Inflation Report

April - June 2011

Summary

During the second quarter of 2011 the expansion of the world economy continued, although at a slower pace. The lower growth rate was partially due to temporary factors, such as the effects of the natural disasters in Japan on the global production chains and high commodity prices.

To this environment of slower economic activity growth, downside risks for the world economy growth outlook are added, especially considering the complex issues faced by the United States and Europe. In this context, the balance of risks to the growth of the global economy has deteriorated.

In the U.S., with which Mexico is considerably integrated, GDP growth decelerated during the first quarter of the year and remained weak in the second quarter. Although fiscal and monetary stimuli continue supporting consumption, diverse indicators suggest that it has been registering a lower growth pace during the last months. Considering the households' still weak financial position, high unemployment, fragility of the housing market and firms' caution regarding hiring and expanding their investment, the possibility of persisting weak economic growth is high. This perception has been accentuated in the last days due to the credit rating downgrade of the U.S. Treasury debt by one of the rating agencies. Uncertainty about the pace of a possible withdrawal of the fiscal stimulus and its possible effect on private spending is added to the aforementioned.

Although inflation has risen worldwide during the year, in most economies inflation levels are considerably lower than in the previous economic cycles. The increase in headline inflation in advanced economies during the second quarter reflected the surge of commodity prices during the previous months. In turn, core inflation also increased, although it remains at reduced levels. It is noteworthy that in these economies persists a high degree of resource slack and that medium- and long-term inflation expectations remain anchored.

In the case of emerging economies, the overheating registered by some of them has been reflected in inflationary pressures. Hence, some central banks continued withdrawing part of the strong monetary stimulus introduced in the past.

Reflecting the lower dynamism of the world economic activity and the downward adjustment of its growth expectations, international commodity prices decreased since the mid-second quarter. Thus, during the last weeks some central banks of both advanced and emerging economies have moderated their restrictive monetary policy stance.

During the analyzed period, international financial markets were affected by increased uncertainty. This was a reflection of the fear of the prolongation of the recent economic weakness of the major advanced economies, particularly in the face of the possible withdrawal of their fiscal and monetary stimuli; the difficulties in reaching a legislative agreement in the U.S. in order to raise the debt ceiling; and also the seriousness of the fiscal and financial problems of some European countries, associated with a high contagion risk.

Productive activity in Mexico continued presenting a positive trend during the second quarter of 2011. Industrial production and service sector activity showed further strengthening. Despite that, some indicators of domestic demand would seem to suggest a moderation in its growth pace. Even though the formal employment continued recovering, the labor market still presents slack conditions. In turn, the evolution of financing is far from reflecting a problem of overheating in the economy and does not indicate pressures on the interest rates. Thus, in the reported period no widespread pressures on prices or on external accounts were observed in Mexico.

Headline inflation continued showing a downward trend during the analyzed quarter. Furthermore, so far in 2011, this indicator has remained within the variability interval of plus/minus 1 percentage point around the 3 percent permanent inflation target, approaching this target. In fact, in the referred period annual core inflation, mainly reflecting the medium-term trend of headline inflation, remained at levels close to 3 percent. It should be noted that both temporary phenomena and longer-lasting factors, which are analyzed in this Inflation Report, contributed to these results.

Considering the evolution of inflation, its outlook and determinants, Banco de México's Board of Governors maintained the Overnight Interbank Interest Rate at 4.5 percent during the period studied in this Inflation Report. This monetary policy decision was made in a context of extraordinary monetary easing in the U.S., implying high interest rate spreads between Mexico and that country. The aforementioned, together with solid macroeconomic fundamentals, contributed to the strengthening of the Mexican currency. The anchoring of inflation expectations contributed to the good performance of the Mexican peso (MXN), generating a virtuous circle favoring the gradual convergence of inflation towards its 3 percent permanent target. Thus, Banco de México's strong commitment to price stability has allowed the Central Institute to maintain inflation and its expectations under control in accordance with its priority mandate.

The macroeconomic scenario foreseen by Banco de México is:

Growth of the Mexican Economy: Taking into consideration the recent performance of the Mexican economic activity, as well as the balance of risks of the external conditions faced by the economy, GDP growth for 2011 is estimated to be within an interval of 3.8 and 4.8 percent, implying an adjustment with respect to the interval of 4.0 and 5.0 percent presented in the previous Inflation Report. In turn, given the deterioration of the growth outlook of the U.S. economy in 2012, for that year the interval of Mexican GDP growth of 3.8 to 4.8 percent, presented in the previous Inflation Report, is revised to an interval of 3.5 to 4.5 percent (Graph 1a). In the remainder of 2011 and during 2012, although the output gap is anticipated to continue closing, it is expected to happen at a slower pace than previously forecasted. In this way, no generalized pressures on prices are expected, especially if the high slack prevailing in the labor market is considered (Graph 1b).

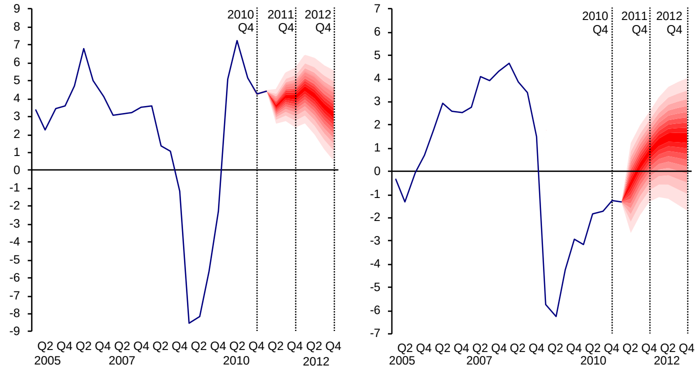
Employment: The development of the formal employment in the first part of the year, as well as the economic activity growth anticipated for the rest of 2011 is estimated to lead to the creation of between 575 and 675 thousand new formal employments. For 2012 the creation of between 570 and 670 thousand new formal employments is forecasted, taking as a reference the number of IMSS-insured workers.

Current Account: A deficit in the trade balance of USD 4.6 billion (0.4 percent of GDP) and a deficit in the current account of USD 12.9 billion (1.1 percent of GDP) are predicted for 2011. Likewise, a deficit of USD 11.0 billion in the trade balance (0.9 percent of GDP) and a deficit of USD 20.7 billion in the current account (1.6 percent of GDP) are estimated for 2012. These forecasts, together with the fact that the Mexican Government already prefinanced its external debt amortization program for 2011 and 2012, suggest that no problems will arise for financing the moderate current account deficit and there will be no pressures on the exchange rate, stemming from this source.

Fan Charts 1

a) Output Growth
Annual percent

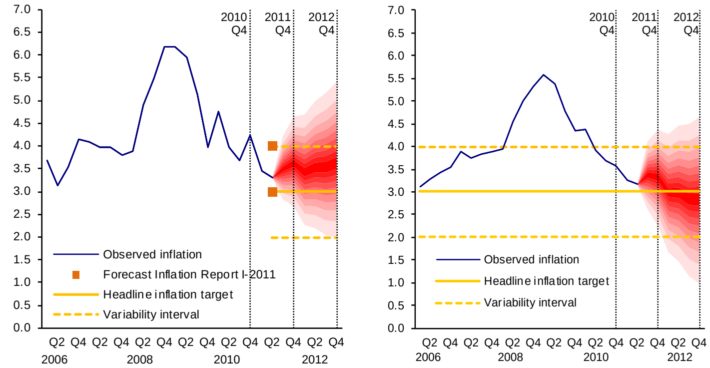
b) Output Gap
Percent



Fan Charts 2

a) Annual Headline Inflation
Annual percent

b) Annual Core Inflation
Annual percent



Diverse risks to the growth scenario of the Mexican economy prevail, some of which have increased in recent months. Among them the following stand out:

I. Uncertainty with respect to the recovery strength of the economic activity in the U.S. has increased, and both its labor market and the housing market continue showing signs of weakness. In addition, although the U.S. fiscal consolidation would imply a positive long term effect on its fiscal sustainability, in the short term these adjustments might translate into a smaller boost to this economy.

II. The possible withdrawal of the fiscal and monetary stimuli by advanced economies could lead to a lower dynamism of Mexico's external demand.

III. The precarious fiscal and financial situation in some European countries could result in contagion to the banking systems of those economies that are more exposed to these countries' debt, generating lower growth in advanced economies.

IV. In this context of vulnerability in the international financial markets, greater uncertainty of investors could result in a reversal of capital flows that have been channeled to emerging economies, the Mexican economy among them.

V. At the national level, according to economic specialists surveyed by Banco de México, public insecurity and the absence of structural reforms in the country continue being factors that could adversely affect the growth of the Mexican economy.

Inflation: It is confirmed that most likely in 2011 and 2012 the annual headline inflation will be located within the intervals published in the previous Inflation Report, thus being congruent with the 3 percent permanent inflation target, considering a plus/minus one percentage point variability interval (Graph 2a). Likewise, annual core inflation is expected to register a level between 3.0 and 3.5 percent during the second part of 2011, while at the beginning of 2012 it is forecasted to decrease, locating below 3 percent during the rest of the year (Graph 2b).

The balance of risks for the expected inflation trajectory has changed compared to that presented in the previous Inflation Report:

I. Upward risks associated to the international commodity prices, including grains, have decreased.

II. 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.

III. In contrast, given the episodes of turbulence in the international financial markets, an increase in the exchange rate volatility continues being a latent risk that could generate upward pressures on prices of different goods.

IV. Additionally, the possibility of the rebound of some agricultural prices with the consequent effect on inflation cannot be ruled out.

In short, all the above mentioned suggests that the balance of risks to the Mexican economy growth has deteriorated, while that corresponding to inflation has moderately improved.

It is noteworthy that progress made in terms of inflation has been reached in the context of strengthening of the macroeconomic policy conduction and, in general, in an environment of improvement of the economic fundamentals of the country. Thus, 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, as well as progressing in convergence towards the 3 percent permanent inflation target.

This has distinguished Mexico from other emerging economies. In a context where the international commodity prices presented a considerable increase in the first months of the year, these economies were more affected in their inflation levels. In contrast, Mexico continued with the process of convergence towards its inflation target and it is forecasted to follow this direction.

On the other hand, as mentioned in other Inflation Reports, the uncertain international environment faced by Mexico confirms the need of continuing the macroeconomic strengthening of the country and the progress in its structural change. To reach the economic growth rhythm 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, for which the referred structural reforms are indispensable. This is the right time to boost the abovementioned reforms given the strong Mexican macroeconomic framework, reached thanks to a prudent fiscal policy and a monetary policy committed to price stability.

Banco de México's Board of Governors 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 Central Bank will adequately adjust the monetary policy stance in order to reach the convergence of inflation to the 3 percent permanent target.