BBVA | RESEARCH

Mexico Economic Outlook

First Quarter 2015
Economic Analysis

- Exports will be the main driver of economic growth in 2015
- Uneven growth is observed depending on geographic areas resulting in opposite monetary policies in the US and the eurozone
- Inflation will remain close to the Bank of Mexico target of 3.0% for most of the year

BBVA Bancomer

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Closing Date: February 20, 2015

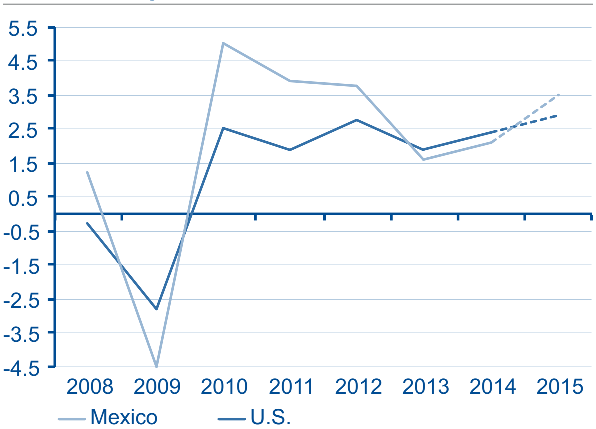
1. Summary

Driven by external demand, the Mexican economy put in a more favourable performance in the fourth quarter of 2014, which is expected to continue in 2015, although private-sector consumption remains weak. Economic growth of 3.5% per year is expected for 2015, from 2.9% annual growth in the United States (US) (see figure 1), and a more depreciated Mexican peso that would support exports and limit imports. This forecast has a downside bias in the face of the recently-announced cut in public spending, the possibility that private domestic demand does not show more sustained recovery despite the expected improvement in the manufacturing sector and if the recent fall in oil production does not turn around in the coming months. Given that the spending cut is initially concentrated on current spending and the limited effect that public-sector spending has had on growth, we expect that this measure will have a marginal Impact on GDP growth in 2015, which could be offset by the improvement that we are seeing in the US economy.

As anticipated, annual inflations fell slightly, from 4.08% in December to 3.07% in January. This fall in inflation is the consequence mainly of the dilution of the effect of the increase in taxes in 2014 and lower prices of telecommunication services after the national long-distance charge was eliminated, but also after seeing the first positive effects for consumers of greater competitive pressure due to the approval of the telecommunications reform. The sharp fall in annual inflation In January suggests that inflation could close 2015 at around 2.9%. Hence, we expect that inflation will remain close to the Bank of Mexico target of 3.0% for most of the year. The upside risks for inflation include a possible passing on of the exchange rate depreciation and, to a greater extent, increases in farm produce prices.

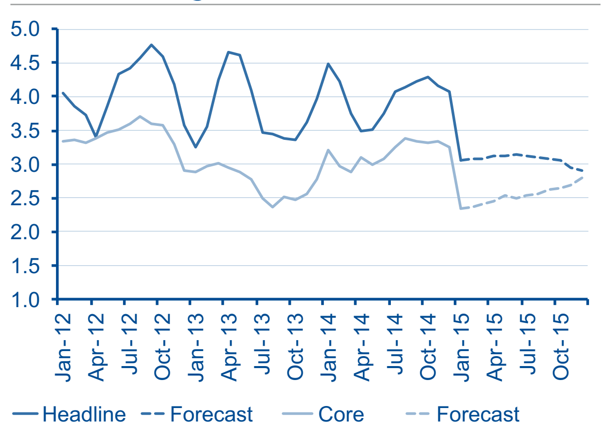
Low levels of inflation, along with economic pressure from low growth in 2013 and 2014, suggest that the central bank has room to keep its reference interest rate unchanged for some time yet. However, the improvement in the economy would gradually reduce room for manoeuvre in the economy, and the central bank mentions in its communiqué the high probability of domestic interest rates having to increase if there is a sharp rise in US interest rates. Thus, we expect a gradual adjustment to interest rates, in synchrony with the US economic and monetary cycle, leading us to forecast the interest rate closing the year at 3.5%.

Figure 1
Growth of Mexican and US GDP (YoY % change, sa)



sa=seasonally adjusted. YoY= year on year
Source: BBVA Research, In-house estimate

Figure 2
Inflation prospects (Annual % change)



Source: BBVA Research

During the first two months of the year, apart from an economic backdrop of falling oil prices and lower global growth, with the exception of the US, there have also been two new uncertainty factors for the Mexican economy: the expectation of an early start to the Federal Reserve's normalisation cycle and doubts concerning the negotiation of a new bail-out package for Greece. These two new factors have weighed on financial markets in Mexico. On the one hand, the volatility and exchange rate have increased, with the peso changing at over 15 pesos to the dollar for the first time since March 2009. On the other hand, interest rates on long-term government debt have maintained the close correlation to their US counterparts so, in the face of market expectations of an early hike in federal interest rates in the summer of this year, long-term interest rates reached a turning point and started to climb, and this has continued in the first half of February. It is worth mentioning that, despite expectations of an increase in interest rates in the US, foreign investment flows in fixed income instruments have continued.

In the future, we expect that the US macro-economic data and the report from the Federal Reserve will be the centre of attention for markets, with the proximity of the monetary normalisation process. With respect to exchange rates, we expect there to be clarity about the pattern of federal interest rate increases, once the economy shows signs of improvement, and in the absence of further falls in oil prices the peso could appreciate to around 14 to the dollar by the end of the year. Concerning the interest rate on government debt, the most probable scenario remains a gradual rise in the face of the prospect of increasing interest rates in the US and Mexico. We anticipate that the yield on the 10-year US Treasury note will be around 2.6%, while the Mexican 10-year bond will settle around 6.1%.

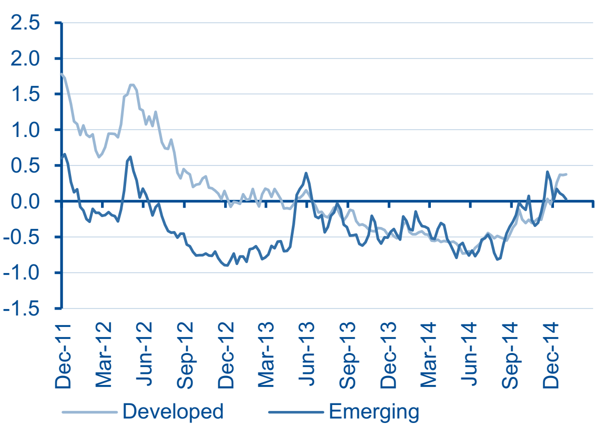
2. Moderate global growth with increasing divergence among economic areas

The world economy will have finished 2014 growing a similar pace to that in 3Q14,[1] close to 0.8% QoQ, according to our estimates, and slightly stronger than in the first half of the year. A dynamic economic performance in the US has been offset by the weakness of the recovery in Japan and the euro area, and the progressive deceleration of China and other emerging economies.

In the EM block, the divergence between industrial activity and services indicators continues. The gradual improvement in private consumption, on the back of the stabilisation or increase in employment, has continued to feed through into the figures for retail sales and the confidence indices in the services sector. Meanwhile, the relative improvement in world trade in the first two months of 4Q14 has not yet translated into a substantial increase in industrial production. In general, the EMs are seeing the fall in commodity prices in a scenario where there is already a trend towards more moderate growth in China. Altogether, we estimate that global GDP will have grown 3.3% in 2014, 10bp more than in 2013, with a slight increase in the DMs' contribution vs. the three previous years, and the EMs continuing to decelerate.

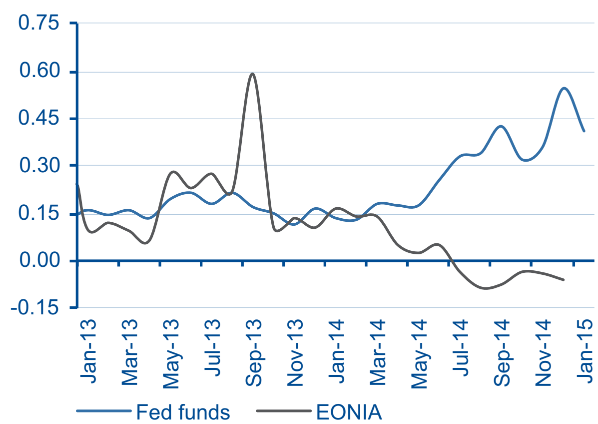
One of the novelties in the global economic scenario in recent months is the very sharp fall in the oil price and its uneven impact on different countries, depending on whether they are net importers or exporters. Overall, we think the global impact of cheaper oil should be positive in terms of growth, inasmuch as the reduced burden on household and corporate income in oil-importing countries (such as the US, the euro area and China) offsets the reduced activity in the principal producer countries. However, even lower prices or levels like those at present for Brent, around USD50/bbl, for an extended period could generate geopolitical and/or financial tensions that might compromise global stability.

Figure 2.1
BBVA Research Financial Tensions Index



Source: BBVA Research and Bloomberg

Figure 2.2
Monetary policy expectations: 12M forward interest rates (%)



Source: BBVA Research and Bloomberg

In fact, the increased volatility in financial markets, which has now reached the same level as in mid-2013 according to the BBVA Financial Tensions Index, is another of the highlights of the quarter, and one the EMs and the DMs have in common as a consequence of two factors. First, the combination of the geopolitical crisis between Russia and Ukraine with the fall in commodity prices, which has raised doubts on the economic preformance of many EMs. Second,

[1] Estimate based on the BBVA Research GAIN indicator; for details of the methodology, see: http://bit.ly/1nl5RIn

the uncertainty around the Fed's rate-hiking cycle, especially when the ECB is introducing QE measures and there is an increasing political debate on the most appropriate balance of policies to strengthen the region's recovery.

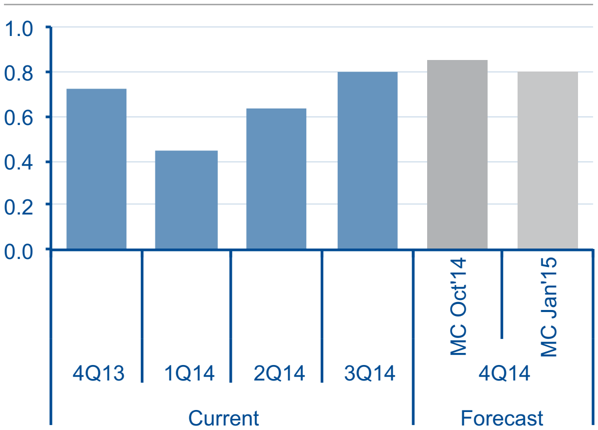
The correction in the oil price also accentuates the risks of a global scenario of too low inflation, at least until the second half of 2015. In addition to the recent general decrease in inflation, common to all the principal geographies (the average for the US, the euro area, Japan and China was 1% in 2014), there has been the steep fall in industrial production and import prices. Although so far the translation of the fall in energy prices to core inflation and salaries appears to be contained, the sharp adjustment in medium-term inflation expectations and the all-time lows in long-term interest rates reveal the degree of uncertainty that exists about the rate of recovery of the global cycle and the capacity of the central banks to restore inflation to levels compatible with their objectives.

In this context of low inflation and moderate economic growth, monetary policies remain accommodative in tone, although the biases differ (with the Fed and the Bank of England on the one side, and the ECB and the PBoC on the other).

The new oil-price scenario gives the most important central banks room for manoeuvre to delay or reduce the intensity of the upward path of benchmark interest rates. In the case of the ECB, negative inflation prints have been the catalyst prompting the decision made in January to announce an expansion of the bank's asset purchase programme, this time to include purchases of public debt. The PBoC could introduce further cuts in the discount rates to cushion the deceleration of activity while tightening controls over private and local authority borrowings. In the EMs, those countries that are benefiting from cheaper commodity prices, reflected inter alia in an improvement in their external balances (for example India or Turkey), are also opting for more lax monetary policies in spite of the Fed's potential interest-rate hike in 2015.

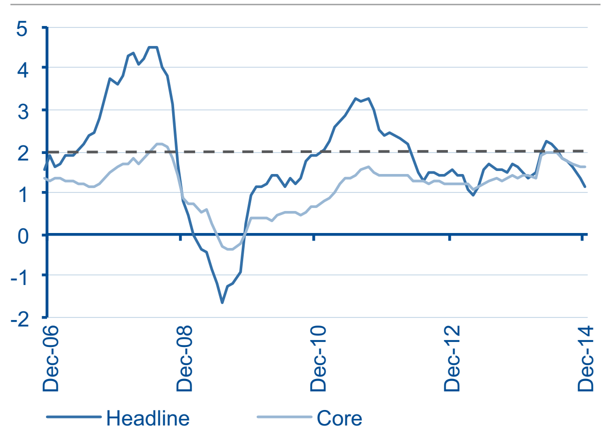
The convergence of US growth towards 3% over the course of 2015, together with the progressive normalisation of the Fed's monetary policy, should translate into a gradual increase in the yield on the long bond. We expect yields on German public debt to rise more slowly, as a reflection of our expectation of slower nominal growth in the euro area and the impact of the ECB's above-mentioned purchases of sovereign assets. The different rates of growth anticipated for the US and the euro area and, above all, the change in expectations of monetary policy in the two areas, have been reflected in the evolution of EURUSD, with a significant appreciation of the dollar in recent months. This has sent the pair back to around 1.15, and we think it could continue to trade around this level for the rest of this year, on average.

Figure 2.3
Global GDP based on BBVA-GAIN, %, QoQ



Source: BBVA Research

Figure 2.4
Global inflation*, %



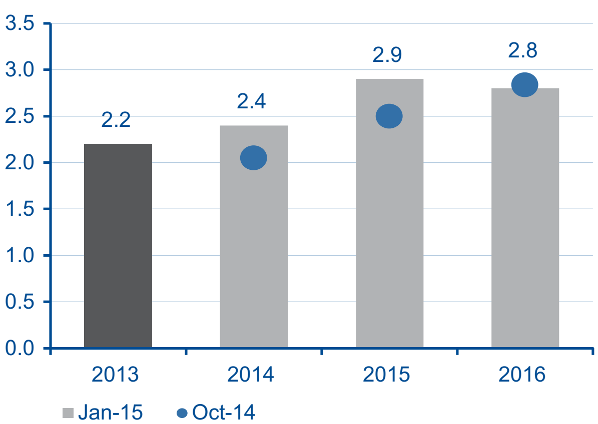
* Calculated as the simple average of inflation in the US, the euro area, Japan and China
Source: BBVA Research and Haver Analytics

Altogether, and in spite of the support offered by economic policies and lower oil prices, the risks to world growth in 2015 remain to the downside. The risks presented by geopolitical tensions have been joined by risks associated with the effectiveness of the monetary policies introduced to increase inflation expectations and – in the case of the Fed in particular - to establish a strategy for withdrawing stimulus that does not erode the EMs' financing conditions to such an extent that this restricts their growth.

Momentum in the US recovered over the course of 2014, and particularly in 2Q and 3Q, with QoQ GDP growth slightly above 1%. The strength of domestic demand and the stabilisation of residential construction are key to the US growth model. With net job creation of around 200k a month and an unemployment rate at year-end 2014 of 5.6%, wage increases will continue to support household consumption. The lower oil, and eventually, fuel prices are also helping to free-up disposable income for spending on other consumer goods.

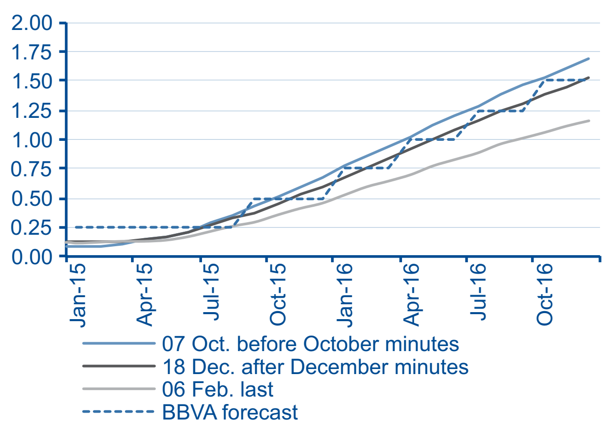
As a result of the good performance in previous quarters, and in spite of a more moderate figure for GDP growth in the fourth quarter, US growth could reach 2.4% in 2014 and up to 2.9% in 2015, in both cases beating the mid-year targets. The combination of stronger growth and lower inflation (the headline rate will be below 2% until 2016) will accentuate the Fed's dilemma when it comes to start its monetary normalisation process, in a context in which the global appreciation of the dollar favours more moderate inflation. Our forecast for the first increase in the fed funds rate remains in 3Q15.

Figure 2.5
U.S., economic growth, % YoY



Source: BBVA Research

Figure 2.6
U.S., expectations for the Fed funds rate, %

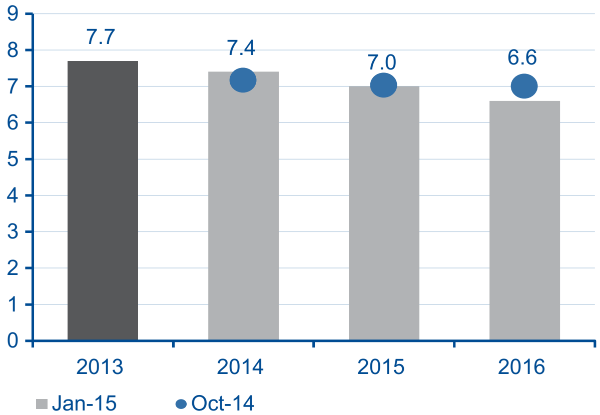


Source: BBVA Research and Bloomberg

In China, the slow deceleration in activity continued throughout 2014. The flash GDP estimate for 2014 as a whole puts it at 7.4%, which would imply the YoY rate for the fourth quarter at around 7.2%, the slowest since 2009. The macroeconomic dynamics in China are explained by the loss of momentum in fixed capital investment and the deterioration in external competitiveness which was driving yuan appreciation, together with the correction in the real estate sector.

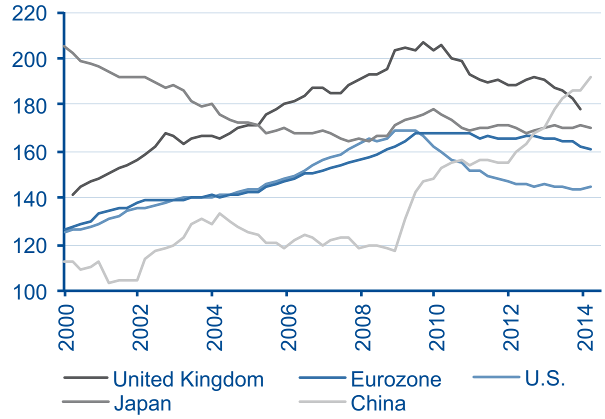
Although we have left our forecast for growth in 2015 unchanged at 7%, the risks are clearly biased to the downside as a reflection of the magnitude of accumulated financial imbalances, the uncertainty over the evolution of the real estate market and the uncertainties regarding the capacity for policies to achieve a correction in the present imbalances with economic liberalisation underway. The authorities have started to show more tolerance towards economic deceleration, as long as job-creation is consistent with the behaviour of the active population, while simultaneously betting on a redirection of the growth model towards less dependence on investment. This will allow them to combine an increase in monetary policy laxity with the adoption of fiscal control measures that contain debt, both at the private-sector and public administration levels (in the last decade, non-financial private-sector debt in China increased by 67bp of GDP).

Figure 2.7
China, economic growth, % YoY



Source: BBVA Research

Figure 2.8
Private non-financial sector debt as % GDP

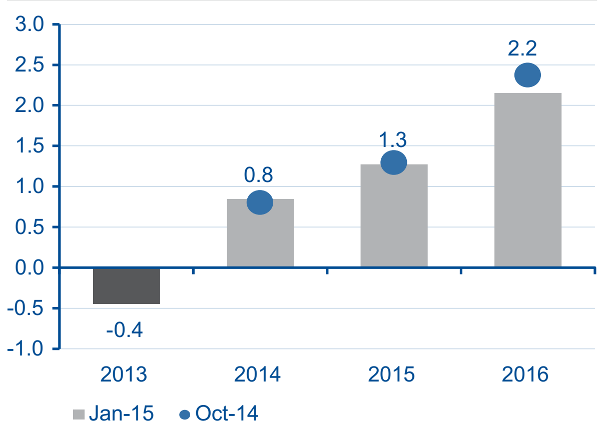


Source: BBVA Research and BIS

Of the large economic areas, the eurozone is the one which is most likely to have to deal with a scenario of inflation that is too low for too long. In addition to the negative surprises on consumer prices, the area has only a moderate economic growth profile, in line with expectations. Assuming GDP growth reaches around +0.2% in 4Q14, supported by a similar increase in activity in Germany and France and a better relative performance in Spain, our estimate for the eurozone is +0.8% YoY.

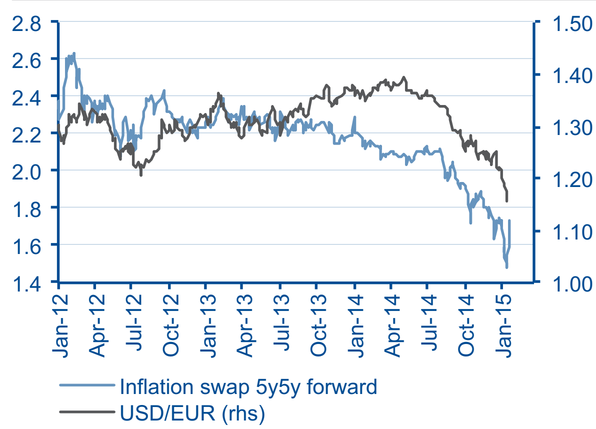
Altogether, we maintain our forecast for growth of 1.3% for 2015, supported by the fall in the price of oil, the accumulated depreciation of the euro in recent months and the relaxation of monetary conditions thanks to ECB actions. The less restrictive nature of fiscal policy in the peripheral countries is also an element to take into account, as well as the so-called "Juncker Plan", designed to favour investment, and the first fruits of which are expected in the second half of this year.

Figure 2.9
Eurozone, economic growth, % YoY



Source: BBVA Research

Figure 2.10
EURUSD and medium-term eurozone inflation expectations (5Y/5Y fwd inflation swap, %)



Source: BBVA Research and Bloomberg

Some threats arise, including the potential impact of increased tensions in Russia's sphere of influence, both in commercial and (more importantly) financial terms, given the heavy exposure of European banks to those countries. A second risk factor is the uncertainty generated by the divergences between some national authorities and the EU institutions as to the most appropriate supply-side reform, the pace of fiscal consolidation and the support of the ECB to foster growth. Finally, another risk is that medium-term inflation expectations continue to fall, discouraging consumption, and leading to a negative feedback loop.

To deal with the latter, the ECB has extended its asset purchase programme to public debt and increased the monthly purchases to EUR60bn. However, although a plan has been established for absorbing any losses (a high proportion of the risk of losses on the public bonds purchases is assumed by the national central banks), this does not resolve the problem of financial fragmentation in the bosom of the eurozone, the size of the programme or, above all, the commitment to leave it in place until the path of inflation converges with the ECB's objectives, it does represent a significant step in that direction.

There are three main transmission channels to the economy of the recently announced QE. First, a reduction of the financial burden on both public and private sector, and thus more disposable income for consumption or investment; second, euro depreciation and support for exports; and, lastly, reducing risk aversion in a context of very low long-term interest rates. The eventual impact of all of these on the real economy and the flow of credit will be key to the path of inflation expectations in the medium and long term, although not alone: the definition of credible fiscal consolidation strategies are also fundamental, given the scenario of low nominal growth and the maintenance of reform policies in sectors or markets important for the reactivation of potential growth.

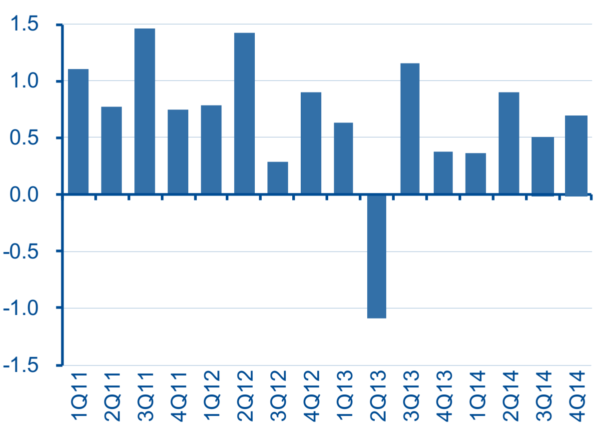
3. Greater growth in 2015 driven by economic acceleration in the United States

3.1 Economic improvement in the fourth quarter of 2014, which we believe is set to continue in the coming quarters

The seasonally-adjusted (sa) quarterly (QoQ) growth rate for the third quarter of 2014 (3Q14) in Mexico was 0.53%. Because of this, and because the INEGI revised down the growth rate for the previous quarters at that time, we adjusted our economic growth expectations for 2014 from 2.5% to 2.1%. 4Q14 GDP-growth however, was 0.7%, making annual growth in 2014 reach 2.1% (see figure 3.1).

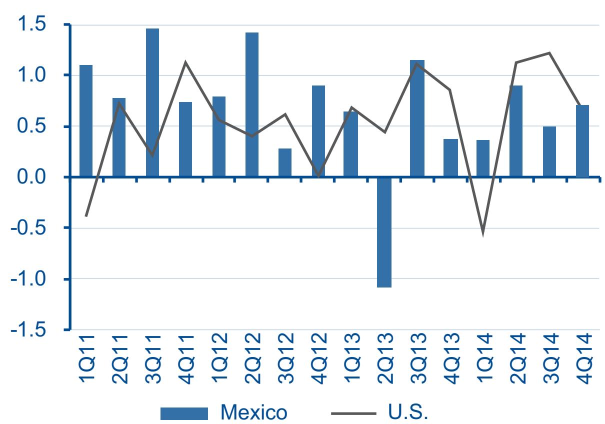
On 30 January 2015, the Secretary of Finance and Public Credit (SHCP, from the Spanish) announced a cut in current spending equivalent to 2.6% of the country's total net spending, or 0.7% of GDP. With the size of the cut, the fact that it is concentrated in current spending (65%) and the limited effect that public spending has had on growth, we expect this to have a limited effect on GDP growth in 2015, which could be offset by the improvement we are witnessing in the United States (US) economy. This does, however, put a downward bias on our economic growth expectations for 2015, set at 3.5% (see figure 3.2).

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



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

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



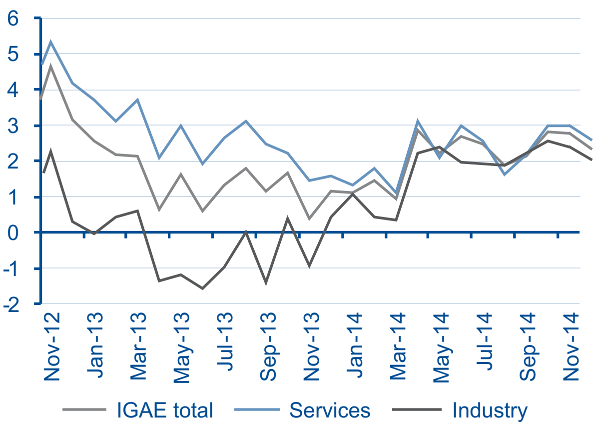
sa=seasonally adjusted QoQ=quarter on quarter
Source: BBVA Research with information from INEGI and the BEA

3.1.1 Domestic sector: internal demand remains weak, although recent job increases seem to suggest an improvement for the coming months

Economic activity grew moderately in 2014, underperforming against the expectations raised at the end of 2013. This was due to several factors: a negative effect of the tax reform on consumption; low investment associated with economic tension; the existence of conflict and a certain social instability and a fall in international mineral and oil prices.

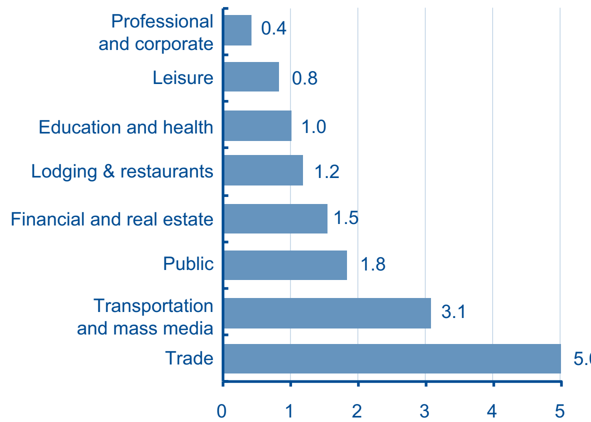
The annual growth rate (YoY) of the Global Economic Activity Indicator (IGAE, from the Spanish) was 2.3% sa in December 2014. If we look at the components of the IGAE, the farming sector grew 2.4% YoY, industry increased 2.0% YoY and the services sector expanded 2.5% YoY, all figures seasonally adjusted (see figure 3.3). In monthly terms (MoM), the IGAE shrank by 0.3%, sa. This is mainly due to a fall in the industrial (0.3% MoM, sa) and services sectors (0.2% MoM, sa), while agriculture increased (5.6% MoM, sa) (see figure 3.4).

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



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

Figure 3.4
Services sector: component of IGAE, November 2014 (YoY % change, sa)



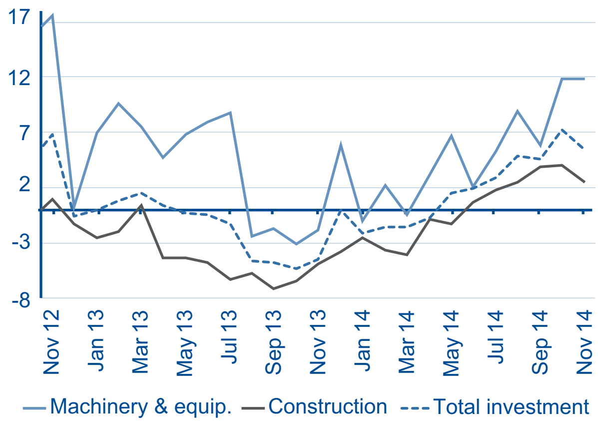
sa=seasonally adjusted. YoY=year on year. *Data estimated by BBVA.
Source: BBVA Research with information from INEGI

However, confidence among economic agents slowed at the beginning of 2015. For example, although business confidence has stayed in the area of optimism for 59 consecutive months (above the threshold of 50 points), expectations for economic activity did fall slightly. The index fell from 50.7 points (pt) in December 2014 to 50.4pt in January 2015, after seasonal adjustments. The consumer confidence index (CCI), in turn, fell from 92.7pt in December 2014 to 91.8pt in January 2015. Moreover, the Mexican Institute of Finance Executives (IMEF, from the Spanish) indicators for manufacturing and non-manufacturing business expectations in January showed similar behaviour. The IMEF Manufacturing Index reached 50.9 points (pt) in January (scarcely above the 50pt optimistic expectations threshold) when seasonally adjusted. The non-manufacturing index fell from 49.9pt to 49.2pt (sa) in the same period.

Information on the components of GDP for 4Q14 is not yet available. Given the above, we consider that total gross fixed investment and its components can be expected to continue their positive performance for this quarter. In October, the annual growth rate of Investment was 7.2%, sa, reaching 5.4%, sa, in November. The Plant and Machinery component grew 11.8% YoY, sa, In November. The domestic sub-component of investment increased 17.4% YoY, sa, and imported investment grew 9.8% YoY, sa. On the other hand, Construction increased 2.4% YoY, sa, in November 2014 (see figure 3.5). Progress in planned infrastructure for 2015, along with an improvement in economic prospects, could help investment to improve further.

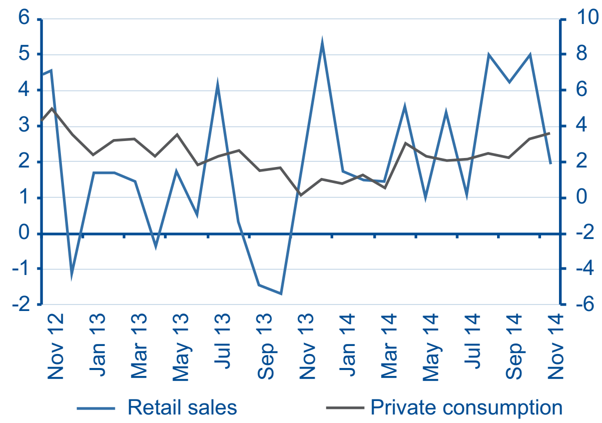
Moderately positive growth rates were seen for retail sales in the fourth quarter of 2014. The year-on-year change was 5.0%, sa, in October 2014, the highest since December 2013, and the growth rate was 1.9% YoY, sa, in November. This indicates moderate economic recovery materialising against a backdrop of low product growth of around 2.3% for the whole of 2014 (see figure 3.6).

Figure 3.5
Components of investment, 2012-14 (YoY % change, sa)



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

Figure 3.6
Retail sales and private-sector consumption, 2012-14 (YoY % change, sa)

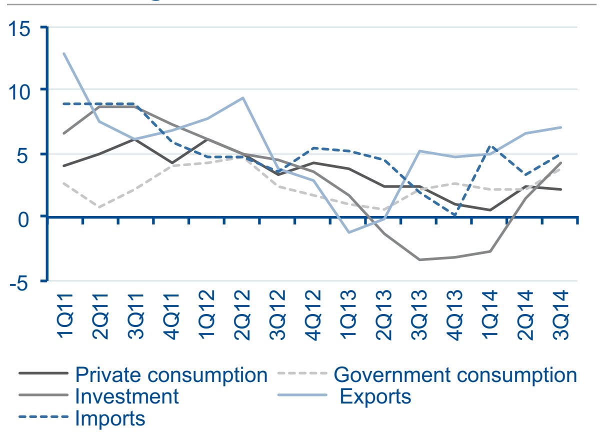


YoY=year on year.
Source: BBVA Research with information from INEGI and STPS

The components of aggregate demand rose, albeit moderately in the third quarter of 2014. The highest annual growth rate of these components was seen in exports, with a 7.0% increase in 3Q14 vs 6.5% in 2Q14. Gross total fixed capital formation grew 4.3% YoY in 3Q14, with an increase in private-sector investment of 7.0% YoY and a 6.25 YoY fall in public-sector investment. Private-sector consumption increased 2.2% YoY, while public-sector consumption grew 3.8% YoY. Imports increased 5.0% YoY in 3Q14, which was greater than the 3.3% of the previous quarter, all seasonally-adjusted (see figure 3.7). We expect all components of demand to have accelerated in the fourth quarter of 2014.

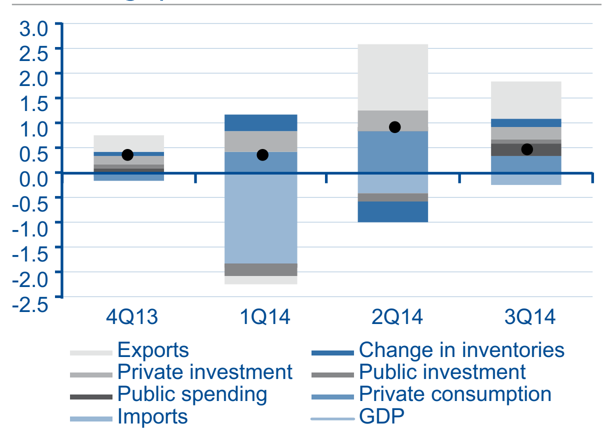
The contribution of expenditure and public investment to the growth of GDP was positive for the first time during the year in the third quarter of 2014. However, these components have made a limited contribution to the country's economic activity, despite the major expenditure approved by Congress for 2014. This suggests that there are problems in assigning and implementing resources, which must be avoided with greater transparency and accountability in all government orders, to guarantee the efficient use of the State budget. That is why it is important to adopt a transparent legal framework, provide access to the information and ensure public integrity.

Figure 3.7
Aggregate demand: components, 2011-14 (YoY % change, sa)



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

Figure 3.8
Contribution to GDP growth, 4Q13-2Q14 (Percentage points, QoQ, sa)



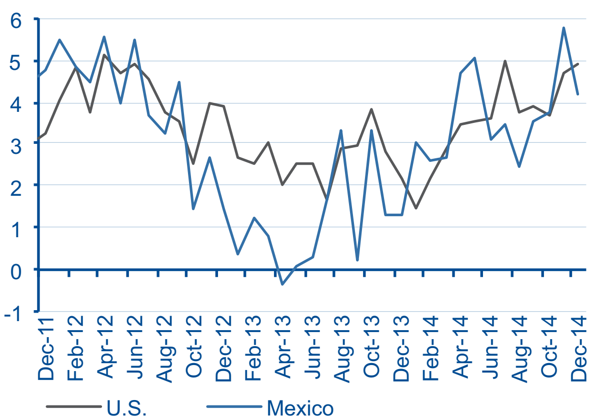
sa=seasonally adjusted. QoQ=quarter on quarter.
Source: BBVA Research with information from INEGI

In order of contribution to economic growth in 3Q14, we have, first of all, exports followed by private-sector consumption, then private-sector investment, public-sector spending, variation in stocks and finally, public-sector investment. Imports made a smaller negative contribution to GDP growth than in the two previous quarters (see figure 3.8).

3.1.2 External sector: highly dynamic in 2014

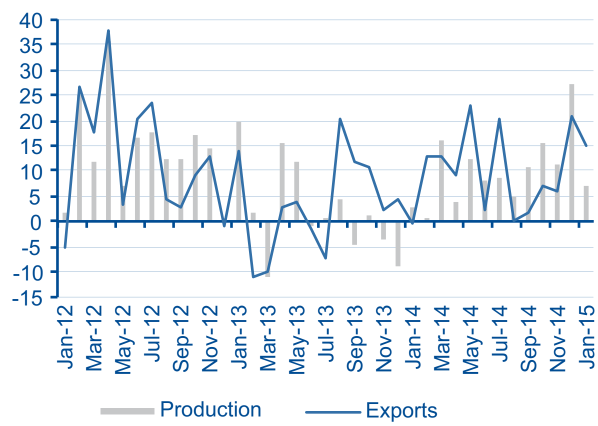
As we have said, external demand was consolidated as the main factor driving the country's economic growth in 2014. The sector that has most benefited from external demand (especially from the United States) is the manufacturing sector, with an annual growth (YoY) of 4.2%, sa, in December (see figure 3.9). This spike in manufacturing production was induced to a large extent by dynamic production and automotive exports. According to the Mexican Automotive Industry Association (AMIA), the accumulated production of vehicles increased 9.8% from January to December 2014 against the same period of 2013 and vehicle exports recorded a growth rate of 9.1% (see figure 3.10).

Figure 3.9
Manufacturing output of Mexico and the United States, 2011-214 (YoY % change, sa)



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

Figure 3.10
Automotive production and exports, 2012-14 (YoY % change)

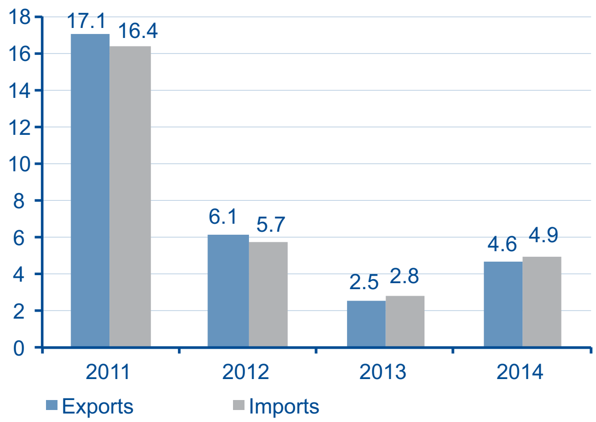


YoY=year on year.
Source: BBVA Research with information from INEGI

3.1.2.2 Exports of goods

The annual growth rate of total goods exports in 2014 was 4.6%, greater than the rate recorded in 2013 of 2.5% (figure 3.11). The export sector performed better than the previous year. This can also be seen if we realise that the annual growth rate of exports was negative (figure 3.12) in three months of 2013 (February, March and May), while this only happened once in 2014 and that was at the beginning of the year (January).

Figure 3.11
Annual exports and imports of goods
(Annual % change)



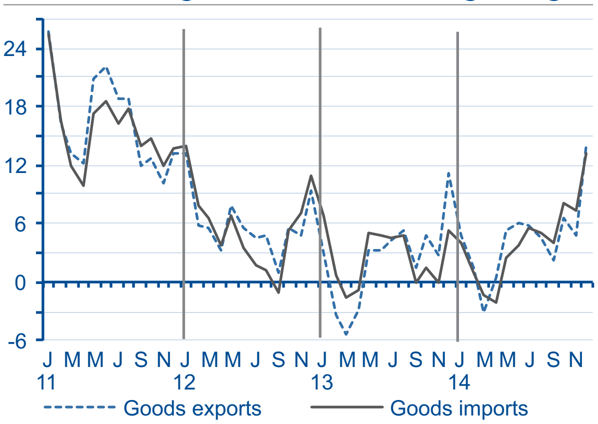
Source: BBVA Research with information from INEGI.

Figure 3.12
Monthly exports and imports of goods
(Annual % change)

Source: BBVA Research with information from INEGI.

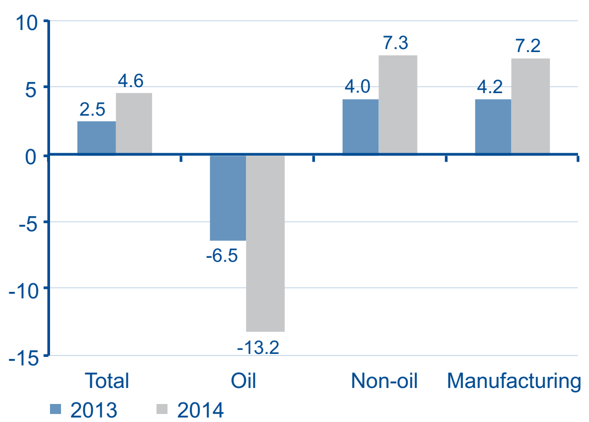
Taking the three-month moving average of the annual export growth rate (figure 3.13), we can see that the rate of growth of exports picked up significantly in the second half of 2014.

Figure 3.13
Exports of goods
(Annual % change of three-month moving average)



Source: BBVA Research with information from INEGI.

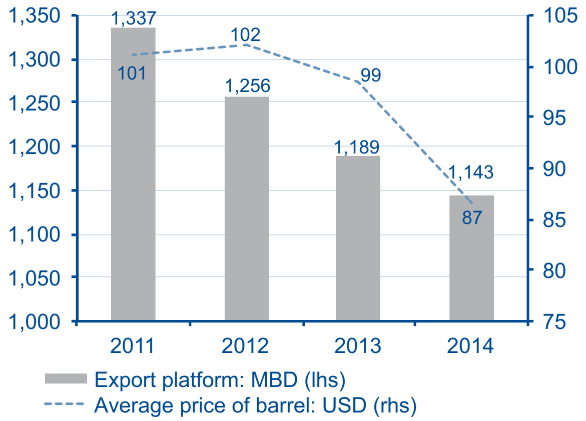
Figure 3.14
Exports of goods by kind of goods
(Annual % change)



Source: BBVA Research with information from INEGI.

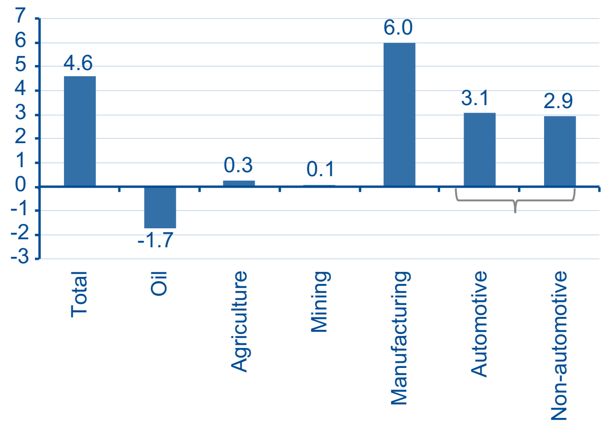
With respect to the performance of each of the different kinds of export goods, oil exports were poor, as annual sales showed an annual fall of 13.2% (figure 3.14). The contraction of these exports was due to a combination of two factors. On the one hand, the crude oil export platform fell 3.9% In 2014 against 2013, from 1,189,000 barrels a day (b/d) on average in 2013 to 1,143,000 b/d in 2014 (figure 3.15).

Figure 3.15
Crude oil exports: annual average of the platform and export price (000s b/d and USD/bbl)



Source: BBVA Research with information from INEGI

Figure 3.16
Annual exports of goods in 2014 (Contribution to growth, percentage points, pp)



Manufactured goods include automotive and non-automotive goods.
Source: BBVA Research with information from INEGI

Furthermore, the average price of a barrel of crude oil exported by Mexico in 2014 was 12.1% lower than in 2013. It is worth mentioning that the fall in Mexican oil exports occurred after July 2014. In July 2014, the average monthly price of a barrel of export crude was USD94.65, and by December, it was USD52.35/bbl. In January and February 2015, the price has even fallen below USD40/bbl.

The decline In value of oil exports in 2014 led their contribution to the growth in the total exports of goods, which was 4.6% in the year, to turn negative by 1.7 percentage points (pp). The non-oil export contribution to 4.6pp growth was 6.3pp. This means that if the oil exports contribution had not declined in 2014 and had made a zero contribution, then total exports of goods would have shown greater growth than the observed rate of 6.3%.

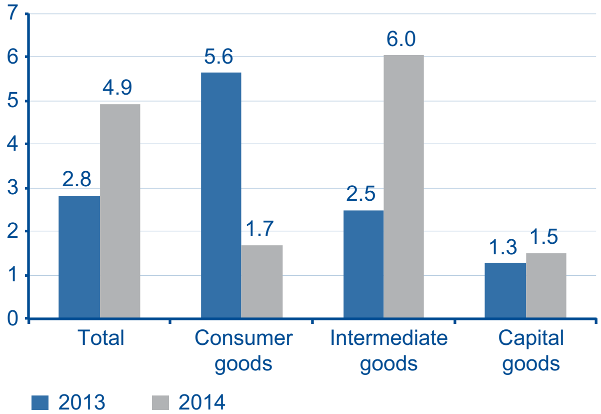
Non-oil exports were led by automotive exports, as these made the largest contribution to the growth of total exports, with 3.1pp, followed by non-automotive manufacturing exports with 2.9pp. The contribution of farming goods to growth was positive (0.3pp), while the contribution made by non-oil extractive exports was the smallest of all at 0.1pp (see figure 3.16). The sound performance of these four export categories as a whole in 2014 more than offset the deterioration of oil exports.

3.1.2.3 Imports of goods

In 2014 the growth rate of goods imports was 4.9%, above the 2.8% that these recorded in 2013 (figure 3.17). In 2014, the dynamism of imports was concentrated in intermediate goods, while the slow rate of growth seen among consumer goods imports (1.7%) and capital goods (1.5%) reflected the slowdown in both domestic consumption and investment in the country. The 6.0% annual growth rate recorded by intermediate goods imports in 2014 indicates that a large proportion of these purchases from abroad were channelled to make export products, such as is the case for manufactured goods.

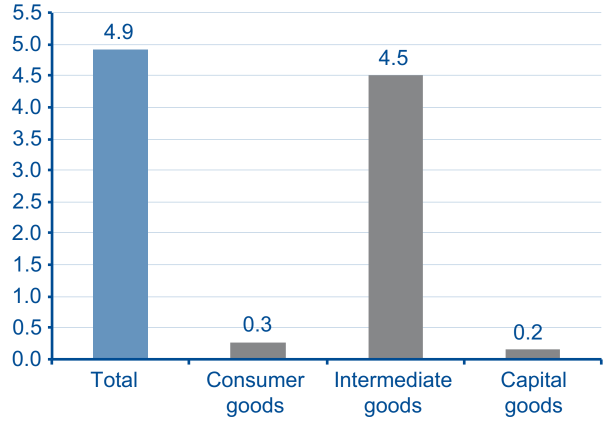
Thus, the imports of Intermediate goods made the largest contribution to total goods imports in 2014, with 4.5pp of the 4.9pp growth in total imports (figure 3.18). Consumer goods, on the other hand, made a limited contribution, of 0.3pp, as did the imports of capital goods (0.2 pp). Against a backdrop of a more dynamic economy in Mexico, one would expect a spike in the import of consumer and capital goods.

Figure 3.17
Annual imports of goods by type (Annual % change)



Source: BBVA Research with information from INEGI

Figure 3.18
Annual imports of goods in 2014 (Contribution to growth, pp)

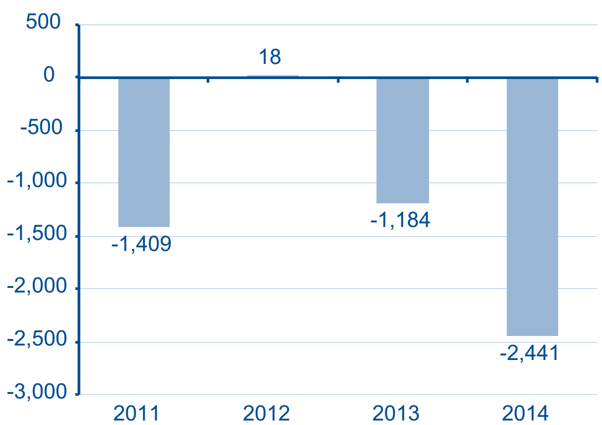


Source: BBVA Research with information from INEGI

3.1.2.4 Balance of trade deficit

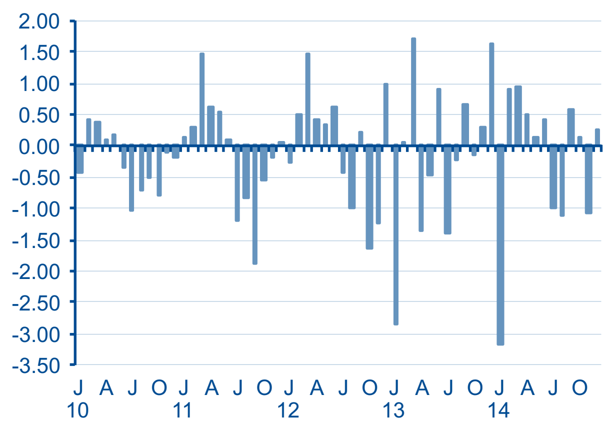
The balance of trade showed a deficit in 2014 of USD2.441bn, more than double the deficit reported in 2013 of USD1.184bn (figure 3.19). As we have said, the deficit in the balance of trade can be explained to a large extent by the decline in crude oil exports recorded in 2014 against 2013. For example, in 2014 total oil exports amounted to USD36.2bn, while they were greater - USD42.7bn - in 2013. In other words, the value of crude oil exports fell by almost USD6.5bn (15.2%) in 2014.

Figure 3.19
Annual balance of trade (USD million)



Source: BBVA Research with information from INEGI.

Figure 3.20
Monthly balance of trade (USD billion)



Source: BBVA Research with information from INEGI.

Crude oil export revenues fell by 2.7 times the balance of trade deficit in 2014, indicating the weakness of Mexican oil exports. Should this continue, it could trigger greater deficits in the balance of trade than those we have seen in recent years.

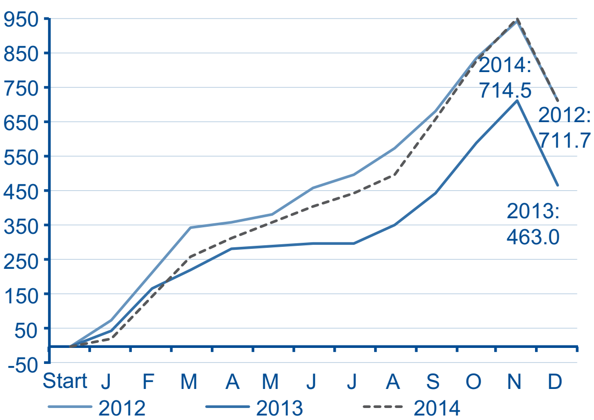
3.1.3 Employment in the Mexican Social Security Institute (IMSS): substantial increase in the number of workers registered in 2014

3.1.3.1 Recent performance of private employees registered with social security

In 2014, the total number of workers in the Mexican Social Security Institute (IMSS) increased by 714,526 against the previous year (figure 3.21). 74.5% of the increase comprised workers with a permanent employment contract and the remaining 25.5% came from workers who have a temporary or fixed-term contract. It is worth pointing out that the total number of workers registered with the IMSS represents the formal jobs created by the private sector.

Figure 3.21

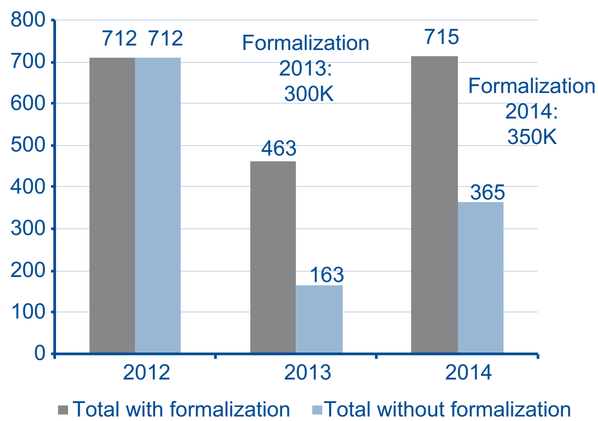
Accumulated monthly increase in the total number of workers registered with the IMSS



Source: BBVA Research with information from INEGI.

Figure 3.22

Accumulated 12 months of total number of workers registered with the IMSS: Sept-Sept



Source: BBVA Research with information from INEGI.

All in preceding paragraph and chart. This means that formal job creation in 2014, measured by the number of workers registered with the IMSS, was 54.3% greater than in 2013. In other words, far more formal jobs were created in the economy in 2014 than the previous year, particularly in the final part of the year. As we will see in the next section, the better performance in creating formal jobs in 2014 was due to a large extent to the continuation of the IMSS Job Formalisation Programme.

3.1.3.2 Continuation of the IMSS Job Formalisation Programme in 2014 and possible effects in 2015

The authorities started rolling out the IMSS Job Formalisation Programme in the second half of 2013. This programme consists of enrolling as a member anyone with a job who is not registered with the IMSS.. It is worth mentioning that people who work and whose jobs were formalised do not represent the creation of a new job as a consequence of growing economic activity that can be observed at a given moment; they represent those who leave the informal sector of the economy to start working In the formal sector.

In February 2014, the Secretary of Employment and Social Benefits (STPS, from the original) estimated that a total of 300,000 jobs were formalised in the previous year.[1] Moreover, in January 2015, the STPS indicated that 300,000-350,000 jobs registered with the IMSS in 2014 were the consequence of the Job Formalisation Programme.[2] If we subtract the 300,000 and the 350,000 jobs that were formalised in 2013 and 2014 respectively, we have the increase in the number of workers registered with the IMSS in those years, facilitated by the expansion of economic activity: 163,000 and 365,000 (figure 3.22).

[1] See article "Se formalizan 40 mil empleos en el Estado de México", published in El Financiero 7 February 2014.
[2] See article "Formalizan 350 mil trabajos en 2014" published in El Financiero 11 January 2015.

As GDP grows at a faster rate than it did in 2013 (1.4%) and in 2014 (2.1%), we will be able to see greater formal job creation that is the product of greater economic activity. By the same token, the Job Formalisation Programme has been successful at formalising jobs, so continuing to implement it in 2015 could limit (or even reduce) the increase in informal employment.

3.1.4 Public-sector finances: greater deficit in 2014 than in 2013

Public-sector finances in 2014 were characterised by the fact that part of total public-sector revenues only recorded a 0.8% real annual growth rate. This situation was due to the poor performance of the main revenue streams: oil and non-oil revenues. The former fell 7.5% in real terms in 2014 as a consequence of the reduction of the crude oil export platform and lower crude oil export prices. As mentioned in section 3.1.2.2, Goods exports, the oil situation was not only unfavourable in the context of the external sector (see figure 3.14), as public-sector revenues were also unfavourable (Table 3.1).

Public-sector non-oil revenues on the other hand, performed better, with a real annual growth rate of 4.9%. This was due mainly to the growth of tax revenues, which increased by 11.3% as a consequence of the tax reform that came into effect in 2014. It is worth mentioning that unless the deterioration experienced by oil production and international oil prices is reversed, public-sector revenues could continue to deteriorate in 2015 and 2016.

Table 3.1
Public-sector budget revenues (Accumulated figures in MXN bn)

	January - December 2014		
	Sum total	Real % chge.	Struc. %
Total	**3,983.4**	**0.8**	**100.0**
Oil	1,213.3	-7.5	30.5
Non-oil	2,770.1	4.9	69.5
Federal government	2,888.1	2.7	72.5
Tax	1,807.8	11.3	45.4
Non-tax	1,080.2	-9.0	27.1
Agencies & Co.	1,095.3	-4.0	27.5

Source: BBVA Research with information from SHCP.

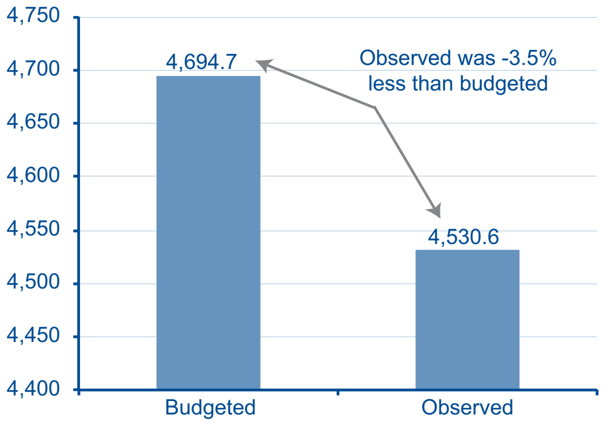
Table 3.2
Public-sector budget expenditure (Accumulated figures in MXN bn)

	January - December 2014		
	Sum total	Real % chge.	Struc. %
Total	**4,530.6**	**4.2**	**100.0**
Projected Expenditure	3,580.3	3.8	79.0
Current Expenditure	2,682.9	5.7	59.2
Capital Expenditure	897.4	-1.5	19.8
Non-Projected Expen.	950.3	6.0	21.0
Investmnts. in States	584.7	5.6	12.9
Borrowing Cost	346.0	5.8	7.6
Adefas and other	19.6	28.2	0.4

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

In 2014, the public sector reported a real annual growth in total net expenditure of 4.2%, driven strongly by current spending (table 3.2). In 2014, the latter recorded a real annual growth rate of 5.7% in current spending, while capital expenditure fell 1.5%. Should this situation prevail, public-sector spending would be channelled towards increasing consumer spending to the detriment of investment in this sector. A situation of this kind implies that public-sector spending is not focused on Increasing the country's long-term output capacity, which suggests that this is supporting the process of long-term economic growth.

Figure 3.23
Public sector budget expenditure in 2014: programmed and observed (MXN bn)



Source: BBVA Research with data from SHCP

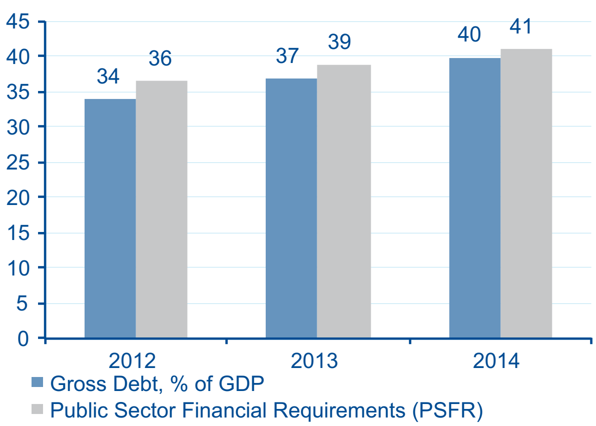
Table 3.3
Public sector finances in 2014 (MXN bn)

	2013	2014	Real % chge.
Public balance	-374.2	-545.0	ns
Budget balance	-377.9	-547.2	ns
Budget revenue	3,800.4	3,983.4	ns
Net budget expenditure	4,178.3	4,530.6	ns
Federal government	-393.0	-491.0	ns
Agencies and companies	15.1	-56.2	ns
Pemex	-35.7	-132.7	ns
Other companies	50.8	76.5	50.6
Indirectly-controlled institutions	3.7	2.2	-39.4
Primary balance	-60.2	-193.3	ns
Budget balance	-63.4	-201.2	ns
Federal government	-122.7	-199.2	ns
Agencies and companies	59.4	-2.0	ns
Pemex	-3.1	-90.0	ns
Other institutions	62.4	87.9	40.8
Indirectly-controlled institutions	3.1	7.9	153.4

ns=not significant
Source: BBVA Research with data from SHCP

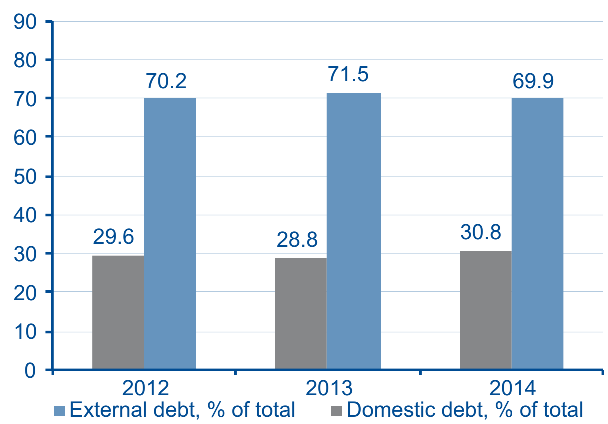
The 2014 public-sector deficit, on the other hand, was greater than in 2013, increasing by 45.6% in absolute terms. The public-sector deficit of MXN545bn in 2014 accounts for 3.0% of the nominal GDP estimated for that year (table 3.3). However, if all Public Sector Financial Requirements (PSFR) are considered)[3], the deficit would grow to MXN678.3bn, increasing the 2014 PSFR to 3.7% of GDP.

Figure 3.24
Total gross debt and Public-Sector Financial Requirements (% of GDP)



Source: BBVA Research with information from SHCP.

Figure 3.25
Percentage structure of total public-sector debt: Domestic and external (% of total debt)



Source: BBVA Research with information from INEGI.

The public sector reported a significant deficit in 2014 and this was also reflected in the increase in the proportion of the total gross debt of the public sector or the balance of PSFR compared with GDP in that year. Hence, total gross debt to GDP roses from 37% to 40% between 2013 and 2014. PSFRs also rose from 39% in 2013 to 41% in 2014 (figure 3.24).

[3] Apart from the traditional public-sector balance, which is MXN545bn in this case, PSFRs also include items such as: I) Pidiregas financial requirements (+MXN5.3bn); ii) IPAB financial requirements (-MXN13.2bn); iii) adaptations to budget entries (-MXN124.8bn); iv) FONANDIN financial requirements (-MXN1.4bn); v) debtor programme (-MXN13.7bn), and vi) Development banking and financing (+MXN14.4bn).

On the other hand, expectations that international crude oil prices will continue to fall for a prolonged period, which had led oil prices to fall to below USD40/bbl in January 2015, forced the SHCP to announce on 30 January that It will cut public spending previously approved for the year. The spending cut announced is equivalent to 0.7 percentage points of the expected 2015 GDP (see box 1). This situation will reduce the impetus that public-sector spending could have given to expanding economic activity in 2015, and possibly in later years too, if crude oil export prices do not pick up to around USD100/bbl.

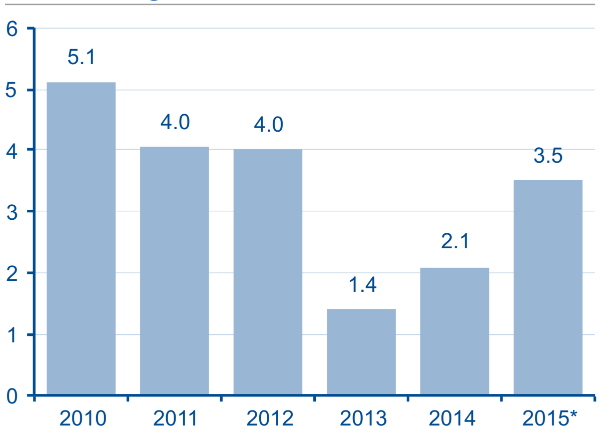
3.1.5 Outlook: the economy advances in 2015

We estimate 3.5% economic growth for 2015 (see figure 3.26), but there are factors that could put economic activity at risk. First, as the infrastructure projects that have already started move forward, this efficient and productive use of public-sector spending is expected to limit the effect of the announced reduction in spending, primarily current expenditure. But to date, public-sector resources have had only a marginal effect on the country's economic growth. Second, the estimate depends to a large extent on the expectation of accelerated economic growth in the United States from 2.4% in 2014 to 2.9% in 2015 (see figure 3.27).

In recent months, reports of mixed indicators have continued, generating uncertainty around the pace of acceleration in the US. For example, US economic growth in the fourth quarter was 0.65% YoY sa, far below the 1.22% of the previous quarter and less than the market had expected. Moreover, even If there is vigorous growth in the US, in Mexico we face the challenge of harnessing this drive, which could become increasingly difficult if we consider that the closest ties between the two economies are in manufacturing, which has been losing specific weight in generating Mexican GDP over the last three years. Third, international prices of the Mexican oil mix and of the production platform have fallen since mid-2014 and in 2015, which has a negative effect on the country's public-sector finances and external accounts, especially with respect to 2016 when we do not have oil hedges to offset the country's expenditure.

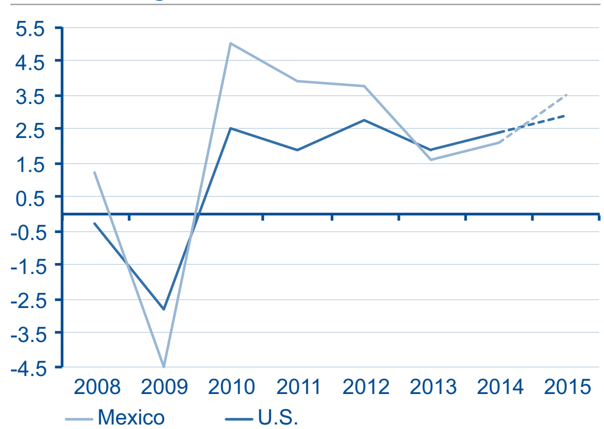
In conclusion, even though external demand drove economic growth in Mexico in 2014 and is expected to continue doing so in 2015, strengthening domestic demand with the joint support of the government and the private sector is a pressing need. This requires programmes to be rolled out that will: i) foster well-paid formal job creation; ii) drive productive investment; iv) display greater resolve in controlling crime by strengthening the rule of law, and v)encourage greater transparency to reduce corruption and impunity.

Figure 3.26
Annual growth of Mexican GDP, 2010-15 (YoY % change)



YoY=year on year.
Source: BBVA Research with information from INEGI

Figure 3.27
GDP of Mexico and the United States, 2008-15 (YoY % change, sa)



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

Box 1: Public-sector spending cuts announced for 2015

On 30 January 2015 the Secretary of Finance and Public Credit (SHCP) announced a MXN124.3bn cut in public-sector spending, due to lower revenues expected by the public sector as a result of the expectations that international oil prices will remain low for a prolonged period, in order to take a precautionary stance for public-sector finances in 2016. The spending cut announced represents 2.6% of the federation's total net spending, equivalent to 0.7% of GDP. Pemex and CFE account for 58% of the adjustment to expenditure, equivalent to MXN72bn. The remaining MXN52bn will be adjusted in the offices of the Federal Government, 65% of which will be cut from current spending and the remaining 35% will be cut from investment projects, including the cancellation of the Trans-peninsular passenger railway and the suspension of the Mexico City-Querétaro train.

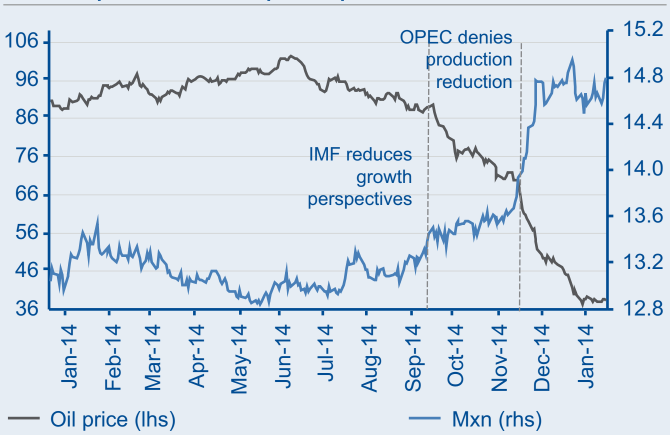
Oil revenues account for around one-third of total public-sector revenues. With the fall in oil prices, public revenues are reduced. But financial hedging of the price of a barrel of oil bought for 2015, higher prices for the petrol sold in the country against the cost of importing it (50% of the petrol consumed in Mexico is imported and the price is around 60% higher in Mexico than in the U.S.), the depreciation of the exchange rate that increases revenues in pesos from oil exports and the resources in the Oil Fund (*Fondo Petrolero*) together enable us to maintain resources close to the amount set forth in the 2015 Revenues Act (*Ley de Ingresos*). In 2016 however, in the absence of oil price hedges and in the event that the Mexican mix does not recover (i.e. USD40 per barrel), we estimate that there could be a shortfall in public-sector revenues of between 0.4% and 0.7% of GDP, depending on the resources available at the time in the Mexican Oil Fund.[1]

On the other hand, given that the spending cuts are concentrated on current spending, and that public-sector spending has had a very limited effect on the growth of output, we estimate that the measures announced will have a limited effect on GDP growth in 2015. But the drive expected from public-sector spending on economic activity in the first six months could be compromised if the reduction in spending is not partially off-set with a significant advance in planned infrastructure works.

Should revenues remain around the figure set forth in the Revenues Act and GDP growth is 3.5%, the spending cuts would imply that the public-sector financial requirements in 2015 would be around 3.3% of GDP, instead of the pre-

Figure 3.28

Price of oil and Mexican peso (dollars per barrel and pesos per dollar)



Source: BBVA Research, with data from Bloomberg.

Figure 3.29

Price of low-octane petrol (pesos)

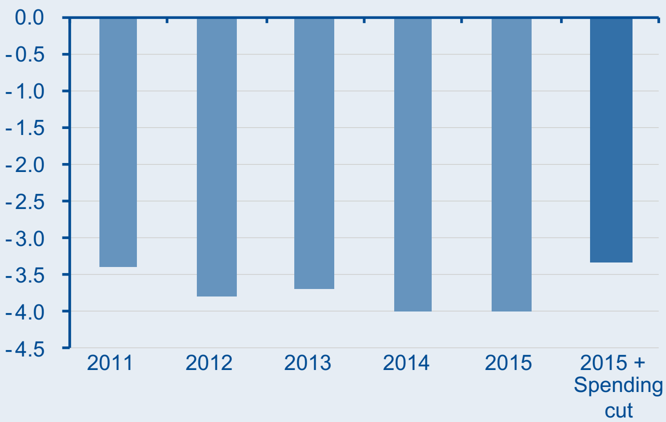
Source: BBVA Research, with data from Bloomberg.

[1] For further details about the estimated change in public-sector revenues resulting from a fall in the price of oil, see publication "Se anuncia recorte al gasto del sector público de 0.7% del PIB" available at http://www.bbvaresearch.com/wp-content/uploads/2015/01/150130_FlashMexico_GastoPublico.pdf

viously estimated 4.0%, which would help the debt to grow at a slower rate. However, there are additional risks to public revenues, such as the possibility of higher interest rates, but particularly of a lower oil production platform, which in the last six months has been below the level considered in the 2015 Revenues Act of 2.4 million barrels a day.

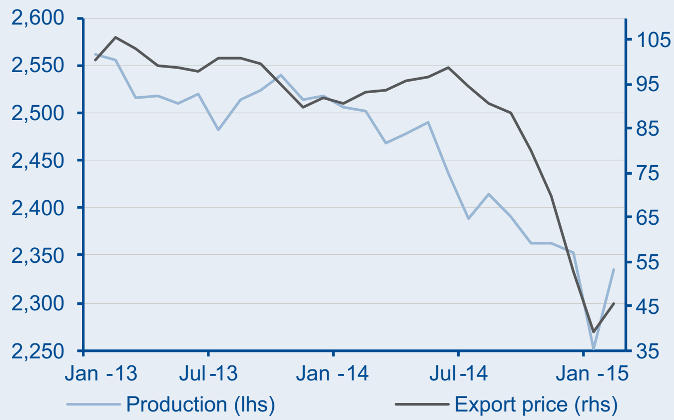
The cut-back In public-sector spending is a positive measure with a view to reducing tax risks for 2015 and 2016, thus attempting to attain macro-economic stability and mitigating the possibility of having to make a drastic reduction in public-sector spending in 2016. In order to maintain fiscal stability and soundness in the medium term, it is important to reduce the public-sector deficit in the next few years in such a way that the public-sector debt stops growing so fast.

Figure 3.30
Public-Sector Financial Requirements (% of GDP)



Source: BBVA Research, with data from SHCP.

Figure 3.31
Oil production in Mexico and its international price (‘000s of barrels a day and dollars per barrel)



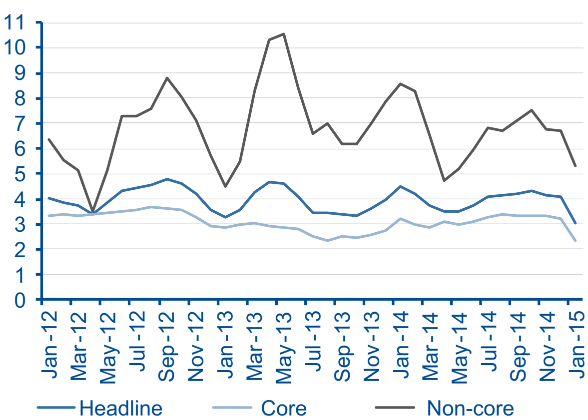
Source: BBVA Research, with data from INEGI, Pemex and Bloomberg.

3.2 Inflation: as anticipated, there was a substantial fall in January and no demand pressure on prices

At the end of 2014, general annual inflation started to fall, as anticipated, after rising between June and October (see figure 3.32), associated mainly with two factors: i) an unfavourable comparable base due to a significant fall in farm products in June and July 2013, and ii) a significant increase In the price of beef and pork, as a consequence of supply shocks on these products. Hence, general annual inflation fell from 4.30% in October to 4.08% in December. But average general annual inflation increased slightly, from 4.15% in 3Q14 to 4.18% in 4Q14. The fall in general inflation would have been even greater in the last two months of 2014, as we had anticipated, if it had not been for the strong increase observed in farm product prices.

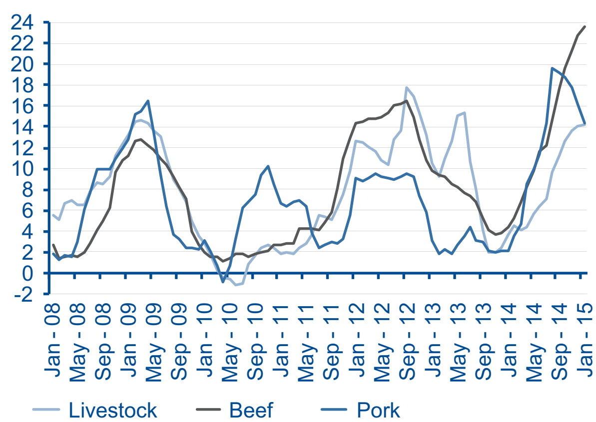
The non-core annual inflation - the sub-index that contains farm products, energy and public tariffs - increased from 6.89% to 6.99% on average between the third and fourth quarters. This spike was associated with the increase in the annual Inflation of farm product prices - which rose from 6.52% in Q3 to 8.04% in Q4– mainly as a consequence of the spike in farm product prices that almost doubled its annual inflation between July and December, increasing from 7.14% to 14.03%. Two factors explain this bullish trend. On the one hand, the favourable performance of the fruit and vegetable prices and farm produce prices seen in the third quarter of 2013 was not repeated in 2014. And, on the other, adverse supply conditions in the US triggered significant increases in the price of beef and pork (see figure 3.33), although pork prices slowed down in the fourth quarter. The increase in farm products was partially offset by a reduction in energy prices and government-authorised tariffs, where the average annual rate fell from 7.11% to 6.36% between Q3 and Q4, and registered an additional fall in December to 5.55%.

Figure 3.32
Inflation and components
Annual % change



Source: BBVA Research with data from INEGI

Figure 3.33
Inflation of farm products
Annual % change



Source: BBVA Research with data from INEGI

Despite the tax hikes of January 2014, core inflation remained close to 3.0% for most of the year. The annual rate increased in the second half of 2014, but it remained low and showed no sign of demand pressure on prices. Annual average core inflation increased from 3.05% in the first six months of 2014 to 3.31% in the second half, settling at 3.24% at year-end. This behaviour was mainly associated with the increase in the goods sub-index, where the annual inflation rate spiked from 3.00% in the first half of 2014 to 3.52% in the second, mainly because of the increase in food prices, because the increase in meat prices was passed on to some processed foods, such as sausages. Hence, annual average inflation of the sub-index of processed food increased from 4.73% in the first half of the year to 5.34% in the second half, settling at 5.31% in December. The average annual inflation of non-food goods, in turn, also increased, but remained low, rising from 1.62% to 2.05% between the first and second half of the year, settling at 2.04% in December. Annual average inflation of the services sub-index remained practically unchanged between the first and second half of 2014, rising slightly from 3.09% to 3.14%. The component of services other than education and housing explains the spike, although it started to fall again in the fourth quarter. Between the second and third quarter, the average annual inflation of this sub-index increased from 3.54% to 4.06%, falling to 3.72% In Q4. The increase was mainly due to higher air-transport prices, while the reduction seen in Q4 was associated with lower prices of mobile telephone services due to the introduction of promotions and new monthly rental plans.

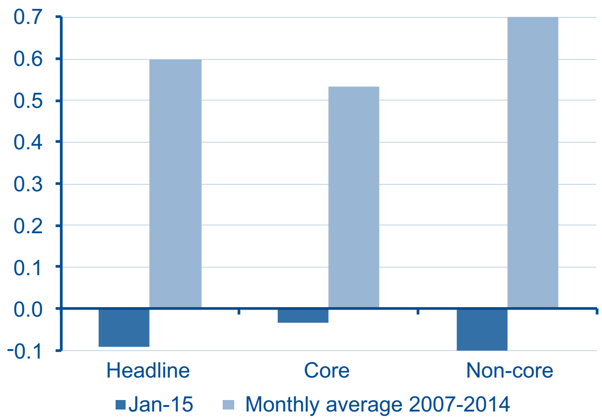
In January 2015, annual inflation fell slightly, as had been broadly anticipated by analysts; in fact, it even fell more than expected. Annual general inflation fell from 4.08% in December to 3.07% in January, while annual core inflation fell from 3.24% in December to 2.34% in January. This is a reflection mainly of the dilution of the effect of the 2014 tax hikes on the inflation of different goods and the sharp fall in the sub-index of the price of services as a consequence of lower prices in telecommunications services when the long-distance national call charge was eliminated. But it is also due to seeing the first positive effects for consumers arising from greater competition by approving a change of supplier in 24 hours, yet keeping the same number, as part of the telecommunications reform. Thus, the annual inflation of the goods sub-index fell from 3.50% in December to 2.43% in January, while the services sub-index fell from 3.03% to 2.26% in the same period. These effects were foreseen, although the fall in the price of telecommunication services was sharper than anticipated, perhaps to a large extent because we expected the benefits of competition to be seen more gradually throughout the year. Along with the above, general inflation fell 0.09% in monthly terms in January, an atypical inflation in seasonal terms (see figure 3.34). This surprise was also associated with a sharp fall in the sub-index of agricultural prices (5.33% monthly), and the sub-index of energy prices which fell surprisingly (0.23% monthly) because of reductions in electricity and natural gas prices and lower-than-expected increases in the price of petrol. The petrol-price increases can be explained by the lower-than-announced increases for this year in much of the country and reductions in prices at the border, due to the fact that petrol prices in the US are just over half of the prices that currently prevail in Mexico.

Inflation prospects: we anticipate that general inflation will remain close to 3.0% throughout the year and core inflation will remain even lower throughout 2015

Considering that the factors that explained the rising trend in inflation up to October 2014 were supply shocks (i.e. the tax changes in 2014 and changes in relative prices, mainly of livestock products) that have not had a secondary effect on the formation of prices, our prospects for inflation In 2015 remain favourable. Considering a favourable and faster-than-expected effect of the telecommunications reform due to greater competition, the lower-than-expected increase in energy prices, the fact that there are no signs of the depreciation of the peso being passed on to inflation (due to high economic comfort; the output gap is expected to remain negative throughout 2015) and the absence of inflationary pressure on the demand side, we anticipate that annual inflation will remain close to 3.0% throughout the year.

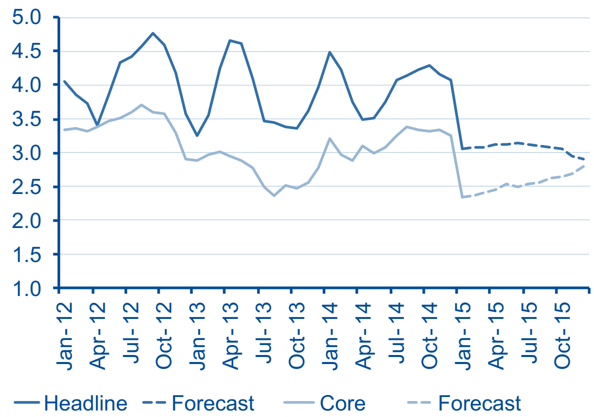
In qualitative terms, our inflation scenario does not change. But in quantitative terms, the positive surprise in January and, beyond the numerical surprise, the fact that much of this represents permanent changes during the year - i.e. the more pronounced than expected fall in the prices of telecommunication services and the lower-than-expected increase in energy prices – lead us to revise down our forecasts for general Inflation at year-end 2015 from 3.2% to 2.9%, and from 3.0% to 2.8% for core inflation. Moreover, we now forecast that general inflation will remain close to the central bank's target of 3.0% throughout the year, and that core inflation will remain below 3.0% throughout 2015.

Figure 3.34
Inflation and components
Monthly % change



Source: BBVA Research with data from INEGI

Figure 3.35
Inflation prospects
Annual % change



Source: BBVA Research

Another element to highlight is that the smaller increase in energy prices will not only facilitate lower inflation this year because of its direct effects on the INPC basket, but it should also favour the convergence of inflation towards the 3.0% target permanently, insofar as energy prices have indirect effects on others. Furthermore, as soon as economic stake-holders realise that the slower annual growth rate is going to be permanent, it could also help to anchor inflation expectations in the medium and long terms at lower levels. In short, the non-core component should behave more favourably in 2015 against previous years because of the impact of petrol prices.

Faced with the prospect of gradual economic recovery, we do not anticipate pressure on prices. Underlying inflation, the one that best indicates the medium-term behaviour of inflation, remains favourable because of the weakness of the economic cycle and the consequent comfort that has translated into an absence of demand pressure on prices. For 2015, the output gap will remain negative, allowing us to anticipate that core prices will continue to behave favourably. We anticipate that it will settle at 2.54% during the year, although it could experience a gradual increase in the second half of the year if economic recovery is consolidated.

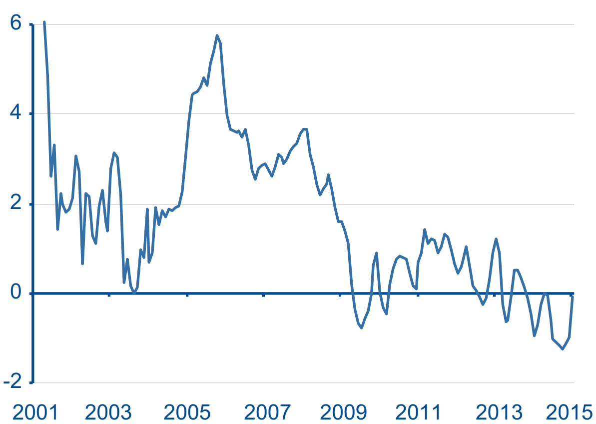
Our forecasts are subject to both downside and upside risks. The main downside risks concern core inflation, which include less-than-expected dynamism in the economy, that widens the output gap instead of closing it, and the possibility of an addition fall in mobile telephone services if the changes from the telecommunications reform drive greater competition in the sector. Upside risks would come from the exchange rate, if the current rate is consolidated or there is a greater depreciation (although our estimated transfer is low), and from a possible increase in the minimum wage. But the effect of the latter should be transitory and similar to other supply shocks, such as last year's tax modifications. Bearing in mind that the increase is limited to the universe of workers earning the minimum wage, this will not be a recurring policy and economic stake-holders perceive it as such.

3.3 The start of the upward cycle is approaching in the face of the greater relative specific weight of Banxico's monetary policy compared with the US

After maintaining accommodating monetary positions for the last six years, the possibilities of seeing an increase in interest rates in Mexico are high. This is based on two factors. The first is the start of the monetary normalisation cycle by the Federal Reserve (Fed). The American economy gave clear signs of recovery in 2014 when it grew 2.4%, its best economic performance since 2010, accompanied by the creation of over three million jobs, which in turn drove the unemployment rate to fall to 5.6%, its lowest level since 2008. These data, taken together with the good growth expectations for this year, have generated a change in Fed communications. Although it has reiterated that it will be patient in starting the cycle of monetary normalisation, it now points to the second half of the year for the first hike in interest rates since 2006.

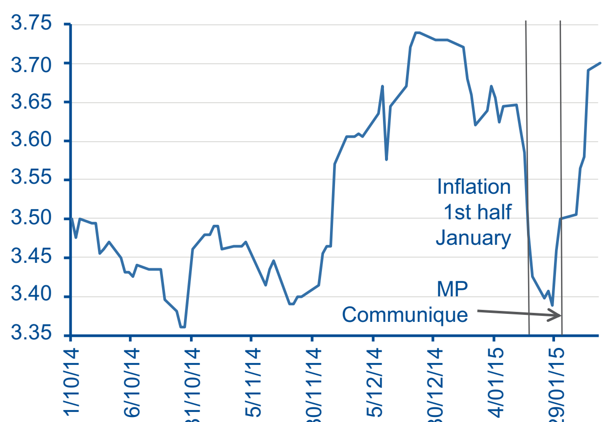
Against this backdrop of expectations of higher interest rates, and taking into account the fall in oil prices, Banxico has shown concern about possible pressures on the real exchange rate, inflation and interest rates. Consequently, it has indicated the important role of monetary policy for anchoring expectations and preventing disorderly movements in the yield curve. The minutes of the December monetary policy meeting mentioned that if the increase in real short-term interest rates, the result of falling inflation (see figure 3.36), were not sufficient to reduce the aforesaid pressures that could be faced, a change in the reference rate would have to be considered. Together with this, the governor of the central bank recently declared that in the face of a sharp increase in US interest rates, there is a strong possibility that domestic interest rates would have to be increased. In short, even though inflation has fallen to around the target level (3.08% annual in January), Banxico is being cautious and is intimating that it will not hesitate in taking measures to consolidate the trend towards the inflation target of 3.0%; especially given the risks to inflation of a turbulent financial environment such as the current one.

Figure 3.36
Real short-term interest rate (%)



Source: BBVA Research with data from Banxico and INEGI.

Figure 3.37
Yield on 1-year interest rate swap contracts



Source: BBVA Research with data from Bloomberg

Second, there are the economic growth expectations for this year and for the next few years: Although economic prospects are not robust enough to generate demand pressure on prices in the upcoming quarters, they would generate a gradual reduction in the tension of the economy. In fact, if we consider expected growth of over 3.0% for the next two years, the output gap could close towards the end of 2016, which could justify a reduction in monetary laxity. In other words, a recovery of the economy would allow a gradual disappearance of quantitative easing, which is not the same as the central bank taking a tougher stance. Thus, Banxico would also be entering an upward cycle, considering the gradual improvement in economic activity and a convergence with the inflation target.

In conclusion, we consider that relative monetary conditions in comparison with the US will be more important for monetary policy in Mexico this year. However, convergence with the 3.0% inflation target and the degree of tension in the economy will have a decisive impact on when the normalisation cycle starts and how fast it can be completed. Consequently, given our GDP growth prospects of over 3.0% for 2015 with end-of-period inflation around 3.0%, we maintain our expectations of an increase in interest rates during the third quarter of 2015.

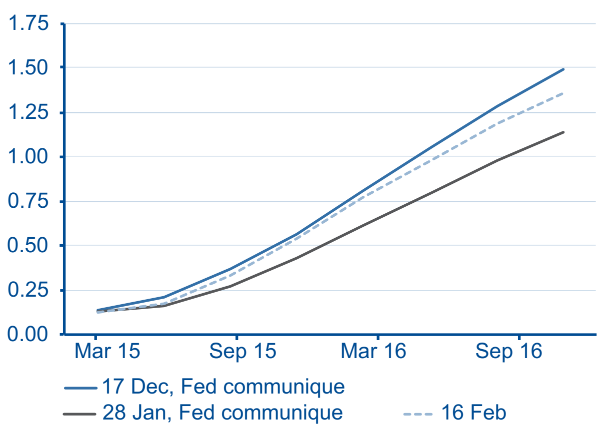
3.4 Uncertainty about the date of the first rise in federal interest rates and geo-political risks exacerbate exchange rate volatility

Volatility and the exchange rate have increased so much during the first two months of the year that the dollar has reached an exchange rate of over 15 pesos for the first time since March 2009. On top of slower world economic growth, except for the US, and the fall in oil prices, there are also two new uncertainty factors which have had an adverse impact on financial markets in Mexico. The first of these factors is the expectation of an early normalisation cycle by the Federal Reserve (Fed). The 257,000 increase in the non-farming payroll in January and the increase in wages in the US caused the market to bring forward its expectations of the first rise in federal interest rates to the summer of this year (see figure 3.38).

Together with the above, the comments of some members of the Federal Open Market Committee (FOMC) that economic activity and job indicators indicate an increase in interest rates sooner than expected have reinforced the idea that we could see the first movement by the Fed during the summer. Bringing expectations forward has once again been reflected in the negative correlation between US economic data, which were better than expected, and the exchange rate, given the greater expected risk-adjusted yield that US instruments would have. In fact, when the January employment data were released, the exchange rate depreciated by 1.22%. It is worth highlighting that this had already happened in 2014 in the face of the gradual reduction in the Fed's asset purchase programme, although it dissipated once the market accepted the expectation that the rhythm of growth of the US economy could be sustained even against a backdrop of gradually rising interest rates.

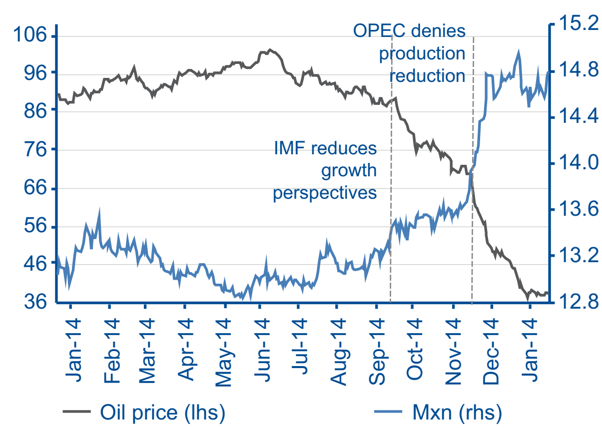
The second factor that has exacerbated the depreciation of the peso is comprised of doubts about negotiating a new bail-out package for Greece and geo-political risks. The lower aversion to risk that had prevailed in the markets almost throughout the second half of 2014 came to an end at the end of December, when the imminent victory of a left-wing party in the Greek elections was expected. This was a party that proposed renegotiating its debt and putting an end to the package of fiscal austerity measures in the country. These expectations materialised at the end of January, and the lack of agreement ever since between the authorities of the European Union and the Greek government regarding a relaxing of the austerity measures imposed on Greece has led to intermittent increases in the aversion to risk. It is worth bearing in mind that these increases are a long way from what was seen in 2011, when doubts were cast on Greece's continued membership of the eurozone, a scenario that the markets now appear to rule out for the moment. Apart from the situation in Greece, the conflict in the Ukraine is far from being resolved, which has added to the global aversion to risk for several days.

Figure 3.38
One month federal interest rate futures (%)



Source: BBVA Research with data from Bloomberg

Figure 3.39
Exchange rate and oil price (pesos per dollar, dollars per barrel)



Source: BBVA Research with data from Bloomberg

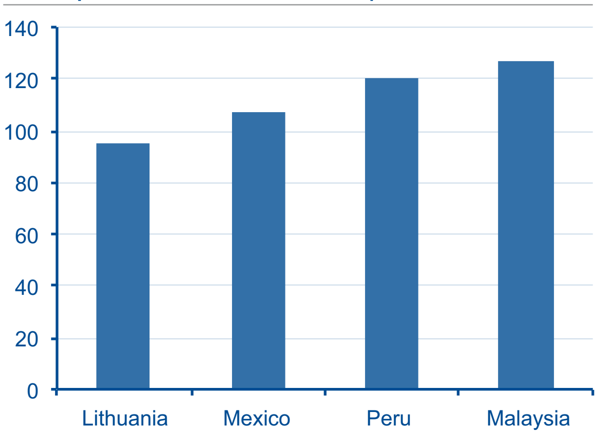
As we have said, these two factors have exacerbated exchange rate depreciation, but the main factor behind the fall of the peso since November remains present. That is, the uncertainty regarding the duration and the magnitude of the fall in oil prices has not been dissipated, and the close correlation between the peso and this uncertainty. The fact is that, although energy prices have stabilised around USD50 for a barrel of Texas (i.e. West Texas Intermediate - WTI), the market reacts significantly to any OPEC announcement or to US oil stocks data. Although low prices have triggered a cut-back in investment spending by oil companies, it is still not clear if this will be enough to eliminate the excess supply in the short term, estimated at around two million barrels a day, in the face of OPEC's refusal to cut back its production.

The absence of a sudden and sustained movement in aversion to risk has caused other financial variables to behave differently from other episodes of exchange rate depreciation. The fall in inflation has impacted the government interest rate market, but the falling trend of US Treasury bonds has dominated until the end of January this year. In fact, in the first half of December 2014 alone (when the yield on the 10-year M bond (M10) reached 6.17%), changes in the long-term Mexican interest rate were disassociated from the movements of their US counterparts when pressures on the peso intensified. In the second half of December, however, the close correlation between the long-term interest rate movements of both countries returned and has been maintained to date, even in a context of high uncertainty in the face of the policies that Greece may implement. Hence, interest rates tended to fall in January, and at the end of the month the US 10-year Treasury note fell to 1.64% (against 2.17% at the close of 2014) while the M10 bond fell to 5.23% (against 5.83% at the end of December 2014) (see figure 3.41).

Since the beginning of February, after releasing the report on the US January non-farming payroll, which not only showed accelerated job creation but also rising wages, the markets brought forward their expectations concerning the date of the first rise in federal interest rates, to June of this year. Based on the above, long-term interest rates reached a turning point and started to rise, a trend that has continued during the first half of February. This was partially supported by the words of some members of the FOMC which went in the same direction as the movement in market expectations, insofar as the upcoming start of the monetary normalisation cycle in the US. This drove the 10-year Treasury note to 2.05% (against 1.64% at the close of January), while the rate on the M10 bond rose to 5.69% (against 5.23% at the end of January). But long-term interest rates remain low if we compare them with average rates in 2014 (2.53% for the 10-year Treasury note and 6.01% for the M10 bond).

Figure 3.40

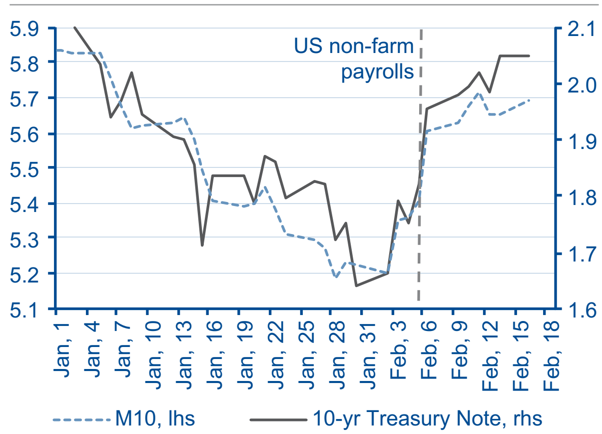
Sovereign credit default swaps (basis points, data at 13 February 2015)



Source: BBVA Research with data from Bloomberg

Figure 3.41

Yield on 10-year Mexican and US government bonds (%)



Source: BBVA Research with data from Bloomberg

This behaviour of interest rates is in line with what happened in flows to the domestic fixed income market. Holdings of Mexican M bonds by foreigners increased by over USD4.6bn in January 2015, slightly below the almost USD5.5bn of December, which made 2014 the second-best year in the last five years in terms of foreign flows. As for CETES, in December and January there was a fall in foreign holdings of just over USD1.05bn on average, lower than the average reductions recorded in 2014 and explained in part by an increased aversion to risk.

Regarding sovereign risk, the credit default swap (CDS) recorded an increase of 20 basis points from November to date, which puts it now at 107 basis points, below most countries with a similar credit rating (figure 3.41). It is worth highlighting the fact that this variable did not show any significant change when the cut-back in government spending was announced, although there was an increase on the days of the sharpest falls in oil prices. Finally, on the stock markets, the positive differentiation towards US indexes has been partially reversed in the year to date. The S&P 500 has climbed 1.85%, whereas the MSCI World Index excluding the US, which is a reference of stock markets worldwide, registered an increase of 3.03%. The reference index for emerging markets also climbed 3.13%, although the IPC maintains negative growth of 0.17% in the year to date.

Moving forward, we expect the US macro-economic data and the Fed communication to be the centre of attention for markets expecting an upcoming start to the process of monetary normalisation. This will intensify already high volatility with uncertainty in the oil market. Specifically, in exchange-rate matters, we expect there to be clarity regarding the rising trend of interest rates once the economy shows clear signs of improvement and, in the absence of further falls in oil prices, the peso could appreciate to around 14 pesos to the dollar by the end of the year. As far as interest rates on government debt are concerned, the most probable scenario remains one of a gradual increase, subject to market expectations about when monetary normalisation will start in the US and the rhythm of the increase expected for the next upward cycle in interest rates, in both Mexico and the US. We anticipate that the yield on the 10-year Treasury note will be 2.6% by the end of the year, whereas the M10 bond will increase to 6.1%.

4. Indicators and forecasts

Table 4.1

Macroeconomic forecasts: Gross Domestic Product

(YoY growth rate)	2012	2013	2014	2015	2016
United States	2.3	2.2	**2.4**	**2.9**	**2.8**
EMU	-0.7	-0.4	**0.8**	**1.3**	**2.2**
Germany	0.6	0.2	**1.5**	**1.4**	**2.2**
France	0.4	0.4	**0.4**	**1.0**	**1.8**
Italy	-2.3	-1.9	**-0.4**	**0.6**	**1.3**
Spain	-2.1	-1.2	**1.4**	**2.7**	**2.7**
UK	0.7	1.7	**2.6**	**2.8**	**2.5**
Latin America *	2.5	2.5	**0.8**	**1.5**	**2.4**
Mexico	3.8	1.7	**2.1**	**3.5**	**3.4**
Brazil	1.0	2.5	**0.1**	**0.6**	**1.8**
EAGLES **	5.5	5.4	**5.1**	**5.0**	**5.2**
Turkey	2.1	4.1	**2.5**	**3.7**	**4.5**
Asia-Pacific	5.5	5.4	**5.4**	**5.5**	**5.4**
Japón	1.5	1.5	**0.7**	**1.3**	**1.2**
China	7.7	7.7	**7.4**	**7.0**	**6.6**
Asia (exc. China)	3.9	3.7	**3.7**	**4.3**	**4.4**
World	3.3	3.2	**3.3**	**3.6**	**3.8**

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Corea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Closing date: February 6, 2015
Source: BBVA Research

Table 4.2

Macroeconomic Forecasts: inflation (Average)

(YoY growth rate)	2012	2013	2014	2015	2016
United States	2.1	1.5	**1.6**	**0.6**	**2.0**
EMU	2.5	1.4	**0.4**	**0.1**	**1.0**
Germany	2.1	1.6	**0.8**	**0.3**	**1.1**
France	2.2	1.0	**0.6**	**0.1**	**0.9**
Italy	3.3	1.3	**0.2**	**-0.2**	**0.6**
Spain	2.4	1.4	**-0.2**	**-0.4**	**1.4**
UK	2.8	2.6	**1.5**	**0.4**	**1.5**
Latin America *	7.8	9.3	**12.7**	**13.7**	**14.0**
Mexico	4.2	3.8	**4.0**	**3.0**	**3.6**
Brazil	5.4	6.2	**6.3**	**6.7**	**5.7**
EAGLES **	5.0	5.3	**4.6**	**4.3**	**4.1**
Turkey	8.7	7.5	**8.8**	**6.4**	**6.6**
Asia-Pacific	3.7	4.0	**3.5**	**3.2**	**3.3**
Japón	-0.1	1.6	**3.0**	**1.3**	**1.6**
China	2.7	2.6	**2.1**	**2.2**	**2.5**
Asia (exc. China)	4.5	5.1	**4.5**	**4.0**	**4.0**
World	4.4	4.2	**4.1**	**4.0**	**4.2**

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, Corea, China, India, Indonesia, Mexico, Russia, Taiwan, Turkey
Closing date: February 6, 2015
Source: BBVA Research

Table 4.3

United States indicators and forecasts

	2013	2014	2015	2016	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15
Macroeconomic Indicators												
GDP (real % change)	2.2	2.4	2.9	2.8	-2.1	4.6	5.0	2.6	2.6	1.4	3.2	3.0
Personal consumption (real % change)	2.4	2.5	2.8	2.6	1.2	2.5	3.2	4.3	2.0	2.5	2.6	2.4
Gov. consumption (real % change)	-2.0	-0.2	0.4	-0.2	-0.8	1.7	4.4	-2.2	0.2	0.2	0.2	0.2
Gross fixed investment (real % change)	4.7	5.2	5.5	5.8	0.2	9.5	7.7	2.3	5.7	5.1	5.9	6.5
Construction	3.4	4.6	5.3	4.2	4.7	5.5	8.8	7.2	4.1	3.6	4.5	4.9
Industrial prod. (real annual % change)	2.9	4.2	4.8	4.3	3.3	4.2	4.6	4.8	4.9	4.5	5.1	4.7
Current account balance (% of GDP)	-2.5	-2.6	-3.0	-3.0	-2.6	-2.4	-2.4	-2.6	-2.8	-2.8	-2.9	-3.0
Final annual inflation	1.5	0.8	1.8	2.1	1.5	2.1	1.7	0.8	0.5	0.1	0.7	1.8
Average annual inflation	1.5	1.6	0.6	2.0	1.4	2.1	1.8	1.2	0.5	0.2	0.5	1.3
Primary fiscal balance (% of GDP)	-4.1	-2.9	-2.7	-2.6				-2.9				-2.7

Note: **Bold** figures are forecast
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	3.5	3.4	0.9	2.8	2.2	2.6	3.4	3.3	3.6	3.8
Per inhabitant (US dollars)	10,630	10,627	10,720	11,009	10,506	10,939	10,827	10,468	10,311	10,633	10,670	11,168
US$ billions	1,255.6	1,272.0	1,297.0	1,467.0	1,257.7	1,309.6	1,296.2	1,253.2	1,247.7	1,286.7	1,291.2	1,351.3
Inflation (average, %)												
Headline	3.8	4.0	3.0	3.6	4.2	3.6	4.1	4.2	3.0	3.1	3.1	3.0
Core	2.7	3.2	2.5	3.3	3.0	3.1	3.3	3.3	2.3	2.5	2.6	2.7
Financial Markets (eop, %)												
Interest rates												
Bank funding	3.5	3.0	3.5	4.5	3.5	3.3	3.0	3.0	3.0	3.0	3.3	3.5
28-day Cetes	3.2	3.0	3.5	4.8	3.2	3.1	2.8	2.9	2.9	3.0	3.3	3.6
28-day TIIE	3.8	3.4	3.9	4.9	3.8	3.6	3.3	3.3	3.4	3.4	3.5	3.7
10-year Bond (%, average)	5.7	6.1	5.8	6.4	6.3	5.9	5.9	5.8	5.6	5.7	5.8	6.0
Exchange rate (average)												
Pesos per dollar	13.0	13.3	13.6	14.2	13.2	13.0	13.2	14.1	14.8	14.3	14.2	13.9
Public Finances												
*FRPS (% of GDP)	-3.0	-4.0	-4.0	-3.5	-	-	-	-4.0				-4.0
External Sector[3]												
Trade balance (US$ billions)	-1.2	-2.4	-3.2	-3.9	-1.3	1.1	-1.5	-0.7	-1.2	0.2	-1.8	-0.4
Current account (US$ billions)	-26.3	-23.9	-25.4	-27.7	-9.0	-7.7	-2.7	-4.6	-6.9	-6.1	-6.0	-6.4
Current account (% of GDP)	-2.1	-1.9	-2.0	-1.9	-2.9	-2.4	-0.8	-1.5	-2.2	-1.9	-1.9	-1.9
Employment												
Formal Private (annual % change)	3.5	3.5	3.9	3.9	2.9	3.2	3.8	4.2	4.2	4.0	4.0	3.5
Open Unemployment Rate (% active pop.)	4.9	4.9	4.6	4.3	5.0	4.9	4.9	4.5	4.6	4.6	4.7	4.6

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Mexico Indicators and Forecasts

	2013	2014	2015	2016	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15
Aggregate Demand [4] (annual % change, seasonally-adjusted)												
Total	1.9	**2.9**	**4.2**	**5.1**	2.0	2.9	2.9	**3.9**	**3.2**	**3.8**	**4.7**	**5.1**
Domestic Demand	1.9	**1.8**	**3.0**	**3.6**	1.0	1.8	1.5	**3.0**	**0.9**	**2.8**	**4.2**	**4.0**
Consumption	2.4	**2.2**	**3.5**	**4.0**	0.7	2.3	2.4	**3.2**	**3.6**	**3.3**	**3.4**	**3.8**
Private	2.5	**1.8**	**2.8**	**3.4**	0.5	2.4	2.2	**2.3**	**2.6**	**2.1**	**2.6**	**3.7**
Public	1.6	**4.1**	**8.2**	**7.2**	2.2	2.1	3.8	**8.5**	**9.7**	**10.4**	**8.3**	**4.7**
Investment	-1.0	**1.9**	**5.9**	**5.1**	-2.2	0.9	4.3	**4.6**	**5.4**	**6.0**	**6.0**	**6.3**
Private	-0.7	**3.6**	**5.0**	**6.9**	-1.7	3.5	7.0	**5.7**	**4.9**	**4.2**	**4.1**	**6.6**
Public	-1.9	**-4.8**	**10.0**	**-2.1**	-4.2	-9.1	-6.2	**0.4**	**7.3**	**13.7**	**14.4**	**4.9**
External Demand	2.1	**6.4**	**8.0**	**9.3**	5.0	6.5	7.0	**6.9**	**10.4**	**7.1**	**6.5**	**8.2**
Imports	2.9	**5.5**	**6.3**	**10.0**	5.6	3.3	5.0	**8.0**	**2.5**	**5.4**	**8.1**	**9.3**
GDP by sectors (annual % change, seasonally-adjusted)												
Primary	0.8	3.1	**3.1**	**1.7**	2.8	2.1	6.7	0.9	**3.3**	**3.5**	**2.5**	**3.3**
Secondary	-0.5	1.9	**2.7**	**2.8**	0.4	2.7	2.0	2.4	**2.7**	**2.7**	**2.5**	**3.0**
Mining	-0.5	-2.2	**-2.3**	**-1.5**	-0.3	-0.2	-2.8	-5.7	**-4.7**	**-3.7**	**-1.6**	**0.8**
Electricity	0.5	1.8	**2.5**	**2.9**	2.3	1.7	1.5	1.6	**1.7**	**2.6**	**3.0**	**2.8**
Construction	-4.7	1.8	**n.a.**	**n.a.**	-3.3	1.3	3.8	5.7	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Manufacturing	1.6	3.7	**4.2**	**4.1**	2.9	4.1	3.3	4.7	**4.6**	**4.5**	**4.0**	**3.9**
Tertiary	2.7	2.2	**4.0**	**3.8**	1.2	2.8	2.1	2.8	**3.8**	**3.8**	**4.5**	**4.0**
Retail	2.9	3.3	**5.7**	**5.1**	0.5	3.4	3.9	5.4	**6.6**	**5.8**	**6.2**	**4.4**
Transportation, mail and warehouse	2.8	1.9	**4.9**	**3.6**	1.7	2.9	0.8	2.2	**4.3**	**4.4**	**5.7**	**5.1**
Massive media information	5.1	2.2	**5.6**	**7.3**	2.4	4.6	-0.3	2.2	**3.5**	**3.5**	**7.6**	**7.8**
Financial and insurance	9.9	2.0	**5.1**	**8.9**	3.8	1.4	1.1	2.0	**4.0**	**5.4**	**5.0**	**6.0**
Real-estate and rent	1.0	2.1	**3.5**	**2.6**	1.8	2.2	2.3	2.2	**3.0**	**3.3**	**3.7**	**4.1**
Prof., scientific and technical servs.	0.9	1.2	**3.6**	**2.1**	-0.6	0.2	1.2	4.0	**4.8**	**4.5**	**3.9**	**1.2**
Company and corporate management	-1.4	6.4	**7.6**	**3.2**	6.5	3.9	3.4	12.4	**6.1**	**6.7**	**6.4**	**11.4**
Business support services	4.3	0.0	**1.7**	**2.9**	0.4	1.8	-0.1	-2.0	**0.8**	**0.3**	**2.8**	**2.8**
Education	0.8	1.5	**1.4**	**1.6**	1.0	1.8	2.3	0.9	**1.2**	**0.7**	**1.7**	**2.0**
Health and social security	2.5	0.6	**1.6**	**1.4**	0.4	0.9	0.8	0.5	**1.5**	**1.2**	**1.9**	**1.7**
Cultural and sport	3.9	-0.8	**2.8**	**3.0**	-1.9	-0.8	1.9	-2.3	**0.9**	**3.5**	**3.8**	**3.1**
Temporary stay	1.9	2.9	**3.1**	**3.1**	1.9	4.2	2.0	3.3	**4.2**	**2.5**	**3.5**	**2.4**
Other services, except government activities	1.8	1.4	**1.7**	**1.7**	0.3	1.4	1.9	2.0	**2.3**	**1.4**	**1.2**	**1.7**
Government activities	-0.1	2.5	**2.0**	**0.2**	3.3	2.7	2.3	1.8	**1.1**	**2.9**	**2.1**	**1.9**

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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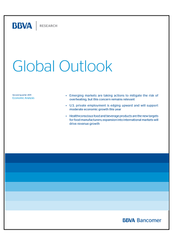
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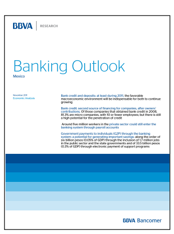
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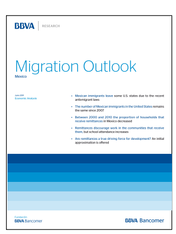
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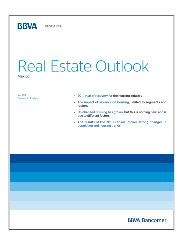
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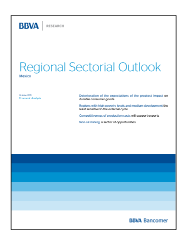
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