Mexico Inflation Flash

Supply shocks keep pushing inflation upwards and increases Banxico's concerns over short term risks. However demand pressures are inexistent.

General: Actual: 0.3'% m/m vs. BBVA: 0.27% m/m Consensus: 0.27% m/m
Core: Actual: 0.22% m/m, vs. BBVA:0.24% m/m, Consensus:0.25% m/m

- **Inflation increased again in August driven by external shocks affecting the prices of food and energy.**
- **Banxico shows greater concern about short term inflation risks that leads to a less neutral tone. The balance of risks of economic activity continues its impairment. Altogether these conditions are still consistent with a protracted monetary pause.**
- **Inflation of non-food merchandise keeps increasing driven by exchange rate pass through, however this increases could moderate in coming months.**
- **Services remain well anchored at 2.4% y/y, reflecting the absence of demand pressures.**
- **We expect inflation will reduce below 4% at year's end, but if new supply shocks arise the probability of this outcome will be lower.**

August's inflation increased 0.30% m/m slightly above market consensus and our estimate (0.27% m/m), reaching 4.6% annually, an increase from July's result of 4.42%. Core inflation turned out slightly lower than expected by increasing 0.22% m/m, reaching 3.7% y/y form 3.6% y/y in July. Non-core inflation increased from 7.3% in July y/y to 7.6% in August.

Higher merchandise inflation keeps pushing core inflation upwards. Merchandise inflation increased 0.39% m/m, an increase from its 4.9% y/y rate in July to 5.23% y/y in August. This is the result of pressures within its processed food component caused by the high prices of grains, and the acceleration of the prices of the rest of merchandise caused by the persistent depreciation of the peso. The prices of services reached its lowest rate in the last five months reaching 2.43% y/y in August, it is worthy to highlight the positive performance of its education component which reduced from 4.6% in July to 4.2% in August, providing further evidence that at this point demand pressures are inexistent. Core inflation has been pushed upwards by supply shocks and the exchange rate pass through, however it will be able to moderate after September when negative statistical effects start fading.

Non core inflation increased again in august driven by the prices of livestock and energy. Livestock prices have increased from 10.4% y/y in June to 13.7% in August, because of the effects of the bird flu outbreak which disrupted the production of eggs, these prices will probably peak in September but it remains to be seen the speed at which they will adjust downwards. The high prices of oil have pushed energy inflation since April, however a positive comparison base will moderate this increases in coming months. It is worth highlighting that the inflation of tariffs set by local governments stands at 0% y/y, this will constitute an anchor to non core inflation the remainder of the year, but we must be cautious of the performance of this component at the beginning of 2013, when typically this tariffs are adjusted. Non-core inflation seems to be stabilizing although at a high rate, however we cannot rule out a new acceleration of this component if new supply shocks arise in coming months.

In light of these inflation figures and unlike previous statements, Banxico modified the neutrality of its policy paragraph from a rate movement either upwards or downwards depending on the economic scenario to a rate hike advise in case of the appearance of second round effects from recent supply shocks. In particular, the central bank stresses that it will follow closely that the price increase of agricultural prices and exchange rate fluctuations do not lead to second round effects on inflation, as is not the case nowadays. However, on the other hand, **concerns about economic activity remain**. According to the current statement, the balance of risks of economic activity has impaired further, thus leading to lower inflationary pressures in the medium term. Besides the latter, Banxico balances somewhat its short term inflation concerns by pointing out that it will follow the evolution of the relative monetary policy stance with respect to advanced economies. This argument has been used before in previous communications as a signal of possible relative tightening of monetary conditions. **We consider that even though Banxico's tone is less neutral, the absence of demand side pressures and the expectations that the current supply shocks will fade out in the coming months, current conditions are still consistent with a monetary pause. A rate cut, however is less probable now, given the short term inflation pressures.**

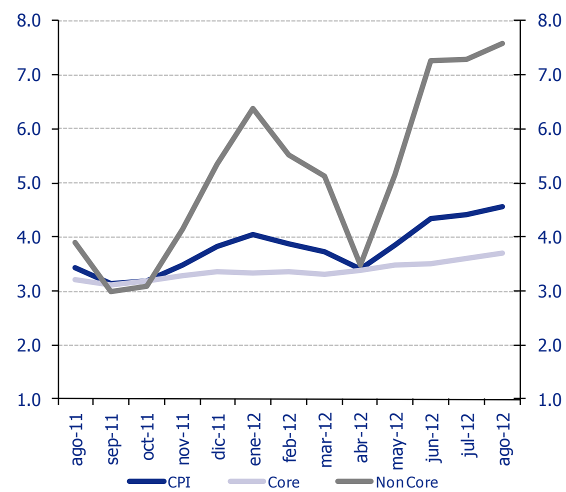
Bottom line: Inflation has increased due to supply shocks and to a lower extent to the weak peso, however at this point there is no evidence of second round effects. Demand pressures are inexistent given the slow recovery of consumption since 2010. We expect inflation will reduce below 4% at year's end, but if new supply shocks arise the probability of this outcome will reduce.

Table 1
Inflation (y/y and f/f % change)

	m/m % Change			y/y % Change	
	ago-12	Consensus	BBVA Research	jul-12	ago-12
CPI	**0.30**	**0.27**	**0.27**	4.42	**4.57**
Core	**0.22**	**0.25**	**0.24**	3.59	**3.70**
Non Core	**0.55**	**0.34**	**0.37**	7.30	**7.58**

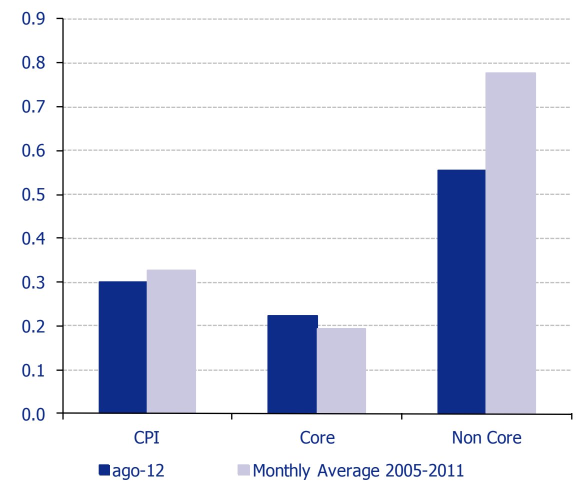
Source: BBVA Research

Graph 1
Inflation and components (y/y % chg.)



Source: BBVA Research

Graph 2
Inflation and components (f/f % chg.)



Source: BBVA Research

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