

Inflation Report

October - December 2010

Summary

The world economy's growth prospects for 2011 have improved. During the last months a recovery of diverse indicators of the major advanced economies was registered which responds, to a large extent, to the effect of the fiscal and monetary stimuli. Meanwhile emerging economies continue to show strong growth. Nevertheless, structural factors persist in diverse advanced economies indicating that these economies will continue presenting relatively low growth rates in the next years.

During the fourth quarter of 2010, central banks of the major advanced economies maintained their policy rates close to zero and expanded their quantitative easing programs. In the United States, new fiscal stimulus measures were approved. Nevertheless, this has generated concern given the uncertainty with respect to the sustainability of private spending recovery, once the process of withdrawing the supportive measures starts.

At the end of 2010, increases in headline inflation were registered in the major advanced economies due to the rise in commodity prices. However, core inflation remained low. Due to this, as well as the reduced anticipated levels of installed capacity utilization, no inflationary pressures are expected for a certain time. In contrast, in some emerging economies inflation and its expectations increased, as a result of higher demand pressures and the increase in commodity prices, mainly food prices.

Financial markets again experienced nervousness caused by the concerns about the fiscal sustainability and banking system's solvency in some European countries and given the possibility of an obligatory participation of debt holders in future bailouts. To avoid contagion to other markets, a financial support package for Ireland was announced, the strengthening of the European Financial Stability Facility (EFSF) was agreed on and the European Central Bank moderately increased its sovereign debt purchases.

The improvement of emerging economies' fundamentals and the search for yield, attributable to the environment of high global liquidity, have induced important capital flows towards these countries. Due to this, currencies of some countries with flexible exchange rate regimes have considerably appreciated, which could have an impact on their exports. There is also fear that an excessive credit expansion might occur, leading to a formation of asset price "bubbles" and, on the other hand, there is a risk of sudden capital flow reversals.

Various economies, mainly the emerging ones, whose currencies are appreciating significantly and whose aggregate demand is increasing at high rates, face a monetary policy tradeoff: to reduce interest rates to discourage capital inflows or to increase them to offset the strong growth of the aggregate demand and higher inflationary pressures. Surely, the latter would tend to appreciate the exchange rate more.

The problem of global imbalances has become more urgent, since current account figures in the deficit countries have not declined at the expected pace. Some emerging economies have responded with diverse measures trying to slow down the appreciation of their currencies. However, a generalized policy, focused on sustaining economic recovery based on real depreciations of their exchange rates, is not a viable solution for the world economy. An increased international coordination to maximize the global growth and to ensure medium-term sustainability is necessary.

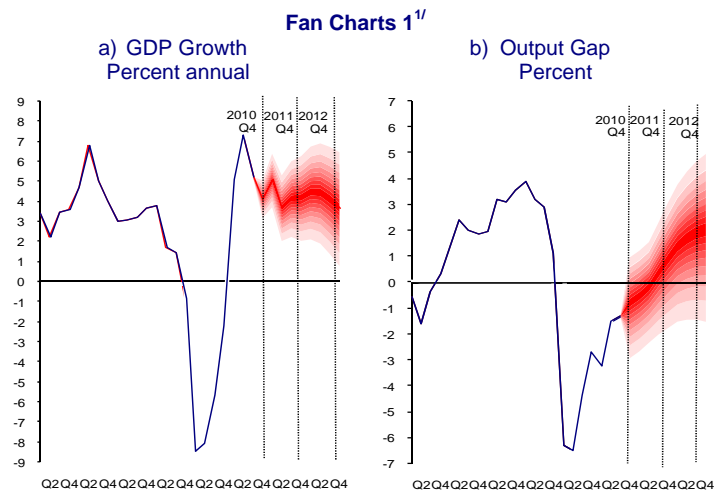
During the last quarter of 2010, the aggregate demand in Mexico continued showing an upward trend. Indeed, goods and services exports seemed to have resumed an increasing trajectory in this quarter. In turn, the domestic demand showed a relatively more noticeable and generalized recovery as compared to the previous quarters. Consequently, the output gap has been closing. Nevertheless, during the referred period no demand-related pressures on utilization, and thus, neither on main input prices, nor on country's external accounts, were observed.

During 2010, inflation reached levels lower than those expected at the beginning of the year. In particular, in the analyzed quarter, annual headline inflation rebounded, averaging 4.25% (during the third quarter it was 3.67%), being located in the lower limit of Banco de México's forecast interval for this period (4.25 to 4.75%), which was revised downwards by

0.50 percentage points (pp) in the previous Inflation Report. Annual core inflation declined from the third to the fourth quarter, so that the rebound experienced by headline inflation was mainly due to the performance of the non-core component.

The macroeconomic scenario forecasted by Banco de México is the following:

GDP Growth: GDP is estimated to have shown an increase of 4.3% in the last quarter of 2010 and 5.4% for the entire year. Furthermore, GDP growth in 2011 is expected to lie between 3.8 and 4.8%, as compared to the interval of 3.2 and 4.2% for 2011 published in the previous Inflation Report (Graph 1a). Also, for 2012 GDP is estimated to grow between 3.8 and 4.8%. The faster growth of the aggregate demand forecasted for 2011 suggests that the output gap will close more rapidly than previously estimated (Graph 1b).



1/ Fan Charts show the probability of realization of annual growth and output gap forecasts for the forecasted time horizon. The darker shaded areas represent the projection more likely to occur. The bands of each side with the same color but with lighter tones accumulate in total 10% of the probability successively until adding up 90% of the probability.

Employment: It is anticipated that in 2011 and 2012 between 600 and 700 thousand new formal employments will be created each year.

Current Account: For 2011, the trade balance is forecasted to register a deficit of 10.0 billion USD (0.9% of GDP), while the current account is expected to register a deficit of 14.2 billion USD (1.2% of GDP). The liquidity conditions that are expected to prevail in the international financial markets, as well as the fact that the Federal Government already pre-financed its external debt amortization program for 2011, suggest that the projected deficit of the current account will be easily financeable.

Despite the improvement registered in the growth expectations of the US economy for 2011, there are diverse risks in the external environment that still persist and that might affect the performance of the Mexican economy, as shown by the Fan Charts (Graph 1). Among the most important risks are:

- i. The fiscal situation in various European countries.
- ii. The US economy will have to continue reducing its structural problems in the future.

Finally, in line with private sector economic specialists, public insecurity is a factor that might limit the growth of investment in Mexico.

Inflation: The annual headline inflation forecast remains unchanged, except for the first quarter of 2011, which is revised downwards: for 2011-Q1 the interval is revised from 3.75 - 4.25% to 3.0 - 4.0%; for 2011-Q2 the inflation is estimated to lie between 3.0 and 4.0%; while starting from 2011-Q3 the inflation is expected to converge to levels congruent with the

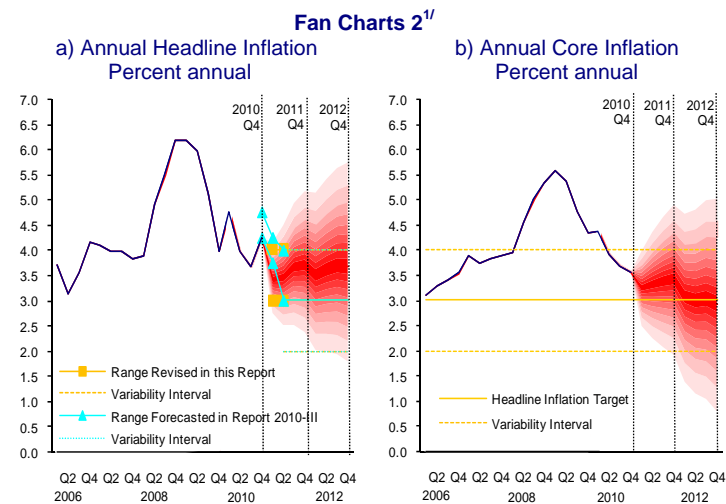
Summary

permanent inflation target of 3%, taking into account the variability interval of +/- 1 pp (Graph 2a).

In addition to a monetary stance congruent with the attainment of the inflation target, four principal factors that will contribute to reducing inflation during 2011 are taken into consideration:

- Fading away of the impact associated to fiscal changes and fares at a federal and local level observed in the previous year.
- A slower growth pace expected in the services prices, especially housing and tourism.
- Absence of pressures on labor costs faced by firms.
- Exchange rate behavior.

In turn, the downward revision of the inflation forecast corresponding to the first quarter of 2011 is mainly a consequence of the expectation of a greater reduction in comparison to the one previously forecasted in the price quotes of agricultural products with a high CPI weight.



1/ Fan Charts show the probability of the realization of headline and core inflation forecasts for the forecasted time horizon. The darker shaded areas represent the projection more likely to occur. The bands of each side with the same color but with lighter tones accumulate in total 10% of the probability successively until adding up 90% of the probability.

The inflation forecast is subject to diverse risks that generate uncertainty about it. These can be observed in the Fan Charts (Graph 2). Among the most important upward risks stand out the following:

- Increases higher than those forecasted in international commodity prices, in particular, grain prices.
- The growth rate of goods and services prices, whose fares are determined by local governments.
- Higher vulnerability to cost shocks, in an environment where the output gap has been closing.
- Exchange rate volatility due to a capital flow reversal.

Taking these risks into account, the trajectory most likely to occur, represented by the band of the most intense red color, is located during the entire forecast horizon between 3 and 4% (Graph 2a). Reflecting the existence of diverse upside inflation risks which for the most part do not respond to the monetary policy actions, a part of the fan chart is above the upper limit of the variability interval of 4% during most of the forecast horizon.

Graph 2b shows that the most probable trajectory of the core inflation, which is the CPI component that is the most responsive to the monetary policy stance, is located at a level lower than that of the headline inflation and under 3.5% during 2011. Besides, for 2012, the abovementioned trajectory is forecasted to lie around the permanent inflation target of 3.0%. It is noteworthy that this period represents the time horizon where the transmission channels of the monetary policy fully function.

The difference projected in the trajectories of the headline and core inflation for the next two years is due to the higher growth rate forecasted in CPI's non-core component. This is associated to three elements: i) the policy of increments of energy prices aimed at reducing the existing gap between these and their international references, given the increase of the latter ones; ii) the forecast of revisions of different fares authorized by local governments at a pace higher than the expected headline inflation; and, iii) during 2012 the group of fruit and vegetables is expected to make a greater contribution to the inflation. It is worth mentioning that Banco de México

has already mentioned on previous occasions that the misalignment between domestic and international energy prices entails significant fiscal and economic costs, so that the policy of increments oriented at decreasing the abovementioned misalignment, will allow the government to have sound public finances. This in the long run is an essential element to maintain an environment of low inflation.

Thus, Banco de México will carefully monitor the evolution of inflation and its expectations. In case of an adverse change in the performance of the inflation determinants (such as the output gap, public prices, prices of grains and other commodities), or if a sustained difference of inflation expectations regarding the permanent target of 3% is detected, the Central Institute will adequately adjust its monetary policy.

As it has been repeatedly indicated, Banco de México has defined a variability interval of +/- 1 pp around the inflation target of 3%. The interpretation of this interval should not be perceived as indifference on the part of the monetary authority towards different realizations of the inflation rate within it, but as a consideration of the uncertainty margin of the precise and accurate attainment of the target, due to a wide variety of factors influencing inflation evolution and that are beyond control of the monetary authority. This, in addition to the fact that it is well known that the monetary policy affects inflation with long and variable lags.

The risks Mexico is facing, given an international environment that is prone to rapid changes, make it imperative to continue strengthening the macroeconomic soundness of the country and to deepen its structural change. As it has been mentioned, in order to reach an economic growth rate that would lead to a greater level of development, in the first place, a combination of solid public finances and a monetary policy aimed at attaining the inflation target is needed. In particular, the monetary policy will continue with its orientation towards reaching the convergence with the permanent objective of headline inflation of 3%. Likewise, the fiscal policy, even though still facing considerable challenges, has been solid and congruent with low and stable inflation.

It is important to highlight the policy of accumulating international reserves that with an increase of 22.8 billion USD in 2010 has taken the reserves balance to historical levels of 113.6 billion USD at the end of the period. This, together with the Flexible Credit Line contracted with the International Monetary Fund for approximately 73 billion USD for two years, implies that the resources, available for Mexico in order to deal with possible shocks coming from abroad, would amount to around 200 billion USD.

Macroeconomic policy needs to be complemented by an incentive structure that favors higher productivity levels in the economy, which, in turn, is associated with a stronger promotion of competition in the markets and flexibility in allocation of the country's productive resources. A higher level of competition is especially relevant in the markets of goods which affect consumer spending the most, as well as in the sectors offering various inputs of widespread use in production, such as energy and telecommunications. On the other hand, the flexibility in the allocation of the productive resources of the country is an indispensable condition for the country to fully exploit its comparative advantages, especially in an international environment characterized by relatively frequent changes in the relative prices of different goods. It is for this reason that Banco de México reasserts its stance regarding the great benefits that the Mexican economy is perceived to possibly capitalize, to the extent to which reform efforts take effect, in the areas of the competition policy in the country and in the labor, telecommunication and energy sectors.