Inflation Report

April - June 2013

Summary

Banco de México's actions contributed to generating an environment of credibility regarding the efforts to curb inflation in Mexico. In recent years, the virtuous circle between the price formation process and the anchoring of inflation expectations, which are increasingly less affected by the relative price adjustments, strengthened. In this context, in the second quarter of 2013 it was confirmed that the inflation uptick at the end of the first quarter was temporary.

Hence, over the period analyzed by this Inflation Report, Banco de México's Board of Governors decided to maintain unchanged its target for the Overnight Interbank Interest Rate at 4 percent. This decision was made after having considered the recent evolution of inflation and its outlook, the important deceleration of the Mexican economy, the fragile international environment as well as the volatility in international financial markets.

Following a rebound in March and April 2013, annual headline inflation began a downward trend from May onwards. This headline inflation dynamics mainly reflected the non-core inflation evolution, which was temporarily affected by the change in the relative price of a reduced group of goods. Alongside with this, annual core inflation continued to locate below 3 percent, even with a slight downside trend. Thus, the inflation evolution, supported by the monetary policy stance, confirms the continuity in its convergence to the 3 percent permanent target.

In the second quarter of 2013, the slowdown of the Mexican economy, which had been observed since the second half of 2012, intensified. This loss of dynamism derives from a series of adverse shocks, both domestic and external, which have amplified the slack in the economy.

The above took place in a context of persisting considerable downward risks to the global economy. Specifically, international trade kept weakening and the global growth continued to slow down, although considerable differences prevail, on the one hand, among the main advanced economies, and, on the other hand, between these and the emerging ones. Therefore, given the greater weakness of the world economy and lower international commodity prices, an outlook of low inflation in a number of countries is expected.

In the second quarter of 2013, the U.S. Federal Reserve announced that, if the employment recovery and an inflation trend congruent with its long-term target persist, it could start to reduce the pace of asset purchases in the second half of the year. This generated increases in risk premia and, consequently, higher medium- and long-term interest rates in the U.S. Moreover, given the global importance of the U.S. financial conditions, long-term interest rates in other economies also increased in a context of high volatility in international financial markets.

Although all emerging markets were affected by the referred volatility, its impact was lower in those characterized by better macroeconomic fundamentals, as is the case of Mexico. Thus, adjustments in the domestic exchange rate and fixed-income markets took place in an orderly manner. In this regard, in addition to the monetary policy contribution, the soundness of public finances should be noted, highlighting the fiscal consolidation effort anticipated for this year. Hence, despite the abovementioned turbulence and the transitory inflation increase, its evolution expectations and the inflationary risk premium have remained stable.

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

Growth of the Mexican Economy: The slowdown of the Mexican economy, observed since the second half of 2012, accentuated in the second quarter of 2013. This loss of dynamism was faster and more profound than anticipated, in an environment of lower growth rates in different emerging economies. Thus, even though the economic activity is expected to strengthen in the second half of 2013, driven by enhanced public spending, greater growth of the U.S. economy and the recovery of private domestic demand, weakness of the economic activity in Mexico in the first half of the year makes necessary a revision of the GDP growth forecast in Mexico for 2013 as a whole. Hence, the forecast interval for the GDP growth rate in Mexico for 2013 is revised down from one of 3.0 to 4.0 percent in the previous Inflation Report to one of 2.0 to 3.0 percent (Chart 1a).

On the other hand, different aspects related to the world economy point to weakness of external demand and downward risks to growth in 2014. In particular, as compared to what was expected in the previous Inflation Report, a gradual increase in international interest rates is currently anticipated, although volatility periods cannot be ruled out. Furthermore, there is little room in the global economy to considerably expand public expenditure, the economic activity in Europe remains weak and emerging economies have been slowing down. These factors, together with a less favorable performance of the Mexican economy in the first half of 2013, could be reflected in lower expectations for the growth of the Mexican economy in 2014. Nevertheless, these conditions will tend to be offset by the relatively greater U.S. economic growth estimated for that year, and by the favorable impact of the recently approved structural reforms, such as the labor reform, the economic competition reform and the telecommunications reform, onto the potential growth of the Mexican economy. Thus, despite the relatively adverse international environment, for 2014 the forecast interval for the GDP growth rate remains unchanged with respect to the previous Inflation Report at 3.2 to 4.2 percent (Chart 1a).

Employment: In line with the revision of expected GDP growth, an increase of 450 to 550 thousand IMSS-insured workers is anticipated for 2013, as compared to a range of 550 to 650 thousand insured workers expected in the last Inflation Report. For 2014, in line with the forecast of the previous Inflation Report, an increase of 700 to 800 thousand IMSS-insured workers is estimated.

Current Account: For 2013, the expected deficits in the trade balance and the current account amount to USD 2.7 and 15.6 billion, respectively (0.2 and 1.2 percent of GDP). For 2014, deficits in the trade balance and the current account of USD 4.9 and 17.9 billion are estimated, respectively (0.4 and 1.3 percent of GDP). It is noteworthy that the expected moderated current account deficits, as well as the measures taken by the Mexican Federal Government to finance its external debt liabilities suggest that financing these deficits will not pose a problem in the forecast horizon and that there will be no pressures on the exchange rate arising from this source.

In line with the forecasts for the evolution of the Mexican economy, no aggregate demand-related pressures on inflation or the current accounts are anticipated. In particular, the output gap, that had been diminishing, is expected to gradually recover in the second half of 2013 and to remain at levels close to zero in 2014 (Chart 1b). Thus, the current cyclical phase of the economy is estimated to contribute to consolidating the downward inflation trend.

In addition to the fact that the Mexican economic growth outlook in the short term has become more unfavorable, downward risks have also increased. Among the main risks, the following should be pointed out:

I. The possibility that external demand remains without presenting a solid recovery. In this sense, in the case of lower than expected U.S. expansion rate or if the U.S. growth keeps concentrating in the sectors that normally do not represent a relatively important impulse for Mexican exports, an environment of low growth could prevail in Mexico.

II. In an environment in which decompression of risk premia is anticipated to persist in the U.S. financial markets, an abrupt adjustment in the emerging economies' financial markets, with a consequent adverse effect on the economic activity, cannot be ruled out.

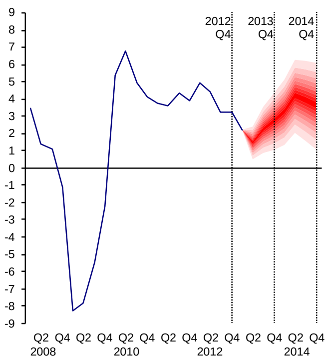
III. Lack of consolidation of the reforms required for Europe to resume its sustainable growth trend could extend the recession in the region, which could, in a more noticeable way, affect global demand and international financial markets.

In contrast, the reactivation of public spending on investment expected for the second half of the year could generate an environment of lower uncertainty that would induce higher spending of the private sector.

Likewise, progress in the process of structural reforms could also contribute to a more favorable environment for growth.

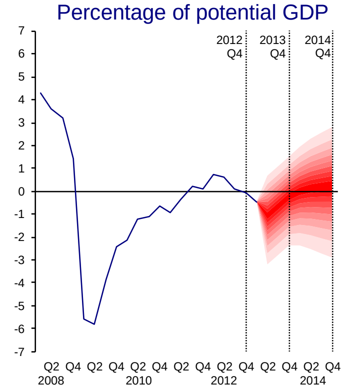
Fan Charts 1

a) Annual GDP Growth Rate, s. a.
Percent



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

b) Output Gap Estimate, s. a.
Percentage of potential GDP

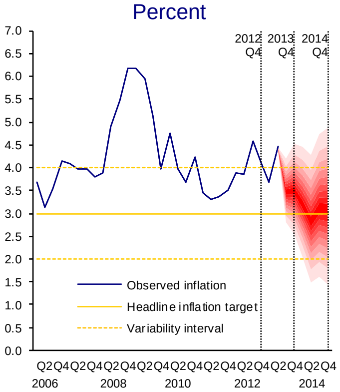


s. a. / Based on seasonally adjusted figures.
Source: Banco de México.

Inflation: Taking into account the economic activity evolution and the monetary policy stance established by the Board of Governors, inflation is anticipated to present a convergence trend towards the 3 percent target over the next quarters. In particular, the forecast for annual headline inflation for the rest of 2013 and 2014 is slightly below with respect to the one of the previous Inflation Report. From July onwards, annual headline inflation is anticipated to locate close to 3.5 percent, fluctuating over the next months and concluding 2013 around this level. In 2014 inflation will resume its downside trend to locate close to 3 percent at the end of the year (Chart 2a). In line with the forecast for annual core inflation, for the rest of 2013 and 2014 this variable will remain below 3 percent (Chart 2b).

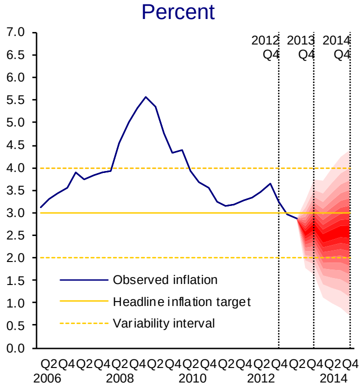
Fan Charts 2

a) Annual Headline Inflation 1/
Percent



1/ Quarterly average.
Source: INEGI and Banco de México.

b) Annual Core Inflation 1/
Percent



1/ Quarterly average.
Source: INEGI and Banco de México.

These forecasts are congruent with the current phase of the economy and, therefore, with the slack prevailing in input markets, reasons for which no demand-related inflationary pressures are anticipated. By virtue of the abovesaid and considering the low pass-through of exchange rate adjustments onto inflation, the recent depreciation of the national currency is not estimated to generate inflationary pressures. In sum, the forecast inflation trajectory lies very close to 3 percent within the horizon at which the monetary policy operates. In this sense, the monetary policy is congruent with the inflation convergence towards the permanent target set by Banco de México.

In line with the forecast for annual core inflation, the annual change of the merchandise prices is estimated to persist around or even under 3 percent and that of the services' prices, below that level in the forecast horizon, which is particularly relevant, given that, as indicated before, it is this price subindex that better reflects the domestic conditions affecting inflation. Considering that practically since December 2012 annual core inflation remained below 3 percent, this forecast implies a considerably long period (2 years), over which the referred indicator is anticipated to remain close to its minimum historical levels. This is another proof of the progress in the convergence process of inflation towards its 3 percent target.

The forecast considers the downward trend of annual non-core inflation given the expectation of larger agricultural production in 2013 with respect to 2012 and in light of a downward trend in the international prices of food commodities. Additionally, the fading of the effect produced by the higher egg price on the annual growth rate of this subindex is expected.

In light of the recent inflation trajectory and the presented forecasts, the balance of risks for inflation is considered to have improved with respect to the previous quarter. Nonetheless, the anticipated trajectory of this variable could be affected by some factors, among which the following stand out:

1. The possibility that the weakness of the Mexican economic activity could continue in the second half of 2013, which could generate downward demand-related pressures.
2. Higher exchange rate volatility given the new conditions in international financial markets, which could affect inflation both upwards and downwards. Nonetheless, as stated above, the pass-through of the exchange rate fluctuations on inflation has been low, reason for which the impact on inflation would be limited, even more so if the period of slackness in the economy is extended.
3. In the medium-term, the possibility of stronger market competition in the economy, derived from progress in the process of structural reforms, which could contribute to lower inflation.
4. Adverse weather or sanitary conditions, which would lead to upward adjustments in the agricultural products' prices, or new adjustments in public prices. Insofar as these shocks have a clearly identified origin, the impact on inflation is expected to be transitory and no second round effects are anticipated.

Considering the recent performance of inflation and its outlook, a major deceleration of the Mexican economy, weakness of the international environment and volatility in international financial markets, the Board of Governors considers the monetary policy stance to be congruent with an environment in which no widespread pressures on inflation are expected, and in which the growth rate of spending in the economy is anticipated to be in line with the convergence of inflation towards its 3 percent target in the medium term. In any event, the Board will monitor the implications of the economic activity performance and the monetary stance of Mexico relative to other countries onto the inflation outlook. It will also remain alert so that the relative price changes do not affect the price formation process in the economy. All of the above, in order to take action, if required, so as to reach the abovesaid permanent inflation target.

Finally, it should be noted that the downward revision of the GDP growth forecast for 2013, largely due to the lack of impulse from abroad, should strengthen the conviction for the pressing need to proceed with the structural reforms in Mexico. Unfortunately, it is clear that over the next years the world economic situation can hardly be expected to improve to such an extent that it would make the Mexican economy expand above the interval forecast in this Inflation Report for 2014, particularly, that of 3.2 to 4.2 percent. The referred growth interval is clearly insufficient to reduce the unemployment rate to levels comparable to the pre-crisis ones, to create better-paid jobs and to combat poverty in a fast and sustainable manner. Hence, it is imperative to increase the potential GDP growth rate of the country to levels above 5 percent in the medium term, for which it is necessary to properly implement the already legislated reforms and to carry out the pending ones, the energy, fiscal and financial reforms standing out among them.