Inflation Report

October - December 2008

Summary

The escalating turmoil in international financial markets since mid-September 2008 severely affected the world economy during the fourth quarter of the year. Despite the actions implemented in some economies to mitigate the effects of the financial crisis, global economic activity weakened considerably during that quarter. As a result, in 2009, the world economy is expected to experience its sharpest slowdown in decades.

The economic slowdown and the fall in international commodity prices allowed inflationary pressures to ease worldwide. The inflation rate in advanced economies fell considerably and in many emerging market economies it followed a downward path during the quarter. Inflationary pressures in both advanced and emerging economies are expected to decrease in 2009.

The bankruptcy of an important U.S. investment bank at the end of the third quarter of 2008, and initially the lack of clarity about the use of emergency funds to aid the U.S. financial sector, led to a general loss of trust in international financial markets. Both advanced and emerging economies were severely affected by these events. Emerging economies were considerably affected in their equity, foreign exchange, and domestic debt markets. In contrast with previous crisis episodes, the current crisis has engulfed all countries, and is considered the first global financial crisis in history.

In response to the crisis, both advanced and emerging economies implemented extraordinary measures during the last quarter of 2008 to improve the functioning of financial markets. The challenge for the financial authorities is to break the negative feedback between a deteriorating financial sector, the consequent credit crunch, and the weakening of the economy.

Once it was evident that these measures were insufficient to prevent the problems in the financial sector from adversely affecting the real sector, many advanced and emerging economies announced fiscal-support packages for both households and companies in order to attenuate the negative impact of the crisis.

The deterioration and uncertainty about both financial markets and the outlook for the U.S. and the rest of the world economies negatively affected the Mexican economy and its financial markets. Under this scenario, the Mexican economy, which had been growing at a slow rate since 2008, at the end of the year began to grow at even slower rates, while risks of a downward adjustment in economic growth for 2009 have increased considerably. Indeed, during the fourth quarter of 2008, economic activity in Mexico continued to weaken. During such period, both confidence and business climate indicators deteriorated significantly as well. During the fourth quarter, Mexican GDP is expected to have contracted 1.0 percent in annual terms.

The environment of risk aversion that prevailed worldwide raised considerably market volatility in Mexico's financial markets during the last quarter of 2008. Under these conditions, Banco de México, together with the Ministry of Finance, set off multiple actions to maintain the proper functioning of domestic capital markets. If these measures had not been implemented, the high costs originated by the global crisis would have increased, having pernicious consequences on Mexico's economic activity.

In contrast with other countries, during the last quarter of 2008, annual headline inflation in Mexico continued following an upward trend and rose more than expected. This result is partially due to the constant increases in energy and food prices, and to the impact on costs of the exchange rate depreciation.

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

GDP Growth: GDP measured in pesos is expected to have grown 1.5 percent in 2008 and to contract between 0.8 and 1.8 percent for 2009.

Employment: By the end of 2008, 37,500 job positions in the formal sector of the economy (number of workers with social security) were lost. By the end of 2009, this amount could escalate from 160,000 to 340,000 workers annually.

Current Account: The current account deficit is expected to have been 1.4 percent of GDP in 2008. For 2009 it is forecasted to represent between 2.6 and 2.8 percent of GDP.

The estimated scenario reflects, on the one hand, the significant deterioration of growth prospects for the Mexican economy during the last few months and, on the other, the expected positive effect of the policies to foster aggregate demand on economic activity. The downward adjustment in the outlook for the Mexican economy growth is mainly due to the severe deterioration of the external environment.

Inflation: Inflation is expected to start to decline in the first quarter of 2009 and then follow a downward path for the next two years. Annual headline inflation is forecasted to be below 4.0 percent in December 2009. These figures are based on diverse factors, such as the recession that is still expected to continue in terms of global economic activity (at least during the first semester of 2009); plummeting international commodity prices; and, the federal government's decision to freeze gasoline prices, to reduce by 10 percent the price of LP gas and by 9 percent both low tension and commercial use electricity tariffs (these prices are not expected to increase in 2010), and its announcement to reduce import duties, which should help inflation follow a downward path.

Despite these factors, the rate of inflation some CPI price subindices reached at the end of 2008 indicates that inflation will be above the figures forecasted in the Inflation Report of July– September 2008 (Table 1).

Table 1

Base Scenario for Annual Headline Inflation

Quarterly average in percent

Quarter	Forecast Inflation Report IV-2008	Forecast Inflation Report I-2009
2008-IV	5.50 - 6.00	6.18[1/]
2009-I	5.25 - 5.75	5.75 - 6.25
2009-II	4.50 - 5.00	5.25 - 5.75
2009-III	3.75 - 4.25	4.50 - 5.00
2009-IV	3.50 4.00	3.75 - 4.25
2010-I	3.50 4.00	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

1/ Observed figure.

The achievement of the inflation rate previously forecasted depends on several upward and downward risks, such as:

I. The stage of the economic cycle.

II. The high level of uncertainty about the path that international prices of several commodities will follow.

III. The behavior of domestic grain prices in Mexico does not necessarily correspond to their international benchmarks, as observed recently.

IV. The path that energy commodity prices could follow depends on the performance of the global economy and on production cuts caused by geopolitical problems or weather events.

V. The exchange rate has depreciated significantly, in a context where economic activity has slowed down considerably, which implies higher uncertainty about the probable pass-through effect of the exchange rate to consumer prices.

This outlook indicates that, worldwide, the balance of risks has been affected more in terms of economic activity than of inflation, and Mexico is not the exception. In line with these developments, in January, Banco de México's Board of Governors decided to reduce the overnight interbank interest rate target by 50 basis points.

The imbalances in the financial market are still a risk factor for the inflation path. Consequently, Banco de México will continue to monitor closely the risk balance. Monetary policy measures decided by the Board of Governors will be conditioned to reaching the 3 percent inflation target at the end of 2010. Given that domestic financial markets' proper functioning is essential to achieve macroeconomic stability, the Board of Governors will remain alert to ensure adequate operations in these markets.

In a context in which global economic activity is undergoing the lowest stage of the cycle and, thus, Mexico's current levels of external demand are expected to drop substantially, fiscal policy is naturally anticipated to become more expansionary and monetary policy to loosen in order to boost aggregate demand. The purpose is to partially soften the effect of the described environment on domestic productive activity.

Because of the current conditions, this type of policies can be applied with a wider margin of maneuvering. The expected decline of aggregate demand, together with the lower prices of LP gas and electricity -and the freeze on gasoline prices- mitigate inflationary pressures. This allows fiscal policy to become more expansionary and gives monetary policy a greater margin to loosen, without jeopardizing the convergence of inflation to its target.

It is important to emphasize that policies that foster aggregate demand should never jeopardize the health of public finances and also adjust to the current credit restrictions. For Mexico, the outlook regarding its sources of financing for the next few years portrays a complicated scenario. First, as recession in the United States deepens further and lasts longer, exports and remittances are expected to continue to grow at slower rates. Second, Mexico's oil trade balance has deteriorated significantly, turning negative during the fourth quarter of 2008. Finally, the critical situation of all financial institutions throughout the world suggests tighter conditions for financing in both domestic and international capital markets.

In the current environment, the different monetary transmission channels might operate with limited efficiency for two reasons. First, the world financial astringency, together with the market structure that seems to characterize the domestic financial sector, undermines the stimulus to credit supply associated with reference rate cuts. And second, given the deterioration of prospects for growth and employment, the demand for credit could also be affected.

Summing up, it must be emphasized that the effects of macroeconomic policies that foster aggregate demand in the economy are constrained and thus they are not likely to permanently boost GDP growth.

However, nowadays Mexico is in a better position to face the current international crisis. Macroeconomic stability has gradually consolidated as a result of several years of sound public finances and monetary policy focused on abating inflation. In particular, the institutional setting under which macroeconomic policies are implemented has recently transformed itself into a framework centered on stability. Today Mexico has the lowest inflation levels in decades, balanced public finances, a relatively small public debt to GDP ratio for many years, a better public debt maturity profile, a reduced deficit in its external accounts that has been financed without problems, high amounts of foreign direct investment, and record levels of international reserves. This environment of stability offers a great opportunity to implement policies that will lead to sustained growth by decisively reforming the economy's legal structure and regulatory framework.