Inflation Report

January - March 2009

Summary

The world economy continued in recession during the first months of 2009. Global GDP is expected to fall sharply during the January-March period. Economic activity has weakened more strongly in advanced than in emerging economies. Nevertheless, a growing number of emerging market economies is experiencing lower levels of economic activity

Indicators suggest that the rate of contraction of economic activity and world trade could slow down during the second half of the year. However, the outlook is still grim due to, among other causes, the pernicious feedback that still persists between the real and the financial sectors. Under these conditions, the world economy is expected to contract, on average, in 2009 and to grow below its potential rate during 2010.

Economic deceleration together with commodity prices being far below their average levels observed in 2008 have reduced inflationary pressures. Although this has been a worldwide trend, inflation has declined more gradually in emerging economies.

International financial markets performed slightly better at the beginning of 2009. The measures implemented throughout 2008 to reestablish the good functioning in different market segments and to prevent the risk of systemic collapse contributed to such an improvement. During the first quarter of 2009, additional measures were also implemented, especially in the U.S. These facilities, which aimed at injecting capital to financial institutions, increasing financial transparency, acquiring troubled assets from banks, and reestablishing adequate credit flows for households and firms, also contributed to reduce uncertainty. International cooperation efforts by G-20 country members at the beginning of 2009 also contributed to the aforementioned.

Nevertheless, financial markets continued to be subject to considerable strain. In particular, the financial system has not entirely sorted out its difficulties, and despite the measures implemented, the return to normality seems rather distant. In this context, credit to the private sector in advanced economies has been hindered and foreign financing to emerging economies has shrunk significantly.

During the first two months of the year, financial markets in emerging economies deteriorated considerably. The exchange rates of many of these nations depreciated substantially and became more volatile. Sovereign and private debt spreads for these economies also widened significantly, and the conditions for foreign financing tightened. However, since March, conditions seem to have slightly gained ground as observed by the appreciation of their exchange rates, the narrowing of their sovereign debt spreads, and an improvement in their access to international financing. Despite the aforementioned, the availability of foreign resources for these economies is still very limited. Under this setting, the need to maintain adequate incentives for foreign capital flows and prevent disorderly adjustments in their exchange rates has reduced the margin of maneuvering to implement countercyclical policies in a large number of these economies.

In Mexico, during the first months of the year uncertainty rose significantly regarding the amount of resources that would be available to finance the expected current account deficit for 2009, and the possible impact this situation could have on the level of the central bank's international reserves. This uncertainty was mainly a result of the downfall in oil prices, public concern over domestic security issues, and the prevailing astringency in capital markets. This situation contributed to increase market nervousness, leading to a sharp depreciation of the peso and to higher exchange rate volatility, making many sovereign risk indicators for Mexico rebound considerably.

In light of these events, the Foreign Exchange Commission analyzed the expected balance of payments' behavior and concluded that in 2009 Mexico will not face problems to finance the estimated current account deficit. This conclusion is based on the fact that the growth in the current account deficit from 2008 to 2009 is expected to be fully financed through resources from the crude oil hedging and through greater public sector long-term financing from many international financial institutions. The Commission established a mechanism to guarantee that a considerable portion of the forecasted international reserve accumulation in 2009 be sold in the exchange rate market. As a result, Banco de México auctioned 100 million US dollars every day from March 9 to June 8, in order to foster orderly conditions in the exchange rate market.

Additionally, as part of a set of actions to promote orderly conditions in the exchange rate market, the Mexican authorities signed for a funding arrangement under the Flexible Credit Line (FCL) facility launched by the IMF. This arrangement was shortly activated as a precautionary measure (i.e., the authorities have stated their intentions to not draw on the line). In addition, Banco de México held a first auction of US dollar funding among financial institutions in Mexico with funds drawn from the currency swap line agreed with the U.S. Federal Reserve. These actions have contributed to foster an environment of greater stability in the exchange rate market and, in general, in domestic financial markets.

During the first quarter of 2009, the adverse international environment affected economic activity in Mexico. Most figures on domestic demand and productive activity suggest that the levels of economic activity in Mexico fell considerably in such quarter. Based on available information, GDP is expected to have fallen between 7 and 8 percent in annual terms during the first quarter of 2009.

The downward pattern of inflation during the first three months of the year was mainly influenced by the development of the administered prices' subindex. Core inflation, however, has still not reached an inflection point. In particular, core merchandise inflation increased possibly as a result of the significant depreciation of the exchange rate. Nonetheless, core services inflation has started to follow a more noticeable decreasing trend.

Banco de México has forecasted the following scenario for the Mexican economy:

GDP Growth: GDP is expected to contract between 3.8 and 4.8 percent in annual terms in 2009, and to grow between 1.5 and 2.5 percent in annual terms in 2010.

Employment: An annual reduction of between 350 and 450 thousand formal jobs (IMSS-insured workers) is expected for the end of 2009. However, between 200 and 300 thousand formal jobs are expected to be created in 2010.

Current Account: The current account deficit is expected to be between 2.2 and 2.3 percent of GDP (20.4 and 23.7 billion US dollars) in 2009 and 2010, respectively.

To determine growth prospects it is important to recognize that the recent developments of productive activity in Mexico seem to be responding to disturbances in the global economy. Considering the strong synchronization of Mexico with the U.S. business cycle and

the fact that uncertainty about the sources of financing for the Mexican economy has diminished in the last weeks, economic activity in Mexico could be expected to perform better during the second half of 2009 than in the first months of the year.

However, this scenario is still subject to downward risks. The abovementioned macroeconomic framework is based on the assumption that during the second half of 2009 the economic environment in the world, and, particularly, in the U.S., will improve slightly. An additional risk factor that affected the levels of productive activity during the second quarter of the year was the outbreak of swine flu during the end of April.

Inflation: The expected path of inflation was determined based on two main factors: first, the pass-through effect from the exchange rate depreciation to consumer merchandise prices and, second, the effect of Mexico's recession on the price determination process. It is thus feasible that most of the pass-through effect of the exchange rate depreciation on prices has materialized, although the fact that in the following months this process could continue for certain products' prices cannot be ruled out. The appreciation and stability of the exchange rate over the last weeks will very likely reduce this pass-through effect. On the other hand, the recessive conditions are expected to gradually affect with more intensity the price determination process in the services sector, and possibly induce a stronger fall in services inflation. In balance, merchandise inflation is expected to grow above services inflation in the next months; nevertheless, the development of both of them is also anticipated to contribute to a reduction of headline inflation starting May of this year, and to a convergence to its target at the end of 2010.

Based on these considerations, the forecast for annual headline inflation changed in relation to the previous Inflation Report. The new forecast for average annual headline inflation from the second to the fourth quarter of 2009 was revised upwards by 25 basis points, and the forecast for 2010 was left unchanged. Annual headline inflation is thus expected to converge to its target at the end of 2010 (Table 1).

Forecasts were revised because despite the deterioration of economic activity, recently, core inflation has continued to follow an upward pattern that might be associated with the exchange rate depreciation's impact on production's cost structure. Within the non-core component, price quotes of some vegetables, especially tomato, increased considerably, and an offer on mobile telephone air time ended.

Table 1
Base Scenario for Annual Headline Inflation
Quarterly average in percent

Quarter	Forecast Inflation Report 4-2008	Forecast Inflation Report 1-2009
2009-I	5.75 - 6.25	6.18 1/
2009-II	5.25 - 5.75	5.50 - 6.00
2009-III	4.50 - 5.00	4.75 - 5.25
2009-IV	3.75 - 4.25	4.00 - 4.50
2010-I	3.75 - 4.25	3.75 - 4.25
2010-II	3.25 - 3.75	3.25 - 3.75
2010-III	3.25 - 3.75	3.25 - 3.75
2010-IV	3.00 - 3.50	3.00 - 3.50
2011-I	-------------	3.00 - 3.50

1/ Observed figure.

Although inflation is expected to follow a downward trend in the next months, the following upward risks stand out:

I. Up to now, despite the recessive conditions, inflation has declined at a slower than expected rate.
II. The exchange rate depreciation has had an upward effect on firms' operation costs. Despite the mitigating factors previously mentioned, the fact that this process could last longer cannot be ruled out.
III. International food commodity prices being subject to upward pressures cannot be discarded.

The risk that recession deepens or lasts longer than currently expected and therefore that inflation declines faster than forecasted prevails. This situation is particularly relevant under the current environment in which the swine flu outbreak is taking place.

Given the significant deterioration of the outlook for economic activity in the last months, Banco de México's Board of Governors has loosened the monetary policy stance as a preventive measure, cutting the target for the overnight interbank rate by 225 basis points between January and April 2009. Considering the different elements of the balance of risks, the Board of Governors will continue monitoring closely such balance, so its monetary policy actions are consistent with both the economic situation and the expected path for inflation and the attainment of the 3 percent inflation target at the end of 2010.

Finally, the world economic recovery process is expected to converge to an equilibrium in which the potential growth of several economies, among them the U.S., will be below that observed in the recent past. Considering that the U.S. is the main market for Mexican exports, Mexico's foreign trade could face a less dynamic scenario in the future as compared with the years prior to the crisis. Under this situation, the main challenge is to reform the country's legal, regulatory and incentive framework in order to increase productivity and attain better prospects for growth in the medium run by giving a greater boost to the domestic market.

Note: An outbreak of swine flu has struck Mexico. Since it happened very recently, no information is available on its life span and level of intensity. Consequently, its effects on variables like inflation, growth, and the exchange rate cannot be determined. For this reason, the results and forecasts presented in this Report do not consider the effects this outbreak could have on the economy.