

INFLATION REPORT
JULY - SEPTEMBER 2010



BANCO DE MÉXICO

October, 2010

1. External Conditions

2. Economic Activity in Mexico

3. Inflation and Monetary Policy

4. Forecasts and Balance of Risks

5. Modifications to the Communication Scheme



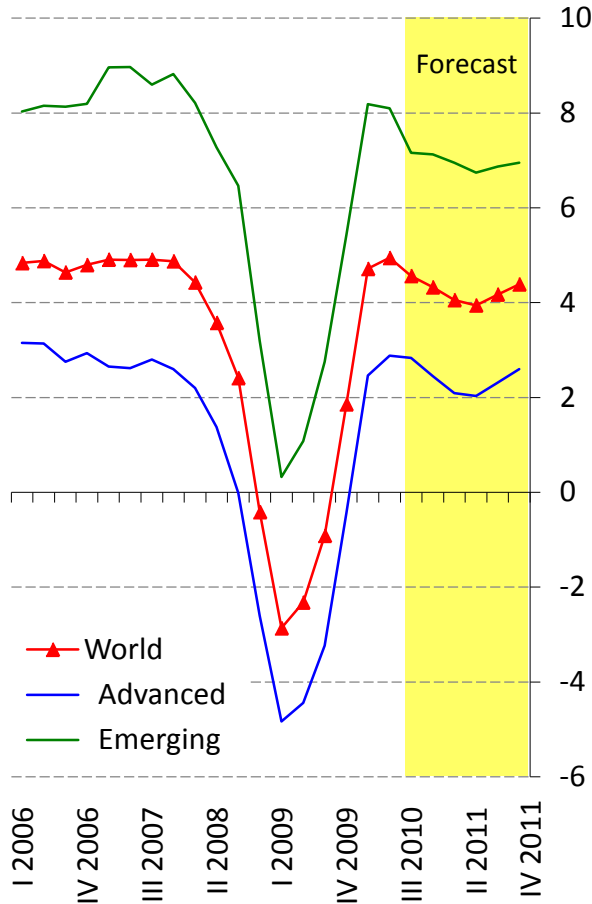
1. External Conditions

- The world economy experienced a slowdown during the third quarter of 2010:
 - ✓ *Domestic demand in the major advanced economies remains weak.*
 - ✓ *In the U.S. households continue to deleverage and to adjust their spending to sustainable levels.*
 - ✓ *The financial system remains fragile.*
- Emerging economies continued growing at a faster pace than advanced economies, although in some cases there appeared signs of deceleration.
- World inflation remains at low levels. Moreover, in some advanced economies concerns about the possibility of deflation have increased.

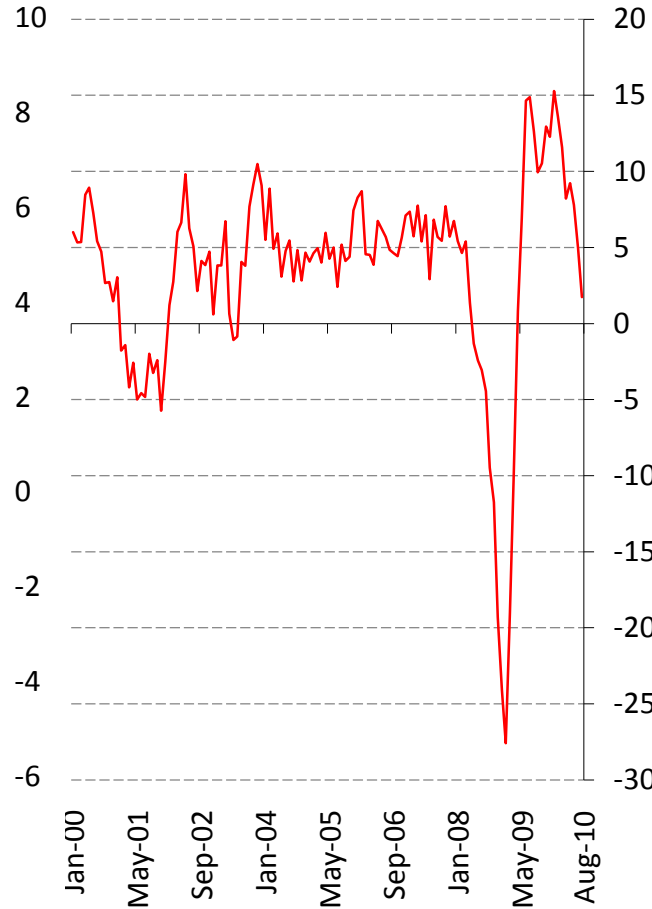


1. External Conditions

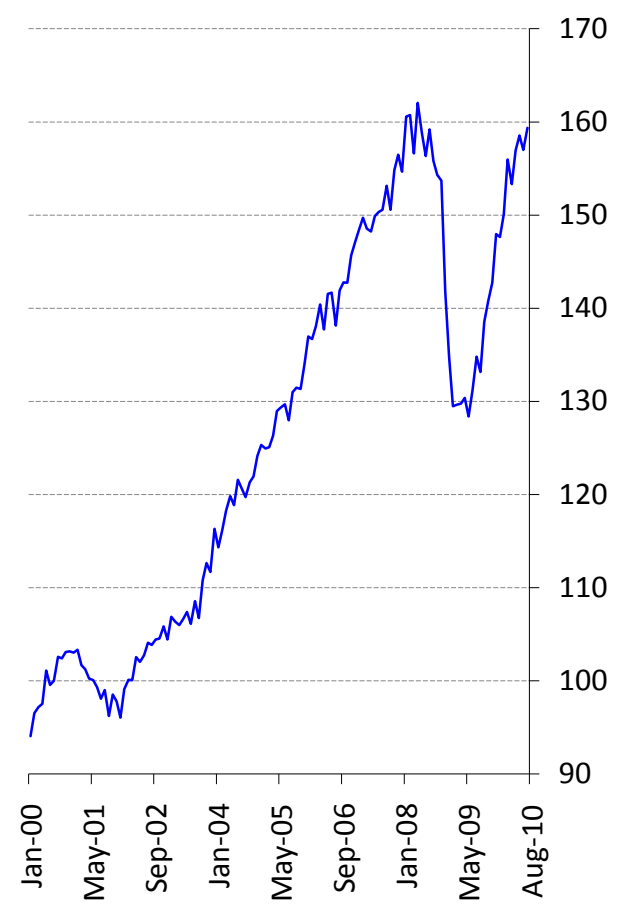
Gross Domestic Product
(Annual % change)



World Industrial Production
(Annualized % change over 3 months)



World Trade Volume
(Index 2000=100)



Source: IMF, WEO October 2010.

Source: CPB Netherlands.

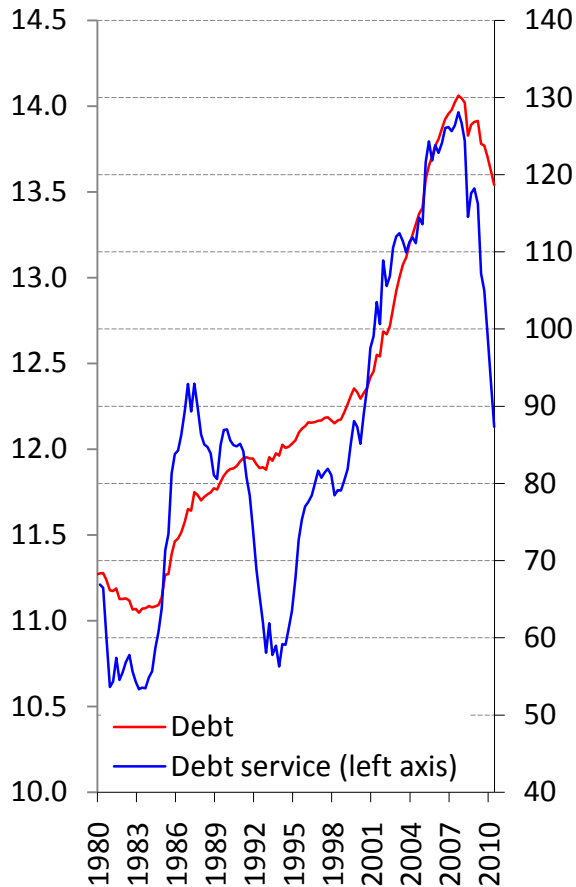
Source: CPB Netherlands.



1. External Conditions

U.S.: Households' Debt and Debt Service

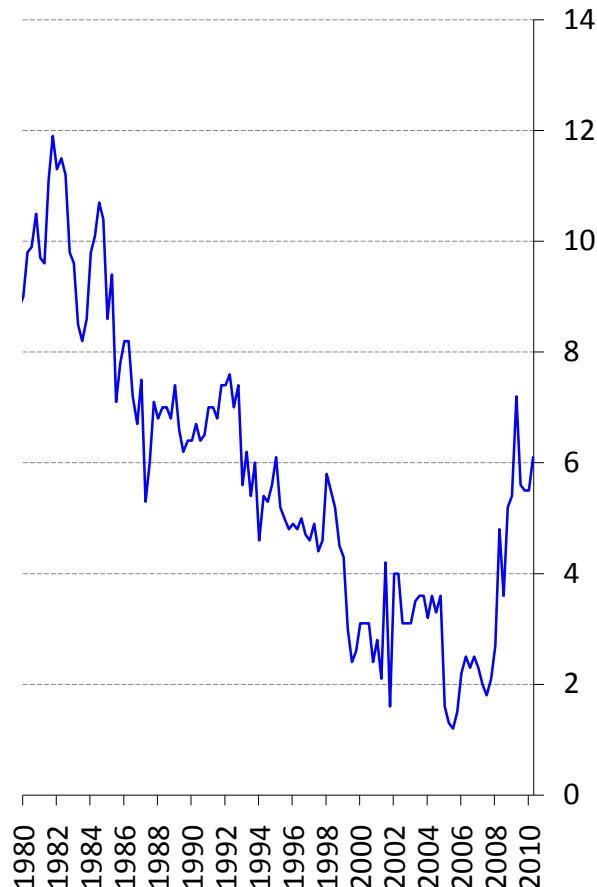
(% of Disposable personal income; s.a.)



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

U.S.: Households' Saving Rate

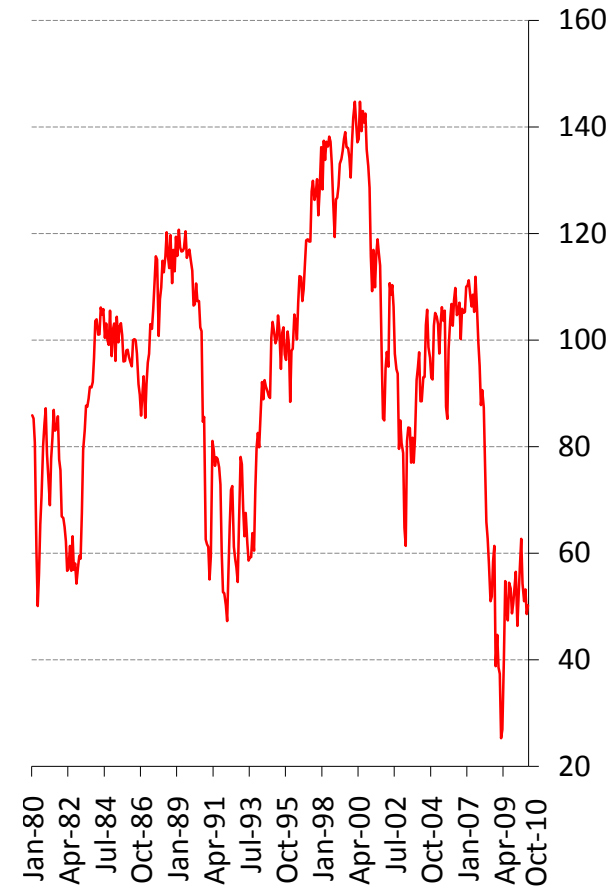
(% of Disposable personal income; s.a.)



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

U.S.: Consumer Confidence

(Index 1985=100)



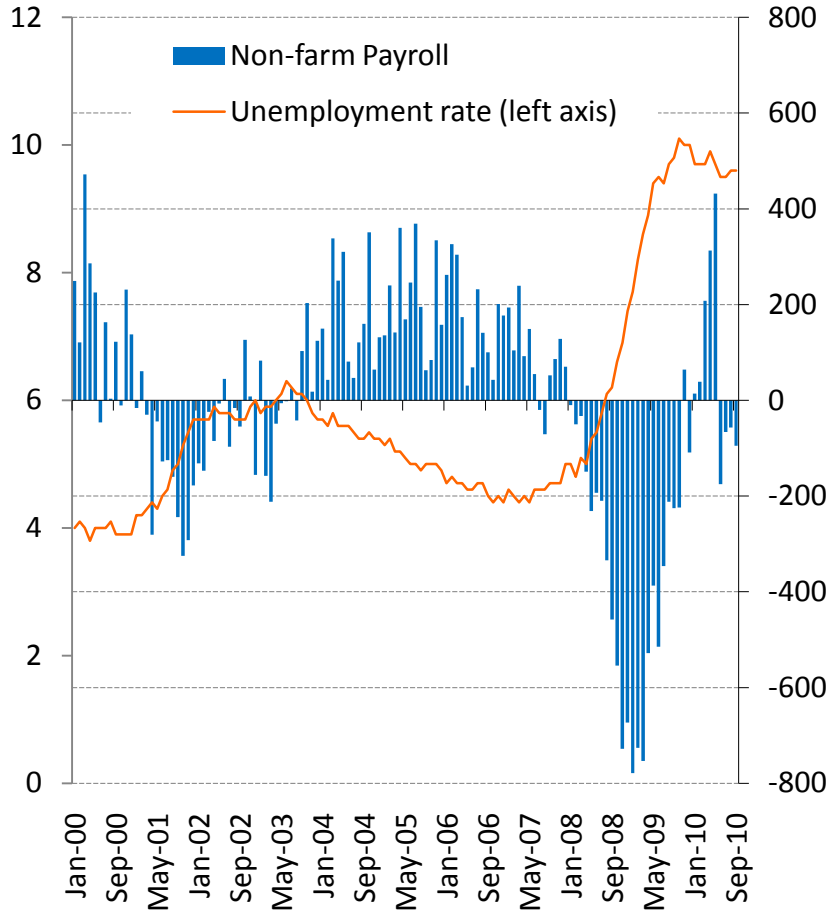
Source: Conference Board.



1. External Conditions

U.S.: Non-farm Payroll and Unemployment Rate

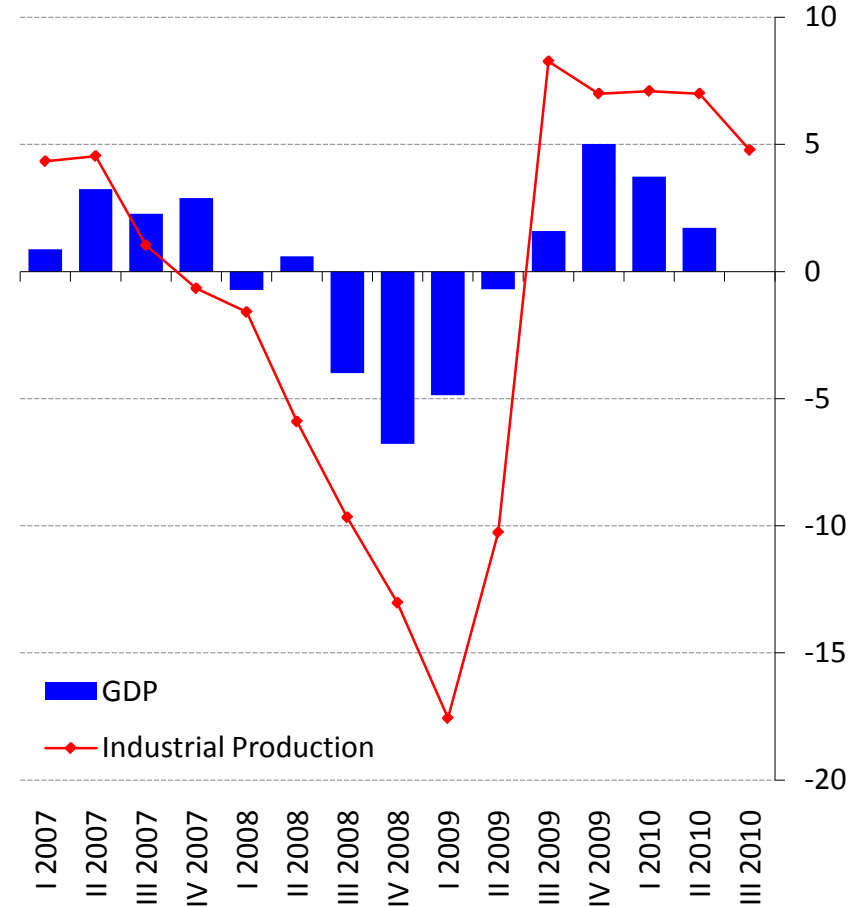
(Change in thousands of jobs and %; s.a.)



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

U.S. : GDP and Industrial Production

(Quarterly annualized % change; s.a.)

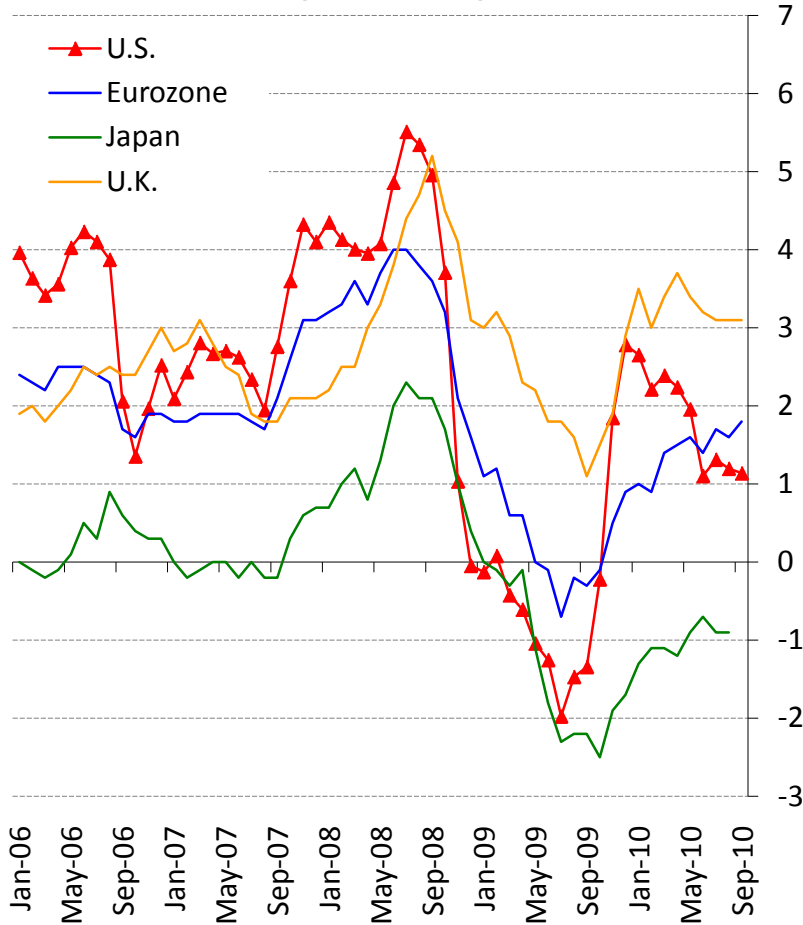


s.a./ Seasonally adjusted.
Source: BEA and Federal Reserve.



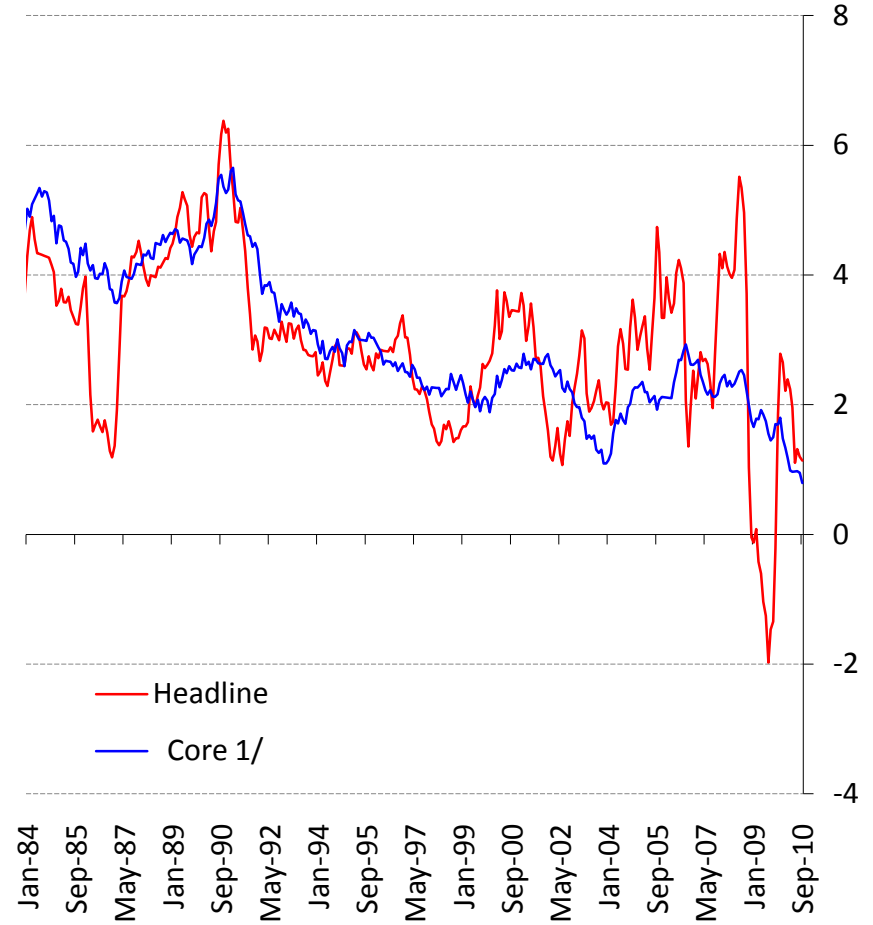
1. External Conditions

Inflation in Advanced Economies (Annual %)



Source: Bloomberg.

U.S.: Headline and Core Inflation (Annual %)



1/ CPI excluding food and energy.
Source: BLS

1. External Conditions

- The degree of monetary accommodation in advanced economies has generated abundant global liquidity, which has led to a search for higher yields.
- This has contributed to:
 - ✓ *Substantial capital inflows to emerging economies;*
 - ✓ *Appreciation of their currencies; and*
 - ✓ *Upward pressures on asset prices (that could even lead to “bubbles”).*
- All of these complicate monetary policy in emerging economies.

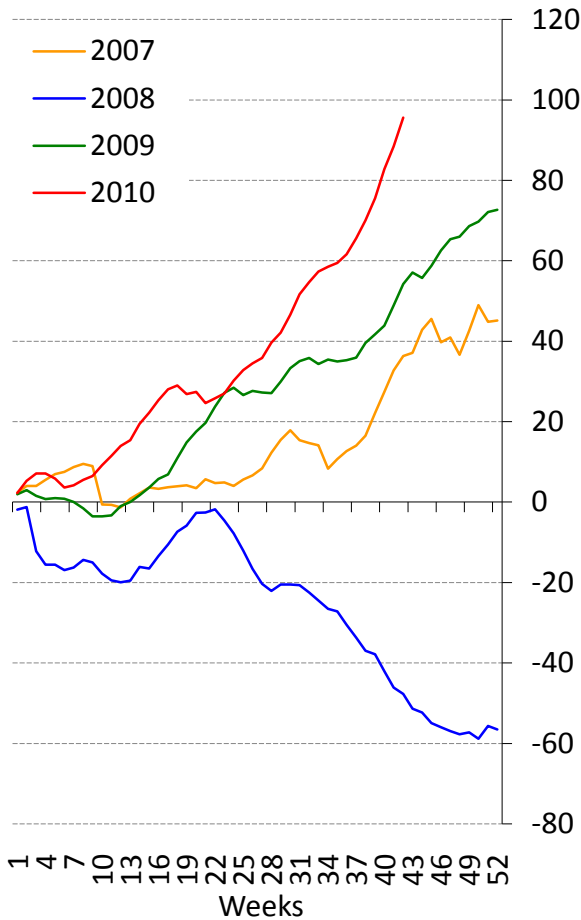
1. External Conditions

- Currency appreciation can affect export competitiveness.
 - ✓ *Some economies have taken certain steps to try to contain this appreciation.*
 - ✓ *Nevertheless, in some cases currency appreciation reflects, at least partially, more fundamental factors, such as an improvement in the terms of trade (e.g., an increase in the prices of commodities).*
- A widespread policy of sustained economic recovery by means of depreciated real exchange rates (“competitive depreciations”) is not a viable solution for the global economy.
 - ✓ *Greater coordination among countries is necessary in order to maximize growth in the global economy.*



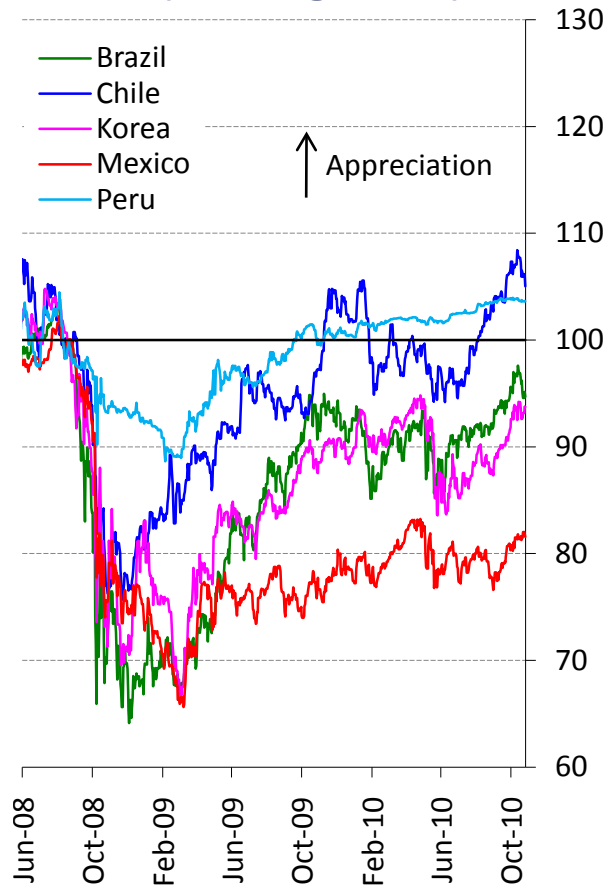
1. External Conditions

Accumulated Flows to Emerging Economies (Equity and Debt) ^{1/}
(Billions of dollars)



1/ The sample covers funds used for buying and selling stocks, and bonds from emerging countries listed in advanced economies' markets. Flows exclude portfolio performance and exchange rate fluctuations. Source: EPFR.

Exchange Rate in Emerging Economies vs. U.S. Dollar ^{2/}
(Index Aug-08=100)



2/ Exchange rates in relation to USD. An increase implies an appreciation.
Source: Bloomberg.

Commodity Prices
(Index 31-Dec-02=100)



Source: IMF.



Outline

1. External Conditions

2. Economic Activity in Mexico

3. Inflation and Monetary Policy

4. Forecasts and Balance of Risks

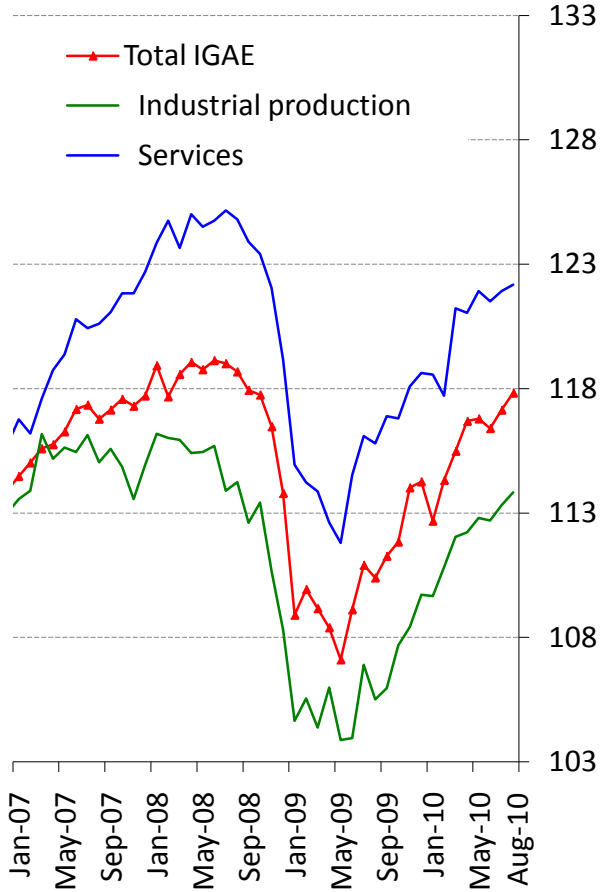
5. Modifications to the Communication Scheme



2. Economic Activity in Mexico

Economic Activity Indicators

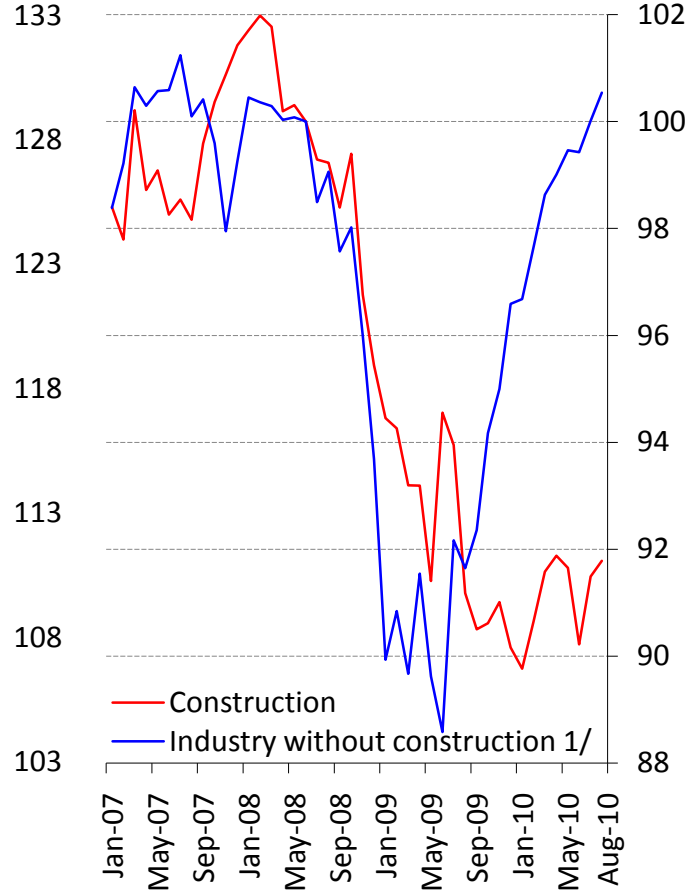
(Index 2003=100; s.a.)



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

Industrial Production Indicators

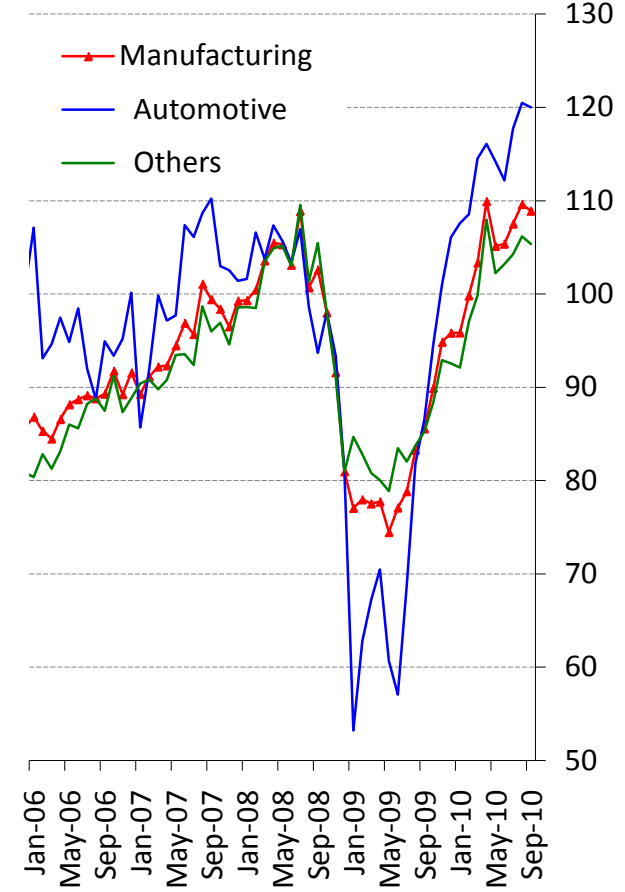
(Index Jun-2008=100; s.a.)



s.a./ Seasonally adjusted.
1/ Calculations by Banco de México with data from INEGI.
Source: INEGI.

Manufacturing Exports

(Index 2008=100; s.a.)



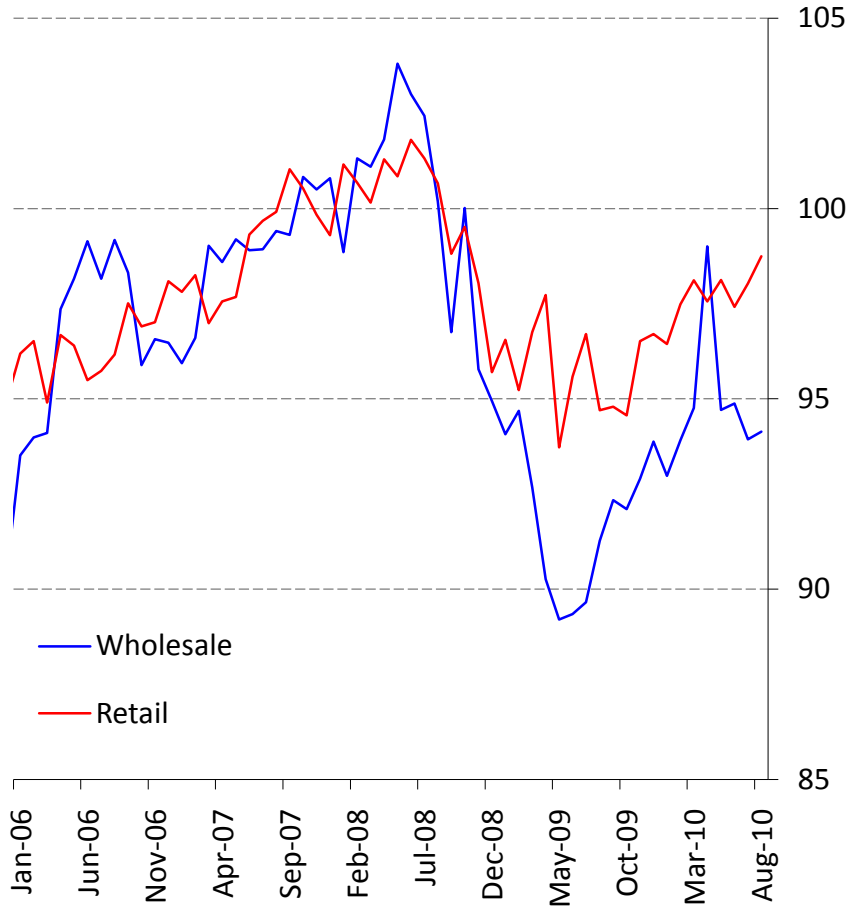
s.a./ Seasonally adjusted.
Source: INEGI.



2. Economic Activity in Mexico

Sales in Commercial Establishments

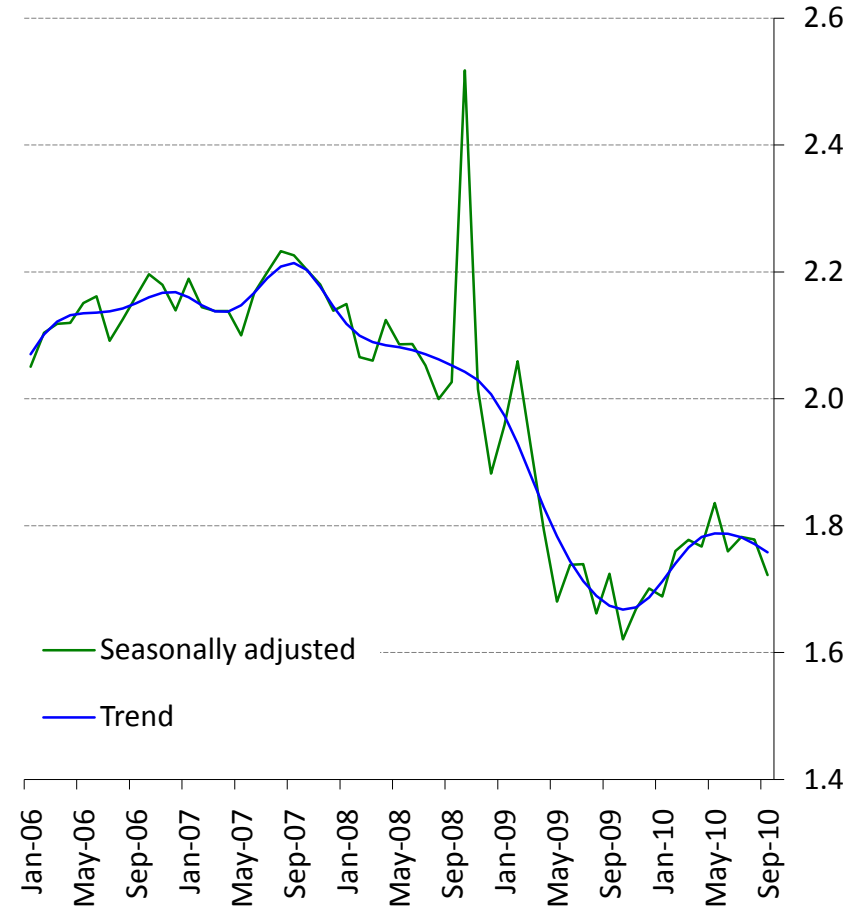
(Index 2008=100; s.a.)



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

Workers' Remittances

(Billion dollars; s.a.)



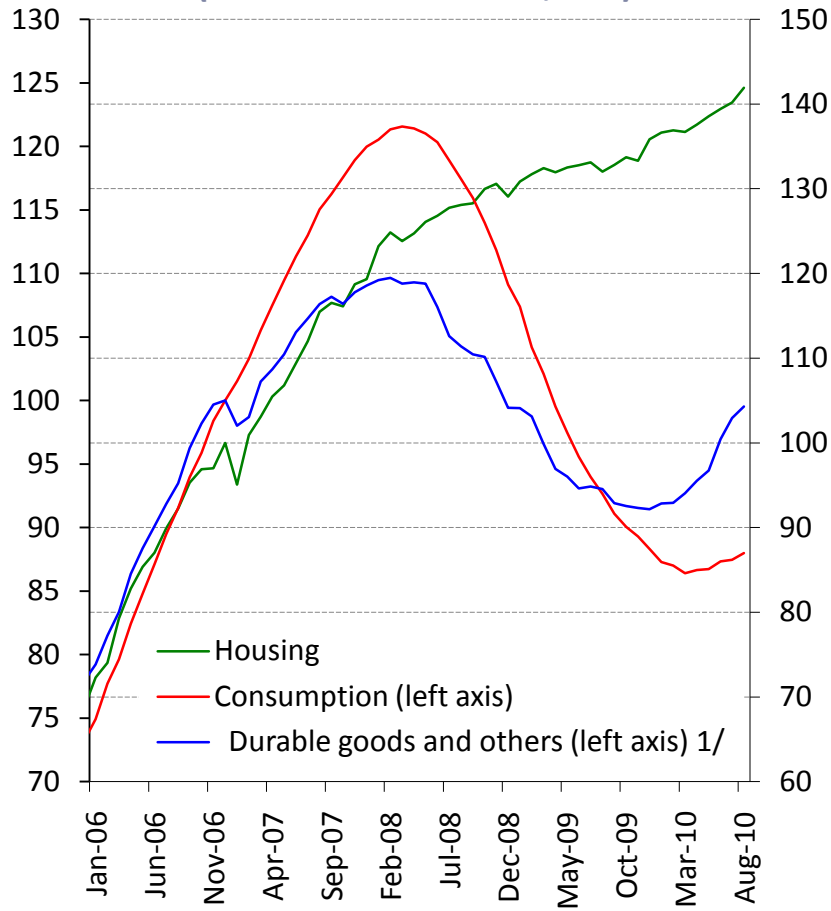
s.a./ Seasonally adjusted.
Source: Banco de México.



2. Economic Activity in Mexico

Commercial Banks' Credit to Households

(Index Dec-2006=100; s.a.)



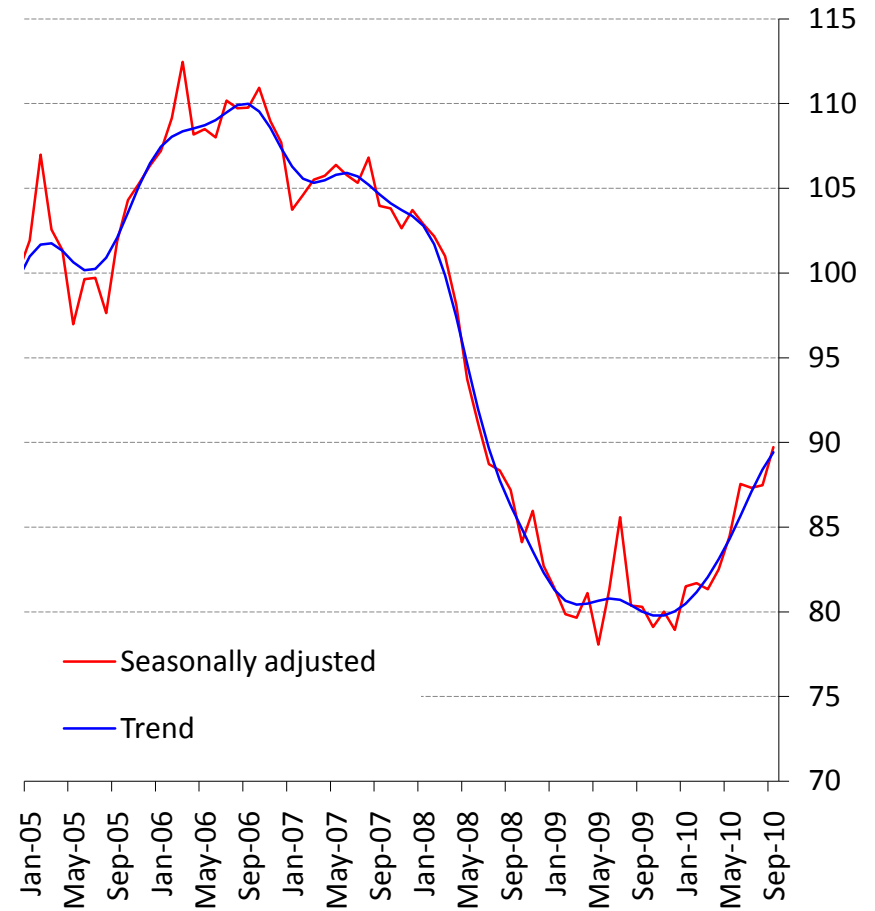
s.a./ Seasonally adjusted.

1/ Includes credits for automobiles and real estate acquisition, for capitalized leasing, personal, and other consumption credits.

Source: Banco de México.

Consumer Confidence Index

(Index 2003=100; s.a.)



s.a./ Seasonally adjusted.

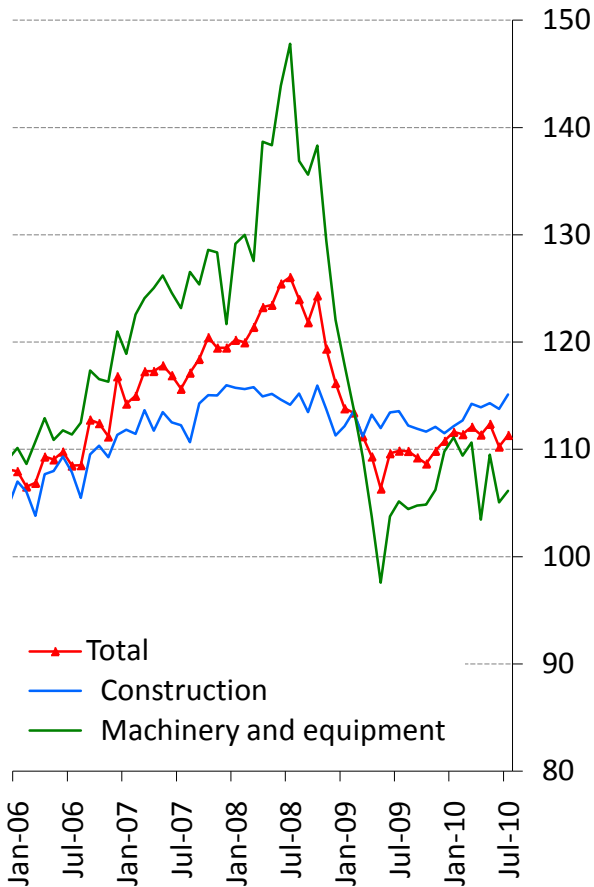
Source: INEGI and Banco de México.



2. Economic Activity in Mexico

Gross Fixed Investment and Components

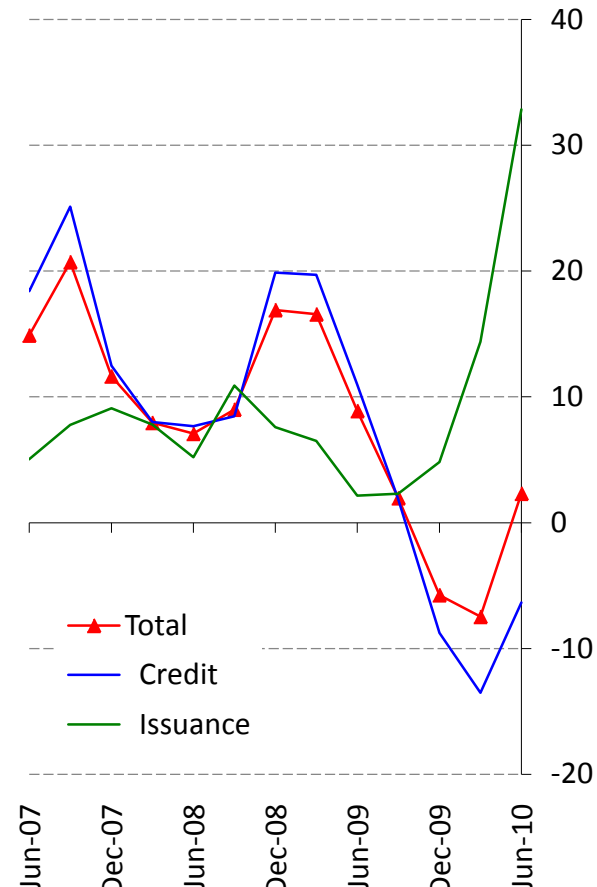
(Index 2005=100; s.a.)



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

Total Financing to Non-financial Private Firms ^{1/}

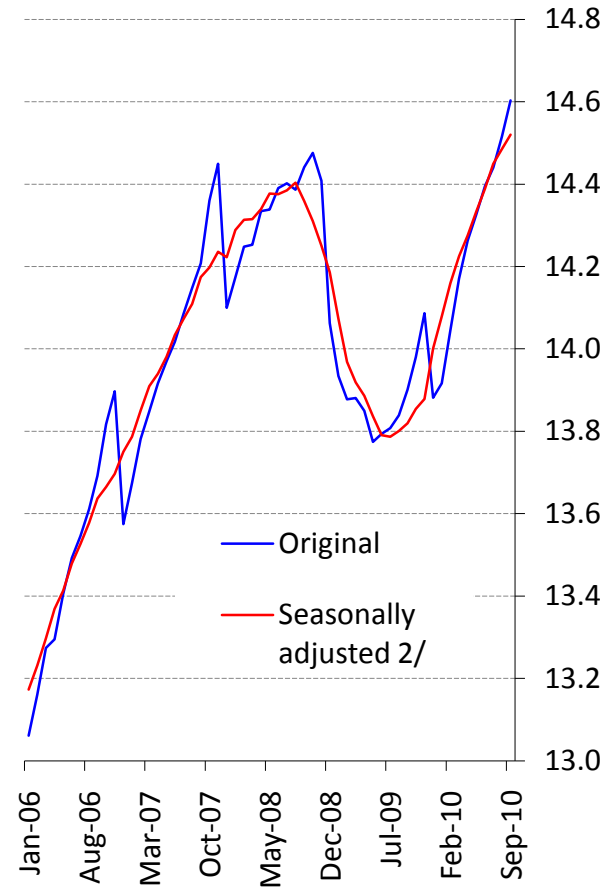
(Real annual % change)



^{1/} It includes total banking credit and the one provided by other non-banking financial intermediaries in the country, as well as financial credit provided by commercial banks, bilateral, and foreign suppliers.
Source: Banco de México.

IMSS-insured Permanent and Temporary Workers in Urban Areas

(Million workers; s.a.)



^{2/} Seasonally adjusted by Banco de México.
Source: IMSS.

Outline

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- 3. Inflation and Monetary Policy**
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5. Modifications to the Communication Scheme



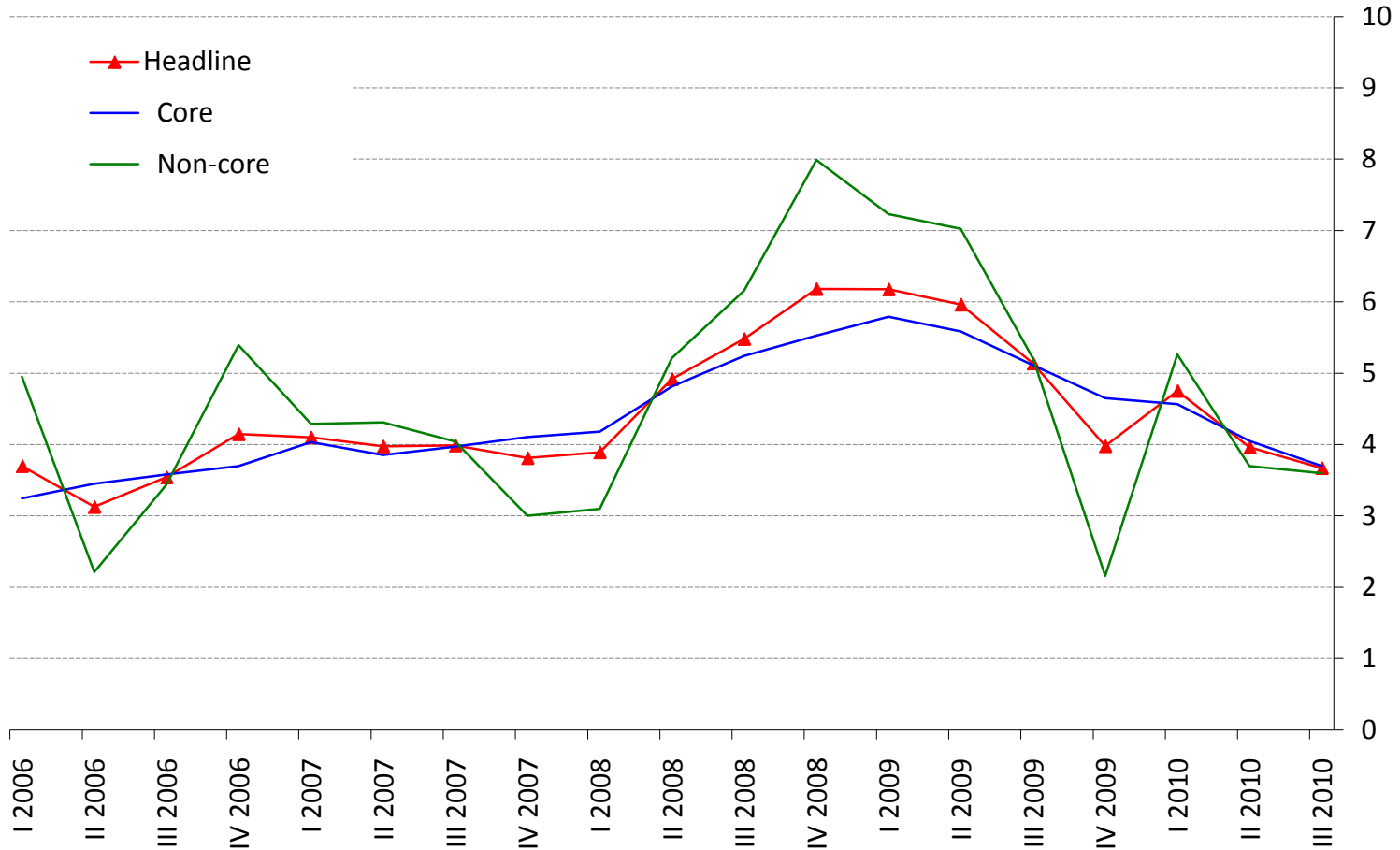
3. Inflation and Monetary Policy

- During the third quarter, average annual headline inflation decreased and was below the lower limit of Banco de México's forecast interval.
- This performance mainly reflects:
 - ✓ *Currency appreciation.*
 - ✓ *A negative output gap.*
 - ✓ *Intensified competition among some retail chains.*
 - ✓ *Low levels of world inflation.*
- All of these elements have taken place in a context of a monetary policy aimed at achieving the inflation target.



3. Inflation and Monetary Policy

Annual Inflation
(Quarterly average in %) ^{1/}



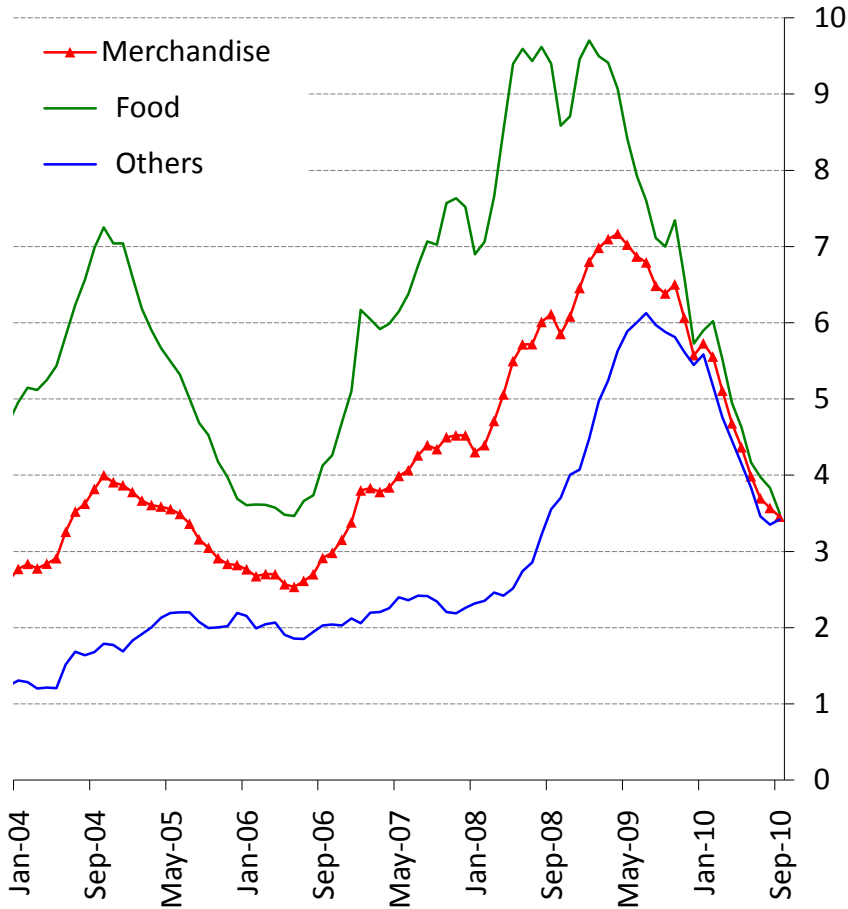
1/ Quarterly average of annual inflation.

Source: Banco de México.



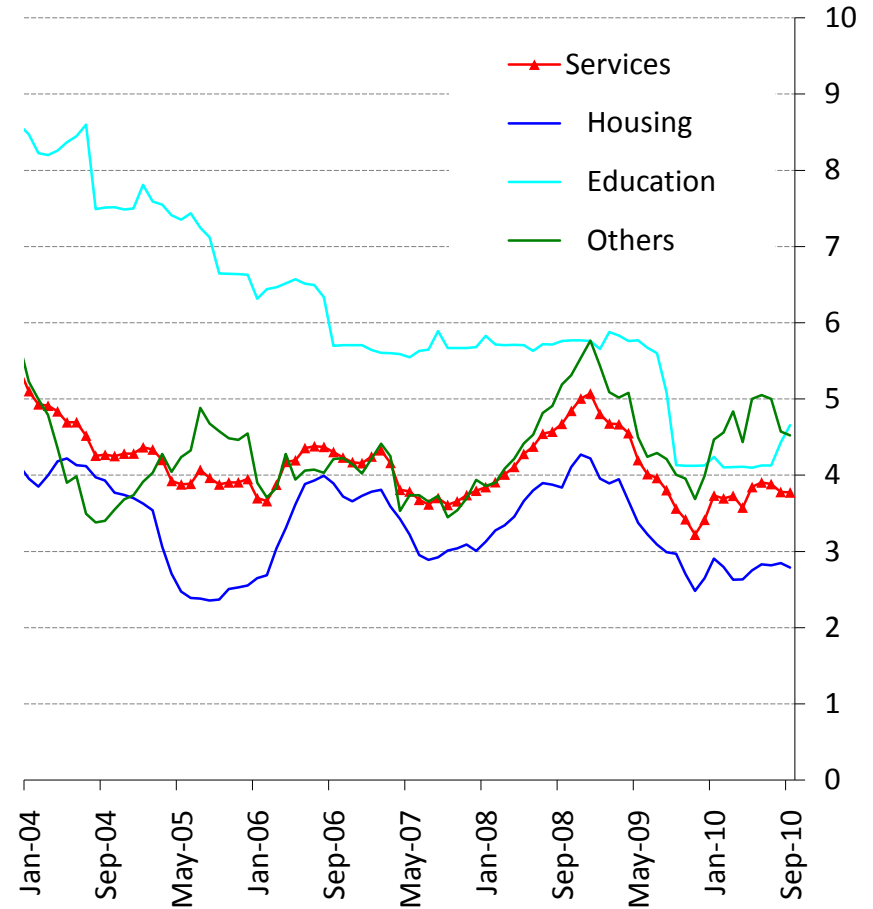
3. Inflation and Monetary Policy

Annual Merchandise Core Inflation (%)



Source: Banco de México.

Annual Services Core Inflation (%)



Source: Banco de México.



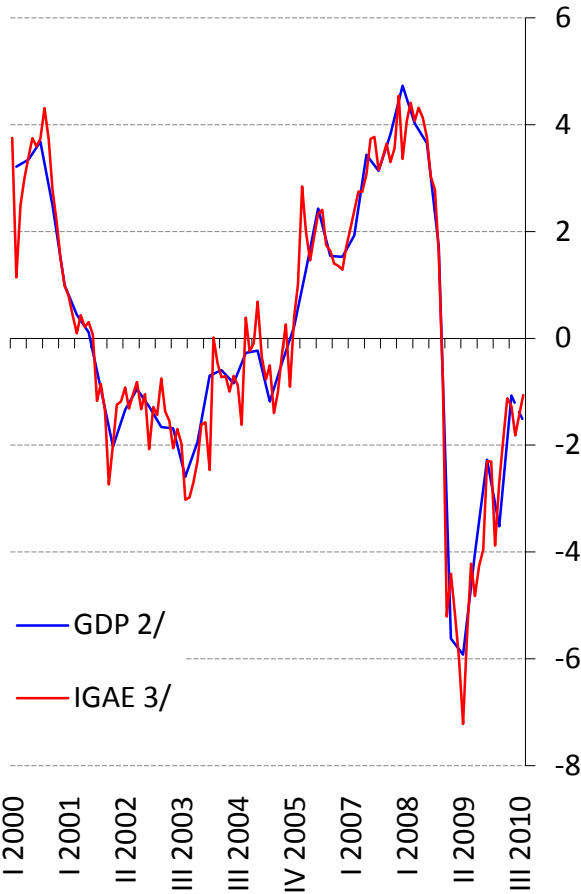
3. Inflation and Monetary Policy

- Favorable developments on inflation and its expectations have taken place in an environment where there are no demand-related pressures on prices:
 - ✓ *Moderate wage increases.*
 - ✓ *Unused installed capacity.*
 - ✓ *Moderate credit recovery.*
 - ✓ *So far, increases in the international prices of wheat, corn, and sugar have not affected domestic prices.*

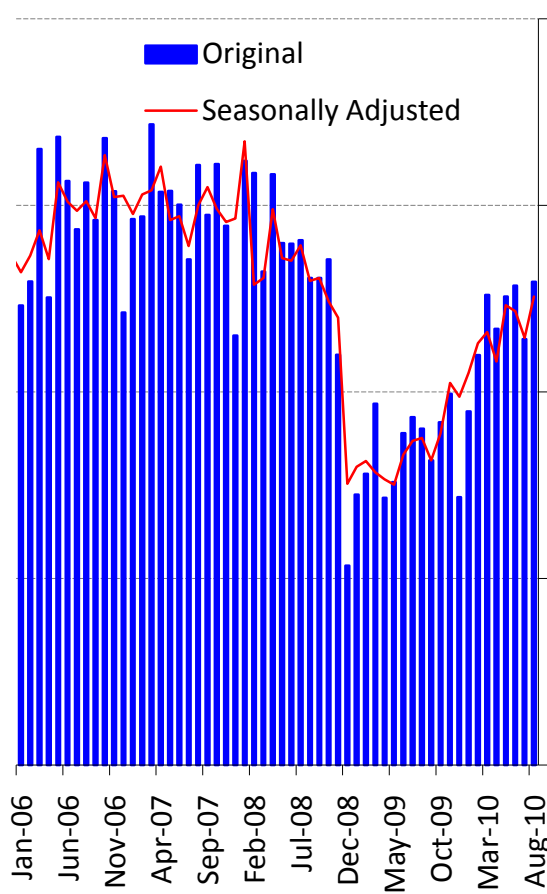


3. Inflation and Monetary Policy

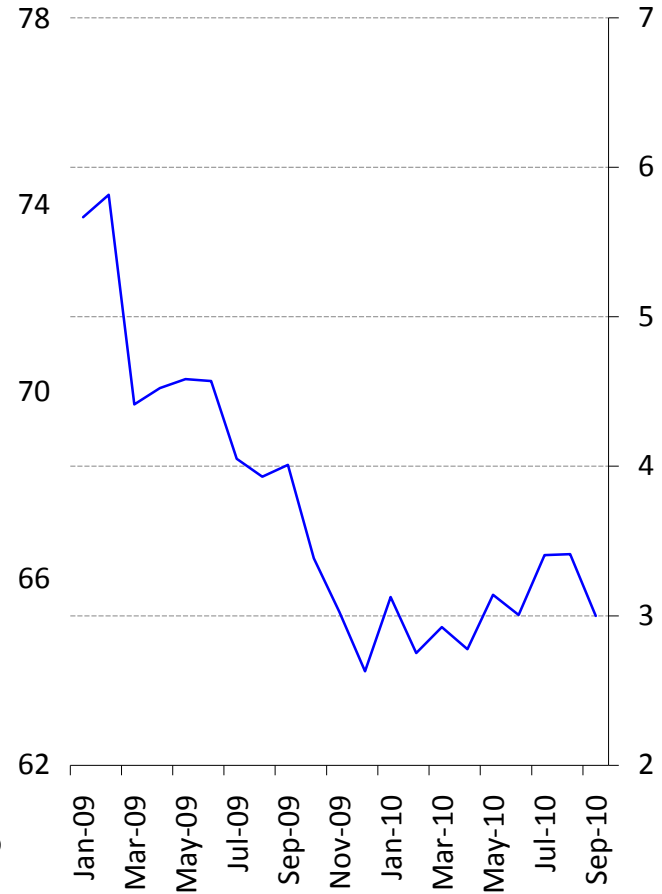
Output Gap ^{1/} (% of Trend)



Installed Capacity Utilization (%)



IMSS Reference Wage (Annual % change)



1/ The output gap was estimated using the Hodrick- Prescott (HP) method with tail corrections; see Banco de México (2009), "Inflation Report April-June," p.69.

2/ GDP of the third quarter of 2010 estimated by Banco de México.

3/ Data up to August, 2010.

Source: Banco de México.

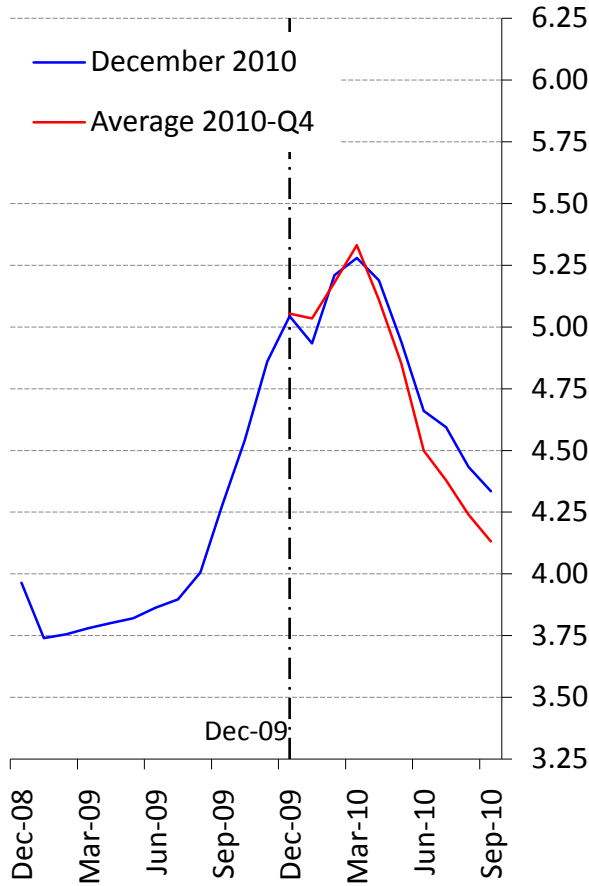
Source: Banco de México.

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



3. Inflation and Monetary Policy

Headline Inflation Expectations for 2010^{1/}
(Annual %)



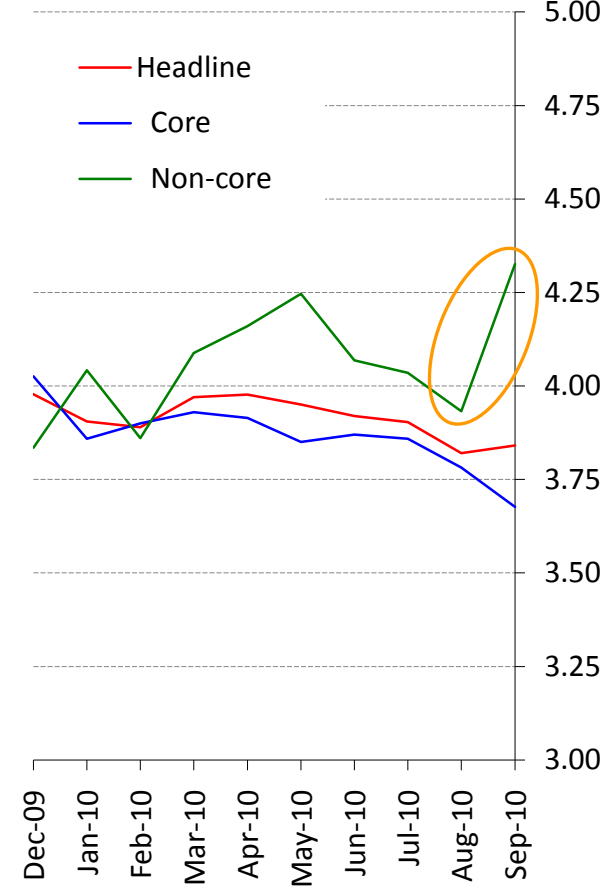
^{1/} Average inflation expectations for the fourth quarter of 2010 are calculated based on monthly inflation expectations for each of the next twelve months.
Source: Banco de México Survey.

Headline Inflation Expectations
(Annual %)



Source: Banco de México Survey.

Headline Inflation Expectations for 2011
(Annual %)

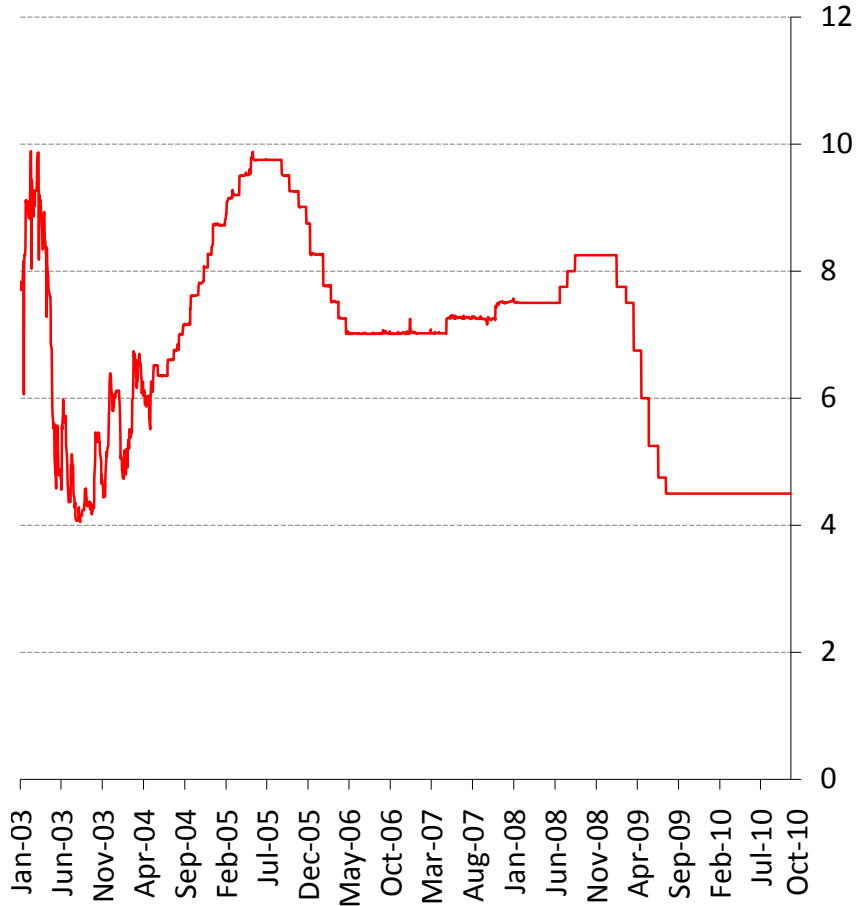


Source: Banco de México Survey.



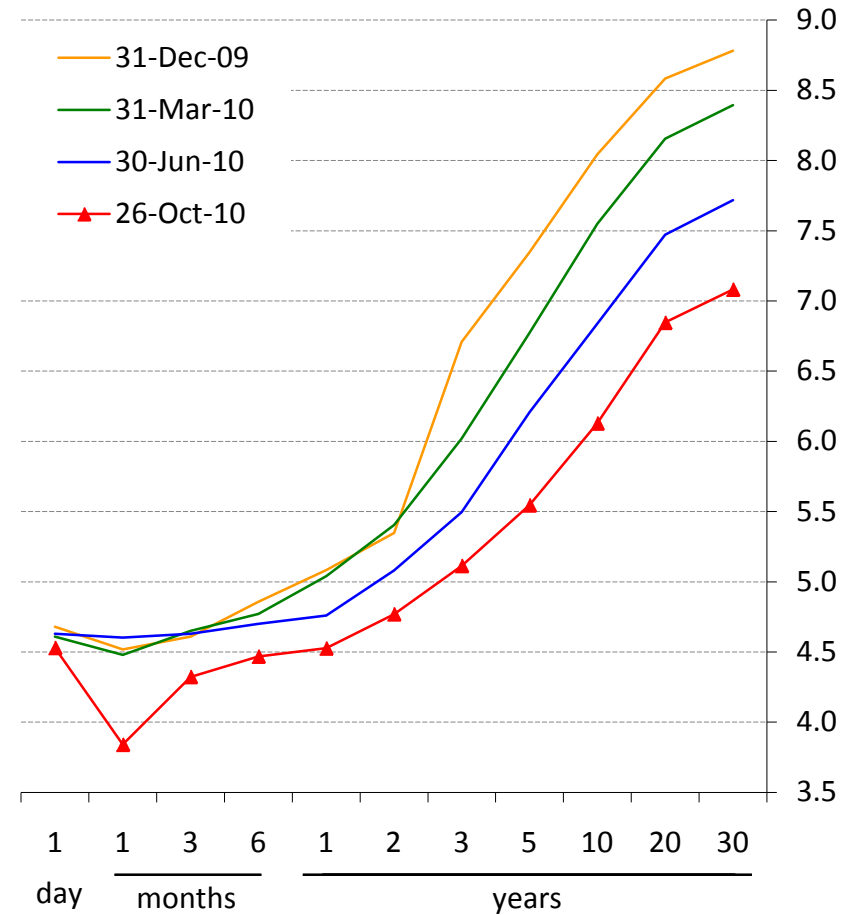
3. Inflation and Monetary Policy

Overnight Interbank Interest Rate ^{1/} (%)



1/ The target for the overnight interbank interest rate (Banco de México's operating target) is shown since January 21, 2008.
Source: Banco de México.

Mexico's Yield Curve (%)



Source: Banco de México and Proveedor Integral de Precios.

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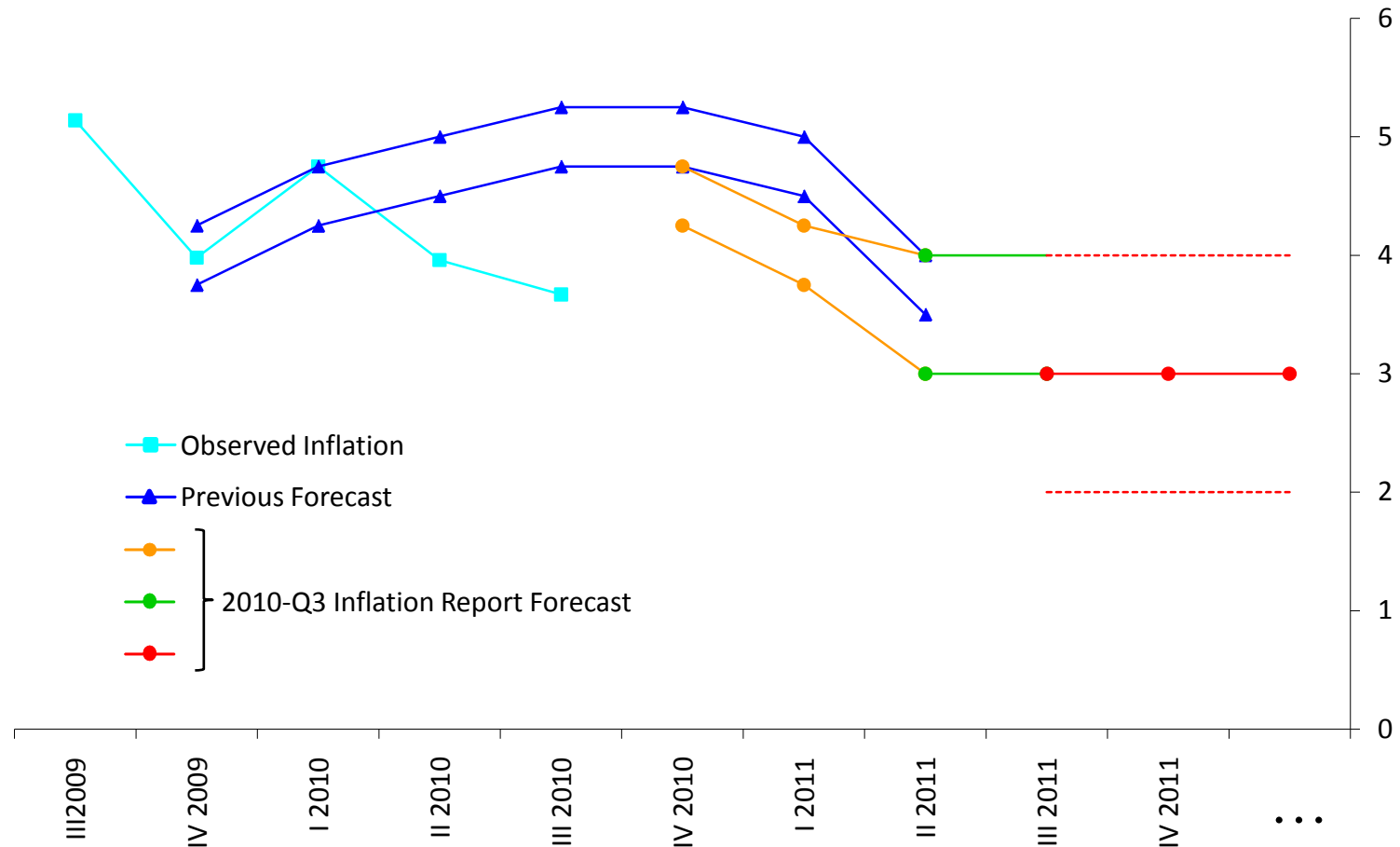
4. Forecasts and Balance of Risks

- During the third quarter the balance of risks associated to inflation improved. Therefore, the forecast for annual headline inflation **has been revised downwards:**
 - ✓ *Next two quarters' intervals were revised downwards:*
 - 2010-Q4: from 4.75 - 5.25% to 4.25 - 4.75% (-50 bp revision).
 - 2011-Q1: from 4.50 - 5.00% to 3.75 - 4.25% (-75 bp revision).
 - ✓ *For 2011-Q2 inflation is expected to be between 3 and 4%.*
 - ✓ *From 2011-Q3 onwards inflation is expected to converge towards the target of 3%, bearing in mind the variability interval of +/- 1 percentage point.*



4. Forecasts and Balance of Risks

Headline Inflation Forecasts (% Quarterly Average)



Source: Banco de México.



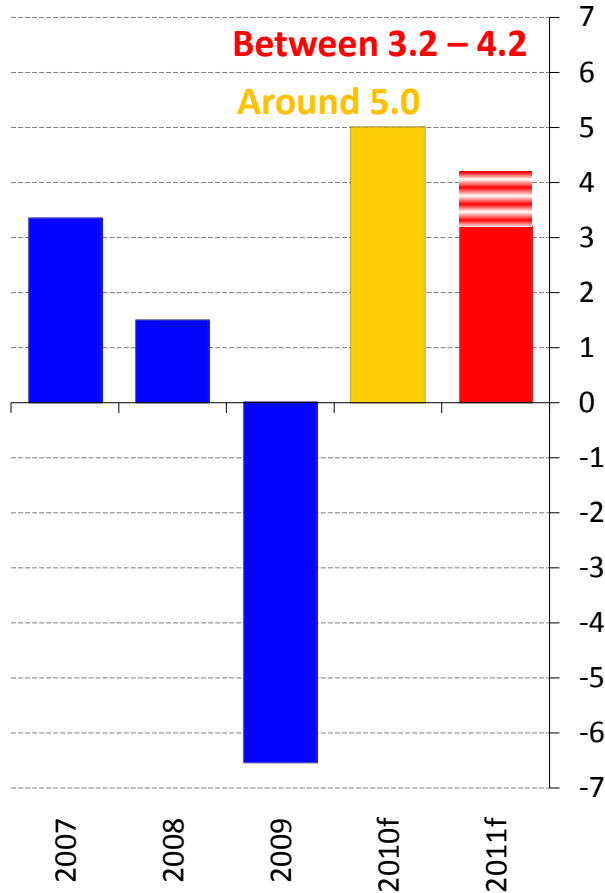
4. Forecasts and Balance of Risks

- The inflation forecast is subject to risks:
 - ✓ *The growth rate of public sector prices and tariffs. (↑)*
 - ✓ *The possibility of a reversion of the effects of greater competition among retail chains. (↑)*
 - ✓ *Abrupt changes in the exchange rate. (↑↓)*
 - ✓ *Volatility of the international prices of grains. (↑↓)*
 - ✓ *Higher downside risks on economic activity. (↓)*
 - ✓ *High degree of volatility of fruit and vegetable prices. (↑↓)*



4. Forecasts and Balance of Risks

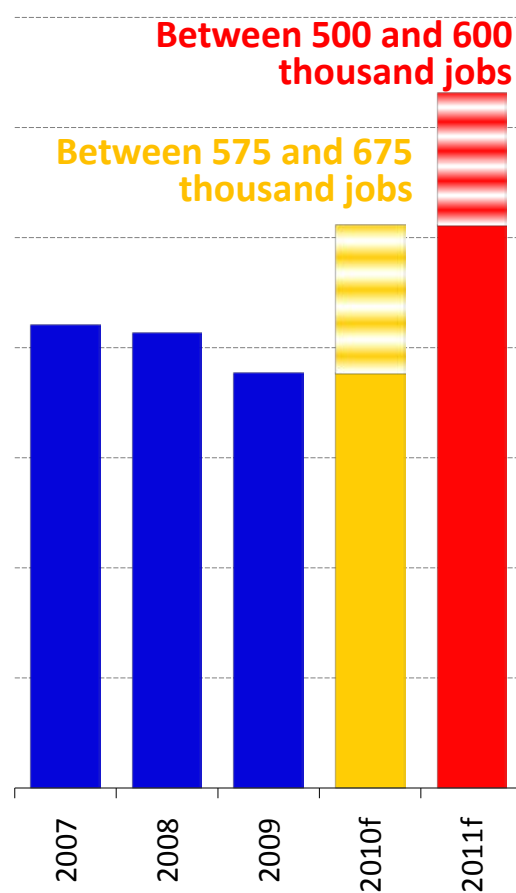
Gross Domestic Product (Annual % change)



f/ Forecast.

Source: INEGI and forecast of Banco de México.

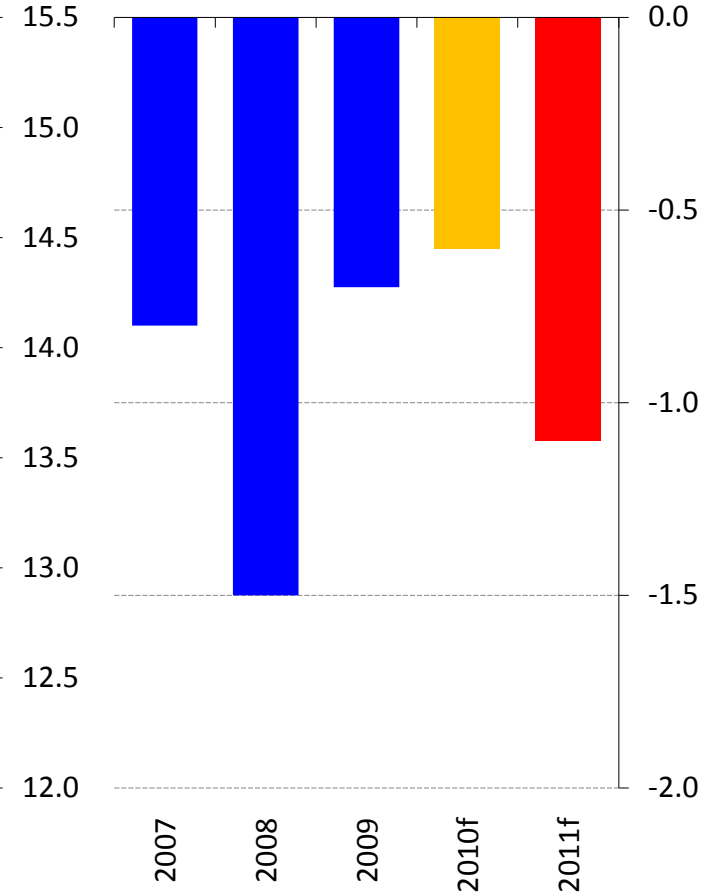
IMSS-insured Workers (Million)



f/ Forecast.

Source: IMSS and forecast of Banco de México.

Current Account (% of GDP)



f/ Forecast.

Source: Banco de México.



4. Forecasts and Balance of Risks

- The Mexican economy faces the challenge of generating growth rates that will lead to a greater level of development.
 - *Macroeconomic policy plays a fundamental role.*
 - *Nevertheless, it needs to be complemented by an incentive structure that leads to gains in productivity.*

- Public policies that could have a favorable effect:
 - ✓ *Increasing the degree of competition in input and final goods markets.*
 - ✓ *Flexibility in the labor market.*



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5. Modifications to the Communication Scheme

- ① *Publication of Minutes of the Board of Governors' meetings regarding monetary policy decisions from 2011 onwards.*
- ② *The number of predetermined monetary policy announcement dates will be reduced from 11 to 8 in 2011.*
- ③ *Changes in the format used to publish inflation and economic activity forecasts. Starting from the next Inflation Report onwards, these forecasts will be published using "Fan Charts".*



5. Modifications to the Communication Scheme

① *Publication of Minutes*

- The publication of Minutes will contribute to increase the transparency of the Central Bank and to be in line with the best practices in these matters.
- Information on the monetary policy decision-making process will be provided, in particular on the factors that influence the decisions of the members of the Board.
- The Minutes will be released 10 working days after the announcement of the monetary policy decision.



5. Modifications to the Communication Scheme

② *Reduction in the Number of Predetermined Monetary Policy Announcement dates*

- Considering that inflation has converged to low and stable levels during recent years, the number of predetermined dates to announce monetary policy decisions will be reduced from 11 to 8 in 2011.^{1/}
- The Central Bank will be publishing information on monetary policy during all of the months of 2011 through the abovementioned announcements, the Minutes and/or the Inflation Reports.
- Indeed, although the number of monetary policy announcements during the year will be reduced, the amount of information released to the public will increase.

^{1/} As in previous years, the Board of Governors reserves the right to announce changes in the monetary policy stance at dates different to those previously scheduled, in the case of extraordinary events or situations requiring the Central Bank's intervention.



5. Modifications to the Communication Scheme

Calendar for 2011

Month	Announcement of the Monetary Policy Decision	Minutes of the Board of Governor's Meetings Regarding Monetary Policy Decisions	Inflation Reports ^{1/}
January	21		
February		4	9
March	4	18	
April	15	29	
May	27		11
June		10	
July	8	22	
August	26		10
September		9	
October	14	28	
November			9
December	2	16	

1/ The Inflation Report that will be published on February 9, 2011 corresponds to 2010-Q4, the one to be published on May 11 to 2011-Q1, the one to be published on August 10 to 2011-Q2, and the one to be published on November 9 to 2011-Q3.



5. Modifications to the Communication Scheme

③ *Changes in the format of forecast publications*

- Starting from the next Inflation Report onwards, the forecasts of inflation and economic activity will be published using “Fan Charts”.
- Advantages of using these graphs:
 - ✓ *They illustrate the uncertainty associated to the forecasted variable.*
 - ✓ *They explicitly indicate the probability with which the forecasted variable is expected to lie within different intervals.*
 - ✓ *They reflect the fact that the longer the forecast horizon, the greater the uncertainty of the estimates.*
 - ✓ *Their use is considered a best practice among central banks.*



5. Modifications to the Communication Scheme

Fan Chart Example for a Particular Variable

