Inflation Report

April - June 2012

Summary

Global economic growth slowed down during the second quarter of the year, mainly driven by the problems in the Euro zone, the U.S. recovery more modest than anticipated, and a greater than expected slowdown in major emerging economies, except for Mexico. This deterioration of the external environment affected the Mexican economy by means of two shocks: lower external demand and an increased risk premia associated with periods of great uncertainty in international financial markets.

The first shock relates to a U.S. GDP growth rate that was lower than expected by economic analysts, predominantly resulting from a less dynamic industrial production in recent months, weakness of the main aggregate demand components and the fact that employment recovery lost momentum. As to the second shock, growing uncertainty about the Euro zone problems led to an increase in risk premia during the reference quarter, especially in Spain where, despite the announcement of different measures aimed at tackling its problems, the referred premia have not decreased significantly. However, as a result of the steps taken by European authorities to strengthen financial and fiscal integration in the Euro zone, this uncertainty has partially reverted in recent weeks. Although these measures provided a temporary relief to financial markets, great uncertainty prevails regarding their implementation and effectiveness, such that a catastrophic event in Europe cannot be ruled out yet.

This environment of less dynamic economic activity and greater uncertainty in international financial markets had important effects on emerging economies. Even though their economic performance compares favorably to that of advanced economies, a substantial number of these decelerated significantly, China, India and Brazil among them. Additionally, capital flows towards emerging economies became more volatile, as reflected in their financial markets. Given greater risk aversion, currencies depreciated in most of these economies.

Growing concern regarding the world growth prospects was also reflected in a considerable reduction in international commodity prices, with the exception of some grains due to climatic reasons, during the second quarter of 2012. In this regard the drop in energy prices is noteworthy.

In line with the slowdown of the world economic growth and the concomitant decline in main international commodity prices, lower inflation levels in 2012 and 2013 as compared to 2011 are anticipated in most countries, with very low levels in the case of advanced economies. Hence, in these economies and in a great number of emerging ones a monetary policy easing has taken place, reaching an unprecedented level of lassitude. It is even likely that in various advanced and emerging economies still more accommodative monetary stances are adopted.

The solid fundamentals of the Mexican economy have contributed to its favorable evolution in the second quarter of 2012, despite the deterioration of the external environment. Economic activity in Mexico continued its positive trend, reflecting a dynamic expansion of the external sector and a persistent growth of domestic spending.

During the second quarter of 2012, average annual headline inflation was practically the same as in the previous quarter, locating in both quarters below the upper bound of the variability interval of plus/minus one percentage point around the 3 percent target. However, in June annual headline inflation rose and exceeded the referred bound. This was mainly a result of changes in the relative price of a reduced number of agricultural products, whose production was affected by climatic factors, rather than a result of a widespread phenomenon of price increases of the CPI basket. Therefore, the increase in inflation is expected to be transitory. It stands out that so far no second round effects, derived from changes in relative prices registered in the economy, have been observed in the price formation process.

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

Growth of the Mexican Economy: Taking into account the recent evolution of the Mexican economic indicators, as well as the growth expectations for U.S. industrial production, the forecast for the GDP growth rate in Mexico for 2012 and 2013 remains unchanged with respect to that in the previous Inflation Report. Thus, for 2012 annual GDP growth rate in Mexico is expected to lie between 3.25 and 4.25 percent, while for 2013 the growth rate of the Mexican economy is forecast to be between 3.0 and 4.0 percent (Graph 1a). However, the balance of risks associated to this scenario is believed to have deteriorated.

Employment: The expectations regarding the number of IMSS-insured workers in 2012 and 2013 also remain unchanged as compared to the previous Inflation Report. Particularly, an increase of between 540 and 640 thousand persons is expected for 2012, and of between 500 and 600 thousand persons, for 2013.

Current Account: For 2012, deficits of USD 3.1 billion for the trade balance (0.3 percent of GDP) and of USD 10.5 billion for the current account (0.9 percent of GDP) are estimated. The moderate current account deficit expected for 2012, together with the measures taken by the Mexican federal government to finance its external debt liabilities for this year, suggest that financing these deficits will not pose a problem and that there will be no pressures on the exchange rate arising from this source during the reference period. For 2013, deficits of USD 7.5 billion and USD 18.0 billion are expected for the trade balance and the current account, respectively. In terms of GDP, these figures correspond to 0.6 and 1.4 percent, in the same order.

Given the moderate growth forecast for the Mexican economy, the output gap is anticipated to remain at levels close to zero, although with a slight upward trend (Graph 1b). In this way, no aggregate demand-related pressures on inflation are expected in the forecast horizon. Indeed, no pressures are perceived either on prices in the input markets, both labor and credit, or on the external accounts.

Even though the Mexican economy remained resilient to the current international environment, adverse global economic conditions led to a deterioration of the balance of risks of the Mexican economy as compared to the previous Inflation Report. In particular, the difficulties to definitely solve the problems in the Euro zone increased uncertainty and volatility in financial markets, with U.S. fiscal adjustment remaining undefined and economic activity in the main emerging economies having decelerated. This situation worsened world growth expectations. In this sense, the following downward risks persist:

i. A weaker evolution of the U.S. economy, which would generate a less favorable environment for economic growth in Mexico.

ii. Growth of the U.S., just like of other economies, could deteriorate as a consequence of a further increase in uncertainty and financial volatility derived from the fiscal and financial difficulties in the Euro zone.

iii. The situation in Europe, which could boost investors' search for safe haven assets, limiting capital flows to economies like the Mexican.

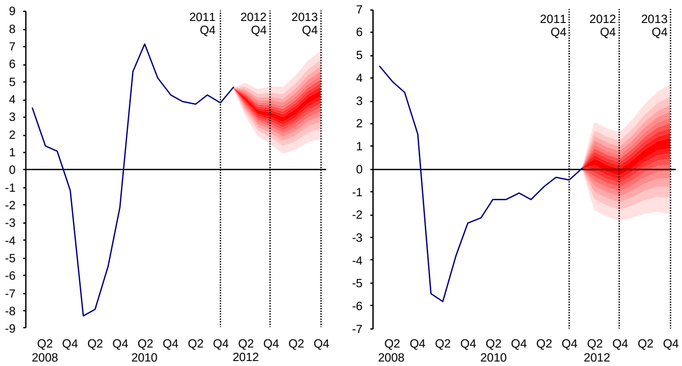
iv. The slowdown of emerging economies, like China, India and Brazil, which just until recently supported part of the world economic growth, could further reduce global demand.

v. According to economic specialists surveyed by Banco de México, public insecurity and absence of structural changes are still factors that could hamper Mexican growth.

Fan Charts 1

a) Output Growth, s. a.
Annual percent

b) Output Gap [1/]
Percent



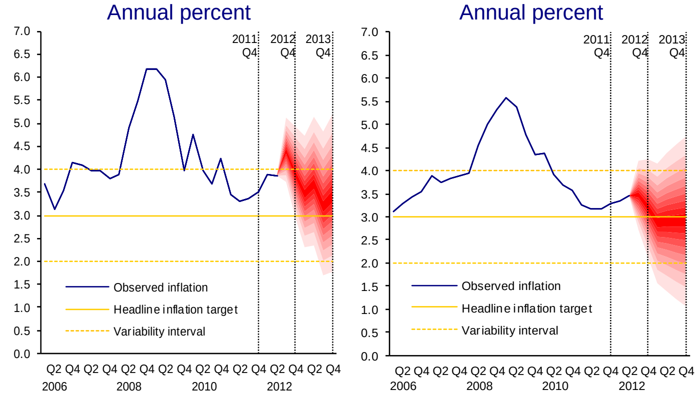
s. a. / Seasonally adjusted figures.
Source: INEGI and Banco de México.

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

Fan Charts 2

a) Annual Headline Inflation
Annual percent

b) Annual Core Inflation
Annual percent



Source: INEGI and Banco de México.

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Inflation: The inflation forecast for the rest of 2012 and 2013 is in line with the convergence process of inflation towards the 3 percent permanent target. This is mainly the result of a monetary policy aimed at pursuing this objective. Thus, in the mentioned horizon, annual headline inflation will most likely be between 3 and 4 percent (Graph 2a). However, the expected behavior of the non-core component is estimated to be likely affected by some vegetable price quotes, as well as by the detection of the avian influenza in some farms in Jalisco (thus limiting the production of eggs). As a consequence of the referred behavior, the described forecast for annual headline inflation does not include the third quarter of 2012, in which it is possible to locate above the upper bound of the mentioned interval.

Annual core inflation is anticipated to approach 3 percent by the end of 2012, and to fluctuate around this level in 2013 (Graph 2b). Its average is estimated to be lower in 2013, given that the effects associated with the price increases in some food items driven by higher international grain prices are expected to vanish that year.

In addition to the monetary policy stance, the foreseen environment of low inflation will be influenced by four main factors. First, relatively weak global growth, a forecast which became more pronounced throughout 2012. Second, even though labor market slackness has gradually narrowed, no considerable demand pressures on the Mexican economy are expected. Third, intensified competition in some sectors, such as the telecommunication industry. Fourth, vanishing of disturbances associated with the surge in commodity prices during the first part of 2011.

The risks to the inflation forecast changed during the last quarter. Among the upward risks, the following must be highlighted:

- In the short term, climatic conditions, which have been unfavorable for the production of some vegetables, and the effect of the avian influenza on livestock production in Mexico. Downward revisions of global production estimates for corn and other grains are also a matter of concern.
- The possibility of increased instability in financial markets that could induce exchange rate volatility.

In turn, among the downward risks are:

- In the medium term, both external and domestic demand that have further weakened.
- The recent exchange rate appreciation that could contribute to reducing inflation pressures.

Banco de México's Board of Governors considers the present monetary policy stance as congruent with the convergence process of inflation to the 3 percent permanent target. Nevertheless, it is noteworthy that the Board will remain very attentive in order to take action in a timely manner, to restrict or to relax the monetary policy stance as necessary given the circumstances. Special attention will be paid to relative price changes, deriving from both agricultural products and exchange rate fluctuations, in order to prevent second round effects on inflation dynamics. Even though inflation is expected to be above 4 percent in the short term, the fact that the Central Institute has not modified the monetary policy stance during the period analyzed in this Inflation Report should not be interpreted as a sign of indifference regarding an inflation increase. The shift of inflation above 4 percent is due to transitory and reversible factors, so it is expected to return to levels below 4 percent in a couple of months and, thus, to continue its convergence process to the 3 percent permanent target. Therefore, restricting the monetary policy stance has not been regarded as convenient.

Finally, it must be pointed out that the solid macroeconomic fundamentals of the Mexican economy have been defining factors in keeping up a sustainable growth pace, even in an adverse international environment. However, these fundamentals are a necessary, but not sufficient, condition to attain the growth rate Mexico requires to reach significantly higher development levels. For that, it is indispensable to bring forward structural reforms that promote flexibility in the country's resource allocation towards their most productive uses, that increase market competition and that ensure an incentive structure leading to increased productivity. It is important to enhance the institutional framework in order to provide legal security and certainty for economic agents, to reduce transaction costs and to stimulate more productive investment. Similarly, it is essential to promote a more flexible labor market, shifting labor to its most productive uses, facilitating the adjustment of firms and workers to new production cycles and favoring job creation. Additionally, it is necessary to encourage reforms that increase human capital and boost labor productivity and employment quality. Besides increasing the welfare of the population and economic growth, these reforms would help to maintain an environment of low and stable inflation, since increased market competition would lead to lower prices, and higher productivity would allow satisfying higher growth rates of aggregate demand without generating pressures on prices.