

# Inflation Report

*April - June 2007*

## Summary

**T**he outlook for the world economy continues to be positive. In particular, robust growth is anticipated for both this year and the following. After having slowed down at the beginning of the year, growth of the U.S. economy recovered during the second quarter. The U.S. economy is expected to continue to recover during the remainder of 2007 and during 2008.

Inflation expectations over the medium and long term have remained stable in advanced economies. However, in some of them headline inflation has been affected by increases in commodity prices, mainly in those related to crude oil and food, as well as by high rates of resource utilization. Against this backdrop, various central banks have thereby continued to tighten their monetary policy stance in the last few months.

During the first half of 2007, economic activity in Mexico grew at a significantly lower rate than in 2006, due to reduced external demand and a slower growth rate of domestic consumption and investment spending. Economic growth is expected to recover moderately during the rest of the year, in line with the gradual recovery expected for U.S. economic activity.

Since mid-2006, inflation has been affected by a series of supply shocks, which prompted a rebound in both annual headline and annual core inflation.

Given the number, magnitude, and persistence of these shocks, and considering that their direct effect on annual inflation calculations takes some time to disappear and that provisions for short-term inflation have been revised upward considerably, the balance of risks for inflation worsened during the first months of the year. Under this setting, in April, Banco de México's Board of Governors determined to tighten its monetary policy stance as a preemptive measure.

Since the effects of monetary policy actions on the economy take place with some lag, once the effects of the supply shocks on headline inflation's annual variations disappear, and in absence of further supply shocks, annual headline inflation is expected to

converge gradually towards its 3 percent target, closely approaching it by the end of 2008.

Nonetheless, risks regarding the attainment of such prevision prevail. Consequently, Banco de México's Board of Governors has maintained a tightening bias in regards to its monetary policy stance.

### ***Recent Developments in Inflation***

During the second quarter of 2007, annual headline inflation remained slightly below 4 percent (3.98 percent at the end of June). Average annual inflation during this quarter was 3.97 percent, 0.13 percentage points below the first-quarter figure. This was mainly due to the gradual fading of two supply shocks that affected prices since last year, and to the lower contribution of prices of travel packages on inflation. As for the referred shocks, worth mentioning are the declines in the annual price variation of the core group of housing-related services as well as fruits and vegetables. The fact that the sharp increases in the prices of construction materials manufactured from metals that took place between April and June 2006 did not repeat, contributed to the results of the Residential Construction Cost Index (*Índice del Costo de la Construcción Residencial, ICCR*), which affects housing items' quotes. In the case of fruits and vegetables, the result was mainly determined by the reduction in onion and lemon prices (due to supply normalization).

During the analyzed quarter, within the core CPI index, the annual growth rates of the services and merchandise subindices followed opposite patterns. Regarding the former, its growth rate declined in greater magnitude compared to the latter. As a result, annual core inflation decreased to 3.70 percent at the end of the quarter.

In June 2007, the services core price subindex recorded an annual variation of 3.31 percent, 0.58 percentage points below its figure at the end of the first quarter. This result was due to a reduction in the annual growth rates of prices of housing-related services and other services.

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The pattern followed by housing prices between April and June 2007 was mainly influenced by the reduction of inflation in the Residential Construction Cost Index, as a result of the fading of the shock that affected the prices of materials manufactured from copper and steel during the same period of last year.

The reduction in non-housing services price inflation was mainly determined by the decline in the annual growth rates of both travel-services and air-transportation fees.

The merchandise subindex grew at an annual rate from 3.78 percent in March to 4.07 percent in June 2007, due to a faster growth rate of the prices of processed foods and the rest of merchandise.

During the second quarter of 2007, the increase in annual core food inflation was primarily influenced by the price increase in several dairy products. These increases were due, among other factors, to the higher prices of grains -which have raised production costs in the milk and dairy industries- and to a greater world demand for animal originated foodstuffs.

The increase in core food price inflation during the analyzed period was compensated by the price behavior of corn-tortillas and sugar. The annual growth of corn-tortilla prices has decreased as a result of the stability exhibited by the tortilla market in the last five months. This has taken place within the Agreement to Stabilize Corn-tortilla Prices, signed by the federal government and different sectors of the corn-tortilla industry. On another front, sugar prices continued to decline during the first half of the year, as a result of the fall in their international references and, recently, to the significant reduction of sugar import duties from the U.S. and Canada. Nevertheless, domestic prices of sugar have been converging to their international references slowly.

Annual non-core inflation reached 4.58 percent at the end of the second quarter of 2007, 0.40 percentage points below March's figure. The non-core price subindices recorded different rates of inflation. On the one hand, the corresponding rate for fruits and vegetables declined, while that for livestock products and for administered prices increased.

### ***Main Determinants of Inflation***

#### *International Environment*

Global economic activity exhibited robust growth during the second quarter of the year. In the U.S., economic activity strengthened, although GDP continued to expand at rates below that of potential output. At the same time, incoming information suggests dynamic growth in both the Euro area and Japan and a vigorous

expansion in emerging market economies. In general, inflation remained under control. Nonetheless, concerns about the future path of inflation persist, mainly because of the intensive use of production resources in several economies and the increase in the level and volatility of commodity prices, particularly crude oil and food prices. In this context, several central banks continued to tighten their monetary policy stance.

During the second quarter of the year, long-term interest rates in the U.S. followed an upward albeit oscillating trend. As a result, the slope of the yield curve increased. Unlike the rebound in long-term interest rates recorded in mid-2006 –which was associated with increased uncertainty about inflation- the recent increase in rates reflected an upward adjustment in real interest rates, which appears to be the result of greater confidence in the outlook for growth in the US. International financial markets have adjusted in an orderly fashion to an environment of higher interest rates, characterized by a persisting appetite for risky assets. Hence, the prices of various assets and currencies of emerging market economies recorded positive results.

However, since mid-June, long-term interest rates started to decline, while stock markets recorded losses and the spreads on sovereign debt instruments of emerging market economies increased. This occurred in a context of increasing concerns about losses on subprime mortgage loans in the U.S., and their potential impact on credit markets and economic activity in that country.

#### *Aggregate Demand and Supply in Mexico*

During the second quarter of 2007, economic activity in Mexico is expected to have grown moderately in annual terms, slightly above first-quarter figures. The diminished dynamism of economic activity during the first half of 2007, as compared with 2006, included the different components of aggregate supply and demand and was affected negatively by external conditions.

During the second quarter of the year, aggregate demand was characterized by: i) both components of demand –domestic and external- grew moderately; ii) the slowdown of consumer spending that began during the fourth quarter of 2006 continued in the second quarter of 2007; iii) investment expenditure grew at an annual rate above first-quarter figures, but significantly below that observed during 2006; and iv) exports of goods and services, particularly manufacture exports, grew moderately in annual terms, although slightly above first-quarter figures.

The following external factors affected negatively both domestic expenditure and production: i) the slowdown

of U.S. demand for Mexican products continued; ii) automotive exports recorded negative growth during the first half of the year; iii) revenues from workers' remittances fell in annual terms during the second quarter; and, iv) the oil trade balance surplus decreased.

#### *Costs and Prices*

During the second quarter of 2007, firms under federal jurisdiction negotiated with their workers the same average wage increase as in the second quarter of 2006.

During the second quarter of 2007, international prices of energy increased, surpassing those observed during the first quarter. Nonetheless, this increase only affected the natural gas domestic market, as both propane and gasoline prices for the domestic market are determined according to a pre-established rate of change. Recent futures prices of gasoline and propane were above those observed at the beginning of April. Futures prices of natural gas exhibited opposite results.

International prices of grains continued to increase, following the same trend since September 2006. Most recent futures prices of soy and wheat were above those observed at the beginning of April. In contrast, futures prices of yellow corn reached slightly lower levels, due to a significant increase in corn's total sown area, as confirmed by the U.S. Department of Agriculture in late June.

Between April and June 2007, international prices of beef and pork meat followed opposite trends (the former decreased while the latter increased). Nonetheless, futures prices of these products suggest that this change in prices could revert during the second half of the year.

#### *Monetary and Credit Aggregates*

During the first five months of 2007, bank credit to the private sector continued to grow at high rates. In the case of credit to households, it grew at more moderate rates than in 2006. Direct performing loans to households grew 27.4 percent in annual terms in May. As for financing to firms, bank credit rather than financing through securities has accounted for most of the growth of domestic financing to firms. Banks' direct performing loans to firms increased by 23.8 percent in annual terms. The medium-term corporate debt market exhibited less dynamism, growing at a real annual rate of 5.3 percent in May.

#### *Monetary Policy Actions*

Inflation in Mexico has been negatively affected since mid-2006 by several supply shocks that prompted it to

increase in the last months of that year and in the first months of 2007. During the first quarter of 2007, annual headline inflation was, on average, above 4 percent.

Up to now, available information suggests that the referred shocks will only affect inflation temporarily. These shocks arose from the price increases of a reduced number of products (sugar, corn-tortillas, cigarettes, and dairy products) and, apparently, have not contaminated the price determination process. However, by the end of the first quarter of the year, the balance of risks for inflation worsened.

The assessment of a wide variety of indicators shows that during the first months of the year, the trend for core inflation increased, the proportion of products included in the CPI basket that had been growing above 4 percent in annual terms increased, and short-term inflation expectations were revised upward considerably. The fact that headline inflation is above the upper limit of the inflation target variability interval increases the risk of contaminating the price determination process.

As mentioned in previous Inflation Reports, when inflation pressures originate from supply shocks, they reflect changes in relative prices, which should affect inflation only temporarily. In this case, the recommended policy response is that the central bank does not offset these pressures.

However, if the central bank considers that inflation expectations or the price determination process are likely to be contaminated, or that the balance of risks could worsen significantly, it must tighten its monetary policy stance to prevent such outcome. These circumstances led Banco de México's Board of Governors to tighten the monetary conditions by 25 basis points in April as a preemptive measure, after having left them unchanged since May 2006. As a result, the overnight interbank rate rose to 7.25 percent.

The path followed by the yield curve in Mexico has been mainly determined by the conditions prevailing in international financial markets, as well as by the effects of the adopted monetary policy actions. In particular, despite the increase in long-term interest rates in the U.S. during the second quarter of 2007, medium and long-term interest rates in Mexico remained close to their historic minimum levels. As a result, the spread between Mexico and U.S. interest rates for different terms narrowed considerably during the quarter, particularly for long-term interest rates.

During the second quarter, the yield curve in Mexico "flattened" while the yield curve in the U.S. "steepened". The tighter monetary restriction adopted in April and the

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effects of this measure on long-term inflation expectations in Mexico contributed to these results.

Nonetheless, since mid-June international financial markets have exhibited volatility due to problems in the U.S. mortgage market. This has led to a moderation in appetite for risk, which, in turn, has prompted an adjustment in securities markets and in the prices of assets and currencies of emerging market economies.

As for the outlook for inflation, once the effects of the shocks on annual headline inflation start to fade, and, in absence of further supply shocks, inflation is expected to resume its downward trend. Considering that the effects of monetary policy actions on the economy take place with a lag of between 18 and 24 months, headline inflation is anticipated to converge gradually to its 3 percent target, reaching it closely by the end of the fourth quarter of 2008. Given the aforementioned, the Board of Governors decided to leave monetary conditions unchanged in May, June, and July.

Recently, the risks surrounding the aforementioned provision have increased (see Balance of Risks and Final Remarks). Therefore, the Board of Governors believes that the monetary policy stance must maintain a tightening bias. This means that, in the near future, the Board will most likely adopt measures to tighten rather than loosen monetary conditions. The Board will continuously evaluate the balance of risks and, should it perceive a deterioration that could hinder the attainment of the inflation target, it will act accordingly.

### ***Balance of Risks and Final Remarks***

Based on the aforementioned macroeconomic conditions, and on information analyzed in this Report, Banco de México's baseline scenario for 2007 is as follows:

**Growth:** Between 3 and 3.5 percent.

**Employment:** Creation of around 660 thousand jobs in the formal sector (number of workers insured by the IMSS).

**Current Account:** Current account deficit of around 1.2 percent of GDP.

**Inflation:** Considering that the effects of monetary policy actions on the economy take place with a lag of between 18 and 24 months, the Board of Governors believes that the current monetary policy stance, in absence of further supply shocks, will help headline inflation to converge to its 3 percent target, reaching it closely by the end of 2008.

As for the short run dynamics of inflation, annual headline inflation is expected to be between 3.75 and

4.25 percent during the third quarter of the year, and between 3.25 and 3.75 percent during the fourth quarter. As for core inflation, it is anticipated to show a slightly decreasing trend during the second half of 2007, ending the year at around 3.5 percent. In this regard, the following is worth mentioning:

- The merchandise subindex has been affected by price increases in corn-tortillas, sugar, cigarettes, and, recently, dairy products. In absence of further shocks, the effects of these price increases on annual inflation calculations are expected to start to fade starting September. This result is contingent to the behavior of corn-tortilla prices, which have stabilized due to the Agreement to Stabilize Corn-tortilla Prices, which was extended to August 15, 2007.
- Non-food merchandise prices have grown at a relatively stable annual rate since 2002, currently fluctuating slightly above 2 percent. Similar results are expected in the future.
- In 2006, the price subindex of housing services was affected by the price increase in construction materials, mainly those manufactured from copper and steel. The effect of these shocks has mostly disappeared in the last months and no further pressures are expected.
- Prices of non-housing services are expected to continue to grow at annual rates slightly below 4 percent.
- The non-core price index will continue to be determined by the trajectory of fruits and vegetables prices. In absence of further shocks, fruits and vegetables prices are expected to reduce their contribution to annual headline inflation between August and October, due to the high prices attained by these products during the same period of 2006.
- Prices of livestock products could grow at higher annual rates, given that they continue facing pressures originated by the increase in grains prices and by the higher world demand for meat products.
- Administered prices are not expected to affect inflation significantly in the short term. Nonetheless, gasoline prices could be affected negatively if an additional tax on this product is authorized next year. On another front, the regulated prices subindex could grow at a faster rate, due to the updating of public transportation fees in some cities.

Among the risks for inflation in the short term, the following stand out:

i) High uncertainty about certain food prices prevails. On the one hand, the international prices of grains have been subject to pressures and have become more volatile. On the other, the increase in world demand for high-protein food products has been a continuous factor of pressure on the prices of these products (meat, dairy products, among others).

ii) Expectations that headline inflation will remain high in the short term increase the risk of greater side effects on other prices.

iii) Energy prices have remained high and have fluctuated significantly. In addition, the prices of other commodities, such as metals, remain volatile.

iv) If changes to the tax system that include additional taxes on certain goods like gasoline and cigarettes are approved, or if there is a significant increase in the fiscal burden on some sectors as a result of new taxes, headline inflation could be subject to temporary pressures.

Efforts to make inflation reach its 3 percent target face the following risks:

i) Services prices continue to grow at high rates.

ii) Inflation expectations are still above the 3 percent target.

The Board of Governors considers that the current monetary policy stance is consistent with the convergence of inflation to its target, in a time horizon compatible with the operation of the different channels of monetary policy transmission. Nonetheless, several risks prevail, especially regarding the increases in the international prices of food products. Although the significant increase in food prices has affected other economies as well, the high weight of food prices in the CPI, and various distortions in domestic food markets, make inflation in Mexico more vulnerable to this process. One of the most severe distortions is the lack of competition in some stages of the production chain of some food products, which aggravates the impact of the increase in the international prices of some food products on their domestic prices. Since the aforementioned entails higher risks on inflation, Banco de México's Board of Governors decided to keep a tightening bias in regards to its monetary policy stance.

There are other risk factors that could affect mainly the base scenario for GDP growth.

One of the main risks for the Mexican economy is the possibility that U.S. growth slows down more than expected. The possibility of a further deterioration of the U.S. real estate market deserves mention because it could affect financial markets and emerging market

economies' access to financing. If the weakness of the real estate market continues or aggravates, consumption, which has remained vigorous up to now, would be negatively affected. Consequently, U.S. demand for foreign products, including those from Mexico, would decrease.

Finally, the revision and redesign of public finances should contribute to align the incentives framework for the Mexican economy, with the aim of increasing productivity and competitiveness. Banco de México considers necessary to advance in the actions to solve the structural problems of public finances, in order to reduce the country's dependence on oil revenues and foster the increase of productive public spending and public savings. This should take place under a framework that favors investment spending in projects with high social returns and promotes accountability of all levels of government and of public entities in charge of spending.

The approval of the fiscal reform would strengthen the government capacities and generate positive expectations. However, to consolidate long-term growth, structural changes must be undertaken regarding the fostering of competition, modernizing regulations, strengthening the security system, and, in general, improving the country's institutional framework. Only through these measures will competitiveness increase and potential growth be unlocked so that the Mexican economy can grow to its full potential and be able to create more opportunities and benefits for all Mexicans.