Inflation Report

July - September 2010

Summary

The world economy experienced a slowdown during the third quarter of 2010. This partly reflects that domestic demand in the major advanced economies remained weak, which continued to be limited by households' efforts to deleverage and to adjust their spending to sustainable levels, as well as the fragile situation of the financial system. In turn, emerging economies continued growing at a faster pace than advanced economies, driven by both their domestic demand and their exports, although in some cases there appeared signs of deceleration. In this context, the global economic recovery is expected to moderate its pace in the next quarters.

World inflation remained at low levels throughout the third quarter of the year. The major advanced economies registered low levels of consumer inflation and in some cases the concern about the possibility of deflation increased. In this context and in the expectation of lower growth, the central banks of the major economies reasserted their decision to maintain their policy rates at low levels and expressed their disposition to take additional measures for monetary easing. In contrast, some emerging economies, mainly from Latin America and Asia, registered higher inflation levels during this quarter of the year, in some cases as a consequence of demand pressures and in others due to the increased international grain prices. In view of this, the central banks of some of these economies responded by partially withdrawing the monetary stimulus.

The monetary policy implemented in advanced economies has generated abundant global liquidity, which has led to a search for higher yields. This search has contributed to substantial capital inflows to emerging economies, appreciation of their currencies, as well as upward pressures on the asset prices of those economies that could even lead to bubbles. All of this complicated monetary policy in emerging economies. There is also fear of a sudden reversal of capital flows, which has been one of the reasons that encouraged an increase in international reserves accumulation by capital receiving economies.

Currency appreciation can affect export competitiveness of emerging countries in the international markets. For this reason and out of concern about the possible weakening of the global economy, some of these economies have taken certain steps to try to contain this appreciation, e.g. international reserves accumulation. Nevertheless, at least two considerations are worth mentioning. First, in some cases, currency appreciation reflects, at least partially, more fundamental factors, such as the improvement in the terms of trade that has benefited some commodity exporting countries. Therefore, appreciation does not necessarily decrease competitiveness of all exports. Second, a widespread policy of sustained economic recovery of external demand by means of depreciated real exchange rates is not a viable solution for the global economy. This brings out the need of greater coordination among countries to maximize growth in the global economy.

International financial market volatility decreased during the third quarter of the current year, and so far in the fourth quarter, due to improvements on the perception that the sovereign crisis in Europe could have significant systemic implications, although this risk remains a source of uncertainty. In particular, despite the fiscal adjustment measures implemented in various European countries, their capacity to considerably diminish the sovereign risk is still doubtful. This factor could affect the growth prospects both for the European region and the global economy. In addition to that, financial institutions of various advanced countries are still dependent on the capital and liquidity support from both their governments and central banks. Since private banks have to refinance high debt maturities, they remain highly sensitive to the economic activity deterioration and confidence shocks. In this context, the recent announcement of the Basel Committee on the new global capital and liquidity standards represents significant progress in the future strengthening of the international financial system.

In Mexico, available timely indicators suggest that the expansion rate of the economy observed a slight moderation during the third quarter of the year, this is a result of both a lower growth rate in the external demand and the lack of consolidation in the domestic demand recovery. Thus, it is estimated that throughout the reported period there has been an absence of demand-related pressure on the utilization of main inputs and, as a result, on their prices and the country's external accounts.

The annual headline inflation was 3.67 percent on average during the reference period, which compares favorably to both the figure of the second quarter of the current year that was 3.96 percent and the lower limit of the forecast interval Banco de México published in the previous Inflation Report, which was 4.75 percent. This performance, with the merchandise core inflation behavior standing out, mainly reflects the national currency appreciation, the low world inflation, the negative output gap, as well as other seasonal and juncture factors, especially the intensified competition among some retail chains. All of these appear in the context of a prudent monetary policy aimed at achieving the inflation target.

Considering the aforementioned, Banco de México's Board of Governors decided to maintain the overnight interbank interest rate target unchanged during July, August, September and October of the current year.

The macroeconomic scenario forecasted by Banco de México for the remainder of 2010 and for 2011 is as follows:

GDP Growth: The annual GDP in Mexico is estimated to grow around 5 percent during 2010, representing a moderation in its annual growth rate during the second half of the year. In 2011 the GDP is expected to increase between 3.2 and 4.2 percent, as in the forecast from the Inflation Report, April-June 2010. These forecast imply that even though the output gap is expected to close gradually, it will remain negative during the remainder of 2010, as implied by the growth forecasts. Nevertheless, there is a slight probability that it could turn positive during the second half of 2011.

Employment: The number of IMSS-insured workers is expected to increase between 575 and 675 thousand by the end of 2010 and between 500 and 600 thousand in 2011.

Current Account: The trade balance and current account deficits are expected to be moderate in 2010 at levels of USD 5.1 and 6.5 billion in 2010, respectively (0.5 and 0.6 percent of GDP), as compared to USD 4.6 and 5.7 billion (0.5 and 0.7 percent of GDP) in 2009. In turn, for 2010 the trade balance is expected to exhibit a deficit of USD 10.5 billion (0.9 percent of GDP) and the current account, of USD 12.7 billion (1.1 percent of GDP).

The large resource inflows to emerging economies, including Mexico, as well as the expected access conditions to international financial markets, suggest that the estimated moderate deficits in the current account will be fully financeable. Indeed, the federal government and the private sector have had access to the international markets under favorable conditions, regarding both term and costs. In particular, according to the Ministry of Finance (Secretaría de Hacienda y Crédito Público), the amounts obtained for the recent issuance of 100-year bond and the ones obtained from the placement of Japanese Yen-denominated bonds cover the programmed amortizations of the federal government's external debt until 2012. The available information on the expected trajectory of external debt maturities of the private sector indicates that no maturity-related pressures on the capital account will be observed in the remainder of 2010 and 2011. Finally,

the economy is expected to receive significantly more foreign direct investments in 2010 and 2011, as compared to 2009.

Considering the less favorable scenario for the world economy, the downward risks for the Mexican economy have increased:

i. A more moderate US economic growth in the future.

ii. There is a risk that various countries intend to stimulate exports through "competitive depreciations".

iii. The need of various countries to consolidate their public finances.

iv. A sudden reversal of capital flows.

Inflation: During the third quarter the balance of risks associated to inflation improved. Therefore:

- The annual headline inflation forecast interval for the next two quarters were revised downwards: 0.50 percentage points for 2010-Q4 and 0.75 percentage points for 2011-Q1. Thus, the corresponding intervals are: 4.25 to 4.75 percent for 2010-Q4 and 3.75 to 4.25 percent for 2011-Q1.

- The annual headline inflation is expected to lie between 3 to 4 percent in the 2011-Q2.

- From 2011-Q3 onwards the annual headline inflation is expected to converge towards the target of 3 percent, bearing in mind the variability interval of plus/minus 1 percentage point.

The downward revision in the inflation forecast is basically due to four considerations: i) the favorable performance demonstrated by the growth rate of merchandise prices, driven by the appreciation of the exchange rate, as well as by the intensified competition in the commercial sector of the country; ii) the prospect that the output gap will remain negative for a prolonged period with a high probability; iii) the expectation that supply conditions for crops with a high CPI weight (e.g. tomatoes) will remain relatively normal in the next half year, despite the adverse weather conditions observed in different regions in the country; and, iv) favorable worldwide inflationary conditions.

Among the major risks that the inflation forecast faces are: i) the growth rate of public sector prices for goods and services; ii) the possibility of a reversion of the effects of greater competition among retail chains; iii) abrupt changes in the exchange rate parity; iv) the volatility of the international prices of grains; v) higher downside risks of economic activity; and, vi) high degree of volatility of fruit and vegetable prices.

Banco de México's Board of Governors will continue to monitor inflation expectations, output gap, public prices, grain prices, as well as other inflation determinants that might signal unexpected and widespread pressures on prices. All of this so that, in such eventuality, the central bank could adjust its monetary policy stance in order to reach the 3 percent target by the end of 2011.

At the moment, the Mexican economy faces the challenge of generating growth rates that will lead to a greater level of development. This could present certain difficulties in the coming years given a less dynamic international environment, unless it is counterbalanced by a more dynamic domestic market driven by an increased investment and productivity stimulus.

Macroeconomic policy plays a fundamental role. The combination of sound public finances and a monetary policy aimed at reaching the inflation target, favors a macroeconomic environment characterized by stability and certainty, which is a necessary condition to encourage investment. Nevertheless, a sound implementation of macroeconomic policy needs to be complemented by an incentive structure that favors the productivity growth in the economy. Among the microeconomic policies that could favorably affect the incentive structure, the following measures stand out: increasing the degree of competition in input and final goods markets and the flexibility in the labor market.

Modifications to the Communication Scheme

1. **Publication of Minutes.** Publication of Minutes of the Board of Governors' meetings regarding monetary policy decisions from 2011 onwards.

   - The publication of Minutes will contribute to increase even more the transparency of the Central Bank and to be in line with the best practices in these matters.

   - Information on the decision-making process in the monetary policy will be provided, in particular on the factors that most influenced the decisions of the Board.

   - The Minutes will be released 10 working days after the announcement of the monetary policy decision.

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 (Table 1).[1/] However, it is worth mentioning:

   - The Central Bank will be publishing information on the monetary policy during all of the months of 2011 though 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.

Table 1
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.

3. **Changes in the Format of Inflation and Economic Activity Forecasts.** Starting from the next Inflation Report onwards, these forecasts will be published using "Fan Charts". Among the advantages of these graphs are:

   - 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.

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.