9th Jan. 2012

Food prices drive Mexican inflation higher

- **While Mexican inflation has risen in recent months, the increase appears to have been due to higher food prices and not the sharp depreciation of the peso. With the economy set to slow this year, and food inflation likely to fall back, we continue to expect interest rates to be cut to 4.0% by mid-year.**
- Data released today revealed that prices rose by 0.8% on the month in December. This caused the annual rate of headline inflation to rise to 3.8% y/y (from 3.5% in November). But while any increase in inflation is clearly a concern, policymakers can at least take some comfort from the fact that the increase was overwhelmingly driven by food inflation. A 6.9% m/m increase in fresh food prices, which has come on the back of a drought in the northern part of the country, caused food inflation to rise to 6.0% y/y (from 5.0% y/y in November). **Given that food accounts for around one-quarter of the CPI basket, it accounted for around two-thirds of the overall 0.3%-pt increase in the annual rate of inflation.** (See Chart 1.)
- That should reassure policymakers who are already concerned that the sharp depreciation of the peso since the summer (down 15% against the dollar since August) could drive inflation far above the central bank's (BANXICO's) 3±1% target range. So far at least, higher inflation appears to have been largely confined to the volatile food and energy components. Mexico is a net exporter of both. By contrast, core inflation, which includes more imported goods and is therefore more exposed to the exchange rate, has been stable and only edged up to 3.4% y/y (from 3.3% y/y in November). In other words, **it is not clear that the weaker exchange rate has begun to pass through to inflation.**
- Admittedly, **the stronger-than-expected performance of the economy recently means that there is a risk that firms will begin to pass rising import costs on to consumers.** In the past we have argued that firms would absorb much of the price increases into their margins on account of weak domestic demand. But while that does appear to have been the case so far, the economy performed much better than expected towards the end of last year. With this in mind, and producer price inflation currently at 6.6% y/y, there is a risk that firms will take the opportunity to increase their retail prices.
- **Even with this in mind, though, we expect inflation to remain within BANXICO's target range and to trend back towards the central bank's 3% over the course of this year.** (See Chart 2.) For a start, we expect the economy to cool over the coming months. US growth looks set to slow to just 1.5% this year, while the euro-zone will probably tip back into recession. As things stand, we expect Mexican GDP growth to slow to a below-potential (and below-consensus) 2.5% this year from around 4.0% last year. As a result, the persistent slack in the economy will keep a lid on core prices increases. Moreover, the recent pick-up in food inflation will probably prove to be temporary and, once local disruption has settled, its reversal could knock over 0.5%-pts off the headline rate of inflation by mid-year.
- **If we are right, then the priority of policymakers is likely to switch back to supporting the economy as evidence of slower growth begins to emerge.** As we have argued before, political deadlock ahead of July's presidential elections probably rules out any substantial fiscal measures and so policymakers look set to rely on monetary stimulus to do the work. Indeed, **we think that interest rates will be cut to 4.0% by mid-year, perhaps starting as early as March, although the recent episode of higher inflation may delay a first cut.** Either way, it seems increasingly likely that rates will remain at historic lows for a while longer.

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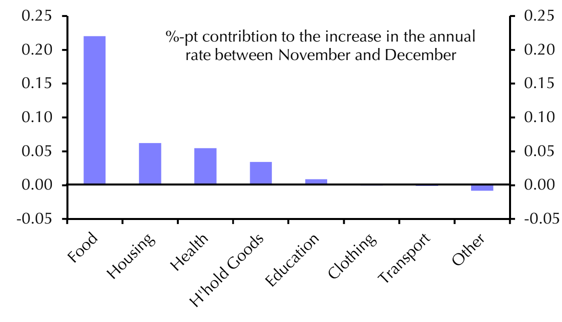
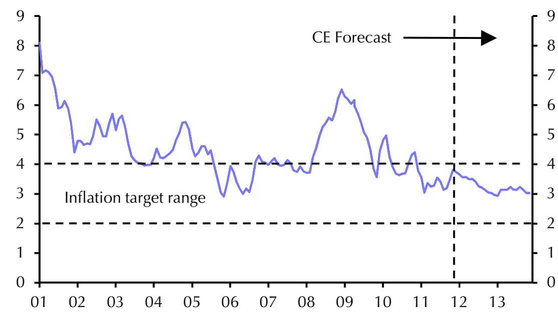
Chart 1: Contribution to Increase in Inflation (%-pts)



Sources – Thomson Datastream, CE

Chart 2: Consumer Prices (% y/y)



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