Inflation Report

October - December 2009

Summary

During the October - December 2009 period, the recovery of the world economy strengthened. Nevertheless, various countries have just started to recover and the global economy is still vulnerable to new shocks. The expansionary economic policies and the gradual reduction of difficulties in the financial systems of the major advanced economies have been the main factors behind this recovery.

Despite the fact that both world economic activity and trade flows have increased, in the short term, the rate of growth of the global economy is expected to recover moderately due to a weak domestic demand in advanced economies, which is anticipated to persist as long as: 1) the income, employment, and financial situation of households in those economies continues to improve slowly; 2) firms continue operating with a high idle capacity; and, 3) credit conditions remain tight. For these reasons, the output gap in these economies might take some years to close.

After having been in negative territory for several months in most advanced economies, inflation registered positive figures during the last quarter of 2009, albeit still remaining at low levels. In emerging economies, prices increased at a relatively moderate rate during the same period, although with important differences among countries, and with some of them experiencing a certain price rebound. In the last three months of the year, the monetary policy stance continued to be accommodative in practically all economies, both advanced and emerging. However, some countries began the process of withdrawing the monetary stimulus.

International financial markets improved between October and December of 2009, following the trend observed since the second quarter of the year. Nevertheless, conditions that still prevail in these markets have not fully gone back to normality. In particular, the world financial markets are still vulnerable to any setbacks that could hamper the world's economic recovery. Furthermore, the extended period of the monetary stimulus could translate into asset prices that do not fully reflect the economic fundamentals, raising the probability of a sudden correction once the interest rates in advanced economies increase.

Indeed, low interest rates in the U.S. and other advanced economies, expectations that these rates will remain low for a long period, and the weakness of the US dollar, have allowed, together with an improved outlook for growth in most emerging economies, the upsurge of carry-trade. This is basically the search for higher yields through cheap financing in advanced economies' currencies. These operations have led to a significant increase in capital flows to emerging economies. This situation could become a factor of risk and instability in the future, leading to a scenario where capital flows could suddenly revert, once the stimulus measures in advanced economies are withdrawn.

As for productive activity in Mexico, most recent indicators confirm that, during the last quarter of 2009, it continued following the same increasing trend observed since the third quarter. The rebound in economic activity since the third quarter was essentially fueled by the recovery of the world economy, which has led to an upturn in manufacturing exports and to a gradual transmission of this recovery to other sectors of the economy, such as the services sector. Nevertheless, in contrast to the significant increase in external demand, available indicators of domestic demand are just starting to improve. In general terms, the economy continues operating under slack conditions, below its potential growth levels.

During the fourth quarter, annual headline inflation continued following the same downward trend observed since the beginning of 2009, registering 3.98 percent. Both core and non-core inflation components account for this result. This reduction in inflation was widespread across all subindices and resulted from the total aspects inherent to the current phase of the business cycle, the absorption of the supply shocks that took place previously, and the price setting policies adopted by the different government levels. Nevertheless, it is important to point out that the degree of core inflation inertia in Mexico is still high.

Under these conditions, in January 2010, Banco de México's Board of Governors left its target for the interbank interest rate unchanged at 4.5 percent.

Banco de México foresees the following macroeconomic base scenario for the Mexican economy:

GDP Growth: GDP is expected to have grown during the last quarter of 2009 above 1 percent in seasonally adjusted terms as compared with the previous quarter (a contraction below 3 percent in annual terms). Thus, for the year, GDP is expected to have contracted below 7 percent in annual terms. For 2010 and 2011, GDP is anticipated to grow between 3.2 and 4.2 percent, respectively. This forecast is mainly determined by the rebound of the world economy and, especially, by the anticipated upturn in U.S. industrial activity. Despite the foreseen expansion, productive activity is expected to remain below its potential level and, therefore, the output gap would remain negative in 2010 and 2011.

Employment: on the basis of the recovery in the number of IMSS-insured workers at the end of 2009, and expected growth in GDP for 2010, employment is anticipated to increase by 350 thousand and 450 thousand jobs in 2010. Moreover, the expected development of economic activity in 2011 is also anticipated to lead to an increase of between 500 thousand and 600 thousand formal jobs in the same year.

Current Account: on the basis of the 4.7 billion dollar deficit in the trade balance (0.5 percent of GDP) observed in 2009, the current account deficit for that year is expected to have been around 5.2 billion dollars (0.6 percent of GDP). These deficits reflect the adjustment in domestic expenditure during 2009, which led to a significant contraction in imports of goods and services. For 2010, the trade balance and the current account are anticipated to register higher deficits than those observed in 2009. Nevertheless, they still remain moderate (11.7 billion dollars or 1.2 percent of GDP, in both cases).

The economy is not expected to face foreign financing problems in 2010. This is mainly attributed to the combination of different factors such as: 1) the anticipated relatively small deficit of the current account; 2) the high level of international reserves to date;

3) the fact that the federal government has made significant progress in covering its refinancing needs for 2010; and, 4) the flow of foreign financing that is expected to continue, as long as the world economy gains momentum and international financial conditions improve.

Notwithstanding the above, the foreseen base scenario is not exempt from risks, which, despite not being imminent, must be considered thoroughly. Among these are:

i) The effect that the withdrawal of fiscal and monetary stimulus measures in advanced economies could have on the still weak economic recovery.

ii) The eventual withdrawal of the monetary stimulus measures could lead to a sudden correction in asset prices and to a reversal in capital flows to the emerging economies.

iii) The attainment of higher and more sustainable growth rates worldwide in the medium and long terms will require adjustments in the composition of world demand.

Inflation: the forecast for annual headline inflation for the next two years is the same as that released in the Addendum to the Inflation Report of July - September 2009. This forecast considers an increase in annual headline inflation for 2010, as a result of the effect on the CPI of the tax changes approved by Congress, and the realignment of energy prices with their international references as well as the price increases determined by the local governments, such as the subway fares in Mexico City. The rebound in inflation for 2010 is expected to be temporary, to manifest itself as a one-off effect on the price level, and to fade gradually in 2011. Nevertheless, second round effects on inflation can arise if expectations for longer terms are affected, which, in turn, would also affect the economy's price formation process. Up to now, these expectations have remained relatively stable and there are no signs of widespread pressures on inflation, despite the fact that they remain above the 3 percent inflation target. The slack conditions that prevail in the economy and foreign capital inflows have also contributed to the aforementioned stability of the longer term inflation expectations. Both of these factors are expected to perform similarly during 2010.

The increase in headline inflation is expected to revert in 2011, positioning itself close to the 3 percent inflation target during the fourth quarter of that year (Table 1). The downward pattern inflation is expected to follow in 2011 is based mainly on three considerations:

1. Tax changes usually have a temporary effect on the growth rate of prices. Thus, although consumer prices are expected to be revised during the first half of this year, the effect would disappear from annual inflation estimates during the same period of next year.

2. The freeze in gasoline prices in non-border cities during practically all 2009 and the reduction in propane and natural gas prices, as well as in peak rate electricity fees, generated a high fiscal cost. The reestablishment of the policy of gradually adjusting energy prices on a monthly basis in 2010 will contribute to reduce such cost. Likewise, in 2011, the annual inflation of the subindex of administered prices would not be expected to resent the arithmetical effect associated with the low base of comparison generated by a policy for energy prices with no monthly adjustments, unlike in 2010.

3. The expected adjustments for 2010 in the prices and fees determined by local governments must be reflected in a more efficient use of the economy's resources. Insofar as a considerable number of adjustments are implemented this year, prices could grow at slower rates the following year.

Thus, the recent developments in inflation and economic activity, the outlook for economic activity for the following two years and, finally, some adjustments to the assumptions previously considered in the Addendum to the Inflation Report of July - September 2009 to obtain the previous inflation forecast, reveal a trajectory for annual headline inflation for the following eight quarters that falls within the intervals published in the referred Addendum.

Table 1
Base Scenario Forecast for Annual Headline Inflation
Quarterly average (percent)

Quarter	Forecast Addendum to the Inflation Report III-Q 2009	Forecast Inflation Report IV-Q 2009
2009-IV	3.75 - 4.25	3.98 [1/]
2010-I	4.25 - 4.75	4.25 - 4.75
2010-II	4.50 - 5.00	4.50 - 5.00
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

1/ Observed figure.

Nevertheless, the forecasted path for headline inflation is subject to diverse risks, among which the most noteworthy are:

i) An upward revision in long-term inflation expectations due to the expected rebound in inflation.

ii) A magnitude different from that estimated for the foreseen adjustments to administered and regulated prices.

iii) A pass-through to prices different from that expected from the tax changes approved by Congress.

iv) Weather conditions that could affect the supply of fruits and vegetables.

v) A rate of recovery in economic activity different from that expected would definitely affect the inflation path.

vi) A reversal in capital flows which would adversely affect the exchange rate.

Despite the fact that the slackness in the output gap is expected to diminish the effect on consumer prices of the fiscal measures and of the adjustments in public prices and fees, it will be of utmost importance for the monetary authority to remain vigilant that other prices are not contaminated. In this regard, in order for inflation to resume a downward trend conducive to the 3 percent annual inflation target, inflation expectations for the medium and long terms need to remain well anchored, and no widespread inflationary pressures must be present. This will allow, once the foreseen rebound in inflation disappears, inflation to decline significantly throughout 2011 and then come close to the 3 percent annual target at the end of that year.

In addition to having a central bank vigilant on price stability, the feasibility of attaining low and stable inflation, as well as how efficiently it can be achieved, increases insofar as the country has a flexible economy that responds more rapidly to the changing domestic and external conditions. In particular, a greater degree of competition and flexibility in domestic markets prevents rigidities in the price formation processes. In addition, the institutional arrangements that affect productivity are crucial for determining the economy's supply conditions and, therefore, the population's cost of living. Considering the aforementioned issues, the possibility that U.S. potential growth might have been affected and that the economy of that country could recover at a relatively slow rate –therefore hindering the contribution of external demand to the domestic economy's dynamism- raises the urgent need to resume the structural reforms' agenda that would boost the development of Mexico's domestic growth sources.