



# Inflation Report

April – June 2011

August, 2011



BANCO DE MÉXICO

# Outline

## 1. External Conditions

## 2. Economic Activity in Mexico

## 3. Monetary Policy and Inflation Determinants

## 4. Forecasts and Balance of Risks

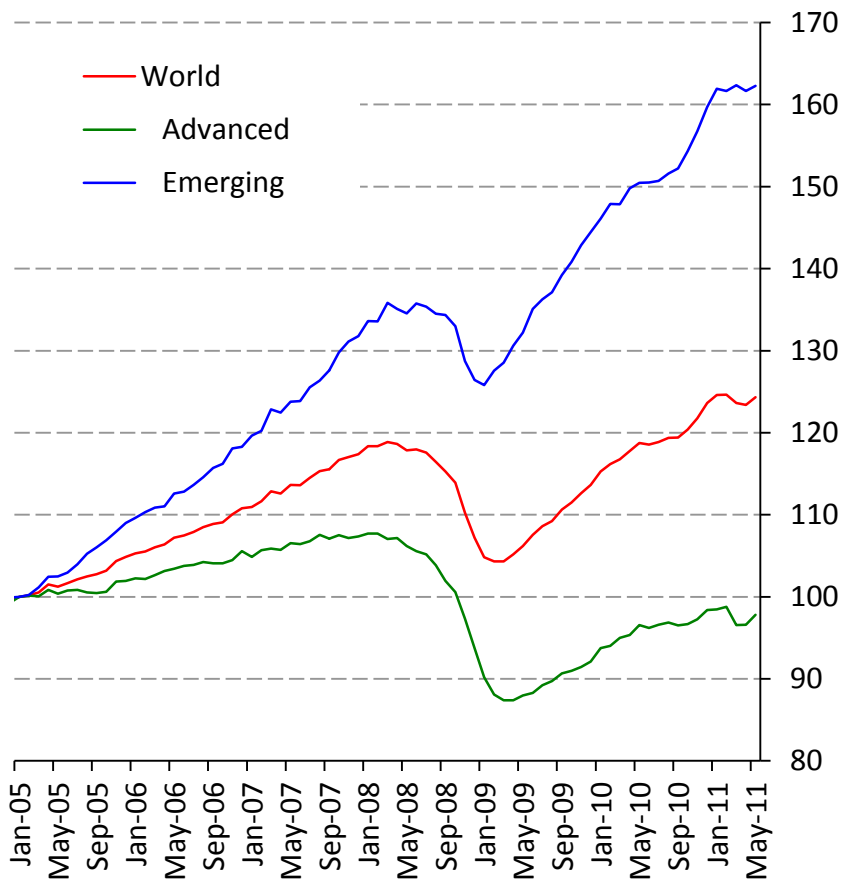
# 1. External Conditions

- During the second quarter of 2011 the expansion of the world economy continued, although at a slower pace.
  - ✓ *Temporary factors: effects of natural disasters in Japan and high commodity prices.*
  - ✓ *Complex problems faced by the U.S. and Europe have increased downward risks to the growth outlook of the world economy.*
- Although inflation has risen worldwide, in most economies inflation levels are considerably lower than in the previous economic cycles.
- In this context, the balance of risks to the growth of the world economy has deteriorated.

# 1. External Conditions

## World Industrial Production

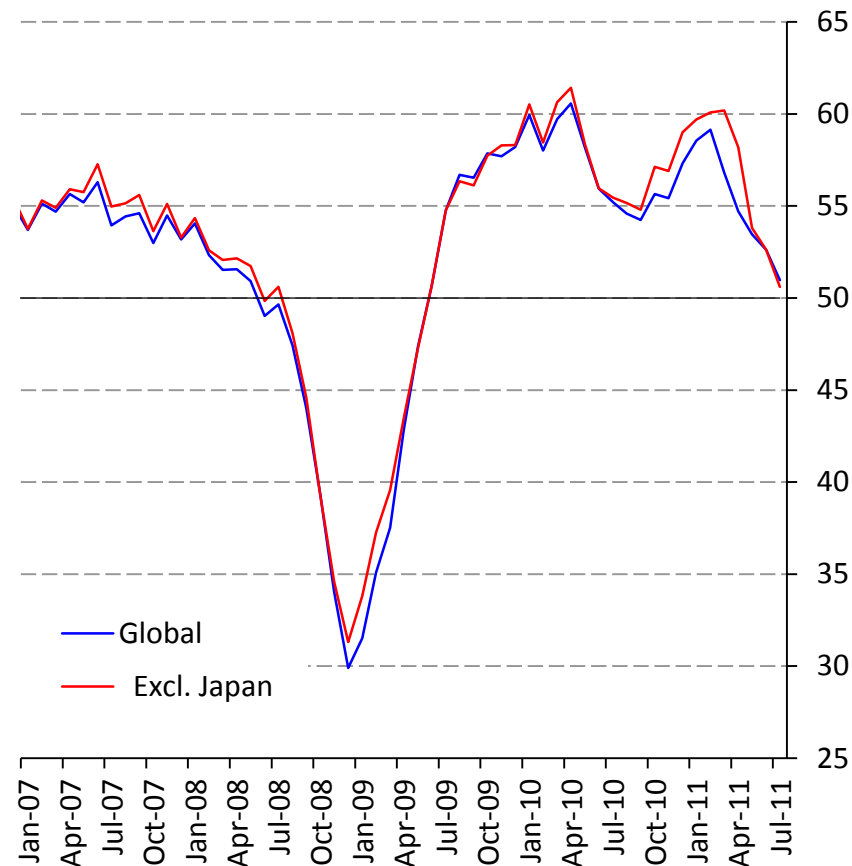
(Index Jan-2005=100; s.a.)



s.a./ Seasonally adjusted.  
Source: CPB Netherlands.

## Global PMI: Production

(Diffusion index; s.a.)

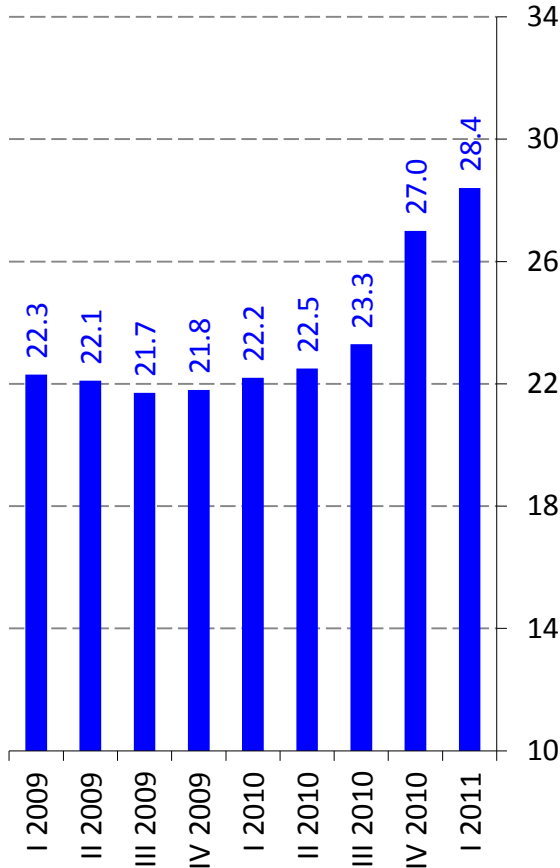


s.a./ Seasonally adjusted.  
Source: Markit, Manufacturing PMI.

# 1. External Conditions

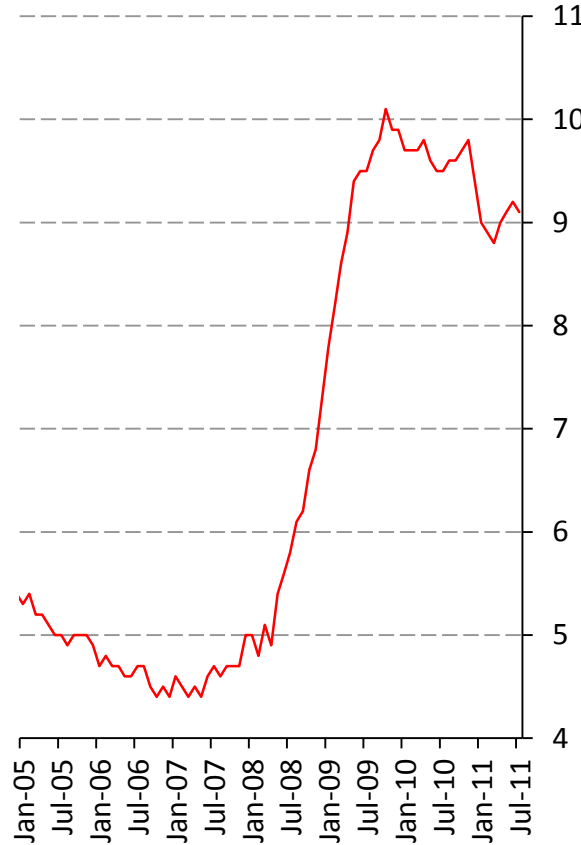
**U.S.: Single Family Homes with Negative Equity <sup>1/</sup>**

(% of homeowners with mortgages)



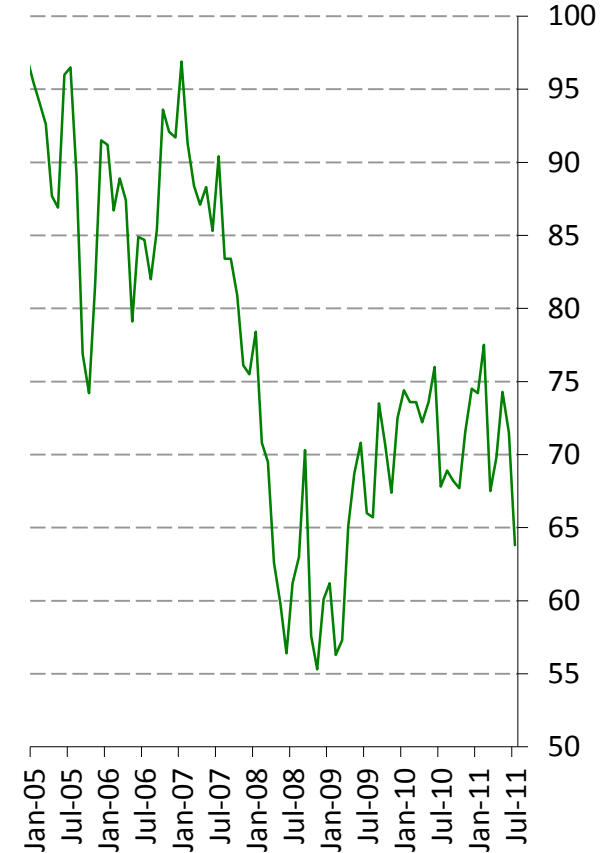
<sup>1/</sup> Percentage of homeowners who owe more on their mortgage than their home is worth.  
Source: Zillow.

**U.S.: Unemployment Rate**  
(%; s.a.)



s.a./ Seasonally adjusted.  
Source: BLS.

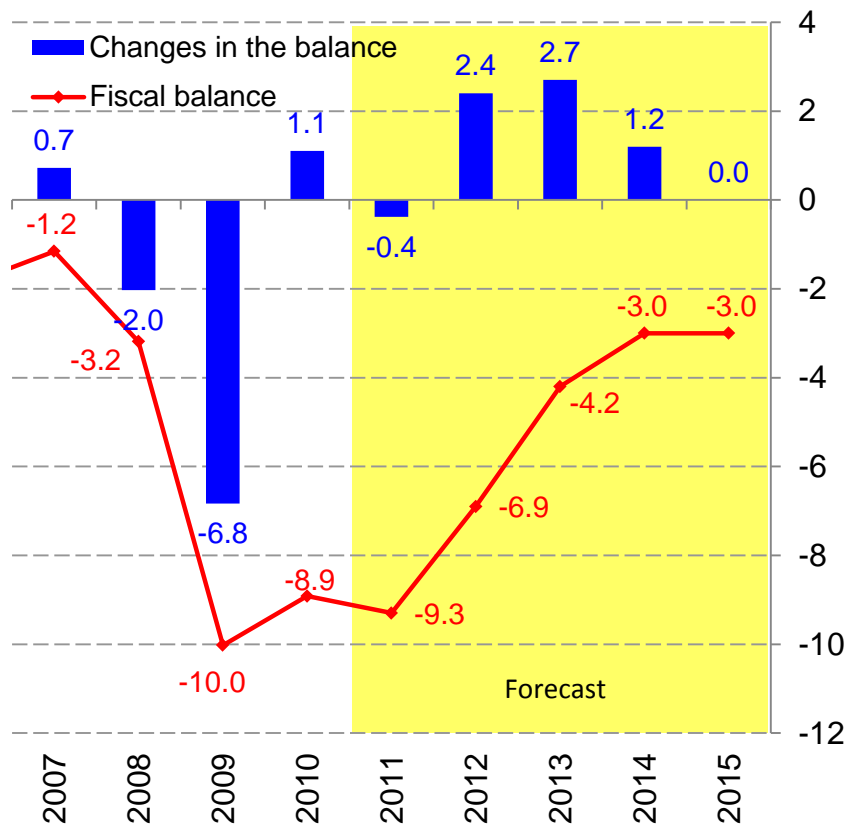
**U.S.: Consumer Confidence**  
(Index 1966=100; s.a.)



s.a./ Seasonally adjusted.  
Source: Michigan University.

# 1. External Conditions

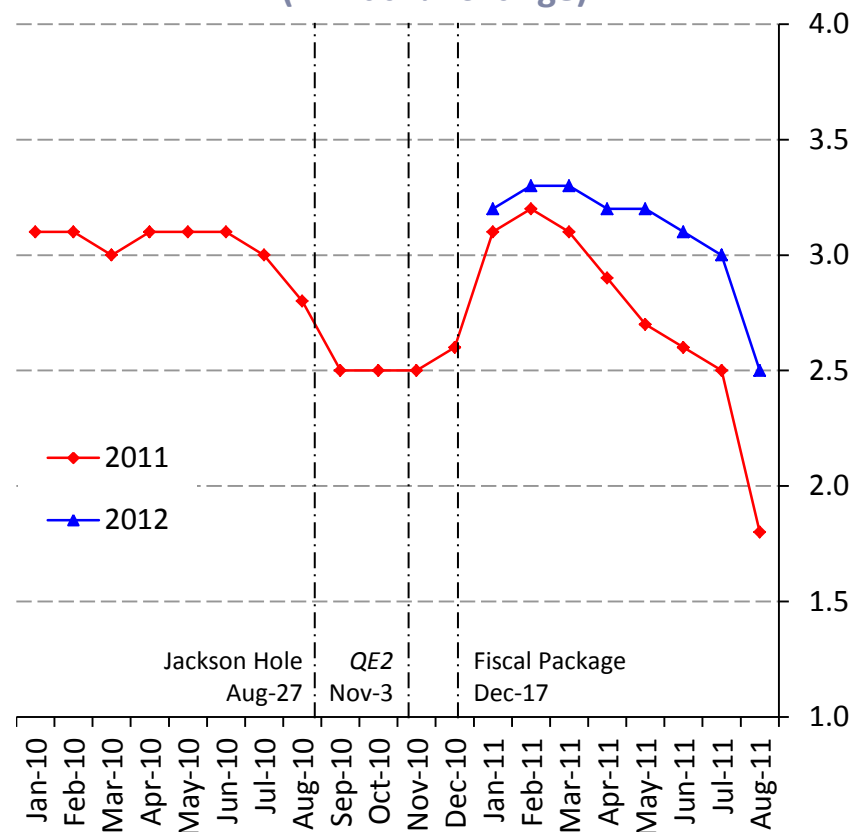
**U.S: Fiscal Balance <sup>1/</sup>**  
(% of GDP)



1/ The base scenario conforms to the actual legislation, e.g.: a) tax cuts instrumented in 2001 and extended for two years in 2010 are not extended in 2013; b) the decrease of two percentage points of workers' payroll tax decreed for this year is not renewed in 2012 and c) the extinction of extraordinary unemployment insurance benefits after 2012.

Source: CBO.

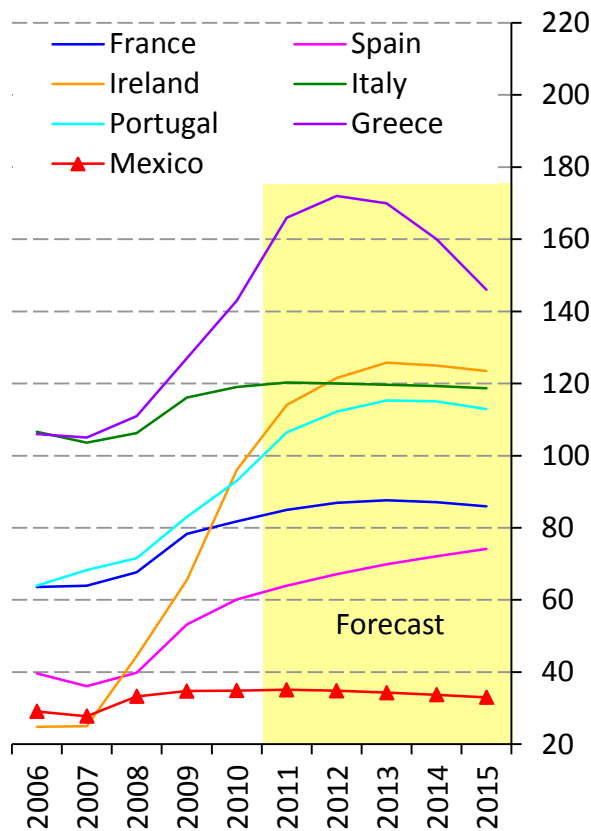
**U.S.: Real Gross Domestic Product Forecasts**  
(Annual % change)



Source: Blue Chip.

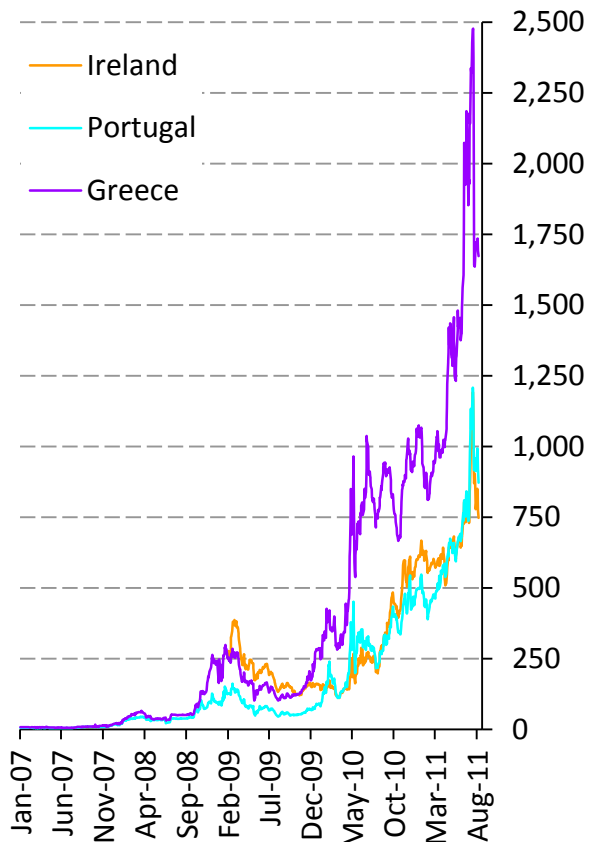
# 1. External Conditions

**Gross Public Debt of Selected Economies <sup>1/</sup>**  
(% of GDP)



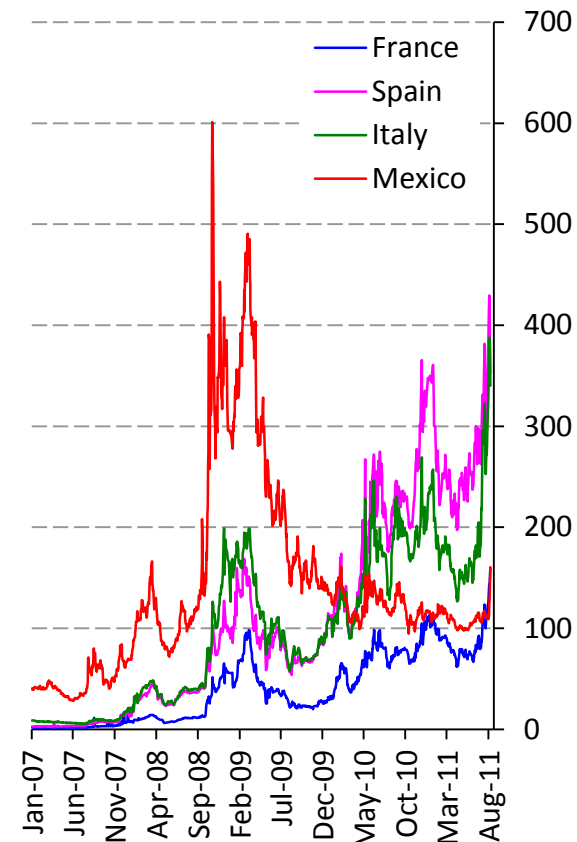
1/ Refers to the Gross General Government Debt, which includes all government units and nonprofit institutions that are controlled and funded by government agencies. Source: Fiscal Monitor (IMF) and Mexico's Ministry of Finance (SHCP).

**Credit Default Swaps in Selected Economies <sup>2/</sup>**  
(Basis Points)



2/ 5-year CDS.  
Source: Bloomberg.

**Credit Default Swaps in Selected Economies <sup>3/</sup>**  
(Basis points)

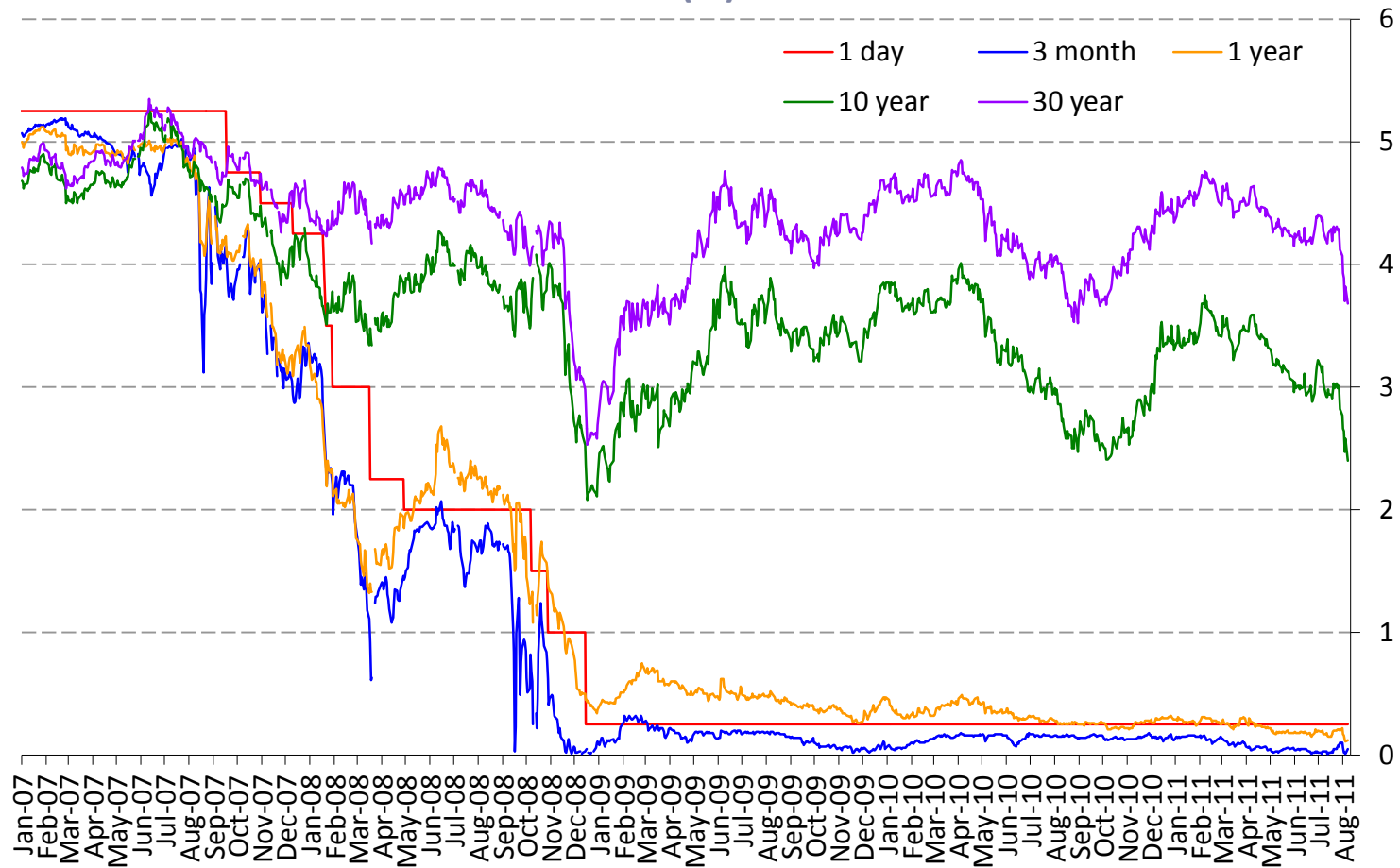


3/ 5-year CDS.  
Source: Bloomberg.

# 1. External Conditions

## U.S.: Interest Rates

(%)



Source: Federal Reserve and Department of the Treasury.



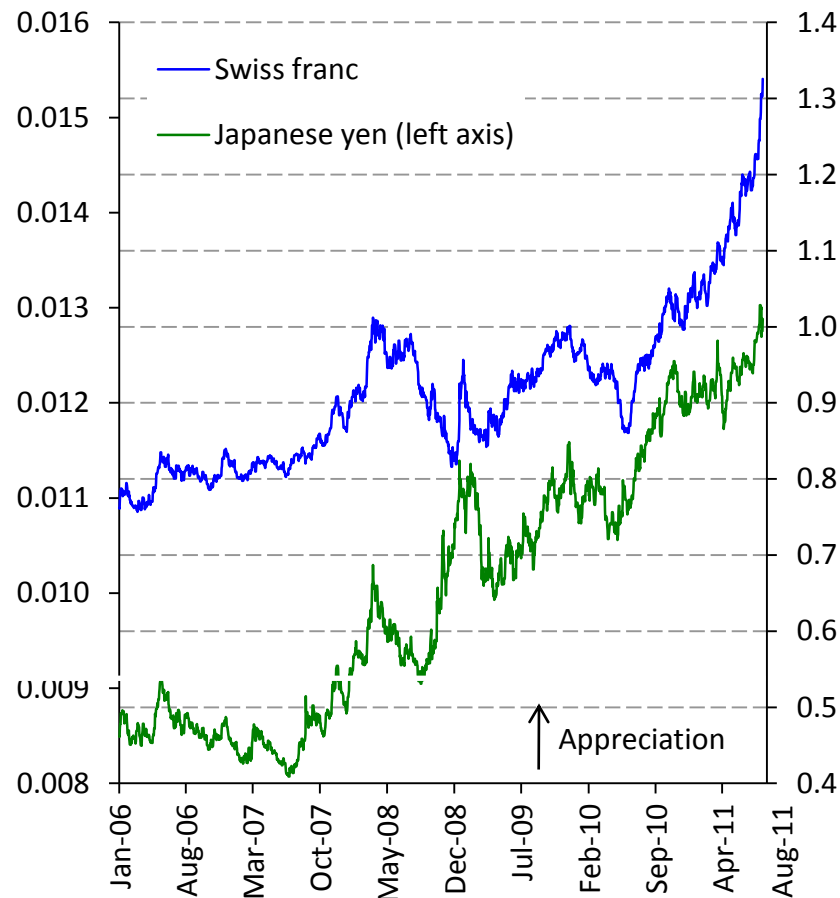
# 1. External Conditions

## International Gold Price (Dollars per ounce)



Source: Bloomberg.

## Exchange Rate of Switzerland and Japan vs. U.S. Dollar <sup>1/</sup> (Dollars per Swiss franc and Dollars per yen)



<sup>1/</sup> An increase implies an appreciation against USD.

Source: Bloomberg.

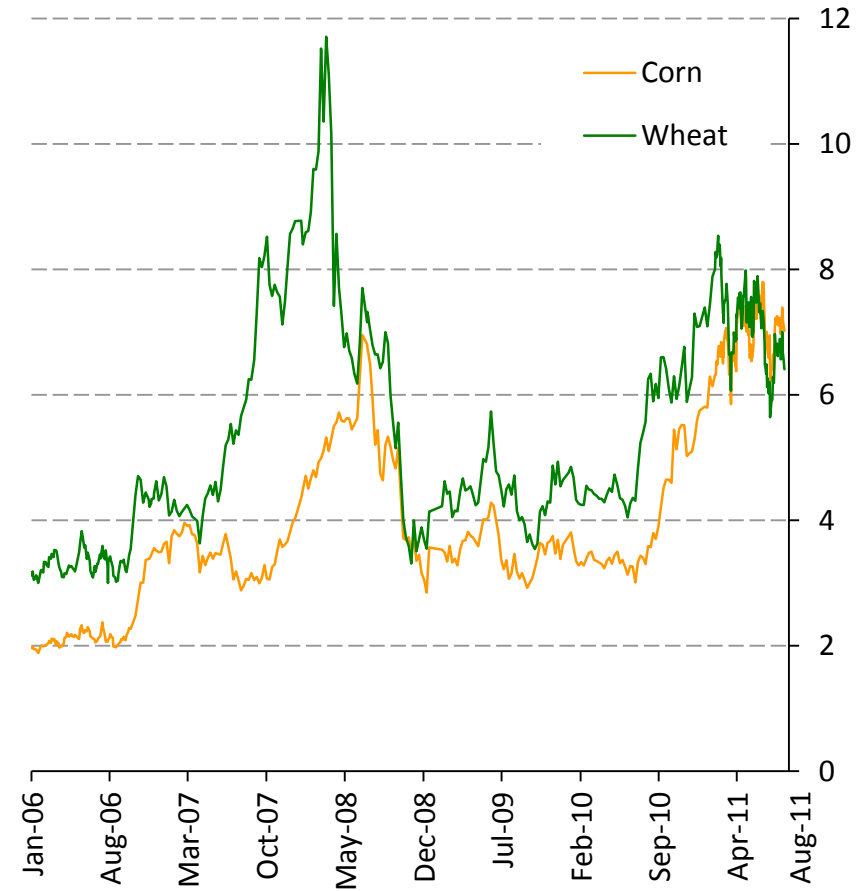
# 1. External Conditions

**International Oil Price (WTI)**  
(Dollars per barrel)



Source: Bloomberg.

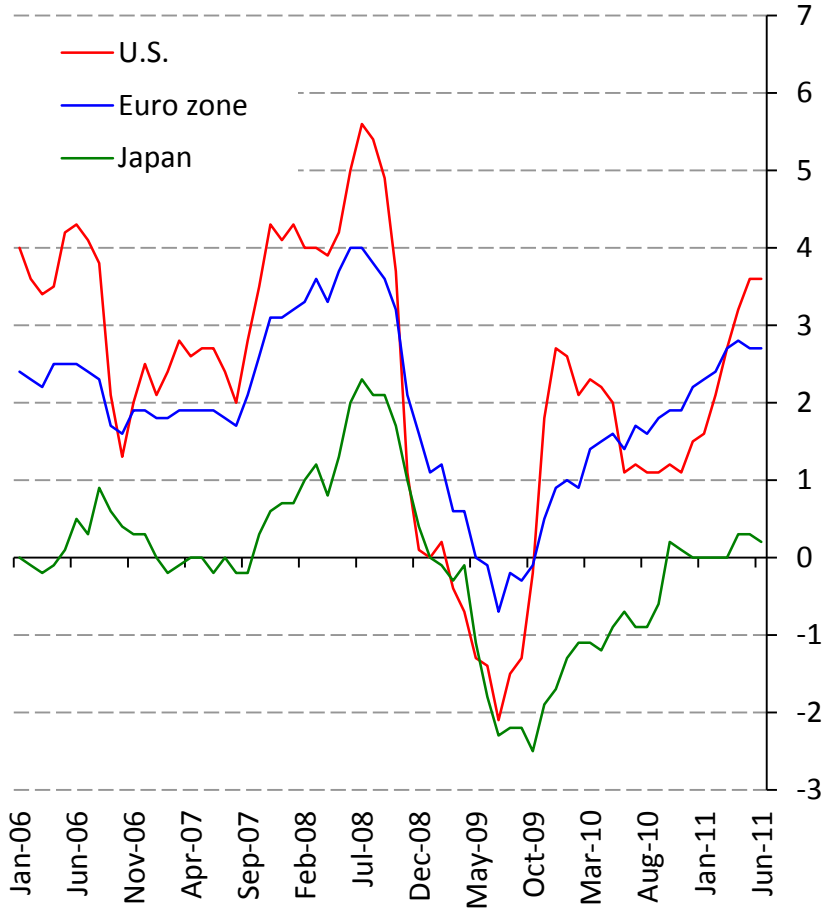
**International Prices of Grains**  
(Dollars per bushel)



Source: Department of Agriculture (USDA).

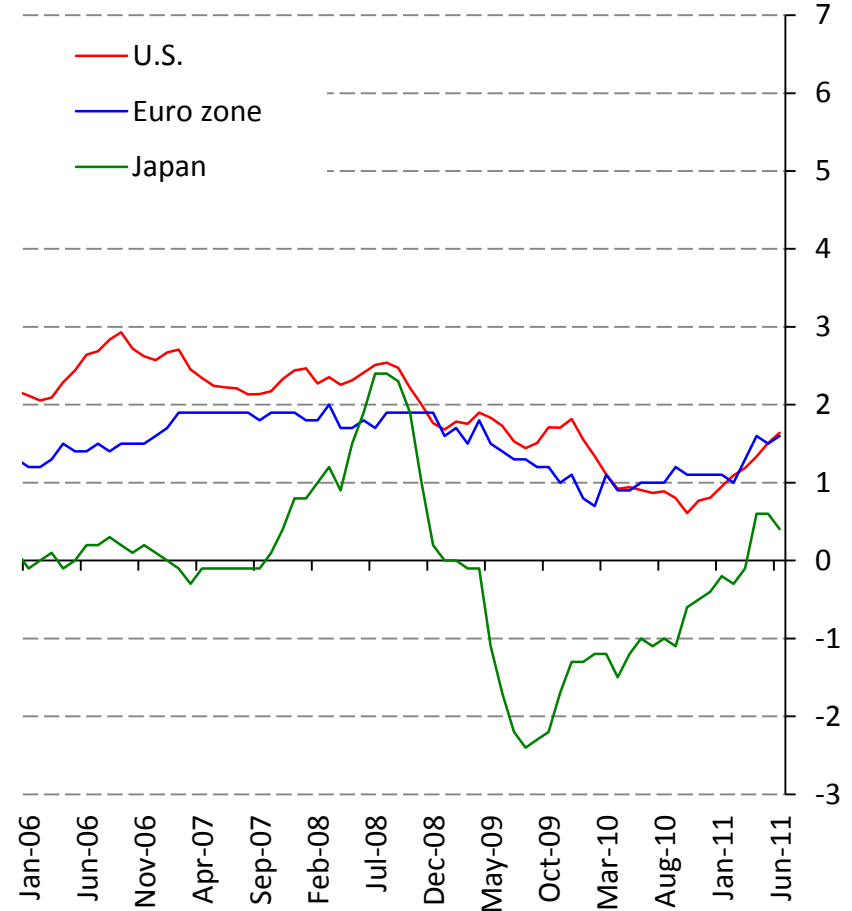
# 1. External Conditions

**Advanced Economies:  
Headline Inflation  
(Annual %)**



Source: BLS, Eurostat and Japan Statistics Bureau.

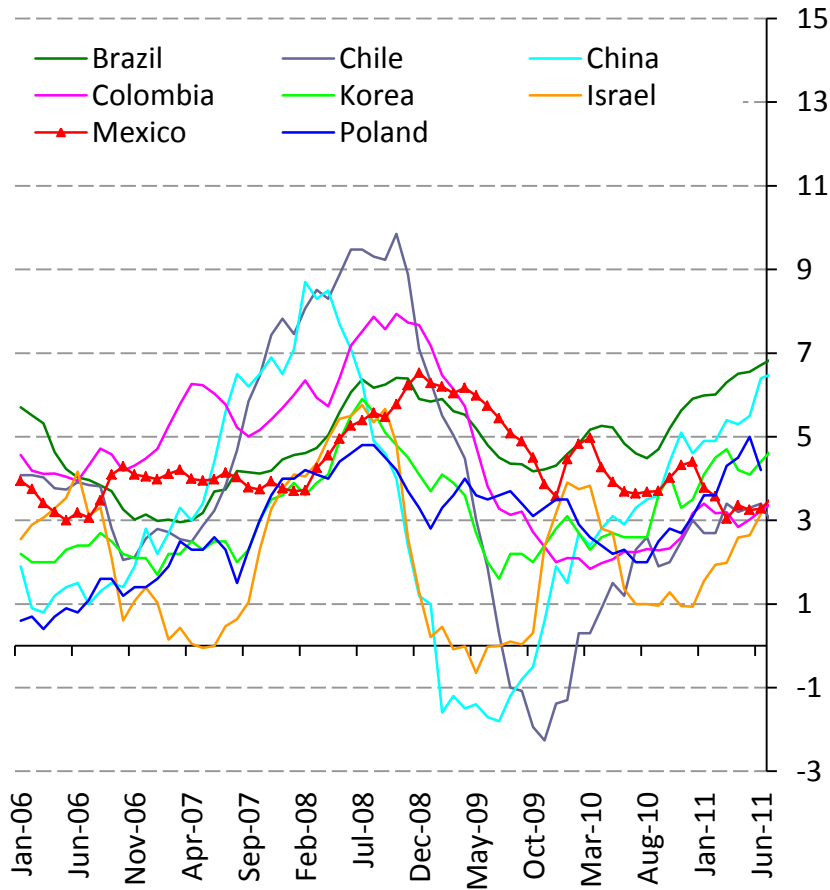
**Advanced Economies:  
Core Inflation  
(Annual %)**



Source: BLS, Eurostat and Japan Statistics Bureau.

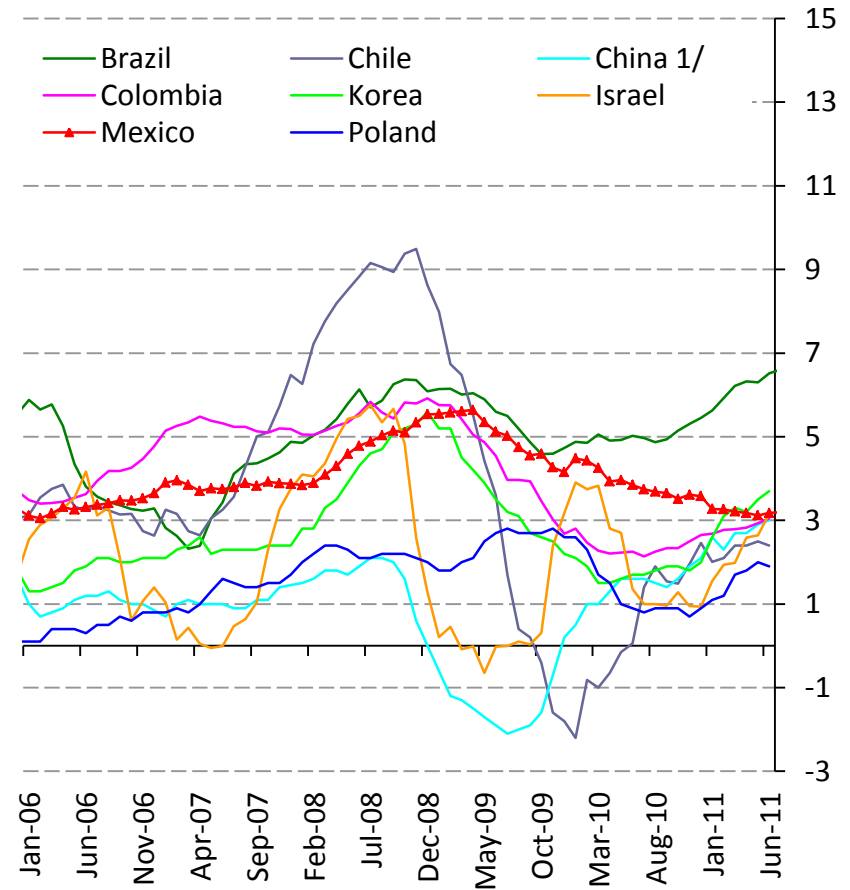
# 1. External Conditions

**Emerging Economies:  
Headline Inflation  
(Annual %)**



Source: Bloomberg and Banco de México.

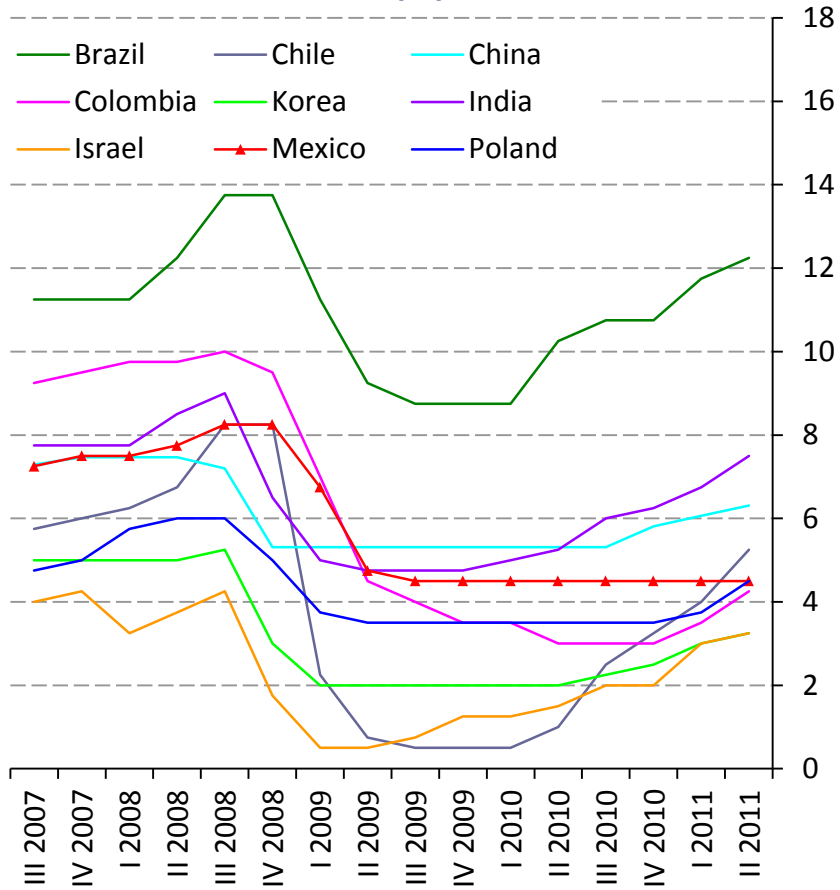
**Emerging Economies:  
Core Inflation  
(Annual %)**



1/ Headline inflation excluding only food.  
Source: Bloomberg and Banco de México.

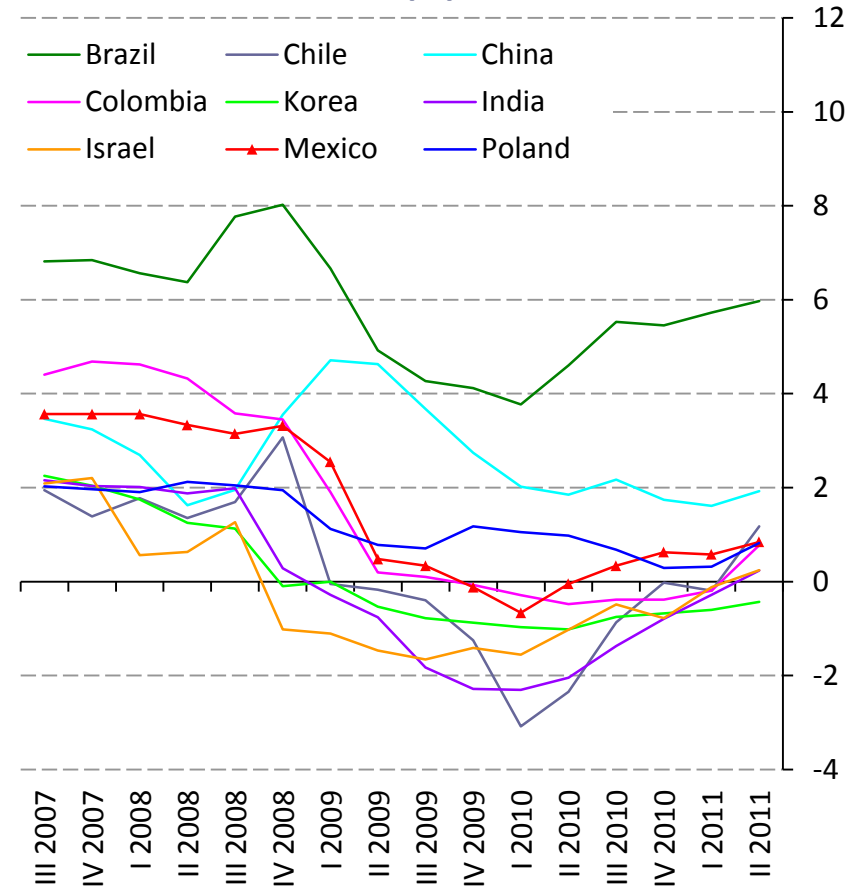
# 1. External Conditions

**Nominal Interest Rates in Selected Economies (%)**



Source: Bloomberg.

**Ex-ante Real Interest Rates in Selected Economies (%)**



Source: Consensus Forecasts and Bloomberg.

# Outline

1. External Conditions

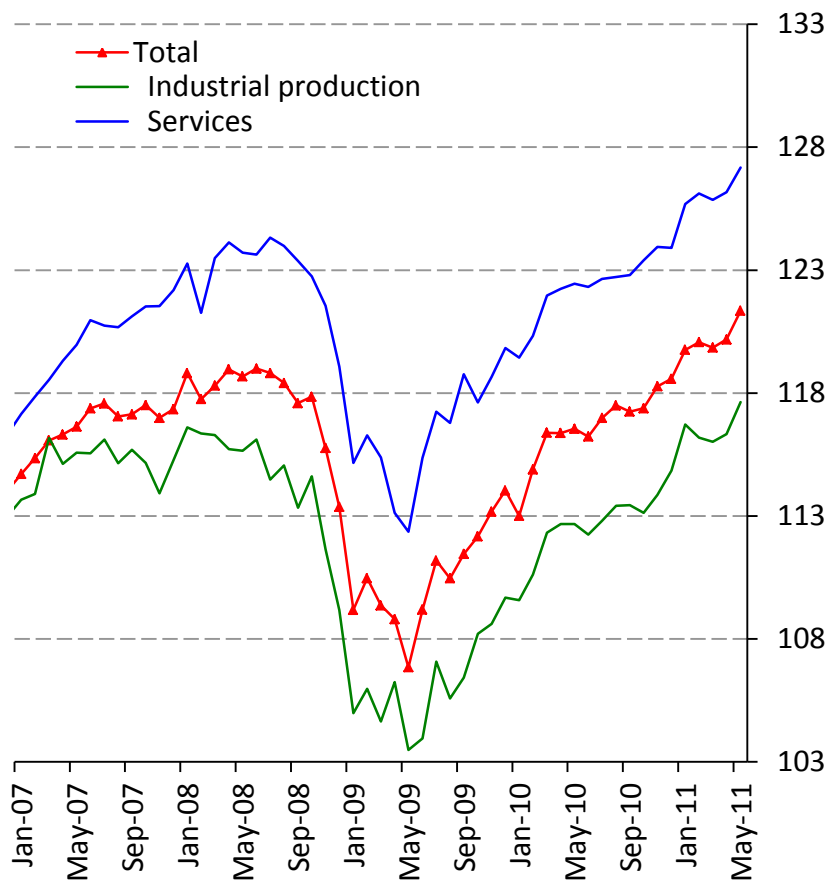
2. Economic Activity in Mexico

3. Monetary Policy and Inflation  
Determinants

4. Forecasts and Balance of Risks

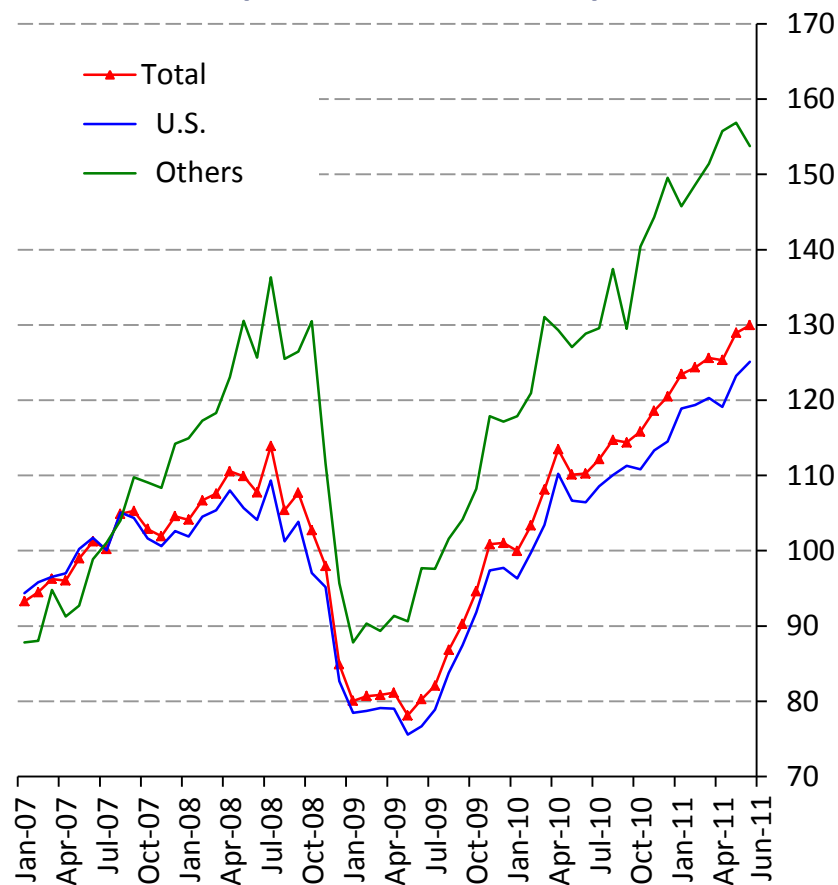
# 2. Economic Activity in Mexico

**Economic Activity Indicators**  
(Index 2003=100; s.a.)



s.a./ Seasonally adjusted.  
Source: INEGI.

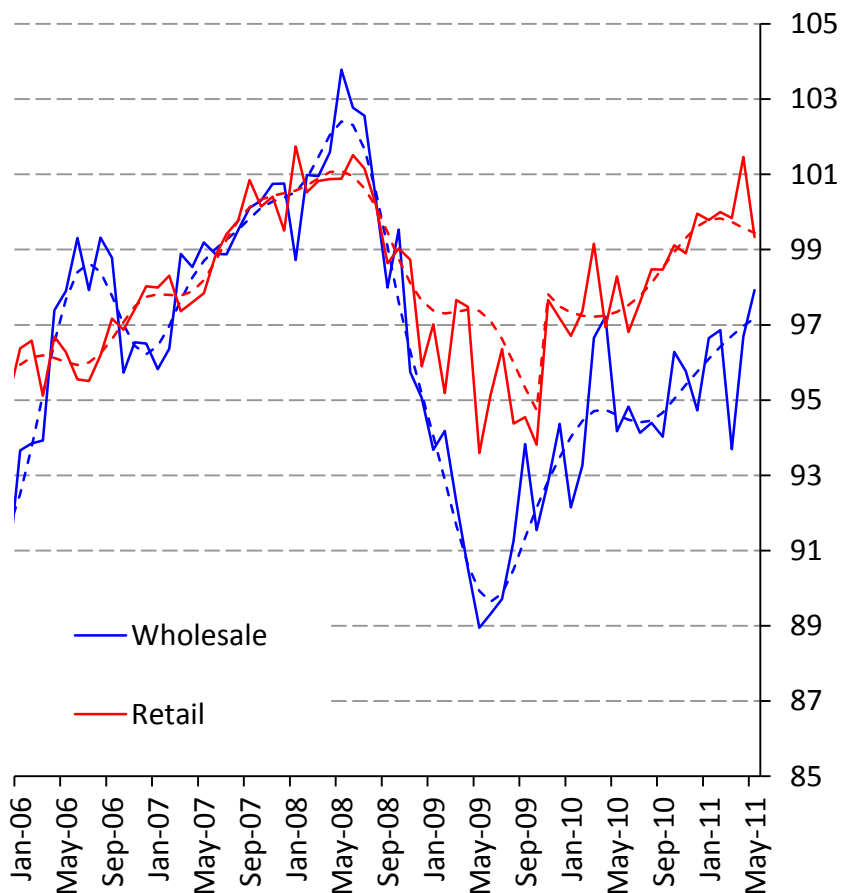
**Manufacturing Exports by Destination**  
(Index 2007=100; s.a.)



s.a./ Seasonally adjusted.  
Source: Banco de México.

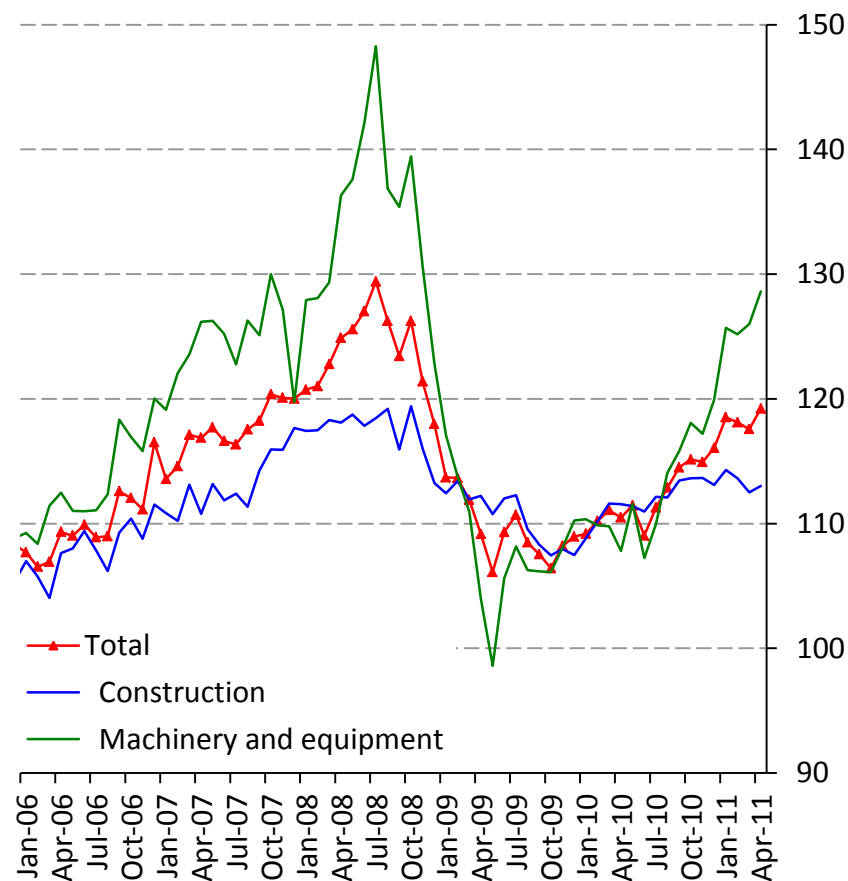
# 2. Economic Activity in Mexico

## Commercial Establishments' Sales (Index 2008=100; s.a.)



s.a./ Seasonally adjusted.  
Source: INEGI.

## Gross Fixed Investment and Components (Index 2005=100; s.a.)

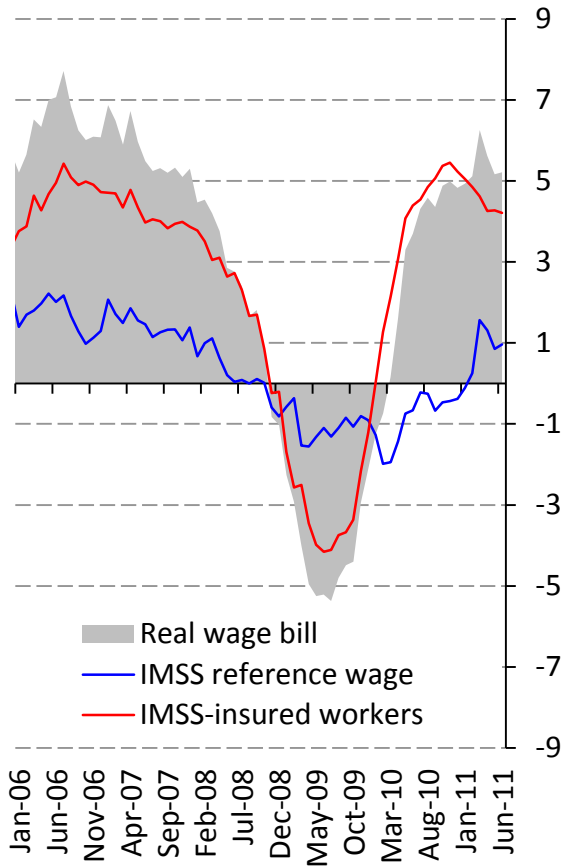


s.a./ Seasonally adjusted.  
Source: INEGI.



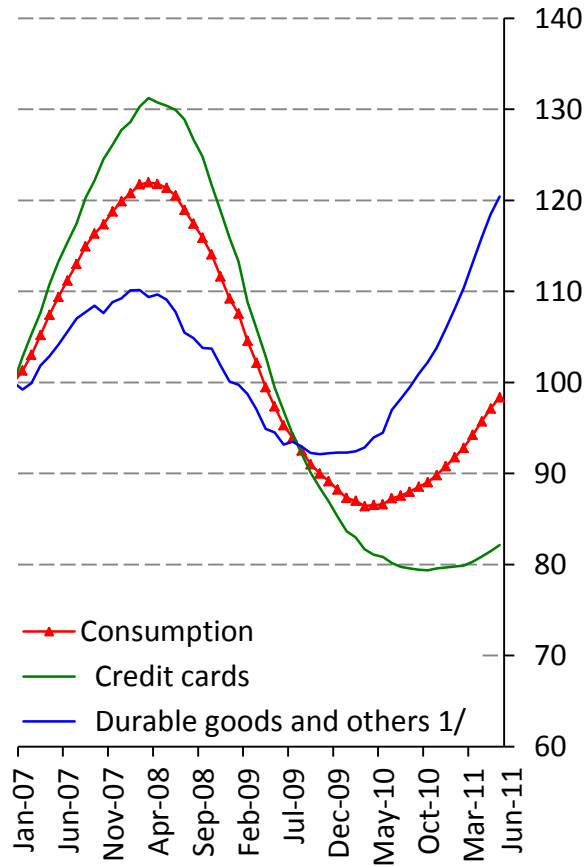
# 2. Economic Activity in Mexico

**Formal Sector Real Wage Bill**  
(Annual % change)



Source: Calculated by Banco de México with data from IMSS.

**Commercial Banks' Credit to Consumption**  
(Index Dec-2006=100; s.a.)

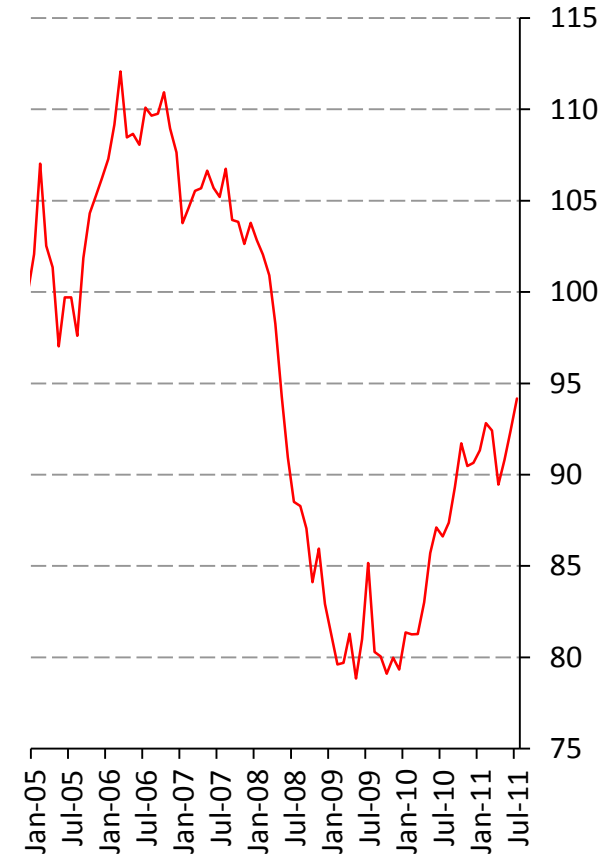


s.a./ Seasonally adjusted.

1/ Includes credits for automobile and real estate acquisition, for capitalized leasing operations, personal, and other consumption credits.

Source: Banco de México.

**Consumer Confidence**  
(Index Jan-2003=100; s.a.)



s.a./ Seasonally adjusted.

Source: INEGI.

# Outline

1. External Conditions

2. Economic Activity in Mexico

3. Monetary Policy and Inflation  
Determinants

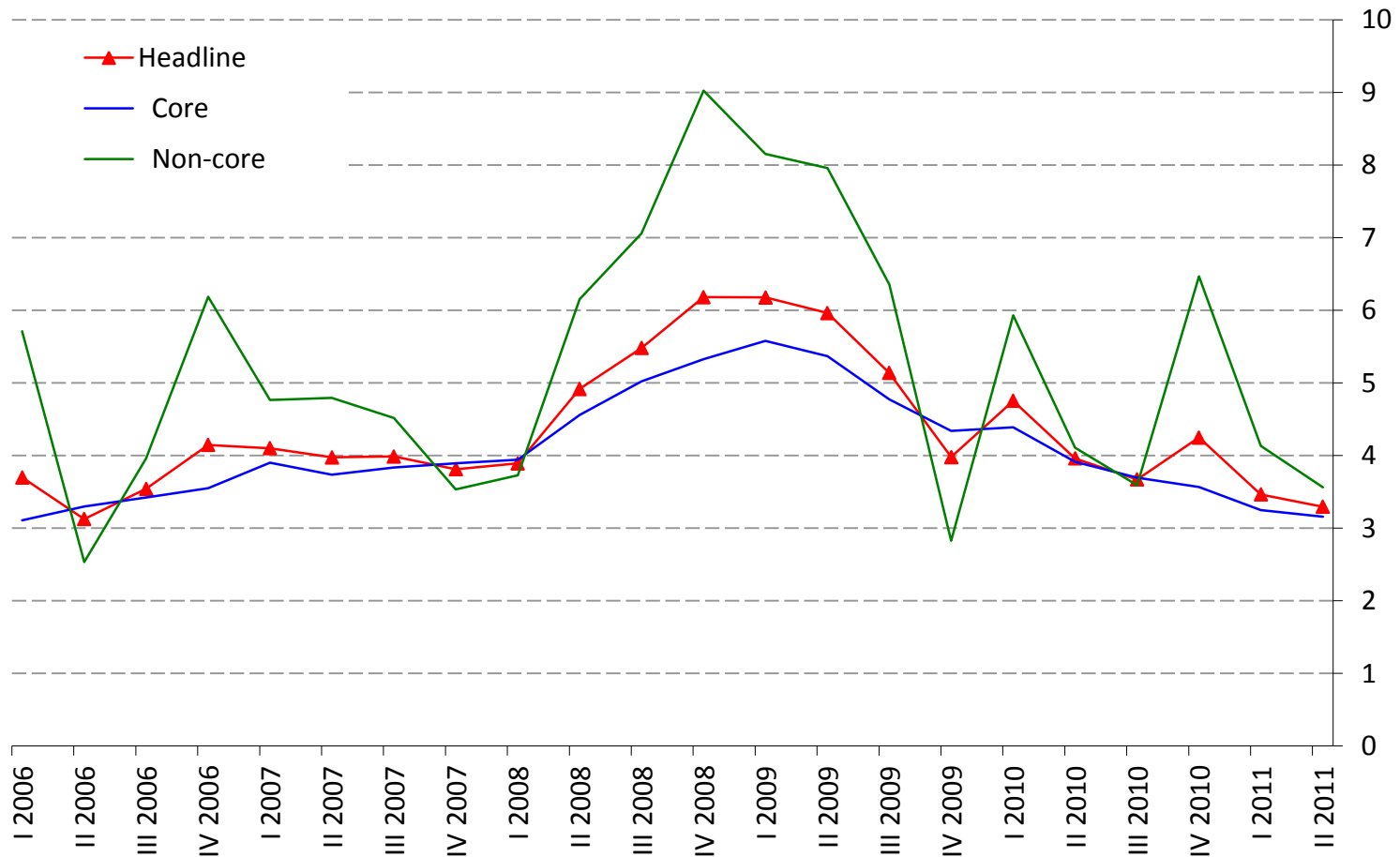
4. Forecasts and Balance of Risks

# 3. Monetary Policy and Inflation Determinants

- During the reported period, the Overnight Interbank Interest Rate was maintained at 4.5 percent. Among the elements that influenced that decision stand out:
  - ✓ *Favorable development of the exchange rate.*
  - ✓ *Reduction of the pace at which the output gap has been closing.*
  - ✓ *Reduced impact on inflation and its expectations regarding the increase in the international commodity prices which occurred in the first months of the year.*
  - ✓ *Inflation expectations for different horizons that are well anchored.*

# 3. Monetary Policy and Inflation Determinants

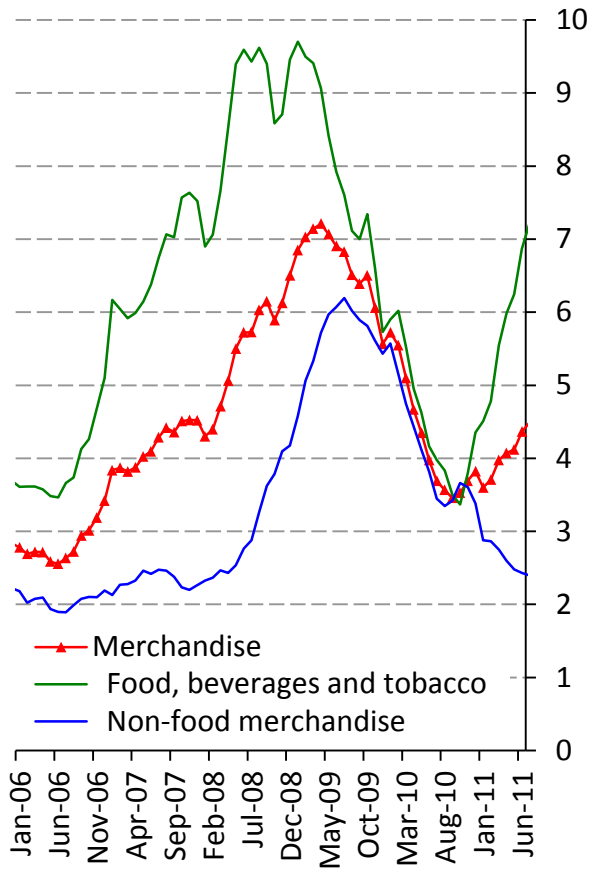
**Annual Inflation**  
(Annual average % change)



Source: Banco de México.

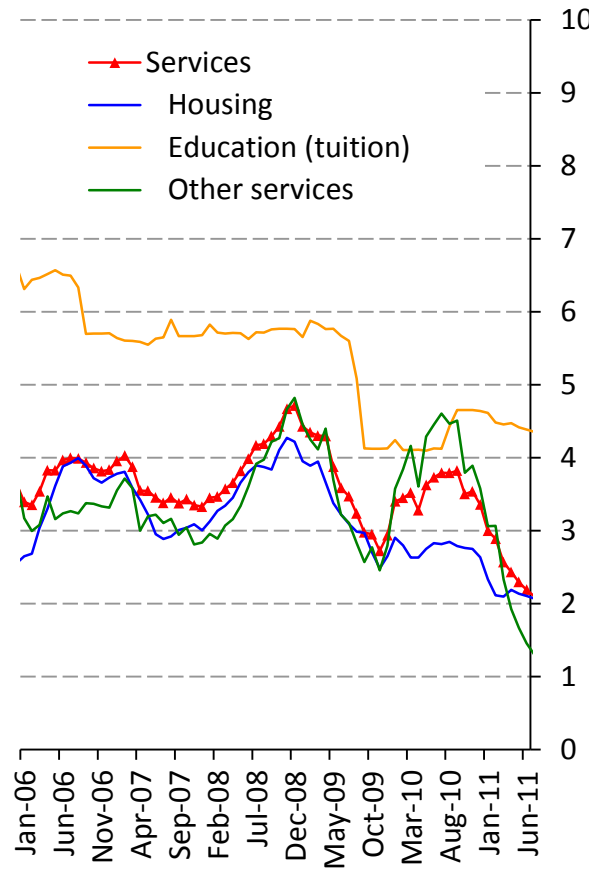
# 3. Monetary Policy and Inflation Determinants

**Annual Core Inflation of Merchandise (%)**



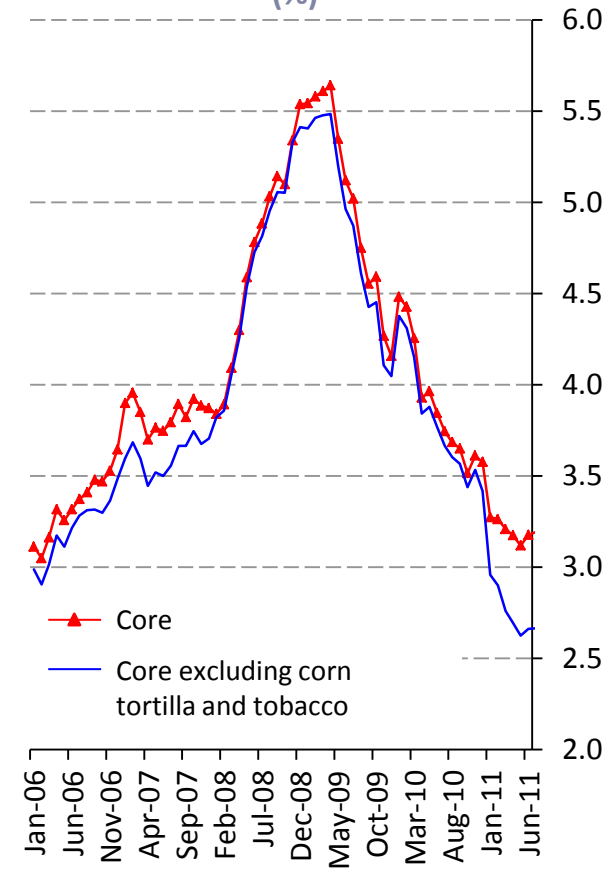
Source: Banco de México.

**Annual Core Inflation of Services (%)**



Source: Banco de México.

**Annual Core Inflation and Core excluding Corn Tortilla and Tobacco (%)**



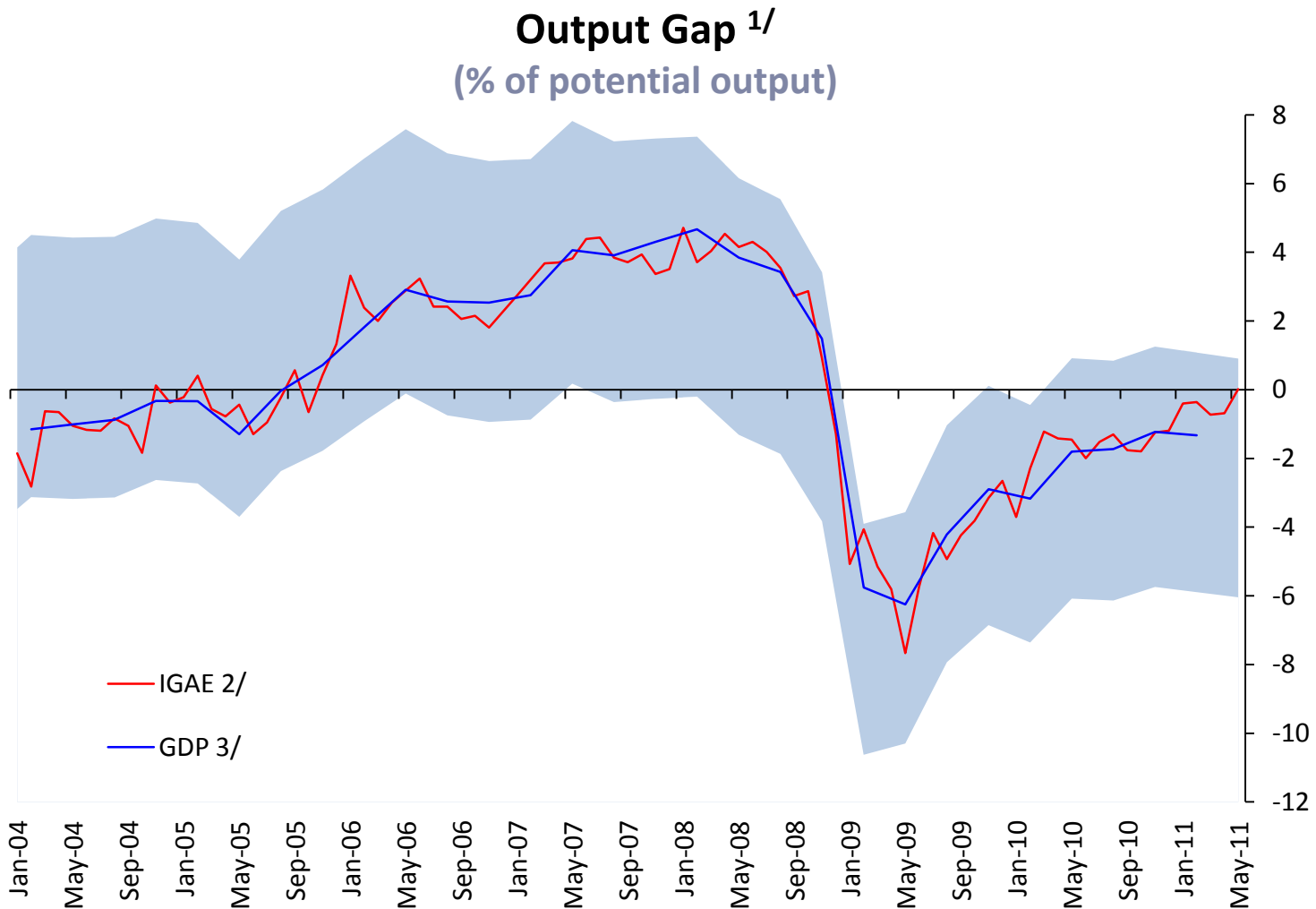
Source: Banco de México.

### 3. Monetary Policy and Inflation Determinants

- Various indicators suggest that presently no generalized pressures are observed either on main input prices or the country's external accounts:

- ① *The output gap has been closing at a slower rate than anticipated.*
- ② *Slack conditions in the labor market persist.*
- ③ *Unit labor costs have shown a reduction.*
- ④ *Commodity prices have exhibited a considerable decrease.*
- ⑤ *Expansion of total financing is congruent with the current phase of the economic cycle.*
- ⑥ *Reduced deficit in the external accounts.*

# 3. Monetary Policy and Inflation Determinants

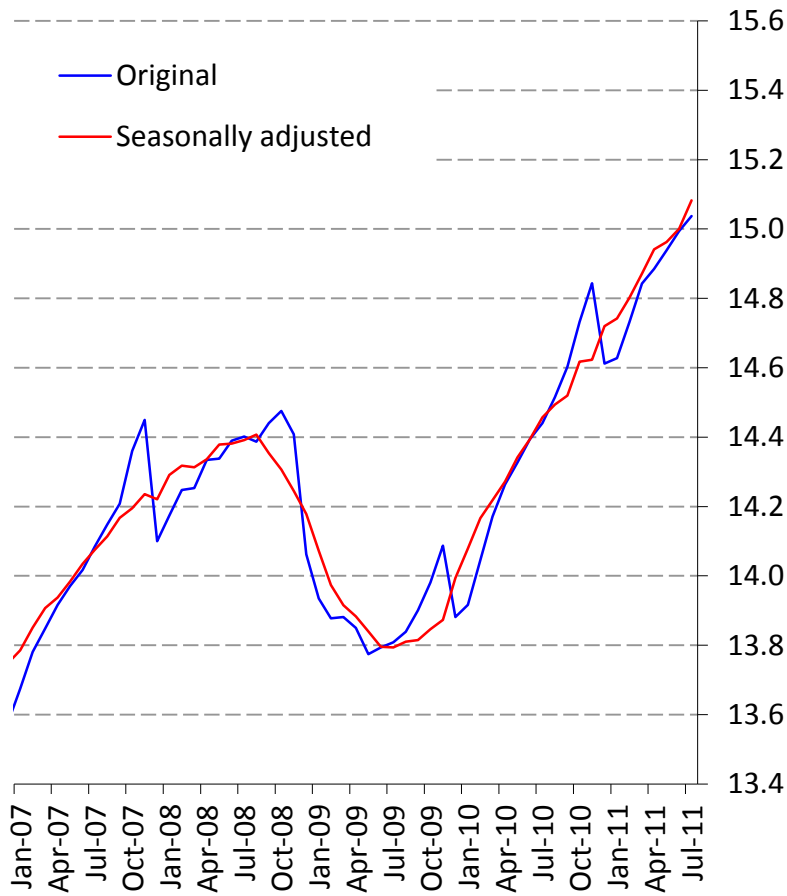


1/ The output gap was estimated using the Hodrick-Prescott (HP) method with tail corrections; see Banco de México (2009), "Inflation Report, April-June," p.69. The shaded area is the 95% confidence interval of the output gap, calculated with the unobserved components method. 2/ IGAE data up to May 2011. 3/ GDP data up to the first quarter of 2011.

Source: Calculated by Banco de México with information from INEGI.

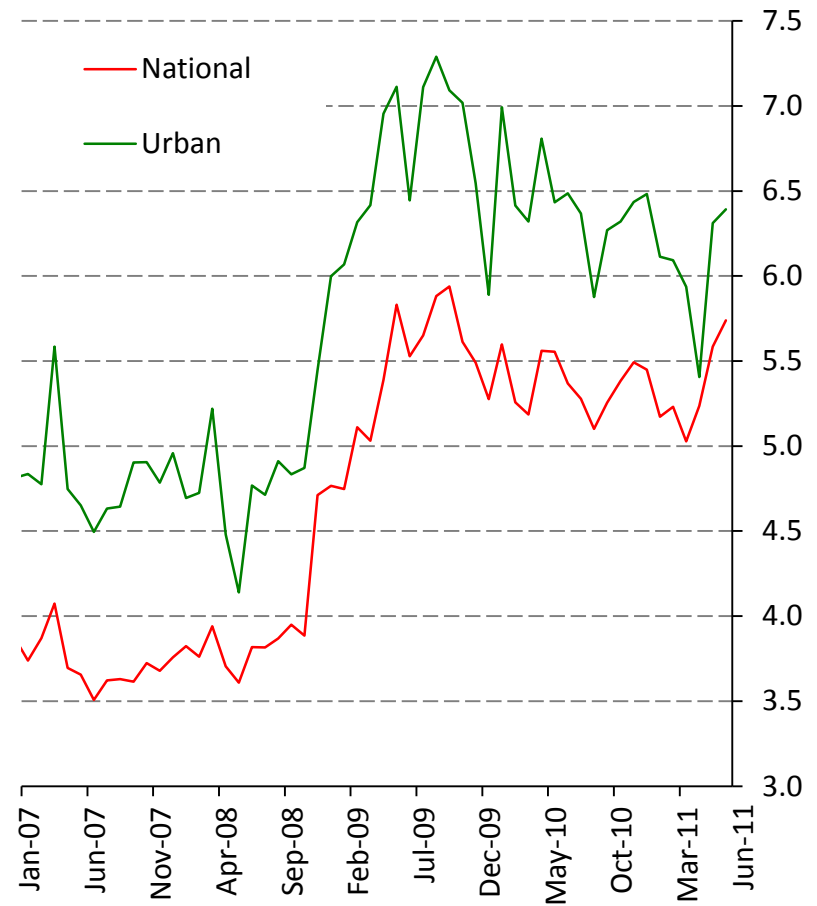
# 3. Monetary Policy and Inflation Determinants

**IMSS-insured Workers <sup>1/</sup>**  
(Million workers)



<sup>1/</sup> Permanent and temporary workers in urban areas.  
Source: IMSS and seasonally adjusted by Banco de México.

**Unemployment Rate**  
(%; s.a.)

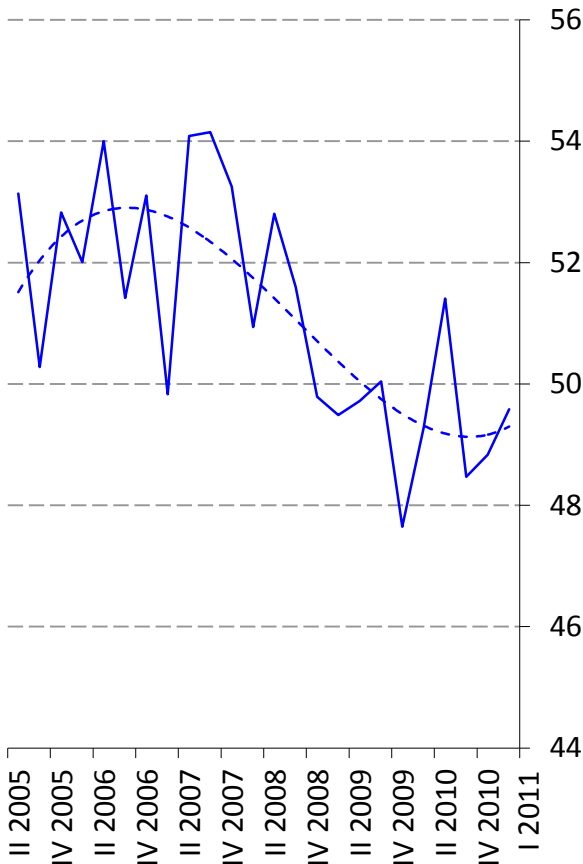


s.a./ Seasonally adjusted.  
Source: INEGI.



# 3. Monetary Policy and Inflation Determinants

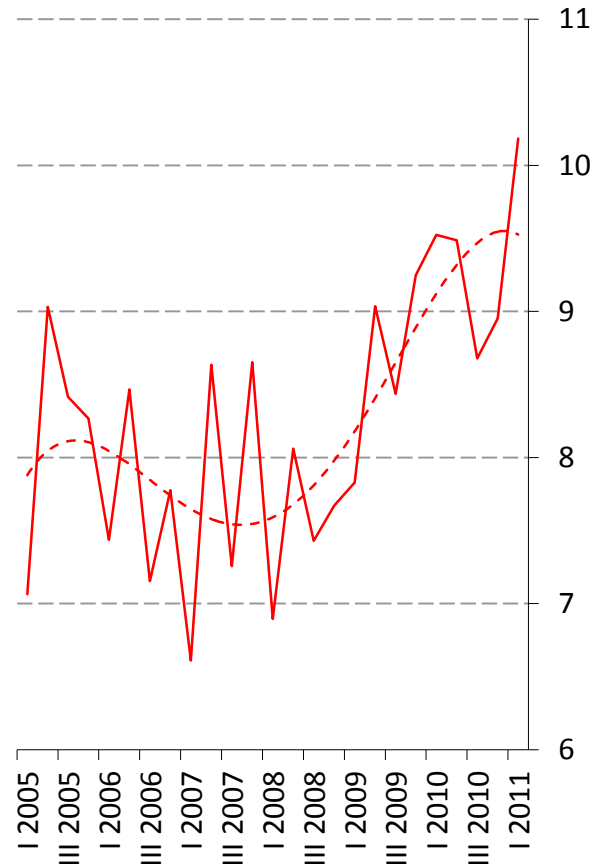
**Unemployed that became Employed in the Next Quarter <sup>1/</sup>**  
(%)



<sup>1/</sup> Only considered unemployed people with valid interview in the next quarter.

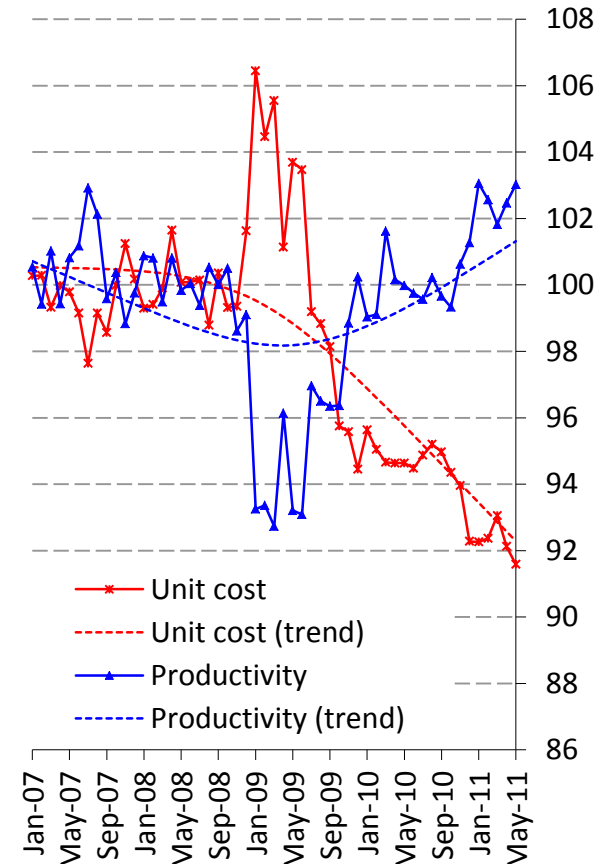
Source: Calculated by Banco de México with information from INEGI.

**Duration of Unemployment**  
(Average weeks searching jobs; searching unemployed population)



Source: Calculated by Banco de México with information from INEGI.

**Productivity and Unit Cost of Labor Force**  
(Index 2008=100; s.a.)

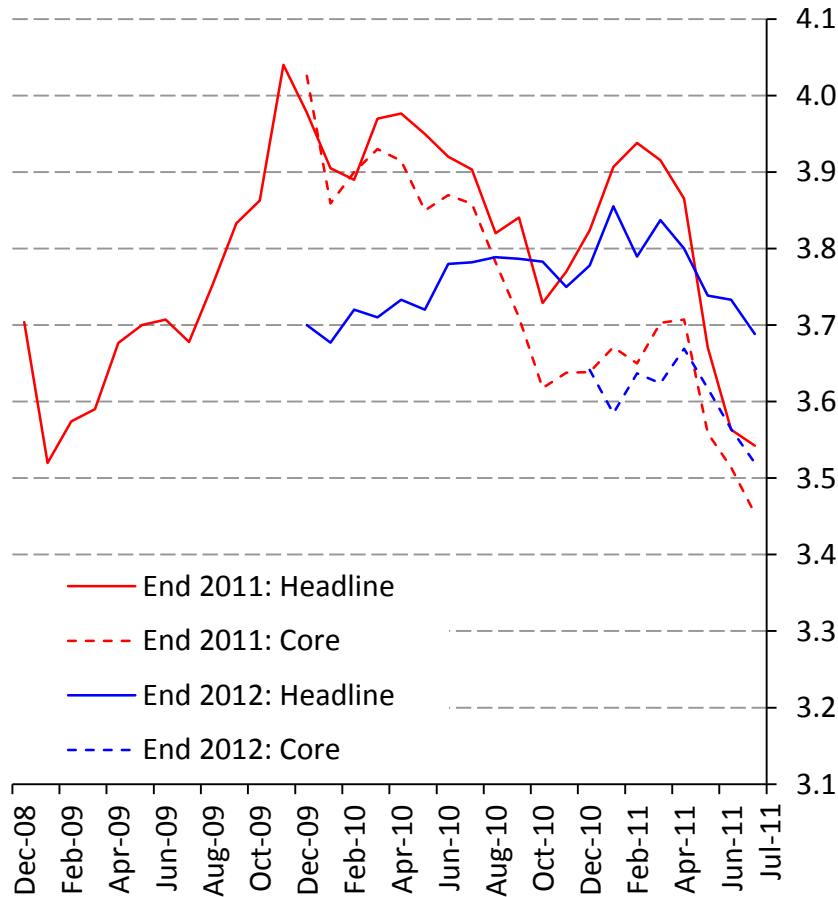


s.a./ Seasonally adjusted.

Source: Prepared by Banco de México with seasonally adjusted data from the Extended Industry Survey (*Encuesta Industrial Ampliada*), INEGI.

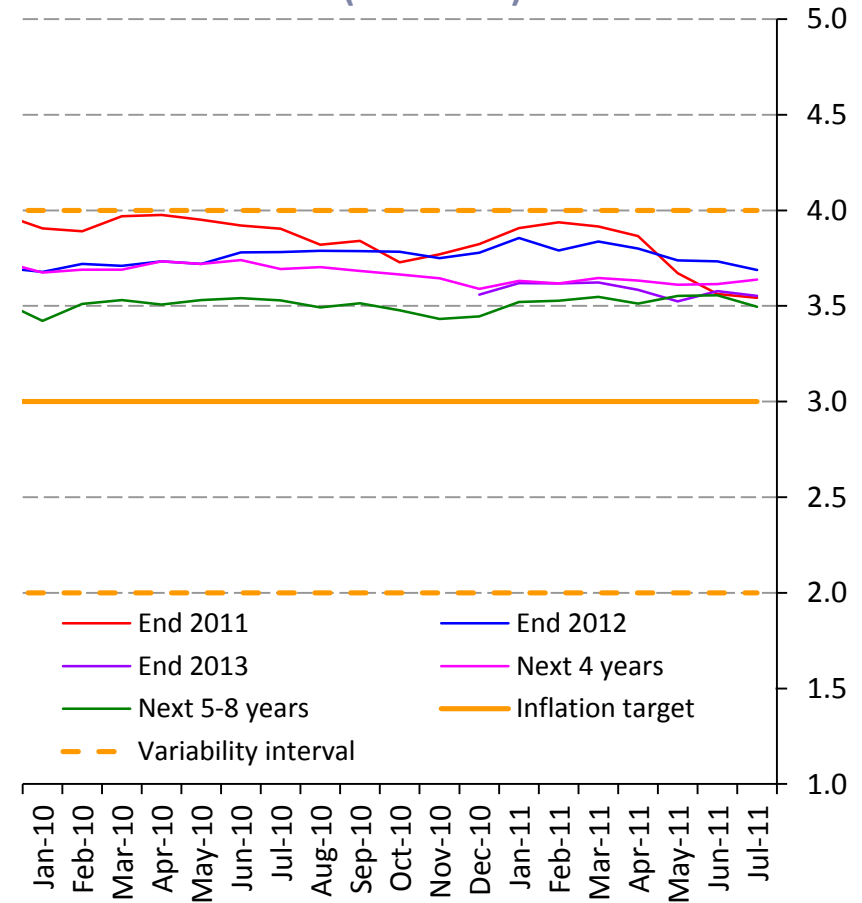
# 3. Monetary Policy and Inflation Determinants

## Headline and Core Inflation Expectations (Annual %)



Source: Banco de México's survey.

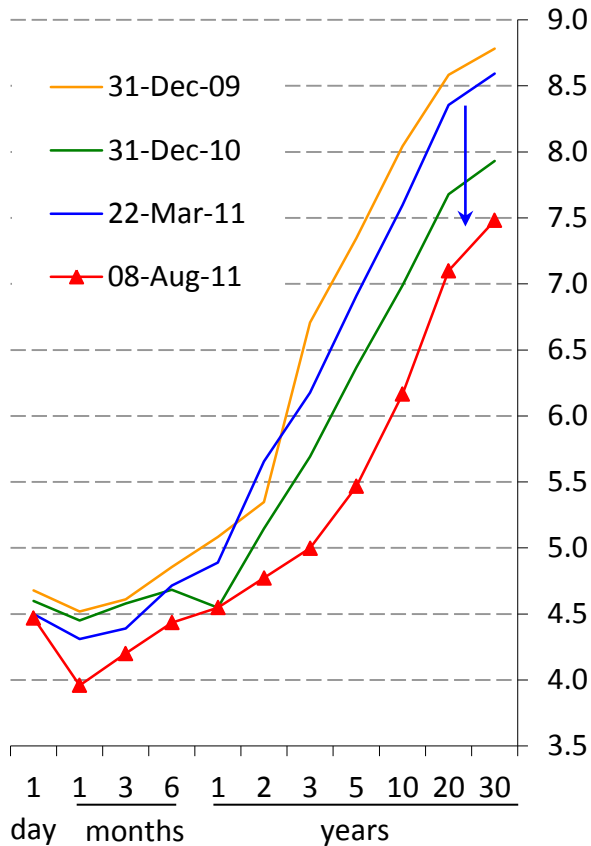
## Headline Inflation Expectations for Different Time Horizons (Annual %)



Source: Banco de México's survey.

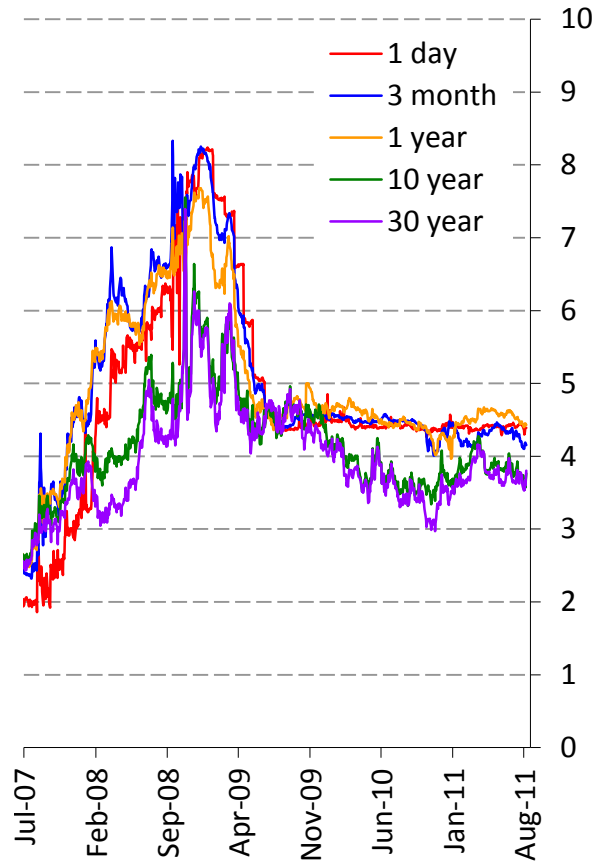
# 3. Monetary Policy and Inflation Determinants

**Mexico's Yield Curve**  
(%)



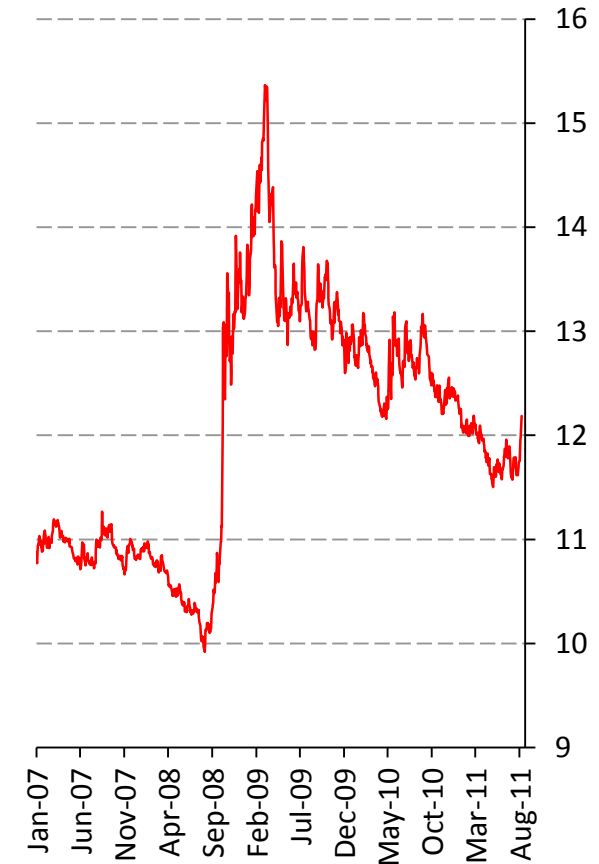
Source: Banco de México and *Proveedor Integral de Precios* (PiP).

**Mexico and U.S. Interest Rate Spread**  
(%)



Source: Banco de México, *Proveedor Integral de Precios* (PiP) and Department of the Treasury.

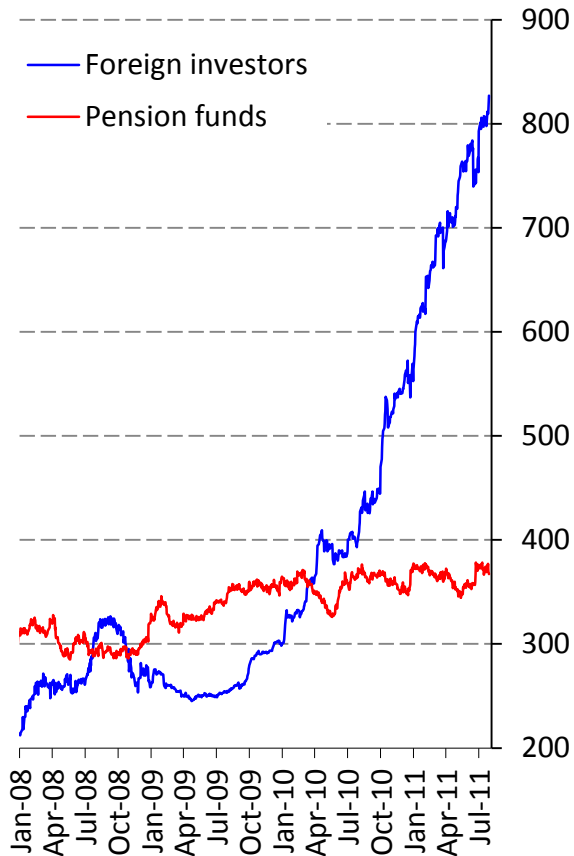
**Exchange Rate**  
(Pesos per dollar)



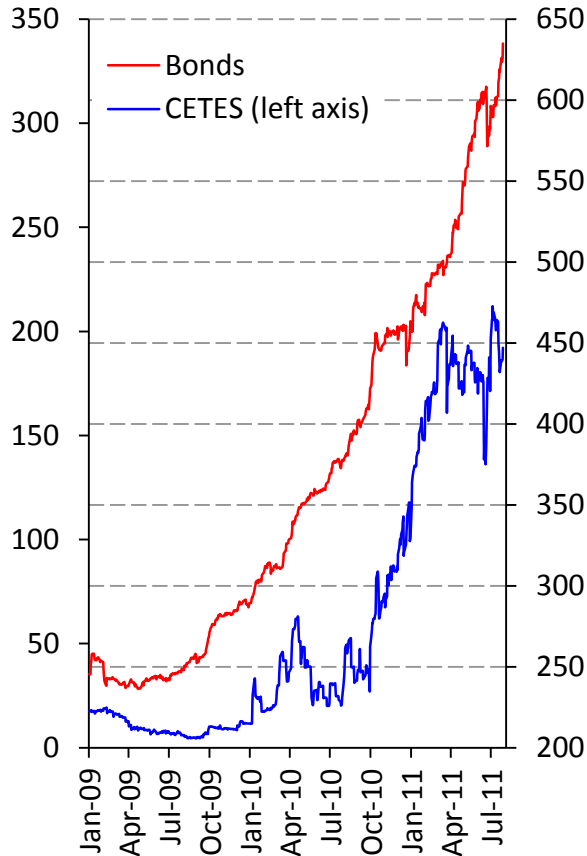
Source: Banco de México.

# 3. Monetary Policy and Inflation Determinants

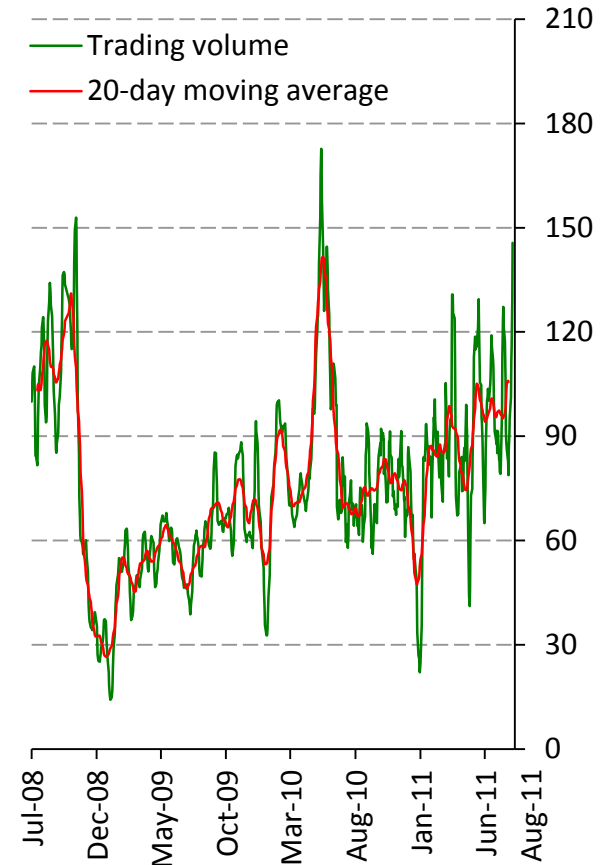
**Government Securities Holdings <sup>1/</sup>**  
(Billions of pesos)



**Government Securities Holdings of Foreign Investors**  
(Billions of pesos)



**FX Spot Trading Volume**  
(Index Jul-2008=100)



1/ Includes Bonds and CETES.  
Source: Banco de México.

Source: Banco de México.

Source: Banco de México and Reuters.

# Outline

1. External Conditions
2. Economic Activity in Mexico
3. Monetary Policy and Inflation Determinants
4. Forecasts and Balance of Risks

# 4. Forecasts and Balance of Risks

## Growth of the Mexican Economy:

- ✓ *Between 3.8 and 4.8% in 2011 (between 4.0 and 5.0% in the previous Inflation Report).*
- ✓ *Between 3.5 and 4.5% in 2012 (between 3.8 and 4.8% in the previous Inflation Report).*

## Employment:

- ✓ *Creation of between 575 and 675 thousand new formal employments in 2011.*
- ✓ *Creation of between 570 and 670 thousand new formal employments in 2012.*

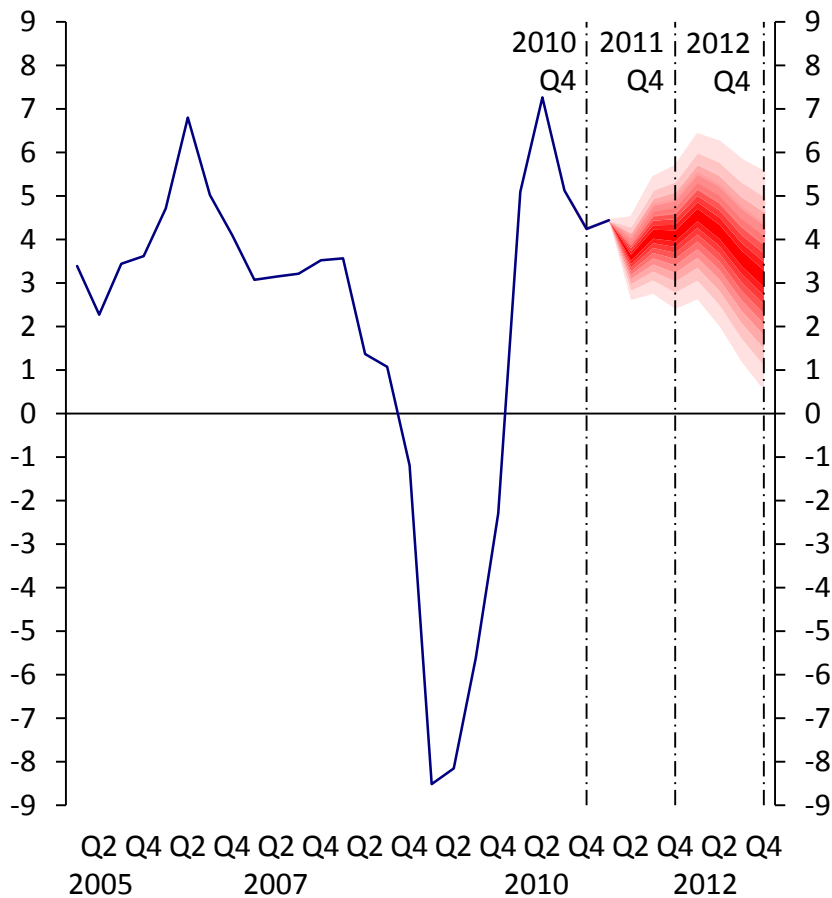
## Current Account:

- ✓ *Deficit of USD 12.9 billion (1.1% of GDP) for 2011.*
- ✓ *Deficit of USD 20.7 billion (1.6% of GDP) for 2012.*

# 4. Forecasts and Balance of Risks

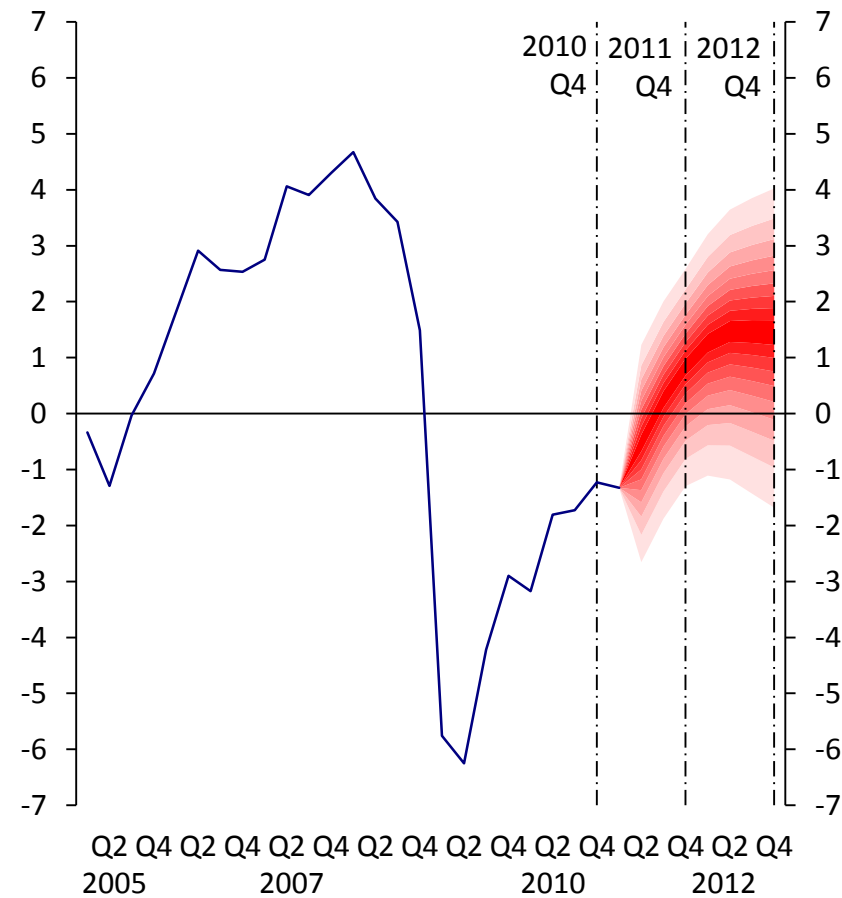
## Fan Charts

**GDP Growth**  
(Annual %)



Source: Banco de México.

**Output Gap**  
(%)



Source: Banco de México.

## 4. Forecasts and Balance of Risks

- Diverse risks for the growth scenario of the Mexican economy prevail:
  - ✓ *Uncertainty with respect to the economic recovery in the U.S.*
  - ✓ *The eventual withdrawal of the fiscal and monetary stimuli by more advanced economies could lead to a lower dynamism of Mexico's external demand.*
  - ✓ *The precarious fiscal and financial situation in some European countries could result in lower growth in advanced economies.*
  - ✓ *Greater uncertainty in the international financial markets could result in a reversal of capital flows that have been channeled to emerging economies, the Mexican economy among them.*



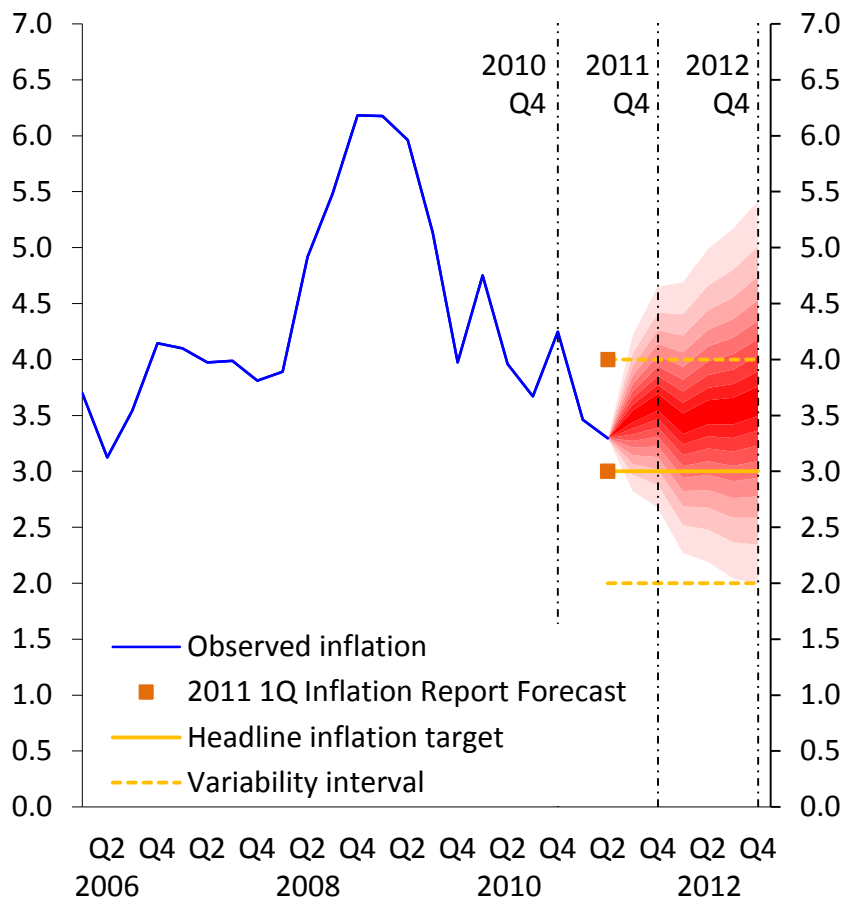
## 4. Forecasts and Balance of Risks

- The inflation forecast remains unchanged.
  - ✓ *Annual headline inflation in 2011 and 2012 is expected to be congruent with the 3 percent permanent inflation target, considering the variability interval of plus/minus one percentage point.*
  - ✓ *Annual core inflation is expected to register a level between 3.0 and 3.5 percent during the second half of 2011, while at the beginning of 2012 it is anticipated to decrease, locating below 3 percent for the rest of the year.*

# 4. Forecasts and Balance of Risks

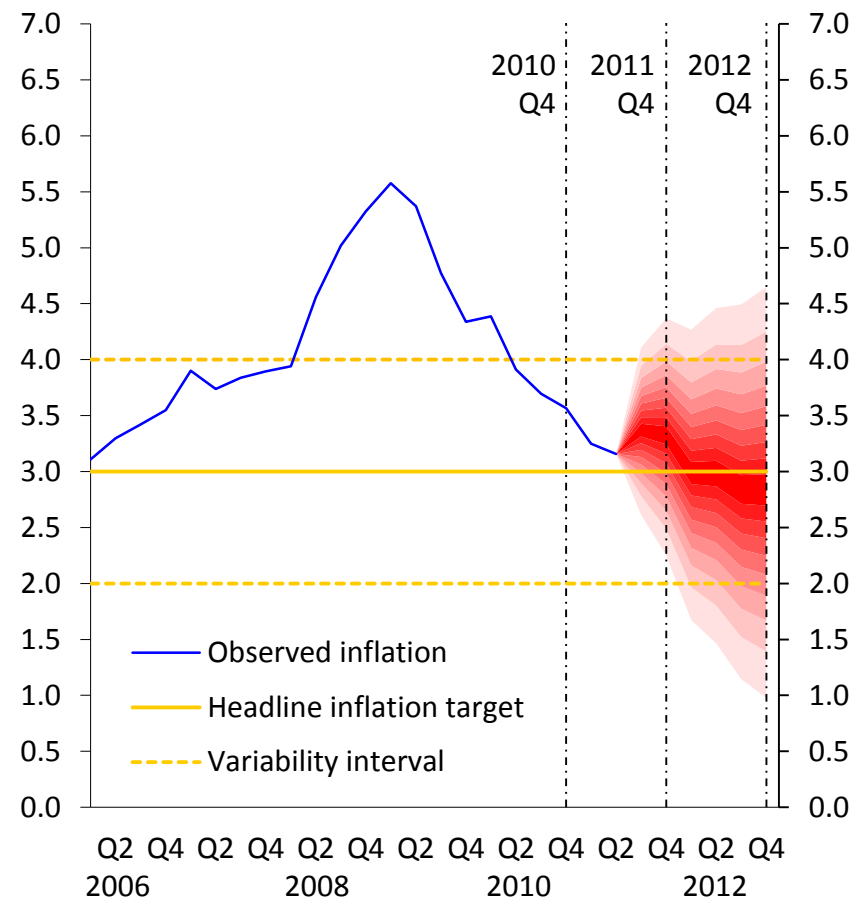
## Fan Charts

### Annual Headline Inflation (Annual % change)



Source: Banco de México.

### Annual Core Inflation (Annual % change)



Source: Banco de México.

## 4. Forecasts and Balance of Risks

- The inflation forecast is subject to diverse risks:
  - ✓ *Upward risks associated with the international grain prices have decreased.*
  - ✓ *The fact that the world economy might suffer a considerable loss of dynamism, which would affect the performance of the Mexican economy, persists as a downward risk.*
  - ✓ *In contrast, given the episodes of turbulence in the international financial markets, the possibility that the exchange rate volatility increases continues being an upward risk.*
  - ✓ *The possibility of a rebound of some agricultural prices cannot be ruled out.*

## 4. Forecasts and Balance of Risks

- Mexico has distinguished from other emerging economies:
  - ✓ *Progress made in terms of inflation has been reached in the context of strengthening of the macroeconomic policy conduction.*
  - ✓ *The monetary policy conduction, together with a prudent fiscal policy, a flexible exchange rate regime and an adequate regulation and supervision of the financial system have been determining elements in reaching a considerable reduction in the level, volatility and persistence of inflation in the last years.*

## 4. Forecasts and Balance of Risks

- The uncertain international environment confirms the need of continuing the macroeconomic strengthening of the country and the progress in its structural change.
  - ✓ *To reach the economic growth pace that would lead to a higher level of development, without inflationary pressures, it is necessary to increase the potential GDP growth rate of the country.*
  - ✓ *This is the right time to boost the pending structural reforms. It is particularly urgent to pursue these reforms, given the recent deterioration of the growth outlook of the advanced economies.*

## 4. Forecasts and Balance of Risks

- Banco de México will continue monitoring the behavior of inflation expectations, output gap, grain and other commodity prices, as well as diverse inflation determinants that could signal widespread pressures on prices.
- If this eventuality materializes, the Board of Governors will adequately adjust the monetary policy stance in order to reach the convergence of inflation towards the 3 percent permanent target.