Inflation Report

July - September 2013

Summary

Strengthening of the monetary policy, stable inflation expectations and a sound functioning of the financial markets in Mexico contributed to an environment, in which the process of inflation convergence towards the 3 percent target has been consolidating. This provided Banco de México with more room for maneuver in the monetary policy conduction.

The above propitiated that, in light of the weakening of the economic activity and in an environment of low inflation, the Central Institute could implement downward adjustments of 25 basis points in the target for the reference rate in September and October, thus reducing the referred target from 4 to 3.50 percent, without compromising the process of inflation convergence towards the 3 percent target. It should be pointed out that this policy rate adjustment derived from both domestic and external factors, and was implemented despite the uncertainty prevailing in international financial markets.

Headline inflation continued to display the downside trend that it had started in April. This was consequent on the annual core inflation component remaining on average below 2.5 percent in the third quarter, close to its historical minimum levels. The performance of headline inflation was also accounted for by the fading of the effects of the shocks, which affected the non-core inflation at the end of the first quarter of the year, which, as anticipated by Banco de México, turned out transitory and did not generate second round effects on the process of price determination in the economy. Hence, headline inflation lied within the interval of plus/minus one percentage point around the 3 percent target throughout the period analyzed by this Inflation Report.

The economic activity in Mexico weakened significantly over the first half of 2013. However, in the third quarter, some indicators suggest that it may have resumed a positive trajectory. The recent mixed performance of some indicators starts to reflect the fact that part of the impacts of the shocks that had adversely affected the economy in the previous quarters began to dissipate in the quarter under analysis.

This occurred in an environment of persisting weak growth of the world economy, as a result, on the one hand, of a mixed performance in advanced economies, which partly reflected divergences in their respective phase of the business cycle, and, on the other hand, as a result of lower than expected growth in main emerging economies.

At the beginning of the quarter, the U.S. economy expanded at a moderate rate, which indicated that the Federal Reserve could begin reducing its asset purchases in September, which, in turn, contributed to the fact that the decompression process of some risk premia and the corresponding increase in long-term interest rates, which had begun in the previous quarter, continued. Nonetheless, the release of some economic figures in August and September pointed to a moderation in this recovery. Under these circumstances and given the uncertainty regarding the effects of the fiscal debate in the U.S., in September the Federal Reserve decided to maintain the pace of its asset purchases unchanged, thus giving rise to a temporary halt in the increase of risk premia, which had been observed in the previous months. In particular, a drop in long-term interest rates and a recovery in international financial markets were registered. Finally, in its October meeting, the Federal Reserve ratified its decision to maintain unchanged the pace of asset purchases.

In a highly volatile global environment, the adjustments in Mexican financial markets took place in an orderly manner without affecting either inflation expectations, or the inflation risk premium. Thus, higher long-term interest rates in the period from May to August were consequent on external factors, in particular, on the above referred decompression process of some risk premia in the U.S. Still, in September, the downward adjustment in the reference interest rate in Mexico, combined with the interest rates' evolution in international financial markets, contributed to lower interest rates of all terms in Mexico. Moreover, the exchange rate adjustment in the period analyzed in this Inflation Report was orderly and congruent with the referred global environment.

The macroeconomic scenario foreseen by Banco de México considers the impact on the economic activity of the economic package for 2014 approved by the Congress, inflation and the use of financial resources:

Growth of the Mexican Economy: Considering the adverse results of the economic activity in the first half of 2013, which were more unfavorable than anticipated, the forecast interval for the GDP growth rate in Mexico in 2013 is revised down from 2.0 to 3.0 percent in the previous Inflation Report to 0.9 to 1.4 percent (Chart 1a). Even though some elements, which affected growth in 2013, will have dissipated by 2014, given an uncertain international environment and the fragility of the U.S. industrial sector, the forecast interval for GDP growth in 2014 is modified down from 3.2 to 4.2 percent to 3.0 to 4.0 percent. This new interval includes the net impact on the economic activity of approximately 0.2 additional percentage points to the GDP growth, derived from the expansionary fiscal policy implicit in the abovementioned economic package. For 2015, the GDP growth rate is anticipated to lie within the interval of 3.2 to 4.2 percent.

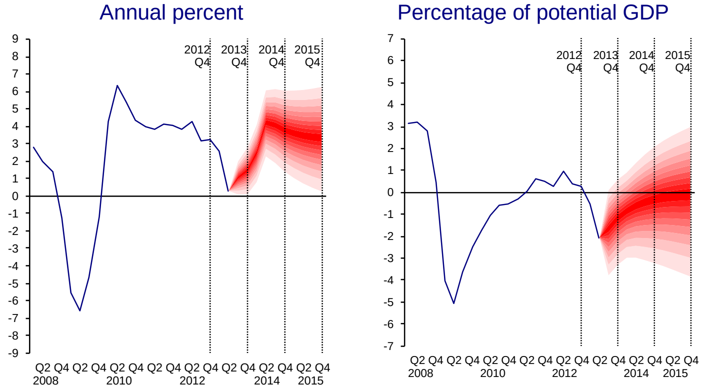
Employment: In line with the revision of the GDP growth forecasts, in this Inflation Report the expected increase in the number of IMSS-insured workers (permanent workers and temporary workers in urban areas) is adjusted downwards both for 2013 and 2014. In particular, for 2013 an increase of 400 to 500 thousand IMSS-insured workers (450 to 550 thousand in the last Inflation Report) is expected, while for 2014 additional 620 to 720 thousand IMSS-insured workers are estimated (700 to 800 thousand in the previous Inflation Report). For 2015, an increase similar to that of 2014 is anticipated.

Current Account: For 2013, the expected deficits in the trade balance and the current account amount to USD 4.2 and 18.8 billion, respectively (0.3 and 1.5 percent of GDP). For 2014, deficits in the trade balance and the current account of USD 5.2 and 22.2 billion are estimated, respectively (0.4 and 1.7 percent of GDP). For 2015, deficits in the trade balance and the current account are expected to amount to USD 5.7 and 23.7 billion, respectively (0.4 and 1.7 percent of GDP).

Fan Charts 1

a) GDP Growth Rate, s. a.
Annual percent

b) Output Gap Estimate, s. a.
Percentage of potential GDP



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

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

In this environment of lower expected growth of the economic activity, an ample slack in the economy is anticipated to persist for an extended period, even though it is expected to decrease during the horizon at which the monetary policy operates. Thus, no aggregate demand-related pressures on inflation or the external accounts are anticipated. Indeed, derived from a major deceleration of the economy in the first semester of 2013, the output gap is currently negative. Likewise, given the growth prospects presented above, this indicator is expected to lie below zero in the forecast horizon (Chart 1b).

Downward risks to the growth of the Mexican economy, even though lower than in recent months, remain high. Among these, the following should be pointed out:

I. A lower than expected U.S. economic expansion rate, which could be caused by the a failure to solve its fiscal situation and by volatility in its financial markets. It could also derive from reduced external demand, as a consequence, for example, of the deferred implementation of structural reforms in Europe, necessary to guarantee its recovery, or from a major deceleration of emerging economies.

II. Possible episodes of high volatility in international financial markets, which could stem from uncertainty over the changes in the U.S. monetary policy or the instability in the Euro zone.

III. A less dynamic than anticipated evolution of public expenditure in Mexico. Even though measures to increase the spending capacity seem to be taken, lower than expected growth of the economy could limit tax revenues, and, therefore, the potential for public expenditure.

IV. The possibility that the housing sector could remain an obstacle for the recovery of the construction sector, and, therefore, for the productive activity.

V. Additionally, there is a risk that the reforms currently discussed in Congress will not be approved or that the version of the reform that will be in the end implemented will be of a limited scope as compared to that anticipated by the economic agents. It should be kept in mind, that there have been considerable shortages in the energy sector.

Furthermore, the flow of funds to the private sector is expected to slide from 2.7 percent of GDP estimated for 2013, to 2.3 percent of GDP in 2014. This derives from the increment in the public sector borrowing requirements expected in line with the approved economic package.

Inflation: Given the lower expected economic growth mentioned above and the corresponding ample slack in the economy anticipated for an extended period, for the fourth quarter of 2013 annual headline inflation is expected to persist at levels close to 3.5 percent. For 2014, the forecast is slightly revised upwards, when the possible impact of the changes in taxes is considered, which, in turn, is estimated to be moderate and transitory, and is not anticipated to generate second round effects. Specifically, the total impact of the referred fiscal changes, considering both direct and indirect effects, will be of 40 basis points in the change in the CPI between December 2013 and December 2014. Thus, the most probable trajectory of annual headline inflation is estimated to fluctuate around 3.5 percent throughout the next year. In turn, for 2015 it is foreseen to present a downside trend and to locate around the 3 percent target (Chart 2a). This forecast takes into account the fading of the estimated effects of the fiscal changes on inflation in 2014, and a reduction in the fuel price adjustment, in line with the changes recently approved by the Congress to determine these prices from 2015 onwards.

Core inflation, which better reflects the inflation trend in the long run, is expected to remain at levels below 3 percent in 2013. For 2014, it is anticipated to persist below this level, even taking into account the effects caused by the fiscal changes. In 2015, core inflation is estimated to register slightly lower levels as compared to last year (Chart 2b).

The expected inflation trajectory is not without risks and could be affected by different factors, among which the following can be found:

i. In the short run, the possibility that the economic activity recovery in Mexico may turn out lower than anticipated could generate downward pressures.

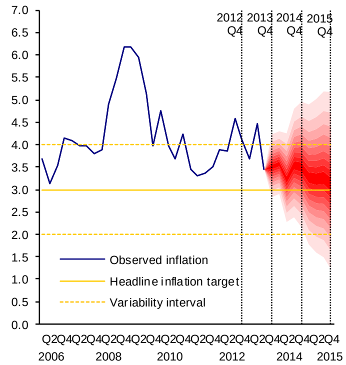
ii. Regarding upward risks, in light of major volatility in international financial markets, the exchange rate adjustments cannot be ruled out, with their consequent effect on inflation. However, depending on their scope, a limited effect would be expected, derived from a low pass-through of exchange rate adjustments on inflation.

In short, the balance of risks for inflation in the horizon, in which the monetary policy operates, has improved. The above is reinforced by an expected downside trend in international commodity prices, as well as by the prospects of a good water supply in the next agricultural cycles, given a recently observed recovery in the level of dams at the national level. Moreover, despite the impact of the economic package on the economic activity, inflation and the use of financial resources, the inflation outlook for 2014 remains below 4 percent, while the longer-term forecast is stable, which emphasizes the anchoring of the inflationary process in Mexico.

Given the above considerations and Banco de México's expectation of the amplified slack in the economy prevailing for a prolonged period of time, although decreasing in the horizon in which the monetary policy operates, and taking into account the expected fiscal policy, the Board of Governors estimates that the monetary policy is congruent with the efficient convergence of inflation towards the 3 percent target. Still, it considers that additional reductions to the reference interest rate target will not be advisable in the foreseeable future, given that, the ex-ante short-term real interest rate lies at levels close to zero. Thus, the current macroeconomic stance is conducive to a gradual recovery of the economy without generating inflationary pressures. In any event, the Board of Governors will remain alert so that the relative price changes derived from the fiscal adjustments do not generate second round effects on inflation. Likewise, it will monitor the implication of the evolution of the economic activity and the monetary stance of Mexico relative to the U.S., among other factors, onto the inflation outlook, so as to reach the abovesaid inflation target.

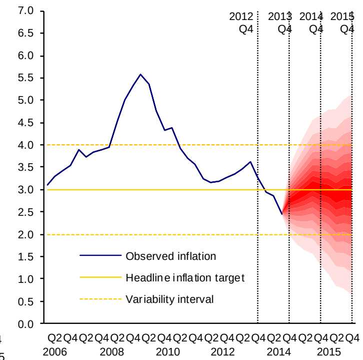
Fan Charts 2

a) Annual Headline Inflation [1/]
Percent



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

b) Annual Core Inflation [1/]
Percent



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

It should be pointed out that the international environment characterized by high commodity prices, low interest rates and ample liquidity in international financial markets prevailing over the recent years started to revert. Therefore, in the following years emerging economies, Mexico among them, are likely to face a relatively more difficult external environment, particularly with respect to available sources of financing of the economic activity. In this context, the referred economies should adopt the public policies and the economic reforms aimed at fostering the domestic sources of growth and at encouraging and maintaining solid economic fundamentals. In this regard, two key elements in supporting the favorable evolution of the Mexican economy in the coming years should be noted. The first one refers to the recently implemented structural reforms in Mexico and those currently under discussion in Congress. Insofar as these reforms boost the economy's productivity and competitiveness, it will be possible to reach high and sustained growth rates without jeopardizing price stability. The second factor refers to the importance of strengthening the framework for the conduction of the macroeconomic policy, in particular public finances. It will be achieved insofar as the downward trend of public deficits will consolidate, tending towards equilibrium, which would guarantee the sustainability of public debt and would allow a greater inflow of resources to the private sector financing. In this respect, the commitment of the Mexican Government to bringing the fiscal deficit to zero in 2017 at the latest and the strengthening of the Federal Law of Budget and Fiscal Responsibility are fundamental.