



Inflation Report

July–September 2012

November 7, 2012



BANCO DE MÉXICO

Outline

1 External Conditions

2 Economic Activity in Mexico

3 Monetary Policy and Inflation
Determinants

4 Forecasts and Balance of Risks

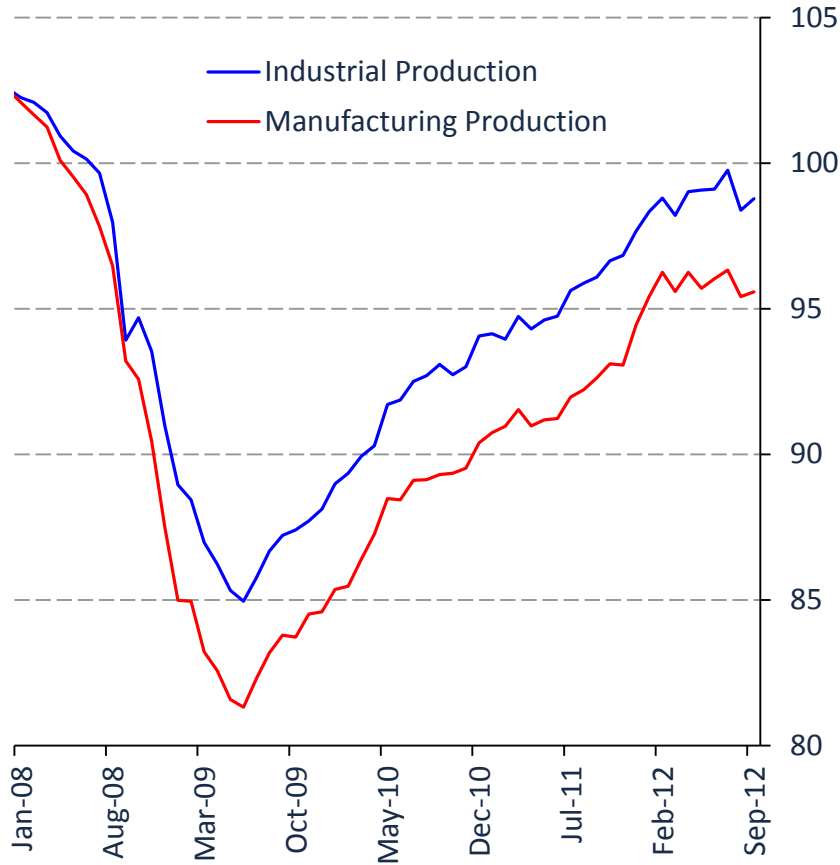
External Conditions

- The growth rate of the world economy kept losing its dynamism:
 - ✓ *In the U.S., economic growth remained moderate.*
 - ✓ *In the Euro Zone, economic activity is expected to have contracted further.*
 - ✓ *In emerging countries, economic growth continued decelerating.*
- In an environment characterized by weak growth of the world economic activity and lower commodity prices, the following is anticipated in most economies:
 - ✓ *Inflation is expected to moderate by the end of 2012 and in 2013.*
 - ✓ *Further monetary policy easing is anticipated.*

In the U.S., industrial production has lost dynamism and employment recovery has not consolidated.

U.S.: Industrial and Manufacturing Production

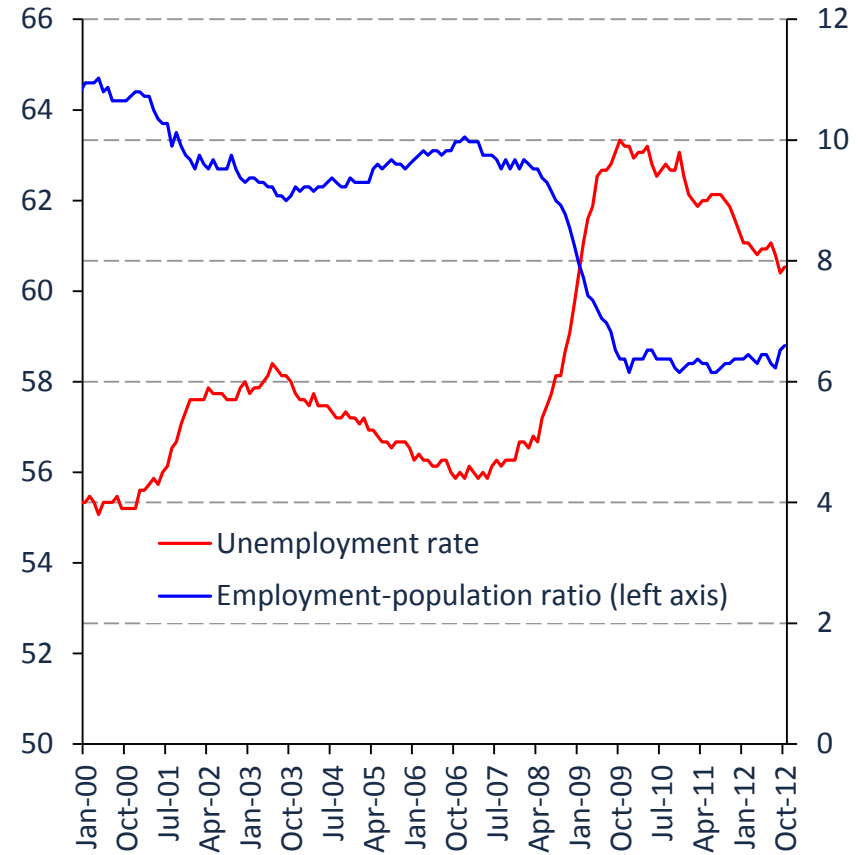
Index Jan-2007=100; s.a.



s.a./ Seasonally adjusted.
Source: U.S. Federal Reserve.

U.S.: Unemployment Rate and Employment-Population Ratio

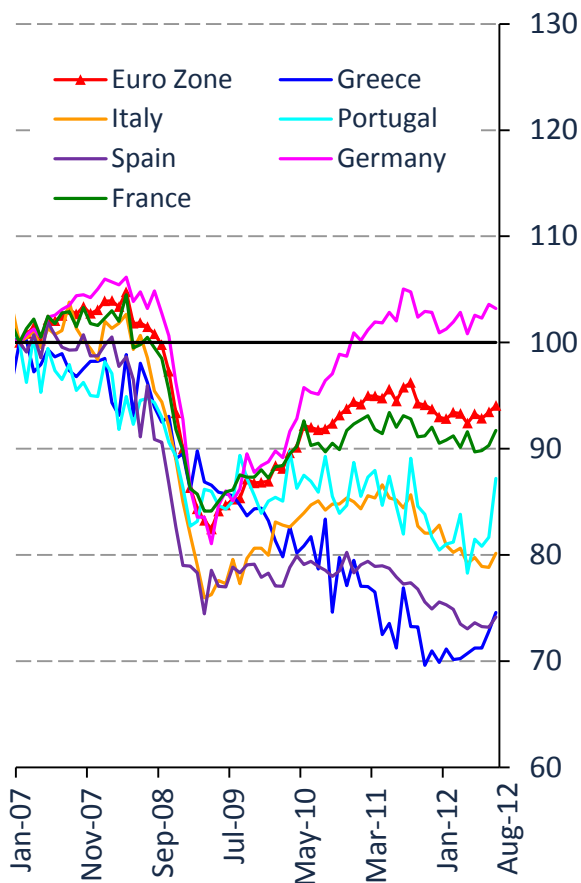
%; s.a.



s.a./ Seasonally adjusted.
Source: Bureau of Labor Statistics (BLS).

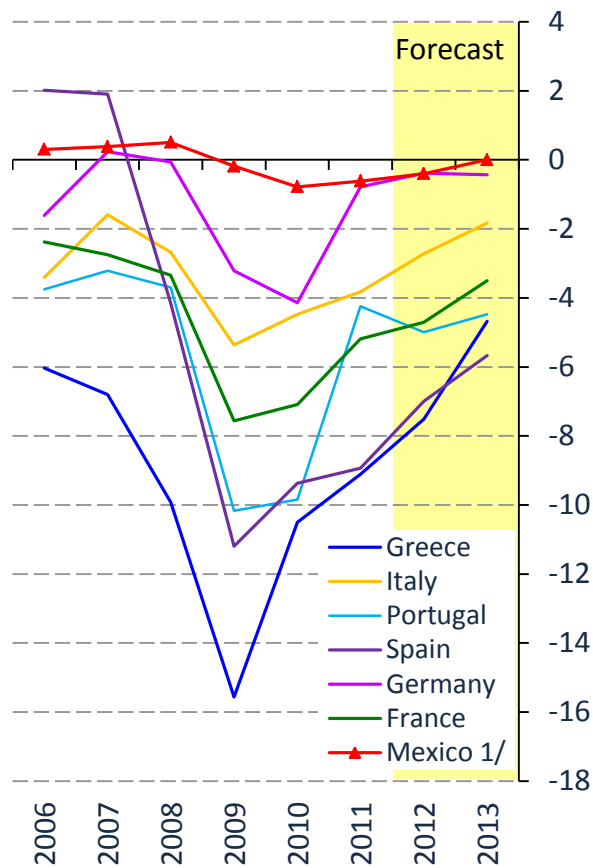
In the Euro zone, fiscal and credit adjustments continued negatively affecting economic activity.

**Euro Zone:
Industrial Production**
Index Jan-2007=100; s.a.



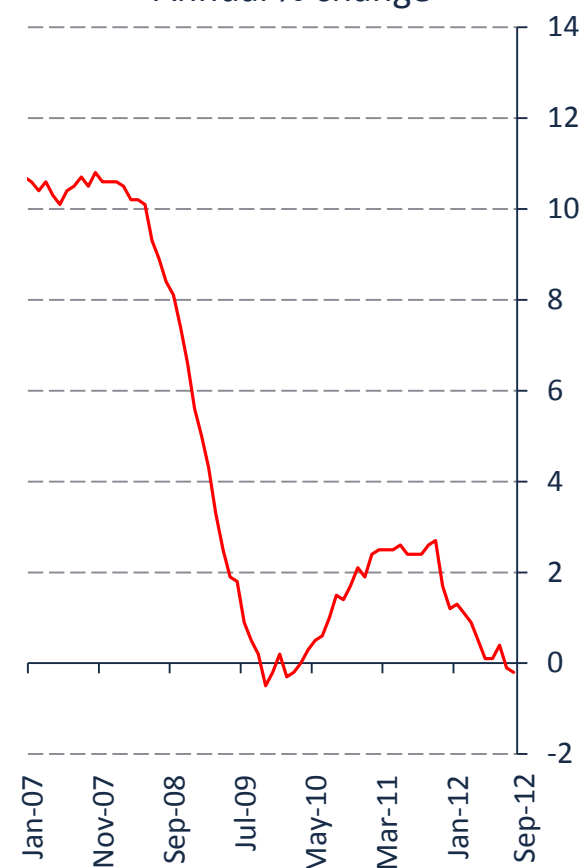
s.a./ Seasonally adjusted.
Source: Eurostat.

Euro Zone: Public Balance
% of GDP



1/ Public Balance without Pemex investment.
Source: Fiscal Monitor (IMF) and Mexico's Ministry of Finance (SHCP).

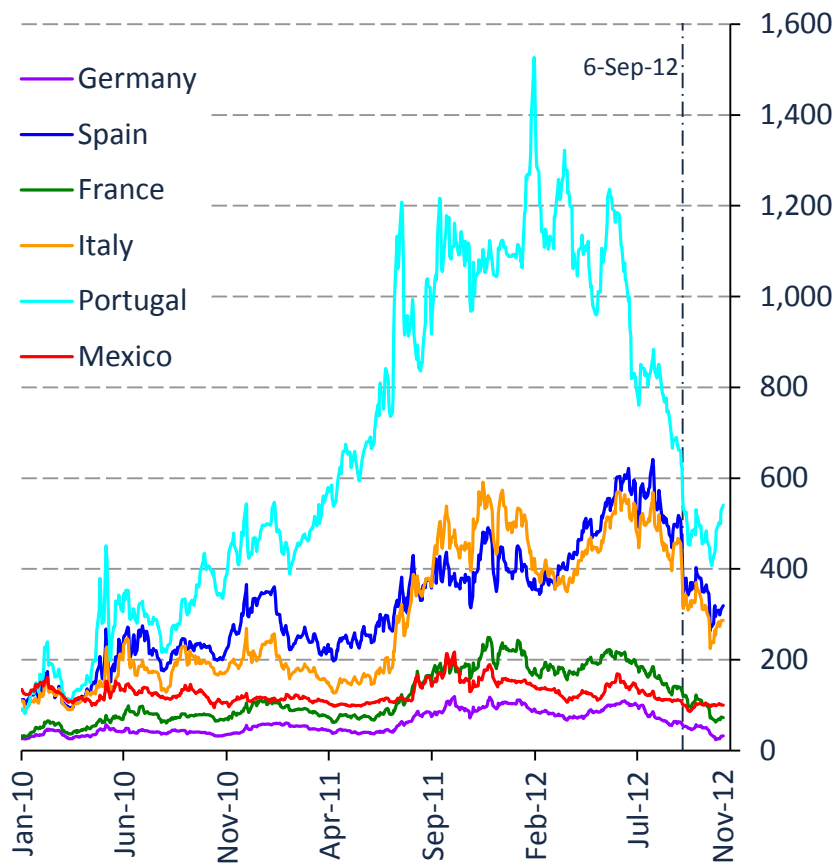
Euro Zone: Credit of Financial Institutions to Private Sector
Annual % change



Source: European Central Bank.

Measures announced by financial authorities in main advanced economies contributed to improved conditions in international financial markets.

Credit Default Swaps ^{1/}
Basis points



1/ 5-year CDS. On September 6, the European Central Bank announced its new program of sovereign bond buying.
Source: Bloomberg.

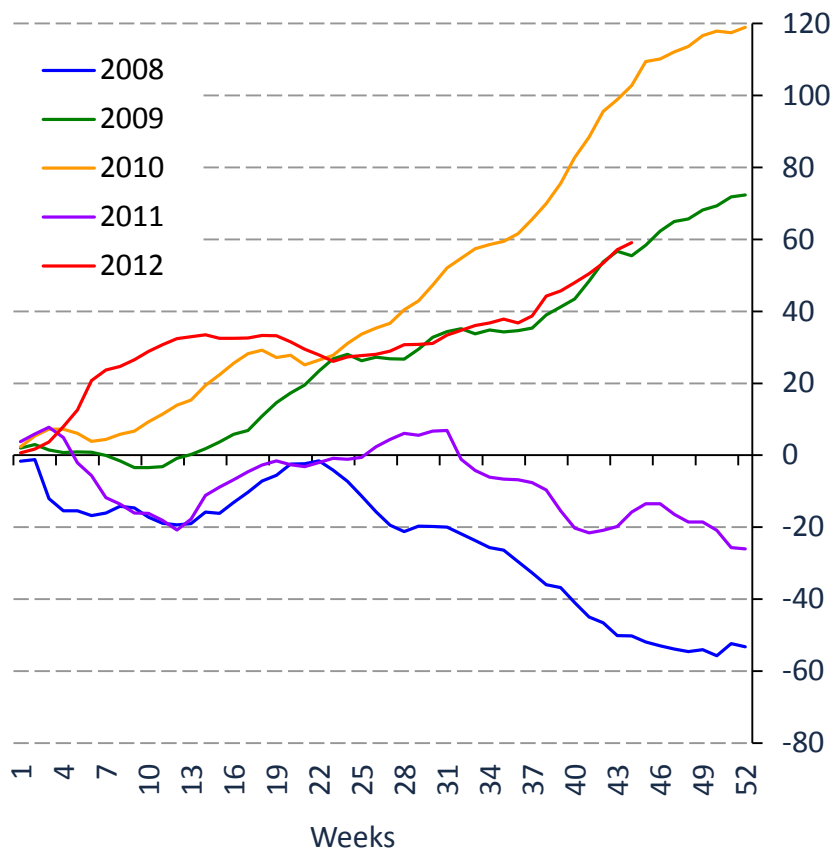
3-month Libor-OIS and Euribor-EONIA Spread ^{2/}
Spread in basis points



2/ For United States it refers to the 3-month Libor-OIS spread, and for the euro area it refers to the 3-month Euribor-EONIA spread. On September 6, the European Central Bank announced its new program of sovereign bond buying.
Source: Bloomberg.

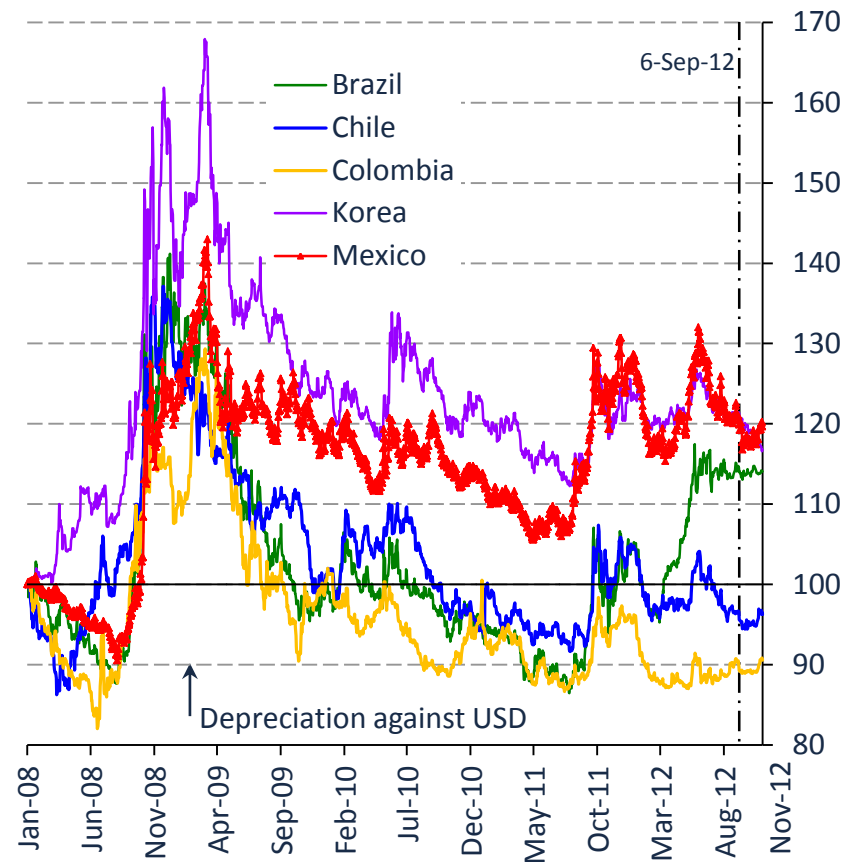
Improved international financial conditions contributed to a rebound in capital flows towards emerging markets.

Emerging Economies: Accumulated Capital Flows (Debt and Equity)
Billions of dollars



Source: Emerging Portfolio Fund Research.

Emerging Economies: Exchange Rate ^{1/}
Index 1-Jan-2008=100

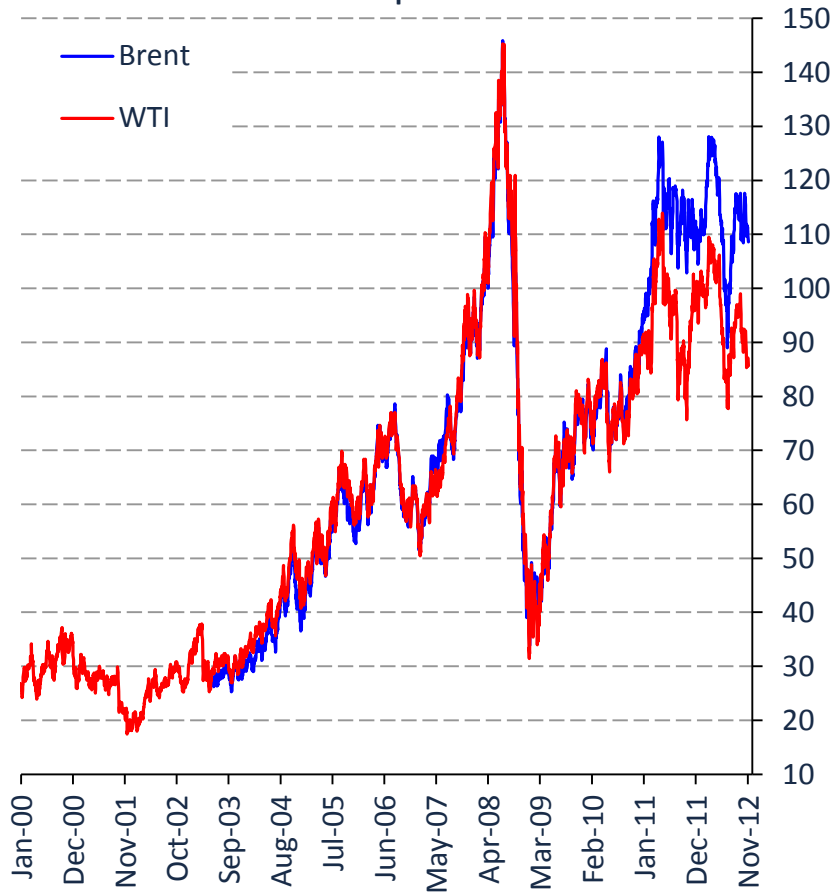


1/ On September 6, the European Central Bank announced its new program of sovereign bond buying.

Source: Bloomberg.

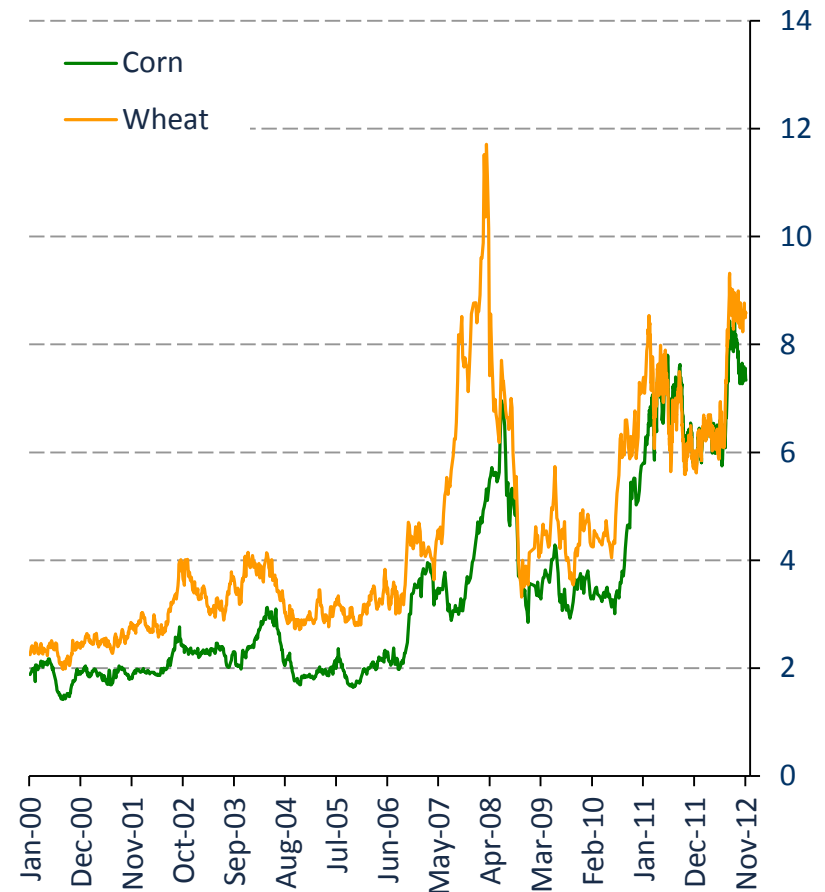
The deterioration of global growth prospects, together with better production outlook, suggest lower commodity prices.

International Price of Crude Oil Dollars per barrel



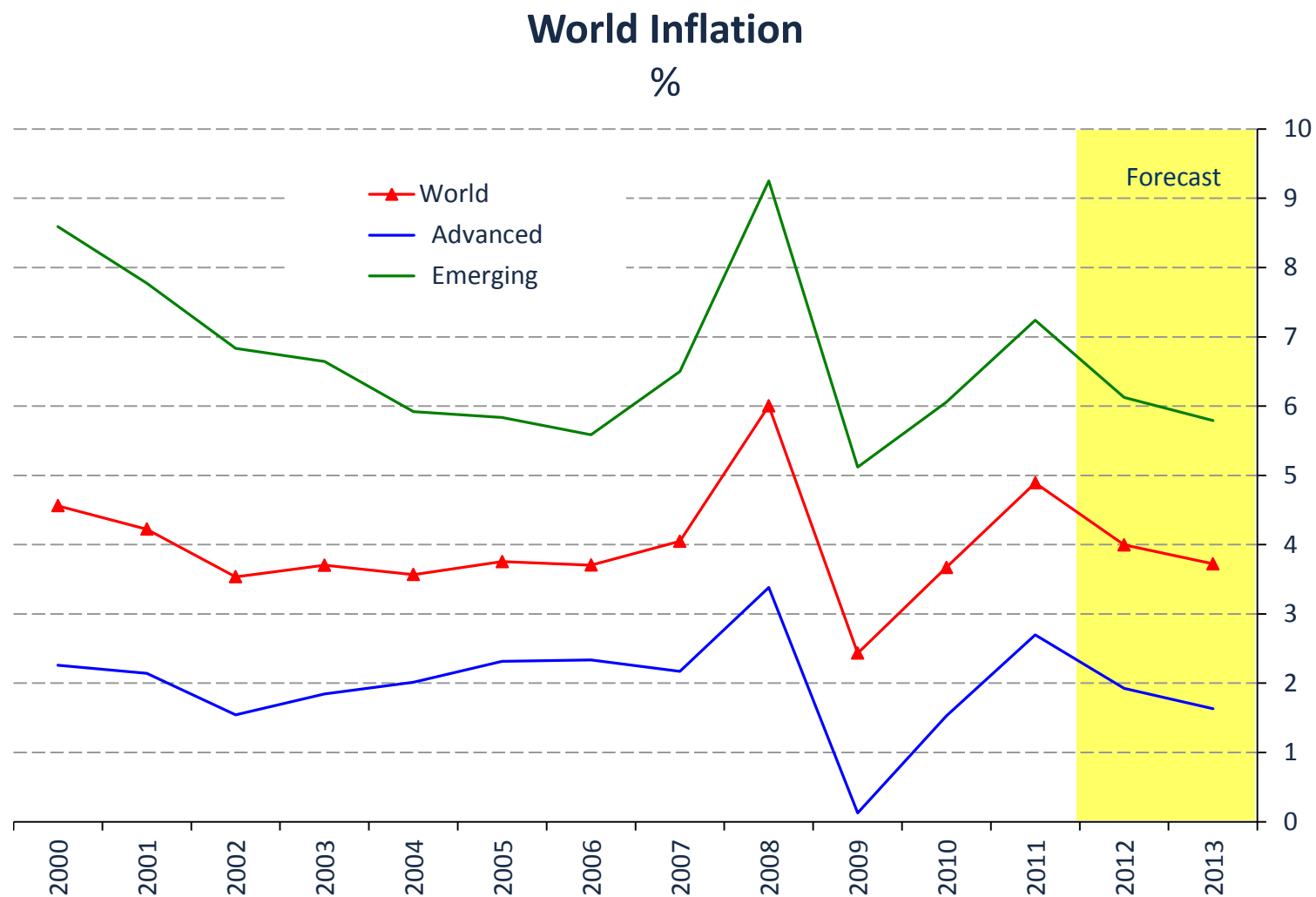
Source: Bloomberg.

International Price of Grains Dollars per bushel



Source: Bloomberg.

Inflation in 2012 and 2013 is expected to be lower than in 2011 in most countries.



Source: International Monetary Fund.

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2 Economic Activity in Mexico

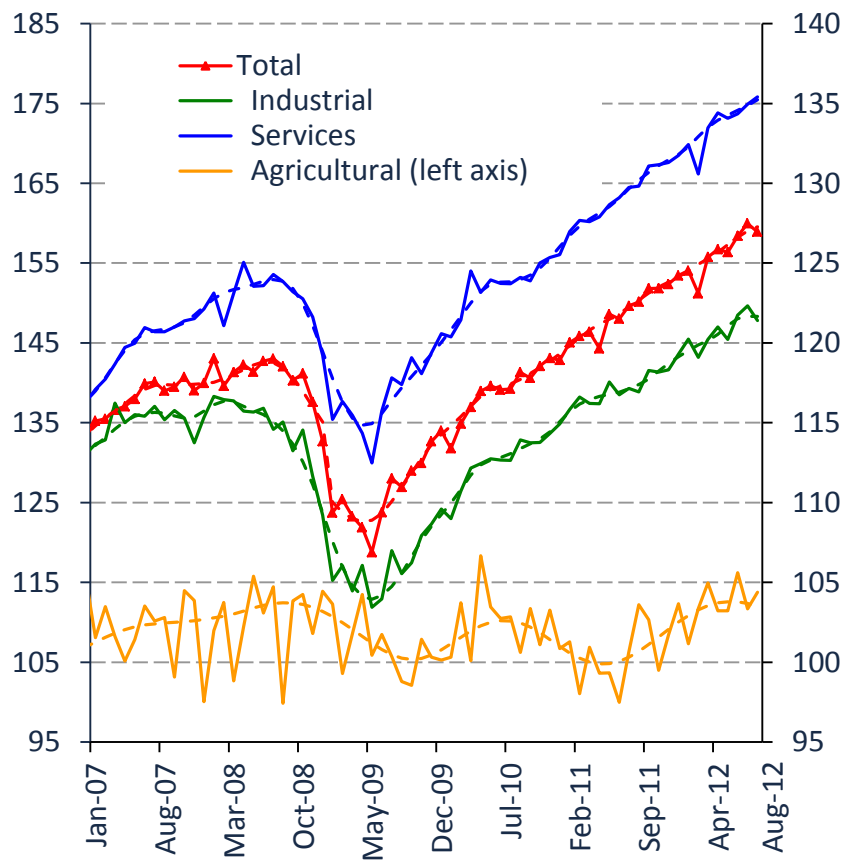
3 Monetary Policy and Inflation
Determinants

4 Forecasts and Balance of Risks

During the third quarter of 2012 economic activity in Mexico kept expanding, although it started showing signs of slowdown.

Global Indicator of Economic Activity (IGAE)

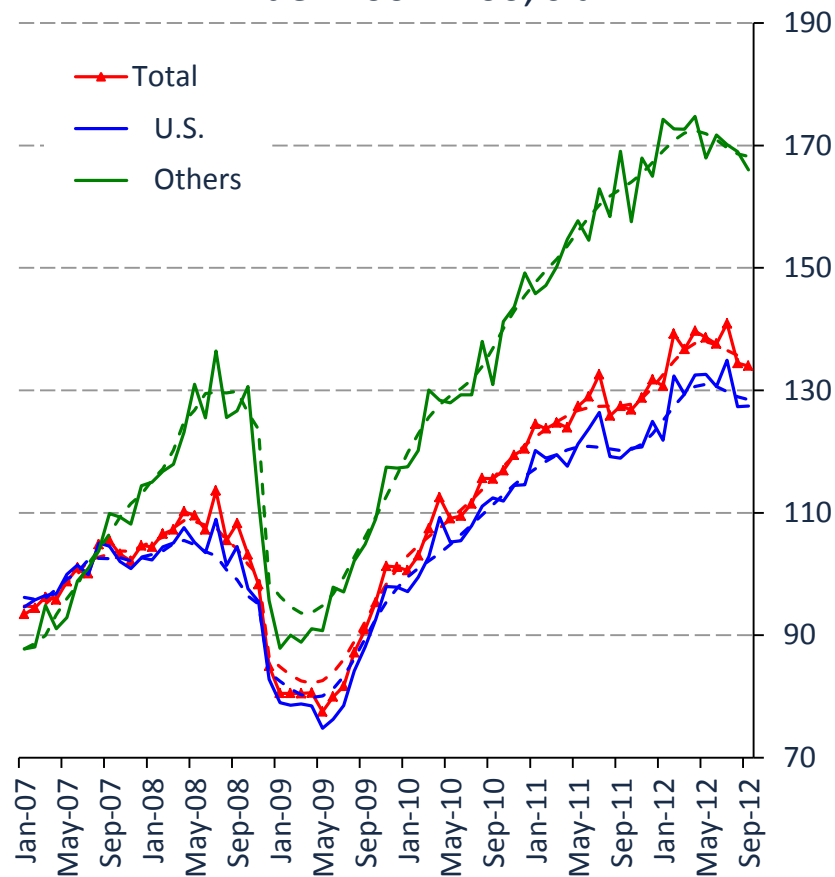
Index 2003=100; s.a.



s.a./ Seasonally adjusted and trend data.
Source: INEGI.

Manufacturing Exports by Region of Destination

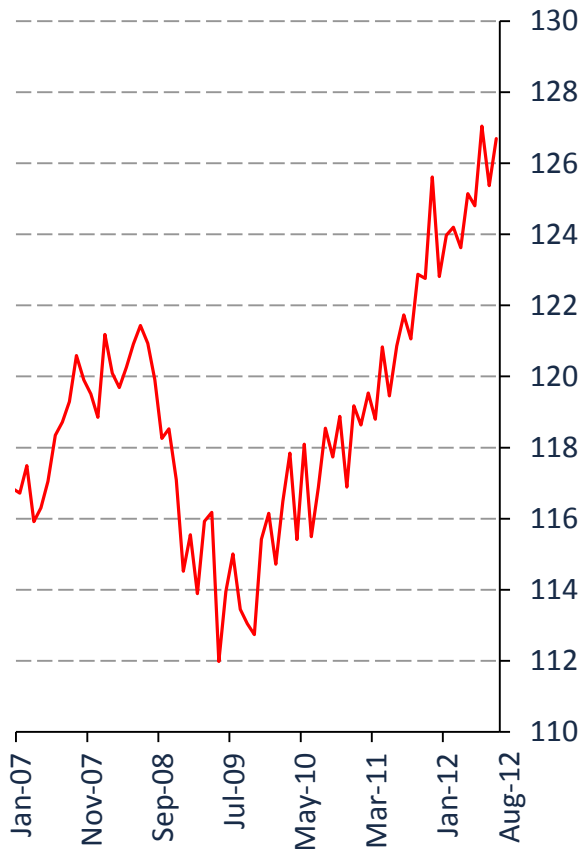
Index 2007=100; s.a.



s.a./ Seasonally adjusted and trend data.
Source: Banco de México.

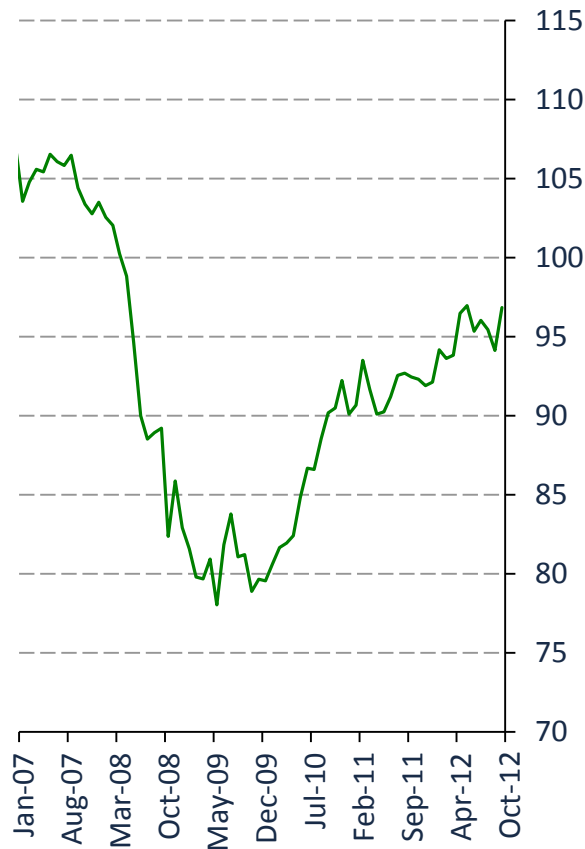
Private consumption exhibited a growing trend, even when some of its determinants slowed down.

Commercial Establishments' Retail Sales
Index 2003=100; s.a.



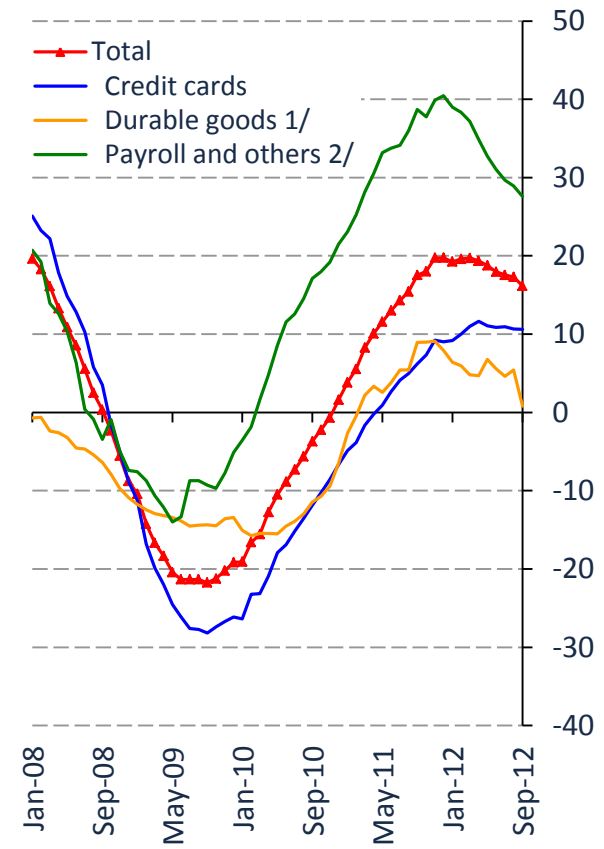
s.a./ Seasonally adjusted data.
Source: INEGI.

Consumer Confidence
Index Jan-2003=100; s.a.



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

Commercial Banks' Performing Credit for Consumption
Real annual % change

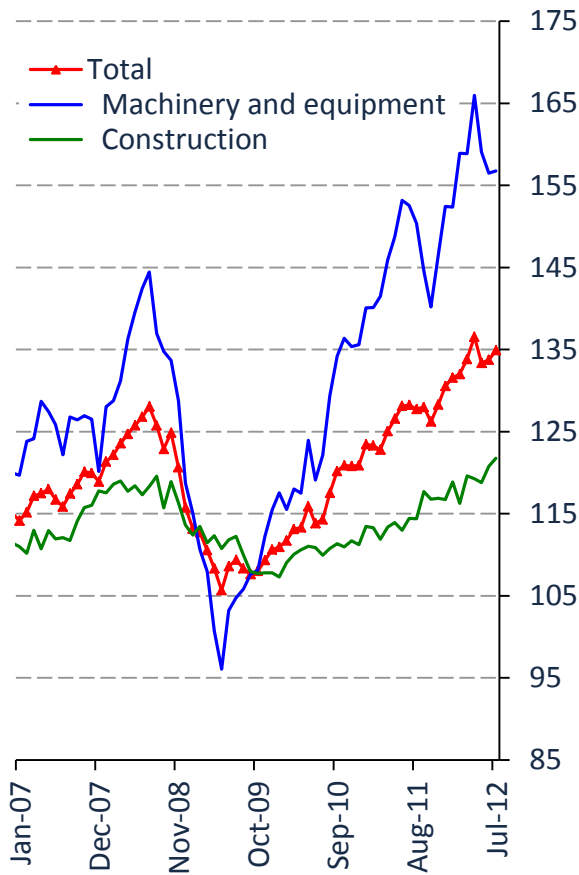


1/ Includes credit for the acquisition of property and automobile credits.
2/ "Others" refers to personal credits, credit for payable leasing operations and other consumption credits.
Source: Banco de México.

Gross fixed investment presented slower growth in the third quarter of 2012.

Investment and its Components

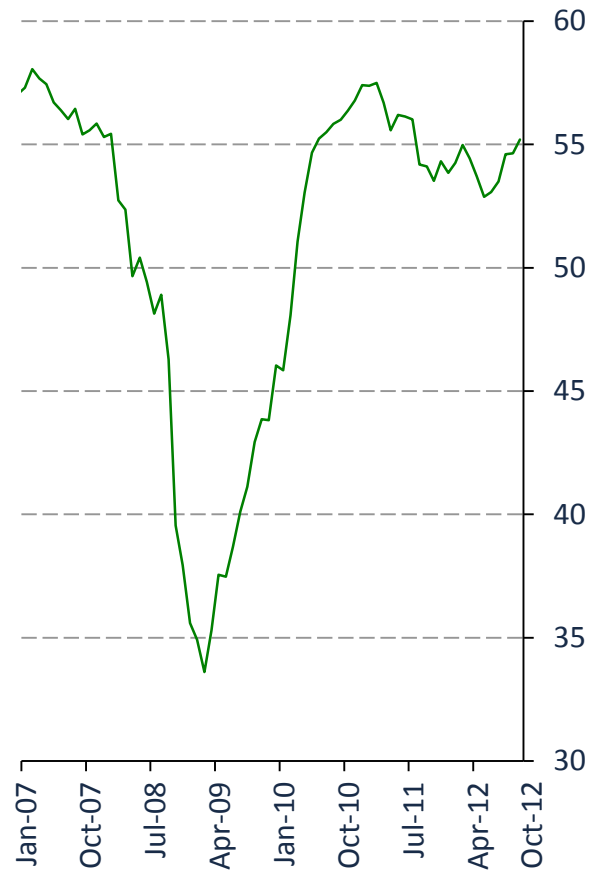
Index 2005=100; s.a.



s.a./ Seasonally adjusted.
Source: INEGI.

Producer Confidence Index

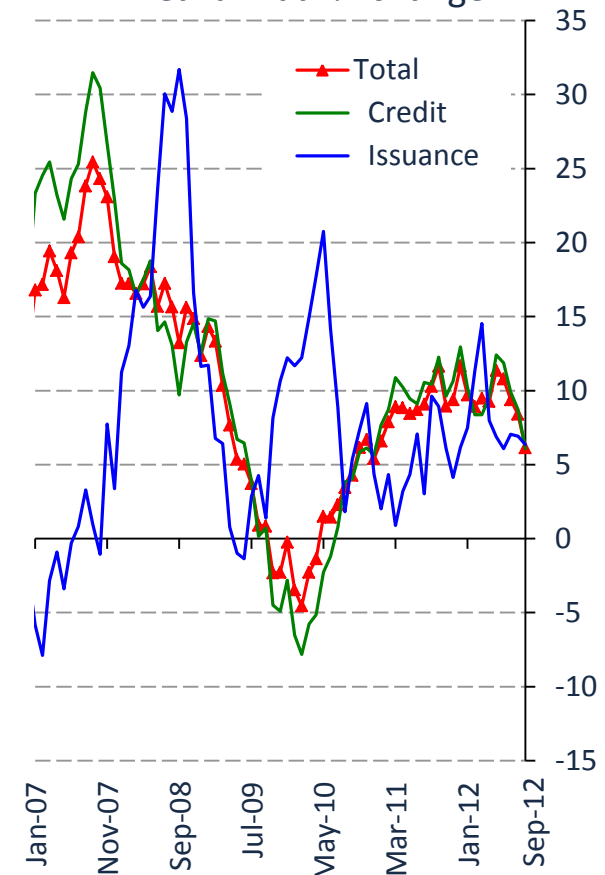
50 points reference; s.a.



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

Domestic Financing to Non-Financial Private Firms

Real annual % change



Source: Banco de México.

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Monetary Policy and Inflation Determinants

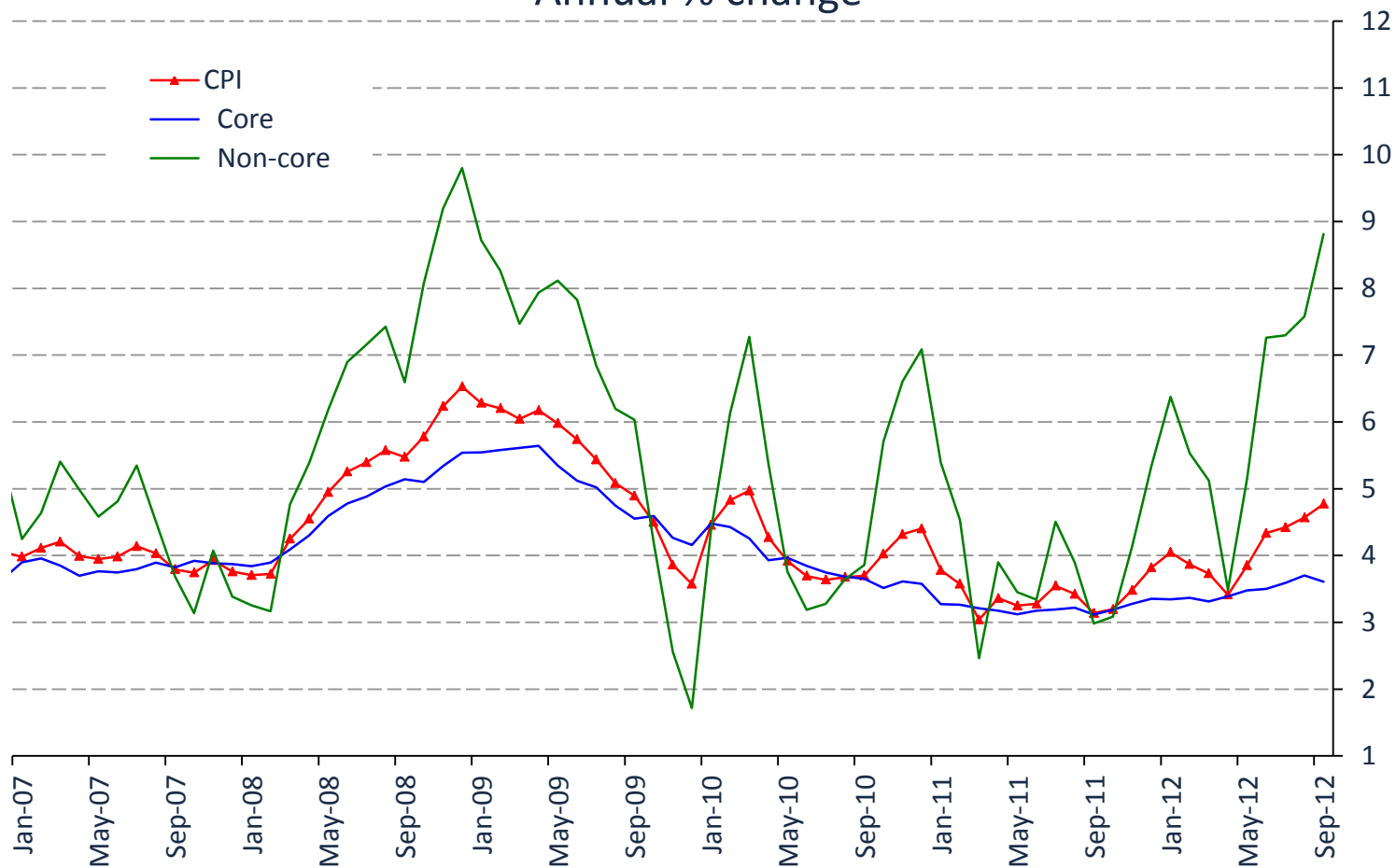
- In recent months monetary policy faced a difficult situation, characterized by the following factors:
 - ✓ *Weakening of external demand started to affect economic activity, with the possible impact on inflation in Mexico.*
 - ✓ *A series of supply-related shocks led to a rebound in inflation, which, although expected to be temporary, has been persistent and of considerable magnitude.*
- After balancing the referred risks, the Board of Governors decided to maintain the Overnight Interbank Interest Rate at 4.5 percent, although it has repeatedly expressed concern regarding the evolution of inflation determinants.

Monetary Policy and Inflation Determinants

- During the third quarter of 2012, average annual headline inflation increased and exceeded the upper bound of the variability interval around the established target.
 - ✓ *This evolution is mainly accounted for by increases in agricultural products' prices.*
 - Four products with the highest incidence on inflation stand out: egg, chicken, beef and tomato.
- Keeping in mind the transitory character of shocks affecting inflation, the referred increase is estimated to be temporary, although these shocks' persistence has become a reason for concern.

Higher annual headline inflation is mainly explained by the increase in some food prices.

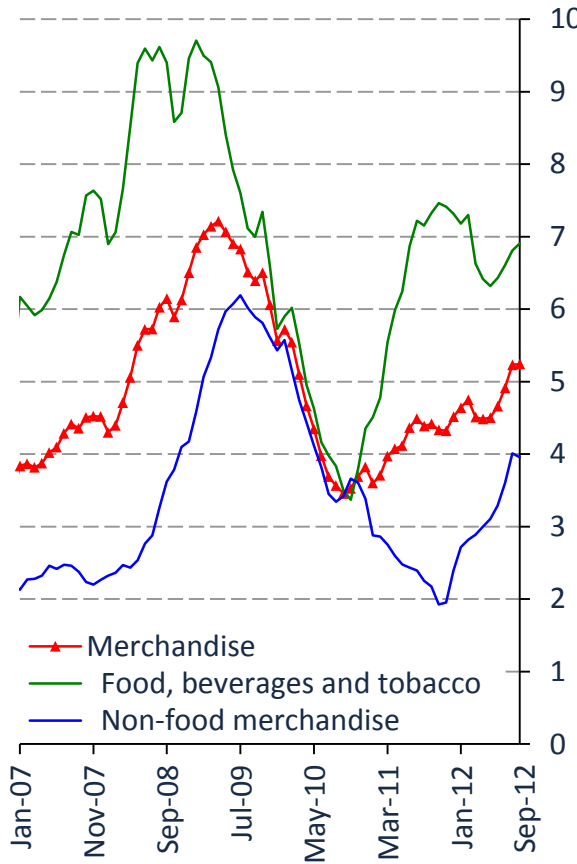
Consumer Price Index Annual % change



Source: Banco de México and INEGI.

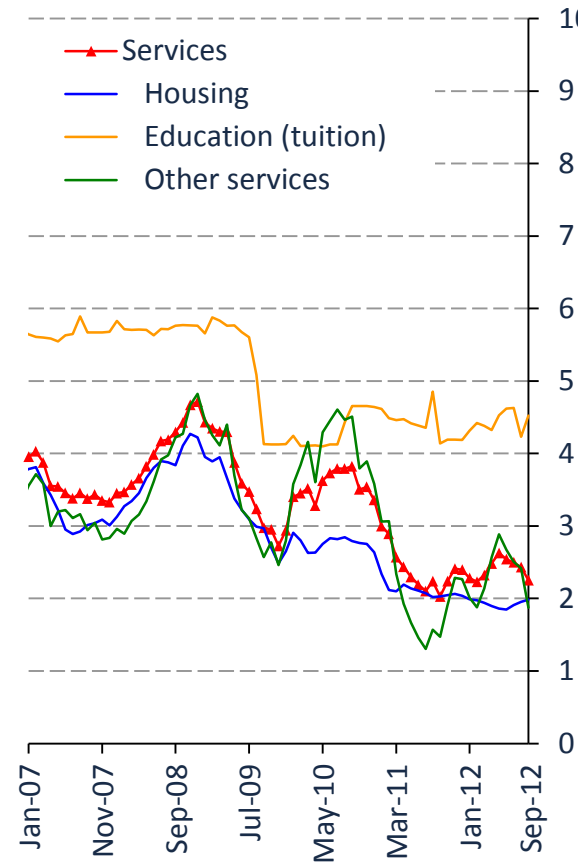
The behavior of annual core inflation has been the consequence of an adjustment in some products' relative prices, rather than generalized price increases in the economy.

Subindices of Core Merchandise Prices
Annual % change



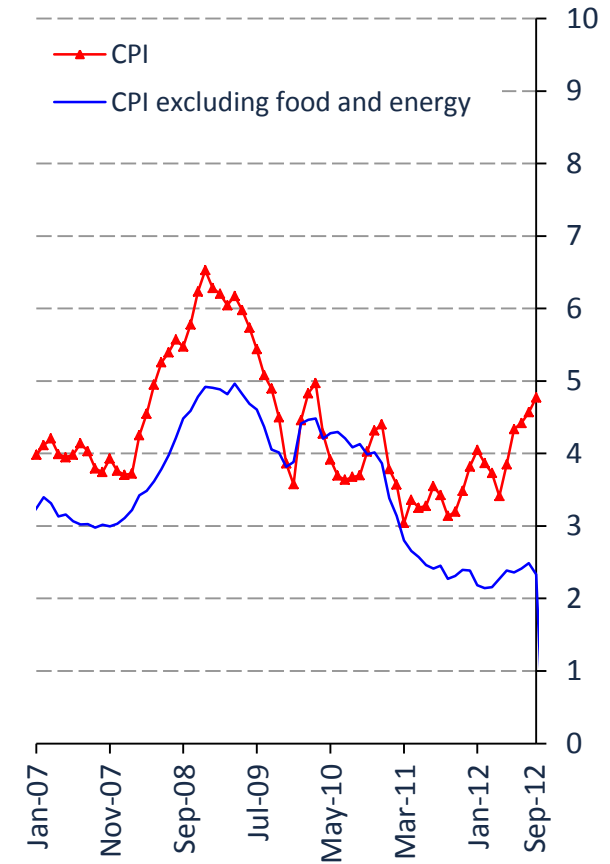
Source: Banco de México and INEGI.

Subindices of Core Services Prices
Annual % change



Source: Banco de México and INEGI.

CPI Excluding Food and Energy ^{1/}
Annual % change

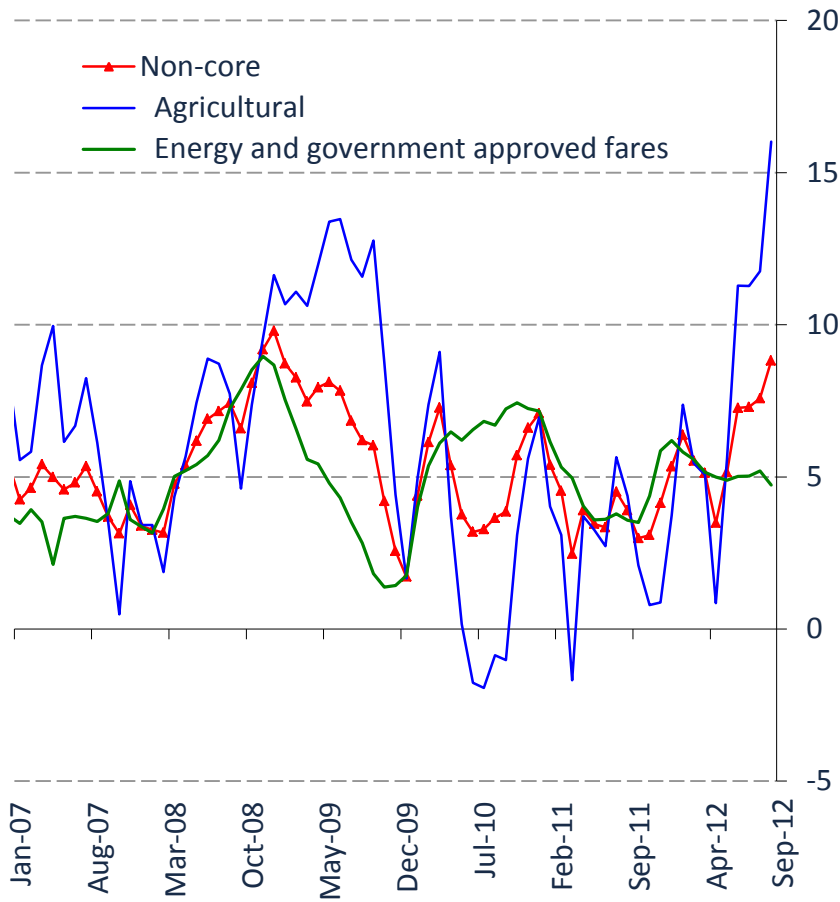


^{1/} Excluding food at home (raw and processed foods and non-alcoholic beverages), food outside home, and energy.

Source: Banco de México and INEGI.

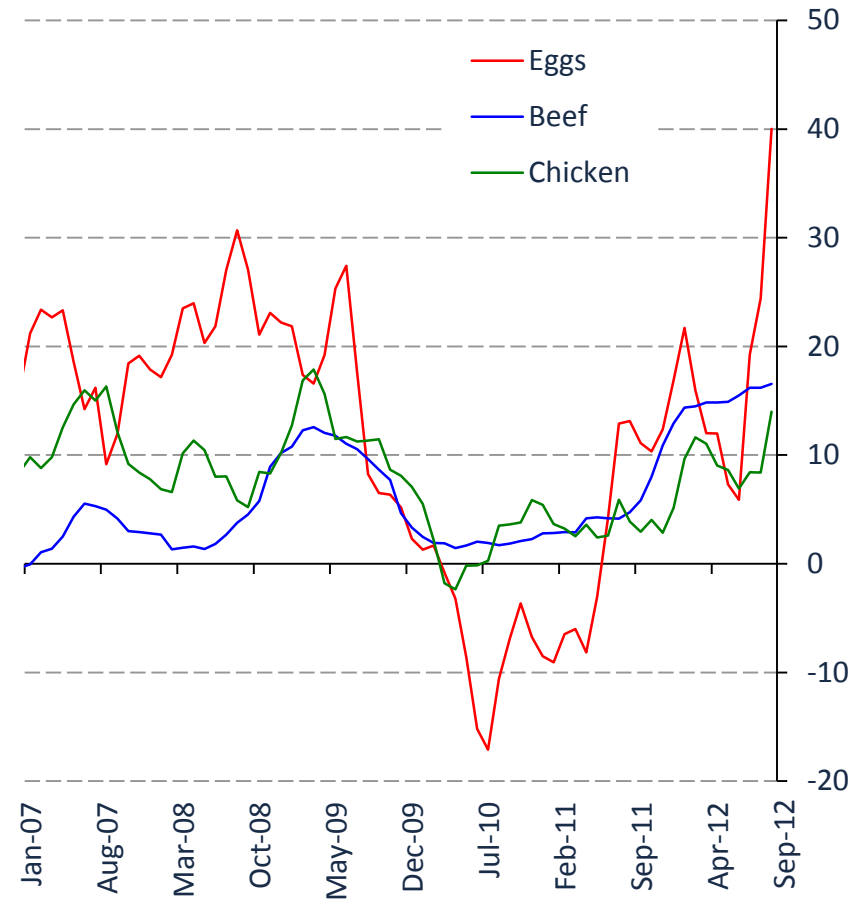
Non-core inflation increased due to the performance of agricultural products' prices, driven by climatic and sanitary conditions.

Non-core Inflation and Components
Annual % change



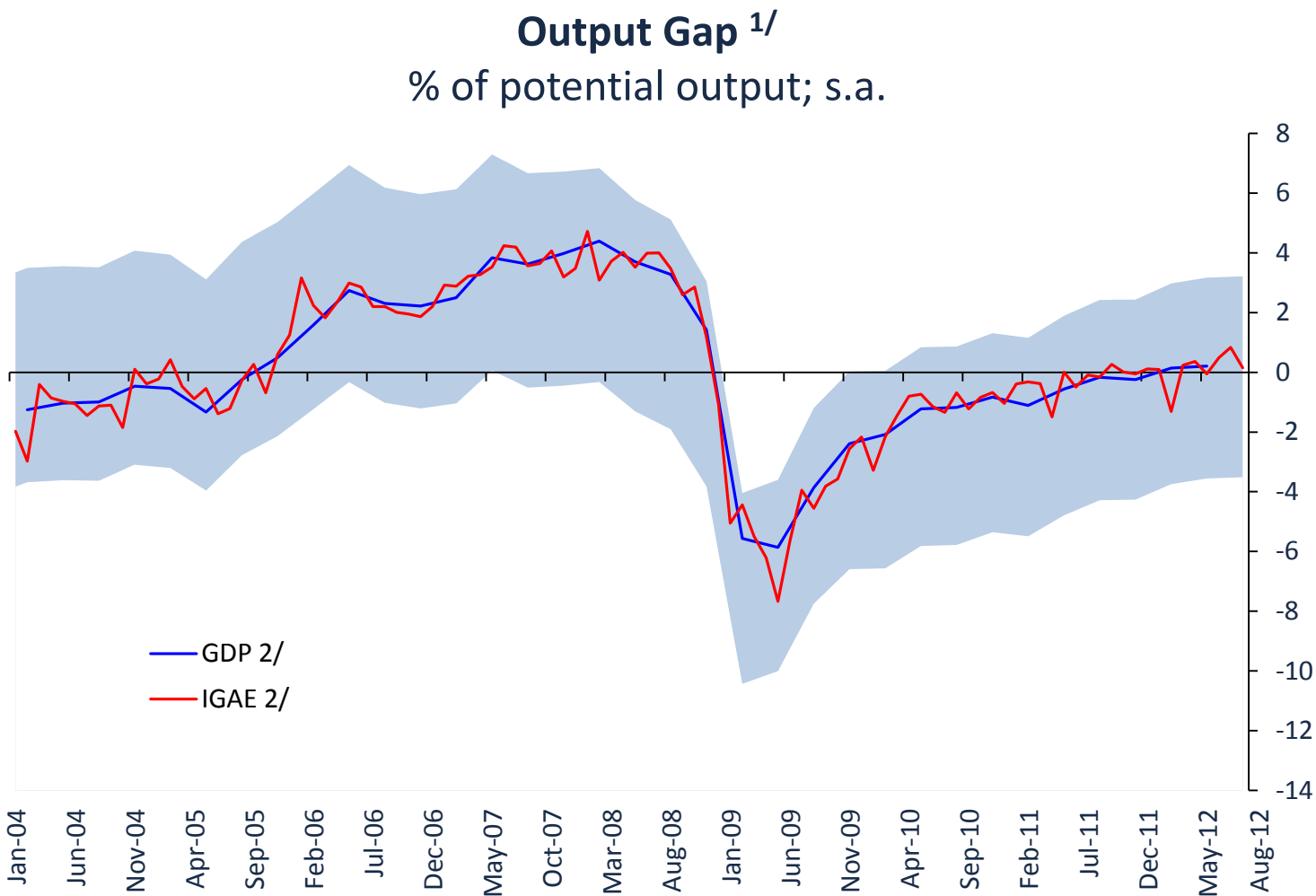
Source: Banco de México and INEGI.

Subindex of Livestock Products Prices
Annual % change



Source: Banco de México and INEGI.

The output gap has remained around zero.



s.a./ Calculated with seasonally adjusted data.

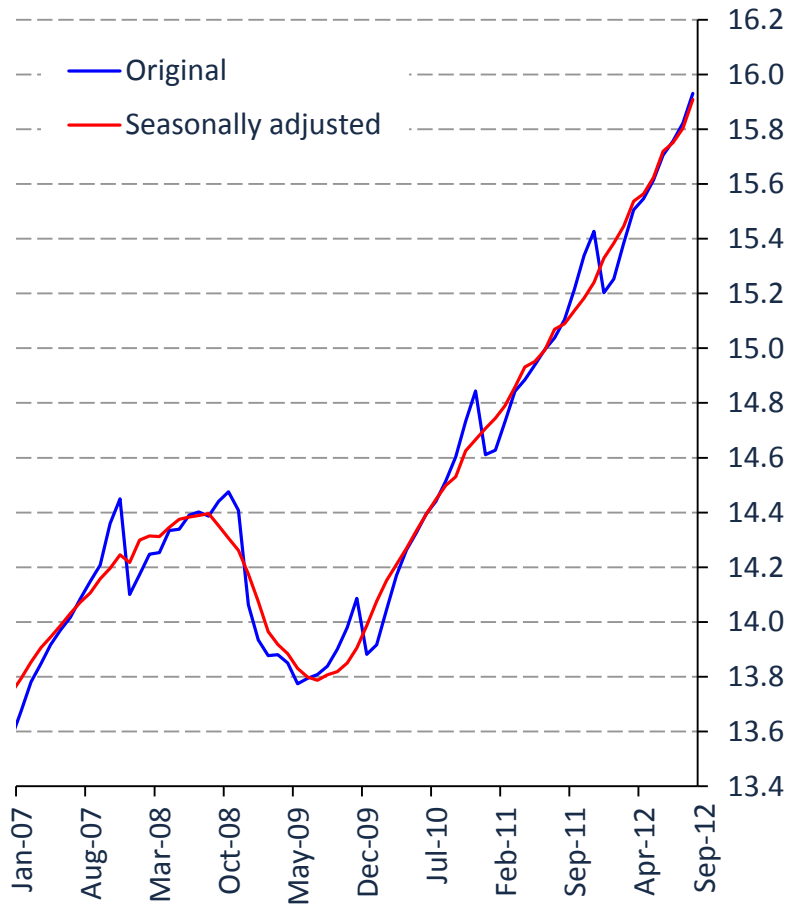
1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p.69. The shaded area is the 95% confidence interval of the output gap, calculated with an unobserved components method.

2/ GDP figures up to the second quarter of 2012; IGAE up to August 2012.

Source: Calculated by Banco de México with data from INEGI.

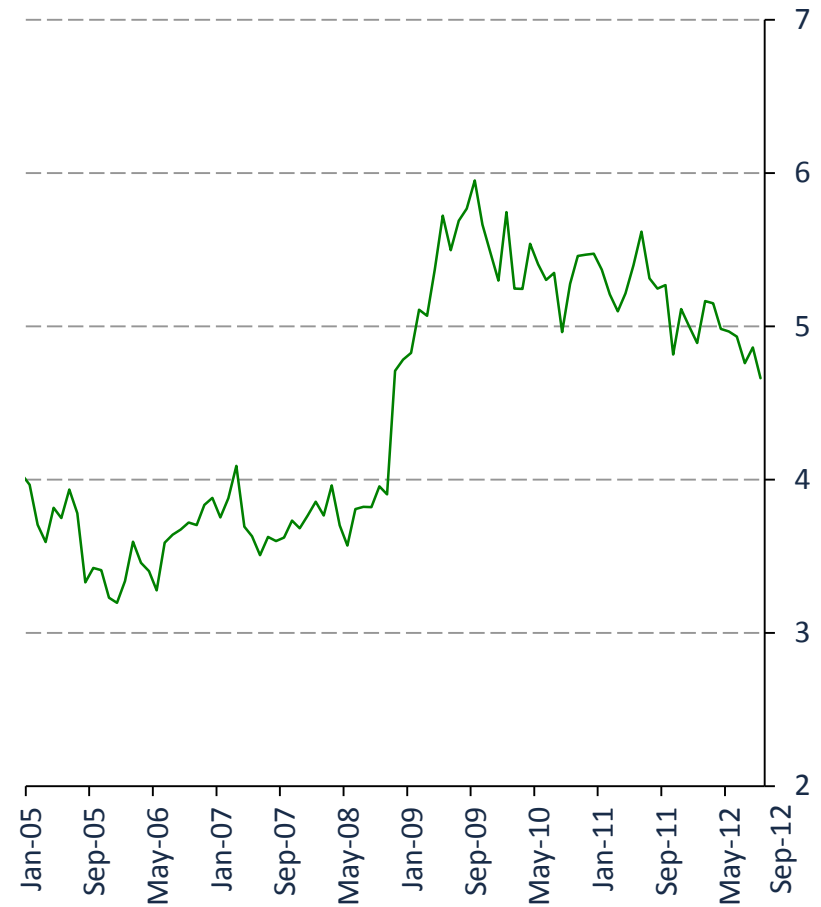
Diverse labor market indicators kept recovering.

IMSS-insured Workers ^{1/}
Million workers



^{1/} Permanent and temporary workers in urban areas.
Source: IMSS and seasonally adjusted by Banco de México

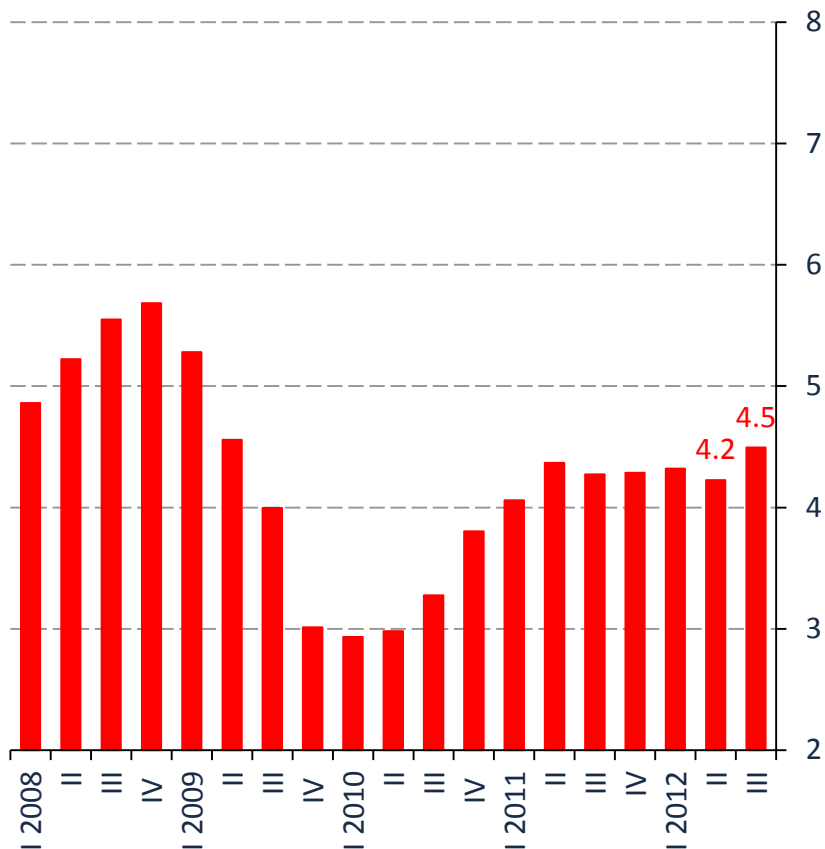
National Unemployment Rate
%; s.a.



s.a./ Seasonally adjusted.
Source: National Employment Survey (*Encuesta Nacional de Ocupación y Empleo*), INEGI.

Although it is not a widespread phenomenon, some wage negotiations reached higher increases than those registered in the past.

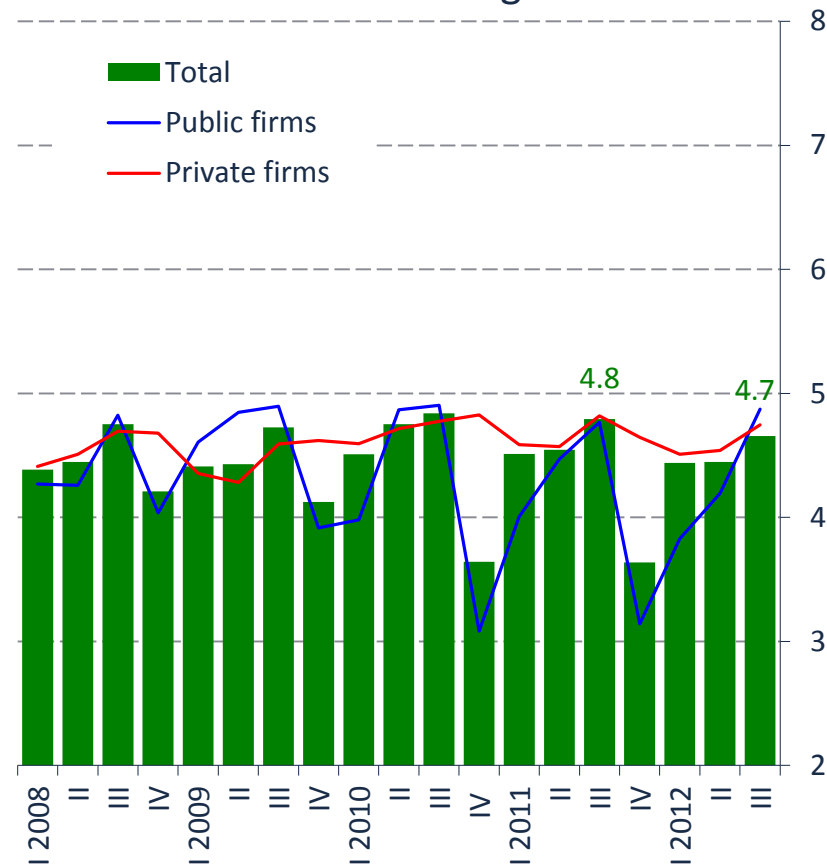
IMSS Reference Wage ^{1/} Annual % change



1/ The IMSS reference wage (*Salario base de cotización, SBC*) considers the daily average earnings of IMSS-insured workers during a certain period and some fringe benefits (e.g., end-of-year bonuses, vacation bonuses and commissions).

Source: Calculated by Banco de México with data from IMSS and STPS.

Contractual Wage ^{2/} Annual % change



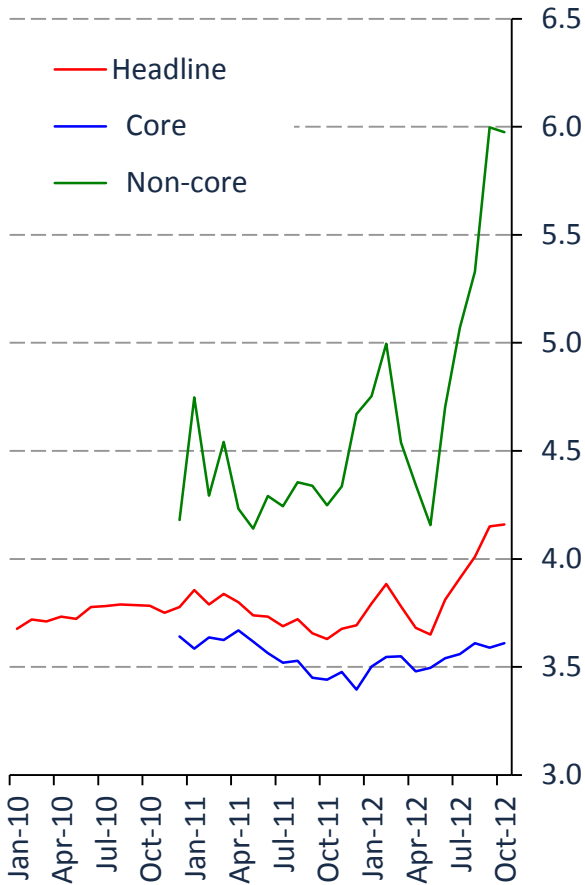
2/ The number of workers in firms under federal jurisdiction that annually report their wage increases to the Secretary of Labor and Social Welfare (*Secretaría del Trabajo y Previsión Social*) equals approximately 2 million.

Source: Calculated by Banco de México with data from IMSS and STPS.

Medium- and long-term inflation expectations remained stable.

Inflation Expectations for the End of 2012

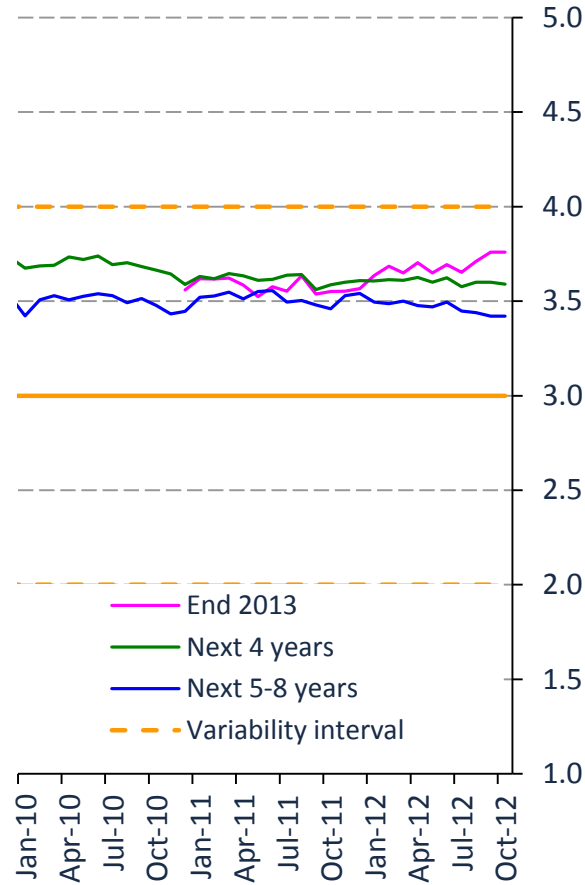
%



Source: Banco de México's survey.

Headline Inflation Expectations

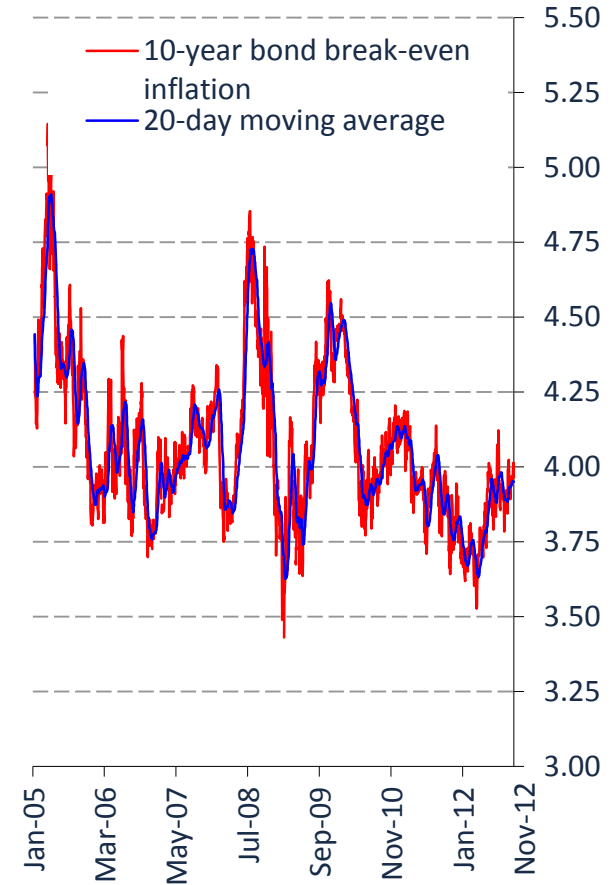
%



Source: Banco de México's survey.

Break-even Inflation and Inflationary Risk ^{1/}

%



^{1/} The break-even inflation and inflationary risk implicit in 10-year bonds is calculated based on nominal and real interest rates of the secondary market.

Source: Banco de México estimate with data from Valmer.

The national currency registered an appreciation trend in the reference period and securities' holdings by foreign investors kept rising.

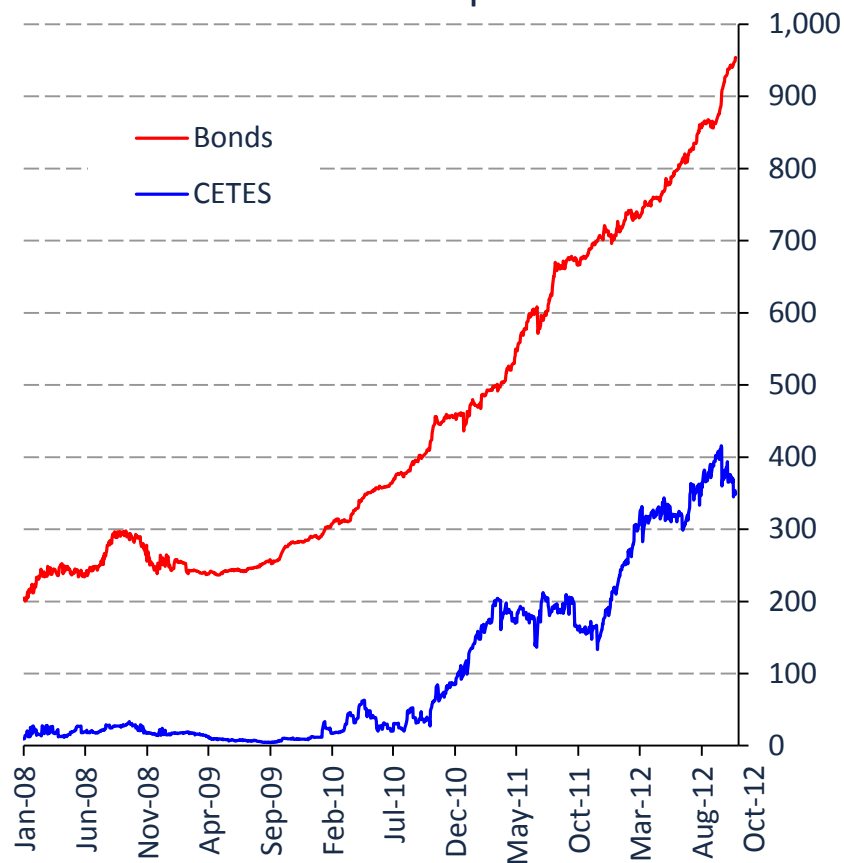
Exchange Rate and its Expectations for the End of 2012 and 2013 ^{1/} Pesos per dollar



1/ The observed exchange rate is the daily FIX exchange rate. The latest data for the observed exchange rate is November 5, 2012 and the foreign exchange rate forecasts is November 5, 2012.

Source: Banco de México and Banamex survey.

Government Securities Holdings by Foreign Investors Billions of pesos



Source: Banco de México.

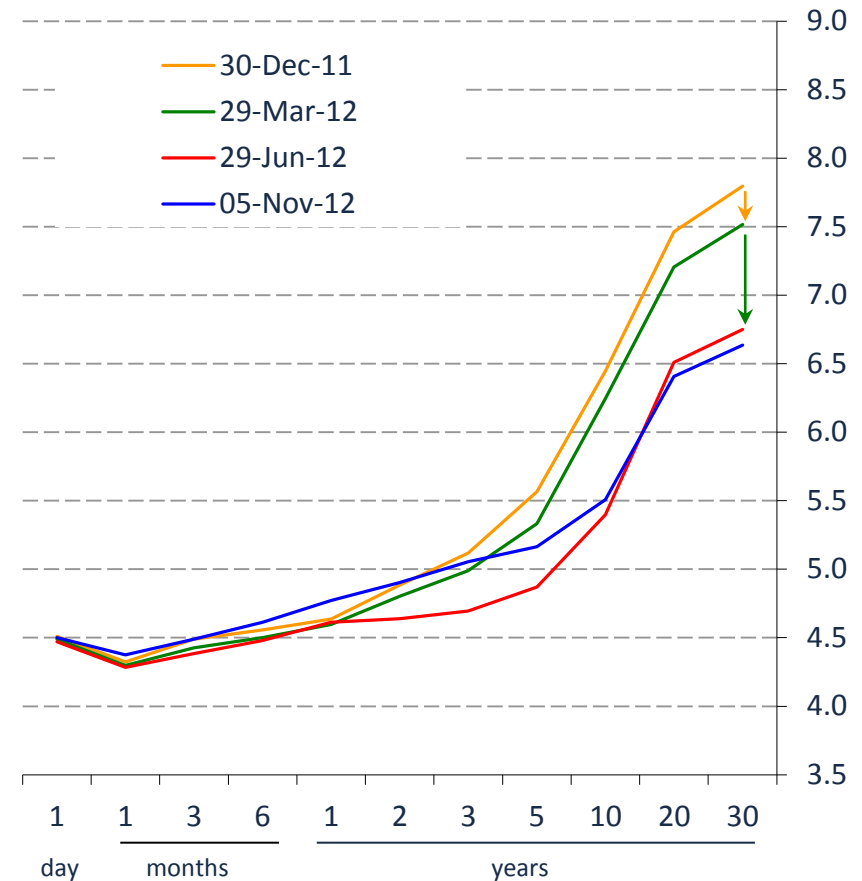
The aforementioned, together with stable longer-term inflation expectations, caused domestic interest rates to remain stable as well.

Interest Rates of Government Securities ^{1/}
%



^{1/} Since January 21, 2008, the one-day (overnight) interest rate corresponds to the target for the Overnight Interbank Interest Rate. Source: Banco de México and Proveedor Integral de Precios (PiP).

Mexico's Yield Curve
%



Source: Banco de México and Proveedor Integral de Precios (PiP).

Monetary Policy and Inflation Determinants

- So far, the evolution of different inflation determinants suggests the following:
 - i. That the above referred supply shocks, even when they have been successive, have not contaminated so far the price formation process of the economy.*
 - ii. That there is no evidence indicating aggregate demand-related pressures on inflation.*
 - iii. Some wage increases higher than in previous months have been observed, albeit mainly in the public sector.*
- However, in this context:
 - ✓ *With inflation at high levels during various months due to the persistence of shocks,*
 - ✓ *With the output gap around zero,*
 - ***The risk of the price formation process being contaminated cannot be ruled out.***

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Forecasts for the Mexican Economy:

GDP growth:

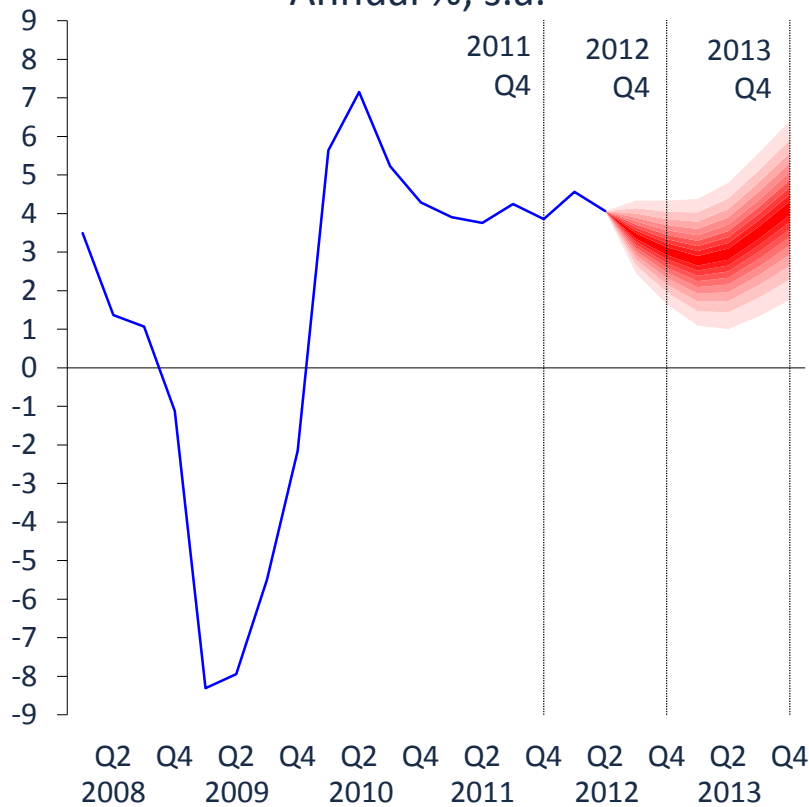
- ✓ *Between 3.5 and 4.0% in 2012.*
- ✓ *Between 3.0 and 4.0% in 2013.*

Increase in the number of IMSS-insured workers:

- ✓ *Between 600 and 700 thousand in 2012.*
- ✓ *Between 500 and 600 thousand in 2013.*

Fan Chart: GDP Growth

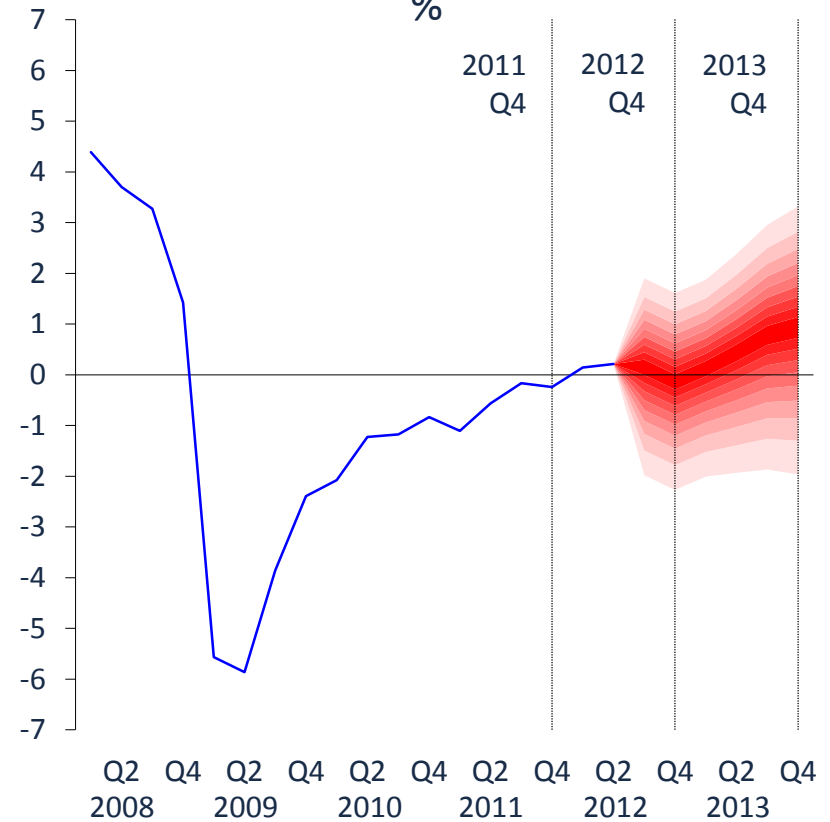
Annual %; s.a.



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

Fan Chart: Output Gap ^{1/}

%



^{1/} Calculated with seasonally adjusted data.
Source: Banco de México.

Balance of Risks for the Economic Activity.

- Downward risks have increased due to prevailing factors that could induce a more unfavorable environment for the Mexican economy:
 - ✓ *A more pronounced slowdown of the U.S. economy.*
 - ✓ *An environment of increased volatility and uncertainty in international financial markets, if no progress is made in solving the fiscal and banking problems in the Euro Zone.*
 - ✓ *The slowdown of emerging economies, like Brazil, China and India, could intensify, further affecting global demand.*

- As opposed to the risks mentioned before, the growth scenario for Mexico could be favorably affected by the approval and implementation of structural reforms that strengthen domestic sources of growth.

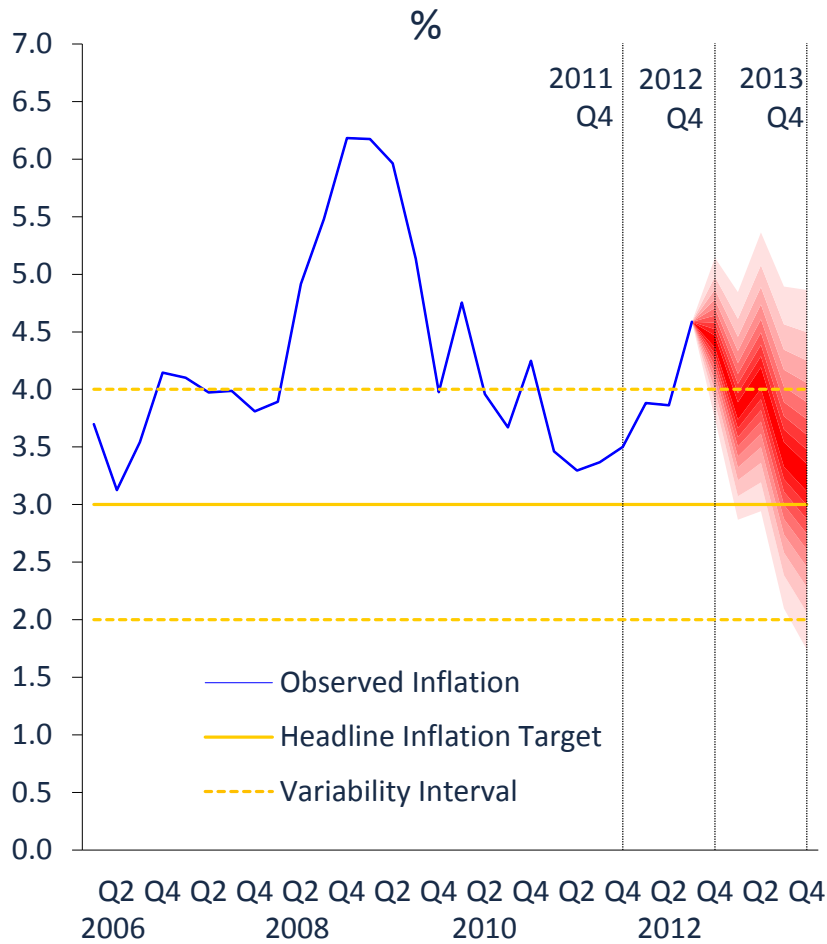
Inflation Forecasts

- Headline inflation is anticipated to have changed its trend in September and the following elements are expected to contribute to its further downward trajectory:
 - ✓ *A global environment of weak growth.*
 - ✓ *Absence of considerable demand pressures on the Mexican economy, even if the degree of slackness in the labor market has decreased.*
 - ✓ *Intensified competition in some sectors.*
 - ✓ *Fading of the effect that some food price shocks had on inflation during 2012.*
 - ✓ *The MXN appreciation after the announcement of a further round of monetary easing (QE3) in the U.S.*
 - ✓ *Core inflation is also expected to have changed its trend since August 2012.*

It is estimated that annual headline inflation will be very close to 4 percent at the end of 2012 and will locate between 3 and 4 percent in 2013.

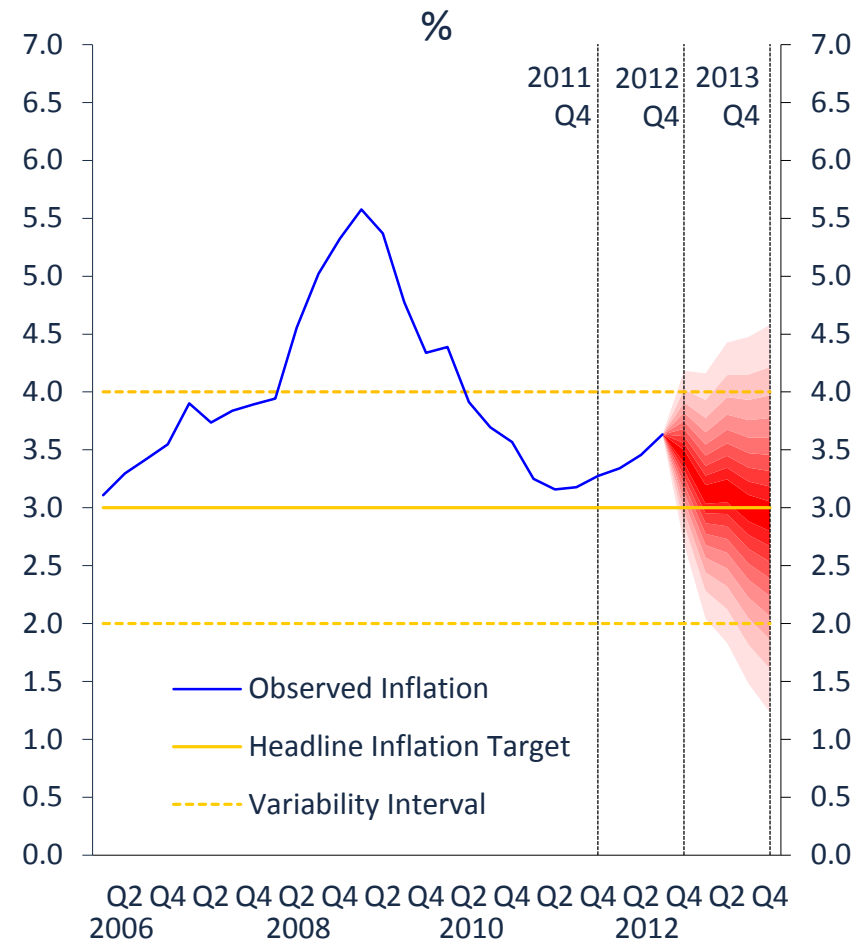
Fan Charts

Annual Headline Inflation ^{1/}



1/ Quarterly average of annual headline inflation.
Source: INEGI and Banco de México.

Annual Core Inflation ^{2/}



2/ Quarterly average of annual core inflation.
Source: INEGI and Banco de México.

However, upward risks to inflation have increased.

- In an environment where the output gap has closed, the following risks stand out:
 - ✓ *The situation prevailing in the national production of eggs.*
 - ✓ *Unfavorable climatic conditions in North America that affected international grain and meat product prices.*
 - ✓ *The possibility of new increases in agricultural products' prices, derived from these products' affected production.*
 - ✓ *The possibility that prices and/or fares of public goods and services increase more than foreseen.*
 - ✓ *The return of volatility in international financial markets that cannot be ruled out.*
 - ✓ *Derived from the fact that inflation has remained at high levels during various months:*
 - The risk of observing a contamination of the wage setting process in the economy.
 - The risk that the elevation of inflation above the upper bound of the variability interval around the 3 percent target is a topic that received more public attention.

Monetary Policy Stance

- Considering the aforementioned, the Board of Governors estimates that if inflation shocks persist, even if presumed as transitory, and the changes in the trend of headline and core inflation are not confirmed, it would be appropriate to adjust upwards the reference rate in the near future, in order to:
 - ✓ *Consolidate the anchor of inflation expectations.*
 - ✓ *Prevent the contamination of the rest of the price formation process in the national economy.*
 - ✓ *Avoid jeopardizing the convergence of inflation to the 3 percent permanent target.*

It is necessary to strengthen domestic sources of growth.

- Together with the environment of macroeconomic stability reached by Mexico, necessary for its economic development, the progress in the economy's structural change could boost the country's economic growth, especially in the medium and long run.
- These reforms would also favor the maintenance of a low and stable inflation environment.
- Indeed, rising productivity would allow reaching higher aggregate demand growth rates without generating pressures on prices.



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