

# Annual Report 2012

## Summary

The world economic recovery in 2012 was lower as compared to the previous year, among other factors, due to the deleveraging process in major advanced countries, the difficulties in the Euro zone and the uncertainty regarding the magnitude of the fiscal adjustment anticipated for 2013 in the U.S. The slowdown of the world economy was widespread. In particular, the world economic growth rate, which shifted from 4.0 percent in 2011 to 3.2 percent in 2012, affected both advanced and emerging economies, though the latter kept expanding at a greater pace than the former.

World inflation observed a downward trend during most of 2012, given the slowdown of the world economic activity and lower international commodity prices. In this context, the monetary policy of the advanced and most emerging economies became more accommodative in 2012. It should be noted that in an environment of the benchmark interest rates close to zero, the central banks of some of the main advanced economies also adopted additional unconventional measures so as to support the recovery of the economy and employment.

International financial markets registered high volatility during the second and most of the third quarter of 2012, mainly due to the aggravation of the difficulties in the refinancing of different Euro zone countries, given the doubts regarding the ability of some of the region's countries to reach their fiscal consolidation targets. This, together with the detriment of the world economic growth outlook, was reflected in the worsening of the international financial market conditions. Nonetheless, in the last months of the year the financial markets improved significantly, mainly as a result of further monetary stimulus measures in the major advanced economies, of the announcement of the European Central Bank measures to support liquidity and to improve the functioning of the sovereign debt and interbank markets in the Euro zone, and of the progress towards the financial and banking integration of the region. It is noteworthy that throughout 2012 the referred measures were fundamental to sustain the economic recovery and to

avoid fragmentation in international financial markets.

Greater volatility in international financial markets in the second and most of the third quarter of 2012 contributed to increased demand for low-risk assets. However, the improvement observed in the last months of the year in these markets was reflected in a rebound in capital flows to emerging markets. This led to the currency appreciation and an improvement in the stock markets in most emerging economies.

The strength of the macroeconomic fundamentals in Mexico allowed the national economic activity to observe a positive trend and to register an annual GDP growth of 3.9 percent in 2012. Nevertheless, the world economic slowdown and the volatility in international financial markets led to a slower growth rate of the productive activity in Mexico in the second half of the year with respect to the first one. Particularly, this global environment brought about lower exports' growth rates and the spread of this shock to some domestic demand components.

In this environment, no aggregate-demand related pressures on prices or the country's external accounts were observed. This was perceived in the behavior of different indicators related to the slack conditions prevailing in the economy in 2012, particularly, to the absence of demand-related pressures on the main input markets, e.g. the labor and the credit markets. In that regard, it should be noted that the economic growth rate in 2012 led to the output gap persisting close to zero.

Since the end of the 1990s annual headline inflation has been converging towards the 3 percent target established by Banco de México. Thus, this indicator concluded 2012 within the variability interval of plus/minus one percentage point around the established target. At the end of 2012, annual headline inflation located at 3.57 percent, while in December 2011 it was 3.82 percent. Nonetheless, throughout 2012 annual headline inflation was affected by transitory shocks, with a special impact produced on agricultural goods' prices and merchandise prices, and which started to dissipate towards the last quarter of the year. These factors

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brought about a temporary rebound of headline inflation, locating it at levels above 4 percent over the period of several months. Subsequently, in the last quarter of the year it resumed its convergence trend towards the 3 percent permanent inflation target, once the referred shocks started to dissipate.

Annual core inflation, which represents the main indicator of the medium-term inflation trend, maintained within the interval of plus/minus one percentage point around the 3 percent target throughout the year, indicating that the general price formation process was not contaminated by the abovementioned transitory shocks. In particular, in December 2012 this indicator lied at 2.90 percent, which implied a downward shift with respect to 3.35 percent observed in December 2011. The evolution of the core inflation was affected by the minor annual change of the services subindex –part of the core component, which reflects to a greater extent domestic conditions that affect inflation. At the end of 2012 this variable was 1.15 percent, while in December 2011 it was 2.40 percent.

improvement in Mexico's economic fundamentals in recent years have made the national economy more resistant to possible adverse shocks. Since more than a decade ago, a monetary policy aimed at preserving the stability of the national currency purchasing power and a prudent fiscal management have allowed to advance considerably in controlling inflation, which became clear in 2012. As mentioned before, a series of supply-related shocks affected the national economy and resulted in a transitory inflation rebound in 2012. However, the changes in relative prices related to these shocks took place in an orderly manner and without contaminating the price and wage formation process in the economy. Considering the abovementioned, and given that the medium- and long-term inflation expectations remained stable, Banco de México's Board of Governors decided to maintain the target for the Overnight Interbank Interest Rate at 4.5 percent in 2012.

The strengthening of the framework for the macroeconomic policy conduction and the