Inflation Report

January – March 2003

Summary

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.

Recent Developments in Inflation

The evolution of prices during the first quarter of 2003 was, basically, as forecasted in the previous Inflation Report. Annual headline inflation (5.64 percent in March) was slightly lower than that of December 2002 (5.70 percent) while core inflation continued falling (from 3.77 percent in December 2002 to 3.53 percent in March of 2003). The different behavior of both indexes is explained by the rise in agriculture prices.

The fall in annual core inflation during January-March 2003 was influenced by the reduction in that of services. Moreover, inflation of tradable goods remained at a pace similar to that observed in the previous quarter, notwithstanding the significant depreciation of the exchange rate.

Main Determinants of Inflation

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

The average WTI oil price was 34.32 US dollars per barrel, 6 dollars higher than the 28.35 US dollars posted during the fourth quarter of 2002.

The United States economy, which had shown signs of recovery by mid-2002, weakened once more while the rest of the countries 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 stimulate the upturn of demand.

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Most indicators for the real sector show that Mexico's economy lost strength in the first thee 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.

Given the modest recovery of the indicators for industrial production, the reduction in the exchange of merchandise and services brought about by the negative external environment and the slow expansion of private consumption and investment, annual real GDP is expected to have grown 2.6 percent during the first quarter of the year.

The meager recovery of demand meant further slack in the labor market.

Employment indicators continued weakening 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.

The average rise in nominal contractual wages was 5.1 percent. Thus, the average spread between increases in contractual wages and expected inflation for the following twelve months was 0.69 percent.

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 sector.

Insufficient job creation can be attributed to the weakness of the economy and, in spite of their moderation, to still high wage revisions.

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Annual inflation of goods and services whose prices are regulated by the public sector went down significantly while that of the subindex of administered prices did so but only moderately. The latter stemmed from increases in domestic gas and in low-lead gasoline prices in U.S.-Mexico border cities.

Annual inflation of agriculture products rose sharply due to two factors: a less marked reduction in the prices of fruits and vegetables than that observed during the same quarter of last year, and higher prices of meat and eggs.

Monetary Policy During the First Quarter of 2003

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. The three increases in the "short" during this quarter came after two decisions in the same direction taken during the second half of 2002.

The latest five monetary policy measures have been aimed mainly at inducing a downward movement of inflation expectations, and at creating the appropriate monetary conditions so that CPI inflation can converge sustainably with the target in 2003.

Domestic financial markets reacted in a manner consistent with the intensification of the monetary restriction. As a result, domestic interest rates went up during 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).

The aforementioned increases contrasted with the low level and stability of nominal rates in dollars in the United States, as well as with the low total yield of Mexican sovereign bonds issued abroad. Furthermore, the high real yield of financial instruments in Mexico took place in an environment where real rates on short-term instruments in the United States were negative.

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

(a) A deposit at Banco de México of 30,000 million pesos by credit institutions for monetary regulation purposes.

(b) As of April 10th, the replacement of the system of commercial banks' accumulated balances in their current accounts held at Banco de México by a new one based on daily balances. This substitution was adopted for the following reasons. First, because the advantages of the former scheme that allowed positive and negative stocks of the accumulated balances to be compensated during the measuring period have diminished with the adoption of an improved operational framework that has raised 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.

Monetary and Credit Aggregates

The evolution of the monetary and credit aggregates does not suggest the presence of aggregate demand pressures that could jeopardize the abatement of inflation.

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).

During the same period, the stock of net international assets of Banco de México rose 3.28 billion US dollars, ending March at 54.003 billion.

Given the current level of the stock of net international reserves and further accumulation expected throughout the rest of the year, the Exchange Rate Commission (*Comisión de Cambios*) decided to implement a mechanism to slow the pace of accumulation of international reserves. Consequently, part of the foreign currency flows that could potentially increase the level of the country's reserves will be channeled to the market.

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

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 13.5 thousand million pesos, accounting for 56 percent of total resources channeled to firms.

***Private Sector Outlook for 2003*[1]**

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 (from 3.2 percent in December 2002 to 2.5 percent in March 2003), higher annual headline inflation at year-end (from 4.21 percent in December 2002 to 4.38 percent in March 2003), and higher annual core inflation (from 3.48 percent in December 2002 to 3.74 percent in March 2003). Regarding exchange rate expectations for year-end 2003, these were revised upward (from 10.51 pesos per US dollar in December 2002 to 10.88 pesos in March 2003).

Balance of Risks

During the first quarter of 2003, the evolution of the Mexican economy was largely influenced by two factors: the weak recovery of the United States and the slow 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. Specifically, estimates of annual real GDP growth in the United States were modified from 2.7 to 2.3 percent. As a result, the forecast of the main macroeconomic variables for 2003 was revised as follows:

Economic Growth: Estimates for average real GDP growth were modified downward, from 3 to 2.4 percent.

Employment: Due to lower GDP growth, 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: In the absence of 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.

The base scenario just described is subject to a very high degree of uncertainty due to different external and domestic risks. Among the external ones, the fragile rebound in the United States economy (which could turn out to be

[1] Forecasts obtained from the Survey of Private Sector Analysts' Expectations undertaken every month by Banco de México.

weaker than anticipated) is noteworthy. The latter, as a result of higher geopolitical uncertainty due to the continuous presence, and even a flare-up, of terrorism as well as contagion of war tensions to other countries; of persistently high oil prices; and of a greater loss of consumer confidence, which could induce families to cut down on their spending.

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 that are incompatible with the inflation objective; and

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

Furthermore, the risks associated to a less robust than expected recovery of the Mexican economy and lackluster job creation still prevail.

Over 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 through the preservation of strong macroeconomic fundamentals and also by making progress in the agenda of structural reforms, in order to improve institutional effectiveness and to 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 indeed a risk of a weakening of the world economy, which would likely tend to ease inflationary pressures in 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, wage increases 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 apply, in a timely manner, the necessary monetary policy actions to ensure the attainment of the inflation objective.