Mexico

Economic Watch

Economic Analysis

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Surprise downturn in inflation in first half of January without impact from CPI update

Inflation for the first two weeks of January 2011

- **Banxico updates CPI to the spending basket of the National Survey of Family Income and Expenditure (ENIGH) 2008, which improves the significance of the index as a reflection of the spending structure of Mexican homes**

- **Inflation rose 0.17% bi-weekly, (0.18% according to non-updated IPC), under our forecast of 0.30% and that of the consensus of 0.31%.**

- **The core component rose 0.21% over the previous corresponding period (0.25% without the update according to our calculations), somewhat less than our estimate of 0.27%, and that of the consensus (0.18%)**

- **Non-core inflation showed a very favorable evolution, increasing by only 0.06% (0.04% without the update) thanks to the favorable evolution of some primary sector prices and a lesser increase than expected of local authorities' tariffs**

- **Awaiting the results of the second half of the month, it seems that there was a real downward surprise during the first half with respect to the evolution of prices compared to market expectations**

Inflation during the first half of January surprised the market by increasing only 0.17% over the previous period, a result under our estimate (0.3%) and under that of the consensus (0.31%), thanks to the very favorable evolution of non-core prices, which increased only by 0.06%. The core index only rose by 0.21%, also better than expected (BBVA 0.27% over the previous two weeks, Consensus 0.27%), although with contrasting movements in its components that were partially compensated. After correcting this classification biases–fundamentally the inclusion into the core CPI by Banxico of telephony, lubricants, and internal transport, the conclusions are maintained. In annual terms, inflation passed from 4.55% in the second half of December 2010 to 3.96% in the first half of January, a reduction that is in good part due to the comparison to the same period in 2010, when the VAT increase by one percentage point became effective, some special taxes were increased, and controlled prices such as that applied to automotive fuel were released.

Core inflation over two weeks (0.21%), although relatively low, was not exempt from pressures, given that within the sub-index of goods which increased (0.44%) strong pressures occurred in the area of food prices, which saw in increase of 0.80% in the period with the favorable evolution of non-food goods (0.17%). The processed foods index fundamentally increased as a result of the Special Tax on Products and Services (IEPS) for cigarettes and adjustment to the price of the tortilla, two effects observable since December, and that will phase out in the short term. For their part goods prices increased moderately, in good part due to the end of the Christmas season. The services sub-component increased 0.02% in the two-week period due to the limited increase of home prices (0.12%) and the falls in other services (–0.14%). Within the aforementioned, of particular note are the greater-than-expected reductions compared to the previous two weeks of Package Tourism Services (–5.25%) and Air Transport (–7.99%). In sum, core inflation evolved very favorably during almost all of 2010 and we expect it will keep falling during the first quarter of 2011, thanks to the base effect compared to the same period of 2010.

Still, potential risks exist associated to the increase of food prices that could possibly result from international price increases, although the structure of the local markets and the existence of subsidies should tend to minimize the possible impact. Also, goods prices should be moderated in the short term as a result of the strengthening of the peso. Finally, although the recovery of the Mexican economy is underway, we estimate that it is still too soon to talk about pressure on prices from the demand side.

Non-core inflation increased only by 0.06% as a result of the downturn in the primary sector (–1.18% in the first two weeks of January versus 3.06% in the last two of December). The increase of government-authorized tariffs (0.91%) compares favorably with that of the same period last year (2.57% compared to the preceding two weeks). Energy prices increased 0.7% compared to the preceding two weeks, which is less than the corresponding figure a year ago (1.1%), although we believe that planned increases in low octane gasoline prices ("Magna") will be the main booster of energy prices during the year, we do not rule out greater pressures in the short term on gas and electricity prices, under the influence of their increasing value in the international markets.

As we have been predicting for a few months, inflation will drop to rates close to 3.3%–3.0% toward the end of the first quarter this year, although the final magnitude of this reduction will depend on the final outcomes of some of the current latent inflationary risks, such as the increases seen in the prices of foods and other commodities. We estimate that these pressures are temporary in many markets, being linked more to supply problems than to demand pressures as well as exacerbated by the greater flow of investments aimed at increasing profitability in those markets.

## Banxico updates the CPI by improving its representativeness of household consumption

These two-week data are the first that Banxico publishes based on the update of the CPI to the base date of the first two weeks of December 2010. The new variables used in the calculations are based on the spending structure described in the National Survey of Family Income and Expenditure (ENIGH) 2008 carried out by the INEGI, a reference that Banxico updates on the first half-month of 2010, taking into consideration the recorded evolution of relative prices. The previous CPI used variables based on ENIGH 2000, and it was therefore important to update the index so that it may continue to reflect the consumption of Mexicans in the most accurate manner possible. Among the novelties in this CPI is the greater relative importance in the consumption basket of telephony and real estate. In addition, some prices were withdrawn from the sub-index of controlled prices, within the non-core component, and reassigned to the core basket because the prices of these products are no longer determined by government regulation. These are the prices for the services of telephony, foreign public transport, and automotive lubricants, which together constitute 3.83% of the new CPI basket, and now increase the size of its core component[1].

To check that the result of the first two weeks of January 2010 did not constitute a significant bias with regard to the update of the index, one can compare a series made with the previous classification and variable weighs of the CPI, the series with the previous classification and the new weighs and the new series, the last two provided by Banxico. Comparing the two-week variations of the series since the first two weeks of February 1995, classification, weighting, and total bias measurements were obtained, and the conclusion reached, as seen in Table 2 that previously recorded inflation would have been the same on average had it been measured with the new criteria, with deviations that normally should be under four hundredths of a percent.

As expected, the aforementioned reclassification between core and non-core generates more relevant changes that are compensated in the total of the CPI (Table 3) chiefly as a consequence of the reclassification of telephony to the core index, given that the January deceleration of the core index is somewhat lower than with the previous classification. In any case, we conclude that the update of the CPI is not a source of bias and that the new index is more accurate to reflect a more up-to-date consumption basket.

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[1] In addition, the reliability of the variables used has been increased due to the greater number of questionnaires collected and the spending structure has been corrected by showing more detail, for example in the area of health spending. See Banxico Methodology.

Chart 1
**General inflation and components
(% change y/y, bi-weekly series)**
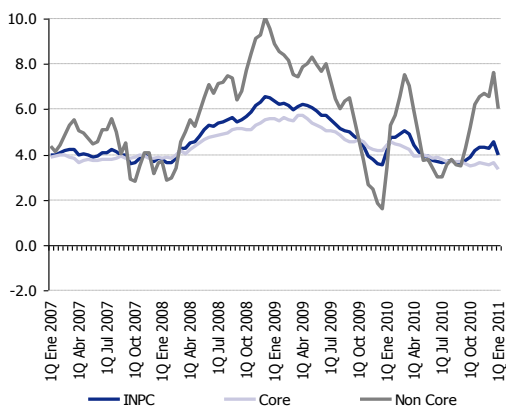
Source: BBVA Research with Banxico data

Table 1
**Inflation breakdown
(% change bi-weekly)**

|	Avg bi-week 2003-2009	Bi-weekly Jan 2010	Bi-weekly Jan 2011	YoY % chg. Bi-weekly 2011
CPI-Mx	**0.26**	**0.75**	**0.17**	**3.96**
Core-Mx	**0.23**	**0.49**	**0.21**	**3.32**
Goods	**0.31**	**0.69**	**0.44**	**3.68**
Food products	0.57	0.83	0.80	4.59
Other Goods	0.12	0.57	0.17	2.96
Services	**0.16**	**0.32**	**0.02**	**3.02**
Rent	0.21	0.34	0.12	2.41
Education	0.18	0.22	0.21	4.64
Other serv.	0.12	0.34	-0.14	3.03
Non Core-Mx	**0.35**	**1.58**	**0.06**	**6.00**
Farm products	-0.37	1.49	-1.18	5.43
Fruits//Vegetables	-1.90	3.13	-2.78	10.75
Meat//Eggs	0.68	0.43	0.04	1.99
Public managed	**0.80**	**1.65**	**0.77**	**6.27**
Energy	0.72	1.10	0.70	6.03
Government Authorized	0.94	2.57	0.91	6.67

Source: BBVA Research with Banxico data and the Banamex survey data

Chart 2
**Core inflation breakdown
(% change y/y, bi-weekly series)**
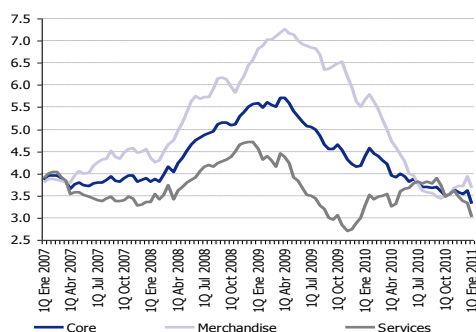
Source: BBVA Research with Banxico data

Chart 3
**Non-core inflation breakdown
(% change m/m, bi-weekly series)**
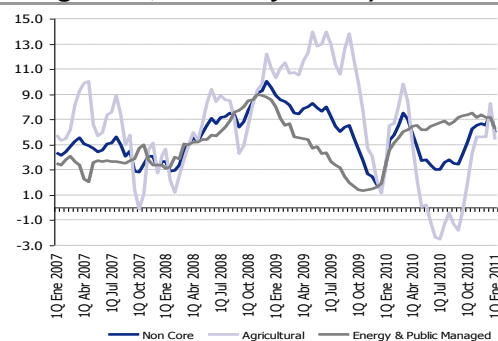
Source: BBVA Research with Banxico data

Table 2
**CPI in the first two weeks of January,
classification and weighting bias
(% variation over two weeks)**

Evaluation of the historic weighting and classification biases in the INPC				
	Bi-weekly % Chg.	Clasification Bias (1 minus 2)	Weighting Bias (2 minus 3)	Total Bias (1 minus 3)
1.INPC New Index	0.00	0.00		
2.INPC old Classification	0.00		0.00	
3.INPC old classification and weighting	0.00			0.00
Bias historic average		0.02	0.00	0.02
Bias Standard Deviation		-0.12	0.03	-0.10

Source: BBVA Research with Banxico data

Table 3
**Core and non-core inflation in the first two weeks of January,
classification and weighting bias
(% variation over two weeks)**

Evaluation of tha classification and weighting Bias for the Core and Non-Core Subindexes				
	Bi-Weekly % Chg.	Classification Bias (1 minus 2) (4 minus 5)	Weighting Bias (2 minus 3) (5 minus 6)	Total Bias (1 minus 3) (4 minus 6)
1. Core New Index	0.21	-0.02		
2. Core New Classification	0.23		-0.01	
3. Core old classification and weighting	0.24			-0.03
4. Non Core New Index	0.06	0.03		
5. Non Core New Classification	0.03		0.01	
6. Non Core old classifiaction and weighting	0.02			0.04

Source: BBVA Research with Banxico data