

Inflation Report

July - September 2011

Summary

The expansion rate of the world economic activity kept weakening during the third quarter of the year. This was negatively fed back by greater uncertainty in international financial markets. This environment increased the downward risks to the global economy and reduced the growth expectations for most countries, in particular advanced economies. Consequently, the inflation outlook has modified, and it is expected to start decreasing in most countries. In this context, a change in the monetary policy stance has been observed worldwide.

In the U.S., available indicators show that during the third quarter the economy continued exhibiting signs of weakness, although the economic activity growth was greater than that registered in the previous quarter. Unfavorable conditions in the labor market and higher uncertainty due to the lack of agreements guaranteeing fiscal sustainability have adversely affected consumers' and firms' confidence. Along with the abovementioned, lower prices of homes and financial assets, as well as households' high debt levels are expected to keep limiting the consumption recovery. In turn, economic activity in the Euro zone weakened considerably. In particular, fiscal, as well as sovereign debt problems of some European economies and their possible consequences for the financial system have significantly deteriorated this region's prospects. As far as emerging economies are concerned, they continued expanding. However, their growth rate moderated and given an adverse international environment they are expected to continue losing their dynamism.

International financial markets exhibited higher volatility in the reported quarter. This was a consequence of both the lack of consensus for resolving imbalances in public and private sectors of advanced economies, and the vulnerability of the Euro zone's banking system to the sovereign debt of some countries in the region. In this context, given the deterioration of Greece's situation and the possibility of other European economies contagion, it is necessary to implement the recent agreements reached by the European authorities. However, it must be ensured that these measures are sufficient to deal with the crisis, to recapitalize European banks, and to consolidate fiscal adjustment. Thus, even if uncertainty in international financial markets is dispelled, the following years will be marked by weak growth of advanced economies.

World inflation outlook has improved in recent months, as a consequence of lower than expected growth in both advanced and emerging economies, as well as of commodity price reductions in international markets. Thus, a looser monetary policy stance is anticipated in advanced economies, and in emerging ones, despite concerns regarding the exchange markets' volatility, the monetary stimulus withdrawal is expected to remain paused, or even, in some cases, the reference interest rate is expected to decline.

The change in the world economic environment represents an adverse shock for the Mexican economy. However, among emerging economies, Mexico stands out given the solidity of its fundamentals and macroeconomic policies. Thus, although the Mexican economy's adjustment to the new world economic environment implies a depreciation of the real exchange rate, it should be pointed out that this adjustment is occurring in an orderly manner.

Although during the third quarter of 2011 productive activity in Mexico continued presenting a positive trend, the most recent information indicates a deceleration in its growth rate. This largely reflects the deceleration effects of the world economic activity levels, in particular the U.S., on external demand that the country faces. In turn, the described international environment has implied less favorable growth expectations for the global economy, especially for 2012; therefore, Mexico's economic growth forecasts have also been revised downwards. In this context, slack conditions in the economy are anticipated to prevail in the remainder of 2011 and during 2012.

Over the past months of 2011 annual headline inflation located within the plus/minus one percentage point variability interval around the 3 percent permanent target established for this indicator. At the end of the third quarter of 2011 annual headline inflation registered a level close to 3 percent. Likewise, annual core inflation, which to a great extent reflects the medium-term trend of headline inflation, remained during the analyzed quarter at levels close to 3 percent. It is noteworthy that so far the recent depreciation of the exchange rate has not produced a discernible impact on the price formation process. This is congruent with the view, according to which in the medium term the exchange rate is anchored thanks to the Mexican economy's solid fundamentals, and with statistical evidence indicating that exchange rate pass-through to inflation has been low in Mexico during the last decade. Thus, the inflation forecast remains without qualitative changes with regard to the one published in the previous Inflation Report.

The macroeconomic scenario forecasted by Banco de México is:

Growth of the Mexican Economy: Taking into account the most recent information regarding the Mexican economy, as well as lower growth expectations for the U.S. economy at the end of the year, the forecast interval for the annual GDP growth in 2011 is revised downwards in relation to the one presented in the previous Inflation Report, from an interval of 3.8 to 4.8 percent to the one of 3.5 to 4.0 percent. Likewise, the deterioration in the world economic growth expectations, in particular in the U.S. industrial activity, leads to an expectation of Mexico's GDP expanding between 3.0 to 4.0 percent in 2012 (Graph 1a). This interval is compared to the one forecasted in the previous Inflation Report, of 3.5 to 4.5 percent. In this way, the output gap is expected to continue closing at a slower pace than previously forecasted, and throughout the whole forecast horizon it is expected to maintain at levels congruent with the absence of generalized demand-related pressures on prices (Graph 1b).

Employment: Considering the performance of formal employment so far in 2011, as well as the economic activity growth anticipated for the rest of the year, a creation of between 560 and 620 thousand new formal jobs is estimated, taking as reference the number of IMSS-insured workers. In turn, for 2012 a creation of between 500 and 600 thousand new formal jobs is expected.

Current Account: For 2011, a trade balance deficit of USD 3.4 billion (0.3 percent of GDP) and a current account deficit of USD 11.1 billion (1.0 percent of GDP) are forecasted. Likewise, for 2012, a deficit of USD 8.0 billion for the trade balance (0.7 percent of GDP) and of USD 17.0 billion for the current account (1.4 percent of GDP) are estimated.

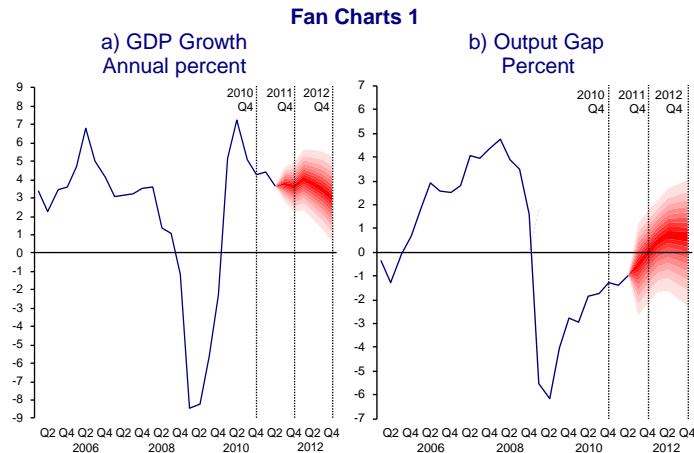
The moderate current account deficits expected for 2011 and 2012, together with the fact that the Mexican Federal Government has already pre-financed its external debt amortization program for these years, suggest that financing of these deficits will not be a problem and no pressures on the exchange rate are expected from this source. This contrasts with the situation prevailing at the beginning of 2009, when there was certain doubt that eventually proved unfounded about the economy's capacity of financing the current account.

Given the conditions prevailing in international markets and in the U.S. economy, it is clear that the downward risks to the Mexican economy's growth scenario described above have increased. Among them stand out:

1. The problematic fiscal and financial situation in various European countries, together with the structural problems in the U.S. economy, could result in external demand lower than anticipated and uncertainty prevailing in international financial markets. The latter could lead to an additional portfolio adjustment, which would possibly affect the financing of emerging economies, Mexico among them.

Summary

- II. Despite the announcements realized at the end of October by the European authorities, there is still certain probability that a tail event -i.e., an event that normally would have a low probability of occurrence, but which could have catastrophic effects- might occur in international financial markets, considerably affecting economic activity in both advanced and emerging economies, as well as stability in international financial markets.
- III. At the domestic level, according to specialists surveyed by Banco de México, public insecurity and absence of structural changes continue being factors that might negatively affect economy's growth.



Inflation: The considerations exposed in this Inflation Report imply that the trajectory foreseen for this variable presents minor changes, which do not qualitatively change the forecast made in the previous Inflation Report. Thus, it is ratified that the trajectory for annual headline inflation most likely to occur in the remainder of 2011 and 2012 lies in the interval of 3 to 4 percent (Graph 2a).

Regarding annual core inflation, most likely it will be located at levels between 3 and 3.5 percent during the rest of 2011, and very close to 3 percent during 2012. The latter would be supported by the absence of widespread pressures on inflation and the dissipation of the effects of disturbances that during this year have impacted the dynamics of the prices of some products of the CPI's foods, beverages and tobacco group as a consequence of tax modifications and the increase in international food commodity price quotes (Graph 2b).

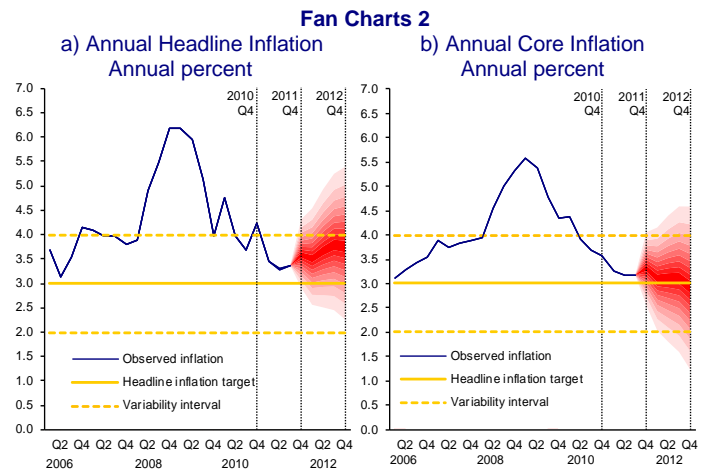
In addition to the elements mentioned before, it is worth emphasizing two factors that will contribute to inflation evolution being in line with the trajectory foreseen for the next year: i) the absence of tax changes that might affect inflation dynamics; and ii) the forecast that the amount of energy price increments will be similar to the one observed this year, which, considering a higher comparison base, would imply a lower annual growth rate and, thus, a lower contribution to this group's inflation.

Nevertheless, the foreseen inflation trajectory is not risk-free. Among the downward risks stand out:

- a) The possibility of further weakening of external and domestic demand, in a context where especially the weakness of the external demand could prevail for a prolonged period, implying less inflationary pressure.
- b) A stronger than anticipated weakening of world economic growth would have an additional dimension, i.e., the downward impact on international commodity prices, whose materialization would lead to less pressure on production costs of diverse goods and services.

On the other hand, and not less important, as upward risks for the foreseen trajectory stand out:

- a) The possible increase in international financial markets uncertainty that could generate adverse exchange rate dynamics, affecting the price formation process.
- b) The potential volatility of agricultural products' prices could induce short-term inflation deviations with respect to the forecast presented in this Inflation Report.



Finally, it should be pointed out that the Mexican economy's adjustment to the deterioration of the external conditions is taking place in a gradual and orderly manner. This is the result of the strengthening of the framework for the macroeconomic policy and, in general, an environment of improving economic fundamentals in Mexico. Thus, monetary policy focused on ensuring price stability as a nominal anchor, together with a prudent fiscal policy, a flexible exchange rate regime and adequate regulation and supervision of the financial system have contributed to improving confidence in the Mexican economy and have permitted to attenuate the negative impact of external shocks, such as the recent episode of turbulence in the international financial markets. Therefore, it is important to reiterate the importance of preserving the strength of the macroeconomic framework, particularly given the expectation that the Mexican economy may face an adverse external environment next year.

A solid macroeconomic framework is essential to continue with the convergence process of inflation to its 3 percent permanent target. In turn, price stability is an indispensable condition in order to encourage an investment-friendly environment and the creation of employments that allow the improvement of people's living conditions. Surely, the benefits of low and stable inflation for the economic activity would be enhanced by further advancing in the process of structural reforms, which contribute to increasing the economy's productivity.

Based on the evolution of inflation, the Board of Governors considers that the current monetary policy stance is conducive to reach the 3 percent permanent inflation target. Thus, it had decided to maintain the Overnight Interbank Interest Rate unchanged during the period of this Inflation Report. However, it 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. In any event, the Board of Governors will monitor the behavior of inflation determinants, and in particular of the exchange rate, which 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.