

Inflation Report

October - December 2011

Summary

The world economic outlook continued deteriorating during the fourth quarter of 2011, mainly as a result of the problems prevailing in Europe. For the Mexican economy, this implied a transition to a less favorable growth environment with respect to what was forecast up until the first half of 2011. An international environment of less dynamic economic activity and high uncertainty in financial markets naturally generates a depreciation of the real exchange rate in Mexico, which in turn facilitates the adjustment of the Mexican economy.

In the United States, although the most recent information on economic activity shows a relative improvement, there are still several structural problems, such as the weakness of the labor and housing markets, as well as high levels of household debt, which are expected to keep hampering the recovery of consumption. Also, there is still uncertainty arising from the lack of political agreements over the consolidation of public finances. In the Euro zone, the effects of the crisis spread to the region's core countries, which further deteriorated household and firm confidence. This, together with the planned fiscal adjustments and the banks' deleveraging process, has negatively affected economic activity and is expected to result in a recession for at least the first half of 2012. In turn, emerging economies' growth moderated further due to the deterioration of the international environment and lower domestic demand.

The absence of a definitive solution to the sovereign debt problems in the Euro zone was the main source of volatility in international financial markets. This, coupled with the vulnerability of many of the financial institutions of the region, led to a deleveraging process in the banking sector. The result was a contraction in funding and liquidity that generated very high levels of credit risk indicators for the countries and banks in the region. In order to at least partially ease the shortage of liquidity within the system, the European Central Bank (ECB) adopted unprecedented and unconventional measures, which contributed considerably to stabilize the functioning of financial markets, particularly the sovereign debt and bank funding markets. Although these measures helped to reduce the possibility of a catastrophic event, structural problems persist in the Euro zone and the possibility of such an event cannot be yet ruled out.

The increase in risk aversion induced by the euro crisis had a significant impact on emerging economies' financial markets during the last months of 2011. In particular, capital flows were affected, the currencies of these economies depreciated and, in some cases, stock indices fell sharply. Nevertheless, as a result of the measures taken by the ECB, international financial markets have shown certain improvements during the last few weeks. In this environment, investors' search for yield has resumed, which has reflected a general increase in the prices of financial assets, including those traded in stock and exchange markets of emerging economies.

In general, for both advanced and emerging economies, a reduction in inflation rates is expected for 2012 with respect to what was registered during 2011. In the main advanced economies, the reduction in inflationary pressures has been due to the existence of large excess capacity, as well as the decline in several commodity prices. In most emerging economies, inflationary pressures have moderated, although some countries seem concerned with respect to the potential effect of their currencies' depreciation on domestic inflation. In this context, for most of the advanced and emerging economies, an accommodative or in some cases an even more relaxed monetary policy stance is expected to prevail.

In line with the above, the growth pace of economic activity in Mexico moderated during the last quarter of 2011. This was largely due to a weaker impulse from external demand, especially from the U.S., although a slowdown in some components of domestic demand was also observed. Given existing conditions in the world economy, it is anticipated that the moderation of growth in the Mexican economy will persist during 2012. In this context, conditions of slackness are expected to prevail in the economy and, thus, no demand pressures on main input prices or the country's external accounts are foreseen.

Annual headline inflation rebounded during the fourth quarter of 2011, while core inflation remained at levels close to 3 percent in annual terms. The performance of headline inflation was the consequence of transitory phenomena that mainly reflect changes in relative prices within the economy. Thus, the inflation increase is expected to be temporary and moderate. Until now, no second-round effects on the price formation process have been observed in response to relative price shocks. In particular, it has been confirmed that the pass-through of exchange rate fluctuations to inflation has been low, congruent with what has been observed in Mexico for over a decade and in line with the current phase of the business cycle, which could limit the pass-through even further. That inflation expectations have been practically unaffected by the exchange rate depreciation provides support to these arguments. At the same time, this reflects the view that the value of the currency is anchored by the solid fundamentals of the Mexican economy. Thus, annual headline inflation is anticipated to maintain a performance congruent with the convergence process to the 3 percent permanent target.

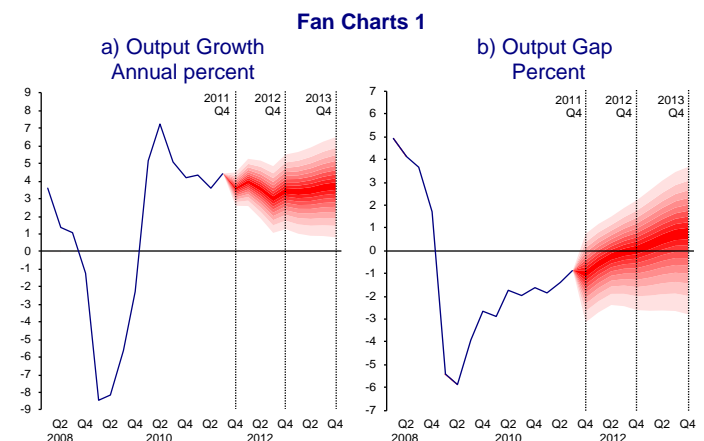
The macroeconomic scenario foreseen by Banco de Mexico is the following:

Growth of the Mexican Economy: The forecast of the evolution of Mexican GDP in 2012 remains unchanged with respect to the one presented in the previous Inflation Report. Indeed, GDP is anticipated to grow at a rate between 3.0 and 4.0 percent, in line with the slowdown in U.S. industrial activity expected in 2012 (Graph 1a). For 2013, the growth rate of the Mexican economy is also anticipated to lie between 3.0 and 4.0 percent, which partly reflects the expected evolution of external determinants of the country's economic activity growth, as well as a gradual expansion of domestic demand.

Employment: The growth of economic activity anticipated for 2012 suggests that the number of IMSS-insured workers will increase between 500 and 600 thousand persons. For 2013, the variation in this indicator is expected to lie within the same range.

Current Account: For 2012, deficits of USD 3.9 billion and USD 13.7 billion are estimated for the trade balance (0.3 percent of GDP) and the current account (1.2 percent of GDP), respectively. Thus, the moderate current account deficit expected for 2012, together with the fact that the Mexican Federal Government already pre-financed its external debt amortization program for this year, suggests that financing these deficits will not be a problem and no pressures on the exchange rate are anticipated from this source. For 2013, trade balance and current account deficits of USD 6.7 billion and USD 17.7 billion are expected, respectively (0.5 and 1.4 percent of GDP in that order).

Based on these prospects, it is expected that the output gap will continue to close during the forecast period, although it will remain at levels close to zero. In fact, the pace at which the gap will be closing is estimated to decrease, since lower GDP growth is anticipated in 2012 and 2013 as compared to 2011. Thus, no inflationary pressures arising from aggregate demand are expected within the forecast horizon (Graph 1b).



Summary

Downward risks with respect to the growth scenario presented previously have increased. Some of the factors that could generate a more unfavorable environment are: i) the possibility that the U.S. economy grows less than expected, which would reduce the impulse from external demand and, probably, affect the dynamism of domestic spending; ii) an increase in investor risk aversion due to the turbulence in external markets could negatively affect capital inflows to emerging economies, including Mexico; and iii) regarding domestic affairs, according to specialists in the Mexican economy surveyed by Banco de México, public insecurity and the absence of structural changes remain factors that could adversely affect the economy's growth.

There are also upward risks to the growth scenario described above. Mexico's growth could improve with respect to this scenario to the extent that the actions taken by the European authorities continue to improve the functioning of financial markets, or to the extent that the U.S. economy performs better than expected. This, coupled with a better performance of domestic financial markets and considering the solid macroeconomic fundamentals, could lead to an improvement in the relative risk perception of Mexico at the international level.

Inflation: Regarding the inflation forecast, it is expected that in 2012 inflation will perform in line with the convergence process to the 3 percent permanent target. This environment will be mainly influenced by six elements: i) the expected slowdown in economic activity; ii) conditions of slackness in the economy in general and, in particular, in several indicators of the labor and credit markets, as well as the external sector; iii) the reduction in the cost of mobile phone use, as well as other goods and services that observe rapid technological progress; iv) global disinflation; v) the possibility of a more favorable environment in international financial markets, which would be reflected in an exchange rate appreciation; and vi) however, inflation will also be affected in the short run by the behavior of agricultural products, whose price fluctuations are influenced by weather conditions and by changes in international commodity prices.

Thus, congruent with the inflation trajectory forecast, the most likely scenario for annual headline inflation in 2012 contemplates a range between 3 and 4 percent, in line with the forecast described in the previous Inflation Report (Graph 2a). For 2013, it is also anticipated that annual headline inflation will lie in a range between 3 and 4 percent and that it will approach the lower bound of this interval, insofar as the effects of the relative price adjustments stated in this Inflation Report -which are estimated to be mainly reflected in the CPI non-core component- begin to dissipate. Here, it is important to highlight the main arguments behind the prediction that the contribution of the non-core component to headline inflation will fall in 2013: i) the fading of the effect of the shock in meat prices, once production, which has been affected by a drought in North America, returns to normal levels; ii) the biannual pattern observed for fruits and vegetables price inflation, which implies that the growth in the prices of these products will be considerably lower in 2013 with respect to the forecasts for 2012; and iii) a lower growth rate of energy prices.

It is estimated that annual core inflation will most likely remain close to 3 percent during 2012, congruent with the forecast of the previous Inflation Report. Likewise, during 2013 it is anticipated to remain around 3 percent (Graph 2b).

The forecast trajectory for inflation is subject to several risks. Among the upward risks that stand out are: i) the possibility of external financial shocks, which could lead to a significant exchange rate depreciation; and ii) the possibility that the prices of some agricultural products rebound, especially in the current context of adverse weather conditions. On the other hand, some of the downward risks are: i) the possibility of a further weakening of external and domestic demand; and ii) the possibility of continued improvement in the relative risk perception of Mexico at the international level. In sum, it is concluded that the risk balance for inflation remains neutral.

In light of the abovementioned risks that the Mexican economy is affected by less favorable external conditions, it is important that our country maintains the current strength of its macroeconomic fundamentals and advances its structural reform process. On the one hand, the economy's adjustment to the deterioration of the global environment has taken place in a gradual and orderly manner. Furthermore, the Mexican economy has shown a strong resilience to external shocks, which has precisely been the result of the solid macroeconomic fundamentals of the country. There are four pillars that explain such solidity: first, the conduction of a monetary policy aimed at procuring price stability; second, a prudent fiscal policy; third, a flexible exchange rate; and, fourth, a well-capitalized financial system with adequate regulation and supervision.

On the other hand, progress in the structural reform process is crucial for raising the economy's productivity and potential growth rate. Banco de México has emphasized the importance of promoting market competition, as well as improving the flexibility of the productive resource allocation in the country. In particular, an increase in competition induces producers to adopt better technologies in order to avoid being displaced from the market. Also, increased flexibility in input markets, such as the labor market, would allow better exploitation of the country's comparative advantages by inducing greater mobility of the resources to their most productive uses. The increase in the growth pace of productivity induced by structural reforms would allow aggregate demand to be more dynamic, which would favor consumers without exerting inflationary pressures. Thus, by reaching higher potential growth, the economy will be in a more favorable position to more aptly satisfy the consumption needs of the population in an environment of low and stable inflation.

In light of the arguments presented above, the Board of Governors considers that the current monetary policy stance is conducive to reaching the 3 percent permanent inflation target. Thus, it maintained the Overnight Interbank Interest Rate unchanged at 4.5 percent during the period analyzed in this Inflation Report. However, the Board will closely follow the world economic growth outlook and its possible implications for the Mexican economy, which, in the context of highly loose monetary conditions in the main advanced countries, could eventually make monetary easing convenient. The Board of Governors will also continue to closely monitor the behavior of all inflation determinants that might signal widespread pressures on prices, in order to adequately adjust the monetary stance, ensuring at all times the convergence of inflation to its 3 percent permanent target.

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