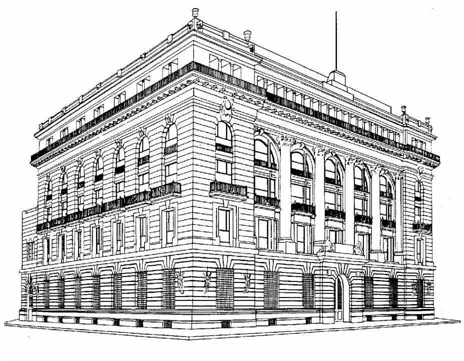
Inflation Report

January – March 2003



BANCO DE MEXICO

APRIL 2003

BOARD OF GOVERNORS

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FOREWARNING

Unless otherwise stated, this document has been prepared using data available as of April 25, 2003. Figures are preliminary and subject to change.

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I. Introduction

The path of inflation and of its main determinants during the first quarter of 2003, as well as their expected performance in the remainder of the year are, in general, in line with the attainment of an annual CPI inflation of 3 percent (with a variability interval of plus/minus one percent) by the end of December. In particular, current financial conditions, a less robust recovery of the economy than expected at the onset of the year, and the preventive intensification of the monetary restriction should help contain inflationary pressures. However, an unusual degree of uncertainty still prevails owing to current external and domestic factors. Thus, the Board of Governors of Banco de México will continue evaluating thoroughly the indicators it uses to detect inflationary pressures that could cause the path of inflation to deviate from the objective. Should the latter occur, the Board of Governors would adopt all the actions required to re-establish the monetary conditions to bring inflation into line with the target.

In the first quarter of 2003 the Mexican economy was adversely affected by a particularly complex international environment. The United States economy, which had shown signs of recovery by mid-2002, weakened once more while the rest of the world did not experience high enough growth to offset this development. Moreover, the world's main financial markets were influenced by lackluster firms' profits, falling stock prices, and losses suffered in investors' portfolios. In industrial economies, consumer and business confidence indexes fell, and, overall, the prevailing environment did not foster an upturn of demand.

Most indicators for the performance of the real sector show that Mexico's economy lost strength in the first three months of the year. During the last quarter of 2002, economic activity remained stagnant due to less vigorous private consumption and investment, and to the slower growth of exports. Current available data suggests that spending by households, firms and external markets has not picked up. The meager recovery of demand meant further slack in the labor market.

The monetary policy stance was tightened on three occasions during the quarter. As a result, five policy actions with the same purpose have been taken since September 2002. Domestic interest rates rose in line with the increases in the "short" during the period reported. In contrast, interest rates remained low and stable in the United States and net yields on Mexican sovereign bonds declined.

In the context of weak economic growth and restrictive monetary conditions, annual CPI inflation remained relatively stable during the first quarter of the year. Annual core inflation fell mainly as a result of the reduction in the core subindex of services, which had shown a certain degree of downward rigidity throughout 2002. Meanwhile, annual core inflation of goods remained at around 2 percent during the quarter. Thus, up until the time of publishing this Report there is no evidence of a pass-through effect from exchange rate depreciation to consumer prices. Nonetheless, the reduction in annual core inflation did not bring about a more pronounced decline in annual headline inflation. This is partly attributable to rising of agricultural prices.

In the following sections of this document, a detailed assessment of the performance of inflation and its main determinants during January-March of 2003 is presented. Likewise, the Board of Governors' outlook on the future path of inflation is described.

II. Recent Developments in Inflation

The evolution of prices during the first quarter of 2003 was, in general, as had been forecasted in the previous Inflation Report. Annual headline inflation was marginally lower than in December 2002, while core inflation continued to decline. The difference in the behavior of these two indexes can be explained by the increase in agricultural prices. During January-March, the most noteworthy price developments were as follows:

(a) Annual CPI inflation remained relatively stable;

(b) The substantial fall in annual core inflation stemmed from the reduction in core inflation of services, which was brought about by a reversal of the rebound in annual inflation of three of its components: owner occupied homes, home rentals and car insurance;

(c) Annual core inflation of goods moved on at a similar pace to that observed in the previous quarter, notwithstanding the significant depreciation of the exchange rate;

(d) Annual inflation of agricultural products rose sharply in response to two factors: a less pronounced reduction in the prices of fruits and vegetables than that observed in the same quarter of last year, and higher prices of meat and eggs;

(e) Annual inflation of goods and services whose prices are regulated by the public sector fell considerably while that of the subindex of administered prices registered only a moderate decline; and

(f) The depreciation of the exchange rate led to an increase in inflation of the export component of the PPI excluding oil.

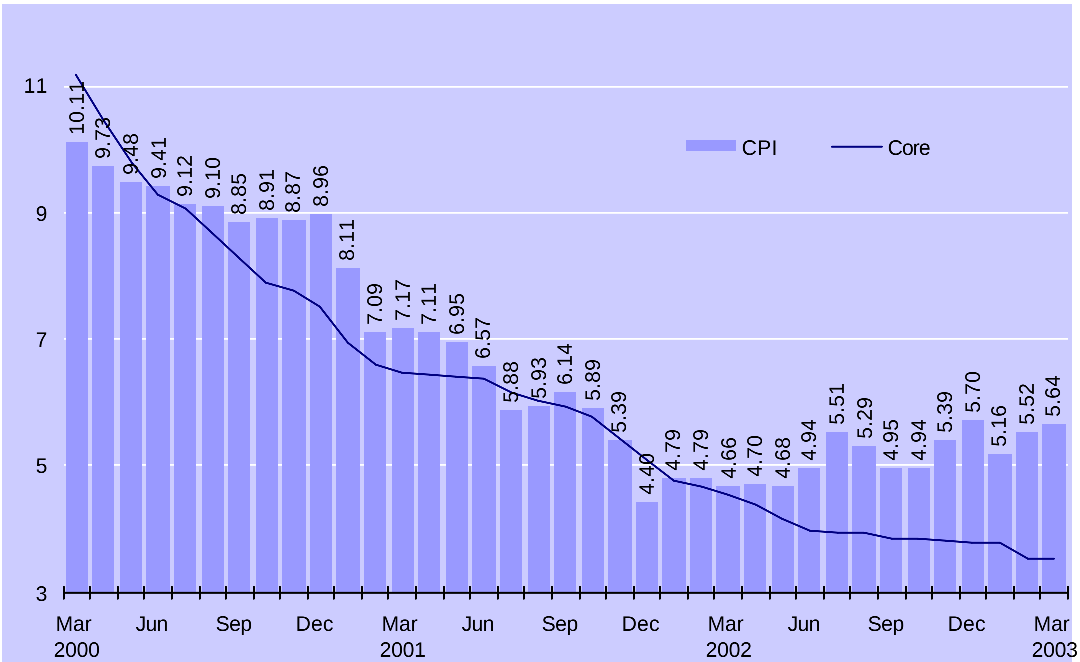
II.1. Evolution of Several Inflation Indicators

II.1.1. Annual Inflation of the Consumer Price Index and Core Price Index

At the end of the first quarter of 2003, CPI inflation and core inflation were 5.64 percent and 3.53 percent, respectively. Core inflation declined 0.18 percentage points more than CPI inflation (Graph 1).

Graph 1 **Consumer Price Index and Core Price Index**

Annual percentage change



The behavior of headline inflation mainly responded to the non-core component of the CPI. In this regard, the increase in the inflation of agricultural products was particularly noteworthy. The latter was mainly due to the fact that in the same quarter of the previous year, the fruit and vegetables component of the subindex of agricultural prices fell more than in the present quarter, while prices of meat and eggs rose significantly.

Inflation of goods and services whose prices are administered or regulated by the public sector remained high, notwithstanding the substantial reduction in inflation of the subindex of regulated prices (Table 1). Among the components of the subindex of administered prices, the rise in domestic gas prices during the last months of the previous year had an adverse impact on inflation. Moreover, higher gasoline prices (particularly in northern border cities) during the first three months of the year also had an upward effect on inflation.

Table 1 **Price Indexes: CPI, Core, Agricultural Products, Education and Goods and Services Administered and Regulated by the Public Sector**

Percent

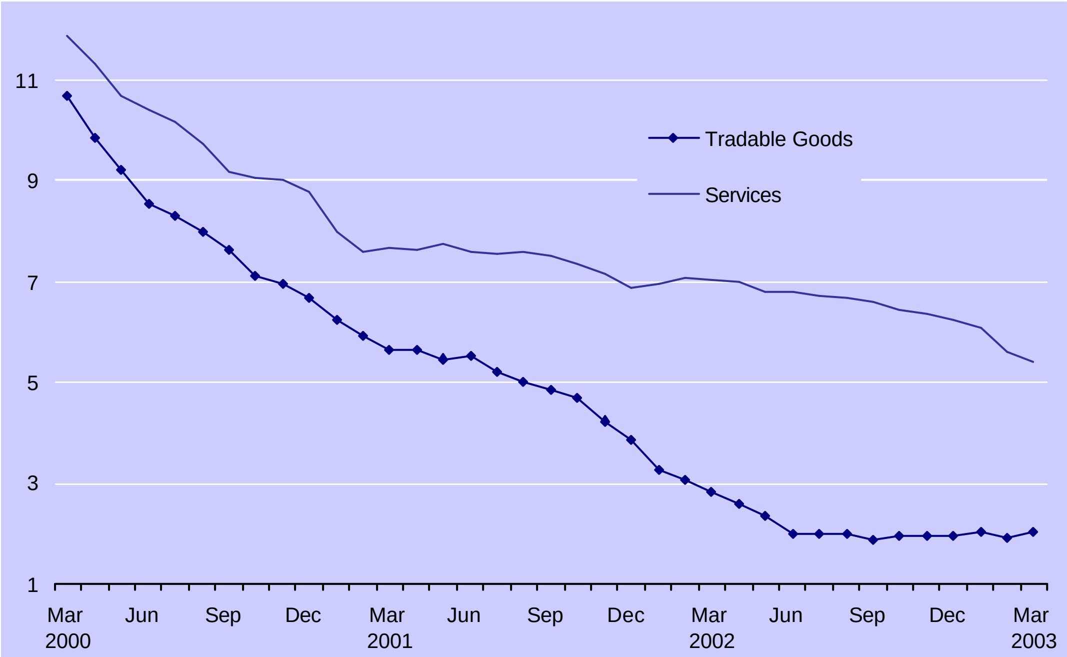
	Annual Variations			Quarterly Variations		
	Mar 2003/ Mar 2002/	Dec 2002/ Dec 2001/	Mar 2002/ Mar 2001	Mar 2003/ Dec 2002/	Dec 2002/ Sep 2002/	Mar 2002/ Dec 2001
CPI	5.64	5.70	4.66	1.32	1.69	1.37
Core	3.53	3.77	4.54	1.43	0.71	1.67
Tradable Goods	2.03	1.95	2.84	1.09	0.55	1.01
Services	5.40	6.23	7.02	1.81	0.89	2.61
Agricultural	13.42	8.65	2.85	-0.77	6.22	-4.95
Fruits and Vegetables	28.90	22.23	0.06	-6.55	14.22	-11.38
Meat and Eggs	4.37	-0.10	4.56	3.73	0.72	-0.71
Education	10.24	10.04	13.61	1.17	0.00	0.98
Administered and Regulated	8.22	10.96	4.58	1.93	4.07	4.51
Administered	15.02	16.84	1.35	3.09	8.46	4.73
Regulated	2.60	6.12	7.28	0.88	0.39	4.34

During January-March of 2003, core inflation of goods remained at a level similar to that observed at the end of the preceding quarter (Graph 2). So far, there is no evidence that the exchange rate depreciation undergone since the second quarter of the previous year has translated into additional inflationary pressures on consumer prices.

Core inflation of services had a favorable behavior in the first quarter of 2002 (Graph 2). The decline in the rate of growth of this subindex, the most pointed in the last 8 months, stemmed from lower levels of inflation in most of its components. In particular, the upward trend of prices of owner occupied homes, home rentals, and car insurance reverted. In previous quarters, such trend had prevented faster reductions in this sector's inflation.

Graph 2 **Core Price Indexes for Tradable Goods and Services**

Annual percentage change

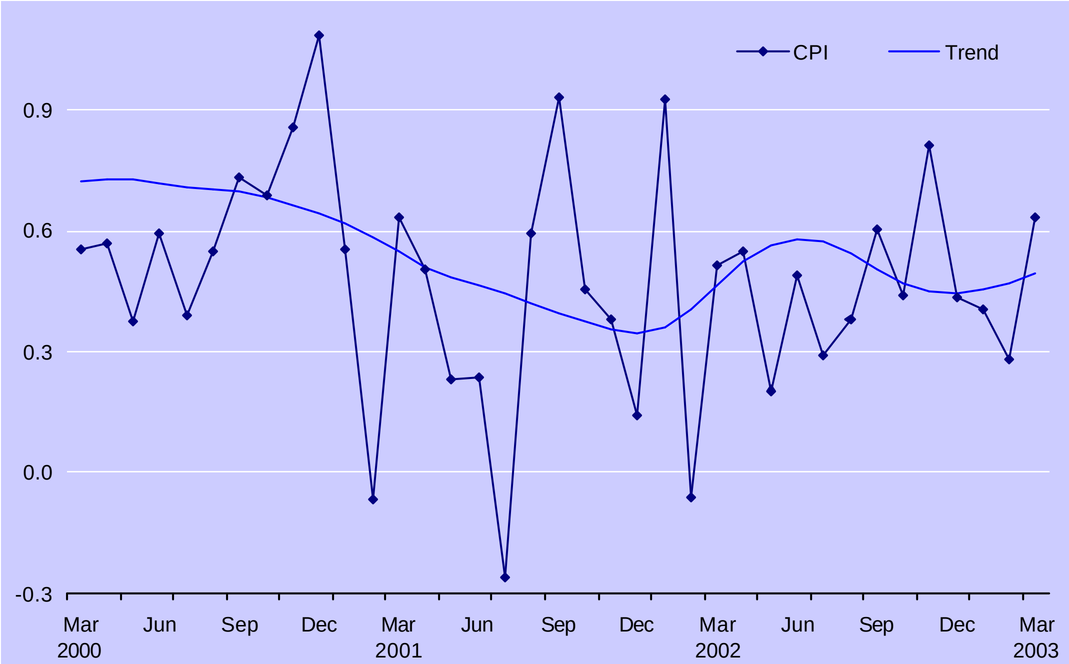


II.1.2. Monthly Inflation of the Consumer Price Index and Core Price Index

In the first quarter of 2003, trend CPI inflation increased slightly (Graph 3). It should be mentioned that trend series eliminate the effect of seasonal factors on inflation.

Graph 3 **Consumer Price Index**

Monthly percentage change



In January and February of 2003 inflation was lower than forecasted by private sector analysts. Nonetheless, in March it turned out to be higher mainly due to increases in prices of agricultural products, which are difficult to predict because of their volatility (Table 2).

Table 2 **Observed and Expected Monthly Inflation**

Monthly percentage change

	2003		2002	
	Observed	Expected 1/	Observed	Expected 1/
January	0.40	0.59	0.92	0.92
February	0.28	0.30	-0.06	0.48
March	0.63	0.33	0.51	0.39

1/ Expected inflation at the end of the previous quarter according to the Survey of Private Sector Economic Analysts' Expectations undertaken by Banco de México.

From December 2002 to March 2003, trend core inflation of goods rebounded slightly, but remained below 0.2 percent. Meanwhile, the trend core inflation of services remained at the same level as that registered at the end of the previous quarter (Graph 4).

Graph 4 **Core Price Indexes for Tradable Goods and Services**

Monthly percentage change

II.1.3. Producer Price Index (PPI)

During the first quarter of 2003, the path of annual inflation of the PPI excluding oil and services continued upward. It closed at 8.34 percent, 2.05 percentage points higher than at the end of the fourth quarter of 2002. This increase responded mainly to the depreciation of the exchange rate during the period.

II.2. Main Determinants of Inflation

The main factors that affected inflation, both directly and indirectly, are analyzed in this section. The international environment, which has been characterized by the weak recovery of the economies of the United States and other industrialized countries, is examined first. Next, the evolution of aggregate supply and demand as well as of the labor market is reviewed. Third, the behavior of the balance of payments, capital flows, and the exchange rate is described. Finally, the path of prices administered or regulated by the public sector as well as that of the subindex of prices of agricultural products are also assessed.

II.2.1. International Environment

During the first quarter of 2003, the Mexican economy was adversely affected by a rather complex international scenario.

Although it is likely that this has helped to ease inflationary pressures, by slowing the expansion of aggregate demand, it could also have a harmful effect on inflation if the financial variables, particularly the exchange rate, are influenced negatively.

During the quarter covered by this Report, the global economy was characterized by uncertainty surrounding the complex geopolitical scenario that eventually led to war in Iraq. Concern regarding the duration of the conflict, its costs and consequences, created volatility in international oil prices and reduced consumer and investor confidence around the world. The latter affected financial markets and brought about falls in developed countries' stock market indexes.

In the United States, the overall balance of economic indicators was negative. As a result, expectations regarding the pace at which the U.S. economy could recover during the first quarter of 2003, as well as those related to real GDP growth for the year as a whole, were revised downwards. Moreover, preliminary economic indicators for the euro zone suggest that economic expansion was less vigorous than originally expected. Meanwhile, the Japanese economy showed signs of a feeble recovery.

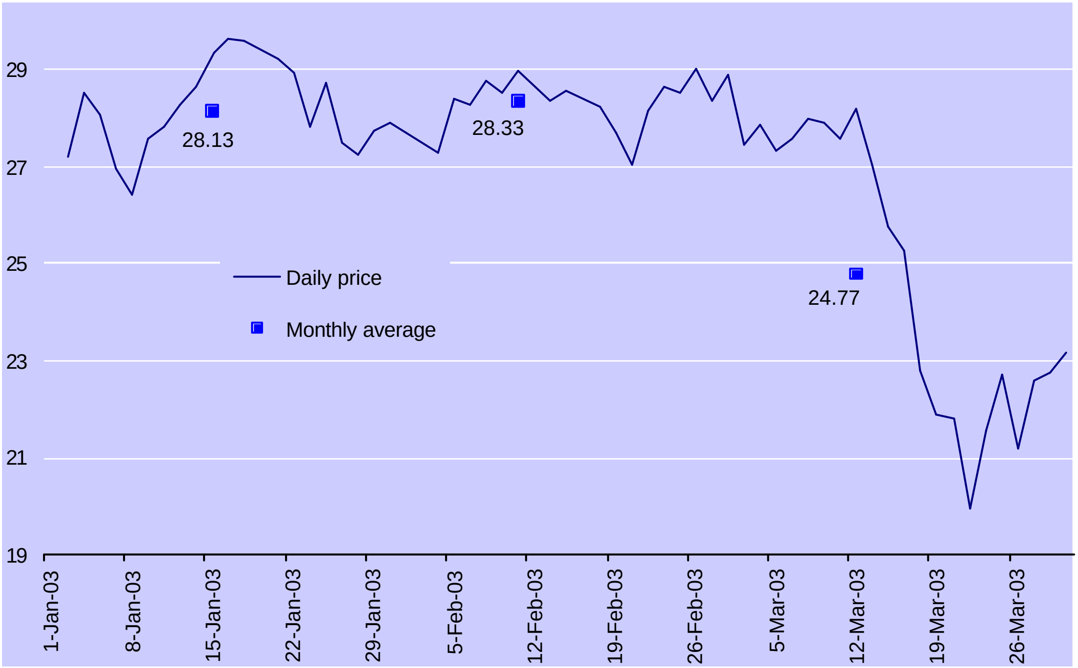
II.2.1.1. Oil Prices

In the first quarter of 2003, the WTI oil price averaged 34.32 US dollars per barrel, 6 dollars higher than the 28.35 dollar figure posted during the fourth quarter of 2002. For most of January-March this price remained at levels similar to those registered at the end of 2002. Although at the beginning of March oil prices fell due to expectations that the conflict in Iraq would be short-lived, at the end of the month they rebounded as optimism concerning the war began to wane.

The price per barrel of the Mexican oil export-mix behaved similarly to reference prices. The price of this mix averaged 26.99 US dollars per barrel, 4.28 dollars higher than prevailing prices during the fourth quarter of 2002 (Graph 5).

Graph 5 **Mexican Oil-Export Mix Price**

US dollars per barrel



Source: Reuters.

High oil prices have several effects on the domestic economy. On the one hand, increased oil revenues help to reduce the pro-cyclical adjustment of public expenditures and the size of the external deficit. On the other, they also hamper a possible recovery of the global economy and international trade. As a consequence, the net impact of rising oil prices on the Mexican economy, especially on inflation, is uncertain as explained in more detail in section V of this Report.

II.2.1.2. Evolution of the United States economy

Preliminary indicators for the United States reveal an insufficiently robust performance of the economy during the first quarter of 2003, notwithstanding the promising data available at the onset of the year. In particular, at the start of the quarter, both the industrial output index and data concerning manufacturing orders in the industrial sector led to expectations that the economy was beginning to recover. Nevertheless, towards the middle and end of the quarter employment indicators, surveys of purchasing managers in the manufacturing and non-manufacturing sectors, as well as consumer confidence indexes pointed to less favorable conditions.

The fragile economic recovery, clearly seen in the behavior of indicators of economic activity during January-March

2003 was compounded by confirmation that the economy had expanded only slightly during the fourth quarter of 2002. Thus, in the last three months of the year real GDP registered an annualized quarterly increase of 1.4 percent, accounting for a significant reduction compared to its level in the third quarter (4 percent).[1]

Despite the feeble economic situation described above, the Federal Reserve Board, in its meeting on March 18th 2003, did not decide to further ease monetary policy. The reason was that the Federal Open Market Committee considered that many of the lackluster figures published at the beginning of the year were mainly a result of higher oil prices and geopolitical uncertainty. Thus, the monetary policy authority of the United States concluded that monetary conditions and gains in productivity would be sufficient elements to boost the economy as soon as uncertainty caused by the war dissipated.

Consequently, forecasts for average annual growth of real GDP in the United States during 2003 decreased in line with the adverse behavior of the economy. Analysts (Consensus Forecasts) revised downward their expectations on annual average growth in 2003, from 2.7 percent in January to nearly 2.3 percent in April. The latter figure is similar to the IMF's forecast of 2.2 percent (Table 3). Nevertheless, by the end of April, analysts (brokers) average expectations for annualized quarterly growth of GDP during the first quarter of 2003 were still around 2.2 percent.

Table 3 **Forecasts for GDP Growth in the United States**

Annual percentage change

	Start of January 2003		End of April 2003	
	I/2003	2003	I/2003	2003
Consensus Forecasts 1/	n.a.	2.7	n.a.	2.3
Deutsche Bank	2.0	2.8	2.0	2.5
Goldman Sachs	1.5	2.1	2.0	2.2
JP Morgan	3.0	2.8	2.5	2.4

1/ January 13th and April 7th 2003 issues of the *Consensus Forecasts*. Since the quarterly forecasts correspond to a survey carried out on a date different from that of the *Consensus Forecasts*, no reference is made to the quarterly forecast in this document.

[1] The aggregate demand component that contributed most to reduced growth during the fourth quarter of 2002 was private consumption, which rose only 1.7 percent compared to 4.2 percent in the previous quarter. In contrast, increases in public expenditure and private investment made a positive contribution to the expansion of GDP, which turned out to be larger than that registered in the previous period. Public expenditure rose from 2.9 to 4.9 percent between the third and the fourth quarters of 2002 while private fixed investment went up from -0.3 to 4.6 percent. Thus, the average annual growth of real GDP in the United States during 2002 was 2.4 percent, significantly higher than in 2001.

II.2.1.3. Developments in the Rest of the World's Economies

The recovery in the euro zone has also been less robust than originally expected, with a moderately rising unemployment and falling consumer and investor confidence indexes. In 2002, real GDP growth in the euro zone was 0.8 percent, below the region's potential. A modest recovery for 2003 is expected, with forecasts centered around 1.1 percent (Table 4).

The weak performance of the German economy is one of the main risk factors for the euro zone, in light of the meager results of preliminary indicators for output, business confidence, and sales. Moreover, no fiscal or monetary stimulus is expected for 2003. This is due to the fact that inflation in the euro zone ended 2002 at 2.2 percent, marginally above the 2 percent upper limit of the European Central Bank (ECB) target, and convergence agreements between European countries have restricted their fiscal authorities' room for maneuver.

The Japanese economy showed signs of a meager recovery and deflation has not been abated. In January, the unemployment rate was 5.5 percent, the same level being registered since October 2002. Meanwhile, real annual GDP growth is expected to reach only 0.8 percent in 2003.

As for Latin America, real GDP is expected to grow around 1.5 percent in 2003, after having declined 0.1 percent in 2002. These rates of economic expansion are below those considered necessary to place countries within the region on sustainable fiscal paths. However, measures adopted to consolidate public finances have reduced the likelihood of experiencing difficulties in servicing the debt.

In this regard, it is important to describe recent developments in two countries that were sources of instability in Latin America during 2002. First, Brazil has recently created favorable expectations among investors due to the government's prudent management of public finances. The new administration has achieved a higher primary surplus than that originally programmed and has also promoted structural reforms in social security and related to the central bank's autonomy. Second, Brazil has complied comfortably with its commitments to the IMF, thus mitigating the government's short-term insolvency risks. Nevertheless, there remain fears concerning this country's ability to continue generating a high primary surplus and, thereby, its public debt sustainability. The IMF forecasts real economic growth for Brazil will be 2.8 percent in 2003 and average annual inflation, 14 percent.

The second case is Argentina, whose economy apparently hit bottom in the last quarter of 2002. On the optimistic side, the rebound observed in some manufacturing sectors and the considerable trade surplus accumulated can be mentioned. The latter has contributed to the stability and even appreciation of Argentina's currency. On the negative side, there are serious doubts about the likelihood of consolidating growth recovery without access to international credit markets given the country's excessive level of indebtedness. Furthermore, an upturn in inflation could occur given the release of previously frozen bank deposits. Thus, the IMF predicts that the Argentinian economy will expand 3 percent in 2003 with an average annual inflation of 22.3 percent (Table 4).

Table 4

IMF Forecasts for Gross Domestic Product Growth

Annual percentage change

	2001	2002	2003 e/	2004 e/
World	2.3	3.0	3.2	4.1
Industrialized Economies	0.9	1.8	1.9	2.9
United States	0.3	2.4	2.2	3.6
Japan	0.4	0.3	0.8	1.0
Germany	0.6	0.2	0.5	1.9
France	1.8	1.2	1.2	2.4
Italy	1.8	0.4	1.1	2.3
United Kingdom	2.0	1.6	2.0	2.5
Canada	1.5	3.4	2.8	3.2
Other countries	1.6	2.7	2.5	3.2
Euro Zone	1.4	0.8	1.1	2.3
Asian RIE 1/	0.8	4.6	4.1	4.5
Latin America	0.6	-0.1	1.5	4.2
Argentina	-4.4	-11.0	3.0	4.5
Brazil	1.4	1.5	2.8	3.5
Chile	2.8	2.0	3.1	4.8
Mexico	-0.3	0.9	2.3	3.7
Uruguay	-3.1	-10.8	-2.0	4.5
Venezuela	2.8	-8.9	-17.0	13.4

Source: World Economic Outlook, April 9th 2003, IMF.
e/ Estimated.
1/ Recently Industrialized Economies.

Capital flows to Latin America contracted drastically in 2002. Mexico, however, remained attractive to external capital (see Section II.2.4.). Capital inflows to the region are expected to be resumed in 2003. In particular, Latin America is expected to receive a larger amount of private capital, while capital from official sources continues to decline (Table 5).

Table 5 **Capital Flows: Emerging Economies**

Billion US dollars

	2001	2002	2003 e/
Total 1/	77.6	111.7	88.4
Africa	7.6	7.6	11.3
Asia 2/	9.4	59.3	12.7
Middle East and Turkey 3/	-32.1	-12.8	-2.3
Countries in Transition	34.2	37.0	32.2
Latin America	58.5	20.6	34.5
Net Private Capital Flows 4/	34.8	2.2	27.5
Net Foreign Direct Investment	65.9	38.5	36.0
Net Portfolio Investment	2.8	-6.5	6.4
Other Net Private Flows	-33.9	-29.8	-14.9
Net Official Flows	23.7	18.4	7.0

Source: World Economic Outlook, April 2003, International Monetary Fund.
e/ Estimated.
1/ Net capital flows correspond to net foreign direct investment, net portfolio investment and other short and long-term flows, including private and official borrowing.
2/ Excluding Hong Kong.
3/ Including Israel and Malta.
4/ Due to data limitations, the item Other Net Private Flows may include some official flows.

II.2.2. Wages, Salaries and Employment

During the first quarter of 2003, the labor market continued to show signs of stagnation. Unemployment remained at levels similar to those observed in the past quarter and formal employment contracted. Nevertheless, in January the annual rate of growth of real wages rebounded in every sector due to statistical effects derived from their contraction during the same period of the previous year. Meanwhile, contractual wage increases remained above inflation expectations. Thus, in the present context of sluggish economic growth, Banco de México reiterates the need to ease wage increases in order to foster the recovery of employment.

II.2.2.1. Wages

In January 2003 nominal and real wages[2] registered annual variations in all sectors of the economy, substantially higher than those observed in the last quarter of 2002 (Table 6).

[2] Wages include total income of workers in the manufacturing and in-bond industries as well as in the commerce sector during the referred month. They are therefore an indicator of the current level of workers' income while contractual wage revisions are an indicator of its future level.

Table 6 **Compensations per Worker**

Annual percentage change

	Nominal								Real							
	2002						2003	Average Jan-Dec 2002	2002						2003	Average Jan-Dec 2002
	Jul	Aug	Sep	Oct	Nov	Dec	Jan		Jul	Aug	Sep	Oct	Nov	Dec	Jan	
Manufacturing	6.0	5.7	5.6	7.7	3.1	4.7	6.2	6.6	0.4	0.4	0.6	2.7	-2.2	-1.0	1.0	1.5
In-bond Industry	10.5	8.9	9.0	7.8	6.1	6.0	6.8	9.4	4.7	3.5	3.8	2.7	0.7	0.3	1.5	4.2
Commerce	8.8	8.2	7.1	11.7	11.0	8.8	12.8	8.7	3.1	2.7	2.0	6.5	5.3	2.9	7.3	3.5

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

In January, labor productivity posted negative annual variations in the commerce sector, while remaining positive in the manufacturing and in-bond sectors. Unit labor costs registered positive annual variations in the in-bond industry and in commerce, and negative ones in the manufacturing industry. Thus, only in the manufacturing industry were productivity gains sufficient to offset real wage increases during the referred month (Table 7).

Table 7 **Output per Worker and Unit Labor Costs**

Annual percentage change

	Output per Worker								Unit Labor Costs							
	2002						2003	Average Jan-Dec 2002	2002						2003	Average Jan-Dec 2002
	Jul	Aug	Sep	Oct	Nov	Dec	Jan		Jul	Aug	Sep	Oct	Nov	Dec	Jan	
Manufacturing	7.0	4.6	3.8	5.0	3.0	5.4	2.5	5.4	-6.1	-4.0	-3.1	-2.2	-5.0	-6.0	-1.5	-3.6
In-bond Industry	5.7	-1.1	1.2	4.2	-0.9	1.6	1.3	1.4	-0.9	4.7	2.5	-1.4	1.6	-1.3	0.2	2.8
Commerce	0.0	-2.6	-3.6	-1.4	-3.1	-2.0	-0.3	-2.3	3.1	5.4	5.9	8.0	8.7	5.0	7.5	6.0

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

In this regard, it should be reiterated that the relatively high growth in real wages and unit labor costs is incompatible with the slack that currently prevails in the labor market. It is therefore of utmost importance that real wage increases come into line with sustainable productivity gains in order to enable greater job creation and the convergence of headline inflation with the target.

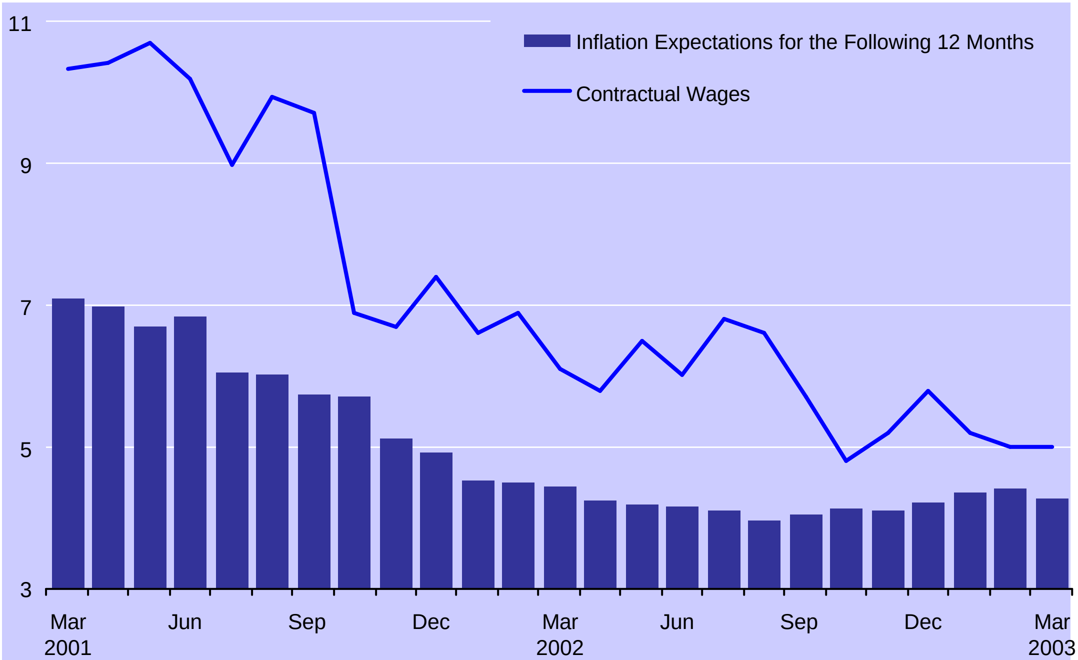
II.2.2.2. Contractual Wages

The average rise in nominal contractual wages was 5.1 percent during the first quarter of 2003. Although these upward revisions were more muted than in the past quarter, they are still high given the present slack in the labor market and foreseeable productivity gains.

The average spread between increases in contractual wages and expected inflation for the following twelve months was 0.69 percent. It should be mentioned that this gap is narrower than the 0.77 percent observed during the previous quarter (Graph 6).

Graph 6 **Contractual Wages and Expected Inflation for the Following 12 Months**

Annual percentage change



Source: Survey of Private Sector Economic Analysts' Expectations, Banco de México; and Ministry of Labor.

In the first quarter of 2003 nominal contractual wages rose similarly in the manufacturing sector and in other sectors of the economy, the average difference being only 0.4 percentage points. Meanwhile, contractual wage increases in private companies were 0.9 percentage points higher than in public corporations (Table 8).

Table 8 **Contractual Wages by Sector and Type of Business**

Annual percentage change

	2002						2003			
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Jan-Mar
Total	6.8	6.6	5.7	4.8	5.2	5.8	5.2	5.0	5.0	5.1
Manufacturing	7.1	6.8	5.7	6.1	5.0	5.9	5.4	5.0	5.5	5.3
Other Sectors	6.5	6.5	6.2	4.6	5.3	5.7	5.1	4.9	4.6	4.9
Public Corporations	6.4	5.5	5.5	4.5	4.3	7.0	4.3	4.3	4.3	4.3
Private Companies	6.8	6.6	6.3	5.8	5.4	5.8	5.4	5.0	5.3	5.2

Source: Prepared by Banco de México with data from the Ministry of Labor.

II.2.2.3. Employment

Employment indicators continued showing signs of weakness during the first quarter of 2003. At the end of March, the number of employees affiliated to the IMSS (permanent and temporary urban workers) declined by 18,283 individuals compared to year-end 2002 (Graph 7a). This fall was less pronounced than that registered in the same period of 2002 (34,269 individuals). As a result, the seasonally adjusted series for this indicator registered a modest increase of 1,429 individuals during the quarter covered by this report.

At the end of March the annual growth of the number of employees affiliated to the IMSS was 77,931 individuals, below January's figure (109,987 workers). In March, the number of temporary urban workers in the formal sector rose by 72,369 individuals, while the number of permanent urban workers increased by 5,563 individuals, but only in the construction industry.

In the first quarter of 2003, the main unemployment indicators posted similar results to those observed during the previous quarter. Thus, the average open unemployment rate was 2.8 percent while in the last three months of 2002 it was 2.5 percent (Graph 7b). The underemployment rate (less than 35 hours worked per week) and unemployment rate reached 20 percent during the first quarter, compared to 17.2 percent in the previous quarter (Graph 7c). In both cases, unemployment rates were significantly affected by seasonal factors, and trend series show that unemployment levels were similar to those during the preceding quarter. Scant job creation can be attributed to the weakness of the economy and to high wage settlements (despite the fact that these have eased). It is important to stress, in particular, that international experience shows that advances in structural reforms are key factors in the recovery of employment (Box 1).

Box 1

China's Economic Transformation and Competitiveness

In the last decade, China has become an export powerhouse and a very important pole of attraction for Foreign Direct Investment (FDI). Notwithstanding, the country's transformation into a more open economy is not a recent phenomenon.

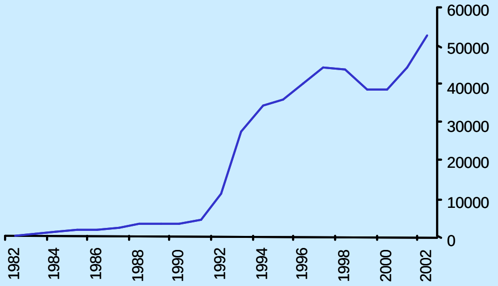
In 1979 China adopted the "Reform and Open Door Policy", which emphasized the role of exports as a key factor for economic development. As a first step, special economic regions and industrial parks were established. FDI was channeled to these regions by offering lower taxes, new infrastructure and more flexible regulations than in the rest of the country.

With its entry into GATT in 1986, China launched a more aggressive opening-up of its economy through a very ambitious program of incentives destined, in particular, to export-oriented foreign companies related to software production and to the development of high technology. Low income taxes were instituted as a main incentive for FDI.

As a result of these measures, from 1992 on, China began to capture increasing flows of FDI. Since 1997 to date, foreign investment has averaged 43 billion US dollars per year (nearly one fourth of total capital flows destined to developing countries). Chinese exports have also expanded continually as a share of global exports. Since China became a member of the World Trade Organization (WTO), and despite the global economic slowdown, both its FDI and foreign trade levels have grown substantially.

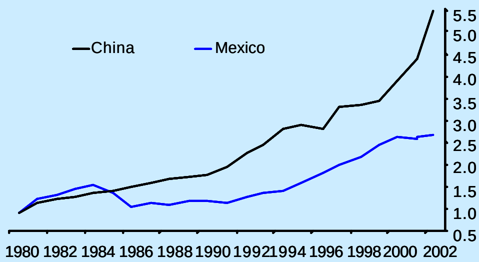
The rise in exports and capital formation (the latter, founded on investment by public corporations) explain, to a great extent, the average annual growth (8%) in real GDP registered by this country in the last five years. Furthermore, during the previous decade China was the country with the highest GDP growth per inhabitant. These results are rather surprising given the inefficiency that still prevails in the Chinese economy, which is characterized by excessive regulation, the lack of soundness of its financial system, and by the high non-performing portfolio of state-owned banks.

Graph 1
Foreign Direct Investment
Million US dollars



Source: International Financial Statistics, IMF; National Bureau of Statistics, People's Republic of China.

Graph 2
Exports
As a percentage of global exports



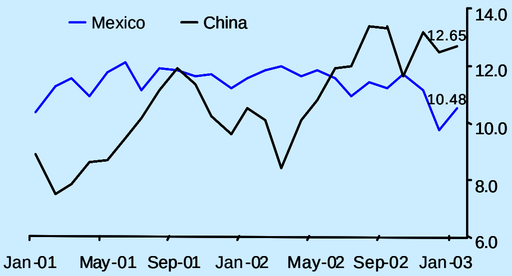
Source: World Bank; National Bureau of Statistics, People's Republic of China.

China's entry into the WTO will imply, among other things, a reduction in average tariffs from 2005 on (from 14.8 to 5.9% in industrial goods, and from 18.9 to 3.9% in agricultural products), the elimination of FDI requirements such as geographic location and performance, as well as lesser restrictions to this type of investment in the financial and telecommunications sectors.

The IMF estimates China's entry into the WTO will boost real GDP growth by an additional six to eight tenths of a percentage point per year. These figures could double once quotas applied to this country by the Textile and Clothing Agreement are eliminated (some countries have safeguards that will remain in force until 2008). The UNCTAD also foresees that FDI flows to China will total 60 billion US dollars in 2005 and might even reach 100 billion if mergers and purchases related to state-owned corporations materialize. The OECD reports similar figures by estimating that FDI to China could grow at an annual rate of 10% during the next decade, reaching almost 100 billion US dollars by 2010.[1]

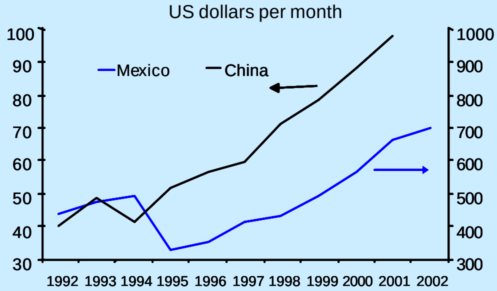
Regarding Mexico, despite the advantages derived from NAFTA, which allows direct access to U.S. markets, the share of Mexican exports in U.S. total imports declined during the second half of 2002. In contrast, China's share increased, surpassing Mexico as the second supplier to the United States. The rapid growth of Chinese exports might respond to the comparative advantage in wages this country has in relation to Mexico. Nonetheless, there are other additional (and even more relevant) factors that have also contributed favorably to the expansion of Chinese exports.

Graph 3
Share of Chinese Exports in Total U.S. Imports
Percent



Source: U.S. Department of Commerce, Census Bureau.

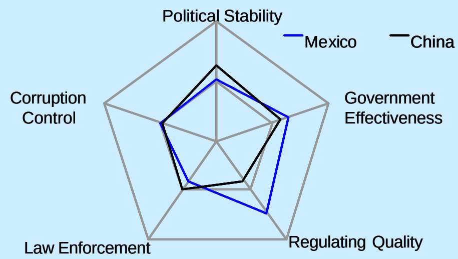
Graph 4
Wages (manufacturing sector)
US dollars per month



In the case of Mexico, the manufacturing sector refers to the in-bond sector.
Source: International Labor Organization (ILO) and Banco de México.

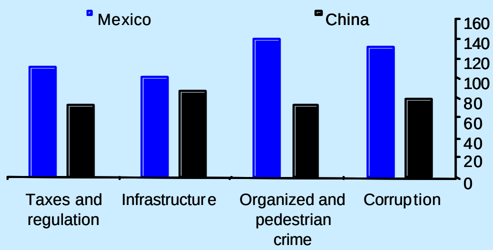
For example, according to the "good governance" indicators estimated by Kauffman, Kraay and Zoido-Lobatón, China exceeds Mexico in terms of political stability, corruption control and law enforcement.[2]

Graph 5
Indicators of Good Governance
Percentile based on country classification (174 countries)



According to the World Business Environment Survey published by the World Bank, China has a more favorable environment than Mexico in terms of general restrictions on investment. The items that integrate this concept are taxes, regulation, infrastructure, organized and pedestrian crime, and corruption. As for infrastructure, the survey also indicates that China offers more efficient services than Mexico in terms of roads and highways, telephone services and electricity.

Graph 6
Rating According to General Restrictions on Investment
Average 80 countries=100

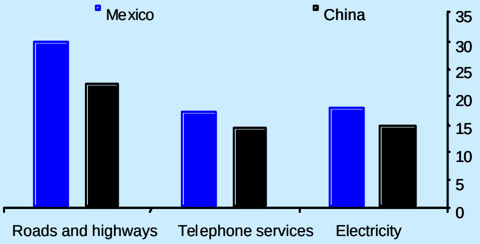


Source: World Bank, World Business Environment Survey. A higher rating implies more restrictions on investment.

1 IMF, SM/00/150, July; UNCTAD (2000): *World Investment Report*; OECD (2002): *China in the World Economy*, Chapter 10 and Appendix 2.

2 Kauffman, D., A. Kraay and P. Zoido-Lobatón (1999): "Governance Matters", World Bank Policy Research Working Papers. The limits in the outer pentagon represent the country (countries), out of 174, that obtained the best results. The inner pentagon represents the median.

Graph 7
Rating in infrastructure
Percentage of surveyed firms that consider the specific item (service) as "bad", "very bad" or "rather bad"



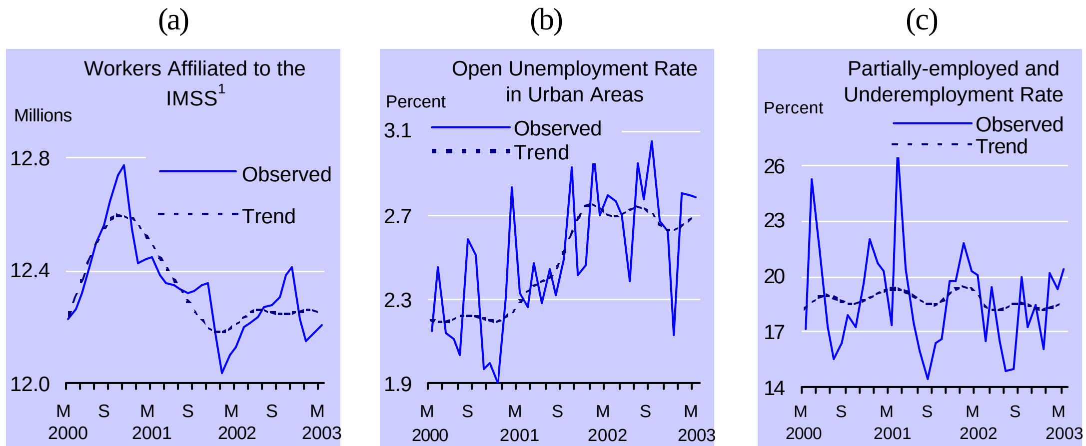
Source: World Bank, World Business Environment Survey.

China's advantages over Mexico in the items of environment for investment and competitiveness have also been pointed out by the UNCTAD and by the International Institute for Management Development (IIMD). For the period 1998-2000, the FDI Performance Index prepared by the UNCTAD rates China in 47th place among 140 countries, after having been 61st between 1988 and 1990. During the same periods, Mexico moved from 42nd to 78th place. The Global Competitiveness Indicator prepared by the IIMD classifies Mexico in 42nd place whereas China rates 31st (out of a total of 49 countries).

According to the same sources, Mexico outranks China in different items of competitiveness such as copyright protection, skilled labor productivity, transport costs to the United States, and preferential access to this last country due to NAFTA. However, the high penetration of Chinese exports in the U.S. market continues, even of products that require some degree of labor sophistication. The latter suggests that Mexico cannot settle only for the comparative advantages granted by NAFTA. Given China's entry to the WTO and the impulse it will have on this country's trade and investment flows, it is imperative that Mexico makes better use of its comparative advantages. In this respect, the approval and implementation of the pending structural reforms is a necessary factor to guarantee the attainment of this objective.

Graph 7 **Employment and Unemployment Indicators**

Trend Series



Source: IMSS and INEGI.
1/ Permanent and temporary urban workers.

II.2.3. Aggregate Supply and Demand

The behavior of aggregate supply and demand was unfavorable during the fourth quarter of 2002. In general, the recovery of the Mexican economy lost strength, as evidenced by a moderate real annual growth.

The modest economic expansion during the final quarter of last year can be attributed to three factors: the negative effect originated by reduced growth of industrial output in the United States, the slowdown of private consumption, and the contraction in private investment. These elements were partially offset by increased public investment and the rise in inventories[3].

An assessment of the evolution of the main components of aggregate supply and demand based on the quarterly variation of seasonally adjusted data confirms that the economic slowdown continued during the fourth quarter of 2002. Thus, quarterly growth rates of aggregate supply and demand fell from 0.5 percent in the last quarter of 2002 to 0.2 percent in the first quarter of 2003. On the aggregate demand side, there was a moderate improvement in the quarterly growth of consumption and total investment, mainly driven by public sector expenditures. In contrast, private consumption registered a slightly negative quarterly variation while private investment posted its most significant fall since the first quarter of 2001. Meanwhile, exports decreased compared to their level during the previous quarter, and imports increased moderately. As a consequence, real GDP registered zero growth in the fourth quarter, after having expanded at a quarterly rate of 0.8 percent during the preceding quarter (Table 9).

Table 9 **Aggregate Demand and Supply in 2001 and 2002**

	Real Annual Percentage Change						Real Quarterly Percentage Change (Seasonally Adjusted Series)				
	2001	2002					2001	2002			
	IV	I	II	III	IV	Annual	IV	I	II	III	IV
Aggregate Supply	-2.8	-2.8	2.4	2.6	2.1	1.1	0.7	-0.3	2.0	0.5	0.2
GDP	-1.5	-2.2	2.0	1.8	1.9	0.9	-0.1	0.0	1.2	0.8	0.0
Imports	-6.1	-4.5	3.5	4.8	2.5	1.6	3.1	-0.9	4.0	-0.2	0.7
Aggregate Demand	-2.8	-2.8	2.4	2.6	2.1	1.1	0.7	-0.3	2.0	0.5	0.2
Total Consumption	1.4	-1.5	2.5	1.7	0.8	0.9	0.3	-0.4	1.6	-0.1	0.1
Private	1.0	-1.6	3.1	2.0	1.2	1.2	0.4	-0.2	1.8	-0.1	-0.2
Public	4.0	-1.1	-1.7	-0.8	-1.3	-1.3	-0.8	-1.2	0.3	0.4	1.9
Total Investment	-9.1	-6.9	2.8	-0.8	0.0	-1.3	0.4	0.1	1.9	-2.2	-1.5
Private	-11.9	-5.9	1.3	-1.5	-5.2	-2.8	-0.5	-0.6	0.1	1.1	-5.8
Public	2.7	-13.2	13.8	3.6	18.6	7.3	5.3	4.3	11.7	-18.7	24.8
Exports	-9.2	-6.7	3.1	6.0	3.4	1.4	1.4	0.6	2.9	1.2	-2.6

Source: Banco de México and INEGI.

In the fourth quarter of 2002, aggregate supply and demand posted a real annual increase of 2.1 percent, meaning that these aggregates grew at an average annual rate of 1.1 percent during the year. Meanwhile, real GDP grew at an annual rate of 1.9

[3] Contributions to real annual GDP in the fourth quarter were as follows: Private Consumption, 0.8 percent; Public Consumption, -0.2 percent; Private Sector Gross Fixed Capital Formation, -0.8 percent; Public Sector Gross Fixed Capital Formation, 0.8 percent; Inventories, 1 percent; Exports, 1.2 percent; and Imports, –0.9 percent.

percent in the fourth quarter of 2002, only marginally above the level observed during the third quarter (1.8 percent).

As for production, the agricultural, forestry and fishing sectors contracted 4.5 percent during the last quarter of 2002, while the industrial and service sectors increased 0.9 and 3.1 percent, respectively. Annual growth of industrial and services GDP, which experienced positive variations in all their components, was higher in the fourth quarter than in the third.

The slowdown of annual private consumption occurred despite the recovery of spending on consumer durables (motor vehicles, wooden furniture, and radio and T.V. sets, among others) compared to the previous quarter[4]. The latter coincides with real increases in financing granted by commercial banks to the private sector (driven by lower nominal interest rates due to falling inflation) for the consumption of durable goods.

In the fourth quarter of 2002, total annual investment remained virtually unchanged as the decline in private investment was offset by higher levels of investment from the public sector. As a result, investment was the component influenced aggregate demand and GDP growth the most during 2002.

Available information regarding economic activity in the first quarter of 2003 suggests production grew at a moderate pace. In general:

(a) The annual growth of the Global Economic Indicator (*Indicador Global de la Actividad Económica, IGAE*) was 2 percent in February, a level similar to that observed in January (2.1 percent). Meanwhile, seasonally adjusted monthly data for this indicator in February had a monthly variation of –0.2 percent;

(b) In the first two months of the current year, industrial output expanded at an annual rate of 0.8 percent. This stemmed from increases of 4.3 and 2.5 percent in construction and electricity, with mining and manufacturing remaining practically unchanged;

(c) The weakness of international trade flows in the first quarter of 2003 (see Section II.2.4.) indicates that

[4] The 5.2 percent annual increase in the consumption of durable goods was higher than the 3.1 percent observed in the third quarter. In contrast, the annual growth in purchases of non-durable goods and services during the fourth quarter was lower than the figure of 2.1 percent registered in the preceding quarter.

domestic output and aggregate spending declined during that period;

(d) The slack in the labor market during the first few months of the year is compatible with the lackluster economic activity (see Section II.2.2.); and

(e) In February, the Leading Cyclical Indicator calculated by Banco de México registered a monthly increase of 1.9 percent, its second positive monthly variation. During the same month, the Conference Board's index rose 0.2 percent, its fourth successive positive variation. Meanwhile, INEGI's index for January posted a monthly increase of 0.4 percent, after having fallen in the previous month. The behavior of these indicators suggests that economic activity will show positive but modest growth rates in the next few months.

As for the components of domestic demand, indicators available at the time of publishing this Report suggest a less than robust performance during the first quarter. Retail sales were the only exception, with an annual rate increase of 3.8 percent during the first two months of 2003 and a 0.7 percent increase in their seasonally adjusted monthly figures for February. In this regard the following are noteworthy:

(a) Retail car sales posted annual variations of –7, 1.3 and 2.2 percent in January, February and March, respectively;

(b) In February, the growth of performing credit granted to the private sector by commercial banks eased (see Section II.2.3.); and

(c) The monthly survey of manufacturing sector conditions indicates that the number of orders coming from the domestic and external markets during the first two months of 2003 was insufficient, although there was a slight improvement in both markets during March.

As a result of the modest advance in industrial output indicators, the lower levels of trade of merchandise and services brought about by the adverse international environment, together with a meager expansion of private sector consumption and investment, real GDP is estimated to have increased 2.6 percent in the first quarter of the year. It is therefore unlikely that the behavior of aggregate demand was a source of inflationary pressures during the quarter.

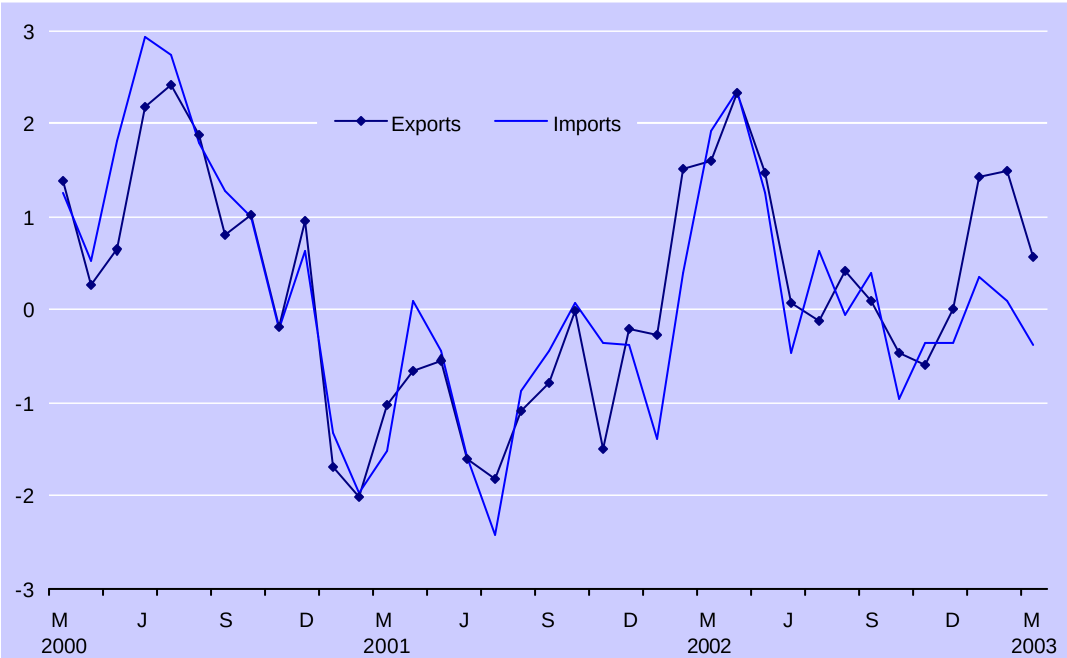
II.2.4. Balance of Payments, Capital Flows and Exchange Rate

In the first quarter of 2003, Mexico's international trade results mirrored the fragile economic activity in the United States and the deceleration of domestic output. Although the annual growth of total exports rose from 5.6 percent in the last quarter of 2002 to 7.5 percent in the first quarter of 2003, the behavior of non-oil exports was disappointing. The latter posted an annual increase of 1.6 percent during the period reported, a rate lower than the 2.4 percent level observed in the last quarter of 2002.

The annual growth of imports rose from 3.3 percent in the fourth quarter of the previous year to 3.9 percent in the January-March period of 2003. This increase stemmed from a rise in imports of consumption goods, while those of capital goods declined considerably. Thus, the correlation that has existed between imports and exports over the last few years declined in the quarter covered by this Report (Graph 8).

Graph 8 **Exports and Imports: Seasonally Adjusted Series**

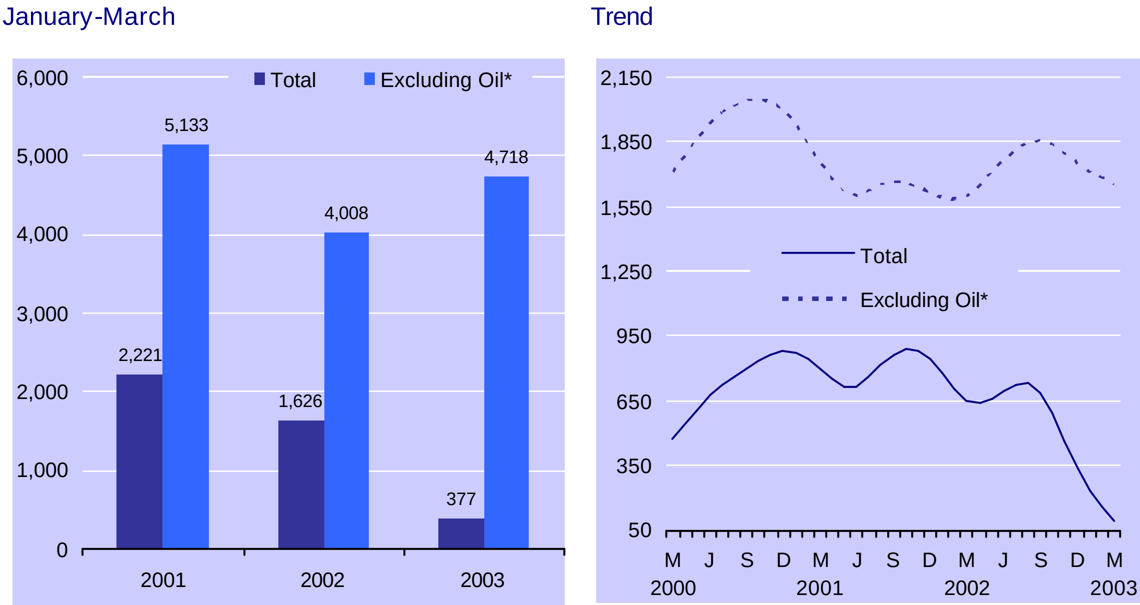
Monthly percentage change (3-month moving average)



Mexico's trade deficit totaled 377 million US dollars in the first quarter of the year. This result reflected the high value of oil exports stemming from higher international oil prices. Meanwhile, the non-oil trade deficit was 4,718 million US dollars, a figure stronger than that observed in the same period of the previous year (Graph 9).

Graph 9 **Trade Deficit (Total and Excluding Oil)**

Million US dollars



* Excluding oil exports, gasoline and butane and propane gas imports.

The sluggish recovery of merchandise imports relative to the growth of total exports helped to moderate the current account deficit, which is estimated to have been around 2,000 million US dollars in the first quarter of 2003.

As for the capital account, the Federal Government placed two global bonds in the international markets in order to repay liabilities issued under less favorable conditions. The first of these was for 2,000 million US dollars; the second was for 1,000 million dollars and included Collective Action Clauses (*Cláusulas de Acción Colectiva, CAC*), which include a mechanism to facilitate debt renegotiation when necessary. It should be mentioned that due to markets' favorable country risk perceptions for Mexico the use of CAC in the Mexican global bonds did not imply additional costs.

Based on information available at the time of publishing this Report, it is estimated that the capital account surplus in the first quarter of 2003 reached nearly 6,000 million US dollars (including errors and omissions).

During the first quarter of the year, the conditions of access to external financing improved for Mexico and other Latin American countries, except Argentina, Uruguay, and Venezuela. Country risk indicators deteriorated for the last two countries, and the leading rating agencies reduced their sovereign ratings (Table 10). The favorable performance of the remaining Latin American sovereign debt markets is partly due to prudent fiscal and monetary policies, as well as to the fact that investors have been attracted to better yields than those offered by developed countries. This took place despite the instability in international financial and stock markets during the period related to the geopolitical scenario and war in Iraq. Nevertheless, continuing favorable conditions in this market depend on the recovery of the world economy. Should this not occur, the availability of external resources to the region would probably be cut down.

Table 10 **Country Risk Indicators for Latin America (Global EMBI)**

Basis points

	2001				2002				2003
	I	II	III	IV	I	II	III	IV	I
Latin America	757	787	1,069	888	688	1,034	1,316	981	810
Argentina	967	1,050	1,615	5,363	5,030	7,078	6,475	6,342	6,096
Brazil	805	844	1,163	864	716	1,560	2,412	1,460	1,050
Chile	189	169	220	175	120	209	218	176	156
Colombia	645	528	615	508	511	592	1,066	633	595
Ecuador	1,366	1,303	1,516	1,233	1,037	1,262	1,975	1,801	1,372
Mexico	408	307	427	306	249	323	435	329	289
Panama	n.a.	n.a.	n.a.	n.a.	347	466	561	446	399
Peru	650	632	669	521	409	628	880	609	477
Dom. Republic	n.a.	n.a.	n.a.	446	313	383	521	499	527
Uruguay	n.a.	251	299	284	525	869	1,643	1,228	1,344
Venezuela	877	847	997	1,130	898	1,113	1,166	1,131	1,406

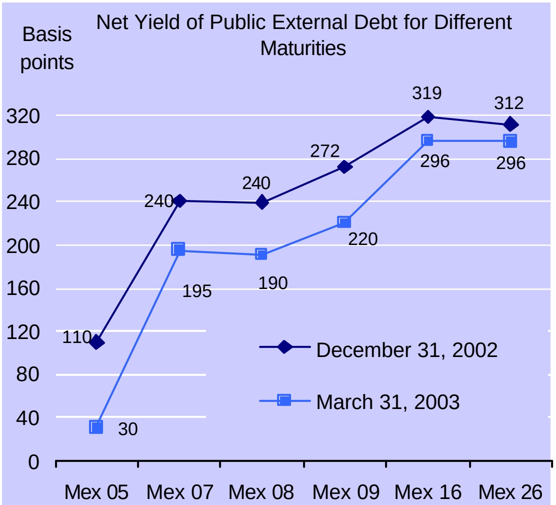
Source: JP Morgan. End-quarter Index.

Similar to other Latin American countries, Mexico's sovereign debt behaved favorably during the first quarter of 2003. This can be explained by fiscal discipline, the commitment not to increase external indebtedness, and preventive monetary policy actions implemented in the country. In mid-March Moody's upgraded Mexico's sovereign debt from stable to positive.

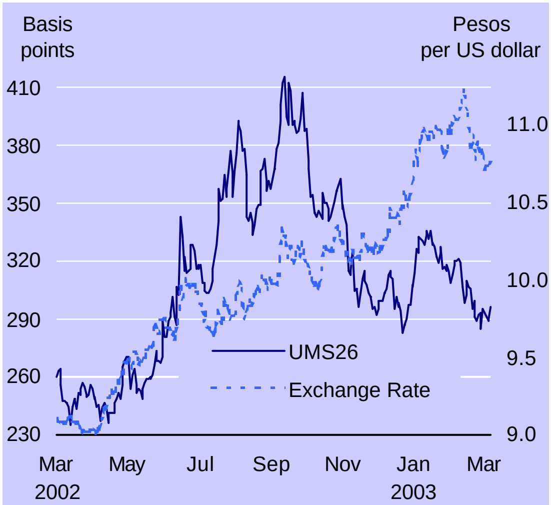
Notwithstanding the above, the Mexican peso depreciated vis-à-vis the U.S. dollar throughout the first quarter. Thus, while UMS26 bond yields declined slightly, by 16 basis points, compared to the end of 2002, the Mexican peso depreciated 3.5 percent vis-à-vis the dollar during the same period (Graph 10).

Graph 10 **Country Risk Indicators for Mexico and Exchange Rate**

Basis points



Basis points and pesos per US dollar

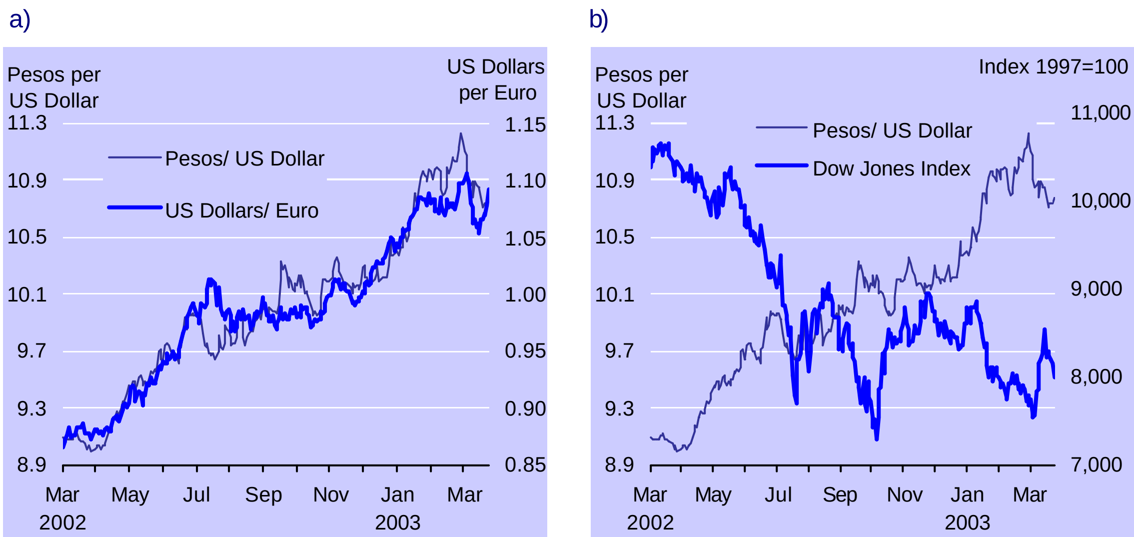


Source: Bloomberg and Banco de México.
Note: The net yield of the UMS26 bond is the difference between its gross yield and that of a U.S. Government bond of similar maturity.

Just as in the previous quarter, there was a close correlation between the peso/dollar and dollar/euro exchange rates. Nonetheless, towards the end of March the peso/dollar exchange rate decoupled from the dollar/euro exchange rate fluctuations (Graph 11a).

The easing of the above correlation could have been influenced by the announcement at the end of March of a mechanism to reduce the rate of accumulation of international reserves (see Section III.2.1). This confirms, as indicated in previous Reports, that some statistical relationships between peso/dollar exchange rates and other financial variables may be unstable and short-lived (Graph 11b).

Graph 11 **Exchange Rates (US Dollar Vis-à-Vis the Euro and Peso Vis-à-Vis the US Dollar) and Dow Jones Index**



Source: Reuters and Banco de México.

It is important to mention that the depreciation of the peso vis-à-vis the US dollar that began nearly one year ago could also respond to factors that affect the performance of the real variables that determine the exchange rate in the long run[5]. An example is the growing competition faced by Mexican exports from those of China.

II.2.5. Prices Administered or Regulated by the Public Sector

In January and February of 2003, the monthly inflation of the subindex of prices administered or regulated by the public sector[6] was higher than that of the CPI, a reversal of the pattern seen in March. Thus, in January, February and March the monthly growth of this subindex was 1.16, 0.30 and 0.46 percent, respectively, while the CPI expanded 0.40, 0.28 and 0.63 percent during the same months (Graph 12). However, monthly increases

[5] See pages 32 and 33 of the Inflation Report of October-December 2002.

[6] The basket of the subindex of prices administered by the public sector includes high and low-lead gasoline, domestic gas and electricity. Products whose prices are regulated by the public sector are international long distance phone calls, domestic long distance phone calls, phone line installation and service fees, taxi fares, city bus fares, subway or electric transportation fares, inter-city bus services, parking lots, automobile ownership taxes, local phone services, highway tolls, oil and lubricants, and duties and licences.

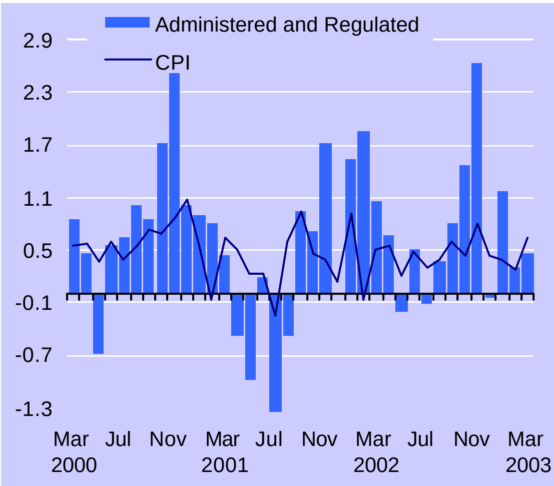
of the subindex of prices administered or regulated compare favorably with those registered in the same months of 2002[7].

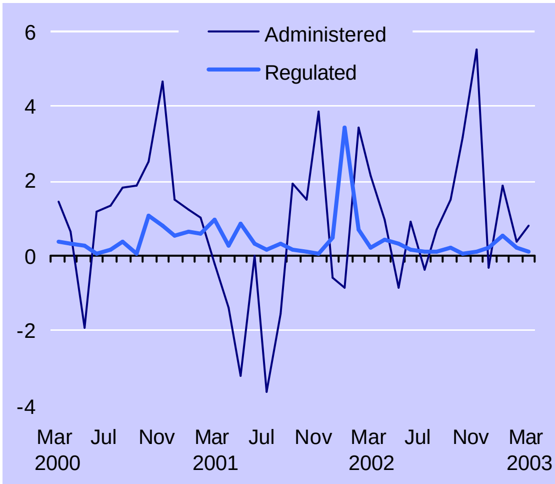
Higher levels of inflation of this subindex were due mainly to the rise in administered prices. It is worth remembering that the same pattern was observed during the previous year. Higher inflation stemmed from increases in prices of domestic gas and low-lead gasoline in U.S.-Mexico border cities (between December 2002 and March 2003 these prices went up 4.19 and 4.04 percent, respectively).

The increase in the price of low-lead gasoline during the quarter mirrored the corresponding fluctuations of this price in U.S. cities on the border with Mexico. This stemmed from the Mexican Federal Government's decision in November 2002 to equal the price of this fuel at the northern border with that in neighboring U.S. cities. This measure, which came into force in December 2002 and was modified in March of this year, set as an upper limit the price prevailing in the rest of the Mexican states.

Graph 12 **Index of Prices Administered and Regulated by the Public Sector and CPI**

Monthly percentage change





Given the importance of the subindex of prices administered or regulated by the public sector in the determination of CPI inflation, Banco de México reiterates the need for its behavior to be consistent with the inflation target for 2003.

[7] Monthly variations in January, February and March of 2002 were 1.53, 1.86 and 1.05 percent, respectively.

II.2.6. Transitory Factors that Affected Inflation

Annual inflation of the subindex of agricultural prices was negative during the first quarter of 2003. Nevertheless, the decline was less pronounced than that observed in the same quarter of the previous year. On the one hand, the component related to fruits and vegetables fell 6.55 percent, compared to 11.38 percent in the same quarter of last year. On the other, prices of meat and eggs went up 3.73 percent, in contrast with the 0.71 percent reduction registered during the same period of 2002. This behavior caused annual inflation of this subindex to increase from 8.65 percent in December 2002 to 13.42 percent in March 2003.

Annual inflation of agricultural products is usually characterized by a volatile behavior. In an environment of low inflation such volatility can generate relatively sharp movements in the CPI. This highlights the relevance that core inflation has acquired as an indicator of medium-term inflationary pressures.

III. Monetary Policy During the First Quarter of 2003

This section reviews the reasons that prompted Banco de México's Board of Governors to increase the "short" on three occasions during the first quarter of 2003 (January 10th, February 7th and March 28th). With such purpose, a brief assessment of the evolution of private sector inflation expectations and of interest rates during the period is also presented. The behavior of these variables complements the information regarding the level and variations of the "short" for the appraisal of monetary conditions that prevailed during the quarter. Finally, the path of the monetary base as well as other monetary and credit aggregates will also be discussed.

III.1.1. Monetary Policy Actions

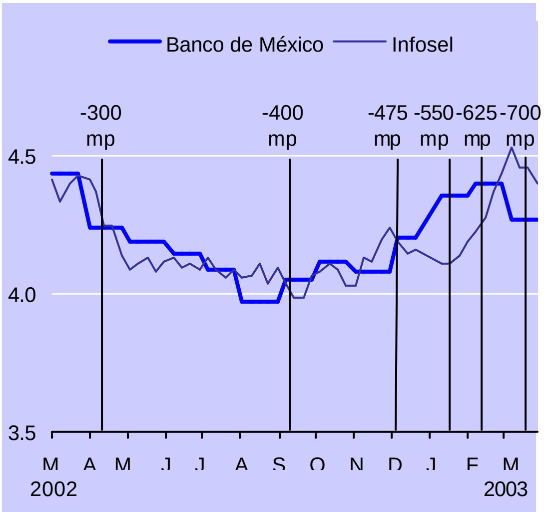
During the first three months of the year, the Board of Governors of Banco de México raised the "short" from 475 to 700 million pesos, thus intensifying the monetary restriction. These three increases in the "short" during this quarter came after two decisions in the same direction during the second half of 2002.

The latest five monetary policy measures have been particularly aimed at inducing a downward movement of inflation expectations, and at creating the appropriate monetary conditions so that CPI inflation converges sustainably with the target in 2003. The tightening of the monetary restriction during the last six months has been necessary given the downward rigidity of inflation expectations. Although analysts' inflation estimates for the following twelve months seem to have stabilized in the last few months, they still remain high (Graph 13).

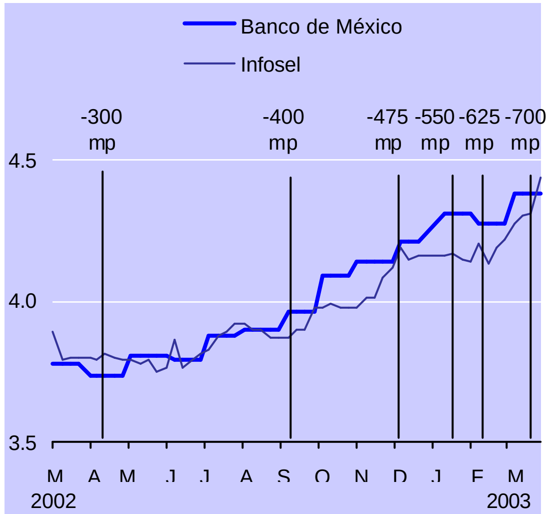
Graph 13 **Inflation Expectations for the Following 12 Months and for Year-End 2003 (INFOSEL and Banco de México)**

Percent

Inflation Expectations for the Following 12 Months



Inflation Expectations for Year-End 2003



Source: INFOSEL and Banco de México, Survey of Private Sector Economic Analysts' Expectations.

Analysts' expectations for annual CPI inflation as well as those implicit in wage increases have not clearly converged with the target for December 2003 despite the following factors consistent with falling inflation:

(a) The intensification of the monetary restriction on five consecutive occasions;

(b) The fact that accumulated economic growth over the last two years has been clearly below potential and the economy is currently at a point where the use of installed capacity is low and there is a slack in the labor market (see Section II.2.2.);

(c) There have been no signs of a pass-through effect from the depreciation of the exchange rate to domestic prices; and

(d) Deflation of merchandise prices in the United States has reduced pressure on the same prices in Mexico.

Expectations regarding annual core inflation for December 2003 (3.93 and 3.74 percent according to surveys carried out by Infosel and Banco de México, respectively) are considerably lower than those for CPI inflation (4.44 and 4.38 percent according to INFOSEL and Banco de México, respectively). This seems to indicate that analysts foresee a slower decline in inflation of non-core price subindexes.

As described above, Banco de México tightened the monetary restriction on three occasions during the first quarter. The first of these actions raised the "short" from 475 to 550 million pesos on January 10th. This preventive measure was taken to create the monetary conditions necessary to reduce inflation expectations, as the disinflationary process faced a major challenge considering that the target set forth for 2002 had not been met. The latter responded to the substantial increase in the subindex of prices administered or regulated by the public sector. If this subindex had gone up at an annual rate of 4.5 percent, the deviation from the inflation objective would have been only 0.1 percent.

The "short" was increased again on February 7th from 550 to 625 million pesos. Nevertheless, inflation expectations still continued without showing signs of convergence towards the inflation target, and contractual wage increases did not ease sufficiently to hasten the decline in core inflation of services. Furthermore, there were risks that the depreciation of the exchange rate and volatility in the currency market would bring about an upward revision of inflation forecasts.

The restrictive monetary policy measures adopted in January and February were reinforced by an additional increase in the "short" from 625 to 700 million pesos on March 28th. This decision was implemented in the midst of an adverse environment where inflation expectations continued on a rising path, and the unfavorable behavior of non-core inflation could worsen the price formation process. Thus, the Board of Governors confirmed its commitment to continue modifying monetary conditions according to the current and foreseeable economic environment.

The Board of Governors announced the maintenance of a restrictive monetary stance as long as inflation expectations do not resume a downward trend consistent with the target. In this way, the monetary authority confirmed its commitment to price stability, defined as an annual CPI inflation of 3 percent with a variability interval of plus/minus one percentage point.

The increases in the "short" during the first three months of 2003 had an upward effect on interest rates. This contrasted with the low level and stability of nominal rates in dollars in the United States, as well as with the reduction of the total yield of Mexican sovereign bonds issued abroad. Moreover, the rise in real yields on financial instruments in Mexico took place in an environment in which real rates on short-term instruments in the United States were negative.

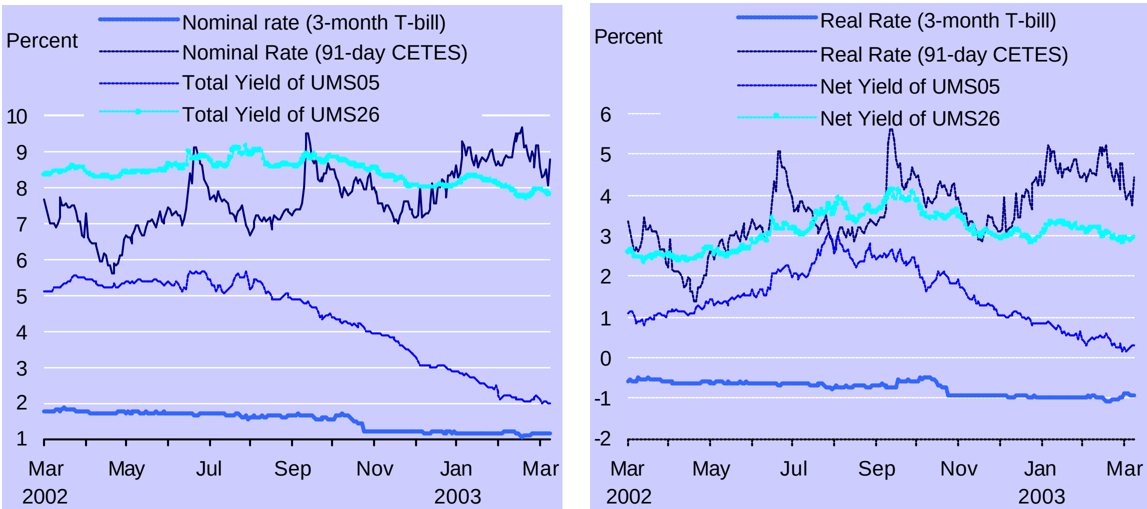
It is worth remembering that during the first quarter of 2003 the external scenario was characterized by sharp declines in the world's most important stock markets and an unexpected increase in the demand for bonds issued by emerging markets. Falling stock prices can be explained by global geopolitical uncertainty and expectations that the recovery in the United States and in the world economy would be more gradual than anticipated. Thus, in line with the foreseen economic situation, some of the world's most important central banks reduced their target interest rates, hence increasing the probability that others would follow suit.

In the adverse environment described above, the spread between the yield on Mexican sovereign bonds issued abroad and interest rates on U.S. Treasury bonds narrowed during the first quarter of 2003 despite the unfavorable conditions prevailing in industrialized countries' financial markets. This was due partly to the positive influence of improved financial conditions in several Latin American economies (whose performance had caused uncertainty in the previous year) on Mexican financial markets. As a result, Mexico's country risk perception improved between December and March. In contrast, domestic nominal interest rates rose substantially during the first quarter.

Domestic financial markets reacted consistently with the intensification of the monetary restriction. As a result, domestic interest rates went up in the days following the monetary policy actions adopted on January 10th, February 7th and March 28th. It should be mentioned that during the first quarter, government and bank's funding rates rose 67 and 53 basis points, respectively. Likewise, interest rates of 28-day and 91-day CETES went up 55 and 120 basis points, respectively (Graph 14).

Graph 14 **Nominal Interest Rates, Real Interest Rates 1/ and Total Yield of UMS05 and UMS26 Bonds**

Percent



Source: U.S. Federal Reserve Board, INFOSEL and Banco de México.
1/ Nominal interest rates deflated by inflation expectations for the following 12 months.

Regarding the implementation of monetary policy, two important changes were announced:

(a) A deposit at Banco de México of 30,000 million pesos by credit institutions for monetary purposes and to enable the Central Bank to maintain a liquid creditor position vis-à-vis the banking system. This would allow monetary policy to remain effective in influencing the behavior of short-term interest rates; and

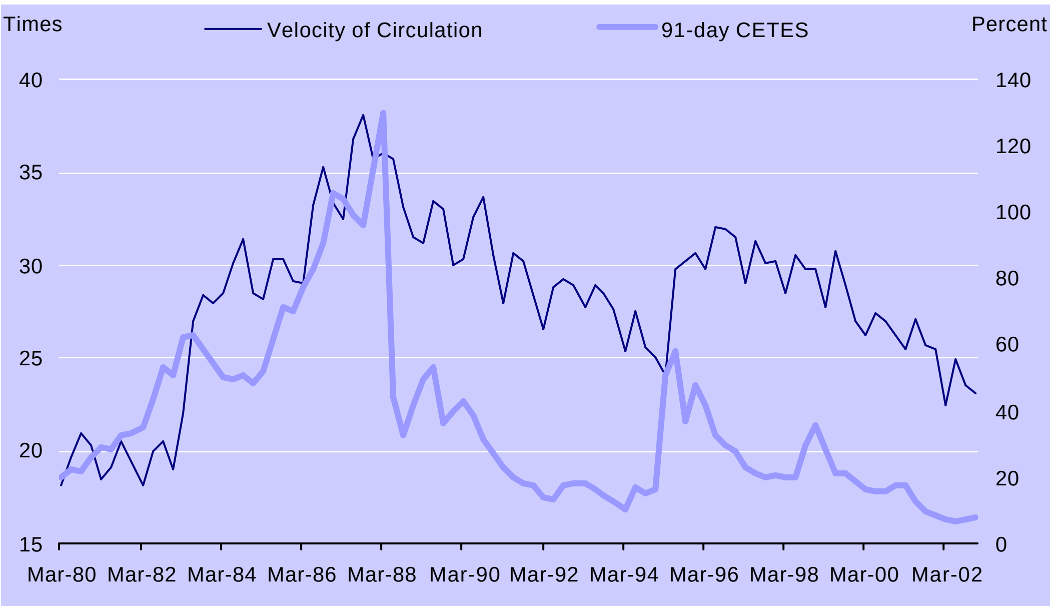
(b) As of April 10^{th}, the replacement of the existing regime of commercial bank's accumulated balances in their current accounts held at Banco de México by a new one based on daily balances. Thus, although on April 9^{th} the accumulated balances objective for each 28-day period ("short") was 700 million pesos, on the following day the daily balances objective was 25 million pesos (700 million pesos ÷ 28 days = 25 million pesos every day). In this way, the measure did not alter the monetary policy stance consistent with the level of the "short". This substitution was adopted for the following reasons. First, because the advantages of the former scheme that allowed positive and negative stocks to be compensated during the measuring period have diminished mainly as a result of the adoption of an improved operational framework that has improved the accuracy of financial programming. Second, because this is a more transparent mechanism.

It is important to point out that none of the above steps modify the liquidity of the system and therefore do not imply a change in the monetary policy stance.

III.2. Monetary and Credit Aggregates

Although the short-term relationship between monetary aggregates and inflation has been unstable, it is advisable to review its evolution in order to identify the presence of possible long-term inflationary pressures. The velocity of circulation of base money has slowed considerably since 1997. This mainly as a result of the remonetization process which consists of an increase in the demand for monetary balances induced by falling interest rates during the stabilization process. In other words, it has responded to the reduced opportunity cost of maintaining liquid assets (Graph 15). It should be mentioned that the velocity of circulation is still higher than during periods of low inflation, and it would not be surprising that the gap between the growth of monetary base and nominal income persisted for a longer period of time.

Graph 15 **Velocity of Circulation of the Monetary Base[1/] and Interest Rate for 91-day CETES**



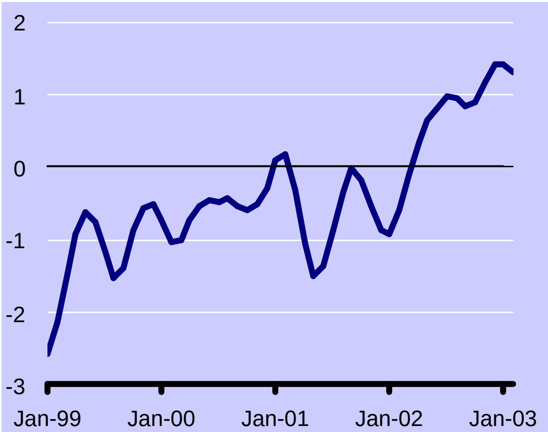
1/ Calculated as the ratio private consumption to bills and coins in circulation.

As for the broad monetary and credit aggregates, the rise in total financing granted to the private sector by the financial system[8] is noteworthy, although still modest (Graph 16a). In fact, the net creditor and debtor positions of households and firms have remained relatively stable (Graph 16b)[9]. Thus, the evolution of the monetary and credit aggregates does not suggest the presence of aggregate demand pressures that could jeopardize the abatement of inflation.

Graph 16 Total Financing to the Private Sector and Creditor Position of Firms and Households

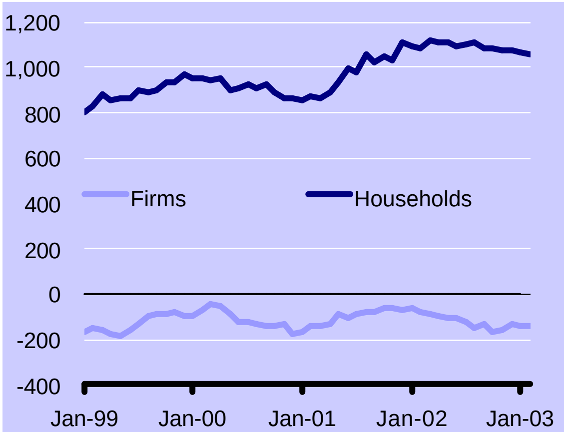
a) Total Financing to the Private Sector

Real monthly variation of trend series (Percent)



b) Creditor Position of Firms and Households

Real stocks in thousand million pesos



III.2.1. Monetary Base, Net Domestic Credit and Net International Assets

During the first quarter of 2003, the annual variation of the stock of base money was on average 16 percent, very similar to that anticipated in the monthly forecast published in the Monetary Program (16.2 percent). The pace of growth of the monetary base is expected to slow from the second quarter on (Graph 17).

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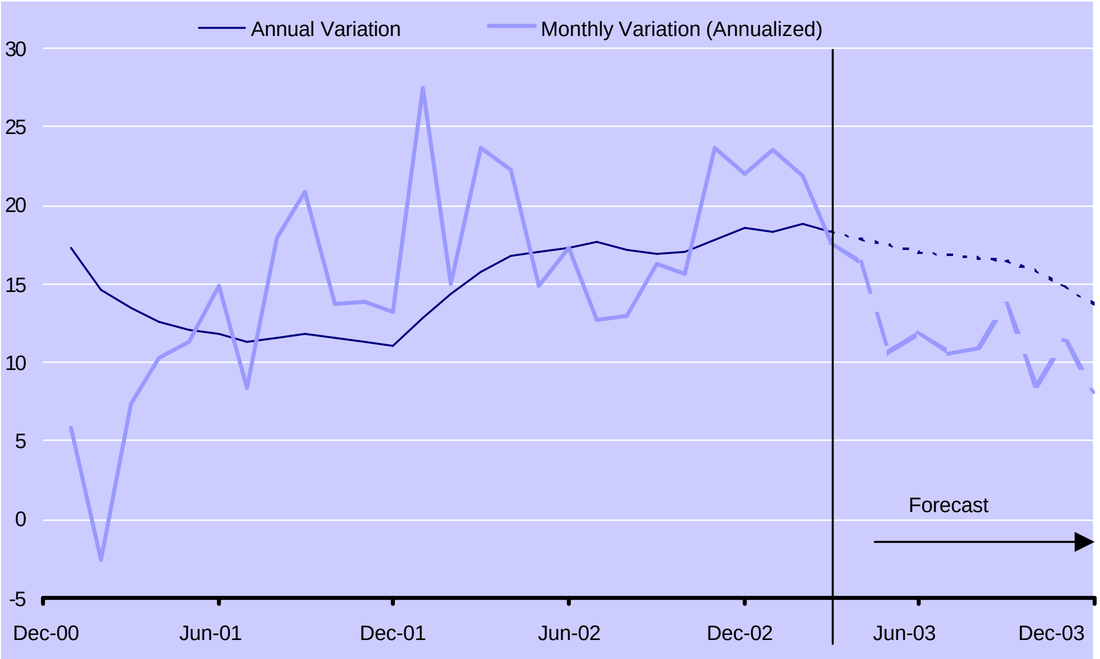
8 See the Mexican Financial System Outlook, published on Banco de México's website, which consolidates assets and liabilities of the following intermediaries: commercial banks, development banks, Banco de México, leasing companies, factoring companies, SOFOLES, savings and loans companies, credit unions, insurance companies, SIEFORES, development trust funds, deposit warehouses, investment funds, brokerage houses, and bonding companies. Conceptually, this is the widest measure of domestic financing. Its main source of funds is the share of financial saving (M4) channelled by financial intermediaries to the private sector.

9 The net creditor position is obtained by subtracting private sector's total financial assets from its total financial liabilities. Information is drawn from the Mexican Financial System Outlook.

Graph 17 **Evolution of the Monetary Base**



During the same period, the stock of net international assets[10] of Banco de México rose 3,281 million US dollars, ending March at 54,003 million. The main source of this buildup was PEMEX who sold 2,899 million dollars to Banco de México while the Federal Government purchased 96 million US dollars.

From December 2002 to March 2003 Banco de México's net domestic credit shrank 61,529 million pesos. The aforementioned mainly reflected the sterilization of the monetary impact of the increase in international assets and the seasonal reduction in the demand for monetary base.

During the last five years (December 1997 to March 2003) Banco de México has accumulated international assets amounting to 34,179 million US dollars (Graph 18a). The latter mainly stems from the net effect of several factors: currency inflows received by PEMEX (44,090 million US dollars), sales to the Federal Government to cover public debt service (23,647

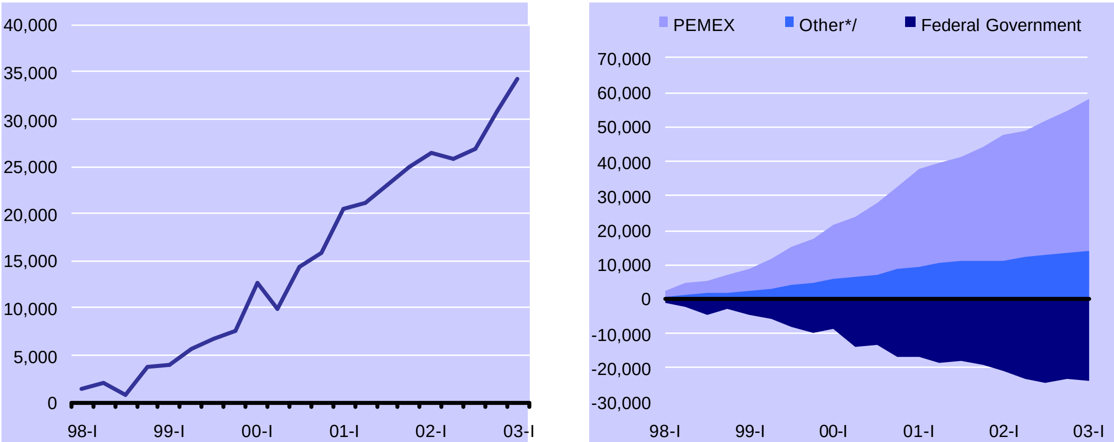
[10] Net international assets are defined as gross reserves plus credit agreements with central banks with more than six months to maturity, minus total liabilities payable to the IMF, and minus credit agreements with central banks with less than six months to maturity. Furthermore, it includes the change in value in U.S. dollar terms of foreign currency transactions carried out to date.

million US dollars) and other revenues worth 13,736 million US dollars[11] (Graph 18b).

Graph 18 **Sources of Accumulation of International Assets**

a) International Assets
Accumulated flows (million US dollars)

b) Main sources
Accumulated flows (million US dollars)



*/ Includes interest revenue from international assets and, during its term period, to the net accumulated foreign exchange obtained through the public auctioning of dollar put options and the automatic mechanism of dollar sales.

To offset the monetary impact from the accumulation of international reserves[12], Banco de México removes excess liquidity from the market by issuing securities (mainly BREMS) or other liabilities with monetary regulation purposes, such as the recent deposits credit institutions were required to make at Banco de México (see Section III.1.1). Thus, Banco de México's cost for maintaining international reserves corresponds to the difference between the yield on the reserves and interest rates on liabilities issued by the Central Bank to finance their holding.

Given the current level of net international reserves and the expected pace of further accumulation for the rest of the year, it is possible to conclude that the net benefits, mainly reflected in lower financing costs for Mexico abroad, will diminish in time. Thus, the Exchange Rate Commission (*Comisión de Cambios*) decided to implement a mechanism to slow the velocity of accumulation of international reserves. As a consequence, part of the foreign currency flows that could potentially increase the level of reserves will be channeled to the market. This scheme will function independently from exchange rate levels and trends (Box 2).

[11] Refers to interest earned on international assets and, during their period in force, to the net accumulation of foreign exchange via the auctioning of options to sell dollars and the automatic dollar sales mechanism.

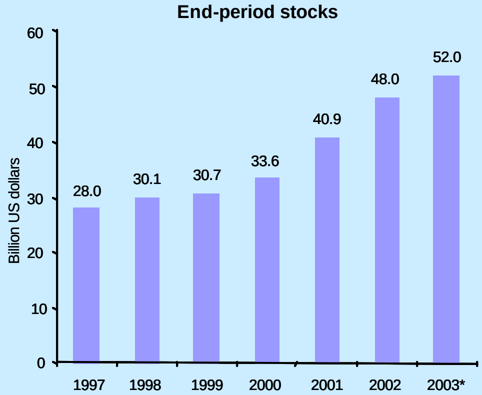
[12] International reserves are defined in Banco de México's Law (Articles 19 and 20).

Box 2
Mechanism to Reduce the Pace of Accumulation of Banco de México's International Reserves

On March 20, 2003 the Exchange Rate Commission (*Comisión de Cambios*) announced the implementation of a mechanism to slow down the pace of accumulation of Banco de México's international reserves (IR), to become effective May 2, 2003. This box presents a description of such mechanism and some considerations regarding its adoption.

During the last years, the level of IR of Banco de México has increased continually in a significant way. From December 1997 to April 2003 the amount of reserves practically doubled, from 28,000 million US dollars to nearly 52,000 million. Since June 2001, when the scheme to accumulate reserves via options was suspended[1], these have been accumulating through the purchasing of excess foreign exchange from PEMEX (see Graph 18 in Section III.2.1).

Graph 1
Net International Reserves
End-period stocks



*Up to April 4, 2003.
Source: Banco de México.

The need to have an "adequate and sufficient" level of IR in emerging economies that operate under a floating exchange rate regime (Mexico, for example) stems from their relative vulnerability to international capital movements. These countries have uncertain access to world's capital markets, which can cease or become restricted abruptly. Under such circumstances, a significant level of IR reduces the likelihood of these markets becoming unavailable. By mitigating these risks, IR contribute to upgrade the country's credit rating, thus lowering the costs Mexican agents have to face when issuing external debt instruments.

The benefits of having an adequate level of IR are evident when markets sense a country is able to face its external short-term commitments. The current level of Mexico's IR is sufficient to cover 1.4 times the country's external short-term commitments (public and private) for this year[2]. Moreover, it would also help to handle import operations for 4 months. In fact, payments of short-term public external debt are likely to decrease in the next years mostly as a result of accumulated reserves, while the weighted average maturity of public domestic debt has widened[3]. These elements reduce the need to continue accumulating international reserves.

Despite the mentioned benefits, the accumulation of reserves entails costs. For example, the cost of maintaining a certain level of IR originates from the difference between the yield of the reserves and the interest rate to be paid on the securities that are issued to finance the accumulation of reserves. International assets are invested abroad in securities and deposits with high credit rating that are either easily disposed of or have a very liquid market. However, high levels of liquidity often translate into lower yields. Furthermore, the accumulation of IR reduces potentially available resources to cover larger current account deficits. Given the current level of IR and the pace of accumulation expected in 2003[4] it might be concluded that any benefits to be obtained (which

[1] In August 1996, Banco de México implemented a mechanism to accumulate reserves through the auctioning of options (see Banco de México, Annual Report 1996, p.106). With this mechanism, the Central Bank accumulated reserves for more than 12,000 million US dollars. In 2001, the Foreign Exchange Commission considered that this mechanism had attained its objective, thus deciding to suspend it as of June 29th of that year (see Banco de México, Inflation Report April-June 2001, p.38).

[2] These estimates include a forecast of public debt service (capital and interests) in 2003 and amortizations of private debt for the same year. Also, bank's overall outstanding debt at year-end 2002 is assumed to be short-term debt. Finally, amortizations on domestic public debt held by non-residents in 2003 are also included.

[3] See SHCP, "Informe sobre la Situación Económica, las Finanzas Públicas y la Deuda Pública", cuarto trimestre de 2002.

[4] Under the present conditions, the Exchange Rate Commission estimates that the accumulation of reserves in 2003 will be nearly 7,000 million US dollars.

are the counterpart of the mentioned costs) will likely be smaller.

Given this scenario, the Exchange Rate Commission decided to implement a mechanism to reduce the pace of accumulation of reserves. From the day it comes into effect, part of the foreign currency flows that could potentially increase the level of the country's reserves will be channeled to the market. The mechanism establishes that Banco de México will sell dollars directly to the market according to the following rules:

1. On a quarterly basis, Banco de México will make public in advance the amount of dollars to be offered in the exchange market during the next quarter. The amount of dollars to be auctioned in the quarter will equal to 50% of the IR flows accumulated in the previous quarter (after considering the total number of offerings done via this mechanism during the same period).

2. Depending on the amount of dollars to be offered, Banco de México will auction a fixed amount of US dollars every day on a predetermined schedule. Daily offerings will be determined based on the number of working days in the quarter in which auctions will be held. For example, if the procedure considers that 1,500 million US dollars will be sold during the quarter and this period has 60 working days, the daily amount to be auctioned will be 25 million US dollars.

3. The country's credit institutions are the only agents allowed to participate in these auctions.

4. Should the amount to be offered during the quarter be less than 125 million US dollars, the mechanism will be suspended temporarily.

5. Considering the above, auctions of dollars will resume only after reserves reach a level 250 million US dollars higher than that observed at the beginning of the last quarter in which the mechanism was still in force (after considering all offerings done in the same quarter).

6. Auctions will begin on May 2, 2003 based on the accumulation of IR registered between January 17th and April 16th. The exact amount of dollars to be offered daily will be announced on April 22nd.

The mechanism of daily auctioning of foreign currency will help to slow down the pace of accumulation of IR without reducing the current level of international reserves held by Banco de México. Following are several characteristics of the mentioned scheme that deserve mention:

- The mechanism is based on pre-established rules and, therefore, is not subject to discretionary decisions by the financial authorities.
- This framework provides certainty to the market, meaning that after the quarterly announcement has been made, the public will know in advance the amount of dollars to be auctioned daily.
- The mechanism of daily auctioning of dollars will operate independently of the market conditions prevailing at the time each auction is held.

The latter implies that this mechanism will not alter the current floating exchange rate regime nor try to influence the foreign exchange market in order to ensure or maintain a fixed exchange rate.

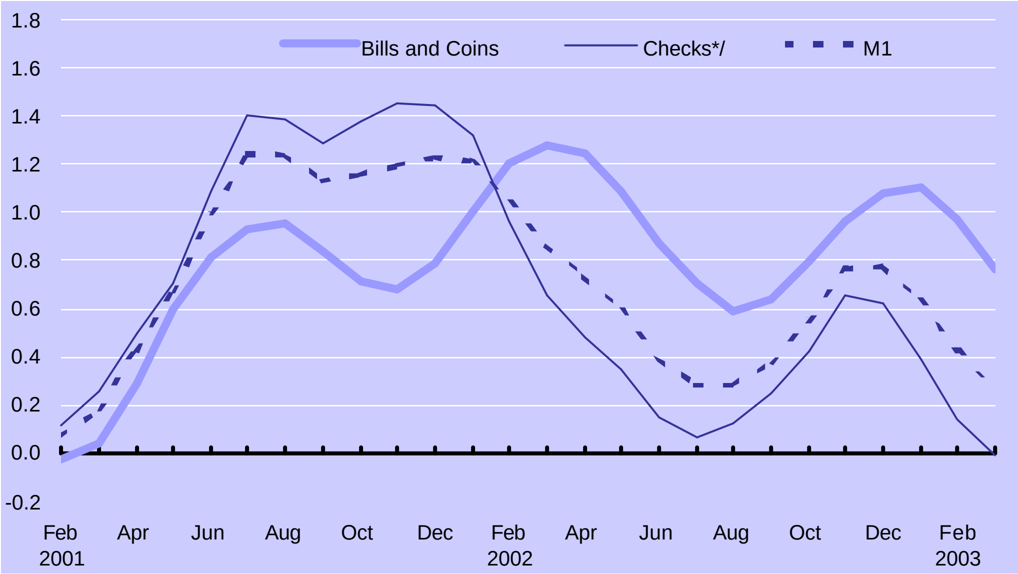
III.2.2. Monetary Aggregates

The growth rate of M1 in domestic currency fell during the first quarter of 2003 (Graph 19). In particular, checking accounts posted lower rates than in previous months. This can be partly explained by the spread between the yield on time deposits and interest paying checking accounts[13], and by the higher operative cost of checking accounts.

[13] In March the spread between the yields on checking accounts and 28-day time deposits offered by commercial banks was 377 basis points, 97 points higher than in December 2002.

Graph 19 **M1 in Domestic Currency**

Real monthly variation of trend series
(Percent)



*/ Includes checking accounts in domestic currency and current account deposits.

At the end of the first quarter, the annual real growth of the broad monetary aggregate M2 was 4.6 percent, thus implying a flow of financial savings from Mexican residents of 57,182 million pesos. The structure of financial saving changed during the quarter, as the holding of securities declined and bank deposits increased (Table 11). This resulted from the reaction of different banks to the flight of investors from investment funds given that a number of them were adversely affected by higher interest rates.

During the mentioned period, commercial banks channeled most of the increase in deposits to public securities. As a result, the private sector reduced its holdings of these securities, thus altering the composition of domestic financial saving (M2).

Table 11 **Monetary Aggregates**

Real annual percentage change

	Dec.02	Jan.03	Feb.03	Mar.03
M1	**6.5**	**7.9**	**6.7**	**3.8**
Bills and Coins Held by the Public	10.4	13.9	13.9	5.6
Checking Accounts in Domestic Currency	5.4	5.1	4.0	4.2
Checking Accounts in Foreign Currency	-5.3	-2.5	-5.6	-0.5
Current Account Deposits	13.5	15.1	13.3	2.3
M2	**5.4**	**7.3**	**5.6**	**4.6**
Bank Deposits	-12.1	4.7	8.3	9.6
Public Securities	14.3	7.2	2.0	0.3
SIEFORES Holdings	17.7	17.4	16.3	17.9
Other	13.4	4.4	-1.7	-4.3
Private Securities	31.6	29.7	24.4	26.2
M3	**5.1**	**7.5**	**5.7**	**4.9**
M4	**4.8**	**7.1**	**5.7**	**4.9**

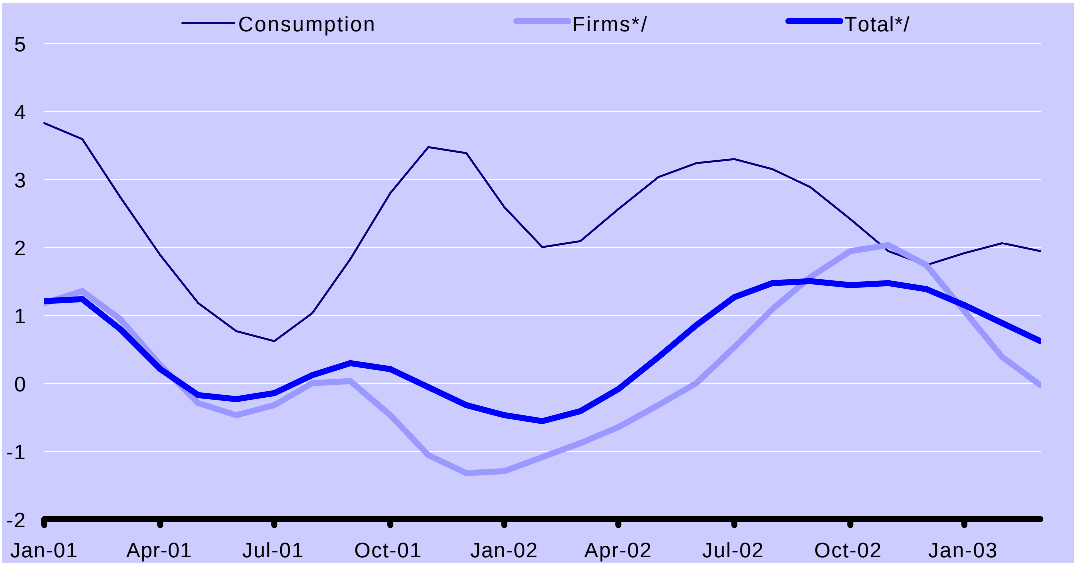
III.2.3. Financing to the Private Sector

The expansion of performing credit granted by commercial banks to the private sector eased. This behavior was in line with the lack of strength in consumption and industrial production observed over the last few months (Graph 20).

Performing credit to the private sector has been destined mainly to the services sector, particularly, to commerce. On February 2003 the latter received an annual flow of 13,500 million pesos, accounting for 56 percent of total resources channeled to firms (Table 12).

Graph 20 **Performing Credit**

Real monthly variation of trend series (percent)



*/ As for credit denominated in foreign currency, revalued stocks are considered.

Table 12 **Performing Credit by Sector**

	Stocks February 2003			Flows (thousand million pesos)	Annual
	Thousand million pesos	GDP %[1/]	Sectorial GDP %[1/]	Feb 02 / Feb 03	Real Variation %
Total	279.83	4.5	4.55	24.12	3.71
Agricultural	8.66	0.1	3.83	-5.55	-42.24
Industrial	141.29	2.3	9.50	7.95	0.42
Mining	2.76	0.0	3.65	-0.61	-22.29
Manufacturing	105.50	1.7	9.95	9.41	4.05
Construction	33.02	0.5	12.00	-0.86	-7.63
Services	129.88	2.1	3.26	21.73	13.81
Commerce, restaurants and hotels	71.00	1.2	6.10	15.97	22.28
Commerce	61.14	1.0	n.a.	13.51	21.66
Restaurants and hotels	9.86	0.2	n.a.	2.46	26.31
Other	58.88	1.0	2.09	5.75	5.03

n.a. Not available.
1/ Calculations based on the annual Gross Value Added (2002).

Finally, it is important to point out that the prevailing economic uncertainty has inhibited private firms' security issues on the domestic market. In March this year, the stock of these issues registered a real annual variation of 17.4 percent, compared to 39 percent posted in September 2002.

IV. Private Sector Outlook for 2003[14]

During January-March 2003, private sector analysts revised their forecasts on the outlook for the Mexican economy in 2003 as follows: lower real GDP growth and higher inflation.

IV.1. Forecasts for the Main Determinants of Inflation

In contrast to the previous Inflation Report, most private sector analysts estimated lower GDP growth in the United States and Mexico for 2003. Forecasts for economic growth in the United States were revised downward from 2.7 to 2.4 percent while those for real GDP growth in Mexico during 2003 and 2004 went from 3.2 to 2.5 percent, and from 4.2 to 4 percent, respectively. Meanwhile, Mexican analysts revised their estimates for the price of the Mexican oil export-mix in 2003 upwards, from 19.08 to 21.80 US dollars per barrel (Table 13).

Forecasts for the exchange rate at the end of 2003 were raised throughout the first quarter. As for contractual wages, analysts foresee increases of 5.1 and 5 percent in April and May, respectively.

Indicators of the business climate and confidence levels are less optimistic in March than in December 2002. In March, 56.7 percent of analysts surveyed were of the opinion that the business climate for the second half of the year will improve, while 40 percent mentioned that it would remain unchanged and the rest believed it would deteriorate.

According to analysts who took part in the survey, the main factors that could hinder economic growth over the next six months are the following: the weakness of external markets and of the world economy (28 percent); international political instability (17 percent); the lack of structural changes in Mexico (13 percent); the weakness of the domestic market and uncertainty regarding the domestic economic environment (9 percent for each of these two factors); and international financial instability and domestic political uncertainty (7 percent for each of these two factors).

[14] Unless otherwise stated, all forecasts reported in this section are drawn from the Survey of Private Sector Economic Analysts' Expectations undertaken each month by Banco de México.

Table 13 **Private Sector Expectations: December 2002 and March 2003[1/]**

	December 2002	March 2003		December 2002	March 2003
Real GDP Growth in Mexico			**Exchange Rate**		
			(Pesos per US dollar, Year-end)		
2003	3.16%	2.54%	2003 Survey BANXICO	10.51	10.88
2004	4.24%	4.00%	Futures[3/]	11.17	11.33
			2004 Survey BANXICO	n.a.	11.23
Trade Deficit			**Mexican Oil Mix**		
(Million US dollars)			(Average US dollars per barrel)		
2003	10,600	9,286	2003 Survey BANXICO	19.08	21.80
			Futures[6/]	24.14	24.13
Current Account Deficit			**Wage Increases**		
(Million US dollars)					
2003	18,490	16,234	April 2003	n.a.	5.1%
			May 2003	n.a.	5.0%
Foreign Direct Investment			**Business Climate**		
(Million US dollars)			Will improve	64.3%	56.7%
2003	13,691	13,201	Will remain the same	25.0%	40.0%
2004	n.a.	14,348	Will worsen	10.7%	3.3%
Real GDP Growth in the U.S. (2003)					
Survey BANXICO	2.7%	2.4%	I Q. Brokerage Firms (Average)[5/]	2.2%	1.8%
Consensus Forecasts[2/]	2.7%	2.3%	II Q. Brokerage Firms (Average)[5/]	3.2%	1.7%
Brokerage Firms (Average)[4/]	2.6%	2.3%	III Q. Brokerage Firms (Average)[5/]	3.7%	3.5%
			IV Q. Brokerage Firms (Average)[5/]	3.6%	3.5%

n.a. not available.
1/ Unless otherwise stated, data was drawn from the Survey of Private Sector Economic Analysts' Expectations undertaken every month by Banco de México.
2/ January 13th and April 7th 2003 issues of the *Consensus Forecasts*.
3/ Exchange rate futures of December 31st 2002 and March 31st 2003.
4/ Average Forecasts of Deutsche Bank, Goldman Sachs and JP Morgan's brokerage firms.
5/ Annualized quarterly variation.
6/ The price of the Mexican oil mix corresponds to the difference between the price futures of the WTI oil (April 31st 2003) and the price of the Mexican oil mix on that same date.

IV.2. Inflation Expectations

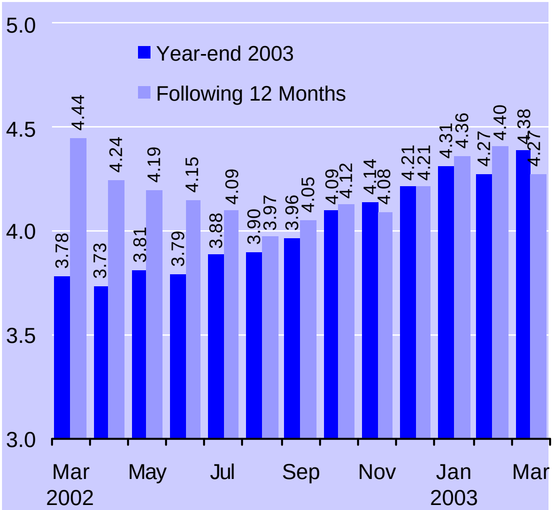
Forecasts for monthly CPI inflation in April, May and June of 2003 were 0.36, 0.24, and 0.29 percent, respectively.

As for annual inflation for year-end 2003, estimates went from 4.21 percent in December 2002 to 4.38 percent in March. Meanwhile, expectations regarding core inflation at the close of 2003 were revised upward from 3.48 percent in December to 3.74 percent in March. Forecasts for headline inflation in the following twelve months rose from 4.21 percent in December to 4.27 percent in March. Finally, estimates for overall inflation at year-end 2004 decreased slightly from 3.76 percent in December to 3.73 percent in March (Graph 21). It is important to mention that at the time of publishing this Report expectations regarding CPI inflation for 2003 still remain above the upper limit of the variability interval around the target for the year.

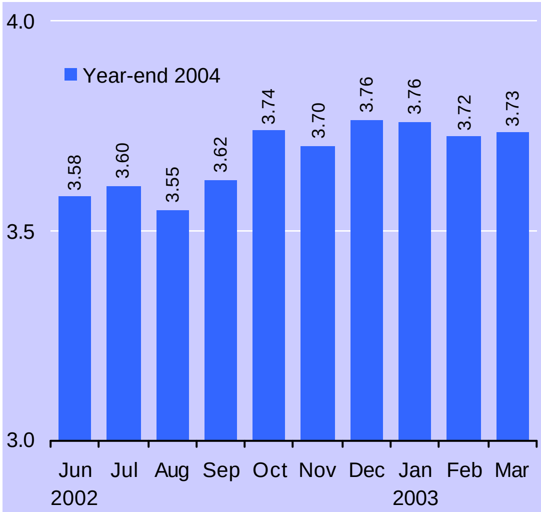
Graph 21 **Evolution of Inflation Expectations**

Annual percentage change

Year-end 2003 and Following 12 months



Year-end 2004



Source: Survey of Private Sector Economic Analysts' Expectations, Banco de México.

V. Balance of Risks

During the first quarter of 2003 the evolution of the Mexican economy was largely influenced by two factors: the weak economic recovery in the United States and the sluggish expansion of domestic demand, particularly that of the private sector.

A less optimistic outlook regarding the recovery of the United States economy led Banco de México to update the assumptions behind its base scenario:

(a) Estimates for annual real GDP growth in the United States were reduced from 2.7 to 2.3 percent. Furthermore, and more importantly, forecasts for average annual expansion of industrial output in that country fell from 2.4 to 1.4 percent;

(b) Given the high degree of uncertainty concerning the evolution of oil prices in 2003 and expectations that once the war in Iraq ends prices will fall substantially, Banco de México did not change its assumption about the average price of the Mexican oil export-mix and kept it at 17 US dollars per barrel; and

(c) So far, expectations about the Mexican economy's access to international financial markets for the remainder of 2003 have not been modified. Therefore, similar conditions to those prevailing during the first quarter are assumed.

On the basis of the described scenario and available information on the evolution of the Mexican economy, Banco de México prepared a forecasting exercise of the main macroeconomic variables for 2003. The key results are the following:

Economic Growth: Estimates for average real GDP growth were revised downward, from 3 to 2.4 percent. This is mostly based on the weakness of economic activity in the United States and the rest of the world, as well as on the meager results that economic indicators signal for the Mexican economy (Box 3).

Box 3

Revised Forecasts for GDP Growth in Mexico in 2003

Forecasts for GDP growth in Mexico in 2003 have been modified due to the following considerations:

a) As mentioned in this Report, expectations regarding the expansion of the U.S. economy in 2003 have been revised considerably downward in the last months. Likewise, forecasts for world economic growth have also declined significantly.

Table 1
Revised Forecasts for Real GDP Growth in 2003
Percent

	OECD[1/]		IMF[2/]		CE[3/]	
	Dec. 02	Apr. 03	Sep. 02	Apr. 03	Jan. 03	Apr. 03
United States	2.6	2.5	2.6	2.2	2.7	2.3
Canada	3.1	2.8	3.4	2.8	3.2	2.9
European Union	1.9	1.3	2.3	1.3	1.6	1.3
United Kingdom	2.2	2.3	2.4	2.0	2.3	1.9
Euro Zone	1.8	1.1	2.3	1.1	1.4	1.0
Germany	1.5	0.5	2.0	0.5	0.9	0.5
France	1.9	1.3	2.3	1.2	1.6	1.2
Italy	1.5	1.0	2.3	1.1	1.4	1.2
Japan	0.8	0.8	1.1	0.8	0.4	0.8
Latin America	---	---	3.0	1.5	3.9	1.4

1/ OECD, Economic Policy Committee (EPC), December 2002 and April 2003.
2/ IMF, World Economic Outlook, September 2002 and April 2003.
3/ Average forecasts of analysts surveyed by *Consensus Forecasts* (January 12 and April 7, 2003). In the case of Latin America, forecasts correspond to the *Latin American Consensus Forecast* (December 16, 2002 and April 14, 2003).

b) Although the annual growth of real GDP during the fourth quarter of 2002 (1.9 percent) was practically the same as that forecasted by Banco de México (2 percent), this was due, to a certain extent, to the greater boost coming from public investment and to higher accumulated inventories than those estimated at the onset of the year. The latter suggests that aggregate demand weakened in relation to production during the same period. In particular, private consumption slowed down while private investment contracted and export growth eased.

c) Investment spending has been feeble since January 2003, especially in imports of capital goods, which have suffered a contraction at an annual rate. Furthermore, non-oil exports have barely increased. Finally, job creation in the formal sector has been modest and could therefore hinder the upturn of consumption.

Based on the previous considerations and on a forecast exercise using econometric models, Banco de México has modified its estimates for annual average growth of real GDP in 2003 to 2.4 percent.

Table 2
Revised Forecasts for Real GDP Growth in Mexico in 2003
Real annual percentage change

	Jan. 03	Apr. 03	Diff.
GDP in Mexico	**3.00**	**2.40**	**-0.60**
Assumptions:			
GDP in the United States	2.70	2.30	-0.40
U.S. Industrial Production	2.40	1.40	-1.00
Mexican Oil-export Mix Price [1/]	17.00	17.00	0.00

1/ US dollars per barrel.

It should be mentioned that the growth of annual GDP in the first quarter of 2003 will have an upward bias due to seasonal factors related to the Easter Holiday. In 2002, it took place in March, whereas this year it will be in April. Taking this effect into account, annual GDP is expected to expand around 2.6 percent in the first quarter. Furthermore, the opposite effect is likely to occur in the second quarter as the period will include less business days than in 2002.

For the remainder of the year, once geopolitical stability has been re-established and the recovery of the United States economy is underway, the export and industrial sectors are expected to provide the initial boost to reactivate economic activity in Mexico. This owing to the fact that, presently, Mexico does not face macroeconomic imbalances that would otherwise need to be corrected in order for the economy to grow at a faster pace. Considering the latter, it is likely that the external stimulus will be followed by the expansion of private sector consumption and investment. As a result, annual average GDP is expected to increase nearly 3 percent in the second half of the year.

Employment: Due to downward revisions in forecasts for GDP growth and the still moderate ease of contractual wage increases, the creation of formal employment in 2003 is expected to be weaker than anticipated in the previous Inflation Report. Specifically, it is expected that between December 2002 and December 2003, 250 thousand new jobs will be created in the formal sector.

Current Account: The current account deficit (measured in relation to GDP) is anticipated to remain close to 3 percent.

Inflation: During the first few months of the year, the path of inflation measured by the different price indexes has generally been compatible with Banco de México's base scenario outlined in the Monetary Program for 2003. Thus, in the absence of large and unexpected increases in the non-core subindexes during the rest of the year, headline inflation is expected to converge towards core inflation and the target by end-December 2003.

As for the behavior of the core subindexes for goods and services, due to the low levels it has already reached the first is expected to remain stable throughout the year, while the second will decline steadily.

As explained in the Monetary Program for 2003, Banco de México included on its base scenario its estimate for the inflation of prices administered or regulated by the public sector (3.5 percent). This figure considered the increases in public sector prices announced by the Ministry of Finance that are included in the CPI. Meanwhile, inflation of agricultural prices is expected to decline slightly in 2003 and more evidently during the second quarter of the year.

The base scenario described above is subject to a very high degree of uncertainty due to different external and domestic risks. Among the external ones, the fragile rebound of the United States economy (which could turn out to be weaker than anticipated) is noteworthy. This could respond to several factors, among which the following deserve mention:

(a) Higher geopolitical uncertainty due to the continuous presence, and even the flare-up, of terrorism as well as contagion of war tensions to other countries. This could cause firms to postpone investment, apart from adversely affecting financial markets;

(b) Persistently high oil prices caused by geopolitical uncertainty in the Middle East and the difficulties other oil producing countries could face. Nevertheless, during the quarter risks that oil prices would remain high diminished, due to the weakness of the world economy and less fear regarding possible damage to oil installations in Iraq; and

(c) A greater loss of consumer confidence that could induce families to cut down on their spending. This lack of confidence could be worsened by a deterioration of labor market conditions or reduced fiscal stimulus over the medium term due to the costs of war in Iraq.

The unstable international environment, the global economic slowdown, and the high current account deficit of the United States -combined with certain domestic factors which are described below– could lead to a contraction in capital flows to Mexico.

The impact of a slower than expected recovery in the United States' economy on Mexico is uncertain. On the one hand, it could lessen inflationary pressures that tend to arise from a more robust aggregate demand. On the other, it could create a larger trade deficit which, if it materialized, would pressure Mexico's external accounts and translate into a depreciation of the exchange rate. Should the pass-through of a depreciation of the exchange rate to domestic prices reappear or become more likely it would have an adverse effect causing a deterioration of inflation expectations.

The base scenario could also be altered by domestic shocks. Among those that could have a direct incidence on inflation are:

(a) Unforeseen rises in administered and regulated prices incompatible with the inflation target; and

(b) An interruption in the declining trend of core inflation of services due to an insufficient moderation of wage increases.

Furthermore, similar to the case of the United States economy, the risks associated with a less robust than expected recovery of the Mexican economy and lackluster job creation still prevail. Both phenomena would mitigate inflationary pressures.

In the following quarter, the programmed elections events could limit political consensus over the pending structural reforms. This would have a negative impact on expected returns of investment and, thereby, on investment itself. Obviously, should this occur, Mexico's long-term production capacity would diminish. Moreover, the vulnerability of the public finances implies a medium-term risk factor for the attainment of low and stable inflation. In the future, both factors could limit the margin of fiscal and monetary policies to cope with destabilizing external shocks.

In the medium term, world economic growth will probably be less vigorous than in the preceding decade. This will impel Mexico to modify the foundations that have supported the country's development in the last few years, calling for stronger domestic sources of growth. In order to do so, it will be necessary to raise the level of competitiveness by strengthening the macroeconomic framework and also by making progress in the agenda of structural reforms, in order to improve institutional effectiveness and make the economy more flexible and efficient.

The balance of external and domestic risks that could affect the base scenario provides mixed results. There is a bias towards a weaker world economy, which would tend to ease inflationary pressures over the medium term. Nonetheless, private sector analysts' expectations regarding inflation and those implicit in contractual wage settlements are above the target for this year. As previously stated, recent wage settlements do not correspond to the prevailing conditions in the labor market. Higher wage revisions, albeit more moderate, have inhibited the creation of jobs as well as a more rapid fall in inflation. Therefore, the Board of Governors of Banco de México will continue to assess the behavior of the different variables that might affect the path of inflation in order to undertake, in a timely manner, the necessary monetary policy actions to ensure the attainment of the inflation objective.