

Inflation Report

January - March 2011

Summary

The world economy continued its recovery in the first quarter of 2011, even though uncertainty about the world economic prospects has increased. Economic growth in advanced economies was moderate due to the slow recovery of the private demand, while emerging economies maintained a vigorous economic expansion.

Although at a slower pace than in the previous quarter, U.S. economic activity increased during the first quarter of 2011, with the expansion of the industrial production standing out. In turn, private consumption rose at a more moderate pace, affected by the increase in the price of fuels. In the labor market, the unemployment rate remained high, although certain signs of improvement were observed. Also, the housing market and its prospects remained stagnated. In this way, there is still uncertainty as to the sustainability of the economic recovery in the U.S. once the fiscal and monetary stimuli are withdrawn.

International commodity prices continued to show an upward trend in the first quarter of the year. Increases in the energy price quotes were noteworthy. This was a consequence of the rapid growth of the emerging economies, which increased the demand for the abovementioned products. In addition to this, in the case of crude oil, the supply has been affected by political instability in the Middle East and North Africa.

In the major advanced economies, headline inflation and its short-term expectations registered an increase associated with the rebound of the commodity prices. However, core inflation remained low, due to the excess of existing capacity and the still weak conditions in the labor market. In turn, long-term inflation expectations remained anchored. The U.S. Federal Reserve announced that: a) next June it would complete its program of Treasury securities net purchase, as it had been originally announced, and will maintain its present policy of reinvestment of principal payments from its securities portfolio; b) it would regularly review the amount and the composition of its security holdings; and, c) it expected that the economic conditions would probably warrant the target of the federal funds rate to be located at exceptionally low levels for an extended period. In turn, at the beginning of April the European Central Bank decided to increase its policy rate by 25 basis points, claiming higher risks for price stability in the medium term. Besides, central banks of other advanced economies, such as Canada, Sweden and Australia, have increased their reference interest rate. All this has led to a depreciation of the USD with respect to the currencies of other advanced countries.

Higher inflationary pressures were observed in various emerging countries, which reflected both the commodity price increase and the fact that some economies are going through an advanced phase of their business cycle. Some of them even registered signs of overheating, hence their central banks increased their reference rates, which for some of these countries resulted in a continued withdrawal of the significant monetary stimulus that they introduced.

In the international financial markets, the conflicts in the Middle East and North Africa, as well as the natural disasters in Japan, have produced relatively limited effects up to now. Global financial conditions demonstrated an improvement from the end of 2010 up to the moment, with the exception of Europe, where the tensions, caused by the precarious fiscal situation in some of the countries in the region and the uncertainty about some banking systems' soundness, persist. Therefore, a possibility of a new crisis is not ruled out.

During the first three months of the year, capital flows to the emerging countries showed volatility. Nevertheless, starting from the end of March a recovery of these flows has been observed, and, in general, the trend towards appreciation of the emerging economies' currencies was

intensified. A contribution to this was an environment of lower risk aversion in the international financial markets.

In Mexico, during the first quarter of 2011 the dynamism of the external demand continued passing onto the components of domestic expenditure, which led to aggregate expenditure consolidating its positive trend and presenting a more balanced composition. Thus, productive activity and employment kept registering a positive trend. However, various indicators of the conditions prevailing in the markets of the main productive factors, as well as an evaluation of the balance between economy's income and expenditure, suggest that no generalized pressures on prices are observed.

In this sense, annual headline inflation significantly decreased during the first quarter of 2011, reaching at 3.04 percent in March, while at the end of the previous quarter it was 4.40 percent. This performance was congruent with the forecast published by Banco de México in the last Inflation Report. Annual core inflation also continued exhibiting a downward trend. Essentially, this was influenced by the monetary policy conduction and by the absence of labor cost related pressures. Besides, the fading effects of various shocks presented last year and, especially, the exchange rate appreciation contributed to this result. Thus, the reduction of headline inflation in Mexico, contrary to the development observed in most countries, was due to the fact that the impact of the international energy price increase had a limited influence on domestic prices given the policy of increments applied in their determination, apart from the previously mentioned elements. In this sense, it is noteworthy that non-core inflation performed better than expected, which could revert in the future.

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

Growth of the Mexican Economy: In the short term, the boost coming from U.S. industrial production is expected to continue. In turn, various indicators suggest a strengthening of domestic demand in Mexico during the first quarter of 2011. Consequently, the recent evolution of the economy and of the expectations of its main determinants, suggest that in 2011 GDP growth in Mexico could be greater than the one forecasted in the previous Inflation Report. Therefore, the forecast interval is adjusted from one of 3.8 to 4.8, to one of 4 to 5 percent. For 2012 the forecast remains unchanged, with the growth forecasted to be between 3.8 to 4.8 percent (Graph 1a). It is estimated that in the remainder of 2011 and in the first months of 2012 the output gap will continue closing, but it will be statistically located around zero. This, together with the presented analysis of conditions prevailing in the input markets, implies that no generalized pressures on prices are expected (Graph 1b).

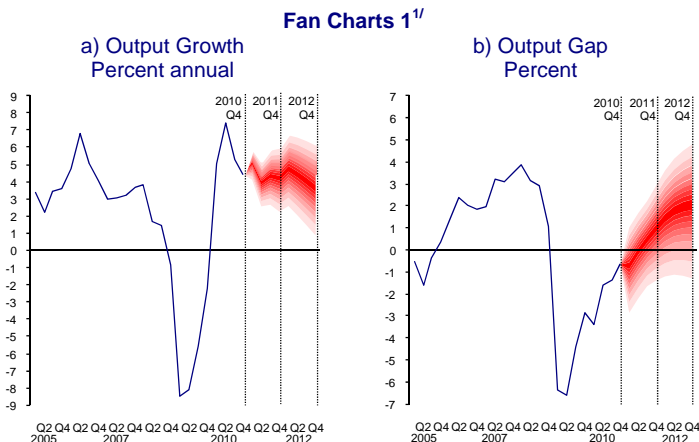
Employment: Economic activity growth, as anticipated for 2011 and 2012, suggests the creation of between 600 and 700 thousand new formal employments, in each of these two years.

Current Account: It is expected that the gradual expansion of domestic demand will lead to a more widespread reactivation of imports. Therefore, in 2011 the trade balance and current account deficits are expected to be higher than those observed in 2010. Nevertheless, the observed dynamism of exports suggests that these deficits will remain at reduced levels. In particular, trade balance is anticipated to register a deficit of USD 5.7 billion (0.5 percent of GDP), while the current account would present a deficit of USD 11.3 billion (1.0 percent of GDP).

The liquidity conditions anticipated to prevail in international financial markets, the expectations of greater foreign direct investment flows, as compared to those of 2010, as well as the fact that the Mexican Government already prefunded its external debt amortization program

Summary

for 2011 and 2012, suggest that the projected deficit of the current account will be easily financeable.



1/ Fan Charts show the probability of realization of these forecasts for the considered 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.

Diverse risks to economic growth prevail. In particular, although 2011 and 2012 are expected to be good years for the growth of the Mexican economy, greater risks to global growth begin to arise, especially in the medium term. These risks, if materialized, might affect aggregate expenditure growth in Mexico:

- I. Uncertainty persists with respect to the sustainability of U.S. recovery and its implications for the speed at which the output gap closes in Mexico.
- II. High international oil prices.
- III. Global imbalances.
- IV. Episodes of instability in international financial markets.
- V. Reversal of capital flows which have been directed to emerging economies.
- VI. According to the economic specialists surveyed by Banco de México, public insecurity and the absence of structural changes in Mexico continue being factors that might negatively affect the growth of the Mexican economy.

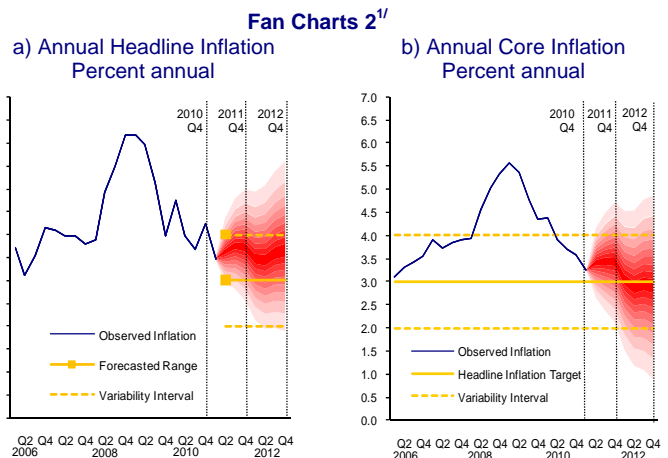
On several occasions Banco de México has reiterated how medium- and long-term growth has been affected by diverse institutional features that influence the allocation of productive resources. In this context, the deepening of the structural reform process is considered vitally important.

Inflation: The inflation forecast remains unchanged. Thus, annual headline inflation is expected to be congruent with the 3 percent inflation target during the next two years, considering a +/- 1 percent variability interval. In this regard, it is noteworthy that the forecast implies that during the whole horizon the most likely annual headline inflation trajectory will be between 3 and 4 percent (Graph 2a).

The most likely trajectory of core inflation lies below the one expected for headline inflation, ranging between 3 and 3.5 percent during 2011 and slightly below 3 percent in 2012 (Graph 2b).

The risks to which the world economy is subject to and consequently the economic activity in Mexico, can clearly affect the Mexican inflation outlook. Regarding the upward risks that are considered to affect the expected inflation trajectory, stand out:

1. Potential increases in the prices of grains, in particular corn, and other commodities, which might influence the price formation process of diverse products. This turns out to be especially relevant since the market structure prevailing in some industries raises the risk of producers trying to coordinate price increases. It should also be considered that in the medium term, if international energy prices remain high, such wide gaps between domestic and external prices are not sustainable.
2. Pressures on the exchange rate that are reflected in price increases, given episodes of turbulence in international financial markets.



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On the other hand, existing concerns regarding the possibility that the U.S. economy will maintain its dynamism, given the evident consequences on the performance of the Mexican economy, implies a downward risk to the expected inflation trajectory.

As stated before, the expected levels of the CPI non-core inflation component generate a difference in the headline and core inflation trajectories for the next two years. This is mainly associated with three elements: i) the policy of increments in energy prices aimed at reducing the existing gap between these and their international references, especially given the recent increase of the latter ones; ii) the expected 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 inflation, given the biannual cycle presented by their prices. Banco de México has already mentioned on previous occasions that the misalignment between domestic and international energy prices entails significant fiscal and economic costs. For this reason, the policy of increments oriented at decreasing the abovementioned misalignment will allow the government to have sound public finances. This is an important element in order to maintain an environment of low inflation.

Considering the abovementioned, Banco de México's Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate unchanged from January to April 2011. In any event, the Board of Governors will continue to monitor the performance of inflation expectations, output gap and, especially, grain and other commodity prices, as well as diverse inflation determinants that might signal unexpected and widespread pressures on prices. Thus, if, according to the Board of Governors, this eventuality materializes, the Central Institute will adequately adjust the monetary policy stance in order to reach the convergence of inflation to the 3 percent permanent inflation target.