Inflation Report

October - December 2012

Summary

During 2012, Mexico's economic growth led activity levels to continue in an orderly manner the convergence towards the productive potential of the country, in a context in which no demand-related inflationary pressures were observed and in which inflation resumed its downward trend, once the effects of the temporary shocks affecting it dissipated. The balance between the income from productive factors and the absorption in the economy, reflected in the country's external accounts, allowed them to persist at reduced and fully fundable levels. The national financial system has supported economic growth in a sound manner, i.e., without accumulating imbalances in the referred sector. This favorable performance is largely due to the adequate macroeconomic policy stance. Particularly, the strengthening of public finances and the monetary policy aimed at reaching the 3 percent permanent inflation target are noteworthy.

The fact that the abovementioned economic phenomena took place in an international environment of persistent signs of weakness emphasizes the benefit of maintaining a strong macroeconomic framework in Mexico. According to preliminary data, U.S. GDP growth rate contracted slightly in the fourth quarter of 2012. Available indicators suggest that the Euro zone's GDP contracted in the referred period, while that of Japan remained practically stagnated. Emerging economies continued expanding slowly and in many of them the industrial production expansion rate decelerated. Thus, the growth prospects for 2013 in advanced and emerging economies continued to worsen, even if in January they seem to have stabilized, although at low levels. In sum, significant downward risks for the world economy prevail, although at the margin these risks diminished. In particular, the probability of a systemic adverse event in Europe seems to have decreased.

The international prices of the main commodities observed a downward trend during the last three months of 2012, though with certain volatility. This decrease in prices was in line with the weak world economic environment and was reflected in lower inflation levels in advanced economies. Meanwhile in some of the emerging economies inflation stabilized after having observed an increase in the previous quarter. In most countries inflation is expected to register a downward trend during 2013.

In this environment, the monetary policy stance of main advanced economies, as well as most of the emerging ones remained accommodative showing, in some cases, additional easing. Further monetary stimulus, together with measures aimed at allowing the functioning of the sovereign debt and interbank markets in the Euro zone, the agreements reached to strengthen the institutional framework and governance of the region and the reduced probability of a severe and abrupt fiscal adjustment in the U.S. in the short term contributed to an improvement in the financial markets. In particular, a renewed demand for higher-risk assets was observed, which was reflected in their prices. Nonetheless, new episodes of volatility cannot be ruled out, given the difficult situation prevailing in the Euro zone and the persisting uncertainty concerning the fiscal situation in the U.S.

During the last quarter of 2012, economic activity in Mexico grew at a lower rate than it did on average in the first half of the year, primarily due to the lower dynamism of the world economy, which led to a deceleration in the external and some components of the domestic demand. Although this downturn affected Mexico's industrial activity, it has not been fully reflected in the performance of the services sector, which kept exhibiting greater dynamism with respect to the industrial sector.

Inflation in Mexico converged to low and stable levels over a decade ago. In recent years, annual headline inflation has been converging towards the 3 percent target with the variability interval of plus/minus one percentage point, established by Banco de México. This process has been more pronounced since mid-2011, and despite annual headline inflation being affected by transitory shocks for various months in 2012, the indicators of its medium-term trend do not signal any contamination of the process of price determination in the economy by the referred shocks. Indeed, in the fourth quarter of 2012, these shocks began dissipating and headline inflation resumed its downward trend, declining considerably by the end of the year and the beginning of 2013. Thus, after a span of several months, when annual headline inflation persisted above the upper bound of the variability interval of plus/minus one percentage point around the 3 percent permanent target, at the end of the year it returned to this interval, just as foreseen by Banco de México. Annual core inflation, which remained below headline inflation, kept decreasing during the reference quarter, so as to locate at a level below the 3 percent mark in December 2012 and in January 2013.

The macroeconomic scenario foreseen by Banco de México is the following:

Growth of the Mexican Economy: Considering U.S. industrial production growth in 2012 and the performance of the Mexican economy throughout the year, the annual GDP growth in Mexico is calculated to have been around 4.0 percent in 2012. For 2013, the interval for the expected GDP growth rate in Mexico announced in the last Inflation Report remains unchanged, so that GDP growth is estimated to be located between 3.0 and 4.0 percent. For 2014, the GDP growth rate of Mexico is foreseen to lie between 3.2 and 4.2 percent, in line with the expectation of a stronger U.S. economic expansion for that year (Chart 1a).

Employment: For 2013, considering the anticipated economic activity growth and the recent approval of the labor reform, the forecast for the increase in the number of IMSS-insured workers is revised upwards from an interval of 500 to 600 thousand workers stated in the previous Inflation Report to an interval of 550 to 650 thousand insured workers. For 2014, an increase of between 700 to 800 thousand workers is expected.

Current Account: Regarding the external accounts, the trade balance registered a moderate surplus of USD 0.2 billion (estimated at 0.0 percent of GDP) in 2012, so that the current account deficit is expected to have reached USD 7.0 billion (0.6 percent of GDP). For 2013, the anticipated trade balance and the current account deficits are USD 5.5 and 17.3 billion, respectively (0.4 and 1.3 percent of GDP). For 2014 the forecast for the trade balance and the current account deficits are USD 12.8 and 24.6 billion, respectively (0.9 and 1.7 percent of GDP).

Economic growth is expected to be balanced between the industrial and the services sectors, reflecting both the scenario of the moderate growth in the U.S., and the fact that no real exchange rate misalignments are anticipated. Therefore, the main indicators of slackness in the most important input markets are expected to keep suggesting the absence of aggregate-demand related pressures on prices, although it will be important to remain very alert in order to identify the existence of such pressures in a timely manner, if they happen to occur. In particular, the output gap is estimated to remain close to zero during the forecast horizon, with a slight upward trend in 2013, which, to some extent, would revert in 2014 (Chart 1b).

The forecast growth scenario is very peculiar, given that it shows the convergence of the economy to its growth potential without presenting inflationary pressures and with a fully fundable current account deficit. However, the main risks for the growth scenario of the Mexican economy are still on the downside. The following risks stand out:

i. Lower growth rates of the U.S. economy.

ii. Events in the Euro zone affecting international financial markets.

iii. A further slowdown of emerging economies.

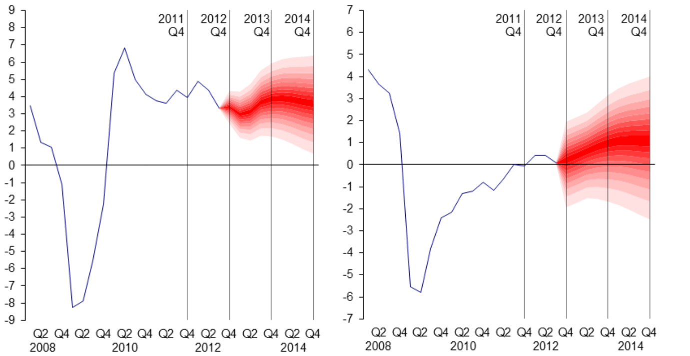
iv. In contrast to the previously mentioned risks, this one refers to the fact that the main advanced economies' central banks could begin the process of monetary policy normalization earlier than anticipated.

Nevertheless, insofar as the process of structural reforms in the country keeps advancing, the growth scenario for Mexico in the medium term could become more favorable.

Fan Charts 1

a) GDP Growth, s. a.
Annual percent

b) Output Gap [1/]
Percent



s. a. / Seasonally adjusted figures.
Source: INEGI and Banco de México.

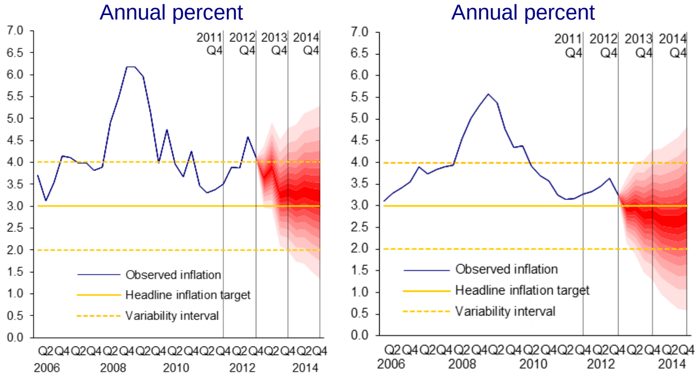
1/ Calculated based on seasonally adjusted figures.
Source: Banco de México.

Inflation: Annual headline inflation for the following two years is expected to be lower than in 2012. Particularly, annual headline inflation is estimated to lie at levels close to the 3 percent target during most of 2013 and in 2014. However, given its evolution in 2012, this variable is expected to increase temporarily by the end of the first quarter and the beginning of the second quarter of 2013. This effect is expected to partially revert in subsequent months and it is not anticipated to affect the process of inflation convergence to the 3 percent permanent target (Chart 2a). The forecast for annual core inflation remains close to 3 percent and even below that level throughout most of the reference horizon (Chart 2b).

Fan Charts 2

a) Annual Headline Inflation [1/]
Annual percent

b) Annual Core Inflation [1/]
Annual percent



1/ Quarterly average.
Source: INEGI and Banco de México.

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Source: INEGI and Banco de México.

Apart from the monetary policy stance, the forecasts of low and stable inflation for the next two years are based on the following elements: i) a global environment of weak growth; ii) absence of considerable demand pressures; iii) intensified competition in some sectors; and iv) fading of the effect that some food price shocks had on inflation.

Even in an environment in which the economy is expected to locate close to its potential, and therefore without demand-driven pressures, the following factors could have an upward impact on the mentioned forecast:

A. The possibility of increases in public goods and services' prices higher than expected, especially with regard to local public transport fares and fees for the license place endorsement. Despite this, it should be considered that so far the referred fee has been suggested solely for high-value vehicles, which means that its impact on inflation is estimated to be relatively limited.

B. Unfavorable climatic or sanitary conditions, which impact agricultural products' supply. However, if adverse conditions emerge, they would only produce a temporary effect on headline inflation, and would not affect its downward trend in the medium term, nor would they impact inflation expectations.

C. A new episode of volatility in international financial markets that could impact the evolution of the exchange rate. Nonetheless, the strength of the macroeconomic framework in Mexico and the recent evidence of a low pass-through of exchange rate variations to inflation suggest that the effect on inflation would be limited.

In contrast, a factor that would exercise a downward impact on inflation forecast is the following: insofar as the competition in the telecommunication industry intensifies and as the quality of the services it offers to the public keeps improving, the downward contribution of this group's inflation would be greater than presently estimated.

In this context, considering that the inflation increase between May and September of 2012 was primarily due to transitory shocks, that there was no evidence of generalized prices increases, that no new shocks emerged and that changes in the evolution of headline and core inflation, which had been forecast, were confirmed, Banco de México's Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate unchanged at 4.5 percent during the fourth quarter of 2012. Later in January 2013, taking into account that inflation continued its downward trend and that the economic activity kept transiting in an orderly fashion towards lower growth rates, the Board of Governors maintained the reference rate unchanged. Nevertheless, it mentioned that if this environment is consolidated, it could be advisable to adjust the referred target downwards so as to facilitate the economy's adjustment towards a situation of lower growth and lower inflation. In any event, the Board clarified that it would monitor the evolution of all inflation determinants, in order to reach the permanent 3 percent inflation target.

The possibility of a decrease in the reference rate should be analyzed taking into account the strengthening of the framework for the macroeconomic policy conduction and that the improved fundamentals have made the Mexican economy more resistant to adverse scenarios. The prudent conduction of public finances and a monetary policy focused on preserving stability of the national currency purchasing power have allowed a considerable reduction in the level, volatility and persistence of inflation. This has been essential to allow the relative price adjustments in the economy to occur without second round effects. In this sense, once the shocks that had recently affected inflation started dissipating, achievements in curbing it became more evident. This has generated an environment of greater certainty, giving rise, among other benefits, to a reduction in risk premia, in particular those associated with inflation risk, which in an international context of great monetary relaxation led to lower interest rates across all contract lengths. This in an environment in which productive activity seems to be converging to levels close to its potential, inflation to its permanent target, and the current account deficit to moderate and fundable levels.

The eventual reduction in the reference interest rate would have two main purposes. On the one hand, it would acknowledge the reduction in the inflation risk premia, which reflects medium-term achievements in controlling inflation. On the other hand, it would adjust the referred rate to the present conditions of the Mexican economy. In particular, given the environment of greater stability and the prevailing uncertainty, a measure of this kind could possibly be compatible with the convergence of inflation towards the 3 percent permanent target.

Finally, Mexico is expected to display further economic growth in the future, derived from the deepening of the process of structural reforms, which is expected to lead to a more efficient resource allocation, and therefore to increase productivity growth. This, together with the progress made in terms of curbing inflation, will allow the economy to grow at higher rates without generating inflationary pressures. It would also contribute to a greater resilience of the Mexican economy to different shocks, and will further enhance the degrees of freedom for monetary policy to maintain inflation at low and stable levels.