



# Inflation Report

April–June 2013

August 7, 2013



BANCO DE MÉXICO

# Outline

**1**

**External Conditions**

**2**

**Economic Activity in Mexico**

**3**

**Monetary Policy and Inflation  
Determinants**

**4**

**Forecasts and Balance of Risks**

# External Conditions

## Global Environment in 2Q 2013

### Growth

- ✓ *International trade kept weakening and the world economy continued showing a deceleration.*
  - ➔ ***Considerable downward risks to the global economy persist.***

### Inflation

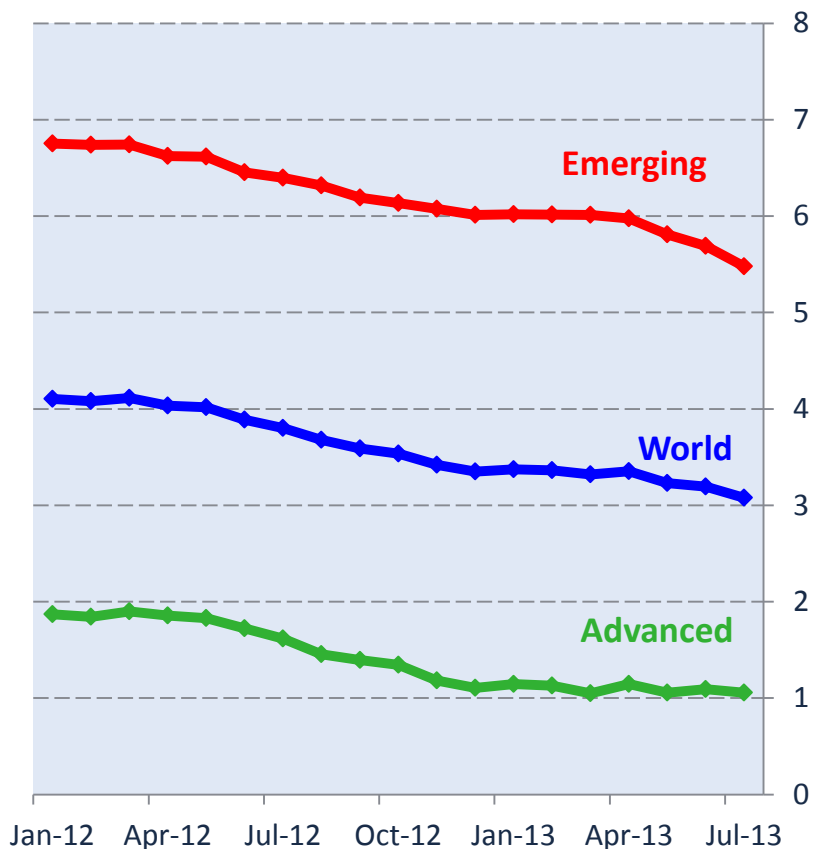
- ✓ *In light of further weakness of the global economy and lower commodity prices:*
  - ➔ ***An outlook of low inflation is anticipated.***

### Monetary Policy

- ✓ *Desynchronization of the monetary policies of the main advanced economies' central banks.*
  - ***The expectation that the U.S. Federal Reserve could reduce the pace of asset purchases.***

# The downside revision of the growth forecasts for 2013 continued. International trade kept losing dynamism, affecting industrial activity at the global level.

**GDP Growth Forecast for 2013 <sup>1/</sup>**  
Annual % change



<sup>1/</sup> An average per region is calculated, weighting the participation of each country's GDP based on purchasing power parity relative to total world GDP. Source: Estimated by Banco de México with data from the International Monetary Fund and Consensus Forecasts.

**World Trade and Industrial Production**  
Annual % change; s.a.

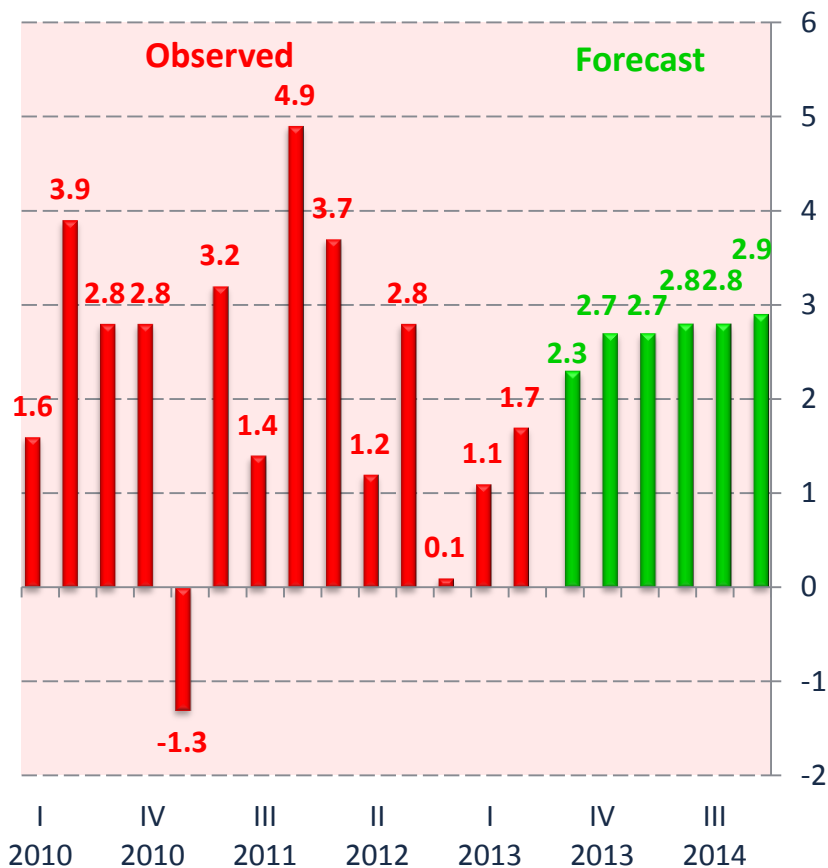


s.a./ Seasonally adjusted data.  
Source: CPB Netherlands.

# The U.S. economy continued to recover in 2Q 2013. Particularly, employment kept improving.

## Gross Domestic Product

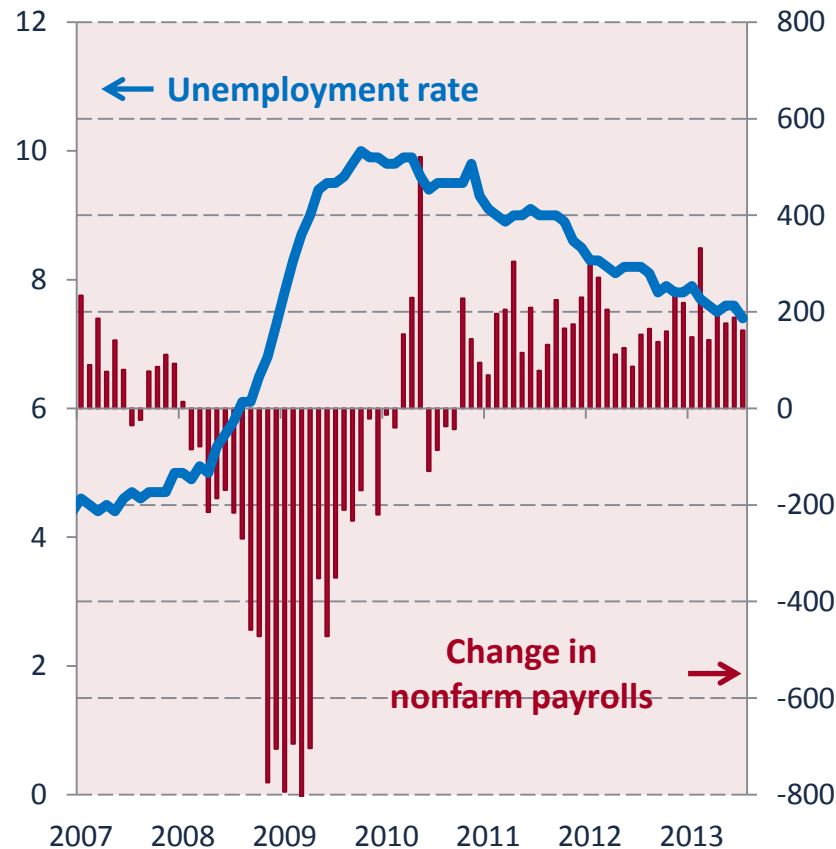
Quarterly growth at annual rates %; s.a.



s.a./ Seasonally adjusted data.  
Source: BEA and Blue Chip.

## Change in Nonfarm Payroll and Unemployment Rate

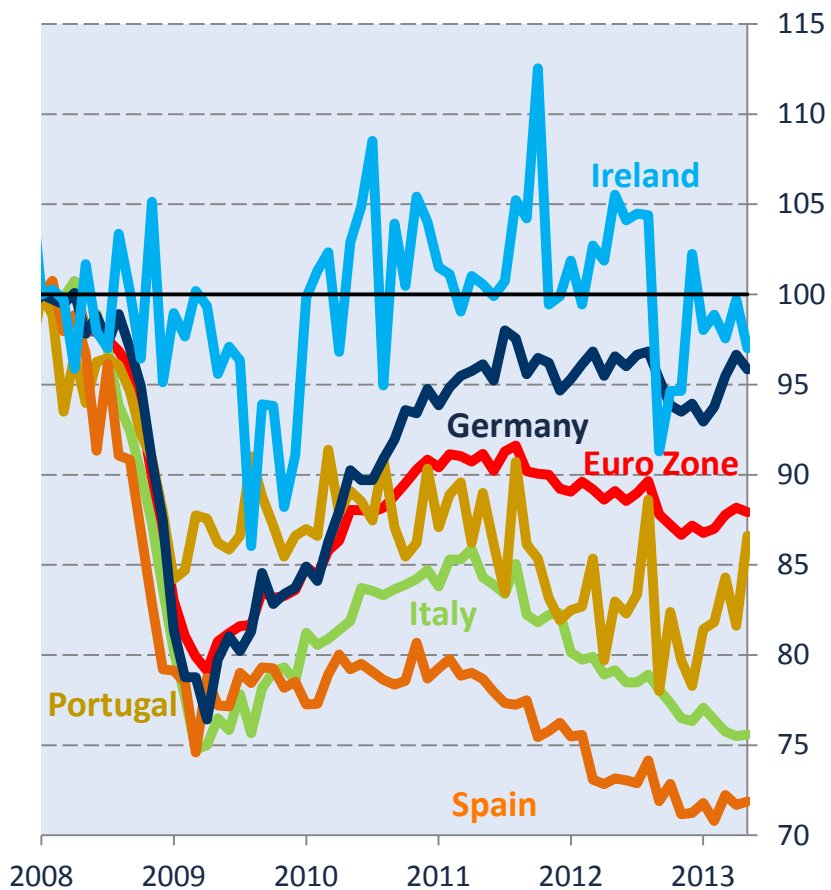
Thousands of jobs and % of EAP; s.a.



EAP: Economically Active Population.  
s.a./ Seasonally adjusted data.  
Source: Bureau of Labor Statistics (BLS).

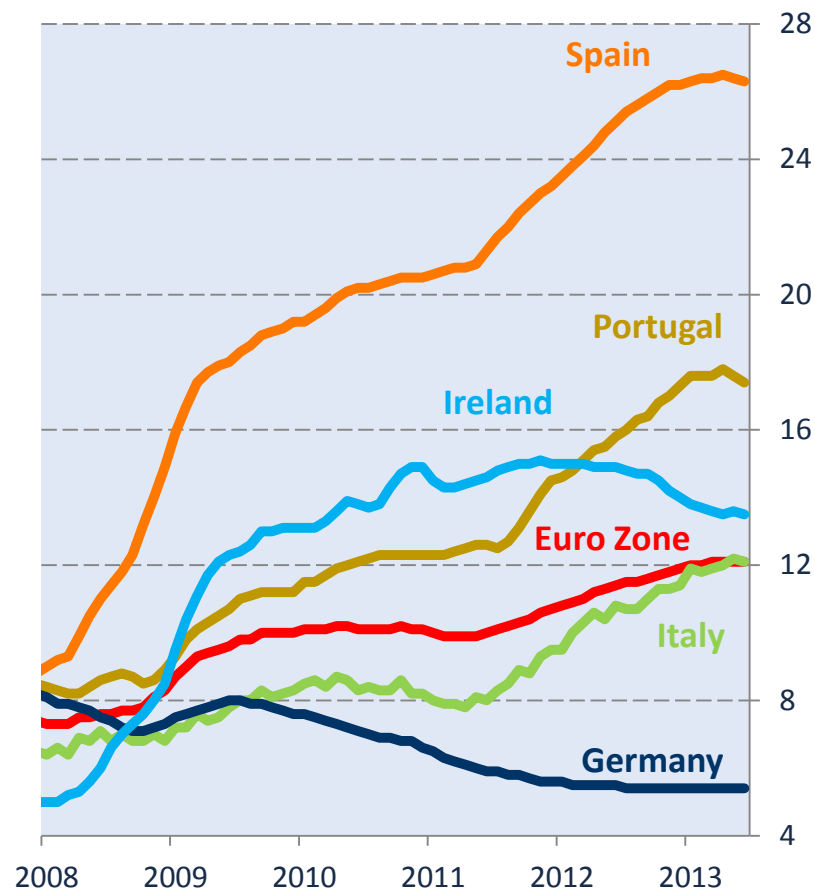
The Euro zone has been going through a period of severe recession since 1Q 2012, although at the margin some economies present certain signs of recovery.

**Industrial Production**  
Index Jan-2008=100; s.a.



s.a./ Seasonally adjusted data.  
Source: Eurostat.

**Unemployment Rate**  
% of EAP; s.a.

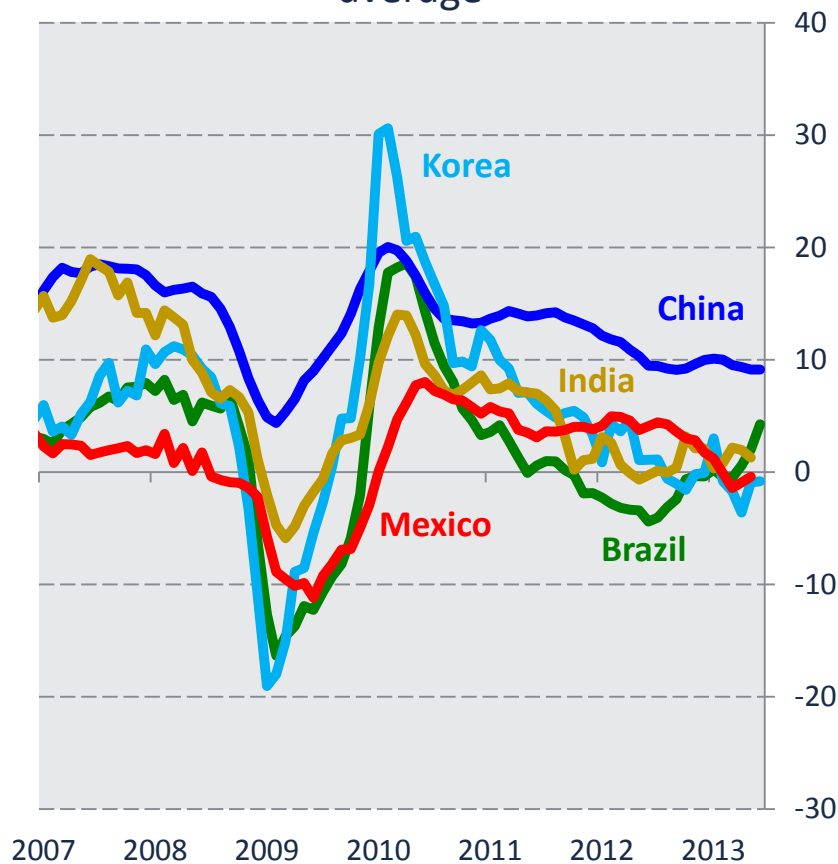


EAP: Economically Active Population.  
s.a./ Seasonally adjusted data.  
Source: Eurostat.

The growth of emerging economies continued moderating, in light of reduced commodity prices and lower dynamism of both domestic and external demand.

### Industrial Production

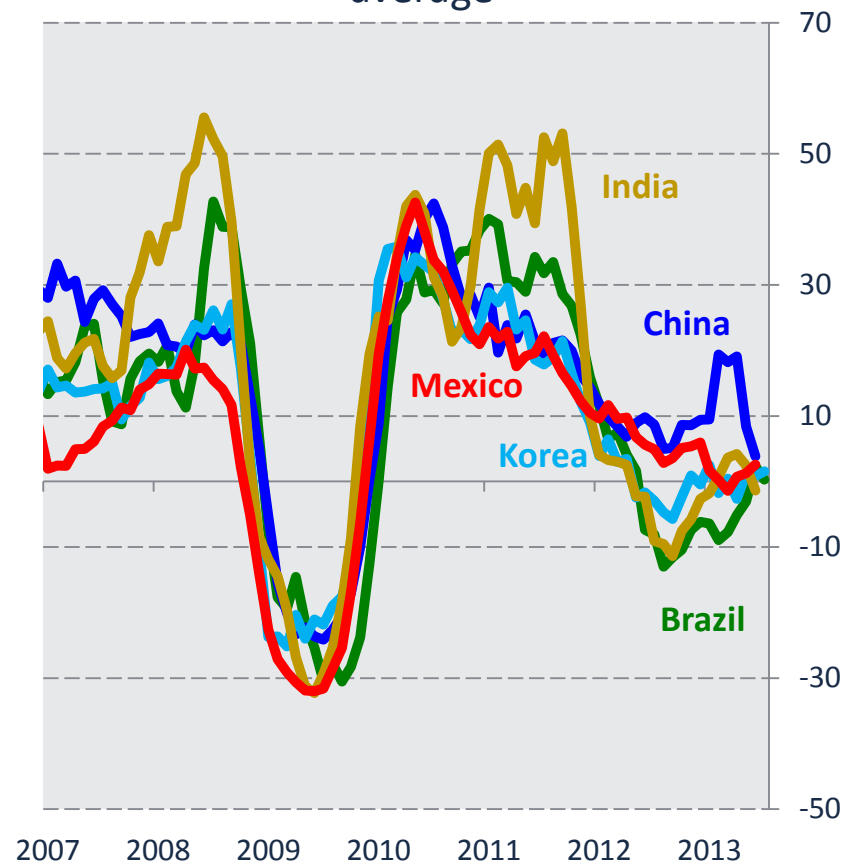
Annual % change of 3-month moving average



Source: INEGI and Haver Analytics.

### Exports

Annual % change of 3-month moving average



Source: INEGI and Haver Analytics.

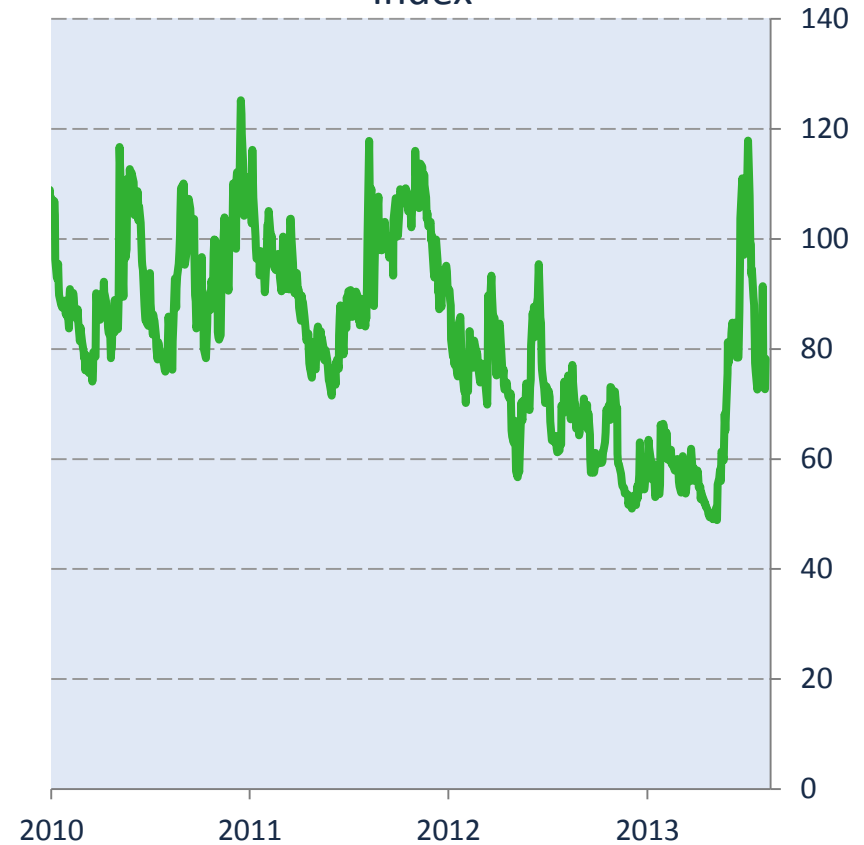
The Federal Reserve announced that it could begin the tapering of asset purchases in 2H 2013, which generated increases in long-term interest rates in the U.S. and other countries, in a context of high volatility in the financial markets.

Advanced Economies 10-year Yields  
%



Source: Bloomberg.

Annual Implied Volatility of U.S. Treasury Securities (MOVE)<sup>1/</sup>  
Index



<sup>1/</sup> MOVE: Merrill Lynch Option Volatility Estimate. Index of the implied volatility on 1-month Treasury *at the money* options on bonds maturing in 2, 5, 10 and 30 years. 'MOVE' is a trademark product of Bank of America / Merrill Lynch.  
Source: Bloomberg.

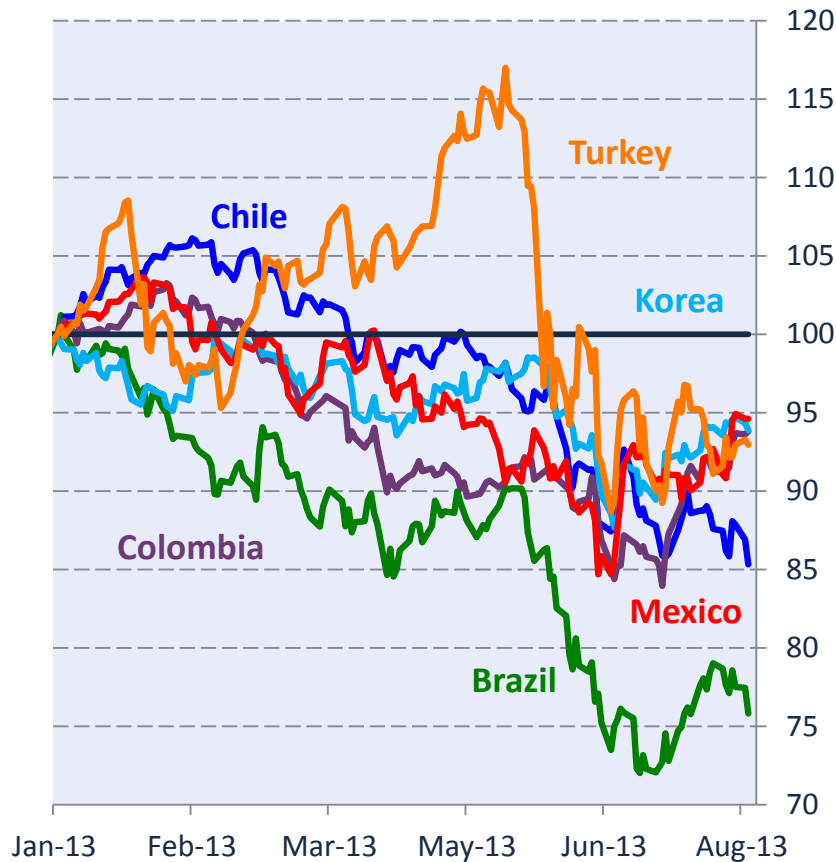


In emerging economies, this announcement, together with a downward revision of their growth prospects, generated falls in their stock markets and a depreciation of their currencies.

## Emerging Economies

### Stock Markets

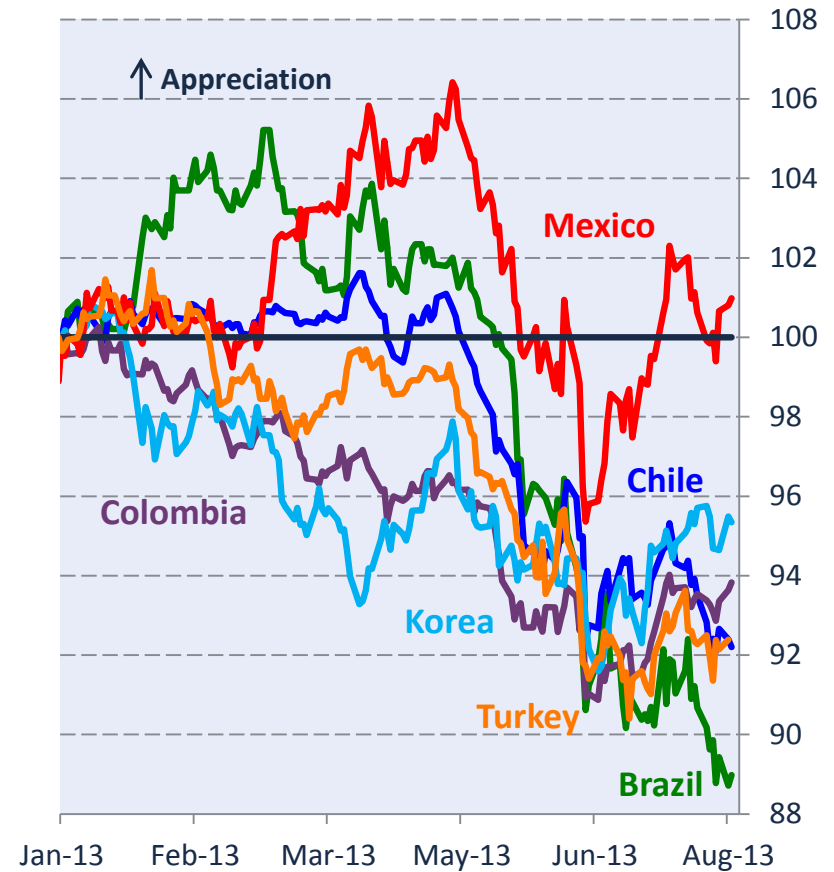
Index 02-Jan-2013=100



Source: Bloomberg.

### Exchange Rate

Index 02-Jan-2013=100

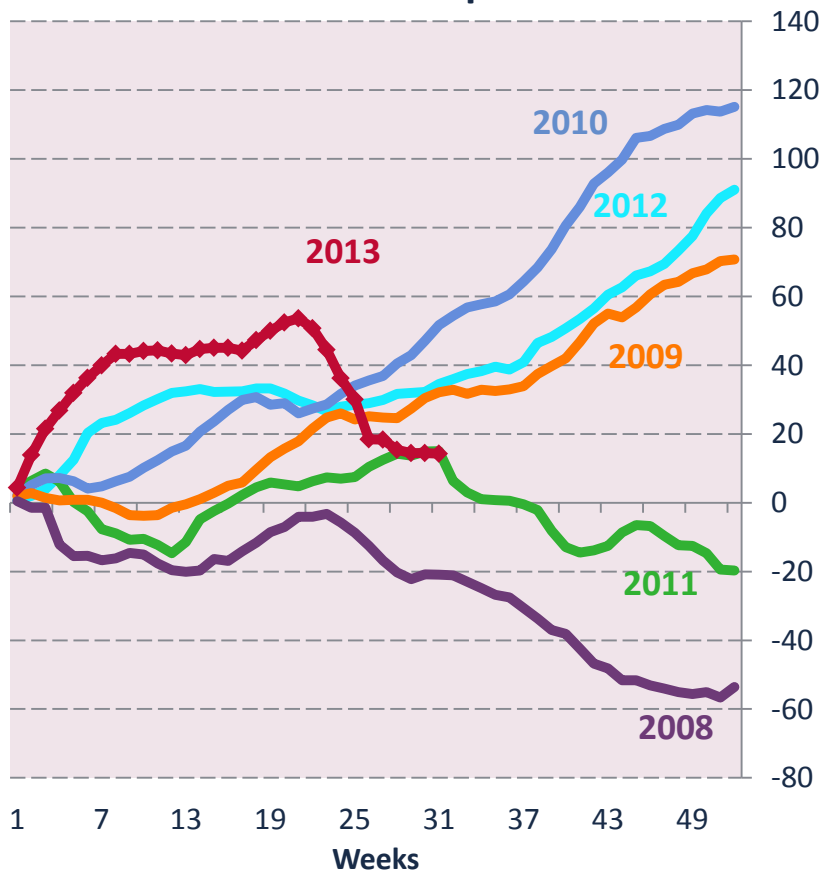


Source: Bloomberg.

In this context, capital outflows from emerging economies have been registered.

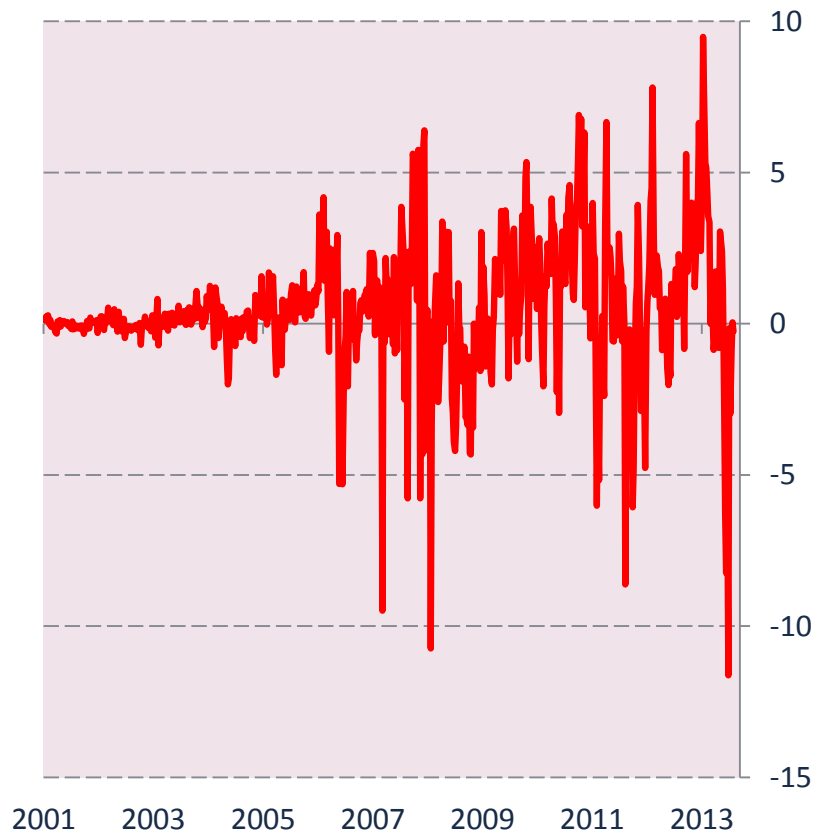
## Emerging Economies: Capital Flows (Debt and Equity) Billions of dollars

### Accumulated Capital Flows



Source: Emerging Portfolio Fund Research.

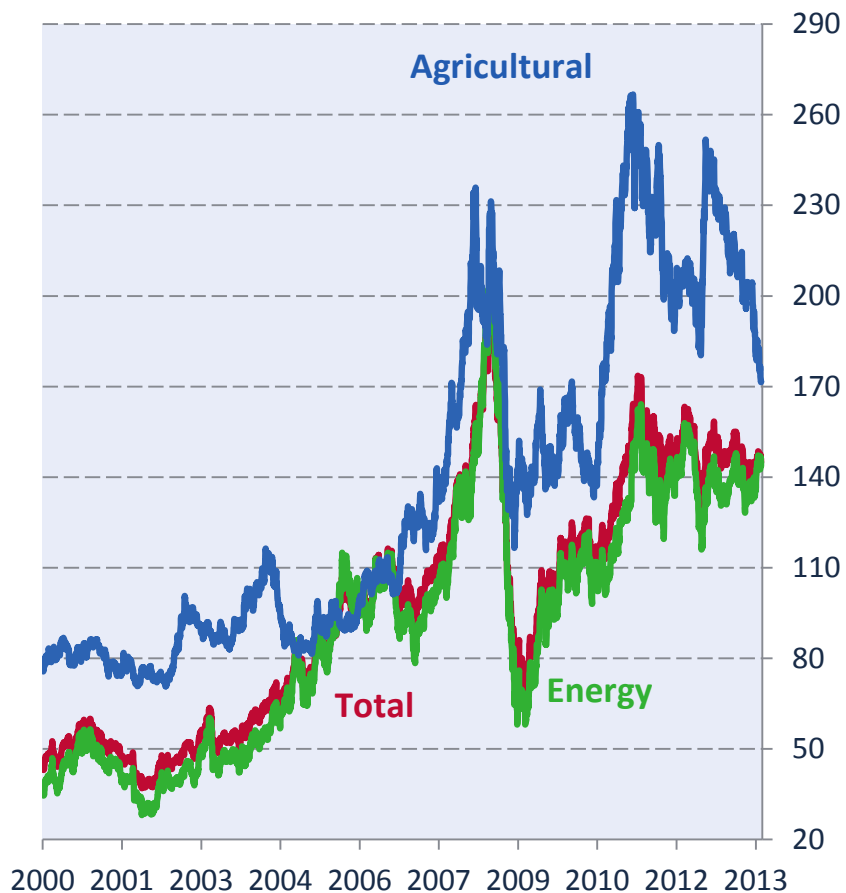
### Weekly Capital Flows



Source: Emerging Portfolio Fund Research.

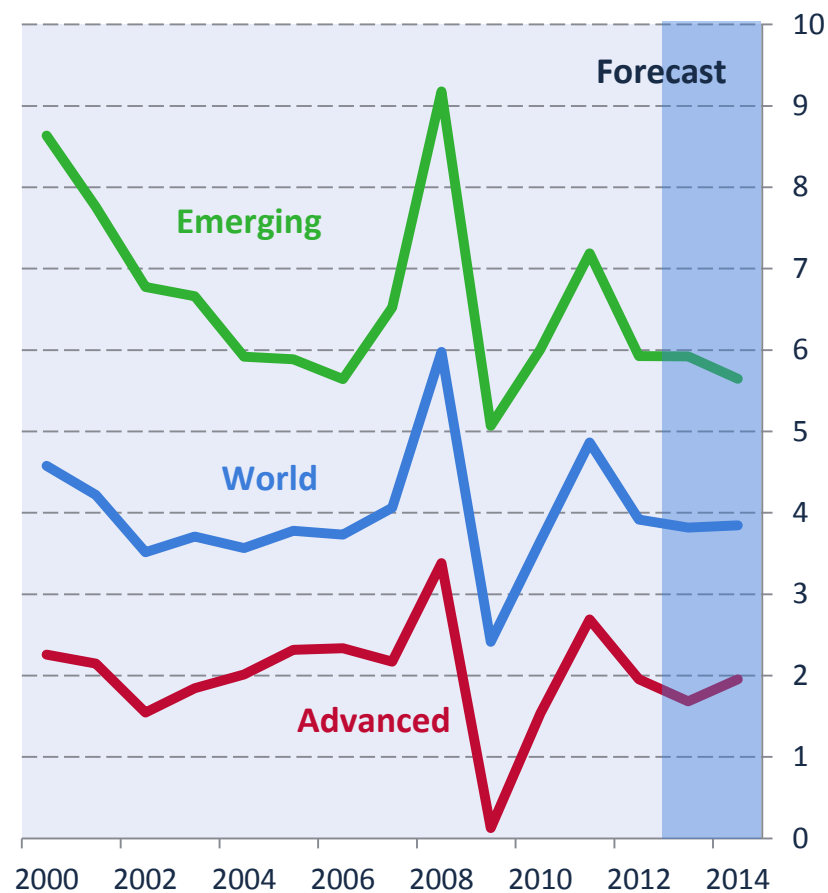
Given the weaker global economy and lower international commodity prices, an outlook of low inflation is anticipated in a number of countries.

**Commodity Prices**  
Index 03-Jan-2006 = 100



Source: Standard & Poor's.

**World Inflation**  
% Annual



Source: International Monetary Fund.

# Outline

**1** External Conditions

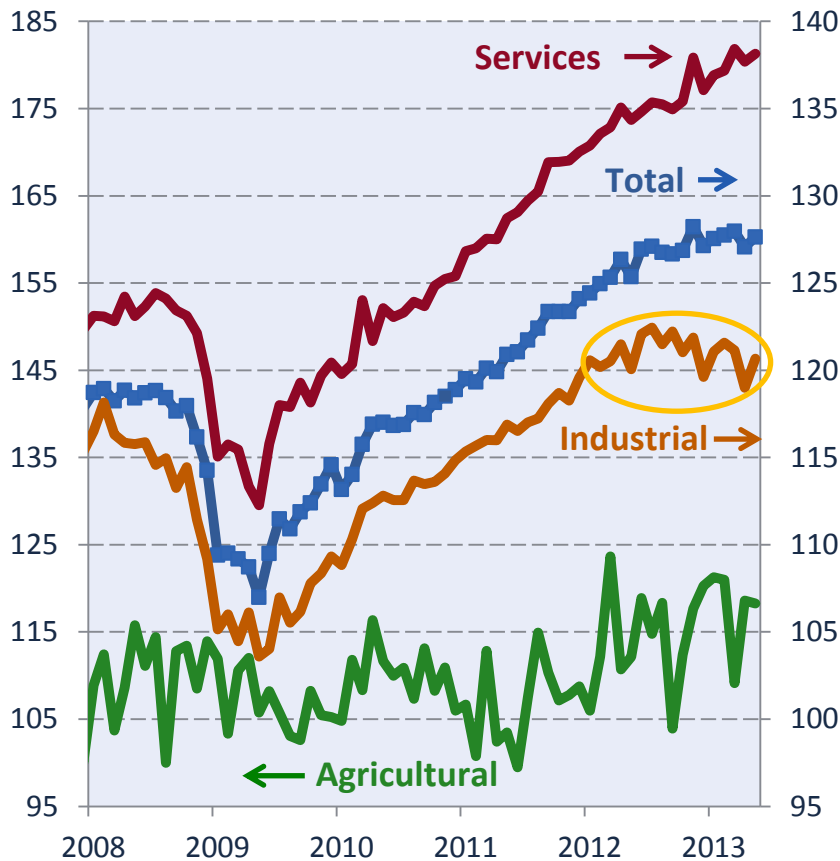
**2** Economic Activity in Mexico

**3** Monetary Policy and Inflation  
Determinants

**4** Forecasts and Balance of Risks

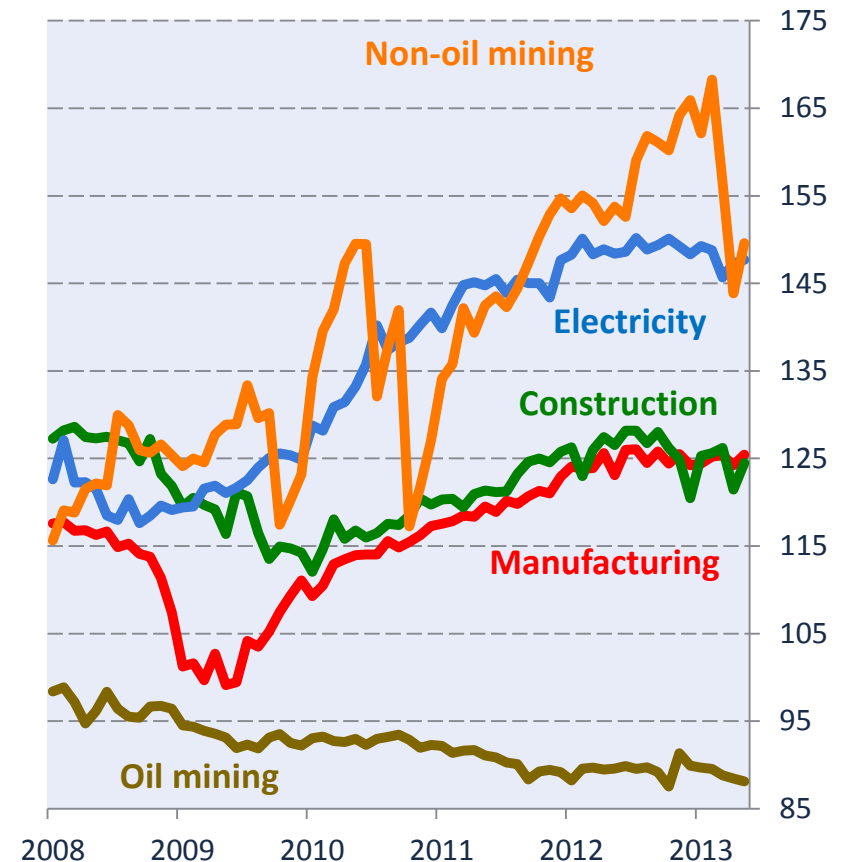
# In 2Q 2013, the deceleration of the Mexican economy, observed since 2H 2012, intensified.

**Global Indicator of Economic Activity (IGAE)**  
Index 2003=100; s.a.



s.a./ Seasonally adjusted data.  
Source: INEGI.

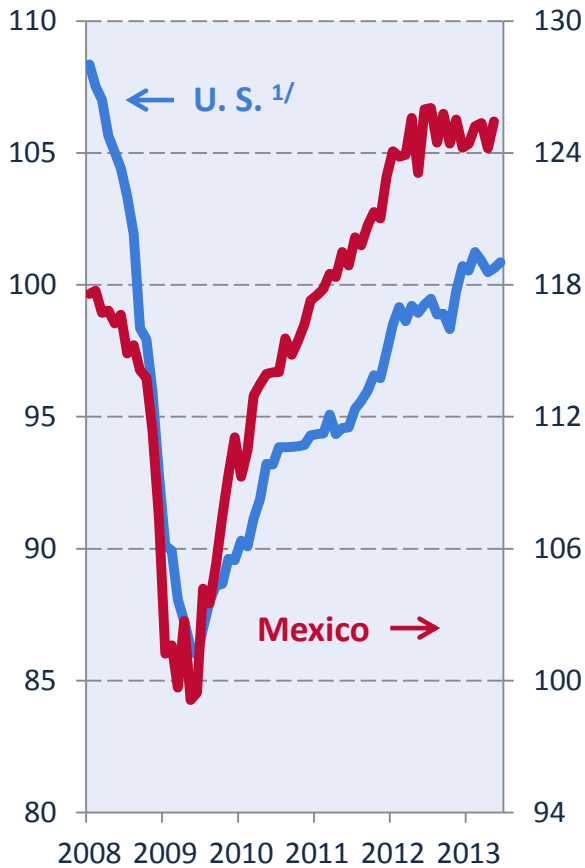
**Industrial Activity**  
Index 2003=100; s.a.



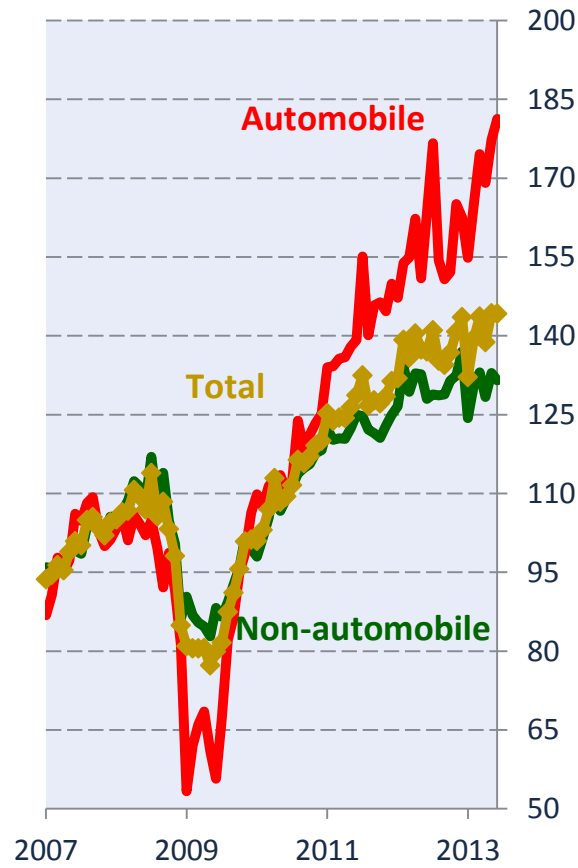
s.a./ Seasonally adjusted data.  
Source: Banco de México.

# Weak external demand, exhibited since mid-2012, was reflected in the stagnation of the Mexican manufacturing production and exports.

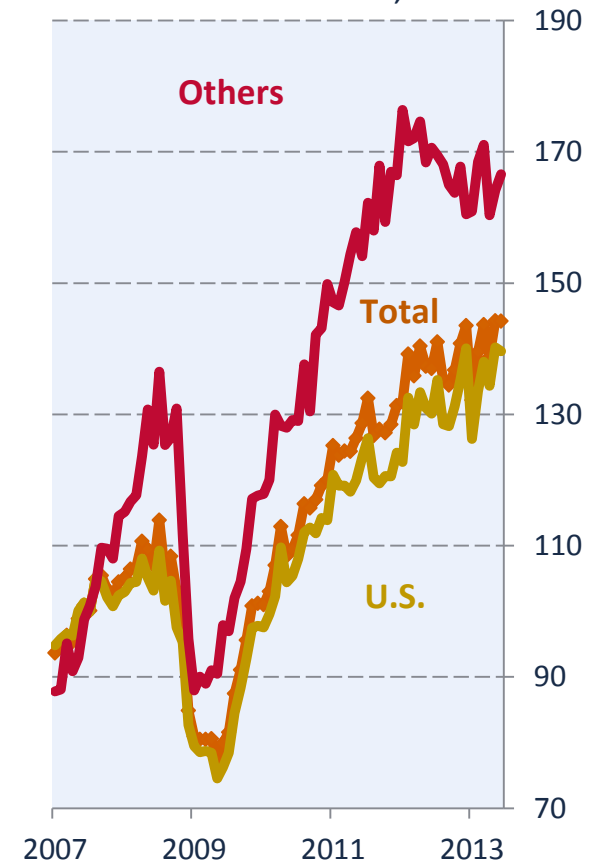
**Manufacturing Production**  
Index 2003=100; s.a.



**Manufacturing Exports**  
Index 2007=100; s.a.



**Manufacturing Exports by Region of Destination**  
Index 2007=100; s.a.



s.a./ Seasonally adjusted data.

1/ Excludes high-technology industries. Available data for Mexico up to May 2013. Source: Federal Reserve and INEGI.

s.a./ Seasonally adjusted data.

Source: Banco de México.

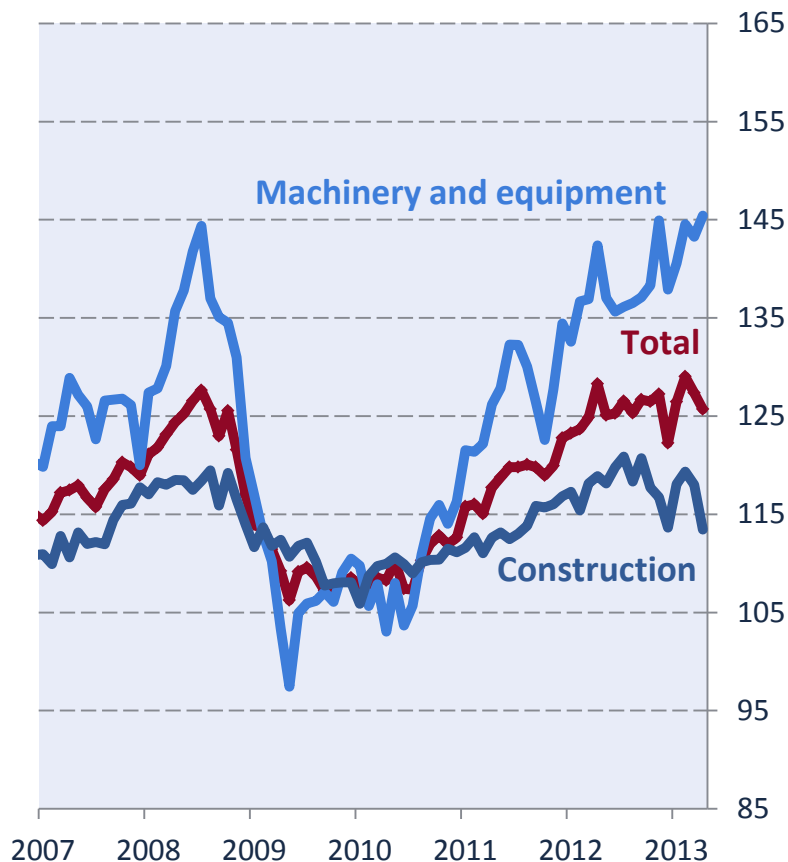
s.a./ Seasonally adjusted data.

Source: Banco de México.

# The recent data suggest that the gross fixed investment kept decelerating in 2Q 2013.

## Investment and its Components

Index 2005=100; s.a.

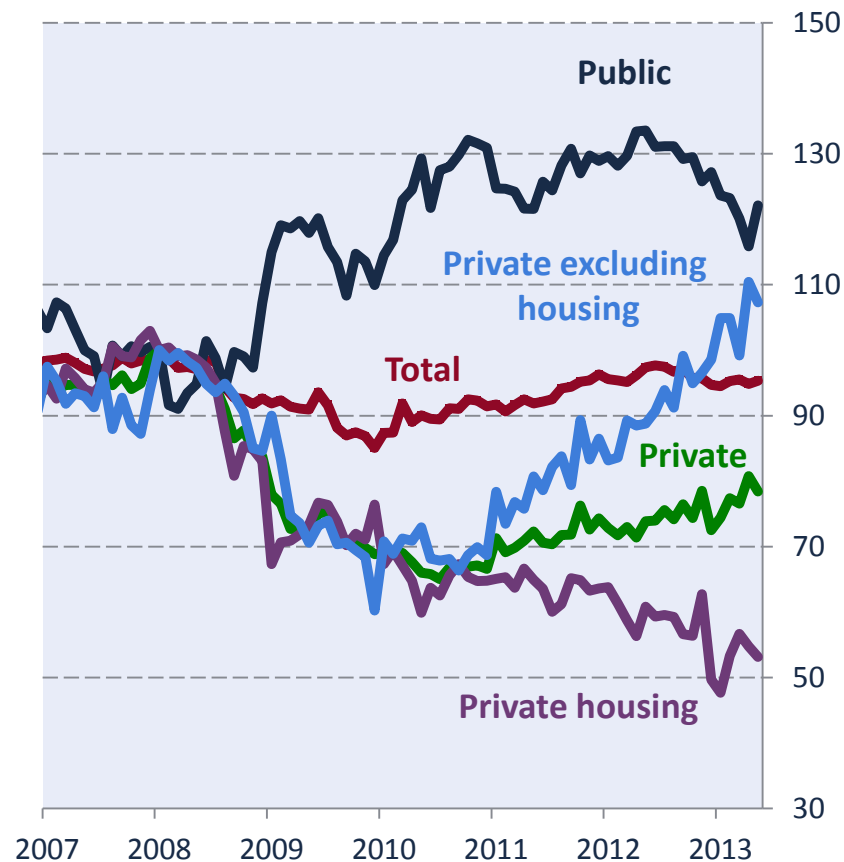


s.a./ Seasonally adjusted data.

Source: Estimated by Banco de México with data from INEGI.

## Real Value of Production in Construction

Index Jan-2008=100; s.a.



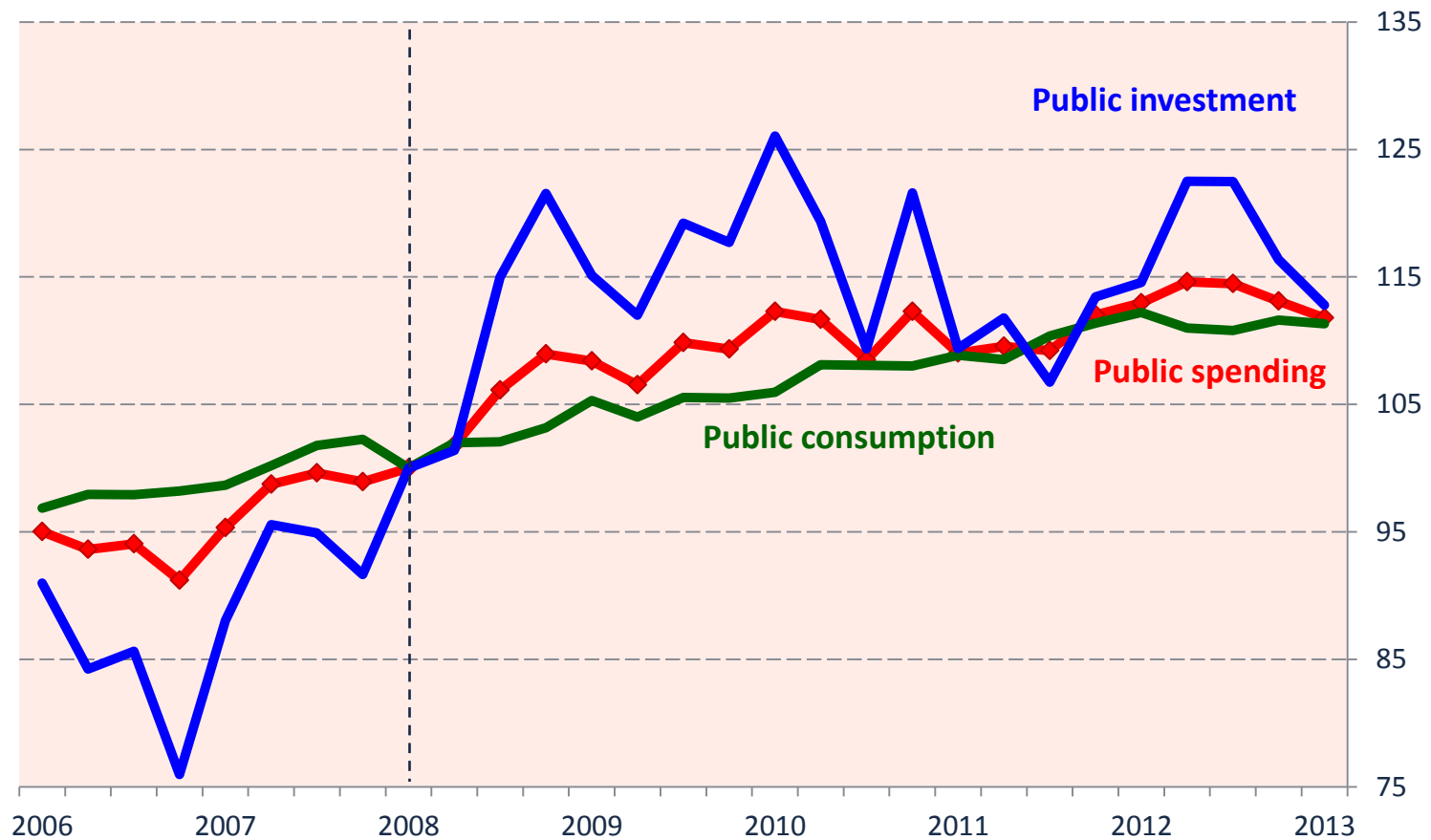
s.a./ Seasonally adjusted data.

Source: INEGI and seasonally adjusted by Banco de México in the case of public and private construction (private housing and private excluding housing).

# Reduced public investment expenditure in the first months of 2013 contributed to lower the growth rate of domestic demand.

## Total Public Spending and its Components

Index I-2008=100; s.a.



s.a./ Seasonally adjusted data.

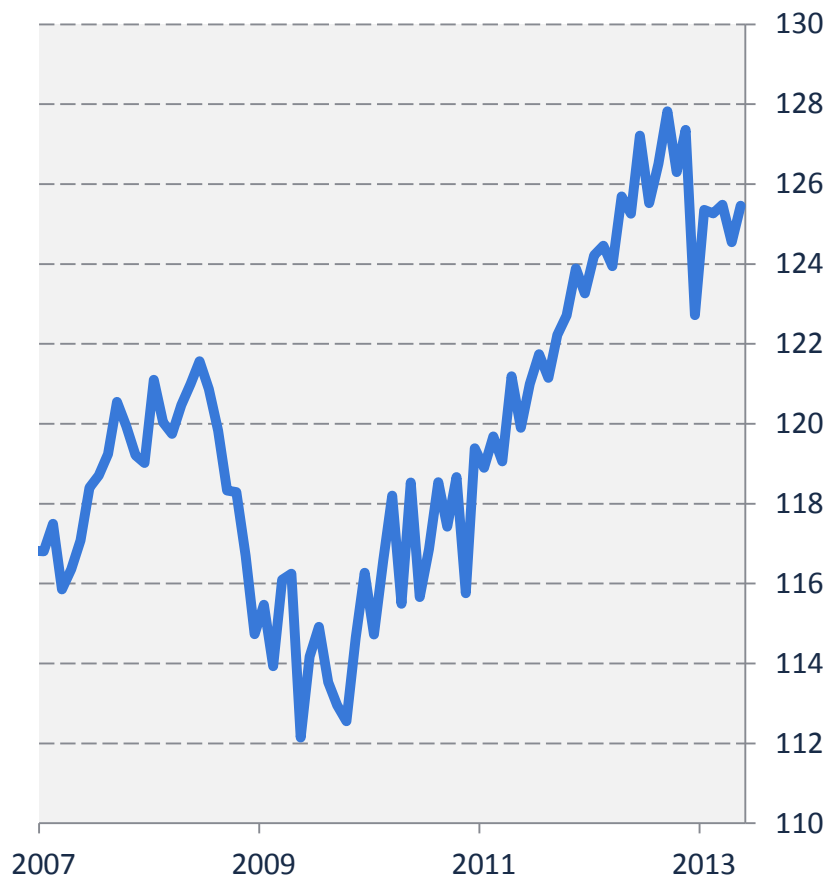
Source: Estimated by Banco de México with data from Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.



# Private consumption continued observing a weak growth rate in 2Q 2013.

## Commercial Establishments' Retail Sales

Index 2003=100; s.a.



s.a./ Seasonally adjusted data.  
Source: INEGI.

## Consumer Confidence

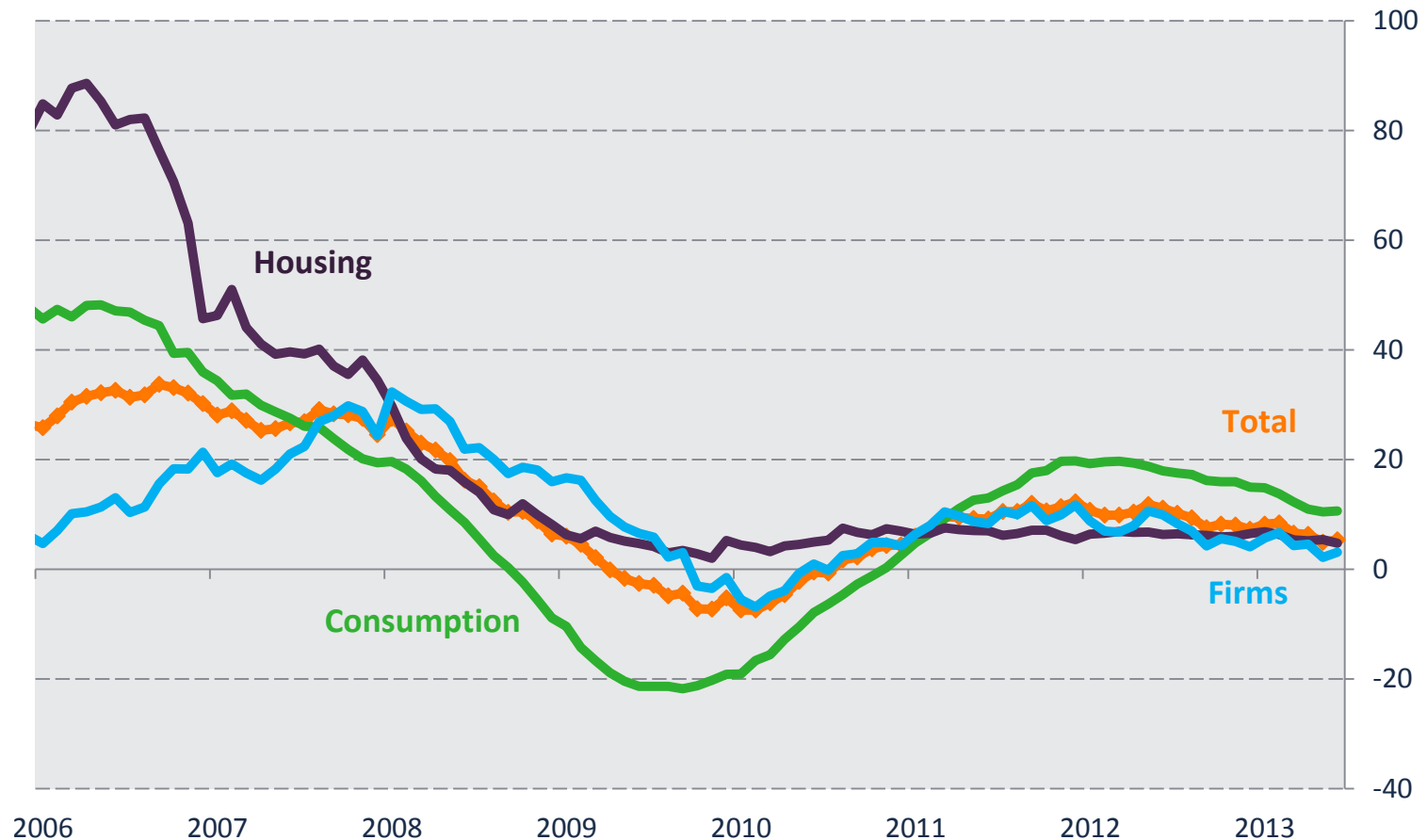
Index Jan-2003=100; s.a.



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

Given the growth moderation of the Mexican economic activity, the soundness of the financial system has been a factor that has partly attenuated the shocks the economy had been going through.

### Commercial Banks' Performing Credit to Non-Financial Private Sector Real annual % change



Source: Banco de México.

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**Banco de México's actions have contributed to generating an environment of credibility regarding the effort to curb inflation.**

In particular, the second round effects have been averted, in light of various episodes of changes in the relative prices that temporarily affected inflation in recent years.



The virtuous circle has strengthened between:

*The price formation process*



*Anchoring of medium- and long-term inflation expectations*

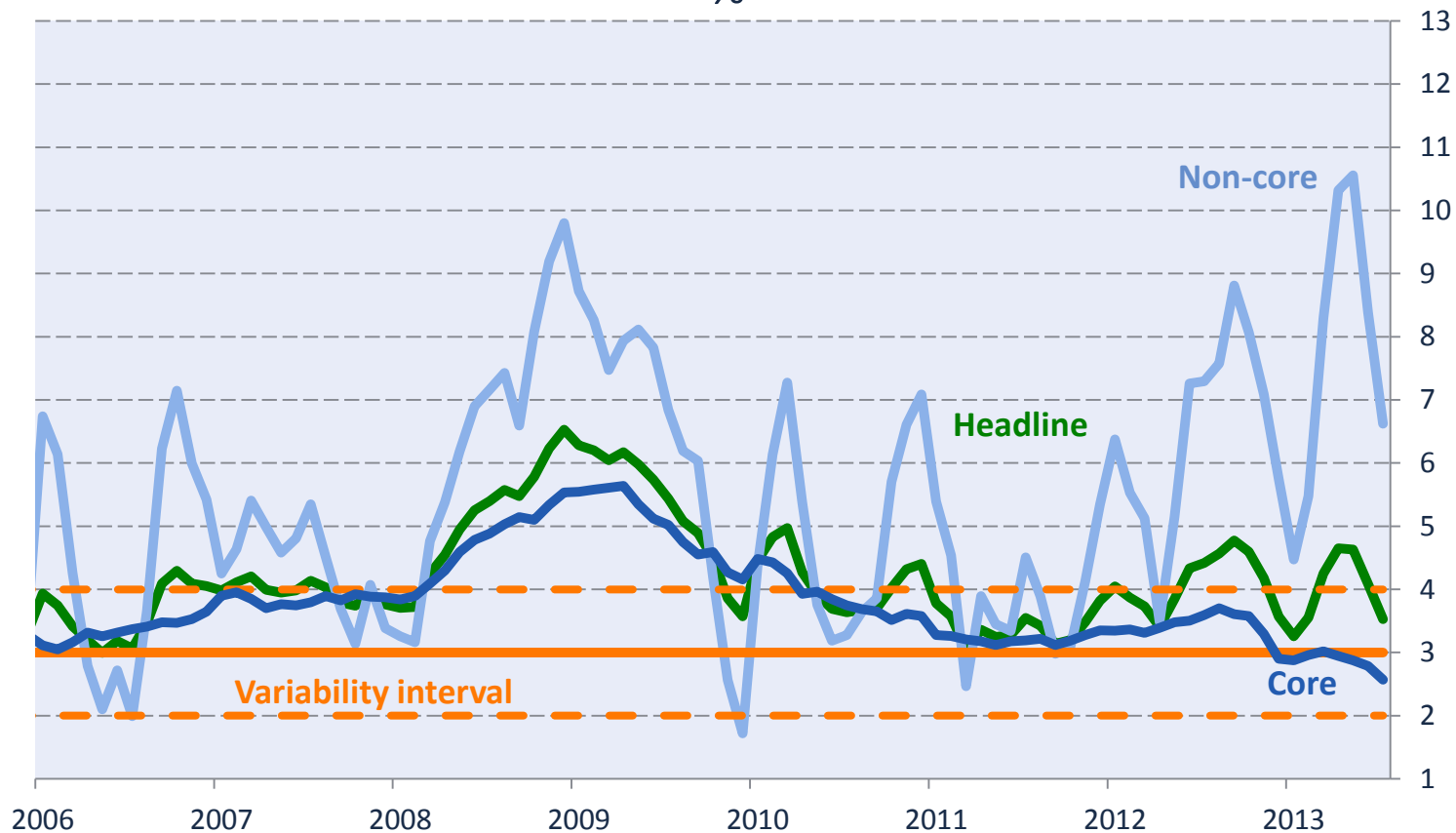


*The above allowed consolidating the process of inflation convergence to the 3 percent target.*

The evolution of inflation, supported by the monetary policy stance, confirms the continuity of convergence towards the 3 percent permanent target.

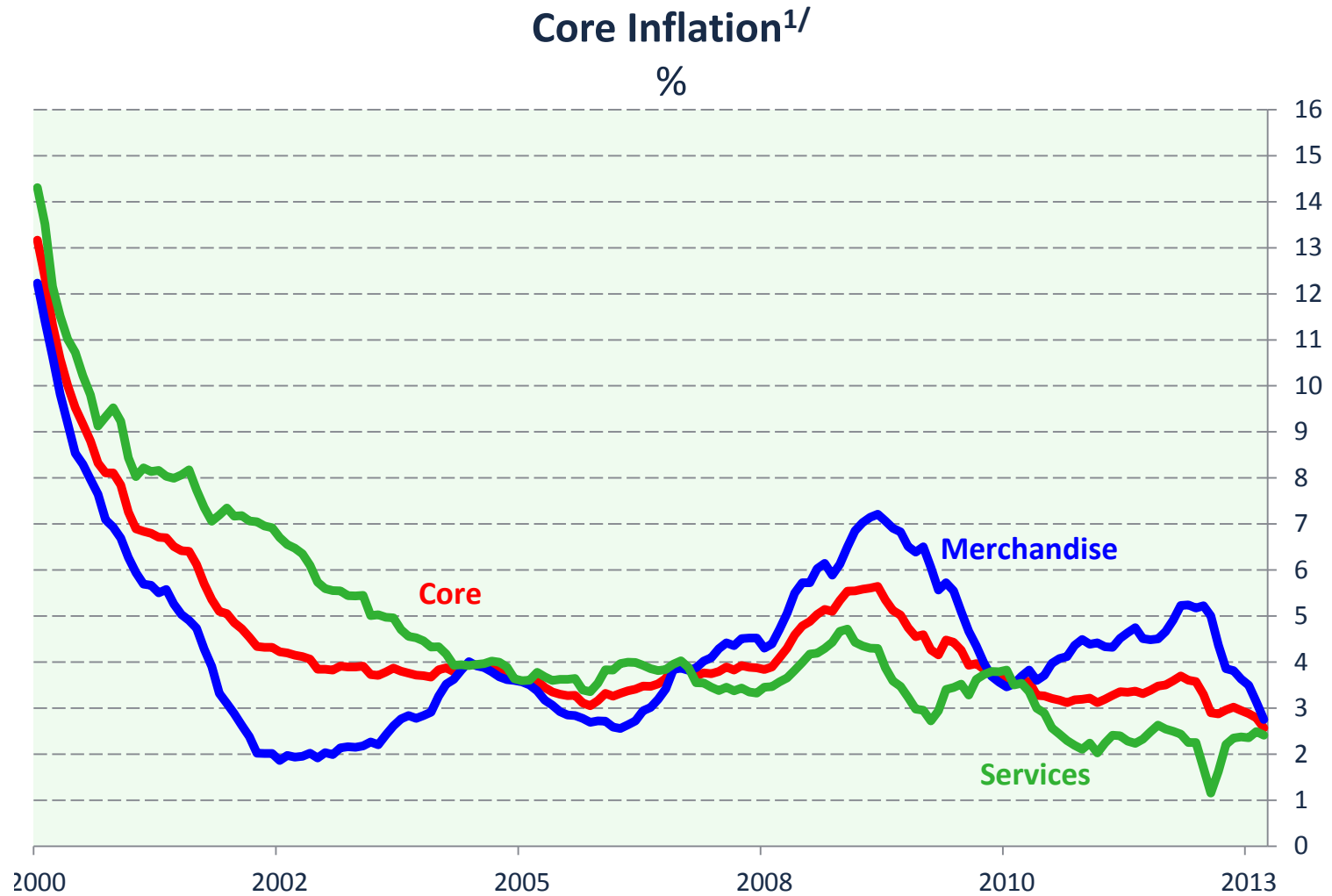
### Headline, Core and Non-core Inflation <sup>1/</sup>

%



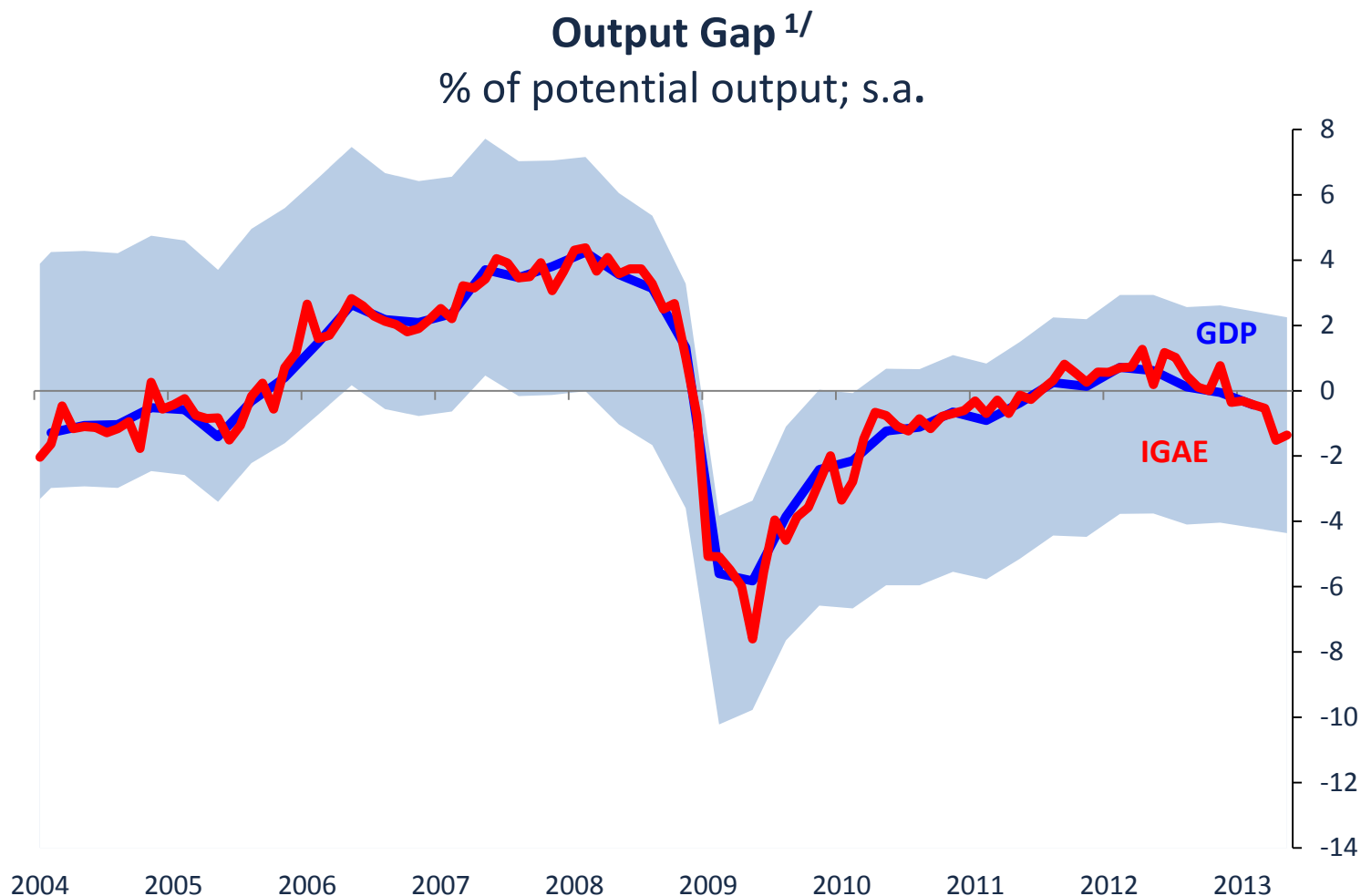
<sup>1/</sup> Data as of the first fortnight of July 2013.  
Source: Banco de México and INEGI.

Core inflation has persisted at levels below 3 percent in recent months, even with a slight downside trend.



1/ Data as of the first fortnight of July 2013.  
Source: Banco de México and INEGI.

# The lower growth recently presented by the economy was reflected in the negative trend of the output gap.



s.a./ Calculated with seasonally adjusted data.

1/ Estimated using the Hodrick-Prescott (HP) filter with tail correction method; see Banco de México (2009), "Inflation Report April-June 2009", p.69. The shaded area is the 95% confidence interval of the output gap, calculated with an unobserved components method. GDP figures up to 1Q 2013; IGAE up to May 2013. Source: Calculated by Banco de México with data from INEGI.

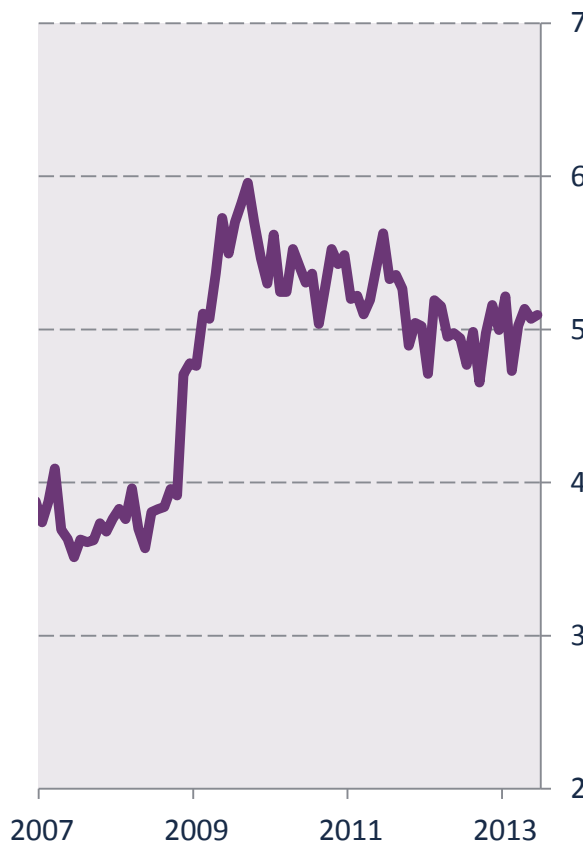
# A greater degree of slackness in the labor market has been registered.

**IMSS-insured Workers <sup>1/</sup>**  
Index Jul-2009=100



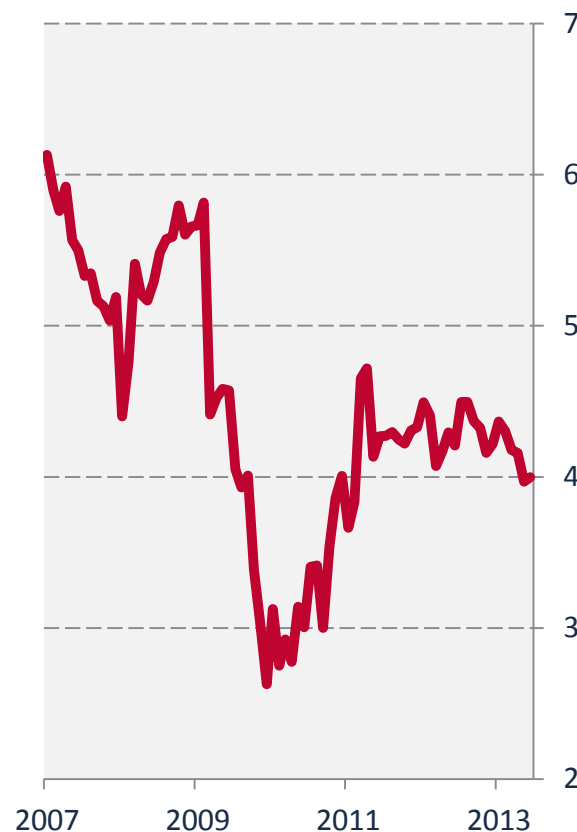
<sup>1/</sup> Permanent and temporary workers in urban areas.  
Source: Calculated by Banco de México with data from IMSS.

**National Unemployment Rate**  
% of EAP; s.a.



EAP/ Economically Active Population.  
s.a./ Seasonally adjusted data.  
Source: National Employment Survey (*Encuesta Nacional de Ocupación y Empleo*), INEGI.

**IMSS Reference Wage**  
Annual % change

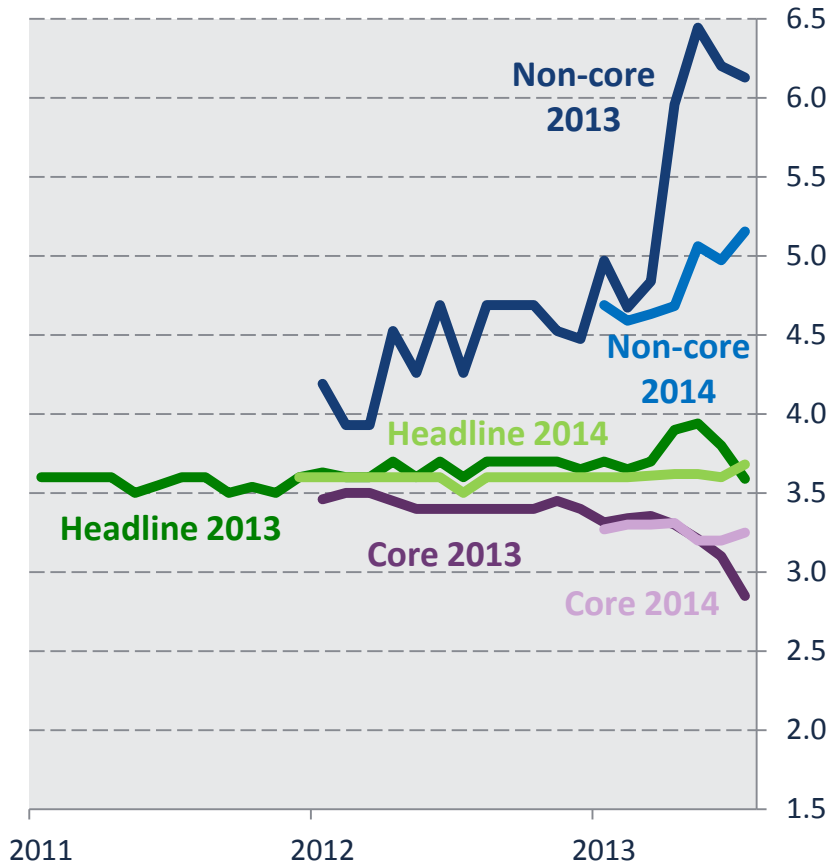


Source: Calculated by Banco de México with data from IMSS.



In the last months, inflation expectations remained stable, just as in other recent episodes of changes in relative prices.

**Inflation Expectations for the End of 2013 and 2014**  
Median, %



Source: Banco de México's survey.

**Annual Headline Inflation Expectations**  
Median, %



Source: Banco de México's survey.

# Given the expected changes in the U.S. monetary policy, medium- and long-term interest rates in Mexico increased considerably.

## Yields of Government Securities <sup>1/</sup>

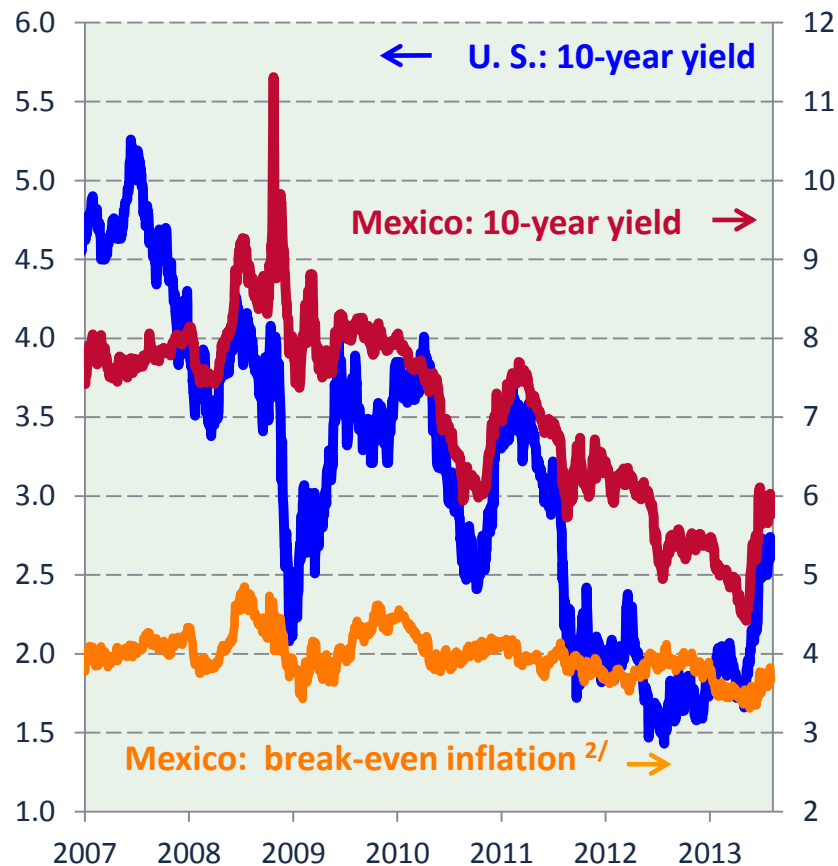
%



1/ Since January 21, 2008, the overnight interest rate corresponds to the target for the Overnight Interbank Interest Rate. Source: Banco de México and *Proveedor Integral de Precios* (PIP).

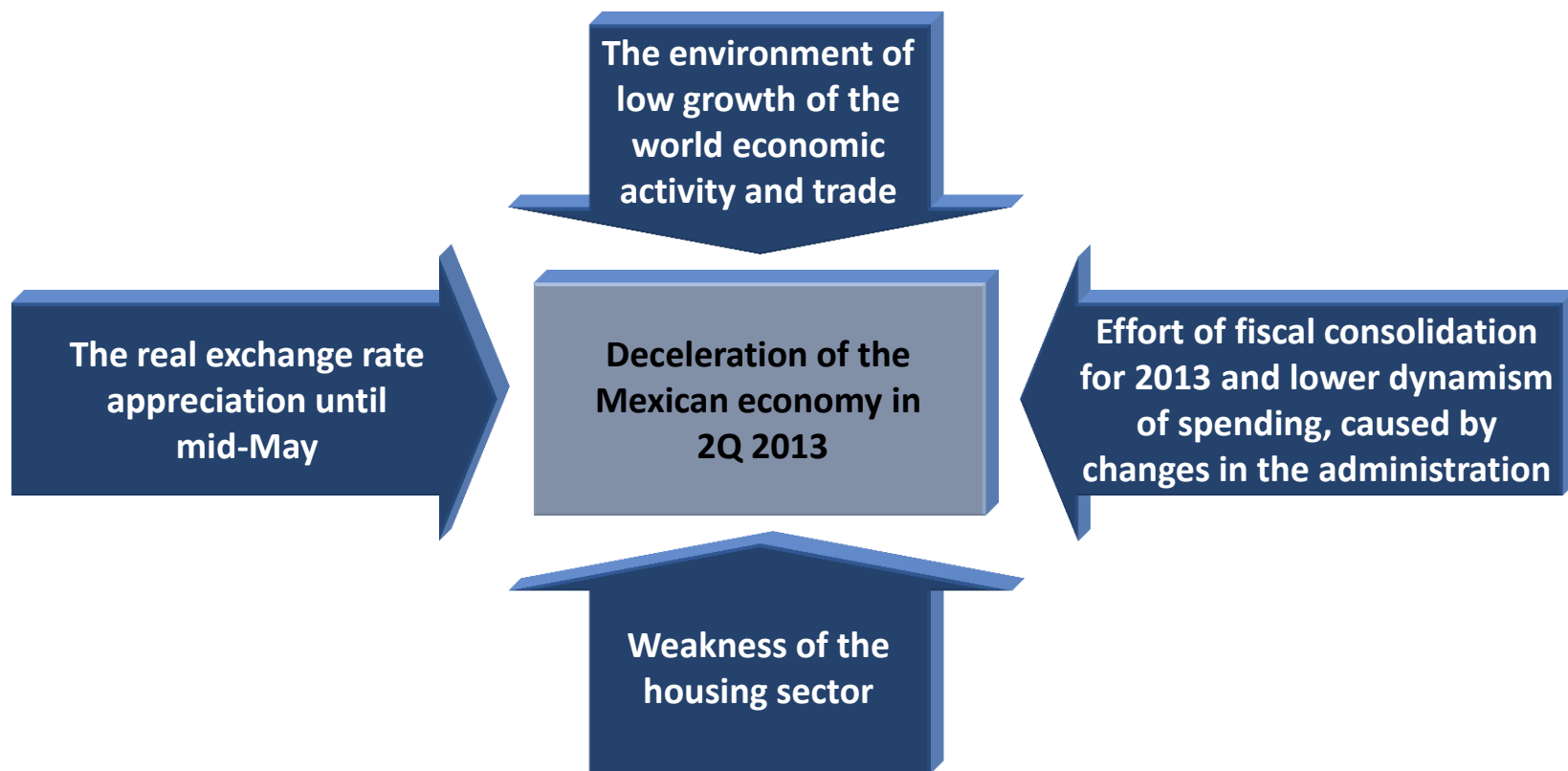
## 10-Year Yields and Break-even Inflation and Inflationary Risk

%



2/ The break-even inflation and inflationary risk implicit in 10-year bonds is calculated based on nominal and real interest rates of the secondary market. Source: Banco de México estimate with data from *Valmer*, *Proveedor Integral de Precios* (PIP) and U.S. Department of the Treasury.

In sum, the loss of dynamism that the Mexican economy has presented is driven by a series of adverse shocks.



The economic activity is expected to strengthen in 2H 2013, driven by:

- *Increased public expenditure*
- *Further growth of the U.S. economy*
- *Recovery of private domestic demand*
- *Reorganization of the housing sector*

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**From 2H 2013 onwards, the Mexican economy is estimated to observe a higher growth rate.**

## **GDP growth:**

- ✓ *Between 2.0 and 3.0 percent in 2013.*
- ✓ *Between 3.2 and 4.2 percent in 2014.*

## **Increase in the number of IMSS-insured workers:**

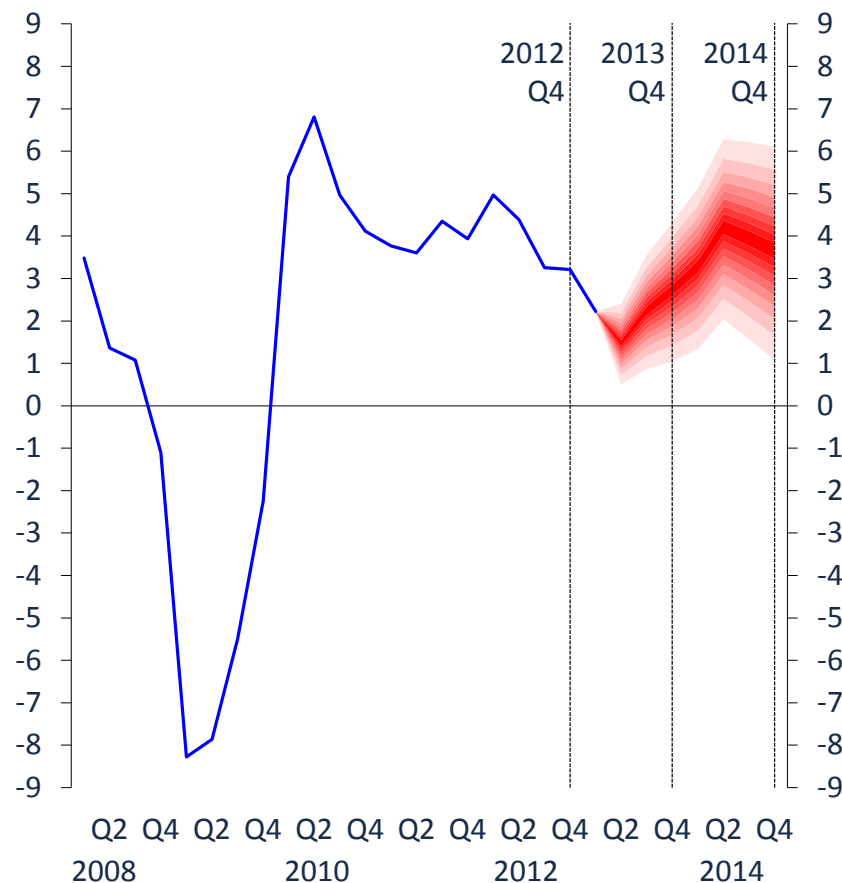
- ✓ *Between 450 and 550 thousand in 2013.*
- ✓ *Between 700 and 800 thousand in 2014.*

## **Current Account:**

- ✓ *1.2 percent of GDP in 2013.*
- ✓ *1.3 percent of GDP in 2014.*

### **Fan Chart: GDP Growth**

Annual %; s.a.



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

# Inflation Forecasts

The inflation forecast for the rest of 2013 and 2014 is slightly below that of the previous Inflation Report.

Headline inflation

**2013**

From July onwards, it is estimated to lie close to **3.5 percent**, fluctuating in the next months and concluding the year around this level.

**2014**

A downward trend is anticipated so as to locate close to **3 percent** by the end of the year.

Core inflation

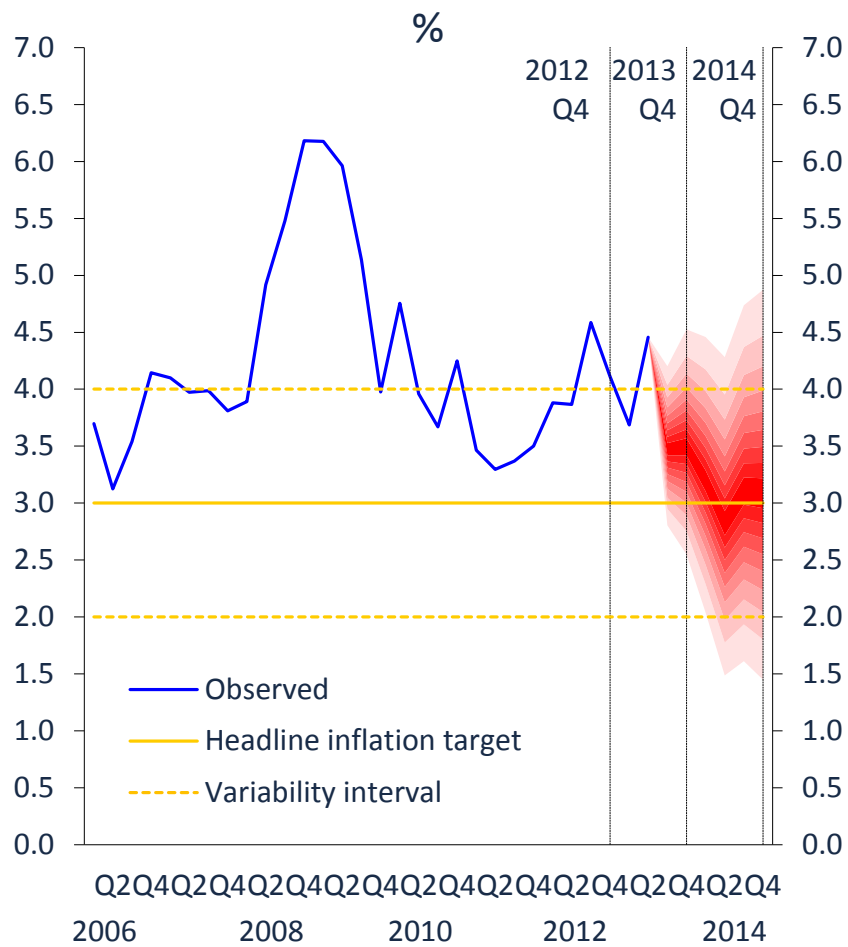
**2013-2014**

Will remain below 3 percent.

Thus, over the next quarters inflation is expected to present a trend of convergence towards the 3 percent target.

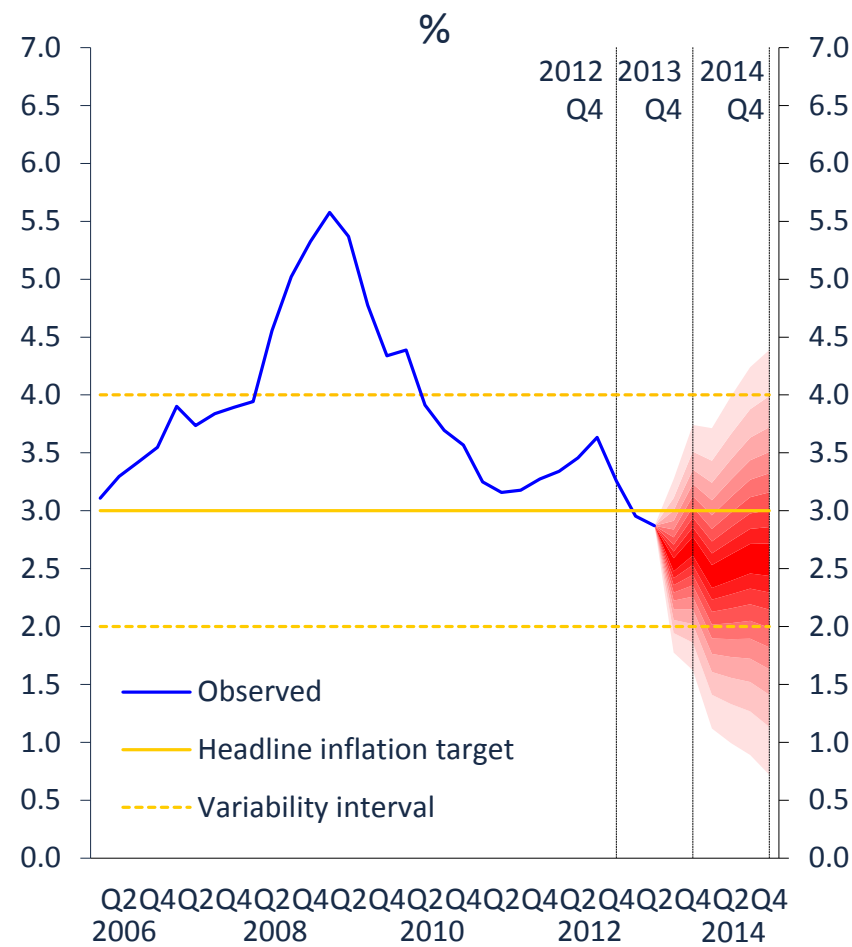
## Fan Charts

### Annual Headline Inflation <sup>1/</sup>



<sup>1/</sup> Quarterly average of annual headline inflation.  
Source: INEGI and Banco de México.

### Annual Core Inflation <sup>2/</sup>




<sup>2/</sup> Quarterly average of annual core inflation.  
Source: INEGI and Banco de México.

# Balance of Risks for Inflation

The balance of risks for inflation has improved with respect to 1Q 2013.


## Downward risks




No aggregate demand-related inflationary pressures are anticipated in 2H 2013.

The possibility of a more intensified market competition in the economy, derived from the progress in the process of structural reforms.

Further exchange rate volatility given the new conditions in international financial markets.



## Upward risks



Adverse weather and sanitary conditions, which would increase the agricultural products' prices, or new adjustments in the public prices.



**It is necessary to proceed with the process of structural reforms, strengthening the potential growth of the Mexican economy.**

- The downward revision of the GDP growth forecast for 2013, largely due to the lack of impulse from abroad, must strengthen the conviction about the urgency to **continue with the structural reforms in the country.**
  - Over the next years the world economic situation can hardly be expected to improve to the extent that it would make the Mexican economy expand above the interval forecast of this Inflation Report for 2014, i.e. 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.***



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