BBVA | RESEARCH

Servicio de Estudios Económicos
del Grupo BBVA

Mexico Economic Outlook

Second Quarter 2013
Economic Analysis

- Global growth continues, but increases the divergence between areas
- Thanks to its stability and the prospect of reforms, Mexico benefits from global liquidity, which in turn supports the growth
- Recent reform proposals significantly improve Mexico's relative position compared to other emerging economies

BBVA Bancomer

Index

Closing Date: May 10, 2013

1. Summary

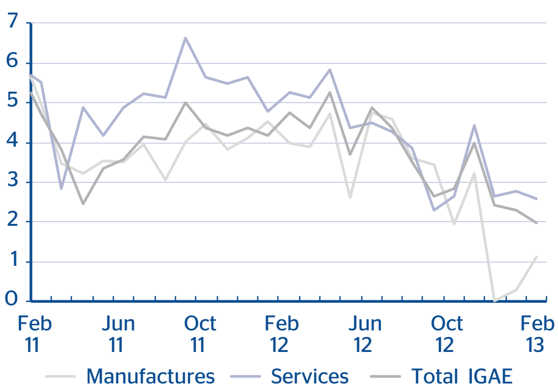
Thanks to its stability and reform prospects, global liquidity is benefiting Mexico as it favors sustainable growth

Global growth has sustained its gradual recovery, but the main economies' decidedly uneven prospects limit the strength of GDP recovery expected for 2013 and 2014. Global GDP growth for the most recent quarter, estimated by BBVA Research in 0.7%, would mark a slight improvement over the 0.6% expansion recorded for the last quarter of 2012. However, indicators to date point to a growing dispersion of activity, especially among the most developed economies, with the Eurozone once again lagging the US and even Japan. Still, global expansion is projected to reach 3.3% in 2013, a mere tenth higher than what was estimated for 2012. Growth in 2014 is expected in the vicinity of 4%, but downside risks prevail.

US growth prospects are underpinned by the vigor of private demand in the face of fiscal adjustment. Uncertainty as to the near-term fiscal policy has abated relative to earlier scenarios that included a shutdown of government offices (even as we have yet to see credible measures for achieving long-term fiscal consolidation). The combination of allowing some tax breaks to expire and implementing spending cuts does not appear to have entailed a significant containment to private spending as the monetary expansion has kept credit conditions highly favorable and is contibuting to greater incomes and wealth levels. At this point it appears reasonable to sustain the 2013 estimate of 1.8% growth despite downside surprises in public demand on 4Q12 and 1Q13 GDP.

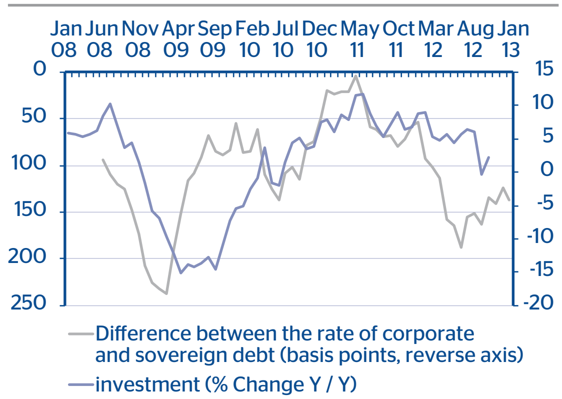
We continue to look for Mexico to grow by better than 3.0% on the back of favorable credit conditions and diminished external risk prospects. Government medium- and long-term debt rates have fallen considerably. This improvement in conditions for financing the economy have trickled through to corporate debt conditions, which in turn have grown more conducive to private investment. External risks have attenuated, and as we have already noted, the US continues to grow at a moderate pace and the effects of fiscal consolidation in that country have proven less severe than originally feared. Monetary policy in Europe has helped limit the impact of new shocks, such as the recent crisis in Cyprus, on credit conditions in Eurozone countries.

Graph 1
IGAE
(% change y / y)



Source: BBVA Research and INEGI

Graph 2
Difference between the rate of corporate and sovereign debt, and the total investment
(basis points, and var.% y / y)



Source: BBVA Research and INEGI

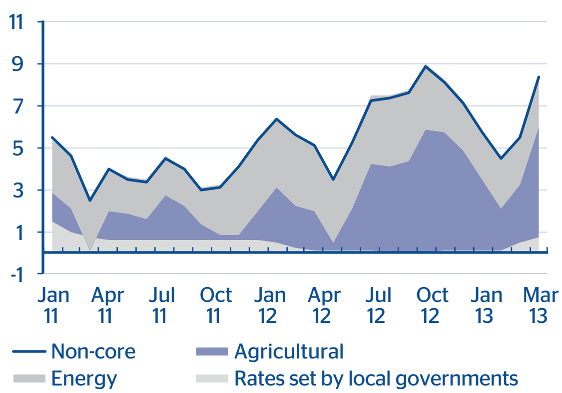
Despite the economic sluggishness expected for the first quarter of the year due to weaker external demand undercutting industrial output, growth appears poised to accelerate towards the second half of the year on the normalization of public spending and greater demand growth in the US once the effects of the sequestration in that country are behind us. We note that the service sector in Mexico has managed to sustain its growth profile, in part assisted by ongoing job creation. Furthermore, the country has maintained one of its greatest assets: macroeconomic stability. Public finance remains in line with the object of a balanced budget for the year, international reserves are at favorable levels and continue to grow, there are no apparent external account imbalances, and inflation will return to the variability range and near its target. Mexico has also begun the process of implementing reforms in those areas where substantial change has eluded the country for some time, such as public education, labor law, the telecommunications sector, and public security. This reform drive is expected to extend into the second half of the year with more bills of this nature slated to go before Congress.

Inflation is projected to break back below 4.0% as we witness a dissipation of supply shocks and core inflation remains firmly anchored. Following inflation's good performance early in the year, falling as low as 3.25% at the end of January in annual terms, the emergence of new supply shocks in markets for agricultural and livestock products, combined with sharp upside adjustments in tariffs and prices set by local governments propelled the headline rate past 4.0%. Despite this new wave of supply shocks, core inflation remained near 3.0% during the quarter thanks to a sharp reduction in goods inflation facilitated by a firmer Mexican peso, the absence of spillover supply effects to other prices, and the general health of economy. As the recent upturn in inflation was mainly powered by supply shocks, inflation is expected to start moving lower around May as the supply of goods begins to normalize, and close the year below the 4.0% threshold.

The search for better returns in financial markets as a result of the liquidity glut, combined with the local economy's strong fundamentals, have significantly contributed to increased demand for Mexican financial assets as evidenced by the exchange rate downtrend and falling bond rates. The peso has fluctuated between 11.9 and 12.3 to the dollar in recent weeks, apparently heralding a long-term scenario of greater appreciation on the implementation of structural reforms and a context of global liquidity. As a result, the USDMXN could break below 11.9 towards the second half of the year once the reform agenda intensifies. Should structural reform continue to impress in timing and content, and global liquidity endures, interest rates could fall further and the peso continue to firm over the medium term.

Graph 3

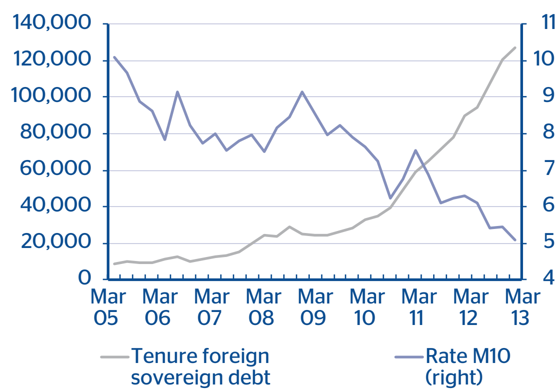
Non-core inflation and its components (% Change y / y and contributions)



Source: BBVA Research and INEGI

Graph 4

Tenure foreign sovereign debt and bond yield rate for 10 years (Million dollars and percentage, respectively)



Source: BBVA Research, Bloomberg and Banxico

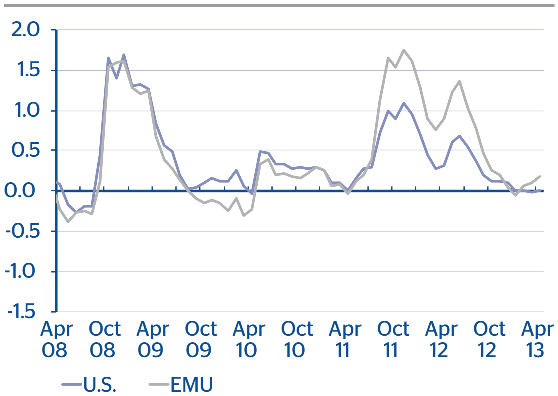
2. Growing divergences in the global economy

In the last three months some of the threats to world economic recovery have dissipated, however, a greater divergence has been noted between different areas. Indeed, economic growth is diverging between the US and the eurozone, where weakness has also reached the core economies. In addition, despite doubts about the long-term sustainability of growth in China (or even the growth it finally achieves in 2013), the country does not appear to be heading towards a sharp adjustment in the short term. There is some disappointment in the rest of the emerging Asian economies when compared with earlier growth expectations, though these were perhaps too high. Japan is on the crest of a wave of economic optimism, although so far this has only manifested itself in the valuations of some financial assets and indicators of confidence, rather than indicators of the real economy.

There has only been a limited response in the financial markets to events such as the continued uncertainty regarding the definition of long-term fiscal policy in the US, on the one hand, and the internal political paralysis in Italy and events in Cyprus and Portugal in the eurozone, on the other (see Chart 5). Thus, risk premiums have fallen in the eurozone, largely due to the implicit support from the ECB's OMT program and the abundant global liquidity, which is benefiting the dash for return and the ensuing financial risk-on mood at the global level. Nearly all assets are benefiting from this change in perception, with practically only one exception: the upturn in the credit risk indicators of the eurozone's banking sector.

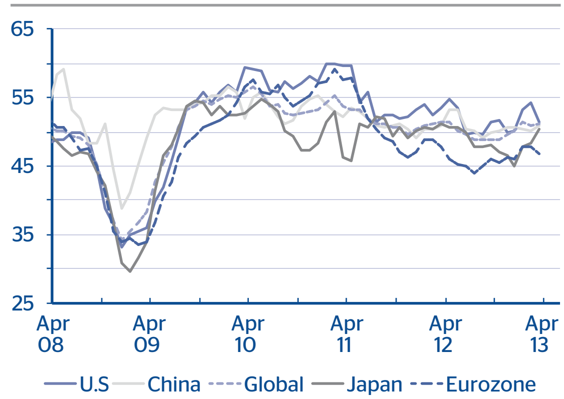
The most recent economic indicators reflect the divergence between areas. In all, the trend towards stability in global manufacturing confidence has been maintained, although with growing divergence between regions (see Chart 6 and Chart 7). In any event, the positive tone in the financial markets and divergence in cyclical prospects have not yet led to any significant change in activity or trade at a global level. According to our BBVA-GAIN global activity indicator, 1 even the most recent data confirm our expectations of continuing global GDP growth at a quarterly 0.7% (see Chart 8). However, more disparate prospects among the main economies (in particular due to the downward revision in GDP growth in the eurozone and also in some economies in emerging Asia) have put a brake on the strength of the recovery expected in 2013 and 2014. As a result, we have revised our growth forecasts for the world economy downward to 3.3% in 2013 and 3.9% in 2014, from 3.6% and 4.1% respectively.

Graph 5
BBVA Financial Stress Indicator



Source: BBVA Research

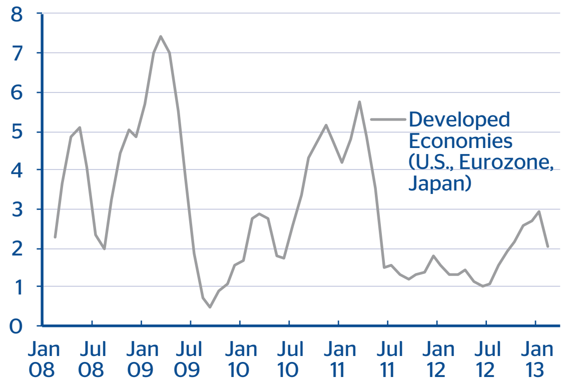
Graph 6
Confidence indicators (PMI)



Source: Markit and BBVA Research

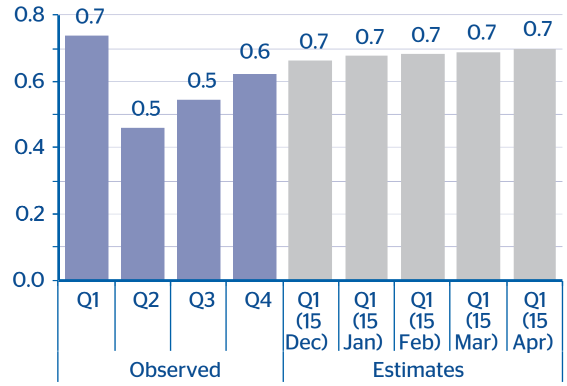
[1] For further details see our US Economic Watch, published on March 6, 2013, and available at: http://www.bbvaresearch.com/KETD/fbin/mult/130306_EcWatch_BBVAGAIN_tcm348-379375.pdf?ts=2942013

Graph 7
Developed Economies: Standard deviation Manufacturing PMI (US, eurozone and Japan)



Source: Markit and BBVA Research

Graph 8
Global growth based on BBVA-GAIN (%, q/q)



Source: BBVA Research

What lies behind the sustained growth in the US, despite fiscal uncertainty? Strong private consumption and continued monetary expansion

Although GDP growth figures in the first quarter of 2013 were below market expectations, they confirmed the continued healthy tone shown so far by private consumption. This is due to an improvement in job creation, in terms of jobs and wages, and the financial situation of households (wealth effect). Private spending has thus become a support for growth in the US. Furthermore, American financial markets have not been affected by external contagion from risk events such as those from the euro area. However, the most recent indicators of cyclical prospects (manufacturing expectations) have fallen in March and April to levels compatible with a slump of activity, so we expect an additional slowdown of the GDP in the second quarter. 2

In all, we maintain our forecasts for the US economy in 2013 and 2014 without major changes, with rates of growth at 1.8% and 2.3%, respectively, mainly for two reasons. First, despite the uncertainty regarding the fiscal cliff and the coming into effect of the sequester (automatic public spending cuts), private spending has given clear signs of resilience. Second, since inflation expectations are well anchored, quantitative easing (QE) may continue without problems until there is significant improvement in labor market prospects. Although some of the data at the start of the year could have prompted an early withdrawal of stimuli, the most recent information shows that the American economy is still far from sufficiently robust growth rates, so monetary policy will continue to be a support for growth.

Stagnation in the eurozone; the ECB begins to act

The most recent development in the eurozone situation is the weak activity spreading from peripheral countries to the core economies in the area, particularly France, but also Germany and the Netherlands. In France, economic agents' confidence is being undermined by uncertainty about tax policy and fiscal consolidation, and the lack of reforms. In April Germany saw how its confidence indicators resumed their downturn, and how its exports have dropped despite resilient demand from emerging countries. The Netherlands, lastly, has also seen how its recession has been compounded by the slump in investment and household consumption despite its good performance in exports. Lastly, in the periphery of the eurozone it is important to note the strong return of appetite for risk in sovereign debt thanks to the

[2] For further details see our US Economic Watch, published on April 1, 2013: http://www.bbvaresearch.com/KETD/fbin/mult/130401_EconomicWatchEEUU_194_tcm348-381612.pdf?ts=3042013

ECB, with its bond buyback program in the secondary market, and improvement in global liquidity with quantitative easing in Japan. In particular, in April the Italian 10-year bond reached its lowest level since November 2011, despite political uncertainty. Another example of this reduction of risk premiums is Spain, where the 10-year bond has remained at 4.5% in recent weeks.

Although the most recent figures for retail sales and industrial output in February point towards a certain degree of stabilization of eurozone activity in the first months of the year, the gloomier confidence polls suggest that recovery is still a long way off. Meanwhile, eurozone authorities continue with the process of building the area's economic architecture (how to achieve a single banking market), while at the same time there is growing debate about the appropriate degree of fiscal consolidation to achieve a credible reduction in public deficit and debt sustainability without damaging activity in the short term in such a way that it would undermine adjustment efforts.

Turning to progress in banking union, the agreement finally reached for a solution to the Cyprus crisis has included applying the bailout model which is being negotiated for the sector in the area. Before the bailout, bank creditors will have to take part, including, if necessary, uninsured depositors. As far as fiscal consolidation is concerned, the latest statements by the European Commission supporting a delay in reaching the public deficit target of 3.0% by 2016 in Spain are focused on attaching more importance to quality and the composition of the adjustment than to bringing about rapid corrections which could have potential negative effects on growth.

In this context, our scenario includes a downward revision of eurozone growth. We estimate that GDP will fall by 0.1% in 2013 and rise by 1% in 2014, 0.4 and 0.3 points, respectively, below the forecasts in our January publication. In any event, the risks continue to have a downside bias. A key point is that Germany must not remain the only source of growth in the area thanks to its easy access to finance, high level of competitiveness and greater exposure to the best performing sources of global demand.

The easing of financial stresses acts as support for the growth achieved through the ECB's program of buying public debt on the secondary market and thus ensuring that monetary policy is transferred to the economy as a whole. But the fall in costs and improved access to finance for sovereign bonds does not suffice; the fragmentation of the financial markets in the area is shown by the large variation in availability and cost of lending to households and companies throughout the eurozone.

In a setting of prolonged economic weakness, spreading to a greater number of countries, with inflation standing below the target, the ECB carried out a 25 bp cut in the benchmark rate, from 0.75% to 0.50%, while it narrowed the corridor of lending and deposit transactions from +/- 75 basis points to +/-50 bp. Furthermore, the ECB announced an extension of liquidity auctions for banks at a fixed rate and for unrestricted amounts for as long as necessary or at least until July 2014. The ECB has also begun consultations with other European institutions (European Investment Bank and the Commission) to boost the financial instruments market supported by business loans, in an attempt to address the pressing need for credit by companies on the periphery. In all, the cut in interest rates may have a limited impact on the real economy, and given that risks continue downward, the ECB has stated that in the event of further deterioration in economic outlook it might have to take additional measures. One of the measures which might be put forward by the ECB would be to cut the deposit facility rate below zero, and to adopt non-standard measures or support to European institutions in providing credit to SMEs.

In Asia, doubts linger about the strength of Chinese growth Optimism in Japan on the back of its massive quantitative easing

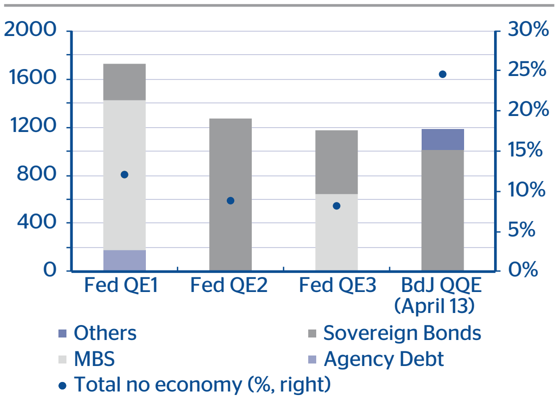
The Chinese economy has lost steam in the first quarter of 2013, with a negative surprise of weak investment, despite the greater strength of foreign demand and growth remaining in line with the government's target of 7.5% for 2013. The measures implemented to limit domestic financial fragility appear to have contributed to the slowdown. However, the change in the growth model towards a greater weight of consumption continues. With inflation also lower than expected, there is less pressure on tightening monetary conditions, so the authorities have room for maneuver, given their commitment to sustainable growth for achieving the announced growth target. That is why our growth forecast for China remains unaltered at 8.0% for 2013 and 2014.

In contrast, the Japanese economy will benefit from a package of more aggressive than expected policies. Among them is the massive quantitative easing, whose size amounts to around 25% of Japan's GDP (each of the QE implemented by the Fed represented an average of 10% of America's GDP), aimed at changes in inflation expectations and boosting growth. This monetary boost will be more effective if it is accompanied by effective fiscal measures and, in particular, structural reforms. Thus our growth forecast for the Japanese economy for 2013 and 2014 remains at 1.7%, above the 1.3% consensus.

In any event, it is difficult to quantify the impact of this new move and know how investors will react, given that many uncertainties still exist. For example, if this policy is successful in promoting growth and confidence at the national level, it could generate greater net capital inflows globally (instead of outflows). In addition, its impact at the domestic level in Japan is also uncertain, as the Bank of Japan's policy involves some risks: strong volatility in sovereign bonds (JGB), risks for bank balance sheets and the costs of debt for the government when nominal yields grow, provided the Bank of Japan is successful in meeting its inflation target of 2%.

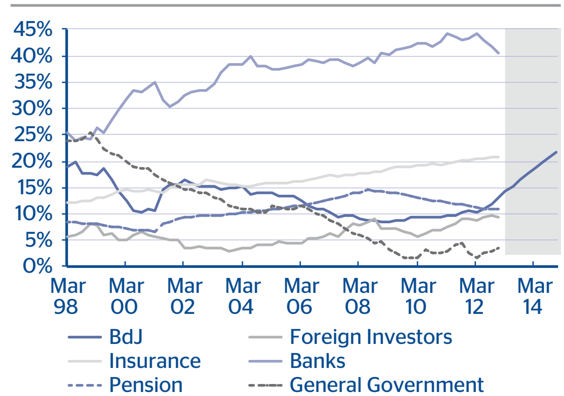
However, the new monetary facility provides arguments in favor of Japanese investors investing increasingly abroad. The Bank of Japan's demand will push private Japanese investors away from domestic assets, as the central bank plans to buy around 70% of all the new issues of sovereign bonds. As a result, the Japanese government's share of bonds in 2014 will be over 20%. The movement of funds will therefore also be uncertain. The appetite of Japanese investors for US bonds has increased since the start of the eurozone crisis, but they also returned to the European stock markets last year. In particular, they invested in countries at the core of the eurozone, such as France, the Netherlands and Germany, while limiting sales in peripheral securities. This trend with respect to peripherals has recently shifted. In this context, we expect demand for assets in euros to increase, provided that the euro-convertibility risk does not emerge again.

Graph 9
Successive rounds of QE (USD bn), Fed and BoJ



Source: Haver and BBVA Research

Graph 10
JGB holders since 1998, percentage structure (%)



Source: Haver and BBVA Research

Monetary easing in developed economies favors risk taking, pushes long-term rates down and the appreciation of emerging market currencies

Financial markets are still dominated by the flow of liquidity from central banks, inflation below targets in the eurozone, the U.S. and Japan, a neutral balance of risks to growth in the U.S., biased downward in the eurozone, and waiting for improvements in real activity indicators o be reflected in improvements in confidence indicators.

Against that backdrop, long-term rates on US bonds and, in particular German bonds, have gone down in recent months. The ensuing dash for yield in a less risk-averse environment (partly because of the ECB actions) has also prompt a sharp fall in yields on government bonds in the periphery of the eurozone to levels not seen since 2010. In this context, there have been capital inflows to emerging fixed- income markets, especially the most liquid (Turkey, Brazil, Mexico), anticipating capital outflows from Japan after its QE program was announced, which includes purchases of public debt by the Central Bank of Japan.

As a result, the euro has shown great resilience to cyclical weakness in the area. The lower probability of high-risk scenarios and a monetary policy in Europe less accommodative vis-à-vis other central banks have contributed to strengthen the euro. In the absence of major risk events in Europe and as long as no surprises in the QE exit strategy by the Fed occur, the euro could continue trading in its current range of 1.30 to 1.32 dollars per euro until the end of this year. This does not rule out episodes of dollar appreciation as a result of changes in the cyclical-risk balance and the reaction of the respective central banks, putting the downward and accommodative bias more in Europe than the US.

3 Thanks to its stability and outlook for reforms, Mexico is benefiting from global liquidity, which fuels growth

3.1 Growth prospects of more than 3.0% continue, underpinned by favorable financing conditions and outlook for improvement in foreign demand

In the first quarter of the year, the pace of economic activity was slower than was expected three months ago. Both external and domestic drivers ran out of steam. However, the outlook of improved foreign demand for the second half of the year helps to maintain the outlook of growth in GDP for this year in the region of 3.1%.

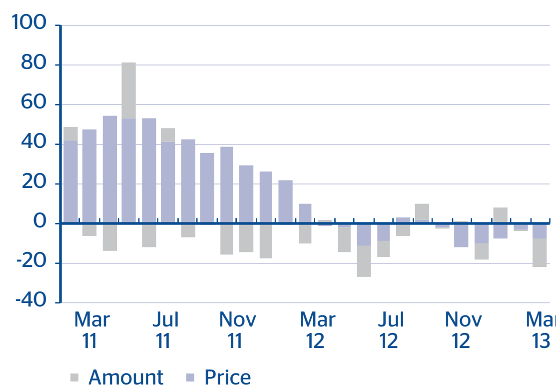
The rate of growth in Mexico's exports has slowed, from 6.1% y/y in 2012 to 0.0% y/y on average in 1Q13. Both manufacturing exports (82.0% of the total) and oil exports (14.2% of the total) have slowed, in the first case from 8.3% in 2012 to 2.1% in 1Q13, while in the second case the slowdown continues with the decline observed since 2012 (-5.5% in 2012, -9.4% in 1Q13).

Mexico's oil export revenues have been declining consistently since 2012, given that although the exported volume has remained relatively constant (1,256 tbd (thousands of barrels per day) on average in 2012, 1,204 tbd in 1Q13), the average price per barrel has tended to fall since mid-2012, from its highest level of 112.8 dpb (dollars per barrel) in March 2012 to 104 dpb in 1Q13.

Graph 11
Mexican exports
(y/y % change and contribution to growth)

Source: BBVA Research and INEGI

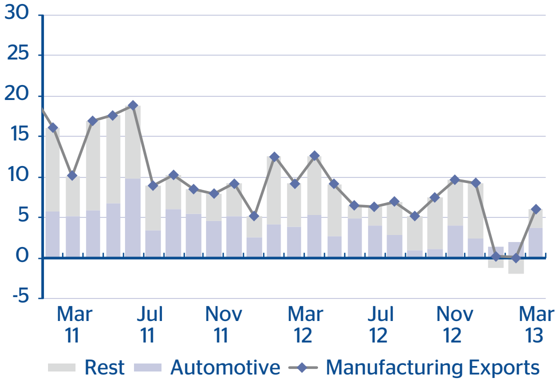
Graph 12
Oil exports
(y/y % change and contribution to growth)



Source: BBVA Research and INEGI

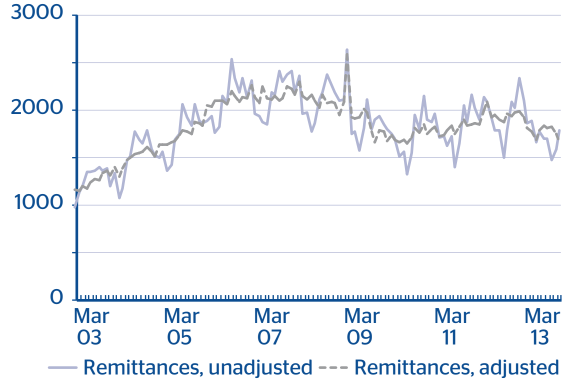
Revenue from manufacturing exports showed lower growth in foreign demand, which means that both the US and the Mexican manufacturing production indices have registered lower rates of growth compared to one year ago. Revenue from manufacturing exports amounted to USD 370,892 million in 2012 and in the first three months of 2013 it has amounted to USD 92,848 million, a figure very similar to that for the same period last year. It is important to note that the automobile industry plays a particularly relevant role in manufacturing output for exports; vehicle exports account for around 30% of the total, and their growth has remained strong over the first three months of the year: 8.3% higher than one year before. Other branches of exports declined slightly during the first three months of the year, equivalent to (-)0.3% y/y, so that total manufacturing exports in terms of dollars were 2.1% higher in 1Q13 than one year before, positive but a long way off the average growth of 8.3% in manufacturing exports in 2012.

Graph 13
Manufacturing exports (y/y % change and contribution to growth)



Source: BBVA Research and INEGI

Graph 14
Remittances (Millions of dollars)

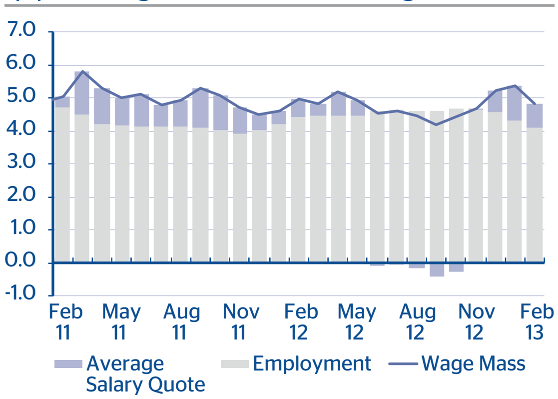


Source: BBVA Research and INEGI

The slowing in exports growth throughout 2012 and in the first months of 2013 is caused by exports for the US market, and also, more importantly, by the exports to the rest of the world, in light of the weakness of several economies.

Furthermore, since 2012 there has been a downward trend in the inflow of currency from remittances by Mexican workers abroad, and the level registered in March was the lowest since January 2010, in fact one of the heaviest declines in the series (-14.7%), accumulating 9 months of falls in year-on-year terms. This has been influenced mainly by the employment situation in sectors which receive Mexican labor, with an average unemployment rate of 7.7% for Mexican migrants during the first three months of the year.

Graph 15
Wage bill in the private formal sector (y/y % change and contribution to growth)



Source: BBVA Research and INEGI

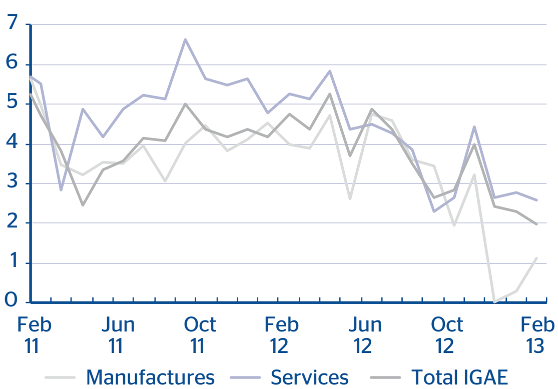
Graph 16
Annual employment created in the private formal sector (thousands of people)

Source: BBVA Research and INEGI

The slowing foreign demand was also evident in slowing imports, as might have been expected, particularly in intermediate goods (more linked to manufacturing exports). The other components of imports, consumer and capital goods, have had mixed performances: growth in consumer goods imports contrasts with imports of capital goods, linked to companies' investment in equipment and machinery.

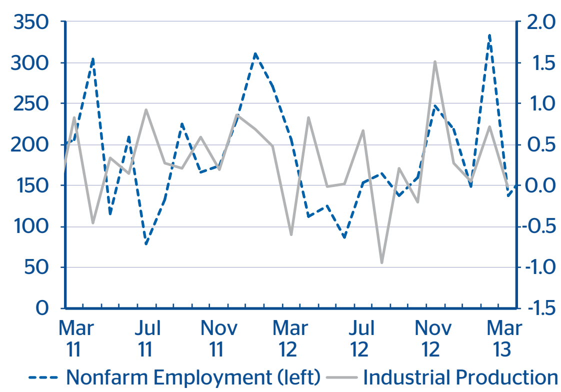
Key components of domestic demand such as employment and real wages registered slower growth in the first months of 2013 then they did in the preceding quarter. Although the rate of growth in the wage bill remained relatively stable, in the region of 5.0% in annual terms, it is important to note the slowing rate of employment creation in recent months, which has gone from average real growth of 4.5% in 2012 to 4.1% in the first three months of 2013. A particularly sharp fall in employment has been reported by the construction sector, which over the last nine months has consistently reduced the number of jobs created. The lower external demand has also been evident in the manufacturing sector, although the fall in employment has been less than proportional to demand (4.5% y/y in 1Q13, vs 4.7% in 2012).

Graph 17
IGAE
(y/y % change)



Source: BBVA Research and INEGI

Graph 18
US indicators: employment and industry
(thousands of people and m/m % change)



Source: BBVA Research and INEGI

The retail sales indicator has been adjusted to a greater degree in recent months, while the dynamics in other services has partially offset the loss of drive in industry. This is shown by the fact that the IGAE (Global Economic Activity Indicator) has slowed only slightly, and that the IGAE for the services sector continues to grow at levels of around 3.0%. In the first months of the year, bank financing has continued to prop up growth in its three components: consumer, housing and SME.

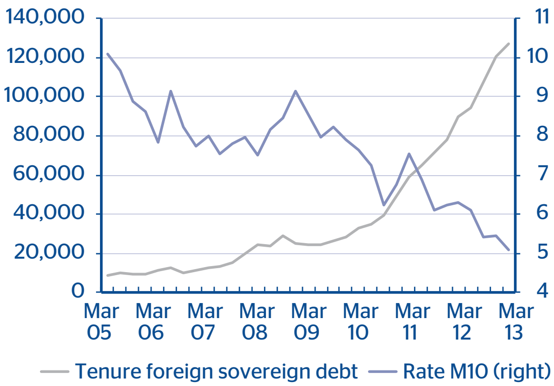
Meanwhile, the most relevant indicators for foreign demand show improvement. In particular, the US economy has continued to create employment at favorable rates, and industrial output continues to rise. This, combined with the reduction in global financial tensions and the agreement to avoid the fiscal cliff, suggests that economic activity will rebound in the US, thus creating greater demand for Mexican products. In other words, the slowdown is expected to be temporary, and the situation should improve significantly towards the second half of 2013.

Thanks to its sound economic fundamentals and the outlook for reforms, Mexico has also been able to benefit from abundant global liquidity. Mexico compares favorably with other emerging countries in macroeconomic terms. It has also started to apply reforms in sectors where relatively speaking it had lagged behind, such as in the education, telecommunications and public security sectors, among others (see Box 2 for further details of Mexico's weaknesses and strengths in relation to emerging countries). Consequently, the amount of sovereign debt held by foreigners has increased, and interest rates for financing medium and long-term debt have fallen considerably. This improvement in terms of financing the economy has also extended to conditions of corporate debt, which in turn props up private investment. The approval and gradual implementation of structural reforms will also help to brighten the outlook for business opportunities in Mexico, which should promote higher investment and consumption.

Graph 19

Foreign ownership of sovereign debt and rate of return on 10-year bonds

(Millions of dollars and percentage, respectively)

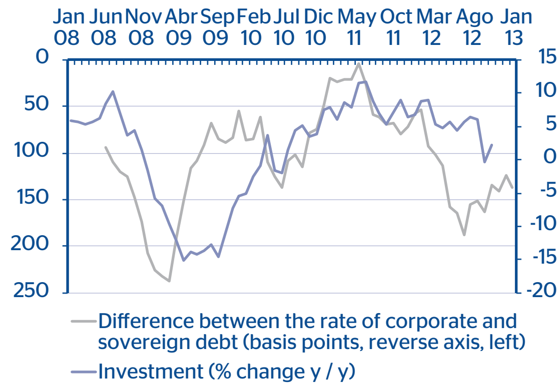


Source: BBVA Research, Banxico and Bloomberg

Graph 20

Difference between corporate and sovereign debt interest rate, and total investment

(basis points and y/y % change)



Source: BBVA Research, INEGI and Bloomberg

In short, although growth has slowed in the first quarter, this slowdown is expected to be temporary, so the outlook of growth slightly above 3.0% for 2013 is maintained.

Box 1: The approval of the telecommunications reform will help boost the sector and economic growth

It has been said in a number of circles that Mexico is lagging behind in telecommunications, resulting in high prices and low penetration in various telecommunications services, such as in broadband, for example (see charts below). In response, authorities have gradually applied measures, though this process has taken some time. On March 11, 2013, with the object of progressing more quickly in this sector, the federal government, together with the three major political parties and as part of the Pact for Mexico undertakings, presented a telecommunications and economic competition reform bill which was subsequently approved with slight amendments by Congress. The day the reform bill was presented, the share prices of the leading telecommunications companies slumped given the perception that the reform would promote greater competition and regulation. The most important aspects of the reform are as follows:

i) Constitutional autonomy for the Federal Economic Competition Commission (CFCE) and the new telecommunications regulator, the Federal Telecommunications Institute (IFT). These institutions are also empowered to remove barriers to competition and to divest assets.

ii) More strict regulation regarding dominant companies, which are defined as those with a share of more than 50% by number of users, by network traffic or by network capacity used.

ii) Entry of new companies through the granting of new licenses and allowing greater access for foreign direct investment. In particular, foreign investors will be able to own 100% of a telecommunications and satellite communication company, and 49% of a broadcasting company. Licenses for two new private television channels will be granted, with an investment in the region of 0.2% of GDP.

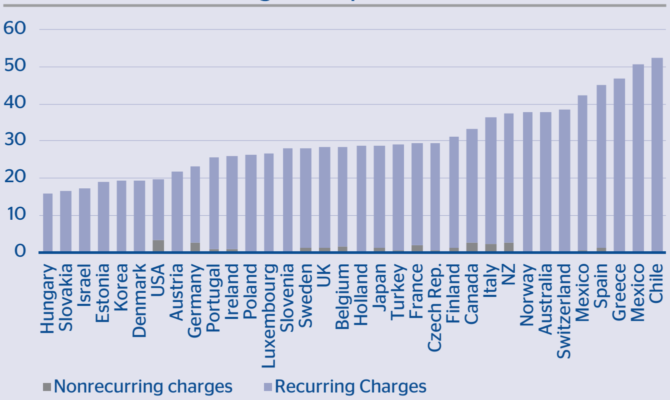
iii) Specialized competition and telecommunications tribunals are created. The creation of these tribunals can represent an important step forward in the law enforcement process, and should help to ensure that legal rulings concerning these matters are handed down with in-depth knowledge of the sector.

iv) The government will provide a new central dark fiber network which will provide a service at competitive rates, helping to promote the creation of telecommunications retailers and operators.

v) Given that the provisions of the new Act have the status of constitutional law and define the terms for use of infringements of fundamental rights and freedoms claims, there will be less of an incentive for litigation within the sector. In particular, the general rules and actions of the regulators can only be challenged by means of the indirect infringements of fundamental rights claims and shall not be suspended, meaning that they will be applied immediately. Only in cases in which fines or divestment of assets are imposed, rulings will be executed until the infringements of fundamental rights and freedoms claim is resolved, should it be brought.

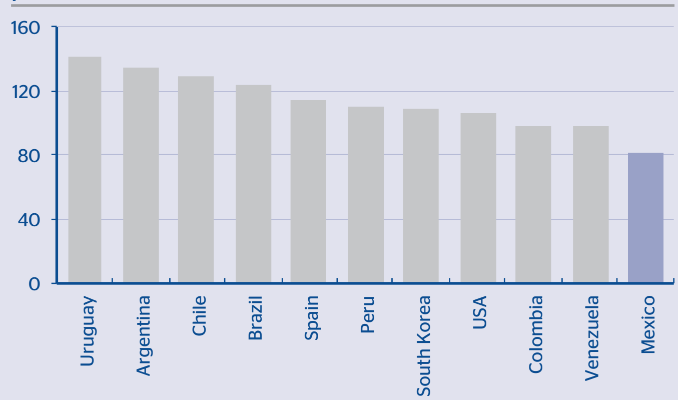
The reform is expected to have beneficial effects in the coming years in terms of new operators, investments and prices in the sector, eventually giving rise to increased rates of potential growth in the economy and lower and more stable medium-term inflation.

Graph 21
Prices of "2 Baja" Basket of the OECD: 6 GB, 2.5 Mbit/s and higher, September 2011



Source: OECD

Graph 22
Cell phone subscriptions per 100 inhabitants



Source: Cofetel

Box 2: The recent reform proposals are appropriately focused on a number of sectors where Mexico has fallen behind other emerging countries

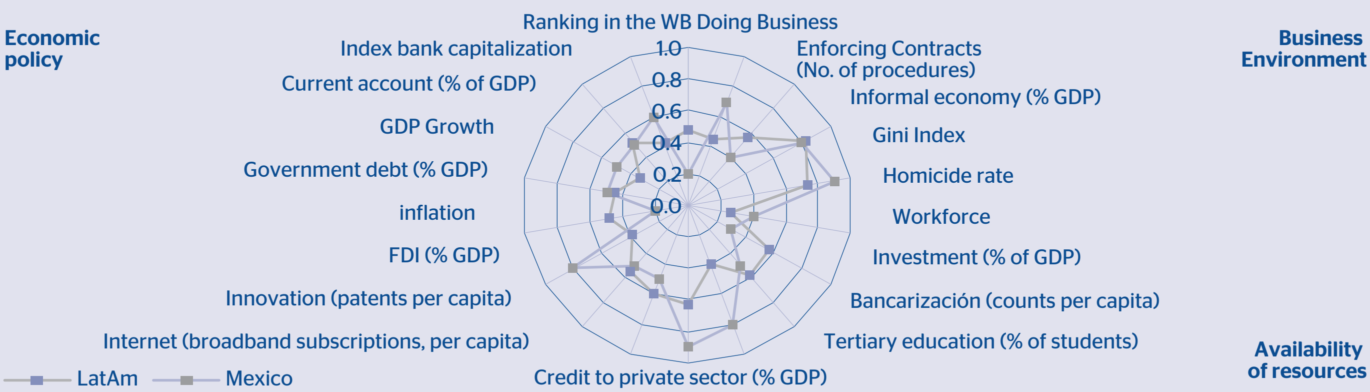
The purpose here is to assess Mexico's relative economic position compared with emerging countries, a relevant exercise in an environment where reforms are to be instrumented. If we examine an economy from a supply perspective, estimating its capacity to expand by the appropriate interaction of production factors and efficiency, there are three major groups of variables to consider: economic policy, business environment and availability of resources. As shown in the chart, 18 representative variables have been chosen for these three aspects, in such a way that their level with regard to a reference group of emerging economies is indicated.[1]

As far as availability of resources are concerned, the demographic bonus is higher in Mexico than in Latam, with a higher participation of the population in the labor market, but lower than the average for the group of emerging economies analyzed. Investment, banking penetration and banking credit: Mexico has an advantage in investment, does not stand out in banking penetration and is at a considerable disadvantage in terms of banking credit (credit to the private sector in Mexico is 26.1%, compared with an average of 40.2% for the Latam countries considered, and 59.7% on average for all the countries considered). The key to potential growth lies in how efficiently the available production factors are used. Measuring productivity, the ability to produce more with less, is problematic since it is not a directly observable variable. Productivity is usually calculated as the part of output not resulting from the amount of resources used and, therefore, it would be a result of how efficiently they are combined. In the radar chart, as part of the variables selected as representative of productivity, Mexico is at a relative disadvantage, both in its comparison with Latam and the emerging economies, in particular in the variable representing the percentage of pupils in tertiary education. In terms of telecommunications infrastructure (per capita subscriptions to broadband Internet) and innovation (patents per capita), Mexico's relative position is in line with the average for emerging countries and slightly better than the Latam average.

Improving the business environment is one of Mexico's major challenges. Although Mexico has a favorable relative position in the World Bank's Doing Business ranking, Mexico is clearly at a disadvantage in terms of insecurity (murder rate), legal challenges (enforcement of contracts) and inequality (Gini index). Although the size of the informal economy is smaller in Mexico, the country still needs to find a way of reducing it. Lastly, Mexico does not show clear advantages or disadvantages in items relating to economic policy, except for price stability -which is better in Mexico- and foreign direct investment (as a percentage of GDP), where Mexico is at a disadvantage. But in fact this latter variable could turn out to be one of the first in which Mexico improves its relative position, in light of the capacity it is beginning to show to carry out reforms in order to address its weak points. The labor and telecommunications reforms already enacted, the proposed financial reform, and the energy and fiscal reforms which are planned to be presented in the second half of the year tackle Mexico's areas of vulnerability. So if they are approved and efficiently implemented, then the country's structural outlook -and with it Mexico's relative position vis-à-vis other economies- could improve considerably.

Graph 23

Mexico and Latam, Vulnerability radar vis-à-vis emerging economies (the lower the value, the better the relative position)



Fuente: BBVA Research

[1] Reference emerging economies are: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, the Philippines, Thailand, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russia and Turkey. The lowest value, 0, would be the most favorable position in the variables for all countries reviewed; 1 would be the least favorable; meanwhile, 0.5 would represent the average for emerging economies.

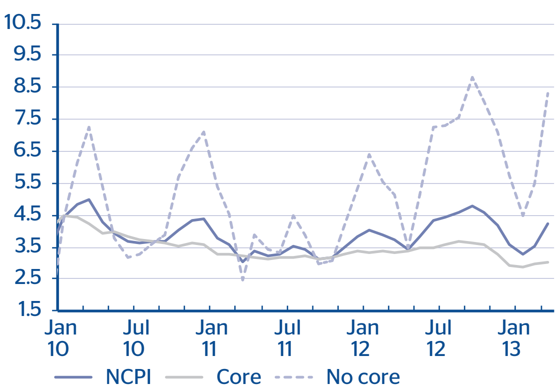
3.2 New supply shocks once again push inflation above 4.0%, while core inflation is at its lowest level in recent history

2013 began optimistically as far as inflation is concerned; in January the general index reached 3.25% y/y, a favorable result in a context in which inflation was above 4.0% between June and November 2012, reaching a high of 4.77% y/y in September of that year. The sharp fall in inflation occurred because the many supply shocks which dramatically increased non-core inflation in 2012 (e.g. outbreak of avian flu in Jalisco) began to fade, while international commodity prices fell away and the peso strengthened. The latter factor prompted a slowing of the goods sub-index of core inflation. Furthermore, mobile telephony prices fell sharply at the end of the year due to the aggressive offers made by suppliers, triggering a fall in services inflation of 2.5% y/y in July to 1.2% y/y in December, bringing core inflation to 2.9% in January 2013.

Despite the considerable improvement in the balance of risks at the start of this year, the appearance of new supply shocks in agricultural and livestock markets, combined with sharp adjustments in the prices of tariffs set by local governments, meant that inflation was much higher than was initially estimated in February and March, in fact it reached 4.3% in the latter month. Despite this new wave of supply shocks, core inflation remained at around 3.0% in the quarter due to 1) a heavy reduction in the inflation of goods, which went from 5.0% in December to 3.8% in March, offsetting the rise in inflation of services due to the end of the year-end special offers in telephony prices, y 2) the lack of contagion of the supply shocks to services prices (second-round effects). Thus the services sub-index and core inflation continue to react to the fundamentals of the economy, which does not yet grow with sufficient force as to be able to put upward pressure on inflation given the wide availability of productive resources.

Graph 24

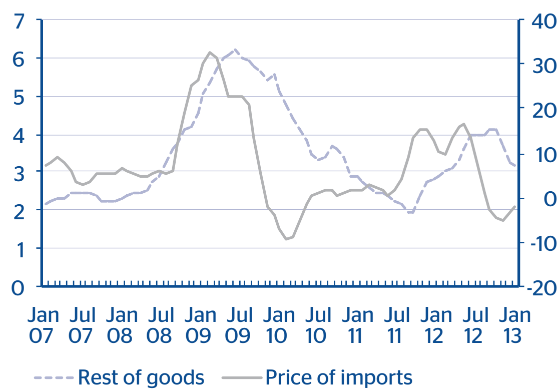
Inflation breakdown (y/y % change)



Source: BBVA Research with INEGI data

Graph 25

Inflation: rest of goods and imports (y/y % change)

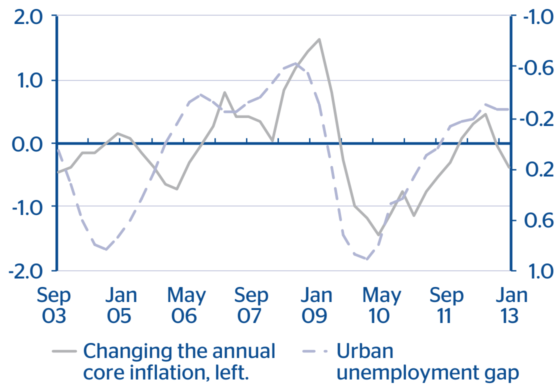


Source: BBVA Research with INEGI data

Core inflation reached its lowest quarterly average in recent history, 3.0% in the first quarter of this year. Therefore it is necessary to analyze the performance of its two components, goods and services.

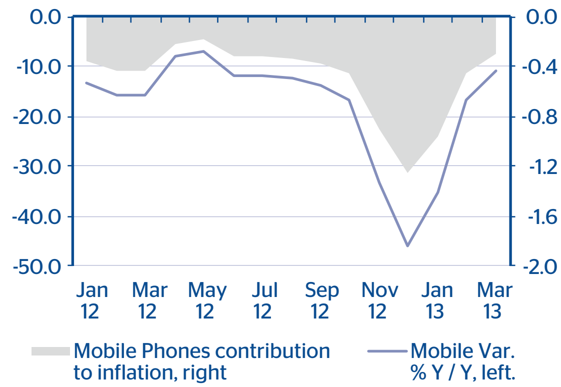
Inflation in the goods component fell from 5.0% in December to 3.8% in March (average of 4.0% 1Q13) due to reductions in both inflation of processed foods and in the rest of goods. Annual inflation for processed foods went from 6.1% y/y in December to 4.6% in March, while other goods fell from 4.1% y/y to 3.2% in the same period. The main reasons for the fall in inflation of processed foods were lower global grain prices and the appreciation of the peso. The main reasons for the lower inflation in the rest of goods are the appreciation of the currency and the fact that there have not been demand pressures.

Graph 26
Change in core inflation and urban unemployment gap



Source: BBVA Research with INEGI data

Graph 27
Inflation of mobile telephony and its contribution to core inflation
(y/y % change and percentage contribution)



Source: BBVA Research with INEGI data

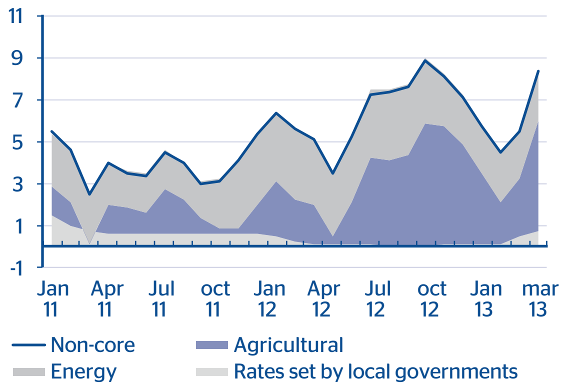
Inflation in the services component rose from 1.2% in December to 2.4% in March, a sharp increase over a relatively brief period. Analysis of the components of the services inflation shows, however, that the factor which had the most impact was the end of the year-end special offers in mobile telephony. Housing inflation increased from an average 2.03% in 4Q12 to 2.08% in 1Q13, while education inflation did so from an average 4.47% to 4.55% in the same period; this meant that these two sectors had a marginal effect on the rise in service prices. In contrast, mobile telephony prices rose 60% between December and March, and were thus largely responsible for the rise in inflation of services.

The improvement in key components of core inflation such as the appreciation of the peso and the lower international grain prices played a very valuable role in keeping core inflation at historical low levels. It is important to note, however, that the persistent slack in the economy, which is shown by levels of unemployment being still above pre-crisis levels, has been the main factor for the convergence of core inflation at 3.0% (see chart 26).

Non-core inflation stood at 4.5% y/y in January of this year, its lowest level since April 2012. In February and March, however, it rose sharply due to various pressures in its components. First, agricultural and livestock prices rose from 5.5% in January to 14.3% in March. This was the result of a strong surge in agricultural prices from -2.2 in January to 19.9% in March, due to pressures on products such as green tomatoes, zucchini, string beans and lemons, and an unfavorable base effect vs. 2012. Furthermore, inflation of livestock products remains high, 11.0% in March, given that the new outbreak of avian flu –on this occasion in the state of Guanajuato– once again put upward pressure on egg and chicken prices. Public prices rose from 3.9% y/y in January to 5.0% in March thanks to a slight increase in energy prices from 5.6% to 5.9% and to a sharp rise in tariffs set by local authorities from 0.6% to 3.4% in the same period. The hike in energy prices was largely due to stronger gasoline upturns, while the increase in tariffs set by local authorities was prompted by a reduction in the subsidy on car ownership tax in certain states, and the rise in the cost of the water service and public transport. Although this increase in the prices set by sub-national governments was widely anticipated, it has proved to be higher than expected, and there might even be further hikes given that many of these governments have weak public finances.

Graph 28

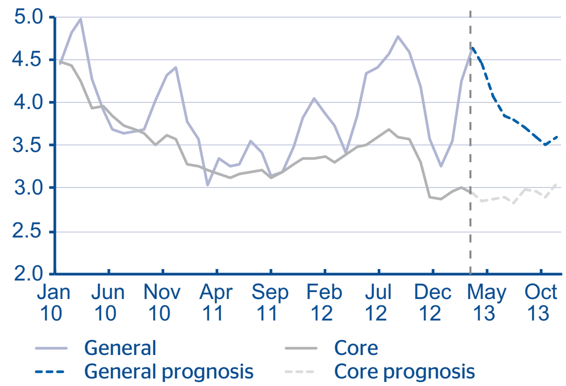
Non-core inflation and components (y/y % change and breakdown)



Source: BBVA Research with INEGI data

Graph 29

BBVA Research inflation scenario (y/y % change)



Source: BBVA Research

To sum up, the recent rise in inflation has largely been prompted by supply-side shocks within non-core inflation, shocks which are expected to fade in the short term, and which are very relevant given that they are one of the main factors for forming consumer expectations (see Box: Inflation expectations of consumers and determining factors). Taking the above factors into account, we expect that inflation will begin to fall from May onward and that by the end of the year it should be below the 4.0% threshold. However, there are certain risks in this scenario. An upward risk is the possibility of new hikes in local and global commodity prices, and of tariffs set by sub-national authorities in light of continuing weaknesses in their finances. A downward risk would be a further slowdown in the global economy which could increase the slack in the Mexican economy and put downward pressure on commodity prices, or a sharp appreciation of the peso.

Box 3: Consumer inflation expectations and their determining factors

nflation expectations are an extremely important input for carrying out monetary policy. This is particularly true for central banks which use target inflation schemes because they are basically forward-looking. Berk and Hebbink (2010) identify three possible goals or uses of inflation expectations: a) as a factor to be taken into account for determining the monetary policy which helps the inflation target to be reached, b) as a tool for continuously monitoring the central bank's credibility by comparing its measurements with the inflation target set, and c) as a variable of interest in carrying out the central bank's forecasts.

Inflation expectations are obtained in two ways: first, by extracting implicit inflation expectations in financial instruments, and second, by carrying out surveys among specialists or consumers. In Mexico, a number of surveys are carried out on economic and financial analysts, which are used as a reference both by the central bank and by the various agents taking part in the markets. Consumer inflation expectations are monitored less closely, however, because less data is available. In this section, we shall summarize the analysis and main results obtained by BBVA Research in the "Consumer inflation expectations: determining factors and reaction levels" document 1, which will be used to analyze the nature and the relevant variables for consumers' inflation expectations.

The information on Mexican consumers' inflation expectations was taken from the qualitative responses to question 12 of the basic questionnaire of the National Consumer Confidence Survey (Encuesta Nacional sobre Confianza del Consumidor, ENCO), which is formulated as follows:

Compared with the last 12 months, how do you think prices will perform in the country over the next 12 months?

1. They will decrease a lot
2. They will decrease a little
3. They will remain unchanged
4. They will increase a little
5. They will increase in the same measure
6. They will increase a lot
7. Doesn't know

In order to have an aggregate measure of Mexican consumers' inflation expectations, a monthly diffusion index was built. 2 Data from October 2010 to January 2013 were used. Diffusion indices by gender were also built in order to take into account only responses by women or by men. In Chart 30, it is evident that pessimism periods (diffusion index higher than 50) are relatively infrequent in the sample period. In other words, the pessimism threshold was only exceeded in 10.7%, 32.1% and 3.6% of the months for the total indices, for the women and men, respectively.

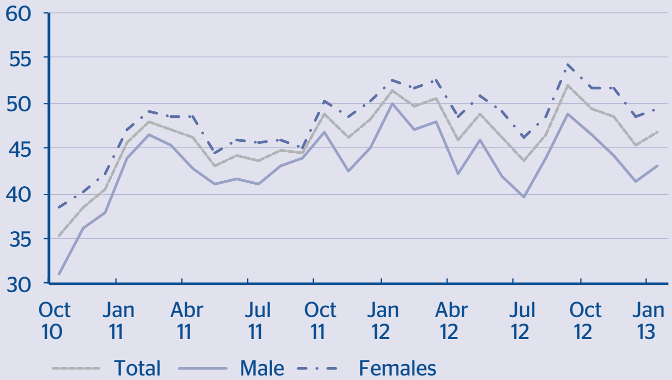
In order to find and classify the importance of the most relevant inflation components for forming consumer expectations, the Regression Trees methodology was used. It was chosen mainly for two reasons: (i) it is appropriate in view of the relatively high number of inflation components which were tested and the relatively low number of observations over time within the estimation sample; and (ii) it also allows us to classify the importance of the components in forming inflation expectations, and to obtain levels from which consumers react in order to fit the aforesaid expectations.

As far as the explanatory factors explored are concerned, the annual rates of growth in the following indices (together with their first two lags) were used: headline, core, goods, processed foods, other goods, services, housing, education, other services, non-core, agricultural, farm, public (utilities and public sector tariffs), energy and public sector tariffs. Two ad-hoc indices were also built: one containing all the energy and food components, and another containing all products other than energy and food.[3]

[1] Document available at: http://www.bbvaresearch.com/KETD/fbin/mult/130404_ObsEcoMexico_32_tcm346-382051.pdf?ts=3042013
[2] The diffusion index was calculated as follows: (1) the "Doesn't know" response was prorated amongst the other response options to question 12; (2) the proportions of response to these options were calculated over total responses without considering expansion factors for households; (3) the weights of 0.0, 0.0, 0.0, 0.0, 0.5 and 1.0 were used for the "They will decrease a lot", "They will decrease a little", "They will remain unchanged", "They will increase a little", "They will increase in the same measure" and "They will increase a lot" options respectively; (4) each proportion was multiplied by its corresponding weight; and (5) the products of the last step were added together. Zero weight is allocated to the first 4 options so that the level of 50 will reflect neutral inflation expectations. In other words, expectation of the same inflation for the next 12 months.
[3] An index taking in all energy and food prices has been included because these products make up an important part of the consumer basket (40% of total spending), and also because of the high sensitivity of their prices to local or global supply shocks.

Graph 30

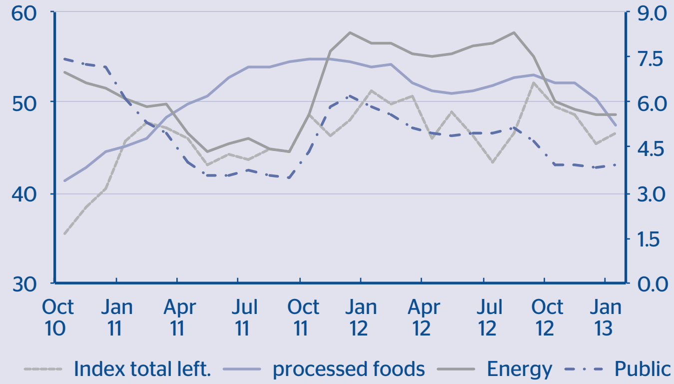
Consumer inflation expectations (diffusion index)



Source: BBVA Research with INEGI data

Graph 31

Inflationary expectations of all consumers and miscellaneous inflationary components (Diffusion index and y/y % change)

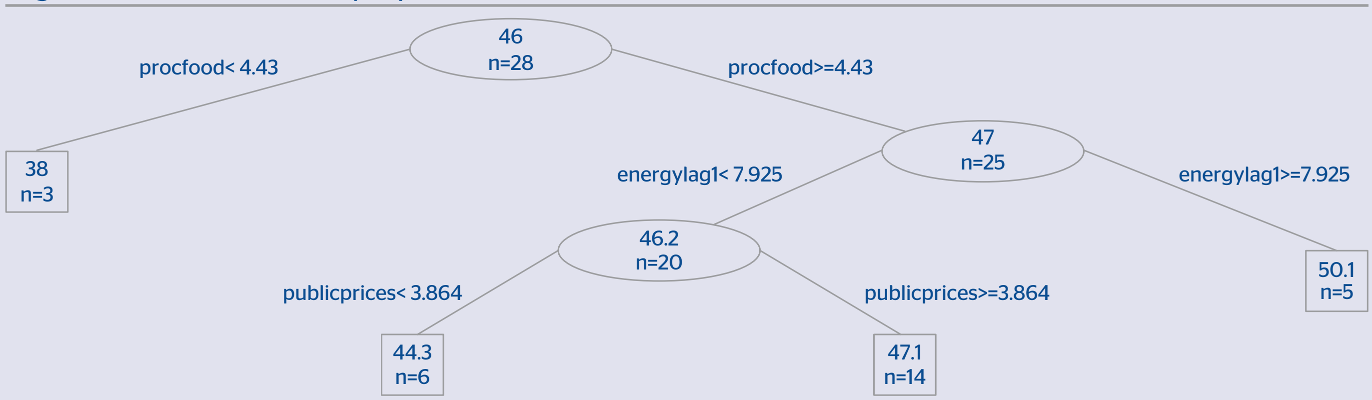


Source: BBVA Research and INEGI

The regression trees are read as follows: any branch which grows to the right of a node implies an increase in the average dispersion index in the event of the explanatory variable in that node exceeding the specified level. Thus, if after the conditions specified in each node are met the average level of the remaining observations is higher than 50, we can be certain that in those periods consumers expect inflation to increase over the next 12 months. Similarly, branches to the left of a node imply that if the explanatory variable does not exceed the expected level in that node, the average dispersion index will be reduced, so that if the average is lower than 50 in the end node, consumers expect that there will be less inflation over the next 12 months. Thus, we can see in the tree built for all consumers that if inflation of processed foods (alimproc) equals or exceeds the level of 4.43% y/y, the dispersion index will increase its average from 46 to 47. In addition, if the energy lag (energíarez1) is higher than or equal to 7.92%, the index average in the periods in which that condition is met will increase from 47 to 50.1, so that in the 5 periods in which we may conclude that both conditions are met, consumers expected higher inflation for the next 12 months.

Graph 32

Regression tree for inflationary expectations of all consumers

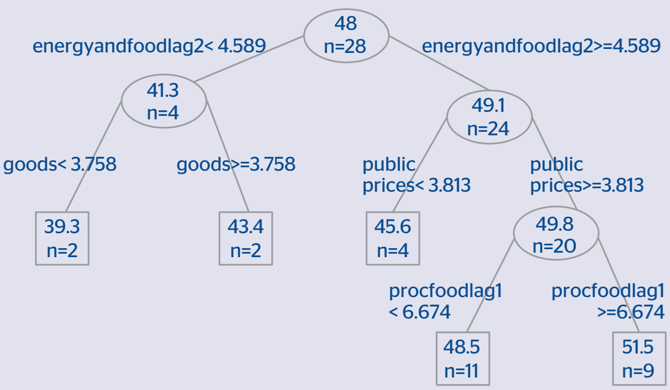


Source: BBVA Research

[4] The model is outlined in López Marmolejo (2006), "Barriers to work, underground economy and aggregate fluctuations". UAB mimeo. This exercise does not consider the additional benefit of social security for the informal sector, as it assumes that this is neutralized through a tighter control of this sector.
[5] Source: World Energy Outlook 2010

For women, it is evident in chart 33 that the most relevant factors are: the second lag of energy and food, utilities and the first lag of processed foods. The diffusion index shows inflationary pessimism when the level of these factors is higher than or equal to 4.59%, 3.81% and 6.67%, respectively. Lastly, for men, Chart 34 shows that the most important components are: processed foods and the first lag of utilities, although in the observed period the level of 50 is never exceeded, so that during the entire analysis period men expect inflation to be lower over the next 12 months.

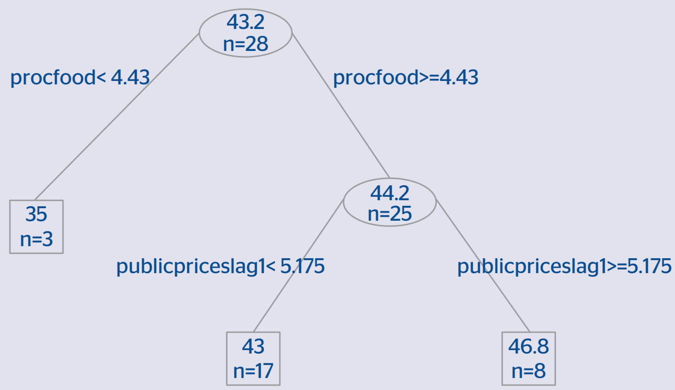
Graph 33
Regression tree for women's inflationary expectations



Source: BBVA Research

The following conclusions can be drawn from these results: i) generally speaking, inflation expectations of people interviewed are predominantly optimistic, which is consistent with the good performance of average headline inflation in the period (3.8%); ii) the diagrams of the regression trees indicate that consumers react (in descending order of importance) to the following inflation components: processed foods, energy and utilities; iii) if we separate the sample into women and men we observe that although women are more optimistic for most of the sample, they are more pessimistic than men; iv) lastly, consumers react to the prices of the products which they consume on a daily basis, such as food, utilities and energy prices.

Graph 34
Regression tree for men's inflationary expectations



Source: BBVA Research

References

Berk, J.M. and Hebbink, G. (2010). "The European consumer and monetary policy." In Sinclair, P. (editor). Inflation Expectations. Routledge, London and New York.

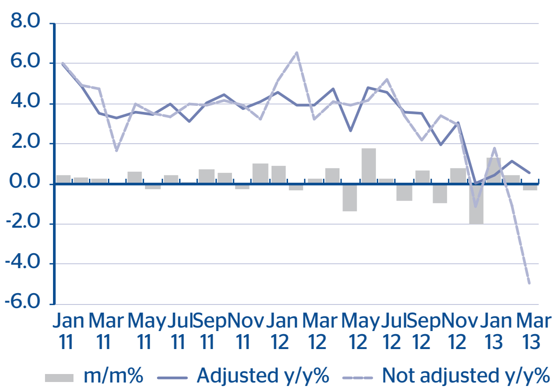
3.3 Accommodative monetary policy insofar as inflation stands within the target inflation variability range

In a setting where central banks continue to relax their monetary stance, the tone of the minutes from Banxico's last monetary policy meeting and recent activity and inflation data lead us to expect that a cut in the lending rate in the second half of the year is very likely. Specifically, for the following reasons.

First, according to the minutes most members of the Board believe that inflation has been allowed to converge towards the target. This would be the result of core inflation having remained in the region of 3.0%, despite headline inflation having risen above 4.0% due to the recent supply-side shocks. In particular, the majority argue that "once the shocks are separated into those [prices] where monetary policy has a direct or indirect effect, convergence to 3% is occurring". In this sense, the latest inflation figures and the prices on wholesale markets point to supply shocks seemingly falling quicker than expected, meaning inflation is expected to possibly come in below 4% from July on.

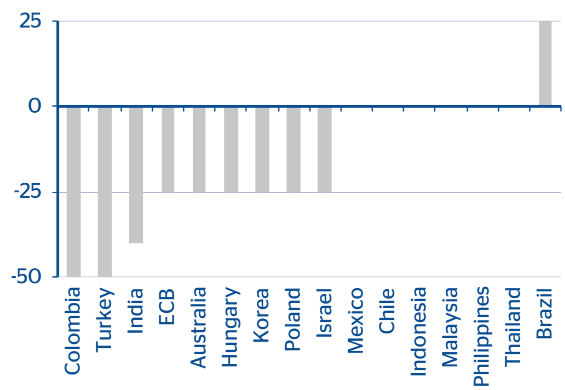
Second, even with Banxico not changing its growth forecasts in its most recent inflation report, most of the members of the Board are pessimistic about domestic output, as well as agreeing that downward risks remain. This line of argument points to the monthly fall of 0.3% in industrial output in March, and the recent manufacturing export and employment figures indicating weaker growth in the second quarter. See Radar of financial macro conditions at the end of the chapter.

Graph 35
Industrial output, (m/m and y/y % change)



Source: BBVA Research with INEGI data

Graph 36
Changes in the monetary policy rate from April on (basis points)



Source: BBVA Research with data from Bloomberg

Third, the Board has assigned a relevant weight to the evolution of Mexico's relative monetary position vis-à-vis other countries, and over the last two months a number of central banks worldwide have cut their monetary rates. The weight of the relative monetary position has been highlighted in the minutes, as several paragraphs are given over to the revision of monetary easing measures around the world and some members directly associate it with a marginal tightening of monetary conditions in emerging economies. Furthermore, the argument about the tightening of monetary conditions has not only been repeated in the Banxico statement, but in the most recent monetary policy statement it was stressed as a relevant factor in determining its monetary policy.

Lastly, it is important to note that the balance of opinions within the Board is tipped towards a more relaxed tone, similar to the situation in March, when the majority decision was taken to implement a 50 bp cut under unusual circumstances (inflation and growth).

Based on the above, we believe that the conditions will be in place for a 50 basis points cut in the policy rate in September once inflation is in the range around the inflation target. It should be stated that the timing of a cut is strongly influenced by when inflation is on a sustained downward trend and below 4%.

The increase in global liquidity and the bright outlook for Mexico heighten investors' demand for Mexican assets

The setting of a search for return created by the extraordinary monetary easing measures taken by the central banks of developed countries have had a considerable impact on the increased demand for Mexican financial assets, which in turn has prompted an appreciation of the exchange rate and a fall in interest rates. Over the last year, foreign ownership of fixed nominal rate government bonds has increased from 44% to 56% of the total, the exchange rate has strengthened by 7.24%, and the yield on the 10-year government bond has fallen 170 basis points. Against the background of slow recovery in world growth, in which emerging countries account for most of this growth, the higher demand for Mexican assets can be explained by competitive risk-adjusted returns, bolstered by the favorable comparison with Mexico's economic fundamentals and its outlook compared to other countries. For example, the expected yield in dollars on the 1-year Mexican sovereign bond for each 100 basis points of credit risk (measured using credit default swaps, CDS) is in the region of 5.5%, while that of Colombia stands at around 4.2%. The yields in dollars of the fixed-income government bonds have remained at attractive levels largely due to the rise in the exchange rate, a rise which is expected to continue given the prospects of Mexico implementing reforms to boost its productivity. What is more, Mexico's credit risk indicators have also fallen, bringing it currently at the level of countries with a sovereign debt rating three places above. No doubt this is underpinned by the healthy fundamentals of the Mexican economy, such as a fiscal deficit of only 2.0% of GDP, considering PEMEX investment, a debt/GDP ratio in the region of 40%, reserves of 14% of GDP and on the rise, inflation under control, and, on average, within the inflation target range. An additional factor is the prospect of fiscal resources being increased through reforms, thus reducing the country's dependence on oil revenue, which in turn might bring about an improvement in Mexico's sovereign debt rating. In this regard, it is important to note that a number of rating agencies have pointed out that the possible improvement in rating would depend on the reforms being correctly instrumented, and it would not suffice merely with approval by Congress.

Given the compelling yield in risk-adjusted dollars of Mexican assets, foreign investors have significantly increased their positions in fixed-rate government bonds. Since March 2010, the flows of foreign investors towards M bonds has increased by an average of USD 4.8 billion by quarter, mainly in the medium and long part of the curve, and reaching USD 8.3 billion in the first quarter of 2013. In the case of the CETES, after an inflow of around USD 9.3 billion was registered in December 2012, a fall in foreign-owned bonds was reported in the first quarter of the year, which might have been influenced by the cut in the monetary policy rate. It is important to note that given the fall in the yields of CETES, the outlook for increases in the exchange rate may account for a significant part of the yield in carry trade strategies.[1]

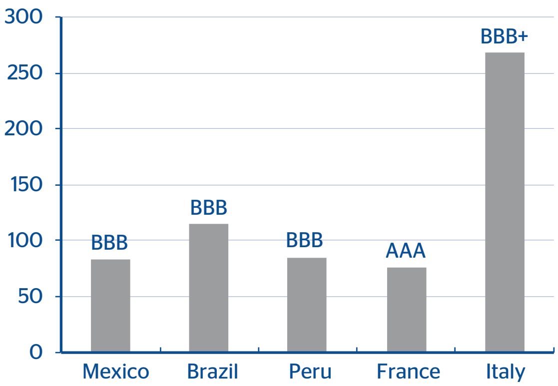
Over the year so far, the medium and long part of the curve has fallen by 90 and 98 basis points on average respectively, and even fell 40 and 55 average basis points following the cut in the monetary policy rate. In the short term, the CETES rates for terms equal to or shorter than 182 days already stand below the lending rate, a situation which has been maintained practically since the last quarter of 2010, partly due to abundant liquidity. As far as exchange rates are concerned, the peso has appreciated by 5.9% during the first four months of 2013, underpinned by Japan's new monetary stimulation package, outlook for the approval of reforms, and the prospects of the acquisition of assets by the US Federal

[1] A carry trade strategy involves taking a short position in an instrument which pays a short-term rate in foreign currency (e.g. one-month Libor) and a long position in an instrument which pays a short-term rate in domestic currency (e.g. TIIE at 28 days)

Reserve remaining in force.[2] The peso has remained within a range of between 12.0 and 12.3 pesos per dollar in recent weeks, levels which appear to suggest higher appreciation of the exchange rate in the long term after structural reforms are implemented in an environment of global liquidity.[3] In the short term, the exchange rate will be particularly sensitive to global cycle indicators, especially in the US, insofar as markets try to anticipate forthcoming steps to be taken by central banks.

Graph 37

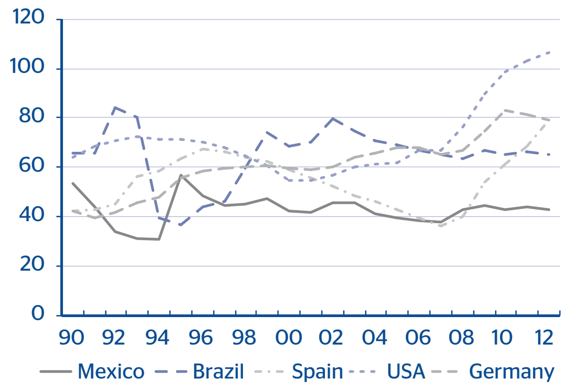
Risk premium for credit default swaps (basis points) as of April 2013



Source: Bloomberg, Fitch and BBVA Research

Graph 38

Public debt (% GDP)



Source: International Monetary Fund

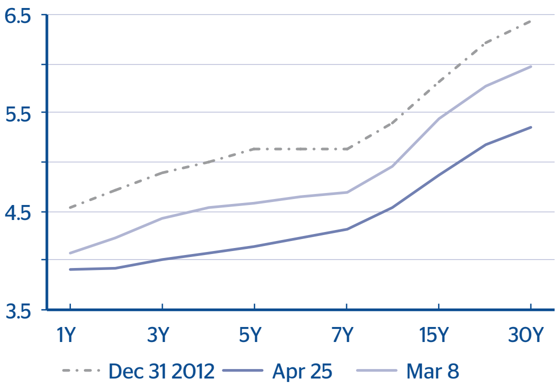
In recent weeks, the rise in the exchange rate has been related to a possible official intervention in the foreign-exchange market. Especially after Banxico referred to the unnecessary toughening of monetary conditions, resulting from the significant increase in capital flows, as an additional element for supporting the cut in the lending rate. If we look back over the interventions in the foreign-exchange market over the last five years, it is evident that these interventions have focused on restoring liquidity in the event of episodes of high-volatility in the financial markets. In fact, during recent episodes of exchange rate appreciation there have been no one-off interventions in the market. 4 Even in 2008, when the exchange rate reached levels below 10 pesos per dollar, the only measure taken was to increase the amount of international reserves after the federal government acquired USD 8 billion to cover currency operating needs in advance. Therefore, although an intervention cannot be ruled out, there is evidently room to accumulate reserves owing to two factors. First, Mexico's international reserves account for around 14% of GDP, a lower level than in several emerging economies, particularly if we consider the emerging countries with the most liquid currencies, such as South Korea and Singapore. The peso is the third most liquid currency among emerging economies, with daily exchange transactions of around 50 billion dollars. In addition, Mexico has been granted a flexible credit facility by the IMF of up to USD 73 billion that gives it unrestricted access to funds at low cost. Second, foreign ownership of Mexican fixed-income bonds as a percentage of international reserves has increased from 30% to 72% in only 3 years, which could imply a risk of volatility in the event of a sudden withdrawal prompted by an episode of global aversion to risk. However, a potential withdrawal of flows would not pose a risk for the economy given that the required financing in foreign currency is low, as shown by the current account deficit of only 0.8% of GDP in 2012.

[2] In recent weeks, the lower-than-expected economic activity indicators in the US have prompted markets to believe that the Federal Reserve may maintain its monetary stimulation measures for longer, and the peso has even appreciated in reaction to these figures. For example, the exchange rate appreciated 0.81% even after the lower- than-expected job creation figure for February in the US was released.

[3] For an estimate of the long-term level of the exchange rate due to structural reforms refer to the box entitled "Impact of possible instrumentation of structural reforms on the long-term exchange rate level" in this report.

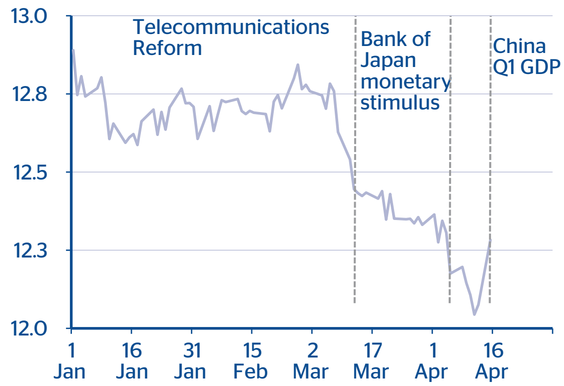
[4] For a review of recent intervention measures see: "Room for accumulating reserves in view of the strength of the exchange rate". Mexico Economic Flash. Available at: http://www.bbvaresearch.com/KETD/fbin/mult/130422_ObsEcoMexico_33_tcm346-383438.pdf?ts=152013

Graph 39
Interest rates curve (%)



Source: BBVA Research and Bloomberg

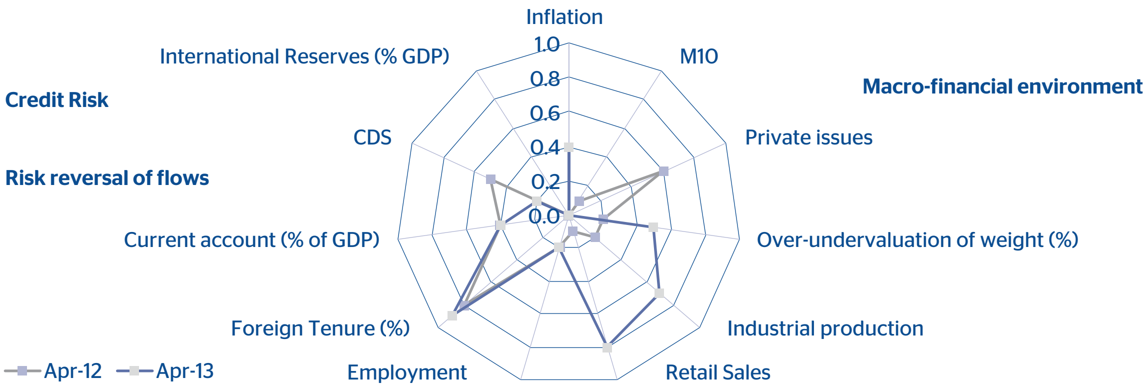
Graph 40
Exchange rate (peso/dollar)



Source: BBVA Research and Bloomberg

In short, the better relative position in terms of the risk and return of Mexican instruments compared to other countries has benefited Mexico, with foreign capital inflows exerting an impact on the fall of interest rates to historically low levels together with exchange rate levels similar to 2011. If the structural reforms are implemented adequately against a background in which global liquidity is maintained, Mexico would be able to achieve lower interest rates and a stronger exchange rate in the medium term (see box 4). However, should any of these prospects not materialize, then we do not rule out new episodes of high volatility.

Graph 41
Mexico. Radar of financial macro conditions (The lower the value, the better the relative position)



Source: BBVA Research.

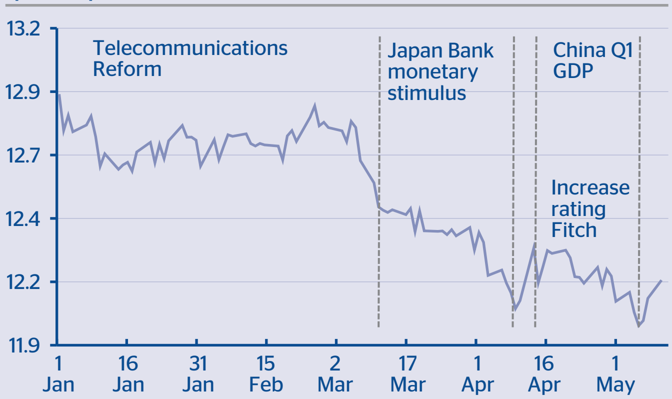
Box 4: Impact of possible implementation of structural reforms on the long-term exchange rate level

The new administration in Mexico has brought new interest in approving reforms and also fresh optimism among investors with regard to the country's growth outlook. Expectations center mainly around a fiscal reform and an energy reform, and have caused a new debate about the growth potential of the Mexican economy and the additional effects this would have on other macroeconomic variables. One of these variables is the exchange rate. In the first four months of the year, the peso has strengthened by over 5.0% against the dollar, making it the currency which appreciated most in Latam during the period. Although this increased strength of the peso has been underpinned by a global backdrop of abundant liquidity and dash for return, market agents attribute part of this appreciation to the stability of the economy, the outlook of higher growth in the medium term, and possible further improvements in the sovereign debt rating which might materialize once the reforms are implemented. With the object of assessing the effect of higher economic growth on the exchange rate, the impact of an increase in potential GDP on the long-term exchange rate level will be analyzed.

The analysis of the long-term exchange rate level is based on the arbitrage condition of Purchasing Power Parity, considering the Balassa-Samuelson effect, whereby it is thought possible to estimate the long-term exchange rate using prices in relation to the trading partners of the country in question and the relative productivity of its tradable goods sector.[1] However, it is important to note that in the short term there are other relevant factors, such as expectations and the perception of risk, among others. According to this approach, an increase in potential output would be based on an increase in productivity, which would be consistent with an appreciation of the long-term level. In order to identify the statistical relationship between the exchange rate and the aforementioned economic fundamentals, a cointegration model capable of incorporating short and long-term exchange rate determining factors is used.[2]

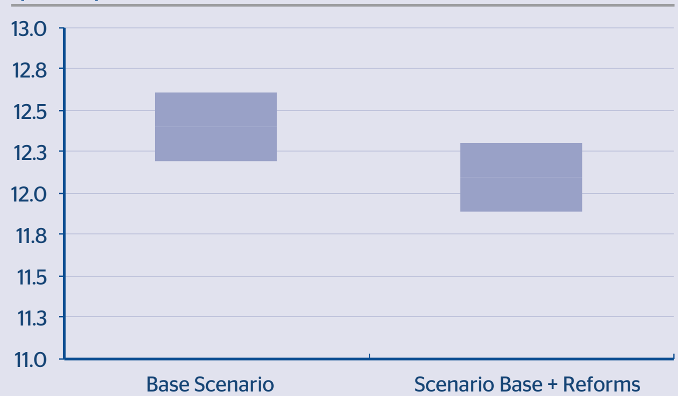
If we assume an increase in potential GDP of 1.0% in Mexico due to the reforms, and we also assume the following: 1) that the US economy reports average growth of 2.3% y/y over the next five years, and 2) that annual average inflation in the US and Mexico during the next five years will stand at 2.3% and 3.6%, respectively, then we can state that gains in relative productivity of the labor force in Mexico against the US equivalent could cause appreciation in the long-term level of the peso against the dollar of

Graph 42
Exchange rate (pesos per dollar)



Source: BBVA Research and Bloomberg

Graph 43
Long-term exchange rate (pesos per dollar)



Source: BBVA Research

[1] According to the arbitrage condition of the Purchasing Power Parity (PPP), if two similar goods have a different price in different countries, then there will be greater demand for the cheaper good. Under arbitrage, supply and demand will be adjusted in order to make the prices equal. The Balassa-Samuelson effect considers the differences in the productivities of the tradable goods sectors between countries to explain deviations in PPP.
[2] For an in-depth review of the model's methodology and estimation, see López Arnoldo and Iván Martínez (2011).
[3] For an in-depth review of the model's estimation and the hypothetical measures that each reform involves, refer to "Impact of possible reforms on Mexico's potential GDP" in Revista Situación México, first quarter of 2013. http://www.bbvaresearch.com/KETD/fbin/mult/1302_MexicoOutlook_1Q13_tcm346-374661.pdf?ts=2442013

around 30 cents. In other words, the long-term level which is presently estimated to be between 12.2 and 12.6 pesos per dollar could fall to levels of between 11.9 and 12.3 pesos per dollar. It is important to note that i) the long-term level refers to a trend with a quarterly frequency, and ii) that the aforementioned anchoring would not occur immediately. This result suggests that part of the appreciation which has been observed to date could be due to the markets having factored in expectations of possible reforms to current exchange rate levels

References

Driver Rebecca and Peter F Westaway (2004). "Concepts of equilibrium Exchange rates". Working paper No. 248, Bank of England.

López Arnoldo and Iván Martínez (2011), "Tipo de cambio, nivel fundamental e impacto de la volatilidad global", Economic Watch, BBVA Research.

4. Indicators and forecasts

Chart 1
Macroeconomic forecasts: Gross Domestic Product

(YoY growth rate)	2010	2011	2012	2013	2014
United States	2.4	1.8	2.2	**1.8**	**2.3**
EMU	1.9	1.5	-0.5	**-0.1**	**1.0**
Germany	4.0	3.1	0.9	**0.8**	**1.8**
France	1.6	1.7	0.0	**0.0**	**1.1**
Italy	1.7	0.5	-2.4	**-1.3**	**0.8**
Spain	-0.3	0.4	-1.4	**-1.4**	**1.1**
UK	1.8	1.0	0.3	**1.0**	**1.9**
Latin America *	6.2	4.3	2.8	**3.4**	**3.6**
Mexico	5.3	3.9	3.9	**3.1**	**3.1**
Brazil	7.6	2.7	0.9	**3.4**	**3.8**
EAGLES **	8.4	6.6	5.1	**5.6**	**6.0**
Turkey	9.2	8.5	2.3	**4.0**	**5.5**
Asia-Pacífico	8.2	5.7	5.3	**5.4**	**5.8**
Japón	4.7	-0.6	2.1	**1.7**	**1.7**
China	10.4	9.2	7.8	**8.0**	**8.0**
Asia (exc. China)	6.7	3.4	3.6	**3.8**	**4.3**
World	5.1	3.9	3.2	**3.3**	**3.9**

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Corea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Closing date: May 7, 2013
Source: BBVA Research

Chart 2
Macroeconomic forecasts: inflation (Avg.)

(YoY growth rate)	2010	2011	2012	2013	2014
United States	1.6	3.1	2.1	**2.1**	**2.2**
EMU	1.6	2.7	2.5	**1.6**	**1.5**
Germany	1.2	2.0	2.0	**1.7**	**1.8**
France	1.5	2.1	2.0	**1.4**	**1.5**
Italy	1.5	2.8	3.0	**2.0**	**1.7**
Spain	1.8	3.2	2.4	**1.7**	**1.2**
UK	3.3	4.5	2.8	**2.7**	**2.2**
Latin America *	6.4	8.0	7.5	**8.4**	**8.4**
Mexico	4.2	3.4	4.1	**3.9**	**3.5**
Brazil	5.0	6.6	5.4	**6.2**	**5.4**
EAGLES **	5.3	6.0	4.2	**4.4**	**4.6**
Turkey	8.6	6.2	8.5	**6.9**	**5.9**
Asia-Pacífico	3.6	4.7	3.0	**3.1**	**3.6**
Japón	-0.7	-0.3	0.0	**0.1**	**0.7**
China	3.3	5.4	2.6	**3.0**	**4.0**
Asia (exc. China)	3.7	4.3	3.3	**3.2**	**3.4**
World	3.7	5.1	4.1	**3.9**	**4.0**

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Corea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Closing date: May 7, 2013
Source: BBVA Research

Chart 3

United States indicators and forecasts

	2011	2012	2013	2014	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13
Macroeconomic Indicators												
GDP (real % change)	1.8	2.2	**1.8**	**2.3**	2.0	1.3	3.1	0.4	2.5	**1.1**	**2.0**	**2.2**
Personal consumption (real % change)	2.5	1.9	**1.9**	**1.8**	2.4	1.5	1.6	1.8	3.2	**0.8**	**1.6**	**1.6**
Gov. consumption (real % change)	-3.1	-1.7	**-2.2**	**0.3**	-3.0	-0.7	3.9	-7.0	-4.1	**-2.0**	**0.4**	**0.4**
Gross fixed investment (real % change)	6.6	8.7	**6.9**	**7.3**	9.8	4.5	0.9	14.0	4.1	**9.0**	**6.8**	**7.0**
Construction	-1.4	12.1	**11.5**	**6.6**	20.6	8.4	13.6	17.5	12.6	**8.2**	**8.2**	**6.6**
Industrial prod. (real annual % change)	3.4	3.6	**3.7**	**5.1**	4.0	4.5	3.3	2.7	2.6	**3.3**	**4.0**	**4.8**
Current account balance (% of GDP)	-3.1	-3.1	**-3.0**	**-3.4**	-3.5	-3.0	-2.8	-2.8	-3.6	**-2.9**	**-2.7**	**-3.0**
Final annual inflation	3.0	1.7	**2.7**	**1.6**	2.7	1.7	2.0	1.7	1.5	**2.4**	**1.9**	**2.7**
Average annual inflation	3.2	2.1	**2.1**	**2.2**	2.8	1.9	1.7	1.9	1.7	**2.2**	**2.2**	**2.3**
Primary fiscal balance (% of GDP)	-8.7	-7.0	**-5.4**	**-3.8**				-7.0				**-5.4**

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

Chart 4

Indicadores y Pronósticos México

	2010	2011	2012	2013	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	5.3	3.9	3.9	**3.1**	4.9	4.4	3.3	3.3	**2.2**	**2.7**	**3.5**	**3.9**
Per inhabitant (US dollars)	9,557.5	10,443.2	10,872.4	**12,420.5**	10,648.7	10,291.4	10,874.4	11,533.2	**11,693.9**	**12,173.8**	**12,761.1**	**13,102.8**
US$ billions	1,032.5	1,139.4	1,192.8	**1,372.3**	1,175.0	1,139.9	1,192.1	1,264.3	**1,286.1**	**1,343.1**	**1,410.7**	**1,449.3**
Inflation (average, %)												
Headline	4.2	3.4	4.1	**3.9**	3.9	3.9	4.6	4.1	**3.7**	**4.4**	**3.8**	**3.6**
Core	3.9	3.2	3.4	**2.9**	3.3	3.5	3.6	3.3	**3.0**	**2.9**	**2.9**	**3.0**
Financial Markets (eop, %)												
Interest rates												
Bank funding	4.5	**4.5**	4.5	**3.5**	4.5	4.5	4.5	4.5	**4.0**	**4.0**	**3.5**	**3.5**
28-day Cetes	4.4	4.4	3.9	**3.3**	4.3	4.4	4.2	3.9	**4.2**	**3.7**	**3.3**	**3.3**
28-day TIIE	4.9	4.8	4.8	**3.8**	4.8	4.8	4.8	4.8	**4.4**	**4.3**	**3.9**	**3.8**
10-year Bond (%, average)	6.9	6.8	5.7	**4.7**	6.2	5.9	5.3	5.4	**5.1**	**4.6**	**4.6**	**4.7**
Exchange rate (average)												
Pesos per dollar	12.7	12.5	13.1	**12.2**	12.9	13.6	13.1	13.0	**12.6**	**12.2**	**11.9**	**12.0**
Public Finances												
*FRPS (% of GDP)	-3.4	-2.6	-3.1	**-2.4**	-	-	-	-3.1				**-2.4**
External Sector[3]												
Trade balance (US$ billions)	-2.9	-1.2	0.5	**-6.4**	1.9	1.6	-1.1	-2.0	**0.6**	**-0.8**	**-2.1**	**-4.1**
Current account (US$ billions)	-1.9	-9.7	-9.2	**-16.4**	-1.4	-0.5	-0.9	-6.5	**-4.5**	**-2.4**	**-3.6**	**-5.9**
Current account (% of GDP)	-0.2	**-0.9**	-1.0	**-1.2**	-0.5	-0.2	-1.3	-2.1	**-1.4**	**-0.7**	**-1.0**	**-1.6**
Oil (Mexican mix, dpb, eop)	72.3	101.1	101.8	**99.7**	110.5	100.6	99.7	96.6	**104.3**	**98.5**	**97.9**	**98.1**
Employment												
Formal Private (annual % change)	3.8	4.3	4.6	**3.9**	4.5	4.6	4.7	4.7	**4.1**	**3.8**	**3.8**	**3.9**
Open Unemployment Rate (% active pop.)	5.4	5.2	5.0	**4.8**	5.0	5.0	4.8	5.0	**5.0**	**4.8**	**4.7**	**4.6**

Continues on next page

Mexico indicators and forecasts

	2010	2011	2012	2013	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13
Aggregate Demand [4] (annual % change, seasonally-adjusted)												
Total	8.6	4.7	4.0	**3.3**	5.2	4.3	2.7	3.8	**2.6**	**3.1**	**4.1**	**3.5**
Domestic Demand	4.9	3.9	3.8	**3.2**	5.0	4.2	2.7	3.2	**2.5**	**3.2**	**3.6**	**3.4**
Consumption	4.6	4.1	3.1	**3.0**	4.0	3.6	1.9	3.0	**2.6**	**3.4**	**3.1**	**2.7**
Private	5.0	4.4	3.4	**3.3**	4.2	3.8	2.1	3.5	**3.2**	**3.7**	**3.3**	**2.8**
Public	2.3	2.1	1.5	**1.0**	3.1	2.3	0.4	0.2	**-0.8**	**0.9**	**1.8**	**2.0**
Investment	0.3	8.3	5.8	**2.7**	8.2	6.1	5.6	3.5	**1.3**	**1.9**	**2.8**	**4.8**
Private	-0.3	13.9	5.3	**4.0**	9.3	4.8	2.4	4.8	**2.4**	**4.4**	**5.0**	**4.4**
Public	2.6	-7.4	7.8	**-1.0**	4.3	9.6	14.7	2.8	**2.0**	**-4.7**	**-3.5**	**2.5**
External Demand	21.7	7.6	4.6	**3.6**	5.7	5.0	2.8	4.9	**2.0**	**2.4**	**5.6**	**4.4**
Imports	19.7	7.1	4.1	**3.9**	5.9	4.2	1.1	5.2	**3.5**	**4.0**	**5.8**	**2.3**
GDP by sectors (annual % change, seasonally-adjusted)												
Primary	2.9	-2.4	6.5	**2.9**	6.6	11.1	1.5	7.1	**5.6**	**2.1**	**1.4**	**2.7**
Secondary	6.1	4.0	3.6	**2.5**	4.9	4.1	3.5	1.9	**0.5**	**2.6**	**3.0**	**3.7**
Mining	1.2	-1.0	1.2	**2.1**	0.9	-0.1	2.3	1.8	**2.1**	**2.1**	**1.9**	**2.4**
Electricity	10.2	6.5	2.3	**1.0**	4.0	2.3	2.1	0.8	**-0.7**	**1.1**	**1.0**	**2.7**
Construction	-0.6	4.6	3.3	**2.2**	5.5	4.9	3.7	-0.8	**-2.2**	**2.8**	**3.3**	**4.8**
Manufacturing	9.9	5.0	4.0	**2.8**	4.7	4.9	3.9	2.7	**0.9**	**2.8**	**3.4**	**3.7**
Tertiary	5.2	4.7	3.8	**3.4**	4.5	4.7	3.0	3.0	**3.2**	**2.9**	**3.7**	**3.9**
Retail	11.7	9.4	5.2	**4.0**	7.5	5.4	2.4	5.5	**4.0**	**3.8**	**4.0**	**4.3**
Transportation, mail and warehouse	7.5	3.2	4.3	**3.9**	5.3	4.2	3.7	4.0	**3.8**	**3.3**	**4.3**	**4.4**
Massive media information	1.6	5.1	8.5	**9.1**	7.7	10.2	9.7	6.6	**10.7**	**8.8**	**8.7**	**8.2**
Financial and insurance	13.1	10.1	8.1	**6.7**	12.7	11.6	5.2	3.5	**4.3**	**5.3**	**8.1**	**9.1**
Real-estate and rent	1.9	2.4	2.4	**1.7**	2.5	2.3	3.0	1.9	**1.5**	**0.8**	**2.1**	**2.3**
Prof., scientific and technical servs.	-0.7	4.8	0.7	**2.0**	5.2	0.8	0.1	-3.0	**2.0**	**1.9**	**2.0**	**2.0**
Company and corporate management	4.9	2.1	4.0	**4.2**	4.8	3.8	4.5	3.1	**5.2**	**3.7**	**4.0**	**3.9**
Business support services	1.5	5.1	4.0	**3.0**	3.0	5.1	3.3	4.7	**3.0**	**2.8**	**2.9**	**3.1**
Education	0.2	1.8	1.1	**0.7**	1.9	0.9	0.5	0.9	**0.9**	**0.6**	**0.6**	**0.5**
Health and social security	0.7	1.8	2.1	**1.6**	2.1	1.7	2.2	2.5	**1.9**	**1.4**	**1.5**	**1.6**
Cultural and sport	5.9	2.5	4.0	**2.8**	-0.2	3.5	6.0	6.7	**4.4**	**2.2**	**2.3**	**2.3**
Temporary stay	3.2	2.5	4.9	**3.4**	4.6	4.2	5.7	5.3	**4.8**	**3.6**	**2.7**	**2.7**
Other services, except government activities	0.9	2.9	4.1	**3.1**	3.4	4.5	4.3	4.4	**3.2**	**3.1**	**3.1**	**3.1**
Government activities	3.1	-2.3	0.6	**0.3**	2.0	2.2	-1.4	-0.2	**-2.0**	**-1.4**	**2.4**	**2.4**

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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