Inflation Report

January - March 2013

Summary

The growth prospects for the global economy stabilized in the first quarter of 2013, as a result of the implementation of measures designed by the authorities of the main advanced economies to support the economic recovery and the functioning of financial markets. Nonetheless, world economic activity keeps showing signs of weakness, with significant differences among regions, and it is still dependent on the monetary and fiscal stimuli in advanced economies. Therefore, a risk of an extended period of slow growth persists and, albeit the probability an event of systemic consequences has reduced, it has not vanished altogether. Besides, new volatility episodes in international financial markets cannot be ruled out.

In the U.S., various indicators of economic activity improved more than anticipated in the first months of 2013. However, recently some of them point to a weaker economic recovery pace. In the Euro zone, the necessary efforts of fiscal consolidation, the fragility of the banking system and the ongoing deleveraging process, particularly in the economies of the periphery, have kept the region in recession. In Japan, the economic activity growth outlook improved in the short term given the announcement of further fiscal and monetary stimulus. Emerging economies' growth moderated in response to a lower dynamism of economic activity in advanced countries.

International commodity prices continued their downward trend in the first months of 2013. This, together with an environment of low growth, was reflected in the moderate inflation levels in the major advanced and most of the emerging economies. In this environment, the monetary policy stance remained expansive in most economies and in some cases it became even looser.

The measures adopted by the authorities of the main advanced economies to strengthen the economic recovery favored a gradual improvement in international financial markets in the first months of the year. The sovereign bond spreads in the countries at the periphery of the Euro zone diminished and the conditions of access to the interbank market of the region's banks improved. Still, certain volatility persisted given the difficulties to solve the fiscal and financial problems in different economies of the region and to further advance in the implementation of the required structural reforms, as well as given the uncertainty caused by political events in some countries.

In the period analyzed in this Report, capital flows to emerging countries increased, although with a certain volatility, largely as a result of the more accommodative monetary policies in the main advanced economies. In this environment, some emerging countries' exchange rates appreciated in the first months of the year. Given that Mexico is an economy highly integrated in terms of trade and finances with the world economy, particularly with the U.S., this situation was reflected in the national financial markets, through a considerable appreciation of the Mexican peso and a fall of the market interest rates to their historical minimum.

In the first quarter of 2013 the expansion rate of the Mexican economy continued showing moderation, a tendency which had been observed since the second half of 2012. Particularly, the external demand and some consumption indicators continue to show signs of weakness.

In the period from the fourth quarter of 2012 to the first one of 2013, the average annual headline and core inflations decreased. In fact, core inflation located below 3 percent. However, by the end of the first quarter of 2013 and the beginning of the second one, there was a considerable uptick in annual headline inflation, following a significant increase in non-core inflation. This shock was due to comparison base effects in the CPI, which had been anticipated by Banco de México, as well as by clearly identified supply shocks which affected the relative prices of a small set of goods pertaining to the non-core CPI basket, reason for which it is expected to be temporary.

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

Growth of the Mexican Economy: The forecast intervals for the Mexican GDP growth remain unchanged with respect to the previous Inflation Report. Specifically, for 2013 the GDP growth rate is estimated to lie between 3.0 and 4.0 percent. Additionally, in line with a higher growth anticipated for the U.S. economy in 2014 as compared to 2013, Mexican GDP growth rate is expected to lie between 3.2 and 4.2 percent (Chart 1a). It should be noted that both in 2013 and 2014 the economic growth rate could be higher than expected, depending on the structural reforms approved and implemented in Mexico. Their effect was not considered in the forecasts.

Employment: In line with the growth expectations of economic activity in Mexico, the forecasts for the increase in the number of IMSS-insured workers remain unchanged with respect to the previous Inflation Report. In particular, an increase of between 550 to 650 thousand insured workers and of between 700 to 800 thousand workers are expected for 2013 and 2014, respectively.

Current Account: Regarding the external accounts, the expected deficits for 2013 in the trade balance and the current account amount to USD 5.0 and 17.4 billion, respectively (0.4 and 1.3 percent of GDP). For 2014, the deficits in the trade balance and the current account of USD 7.9 and 20.1 billion, respectively, are estimated for 2014 (0.5 and 1.4 percent of GDP). It is noteworthy that the expected moderate current account deficits, as well as measures taken by the Mexican federal 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.

Given these forecasts for the Mexican economy, no aggregate demand-related pressures on inflation are anticipated and the current account deficit is expected to be easily financed. Indeed, no demand-related pressures on the main production input markets are expected and the output gap is forecast to observe an upward trend, albeit still at levels not statistically different from zero, over the forecast horizon (Chart 1b). It should be noted that the estimation of the output gap is subject to a certain degree of statistical uncertainty, which could become larger in a context in which the potential GDP could be changing due to the implementation of structural reforms.

Even though financial markets observed certain improvement and the U.S. growth expectations stabilized, important downward risks to the Mexican economic growth persist. In particular:

i. A less favorable evolution of the U.S. economy.

ii. Given that the fiscal and financial problems in the Euro zone persist, a possibility that events originated in the region could generate adverse effects on the conditions in international financial markets prevails.

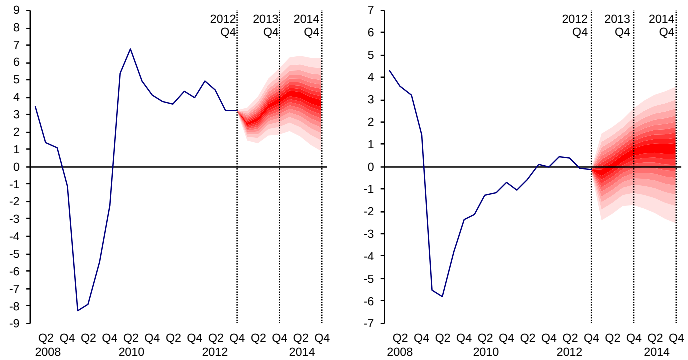
iii. The possibility of a monetary stimulus withdrawal in the U.S., and perhaps in other advanced countries, sooner than anticipated, could generate disruptions in international financial markets. Even though it is not expected to occur in the short run, such a situation would entail a risk of a reversal of capital flows in emerging countries. It should be pointed that the measures announced by the Bank of Japan partially mitigate this risk.

In contrast, insofar as the process of structural reforms continues, the growth scenario of the Mexican economy could become even more favorable than that considered in the described forecast. In this respect, the ongoing reform program is encouraging. If the reforms are able to generate a better resource allocation, then they could generate higher sustained growth, while at the same time strengthening the environment of low and stable inflation.

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/ Based on seasonally adjusted figures.
Source: Banco de México.

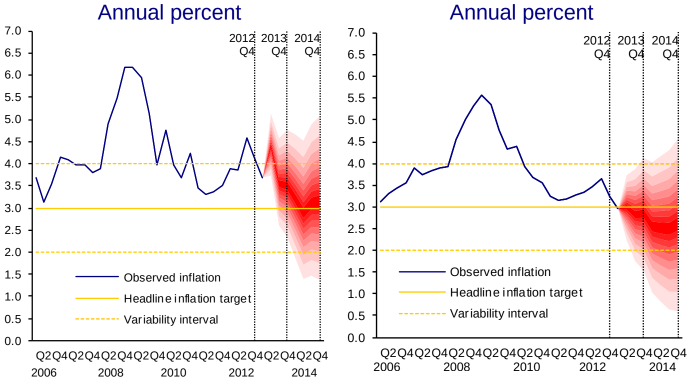
Inflation: The annual headline inflation forecast displays a similar trend to the previous Inflation Report. However, given the changes in the relative prices described in this Inflation Report, it is expected to remain high through April and May, resuming a downward trend from June onwards. Thus, in the third and fourth quarters of 2013 this variable is estimated to lie between 3 and 4 percent. As a result, average annual headline inflation forecast for 2013 is higher than what was anticipated in the last Inflation Report. Nevertheless, it should be pointed out that the monetary conditions prevailing in the economy are not conducive to the second round effects derived from the recent changes in the relative prices and are in line with the medium-term downward trend of inflation. For 2014 annual headline inflation is anticipated to lie very close to 3 percent, at levels slightly below those estimated in the previous Inflation Report (Chart 2a).

The forecasts indicate an inflation trend congruent with the convergence towards the 3 percent target over the next two years. As mentioned before, the conditions prevailing in input, services and credit markets have contributed to maintaining the inflation expectations stable. Likewise, they have contributed to the fact that the supply-related shocks, which recently led to a temporary rebound of annual headline inflation, do not generate the second round effects that impact the price formation process of the economy. Besides, it should be pointed out that headline inflation is expected to locate close to 3 percent in the monetary policy horizon.

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.

Annual core inflation is expected to be slightly below the trend announced in the last Inflation Report. It stands out that in 2013 and 2014 it will remain close to 3 percent and even below this level over most of the referred horizon (Chart 2b). This was particularly caused by a lower than expected contribution of the merchandise price subindex and the moderate growth pace of the services prices. The anticipated evolution of these subindices' annual inflation is affected by various factors, among which stand out the following: the forecast of a downward trend in commodity prices, the fading of the shocks that affected the food services' prices, as well as a forecast of low growth rates in housing and telecommunication services' prices.

The non-core inflation is expected to display a downward trajectory in the rest of 2013 and 2014. Particularly, the annual change of the non-core subindex is anticipated to continue falling from June 2013 onwards, once the growth rate of agricultural goods' prices slows down. At the same time, in 2014 the downward trend will become more noticeable, when the production of different livestock products, affected by sanitary problems, input costs and adverse weather conditions in 2012 and early 2013, recover.

In sum, the inflation forecast is based on the following factors: i) the monetary policy stance; ii) the world environment of weak growth; iii) absence of demand-related pressures on the Mexican economy; iv) more intense competition in certain sectors; v) a downward trend in international commodity prices; and, vi) fading of the shocks related to some food price increases on inflation.

The expected inflation trend could be affected by some factors. Among those with an upward impact the following stand out:

1. Even when the public transport fares have recently been revised in some entities with a high CPI weight, other entities could increase their fares.
2. The Mexican government has adopted stronger measures to prevent the spread of the avian flu virus, which affected egg and chicken production in recent months. However, new sanitary contingencies or adverse weather conditions could take place, affecting agricultural production.

On the other hand, among the downward risks associated to the inflation forecast the following should be mentioned:

1. In an environment of weak global growth, the expected downward trend in commodity prices could become more pronounced.
2. The possibility of stronger competition in the economy in general and in the telecommunications sector in particular, in light of the proposed reforms.

Finally, it should be noted that a solid institutional framework, congruent with the macroeconomic policy conduction has allowed the creation of an environment of stability and certainty in the Mexican economy, in which a structural progress in curbing inflation stands out. In this way, a monetary policy oriented at ensuring stability of the national currency purchasing power, together with a prudent fiscal policy, a flexible exchange rate regime and a sound and well-capitalized financial system, have contributed to reducing the level, volatility and persistence of inflation. Likewise, the anchoring of analysts' inflation expectations has been consolidated, although they still remain above the 3 percent target. Besides, a considerable reduction in the risk premia, mainly inflationary, has been observed, which led to lower interest rates in the Mexican economy. In this context, after reducing by 50 basis points the target for the benchmark interest rate in March, the Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate unchanged at 4 percent in its monetary policy decision in April. The Board estimates the monetary policy stance to be congruent with the outlook in which no widespread pressures on inflation are anticipated and in which the expenditure dynamics are expected to be in line with the inflation convergence to the 3 percent permanent target. In the future, the Board will monitor the evolution of all inflation determinants. Particularly, it will remain alert so that the recent changes in relative prices do not generate the second round effects on the price formation process in the economy, and will monitor the evolution of the monetary policy of Mexico relative to other economies. All of the above, in order to take action if required, so as to reach the inflation target.