

# Inflation Report

## *July - September 2006*

# Summary

**T**he prospects for world economic activity continue to be positive. Nonetheless, the rate of growth of the world economy is expected to slow down gradually. The recent deceleration of the U.S. economy might have been partly mitigated by the reduction in gasoline prices and by higher employment and its effect on private consumption. These developments have contributed to ease the effect of falling real estate prices on household income. On another front, economic recovery in Europe and Japan continued, while the emerging economies, particularly those from Asia, continued to exhibit a favorable performance.

As a result of world economic growth, some developed economies have increased their resource utilization. Nonetheless, as already mentioned, the perception that the U.S. economy is currently at the mature stage of its cycle prevails. Consequently, the U.S., and, therefore, the world economy, is foreseen to grow more moderately. Under such context, international prices of oil and other commodities have started to cease, despite the fact that they still remain at relatively high levels. In balance, although concerns of a new upturn in world inflation prevail, expectations for the medium and long terms in most economies have not been affected, thus remaining well anchored.

This environment has prompted long-term interest rates in the U.S. to decline, which, in turn, has contributed to the recovery of asset prices and currencies of most emerging economies. The performance of financial markets in Mexico during the third quarter reflected both the reduction of risk premia in international capital markets and the dissipation of uncertainty regarding Mexican elections this year. As a result, long-term interest rates decreased, hence leading to a flattening of the yield curve.

Under such conditions, Mexico's economic activity continued to expand. In particular, all components of aggregate demand exhibited positive results: on the domestic side, the strength of consumption and the dynamism of investment stand out; on the external side, the increase in manufacturing exports,

especially from the automotive industry, deserve mention. Domestic expenditure continues to be favored by the higher revenues from workers' remittances and oil exports.

As for recent developments in inflation, during the third quarter of the year, supply shocks arose, generating a rebound in annual headline inflation. Among these, adverse weather conditions that affected the tomato harvest in Mexico's Northwest region; also, sugar supply problems; and, the increase in tortilla prices by some retailers. These phenomena prompted annual inflation to climb to 4.09 percent in September, 91 basis points above June figures.

In the following two months, the effects of these factors will add to the anticipated rebound in annual headline inflation, due to a reduced base of comparison. In October and November of the previous year, the annual variation of fruits and vegetables' prices was atypically low. Consequently, annual headline inflation is expected to remain close to 4.5 percent in those months, and then follow a downward trend.

Since the referred shocks are temporary, they are not expected to affect inflation expectations for 2007 and the following years. In fact, although inflation expectations for the end of 2006 have been revised upward, those for the medium and long terms have remained stable.

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

At the end of the third quarter, annual headline inflation was 4.09 percent, 0.91 percentage points above June figures. This rebound is mainly explained by the behavior of tomato (0.56 points), sugar (0.07 points), and tortilla (0.06 points) prices. Prices of these products, which have a high weight in the Consumer Price Index (CPI), were affected by supply shocks. In the former case, these were attributed to weather factors, while in the last two cases, to various problems related to the commercialization of both products.

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The trajectory of sugar and tortilla prices affected the development of the core component of the CPI, while the path followed by tomato prices affected the non-core component. Thus, in September, the annual variations of the core and non-core indexes were 3.45 and 5.44 percent (in June, these figures were 3.22 and 3.12 percent, respectively). Sugar prices accumulated an increase of 28.7 percent during the referred quarter, associated with a strong reduction in the level of inventories. In response to this situation, the Ministry of the Economy, authorized, starting August 30, sugar import quotas, as a complement to domestic supply. This measure, together with the new sugar cane harvest cycle that starts in November, suggests that during the next months, sugar price increases could revert.

During the third quarter, tortilla prices accumulated an increase of 4.73 percent. Two elements apparently influenced this upward movement: i) a reduction in field corn inventories, due to the unexpectedly high level of field corn grain exports, which raised uncertainty regarding the supply for the domestic market; and ii) significant price increases in some retail outlets.

The annual variation of the core services subindex increased 0.08 percentage points between June and September. Considering the two components that make up this subindex, housing and rest of services, the annual growth rate of the former remained practically unchanged at 3.89 percent in September (in June this figure was 3.88 percent). As for the latter component, it increased 0.15 percentage points, reaching 4.21 percent in September (4.06 percent in June). In this case, 0.13 percentage points of the increase was attributed to the item travel packages, whose annual price variation increased, mostly, as a result of the increase in fuel-oil prices, which also affects air transportation fares.

Annual non-core inflation results explained, for the most part, the increase exhibited by annual headline inflation during the third quarter of 2006. This was mainly due to the development of fruits and vegetables' prices, whose annual variation was determined by two factors: first, the significant increases in the prices of some vegetables such as tomato, whose supply was affected by plagues, heavy rain, and hurricane Lane; and second, by the fall of certain products' prices recorded during the same period of the previous year, which led to a lower base of comparison to calculate annual inflation.

A factor that also affected the CPI non-core component was the subindex of livestock products,

whose annual variation fluctuated from -0.83 to 0.89 percent between June and September. The result was influenced by price increases in eggs, poultry, and beef. In contrast, the annual variation of the subindex of administered and regulated prices declined from 4.54 to 4.35 percent between June and September. Regulated prices were affected by the increase in public transportation fares, while administered prices reflected the reductions in the prices of natural gas and gasoline in certain border cities. Finally, the price subindex of private education recorded an annual variation of 5.70 percent in September, 0.81 percentage points below its level in June.

## **Main Determinants of Inflation**

### *International Environment*

The world economy apparently grew soundly during the third quarter of 2006. Most recent data suggests that, parallel to the slowdown of the U.S. economy, the European and Japanese economies continued to recover, while emerging market economies, particularly those of Asia, exhibited a favorable performance. On another front, the moderation in the U.S. growth rate has contributed to reduce upward risks on inflation. The latter has been also influenced by the downward adjustment in oil prices as compared to their levels in June and August. Under such context, after the volatility episode during the second quarter, during the July-September period, long-term interest rates in international markets declined, stock markets rebounded, and emerging economies' sovereign debt margins declined.

### *Aggregate Demand and Supply in Mexico*

Several indicators suggest that during the third quarter of 2006, economic activity in Mexico grew significantly at an annual rate, albeit slightly below that recorded during the first half of the year. In general terms, aggregate demand was characterized by the following aspects: i) both components of aggregate demand –domestic and external- grew significantly at an annual rate; ii) within domestic demand, consumption expenditure grew, but not as dynamically as in the first half of the year; iii) investment increased markedly; however, its annual growth slightly slowed. Imported goods continued to be the most dynamic component of investment; and, iv) exports of goods and services grew at a rate close to that exhibited during the first half of the year, despite the slowdown of U.S. imports, Mexico's main export market. Domestic expenditure in Mexico was favored by a high oil

trade surplus and by increases in revenues from workers' remittances.

The significant improvement of industrial production during the first half of the year prevailed during the third quarter of 2006. This is the result of considerable annual growth in its four sectors, especially in construction and manufacturing. In the case of the latter, the upturn exhibited during the year was boosted by the strong recovery in annual terms of automotive production, especially export-oriented production. Manufacturing production, excluding automotive, grew modestly, although above 2005 figures.

GDP and domestic demand growth during 2006 have not implied significant pressures to the economy's productive capacity.

#### *Costs and Prices*

During the third quarter of 2006, wage increases negotiated by firms under federal jurisdiction were on average, of 4.2 percent (0.2 percentage points below those granted during the same period of 2005).

In September 2006, the subindex of administered prices recorded an annual variation of 7.29 percent, 0.89 percentage points below June figures. This reduction is mainly attributed to a contraction in the growth rate of propane prices and to a fall in prices of natural gas and gasoline in certain border cities. At the end of the third quarter of 2006, the annual variation of the subindex of prices regulated by the government was 1.63 percent, 0.41 percentage points above June figures. This increase was due mainly to the upward movement in urban bus fares in several cities.

Most recent information on futures indicates that wheat, corn and soy prices for the following 12 months will be above their current levels. In addition, between June and September, wheat reference prices rose by 16.11 percent. Thus, the behavior of grain prices and futures suggests likely pressures on their domestic references, and also on the processed foods that used them as inputs. In contrast, future prices of pork meat are below their levels recorded at the end of the third quarter, and beef prices remain at a similar level. During the third quarter, the upward movements followed by the domestic prices of copper and certain steel by-products, such as rod, partially reverted. These developments will contribute to reduce the growth rate of construction material prices and, in the next

months, could also prompt the decline in high consumption electricity tariffs.

#### *Monetary and Credit Aggregates*

During the third quarter of 2006, the monetary base grew, on average, 18 percent as compared with the same period of last year, slightly above the figure observed during the previous quarter (17.1 percent). Its behavior was above that anticipated, due partly to the higher growth of economic activity and to the longer-than-expected increase of the monetary base prior to Mexico's elections.

At the end of the first half of 2006, the annual flow of the economy's sources of financing was nearly one percentage point of GDP (7.9 percentage points) above that observed at the end of the first half of the year. The greater availability of financial resources and public sector's lesser borrowing requirements allowed more financial resources to be available for the private sector. The annual flow of total financing to households rose from 1.9 percent of GDP during the first half of 2005 to 2.3 points during the same period of 2006. Total financing to firms decreased from 1 to 0.8 percent of GDP, due mainly to a reduction in foreign financing.

#### *Monetary Policy Actions*

In general terms, during the last months, the balance of risks for world inflation has improved. On the one hand, although the outlook for the global economy continues to be positive, the phase of the cycle it is currently undergoing allows for anticipating that the world economy will decelerate for the remainder of 2006 and for 2007. On the other hand, prices of energy and other commodities have eased during recent months. This environment has contributed to reduce inflationary pressures and risks worldwide and, therefore, uncertainty regarding the main central banks' monetary policy actions. In particular, markets seem to anticipate that the Federal Reserve's cycle of actions to tighten monetary policy has come to an end. The aforementioned conditions have led to a reduction in long-term interest rates in the U.S.

Considering the developments in inflation in Mexico, during the third quarter, certain supply shocks to a reduced number of food goods prompted a rebound in headline inflation. This rebound is expected to be temporary and should not contaminate inflation expectations for longer terms. In this regard, although inflation expectations for the end of 2006 have been revised upward, those for the next 12 months and for the end of 2007 have remained

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stable. Analysts expect the impact of supply shocks on inflation to dissipate in the following months. Long-term inflation expectations have also not been affected.

Another indicator that signals that long-term inflation expectations are anchored can be obtained by calculating the inflation compensation (inflation expectations plus a risk premium) that investors demand for holding long-term peso-denominated bonds. Thus, subtracting the real yield associated with 10-year indexed-debt instruments (UDIBONOS) from the 10-year bond interest rate, inflation compensation has remained stable during the year.

Given the abovementioned scenario, and as stated in its press releases, Banco de México's Board of Governors decided to maintain the monetary conditions unchanged during July, August, September, and October. As a result, the bank funding rate remained at 7 percent. Nonetheless, the Board of Governors will stay alert that inflation expectations remain well anchored.

During the third quarter, domestic capital markets were favored by the reduction in risk premia observed during the previous quarter. In addition, the uncertainty associated with this year's elections gradually dissipated. These elements enabled the recovery of prices of several domestic assets. Interest rates of long-term bonds fell significantly, thus leading to a flattening of the yield curve. For the first time, on October 24, a fixed-interest rate peso-denominated 30-year bond was auctioned, as part of a strategy to extend the maturity of the federal government debt and to contribute to the development of domestic debt markets. The rate of return on this bond (8.08 percent) was below that for the 20-year bond.

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

Based on the abovementioned conditions, and on most recent information on the Mexican economy, Banco de México's baseline scenario for the rest of 2006 and for 2007 is as follows:

**GDP Growth:** GDP growth for 2006 is expected to be between 4.3 and 4.8 percent, and for 2007, between 3.25 and 3.75 percent.

**Employment:** Approximately 900 thousand jobs are expected to be created in the formal sector (number of workers insured by the IMSS) in 2006, and 750 thousand in 2007.

**Current Account:** The current account deficit of the balance of payments is expected to be 0.6 and 1.3 percent of GDP in 2006 and 2007.

**Inflation:** Annual headline inflation is expected to be below 4.0 percent at the end of the year, and annual core inflation, between 3 and 3.5 percent. Nonetheless, given the effects of supply shocks on the prices of certain foods, together with a reduced base of comparison, during October and November 2006, annual headline inflation is expected to remain at levels close to 4.5 percent. For 2007, core inflation is expected to be around 3 percent while headline inflation is anticipated to resume its downward trend, ending the year at a level below 3.5 percent. In particular, the following should be highlighted:

a) As the effects of the shocks that have affected its path in the last two quarters gradually dissipate, core inflation will be subject to lesser pressures.

b) As for inflation in services, a slower growth rate is expected in the prices of housing-related services, given that the pressures on the prices of several copper and steel-related construction materials have started to revert. This is the outcome of both a downward adjustment in the international prices of copper and certain steel by-products and the favorable settlement of labor disputes that affected the production of these materials. As for the rest of services, the annual variation of the price subindex of rest of services is expected to end 2006 at levels slightly below 4 percent.

c) As for merchandises included in the core price subindex, the item processed foods has been recently affected by the increase in sugar prices. Under such context, these prices could decrease in the following months due to both the new sugar harvest cycle and the sugar import quotas authorized by the Ministry of the Economy. Nonetheless, the recent price increases in certain grains could be a pressure factor for processed foods' prices. On another front, the annual variation of the prices of merchandise excluding foods is expected to remain stable around 2 percent.

d) Non-core inflation will continue to be determined, for the most part, by the behavior of fruits and vegetables price inflation. The effects originated by the shortage of certain vegetables –whose production was affected by weather conditions- are expected to begin to fade by the end of the year.

e) On the other hand, the subindex of administered and regulated prices could grow at a rate similar to

that observed this year, although with some differences in terms of its components. On the one hand, administered prices could put less pressure on headline inflation due mainly to the reduction in low consumption electricity tariffs and in gasoline prices at border cities. On the other hand, regulated prices could increase its incidence if public transportation fares are raised in several cities.

Summing up, annual headline inflation is expected to be below 4 percent by the end of the year. Nonetheless, this result will be mainly determined by how fast the supply shocks that affected agricultural prices revert.

As part of the assessment of inflation expectations, following are the main inflationary risks:

- i) Although the prices of energy and other raw materials have moderated recently, they are still fluctuating and remain at high levels. Agricultural prices have behaved similarly.
- ii) The growth rate of services prices remains high.
- iii) Inflation expectations are still above the 3 percent target.

Although the trend of inflation has evolved as expected, short-term inflation has rebounded. The Board of Governors of Banco de México considers the unexpected pressures on certain prices to be temporary and, therefore, not to pass on to inflation expectations for 2007 and onward. However, the Board will surveil that inflation expectations are well anchored, reiterating its intention to foster the convergence and consolidation of inflation to its target.

On another front, various risk factors prevail that could mainly affect productive activity growth.

In recent years, real estate asset prices have increased considerably in several developed economies. In particular, in the U.S., this contributed significantly to strengthen households' financial balances and, therefore, their spending. Nonetheless, in the last months, real estate markets in the U.S. have lost dynamism and this trend is expected to continue. Should this sector undergo a major and/or sudden correction, household spending, and, consequently, the pace of economic activity could be affected significantly. This scenario would undermine industrial production in the U.S., and, therefore, the demand for Mexican non-oil exports. Under such setting, economic activity and job creation in Mexico would be affected more negatively than currently expected.

Given the global mismatches that have accumulated, risks of an abrupt adjustment prevail. Nonetheless, this is a medium-term risk factor.

The loss of competitiveness is an element that has affected the rate of growth of the Mexican economy and, therefore, the creation of more and better jobs. In particular, progress has not been sufficiently attained in strengthening the domestic sources of growth, and, therefore, the country's potential has not been fully tapped. Mexico's decline in the different international scales of competitiveness, and investment attractiveness among countries, reveals the costly effect of postponing the necessary economic and institutional changes required by the country. Many nations have actively become part of the globalization process, implementing significant changes in their economies. Consequently, the need to undertake the necessary reforms to increase the flexibility and competitiveness of Mexico's industry becomes even more urgent. If these relevant issues are not tackled, the fight against some of the country's endemic problems, such as poverty and the unequal distribution of income, will be considerably more difficult.

### ***Monetary Policy Announcements for 2007***

#### ***Calendar of Monetary Policy Announcements, Monetary Policy Press Releases, and Inflation Reports for 2007***

Month	Monetary Policy	
	Announcements and Press Releases	Inflation Reports
January	26	31 <sup>1/</sup>
February	23	
March	23	
April	27	30
May	25	
June	22	
July	27	31
August	24	
September	21	
October	26	31
November	23	
December	7	

1/ Includes the Monetary Program for 2007.