

Economic Outlook

Mexico

Second Quarter 2012
Economic Analysis

- Mexico will grow 3.7% in 2012, with inflation that will not surpass 4% and historically low and stable rates
- World growth will recover gradually in 2012 from the slump of the fourth quarter of 2011. The recovery will be more pronounced in Asia. On the other end, Europe will endure a slight recession
- World growth risks are strongly biased downward due to the continued crisis in Europe. Mexico has considerable maneuvering margins to face this situation
- Within the group of the EAGLES, Mexico faces the challenge of increasing its trade exchange with Asia

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Closing date: May 8, 2012

1. Summary

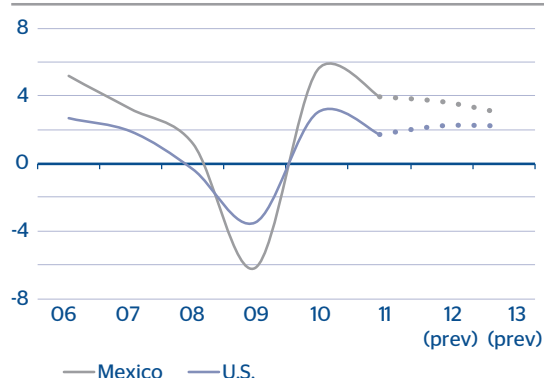
Upward revision for growth in Mexico in a global scenario that improves at the beginning of 2012, but at the same time faces significant downward risks due to Europe

The first quarter of 2012 will confirm the heterogeneity of growth among the different economic areas, a behavior that will be maintained in 2012 and 2013. In the early months of 2012 the previous perspectives for improvement in global activity after a final quarter downward of 2011. Probably world growth for the first quarter of 2012 will surpass that of the previous quarter supported by the improvement in Asia, especially China, and in Latin America. The United States temporarily experienced a slowdown in growth in the period and the euro area will confirm entering into a recession for a second consecutive quarter with a drop in GDP. To summarize, a situation consistent with some perspectives of BBVA Research for 2012 and 2013 in which the emerging economies will expand their growth differential with that of the developed economies. This will also occur between the U.S. and the area of the euro as a consequence of the financial tensions in Europe, which will abate only gradually, despite the fact that decisive measures will be taken to alleviate the situation. In short, it is estimated that world growth will be 3.6% in 2012 and 4.0% in 2013, with some emerging economies contributing with four fifths of the total. The risks of this scenario are downward, conditioned by the evolution of the crisis of access to financing in some countries in the euro area.

Mexico's growth will continue above 3.5% for the third consecutive year, supported by inflation anchored at low levels and favorable financing conditions. In this global environment, the Mexican economy, after 3.9% growth in 2011, could grow 3.7% in 2012, a slightly higher growth rate than that foreseen three months ago in this same publication. In this sense, the information received in the early months of the year, in particular as regards the labor market and inflation, with sustained growth in formal employment and lower price growth than expected, supposes support for households' disposable income. This, together with credit supply capable of attending the requirements of solvent demand without restrictions and under favorable conditions, especially by the banking system, indicates a positive environment for the growth of households' and companies' spending. At the same time, exports and corporate investment continue to benefit from demand in the U.S. and the gain in competitiveness of the Mexican economy.

Graph 1

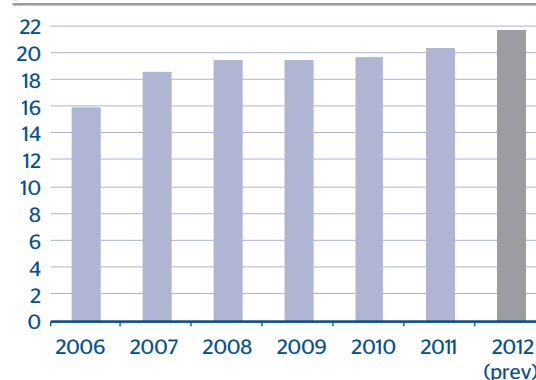
Economic growth GDP %



Source: BBVA Research

Graph 2

Mexico, credit from the banking sector Ratio of credit from the banking sector to the private sector (%)



Source: BBVA Research with Banxico (central bank) and INEGI data.

The outlook for 2013 will depend, in the external sense, on the performance of the U.S. economy, for which growth perspectives are 2.3%, very similar to those of 2012 (2.2%), but with an important degree of uncertainty with a downward bias. This is due to doubts on the impact on activity of a budget consolidation that could occur at the beginning of next year, either due to higher taxes already approved, which would come into force in 2013, or due to an agreement between the Executive and the Legislative branches to exchange these automatic adjustments with other measures. Similar to this process, which will be associated in the United States with the Presidential elections, in Mexico there is uncertainty regarding the behavior of public demand, affected by the ensuing change in the six-year administration cycle. In any case, this impact should be transitory and despite this, monetary and budgetary policies should remain anchored, directed toward monetary and financial stability: not favorable to imbalances in inflation, the current account or deficit, or the public debt.

The external environment continues to be the main source of uncertainty for Mexico, and in particular the impact of the financing crisis in the area of the euro, against which Mexico has significant maneuvering margins. The maneuvering margin that the Mexican authorities have in facing potential external occurrences that could lead to a deterioration of activity and/or an upward impact on inflation is considerable. From the standpoint of monetary policy, we believe that in the base scenario, the next movement of the funding rate, from the current 4.5%, will be upward, toward the middle of 2013, to end next year above 5%. However, a cut could be feasible, to around 4.0%, a level consistent with a real short-term rate close to zero, if potential downward risks are seen for activity in an environment that lowers interest rates in view of the uncertainty regarding global growth. A movement of this type could coincide with the implementation of interventions in the foreign-exchange market, purchasing pesos in accordance with the rules set by the Foreign Exchange Commission. The reserves accumulated and the availability of the Flexible Credit Line (FCL) with the International Monetary Fund (IMF) make it possible to face global volatility thanks to a budgetary policy that guarantees, given the annual objective of a budget balance, the non-accumulation of liabilities beyond that of the amounts budgeted each year.

A second source of global uncertainty is the rise in oil prices, which Mexico faces from a relatively favorable position. The rise in oil prices in the early months of the year has resulted in an almost 15% increase in the previous perspectives for the year, fundamentally as a result of demand sustained by some margins of an increase in supply and well-adjusted stocks, in addition to geopolitical risk due to the tensions with Iran. In this scenario of price increases, the negative impact of revenue for Mexico due to lower external demand will be more than compensated by the positive price effect due to greater oil revenues, at least in the short term. After a few quarters, and in case the tensions should continue, the most important route of contagion would be fundamentally that derived from lower external demand from the U.S.. From a domestic standpoint, higher budget revenue obtained due to the rise in oil prices is distributed among public expenditures, provision to stability funds and subsidies to fuel products.

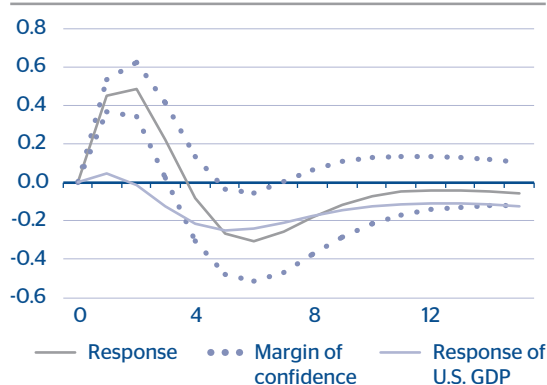
In accordance with BBVA Research analysis, in the next ten years, Mexico will be one of the leading economies in contribution to world growth (*Eagles: Emerging and Growth Leading Economies*, www.bbvaeagles.com), above the average of Germany, Canada, France, Italy, Japan and the United Kingdom, the most developed countries outside the U.S. Mexico, in terms of its size and growth perspectives fits easily into the group of Eagles, so that it is not at risk of losing its position among the most important economies in the world. In any case, it would consolidate its position and advance within the group of Eagles if the well-diagnosed reforms aimed at eliminating the bottleneck of low productivity are implemented. This is especially necessary if some perspectives are considered according to which the Asian economies will be the main contributors to the growth of global GDP, with 60% of the total, almost six times more than the growth from the U.S. and Canada, Mexico's main clients. The window of opportunity of increasing economic interchange with Asia cannot be ignored and more so, when considering that the pattern of Mexican foreign trade is not, contrary to that of the large countries of Latin America, based on raw materials. Mexico specializes in manufacturing, something that supposes a lower dependence on less manageable natural factors, and a growing complementary nature with the type of imports of that geographic area. It is true that this potential advantage can only be effective with a greater trade opening of Asia in general and of China in particular, something that Mexico has much to teach the world in these times in terms of its non-protectionist or interventionist policy on trade and financial flows.

This exporting specialization assumes strong competition for Mexico from countries such as China in the U.S., which has been reflected in the growing penetration of products of Chinese origin at the expense of, among others, lower increases or drops in the share of goods of Mexican origin. This is change as of two or three years ago, thanks to a relative improvement in Mexico's competitiveness which it appears will remain in the scenario during a prolonged period of time. In the first place, due to an appreciation of the Yuan in terms of the Mexican peso, and in the second place, a faster increase in labor costs in China, both of which are factors that give greater value to the absolute advantages of Mexico's proximity to the destination market and strong foreign direct investment rates, especially in some sectors.

Graph 3

Mexico. Response of economic growth to a rise in oil prices

Change in annual GDP growth in view of a 10% rise in oil prices without restriction in supply

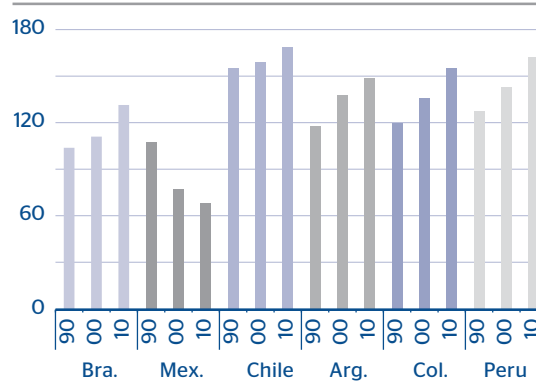


Source: BBVA Research

Graph 4

Index of similitude with China in export structures

(Index, 0 = identical vs 200 = totally different)



Source: BBVA Research

2. Global recovery, but risks reignite

Global economic activity will gradually recover, with wider growth differentials across the main areas. But the risks to growth are tilted to the downside

After a gradual deceleration during 2011, especially in the last quarter, the global economy is starting to show signs of increased dynamism. Global growth in 2012Q1 is expected to have been higher than in Q4, given stronger growth in Asia ex China (including Japan) and Latin America and sustained –but modest– dynamism in the US. We estimate that global growth will continue increasing and surpass 1% quarter-on-quarter at the end of 2012 (0.6% in 2011Q4). This recovery will also be quite heterogeneous, increasing the divergence in growth rates between the main economic areas. The increase in growth in 2012 will be more evident in Asia, given the rebound from natural disasters in Thailand and Japan (affecting regional supply chains) and the partial turnaround of policy tightening measures implemented until mid-2011. Also, growth in Latin America is likely to pick up, as Brazilian growth rates increase on the back of easier monetary policy and Mexico maintains growth over 3.5% helped by US demand, improved competitiveness and supportive funding conditions. On the other hand, the US will continue sustaining quarterly growth rates of around 0.6% in 2012 and 2013, significantly lower than in previous recoveries. Still, this will be better than a basically stagnant activity in the euro-area in 2012, dragged in peripheral countries by aggressive fiscal consolidation and persistently high financial stress, after tensions eased temporarily in the first quarter.

Therefore, **emerging economies will recover their growth differential vis-à-vis developed economies**, of around 4 percentage points, for the whole of 2012 and 2013. In turn, Europe and the US also will continue to increase their growth gaps in the next two years, even as we expect European authorities to continue taking decisive actions which will slowly lower financial tensions.

All in all, our growth projections are not very different from those of our previous Global Economic Outlook (published in February). We expect global growth of 3.6% in 2012 and 4% in 2013, with emerging economies contributing around 80% of that increase in global activity (Graph 5). But, as mentioned before, this scenario is conditioned on the evolution of the crisis in Europe, **and thus risks to these projections are still strongly tilted to the downside.**

In this context, monetary policies in advanced economies will continue to be very accommodative for an extended period, fulfilling the role of bridging the slump in activity towards the medium and long-term. However, the effectiveness of further intervention (conventional or not) is decreasing, while at the same time the costs increase –including the risk of reduced central bank independence and the collateral damage from unconventional measures–. Thus, it is time for other policymakers and institutions in the US and Europe to decisively take up part of the burden of reviving growth from central banks, implementing economic and institutional reforms and managing fiscal risks. While these measures take effect, central banks should continue supporting an adequate functioning of the monetary transmission mechanism.

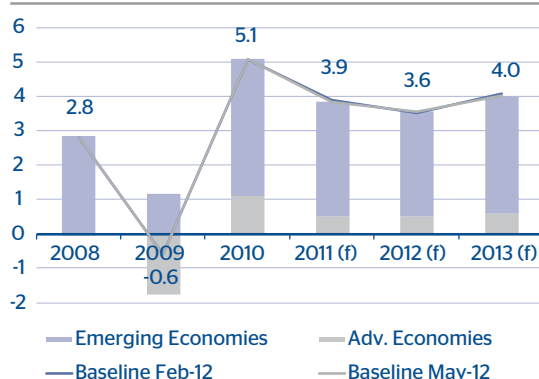
Easy monetary policies in advanced economies will mean favourable financing conditions in emerging countries. Here central banks will have to weigh the pressure from capital inflows and an uncertain external demand against inflationary risks (in part from oil prices) and strong domestic demand. The difference in inflation projections in Asia and Latin America –declining in the former but stable in the latter– will condition a different outlook for monetary policies. We expect the easing cycle to have ended in much of emerging Asia (except, notably, in China and India), and a cautious tightening bias in most of Latin America, except in Brazil.

There have been some advances towards the solution to the European crisis, but crucial steps are still to be taken. Europe needs a clear roadmap to end the crisis

In the last months, there have been some advances towards the solution to the European crisis, but there are still many important pending issues. **First, Greek sovereign debt held by the private sector was restructured**, although substantial doubts about its long-run sustainability persist, including an unclear majority from recent elections, reform fatigue and a possible deeper recession than projected. **Second, the European Stabilization Mechanism (ESM) was provided with a fresh lending capacity of 500bn EUR (on top of 200bn already committed by the EFSF)**. However, that has not been enough to quell market anxiety, given its falling short of Spain and Italy's financing needs for the next 3 years and the presumption that ESM loans would be senior to existing private bondholders, thus seriously impairing its catalytic effect on further financing from the private sector. Further, it was not clear to what extent the increase in IMF resources by 430bn USD (approximately 330 bn EUR) could be targeted to European countries. **Third, the fiscal compact was sanctioned (pending national approval), committing governments to structural deficits not bigger than 0.5% of GDP.** This is a significant change towards controlling member's budgets, but the allowance for deviations to the rule under "exceptional circumstances" may depict it as not strong enough to justify a more forceful action by hardliners at the ECB of core countries in Europe. **In addition, there have been no advances towards a fiscal union or Eurobonds. All in all, a clear roadmap to where Europe is heading continues to be missing.**

Graph 5

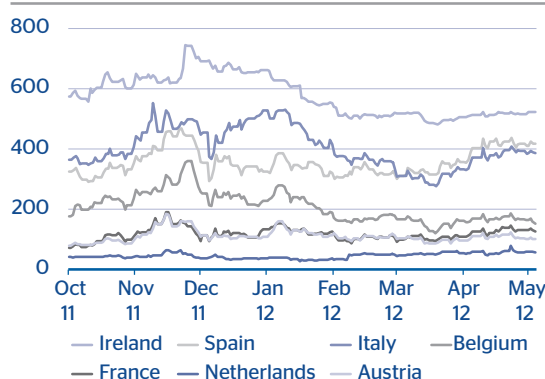
Global GDP growth (%qoq)



Fuente: BBVA Research

Graph 6

European sovereign risk premium (10yr bond spreads to Germany, bp)



Fuente: Datastream y BBVA Research

A new flare-up of the European crisis is still the main global risk

Undoubtedly, one of the most important actions in the last four months was the provision of long-term liquidity by the ECB. This allowed, at least until March, a significant reduction in liquidity risk in European banks, a timid opening of wholesale funding markets and a compression of sovereign spreads in peripheral countries (Chart 6). But these positive effects proved temporary, as markets (i) detected some complacency on the part of policymakers as risk premia decreased in the first quarter of 2012, and (ii) they both doubted the ability of many peripheral countries to reach their fiscal targets and feared the fallout on growth of actually achieving them. Thus, since March, risk premiums increased rapidly in Italy and Spain, in the latter to levels similar to the high tensions reached back in November (Chart 6).

The short-lived effect of the long-term liquidity injections and the conundrum between fiscal consolidation and restoring growth highlight two conclusions. First, **ECB actions can only bridge the short-run** while the underlying economic and institutional problems are tackled. This means that talk of exit strategies for the ECB should not come too soon, but it also implies that economic reforms should be pushed forward, at the same time as demand is rebalanced within the Euro zone, with core countries stimulating it. Second, **it is imperative to reconsider fiscal consolidation paths in a coordinated way (to avoid introducing special cases that would be difficult to understand)**, targeting structural deficits –consistent with the spirit of the fiscal compact– in a more gradual trajectory. In exchange for more gradualism, member states must produce explicit, comprehensive, detailed and multi-annual consolidation plans. This way, sound public finances could be achieved without big damage to short-term growth. At the same time, this will allow to reap the benefits of long-term structural reforms that are being implemented in peripheral countries.

In this context, **we still see a new flare-up of the European crisis as the main risk, with potentially very negative consequences for global growth.** Increased tensions can come about from reform fatigue in peripheral countries coupled with bailout fatigue in core countries, in the context of electoral processes –and a referendum– in many European countries: a key state in Germany, Ireland and the Netherlands are holding them in the first half of this year, after elections in France, Greece and another German state were held on May 6.

Current oil prices will have only a moderate impact on global growth. However, a big oil price spike constitutes a significant risk to growth

A second threat to the global economy is a further increase in oil prices. The recent spike at the beginning of 2012 can be traced back in part to tightening fundamentals (demand and supply) but also to an increase in the geopolitical risk premium to around 10-15 USD per barrel, given tensions around Iran and very reduced market buffers (oil inventories and producer's spare capacity, see Box 2). In our baseline scenario, we consider prices around 120 USD per barrel of Brent oil for much of 2012, around 20% higher than in our February forecasts. In our view, this will only have a moderate negative impact on global growth, as central banks in advanced countries will view this as a temporary shock and their weak cyclical positions will prevent them from tightening monetary policy, one of the traditional channels of transmission to lower growth. Nevertheless, should the conflict in the Gulf escalates, there could be a very large spike in oil prices, and even if central banks still do not react, growth could be damaged through the associated increase in global risk aversion. We consider that the probability of an escalation in the Gulf is relatively reduced, but it is a scenario that would have a significant impact on global growth should it materialize.

3. Mexico, a better outlook for 2012 activity, anchored inflation and favorable financing perspectives

We reviewed upward the growth forecast for Mexico in 2012, from 3.3% to 3.7%

In the first quarter of 2012, economic activity will have shown an expansion rate similar to that seen in the last quarter of 2011. We estimate that GDP in the early months of the year will have expanded at a rate of 0.5%¹ a figure that we will confirm next May 17th. All told, we increased our growth forecast for 2012 from 3.3%, which was estimated three months ago, to 3.7% now, which we consider is viable, given the expected dynamics of the foreign sector and of domestic support of demand.

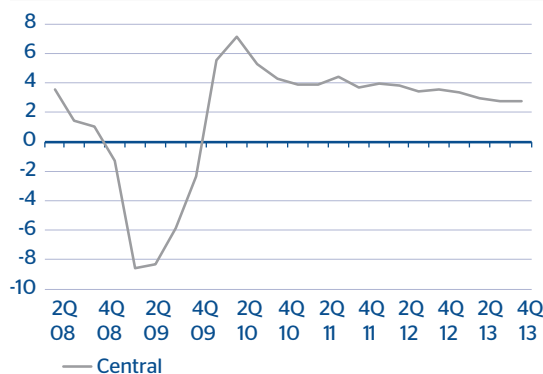
A lower expansion rate of the indicators linked to external demand and a sustained increase in that of services. Even though at the beginning of the quarter, the indicators available pointed to a quarterly expansion rate of GDP close to 1.0%, the information that was disclosed indicated moderation relative to the indicators more closely related to external demand. It is thus that total exports grew at an annual rate of 9.5% in the first two months of the year (at an average annual rate), below the 11.2% expansion of the last quarter of 2011. Manufacturing exports directed to the U.S., our main trading partner, are those that have slowed down to a greater extent, until they registered annual growth of 3.0% on average vs. 12.9% yr/yr of the exports directed to the rest of the world. The lower expansion rate of sales abroad of goods has been reflected in the industrial production and, particularly, in manufacturing, with growth moderations from 3.4% on average in the last quarter of 2011 to 2.8% in the first two months of 2012. Other indicators of external demand of the Mexican economy such as revenues from remittances and tourism have maintained or increased their growth in the first months of this year. Revenues from tourism in the last quarter of 2011 were growing 3.4% 2.1pp less than what was registered in the first quarter of 2012. In the case of revenue from remittances, these maintained an expansion rate on the order of 7.0% in both periods.

The indicators on domestic spending are growing faster at the beginning of 2012. The indicators more related to internal demand such as retail sales and the income from the services sector (without trade) have shown higher annual growth rates in this beginning of the year than in the previous quarter, while in industrial activities less exposed to the foreign sector, performance has been more diverse, while some activities such as professional scientific and technical services, have grown at rates close to an annual 20% in the early months of the year (15.9% in the last quarter of 2011). Others such as educational services have decreased their expansion rates markedly (from 5.4% to an annual 3.8% in January and February of this year). Retail sales expanded an annual 4.2% in the first two months of the year and 3.1% in the fourth quarter of 2011.

On the other hand, an important variable for the improvement of productivity, such as gross fixed investment, has accelerated its growth rate, since even though there are still no data of the total investment indicator, imports of capital goods, a variable highly related to investment, have expanded at a rate of 14.2% (annual average) higher than the 10.2% of the last quarter of 2011.

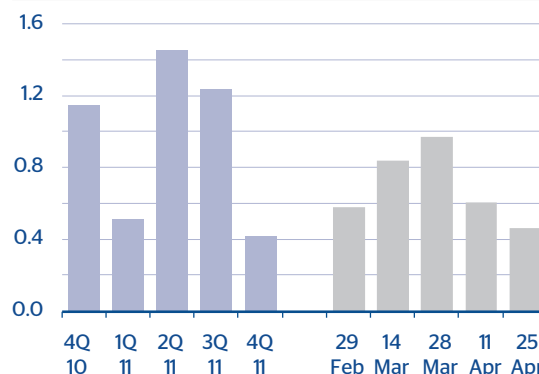
¹ Estimate of the MICA-BBVA for the quarterly GDP variation through May 2nd, 2012. The MICA BBVA is structured based on the contemporary spending indicators, expectations and financial activity. This instrument can provide expectations of the quarterly changes of GDP as timely as the arrival of new data, which in the case of the financial data, is daily.

Graph 7
GDP Mexico
(% change yr/yr)



Source: BBVA Research and INEGI

Graph 8
GDP growth estimate in 1stQ12
Estimate in real time through the MICA-BBVA
Bancomer model

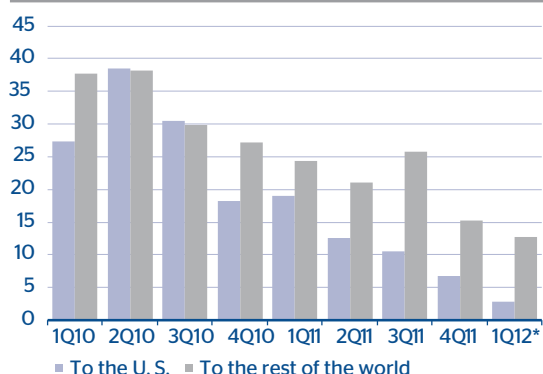


Source: BBVA Research and INEGI

It should be mentioned that the presence of one additional day in the month of February of 2012, because it is a leap year, implied an adjustment in the seasonally-adjusted data and the labor calendar of said month, which, as per the experience of previous years, and the equality in all of the rest, it has to have an exit effect upward in the March² data, which will be made known in coming dates.

The assumptions point to the continuity of growth in 2012. The most timely indicators of the evolution of the economy, producer and consumer confidence, are consistent with the continuity of the expectations of both groups. Producer confidence maintained marginal growth in the first quarter of the year, a result of the drops in the sub-indexes of the production, plant, use or expected demand, while those linked to the right moment for investment improved, or the perception of the present and the future of the company and the economy in general. As regards consumer confidence, it increased slightly in the 1stQ12 thanks to the improvement of the perception of the present and future situation of the home and the country, at the same time that the possibility of the consumption of durable goods, an important signal for the consumer, moderated its growth in these early months of 2012.

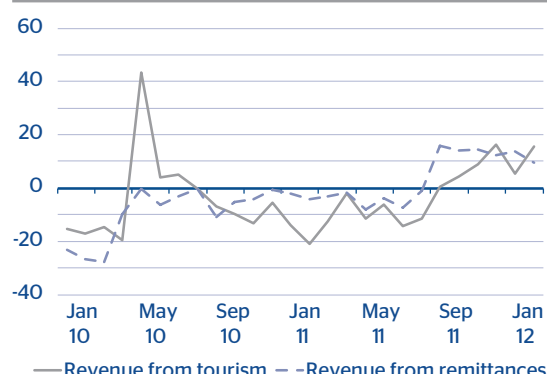
Graph 9
Non-oil exports to the U.S. and to the rest of the world (% change yr/yr)



Source: BBVA Research and INEGI

* Compared up to the month of February with the same period of the year before

Graph 10
Revenues from tourism and remittances, real pesos (% change yr/yr)



Source: BBVA Research and INEGI

² Taking as a reference the GIEA corrected calendar data provided by the INEGI, the leap year correction implies on average an adjustment downward close to 3% among the data of adjusted level of calendar effect and the originals.

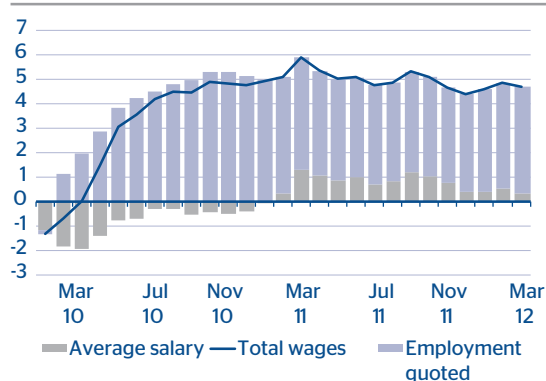
Household spending, expense growth supported by disposable income, particularly in the formal market and dependent on favorable financing.

Employment in the formal sector and wages in real terms also in the formal sector continued to expand at an annual rate of 4.4% and 0.4 %, respectively, similar to that observed in the last quarter of last year. Employment in the formal private sector represents approximately 30% of the total Mexican economy, which in 4Q11 grew at an annual rate of 5.5%. However, the breakdown of employment by levels of minimum wage continues to be biased toward the lowest levels: 45% of employees perceive up to two minimum wages, while less than 10% perceive more than five minimum salaries. The percentage of those employed in the informal market continues with levels close to 30% of the total, while other indicators of the labor market, such as the unemployed or the under-employed or those under critical conditions of employment³ also show resistance to reaching the levels prior to the recession of 2009. These structural characteristics of the labor market continue to be a limiting factor to the sustained expansion of household income and domestic spending.

At the same time, financing conditions continue to be favorable as reflected with credit to the private sector that continues to show important expansion rates in this first quarter of the year. Credit to companies and consumer credit grew 7.6% and 19.5% yr/yr, respectively, over the registries of the last quarter of 2011, by 10.2% and 19.2% pp, respectively.

Graph 11

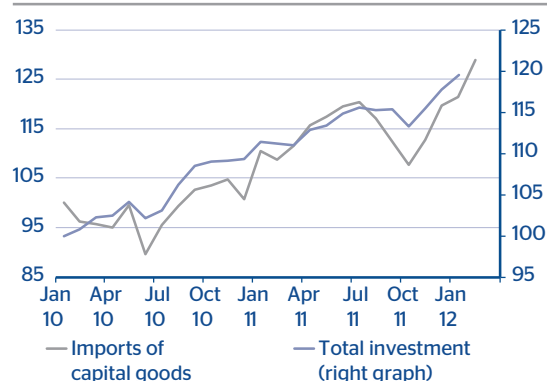
Total wages in the formal private market; annual change and contributions (% and pp)



Source: BBVA Research and INEGI

Graph 12

Total investment and imports of capital goods (Jan. 10 = 100)



Source: BBVA Research and INEGI

Inflation: without demand pressure, the most volatile prices indicate a surprise downward and reduce the inflation outlook for 2012

After ending the year 2011 on an up trend, the most volatile product prices surprise and reduce inflation expectations. Since last October, inflation experienced an intense rally boosting it up to an annual 4.05% in January of this year. This rally was influenced mainly by non-core factors like the marked increases in the prices of livestock and energy products, in particular electricity and domestic gas rates and the slight rise in the price of agricultural products. In addition, in the interior of the non-core component of inflation, the prices of processed food maintained annual inflation persistently above 7%, while the rest of the merchandises underwent a slight rise in their inflation due to the depreciation of the peso.³

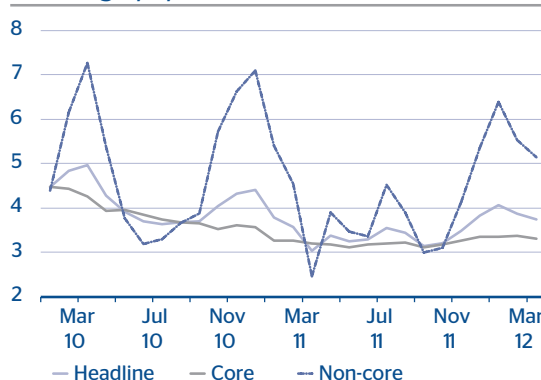
Had the trends described been maintained, headline inflation would have stood above 4% during some months in mid-2012. However, as of the month of February, inflation began to show a surprising downward trend, thanks to non-core factors.

³ Employment is considered to be in critical conditions when those working are doing so less than 35 hours a week due to market factors, and those who work over 35 hours a week with a monthly income lower than the minimum wage, and those who work over 48 hours a week and earn up to two minimum wages.

In core inflation, the divergent behavior between the prices of merchandises and services is maintained. Since January 2011 core inflation has fluctuated between 3.4% and 3.12% yr/yr (the minimum reached in May 2011), the result of the price reduction in services (3.4% in December 2010, 1.9% in November 2011) which compensated the higher inflation of merchandises (3.8% in December 2010, the highest at 4.8% last February). The divergent behaviors between the prices of merchandises and services are mainly due to the fact that the former were affected by the price rises in raw materials and to a lower extent on the depreciation of the peso, while the latter have responded to the ample availability of the productive factors of the economy, of which the product gap is still negative.

Graph 13

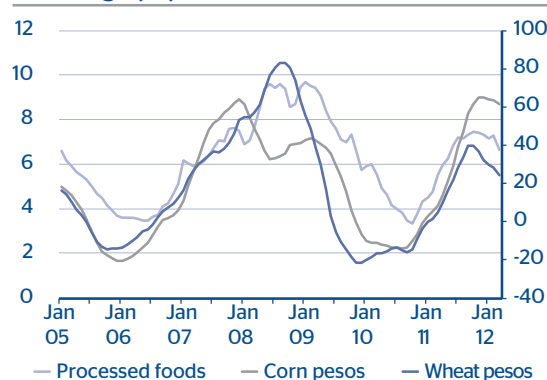
Inflation and its components (% change yr/yr)



Source: BBVA Research with INEGI data

Graph 14

Inflation: processed foods and international prices of corn and wheat in pesos (% change yr/yr)



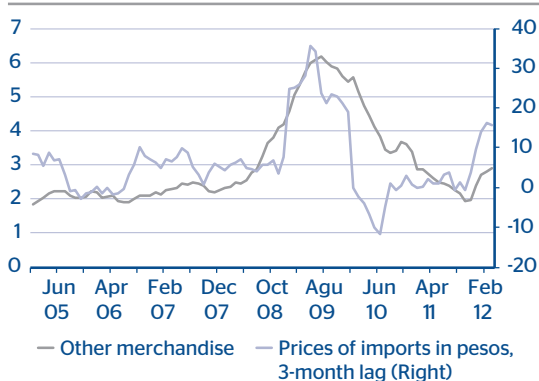
Source: BBVA Research with INEGI and Bloomberg data

The prices of processed foods at the rate of grain prices. The prices of processed foods have been the most rallying component of core inflation since February 2011, due to the high prices registered by basic grains such as corn and wheat on the international markets (maximum annual growths in pesos: 103% and 56%, respectively in May 2011). This situation worsened due to shocks in domestic supply, first as a result of the frost spells in the north of the country, and later due to drought. Even so, inflation in the prices of foods went from an annual 4.4% in December 2010 to a high of 7.5% in October 2011. Last March, a reduction in annual inflation was finally observed, which we consider will continue in the coming months, given the drop in the prices of corn and wheat. However, this moderation in inflation of food products will not be as fast as the price increases were, because of the decline in supply due to the drought.

The prices of non-food merchandises, with a very limited impact of import costs. For their part, the prices of the rest of the merchandises have rallied in recent months, affected by the depreciation of the peso since August of last year of an annual 8.4% on average since then. However, inflation of these products has remained below 3% since January 2011, reaching their minimum of the period last October (1.9% yr/yr). Since then, inflation of the rest of the merchandises has rallied and reached 2.8% last March. We believe that the prices of the rest of the merchandises, even though they have been affected by the exchange rate the same as services, also respond to the looseness in the economy, which generates a counterbalance to the increases that producers could realize, in facing higher costs of Imported goods.

Graph 15

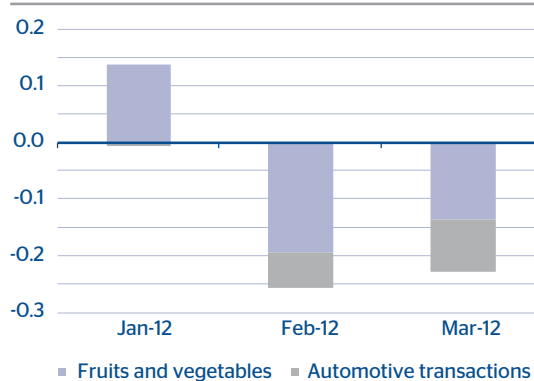
Inflation, other merchandise and prices of imports in pesos (% change yr/yr)



Source: BBVA Research with INEGI and Banxico data

Graph 16

Share in monthly inflation of fruits and vegetables and vehicular transactions (including car tenure tax) pp



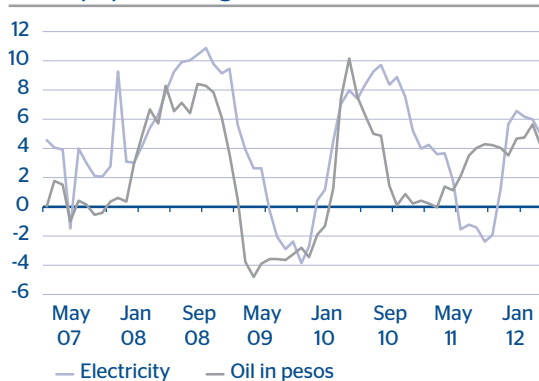
Source: BBVA Research with INEGI data

The low inflation in services, the result of the lack of pressure from demand. The prices of services have remained with inflation below 2.5% yr/yr since April 2011, a performance that is due to the fact that its three components:--housing, education and other services-- mainly respond to the growth rate of demand, which, although positive, is not sufficiently intense so that the available resources (financial, labor, and of the productive plant) are not sufficient to attend to it without price tensions.. Also some specific services have had an outstanding downward performance. This is the case of cellular telephony which shows a cumulative drop in its prices of 201% in an environment of greater competition. In the scenario foreseen, the prices of the services should remain with very limited change over a prolonged period of time, even although permanent lower rates do not seem to be permanently reasonable either. The downward rigidity of the costs and the slow reduction of the margin of the resources available should more than compensate the additional earnings due to increased competition.

The inflation outlook evolves according to its most volatile component. Due to the stability prevailing in core inflation in the short term, the non-core products will be the main contributors to changes in the inflation outlook. The non-core component consists of the products and services that have more intense changes since they respond to supply conditions that can change suddenly (agricultural and some energy products) or that the determination of these prices is alien to market mechanisms (tariffs set by the public administration).

Graph 17

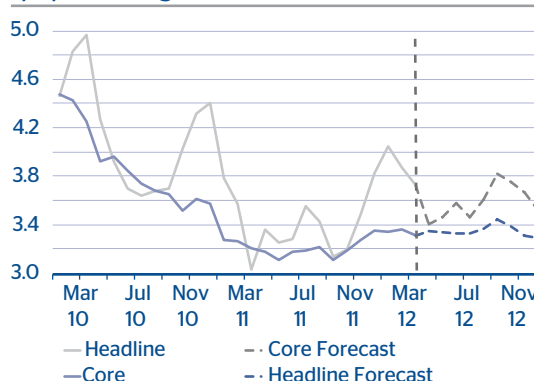
Oil Prices in pesos and inflation in electricity rates (yr/yr % change)



Fuente: BBVA Research con datos de INEGI y Bloomberg

Graph 18

Inflation scenario for 2012, (yr/yr % change)



Fuente: BBVA Research

Especially due to the diverse favorable shocks experienced throughout the year by non-core inflation, we reviewed our outlook for inflation downward, from an annual average of 4% to an average of 3.7%. We consider that the pressure from grain prices in the world will continue to moderate, thanks to an improvement in their availability. Also, we estimate that the current price rise in oil is transitory and will tend to drop in the coming months, provided that geopolitical tensions in the Middle East do not worsen. With this, the prices of processed foods, livestock products and electricity rates will contribute to slow down consumer prices. Also reviewed very slightly downward is core inflation (from the expected 3.5% in January to 3.3%). We believe that in addition to the better outlook for the prices of processed foods, in our base scenario, the exchange rate, in the absence of a rise in the global aversion to risk, it should appreciate slowly. The looseness of the resources in the economy to attend to increases in demand will be maintained, even though it will be closing little by little until a tensioning of monetary policy is considered convenient.

The balance of inflationary risks is in equilibrium, since we have as possible downward factors the reduction in grain prices, stability and the potential appreciation of the peso and unrestraint in the economy as possible downward factors, we cannot discard as rallying factors a reversion of the downward trend of the prices of fruits and vegetables, the possibility that there will be new increases in oil prices or that a rise in the aversion to risk could lead to a significant depreciation of the peso.

Banxico (Mexico's central bank), monetary pause. Next movement upward

The minutes of the central bank's monetary policy meeting of March 16 reflected an intense debate on the convenience of a cutback in the funding rate. The monetary policy rate in Mexico has remained unchanged since July 2009. Nevertheless, very few announcements of monetary policy had aroused such expectations as that of last April 27th. This expectation was generated based on the minutes of the monetary policy meeting of March 16th, which showed an intense debate among the members of the central bank's Board of Governors regarding the convenience of reducing the funding rate. In particular, those members in agreement with a cutback alluded to the favorable outlook for inflation, as well as for the good functioning of the nominal system of the Mexican economy to affirm that in the measure that the growth outlook was maintained and inflation continued to converge with the long-term target, it would be advisable to reduce the funding rate. On the contrary, those opposing argued that lowering the funding rate without having achieved convergence with the inflation target and expectations of 3% could be perceived as failure with regard to the commitment with the objective of price stability and ultimately increase the cost in terms of the rate to achieve convergence. In short, the matter of the role of the credibility of monetary policy in obtaining price stability stood at the center of the debate. For those members in favor of the cutback, the credibility achieved through the years by the central bank constitutes an asset that ultimately provides a maneuvering margin, while for those members against its use under these circumstances can suppose an ultimate cost. Another debate of significant relevance among some of the members of the Board of Governors is that they should consider additional variables beyond the exclusive attainment of annual growth of the NCPI of 3% in the determination of the fulfillment of the Banxico mandate.¹

The intense debate of the minutes, added to inflation in March and in the first two weeks of April, which did not meet expectations caused the market to discount a cutback of 25 bp at the April 27 meeting. Consequently, the government bonds curve dropped 10bp on average in an environment of aversion to global risk derived from renewed fears of the debt crisis in Europe. Despite this, the yield to maturity of the 10-year government bond reached a quotation below the 6% figure, not seen since the end of January of this year. It should be pointed out that even when the market indicators discounted a cutback, there were few analysts who changed their outlook of a monetary pause for the meeting at the end of April.

The communiqué of April 27 had a less accommodating tone than the March meeting minutes. Finally, last April 27, Banxico kept the funding rate unchanged at 4.5%. The tone of the announcement was slightly more neutral, although it made clear that an improvement in the financial markets would increase the pos-

¹ See page 20 of the document of the Banco de México "Minuta número 10", of March 30th. Available on the Internet at www.banxico.gob.mx

sibilities of a cutback. Of this recent episode of uncertainty surrounding the central bank's decision some conclusions can be deduced:

First: the Banxico communication with the public is a process that is still found at its construction phase. Based on the publication of the last minutes, the public has at hand greater information regarding the decision-making of monetary policy, which seeks to immediately incorporate the price of the assets. This incorporation process of the information supposes a learning period regarding the manner of issuing and interpreting the various messages that are provided through the different communication means of the central bank. Thus, the recent episodes in the markets that anticipate a different result than that of the Banxico decision are part of this learning process, and not necessarily signs of deficient communication.

Second: the tone of the most recent announcement denotes caution in face of an uncertain economic environment. In its most recent communiqué, Banxico did not modify its balance of inflation risk, even when the data on price growth in March and in the first two weeks in April were lower than expected. This could indicate that Banxico pondered in its decision the fact that the recent drop in inflation is mainly due to the non-core component, in addition to the fact that core inflation has remained for a prolonged period at around 3.3% and the inflation expectations have remained anchored at around 3.5%. All of this, in an international environment characterized by the rise in tensions surrounding the austerity measures taken in the euro zone.

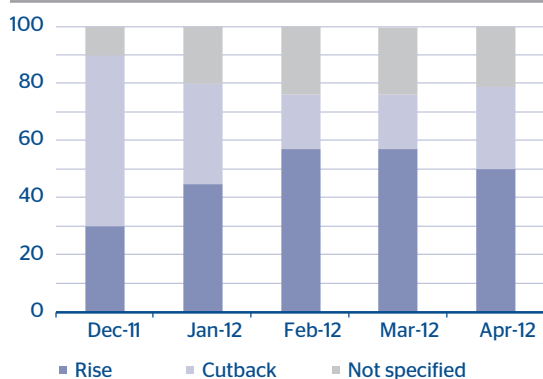
Third, the debate regarding the cutback in the funding rate will be maintained in the next minutes. It should be recalled that since July 2011 the minutes have shown the intent of some members of the central bank's Board of Governors to reduce the funding rate, even though it was in the most recent minutes when these showed clearer intents. This does not necessarily indicate an immediate cutback of the monetary policy rate. Moreover, it would have to be considered that the minutes are information complementing the announcement by which in general a rate cutback not preceded by an announcement in the same sense would be unusual.

Finally, it should be taken into account that the debate does not deal with generating stimuli to economic activity per se, but with the efficiency of the monetary policy. That is, on the possibility of reaching convergence with the objective of long-term inflation with a lower interest rate. In addition, it should not be forgotten that uncertainty remains regarding the consequences in terms of credibility of a cutback in an environment with inflation of over 3%.

Currently, the BBVA Research scenario indicates GDP growth for 2012 of 3.7% and inflation of 3.6% on average for the rest of this year. Thus, based on the conclusions mentioned and our scenario for growth and inflation, we maintain our outlook of a monetary pause through June 2013. Nevertheless, we consider that there is a greater possibility of a cutback than of a rise in the rate, given that the risks on activity and inflation are biased downward, more so in the case of activity than on inflation.

Graph 19

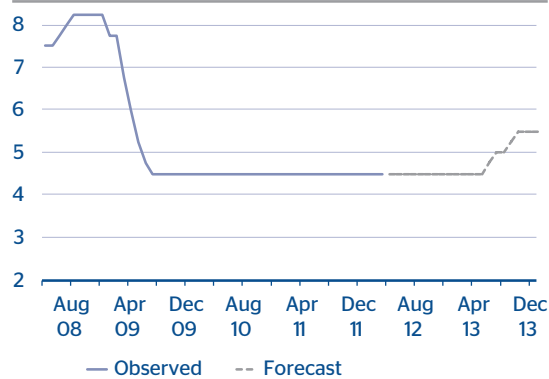
Expectation of the next movement of the monetary policy rate (% analysts)



Fuente: Encuesta de expectativas de analistas de mercados financieros. Banamex

Graph 20

Funding rate (%)



Fuente: BBVA Research y Banxico.

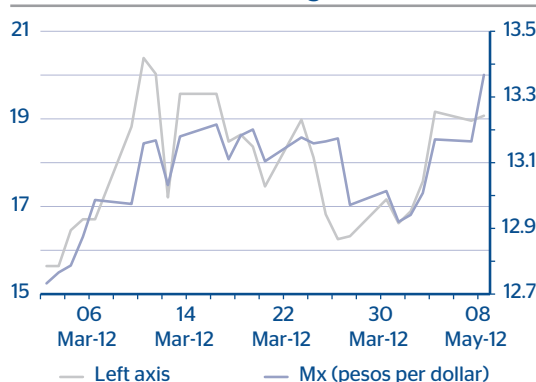
Financial markets at the rhythm of inflation, monetary policy and global risk

In recent months the interest rates of the government debt were unlinked from the global risk responding to events of Inflation and the expectation of monetary rate

As of the last week in March, global uncertainty increased due to deterioration of the financing crisis in Europe. The close relationship with the exchange rate of the peso led to a depreciation of over 3.0% between the 4th and the 16th of April. Nevertheless, the interest rates on Mexican government bonds did not increase; on the contrary, they were reduced in the same period in face of a lower inflation, better than expected by the market in March and April. In addition, the market perceived a tone of greater monetary relaxation, resulting from the minutes on the meeting on monetary policy and the decision published on March 30th.

Graph 21

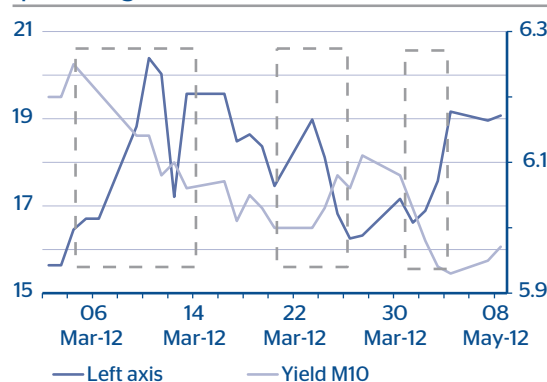
Global risk and the exchange rate



Source: BBVA Research and Bloomberg.

Graph 22

Global risk and the 10-year bond yield rate (percentage)



Source: BBVA Research and Bloomberg.

The drop in inflation in March had an impact on the total yield curve. The downward surprises of inflation, in addition to reducing the risk premium on inflation, reinforced the outlook of a possible cutback in the funding rate for the central bank meeting of April 27th. This can be observed in the atypical drop from the April 9 government bond yield with a 10-year maturity, the date on which the first inflation surprise was registered after the minutes of the Banxico monetary policy meeting were known. In face of the two-week inflation surprise (i.e. observed- expected) of -0.04 percentage points, a 12 basis-point drop was observed in the yield of the 10-year bond, even when the comparable yield of the U.S. Treasury bond dropped only one basis point. From 2003 to date, when considering the behavior of the 10-year bond yield rates, it can be observed that the above-mentioned drop has occurred in only 9% of the cases when inflation surprises and changes in the yields of the Treasury bonds are combined, as either the same or higher than those registered on the day in question.

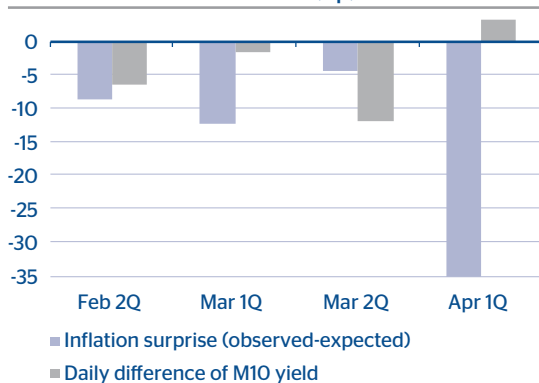
Another factor that contributed temporarily and to a lower extent to a reduction in the Mexican yield rates in the months of March and April was the drop in interest rates on U.S. government bonds.

Most of the inflation surprises have reduced the bond yield rates to a greater extent in the medium and the long part of the curve.² Nevertheless, the surprise of lower inflation in the first two weeks of April was not accompanied by a drop in the rates in the long part, but only in the short part, which seems to suggest that the market was already quoting to a certain extent a possible reduction in the monetary policy rate and lower inflation in the future.

² Empirical studies show that inflation is one of the most relevant determining factors of the level and the slope (i.e. the long-term yield compared to the short-term part) of the curve of government debt and which in general affects the long part more than the short part of the curve both in the case of Mexico and that of the U.S. For further details see "Economic Watch of BBVA Research of February 9th, 2012 "Growth, inflation, monetary rate, and interest rate curve: impact on both sides".

Graph 23

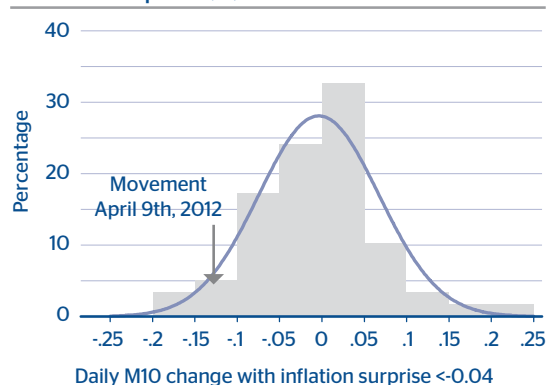
Inflation surprise and differences in the daily yield of the 10-year bond after the announcement of inflation (bp)



Source: BBVA Research.

Graph 24

Distribution of the daily yield of the 10-year sovereign bond yield, conditioned to an inflation surprise (%)



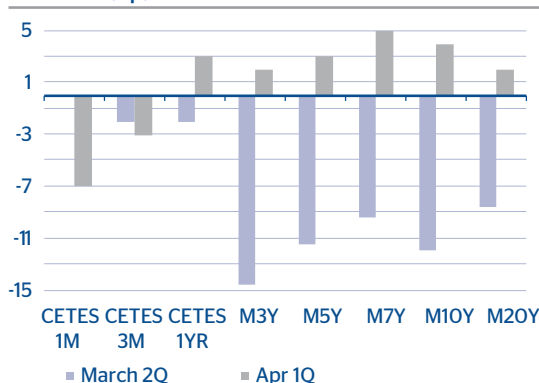
Source: BBVA Research. Note: the sample only considers the days in which the inflation surprise was higher or equal to -0.04 and the change in the yield of the Treasury bond was higher than -2 basis points

Finally, the central bank did not cut back the funding rate at one day in the April 27 meeting, and as a result they stopped quoting a possible reduction in the leading rate and suffered a considerable increase. For example, the 3-year bond increased close to 20 basis points on the day of the announcement of the monetary policy decision.

Given the outlook of BBVA Research on moderate inflation and growth, and an unchanged monetary policy rate this year, slow growth is expected in the yield rate of medium- and long-term maturity sovereign debt. Thus, for example, the yield of the 10-year bond could remain at around 6.5% at the end of 2012. In case a quick drop in the funding rate were to be seen in an environment of lower inflation or of more moderate activity, the yield on the bond would be approximately 15 bp. lower than that indicated.

Graph 25

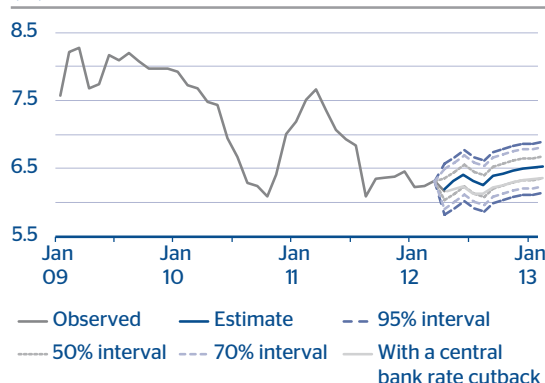
Rate curve: daily change with the change in inflation (bp)



Source: BBVA Research and Bloomberg

Graph 26

10-year bond yield rate (%)



Source: BBVA Research.

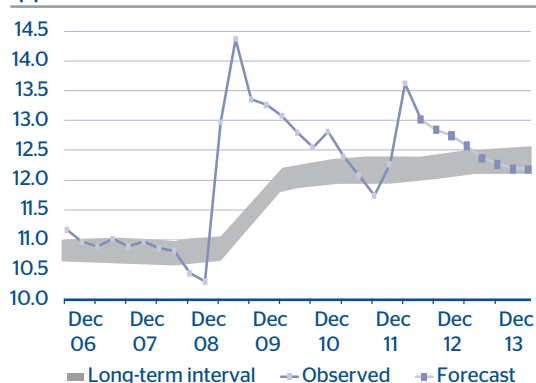
During the greater part of the period from February to date, the peso/dollar exchange rate has remained in an interval of between 12.5 and 13.0 pesos per dollar, after which, in the first two months of this year, an appreciation on the order of 8% was registered. Similar to previous episodes, during the month of April the increase in global aversion to risk brought with it a peso depreciation that took the parity to touch levels of over P\$13.2 per dollar. In particular, the publication of data that are below expectations for employment and industrial production of the U.S., as well as the deterioration of the economic situation in Europe are among the factors that contribute to the depreciation of the peso. Added to this, market expectations of a cutback in the funding rate as a result of the minutes of the monetary policy meeting of March 16th also had an effect on the peso.³

The performance of the entry of foreign flows to Mexico is coherent with the lateral evolution of the exchange rate. As opposed to the first two months of the year, during the month of March and a good part of April, bond holdings by foreigners moderated their increases. As per central bank data, after the first two months of the year, the increase in holdings by foreigners stood at around US\$9 billion, a figure only surpassed in the 4th quarter of 2010 and the first quarter of 2011; in March and April the change in foreign holdingd barely surpassed US\$2.25 billion, a figure slightly higher than the average registered since January 2010. All in all, the continuity of the entry of foreign flows in government instruments is noteworthy, a sign of the certainty of Mexico's domestic budget policy.

In the medium term, the outlook for growth and inflation in Mexico and the U.S. is consistent with a trend of the peso's appreciation against the dollar. As per the BBVA Research scenario for growth in 2012, Mexico has been reviewed upward, from 3.3% to 3.7% and inflation has surprised downward, which will lead to closing the year at around 3.5%. Thus, to the extent that global uncertainty dissipates, the economic fundamentals indicate that the exchange rate could appreciate to approach its long-term level toward the end of the year, which is estimated at around P\$12.5 per dollar.

Graph 27

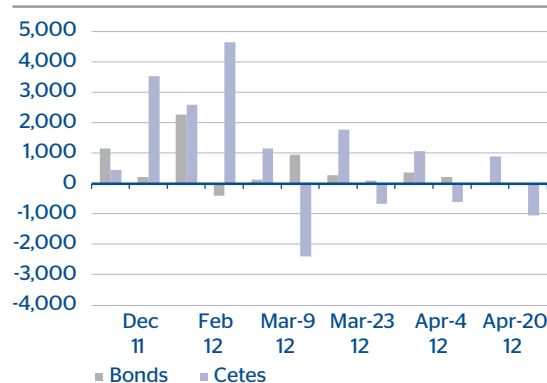
Exchange rate (ppd)



Source: BBVA Research

Graph 28

Foreign flows to fixed income instruments (US\$ millions)



Source: BBVA Research and Banxico.

³ This was due to the fact that although various factors intervene in foreign exchange movements, last Friday, April 27th, when the central bank kept the funding rate unchanged in an environment without economic data of great importance, the exchange rate registered an appreciation of 1.6% that took it once again to below 13 pesos per dollar.

Inset 1: Inflation in Mexico with a high probability of maintaining its path toward convergence with the central bank target

Inflation expectations, in particular those pertaining to 12-month projections, have been persistent in recent years. Although in recent months these expectations have been slightly higher than the inflation level eventually seen, only three years ago, those levels rose moderately despite a rebound in inflation that reached a 6.5% annual rate in December of 2008. These divergences are the result of various factors with a highly volatile behavior, which are difficult to foresee 12 months in advance, added to the intrinsic difficulty of modeling the intensity with which the shocks considered will be transferred to prices. Among these are the variation in the international prices of raw materials, subject to climate or geopolitical factors, changes in taxes or intense fluctuation in the exchange rate, among others.

The performance of such expectations suggest that the market's outlook for inflation maintains an important degree of uncertainty. With the aim of quantifying the uncertainty on price variations, the probability of occurrence of different inflation ranges is estimated. That is, the uncertainty is curtailed in relation to the behavior of the determining factors of prices. These determining factors are identified in the inflation model shown in Observatorio Económico: *"La inflación, al ritmo de la holgura de factores productivos"*¹ ("Inflation at the rate of ease of the productive factors"). In this analysis, the conclusion is that there does not seem to have been a recent structural change in the process of price

determination. Rather, the exceptional performance under factors such as demand pressures is what is behind the moderate inflation rates. Once the important determining factors in the process of price formation for consumption in Mexico are identified, an ordered Probit type model is estimated. That is, a model of qualitative options that assigns a probability that the dependent variable—inflation—will fall within a given range, in this case, the following: from 0.00% to 3.20%, from 3.21% to 3.49%, from 3.50% to 3.99%, from 4.00% to 4.49%, from 4.50 to 4.99%, from 5.00% to 6.00% and from 6.01% and on. The estimate of the probabilities is based on the economic scenario of BBVA Research.² The results suggest that inflation will be contained between 3.0% and 4.0%, with a probability of 80% and 90% in 2012 and 2013, respectively. It is estimated that inflation at the end of 2012 will be between 3.5% and 4.0%, with a 60% probability, and at the end of 2013, it will be between 3.0% and 3.5%, with a very similar probability, although with a 30% downward bias that it will be between 3.5% and 4.0%. This as a result of core inflation between 3.2% and 3.5%, with a probability of around 70%. In the case of core inflation, the bias is balanced, with a 14% probability that it will be above 3.5% and below 3.2%. The probability that inflation will be close to 3% (between 2.9% and 3.2%) at the end of 2012 and 2013 is of 2% and 20%, respectively, although with a greater probability of a higher rather than a lower result.

Graph 29

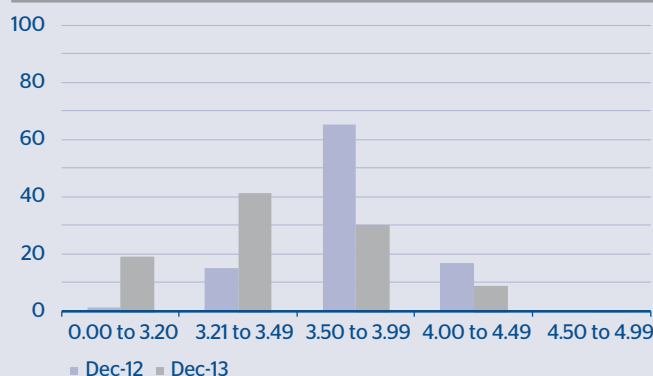
Inflation observed and expectations a year before (Annual % change, y/y)



Source: BBVA Research with SMN data

Graph 30

Probability of inflation ranges for December 2012 and 2013



Source: BBVA Research and INEGI

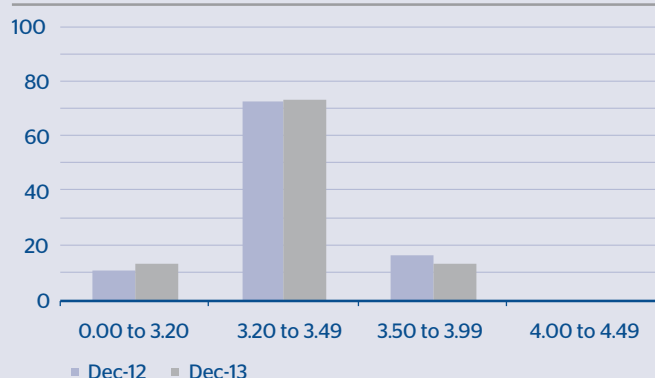
¹ Available on the internet at http://www.bbvarresearch.com/KETD/fbin/mult/110801_InflacionMexico_71_tcm346-265004.pdf?ts=452012

² It is considered that the prices of raw materials will be more moderate. In the case of Mexico, the price of corn is especially relevant due to its weight in the basket of consumption and the moderation is at levels of US\$600 per bushel, (from US\$640 previously in February). The rest of the economic scenario is as follows: GDP growth of 3.7% and 3.0% in 2012 and 2013, respectively, which will be transferred to wages. Transportation prices maintain a similar behavior to the average observed in the years 2009-2010, and the exchange rate shows a slight appreciation of the peso to reach a level of 12.5 pesos per dollar in December of 2013, while 12-month inflation expectations remain at the present level.

Given the economic scenario of BBVA Research, the possible effects on inflation of the errors in prevision generated by volatile factors can also be visualized through a fan-shaped graph. The estimate is done based on the same determining factors than those of the Probit model and show that inflation should trend toward a moderate reduction, maintaining levels between 3% and 4% during 2013. This last result, added to the increased probability of expected inflation between 3.0% and 3.5% in December of 2013 suggests that inflation should trend toward a convergence with the central bank's inflation target (3%+/-1%) in the event of maintaining moder-

ate growth, a slight reduction in the price of raw materials, an appreciation of the peso in the peso/dollar exchange rate toward the level considered as long-term and stable inflation expectations. These behaviors are consistent with stability in fiscal and monetary policy and more so in an uncertain global environment such as the present one. The results shown in the fan-shaped graph are consistent with the estimated probabilities of the Probit model. For example, both cases assign a probability of over 50% to inflation within a range between 3.0% and 4.0% in December of 2013 and a trend toward a reduction of inflation over the next year and a half.

Graph 31

Probability of core inflation ranges for December 2012 and 2013


Source: BBVA Research.

Graph 32

Annual inflation, fan-shaped graph (%)


Source: BBVA Research.

Inset 2: Mexico, favored by increases in oil prices that do not constrain demand from its trading partners

At the beginning of 2012, the price of Brent crude oil rose to over US\$ 120 a barrel, levels not seen since the first quarter of 2008. This time the increase has resulted from the combination of sustained demand with supply marked by a limited margin of response and uncertainty derived from the embargo on Iranian oil production by some countries. This embargo is the result of geopolitical tensions that, if not resolved, could involve strong restrictions on the supply of crude oil. While it is true that these tensions have decreased,

foreseeably until after the U.S. elections, a prolonged period of negotiations and uncertainty is anticipated, at least for an additional six months.

This situation has led to revised forecasts for oil prices from an estimated average for 2012 of US\$ 98.2 per barrel (Brent) projected in December, to the current US\$ 121.60 per barrel. The analysis of the possible implications of this change for the Mexican economy is described below.

Graph 33

Price of Brent crude oil (dollars per barrel), outlook



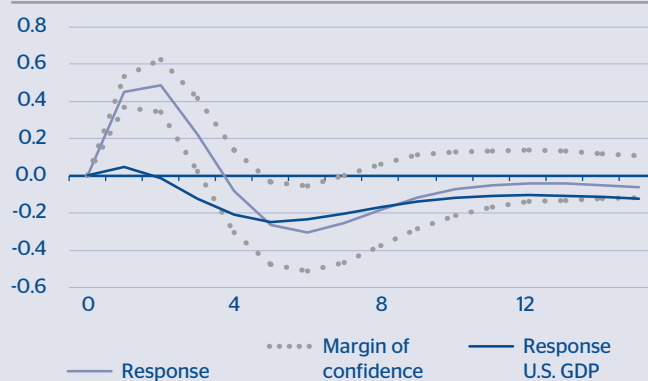
Fuente: BBVA Research.

An increase in the price of oil is beneficial for Mexico as long as it is not a constraint on the growth of its trading partners

Considering that Mexico is a net exporter of oil products, higher oil prices should have a positive effect in terms of export earnings, budget revenue, and economic activity, at least in the short term. Indeed, public finances obtain additional resources that are transferred in a regulated manner to public spending, to finance the Oil Revenue Stabilization Fund (FEIP for its Spanish initials), and to cover the cost of increased fuel subsidies, which grows with the rise in their benchmark prices, given the continuation of the gradual fixed programmed increases in the real price.¹ Government regulated fuel prices limit the downward impact on the dis-

Graph 34

Impact on growth of Mexican GDP of a 10% increase in oil prices, without restrictions on the supply side (percentage points)



Fuente: BBVA Research.

posable income of households and companies and the upward impact on inflation.

In order to quantitatively approximate the impact of a price increase or a restriction on oil supply, we estimated a vector auto-regression model (VAR) that takes into consideration the relations between the U.S. and Mexican GDP, inflation, and the monetary policy rate of the two countries, global financial risk, and the price and amount of global oil production. The results show that the reason why oil prices are rising is a factor. If rising oil prices are caused by a restriction of supply this has a downside effect on economic activity while if it is a result of increased demand it can have an upside effect in the short term.

¹ Surplus revenue is earmarked primarily to offset the increase in spending in relation to the budget and to attend to natural disasters when the resources budgeted for such purposes turn out to be insufficient. Subsequently, additional resources are distributed among the Oil Revenue Stabilization Fund, the states, and infrastructure investment in PEMEX.

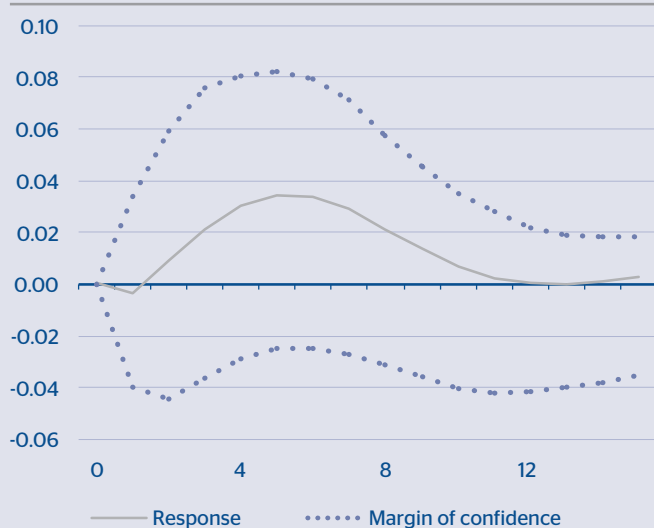
Nevertheless, despite the improvement in Mexican GDP in the short term, it is estimated that in the medium term, the effect of less demand from the United States will become a dominant trend and therefore could have a negative impact on the Mexican GDP. The economy of the U.S.-Mexico's largest trading partner- is more exposed to the effect

of fluctuations in oil prices, and therefore the response to a price increase is a decline in GDP in the short, medium, and long term.

In the case of inflation, the effect of an increase in oil prices is bullish, but the ranges of uncertainty in the statistical estimation do not allow for rejecting the absence of an impact.

Graph 35

Impact on annual inflation in Mexico of a 10% increase in oil prices, without restrictions on the supply side (percentage points)



Source: BBVA Research.

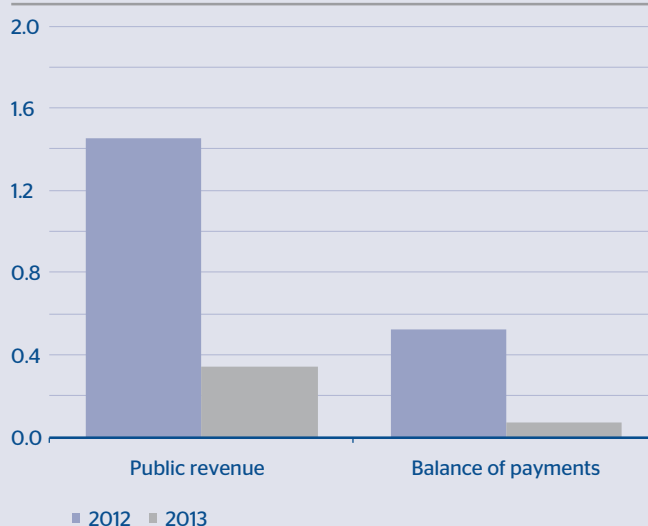
The oil revenue that is received is distributed among public spending, gasoline subsidies, and provision of public funds

Higher oil prices affect the balance of payments and public accounts through greater revenue from net oil exports and higher fiscal revenue. These effects are short term and persist to the extent that the price increases are not as severe or prolonged so as to affect the growth of Mexican external demand.

To estimate the effect on the current account and public revenue, an estimate is made of the price of the Mexican crude oil mix (in relation, in turn, with the price of Brent crude) assuming stability in export levels. Based on these consider-

Graph 36

Direct effect of the change in oil price scenarios (% of GDP)



Source: BBVA Research.

ations, it is estimated that if the price of Mexican crude oil is close to US\$ 22 per barrel higher than expected for the year's average, the additional revenue via an improvement in the current account will be around 0.5% of GDP while the effect via higher government revenue will be around 1.5% of GDP in 2012. By 2013, both effects will taper off to 0.3 and 0.1% of GDP in public revenues and the balance of payments, respectively.

The 1.5% of GDP corresponding to higher public revenue does not presume a reduction in the budget deficit to the same extent, given that the funds are distributed as noted above. In this case, the distribution of the surplus revenue would be approximately as follows:

Chart 1

Distribution of additional government revenue from crude oil exports, 2012

Average expected price of the Mexican crude oil mix in 2012 (dollars per barrel)	Surplus government revenue (% of GDP)	Extraordinary fees (% of GDP)	Surplus revenue (% of GDP)				
		State government revenue	State government revenue, 25%	State government infrastructure, 10%	Stabilization Fund, 40%	PEMEX infrastructure, 25%	STPS, gasoline (% of GDP)
104	1.48	0.19	0.15	0.06	0.25	0.15	0.67

Memorandum:

States 0.41

Stabilization fund 0.25

PEMEX infrastructure 0.15

Notes:

Expected GDP growth in 2012 of 3.7%

Price of oil at US\$ 84.90 in the budget revenue estimate

Extraordinary fee: a 131% fee is applied to the difference between the sale price of oil and the budgeted price

Assuming that the IEPS on gasoline is financed by surplus oil revenue

Production of crude oil for 2012 of 2.56 million barrels daily

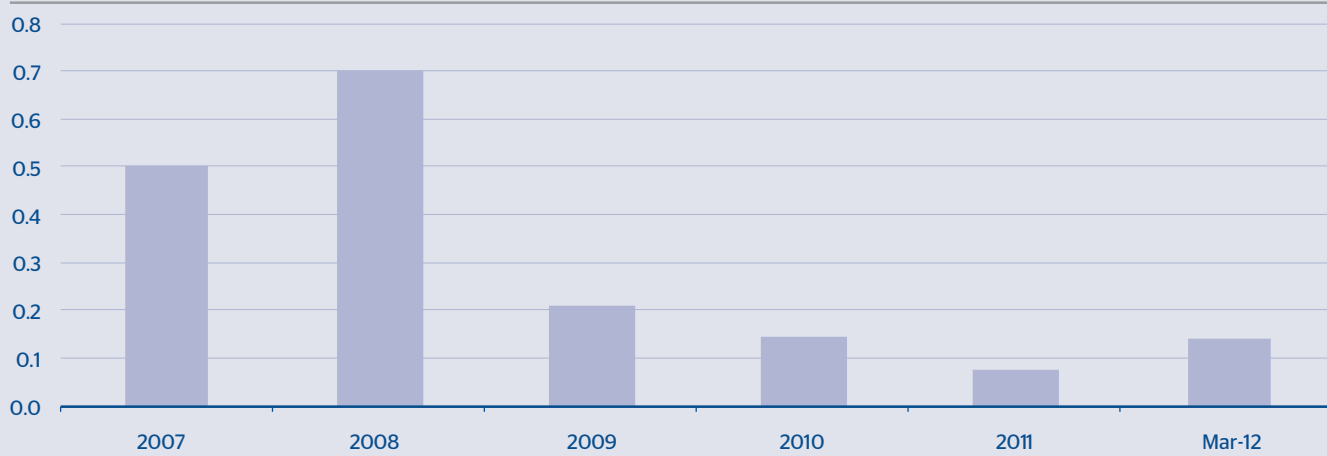
Estimated average exchange rate of 12.8 pesos per dollar

Source: BBVA Research with Finance Ministry data

In March 2012, the balance of the Oil Revenue Stabilization Fund was low, less than 0.2% of GDP. Despite the extraordinary revenue resulting from higher than expected oil prices in 2011 and 2012, this year the fund is expected to reach an amount only equivalent to about 0.5% of GDP. Considering the dependence of public finances on oil revenue, and that the purpose of the Fund is to accumulate resources for a possible drop in revenue, both oil and non-oil, it would be desirable to increase its balance. Other countries that have

natural resources have established stabilization funds with the goal that the non-renewable resources contribute to long-term development; for example, helping to maintain the stability of public finances, or distributing resources between generations, and investing a portion of these resources in projects that enable greater economic diversification and a better risk performance ratio, given the future depletion of such natural resources.

Graph 37

Balance of the oil revenue stabilization fund (% of GDP)

Source: BBVA Research.

4. Mexico, EAGLES and trade with Asia, opportunities in perspective

The EAGLES, a group of leading economies in terms of their contribution to world GDP and concentrated in Asia. In 2010, BBVA Research created the category of a group of emerging markets known as EAGLES ("Emerging and Growth-Leading Economies") which encompass those countries whose expected increase in GDP levels over the next 10 years will exceed the average for industrialized economies excluding the United States (Germany, Canada, France, Italy, Japan, and the United Kingdom). The concept of the EAGLES is dynamic because it does not involve a fixed group of economies, but its composition is reviewed annually. This annual review is carried out not only for the economies that are candidates for joining the EAGLES, but also in terms of the threshold as of which their entry is considered. It should be noted that in the latest review this threshold was set at 405 billion dollars. Given that it is expected that in the next 10 years, Mexico will increase its GDP by more than 500 billion dollars, it will be part of this group together with Brazil, China, South Korea, India, Indonesia, Russia, Taiwan, and Turkey. The EAGLES will account for about 50% of global GDP growth and will be located mainly in Asia.

The dominance of Asian countries within the EAGLES is a great challenge and an opportunity for Latin America as a whole and Mexico in particular. Mexico, with a major trade opening in its economy (the sum of imports and exports is about 60% of GDP), sells 80% of its exports to the United States, while the trade structure of other countries of the region¹ remains more diversified, with greater weight for foreign trade with Asia. Thus, these countries have posted a sevenfold increase in trade flows with Asia in the last 10 years, while for Mexico the growth has been 3.2 times.

The structure of Mexican foreign trade is becoming increasingly complementary with China. Mexico has an export structure, unlike the rest of Latin America, that is completely integrated with the United States and Canada in the context of the North American Free Trade Agreement (NAFTA), focused moreover on manufacturing production. Thus, the structure of Mexico's trade with China is similar to what the country has with the rest of the world, led by manufactured goods, except for the greater weight of non-energy commodities (non-fuel and non-food raw materials). The foreign trade of the other Latin American countries is marked by a much greater weight of commodities. As shown in Figure 38, Among the Latin American economies, the Mexican economy has an export and import structure that has most rapidly increased its complementarity with China's trade structure, which provides it with an opportunity for the future development of trade, which currently is at low levels and, in any case, very much at a deficit for Mexico. Thus, Mexico has a trade deficit with Asia and specifically with China (a 46.2 billion dollar deficit in 2011). This is the result of the difficulty faced by Mexican products in making China an important destination market, but it can also be attributed to trade linked to imports from China that adds value to and re-export the products. In this sense, among the main items that Mexico imported from China in 2011, those with the most weight correspond to semi-finished products earmarked for Mexican manufactured goods exports such as assembly parts for LCD (flat-screen) televisions (6% of total imports from China), modular circuits (3.3% of total), and transmitters with built-in devices (3.3%).

¹ Latin America-7: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela

Graph 38

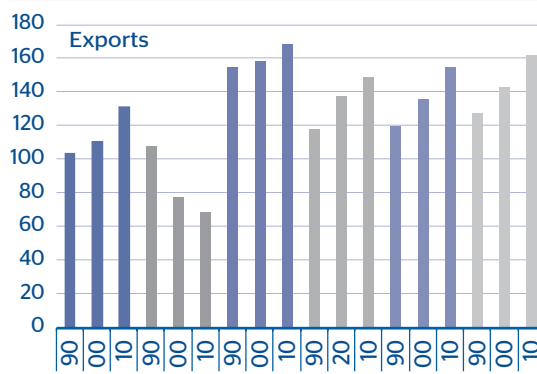
Indices of similarities in export and import structures of Latin America and China
(Index, 0 = identical vs 200 = totally different)



Source: BBVA Research and COMTRADE

Graph 39

Index of similarities with China in export structures
(Index, 0 = identical vs 200 = totally different)

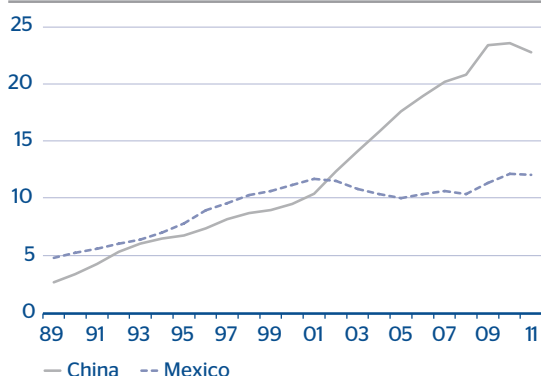


Source: BBVA Research and COMTRADE

At the same time, the growing similarity of exports from China and Mexico is a challenge in terms of the competition that this implies in other markets such as the United States, so important for both economies, given that it is the number one destination for Mexican exports and number two for Chinese overseas sales. In 2002, Mexico and China each supplied the United States with about 12% of that country's imports of manufactured goods. In the case of Mexico, this percentage share stagnated, while China's has doubled. The absolute cost advantages from the Chinese side, amplified by a highly depreciated exchange rate and China having joined the World Trade Organization are the factors that triggered this process, which has been undergoing an adjustment in the past three years. The Chinese yuan has been appreciating against the dollar and even more intensely against the peso, which implies a gain in price competitiveness for Mexico that is beginning to add value to the absolute advantages of location and transportation costs between the two countries and the United States.

Graph 40

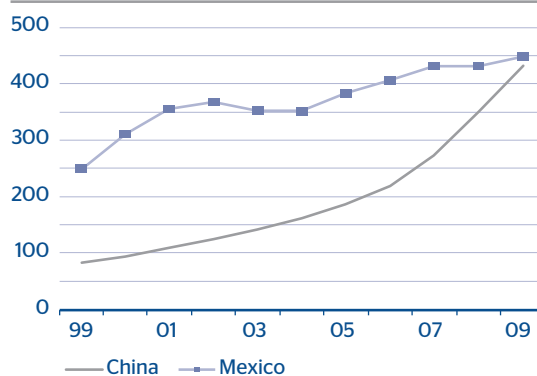
U.S. imports of manufactured goods
(% of total)



Source: BBVA Research and INEGI

Graph 41

Total average wage Mexico-China
(Monthly income in dollars)



Source: ILO, 2009 estimate

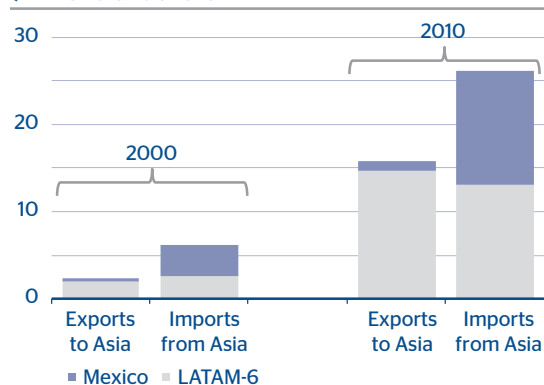
Mexico, institutional improvements to increase the strength of its foreign trade. Given that the exchange rate is not the only relevant variable for increasing competitiveness, Mexico has sought to expand trade through trade facilitation policies and programs, which include tariff simplification, customs facilitation, and the strengthening of its institutions. Tariff simplification seeks to boost industry in Mexico through an aggressive tariff reduction program, which began in 2008 and aims to reduce import duties on 10,000 products corresponding to the industrial sector. This policy seeks to extend the benefits of already existing sectoral programs in addition to removing incentives for triangular trade and facilitating the creation of a North American customs union, as tariffs on these products will be brought into line with U.S. import duties within five years, thus encouraging industrial investment and employment.

The main purpose of customs facilitation is to reduce both the time and transaction costs involved in importing and exporting goods to and from Mexico. This will be done by establishing a one-stop window for foreign trade procedures, which through the use of the Internet will make foreign trade paperwork procedures for the import, export, and transfer of goods more agile, increasing transparency, facilitating tax collection, and strengthening security in customs paperwork and transactions. It is expected that the implementation of this one-stop window could occur later this year.

Finally, to fine-tune the institutional framework, the Foreign Trade Commission (COCEX) was established. It is a multi-institutional body comprised of various public sector ministries and institutions (Department of the Economy (SE for Secretaría de Economía), Finance Ministry (SHCP), Foreign Relations Ministry (SRE), Department of Agriculture (SAGARPA), Department of the Environment and Natural Resources (SEMARNAT), Banco de México (the central bank), and the Federal Commission on Competition (CFC), which aims to provide order and continuity in the regulation of foreign trade. With this in mind, a legal requirement was established that in order to apply any tariff or trade regulation, the COCEX's opinion must be obtained.

Graph 42

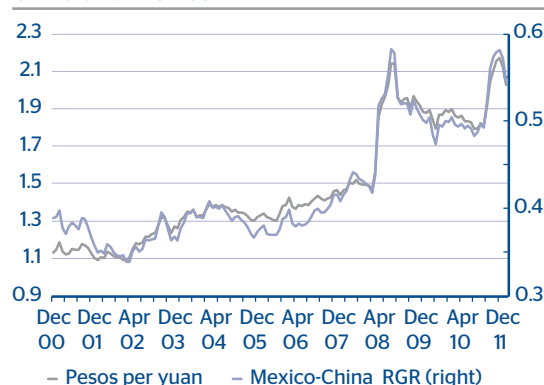
Foreign trade with Asia (millions of dollars)



Source: BBVA Research and CEPAL

Graph 43

Nominal and real exchange rate China and Mexico



Source: Bloomberg and Haver Analytics

5. 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	1.9	1.5	-0.2	0.9
Germany	-5.1	3.6	3.1	0.7	1.6
France	-2.6	1.4	1.7	0.5	1.1
Italy	-5.1	1.8	0.5	-1.5	0.1
Spain	-3.7	-0.1	0.7	-1.3	0.6
UK	-4.4	2.1	0.7	0.5	1.4
Latin America *	-0.6	6.6	4.5	3.8	4.1
Mexico	-6.1	5.4	3.9	3.7	3.0
EAGLES **	4.0	8.4	6.7	5.8	6.4
Turkey	-4.9	9.2	8.5	2.7	5.6
Asia Pacific	4.2	8.1	5.7	5.7	6.1
China	9.2	10.4	9.2	8.3	8.7
Asia (exc. China)	1.0	6.6	3.4	4.1	4.4
World	-0.6	5.1	3.9	3.6	4.0

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela

** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey

Forecast closing date: April 30, 2012

Source: BBVA Research

Chart 3

Macroeconomic forecasts: inflation (Avg.)

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-0.4	1.6	3.1	2.5	2.2
EMU	0.3	1.6	2.7	2.4	1.5
Germany	0.2	1.1	2.3	2.0	1.5
France	0.1	1.5	2.1	2.2	1.6
Italy	0.8	1.5	2.8	3.1	1.9
Spain	-0.3	1.8	3.2	1.9	0.7
UK	2.2	3.3	4.5	3.0	1.9
Latin America *	6.9	9.0	10.0	9.3	10.0
Mexico	5.3	4.2	3.4	3.9	3.6
EAGLES **	2.8	5.3	6.3	4.8	4.6
Turkey	6.3	8.6	6.7	9.6	7.1
Asia Pacific	0.3	3.6	4.8	3.5	3.5
China	-0.8	3.3	5.4	3.5	3.8
Asia (exc. China)	1.1	3.7	4.3	3.4	3.2
World	2.2	3.5	5.1	4.4	4.0

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela

** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey

Forecast closing date: April 30, 2012

Source: BBVA Research

Chart 4

United States indicators and forecasts

	2010	2011	2012	2013	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12
Macroeconomic Indicators												
GDP (real % change)	3.0	1.7	2.3	2.2	2.2	1.6	1.5	1.6	2.1	2.4	2.5	2.4
Personal consumption (real % change)	2.0	2.2	2.2	2.0	2.8	2.2	2.0	1.6	1.9	2.2	2.3	2.3
Gov. consumption (real % change)	0.7	-2.1	-1.5	0.4	-1.1	-2.2	-2.4	-2.8	-2.1	-1.8	-1.7	-0.6
Gross fixed investment (real % change)	17.9	4.8	8.2	6.0	7.4	2.9	1.0	8.1	8.7	8.6	9.7	6.0
Construction ¹	-4.3	-1.4	9.9	5.9	-2.9	-6.8	1.3	3.5	8.8	9.6	11.2	9.8
Industrial prod. (real annual % change)	5.4	4.1	4.1	3.3	5.4	3.6	3.3	4.0	4.3	4.6	4.0	3.6
Current account balance (% of GDP)	-3.3	-3.3	-3.0	-3.3	-3.3	-3.3	-2.9	-3.3	-3.0	-3.0	-3.0	-3.1
Final annual inflation	1.5	3.0	2.8	2.2	2.7	3.6	3.9	3.0	2.7	2.5	2.2	2.8
Average annual inflation	1.6	3.2	2.5	2.2	2.1	3.4	3.8	3.3	2.8	2.4	2.3	2.6
Primary fiscal balance ² (% of GDP)	-8.9	-8.7	-7.6	-5.0				-8.7				-7.6

Update: May 13, 2012
Source: BBVA Research

Chart 5

Mexico indicators and forecasts

	2010	2011	2012	2013	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	5.5	3.9	3.7	3.0	3.9	3.9	4.4	3.7	3.9	3.8	3.4	3.6
Per inhabitant (US dollars)	9,582	10,515	10,998	12,191	10,538.8	11,050.1	10,729.5	9,843.2	10,548.7	10,871.7	11,144.5	11,445.8
US\$ billions	1,035	1,144	1,206	1,346	1,146.8	1,202.4	1,167.5	1,071.1	1,156.4	1,191.8	1,221.7	1,254.8
Inflation (average, %)												
Headline	4.2	3.4	3.7	3.5	3.5	3.3	3.4	3.5	3.9	3.5	3.6	3.6
Core	3.9	3.2	3.3	3.4	3.2	3.2	3.2	3.3	3.3	3.3	3.4	3.3
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	4.3	4.4	5.5	4.3	4.4	4.2	4.3	4.3	4.4	4.4	4.4
28-day TIIE	4.9	4.8	4.9	5.9	4.8	4.9	4.8	4.8	4.8	7.8	4.8	4.9
10-year Bond (% average)	6.9	6.8	6.4	7.0	7.5	7.0	6.4	6.3	6.1	6.4	6.4	6.6
Exchange rate (average)												
Pesos per dollar	12.6	12.4	12.8	12.2	12.1	11.7	12.3	13.6	12.9	12.9	12.8	12.6
Public Finances												
*FRPS (% of GDP)	-3.5	-3.0	-3.0	-2.8	--	--	--	-3.0	--	--	--	-3.0
External Sector³												
Trade balance (US\$ billions)	-3.0	-1.6	-9.1	-15.4	1.5	1.4	-3.8	-0.7	0.2	-0.5	-4.3	-4.6
Current account (US\$ billions)	-3.1	-8.8	-15.7	-19.1	-0.1	-1.8	-3.4	-3.5	-1.7	-3.7	-4.1	-6.2
Current account (% of GDP)	-0.3	-0.8	-1.3	-1.4	0.0	-0.6	-1.2	-1.3	-0.6	-1.2	-1.3	-1.9
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	4.3	3.6	2.9	4.9	4.2	4.2	4.1	4.0	3.8	3.4	3.3
Open Unemployment Rate (% active pop.)	5.4	5.2	5.1	4.8	5.2	5.5	5.3	5.0	5.0	5.1	5.1	5.2

Continues on next page

Mexico indicators and forecasts

	2010	2011	2012	2013	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12
Aggregate Demand ⁴ (ann. % chge., seasonally-adjusted)												
Total	9.0	4.7	4.2	4.3	5.2	4.6	5.0	4.0	3.9	3.5	4.3	5.2
Domestic Demand	5.2	4.9	3.6	3.4	5.5	5.0	5.1	4.2	3.6	3.5	3.3	3.8
Consumption	4.8	4.0	3.1	2.7	4.6	3.7	4.1	3.8	3.5	3.5	2.7	2.8
Private	5.3	4.6	3.4	2.8	5.1	4.5	4.6	4.1	3.8	3.9	2.7	3.0
Public	2.1	0.6	1.6	2.0	1.2	-1.4	0.7	1.9	1.9	1.0	2.2	1.3
Investment	6.4	8.3	5.1	5.9	9.0	9.7	8.7	5.9	3.6	3.7	5.7	7.3
Private	6.4	12.1	4.7	4.4	14.5	17.4	10.3	6.7	2.5	1.9	4.5	10.1
Public	6.6	-1.8	6.3	10.6	-5.2	-9.4	4.0	3.8	7.1	9.5	9.4	-0.2
External Demand	21.7	6.8	5.6	6.5	11.6	8.7	4.4	3.0	1.6	2.7	7.5	10.8
Imports	20.6	6.8	5.9	8.0	9.3	6.8	6.5	4.9	3.7	2.8	6.8	10.1
GDP by sectors (ann. % chge., seasonally-adjusted)												
Primary	2.8	-0.4	2.5	1.9	-2.6	-5.8	7.0	-0.1	-1.5	2.6	6.8	1.8
Secondary	6.1	3.9	3.6	3.0	4.7	4.2	3.5	3.1	3.8	3.9	3.2	3.4
Mining	1.1	-2.3	1.3	1.7	-2.7	-2.0	-3.4	-1.0	0.8	1.5	1.5	1.6
Electricity	10.1	5.4	3.5	3.4	9.9	7.5	3.0	1.8	3.4	3.5	3.6	3.5
Construction	0.0	4.8	3.8	4.0	5.8	3.8	5.2	4.5	4.0	4.8	3.6	2.8
Manufacturing	9.9	5.1	4.1	3.0	6.1	5.4	5.3	3.6	4.5	4.3	3.5	4.1
Tertiary	5.6	4.2	3.7	2.9	4.2	3.7	4.7	4.2	4.3	3.8	3.3	3.4
Retail	13.7	7.7	4.9	3.4	8.4	8.4	8.1	5.9	5.7	4.8	4.4	4.8
Transportation, mail and warehouse	7.6	3.5	3.1	2.9	3.4	3.3	4.0	3.3	2.8	2.9	3.0	3.8
Massive media information	1.7	6.6	8.1	6.5	5.1	6.0	8.0	7.3	8.0	8.3	8.1	7.9
Financial and insurance	12.3	4.8	6.2	5.4	4.6	0.4	7.5	6.7	7.0	7.4	5.2	5.2
Real-estate and rent	1.9	2.1	1.7	1.4	1.8	1.9	2.1	2.7	2.0	1.9	1.6	1.5
Prof., scientific and technical servs.	-1.1	5.8	3.6	2.5	3.7	7.0	5.4	7.0	6.3	4.2	2.1	1.7
Company and corporate management	4.9	5.8	3.3	4.6	4.2	7.3	4.4	7.2	3.2	2.6	3.0	4.3
Business support services	1.5	4.2	4.1	3.4	3.5	4.6	4.6	4.3	4.1	4.2	4.2	4.0
Education	0.2	1.5	2.2	2.0	0.0	0.9	2.8	2.5	1.9	2.0	2.3	2.3
Health and social security	0.7	1.7	2.2	1.4	1.1	2.8	2.9	-0.1	3.0	2.7	1.8	1.5
Cultural and sport	5.9	6.6	4.8	3.7	7.6	7.3	6.1	5.5	5.7	5.9	4.0	3.8
Temporary stay	3.2	2.6	3.0	2.1	0.6	2.5	3.1	4.3	3.8	3.5	3.0	1.8
Other services, except government activities	0.7	4.0	3.3	2.3	2.9	4.5	4.2	4.3	3.2	3.4	3.4	3.3
Government activities	2.6	-0.8	0.8	1.1	0.1	-5.1	-0.7	2.7	3.5	0.5	-0.3	-0.5

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 adjustment

dpp: dollars per barrel

*FRPS: 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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