RESEARCH

Mexico Economic Outlook

Third Quarter 2015
Mexico Unit

- We are expecting demand from the United States to rise in the next few months and buoy economic growth in Mexico in the second half of the year
- We estimate that annual inflation will continue to come down and close the year at a historical low of around 2.5%
- Recent peso depreciation has been dominated by external factors, such as expectations of an imminent policy rate hike in the United States and the drop in the oil price. The peso should start to appreciate moderately as these factors wear off

Index

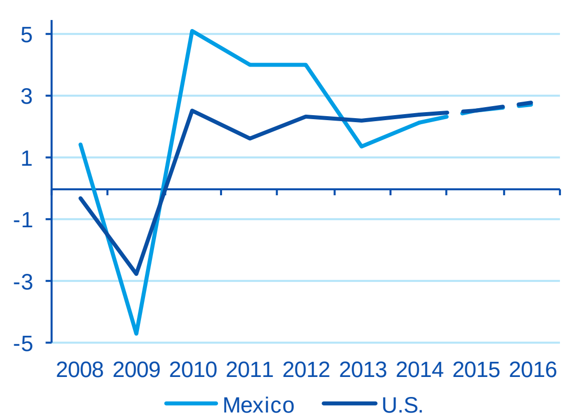
Closing Date: August 14, 2015

1 Summary

The world economy continues to grow, but at a slightly slower pace than we had forecast, especially with respect to the emerging economies, as certain risks loom larger. The developed economies still have encouraging prospects and 2015 will see their strongest growth since 2010, based on monetary policy, lower private borrowing and a retreating oil price, while the emerging economies will slow down for the fifth year in succession, with corrections for both China's growth rate and commodity prices over this period. World growth will nonetheless be modulated by the impact of the Federal Reserve's rate hike, which will be the first since January 2004, as well as the pace of the deceleration of China's economy. In the most likely scenario, 2015 world GDP growth will repeat the figure of 3.4% which was marked in 2014 and will quicken to 3.8% in 2016.

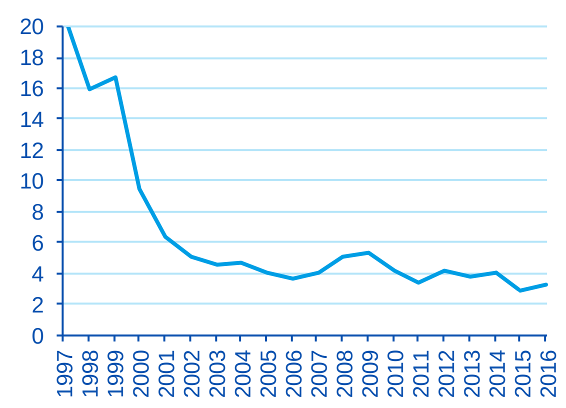
The Federal Reserve (Fed) could make a start on raising the federal funds rate in December, as the targeted level of strength for the US labour market is being reached. Core inflation and wages do not pose any apparent risk to price stability, which, added to the wariness one might expect over the first hike in close to a decade, hints at a very gradual pace for rises, with the federal funds rate arriving at 1.50% around the end of 2016. Within its communications strategy for monetary normalisation, the Fed has said that "this depends on the figures", for which reason any deterioration in the economic situation, most probably outside the United States, or relaxation of inflationary pressure, could delay the first hike and even slow down the pace of those thereafter.

Figure 1
Annual GDP growth in Mexico and the United States (Percentage)



Source: INEGI, BEA & BBVA Research

Figure 2
Annual inflation (Percentage)



Source: INEGI & BBVA Research

In the case of Mexico, we maintain our forecast growth of 2.5% for 2015 and 2.7% for 2016, implying that the economy should be more dynamic than in the previous two years. The key driver of growth should be external demand from the United States, which seems to have begun to materialise with the recent upturn in industrial production there. Additional momentum should come from improved domestic consumption, where, for example, the rise in retail sales suggests a slight pick-up in domestic demand, albeit only a mild one. Such improvement might be linked to the rise in public-sector expenditure that was observed in the first half, a marginal rise in the real wage (around 1.3% above inflation) from falling inflation, and the job formalisation process. Most notable among the risks to this outlook are a greater than expected effect of the announced reduction of public spending (or even a bigger actual cut-back) and lower growth for US industry as a result of weaker global demand.

Headline inflation has continued to plumb new historical lows. In the past three months (May, June and July) it has stood at under 2.9%, even sinking to 2.74% in July. We anticipate that it will stay at under this level for the rest of the year, closing at around 2.5%. Flattering annual comparison effects that are attributable to i) the tax hikes in January 2014, ii) smaller rises in fuel prices, iii) lower electricity tariffs due to the drop in the price of the fuels used to generate it, iv) the substantial slack in the economy, and v) the telecommunications reform, which not only brought an end to long distance charges but also gave rise to tougher competition (this is still feeding through into reductions in the various tariffs for consumers), are the chief factors which have contributed to a benign inflation trend this year and which will allow it to fall back to a historical low at year-end. The main risk as regards inflation and expectations for it is the recent currency depreciation. We nonetheless think that exchange rate pass-through to prices will be limited, given the large amount of slack in the economy and the prospects of the depreciation discontinuing, while we might even see a mild appreciation in 2016. Looking at 2016, we forecast a muted recovery of economic activity, while the comparison effect is likely to be unfavourable with respect to annual inflation, so we predict that this will rise to a shade above 3.0% from January 2016 and average about 3.3% over the year.

Turning to monetary policy, it is worth noting that the central bank has rescheduled its monetary policy decision meetings to one or two days after the Fed discloses its decisions on monetary policy. As well as this, the central bank has been stating that the chief risk regarding inflation is currency depreciation, which could become more accentuated with the start of the cycle of MPR hikes in the United States. We therefore predict that the central bank will open its rate rise cycle at the same time as the Fed. For the moment we still expect both central banks to make their first rises in December this year. Further ahead, the pace of hikes should be gradual and similar to that of the Fed. We still anticipate that Banxico could lift its reference rate to 3.25% and 4.00% by the close of 2015 and 2016 respectively. Even so, if the large amount of slack and low inflation persist for longer than expected, Banxico might consider raising rates at a slightly gentler pace.

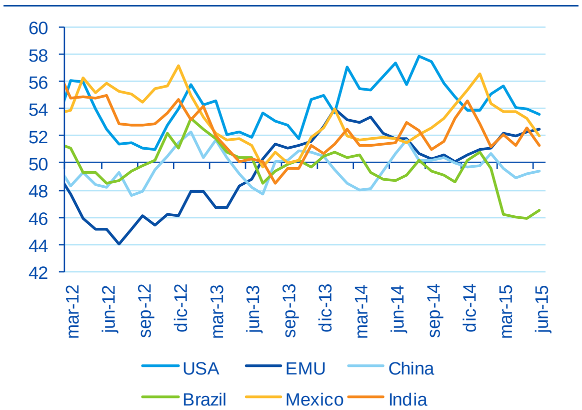
The dollar exchange rate has been hitting historical highs of over MXN16, driven up by figures which support a start on monetary policy normalisation in the United States and a drop in the oil price, which we expect to have bottomed-out. We consider that the peso is above its long-term level, for which reason any statement by the Fed suggesting that the cycle of rate hikes is likely to be slow (this is supposedly set to begin in December) would lend weight to the perception that there will still be liquidity for some time yet, and thus offer scope for a slight appreciation of the peso/dollar exchange rate, which we estimate will be around MXN15.1 at yearend.

2 Moderation in world growth and a marked deceleration in the emerging economies

The growth figures for the major economies confirmed that world GDP decelerated in 1Q15 by showing the weakest annual rate of growth since early 2014 (2.1% compared to an average of 2.8% for the two preceding quarters) according to our estimates[1], The available activity indicators predict more dynamic growth in the world economy in 2Q15, on the back of the recovery in the US (after the stagnation in GDP observed in the first few months of the year), euro area strength and GDP growth in China of 7% YoY, the same reading as in the first quarter. Despite this, world GDP is likely to have grown at under 3% YoY in the first half of the year, thus justifying our downward revision of growth for 2015 as a whole (3.4%, which is 0.1pp below what we were predicting in April). Looking to 2016, the world economy could pick up pace and attain growth of 3.8%.

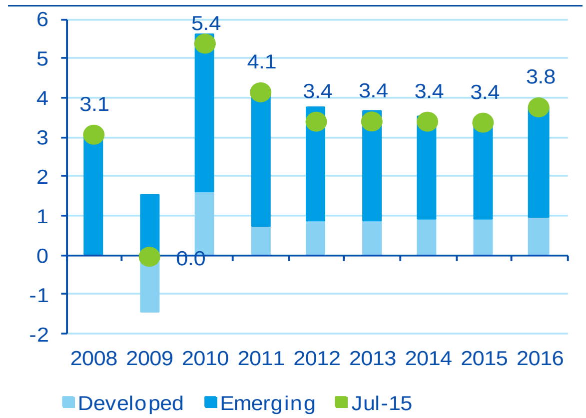
Despite the negative surprise produced by US GDP in the first quarter, the developed economies continue to share encouraging growth prospects, which will contribute to mitigate the impact on world activity and trade of the current slowdown among the key emerging economies. Specifically, while in 2015, the developed nations have the potential to grow at their fastest pace since 2010, at a shade over 2% YoY, the major emerging markets could see weaker growth again for the fifth year in succession.

Figure 2.1
Manufacturing PMI (levels of over 50 points indicate an expansion of activity)



Source: BBVA Research & Haver

Figure 2.2
World growth: annual growth (%). 2015-16 forecasts1



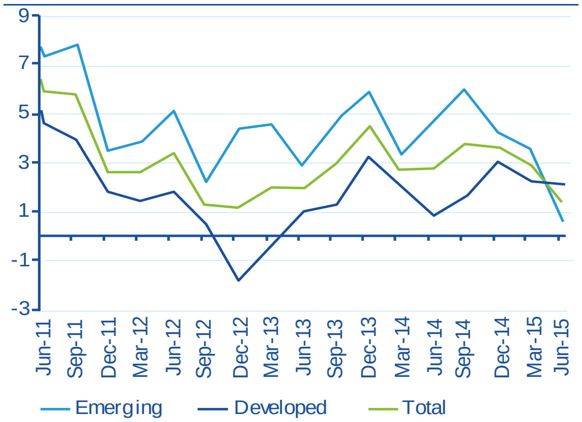
Source: BBVA Research

An indication of the stubbornness which has set into the deceleration of the emerging cycle is the deterioration of the readings for trade, industrial production and business confidence in some of the more notable economies since late 2014. Asia's export volume experienced the biggest quarterly correction since 2009 in the course of the first half, which was largely due to the effect of weaker demand from China on the trade flows of the other countries in the region. The industrial activity weakness in Latin America, which has been on the wane for seven consecutive quarters now, is another thermometer which tells a tale of both the impact of the lower growth in China and the loss of domestic demand pull in major economies such as Brazil. The fact that the manufacturing sector sentiment indexes in Asia and Latin America still stand at levels compatible with a contraction in production at the end of the

[1]: Estimation based on the BBVA Research global activity indicator (GAIN). Details on methodology at http://bit.ly/1nl5RIn

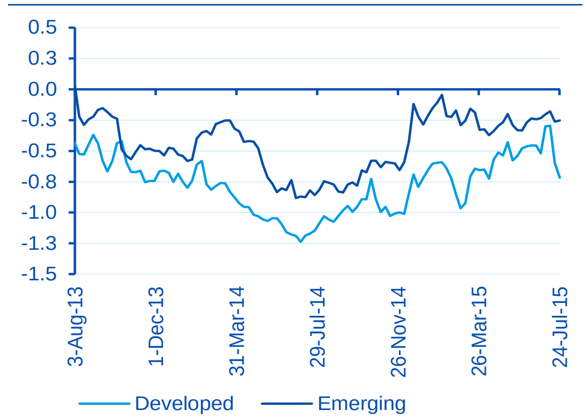
second half does nothing to hint at any reversal in these dynamics in the short term, above all in a context of stabilization of commodity prices at low levels (the price of Brent has come down by 10 dollars per barrel in one month to 55 dollars at the end of July). Eastern Europe's trade exposure to the euro area, and in particular Germany, accounts for the better relative performance of this region at the start of the year.

Figure 2.3
World trade
(YoY change of goods export volume, %)



Source: BBVA Research & CPB

Figure 2.4
BBVA financial tensions index



Source: BBVA Research

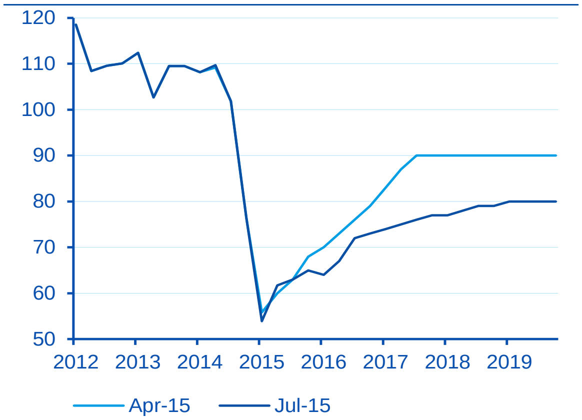
Besides the downward revision of growth forecasts for the world economy, a hallmark of the global context in the last quarter has been the manifestation of some of the risk events that we singled out three months ago and, if they take a turn for the worse, this could bring the global economic recovery to a halt. The first of these involves the bout of financial instability in China. This was brought about by the sharp correction of its stock market, within a situation of trend deceleration in growth, which has drawn on substantial borrowing, and a process of financial liberalisation still underway. The second, which is equally significant, is the Greek crisis, and the constrains to reach an agreement that ensures that the country will face its financial commitments in the short term, as well as the sustainability of its debt via reforms to enhance the economy's capacity to grow in the long term.

The combination of these two risk events, together with the approach of the Fed's rate hike, has heightened financial disruption the world over, particularly in the form of greater volatility in stock and currency markets, with a heavier impact on the euro area and Asia. The upturn in the BBVA financial tensions index has been significant, both among the block of developed countries and in their emerging counterpart, since the end of 2014. In this regard, the maintenance of loose monetary policies, above all in the wake of the implementation of the ECB's public debt purchase programme, is proving decisive. Even so, the risk that we might see a further outbreak of financial volatility when the US rate hike cycle takes place remains high.

The strength of the US labour market and the transient nature of the recent correction of activity continue to suggest that the first fed funds rate hike is set to take place in December. As the Fed continues to say that monetary tightening will be very gradual and the global context has worsened on events in China and Greece, the market is discounting a pace of hikes, and therefore the level of the fed funds rate in late 2016, substantially below FOMC forecasts. The need for the monetary normalisation process to take place makes the case for 2015 as the year when the first rate hike occurs. Nonetheless, the path of the hikes will be conditioned by the soundness of economic recovery and inflation expectations. We think that any further deterioration in the external environment of the US could delay the lift-off of the hike cycle, which in any event would take the Fed funds rate to a level of 1.50% at the end of 2016. If the

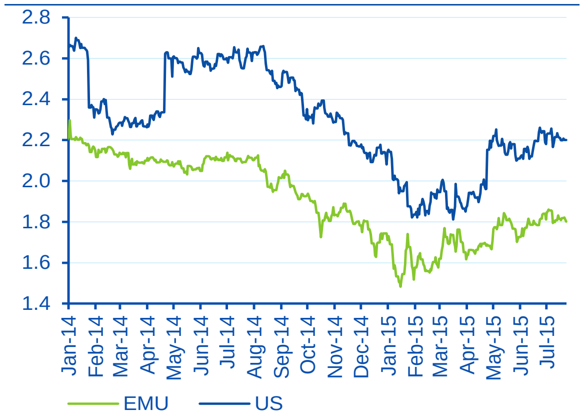
Fed chooses a pattern of hikes which is more aggressive than the recovery suggests, the increases in financial volatility could be substantial; however, whatever happens, the room for manoeuvre of the central banks in the emerging economies to make further cuts in rates, which are at historically low levels in most of them, would be minimal given the risk of a reallocation of capital flows towards developed countries.

Figure 2.5
Oil price (USD/bbl) and forecasts



Source: BBVA Research & Bloomberg

Figure 2.6
Medium term inflation expectations (inflation swaps, %)



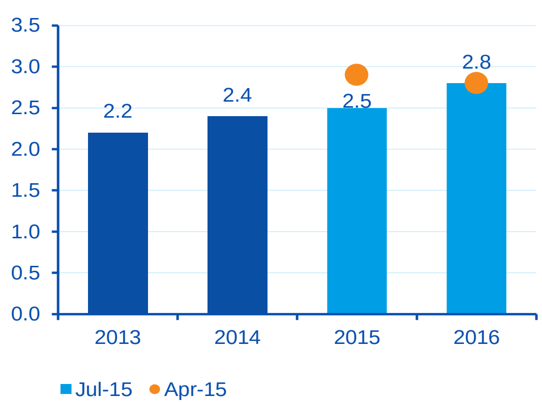
Source: BBVA Research & Bloomberg

With respect to the situation regarding prices, one of the distinguishing factors of the global scenario in the past quarter has been the moderation of the decline in rates of inflation in response to the stabilization of the oil price and the scale of monetary stimuli. Even so, in the block of developed countries these remain some way below the levels that are compatible with the price stability targets of monetary authorities. The correction of oil price forecasts due to both supply factors and the slowdown in demand in China could become a burden on the fledgling recovery in consumer prices and lead to heavier falls in industrial and import prices. The increase in the oil supply from Iran after its nuclear agreement with the US and the improved efficiency in US production channels herald a larger supply increase than was forecast early on in the year. Although lower energy prices arising from a more readily available supply provide a kick-start for world economic growth in the medium term, they might hold it back in the short term given their negative impact on the revenues of net producers and energy sector investment in economies such as the US.

The direction of monetary policies, and developments regarding risk flashpoints and the commodities market will continue to set the course for capital flows and, therefore, financial variables. The expected divergence between the monetary policies of the Fed and the ECB, as well as uncertainty over the resolution of the Greek crisis, will continue to bolster the dollar's exchange rate against the euro in a scenario where the long-term yield spread between sovereign assets in the two areas will remain more favourable to the US. Meanwhile, the slower growth in the bulk of the emerging economies will limit the appreciation of their currencies.

Looking in more detail at the key areas, note the sharp slowdown in the US economy, with essentially stagnation of GDP in the first quarter, while the progress made in 2Q15 was only modest judging by the available indicator readings for activity and confidence. The worse than expected first half on balance warrants a downward revision for growth for 2015 as a whole, which could amount to 2.5%, or some 0.4pp below the level we forecast in April. The uncertainty over how the economic cycle will perform in the coming quarters has now been heightened bearing in mind the impact of the persistent dollar appreciation on exports, the weakness of private investment and the deterioration in the global situation. Even so, US GDP could grow by 2.8% in 2016.

Figure 2.7
US: economic growth (% annual change)



Source: BBVA Research

Table 2.1
Fed monitor of economic data

	Unemp. rate, %	3MMA Change in Nonfarm Payrolls	PCE Core Inflation (YoY, %)	Average Hourly Earnings (YoY, %)
Goal	5.2-5.5	200	2.00	2.50
QE3 Start (Sep-12)	7.8	157	1.66	1.44
Dec-13	6.7	198	1.34	2.16
QE3 End (Oct-14)	5.7	228	1.48	2.27
May/June 2015	**5.3**	**221**	**1.24**	**1.94**

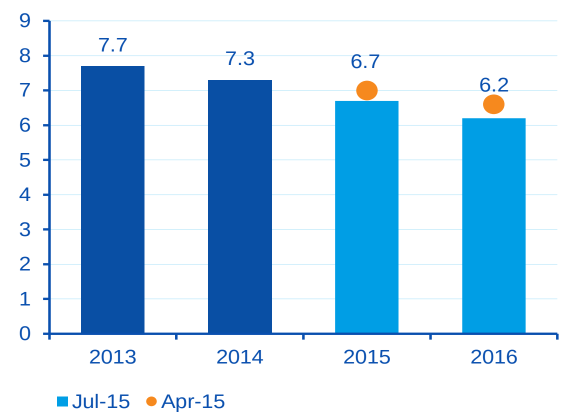
Source: BBVA Research & Haver

Expectations of improved economic activity to a large extent hang on growth in private consumption backed by sustained job creation (the US continues to create jobs at a rate of 200,000 a month and the unemployment rate has dropped to 5.3%), the steady recovery in housing prices and the relief provided to the household debt burden from interest rates remaining at low levels. Despite this, modest real wage growth, which still stands at slightly below 2% YoY, and the upturn in the family savings ratio account for the slower rise in consumption compared to other periods of similar activity levels in the labour market and low prices. The gradual convergence of inflation towards the 2% monetary policy target also hinges on an increase in private consumption. This target might not be achieved until as late as 2017 (0.5% and 1.8% are the headline inflation forecasts being mentioned for 2015 and 2016) and is what is determining the Fed's response function.

China has become the focus of attention in the last quarter on account of the sharp correction to its stock market and the potential impact that this might have on both its domestic economic cycle and world growth. For the moment, the first half of the year has produced a 7% increase in GDP YoY, although the pace of the economy's growth is likely to ease up owing to the impact of the recent bout of financial tensions. Besides the negative effect on the confidence of private sector, there might also potentially be some reversal of consumption decisions as a result of the drop in households' financial wealth[2]. More than anything though, there is likely to be a deterioration in financing conditions for corporates, which is associated with both the suspension of new placements and the loss of value of collateral backing bank loans. These are the factors responsible for the downward revision in the growth forecast for China in 2015 and 2016 to 6.7% and 6.2% respectively (0.3pp and 0.4pp lower than in our April scenario).

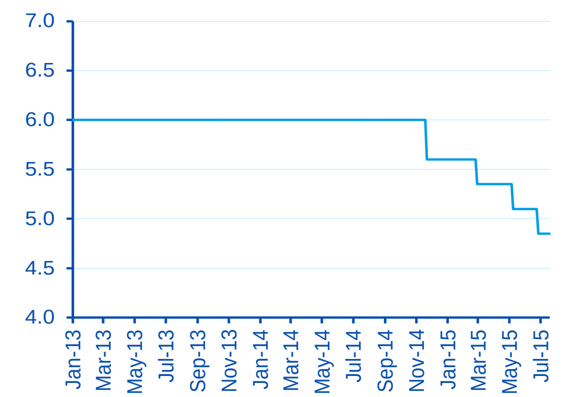
[2]: Based on available information as of 2012 from the Household Financial Survey, 8% of Chinese households acknowledged having investments in the stock market, while the percentage almost doubled in the case of urban households.

Figure 2.8
China: economic growth (% annual change)



Source: BBVA Research

Figure 2.9
China: official interest rates (%)



Source: BBVA Research & Haver

The battery of stimulus measures implemented by the country's authorities to stave off the possibility of even worse contagion to the economic activity cycle is the reason why we do not expect a more intense correction to the rate of growth. This is even taking into account the ongoing deceleration in the economy (the stabilisation of headline inflation rates at below 2% is a good example of this). In addition to the three cuts in the reference rate and the two cuts in the reserve requirement since the end of 2014, there has been a programme to inject liquidity into the banking sector by means of discounting local government debt (pseudo quantitative easing) and recent decisions have targeted stock market stabilisation, which has received a decisive boost from the state-owned companies. It is likely that loose monetary policy will be continued for the rest of the year, with a further 50bp cut in the reference rate, and that fiscal policy will gradually be made more flexible.

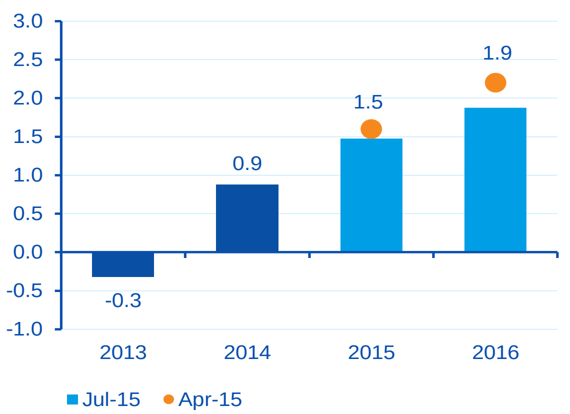
The pattern in the euro area is still one of sustained recovery, with quarterly GDP growth rates in the order of 0.4% in the first two quarters of the year. Domestic demand, and in particular, private consumption, are continuing to underpin improved activity, which is beginning to become a common feature among the key economies as a whole. The improved dynamics in France and Italy are combining with the strength of Germany and Spanish GDP growth, which is advancing at a quarterly pace of close to 1%. The emergence of certain risk hotspots with differing impacts on the region could slightly reduce estimated growth for 2015 and 2016 but, even so, the forecasts are still positive (+1.4% in 2015 and +1.9% in 2016, 0.1pp and 0.3pp below those we forecast in April).

The economic recession in Russia and the deceleration in China could affect export dynamics in a situation where euro depreciation might be more contained than expected at the start of the year. Investment growth is still one of the outstanding issues in euro area recovery, as it is still languishing at a low level (less than 22% of GDP), for which reason any tighter financing linked to uncertainty over the Greek crisis could eventually affect new lending decisions (higher costs and/or a reduction of loan principal granted) and, in the end, investment. On the other hand, the fall in the oil price and the ECB monetary stimuli[3] constitute key elements of support if GDP growth is to achieve the rates forecast. The improvement in demand and the scale of the ECB's liquidity injections are in fact reducing the risk of deflation, judging by the stabilisation of inflation readings and the upturn in medium-term price expectations. We will nonetheless have to wait until 2017 to see inflation rates converging towards 2%.

[3]: The monetary authority has repeated its intention to see its asset purchase programme through and keep it going until at least September 2016.

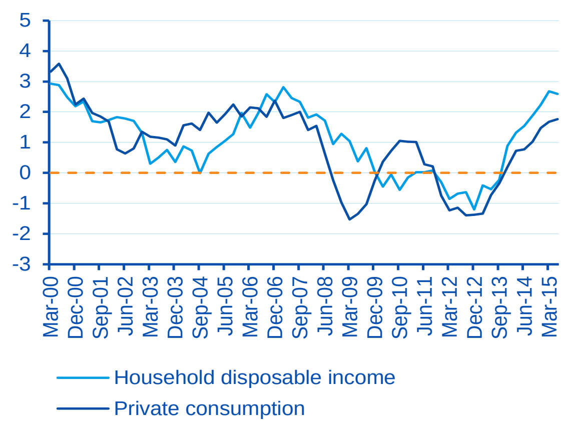
In addition to consolidating the economic recovery, the euro area faces major challenges in the medium term. Without a doubt the most significant of these is to try and dispel any scepticism about the irreversibility of the monetary union project. The financial firewalls, progress in banking union and the reforms undertaken in the area's various economies, as well as the reinforcement of the economic cycle, have substantially reduced the financial contagion from the Greek crisis compared to 2010 and 2012. Even so, in the absence of greater progress towards unifying banking and capital markets which might allow a reduction in financial fragmentation, plans that demonstrate the will to move towards greater fiscal integration, and without any rethinking of potential bailout programmes, the risk of disruptive scenarios emerging in the euro area as a whole is high. The discrepancies observed in the negotiations between the Greek government and the European authorities, and between the latter and other official organisations such as the IMF in relation, for example, to the need to deal with the issue of debt restructuring, are evidence of the need to define a framework for handling financial assistance for countries with debt sustainability problems that goes beyond fiscal consolidation.

Figure 2.10
Eurozone: economic growth (% annual change)



Source: BBVA Research

Figure 2.11
Euro area: private consumption and household real disposable income (% YoY change)



Source: BBVA Research & Eurostat

3 Moderate economic activity and inflation at a historical low

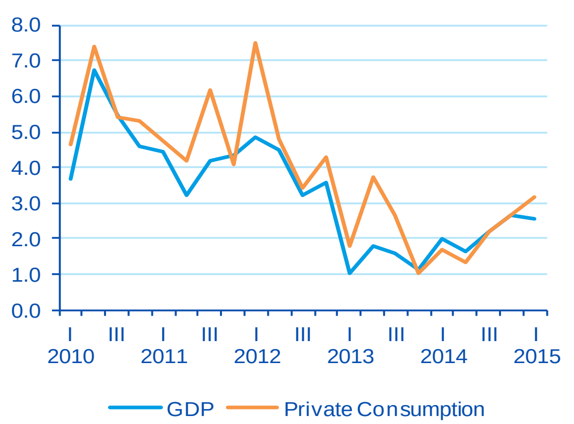
3.1 External factors are limiting economic growth

In the past few months, Mexico's economy has been exposed to various exogenous elements which have cramped its economic growth. Most notable among these are a sharp fall in the international price per barrel of oil and limited signs of life in the US economy. Conversely, there has been something of an improvement in domestic aspects. The cumulative effect of these factors is identifiable in the performance of the different components of GDP, which we shall go on to examine.

3.1.1 Private consumption

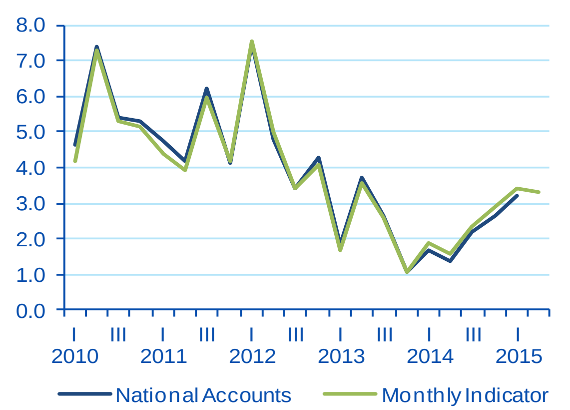
The portion of consumption realised by the private sector is the principal component of GDP. According to the National Accounts, on average, private consumption over 2005-14 represented some 66.7% of GDP, meaning that healthy private consumption growth will go hand in hand with a rise in national output (see Figure 3.1).

Figure 3.1
GDP and private consumption (Real YoY % change)



Source: BBVA Research with INEGI's National Accounts data.

Figure 3.2
Private consumption: National Accounts and quarterly average for the monthly private consumption indicator (Real YoY % change)

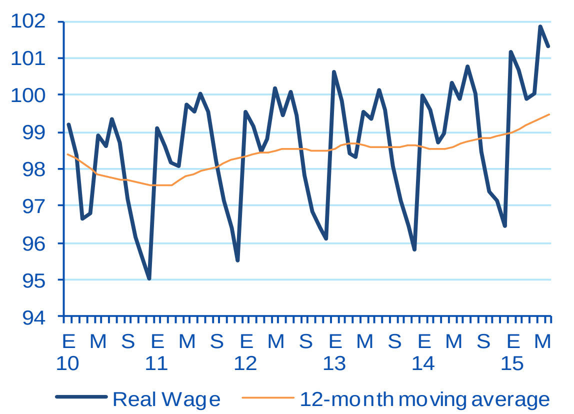


II * 2Q15 estimated.
Source: BBVA Research with INEGI data.

Although the figures on private consumption which INEGI publishes are quarterly, it also publishes the monthly indicator of private consumption in the domestic market, which shadows the National Accounts figure very closely (see Figure 3.2). Using the observed information for April and May provided by the monthly private consumption indicator, and estimating the figure for June based on the recent labour market performance, we calculate that private consumption's annual growth rate (AGR) in 2Q15 is likely to have been 3.3%, which is on a par with the figure of 3.2% for 1Q15.

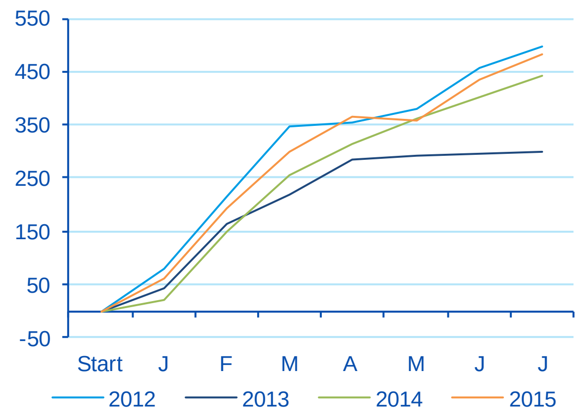
Among the key variables in determining private consumption's performance is the average wage associated with contributions for workers registered with the IMSS (Mexican Social Security Institute) and new jobs created within the formal sector. Note that those who work and are registered with the IMSS represent the formal employment segment in Mexico's private sector. In the last few months, the real wage has risen gently, thanks to the drop in inflation, which has stood at under 3.0% (see Figure 3.3). This situation might, however, be temporary, as inflation is expected to increase in 2016.

Figure 3.3
Average wage registered with the IMSS in real terms (January 2014=100)



Source: BBVA Research with INEGI data.

Figure 3.4
Cumulative monthly rise in new IMSS-registered workers (thousands)

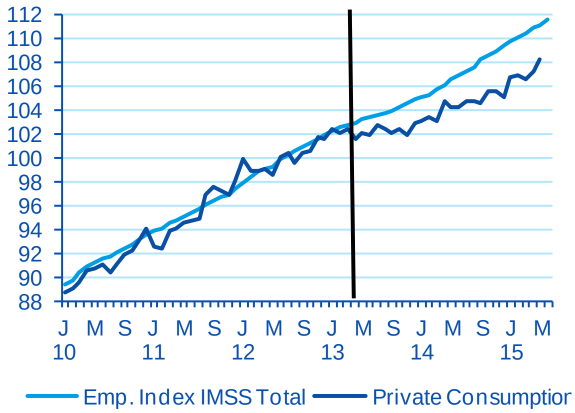


Source: BBVA Research with INEGI data.

From January to July 2015 the trend in numbers of workers registered with the IMSS was positive. Specifically, from December 2014 to July 2015 the total number of IMSS-registered workers rose by 482,000 (see Figure 3.4), while this increase was larger than that recorded in 2013 (almost 301,000) and 2014 (441,000) and marginally below the rise in 2012 (499,000).

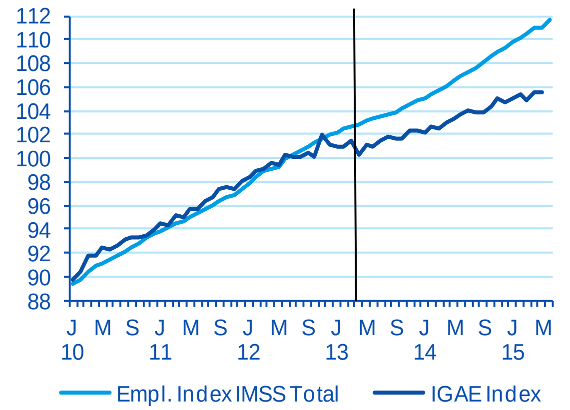
Nonetheless, as regards recent readings for IMSS-registered workers, it is important to bear in mind the job formalisation programme, which has enjoyed success in encouraging social security cover for existing jobs that previously did not benefit from this. This fact is manifested by a divergence from 2013 between the total number of IMSS-registered workers and both private consumption (see Figure 3.5) and economic activity measured via the Global Economic Activity Indicator or IGAE (see Figure 3.6), in the sense that before 2013 new worker registrations with the IMSS used to provide a more direct indication that new jobs represented additional income that could be spent on private consumption.

Figure 3.5
Total number of IMSS-registered workers and private consumption index (2012=100, sa)



Source: BBVA Research with INEGI data.

Figure 3.6
Total number of IMSS-registered workers and the IGAE (2012=100, sa)

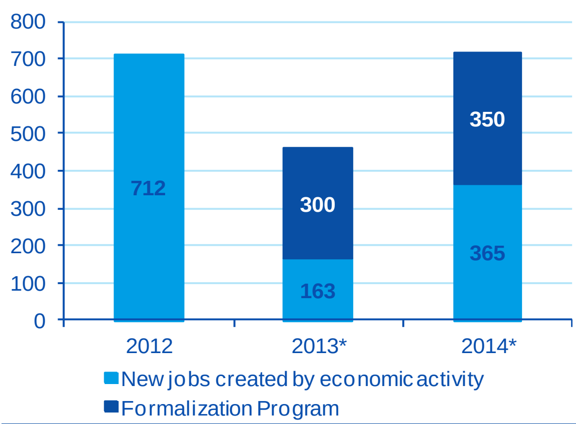


Source: BBVA Research with INEGI data.

With respect to the scope of the job formalisation programme, the labour authorities have stated that in 2013 this benefited some 300,000 workers and from 300,000 to 350,000 in 2014 (see Figure 3.7).[4]

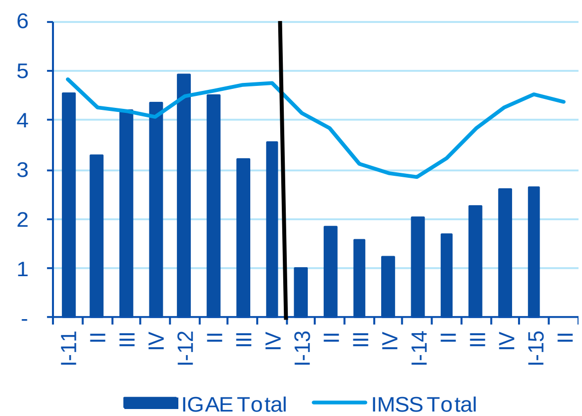
The figures suggest that the job formalisation programme continues to be effective, as official numbers for IMSS-registered workers continue to rise at relatively high rates in comparison with both private consumption and economic activity in Mexico (see Figure 3.8).

Figure 3.7
Total IMSS employment generated by economic activity and formalisation (thousand IMSS-registered workers)



*Estimated
Source: BBVA Research with INEGI & STPS data.

Figure 3.8
Total IMSS employment and IGAE (Annual growth rate, quarterly average)



Source: BBVA Research with INEGI data.

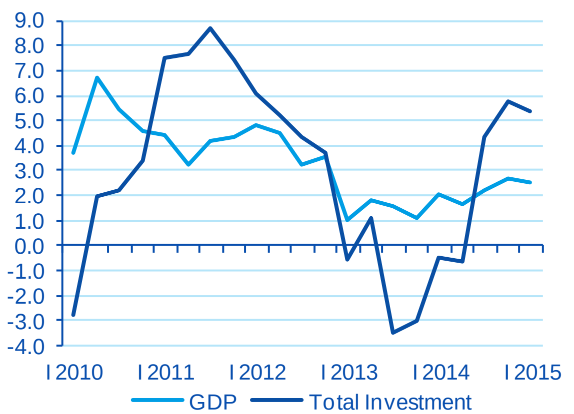
[4] See article "Se formalizan 40 mil empleos en el Estado de México", published in El Financiero 7 February 2014.

The job formalisation programme provides welfare for workers, who benefit from it, since both they and their families gain access to social security cover. That said, it would be desirable for the monthly statistics that are published by the IMSS to separate out the percentage of the number of new IMSS-registered workers that arises from the job formalisation programme, since this would help to estimate the future trend for private consumption and the IGAE with greater accuracy.

3.1.2 Gross Fixed Investment

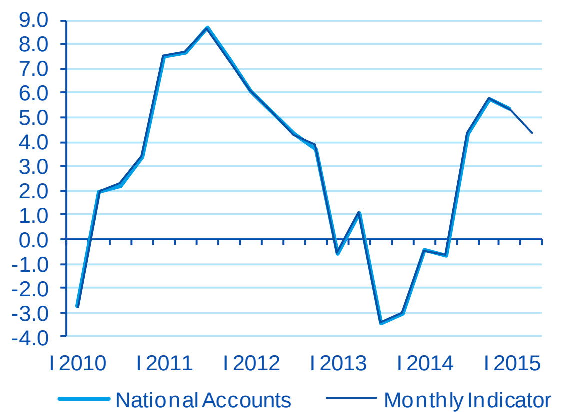
Total gross fixed capital formation (GFCF) covers fixed investment made by both the public and the private sectors. This variable is one of the components of GDP and, according to the National Accounts, on average for 2005-14 represented 21.8% of GDP (16.9% private and 4.9% public). The variable's performance in 2013 was poor, since it recorded negative annual growth of 1.6% and, although this improved to a positive reading in 2014, this was also still only limited (2.3%), featuring negative annual growth rates in the first two quarters and a rally to relatively high rates in the last two that year, largely on account of an annual comparison effect since the most decisive of falls in 2013 (see Figure 3.9). This same comparison effect influences the positive annual growth in 1Q15 (see Figure 3.10). Using the monthly gross fixed investment indicator reading observed in April and May, and only estimating the June figure, we calculate that GFI in Q2 is likely to have grown by 4.4% in annual terms from 5.3% in the previous quarter.

Figure 3.9
GDP and total Gross Fixed Investment (YoY % change)



Source: BBVA Research with INEGI's National Accounts data.

Figure 3.10
Gross Fixed Investment: National Accounts and monthly GFI indicator quarterly average (YoY % change)



II * 2Q15 estimated by BBVA Research
Source: BBVA Research with INEGI data.

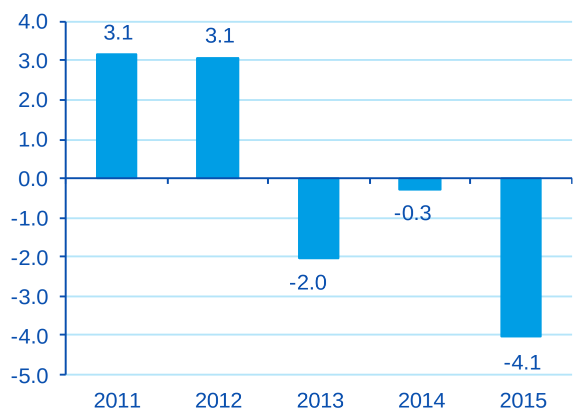
For the second half of the year, we expect somewhat lower annual growth rates (AGRs) for gross fixed investment. This is due to two factors. First, an unfavourable arithmetical effect in comparison with a major improvement in 2H14. Second, limited public-sector investment given the tax cut announced last January and the need to reverse federal government expenditure which, by 1H15, had overshot the authorised level of 6% for the year.

On top of this, one factor which could harm gross fixed investment, especially its import-sourced machinery and equipment investment component, is if the dollar exchange rate were to stick at high levels for a long time, which would make such investment more expensive.

3.1.3 External sector

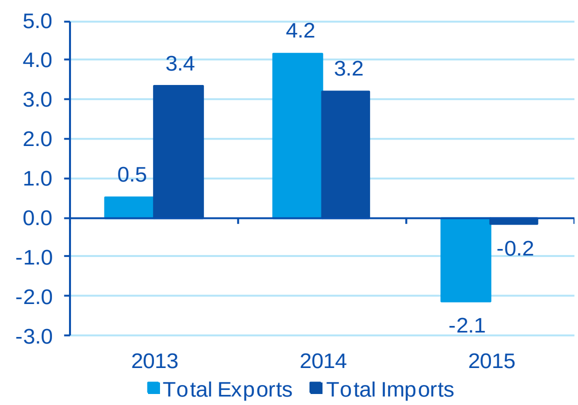
In 1H15 the country's balance of trade deteriorated in relation to the reading in 2014. In the first six months of the year the trade deficit was almost USD4.1bn, whereas over that time in 2014 the cumulative deficit was a mere USD0.3bn (see Figure 3.11). The decline in this account with the outside world was brought about by the fact that over this time total exports came down by 2.1% YoY, while imports shrank by a lesser extent, of only 0.2% (see Figure 3.12).

Figure 3.11
Cumulative trade balance from January to June (USD bn)



Source: BBVA Research with INEGI data.

Figure 3.12
Cumulative goods imports and exports from January to June (YoY % change)



Source: BBVA Research with INEGI data.

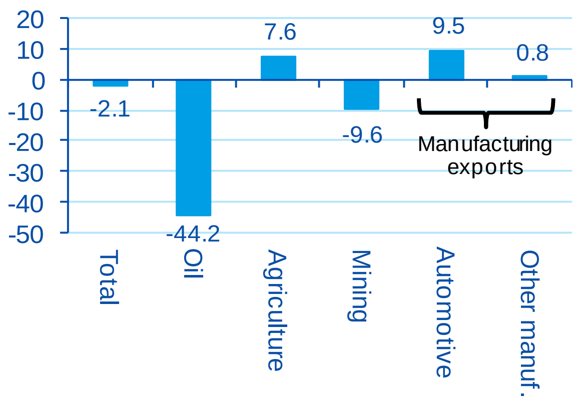
3.1.3.1 Goods exports

The reason for the poor performance by total exports in 1H15 was the drop in revenues from oil exports. In the first six months of 2014 the oil exports totalled almost USD23bn, while over the same time in 2015 this figure fell back to USD12.8bn. In other words, first half oil exports shrank by USD10.3bn compared to the previous year, which represents a 44.2% decline. It is worth noting here that the figure of USD10.3bn represents more than double the trade deficit of USD4.1bn in the first six months of 2015.

The fall in oil exports was mainly because the price per barrel of Mexican export mix dropped from an average of USD94.7 in 1H14 to one of USD49.7 in the same half of 2015, meaning that the average export price of a barrel of crude plunged by 47.5%. This percentage fall is similar to the figure of 44.2%, which describes the drop in oil exports over the time referred to. Consequently, the relative weight of oil exports within exports overall also came down, from 11.9% in 1H14 to 7.0% in 2015.

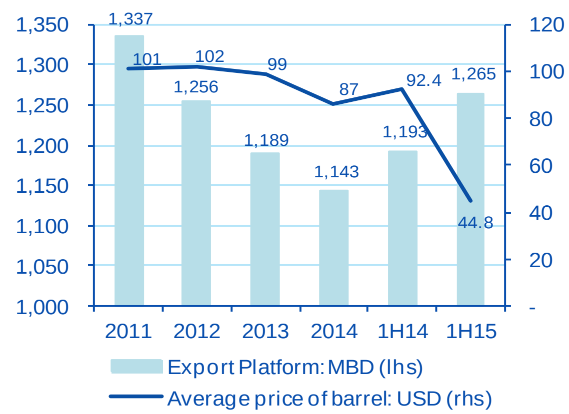
By way of contrast, in 1H15 non-oil exports performed better, recording annual growth of 3.6% over this time, which, in absolute terms, represents USD6.1bn more compared to the reading for these in the same period in 2014. Within the components of this item, in 1H15 automotive exports featured prominently, posting an AGR of 9.5% and accounting for 30.1% of total goods exports, while agriculture and livestock rose 7.6% with a share of 3.9% of the total figure, although non-automotive manufactures grew by a meagre 0.8% and yet represented 57.9% overall, and non-oil extractive exports fell away by 9.6%, with 1.3% of the total.

Figure 3.13
Cumulative goods exports from January to June by category (YoY % change)



Source: BBVA Research with INEGI data.

Figure 3.14
(Thousands of barrels exported per day, TBD, and average price per barrel exported in USD)

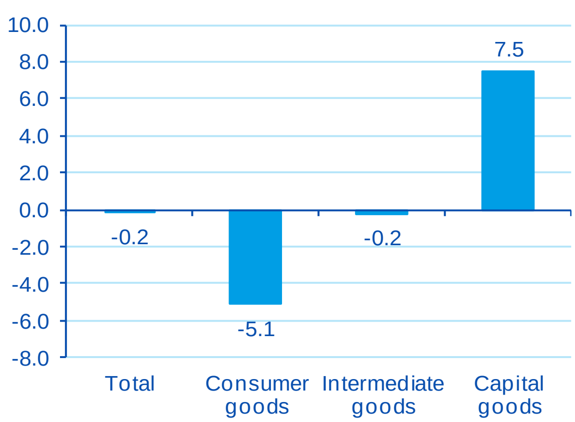


1H= first half
Source: BBVA Research with INEGI data.

3.1.3.2 Goods imports

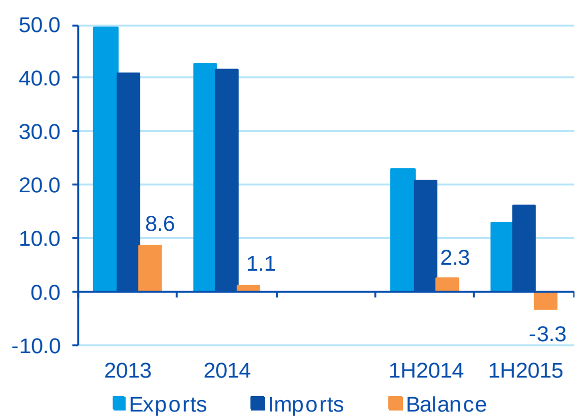
As has been said, in 1H15 total goods imports registered an AGR of a negative 0.2%. By category, capital goods imports were the only ones which showed positive growth over this time, which was 7.5%, although their relative weight within total goods imports is small, as these represent 10.5% of total imports.

Figure 3.15
Cumulative goods imports from January to June (YoY % change)



Source: BBVA Research with INEGI data.

Figure 3.16
Oil balance (USD bn)



1H= first half
Source: BBVA Research with INEGI data.

On the other hand, intermediate goods imports showed an AGR of a negative 0.2% and represented 76% of total imports, while consumer goods imports came down by 5.1% and had a 13.6% share of total imports. It should be pointed out that this type of import decreased due to the fact that imports of oil consumer goods dropped by 22.4% in the time used for comparison, while other consumer goods rose by 1.9%.

Given that non-automotive manufacturing exports represent 58% of Mexico's total exports, if their weak showing persists, the country's export sector will be hard-pressed to generate significant GDP growth, even though imports have been only limited. The need to have a dynamic non-oil export sector is overwhelming if we take stock of the fact that for 1H15 the balance of trade figure for the oil sector was negative.

3.1.4 Public finances

3.1.4.1 Public sector expenditure

Total public sector budget expenditure showed a real AGR in 1Q15 of 11.9%, with one of 7.4% in cumulative terms for the first half, which means that the implied annual rate for Q2 ought have been 4.2%. This tells us that although expenditure has continued to rise, it has been slowing down slightly.

On the other hand, total net public sector budget expenditure in the first half showed an overshoot of 5.7%, for which reason a correction is expected in H2. In addition to this correction, the spending cut announced in January as a result of expectations of a lower oil price on world markets suggests that in 2H15 total public-sector expenditure will continue to be reined in.

Table 3.1
Cumulative public-sector budget expenditure, January-June 2015 (MXN bn)

	Sum	Real % chge.	% struc.
Total	**2,398.7**	**7.4**	**100.0**
Projected Expenditure	1,846.8	**7.4**	77.0
Current Expenditure	1,374.7	**5.8**	57.3
Capital Expenditure	472.1	**12.2**	19.7
Non-Projected Expenditure	551.9	7.7	23.0
Investments in States	320.0	2.5	13.3
Borrowing Cost	210.3	17.9	8.8
Adefas* and other	21.6	-0.8	0.9

* Adefas: Debits carried over from previous years
Source: BBVA Research with SHCP data.

Table 3.2
Cumulative public-sector budget revenues, January-June 2015 (MXN bn)

	Sum	Real % chge.	% struc.
Total	**2,048.5**	**4.0**	**100.0**
Federal government	1,582.8	7.8	77.3
Tax	1,229.1	29.2	60.0
ISR	662.4	24.8	32.3
IVA	346.5	0.9	16.9
Non-tax	353.6	-31.6	17.3
Agencies & Companies	152.0	5.3	7.4
Government productive companies	313.8	-12.0	15.3
Pemex	165.4	-14.4	8.1
CFE	148.5	-9.1	7.2
Total	2,048.55	4.0	100.0
Oil income	381.9	-38.3	18.6
Non-oil income	1,666.7	26.5	81.4

Source: BBVA Research with SHCP data.

In accounting terms, public expenditure is divided into two broad categories, which are: i) projected expenditure, where the cumulative figure from January to June 2015 showed an AGR of a real 7.4% and represented 77% of total expenditure, and ii) non-projected expenditure, for which annual growth was 7.7% and which accounted for 23% of total expenditure. Projected expenditure is further divided into *Current expenditure*, where real annual growth in the period under review was 5.8%, and *Capital expenditure*, which saw growth of 12.2% (see Table 3.1).

With respect to non-projected expenditure, we find that it is the *Borrowing cost* line that has exhibited the strongest growth rate, which was 17.9%. This item could grow even more, given expectations of a potential rate hike in the United States. On the other hand, the non-projected line *Investments in states* recorded modest growth (2.5%), while *Debits carried over from previous years* (Adefas) came down (-0.8%).

Note that the contribution to GDP by public-sector expenditure in both its Public Sector Consumption and Public Sector Gross Fixed Investment items in the National Accounts has typically been limited. For example, in 1Q15 the items as a whole within Public Sector Consumption plus Public Sector Investment contributed 0.4 percentage points (pp) out of annual growth of 2.5% or 2.5pp of GDP in the first quarter, and this occurred with an AGR of 11.9% for public sector expenditure over the period.

However, in 2Q15 public sector expenditure's AGR was brought down to 4.2%, so there is a good chance that this type of expenditure's contribution to growth over the period will have been smaller than the figure of 0.4pp which was registered in the first quarter, unless execution of expenditure has fallen significantly behind or been more concentrated on infrastructure.[5]

3.1.4.2 Public-sector revenues

Cumulative public-sector revenues in 1H15 registered a real AGR of 4.0%. Of the three major categories of revenue, the item for the Federal Government was the one which grew the most (7.8%), followed by *Agencies and companies under budgetary control* (5.3%). On the other hand, the *Government productive companies* revenue contracted by 12% (see Table 3.2). This was mainly brought about by the lower price of the Mexican mix of crude oil for export.

The drop in the international price per barrel of Mexican export crude caused the share of oil revenues out of the total for the public sector to fall from 31.4% in June 2014 to 18.6% on the same date in 2015. This provides an insight into how the structure of public-sector revenues could be altered if the price per barrel of Mexican mix export crude stays at relatively low levels of around the USD50 mark.

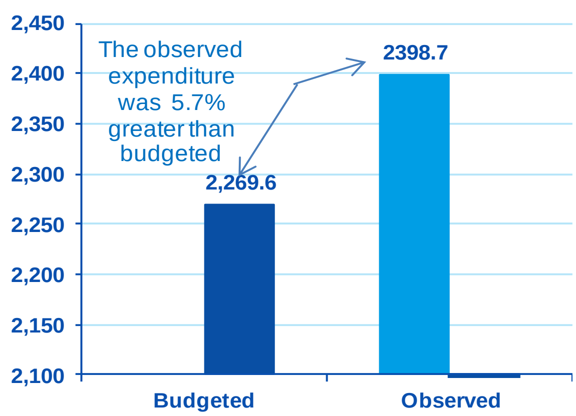
It is worth noting that in 1H15 oil revenues registered an annual reduction of 38.3%, while the public sector's non-oil revenues grew to such an extent that their overall rise (26.5%) managed to offset the drop in oil revenues and even produce real growth of 4.0% in total revenues. Behind this showing by total revenues was a fine performance by Federal Government tax revenues, which grew by a real 29.2% over the period. Notable within tax revenues was the strong reading for income tax or *ISR* (24.8%). This sound performance by ISR could be attributable to tighter oversight of it and the impact of the 2014 tax reform. On the other hand, the special petrol and diesel production and services tax (*IEPS*) has also been a fruitful source of revenues, and this revenue line has seen a sea-change, from a negative total of MXN17.7bn in 1H14 to a positive MXN114.5bn for 1H15, when it accounted for 9.3% of all tax revenues.

[5] The calculation of the contribution to GDP growth by its components that are part of the National Accounts of the country, such as the case with items of Public Consumption and Public Investment, is based on multiplying the percentage structure of these concepts within the GDP in the preceding period for its annual growth rate. As an example we have the following case. In the first quarter of 2015 the sum of the items of Public Consumption and Public Investment reported an annual growth rate of 2.7% or 2.7 pp., in addition to the relative share of these items in GDP in the first quarter of 2014 was 15%. Multiplying 2.7 pp growth by 0.15 of percentage structure gives the 0.4 pp contribution to growth of public spending to GDP growth in the first quarter of 2015.

3.1.4.3 Public-sector balance

The acceleration of public sector expenditure compared to its revenues translated into a public sector deficit position of MXN345bn in 1H15 (see Table 3.3), which represents 1.9% of GDP. According to the tax authorities, this shortfall meant an overrun of almost MXN40bn in relation to the deficit that had originally assumed for the first half of the year and arose from the drop in the price per barrel of Mexico's export oil mix, as the expected revenue from the hedging by the federal government against the oil price per barrel has still not been included, which will be received in around December this year.

Figure 3.17
Public-sector budget expenditure. January to June 2015: projected and observed (MXN bn, cumulative)



Source: BBVA Research with SHCP data.

Table 3.3
Public-sector finances from January to June (MXN bn, cumulative)

	2014	2015	Real % chge.
Public balance	-233.1	-345.0	ns
Public balance w/o productive investment	-53.2	-87.0	ns
Budget balance	-255.8	-350.2	ns
Budget revenue	1,912.0	2,048.5	4.0
Net budget expenditure	2,167.8	2,398.7	7.4
Federal Government Balance	-226.5	-256.6	ns
Agencies and Companies Balance	-29.3	-93.5	ns
Primary Balance	-65.0	-130.3	ns
Budget Balance	-82.6	-139.9	ns
Federal Government	-77.0	-93.4	ns
Agencies and Companies	-5.6	-46.4	ns
Pemex	-80.3	-125.7	ns
Other institutions	74.7	79.3	3.0
Indirectly-controlled institutions	17.6	9.6	-47.4

Source: BBVA Research with SHCP data.

3.1.4.4 Public-sector debt

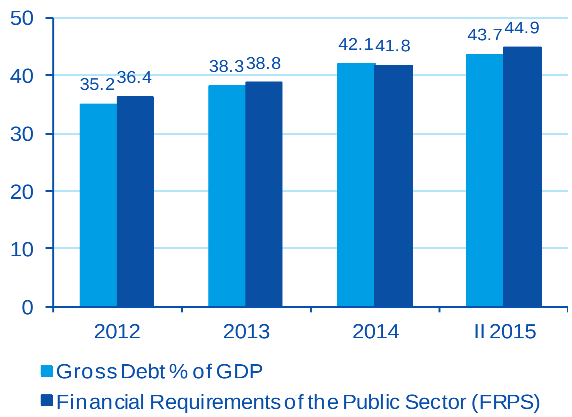
Total gross public-sector debt rose from 42.1% of GDP in 2014 to 43.7% in June 2015 (see Figure 3.18). In the first six months of the year total gross debt climbed by 1.6 percentage points of GDP as a result of the public-sector deficit and the limited growth in economic activity in the period. Alternatively, if we look at the historical balance of the public-sector net cash requirements (PSNCR)[6] as a proportion of GDP, this has risen by a greater degree, doing so by 3 percentage points of GDP over this period.

Between the end of 2012 and June 2015, total gross public-sector debt rose by 30.9% in real terms, whereas over the same period GDP is likely to have grown by around 5.5%, meaning that during this time real growth of the balance for gross public-sector debt far outstripped GDP growth.

In a climate of uncertainty which has been marked by the slump in the oil price on world markets, expectations of a US rate hike and lower global growth, sound fiscal housekeeping is a vital element in bolstering confidence in the economy and limiting financial volatility, for which reason the percentage of gross debt to GDP must be brought down as has been proposed in the public sector.

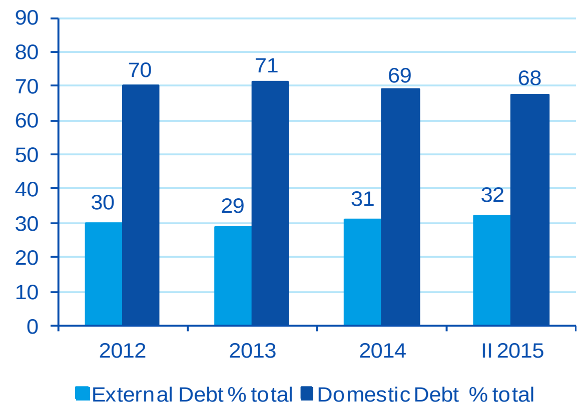
[6] Public-Sector Net Cash Requirement include the public sector debt plus liabilities and obligations of: the IPAB, the Debtor Support Program (*Programa de Apoyo a Deudores*), the National Infrastructure Fund (*Fondo Nacional de Infraestructura*), development banks and development funds; and CFE Pidiregas, hence its amount and its ratio to GDP is greater than the public sector debt.

Figure 3.18
Total gross debt and Financial Requirements of the Public Sector (% of GDP)



Source: BBVA Research with SHCP data.

Figure 3.19
Percentage structure of total public-sector debt (% of total debt)



Source: BBVA Research with INEGI data.

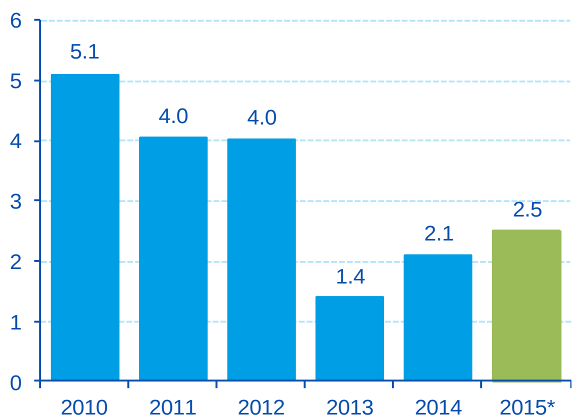
3.1.5 Outlook for Mexico's economy

Over the past two years, the GDP's annual growth rate (AGR) has been marginal (it averaged 1.8% in 2013-14). For 2015, Mexico's economy we expect it to be more dynamic, with forecast annual growth of 2.5%.

For 2016 we are standing by our growth forecast of 2.7% YoY, as we predict that the US economy will see a modest improvement with growth of 2.8% YoY, and taking into account the announced reduction in public expenditure. Given the slowdown of growth in recent years and the uncertainty over the strength of demand from abroad in the coming years, it is important to implement public policy which builds up domestic demand as the linchpin of economic growth.

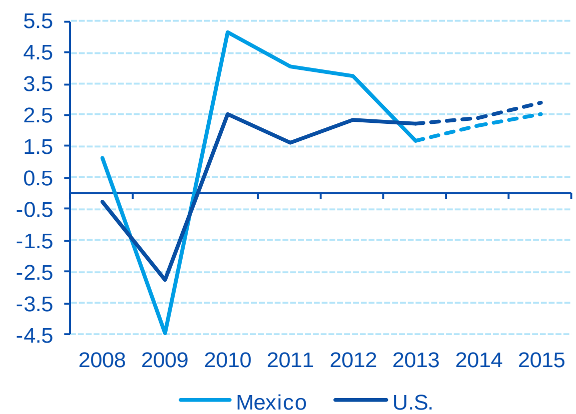
On the other hand, it is also important to note that Mexico's economic growth process is not free of risks, where it is worth highlighting i) a further deterioration in the domestic oil market, which could arise from a lower international price per barrel of crude than the level seen in the past few months, or else a lack of recovery in production, or even an additional decline, and ii) weaker growth in the US economy than has been observed in the first half of the year, which was in itself modest. In terms of quarterly growth rates, US GDP rose by a seasonally adjusted 0.2% in Q1 and 0.6% in Q2, which means an annual rate of 2.9% and 2.3% respectively. In other words, these figures tell us that Mexico's economic growth requires dynamic growth from the US economy, and if this is not forthcoming, Mexico's GDP is destined to grow at moderate rates.

Figure 3.20
Annual growth of Mexican GDP (YoY % change)



Source: BBVA Research with INEGI data.

Figure 3.21
GDP of Mexico and the United States (YoY % change, sa)



Source: BBVA Research with INEGI & BEA data.

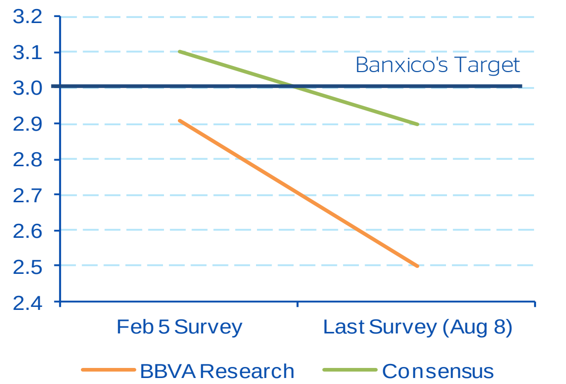
3.2 Inflation continues to plumb historical lows

Ever since the positive inflation surprise of the first fortnight in January this year, we have been saying that inflation would end the year below 3.0%. The course taken by inflation over the first seven months of 2015 supports this prediction. Prices have risen even less than forecast, for which reason we estimate that inflation ought to stand at around 2.5% at year-end. We think that the consensus (currently 2.9%) will continue to converge gradually towards our estimate in the coming months, just as it did in the first few months of the year (see Figure 3.22). A notable point about this benign path of inflation is that, as we were predicting, the pass-through from peso depreciation to consumer prices has remained muted and mainly shows up in the durable goods segment without having given rise to second-round effects (see Figure 3.23). This has been helped by, on the one hand, the anchoring of inflation expectations (those for the short term have come down, while those for the medium to long term have not exhibited any significant changes), and on the other hand by conditions of considerable economic slack. On top of this, falls in energy and telecommunications service prices have contributed to low inflation in 2015.

As anticipated, annual headline inflation dropped sharply in January this year. Annual inflation fell from 4.08% in December 2014 to 3.07% in January 2015, while annual core inflation retreated from 3.24% to 2.34% over the same time. This decrease was mainly a manifestation of the wearing off of the inflationary effect of the 2014 tax hike on several goods and the heavy fall in the services sub-index as a result of the telecommunications reform, which led to the removal of domestic long-distance charges and keener competition in the sector after including measures such as a change of operator within the space of 24 hours and keeping the same number. An additional contribution to lower inflation was also provided by lower electricity tariffs. Despite the heavy fall in the value of the peso over the past 10 months, headline inflation has remained on a downward tack. It was already averaging 3.07% in 1Q15 (compared to 4.18% in 4Q14), which meant that it had reached a historical low for a quarter in the recent records of the National Consumer Price Index (INPC) and stood at a level very close to the central bank's 3.0% target. In the second quarter it fell further, averaging 2.94%. Note that since May it has stood below 3.0% and achieved three historical lows in a row, arriving at 2.74% in July, which is the last available figure (see Figure 3.24).

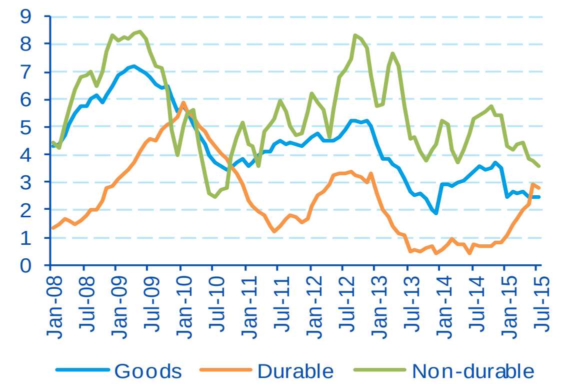
On the other hand, annual core inflation averaged 2.32% in 2Q15, a new historical low for a quarter after 2.39% in Q1. These averages compare well with that of 3.30% for the final quarter in 2014. Annual core inflation has in fact held at close to 3.0% since 1Q11, registering a quarterly average of 3.04% between January 2011 and July 2015. Although annual core inflation has remained low over several quarters and not shown any signs of demand pressure on prices, it had risen from an average of 3.05% in the first half of 2014 to 3.31% in the second, showing 3.24% at yearend. This behaviour was principally associated with the rise in the goods sub-index, where the annual inflation rate saw an upturn from 3.00% in the first half of 2014 to 3.52% in the second, mainly on the increase in food products as the rise in meat prices was passed on to certain processed foods such as sausage meat goods. In 1Q15, as a result of the wearing off of the supply shock seen in January 2014 from the tax hikes, annual core inflation fell away notably and has stayed very low despite the sharp depreciation of the peso over the past two quarters.

Figure 3.22
Estimated inflation for the close of 2015 (YoY % change)



Source: Banamex Survey

Figure 3.23
Goods inflation (YoY % change)



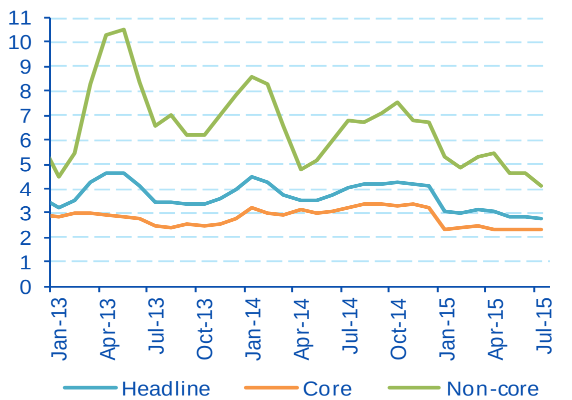
Source: BBVA Research with INEGI data

Annual variations in the goods and services components of core inflation dipped in the first two quarters of 2015. Average annual inflation in the goods sub-index came down from 3.57% to 2.56% between 4Q14 and 1Q15, and to 2.52% in 2Q15. In July the reading was 2.47%. The low inflation for this component is chiefly due to a heavy fall in the processed foods component, where the average decreased from 5.35% YoY in 4Q14 to 3.15% and 2.56% in the first and second quarters respectively. In July it fell back further, to 2.27%. This encouraging pattern has offset the small amount of exchange rate pass-through to prices that is apparent in the other goods component, as annual inflation of non-food goods has displayed a gradually rising trend, having come up from 2.04% at the close of 2014 to 2.64% in July 2015. We therefore find that exchange rate pass-through to prices has been limited to durable goods prices and has not given rise to second round effects in the price formation process. With respect to the average annual variation in the services sub-index, this was substantially pared back between 4Q14 and 1Q15, from 3.08% to 2.26%, in a trend which continued into the second quarter when it arrived at 2.15%. In July it stood at 2.18%. Two factors more than others explain this kinder performance, i) the fall in telecommunications service prices and ii) the slack that exists in the economy.

Despite the three different shocks confronting core inflation, such as the tax rises, the surge in meat prices at the end of last year which was passed on to certain processed foods, and the dramatic peso depreciation, it is striking how well it has behaved over the past six quarters. This was helped by the stability of inflation expectations and the weakness of domestic demand within a context of slackness in the economy. Significant risks to the upside still lurk, however, not least of which is that the high outright exchange rate levels might come to sour inflation expectations.

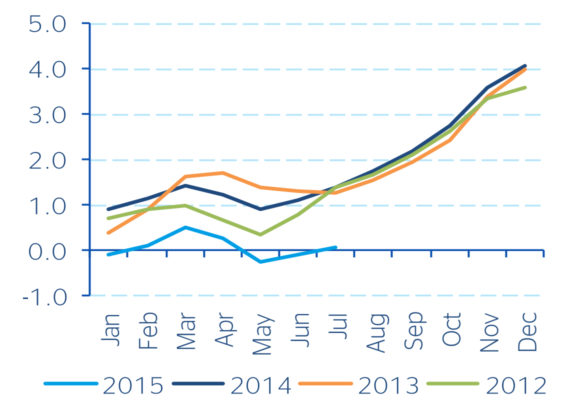
Annual inflation in the non-core sub-index, which contains more volatile products such as agriculture and livestock, energy and public rates, dropped back from 6.99% to 5.17% on average between 4Q14 and 1Q15, and fell back further to 4.91% on average over Q2, while in July it stood at 4.12%. This receding trend was originally chiefly associated with energy product prices, which sank back from an annual rate of variation of 7.13% in 4Q14 to one of 3.82% in 1Q15, and then to one of 3.21% in Q2, arriving at 2.61% in July. This arose mainly from a slower pace of petrol price rises as well as tariff reductions for electricity, which were helped by the softer prices of the fuels used to generate it (principally fuel oil and natural gas). With respect to agriculture and livestock prices, it appears that, although no obvious change of trend was registered in the first six months of the year (they averaged 8.39% and 8.34% YoY in 1Q15 and 2Q15, compared to 8.04% in 4Q14), the welcome developments regarding livestock prices over the past few months are already beginning to be reflected in a downward pattern for this sub-index. The strong pressures on livestock prices that were observed in 2H14, and which had not remitted in 1Q15, began to ease up in 2Q (this component averaged 13.43% in 4Q14 and 14.15% in 1Q15, compared to 8.85% in Q2 and 5.92% in May). This gradual dissipation of the supply shock on livestock prices combined with the slower rate of energy price rises to explain the downward trend in non-core inflation.

Figure 3.24
Inflation and components (YoY % change)



Source: BBVA Research with INEGI data

Figure 3.25
Cumulative inflation by year (Percentage points)



Source: BBVA Research with INEGI data

To summarise, the course taken by inflation has been very encouraging over the first seven months of the year thanks to the fact that the following factors have all come together: i) dissipation of the effects of both the 2014 tax changes and the livestock price supply shock in 2H14, ii) the positive effect from the telecommunications reform, the lower electricity tariffs and the milder rises in petrol prices, iii) the slack in the economy, and iv) the central bank's credibility has managed to keep inflation expectations anchored despite several changes in relative prices. Thus, as can be seen from Figure 3.25, for the first time historically, cumulative inflation as of June has been negative, by 0.09 percentage points (pp), and as of July it was barely above zero (0.06pp).

We forecast that inflation will close the year at 2.5%

Assuming our estimates for economic growth in 2015 and 2016, we predict that that ample slack in the economy will remain for a considerable length of time, which, aided by the central bank's credibility, should contribute to keeping the pass-through to inflation from the peso's depreciation only limited and no second-round effects emerging, as has thus far been the case. Nonetheless, given the huge scale of the peso's currency depreciation, the present exchange rate brings upside risk to our forecasts, and if it sticks at this level for long, we could see an upturn in inflation expectations which could lead to higher prices than those we currently envisage.

In qualitative terms, our inflation scenario is unaltered, yet quantitatively we are revising our forecasts for headline inflation at the end of 2015 downwards, from 2.65% in our previous Outlook to 2.5%. We our standing by our forecast of 2.5% for core inflation. If our estimates prove right, annual headline inflation will average 2.8% in 2015, against 4.0% in 2014. We still anticipate that annual core inflation will average 2.4% this year, 0.7 percentage points below the 2014 level.

Looking forward, if energy prices (petrol and electricity mainly) keep to their current pattern, the non-core inflation sub-index should perform a little better than it has done in previous years and contribute to achieving lower inflation in the coming years, thereby helping in the process of inflation's convergence towards the 3.0% target on a steady basis. Moreover, once economic agents perceive that the slower pace of annual rises will be an enduring feature, this could help to anchor medium and long term inflation expectations at lower levels.

The forecasts are subject to both downside and upside risk. The chief risks to the downside are lower than expected levels of activity in the economy and potential additional price falls in mobile telephone services if competition in the sector becomes fiercer. On the other hand, the most significant upside risk should arise from the peso exchange rate if its current level sets in or additional depreciation takes place (although the pass-through we estimate is only low).

3.3 Financial stability is becoming increasingly influential in any decision on a monetary policy rate hike

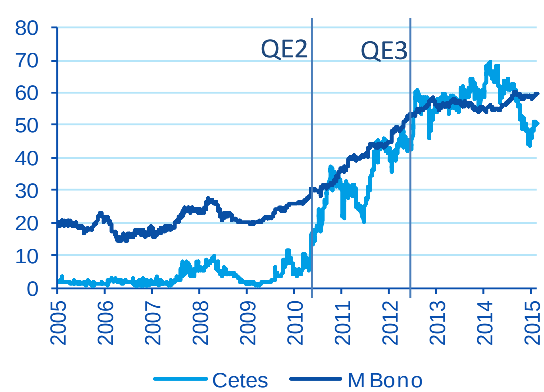
The recent volatility in financial markets has over time suffused the communication from Mexico's central bank with a more restrictive tone, particularly in the light of an imminent start on monetary normalisation in the United States and the impact that this has had on the exchange rate. Since mid-2013 Banxico's communication has maintained its monetary policy position relative to the United States as one of the key themes in its decisions in this area, although at the same time it has laid emphasis on the guiding criterion in its decision-making being "efficient convergence" towards its inflation target, i.e. least-cost convergence in terms of economic activity. Even so, given the Mexican peso's significant depreciation since the last quarter of 2014 and the risks of pass-through to inflation which this might imply, the term "efficient convergence" gave way to stressing consolidation of convergence towards the target level. This indicates that efforts are being made, not only to get inflation to alight temporarily at the target rate, but to pin it there for some length of time. Furthermore, in Q2 this year the central bank made it clear that the next federal funds rate hike constitutes the biggest risk to consolidation of convergence towards the target rate, given the possible aftermath as regards the peso's exchange rate and, as a result, the effects on both inflation and expectations of it.

In view of all this, any Fed decision to raise its policy rate loomed as a potential trigger for a rate move by Banxico, above all given the situation of inflation at a historical low and ample slack still in the economy, even though the option remained of making a pre-emptive benchmark rise ahead of the Federal Reserve. The potential for this appeared to have melted away at the June meeting, as according to the central bank's minutes "…, most of those present felt that, in the absence of a de-anchoring of inflation expectations, making a move ahead of the Federal Reserve would entail more costs than benefits, since the sluggishness in economic activity could become even worse". This outlook gained credibility after Banxico altered its time-tabling so as to schedule its decision-making policy meetings after those of Fed and, of course, after observed inflation hit a historical low of 2.74% and medium- and long-term expectations stayed anchored at around 3.5%.

Figure 3.26
3-month swap rate
(%)

Source: BBVA Research with Bloomberg data.

Figure 3.27
Foreign-held *Cetes* and M-bonds
(% of total holdings)



Source: BBVA Research with Banxico data.

At the monetary decision meeting in July, the members of Banxico's governing board were more concerned over the risks to financial stability and gave their statement a more restrictive tone. Here we should not lose sight of the fact that this meeting took place on the day when the exchange rate reached its historical absolute high of a dollar rate of MXN16.48 and did so a few hours before the announcement of a step-up in dollar auctions by the Currency Commission. Indeed, it could be said that financial stability took on new importance with regard to inflation expectations, as according to the minutes from said meeting: "…, certain [members] mentioned that if implications for financial stability should arise in connection with major offloading of government securities held by non-residents, a monetary policy response would be justified even if inflation expectations remain stable". If on top of this we add the fact that one of the members of the board actually voted in favour of raising the benchmark rate, the toughening of the tone is plain to see.

In short, the spike in volatility in financial markets, particularly the currency market, and the uncertainty over the future that looms over them, have prompted a shift in monetary policy focus towards financial stability in an environment where inflation stands at its historical low and slackness predominates in the economy. In these circumstances we are standing by our forecast that Banxico will raise its benchmark rate by 25 basis points in December after the Fed does the same thing at around this time. So far we think that the tougher tone used by the central bank at its latest monetary policy meeting gave a signal to the markets to allay doubts over the future pattern of Mexico's monetary policy in relation to that in the United States. That said, the potential for an earlier rise could become significant given any sudden deterioration in the peso exchange rate or flows of foreign investment in government securities.

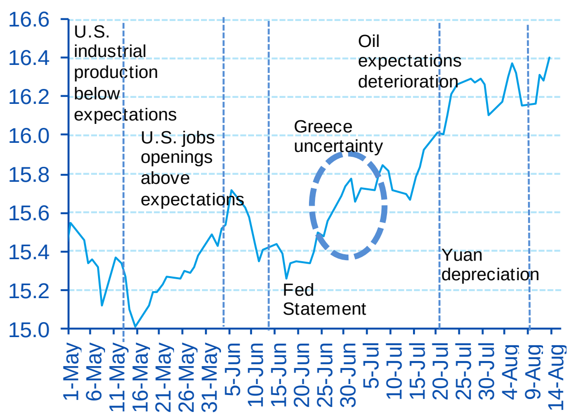
Nonetheless, if financial markets continue to behave efficiently and their volatility is no worse after rates in the United States begin to climb, given the low levels of both growth and inflation in the economy, we predict that the central bank would opt to carry out policy rate hikes at a slower pace than the Federal Reserve.

3.4 The dollar has hit a historical high on expectations of an impending policy rate rise in the United States in the coming months

The divergence in the economic prospects and in terms of monetary policy between the United States and the rest of the world continues to be the paramount factor behind movements in financial markets. Specifically, the proximity of the start of monetary normalisation in the United States is prompting the reallocation of funds among the various asset classes by investors into dollar-denominated instruments. An effect of this is that most of the emerging market currencies have seen a substantial depreciation in 2015. In particular, the peso/dollar rate stands at close to MXN16.50, having depreciated by around 10% this calendar year, and 20% if we compare with the same date last year. In addition to the uncertainty from the Fed's imminent move, episodes of risk aversion and oil market movements have helped to weaken the currency. The first of these has included uncertainty over a possible Grexit and doubts over the speed of the slowdown in China, which have been expressed in the sharp drop in its stock markets and the recent depreciation of its currency. Here we should remember that although the Fed is in the limelight as far as investors are concerned, the inverse relationship between the peso and risk aversion persists.

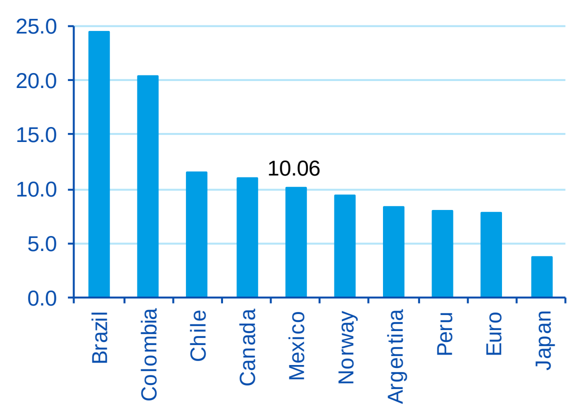
With respect to the oil market we find that, after almost two months of relatively stable prices in the USD55-60bbl range for the Mexican mix of oil, the nuclear deal with Iran has added fuel to expectations of oversupply for some time to come, which has sent both the oil price to just over USD40bbl and the currencies of oil-exporting countries onto a course of further depreciation. These exchange rate levels have given rise to an increase of preventive measures to provide market liquidity by the Currency Commission, which comprises members of the Ministry of Finance and Public Credit and the central bank. The Currency Commission provided for an increase in the daily dollar auctions from USD52mn-200mn and reduced the depreciation required to trigger an extraordinary auction from 1.5 to 1.0%. Going forward, and as the Fed's December meeting draws near, which is expected to produce the first policy rate hike, the peso's trend of depreciation is highly likely to persist, after which we can expect (fairly likely) a modest appreciation as a degree of uncertainty is dispelled.

Figure 3.28
Exchange rate (USD/MEX)



Source: BBVA Research with Bloomberg data

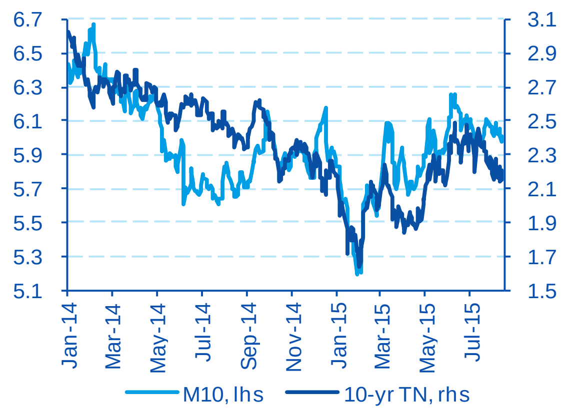
Figure 3.29
Depreciation in 2015 (%)



Source: BBVA Research with Bloomberg data

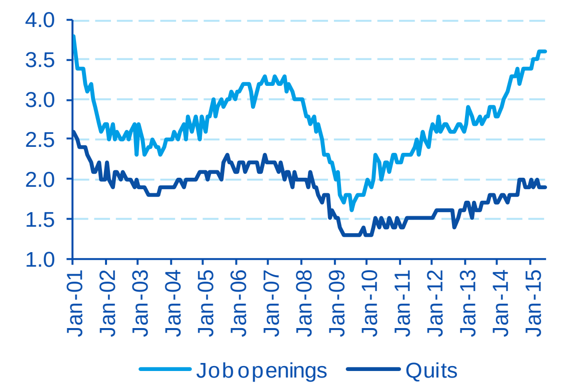
Nevertheless, beyond short-term movements, the fact is that the peso has depreciated in 10 of the past 12 months and been going down for six months in a row. This behaviour is completely at odds with what we have seen in recent years and merits closer examination. To be precise, even though elements exist to reasonably expect that a peso appreciation might emerge (once both the monetary normalisation process begins in the United States and the Fed discloses more details on how gradual the path of federal funds rate rises will be), we should bear in mind that certain factors pose additional question marks over the long term level for Mexico's economy, such as both expectations of a low oil price in the coming years and the looser relationship of late between the growth figures for Mexico and the United States. That is to say, expectations of a peso exchange rate appreciation are based on the fact that the current level is patently above one that matches growth and inflation readings, and if the above-mentioned factors have a long-lasting effect on growth, then the peso's appreciation could be only marginal.

Figure 3.30
10-year US and Mexican government bond yields (%)



Source: BBVA Research with Bloomberg data

Figure 3.31
Job creation and quits (Percentage of employment)



Source: BBVA Research with Bloomberg data

On the other hand, switching of funds among the various asset classes by investors into dollar-denominated instruments given the forthcoming monetary policy normalisation cycle in the United States has not had any obvious effect on the yields of long-term Mexican bonds, which, for most of the year have moved in step with their UST counterparts. The yield on the 10-year M-bond (M10) stands at 6.01%, which is some way below the level that was reached during the worst moments of financial upheaval in the wake of the Lehman Brothers failure (an average of 9.82% in November 2008) and close to 120 basis points (bp) below the average recorded in 1H11 when concern over the EUR crisis was mounting. Thus far in 2015, M10 bond yields have tracked those of the 10-year UST (see Figure 3.30). It may be noted that at times when job creation and wage growth figures in the United States are positive and influence expectations that the federal funds rate will be hiked in the short term, long term bond yields in both countries have trended upwards, for example, whereas, at those times when the US economic activity data are poorer than expected, long-term interest rates have halted their upward trend and fleetingly back-tracked to slightly lower levels. Nonetheless, having traced a downward path in 2014, long-term interest rates have edged up gradually in 2015 (see Figure 3.31). In fact, after marking their lowest recent levels early on in the year, of 1.64% for the 10-year Treasury Note and 5.19% for the M10 bond, yields on both government bonds have increased 84bp and 107bp respectively, touching highs for the year at 2.48% and 6.26% respectively on 10 June. Having hit these highs, long-term yields brought their climbing pattern to a stop and tended to stabilise, even retracing a little in the last few months to their current levels of 2.20% and 6.01% respectively.

Looking ahead, when the Fed's monetary normalisation begins (foreseeably in December this year), and once the perception sinks in that interest rates will gradually leave behind their exceptionally low levels for good, as the situation in the United States comes to take on the appearance of that of a normal economy rather than one where any continuation of growth has to be propped up by expansionary monetary policies, bond yields at the long end will tend to rise. That said, the upward trend ought to be slow but sure, as the Fed's hike cycle will be measured. Given all these factors, we anticipate that 10-year government interest rates in Mexico will close the year at around 6.2%, while those in the United States will do so at 2.5%.

4 Indicators and forecasts

Table 4.1
Macroeconomic forecasts: Gross Domestic Product

(YoY growth rate)	2012	2013	2014	2015	2016
United States	2.3	1.5	2.4	2.5	2.8
EMU	-0.8	-0.3	0.9	1.5	1.9
Germany	0.6	0.2	1.6	1.5	1.9
France	0.3	0.7	0.2	1.3	1.7
Italy	-2.8	-1.7	-0.4	0.7	1.3
Spain	-2.1	-1.2	1.4	3.2	2.7
UK	0.7	1.7	3.0	2.5	2.3
Latin America *	2.8	2.5	0.8	0.3	1.2
Mexico	4.0	1.7	2.1	2.5	2.7
Brazil	1.8	2.7	0.2	-1.5	0.5
EAGLES **	5.7	5.6	5.2	4.8	5.2
Turkey	2.1	4.1	2.9	3.0	3.9
Asia-Pacific	5.7	5.9	5.7	5.7	5.6
Japan	1.8	1.5	-0.1	1.3	1.2
China	7.8	7.7	7.3	6.7	6.2
Asia (exc. China)	4.1	4.5	4.3	4.9	5.1
World	3.4	3.4	3.4	3.4	3.8

* Argentina. Brazil. Chile. Colombia. Mexico. Peru & Venezuela.
** Saudi Arabia. Bangladesh. Brazil. China. Philippines. India. Indonesia. Iraq. Mexico. Nigeria. Pakistan. Russia. Thailand & Turkey.
Closing date: July 30, 2015.
Source: BBVA Research & IMF

Table 4.2
Macroeconomic Forecasts: inflation (Average)

(YoY growth rate)	2012	2013	2014	2015	2016
United States	2.1	1.5	1.6	0.5	1.8
EMU	2.5	1.4	0.4	0.3	1.3
Germany	2.1	1.6	0.8	0.5	1.4
France	2.2	1.0	0.6	0.3	1.2
Italy	3.3	1.3	0.2	0.2	1.1
Spain	2.4	1.4	-0.2	-0.2	1.3
UK	2.8	2.6	1.5	0.1	1.5
Latin America *	7.8	9.2	12.6	15.7	26.3
Mexico	4.1	3.8	4.0	2.8	3.3
Brazil	5.4	6.2	6.3	8.7	6.1
EAGLES **	5.2	5.2	4.6	4.9	4.3
Turkey	8.9	7.6	8.9	7.5	7.5
Asia-Pacific	3.9	4.1	3.4	2.6	3.0
Japan	0.0	1.6	2.7	1.0	1.6
China	2.6	2.6	2.1	1.6	2.0
Asia (exc. China)	4.8	5.2	4.4	3.5	3.9
World	4.5	4.2	3.9	3.9	5.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru & Venezuela.
** Saudi Arabia, Bangladesh, Brazil, China, Philippines, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Russia, Thailand & Turkey.
Closing date: July 30, 2015.
Source: BBVA Research & IMF

Table 4.3
United States indicators and forecasts

	2013	2014	2015	2016	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15
Economic Indicators												
GDP (real % change)	1.5	2.4	**2.5**	**2.8**	-0.9	4.6	4.3	2.1	0.6	2.3	**4.0**	**2.9**
Personal consumption (real % change)	1.7	2.7	**3.0**	**2.7**	1.3	3.8	3.5	4.3	1.7	2.9	**3.2**	**2.6**
Gov. consumption (real % change)	-2.9	-0.6	**0.6**	**0.9**	0.0	1.2	1.8	-1.4	-0.1	0.8	**3.9**	**-0.8**
Gross fixed investment (real % change)	4.2	5.3	**4.9**	**7.5**	6.0	5.6	7.9	2.5	3.3	0.8	**13.3**	**8.8**
Construction	3.8	5.2	**6.5**	**5.5**	7.8	4.9	6.5	6.9	7.4	5.5	**7.8**	**4.5**
Industrial prod. (real annual % change)	1.9	3.7	**1.2**	**2.4**	2.5	3.7	4.2	4.5	3.5	1.6	**0.3**	**-0.4**
Current account balance (% of GDP)	-2.4	-3.0	**-2.9**	**-2.9**	-2.3	-2.1	-2.2	-2.3	-2.6	-2.4	**-3.3**	**-2.7**
Final annual inflation	1.5	0.8	**1.9**	**1.5**	1.5	2.1	1.7	0.8	-0.1	0.1	**0.8**	**1.9**
Average annual inflation	1.5	1.6	**0.5**	**1.8**	1.4	2.1	1.8	1.2	-0.1	0.0	**0.6**	**1.4**
Primary fiscal balance (% of GDP)	-4.1	-2.8	**-2.9**	**-2.6**				-2.8				**-2.9**

Note: forecasts in **bold**
Source: BBVA Research

Table 4.4
Mexico Indicators and Forecasts

	2013	**2014**	**2015**	**2016**	**1Q14**	**2Q14**	**3Q14**	**4Q14**	**1Q15**	**2Q15**	**3Q15**	**4Q15**
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	1.7	2.1	**2.5**	**2.7**	0.9	2.8	2.2	2.6	2.5	**2.1**	**2.5**	**2.7**
Per inhabitant (US dollars)	10,630	10,627	**10,720**	**11,009**	10,506	10,939	10,830	10,414	9,650	**9,557**	**9,452**	**10,024**
US$ billions	1,256	1,272	**1,297**	**1,467**	1,258	1,310	1,296	1,247	1,168	**1,156**	**1,144**	**1,213**
Inflation (average, %)												
Headline	3.81	4.02	**2.81**	**3.30**	4.16	3.59	4.15	4.18	3.07	2.94	**2.68**	**2.55**
Core	2.72	3.18	**2.37**	**3.08**	3.03	3.07	3.32	3.30	2.39	2.32	**2.33**	**2.43**
Financial Markets (eop, %)												
Interest rates												
Bank funding	3.50	3.00	**3.25**	**4.00**	3.50	3.33	3.0	3.0	3.00	3.00	**3.25**	**3.25**
28-day Cetes	3.16	3.00	**3.25**	**4.00**	3.23	3.14	2.79	2.86	2.94	3.01	**3.14**	**3.25**
28-day TIIE	3.80	3.35	**3.85**	**4.85**	3.79	3.63	3.29	3.30	3.30	3.31	**3.40**	**3.58**
10-year Bond (%, average)	5.68	6.10	**5.78**	**6.38**	6.34	5.87	5.9	5.8	5.60	6.01	**6.18**	**6.21**
Exchange rate (average)												
Pesos per dollar	13.0	13.29	**15.1**	**14.5**	13.2	13.0	13.2	14.1	15.1	15.5	**15.9**	**15.3**
Public Finances												
*FRPS (% of GDP)	-3.0	-4.0	**-4.0**	**-3.5**	-	-	-	-4.0	-	-	-	**-4.0**
External Sector[3]												
Trade balance (US$ billions)	-1,183	-2,441	**-7,240**	**-4,844**	-1,314	1,065	-1,513	-679	-2,201	-1,852	**-2,094**	**-1,482**
Current account (US$ billions)	-30,446	-26,453	**-26,339**	**-25,730**	-10,409	-7,667	-3,294	-5,083	-9,446	**-5,848**	**-5,472**	**-5,574**
Current account (% of GDP)	-2.4	-2.1	**-2.2**	**-2.0**	-3.3	-2.4	-1.0	-1.6	-3.2	**-2.0**	**-1.9**	**-1.8**
Employment												
Formal Private (annual % change)	3.5	3.5	**4.2**	**3.7**	2.9	3.2	3.8	4.2	4.5	4.4	**4.4**	**3.5**
Open Unemployment Rate (% active pop.)	4.94	4.83	**4.53**	**4.70**	4.81	4.89	5.24	4.38	4.23	4.35	4.78	4.76

Note: forecasts in **bold**
Source: BBVA Research

Table 4.4

Mexico Indicators and Forecasts

	2013	2014	2015	2016	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15
Aggregate Demand [4] (annual % change, seasonally-adjusted)												
Total	2.0	3.1	**2.7**	**4.0**	2.0	3.0	3.1	4.5	2.9	**2.3**	**2.7**	**2.9**
Domestic Demand	1.8	1.8	**1.2**	**2.4**	1.0	1.9	1.7	2.6	0.0	**0.7**	**1.7**	**2.3**
Consumption	2.4	2.0	**2.5**	**2.3**	0.8	2.4	2.4	2.6	3.5	**2.6**	**1.9**	**2.1**
Private	2.6	2.0	**2.6**	**2.6**	0.5	2.4	2.2	2.7	3.5	**2.4**	**2.2**	**2.2**
Public	1.5	2.5	**2.1**	**0.8**	2.2	2.1	3.8	1.9	3.2	**3.5**	**0.4**	**1.5**
Investment	-1.5	2.2	**3.7**	**3.5**	-2.4	1.3	4.4	5.7	6.3	**4.8**	**2.2**	**1.7**
Private	-0.9	4.6	**5.4**	**5.6**	-1.6	3.4	7.2	9.7	7.2	**5.5**	**4.9**	**4.2**
Public	-1.5	-6.9	**-4.7**	**-6.6**	-4.3	-8.5	-6.0	-8.7	0.8	**2.2**	**-10.1**	**-11.4**
Exports	2.2	7.3	**7.4**	**8.8**	5.1	6.5	7.1	10.2	12.3	**7.2**	**5.5**	**5.0**
Imports	3.0	6.2	**3.4**	**8.1**	5.6	3.2	5.7	10.4	4.1	**5.2**	**3.0**	**1.6**
GDP by sectors (annual % change, seasonally-adjusted)												
Primary	0.8	3.5	**5.8**	**2.7**	2.6	3.1	6.8	1.4	6.8	**5.5**	**6.4**	**4.6**
Secondary	-0.6	1.9	**1.5**	**2.8**	0.4	2.7	2.0	2.3	1.5	**1.9**	**1.6**	**1.2**
Mining	-0.5	-2.2	**-3.8**	**-1.5**	-0.3	-0.2	-2.8	-5.6	-4.7	**-4.7**	**-3.6**	**-2.2**
Electricity	0.5	1.8	**3.2**	**3.9**	2.2	1.7	1.5	1.7	3.2	**2.6**	**4.0**	**2.8**
Construction	-4.7	1.8	**2.5**	**3.7**	-3.2	1.3	3.8	5.6	4.4	**5.3**	**1.8**	**-1.2**
Manufacturing	1.5	3.7	**3.5**	**3.8**	2.9	4.1	3.3	4.6	3.8	**3.2**	**3.5**	**3.5**
Tertiary	2.7	2.2	**2.8**	**2.7**	1.2	2.9	2.1	2.8	2.9	**2.5**	**2.9**	**2.8**
Retail	2.9	3.3	**3.4**	**3.4**	0.6	3.4	3.9	5.4	5.7	**3.1**	**2.7**	**2.1**
Transportation, mail and warehouse	2.7	1.9	**2.9**	**3.3**	1.6	2.9	0.8	2.3	3.1	**2.5**	**2.8**	**3.0**
Massive media information	5.1	2.2	**7.3**	**6.5**	2.1	4.6	-0.2	2.4	5.7	**5.6**	**9.5**	**8.6**
Financial and insurance	10.5	2.0	**2.9**	**6.8**	4.2	1.4	1.0	1.7	1.5	**2.5**	**3.0**	**4.6**
Real-estate and rent	1.0	2.1	**2.2**	**2.0**	1.8	2.2	2.3	2.2	1.5	**1.9**	**2.6**	**2.9**
Prof., scientific and technical servs.	0.9	1.2	**2.6**	**1.9**	-0.5	0.2	1.3	3.7	2.5	**3.3**	**2.8**	**1.9**
Company and corporate manageme	-1.4	6.4	**0.0**	**1.8**	6.5	3.9	3.4	12.5	-2.8	**-2.0**	**2.9**	**1.9**
Business support services	4.3	0.0	**2.2**	**1.2**	0.0	1.8	-0.1	-1.7	2.6	**1.3**	**2.5**	**2.4**
Education	0.8	1.5	**1.0**	**0.8**	1.1	1.8	2.3	0.9	0.6	**0.7**	**1.2**	**1.6**
Health and social security	2.5	0.7	**1.2**	**0.8**	0.3	0.9	0.8	0.6	1.3	**1.1**	**1.5**	**1.1**
Cultural and sport	4.0	-0.8	**3.4**	**2.6**	-2.2	-0.9	2.0	-2.0	3.7	**3.9**	**3.1**	**2.9**
Temporary stay	1.9	2.9	**3.3**	**2.0**	1.9	4.2	2.1	3.3	3.6	**3.0**	**3.8**	**2.8**
Other services, except government a	2.2	1.4	**1.8**	**1.6**	0.4	1.4	1.9	1.9	2.8	**1.4**	**1.2**	**1.7**
Government activities	-0.5	2.5	**3.0**	**-2.3**	3.0	2.6	2.3	2.0	5.2	**2.9**	**2.1**	**1.9**

Note: forecasts in **bold**
Source: BBVA Research

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