

Inflation Report

July - September 2007

Summary

World economic activity continued to expand at a solid pace during the third quarter of 2007. However, most recent information suggests a slowdown among certain advanced economies, particularly the U.S. economy. Since the worsening of the real estate market, which was followed by a loss of confidence and a liquidity crisis, prospects for U.S. GDP growth have been revised downward. These phenomena have extended to other markets, creating the perception of higher credit risk worldwide. Although the measures implemented by the world's central banks have calmed markets, concerns prevail over the likely effects of these events on the world economy.

Not all types of assets have been affected to the same degree by this situation. In particular, financial markets in emerging market economies have sorted out this episode of volatility, in most cases, without sizable side effects. In the case of Mexico, this result has been due to an improvement in the perception of sovereign risk and to the development and deepening of the Mexican exchange and money markets.

Food and energy prices have increased significantly worldwide. The former have been driven by a shift in relative prices as a result of increased demand for these products from countries such as China and India; greater use of certain grains as inputs for biofuel production; and adverse weather conditions in various regions of the world.

Given the importance of foods in the consumption basket of emerging economies, some of these have faced significant inflationary pressures. In addition, the fact that in some of these economies the increase in food prices has taken place in tandem with the upper phase of the business cycle they are currently undergoing has increased these pressures. Although the most advanced economies have also been affected by these price increases, the relative impact has been of lesser magnitude.

During the third quarter of the year, the Mexican economy grew at a higher rate than in the first two quarters. Both domestic and external demand improved as compared with the first half of the year. Economic activity is expected to grow during the second half of the year at a higher rate than in the first half of the year. However, the slowdown in U.S. economic activity expected at the end of 2007 and the beginning of 2008 could affect negatively the Mexican economy.

Banco de México's base scenario for the Mexican economy is as follows:

Growth: Around 3.2 percent in 2007 and between 3.25 and 3.75 percent in 2008.

Employment: Creation of around 800 thousand jobs in the formal sector in 2007 and 700 thousand during 2008 (number of workers insured by the IMSS).

Current Account: Current account deficit of around 1 percentage points of GDP in 2007 and 1.2 percent in 2008.

Inflation: During 2007, inflation has been influenced by a series of supply shocks, which have made both headline and core inflation rebound. These shocks have been very persistent and of significant magnitude, and many of them have originated from the rise in the international price references of grains and dairy products. Although the effects of these shocks on inflation are anticipated to be temporary, inflation has increased and remained high for a long period. Nonetheless, the effect of these shocks on the prices of non-food products has been limited.

Further inflationary risks prevail. Some firms would be expected to pass to consumers the cost associated to the greater fiscal burden they currently face, the process of world adjustment in foods relative prices apparently has not ended, and expectations for long-term inflation remain more than half a percentage point above the inflation target.

Inflationary pressures have taken place in an environment where the U.S. economy is growing at a slower rate. Nonetheless, and based on most recent information, the rate of growth of the U.S. is not expected to deteriorate in such a way to mitigate significantly the referred inflationary pressures.

Monetary authority's decisions are based on a thorough assessment of the current economic conditions and the prospects for inflation. It is important to consider that the channels of monetary policy transmission operate in horizons of a range between 6 and 8 quarters. Therefore, the prospects for inflation need to be evaluated within a 2-year horizon.

To prepare the forecasts for inflation included in this Report, the following elements were considered:

- The fiscal reform is expected to create once-and-for-all adjustments in the general price level of between 40 and 50 basis points for 2008 and between 2 and 5 basis points for 2009. This estimate is subject to a high degree of uncertainty. The pass-through effect of prices to consumers will depend on each sector's market conditions.
- During 2008 and 2009, electricity tariffs and prices of LP gas will increase at rate similar to that of 2007. Considering the new taxes, during the same years, gasoline prices are expected to increase slightly above this year's rate of change.
- During 2008, the subindex of regulated prices is expected to be a source of inflationary pressures of greater magnitude than that observed in the past three years in view that public transportation fares could be revised in some cities.

Following is Banco de México's baseline scenario of average quarterly inflation in annual terms for the next two years:

Summary

Base Scenario for Annual Headline Inflation Quarterly average in percent

Quarter	Inflation
2007-IV	3.50 - 4.00
2008-I	3.75 - 4.25
2008-II	4.00 - 4.50
2008-III	4.00 - 4.50
2008-IV	3.75 - 4.25
2009-I	3.50 - 4.00
2009-II	3.50 - 4.00
2009-III	3.00 - 3.50

Headline inflation is expected to follow an upward trend during the first half of 2008 and peak in May of that year. During the second half of that year, headline inflation could start to follow a moderate downward trend, once the supply shocks previously mentioned start to fade. During 2009, headline inflation is expected to follow a sharper downward trend, once the expected effects of the fiscal reform start to dissipate. Annual headline inflation is expected to come close to the inflation target during the third quarter of 2009, instead of 2008, as previously forecasted.

Any forecast exercise is subject to a certain degree of uncertainty. Thus, forecasts must be interpreted considering all associated risks involved. Following is a balance of the most important risks surrounding the current forecasts for inflation for the following two years:

- The effects of the supply shocks on prices could lead to new inflationary pressures if wage negotiations are contaminated.
- High degree of uncertainty prevails regarding international prices of foods.
- The U.S. economy could grow less than expected.
- Volatility in international financial markets could increase.

Monetary policy currently faces a complex economic situation. Up to now, supply shocks have had limited effects on non-food prices. Wage negotiations have apparently not been affected. However, Banco de México's forecasts for inflation have been revised upward and the balance of risks for inflation has deteriorated.

Consequently, in its announcement of October, the Board of Governors of Banco de México decided to tighten monetary

conditions by 25 basis points in order to contribute, on the one hand, to prevent the price and wage determination processes from being contaminated, and, on the other, to moderate inflation expectations. The Board will remain attentive to the balance of risks regarding the revised forecasts in order to achieve the inflation target.

In addition to monetary policy, other economic policies must contribute to lead the economy towards a low inflation equilibrium and growth in order to gradually increase Mexicans well-being.

Fiscal policies play a key role. In particular, the sound management of public finances is crucial for the well functioning of the economy. The recently approved fiscal reform is a significant step in the right direction.

A second relevant policy under the current economic conditions is the competition policy. The responsible authorities must prevent some firms from trying to coordinate themselves to raise their prices above what, under an environment of competitive markets, these firms would adjust naturally given the fiscal burden they face due to the tax reform.

Beyond the importance of having competitive markets to mitigate the likely impact of the tax reform on prices, Banco de México has stressed the urgent need to promote greater competition in key economic sectors in the country, in order to diminish costs and foster greater efficiency and quality of goods and services.

Monetary policy will be very attentive in order to induce inflation to converge to its target. These efforts will indeed be more effective if they are complemented by other economic policy actions.

This document includes three appendices. Appendix 1 explains Banco de México's decision for changing the definition for the core price subindex. This change implies that starting January 2008, this index will incorporate the items of the private education price subindex. Appendix 2 describes the methodology for estimating the probable impact of the recently-approved fiscal reform on the CPI. Appendix 3 announces that, starting January 21, 2008, Banco de México will adopt the overnight interbank interest rate as an operating target instead of the corto. This change does not imply a modification to Banco de México's monetary policy stance.