Inflation Report

January - March 2010

Summary

The world economy continued to recover during the first quarter of 2010 more rapidly than anticipated, although differently among regions and countries. Advanced economies have grown at a considerably more moderate rate than emerging economies and continue to depend to a great extent on the stimulus from accommodative macroeconomic policies. The rebound of these economies has also relied on the growth of net exports and, in general, on the recovery of inventories. Showing sound economic fundamentals, emerging economies have benefited from the expansion of foreign trade as well as the strong world demand for commodities.

Conditions in international security markets have gradually returned to normal. In particular, access conditions to these markets regarding costs and terms have rapidly recovered. Nevertheless, bank lending is still weak, particularly in advanced economies. Thus, the sustainability of the recovery of international economic activity will mainly depend on the banking sector's capacity to refinance itself, and to strengthen its balances and grant credit to the private sector.

Inflationary pressures have been contained in most advanced economies, basically as a result of lower than potential production, the consequent idle capacity, and the high levels of unemployment in these economies, which have contributed to maintain inflation expectations low and stable. In light of the need to continue boosting the recovery and improvement of financial systems, the central banks of these economies decided to leave their monetary policy stances unchanged. In contrast, emerging economies which where less affected by the global crisis and therefore exhibit less slackness in their economies, have started to withdraw their monetary and credit stimuli.

Emerging economies continued registering high capital inflows, partly as a result of expectations of interest rate spreads relative to advanced economies remaining high in the near future. Prospects of a continuous appreciation of their exchange rates and higher growth in relation to advanced economies have also contributed to this phenomenon. In fact, the extremely accommodative monetary and fiscal policy stance in advanced economies is a factor that could complicate macroeconomic management in emerging economies.

In Mexico, manufacturing production continued following a positive trend during the first quarter of 2010. The greater dynamism of industrial activity in the U.S. contributed to such a trend, which also raised the trade volume of Mexican exports. In contrast, domestic expenditure has rebounded at a slower pace, especially private investment, which has hardly recovered. Under these conditions, the economy continues operating below its productive potential level.

Annual headline inflation rose from 3.98 percent on average during the fourth quarter of 2009 to 4.75 percent during the first quarter of 2010, placing itself in the upper limit of the forecast interval published by Banco de México in the Addendum to the Inflation Report of July-September 2009 in November of that year. Upward pressures on headline inflation concentrated mainly on the CPI's non-core component, given that the core component –which reflects to a greater extent the medium-term inflation trend– decreased. The increase in non-core inflation was affected by the resetting of the policy of monthly fuel price adjustments and changes in prices and fares determined by local governments, as in the case of the subway and water supply services in Mexico City. This pattern was also influenced by the extraordinary rise in the prices of certain vegetables originated by the adverse weather conditions that affected their production. As for core inflation's reduction, it was driven by the exchange rate appreciation which lessened the impact of the recent tax adjustment on prices, in an environment where wages adjusted moderately and medium and long-term inflation expectations remained relatively stable.

Under this environment, up to now, Banco de México's Board of Governors has kept its target for the Interbank Interest Rate (operational target) at 4.5 percent.

Banco de México foresees the following macroeconomic base scenario for the Mexican economy:

GDP Growth: the improvement in the outlook for industrial production growth in the U.S., together with the recent development of Mexican economic activity, suggests that GDP in Mexico will grow above previous quarters' forecasts. In particular, the Mexican economy is expected to grow between 4.0 and 5.0 percent during 2010. In 2011, GDP is expected to grow between 3.2 and 4.2 percent, just as forecasted in the Inflation Report of the previous quarter.

Despite the recovery of productive activity foreseen in this scenario, slackness is anticipated to prevail in the Mexican economy during 2010. Nevertheless, as a result of the upward revision in growth expectations for both Mexico and the U.S., these conditions are expected to fade more rapidly than expected. Indeed, it is likely that the output gap closes relatively faster than as forecasted in the previous Report, therefore increasing the probability of certain scenarios of output gap becoming positive during the first half of 2011.

Employment: the number of IMSS-insured workers is expected to increase between 500 and 600 thousand in annual terms in both 2010 and 2011.

Current Account: the scenario for domestic demand and productive activity foreseen for 2010 is anticipated to be reflected in a deficit in both the trade balance and the current account of 11.5 and 11.9 billion U.S. dollars in both cases (1.1 percent of GDP), as compared with the 4.7 and 5.2 billion dollar deficit in the trade balance (0.5 percent of GDP) and in the current account (0.6 percent of GDP).

Since resources availability in international financial markets has improved, the Flexible Credit Line with the International Monetary Fund of approximately 48 billion U.S. dollars was renewed, and the expected repayment of public and private sector's debt has been distributed in time, the economy is not expected to face foreign financing problems in 2010.

The foreseen scenario for economic growth in Mexico for the next two years is not risk-free. In this regard:

i) The effect that withdrawing both fiscal and monetary stimuli in advanced economies could have on the recovery of the world economy and on emerging economies' access to financing.

ii) In the short run, tighter conditions in sovereign debt markets could arise, in light of a possible contagion from countries facing fiscal difficulties.

iii) If the appreciation of the exchange rate continues, export dynamics would be affected and therefore the capacity of the economy to recover. The latter, inasmuch as this appreciation does not reflect the progress in relative productivity of the sector of internationally-traded goods, which would lower production costs in this sector.

Inflation: the forecast for annual headline inflation for 2010 and 2011 remains unchanged as compared with that of the last two Inflation Reports (Table 1). This is due to the following:

1. The effect on inflation of the tax increases has been as expected and up to now no second-round price increases have been observed.
2. The impact on inflation of the resetting of the policy of monthly increases in fuel prices as well as of price and fare increases of local governments, has been consistent with what was anticipated.
3. Wages are expected to continue adjusting moderately.
4. Medium and long-term inflation expectations remain relatively stable, although above the 3 percent target.
5. Given the volatility of vegetable prices, their impact on inflation is expected to be short-lived.
6. Productive activity is anticipated to remain below its potential level in the following quarters. As a result, no inflationary pressures from the aggregate demand side are expected.

Table 1
Base Scenario for Annual Headline Inflation[1/]
Quarterly average (percent)

Quarter	Forecast Inflation Report I-Q 2010
2010-I	4.75 [2/]
2010-II	4.50 - 5.00
2010-III	4.75 - 5.25
2010-IV	4.75 - 5.25
2011-I	4.50 - 5.00
2011-II	3.50 - 4.00
2011-III	3.25 - 3.75
2011-IV	2.75 - 3.25
2012-I	2.75 - 3.25

1/ The forecast of this Report coincides with that of the previous one and also includes that for the first quarter of 2012. The Inflation Report's forecast up to the fourth quarter coincided with that of the Addendum to the Inflation Report of the third quarter. In each Inflation Report, the forecast horizon covers the following 8 quarters. For this reason, on each occasion, one quarter (the eighth) is added to the forecast, as compared with the first quarter of the previous Report, where it becomes an observed figure.
2/ Observed figure.

It is important to point out that although the fiscal changes implemented entail costs regarding short-term inflation, they will also be beneficial for the good functioning of the economy. Mexico is a country with a huge need for public spending in both physical and human capital investment. Financing this type of spending through stable sources of income is crucial to maintain a macroeconomic environment characterized by low and stable inflation.

The forecast for annual inflation is subject to various risks, among which the following stand out:

i) A sudden reversal in capital flows could lead to an abrupt and rapid exchange rate adjustment.

ii) The possibility that the economic recovery process is more (less) vigorous than previously anticipated could increase (reduce) inflationary pressures from the demand side.

iii) As recently observed, the high volatility of fruits and vegetables prices.

Despite these risks, others have eased in the last months. In particular, the possibility that a greater pass-through to prices related to both fiscal changes and public price and fare increases has diminished, as well as that of a greater rate of adjustment in goods and services with administered and regulated prices.

After analyzing the development of inflation in Mexico over the last years, as well as its outlook for the following ones, the following thought arises. It is well known that inflation is a monetary phenomenon and therefore central banks are entailed to fight it. However, in the short term many other factors might affect inflation and make difficult the attainment of the inflation target set implicitly or explicitly by the central bank or by society itself. In this regard, it is clear that a key element to maintain low and stable inflation is sound public finances.

Nevertheless, various microeconomic policies can also affect inflation dynamics. Two particularly relevant issues in this regard are the degree of economic competition and the presence of labor market rigidities.

First, besides preventing resources from being allocated efficiently and modern technologies from being adopted more rapidly -which consequently hampers productivity and economic growth- the lack of competition leads to excessively high prices of inputs and finished goods, affecting the distribution of income and magnifying rigidities in the inflationary process. This, in turn, can make more difficult the convergence of price growth to the central bank target.

Second, the lack of flexibility in the labor market not only complicates labor mobility towards its more productive uses, but also translates into higher labor costs, which also leads to higher prices of various goods and services produced in Mexico.

It is precisely this type of measures and not the fluctuations in the nominal exchange rate that will ensure the Mexican economy remains competitive.

Under this setting, it is crucial to promote both market competition and flexibility in allocating labor. The approval of the draft proposal to reform the Law on Economic Competition and the Labor Law currently under discussion would be a significant step in this direction.

Finally, regarding monetary policy, Banco de México's Board of Governors will carefully monitor the trajectory of medium and long-term inflation expectations as well as other determinants of inflation that may signal unexpected and widespread pressures on prices. In particular, it will remain attentive of how fast the output gap closes so that the central bank adjusts monetary policy in order to attain the 3 percent inflation target by the end of next year.