Addendum to the Inflation Report

July - September 2009

Summary

The Inflation Report of July - September 2009 reported exclusively on the state of the Mexican economy during that period. Once the Mexican Congress approved the final version of the 2010 federal budget on November 17, in this Addendum to the aforementioned report, Banco de México releases its macroeconomic forecasts for the next quarters as well as the corresponding balance of risks.

Information known after publishing the previously mentioned inflation report reveals a global economic environment characterized by an expansion of economic activity in different regions, lower world inflation, and a further improvement in financial market conditions. However, there are significant risks that still prevail. In particular, economic activity has not recovered uniformly throughout the world and continues to depend mainly on macroeconomic stimulus and financial system support policies, especially in advanced economies. In this regard, it is convenient to mention that the authorities of the main developed economies have been pointing out the importance of maintaining stimulus measures for an extended period in order to reduce the risks associated with the sustainability of the cyclical expansion of their economies. This has prompted the low cost of the carry-trade in financial markets to be reflected in the appreciation of different assets and exchange rates, especially in emerging economies. The probable reversal of capital flows as monetary stimulus measures are withdrawn in advanced economies could have a considerably negative impact in emerging economies, particularly if it takes place in an unanticipated way.

As foreseen in the July - September 2009 Inflation Report, economic activity in Mexico reached an inflection point at the start of the third quarter of this year, leading to a 2.9 percent increase in seasonally adjusted GDP during that period as compared with the previous quarter. Other timely indicators on production and aggregate demand components as well as various forward-looking and leading indicators are consistent with this change of trend and suggest that Mexico will continue growing during the fourth quarter.

Annual headline inflation continued to decline between September and the first two weeks of November 2009, following the downward pattern exhibited since the start of the year. In addition, the disinflationary process continued to be widespread across all CPI subindices and all regions of the country.

On the basis of the most recent information, the following scenario for the Mexican economy is foreseen:

GDP Growth: GDP is anticipated to have contracted around 7 percent in annual terms in 2009 and it is expected to grow between 2.5 and 3.5 percent in 2010 at an annual rate. Both forecasts are in line with the scenario described in the Inflation Report of April - June 2009. Additionally, preliminary inertial studies show that the economy could grow in annual terms between 3 and 4 percent in 2011.

Economic growth in 2010 will be influenced by several factors, including the recovery of the world economy, as well as the impact of the referred year's federal budget on production and the private and public components of aggregate demand. The total impact of this budget on economic growth in 2010 is expected to be relatively small. On the basis of this information, together with the aforementioned improvement in the forecasts for U.S. industrial production, there is no need to modify the scenario for GDP growth published in the Inflation Report of April-June 2009.

The above forecasts suggest that although the difference between observed and potential GDP (i.e. the output gap) will tend to diminish in the following quarters as a result of the economic growth foreseen for the next two years, it will probably remain in negative territory in 2010 and 2011. These suggestions are based on the fact that in 2009 the output gap widened significantly and that it will take some time until it finally closes. This implies that slack conditions will prevail in the Mexican economy, which will contribute not only to prevent demand-side inflationary pressures from arising, but also to reduce the impact of the economic program on inflation.

Employment: the number of IMSS-insured workers is expected to register an accumulated reduction of between 325 and 425 thousand workers at the end of 2009. Between 300 and 400 thousand formal jobs are expected to be created in 2010. In light of the aforementioned forecasts for economic growth in 2011, this positive trend is anticipated to continue during that year.

Current Account: the trade balance and the current account deficit are expected to be 0.9 and 0.8 percent of GDP, respectively (around 7.5 and 7 billion US dollars, respectively) in 2009. In 2010, both deficits are expected to represent 1.3 percent and 1.1 percent of GDP, respectively, in that year (12.5 and 10.7 billion US dollars, respectively).

It is important to emphasize that the current account deficit foreseen for 2010 is relatively small. It is possible that the surplus in the capital account (due, among other factors, to the amount of expected foreign direct and portfolio investment flows, and to the pattern and expected amount of public sector's net foreign financing) could surpass such deficit. Under these conditions, the Mexican economy is not expected to face financing difficulties in 2010.

It is worth mentioning that the scenario for 2010-2011 described above is based on the assumption that the global economy in general, and the U.S. economy in particular, will gradually improve. This will in turn foster a change of trend in external demand and contribute to sustain a more dynamic domestic market. However, this scenario is not free of risks, mainly downward risks. Among them the following stand out:

a. The uncertainty about the magnitude and speed of the U.S. economic recovery.

b. The future performance of automotive production in that country and, therefore, in Mexico.

c. The low potential growth of the Mexican economy.

Inflation: the forecasted path of annual headline inflation for the following two years was revised upwards. This revision takes into account a temporary rebound in headline inflation during 2010, foreseeing that it will peak towards the fourth quarter of that year and place itself on average between the 4.75 and 5.25 percent interval. Inflation would start to decline during the first quarter of 2011, and then converge nearly to its 3 percent target in the last quarter of 2011 (Table 1). The aforementioned behavior of inflation is expected to respond to the following:

1. The one-off effect on prices of the tax changes included in the recently approved fiscal measures. Even in an environment of slack economic activity, most of the impact of the tax change on prices will take place during the first quarter of 2010. It is important to point out that the impact on inflation will be temporary and most of it will revert during the first half of 2011.

2. Expectations that inflation of goods and services with administered prices will increase in the following year given the current gap between the domestic and international prices of both gasoline and propane. Thus, the forecasts shown in this document consider that goods and services with administered prices will have a growing incidence on inflation in 2010, since it was assumed that they would increase in 2010 after having remained unchanged in 2009. This assumption contrasts with that of no increases in administered prices used to estimate the inflation forecasts published in the Inflation Report October-December 2008 and that were in effect until the publication of this Addendum.

   The foreseen increase in energy prices' growth rate for 2010 will contribute to narrow the gap between international and domestic prices. These price quotes are expected to grow at a slower rate in

2011 and, therefore, contribute to reduce the levels of inflation in that year.

3. The probable increase in the growth rate of the price index of goods and services with regulated prices. In particular, there have been signs of possible increases in some locally determined prices, such as those put forward in the 2010 Mexico City budget for subway fares and water supply fees. These increments are anticipated to have a one-off impact on prices, similar to that associated with the tax changes included in the fiscal measures recently approved. The effects of these price increases on inflation are expected to fade during the first few months of 2011.
4. In contrast, the slackness that is expected to prevail in the Mexican economy will undoubtedly help to offset the upward pressure on inflation generated by the three factors mentioned above.

Table 1
Base Scenario Forecast for Annual Headline Inflation
Quarterly average (percent)

Quarter	Forecast Inflation Report I-Q 2009	Forecast Inflation Report II-Q 2009	Forecast Addendum to the Inflation Report III-Q 2009
2009-II	5.50 - 6.00	5.96 1/	5.96 1/
2009-III	4.75 - 5.25	4.75 - 5.25	5.14 1/
2009-IV	4.00 - 4.50	4.00 - 4.50	3.75 - 4.25
2010-I	3.75 - 4.25	3.75 - 4.25	4.25 - 4.75
2010-II	3.25 - 3.75	3.25 - 3.75	4.50 - 5.00
2010-III	3.25 - 3.75	3.25 - 3.75	4.75 - 5.25
2010-IV	3.00 - 3.50	3.00 - 3.50	4.75 - 5.25
2011-I	3.00 - 3.50	3.00 - 3.50	4.50 - 5.00
2011-II	------------	3.00 - 3.50	3.50 - 4.00
2011-III	------------	------------	3.25 - 3.75
2011-IV	------------	------------	2.75 - 3.25

1/ Observed figure.

The tax changes are expected to have a relatively small effect on inflation, in contrast to the larger impact generated by the possible changes in the policy for determining administered prices and the expected revisions in local prices and fees. Therefore, the overriding factor in the upward revision of forecasts for both headline inflation and its increasing trend throughout 2010 is the expected change in the policy for determining government administered prices and fees.

As for core inflation, it is foreseeable that the changes in the approved fiscal measures will influence the development of this price index. However, the decline in international commodity prices from their record high levels in an environment of greater exchange rate stability will help to reduce core inflationary pressures.

The forecasts for inflation had remained unchanged since the Inflation Report of the first quarter of 2009 (Table 1). In relation to these forecasts, it is important to emphasize that the downward trend followed by inflation has remained within the estimated intervals. As shown in the forecasting exercise included in this document, at the end of 2009 inflation is expected to be even below the figures originally anticipated in the forecasts that have been valid up to now, with a high probability that this variable will be at levels below 4 percent in December. Undoubtedly, in an inertial scenario where both the tax structure and the current policy of administered and regulated prices remain unchanged, inflation would be expected to continue adjusting downwards next year.

The forecast for inflation is not exempt from upward and downward risks, among which are:

i) The contamination of the price formation process due to a temporary rebound in inflation.

ii) A rate of adjustment (upwards or downwards) for administered prices different from that anticipated.

iii) Changes in some government regulated prices and fees different from those foreseen.

iv) A pass-through effect from tax increases to consumer prices different from that estimated.

v) The effects of weather conditions on the supply of fruits and vegetables.

vi) A higher than anticipated world inflation, a phenomenon which would particularly affect the expected disinflationary process for merchandise prices.

vii) A slower or smaller than expected recovery in the Mexican economy, possibly leading to lower-than-anticipated inflation.

The recently approved fiscal measures contribute to clearly improve the structure of public finances. Something similar can be said about the anticipated changes in the policy of goods and services with administered and regulated prices. Nevertheless, the fact that these measures are expected to be effective in raising tax revenues also implies that they will have an impact on consumer prices. In particular, both the tax modifications and possible adjustments in the policy of regulated prices are expected to have a one-off effect on the consumer price index and, therefore, to affect inflation temporarily.

The expected change in the policy of goods and services with administered prices, in an environment where the international prices of these products are at higher levels, will also improve the structure of public finances. This will take place in the form of smaller subsidies on the prices of certain goods and services. These adjustments offer the additional benefit of reducing certain microeconomic distortions which tend to lead to an inefficient allocation of resources. Nevertheless, as explained earlier, these measures are also expected to cause an increase in inflation. In this case, the impact on consumer prices is anticipated to take place throughout the year if the policy of raising fuel prices by a certain amount of cents each month is adopted.

The most important factors affecting inflation up to now have been, on the one hand, the effects of the depreciation of the exchange rate and, on the other hand, the slackness that continues to prevail in the Mexican economy. In such an environment, the expected increase in inflation, although temporary, does affect the balance of risks faced by it. Indeed, although the output gap is expected to contribute to offset the effect on consumer prices of the fiscal measures and the adjustments to public prices and fees, it will be of utmost importance for the monetary authority to remain vigilant to ensure other prices are not contaminated. In this sense, in order for annual inflation to resume a downward path and converge to its 3 percent target, it is extremely important that medium-term inflation expectations remain well anchored during the next quarters. This will allow, once the foreseen rebound in inflation has dissipated, inflation to decline sharply at the beginning of 2011 and register more moderate reductions during the second half of that year, until coming close to the 3 percent annual target at the end of 2011.