Inflation Report

April - June 2005

Summary

Most recent information suggests that during the first half of 2005 world economic activity grew soundly, despite having slowed slightly as compared with the previous year. The outlook for world economic growth for the remainder of the year continues to be favorable. In addition, the increase in risk aversion observed towards the end of the first quarter in international financial markets has been dissipating. These developments have improved the access to credit markets, both for sovereign and private issuers.

During the second quarter of the year, the rate of growth of the U.S. economy slowed, mainly as a result of the new maximum levels attained by crude oil international prices. Nonetheless, most recent data suggests that the economy gained strength once more towards the end of the quarter.

The U.S. industrial sector has been affected by the restructuring of worldwide manufacturing production. This phenomenon, which began a few decades ago, gained momentum with the increasing participation of China in international trade flows, contributing in recent years to a significant reduction in the international prices of manufactures and to an increase in those of several commodities, especially energy. In addition, in several economies such as the U.S. this change in relative prices has generated a greater dynamism in the services sector, regarding both production and job creation.

The aforementioned environment has affected the Mexican economy. On the one hand, manufacturing exports have been loosing share in international markets, due to the greater presence of Chinese products and the gradual loss of competitiveness of Mexican exports. On the other, the reduced strength of external demand has been offset by crude oil international price increases and by the vigorous growth of workers' remittances, both of which constitute a significant source of financing for domestic expenditure. Under such context, it is likely that Mexico is also undergoing changes in its structure of production and expenditure due to external conditions.

Recent Developments in Inflation

In June 2005, annual headline inflation reached 4.33 percent, while at the end of the previous quarter it was 4.39 percent. This reduction in headline inflation derives from a 0.23 percentage point contraction in annual core inflation, which at the end of the second quarter recorded an annual variation of 3.38 percent. The latter was partly driven by the fading effect of several shocks that affected inflation during the previous year.

Within the core index, during the second quarter of 2005 the merchandise and services subindexes recorded lower annual variations (from 3.61 to 3.49 percent and from 3.61 to 3.27 percent, respectively).

As for the core services subindex, housing prices exhibited a reduction in their annual growth rate (from 3.06 in March to 2.39 percent in June). This was due to a decline in the growth rate of prices of construction materials (which rose considerably during 2004), a greater supply of housing, and to an increase in the availability of mortgage financing, contributing, as a whole, to moderate the rate of growth of housing rents. The rest of the core services subindex moved from an annual rate of 4.28 percent in March to 4.32 percent in June 2005.

The decline in the annual growth rate of the core merchandise subindex resulted from a reduction in the annual variation of processed foods (from 5.90 percent in March to 5.32 percent in June). This reflects both the reduction in food commodity prices and the perception of a greater stability of their futures prices. Nonetheless, this was partially offset by the increase in the annual growth rate of the rest of the items of the core merchandise subindex (from 2.00 percent in March to 2.20 percent in June).

Annual non-core inflation was 6.41 percent in June 2005, while at the end of the previous quarter it amounted to 6.04 percent. This result was mainly due to the increase in the annual growth rate of the price subindex of agriculture products, which was partially compensated by the reduction in the annual variation of the subindex of administered and regulated prices.

Annual inflation of the subindex of agriculture products was 11.95 percent in June 2005, figure above that of March (5.73 percent). Price growth of fruits and vegetables contributed significantly to such increase (their annual growth rate rose from 4.65 in March to 20.47 percent in June due to adverse weather conditions).

During the second quarter of 2005, the annual growth rate of the subindex of administered prices decreased from 8.39 to 4.35 percent. Electricity tariffs contributed the most to such reduction. This was due to the downward adjustment in household tariffs for high consumption (*Tarifas Domésticas de Alto Consumo, DAC*) that resulted from the unification of the two existing tariffs to their lower rate in February 2005 and the reduction of some reference prices used for the determination of these tariffs.

The greater stability of propane international references also contributed to the lower growth rate of administered prices. The annual growth rate of prices of household-use gas fell from 17.73 percent in March to 14.60 percent in June. Gasoline prices at non-border cities have observed monthly variations in line with a 3 percent annual growth rate. At the border, gasoline prices are fixed according to the nearest foreign city, with the price in the rest of the country as an upper limit. Gasoline prices at border cities have reached this upper limit. This has limited the monthly increases of such prices, resulting in an accumulated variation that during the second quarter of 2005 was below that observed during the same period of the previous year.

The reduction in the annual growth rate of the subindex of regulated prices was a factor that also contributed to contain the upward movement in annual non-core inflation during the second quarter of 2005. This subindex exhibited annual variations of 3.19 percent in March 2005 and 2.78 percent in June. Such reduction was influenced mainly by the lower growth rates of public urban transportation fares, and to the fact that these took place in cities that have a lower weight in the CPI.

Main Determinants of Inflation

The world economy grew at the favorable pace during the first half of 2005, although available information suggests a lower rate of growth than that observed in 2004. In the U.S., the rate of growth of economic activity continued to diminish towards more sustainable rates. During the second quarter of 2005, the U.S. economy grew less than originally expected; however, timely indicators point to a new strengthening towards the end of the referred period.

Although oil prices reached new historically high levels, the inflation rate in industrialized countries remained at moderate levels. This contributed to maintain their long-term interest rates low and to foster favorable conditions for emerging economies' access to international financing.

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In Mexico, economic activity grew significantly at an annual rate basis during the second quarter of 2005, above that observed in the previous quarter. Nonetheless, the behavior of output in both periods was influenced by the statistical effect associated with the Easter holiday. This implied more working days during the second quarter as compared with those observed in the same period of 2004, and a reduction in those corresponding to the first quarter of 2005. The latter induced an increase in the annual growth rate of GDP during the period April-June and a reduction in that of the first quarter. Seasonally adjusted GDP figures indicate a moderation in the economy's growth rate throughout the first and second quarters of the year, as compared with those observed during the previous year and, particularly, during the second semester of 2004.

All components of aggregate demand, both domestic and external, contributed to GDP growth during the second quarter of 2005. Four aspects deserve mention. First, the dynamism of domestic expenditure in consumption and investment prevailed during the second quarter; however, just as in the previous quarter, both components moderated their annual growth rates with respect to those observed during the second half of the previous year. Second, exports of goods and services grew significantly during the second quarter -albeit at a lower pace than the one observed in the second half of the previous year- as a result of a reduction of external demand, particularly from the U.S. Third, the expansion of both aggregate demand and output translated into higher imports of goods and services. Finally, the behavior of the different components of demand during the first half of 2005 indicates that during that period the relative contribution of domestic expenditure to GDP growth increased with respect to that of external demand.

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During the second quarter of 2005, Mexico's external sector performed similarly to the previous quarter and was characterized by the following: a) imports and non-oil exports grew at slower rate than in the second half of 2004; b) the value of oil exports increased; c) moderate trade and current account deficits; d) a significant inflow of workers' remittances; e) a small capital account surplus; and, f) a slight accumulation of international reserves.

Monetary Policy Actions

Inflation pressures originated by the numerous supply shocks that arose in 2004 continued to dissipate in 2005. As a result, inflation has resumed its downward trend, decreasing from 5.43 percent in November 2004 to 4.33 percent in June 2005. Core inflation has also declined considerably.

Under such conditions, inflation expectations have also been revised downward. In particular, Banco de México's surveys indicate that estimates for headline inflation for the end of 2005 have declined from 4.32 percent in December 2004 to 3.79 percent in June 2005, level close to that observed before the supply shocks of the previous year took place. Expectations for core inflation for the end of the year decreased from 3.76 to 3.42 percent during the same period. Nonetheless, expected inflation for longer terms still remains at relatively high levels compared with the 3 percent inflation target.

Taking into account the previous considerations, Banco de México decided to modify the process it had been using to determine its monetary policy stance. During the last quarters, the Board of Governors of Banco de México had tightened its monetary policy stance through two channels: i) by increasing the *corto* (short position); and, ii) by stating in its monetary policy announcements that, as deemed necessary, domestic monetary conditions should reflect, at least, the greater monetary astringency in the U.S.

During the period April-June, the Board of Governors of Banco de México decided to leave the *corto* unchanged and, since the press release on monetary policy of June 24, it stopped making reference to item ii) of the above mentioned paragraph. Nonetheless, in the same press release it stated that, as deemed necessary, domestic monetary conditions should not loosen. As a result of such actions, the one-day bank funding rate rose from 9.25 to 9.75 percent during the second quarter of the year, remaining at that level since May 3, 2005.

On another front, the yield curve in Mexico has been clearly influenced by global liquidity conditions and the consequent appetite for risk prevailing in international financial markets.

In the last months, international market conditions have been subject to volatility. Towards the end of the first quarter, uncertainty regarding the outlook for inflation in the U.S., and therefore, for long-term interest rates in that country, increased. In addition, some important issuers began to exhibit a significant deterioration in their credit ratings, therefore increasing risk aversion in international financial markets. The outcome of such events implied, at that time, higher costs for medium and long-term financing by sovereign and private issuers, both in external and domestic markets.

Nonetheless, during the second quarter the aforementioned conditions reversed, as long-term interest rates in the U.S. fell significantly and appetite for risk in international financial markets began to increase.

This process generated a significant increase in the demand for instruments of emerging market issuers, both in external and domestic markets. Numerous foreign investors have searched in the domestic markets of many emerging economies, particularly in Mexico, for alternatives to increase their portfolio yields. This has led to an increase in capital inflows to purchase longer-term debt instruments in domestic currency. In fact, the opportunity to finance emerging market domestic securities with short-term liabilities in foreign currency has supported increased capital inflows.

Thus, during the second quarter, Mexico's yield curve continued to flatten as a result of both, an increase in short-term interest rates and the reduction in the rate of longer-term instruments. Inclusively, towards the end of June, the slope of the yield curve inverted.

The aforementioned conditions in international financial markets have significantly contributed to the appreciation of the nominal exchange rate.

Private Sector Outlook: 2005-2006

In the survey conducted in June, private sector economic analysts' forecasts were as follows: i) GDP is expected to grow 3.57 percent in 2005 (in the survey conducted in March 2005 such figure was 3.88 percent), and 3.50 percent for 2006; ii) in 2005 and 2006, 419 and 433 thousand jobs, respectively, are expected to be created in the formal sector; iii) expectations regarding interest rates for the next months were revised slightly upward as compared with those reported in the March survey; iv) the expected level of the peso exchange rate for the end of 2005 was adjusted downward; v) moderate trade and current account deficits are expected at the end of 2005; and, vi) inflation expectations for different horizons were revised downward. Headline CPI inflation for 2005 is expected to be 3.79 percent in June 2005, figure lower than that reported in the March survey (3.95 percent). Core CPI inflation for 2005 was revised downward from 3.67 percent in March to 3.42 percent in June. Inflation expectations were also revised downward: for 2006, from 3.96 to 3.93 percent; and for 2007 and for the annual average for the period 2006-2009, from 3.84 to 3.76 percent.

Balance of Risks and Final Remarks

Based on the above macroeconomic environment and on most recent information, Banco de México's expected scenario for 2005 is as follows:

GDP Growth: GDP growth is expected to be between 3.25 and 3.75 percent.

Employment: Approximately 430 thousand jobs are expected to be created in the formal sector.

Current Account: A moderate current account deficit of the balance of payments of approximately 1.5 percent of GDP is expected.

Inflation: Annual headline inflation is expected to continue its downward trend and end the year below 4 percent, as long as episodes of extreme volatility do not arise, especially concerning the non-core price subindex. In this regard, the following deserves mention:

a) The prices of fruits and vegetables rose significantly during the second half of 2004, due to extremely adverse weather conditions. As long as these conditions do not repeat, the annual variation of these items is anticipated to decrease in the second half of the year. Nonetheless, it is important to point out that prices of this group of products are characterized by being very volatile and difficult to anticipate.

b) The recent behavior of meat products' international prices and their futures prices suggests that the annual rates of growth of meat products' domestic prices could decline in the following months.

c) The impact of international energy prices on the subindex of administered prices is expected to be limited, mostly affecting the electricity item. This is mainly due to the following: i) gasoline prices at the border are practically at the same level of those at the rest of Mexico and, therefore, any new increases in the international prices of this fuel would have a limited effect on inflation; ii) propane futures prices exhibited a stable behavior; therefore increases in the domestic prices of this fuel are expected to be set near the lowest limit of the variability interval determined by the authorities (0.75 to 1.75 percent per month); and, iii) in contrast, household electricity tariffs for high consumption (*Tarifas Domésticas de Alto Consumo, DAC*) are determined according to a formula which includes prices of different fuels, such as natural gas and, therefore, any price increases of this fuel could affect them.

d) Annual inflation of the subindex of regulated prices is expected to remain at levels close to those recorded, on average, during the first half of 2005.

e) Education prices are expected to reduce their annual growth rate during the third quarter of the year, as the increase in school fees for the new school year go into effect. Nonetheless, school fees are expected to grow at a higher rate than that of the CPI.

Core CPI inflation for the rest of 2005 is expected to be lower than its average level recorded during the first half of the year. However, the contribution of merchandise prices is expected to decline, while the opposite is anticipated to occur for the services subindex. In particular, the following deserves mention:

a) The reduction in the annual growth rate of merchandise prices is expected to reflect the slower rate of growth of processed foods, originated by reduced inflationary pressures for this type of goods worldwide. Inflation of the rest of merchandise is expected to follow a lateral trend, given that no significant pressures from the international prices of these goods have been detected recently.

b) Core services inflation could increase slightly during the rest of the year. On the one hand, prices of services excluding housing have followed an upward trend, due to, among other reasons, price increases in different goods used as inputs. On the other, the annual growth rate of housing prices is expected to follow a lateral trend during the third quarter and to increase moderately during the fourth due to a reduction in its base of comparison.

Although the outlook for inflation has improved in recent months, the convergence of inflation to its target still faces significant challenges, such as:

a) Medium-term expectations for headline inflation remain above 3 percent.

b) Prices of crude oil and other energy goods, and their futures prices, are high.

c) Although available information does not allow for identifying considerable pressures from aggregate demand, domestic expenditure is expected to have grown at a higher rate than GDP for the last three quarters; however, this difference narrowed in the second quarter of the year.

Banco de México will remain vigilant that no inflationary pressures from the demand side arise and that any upward pressures originated by the supply shocks that took place last year remain contained. In this regard, the Board of Governors reiterates its conviction to conduct monetary policy in such a way that monetary conditions propitiate the convergence of inflation to its target.

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Banco de México's base scenario is subject to the following risks:

First, although most recent data suggests that economic activity in the U.S. strengthened towards the end of the quarter, there is the possibility that it may slow down sharply. This outcome could arise if prices of crude oil and oil by-products increase further, or else, if real estate prices fall significantly, situation that would lead to an adjustment in consumption growth. Under such scenarios, the Mexican economy would be affected by the lower demand for its exports, which would reduce the outlook for growth and employment. Furthermore, should the economic slowdown derive from significant increases in energy prices, inflation would also be affected negatively.

Second, the high U.S. current account deficit could become unsustainable. Strong recession pressures would arise worldwide and international financial markets would become more volatile. Such conditions would affect emerging economies significantly.

Third, the share of China and other Asian economies in global manufacturing production could continue to displace this type of activity, both in the U.S. and Mexico. This risk -due partly to the lack of progress to increase Mexico's competitiveness-would have severe consequences. In the case of Mexico, the industrial sector, especially manufacturing, has played a crucial role in the economy's expansion since the beginning of the nineties.

Finally, some analysts have pointed out that political uncertainty in Mexico could increase as the 2006 elections near, inducing higher volatility in domestic financial markets. In this regard it is important to mention that the Mexican economy has reduced its vulnerabilities significantly and, therefore, it is in a better position to cope with external and domestic shocks.

The strong macroeconomic anchorage, of which monetary policy has and will continue to be a key element, has brought such benefits to the Mexican economy.

Stability is a necessary, although not the only, condition for sustained growth. Under such context, it is even more imperative to advance in Mexico's pending agenda of structural change. Economic activity needs urgently a modern regulatory framework that translates into greater incentives for investment, gains in productivity, increased demand for employment and, therefore, into higher growth rates.

In recent years, the Mexican economy has accumulated competitive shortfalls with respect to other emerging economies. As consensus over structural change measures with a long-term vision are attained, Mexico will be able to amend its lag in competitiveness. Progress in structural reforms will allow the Mexican economy to take better advantage of its strategic position and increase the scope of its social policies.