

Chart 2.5
US: GDP growth (% YoY)



Source: BBVA Research

Chart 2.6
US: expectations of Fed funds rate (%)

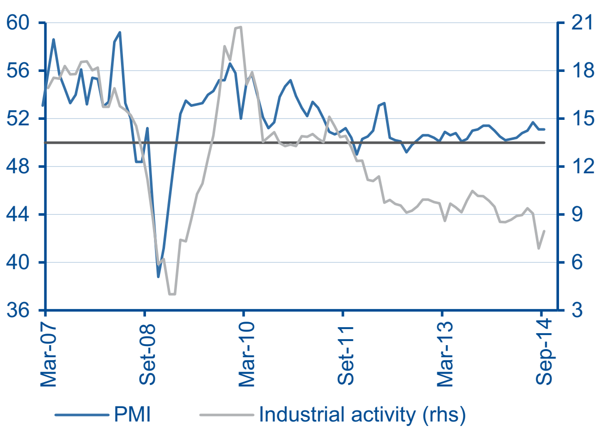


Dates are the last day in the quarter with the exception of 3Q14, which is 16 October
Source: BBVA Research

Our outlook for China is unchanged, but with a downward bias due to the external environment and the possibility of economic policy support. In 3Q14 GDP growth continued to decelerate, to 7.3%, reflecting the moderation in domestic activity, particularly in the construction and real estate sectors, but partially offset by an unexpected and intense upturn in exports. We maintain our outlook for GDP growth at 7.2% in 2014, although we do not rule out that the final print could be a few basis points higher. Altogether, the risks to growth in China continue to be to the downside from 2015 onwards, precisely because of the brake on external demand that the situation in Europe might imply and the adjustment underway in the real estate sector in a context of high leverage and the introduction of measures to control its less regulated banking system.

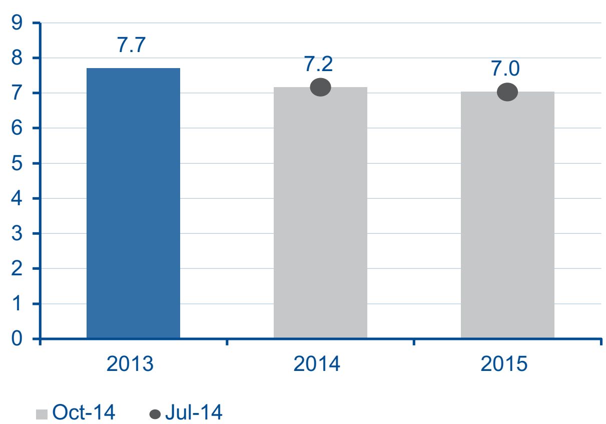
China is facing the task of managing the present deceleration of economic growth while reducing its financial risks and rebalancing growth in favour of domestic demand. In this scenario, the authorities will remain disposed to intervene so that the deceleration does not intensify more than is desirable, and growth does not fall below the targets set. Thus we would not be surprised to see additional monetary policy easing (with cuts in the reserve ratio or liquidity injections), expansive central government fiscal policy (albeit with consolidation at the local government level) and on-going structural reforms.

Chart 2.7
China: confidence and industrial activity indicators, level and % YoY



Source: Haver Analytics

Chart 2.8
China: GDP growth (% YoY)



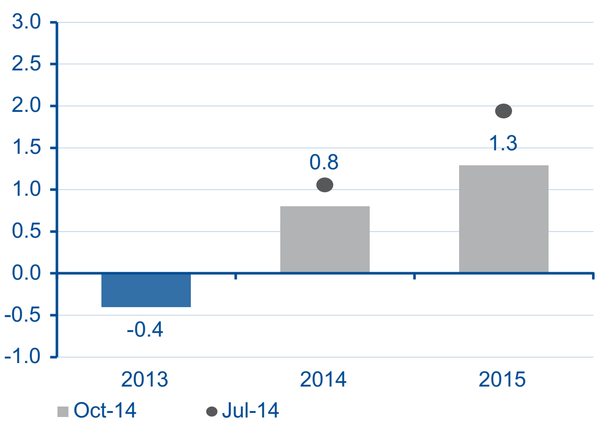
Source: BBVA Research

In the eurozone the recovery will be even slower than expected. The stagnation of GDP growth in 2Q14, with weaker performances in general in the larger economies, has led us to revise our outlook for growth in the region downwards for 2014 and 2015. The Ukraine/Russia crisis is having an impact on trade and the confidence indicators of the more exposed economies in the centre of Europe, which in the case of Germany is feeding through into negative surprises in investment. In Europe as a whole, this reduced confidence is coinciding with weak activity prints and the limited ability of the authorities in the region to take steps to tackle this deterioration of expectations of low growth and inflation. The lack of agreement between the national authorities as to the causes of the problems, and thus the differences about the most appropriate measures to implement, together with an increasingly domestic rather than European bias to the decisions, is continuing to hamper governance of the euro area. What the euro area needs is a combination of deeper reforms, the continuation of monetary and liquidity stimuli and, finally, a fiscal policy that allows some room to manoeuvre the rules in support of growth.

The ECB has continued to take action, going ahead with the first TLTRO auction, with rather disappointing results, and setting in motion its purchase programme for assets in the hands of the banking system backed by credit. All the measures, those already implemented, those announced and those that will probably eventually be announced (secondary-market sovereign bond purchases) are designed to bring inflation expectations more closely into line with the objective of price stability, which have been de-anchoring since 2H12. In our most likely scenario, euro depreciation has to make a contribution, given the different expectations of Fed and ECB actions. While for the former we are expecting a gradual withdrawal of stimuli, for the latter we are expecting the opposite, balance-sheet expansion.

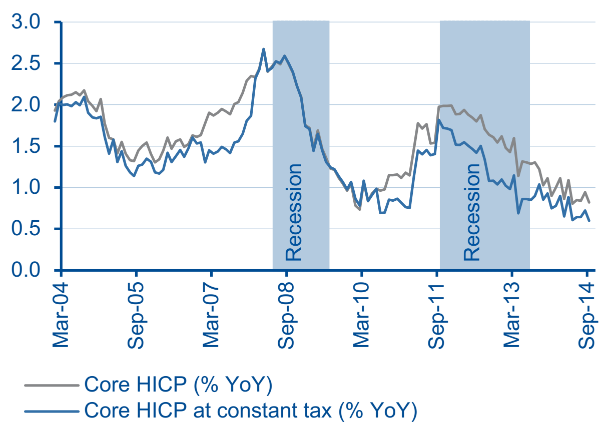
An additional positive element for the conditions of growth in the euro area is the recent announcement of the asset quality review and balance-sheet stress test that was carried out on the banking sector. This process has given the market more and more homogenous information on the European banking sector and implies the implementation of the common banking supervision in the eurozone. All of this is a necessary condition for allowing the flow of bank credit to meet solvent demand.

Chart 2.9
Eurozone: GDP growth (% YoY)



Source: BBVA Research

Chart 2.10
Eurozone: core inflation (% YoY)



Source: BBVA Research

3. Economic growth is slowing down as the year closes and should pick up in 2015

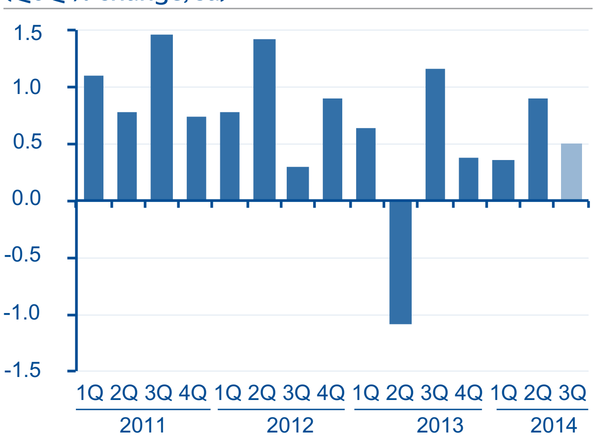
3.1 Economic activity perked up in the second quarter but eased up in the third

In 2Q14, the Mexican economy performed better than it had done going into the year, with seasonally-adjusted GDP growth QoQ coming in at 0.90%. This was driven by a major boost from the external sector, associated with the growth of the US economy over the quarter (1.13% QoQ sa). All the major sectors grew almost uniformly (QoQ sa), with the primary sector (agriculture and livestock) advancing 2.0%, the secondary sector (industrial activities) progressing 0.9%, and the tertiary sector (services) expanding by 0.9%.

On the other hand, 3Q14 GDP growth was 0.50% (QoQ, sa), which equates to growth of 2.1% YoY and was below estimates (BBVAe: 0.65%, consensus: 0.60%, both QoQ). In Q3 it was primary activities which performed the strongest, posting growth of 2.5%. These were followed by tertiary activities with growth of 0.5%, while secondary activities only managed growth of 0.4% (all QoQ sa). As well as this, growth for the first two quarterly readings of the year was revised downwards (1Q14 from 0.44% to 0.36%, and 2Q14 from 1.04% to 0.90%, both QoQ, sa), which suggests that economic activity has dragged its heels in the first nine months of the year. We are therefore revising annual growth for 2014 down from 2.5% to 2.1%.

This sluggish showing by GDP was associated with domestic demand weakness and only a limited upturn in investment. Here the foreign sector was the main driver of growth. We expect public sector expenditure in Mexico to be employed more efficiently over the rest of the year, specifically with a larger share for infrastructure and productive projects, and that the US economy will continue to make progress (see chart 3.2). Both factors are necessary for the country to achieve economic growth of 2.1% in 2014.

Chart 3.1
Gross Domestic Product 2011-14
(QoQ % change, sa)



sa = seasonally adjusted. e=BBVA estimate
QoQ=quarter on quarter.
Source: BBVA Research with information from INEGI

Chart 3.2
Mexican and US GDP, 2011-14
(QoQ % change, sa)

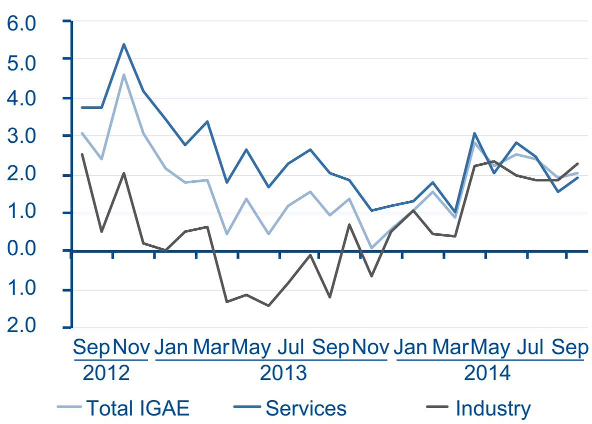
sa=seasonally adjusted. QoQ=quarter on quarter.
Source: BBVA Research with information from INEGI and the BEA

3.1.1 Domestic sector: foreign demand as the prime driver for growth in the Mexican economy. Goods consumption has fallen behind, although the recent pick-up in employment appears to suggest an upswing in the next few months

The growth rate of economic activity slowed down in 3Q14 relative to the previous quarter. This was because foreign demand has been the main driver of Mexico's economic growth (for further details see section 3.1.2), given that, despite recent progress, the domestic market has remained muted as a result of the scant growth of the labour market (see Section 4, Factors shaping private consumption in Mexico), which is still below the level observed in 2012.

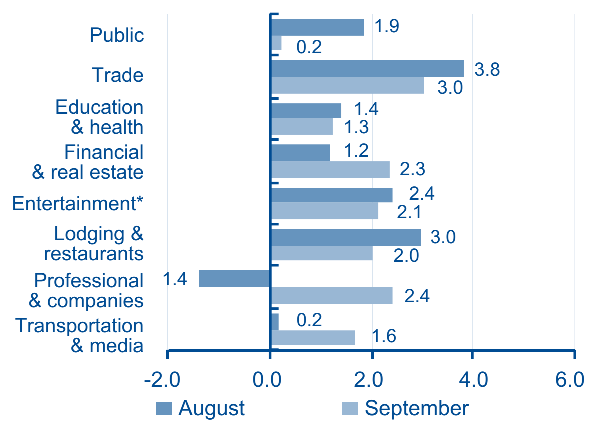
The annualised growth rate for September of the Global Economic Activity Indicator (IGAE) was 2.0% YoY, sa. The sectoral breakdown shows that agriculture grew by 7.6%, industry by 2.3% and services by 1.9%, all YoY sa (see chart 3.3). In monthly terms the IGAE was down by 0.1%, sa. This setback was principally on the retreats in industry (-0.1% MoM, sa) and agriculture (-1.0% MoM, sa). On the other hand, services rose by a meagre 0.1% MoM sa, which was associated with a slowdown for almost all of its components, especially public services (see chart 3.4). These readings show a slow but sure performance, attributable to a lack of domestic dynamism over the year.

Chart 3.3
Global Economic Activity Indicator (IGAE) and its components, 2012-14 (YoY % change, sa)



sa = seasonally adjusted. YoY = yea r-on-year
Source: BBVA Research with information from INEGI

Chart 3.4
Services sector: IGAE component, August to September 2014 (YoY % change, sa)



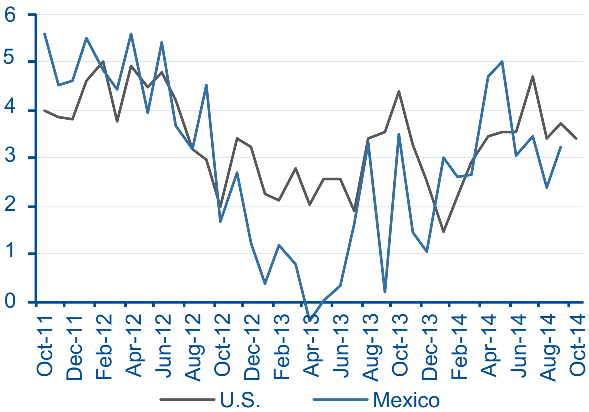
sa = seasonally adjusted. YoY = yea r-on-year. *BBVA estimates.
Source: BBVA Research with information from INEGI

One of the sectors which has most benefited from foreign demand (especially the United States) is industry, particularly manufacturing production, with growth of 0.3% MoM sa in September (see chart 3.5). The buoyancy of foreign demand is very noticeable in the case of the acceleration in auto exports.

The healthy pattern displayed by auto production and exports has gone from strength to strength over the year. According to the Mexican Automotive Industry Association (AMIA), from January to October 2014 cumulative vehicle production grew 8.5% relative to the like period in 2013, with vehicle export growth exactly matching this percentage (see chart 3.6). While auto exports continue to grow, Mexico's manufacturing industry will receive a major boost from this driver.

Chart 3.5

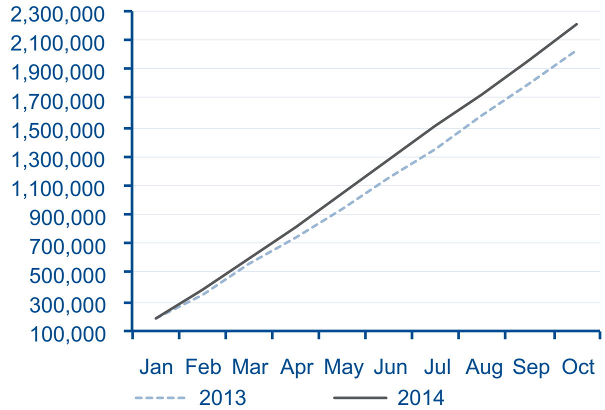
Mexican and US manufacturing production, 2011-14 (YoY % change, sa)



sa=seasonally adjusted. YoY=yea r-on-year
Source: BBVA Research with information from INEGI

Chart 3.6

Auto exports 2013 and 2014 (cumulative unit sales)

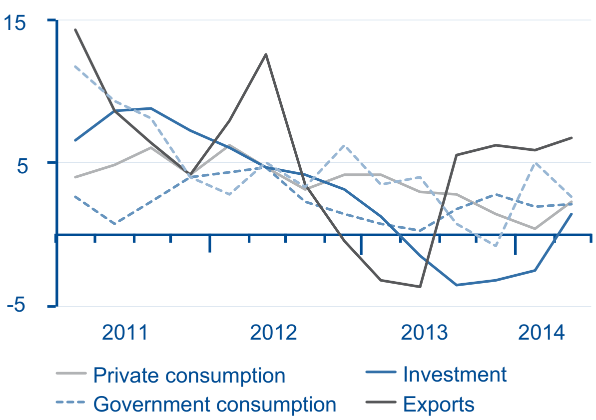


YoY=yea r-on-year
Source: BBVA Research with information from INEGI

Here we should point out that up to now information is only available up to 2Q14 for Mexican aggregate demand components. These performed better than they had done in the previous quarter (see chart 3.7), although we predict that in Q3 progress will be more modest. The element which saw the largest annual growth rate was exports, which rose 6.8% in 3Q14 vs 5.9% in 2Q14. Consumption made positive progress, though this was slight owing to deficient job creation and the limited increase in real wages in 2Q14 (see section 3.1.3). Private consumption rose 2.3% YoY, while public consumption did so by 2.1%, which compares with 0.4% and 2.0% respectively (both YoY) for the previous quarter (see Box 1). Total gross fixed capital formation advanced by 1.4% YoY in 2Q14, having fallen back by 2.5% YoY in 1Q14. Notable here were private investment, up by 3.3% YoY, and the 8.4% drop YoY in public investment in 2Q14. Imports grew by 2.7% YoY in 2Q14, which was about half of their rise the previous quarter (5.1% YoY), all seasonally adjusted. For Q3 the performance of the GDP components is expected to be more subdued than in Q2.

Chart 3.7

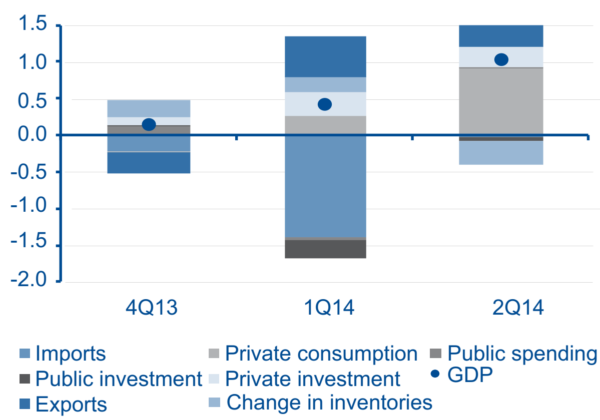
Aggregate demand: components, 2011-14 (YoY % change, sa)



sa = seasonally adjusted. YoY = yea r-on-year
Source: BBVA Research with information from INEGI

Chart 3.8

Contribution to GDP growth, 4Q13 to 2Q14 (percentage points, QoQ, sa)

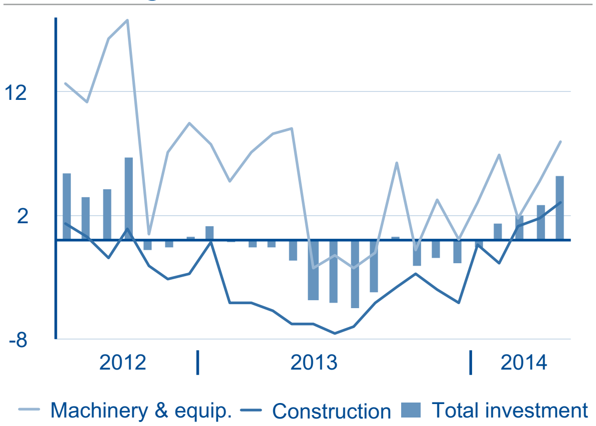


sa = seasonally adjusted. QoQ = quarter on quarter
Source: BBVA Research with information from INEGI

As regards the share of these components in GDP growth, the elements which made a positive contribution in 2Q14 were headed up by exports, which were followed by private consumption, then private investment, and lastly public expenditure. There was a negative contribution to growth from the variation in stocks, public investment and imports (see chart 3.8). These results mean that uncertainty lingers over the marginal, and even negative, contribution of public expenditure and investment to quarterly GDP growth, as they are factors that are key to the country's economic recovery, even more so considering current public expenditure growth. We therefore expect public investment to be managed efficiently and to focus on productive infrastructure projects that have an energising and permanent effect on GDP growth. This factor and the implementation of the economic reforms could prove to be the elements that kick-start more substantial potential growth in the medium term (see Box 2). In fact, in October the international assessment in the report "Doing Business 2015: Going Beyond Efficiency" was announced, and, among other aspects thanks to these reforms, Mexico's ranking improved among those countries best placed in terms of ease of doing business. Mexico rose four places, from 43rd in the report for 2014 to 39th in the 2015 ranking. Although this is a positive sign, it should be said that the country still has some way to go in terms of improving its competitiveness and productivity.

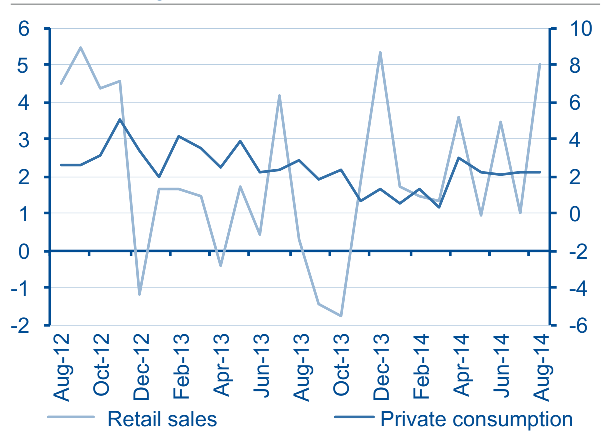
For 3Q14, total gross fixed investment and its components are expected to continue to make inroads into positive territory. From June there are figures which support this prospect, since that month marked the first time since November 2012 that all the investment components posted positive annual variation rates in seasonally adjusted terms. Moreover, in August these components showed strong growth. Machinery and equipment grew by 8.0% YoY, sa. The domestic sub-component rose by 5.9% while that for imports did so by 9.0% (both YoY, sa). Construction progressed by 3.1% YoY sa, a rate not seen since July 2012 (see chart 3.9). These figures nevertheless still seem to fall short of the level required to achieve vigorous and sustained economic growth. For this to happen, both greater private investment and a good fit with public investment projects are required. The latter are outlined in the 2014-18 National Infrastructure Programme and we expect public funds for this to be employed productively, efficiently and transparently in the coming months to underpin the expansion of the Mexican economy.

Chart 3.9
Investment components, 2012-14 (YoY % change, sa)



sa=seasonally adjusted. YoY=yea r-on-year
Source: BBVA Research with information from INEGI

Chart 3.10
Retail sales and private consumption, 2012-14 (YoY % change, sa)



YoY=yea r-on-year
Source: BBVA Research with information from INEGI and the Secretariat of Labour and Social Welfare

Retail sales levels over Q2 and most of Q3 revealed positive growth rates. Notably, the annualised rate of change in August was 5.0% sa, which was the largest since December 2013. Average retail sales growth between January and August 2014, however, was 2.3%, which was over the level of 1.4% which this indicator had shown for the like period in 2013, but still below the 2012 figure for the comparable period of 4.4%. This suggests a mild economic recovery, which has manifested itself in low goods consumption growth of close to 2%, according to the figures available up to July 2014 (see chart 3.10). Consumption weakness also becomes apparent if we remember that, according to CONEVAL, 3Q14 represents the juncture marking four years of a rise in the percentage of the Mexican population whose income is not enough to cover their basic needs. With respect to this quarter each year, this percentage has climbed from 46.8% in 2010 to 48.9% in 2011, 51.1% in 2012, 52.9% in 2013 and 54.5% in 2014 (around 62 million Mexicans).

The confidence of economic agents showed improvement as far as Q3 too, though expectations regarding dynamic growth in the coming months were mixed. For example, the Producer Confidence Index touched 53.2 points in September 2014, which represented a high since August 2013. Meanwhile the Consumer Confidence Index showed a reading of 90.4 points in September 2014, which is short of the figure of 92.7 points registered that same month in 2013. What this means is that, even though we can expect an upturn in the macroeconomic climate soon, the feeling is that this will be limited.

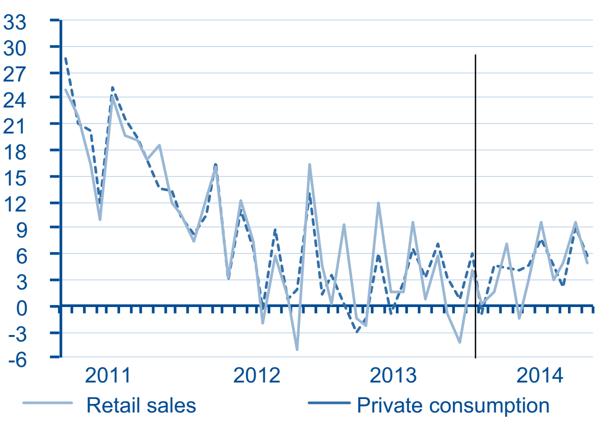
3.1.2 Foreign sector

3.1.2.2 Goods exports

Over 2014, the foreign sector has performed better than it did in 2013. For example, in 2013 the growth rate for goods exports was negative for January, February, April and December. With respect to the first 10 months of 2014 the export growth rate has been positive from February (chart 3.11). Additionally, exports have been more robust in the first 10 months of 2014 than they were in the same months in 2013, as the average annual growth rate over this time in 2014 was 4.6%, whereas for 2013 this figure was 2.3% (chart 3.12).

Chart 3.11

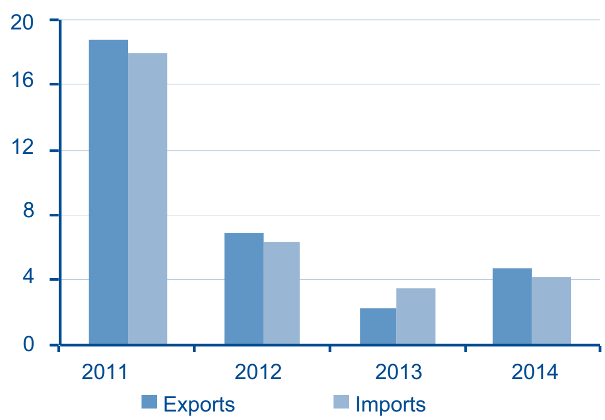
Goods exports and imports (YoY % change)



Source: BBVA Research with information from INEGI

Chart 3.12

Goods exports and imports: average growth rate, January to October (YoY % change)



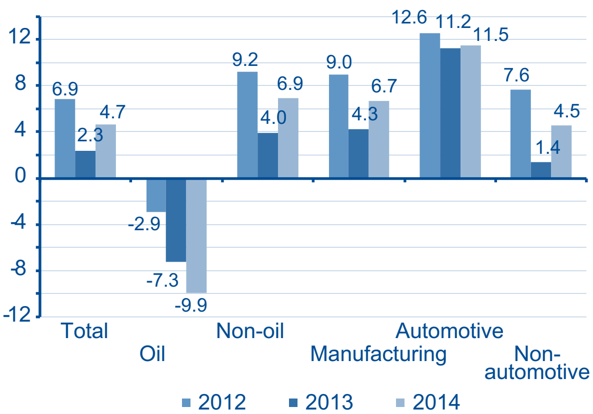
Source: BBVA Research with information from INEGI

On the other hand, the annual growth rate for total cumulative goods exports from January to October 2014 was 4.7%, which was higher than the rate of 2.3% for the comparable period in 2013. This was prompted by the greater vigour of non-oil exports, and in particular manufacturing exports (auto and non-auto manufacturing exports). Auto exports advanced by 11.5% YoY from January to October 2014, while non-auto manufacturing exports were up 4.5% YoY over the same period (see chart 3.13).

Conversely, oil exports braked sharply, down 9.9% in the first 10 months of this year, following on from the figure of -7.3% in 2013. The slowdown in oil exports is as a result of a lower export volume and average price per barrel exported. To clarify, and based on the latest information available, up to September, from January to September 2013 a monthly average of 1.174 million barrels of crude oil per day (mbd) were exported and for the same range of months in 2014 the average volume exported fell back 4.3%, given that the average volume exported dropped to 1.124mbd. As regards the average price of the barrel of Mexican mix for export, for 2013 to September this was USD100.7 and for the same period in 2014 it dropped 6.8%, down to USD93.86.

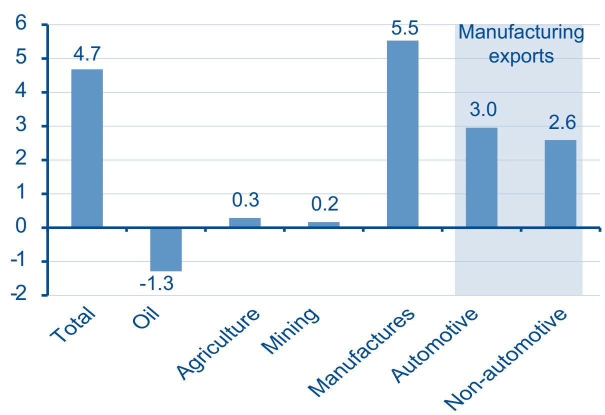
The diminished value of oil exports led to a negative contribution to goods export growth from January to October 2014 of 1.3pp, whereas manufacturing exports contributed 5.5pp, which breaks down into 3.0pp from auto exports and 2.6pp from other manufacturing exports (see chart 3.14). It should be remembered that the stronger showing by manufacturing exports in 2014 YtD is largely due to the upturn in the US economy, particularly in the industrial sector.

Chart 3.13
Cumulative goods exports, January to October (YoY % change)



Source: BBVA Research with information from INEGI

Chart 3.14
Cumulative goods exports, January to October (Contribution to growth, percentage points, pp)



Source: BBVA Research with information from INEGI

Finally, it is worth noting that in October 2014 goods exports grew at an annual rate of 5.7%, which is higher than the average rate of 4.7% that exports indicated for the first 10 months of the year. The fine performance by exports in October was to a great extent attributable to non-auto manufacturing exports, as the annual growth rate for these in October was 18.6%. On the other hand, the annual growth rate for manufacturing exports that same month was 5.1%.

These figures suggest that to the extent that the current growth rate of non-auto manufacturing exports is sustained, and also that this might rise in the near future, it is evident that the strength of Mexico's export sector could receive a considerable boost and could thereby make a larger contribution to the country's economic growth. This point can be put into perspective if we consider that non-auto manufacturing exports account for almost 57% of total exports and some 68% of manufacturing exports.

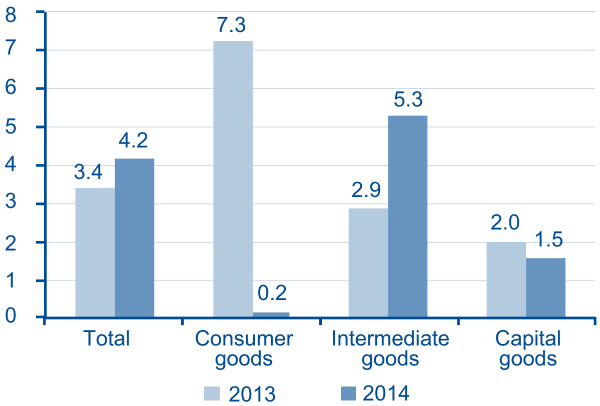
3.1.2.3 Goods imports

In connection with trends for goods imports, the cumulative total for the average annual growth rate for the first 10 months of 2014 was 4.2%, which was higher than the rate of 3.4% observed for the same monthly range in 2013 (see chart 3.15). Notable here is the fact that in the first 10 months of 2014 consumer goods imports have grown a little (0.2%), while imports of capital goods have only advanced slightly (1.5%).

Intermediate goods imports have been the most lively, as the average annual growth rate for the overall amount of these in the first 10 months of 2014 has been the highest of the three categories examined (5.3%). This has meant that this class of imports has almost single-handedly contributed to total import growth in the first 10 months of 2014 (see chart 3.16).

Chart 3.15

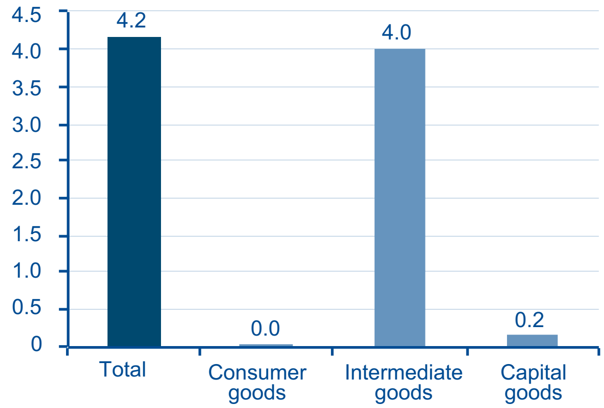
Cumulative goods imports, January to October (YoY % change)



Source: BBVA Research with information from INEGI

Chart 3.16

Cumulative goods imports, January to October (Contribution to growth, pp)



Source: BBVA Research with information from INEGI

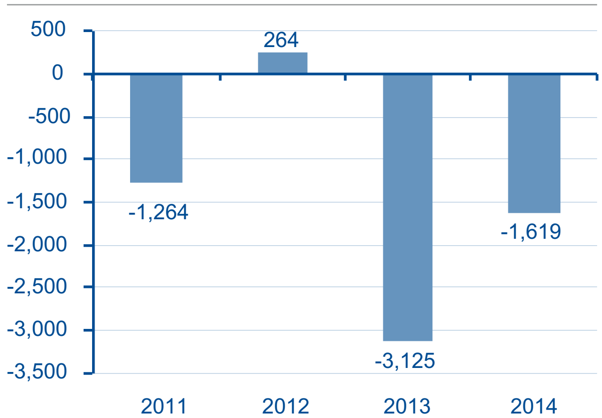
It should be pointed out that intermediate goods imports are, to a large extent, linked to exports of finished goods themselves and the production of goods for domestic consumption. In this sense, an upswing in the US economy could be expected to lead to both more exports and increased imports of intermediate goods. As the country's export sector gathers momentum and consolidates, a higher growth rate for capital goods imports will be noted.

3.1.2.4 Trade deficit

Over the first 10 months of 2014 the cumulative balance of trade has shown a deficit of a little over USD1.6bn, which is lower than the deficit of USD3.1bn that this account registered over the same monthly span in 2013 (see chart 3.17). It should be noted that over the first 10 months of 2014 the balance of trade was only actually in deficit in January (USD3.2bn), July (USD1bn) and August (USD1.1bn), whereas in 2013 and for the same monthly range there was a deficit in a greater number of months: January, April, May, July, and August (see chart 3.18).

Chart 3.17

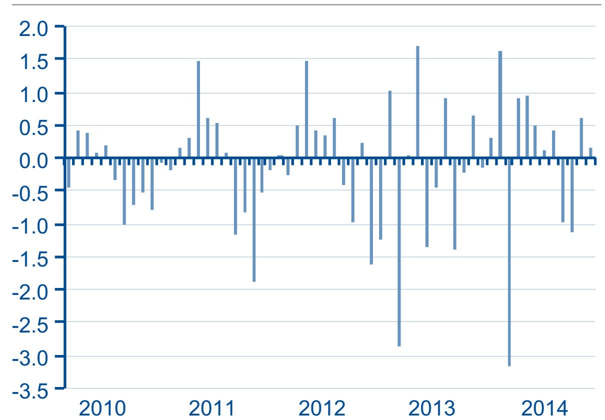
Cumulative balance of trade, January to October (USD mn)



Source: BBVA Research with information from INEGI

Chart 3.18

Balance of trade by month (USD bn)



Source: BBVA Research with information from INEGI

If the US economy's growth rate is high, a big imminent demand for Mexican exports is likely to translate into a trade surplus. This will also be mirrored in faster growth of Mexico's economic activity.

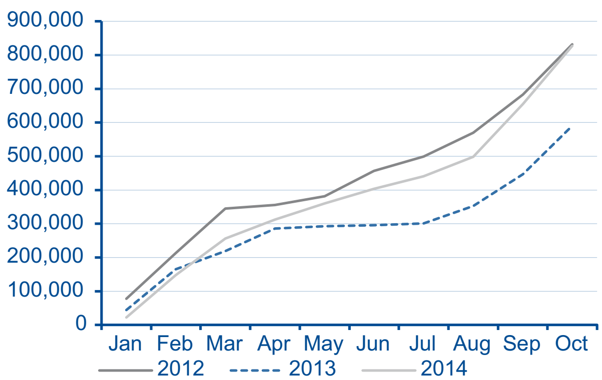
3.1.3 Employment

3.1.3.1 IMSS-registered employment: formal employment remains on the rise

Trends in the total number of workers registered with the Mexican Social Security Institute (IMSS) are strongly linked to the performance of various macroeconomic variables, such as private consumption (see Section 4, Factors shaping private consumption in Mexico). The total number of workers registered with the IMSS also represents formal sector employment generated by the private sector.

Chart 3.19

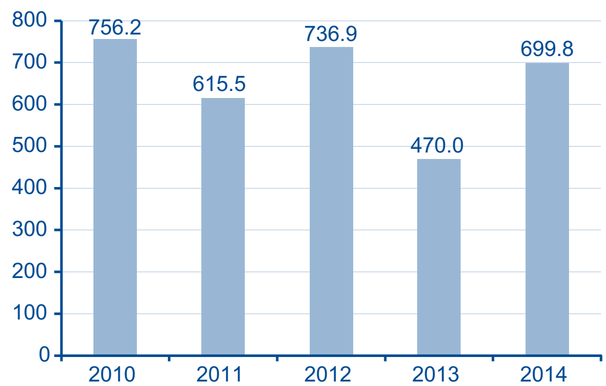
Increase in the total number of workers registered with the IMSS, December to October (Number of persons)



Source: BBVA Research with information from the IMSS.

Chart 3.20

12-month cumulative total for number of workers registered with the IMSS, October to October (Thousands of persons)



Source: BBVA Research with information from the IMSS.

Even though the increase in formal employment has been greater in the first 10 months of 2014 compared to the same period in 2013, so far this is below the growth registered by formal employment filed with the IMSS that was reported in the first 10 months of 2012 (see chart 3.19).

If we consider job creation over a 12-month span, we see that from October 2014 to the same month in 2013 some 48.9% more jobs had been created than between September 2013 and the same month in 2012 (see chart 3.20). This second indicator confirms a better performance by IMSS formal employment in 2014 than in 2013.

3.1.3.2 IMSS job formalisation programme

From 2H13, the Secretariat of Labour and Social Welfare (STPS) embarked on a programme to promote job formalisation. This consists of encouraging workers who are in informal employment, in the sense that they have no social security cover, to regularise their situation and therefore register with the IMSS. Consequently, a portion of the rise in the number of workers registered with the IMSS that was posted from August 2013 is attributable to this programme. The employment authority estimates that in 2013 around 300,000 jobs were formalised.[1]

These figures suggest that even though the total increase in job registrations with the IMSS in 2013 was for 463,018 persons, taking out the effect of the job formalisation programme only 163,000 jobs would have been created as a result of growth in economic activity that year. It is worth recalling that GDP in that year grew 1.4%. These figures show that 65% of the increased employment registered with the IMSS in 2013 originated from the job formalisation programme and the other 35% came from an expansion of economic activity.

[1] The article headed "40,000 jobs formalised in the State of Mexico", which was published in El Financiero on 7 February 2014 says that the Secretary of Labour and Social Welfare had stated that "…initial STPS figures show that across the whole country and via the Social Security system around 300,000 jobs were formalised in 2013, which are not new jobs because they have not been generated by economic growth, but by job formalisation instead ". In the press release of 7 February 2014 issued by the STPS it says that the Secretary of Labour and Social Welfare "… emphasised that among the targets subscribed to in the presence of the President of Mexico as part of the programme to migrate to job formalisation, that for the State of Mexico was among the highest, at 40,000, and 'Doctor Eruviel Ávila's government met this in full".

3.1.3.3 Trends in formal IMSS employment in 2014

The job formalisation programme is still in progress and so it is reasonable to expect a sizeable share of the increase in the number of workers registered with the IMSS to derive from efforts in this direction.[2] It is worth noting that the authorities have pointed out that a feature of the formalisation process has been that it has boosted the number of temporary workers on low wages.

With respect to monthly job registrations with the IMSS, a marked rise can be observed in the opening months of the year, which then slows down from May to July, and thereafter climbs again until November. What stands out here is that October 2014 shows a substantial increase in registrations with the IMSS, at slightly over 172,000 jobs, which represents the largest monthly increase for October in recent years. Out of this rise, the contribution from temporary workers was 28%. This could serve as an indicator of the impact of increased public expenditure on infrastructure construction, as a very significant part of formal employment generated within the temporary employment format is from the construction industry. By the same token, a large slice of this increase could also derive from the job formalisation programme. The remaining 72% was from workers with permanent employment contracts.

The progress made in formalising employment in Mexico is very considerable, because it means that a larger percentage of the population has social security cover and that this segment has managed to reduce the extent of its vulnerability, boost its level of welfare and enhance its quality of life. On the other hand, it would help in this regard if statistics were available on worker registrations with the IMSS which originate from job formalisation. This would be useful in discovering how successful the programme is, and to monitor with greater clarity the economic variables which rely crucially on job creation, such as, for example, private consumption (see Section 4: Factors shaping private consumption in Mexico).

3.1.4 Public finances

From January to October 2014, total public sector budget revenues showed a real annual growth rate of 2.5%. This arose from an annual decline of 1.8% in oil revenues and growth of 4.7% for non-oil revenues. The former accounted for 31.7% of total revenues for the period under review and the latter contributed the remaining 68.3% (see table 3.1).

Table 3.1
Cumulative public sector budget revenues (MXN bn)

	January to October 2014		
	Sum total	Real % chge.	Struc. %
Total	**3,182.3**	**2.5**	**100.0**
Oil	1,008.3	-1.8	31.7
Non-oil	2,173.9	4.7	68.3
Federal government	2,337.3	3.6	73.4
Tax	1,492.6	11.2	46.9
Non-tax	844.7	-7.7	26.5
Agencies & Co.	844.9	-0.1	26.5

Source: BBVA Research with SHCP data

Table 3.2
Cumulative public sector budget expenditure (MXN bn)

	January to October 2014		
	Sum total	Real % chge.	Struc. %
Total	**3,635.7**	**8.4**	**100.0**
Projected Expenditure	2,902.5	9.3	79.8
Current Expenditure	2,172.9	7.3	59.8
Capital Expenditure	729.6	15.7	20.1
Non-Projected Expen.	733.3	5.0	20.2
Investmnts. in States	494.7	5.7	13.6
Borrowing Cost	217.5	4.0	6.0
Adefas and other	21.1	-0.8	0.6

Source: BBVA Research with SHCP data

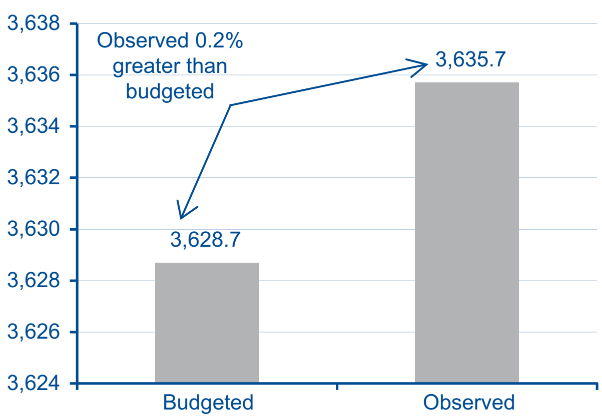
As has already been mentioned, the dampening of public sector oil revenues is largely due to a decline in the crude oil export platform. On the other hand, public sector non-oil revenues were boosted by tax revenue growth (with a cumulative real annual growth rate of 11.2% from January to October 2014), which were driven by tax hikes within the

[2] In an interview of the Secretary of Labour and Social Welfare which was published by El Financiero on 15 October 2014 and titled "Temporary employment and the first step on the ladder with a mini-wage", he said, with reference to the progress made by registrations of workers with the IMSS, that "... we must work on the assumption that there are a good number of registrations which are from job formalisation by those in work and that we will be able to close off collections after October and early November because we will be faced with the prospect of the December downturn".

context of the tax reform programme. Over the first 10 months of the year both the special tax on production and services (IEPS) and VAT were particularly strong, as the real annual growth rate of the former was 49.1%, and that of the latter 16.9%. Cumulative income tax (ISR) revenues over the same timeframe mentioned slipped back at a real annual rate of 2.6%.

Looking at cumulative public sector budget expenditure, this experienced a real annual growth rate of 8.4% from January to October 2014. Over this span of months projected expenditure, which accounts for almost 80% of the total outlay, grew by 9.3% in real annual terms (the current expenditure component did so by 7.3% and capex grew by 15.7%). On the other hand, non-projected expenditure, which represents the remaining 20% of overall expenditure, rose at a more sedate rate of 5% (see table 3.2).

Chart 3.21
Cumulative public sector budget expenditure, January to October: projected and observed (MXN bn)



Source: BBVA Research with SHCP data

Table 3.3
Cumulative public sector financial position, January to October (MXN bn)

	2013	2014	Real % chge.
Public balance	-218.1	-437.1	ns
Publ. bal. ex Pemex investment	-23.6	-16.4	ns
Budget balance	-241.7	-453.5	ns
Budget revenue	2,983.9	3,182.3	ns
Net budget expenditure	3,225.7	3,635.7	ns
Federal government	239.4	-405.9	ns
Agencies and companies	-2.3	-47.5	ns
Pemex	-62.2	-143.4	ns
Other companies	59.9	95.9	54.0
Indirectly-controlled institutions	23.6	16.3	-33.6
Primary balance	-24.9	-217.4	ns
Budget balance	-40.6	-236.0	ns
Federal government	-71.7	-230.4	ns
Agencies and companies	31.1	-5.6	ns
Pemex	-38.1	-111.4	ns
Other institutions	69.2	105.8	47.1
Indirectly-controlled institutions	15.7	18.6	13.9

ns=not significant
Source: BBVA Research with SHCP data

On the other hand, expenditure carried out in the YtD is in line with the amount budgeted for, and the difference is only minimal (see chart 3.21).

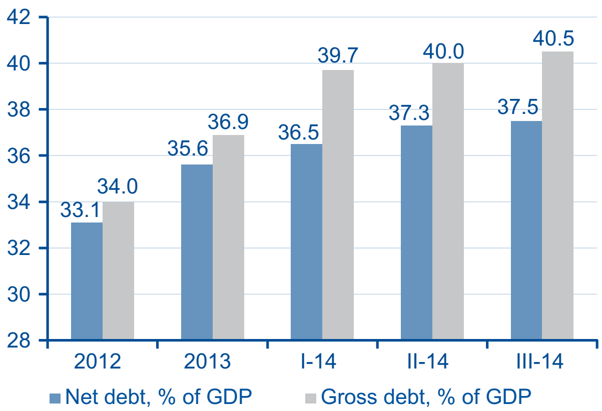
As illustrated by the figures for Mexico's public sector budget revenues and expenditure for the first 10 months of the year, the greater buoyancy of expenditure activity than that of revenues in the public sector has led to a public deficit over this period which has outstripped that of 2013. This is already on a substantial scale (see table 3.3), even without including the deficit arising from the Pemex investment, as is the case for the deficit emerging in the primary balance.

Including the investment in Pemex, the scale of the cumulative deficit over the first 10 months of the year works out at twice as large as it does in the scenario where the fiscal deficit leaves out the Pemex investment. Given the vastness of the investment that has been made in Pemex over the first 10 months of this year, positive results should materialise reasonably soon, in the form of increased crude production by the company, for example.

The public sector deficit has fed through into rising debt as a proportion of GDP, regardless of whether net or gross debt is examined (chart 3.22). By way of illustration, between the end of 2013 and September 2014 (the latest available figure) gross debt moved up by 3.6pp as a proportion of GDP, from 36.9% to 40.5%.

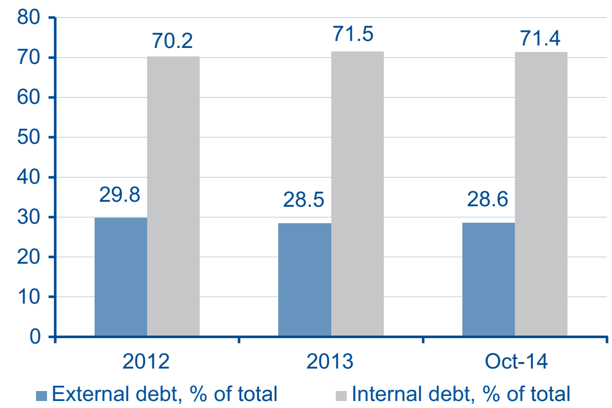
Bearing in mind that public sector debt brings about a borrowing cost in the medium term, where the servicing of this is covered using public funds, it thus becomes apparent that gross debt not only shows that the country is borrowing more, but also betrays a heavier financial burden on it. In this sense, the swelling of gross debt should mean thinking very seriously about the future financial obligations that it implies.

Chart 3.22
Total net and gross public sector debt as a proportion of GDP (%)



Source: BBVA Research with information from the SHCP

Chart 3.23
Percentage composition of total public sector debt, both domestic and external (%)

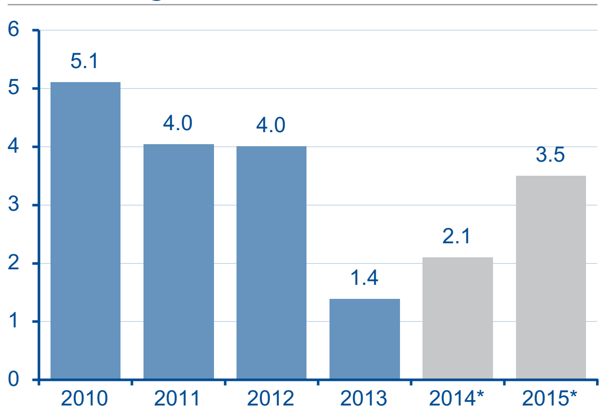


Source: BBVA Research with information from the SHCP

3.1.5 Outlook: the economy is making headway in its recovery and in lifting potential GDP, although sluggish economic activity and serious risks to growth persist

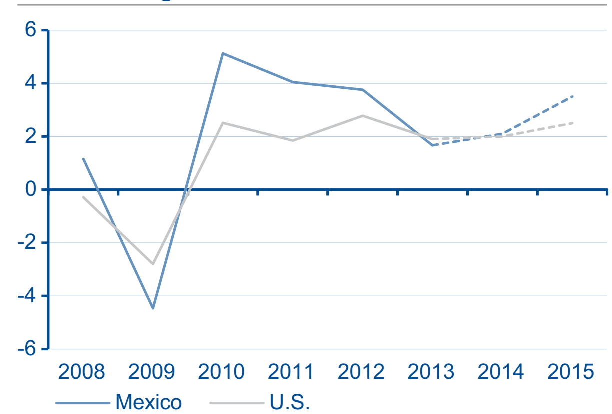
The healthy progress of foreign demand, particularly from the direction of the US economy, has worked in favour of Mexico's economic performance over the year. Nevertheless, consumption and investment have been extremely weak. We therefore forecast that economic growth for 2014 will be 2.1% and 3.5% for 2015. These growth rates mostly depend on the pick-up in growth in the US economy not losing steam (2.0% for 2014 and 2.5% for 2015) and the efficient and productive channelling of public expenditure in Mexico.

Chart 3.24
Mexican annual GDP growth, 2010-15 (YoY % change)



YoY = yea r-on-year
Source: BBVA Research with information from INEGI

Chart 3.25
Mexican and US GDP, 2008-15 (YoY % change, sa)

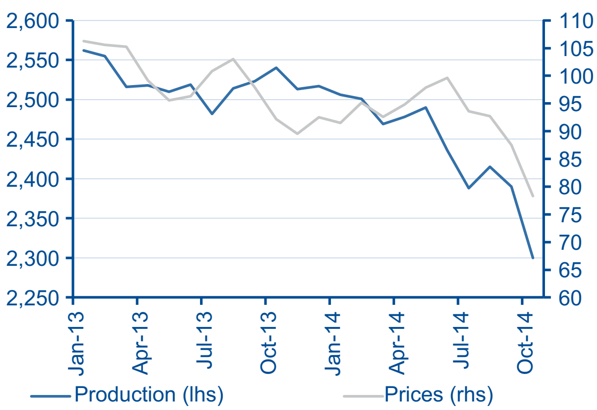


sa = seasonally adjusted. YoY = year-on-year
Source: BBVA Research with information from INEGI and BEA

Furthermore, certain risks loom over this scenario. On the one hand, the US economy's performance might not turn out to be robust enough, as mixed indicators are being reported which fuel a degree of uncertainty over its economic resilience. For example, in 3Q14 the US economy grew 0.9% QoQ, sa (underpinned by a lower than expected trade deficit and a considerable step-up in defence spending), yet consumption is wavering. Besides this, even if a sustained recovery emerges in the US economy, the challenge remains in Mexico to capitalise on the advantages provided by the proximity of the United States by speeding up the process of bringing down electrical energy costs and by delivering productive chaining and one-stop supply policies for Mexico's export chain. On the other hand, another subject which should be borne in mind is that, in spite of the increase in public expenditure in Mexico, there are still no clear signs that the bigger injection of funds is having a revitalising effect on the economy.

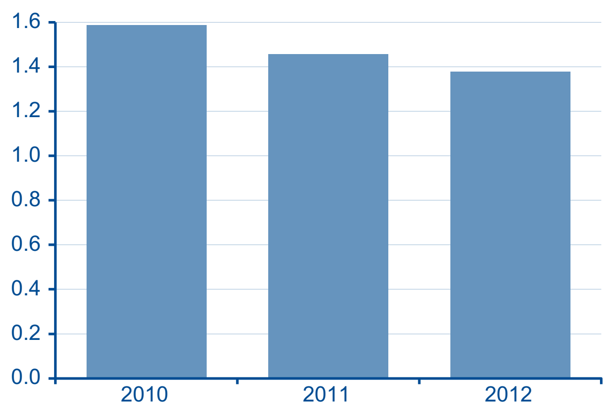
Other risks also lurk, which could threaten Mexico's economic growth. One of these is the drop in world Mexican oil mix and production platform prices, and the effect of this on the country's public finances (see chart 3.26 and Box 2: Effects of a fall in the oil price on the Mexican economy). Another risk, which is just as serious, relates to the pattern of crime and crime rates in Mexico over time. According to INEGI, the economic cost of crime has come down from 1.6% of GDP in 2010 to 1.4% in 2012 (see chart 3.27). Even so, this places considerable constraints on achieving greater development and economic growth in the long term, which have to be overcome to avoid holding up Mexico's economic expansion.

Chart 3.26
Mexican mix oil production and prices, 2013-14 (Barrels of oil, USD per barrel, eop)



sa=seasonally adjusted. YoY=yea r-on-year
Source: BBVA Research with information from INEGI

Chart 3.27
Economic cost of crime (% of GDP)



Source: BBVA Research with information from INEGI

On the other hand, the president of Mexico, Enrique Peña Nieto, recently gave an address with the theme "For a Mexico at peace, with justice, unity and development" at the National Palace two months on from the disappearance of 43 students from the Ayotzinapa Normal Rural School. In his speech he unveiled a plan aimed at bringing down violence levels, bolstering the State's institutional framework and laying down guidelines and rules to afford greater protection of citizens' human rights. This comes in a climate of mounting insecurity, a phenomenon which, if left unchecked, could seriously undermine Mexico's economic progress. Although the cost of crime was brought down in 2012 or thereabouts, it still represents a high price for Mexico considering the deficiencies facing the Mexican population, as well as the backwardness of various institutional elements in relation to public safety and how justice is administered. For the measures announced to enjoy success and achieve their objectives, the government's ability to deliver will be crucial in the complex area of administering justice and public safety in a situation where there is a serious backlog of action to be taken in implementing the reforms already passed.[3]

To conclude, even though foreign demand has driven Mexico's economic growth, steps really must be taken to facilitate a departure from weak consumption and investment that is proving inadequate. For this reason we think that a powerful boost from the State in the areas of investment and security is called for, as well as a structure that complements the private sector and the inclusion of citizens to foment the changes which Mexico requires to achieve increased productive activity and an enhancement of the welfare of Mexicans in the medium and long term.

[3] See the Mexico Flash: "*The Plan of Justice by the Federal government is a key step to improve the living conditions of all Mexicans*", at https://www.bbvaresearch.com/wp-content/uploads/2014/11/141127_FlashMexico_PlanJusticia.pdf

Box 1: Effect of structural reforms on long-term GDP

One of the key objectives of the structural reform process underway in Mexico is to enhance long-term economic growth. The reforms aim to minimise the obstacles which are currently hampering the country's economic growth, as well as to allow private sector investment in activities that were formerly the exclusive preserve of the public sector.

The energy reform, in particular, will be one of the drivers of stronger economic growth in Mexico, based on the heavy investment expected in the industry and the galvanising knock-on effects of this on a large number of the country's productive sectors. The reform was enacted by the federal government on 20 December 2013 and published the following day in the *Diario Oficial de la Federación* (Official Journal of the Federation). The secondary laws endorsing it have also been published, which provide the reference framework for the reform to become operative very shortly and to produce the expected results. Specifically, the energy reform is expected to gradually lift both domestic and foreign private investment in the sector to USD25bn by the year 2020. These funds will deepen the industry's infrastructure and will therefore strengthen the domestic energy supply, among other long-term benefits which the energy reform will bring to Mexico.

Given the investment flows described which should arise from the energy reform, as well as other essential macroeconomic circumstances, such as vigorous public investment in several projects which have already been announced and stable economic growth in the United States,[1] the economic reforms enacted recently in Mexico should bring about an increase in the growth rate of the country's potential GDP. This should climb steadily from our current 2.9% estimate for the growth rate of potential GDP to 4.0% in 2020. The table and the figure below show how Mexico's potential GDP growth rate should gradually rise.

Table 3.4
Annual GDP growth, 2014-20 (YoY % change, sa)

	Baseline scenario	Scenario with reforms	Reforms*
2000-13 avge.	2.3		
2014	2.1		
2015	3.5	3.5	0.0
2016	2.9	3.4	0.5
2017	2.9	3.5	0.6
2018	3.0	3.7	0.7
2019	2.9	3.9	1.0
2020	2.9	4.0	1.1

sa = seasonally adjusted. YoY = year-on-year
*Reforms included: energy sector and public infrastructure investment
Source: BBVA Research with information from INEGI

Chart 3.28
Annual GDP growth, 2014-20 (YoY % change, sa)

sa = seasonally adjusted. YoY = year-on-year
Source: BBVA Research with information from INEGI

[1] A significant assumption is that it is understood that the public sector invests those sums of funds which are given in the 2015 General Criteria for Economic Policy which the Secretariat of Finance and Public Credit (SHCP) announced in September 2014, and also that the National Development Programme is fulfilled. Other very big assumptions are that the price of Mexican mix crude oil for export will be USD82/bbl from 2016 onwards, and that the US GDP will grow in a stable and sustained manner at 2.5%, and 2.8% a year in 2015-20.

To arrive at these results, several models were used in our estimates,[2] and in each of these it was assumed that the annual inflow of investment prompted by investment in the energy sector began at USD2bn and reached USD25bn in 2020, in addition to the assumptions already described. The investment generated in the energy sector should feed through into higher sector production capacity, increased tax revenues for Mexico and thus also lead to a higher level of public expenditure and investment. All of this translates into increased employment, which means greater welfare for Mexico's families as well.

The most remarkable conclusions of the findings which are generated by the estimates of the increase in the potential GDP growth rate after the reforms are that: i) there are positive and significant effects on Mexico's economic growth from the reforms which mean that the economy's potential growth rate should manage to reach 4.0% in the medium term; ii) economic activity needs to be stimulated all along the way by greater public investment and efficient use of the funds applied for this purpose, and lastly iii) although the previous points are important, a positive international economic environment is required which would be provided by sustained growth of the US economy.

To summarise, given that the structural reforms that have been passed are a prerequisite to achieving a faster pace of economic growth for Mexico, now that this has happened the next step is to implement them transparently and effectively so as to produce a sustained rise in family incomes.

[2] The models used were: i) Cobb-Douglas: this model assumes the traditional structure of a Cobb-Douglas production function. The added investment arising from the reform affects the level of capital (K); ii) Input-output matrix: by using technical production coefficients in an input-output matrix, we obtain the effect on GDP of additional investment; iii) Imports-investment: this model estimates the impact of additional investment on GDP, taking into account the negative effects of a rise in imports on the Mexican economy, and iv) a macroeconomic model of GDP components: this relates to a system of equations for the various GDP components assuming certain levels of investment, public expenditure and exports for each year, based on the propositions given in the section titled "2016-20 Medium Term Economic Outlook" in the General Criteria for Economic Policy for the 2015 fiscal year published by the Secretariat of Finance. The different models yielded similar results.

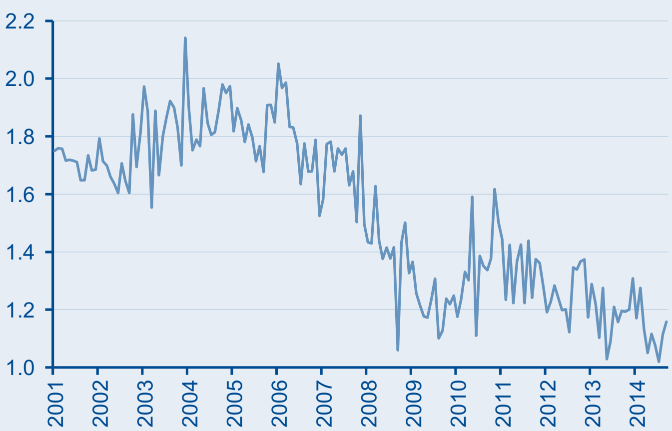
Box 2: Effects of a fall in the oil price on the Mexican economy

In Mexico, oil accounts for around 10% of the country's total exports. Even though this percentage share has fallen substantially in recent decades (in the 1970s it came to represent as much as c.75%), Mexico is still a major exporter of this commodity, though far less reliant on it. From the point of view of the public sector budget, however, oil remains extremely important, given that 30% of tax revenues derive from this source.

These two factors imply that a fall in the oil price should have negative effects on Mexico's economy. There are nonetheless also positive consequences of lower oil prices for Mexico, which soften these adverse effects. The first of these is that lower oil prices help to spur on the US economy. This is because petrol prices in the United States are directly linked to oil prices (as might reasonably be expected when these are determined by market forces), which means that when the petrol price falls the available income of families is boosted, so consumption rises and, to a lesser extent, so does investment. As we know, a stronger performance by the US economy leads to a higher volume of Mexican exports into the United States and, by extension, the Mexican economy fares better. The second consequence is that Mexico is becoming an importer of petrol, with 50% of this originating from abroad. This means that when the oil price falls the petrol imported into Mexico is cheaper, which is good for public finances. Thus the recent slip in the petrol price in the external market will have a positive impact on the public coffers, as the petrol price in Mexico currently stands between 13% and 16% higher than that observed in the United States. The more the oil price comes down, the greater will be the tax revenues due to the fact petrol can be sold at a higher price than that paid for importing it. This implies that the Mexican government has an automatic hedging mechanism available against falls in the oil price.

Overall this means that the Mexican economy is adversely affected when there is a fall in the oil price, though less so than in the past. In specific terms, we estimate that for every USD10 fall in the oil price, a decrease of 0.2 percentage points in GDP is experienced. Thus, if the price of Mexican mix oil comes down from an average level of 90 dollars to one of 50-60 dollars per barrel, the economy should grow by 0.6% to 0.8% less. Here we should point out that these estimates do not factor in the possibility of the US economy picking up speed on the fall in the oil price.

Chart 3.29
Mexican crude oil exports (million barrels per day, mbd)



Source: BBVA Research with information from INEGI.

Chart 3.30
Mexican mix oil price (USD per barrel)

Source: BBVA Research with information from Bloomberg.

With regard to the public finances, no substantial negative effects are expected in 2015. This is because the government has bought oil hedges at price levels of around 76 dollars per barrel, whereas the price in the federal budget is 79 dollars. Together with the resources from the Mexican Petroleum Fund and the point about imported petrol, this hedge means that there should be no cause for concern over public revenues in the new year.

Should the fall in the oil price persist beyond 2015, however, negative fiscal effects would be likely to be noted. If the price should hold in the range of USD60-70 per barrel in 2016, the government would receive USD6bn-9bn less in revenues. This represents around 0.6% of GDP. In current conditions this could be covered with further deficit financing, which, given the currently low level of gross public borrowing of 41% of GDP, should not affect either macroeconomic fundamentals or Mexico's sovereign rating.

If the fall in the oil price should turn out to be long-lasting, at some point further tax reform would have to be implemented to offset the lower revenue flow. Fortunately, the low borrowing to GDP ratio allows the State some room for manoeuvre, in the sense that such reform would not have to be carried out hastily and attention could be turned to sources of fiscal shortcomings in Mexico, such as tax evasion and avoidance.

To conclude, it is worth raising the point of whether we should be worried about the effects of the fall in the oil price on the recently passed energy reform. Broadly speaking, the world's most efficient oil companies know that deep-water oil extraction in the Gulf of Mexico is profitable as long as the oil price stands within the range of USDS40-50 per barrel, depending on the characteristics of any particular project. As long as the price does not drop below these levels, the energy reform can be expected to attract healthy investments.

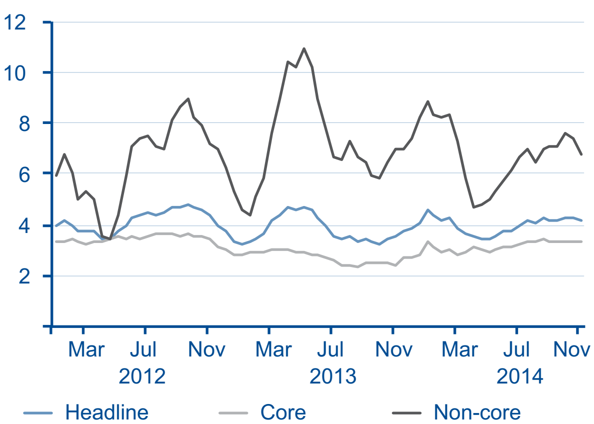
3.2 Recent inflation trends: an upturn linked to higher meat prices

From June and up to the first half of October, inflation exhibited an upward pattern which was mainly associated with two factors: i) an unfavourable basis for comparison which derived from significant falls in agriculture and livestock products in June and July 2013, and ii) the jump in beef and pork prices, owing to a supply shock affecting these items. In specific terms, annual headline inflation rose from 3.51% in May until it spiked in October when it hit 4.30%. Average annual inflation rose from 3.59% in 2Q14 to 4.15% in the third.

Annual inflation of the non-core sub-index, which takes in agricultural and livestock products, and energy and public rates, rose from 5.29% to 6.89% on average between Q2 and Q3, experiencing an additional upturn in October, when it nudged 7.51%. The upturn came from agricultural and livestock product prices, and was partly offset by the slip in the sub-index for energy prices and government-authorised rates, where the average annual rate dipped from 8.09% to 7.11% between Q2 and Q3, and fell back further in October, when it came down to 6.93%. The energy component benefited from smaller increases in the domestic gas price, whereas government-authorised rates have been helped this year by the fact that collective transport fares have not risen as sharply again as last time. Conversely, the sub-index of agricultural and livestock prices rallied strongly from June to October. The average annual variation surged from 0.94% to 6.53% between Q2 and Q3, reaching 8.46% in October. Two factors underlie this upward movement: on the one hand the more tempered performance by the fruit and vegetable and agricultural and livestock price sub-indexes (seen last year over the same period) were not repeated, and on the other hand adverse supply conditions in the United States provoked sharp rises in beef and pork prices (see chart 3.32).

Chart 3.31

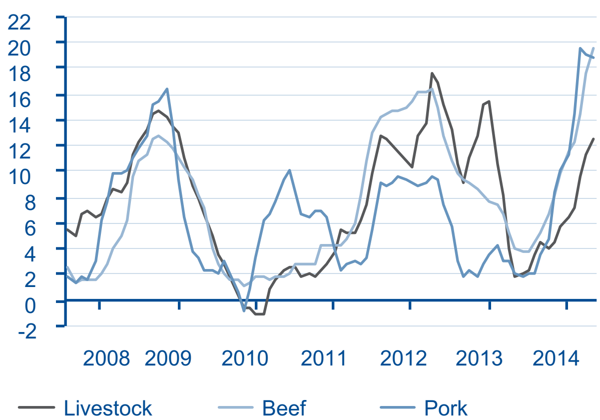
Inflation and components
YoY % change, fortnightly series



Source: BBVA Research with INEGI data

Chart 3.32

Inflation of livestock prices
YoY % change, fortnightly series



Source: BBVA Research with INEGI data

Annual core inflation also advanced, although it remained low and gave no sign of demand pressure on prices. Average annual core inflation moved up from 3.07% in Q2 to 3.32% in Q3, coming in at the same level in October. The sub-indexes for both goods and services increased, although the latter did so to a lesser extent. Average annual goods inflation ticked upwards from 3.10% in Q2 to 3.46% in Q3, mainly on the increase in foodstuff prices, as the rise in meat prices fed through to certain processed foods such as sausage-meat products. Average annual inflation of the processed foods sub-index thus moved ahead from 4.81% in Q2 to 5.32% in Q3, and it registered 5.33% for October. On the other hand, average annual inflation for non-food goods held at a low level, rising gently from 1.72% to 1.96% between Q2 and Q3, marking 2.07% in October. Average annual inflation for the services sub-index also crept up from 3.04% to 3.21% between Q2 and Q3, although it dropped back to 3.14% in October. The component for services other than education and housing accounted for the uptick, as between Q2 and Q3 average annual inflation in this constituent category rose from 3.54% to 4.06%, and slipped back to 3.86% in October. The higher level attained had chiefly been due to an increase in air transport prices, while the October retreat related to lower mobile phone prices with the running of promotions and new monthly payment schemes.

Inflation outlook: annual inflation is on a downward path. It will close the year at around 4.0% and fall considerably in January 2015

Bearing in mind that the factors which have explained the upward trend in inflation are supply shocks that have had no deeper effects on pricing, we anticipate that the downward course of inflation which began in the first half of November will continue over December, and will become more pronounced in January 2015. This will occur both with the dissipation of the arithmetical effect of the changes in relative prices which were observed in January 2014 (these were caused by new indirect taxes on certain products) and as long-distance domestic telephone charges are phased out.

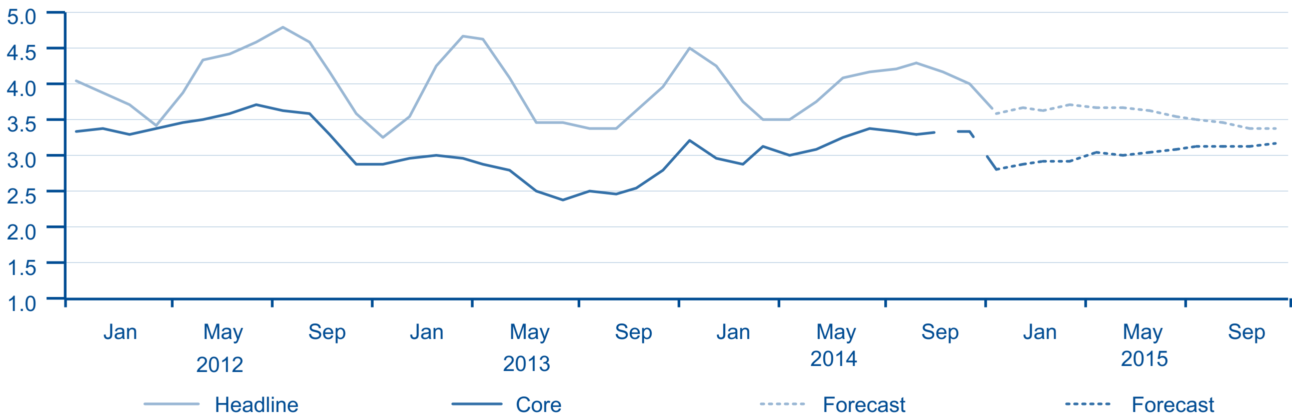
As we were expecting, the figure for the first half of November confirmed that inflation had begun to come down again. In December the falling pattern should gather momentum. Despite the fact that agricultural and livestock prices are still on the rise, we do not foresee a repeat of the intensity of pressures on them which we saw last year (fruit and vegetable prices ballooned 11% in the final two months of 2013). As a result, we predict that inflation will see out the year at around 4.0%. Having said this, following the continuation of pressures on meat prices in recent months, we now think that inflation is unlikely to end the year within the central bank's tolerance margin of 3.0% +/- 1pp. To be precise, we estimate inflation of 4.02% in December 2014.

For January 2015, we forecast that annual inflation will fall considerably, chiefly because of two factors: i) an arithmetical effect conducive to this, since there are no more tax changes and so the impact of the tax changes in January 2014 will wear off, and ii) the scrapping of long-distance domestic telephone charges. We therefore foresee annual inflation at 3.58% in January, which will average at 3.56% throughout the whole of 2015, and will close the year at 3.36%. The lower inflation levels expected for next year relate to both of the factors described earlier and to the lower increase in petrol prices which, has been announced (see Box 3). The lower rise in petrol prices (3.0% in 2015, compared to an annual average of 11.0% for 2010-14) will not only help inflation stay lower from 2015 because of the direct effect which this has on the basket of items making up the National Consumer Price Index (NCPI), but it should also help inflation converge towards the target of 3.0% to the extent that it manages to have knock-on effects on other prices. Moreover, when economic agents notice that the lower annual rate is set to stay, this could also contribute to an anchoring of medium- and long-term inflation expectations at lower levels. In short, the behaviour of the non-core component in 2015 should be more benign compared to previous years, owing to the impact of petrol prices.

Given the prospect of gradual economic recovery, we do not envisage pressure on prices. The pattern of core inflation, which is the measure that best shows how inflation performs in the medium term, remains hopeful because of the weakness in the economic cycle and the consequent available slack which has meant an absence of demand pressure on prices. For 2015 the GDP gap will remain negative, which leads us to expect that core prices will continue to behave kindly in 2015. For annual core inflation we forecast 3.34% for the close of 2014 and a comparable figure of 3.18% for 2015. We expect annual core inflation to be under 3.0% in January 2015 with the fading of the shock effect on relative prices from tax changes in 2014 and as the benefits are felt of the abandonment of charges for long-distance telephone services. We likewise forecast that the average rate will be below 3.0% during 1H15, prior to a mild rise in H2, for which this figure will be 3.13%.

Chart 3.33

Prospective inflation
YoY % change



Source: BBVA Research with INEGI data

Our forecasts are vulnerable to risks on both the downside and the upside. The key downside risks concern core inflation and are lower-than-expected economic activity, which leads to a wider (rather than narrower) GDP gap, and the possibility of a decrease in mobile telephone services if the changes from the reform of the telecoms sector manage to provide a major boost to competitiveness in the sector.[1] Looking at the most notable risks on the upside, however, these are larger upward exchange rate adjustments against the USD (although our exchange rate estimate is low) and potential increases in the minimum wage. The effect of the latter should be temporary and similar to the other supply shock that was seen this year with the tax changes, if economic agents feel that the increase is confined to the pool of workers who earn the minimum wage and that it will only be a one-off policy.

[1] See "*Box 2: Correction to the downside of our forecasts for 2015, thanks to the favourable effects of the telecoms reform on prices*". Mexico Economic Outlook, Third Quarter 2014, p. 22.

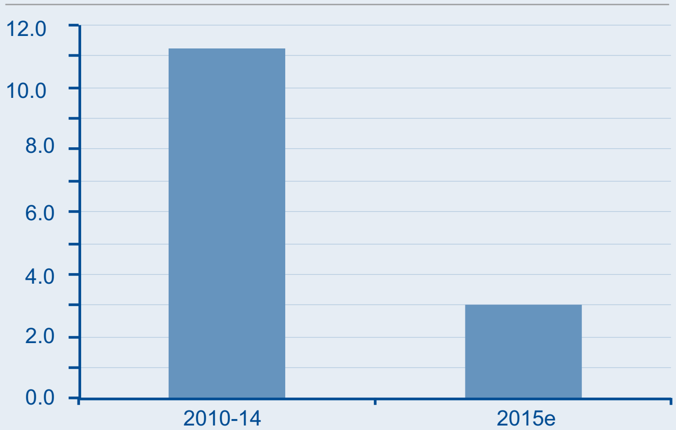
Box 3: Effect on inflation of a smaller rise in petrol prices

The announcement by the federal government regarding a smaller increase in petrol prices for 2015 (equal to the inflation target of 3.0%) is likely to lead to lower annual inflation next year. The drop in the annual growth rate of the petrol price will have a direct arithmetical effect on 2015 inflation, and could help inflation converge with its standing target looking forward.

As for the direct arithmetical effect that will be observed next year, the smaller increase in the petrol price will have a major downward impact on inflation next year, for the following reasons: i) the significant easing in the annual rate of increase, and ii) the powerful impact of petrol price increases on headline inflation due to the relatively large weight of this item in the basket of prices in the National Consumer Price Index (NCPI). As can be seen in chart 3.34, because the annual variation in the petrol price in the last five years has averaged over 11%, upward pressure on headline inflation has been generated by the non-core component. In fact, as can be observed in chart 3.35, in 2010-14 the petrol price has contributed over 0.43pp (percentage points) to annual inflation growth. In this respect, the 3.0% increase announced for next year will have an impact of only 0.13pp on annual headline inflation, which is 0.30pp less than the average effect for the previous five years.

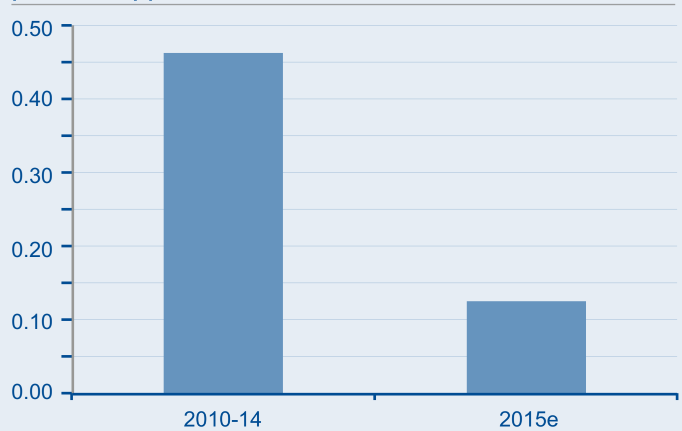
On the other hand, the indirect effects of the smaller increase in petrol prices are less easily identifiable and are associated with lower transport costs, which could have an effect on keeping down price increases for other goods and services (e.g. the increases in collective transport fares, company transport costs, etc.). They also relate to a potentially helpful effect on expectations of inflation in the medium and long term, which should encourage the convergence of headline inflation with its standing target. These indirect effects may also be more in evidence from 2016, once economic agents sense that the lower annual growth rate of these prices will be long-lasting. Given this situation and the uncertainty, we have opted not to factor these potential indirect effects into our inflation forecast for 2015.

Chart 3.34
Average annual petrol price rise
%



Source: BBVA Research with INEGI data

Chart 3.35
Impact on headline inflation of the average annual petrol price rise (pp)



Source: BBVA Research with INEGI data

Box 4: Upside inflation risk from possible minimum wage rises would have a limited and temporary effect if they were to materialise

One of the main risks on the upside concerning inflation for 2015 comes from the possibility of a minimum wage rise. Beyond the debate over this matter in recent months, two facts lend weight to the likelihood of a rise in the minimum wage sometime next year. The first is the decision by the Legislative Assembly of the Federal District (ALDF) to uncouple the minimum wage from various penalties referenced against it. This is in view of the fact that ending such a link is held to be the first step towards bringing about a minimum wage rise. To do this the ALDF passed a motion to create the Unit of Account as a measure of value to replace the minimum wage in determining administrative sanctions, payment categories and relevant sums provided for in local regulations. The second fact is the announcement by the president of Mexico that he will bring a bill before the Congress to dissociate the minimum wage from various prices and rates within the economy, "to foster a serious and searching debate on measures to allow a higher income for Mexicans". We think, however, that increasing the minimum wage would only have a direct effect on price rises that would be analogous to other supply shocks such as this year's tax changes. This is foreseeable if we bear in mind that economic agents are most likely to perceive that the rise is chiefly confined to the pool of workers who earn the minimum wage and that this will be a one-off policy. In other words, that the effect of the additional increment will be contained and confined to workers on low wages. If this is so, the impact on inflation should be limited and temporary.

To estimate the direct effect on prices of an increase in the minimum wage, we assume that the rise would be confined to formal workers who receive between one and three times the minimum wage, although the addition of a significant increment to the minimum wage would only be partial in the case of workers who receive two or three times the minimum wage. Thus, if we consider the percentage of workers on each of these wage levels,[1] we can calculate an estimated weighted increase for the salary level within the economy. To give a worked example of this, we apply our assumption in the baseline scenario that wages will rise by a nominal 4.0% (–0.6% in real terms) on average. Then, to measure the potential impact on inflation of an increase of the minimum wage, we assume a rise of 10% for the minimum wage and that, of the increment added to the minimum wage over and above the amount in the baseline scenario (i.e., 10% - 4.0% = 6.0%), one-fifth and one-tenth respectively is added to the wages of workers who receive two and three times the minimum wage. We thus find that a 10% rise in the wage of workers receiving one minimum wage could mean an increase of 5.3% for those earning two minimum wages and one of 4.7% for those receiving three. We stick with rises of 4.0% (i.e. the increase assumed in our baseline scenario) for the other workers in the economy who have incomes of over three times the minimum wage. In this case the weighted increase in wages for the economy for 2015 would work out at 4.80%.

After arriving at this calculated result, we apply the ranges for wage elasticity of inflation that have been obtained from various models of determinants of inflation. We therefore estimate that a 10% increase in minimum wages, with the increments added to other wages as described, would have an impact on inflation next year of between 0.3 and 0.6 percentage points. This means that, if an increase such as that we outline were to be confirmed, inflation would close 2015 in the 3.7-4.0% range.

[1] 3.37% of all formal workers in the economy earn the minimum wage, 35.33% earn twice this figure, and 20.55% receive three times this, while 40.74% have incomes higher than three times the minimum wage, according to data from October 2014.

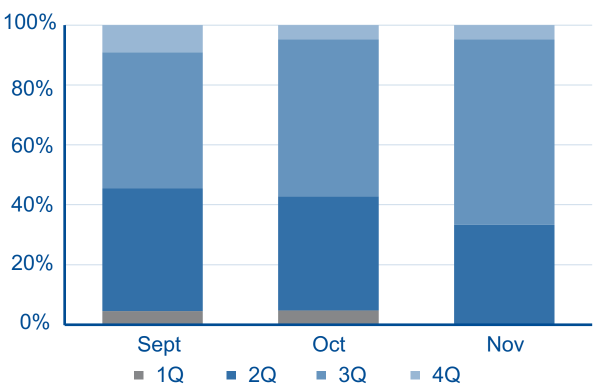
3.3 Expectations of a pause in monetary policy activity for the remainder of the year, due to mixed economic activity figures and a neutral tone to central bank announcements

After the surprising monetary policy rate cut in June, the central bank has adopted a neutral tone in recent statements. The change of tone can be attributed to the following factors: i) the increase in short term inflation risks. The rise in livestock prices and the fact that they are persisting at high levels, which is particularly true in the case of meat, have been detrimental to the balance of short-term inflation risks, which has in turn had a bearing on changes by the central bank to its inflation forecasts for the end of the year and 2015. In precise terms, the central bank expects inflation to see out 2014 at "around 4.0%" and not "below 4.0%" as it stated in its quarterly inflation report in June, while expectations of closing in on 3.0% were put back from January 2015 to some point from mid-2015 onwards; ii) the positive outlook for US economic activity. Although the figures for domestic activity for Q3 came in below expectations (0.5% growth QoQ), and even though the risks to the downside for world economic activity have taken a turn for the worse, the central bank expressed the opinion in its last statement that the outlook for the US economy, taken together with the structural reforms, mean that the balance of risks for economic activity remains the same. In other words, it could be said that the brighter outlook for the US economic cycle is, to a certain extent, managing to offset the risks to the downside facing the economic situation worldwide, and iii) the greater volatility of financial markets. After hitting historical lows for volatility over the summer, the flagging by the Federal Reserve of the risk of a slowdown in the United States on weakness in the world economy brought volatility back to the markets, interest rate rises and a depreciation of the peso. Although these movements have been orderly in terms of liquidity, the central bank considers such currency weakness to pose the risk of higher inflation.

Note that this shift towards a neutral tone by the central bank, and particularly the fact that it had held its assessment of the balance of risks to activity unchanged, only days after the drop in the Global Economic Activity Indicator (IGAE) for August was announced, fuelled higher market expectations regarding the level at which the monetary policy rate should be standing in 12 months, whereas this level had been coming down in October. Subsequently, the expected future MPR was lowered on economic growth figures which disappointed, though this happened without it sinking as far as the October low. The markets are therefore expecting that the next move by the central bank will be upwards, and will take place towards the middle of next year, in line with the consensus figure which analysts forecast (see chart 3.36).

The central bank's confidence that the higher-than-expected figures for the US economy (see chart 3.37) will feed through to more vigour in the domestic economy towards the end of the year, coupled with our own prediction of lower inflation in 2015, suggests that the monetary policy rate will be held unchanged at 3.0% for at least the rest of the year.

Chart 3.36
Estimated quarter in 2015 for the next monetary policy rate hike (% of analysts)



Source: BBVA Research with data from the Expectations Survey of financial markets analysts

Chart 3.37
US economic activity surprise index (2009=100)

Source: BBVA Research

3.4 The positive differentiation of US financial assets and oil price weakness has triggered volatility in Mexican markets

The better than expected economic growth in the United States, in an environment of deflation risks in the eurozone and slower economic growth in China, has brought about greater demand for US financial assets. This increased demand has been influenced by two factors. First, there is the better performance which is expected in comparison with other countries. Unlike what had been seen in previous months, market participants now expect the pace of growth in the US economy to continue to be kept up amidst a steady rise in interest rates. Thus, since the United States is the only region in the world with growth prospects and interest rates on the rise, investors have cut back on raising their exposure further in emerging markets and are strengthening positions in safe assets that are expected to yield more. Second, there is the low level of US inflation and the feeling that the chances of a sudden increase in risk-aversion are low. Unlike what happened in other recovery periods, US inflation now stands at around 1.4% YoY, which is below the Fed's target rate of 2.0%, although this is still at a distance from the deflation fears gripping Europe and Japan. This mix of bigger growth and controlled inflation has fed through into increased demand for T-bonds, which has in turn checked the rise in yields to the extent that over 10 years these are marking a level of 2.2%. Although this is in itself a low level, it is still above that for German bonds, the rate for which in euros stands at a paltry 0.7%. Moreover, at least for the time being, there is the perception that the geo-political risks which have blown up over the year do not represent a widespread threat to financial markets. In fact the VIX index, which gauges global risk aversion, sank to 14% from a level of 26% in mid-October, after the slowdown in Europe and China did not reveal any significant detrimental overspill effect into the US economy.

Chart 3.38

USD against the 16 major currencies worldwide* (index)

Source: BBVA Research with Bloomberg data

Chart 3.39

Stock markets (index, January 2014=100)

Source: BBVA Research with Bloomberg data

This situation has seen the dollar strengthen by about 10% in the YtD (see chart 3.38) against the key currencies and it stands at a four-year high. The dollar's average appreciation against G10 currencies in 2014 has been of the order of 8.3%, whereas against the emerging market currencies this has been 7.8%. In the latter case, magnitudes range from 0.02% for the Hong Kong dollar up to 36% for the Russian rouble. The peso has depreciated by 6.82% over the year (the second smallest margin among the Latam currencies), which has taken it to over MXN13.90 against the dollar, a level not seen since 2012. This depreciation has been exacerbated in recent weeks with the drop in the oil price, which stands at around USD60/bbl. OPEC's refusal to cut production levels had generated expectations of low prices for a very long time, which in turn gave rise to widespread selling of the currencies of oil-exporting countries, above all on days of low trading volumes, such as the Thanksgiving weekend in the United States.

In the stock markets there has also been noticeable positive differentiation in favour of US capital. The S&P 500 index has gained over 12% in the YtD and is at a new historical high, after 80% of companies in the index reported income above analysts' Q3 forecasts. This performance contrasts with what has been noted in the other markets, as the MSCI emerging markets index has shown a gain of a mere 1.0% in 2014, while the MSCI Europe Index has only advanced marginally at around 0.05% in the same period. In Mexico the key stock market index has risen 1.50% over the year, which is similar to the comparable figure of 1.49% for Brazil's Bovespa index (see chart 3.39).

Moving to the government bond markets, the Treasury bond curve has flattened out further in recent months, particularly in the middle and at the long end. As mentioned before, inflation below the Fed target rate within a context of economic recovery has prompted increased demand, which has fed through into a fall of around 10bp in the 10-year yield relative to its level in early September. In the case of the 30-year yield, this has come down by as much as 13bp. In contrast, the short end is sloping steeper on expectations of the opening federal funds rate hike being put off from Q2 until Q3 in 2015, after the Fed mentioned in the minutes of its September meeting that it would rather delay the start of the cycle to return to normality than bring it forward and thereby jeopardise economic recovery (see chart 3.40). In Mexico, movements in long-term interest rates have uncoupled from those in the United States on two occasions during the year (see chart 3.41), early on in the year when downside risks for the global economic cycle, mainly on fears of a sharp slowdown in China, and geo-political risks hit market sentiment, which hurt the price of the financial assets of emerging economies.

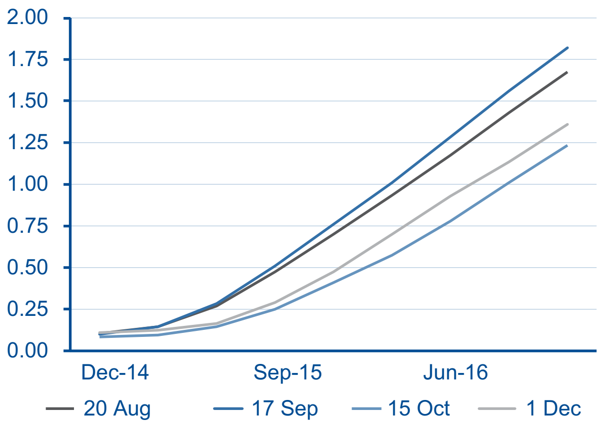
More precisely, in January this year and up to the first few days of February, long-term interest rates in Mexico showed a marked upward trend, which contrasted with subsiding rates in the United States. In the following months, movements once again exhibited a close relationship until June, when the central bank made the surprise decision to cut the reference rate by 50bp. At that time, Mexican interest rates dipped all along the curve, but after this surprise move they returned to being closely tied to patterns in US rates. This lasted until mid to late September, when concern over the upward revision of forecasts for the future cycle of rate hikes in the United States by the Fed, together with the surprisingly high US GDP figure, fuelled an increase in perceived risk and investors once again stepped up their positions in US T-bonds, switching to cut their exposure to emerging market bonds. Despite this, the allaying of fears over the strength of the global cycle kept the perception of risk in markets in check and worked in favour of emerging market bonds, with Mexican debt among these. From then on, Mexican long-term interest rates have moved in keeping with levels in the United States. Up until now, they have remained unaffected by exchange rate movements, partly because the perceived risk for Mexican bonds has not risen, as is evidenced by the fact that the level indicated by credit default swaps has not increased.

With respect to inflows by foreigners into M-bonds (Mexican government development bonds), these began growing again from September, and between September and November they built up a rise of USD5.662bn, which is a little under the cumulative figure of almost USD12.4bn for January through to August this year. As for Cetes (Mexican government Treasury certificates), the demand from foreigners rose substantially in November, doing so by USD5.074bn. This figure marks the second largest inflow in the YtD and brings the change in holdings by foreigners for 2014 into positive numbers. With these recent increases the cumulative figure for foreign flows into Cetes and M bonds so far this year is slightly ahead of that seen in 2013.

Looking ahead, we expect FX market volatility to continue on the strong dollar and currency weakening associated with crude oil exports. With regard to interest rates, movements of these are likely to retain a close correlation with those of rates in the United States. To the extent that US long-term interest rates do not rise by a considerable amount, we should expect something similar to occur with those in Mexico. That said, a scenario of long-term interest rates creeping up in both countries still looks the most likely in a context where the Federal Reserve is set to commence its round of hikes next year. The pace of these will be marked by the speed of the rise in the federal funds rate. This is most likely to be slow, and so we do not expect sudden upticks in long-term yields next year.

Chart 3.40

Market expectations of the US Federal Funds Rate (%)



Source: BBVA Research with Bloomberg data

Chart 3.41

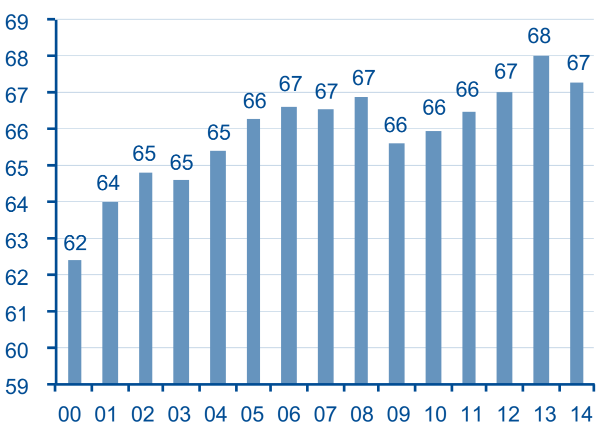
Government 10-year bond yields, Mexico and the United States (%)

Source: BBVA Research with Bloomberg data

4. Factors shaping private consumption in Mexico

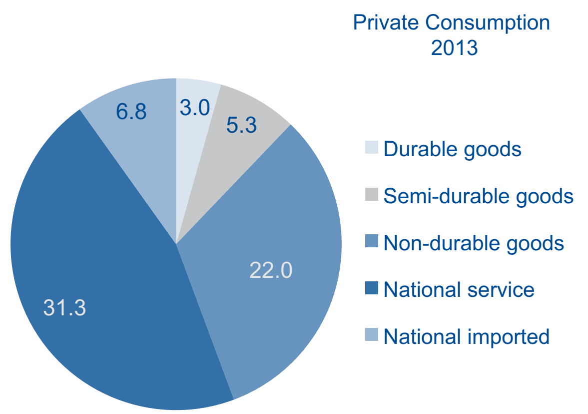
Private consumption is the largest component of GDP, and it accounts for around 70%. Private sector represents a higher proportion of GDP than public sector consumption, total gross fixed capital formation (public plus private), exports and imports. Since the year 2000 the relative share of private consumption in GDP has risen. Specifically, in 2000 private consumption accounted for 62% of output and in 2013 this percentage rose to 68% (see chart 4.1). As consumption takes on an increasingly important role in economic activity, in both absolute and relative terms, its contribution to GDP growth will become larger. It is therefore appropriate to examine how private structure breaks down and what factors determine how it behaves.

Chart 4.1
Private consumption, % of GDP



Source: BBVA Research with INEGI data

Chart 4.2
Components of private consumption, % of GDP



Source: BBVA Research with INEGI data

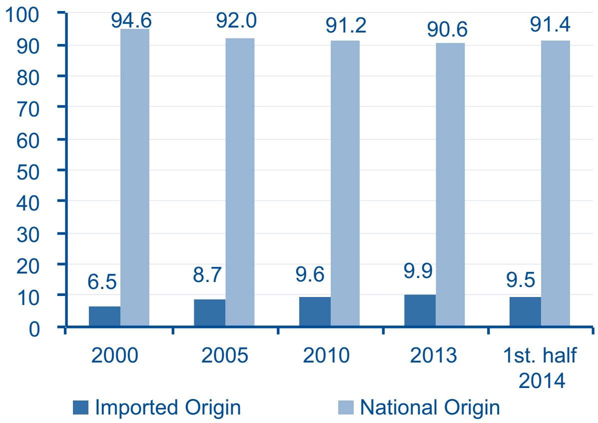
Structure of private consumption

Private consumption splits out into goods consumption and services consumption. Both of these can be either domestic or imported. The most significant category within consumption is services originating domestically, which represents 31.3% of GDP. This is followed by the consumption categories of non-durable goods in second place (22% of GDP), imported goods and services in third (6.8%), and semi-durable goods in fourth (5.3%), with durable goods in fifth (3% of GDP).

In terms of the origin of production, the relative weight of imported goods and services consumption increased, rising from 6.5% of total private consumption in 2000 to 9.9% in 2013 (see chart 4.3). On the other hand, domestic goods and services consumption moved down from 94.6% in 2000 to 90.6% in 2013. Within the domestic goods and services consumption component, in 2000 the goods component prevailed over services, but this ceased to be the case from 2010 (see chart 4.4).

Chart 4.3

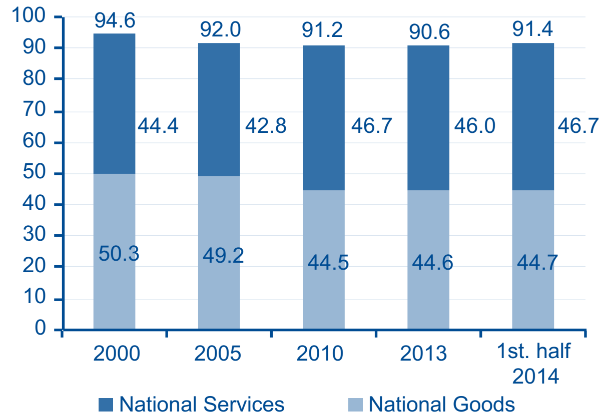
Private consumption, breakdown of domestic and imported goods and services, %



Source: BBVA Research with INEGI data

Chart 4.4

Breakdown of private consumption of domestic items, %



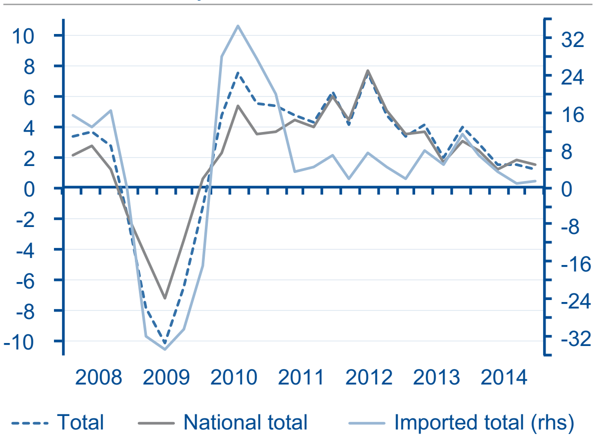
Source: BBVA Research with INEGI data

Recent patterns in private consumption

Total private consumption was badly hit by the recession in 2009, as that year its annual growth rate was -6.5% (see chart 4.5). The following year it returned to a rising path, growing at 5.7%, 4.8%, and 4.9% in 2010, 2011 and 2012 respectively. In contrast, in 2013 and in 1H14 consumption slowed down sharply, growing at only 2.6% and 1.4% in these periods. It is worth noting that since 2Q12 the consumption of services of domestic origin has grown at a faster rate than consumption of domestic goods.

Chart 4.5

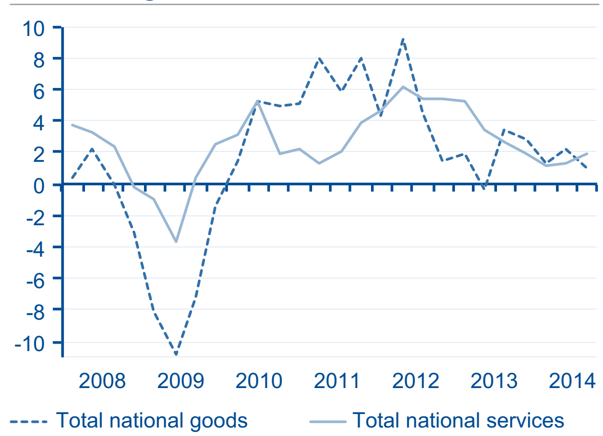
Annual growth rate of private consumption: domestic and imported



Source: BBVA Research with INEGI data

Chart 4.6

Consumption of nationally produced goods and services, % growth YoY



Source: BBVA Research with INEGI data

Identifying determinants of private consumption

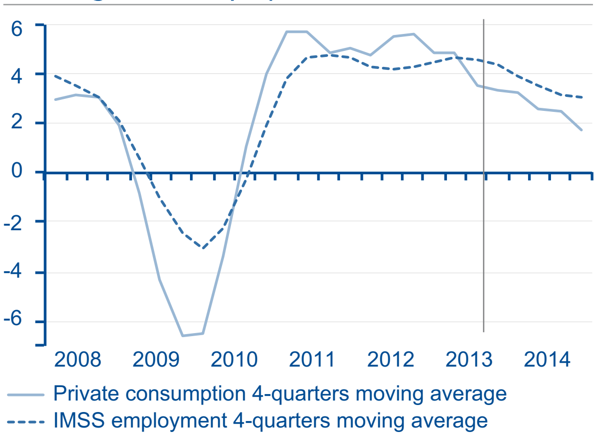
To understand the behaviour of private consumption and gauge how this might evolve in the future, statistical methods were used to identify the key determinants of the various categories of private consumption (i.e. the consumption of durable goods, semi-durables, non-durable goods and services, as well as the consumption of imported goods and services).[1]

Among the explanatory variables determining the pattern for the different categories of private consumption the most notable are: a) those with a positive effect on private consumption, such as 1) the total number of workers registered with the Social Security system (IMSS), i.e. formal employment, and 2) the average IMSS-registered wage in real terms, and b) those with a negative effect, such as 3) annual inflation. The exchange rate, though, has a positive or a negative effect according to the private consumption category under consideration. For example, for the case of durable goods consumption, the exchange rate effect is negative, possibly due to the fact that these have a high element of imported parts or they can be exported easily, such as in the case of autos. In the case of consumer durables the exchange rate effect is positive, which could indicate that domestic goods of this kind are substituting imported goods in this category.

The results of the estimates suggest that formal employment (in this case referred to as the number of workers registered with the IMSS) is the most important explanatory variable of those which are considered. This is due to the magnitude of the estimated coefficient for this variable in the various categories of private consumption. This means that an increase in formal employment will feed through into an increase in private consumption in its various categories, and therefore the aggregate for this, which can be noted in the significant positive relationship between these two variables (see chart 4.7).[2] To be precise, we estimate that an increase of 100,000 workers registered with the IMSS raises private consumption by around 0.7% in annual terms.

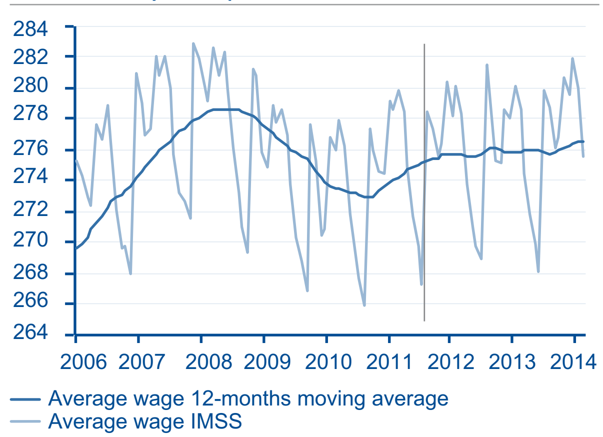
On the other hand, the increase in the real average wage registered with the IMSS has a positive bearing on private consumption, since it demonstrates greater purchasing power for goods and services for the formal workers in the private sector. An increase in inflation, though, reduces the purchasing power of consumers in general with the increase in the price of goods relative to family incomes. We note that in recent years the real wage variable has become less meaningful in terms of explaining private consumption. This is likely to be because, since the beginning of 2012, the real wage over a moving average of 12 months has not risen (see chart 4.8).

Chart 4.7
Annual growth rate of private consumption and IMSS-registered employment, %



Source: BBVA Research with INEGI and IMSS data

Chart 4.8
Average wage registered with the IMSS in real terms, MXN per day



Source: BBVA Research with IMSS data

[1] The source of the information on the various categories of private consumption is the National Accounts which are published quarterly by INEGI. The econometric estimates were made for a sample running from 1Q04 to 2Q14 and all the variables included are transformed through first differences to ensure stationarity. In estimating, certain dummy variables were included to capture specific events such as the 2009 recession.

[2] The correlation between the annual growth rate of total quarterly private consumption and total quarterly IMSS-registered employment using a moving average covering four quarters which was calculated from 1Q06 to 2Q14 was 0.94. If only the growth rates ex moving averages are considered for these two variables, the correlation coefficient is 0.89. Moreover, if the cointegration test is carried out for private consumption with formal IMSS employment, we find that we cannot discard the existence of this long-term relationship between these two variables for the time from 1Q01 to 2Q14.

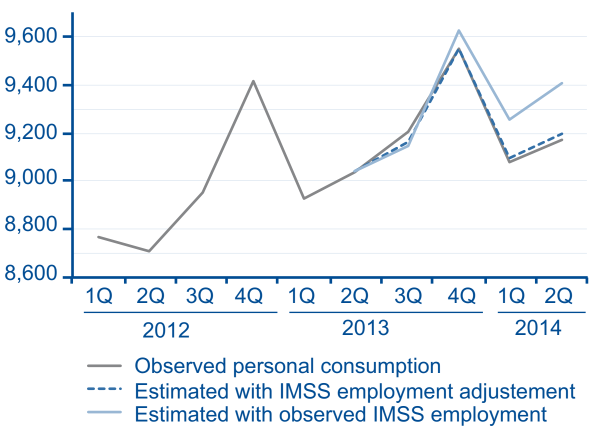
Relationship between consumption and employment registrations within the context of application of a job formalisation programme

Considering the large size of the informal sector within the economy, where it is estimated that around two-thirds of the labour force are in an informal employment situation, the implementation of a Job Formalisation Programme by the Secretariat of Labour and Social Welfare (STPS) has been extremely positive. According to official figures, this programme seems to be enjoying success, having achieved a move by approximately 300,000 from the informal to the formal employment sector in 2013, meaning that these workers now have social security services available to them, including registration of them with the IMSS.[3]

In terms of the relationship between workers registered with the IMSS and private consumption, the Job Formalisation Programme run by the STPS has altered the historical pattern between these two variables. This has arisen because prior to the implementation of the Job Formalisation Programme virtually all of the increases in the number of workers registered with the IMSS used to represent new employment, and therefore meant a rise in family incomes. In contrast to this, after the formalisation programme came into effect new registrations with the IMSS have not necessarily implied that additional money income has been generated, since the informal workers who have benefited from this programme already had a previous income. This means that, in statistical terms, the recent rises in worker registration numbers which have been observed at the IMSS are having a less substantial effect on boosting consumption than was the case before the STPS job formalisation programme came into existence. To illustrate this point numerically, even though the observed annual growth rate of job registrations with the IMSS between 3Q13 and 2Q14 averaged 3% over the four quarters, according to the historical econometric estimate, private consumption should have grown by 2.8% on average, and not by the figure of 1.8% which was actually the case.

Chart 4.9

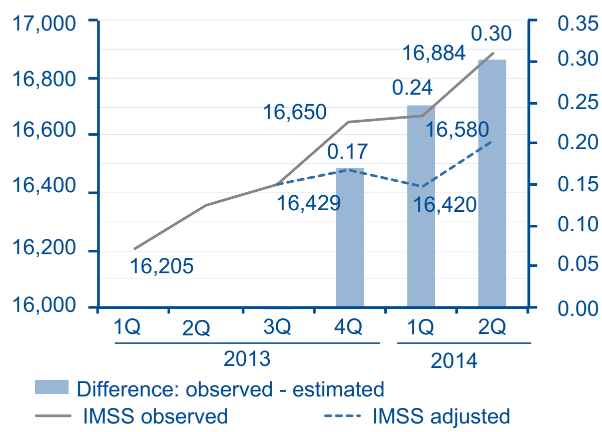
Observed and estimated figures for both personal consumption and IMSS registration (MXN mn, 2008)



Source: BBVA Research with INEGI and IMSS data

Chart 4.10

IMSS-registered employment: observed and adjusted (a decrease) to chart private consumption,'000s workers



Source: BBVA Research with IMSS data

To convey the point that the effect of IMSS-registered formal employment on private consumption has now diminished due to the job formalisation programme, an additional statistical analysis was conducted. In this, a reverse procedure was followed in which an attempt was made to estimate the level of new IMSS-registered formal employment that would be compatible with the private consumption levels which were seen from the end of 2013 up to 2Q14. In an initial step, IMSS-registered employment observed from 4Q13 up to 2Q14 was adjusted downwards. A second step involved predicting private consumption using this adjusted data for IMSS-registered formal employment. The findings from this procedure revealed an estimated private consumption level practically the same as that actually observed (chart 4.11).

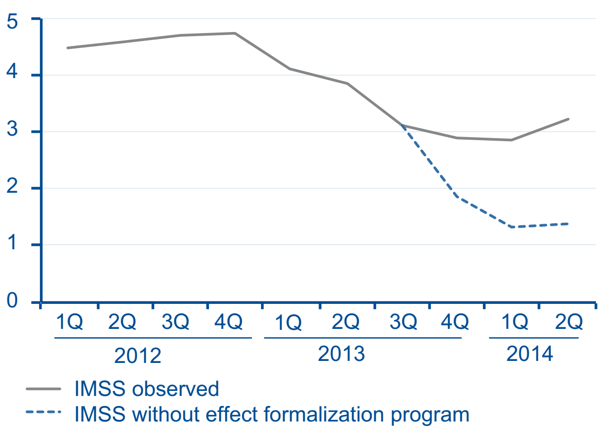
[3] The figure of 300,000 workers formalised through the Job Formalisation Programme can be consulted in the article published in *El Financiero* on 7 February 2014 under the heading "40,000 jobs formalised in the State of Mexico". This source maintains that the Secretary of Labour and Social Welfare stated that "..initial STPS figures show that across the whole country and via the Social Security system around 300,000 jobs were formalised in 2013, which are not new jobs because they have not been generated by economic growth, but by job formalisation instead".

The results for estimates show that in 4Q13 a number some 170,000 lower than that actually observed for workers registered with the IMSS in the period is the one which accurately charts the historical value for private consumption for that quarter. For 1Q14 and 2Q14, the lower number of workers which makes it possible to chart private consumption almost exactly over that time was 247,000 and 304,000 respectively (chart 4.12).[4] According to these calculations, the adjusted figure for the level of formal IMSS-registered employment for 2Q14 which resulted from this analysis, and which accurately charts observed private consumption for this period, was 16,580,000 persons, and not 16,884,000, as the latter includes 304,000 workers who were formalised and who did not contribute new income to the economy. This means that the published figure of 16,580,000 workers implies the possibility that the increase in the number of IMSS-registered workers who were being newly remunerated was around 227,000.

The findings from the analysis suggest that the main cause of the weak annual growth of private consumption in 2Q14 of 1.4% was likely to be the lack of buoyancy of the formal employment segment which brings new income into the economy. Thus, if we make the adjustment for the job formalisation effect, we find that IMSS-registered formal employment also grew by an annual 1.4% in the first half of the year (and not 3% as the unadjusted IMSS-registered formal employment figures state). There then seems to be greater congruence between the adjusted formal employment growth rate and that for private consumption (see chart 4.12).

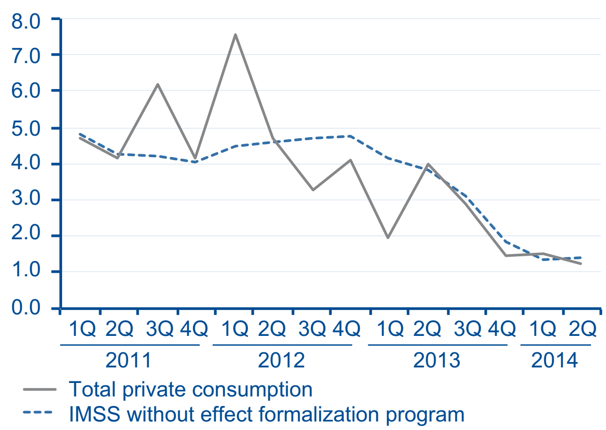
Looking over the medium term, the job formalisation programme could represent a boost for consumption, through providing greater security and longer-term stability in employment, as well as a safety net that should lift workers' available income. The latter cuts down on unexpected outlays on healthcare provision and helps them obtain other welfare benefits. All this should manifest itself in an increase in consumer confidence among those who benefited from the job formalisation programme, which should allow them to step up their future consumption levels.

Chart 4.11
Annual growth rate of IMSS-registered employment, observed and adjusted, %



Source: BBVA Research with INEGI and IMSS data

Chart 4.12
Annual growth rate of IMSS-registered employment and private consumption, %



Source: BBVA Research with IMSS data

Conclusion

Bearing in mind that new employment is the primary source of private consumption growth, it would be desirable to have statistics available that are clear and uniform over time and that make it possible to know what percentage of new workers who have registered with the IMSS represent newly engaged employment prompted by an increased level of economic activity and which IMSS registrations are as a result of the formalisation campaign. This distinction and clarity of figures should allow a better understanding of trends in private consumption and other macroeconomic variables which are closely related to formal employment.

Finally, we make the point that, while the estimate calculation methods presented in this piece could be refined further, they represent an attempt to gain a clearer picture of the reasons why private consumption has grown only modestly since 2013.

[4] Note that the quarterly average figure of 304,000 jobs is given using the described methodology as an estimate of those jobs which do not entail new income, and which therefore do not influence the observed consumption level. This is similar to the figure which the Secretary of Labour and Social Welfare referred to in the interview he gave to the press in February 2014.

5. Indicators and forecasts

Table 5.1

Macroeconomic forecasts: Gross Domestic Product

(YoY growth rate)	2011	2012	2013	2014	2015
United States	1.6	2.3	2.2	**2.0**	**2.5**
EMU	1.6	-0.6	-0.4	**0.8**	**1.3**
Germany	3.7	0.6	0.2	**1.3**	**1.4**
France	2.1	0.4	0.4	**0.4**	**1.1**
Italy	0.6	-2.4	-1.8	**-0.3**	**0.8**
Spain	-0.6	-2.1	-1.2	**1.3**	**2.0**
UK	1.1	0.3	1.7	**3.1**	**2.7**
Latin America *	4.1	2.6	2.4	**0.9**	**1.8**
Mexico	4.0	3.7	1.3	**2.1**	**3.5**
Brazil	2.7	1.0	2.5	**0.2**	**1.3**
EAGLES **	7.0	5.4	5.3	**4.9**	**5.3**
Turkey	8.8	2.1	4.1	**2.5**	**3.9**
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	3.4	**3.5**	**3.9**
World	4.1	3.4	3.2	**3.2**	**3.7**

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

Table 5.2

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	**0.5**	**1.0**
Germany	2.5	2.1	1.6	**0.9**	**1.5**
France	2.3	2.2	1.0	**0.7**	**0.9**
Italy	2.9	3.3	1.3	**0.3**	**0.7**
Spain	3.2	2.4	2.4	**0.0**	**1.0**
UK	4.5	2.8	2.6	**1.5**	**1.6**
Latin America *	7.0	6.3	7.8	**13.1**	**14.2**
Mexico	3.4	4.1	3.8	**4.0**	**3.6**
Brazil	6.6	5.4	6.2	**6.3**	**6.2**
EAGLES **	6.6	5.1	5.3	**4.8**	**4.6**
Turkey	6.5	8.9	7.5	**8.8**	**7.0**
Asia-Pacific	4.9	3.4	3.5	**3.4**	**3.6**
Japón	-0.3	0.0	0.4	**2.2**	**1.5**
China	5.4	2.6	2.6	**2.2**	**2.3**
Asia (exc. China)	4.6	4.0	4.2	**3.9**	**3.7**
World	5.2	4.2	4.0	**4.2**	**4.4**

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

Table 5.3

United States indicators and forecasts

	2012	2013	2014	2015	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15
Macroeconomic Indicators												
GDP (real % change)	2.3	2.2	**2.0**	**2.5**	-2.1	4.6	3.9	**-1.0**	**3.3**	**2.8**	**3.0**	**2.5**
Personal consumption (real % change)	1.8	2.4	**2.1**	**1.8**	1.2	2.5	2.2	**0.0**	**2.4**	**2.4**	**2.0**	**1.4**
Gov. consumption (real % change)	-1.5	-2.0	**-0.3**	**0.1**	-0.8	1.7	4.2	**-3.9**	**0.4**	**0.4**	**0.4**	**0.4**
Gross fixed investment (real % change)	8.3	4.7	**4.7**	**4.8**	0.2	9.5	6.2	**-2.5**	**6.4**	**6.1**	**6.2**	**6.7**
Construction	3.9	3.4	**3.7**	**3.3**	4.7	5.5	6.4	**-2.0**	**4.1**	**3.6**	**4.5**	**4.9**
Industrial prod. (real annual % change)	3.8	2.9	**4.0**	**3.9**	3.3	4.2	4.4	**3.9**	**4.0**	**3.5**	**3.6**	**4.6**
Current account balance (% of GDP)	-3.0	-2.5	**-2.7**	**-2.8**	-2.6	-2.4	-2.5	**-3.0**	**-2.8**	**-2.8**	**-2.8**	**-2.5**
Final annual inflation	1.7	1.5	**2.1**	**2.2**	1.5	2.1	1.7	**2.1**	**2.1**	**2.2**	**2.5**	**2.2**
Average annual inflation	2.1	1.5	**1.8**	**2.2**	1.4	2.1	1.8	**1.9**	**2.1**	**2.2**	**2.3**	**2.3**
Primary fiscal balance (% of GDP)	-6.8	-4.1	**-3.1**	**-2.7**				**-3.1**				**-2.7**

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

Table 5.4

Mexico Indicators and Forecasts

	2012	2013	2014	2015	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	3.7	1.7	**2.1**	**3.5**	0.8	2.8	2.1	**2.5**	**3.4**	**3.2**	**3.5**	**3.7**
Per inhabitant (US dollars)	10,156	10,570	**10,769**	**11,403**	10,462	10,909	10,908	**10,795**	**10,957**	**11,231**	**11,540**	**11,884**
US$ billions	1,188.8	1,251.4	**1,289.2**	**1,379.8**	1,252.4	1,306.0	1,305.9	**1,292.4**	**1,325.9**	**1,359.0**	**1,396.4**	**1,438.0**
Inflation (average, %)												
Headline	4.1	3.8	**4.0**	**3.6**	4.2	3.6	4.1	**4.2**	**3.6**	**3.7**	**3.6**	**3.4**
Core	3.4	2.7	**3.2**	**3.0**	3.0	3.1	3.3	**3.3**	**2.9**	**3.0**	**3.1**	**3.2**
Financial Markets (eop, %)												
Interest rates												
Bank funding	4.5	3.5	**3.0**	**3.5**	3.5	3.3	3.0	**3.0**	**3.0**	**3.1**	**3.3**	**3.5**
28-day Cetes	3.9	3.2	**3.0**	**3.5**	3.2	3.1	2.8	**3.0**	**3.0**	**3.3**	**3.6**	**3.7**
28-day TIIE	4.8	3.8	**3.4**	**3.9**	3.8	3.6	3.3	**3.3**	**3.4**	**3.4**	**3.7**	**3.9**
10-year Bond (%, average)	5.7	5.7	**6.1**	**6.6**	6.3	5.9	5.9	**5.9**	**6.0**	**6.4**	**6.6**	**6.6**
Exchange rate (average)												
Pesos per dollar	12.9	13.0	**13.3**	**13.6**	13.2	13.0	13.2	**13.6**	**13.8**	**13.7**	**13.8**	**13.3**
Public Finances												
*FRPS (% of GDP)	-3.2	-3.0	**-4.2**	**-4.0**	-	-	-	**-4.2**				**-4.0**
External Sector[3]												
Trade balance (US$ billions)	0.0	-1.2	**-1.3**	**-3.2**	-1.3	1.1	-1.5	**0.5**	**-1.2**	**0.2**	**-1.8**	**-0.4**
Current account (US$ billions)	-15.4	-26.5	**-23.9**	**-25.4**	-9.0	-7.7	-2.7	**-4.6**	**-6.9**	**-6.1**	**-6.0**	**-6.4**
Current account (% of GDP)	-1.3	-2.1	**-1.9**	**-1.8**	-2.9	-2.3	-0.8	**-1.4**	**-2.1**	**-1.8**	**-1.7**	**-1.8**
Oil (Mexican mix, dpb, eop)	102.0	98.6	**88.1**	**75.8**	93.1	97.4	91.3	**70.6**	**74.0**	**74.8**	**76.1**	**78.1**
Employment												
Formal Private (annual % change)	4.6	3.5	**3.5**	**3.7**	2.9	3.2	3.8	**4.1**	**4.0**	**3.7**	**3.8**	**3.2**
Open Unemployment Rate (% active pop.)	4.9	4.9	**4.9**	**4.7**	4.9	4.9	4.9	**4.9**	**4.8**	**4.7**	**4.6**	**4.6**

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Mexico Indicators and Forecasts

	2012	2013	2014	2015	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15
Aggregate Demand [4] (annual % change, seasonally-adjusted)												
Total	3.9	1.8	**2.9**	**4.1**	1.8	2.8	3.2	**3.7**	**3.5**	**3.9**	**4.2**	**4.7**
Domestic Demand	3.5	1.6	**2.0**	**3.4**	0.6	1.3	3.0	**3.0**	**3.0**	**3.7**	**3.2**	**3.6**
Consumption	4.2	2.9	**2.2**	**4.3**	0.7	1.9	2.8	**3.2**	**4.3**	**3.9**	**4.2**	**4.9**
Private	4.4	3.2	**1.6**	**3.5**	0.4	1.8	1.8	**2.3**	**3.4**	**2.9**	**3.4**	**4.1**
Public	3.2	1.4	**5.6**	**9.6**	2.0	2.8	8.9	**8.5**	**10.0**	**10.4**	**9.0**	**9.1**
Investment	4.5	-1.7	**2.0**	**5.3**	-2.1	1.4	4.7	**4.2**	**4.1**	**5.5**	**5.0**	**6.6**
Private	8.1	-0.3	**2.8**	**4.7**	-0.5	4.6	4.5	**2.8**	**2.7**	**3.3**	**5.6**	**7.4**
Public	-9.3	-3.7	**-1.8**	**6.4**	-8.2	-8.4	4.9	**4.7**	**7.8**	**12.9**	**2.7**	**3.2**
External Demand	5.7	1.9	**5.9**	**6.2**	6.1	7.2	3.9	**6.4**	**5.1**	**4.8**	**7.1**	**8.0**
Imports	4.4	2.1	**5.5**	**6.0**	5.1	2.7	6.6	**7.6**	**3.8**	**6.2**	**6.2**	**7.7**
GDP by sectors (annual % change, seasonally-adjusted)												
Primary	6.9	0.8	**4.7**	**3.7**	2.6	2.7	7.2	**6.3**	**3.9**	**3.9**	**3.9**	**3.0**
Secondary	2.9	-0.5	**1.6**	**2.7**	0.3	2.6	2.0	**1.4**	**2.5**	**2.7**	**2.6**	**2.8**
Mining	1.3	-0.5	**-1.1**	**0.4**	-0.3	-0.2	-2.7	**-1.3**	**0.3**	**0.4**	**0.4**	**0.4**
Electricity	2.2	0.5	**1.8**	**2.7**	2.3	1.7	1.5	**1.8**	**2.7**	**2.7**	**2.7**	**2.7**
Construction	2.5	-4.7	**nd**	**nd**	-3.8	1.3	4.0	**nd**	**nd**	**nd**	**nd**	**nd**
Manufacturing	3.5	1.6	**3.5**	**3.8**	2.9	4.1	3.1	**3.8**	**4.3**	**3.3**	**3.8**	**4.0**
Tertiary	4.3	2.7	**2.2**	**3.9**	1.2	2.8	2.0	**2.8**	**3.8**	**3.7**	**4.0**	**4.0**
Retail	4.2	2.9	**2.9**	**5.1**	0.5	3.4	3.9	**3.9**	**5.1**	**4.2**	**5.2**	**5.9**
Transportation, mail and warehouse	3.8	2.7	**1.6**	**4.5**	1.7	2.6	0.7	**1.7**	**3.9**	**5.5**	**5.0**	**3.7**
Massive media information	16.3	5.1	**3.1**	**6.5**	2.4	4.6	-0.3	**5.8**	**6.2**	**6.2**	**6.5**	**6.8**
Financial and insurance	7.7	9.9	**1.6**	**4.2**	3.8	1.1	-0.7	**2.2**	**3.7**	**4.3**	**4.3**	**4.5**
Real-estate and rent	2.5	1.0	**2.3**	**3.1**	1.8	2.2	2.3	**2.8**	**3.9**	**3.0**	**3.0**	**2.5**
Prof., scientific and technical servs.	1.0	0.9	**0.5**	**2.2**	-0.5	0.1	0.8	**1.6**	**1.9**	**2.0**	**2.6**	**2.3**
Company and corporate management	8.7	-1.5	**3.1**	**3.1**	2.5	5.8	1.0	**3.0**	**2.8**	**3.1**	**3.3**	**3.4**
Business support services	4.3	4.3	**0.8**	**3.5**	0.5	1.8	0.0	**0.8**	**3.6**	**4.0**	**3.6**	**2.8**
Education	2.2	0.8	**1.7**	**1.5**	1.0	1.8	2.4	**1.5**	**0.6**	**1.6**	**1.9**	**2.0**
Health and social security	2.1	2.5	**0.8**	**1.6**	0.4	0.9	0.8	**1.1**	**1.5**	**1.5**	**1.6**	**1.7**
Cultural and sport	2.6	3.9	**0.1**	**2.2**	-2.2	-0.6	2.3	**1.2**	**2.9**	**1.9**	**2.0**	**2.0**
Temporary stay	5.5	1.9	**2.7**	**3.1**	1.9	4.2	1.9	**2.6**	**2.8**	**2.9**	**3.3**	**3.2**
Other services, except government activities	3.3	1.8	**1.5**	**2.0**	-0.3	1.9	2.4	**2.1**	**1.5**	**1.7**	**2.5**	**2.3**
Government activities	3.7	-0.1	**3.3**	**4.5**	3.2	2.6	3.2	**4.1**	**4.1**	**3.9**	**4.6**	**5.4**

1: Residential investment
2: Fiscal balance (% GDP)
3: Accumulated, last 12 months
4: Base 1993=100; GDP by sector base 2003=100. The observed data of the primary sector, secondary and tertiary seasonally-adjusted by INEGI, the rest own seasonally-adjusted
bd: billions of dollars
dpb: dollars per barrel
*FRPS: Financial Requirements of the Public Sector
na: not available
Note: **Bold** figures are forecast
Source: BBVA Research with Federal Reserve, Bureau of Labor Statistics, Banco de Mexico, INEGI and SHCP data

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This report has been produced by the macroeconomic unit of Mexico:

Chief Economist
Carlos Serrano
carlos.serranoh@bbva.com

Principal Economist
Arnoldo López
arnoldo.lopez@bbva.com

Javier Amador
javier.amadord@grupobbva.com

Iván Martínez
ivan.martinez.2@bbva.com

Juan Carlos Rivas
juancarlos.rivasvaldivia@bbva.com

Fco. Javier Morales
francisco.morales@bbva.com

With collaboration of:
Economic Scenarios

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Economies:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiza@bbva.com

Asia
Xia Le
xia.le@bbva.com.hk

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo_lopez@bbva.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@grupobbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Recovery and Resolution Strategy
José Carlos Pardo
josecarlos.pardo@bbva.com

Global Coordination
Matías Viola
matias.viola@bbva.com

Global Areas:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation and Process
Oscar de las Peñas
oscar.delaspenas@bbva.com

BBVA Research Mexico
Avda. Universidad 1200
Colonia Xoco
C.P. 03339 México D.F.
Publications:
E-mail: bbvaresearch_mexico@bbva.com

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