

Inflation Report

October - December 2007

Summary

During the fourth quarter of 2007, world economic activity lost momentum and the balance of risks for 2008 deteriorated, in terms of both growth and inflation. For 2008, in addition to its direct effect on productive activity, the adjustment in the U.S. residential sector is expected to reduce households' real estate wealth. The latter, together with the weakening labor market and the increase in gasoline prices, are expected to reduce the rate of growth of consumption. The mortgage sector crisis has deteriorated financial conditions and has increased the risks of a slowdown of aggregate demand in the U.S., thus increasing the probabilities of a recession in that country.

Prospects of additional increases in delinquency rates and foreclosures in the subprime mortgage credit market in the U.S., the announcement of significant losses in some commercial banks and securities insurance companies, and the uncertainty of additional losses in these and other financial institutions -and contagion to other segments of financial markets originated by these problems- deteriorated financial market conditions. The downturn of financial conditions has also affected emerging market economies. In particular, spreads on emerging market sovereign debt have increased in the last months.

There has been a deterioration of the outlook for world inflation, for both advanced and developing economies, which is mainly associated with the increase on food commodity prices and to renewed pressures on energy prices.

Prospects of a weakening in economic activity and an increase in inflationary pressures worldwide pose further challenges for the conduct of monetary policy.

During the fourth quarter of 2007, the Mexican economy grew moderately in annual terms, at a rate close to that observed during the previous quarter. Nevertheless, this expansion implied, with seasonally adjusted data, a quarterly percentage change of GDP below that observed during the second and third quarters of the year. The slower growth of aggregate expenditure in quarterly terms mainly reflected the reduced demand from the U.S. The moderate growth of domestic demand, particularly of private consumption, was influenced among other factors, by the lesser growth of the total wage bill. Consumption slowdown is clearly observed in the declining rate of growth of consumer financing.

The baseline scenario for the Mexican economy forecasted by Banco de México is as follows:

GDP Growth: Between 3.2 and 3.3 percent in 2007 and 2.75 and 3.25 percent in 2008.

Employment: 756 thousand jobs (number of workers insured by the IMSS) were created in the formal sector in 2007. For 2008, 620 thousand jobs are expected to be created.

Current Account: Current account deficit of around 0.8 percentage points of GDP in 2007 and 1 percent in 2008.

This scenario for economic activity in Mexico is conditional to, as suggested by most recent data, the U.S. economy not slowing so markedly and that this event is short-lived. As a more

adverse scenario materializes, the Mexican economy could grow less due to:

- i) A greater reduction in external demand for Mexican products.
- ii) A greater reduction in the amount of remittances sent by Mexicans in the U.S.
- iii) Tighter conditions in international financial markets.

Nevertheless, some factors are currently present which -unlike other periods in which the U.S. economy transited through the lowest phase of the business cycle- could mitigate the negative effects of an acute slowdown of the U.S. on the Mexican economy. Among these are:

- i) A greater diversification of non-oil exports, in terms of destination markets.
- ii) A strong domestic market and, particularly, the current growth of financing to the private sector.
- iii) Expectations that the public sector expenditure in infrastructure and housing for this year will boost significantly economic growth.

Additionally, it is important to remember that the impact of the slowdown of U.S. production on Mexico perceived in 2001 was magnified by the initial effect of China's entry to the World Trade Organization on Mexican non-oil exports to the U.S. Under this context, the effect of lesser economic activity in the U.S. during 2008 will not be once more influenced by this type of shock.

Inflation: Inflation in Mexico has been affected by a considerable increase in world inflation. In particular, the increase in the international prices of grains and dairy products has had a significant impact on the domestic prices of various products that use them as raw materials. Despite the aforementioned, and mainly because both a reduction in the prices of vegetables -which are very volatile- and a price fixing on gasoline, gas, and electricity decreed by the Federal Government for the last three months of 2007, during the fourth quarter, average headline inflation decreased by 0.18 percentage points -as compared with the previous quarter- reaching 3.81 percent. This figure is within the range forecasted by Banco de México in its Inflation Report of July-September 2007.

The forecasted path for annual headline inflation for the following two years remains unchanged in relation to the previous Inflation Report. Available information continues to suggest that, in the future, no aggregate demand pressures are expected, and developments in inflation are foreseen to be determined mostly by the rise and fading of the previously identified supply shocks.

Inflation is expected to start to decline during the second half of 2008 and continue to do so at a higher rate in 2009. Nevertheless, this result is contingent to the lack of additional shocks, particularly in the food sector.

Summary

Base Scenario for Annual Headline Inflation Quarterly average in percent

Quarter	Previous Forecasts	Current Forecasts
2007-IV	3.50 – 4.00	3.81 ^{1/}
2008-I	3.75 – 4.25	3.75 – 4.25
2008-II	4.00 – 4.50	4.00 – 4.50
2008-III	4.00 – 4.50	4.00 – 4.50
2008-IV	3.75 – 4.25	3.75 – 4.25
2009-I	3.50 – 4.00	3.50 – 4.00
2009-II	3.50 – 4.00	3.50 – 4.00
2009-III	3.00 – 3.50	3.00 – 3.50
2009-IV	n.a.	3.00 – 3.50

^{1/} Observed figure.

n.a. Not available.

Among the main upward and downward risks that might influence the expected path of inflation are the following:

- i) The possibility that new shocks arise and affect the prices of food commodities or that the shocks that have already taken place have a longer-than-expected effect.
- ii) Prices of oil products have been at higher levels than those expected at the end of the previous quarter. As a result, in some cases, the gap between the international references and domestic prices of these products has widened.

- iii) The magnitude and velocity that the effect of the new flat rate business tax (*Impuesto Empresarial a Tasa Única a los precios, IETU*) could have on consumer prices. This risk, which is difficult to estimate, is subject to a high level of uncertainty due to the downward phase of the business cycle the Mexican economy is undergoing.
- iv) Expectations that headline inflation will remain high during the next months increase the risk of contagion for the price and wage determination processes.

Based on the aforementioned conditions, the prospects for inflation, and the balance of risks associated to these prospects, Banco de México's Board of Governors decided to keep monetary conditions unchanged in November, December, and January, after having tightened them in October. The Board will remain attentive to the balance of risks in order to meet the 3 percent inflation target as forecasted.