

Inflation Report

April - June 2008

Summary

The problems the world economy was confronting continued during the second quarter of 2008, and still do not show signs of correction. Most recent information suggests that world economic activity weakened further during the quarter. Inflationary pressures increased, and a new period of uncertainty in financial markets arose. Although U.S. GDP growth apparently strengthened, this positive development is expected to be temporary as the U.S. economy expands at a slower rate during the rest of the year. In other advanced and emerging market economies, economic activity apparently decelerated.

Price increases in foods, energy, and other commodities continued to affect world inflation negatively and have raised concerns in practically all central banks about the deterioration of inflation expectations. Under these conditions, the monetary authorities of some countries have tightened their monetary policy stances or have interrupted processes previously started to cut their reference interest rates. Inflationary pressures rose even more in emerging market economies, due to both their cyclical position and the greater share of foodstuffs in their consumer baskets. During the analyzed period, inflation was above the targets determined by the monetary authorities of many advanced and developing countries.

The turmoil in international financial markets, which had somewhat eased since the end of the first quarter of 2008, resumed by mid-year. The latter was influenced by expectations of additional losses in various financial institutions in the U.S. (particularly, government-backed mortgage agencies). This situation prompted a new increase in risk perception. Risk spreads for bond markets rose and stock markets fell. Sovereign risk spreads for emerging market economies also increased considerably.

So far, economic activity in Mexico has not been affected significantly by the weakening of the U.S. economy, although it has continued to exhibit the slowdown pattern observed during the first quarter of the year. This slowdown includes both aggregate demand and production. The near future is still subject to considerable downward risks.

Annual headline inflation has followed an increasing trend during the second quarter of 2008. This upward adjustment was the result of the materialization of several upward inflationary risks that Banco de México had repeatedly forewarned. Among these risks is the increase in international commodity prices, which has affected firms' cost structure. Firms that have accumulated a higher tax burden might have also passed part of these costs to their prices. Weather problems have also affected the supply of fruits and vegetables. On another front, no pressures from aggregate expenditure have arisen.

The recent developments in inflation have led to an upward revision in economic agents' short-term inflationary prospects in the last months. However, medium and long-term expectations remain, in general terms, well anchored.

Summing up, during the last months, various inflationary risks which had been forewarned by Banco de México took place. In

order to prevent the consequent rebound in inflation from affecting the anchoring of medium and long-term inflation expectations and, therefore, the process of price determination, the Board of Governors tightened its monetary policy stance in June and July.

Banco de México's expected scenario for the Mexican economy is as follows:

GDP Growth: Between 2.25 and 2.75 percent in real terms in 2008.

Employment: 370 thousand jobs (number of workers insured by the IMSS) are expected to be created for 2008.

Current Account: Current account deficit of around 0.5 percentage points of GDP in 2008.

This macroeconomic scenario is conditional to previsions based on most recent information on the development of the U.S. economy and international financial markets. Therefore:

- i) A greater-than-expected deceleration of economic activity in that country could make non-oil exports slow their rate of growth and also reduce the flow of workers' remittances.
- ii) Greater uncertainty in international financial markets could tighten credit conditions for emerging economies' access to international capital markets, among those, the Mexican economy.
- iii) Further deterioration in both confidence and business climate indicators in Mexico could be reflected in a greater slowdown of private sector spending.

Inflation: The forecast for annual headline inflation has been revised upwards as compared with the figures released in the Inflation Report of January-March 2008. On average, the band adjustment for the seven quarters considered is of 89 basis points.

Base Scenario for Annual Headline Inflation Quarterly average in percent

Quarter	Forecast	Forecast
	first quarter 2008	second quarter 2008
2008-I	3.89 ^{1/}	3.89 ^{1/}
2008-II	4.50 – 5.00	4.92 ^{1/}
2008-III	4.50 – 5.00	5.25 – 5.75
2008-IV	4.25 – 4.75	5.50 – 6.00
2009-I	3.75 – 4.25	5.25 – 5.75
2009-II	3.50 – 4.00	4.50 – 5.00
2009-III	3.00 – 3.50	3.75 – 4.25
2009-IV	3.00 – 3.50	3.50 – 4.00
2010-I	3.00 – 3.50	3.50 – 4.00
2010-II	—	3.25 – 3.75

1/ Observed figure.

Summary

Banco de México's forecast has been revised due to the following reasons. First, the prices of commodities in international financial markets in the last months have followed an upward pattern, higher than those expected in futures markets at the end of the previous quarter. In addition, although spot prices of certain food and energy commodities declined during July, the pass-through effect of the high levels of these price quotations to consumer prices apparently has not come to an end. The latent inflationary pressures originated by the previous increases in commodity prices have been included in Banco de México's current provisions. Finally, the rate of correction of the subsidy for energy prices in Mexico has increased.

Second, the new forecast also considers the following:

- i) Although international prices of commodities are expected to remain high, their recent pattern and/or the futures quotations for several of them suggest a more positive outlook for the next months. The further weakening of economic activity worldwide is a decisive factor in this consideration. These factors are expected to contribute to ease world inflationary pressures.
- ii) The greater tightening of the monetary policy stance is expected to gradually affect inflation through the different channels of the monetary policy transmission mechanism to be completed within a period of 18 to 24 months.

The assumptions considered in the new estimates for the inflation interval imply that inflation is expected to follow an upward pattern for the rest of the year and begin to decline in 2009. Nevertheless, by the end of 2009, inflation is expected to fall in the upper level of the variability interval around the 3 percent target and is anticipated to converge more convincingly to such target only until 2010.

Inflation is therefore expected to converge to a level close to the 3 percent target in 2010. This provision is foreseen to take place once Banco de México's monetary policy measures thoroughly impact the price determination process of the economy and the external shocks that have been affecting domestic inflation finally dissipate.

Considering the aforementioned, the outlook for inflation in Mexico is positive. This perception is based on the following:

- i) The referred recent reduction in the prices of various commodities which points to an eventual decline in the upward pressures the economy has faced in the last two years.
- ii) The weakening of domestic economic activity, which will make more difficult for firms to pass on their cost increases to consumer prices.
- iii) The tightening of the monetary policy stance by Banco de México, which will help to maintain inflation expectations properly anchored in a longer term horizon.

The provisions for inflation are conditional to not having any additional shocks than those currently forecasted. Among the risks that have been identified are:

- i) International prices of commodities higher than those currently expected.

- ii) Adverse weather conditions could affect the supply and prices of vegetables.

- iii) Uncertainty regarding the magnitude and speed of the pass-through from higher tax burden on prices.

The cyclical phase the Mexican economy is undergoing is a factor that mitigates both pressures and risks currently faced by inflation. If the economic slowdown were to be of a greater magnitude, both inflationary pressures and risks would also diminish.

Summing up, although the forecast for inflation for a relevant horizon is being revised upwards, nowadays, it is clearer that the factors that have caused the main inflationary problem worldwide since the seventies have moderated significantly. The aforementioned undoubtedly is a positive element in Mexico's future inflation outlook.

Monetary policy's best contribution to improve Mexicans welfare is to promote sustained growth by providing an environment of price stability. Banco de México considers the anchorage of medium and long-term inflation expectations key in achieving such a goal. Thus, it will continue to monitor closely the balance of risks on inflation so that the 3 percent inflation target can be attained by 2010.