Inflation Report

July – September 2003

Summary

At the end of September 2003, annual inflation fell compared to the end of June figures. Thus, its path was in line with the attainment of the 3 percent target (with a variability interval of plus/minus one percent) for the end of the year and for the long term.

During the third quarter of 2003, the performance of the Mexican economy was conditioned by different factors. Among the external ones, the economy faced a more favorable international environment. On the domestic front, economic activity grew moderately, posting mixed results both at the sectorial level, and within the components of domestic expenditure.

Under such conditions, and given the gradual trend of inflation towards its target, from July to September of 2003, Banco de México maintained the "short" unchanged. The conduction of monetary policy has allowed monetary conditions in Mexico to orderly reflect the high liquidity environment prevailing in global financial markets.

Furthermore, fiscal and monetary discipline over the past years, together with the financial reforms that have been implemented, have fostered the development of capital markets in our country.

Thus, in an environment characterized by low interest rates and deeper and more robust capital markets, the Central Bank's policy has contributed to facilitate the recovery of domestic demand in Mexico. In particular:

(a) Private consumption has continued to expand, fostered by favorable financial conditions, as well as a greater availability of credit; and

(b) Businesses have improved their financial positions, which sets the ground for them to increase their investments more rapidly once the demand for their products recovers.

The aforementioned has taken place under a strict surveillance of the path of inflation and of inflation expectations.

The Board of Governors of Banco de México considers that, for the remainder of the year, annual headline inflation will continue converging towards its target. Furthermore, core inflation will remain firmly within the variability interval for headline inflation, which lends support to the convergence of CPI inflation to its target. Nevertheless, such scenario is subject to several risks.

From a broader perspective, two main trends have emerged in the world economy, both representing a great challenge for Mexico: on the one hand, the significant economic slowdown in the United States (with a sharp fall in manufacturing production and employment); on the other hand, China's new role as a major participant in the world economy. Mexico's economy has not reacted swiftly to mitigate the impact from both events. In addition, the boost to growth it received from the North American Free Trade Agreement during the second half of the nineties has been diminishing. Thus, Banco de México, as in other Inflation Reports, reiterates the need to implement the structural reforms

that will enable the country to adapt to an increasingly competitive external environment.

Recent Developments in Inflation

At the end of September 2003, annual CPI inflation was 4.04 percent, 0.23 percentage points lower than in June. This is the lowest inflation since January 1969 (when the CPI began to be computed). The fall in annual CPI growth is explained mainly by the decline in non-core inflation (0.57 percentage points) and, to a smaller degree, by the reduction of core inflation (0.09 percentage points). The latter resulted from the decline in services annual inflation (0.34 percentage points). This decrease offset the marginal increase in goods annual inflation (0.09 percentage points).

Main Determinants of Inflation

Several external and internal factors influenced the performance of the Mexican economy during the third quarter of 2003.

During such period, the price of the Mexican crude oil export mix was, on average, 24.55 US dollars per barrel. This figure is 2.1 dollars higher than in the previous quarter.

During the second quarter of 2003, the U.S. economy exhibited a greater than expected recovery. This stemmed both from the fiscal stimulus and favorable conditions in financial markets. Households' expenditure, driven by an increase in their indebtedness, continued to be a significant force behind the economic recovery. In addition, government expenditure and fixed investment (which exhibited its highest rate of growth since 2000) contributed to the economic expansion.

Several indicators suggest that the recovery of the U.S. economy gained momentum during the third quarter of 2003. First, despite the significant fall in mortgage refinancing, tax rebates have encouraged the increase in consumption. Second, the placement of new orders for capital goods suggests a continued recovery of investment in equipment and software. Finally, during July and August, the external sector showed signs of improvement.

GDP growth has not translated into a similar expansion of industrial production. Within this sector, manufacturing has been significantly affected. Despite having grown during July-September (at quarterly annualized rates), the average manufacturing output for the first 9 months of the year was below the figures observed in the same period of 2002. The difficult situation faced by the U.S. manufacturing sector has resulted in reduced Mexican manufacturing exports to the United States. Nonetheless, there are indicators that suggest a recent strengthening of this sector.

The economic expansion in the United States has not led to a significant reduction in the rate of unemployment or to the recovery of employment. Job losses in the manufacturing sector have been quite significant. Nonetheless, the increase in the non-farm payroll in September 2003 (the first in the last eight months) could be a sign of a slight improvement in labor market conditions.

Overall, during the fourth quarter of 2003, the United States economy seems to be consolidating its recovery. Moreover, the outlook in the medium term has improved, as a result of both higher corporate profits and a rapid increase in productivity.

Nonetheless, there are still certain factors that could limit the speed of economic expansion. First, the asymmetry of the economic recovery among the main economies could negatively affect the U.S. external balance. A second risk factor is the significant deterioration in the U.S. fiscal position. Finally, the weakness in the labor market could limit the expansion of household expenditure.

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During the third quarter of 2003, Mexico's labor market remained stagnant. On the one hand, the demand for labor in the formal sector remained weak, while the main unemployment figures rose compared to the previous quarter.

On the other, and despite the slack in the labor market, real wages kept rising possibly at a rate higher than productivity growth.

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Available information suggests that the Mexican economy experienced moderate growth during the third quarter of 2003. On the domestic demand side, private consumption expenditure continued its expansion, favored by lower interest rates, and a higher availability of credit. In contrast, investment was the less dynamic component of domestic expenditure due to the weakness both of external demand and of domestic sales in many sectors of the economy, as well as by the lack of progress in implementing different measures to promote structural change. Finally, during the third quarter of 2003, exports of goods and services are expected to have barely grown at an annual rate.

Regarding production, the performance of the Global Indicator for Economic Activity (*Indicador Global de Actividad Económica*, *IGAE*), of industrial output, and as of the different indicators on business confidence and business climate, point to a modest expansion of the economy.

Summing up, the behavior of both aggregate supply and demand in 2003-III confirms the absence of inflationary pressures.

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Mexico's external sector during the third quarter posted very similar results to those observed in the first half of the year. In general, foreign trade and the current account were affected by the weakness of external and domestic demand. The former had a negative effect on non-oil exports, while the latter reduced the demand for imports. This explains the expectation that the balance of payments will show in the third quarter a moderate deficit in the current account, a small surplus in the capital account, and a slight reduction in international reserves. These results reflect the natural and orderly adjustment of the Mexican economy to the world economic slowdown. Furthermore, they also confirm the absence of exchange rate pressures from the external accounts.

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In September 2003, the annual variation of the subindex of prices of goods administered or concerted by the public sector was 4.02 percent, marginally inferior to that of headline inflation. Within this subindex, administered prices rose at an annual rate of 6.47 percent, while prices concerted with the public sector increased 1.96 percent. Finally, the annual increase in the subindex of education reached 8.57 percent.

Monetary Policy During the Third Quarter of 2003

In 2002, and, to a lesser extent, during the first quarter of 2003, the Mexican economy faced several supply shocks that affected the disinflationary process, and in particular, the non-core component of headline inflation.

As a result, and in order to reduce the impact of the shocks on inflation expectations, Banco de México increased the "short" on several occasions at the end of 2002 and in the first quarter of 2003. Monetary policy actions allowed these shocks to be absorbed and prevented any significant or lasting contagion on inflation expectations. Thus, headline inflation was affected only temporarily. Ever since, inflation expectations for 2003 have diminished considerably, remaining since July within the variability interval of plus/minus one percentage point around the 3 percent target.

During 2003-III, the exchange rate experienced a moderate depreciation and an increase in its volatility. This behavior has not been different from that observed in the main currencies, which have also fluctuated given the uncertainty regarding the recovery of the different economies. As for Mexico, additional factors such as some concern over the lack of response to the greater competition in world markets has put additional pressure on the peso during some short-lived episodes. Nevertheless, it is important to point out that the exchange rate adjustment has taken place in an orderly manner, with a low pass-through to prices and a small impact on interest rates.

Concerning aggregate demand, its behavior has reflected worldwide economic activity and, therefore, conducive to contributing to the disinflationary process.

As a result, during the third quarter of 2003, conditions remained appropriate to attain the year-end and long-term inflation targets. Thus, the Board of Governors decided to maintain the level of the "short" unchanged at 25 million pesos daily.

The monetary policy loosening by the world's main central banks has created coordinated conditions to encourage spending not often seen in recent history. This has led to reduced interest rates in world financial markets throughout the entire yield curve. In this context, there have been certain factors that have also contributed to loosen monetary and financial conditions in Mexico. In particular:

(a) Monetary policy has allowed a significant reduction in short-term interest rates. This has taken place in a context in which inflation is expected to converge to its long-term target, therefore translating into a smaller inflationary risk and a reduction of long-term interest rates. Thus, during the third quarter of 2003, the yield curve reached, on average, historically low levels;

(b) As in other economies, Mexico's macroeconomic adjustment to its cyclical phase comes with a reduction of long-term interest rates due to the temporary perception of lower rates of return on investment; and

(c) Global liquidity conditions have favored a change in the structure of portfolios towards riskier assets. Thus, given the increased demand for emerging markets securities, like those from Mexico, and the environment of macroeconomic stability that prevails, the greater availability of external financing has been reflected in domestic financial markets.

In short, given the environment of high liquidity in world financial markets and lower inflation risk at home in the future, the conduct of monetary policy during the downward stage of the business cycle has allowed a reduction of interest rates along the whole yield curve. This has been a crucial factor in creating the appropriate conditions for the recovery of the different components of spending, both consumption and investment, without jeopardizing the inflation target.

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During the third quarter of 2003, the monetary base grew at an annual rate of 14.7 percent. This expansion is consistent with the Monetary Program for 2003, and reflects that the remonetization process that began in 1997, as a result of both lower interest rates and inflation, is still underway.

From January to September 2003, Banco de México's international assets rose by 4.173 billion US dollars, while net domestic credit was reduced by 70,347 million pesos. Likewise, the mechanism to reduce the pace of accumulation of international reserves led to sales of 2.640 billion US dollars from May 2 to September 30, 2003. As a result of these auctions, it was not necessary to place 27,716 million pesos of central bank's liabilities. Thus, these resources became available in the domestic market.

As for household's indebtedness, this has been characterized by a significant increase in commercial bank's consumer credit, which has expanded at real annual rates of above 20 percent in the last three years, and by the impulse of housing credit granted by the

SOFOLES. The issuance of private securities in the domestic market has also shown great dynamism. However, these resources have been destined mainly to substitute external liabilities. This process has been driven by lower domestic interest rates, the greater depth of domestic financial markets, and the increasing demand for long-term instruments denominated in domestic currency.

Private Sector Outlook for 2003

During the third quarter of 2003, private sector economic analysts revised downward their forecasts for Mexico's GDP growth in 2003, from 2.16 percent in June to 1.60 percent in September. In line with the above, forecasts for domestic demand (especially for consumption and private investment), formal employment, and the balance of payments' current account deficit were also adjusted downward.

During 2003-III, inflation expectations were also revised downward. Forecasts for headline inflation for the end of 2003 declined from 4.01 percent in June to 3.78 percent in September. During that period, forecasts for core inflation dropped slightly, from 3.58 percent in June to 3.49 percent in September. Private sector analysts anticipate a scenario of low and stable inflation in the coming years: 3.67 percent in 2004 and 3.49 percent (on average) in 2005-2008.

Balance of Risks

During the third quarter of 2003, the performance of the Mexican economy was influenced by both an external demand that only showed a gradual recovery, and a weak domestic demand. As for the structure of domestic expenditure, consumption kept showing a moderate dynamism while investment has remained weak for a long period. Regarding aggregate supply, the aforementioned behavior has translated into a higher share of the services sector in domestic production and employment, while industrial activity has contracted. Moreover, the labor market remains weak, as confirmed by the scarce job creation in the formal sector.

Given the aforementioned conditions, Banco de México's base scenario for the end of 2003 and for 2004 is based on the following assumptions: i) although forecasts for average annual GDP growth in the United States for 2003 were revised upward (from 2.3 to 2.7 percent), annual average growth of industrial output in that country for 2003 is expected to be 0.1 percent, rather than the previous 0.6 percent. For 2004, real GDP and industrial output are expected to grow by 3.9 and 4.2 percent, respectively; ii) the price of the Mexican crude oil export mix is expected to be, on average, 24 US dollars per barrel in 2003 and 18 US dollars in 2004; and iii) for the remainder of the year and throughout 2004, the conditions for Mexico's access to external financing will remain favorable.

Based on these assumptions, as well as on the latest available information on the performance of the Mexican economy, Banco de México's forecasting exercise for the main macroeconomic variables for the remainder of 2003 is as follows:

Economic Growth: Annual GDP growth for 2003 was revised downward to around 1.5 percent.

Employment: During 2003, there will be no job creation in the formal sector of the economy (in net terms).

Current Account: The current account deficit of the balance of payments is expected to be below 2.0 percent of GDP.

Inflation: Inflation is expected to converge towards the 3 percent target, considering a variability interval of plus/minus one percentage point. Annual core inflation is also estimated to continue its downward trend within the variability interval for headline inflation. As for core price subindexes, the behavior of prices of goods is anticipated to remain stable, while that of services will further contribute to the reduction of headline inflation. Nevertheless, the magnitude of the latter's contribution will depend, to a large extent, on the path of wage increases.

The base scenario considers that the Mexican economy will grow at a faster pace in 2004. This expectation is based on the assumption that private consumption will maintain its relative dynamism, supported by favorable conditions in financial markets and by the impulse of bank credit. In line with an increase in industrial activity in the United States, private investment is expected to exhibit a slight recovery, fueled by the low level of interest rates that prevail both in Mexico and worldwide, and by the improvement in the private sector's financial position. Higher growth in 2004 will also be the result of the simple arithmetical effect of having a relatively low base of comparison. Specifically, real GDP growth in Mexico for 2004 is expected to be between 3.0 and 3.5 percent.[1] It is important to mention that the above scenario is basically inertial in nature.

As for inflation in 2004, the exercise indicates that the current stance of monetary policy is compatible with a path of inflation that continues its convergence towards the long-term objective. This consideration is based on both actual business cycle and structural factors:

(a) Among the first ones, the weakness of aggregate demand and the absence of anticipated supply shocks point to reduced inflationary pressures from these elements;

(b) As for structural ones, these are part of Mexico's transition towards an environment of low stable inflation, with more robust financial markets, a greater remonetization of the economy, and a lower pass-through from exchange rate fluctuations to prices. In this regard, Banco de México's monetary policy actions in the last years have fostered the attainment of a low inflation macroeconomic environment.

The abovementioned scenario for the end of 2003 and for 2004 is subject to several risks. Among the external ones, the most important would be that the recovery of the U.S. economy does not consolidate. This could have a negative effect on Mexico, particularly if the lack of strength of the U.S. economy comes from manufacturing output and non-residential investment.

As for domestic risks, the following deserve mention:

(a) The possibility that the loss of competitiveness of the Mexican economy could be such that, despite a rebound in industrial activity in the United States, industrial production and employment in Mexico do not post a strong recovery;

(b) The lack of competitiveness of the domestic industry is also a potential hazard for the economy in the medium run. Competitiveness has implications on the economy's growth potential and is necessary to sustain low inflation in a longer horizon;

(c) Although core inflation fell during the third quarter of 2003, its reduction was barely significant;

(d) Wage increases are still incompatible with the slack in the labor market conditions and with the expected gains in productivity; and

(e) Headline inflation may deviate from its anticipated path if the non-core component is subject to supply shocks.

As it can seen, the recovery of the Mexican economy is still subject to numerous risks.

[1] Following the practice of other central banks (the Federal Reserve System, the European Central Bank, and the Bank of Japan, among others) from 2004 onward, Banco de México will announce an interval for its growth estimates, thus reflecting the presence of uncertainty and the confidence intervals inherent to any statistical projection.

Nonetheless, on the external side, the perceived increased dynamism of the world economy in the near future, as well as favorable worldwide financial conditions, are factors that support an upturn in economic activity in Mexico. On the domestic side, the presence of interest rates at historically low levels, favored by the conduct of monetary policy, should also add to the recovery.

Under such context, fiscal and monetary discipline, together with social security and financial sector reforms, have had a positive effect on the development of domestic capital markets. The soundness of the Mexican financial system has been a key factor in maintaining the relative strength of private consumption during the current business cycle, since the increase in the availability of credit has contributed to overcome liquidity restrictions. In this regard, a sound financial system is also an important element to encourage the expansion of private investment under a more favorable scenario, as the one anticipated.

The foreseen macroeconomic scenario deserves special attention. Even in the presence of more favorable conditions, the macroeconomic outlook for 2004 does not envision economic growth to be robust enough to significantly improve the welfare of the majority of Mexicans. Therefore, the necessary actions to boost the recovery of the Mexican economy can no longer be postponed. In this regard, the structural reforms are designed to attain such goal. As they increase the flexibility and ability to respond of the Mexican economy, they will also create new opportunities for economic development. In particular, the implementation of these reforms could foster high growth in Mexico, even in the short-term (2004), and, of course, increase its long-run growth potential.

In sum, in order to materialize and consolidate the growth potential of the Mexican economy, it needs to be modernized. The structural reforms currently being discussed, and more deregulation of the economy, would allow Mexico to adjust successfully to an increasingly competitive international environment. The mere presence of China as the most important emerging competitor worldwide posts a significant challenge for Mexico as well as for the rest of the emerging economies. Nevertheless, while other countries have addressed these challenges by increasing their productivity and their economies' flexibility (through investment in infrastructure and by escalating in value chains), our country has lagged.

For this reason, and as stated in previous reports, Banco de México reiterates the need to advance in the consensuses necessary to implement the structural changes required by our economy.

Finally, Banco de México envisions the convergence of headline inflation towards the year-end target. It should be pointed out that the long-term target was set at 3 percent (with a variability interval of plus/minus one percent). This objective does not apply only for year-end inflation, it will operate continuously. The purpose of the variability interval is to set a margin to accommodate positive and negative shocks to relative prices. In this regard, the inflation target should be considered more as an average objective throughout a certain period than a precise target for a given point in time.

Following this line, it is important to emphasize that the convergence of inflation towards its objective in 2003 (considering its variability interval) does not guarantee the consolidation of price stability. This achievement is only the first step in a long process, which requires maintaining low inflation for several years in order for society to perceive that inflation has truly been eradicated. Thus, the design and conduct of monetary policy will be geared towards maintaining headline inflation in its long-term objective. This is the Central Bank's best contribution to economic development.

Calendar of Announcements for Monetary Policy Decisions in 2004

Month	Announcements on Monetary Policy	Press Releases	Publication of Inflation Reports
January	9, 23	23	28 1/
February	6, 20	20	
March	12, 26	26	
April	7 2/, 23	23	28
May	14, 28	28	
June	11, 25	25	
July	9, 23	23	28
August	13, 27	27	
September	10, 24	24	
October	8, 22	22	27
November	12, 26	26	
December	10	10	

1/ Includes the Monetary Program for 2004.
2/ Corresponds to the previous working day to the date set by the guidelines for the determination of the calendar dates for monetary policy announcements.