BBVA | RESEARCH

Economic Outlook

Mexico

Third quarter 2011

Economic Analysis

- The outlook is for strong global growth, with downward risks and challenges in fiscal consolidation
- In Mexico, domestic spending partly offsets lower external growth. The outlook for growth of the Mexican economy in 2011 is of over 4%
- Inflation is at the comfort level of the productive factors to meet demand. The minimum inflation rates had already been met and no rallies over 4% are foreseeable
- Mexico's exposure to the sovereign debt crisis in the area of the euro is limited because of its low trade relationship with that area and the strength of the domestic policies

BBVA Bancomer

Content

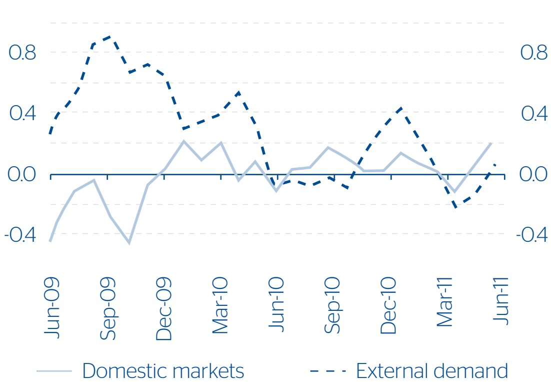
Closing date: July 28, 2011

1. Summary

Lower external growth in the first half of 2011 has slowed down economic growth in Mexico, which will remain above 4% for the year

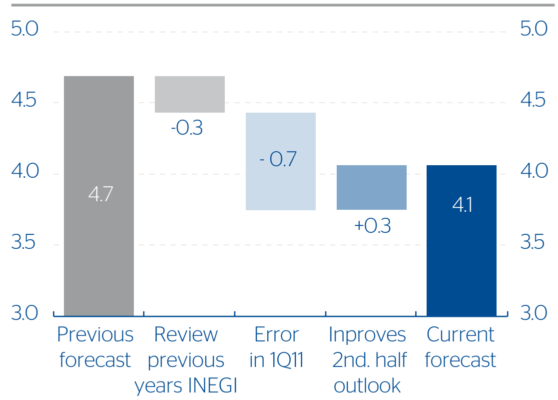
In the first half of the year, the Mexican economy has been affected by the slowdown in global recovery, particularly that of the United States, the result of eminently transitory factors. Thus, the supply problems of manufacturing inputs from Japan as a result of the earthquake and tsumani in March and the rise of oil prices, all of which has curbed spending in the U.S., are subsiding. As a result, it is foreseeable that the second half of 2011 will register higher growth levels, on average, than those of the first half of the year. The lower downturn in domestic spending, consistent with higher disposable income in households due to greater formal employment and lower inflation levels, which should continue at low levels over the next quarters, leads us to expect economic growth slightly surpassing 4% In 2011.[1] All in all, the risk balance of this provision is biased downward, in the same direction as uncertainty regarding the global scenario, given the slow recovery of employment and the lack of solutions to the potential insolvency of the public debt in Greece, with the resulting contagion on the cost and availability of financing of other economies in the area of the euro. Additionally, the underlying vulnerabilities of household spending remain, derived from the lower level and growth and the greater volatility of income from the informal market, in addition to more difficult access to financing.

Graph 1
Mexico, synthetic indicators of the state of the economy, pp. standardized growth. Positive values are consistent with growth surpassing the average



Source: BBVA Research

Graph 2
Revision of Mexico's growth perspectives for 2011



Source: BBVA Research

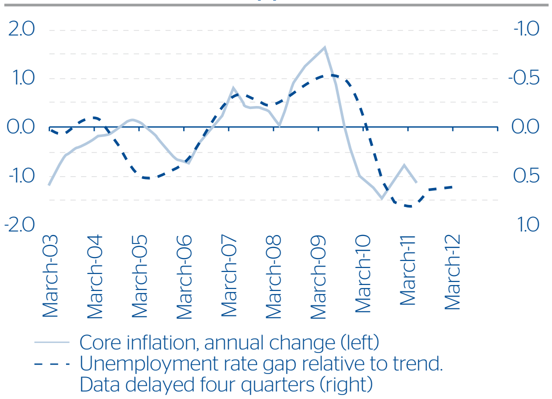
The outlook for the next two years remains high, at average rates of close to 3.5%, surpassing the average of the past decade[2]. The underlying factors for this scenario remain: -- historically moderate growth -- a positive impact from the U.S. due to gains from the competitiveness of some sectors and favorable financing conditions, consistent with inflation that will continue to be historically low as well as stable, and with some economic, fiscal and monetary policies directed toward stability.

[1] This revision downward, from an estimated 4.7% three months ago, also incorporates the effect of the downward revision by INEGI regarding GDP level and growth from 2008 to 2010. As regards the previous scenario by BBVA Research, the simple revision of already known data assumes 0.3 pp lower growth in 2011.
[2] Average annual growth of the Mexican economy for 2001-2010 was 1.8%, a figure that would have been 2.7%, if 2009 is not considered, when GDP fell 6.2%.

The improvement in inflation is due to the lack of demand pressures, by which the minimum inflation rates were reached in the first half of 2011

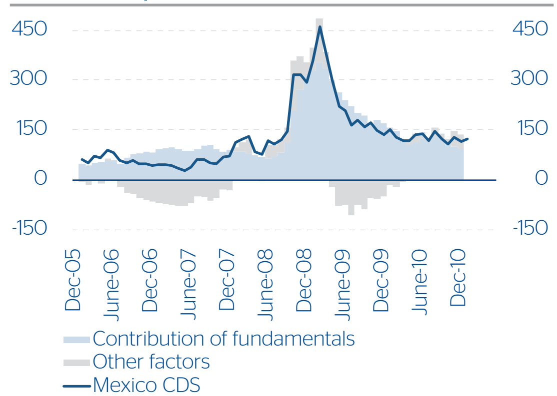
If in terms of activity the outlook for the first half of the year could be classified as mixed, in terms of inflation, it has been positive, with monthly variations in the lowest prices than those expected by BBVA Research and the market consensus, which given the seasonal component of prices took the annual inflation rate to its minimum level in five years, of 3.0% in March. The surprises registered were the result of the accumulation of favorable factors, both in the non-core component of the basket of prices, as well as in core inflation. In the first: a lower than expected increase in government-regulated prices, given the increase in fuel prices; and some fresh food and agricultural products with lower price changes. In the second: upward pressures only on processed foods, while services, housing and manufactured products posted only minimum inflation. The lack of demand pressures and the appreciating trend of the peso versus the dollar are the underlying factors of this behavior. All told, the intensity of the decline in annual core inflation, close to the percentage point in recent quarters and the almost permanent surprise downtrend for the consensus of the market could lead to the idea that there is more behind the behavior of prices, a change in their formation process due to the rise in competition or the role of some anchored medium-term inflation expectations. Nevertheless, there is no conclusive evidence regarding this change according to the analysis made, and inflation in Mexico continues to adjust in the same manner to the availability of unutilized resources and to production and distribution costs. Thus, It seems reasonable to believe that minimum inflation rates, or at least their most stable component, have already been seen in the first half of 2011. Therefore, it is foreseeable that there might be inflation rallies throughout the following quarters, consistent with the continuity of growth. In any case, sustained inflation upturns above 4% in 2011 and 2012 are not foreseeable, which would allow the central bank to maintain the monetary pause anchored at 4.5% toward the middle of next year.

Graph 3
Mexico, inflation and availability of resources in the factor markets, pp



Source: Banxico and BBVA Research

Graph 4
Risk premium for the Mexican economy: fundamental factors and external contagion measured through 5-year Mexican CDS (credit default swaps) in U.S. dollars



Source; BBVA with OECD data

Favorable panorama for financing of the Mexican economy, distant from the risk sources in Europe

The financing conditions in which the Mexican economy will evolve continue to be favorable for growth, to the extent that the outlook for inflation remains anchored, public finances continue to show reduced deficits and the commitment to sustainability of the public debt is maintained, given that its price sets the floor for the cost of financing for the rest of the Mexican economy. Nevertheless, although contagion to Mexican financial assets from external events cannot be ruled out completely, such as for example, the resolution in the area of the euro to problems of liquidity and solvency of the public debt of some of its members, the impact should be very limited. Mexican exports to Europe account for less than 5% of the country's exports of goods and although direct investment from that area is not lower, it is the growth expectations of the destination economy that dictate this type of flows.

In any case, the risk for Mexico seems very limited as long as its economic growth is linked to that of the United States and Mexico's commitment to solvency of the debt. Thus, the evolution of Mexican financial risk, given by derivatives of Credit Default Swaps (CDS) "is infected" in periods of crisis due to global risk aversion, but after this it begins to behave according to factors linked to the cycle, but also due to the result of policies, such as the level of reserves and the foreign debt.

2. Goblal scenario: politics at the center of the economic outlook

The global economy will continue growing strongly, after a soft patch in the first semester

The global economy experienced a mild slowdown in the first half of the year, mostly in the US, but also in some emerging countries. Nevertheless, as the factors behind the slowdown are mostly temporary in nature (high oil prices, supply chain disruptions from Japan and bad weather), global growth is set to continue at a robust pace, at 4.3% in 2011 (slightly lower than in the previous Global Economic Outlook) and 4,5% in 2012 (Chart 5).

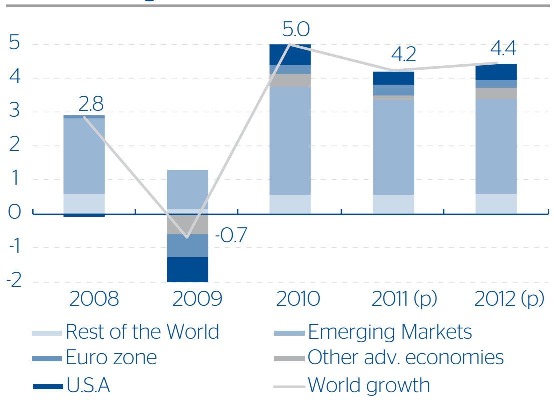
However, risks to the outlook are now more tilted to the downside. Although the slowdown in activity in the US should be temporary as oil prices stop climbing and international supply chains are restored, the recovery is still weak and may be prone to relapses, as expected in the aftermath of a financial crisis with highly leveraged consumers. The recent soft patch in the US has reminded markets of that, and may dent consumer and producers sentiment going forward.

Both in Europe and the US, fiscal concerns pose big challenges for policymakers. As solvency concerns have not been fully addressed, the sovereign debt crisis in peripheral Europe intensified (Chart 6), with the risk of it becoming systemic as market pressure spreads beyond Greece, Portugal and Ireland to Spain, Italy and could eventually claim Belgium. Although its solvency is not being put in doubt, the US also faces the challenge of a large near-term fiscal adjustment, with the risk that political negotiations turn just to short-term fixes but not to a long-term consolidation plan. This would increase the chances of a sudden spike in long-term yields in the US.

Finally, in emerging economies, overheating concerns have eased slightly as tightening measures continue to ease growth gradually in Asia and Latin America, although fiscal policies still remain mostly accommodative, thus overburdening monetary authorities, at a time when concerns over the appreciation of exchange rates in these economies remain.

Graph 5

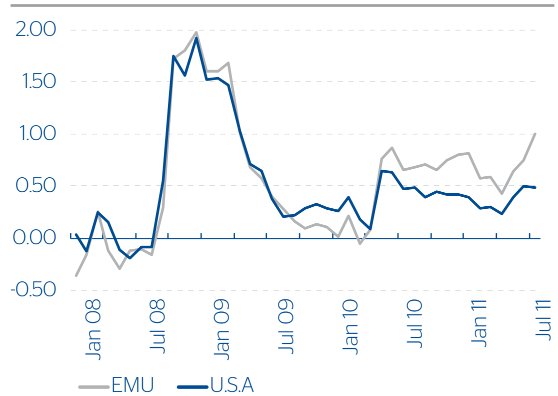
Global GDP growth and contributions



Source: BBVA Research and IMF

Graph 6

Financial Stress Index



Source: BBVA Research

It is high time to address solvency concerns in Europe, and that requires continued bold actions from EU politicians

In recent weeks, a new round of financial market stress in Europe has extended to Spain and Italy, and thus has increased the chances of the crisis becoming systemic in all Europe (with spillovers beyond the EU). This was the result of the delay in providing a second package to Greece and the insistence that private bondholders should bear part of the cost of further financial aid to that country, together with the lack of a comprehensive solution to underlying solvency concerns in Greece. This lack of resolve in Greece spilled over countries with no solvency problems such as Spain and Italy, and as a consequence to the European financial sector, which quickly saw their liquidity dry up.

In this context, with so much at stake, the Eurogroup agreed on July 21 to deal with liquidity and solvency concerns. For the former, it decided to improve the EFSF by allowing it to lend preemptively to solvent countries in distress –much like the Flexible Credit Line from the IMF– and to buy sovereign bonds in secondary markets. Regarding solvency, it softened the conditions of official loans to Greece (also extended to other program countries) and reached an agreement with the private sector for a reduction of net present value of their holdings of Greek debt by 21%, through debt swaps and buy-backs.

These have surely been big –and, in some cases, unexpected– steps in the right direction towards solving the financial crisis in Europe. But Europe is not out of the woods, and that has been reflected in only a moderated reduction in the risk premium in peripheral countries. Apart from filling in the technical details of the July 21 agreements, there are still four main lines of action. First, the EFSF should be expanded and pre-financed according to its new capacity to buy bonds in secondary markets and as provider of liquidity (even preemptively) for countries beyond those under an EU/IMF program. Second, Europe needs to work towards a closer fiscal union, ending with the introduction of Eurobonds, together with fiscal rules and tight control of national budgets. Third, economic reforms should continue to be implemented credibly in program countries and credible reform agendas should be drawn up in the rest of the EU, especially those countries at risk of being shut out of financing by markets. Fourth, EU authorities should finally decide how they will bring Greece's debt to a sustainable level and end solvency concerns, be it by a public bailout, reaching a consensus with the private sector or agreeing on an orderly default.

Until these four steps are not taken, Europe will be confronted with elevated sovereign spreads (not just for peripheral Europe) and a bigger debt restructuring down the road. In the meantime, Europe will continue to be subject to "accidents" due to reform fatigue or bailout fatigue leading to a disorderly debt restructuring, which could have a global impact. Thus, a political consensus is needed in which political parties and countries will have to make compromises. On one side, peripheral countries need to put forward fully credible plans to reduce its imbalances and undergo structural reforms to increase their potential growth. However, most likely credibility will only be achieved by forgoing some economic policy sovereignty to EU institutions. In exchange for these commitments, strong core Eurozone countries should back an expanded European Financial Stability Fund (EFSF) to act as a real backstop to threatened countries, now that is has been improved in its functioning and the creation of a Eurobond, which will have to include a reduction of fiscal sovereignty in countries that benefit from it.

This grand bargain between core and peripheral countries would surely entail costs but its benefits would surely be bigger and benefit all EU countries: greater financial stability and a more balanced and sustainable recovery.

Fiscal consolidation in the US also focuses the attention on politics

In the US, the political haggling between two opposite (and highly polarized) approaches to deficit reduction has added much noise, but so far has not increased market pressure on US rates. This reflected the belief that a solution to raising the debt ceiling would be found and default averted. But an accord to raise the debt ceiling without a plan for long term fiscal consolidation will not address long-term sustainability concerns.

Politics also holds the key to the outlook in many countries in Latin America

To a lesser extent, in Latin America, many countries also face uncertainty derived from the future course of politics. In some cases this is derived from perceived weakness by some governments as they are saddled by corruption charges or by massive protests. In other cases, it is the result of recent changes in governments or the uncertainty about the outcome of upcoming elections. Although it is true that the election cycle in the region has had less influence on the economic cycle in the last decade, it is crucial that this capital is not wasted by wide policy swings straying from continuing economic reforms.

Overheating concerns ease slightly in many emerging economies, but global risks and currency appreciation might turn policy tightening more cautious

Emerging economies continue to show risks of overheating, although as a whole they have receded somewhat given ongoing tightening measures and headwinds (in Asia) from higher commodity prices and the earthquake in Japan. Importantly, risks of a hard landing in China were reduced as Q2 growth showed only a slight deceleration, still on track for a soft landing. However, inflation in emerging economies remains a concern, and there is the risk of policymakers falling behind the curve, in some cases as they remain cautious about the global environment and in other cases as they worry about excessive currency appreciation.

3. Mexico, growth in 2011 affected by the lower external dynamism in the first half

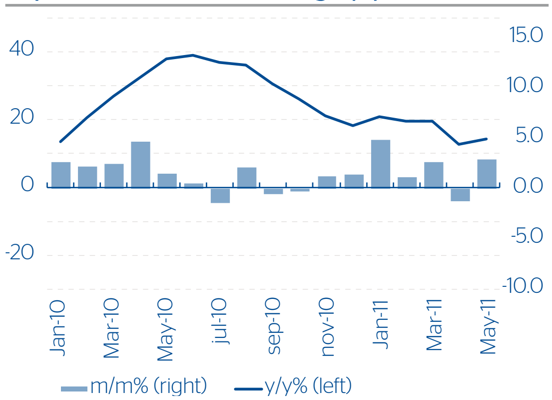
Slowdown predictably transitory in the first half of 2011 and linked to moderation in external demand

Even though 2011 began in what in an economic situation is referred to as a good footing, continuing the positive tone of the end of 2010, the great linkage of our industry with the external cycle and the weight of the automobile sector were factors that implied Mexico's greater exposure to adverse external events that led to a more acute moderation than originally expected and that, at the close of this publication, seems to be of a temporary nature..

Two external events marked the pace of the first part of the year: on one side, the delay in the recovery of spending in American households, together with the slowdown in overall GDP. This was caused by the weakness derived from the unleveraging process in which they are found and from a labor market that is still distant from resuming the previous levels of the crisis, to which the impact of price hikes in raw materials must be added. The U.S. is the destination for 80% of Mexican manufacturing exports, quite concentrated in some branches of durable consumption goods,[1] which are precisely those which tend to moderate their growth to a greater extent, in view of the uncertainty regarding the present and future evolution of disposable income.

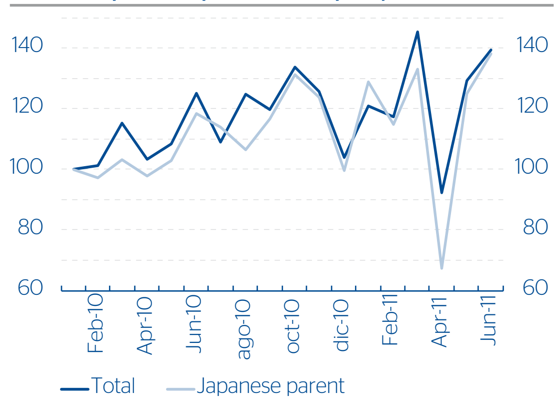
On the other hand, a second event that had an impact both on the U.S. and on Mexico was the catastrophe generated by the earthquake in Japan last March, which affected the input supply chain for the automobile industry. Thus, in April, automobile production underwent the most pronounced drop after the collapse in 2009, with a monthly decrease of 19.3% (31.1% in companies held by a Japanese parent company).

Graph 7
Exports to the U.S. (% change y/y and m/m)



Source: BBVA Research with INEGI data

Graph 8
Automobile Production: Total and companies with a Japanese parent company (Jan 10=100)



Source: BBVA Research with INEGI data

[1] By order of amount exported, the automobile industry assigns 83% of its exports to the U.S.; another figure that goes beyond 95% is computer equipment and 74% for TVs

Financing conditions and disposable income favor the consumption of households, although with latent vulnerabilities

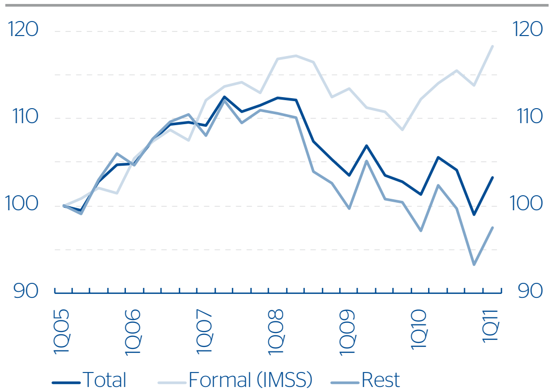
The moderation in indicators related with Industry and the external sector was partially offset by the better relative evolution of the services sector, which although with much heterogeneity among its components, stands out positively with activities such as retail sales, support to businesses or transportation activities.

Thus, consumer spending of households has been better than expected three months ago, related with the combination of two positive effects: improvement, on one hand, of disposable income[2] and, on the other, the availability of financing supply. As to the availability of supply, it should be recalled that the credit supply indicator points to the fact that this availability has been increasing since the events of 2008-2009.[3] As to the first aspect, it should be stated that job creation, as per data from the Mexican Institute of Social Security (IMSS for its Spanish initials) has surpassed by much the level prior to the crisis (in the order of 450,000 jobs more than the maximum in the 3Q08). In turn, real wages in the group have shown a trend toward gradual improvement.

All In all, the vulnerabilities continue on the performance of household spending, linked to the low level of disposable income from a very significant part of the employed, who, in addition, do not always have easy access to bank loans, in order to modulate their expense and investment decisions over time. The thing is that the disposable income forthcoming from the labor market for all those employed outside the formal private sector, almost 70% of the employed population, is still below the level prior to the crisis, which responds mainly to lower levels of labor income by the hour in real terms. To this are added other indicators reflecting the vulnerability of the overall labor income of the population, like the still high unemployment levels or the percentage of those employed in critical conditions or under-employement.[4] Thus, the unemployment rate has passed from 4% in 2008 to up to 5.4% on average in 2010, without a clear trend toward decline until now. At the same time, those employed in what the ENOE denominates "critical conditions" has gone from 10.5% of those employed to 11% in the same period of comparison; while those underemployed have gone form 6.8% to 8.6% of the total.

Graph 9

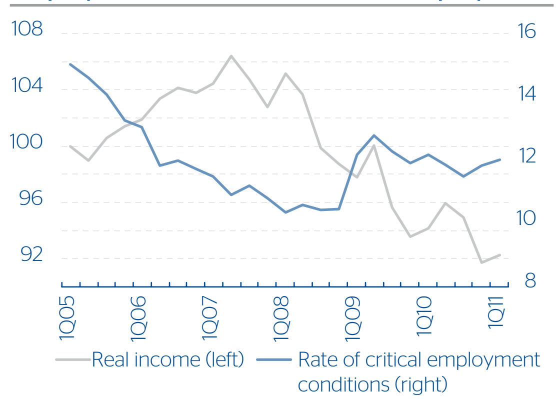
Real Disposable Income from the labor market (1Q05=100)



Source: BBVA Research

Graph 10

Real Income and Rate of critical conditions of employment (1Q05=100 and % of employed)



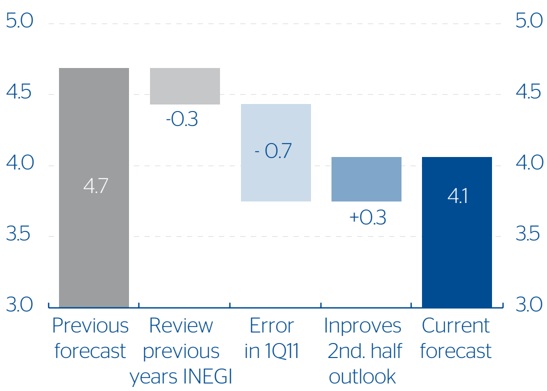
Source: BBVA Research

[2] The variable that we structured to bring nearer the disposable income forthcoming from the labor market combines employment with income per hour or per person in real terms. The estimates are based on data published by the ENOE which take as a basis the Population Census of 2006 through the 4Q10, while the 1Q11 is consistent with the Population Census of 2010. This makes data comparison difficult.
[3] As mentioned in the Mexico Economic Outlook publication of the 2Q11 (page 12), the construction methodology of the indicator changed, due to which It is not perfectly comparable before and after the 3Q10.
[4] Underemployment: percentage of the employed population who has the need and the availability of offering more working time than his present job allows. Critical Conditions of Employment: percentage of the employed population that is working fewer than 35 hours a week due to market reasons, plus the section that works more than 35 hours per week with a monthly income lower than the minimum wage, and that works more than 48 hours a week earning up to two minimum wages.

Growth, similar outlook beyond 2011

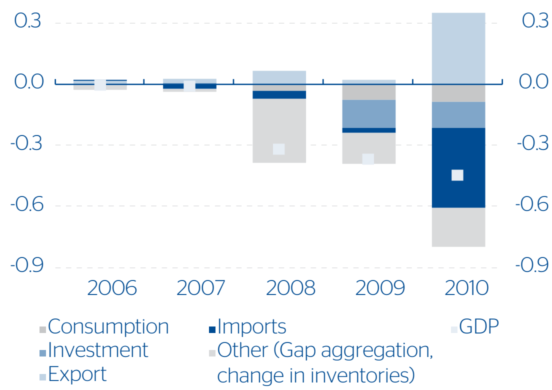
The global environment described in the previous section as refers to the U.S. shows downward growth in that country, from 3.0% projected for 2011 three months ago, to 2.1% now. Also, the forecasts for the following years remained unchanged, given the hypothesis of the transitory nature of the factors justifying the change in the views on 2011. In a parallel manner, in Mexico growth in the first half of the year would have been weaker than expected three months ago, although with a recovery profile in the more recent period. On the other hand, the INEGI has reviewed the GDP level from 2008 to 2010 with an increasingly intensive downward trend, which has therefore assumed lower growths than considered up to now in the previous three years.[5] This supposes a downward bias on the 2011 outlook by a simple comparison of 0.3 pp. In addition, the downward surprise in growth in the 1Q11, compared to what was foreseen three months ago, would lower our growth estimate for the year by 0.7pp. However, taking into account the positive outlook regarding the future dynamics of external demand variables, as well as the continuity in the improvement of disposable income of households and in their access to financing, we estimate that there is space for the expansion of GDP to be slightly higher than foreseen three months ago. In particular, we believe that there are elements sustaining robust private spending of families in the coming quarters, accompanied by the improvement of investment by companies of the private sector. By this, we estimate that the downward adjustment in the growth outlook for Mexico will be of six tenths compared to what was previously estimated, up to 4.1%, maintaining the forecast for the later years without important changes. In this sense, a moderate growth scenario is maintained, in line with the rate of recovery in external demand, sustained by the commitment of domestic demand policies directed toward the stability of inflation and the consolidation of public finances.

Graph 11
Revision of the growth outlook for Mexico for 2011



Source: BBVA Research

Graph 12
GDP decline by components of the review of the level



Source; BBVA Research and CNBV

[5] At the same time that GDP data is revised downward, the 2010 Population Census figures increase the estimate for the population level by almost four million persons. With this, it seems necessary that the level of Mexico's per capita product be revised downward and we do not know if in its growth, given that, still pending is knowing the new trend of population evolution consistent with the 2010 Census. The levels of apparent productivity in the ratio between product and employment could also be affected.

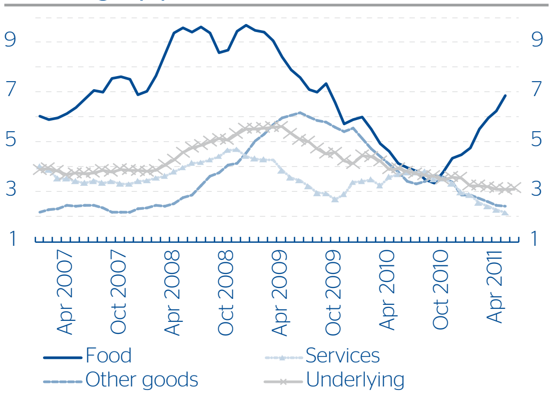
4. Inflation: surprises on the downside due to the accumulation of favorable, transitory, and cyclical factors

Inflation again surprised on the downside in the 2Q11 due to volatile factors and the lack of demand pressure

After a first quarter in which inflation decreased to rates very close to 3%, a rebound over the course of the second quarter was to be expected, underpinned by increases in the prices of various commodities such as oil, corn, and wheat, as well as the rise in prices of agricultural products that occurs at the end of the spring harvest cycle. However, inflation slowed from 3.5% in 1Q11 to 3.3% in 2Q11. Price increases greater than those observed in core inflation were also factored in, consistent with the end of the gap in disposable income to meet demand, which in the end did not occur.

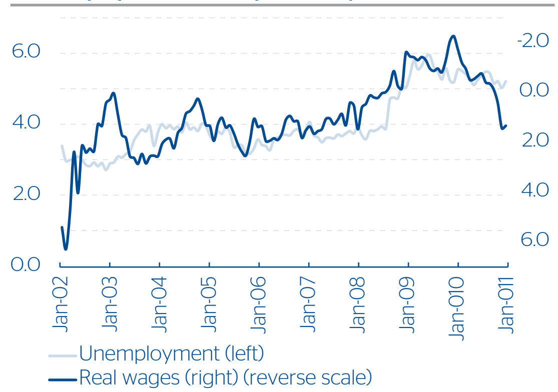
Given the better than expected inflation data in the 2Q11, and factoring in the downward revision in growth projections, our inflation outlook for 2011 and 2012 improved. Thus, the decline in core inflation from 3.3% to 3.2% between 1Q11 and 2Q11 is the result of divergent behaviors among its components. On the one hand, the prices of processed foods have reacted quite intensely to the high corn and wheat prices in international markets, and increased from 5.5% y/y in March to 6.9% y/y in June. On the other hand, prices on the rest of the components of the core sub-index, other goods and services, have slowed steadily since 4Q10, with their growth reaching 2.4% and 2.2% y/y respectively in June. The low growth in prices shown by these components has offset the pressures from food prices, contributing to core inflation having posted its second-lowest rate in history in the 2Q11.

Graph 13
Core inflation and components (% change, y/y)



Source: BBVA Research with Banxico data

Graph 14
Change in real wages and unemployment rate (% change y/y and % of the economically active population respectively)



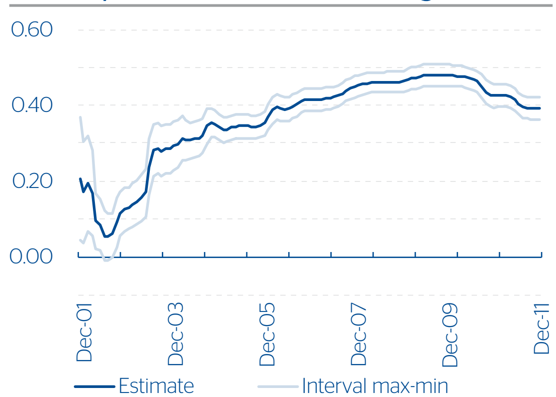
Source; BBVA Research with IMSS and INEGI data

Inflation, subject to the rhythm of the positive maneuvering room of the factors of production to meet demand

The good performance of core inflation--excluding food--is closely tied to economic cycles. The high GDP growth rates in the past few quarters have been linked more to activities related to external demand than the domestic market. Inflation is largely determined by production costs faced by businesses, basically wages, input prices, transportation costs, and the expected increase in input prices and competitors' prices. Given that wages are one of the major costs, in the current context of a labor market in which the unemployment rate remains well above its pre-crisis level, wages and hence costs display upside resistance. Moreover, budgetary policy that through the use of subsidies seeks to cushion the rise in fuel prices also slows down the growth in distribution costs. Finally, inflation will remain curbed as long as the pace of the recovery in spending is not sufficient in order for companies, fearful of giving up market share to their competitors, to raise the prices of their products.

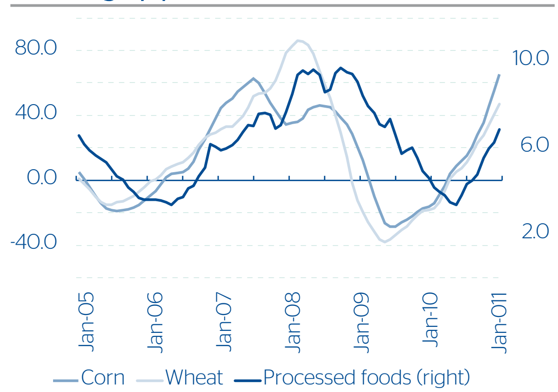
Thus, prices of processed foods represent the main upside risk in the core component. However, our scenario for agricultural commodity prices (mainly corn and wheat) is for a continual drop in prices, as they have already hit their peak. However, core inflation will remain contained and as a whole will close 2011 at around 3.4%. In 2012 the moderate but sustained growth in domestic demand will end up significantly reducing the amount of resources available to attend to it, spurring limited increases in core inflation. These increases will be limited to the extent that employment is not strong enough to significantly reduce the unemployment rate, driving the recovery of income and household consumption to a level where companies' pricing power is greater. In any case, we do not believe that has been a change in the price generating process that would allow for stable inflation rates at current levels in the forecast horizon.[1]

Graph 15
Elasticity of inflation on nominal wage (%)



Source: BBVA Research. Results of a regression estimate progressively expanding the sample (rolling regression).

Graph 16
Prices of processed foods (NCPI) and corn and wheat prices in international markets (% change y/y)



Source; BBVA Research with Infosel data

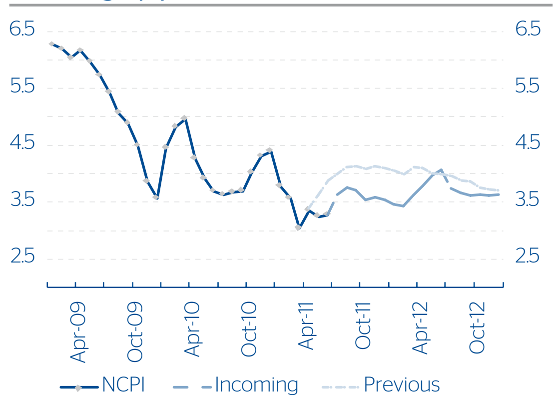
Non-core inflation also surprised on the downside in the first half of the year, contributing to improving the balance of inflation risks. There are elements already factored in on the performance of core inflation for the rest of the year, and therefore we feel that even though it will experience high volatility, its contribution will be a supporting factor for headline inflation at around 3.6% at the end of 2011. Thus, we feel that the increase in the prices of agricultural products will be less pronounced in the second half of 2011, benefiting from the period of greatest production of the two-year cycle, which has been very regular since 1999. In addition, livestock prices are less affected by the worldwide increase in grain prices, with which core food prices are unlikely to push year-end inflation upward. Meanwhile, energy prices are to a large extent factored in, given the policy of programmed regular minor increases in gasoline prices. Despite this, there is uncertainty regarding electricity rates and

[1] See Economic Watch entitled "Inflation, influenced by slack in production factors". Available at: http://www.bbvaresearch.com/KETD/fbin/mult/110801_InflacionMexico_71_eng_tcm348-265004.pdf?ts=382011

gas prices, which are partially influenced by crude oil prices and so far have experienced very moderate pressures, which moreover should decrease given the outlook for oil prices. Finally, we feel that the rates set by local governments, which surprised on the downside since the beginning of the year, will continue to see their increases limited even in 2012, given the cancellation of the automobile ownership tax that will surely be approved in most states and the fact that these rates were strongly adjusted in 2010. Thus, even though it is impossible to rule out upside risks to non-core inflation, over the past two years, it has surprised on the downside, so we feel it is unlikely that it will divert price trends above the Banxico (central bank) variability interval.

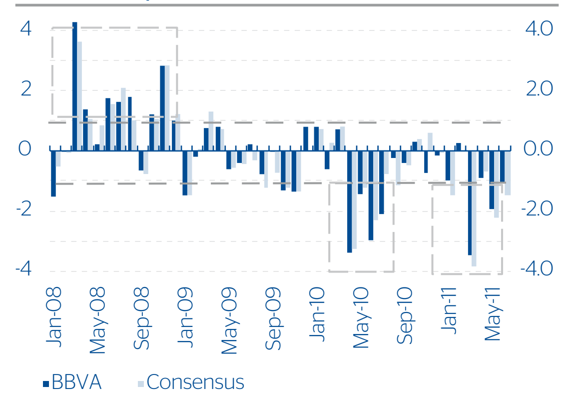
In conclusion, the inflation outlook for 2011 improved very significantly in the 2Q11 underpinned by specific volatile elements, but mainly due to the absence of demand pressures. This latter situation will not be reversed in the short term, and therefore it is the main inflation anchor. In addition, supply shocks seem to have begun to recede in the various commodity markets, and even though there is still some way to go in this regard, we feel that it is highly likely that commodity prices will continue to decline over the coming months. Therefore we estimate that inflation will end the year at around 3.6%, within the central bank's variability range. In regard to 2012, and considering the previously mentioned core inflation, the projections are for rates remaining below 4%.

Graph 17
BBVA Research Inflation Scenario (% change y/y)



Source: BBVA Research

Graph 18
Inflation surprises
One-month standardized projection error of the monthly NCPI index



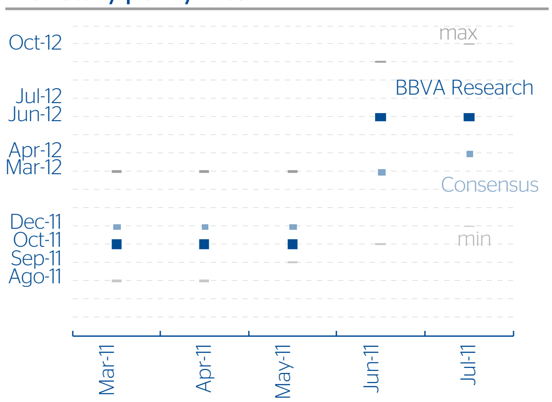
Source: BBVA Research with Infosel data

The absence of demand pressures on prices and the prospect of anchoring the medium-term inflation outlook point to a monetary pause until well into 2012

Uncertainty regarding the central bank's medium-term monetary policy approach has been significantly reduced. Following a first quarter characterized by higher international commodity prices and adverse weather conditions that indicated the possibility of an inflationary rebound during the summer, the growth in prices has surprised on the downside and has been accompanied by a scenario of an increase in the funding rate in 2011. A lower than expected transfer of the inflationary effect to commodity prices, coupled with a slower rhythm of reduction in the positive maneuvering room in productive resources, lead us to return to our scenario from earlier this year of a monetary pause until June 2012.[2]

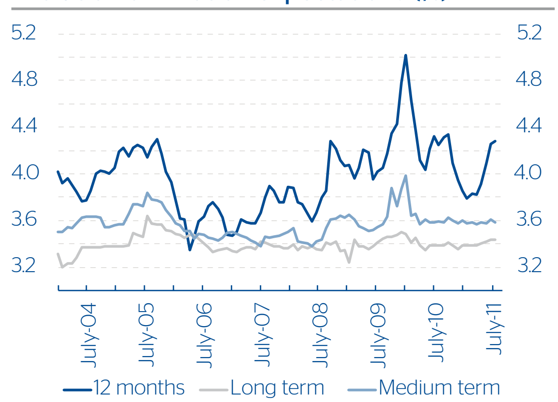
The Banxico statement has emphasized its slowdown, factoring in the latest elements in the balance of inflation risks. Thus, since the central bank's May statement on monetary policy, the central bank has emphasized the improvement in the balance of inflation risks and reiterated that, despite some uncertainties ahead, it expects the growth in prices to be in accordance with its projection. This puts inflation in its most likely scenario at between 3% and 4% in 2011 and 2012, with core inflation slightly below 3% in 2012. In terms of activity, a slowdown in the growth rate leads to a less rapid close of the output gap and a reiteration of the signs of a comfortable degree of maneuvering room in the economy (i.e., use of installed capacity, labor and credit markets) that has been identified since March. Based on this scenario, Banxico concluded that, for the time being, "generalized pressure on prices is not expected", thereby toning down the discussion shown in the minutes of the central bank's March and April meetings on the capacity of the output gap to adequately approximate price pressures.

Graph 19
Analysts' expectations on the next rise in the monetary policy rate



Source: BBVA Research with Banamex data

Graph 20
Evolution of inflation expectations (%)



Source: BBVA Research and Infosel survey

[2] At the close of this publication a timetable for monetary policy decisions for 2012 was not available.

Growing debate in Banxico on the impact of its statement on inflation expectations anchored above the 3% price stability target

As reflected in the policy meeting minutes, the downward surprises in inflation have intensified the debate among members of the Board of Governors of Banco de Mexico (the Board) on inflation expectations and adherence to the 3% target. Even though various opinions have been aired since the minutes of the March meeting were released concerning the resistance shown by inflation expectations to adjust downward, in the minutes of the May meeting of particular importance was the exchange of views on the role of the central bank statement in the formation of expectations. This was specifically the case concerning the possible effect of highlighting the progress in reducing inflation.

Two positions can be seen. The first supports the idea that emphasis should be placed on the progress in reducing inflation when this is the case and even proposes accompanying the monetary policy decision with a message in which such achievements are listed. In contrast, the second position within the Board, points out that highlighting the progress made when the target has not been reached can be interpreted by the economic agents as a sign of complacency on the part of the central bank and can thus raise the costs of converging inflation toward the 3% goal. This exchange of views is important given that inflation expectations are an indicator of tensions in the growth of prices that could involve higher inflation rates in the future. This would entail the need for action on monetary policy, given the delay with which the impact occurs. However, even when most members of the Board concluded that the bank's statement must be balanced by highlighting progress and the challenges ahead, it should be noted that in the past two statements some additional lines have been dedicated to highlighting the progress in fighting inflation.

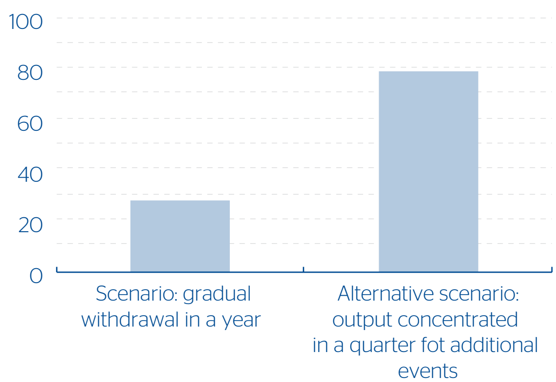
5. Financial markets at the rhythm of global factors

The uncertainty concerning the situation of public finances in Europe and the U.S. relegates, for now, the discussion on the withdrawal of the monetary stimuli in the U.S., which we consider will have a moderate effect on interest rates

The prices of financial assets at a global level have been influenced both by episodes of aversion to risk and by the uncertainty regarding the duration and intensity of the economic slowdown in the U.S. On one hand, attention has been centered on the contagion of the Greek public debt crisis that the Italian and Spanish economies could undergo. In face of these episodes of global aversion to risk, the search for refuge assets (flight to quality) has led to a reduction in interest rates in the U.S. and, consequently also, interest rates in Mexico. As opposed to other periods of aversion to risk, Mexican fixed income assets have not shown a drop in their prices, which is consistent with the narrow channel of direct contagion of the European debt crisis to the Mexican market. More recently, the doubts throughout the process of expansion of the public debt ceiling in the U.S. also assumed tensions on the market.

Graph 21

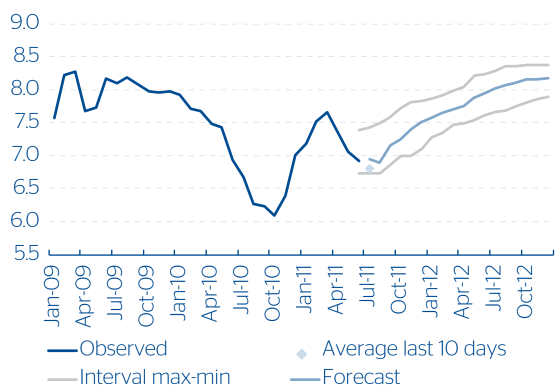
Impact on the yield of the 10-year Bond of the exit strategy of the QE2, bp



Source; BBVA Research. For details on scenarios, see the Economic Watch of July 28th entitled "The end of the QE2 will have a limited rallying impact on the domestic rates"

Graph 22

10-year. Bond interest rate at a fixed rate (%)



Source; BBVA Research

On the other hand, the most recent data of the U.S. economy point to a slow recovery rate, with a weak labor market and a still depressed housing sector. In view of this panorama, the FED communication allows seeing that the federal funds rate will remain unchanged, at least for the rest of the year, and even indicated in its latest minutes that it is planning to take two to three years to return to a balance consisting exclusively of Treasury bonds. Regarding an additional round of monetary easing, the FED Chairman indicated to the U.S. Congress that it is one of the options, in view of new deflationary threats. However, it was clear that it is a measure that is not planned to be started up in the short term, and even less if there are no liquidity problems in the functioning itself of the markets. The very moderate growth panorama generates additional downward pressure on interest rates, both in the U.S. and in Mexico, by increasing demand for fixed income assets.

The above-mentioned elements of uncertainty have dominated the international scene, leaving aside the debate on the possible increases in interest rates as a result of the withdrawal of the interventions on the market of government bonds by the FED (QE2). Nevertheless, to the extent that these events take a clearer course, the discussion on the effect of the termination of the QE2 will once again be relevant. According to the analysis made by BBVA Research,[1] the end of the QE2 will have limited effects on long-term interest rates in Mexico. The departure of foreign flows will be predictably moderate, given that the withdrawal of liquidity will also be gradual. Also, we expect that other favorable factors will remain for the Mexican economy, such as the spread between interest rates in Mexico and the U.S. and the membership of Mexico in the World Government Bond Index (WGBI). In particular, it is estimated that the end of the QE2 could generate an increase between 30 and 40 basis points in the 10-year rate throughout the next 12 months. These estimates are consistent with our scenario, which indicate August levels close to 6.9%, which predictably will increase as of September and could reach levels of 7.5% at the end of 2011. In any case, the uncertainly surrounding the forecasts is more biased to a rally than to a drop, consistent with the bias of the growth outlook and of interest rates in the U.S.

With respect to the exchange rate, the peso will be affected by the risk elements noted, which will predictably assume a rise in its short-term volatility with a tendency to depreciation, without surpassing P$12 pesos per dollar (ppd) at the at the fluctuation of preference for global risk. Later, once a scenario of lower aversion to risk is confirmed by the resolution of uncertainty in force on the profile and sustainability of the public debt of some developed countries, the exchange rate should once again reflect the elements of growth, inflation and the spread between rates with the U.S. Thereby, it would be reasonable to consider resuming a moderate depreciation course.

The effect on Mexico of the sovereign debt crisis in Europe should be limited in view of its low exposure to that continent

The degree of the relationship of the Mexican economy with the European is not high. As a destination of Mexican exports, Europe has only marginal weight. Of the 29% of GDP that Mexico's exports represent, only 1.4% of GDP has Europe as its destination. As a source of foreign direct investment, its importance is relevant, even reaching more than half of total investment received in 2010. However, the relevant determining factor for this type of investment is the expectation of economic activity of the destination, in this case Mexico. The liquidity of European investors will be more easily directed to emerging economies far from their economic cycle in view of moderation in the activity of their countries of origin.

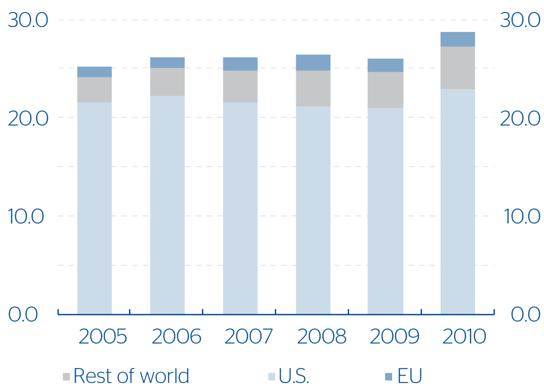
As to the possible existence of a "bank channel", result of the important role of Mexican subsidiaries with parent companies in European countries in the banking system, a high direct vulnerability for Mexico does not exist in view of the potential risk scenarios for the European banks. The banks of foreign ownership are independent subsidiaries with autonomy in the management of capital and liquidity, which limits exposure to their parent companies, in addition to the fact that local regulation and supervision ensure that credit risk does not have a relevant weight. Also, the banks in Mexico maintain high levels of capital which would allow them to face stress conditions, should these actually appear.[2] Stress tests conducted by the Council for Stability of the Financial System indicate that the banking sector would maintain its solvency despite adverse conditions both economic and financial.[3]

[1] See the Economic Watch publication of July 28th entitled "The end of the QE2 will have a limited rallying impact on domestic rates" Available at: http://www.bbvaresearch.com/KETD/fbin/mult/110728_ObsEcoMexico_23_tcm346-264823.pdf?ts=2972011.
[2] Through the month of May, the commercial banks maintain a capital index close to 17%, which stands at more than the regulatory minimum, which is at 8%.
[3] The annual report (April 2011) of the Stability Council contains stress tests that include: i) depreciation of the exchange rate, such as that which occurred in the Lehman Brothers bankruptcy, ii) increase in interest rates to levels observed after the Sept. 11th event, and iii) expected losses and defaults in the loan portfolio, such as those occurring in the 2009 recession. The annual report is available at: http://www.cesf.gob.mx/docs/informe_anual_2010_cesf.pdf.

During the subprime crisis, the rise in the risk of U.S. banks was perceived in the increase of interest rates in its interbank market. In the case of Mexico, in view of episodes of uncertainty of contagion from Greece to other European countries occurring between May and July 2011, the interbank market was not affected.[4] In the event that, finally, a disorderly resolution were given to the sovereign debt crisis in some European countries, the impact on Mexico would be determined by the magnitude of the contagion that the United States, Mexico's main economic partner, would experience.

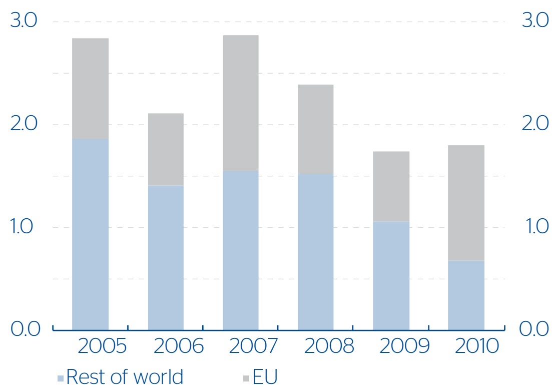
The low transfer of risk from Europe to Mexico is also observed in Credit Default Swap derivatives, which remain anchored, a result of the good macroeconomic conditions of the country, in particular due to the low level of foreign debt and growing reserve levels (for further details see Economic Watch entitled "The economic fundamentals anchor the level of Mexico's CDS in an uncertain global environment").[5]

Graph 23
Mexican exports of goods by destination, % of GDP



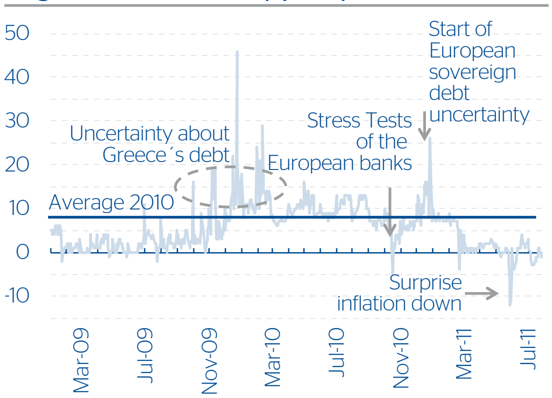
Source: BBVA Research with INEGI data.

Graph 24
Foreign Direct Investment in Mexico by origin, % of GDP



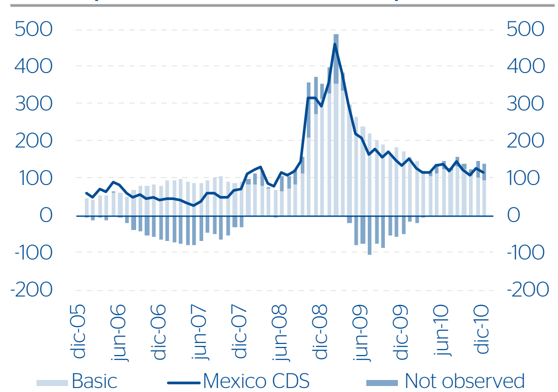
Source; BBVA with Department of the Economy data.

Graph 25
Spread between the bank funding rate and the target rate of monetary policy, %



Source: BBVA Research with Banco de Mexico data

Graph 26
Decomposition of the CDS (basis points)



Source; BBVA Research with CNBV (National Banking and Securities Commission) data

[4] Although in the first episodes of uncertainty on the condition of the Greek debt, certain volatility seems to have been observed in the interbank market, it has been dissipated.
[5] Available in the Economic Watch: "The economic fundamentals anchor Mexico's CDS level in an uncertain global environment" http://www.bbvaresearch.com/KETD/fbin/mult/110627_ObsEcoMexico_21_tcm346-261237.pdf?ts=2872011

6. Indicators and Forecasts

Chart 1

United States Indicators and Forecasts

	2009	2010	2011	2012	1T10	2T10	3T10	4T10	1T11	2T11	3T11	4T11
Macroeconomic Indicators												
GDP (real % change)	-3.5	3.0	**2.1**	**2.6**	2.2	3.3	3.5	3.1	2.2	**1.6**	**2.0**	**2.4**
Personal consumption (real % change)	-1.9	2.0	**2.1**	**2.1**	0.9	2.1	2.2	3.0	2.8	**2.1**	**2.0**	**1.7**
Government consumption (real % change)	1.7	0.7	**-1.4**	**1.1**	1.2	0.7	0.6	0.1	-1.1	**-2.2**	**-1.8**	**-0.5**
Gross fixed investment (real % change)	-18.8	2.6	**6.3**	**8.1**	-5.0	4.0	4.5	7.4	7.4	**4.2**	**6.6**	**7.0**
Construction[1]	-22.2	-4.3	**-1.5**	**4.0**	-6.8	4.2	-7.8	-6.3	-2.9	**-6.9**	**1.9**	**2.3**
Industrial production (real annual % change)	-11.0	5.3	**3.9**	**3.5**	1.6	6.5	6.9	6.2	5.4	**3.8**	**3.0**	**3.3**
Current account balance (% of GDP)	-2.7	-3.3	**-3.7**	**-4.2**	-3.4	-3.4	-3.4	-3.2	-3.4	**-4.1**	**-3.7**	**-3.7**
Final annual inflation	2.7	1.5	**2.6**	**2.6**	2.3	1.1	1.1	1.5	2.7	**3.6**	**2.9**	**2.6**
Average annual inflation	-0.4	1.6	**2.8**	**2.2**	2.4	1.8	1.2	1.3	2.1	**3.4**	**3.0**	**2.7**
Primary fiscal balance[2] (% of GDP)	-10.0	-8.8	**-9.4**	**-6.8**	-	-	-	-8.8				**-9.4**

Chart 2

Mexico Indicators and Forecasts

	2009	2010	2011	2012	1T10	2T10	3T10	4T10	1T11	2T11	3T11	4T11
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	-6.2	5.4	**4.1**	**3.8**	5.1	7.3	5.1	4.2	**4.4**	**3.4**	4.2	4.2
Per inhabitant (US dollars)	7,572	8,680	**10,158**	**10,502**	8,344	8,634	8,605	9,137	**9,580**	**10,194**	**10,450**	**10,408**
US$ billions	881	1,035	**1,212**	**1,271**	995	1,030	1,026	1,090	**1,143**	**1,216**	**1,247**	**1,242**
Inflation (average, %)												
Headline	5.3	4.2	**3.4**	**3.8**	4.8	4.0	3.7	4.2	3.5	3.3	**3.4**	**3.5**
Core	5.0	3.9	**3.2**	**3.3**	4.4	3.9	3.7	3.6	3.2	3.1	**3.3**	**3.3**
Financial Markets (eop, %)												
Interest rates												
Bank funding	4.5	**4.5**	**4.5**	**5.5**	4.5	4.5	4.5	4.5	4.5	4.5	**4.5**	**4.5**
28-day Cetes	4.5	4.3	**4.7**	**5.6**	4.5	4.5	4.5	4.1	4.1	4.3	**4.4**	**4.6**
28-day TIIE	4.9	4.9	4.4	5.9	4.9	4.9	4.9	4.9	4.9	4.8	**4.9**	**4.7**
10-year Bond (%, average)	8.1	6.6	**7.3**	**8.1**	7.7	6.9	6.0	5.8	7.5	7.0	**7.3**	**7.6**
Exchange rate (average)												
Pesos per dollar	13.5	12.6	**11.8**	**12.2**	12.8	12.6	12.8	12.4	12.0	11.7	**11.7**	**11.8**
Public Finances												
*FRPS (% of GDP)	-2.7	**-3.2**	**-2.9**	**-2.7**	--	--	--	-3.2	**--**	**--**	**--**	**-2.9**
External Sector[3]												
Trade balance (US$ billions)	-4.9	-3.0	**-3.8**	**-6.4**	0.3	-0.1	-2.2	-1.0	2.0	1.4	**-3.8**	**-3.4**
Current account (US$ billions)	-6.4	-5.6	**-10.2**	**-14.3**	0.4	-0.7	-1.9	-3.5	-1.4	**-0.2**	**-3.8**	**-4.8**
Current account (% of GDP)	-0.7	-0.5	**-0.8**	**-1.1**	0.2	-0.3	-0.7	-1.3	-0.5	**-0.1**	**-1.2**	**-1.5**
Oil (Mexican mix, dpb, eop)	70.3	77.6	**90.0**	**85.7**	71.5	69.9	69.5	77.6	93.4	102.9	**98.1**	**90.0**
Employment												
Formal Private (annual % change)	-3.1	3.7	**4.3**	**3.4**	1.0	3.7	4.9	5.4	4.9	**3.9**	**4.2**	**4.1**
Open Unemployment Rate (% active pop.)	5.4	5.4	**4.8**	**4.1**	5.3	5.6	5.2	5.5	5.2	**4.9**	**4.7**	**4.5**

Chart 3

Mexico Indicators and Forecasts

	2009	2010	2011	2012	1T10	2T10	3T10	4T10	1T11	2T11	3T11	4T11
Aggregate Demand (ann. % chge., seasonally-adjusted)												
Total	-9.4	9.5	**5.2**	**5.4**	8.9	12.8	9.3	7.3	6.0	**5.0**	**4.7**	**5.0**
Domestic Demand	-7.1	4.2	**4.1**	**3.7**	2.4	5.7	4.0	4.7	4.6	**4.1**	**3.5**	**4.0**
Consumption	-5.8	4.7	**3.9**	**3.5**	3.7	6.8	4.1	4.1	4.5	**4.2**	**3.4**	**3.6**
Private	-7.2	5.0	**4.0**	**3.5**	4.2	7.0	4.3	4.5	5.0	**4.7**	**3.2**	**3.2**
Public	3.8	2.8	**3.3**	**3.6**	1.2	5.3	2.5	2.0	1.3	**1.3**	**4.4**	**6.1**
Investment	-11.5	2.4	**4.6**	**4.1**	-2.5	2.0	3.5	6.9	5.1	**3.6**	**4.2**	**5.4**
Private	-16.8	2.9	**5.9**	**2.9**	-4.1	2.0	6.3	7.9	15.1	**5.7**	**1.0**	**2.2**
Public	7.1	1.2	**1.1**	**7.5**	2.0	2.3	-3.6	4.2	-21.1	**-1.9**	**13.3**	**14.3**
External Demand	-13.5	26.0	**10.7**	**10.2**	24.7	34.6	27.9	16.9	14.0	**9.4**	**9.2**	**10.3**
Imports	-18.4	23.8	**8.4**	**9.8**	21.8	33.1	23.5	17.0	10.8	**9.6**	**6.3**	**7.2**
GDP by sectors (ann. % chge., seasonally-adjusted)												
Primary	-2.1	3.3	**2.1**	**2.8**	-0.2	2.1	5.3	6.0	1.6	**1.2**	**2.7**	**2.9**
Secondary	-7.6	6.0	**4.1**	**4.0**	6.2	7.2	6.3	4.6	4.5	**4.0**	**4.1**	**4.0**
Mining	-2.9	2.2	**0.1**	**1.8**	1.5	3.0	2.8	1.5	-2.4	**-0.5**	**2.2**	**1.2**
Electricity	2.2	2.4	**7.5**	**4.0**	0.7	2.1	3.4	3.2	8.7	**7.1**	**7.2**	**7.0**
Construction	-7.3	0.0	**4.3**	**5.6**	-3.6	-1.6	0.9	4.5	4.9	**3.3**	**3.8**	**5.3**
Manufacturing	-9.7	10.0	**5.0**	**4.1**	12.0	13.3	9.2	6.1	6.2	**5.4**	**4.4**	**4.0**
Tertiary	-5.2	5.0	**4.0**	**3.8**	4.8	7.3	3.9	4.1	4.2	**3.4**	**4.1**	**4.3**
Retail	-14.2	13.4	**7.9**	**7.6**	14.9	17.7	11.9	9.4	8.1	**6.0**	**7.9**	**9.6**
Transportation, mail and warehouse	-6.5	6.5	**3.2**	**2.8**	7.3	10.9	5.1	2.9	3.3	**2.8**	**3.7**	**3.1**
Massive media information	0.8	5.6	**4.0**	**4.9**	5.3	4.4	6.1	6.6	7.1	**4.6**	**2.1**	**2.3**
Financial and insurance	-4.4	2.7	**3.5**	**3.2**	-0.2	5.6	-2.6	8.8	2.1	**2.3**	**5.8**	**3.6**
Real-estate and rent	-1.3	1.8	**3.3**	**2.8**	3.6	1.4	1.0	1.4	2.3	**3.7**	**3.6**	**3.6**
Prof., scientific and technical servs.	-4.7	-3.0	**3.3**	**2.5**	-4.0	-3.7	-2.6	-1.7	5.5	**2.8**	**2.5**	**2.6**
Company and corporate management	-7.6	1.4	**3.6**	**4.6**	-6.9	-2.0	9.2	6.3	2.5	**3.6**	**3.8**	**4.6**
Business support services	-4.7	1.3	**2.6**	**2.5**	-0.6	2.0	1.0	3.0	3.4	**2.6**	**2.0**	**2.5**
Education	0.5	3.0	**1.1**	**1.0**	2.2	13.5	-0.8	-1.1	1.0	**1.2**	**1.0**	**1.1**
Health and social security	0.7	-1.8	**0.8**	**1.4**	1.3	-9.9	0.7	1.3	0.3	**1.2**	**1.0**	**0.9**
Cultural and sport	-4.6	1.7	**2.8**	**2.2**	-1.8	2.0	2.2	4.5	5.1	**2.0**	**1.9**	**2.1**
Temporary stay	-7.7	3.9	**1.7**	**2.0**	-0.8	11.9	2.7	2.6	0.8	**2.0**	**1.8**	**2.0**
Other services, except government activities	-1.1	0.6	**2.7**	**2.8**	-0.9	-0.9	1.4	2.7	3.1	**2.6**	**2.6**	**2.6**
Government activities	4.8	4.4	**1.5**	**1.7**	0.9	8.5	5.0	3.2	0.6	**0.6**	**2.0**	**2.8**

1: Residential investment
2: Fiscal balance (% GDP)
3: Accumulated, last 12 months
dpb: dollars per barrel
*RFSP: Financial Requirements of the Public Sector
Note: **Bold** figures are forecast
Source: BBVA Research with Federal Reserve, Bureau of Labor Statistics, Banco de Mexico, INEGI and SHCP data

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