Inflation Report

October - December 2001

Monetary Program

For 2002

Summary

Throughout 2001 economic growth in Mexico was severely affected by the slowdown of the United States' economy. Mexican GDP is estimated to have fallen by 0.3 percent in real terms last year and the economy suffered its first recession since 1995. Despite the aforementioned, some positive and important results were obtained. Amongst these achievements, the reduction of annual inflation from 8.96 percent in December 2000 to 4.40 percent in December 2001 and the substantial fall of both nominal and real interest rates to levels unseen for many years, are noteworthy. Thus, in 2001 the economy experienced, for the first time in the last 25 years, a normal economic cycle in which the slowdown was accompanied by a stable behavior of the main financial variables.

The favorable evolution of Mexican financial variables is due to the disinflationary effort, prudent fiscal policy, continued foreign investment driven by the structural reforms that were implemented in the past and the stability of the current account deficit.

In the area of inflation, positive results were obtained in 2001 and the target was met for the third consecutive year. The decline in the growth rate of prices was based on the following factors: the application of a preventive monetary policy in 2000 and at the start of 2001; the weakness of aggregate demand; the stability of the exchange rate; and, finally, the supportive evolution of agricultural and livestock goods' prices and of prices of goods and services provided or regulated by the public sector.

Mexican economic activity is expected to gradually recover during 2002. Nevertheless, the economy could confront some elements that might hinder high growth rates and the rapid recovery of employment.

The above underlines the importance of decisively advancing the process of structural change in order to increase productivity so that swift and vigorous expansion of economic activity takes place, accompanied by substantial job creation.

Inflation Report: October–December 2001

Recent Developments in Inflation

Price developments during the fourth quarter of 2001 were generally favorable. Annual inflation was 4.4 percent at year-end and the target of less than 6.5 percent was therefore met comfortably. During the quarter covered by this Report, annual inflation was characterized by lower increases in all of the price sub-indexes that make up the Consumer Price Index (CPI). In this respect, the following should be mentioned:

(a) While both CPI and core inflation decreased, the former indicator declined more.

(b) The annual core inflation of goods fell more than that of services.

(c) The annual core inflation of services decreased after remaining constant for two quarters.

(d) The annual inflation of the price sub-index for agricultural goods and that of goods and services provided or regulated by the public sector diminished considerably. As a result, prices for these groups of goods and services registered the lowest growth during the year.

(e) The substantial fall in the annual inflation of the price sub-index for agricultural goods as well as goods and services provided or regulated by the public sector suggests that a fraction of the decrease in CPI inflation during 2001 could have been of a transitory nature. This, in light of the possibility that some favorable factors that prevailed during the year could revert.

    In this context, core inflation has become a more reliable indicator of inflation trends.

(f) The annual inflation of the Producer Price Index (PPI) excluding oil and services also posted a significant decline.

Main Determinants of Inflation

Recessive forces continued to affect the world economy during the fourth quarter of 2001. The persistent downward adjustments of some economic variables in the United States' had repercussions in most countries. However, towards the end of the year, indicators of economic activity in the United States were better than forecasted. This was in sharp contrast to the less favorable situation in the rest of the world's economies. The prospect of a recovery of world economic growth, driven by the end of the recession in the United States, dominated the scene towards the end of the year.

In the October-December quarter of 2001, the average price of the Mexican crude oil export mix was 14.92 dollars per barrel, 5 dollars less than in the previous quarter.

Although the terrorist attacks on September 11th severely affected some sectors of the United States' economy, their negative impact was weaker than feared. As a result, the recovery of some macroeconomic variables was reported in the months following the attacks.

Building on evidence pointing to a less pronounced deceleration of aggregate demand than had been expected, analysts' opinion at the time of publishing the Report is that the United States' economy probably contracted 1.8 percent in the fourth quarter of 2001. This projection represents an improvement over that prevailing immediately after the tragic events.

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In October 2001, in those sectors of the Mexican economy for which information is available, nominal wages rose between 5.1 and 14.7 percent on an annual basis. Thus, in the first 10 months of the year, these compensations registered average increases of between 5.9 and 17.6 percent at annual rates. Excluding the commerce sector, nominal wages grew at average annual rates above 12.7 percent during the same period. This implied a real average increase of more than 5.6 percent in three out of the four sectors analyzed.

The substantial recovery of real wages during 2001 was accompanied by an equally significant slowdown of productivity growth. The highest average productivity growth from January to October was observed in the manufacturing industry (0.5 per cent). Productivity fell in the remaining sectors. The foregoing developments led to a considerable increase in unit labor costs. On average, in the first 10 months of the year, unit costs went up by at least 5.1 percent, the construction industry being the most adversely affected.

In line with the above, the deterioration of labor market conditions has been so significant that despite the substantial increase of real wages, the total wage bill has contracted in several sectors. Thus, total labor income has fallen.

In the quarter covered by the Report, the average increase of nominal contractual wages was 6.90 percent. Thus, wage pressures eased during the period. Nonetheless, the behavior of contractual wages in October was particularly influenced by the wage revision granted by the Mexican Social Security Institute (*Instituto Mexicano del Seguro Social,* IMSS). If that outcome is excluded, an average of 8.9 percent is obtained. Furthermore, in November and December the average increase of contractual wages was 6.7 and 7.4 percent, respectively.

In 2001, the average spread between contractual wages and expected inflation for the following twelve months was around 2.9 percent. This gap widened in the first three quarters, but levelled off in the fourth. Wage increases in private firms have yet to ease. Increases granted so far are still high when compared to the sum of expected inflation and foreseeable productivity gains in 2002.

Employment in Mexico contracted substantially throughout 2001. By the end of December, the number of workers affiliated to the IMSS (permanent and temporary urban employees) was 12,163,637, close to 383 thousand less than at year-end 2000. This implied a 3 percent reduction in formal employment.

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In the third quarter of 2001, aggregate supply and demand decreased considerably (3.2 percent).

During the fourth quarter of 2001, the weakness of all the main components of aggregate demand and output persisted. Although only preliminary and incomplete information is available at this time, it suggests that the above judgement is valid.

Despite the fact that the trade deficit for 2001 was 21.6 percent higher than in 2000, the non-oil trade deficit decreased by 10.4 percent. The trade and current account deficits were significantly lower at year-end 2001 than what had been forecasted at the onset of the year. This outcome reduced the demand for external resources and contributed to exchange rate stability, declining domestic interest rates and falling inflation. In the first nine months of the year, the capital account surplus amounted to 16.3 billion dollars, its highest level for this period in the last 7 years.

At the end of December 2001, the nominal exchange rate was 9.16 pesos per dollar, which implied a 3.8 percent appreciation when compared to its level at the end of the previous quarter.

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In October, November and December of 2001 the monthly inflation of the sub-index of prices for goods provided or regulated by the public sector was 0.72, 1.72 and 0.0 percent, respectively. As a result, at the end of the fourth quarter its annual growth was 2.21 percent.

In the October-December quarter, the sub-index for prices of agricultural products accumulated a 0.10 percent growth, 0.87 percentage points lower than that of the CPI, and 5.21 percentage points below that observed during the same quarter of 2000.

Monetary Policy during the Fourth Quarter of 2001

During the fourth quarter of the year, the convergence of inflation with the corresponding target made it clear that the objective set for 2001 would most likely be attained. Therefore, the decision not to alter the monetary policy stance was motivated by the determination to create the necessary conditions to reach an inflation of less than 4.5 percent in 2002.

Despite the presence of factors that could hold in check additional inflationary pressures during the current year, the possible reversion of transitory factors that contributed to a sharper decline of inflation in 2001 and the existence of other sources of inflationary pressures led the Board of Governors of Banco de México to keep the “short” unchanged.

Thus, the most prudent course for monetary policy in the present situation is to maintain the current stance and continuously evaluate the following: the path of the main macroeconomic variables, the impact of changes in indirect taxes, and the evolution of agricultural goods' prices and prices of goods and services provided or regulated by the public sector on inflation expectations and on prices of those goods that are not directly affected by the above factors.

The absence of changes in monetary policy during the fourth quarter did not hinder the decline of interest rates. The behavior of both nominal and real domestic interest rates was very similar to that of external rates in the quarter.

Monetary and Credit Aggregates

At year-end 2001, the stock of base money was 225,580 million pesos, 11,806 million below estimates. Thus, during the year the monetary base grew at an average nominal rate of 12.8 percent, less than forecasted in the monetary program (16 percent). This meant an average deviation of –2.9 percent, which is mainly explained by the unforeseen slowdown of economic activity. Nevertheless, the monetary base measured as a proportion of GDP rose, furthering the process of remonetization that began in 1977.

The accumulation of net international assets during 2001 totalled 9.288 billion dollars. In order to preserve the balance between the supply of monetary base and the public's demand for it, Banco de México sterilized the monetary impact of the aforementioned accumulation by increasing other non-monetary liabilities. The latter led to a 71,517 million peso contraction of net domestic credit.

Overview of the Economy in 2001 and Private Sector Outlook for 2002

The slowdown of the Mexican economy was related to an adverse international environment and not to domestic imbalances. The present economic cycle is clearly different from the financial and balance of payments crises that occurred in the past and despite the considerable disturbances that the Mexican economy faced, it did not experience price instability, sudden interest rate rises or permanent exchange rate depreciations in 2001.

Outstanding Aspects of the Evolution of the Economy and of the Implementation of Monetary Policy in 2001

The Mexican economy reacted in an orderly manner to the world economic downturn and the financial markets showed a favorable behavior. The exchange rate remained stable throughout 2001, there was a high level of foreign investment and interest rates decreased continually. These results were based on the economy's strengths:

(a) a flexible exchange rate regime;

(b) prudent fiscal policy;

(c) management of the public sector debt with the aim of reducing the concentration of amortizations;

(d) monetary policy oriented to attaining the inflation targets; and

(e) a more solid financial system.

Regarding the evolution of fiscal policy in 2001, a great effort was made in order to comply with the objectives set for the public deficit even in the midst of an economic slowdown.

Furthermore, the positive results observed in the Mexican financial markets are to a large extent attributable to the fact that international capital markets discriminated, more than in the past, between those economies with solid foundations and those with significant weaknesses. This was clearly reflected in the differing behavior shown by country risk indicators for the main emerging markets throughout 2001.

Private Sector Forecasts for 2002[1]

Private sector financial analysts continue to believe that an unfavorable international environment will continue to prevail in 2002.

Estimates of real GDP growth in 2002 were revised downward, from 2.9 percent in September's survey to 1.4 percent in December. GDP is expected to expand by 4 percent in 2003.

In the opinion of private sector specialists, the main factors that could hold back economic activity during the following six months are as follows: the weakness of external markets and of the world economy (32 percent of all responses); oil prices (19 percent of all responses); the weakness of the domestic market and the uncertainty about the domestic economy (7 percent of all responses each); and international financial instability (6 percent of all responses).

In the survey conducted in December 2001, expectations for monthly inflation in January, February and March 2002 were 0.92, 0.48 and 0.39 percent, respectively. These forecasts imply that annual inflation will move from 4.4 percent in December 2001 to 5.1 percent in March 2002.

Projections for annual inflation at year-end 2002 were revised from 5.24 percent in September to 4.92 percent in December and expected inflation for 2003 is 4.15 percent.

Monetary Program for 2002

Elements of the Monetary Program

The main components of the Monetary Program for 2002 are:

(a) Inflation targets.

(b) The framework for the implementation of monetary policy.

(c) The framework for the analysis of the economic situation and inflationary pressures.

(d) The policy for communicating with the general public.

Banco de México's main objective, as specified in the Constitution, is to ensure the stability of the Mexican currency's purchasing power.

A number of studies indicate that inflation influences five fundamental aspects of an economy's performance in the following way:

(a) It limits output growth;

(b) It considerably hinders improvements in real wages;

(c) It inhibits the development of financial markets;

(d) It leads to a deterioration of the income distribution; and

(e) It weakens public sector finances.

Due to the above reasons, the consolidation of the stabilization process that began in 1996 is indispensable to the attainment of rapid and sustainable economic growth. In 2000, as part of a strategy to gradually reduce inflation, the Board of Governors of Banco de México set, as a medium-term target, an inflation of approximately 3 percent for 2003. Likewise, in the Monetary Program for 2000 an objective of less than 4.5 percent inflation was established for year-end 2002. These are the objectives that will guide the implementation of monetary policy during the current year.

The elements deemed necessary to attain, in the first instance, the proposed inflation target for 2002 and, subsequently, a convergence with the target of approximately 3 percent in 2003 are as follows:

(a) A monetary policy compatible with the adopted targets;

(b) Adjustments to prices provided or regulated by the public sector in line with the inflation targets;

(c) Wage increases consistent with sustainable productivity gains and the inflation target;

[1] Unless otherwise stated, the reported forecasts are taken from the Survey of the Expectations of Private Sector Economic Specialists conducted on a monthly basis by Banco de México.

(d) The absence of severe external disturbances -such as a drastic deterioration of the terms of trade or a sudden fall in the supply of foreign capital- that may lead to a substantial depreciation of the real exchange rate; and

(e) A structurally sound fiscal stance;

The consequences of failing to achieve one or more of the above conditions will be evaluated in the quarterly inflation reports that Banco de México will publish in 2002. Moreover, the central bank will attempt to forecast the speed at which any inflationary disturbance could be absorbed. This analysis will, of course, be subject to a considerable degree of uncertainty.

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Banco de México, like the majority of the world's central banks, above all guarantees that it will generate neither an excess nor a shortage of base money. In order to do this, it adjusts the supply of primary money on a daily basis, allowing it to always satisfy the demand for base money.

The "short" is the instrument that Banco de México uses in order to induce those interest rate movements necessary to attain the proposed inflation targets. The "short" has been very efficient in allowing a spontaneous distribution of the effects of external shocks between the exchange rate and interest rates. This is an enormous advantage in an economy like Mexico's, which is subject to high financial volatility. Furthermore, reliance on this mechanism has also contributed significantly to the disinflation process, since nominal and real interest rates have reacted swiftly to changes in the level of this instrument and to deviations of anticipated inflation from the target.

The monetary policy actions a central bank implements affect inflation with a considerable lag and a substantial degree of uncertainty. Thus, in order to accomplish the proposed targets, the monetary authority's actions must be based on a very careful analysis of inflation perspectives.

An appropriate framework for the detailed study of the evolution of inflationary pressures must give special attention to the following variables:

(a) the international environment and the exchange rate;

(b) wages, contractual wage settlements and unit labor costs;

(c) employment and unemployment indicators;

(d) aggregate supply and demand;

(e) interest rates and country risk indicators;

(f) public sector finances;

(g) prices of goods and services provided or regulated by the public sector;

(h) transitory factors that affect inflation; and

(i) monetary and credit aggregates.

Regarding monetary aggregates, despite the reservations expressed in previous Reports, monetary base growth is a general reference for monetary policy assessment. This is why the expected daily path of the monetary base, estimated with the information available as of January 2002, is included.

Outlook for 2002 and Balance of Risks

Once more, in 2002 the performance of the Mexican economy is expected to be strongly conditioned by the economic cycle in the United States. In addition, it is anticipated that the availability of external financing will remain as favorable as in 2001.

After having undergone in 2001 the most generalized and intense downturn in two decades, the world economy is expected to begin a gradual rebound in 2002. Forecasts are for a recovery that will gather speed towards the second half of the year.

There are several factors that point to the reactivation of the United States' economy, amongst which the following are noteworthy: falling energy prices, the end of the process of inventory depletion, the recovery of the stock market, improvements in business climate and consumer confidence indicators and the monetary and fiscal stimuli.

There have been some unfavorable news which have not affected the expectations regarding the performance of the United States' economy. In particular:

(a) Failure to reach an agreement with Congress on the approval of an additional fiscal package. Most analysts discounted that a significant stimulus would be implemented (between 0.7 and 1.0 percentage points of GDP);

(b) The economic growth rate was revised marginally downward in the third quarter; and

(c) Although the number of unemployment claims decreased, they are still at levels that indicate slack in the labor market.

The recovery of the world economy is expected to be accompanied by a slight rebound in international oil prices during the second quarter. Oil futures prices indicate that the Mexican crude oil export mix is likely to move from 14.94 dollars per barrel on January 25th to 15.08, 15.55, 15.64 and 15.70 dollars per barrel at the end of March, June, September and December, respectively.

Based on the above, the assumptions behind Banco de México's forecasts concerning the evolution of the external environment were only slightly modified from those published in the Inflation Report for June- September 2001.

(a) The forecast for the expansion of the United States' economy in 2002 remained unchanged at 0.7 percent.

(b) The average price of the Mexican crude oil export mix in 2002 is expected to be between 14 and 16 dollars per barrel.

(c) The conditions and availability of external financing will be similar to those observed in 2001. In particular, country risk perception will resemble that which prevailed in 2001.

The evolution of the Mexican economy in 2002 will be determined, to a large extent, by two factors:

(a) The profile of the economic recovery in the United States; and

(b) The conditions and availability of external financing.

In the domestic realm, the most important factor besides those used in the preparation of the macroeconomic framework published in the Inflation Report for July-September, is the approval by Congress of the Federal Budget, the Federal Revenues Law and the new tax measures. While the package included both positive and negative elements, the balance is moderately favorable.

The fact that a plural Congress approved a prudent budget and a moderate measured public deficit for the fourth consecutive year is noteworthy. In addition, the Federal Budget once again incorporates automatic stabilizers that, if the revenues estimated for 2002 do not materialize, provide the Ministry of Finance with the authority to reduce expenditures and thereby ensure the attainment of the targeted deficit. These clauses and their use whenever necessary are essential to maintain fiscal discipline and consolidate macroeconomic stability.

Thus, the reform that was obtained, together with the continuing prudent management of public sector finances, has increased confidence among investors in the stability of the Mexican economy. Nevertheless, a great opportunity to solve the structural problems of the public finances was indeed lost. This would have allowed simultaneous increases in social expenditures and public sector saving. Moreover, a more ambitious reform would have fostered a substantial decrease in both short and long-term interest rates. Lower public sector's borrowing requirements would have eased pressures on available financial resources.

Based on the above assumptions and on still incomplete information about the evolution of the economy during the last quarter of 2001, Banco de México prepared a forecast of the main macroeconomic variables in 2002.

Economic Growth: The economy is expected to grow by 1.5 percent. It is anticipated that GDP will register a slightly negative annual percentage change in the first quarter of the year and that the economy will again experience positive growth rates from the second quarter onwards.

Current Account: The deterioration of the trade balance during the last few months of 2001, which is partly explained by the fall in oil prices, points to a current account deficit for 2002 of around 3.2 percent of GDP.

Inflation: The current monetary policy stance is considered appropriate to meet the inflation target for year-end 2002. However, at present important inflationary pressures exist that might eventually curb the decline of inflation. Among these the following deserve mentioning:

(a) At year-end 2001, contractual wage increases in the private sector were still above levels consistent with the inflation target and foreseeable productivity gains.

(b) The recently approved tax measures will have an upward effect on prices.

(c) Increases in some prices provided or regulated by the public sector. In particular, prices for the subway and urban bus services in Mexico City as well as electricity for residential use.

As a result, in the first quarters of the year it will be of utmost importance to carefully analyze the evolution of the core inflation indexes, as well as other related statistics, in order to measure the impact of the fiscal reforms and the time it may take to absorb them.

Annual CPI inflation will most likely rebound in January and February as a result of the following factors:

(a) Rises in subway, urban bus service and electricity prices;

(b) The impact of the fiscal measures; and

(c) An arithmetic effect associated with the low monthly inflation in January and February 2001 as a consequence of the limited growth in those same months of prices for agricultural and livestock products.

In the context of volatile CPI inflation, core inflation will become more reliable as a reference to assess inflationary pressures over the medium term. Thus, especially in the first quarter of 2002, the latter indicator will be extremely relevant to guide monetary policy decisions.

The above base scenario is subject to a much greater degree of uncertainty than in previous years for the following reasons:

(a) Uncertainty regarding the future evolution of the United States' economy.

(b) Uncertainty related to the impact of the eventual reactivation of the United States' economy on the Mexican economy.

The main external risks that could affect this scenario are as follows:

(a) Slower than expected economic growth in the United States; and

(b) A more pronounced fall in oil prices.

Although the risks remain biased towards slower growth than that considered in the base scenario, some analysts believe there is a possibility of a more vigorous expansion in the United States than assumed.

The most important domestic risks factors are:

(a) Widening of the spread between contractual wage revisions and the sum of the inflation target and foreseeable labor productivity gains; and

(b) Increases in annual CPI inflation resulting from arithmetic effects, from adjustments in prices provided or regulated by the public sector or from the impact of the new fiscal measures may contaminate the formation of expectations.

If either a) or b) or both occur, monetary policy will have to be tightened in order to ensure that medium-term inflation targets are met and that employment recovers rapidly.

Likewise, in a scenario in which expected inflation should be, in Banco de México's judgement, at sustainable levels on a path compatible with the targets, the Central Bank would ease monetary policy, as it did on two occasions in 2001.

Final Remarks

During 2001, the adverse external environment was the most important factor determining the performance of the Mexican economy. However, several elements of strength allowed an orderly adjustment to the downward phase of the economic cycle:

(a) The positive results of the disinflationary efforts;

(b) The discipline of public sector finances;

(c) The floating exchange rate regime and market-determined interest rates;

(d) The comfortable foreign public debt amortization schedule in 2001 and 2002;

(e) The stability of foreign investment fostered by previous structural reforms; and

(f) The moderation of the current account deficit.

Notwithstanding the expected recovery of world growth, it is unlikely that economic activity in Mexico's main trading partners will return to the levels seen before the current downturn. This underlines the need to reinforce those domestic factors that will allow Mexico to reach high and sustainable growth rates within the context of a less favorable international environment. Among these factors the following should be mentioned:

(a) Macroeconomic stability;

(b) Reform of the energy sector;

(c) The deepening of the economic deregulation process;

(d) The promotion of the development of the capital market and of higher domestic saving rates;

(e) The stimulus to investment in infrastructure, technology, education and health; and

(f) The labor market reform.

The elements above are deemed essential to achieve the needed productivity gains in order to promote job creation, improvements in real wages and economic growth.

Perseverance in monetary and fiscal discipline will be crucial for a return to the path of high and sustainable growth. For 2002, the Federal Government and Congress have confirmed their firm commitment to continue the implementation of prudent fiscal policy in the midst of an uncertain environment. Regarding monetary policy, the Board of Governors of Banco de México reiterates its commitment to attain an inflation rate of less than 4.5 percent in 2002 and a convergence towards inflation of approximately 3 percent in 2003. The Central Bank will use the instruments at its disposal in a timely and effective manner in order to ensure an environment of low and stable inflation that, together with the recovery of economic growth, will result in a sustainable improvement in the well-being of the population.