Inflation Report

January - March 2001

Summary

During the first quarter of 2001 the growth of the United States' economy weakened even more than had been expected and the price of oil was significantly lower than in the previous year. The economic slowdown in the United States has affected exports and imports, as well as output and employment in Mexico.

The less favorable environment has not precluded important gains in the abatement of overall inflation, and especially core inflation. Although significant reductions in price growth have been registered recently, some factors still remain that could limit future advances in this field. Among these, it is worth mentioning higher unit labor costs and expectations above the inflation target. Furthermore, three main areas of uncertainty regarding the domestic economy's outlook can be identified: the possibility that the United States could fall into a recession, a further decline in international oil prices and the outcome of discussions over the proposed Fiscal Reform.

In light of the existing risk factors, Banco de México has decided it is prudent to maintain the restrictive monetary policy stance in order to meet the inflation target established for this year and consolidate the credibility of the medium term target.

Recent Developments in Inflation

Price developments during the first quarter of 2001 were favorable as annual inflation resumed its downward trend and accumulated inflation for the quarter was below the figure private sector analysts had expected at the beginning of the period.

The transitory effect of the considerable fall in the prices of agricultural and livestock products influenced the performance of inflation. In spite of this, the reduction of inflation over the period was not sustained by temporary factors alone, as annual core inflation continued to descend and was less than 6.5 percent at the end of March.

The behavior of prices in the quarter was compatible with the trajectory necessary to meet the annual inflation target of less than 6.5 percent by December 2001.

In March 2001, the Consumer Price Index (*Indice Nacional de Precios al Consumidor*, INPC) annual inflation was 7.17 percent, that is, 1.79 percentage points below the figure posted last December. In turn, the annual growth rate of the core price index was 6.46 percent, 1.06 percentage points less than at year-end 2000. Thus, the January-March period of 2001 was the third consecutive quarter in which annual core inflation was lower than overall inflation.

The gap between annual INPC inflation and core inflation narrowed in the first quarter of the year as the transitory factors that had had an upward effect on prices in the last quarter of 2000 partially reverted. Among these factors, the lower growth of the agricultural and livestock products' price sub-index is worth underscoring. At the end of the quarter covered by this Report, this sub-index posted an annual growth rate of 3.98 percent, while in the previous quarter it had been 10.07 percent.

In the January-March period, the evolution of the prices of goods and services provided or regulated by the public sector continued to be an important source of inflationary pressures. Over the quarter this sub-index contributed 0.39 percentage points to the increase of the INPC. The annual growth rate of this sub-index in March (10.62 percent) is still a cause for concern as it remained above that of the INPC.

In March 2001 annual core inflation for goods (5.66 percent) and for services (7.66 percent) were lower than those observed in December of last year, having declined 1.02 and 1.11 percentage points in the first quarter, respectively. Inflationary pressures in both sectors were limited by the appreciation of the exchange rate and the economic slowdown.

Main Determinants of Inflation

During the first quarter of 2001 the evolution of the external variables affecting the behavior of the Mexican economy was not entirely favorable. Nonetheless, the restrictive monetary policy being applied in Mexico along with positive expectations about the national economy's outlook helped to offset the effects of external shocks on domestic financial variables.

Although during the period international oil prices were higher than the average price that had been expected at the beginning of the year, they were 16 percent lower than those prevailing in the last quarter of 2000. In addition, the United States' economy has slowed down considerably —in the fourth quarter of 2000 it grew one percent only, the lowest quarterly rate in the last five years. The exchange rate crisis in Turkey and the political uncertainty in Argentina also affected some emerging markets; yet, they only had a temporary impact on Mexican financial markets.

Indications of a more severe economic downturn in the United States became known at the beginning of the quarter. These reports suggested a general deterioration of manufacturing activity which was later confirmed by the industrial output index. The deceleration of the industrial sector has been associated with pessimistic expectations about corporate profits and consumption growth.

Although weaker manufacturing activity in the United States continued in February and March, and was reflected in higher unemployment rates during those months, it did not have a severe impact upon consumer spending.

Through their combined effect on employment, the drop in corporate profits reported during the quarter, together with the stock market fall and the slowdown of industrial activity, have increased the likelihood that the expansion of consumption will diminish even further. Consequently, a drastic correction in economic growth forecasts for 2001 has taken place in the past three months. At the time of publishing of this Report, international analysts expect, on average, that real GDP in the United States will grow 1.7 percent in 2001.

Acknowledging that economic conditions had deteriorated in the final weeks of last year, on January 3rd, 2001 —out of the pre-established schedule for its meetings— the Federal Reserve announced a 50 basis point cut in its federal funds rate objective. This was then followed by a further reduction of equal magnitude on the last day of January, and by an additional downward adjustment of 50 basis points in the third week of March.

The lower growth of the United States has been reflected in a significant weakening of economic activity in Mexico and in a larger current account deficit. The latter was financed comfortably and without causing pressure on the exchange rate, due to the fact that in the January-March quarter foreign capital inflows —especially direct foreign investment— were substantially larger than those registered during comparable periods of the last six years.

In spite of the deterioration of the international environment during the quarter, the behavior of Mexican financial variables was stable. This can be explained by three factors. Firstly, the favorable perception of financial markets regarding the Mexican government's commitment to macroeconomic stability, and the fact that investors see it as highly likely that the Fiscal Reform will be passed by Congress. They believe that, should this be the case, Standard & Poor's will grant investment grade to Mexican sovereign debt without much delay. Secondly, the positive spread that exists between the yields on assets denominated in pesos and those denominated in foreign currency. Finally, the greater than expected slowdown of domestic demand meant that the trade deficit grew only moderately during the period.

The rise of real wages over productivity gains translates into higher unit labor costs. In the fourth quarter of 2000 and in January 2001, the annual growth rate of real remunerations remained at high levels in most sectors, while output per worker declined significantly. Therefore, unit labor costs have risen.

Although the average nominal growth rate of contractual wages fell from 11.5 percent in the fourth quarter of 2000 to 10.3 percent in January-March 2001, the differential between contractual wages' nominal growth rate for the quarter and the inflation target for the year was still large. The downward rigidity of nominal contractual wage growth deserves careful attention. Even in light of the recent moderation, the expected increase in real wages is likely to surpass sustainable gains in labor productivity throughout 2001. Should the trend in real wages continue, unit labor costs will probably keep on rising, a development which could in turn lead to greater inflationary pressures.

In the context of an economic downturn, higher unit labor costs could eventually mean slower employment growth or even a contraction. The aforementioned could be reinforced by two additional factors: the slowdown of the United States' economy and less vigorous investment spending in Mexico.

At the end of the first quarter 2001, the number of workers (temporary and permanent urban employees) affiliated to the Mexican Social Security Institute (*Instituto Mexicano del Seguro Social*, IMSS) fell by approximately 97,000 individuals compared to the level reported in December of last year. The open unemployment rate stood at 2.3 percent in March, 0.4 percentage points above the figure for December 2000. Regarding the underemployment rate, it has registered a significant rebound since last September.

The deceleration of domestic supply continued in the fourth quarter of 2000 and a reduction in the growth of all the components of aggregate demand was evident. The weakening of both aggregate supply and demand is even clearer if seasonally adjusted quarterly growth rates are used.

Preliminary information about the evolution of aggregate supply and demand in the first quarter of 2001 suggests that the trends observed during the latter months of 2000 have become more pronounced: i) the main indicators of private consumer spending show a lower rate of expansion; ii) the annual growth rates of imports of consumption and capital goods fell in the first quarter; iii) in January, the annual growth rate of gross fixed investment was the lowest of the last 27 months; iv) the annual growth rate of the Indicator of Overall Economic Activity (*Indicador Global de la Actividad Económica*, IGAE) fell to 3.2 percent in January; and v) industrial output has suffered a considerable deceleration, posting an annual growth rate of -3.7 percent in February 2001.

Taking the above into account, Banco de México estimates that in the first quarter of 2001 private consumption and total investment rose 5 and 1.2 percent in annual terms. This would be compatible with an aggregate demand expansion of around 3 percent. In turn, the Central Bank estimates that real GDP's annual growth rate could be 2 percent in the first quarter, and around 3 percent for the year as a whole.

As a result of the downturn that has been affecting the economies of the United States and Mexico, starting in the last few months of 2000 the rise in Mexican imports and exports has been less vigorous. Although the trade deficit accumulated in the first quarter of 2001 widened as compared to that observed over the same period of the previous year, it's current trend points to an incipient reduction. This seems to confirm that the disparity between the growth of domestic supply and demand is narrowing.

Monetary Policy in the First Quarter of 2001

On January 12th Banco de México increased the "short" from 350 to 400 million pesos and maintained it at this level for the remainder of the quarter. This measure, just as the increases of the "short" implemented during the last quarter of 2000, was undertaken in order to ensure the attainment of less than 6.5 percent inflation in 2001.

In the last few weeks of 2000 and the early weeks of 2001 various risk factors about which Banco de México had repeatedly warned began to materialize. Available data suggested that domestic spending continued to grow at rates higher than those for output. In the external front, the United States' economy slowed down considerably while the price of the Mexican crude oil export mix fell significantly.

In response to the above situation, some analysts revised their inflation forecasts for 2001 upwards. However, in the first few days of January domestic interest rates fell, which was incompatible with the appearance of the aforementioned risk factors. Thus, the attainment of the inflation target for the year required a more restrictive monetary policy stance.

As in previous increases of the "short", after the rebound in inflation expectations that occurred in January due to the deterioration of the international environment, expected inflation resumed its downward trend. The impact of the "short" was undoubtedly strengthened by the significant decline in inflation observed in February. In all, inflation expectations for 2001 were 7 percent in the first quarter of the year, 0.58 percentage points below their level in December 2000.

In the first quarter of 2001 the demand for monetary base decreased by 32,833 million pesos. This contraction was mainly due to the strong seasonal pattern shown in this period every year. This outcome was very close to the forecast, having deviated -2.4 percent on average.

It is worth mentioning that, unlike other years, Banco de México's Monetary Program for 2001 did not establish a limit on the variation of net domestic credit. During the period under analysis, the stock of this variable fell by 78,995 million pesos. This can be explained by the aforementioned decline in the demand for base money and by an important accumulation of international assets (4.716 billion dollars).

Private Sector Expectations for 2001[*/]

Private sector expectations indicate that for the rest of this year the international environment will continue to be unfavorable for the Mexican economy. According to analysts' responses to Banco de México's survey conducted in March, the following forecasts deserve special mention:

(a) A 1.8 percent annual growth rate for the United States' economy in 2001.

(b) An average price for the Mexican crude oil export mix of 19.23 dollars per barrel in 2001.

In addition, expectations for the exchange rate improved significantly, while the analysts surveyed anticipate a moderation of nominal contractual wage rises.

According to the results of the survey conducted in March, analysts expect Mexico's real GDP growth rate to be 3.3 percent in 2001 —below the 3.8 percent estimation reported in January's survey. In turn, they forecast trade and current account deficits of 12.013 billion dollars and 21.956 billion, respectively. Finally, they anticipate a direct foreign investment inflow of 13.274 billion dollars for this year.

In general, business climate and business confidence indicators show a clear deterioration vis-à-vis those registered at year- end 2000.

Between January and March, the analysts surveyed adjusted their inflation expectations for 2001, from 7.87 percent to 7 percent. Over the same period, inflation expectations for the following twelve months were lowered to 7.09 percent, while those for 2002 were adjusted downward to 5.92 percent.

Taking into account the likely effects of an eventual approval of the Fiscal Reform, the consultants have estimated a 9.16 percent inflation rate for the following twelve months and 8.76 percent for the end of this year.

Risk Balance and Conclusions

The evolution of the international environment and of the Mexican economy during the first quarter of 2001 led to a revision of Banco de México's base scenario for the rest of this year. The assumptions about the external situation have changed as follows:

(a) The real annual growth rate forecast for the United States' economy has been revised, moving from an interval between 1.8 and 2.4 percent to one between 1.2 and 1.8 percent. Likewise, the recovery that had been expected for the third quarter will probably be delayed.

(b) The anticipated average price for the Mexican crude oil export mix in 2001 was modified from 18.52 dollars per barrel in January to 19.23 dollars in April.

[*/] Unless otherwise stated, the reported forecasts are taken from the Survey of the Expectations of Private Sector Economic Specialists conducted by Banco de México.

(c) The behavior of the various components of the capital account in the January-March period makes it possible to anticipate that the availability of external funds in 2001 —direct foreign investment in particular— will provide stable and sufficient resources to finance Mexico's current account deficit.

Weaker growth in the United States' economy has had an important impact on Mexican exports, imports, output and employment. Therefore, it is likely that the expansion of real GDP will be less vigorous than originally expected.

It is also possible that the growth of domestic demand will slow down more than that of domestic supply. It is thus reasonable to expect that the current account deficit will be equivalent to 3.6 percent of GDP in 2001.

In the base scenario for the remainder of this year, some domestic factors that could hamper the disinflation process still remain. Among these are the following:

(a) private sector expectations are still higher than the inflation target; and
(b) contractual wage revisions continue to be incompatible with the inflation target and with foreseeable gains in productivity.

In the base scenario described above, the current restrictive monetary policy stance is considered appropriate in order to reach the short and medium term inflation targets.

The base scenario is undoubtedly subject to a great deal of uncertainty. The main external risk elements that could complicate the reduction of inflation and limit Mexico's economic expansion are:

(a) a more drastic slowdown or even a recession in the United States;
(b) a price of oil substantially lower than that anticipated at present.

A recession in the United States would have multiple effects on the Mexican economy and its eventual repercussions on domestic inflation are therefore not evident. Should a recession take place, it is likely to have an unfavorable impact on domestic output and job creation. This would be reflected in a further reduction of aggregate demand growth that would mitigate inflationary pressures.

Nevertheless, the easing of aggregate demand pressures might not be enough to prevent a widening of the trade deficit —which would deteriorate further should oil prices fall. In turn, a larger current account deficit could generate additional demand for foreign currency, which if not offset by greater supply, would lead to an upward adjustment in the peso's real exchange rate. This could then give rise to inflationary pressures.

Under the above circumstances, Banco de México would respond in a timely manner to any indication of an upward revision of medium term inflation expectations and to the unfavorable behavior of non-tradable goods prices.

Upon publication of this Report, the main domestic risk factor for the base scenario has to do with the Fiscal Reform that has been proposed to Congress by the President.

Recent crises in emerging economies have fundamentally been a consequence of fiscal problems stemming from the failure to achieve the social consensus necessary to guarantee public sector solvency. Therefore, the approval of a fiscal reform in Mexico, that would strengthen public finances and reduce their dependence on oil revenue, is a requisite in the process of consolidating macroeconomic stability.

In order to attain permanent price stability at the lowest possible social cost, the economic policies of the Federal Government and those of the Central Bank must be compatible. The costs of abating inflation are minimized in the presence of strong public finances, as this reduces pressure on financial markets and allows the transition to lower inflation rates to be obtained with lower interest rates. In this respect, it is also relevant to emphasize that the need to finance high public sector financial requirements in domestic markets exerts an important pressure on real interest rates.

The approval of the Fiscal Reform would not only facilitate the success of the disinflation process over the medium term, but is also indispensable to attain it.

Should the aforementioned reform have an upward impact on prices, in the short run it would produce a transitory deviation from the inflation target. However, if the monetary authority's preventive actions manage to ward off the materialization of secondary effects, in the medium term inflation would return to its originally planned path. Moreover, once the possible deterioration of inflation expectations was contained, the inflation reduction process would be significantly reinforced by a more solid fiscal stance. Therefore, the likelihood of attaining the medium and long term inflation targets would increase.

Due to the aforementioned risks, the advisability of maintaining a restrictive monetary policy stance is buttressed by the need to consolidate public credibility in multi-annual inflation targets. Although the results that have been obtained in the transition towards an inflation targeting regime have been positive — with observed inflation rates below the targets set for 1999 and 2000— it should not be forgotten that the international environment was particularly favorable in those years.

In order to strengthen the credibility of monetary policy, it is important that the inflation target for 2001 be attained as well, notwithstanding the less auspicious environment. If the risk factors weaken in the course of the year and the evolution of observed and expected inflation becomes more compatible with the agreed multi-annual targets, pressures on monetary policy should tend to ease.