Inflation Report

July - September 2008

Summary

During the third and the beginning of the fourth quarters of 2008, the world economy has been affected by the most severe financial crisis since the 1930s. This crisis has affected both the functioning of financial markets and global economic activity. Economic growth in the U.S. declined significantly and production may have even contracted during the third quarter. Furthermore, the latest information suggests that both Euro and Japanese economies, which had contracted during the second quarter of the year, continued to exhibit weak growth during the July-September period. Emerging economies also slowed down during such period, although growth remained strong in some of them.

Although world inflation continued at high levels during the third quarter, inflationary pressures, especially in advanced economies, have subdued due to reduced global economic activity and declines in the international prices of oil and other commodities. Meanwhile, in several emerging economies, upward pressures on prices continued, mainly in response to the still relatively dynamic growth of domestic demand, the weaker anchorage of inflation expectations, and a slower pass-through from falling commodity prices, possibly associated with the lower level of competition within the industries of those countries. Nevertheless, expectations for headline inflation began to be revised moderately in some of these economies.

The problems in international financial markets worsened during the third and the beginning of the fourth quarters of 2008. Such deterioration stemmed from doubts regarding the solvency of government-sponsored enterprises in the U.S. as well as the difficulties faced by investment banks and some insurance companies in that country, together with worsening problems in European and other regions' financial institutions. A widespread deterioration of confidence prevailed, a significant increase in risk aversion, and a considerable rise in the volatility of the main financial variables.

The above mostly responded to the fact that problems suffered by many commercial banks led to a substantial increase in the perception of counterparty in the interbank market. As is well known, lending between banks is a normal part of their daily activity and when uncertainty regarding the financial condition of their counterparties in the daily interbank funding market increased, financial institutions reacted by showing a high degree of reluctance to continue granting them credit. This phenomenon expanded significantly and has led to a widespread tightening of credit conditions. This process was highly influenced by the lack of clarity surrounding financial institutions' disclosure of their exposure to high risk products. Institutions' balance sheets did not adequately reflect their exposure to risk and this led to doubts over their real financial situation. The lack of transparency and regulatory and supervisory bodies' forbearance for such a behavior are among the factors that explain the outbreak of the financial crisis.

From a general perspective, the volatility observed in international financial markets has responded to the need to begin a significant global deleveraging process intended to reduce the world economy's indebtedness to sustainable levels. As should be remembered, the latter mainly stemmed from changes in the origination and distribution of risk in international financial markets amid an environment where financial supervision and regulation did not adjust to the changing circumstances. The referred deleveraging process will need to be accompanied by a considerable reduction in global expenditure growth. Indeed, it is from this fact that the deteriorating outlook for world economic growth originates.

The U.S. authorities and those of other advanced economies have responded to the situation by implementing or announcing measures which include the capitalization of some financial institutions, purchasing toxic bank assets as well as coordinating efforts to provide liquidity, cutting reference interest rates, and injecting capital to banks and supporting interbank credit, among others. However, despite the measures implemented, uncertainty in financial markets still persisted at the end of October.

Under such context, financial conditions in the markets of both emerging and advanced economies have continued to tighten. The deterioration in risk perceptions has also led to a generalized fall in the demand for emerging economies' assets. Consequently, sovereign risk spreads on these countries' bond issues have widened significantly, stock markets of these countries have fallen, and their exchange rates have also depreciated considerably, all of which has been accompanied by a significant increase in volatility.

The volatility of international financial markets, particularly during September and October, together with the deterioration and uncertainty about forecasts for the world economy and, specifically, those for the U.S., have generated a scenario which is adversely affecting the Mexican economy through several channels. On the one hand, the weakening of world economic activity is expected to lead to lower manufacturing exports, lower revenues from remittances, and a reduction in the demand for energy goods that translates into lesser revenues from net exports of oil products. On the other, the greater difficulties that both firms and households are facing to access credit –and very likely will continue to face during the next quarters- will foster lower spending in the Mexican economy.

During the third quarter of 2008, annual headline inflation in Mexico rose in line with forecasts stated in the previous Report. Both core and non-core components greatly influenced such an increase. The increase in core inflation mainly resulted from price increases in some goods and services whose cost structures were affected by various factors, among which previous increases in commodity prices and the greater tax burden some firms have faced this year are noteworthy.

Meanwhile, the higher contribution of headline inflation's non-core component responded to three factors: first, a rise in the rate of adjustment of gasoline and LP gas prices; second, revisions on public transportation fares in some cities; and, third, increases in the prices of livestock products.

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

GDP Growth: around 2 percent (in real terms) during 2008 and between 0.5 and 1.5 percent in 2009.

Employment: Around 230 thousand jobs (number of workers insured by the IMSS) are foreseen to be created in the formal sector in 2008. For 2009, from 150 to 250 thousand additional jobs are expected to be created in this sector.

Current Account: Current account deficit of around 1.4 percent of GDP in 2008 and of between 1.6 and 2.0 percent in 2009.

This macroeconomic scenario is conditional to the current consensus among analysts concerning the referred performance of the U.S. economy and international financial markets. Nevertheless, uncertainty surrounding developments in that economy and in the rest of the world, as well as the volatility prevailing in international financial markets, suggest that the risks of deterioration for economic activity in Mexico might have even increased.

Inflation: The forecasted path for annual headline inflation for the following two years remains unchanged in relation to the one published in the previous Inflation Report (Table 1), because the factors that could make inflation shift upwards are offset by others operating inversely. Among the former factors are the exchange rate depreciation recorded in October and the more frequent revisions to administered and regulated prices of goods and services. Among the latter factors are the reduction in the prices of several commodities and the outlook of slower growth in economic activity.

Among the most noteworthy risks that might influence the expected path of inflation are:

I. As economic agents start to perceive the depreciation of the exchange rate as permanent, the depreciation is expected to eventually have a greater impact on prices. However, the size and speed of the pass-through effect of this shock to consumer prices are highly uncertain.

II. Although the prices of commodities have fallen in recent months, these products have recorded considerable volatility in response to both supply and demand side factors.

III. Uncertainty prevails regarding the size and speed of the pass-through effect of the increased tax burden to prices.

Nevertheless, the phase of the cycle the Mexican economy is undergoing, in the context of reduced global economic activity, reduces significantly the pressures and risks inflation faces at present.

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

Quarter	Forecast Inflation Report 2008-2	Forecast Inflation Report 2008-3
2008-II	4.92 [1/]	4.92 [1/]
2008-III	5.25 - 5.75	5.48 [1/]
2008-IV	5.50 - 6.00	5.50 - 6.00
2009-I	5.25 - 5.75	5.25 - 5.75
2009-II	4.50 - 5.00	4.50 - 5.00
2009-III	3.75 - 4.25	3.75 - 4.25
2009-IV	3.50 - 4.00	3.50 - 4.00
2010-I	3.50 - 4.00	3.50 - 4.00
2010-II	3.25 - 3.75	3.25 - 3.75
2010-III	-------------	3.25 - 3.75

1/ Observed figure.

The Law governing Banco de México (Article 2) defines fostering the sound development of the financial system as one of the central bank's objectives. Under the current situation of a global financial crisis unseen in decades, the fact that the Mexican economy is financially integrated to the rest of the world economies has implied that part of the volatility that has been observed in international financial markets has spilled to the Mexican financial markets. Under this context, Banco de México's actions have focused on fostering the liquidity of financial institutions in Mexico. As for the Exchange Commission, its actions (as stated in Article 18 of the abovementioned Law) have been oriented to reduce the high volatility in the exchange market, which could affect negatively both economic activity and price stability.

The orderly functioning of the financial system is necessary for the sound development of the economy, while at the same time it sets the proper conditions for price stability. In light of the uncertainty characterizing the current economic conditions, Banco de México's Board of Governors will remain attentive of financial markets (as well as their effects on economic activity) and of those factors that could affect the projected path for inflation and therefore its convergence to the 3 percent target.