Inflation Report

July - September 2012

Summary

During the third quarter of 2012, economic activity in Mexico continued its expansion, although it started to show signs of deceleration given the intensified negative shock to external demand. This shock was partially mitigated by the reduction of uncertainty in international financial markets, that resulted from measures announced by financial authorities in main advanced economies, and led to a reduction in the risk premia. Additionally, various transitory supply-related shocks in Mexico brought about increases in some food prices, causing inflation to register an important rebound, exceeding the upper bound of the variability interval of plus/minus one percentage point around the 3 percent permanent inflation target for several months.

Indeed, the rate of global economic growth continued to lose dynamism during the third quarter of the year. In the Euro zone, economic activity contracted further, due to fiscal and credit adjustment processes, caused by current imbalances in different countries of the region. In turn, this contributed to a slow progress in correcting internal imbalances among the countries in the referred region. U.S. economic growth remained moderate, as a reflection of the weakening observed in various aggregate demand components. In turn, in emerging economies the growth rate continued decelerating, as a result of weak external, and, in some cases, also domestic demand. In this context, the growth prospects for this and next year have been further revised downwards for both advanced and emerging economies.

The measures announced by central banks of the main advanced economies contributed to improve conditions in international financial markets, thereby reducing risk premia. Particularly, the European Central Bank announced a new program of sovereign bond purchases, conditional on the application for support by issuing governments to the European Stability Mechanism. However, uncertainty prevails regarding the implementation of these measures. In turn, given the slow recovery of economic activity, and particularly of employment, the U.S. Federal Reserve announced the expansion of its monetary stimulus program. In emerging economies, this improvement in financial markets mainly resulted in a moderate appreciation of their currencies against the USD.

On the other hand, even though commodity prices increased during the third quarter, reflecting various supply shocks, in recent weeks these products' prices decreased as their production prospects improved. Thus, in an environment, characterized by slow growth of the world economic activity, with inflation in advanced economies remaining at very low levels, and with lower commodity prices, inflation is expected to reach moderate levels in most countries by the end of 2012 and in 2013. The above favored greater monetary policy easing in various advanced and emerging economies during the analyzed period, and many economies from both groups are expected to continue easing their monetary policy stances in the following months.

During the third quarter of 2012 economic activity in Mexico maintained an upward trend, causing the output gap to remain close to zero, as different labor market indicators continued their recovery. However, manufacturing exports and some of the domestic demand components, such as investment, became more noticeably affected by adverse world economic conditions.

Further, during the reference period, annual headline inflation increased and exceeded the upper bound of the variability interval around the established target. This evolution of inflation, in certain measure foretold in the previous Inflation Report, is primarily accounted for by price increases in agricultural and livestock products. Keeping in mind the transitory nature of shocks affecting inflation, the referred increase is expected to be temporary, although these shocks' persistence did become a reason for concern.

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

Growth of the Mexican Economy: Even though the deterioration of U.S. growth expectations could translate into a lower dynamism of external demand for Mexico, given the still relatively moderate magnitude of these expectations' adjustment, as well as the positive evolution of the Mexican economic indicators, the forecast interval for the national economy growth rate remains unchanged with respect to that detailed in the previous Inflation Report. However, given the availability of more information, the interval of the expected annual GDP growth rate of Mexico for 2012 is revised from between 3.25 to 4.25 percent in the last Inflation Report to an interval of 3.5 to 4.0 percent in the current. For 2013, as in the previous Inflation Report, Mexican economic growth is anticipated to lie between 3.0 to 4.0 percent (Chart 1a).

Employment: Considering the dynamism recently exhibited by the number of IMSS-insured workers, this indicator is expected to rise by between 600 and 700 thousand insured workers for 2012 (between 540 and 640 thousand in the previous Inflation Report). In turn, for 2013 the expectation of an increase of between 500 and 600 thousand workers in this indicator, specified in the last Inflation Report, is maintained.

Current Account: Regarding external accounts, for 2012 the trade balance is expected to be close to zero and the current account deficit to be USD 4.6 billion (0.4 percent of GDP); while for 2013, deficits of USD 7.9 and 20.7 billion are anticipated for the trade balance and the current account, respectively (0.6 and 1.6 percent of GDP). Thus, the moderate current account deficits expected for 2012 and 2013, as well as the measures taken by the Mexican government to finance its external debt liabilities, suggest that financing these deficits will not pose a problem in the forecast horizon and that there will be no pressures on the exchange rate arising from this source.

Derived from these forecasts, the output gap is anticipated to present a slight upward trend, although remaining at levels close to zero (Chart 1b). Thus, no aggregate demand-related pressures on prices are expected during the forecast horizon.

Although the Mexican economy has been relatively resilient to the adverse global economic conditions thus far, downward risks regarding the growth scenario for the Mexican economy have increased. In particular, among the prevailing factors that could induce a more unfavorable environment for the national economy, the following stand out:

i. A more pronounced weakening of the U.S. economy. This situation could result from a fiscal consolidation greater than expected by analysts for 2013.

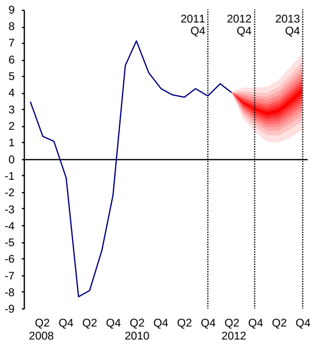
ii. Additionally, there is the risk of an environment of greater volatility and uncertainty in the international financial markets if no progress is attained in solving the fiscal and banking problems in the Euro zone. This situation could affect the U.S. economy by means of contagion of its financial system, through an adverse effect on its foreign demand, or by discouraging investment. Further, an uncertain international environment could boost investors' search for safe haven assets, reducing capital flows to other economies, such as Mexico's.

iii. In this context, the slowdown of emerging economies, like China and India, which until early 2012 partly supported world economic growth, could intensify, affecting global demand even more.

iv. Finally, the absence of structural changes and the problems of public insecurity, in addition to the problems of the global economy and international financial instability, are still factors that, according to the economic specialists surveyed by Banco de México, could hamper Mexican growth.

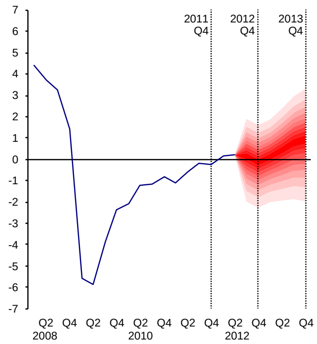
Fan Charts 1

a) GDP Growth, s. a.
Annual percent



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

b) Output Gap [1/]
Percent



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

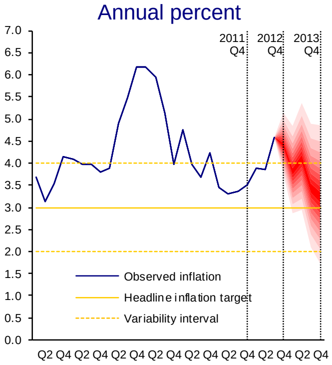
It is worth mentioning that, as opposed to the risks mentioned above, Mexico's growth scenario could be favorably affected by the implementation of structural reforms that strengthen domestic sources of growth, particularly from a microeconomic viewpoint. Thus, together with the environment of macroeconomic stability achieved by Mexico, and that is a necessary condition for its economic development, the progress in the economy's structural change could boost Mexico's economic growth, especially in the medium and long run. These reforms would also favor maintaining a low and stable inflation environment. Indeed, greater productivity would allow reaching higher growth rates of aggregate demand without generating pressures on prices. In this context, the importance of the labor reform and the amendments to the General Public Accounting Act (*Ley General de Contabilidad Gubernamental*), which are recently discussed by the Congress, is noteworthy.

Inflation: The inflation forecast does not show a significant change with respect to that in the previous Inflation Report. Annual headline inflation is expected to have changed its trend during the third quarter of 2012. Thus, it is very likely that it will locate close to 4 percent by the end of 2012 and to continue falling in 2013, lying within the interval of 3 and 4 percent (Chart 2a).

The core inflation forecast does not present important changes as compared to that of the last Inflation Report either. Thus, annual core inflation is expected to decrease further in the following months, locating close to 3 percent at the end of 2012, and to fluctuate around this level in 2013 (Chart 2b).

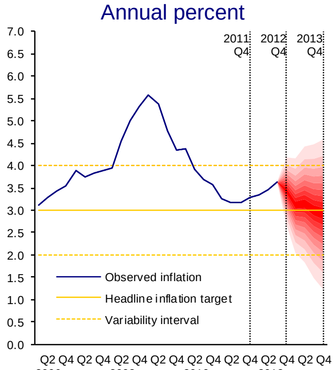
Fan Charts 2

a) Annual Headline Inflation [1/]
Annual percent



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

b) Annual Core Inflation [1/]
Annual percent



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

Besides the monetary policy stance, the downward trajectory of inflation is anticipated to be determined by the following elements:

1. A global environment of weak growth.
2. Absence of considerable demand pressures on the Mexican economy, even if the degree of slackness in the labor market has decreased.
3. Intensified competition in some sectors.
4. Fading of the effect that some food price shocks had on inflation during 2012.
5. The MXN appreciation after the announcement of a further round of monetary easing (QE3) in the U.S.

Even though inflation is estimated to have presented a change in trend in the third quarter of 2012, upward risks have markedly increased in the short term, particularly in an environment where the output gap has closed:

A. The situation that prevails in the national production of eggs due to the outbreak of the avian influenza.

B. Unfavorable climatic conditions in North America that affected international grain prices and, thus, meat product prices.

C. The possibility that agricultural and livestock product prices increase further due to production disruptions.

D. The possibility that prices and/or fares of public goods and services increase more than has been foreseen.

E. The return of volatility in international financial markets that cannot be ruled out.

F. Derived from the fact that inflation has remained at high levels during various months, the risk of observing a widespread contamination of the wage setting process in the economy. The main concern is that the elevation of inflation above the upper bound of the variability interval is a topic that received more public attention.

Given that the increase in inflation in the last months was mainly due to shocks that should prove to be transitory, and that there is so far no evidence of a process of generalized price increases, Banco de México's Board of Governors decided to maintain the target Overnight Interbank Interest Rate unchanged during the period analyzed in this Inflation Report. However, if shocks to inflation persist, even if presumed to be transitory, and if the changes in the trend of headline and core inflation are not confirmed, the Board estimates that it would be appropriate to adjust the reference rate upwards shortly thereafter, in order to consolidate the anchoring of inflation expectations, in order to prevent the contamination of the rest of the price formation process in the national economy and to avoid jeopardizing the convergence of inflation to the 3 percent permanent target.