Inflation Report

April - June 2009

Summary

The world economy continued in recession during the second quarter of 2009. Most recent information suggests that global economic activity remained weak during such period. Nevertheless, various economies showed signs of either a slower rate of contraction or an improvement in their rates of growth. Economic activity in the U.S. apparently has continued to decline, but at significantly lower rates than in the previous two quarters. Signs of a recovery arose in emerging economies during the same period.

Due to the widespread widening of output gaps, global inflation continued facing downward pressures. Although annual consumer headline inflation was extremely low and even negative in a large number of advanced economies, concerns prevail that monetary and fiscal policies implemented to promote economic activity might lead to inflationary pressures in the future if measures to revert them are not implemented on time. In most emerging economies, inflation also decreased during the period, but at more moderate rates. In some emerging economies, the adverse effect of the depreciation of their currencies on the price determination process contributed to these developments. Moreover, implementing expansionary fiscal policies in countries with relatively weaker fiscal institutions is a factor that has reduced the margin of maneuvering of monetary authorities, as it may affect their prospects for medium-term inflation.

As is well known, the resuming of orderly activity in financial markets is a necessary condition for the sustained and widespread recovery of world economic activity. Although financial conditions have not returned to normality, the situation in international financial markets improved substantially during the second quarter of the year. The stimulus programs implemented by the authorities of both advanced and emerging economies since the end of last year have been crucial in this recovery.

As a result of the contraction of external demand and its pass-through effect on the domestic market, during the second quarter of 2009, the negative trend followed by productive activity in Mexico during the previous months escalated due to events which are expected to temporarily affect economic activity. Among these are: first, the effect of the outbreak of the influenza A virus (H1N1) on Mexico's production levels in activities that were perceived as being a major risk of disease transmission (restaurants, hotels, recreational, retail, among others); second, the temporary shutdown in Mexico of plants of two American automobile companies that began bankruptcy proceedings; and, third, the effect of the Easter holiday on production levels in April. Despite the aforementioned, prospects of a gradual recovery of the U.S. economy during the second half of 2009 suggest that the Mexican economy could begin a change of trend in the third quarter of 2009. This perception is based on recent positive opinions captured by surveys. The eventual fading of the temporary shocks that negatively affected economic activity during the second quarter of the year would also contribute to the aforementioned results.

The global financial crisis has revealed key weaknesses and strengths of the Mexican economy. As mentioned in this Report, under the current world recessive environment, the Mexican economy has contracted sharply and more than other economies. Apart from the abovementioned temporary events' contribution to these results, this situation also reflects, among other factors: i) the high dependence of Mexico on the U.S. business cycle; ii) the deterioration of investors' confidence due to a considerably narrower margin of maneuvering of public finances, as a result of the fall in international oil prices (compared to last year's levels), and in the volume of domestic oil production; iii) Mexico's low flexibility to efficiently relocate its productive factors; and, iv) the lack of major incentives to adopt state-of-the-art technology and more efficient work practices. Nevertheless, Mexico has proven to be highly resilient to the effects of the world economic crisis. In particular, the macroeconomic strategy adopted in the last years has prevented accumulating the type of imbalances which in the past irreversibly led to financial and balance of payments' crises.

Inflation remained on a downward path during the second quarter of 2009. Both core and non-core inflation contributed to such a result. Core inflation was mainly influenced by the fall in the annual growth rates of the services price subindex, due to plummeting economic activity and, to some extent, to the influenza A virus (H1N1) contingency, which lowered the demand for tourism and food services. Nevertheless, the fall in services inflation was partially offset by the growth of merchandise inflation. The development of both price subindices has led to an increase in the relative price of merchandises as compared with services, originated by the depreciation of the real exchange rate. As for non-core inflation, its decline during the analyzed period was mostly due to the slower rate of growth of the subindex of administered and regulated prices of goods and services.

Considering the information analyzed in this Report, Banco de México has forecasted the following base scenario for the Mexican economy:

GDP: GDP is expected to contract between 6.5 and 7.5 percent in annual terms in 2009, and to grow between 2.5 and 3.5 in annual terms in 2010.

Employment: an annual reduction of between 635 thousand and 735 thousand formal jobs (IMSS-insured workers) is expected at the end of 2009. Between 200 and 300 thousand formal jobs are expected to be created in 2010.

Current Account: a current account deficit of 1.5 and 1.7 percent of GDP is expected for 2009 and 2010, respectively.

The prospects for growth in Mexico for the remaining quarters of 2009 and for 2010 are based on expectations of a gradual recovery in the U.S. economy starting in the second half of 2009, and on the fading of the temporary shocks that prompted a greater fall in productive activity during the second quarter. This suggests that Mexico might begin to experience a change of trend in economic activity during the third quarter of 2009.

Nevertheless, the forecasted scenario for economic activity continues to be subject to downward risks, such as:

a. This scenario is primarily based on the assumption that, during the second half of 2009, the world economic environment in general, and the U.S. environment in particular, will improve. If the world recession lasts longer or financial conditions in international markets again deteriorate significantly, growth expectations for the Mexican economy could be revised downwards.

b. Uncertainty still prevails about the current situation of the main automobile companies in the U.S. and its consequences on Mexico's automobile industry.

c. A possible consequence of the financial crisis experienced during the current cycle is that U.S. potential growth could be affected and thus inevitably hinder Mexico's potential growth.

Inflation: as foreseen in the January-March 2009 Inflation Report, the quarterly average of annual headline inflation continued to decrease during the second quarter. Nevertheless, due to the magnitude of economic activity contraction, headline inflation has exhibited a relatively small downward adjustment. Although this effect partly responds to the change in merchandises relative prices (compared to services prices) as a result of the exchange rate depreciation, core services inflation has declined significantly.

As for merchandises, the effect of the exchange rate is expected to already have been passed on to consumer merchandise prices. Thus, as long as the exchange rate and international commodity prices remain stable, core inflation of the remaining merchandises is expected to reach an inflection point. The latter, together with the decrease in processed foods prices, would contribute to bring down headline inflation in the next quarters.

As for the CPI non-core component, it is expected to record lower inflation rates as long as the current policy of administered prices is maintained and no significant supply shocks on agricultural markets occur.

Based on the aforementioned, the forecasted trajectory for headline inflation for the following eight quarters is expected to remain unchanged as compared with that of the previous Inflation Report. Headline inflation is thus expected to continue declining and converge to its 3 percent target at the end of 2010 (Table 1).

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

Quarter	Forecast Inflation Report I-2009	Forecast Inflation Report II-2009
2009-II	5.50 - 6.00	5.96 [1/]
2009-III	4.75 - 5.25	4.75 - 5.25
2009-IV	4.00 - 4.50	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	3.00 - 3.50
2011-II	--------------	3.00 - 3.50

1/ Observed figure.

The attainment of the target for headline inflation is not exempt of upward and downward risks that could change its expected trajectory. Among these are:

1. Increases in international commodity prices.
2. Changes in the current policy of administered prices in 2010.
3. Given the high share of imported inputs in domestic production, new episodes of exchange rate adjustments or an increase in its volatility could affect short-term inflation.
4. A rebound in the prices of the remaining services, which have been affected by the economic recession and by the outbreak of influenza A (H1N1).
5. If economic activity recovers more slowly or if its recovery is of lesser magnitude, the current output gap could last longer and hence contribute to make inflation decline more and at a faster than expected rate.

In the official press releases on monetary policy of April, May and June, Banco de México's Board of Governors stated that due to the large contraction of economic activity, the balance of risks regarding economic activity had deteriorated more than that of inflation. In order to reduce the negative effects of the crisis, the Board loosened its monetary policy stance by 200 basis points, cutting the reference rate from 6.75 to 4.75 percent. In its monetary policy announcement of July, it cut the reference rate by 25 additional basis points to 4.5 percent and decided to make a pause in the current phase of monetary loosening. The Board of Governors' future monetary policy actions will be consistent with the balance of risks, always following the development of the economy and the expected path of inflation, in order to meet the 3 percent inflation target at the end of 2010.

It is important to emphasize on the need to consolidate a solid structural improvement of public finances. As the current crisis has proven, countries with relatively sounder fiscal positions have had a greater margin of maneuver to reduce the effects of recession via countercyclical macroeconomic policies. Progress must therefore be made in two fronts. First, expanding the sources of public funding would allow for having more degrees of freedom to adjust public expenditure throughout the business cycle and channel a greater amount of funds to projects with higher social returns, such as poverty alleviation, improving education, and building and maintaining infrastructure. Second, strengthening the mechanisms of transparency and accountability in public budget exercise, particularly regarding efficiency criteria, would trigger a greater number of productive projects and gather more support to adopt measures to make the recurring sources of public revenues more robust. Putting off these measures could make the economy more vulnerable, in addition to propitiating wasting future favorable cycles and delaying the recovery of living standards of most Mexicans.

Finally, once the recession ends, Mexico's capacity to position itself on a path of sustained growth will depend on the progress to approve and implement the structural reforms needed to make the economy more flexible and competitive. Under this setting, a main determinant in triggering economic growth is the adoption of an institutional framework that fosters greater market competition, allows more flexibility to allocate productive resources, and establishes incentives in a way that economic agents can adopt more efficient and productive technologies and processes. The current economic conditions offer a great opportunity for Mexico to assess and adopt new growth strategies.