Inflation Report

January - March 2012

Summary

In the second half of 2011 the world economic outlook and confidence in international financial markets deteriorated, which entailed both a negative shock to the Mexican economy, as a result of lower external demand, and, an increase in risk premia in financial markets. Nevertheless, the improved world economic environment in the first months of 2012 implied that the first shock was partially offset by a slight upward revision of the U.S. economic prospects. It also caused a partial reversal of the referred increment in risk premia, as a catastrophic event in international financial markets became less likely. Thus, the adjustment of the Mexican economy in an adverse and changing international environment has been favorable.

During the first months of 2012, various indicators of U.S. production and employment improved. However, the main components of aggregate demand still point to a moderate growth of economic activity in 2012. In the Euro zone a negative feedback loop persists among the weakening of economic activity, banks' deleveraging and fiscal vulnerability faced in different economies of the region. Most emerging economies also registered lower growth rates, due to less dynamic external and domestic demand.

Volatility in international financial markets declined, as a result of the policies adopted by the authorities of major advanced economies during the first quarter of 2012. Particularly, unconventional measures adopted by the European Central Bank aimed at providing liquidity to financial institutions, the effort to recapitalize these institutions, and the progress in the fiscal consolidation in some Euro zone member states, contributed to the improved functioning of interbank and sovereign debt markets. However, these actions do not represent a definitive solution to the challenges faced by some economies of the region yet. Therefore, these measures rapidly lost effectiveness, which resulted in a new increase in uncertainty and volatility in financial markets in April and in the first fortnight of May, when doubts arose about the capacity and political support regarding the implementation of the necessary fiscal adjustment measures.

Given the reduced uncertainty in international financial markets during the first quarter of 2012, investors resumed their search for yield. Thus, capital flows to emerging economies grew considerably in the first three months of 2012 compared to those observed in previous years. Nevertheless, in April and the first fortnight of May this tendency was interrupted as a result of increased uncertainty in international markets.

Even though the most recent international economic forecasts for 2012 have improved, there is still a consensus that world economic growth will be lower than that in 2011. This, coupled with higher expected stability of international commodity prices, allows anticipating that most countries will face lower inflation in 2012 as compared with the previous year. Therefore, the monetary policy stance in the main advanced economies and in most emerging economies is expected to remain accommodative.

The strength of the macroeconomic framework in Mexico is a key element that has contributed to the resilience demonstrated by the Mexican economy to the abovementioned shocks and that has facilitated its transit through a less favorable international economic environment. Thus, Mexico's productive activity continued its positive trend during the first quarter of 2012. In this regard, three elements should be highlighted. First, the real exchange rate adjustment, in light of the deterioration in the international environment in 2011 contributed to a more dynamic export sector during the period, given an orderly depreciation of the nominal exchange rate with well-anchored inflation expectations. Second, external demand rebounded recently, which also favored exports growth. Third, the adequate functioning of Mexico's financial system supported the economic activity. Nevertheless, given the conditions prevailing in the world economy, the Mexican economy is estimated to register moderate growth during 2012 and 2013. In this context, slack conditions in the economy are expected to remain, and, hence, no demand-related pressures on either main input prices or the country's external accounts are expected.

In the first quarter of 2012 annual headline inflation was lower than in the previous quarter, thus partially offsetting the increase observed between November 2011 and January 2012. Therefore, as forecast by Banco de México in the previous Inflation Report, the referred increase was transitory. Additionally, the performance of headline inflation and its main components indicated the absence of second round effects derived from relative price changes in the economy. In this context, the forecast for the annual headline inflation for 2012 and 2013 is confirmed, i.e., this variable's most probable trajectory is expected to remain within an interval of 3 to 4 percent.

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

Growth of the Mexican Economy: Given the dynamics observed in the most recent indicators, as well as the change in the U.S. growth outlook, the forecast interval for the annual GDP growth rate is revised upwards with respect to the one presented in the previous Inflation Report, while that estimated for 2013 remains unchanged. Particularly, Mexico's annual GDP growth rate is anticipated to lie between 3.25 and 4.25 percent in 2012, as compared to the interval of 3.0 to 4.0 percent in the previous Inflation Report. In turn, the Mexican economy is forecast to grow at a rate between 3.0 and 4.0 percent in 2013 (Graph 1a).

Employment: In 2012, the number of IMSS-insured workers is expected to increase between 540 and 640 thousand persons. This forecast is compared to the interval 500 to 600 thousand persons published in the previous Inflation Report. In turn, the expectation for 2013 published in the last Inflation Report is maintained, anticipating an increase between 500 and 600 thousand workers.

Current Account: For 2012, deficits of USD 3.2 billion for the trade balance (0.3 percent of GDP) and of USD 12.0 billion (1.0 percent of GDP) for the current account are estimated. The moderate current account deficit expected for 2012, together with the measures taken by the Mexican federal government to finance its external debt liabilities for this year, suggest that financing these deficits will not pose a problem and that there will be no pressures on the exchange rate arising from this source during the reference period. For 2013, deficits of USD 6.0 billion and USD 17.1 billion (0.5 and 1.3 percent of GDP) are expected for the trade balance and the current account, respectively.

Given these forecasts, no inflation pressures coming from aggregate demand are anticipated in the forecast horizon. Indeed, the output gap is expected to remain at levels close to zero, although with a positive trend (Graph 1b).

Slightly improved U.S. growth prospects resulted in an improvement of both the general outlook and the balance of risks for Mexico's expected economic growth, as compared to the previous Inflation Report. Nevertheless, downward risks for Mexico's expected growth persist. Specifically, the main factors that might give rise to a less favorable environment are:

i. The possibility of the U.S. economy to grow at lower rates than expected, negatively affecting Mexico's external sector and possibly resulting in lower domestic spending. This situation could result from circumstances such as a greater than anticipated effort of fiscal consolidation in the U.S. In this sense, the U.S. electoral environment could increase the uncertainty regarding the speed of this consolidation. Likewise, higher oil prices could diminish confidence and the level of U.S. consumers real spending.

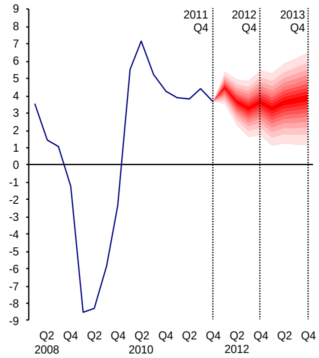
ii. The lack of political agreements to implement the necessary fiscal adjustment measures has recently made the already challenging situation prevailing in Europe even more difficult, increasing the risk of further deterioration in international financial markets and in global

growth, which in turn could be reflected in lower growth of the Mexican economy. A transmission channel of the abovementioned risk might be the effect of the European situation on the U.S. financial system. In this sense, increased uncertainty in international financial markets derived from the situation in Europe could negatively influence capital flows to emerging countries, Mexico among them.

iii. In accordance with economic specialists surveyed by Banco de México, public insecurity and the absence of structural changes are still factors that could hamper economic growth in Mexico.

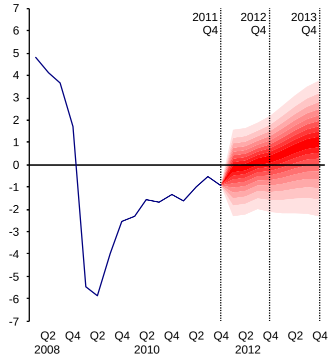
Fan Charts 1

a) Output Growth, s. a.
Annual percent



s. a. / Seasonally adjusted figures.
Source: INEGI and Banco de México.

b) Output Gap [1/]
Percent



1/ Elaborated with seasonally adjusted data.
Source: Banco de México.

Inflation: The forecast for annual headline inflation for 2012 and 2013 is in line with the convergence process to the 3 percent permanent target, fundamentally as a result of a monetary policy oriented at attaining this goal. Also, the expected environment of low inflation will be strongly influenced by four main elements: first, a relatively weak growth of the world economy; second, absence of demand-related pressures on the domestic economy; third, intensified competition in some sectors, such as the telecommunications industry; and fourth, prospects of lower pressures on international commodity prices.

Thus, the most likely trajectory of annual headline inflation for the rest of 2012 and 2013 is located within an interval of 3 to 4 percent (Graph 2a). According to projections, annual headline inflation in 2013 is expected to approach the lower range of the aforementioned interval, once the effects of relative price adjustments vanish.

Annual core inflation is anticipated to be close to 3 percent in 2012 and to fluctuate around this level in 2013. It should be noted that this variable is forecast to present a lower average level in 2013 as compared to that anticipated for this year, given that the effects of increases in certain food prices, corn tortilla among them, are expected to fade (Graph 2b).

The balance of risks associated to the inflation forecast has improved with regard to that described in the previous Inflation Report. On the one hand, regarding upward risks:

A. In the last months, the group of agricultural products affected by droughts reduced, although the possibility of higher volatility in international financial markets prevails.

On the other hand, the following downward risks are highlighted:

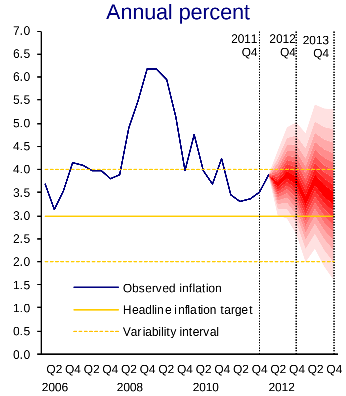
A. The risk corresponding to lower relative risk perception of Mexico's economy has intensified.

B. The risk corresponding to the weakening of external and domestic demand prevails.

The Board of Governors considers the present monetary policy stance as conducive to reaching the 3 percent permanent inflation target, reason for which it decided to maintain the Overnight Interbank Interest Rate at 4.5 percent during the period analyzed in this Inflation Report. In the future, the Board will continue to monitor the evolution of international financial markets, given that their more favorable performance, together with the prospects for Mexico's economic growth and for inflation, in a context of great monetary lassitude in main advanced and emerging countries, could make a monetary policy easing advisable. Besides, the Board will continue to carefully watch the behavior of all inflation determinants that could signal generalized pressures on prices, in order to adequately adjust the monetary stance. In any event it will pursue at all times the convergence of inflation to its 3 percent permanent target.

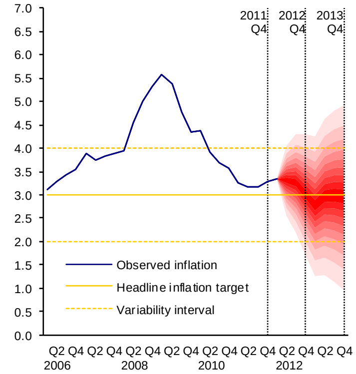
Fan Charts 2

a) Annual Headline Inflation
Annual percent



Source: INEGI and Banco de México.

b) Annual Core Inflation
Annual percent



Source: INEGI and Banco de México.

It is important to emphasize that the external conditions faced by the Mexican economy suggest a relatively moderate world growth rate for the following years. Thus, these conditions will not necessarily be conducive to attain the growth rate Mexico requires to reach significantly higher development levels. It is imperative to further promote the economy's structural change, aimed at strengthening its domestic sources of growth. For that, it is fundamental to increase the country's potential GDP growth rate, and particularly to secure the incentive structure that leads to increased productivity levels of the economy. Thus, it is especially relevant to adopt measures that foster economic competition in the markets and promote flexibility in the country's resources allocation, as they would positively influence the population's income and welfare. These reforms would induce producers to adopt more advanced technologies and to implement more efficient working practices, which would increase productivity and allow for a more beneficial use of comparative advantages, as a consequence of higher mobility of resources towards their most productive uses.

Finally, progress in the aforementioned reforms would support the performance of the nominal system of the economy, which would strengthen the environment of low and stable inflation. Higher productivity would allow meeting a more dynamic aggregate demand without generating pressures on inflation. Besides, higher competition would directly benefit consumers through lower prices, which would increase the welfare of the population.