

Inflation Report

January - March 2008

Summary

Most recent information suggests that the world economy grew at a slower rate during the first quarter of 2008. The U.S. economy continued to perform weakly at the beginning of this year, while GDP growth in other advanced economies apparently decelerated. Timely indicators suggest that emerging market economies grew vigorously during the same period, although some of them showed signs of slowing down.

Despite the slower rate of growth of the world economy, inflationary pressures in both advanced and emerging economies rose during the first quarter of the year, and inflation risks increased mainly due to the higher prices of food and energy.

In a scenario of upside risks for inflation and downside risks for GDP growth, the challenges for monetary policy implementation worldwide have increased.

During the first months of 2008, financial markets in various advanced economies continued to be subject to pressures. The central banks of these countries faced this situation by implementing several measures, which partially eased the turmoil in financial markets. However, uncertainty in these markets continued, as evidenced by persistently high interbank interest rates and by tighter credit conditions.

Although the turmoil in advanced economies' financial markets raised the spreads for emerging economies' debt instruments during the quarter, this increase was below that observed during previous episodes of volatility.

During the first quarter of 2008, GDP in Mexico is expected to have grown around 3 percent in annual terms and, with seasonally adjusted data, close to 4 percent.

During the same period, annual average inflation remained within the range forecasted by Banco de México, although annual headline inflation tilted upwards in March. In particular, during the last months, some of the upward risks foreseen by the central bank have gradually materialized. The new fiscal regime also affected the costs of some firms and might be influencing their price revision processes.

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

GDP growth: between 2.40 and 2.90 percent (in real terms) during 2008.

Employment: creation of 530 thousand jobs (number of workers insured by the IMSS) in 2008.

Current account: current account deficit of around 1 percentage point of GDP in 2008.

This macroeconomic scenario is subject to economic activity in the U.S. not falling sharply or for a long period. If the U.S. economy should face a more adverse scenario, the Mexican economy would be affected by:

- i) The slower growth of external demand from the U.S.
- ii) Lesser remittances from Mexican workers abroad.
- iii) Greater difficulties to obtain financing in international markets.

Despite the aforementioned, several factors have offset the negative effects of the U.S. economic slowdown on the Mexican economy. Among the most noteworthy are:

- i) Federal Government's greater margin to channel spending in projects to boost the economy.
- ii) Greater diversification of Mexican non-oil exports' destination markets.
- iii) The peso's real exchange rate has been depreciating against the currencies of Mexico's main competitors in the U.S. market, mitigating the impact of the slower growth of the U.S. economy.
- iv) The share of Mexican automotive production in total North American automotive production has increased.
- v) Despite their recent slowdown, growth rates of financing to households continue high, while those of financing for private firms have remained stable in the last months, after having increased in 2007.
- vi) On this occasion, the U.S. recession originated in the real estate sector and passed on to the financial sector, and, unlike previous episodes, did not affect significantly the industrial sector, which is highly linked with Mexico's productive activity.

Inflation: As compared with the previous Inflation Report, the forecast presented in this Report was revised upwards for the last three quarters of 2008 and the first quarter of 2009. For the remaining quarters of 2009, provisions remained unchanged. Banco de México's provisions for inflation have changed as certain risks identified by the central bank in its previous Inflation Report have materialized. In this regard, two events are worth mentioning: first, prices of food, energy, and metals have grown more than originally expected; and, second, prices of tomato and green tomato have grown significantly.

As for the higher prices of international commodities, at the end of the first quarter of 2008, these reached levels significantly higher than those expected (which were already very high) in the futures market at the end of 2007. In particular, as shown in the following table, the difference between the observed price in March and the price expected with December's futures contracts for corn and wheat was 11.8 and 15.6 percent, respectively. The international prices of copper and natural gas also exhibited deviations of 27.3 and 26.1 percent, respectively.

The curves of most recent futures of food commodities also suggest that, in the next months, the prices of some of these commodities could be facing additional pressures. Nevertheless, the prices of grains are expected to be subject to lesser pressures than those recorded in the past year. On the other hand, in the case of oil and metal-related products, prices of these futures also suggest that these could remain high for the next twelve months.

**International Commodity Prices:
Observed and Expected**

	March 2008				
	Expected ^{1/}		Observed ^{2/}	Differences in percent	
	31 oct 2007 (a)	31 dec 2007 (b)		(c)	(c)/(a)
Grains (USD per bushel)					
Corn	3.9	4.6	5.1	29.8	11.8
Wheat	8.3	8.9	10.2	23.3	15.6
Soy	10.4	12.1	12.6	21.1	3.9
Metals (US cents per pound)					
Copper	349.3	304.1	387.1	10.8	27.3
Energy products (US cents per gallon)					
Gasoline	238.2	252.1	270.5	13.6	7.3
LP gas	146.0	156.5	147.5	1.0	-5.8
Natural gas ^{3/}	8.5	7.5	9.5	11.8	26.1

1/ Prices expected for March 2008 according to futures prices of October 31 and December 31, 2007.

2/ Average price observed during March 2008.

3/ USD/ MMBtu.

Source: Bloomberg.

Summing up, although information obtained from the futures contracts should be interpreted with reserve, due to its volatility, in general terms, two issues regarding its recent development deserve mention: first, prices of commodities are expected to remain high for the next year; second, in annual terms, over the next months, prices of these products are expected to be subject to lesser pressures than currently.

In April 2008, prices of tomato were almost 80 percent above the level observed during the previous year and are expected to remain high for the next two quarters. As for green tomato, its price in April was around 150 percent higher than in the previous year.

As the effects of the shocks recorded during 2007 disappear gradually, the path of inflation is expected to reach an inflection point during the fourth quarter of this year. Among the factors that, if materialized, would contribute to reduce inflation in that quarter are that price increases in dairy products observed during the fourth quarter of 2007 do not repeat; that the rate of price inflation of wheat products decreases slightly; and, that the supply of tomato and green tomato normalizes.

Inflation is expected to follow a trend towards convergence to the 3 percent target in 2009, as the supply shocks that will take place in 2008 are absorbed by the economy. Among these shocks, worth mentioning during the first half of the year were those originated by the price increase in food commodities (soy and wheat products), and, throughout the year, those related to metals (steel and copper-manufactured materials for construction) and natural gas (besides this fuel, the price increase affects high consumption electricity tariffs). The aforementioned trend would be the result of these commodity prices growing at a slower rate in 2009 than in 2008. Especially during the first half of 2009, the reduction in the rate of growth of revised regulated prices (property and water-services taxes and public transportation fares), as compared with that forecasted for 2008, and the fact that the effect of the single rate business tax (*Impuesto Empresarial Tasa Única*, IETU) on inflation should be absorbed throughout 2009, are also expected to contribute to the decline in inflation in 2009.

Based on the aforementioned, the forecasted range for quarterly average inflation for the rest of 2008 was revised 50 basis points upwards, and for the first quarter of 2009, by 25 basis points. The forecasted ranges for the last three quarters of 2009 remained unchanged.

**Base Scenario for Annual Headline Inflation
Quarterly average in percent**

Quarter	Previous forecast	Current forecast
2008-I	3.75 – 4.25	3.89 ^{1/}
2008-II	4.00 – 4.50	4.50 – 5.00
2008-III	4.00 – 4.50	4.50 – 5.00
2008-IV	3.75 – 4.25	4.25 – 4.75
2009-I	3.50 – 4.00	3.75 – 4.25
2009-II	3.50 – 4.00	3.50 – 4.00
2009-III	3.00 – 3.50	3.00 – 3.50
2009-IV	3.00 – 3.50	3.00 – 3.50
2010-I	—	3.00 – 3.50

1/ Observed figure.

In previous Reports it has been mentioned that the prevision for inflation is subject to certain risks that, if materialized, could modify this forecast. Among the most noteworthy risks, which could lead to higher-than-expected rates of inflation, are:

- i) Higher-than-expected increases in international commodity prices.
- ii) Recently, international energy prices have increased more than expected.
- iii) Prices of white corn (field corn) are expected to increase in the following months, thus exerting additional pressures on the prices of corn flour and corn tortilla.
- iv) The relatively high levels of inflation that could be observed in the next months could affect inflation expectations.

If the Mexican economy slows down more than currently forecasted, prices could grow at a slower-than-expected rate. This risk should not be underestimated, especially given the strong deterioration in the outlook for growth in the U.S.

Monetary policy currently faces a complex scenario in view that both inflationary pressures and risks for growth for the Mexican economy have increased. Banco de México will continue to monitor the balance of risks. In particular, it will monitor closely the effects on prices –in a horizon relevant for monetary policy- of external inflationary pressures, the slowdown of economic activity in Mexico, and the tighter credit (and relative monetary) conditions originated by the world financial turmoil. The aforementioned aims at achieving the convergence of inflation to its target within the expected time horizon.