

# Inflation Report

## July - September 2009

### Summary

The main purpose of the Inflation Reports published by Banco de México is to analyze the most relevant aspects that affect the recent developments in inflation. The final part of the document usually includes a section with the central bank's updated forecasts on the main macroeconomic variables for the following quarters. Moreover, an assessment of the balance of risks around these forecasts is also presented. However, at the time of publishing this Report, the government's draft proposal for the Federal Budget for 2010, submitted by the President to Congress, is still being debated by legislators. Consequently, this Inflation Report focuses on informing only on the state of the economy during the third quarter of 2009. Once the fiscal proposal is approved by Congress, Banco de México will publish, no later than four weeks after the approval, an addendum to this Report that will include both the central bank's forecasts on the main macroeconomic variables for the next quarters and the balance of risks.

Global economic activity, which started to recover during the second quarter of the year, gained strength during the third quarter, after having contracted sharply during the last quarter of 2008 and first quarter of 2009. Economic activity has recovered more soundly in Asian emerging economies, although this pattern is becoming widespread worldwide. The fiscal and monetary stimulus programs implemented by different advanced and emerging economies, as well as the actions taken to reestablish orderly conditions in international financial markets, have influenced the aforementioned recovery.

In the U.S., economic contraction seems to have come to an end during the third quarter, and the economy is beginning to grow at faster rates than those expected in previous months. Timely information on the third quarter also points to an improvement in economic activity in the Eurozone, although this region still remains relatively stagnant. In the case of Japan, information available suggests that its economy continued to recover during the third quarter. Emerging economies seem to have grown in a more widespread fashion and at a faster rate than in advanced economies during the same period. Economic activity in these countries has benefited from the measures implemented in recent years to strengthen their economic fundamentals, the actions that have been taken to tackle the global financial crisis, and the new increase in commodity prices.

Despite the global economic rebound that has been observed recently, the world economy is expected to grow at slower rates than during the time prior to the current financial crisis. Furthermore, this recovery is also subject to considerable risks due to, among other factors, the difficult situation that prevails in international financial markets, weak labor markets in most economies, and the high levels of households' debt in some countries.

As a result of weak economic activity and the existence of negative output gaps in a significant number of countries, global inflation remained low during the third quarter. In some advanced economies, consumer inflation remained negative in annual terms during the quarter. In absence of inflationary pressures and in the presence of uncertainty about the soundness of economic recovery, the central banks of the main advanced economies decided to keep their policy rates at low levels, in some cases even close to zero. They also continued adjusting their financial stimulus programs in order to foster financial intermediation and promote credit. In general, inflation in emerging economies decreased during the July-September period, although more markedly in Asian countries. During the third quarter of 2009, most emerging economies left their policy rates unchanged or continued to reduce them but more moderately.

As a consequence of the recovery of the world economy, together with the measures to support the financial system, during the third quarter, financial conditions continued to improve, while risks of a general collapse have diminished considerably. Although the measures implemented by the authorities of some countries have been crucial in providing support to the financial system, this improvement has also generated a more positive feedback between the outlook for growth in the real economy and financial conditions. Nevertheless, it is important to stress that conditions in financial markets have not yet gone back to normality and they continue facing significant challenges.

As for economic activity in Mexico, most recent information on production suggests that its trend reached an inflection point at the beginning of the third quarter. Indeed, during this quarter, GDP is expected to have grown around 3 percent in seasonally adjusted terms when compared to the previous quarter (which would imply a fall in GDP of between 6 and 7 percent in annual terms, and comparing favorably with the 9.2 percent fall in annual terms observed during the first half of the year). Two factors have influenced these results: first, the world economic recovery, which has made Mexico's external demand perform less unfavorably; and, second, the fading of the effects of some temporary factors, which affected the economy during the second quarter. In particular, the levels of activity of various services, which had been affected by the outbreak of the influenza A (H1N1) virus, started to recover during the third quarter. At the same time, the levels of automotive production and exports rebounded considerably, as a result of the return to normal operations of some car assembly plants which had entered into temporary shutdowns during the previous quarter, and the positive effect on automotive exports of the program to support vehicle sales in the U.S. Nevertheless, although productive activity in Mexico has recently shown signs of an eventual recovery, it is still foreseen to remain for some time at levels below those prior to the onset of the financial crisis.

During the third quarter of 2009, annual headline inflation continued the downward trend it has been following since the beginning of the year. All CPI subindices followed the same pattern. In all regions, annual inflation kept following a common downward trajectory. After having reached 6.53 percent in December 2008, annual inflation declined to 4.89 percent in September. These developments are mainly attributed to four factors: first, the absorption of the inflationary effects originated by diverse supply shocks that had taken place before; second, the government's pricing policy that set a freeze on gasoline prices in non-border cities, and the reduction of other fuels prices in 2009; third, the slackness that prevails in the economy; and, fourth, the greater stability of the exchange rate together with the fact that most of the pass-through from the exchange rate to consumer prices is expected to have already been absorbed.

As already mentioned, in Mexico, the depreciation of the real exchange rate prompted the relative prices of merchandise to increase in relation to those of services. Thus, during the first three quarters of the year, core merchandise annual inflation remained above core services annual inflation. In the case of the former, during the third quarter it continued the same downward trend observed since May, adjusting from 7.17 percent in April, to 6.38 percent in September. The fact that the effect of the exchange rate depreciation on consumer merchandise prices seems to have already been absorbed contributed to the aforementioned results. During the same reference period, annual core services inflation also followed the same downward trajectory observed since January, adjusting from 5.07 percent in December 2008, to 3.56 percent in September 2009.

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Different indicators which are useful to analyze the recent developments in inflation show that during the third quarter, the effects of the slackness in the economy were more evident on inflation. In the case of merchandise, as already pointed out, this effect was offset during the first months of the year by the impact of the exchange rate depreciation. However, as the effect of the depreciation on consumer prices has been gradually absorbed, the impact of the economic contraction on core merchandise inflation has become more noticeable. Since August 2009, the decline in annual merchandise inflation is no longer attributed solely to the lower annual price adjustments in processed foods, beverages and tobacco, but also to the lower annual inflation of the remaining merchandise prices. As for the core services price subindex, the lower annual price adjustments observed during the third quarter are attributed to a decline in annual inflation in the three main categories that comprise it: housing, education, and remaining services. Thus, all CPI price subindices have followed a downward pattern.

Annual inflation has behaved accordingly to Banco de México's estimates, by falling on average within the forecast interval specified in the two previous Inflation Reports. Despite the foresight that economic activity will continue to recover for the remainder of 2009 and during 2010, given the degree of the estimated slackness that prevailed in the economy at the end of the first half of the year, the output gap is expected to remain considerably negative for some time. Therefore, by taking into account the aforementioned four factors, favorable conditions are expected to prevail so that inertial inflation continues adjusting downwards (that is, without considering the possible effects some of proposed fiscal measures for 2010 could have on inflation).

As for the inertial outlook for inflation in the nearest future, inflation expectations for the end of 2009, which are obtained from Banco de México's survey on private sector economic analysts' expectations, are consistent with forecasts of inflation continuing to adjust downwards during the fourth quarter of the year. Nevertheless, during the third quarter, economic analysts' inflation expectations for the end of 2010 were revised upwards. As shown in this Report, the deterioration of economic analysts' inflation expectations for the next year is mainly due to the perception of the adverse effects on inflation some of the fiscal measures included in the government's budget for 2010, which was submitted to Congress on September 8 of this year, might have.

Although the upward revision in inflation expectations for 2010 represents a risk for inflation, up to now the increase in inflation expectations for longer terms has been smaller, as they have remained relatively better anchored. Nevertheless, in the future, it will be important to carefully monitor the evolution of these indicators.

In view of the above, some brief considerations regarding the recent behavior of inflation and its outlook for the next quarters are worth mentioning. Although inflation in Mexico has not decreased as similarly as in other countries due to a larger depreciation of the exchange rate and to differences in the type of public policies used to determine energy prices (which also imply that prior to the onset of the crisis these prices did not increase in our country in the same magnitude as in other countries), there seem to be several distortions in the economy that make firms' respond in a limited way to adverse shocks on the demand side. In general, firms' response in terms of how they determine their prices seems to be asymmetric depending on the type of shocks they face and the direction these shocks follow. That is, firms seem to respond more to cost-related shocks than to demand-related shocks, and with more intensity to shocks that lead to price increases than to those leading to price reductions. Indeed, as Banco de México has reiterated on numerous occasions, the different distortions that affect the Mexican economy not only do lead to lower economic growth, but they could also be producing a strong resistance for inflation to decline.

In response to the economic environment described above, in its monetary policy announcement of July, Banco de México's Board of Governors cut its target for the overnight interbank rate by 25 basis points (after reducing it by a total of 350 basis points during the first half of the year), and decided to make a pause in the cycle of monetary policy loosening. Following these policy actions, the interbank rate reached 4.5 percent. In its announcements of August, September, and October, the Board left the target unchanged at 4.5 percent. In the announcements of the last two months, the Board pointed out that the central bank future actions will be consistent with the balance of risks, and that such balance will consider the impact on inflation that might result from, on the one side, the fiscal measures to be approved by Congress and, on the other, the evolution of the economy and the expected path of the output gap. These effects will be taken into account in order to meet the 3 percent annual inflation target.

The tax proposal that is currently being debated in Congress will likely have an impact on the macroeconomic scenario for 2010 and the following years. As it is well known, Mexico currently faces significant challenges to improve its growth and development opportunities in the coming years. In particular, in view of the structural deterioration of public finances, progress needs to be made in different fronts in order to make them less dependant on oil revenues, to increase both the taxable base and the number of taxpayers, and to decisively improve the public budget exercise by making it more efficient, transparent, and accountable. In this regard, it is essential that the different political actors reach ample consensus to achieve the necessary agreements that can allow for consolidating macroeconomic stability and foster the country's competitiveness under more sound and permanent foundations.