



Inflation Report

January–March 2013

May 8, 2013



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

Global Environment in 1Q 2013

Growth

- ✓ U.S.: improvement greater than anticipated, although recently some indicators point to weaker readings.
 - ✓ Euro zone: remained in recession.
 - ✓ Emerging economies: expansion has moderated.
- **Stable, though weak, global growth.**

Inflation

- ✓ Downward trend of commodity prices.
- ✓ Moderate inflation levels in main advanced and emerging economies.

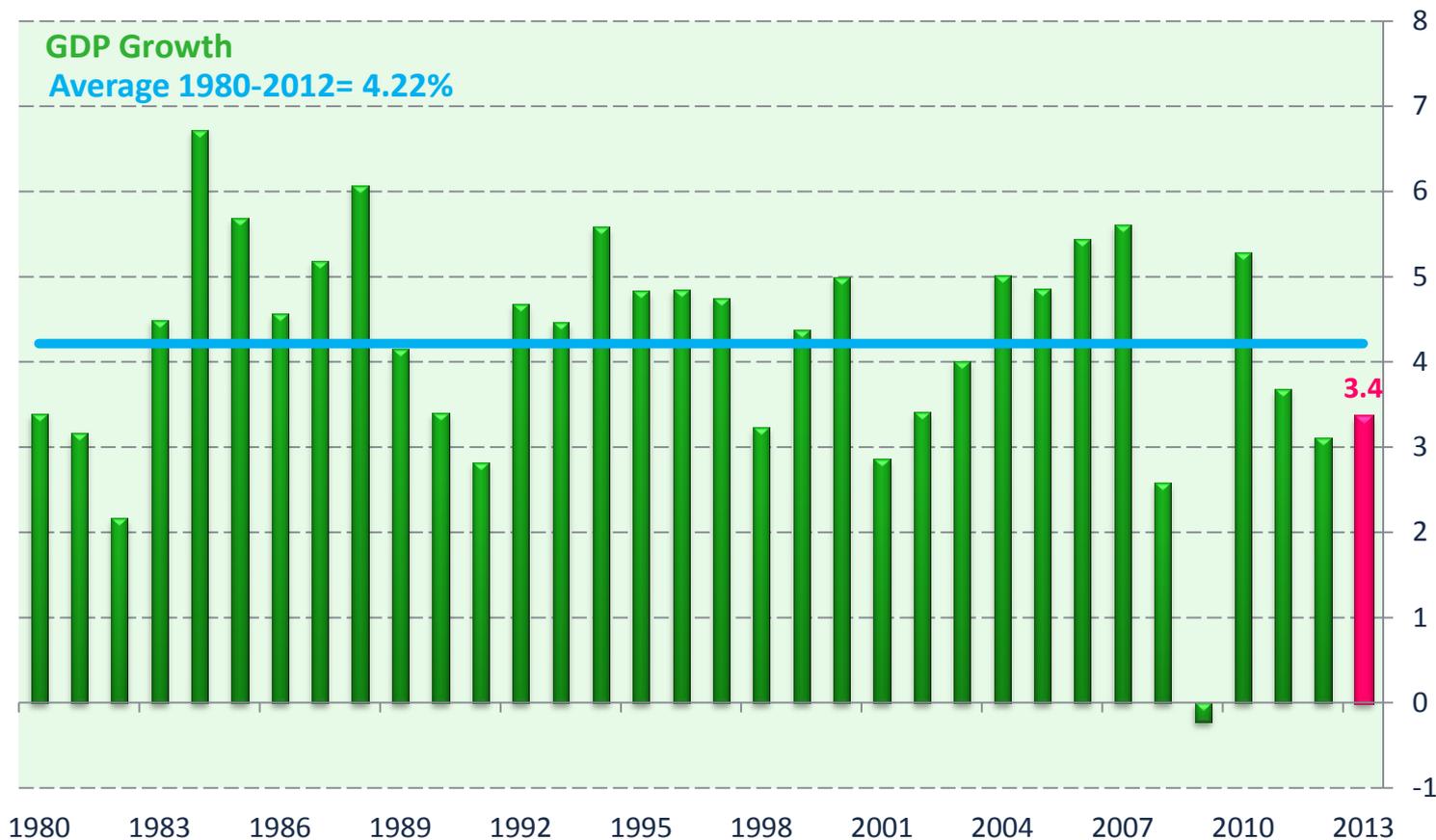
Global Monetary Policy

- ✓ Remained expansive in most countries.
- ✓ In various cases became even looser.

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.

World Economy: GDP Growth and GDP Growth Forecast for 2013

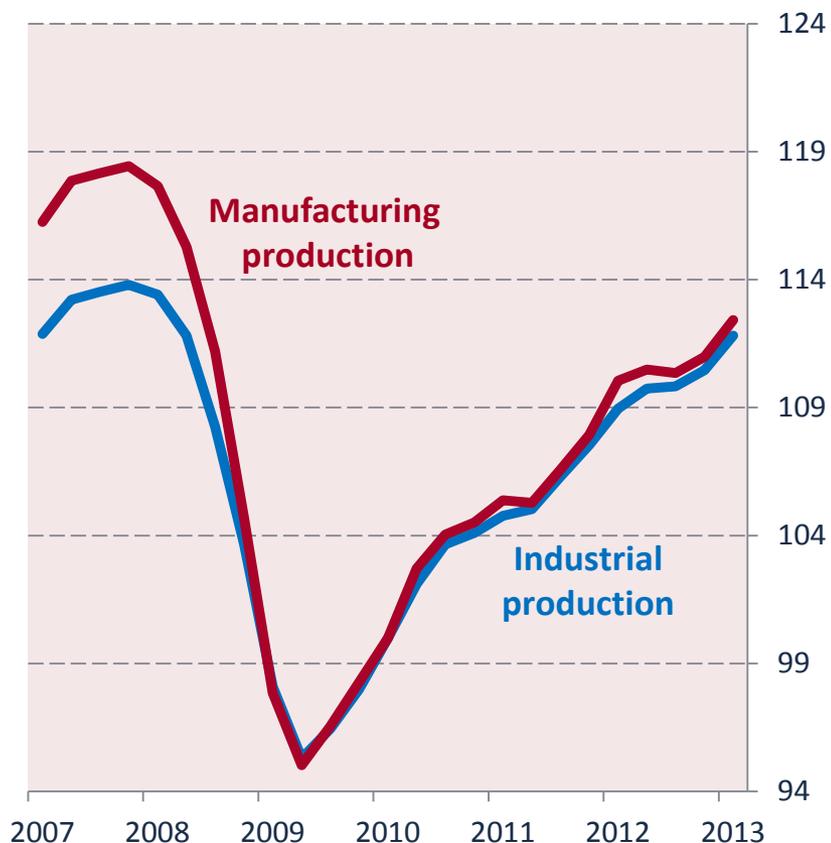
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Source: Estimated by Banco de México with data from IMF and Consensus Forecasts.

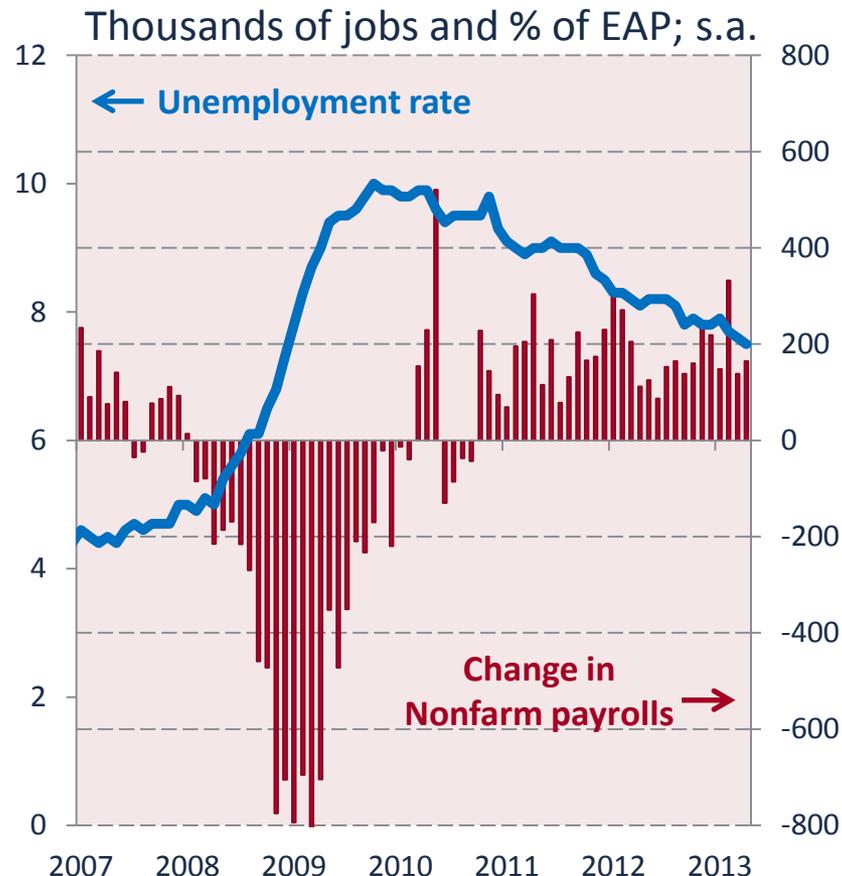
In the U.S., various indicators improved more than anticipated. However, recently some of them have pointed to a weaker economic recovery pace.

Industrial and Manufacturing Production
Index I 2010=100; s.a.



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

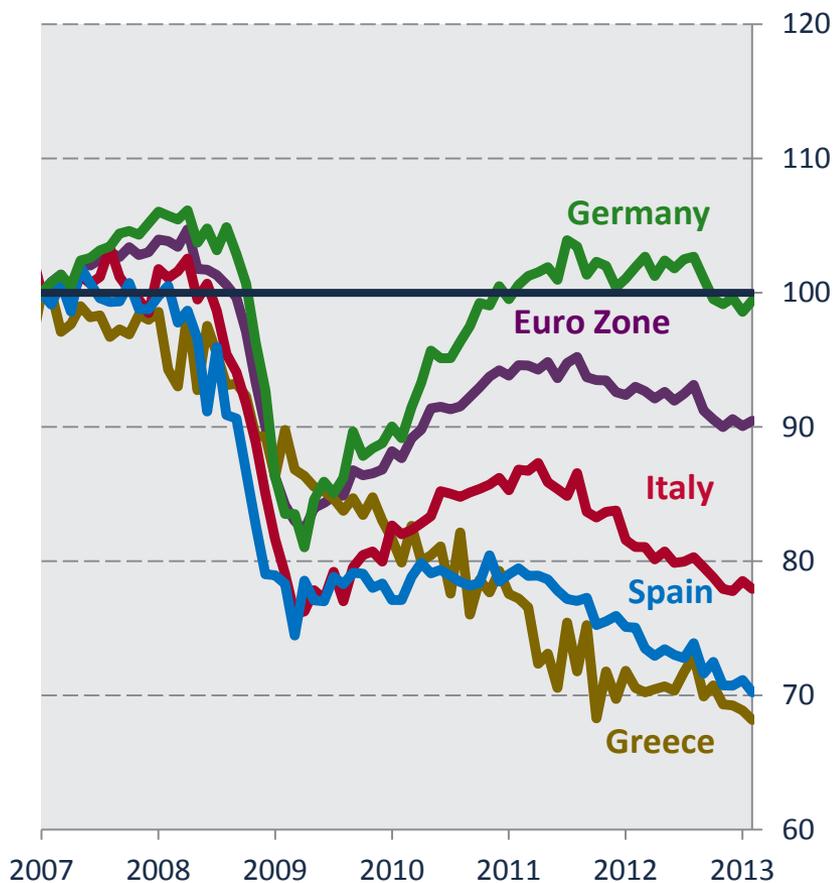
Change in Nonfarm Payroll and Unemployment Rate
Thousands of jobs and % of EAP; s.a.



EAP: Economically Active Population.
s.a./ Seasonally adjusted data.
Source: Bureau of Labor Statistics (BLS).

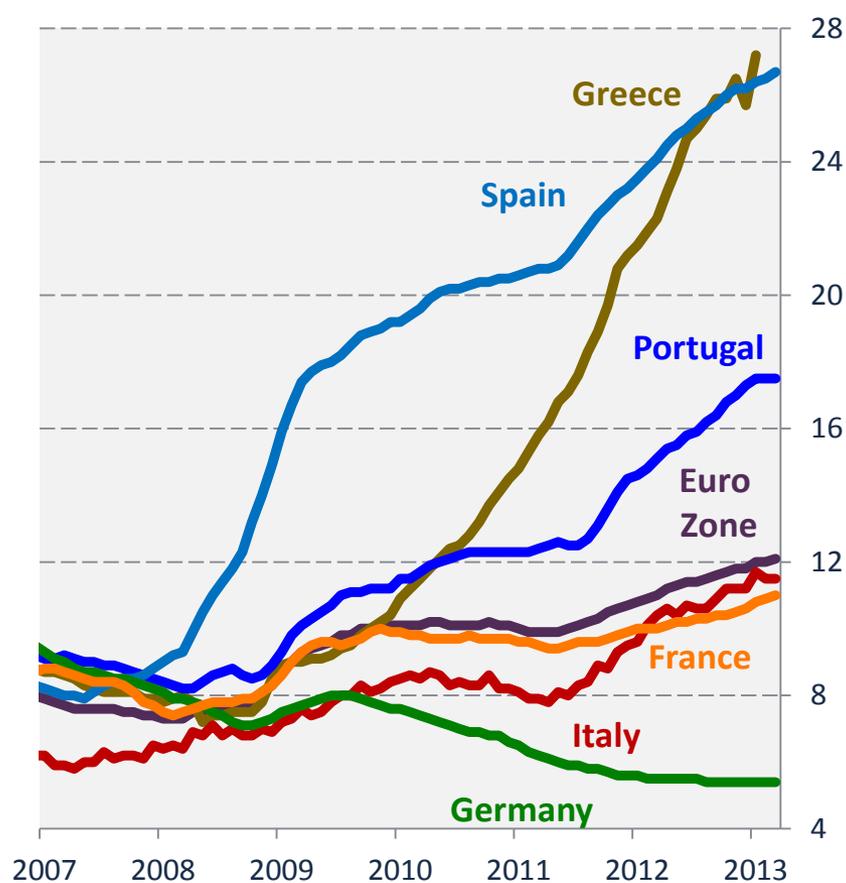
In the Euro zone, the necessary effort of fiscal consolidation, the fragility of the banking system and the ongoing deleveraging process, particularly in the economies at the periphery, maintained the region in recession.

Industrial Production
Index Jan-2007=100; s.a.



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

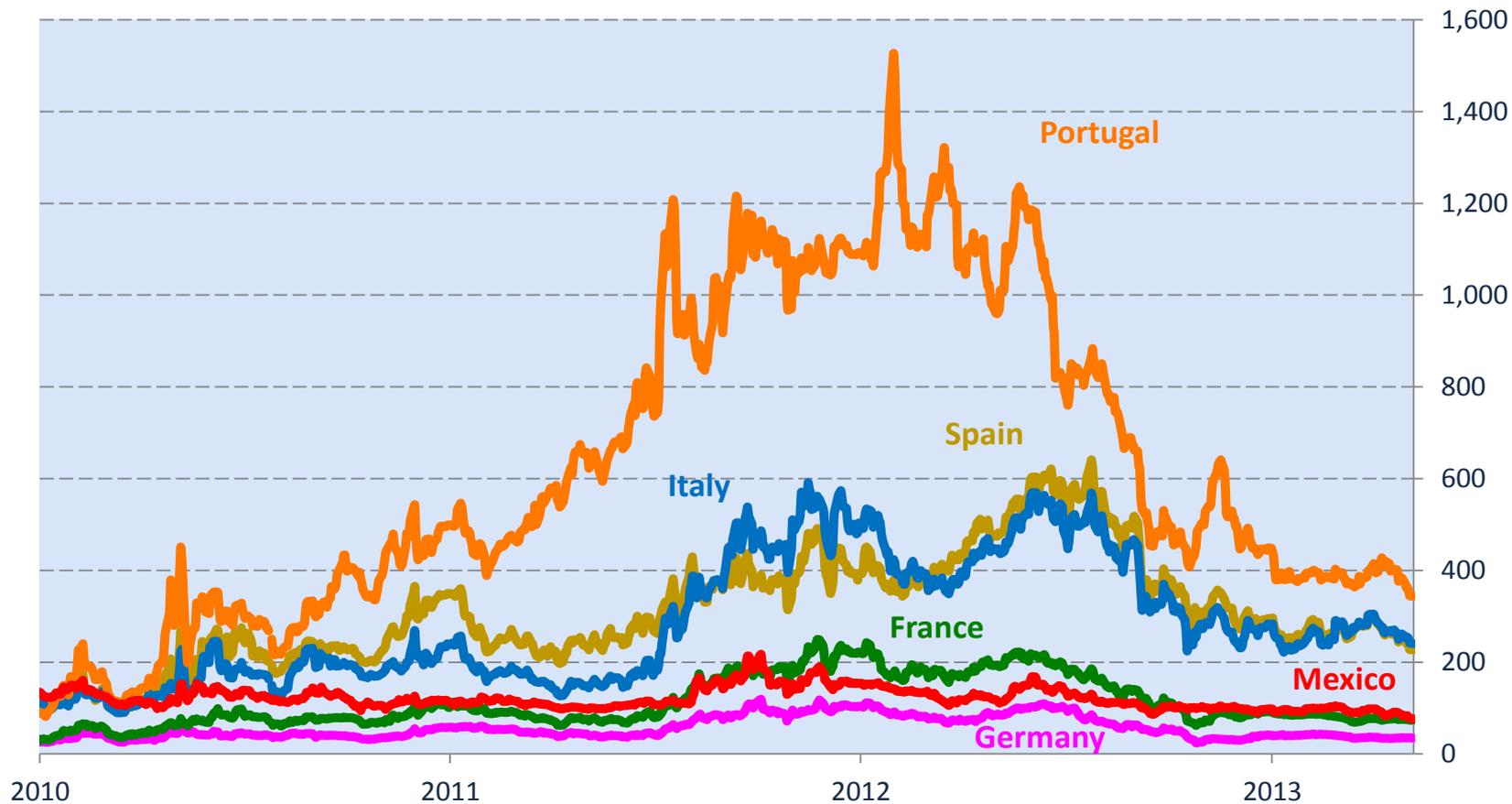
Unemployment Rate
% of EAP; s.a.



EAP: Economically Active Population.
s.a./ Seasonally adjusted data.
Source: Eurostat.

International financial markets improved in the first months of 2013, albeit with certain volatility.

Credit Default Swaps ^{1/} Basis points



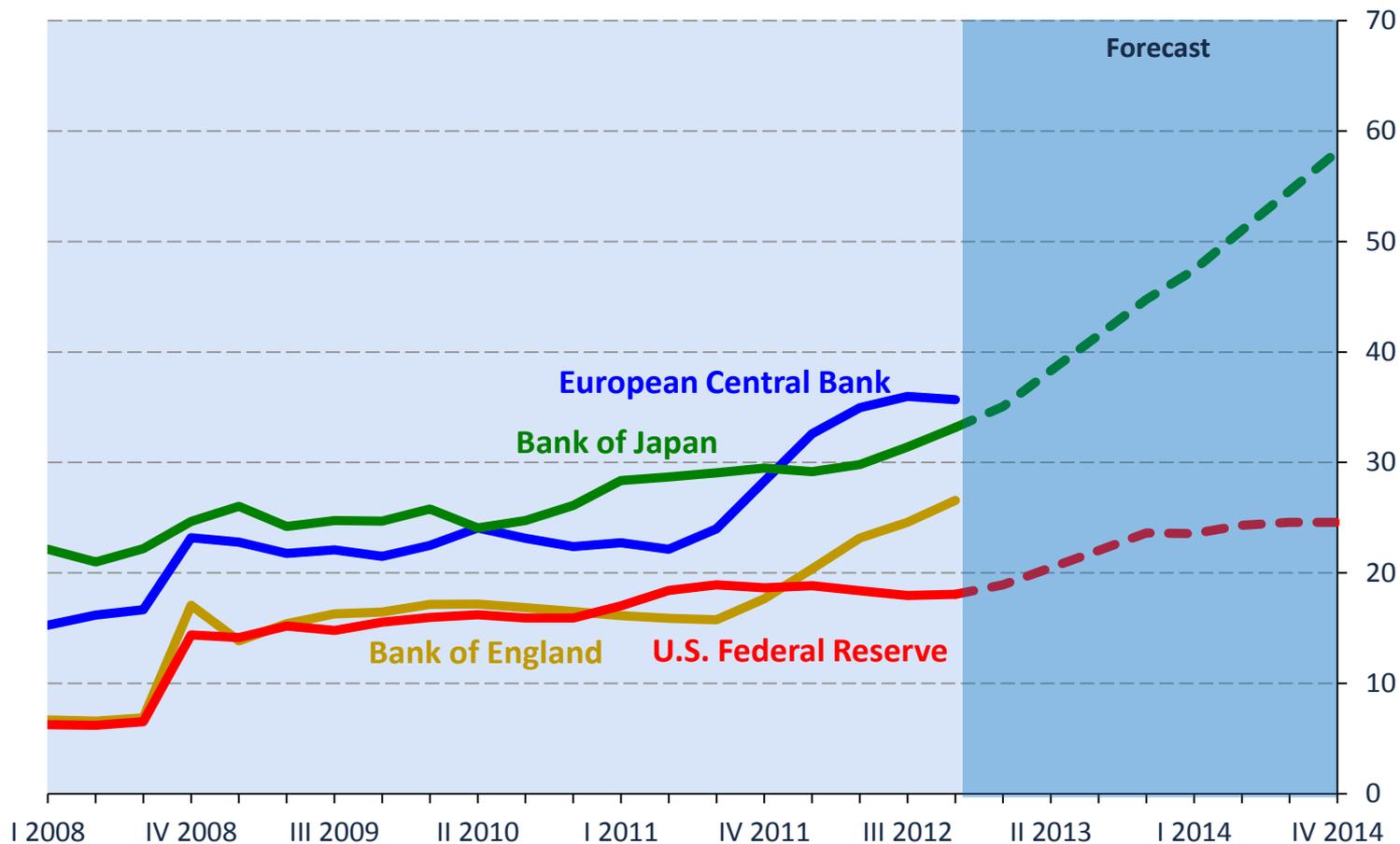
^{1/} 5-year CDS.

Source: Bloomberg.

The monetary policy is expected to remain accommodative in the major advanced economies, and in some cases additional easing could take place.

Balance Sheets of Selected Central Banks

Assets as % of GDP

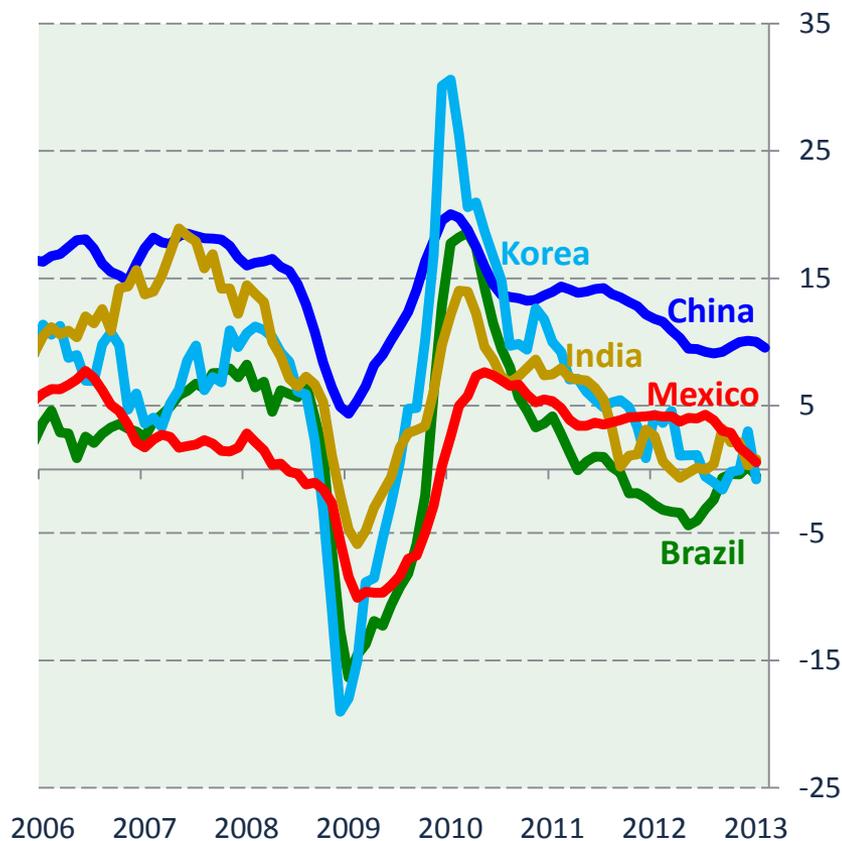


Source: Central banks and Haver Analytics.

In emerging economies, the economic activity growth has moderated, even though significant differences at the regional level persist.

Industrial Production

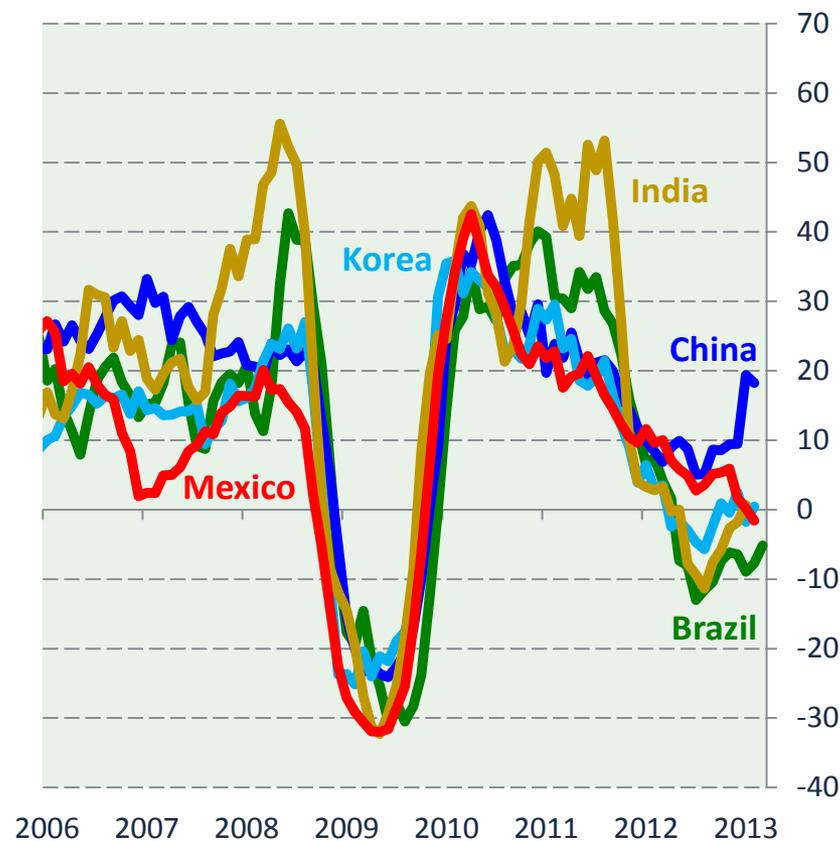
Annual % change of 3-month moving average



Source: INEGI and Haver Analytics.

Exports

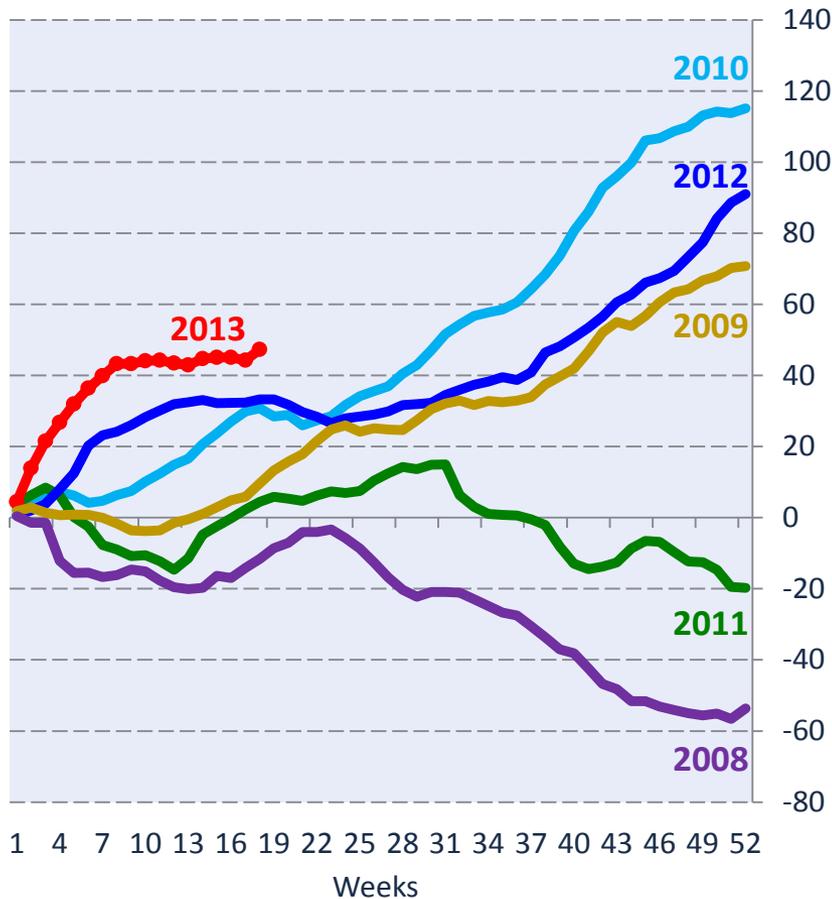
Annual % change of 3-month moving average



Source: INEGI and Haver Analytics.

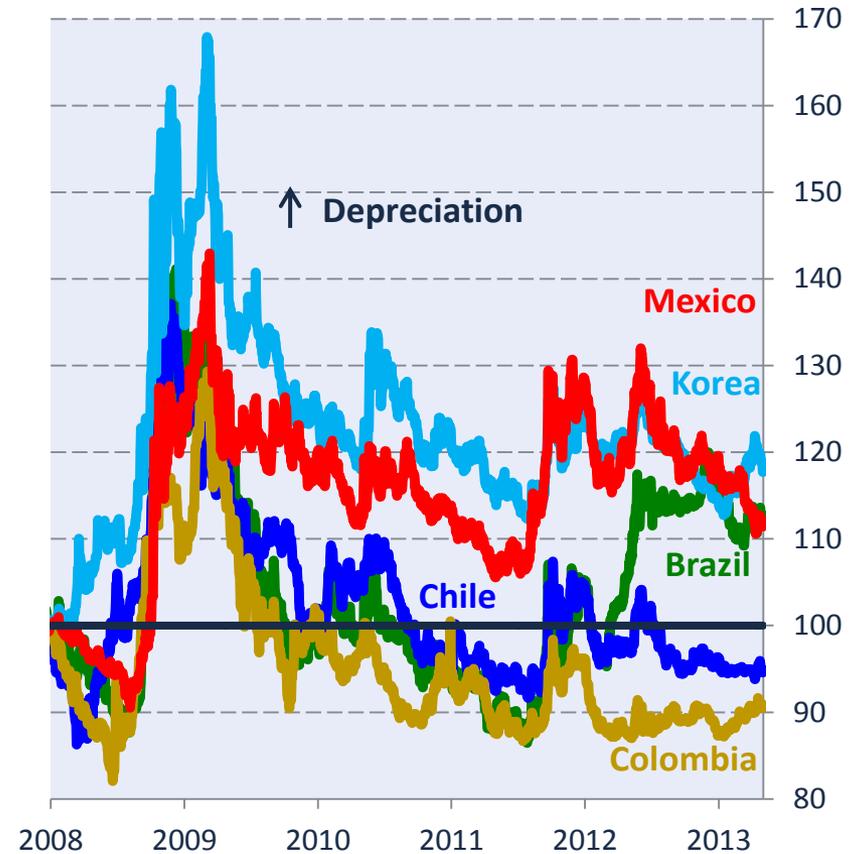
Capital flows to emerging economies increased at a greater pace with respect to the previous years, although with certain volatility, and the currencies of some of these economies (including Mexico) appreciated.

Accumulated Capital Flows ^{1/}
Billions of dollars



1/ Debt and Equity.
Source: Emerging Portfolio Fund Research.

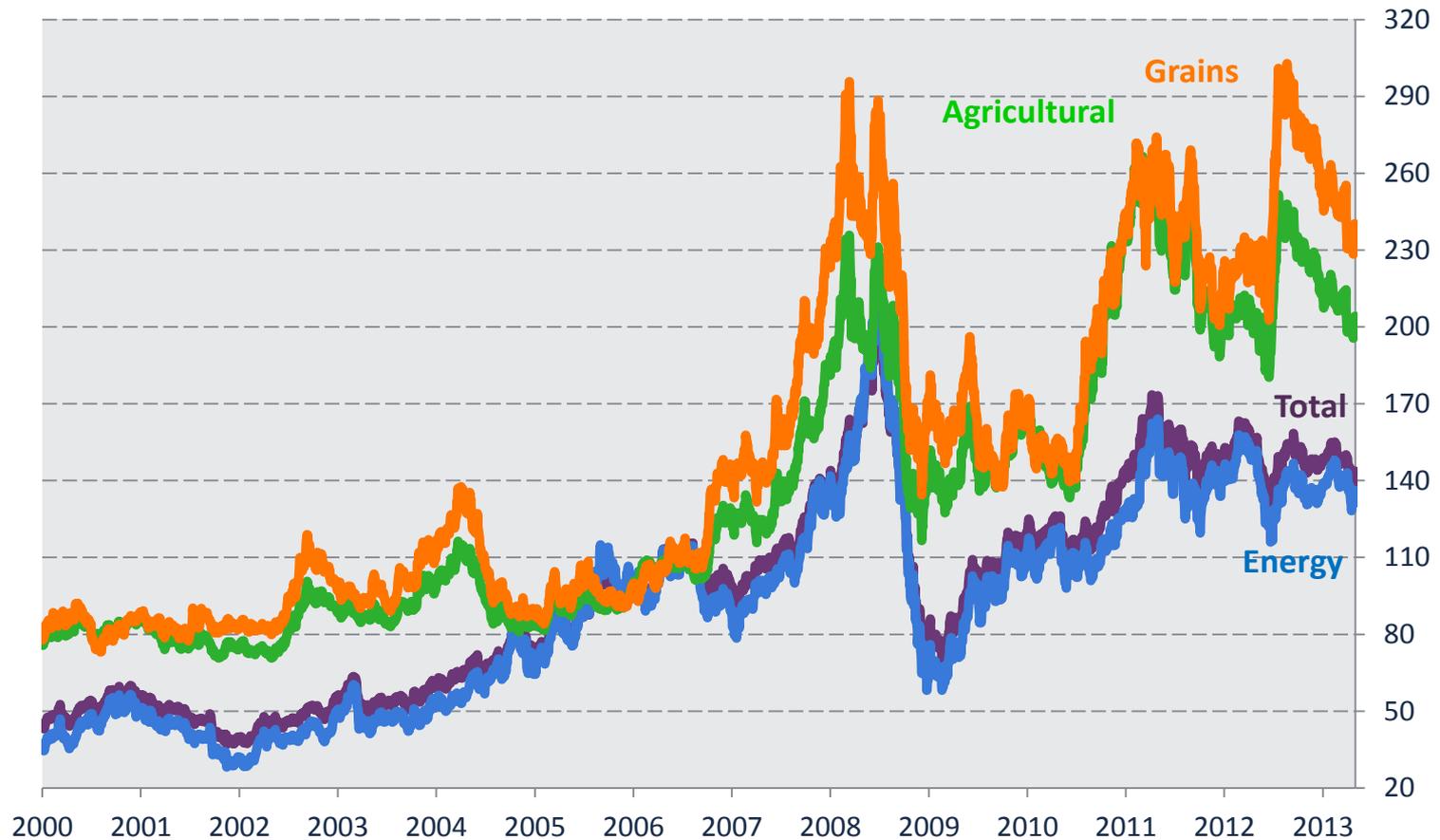
Exchange Rate
Index 1-Jan-2008=100



Source: Bloomberg.

International commodity prices generally maintained a downward trend in the first months of 2013.

Commodity Prices
Index 03-Jan-2006 = 100



Source: Standard & Poor's.

Outline

1 External Conditions

2 Economic Activity in Mexico

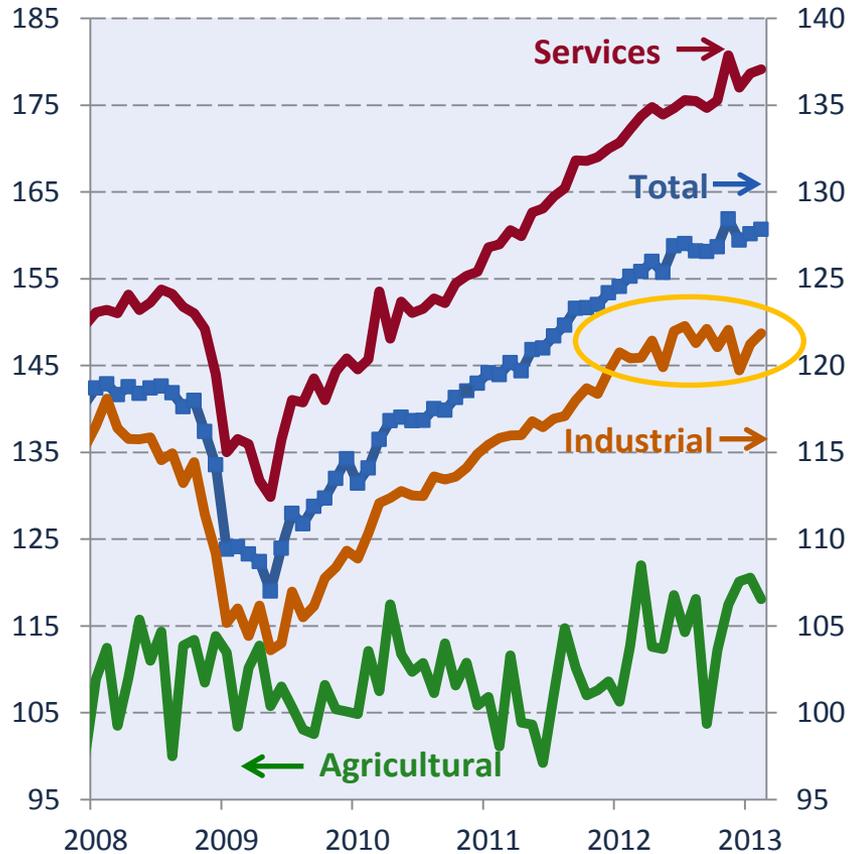
3 Monetary Policy and Inflation
Determinants

4 Forecasts and Balance of Risks

The economic activity in Mexico kept exhibiting moderate growth rates.

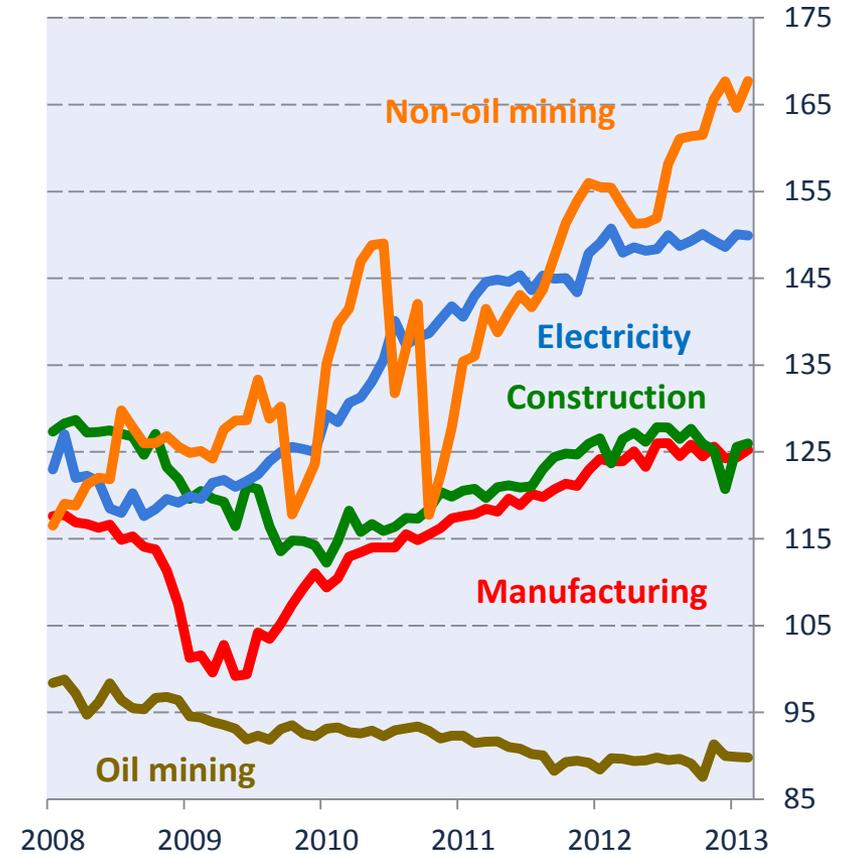
Global Indicator of Economic Activity (IGAE)

Index 2003=100; s.a.



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

Industrial Activity Index 2003=100; s.a.



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

The external demand kept showing lower dynamism.

Manufacturing Exports by Region of Destination

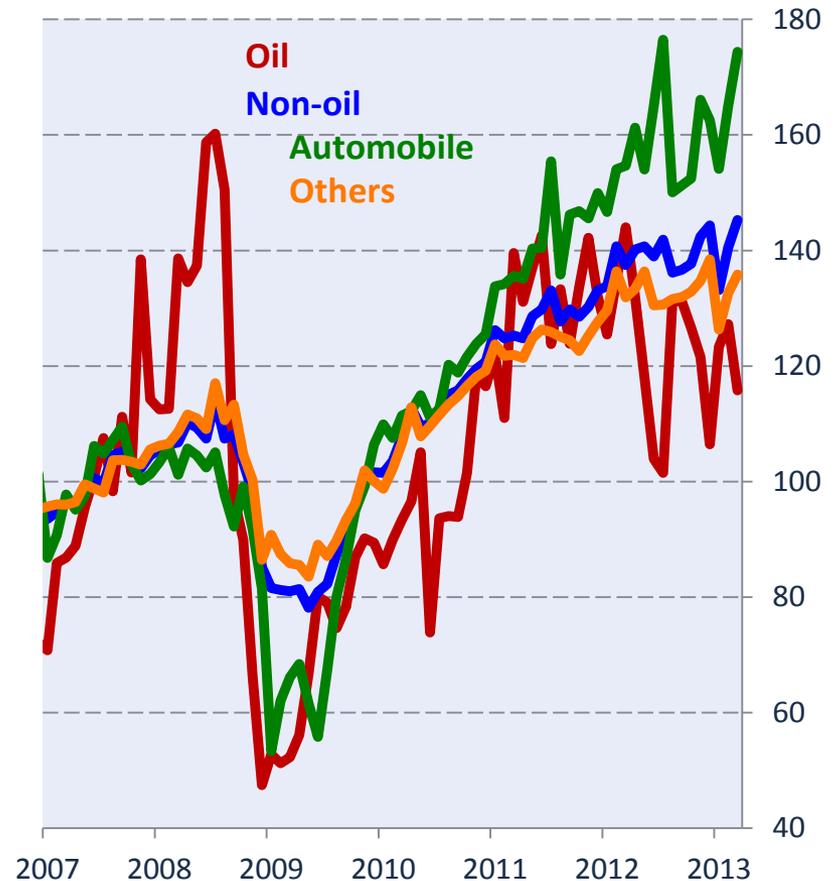
Index 2007=100; s.a.



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

Oil and Non-oil Exports

Index 2007=100; s.a.



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

Some recent consumption-related indicators observed a loss of dynamism.

Commercial Establishments' Retail Sales

Index 2003=100; s.a.



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

Consumer Confidence

Index Jan-2003=100; s.a.

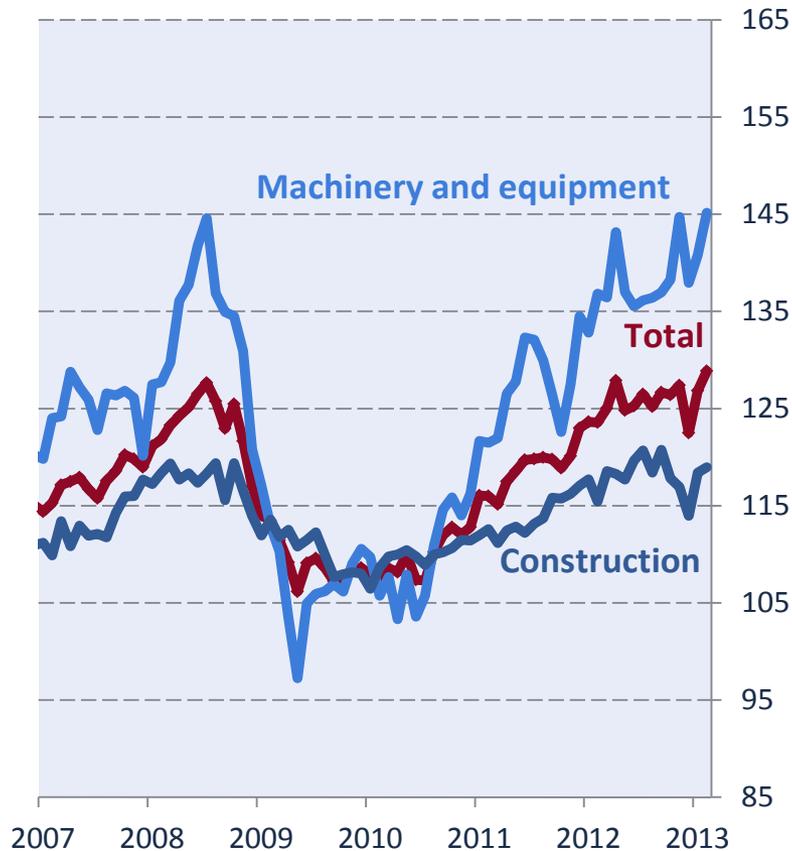


s.a./ Seasonally adjusted data.
Source: INEGI and Banco de México.

Gross fixed investment had mixed performance.

Investment and its Components

Index 2005=100; s.a.

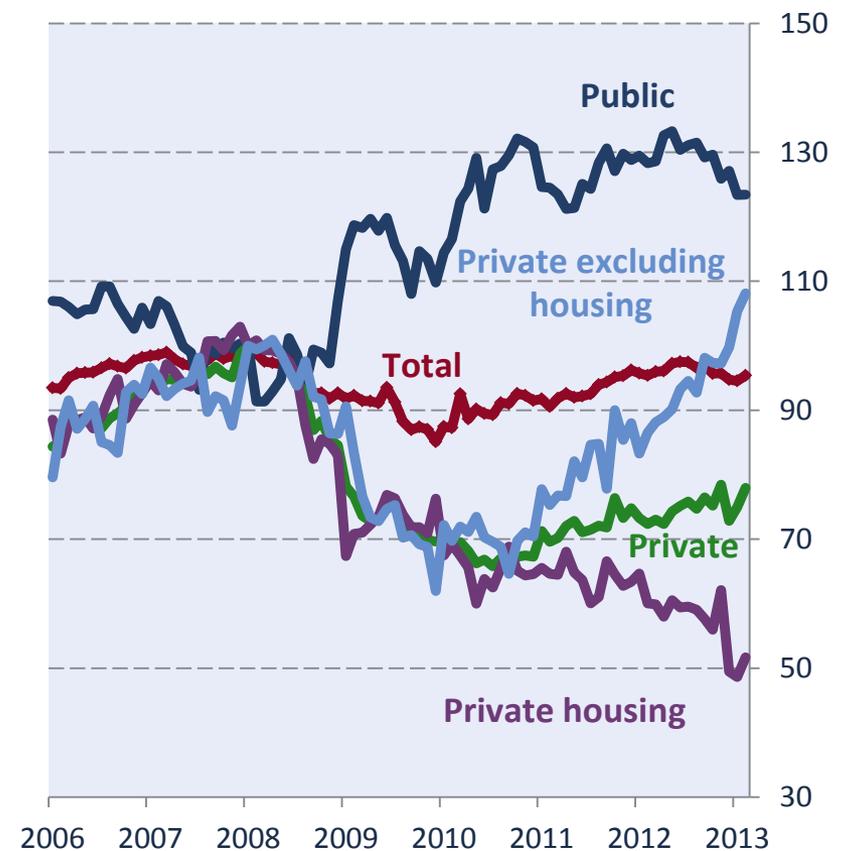


s.a./ Seasonally adjusted data.

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

Real Value of Production in Construction

Index Jan-2008=100; s.a.

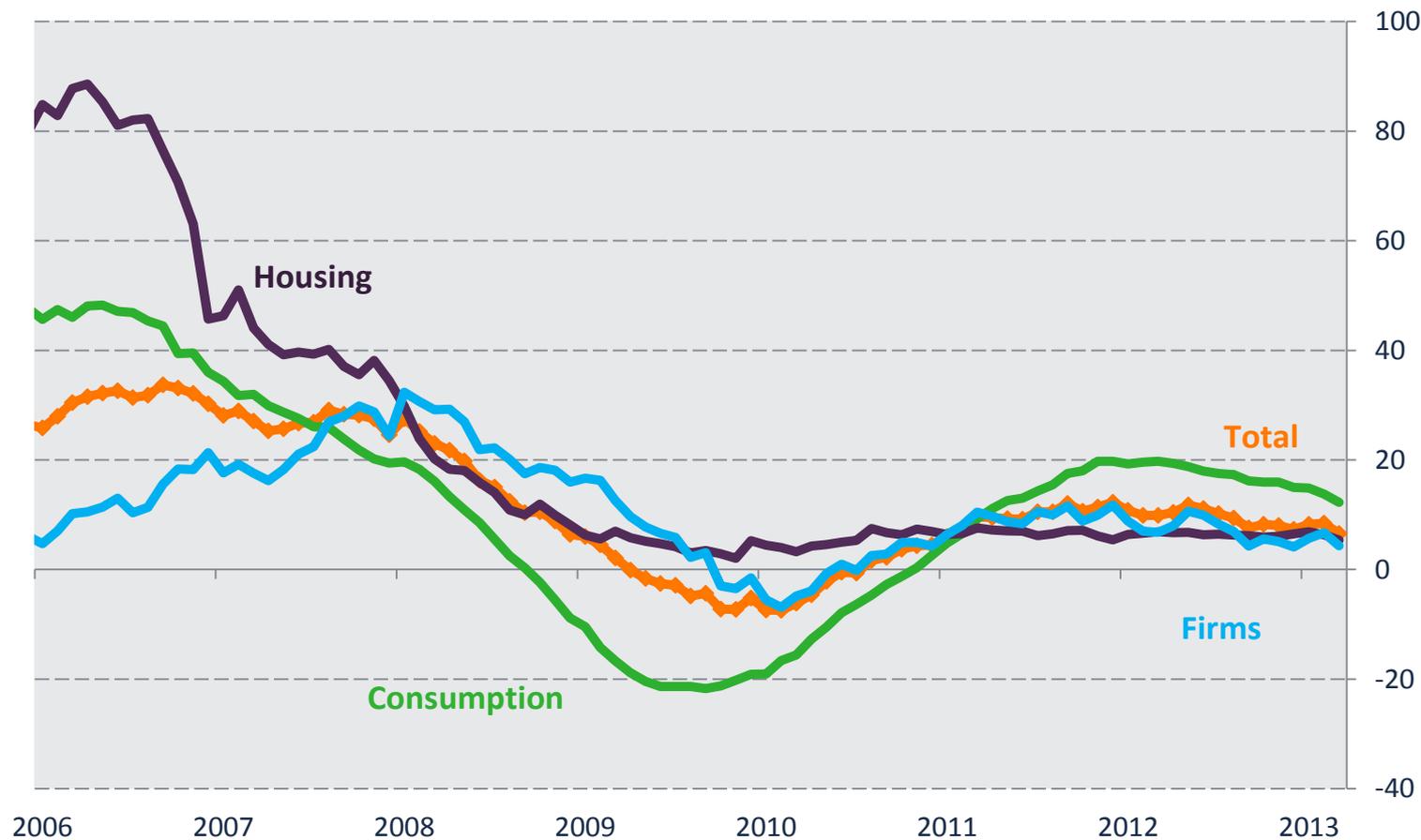


s.a./ Seasonally adjusted data.

Source: INEGI and seasonally adjusted by Banco de México in the case of public and private construction (private housing and private excluding housing).

Commercial banks' credit kept supporting the productive activity of Mexico.

Commercial Banks' Performing Credit to Non-Financial Private Sector Real annual % change



Source: Banco de México.

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4 Forecasts and Balance of Risks

The adoption since more than a decade ago of a monetary policy aimed at preserving the stability of the national currency purchasing power, together with a prudent fiscal policy, has allowed considerable progress in curbing inflation.

Structural progress in curbing inflation

Reduction in the level, volatility and persistence of inflation

Lower pass-through of relative price adjustments and of the corresponding exchange rate adjustments to consumer prices

Anchoring of inflation expectations

Drop of inflation risk premia to minimum levels

In March 2013, Banco de México's Board of Governors reduced by 50 basis points the target for the Overnight Interbank Interest Rate to a level of 4.0 percent.

- This reduction, besides acknowledging the medium-run achievements in curbing inflation:
 - ✓ Is in line with the medium-term inflation converging towards the 3 percent permanent target.
- Later, in April, the Board decided to maintain the reference rate unchanged at 4.0 percent.

Overnight Interbank Interest Rate ^{1/}



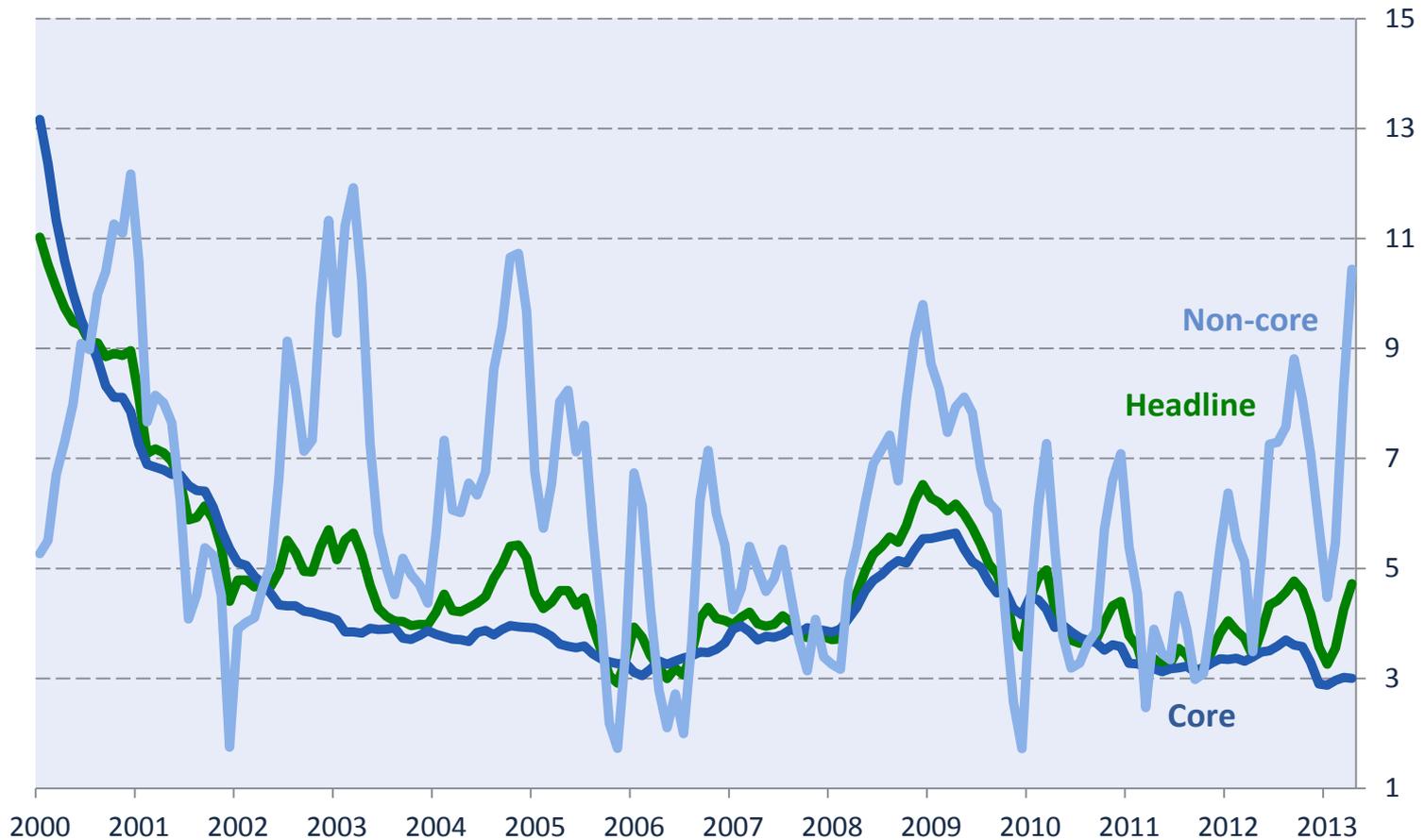
^{1/} Since January 21, 2008, the overnight interest rate corresponds to the target for the Overnight Interbank Interest Rate.

Source: Banco de México.

In 1Q 2013, the quarterly average of annual headline and core inflation was lower as compared to 4Q 2012. Nevertheless, by the end of 1Q 2013 and the beginning of 2Q 2013 a considerable rebound in headline inflation was observed.

Headline, Core and Non-core Inflation ^{1/}

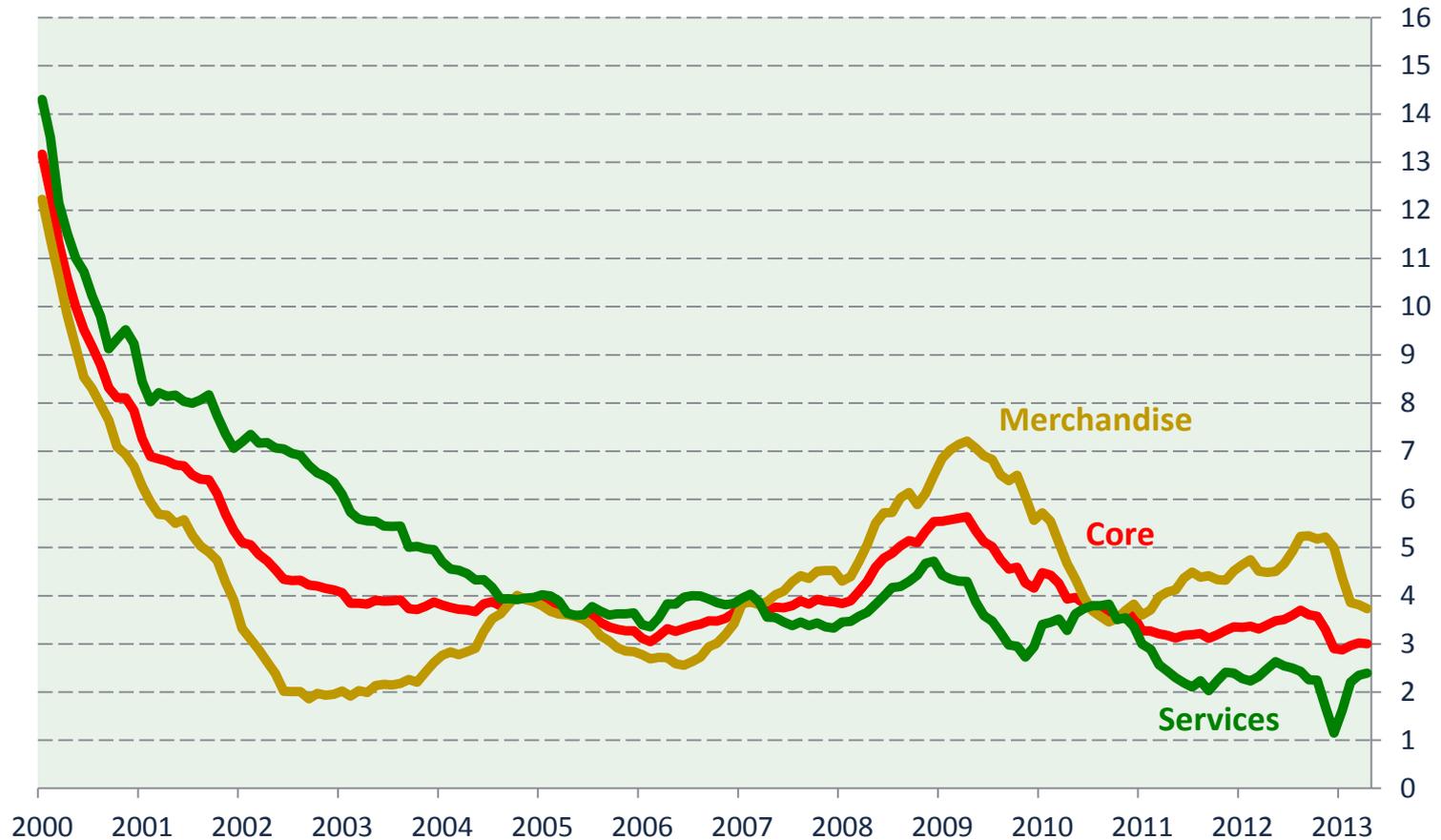
%



^{1/} Data as of the first fortnight of April 2013.
Source: Banco de México and INEGI.

Core merchandise inflation dropped in an environment of lower international commodity prices and the national currency appreciation, while services inflation persisted at low levels.

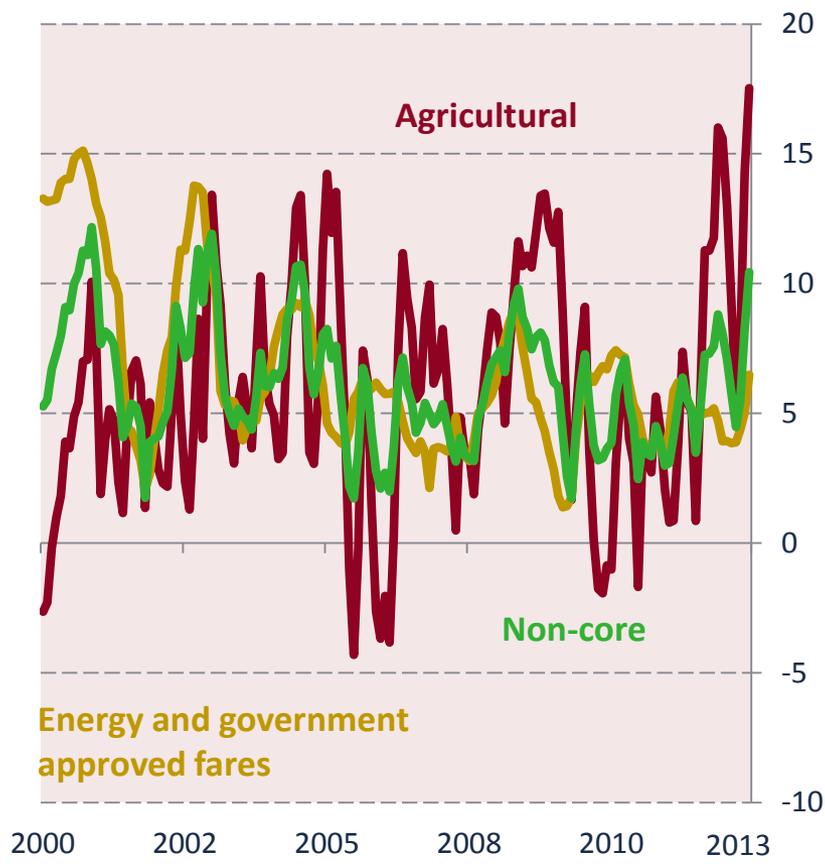
Core Inflation ^{1/}
%



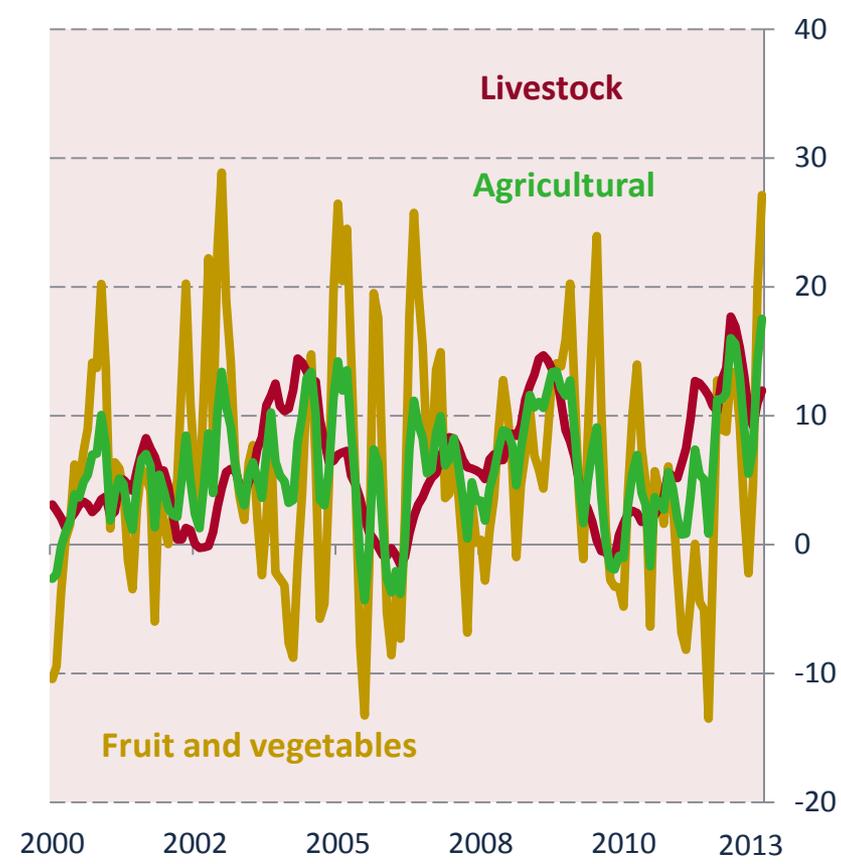
1/ Data as of the first fortnight of April 2013.
Source: Banco de México and INEGI.

Increase in non-core inflation resulted from higher incidences of agricultural products' and energy prices, as well as from the recent increase in public transport fares in Mexico City.

Non-core Inflation ^{1/}
%



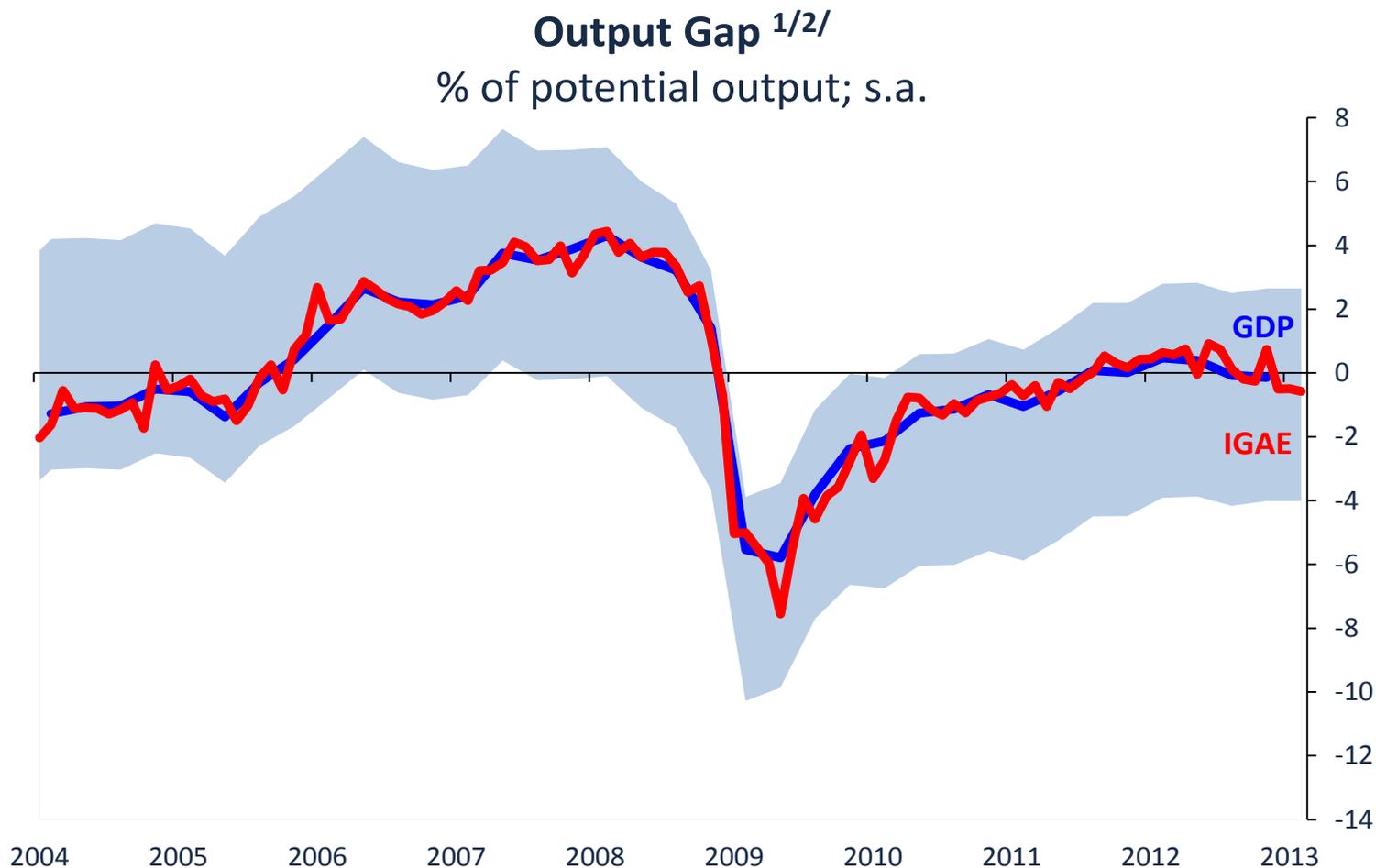
Agricultural Inflation ^{2/}
%



1/ Data as of the first fortnight of April 2013.
Source: Banco de México and INEGI.

2/ Data as of the first fortnight of April 2013.
Source: Banco de México and INEGI.

During 1Q 2013 the output gap is estimated to have continued at levels 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 4Q 2012; IGAE up to February 2013.

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

In this context, the labor market continued presenting slackness.

IMSS-insured Workers ^{1/}
Million workers



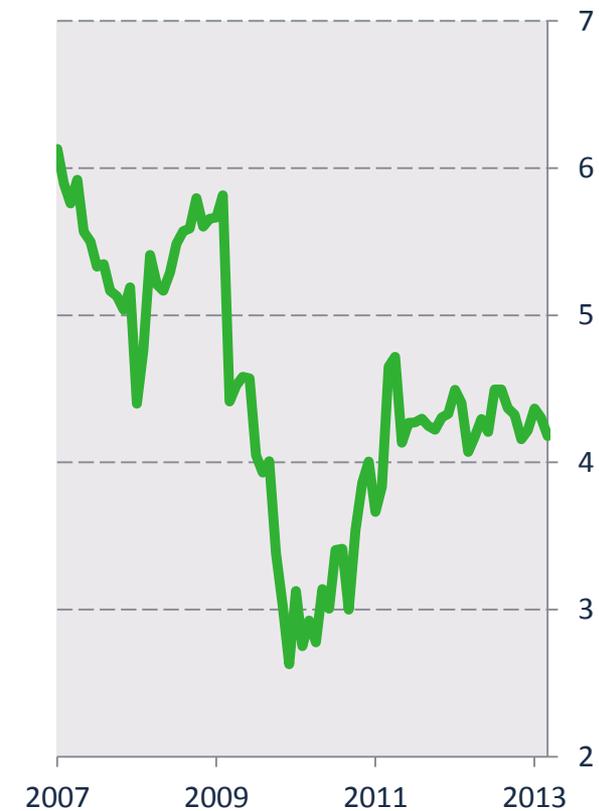
^{1/} Permanent and temporary workers in urban areas.
Source: IMSS and seasonally adjusted by Banco de México.

National Unemployment Rate
% of EAP; s.a.



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

IMSS Reference Wage
Annual % change



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

Despite a recently observed increase in inflation, the medium- and long-term inflation expectations persist stable and the break-even inflation and inflationary risk continued decreasing.

Annual Headline Inflation Expectations ^{1/}
%



^{1/} It refers to the median of inflation expectations.
Source: Banco de México's survey.

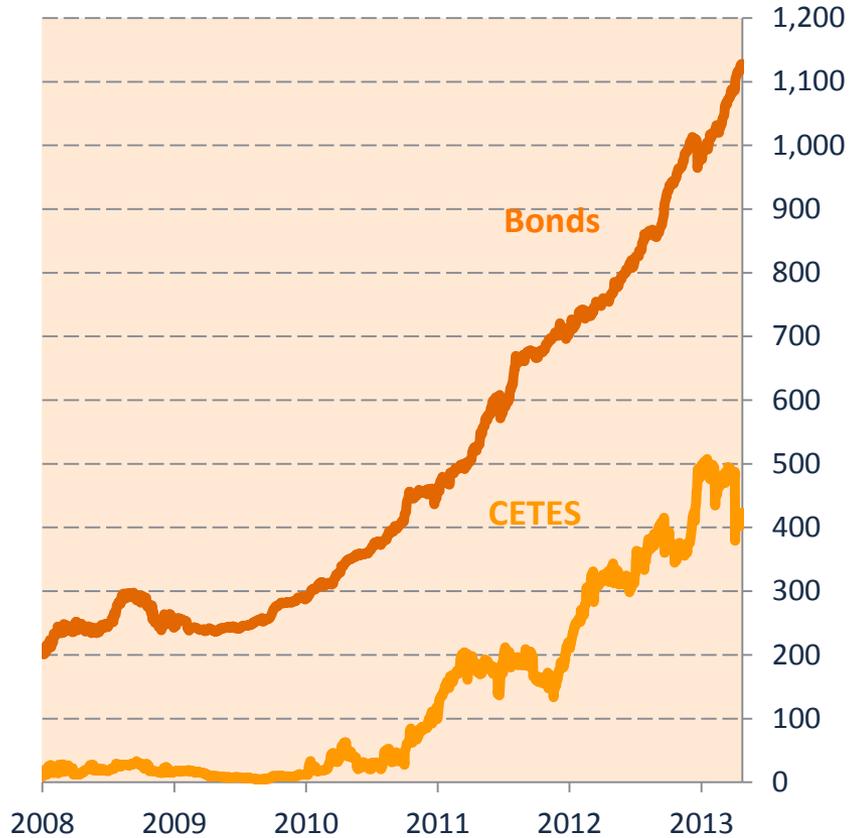
Break-even Inflation and
Inflationary Risk ^{2/}
%



^{2/} 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.

Improvement in international financial markets together with the strength of the macroeconomic framework in Mexico have brought about an increase in capital flows to the country and an exchange rate appreciation.

Government Securities Holdings by Foreign Investors
Billions of pesos



Source: Banco de México.

Exchange Rate and its Expectations for the End of 2013 and 2014^{1/}
Pesos per dollar



^{1/} The observed exchange rate is the daily FIX exchange rate. Data up to May 07, 2013.

Source: Banco de México and Banamex survey.

Interest rates reached levels close to their historical minimum. Nonetheless, interest rate spreads still remain above the pre-crisis levels.

Interest Rates of Government Securities ^{1/}
%



^{1/} Since January 21, 2008, the overnight interest rate corresponds to the target for the Overnight Interbank Interest Rate.

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

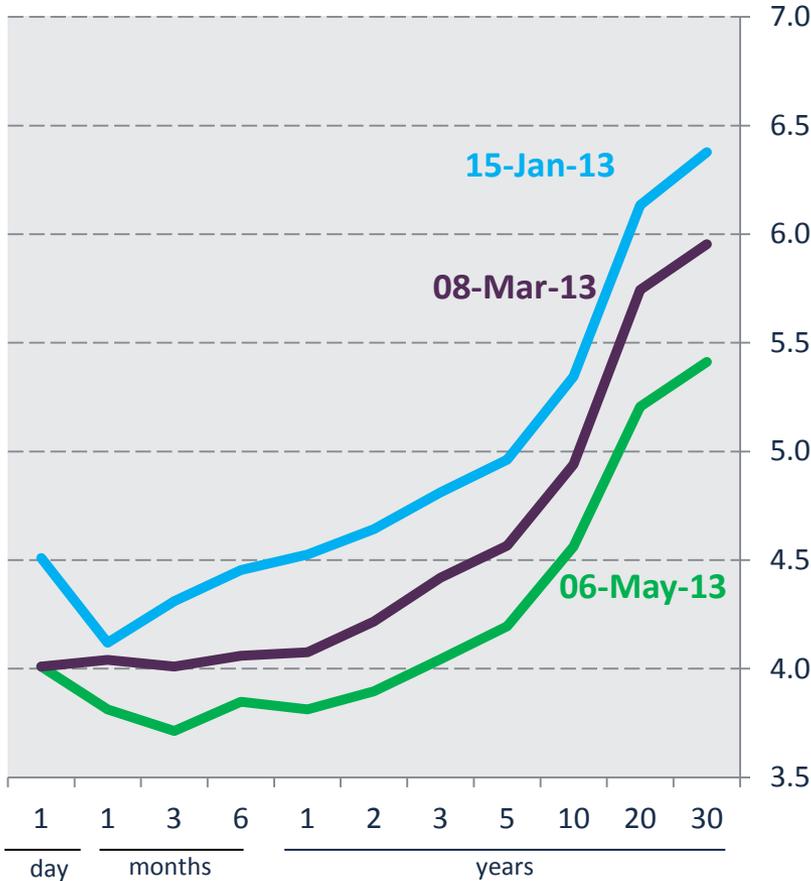
Interest Rate Spreads between Mexico and the U.S.
Percentage points



Source: Banco de México, Proveedor Integral de Precios (PiP) and U.S. Treasury.

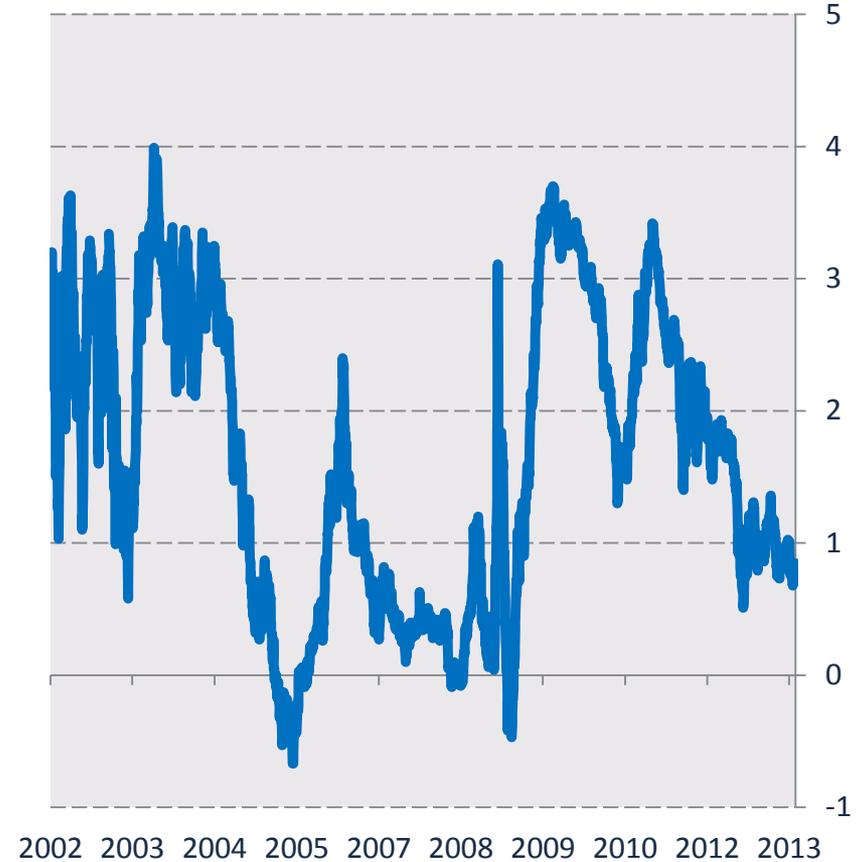
In this context and as a reflection of the anchoring of inflation expectations, the government bond yield curve has flattened.

Government Bond Yield Curve
%



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

Yield Curve Slope ^{1/}
Percentage points



^{1/} The slope is defined as the difference between the 10 years and 3 months interest rates. Source: Proveedor Integral de Precios (PiP).

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**3 Monetary Policy and Inflation
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4 Forecasts and Balance of Risks

Given the forecasts for the Mexican economy, no aggregate demand-related pressures on inflation are anticipated and a loose financing of the current account deficit is expected.

GDP growth:

- ✓ *Between 3.0 and 4.0 percent in 2013.*
- ✓ *Between 3.2 and 4.2 percent in 2014.*

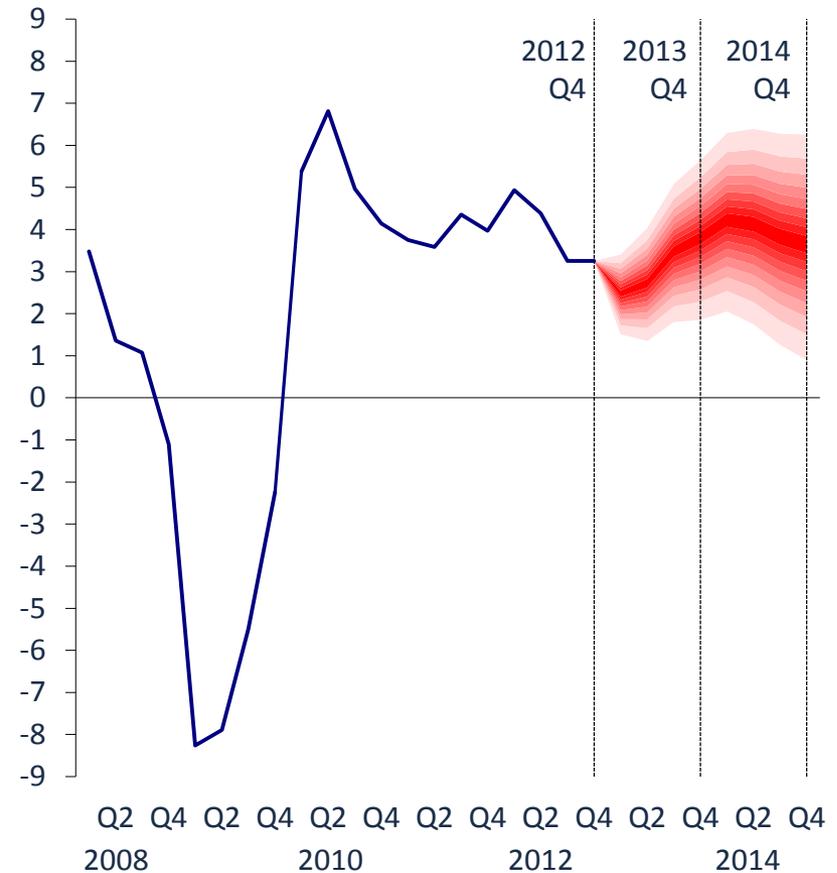
Increase in the number of IMSS-insured workers:

- ✓ *Between 550 and 650 thousand in 2013.*
- ✓ *Between 700 and 800 thousand in 2014.*

Current Account:

- ✓ *1.3 percent of GDP in 2013.*
- ✓ *1.4 percent of GDP in 2014.*

Fan Chart: GDP Growth
Annual %; s.a.



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

Balance of Risks for the Economic Activity

Important downward risks to the economic growth of the Mexican economy persist



In contrast, insofar as the process of structural reforms continues, the scenario for the economic growth in Mexico could become more favorable.

Inflation Forecasts

Inflation forecasts are based on the following factors

The monetary policy stance.

The world environment of slow growth.

Absence of demand-related pressures on the Mexican economy.

Higher competition in some sectors.

Downward trend in international commodity prices.

Fading of the effect on inflation produced by some foods' price increases.

Inflation Forecasts

Annual headline inflation is forecast to observe a similar trend to that in the previous Inflation Report

Headline

2013

Will maintain high levels in April and May. From June onwards it will resume its downward trend to locate in **3Q and 4Q 2013 between 3 and 4 percent.**

2014

Will locate **very close to 3 percent**, slightly lower than expected in the previous Inflation Report.

Core

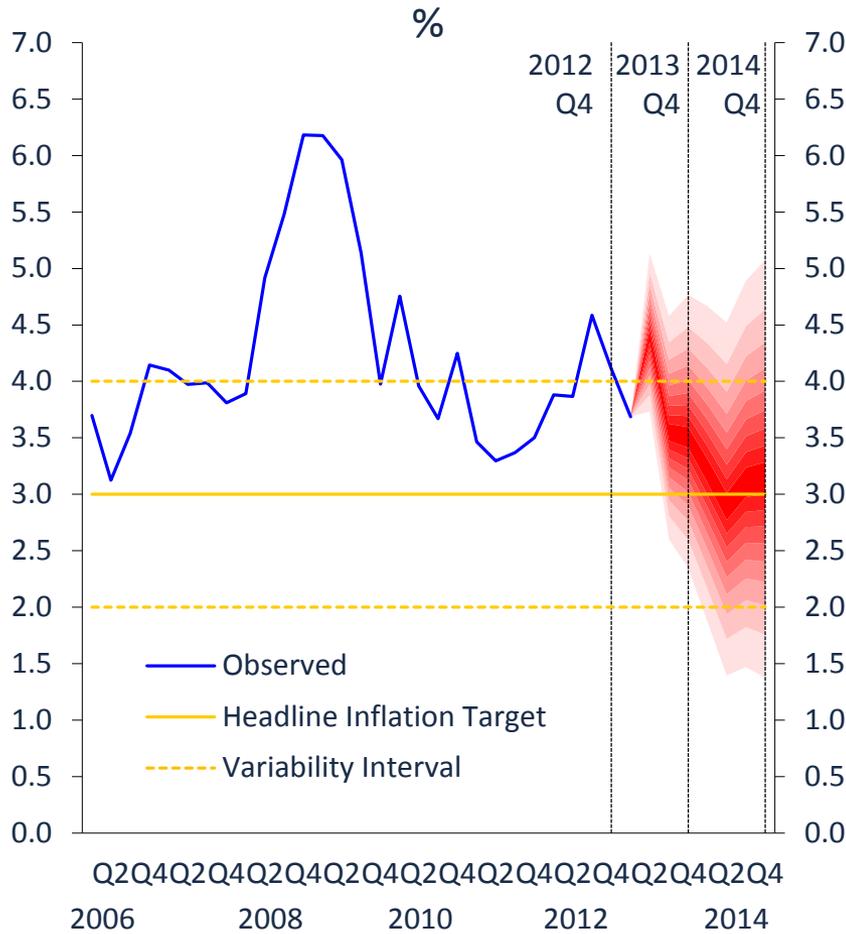
2013-2014

Will remain close, and even below 3 percent.

Headline inflation is anticipated to maintain high levels in April and May, resuming from June onwards a downward trend, while core inflation will remain close to or even below 3%.

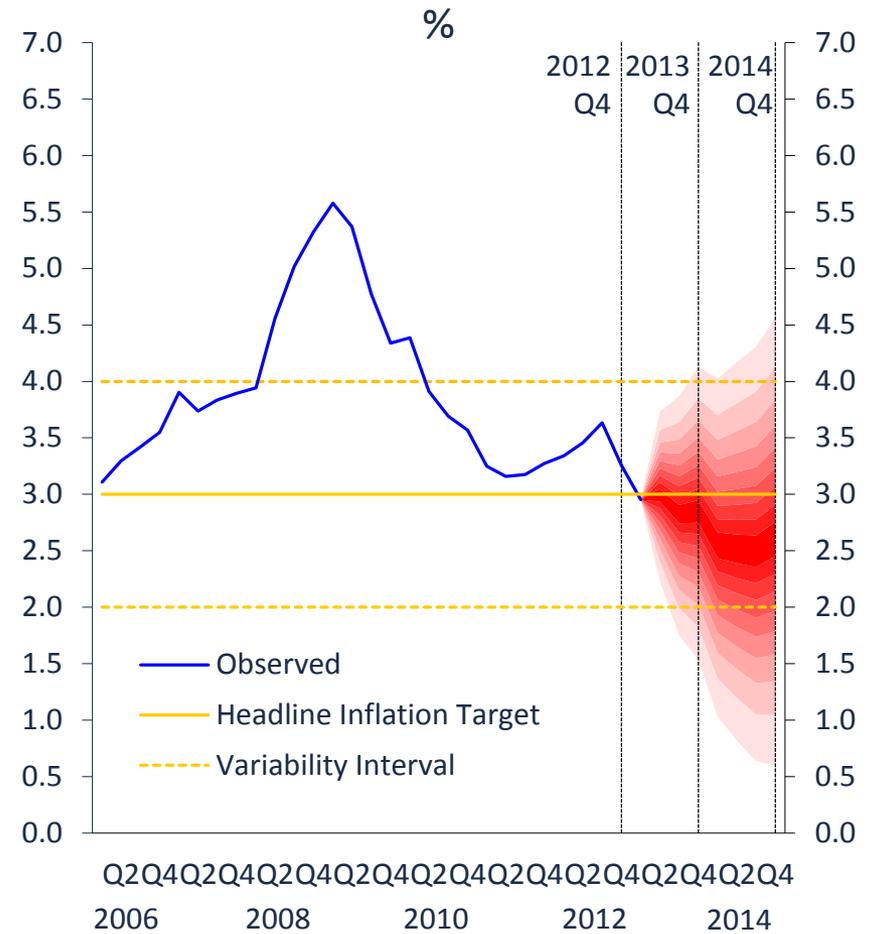
Fan Charts

Annual Headline Inflation ^{1/}



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

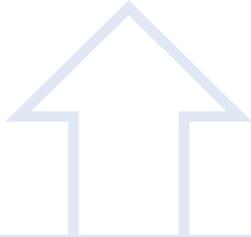
Annual Core Inflation ^{2/}



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

Balance of Risks for Inflation

Upward



Further adjustments to public transport fares

New sanitary contingencies and/or adverse weather conditions, which affect the agricultural merchandise prices

Downward

The possibility that the downward trend of commodity prices will become more pronounced

The possibility of higher competition in the economy in general and in the telecommunications sector in particular

Greater appreciation of the exchange rate



Monetary Policy Stance

- After reducing the benchmark interest rate by 50 basis points 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 that the monetary policy is in line with an outlook in which:
 - ✓ *No widespread pressures on inflation are anticipated.*
 - ✓ *Expenditure dynamics are expected to be in line with the inflation convergence towards the 3 percent permanent target.*
- In the future, the Board will monitor the evolution of all inflation determinants.
 - ✓ *In particular, it will remain alert so that the recent changes in relative prices do not generate second round effects on the price formation process in the economy, as well as 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 3 percent permanent inflation target.

It is necessary to continue with the process of structural reforms, which strengthen the internal sources of growth.

Continue with the reforms that:

Increase productivity from a microeconomic point of view

Complement macroeconomic stability reached by Mexico

Allow a better resource allocation towards their most productive uses and the adoption of better technologies



These reforms would allow:

Greater economic growth, while the environment of low and stable inflation is strengthened

Greater resistance of the economy to different shocks, which could possibly affect it

Make the Mexican economy increasingly competitive and induce more foreign direct investment



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