# Inflation Report

## *April - June 2010*

## *Summary*

The world economy continued to recover during the second quarter of 2010, in spite of the stress in international financial markets originated by concerns over sovereign risk in Europe. Global economic activity has so far been affected in a limited way by the European crisis; however, it has accentuated the differences in growth prospects across regions and countries. It is worth mentioning that most recent figures indicate some slowdown of the U.S. economy. This, together with the potential withdrawal of fiscal stimuli in various industrialized countries, has increased the downside risks for world economic growth.

The major advanced economies continued to grow at moderate rates, especially in activities related to international trade and industrial production. Nevertheless, incoming data point to a weak recovery of private demand, which, in turn, is subject to future risks. Although the exceptional monetary and fiscal stimuli continued to provide considerable support for economic activity in many countries, the required fiscal consolidation has generated uncertainty about private demand's capacity to sustain growth in these countries in the near future. Emerging economies, particularly in Asia, exhibited stronger growth during the second quarter, as reflected by the dynamism of their exports and domestic demand.

World inflation remains low, particularly in the major industrialized countries. In fact, most of them register negative output gaps, as well as low levels of both inflation and its expectations. Considering that the fiscal stimuli will start to be withdrawn, it is foreseeable that monetary conditions will remain highly accomodative for some time. On the other hand, the central banks of some advanced and emerging economies have already started to withdraw the monetary stimulus due to the recovery of their economic activity.

Uncertainty in international financial markets rose significantly in April of this year due to the perception of a greater risk of default in some European countries' sovereign debt. The strong increase in counterparty risk among financial institutions in Europe led to an inadequate functioning of some markets, and even generated the perception among investors of a possible collapse of European financial markets. As a result, the euro depreciated considerably against other currencies. In response, in May, the European Central Bank implemented unprecedented measures to face the severe problems in certain segments of financial markets that were hampering the proper functioning of the monetary policy transmission mechanism. Additionally, the European Union and the International Monetary Fund jointly arranged a financial package for up to 860 billion euros, with the purpose of granting financial assistance to European Union member countries facing difficulties or severely threatened by exceptional circumstances beyond their control. Access to these financial resources is subject to strong conditionality.

The adopted measures contained the deterioration of financial markets and seem to have prevented a situation of widespread contagion. In particular, financing conditions in international markets stabilized in May and have even improved over the last weeks. The situation in Europe therefore did not affect significantly the capital flows to emerging economies. Nevertheless, this recent episode highlighted the propagation mechanism of sovereign debt risk through banks, which could affect other financial markets. Although progress has been made in addressing the fiscal problems in some European countries, this situation is still a source of vulnerability for global economic growth.

As for productive activity levels in Mexico, during the second quarter of 2010 external demand continued to grow and, hence, manufacturing production continued exhibiting an upward trend. Although private sector consumption and investment remained at relatively low levels, recently both seem to be showing a favorable change of trend. The quarterly change in GDP is estimated to have been between 2.5 and 3.0 percent in seasonally adjusted terms during the second quarter of this year, thus strengthening the gradual recovery of economic activity that began in the second half of 2009. Despite this, GDP is expected to remain below the economy's productive potential.

During the second quarter of 2010, average annual headline inflation was 3.96 percent, 0.79 percentage points below first quarter figures, and 0.54 percentage points below the lower limit of the interval forecasted for that period by Banco de México. Inflation numbers have been better than expected. Part of this improvement is due to seasonal and conjunctural factors, such as the strengthening of the exchange rate parity and a reduction in its volatility, the increased competition between various retail chains, and an abundant supply of some vegetables.

Under these circumstances, Banco de México's Board of Governors decided to leave the overnight interbank rate target unchanged at 4.5 percent in the last months.

The macroeconomic scenario forecasted by Banco de México is as follows:

**GDP Growth:** During the rest of the year and in 2011, external demand is expected to continue providing a stimulus for Mexico's growth. This, together with the gradual recovery of domestic demand, suggests a similar scenario to that presented in the Inflation Report for January - March 2010. Thus, the expectation that real GDP will grow between 4.0 and 5.0 percent in annual terms in 2010 and between 3.2 and 4.2 percent in 2011 remains unchanged.

GDP is therefore expected to exhibit a positive performance for the remainder of the year and for 2011, albeit growing at a more moderate pace than in the second quarter of 2010. This scenario suggests that the output gap will remain negative for the year as a whole. Nevertheless, there is a small probability that it could turn positive during the first half of 2011.

**Employment:** The number of IMSS-insured workers is expected to increase between 525 and 625 thousand in 2010, and between 500 and 600 thousand in 2011.

**Current Account:** The recovery of domestic demand and productive activity in 2010 will translate into a higher deficit in the trade and current account balances as compared with 2009, although the dynamism that exports are expected to exhibit will keep such deficit at low levels. Both deficits are therefore anticipated to reach between 7.9 and 8.3 billion US dollars, respectively (0.8 percent of GDP in both cases).

Given the lower deficit in the current account expected for 2010, the present foreseen conditions to access international financial markets, and the end of the federal government's refinancing program for 2010, the Mexican economy is not anticipated to face foreign financing problems for the remainder of the year. The different measures implemented to mitigate the effects on the economy that might arise from an eventual upsurge of new episodes of volatility and uncertainty in international financial markets should also contribute to the aforementioned. Together with the recent fiscal consolidation efforts, worth mentioning are the accumulation of international reserves, the

acquisition of hedge funds for oil prices, and the Flexible Credit Line with the International Monetary Fund.

The expected scenario for economic growth in 2010 and 2011, however, is not risk free. In fact, the current economic situation of various countries in the Eurozone suggests that the downward risks for global economic growth have increased:

a. The perception that world economic growth, especially in advanced economies, has essentially relied on the policies supporting aggregate demand -and which were implemented in response to the recession resulting from the financial crisis in 2008- prevails. Under these circumstances, there is uncertainty about the possible impact of an impending withdrawal of these stimuli on private demand in these economies.
b. The outlook for the U.S. economy seems to be unusually uncertain. The weakness of the labor market and the fact that the incipient improvement of financial conditions in this country has still not been a factor to encourage private spending deserve mentioning. Therefore, there is still the risk of a slow increase in consumption being reflected in a less vigorous demand for Mexican exports.
c. Finally, up to now, the recent volatility observed in international financial markets has not affected the growth prospects in emerging economies significantly. Nevertheless, a further deterioration in these markets could affect the access to financing in these economies.

**Inflation:** The estimated trajectory of annual headline inflation for the following two years remains unchanged in regards to the one published in the Inflation Report of January – March 2010. Thus, inflation is expected to rebound towards the end of the year in line with the foreseen trajectory, and then decline in 2011 in order to converge to the inflation target by the end of 2011 (Table 1).

Although the trajectory of inflation could improve as compared with that anticipated for the second half of the year, Banco de México decided to leave the forecasted trajectory unchanged until more information on the third quarter is available. Nonetheless, by the end of the year, annual inflation is anticipated to increase, although possibly less than as forecasted by Banco de México, due to:

1. A lower base of comparison in the core housing component associated with the decline in steel prices in 2009.
2. A greater contribution of administered and regulated prices to annual headline inflation. This result would be partly due to the resuming of the government's programmed increments in energy prices aimed at diminishing the misalignment between domestic and international energy prices in order to reduce both fiscal and economic costs. On the other hand, administered and regulated prices could have a higher incidence on inflation if public transportation fares for certain routes in Mexico City's metropolitan area continue to be revised.
3. The increase in the annual inflation of fruits and vegetables prices at the end of 2010 as a result of the lower base of comparison observed in the last two months of 2009. Furthermore, the significant decline in the growth rate of agricultural prices observed during the second quarter could revert, due to the volatility usually implicit in these price quotes, originated by the weather conditions that affect the supply of these products.

The forecast of a downward trend in annual inflation in 2011 is based on the following considerations:

i) The tax changes approved by Congress for 2010 affected temporarily the prices of goods and services directly associated with these changes. Thus, during the first quarter of 2011, this effect is expected to fade from annual inflation estimates.
ii) The annual growth rate of administered prices is not expected to exhibit in 2011 the same arithmetic effect observed in 2010, by adjusting from 0 to positive levels. This will contribute to reduce annual inflation, in view that with the resuming of the government's policy of programmed increments in energy prices, the base of comparison for calculating inflation's annual change will not be low, as in 2010.
iii) Prices and fares determined by local governments are expected to contribute less to inflation in 2011, since no changes of similar magnitude like those observed in 2010 are foreseen next year.
iv) Wage increases have been moderate.

**Table 1**
**Base Scenario for Annual Headline Inflation[1/]**
Quarterly average (percent)

| Quarter | Forecast Inflation Report 2010-I | Forecast Inflation Report 2010-II |
|---|---|---|
| 2010-II | 4.50 - 5.00 | 3.96 [2/] |
| 2010-III | 4.75 - 5.25 | 4.75 - 5.25 |
| 2010-IV | 4.75 - 5.25 | 4.75 - 5.25 |
| 2011-I | 4.50 - 5.00 | 4.50 - 5.00 |
| 2011-II | 3.50 - 4.00 | 3.50 - 4.00 |
| 2011-III | 3.25 - 3.75 | 3.25 - 3.75 |
| 2011-IV | 2.75 - 3.25 | 2.75 - 3.25 |
| 2012-I | 2.75 - 3.25 | 2.75 - 3.25 |
| 2012-II | ------------ | 2.75 - 3.25 |

1/ In each Inflation Report, the forecast horizon considers the following 8 quarters. For this reason, on each occasion, one quarter (the eighth) is added to the forecast, as compared with the first quarter of the previous Report, where it becomes an observed figure.
2/ Observed figure.

The inflation forecast is subject to several risks. Among the most important are:

a) Weather conditions that might affect the supply of fruits and vegetables and, therefore, their prices.
b) A higher than expected rate of recovery of the Mexican economy could increase demand-related pressures, and viceversa.
c) The exchange rate could be affected if conditions in international financial markets deteriorate.
d) That services inflation remains high and exhibits some inertia.
e) Inflation expectations for the medium and long terms remain above the 3 percent inflation target.

Considering the aforementioned, together with inflation exhibiting better results than those forecasted, the balance of risks for inflation has improved.

Regardless of the above, Banco de México's Board of Governors will continue to monitor the path of medium and long-term inflation expectations, the velocity at which the output gap closes, and other inflation determinants that might signal unexpected and widespread pressures on prices. All of this so that, in such an eventuality, the central bank adjusts its monetary policy stance in order to achieve the 3 percent inflation target by the end of next year.

Finally, as in other occasions, it is relevant to emphasize that several microeconomic factors have affected unfavorably the level of inertia that inflation exhibits, hindering the convergence of inflation to Banco de México's target. Two features of the Mexican economy are particularly relevant in this regard: the lack of economic competition in some markets and the presence of various rigidities in the labor market. Under these circumstances, it is imperative to continue the structural economic reform process. This would not only lead to a greater flexibility in the price formation process and hence reduce the costs related to the disinflation effort -which are required to attain the central bank's target- but would also result in a more efficient allocation of economic resources and, therefore, in a higher growth potential.