

Mexico

Economic Watch

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Non-core inflation records surprising downturn for second consecutive month May 2010 inflation

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Inflation recorded a surprising downturn for the second consecutive month in May, -0.63%, which is above our estimate (-0.31%) and the market consensus (-0.56%). Annual inflation stood at 3.9% (vs. 4.3% in April). This deflationary trend is mainly due to the excellent performance in non-core factors, such as electricity prices –with seasonal behavior-, gas and agricultural products. Core inflation was close to the expected rate (0.24% vs. BBVA Research 0.26%), recording a y/y rate of 4.1%, which is the same as the April result. The high volatility that inflation recorded is worth mentioning. In 1Q10, it was at the upper end of the Banxico range (between 4.25% and 4.75%) and in just a couple of months fell to 4.1% on average, which is beneath the range forecast for the second quarter (between 4.5% and 5.0%).

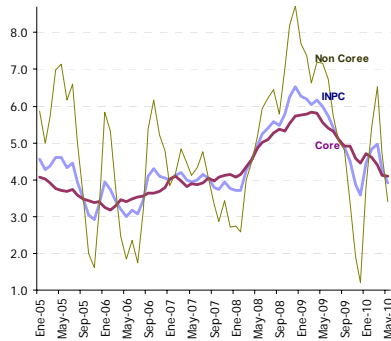
As for non-core inflation, agricultural prices fell by -8.4% m/m (vs. -3.1% estimate), and were the main reason behind the deviation from our forecast. Because prices on wholesale markets hint at lighter falls in the consumer prices of these products than recorded, this trend is likely to appear with some delay. Therefore, given the high volatility in these products and the existence of some medium-term regularities, we do not rule out yet agricultural prices as an inflationary factor during the rest of the year. The fall in administered prices (-5.5% vs. BBVA Research -5.2%) is firstly due to the downturn in electricity prices, of a seasonal nature, and secondly, the excellent performance in domestic gas prices. From now on we expect these prices to push inflation upwards again due to the monthly changes in petrol prices and, from October onwards, with the start of the winter electricity tariffs.

The trend in core component prices is a reflection of mixed factors. Firstly, the lower inflation recorded in processed food in relation to its average levels for May (0.3 vs. 0.5 average) could be related to the flatness of domestic demand; the dilution of the inflationary effect witnessed following the tax reform; and the drop in imported prices due to the appreciation in the exchange rate. The upward pressure in the other services component is also noteworthy, in categories such as air transport, food away from home, health and home ownership. Overall, we still think that core inflation remains under control thanks to a moderate level of demand and relative exchange rate stability.

The inflation trend in the last two months has been extremely positive, causing a downward shift in the monetary policy risk balance compared to previous levels. However, there are some latent risks of inflation rising during the rest of the year in the non-core component. In particular, we predict upside risks in agricultural product prices, which could materialize in the second half of the year, such as certain resistance to falls in service prices in spite of the moderate level of domestic demand. Just by itself, the statistical effect of the surprises recorded in recent months, if everything else remains the same, has raised significantly the probability that inflation would be within the Banxico range at the end of 2010.

By June we expect headline inflation rate of 0.33% (vs. 0.29% consensus) and a core rate of 0.30% (vs 0.33% consensus).

Chart 1
Inflation and components
(Y/y % change, monthly series)



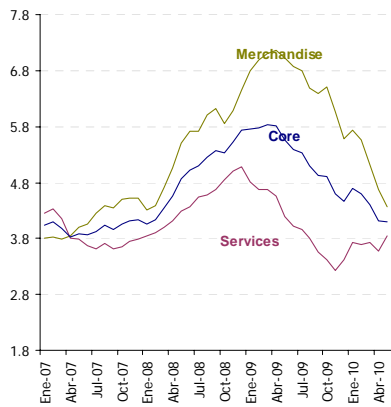
Source: BBVA Research with Banxico data

Table 1
Inflation and components
(Monthly and annual % change)

	Monthly change (%)		Annual change (%)		Dif. (pp)
	Avg. Mar 2003-08	May-10	Abr-10	May-10	
CPI-Mx	-0.31	-0.63	4.27	3.92	-0.35
Core-Mx	0.26	0.24	4.11	4.10	-0.01
Goods	0.33	0.24	4.68	4.37	-0.31
Food products	0.48	0.26	4.95	4.63	-0.32
Other Goods	0.22	0.23	4.46	4.15	-0.31
Services	0.20	0.25	3.58	3.84	0.27
Rent	0.28	0.25	2.63	2.75	0.12
Education	0.10	0.09	4.11	4.10	-0.01
Other serv.	0.14	0.31	4.43	5.00	0.57
Non Core-Mx	-1.90	-3.00	4.70	3.41	-1.29
Farm products	-0.48	-3.45	3.71	0.16	-3.55
Fruits//Vegetables	-1.21	-8.36	10.40	1.32	-9.08
Meat//Eggs	0.02	-0.03	-0.50	-0.57	-0.07
Public managed	-2.59	-2.77	5.24	5.20	-0.03
Energy	-5.20	-5.54	5.08	4.47	-0.62
Controlled prices	0.00	0.08	5.39	5.93	0.53

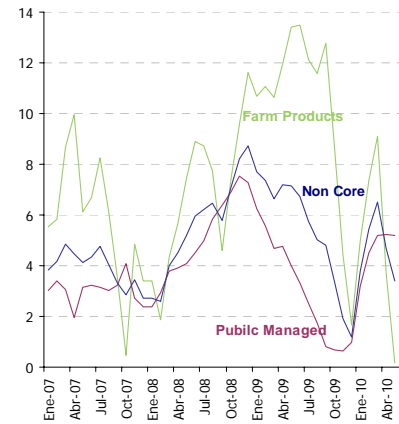
Source: BBVA Research with Banxico data

Chart 2
Core inflation and components
(Annual % change, monthly series)



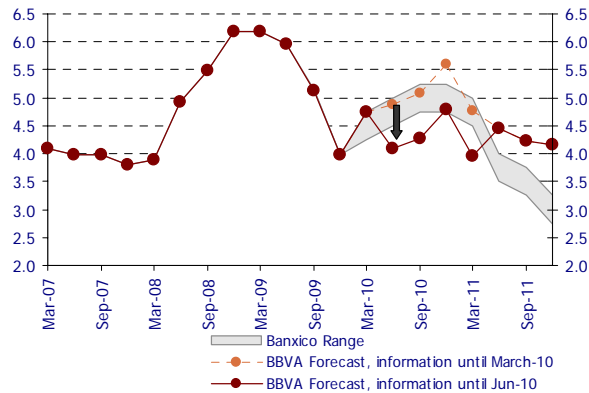
Source: BBVA Research with Banxico data

Chart 3
Non-core inflation and components
(Annual % change, monthly series)



Source: BBVA Research with Banxico data

Table 2
Inflation
(Annual average and statistical adjustment due to error in 2Q10)



Source: BBVA Research with Banxico data

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