BBVA | RESEARCH

Economic Outlook

Mexico

First quarter 2012
Economic Analysis

- The world economy is slowing down. Growth will recover in the second half of 2012, headed by the emerging economies
- Mexico will continue growing more than 3%, with inflation and financing costs anchored and a banking system free of contagion from external risks
- Inflation, interest rates and growth in Mexico. The anchoring of prices puts a brake on activity through the increase of interest rates

BBVA Bancomer

Content

Closing date: February 9, 2012

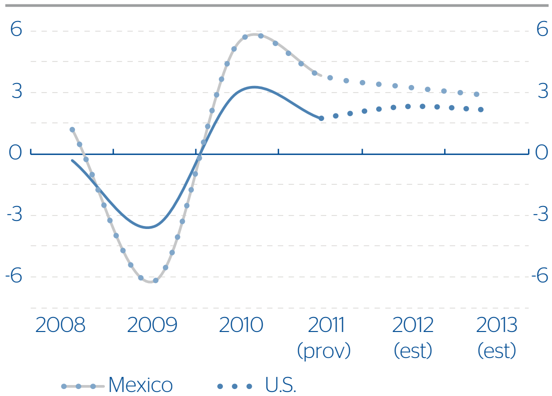
1. Summary

Mexico will grow more than 3% in a global scenario with some uncertainties dispelled, together with the confirmation of a downtrend in risks

In the three months that have transpired since the previous edition of this publication, the incipient trends in the global economic scenario have been confirmed. Thus, the uncoupling is confirmed, with the U.S. growing at rates slighly higher than 2% in 2012 and a euro zone headed toward recession. Also, the data show the expected slowdown in all of the emerging economies, affected by a less favorable external environment but with the support of the available margin of demand policies that will have a more accomodating tone. Finally, it has also been confirmed that the main uncertainty in the global economic scenario is in the area of the euro. This area, although with some advances, continues to search for solutions without finding those consistent in the area of domestic policies, so that the lack of liquidity does not lead to insolvency in view of the lack of mechanisms of shared responsibility for the liabilities of the public sector.

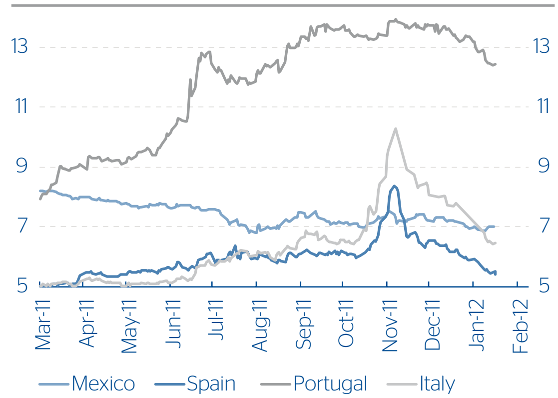
Mexico will continue to grow, with inflation and financing costs anchored and a banking system free from the contagion of external risks. In this global environment, the Mexican economy might have grown nearly 4% in 2011, with inflation and financing costs throughout all the temporary structure at historic lows and an exchange rate that was seen, on average, for the second consecutive year. A positive balance in a complex global environment that we believe will be maintained in what is essential in 2012 and 2013, with growth in activity averaging at a rate of over 3% in the biennium and inflation that will continue to be an anchor for financing conditions in the economy, which should not be restrictive, given the abundance of liquidity due to the role of the U.S. FED and the responsible management of macroeconomic policies in Mexico. In this scenario, the banking system will continue to be a differential element of strength for Mexico given that its regulation and capitalization levels are not exposed to the sources of external uncertainty and could continue to maintain its capacity for credit concession to solvent demand.

Graph 1
Economic growth
GDP %



Source: BBVA Research

Graph 2
Yield rates of bank bonds
%, simple average of bonds of similar duration of the main banks in the economies considered



Source: BBVA Research and Bloomberg. Selected Mexican Banks: Banam,ex, Banco Mercantil del Norte, BBVA Bancomer, and Santander

This relatively favorable outlook for the Mexican economy is not exempt from risks, upward or downward, with a higher probability of occurrence among the downward. Among the first, and unless there is higher growth in the U.S. than expected, or a rebound in public spending in consumption or investment which surpasses that foreseen due to the end of the six-year government administration in Mexico, it can be said that, in the end, the expected slowdown in consumer spending and investment by households and companies will not be seen. Given the evidence available, there is a reduced probability of an autonomous increase in domestic demand, independent of the behavior of external demand. In the first place, this is due to the intense opening of the Mexican economy, not only in industrial activities but also in services. It is also due to the continued descent in real wages in employment, which is not consistent with growth based on improvements in productivity more than on the boost due to the amount received, fundamentally, from abroad.

Among the downward risks, other than an unexpected decline in U.S. demand, two are particularly outstanding: drought and a higher than expected toughening of financing conditions in which the economy develops beyond those foreseen. As regards the first of the risks, the lack of rain does not appear to be *a priori* in assuming an important quantitative downtrend in growth in 2012. The impact of the lower availability of water is lower production volume and higher prices, both due to the lower quantity of product obtained as well as higher costs that the lack of rain water implies. However, as illustrated in the publication, the relation between rainfall, Gross Added Value of the primary sector and consumer prices is very narrow, even more so in prices than in activity. In this sense, the continued relative price increase of the basic basket in comparison with the total NCPI basket, with a greater relative weight of products from the primary sector; an increase also occurs in the prices of production for this type of products, also greater than the NCPI group This has a regressive impact on the distribution of income, given that the lower income population has on average one consumption basket, with the basic basket based mainly on food products. A worse evolution, relative to productivity of the primary sector, could be behind this behavior of their relative prices. And more so, given that the prices of production of the sector, those prior to the costs of distribution and marketing, grow at higher rates than that of total prices of domestic production and inflation.

The external environment could toughen financing conditions, so that domestic nominal stability should be maintained in order to avoid the slowdown of activity. One of the factors that have contributed to the favorable performance of the Mexican economy is having anchored inflation expectations at historically low and stable levels, which, together with the lack of demand pressures, have significantly reduced the transfer of changes in relative prices, as important, for example, as the exchange rate, to the final consumer. This situation favors a virtuous cycle with an impact on agents' expectations, disposable income and, consequently, on access to financing, as well as on the capacity of the banking system's credit concession. In some segments of the credit market, that is the non-intermediary or non-banking segments in dollars, a certain tension is observed in financing conditions linked to the increase of the global risk premium, rather than to doubts regarding domestic factors such as, for example, inflationary perspectives. We do not believe that there is an important probability that the lower domestic production of certain food products could presume a risk with regard to inflation expectations, although the annual NCPI could easily surpass 4% in these early months of 2012. However, as shown based on the results obtained in a recent *Economic Watch* of BBVA Research,[1] there is a relationship of influence both ways between interest rates and macroeconomic variables, but particularly intense and positive from inflation to interest rates and intense and negative from interest rates to activity.

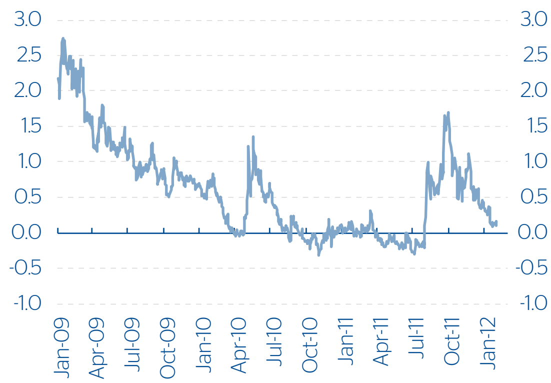
[1] For more details, see the BBVA Research Observatorio Económico "Crecimiento, inflación, fondeo y curva de tasas de interés: impacto en ambos sentidos", ("Growth, inflation, funding and the interest rate curve: an impact in both directions") available at: http://www.bbvaresearch.com/KETD/ketd/esp/nav/geograficas/latinoamerica/mexico/index.jsp.

To summarize, everything that strengthens the commitment to the fundamentals of the Mexican economy, certainty in the management of its macroeconomic policies and its nominal stability will contribute toward mitigating the risks derived from a complex external environment

Graph 3

Mexico. Index of financial tensions

Adds different variables representative of financial spreads and volatility of Mexican financial assets

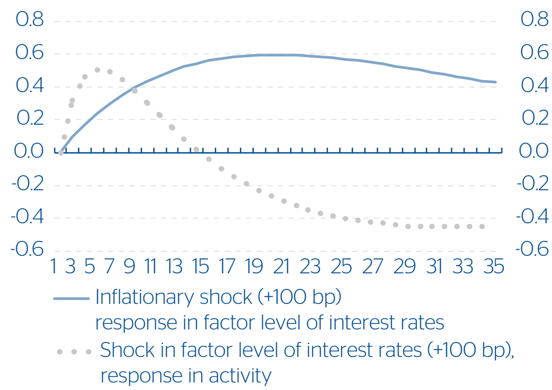


Source: BBVA Research

Graph 4

Mexico. Inflation, interest rates and activity

Stimuli and responses



Source: BBVA Research

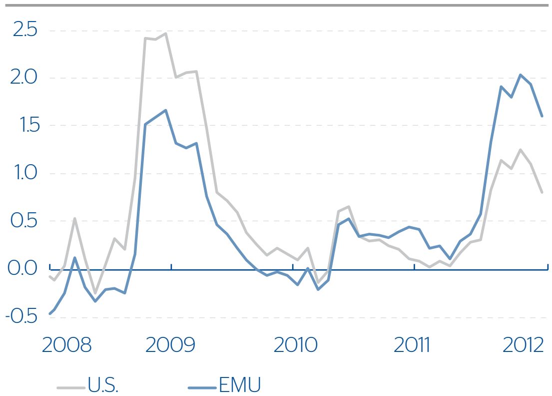
2. Global slowdown and a recession in Europe

The global economy slowed down at the end of 2011, but will rebound in the second half of 2012, led by emerging economies

The global economy decelerated markedly in the last quarters of 2011. This was the result of weaker growth in Europe (with negative growth already in Q4) and the deceleration in emerging economies, to around 1% quarter-on-quarter at the end of 2011, their lowest growth rate since the 2008 crisis. However, the drivers of this deceleration could not be more different in both areas. Europe is starting to feel the effects of persistently high financial tensions since September (see Chart 1), given the lack of major advances to solve the sovereign and financial crisis. On the other hand, the slowdown in emerging economies, apart from headwinds coming from developed economies, is partly the result of deliberate policy tightening until the first half of 2011, designed to avoid overheating.

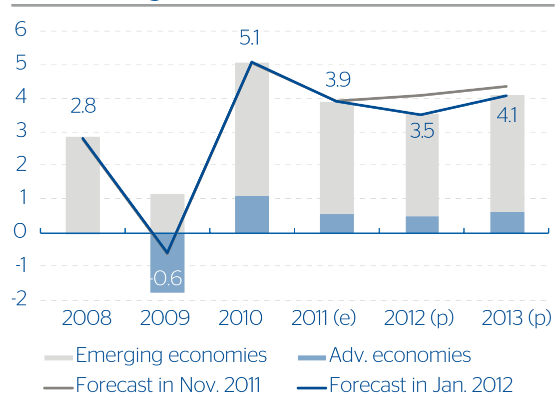
Going forward, we expect decisive action by European authorities that will slowly lower financial tensions in Europe and also global risk aversion, conditioning a global rebound in the second half of 2012. The biggest contribution to that rebound will nonetheless come from emerging economies, as their growth rates recover their historical differential of around 4 percentage points relative to those of developed countries and their policies turn more and more into growth-supportive mode. At the same time, even though the US will grow less than in previous recoveries, it will decouple from the recession in Europe in the first half of the year. Thus, relative to our previous Global Economic Outlook published in November, we are revising down our forecasts for global growth by 0.6pp in 2012 and 0.3pp in 2013, to 3.5% and 4.1%, respectively (Chart 6).

Graph 5
BBVA Financial Stress Index



Source: BBVA Research

Graph 6
Global GDP growth (YoY%)



Source: BBVA Research and IMF

The lack of decisive advances in the resolution of the European crisis makes the euro area still the main risk to the global economic outlook

Even with the downward revision of growth rates in Europe and emerging countries, we still see risks to the global growth outlook tilted markedly to the downside. These risks continue to hinge on the evolution of the sovereign-financial crisis in Europe, which continues unabated and can potentially deepen the recession there and spill to other regions through trade links, financial exposures and an increase in risk aversion.

Although there have been some advances since October –mainly the provision of long-term liquidity by the ECB and some agreement towards more fiscal discipline– there needs to be more decisive action on the three main lines of action to solve the crisis in Europe. First, on the sovereign debt front, concerns about the solvency of Greece need to be cleared by finishing the deal with private sector bondholders. At the same time, sizable and credible sovereign firewalls must be erected to avoid contagion to illiquid countries. Second, macroeconomic reforms should continue to be pushed forward to increase growth, including those aimed at repairing financial institutions' balance sheets but taking care to avoid a sudden deleverage and a reduction in credit to the private sector. Finally, further advances in euro area governance are necessary to reinforce the monetary union, making it easier to implement sovereign firewalls establishing a clear roadmap to a fiscal union.

In line to these three points, European prospects would be greatly helped if the agreed fiscal compact is finally approved at the national level and rapidly implemented after the March EU summit, together with economic reforms proposed for peripheral countries to reduce their vulnerabilities and increase long-term growth. Rapid implementation of that side of the implicit "grand bargain" between core and peripheral Europe will allow the discussion to pivot to two urgent measures to reduce sovereign stress in Europe. First, rapidly increase the resources available to erect a sovereign firewall around Greece, perhaps with a more decisive action by the ECB; second, take into account the negative effect of a weaker cycle on the ability to meet the agreed deficit targets in most European countries.

Sustained financial tensions have pushed Europe into recession. The growth gap with the US will widen in the next two years

Financial tensions in Europe continue at levels higher than after the fall of Lehman Brothers in 2008 (Graph 1). This, together with the effect of fiscal adjustment in peripheral countries, imply a downward revision of our growth projections for Europe, and we are now expecting negative growth at least in the first half of 2012, and -0.5% for the year as a whole, with a slow rebound in 2013. Nonetheless, it is important to note that these projections depend on a fast resolution of the crisis and a notable reduction of financial stress, to avoid a sharper effect on growth. The different performance between the core and the periphery in Europe will continue to be large, partly because of the large fiscal adjustment in the latter.

Contrary to Europe, the US will show resilience in 2012, as in the second half of 2011. Our forecast remains unchanged from 3 months ago, at 2.3% in 2012 and 2.2% in 2013. However, this recovery is weaker than post-recession cycles, and is surrounded by the risks emanating from Europe and the domestic risk of high policy uncertainty, including a possible massive fiscal tightening in 2013 (as tax cuts expire and automatic spending cuts related to the debt ceiling limit agreement are implemented automatically). In addition, weak housing conditions, tight credit markets and ongoing deleverage will limit the pace of consumption growth. All in all, we see more risks to the downside than to the upside in the US.

Emerging economies are heading for a soft landing, buttressed by strong domestic demand. Policies will become more growth-supportive going forward

One important aspect of the current crisis is that confidence has remained resilient in emerging economies, as opposed to the aftermath of the fall of Lehman Brothers in 2008. One possible determinant of this resilience is the surprising nature of the Lehman fall (mostly absent in the European crisis) and the different speed at which each one develops (the European crisis advancing in "slow motion"). This has allowed domestic demand in emerging economies to hold up well, even as some of the effects of increased global risk aversion are felt in financial markets in the region, through lower capital inflows, some impact on trade finance, reduced asset prices and lower exchange rates.

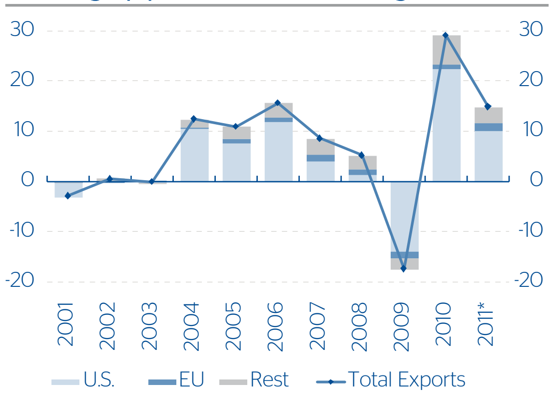
The slowdown in emerging economies during 2011 meant that their growth gap relative to advanced economies was close to 3 percentage points at the end of 2011, below the historical 4 percentage points seen since the beginning of the 2000's. We expect global risk aversion to remain high, but ease slowly in the second half of 2012, in line with the expected gradual reduction of tensions in Europe. In addition, economic policies will take advantage of existing buffers (including lower inflationary pressures and some fiscal space) and turn more and more into growth-supporting mode, in contrast with the tightening experienced in the first part of 2011. This will allow domestic demand to continue supporting growth in the region, in face of external headwinds coming from developed countries. In this context, emerging economies are expected to recover growth rates close to 2% quarter-on-quarter at the end of 2012 (from 1% at the end-2011), and grow 6.2% for the year as a whole. The main exception to this good performance will be concentrated on emerging countries in Europe, as they will be more affected by closer trade and financial links to the euro area.

3. Strengths in face of a complex global scenario

In face of a complex global scenario, Mexico has relevant strengths linked to its macroeconomic policies and its relative exposure to the global environment, which, in the year now starting, would eventually translate into growth higher than 3%, although lower than that posted in 2011. The pillars sustaining the macroeconomic strength are, on the one hand, the country's proximity with regard to trade flows to the United States, in contrast with Europe, and, on the other, the continuity of trustworthy macroeconomic policies directed toward stability, in addition to a financial system without exposure to global risks. Thus, the marked integration of the Mexican economy with that of the United States, together with the solvency and stability of the financial system, will be key for Mexican growth to maintain its moderate slowdown path in the following months and in a scenario such as that described above.

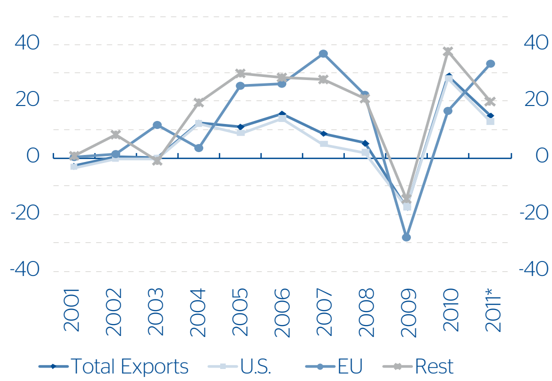
Mexico's trade exposure to the European Union is limited, being that it received close to 4.7% of Mexican exports, while 78% are directed to the U.S., even though, the share of the European Union, as a destination of exports, has increased as of the signing of the Economic Association Agreement, Political Coordination and Cooperation with the European Union, particularly since 2000 when the share of exports was 2.8%.

Graph 7
Exports by destination
% change y/y and contribution to growth)



* data through November
Source: BBVA Research and INEGI

Graph 8
Exports by destination
(% change y/y)



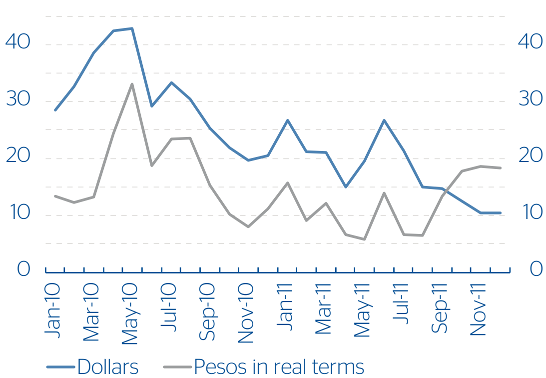
* data through November
Source: BBVA Research and INEGI

The main transmission channels of the external environment to the Mexican economy continued to assume a positive impulse at the end of 2011. In particular, Mexican exports in pesos and in real terms grew in the last quarter compared to the three previous quarters 18% y/y vs. 9.9% on average in the nine previous months, which was favored by the depreciation of the peso, which was more intense in the last quarter of the year. In dollar terms, the expansion although outstanding, is not better than that observed in the greater part of the year (11% 4Q11 vs. 20% the rest of the year, y/y). Mexico continued to export mainly manufactured goods (80%), by which the country exploits the competitive advantage of its closeness to the U.S. and its production costs.

Among the country's export manufactures, of note is the recovery of key products such as transportation equipment. In the years 2008 and 2009, U.S. imports of these manufactures, first in importance for Mexico, had dropped in the order of (-)6.4% y (-)20.9%, respectively. In 2010 and with the improvement in disposable income in that country, the growth of exports in the automobile industry to the U.S. was 50% and, for the 3Q11, it was 16% higher than a year before. In another large group of goods exported to the U.S., computer and electronic equipment is a case of interest, not only because of its share: 25% of Mexican manufacturing exports to the U.S. in this case, and, due to the entry of China into the WTO in 2001, the market share of that country in the U.S. market of that branch in particular, rose from 10% in 2000 to 41.4% in the 3Q11, while that of Mexico has had a marginal improvement from 13.4% to 15.1%.These two groups of goods contribute more than 50% of Mexican exports to its main trading partner, the U.S.

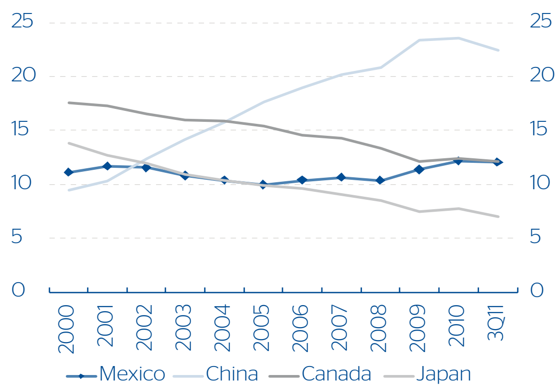
In 2011, Mexico was, among the main suppliers of manufactured goods to the U.S., the only one that did not lose share, neither in durable consumer goods nor in non-durables, and its weight in the U.S. market is maintained in the order of 12% of the total. Even so, Mexican manufactured exports continued to grow at a good rate (15% y/y, in real peso terms), contributing more than 80% of the country's income from exports. With a U.S. economy that could maintain its vigor in the coming quarters within a context of a labor market where the recovery process continues, it is to be expected that Mexican exports could maintain a solid expansion rate.

Graph 9
Total Exports (% change y/y)



Source: BBVA Research and INEGI

Graph 10
U.S. Manufacturing imports (as % of the total)



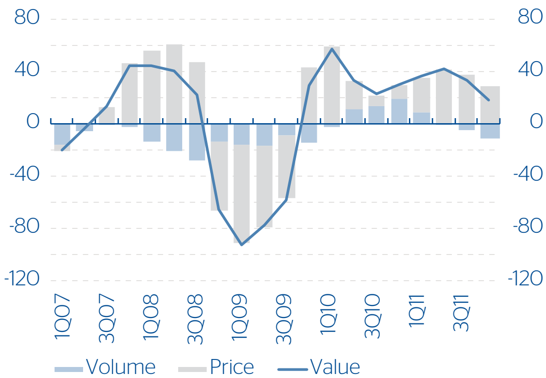
Source: BBVA Research and INEGI

For their part, oil exports grew around 21% in terms of real pesos in the last quarter, which was derived from growth in the price of the Mexican oil mix, for which, on average, US$5 more per barrel will be paid than in the previous months, while the export volume came close to 11% less than one year before. All and all, growth in the entry of resources from oil exports was good in the last part of the year.

Tourist arrivals have put a brake on their trend to drop. Tourist revenues rallied in the last months of last year, relative to the foreign exchange effect. However, the tendency in tourist arrivals has been refatively negative since 2005, when they reached 8.7 million visitors, to nearly 5.8 million at the end of last year. Income in dollars from tourism in Mexico has contracted in an annual comparison since the end of 2010.

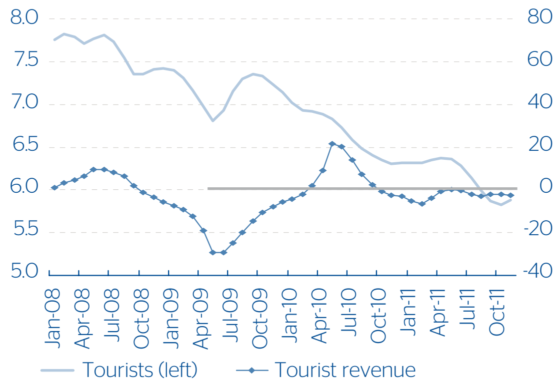
Remittances from Mexican migrant workers grew in real terms. The improvement on the employment of Mexican migrants in the U.S., together with the depreciation of the peso in the final months of the year, contributed, in real peso terms, for remittance growth to reach 16% in the last quarter of the year. This did not prevent the accumulated change to drop to -1%, lower than in 2010. In this heading, with an outlook for improvement in employment linked to the U.S. labor market, it is feasible that in 2012 remittance flows will stand at above US$24 million (US$22.7 million in 2011), which would imply coming close to remittances received in 2008.

Graph 11
Value of oil exports in dollars (% change. y/y and contributions)



Source: BBVA Research and INEGI

Graph 12
Income from tourism (persons and dollars, % change y/y)



Source: BBVA Research and INEGI

Chart 1
Indicators of external supports of the Mexican economy (% change y/y of real pesos)

	2010	2011	1Q11	2Q11	3Q11	4Q11
Total exports	16.8	12.0	12.2	8.7	8.8	18.2
Manufactures	16.3	8.4	9.5	4.0	4.7	15.4
Oil	22.4	30.1	26.4	35.1	26.0	29.1
Income from remittances	-10.3	0.8	-3.5	-6.1	2.8	16.1
Income from tourism	-6.3	-8.6	-15.3	-8.0	-9.7	4.1

Source: BBVA Research.

Fiscal and monetary policies aimed at stability

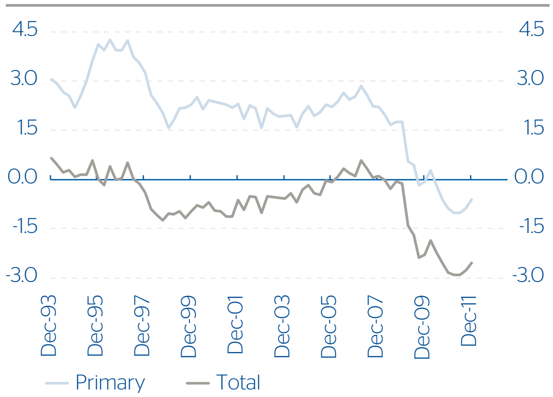
One of the strengths of the Mexican economy, more in the current global environment, is the discipline by which public finances are managed. Mexico has a fiscal balance which in its amplest measure (RFSP)[1] registered a deficit of 2.8% of GDP in 2011, exactly as was foreseen in the approved federal budgetary law at the end of 2010. The balance of the total debt of the federal public sector in 2011 was 38.7% of GDP, a relatively low figure when compared with the developed economies and with a structure between internal and external liabilities (in foreign currency) in favor of the former in a proportion of seven to three. .In addition, the management of the Mexican debt in terms of temporary structure is comfortable when it has an average maturity term of 7.5 years, six years more than in the year 2000. This discipline was compensated in 2011 with the issue of a 100-year bond in dollars with a yield upon maturity of 6.1%. Finally, despite the fact that Mexico's fiscal structure presents important challenges such as the reduction of its oil income as a proportion of the total budgetary income or establishing a standard of structural balance that would allow generating fiscal mufflers at times of a drop in economic activity, it is important to point out a regulatory framework has been constructed , such as the Budget and Treasury Responsibility Law, in which it is stipulated that there should be an annual budgetary equilibrium (although it is possible to legislate for an increase in the deficit), which has allowed the country to progress in a fiscal structure that provides certainty to the markets and that minimizes the contagion of the global risk.

[1] The Financial Requirements of the Public Sector are calculated based on the traditional public balance, adding the financial requirements of the development banks and of the development funds, the financial requirements of the IPAB, the requirements of financial resources of long-term productive infrastructure projects (previously known as PIDIREGAS), and the financial requirements of FONADIN.

On the other hand, **price stability as the only goal of monetary policy, supported by a program of Inflation Targets has favored the anchoring of expectations of medium- and long-term inflation and, therefore, the moderation of growth of the NCPI.**[2] The slow convergence of inflation toward the central bank's price stability objective during the last nine years, to the extent in which the succession of bullish supply shocks on prices has permitted, has favored a greater development of the markets and, by this, a more efficient allocation of both resources and risks. Also, even though the medium- and long-term expectations are found to be above the inflation target of 3%, they have remained anchored despite the recent shocks and the instability of the foreign exchange market.

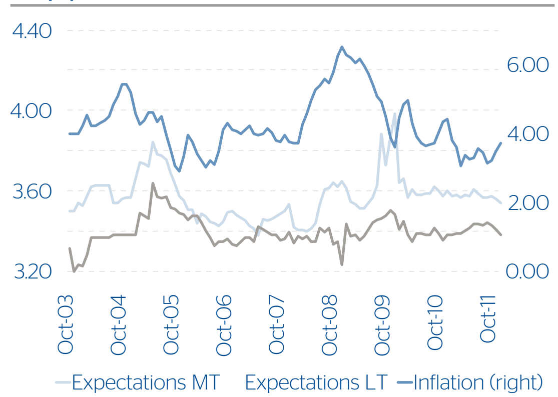
Relative to the management of monetary policy, in recent years, reforms and changes have continued that were started in the decade of the nineties. The last of these changes is the publication of the minutes of the meetings on monetary policy as of January 2011, the objective of which is to increase transparency and the explaining of accounts to the public regarding decision-making of monetary policy. By means of the minutes, it is possible to know both the relevant topics behind the decisions and the points of view of the members of the Government Council regarding said topics, in addition to the degree of debate that is caused. Thus, to the extent that the public has greater information and the credibility of the commitment is strengthened with price stability, the formation of the expectations process will tend to be less volatile and to converge with the objective.

Graph 13
Fiscal Balance and Primary Fiscal Balance (GDP %)



Source: SHCP

Graph 14
Inflation observed and expectations (% y/y)



Sources: BBVA Research with Infosel and Banxico data

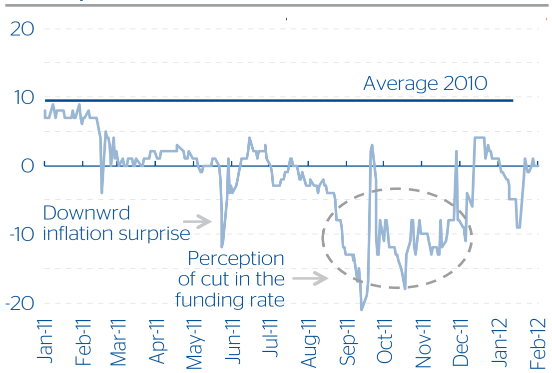
[2] For further details regarding the impact, positive although limited, of inflationary expectations, see Economic Watch of BBVA Research "Inflation at the rate of the productive factors", available on the Internet.

Financial system without exposure to global risks and with regulation of reference

The Mexican banking system has not been contaminated by the risk premium due to the effect that the debt crisis could have on its financial system. As regards the inter-bank funding market, no financing pressure has been observed. The funding cost in this market during 2011 and the first month of 2012 has even been lower than in 2010. The performance of funding throughout the last year has been linked to local economic events, in particular to the expectations regarding changes in the monetary policy rate, without this having had any impact from global financial uncertainty. This also is consistent with the yield on the secondary market of debt bonds of the Mexican banks, currently standing at more than 100 bp below where it was a year ago, which contrasts with the notable increase registered in the same variable for the banks of some European countries This favorable performance of the Mexican bank bond yields is observed in those with capital of both national and foreign origin. In the case of the banks in Spain and Italy, even though the yields of their bonds rallied, they have been lower in recent months as a result of the steps taken by the Central European Bank to increase the liquidity in the system.

Graph 15

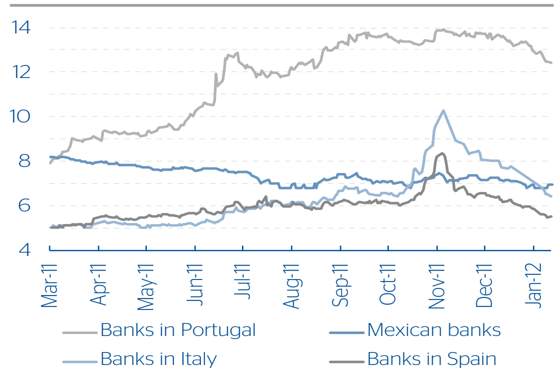
Spread between the bank funding rate and the target rate of monetary policy (basis points)



Source: Banco de Mexico.

Graph 16

Yield rate of bank bonds (%)



Source; BBVA Research and Bloomberg. Selected Mexican banks: Banamex, Banco Mercantil del Norte, BBVA Bancomer and Santander

The market does not quote any global contamination risk for the Mexican banking system, given its solid financial position. On the one hand, the system maintains high capital levels and preventive provisions for credit risks. As to what refers to capital, its quality is outstanding, since 87% of the total capital of the system is constituted by basic capital;[3] while this figure reaches 86% in the case of the seven largest banks. In the case of the preventive provisions, these have remained above 140% in relation to the past-due loan portfolio since the year 2004, and currently it is above 160%. On the other hand, a banking regulation and supervision of international reference is one more strength of the banks in Mexico. For example, this regulation stipulates that the Mexican banks with foreign capital be established under the system of subsidiaries, which is why their administration of capital and liquidity is independent from that of its central office and its funding is local and in domestic currency.[4] Also, said regulation has delimited both domestic and international risks of the banks when promoting low exposures to related parts. All of the above will allow the banking

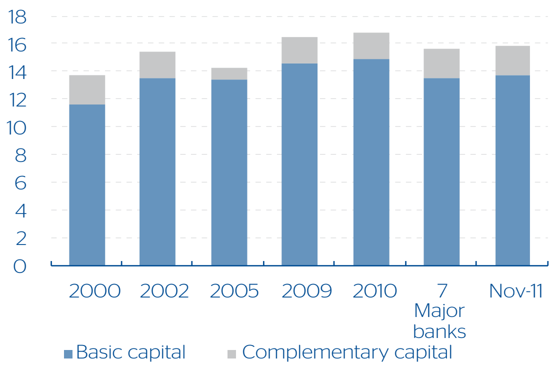
[3] Basic capital is comprised of net worth, the instruments of voluntary and obligatory conversion in stocks of the Institution, non-preferential instruments in which the issuing Institution can cancel the interest payments and defer the main payment, less the subordinate debt, the investment in the capital of the financial entities in related companies in investment corporations, intangible assets and deferred taxes.

[4] A discussion regarding the advantages of the subsidiary scheme relative to that of the branches is available in the presentation "Whither global banks?" by Santiago Fernandez de Lis in the Workshop on "The future of the financial industry, FUNCAS, Madrid, January 31, 2012.

system to continue to be capable of maintaining a capacity for financing concession sufficient to attend the requirements of solvent demand. In face of a very uncertain global scenario, the capacity for credit growth will be an element of both the differentiation and strength of Mexico relative to other economies.

Graph 17

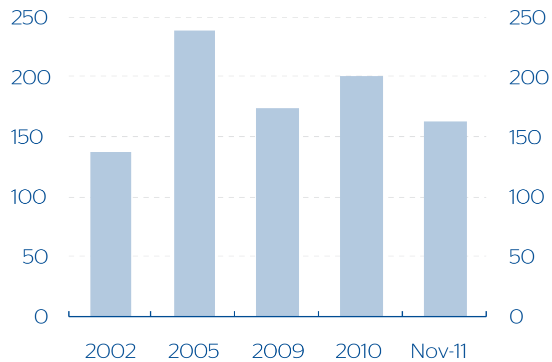
Capitalization Index (%)



Source: National Banking and Securities Commission. Capitalization Index. = Net Capital as a percentage of the Assets Subject to Total Risks.

Graph 18

Preventive estimates for credit risks relative to the past-due loan portfolio (%)



Source: National Banking and Securities Commission.

4. Inflation and rates, anchored at historically low levels

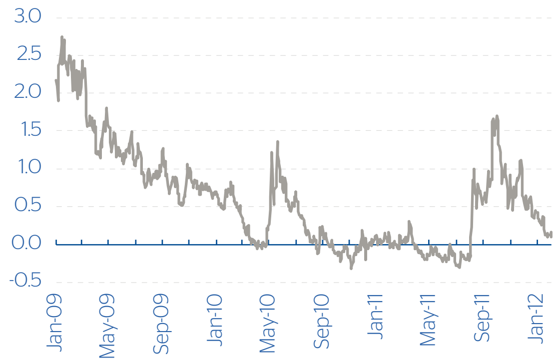
Economic conditions tend to reflect the strength of the economic fundamentals

The reduction in risk aversion on a global level and the better than expected U.S. economic data have led the financial conditions faced by Mexico to behave, to a greater extent than was previously the case, in accordance with domestic fundamentals. The measures adopted by the European Central Bank (ECB) at the end of 2011 to provide liquidity to European banks reduced risk premiums in the global financial markets. In addition, the most recent data show that the U.S. economy maintains a growth rate higher than previously expected with an improvement also registered in the labor market. These elements have enabled an easing of financial conditions in Mexico. To begin with, sovereign risk, measured by the credit default spread (CDS) has declined more than 60 basis points (bp) since September 2011 to below 150bp at the beginning of February. Secondly, the exchange rate has appreciated by nine percent since its peak in September 2011 and is currently at around 12.80 pesos per dollar. The volatility of the exchange rate has also fallen from levels close to 30% in September 2011 to 13% in 2012. All this followed an announcement by the Foreign Exchange Commission at the end of November on daily dollar auctions as a preventive measure as well as to provide liquidity to the market. At the time when this article was written, no auctions had thus far been held. Finally, in the government debt market, declines have also been posted in long-term yields, while conditions in the interbank market have remained without significant changes in an environment marked by a monetary pause. As a reflection of the better performance in financial market conditions, there was the decline in the financial tensions index in the past few months, with the indicator reaching levels similar to those registered at the beginning of August 2011.

The improvement in financial conditions has underpinned investment inflows to the country, mainly in fixed income instruments. Foreign participation in Mexican public debt has been growing consistently since March 2010 when the country's entry into the World Government Bond Index (WGBI) was announced, with the exception of a slight decline during the height of global risk aversion in September 2011. At this time, the share of foreign investor holdings of Mexican public debt reached levels close to 40 percent. This participation is mainly concentrated in bonds in the belly of the curve in which foreign investors control up to 70 percent of some companies. In comparative terms, the inflows to fixed income instruments in Mexico have been greater than the average for Latin American (Latam) markets.[1] According to data on mutual fund investment flows, since 2010 Mexico has contrasted positively with the rest of Latin America, although it maintained a high correlation with the area. It should be noted that as of September 2011, FDI flows to Mexico have fallen more rapidly than in the rest of Latin America, although they have not reached the point of being on equal levels. Meanwhile, Mexico has posted greater inflows compared to the emerging European economies during the last five years. However, it should be noted that in August and September 2011, the emerging European economies moved ahead of Mexico in terms of such inflows, which could be explained by the accumulation of negative news on U.S. economic performance (the downgrade in the sovereign debt rating, cyclical data on the downturn).

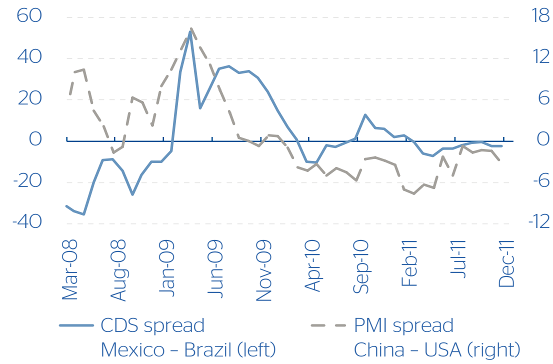
[1] The following countries are considered as part of Latin America: Argentina, Brazil, Chile, Colombia, Dominican Republic, Ecuador, and El Salvador. The emerging European economies include Bulgaria, Hungary, Poland, Russia, Turkey, and the Ukraine.

Graph 19
Financial Tensions Index – Mexico



Sources: BBVA Research. The index is prepared based on an analysis of the main components applied to variables such as the swap rate spread, the slope of the yield curve, exchange rate and stock market volatility, the VIX and the EMBI for Mexico

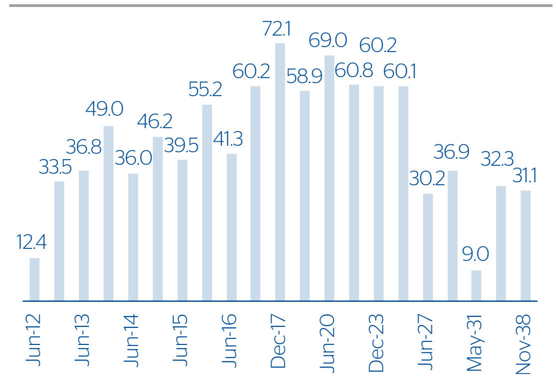
Graph 20
Manufacturing activity and sovereign risk in Mexico and Brazil



Sources: BBVA Research with Bloomberg data

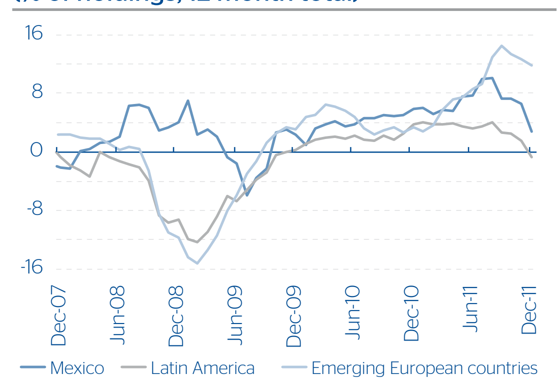
It is important to stress the influence of U.S. economic activity on the financial conditions of the Mexican economy. During the first half of 2011 the financial indicators of the Mexican economy registered levels below the averages of the past few years even though the debt crisis in Europe was already generating strong increases in global risk aversion. This changed sharply in September after various data reflected a weak U.S. economy. In analyzing the relationship between Mexico's sovereign risk and U.S. industrial activity, a clear negative correlation can be seen. More specifically, to the extent that growth in the U.S. Manufacturing Activity Index is positive, Mexico's sovereign risk, measured as the 5-year CDS spread, will tend to decrease. This result holds when analyzing the case of the Chinese and Brazilian economies, with the result that manufacturing activity in the former country influences the sovereign risk of the latter nation. Thus, as can be seen in graph 20, we can illustrate the influence of the industrial activity of the main trading partners on the sovereign risk of the leading economies in Latin America. In the event of a relative improvement in U.S. manufacturing activity with respect to China, the CDS (credit default spread) between Mexico and Brazil would tend to decrease. But if China's economy were to perform better in relative terms in its manufacturing sector, the CDS between Mexico and Brazil would tend to increase. From now on, it will be necessary to carefully follow to what extent the incipient signs of improvement in the U.S. economy are confirmed and allow for easing the effects of changes in global risk aversion on financial conditions in Mexico. This is especially the case after the Fed reiterated in its latest statement that the U.S. labor and housing markets remain weak.

Graph 21
Foreign investor bond holdings per issue (% of the total amount of each issue)



Source: The week. Government Debt. Banamex investment research.

Graph 22
Flows to fixed income securities (% of holdings, 12 month total)



Source: BBVA Research and EPFR

Rise in inflation linked to external supply shocks

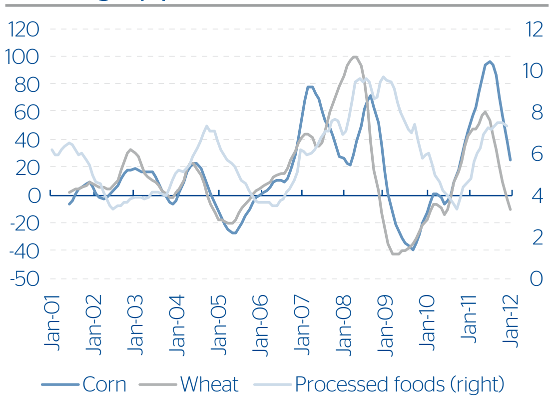
The evolution of inflation was favorable in 2011, as it remained within the range of variability of the Mexican central bank target (3% +-1pp) throughout the year. However during the last quarter, consumer prices rose in annual terms from a rate of 3.1% in September to 3.8% in December. During the first half of January, inflation rose again and moved closer to the upper limit of the central bank variability range, reaching 3.9%.

We believe that the inflation outlook worsened in the past few months due to rising supply shocks experienced by commodities--particularly basic grains and oil--over the course of 2011. The transmission of these shocks along the price formation chain will mean that inflation will exceed 4% in some months of the year, although it will most likely end 2012 below this threshold.

Within core inflation differing behaviors will continue to be observed due to the opposite impact of the effect of food prices and room for improvement in the economy. On the one hand, commodity prices, the growth of which has been above 4% since April 2011, continued to be pressured upward, given that the increases in prices of corn and wheat in global markets have boosted the domestic prices of processed foods. More recently a slight growth has also been observed in the prices of other commodities, due to the peso's depreciation the previous quarter. Meanwhile, services inflation continues to fall in annual terms, as a result of the strength of the economy. The absence of pressure from the demand side is consistent with unemployment continuing to be above its pre-crisis level, the real growth in wages not being significant, and the existence of idle capacity in the manufacturing industry.

Graph 23

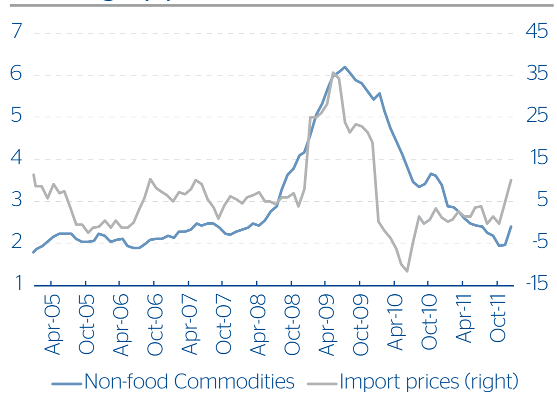
Processed food inflation and corn and wheat prices in international markets in pesos (% change, y/y)



Source: BBVA Research with INEGI and Bloomberg data

Graph 24

Commodities inflation and import prices in pesos with a three-month lag (% change, y/y)



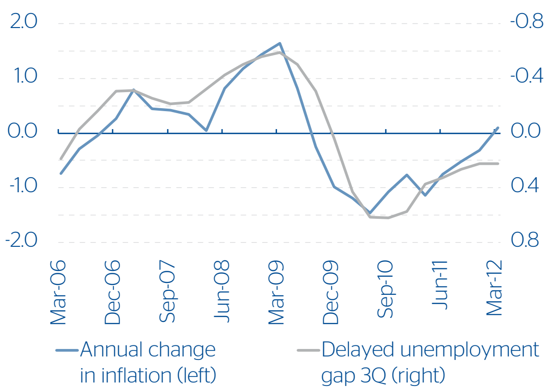
Source; BBVA Research with INEGI and Banxico (Mexico's central bank) data

During 2012 the behavior of core inflation will continue to be similar to its current trend, since both the persistence of high grain prices--which have been sharply slowing down in international markets since June, although they affect inflation with a delayed impact--as well as the slight increase in the prices of the rest of the commodities caused by the weakness of the peso, will prevent commodity prices from rapidly converging at levels below 4%. Nevertheless, it should be emphasized that everything seems to indicate that these prices hit their highest level since October. Furthermore, it should also be noted that the shortage reflected in the prices of grains such as corn and beans in the domestic markets, caused by the drought experienced in some parts of northern Mexico, will only affect specific markets with a low relative weight within the commodities sub-index, while its effects will have a limited impact within processed foods as a whole. At the same time, services prices will remain very stable and close to historic lows, thanks to the situation in which even though in our scenario the economy will continue to grow during 2012, it will not do so fast enough in order to generate significant demand pressures. Thus, we believe that core inflation will close the year at around 3.25%.

With the weakening of the balance of inflation risks, uncertainty regarding the future of its evolution appears balanced. On the upside, a new global shock could emerge that could raise commodity prices or cause instability in the financial markets, which might spur new depreciations of the peso versus the dollar, which due to its persistence also ends up affecting commodity prices. On the downside, the main risk is that global activity will slow suddenly and intensely, which would provide more maneuvering room for domestic prices, both due to less pressure from demand as well as the likely downside impact on prices of raw materials.

Graph 25

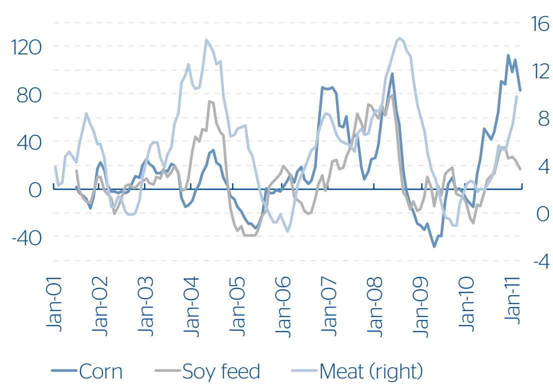
Change in core inflation and unemployment gap (pp, for unemployment, difference with regard to its trend)



Source: BBVA Research with INEGI and Bloomberg data

Graph 26

Growth in prices for meat, corn, and soy in international markets (% change y/y)



Source: BBVA Research

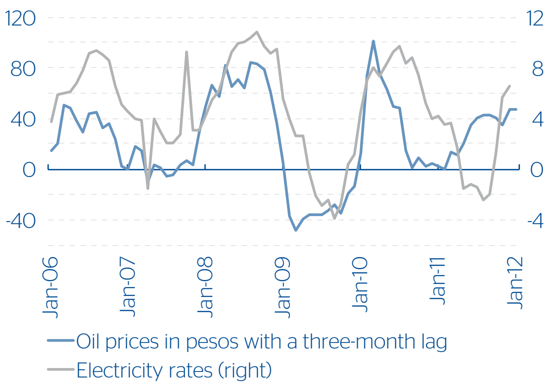
Non-core inflation has been the main cause of the growth in prices in recent months. This growth was caused by heavy seasonal increases in agricultural prices, the pressures on meat markets due to high international grain prices, and finally, by increases in energy prices that have resulted in hikes in electricity rates (see Figure 27).

External pressures will continue to affect the non-core component at least during the first half of the year, which will lead the prices of meat products to keep increasing. Furthermore, if oil prices remain high and, given that the peso depreciation in the first half of the year will probably be higher than in the same period of 2011, electricity and gas rates will continue to rise. In addition to these pressures, it should be noted that during 2012, we will be in the low productivity end of the two-year agricultural cycle and, therefore, there will be greater relative scarcity of these products, which will cause their contribution to annual inflation this year to be positive. We believe that an increase in the fees charged by local governments will remain very limited because, in general, there is no problem with financing public sector spending in the states, given the availability of federal funds and the upcoming elections.

In short: the outlook is favorable in core inflation but with increases in non-core inflation that will lead the NCPI to be above 4% for a good part of the year. In the core component, the still positive maneuvering room of the economy outweighs the potential effects that shocks in commodity prices or the exchange rate could have on the cost of goods. However, prices for the non-core NCPI basket, the high prices of commodities on a world level and their effect on meat products, as well as the rise in energy costs, will contribute to the NCPI being above 4% for a good part of the year. Despite this, we believe that the lack of demand pressures will persist throughout 2012, which, when coupled with a favorable base effect and the gradual appreciation of the peso, will allow inflation to close 2012 at below 4%.

Graph 27

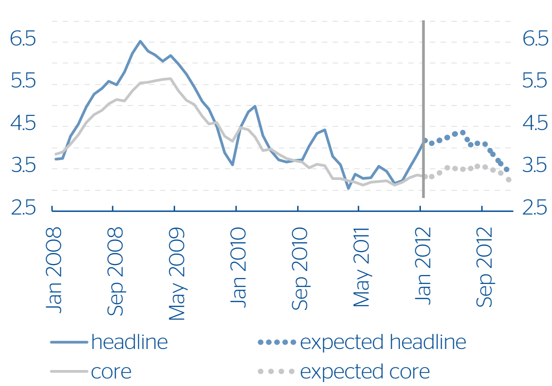
Oil prices and increases in electricity rates (% change, y/y)



Source: BBVA Research with INEGI and Bloomberg data

Graph 28

BBVA Research inflation scenario (% change, y/y)



Source; BBVA Research with INEGI and Banxico data

Inset 1: Drought: limited impact on the primary sector and less so on inflation

In 2011 the amount of rain that fell in Mexico declined 10% in relation to the 1941-2005 average and 17% with regard to 2006-2010 levels,[1] with the primary sector being particularly affected. The lower precipitation should not necessarily translate into less availability of water for its different economic uses or for the supply to the population, given the existence of underground aquifers or prior storage reserves in the distribution and regulation systems. But given that the primary sector (agriculture, livestock, and fishing) consumes 77% of total concessioned water in Mexico and that only 8% of the surface area earmarked for agriculture has access to irrigation systems[2], it seems reasonable to think that its production should be, by far, the most affected by drought. A priori, the impact of the reduced availability of water should be lower production volume and higher prices, due to both the lower harvests as well as the higher costs often associated with the lack of rainfall. However the relationship between rainfall, the Gross Value Added (GVA) of the primary sector, and consumer prices is limited.

The direct impact of drought is limited, and considered to be higher in the primary sector GVA than in inflation for the consumer. Drought does not justify the relative increase in the price of the basic consumer basket. The correlation[3] between the level of rainfall in Mexico and the change in GVA in the primary sector is positive, 0.4 in nominal terms and 0.3 to factor in the impact of prices on production, based on a review of annual data from 2001 to 2011. That is, a pattern of increasingly greater rainfall coincides with a higher variation of primary sector production. In relation to consumer prices, the continued relative increase in the prices of the basic basket of products from the primary sector is striking. Indeed, in the past 10 years such products have become relatively more expensive than the overall NCPI basket or its core component. This has a regressive impact on income distribution as the lower income population in general has an average consumption basket, the basic basket, weighted toward food products. However, there is also a low correlation between rainfall and consumer inflation in relation to the basket of primary sector products, which lies between 0.2 and 0.3.[4] Factors related to the relative productivity of the sector may be behind this behavior since production prices, prior to factoring in distribution and marketing costs, are growing at higher rates than overall inflation.

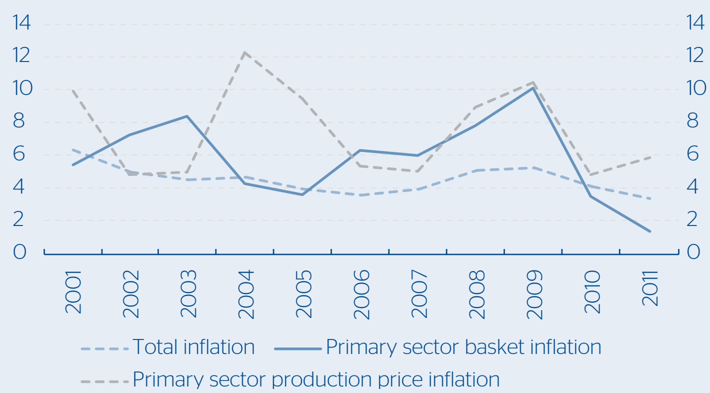
Graph 29

Mexico, average annual rainfall National monthly average, mm

Source: BBVA Research with SMN data

Graph 30

Mexico, consumer and production price inflation in the primary sector for beans and inflation in unprocessed beans NCPI (% change, y/y)



Source: BBVA Research and INEGI

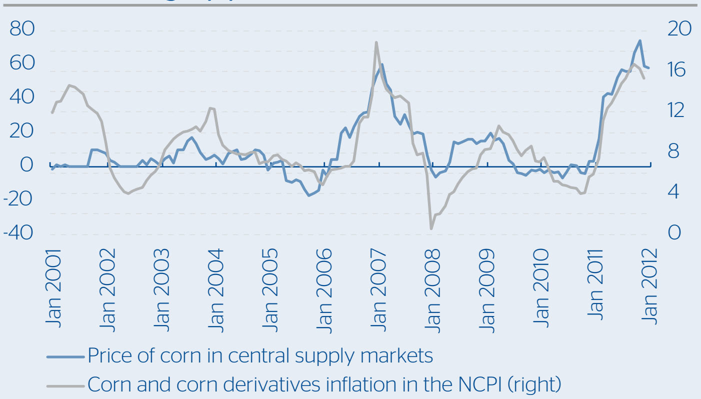
[1] Database of the National Meteorological Service in http://smn.cna.gob.mx/.
[2] National Water Commission, Atlas of Water in Mexico 2011. Available in Internet. The rest of the water uses concessioned is distributed by public supply (14%), electricity production (5%) and industry (5%).
[3] We refer us correlation to the porcentage of the movement from one of the variables that is explained by the other, the statistical coefficient R square of its relation.
[4] What is achieved by considering right that the relevant rainfall is an average of the contemporary and of that of the year before, between 2001 and 2011 or with the contemporary rainfall, but not considering 2011, when the prices of this type of goods, slowed down significantly to 14%, despite the marked drop in rainfall.

Among the agricultural production sectors most affected by drought are corn for human consumption, beans, and livestock –particularly cattle– in states such as Chihuahua, Durango, and Coahuila in northern Mexico. In the case of corn and beans, both of which are highly important in the national diet, their effect on headline inflation will be limited, given that the chains of both products account for only 2% of the NCPI (11.3% for processed foods and 7.7% for agricultural products). In addition, it should be noted that the sub-indexes of processed foods and animal feed in Mexico are much more closely linked to the dynamics of grain prices on international markets--which last year also experienced upward shocks--than that of their local market prices. Thus, even though we will certainly see very direct effects on the prices of tortillas or processed beans, this does not imply generalized effects on other food prices. Finally, it should be noted that steps have been taken to mitigate the effects caused by the lower production of these products, such as extending the import quota for beans, or the relocation of corn cultivation to other parts of the country. In addition, it should be noted there is an insurance coverage program to cover weather-related catastrophes that is implemented through the departments of Finance and Agriculture and the Mexican federal government has an agricultural insurance company (Agroasemex).

In conclusion, even though drought has a downside effect on output and an upside impact on prices, both are limited from a macroeconomic standpoint. However, there are still a significant number of people who earn a living from subsistence agriculture, and higher food prices result in increases in inequality. Indicators such as the NCPI are based on a representative consumer who, on average, is considered indicative of all Mexicans, and they are especially, by definition, based on transactions that require a monetary allotment and which, therefore, may not be adequately calculating the impact of the lack of supply of these products in the country's rural areas, also considering the increased vulnerability of their population.

Graph 31

Local wholesale prices for corn and inflation in the corn chain (% change, y/y)



Source: BBVA Research with data from the National System of Market Information and Integration (SNIIM) and INEGI

Graph 32

Local wholesale prices for beans and inflation of unprocessed beans in the NCPI (%, y/y)

Source: BBVA Research with data from the National System of Market Information and Integration (SNIIM) and INEGI

Inset 2: Inflation has an impact on the temporary interest rate structure, which transfers to activity

The possibility that the deterioration of the balance of inflation risks will end up assuming effective price increases makes it important to analyze the impact on the financing cost in the economy and therefore on activity and employment. With the aim of evaluating this relationship, a model is estimated which includes inflation, activity, funding and temporary structure of interest rates.[1] With regard to the latter, an attempt is made to capture the behavior of the total yield curve, which goes from one month to 30 years, through only three factors that synthesize it. These factors are interpreted, given their similarity with them, such as level, slope, and curvature of the temporary structure of interest rates.[2] In this manner, the affine model seeks to explain the behavior of the three factors in terms of the macroeconomic variables, at the same time that these are also affected by the factors of level, slope and curvature.

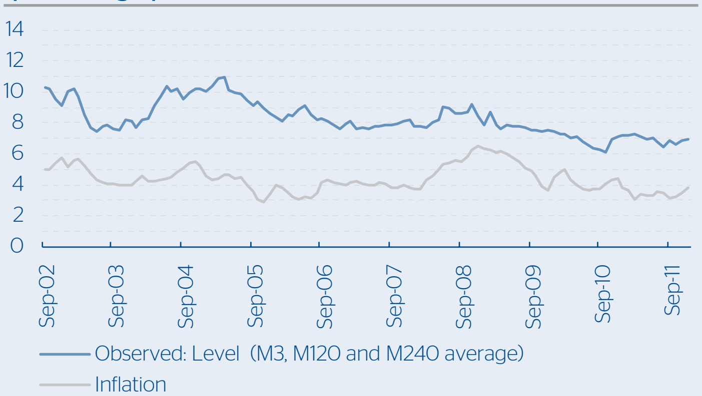
The data and the estimates show that there is an intense relationship between inflation and the average level of the interest rate curve (Graphs 33 and 34). In particular, inflation transfers rapidly to the level and slope of the structure of interest rates and does so more intensely than growth (Graph 34). In accordance with this result, Cortés and Ramos-Francia (2008) show that the level of interest rates is closely related to inflation expectations.

In turn, the interest rate level and its slope increase end up producing a brake to growth (Graph 35). [3] An environment of higher interest rates supposes an increase in the financing cost of the economy, which ends up translating into a level of activity, estimated by the IGAE (the Global Economic Activity Indicator), much lower than in a scenario without changes in interest rates. However, in the short term, the level of interest rates has a positive relationship with activity, which is consistent with the close relationship of the factor of the level of the curve with inflation. In this sense, an increase in the level derived from an increase in inflation reduces real interest rates and boosts activity in the short term, a pattern that, incidentally, is also obtained in similar studies for the U.S.

The response of the factor of the inflation level and funding go in the same direction (Graph 34). That this occurs is consistent with the market expectation that inflation rises are generally followed by increases in the funding rate.

Graph 33

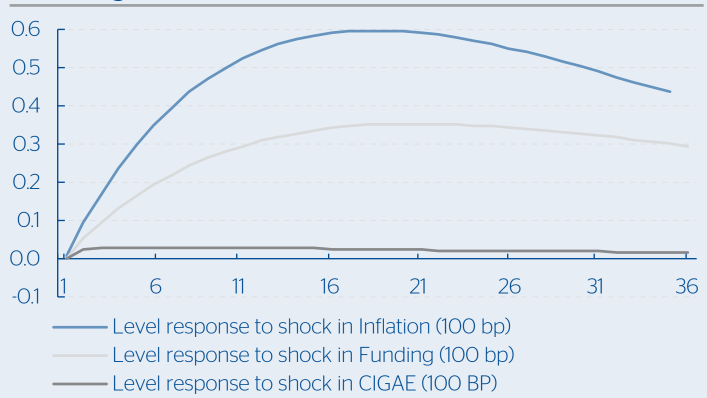
Average level observed in annual inflation rates (percentage points).



Source: BBVA Research and Bloomberg. To identify the bonds, the letter M is used and the number to its right indicates the number of months to maturity.

Graph 34

Response of the curve level to a change in inflation, funding rate and growth of the IGAE



Source; BBVA Research. The numbers in the axis of the "x" s denote months.

[1] For further details, see BBVA Research Observatorio Económico "Crecimiento, inflación, fondeo y curva de tasas de interés: impacto en ambos sentidos" ("Growth, inflation, funding and interest rates curve: impact in both directions", available in: http://www.bbvaresearch.com/KETD/ketd/esp/nav/geograficas/latinoamerica/mexico/index.jsp.

[2] Traditionally, the level of the curve is close to the average of bond yields with short, medium and long-term maturities (e.g. average of 3-month, five- and twenty-year bonds). The slope would be the difference between the yield of a long- and a short-term bond (for example, the difference between a 20-year and a three-month bond). The curvature refers to the difference between the yield of the bond of the medium part of the curve in relation to the short and the long part (for example, 2* the yield of the 2-year bond minus that of 3-month and 10-year bonds).

[3] The slope is defined as the short minus the long term; that is, the contrary of the most common definition.

There is also a reaction to the increase in the funding rate to changes in the level factor of the curve, the market anticipates the evolution of monetary policy (Graph 36). Given that there is more than one month between each meeting on monetary policy, it is probable that the rates respond with anticipation to the actions of the central bank, something that the market could anticipate, for example, in terms of the behavior of inflation, as seen in Graph 33. Moreover, to the extent that the Banco de Mexico has been establishing a more efficient communication and more predictable decisions of its monetary position in accordance with the available economic information, the movements in the bond market should have a greater capacity to incorporate changes in monetary position in advance. The perspective of BBVA Research and the market regarding a possible change in monetary position is presented in the following section.

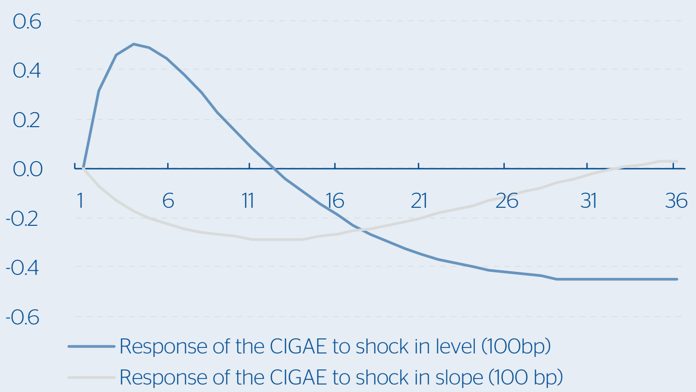
Referencias

Cortés, J. and Ramos-Francia, M. (2008), "An Affine Model of the Term Structure of Interest Rates in Mexico", Banxico Working paper 2008-09.

López Marmolejo, Arnoldo (2012), "Crecimiento, inflación, fondeo y curva de tasas de interés: impacto en ambos sentidos", Observatorio Económico, Febrero 2012.

Graph 35

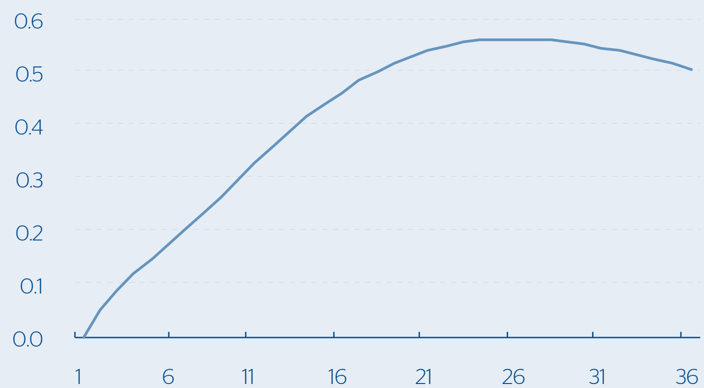
Response of the IGAE to 100 bp growth in the factors of level and slope of the curve



Source: BBVA Research

Graph 36

Response of funding to shock at a level of 100 bp



Source: BBVA Research

Banxico (the central bank) will maintain the monetary pause

In the past two months the economic scenario has changed toward conditions which make a reduction in the rate of monetary policy less likely. The most recent data indicate higher than expected inflation in November, December, and the first half of January, which places the annual growth in prices in the upper range of Banco de Mexico's variability interval. Even though core inflation is at levels close to 3%, influenced by the absence of demand pressures, given the comfortable margins that are maintained in the production factors market, it is expected that in the next few months headline inflation will be above 4%. Furthermore, domestic activity continues to grow, underpinned by the recent improvement in the U.S. economy.

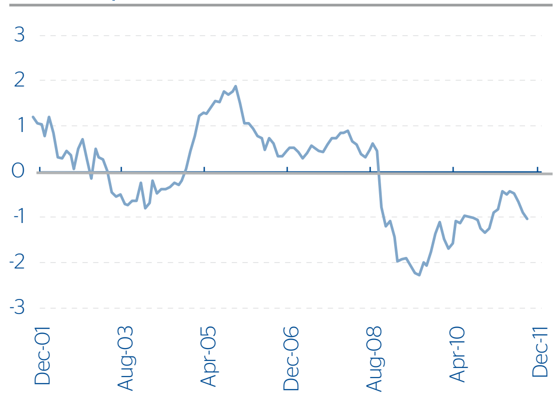
In the international environment, however, risks on the downside in economic activity persist. The U.S. Federal Reserve Board said in its latest statement that it expects the federal funding rate to remain "exceptionally low" at least until the end of 2014, given "modest" economic growth in the next few years and a slow job recovery. For the first time the expectations of members of the Federal Open Market Committee (FOMC) were publicly released in relation to the moment in which they feel it is appropriate to increase the federal funding rate and their projection on what that rate will be. At the same time, uncertainty continues concerning a resolution to the European debt crisis, despite the intervention of the European Central Bank (ECB).

The central bank's statements have shifted toward a neutral stance, although with different positions within the Board on the inflation outlook. On the one hand, the announcements of monetary policy decisions maintain a pessimistic tone in terms of overall activity and an easing of domestic demand. On the other hand, the balance of inflation risks changed from favorable to neutral as a result of the recent depreciation of the peso and growth in some price categories. The messages in the central bank's announcements are the product of discussions within the Board of Governors, with divergent views in terms of the balance of inflation risks. Some members indicated that the factors that led to an easing in the growth of prices during most of 2011 are not sustainable or recurring, a view that does not seem to be shared by the rest of the Board. The depreciation of the peso and its impact on the process of price formation were also debated.

BBVA Research's outlook is for a pause at 4.5 per cent during 2012, with the possibility of a rate cut, given a risk scenario in economic activity. This scenario is based on an outlook of inflation being above 4 per cent for several months but that closes the year within the central bank's target, domestic economic activity that continues to grow, and central bank communication that sends a message of neutrality. However, in the event that the global economic scenario were to rapidly and intensely weaken affecting the domestic economy, the chances of a cut in the funding rate would increase. The possibilities of a hike are very reduced, given the absence of demand pressures on prices and the non-core nature of the recent increase in inflation.

Graph 37

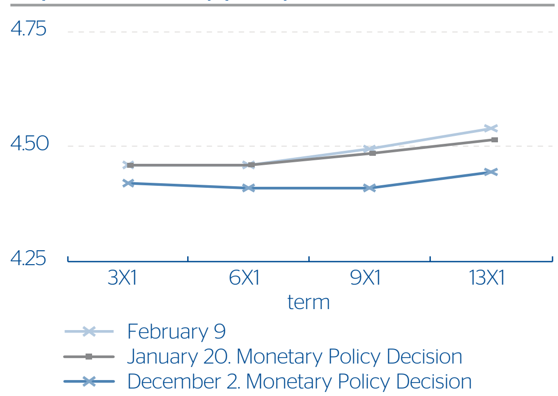
Monetary Conditions Index



Source: BBVA Research. Index calculated on the basis of the real interest rate on 28-day Cetes and the real Exchange rate, each variable with 50% weight.

Graph 38

Implied monetary policy rate in IRS contracts



Sources: BBVA Research and Valmer.

5. Financing conditions, domestic spending and external factors

The improvement in corporate financing conditions is on hold in view of the rise in risk aversion

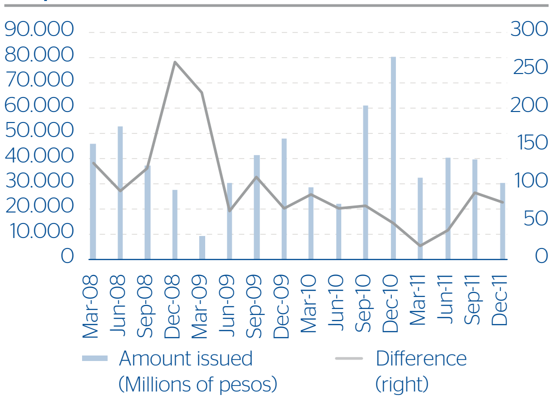
The rise in global risk aversion seen in the last quarter of 2011 translated into more restrictive conditions for financing Mexican corporations in pesos. Thus, on the primary market, the cost of financing in pesos rose for long-term issues when the average difference of the corporate issue rates increased compared to government issues. The 40 bp increase between March and December 2011 is the highest for a similar period since the end of 2008, and, although clearly lower in magnitude, it explains the transmission speed of nominal shocks to corporate financing conditions. Notwithstanding this rise in the cost of financing, long-term debt issues during the last quarter of 2011 maintained the rate seen in previous quarters, even though they were below that of the fourth quarter of the last two years.

Mexican corporations are facing higher costs in the dollar market and a lower appetite given the slowdown in issues. According to the Corporate Bond Index of JPMORGAN for Mexico (CEMBI), the rate that investors demanded for the purchase of Mexican debt in dollars rose from 6.02% to 6.78% between January and September of 2011, its highest point in the year, although very much below the 14.3% of March 2009. As regards the placement of issues, these fell as of September 2011, the month after which only government held entities placed debt in dollars. In fact, as per information obtained by Bloomberg, as of July 2011, the financing market in dollars was closed to corporations with qualifications lower than BBB-. So far in 2012, the market has reactivated with the placement of notes for US$800 million by one Mexican corporation.

The recent rise in the cost of corporate financing did not have a comparable magnitude of that registered during the 2009 crisis, in addition to that the most recent data show that this increase has halted and is even tending to disappear. Nevertheless, it should be recalled that tensions in the primary and secondary financing markets have effects on the real economy via investment and corporate decision-making. To this degree, it will be necessary to attentively follow the effects of the episodes of global aversion to risk with regard to corporate financing.

Graph 39

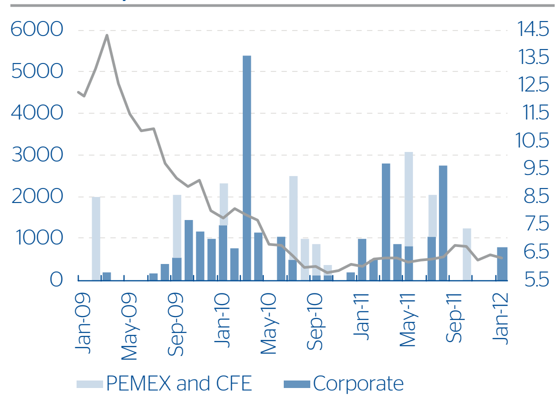
Amount issued and spread with respect to governmental rates. Primary market of corporate debt.



Source: The week. Corporate Debt. Banamex

Graph 40

Amount and financing rate in dollars on the secondary market



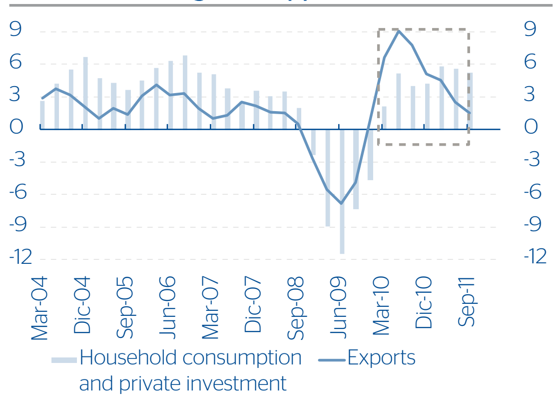
Sources: BBVA Research with Bloomberg data.

The strength of domestic spending continues to depend on the external impulse, although the capacity of the banking system credit supply is a support factor

Rallying surprises in the more domestic spending components. In recent quarters and more specifically in the second and third quarters of 2011 (the latest available figures at the close of this publication), the internal components of demand grew far beyond what external demand suggests; specifically, private consumption surprised in a rallying bout in the 3Q, reaching one of the highest change in the rates since the start of the recovery (2% q/q), while exports contracted by (-)0.1% compared to the previous quarter. Moreover, in the last quarter for which data were made known, consumption and private investment have grown on average by (-)0.2%. In turn, imports in the above-mentioned period progressed at an average quarterly rate of 1.7%. In this situation, it is specified up to what point the growth of the components of internal demand is sustainable autonomously, independently of the external impulse. The available evidence suggests that this would not be the most probable case.

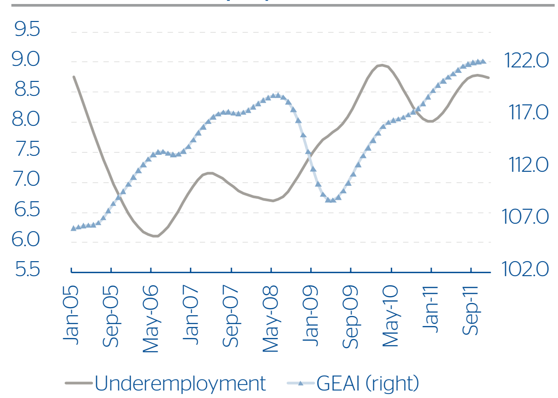
The spending capacity of private economic agents depends on their real disposable income, that is, of that actually perceived and from which they expect to obtain in accordance with activity or income expectations and financing conditions. Among these factors (financing, income, activity), there is a mutual interdependence, although a banking system with a capacity to offer credit is an important support element in view of prior economic cycles.[1] This is particularly significant since it continues the affluence of disposable resources in the economy, following three years of intense recovery of activity. Thus, in what refers to the labor market, indicators, such as the unemployment rate or the proportion of those employed who are able to offer more work than the labor market situation allows them (underemployed), remain above the figures prior to 2009. By dividing the sample into two periods; from 2007 through the lowest point before the recovery (May 2009) and from that point up to now, the underemployment rate averages 7% of those employed, in the first part of the sample, 8.4% in the second (4% vs. 5.4% In the case of the unemployed). In this same sense, manufacturing producers surveyed by Banco de Mexico do not show any significant difference in the difficulty in contracting labor in the previously mentioned periods. Moreover, while at the start of the recovery the indicator for "difficulty in hiring labor" rose throughout 2011 and in terms of the trend, fewer producers mentioned having had any difficulty in hiring.

Graph 41
Exports and domestic demand Contribution to growth, pp



Source: BBVA Research with INEGI data

Graph 42
GEAI (2003=100) and underemployed as a % of those employed

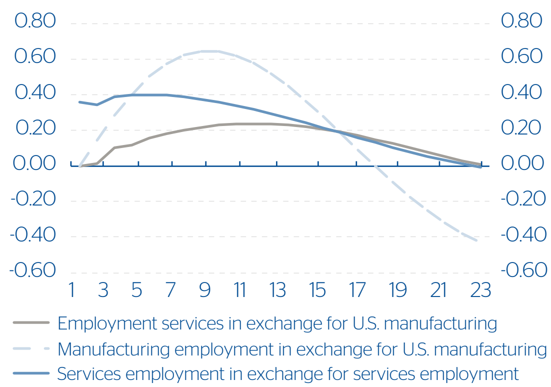


Source; BBVA Research with INEGI data

[1] For further details regarding the impact of the credit supply capacity of the banking system in household spending see Mexico Economic Outlook 1Q11 by BBVA Research, available on the Internet.

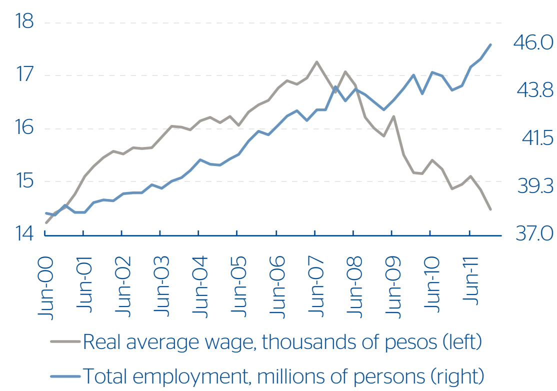
Activity and employment (disposable income) respond significantly to the strength of external demand. An econometric analysis of the response of both the employment component in the formal private sector linked to industry and services, in face of a positive drive in U.S. manufacturing production, is a sign that external demand shows a high and speedy response of the former to the latter.[2] The greater effect, as was to be expected, appears in the employment component in manufacturing; although in services the impact, although less intense, is also more persistent. The persistence of the effect is higher in the case of employment in services and always positive (it disappears two years after the initial shock), while the impact on manufacturing employment drops more quickly and is even negative, a reflection of the initial impulse type considered. The effect on employment of the services sector (60% of total formal employment), a result of a shock in U.S. manufacturing production of a duration comparable with an exogenous shock of the same variable. These results are totally comparable if they are considered instead of the formal employment variables in Mexico, those corresponding to manufacturing and services activity.

Graph 43
Employment in Mexico and Manufacturing in the U.S. Employment response in Mexico to stimuli of manufacturing production in the U.S.



Source: BBVA Research

Graph 44
Employment and Labor Income



Source; BBVA Research with INEGI data.

The affluence in the labor market favors the lack of pressure from costs on prices, given the drop in real labor income, which curbs the rise in the disposable income of total households. The rise in employment at historically moderate rates not higher than the increase in the potentially active population produces a stable performance of the unemployment rate and the decrease in its salary cost, in real terms much below the levels observed prior to the crisis This has favored the improvement in price competitiveness, since it has prevented the improvements derived from the depreciation of the peso in the foreign exchange rate to be absorbed by wage costs, although it also puts a brake on the growth of households' disposable income as a whole and, thereby, their spending capacity.

[2] The three series (employment in the services sector, employment in manufacturing and manufacturing production in the U.S.) are modeled from a VAR model with 3 lags and one constant. To come near to the effect that a standard deviation of the external sector on the Mexican labor market, a Cholesky decomposition is applied on the one that is identified as the services employment variable as the most endogenous, and the representative variable of external demand of Mexico, with manufacturing production of the U.S. as the most exogenous.

6. Indicators and Forecasts

Chart 2
Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-3.5	3.0	**1.7**	**2.3**	**2.2**
EMU	-4.2	1.8	**1.6**	**-0.5**	**1.0**
Germany	-5.1	3.6	**3.0**	**0.5**	**1.7**
France	-2.6	1.4	**1.6**	**0.2**	**1.4**
Italy	-5.1	1.4	**0.4**	**-1.5**	**0.2**
Spain	-3.7	-0.1	**0.7**	**-1.3**	**0.6**
UK	-4.4	2.1	**0.9**	**0.5**	**1.4**
Latin America *	-0.6	6.6	**4.5**	**3.7**	**4.1**
Mexico	-6.1	5.4	**3.8**	**3.3**	**2.9**
EAGLES **	4.0	8.4	**6.7**	**5.9**	**6.5**
Turkey	-4.9	9.2	**8.5**	**1.9**	**4.2**
Asia Pacific	4.2	8.1	**5.8**	**5.8**	**6.1**
China	9.2	10.4	**9.2**	**8.3**	**8.7**
Asia (exc. China)	1.0	6.7	**3.5**	**4.2**	**4.4**
World	0.6	5.1	**3.9**	**3.5**	**4.1**

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 2012
Source: BBVA Research

Chart 3
Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-0.4	1.6	**3.2**	**2.3**	**2.3**
EMU	0.3	1.6	**2.7**	**1.8**	**1.3**
Germany	0.2	1.2	**2.3**	**1.8**	**1.3**
France	0.1	1.6	**2.1**	**1.6**	**1.2**
Italy	0.8	1.5	**2.8**	**2.2**	**1.5**
Spain	-0.3	1.8	**3.2**	**1.2**	**1.1**
UK	2.2	3.3	**4.5**	**2.8**	**1.9**
Latin America *	6.9	7.4	**10.0**	**9.5**	**9.1**
Mexico	5.3	4.2	**3.4**	**4.0**	**3.3**
EAGLES **	2.8	5.3	**6.3**	**4.8**	**4.7**
Turkey	6.3	8.6	**6.7**	**9.1**	**6.0**
Asia Pacific	0.3	3.6	**4.8**	**3.3**	**3.4**
China	-0.8	3.3	**5.4**	**3.3**	**3.7**
Asia (exc. China)	1.1	3.7	**4.4**	**3.2**	**3.1**
World	2.2	3.5	**5.1**	**3.9**	**3.6**

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 2012
Source: BBVA Research

Chart 4

United States Indicators and Forecasts

	2010	2011	2012	2013	1T11	2T11	3T11	4T11	1T12	2T12	3T12	4T12
Macroeconomic Indicators												
GDP (real % change)	3.0	1.8	2.3	2.2	2.2	1.6	1.5	1.7	2.3	2.4	2.5	2.2
Personal consumption (real % change)	2.0	2.2	2.2	2.1	2.8	2.2	2.0	1.6	1.8	2.3	2.4	2.4
Gov. consumption (real % change)	0.7	-2.1	-0.7	0.5	-1.1	-2.2	-2.4	-2.9	-1.3	-1.0	-0.9	0.4
Gross fixed investment (real % change)	2.6	6.6	7.3	5.9	7.4	5.0	7.6	6.6	8.7	7.9	6.1	6.8
Construction[1]	-4.3	-1.4	5.5	4.4	-2.9	-6.8	1.3	3.3	5.2	5.4	6.4	4.9
Industrial prod. (real annual % change)	5.3	4.2	3.4	3.2	5.4	3.8	3.7	3.7	3.3	3.9	3.1	3.2
Current account balance (% of GDP)	-3.3	-3.2	-3.1	-3.2	-3.2	-3.3	-2.9	-3.3	-2.9	-3.2	-3.1	-3.3
Final annual inflation	1.5	3.0	2.6	2.4	2.7	3.6	3.9	3.0	2.3	2.6	1.9	2.6
Average annual inflation	1.6	3.2	2.3	2.3	2.1	3.4	3.8	3.3	2.6	2.3	2.1	2.4
Primary fiscal balance[2] (% of GDP)	-8.9	-8.5	-7.1	-4.6	-	-	-	-8.5				-7.1

Chart 5

Mexico Indicators and Forecasts

	2010	2011	2012	2013	1T11	2T11	3T11	4T11	1T12	2T12	3T12	4T12
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	5.4	3.8	3.3	2.9	4.3	3.6	4.4	3.0	3.2	3.4	2.9	3.7
Per inhabitant (US dollars)	9,582	10,501	10,410	11,888	10,550	11,043	10,733	9,786	10,014	10,191	10,547	10,909
US$ billions	1,035	1,143	1,141	1,313	1,148	1,202	1,168	1,065	1,098	1,117	1,156	1,196
Inflation (average, %)												
Headline	4.2	3.4	4.0	3.3	3.5	3.3	3.4	3.5	4.1	4.3	4.1	3.6
Core	3.9	3.2	3.4	3.2	3.2	3.2	3.2	3.3	3.4	3.5	3.5	3.4
Financial Markets (eop, %)												
Interest rates												
Bank funding	4.50	4.50	4.50	5.50	4.50	4.50	4.50	4.50	4.5	4.5	4.5	4.5
28-day Cetes	4.3	4.2	4.4	5.0	4.2	4.3	4.1	4.4	4.3	4.4	4.4	4.4
28-day TIIE	4.9	4.8	4.8	5.3	4.8	4.9	4.8	4.8	4.8	4.8	4.8	4.9
10-year Bond (%, average)	6.6	6.8	6.4	7.0	7.5	7.1	6.4	6.4	6.1	6.4	6.5	6.6
Exchange rate (average)												
Pesos per dollar	12.6	12.4	13.4	12.5	12.1	11.7	12.3	13.6	13.5	13.7	13.4	13.1
Public Finances												
*FRPS (% of GDP)	-3.5	-3.0	-3.0	-2.8	--	--	--	-3.0	--	--	--	-3.0
External Sector[3]												
Trade balance (US$ billions)	-3.0	-4.3	-6.4	-6.2	1.5	1.4	-3.8	-3.4	-1.2	0.9	-3.4	-2.6
Current account (US$ billions)	-5.7	-11.4	-14.2	-14.7	-2.6	-0.2	-3.8	-4.8	-4.1	-1.8	-3.9	-4.4
Current account (% of GDP)	-0.5	-1.0	-1.2	-1.1	-0.9	-0.1	-1.3	-1.8	-1.5	-0.6	-1.3	-1.4
Oil (Mexican mix, dpb, eop)	72.1	100.1	89.1	92.6	93.0	105.6	101.2	100.8	94.6	86.4	86.4	89.1
Employment												
Formal Private (annual % change)	3.7	4.1	2.9	2.8	4.9	4.2	4.2	2.9	2.5	3.0	2.8	3.4
Open Unemployment Rate (% active pop.)	5.4	5.3	5.3	4.9	5.2	5.5	5.3	5.0	5.2	5.2	5.3	5.3

Chart 6

Mexico Indicators and Forecasts

	2010	2011	2012	2013	1T11	2T11	3T11	4T11	1T12	2T12	3T12	4T12
Aggregate Demand [4] (ann. % chge., seasonally-adjusted)												
Total	9.5	**5.2**	**5.5**	**4.3**	5.8	4.4	4.9	**5.6**	**5.7**	**5.3**	**5.7**	**5.3**
Domestic Demand	4.2	**5.1**	**4.5**	**3.5**	3.2	3.4	5.1	**5.4**	**6.2**	**4.9**	**4.4**	**3.4**
Consumption	4.7	**4.2**	**3.2**	**2.9**	4.5	3.5	4.3	**4.5**	**4.0**	**3.5**	**2.9**	**2.6**
Private	5.0	**4.8**	**3.3**	**3.0**	5.1	4.5	5.0	**4.6**	**4.1**	**3.6**	**2.7**	**2.9**
Public	2.8	**0.8**	**2.5**	**2.0**	1.5	-2.5	0.5	**3.8**	**2.9**	**2.9**	**3.8**	**0.5**
Investment	2.4	**8.3**	**9.1**	**5.8**	5.1	8.5	8.8	**10.8**	**10.3**	**8.6**	**9.9**	**7.5**
Private	2.9	**14.1**	**8.4**	**4.4**	15.2	16.7	11.5	**13.2**	**6.0**	**7.1**	**10.3**	**10.1**
Public	1.2	**-7.3**	**11.2**	**10.6**	-21.2	-12.6	1.1	**4.1**	**26.8**	**13.7**	**8.6**	**-0.2**
External Demand	25.7	**7.9**	**7.7**	**6.5**	14.2	7.6	4.4	**6.1**	**4.0**	**6.4**	**9.6**	**10.8**
Imports	23.5	**9.1**	**11.5**	**8.0**	10.3	7.0	6.2	**12.8**	**12.8**	**10.4**	**13.6**	**9.4**
GDP by sectors (ann. % chge., seasonally-adjusted)												
Primary	3.3	**0.7**	**2.6**	**2.1**	-1.6	-5.3	7.9	**1.9**	**3.0**	**3.1**	**2.8**	**1.8**
Secondary	6.0	**4.0**	**3.1**	**3.1**	4.6	4.2	3.5	**3.5**	**3.4**	**3.6**	**2.6**	**3.0**
Mining	2.2	**-2.4**	**1.1**	**2.2**	-3.1	-2.3	-3.7	**-0.3**	**1.3**	**1.0**	**1.0**	**1.1**
Electricity	2.4	**6.0**	**3.1**	**3.1**	8.2	7.5	5.0	**3.3**	**3.1**	**3.6**	**2.6**	**3.1**
Construction	0.0	**5.1**	**3.8**	**4.0**	5.4	3.9	5.1	**5.9**	**4.0**	**4.8**	**3.6**	**2.8**
Manufacturing	10.1	**5.2**	**3.4**	**3.0**	6.1	5.6	5.4	**3.8**	**3.7**	**3.9**	**2.6**	**3.5**
Tertiary	5.0	**3.9**	**3.2**	**2.9**	3.9	4.0	4.7	**3.1**	**3.2**	**3.2**	**2.8**	**3.5**
Retail	-14.2	**13.4**	**7.3**	**4.2**	8.2	8.4	8.2	**4.5**	**4.7**	**3.6**	**3.0**	**5.3**
Transportation, mail and warehouse	-6.5	**6.5**	**3.4**	**3.2**	3.1	3.6	4.0	**2.7**	**2.9**	**2.9**	**2.7**	**4.3**
Massive media information	0.8	**5.6**	**6.4**	**5.6**	7.0	6.5	7.7	**4.5**	**4.1**	**5.5**	**6.3**	**6.4**
Financial and insurance	-4.4	**2.7**	**3.5**	**3.2**	1.1	2.0	7.7	**3.4**	**2.1**	**3.6**	**3.5**	**3.6**
Real-estate and rent	-1.3	**1.8**	**2.1**	**2.5**	2.4	2.3	1.9	**1.8**	**2.4**	**2.7**	**2.0**	**2.8**
Prof., scientific and technical servs.	-4.7	**-3.0**	**4.5**	**2.9**	3.0	7.0	5.8	**2.4**	**3.3**	**3.6**	**3.1**	**1.6**
Company and corporate management	-7.6	**1.4**	**4.6**	**3.5**	2.9	5.8	4.9	**4.9**	**3.4**	**3.5**	**3.8**	**3.2**
Business support services	-4.7	**1.3**	**4.3**	**3.5**	3.5	4.5	4.7	**4.5**	**3.5**	**3.7**	**3.7**	**3.0**
Education	0.4	**3.0**	**1.7**	**2.2**	0.8	2.0	2.2	**1.8**	**2.3**	**2.4**	**2.1**	**2.2**
Health and social security	0.8	**-1.8**	**2.0**	**1.9**	0.2	2.6	3.2	**1.9**	**1.8**	**2.7**	**1.7**	**1.4**
Cultural and sport	-4.6	**1.8**	**5.2**	**1.8**	5.5	7.0	6.5	**2.0**	**1.5**	**1.8**	**2.1**	**1.9**
Temporary stay	-7.7	**3.9**	**1.9**	**2.0**	0.9	2.4	2.9	**1.5**	**3.0**	**2.1**	**1.7**	**1.2**
Other services, except government activities	-1.1	**0.6**	**3.7**	**2.8**	3.2	4.7	4.2	**2.6**	**2.8**	**2.9**	**2.8**	**2.6**
Government activities	4.8	**4.4**	**-0.4**	**1.9**	0.9	-4.6	-0.9	**3.1**	**3.0**	**2.2**	**1.0**	**1.3**

1: Residential investment
2: Fiscal balance (% GDP)
3: Accumulated, last 12 months
4: Base 1993=100; GDP by sector base 2003=100. The observed data of the primary sector, secondary and tertiary seasonally by INEGI, the rest own seasonal adjusment
mmd: miles de millones de dólares
dpb: dollars per barrel
*RFSP: Financial Requirements of the Public Sector
na: not available
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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