

Inflation Report

January - March 2007

Summary

The world economy recorded high growth during 2006. The pace of the global economic expansion is expected to slowdown gradually in 2007. A favorable performance is nevertheless anticipated. As for the U.S., incoming information suggests that the slowdown in activity could be beyond the scenario projected by analysts at the beginning of the year.

World inflationary pressures are foreseen to diminish in 2007, due to the phase of the world business cycle and as a result of prospects of lower energy prices as compared with 2006. These developments have contributed to maintain inflation expectations in industrialized countries anchored.

The combination of greater risks of a reduction of U.S. economic growth and inflationary risks that have not changed significantly, have contributed to increased liquidity in international financial markets. Thus, both the prices of several assets and currencies of emerging economies have exhibited positive results.

During the first quarter of 2007, the Mexican economy continued to show signs of slower growth rates, in line with the business cycle phase the U.S. is currently undergoing. In particular, production indicators weakened, mainly due to the lesser dynamism of external demand. As for domestic demand, consumption and investment expenditure continued growing, although at slower rates.

Since mid-2006, inflation has been affected by a number of consecutive supply shocks, which have prompted an increase in both annual headline and core inflation. As mentioned by Banco de México, the referred shocks have concentrated on a few products and their effect should be reflected in changes in relative prices. However, their magnitude, the fact that they have materialized in a short period, and the high weight of the prices of the affected products on the Consumer Price Index (CPI), have made annual headline inflation fall above the upper limit of the variability interval set around the 3 percent target.

The price increases of sugar and corn-tortillas stand out, affecting core inflations' merchandise component. In the case of corn-tortillas, although the price increases originated from the rise in corn's international price references, they were intensified by various distortions characterizing the corn-tortilla production chain. Under such conditions, during the first quarter of 2007, the federal government implemented several measures to foster an adequate supply of corn and an ordered determination of prices. On April 25, 2007 the Agreement to Stabilize Corn-tortilla Prices was extended to August 15, 2007.

During the first months of the year, the aforementioned shocks led the central bank to revise upward its inflation prospects for 2007. In particular, annual headline inflation is expected to be between 4 and 4.5 percent up to the third quarter of the year, and between 3.5 and 4 percent at the end of 2007. As for annual core inflation, it is expected to follow a declining trend, ending the year between 3.5 and 4 percent.

Recent Developments in Inflation

During the first quarter of 2007, annual headline inflation was high, mainly as a result of supply shocks that took place since mid-2006 and whose effects have not dissipated yet. Just like in the previous quarter, inflationary pressures continued to concentrate on a few products, such as corn-tortillas, sugar, cigarettes, and onions. Annual headline inflation reached 4.21 percent in March 2007 (in December 2006, it was 4.05 percent).^{1/}

These supply shocks affected mostly core inflation. In particular, the annual price variations of certain food, beverages and tobacco items increased significantly,

^{1/} In the first half of April, the Consumer Price Index recorded a variation of -0.21 percent and an annual variation of 3.96 percent. This result is mainly explained by non-core inflation, which recorded a -0.70 percent variation that was due to a greater-than-seasonally-expected decline in the last years of electricity tariffs corresponding to the beginning of the summer season. Up to 2006, hot-weather electricity tariffs began in February in the city of Tapachula; in April, in 13 cities of the center-south region of the country; and in May, in 13 cities of the north region. Nonetheless, based on the temperature records, the Federal Electricity Commission (*Comisión Federal de Electricidad*, CFE) reclassified the cities of the CPI located in the states of Coahuila and Nuevo León so that they could start applying the referred tariffs in April when, as mentioned previously, they had traditionally done so in May. This led to a 0.16 percentage point reduction in inflation of the first half of April and in its corresponding annual rate. For details on CFE electricity tariffs and their going-into-effect date, refer to <http://www.cfe.gob.mx>.

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making annual core inflation reach, in February 2007, 3.95 percent, its highest level in five years. This indicator started to decline since March, reaching 3.83 percent in that month. Excluding the items affected by the supply shocks (corn-tortilla, sugar and cigarettes) from the basket of core prices, and normalizing the weights of the rest of the items of that basket to add to one hundred, core inflation's annual variation in March would have been 3.45 percent.

The annual inflation of the merchandise subindex increased from 3.38 percent in December 2006 to 3.78 percent in March 2007. This was mainly due to the price behavior of corn-tortillas, cigarettes, and sugar. Prices of corn-tortillas recorded an annual variation of 14.31 percent at the end of the first quarter of 2007, albeit having recorded a higher annual variation in January (19.13 percent). Due to the importance of this item in households' expenditure, the referred increase affected inflation significantly.

The increase in corn-tortilla prices between September 2006 and the first half of January 2007 originated from the hike in corn's international price references. Nonetheless, this increase escalated due to several distortions in the corn-tortilla production chain. The Agreement to Stabilize Corn-tortilla Prices between the federal government and various participants related to the corn-tortilla industry interrupted this upward trend. The Agreement, valid from January 18 to April 30, 2007, determined maximum prices for corn-tortillas and their raw materials (corn and flour). Additional duty free import quotas for corn were also authorized. On April 25, the federal government and corn industry representatives renewed this Agreement to August 15, 2007.

On March 2007, sugar prices increased 28.95 percent in annual terms. As a result, the contribution of this item to core inflation remained high. Domestic prices of sugar behaved differently than their international references. At the end of the first quarter of 2007, international prices of sugar were at a level similar to that observed in December 2005, completely reverting the price increase that took place during the first quarter of 2006. In contrast, in March 2007, domestic wholesale prices of sugar were 21 percent above their level in December 2005, and 125 percent above their international reference.

The annual variation of the services subindex increased marginally, from 3.87 to 3.89 percent between December 2006 and March 2007. This was due to two offsetting trends: a) a greater contribution of services prices, of both food outlets and travel packages (in the case of the latter, due to a change in the starting week of the Easter season, as compared to

the previous year); and, b) a reduction in the annual variation of housing-related services, as the effects of the shocks that affected the prices of materials manufactured from steel and copper began to dissipate.

In March 2007, annual non-core inflation reached 4.98 percent, figure similar to that observed at the end of the previous quarter (4.96 percent). This result originated from the high variation in the agriculture subindex prices (8.67 percent). The latter was also the result of a diminished supply of lemons and onions due to damaged crops originated by adverse weather and, in the case of onions, to a lesser number of crops that were cultivated because of the low selling prices of this vegetable in previous years. Price variations of eggs and poultry also increased due to the higher costs of prepared feed meals. The significant reduction in tomato prices limited the aforementioned increases.

Main Determinants of Inflation

International Environment

The world economy grew significantly at the beginning of 2007, albeit seemingly less vigorously than in the last quarter of 2006. The main economies performed differently. In the U.S., economic activity continued to be affected, among other factors, by weak investment, especially in residential construction. Available information suggests that these developments took place as activity in other advanced economies exhibited sound growth –although at a less vigorous pace than in the previous quarter- and emerging economies grew robustly. The continuation of moderate wage pressures and the slowdown in global growth favored the containment of inflationary pressures and kept inflation expectations anchored, despite the volatility of oil prices. Under this context, and except for a brief episode of financial volatility in the middle of the quarter, conditions in international financial markets continued to be positive for issuers from emerging market economies.

Aggregate Demand and Supply in Mexico

During the first quarter of 2007, economic activity grew moderately. The incipient signs of slowdown exhibited by GDP and aggregate demand during the second half of 2006 were more evident in the first months of the year, extending to all of their components. The main aspects characterizing aggregate demand during the first quarter of 2007 were: i) both components of aggregate demand –domestic and external- grew at slower annual rates; ii) within domestic demand, the moderate expenditure in consumption exhibited during the last quarter of 2006 continued during the first

quarter of this year; iii) investment continued to grow significantly, but below the figure recorded in the last quarter of 2006 (which was the lowest observed during the entire 2006); and, iv) exports of goods and services recorded a moderate annual variation, as a result of a greater slowdown of external demand as compared to the second half of 2006.

During the first months of 2007, external conditions did not contribute –as they had done so from 2004 to 2006- to the growth of both domestic expenditure and domestic production. First, the slowdown of external demand –particularly that from the United States- worsened during the first months of the year, affecting Mexican exports negatively. Second, export-oriented automotive production decreased worldwide in annual terms. Third, the oil trade balance surplus declined significantly as compared to the same period of last year. Finally, although workers' remittances increased during the first quarter of 2007, they did it at a more moderate rate than in previous years. Incoming information suggests that public expenditure for the first two months of 2007 could have grown in annual terms more moderately than during the same period of the previous year. This would imply that this component of aggregate demand might have contributed, at the margin, to slower GDP growth as compared with the same period of 2006.

Costs and Prices

During the first quarter of 2007, firms under federal jurisdiction negotiated with their workers an average wage increase of 4.2 percent, while in the same period of the previous year, 4.3 percent. This confirms that up to now, wage negotiations have not been significantly affected by the recent developments in inflation.

At the end of the first quarter of 2007, the subindex of administered prices recorded an annual variation of 3.43 percent, as compared to 4.42 percent in December 2006. This reduction stemmed from developments in the prices of goods and services that are not fixed according to a predetermined rate of change. In particular, the fall in prices of the following goods deserves mention: gasoline at border cities, natural gas (set according to its international reference), and high consumption electricity tariffs (Tarifas Eléctricas de Alto Consumo, DAC). The sharp reduction in DAC tariffs was due to some factors that affect their calculation formula, particularly the decline in fuel-oil prices and in metal products inflation.

During the analyzed period, international prices of grains recorded moderate growth as compared to the last quarter of 2006. In particular, corn's international prices increased 6.8 percent during the first three

months of 2007, while in the previous quarter, it did so at an annual rate of 60.8 percent. At the moment of writing this Report, corn, wheat, and soy's futures prices were above their current prices, especially wheat and soy.

Monetary and Credit Aggregates

During the first months of the year, the rate of growth of the monetary aggregates followed a downward trend. In February 2007, the monetary aggregate M1 recorded an annual variation of 11.7 percent, compared to an average growth of 15.7 percent during the entire 2006. The stock of M2 grew at a real annual rate of 7 percent, 3 percentage points below its average growth in 2006. The growth of M2 was the result of a real annual increase of 7.2 percent in voluntary savings and 6.4 percent in compulsory savings. Compulsory savings are resources from the retirement funds savings system (*Sistema de Ahorro para el Retiro*, SAR) invested in domestic financial instruments. The increase in compulsory savings has been negatively affected by the fact that, during the last year, there has been an increase in SAR resources invested by Siefors in instruments that are not included in the monetary aggregate M2, particularly in variable-income securities (stocks), government securities issued abroad (UMS bonds), and foreign securities.

Monetary Policy Actions

The inflationary outlook in Mexico has been affected in the last months by various supply shocks, which have affected both annual headline inflation and annual core inflation. In particular, the fact that the referred shocks have materialized in a short period, their magnitude, and the importance (in terms of weight) of the affected prices in the CPI, have prompted annual headline inflation to be, in the last months, above the upper limit of the variability interval for the 3 percent annual inflation target.

As a result of the effects of supply shocks on headline and core inflation, expectations for inflation for the end of 2007 from Banco de México's survey were revised upward: from 3.50 percent in the December survey to 3.68 percent in March (headline inflation), and from 3.30 to 3.57 percent (core inflation). Although inflation expectations for medium and longer terms remained stable during the quarter, they remain above the 3 percent target and at relatively high levels. Expectations for headline inflation for the end of 2008 and 2009, and for the average for the following 4 years have remained around 3.5 percent. Expectations for core inflation for the end of 2008 have remained close to 3.3 percent.

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The latter suggests that although supply shocks have affected both headline and core inflation, their impact on analysts' inflation expectations has concentrated on horizons under twelve months. Inflation expectations for longer horizons have remained relatively stable, although around half a point above the 3 percent target for annual headline inflation.

Although there seems to be no significant evidence of contamination in the price determination process, some food prices have been affected. In addition, some elements that have been included in the balance of risks for inflation have gained importance. In particular, the increase in uncertainty associated with the determination of prices of some products, particularly corn-tortillas and other foods that use various grains as inputs, in a context where volatility of their international reference prices has increased. The prevision that annual headline inflation will be above the variability interval for a long period has also increased risks of contamination in the price and wage determination processes.

As a preemptive measure, the Board of Governors deemed convenient to strengthen the monetary policy stance. Thus, after having kept the monetary conditions unchanged in January, February and March, the Board decided in April to tighten monetary conditions by 25 basis points. As a result, the bank funding rate reached 7.25 percent at the end of April. The purpose of adopting a tighter monetary stance is to have a better balance in terms of inflationary risks and to prevent inflation expectations, prices and wages from being affected by the supply shocks that have taken place. With this measure, Banco de México confirms its intention to reach the 3 percent inflation target.

In the last months, international financial markets have remained loose. Nonetheless, towards the end of February an episode of volatility arose, mainly as a result of the perception of a worsening outlook for U.S. growth. As a result, long-term interest rates in Mexico increased significantly during the first weeks of March, generating a steepened yield curve. Later, when volatility dissipated, the referred increases in long-term yields in pesos began to revert gradually.

Balance of Risks and Final Remarks

Based on the aforementioned macroeconomic environment, and on most recent information on the Mexican economy, Banco de México's baseline scenario for 2007 is as follows:

Growth: Between 3 and 3.5 percent; thus implying a downward adjustment in relation the previous Inflation Report (between 3.25 and 3.75 percent).

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

Current Account: Current account deficit of around 1 percent of GDP.

Inflation: Since mid-2006, the economy has been affected by a sequence of adverse supply shocks. These shocks basically reflect changes in relative prices and, therefore, are not expected to contaminate the price and wage determination processes. Nonetheless, some of these shocks seem to have lasting effects on annual inflation, which will continue for twelve months since the moment they arose. Under this context, headline inflation is expected to be between 4 and 4.5 percent up to the third quarter of the year, and then fall to between 3.5 and 4 percent at the end of the year. Core inflation is also expected to follow a downward trend, reaching at the end of the year an annual rate of change between 3.5 and 4.0 percent. In particular, the following stands out:

a) The recent development of the merchandise subindex was determined mainly by the shocks that affected the prices of few products, such as corn-tortillas, sugar, and cigarettes. In absence of additional shocks, these effects will begin to disappear from annual merchandise inflation calculations starting September. To a great extent, this result will depend on the stability of corn-tortilla prices. On April 25, 2007 the agreement to stabilize corn-tortilla prices was extended to August 15.

b) Prices of non-food merchandise have been growing at a relatively stable rate since 2002, fluctuating slightly above 2 percent. This trend is expected to continue.

c) The subindex of housing services was subject to upward pressures in 2006 due to price increases in copper and steel construction materials. The effect of this shock on the annual variation of this subindex appears to have started to dissipate, being a determining factor for the decline in core inflation up to August.

d) As for non-housing services prices, their annual variation could continue to fluctuate around 4 percent, although with some volatility.

Summing up, the expected decreasing trend for annual core inflation will depend, mainly, on the development of corn-tortilla prices, on the end of inflationary pressures originated by grains international prices, and

on a reduction in the annual variation of the housing subindex.

e) The dynamics of the non-core index will continue to be determined by the development of fruits and vegetables prices. The incidence of these prices on headline inflation could increase during the second quarter of the year, due to their low levels recorded during the same period of the previous year.

f) The annual variations of livestock prices will increase during the rest of the year. This is due to the low prices observed in 2006 and costs pressures originated by the higher prices of grains.

g) Since no considerable changes are expected in the elements that are used to determine administered prices, the latter will not pressure inflation significantly. Regulated prices, however, could grow at a faster rate due to the latest update to public transportation fares in some cities.

Up to now, the development of headline and core inflation has remained, in general terms, in line with its anticipated path, and no significant evidence of contamination in the price determination process has been revealed. However, some food-related prices have been affected. In addition, the following must be considered:

i) The uncertainty associated with the price determination of some products, particularly corn-tortillas and other foods that use various grains as inputs, has increased.

ii) Expectations that inflation will remain above the variability interval for a long period of time increase the risk of contamination in the price and wage determination processes.

iii) International prices of grains and certain commodities have been subject to pressures and their volatility has increased. Energy prices have fluctuated markedly.

iv) Services prices continue to grow at a high rate.

v) Inflation expectations remain above the 3 percent target.

Consequently, although the slowdown of economic activity is a factor that could contribute to mitigate the abovementioned risks, the Board of Governors deemed convenient to strengthen the monetary policy stance as a preemptive measure. After keeping the monetary conditions unchanged during the first quarter, in April it decided to tighten them by 25 basis points. The purpose of this action is to achieve a better

balance in terms of inflationary risks and to prevent the price and wage determination processes from being affected by the supply shocks that have taken place. With this measure, Banco de México aims to strengthen inflation's converging trend to its target.

Other risk factors also prevail that could affect mainly the base scenario for GDP growth.

The main risk for the world economy and, particularly, for the Mexican economy, is the possibility that the U.S. growth rate slows down more than expected. In the last months, growth expectations and the balance of risks for economic activity in that country have been affected by the weakening of the real estate market. If this sector undergoes a greater adjustment, household spending could be affected considerably, thus reducing the U.S. demand for foreign products, including those from Mexico. Expectations for industrial growth in the U.S. have also been revised downward in the last months. This decline in production could be more significant if the cyclical slowdown of demand for durable goods aggravates or if firms' investment expenditure weakens further, thus affecting considerably Mexican exports.

In the short term, the balance of risks for growth also considers the possibility of public expenditure contributing less to the expansion of aggregate demand (as compared with last year), as has been the case when a new administration is installed.

Finally, Banco de México has emphasized for several years the importance of attaining the necessary agreements to flexibilize the country's productive sector and adjust the structure of incentives faced by the Mexican society in several aspects. This would boost both competitiveness and economic growth to take full advantage of the country's development opportunities. The reforms to the public workers' social security law (Ley del ISSSTE) in the last weeks have made progress in this direction. The legal and incentives framework must be adjusted continually, in order to revert the loss of competitiveness the economy has undergone in the last years. Progress in this direction will increase the possibilities of higher economic growth and more and better jobs.