Inflation Report

April – June 2010

BANCO DE MEXICO

JULY 2010

INFLATION REPORT

This report analyzes the development of both inflation and the economy in Mexico, as well as different domestic economic indicators, in compliance with Article 51, last section, of Banco de México's Law.

FOREWARNING

This text is provided for the reader's convenience only. Discrepancies may eventually arise from the translation of the original document into English. The original and unabridged Inflation Report in Spanish is the only official document.

Unless otherwise stated, this document has been prepared using data available as of July 28, 2010. Figures are preliminary and subject to change.

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1. Introduction

The world economy continued to recover during the second quarter of 2010, in spite of the stress in international financial markets originated mainly by concerns over sovereign risk in Europe. Global economic activity has so far been affected in a limited way by the European crisis; however, it has accentuated the differences in growth prospects across regions and countries. It is worth mentioning that most recent figures indicate some slowdown of the US economy. This, together with the potential withdrawal of fiscal stimuli in various industrialized countries, has increased the downside risks for world economic growth.

The major advanced economies continued to grow at moderate rates, especially in activities related to international trade and industrial production. Nevertheless, incoming data points to a weak recovery of private demand, which, in turn, is subject to future risks. Although the exceptional monetary and fiscal stimuli continued to provide considerable support for economic activity in many countries, the required fiscal consolidation has generated uncertainty about private demand's capacity to sustain growth in these countries in the near future. Emerging economies, particularly in Asia, exhibited stronger growth during the second quarter, as reflected by the dynamism of their exports and domestic demand.

World inflation remains low, particularly in the major industrialized countries. In fact, most of them register negative output gaps, as well as low levels of both inflation and its expectations. Considering that the fiscal stimuli will start to be withdrawn, it is foreseeable that monetary conditions in these countries will remain highly accommodative for some time. On the other hand, the central banks of some advanced and emerging economies have already started to withdraw the monetary stimulus due to the recovery of their economic activity.

Uncertainty in international financial markets rose significantly in April of this year due to the perception of greater risk of default in some European countries' sovereign debt. The strong increase in counterparty risk among financial institutions in Europe led to an inadequate functioning of some markets, and even generated the perception among investors of a possible collapse of European financial markets. As a result, the euro depreciated considerably against other currencies. In response, in May, the European Central Bank implemented unprecedented measures to face the severe problems in certain segments of financial markets that were hampering the proper functioning of the monetary policy transmission mechanism. Additionally, the European Union and the International Monetary Fund jointly arranged a financial package for up to EUR 860 billion, with the purpose of granting financial assistance to European Union member countries facing difficulties or severely threatened by exceptional circumstances beyond their control. Access to these financial resources is subject to strong conditionality.

The adopted measures contained the deterioration of financial markets and seem to have prevented a situation of widespread contagion. In particular, financing conditions in international markets stabilized in May and have even improved over the last weeks. The situation in Europe therefore did not affect significantly the capital flows to emerging economies. Nevertheless, this recent episode highlighted the transmission mechanism of sovereign debt risk through

banks, which could affect other financial markets. Although progress has been made in addressing the fiscal problems in some European countries, this situation is still a source of vulnerability for world economic growth.

As for productive activity levels in Mexico, during the second quarter of 2010 external demand continued to grow and, hence, manufacturing production continued its upward trend. Although private sector consumption and investment remained at relatively low levels, recently both seem to be showing a favorable change of trend. The quarterly change in GDP is estimated to have been between 2.5 and 3.0 percent in seasonally adjusted terms during the second quarter of this year, thus strengthening the gradual recovery of economic activity that began during the second half of 2009. Despite this, GDP is expected to remain below the economy's productive potential.

During the second quarter of 2010, average annual headline inflation was 3.96 percent, 0.79 percentage points below first quarter figures, and 0.54 percentage points below the lower limit of the interval forecasted for that period by Banco de México. Inflation numbers have turned out to be better than expected. Part of this improvement is due to seasonal and conjunctural factors, such as the strengthening of the exchange rate parity and a reduction in its volatility, the increased competition between various retail chains, and an abundant supply of some vegetables. In general terms, the balance of risks for inflation has improved.

Under these circumstances, Banco de México's Board of Governors decided to leave the overnight interbank rate target unchanged at 4.5 percent in the last months. Banco de México's Board of Governors stated that it will continue to monitor the path of medium- and long-term inflation expectations, the velocity at which the output gap closes, and other inflation determinants that might signal unexpected and widespread pressures on prices. All of this so that, in such an eventuality, the central bank adjusts its monetary policy stance in order to achieve the 3 percent inflation target by the end of 2011.

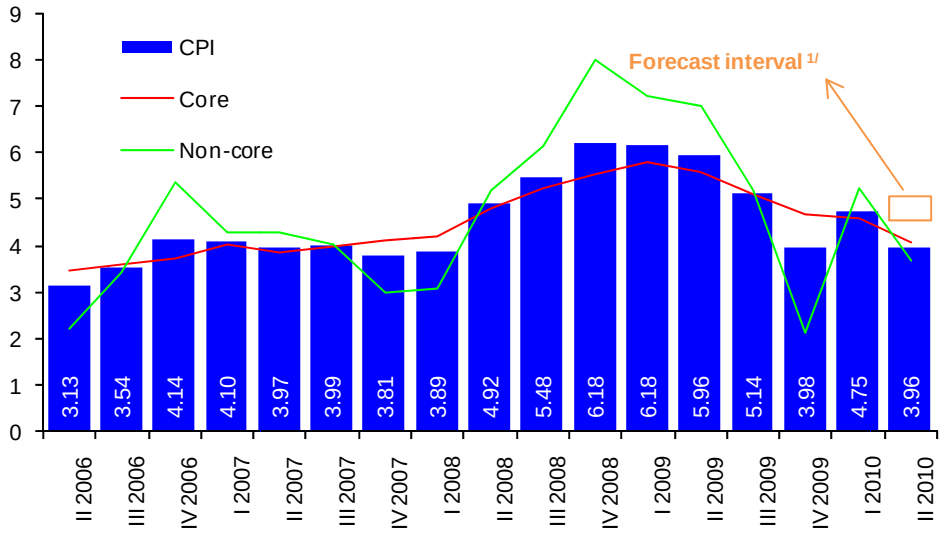
2. Recent Developments in Inflation

2.1. Inflation

During the second quarter of 2010, average annual headline inflation was 3.96 percent, as compared to the 4.75 percent of the previous quarter (Graph 1 and Table 1). This reduction was driven by CPI's core and non-core components. The core component, which reflects mainly inflation's trend in the medium run, exhibited an average annual growth rate of 4.05 percent during the analyzed period, as compared to 4.57 percent in the first quarter of 2010.

During the second quarter of 2010, inflation decreased more than expected. In particular, annual headline inflation in this period was 0.54 percentage points below the lower limit of the interval forecasted for this period by Banco de México (Graph 1). Part of this improvement is due to seasonal and conjunctural factors that affected the price behavior of both processed and non-processed foods and non-food merchandise.

Graph 1
Consumer Price Index
Annual average change in percent



Source: Banco de México.
1/ This forecast, which was originally published in the Addendum to the Inflation Report of July-September 2009, remains unchanged.

The reduction in annual core inflation was caused by a lower inflation of the merchandise price subindex, whose average annual growth shifted from 5.46 percent during the first quarter of 2010 to 4.34 percent during the second quarter (Graph 2a and Table 1). The lower growth rate of this subindex is mainly related to two factors: first, the strengthening of the exchange rate parity, and second, the increased competition among various retail chains (the number of price markdowns in food and non-food products rose by 37 percent during the analyzed period, as compared to the same period of the previous year, thereby contributing to reduce headline inflation by 0.13 percentage points, Box 1).

Table 1
Consumer Price Index and Components
Annual average change per quarter in percent

	Average Annual Change (percent)		Average Incidence 1/		Difference
	I-Q 2010	II-Q 2010	I-Q 2010 (a)	II-Q 2010 (b)	(b-a)
CPI	**4.75**	**3.96**	**4.75**	**3.96**	**-0.79**
Core	**4.57**	**4.05**	**3.34**	**2.98**	**-0.36**
Merchandise	**5.46**	**4.34**	**1.94**	**1.56**	**-0.38**
Foods	5.81	4.58	0.94	0.75	-0.19
Remaining merchandise	5.17	4.14	1.00	0.81	-0.19
Services	**3.72**	**3.77**	**1.40**	**1.42**	**0.02**
Housing	2.78	2.74	0.47	0.46	-0.01
Education	4.15	4.11	0.26	0.25	0.00
Remaining services	4.62	4.83	0.67	0.70	0.03
Non-core	**5.26**	**3.71**	**1.42**	**0.98**	**-0.43**
Agricultural	**7.15**	**0.70**	**0.65**	**0.07**	**-0.59**
Fruits and vegetables	16.31	2.99	0.56	0.11	-0.45
Tomato	38.83	-14.84	0.14	-0.08	-0.21
Potato	46.36	-0.44	0.09	0.00	-0.09
Beans	5.33	-10.52	0.02	-0.04	-0.06
Livestock goods	1.62	-0.74	0.09	-0.04	-0.13
Eggs	0.70	-8.99	0.01	-0.08	-0.09
Administered and regulated	**4.29**	**5.35**	**0.76**	**0.92**	**0.15**
Administered	3.99	4.76	0.37	0.41	0.04
Electricity	6.46	8.24	0.19	0.20	0.00
Gas for residential use	0.65	-0.55	0.02	-0.01	-0.03
Low-octane gasoline	4.32	6.37	0.14	0.20	0.07
High-octane gasoline	3.51	3.59	0.02	0.02	0.00
Regulated	4.61	5.95	0.40	0.51	0.11
Minibus	3.54	7.19	0.07	0.14	0.07
Water supply fees	10.55	12.86	0.09	0.11	0.02

Source: Banco de México.
1/ The incidence refers to each CPI components' contribution (in percentage points) to headline inflation. It is calculated using the weights of each CPI subindex, as well as relative prices and their respective changes. In some cases, the figures from the components of a certain group of subindices may not add up due to rounding.

The decline in core inflation was limited by the inertia in services inflation, which grew on average 3.72 percent during the first quarter of 2010 and 3.77 percent during the second quarter (Table 1). This increase was mainly attributed to the inflation of food and travel service prices, which are included in the "remaining services" category in Table 1 and Graph 2b. Worth pointing out is that during the same period of the previous year, the price quotes of these services were affected by the outbreak of influenza A(H1N1). For this reason, the base of comparison for calculating the annual change of the "remaining services" category was lower during the analyzed quarter.

Box 1
Recent Dynamics of Price Markdowns in Mexico: Evidence from CPI's Micro Database

Introduction

This box presents a statistical analysis of the recent dynamics in price markdowns of goods and services that compose the Consumer Price Index (CPI). The results suggest that competition among retail chains increased during the first half of 2010. This was reflected by the significant increase in the number of price markdowns, mainly in supermarkets, but also in warehouse clubs and in department, convenience and specialized stores. Hence, during the first quarter of 2010, price markdowns rose by 39 percent as compared to the same period in 2009, and by 37 percent during the second quarter of 2010, as compared to the previous year.

The origin of these rounds of price reductions could be related to the financial difficulties that some industry participants faced and/ or to the current phase of the business cycle. Particularly, in an environment of higher demand, the participants of an industry - who are able to exercise certain market power - have higher incentives to extend their market share.

The intensified competition among retail chains is estimated to have contributed to reduce headline inflation by 6 and 13 basis points during the first and second quarter, respectively. Although this phenomenon has had a widespread effect on inflation, the major impact originated from the unusually high number of price markdowns in fruits and vegetables (even after considering harvest volume changes). However, it was also significant in the price quotes of livestock products, processed foods, and non-food merchandise.

This box is organized as follows: the first section includes a short literature review about the rounds of price reductions. The second part describes the CPI data that was used for analyzing the dynamics of price markdowns. In the third section, the results of the statistical analysis on the frequencies of price markdowns in Mexico are presented, as well as the estimates about their possible impact on inflation. The last chapter presents some final considerations.

1. Literature review

Under certain circumstances, firms with market power cut their prices in response to an initial price reduction of a firm which tries to extend its market share. Since this situation reduces the profits of all market players, all firms perceive it as undesirable. Indeed, the mere possibility of this taking place may lead to an equilibrium in which consumer prices are high as compared to costs, e.g. under certain conditions, firms with market power have the incentive to act in a collusive manner. The stability of this equilibrium depends on various factors, such as: the demand behavior, the cost structures, the intertemporal discount rate, the legal framework, and the number of competitors.

The academic literature about this type of episodes (where rounds of price reductions occur) has analyzed the motives, the nature and the impact of them on the market structure and on economic activity, as well as its relation with the strategies and characteristics of different firms of a particular industry or sector. For instance, Porter (1983a) and Green and Porter (1984) developed a model where major competition arises in response to non-anticipated demand fluctuations, and its incidence increases in relation to the number of firms in the industry and in cases where a dominant firms' market share can be taken over. In this model, the duration of these episodes depends inversely on the number of firms.

Rotemberg and Saloner (1986) analyze the response of industries with market power to demand fluctuations. The main result is that collusion between firms becomes more difficult if demand is relatively high. With rising demand, a firm that reduces its prices can achieve higher benefits, because it owns a higher market share, at least until the other firms are able to change their prices. On the other hand, the cost of deviating from collusive equilibrium is smaller as a result of the current state of demand. However, when demand returns to its normal level in the future, such cost might be more evident. Therefore, under certain circumstances (e.g. when demand is high), the benefits of breaking the collusive equilibrium are higher than the costs of complying with the equilibrium, which leads to an intensified competition originated by the rounds of price reductions.

Milgrom and Roberts (1982) and Elzinga and Mills (1999) analyze the background of the price reduction rounds, showing that market entrance of new firms triggers the beginning of these rounds. Another area within the literature analyzes the relation between firms' lower prices, market features and strategies. Organizations with high exit barriers (Heil and Helsen 2001) and high market share or impaired financial status (Busse 2002) are more likely to initiate a price reduction. In principle, firms try to reduce the number of participants in the industry and increase their profits in the long run as a result of lower competition (Fudenberg and Tirole, 1986 and Klemperer, 1989).

There are various empirical studies that analyze the effects and the duration of price reduction rounds in different countries and in different periods and economic conditions. Some of these studies show that certain industries alternate between periods of collusive and competitive behavior. Bresnahan (1987) studies the automobile industry in the United States in the 50s and finds that a competitive equilibrium is more typical in the years of higher economic growth, while a collusive equilibrium better fits the data of the years with less economic growth. Porter (1983b) studies the cartel of the U.S. railway in the late XIX century for the route between Chicago and New York. The author points out that during the years of higher price reductions, there was a higher demand for cargo services.

Levenstein (1997) studies the bromine market for the period from 1885 to 1914, and identifies 6 periods of price reduction rounds. The author finds that collusive phases last longer than competitive phases. Behringer and Filistrucchi (2009) analyze price adjustments in the United Kingdom between the major newspapers during the 90s. The Times anticipated a positive demand shock due to its advertisements and as a result, they lowered their cover prices and finally could increase their market share with respect to their competitors.

Busse (2002) studies the rates and financial statements of 14 of the biggest US airlines between 1985 and 1992, concluding that airlines with financial problems have a higher probability to start a cycle of price reductions as compared to those without financial problems. The aforementioned coincides with the study from Borenstein and Rose (1995) about the biggest bankruptcies of the sector between 1989 and 1993. They find that the average product price of these firms was lower than the market price, several months before they went bankrupt. In contrast, Morrison and Winston (1996) argue that intensified competition is more likely when industry participants estimate demand incorrectly.

Van Heerde, Gijsbrechts and Pauwels (2008) report one of the most recent episodes of intensified competition among supermarkets in the Netherlands, which took place for 2 years and led to an industrial restructuring that forced one of the supermarket chains to close down.

2. Database

The analysis presented herein is based on a micro database which includes the specific quotes that Banco de México considers for the CPI construction. This database contains the price information of a little more than 83,500 products obtained in more than 18,000 points of sale (public markets, convenience and department stores, supermarkets, warehouse clubs and specialized outlets, among others), distributed over 46 locations, from where CPI information is drawn. Table 1 indicates the distribution of the sample by type of commercial business and Table 2 shows the distribution by CPI component. The available information allows analyzing the dynamics of sales prices from January 2009 to June 2010.

Table 1
Composition of CPI Items by Point of Sale
Quarterly average

	Number of items	Percent
CPI	83,580	100.00
Supermarkets	30,685	36.71
Public markets	5,169	6.18
Specialized stores/1	29,705	35.54
Street markets *(Tianguis)* or informal commerce	476	0.57
Convenience stores	1,983	2.37
Department stores	11,852	14.18
Warehouse clubs	1,695	2.03
Other/2	2,015	2.41

1/ Establishments selling well defined articles like drugstores, hospitals, dry cleaners, etc.
2/ Includes expenditure items that require special treatment (electricity, phone services, own housing, etc).

Table 2
Composition of CPI Items by Component
Quarterly average

	Number of items	Percent
CPI	83,580	100.00
Core	63,873	76.42
Merchandise	52,935	63.33
Foods	15,743	18.84
Remaining merchandise	37,192	44.50
Services	10,938	13.09
Housing	2,307	2.76
Private education	1,454	1.74
Remaining services	7,177	8.59
Non-core	19,707	23.58
Agricultural	16,289	19.49
Fruits and vegetables	11,648	13.94
Livestock goods	4,641	5.55
Administered and regulated	3,418	4.09
Administered	524	0.63
Regulated	2,894	3.46

Price quotes of foods and beverages, air transport and travel services are obtained on a weekly basis, while those for the rest of the goods and services, every 2 weeks. The database allows to identify the goods and services marked down by retailers and services suppliers (regardless of whether the price is lower or not), as long as they are not conditioned. The sales prices that include a higher quantity of the listed good are also identified, but if they include a gift other than the listed product, they should not be considered in the CPI calculation.[1] Therefore, it is possible that during episodes of intensified competition with an increased number of conditional and unconditional sales prices, the CPI data tends to underestimate the favorable effect on the population's living costs.

[1] According to best international practices regarding the compilation of price indices, conditional sales prices (e.g. conditioned to a certain form of payment or to the purchase of higher quantities than the unit) should not be considered, neither gifts of products different from the one listed (see Manual del Índice de Precios al Consumidor. Teoría y Práctica (2006), pp. 65,110,564). The rationality behind this is that the access to conditional offers is restricted to a certain part of the population, while gift-including offers could lead to inaccurate CPI calculations.

3. Dynamics of price markdowns in the CPI

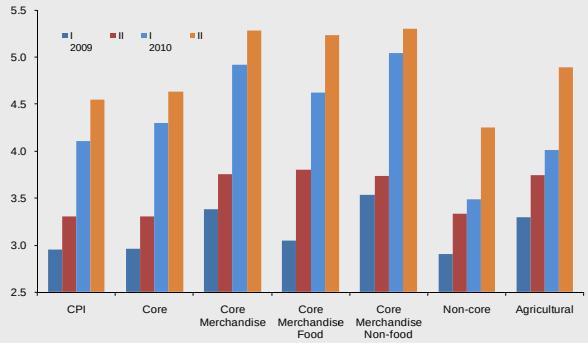
The first half of 2010 was characterized by a significant increase in the number of price markdowns within CPI quotes. Particularly, during the first and second quarters of 2010, an average of 4.11 and 4.54 percent in the goods and services prices of the CPI was marked down, as compared to 2.95 and 3.31 percent, respectively, during the same periods of 2009 (Table 3 and Graph 1). The aforementioned represents an increase of 39.3 and 37.2 percent in the number of price markdowns during the referred quarters.

Table 3
Frequency of Price Markdowns and CPI Components
Quarterly average

	1st Quarter (%)		2nd Quarter (%)		Percentage change	
	2009 (A)	2010 (B)	2009 (C)	2010 (D)	1st Quarter (B)/(A)	2nd Quarter (D)/(C)
CPI	2.95	4.11	3.31	4.54	39.3	37.2
Core	2.97	4.30	3.30	4.63	45.1	40.3
Merchandise	3.39	4.92	3.75	5.28	45.2	40.8
Foods	3.04	4.62	3.80	5.23	51.9	37.7
Remaining merchandise	3.53	5.04	3.73	5.30	42.7	42.1
Services	0.94	1.34	1.12	1.49	43.0	32.7
Housing	1.37	1.60	1.96	2.05	17.5	4.8
Private education	0.00	0.00	0.00	0.00	-	-
Remaining services	0.99	1.52	1.08	1.61	54.4	48.9
Non-core	2.90	3.49	3.34	4.25	20.3	27.3
Agricultural	3.30	4.01	3.75	4.89	21.5	30.5
Fruits and vegetables	2.88	3.13	3.15	4.38	8.4	39.2
Livestock goods	4.35	6.22	5.25	6.17	43.1	17.5
Administered and regulated	1.00	1.01	1.38	1.19	1.5	-14.1
Administered	0.00	0.00	0.00	0.00	-	-
Regulated	1.18	1.20	1.64	1.41	1.5	-14.1

A higher number of price markdowns was observed in most CPI groups, especially in merchandises, services other than education and housing, as well as agricultural products. The higher number of price markdowns in the last group was more evident in the second quarter, since the frequency in this period shifted from 3.75 percent in 2009 to 4.89 percent in 2010 (Table 3).

Graph 1
Subindices with Major Increases in Frequency of Price Markdowns
Quarterly average in percent



The analysis of price markdowns by point of sale shows that the major increases by number and frequency concentrate on the points of sale mostly associated with modern distribution channels, such as supermarkets, warehouse clubs, department, convenience and specialized stores (Table 4). The major percentage change in the number of price markdowns is observed in supermarkets, where the frequency of price reductions rose from 3.99 percent during the first quarter of 2009 to 6.02 percent during the same months in 2010. In the second quarter of 2009, the frequency was 4.73 percent, and during the same period of 2010, 7.08 percent.

Table 4
Frequency of Price Markdowns by Point of Sale
Quarterly average

	1st Quarter (%)		2nd Quarter (%)		Percentage change	
	2009 (A)	2010 (B)	2009 (C)	2010 (D)	1st Quarter (B)/(A)	2nd Quarter (D)/(C)
CPI	2.95	4.11	3.31	4.54	39.3	37.2
Supermarkets	3.99	6.02	4.73	7.08	50.9	49.6
Public markets	2.02	1.12	1.57	1.53	-44.5	-2.9
Specialized stores/1	1.94	2.56	2.24	2.80	32.4	24.5
Street markets *(Tianguis)* or informal commerce	1.68	0.63	1.44	0.28	-62.5	-80.5
Convenience stores	2.99	3.61	3.58	4.32	20.5	20.7
Department stores	3.86	5.30	3.77	4.78	37.3	26.7
Warehouse clubs	2.26	3.98	2.44	3.59	76.1	47.2
Other/2	0.00	0.01	0.00	0.00	-	-

1/ Establishments selling well defined articles like drugstores, hospitals, dry cleaners, etc.
2/ Includes expenditure items that require special treatment (electricity, phone services, own housing, etc).

3.1 Impact of price markdowns on inflation

The effect of the higher number of price markdowns during the second half of 2010 in the CPI was estimated by constructing a "counterfactual". A price index was therefore calculated using the goods and services that were marked down. Instead of including the new lower prices of these products, the prices they had before they were marked down were assigned again, until the sale offers ended. Finally, the annual changes of the price index excluding the price markdowns are compared to those of the CPI (which includes the price markdowns).

The aforementioned process shows that the price index that excludes price markdowns would have registered an average annual change of 4.82 and 4.09 percent, respectively, during the first and second quarters of 2010. Comparing these results with those from the CPI, during the referred quarters CPI inflation turned out to be 6 and 13 basis points lower (Table 5).

Table 5
CPI and Estimation of the Price Index excluding Price Markdowns
Average annual change in percent

	CPI		CPI without price markdowns		Difference	
	I (A)	II (B)	I (C)	II (D)	I (C) - (A)	II (D) - (B)
CPI	4.75	3.96	4.82	4.09	0.06	0.13
Core	4.57	4.05	4.64	4.18	0.08	0.13
Merchandise	5.46	4.34	5.60	4.58	0.14	0.24
Foods	5.81	4.58	5.93	4.78	0.12	0.20
Remaining merchandise	5.17	4.14	5.33	4.41	0.16	0.27
Services	3.72	3.77	3.73	3.79	0.02	0.02
Housing	2.78	2.74	2.78	2.74	0.00	0.00
Private education	4.15	4.11	4.15	4.11	0.00	0.00
Remaining services	4.62	4.83	4.66	4.87	0.04	0.04
Non-core	5.26	3.71	5.29	3.84	0.03	0.13
Agricultural	7.15	0.70	7.23	1.13	0.08	0.43
Fruits and vegetables	16.31	2.99	16.25	3.70	-0.05	0.70
Livestock goods	1.62	-0.74	1.76	-0.49	0.14	0.25
Administered and regulated	4.29	5.35	4.29	5.33	0.00	-0.02
Administered	3.99	4.76	3.99	4.76	0.00	0.00
Regulated	4.61	5.95	4.60	5.90	-0.01	-0.04

4. Final remarks

A statistical analysis of the CPI micro data base shows increased competition among retail chains during the first half of 2010, primarily reflected by a higher number of price markdowns. This strategy has contributed to reduce the rate of inflation during the referred period. Nevertheless, the duration and the final result of this phenomenon are hard to predict, since it could be reversed or intensified depending on demand conditions or number of participants. Worth considering is that when the rounds of price reductions of various retail chains conclude, the industry may undergo a restructuring where the number of participants would decrease. At the same time, this could lead to a return to price equilibrium at prices even higher than those before the rounds of price reductions started.

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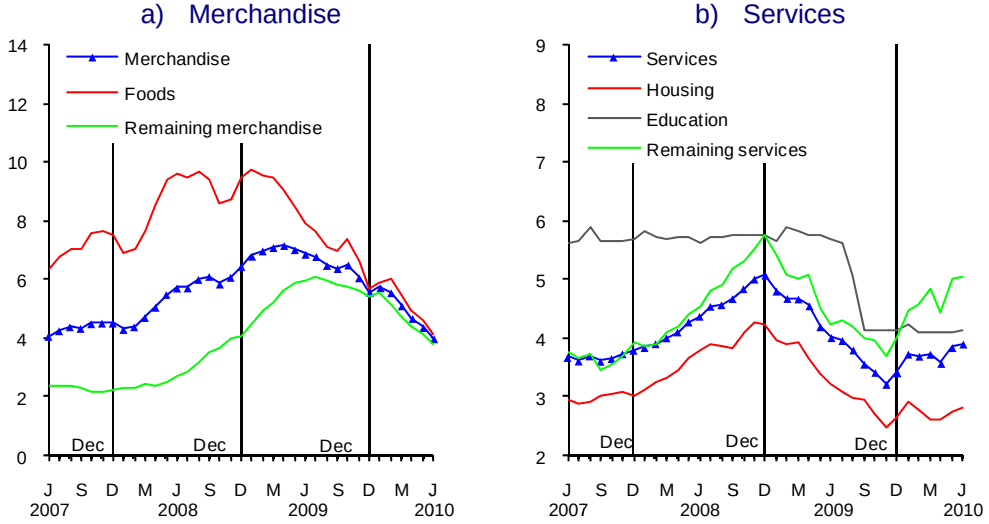
Graph 2
Core Merchandise and Core Services Subindices
Annual change in percent



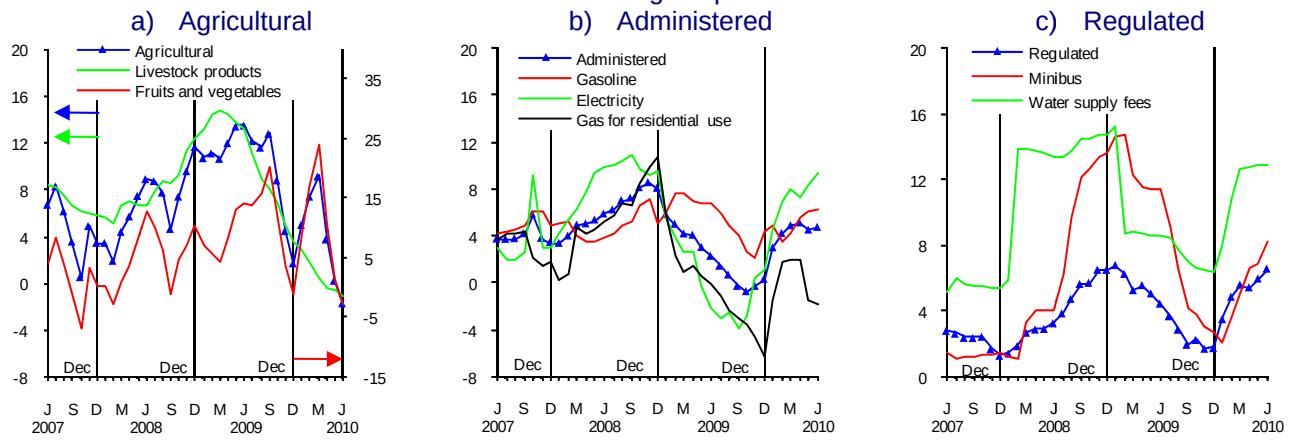
Source: Banco de México.

During the analyzed period, non-core inflation registered an average annual change of 3.71 percent, 1.55 percentage points below the previous quarter figure. This reduction is explained by the development of agricultural product prices, whose annual growth rate shifted from 7.15 percent during the first quarter of 2010 to 0.70 percent during the second quarter (Graph 3a and Table 1). Reasons for this development are the favorable weather conditions that generated an abundant supply of certain vegetables, as well as the already mentioned higher number of price markdowns in several retail chains (Box 1).

The decrease in annual non-core inflation was partially curbed by the development of the subindex of goods and services with administered and regulated prices. The average annual inflation rate of this price subindex rose from 4.29 percent to 5.35 percent from the first to the second quarter of 2010. The major increase in this subindex was registered by the group of goods and services with regulated prices, whose price quotes are mostly determined by local governments. The average annual inflation of this group shifted from 4.61 percent to 5.95 percent during the referred quarters (Graph 3c and Table 1), being particularly relevant the increase in public transportation fares for certain routes in Mexico City's metropolitan area, as well as in water supply fees in Puebla, Matamoros, and Aguascalientes.

The average annual growth rate of goods and services with administered prices rose from 3.99 percent during the first quarter to 4.76 percent during the second quarter of 2010, as a result of government's programmed increments in energy prices, aimed to reducing the fiscal and economic costs associated with the misalignment of domestic prices with their international references (Graph 3b and Table 1). Inflation of administered prices increased moderately due to the observed decline in natural gas price quotes that affected the item gas for residential use, whose average annual growth rate shifted from 0.65 percent during the first quarter to -0.55 percent during the second quarter of 2010 (Table 1).

Graph 3
Non-core Subindex
Annual change in percent



Source: Banco de México.

The decline in headline inflation during the second quarter of 2010 was also reflected in its trimmed mean indicator,[1] which registered 3.86 percent on average, 0.14 percentage points less than in the previous quarter. This decrease was lower than that posted by annual headline inflation (0.79 percentage points) during the same period (Graph 4a), thus indicating that the reduction in headline inflation partly reflected extreme variations in CPI prices.

The trimmed mean of the core subindex was 3.79 percent during the second quarter of 2010, 0.29 percentage points below the first quarter's figure. The differentiated behavior of the two major components of this indicator explains such result. While the trimmed mean of the merchandise subindex decreased significantly (Graph 4b), the average level of the trimmed mean of the services subindex remained unchanged (Graph 4c). The performance of the merchandise trimmed mean indicator suggests that the decline in merchandise inflation was not only due to the extreme price variations in some goods, but rather to a more widespread behavior.

Recent developments in the price formation process during the first half of 2010 show that the adjustment in taxes and in public prices and fares had a lesser impact on this process than that estimated by Banco de México.[2] Although the direct effects were close to those forecasted, the indirect effects must have been smaller considering the wide output gap in the Mexican economy (see Section 6). It is worth mentioning that the impact of the tax adjustments is expected to have been absorbed already, without having second-round effects on the price formation process.[3] However, the shock to inflation originated by the

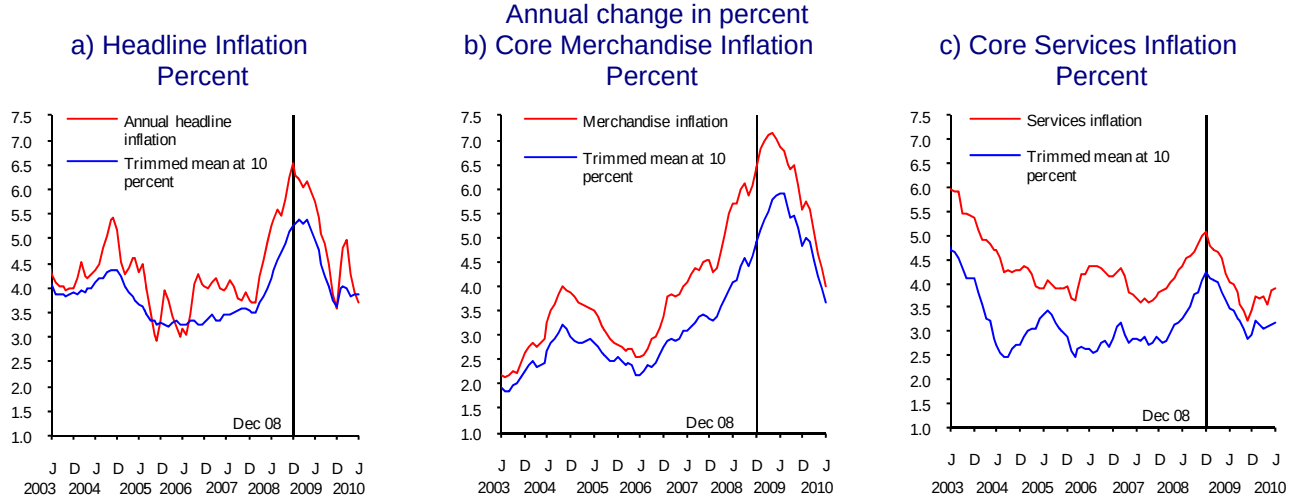
[1] The trimmed mean is an indicator that eliminates the contribution of extreme variations in some goods and services prices from headline inflation. To strip these variations, the following calculations are done: i) the monthly seasonally adjusted variations of CPI prices are arranged in descending order; ii) the items with the highest and lowest variation are excluded, considering up to 10 percent of the CPI basket, respectively, in each distribution tail; and, iii) with the remaining items, which, by construction, are located at the center of the distribution, the trimmed mean is constructed.

[2] Banco de México's estimates of the impact on inflation of the tax adjustments included in the 2010 fiscal measures approved by Congress, are presented in the Addendum to the Inflation Report July – September 2009, published in December of 2009.

[3] In the Inflation Report January – March 2010, Banco de México presented evidence on the absence of second-round effects on the price formation process related to the tax adjustments approved by

revision to the policy of administered and regulated prices and fares is still in the process of being absorbed.

Graph 4
Annual Inflation and Inflation Indicators Excluding the Contribution of Extreme Upper and Lower Price Variations Trimmed at 10 Percent[1/]
Annual change in percent



1/ The trimmed mean excludes the contribution of extreme variations in certain items' prices from headline inflation. To strip these variations, the following calculations are done: i) monthly seasonally adjusted variations of CPI prices are arranged in descending order; ii) the items with the highest and lowest variation are excluded, considering up to 10 percent of the CPI basket, respectively, in each distribution tail; and, iii) with the remaining items, which, by construction, are located at the center of the distribution, the trimmed mean is constructed.

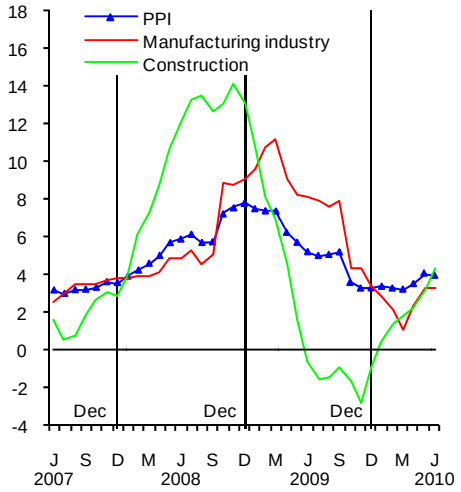
2.2. Producer Price Index

During the second quarter of 2010, the Producer Price Index (PPI) excluding crude oil registered an average annual change of 3.85 percent (as compared to 3.29 percent in the previous quarter). This increase was mainly influenced by the growth rate of manufacturing and construction prices (Graph 5a). Within the former group, the higher annual growth rate of automobile prices stands out, while in the latter group, prices of products made from steel and cement contributed the most to the increase (Graph 5b).

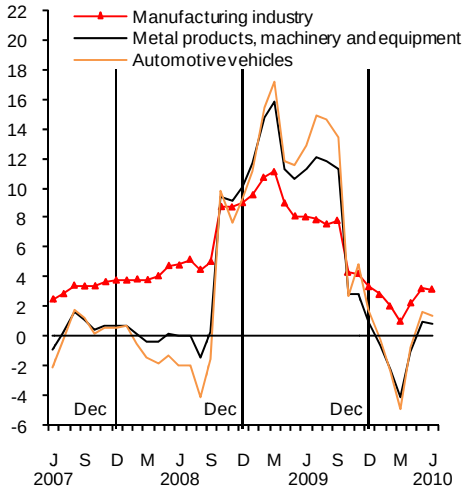
Congress for 2010. After analyzing the same evidence for the second quarter of 2010, the absence of second-round inflationary pressures originated by the mentioned tax adjustments is confirmed.

Graph 5
Producer Price Index
Annual change in percent

a) PPI, Manufactures and Construction



b) Manufactures, Machinery and Equipment, and Automotive Vehicles

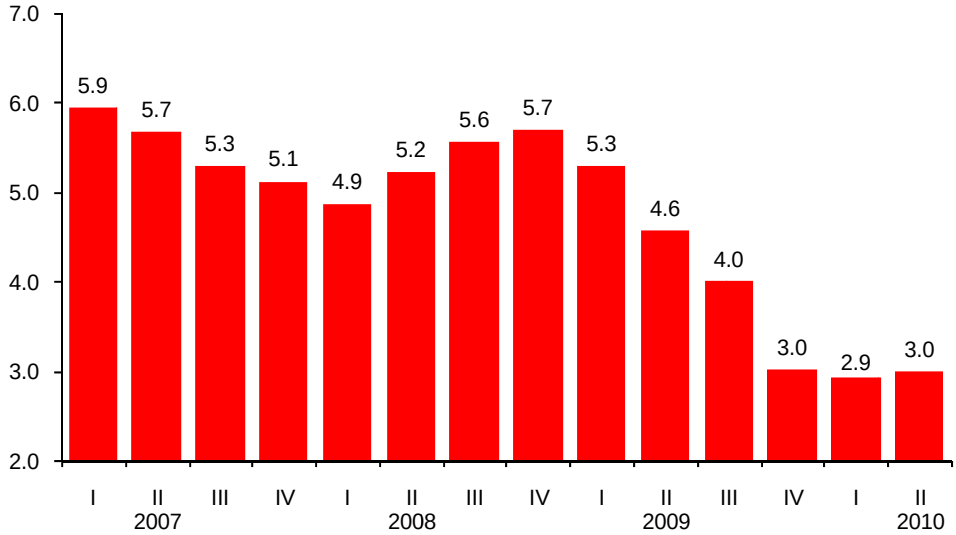


Source: Banco de México.

2.3. Wages

The IMSS reference wage – an indicator of workers' wages in the formal sector of the economy– registered an annual change of 3.0 percent during the second quarter of 2010 (as compared with 2.9 percent during the previous quarter, Graph 6). This, together with other wage indicators (Section 4), suggests that, during the analyzed period, workers' wages were not a source of additional pressure on firms' cost structure and, therefore, on inflation.

Graph 6
IMSS Reference Wage[1/]
Annual change in percent



Source: Estimates by Banco de México based on data from IMSS and INEGI.
1/ On average, 14.3 million workers were registered as being insured by the IMSS during the April-June 2010 period.

3. Economic and Financial Environment

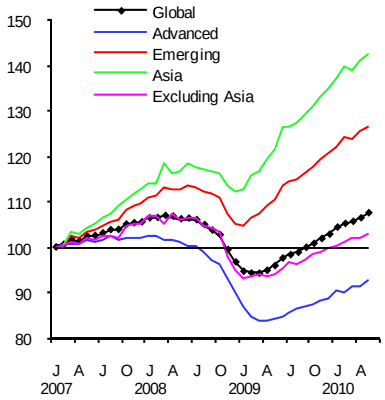
3.1. External Environment

3.1.1. World Economic Activity

The world economy continued to recover during the second quarter of 2010. Most advanced economies recovered moderately, while emerging economies grew, in general terms, significantly. The persistent growth of industrial production and international trade stands out (Graph 7). These results were observed despite the shocks in financial markets originated by sovereign risk problems in Europe, which have affected global economic activity in a limited way.

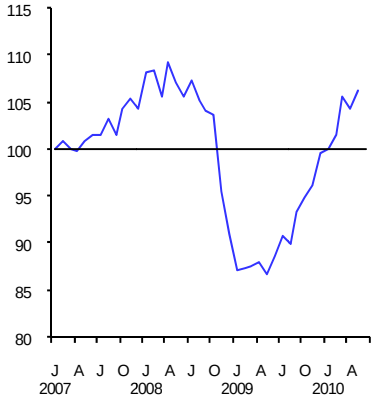
Graph 7
World Economic Activity

a) World Industrial Production Index January 2007=100, s. a.



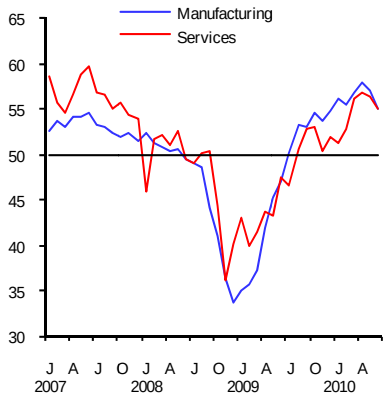
s. a. / Seasonally adjusted figures.
Source: CPB Netherlands.

b) World Trade Volume Index January 2007=100, s. a.



s. a. / Seasonally adjusted figures.
Source: CPB Netherlands.

c) Global, Manufacturing and Services Purchasing Managers Indices (PMI), s. a.



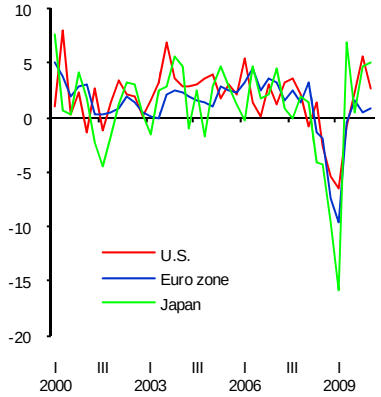
s. a. / Seasonally adjusted figures.
Source: JP Morgan.

US GDP grew at an annualized quarterly rate of 2.7 percent during the first quarter of 2010 (Graph 8), supported by inventory replenishment and the significant contribution of private consumption. During the second quarter, industrial production continued to recover, although at more moderate rates (annualized quarterly change of 6.6 percent as compared with 7.0 percent during the first quarter). These dynamics have benefited Mexican exports. Although industrial activity is still far below its levels prior to the crisis, this growth reflected both the dynamism of foreign trade as well as the continuing process of inventory replenishment. Services activity, on the other hand, continued growing moderately while construction remained weak. Summing up, different indicators reveal that there is still a considerable slack in installed capacity.[4]

[4] The index of installed productive capacity in the U.S. was 74.1 percent in June of 2010, figure below its historical average of 81 percent (1967-2010).

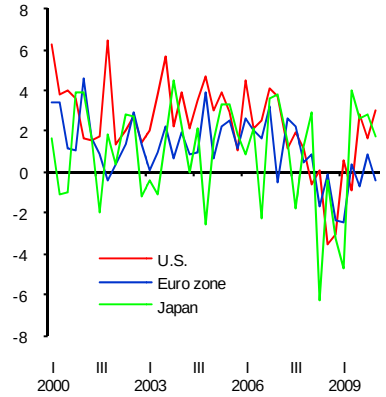
Graph 8
Economic Activity in Main Advanced Economies

a) Real Gross Domestic Product
Annualized quarterly percentage change, s. a.



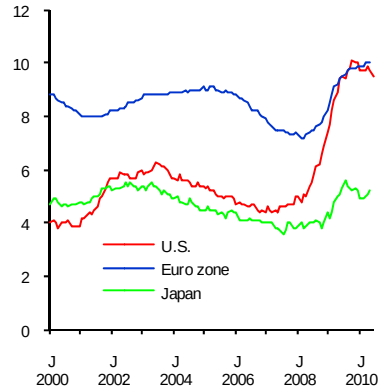
s. a. / Seasonally adjusted figures.
Source: BEA, Eurostat, and Cabinet Office.

b) Real Private Consumption
Annualized quarterly percentage change, s. a.



a. e. / Seasonally adjusted figures.
Source: BEA, Eurostat, and Cabinet Office.

c) Unemployment Rate
Percent, s. a.



s. a. / Seasonally adjusted figures.
Source: BLS, Eurostat and Statistics Bureau.

Private consumption expenditure in the U.S. grew at a slower rate during the second quarter, curbed by the high levels of unemployment, the adjustment in households' net wealth, and tight credit conditions. Firms expenditure in equipment and software continued to increase significantly, driven by the growth of corporate profits and the need to re-establish the capital stock. Nevertheless, investment in non-residential construction remained weak while residential construction seems to have contracted once more in response to the fiscal stimulus withdrawal.[5]

Although the labor market continued to recover, it did do but slowly and therefore did not have a considerable impact on the unemployment rate. The private non-farm payroll rose during the first half of 2010 at a monthly average rate of around 100,000 jobs. This increase is low compared with the net job loss exhibited during the crisis, which by June totaled 7.9 million jobs.

Financial conditions in the U.S. continue being, in general terms, not much supportive for economic growth. Bank credit continued to contract and the placement of private securities declined during the second quarter of 2010 (Graph 11c). In particular, credit conditions for small firms and households are still tight.

During the first quarter of 2010, the euro zone economy grew barely 0.8 percent in annualized quarterly terms. During the second quarter, the depreciation of the euro and higher levels of activity in other regions boosted euro zone exports, which fostered considerable growth in Germany and, to a lesser extent, in France, but not in other country's of the region, were the outlook turned out to be less positive. The sovereign debt crisis in some euro countries and the immediate effect of the announced fiscal adjustments, have been reflected in lower growth expectations for the entire region. Nevertheless, insofar as these adjustments are

[5] The "American Recovery and Reinvestment Act of 2009" program granted fiscal credit for up to USD 8,000 to first-time home owners during the January-November 2009 period. In November 6, 2009, the program was extended to homes purchased or leased until April 30, 2010, and also granted a credit for up to USD 6,500 to families which, after having lived in their current homes for at least 5 years, wished to buy them.

implemented consistently with sustained patterns of fiscal and external accounts in the long term, the fiscal consolidation programs would be expected to positively affect expectations for potential growth in the region. As for Japan, economic activity has rebounded more than expected at the beginning of the year. However, during the second quarter, the economy continued to recover, but at a slower rate and differently among the country's industries and regions.

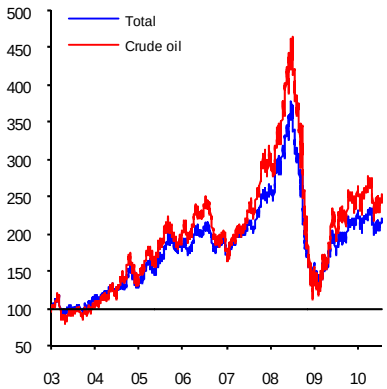
Following the trend observed during previous quarters, emerging economies, particularly in Asia, grew vigorously during the April-June period, supported by the dynamism of both their exports and domestic demand. Nevertheless, incoming data points to a lesser dynamism in this region. Industrial production growth in China declined during the second quarter, reaching 13.7 percent in June, in annual terms, as compared with 18.1 percent in March. Available information, on the other hand, suggests that industrial production in India continued growing during the second quarter. According to GDP figures for the first quarter and available information for the second quarter, economic activity in Latin America continued to recover during the first six months of the year, driven by a greater demand for commodities. Emerging economies in Europe have also shown signs of improvement, although with significant disparities among countries.

3.1.2. Commodity Prices

As mentioned in Section 3.1.4, risk aversion in international financial markets rose in May, temporarily interrupting the upward trend commodity prices had been following (Graph 9). Later, once volatility in financial markets eased, commodity prices recovered. The most affected prices were those of energy and industrial metal products, which even fell.

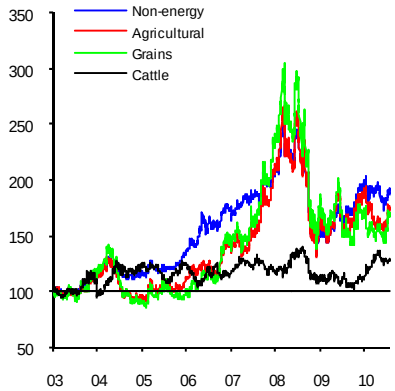
Graph 9
Commodity Prices
Index December 31, 2002=100

a) Total and Crude Oil



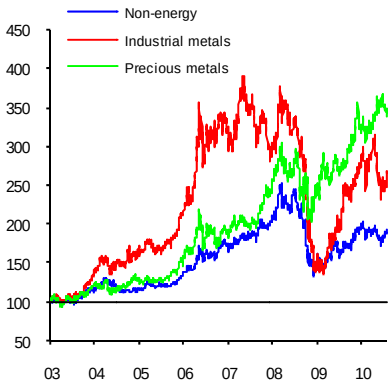
Source: S&P GSCI.

b) Non-energy and Agricultural



Source: S&P GSCI.

c) Non-energy and Metals



Source: S&P GSCI.

3.1.3. World Inflation Trends

Falling energy prices contributed to maintain both inflation and its expectations at low levels during the second quarter of 2010. In fact, at the end of the second quarter, rather than expectations of inflation growing at a faster rate,

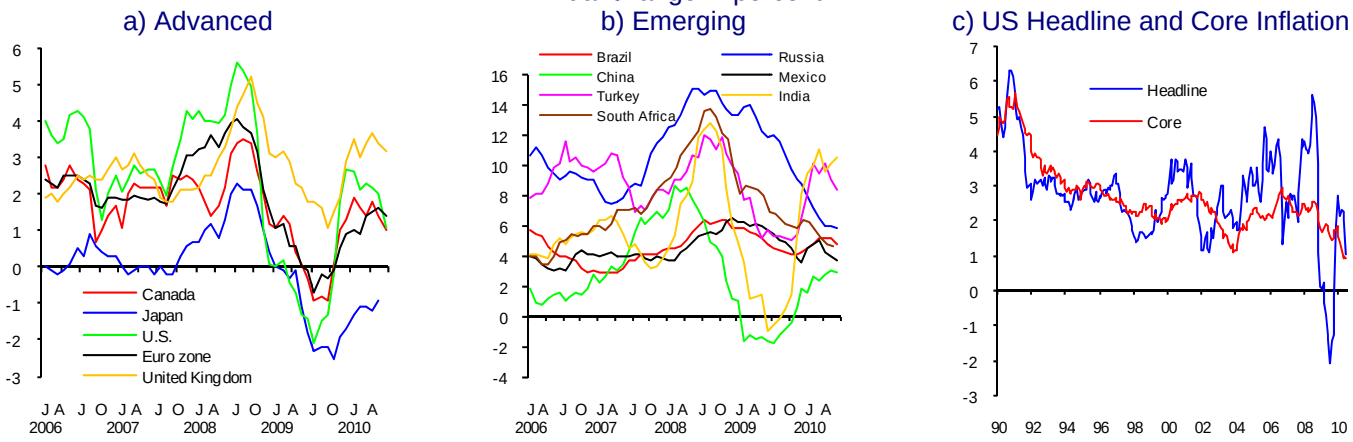
there were fears of a potential deflation in the future. As for emerging economies, concerns of possible inflationary pressures prevailed in some of them (Graph 10).

In the U.S., consumer headline inflation continued to decrease, reaching 1.1 percent in annual terms in June, figure below the 2.3 percent observed in March. The downward trend followed by its core component (Graph 10c), which grew 0.9 percent in annual terms in June (1.1 percent in March), contributed to such a reduction. The wide output gap and the high rate of unemployment contributed to maintain inflation and its expectations at low levels. Consequently, the Federal Reserve kept its policy rate unchanged at an interval of 0 to 25 basis points, stressing that it expects interest rates to remain low for a long period.

In the euro zone, annual headline inflation was 1.4 percent in June (1.4 percent in March), while core inflation was 0.9 percent (1.0 percent in March). In the United Kingdom, inflation was 3.2 percent in June, after having reached 3.7 percent in April. Finally, in Japan, both headline and core inflation continued registering negative annual rates during the second quarter. The central banks of the euro zone, the United Kingdom, and Japan did not change their monetary policy rates.

Expectations of low inflation continue to prevail in the major advanced economies. Considering that the fiscal stimuli have started to be withdrawn and that there is still a high degree of slack in installed productive capacity, analysts have postponed when the monetary stimulus will start to be withdrawn in most advanced economies. For this reason, world monetary conditions are expected to remain accommodative for a long period.

Graph 10
Inflation in Selected Advanced and Emerging Economies
Annual change in percent



Source: National Statistics Bureaus. Source: National Statistics Bureaus. Source: BLS.

The central banks of some advanced and emerging economies, mainly commodity producers, have started to withdraw the monetary stimulus, in light of the recovery of their economic activity and concerns about possible inflationary pressures. In general terms, analysts expect the withdrawal to continue, albeit the increasing uncertainty about the speed of adjustment of reference rates given the possible effects on the world economy of a reduced growth in Europe and expectations of a slower increase in commodity prices.

3.1.4. World Financial Markets

Since October of last year, some concerns have arisen about the fiscal sustainability of some European countries (particularly, Greece, Portugal, Spain, Ireland, and Italy). On April of this year, the situation worsened after Greece entered into crisis. Sovereign risk was revalued considerably, contaminating other economies, especially those with weaker fiscal positions. In light of the significant increase in counterparty risk perception among the European financial institutions, some markets stopped functioning properly and the euro began to depreciate considerably versus other currencies.

With the support of the European Union, Greece entered into a program with the International Monetary Fund (IMF), and other euro countries adopted adjustment measures.[6] The European authorities, jointly with the IMF, implemented unprecedented support measures as well, in order to restore confidence and safeguard the financial system stability. In May of 2010, the European Central Bank (ECB) took the following actions to face the severe problems in some segments of the financial and sovereign debt markets:

i. Dollar liquidity provision. In order to improve the liquidity conditions in markets with high financing needs in US dollars, the ECB restored the swap line with the U.S. Federal Reserve.

ii. Euro liquidity provision. For long-term refinancing operations (LTROs), the mechanism of fixed-rate tenders with full allotment was once again adopted.

iii. Debt markets support. Through the securities market program, the ECB buys government and private bonds in secondary markets in order to restore both the liquidity in these instruments' market and the proper functioning of the monetary policy transmission mechanism. In order to prevent changes in the monetary policy stance, these purchases are sterilized.

The European Union also approved the establishment of an European Stabilization Mechanism, whose main components are: i) a financial support medium-term procedure of EUR 60 billion to assist member countries; and, ii) an European Financial Stability Facility for the euro zone of EUR 440 billion in funds and guarantees granted by member countries. The International Monetary Fund has also pointed out that it will cooperate with the European Union to support countries in distress, according to each country's request (around EUR 250 billion). This mechanism is additional to the EUR 110 billion destined to supporting Greece from 2010 to 2012.

These measures constitute an unprecedented support program for European sovereign debt markets and, moreover, for the integrity of the euro monetary union. Although such measures have had their intended effect in the short term, their long-term functionality is still to be proven, given the enormous fiscal challenges faced by some countries.

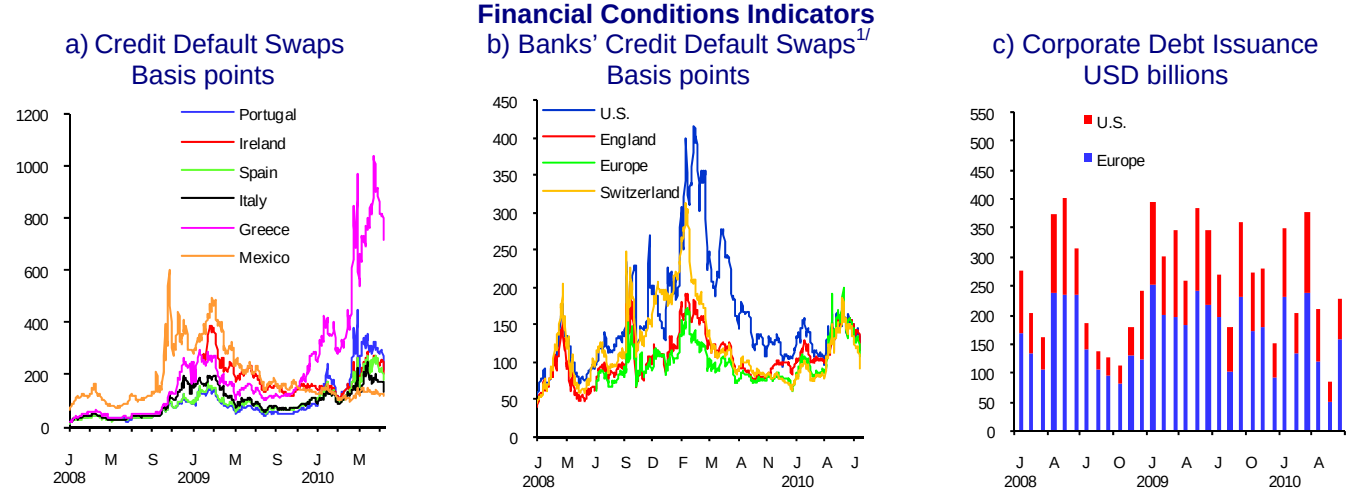
[6] Not only Greece, Spain, and Ireland have adopted fiscal tightening measures, but also Germany, France and the United Kingdom have announced important budget consolidation programs aimed mainly at reducing the public debt to GDP ratio in the next years.

Overall, the measures adopted contained the deterioration of conditions in international financial markets and prevented contagion from becoming widespread. As a result, financial conditions in several markets stabilized at the end of May and have even improved in the last weeks. Nevertheless, although progress has been made in addressing the fiscal problems of some European countries, these are still a source of vulnerability for world economic growth.

As pointed out, volatility escalated at the beginning of May, when doubts arose about the willingness and capacity of the main euro countries with sounder fiscal positions to grant financial support to other country members with weaker positions (Graph 11a). The uncertainty contributed to the fall in the main stock exchange indices and to an increase in firms' financing costs, which temporarily reduced the issuance of private securities in the major advanced economies (Graph 11c). As uncertainty has diminished, financial conditions in international markets have gradually recovered and, consequently, debt issuance.

In response to the perception of fragility in Europe's financial system, in July the authorities published the results of a series of stress tests under possible negative scenarios. The results show that the European Union's banking system is resilient to potentially negative macroeconomic and financial shocks. Although the tests revealed the need to raise capital in a small number of banks and by amounts lower than expected, there is still uncertainty regarding the European banking system's strength when facing larger than expected shocks.[7]

Graph 11
Financial Conditions Indicators



1/ Simple average. US banks: Bank of America, Citigroup, and JP Morgan; euro zone banks: Banco Santander, BNP Paribas, Crédit Agricole, Deutsche Bank, ING Groep, Société Générale, and Unicredit; U.K. banks: Barclays, HSBC, RBS, and Lloyds; and, Swisse banks: Crédit Suisse.
Source: Bloomberg.

As previously announced, the U.S. Federal Reserve closed its Temporary Asset-backed Liquidity Facility (TALF) in June. This instrument was the last of the extraordinary liquidity facilities implemented by the Federal Reserve

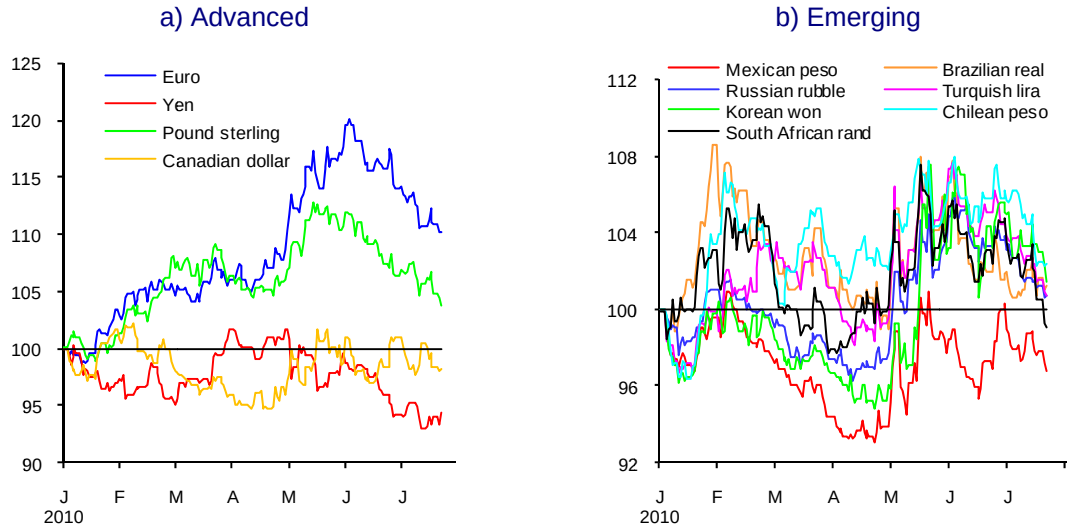
[7] On July 23, the Committee of European Banking Supervisors (CEBS) published the results of stress tests on 91 banks, which account for 65 percent of the European market in terms of total assets. The exercise was carried out for a 2-year horizon (2010 and 2011) and extreme negative scenarios were considered. The purpose of the exercise is to measure credit and market risks under extreme conditions considering banks exposure to sovereign debt. The results indicate that seven banks could experience a fall in their capital asset ratio of less than 6 percent, which implies additional capital requirements of around EUR 3.5 billion.

that remained open. In July, an important financial reform was approved in the U.S. which, among its main purposes, establishes regulation for derivative markets, limits to banking investment activities, and measures to strengthen financial user's protection. In addition, the regulatory authorities' capacity to supervise larger financial intermediaries is increased.

As a result of higher risk aversion in international markets, most currencies, except for the yen, depreciated significantly versus the US dollar (Graph 12). Nevertheless, as financial market conditions in Europe have gradually improved, the depreciation of those currencies, mainly of emerging economies, has reverted in the last weeks.

The reassessment of sovereign risk led in May to a temporary slowdown of capital flows to emerging economies, an increase in sovereign risk spreads, and a fall in stock markets (Graph 13). These effects, however, have started to revert, particularly in countries like Mexico, which have made fiscal consolidation efforts.

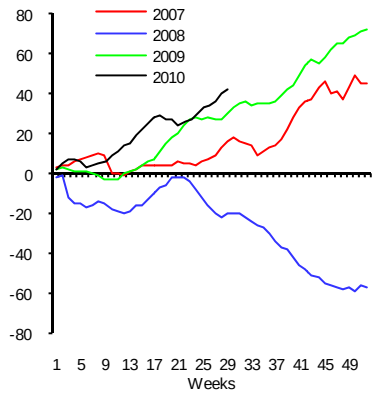
Graph 12
Exchange Rates of Emerging Economies' Currencies Versus the US dollar[1/]
Index 31/12/2009 = 100



1/ An increase equals a depreciation against the US dollar.
Source: Bloomberg.

Graph 13
Emerging Economies Financial Indicators

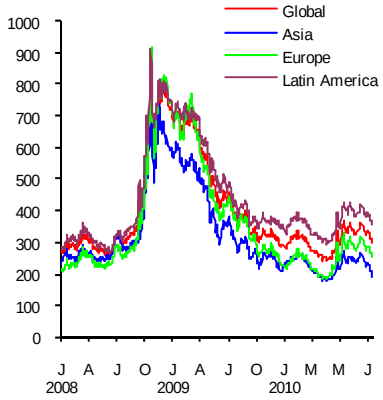
a) Accumulated Flows to Emerging Economies (Equity and Bonds)[1/]
USD billions



Source: Emerging Portfolio Fund Research.

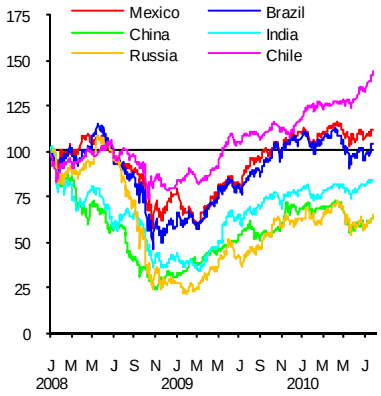
1/ The sample covers funds for the purchase/sale of emerging economies' equity and bonds, listed in advanced economies markets. Flows exclude portfolio results and exchange rate fluctuations.

b) Sovereign Risk Spreads (EMBI)
Basis points



Source: Bloomberg.

c) Stock Markets of Selected Emerging Economies
Index 01/01/2008=100



Source: Bloomberg.

3.2. Developments in the Mexican Economy

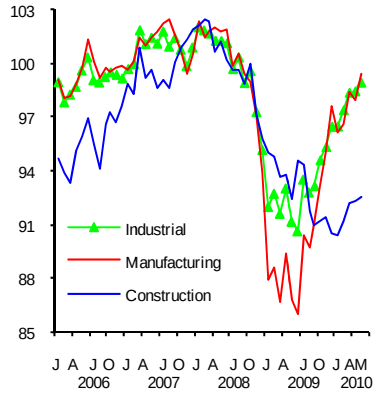
3.2.1. Economic Activity

Available information on manufacturing production up to May of 2010, together with substantial monthly increases in seasonally adjusted terms in exports and production of the automobile sector in June, suggest that industrial sector's activity levels rose significantly during the second quarter of 2010 (Graph 14a and 14b), thereby continuing the positive trend followed by the manufacturing industry since the second half of 2009. This reflects, in addition to the depreciation of the real exchange rate, the greater dynamism of external demand, originating from higher levels of US industrial activity since the second half of 2009 (Graph 14c).

During the second quarter of 2010, manufacturing exports reached levels 7.0 percent higher in seasonally adjusted terms than during the first quarter of the year, with a 3.1 percent increase in automotive industry exports and a 8.5 percent increase in the remaining manufacturing exports, as compared to the previous quarter. With these results, manufacturing exports reached levels similar to those prior to the onset of the global financial crisis. This development also contributed to the growth in manufacturing production during April-May of 2010, which turned out to be 12.8 percent higher than during the same period of last year. This result compares favorably to the annual changes of -1.4 percent and 9.9 percent registered during the last quarter of 2009 and the first quarter of 2010, respectively.

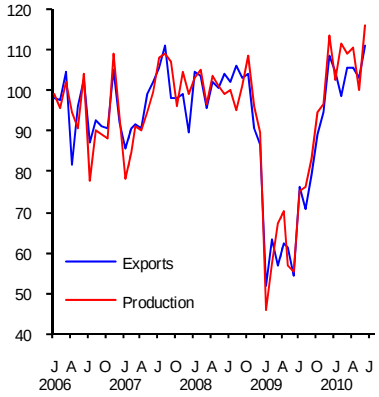
Graph 14
Industrial Sector, Automotive Production and Exports, Manufacturing Exports, and US Industrial Production
Index 2008=100; seasonally adjusted figures

a) Industrial Sector



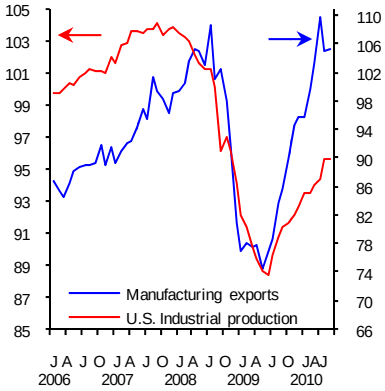
Source: Mexico's National Accounts System (INEGI).

b) Automotive Production and Exports



Source: Prepared by Banco de México with data from AMIA and ANPACT.

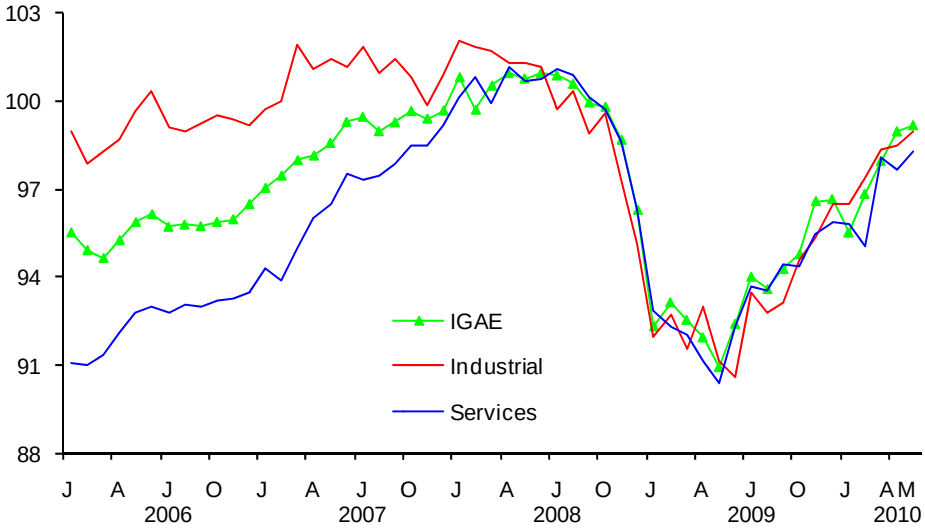
c) Manufacturing Exports and US Industrial Production



Source: Banco de México and U.S. Federal Reserve.

During the second quarter of 2010, the levels of productive activity were also positively influenced by a change of trend in domestic demand, which, nevertheless, remains at relatively low levels. This development has also led to a more dynamic services sector (Graph 15).

Graph 15
Economic Activity Indicators
Index 2008=100; seasonally adjusted figures



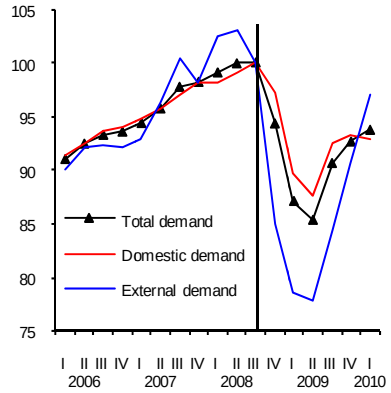
Source: Mexico's National Accounts System (INEGI).

Regarding the aforementioned, until the first quarter of 2010, domestic spending was lagging considerably in relation to external demand's recovery. Indeed, as opposed to the high quarterly growth of goods and services exports during the first quarter of the year (7.01 percent, in seasonally adjusted terms), total consumption remained at the same level as in the fourth quarter of 2009 and

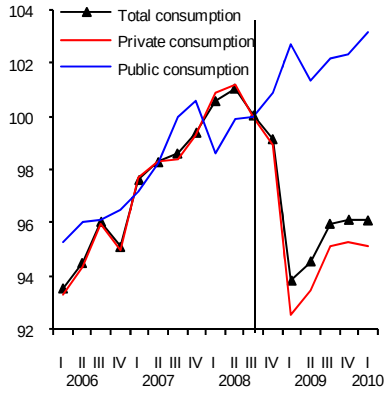
gross fixed capital formation even declined by 0.63 percent as compared to the previous quarter (seasonally adjusted figures for both cases, Graph 16).

Graph 16
Aggregate Demand
Indices third quarter of 2008=100; seasonally adjusted figures

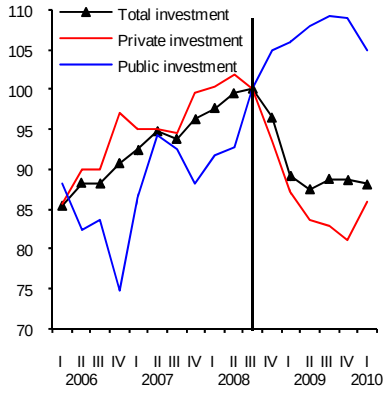
a) Total Aggregate Demand, Domestic and External



b) Total Consumption Components



c) Total Investment Components



Source: Prepared by Banco de México with data from Mexico's National Accounts (INEGI).

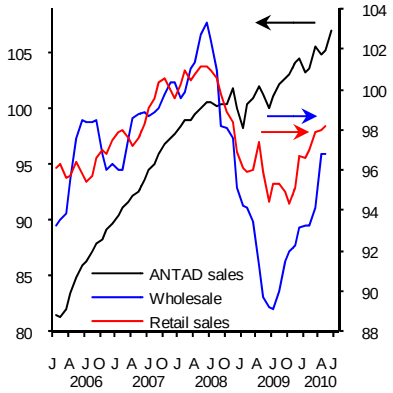
As opposed to the aforementioned, during the second quarter domestic spending is expected to have increased, as compared to the first quarter, although at a significantly lower rate than external demand. In particular, the following results are noteworthy:

I. Regarding consumption, during the second quarter of 2010, seasonally adjusted ANTAD sales rose by 1.37 percent as compared to the first quarter, figure higher than the 0.25 percent change registered in the preceding quarter. Similarly, commercial establishment sales seem to have recovered relatively faster in the last months (Graph 17a).

II. The latest indicators suggest that investment seems to have reached an inflection point, although it continues exhibiting volatility. In particular, during April of 2010, gross fixed capital formation decreased at a monthly rate of 1.06 percent in seasonally adjusted terms, after having followed a moderate upward pattern during the previous six months (Graph 17b). Despite this, investment continued to be 12.1 percent lower than the maximum figure registered in July of 2008. An indicator whose recent improvement seems to suggest that investment could observe a stronger recovery in the coming months is the perception of manufacturers and private sector economic analysts, as to whether they consider firms' current economic situation to be favorable for investments (Graph 17c).

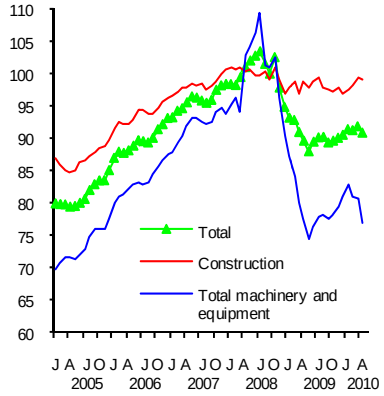
Graph 17
Domestic Expenditure Indicators

a) Total ANTAD and Commercial Establishments Sales
Index 2008=100; 2-month moving average; seasonally adjusted figures[1/]



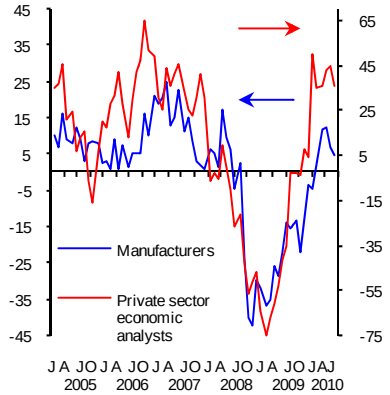
Source: INEGI; and prepared by Banco de México with data from ANTAD.
1/ In order to prevent volatility of these series from affecting their most recent pattern, moving averages are used up to the end of the period.

b) Gross Fixed Investment and Components
Index 2008=100; 3-month moving average, except from 2008 onwards; seasonally adjusted figures



Source: Mexico's National Accounts System (INEGI).

c) Current Economic Conditions to Carry Out Investments
Balance of responses: percentage[1/]



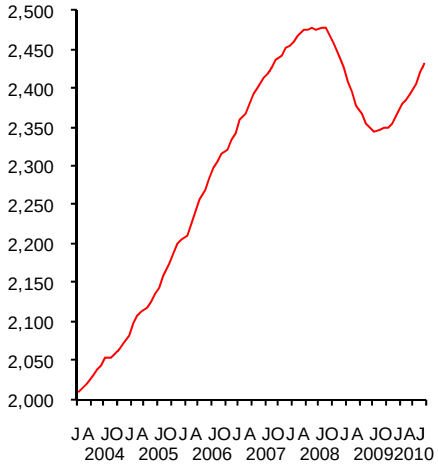
Source: Monthly Manufacturing Business Tendency Survey, and Private Sector Economic Analysts' Expectations (Banco de México).
1/Percentage of those that considered the current situation as a good time to invest, less the percentage of those that believed the opposite.

Some determinants of domestic spending seem to be exhibiting a positive change of trend. In particular, the formal sector wage bill continued to increase. The consumer confidence index also started to show a favorable change of trend during the second quarter of 2010 (although still remaining at significantly low levels, Graph 18). Similarly, workers' remittances began to follow an upward trend since November of 2009; however, they still remain at levels significantly lower than those prior to the global crisis (Graph 19a).[8] Finally, as will be shown in Section 3.2.2 of this Report, commercial banks' financing, mainly to firms, seems to be recovering. As for household financing, consumer credit has stopped contracting in recent months. In the particular case of consumer credit for the purchase of durables and others, it has exhibited a favorable change of trend during the second quarter (Graph 19b).

[8] Revenues from workers' remittances amounted to USD 1,885 million in June of 2010, representing an annual decline of 2.0 percent, after having grown at an annual rate of 0.2 percent and 12.6 percent in April and May, respectively. After considering these results, during the second quarter of 2010, remittances totaled USD 5,808 million (3.7 percent increase as compared to the same quarter in 2009).

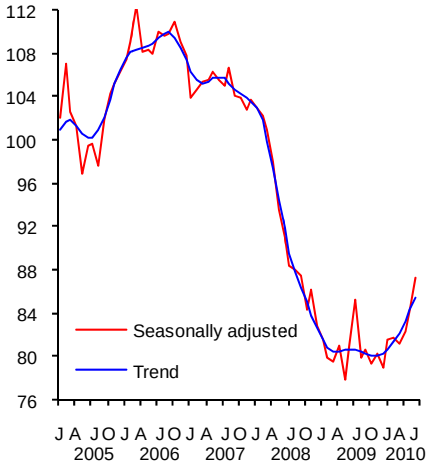
Graph 18
Real Wage Bill and Consumer Confidence Index

a) Real Wage Bill in the Formal Sector
Seasonally adjusted figures; MXN millions



Source: Prepared by Banco de México with data from IMSS.

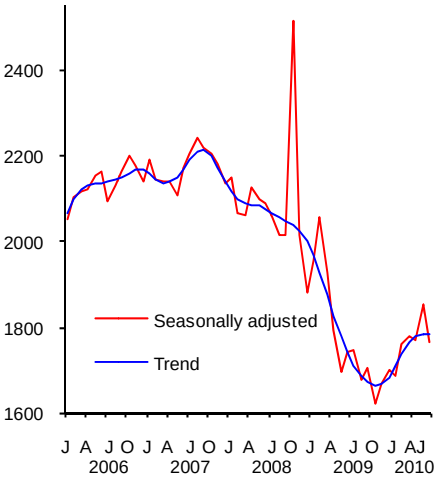
b) Consumer Confidence Index
January 2003=100



Source: INEGI and Banco de México.

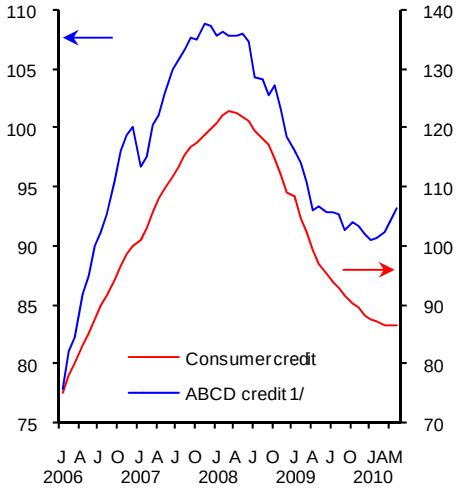
Graph 19
Workers' Remittances and Financing
Seasonally adjusted figures

a) Workers' Remittances
USD millions



Source: Banco de México.

b) Commercial Banks' Performing Credit for Consumption and to Purchase Durable Goods (ABCD) and Others
Index December 2006=100

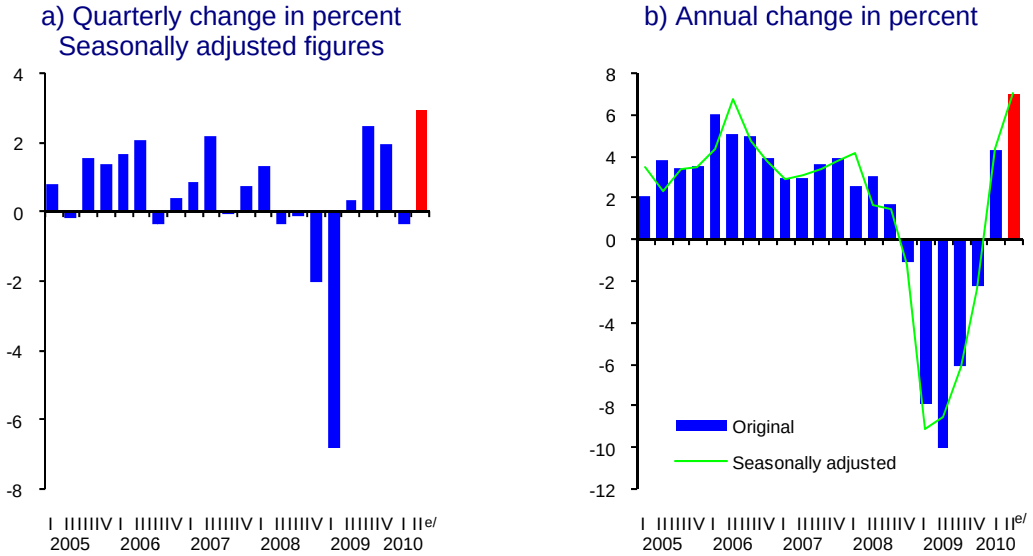


1/ Includes motor vehicle credits, credits to purchase durable goods, credits for capitalized leasing operations, and personal and other consumer credits.
Source: Banco de México.

Under these conditions, the Mexican economy is expected to have exhibited a better performance during the second quarter of 2010 than in the previous one. Seasonally adjusted GDP is forecasted to have grown in quarterly terms between 2.5 and 3.0 percent during the second quarter of 2010 (Graph 20a), which would imply an annual change of more than 7.0 percent in original

figures. GDP would therefore register a second consecutive positive increase in annual terms, after having contracted for five consecutive quarters (Graph 20b). The high annual growth GDP is expected to exhibit during the second quarter is also influenced by a low base of comparison resulting from the effects of the outbreak of influenza A(H1N1) and the temporary shutdown of two of the major automakers in Mexico, whose US headquarters entered into bankruptcy proceedings.

Graph 20
Gross Domestic Product



Source: Mexico's National Accounts System (INEGI). Seasonal adjustments up to second quarter of 2010 by Banco de México.
e/ Estimates.

3.2.2. Financial Saving and Financing in Mexico

The recovery in the availability of financial resources that was observed during the last quarter of 2009 continued in the first quarter of 2010. This was due to the significant inflow of foreign resources, particularly the increasing financial savings by non-residents. On the contrary, the sources of domestic financial resources were lower, as compared with the previous quarter. Nevertheless, these sources, measured by residents' financial savings, seem to have reached a turning point in March of 2010, as shown by the recovery observed during the second quarter of the year (Table 2 and Graph 21a).

The economy's total financial savings, defined as the monetary aggregate M4 less the stock of banknotes and coins, and composed by residents and non-residents' financial savings, grew at a higher rate during the second quarter of 2010, thereby reaching maximum historical levels (in real terms) in May. This change of trend is explained by the recent increase in residents' savings, mainly because voluntary savings have started to grow as a result of the economic recovery (Graph 21b).

Table 2
Total Funding for the Mexican Economy (Sources and Uses)
Percentage of GDP

	Annual Flows						Stock 2010 I	
	2008 IV	2009 I	2009 II	2009 III	2009 IV	2010 I	% GDP	Est. %
Total sources	**6.0**	**5.1**	**4.2**	**3.8**	**4.1**	**5.6**	**76.7**	**100.0**
Domestic sources 1/	5.5	5.5	5.2	4.7	3.4	3.1	55.9	72.8
Foreign financing 2/	0.4	-0.4	-1.0	-0.9	0.7	2.5	20.8	27.2
Total uses	**6.0**	**5.1**	**4.2**	**3.8**	**4.1**	**5.6**	**76.7**	**100.0**
Public sector	1.9	2.9	3.2	3.8	3.5	3.1	38.4	50.1
Public sector (PSBR) 3/	1.6	2.7	2.9	3.3	2.7	2.2	36.1	47.1
States and municipalities	0.3	0.2	0.3	0.6	0.8	0.9	2.3	3.0
International reserves 4/	0.7	-0.6	-1.3	-0.9	0.5	1.8	9.8	12.7
Private sector	2.0	1.3	0.6	-0.4	0.0	0.7	31.7	41.3
Households	0.7	0.5	0.2	0.1	0.0	0.1	14.0	18.2
Consumption	0.0	-0.3	-0.6	-0.6	-0.5	-0.3	3.8	5.0
Housing 5/	0.7	0.8	0.8	0.7	0.5	0.4	10.1	13.2
Firms	1.3	0.8	0.4	-0.5	0.0	0.6	17.7	23.1
Domestic 6/	1.3	1.1	0.7	0.3	0.4	0.5	10.7	13.9
Foreign	0.0	-0.3	-0.3	-0.8	-0.4	0.1	7.1	9.2
Commercial banks' foreign assets 7/	0.4	0.0	0.2	0.1	-0.5	-0.3	1.7	2.2
Other 8/	0.9	1.5	1.5	1.2	0.6	0.3	-4.8	-6.3

Source: Banco de México.
Note: Figures may not add up due to rounding. Figures expressed as a percentage of average GDP of the last four quarters. The information on revalued flows is stripped from the effect of exchange rate fluctuations.
1/ Includes monetary aggregate M4 held by residents. Annual revalued flows of Domestic sources exclude the effect of the reform to the ISSSTE Law on monetary aggregate M4. Information on the stock of domestic sources includes the effect of this reform.
2/ Includes monetary aggregate M4 held by non-residents, foreign financing for the federal government, public institutions and entities, and foreign financed investment projects (PIDIREGAS), commercial banks' foreign liabilities, and financing to the non-financial private sector.
3/ Public Sector Borrowing Requirements (*Requerimientos Financieros del Sector Público*, RFSP or PSBR, for its acronym in English) and Public Sector Borrowing Requirements' historical stock (SHPSBR or SHRFSP, for its acronym in Spanish) as reported by the Ministry of Finance (SHCP). Figures of revalued flows exclude the impact of the reform to the ISSSTE Law on RFSP. Information on SHRFSP does include the effect of this reform on the public debt.
4/ As defined by Banco de México's Law.
5/ Total portfolio from financial intermediaries and from the National Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores,* Infonavit), and from the ISSSTE Housing Fund (*Fondo de la Vivienda del ISSSTE*, Fovissste). Includes debt-restructuring programs.
6/ Total portfolio of financial intermediaries. Includes debt-restructuring programs.
7/ Includes assets from abroad and foreign financing.
8/ Includes capital accounts and results and other assets and liabilities of commercial and development banks, Banco de México, non-bank financial intermediaries, and INFONAVIT, as well as non-monetary liabilities from IPAB, among others.

The highest inflow of financial resources by non-residents during the year was registered in April of 2010. Nevertheless, as observed in other emerging countries, in May and June the inflow of financial resources slowed down due to higher risk aversion originated by the European crisis. Although it might seem as if uncertainty in international financial markets has partly disappeared, as reflected by the higher number of holdings of government securities by non-residents during the first days of July, this episode shows the speed at which foreign resources can stop flowing into the country and be reverted (Graph 21c).

As for financing, during the first quarter of 2010, a significant amount of financial resources was used by the public sector. Nevertheless, at the margin, public sector funding decreased due to, among other factors, the recovery of domestic economic activity, higher oil prices, and the impact of the tax adjustments as well as the adjustments to federal and local public prices and fares for this year, which have raised tax and oil revenues (Table 2). As compared with the fourth quarter of 2009, foreign financing rose from 0.7 to 2.5 points of GDP during the first quarter of 2010. A high fraction of these resources was used to build up international reserves. Furthermore, during the referred period, a higher

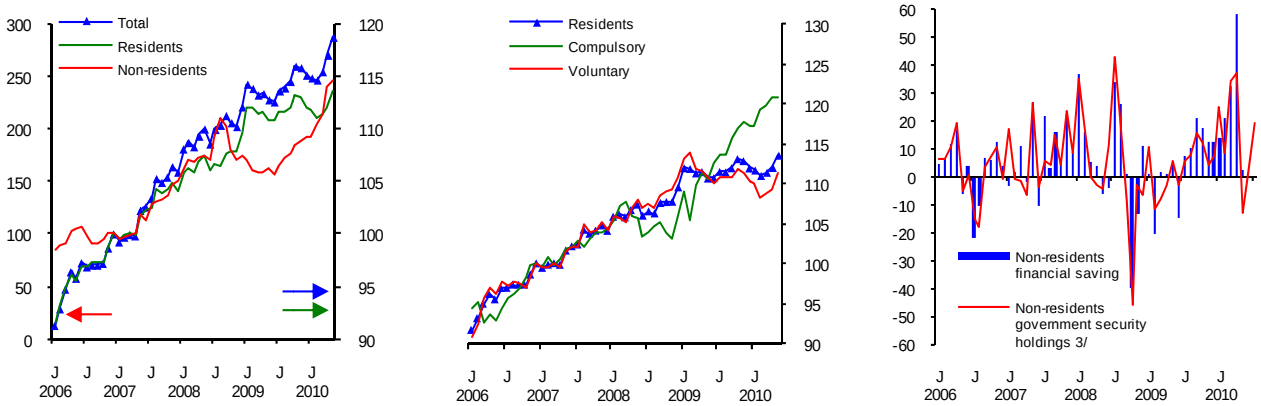
amount of financial resources was channeled to the private sector (Table 2). The share of financial savings absorbed by both international reserve accumulation and the public sector will therefore need to be monitored in the future.

Graph 21
Financial Saving

a) Total Financial Saving[1/ 2/]
Seasonally adjusted stocks
Index Dec. 2006=100

b) Residents Financial Saving[2/]
Seasonally adjusted stocks
Index Dec. 2006=100

c) Non-residents Financial Saving and Government Security Holdings
Monthly change in
MXN thousand millions



Source: Banco de México.
1/ Defined as monetary aggregate M4 less the stock of banknotes and coins held by the public.
2/ Excludes the impact of the ISSSTE law on this aggregate.
3/ Holdings of government securities in nominal terms. Figures available up tp to July 14, 2010.

Stronger signs of recovery of domestic financing to the non-financial private sector were observed in April and May of 2010, particularly of financing to firms. This was driven by the dynamism of securities issuance and the surge in credit granted mainly by commercial banks (Graph 22). Regarding the aforementioned, the recovery of economic activity and expectations of it continuing in the future, appear to be the cause of the higher levels of credit granted.

The increase in risk aversion in international financial markets during the second quarter does not seem to have significantly affected the domestic debt market or the access to foreign financing by non-financial private firms. Indeed, with respect to the domestic securities market, there was no change in the patterns of new debt placements' maturity or in the interest rates for this type of financing (Graph 23a).[9,10] Regarding access to foreign financing, during the second quarter of 2010, in an environment characterized by a temporary reduction of capital flows to emerging economies, Mexican firms continued to issue debt in international markets (Graph 23c).

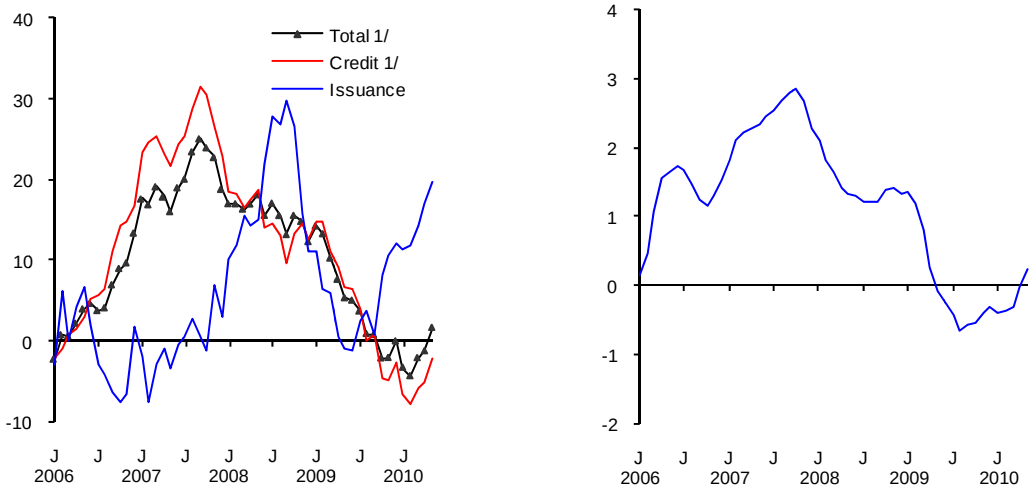
[9] The levels of short-term debt issuance are currently below those observed in the months after September of 2008, when firms opted for short-term debt issues due to the difficulties to place debt instruments at longer terms.

[10] Historically, medium-term debt is not necessarily issued every month of the year.

Graph 22
Domestic Financing and Commercial Banks' Performing Credit for Non-financial Private Firms

a) Domestic Financing for Non-financial Private Firms
Real annual change in percent

b) Commercial Banks' Performing Credit to Non-financial Private Firms 1/ 2/
Trend of real monthly change in percent



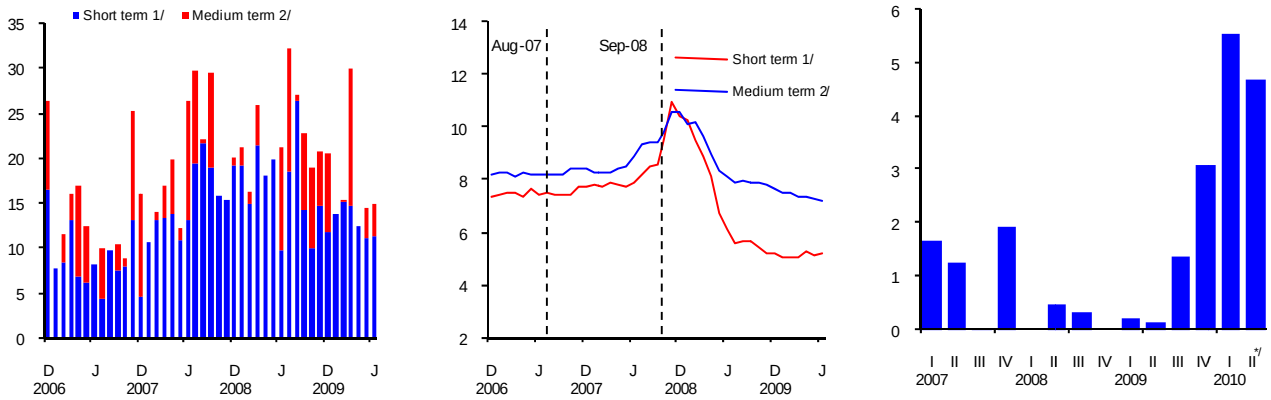
Source: Banco de México.
1/ From February 2009 onwards, figures are affected by the reclassifying of credit granted to small and medium-sized firms (PyMES, for its acronym in Spanish) from consumer credit to credit granted to non-financial firms.
2/ 6-month moving average of real monthly change in seasonally adjusted terms.

Graph 23
Debt Issue and Interest Rates on Private Securities

a) Non-financial Private Firm Instruments Issued in the Domestic Market
MXN thousand millions

b) Interest Rate on Private Debt
Percent

c) Non-financial Private Firm Instruments issued Abroad
Monthly flows in USD billions



Source: Banco de México.
1/ Issues with up to 1-year maturity.
2/ Issues with maturity greater than 1 year.
*/ Preliminary figures for May and June of 2010.

Source: Banco de México.

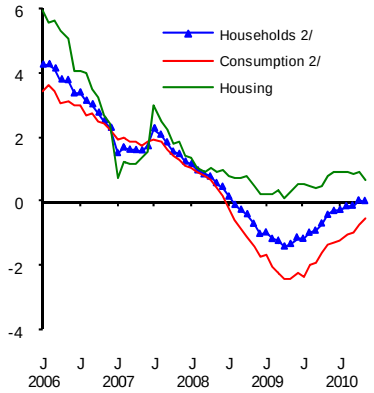
Source: Banco de México and Bloomberg.

As for financing to households, it also improved during the second quarter of 2010. Commercial banks' credit for consumption, which was the most affected credit portfolio during the lower phase of the cycle, has stopped decreasing in the last months, just as mentioned in the previous section of this Report. This would be reflecting, on the one hand, commercial banks' willingness to increase the supply of credit, once the efforts made have enabled the

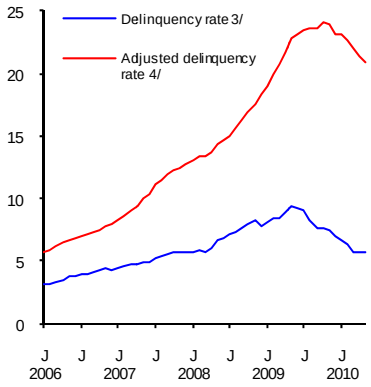
improvement of this portfolio, backed by the recovery of employment and households' income (Sections 3.2.1 and 4) (Graph 24b). On the other hand, the incipient recovery of private consumption expenditure would be encouraging a greater demand for this type of credit. As for mortgage loans granted by commercial banks, they continued to grow in real terms, following the trend observed during the year (Graph 24a).

Graph 24
Commercial Banks' Performing Credit and Delinquency Rates of Commercial Banks' Credit to Households

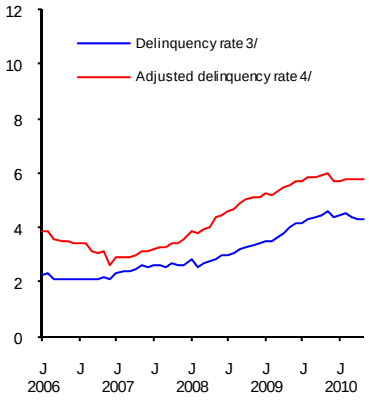
a) Commercial Banks' Performing Credit to Households[1/]
Trend of real monthly change in percent



b) Delinquency Rates and Adjusted Delinquency Rates of Consumer Credit [1/ 2/]
Percent



c) Delinquency Rates and Adjusted Delinquency Rates of Housing Credit
Percent

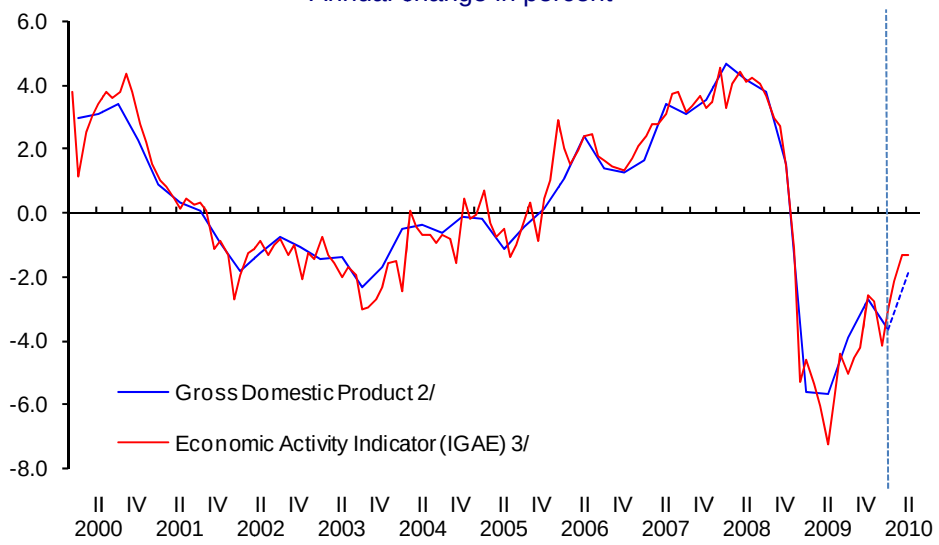


Source: Banco de México and CNBV.
1/ 6-month moving average of monthly real change in seasonally adjusted terms.
2/ Includes credit portfolio of credit card Regulated Sofoms: Banamex credit cards, Santander Consumo, Ixe credit cards, Sociedad Financiera Inbursa, and Soriana Sofom. Since February 2009, figures are affected by the reclassifying of credit granted to small and medium-sized firms (PyMES, for its acronym in Spanish) from consumer credit to credit granted to non-financial firms.
3/ The delinquency rate is defined as non-performing portfolio divided by total loan portfolio.
4/ The adjusted delinquency rate is defined as the sum of non-performing loans plus any write-offs or losses recognized by banks during the twelve previous months divided by total loan portfolio plus the abovementioned write-offs or losses.

4. Inflation Determinants

The information presented in previous sections suggests that productive activity and aggregate demand would have grown considerably during the second quarter of the year, as compared to the previous quarter. The development of aggregate demand would reflect the persistent dynamism of external demand as well as the start of an expansive phase, albeit moderate, of domestic demand, which nevertheless remains significantly below the levels observed before the start of the global crisis in mid-2008. Consequently, although the output gap in relation to potential GDP is expected to have decreased during the second quarter, it is foreseen to remain in negative territory (Graph 25).[11]

Graph 25
Output Gap[1/]
Annual change in percent



Source: Banco de México.
1/ Estimated using the Hodrick-Prescott (HP) method with tail corrections; See Banco de México (2009), "Inflation Report April – June 2009", p.69.
2/ GDP figures for the second quarter of 2010 estimated by Banco de México.
3/ Figures up to May 2010.

During the second quarter of the year, an absence of demand-related pressures on input utilization and on Mexico's external accounts continued to be observed. In particular:

[11] In the Inflation Report of April – June 2009 (p. 69), Banco de México mentioned that the potential output of an economy can be defined as the maximum level of goods and services that a country can produce without generating inflation pressures, given its productive resources and available technology at each point in time. The difference between observed and potential output at each point in time –usually known as the output gap- tends to be associated with aggregate demand shocks. These concepts cannot be observed directly and hence need to be estimated using observed information, e.g. observed GDP series at each point in time. The estimation of the potential output and the output gap is usually obtained from certain statistical methods applied to the observed past information. For this reason, it is hard to expect the estimates of unobserved components to be highly accurate. In particular, before concluding that the output gap is positive or negative at a certain point in time, it is important to analyze if the results are statistically significant at an adequate confidence level. Additionally, given the degree of uncertainty usually associated with these indicators' estimates, the results should be considered carefully.

a) Formal employment, measured by the number of IMSS-insured workers, continued its upward trend, reaching in June a slightly lower level in seasonally adjusted terms than the peak observed in August of 2008 (Graph 26a). Nevertheless, unemployment and underemployment rates remained high (Graph 26b). Furthermore, the results of Banco de México's Monthly Manufacturing Business Tendency Survey indicate that this sector continued not facing difficulties in hiring skilled labor (Graph 26c). Employment has increased during the last months, although mainly in jobs which, on average, have been less remunerated than those lost last year (Graph 26d). These conditions have therefore contributed to curb wage increases.

b) The speed of recovery in the manufacturing sector has implied higher levels of installed capacity utilization, which, nevertheless, remains below the levels observed before the onset of the crisis (Graph 27).

c) The upward trend followed by international commodity prices since the beginning of 2009 was interrupted during the second quarter of 2010. Energy, metal and food commodity price quotes continued at significantly lower levels than their maximum levels in 2008 (see Section 3.1.2). For this reason, both metal and food commodity prices were not a source of pressure for firms' cost structure. As for domestic energy prices, although they continued rising during the analyzed period, they were still at lower levels than their international references, except for natural gas prices.

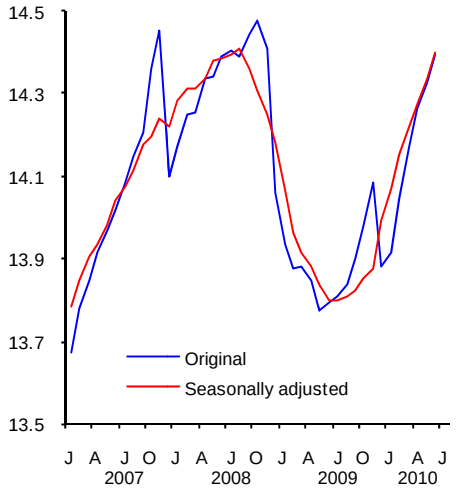
d) The economy's financing needs for the incipient recovery of consumption and investment do not seem to have been a source of pressure for interest rates.

e) The growth in merchandise imports mainly reflects the increase in intermediate goods purchases, which in turn is linked to higher merchandise exports. In contrast, imports of consumer goods, which are mostly related to domestic market developments, grew less (Graph 28a). Imports of capital goods, on the other hand, have not recovered. Thus, the current account deficit is expected to have remained at low levels during the second quarter of 2010 (USD 0.9 billion, equivalent to 0.4 percent of GDP; Graph 28b).

Available information at the time of compiling this Report indicates that during the second quarter of the year, Mexico received foreign inflows for an amount that allows the current account deficit to be fully financed. These inflows have mainly stemmed from foreign investment (both direct and portfolio) and public and private sector's net foreign financing.

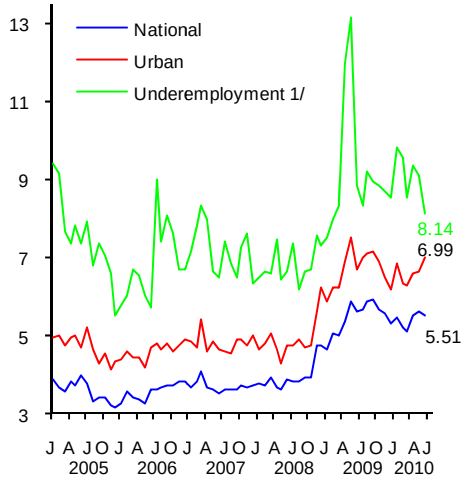
Graph 26
Labor Market Indicators

a) Workers insured by IMSS
Millions



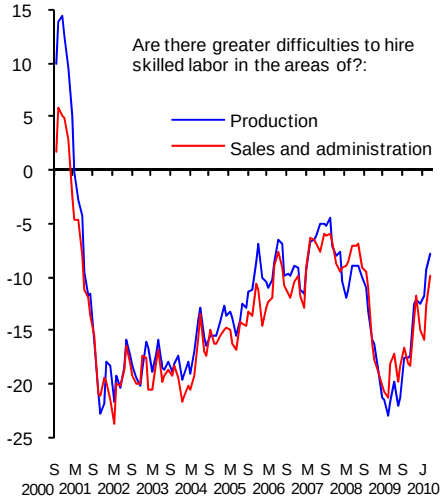
Source: Prepared by Banco de México with data from IMSS.

b) Unemployment and Underemployment Rates
Percent, seasonally adjusted figures



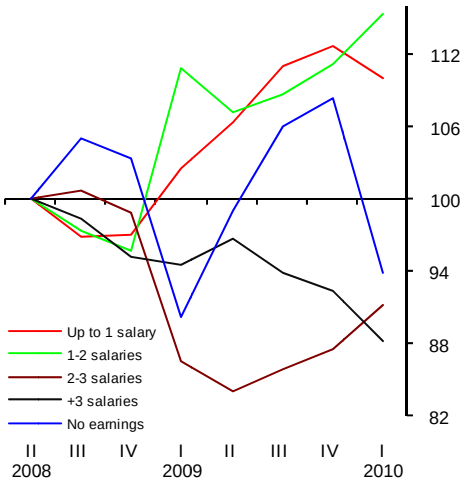
Source: INEGI.
1/ Original series.

c) Labor Shortage Indicators
Two-month moving average of balance of responses



Source: Monthly Manufacturing Business Tendency Survey. Banco de México.

d) Employment by Minimum Wage Range
Second quarter of 2008=100

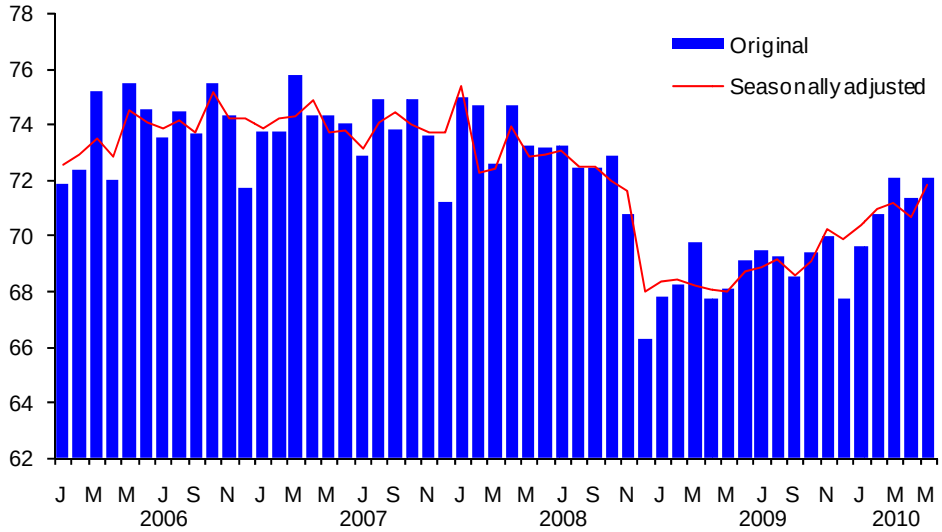


Source: INEGI.

Considerations within this section and throughout this Inflation Report allow concluding that the outlook for inflation has improved substantially. Nevertheless, both observed inflation and short- and medium-run inflation expectations are still above Banco de México's medium-term target. This partly reflects that estimates for annual inflation continue to be affected by this year's adjustments in taxes and in public sector's prices and fares. Additionally, inflation expectations could probably be including the uncertainty associated with the public revenue enhancement role the government's policy of prices and fares has had repeatedly in the past. Indeed, despite the efforts to consolidate public

finances, these continue to exhibit some structural weakness. In particular, total public revenues still depend excessively on crude oil exports.

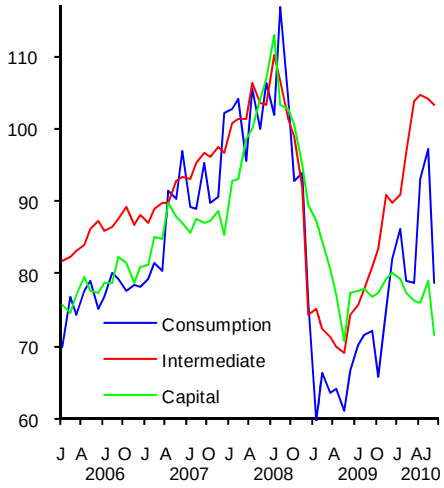
Graph 27
Installed Capacity Utilization: Manufacturing Sector
Percent



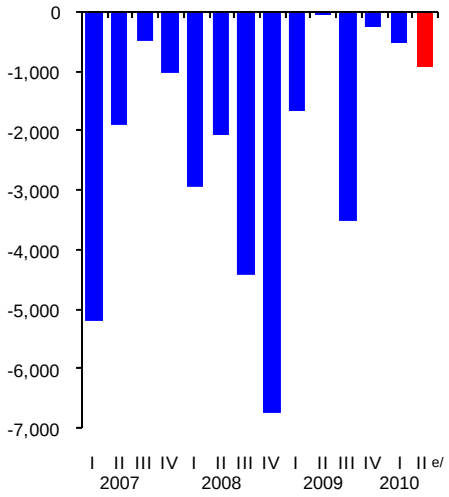
Source: Monthly Manufacturing Business Tendency Survey. Banco de México.

Graph 28
Imports of Goods and Current Account

a) Imports of Consumer, Capital and Intermediate Goods
Seasonally adjusted figures;
Index 2008=100



b) Quarterly Current Account
USD millions

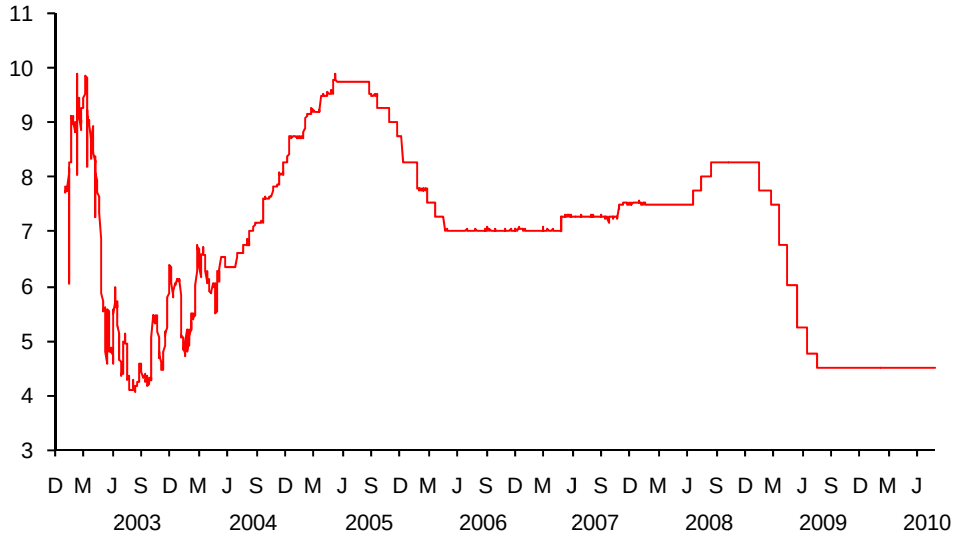


Source: Banco de México.
e/ Estimates.

5. Monetary Policy

During April, May, June, and July of 2010, Banco de México's Board of Governors left the overnight interbank rate target unchanged at 4.5 percent. This level has remained the same since July 17, 2009 (Graph 29).

Graph 29
Overnight Interbank Rate[1/]
Annual percent



1/ The target for the overnight interbank rate (Banco de México's operating target) is shown since January 21, 2008.

In the last months, monetary policy has faced an economic situation characterized by the following:

On the one hand, regarding inflation-mitigating factors:

1. As highlighted in the previous section, the economic conditions have prevented the incidence of widespread demand-related inflation pressures.

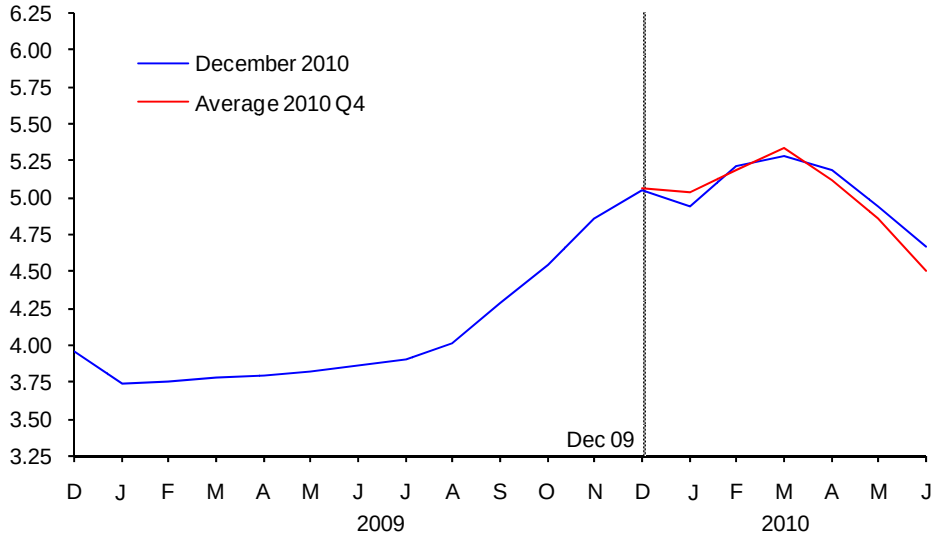
2. Wages have continued to grow moderately (Section 2.3). Therefore, firm's costs related to this factor have not been affected and, consequently, have not led to inflationary pressures.

3. Several economic policy actions carried out in Mexico, such as fiscal consolidation efforts and international reserve accumulation, improved the risk perception on the Mexican economy during the last months, as compared to other emerging economies. Indeed, although exchange rate volatility increased during May due to higher risk aversion in international financial markets, in June it stabilized and the exchange rate even showing a tendency to appreciate. The development of the exchange rate thus has not been a source of pressure for commercial goods' prices or for the costs of firms that use imported inputs.

4. Annual inflation expectations for the fourth quarter average of 2010 were revised downwards in recent months due to the favorable development

of headline inflation and its two components (Graph 30). The mean for economic analysts inflation expectations for the fourth quarter average of 2010 obtained from Banco de México's survey decreased from 5.33 percent in the March survey to 4.5 percent in the June survey.[12]

Graph 30
Annual Headline Inflation Expectations for 2010[1/]
Annual percent



1/ Expectations for average inflation for the fourth quarter of 2010 are calculated based on monthly expectations for each one of the following twelve months.
Source: Banco de México Survey.

On the other hand, regarding inflationary risk factors:

1. As mentioned in Sections 2.1 and 4, both the level and inertia of core services inflation remain relatively high.

2. Inflation expectations for December 2011 have not been revised downwards. The mean of economic analysts' expectations remained around 3.95 percent in Banco de México's survey of April, May, and June of 2010 (Graph 31a).[13] Additionally, inflation expectations for longer horizons remain above the target (Graph 31b).

   In addition to indicators of longer term inflation expectations drawn from the surveys, the compensation for inflation indicator (inflation expectations plus a risk premium) obtained from the difference between the nominal yield on 10-year bonds and the real yield of same term indexed debt instruments (Udibonos), remains around 3.95 percent (Graph 31c).[14]

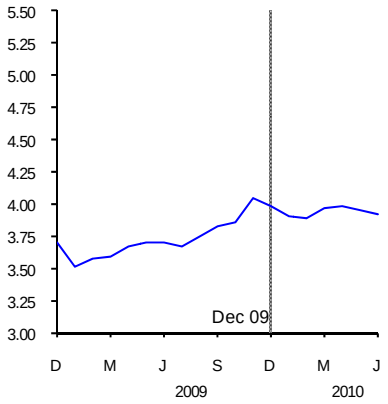
   The fact that medium and long-term inflation expectations continue above the inflation target could be related to two elements: first, the possible effects of public sector's price and fare policy, as already

[12] In the Infosel survey of March 26, expectations for the fourth quarter average of 2010 were 5.26 percent, while in the survey of July 23 they were 4.47 percent.
[13] In the Infosel survey of July 23, the average for inflation expectations for the end of 2011 was 3.81 percent.
[14] This type of indicators should be interpreted carefully due to its high volatility.

mentioned in this Report, and second, the inertia in core services inflation.

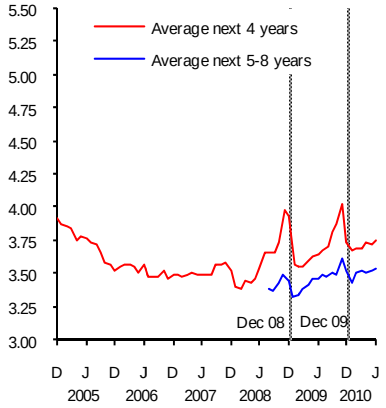
Graph 31
Annual Headline Inflation Expectations and Compensation for Inflation and Inflationary Risk on Long-term Bonds
Annual percent

a) Expectations for Annual Headline Inflation for 2011



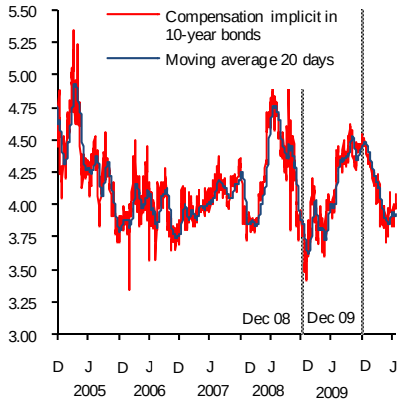
Source: Banco de México Survey.

b) Expectations for Annual Headline Inflation



Source: Banco de México Survey.

c) Compensation for Inflation and Inflationary Risk on Long-term Bonds [1/]



Source: Banco de México estimates with data from Bloomberg.
1/ Compensation for inflation and inflationary risk implicit in 10-year bonds are calculated on the basis of nominal and real interest rates from the secondary market.

Under these conditions, the yield curve flattened considerably during the last months. On the one hand, the short end of the curve has remained stable, given that the reference interest rate has not changed. In particular, interest rates on 3-month government bonds are around 4.6 percent. On the other hand, although longer term interest rates experienced some volatility during May, recently they declined considerably, reaching even lower levels than those observed at the end of the first quarter (before the fiscal problems in Europe worsened). Thus, the yield on 30-year government bonds declined from around 8.4 percent at the end of March, to around 7.4 percent recently (Graph 32). As a result, the slope of the yield curve (defined as the differential between the yield on 30-year and 3-month government bonds) declined by approximately 380 to 280 basis points during the referred period. This flattening reflects:

i) An improvement in the outlook for inflation which has led to a reduction in inflationary risk premia. Consequently, economic analysts have postponed the date they estimate the central bank will withdraw the monetary stimulus.

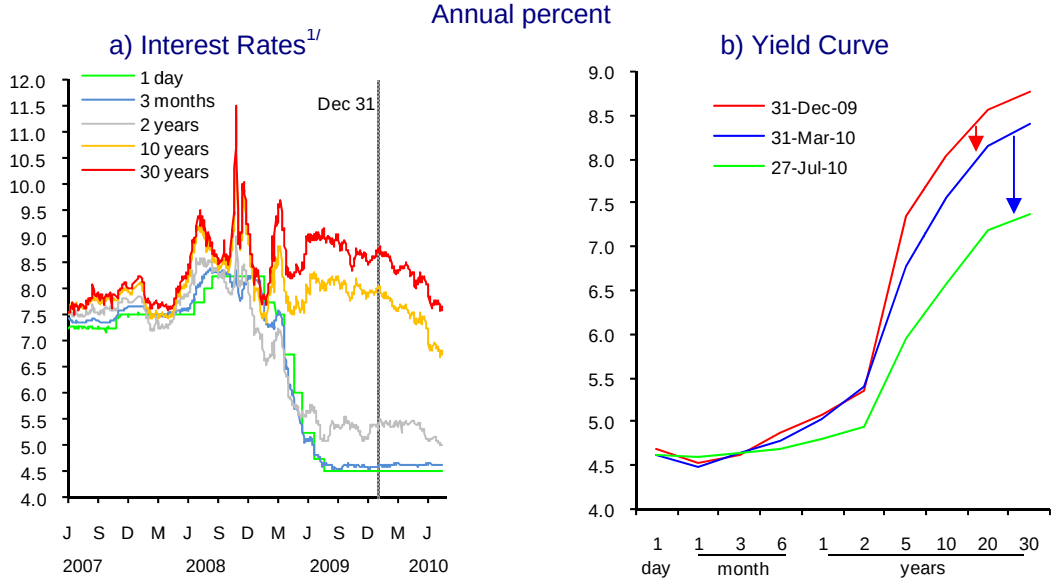
ii) The favorable development of economic activity in Mexico, which has enabled a reduction of the risk premia that had been demanded by investors during the lower stage of the business cycle (premia demanded to compensate for lower yields which are usually associated to this stage).

iii) The relative improvement of sovereign risk perception due to the strengthening of the macroeconomic policy framework that, among others, led to the inclusion of Mexican government bonds in Citigroup's

World Government Bond Index (WGBI), which has therefore raised the demand for Mexican government bonds in relation to sovereign bonds of other emerging economies.

iv) The flattening of the US yield curve as result of a decline in US long-term interest rates. This reduction reflects the low levels of both inflation and its expectations, the downward trend followed by core inflation, and an outlook of moderate growth, which have led to the perception that monetary policy in the U.S. and, in general, throughout the world, will remain accommodative for a long period.

Graph 32
Interest Rates in Mexico
Annual percent



1/Since January 21, 2008, the overnight (one day) interest rate refers to the target for the overnight interbank rate (Banco de México's operating target).

6. Inflation Forecasts and Balance of Risks

The macroeconomic scenario forecasted by Banco de México for the next months is based mainly on expectations that US industrial activity will continue following a positive trend, albeit at a slower rate than during the first half of the year. In particular, economic analysts' forecast average for both industrial activity and GDP growth in that country for 2010 stand at 5.4 and 3.1 percent, respectively,[15] while both indicators are expected to grow at the slightly lower rates of 4.7 and 3.0 percent, respectively, in 2011.

GDP Growth: During the rest of the year and in 2011, external demand is expected to continue providing a stimulus for Mexico's growth. This, together with the gradual recovery of domestic demand, suggests a similar scenario to that presented in the Inflation Report of January - March 2010. Therefore, the expectation that real GDP will grow between 4.0 and 5.0 percent in annual terms in 2010 and between 3.2 and 4.2 percent in 2011 remains unchanged.

GDP is therefore anticipated to exhibit a positive performance for the remainder of the year and for 2011, albeit growing at a more moderate pace than in the second quarter of 2010, when it is expected to exhibit a high quarterly rate (Graph 33). This scenario suggests that the output gap will remain negative during the year. Nevertheless, there is a small probability that it could turn positive during the first half of 2011 (Graph 34).[16]

Employment: The number of IMSS-insured workers is expected to increase in annual terms between 525 and 625 thousand in 2010 and between 500 and 600 thousand in 2011.

Current Account: The recovery of domestic demand and productive activity in 2010 will translate into a higher deficit in the trade and current account balances as compared with 2009, although the dynamism that exports are expected to continue registering will keep such deficits at low levels. Both deficits are therefore anticipated to reach USD 7.9 and 8.3 billion, respectively (0.8 percent of GDP in both cases), as compared with the USD 4.6 and 5.5 billion deficit, respectively, registered in 2009 (0.5 and 0.6 percent of GDP, in the same order).

Given the low deficit in the current account expected for 2010, the currently foreseen conditions to access international financial markets, and the end of the federal government's refinancing program for 2010, the Mexican economy is not anticipated to face foreign financing problems for the remainder of the year. The different measures implemented to mitigate the effects on the economy that might arise from an eventual upsurge of new episodes of volatility and uncertainty in international financial markets should also contribute to the aforementioned. Together with the recent fiscal consolidation efforts, worth

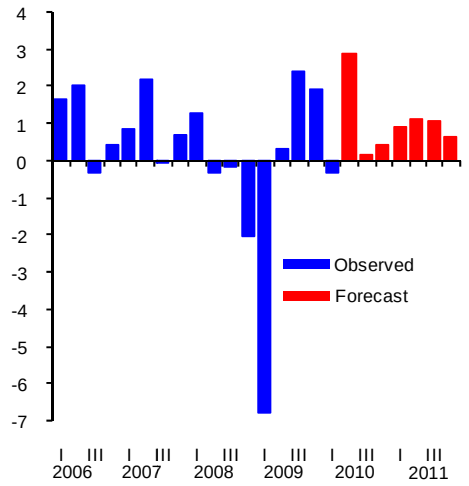
[15] Analysts' forecasts for US industrial activity and GDP growth from Blue Chip Economic Indicators of July 2010.

[16] These estimates were calculated using the Hodrick-Prescott (HP) method with tail corrections and an unobserved components model. These methods are described in Banco de México (2009), "Inflation Report April – June 2009", p.69.

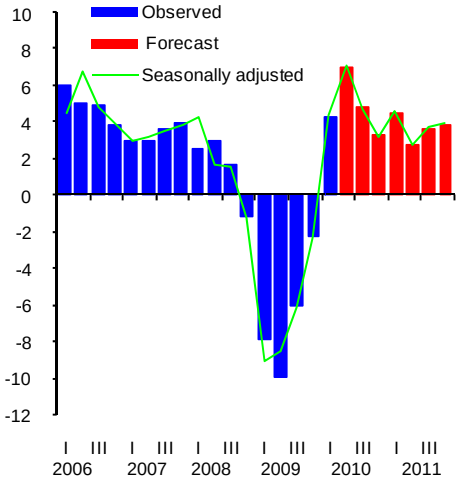
mentioning are the accumulation of international reserves, the acquisition of the oil hedge, and the Flexible Credit Line with the International Monetary Fund.

Graph 33
Gross Domestic Product

a) Quarterly change in percent; seasonally adjusted figures

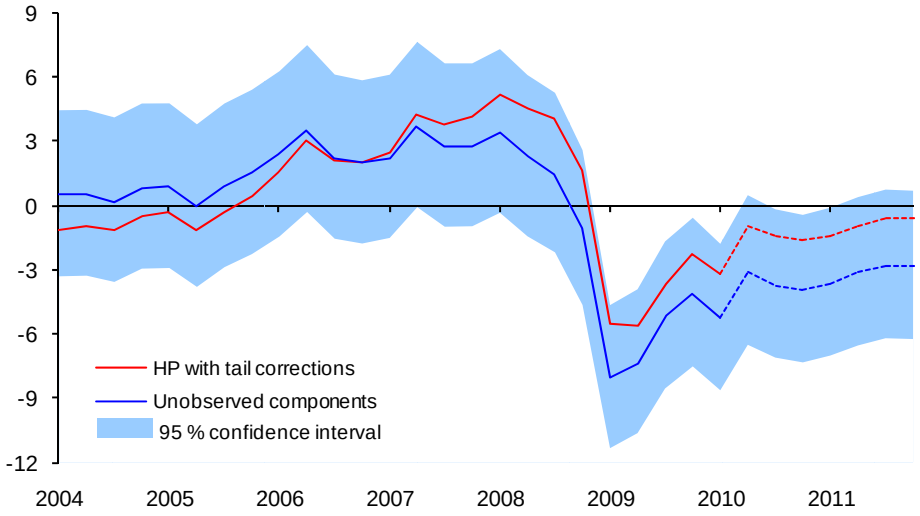


b) Annual change in percent



Source: INEGI.
Banco de México's forecast since Q-II 2010.

Graph 34
Output Gap Estimates
Percent



The expected scenario for economic growth in 2010 and 2011, however, is not free of risks. In fact, the current economic situation of various countries in the euro zone suggests that the downward risks for global economic growth have increased:

I. The perception that world economic growth -especially in advanced economies- has relied in an essential manner on the policies supporting aggregate demand that were implemented in response to the recession

resulting from the financial crisis in 2008, prevails. Under these circumstances, there is uncertainty about the possible impact of an impending withdrawal of these stimuli on private demand in these economies.

II. The outlook for the US economy seems to be unusually uncertain. In particular, it is worth highlighting the weakness of the labor market and the fact that the incipient improvement of financial conditions in this country has yet to be a factor to encourage private spending. Therefore, there is still the risk that a slow increase in consumption will be reflected in a less vigorous demand for Mexican exports.

III. Finally, up to now, the recent volatility observed in international financial markets has not significantly affected the growth prospects in emerging economies. Nevertheless, a further deterioration in these markets could affect the access to financing in these economies.

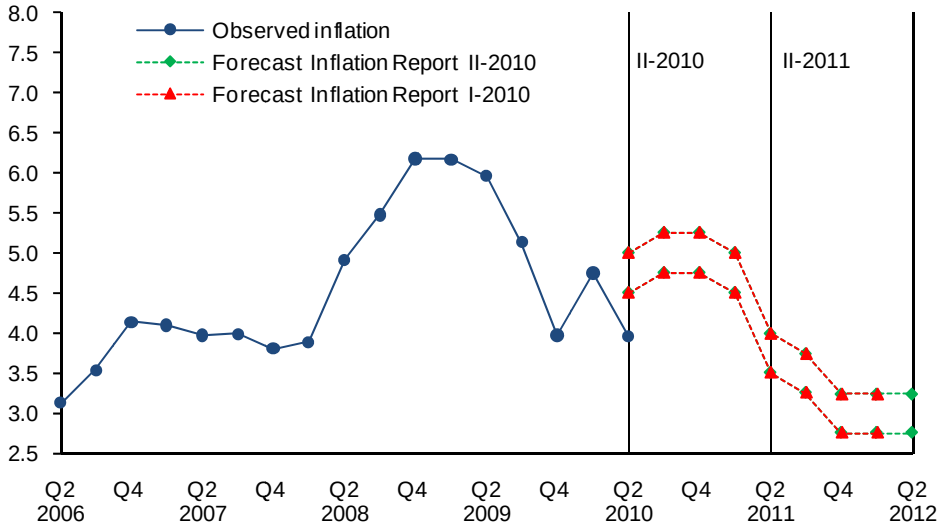
Inflation: The estimated trajectory of annual headline inflation for the following two years remains unchanged in regards to that published in the Inflation Report of January – March 2010. Thus, inflation is expected to rebound towards the end of the year in line with the foreseen trajectory, and then decline in 2011 in order to converge to the inflation target by the end of 2011 (Table 3 and Graph 35).

Table 3
Base Scenario Forecast for Annual Headline Inflation[1/]
Quarterly average in percent

Quarter	Forecast Inflation Report 2010-I	Forecast Inflation Report 2010-II
2010-II	4.50 - 5.00	3.96 [2/]
2010-III	4.75 - 5.25	4.75 - 5.25
2010-IV	4.75 - 5.25	4.75 - 5.25
2011-I	4.50 - 5.00	4.50 - 5.00
2011-II	3.50 - 4.00	3.50 - 4.00
2011-III	3.25 - 3.75	3.25 - 3.75
2011-IV	2.75 - 3.25	2.75 - 3.25
2012-I	2.75 - 3.25	2.75 - 3.25
2012-II	----------	2.75 - 3.25

1/ In each Inflation Report, the forecast horizon covers the following 8 quarters. For this reason, on each occasion, one quarter (the eighth) is added to the forecast, as compared with the first quarter of the previous Report, where it becomes an observed figure.
2/ Observed figure.

Graph 35
Forecasts for Annual Headline Inflation
Quarterly average in percent



During the second quarter of 2010, inflation has exhibited better results than expected. Part of this improvement is due to seasonal and conjunctural factors. Nevertheless, core inflation, especially the merchandise component, has also exhibited more favorable results. This is mainly the result of two factors: a reduction in exchange rate's volatility and exchange rate's tendency to appreciate, and, second, the increased competition among various retail chains (Box 1).

Although the trajectory of inflation could improve as compared with that anticipated for the second half of the year, Banco de México decided to leave the forecasted trajectory unchanged until more information on the third quarter is available. Nonetheless, by the end of the year, annual inflation is anticipated to increase, although possibly less than as forecasted by Banco de México, due to:

1. A lower base of comparison in the core housing component associated with the decline in steel prices in 2009.

2. A greater contribution of administered and regulated prices to annual headline inflation. This result would be partly due to the resuming of the government's programmed increments in energy prices aimed at diminishing the misalignment between domestic and international energy prices in order to reduce both fiscal and economic costs. On the other hand, administered and regulated prices could have a higher incidence on inflation if public transportation fares for certain routes in Mexico City's metropolitan area continue to be revised.

3. The increase in the annual inflation of fruits and vegetables at the end of 2010 as a result of the lower base of comparison observed in the last two months of 2009. Furthermore, the significant decline in the growth rate of agricultural prices during the second quarter could revert, due to the volatility usually implicit in these price quotes, originated by the weather conditions that affect the supply of these products.

The forecast of a downward trend in annual inflation in 2011 is based on the following considerations:

i. The tax changes approved by Congress for 2010 affected temporarily the prices of goods and services directly associated with these changes.[17] Thus, during the first quarter of 2011, this effect is expected to fade from annual inflation estimates.

ii. The annual growth rate of administered prices is not expected to exhibit in 2011 the same arithmethic effect observed in 2010, by adjusting from 0 to positive levels. This will contribute to reduce annual inflation, in view that with the resuming of the government's policy of programmed increments in energy prices, the base of comparison for calculating inflation's annual change will not be low, as in 2010.

iii. Prices and fares determined by local governments are expected to contribute less to inflation in 2011, since no changes of similar magnitude like those observed in 2010 are foreseen next year.

iv. Wage increases have been moderate.

The inflation forecast is subject to several risks. Among the most important are:

a) Weather conditions that might affect the supply of fruits and vegetables and, therefore, their prices.

b) A higher than expected rate of recovery of the Mexican economy could increase demand-related pressures, and viceversa.

c) The exchange rate could be affected if conditions in international financial markets deteriorate.

d) That services inflation remains high and exhibits some inertia.

e) Inflation expectations for the medium and long terms remain above the 3 percent inflation target.

Considering the aforementioned, together with inflation exhibiting better results than those forecasted, the balance of risks for inflation has improved.

Regardless of the above, Banco de México's Board of Governors will continue to monitor the path of medium- and long-term inflation expectations, the velocity at which the output gap closes, and other inflation determinants that might signal unexpected and widespread pressures on prices. All of this so that, in such an eventuality, the central bank adjusts its monetary policy stance in order to achieve the 3 percent inflation target by the end of next year.

Finally, as in other occasions, it is relevant to emphasize that several microeconomic factors have affected unfavorably the level of inertia that inflation

[17] The Inflation Report of January – March 2010 presents evidence on the absence of second round-effects in the price formation process related to the tax adjustments approved by Congress for 2010 (see Box 1, pp.6,7).

exhibits, hindering the convergence of inflation to Banco de México's target. Two features of the Mexican economy are particularly relevant in this regard: the lack of economic competition in some markets and the presence of various rigidities in the labor market. Under these circumstances, it is imperative to continue the structural economic reform process. This would not only lead to a greater flexibility in the price formation process and hence reduce the costs related to the disinflation effort -which are required to attain the central bank's target- but would also result in a more efficient allocation of economic resources and, therefore, in a higher growth potential.